Criteria for stock selection under DHFL Pramerica Deep Value Strategy

This is an attempt to clear up some points about the stock selection criteria employed by our PMS:

We have informed you earlier that these are the following 4 characteristics that we look for while selecting a stock (besides the factors like management quality and purchase price):

(a) A minimum of 15-years track record
(b) A minimum size of Rs.400 crores sales revenue
(c) Consistency in high return on capital employed
(d) Consistency in the ability to generate free cash flow.

You probably are wondering about the significance of these characteristics.

<u>Track record of 15 years</u>

It is the expectation that in 15 years, a company would have completed at least one complete business cycle. If it has completed at least one business cycle, then it is expected that they have dealt with difficult business conditions, and have come out of such a situation. This is an invaluable lesson that hopefully the company would have learnt. Dealing with absolutely new companies or ones that are not old enough, increases the risk on this front. Of course, a 15-year track record does not eliminate this risk, but as investors, we can breathe a little easier.

<u>A size of at least Rs.400 crores revenues</u>

The size of Rs.400 crores was not based upon any scientific yardstick. Since the strategy aims for a multi-cap portfolio, we have to be open to buying large, medium and small companies. Setting the threshold much higher would have meant that smaller and mid-sized companies are kept out to a larger degree. At the same time, we wanted a decent size of operations (after 15 years, if the company still does not generate Rs.400 crore revenues, it deserves to come in only as an exception).

<u>Return on Capital Employed (RoCE)</u>

This may be the most significant financial ratio is an analyst's scheme of things. The RoCE measures how efficiently the total capital of the company is being used.

The higher the RoCE, the better it is for the investor, but the basic idea is to verify whether the company is efficient enough to consistently earn more than its cost of funds.

<u>Example</u>

Let us say that a business is started only with borrowed capital. Let us assume that the company borrows from a bank at 11% per annum. **<u>The business makes sense only if it consistently earns a Return on Capital Employed of at least 11%.</u>**

In listed companies, we have to see that the returns earned by the business are consistently higher than the weighted average cost of capital (WACC)

Total capital consists of

(a) Shareholders capital (i.e., paid up share capital plus reserves, or net worth), and
(b) Borrowed capital (i.e, loans taken by the company).

We know the cost of borrowed capital (it is the interest paid on loans). The cost of equity is usually calculated at a premium over the risk free rate. If the risk free rate (10-year GOI bond rate) is around 7.5%, then the cost of equity would be approximately 12.5% - 14.5%, depending upon the estimated riskiness in the business. If the cost of equity is taken at 12.5%, cost of borrowing at 11%, and the company has a 1:1 debt/equity, then the WACC would be 11.75%. Such a business should consistently earn at least 11.75 % RoCE for it to make sense for the investor.

We have kept a threshold in DHFL Pramerica Deep Value Strategy of 20% RoCE on a consistent basis. This would be significantly higher than the estimated cost of capital.

RoCE = EBIT / Total capital employed.

EBIT = Earnings before interest and taxes
Total capital employed = Equity capital + reserves + total borrowings.

RoCE measures the returns all the investors in the company are getting (including shareholders and lenders).

Another measure normally used to check capital efficiency is the Return on Equity (otherwise called Return on Networth). **RoE = Profit after taxes / Net worth**.

Although RoE is also an important indicator, we do not use this to a large extent, because RoE does not measure return on total capital. For example, by increasing the level of debt in the company, it is possible to earn higher RoE, but a higher level of debt would depress RoCE.

<u>Generation of positive free cash flow</u>

Net profits can be “adjusted” with clever accounting, or with lenient trade terms, but the cash flows of a company indicate how smoothly the business is being run (without constant external funding). The generation of positive free cash flow indicates that the company is in a comfortable financial position.

Just as we would expect any individual to live within his/her means, a company generating positive free cash flow indicates that the company is living within its means.

<u>Example</u>

Let us say there are two companies A & B in the same industry, making similar products. Let us say that both price their products similarly. However, company A insists that the customers should pay up within 2 weeks, whereas company B gives a 2 month credit period.

Company B will initially have more customers, since it is giving more favourable credit terms. The sales and profits of B will also be higher (other things remaining equal). But Company A will have better cash flows since it gets paid faster.

Over a period of time, Company A should have a strong reason to insist upon a shorter payment period. If the customers do not see much value in the quality of their product or service levels (compared to company B), then they would see no reason why they should agree to stricter trade terms. Therefore, the free cash flow will eventually dwindle if Company A does not have a significant strength vis-à-vis company B.

The existence of continuous positive free cash flow is therefore an indicator that the company enjoys a significant competitive advantage.

Free cash flow is calculated as follows:

Reported net profits
(+) Depreciation for the year
(-) Dividend taxes paid by the company
(-) increase in investment in fixed assets during the year
(-) increase in working capital needs during the year

Note: Fixed assets = plant & machinery, land, buildings, computers, etc (including capital Work in progress)
Working capital changes = changes in inventory, sundry debtors and sundry creditors during the year.

Investment objective of DHFL Pramerica Deep Value Strategy: DHFL Pramerica Deep Value Strategy seeks to generate returns by investing in a portfolio of value stocks which have the potential of superior wealth creation over long term.

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