Thematic Study | 12 December 2012

17th ANNUAL WEALTH CREATION STUDY (2007-2012)

Economic Moat

Fountainhead of Wealth Creation

HIGHLIGHTS

- **Economic Moat protects profits and profitability of companies from competitive attack.**
- **Extended CAP (competitive advantage period) of Economic Moat Companies (EMCs) leads to superior levels of profits and stock returns.**
- **Over 2002-2012, EMCs in India have outperformed benchmark indices.**
- **Breach of Economic Moat causes massive wealth destruction.**
- **Markets seem poised to touch new highs in the next 12 months.**

> "(Great companies to invest are like) Wonderful castles, surrounded by deep, dangerous moats where the leader inside is an honest and decent person. Preferably, the castle gets its strength from the genius inside; the moat is permanent and acts as a powerful deterrent to those considering an attack; and inside, the leader makes gold but doesn't keep it all for himself. Roughly translated, we like great companies with dominant positions, whose franchise is hard to duplicate and has tremendous staying power or some permanence to it."
>
> — **Warren Buffett**

TOP 10 WEALTH CREATORS (2007-2012)

	THE BIGGEST		THE FASTEST		THE MOST CONSISTENT		
Rank	Company	Wealth Created (INR b)	Company	5-Year Price CAGR (%)	Company	Appeared in WC Study (x)	10-Year Price CAGR (%)
1	ITC	1,187	TTK Prestige	89	Kotak Mahindra Bank	10	48
2	TCS	1,082	LIC Housing Finance	57	Siemens	10	44
3	HDFC Bank	744	Coromandel Inter	54	Sun Pharma	10	40
4	MMTC	671	Eicher Motors	52	Asian Paints	10	35
5	H D F C	558	IndusInd Bank	50	HDFC Bank	10	31
6	State Bank of India	556	MMTC	48	Hero Motocorp	10	30
7	Infosys	516	Jindal Steel	47	H D F C	10	29
8	Tata Motors	499	Bata India	41	ACC	10	29
9	Hind Unilever	457	Titan Inds	40	Ambuja Cements	10	26
10	Jindal Steel	436	GSK Consumer	39	Infosys	10	21

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We thank Mr Dhruv Mehta (Dhruv.Mehta@dhruvmehta.in), Investment Consultant, for his invaluable contribution to this report.

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Abbreviations and Terms used in this report

ABBREVIATION / TERM	DESCRIPTION
2007, 2012, etc	Reference to years for India are financial year ending March, unless otherwise stated
Avg	Average
CAGR	Compound Annual Growth Rate; All CAGR calculations are for 2005 to 2010 unless otherwise stated
L to P / P to L	Loss to Profit / Profit to Loss. In such cases, calculation of PAT CAGR is not possible
Price CAGR	In the case of aggregates, Price CAGR refers to Market Cap CAGR
INR b	Indian Rupees in billion
WC	Wealth Creation / Wealth Created
Wealth Created	Increase in Market Capitalization over the last 5 years, duly adjusted for corporate events such as fresh equity issuance, mergers, demergers, share buybacks, etc.

Capitaline database has been used for this study

Wealth Creation Study 2007-2012

Objective, Concept and Methodology

Report structure

- **Part 1 | Wealth Creation Study findings:** Here, we identify and analyze the top 100 Wealth Creators in the Indian stock market for the period 2007-2012.
- **Part 2 | Theme - Economic Moat:** Here, we explain the concept of Economic Moat and its effective application for Wealth Creation.

Objective: The foundation of Wealth Creation is in buying businesses at a price substantially lower than their "intrinsic value" or "expected value". The lower the market value compared to the intrinsic value, the higher is the margin of safety. Every year for the past 15 years, we endeavor to cull out the characteristics of businesses, which create value for their shareholders.

As Phil Fisher says, "It seems logical that even before thinking of buying any common stock, the first step is to see how money has been most successfully made in the past." Our Wealth Creation studies are attempts to study the past as a guide to the future and gain insights into the various dynamics of stock market investing.

Concept: Wealth Creation is the process by which a company enhances the market value of the capital entrusted to it by its shareholders. It is a basic measure of success for any commercial venture. Wealth Creation is achieved by the rational actions of a company in a sustained manner.

Methodology & change in methodology from this year: We define Wealth Created as the difference in market capitalization over this period of five years, after adjusting for equity dilution. Hitherto, we ranked the top 100 Wealth Creators based on a simple listing of companies in descending order of absolute Wealth Created. This year, we introduce a condition that during the study period, the company's stock price should have at least outperformed the benchmark index (the BSE Sensex in our case). Speed of Wealth Creation (speed is price CAGR during the period under study).

Due to the "Market Outperformance Filter", 9 companies dropped off from the Top 100 despite high absolute wealth created, some of them by a hair's breadth. We list below the drop-outs and also the companies which made it at their expense.

Market Outperformance Filter (Sensex CAGR over 2007-12 was 6%)

Who missed the Wealth Creators list ... **... and who made it**

Company	Adjusted NWC	Price CAGR (%)	Normal Rank*	Company	Adjusted NWC	Price CAGR (%)	Rank
O N G C	40,863	4.0	11	Tata Chemicals	3,236	11	92
Wipro	26,602	5.6	19	Tata Global	3,201	13	93
I O C L	15,839	5.6	31	TTK Prestige	3,191	89	94
NTPC	10,678	1.7	44	Kansai Nerolac	3,103	22	95
Hindalco Inds.	8,838	1.8	55	Godrej Inds	2,958	10	96
B H E L	7,557	2.6	61	Ashok Leyland	2,953	10	97
Cipla	5,463	5.3	79	BOC India	2,826	30	98
Oracle Fin.Serv.	4,594	4.7	85	MRF	2,796	24	99
Ranbaxy Labs.	3,712	5.9	95	Ipca Labs	2,698	23	100

* Market Outperformance Filter

Wealth Creation

2007-2012

The 17TH Annual Study

Findings

#1 The Biggest Wealth Creators

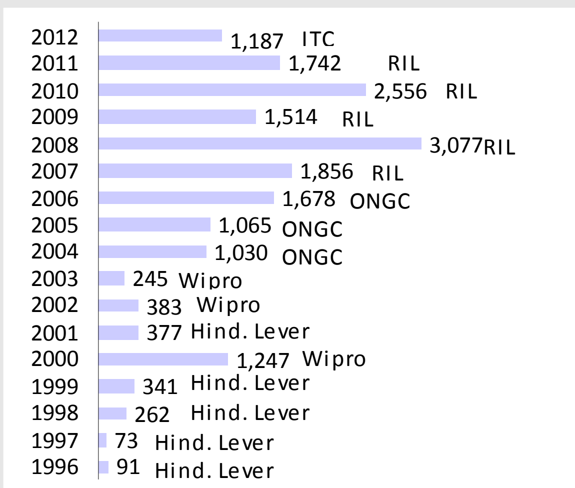
ITC is the Biggest Wealth Creator

- **ITC** has emerged as the biggest wealth creator for the first time ever, significantly improving its 7th rank in last year's study. This breaks the 8-year stranglehold of Oil & Gas companies with Reliance Industries topping the list in the last 5 years, and ONGC in the 3 years prior to that.
- Interestingly, both Reliance and ONGC did not make it to the top 100 wealth creators due to market underperformance (2007-12 stock price CAGR was 4% for ONGC and 2% for Reliance v/s 6% for the Sensex).
- TCS has held on to its position as close runner-up. HDFC Bank is in the third place, jumping 3 spots from its last year's rank of 6th. Going by the findings of our thematic study on Economic Moat (page 16 onwards), Indian Banking is the sector to watch out for, and HDFC Bank is a serious contender for the top spot sooner rather than later.

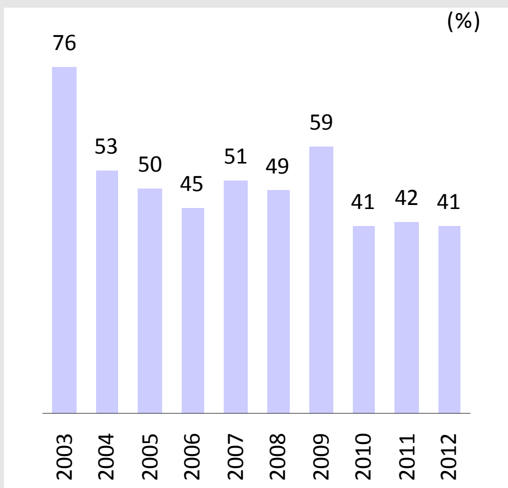
Top 10 Biggest Wealth Creators

Rank	Company	Wealth Created		CAGR (%)		P/E (x)		RoE (%)	
		(INR b)	% Share	Price	PAT	FY12	FY07	FY12	FY07
1	ITC	1,187	7	26	17	29	21	35	28
2	TCS	1,082	7	14	20	22	29	38	56
3	HDFC Bank	744	5	32	36	23	27	19	19
4	MMTC	671	4	48	-8	761	70	5	14
5	H D F C	558	3	21	26	18	22	19	19
6	State Bank of India	556	3	21	19	9	8	16	16
7	Infosys	516	3	8	17	20	29	29	42
8	Tata Motors	499	3	26	46	6	13	52	32
9	Hind Unilever	457	3	15	11	35	29	87	64
10	Jindal Steel	436	3	47	41	13	10	24	32
	Total/Avg of above	**6,707**	**41**	**20**	**24**	**17**	**20**	**24**	**23**
	Total of Top 100	**16,380**	**100**	**20**	**21**	**16**	**16**	**19**	**21**

Biggest wealth creators and wealth created (INR b): ITC breaks the long-standing dominance of Oil & Gas



Share of wealth creation by top 10 declining, suggesting higher dispersion



Key Finding #1

Even as ITC tops the list, Hindustan Unilever has made a silent but strong comeback in the Top 10 list after long gap of 12 years. Most leading consumer companies in India have an Economic Moat and are likely to remain fountainheads of Wealth Creation.

#2 The Fastest Wealth Creators

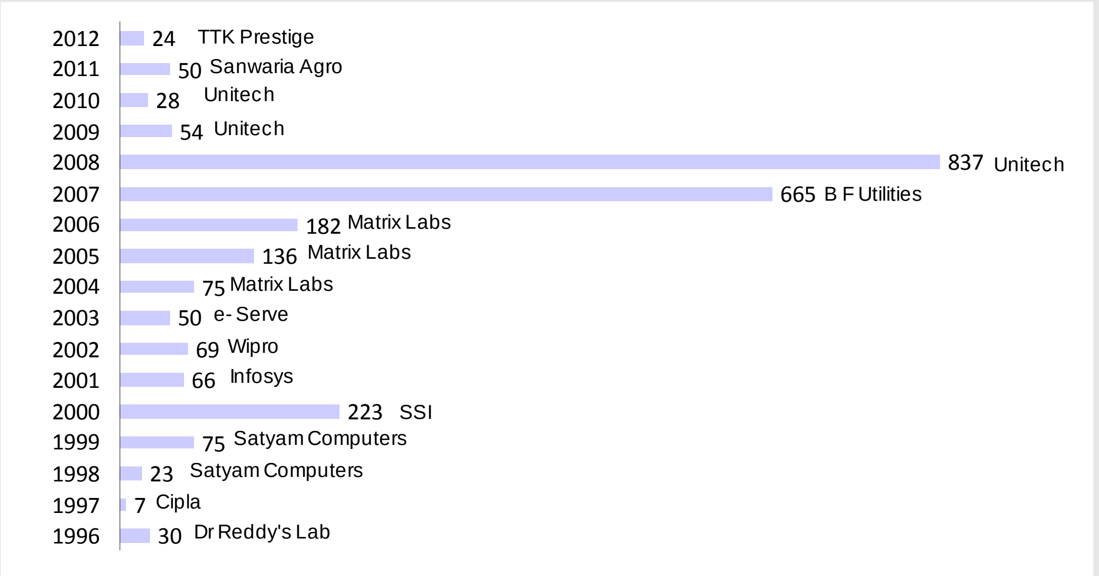
TTK Prestige is the Fastest Wealth Creator

- **TTK Prestige** has emerged as the fastest Wealth Creator between 2007 and 2012, during which period, its stock price multiplied 24x, translating into annualized return of 89%.
- Yet, this stunning performance is one of the slowest among all the Fastest Wealth Creators since 1998.
- Akin to Hindustan Unilever's re-entry into the Top 10 Wealth Creators list, 4 consumer goods companies including TTK have made it to the Top 10 Fastest Wealth Creators list.

Top 10 Fastest Wealth Creators

Rank		Price	CAGR (%)		Wealth Created	Mkt Cap (INR b)		P/E (x)	
		Multiple (x)	Price	PAT	(INR b)	2012	2007	2012	2007
1	TTK Prestige	24	89	58	32	33	1	29	12
2	LIC Housing Fin.	10	57	27	106	133	12	14	4
3	Coromandel Inter	9	54	43	69	81	8	12	7
4	Eicher Motors	8	52	41	47	54	7	19	13
5	IndusInd Bank	8	50	56	118	150	13	19	16
6	MMTC	7	48	-8	671	783	112	761	70
7	Jindal Steel	7	47	41	436	509	73	13	10
8	Bata India	6	41	42	41	49	9	32	33
9	Titan Inds	5	40	41	166	203	37	34	35
10	GSK Consumer	5	39	23	94	116	22	33	17

Of all the fastest wealth creators since 1999, this year is the slowest! (Price multiple - X)



Key Finding #2

Consumer goods companies are generally considered to be steady growth businesses, and deemed unlikely to generate high returns. However, increasing number of consumer companies seem to be enjoying the tailwind of India's NTD era (Next Trillion Dollar of GDP), and breaking into the league of Fastest Wealth Creators as well.

#3 Most Consistent Wealth Creating Companies

Kotak Mahindra is the Most Consistent Wealth Creator

- Kotak Mahindra Bank has retained its place as the Most Consistent Wealth Creator.
- Given low cyclicality, consumer facing companies (both goods and services) are better placed to appear in the list of Most Consistent Wealth Creators. Notable exceptions are Holcim Group companies, ACC and Ambuja Cements, which appear in the top 10 list both this year and last. Clearly, Holcim's presence has made the behavior of these companies more predictable to investors, leading to better and stable valuations.

Top 10 Consistent Wealth Creators

Rank	Company	Appeared in WC Study (x)	10-yr Price CAGR (%)	5-Year PAT CAGR (%)	P/E (x)		RoE (%)	
					2012	2007	2012	2007
1	Kotak Mahindra Bank	10	48	28	30	22	18	15
2	Siemens	10	44	17	48	30	36	23
3	Sun Pharma	10	40	27	29	25	38	25
4	Asian Paints	10	35	28	26	32	37	39
5	HDFC Bank	10	31	36	27	23	19	19
6	Hero Motocorp	10	30	23	18	19	38	66
7	H D F C	10	29	26	22	18	19	19
8	ACC	10	29	3	12	20	41	19
9	Ambuja Cements	10	26	2	15	22	35	16
10	Infosys	10	21	17	29	20	42	29

Consumer facing companies score high on Consistent Wealth Creation

Consistent Wealth Creators (Last 5 years, 2007 to 2012)

Consumer Facing

Healthcare
- Cipla (1)
- Piramal Health. (1)
- Ranbaxy Lab (1)
- Sun Pharma (5)

Consumer
- Asian Paints (4)
- ITC (2)
- Nestle India (1)

Others
- Hero MotoCorp (4)
- HDFC (5)
- HDFC Bank (4)
- Kotak Mah. Bk (3)

Non-Consumer Facing

Technology
- Infosys (5)
- Satyam (1)

Others
- ACC (2)
- Ambuja Cement (3)
- Hind. Zinc (1)
- O N G C (2)
- Siemens (1)
- Reliance Inds (4)

Number in brackets indicates times appeared within top 10 in last five Wealth Creation Studies

Key Finding #3

Quality of management is a key factor behind consistent wealth creation. This is further amplified by the role of management strategy in creating and/or defending a company's Economic Moat which protects its profitability from being eroded by competitive forces (see theme study on Economic Moat from Page 16).

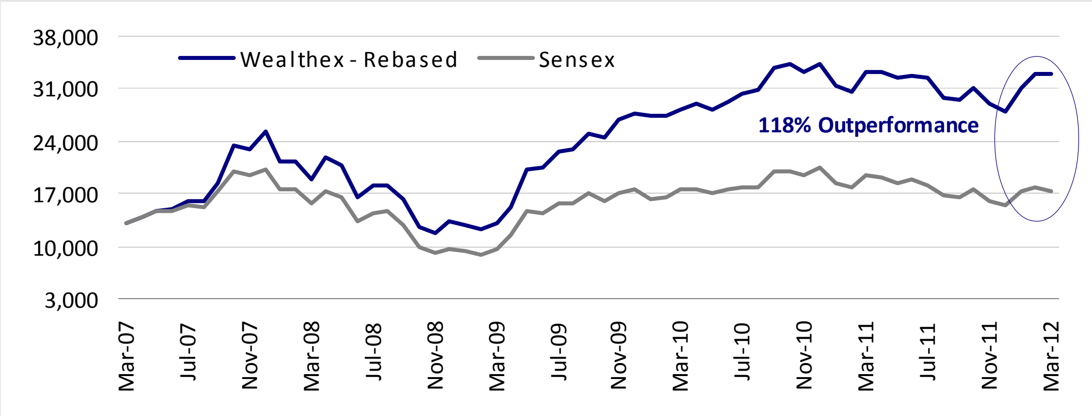
#4 Wealth Creators (Wealthex) v/s BSE Sensex

Superior and more consistent performance over benchmark

We have compared the performance of Wealthex (top 100 Wealth Creators index) with the BSE Sensex on three parameters - (1) market performance, (2) earnings growth, and (3) valuation.

- **Market performance:** Over the last five years, wealth creating companies have delivered point-to-point return CAGR of 20% against only 6% for the BSE Sensex.
- **Earnings growth:** Over the last five years, wealth creating companies clocked earnings CAGR of 21% compared to benchmark earnings CAGR of only 9%.
- **Valuation:** Wealth creating companies' aggregate P/E in March 2007 was at a discount to the Sensex, but over the next five years ended up at a premium to the Sensex. Higher than benchmark earnings growth led to valuation re-rating, combined leading to superior returns over benchmark.

Wealth Creators' Index v/s BSE Sensex (March 2007 to March 2012)



Sensex v/s Wealth Creators: Higher earnings growth, lower valuation

	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11	Mar-12	5-year CAGR (%)
BSE SENSEX	**13,072**	**15,644**	**9,709**	**17,528**	**19,445**	**17,404**	**6**
YoY performance (%)		20	-38	81	11	-10	
Wealthex - based to Sensex	**13,072**	**18,816**	**13,167**	**28,180**	**33,120**	**32,884**	**20**
YoY performance (%)		44	-30	114	18	-1	
Sensex EPS (INR)	**718**	**833**	**820**	**834**	**1,024**	**1,125**	**9**
YoY performance (%)		16	-2	2	23	10	
Sensex PE (x)	18	19	12	21	19	15	
Wealthex EPS (INR)	**809**	**1,026**	**1,111**	**1,436**	**1,838**	**2,102**	**21**
YoY performance (%)		27	8	29	28	14	
Wealthex PE (x)	16	18	12	20	18	16	

Key Finding #4

Most Wealth Creating companies will conform to characteristics of Economic Moat Companies (EMCs). As discussed in our theme study (page 16 onwards), EMCs are those who enjoy a sustainable competitive advantage in their respective industry, which helps them earn superior profits and deliver higher shareholder value.

#5 Wealth Creation Classification by Industry

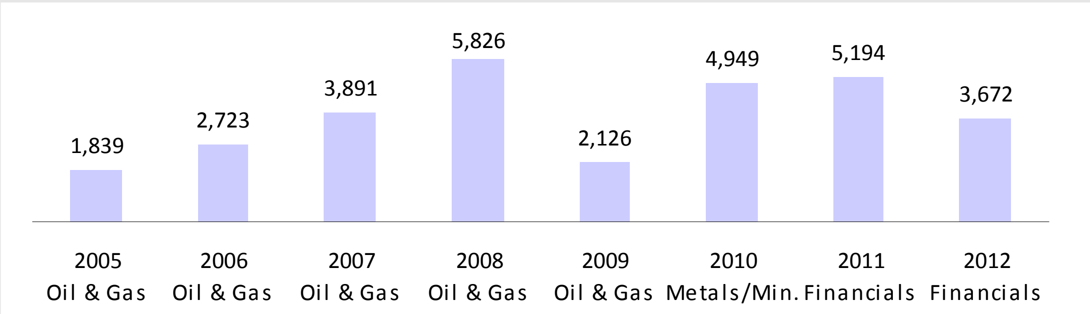
Financials maintain top spot as the largest Wealth Creating sector

- Financials sector has retained its top spot of the largest Wealth Creator. In the 2011 study, Financials emerged as the largest Wealth Creating sector for the first time ever, hitherto a stronghold of commodity sectors, mainly Oil & Gas and Metals/Mining.
- Size apart, Financials has also outperformed in terms of price with 24% CAGR, second only to Metals/Mining (27%). This is on the back of robust 25% CAGR in PAT, second only to Auto (27%).
- Even after a huge run-up in stock prices, Financials sector valuations remain lower than average, arguably on concerns regarding asset quality and the impact of fresh competition by way of new banking licenses.

Wealth Creators: Classification by industry (INR b)

Industry	WC	Share of WC (%)		CAGR (%)		P/E (x)		RoE (%)	
(No of Companies)	(INR b)	2012	2007	Price	PAT	2012	2007	2012	2007
Financials (21)	3,672	22	13	24	25	11	11	16	16
Consumer & Retail (21)	3,358	21	5	24	18	33	25	32	31
Metals / Mining (8)	2,095	13	9	27	19	15	10	22	42
Technology (3)	1,734	11	10	11	18	20	27	30	38
Auto (11)	1,630	10	6	21	27	12	15	28	26
Healthcare (11)	1,215	7	4	23	18	26	21	17	25
Oil & Gas (7)	996	6	24	20	23	11	12	16	10
Cement (5)	668	4	3	16	8	17	12	16	32
Capital Goods (6)	609	4	10	13	21	20	27	18	26
Ultility (3)	235	1	2	18	5	26	15	6	8
Others (4)	166	1	15	30	22	14	10	17	19
Grand Total	**16,380**	**100**	**100**	**20**	**21**	**16**	**16**	**19**	**21**

During FY07-12, the financials sector is beginning to assert its dominance (INR b)



Key Finding #5

Clearly, the Financials sector has gained hugely from restrictions on new banking licenses, a major sector-level entry barrier (or Economic Moat as we call it in our theme study, see page 16). Protected by this moat, even relatively inefficient banks have significantly grown in terms of profits and market cap. When new set of private banks first entered in the 1980s, significant portion of value migrated from public sector banks to private sector counterparts. Fresh banking licenses are expected to be issued sooner rather later. This change in competitive landscape should further separate the men (i.e. those with strong strategy) from the boys (those without strategy).

#6 Wealth Creation by Ownership – PSU v/s Private

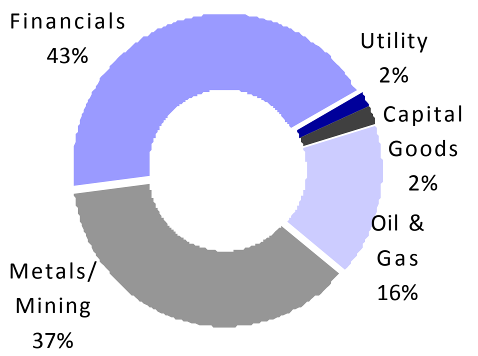
Wealth migration follows value migration

- PSUs' (public sector undertakings) share of wealth creation continues to be on a secular decline with their share of wealth created more than halving from 50% in 2004/2005 to about 20% in the current study.
- This is one of the classic cases of value migration from the public sector to private sector in almost every single erstwhile stronghold of PSUs – banking, oil & gas metals/mining, capital goods, etc.
- As of end-FY12, markets valued Wealth Creating PSUs at about 10x trailing earnings, almost 50% discount to 18x for the private sector Wealth Creating companies. If these multiples are any indication, the markets expect PSUs' share of Value Creation to remain low, implying lower Wealth Creation as well.

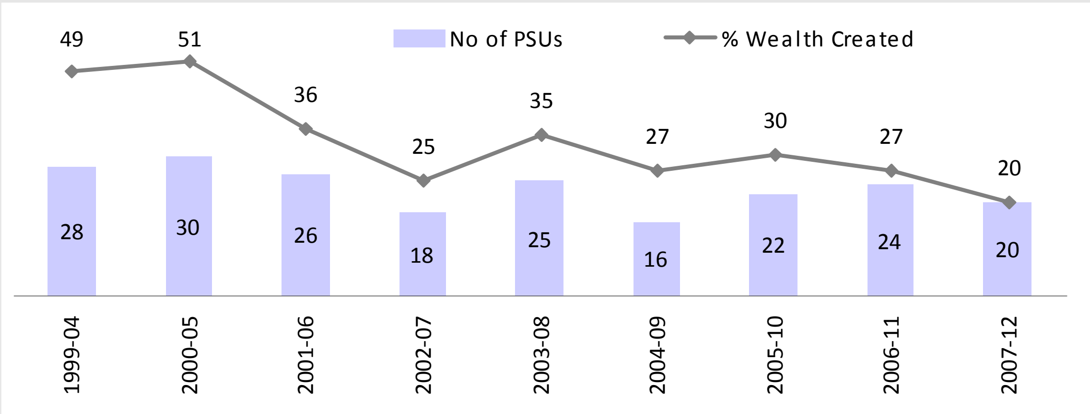
Wealth Creators: PSU v/s Privately-owned

	2007-2012	
	PSU	Private
No. of Wealth Creators	20	80
Share of Wealth Created (%)	20	80
Sales CAGR (2007-12, %)	21	24
PAT CAGR (2007-12, %)	19	22
Market Cap CAGR (2007-12, %)	22	20
P/E - 2007 (x)	9	20
P/E - 2012 (x)	10	18
RoE - 2007 (%)	17	24
RoE - 2012 (%)	16	21

Financials dominate PSU Wealth Creation too



Deregulation diminishes role of state-owned companies in Wealth Created



Key Finding #6

In the context of our theme study on Economic Moat, lower valuation multiples of PSU companies imply that the market expects their competitive advantage period (CAP) to be significantly shorter than their private sector counterparts. See page 30 for insights into the concept of CAP.

#7 Wealth Creation by Age and Market Cap

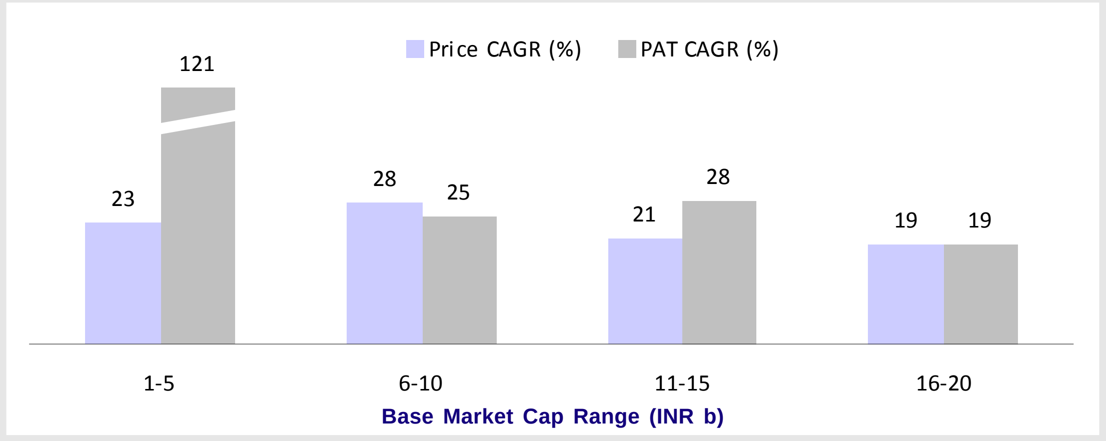
"In youth we learn, in age we understand." - Marie von Ebner-Eschenbach

- Pace of Wealth Creation is fairly agnostic to age of companies. Younger companies start off on a low base and manage to deliver high rates of growth. However, markets are reasonably efficient in pricing these growth rates upfront. As a result, although PAT growth rates vary across age groups, the Price CAGR is much more homogenous, and hovering around average overall return of 20%.
- Unlike younger companies, smaller companies (i.e. small- and mid-caps based on market cap of 2007) seem to have an edge in faster wealth creation. But as is the case with age-based classification, the divergence in market performance of small and large cap companies is much lower than that in earnings growthlarger ones create wealth a bit slowly, but with low level of risk.

Wealth Creators: Classification by age-group

2007 Age	No.	WC	% Share	CAGR (%)		P/E (x)		RoE (%)	
range	of cos	(INR b)	of WC	Price	PAT	2012	2007	2012	2007
1-20	24	4,327	26	22	32	17	25	20	16
21-40	28	4,121	25	18	19	18	19	21	23
41-60	24	3,676	22	21	15	14	11	16	22
>61	24	4,256	26	20	22	14	14	21	22
Total	**100**	**16,380**	**100**	**20**	**21**	**16**	**16**	**19**	**21**

Price CAGR and PAT CAGR by base market cap range



Key Finding #7

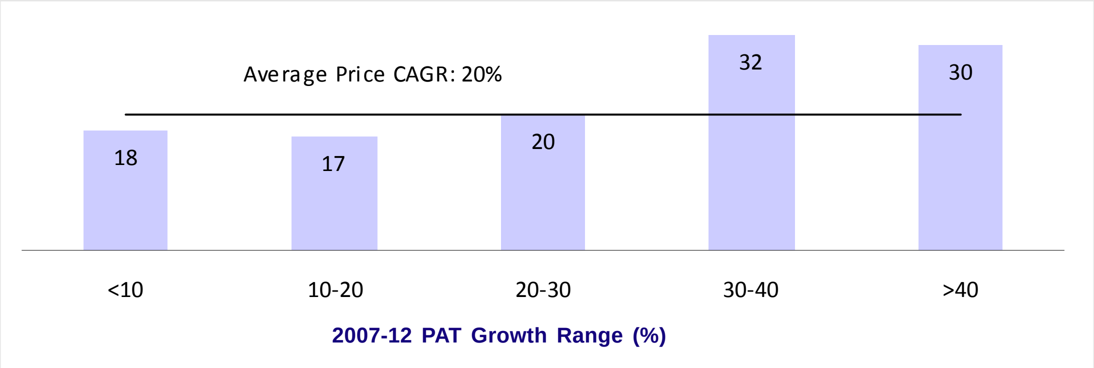
One of the key findings of our theme study this year (see page 16) is that a company's competitive advantage in its industry (what we call Economic Moat) is a key factor influencing sustained profitability and in turn, Wealth Creation. So long as companies generate health profits, markets are agnostic to factors like age of company and market cap at the time of purchase.

#8 Wealth Creation by Sales and Earnings growth

Markets remain slaves of earnings power

- Pace of wealth creation is almost singularly decided by quantum of earnings growth, at least in the short- and medium term. Earnings growth, in turn, has a very high correlation with Sales growth, as margin expansion is not sustainable over long periods.
- In this year's study, the performance of groups based on Sales growth and PAT growth has been significantly influenced by commencement of Sales and PAT at Cairn India, and a significant turnaround in Tata Motors' consolidated performance. As a result, despite PAT growth in excess of 30%, P/Es have shrunk as the markets deem such PAT performance to be cyclical and most likely unsustainable.

Strong correlation between PAT growth & Price CAGR



Wealth Creators: Classification by 2007-12 Sales Growth

Sales Growth	No. of cos	WC (INR b)	% Share of WC	CAGR (%) Price	CAGR (%) PAT	P/E (x) 2012	P/E (x) 2007	RoE (%) 2012	RoE (%) 2007
<15	18	2,091	13	15	6	21	14	18	35
15-20	19	3,154	19	16	12	23	19	20	23
20-25	25	4,653	28	21	20	15	15	20	22
25-30	14	1,680	10	19	23	11	13	17	19
30-35	14	2,340	14	28	26	20	19	15	21
>35	10	2,462	15	26	46	10	21	24	10
Total	**100**	**16,380**	**100**	**20**	**21**	**16**	**16**	**19**	**21**

Key Finding #8

In his 2007 letter to Berkshire Hathaway shareholders, Warren Buffett writes, "Long-term competitive advantage in a stable industry is what we seek in a business. If that comes with rapid organic growth, great. But even without organic growth, such a business is rewarding." In the final analysis, markets love steady earnings growth sustained over long periods in time. This is possible only in the case of companies which enjoy an Economic Moat, as explained in our theme study from page 16.

#9 Wealth Creation by RoE

A key reflector of the strength of Economic Moat

- Even as earnings growth is important, markets also have a keen eye for the depth of a company's competitive advantage (or Economic Moat) and its sustainability. The depth of a company's Economic Moat is reflected in its RoE relative to peers, and its sustainability in its competitive advantage period or CAP (for clarity on these terms, see our theme study on page 16 for details).
- Interestingly, since markets are efficient, in most cases, quality of an Economic Moat is priced in. Given this, it is the deepening or the narrowing of the moat (i.e. delta or incremental RoE) that influences stock prices more than the absolute levels.
- The above is confirmed in this year's study as well. Companies with RoEs in excess of 35% have underperformed the benchmark return of 20%. Apart from low earnings growth, this also reflects their meaningful fall in RoE over the 5-year period, a proxy for lower competitive advantage.

Wealth Creators: Classification by RoE

2007 RoE	No.	WC	% Share	CAGR (%)		P/E (x)		RoE (%)	
Range	of cos	(INR b)	of WC	Price	PAT	2012	2007	2012	2007
<15	17	2,014	12	23	29	10	13	15	9
15-20	24	3,681	22	25	21	15	13	16	17
20-25	15	1,415	9	19	12	19	13	16	22
25-30	15	3,626	22	22	25	15	16	24	27
30-35	14	1,930	12	13	16	20	22	25	33
>35	15	3,715	23	19	18	19	18	28	50
Total	**100**	**16,380**	**100**	**20**	**21**	**16**	**16**	**19**	**21**

Key Finding #9

As our study on Economic Moat suggests, positive change in a company's RoE mostly reflects strengthening of its competitive advantage vis-à-vis its rivals. This is a major trigger for valuation re-rating, a major source of Wealth Creation.

#10 Wealth Creators by Valuation Parameters

Payback ratio of less than 1x continues to guarantee highest returns

- In almost every single of our past Wealth Creation Studies, the key valuation indicators for multi-baggers are -
  1. P/E of less than 10x
  2. Price/Book of less than 1x
  3. Price/Sales of 1x or less
  4. Payback Ratio of less than 1x

  (Payback is a proprietary ratio of Motilal Oswal, defined as current market cap divided by estimated profits over the next five years. We back-test this in 2007, based on the actual profits reported over the next five years).
- Unlike in past years, Wealth Creators with 2007 P/E less than 10x have delivered only average returns despite some re-rating. The main reason is that the group's PAT CAGR at 18% was below the average of 20%.

Wealth Creators: Classification by Valuation Parameters (March 2007)

	No. of	WC	% Share	CAGR (%)		P/E (x)		RoE (%)	
Range	cos	(INR b)	of WC	Price	PAT	2012	2007	2012	2007
P/E - 2007									
<10	18	2,811	17	20	18	9	8	16	16
10-15	21	2,869	18	22	24	11	12	22	25
15-20	19	1,557	10	21	20	17	17	19	18
20-25	13	2,899	18	25	24	22	22	21	22
25-30	13	4,579	28	16	21	23	28	25	33
>30	16	1,666	10	25	24	49	47	19	21
P/B - 2007									
<1	6	972	6	25	28	8	9	16	9
1-2	20	1,944	12	20	19	10	9	14	15
2-3	10	1,088	7	24	21	12	11	19	25
3-4	11	2,110	13	20	20	12	12	24	28
4-5	13	2,348	14	22	24	15	17	19	27
5-6	11	2,326	14	26	21	24	20	27	27
>6	29	5,592	34	17	19	27	30	27	37
P/S - 2007									
<1	23	3,180	19	26	23	10	9	18	17
1-2	27	2,892	18	21	15	17	13	17	22
2-3	19	2,323	14	21	17	16	13	18	34
3-4	9	1,662	10	18	20	20	21	22	26
4-5	7	2,270	14	26	23	25	23	21	18
>5	15	4,053	25	15	26	17	27	23	19
Payback Ratio									
<1	19	2,371	14	26	25	8	8	17	16
1-2	37	5,486	33	23	24	12	13	20	19
2-3	26	4,770	29	20	15	25	20	19	23
>3	18	3,753	23	15	16	28	30	27	36
Total	**100**	**16,380**	**100**	**20**	**21**	**16**	**16**	**19**	**21**

#11 Wealth Creators & dividends

- Our last year's study on Blue Chip Investing had revealed to us the power of dividends in wealth creation, especially over long periods of time across economic and business cycles.
- Wealth creating companies continue to demonstrate that companies with high RoE's tend to have high payout ratios, as they require very little external capital to grow.
- Companies with high dividend payout ratios tend to enjoy high share of share of wealth created.

Wealth Creators: Classification by Payout

2007	No. of	WC	% Share	CAGR (%)		P/E (x)		RoE (%)	
Payout	cos	(INR b)	of WC	Price	PAT	2012	2007	2012	2007
<10	13	2,227	14	22	22	14	14	17	17
10-20	16	3,135	19	18	18	16	16	17	20
20-30	22	3,380	21	21	25	12	14	18	20
30-40	27	3,924	24	19	21	16	17	22	22
>40	22	3,714	23	23	18	27	22	30	26
Total	**100**	**16,380**	**100**	**20**	**21**	**16**	**16**	**19**	**21**

Top 10 total dividend paying companies (2007-12): TCS takes sweet revenge over ITC!

2007-12	Dividend	Avg Payout	CAGR (%)		P/E (x)		RoE (%)	
	(INR b)	(%)	Adj EPS	Price	2012	2007	2012	2007
TCS	167	45	19	14	22	29	38	56
ITC	157	72	16	25	29	21	35	28
Infosys	126	39	16	7	20	29	29	42
State Bank of India	110	19	15	17	9	8	16	16
Hind Unilever	94	81	9	15	35	29	87	64
Hero Motocorp	70	79	23	25	19	18	66	38
H D F C	66	36	-12	17	18	22	19	19
NMDC	62	25	25	20	9	11	33	47
GAIL (India)	56	32	12	16	11	9	18	23
Tata Motors	50	20	32	14	6	13	52	32

Top 10 dividend hike companies (2007-12): Top 4 ranks same as total dividend; HUL, Hero Motocorp, GAIL out, NMDC, Hind Zinc, L&T in

2007-12	△ Div.	△ Payout	CAGR (%)		P/E (x)		RoE (%)	
	(INR b)	(%)	Adj EPS	Price	2012	2007	2012	2007
TCS	44	24	19	14	22	29	38	56
ITC	27	16	16	25	29	21	35	28
Infosys	24	18	16	7	20	29	29	42
State Bank of India	18	4	15	17	9	8	16	16
NMDC	15	6	25	20	9	11	33	47
H D F C	13	-3	-12	17	18	22	19	19
Hindustan Zinc	9	16	4	19	11	5	22	80
HDFC Bank	9	-1	26	22	23	27	19	19
Tata Motors	8	-21	32	14	6	13	52	32
Larsen & Toubro	7	5	15	10	18	25	16	30

#11 Wealth Creators & dividends (contd)

Top payout ratio companies (2007-12): Castrol, Colgate on top, as was the case in 2011

2007-12	Avg Payout (%)	Dividend (INR b)	CAGR (%) Adj EPS	CAGR (%) Price	P/E (x) 2012	P/E (x) 2007	RoE (%) 2012	RoE (%) 2007
Castrol India	90	16	25	38	27	18	83	38
Colgate-Palmolive	85	15	25	27	34	25	109	65
Hind Unilever	81	94	9	15	35	29	87	64
Hero Motocorp	79	70	23	25	19	18	66	38
Nestle India	73	25	26	38	46	28	90	85
ITC	72	157	16	25	29	21	35	28
GSK Pharma	72	19	-7	15	33	26	30	34
Guj Gas Company	66	7	22	25	18	19	33	21
Engineers India	61	13	36	27	14	18	38	14
Britannia Inds	57	4	13	19	37	30	54	18

Top 10 payout ratio hike companies: Piramal tops due to disbursement of business sale proceeds

2007-12	△ Payout (%)	△ Div. (INR b)	CAGR (%) Adj EPS	CAGR (%) Price	P/E (x) 2012	P/E (x) 2007	RoE (%) 2012	RoE (%) 2007
Piramal Ente.	278	3	-19	14	102	22	1	22
Guj Gas	98	3	22	25	18	19	33	21
GSK Pharma	49	1	-7	15	33	26	30	34
Hind Copper	33	1	-4	26	76	38	25	35
Bosch	33	4	15	20	24	24	25	25
MMTC	33	0	-19	48	761	70	5	14
Divi's Lab	30	2	22	20	19	21	27	42
Gillette India	29	0	3	25	108	35	12	22
B P C L	28	-3	-19	18	30	5	5	21
Cummins India	25	3	16	21	26	20	31	29

Top 10 dividend paying companies (Overall)

2007-12	Dividend (INR b)	Avg Payout (%)
O N G C	366	39
NTPC	155	42
Coal India	144	44
TCS	143	45
ITC	135	72
Infosys	108	39
Reliance Inds	105	13
State Bank of India	94	19
I O C L	84	30
Hind Unilever	81	81

Top 10 dividend payout companies (Overall)*

2007-12	Avg Payout (%)	Dividend (INR b)
Castrol India	90	14
Colgate-Palmolive	85	13
Hind Unilever	81	81
Hero Motocorp	79	60
HCL Infosystems	76	7
Nestle India	73	21
ITC	72	135
GSK Pharma	72	16
Engineers India	61	11
Ashok Leyland	54	11

* Among top 100 dividend paying companies

#12 Wealth Destroyers

Wealth Destroyed is over 33% of Wealth Created

- The 2007-12 period saw about INR5.4 trillion of Wealth Destruction, a high 33% of the Wealth Created by top 100 companies (the figure in last year's study was 15%, whereas during the peak of the market boom in 2007-08, the figure was as low as 2%).
- This year's data is a classic case study on how change in the competitive landscape of an industry (a key element of a company's Economic Moat) drastically affects value and wealth creation. Barely 4 years ago, the Indian Telecom sector was the 5th largest Wealth Creator and sector leader Bharti Airtel was the third largest Wealth Creator. Four years later, the Telecom sector leads the Wealth Destruction list, and top 4 of 10 Wealth Destroyer companies emerging from the sector (including RCom, Bharti and MTNL).
- This is a grim reminder to both companies and investors of the far-reaching impact of Economic Moats getting breached. We discuss the concept in detail from page 16.

Top-10 Wealth Destroyers (2007-2012)

Company	Wealth Destroyed		Price
	(INR b)	% Share	CAGR (%)
Rel. Comm.	677	12	-28
Unitech	294	5	-32
Suzlon Energy	276	5	-34
Satyam Computer	249	5	-30
Bharti Airtel	169	3	-2
S A I L	83	2	-4
Tech Mahindra	82	2	-13
M T N L	75	1	-29
Himachal Futuristic	74	1	-12
B F Utilities	73	1	-30
Total of Above	**1,905**	**35**	
Total Wealth Destroyed	**5,425**	**100**	

Wealth Destruction by Industry (%)

Sector	No of	Wealth Destroyed	
	Cos	(INR b)	% Share
Telecom	20	1,111	20
Construction / Real Estate	78	828	15
Technology	149	749	14
Capital Goods	115	575	11
Metals	74	267	5
Banking & Finance	120	240	4
Textiles	160	206	4
Media	48	167	3
Utilities	4	135	2
Auto	71	132	2
Oil & Gas	7	101	2
Chemicals & Fertilizers	65	99	2
Healthcare	51	89	2
Sugar	32	60	1
Consumer	32	59	1
Airlines	4	42	1
Cement	12	32	1
Tea	4	6	0
Paper	21	5	0
Others	259	521	10
Total	**1,326**	**5,425**	**100**

Wealth Creation

2007-2012
The 17TH Annual Study

Theme 2013:
Economic Moat

Economic Moat

Fountainhead of wealth creation

"(Great companies to invest are like) Wonderful castles, surrounded by deep, dangerous moats where the leader inside is an honest and decent person. Preferably, the castle gets its strength from the genius inside; the moat is permanent and acts as a powerful deterrent to those considering an attack; and inside, the leader makes gold but doesn't keep it all for himself. Roughly translated, we like great companies with dominant positions, whose franchise is hard to duplicate and has tremendous staying power or some permanence to it."

- Warren Buffett

Report scope and structure

MOST of us would have read or heard frequent references to "moats" or "Economic Moats" in the context of equity investing. We believe with a clear understanding of the concept and its effective application, moats can prove to be fountainheads of Wealth Creation.

We attempt this in the following pages as follows -

- **Section 1** introduces the concept of Economic Moat and covers 4 examples of how investing in EMCs (Economic Moat Companies) pays off handsomely in the stock markets vis-à-vis non-EMCs.
- **Section 2** discusses the factors determining Economic Moats, including the importance of a strong corporate strategy to defend and deepen the same.
- **Section 3** is where we apply our understanding of Economic Moats for Wealth Creation. Our backtesting of Economic Moats throws up several interesting findings. We finally apply the same methodology to identify EMCs among Nifty constituents.
- **The Appendix** (for the academically inclined) is where we share the methodology of how we went about quantifying what is essentially a qualitative idea.

1. Introduction: Economic Moat – the what and the why

In the long run, investors can earn only as much as the company itself earns

1.1 What is an Economic Moat?

> "The idea of an **economic moat** refers to how likely a company is able to keep competitors at bay for an extended period. One of the keys to finding superior long-term investments is buying companies that will be able to stay one step ahead of their competitors."
> - **MorningStar**, a US-based investment firm, which manages a Wide Moat Focus Index

The concept of 'Economic Moat' has its roots in the idea of a traditional moat. A moat is a deep, wide trench, usually filled with water, that surrounds the rampart of a castle or fortified place. In many cases, the waters are also infested with sharks and crocodiles to further keep enemies at bay, and the inhabitants safe.

Akin to a moat, an Economic Moat protects a company's profits from being attacked by a combination of multiple business forces. Traditional management theory terms such as "Sustainable Competitive Advantage" or "Entry Barriers" essentially connote the idea of an Economic Moat.

1.2 Why Economic Moat?

> The dynamics of capitalism guarantee that competitors will repeatedly assault any business "castle" that is earning high returns ... Business history is filled with "Roman Candles," companies whose moats proved illusory and were soon crossed."
> - **Warren Buffett** in his 2007 letter to Berkshire Hathaway shareholders

The sole financial objective of companies is to maximize return on capital invested in their business, and sustain the same for long periods of time. Capital always chases returns, and hence will find its way to businesses with high profits and profitability. If a company running a highly profitable enterprise does not have a deep and wide-enough Economic Moat, competition from rivals will ensure that its high returns are reduced to the level of the economic cost of capital (which includes a nominal level of profit), or in some cases even lower than that.

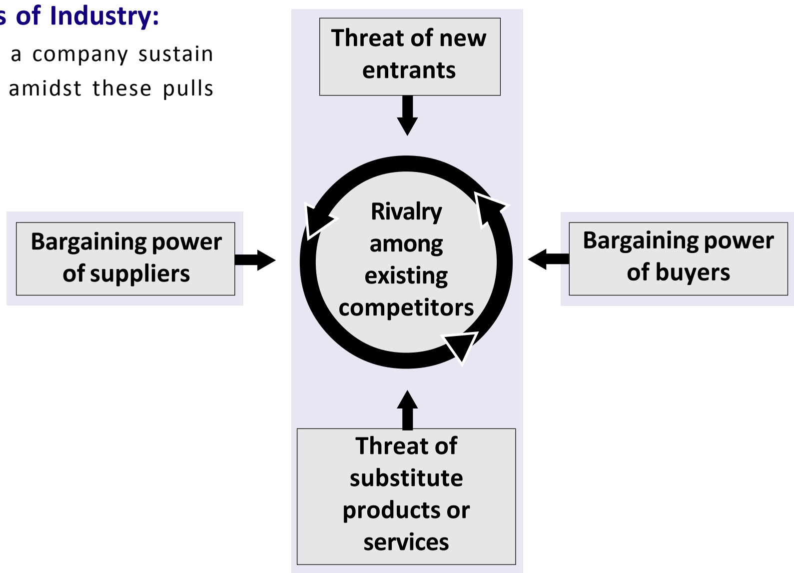
From a broader perspective, companies do not compete only with rivals for profit. As Joan Magretta says in her book ***Understanding Michael Porter*** –

- "Companies are also engaged in a struggle for profits with their customers, who would always be happier to pay less and get more.
- They compete with their suppliers, who would always be happier to be paid more and deliver less.
- They compete with producers who make products that could, in a pinch, be substituted for their own.
- And they compete with potential rivals as well as existing ones, because even the threat of new entrants places limits on how much they can charge their customers."

In this context, an Economic Moat or Sustainable Competitive Advantage is that which helps a business sustain superior long-term profitability amidst various pulls and pressures (commonly known as Michael Porter's Five Forces in management theory parlance).

Porter's Five Forces of Industry:

Economic Moat helps a company sustain superior profitability amidst these pulls and pressures



1.3 Economic Moat and equity investing

> "The number one idea is to view a stock as an ownership of the business and to judge the staying quality of the business in terms of its competitive advantage."
>
> \- **Charlie Munger**, co-owner Berkshire Hathaway, in *Poor Charlie's Almanack*

In essence, equity investing is about forgoing purchasing power today for much higher purchasing power in future, adjusted for inflation and net of taxes. Given this, much like companies, equity investors too chase high returns on their investments. In the long run, equity investors can only make as much money and return as the company itself makes. Hence, it pays to invest in companies with formidable Economic Moats, as this is the only way to ensure sustained superior profitability and wealth creation.

Markets world over are replete with examples of how companies with "deep, dangerous moats" (read, sustainable competitive advantage) comprehensively outperform those without such moats, both in terms of financial performance and stock returns. In the following section, we present examples chosen across sectors in India.

1.3.1 Example #1: Hero MotoCorp v/s TVS Motor

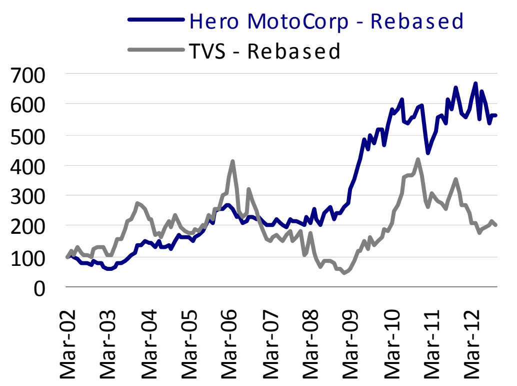
The facts

- Both Hero MotoCorp (then, Hero Honda) and TVS Motor (then TVS Suzuki) started business around the same time in the 1980s, when the Indian government permitted foreign investment.
- Both started off as Indo-Japanese joint ventures - Hero Group with Honda and TVS Group with Suzuki.
- The Indian promoters in both ventures had some background in India's transportation business - Hero was India's leading bicycle manufacturer, and TVS group owned several auto ancillary businesses.
- Still, Hero MotoCorp has gone on to become the world's largest two-wheeler company, whereas TVS Motor is struggling to retain its hitherto No. 3 spot in India's motorcycle market.

The figures

FY12	Hero MotoCorp	TVS Motor
Volume (m)	6.2	2.2
Mkt share (%)	40	14
Sales (INR b)	236	74
PAT (INR b)	22	1
RoE (%)	66	15
FY02-12:		
Sales CAGR (%)	18	14
PAT CAGR (%)	17	11
Avg RoE (%)	56	14

The picture: 363% outperformance (10-yr)



1.3.2 Example #2: Bharti Airtel v/s Tata Teleservices

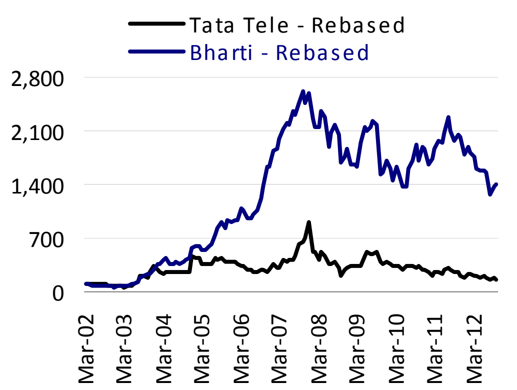
The facts

- Both Bharti and Tata Teleservices were incorporated in 1995 on the eve of India's telecom boom. In fact, unlike Bharti, Tata Tele had the rich legacy of India's foremost business group.
- Both companies have journeyed India's wireless explosion, including a near total value migration from wired telephony.
- Today, Bharti is India's largest telecom service provider, and was among India's leading market cap companies before the stock lost sheen on the back of heightened domestic competition and Bharti's own major foray into Africa.
- In contrast, Tata Teleservices is yet to report a single quarter of positive profit.

The figures

FY12	Bharti Airtel	Tata Tele
Sales (INR b)	715	25
PAT (INR b)	43	-5
RoE (%)	8	-ve
FY02-12:		
Sales CAGR (%)	47	25
PAT CAGR (%)	Loss to Profit	Loss to Loss
Avg RoE (%)	23	-9

The picture: 1240% outperformance (10-yr)



1.3.3 Example #3: L&T v/s HCC

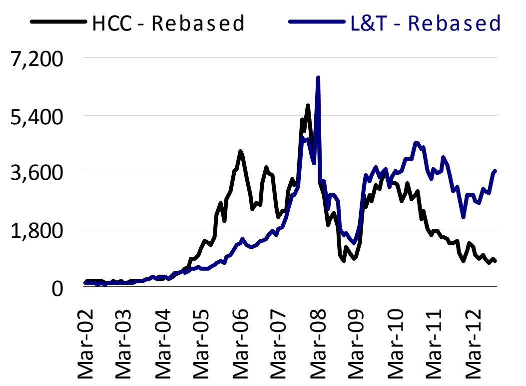
The facts

- Both L&T and HCC are long standing companies in India's construction industry. In fact, HCC was incorporated in 1926, much earlier than L&T in 1946.
- Both companies are primarily engaged in construction and related project activities, and have been beneficiaries of India's exponential growth in infrastructure, real estate and construction activity.
- Today, L&T is not only India's largest construction company, but also has developed global competitive edge. A la General Electric, it has also diversified into businesses such as IT, finance and power generation, and is poised to progressively unlock value in them.
- In contrast, HCC is struggling to remain profitable, with additional troubles on hand (BOT projects, environmental issues in its Lavasa City project, etc).

The figures

FY12	L&T	HCC
Sales (INR b)	643	82
PAT (INR b)	45	-4
RoE (%)	16	- ve
FY02-12:		
Sales CAGR (%)	22	32
PAT CAGR (%)	32	Profit to Loss
Avg RoE (%)	22	11

The picture: 2800% outperformance (10-yr)



1.3.4 Example #4: HDFC Bank v/s Central Bank

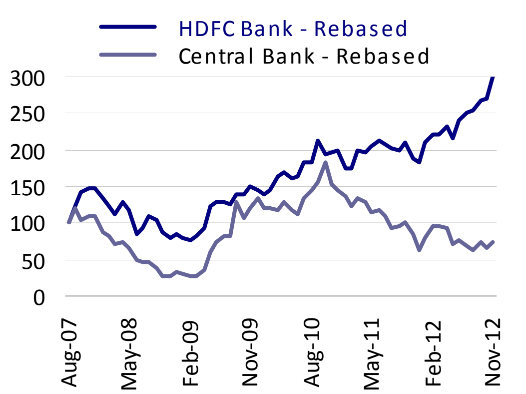
The facts

- Central Bank has recently completed 100 years of existence. HDFC Bank, in contrast, is less than 20 years old.
- Further, Central Bank's branches at over 4,000 are 60% more than HDFC Bank's 2,500. In contrast, HDFC Bank's ATMs at almost 9,000 are 5x that of Central Bank.
- Despite its huge early mover advantage and seemingly wider reach, Central Bank today significantly lags HDFC Bank on all key performance metrics - deposit base, loan book, NPAs, ROTA, RoE, etc.
- HDFC Bank's FY12 PAT is almost 10x that of Central Bank, but even more significantly, its current market cap is a whopping 27x!

The figures

FY12	HDFC Bank	Central Bank
Deposits (INR b)	2,465	1,962
Advances (INR b)	1,988	1,477
PAT (INR b)	52	6
RoE (%)	19	5
RoTA (%)	1.7	0.3
FY02-12:		
PAT CAGR (%)	33	14
Avg RoE (%)	18	17

The picture: 230% outperformance (5-yr)



2. Factors determining Economic Moat

Weave of industry structure and corporate strategy

"Why are some companies more profitable than others? ... The answer has two parts. First, companies benefit from (or are hurt by) the structure of their industry. Second, a company's relative position within its industry can account for even more of the difference."

- **Joan Magretta** in her book *Understanding Michael Porter*

Interestingly, a company's profitability and the strength of its Economic Moat are both determined by the same set of factors: (1) Industry structure, and (2) Company's own strategy.

2.1 Role of industry structure

The industry structure that a company faces is the first-level macro determinant of a company's profitability. As depicted by Porter's Five Forces Framework, the industry structure may be highly favorable or highly unfavorable or, in most cases, somewhere in between.

A favorable industry structure implies that competitors are likely to sink whenever they take the first step to breach it. On the other hand, an unfavorable industry structure makes it easy for competitors to step in.

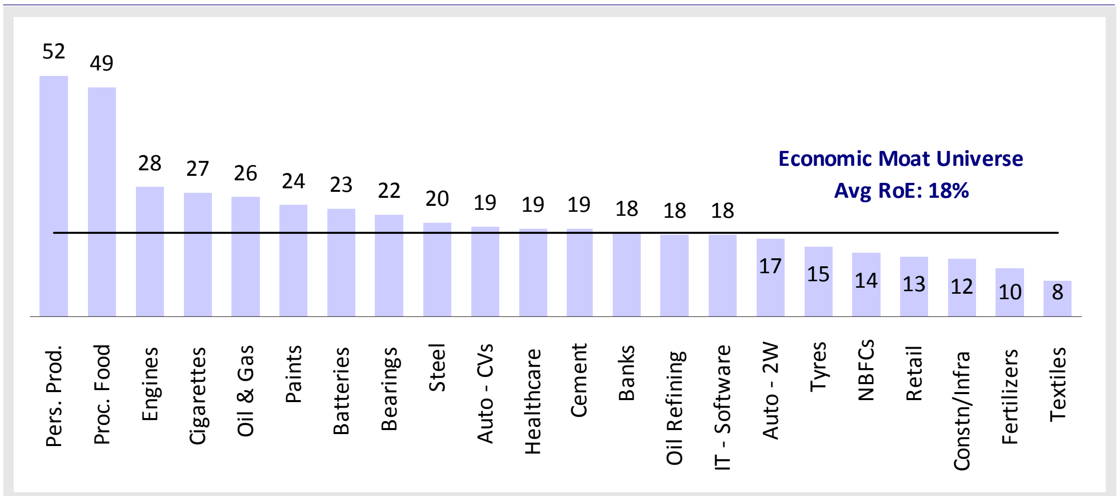
Whether an industry structure is favorable or not depends on several factors, some of which are listed below:

- **Bargaining power with customers:** This affects an industry's terms of trade on the revenue side such as product prices, volume discounts, credit period to customers, ability to pass on cost hikes, finished goods inventory levels, etc. Industries which supply to large, consolidated or well-informed buyers are adversely placed and vice versa. Likewise, if an industry's products can be easily substituted by buyers, it is adversely placed and vica-versa.
- **Bargaining power with suppliers:** This affects an industry's terms of trade on the cost side such as cost of raw materials, credit period from suppliers, ability to defer cost hikes, raw material inventory levels, wage negotiations with labor, etc. Industries with large and consolidated suppliers (including strong worker unions) are unfavorably placed and vice versa.
- **Entry barriers:** Ease of entry decides how quickly supernormal profits can be leveled off in an industry due to emergence of players. Some of the entry barriers to an industry include high capital cost, access to distribution network, government regulations (e.g. on imports, on safety and environment norms, etc).
- **Rapid changes in business environment:** Industries which are vulnerable to rapid and far-reaching changes in business environment are unfavorably placed vis-à-vis more stable industries. For instance, companies in dynamic businesses face overnight obsolescence if a better substitute product or service emerges e.g. audio/video cassettes, film-based photography, pagers, etc. This phenomenon is particularly true in businesses involving high R&D spend such as healthcare and technology.
- **Government policy:** Government policies on various aspects of doing business determine whether or not an industry is favorably placed.

Examples of how industry factors which affect moat

Industry factor	Examples of favorably placed	Examples of unfavorably placed
1. Bargaining power with customers	✓ Computer chip industry (duopoly) ✓ OPEC (global bargaining power)	× Auto ancillaries (supplies to large OEMs) × Unorganized sector
2. Bargaining power with suppliers	✓ Auto OEMs (buy from small parts suppliers) ✓ Large consumer and retail companies e.g. Walmart	× Auto ancillaries (purchase from metals majors) × Plastic processors (purchase from petchem giants) × Glass bottles industry (threat of plastic bottles)
3. Entry barriers	✓ Indian banking (due to licensing restrictions) ✓ Industries with large capital outlays and gestation period such as Oil & Gas, Power, Petrochemicals, Hotels, etc	× Internet-based businesses × Business without specialized skill-sets e.g. general manufacturing, travel agency, etc
4. Government policy	✓ Indian cigarettes industry (no new entrant, whether local or global) ✓ Government ruling on mandatory digitization is highly favorable for Indian TV industry	× Many Indian power generation companies operate on regulated return on capital. × The Indian government's new Drug Pricing Control Order is likely to regulate selling prices of several drugs, affecting the Healthcare sector

Interplay of various forces create wide variations in industry profitability (1995-2002 Avg RoE, %)



2.2 Role of company strategy

As the moat created by the industry structure is broadly the same for all industry incumbents. A weak company in the industry remains vulnerable to both, incumbents and new entrants. Therefore, it is the company's strategy which finally influences the quality of its moat, by making it dangerous for others to try and breach it.

Company's strategic issues which affect moat

Positive impact	Negative impact
✓ Strong brand and/or lowest cost	✗ No unique competitive advantage
✓ High focus on core competence	✗ Diversification into unrelated businesses and/or new geographies
✓ Scale and continuity through innovation, steady capacity expansion	✗ Attempt to achieve scale through large acquisitions, whether domestic or global
✓ High level of ethics and compliance with the law of the land	✗ Lapses in corporate governance by way of unethical or illegal business practices
✓ Balanced approach towards all stakeholders – customers, employees, shareholders, and society at large	✗ Excessive focus on shareholders, and that too the majority owner-shareholders

What is strategy? Very often, the term 'strategy' is confused with things like vision, goal, action plan, decision-making, etc. However, **strategy is all about ensuring that a company creates and/or maintains its competitive edge over rivals i.e. at least defends its Economic Moat and ideally deepens it.** There are several frameworks for a company strategy. Here, we find that Porter's own Value Chain framework integrates well with the concept of Economic Moat (see box below for 5 key elements of Porter's strategy framework.).

Porter's Value Chain cum Strategy framework

A good strategy is one that will sustain superior economic performance for a company, and must pass the following 5 tests -

1. **Distinctive value proposition (to customers):** This emerges from Porter's belief that companies should not compete to be the best, but to be unique. Thus, the first step to achieve this is to meet customer needs differently from rivals by (1) choosing the target customer, (2) identifying the needs, and (3) creating a product or service which addresses both (1) and (2).
2. **Tailored Value Chain:** A Value Chain is the sequence of activities that a company performs to design, produce, sell, deliver, and support its products. In turn, it is part of a company's larger Value System i.e. all activities and players involved to deliver its value proposition, including suppliers, distribution channel, etc. A tailored value chain makes a company's value proposition hard to replicate.
3. **Trade-offs different from rivals:** This essentially involves deciding on what a company will or will not do, differently from its rivals e.g. budget airlines do not offer free food and beverages on board, as they are targeting only those customers whose focus is not food, bur rather to reach their destination faster (than rail, road, etc).
4. **Fit across value chain:** Fit determines how well the value chain activities connect with each other to amplify the company's value proposition, thereby making it even harder to replicate e.g. Globally, Domino's is focused on home delivery of pizzas. Therefore, its outlets are smaller than those of Pizza Hut, which are designed for dine in. In fact, even the Domino's pizza is tailored for home delivery so that it does not get soft and soggy during delivery.
5. **Continuity over time:** Continuity gives an organization the time it needs to deepen its understanding of the strategy. Sticking with a strategy allows a company to more fully understand the value it creates and to become really good at it. Continuity improves an organizations's ability to adapt to changes and to innovate.

2.2.1 Company strategy: Two case studies

We present two case studies of Indian companies which illustrate the Value Chain framework.

Case Study #1: Jubilant Foodworks

The Strategy Framework: The "Domino" effect hits pizza demand

A. Brief description & backdrop

Jubilant Foodworks has entered into a Master Franchise Agreement with Domino's International, which provides them with the exclusive right to develop and operate Domino's pizza delivery stores in India, Nepal, Bangladesh and Sri Lanka. It is growing rapidly in terms of sales, profits and market cap. Recently, it has also entered into a similar arrangement with Dunkin' Donuts to offer a range of donuts and coffee. The menu has been customized for India to include select Indian snack foods as well.

B. Nature of competition

Jubilant competes with QSRs (quick service restaurants) across categories - pizza (e.g. Pizza Hut), burgers (e.g. McDonalds), other breads (e.g. Subway), Indian QSRs (e.g. Dosa Diner).

C. Strategy elements

1. Distinct value proposition

- Hot, ready-to-eat food (pizza) delivered at your doorstep

2. Tailored value chain

- **Several, small outlets:** Domino's has a large number of outlets across the country. However, they are mostly small-sized outlets, designed to discourage dine-in, as their core proposition is home delivery.
- **All owned outlets:** All of Jubilant Foodworks outlets are company owned and operated to ensure no compromise on quality.
- **Pizza more suited for home delivery vis-à-vis rivals:** The pizza dough, other materials used and the baking process of Domino's allows for pizzas to remain fresher and crisper after budgeting delivery time. (Pizza of rivals are more designed for dine-in, and tend to get softer and soggier during the process of home delivery.)

3. Trade-offs

- **Yes to home delivery, no to dine-in:** This is the very first trade-off in the sense that Domino's outlets actually discourage dine-in.
- **Yes to pizza and related products, no to others:** Domino's is focused only on pizzas and related side-dishes like garlic bread and cake.
- **Yes to company owned outlets, no to franchising** (as explained earlier).

4. Fit across value chain

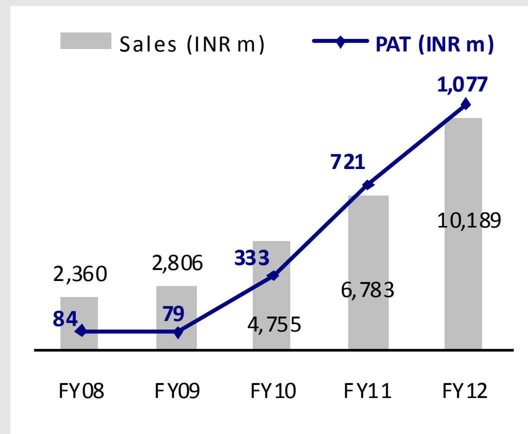
- **Product fit:** The pizza is more suited for home delivery vis-à-vis rivals.
- **Place fit:** Smaller outlets save on rentals, and make up for the occasional dine-in customers that may be lost.
- **Promotion fit:** Every pizza delivered is accompanied by a discount coupon on the next purchase with time validity. This induces repeat purchase.
- **Ordering channel fit:** To ensure that it does not lose orders on account of busy phone lines, and to save on high manpower costs, Domino's is encouraging orders to be placed online by marginally lower pricing.

5. Continuity over time

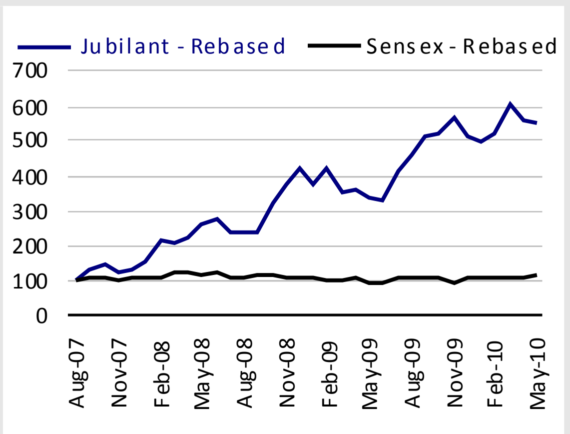
- **Nascent market:** The pizza market in India is nascent and has tremendous room for growth. Jubilant is well placed to leverage its competitive advantage to gain massive scale.
- **Expansion:** Jubilant is continuously adding outlets and entering new cities – within a short span of time, it has established its presence in over 105 cities with over 465 outlets.
- **Replication of Domino's story:** Cash flows from Domino's are being ploughed to replicate the Domino success story with Dunkin' Donuts. The donuts category is currently at the same stage as pizza was when Jubilant entered the business. Domino's and Dunkin' may well prove to be a highly successful combination, making Jubilant's Economic Moat a "Deep & Dangerous" one.

D. The Success Payoff

Sales and PAT Chart



Stock Price Chart



Case Study #2: Bajaj Auto

The Strategy Framework: Re-Discover lost Economic Moat

A. Brief description & backdrop

Bajaj Auto is one of India's earliest manufacturers of two-wheelers. The scooter was the company's staple product for several years. With scooters as the core, the positioning was extended to mopeds and 3-wheelers. In the 1990s, Bajaj Auto's Economic Moat was severely dented by -

(1) The entry of motorcycles; and

(2) The introduction of the gearless scooter by Honda under Kinetic Honda.

The current Managing Director Mr Rajiv Bajaj took over the reins from his father and predecessor Mr Rahul Bajaj in early 2000s.

B. Nature of competition

Competition was intense with the onset of Indo-Japanese motorcycles on the one hand (Hero Honda, TVS Suzuki and Escorts Yamaha), and gearless scooters by Honda on the other. Bajaj's then existing products soon lost their value proposition. Subsequently, Rajiv Bajaj revived the company's competitive advantage. The elements of the strategy he pursued are as given in the following section.

C. Strategy elements

1. Distinct value proposition

- **Sportier, powerful bike:** Bajaj positioned itself firmly in the upwards of 125cc market with Discover and Pulsar brands. The products were positioned as sporty and powerful, vis-à-vis the typical Indo-Japanese bikes positioning of light and fuel-efficient vehicles.

2. Tailored value chain

- **Focus on urban youth:** The product positioning was in line with the marketing focus on urban youth.
- **Lower emphasis on mother brand 'Bajaj' in favor of product brands:** All of Bajaj's advertising is focused on promoting the product sub-brands such as Discover and Pulsar, as the Bajaj brand is associated with a wide range of products - from fans to hair oil.
- **Leveraging domestic scale efficiencies to export competitively priced motorcycles:** Bajaj exports its bikes to other developing countries e.g. in Africa.

3. Trade-offs

- **Yes to motorcycles, no to scooters:** Bajaj does not sell even a single scooter today.
- **Yes to premium powerful, sporty bikes, no to entry-level bikes:** Bajaj sells a very small quantity of mass market bikes.
- **Yes to two-wheelers, no to cars or other vehicles**

4. Fit across value chain

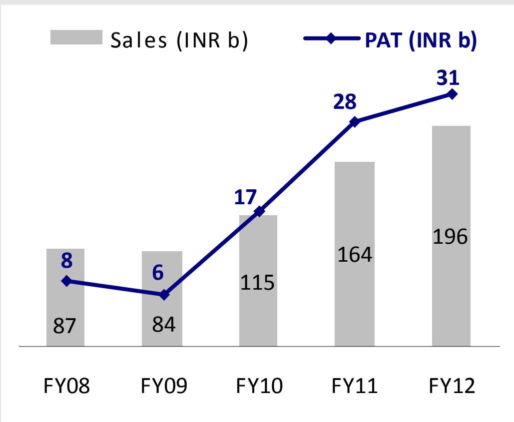
- There is a strong fit within Bajaj Auto's product positioning, promotion and pricing, all combining to make Bajaj Auto one of the most profitable two wheeler companies in the world.

5. Continuity over time

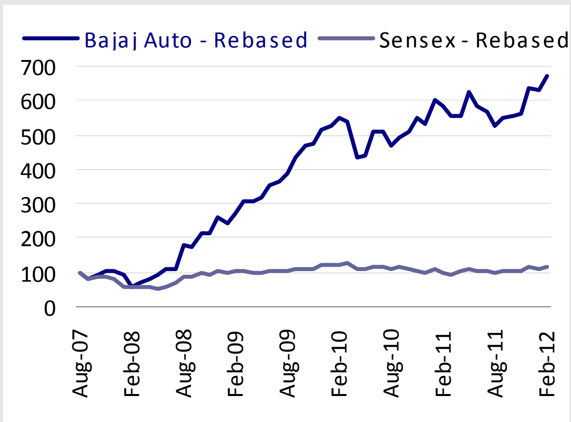
- The company has acquired a 50% stake in KTM, an Austrian manufacturer of sports bikes, to further fortify its global competitive advantage.

D. The Success Payoff

Sales and PAT Chart



Stock Price Chart



3. Applying Economic Moat concept to investing

Buy profit castles with deep and dangerous moats

"Competitive strategy analysis lies at the heart of security analysis."
- **Alfred Rappaport & Michael Mauboussin**, in their book *Expectations Investing*

A truly great business must have an enduring "moat" that protects excellent returns on invested capital.
- **Warren Buffett** in his 2007 letter to Berkshire Hathaway shareholders

The concept of Economic Moat has implications for both companies and investors -

- **For companies:** Truly successful companies are those which intricately weave industry structure and their own strategy to create and defend an unbreachable Economic Moat, ensuring superior profits and high profitability over peers for generations.
- **For investors:** Investors can use the above frameworks to actively seek out companies with "Deep & Dangerous Moats", run by "honest and decent leaders" (to use Buffett's words). This way, investors can ensure that they continue to enjoy their share of the "gold" which the leaders make within the safety of their moat.

In the subsequent sections, we -

1. Present our findings of backtesting the concept of Economic Moat investing, and demonstrate how the strategy works extremely well for equity investing; and
2. Apply the same methodology to Nifty constituent companies both then and now.

3.1 Backtesting the Economic Moat investing hypothesis

As stated through this report, companies with "deep and/or dangerous" moat tend to enjoy superior profits and profitability for sustained periods of time. Thus, such companies are widely acknowledged by the markets as great companies, giving rise to the often heard quote – "great companies are rarely great stocks". The seeming rationale behind this is that while there is no denying the high quality of EMCs (Economic Moat Companies), their premium valuations ensure that they do not generate adequate returns on the bourses.

Accordingly, we backtested the Economic Moat hypothesis over the 17 years between 1995 and 2012. In this section, we present our key steps and findings of the backtest.

Step 1: The Economic Moat hypothesis

Investing in a **portfolio of companies** of EMCs should lead to sustained outperformance over benchmark indices across years, irrespective of market conditions.
(**Note:** The keyword here is portfolio of companies. Else, critics are prone to point out the one-off cases of a Hindustan Unilever underperforming for almost 11 years since 1994 or an Infosys underperforming for 10 years since its peak of 2000.)

Step 2: Establishing criteria for Economic Moat

This was the key challenge for our backtesting as Economic Moat is a highly qualitative concept, not easily reducible to numbers. So, in deciding our final methodology, we applied two key principles of Economic Moat -

1. A company's Economic Moat needs to ultimately reflect in its financials with return on investment significantly superior to peers.

2. Economic Moat or competitive advantage holds true only within a particular sector and not across sectors. Thus, a consumer facing company enjoying RoE in excess of 50% cannot be deemed to enjoy a superior over a bank which earns 20% RoE.

For the academically inclined, we present our full methodology on page 35. In essence, we compared RoE of companies in the same sector vis-à-vis the sector average for 8 years 1995 to 2002. Companies whose RoE was higher than sector average for 6 years or more were deemed to enjoy an Economic Moat. Having flagged off companies with or without Economic Moat, we observed their stock performance over next 10 years to 2012.

Step 3: The findings

We believe our backtesting has thrown up several interesting findings, many of them counterintuitive.

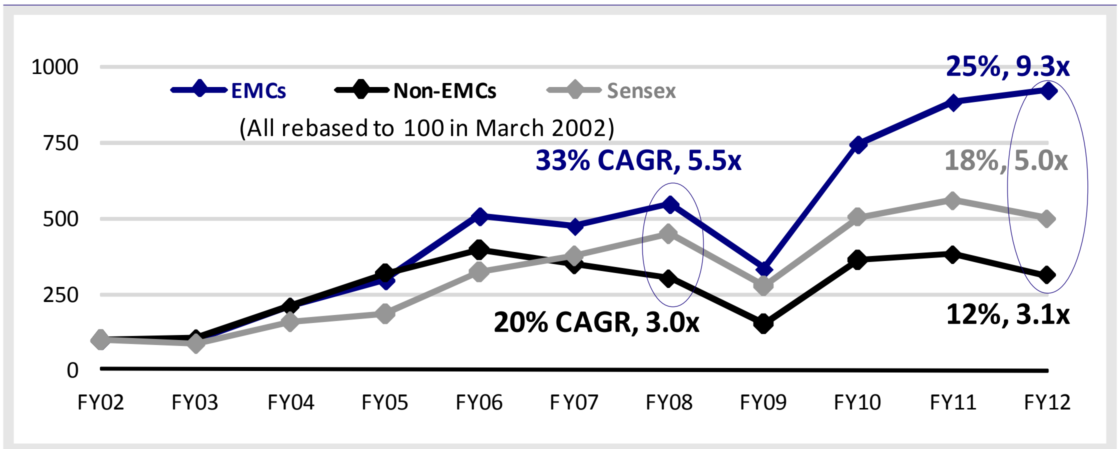
Finding #1 - EMCs handsomely outperform

A portfolio of companies with Economic Moat bought and held for 10 years comfortably outperforms benchmark indices every year over the next 10 years. Further even in terms of annual return, performance of EMCs matches that of non-EMCs for the initial 3 years, before meaningful outperformance sets in from Year 4 every year. Besides, average stock returns on EMCs are 2x that of non-EMCs.

EMCs outperform benchmark, but non-EMCs don't

	EMCs	Non-EMCs	Overall
Return	25%	12%	18%
Sensex	18%	18%	18%
Alpha	**7%**	**-6%**	**0%**

Payoff profile of EMCs, non-EMCs and Sensex (2002-2012)



Finding #2 - EMCs' outperformance is earnings and valuations agnostic

This is arguably one of the most liberating conclusions from the investor's perspective. Most investors are faced with two ordeals - (1) forecasting earnings of stocks, and (2) assessing market's likely valuation of the stock based on the same. However, in our testing, we applied no criteria (past, present or future) other than that of Economic Moat, which is a far easier call to make than a stock's future earnings growth and valuation.

The most plausible explanation for this is as follows -

- **Earnings agnosticism** arises from EMCs' strong competitive advantage which ensures that they enjoy a more-than-fair share of the growth inherent in most sectors in India.
- **Valuation agnosticism** may well be explained by the phenomenon of continuous rollover of EMCs' competitive advantage period (CAP), as explained in the box on page 30.

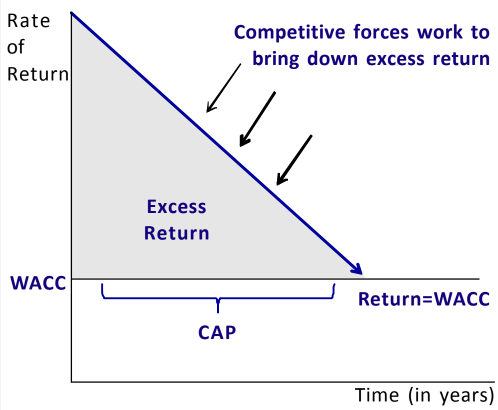
Why EMCs delivery healthy returns over time despite premium valuations

World over, even seasoned investors struggle to explain a profound mystery: **Why do companies with strong franchises (i.e. deep Economic Moat) continue to outperform the market despite their perennial rich valuations?** The answer may well lie in the continuous roll-over of these companies' competitive advantage period or CAP.

What is CAP?

Competitive advantage period (CAP) is the time during which a company is expected to generate returns on incremental investment that exceed its cost of capital. As discussed in the context of Economic Moat, if a company earns supernormal return on its invested capital, its business will attract competitors that will accept lower returns, eventually driving down overall industry returns to economic cost of capital, and sometimes even below it. (The Indian telecom industry is currently a classic case of this phenomenon.)

Markets intuitively value companies based on CAP ...



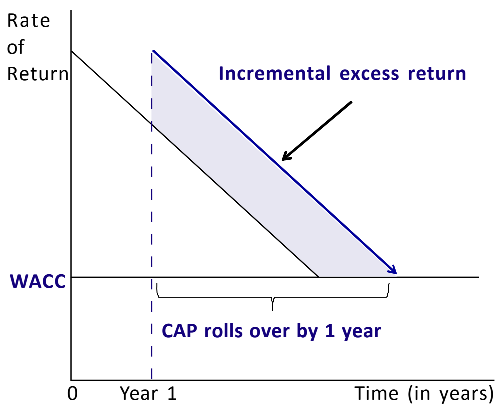
The idea of CAP is graphically presented alongside. Obviously, longer the CAP, the better it is for both the company and its investors.

CAP rollover: Excess returns of EMCs explained

Markets are generally efficient and do indeed assign premium valuations to EMCs (Economic Moat Companies), given their reasonably accurate assessment that such companies enjoy a very long CAP.

Where the markets fail is in recognizing that barring a low mortality rate of less than 15%, these EMCs continue to draw upon the strength of their moat and sustain their high return with passage of time. Thus, as brilliantly put by Michael Mauboussin in a paper written way back in 1997 that with each passing year, the CAP period of EMCs simply rolls over, creating **incremental** excess return for investors in these stocks, as represented alongside.

... but markets are unable to appropriately value EMCs whose CAP rolls over with every passing period



This rollover phenomenon continues so long as EMCs successfully at least defend (if not deepen) their moat, leading to their stock achieving both sustained outperformance in the markets, despite their premium valuations.

Finding #3 - EMCs' outperformance is sector agnostic

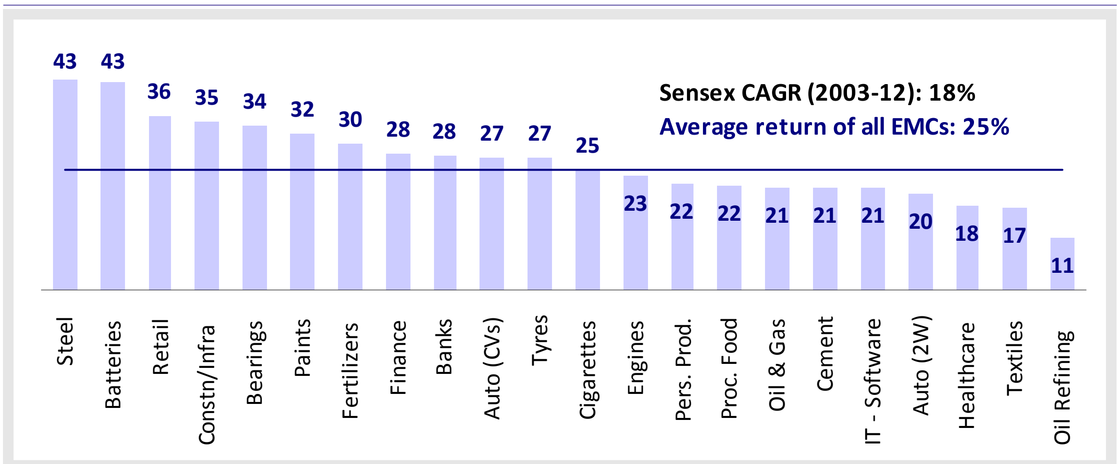
Stocks of EMCs are likely to outperform benchmarks across sectors, even if the sector itself is out of market favor. Thus, out of our 22 homogenous sector groupings, EMCs underperformed the BSE Sensex in only two sectors – Oil Refining and Textiles.

The mother buckets' average price performance (2003-12)

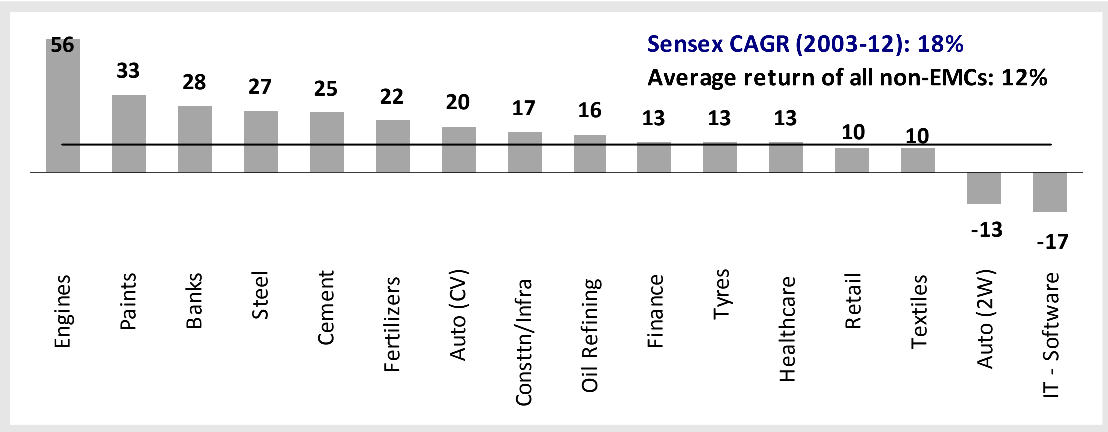
	EMCs (2002)		Non-EMCs (2002)		Sector	
	Price CAGR	Cos.	Price CAGR	Cos.	Price CAGR	Cos.
Auto Ancillaries - Batteries	43	2			43	2
Auto Ancillaries - Bearings	34	3			34	3
Auto Ancillaries - Tyres	27	2	13	3	19	5
Automobile - 2W	20	1	-13	2	-2	3
Automobile - CV	27	1	20	2	22	3
Banks	28	11	28	11	28	22
Capital Goods - Engines	23	2	56	1	34	3
Cement	21	3	25	7	24	10
Cigarettes	25	3			25	3
Construction / Infrastructure	35	2	17	4	23	6
Fertilizers	30	3	22	8	25	11
Finance	28	6	13	4	22	10
IT - Software	21	3	-17	14	-10	17
Metals & Mining - Steel	43	2	27	3	33	5
Oil & Gas	21	3			21	3
Oil & Gas - Refining	11	4	16	1	12	5
Paints	32	2	33	2	32	4
Personal Products	22	5			22	5
Pharmaceuticals	18	9	13	22	14	31
Processed Food	22	3			22	3
Retail	36	1	10	5	15	6
Textiles	17	3	10	14	11	17
Avg Price CAGR / Total cos.	**25**	**74**	**12**	**103**	**18**	**177**

Note: Shaded area is to indicate which of the two group of stocks has outperfomed in a sector
Sectors circled denote EMCs' underperformance to Sensex

2003-12 Average Price CAGR of EMCs by sector



2003-12 Average Price CAGR of non-EMCs by sector



Finding #4 - Future not too meaningful for EMCs, but critical for non-EMCs

We applied the same RoE-based methodology to assess the backtested companies' Economic Moat in the "future" i.e. 2003 to 2012. The most interesting findings are -

- Economic Moats are generally structural; thus, over the next 10 years, only 25 companies upgraded to EMCs out of an initial 103 non-EMCs (i.e. status quo rate of over 75%). Those who did not improve their Economic Moat delivered only 8% return v/s benchmark return of 18%.
- More interestingly, only 12 out of 74 initial EMCs slipped into non-EMCs i.e. status quo rate of 84% and mortality rate of only 16%. But then, even these fallen stars delivered higher than market performance.
- Besides, even going right on the future competitive strength of EMCs did not make a huge difference to returns. In contrast, making the right call on the future of non-EMCs has the highest payoff of 27% compounded over 10 years, but with low probability of only 25%.
- Even the 2003-12 earnings CAGR of EMCs at 18% was comparable with the 21% clocked by upgraded EMCs.

Stock returns matrix of EMCs and non- EMCs

Appraisal period EMCs (2003-12)	Yes	27%	26%
	No	8%	20%
		No	Yes
		Study period EMC (1995-02)	

Note: Sensex return during 2003-12 is 18%
Outperforming quadrants are in blue.

Earnings growth matrix of EMCs & non-EMCs

Future EMCs (2003-12)	Yes	21%	18%
	No	7%	10%
		No	Yes
		Study period EMC (1995-02)	

EMCs's stock performance is even future agnostic!

Sector	EMC (Current Yes; 74 cos) Current-Future		EMC (Current No; 103 cos) Current-Future		Sector Avg Price CAGR (177 cos)
	Y-Y (62 cos)	Y-N (12)	N-Y (25)	N-N (78)	
Auto Ancillaries - Batteries	43				43
Auto Ancillaries - Bearings	39	23			34
Auto Ancillaries - Tyres	27		29	5	19
Automobile - 2W	20			-13	-2
Automobile - CV	27			20	22
Banks	31	16	33	26	28
Capital Goods - Engines	29	18	56		34
Cement	21		28	24	24
Cigarettes	25				25
Construction / Infrastructure	35		19	16	23
Fertilizers	35	21	27	19	25
Finance	27	34		13	22
IT - Software	15	33	7	-26	-10
Metals & Mining - Steel	43		34	23	33
Oil & Gas	21				21
Oil & Gas - Refining	8			16	10
Paints	32			33	32
Personal Products	22				22
Pharmaceuticals	20	10	31	6	14
Processed Food	22				22
Retail		36	57	-1	15
Textiles	24	3	15	9	11
Average Price CAGR	**26**	**20**	**27**	**8**	**18**

Note: Shaded area is to indicate which of the two group of stocks has outperfomed in a sector

3.4 Applying the methodology on Nifty stocks

We backtested our EMC hypothesis on companies which constituted the Nifty in 2002. 38 of 50 companies were common between then Nifty and our Economic Moat Universe of 177 companies. Of these, 29 companies were deemed to be EMCs then and 9 companies to be non-EMCs. During the price performance period 2003-12, the EMCs clocked price CAGR of 22% v/s 16% for non-EMCs and overall return of 20%.

Further, applying the "future (i.e. 2003-12)" EMC test also threw up results similar to that of the broader universe –

- 22 of the 29 initial EMCs remained EMCs, but the total return remained the same at 22% CARG.
- 7 companies regressed to non-EMC and delivered 14% CAGR.
- 3 of the 9 initial non-EMCs maintained status quo and returned only 4% CAGR.
- The balance 6 non-EMCs upgraded to turn EMCs, and delivered returns of 21%, in line with that of status quo EMCs.

Avg stock returns on 2002 Nifty EMCs non-EMCS

	Price CAGR %	No. of cos.
EMCs	**22**	**29**
Non-EMCs	16	9
Overall	**20**	**38**

Note: Nifty return during 2003-12 is 17%

Avg stock returns matrix on Nifty constituents

Future EMC (2003-12)			
	Yes	**21%**	**22%**
	No	4%	14%
		No	**Yes**
		Study period EMC (1995-02)	

Based on our backtesting methodology, the current constituent companies of Nifty can be classified as EMCs as non-EMCs as tabled below. If our findings hold going forward (and we have reasons to believe they will), the ECMs among Nifty should meaningfully outperform both the non-EMCs and overall Nifty index.

Nifty constituents: EMCs and non-EMCs

Nifty EMCs (33 companies)		Nifty non-EMCs (17 companies)	
ACC	Jindal Steel	B P C L	JP Associates
Ambuja Cement	Kotak Mahindra Bank	Bank of Baroda	Ranbaxy Labs
Asian Paints	Larsen & Toubro	Cipla	Reliance Inds
Axis Bank	Lupin	DLF	Reliance Infra
B H E L	M & M	Dr Reddy's Labs	Sesa Goa
Bajaj Auto	Maruti Suzuki	HCL Technologies	Siemens
Bharti Airtel	NTPC	Hindalco Inds	Tata Power
Cairn India	O N G C	ICICI Bank	Tata Steel
Coal India	Power Grid Corporation	I D F C	
GAIL (India)	Punjab National Bank		
Grasim Inds	State Bank of India		
H D F C	Sun Pharma		
HDFC Bank	Tata Motors		
Hero MotoCorp	TCS		
Hind Unilever	UltraTech Cement		
Infosys	Wipro		
ITC			

4. Conclusions

- Consumer sector has bounced back into wealth creation - ITC is the largest wealth creator, TTK Prestige the fastest and Hindustan Unilever is back in the top 10.
- Financials has emerged the largest wealth creating sector for the second time in a row. Absence of new entrants is leading to widespread profitability and stock performance.
- Economic Moat protects the profit of companies from competitive attack.
- Extended CAP (competitive advantage period) of Economic Moat Companies (EMCs) leads to superior levels of profits and stock returns.
- Over 2002-2012, EMCs in India have meaningfully outperformed benchmark indices.
- Breach of Economic Moat causes massive wealth destruction e.g. the Telecom sector has moved from a leading wealth creating sector 4 years ago to the top wealth destroyer in 2012.
- Markets seem poised to touch new highs in the next 12 months.

APPENDIX: Economic Moat – Backtesting methodology

We backtested our Economic Moat hypothesis over the 17 years between 1995 and 2012. In this section, we present the key steps and nuances in our methodology.

Step 1: The Economic Moat hypothesis

Investing in a portfolio of companies of EMCs (Economic Moat Companies) should lead to sustained outperformance over benchmark indices across years, irrespective of market conditions.

Step 2: Establishing criteria for Economic Moat

This was the key challenge for our backtesting as Economic Moat is a highly qualitative concept, not easily reducible to numbers. So, in deciding our final methodology, we applied two key principles of Economic Moat -

1. A company's Economic Moat needs to ultimately reflect in its financials, with return on investment significantly superior to peers.
2. Economic Moat or competitive advantage holds true only within a particular sector and not across sectors. Thus, a consumer-facing company enjoying RoE in excess of 50% cannot be deemed to enjoy a superior Economic Moat over a bank which earns 20% RoE.
3. An Economic Moat is not about being the best or the biggest or even the most profitable, but about being unique.

We applied these principles as follows -

- **Economic Moat Period (EMP):** We intended to test the stock market returns of EMCs across economic and equity cycles. Accordingly, we fixed the price performance period as 2002-2012. This price performance period implied that we identify EMCs as on financial year ending March 2012, and observe their subsequent equity returns. For this purpose, **our EMP was the 8-year period from 1995 to 2002**.
- **Economic Moat Universe (EMU):** We shortlisted our EMU based on 3 criteria: (1) Minimum financial history of 8-years ending 2002, (2), Market cap of at least INR500m as on 31 March 2012 (this was done merely to restrict the EMU to a reasonable size), and (3) From the shortlist given by (1) and (2), select as my homogenous companies as possible. **Our total EMU is 177 companies**.
- **Whether EMC or no in 2002:** To achieve this, we first classified most of the 177 companies into homogenous groups with at least two players. However, most consumer companies do not have comparable peers, though one of their divisions may be competing against each other. In these cases, given their high absolute RoEs, we deem them to enjoy Economic Moat. For others, we calculated the average sector RoE for each of the 8 years 1995 to 2002. **A company was decided to be an EMC if for at least 6 of the 8 years, its RoE was higher than the industry average**. However, even here, if the RoE data suggested a clearly broken business model closer to the investment period, we deemed the Economic Moats of such companies to be drying up. Also, in some homogenous groups with few companies, we considered cases where all of them enjoyed a Economic Moat, deviation from sector average notwithstanding.
- **Whether EMC or no in 2012:** We followed the above process for 2012 as well, except that the EMP was 10 years (2002 to 2012) and the greater-than-industry-average threshold was raised to 7 years.

Step 3: The final 6 buckets

EMCs were flagged off as "Y" and non-EMCs as "N", both in 2002 and 2012, which formed the two mother buckets. Next, depending on how the Economic Moat of companies shaped during the 10 years, 4 more observation buckets emerged -

- **"Y-Y"** - EMC in 2002 which sustained its moat to remain an EMC in 2012 as well
- **"Y-N"** - EMC in 2002 whose moat got breached by 2012
- **"N-Y"** - Non-EMC in 2002 which strengthened in moat to emerge an EMC by 2012, and
- **"N-N"** - Non-EMC in 2002 which remained a non-EMC even in 2012.

Step 4: The final observations

We observed the 2003-12 stock price CAGR of companies in each of these bucket portfolios. The master table is given below, which led us to conclude that EMCs handsomely outperform the market with very low mortality rate of less than 15%. Most interestingly, the observations were future agnostic, sector agnostic, earnings growth agnostic, and even valuation agnostic.

The mother buckets' average price performance (2003-12)

	EMCs (2002)		Non-EMCs (2002)		Sector	
	Price CAGR	Cos.	Price CAGR	Cos.	Price CAGR	Cos.
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Construction / Infrastructure	35	2	17	4	23	6
Fertilizers	30	3	22	8	25	11
Finance	28	6	13	4	22	10
IT - Software	21	3	-17	14	-10	17
Metals & Mining - Steel	43	2	27	3	33	5
Oil & Gas	21	3			21	3
Oil & Gas - Refining	11	4	16	1	12	5
Paints	32	2	33	2	32	4
Personal Products	22	5			22	5
Pharmaceuticals	18	9	13	22	14	31
Processed Food	22	3			22	3
Retail	36	1	10	5	15	6
Textiles	17	3	10	14	11	17
Avg Price CAGR / Total cos.	**25**	**74**	**12**	**103**	**18**	**177**

Stock returns matrix of EMCs and non- EMCs

Appraisal period EMCs (2003-12)		Study period EMC (1995-02): No	Study period EMC (1995-02): Yes
	Yes	**27%**	**26%**
	No	8%	**20%**

Note: Sensex return during 2003-12 is 18%

Outperforming quadrants are in blue.

Earnings growth matrix of EMCs & non-EMCs

Future EMCs (2003-12)		Study period EMC (1995-02): No	Study period EMC (1995-02): Yes
	Yes	21%	18%
	No	7%	10%

Wealth Creation

2007-2012

The 17TH Annual Study

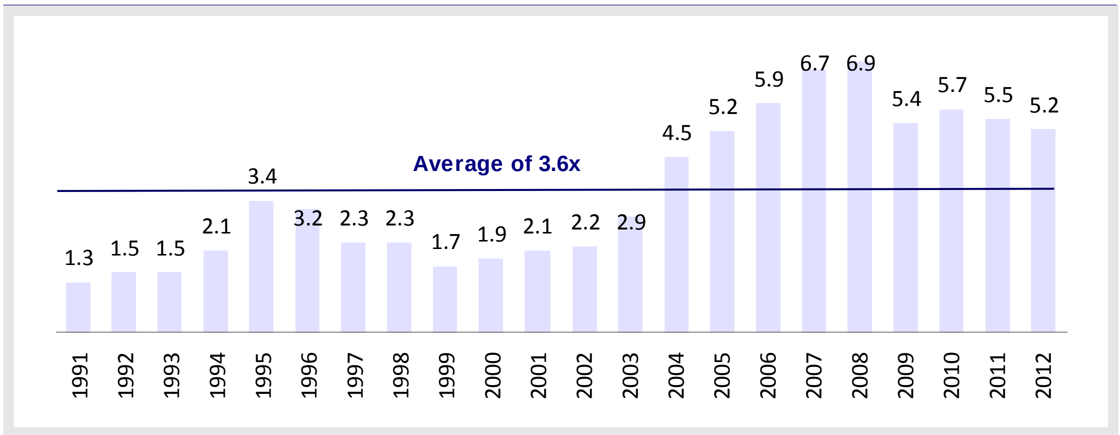
Market Outlook

Market Outlook

Corporate Profit to GDP

Corporate Profit moved up from 3% of GDP in 2003 to a peak of almost 7% in 2008 on the back of high economic growth and rising commodity prices. Corporate profit to GDP has steadiliy declined since, and should be around 5% for 2013 close to the last 10-year average of 4.6%. Corporate Profit growth is expected to remain at 10%.

Corporate Profit to GDP (%)



Interest Rate

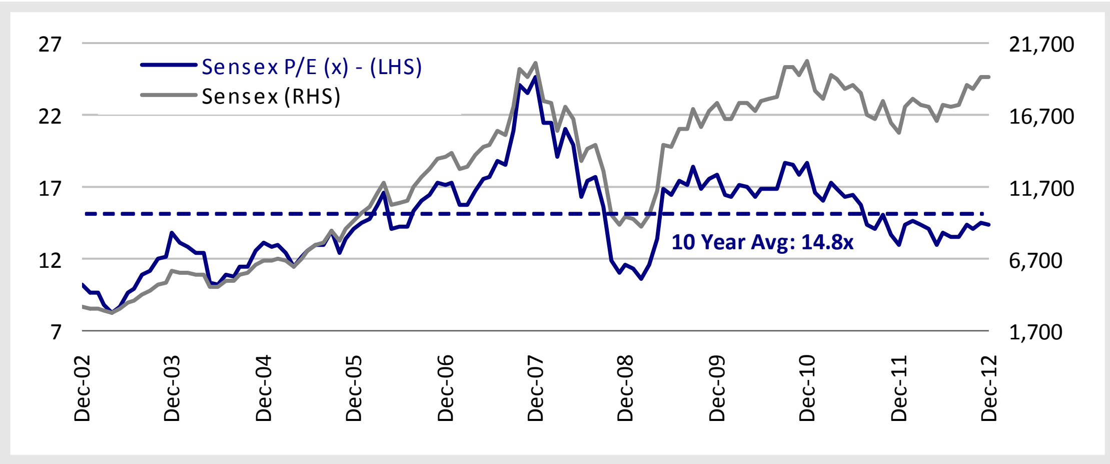
After hitting a peak of 9% last year rates have softened to 8.2% and are expected to further fall over the next year.

10-year G-Sec Yield (%)

Sensex P/E

Despite a 20% increase in the Sensex during the year, the Sensex forward P/E is currently at about 14.4x which is around long-term average and reasonable.

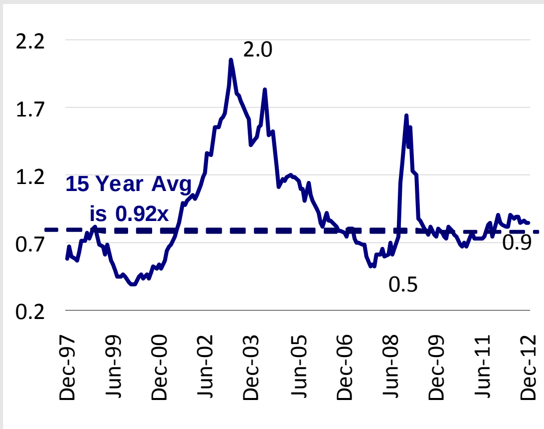
Sensex P/E (x) and Sensex



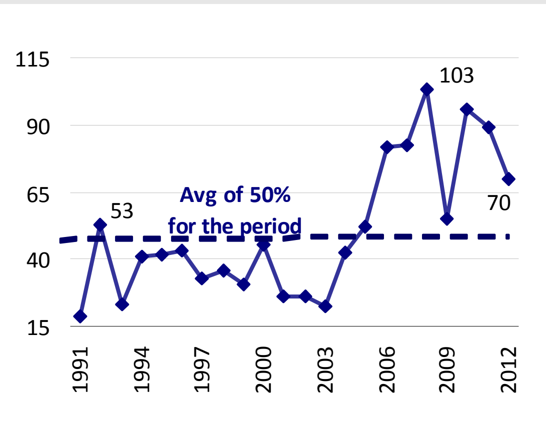
Earnings Yield to Bond Yield

The current Earnings Yield to Bond Yield at 0.9x is just below parity, and is reasonable in the backdrop of current high interest rates, and expected fall in rates over the next one year.

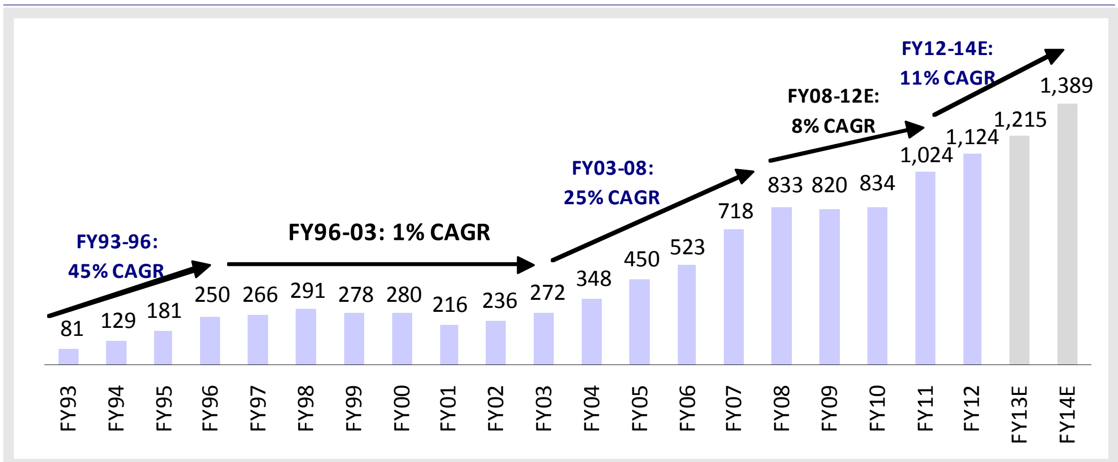
Sensex Earning Yield to Bond Yield (x)



Market Cap to GDP (%)



Sensex EPS



Conclusion

Earnings growth of around 10%, imminent moderation in interest rate, and reasonable current valuation has improved the probability of the market going into new highs in the next 12 months.

Appendix I: MOSL 100 – Biggest Wealth Creators

Ranked according to The Biggest Wealth Creators

		Wealth Created		CAGR (2007-12, %)			RoE (%)		P/E (x)	
Rank	Company	INR b	Share (%)	Price	PAT	Sales	2012	2007	2012	2007
1	ITC	1,187	7	25	17	16	35	28	29	21
2	TCS	1,082	7	14	20	21	38	56	22	29
3	HDFC Bank	744	5	22	36	33	19	19	23	27
4	MMTC	671	4	48	-8	23	5	14	761	70
5	H D F C	558	3	17	26	36	19	19	18	22
6	State Bank of India	556	3	17	19	22	16	16	9	8
7	Infosys	516	3	7	17	19	29	42	20	29
8	Tata Motors	499	3	14	46	39	52	32	6	13
9	Hind Unilever	457	3	15	11	14	87	64	35	29
10	Jindal Steel	436	3	47	41	39	24	32	13	10
11	NMDC	377	2	20	26	22	33	47	9	11
12	Sun Pharma	377	2	22	27	30	25	38	25	29
13	Cairn India	374	2	21	100	164	18	0	8	0
14	Nestle India	354	2	38	24	22	90	85	46	28
15	Hindustan Zinc	321	2	19	3	6	22	80	11	5
16	Larsen & Toubro	290	2	10	20	26	16	30	18	25
17	Hero Motocorp	274	2	25	23	19	66	38	19	18
18	GAIL (India)	252	2	16	12	22	18	23	11	9
19	Axis Bank	247	2	19	45	38	20	19	11	21
20	Asian Paints	237	1	33	28	21	39	37	32	26
21	Kotak Mahindra Bank	211	1	18	28	34	15	18	22	30
22	M & M	206	1	12	14	29	14	30	14	12
23	Grasim Inds	195	1	15	4	12	17	37	10	10
24	Bank of Baroda	193	1	30	36	27	21	13	6	7
25	Lupin	183	1	34	32	29	24	29	27	22
26	UltraTech Cement	178	1	14	23	31	20	56	19	12
27	Dr Reddy's Labs	175	1	19	8	8	29	32	21	13
28	Titan Inds	166	1	40	41	33	48	37	34	35
29	Bosch	157	1	20	19	16	25	25	24	24
30	Maruti Suzuki	153	1	10	-1	19	10	25	26	15
31	B P C L	144	1	18	-18	17	5	21	30	5
32	HCL Technologies	137	1	11	14	28	28	37	14	15
33	Punjab National Bank	135	1	14	25	26	20	15	6	9
34	Hindustan Copper	123	1	26	-1	-1	25	35	76	38
35	IndusInd Bank	118	1	50	56	29	19	9	19	16
36	ACC	117	1	13	3	12	19	41	20	12
37	Cadila Healthcare	113	1	28	25	24	28	31	24	20
38	Canara Bank	110	1	19	17	22	16	19	6	5
39	Tata Power	109	1	15	-204	32	-5	13	0	14
40	Colgate-Palmolive	107	1	27	20	16	109	65	34	25
41	LIC Housing Finance	106	1	57	27	31	19	19	14	4
42	Castrol India	105	1	38	28	11	83	38	27	18
43	Dabur India	103	1	18	18	21	41	57	29	30
44	Shriram Transport Fin.	100	1	38	47	35	24	20	10	11
45	Godrej Consumer	100	1	27	33	39	26	144	29	24
46	GSK Pharma	99	1	15	10	9	30	34	33	26
47	Ambuja Cements	99	1	10	2	15	16	35	22	15
48	Petronet LNG	95	1	32	28	33	34	27	12	10
49	GSK Consumer	94	1	39	23	19	34	25	33	17
50	Power Finance Corp	89	1	12	22	28	17	13	8	10

Appendix I: MOSL 100 – Biggest Wealth Creators (contd.)

Ranked according to The Biggest Wealth Creators

		Wealth Created		CAGR (2007-12, %)			RoE (%)		P/E (x)	
Rank	Company	INR b	Share (%)	Price	PAT	Sales	2012	2007	2012	2007
51	Exide Inds	88	1	29	46	19	19	31	28	48
52	Cummins India	85	1	21	15	14	31	29	26	20
53	Bank of India	81	0	17	20	26	15	20	7	7
54	Sesa Goa	81	0	18	33	32	15	47	6	10
55	Shree Cement	79	0	28	25	27	21	44	23	20
56	Yes Bank	75	0	21	60	61	23	14	13	42
57	Siemens	72	0	7	17	15	23	36	30	48
58	United Breweries	70	0	15	18	25	11	17	113	104
59	Marico	70	0	23	26	21	31	43	34	38
60	Coromandel Inter	69	0	54	43	36	29	23	12	7
61	Torrent Power	67	0	28	53	23	24	5	8	19
62	Indian Bank	64	0	22	16	24	20	28	6	5
63	Divi's Lab	61	0	20	23	21	27	42	19	21
64	Pidilite Inds	61	0	26	24	20	27	25	29	26
65	Engineers India	60	0	27	34	45	38	14	14	18
66	M R P L	60	0	15	12	14	13	20	13	11
67	Neyveli Lignite	59	0	11	20	19	12	7	10	15
68	Union Bank (I)	57	0	18	16	23	14	19	7	6
69	I D F C	57	0	10	25	33	13	18	13	19
70	Piramal Enterprises	56	0	14	-20	-2	1	22	102	22
71	Alfa Laval (I)	56	0	36	14	14	29	31	56	23
72	Gillette India	56	0	25	0	22	12	22	108	35
73	CRISIL	51	0	30	28	23	51	38	34	33
74	Apollo Hospitals	50	0	21	25	27	10	10	39	36
75	Eicher Motors	47	0	52	41	23	23	13	19	13
76	P & G Hygiene	47	0	23	15	19	28	32	40	29
77	Havells India	46	0	21	30	35	46	47	19	23
78	Allahabad Bank	45	0	21	20	26	19	18	5	4
79	Emami	45	0	33	31	23	37	41	24	18
80	Motherson Sumi	43	0	21	15	57	9	38	28	20
81	Bhushan Steel	43	0	32	26	21	15	30	9	7
82	G M D C	43	0	31	39	23	26	12	12	16
83	M & M Financial	41	0	23	37	28	23	18	11	15
84	Britannia Inds	41	0	19	14	19	54	18	37	30
85	Bata India	41	0	41	42	15	34	14	32	33
86	Indraprastha Gas	39	0	31	17	32	27	33	17	10
87	Astrazeneca Pharma	37	0	28	-17	15	11	36	266	31
88	Blue Dart Express	37	0	35	19	17	20	23	38	20
89	Torrent Pharma	37	0	26	29	16	30	25	16	18
90	Guj Gas Company	34	0	25	25	20	33	21	18	19
91	Federal Bank	33	0	21	21	25	14	21	10	6
92	Tata Chemicals	32	0	11	13	19	16	21	9	9
93	Tata Global	32	0	13	1	11	8	17	21	11
94	TTK Prestige	32	0	89	58	31	48	24	29	12
95	Kansai Nerolac	31	0	22	16	15	22	21	23	17
96	Godrej Inds	30	0	10	83	19	4	3	39	454
97	Ashok Leyland	30	0	10	6	13	20	27	14	12
98	BOC India	28	0	30	33	19	10	9	34	23
99	MRF	28	0	24	52	21	17	5	12	33
100	Ipca Labs	27	0	23	18	20	24	28	15	12
	TOTAL / AVG	**16,380**	**100**	**20**	**21**	**23**	**19**	**21**	**16**	**16**

Appendix II: MOSL 100 – Fastest Wealth Creators

Ranked according to The fastest Wealth Creators

		2007-12 Price		CAGR (2007-12, %)		Wealth Created		RoE (%)		P/E (x)	
Rank	Company	CAGR (%)	Multiple (x)	PAT	Sales	INR b	Share (%)	2012	2007	2012	2007
1	TTK Prestige	89	24.0	58	31	32	0.2	48	24	29	12
2	LIC Housing Finance	57	9.6	27	31	106	0.6	19	19	14	4
3	Coromandel Inter	54	8.7	43	36	69	0.4	29	23	12	7
4	Eicher Motors	52	8.0	41	23	47	0.3	23	13	19	13
5	IndusInd Bank	50	7.6	56	29	118	0.7	19	9	19	16
6	MMTC	48	7.0	-8	23	671	4.1	5	14	761	70
7	Jindal Steel	47	6.9	41	39	436	2.7	24	32	13	10
8	Bata India	41	5.6	42	15	41	0.2	34	14	32	33
9	Titan Inds	40	5.4	41	33	166	1.0	48	37	34	35
10	GSK Consumer	39	5.2	23	19	94	0.6	34	25	33	17
11	Castrol India	38	5.0	28	11	105	0.6	83	38	27	18
12	Shriram Transport	38	5.0	47	35	100	0.6	24	20	10	11
13	Nestle India	38	4.9	24	22	354	2.2	90	85	46	28
14	Alfa Laval (I)	36	4.6	14	14	56	0.3	29	31	56	23
15	Blue Dart Express	35	4.5	19	17	37	0.2	20	23	38	20
16	Lupin	34	4.4	32	29	183	1.1	24	29	27	22
17	Asian Paints	33	4.2	28	21	237	1.4	39	37	32	26
18	Emami	33	4.1	31	23	45	0.3	37	41	24	18
19	Bhushan Steel	32	4.0	26	21	43	0.3	15	30	9	7
20	Petronet LNG	32	4.0	28	33	95	0.6	34	27	12	10
21	G M D C	31	3.8	39	23	43	0.3	26	12	12	16
22	Indraprastha Gas	31	3.8	17	32	39	0.2	27	33	17	10
23	Bank of Baroda	30	3.7	36	27	193	1.2	21	13	6	7
24	BOC India	30	3.7	33	19	28	0.2	10	9	34	23
25	CRISIL	30	3.7	28	23	51	0.3	51	38	34	33
26	Exide Inds	29	3.6	46	19	88	0.5	19	31	28	48
27	Shree Cement	28	3.5	25	27	79	0.5	21	44	23	20
28	Astrazeneca Pharma	28	3.5	-17	15	37	0.2	11	36	266	31
29	Torrent Power	28	3.4	53	23	67	0.4	24	5	8	19
30	Cadila Healthcare	28	3.4	25	24	113	0.7	28	31	24	20
31	Engineers India	27	3.4	34	45	60	0.4	38	14	14	18
32	Colgate-Palmolive	27	3.4	20	16	107	0.7	109	65	34	25
33	Godrej Consumer	27	3.3	33	39	100	0.6	26	144	29	24
34	Hindustan Copper	26	3.2	-1	-1	123	0.8	25	35	76	38
35	Torrent Pharma	26	3.2	29	16	37	0.2	30	25	16	18
36	Pidilite Inds	26	3.1	24	20	61	0.4	27	25	29	26
37	Gillette India	25	3.1	0	22	56	0.3	12	22	108	35
38	Guj Gas Company	25	3.1	25	20	34	0.2	33	21	18	19
39	ITC	25	3.0	17	16	1,187	7.2	35	28	29	21
40	Hero Motocorp	25	3.0	23	19	274	1.7	66	38	19	18
41	MRF	24	3.0	52	21	28	0.2	17	5	12	33
42	M & M Financial	23	2.9	37	28	41	0.3	23	18	11	15
43	Marico	23	2.8	26	21	70	0.4	31	43	34	38
44	P & G Hygiene	23	2.8	15	19	47	0.3	28	32	40	29
45	Ipca Labs	23	2.8	18	20	27	0.2	24	28	15	12
46	HDFC Bank	22	2.7	36	33	744	4.5	19	19	23	27
47	Kansai Nerolac	22	2.7	16	15	31	0.2	22	21	23	17
48	Sun Pharma	22	2.7	27	30	377	2.3	25	38	25	29
49	Indian Bank	22	2.7	16	24	64	0.4	20	28	6	5
50	Cummins India	21	2.6	15	14	85	0.5	31	29	26	20

Appendix II: MOSL 100 – Fastest Wealth Creators (contd.)

Ranked according to The fastest Wealth Creators

		2007-12 Price		CAGR (2007-12, %)		Wealth Created		RoE (%)		P/E (x)	
Rank	Company	CAGR (%)	Multiple (x)	PAT	Sales	INR b	Share (%)	2012	2007	2012	2007
51	Havells India	21	2.6	30	35	46	0.3	46	47	19	23
52	Yes Bank	21	2.6	60	61	75	0.5	23	14	13	42
53	Motherson Sumi	21	2.6	15	57	43	0.3	9	38	28	20
54	Federal Bank	21	2.6	21	25	33	0.2	14	21	10	6
55	Apollo Hospitals	21	2.6	25	27	50	0.3	10	10	39	36
56	Allahabad Bank	21	2.6	20	26	45	0.3	19	18	5	4
57	Cairn India	21	2.5	100	164	374	2.3	18	0	8	0
58	Bosch	20	2.5	19	16	157	1.0	25	25	24	24
59	Divi's Lab	20	2.5	23	21	61	0.4	27	42	19	21
60	NMDC	20	2.4	26	22	377	2.3	33	47	9	11
61	Canara Bank	19	2.4	17	22	110	0.7	16	19	6	5
62	Dr Reddy's Labs	19	2.4	8	8	175	1.1	29	32	21	13
63	Britannia Inds	19	2.4	14	19	41	0.2	54	18	37	30
64	Hindustan Zinc	19	2.3	3	6	321	2.0	22	80	11	5
65	Axis Bank	19	2.3	45	38	247	1.5	20	19	11	21
66	B P C L	18	2.3	-18	17	144	0.9	5	21	30	5
67	Sesa Goa	18	2.3	33	32	81	0.5	15	47	6	10
68	Kotak Mahindra	18	2.3	28	34	211	1.3	15	18	22	30
69	Union Bank (I)	18	2.3	16	23	57	0.4	14	19	7	6
70	Dabur India	18	2.2	18	21	103	0.6	41	57	29	30
71	State Bank of India	17	2.2	19	22	556	3.4	16	16	9	8
72	H D F C	17	2.2	26	36	558	3.4	19	19	18	22
73	Bank of India	17	2.2	20	26	81	0.5	15	20	7	7
74	GAIL (India)	16	2.1	12	22	252	1.5	18	23	11	9
75	GSK Pharma	15	2.1	10	9	99	0.6	30	34	33	26
76	United Breweries	15	2.0	18	25	70	0.4	11	17	113	104
77	Grasim Inds	15	2.0	4	12	195	1.2	17	37	10	10
78	M R P L	15	2.0	12	14	60	0.4	13	20	13	11
79	Hind Unilever	15	2.0	11	14	457	2.8	87	64	35	29
80	Tata Power	15	2.0	-204	32	109	0.7	-5	13	0	14
81	Punjab Natl Bank	14	2.0	25	26	135	0.8	20	15	6	9
82	Tata Motors	14	2.0	46	39	499	3.0	52	32	6	13
83	UltraTech Cement	14	2.0	23	31	178	1.1	20	56	19	12
84	Piramal Enterprises	14	1.9	-20	-2	56	0.3	1	22	102	22
85	TCS	14	1.9	20	21	1,082	6.6	38	56	22	29
86	ACC	13	1.8	3	12	117	0.7	19	41	20	12
87	Tata Global	13	1.8	1	11	32	0.2	8	17	21	11
88	M & M	12	1.8	14	29	206	1.3	14	30	14	12
89	Power Finance Corp	12	1.8	22	28	89	0.5	17	13	8	10
90	Neyveli Lignite	11	1.7	20	19	59	0.4	12	7	10	15
91	Tata Chemicals	11	1.7	13	19	32	0.2	16	21	9	9
92	HCL Technologies	11	1.7	14	28	137	0.8	28	37	14	15
93	Maruti Suzuki	10	1.6	-1	19	153	0.9	10	25	26	15
94	Larsen & Toubro	10	1.6	20	26	290	1.8	16	30	18	25
95	I D F C	10	1.6	25	33	57	0.3	13	18	13	19
96	Ambuja Cements	10	1.6	2	15	99	0.6	16	35	22	15
97	Godrej Inds	10	1.6	83	19	30	0.2	4	3	39	454
98	Ashok Leyland	10	1.6	6	13	30	0.2	20	27	14	12
99	Infosys	7	1.4	17	19	516	3.1	29	42	20	29
100	Siemens	7	1.4	17	15	72	0.4	23	36	30	48
	TOTAL / AVG	**20**	**2.5**	**21**	**23**	**16,380**	**100**	**19**	**21**	**16**	**16**

Appendix III: MOSL 100 – Wealth Creators (alphabetical)

Alphabetically arranged

Company	WC Rank		Wealth Created			Company	WC Rank		Wealth Created		
	Biggest	Fastest	INR b	Price CAGR (%)	Price Multi. (x)		Biggest	Fastest	INR b	Price CAGR (%)	Price Multi. (x)
ACC	36	86	117	13	1.8	Hindustan Zinc	15	64	321	19	2.3
Alfa Laval (I)	71	14	56	36	4.6	I D F C	69	95	57	10	1.6
Allahabad Bank	78	56	45	21	2.6	Indian Bank	62	49	64	22	2.7
Ambuja Cements	47	96	99	10	1.6	Indraprastha Gas	86	22	39	31	3.8
Apollo Hospitals	74	55	50	21	2.6	IndusInd Bank	35	5	118	50	7.6
Ashok Leyland	97	98	30	10	1.6	Infosys	7	99	516	7	1.4
Asian Paints	20	17	237	33	4.2	Ipca Labs	100	45	27	23	2.8
Astrazeneca Pharma	87	28	37	28	3.5	ITC	1	39	1,187	25	3.0
Axis Bank	19	65	247	19	2.3	Jindal Steel	10	7	436	47	6.9
B P C L	31	66	144	18	2.3	Kansai Nerolac	95	47	31	22	2.7
Bank of Baroda	24	23	193	30	3.7	Kotak Mahindra	21	68	211	18	2.3
Bank of India	53	73	81	17	2.2	Larsen & Toubro	16	94	290	10	1.6
Bata India	85	8	41	41	5.6	LIC Housing Finance	41	2	106	57	9.6
Bhushan Steel	81	19	43	32	4.0	Lupin	25	16	183	34	4.4
Blue Dart Express	88	15	37	35	4.5	M & M	22	88	206	12	1.8
BOC India	98	24	28	30	3.7	M & M Financial	83	42	41	23	2.9
Bosch	29	58	157	20	2.5	M R P L	66	78	60	15	2.0
Britannia Inds	84	63	41	19	2.4	Marico	59	43	70	23	2.8
Cadila Healthcare	37	30	113	28	3.4	Maruti Suzuki	30	93	153	10	1.6
Cairn India	13	57	374	21	2.5	MMTC	4	6	671	48	7.0
Canara Bank	38	61	110	19	2.4	Motherson Sumi	80	53	43	21	2.6
Castrol India	42	11	105	38	5.0	MRF	99	41	28	24	3.0
Colgate-Palmolive	40	32	107	27	3.4	Nestle India	14	13	354	38	4.9
Coromandel Inter	60	3	69	54	8.7	Neyveli Lignite	67	90	59	11	1.7
CRISIL	73	25	51	30	3.7	NMDC	11	60	377	20	2.4
Cummins India	52	50	85	21	2.6	P & G Hygiene	76	44	47	23	2.8
Dabur India	43	70	103	18	2.2	Petronet LNG	48	20	95	32	4.0
Divi's Lab	63	59	61	20	2.5	Pidilite Inds	64	36	61	26	3.1
Dr Reddy's Labs	27	62	175	19	2.4	Piramal Enterprises	70	84	56	14	1.9
Eicher Motors	75	4	47	52	8.0	Power Finance Corp	50	89	89	12	1.8
Emami	79	18	45	33	4.1	Punjab Natl Bank	33	81	135	14	2.0
Engineers India	65	31	60	27	3.4	Sesa Goa	54	67	81	18	2.3
Exide Inds	51	26	88	29	3.6	Shree Cement	55	27	79	28	3.5
Federal Bank	91	54	33	21	2.6	Shriram Transport	44	12	100	38	5.0
G M D C	82	21	43	31	3.8	Siemens	57	100	72	7	1.4
GAIL (India)	18	74	252	16	2.1	State Bank of India	6	71	556	17	2.2
Gillette India	72	37	56	25	3.1	Sun Pharma	12	48	377	22	2.7
Godrej Consumer	45	33	100	27	3.3	Tata Chemicals	92	91	32	11	1.7
Godrej Inds	96	97	30	10	1.6	Tata Global	93	87	32	13	1.8
Grasim Inds	23	77	195	15	2.0	Tata Motors	8	82	499	14	2.0
GSK Consumer	49	10	94	39	5.2	Tata Power	39	80	109	15	2.0
GSK Pharma	46	75	99	15	2.1	TCS	2	85	1,082	14	1.9
Guj Gas Company	90	38	34	25	3.1	Titan Inds	28	9	166	40	5.4
H D F C	5	72	558	17	2.2	Torrent Pharma	89	35	37	26	3.2
Havells India	77	51	46	21	2.6	Torrent Power	61	29	67	28	3.4
HCL Technologies	32	92	137	11	1.7	TTK Prestige	94	1	32	89	24.0
HDFC Bank	3	46	744	22	2.7	UltraTech Cement	26	83	178	14	2.0
Hero Motocorp	17	40	274	25	3.0	Union Bank (I)	68	69	57	18	2.3
Hind Unilever	9	79	457	15	2.0	United Breweries	58	76	70	15	2.0
Hindustan Copper	34	34	123	26	3.2	Yes Bank	56	52	75	21	2.6

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