Value Research

# Wealth Insight

December 2023 ₹125

# Good companies, but...

## Foolproof scrutiny of moat, management, and valuation

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## EDITORIAL POLICY

The goal of Wealth Insight, as with all publications from Value Research, is not just limited to generating profitable ideas for its readers; but to also help them in generating a few of their own. We aim to bring independent, unbiased and meticulously-researched stories that will help you in taking better-informed investment decisions, encouraging you to indulge in a bit of research on your own as well.

All our stories are backed by quantitative data. To this, we add rigorous qualitative research obtained by speaking to a wide variety of stakeholders. We firmly stick to our belief of fundamental research and value-oriented approach as the best way to earn wealth in the stock market. Equally important to us is our unwaveringly focus on long term planning.

Simplicity is the hallmark of our style. Our writing style is simple and so is the presentation of ideas, but that should not be construed to mean that we over-simplify.

Read, learn and earn – and let's grow and evolve as we undertake this voyage together.








### The evolution of a value investor

**Tom Gayner**
CEO,
Markel Group



### "Our emphasis lies on evaluating cash-flow generation"

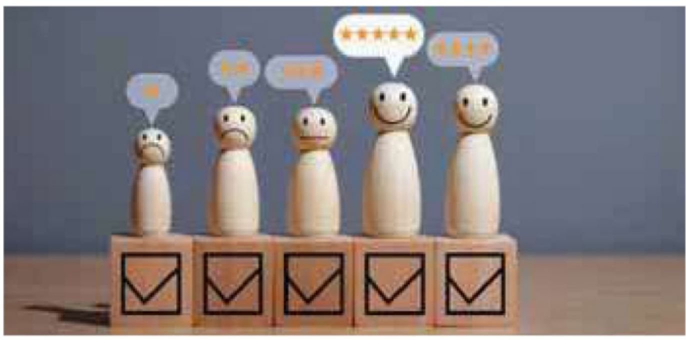
How to avoid quality investing traps?

**Trideep Bhattacharya**
CIO-Equities,
Edelweiss MF



### Introducing Value Research Stock Ratings

Investing simplified, decisions clarified



**TRIDEEP BHATTACHARYA**
CIO-Equities,
Edelweiss MF

# "Our emphasis lies on evaluating cash-flow generation"

How to avoid quality investing traps?

In the cover story, we shed light on three traps that may befall an investor. However, we didn't give you any antidote to such outcomes. Well, we have a good alibi for that. We wanted to share with you the advice of an investing veteran.

With over 20 years of experience, Trideep Bhattacharya is the Chief Investment Officer (Equities) at Edelweiss Mutual Fund. We sat down with him and sought his thoughts on the near-term outlook of equity, how he defines quality companies, and how an investor can successfully navigate through the various traps the market constantly throws. So put your geek glasses on and learn from one of the masters.

### With the US interest rates at their current levels, what's your take on equities in the short-to-medium term? Are the markets pricing in a recession?

We believe global GDP has surprised on the positive in 2023 with stronger growth in the face of the sharpest tightening of interest rates over the last 40 years, driven by profligate fiscal spending by central governments.

In 2024, with the majority of interest-rate normalisation done, we think the macro debate will move from 'interest rate uncertainty' to 'political uncertainty' as two of the major economies of the world, the US and India, go through their national elections, closely followed by UK elections in early 2025.

While we expect political uncertainty to cause volatility in equity markets in the near term, we are constructive on Indian equities over the medium term, driven by the twin positives of:

- A de-leveraged balance sheet of India Inc. operating at high-capacity utilisation, which could potentially lead to a capex cycle and
- Moderating inflation, which could enhance consumers' spending power over time.

On net balance, these factors have the potential to make Indian equities one of the favourite destinations for investors in 2024. We monitor the situation closely.

### It is said that beauty is in the eye of the beholder. How do you identify a quality company? What are some of your non-negotiable criteria?

From a corporate standpoint, we consider the 'consistency of delivery versus promise through business cycles as the ultimate benchmark and practical definition of 'quality.' For investors, recognising such companies in advance serves as a blueprint for wealth creation.

Drawing from 25 years of experience in evaluating companies across developed and emerging markets, I observe that while consistency of delivery is an end result, a few shared characteristics among such companies include:

- A clear and well-defined 'right-to-win' in a 'growing marketplace.'
- Unwavering focus on execution and,
- Management possessing the courage of, conviction and agility to navigate business cycles.

**The vigour of the moat sets the pace of growth while an adept management steers the company toward a path of long-term and sustainable growth**

In our interactions with companies and our investment evaluations, we seek these traits, quantify our assessments to solidify our estimate of intrinsic value, and commit to investment if we identify sufficient economic upside.

While our pursuit of quality investments is continual, one non-negotiable criterion is corporate governance. As minority shareholders, the alignment of management's interests with ours is paramount, as any misalignment could lead to detrimental consequences over time.

### Which is more important - business moat or management? Can you have a successful investment with only one of the two?

Drawing a parallel to the human body, I would equate 'management' to the 'head' and consider the 'business moat' as the 'heart' of the company.

Just as in the human body, the vigour of the heart or business moat sets the pace of growth, adept management or 'head' plays a crucial role in steering the company toward a path of long-term and sustainable growth, keeping in mind the investments for the future.

### How do you avoid quality traps, i.e., companies that have a good return on capital employed but don't compound wealth?

In the framework mentioned earlier, it's vital to thoroughly explore and evaluate the nuanced relationship between the 'right-to-win' and the 'growing marketplace' to avoid such a scenario.

Despite a strong 'right-to-win' leading to favourable return ratios, the growth trajectory may falter if the broader 'market' in which the company operates doesn't offer substantial growth opportunities. This, in consequence, can negatively impact long-term wealth creation.

### Quite often, quality companies trade at high P/E multiples. Do you think these valuations are justified? What is your approach to valuing such companies?

We consider 'P/E multiples' to be inherently static, requiring adjustment based on the magnitude, duration, and sustainability of future growth.

Therefore, our emphasis lies on evaluating cash-flow generation, its ongoing growth, and incorporating these factors into our estimation of the company's intrinsic value.

Ultimately, we believe that 'intrinsic value' serves as a more reliable gauge of value compared to P/E multiples.

### When do you sell a quality company?

Although quality companies often contribute to the compounding of one's portfolio, we remain attentive to certain indicators that prompt a reassessment of our investment in a company:

- When a company's market value significantly exceeds its intrinsic value, signalling an overvaluation, we consider revisiting our position.
- In instances of a thesis violation, where the initial investment rationale is compromised due to changes in management priorities or disruptions, we re-evaluate our investment decision with a fresh perspective.

**Despite a strong 'right-to-win' leading to favourable return ratios, the growth trajectory may falter if the broader 'market' in which the company operates doesn't offer substantial growth opportunities**

In summary, even with a 'quality company', continuous monitoring is essential for wealth creation considerations.

### Can you share some of the mistakes you have made along the way with our readers? And what were the major learnings?

I would classify my investment errors spanning the last 25 years into three distinct categories:

- A shift in management priorities: This often serves as a precursor to capital misallocation, resulting in potential losses.
- Premature selling: Exiting investments too early, especially during short-term challenging periods for a sound business, can lead to suboptimal returns. It's essential to resist succumbing to short-term pressures and instead maintain focus on the long-term growth potential.
- Erosion of the business moat: In an era of constant disruption, traditional business moats face challenges from emerging models. If the management fails to promptly recognise and adapt to disruptive forces, it may result in capital losses.

I've come to recognise that these areas are often challenging to identify at the initial investment stage. However, diligent ongoing scrutiny after the initial decision can help mitigate these risks. ☑