Relaxo Lecture
20 Sept 2013

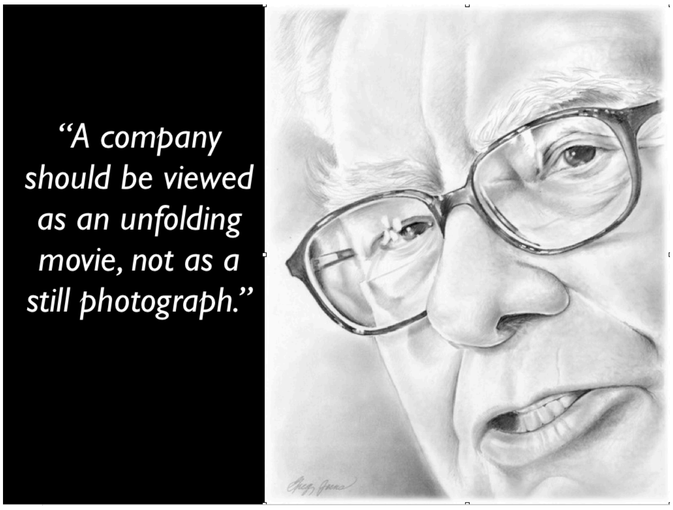
Delivered by Sanjay Bakshi and Ravi Purohit

As you all know, I had created a collaborative project on this company for each class group. I have received submissions from each group. Good. There will be more similar projects in the future.

I have here today with me, Ravi Purohit, who is CIO of Securities Investment Management Pvt. Ltd which is a value investing firm in Mumbai. Ravi's firm is invested in Relaxo and we have been talking about this company for many years now. Ravi was here to attend the company's AGM and after the AGM we met with the company's senior management who initially gave us an hour but that meeting ended up lasting more than three very fascinating hours. I will tell you about that meeting on another occasion (when we come to management quality), but today, I would like Ravi and I to provide you with answers to some of the questions I had posed to each group in the class project.

Here is a picture we took inside the company's HQ yesterday. As you know, these three very popular movie icons are the company's brand ambassadors.


I would like to start by citing one of my favourite Buffett quotes.




*A company should be viewed as an unfolding movie, not as a still photograph.*

Relaxo's story would also be better understood if we were to follow Mr. Buffett's advice. So, let's do that. But before we go in the "flash back" mode of the movie which will show what the company looked like five or ten years ago, let's look at the current strategy being used by the company—because its very visible and very important in understanding where this company is headed.

Take a look at these images and videos.


http://www.youtube.com/watch?v=2Rk0EjKXekg


http://www.youtube.com/watch?v=pkM2P-sj8pk


http://www.youtube.com/watch?v=sAnfe_zoU34

Over the last couple of years, Relaxo has used iconic brand ambassadors which has hugely increased the company's visibility.

Two questions here. First, Why does branding work? And second, how do we know its working or not?

Let me answer the second question first. We know brands work, if they enable the brand owner to earn superior returns on capital. Pure visibility is not enough. Even market share gains is not enough. In the end branding should result in superior profitability. One only has to think about the Kingfisher brand (of that bankrupt airline company not that of the thriving booze company) to know that's true.

In the case of Relaxo, the company earned a pre-tax Return on Equity (ROE) of

35% last year. 10 years ago that number was just 14%. I will put up the numbers in a while.

Now, the first question. Why does branding work? Charlie Munger's framework of models from social psychology and a few models from microeconomics provide the answer. The models from psychology are

1. Liking: We love the brand ambassadors and want to buy what they want us to buy;
2. Pavlovian association: Almost all advertising is a form of creating positive associations between a product or service and happiness and successful brands get consumers to *associate* price with quality (watch this marvellous Buffett video on Franchise Value: http://youtu.be/plw8luDu8Tg);
3. Social Proof: We want to be popular by buying and using stuff that everyone else is using and people buy brands because other people buy brands;
4. Scarcity: Branded products are more exclusive than unbranded ones and that adds value to them; and
5. Authority: Brand ambassadors are symbols of authority even though they were just acting. Cialdini's book cites the example of a very popular doctor actor who subsequently endorses branded medicines on TV commercials. And people buy those med because the "doc told them to" *even* when they know the doc was just an actor.

Here are a few models from economics:

1. Price inelasticity: the really successful brands make consumers relatively indifferent to price increases.
2. Aspirations: Almost every human being wants to get better, wants to move ahead in life and generally speaking, even the poor people, who buy unbranded products, aspire to buy branded ones one day. For millions of such people in India that day has arrived. This demographic change is a key theme for identifying businesses which benefit from this change, and Relaxo happens to be one of them.

Ok, now let's get back to Mr. Buffett's idea of viewing company as an unfolding movie, not as a still photograph. You will recall that in the last class I had talked about the slow contrast effect (the boiling frog syndrome) wherein slow changes tend to go unnoticed. In that context, I had shown examples where long-term trends tend to go unnoticed if one looks at short term data. To see the unfolding movie in Relaxo, I dealt with that problem by knocking out few years of data while presenting it to you. I will now present you with three still photographs— Relaxo in 2003, in 2008, and 2013— omitting the data between those periods. This way, you'll see the unfolding movie emerging in Relaxo.

## Still Photographs from 31 March 2003

**BALANCE SHEET AS AT 31st MARCH,2003**

RELAXO

| Particulars | Schedule | Amount (Rs.) | As at 31.03.03 (Rs.) | Amount (Rs.) | As at 31.03.02 (Rs.) |
|---|---|---|---|---|---|
| **SOURCES OF FUNDS** | | | | | |
| **SHAREHOLDERS' FUNDS** | | | | | |
| Share Capital | I | 6,00,06,000 | | 6,00,06,000 | |
| Reserves & Surplus | II | 30,11,10,319 | 36,11,16,319 | 27,73,87,945 | 33,73.93,945 |
| **LOAN FUNDS** | III | | 4,50,52,120 | | 7,99,37,604 |
| **TOTAL** | | | 40,61,68,439 | | 41,73,31,549 |
| **APPLICATION OF FUNDS** | | | | | |
| **FIXED ASSETS** | IV | | | | |
| Gross Block | | 50,17,01,123 | | 48,58,26,661 | |
| Less : Depreciation | | 9,97,98,680 | | 6,79,85,212 | |
| **NET BLOCK** | | | 40,19,02,443 | | 41,78,41,449 |
| **INVESTMENTS** | V | | 6,24,000 | | 6,24,000 |
| **CURRENT ASSETS, LOANS & ADVANCES** | VI | | | | |
| Inventories | | 12,05,34,570 | | 13,78,40,282 | |
| Sundry Debtors | | 21,12,24,040 | | 25,24,28,080 | |
| Cash & Bank Balances | | 1,46,18,637 | | 2,33,69,607 | |
| Loans & Advances | | 2,14,03,873 | | 2,36,59,356 | |
| | | 36,77,81,120 | | 43,72,97,325 | |
| **LESS: CURRENT LIABILITIES & PROVISIONS** | VII | | | | |
| Current Liabilities | | 30,58,64,057 | | 39,17,54,432 | |
| Provisions | | 1,21,55,072 | | 96,93,823 | |
| | | 31,80,19,129 | | 40,14,48,255 | |
| **NET CURRENT ASSETS** | | | 4,97,61,991 | | 3,58,49,070 |
| **DEFERRED TAX LIABILITY(NET) (SEE NOTE NO 14)** | | | (4,61,19,995) | | (3,69,82,970) |
| Accounting Policies & Notes on accounts | XII | | | | |
| **TOTAL** | | | 40,61,68,439 | | 41,73,31,549 |

AS PER OUR REPORT OF EVEN DATE

## PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 2003

RELAXO

| Particulars | Schedule | | For the year ended 31.03.03 (Rs.) | | For the year ended 31.03.02 (Rs.) |
|---|---|---|---|---|---|
| **INCOME** | | | | | |
| **Sales** | | | 150,84,24,611 | | 150,15,09,521 |
| **Other Income** | | | 67,75,351 | | 1,42,31,376 |
| **TOTAL** | | | **151,51,99,962** | | **151,57,40,897** |
| **EXPENDITURE** | | | | | |
| Cost of Goods Sold | VIII | | 113,83,97,842 | | 113,78,40,537 |
| Personnel Expenses | IX | | 7,97,11,563 | | 7,25,00,334 |
| Administrative, Selling & Other Expenses | X | | 18,04,32,839 | | 17,91,88,395 |
| Finance Charges | XI | | 3,63,82,615 | | 3,91,89,071 |
| **TOTAL** | | | **143,49,24,859** | | **142,87,18,337** |
| **Profit Before Depreciation** | | | **8,02,75,103** | | **8,70,22,560** |
| Depreciation | | | 3,24,51,889 | | 2,43,94,982 |
| **Profit Before Tax and extra-ordinary items** | | | **4,78,23,214** | | **6,26,27,578** |
| Extra-ordinary items | | | **0** | | **3,60,753** |
| **Profit Before Tax** | | | **4,78,23,214** | | **6,22,66,825** |
| Less: Provision for current taxes | | | 37,85,000 | | 44,35,000 |
| Less: Provision for deferred taxes | | | 91,37,025 | | 1,71,72,252 |
| **Profit After Tax** | | | **3,49,01,189** | | **4,06,59,573** |
| Balance B/F from last year :- | | 2,35,84,683 | | 3,21,35,044 | |
| Add/(Less) :- Prior period adjustments | | (10,19,675) | 2,25,65,008 | (67,534) | 3,20,67,510 |
| Amount Available for Appropriation | | | **5,74,66,197** | | **7,27,27,083** |
| **APPROPRIATION** | | | | | |
| Dividend | | | 90,00,900 | | 90,00,900 |
| Tax on Dividend | | | 11,53,240 | | 0 |
| Transferred to General Reserve | | | 3,00,00,000 | | 4,00,00,000 |
| Surplus carried to Balance Sheet | | | 1,73,12,057 | | 2,37,26,183 |
| **TOTAL** | | | **5,74,66,197** | | **7,27,27,083** |
| Basic & Diluted Earning Per Share (Rs.) (See Note no. 13) | | | **2.91** | | **3.39** |
| Accounting Policies & Notes on accounts | XII | | | | |

## CASH FLOW STATEMENT FOR THE YEAR ENDED 31ST MARCH 2003

RELAXO

| S. No. | Particulars | 2002-2003 (Rs.) | 2001-2002 (Rs.) |
|---|---|---|---|
| A. | **CASH FLOW FROM OPERATIVE ACTIVITIES :** | | |
| | **PROFIT BEFORE TAX AND EXTRA-ORDINARY ITEMS** | **4,78,23,214** | **6,26,27,578** |
| | **ADJUSTMENTS FOR** | | |
| | Depreciation | 3,24,51,889 | 2,43,94,982 |
| | Financial Expenses | 3,63,82,615 | 3,91,89,071 |
| | Interest received | (1,25,707) | (1,10,490) |
| | Prior period adjustment | (3,63,424) | 0 |
| | Dividend Received | 0 | (48,32,000) |
| | Donation | (5,000) | (1,41,500) |
| | (Profit)/Loss on sale of Assets | 1,10,364 | (1218) |
| | **Operating Profit before extra-ordinary items** | **11,62,73,951** | **12,11,26,423** |
| | Extra-ordinary items | 0 | (3,60,753) |
| | **Operating Profit before working capital changes** | **11,62,73,951** | **12,07,65,670** |
| | **ADJUSTMENTS FOR** | | |
| | Trade and Other receivables | 4,12,04,040 | (10,59,61,574) |
| | Inventories | 1,73,05,712 | (4,12,00,322) |
| | Other Current Assets | 26,45,648 | 8,92,26,450 |
| | Income Tax | (55,24,339) | (37,21,979) |
| | Trade Payables | (4,47,01,245) | 10,04,54,073 |
| | Other Current Liabilities | (1,45,02,653) | 2,71,22,485 |
| | **Net cash flow from operating activities** | **11,27,01,114** | **18,66,84,803** |
| B. | **CASH FLOW FROM INVESTING ACTIVITIES :** | | |
| | Purchase of Fixed Assets | (1,66,96,895) | (27,05,29,398) |
| | (Increase)/decrease in Capital Work-In-Progress | 0 | 8,54,39,693 |
| | Fixed Assets sold / discarded | 73,648 | 6,300 |
| | Investment | 0 | (3000) |
| | Interest received | 1,25,707 | 1,10,490 |
| | Dividend received | 0 | 48,32,000 |
| | **Net Cash used in investing activities** | **(1,64,97,540)** | **(18,01,43,915)** |
| C. | **CASH FLOW FROM FINANCING ACTIVITIES** | | |
| | Proceeds from long term borrowings ( Net of repayments) | (3,48,85,484) | 3,76,24,334 |
| | Dividend paid | (90,00,900) | (99,18,992) |
| | Financial Expenses | (3,63,82,615) | (3,91,89,071) |
| | Net cash from Financing activities | **(8,02,68,999)** | **(1,14,83,729)** |
| | Net increase in cash & cash equivalents | 1,59,34,575 | (49,42,841) |
| | Cash & cash equivalents at the beginning of the year | (13,15,938) | 36,26,903 |
| | **Cash & cash equivalents at the end of the year** | **1,46,18,637** | **(13,15,938)** |

On 31 March 2003, Relaxo had an aggregate equity market cap of just Rs 19 cr. During FY03, the company earned a pre-tax profit of Rs 4.7 cr on revenues of Rs

151 cr. Pre-tax P/E was 4x.

## Still Photographs from 31 March 2008

By the end of March 2008, the company equity market cap has risen to Rs 48 cr. That's 2.5 times the market cap five years earlier. Revenues for FY08 had grown to Rs 316 cr and pretax earnings for that year soared to Rs 16.7 cr. Pre-tax P/E was just 2.8x.

**Balance Sheet as at 31st March, 2008**

(Rs. in Lacs)

| Particulars | Schedule | | As at 31.03.2008 | As at 31.03.2007 |
|---|---|---|---|---|
| **SOURCES OF FUNDS** | | | | |
| **SHAREHOLDERS' FUNDS** | | | | |
| Share Capital | | 600.06 | | 600.06 |
| Reserves & Surplus | | 5478.48 | | 4531.38 |
| | | | 6078.54 | 5131.44 |
| **LOAN FUNDS** | | | 7148.31 | 6010.58 |
| **DEFERRED TAX LIABILITY** (See Note No. 13) | | | 783.23 | 888.06 |
| **TOTAL** | | | 14010.08 | 12030.08 |
| **APPLICATION OF FUNDS** | | | | |
| **FIXED ASSETS** | IV | | | |
| Gross Block | | 13339.71 | | 11057.91 |
| Less : Depreciation | | 4342.40 | | 3424.49 |
| **NET BLOCK** | | 8997.31 | | 7633.42 |
| Capital work-in-progress | | 2029.03 | | 1718.94 |
| | | | 11026.34 | 9352.36 |
| **INVESTMENTS** | V | | 6.11 | 6.14 |
| **CURRENT ASSETS, LOANS & ADVANCES** | VI | | | |
| Inventories | | 3680.58 | | 2236.85 |
| Sundry Debtors | | 1562.73 | | 1516.24 |
| Cash a Bank Balances | | 415.48 | | 360.33 |
| Loans a Advances | | 692.62 | | 770.98 |
| | | 6351.41 | | 4884.40 |
| **LESS : CURRENT LIABILITIES a PROVISIONS** | VII | | | |
| Current Liabilities | | 3003.62 | | 1802.48 |
| Provisions | | 370.16 | | 410.34 |
| | | 3373.78 | | 2212.82 |
| **NET CURRENT ASSETS** | | | 2977.63 | 2671.58 |
| **TOTAL** | | | 14010.08 | 12030.08 |

## Profit and Loss Account for the year ended 31st March, 2008

(Rs. in Lacs)

| Particulars | Schedule | | 2007-08 | 2006-07 |
|---|---|---|---|---|
| **INCOME** | | | | |
| Sales | | | 30566.22 | 23593.48 |
| Increase / (Decrease) in stock | VIII | | 912.61 | 424.17 |
| Other Income | | | 165.51 | 94.14 |
| **TOTAL** | | | 31644.34 | 24111.79 |
| **EXPENDITURE** | | | | |
| Material & Manufacturing Expenses | IX | | 21281.86 | 16766.39 |
| Personnel Expenses | X | | 2615.70 | 1697.53 |
| Administrative, Selling & Other Expenses | XI | | 3760.04 | 2793.33 |
| Finance Charges | XII | | 1378.48 | 951.82 |
| **TOTAL** | | | 29036.08 | 22209.07 |
| **Profit Before Depreciation** | | | 2608.26 | 1902.72 |
| Depreciation | | | 934.43 | 830.17 |
| **Profit Before Tax** | | | 1673.83 | 1072.55 |
| Less : Provisions for Taxation | | | | |
| - Current Tax | | | 706.00 | 360.00 |
| - Fringe Benefit Tax | | | 27.00 | 19.50 |
| - Deferred Tax | | | (104.83) | 83.49 |
| - For Earlier Years | | | (6.75) | (2.39) |
| **Profit After Tax** | | | 1052.41 | 611.95 |
| Balance b/f from previous year | | 278.34 | | 243.56 |
| Add/(Less) : Prior period adjustments | | 0.00 | 278.34 | 28.14 |
| Amount available for appropriation | | | 1330.75 | 883.65 |
| **APPROPRIATIONS** | | | | |
| Dividend | | | 90.01 | 90.01 |
| Tax on Dividend | | | 15.30 | 15.30 |
| Transfer to General Reserve | | | 500.00 | 500.00 |
| Surplus carried to Balance Sheet | | | 725.44 | 278.34 |
| **TOTAL** | | | 1330.75 | 883.65 |
| Basic & Diluted Earning Per Share (Rs.) (See Note No. 12) | | | 8.77 | 5.10 |

Quality Par Excellence

## Cash Flow Statement for the year ended 31st March, 2008

(Rs. in Lacs)

| S.No. | Particulars | 2007-08 | 2006-07 |
|---|---|---|---|
| | CASH FLOW FROM OPERATIVE ACTIVITIES : | | |
| | PROFIT BEFORE TAX AND EXTRA-ORDINARY ITEMS | 1673.83 | 1072.55 |
| | ADJUSTMENTS FOR | | |
| | Depreciation | 934.43 | 830.17 |
| | Financial Expenses | 1378.48 | 951.82 |
| | Interest Received | (7.07) | (6.81) |
| | Prior Period Adjustment | 0.00 | 28.14 |
| | (Profit)/Loss on sales of Assets | 59.55 | 4.52 |
| | Operating Profit before working capital changes | 4039.22 | 2880.39 |
| | ADJUSTMENTS FOR | | |
| | Investments | 0.03 | 0.00 |
| | Trade and Other receivables | (46.49) | 260.47 |
| | Inventories | (1443.73) | (711.55) |
| | Other Current Assets | 78.36 | (172.12) |
| | Income Tax | (769.89) | (184.82) |
| | Trade Payables | 553.02 | (182.93) |
| | Other Current Liabilities | 648.05 | 164.89 |
| | Net Cash Flow from operating activities | 3058.57 | 2054.33 |
| | CASH FLOW FROM INVESTING ACTIVITIES : | | |
| | Purchase of Fixed Assets | (2680.85) | (2723.02) |
| | Fixed Assets sold / discarded | 12.89 | 137.23 |
| | Interest Received | 7.07 | 6.81 |
| | Net Cash used in investing activities | (2660.89) | (2578.98) |
| | CASH FLOW FROM FINANCING ACTIVITIES : | | |
| | Proceeds from long term borrowings (Net of repayments) | 1137.73 | 1697.91 |
| | Dividend Paid | (104.80) | (102.98) |
| | Financial Expenses | (1378.48) | (951.82) |
| | Net Cash from Financing activities | (345.55) | 643.11 |
| | Net increase in cash & cash equivalents | 52.13 | 118.46 |
| | Cash & cash equivalents at the beginning of the year | 357.39 | 238.93 |
| | Cash & Cash equivalents at the end of the year | 409.52 | 357.39 |

# Still Photographs from 31 March 2013

Over the next five years, the company's equity market cap soared to Rs 704 cr. (it now stands at Rs 900 cr.) representing a jump of 15x in five years and 37x in ten years.



The typical reaction when someone sees figures like this is "OMG! it's gone up so much, how much further could it possibly low." If you focus, however, on the *unfolding movie* aspect of the company, you may look at things a bit differently.

## BALANCE SHEET AS AT 31ST MARCH, 2013

(₹ in lacs)

| Particulars | Note No. | As At 31.03.2013 | As At 31.03.2012 |
|---|---|---|---|
| **EQUITY AND LIABILITIES** | | | |
| **SHAREHOLDERS' FUNDS** | | | |
| Share Capital | 1 | 600.06 | 600.06 |
| Reserves and Surplus | 2 | 20843.50 | 16643.49 |
| **NON CURRENT LIABILITIES** | | | |
| Long-Term Borrowings | 3 | 15024.36 | 9254.27 |
| Deferred Tax Liabilities (Net) | 4 | 2412.69 | 2200.77 |
| Long-Term Provisions | 5 | 337.68 | 316.04 |
| Other Long Term Liabilities | 6 | 565.26 | 401.05 |
| | | **18339.99** | **12172.13** |
| **CURRENT LIABILITIES** | | | |
| Short-Term Borrowings | 7 | 5466.21 | 5297.48 |
| Trade Payables | 8 | 4514.30 | 4207.64 |
| Other Current Liabilities | 9 | 8401.67 | 7124.66 |
| Short-Term Provisions | 10 | 2438.20 | 1424.51 |
| | | **20820.38** | **18054.29** |
| **TOTAL** | | **60603.93** | **47469.97** |
| **ASSETS** | | | |
| **NON CURRENT ASSETS** | | | |
| **FIXED ASSETS** | 11 | | |
| Tangible Assets | | 32151.56 | 26795.97 |
| Intangible Assets | | 520.14 | 338.16 |
| Capital Work-in-Progress | | 2336.78 | 2102.45 |
| Intangible Assets under development | | 37.41 | 24.06 |
| | | **35045.89** | **29260.64** |
| Non Current Investments | 12 | 6.01 | 6.01 |
| Long-Term Loans and Advances | 13 | 1469.08 | 1161.20 |
| Other Non-Current Assets | 14 | 77.27 | 114.37 |
| | | **1552.36** | **1281.58** |
| **CURRENT ASSETS** | | | |
| Inventories | 15 | 15943.94 | 12849.69 |
| Trade Receivables | 16 | 3596.42 | 2295.95 |
| Cash and Bank Balances | 17 | 297.14 | 105.33 |
| Short-Term Loans and Advances | 18 | 3894.08 | 1455.85 |
| Other Current Assets | 19 | 274.10 | 220.93 |
| | | **24005.68** | **16927.75** |
| **TOTAL** | | **60603.93** | **47469.97** |
| Significant Accounting Policies and Additional Notes on Accounts | 27 | | |



## STATEMENT OF PROFIT AND LOSS FOR THE YEAR ENDED 31ST MARCH, 2013

(₹ in lacs)

| Particulars | Note No. | 2012-13 | 2011-12 |
|---|---|---|---|
| **REVENUE** | | | |
| Revenue from Operations (Gross) | 20 | 101658.08 | 86537.64 |
| Less: Excise Duty | | 675.35 | 70.23 |
| Revenue from Operations (Net) | | 100982.73 | 86467.41 |
| Other Income | 21 | 108.24 | 105.79 |
| **TOTAL** | | **101090.97** | **86573.20** |
| **EXPENDITURE** | | | |
| Cost of Materials Consumed | | 43495.25 | 38714.08 |
| Purchases of Stock-in-Trade | | 6800.91 | 8059.11 |
| Changes in Inventories of Finished Goods, Stock-in-Process and Stock-in-Trade | 22 | (3354.08) | (851.49) |
| Employee Benefits Expenses | 23 | 11334.38 | 8234.18 |
| Selling and Distribution Expenses | 24 | 14387.97 | 10658.38 |
| Finance Costs | 25 | 1770.29 | 1867.18 |
| Depreciation and Amortization Expenses | | 2549.82 | 2310.29 |
| Other Expenses | 26 | 17337.59 | 12228.82 |
| **TOTAL** | | **94322.13** | **81220.55** |
| Profit before Exceptional and Extraordinary items and Tax | | 6768.84 | 5352.65 |
| Exceptional Items | | - | - |
| Profit before Extraordinary Items and Tax | | 6768.84 | 5352.65 |
| Extra Ordinary Items [refer Note 27-B(14)] | | - | (3.83) |
| **Profit before Tax** | | **6768.84** | **5348.82** |
| Tax Expense: | | | |
| Current tax | | 1955.93 | 1077.17 |
| Add / (Less) : MAT Credit | | 120.30 | 312.83 |
| Net Current Tax | | 2076.23 | 1390.00 |
| Deferred Tax | | 211.92 | (28.14) |
| Tax for Earlier Years (Net) | | (0.13) | (3.54) |
| **Profit after Tax for the Year** | | **4480.82** | **3990.50** |
| Basic & Diluted Earnings Per Equity Share of ₹ 5 each [refer Note 27-B(9)] | | 37.34 | 33.25 |
| Significant Accounting Policies and Additional Notes on Accounts | 27 | | |

ANNUAL REPORT 2012-13

**CASH FLOW STATEMENT** FOR THE YEAR ENDED 31ST MARCH, 2013

(₹ in lacs)

| S.No. | Particulars | 2012-13 | 2011-12 |
|---|---|---|---|
| A. | **CASH FLOW FROM OPERATING ACTIVITIES :** | | |
| | **PROFIT BEFORE TAX AND EXTRA-ORDINARY ITEMS** | **6768.84** | **5352.65** |
| | **ADJUSTMENTS FOR** | | |
| | Depreciation | 2549.82 | 2310.29 |
| | Finance costs | 1770.29 | 1867.18 |
| | Other Non-operating Income | (26.56) | (5.54) |
| | (Profit)/Loss on sale of Assets | 3.38 | 61.14 |
| | **Operating Profit before extra-ordinary items** | **11065.77** | **9585.72** |
| | Extraordinary Items | - | (3.83) |
| | **Operating Profit before working capital changes** | **11065.77** | **9581.89** |
| | **ADJUSTMENTS FOR** | | |
| | Trade receivables and other assets | (3185.11) | (243.58) |
| | Inventories | (3094.25) | (1190.78) |
| | Trade Payables and other liabilities | 2811.59 | 16.95 |
| | Income Tax | (2089.33) | (893.18) |
| | **Net cash flow from operating activities** | **5508.67** | **7271.30** |
| B. | **CASH FLOW FROM INVESTING ACTIVITIES :** | | |
| | Purchase of Fixed Assets | (8442.44) | (4882.82) |
| | Fixed Assets sold / discarded | 103.99 | 177.02 |
| | Other Non-operating Income | 26.56 | 5.54 |
| | **Net Cash used in investing activities** | **(8311.89)** | **(4700.26)** |
| C. | **CASH FLOW FROM FINANCING ACTIVITIES** | | |
| | Proceeds from borrowings (Net of repayments) | 4974.64 | (673.65) |
| | Dividend paid | (209.32) | (138.83) |
| | Finance costs | (1770.29) | (1867.18) |
| | **Net cash from Financing activities** | **2995.03** | **(2679.66)** |
| | Net increase / (decrease) in cash & cash equivalents | 191.81 | (108.62) |
| | Cash & cash equivalents at the beginning of the year | 105.33 | 213.95 |
| | **Cash & cash equivalents at the end of the year** | **297.14** | **105.33** |

For FY13, the Relaxo delivered revenues of Rs 1,016 cr. and pre-tax earnings of Rs 68 cr. At the year end market cap of Rs 704 cr., the pre-tax P/E was 10x and based on the current market cap of Rs 900 cr., the pre-tax P/E multiple is 13x. So, clearly, the company has enjoyed tremendous re-rating over the last few years, and I would argue that a significant part of it can be explained by the company's much more visible efforts at branding.

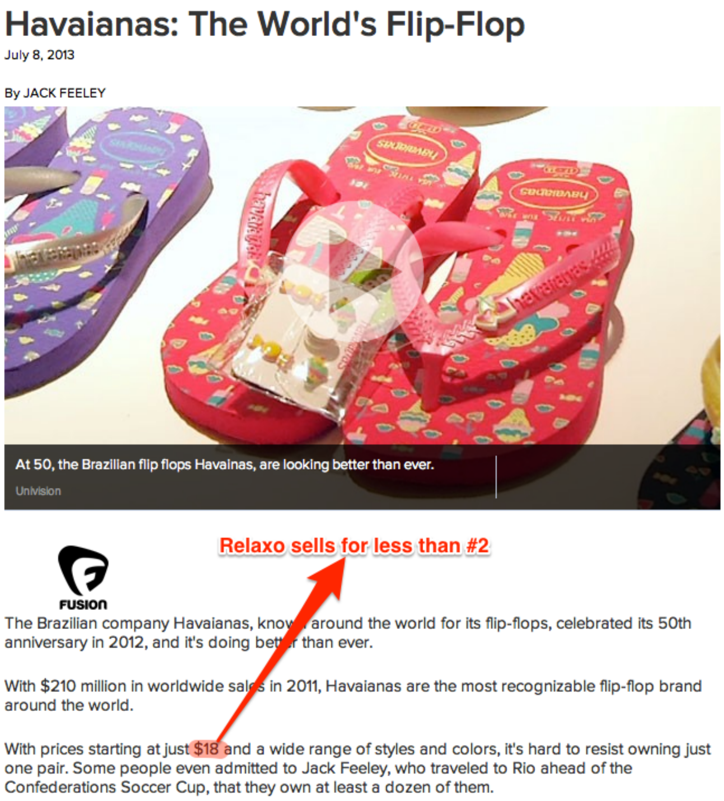
Here is key data over the last 10 years.

| | Mar-13 | Mar-08 | Mar-03 |
|---|---|---|---|
| Market Cap (Rs Mil) | 7,040 | 482 | 186 |
| PAT (Rs. Mil) | 448 | 105 | 35 |
| Net Revenue (Rs. Mil) | 10,050 | 3,057 | 1,508 |
| Pairs of Footwear Sold (Mil) | 100 | 64 | 47 |
| Price/Pair (Rs.) | 100 | 48 | 32 |
| Profit per pair (Rs.) | 4.48 | 1.64 | 0.74 |

What's staggering is that despite all the branding the company has done, it's average realisation per pair of footwear is just Rs 100! That's less than $2.

## A Role Model for Relaxo

Now, take a look at the world's most popular brand in flip flops— a Brazilian one called Havaianas (pronounced "haaveeyaaanaas") where starting prices are $18.


Havaianas: The World's Flip-Flop

July 8, 2013

By JACK FEELEY

At 50, the Brazilian flip flops Havainas, are looking better than ever.

Univision

Relaxo sells for less than #2

The Brazilian company Havaianas, known around the world for its flip-flops, celebrated its 50th anniversary in 2012, and it's doing better than ever.

With $210 million in worldwide sales in 2011, Havaianas are the most recognizable flip-flop brand around the world.

With prices starting at just $18 and a wide range of styles and colors, it's hard to resist owning just one pair. Some people even admitted to Jack Feeley, who traveled to Rio ahead of the Confederations Soccer Cup, that they own at least a dozen of them.

Watch this video:

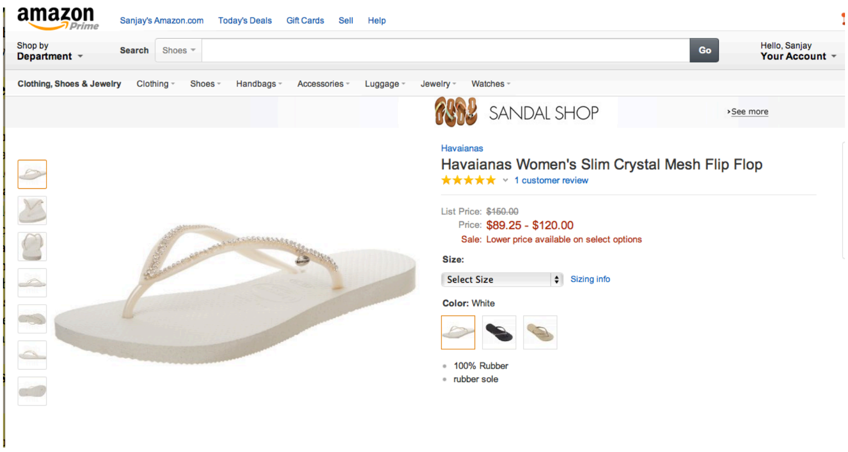
http://abcnews.go.com/ABC_Univision/News/havaianas-recognizable-flip-flop-brand/story?id=19563649

And this one:

http://www.youtube.com/watch?v=Lpg1l76aLX4

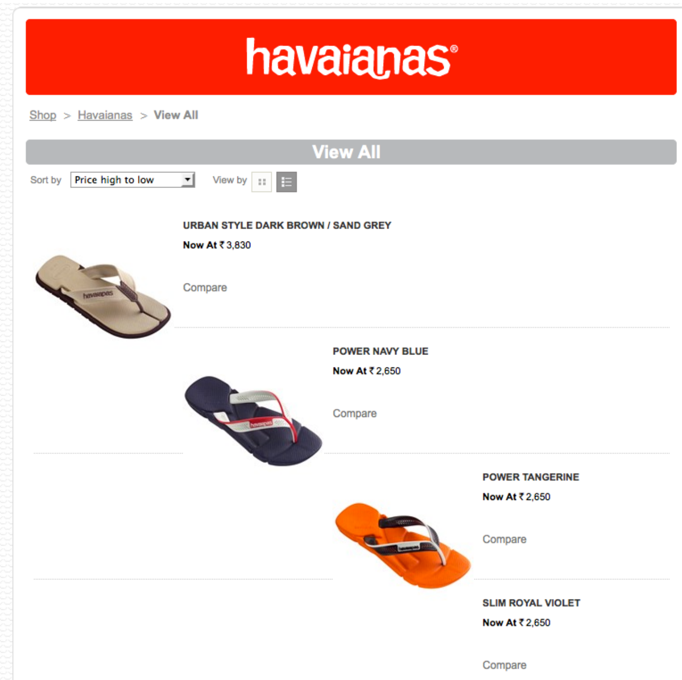
This is the same company profiled in a book on branding which I read recently, and I had send that excerpt to you. You can get it again from here.

This company sells high-end flip flops for $90 on amazon.com.





It also sells them at high prices in India.




Check out their site from http://www.havaianasindia.in

And this video by a somewhat ~~nutty~~ affluent urban Indian:

http://www.youtube.com/watch?v=7rgSc-FEO9Q

When I discussed Havaianas with the company's senior management, the Managing Director told me that one day they want to be them.

So, now we know where Relaxo is coming from and where it wants to go. Will it succeed? I don't know the answer to that question but I do know that the company is trying!

## Warren Buffett's Earnings Retention Test

One of the things, I had asked one of the groups to do was to figure out how good the company has been in creating value for stockholders. Specifically, I wanted you to estimate how every rupee earned but not paid out as dividend showed up as incremental market value.

Investors make money either through dividends or capital gains. When a company decides to retain money and not pay it out as dividends, the only logical reason for that is that the company expects the retention to be beneficial to stockholders. If, for every one rupee retained, incremental market value is Rs 5, why should investors complain about low dividends? Relaxo pays a low dividend but for every rupee it did not pay as dividend became worth much more in incremental market value of the investors' shares. See table below.

| | Mar-13 | Mar-12 | Mar-11 | Mar-10 | Mar-09 | Mar-08 | Mar-07 | Mar-06 | Mar-05 | Mar-04 | Mar-03 | Mar-02 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Market Cap (Rs Mil) | 7,040 | 3,649 | 3,348 | 2,685 | 330 | 482 | 400 | 424 | 348 | 270 | 186 | 180 |
| PAT (Rs. Mil) | 448 | 399 | 267 | 377 | 146 | 105 | 66 | 33 | 37 | 54 | 35 | 41 |
| Dividend (Rs. Mil) | 24 | 18 | 18 | 18 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 |
| Earnings Retained (Rs Mil) | 424 | 381 | 249 | 359 | 137 | 96 | 57 | 24 | 28 | 45 | 26 | 32 |
| 10 Years Delta Market Cap (Rs Mil) | 6,854 | | | | | | | | | | | |
| 10 Years Earnings Retention (Rs. Mil) | 1,801 | | | | | | | | | | | |
| Multiplier | 3.8 | | | | | | | | | | | |
| 5 Years Delta Market Cap (Rs. Mil) | 6,557 | | | | | | | | | | | |
| 5 Years Earnings Retention (Rs. Mil) | 1,551 | | | | | | | | | | | |
| Multiplier | 4.2 | | | | | | | | | | | |
| Based on Current Market Cap | | | | | | | | | | | | |
| Current Market Cap (Rs. Mil.) | 9,000 | | | | | | | | | | | |
| Delta market Cap since March 03 | 8,814 | | | | | | | | | | | |
| Total Earnings Retained | 1,801 | | | | | | | | | | | |
| Multiplier | 4.9 | | | | | | | | | | | |

Why Did
This Happen?

Why did this happen?

Two possible reasons: (1) the company was able to compound money internally at a high rate of return; and/or (2) the market was irrational (either the starting market cap was too low or the ending market cap was too high). Warren Buffett deals with that problem by checking the validity of earnings retention on a five year rolling basis. Here's what he writes in his "Owners Manual," a document you should read over and over again until its words are deeply etched in your memory.

> *"We test the wisdom of retaining earnings by assessing whether retention, over time, delivers shareholders at least $1 of market value for each $1 retained. To date, this test has been met. We will continue to apply it on a five-year rolling basis."*

We will do this exercise later on in BFBV.

In the case of Relaxo, I believe that both reasons apply. First, the initial market cap used to make the computations was too low (recall the low P/E in 2003 and 2008). And second, the company has been able to deliver a high ROE over the last few years, as the table below shows:

| | Mar-13 | Mar-12 | Mar-11 | Mar-10 | Mar-09 | Mar-08 | Mar-07 | Mar-06 | Mar-05 | Mar-04 | Mar-03 | Mar-02 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| PBT (Rs. Mil) | 677 | 535 | 357 | 538 | 240 | 167 | 107 | 46 | 60 | 74 | 48 | 62 |
| Net worth (Rs. Mil) | 2,144 | 1,724 | 1,346 | 1,099 | 740 | 608 | 513 | 460 | 434 | 406 | 361 | 337 |
| PBT/Av Net Worth | 35% | 35% | 29% | 58% | 36% | 30% | 22% | 10% | 14% | 19% | 14% | |

That's Why!

## Economic Earnings Vs. Reported Earnings

Intuitively, these numbers look very impressive buy why? Because they are way above passive rates of return. I use AAA bond yields as a proxy for passive rates of return. At present pre-tax AAA bond yields are between10 and 11%. And because Relaxo earns a pre-tax ROE of 35% that's impressive (Notice that by comparing pretax AAA bond yields with pre-tax ROE, I am comparing apples with apples) even though they are based on reported earnings. Are economic earnings in Relaxo higher than reported ones? I believe they are for two reasons. Let me explain:

Take a look at the company's latest annual P&L account:

RELAXO FOOTWEARS LIMITED

STATEMENT OF PROFIT AND LOSS FOR THE YEAR ENDED 31ST MARCH, 2013

(₹ in lacs)

| Particulars | Note No. | 2012-13 | 2011-12 |
|---|---|---|---|
| **REVENUE** | | | |
| Revenue from Operations (Gross) | 20 | 101658.08 | 86537.64 |
| Less: Excise Duty | | 675.35 | 70.23 |
| Revenue from Operations (Net) | | 100982.73 | 86467.41 |
| Other Income | 21 | 108.24 | 105.79 |
| **TOTAL** | | **101090.97** | **86573.20** |
| **EXPENDITURE** | | | |
| Cost of Materials Consumed | | 43495.25 | 38714.08 |
| Purchases of Stock-in-Trade | | 6800.91 | 8059.11 |
| Changes in Inventories of Finished Goods, Stock-in-Process and Stock-in-Trade | 22 | (3354.08) | (851.49) |
| Employee Benefits Expenses | 23 | 11334.38 | 8234.18 |
| Selling and Distribution Expenses | 24 | 14387.97 | 10658.38 |
| Finance Costs | 25 | 1770.29 | 1867.18 |
| Depreciation and Amortization Expenses | | 2549.82 | 2310.29 |
| Other Expenses | 26 | 17337.59 | 12228.82 |
| **TOTAL** | | **94322.13** | **81220.55** |
| Profit before Exceptional and Extraordinary items and Tax | | 6768.84 | 5352.65 |
| Exceptional Items | | - | - |
| Profit before Extraordinary Items and Tax | | 6768.84 | 5352.65 |
| Extra Ordinary Items [refer Note 27-B(14)] | | - | (3.83) |
| **Profit before Tax** | | **6768.84** | **5348.82** |
| Tax Expense: | | | |
| Current tax | | 1955.93 | 1077.17 |
| Add / (Less) : MAT Credit | | 120.30 | 312.83 |
| Net Current Tax | | 2076.23 | 1390.00 |
| Deferred Tax | | 211.92 | (28.14) |
| Tax for Earlier Years (Net) | | (0.13) | (3.54) |
| **Profit after Tax for the Year** | | **4480.82** | **3990.50** |
| Basic & Diluted Earnings Per Equity Share of ₹ 5 each [refer Note 27-B(9)] | | 37.34 | 33.25 |
| Significant Accounting Policies and Additional Notes on Accounts | 27 | | |

Take a look at the highlighted numbers. For FY13, Relaxo's financial books show that it earned a pre-tax profit of Rs 67 cr., after spending Rs 144 cr. on sales and distribution expenses. What's the *nature* of these expenses? To see that, look at the table below which provides details.

What's the benefit of this money spent?
Is it enduring or short-lived?
Is the company gaining market share, maintaining it, or losing it?

(₹ in lacs)

| Particulars | 2012-13 | 2011-12 |
|---|---|---|
| **NOTE 24** SELLING AND DISTRIBUTION EXPENSES | | |
| Advertisement & Publicity | 5507.62 | 2961.77 |
| Sales Promotion & Incentives | 2234.25 | 2707.26 |
| Cash Discount | 2879.91 | 1993.85 |
| Freight & handling charges | 3766.19 | 2995.50 |
| **TOTAL** | **14387.97** | **10658.38** |

The company has spent a huge amount of money on advertisement and publicity and sales promotions and incentives. And the company has also spent substantial sums on brand ambassadors and is charging off that expenditure over two years. The amount not yet charged off but already paid is recorded as prepaid expenses, as the table below shows. These will be written off in FY14.

| **NOTE 18** SHORT TERM LOANS AND ADVANCES | | |
|---|---|---|
| **Unsecured, considered good** | | |
| - Loans & Advances to employees | 27.73 | 10.67 |
| - Advance to suppliers | 209.31 | 421.78 |
| **Others** | | |
| - Advance Income Tax and withholding tax | 1902.34 | 904.50 |
| - Prepaid Expenses | 1445.36 | 67.45 |
| - Deposits with Government departments and others | 309.34 | 51.45 |
| **TOTAL** | **3894.08** | **1455.85** |

Mostly Brand Ambassadors

All that money spent on marketing in a year is charged off as an expense for that year (except that paid to brand ambassadors which is charged off over two years). Now, think about this for a moment. What is *expense*? And what is *investment*?

If the benefits accruing to the company are likely to be of an *enduring* nature, it would be appropriate to treat the expenditure as a capital item and not a revenue item and therefore amortise (just a fancy word which means to spread over) it over more than one year. After all, this is exactly what we do with fixed assets, right? We buy them for Rs 100 and depreciate them over ten years, reducing profit by Rs 10 every year.

That same logic applies to Relaxo (although when we later deal with periods of amortisation for such expenditure, we will assume much lesser number of years than ten years).

All of those branding efforts we talked about earlier— do they not have an enduring advantage? And if they do, would it not be appropriate to spread them over a number of years instead of charging them off in a single year?

Now, this is dangerous stuff, as you can understand because it allows subjectivity, something accountants don't like very much. This kind of stuff, wrongly used, can allow you to inflate profits, something accountants don't want you to do and something I don't want you to do either. But, unlike the accountants, I would rather be *subjectively* right than be *objectively* wrong (paraphrasing Keynes here). So, I propose two tests both of which are met by Relaxo.

Before treating money spent on marketing as capex and not as a revenue item ensure that

1. ROE *before* that treatment is high; and
2. The company is *gaining* market share

The logic of the second test is that if the money is being spent to just *maintain* market share, then it can't be having an enduring benefit. You are spending it just to stay where you are, not to get ahead in life. That kind of money spending is of a *defensive* nature. If you spend it, you don't move ahead, and if you don't, you'll fall behind. (Remember the Red Queen Effect mental model). But if money spend is enabling you to *gain* market share— and that is exactly what is happening with Relaxo as it's growing much faster than the industry— then it would be right for us to assume that the expenditure has an enduring advantage. This assumption, once made, must be subject to revision based on the behaviour of competitors— something that I will cover in detail later on in BFBV.

So, that's the first reason why I think that Relaxo's reported earnings understate true economic earnings. By how much? That's something we will discuss later when we come to valuation, but for the moment all I want to claim is that the earlier computations which make the company look very profitable were based on accounting earnings which are *lower* than economic earnings.

Incidentally, there is something of a *pattern* here, isn't it? If Relaxo's earnings are understated for reasons mentioned above, then surely there must be *other* companies which also spend significant amounts on sales and distribution (btw, the same logic applies to R&D expenditure too), earn high ROE even before treating such expenditure as capex, and are also gaining market share on a *sustainable* basis. I think, it would be useful for you to search for, and study those companies.

The second reason why Relaxo's reported earnings understate economic earnings is to do with its receivables as the table below shows:

| | Mar-13 | Mar-08 | Mar-03 |
|---|---|---|---|
| Receivables (Rs. Mil) | 360 | 149 | 211 |
| Net Revenue (Rs. Mil) | 10,050 | 3,057 | 1,508 |
| Sales/Average Receivables | 34.1 | 20.3 | 6.5 |

As the company has become more powerful in its market, it has increasingly been able to demand *earlier* payments from its customers. This is exactly the kind of trend you should look out for. In the case of Relaxo, its customers can't be relaxed about payments due to the company. The retail customers, of course, must pay at the time of sale and increasingly so must the company's wholesale distributors. The company now offers credit of only a few days to its largest and oldest distributors. All new growth through newer distributors will be coming from customers who will pay in advance of taking delivery.

Isn't that cool? If Relaxo grows backed by its branding efforts and also because of the growth of the market, would not receivables become negative? And if that happened, would not the company's working capital requirements go down? And if that happened, would not the company's need to carry debt diminish over time? That answer to all of those questions is yes. Incidentally, this kind of thinking is consistent with thinking of a company as an evolving movie and not a still photograph except that here we are focusing on evolutionary changes (which tend to go unnoticed until you look at the big picture by standing back and ignoring interim noise) in the quality of the company's balance sheet over time.

But none of what I just told you tells you anything about why this company's reported earnings are lower than economic ones because of its working capital cycle. I will defer that for a later date but if you're curious, you may want to read up https://db.tt/7GhOZdNp.

## Entry Barriers

I had asked one of the groups to think about entry barriers. The only reason why Relaxo will continue to earn high ROE would be to do with entry barriers. Warren Buffett warns us of companies which have temporarily high ROEs which will disappear.

> *"A truly great business must have an enduring "moat" that protects excellent returns on invested capital. The dynamics of capitalism guarantee that competitors will repeatedly assault any business "castle" that is earning high returns. Therefore a formidable barrier such as a company's being the low- cost producer (GEICO, Costco) or possessing a powerful world-wide brand (Coca-Cola, Gillette, American Express) is essential for sustained success. Business history is filled with "Roman Candles," companies whose moats proved illusory and were soon crossed."*

Is Relaxo a roman candle? Or does it have significant entry barriers which will prevent competition from destroying its ability to earn high ROE.

I'll let Ravi do a thought experiment with you to find out.

Ravi takes over…

Ok, imagine that someone gave you a bundle of cash and told you to go and take market share from Relaxo. How would you do that?

Well, one way you *won't* do that is by selling unbranded footwear. The unbranded footwear market has been losing market share to branded players like Bata, Relaxo, and Liberty for years and that trend is unlikely to reverse. So, you'll have to go the branding way.

Now, the question is how do you compete with a fellow who sells 100 million pairs of branded footwear in year and makes less than Rs 5 per pair?

| | Mar-13 | Mar-08 | Mar-03 |
|---|---|---|---|
| Market Cap (Rs Mil) | 7,040 | 482 | 186 |
| PAT (Rs. Mil) | 448 | 105 | 35 |
| Net Revenue (Rs. Mil) | 10,050 | 3,057 | 1,508 |
| Pairs of Footwear Sold (Mil) | 100 | 64 | 47 |
| Price/Pair (Rs.) | 100 | 48 | 32 |
| Profit per pair (Rs.) | 4.48 | 1.64 | 0.74 |

**How will you compete with THAT?**

You can't obviously start with manufacturing capability anywhere close to that of Relaxo, right? So, let's assume you start with 10 million pairs a year, which by the way, is no mean feat (pun intended). Now, to take market share from Relaxo, you'll have to do several things *together*. For example, you'll have to:

1. Price your products *lower* that those of Relaxo to attract customers; and
2. You'll have to offer a lot of credit to your customers— something Relaxo does not have to do; and
3. Like Relaxo, you will still have to spend large sums of money on marketing and branding; and
4. You'll have to pay higher prices for raw material than Relaxo because you'd be a much smaller customer for those gigantic suppliers of EVA; and
5. You'll have to pay those suppliers much *earlier* than Relaxo pays its suppliers.

If you do the math, by looking at financial statements of Relaxo, you will quickly conclude that it's just not worth it. Why? Because you'll have to tolerate negative margins and much larger working capital requirements— a sort of a double whammy when it comes to the viability of your plans.

Just as an example, let's talk about advertisement and publicity expenses. In FY 13, Relaxo spent Rs 55 cr. on this line item and sold 100 million pairs of footwear, so the amount spent was Rs 5.50 per pair. If you were going to sell 10 million pairs, how much money you'd have to spend on advertisement and publicity? For starters, you simply won't be able to afford brand ambassadors like Mr. Salman Khan, Ms. Katrina Kaif, and Mr. Akshay Kumar. Those icons don't come cheap. So, you won't have the volume to justify hiring iconic brand ambassadors.

The amount of money Relaxo spends on ad and publicity expenditure is like a fixed cost. As volume goes up, cost per pair of footwear sold comes down. If *you* had to spend Rs 55 cr. on ads and publicity and have a business volume of 10 million pairs, you'd be spending Rs 55 per pair! Even if you spent Rs 25 cr., that would translate into Rs 25 per pair of footwear. Just the prospect of that is so scary that if you're rational, you won't do it.

Of course people are not always rational, so the probability of irrational competition is not zero, but it's very very low.

There's beauty in low margins. Philip Fisher, in his wonderful book, "Conservative Investors Sleep Well" writes:

> *"High profit margins may be compared to an open jar of honey owned by the prospering company. The honey will inevitably attract a swarm of hungry insects bent on devouring it. In the business world there are but two ways a company can protect the contents of its honey jar from being consumed by the insects of competition. One is by monopoly, which is usually illegal, although, if the monopoly is due to patent protection, it may not be. In*

> *any event, monopolies are likely to end quite suddenly and do not commend themselves as vehicles for the safest type of investing. The other way for the honey-jar company to keep the insects out is to operate so much more efficiently than others that there is no incentive for present or potential competition to take action that will upset the existing situation."*

By keeping margins low (due to high spent on ad and publicity), Relaxo is likely to keep competitors at bay, isn't it? And because of its *efficiency* (as reflected by high turnover ratios), the company can still earn a very respectable ROE.

What you just saw was an example of a very powerful model — *Economies of Scale* — which explains to a very large extent, Relaxo's ability to earn a high ROE on a *sustainable* basis. Charlie Munger in his famous talk on [Elementary Worldly Wisdom] said something which apply applies to Relaxo:

> *"In terms of which businesses succeed and which businesses fail, advantages of scale are ungodly important.*
>
> *For example, one great advantage of scale taught in all of the business schools of the world is cost reductions along the so-called experience curve. Just doing something complicated in more and more volume enables human beings, who are trying to improve and are motivated by the incentives of capitalism, to do it more and more efficiently.*
>
> *The very nature of things is that if you get a whole lot of volume through your joint, you get better at processing that volume. That's an enormous advantage. And it has a lot to do with which businesses succeed and fail....*
>
> *For example, you can get advantages of scale from TV advertising. When TV advertising first arrived when talking color pictures first came into our living rooms it was an unbelievably powerful thing. And in the early days, we had three networks that had whatever it was say 90% of the audience.*
>
> *Well, if you were Proctor & Gamble, you could afford to use this new method of advertising. You could afford the very expensive cost of network television because you were selling so many cans and bottles. Some little guy couldn't. And there was no way of buying it in part. Therefore, he couldn't use it. In effect, if you didn't have a big volume, you couldn't use network TV advertising which was the most effective technique. So when TV came in, the branded companies that were already big got a huge tail wind. Indeed, they prospered and prospered and prospered until some of them got fat and foolish, which happens with prosperity - at least to some people…."*

So the two things that explain Relaxo's ability to earn high ROEs on a sustainable basis are brands and low cost advantage arising out of scale.

## What Else To Like About Relaxo?

Ravi Purohit speaks:

There are a few more things about Relaxo which I want to highlight. First, this is not a business that is going to become obsolete anytime. Unlike high technology businesses (think Nokia and Blackberry— so much for high switching costs of BBM that tomorrow it will be available as an app across platforms), the rate of change in this business is very very small. I am reminded of what Mr. Buffett wrote in one of his letters to the shareholders of Berkshire:

> *"Our criterion of "enduring" causes us to rule out companies in industries prone to rapid and continuous change. Though capitalism's "creative destruction" is highly beneficial for society, it precludes investment certainty. A moat that must be continuously rebuilt will eventually be no moat at all."*

Clearly, neither will people go back to being barefoot like their distant ancestors, nor will the technology involved in this business resemble that of the conditions that exist in, say, the semiconductor industry. And we love to invest in such businesses because they are so *predictable.*

The other thing I love about Relaxo is how it's moved up the value chain over the years. Many many years ago, the company used to be a contract manufacturer for Nike. Today, it's one of the world's largest non-leather footwear manufacturer with branded products.

| | Mar-13 | Mar-08 | Mar-03 |
|---|---|---|---|
| Market Cap (Rs Mil) | 7,040 | 482 | 186 |
| PAT (Rs. Mil) | 448 | 105 | 35 |
| Net Revenue (Rs. Mil) | 10,050 | 3,057 | 1,508 |
| Pairs of Footwear Sold (Mil) | 100 | 64 | 47 |
| Price/Pair (Rs.) | 100 | 48 | 32 |
| Profit per pair (Rs.) | 4.48 | 1.64 | 0.74 |

Notice how price realisation per pair of footwear has increased over time. At present, the company is realising just Rs 100 per pair of footwear despite it having trebled over the last ten years. The average retail price that customers pay is about Rs 160 per pair. And what's Rs 160 bucks today for Relaxo's target market segment — India's growing middle class?

Not much! Indeed, as a percentage of disposable income it's very small. (Notice the high contrast effect at work here. As the disposable incomes keep on rising, a pair of footwear— even that whose prices also keep on rising— takes a very small share of that disposable income). And *that* makes customers relatively *price insensitive*. One great example of that is Gillette blades. The amount of money a man spends on shaving in a year as a proportion to his annual income is very low. So, even though the blade prices keep rising, the amount of saving by switching to a lower-cost brand is not worth a lot a money. And Gillette's intelligent branding efforts and advertisements ("the best a man can get") don't make it easy for its customers to switch to lower cost brands.

So, very possibly there is untapped pricing power in Relaxo, which is a significant source of value. Over time, I expect two things to happen in Relaxo: (1) Average realisation will continue to grow; and (2) Costs will not grow in line with average realisation. So, margins will improve. The evidence supporting this can be seen from the table below:

| | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 | FY13 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| EVA (per kg) | | | 78 | 81 | 86 | 96 | 128 | 90 | 117 | 124 | 106 |
| | | | | 3% | 7% | 11% | 33% | -29% | 30% | 6% | -15% |
| Natural Rubber (per kg) | 47.3 | 60.8 | 67 | 72 | 99 | 99 | 109 | 112 | 192 | 208 | 177 |
| yoy inc | | 29% | 11% | 7% | 38% | 0% | 11% | 2% | 72% | 8% | -13% |
| | | | | | | | | | | | |
| Gross Margin (%) | 29.7% | 29.4% | 32.8% | 35.0% | 38.4% | 40.3% | 40.7% | 48.0% | 45.7% | 47.0% | 53.6% |
| Delta | | -0.3% | 3.4% | 2.1% | 3.5% | 1.9% | 0.4% | 7.3% | -2.3% | 1.2% | 6.6% |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| PBDITA margin | 8.3% | 5.8% | 5.5% | 7.9% | 10.3% | 10.8% | 10.9% | 14.5% | 10.5% | 11.0% | 11.0% |
| PBT margin | 3.2% | 3.7% | 2.8% | 2.3% | 4.7% | 5.4% | 5.9% | 9.6% | 5.1% | 6.2% | 6.7% |

Notice the long-term change that has happened here. The company's gross margin (Revenues less Raw Material Cost) in FY03 was 30%. In FY 08 that was 40% and in FY13 it was 54%. For companies moving up the value chain, monitoring gross margin is key because that tells you whether or not the company is becoming relatively immune to raw material price hikes. As the above table shows, Relaxo has, over time, become relatively immune from raw material price risk and that is just what you should expect from a company that moves successfully from being a commodity player to becoming a branded one.

| | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12 | FY13 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| EVA (per kg) | | | 78 | 81 | 86 | 96 | 128 | 90 | 117 | 124 | 106 |
| | | | | 3% | 7% | 11% | 33% | -29% | 30% | 6% | -15% |
| Natural Rubber (per kg) | 47.3 | 60.8 | 67 | 72 | 99 | 99 | 109 | 112 | 192 | 208 | 177 |
| yoy inc | | 29% | 11% | 7% | 38% | 0% | 11% | 2% | 72% | 8% | -13% |
| | | | | | | | | | | | |
| Gross Margin (%) | 29.7% | 29.4% | 32.8% | 35.0% | 38.4% | 40.3% | 40.7% | 48.0% | 45.7% | 47.0% | 53.6% |
| Delta | | -0.3% | 3.4% | 2.1% | 3.5% | 1.9% | 0.4% | 7.3% | -2.3% | 1.2% | 6.6% |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| PBDITA margin | 8.3% | 5.8% | 5.5% | 7.9% | 10.3% | 10.8% | 10.9% | 14.5% | 10.5% | 11.0% | 11.0% |
| PBT margin | 3.2% | 3.7% | 2.8% | 2.3% | 4.7% | 5.4% | 5.9% | 9.6% | 5.1% | 6.2% | 6.7% |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Employee & Labour Cost / Sales | | | | | 7.2% | 8.5% | 8.8% | 9.9% | 10.8% | 13.0% | 14.9% |
| Adspend | | | | | 3.0% | 3.6% | 3.2% | 3.7% | 3.6% | 3.4% | 5.4% |
| Sales Promotion | | | | | 4.4% | 3.7% | 4.2% | 6.2% | 4.2% | 3.1% | 2.2% |
| Professional Fees | | | | | 0 | 0 | 0 | 0 | 0 | 0% | 1.1% |

Notice also, how the rise in Gross Margin over the years, was translated into the rise in EBITDA margins. A lot of these costs are of *fixed* nature. For example, the company hired Accenture to help it in supply chain management. The cost of that is charged off to P&L every year but its not going to change as the business grows.

Last year the company also hired 500 people in its marking team (of which 350 were retained) and their cost is eating into the margins right now, but as business volume grows, their cost as percentage of revenues will come down.

The point I am trying to make is a simple one. Once you've started earning a high gross margin, a lot of the subsequent costs are of fixed nature and as the business grows their impact on per unit volume becomes smaller and smaller. And *operating leverage* is *very* attractive from investment perspective especially in companies which are likely to *grow*.

Another thing to like about Relaxo is that this is a *tough* business to get into. The company has eight manufacturing plants and has more than 9,000 employees the vast majority of whom are employed in those plants. Employing thousands of workers in manufacturing plants in India is not a joke and that's another thing to think about when you think about entry barriers.

In addition to the above, what I love about Relaxo is its growth potential. As you know, in FY 13, the company sold 100 million pairs, mostly to Indians (the company has insignificant exports). But India has a population of 1.2 billion and rising! So, clearly the company has a huge potential to grow. The company's latest annual report provides some data:

> *"The size of Indian footwear market is around Rs 26,300 crores and expected to reach Rs 38,700 crores with a CAGR of 15% by 2015. At present, Men's contribute around 60% of footwear market against Women's share of 30%. Men's market is growing at a CAGR of 10% & Women's market is growing at a much faster CAGR of 20 %. India controls 15% of annual global footwear production.*
>
> *Indian footwear retail is mainly an unorganized market with around 60% market share. The size of the organised sector which was around Rs 7,500 crores in 2010 increased to Rs 10,000 crores in 2011, growing at a CAGR of 30% every year since 2008. The market is expected to reach Rs 17,500 crores by 2015 growing at a CAGR of 19% p.a."*

I am confident that Relaxo will continue to grow faster than the market by taking market share from the unorganised players— just as it has been doing over the last several years.

Can the company self-fund that growth? This is a very important question because, other things remaining the same, the attractiveness of a business which can self-fund growth is far more than that of one which can't. Post its IPO, the company has not issued any additional shares to fund its growth. And company was far *less* profitable in its early years than it now is. Management informs us that for the next couple of years, there will be very little capex. The quality of the balance sheet is going to continue to improve as positive receivables move towards becoming negative, thereby reducing working capital requirements. Internal cash flow generation will be more than sufficient to finance the growth of Relaxo over the next several years.

How big can Relaxo become? That's a speculative question. It would be over-optimistic to take recent high growth rates and project them into eternity but I believe that the company's ability to sell 250 million pairs of footwear a decade from now (at higher realisations and higher margins) is well within its reach.

Ends