House **o**f **O**cean **D**ial Series – **HOOD**stock

India Capital Growth Fund's Industry Leaders: #1 Kajaria Ceramics

India Capital Growth Fund's investment mandate is the small and midcap sector of India's listed universe. This can create the impression that our investee companies are less proven or even un-scalable, since a lower market capitalised investment universe can conceal a portfolio of industry leaders, some domestic, others global. Three examples for the sake of brevity; **MCX** is India's major commodity exchange with over 90% market share; **Welspun** is India's principal home textile company supplying 17 of the top 30 retail chains in the world (and the producer of Wimbledon tennis's iconic towel); and **CCL Products** is the world's second biggest private label instant coffee manufacturer, behind Nestlé. This note is part of a new series that looks at industry leaders in the India Capital Growth portfolio to explore their specific strengths and share our optimism on their prospects.

Problem solving

A useful exercise when analysing a company is to ask oneself – *does the business model solve a problem facing the market*?

Picture the multiple challenges that are faced when a family wants to tile their kitchen or bathroom in India. As a customer, the buying experience can be an infuriating challenge. Successfully navigating a sector where 55% of the market operates in the informal sector where tax evasion, price cutting, and poor customer service are the norm is no picnic. **Kajaria Ceramics** is finding ways to overcome this and is achieving scale by innovating to build a better customer journey. To summarise:

- The first tile company to invest in large showrooms offering its entire product range
- Pan-India manufacturing base allowing it to service a broader network of dealers
- Use of customer data and modern inventory management practices
- Early adopter of robotics to minimise product damage

In order to strengthen their brand equity, Kajaria was also the first tile company to invest in film and cricket stars to serve as brand ambassadors. This not only gives them pricing power, but also supports more efficient inventory management. Since many architects have built sufficient confidence in Kajaria's inventory systems and product quality this affirmation is spreading to a broader retail customer base. Architects are able to direct customers to visit a Kajaria showroom and having registered their chosen tile's product code into the system, the "last mile" can be left to the architect's team to complete. This customer-pull strategy reduces working capital intensity whilst allowing the company to maintain a broad product range of approximately three thousand stock keeping units, or SKUs.

Our conversations with dealer networks and architects confirmed this was indeed Kajaria's operational strategy. Founder, Ashok Kajaria, and his two sons ensure a personal touch with their dealers through conducting regular glitzy awards ceremonies and hosting conferences for them overseas. This ensures dealers remain loyal to Kajaria, do not undercut each other on pricing as well as helping to build a pan India network.

Capital allocation

Kajaria's strategy is to drive volume by penetrating deeper into small town India and value with a gradual shift to the premium tile segment as India grows wealthier. Despite our confidence in the management and its strategy we nevertheless have questions over the business opportunity of the industry as a whole which records single digit margins and return on capital employed (ROCE) often below the cost. Growth is important but it must correspond to positive returns for shareholders.

In Kajaria's case, its approach to capital allocation has allowed the company's asset turnover to expand from below 1x to 1.5x, which in turn has enabled ROCE to move well above the cost of capital. First, the cost of higher quality plant machinery, sourced from Italy, halved as competitive pressure from cheaper Chinese entrants drove prices lower. Second, the company's shift to higher valued tiles led to higher revenues, delivering better returns. Finally, Kajaria expanded volumes by outsourcing production and creating joint ventures for sourcing lower-end tiles. This lowered fixed capital investment requirements, enhancing capital efficiency ratios, whilst the asset-light model unlocks cash for further investment into the brand. Indeed, as gross margins expanded over the decade from 55% to 65%, management has successfully held operating margins constant at between 15% and 18% in order to keep investing back in sales and marketing.

The joint impact of better customer servicing and higher investment in brand equity creates a virtuous circle. Spending on both advertising and superior dealer servicing generates higher sales, which in turn allows the company to put more back into the customer, leading to further top-line growth.

"Resilient"

"Resilient" was the only word to feature on the front cover of Kajaria's latest annual report. Readers understand that all companies face difficult operational periods when it becomes a hard battle just to stand still, but where survivors emerge stronger. This has been the case for Kajaria more recently but whilst the long term secular story of growth in sales and profits for Kajaria remains, its profitability will continue to fluctuate cyclically and more so than pure discretionary focused consumer businesses. As such, between 2012-17 the company's revenue and profits compound annually at 14% and 26% respectively allowing the share price to re-rate from an earnings multiple of 13x to 25x. Since then revenue and profit growth have both shrunk to 3% and 10% in turn. Two reasons principally:

1. A broader economic slowdown
2. Unbranded tiles, destined for export, being dumped into the domestic market

During this difficult period, the company managed to preserve EBITDA margins at over 15%. It achieved this as 80% of sales is to retail channels rather than property developers, thus preserving pricing power. In addition, management was able to up-sale, shifting customers towards larger, glazed and vitrified tiles. These tiles are glossier and more scratch resistant than the ceramic alternative, and they command a price premium consequently. Kajaria's focus on investing in new show rooms in Tier 2 to 4 cities bore fruit in 2020. Those urban areas were less impacted by COVID-19 induced lockdowns allowing the company to gain market share. These smaller cities are where incremental demand is likely to be most pronounced for the company in the future.

As the economies globally start to pick-up, this industry pressure is alleviating. Morbi, a town in Gujarat with over 800 tile manufacturers, has ceased dumping unbranded product domestically. In addition, the Indian government's National Green Tribunal is forcing the sector to adopt better practice, which is making life more difficult for the smaller players. The Morbi "cluster" has had to switch to cleaner (more expensive) energy sources, whilst the implementation of the Goods and Services Tax (GST) is making it harder for these companies to avoid tax. Overall, the competitive pressure on Kajaria is diminishing in more ways than one, and these tailwinds have a way to go. Equally positive is the revival in demand for Indian tiles from overseas, as companies look to diversify their tile supply risk away from an over reliance on China.

Risk

We view our role as risk managers in the first instance. One of Kajaria's key risks is that, due to the cyclicality of the business, the stock market overreacts to above average ROCE of 20% for Kajaria, (it went up to 28% at the peak), and over-compensates when ROCE dips below. When capital efficiency fluctuates around the expected cross-cycle average of 20%, we enhance portfolio returns profile by carefully booking profits or judiciously buying more shares as mis-priced opportunities arise. Currently the company delivers returns of 17%, but since its focus on *resilience* and the creation of a wider "moat" has reduced the overall risk profile of the business our conviction has grown. Having booked profits at the peak of its ROCE profile we added more to the portfolio during the March 2020 market collapse, supporting broader performance subsequently. Knowing this company as we do helps us to judge its risk/reward dynamics effectively and deliver stronger returns.

Conclusion

Our conversations across the industry tell us that Kajaria is the gold standard and this is the name that competition look to benchmark themselves against. Through each economic cycle the company emerges stronger, reducing the volatility of its earnings profile, and allowing it to command a higher and more constant valuation multiple for the future. Globally, Kajaria is the largest tile manufacturer in India but still only the eighth largest in the world. As India's prosperity takes-off, we are confident that shareholders will watch it climb the global rankings, whilst as minority business owners, benefitting from strong returns of an exceptionally well-managed company.

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