16th Annual Wealth Creation Study 2011

Blue Chip Investing

Creating wealth from dividends

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Theme 2012

Blue Chip Investing

Creating wealth from dividends

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Investing v/s Speculation

"An **investment operation** is one which, upon thorough analysis, promises **safety of principal** and an **adequate return**.

Operations not meeting these requirements are speculative."

— Graham & Dodd in *Security Analysis*, 1934

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Investing v/s Speculation

"If he buys stocks, and **buys as an investor, he holds for income**; **if as a speculator, for profit** …

Wise investment requires that only such issues as are selling far below their true worth should be bought; then, as **large income payments are received** in subsequent years … a handsome return on the principal can be enjoyed."

— John Burr Williams, Theory Of Investment Value, 1938

What is Blue Chip Investing

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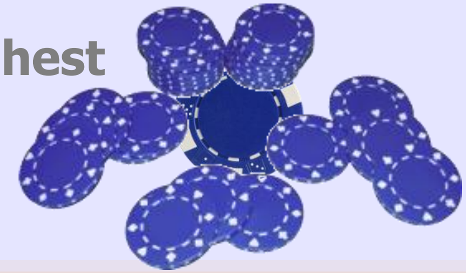
Blue Chip Investing –

Buying and selling **<u>ONLY</u>** Blue Chips, at the right price

What are Blue Chips?

Highly priced stocks, which typically tend to enjoy premium valuations due to their high quality

The term "Blue Chip" comes from poker where the highest and most valued denomination chips are colored blue.



Why Blue Chip Investing

Reason #1: Quality

The problem of poor quality: "The risk of paying too high a price for good-quality stocks — while a real one — is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions.”

— Benjamin Graham, *The Intelligent Investor*

The advantage of high quality: “Good quality companies with strong dividend histories offer as much, if not more, investment growth potential than poor quality companies; and they do so with far less risk.”

— Geraldine Weiss, *The Dividend Connection*

Reason #2: Longevity

Power of compounding works best over long term

4 million times in 70 years.

Big number; but CAGR is only 24%

What is this?

US$ 40 billion

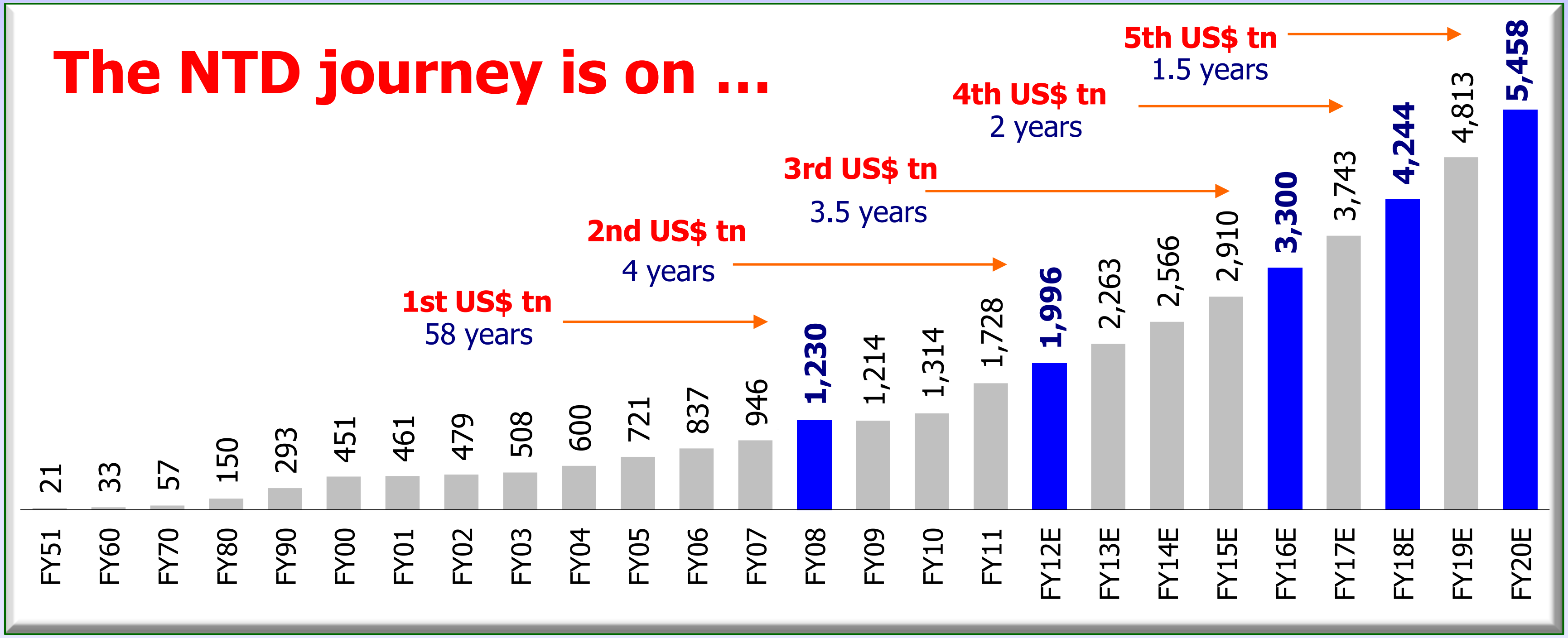
?

How Warren Buffet has compounded his initial capital of US$ 10,000

US$ 10,000

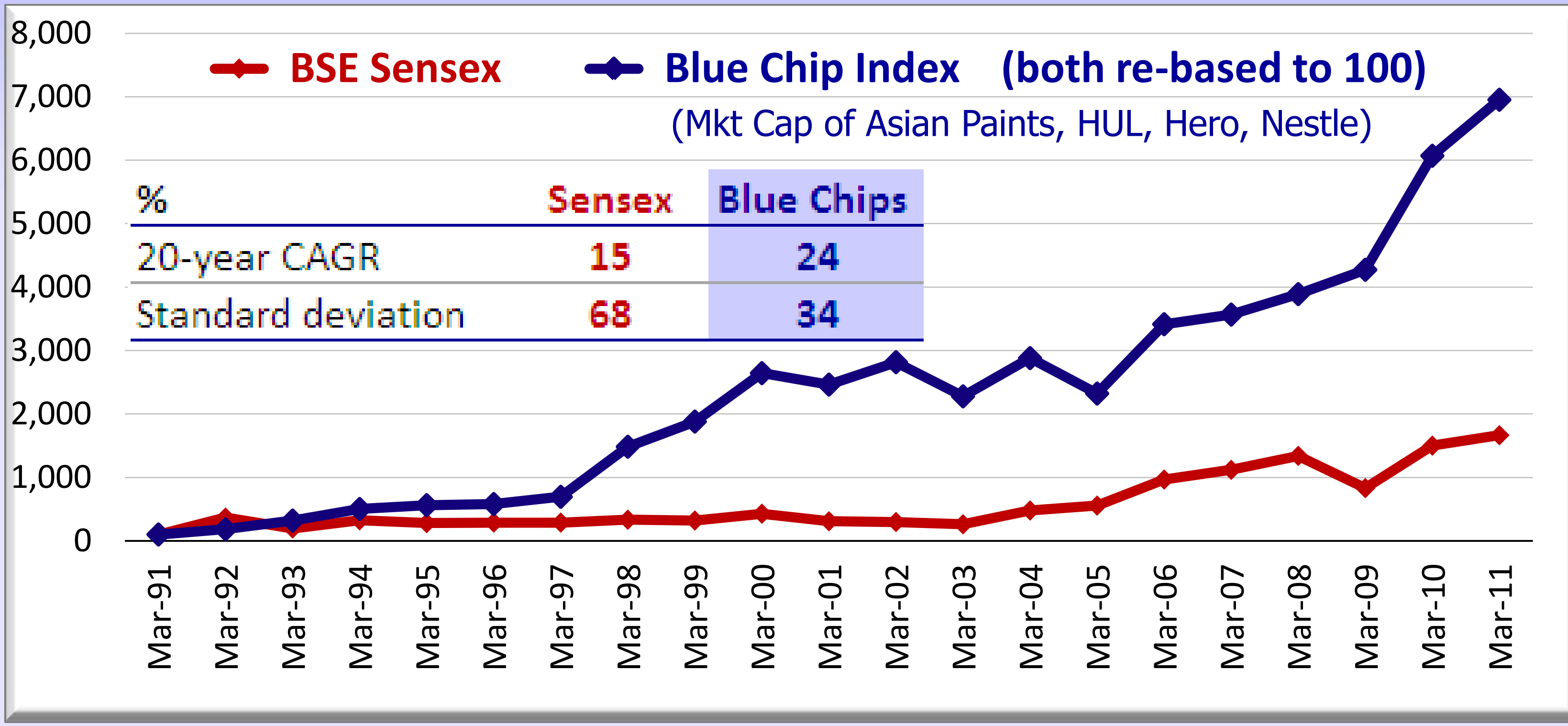
Reason #3: Growth

India's growth story far from over



Reason #4: Low risk

High return but with significantly low risk



%	Sensex	Blue Chips
20-year CAGR	15	24
Standard deviation	68	34

Blue Chip Investing Process

Two Key Steps –

#1 Understanding Quality

- **Business Performance**
- **Financial** Performance
- **Investment** Performance

#2 Recognizing Value

- Buying stocks at reasonable price

6-Screen Quality Filter

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All listed companies

3,000

Screen #1

20 years of uninterrupted dividends

133

Screen #2

Dividends raised in 5 of last 12 years

106

Screen #3

Earnings growth in 7 of last 12 years

76

Screen #4

Average 12-year RoE of 15%

68

Screen #5

At least 5 million shares outstanding

68

Screen #6

At least 80 institutional holders

48
Blue Chips

Screen-tested 48 Blue Chips

Descending Order of Total Return (2000-11)

Blue Chip	12-yr TR CAGR (%)
Sesa Goa	61%
Motherson Sumi	46%
Havells India	43%
Titan Inds	41%
LIC Housing Finance	39%
Federal Bank	37%
Bharat Electronics	36%
Exide Inds	34%
Larsen & Toubro	33%
Blue Star	32%
Ipca Labs	32%
GE Shipping Co	31%
HDFC	31%
Adani Enterprises	30%
Container Corpn	29%
A B B	29%

Blue Chip	12-yr TR CAGR (%)
CRISIL	28%
State Bank of India	28%
Asian Paints	28%
GAIL (India)	27%
Bosch	26%
Bharat Forge	26%
Dewan Housing	25%
Tata Steel	24%
Ashok Leyland	23%
Hero MotoCorp	23%
Nestle India	23%
Pidilite Inds	23%
Cummins India	22%
M & M	22%
Grasim Inds	22%
Reliance Inds	22%

Blue Chip	12-yr TR CAGR (%)
ACC	21%
Bajaj Auto	21%
ITC	21%
Dabur India	20%
IOC	19%
Colgate-Palmolive	18%
Ambuja Cements	18%
GSK Consumer	15%
Cipla	13%
Hindalco Inds	12%
GSK Pharma	12%
Britannia Inds	11%
Infosys	11%
Pfizer	9%
Hind. Unilever	4%
Wipro	-1%

Over same period: BSE Sensex CAGR: 13%

Median Total Return: 23%

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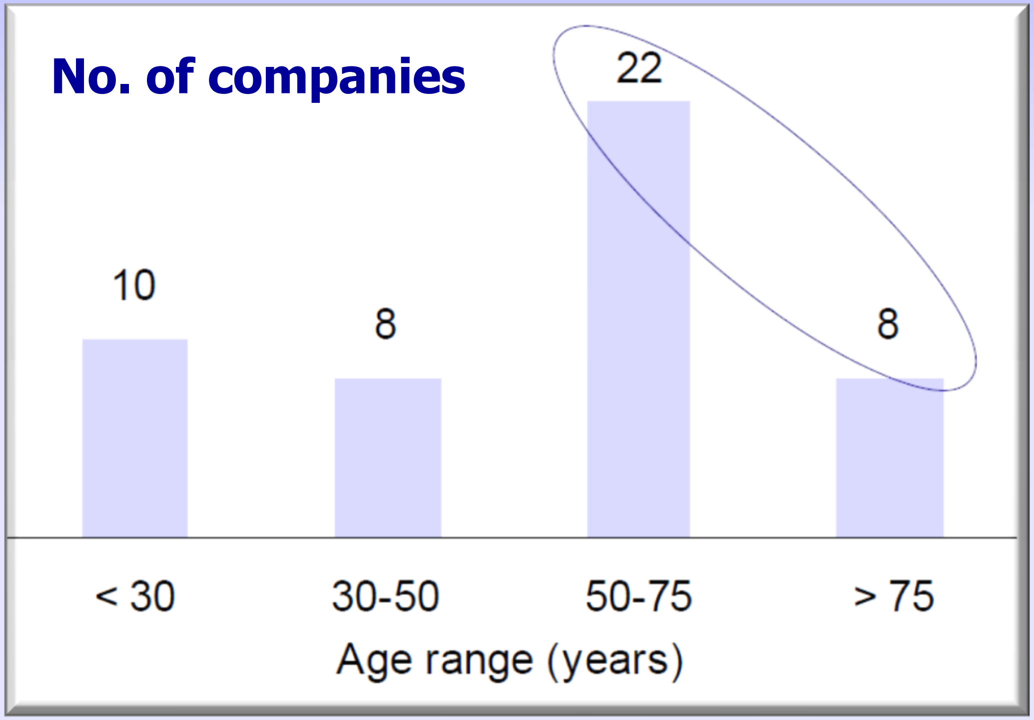
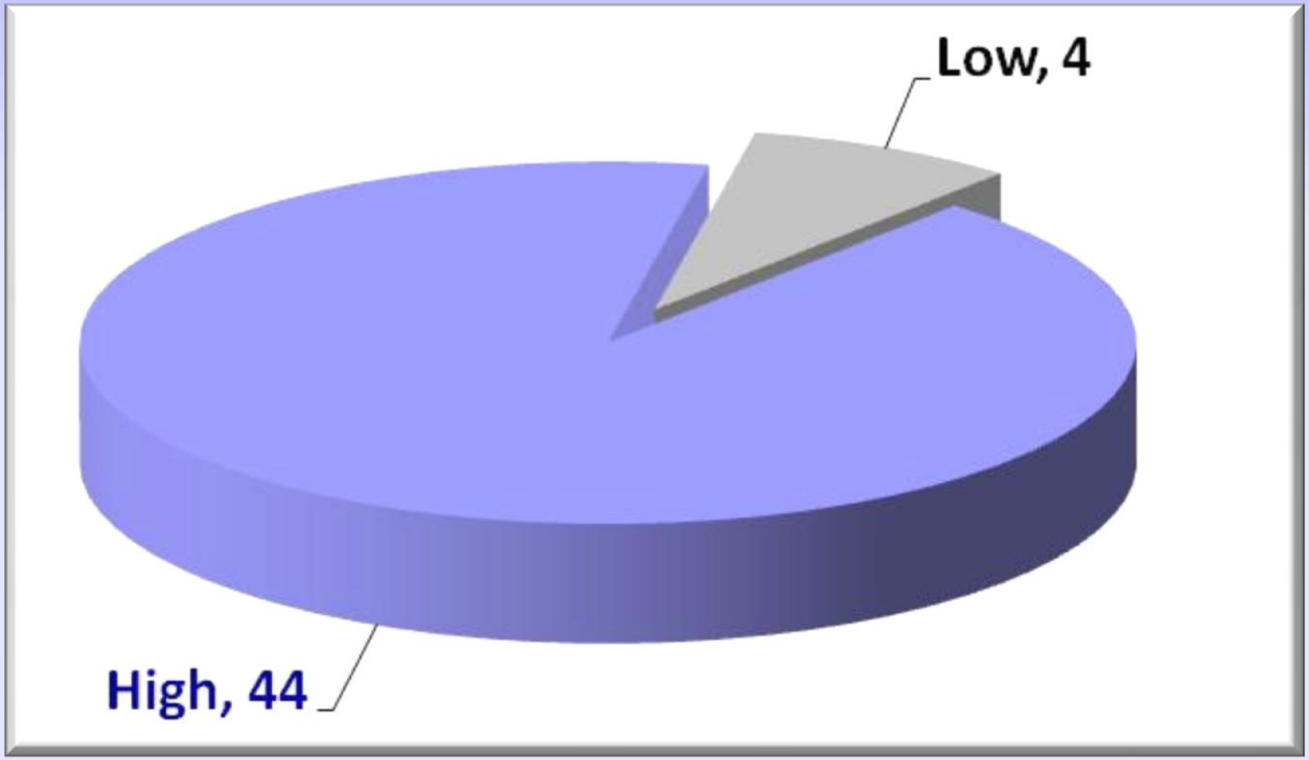
#1 Longevity

Median age of 48 Blue Chips: 57



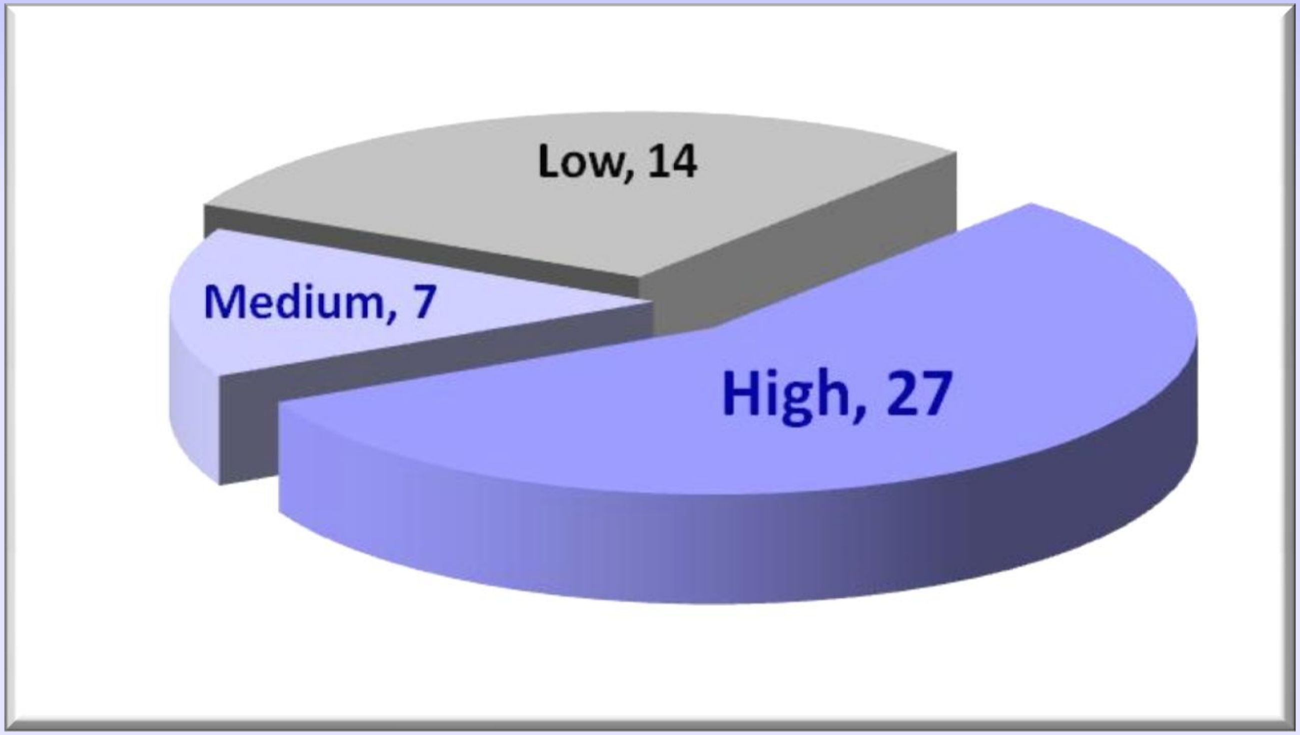
#2 Dominant Market Position

44 out of 48 Blue Chips



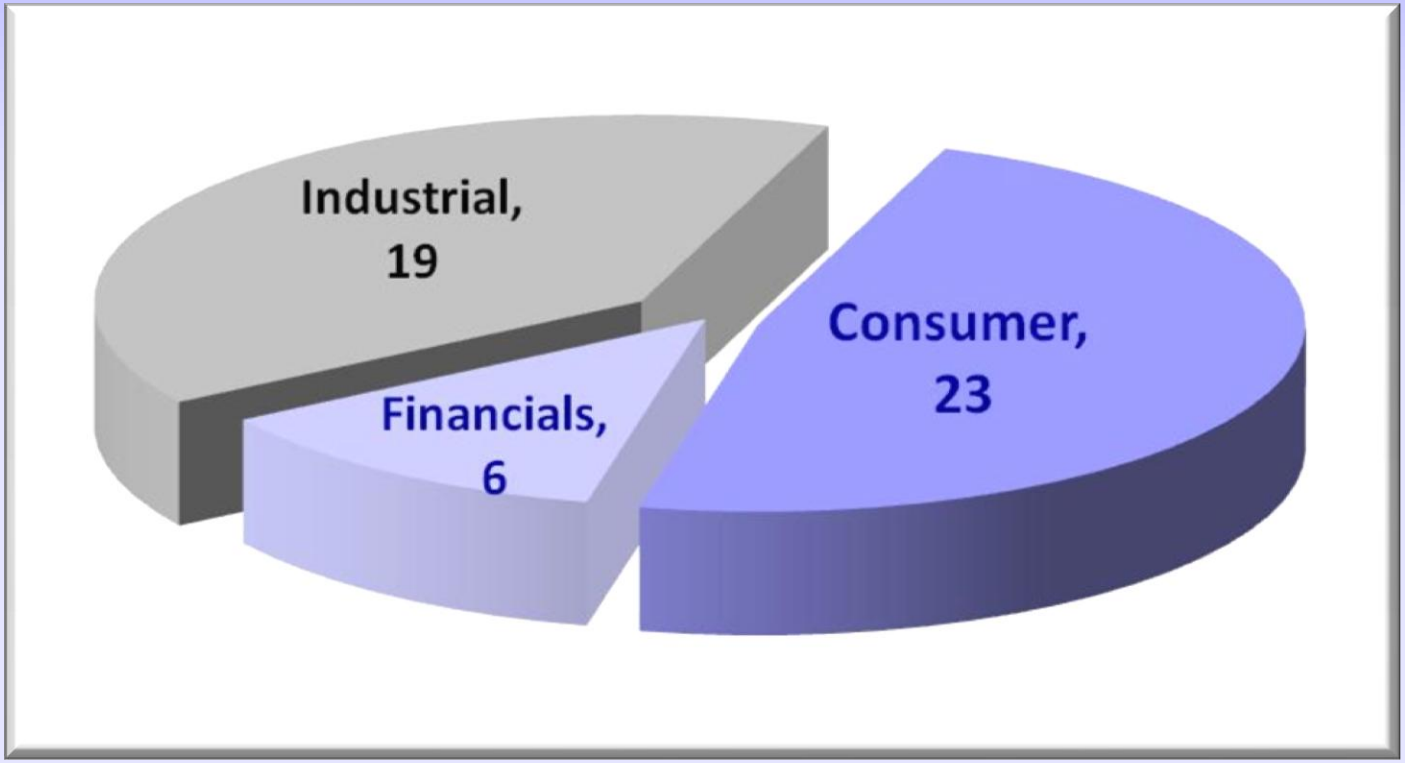
#3 Concentrated Business

Out of 48 — 27 high, 7 Medium



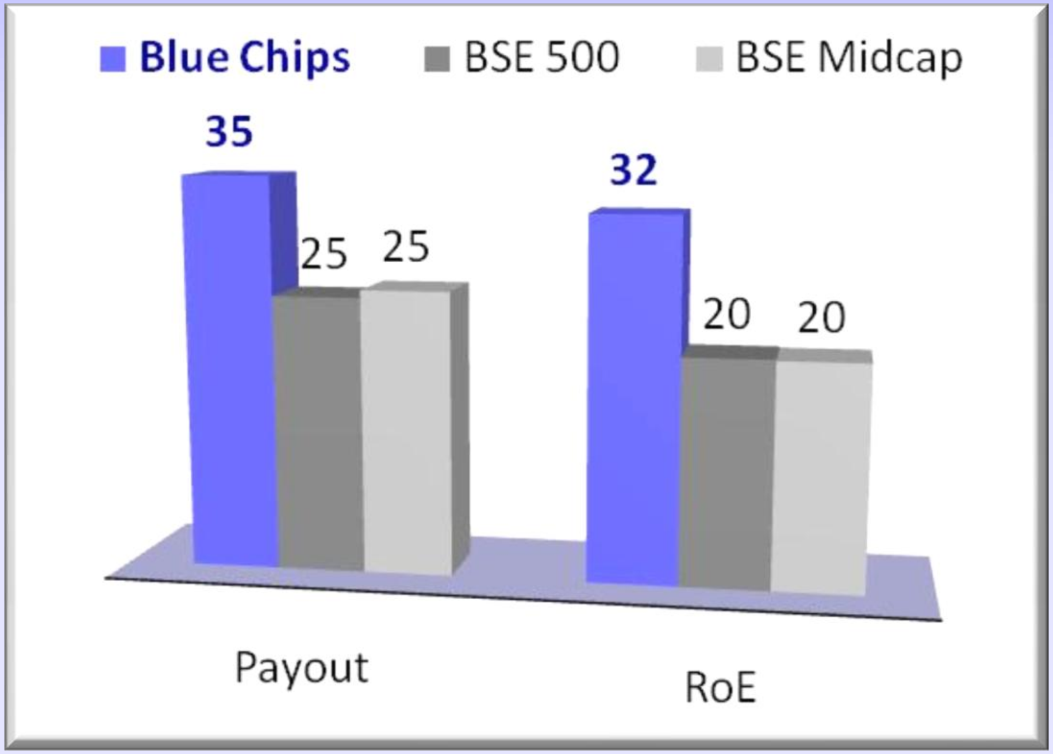
#4 Consumer-facing have an edge

Out of 48 — 23 Consumer, 6 Financials



#5 High quality of management

Reflected in above-average RoE, Payout



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How To Overcome The High P/E Phobia

Understand the Payout-Yield Connection

Divd Yield = **D**(ividend) ÷ **P**(rice)

= **D/E** ÷ **P/E** (dividing both by **E**)

= **Payout** ÷ **PE**

So, **PE** = **Payout** ÷ **Divd Yield**

Even assuming higher end of **Divd Yield** band of say **3%**, for an **80%** payout company –

Floor P/E = 80 ÷ 3 = 27

How To Overcome The High P/E Phobia

Testing the "High Payout = High P/E" hypothesis

Back-to-basics investing math: Classical DDM

$$P = \frac{D}{k - g}$$

Dividing both sides by E (for earnings)

$$P/E = \frac{D/E}{k - g} = \frac{\text{Payout}}{k - g}$$

Thus, higher the payout, and higher the growth, higher should be the P/E

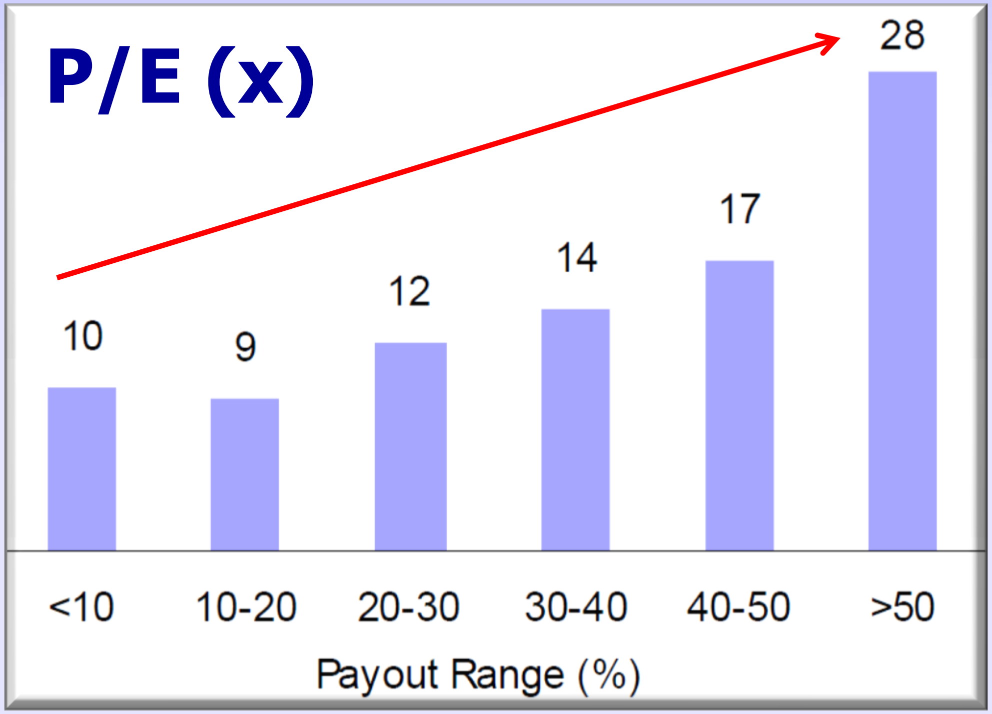
The Valuation Dilemma

How To Overcome The High P/E Phobia

Testing the "High Payout = High P/E" hypothesis

Empirical Evidence

P/E distribution of all listed, **profit-making** companies by payout range



Near perfect correlation between Payout & P/E

The Valuation Dilemma

How To Overcome The High P/E Phobia

Testing the "High Payout = High P/E" hypothesis

3 Company-level Case Studies

Case Study #1: Across sectors

Infosys v/s Asian Paints v/s HUL

	Asian Paints	Infosys	HUL
FY07-11 CAGR (%)			
EPS	**31**	**15**	**8**
Dividend	25	50	1
Stock Price	35	13	7
FY07-11 Avg (%)			
Payout	**45**	**36**	**85**
RoE	44	35	86
P/E (x)	**26**	**22**	**27**
Dividend Yield	1.5	1.4	2.9

HUL's 5-year avg P/E higher than Asian Paints and Infosys, despite low growth

Only reason:

High Payout

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How To Overcome The High P/E Phobia

Testing the "High Payout = High P/E" hypothesis

Case Study #2: Within sector (Non-financial)

Cement : ACC v/s Birla Corp

	ACC	Birla Corp
FY07-11 CAGR (%)		
EPS	**0**	**-1**
Dividend	19	14
Stock Price	0	16
FY07-11 Avg (%)		
Payout	**38**	**12**
RoE	29	38
P/E (x)	**14**	**5**
Dividend Yield	2.4	1.8

Both companies' EPS CAGR is flat; Birla Corp's RoE is much higher than that of ACC

Birla Corp's Payout is $1/3^{rd}$ of ACC

P/E is also exactly $1/3^{rd}$

The Valuation Dilemma

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How To Overcome The High P/E Phobia

Testing the "High Payout = High P/E" hypothesis

Case Study #3: Within sector (Financial)

HDFC v/s Shriram Transport

	HDFC	STF
FY07-11 CAGR (%)		
EPS	**19**	**51**
Dividend	20	21
Stock Price	23	61
FY07-11 Avg (%)		
Payout	**36**	**23**
RoE	23	26
P/E (x)	**22**	**13**
Dividend Yield	1.4	1.3

STF's performance is superior on most counts – EPS CAGR, Divd CAGR, and RoE

But STF's Payout is 2/3rd of HDFC

P/E is also exactly 2/3rd

Blue Chips: When To Buy

Key points to note:

- **P/Es are directly related to Payout and Growth**
- Dividend Yields are more structural and homogenous
- Blue Chips are **unlikely to trade at throwaway prices**, due to superior quality (high RoE, high Payout)
- So, focus on buying at **reasonable valuation**, not necessarily cheap by conventional measures

"We try to invest in outstanding companies at sensible prices rather than in average companies at bargain prices." — Warren Buffett

Blue Chips: When To Buy

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Back-tested two signals for last 5 years

Signal #1

- ❑ Current Divd Yield higher than long-period median yield

and at the same time

- ❑ Current P/E lower than long-period median P/E

Signal #2

- ❑ Current Divd Yield > 3%, irrespective of median

Top Blue Chips on Buy Signals

BLUE CHIP	CMP (INR)	Dividend Yield (%)			P/E (x)		
		Current	Median	Delta	Current	Median	Delta
Hero MotoCorp	2,003	5.2	3.3	**2.0**	19	17	**1**
Blue Star	178	3.9	2.5	**1.5**	24	17	**7**
Infosys	2,608	2.3	0.9	**1.4**	22	28	**-6**
Wipro	378	1.6	0.9	**0.7**	19	29	**-10**
Cummins India	356	3.0	2.4	**0.6**	18	21	**-3**
Tata Steel	385	3.1	2.6	**0.5**	5	7	**-2**
Motherson Sumi	152	1.8	1.4	**0.4**	20	20	**1**
Ashok Leyland	25	4.1	3.6	**0.4**	11	13	**-2**
Bharat Forge	259	1.4	1.1	**0.3**	16	28	**-12**
Exide Industries	116	1.3	1.0	**0.2**	20	22	**-2**

Blue Chips: When To Sell

- Even the **bluest of Blue Chips** must be sold at **extreme valuations**, else they will significantly underperform for a long period

  e.g. Infosys and Wipro since the dotcom boom of 2000

Catching ‘em early

Screening criteria to identify potential Blue Chips

Quantitative Criteria	Qualitative Criteria
1. **Uninterrupted dividends** for the last 5 years	1. **Dominant player** in line of business
2. **EPS increase** in at least 3 of last 5 years	2. **Huge size of opportunity**
3. **Dividend increase** in at least 2 of last 5 years	3. **Competent management** (prima facie corroborated by high minimum 15% RoE)
4. **RoE not less than 15%** in any of the last 5 years	
5. **5-year PAT CAGR of at least 10%**	

Recognized Blue Chips

Those with Mkt Cap > Rs 10,000 crores

20 Recognized Blue Chips

1.	Axis Bank	11.	NMDC
2.	B H E L	12.	Oil India
3.	Cadila Health.	13.	Petronet LNG
4.	Canara Bank	14.	Punjab National Bank
5.	Castrol India	15.	REC
6.	Coal India	16.	Shriram Transport
7.	Godrej Consumer	17.	Sun Pharma
8.	HDFC Bank	18.	Sun TV Network
9.	Jindal Steel	19.	TCS
10.	Lupin	20.	UltraTech Cement

Potential Blue Chips

Current Mkt Cap < Rs 10,000 crores

28 Potential Blue Chips

1. BGR Energy	11. Indraprastha Gas	21. Shriram City Union
2. Biocon	12. Info Edge (India)	22. Talwalkar
3. Coromandel Inter	13. Kansai Nerolac	23. TD Power Systems
4. Crompton Greaves	14. Karur Vysya Bank	24. Thermax
5. Deepak Fertilisers	15. M & M Financial	25. TTK Prestige
6. eClerx Services	16. Mahindra Holiday	26. Voltas
7. Emami	17. Manappuram Finance	27. VST Tillers Tractors
8. GRUH Finance	18. Opto Circuits	28. Zydus Wellness
9. Guj Gas Company	19. Page Industries	
10. Hawkins Cookers	20. Rupa & Company	

Floating the concept of MDO

Bringing back the long-term investor

FY11 payout distribution

Payout (%)	No. Of Cos	P/E (x)
<10	942	10
10-20	395	9
20-30	314	12
30-40	189	14
40-50	97	17
>50	167	28
Total	**2,104**	**12**

Country	Pay-out ratio (%)
Taiwan	76
Malaysia	60
Philippines	49
Pakistan	49
Thailand	45
Germany	40
Brazil	40
UK – FTSE	39
Nikkei	37
Indonesia	36
Singapore	31
Hong Kong	31
Korea	28
China	26
India – Sensex	**23**
MSCI India	21
Russia	12

In Conclusion

- **Financials have emerged as the largest wealth creating sector** for the first time ever. Going forward, expect the sector to maintain its top slot led by existing and new pvt banks, and eventual listing of insurance companies.
- **Very fast growth in stock prices creates transitory multi-baggers**. In most cases, what follows is prolonged and painful price and/or time correction.
- **Blue chips are fountains of dividend**, and offer as much, if not more, investment growth potential than lesser quality companies, with far less risk.
- **In investing, there is no profitable substitute for quality**. Understanding quality of the company doesn't stop at profits and profitability, it must extend to dividend payouts and longevity.
- **Most Blue Chips enjoy premium valuation**. In deciding when to buy, one should focus not only on P/E, but also consider payout ratio, relative dividend yield, and earnings growth potential.
- **In India, over last 20 years, Blue Chips significantly outperformed** benchmark indices with much lower risk.

Thank You !

&

Happy Blue Chip Investing !!