<u>Characteristics of businesses we like (and own)</u>

As a reminder, our investment strategy is to be the long-term owner of 10-20 high-quality businesses listed in India, likely small and mid-cap, and bought at reasonable valuations (if not better). We identify such businesses as those that are led by the right people, with an ability to earn sustainably high returns on their capital, while operating in a growing industry. We expect the investment returns from this strategy to be more than satisfactory over a long enough period of time, which would be mirroring, if not better than, the financial performance of the underlying businesses.

The above objective may sound simple, but finding such businesses is not easy. There are two reasons = (1) rarity of such businesses and (2) difficulty in business assessments. On the first, we estimate that 90% (if not higher) of the listed universe will fail our criteria on one or more of our requirements. Specifically, capitalism's creative destruction will ensure that most companies will struggle to earn sustainably high returns on capital. On the second, it is important to acknowledge the limits of our circle of competence, which reduces the number of businesses that we can understand today. Moreover, there are always uncertainties while analysing a business, especially in disaggregating the roles of skill and luck, even if all relevant information is available (which is itself a hurdle sometimes). Confidence in business assessment usually improves with familiarity, and as our circle of competence expands, slowly, over time.

Difficulties aside, we try to invest in such high-quality businesses because we find the process interesting and challenging, and if done well, quite profitable too, based on direct and vicarious experiences. Restating the original objective stated above, there are three characteristics we try to learn more about:

(1) People: Quality of majority shareholders (promoters) and management teams

(2) Returns: Underlying sustainable returns (Returns on Investment Capital = ROIC and Returns on Equity = ROE) profile of the business and

(3) Growth: Prospects of volume growth in the business and industry over the next 5-10 years

Keeping in mind the aforementioned caveat regarding the difficulty of assessments, we attempt to ascertain the characteristics of each business with the below framework:

	Very High	**High**	**Medium**	**Low**
People	• Proven intentions and track-record • Promoters, ideally owner-manager, own >20%	• Proven intentions and track-record • Promoters (if any) own >20%	• Unsure intentions and/or track-record • Promoters (if any) own >20%	• Poor intentions and/or track-record • Promoters (if any) own <20%
Returns	• Underlying sustainable ROIC and ROE >30%	• Underlying sustainable ROIC and ROE = 20-30%	• Underlying sustainable ROIC and ROE = 15-20%	• Underlying sustainable ROIC and ROE <15%
Growth	• Business growth >20% yoy • Industry growth >5% yoy	• Business growth 10-20% yoy • Industry growth >5% yoy	• Business growth 5-10% yoy • Industry growth >5% yoy	• Business growth <5% yoy • Industry growth <5% yoy

We then filter the characteristics of each business as follows (though we are "not sure" many a time):

	Very High	High	Medium	Low
People	Eagerly accept	Accept	Avoid	Violently Avoid
Returns	Eagerly accept, if People are High or above	Eagerly accept, if People are High or above	Accept, if People are High or above	Violently Avoid
Growth	Eagerly accept, if People are High or above and Returns are Medium or above	Accept, if People are High or above and Returns are Medium or above	Accept, if People are High or above and Returns are High or above	Avoid

Please note that what we have covered so far helps to identify businesses that we like, but not yet prices to buy their stocks at. That said, the understanding of above identified characteristics determines the intrinsic valuation framework that we use and hence what prices to buy. As you would expect, many of these rare businesses are invariably already valued fairly by the market, if not unfairly i.e., implying very high expectations. Hence, we wait for some dislocation in their stock prices, due to reasons that are either market-level (uncommon but most profitable situation), sector-level (more common and our preferred situation) or company-level (occasional, but usually difficult to evaluate). We hope to discuss more on this topic at some point in the future.