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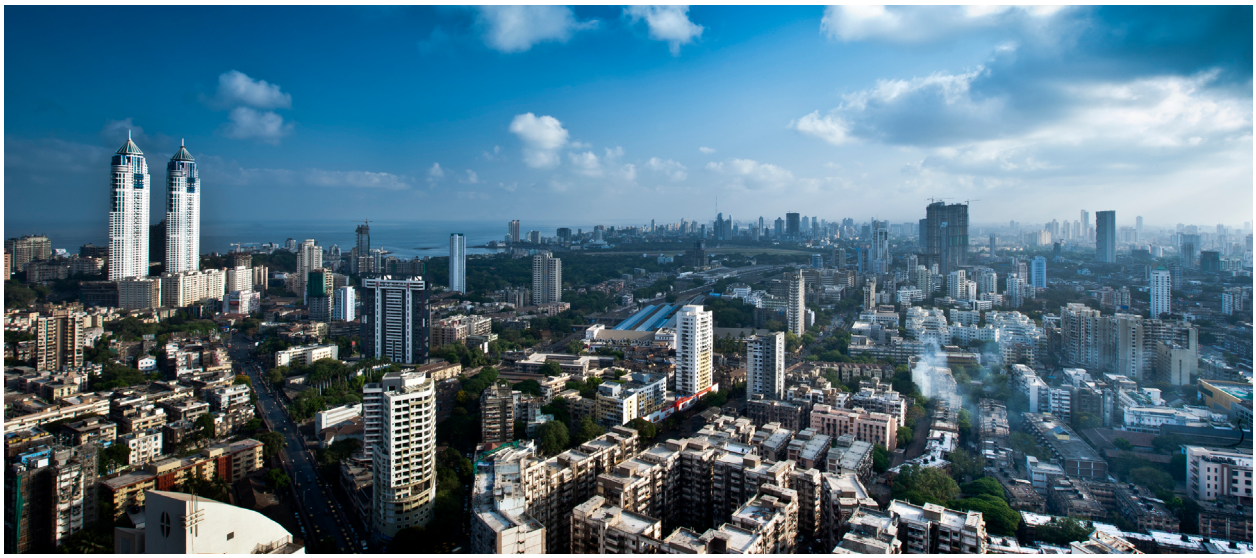
Silverhorn Perspective



India: Home of Compounders

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Together India and China have produced over 280 Consistent Compounders (CC) in the last decade[1].

CCs are companies that have grown their revenue by 10% or more and have generated a minimum Return on Equity (ROE) of 10% for ten consecutive years. In the last 20 years, Emerging Markets (EMs) have grown twice as fast as Developed Markets (DMs) in terms of real GDP growth. During this period, China and India have been the fastest growing EMs. Coupled with the size of their economies, it is unsurprising that these two countries are way ahead of any other EMs when it comes to producing CCs.

Consistent Compounders by Country (2009-2019)

Country	GDP 10-year CAGR (%)	Number of CCs	Share of total listed companies (%)
India	**6.7%**	**162**	**4.6%**
China	7.7%	126	2.8%
Indonesia	5.4%	10	1.5%
Russia	2.0%	12	6.1%
Brazil	1.4%	0	0.0%

Source: Marcellus Investment Managers

[1] Why India Beats China Hollow on Consistent Compounding? by Marcellus Investment Managers

Today, India hosts over 160 companies that have a unique combination of market dominance and return ratios far in excess of cost of capital. The resulting free cash flow generation has enabled these companies to reinvest back into their businesses and strengthen their dominance and return ratios over the years. Accordingly, the last two decades have brought to light companies that have compounded capital at a high and steady rate.

ROE of dominant Indian companies over two decades

Company	Average ROE	
	Apr-99 to Mar-09	Apr-09 to Mar-19
Asian Paints	32%	36%
ITC	30%	30%
Nestle India	65%	68%
Pidilite	25%	27%
Page Industries	38%	51%
Hdfc Bank	21%	19%
Median ROE	**31%**	**33%**
Cost of Equity	15%	15%

Source: Bloomberg

In India, there are only a few companies that dominate each industry. Markets, therefore, continue to favour those few.

In our view, this is a result of polarisation which is far more pronounced in India than in other countries. The Indian stock market has become sharply polarised over the past decade insofar as a handful of companies now take home almost the entire Profit After Tax (PAT) generated by the market. According to Marcellus, an investment firm, the top 20 profit-generating companies in India now account for more than 70% of the country's profits, up from 14% thirty years ago.

A handful of companies drive 80% of the wealth created by Nifty*

Period	Wealth created by Nifty (USD tn)	No. of companies accounting for 80% of wealth creation	Median TSR CAGR (%)	Share in total market PAT (%)
Apr-00 to Mar-10	0.5	26	34%	26%
Apr-10 to Mar-20	1.0	16	15%	79%

*The NIFTY 50 is a benchmark Indian stock market index that represents the weighted average of 50 of the largest Indian companies listed on the National Stock Exchange.

Source: Bloomberg, Marcellus Investment Managers

This dynamic of polarisation in the Indian market extends beyond mere profitability. In the decade ending March 2010, the Nifty added USD 0.5tn in market cap. In these 10 years, 80% of the value generated came from 26 companies who delivered a median Total Shareholder Return (TSR) CAGR of 34%. Whereas, in the decade ending March 2020, when the Nifty added USD 1.0tn in market cap, 80% of the value generated came from just 16 companies, whose median TSR CAGR was 15%. Wealth creation in India is being driven by fewer and fewer companies.

The rise in corporate profitability of India's top 20 PAT generators has been underpinned by the drivers of polarisation, which are rippling through the Indian economy.

There are three distinct layers of polarisation in the Indian stock market. This is reflected by a handful of well-integrated and digitised companies who have achieved success in creating a synergistic flywheel that is keeping competitors at bay. Making it difficult to compete is how Indian CCs are attaining industry dominance.

> **Layer 1: Adoption of technology that is increasing returns to scale and improving efficiency**

The conventional idea of diminishing returns to scale is being replaced by businesses that are generating increasing returns to scale. Increasing returns to scale refer to the tendency of returns to keep increasing as the output increases whereas diminishing returns imply the opposite. At a national level, India's labour productivity and capital productivity are both low. While other developing economies such as China have managed to catch up with advanced economies in capital productivity, India's capital is only about two-thirds as productive as China's (McKinsey). By adopting automation and digital technologies, selected Indian companies with strong balance sheets have been able to generate significant productivity gains.

For example, Asian Paints has perhaps been the most proactive corporate investor in technology across the country over the past 60 years. Through these investments, they have improved their ability to forecast demand for each SKU, each location and for every week of the year with a high level of accuracy. Thereby improving their working capital efficiency. The inability of their competitors to forecast demand precisely has allowed Asian Paints to dominate the Indian decorative paints industry.

> **Layer 2: A networked economy that is disproportionally benefiting nation-wide operating companies**

The rise of India's networked economy (highways, cheap flights, broadband penetration, GST reforms, etc.) has allowed large, nation-wide operating companies to become markedly more efficient. As a result of this, efficient companies with strong distribution systems have differentiated themselves from regional and local players.

For example, as the economy integrated, lending, which was once dominated by regional players, saw the emergence of a few national players like HDFC Bank and Bajaj Finance. Today, HDFC Bank has 5,608 branches and Bajaj Finance has 3,113 branches across India with a significant footprint in rural and urban areas. Their ability to provide a seamless, unified, and omni-channel experience across various channels of banking has made them a customer favorite.

> **Layer 3: Increasing share of intangibles that is creating strong competitive advantages**

In the past 40 years, corporate investments have become increasingly intangible (e.g. brands, trademarks, knowledge). In Capitalism without Capital (2017) by Haskel and Westlake, the pre-eminence of intangible investing has brought to the forefront four fundamental properties of intangible assets: scalability, sunk costs, spillovers, and synergies.

1. **Scalability**: It enables growth in revenue accompanied by a less than proportional increase in variable cost. This has a positive impact on profit and return ratios because a scalable intangible asset can be used without limits. For example, oranges (a tangible rival good) can be used to make marmalade, but only for a certain amount. In contrast, a recipe (intangible non-rival good) can be used to make marmalade without limits. Intangible assets such as a brand or an algorithm are considered the easiest to be scaled up due to network effects affecting them and their ability to reap incumbency advantages. For example, Airbnb, doesn't own a single square meter of real estate, is now worth USD 106 billion, which is more than the combined value of Hilton, Marriott, and Hyatt[3].

2. **Sunk Costs**: Why do some companies systematically outperform their competitors and maintain their leadership position for long periods of time despite competition and changing business landscape? One reason is organisational capital. Organisational capital consists of businesses processes and systems – commitment to rules, norms, and relationships - that enable tangible and intangible assets such as patents, brands, and human capital. Consider Netflix's personalised recommendation algorithms and Zara's relationship with suppliers and process of transmitting customers choices in real time to its suppliers worldwide. A common thread among these business processes and systems is that they are not easily mimicked by competitors. The increasing rate at which new technologies disrupt the way business is done, makes it even more important for companies to develop organisational capital in multiple ways. However, these intangibles have the risk of significant sunk costs being tied to them. The riskiness in intangibles stems from the non-transferability of the asset. For example, when Nokia went bust, it was able to sell the land (HQ building) but not the operating software (Symbian). Therefore, industries that require significant sunk costs often have high entry and exit barriers. A lock-in of this type then leads to a winner-takes-all market.

3. **Spillovers**: Intangibles create spillovers in two ways - productivity spillover and knowledge spillover. Productivity spillover occurs when investments in R&D activities by one firm benefit other firms in the market when they apply the newly-developed technology in their business to reduce costs, without the beneficiary firms contributing to the expenses of the innovating company. Amazon, with the creation of its low-cost cloud storage service (Amazon AWS), has helped SMEs transform the cost of a data centre from fixed to variable cost. Whereas, knowledge spillover occurs when some firms benefit from hiring employees trained by other firms.

4. **Synergies**: Intangible investments tend to possess synergies, or complementarities, whereby they are more valuable together in the right combinations. Together, synergies often result in revenue enhancement and cost savings. Take the case of Facebook. By leveraging its customer base and insights from Instagram, Facebook has become a leader in influencer marketing. Apple, for instance, continues to leverage its brand, design, and App Store capabilities to enhance customer stickiness.

Smart investments into intangible assets can have an explosive impact on growth and profitability. Intangibles are therefore gaining prominence and leading to new use cases with the adoption of technology. A new 'class' of compounders is now emerging that represent 'Digital India'.

[3] Data source: Bloomberg

Since 2010

zomato

Since 1774

Coal India Limited
A Maharatna Company

Zomato is an Indian multi-national restaurant aggregator and online food delivery company with nearly the same market cap as Coal India.

Companies like Zomato, with virtually no tangible assets but very high brand value on the back of the proven business models, have almost the same market cap as Coal India, a monopolistic business with a 70% market share in the coal business. India's strength in intangibles is reflected in the fact that it now hosts more than 60 digital unicorns, some of whom have already become a sector leader and are on track to become a CC.

What does all of this mean for investing in Indian equities?

It may seem that a simple filter-based approach is all that is needed to create a highly attractive portfolio of CCs. However, the obvious problem with this approach is that it is entirely focused on the past. As we all know, past performance is no guarantee for future results, and this is also true for CCs.

We believe that in order to construct a portfolio of future CCs, three factors are required for success:

1. You need a systematic stock selection framework that incorporates the three layers of polarisation discussed above. By looking beyond the standard metrics, the framework helps in finding companies who currently drive or have the potential to drive majority of the market PAT growth.
2. You need to be open-minded and skilled enough to apply the stock selection framework not only to well-established companies with a long public market history (e.g. Nestle India, Pidilite, Asian Paints, etc.) but also to (a) new age technology businesses with less than 10 years of public market history like DMart (founded in 2002, public since 2017), and (b) traditional businesses that have gone through a digital transformation process like Saregama (founded in 1901, the company went public in 1977 under the name The Gramophone Co. (India) Limited). Technology is reshaping the way economies and businesses work in the 21st century. New age tech or digital businesses in the listed space in India are a fairly recent addition. But globally, they have been the dominant drivers of equity indices – in the US and elsewhere – for a while. The 2021 Indian IPO wave will produce a range of future CCs. However, make no mistake, the IPO wave will produce more companies that will likely never reach the status of a CC than vice-versa. Hence, adaptability and a deep fundamental understanding of these new businesses is required to be successful.
3. Applying a systematic framework to detect companies that are likely beneficiaries of the described polarisation and understanding new business models are necessary conditions, but not sufficient. The final piece of the puzzle is "old-school" fundamental company analysis, with a strong focus on understanding the management and its incentives as well as the company's governance structures (which is particularly important in India).

In the end, a company's business can have all the ingredients to become a future CC, but it still depends on the successful execution by the management team. In that sense, we would change the old investment adage "bet on the jockey not the horse" to "make sure you have a very good jockey and a very good horse".

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