‘SCORE’ing Growth

Newsletter – June 2023

BURMAN
CAPITAL MANAGEMENT

Summary

Long-term investments in companies that have a sustainable competitive advantage reward investors handsomely. For instance, Colgate-Palmolive has delivered 25X returns to investors in the last 20 years i.e. CAGR of 18% given its stable, predictable, and fundamentally strong economic characteristics despite modest profit growth of about 13%. When companies with similar characteristics operate in industries that provide them ample room to scale-up, investor returns can become disproportionate. For instance, Titan Industries' earnings have compounded by 30% over the last twenty years, delivering an astounding 1,500X i.e. a CAGR of 44% return for investors.

In this newsletter, we discuss our 'SCORE' framework for growth in the context of companies that have a sustainable competitive advantage. We discuss how we evaluate companies' potential to generate disproportionate returns over the long-term. On the other hand, we also discuss how growth can be a double-edged sword destroying value for shareholders where a company's return on capital is less than cost of capital.

Portfolio performance update

The Jun-23 quarter saw a strong rebound in the Indian markets with headline Indian indices S&P BSE SENSEX and NSE Nifty 50 up between 9.5%-10.5% driven by a myriad of factors including foreign fund inflows to the tune of US$13.6 bn following outflows of US$6.0 bn in FY2023, easing headline inflation/possibility of rates topping-out, continuing strength of the core economy as indicated by GDP growth, IIP numbers, corporate profitability, among others.

Our portfolio reported one of its best quarterly returns of 20.9% vs. 13.2% for our benchmark S&P BSE 500. Since inception i.e. Mar 23, 2021, our portfolio has delivered annualized returns of 42.5% vs. S&P BSE 500 returns of 14.8%, delivering outperformance of over 2,700 bps. The Association of Portfolio Managers (APMI) has started reporting returns delivered by all portfolio managers in India on its website, the same can be accessed at APMI. We are delighted to inform you that we have delivered 3rd highest '2-Year' returns (as on the date of the newsletter) among 554 investment approaches within 'Equity strategy' for Jun-2023.

Performance Snapshot

	1 Month	3 Months	6 Months	1 Year	2 Years	Since Inception
Burman Capital Management	**3.6**	**20.8**	**19.9**	**49.6**	**40.9**	**42.5**
S&P BSE 500 TRI	4.3	13.2	6.8	24.0	11.7	14.8

Monthly performance (Absolute returns, %)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2021	NA	NA	NA	6.5	5.7	-0.5	7.7	3.9	4.3	4.2	7.1	9.6
2022	0.2	-7.0	11.7	-2.5	-5.7	-2.8	9.3	8.7	4.5	4.1	-3.5	0.1
2023	-1.3	1.0	-0.5	9.0	7.1	3.6						

NOTE: All returns are net of fees and expenses (TWRR). Since inception and two year returns are annualized; other time period returns are absolute. Benchmark changed effective from 1st April, 2023 to S&P BSE 500 TRI from S&P BSE Small Cap Index, according to SEBI circular dated December 16, 2022.

How we think about ‘Growth’

The investment community is obsessed about ‘Growth’ vs ‘Value’ investing. ‘Value investing’ is perceived as investing in old-economy companies trading at deep discount to intrinsic valuation, while ‘Growth investing’ is perceived as investing in companies in the new-economy that are ‘hyper-scalers,’ ‘disruptors,’ among others. The fact that ‘Growth’ is one of few key drivers of ‘Value’ is often forgotten. Our definition of a growth company is as follows

‘A company operating in an industry which provides its management room to keep re-investing its excess cashflows at high rates of return while maintaining or improving its competitive advantage.’

There are four key components in the above definition which form the core pillars of our framework, which we call ‘SCORE’ i.e. Strategy, Capacity, Opportunity, and REadiness

- Competitive advantage – What is the company’s **S**trategy for growth?
- Excess cashflows and strong return on capital – Does the company have **C**apacity to grow?
- Room to invest – Is there enough **O**pportunity to grow?
- Management ability to re-invest – What is the company’s **RE**adiness to grow?

For long-term value creation, all these factors are essential – growth cannot be looked at in isolation. Just because ‘electric vehicles,’ ‘defense’ or ‘new-age tech’ are expected to scale-up at a rapid pace does not make investing in companies in these industries attractive. We do not believe in investment themes nor are we trying to back the next ‘big thing’ – we are looking for strong companies that have room to deliver growth in the context of the definition above.

#1 Strategy to grow

Every company has their unique growth strategy which is driven by a wide variety of factors including inherent operational and functional skills of the organization, growth opportunities, owned assets, among others. We typically ask two questions to gain insights into management’s thought process for growth, these are – (1.) What is their targeted pace of growth? and (2.) How do they plan to achieve the same?

We tend to be skeptical of managers who have a precise answer to the first question. For instance, managements that say, “our target is to reach Rs100 bn of sales in five years” or “we clearly see path to grow at 20-25% for the foreseeable future”, are either under-playing business risks or don’t understand them fully – no one knows what the future holds, think COVID-19 or the global financial crisis! By setting over-ambitious and specific number-related targets, managements are at times caught in a tricky situation when growth tapers down. They then either resort to backtracking on their word or worse, look for creative (read: value-destructive) ways to deliver on the promise. We saw this phenomenon play out in one of our portfolio companies that we exited. The company’s management set themselves an unrealistic growth target and to achieve the same they entered business contracts that had low economic value, started expanding business organically into adjacencies thereby diluting focus from the core and went on an acquisition spree. The result was fast topline growth at the expense of value destruction for shareholders.

On the second question, management plans for growth range from expanding distribution to launching new products to acquiring companies. While there is no fixed formula to success, below are certain situations we tend to avoid

- Aggressive growth led by acquisitions i.e. empire building
- Gaining market share by following a loss-leadership model
- Over-diversification leading to a lack of focus

Instead, answers that we are looking for the above questions include “we plan to grow faster than industry/peers by improving our products, customer experience, increasing our value proposition vs peers, among others” or “we are focusing on improving our capabilities over the long-term while increasing both customer satisfaction and deepening our channel relationship, this over time should help us gain an edge over competition thereby driving growth higher than industry”.

Growth number should be an outcome of a well-defined strategy. Targeting specific numbers and then designing a strategy to achieve those numbers can lead to unintended consequences.

#2 Capacity to grow

Growth is a double-edged sword. For companies whose return on capital is less than cost of capital, growth is value destructive. For instance, think of the numerous real estate companies such as Unitech or debt-fueled infrastructure and metals companies that went bust post the 2003-07 boom. Capital intensive businesses (as above) where demand tends to be cyclical generate little economic value over an entire cycle. The best companies are ones that require little capital and where demand is secular. While capital-intensive companies go belly-up or scale-down at times of economic distress, companies that have strong balance sheets double down and invest in such times, making them stronger as the cycle turns upwards, and demand revives.

The key metric we use to assess unit economics is ROCE (Return on Capital employed) – a 20%+ average return on capital over a cycle typically points to strong inherent economics. These companies generate strong cash flows which can be used to invest in growth or pay out dividends/share buybacks, thereby driving shareholder value.

#3 Opportunity to grow

Let us continue from the example on the first page. In India, the penetration of toothpaste is 90%+ and Colgate has a market share of close to 50% - it is not difficult to see that the potential room for Colgate to grow within its existing segment is limited. On the contrary, a company like Titan can continue to grow given that it has EBOs in fewer than fifty cities for some of its categories (e.g. Zoya, Taneira, Fastrack, Mia). There are two key aspects we look at while evaluating opportunity to grow – market size relative to current scale (addressable market) and market share gain potential.

Addressable market/penetration: In a country like India with a population of 1.4 bn it is easy to over-estimate the potential addressable market for any product or service. For e.g. extrapolating a statistic like India’s cars/1000 population of 35 vs US/China at 812/226, to say the car market in India is highly underpenetrated is incorrect. One major reason for the car market in India to be underpenetrated is affordability, hence perhaps a better penetration number could be arrived at by using number of households that can afford a car as the denominator. Therefore, instead of relying on crude/back-of-the-envelope indicators as above, it is important to study consumer profile and behavior in detail to arrive at right conclusions on addressable market.

At times, market opportunity expands multi-fold driven by a sea change in industry dynamics, a phenomenon which is also referred to as Value Migration. Some examples include sharp growth in specialty chemicals industry driven by China + 1 in the 2010 decade, shift of market share from public sector banks to private sector banks and most recently, increasing trend of electronics manufacturing moving to India. At times, these changes increase addressable market exponentially, driving disproportionate value to firms ready to harness such changes.

Market share gain potential: As India becomes more formal and connected, several industries which were traditionally unorganized in nature are consolidating with the organized players gaining disproportionately from this change. For instance COVID-19 has disrupted the supply chain for the luggage industry, hence organized players having domestic capacity are gaining market share versus their unorganized peers. Another source could be government initiatives such as Make in India that are driving import substitution by providing Indian companies a competitive advantage vs imports. In addition, firms also gain market share from legitimate competition by beating them consistently in the marketplace.

#4 REadiness to grow

India is a growing economy, and our entrepreneurs are some of the finest globally. This is because they have been tested multiple times at various levels for instance, dealing with regulatory uncertainty, fending off malpractices (tax evasion) by the unorganized sector, responding to a slow judicial system, among others. We evaluate management/company readiness for growth from the following angles

- Management ambition: to generate disproportionate outcomes in a measured manner
- Business model: design that makes businesses agile and nimble
- Culture: flow-through of management's passion down the organization
- Systems and processes: futuristic, designed for sustainable long-term growth
- Management depth: strong second-line managers supporting company's changing scale

While points #2 and #3 of or SCORE framework focus on quantitative aspects of growth, points #1 and #4 focus on qualitative aspects and are reflective of our view that assessing growth is not a quantitative exercise done on an excel spreadsheet but is a more complex exercise of assessing four core parameters – strategy, capacity, opportunity, and readiness.

Before we end this newsletter, think it is important to highlight certain pitfalls we have seen investors falling prey to

- Capex announcements: these are just announcements and involve execution risk. Even post execution, the increased capacity needs to be utilized.
- Order book announcements: order book translating into economic value is not a given, especially in government orders
- Entry into a 'hot' theme: expansion into EV, 'new age' tech or electronics manufacturing
- Extreme projections/targets by managements

In case you would like to know more about our approach to assessing growth, please feel free to write to us at info@burmancapital.com.

About Burman Capital Management

Burman Capital Management is a part of Burman Family Holdings, the strategic investment platform of the Burman Family, which over the last twenty years has invested over US $500 million in various businesses primarily in India and have partnered and joint ventured with many of the leading Fortune 100 companies from around the world. The Burman family are the control shareholders of the Dabur Group. Dabur was founded in 1884 by Dr. S.K. Burman and is today one of the largest Indian Fast Moving Consumer Good Company in India with over US$1 billion in revenue and a market capitalization of over US$14 billion.

At Burman Capital Management, we are long-term investors with deep passion for identifying and investing in exceptional businesses early. We are fundamentals-driven bottom-up investors and run concentrated portfolios focusing on small to mid-size companies. We are a SEBI-registered Portfolio Manager with registration number INP100007091.

To know more about how we approach investing, please visit www.burmancapital.com or write to us at info@burmancapital.com.

For direct On-boarding, please write to us on: support@burmancapital.com.