

## **Buying Cash generating Companies' Shares is best Investment**

Times like these remind everyone of the definition of investment as given by Benjamin Graham "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative." A prudent investor remembers this definition always. Another statement by Warren Buffett regarding stock market buying rule is of relevance "Be fearful when others are greedy, and greedy when others are fearful." This is a time to start buying stocks, but what kind of stocks should one buy? Not all stocks are will give a decent; some leveraged companies can even go bust. We outline our stock selection criteria below and give some indicators about real estate and mutual funds.

In our opinion stocks in companies which are generating cash, have pricing power and low (or no) debt are the best investments. Some of the popular way to store wealth like fixed deposits, real estate and most mutual funds fail to qualify as an (good) investment option over time horizon of 3-5-10 years currently.

We are looking at following criteria while choosing a company for investment:

**Pricing Power:** Company should have a pricing power. This is of critical importance in present inflationary scenario. The ability to pass on cost will lead to growth in profits. The absence of that ability will lead to fall or stagnation of profits. Pricing power could be due to presence of well known brand or absence of capacity. High entry barriers with little competition would be typical for companies with pricing power.

**Free Cash Flow Generation (if reinvested, high Return on Equity):** Companies are evaluated in how much cash they generate and how they deploy cash. In an economy in growing phase like India, there is temptation to reinvest too much because everybody else is doing the same. In some sectors this would lead to over investment, causing pain to everybody. In some cases the reinvestment is a business need rather than future source of income. Our preference is for companies which reinvest in opportunities with potential for return significantly higher than inflation. Mostly these opportunities are in same area in which company operates, though occasionally it can be related to area of operation.

**Profitable growth potential:** Indian economy is in growing phase and we think that the macro factors are in favour of long term growth. We prefer opportunities where at least some development has happened (so that we can for an informed opinion about parameters) and the potential for growth remains high to moderate.

**Honest and Competent Management:** Honesty of management is illustrated by its willingness to return capital to shareholders rather than going on empire building spree. Quite often in India (this true globally, may be not as big a problem) shareholders pay for management's profligacy. We prefer to be with management with high stakes in business. Though this is not a guarantee against profligacy but it does reduce its occurrence.

**No or low debt:** Companies that have been built on debt will face a tough time in near future. The cost of debt will remain high and that will have an impact on margins. The availability of debt is another issue that most companies will face. Any company that is leveraged faces a much higher risk and should be bought only if potential rewards justify those risks.

**Margin of Safety:** This is a basic principle of (value) investing as has been enunciated by Benjamin Graham. We demand as much margin safety depending upon how far investing in a company is from ideal scenario. A patient investor in Indian equity markets will almost always find a favourable price at some time. If there is too much volatility, an informed investor should benefit from these swings.

Our current portfolio has following parameters: Price Earnings ratio of 6, Dividend Yield of 6% and return on equity of 30%. At current prices we expect a total return (capital appreciation plus dividend reinvestment) of 24%, per annum over a period of five years. The critical assumption is that funds are invested regularly at six months- one year interval. The returns should turn out to be lumpy. One year it may be -30%, while other year it could be 60%. Regular investments will help investors profit from these variations.

Real estate will be one of the worst asset classes in next three years. Prices of properties in India are at least 2-3 times higher than prices in any other major economy, if it is adjusted for level of income and availability and pricing of home loans. This is indicated by the level of rental yield in India which is around 2-3%, compared to 6-10%, most economies. The low rental yield indicates low level demand at these prices. Price will fall by up to 30% from peak and up to 50% in real terms for properties.

For analysis of mutual funds see our write up on mutual funds [www.rirlimited.com](http://www.rirlimited.com) "Why Mutual funds will disappoint". Published on 2 June, 2008.