17th September 2019

Good Business vs. Good Investment

Price at which you buy a stock changes everything.

Ben Graham has mentioned in his book multiple times - in both the books, *Intelligent Investor* as well as *Security Analysis*, all the editions, that price changes everything. So, he would not hesitate in buying a mediocre business provided the price was right, when it was too low. He said **a high price could make a good business into a very bad investment, whereas a low price can turn a mediocre business into a very sound and profitable investment.**

Although there is another approach, which is to focus on good businesses, good managements, and a great price, you don't always get all the things in the same combination. You may have good business; you may have good management but price is almost always wrong. Whereas if you compromise a little bit on the prospects and you compromise may be a little on management quality, but you get a phenomenally low price, then that low price often offsets the disadvantages that you think you have against the other approach. And if you can accept that, then you can go on to developing various themes of value investing where you want to pay very low price in relation to what you think the corporation is really worth. And, you really don't need to know what the corporation is worth, in fact. Let me just give you very quick example. Here are two companies:

Contents	**Company A**	**Company B**	**Comments**
Capital invested	Rs 100 cr.	Rs 100 cr.	Both companies have same amount of capital invested -- Rs. 100 crores.
Return on Capital	35%	10%	Return on capital -- 35 percent in A and a pretty mediocre 10 percent in B.
Price/Book	10x	0.20x	A sells for 10 times book value while B sells for 20 percent of book (i.e. P/B of 0.2)
Market Cap	Rs 1,000 cr.	Rs 20 cr.	Market Cap of Rs. 1,000 crores for A and Rs. 20 crores for B.
PAT	Rs 35 cr.	Rs 10 cr.	PAT for A is Rs. 35 Cr. and for B is Rs. 10 Cr.
Price/Earnings	29x	2x	Higher PE for a better business makes complete sense
Dividend Payout	20%	20%	Assume similar Dividend payout
Dividend	Rs 7 cr.	Rs 2 cr.	
Dividend Yield	0.7%	10%	

Now, one looks like a growth stock, the other looks like a value stock. Now, if you keep the assumptions intact, if you assume that the future will be pretty much as what is been displayed on this slide then obviously company A well turn out to be, not only a better company, but also a better investment.

Company A is no doubt a better business than company B because it earns a higher return on capital and has a rational dividend policy because it retains most of its earnings and so long as the return on capital is high, this money will build up and like an internal compound machine should eventually show up in increased market valuation. Now, if the model assumptions hold, and if we assume that 5 years from now the same assumptions apply, then over those five years A will produce a CAGR of 28%, while B will give a CAGR of 8%. So, A would have been not only a better business but also a better investment. Check out the

Contents	**Company A**						**Company B**					
Year	0	1	2	3	4	5	0	1	2	3	4	5
Cap. Emp	100	128	164	210	269	344	100	108	117	126	136	147
ROCE %	35	35	35	35	35	35	10	10	10	10	10	10
Mkt. Cap	1015	1299	1663	2133	2727	3489	20	22	23	25	27	30
PAT	35	45	57	74	94	120	10	11	12	13	14	15
P/E	29	29	29	29	29	29	2	2	2	2	2	2
Div Pay %	20	20	20	20	20	20	20	20	20	20	20	20
Div	7	9	11	15	19	24	2	2	2	3	3	3
Ret. Erng.	28	36	46	59	75	96	8	9	10	10	11	12
5Y CAGR	28.0%						8.4%					

But how sure are you that these assumptions will hold? That is the key thing here. What history tells us -- **how many companies are able to sustain that kind of growth, which is implicit in that kind of a return and low dividend payout ratio and how many companies are able to sustain that kind of high returns on capital along with the margins? I think the number is very small.** So, if we were to tweak some assumptions to a more realistic one, as follows: we can get a different picture.

(1) In year 5, A's return on invested capital declines to 20 percent maybe due to competition, market saturation, managerial stupidity etc.
(2) As growth subsides, naturally, A's P/E multiple slightly declines from 29x to 19x.
(3) We also assume that in the year 5, B's P/E increases from 2x to 3x.

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5Y CAGR	5.2%						17.6%					

And with these new more realistic and possible assumptions, I think you'll find that A will give a CAGR of 5% over five years and B will give 17% over the same period. So, a drop in return on capital in the year 5 results in a dramatic change in our earlier conclusion that A is a better investment. If we drop the assumption that B's P/E multiple increases, if we assume that everything about B remains unchanged, but we continue with assumptions of A, even then B will outperform A by a large margin by returning 8% as opposed to 5% for A.

And that is the power of value investing, when you pay low prices then you don't need very good things to happen for you to have a good return. When you pay those low prices, then even if some bad news comes out about the company, it's already discounted, the market ignores it. Whereas if any good news comes out, you have a jump, you have a positive, skewed result. So, you end up with P/E multiple going from 2 to 3 which is not expensive by any means, but you can see what impact it has on the overall returns. Like Buffett said and I quote -- Buffett is known as a renowned growth investor, not as a value investor -- ***"You pay a very high price in the stock market for a cheery consensus"*.**