ROCE-Growth Matrix, and Few Potential Wealth Creators

March 25, 2019 | Reading Time: 7 minutes | **20 Comments** |

One of the most important parameters to judge a business's quality is its ability to generate a return on the money it employs on fixed and working capital. It is also one of the key metrics, which when measured over years, can help you assess a management's quality.

Return on capital employed or ROCE also indicates a business's ability to set prices that enables it to earn adequate margins, which when better than competitors also suggests the presence of moat.

Simply defined, ROCE shows how a company uses its capital efficiently by examining the profit it earns in relation to the capital it uses during a given year.

The formula commonly used to calculate ROCE is – Profit before Interest and Tax (PBIT) *divided by* Capital Employed (Equity and Debt).

Let's understand with an example. Say Company A earns PBIT of Rs 500 on sales of Rs 2,500, and Company B earns Rs 750 on Rs 2,500 of sales. In terms of profitability, B, having a 30% profit margin, looks like a better business than A, which has a 20% margin.

But let's say A employs Rs 2,000 of capital and B employs Rs 10,000. Company A has ROCE of 25% (500/2000) while B has ROCE of only 7.5% (750/10,000). The ROCE measurements show us that Company A makes better use of its capital, given that it can squeeze more earnings out of every rupee of capital it employs.

fundamental realities change for the worse after the capital has been employed, such businesses take a hit. Revenues may be difficult to come by, but they must necessarily pay, say, the interest on the debt they had borrowed earlier.

Airlines, textiles, infrastructure, power, retail, oil exploration, and hotels are such industries that suffer from the evil of continuous high capital intensity. So, when you see empty theatre seats, or empty aisles in a retail outlet, or empty seats in an aircraft, or a hotel operating on low occupancy, you know what I am talking about.

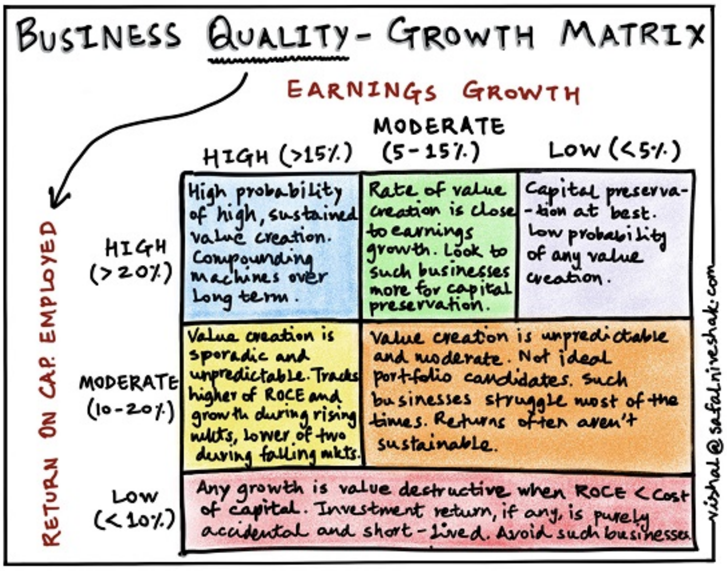
Anyways, just like all profit-making companies or those that see good profit growth are not good businesses and don't necessarily create value, just looking at the capital intensity isn't a good idea till you see the company's capital's efficiency. That is, how well that capital is being utilized (which is what the ROCE tells us).

If a capital-intensive business – which manages a lot of this capital through its own resources like operating cash flows, without resorting to too much debt – can earn high ROCE over years, it can still create value for shareholders. These are, however, rare businesses, and thus your role as a shareholder must be to find businesses that are not high on capital intensity (fixed and/or working capital) and high on capital efficiency (high ROCE). This is where you have a great probability of hitting upon a future wealth creator.

Now, a high ROCE indicates that the company can reinvest a larger part of its profit back into the business. When this reinvested capital is employed again at a higher rate of return, it helps produce an even higher profit growth. A high ROCE is, therefore, also an indicator of high earnings growth.

ROCE + Earnings Growth = Potential Wealth Creation

One of the best theories I have read on the importance of high ROCE and good earnings growth, which make a great combination for value creation, comes from Bharat Shah of ASK Group, who has written a book (sad, it's not available publicly) titled "Of Long Term Value and Wealth Creation from Equity Investing."



(Click on the image to open a larger version)

He basically categorizes businesses into six buckets –

1. Winner: High ROCE (>20%) + High earnings growth (>15%) – Will create the highest value as these show superb capital efficiency and outstanding earnings growth; fertile territory for finding multi-year compounding machines and yet offering great safety during tough market conditions.

2. Aspirer: High ROCE (>20%) + Moderate earnings growth (5-15%) – Provide safety with reasonable value creation due to superior capital efficiency but moderate earnings growth rate; should compound at a rate closer to earnings growth; largely a recipe for capital preservation with reasonable appreciation, though unlikely to be rewarded substantially due to moderate growth.

3. Gentry: High ROCE (>20%) + Low earnings growth (<5%) - At best a recipe for capital preservation; high business quality should ensure that value is preserved but lack of earnings growth would not enable these businesses to create long-term value; in fact, a challenging phase could result in value fading away.

4. Treadmill: Moderate ROCE (10-20%) + High earnings growth (>15%) – Value creation is difficult and unpredictable for these businesses; value creation generally tracks higher of ROCE and growth in good market conditions and lower of the two in bad times; buying at cheap prices could help create returns higher than earnings growth for some time, but that may be unsustainable.

value creation perspective; buying at cheap prices could help create returns higher than earnings growth for some time, but that may be unsustainable.

6. Value Obliterator/ Sweatshop: Low ROCE (<10%) + Any growth – Value is destroyed in the long run as any kind of growth is bad when ROCE is lower than even cost of capital; cheap initial valuation may cause accidental investment returns, but it's not sustainable.

India's Potential Value Creators (and Destroyers)

Based on these six buckets, I have compiled six lists of companies (using data from Screener.in) that meet the respective criteria as described above.

Click here to download the list of companies.

A couple of points worth noting here about these lists –

1. Apart from the ROCE and earnings growth parameters as suggested under each of these buckets, I have also restricted the lists to companies with market capitalization greater than Rs 1,000 crore, and debt/equity lower than 1.
2. Below each list, you can see the screening criteria I have used for creating the list. You may type in the same on Screener's query section to see the list (which may change in the future as the ROCE and/or growth numbers change) or make changes to the criteria to suit your requirements.

You may want to add companies from the Winner and Aspirer lists to your watchlist and then keep your eyes, ears and nose on them, for these may have the potential for future value creation *if* bought at reasonable prices.

ROCE and earnings growth, after all, have a deep impact on value creation. And Winners and Aspirers may have the potential to create lasting and predictable value and thus it is best to focus on these two categories only (unless you only focus on turnarounds, and thus even a bad past may not mean much to you).

Winners and Aspirers: Few Observations

Here are just a few of my observations from the Winner and Aspirer lists –

- Around 37 of the 81 companies (46%) in these two lists operate in the consumer and related spaces. Almost all these are leaders in their respective brand and product/service categories. Shows how the

- The average and median* age of these 37 companies is 54 years and 42 years respectively (**median* means that 18 of these 37 companies are below 42 years of age, 1 company of 42 years, and 18 more than 42 years). Proves that brand building takes time, and a company cannot just spend away money to build it quickly! So, these companies also benefit from some sort of entry barriers that their brands have helped them build in their respective industries.
- Out of the 81 companies in the two lists, just 13 are service-based companies (Thomas Cook, Tata Elxsi, NESCO, Tech Mahindra, V-Mart, CRISIL, Sun TV, Infosys, Zensar Tech, NIIT Tech, Zee Entertainment, ICRA, Persistent Systems). The rest manufacture and/or sell products.
- Median 10-year CAGR in profits of the Winner list is 24%, and median 10-year average ROCE is 28%. Median 10-year CAGR in profits of the Aspirer list is 12%, and median 10-year average ROCE is 29%.
- Median market cap of the Winner list is Rs 7,000 crore, and that of the Aspirer list is Rs 16,000 crore. This helps reiterate the fact that small to mid-size companies have the potential to grow faster than their bigger counterparts (base effect), and when you combine that with high ROCE, you may have a gem in hand (if bought at appropriate valuations).
- Just two companies from these two lists (ITC and Bombay Burmah) have multiple business lines. The rest are mostly focused on single industries (products or services).
- Just three companies from these two lists (Mahanagar Gas, Indraprastha Gas, and Bharat Electronics) are PSUs. Notably, all of these are monopolies in their respective spaces (city gas and defense supplies) and benefit from regulations.
- Of the 47 companies in the Winner list, median age is 38 years, two companies are 100+ years old (Britannia and Bumbay Burmah), fourteen are between 50 and 100 years old, and just three were incorporated in the 21st century (Cera Sanitaryware, Godrej Consumer and V-Mart). Old is gold, you see!
- Of the 33 companies in the Aspirer list, median age is 55 years, two companies are 100+ years old (Castrol India and ITC), sixteen are between 50 and 100 years old, and just two were incorporated in the 21st century (Wabco India and NIIT Tech).

may directly own and may want to move out of your portfolio (just in case), or simply avoid the future.

Click here to download the list of companies.

Words of Warning

Before you look at these lists, here are some words of warning.

What you see there is just data. Numbers speak out loudly in most cases, but sometimes they don't. Like you may never know from past numbers how the future might look, even though a long-term past is a good indicator of what may happen in the future. Also, you may never be able to locate a turnaround based on a poor track record in the past (though as Buffett says, turnarounds rarely turn around).

Also, a great past may fool you into buying a business whose peak is past. Like, for the Winner and Aspirer lists, if you compare the last 10-year ROCE, with 5-year ROCE, with 3-year ROCE (in that order), 13 companies show a declining trend (Mayur Uniquoters, VST Tillers, Colgate, CRISIL, ITC, Infosys, Divi's Labs, Zensar Tech, Wabco, Rallis, Grindwell, Exide, and Pfizer; notably, these are mostly from the Aspirer list where the rate of earnings growth has been low to moderate). If you are tracking these companies, you must keep a close watch on any further decline in ROCE, as that may indicate a weakening moat and business quality.

Another warning is that a great past may lead you to be greedy and imagine with certainty a great future and thus overpay for the stock. So, be careful of what you observe and how you act.

Just treat these lists and the theory around them (ROCE + Earnings Growth) as a mental model to think about how to pick the right kind of businesses and avoid the wrong ones.

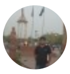
And please remember Warren Buffett's adage that investing –

- *Is simple* – We know that sustainably high ROCE and earnings growth is a great combination for long-term wealth creation
- *But not easy* – Practicing what we know and paying appropriate prices even for the best of businesses and avoiding the bad ones when others may be making some money on them in good times.

Keep this in mind, keep it simple, work hard, and stay safe.

and wrong. I have been wrong many times in the past. I am a registered Research Analyst as per SEBI (Research Analyst) Regulations, 2014 (Registration No. INH000000578).

Comments



Ashok Kumar Meena says
March 25, 2019 at 12:22 pm

Thanks for this idea. But as you know that earnings have accruals problem. What if we use (FCF or OE/Capital Employed) or in other words if we use CROIC and look at the results? Things may change. What do you think?

Reply

Sheetal appaso kumbhar says
March 25, 2019 at 12:41 pm

Awesome inputs sir. You are gem for me. Lots of love and keep your valuable guidance forever.

Reply

Solid work Vishal! Much appreciate.

Yet, one thing that troubles is the trustworthiness of the P&L and B/S of most companies, particularly non MNC and non old Indian business houses like Birlas, Tatas, Bajaj, HDFC to name a few. For the rest, as things show now after the crash their profits have also started tumbling for some very "simple" reason or the other, including "fire at a factory". So how do you advise getting around that? Perhaps that is why most of the wealth creators are the OLD ones;)

Reply

Vishal Khandelwal says
March 26, 2019 at 1:57 pm

Thanks Mr. Sengupta. Yes, focusing on established business houese that have done well over cycles is a good idea. Also ensure low leverage on the balance sheet, because it is leverage that often leads managements to create numbers that would usually not exist. Regards.

Reply

Saket Mishra says
March 25, 2019 at 9:26 pm

Vishal, I am an early follower of Safalniveshal, been hooked to your site for more than 5 years.
But I always get unconfortable when you hazard into stock categorization despite the disclaimers.
Let me refute a couple of categorizations.
1. Nesco – A good company with reserves of 500 cr and no debt. But does it warrants being a winner given it is reliant on low rental income?
Risks – As identified in the blog by Dr. Vijay Malik
o Competing exhibition center might come up from Reliance in BKC which would be closer to South Bombay and hence more lucrative
o Auditors have highlighted delay in payment of service tax
o Questions raised by auditor on details of inventory management

2. PVR – Though an average ROCE, the company has factors aligning to make it very desirable. It warrants a much better categorization than a 'treadmill'
Factors –

o Brand – it has the highest mind space already
o As the oligopoly grows stronger, consistently improving bargaining power with movie producers (Ronnie Screwala filed a case recently against all the movie exhibitors which only confirms that the producers are losing bargaining power)
o Advertisement – Big brands get access to high visibility placement across the country in one shot to captive audience so this is a sustainable revenue source
o F&B – No matter the court rulings, it is difficult to imagine any big decline in this very high margin F&B segment. Alternative of buying food from other shops in mall is also expensive and there is no fun if one has to cook food from home and take it to malls. So this segment will continue to bring revenue – a lot of it.

Not getting into valuations at all because you have not gone there.
I think most value lies in ideintifying companies which are set to go from an undersirable to a more desirable categorization.

Reply

Vishal Khandelwal says
March 26, 2019 at 1:53 pm

Thanks for reading, Saket! I agree with your concerns. And that is what the purpose of my disclaimers and words of warning is. Investors reading this must understand that these lists are purely an output of the screening criteria, and must not base their decisions without proper homework. My idea is just to offer them a sensible way of thinking, amidst the noise around. Thanks!

Reply

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March 26, 2019 at 1:53 pm

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Reply

Hi Sir,
Sometime the ROE or ROCE is good because of high dividend given by company. How do you look at such companies whoes ROE/ROCE is high due to high dividend eg. OFSS.

Reply

Jithin says
March 26, 2019 at 11:28 am

Great work Vishal.

One minor point though: Top performers such as HDFC, Gilette India don't show up in any cateogry

Reply

Vishal Khandelwal says
March 26, 2019 at 1:54 pm

HDFC because of D/E requirement of < 1. Gillette because of 10-year profit CAGR of less than 15%.

Reply

Kamal Garg says
March 31, 2019 at 11:24 am

But Finance based companies like Banks and NBFCs would have different D/E ratio as in their case, 'Debt' is their 'assets', from which they make money on the differential.
At best, D/E in case of finance companies can be taken at between 6 to 7 as the best/moderate case for further analysis.

Reply

Vinayak Bathwal says
March 29, 2019 at 8:14 am

Hi Vishal.Is there a difference between ROIC and ROCE?

Reply

March 31, 2019 at 7:30 pm

Super work Vishal!

Reply

Vardhman Chhajed says
April 1, 2019 at 10:32 pm

Hi Vishal, this is a fantastic piece! Thank you so much for enlightening us. One small query though, the formula you used for 'Winners' pops up Vakrangee as well. Any reason why that was omitted from your excel sheet?

Regards.

Reply

SP says
April 4, 2019 at 8:21 pm

A query, purely from my study /analysis purpose:
In the sweatshop list – 'Bajaj Holdings' is listed – which has 24% in Maharashtra Scooters, 39% Bajaj Finserv, 31% Bajaj Auto, 19% Hercules, 16% Bajaj Electricals among others. Ofcourse, it's holding company and hence ROCE is expected to be low – which probably is the reason it is in sweatshop !

So wondering – for such holding/group companies, is ROCE the right measure ?

Reply

shweta says
April 10, 2019 at 5:48 pm

Awesome inputs sir. You are gem for me. Lots of love and keep your valuable guidance forever.

Reply

Jay says
June 9, 2019 at 2:12 am

Reply

Bharat shah says
September 27, 2019 at 9:07 am

Just for record and insight: Thomas Cook (I) of Winner list may suffer/wipe out all together, though no fault seems, but the parent is bankrupt! I think, one more point to watch before selecting! Please offer your comment.

Reply

Bharat shah says
September 27, 2019 at 9:23 am

Sorry, commenting in hurry. as understood, Thomas Cook(I) is now separate entity since 2012. However the point is still valid , while deciding for a subsidiary of some MNC Is not?

Reply

Kamal Garg says
September 27, 2019 at 11:11 am

There is no relationship whatsoever at all, between Thomas Cook Plc. UK and Thomas Cook India. Not even a business relationship leave alone shareholding/ownership relations. The only relation is that the brand 'Thomas Cook' is owned by Thomas Cook Plc. UK and Thomas Cook India is using this brand name under a licence use agreement and pay royalty on this use.

Reply

Leave a Reply

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Comment