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Why are you so optimistic about Manufacturing when these businesses are lower ROEs relative to Consumer companies and hardly generate any Free Cash Flow.

The 3 key variables that matter in value creation are longevity of profit growth, sustainability of ROE aboveCost of Equity (12% in India) and entry prices paid. Traditional wisdom to buy only high ROE and high FreeCash Flow generating businesses ignores 3 key variables:

- Where the company is in its growth life cycle.
- The important of entry valuations paid.
- That low reported Free Cash Flow today in many manufacturing businesses is just delayedgratification and that reported ROCE is understated.

Our threshold of a good business is one that can generate 18% ROE+ with prudent leverage. The 6% spread over 12% Cost of Equity creates immense value even with 15%+ growth. Hence, a 18-20% ROE business is very attractive and merits consideration in allocation of capital over a 40-50% ROE business basis other factors such as long-term growth prospects, disruption risks, entry prices etc.

Many Consumer businesses which are high ROE today are likely to see greater competitive intensity as competitors attempt to enter adjacencies. Consider Air Conditioners: Voltas market share has dropped from 25% to 22% in last 3 years due to intense competition (Source: Kotak Institutional Equities). Many FMCG businesses are also seeing their high value customers being targeted by D2C brands and launch ofPrivate Labels by organized retail. Paints has seen the entry of Grasim and JSW. This could result in lowermargin and hence lower ROE profiles of these businesses in future vs today as they will need to give up margins to defend market share. FMCG businesses may increase ROE by outsourcing Manufacturing – but they give up some strategic control over pace of new product introduction/experimentation.

While Manufacturing businesses tend to be lower ROE than Consumer (they are more capital intensive and have lower pricing power), they could deliver higher and more sustainable growth than some Consumer businesses this decade due to the de-risking tail winds at play and as MNCs should not grudgetheir Indian partners a 18-20% ROE for reliable supply. Hence, a manufacturing business that can grow at ~15% PAT growth for 2 decades at 18-20% ROE may be a more attractive investment proposition than aConsumer business than can grow PAT at ~10% for 2 decades at 40%+ ROE.

The low Free Cash Flow (FCF) of many Manufacturing businesses today is just delayed gratification. The aim of a business owner needs to be to maximize “long term” Free Cash Flow. Reported Free Cashflow should be examined in context of where a company is on the growth life cycle and the opportunitiesit has to re-invest capital. This is not very different from a graduate who goes on to take an advanceddegree rather than immediately accepting a job. They are postponing a salary they could earn today, forhigher skills and hence better job prospects and a higher salary two years down the road.

Poor FCF in the high growth stage of a company is perfectly normal if the business is re-investing all profitsfor growth at incremental ROE above Cost of Equity. One is essentially sacrificing dividends today for muchhigher dividends down the road.

SRF generated no FCF in the period FY2013-2023 because all Operating Cash Flow was reinvested in newcapacities. This resulted in SRFs PAT growing from ~250crs to ~2150crs from FY 2013 to FY 2023.

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They could have been more conservative on investments, reported higher FCF which they could have paid outas higher dividend, but then the profits today would be significantly lower. Focusing on short term Free Cash Flow would have led to the wrong long-term decisions.

The reported ROCE of a manufacturing business that is investing in growing capacity aggressively is understated and not reflective of its true ROCE.
The useful life of many capital-intensive businesses is higher than the timelines on which they are depreciated. Maintenance capex is typically much lower than depreciation. Hence, reported ROCE expands over time as Sales/Net Block expands.

Steep increase in capital expenditure depresses reported short term ROCE as new plants will typically take 3-5 years to reach full utilization. So the reported ROCE of the company is a mix of very high ROCE of old plants and low ROCE of plants that have not reached full utilization.

Finally, a business that is growing rapidly will over-invest to gain credibility with customers. They may choose to build capacity ahead of demand, choose to keep higher inventories to buffer against unreliable raw material supply, keep inventory closer to customers, have higher Work in Process inventory if they are increasing number of SKUs. All these aspects depress reported ROCE which is temporary. These inefficiencies will be eliminated with time.

Manufacturing businesses in India have a great opportunity to capture market share of global supply chains. Leaders with vision will invest ahead of the curve to establish credibility amongst global customers. This will depress reported ROCE but is the right thing for them to do and we will look at such companies with significant interest.