One quote is copy pasted on my desktop as a sticky note and I read it every time I look at new investment opportunity

What to look for in a great business?

A high return on capital (not contributed by a very low margin operation where margins could fall) which is sustainable - pricing power, low cost advantage etc. Ability to deploy incremental capital at high rates of returns i.e. growth prospects. Ability to self-fund growth – Prof Sanjay Bakshi

A useful way to start would be to create a framework that can help us identify great businesses. Let's try to build a framework by analysing earnings of company as in long run it is earnings which drive stock prices

But how do we analyse earnings of the company? I use a triangular approach

**1. Determine the authenticity of Earnings** – To ensure an accountant is not cooking the books and accrual earnings reported by company are authentic

**2. Composition of Earnings** – A simple DuPont break down of ROE to determine sources of a company's return on equity. This would help us understand what contributes to high or low return on capital

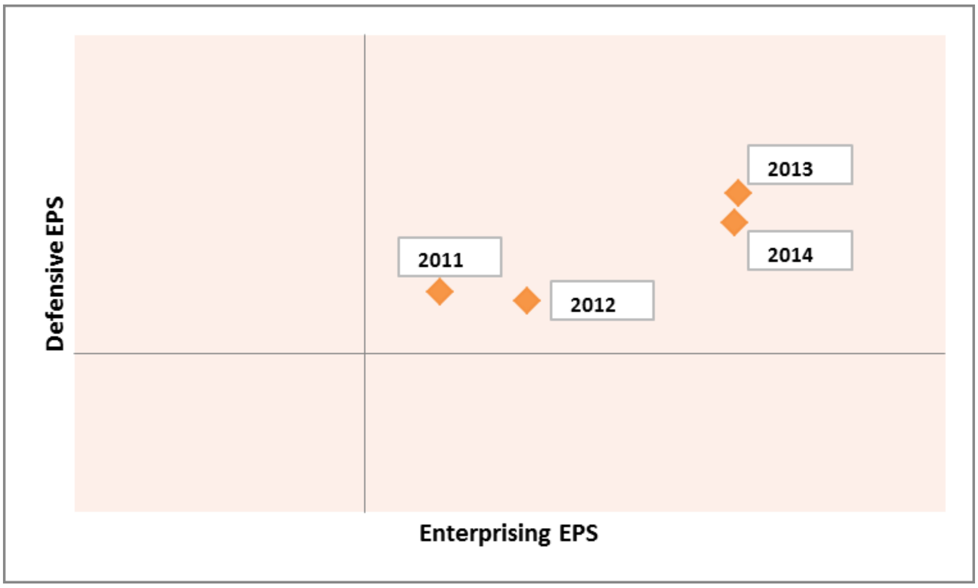
**3. Source of growth of Earnings** – Understanding what factors that are driving earnings growth – pricing power, opportunity size, low cost advantages etc

Laying out an actual case study cements the concept, we will put Atul Auto's earnings to above test.

**Earnings Authenticity** - I did an earlier post on finding stocks with long term earning power using earning power box as explained by Hewitt Heiserman in his bestseller Its Earnings That Count

Companies having authentic earnings power create long term wealth for investors; I am not going to repeat much from the post. But as we learned true wealth creators sit in quadrant 2

**Atul Auto- Earnings power box**

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We can clearly see Atul Auto sits in quadrant 2 which is wealth maximising quadrant with positive defensive profits and enterprising profits in each of the last four years

Conclusion – Growth has been self-funded and company has been able to earn above average returns on capital.

Once we determine that earnings are authentic the next step is to understand what contributes to the superior returns so we turn to

**Composition of Earnings using DuPont model** – Wikipedia defines, The Du Pont model breaks down Return on Equity (that is, the returns that investors receive from the firm) into three distinct elements. This analysis enables the analyst to understand the source of superior (or inferior) return by comparison with companies in similar industries (or between industries)

We should perform this analysis for a number of years to get an insight if there is an emerging trend

The maths is simple

ROE = (Profit margin)*(Asset turnover)*(Equity multiplier) = (Net profit/Sales)*(Sales/Assets)*(Assets/Equity)

Atul Auto's ROE numbers have been fantastic over last four years

| **Dupont** | **2014** | **2013** | **2012** | **2011** |
|---|---|---|---|---|
| NPM | 6.88% | 7.09% | 5.21% | 4.65% |
| Asset Turnover | 2.99 | 2.97 | 3.10 | 2.71 |
| Equity Multiplier | 1.53 | 1.66 | 1.72 | 1.85 |
| **ROE** | **32%** | **35%** | **28%** | **23%** |

The source of high ROE has been improved asset turnover and higher net profit margin, in fact the company has done exceptionally well as it has also consistently reduced its equity multiplier confirming that growth has been self-funded

Conclusion – ROE is going up due to improved asset turnover and higher margins.

Can earnings continue to grow? What is driving profit growth?

For that one needs to **break down the earnings growth**. There are four internal levers that drive earnings growth

Source: Motilal Oswal 19th wealth study

**Earnings Growth: For the arithmetically inclined**

$$\Delta \textbf{EPS} = \Delta\text{Sales volume} \times \frac{\Delta\text{Sales}}{\Delta\text{Sales volume}} \times \frac{\Delta\text{EBIT}}{\Delta\text{Sales}} \times \frac{\Delta\text{EPS}}{\Delta\text{EBIT}}$$

$$= \textbf{Volume growth} \times \textbf{Price Lever} \times \textbf{Operating Lever} \times \textbf{Financial Lever}$$

**Note:** Δ (read as delta) denotes % change. For more on levers, please refer our IF (Investment Framework) series report dated 29-Sep-2014.

Let's do the maths first as that is easy

| Year | 2014 | 2013 | 2012 | 2011 | Comments |
|---|---|---|---|---|---|
| Diluted EPS | 13.3 | 11.57 | 7.16 | 4.3 | |
| **Change in EPS** | **15%** | **62%** | **67%** | | |
| Sales Units | 37557 | 32040 | 27000 | 19404 | |
| **Volume Growth** | 17% | 19% | 39% | | Size of Opportunity will drive this |
| **Pricing Lever** | 0.96 | 1.17 | 1.22 | | Pricing Power will drive this |
| **Operating Lever** | 0.88 | 2.64 | 2.38 | | Margin, improvements in cost structure would drive this |
| **Financial Lever** | 1.03 | 1.07 | 0.58 | | Capital structure would drive this |

Now let's analyse each of the lever

1.Volume growth–a function of demand growth matched by company's capacity to supply; Atul Auto sells 1/4$^{th}$ units compared to its largest peer Bajaj Auto with negligible presence in export markets.  So the opportunity size is big and EPS growth can continue to match volume growth as long as other levers are maintained

2. Price growth –a function of company's pricing power, which in turn is a function of the competitive landscape, the three wheeler industry is a crowded place with multiple national and international large players. Decomposing earnings growth we can see Atul Auto doesn't have significant pricing power

3. Operating leverage -a function of the company's operating cost structure; higher the fixed cost, lower the unit cost incidence and higher the operating leverage. During the year 2012 and 2013 earnings were given a significant flip as operating lever came to fore. This is reflected in improved net margins when we dig deep in financial statements

| Year | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|
| Revenues | 100.00% | 100.00% | 100.00% | 100.00% |
| Material Consumed | 76.29% | 77.50% | 80.78% | 77.71% |
| **Gross Profit** | **23.71%** | **22.50%** | **19.22%** | **22.29%** |
| Change in Inventory | 0.29% | 0.20% | -1.44% | 0.49% |
| Employee Benefit Exp | 6.32% | 5.74% | 5.50% | 5.72% |
| Other Expenses | 5.94% | 5.06% | 5.76% | 6.18% |
| Depreciation | 1.20% | 1.21% | 1.42% | 2.10% |
| **EBIT** | **9.95%** | **10.28%** | **7.98%** | **7.80%** |
| Finance cost | 0.08% | 0.11% | 0.26% | 0.90% |
| Exceptional Cost | 0.00% | 0.00% | -0.04% | 0.00% |
| Tax Expense | 2.99% | 3.09% | 2.56% | 2.24% |
| **Net Profit** | **6.88%** | **7.09%** | **5.21%** | **4.65%** |

4. Financial Leverage -a function of the company's capital structure; higher the debt equity, higher the financial leverage and vice versa, Atul Auto is almost debt free so this lever is unlikely to drive earnings which is a very positive indicator

So source of company's earnings growth would most likely come from increasing sales volume and maintaining operating leverage.

Now let's go back to our definition of great business and see whether Atul Auto fits the bill

A high return on capital **– [Tick]**

(Not contributed by a very low margin operation where margins could fall) - **[Tick]**

Which is sustainable - pricing power **[No visible pricing power],**

Low cost advantage etc. **[Possible needs to check industry cost structures]**

Ability to deploy incremental capital at high rates of returns i.e. growth prospects **[Tick].**

Ability to self-fund growth **[Tick]**

One can use simple tools like

- Earnings power box
- DuPont analysis
- Earnings growth levers

to build a framework to determine great business