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Confounding conundrum: Corporate wealth VS Investor wealth

Though ROE is an objective means to ascertain if the business is a wealth creator, the price at which it is transacted also matters a lot when it comes to wealth creation for the investor.

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Corporate wealth creation seems to be a conundrum which is answered with a multitude of vague, qualitative statements. These statements are typically around the vision and great leadership qualities of the corporate leader, typically the founder/Chairman/CEO. He is a near SuperHero with powers beyond mere mortals. More his photos adorn the business newspapers or the magazines or more we see this charismatic figure appearing on TV propounding “visionary” ideas, more belief is created in this SuperHero’s magical management powers.

Since Buffett does talk about his great managers and their skills and how they create value for Berkshire, everyone who wants to be a Buffett convinces themselves that they too know how to assess “Management”. And then they are willing to pay for it No price is too high. Sometimes, in fact, the higher the price goes the more the belief in the “Management” and the more the price they are willing to pay.

At such times when we are enticed to buy such a “wonderful company” with a “wonderful management” because Buffett would do it too, let’s remind ourselves of the following quote from Buffett:

I try to buy stock in businesses that are so wonderful that an idiot can run them. Because sooner or later, one will. So, Buffett is focused more on a “wonderful business” than on a “wonderful management”.

So, what is a wonderful business?

The equity capital in a business is used to buy assets (assume no debt for now) which are then used to produce and market the products or services and bring in revenue. As long as the cost of these business operations is lower than the revenue some profits are created. That profit is the return generated on the equity capital. Of course, we all know this, but let us soldier on.

One could have kept the equity capital in the bank and earn an interest on it automatically without any practical effort. Since the equity owners have taken the trouble to invest somewhere other than the bank, the expectation is of a larger return.

So the profits generated on the equity capital invested should be more than the return that a bank deposit could have created. Since the bank deposit’s returns are guaranteed and for the business they are not, a higher return is expected by the corporate investor of the equity capital. Without getting into the technicalities of “how much more” we will leave it at “substantially more” for now.

Assuming that a bank deposit gives post tax returns of 6% and a typical corporate gives a post tax return of 15%, we can now calculate what would be the future networth of the bank deposit and the corporate.

	Bank Deposit	Corporate Wealth
Years\returns	6%	15%
5	1.3	2.0
10	1.8	4.0
15	2.4	8.1
20	3.2	16.4
25	4.3	32.9
30	5.7	66.2

The above table shows that the bank deposit nearly doubles in 10 years but the corporate wealth quadruples. In 20 years the difference is a tripling vs 16 times and in 30 years it is 6 times vs 66 times!

That is how wealth is created in a business. The business which can compound its equity capital at high rates of returns can create massive corporate wealth. 15% return on equity (ROE) is typical for an average business in India. The ROE is the engine of corporate wealth. The higher it is the more corporate wealth creation the company can do.

However, since demand can go up and down with economic cycles, the revenues of a company can go up and down and its profits can fluctuate even more while the equity capital invested remains constant. So the ROE fluctuates for many companies. Certain sectors are inherently more stable since the demand and supply is more stable in these sectors; these have stable ROEs. Typically, health care, technology, FMCG (within consumer goods) and utilities have more stable ROE. Typically, the ROE of these sectors, except utilities, are 25% or higher. ROE for utility companies is in 10-15% range. Many other consumer goods and consumer services businesses have high and stable ROE.

Basic materials, industrials, and financials are more cyclical and have ROEs that fluctuate with the economic cycle. At the peak of the cycle they are very high and at the bottom a lot of companies have large losses. However, what matters for cyclicals is what is the total return on the equity capital over a full business cycle. As long as that is positive there is corporate wealth creation.

While the secret to corporate wealth creation is through growth of networth driven by ROE, the secret to investor wealth is not that simple.

A company with high corporate wealth creation potential due to a high and stable ROE is known to most investors in the market as such. Hence they are willing to pay higher prices for the higher growth potential. Now the investor wealth creation becomes difficult for a secondary market investor. Higher ROE companies are typically priced at very high PE ratios. As the price paid becomes higher for a company the returns to the secondary market investor's wealth become lower. Most investors can tell that a company is a “wonderful business” just by looking at its ROE and not paying that much emphasis its management. However, a “wonderful business” can become a “lousy investment” for an investor.

There are a couple of tricks which value investors like Buffett use to get around this. They wait for times when the markets are down, in general, and load up on these corporate wealth creators at significant discounts to intrinsic value. Another possibility is when there are temporary problems in a company and that has reduced the near-term expectations from the business. These are times when the company is likely to be priced at a discount to intrinsic value based on its long-term wealth creation potential.

The conundrum of investor wealth creation can be unravelled in the Buffett way by identifying high and stable ROE companies and waiting for them to be available at a significant discount to intrinsic value and then loading up on them. However, there is also a time to unload them when Mr. Market is willing to buy them off at several times their optimistic intrinsic value.