Reflections On Piramal Enterprises

I started investing in the stock markets [both US and India] from 2006. I never believed in picking individual stocks as I was heavily influenced by John Bogle's writings. I took a passive route to investing by dollar cost averaging in index funds. But it all changed in 2011 when I came across Prof. Sanjay Bakshi's masterpiece Vantage Point.

Like a kid in the candy store, I read all his blog posts. In the process, I came across a case study which he did on Ajay Piramal, who is the Chairman of Piramal Enterprises. The case study piqued my curiosity and I read the annual report of Piramal Enterprises. I could not believe what I saw.

(in crores)	31-Mar-2012
Total Assets	₹13,350.00
Investments	₹6,964.00
Debt	₹2,047.00
Shareholders Equity	₹11,243.00
Investments per share	₹413.00
Book value per share	₹666.00
Share Price	₹438.00

The market offered $1 for 65 cents.

Mr. Market is not a fool to give you a dollar for 65 cents. Why did Mr. Market offer this mouth watering deal? In May 2010, Ajay Piramal sold the Domestic Formulations business for $3.8 billion to Abbott. He did this deal at a mind blowing valuation of 9 times FY2010 sales. This is unheard of in the Indian Pharma industry. At that time the Formulations business was generating 50 percent of the total revenues. Why did Piramal sell the Formulations business?

> In 2010 when we sold our domestic Formulation business I just want to give you the environment as to why we sold and what we did. We have always followed a contrarian strategy in our group. During the late eighties and early nineties we acquired a lot of Formulation businesses in India at a time when people were not interested in acquiring them.
>
> We felt at that time that there was a good scope for formulations and a good scope for branded products which a lot of the multinationals as you know had brands which had been there for several years and were prominent. In 2010 our feeling was that the markets had actually reached the peak. And the valuations that were then there was a lot of hype as far as the domestic markets was concerned.

> **Therefore when we got a valuation which was 30 times of operating profit and 9.5 times sales we said that it made sense to sell out.** India started recognising drug patents effective 2005 and we could anticipate the scenario of price control and a heightened competitive regime, which would have impacted our future growth and profitability. Hence, we decided to exit from our Domestic Formulations business at the right time. We sold the business to Abbott at a record valuation. Domestic industry is now impacted by price control and a tighter regulatory environment. - Ajay Piramal

Ajay Piramal wanted to invest some of the proceeds received from the sale into the existing healthcare businesses [CDMO, Critical Care, and Consumer Products] which he retained. And he wanted to invest the remaining proceeds into one or more new businesses [diversify]. Mr. Market didn't like this diversification as it introduces a lot of uncertainty. This is the reason why the market was offering a dollar for 65 cents. I accepted the deal and made my first stock purchase in India. What made me to embrace the uncertainty when the market was against it?

1. I was investing my own money [unlevered] which I don't need for the next 20+ years. Stock market focuses on the short term. It expects results in the next quarter. But I was willing to wait for several years for the diversification strategy of Piramal to play out. I had enormous staying power.

2. I was not betting my entire farm. Instead I was building my position over a period of time. And I was committing capital only to a point that made me to sleep peacefully at night. I was optimizing for return-per-unit-of-stress.

3. From 1988 to 2009 Ajay Piramal compounded sales at 29 percent and profit after tax at 33 percent. During this 21 year period he compounded minority shareholders wealth at more than 29 percent. While the market over weighed the uncertain future, I gave more weight to Piramal's long term track record. I focused on the base rates.

4. What if the diversification strategy didn't work out? By buying a dollar for 65 cents, I had enough margin of safety. If things didn't work as expected then I could have sold my position without losing a lot of money. I was making an asymmetrical bet where the upside potential is greater than the downside risk [Heads-I-win-Tails-I-do-not-lose-much].

5. Prof. Sanjay Bakshi is one of my role models. And I was heavily influenced by his case study. His authority bias on me definitely played at a subconscious level which was another factor to make the investment.

Only in the Indian movies strategies work perfectly according to the hero's timetable. In real businesses diversification strategies always goes through a bumpy ride. How did it go in the case of Piramal Enterprises? In order to answer this question take a look at the table given below. Do you think the ride was bumpy or smooth?

(in crores)	FY2012	FY2013	FY2014	FY2015	FY2016
		Bumpy ride during the turnaround.		Light at the end of the tunnel.	
Shareholders Equity	₹11,242	₹10,724	₹9,321	₹11,736	₹12,422
Debt	₹1,663	₹7,180	₹9,080	₹6,617	₹14,450
Income	₹2,631	₹3,699	₹4,724	₹5,377	₹6,852
EBIT	₹336	₹382	₹615	₹3,546	₹1,833
Finance costs	₹215	₹575	₹1,050	₹511	₹939
Profit before taxes	₹121	(₹193)	(₹435)	₹3,035	₹894
Book value per share	₹666	₹621	₹540	₹680	₹720
Share Price	₹438	₹583	₹524	₹830	₹1,578
Price-to-Book	0.66	0.94	0.97	1.22	2.19

From FY2012 to FY2014 the ride was definitely bumpy. Ajay Piramal was growing the existing healthcare business both organically and inorganically. Also he divested into Information Management and Financial Services businesses. Click [here]() to learn more about these individual businesses in detail. During this period revenue compounded at a fantastic rate of almost 30 percent. But the company was piling up on debt and the interest expense exceeded the operating profits. What is going on?

1. To expand into new businesses Ajay Piramal was taking a lot of debt. What happened to the cash that he received from Abbott? He invested Rs 5,864 crores in Vodafone India Limited during 2011 – 2012. The objective behind this investment was to deploy the surplus funds that he received from Abbott while he was figuring out the new businesses to divest into. Until he sold his stake in Vodafone he didn't have any other choice except to load up on debt.

2. During this period the company was spending heavily in research and development to discover new drugs. It was working on coming up with 10 new molecules. During this period it spent around 816 crore rupees on this. And this effort didn't produce any revenue.

The above two items were mainly responsible for the piling up of debt, generating operating losses which in turn resulted in reducing the book value. During this period I was mainly focusing on the above two items. Why is that? Remember my original investment thesis was that I was buying a dollar for 65 cents. For that [invariant]() to hold true I need to monitor these items very closely. Both of them got resolved in a positive way in FY2015.

1. Ajay Piramal was able to sell his Vodafone stake for Rs 8,900 crores. In two years he generated a CAGR of 23 percent. This is a much better outcome than the originally assumed return of around 17 percent.

2. The probability of success in drug discovery is extremely low. It might take several years to make any return on investment. I was worried if Ajay Piramal would throw more and more money into a bottomless pit of drug discovery. He is a rational thinker and was not affected by sunk cost fallacy. During August 2014, the company scaled down the R&D activities of drug discovery.

(in crores)	FY2012	FY2013	FY2014	FY2015	FY2016
R&D Expenses	₹233	₹287	₹296	₹267	₹137

3. Ajay Piramal used some of the gains made from Vodafone sale to pay a special dividend of 35 rupees to the shareholders. On my original purchase price of low 400 this resulted in a one time yield of 8+ percent. He used the remaining proceeds to retire some of the non financing debt. Both these actions were top notch. His actions made my conviction stronger on the person and the company. This made me to add to my current position a couple more times. I was not anchored to my initial purchase price and bought more at much higher prices.

From FY2015 onwards things started to improve for the company. There is light at the end of the tunnel. Is it light from an oncoming train? In order to answer this question let's look at how well the company diversified from FY2012 to FY2016. The table given below shows you that data. What do you see?

1. Compared to FY2012 the company is well diversified in FY2016. Around 54 percent of the revenue comes from Pharmaceuticals, 28 percent from Financials, and the balance 18 percent from Information Management.

2. Overall revenue compounded at a healthy rate of 29 percent. Of which Financial services grew at an astounding rate of 62 percent. If you think this is too low then you need to reset your expectations.

(in crores)	FY2012	FY2013	FY2014	FY2015	FY2016	CAGR
Pharmaceutical Businesses	1,987.10	2,451.00	2,834.60	3,121.20	3558.4	16%
Pharma Solutions	1,354.50	1,563.70	1,786.00	2,007.70	2290	14%
Critical Care	412.6	616.1	720.4	756.8	875.8	21%
OTC and Ophthalmology	220	271.2	328.2	356.7	392.6	16%
Financial Services	272.8	388.8	743.7	937.1	1863.8	62%
Information Management	0	651.3	899.3	1,019.60	1156.2	21%
Others	92.6	53.2	42.6	44.8	31.5	
Total	2,352.50	3,544.30	4,520.20	5,122.70	6609.9	29%

From the above table can we conclude that everything is looking great for the company? Not so fast. A company can grow its revenue but still be losing a lot of money. The right way to measure if things are looking great is to see how much a business earns on its invested capital. To keep things simple let's look at the pre-tax return on equity. Take a look at the table given below. What do you see?

	FY2016					
(in crores)	Assets	Liabilities	Equity	Revenue	Pretax Profit	Pretax ROE
Pharmaceuticals	₹4,977	₹982	₹3,995	₹3,565	₹246	6.15%
Information Management	₹5,384	₹608	₹4,776	₹1,156	₹95	1.99%
Financial Services	₹18,977	₹10,953	₹8,024	₹1,837	₹931	11.60%
Unallocable	₹1,498	₹5,871	(₹4,373)	₹52	₹0	
Total	₹30,836	₹18,414	₹12,422	₹6,610	₹1,272	10.24%
Exchange gain					98.21	
Net Unallocated income					(₹130.72)	
Finance cost (non finance operations)					(₹344.82)	
Consolidated Profit before tax					**₹894**	**7.20%**

In whichever way you look at the pre-tax ROE it won't look good. Even the highest ROE generated by the financial services segment is only 11.6 percent. What is going on? If you look at the numbers at face value then you won't understand what is going on. This is because of the limitations of accounting as it doesn't handle the shift from tangible to intangible assets.

> Understanding a business requires understanding the numbers. The task has become more challenging in recent years as companies are investing more in intangible assets and less in tangible assets. For example, in fiscal 2016 Microsoft spent about one-and-a-half times as much on research and development, which it expensed on the income statement, as it did on capital expenditures, which were capitalized on the balance sheet. This shift means that traditional accounting measures are less useful but does not abdicate the responsibility to understand a business's current economics and prospects. - Michael Mauboussin

In order to understand this let's look at Pharmaceuticals and Information Management businesses. The total equity invested in both these businesses add up to Rs 8,771 crores. On this it generated an EBIT of 340 crores. If you add the interest expense of 345 crores then the company didn't make any profit. Why did this happen? In order to grow the top line the company is invested heavily by recruiting more employees, spending a lot on marketing and promotions, and acquiring a lot of companies [results in amortization which is not a real expense]. This is clearly reflected in the table given below.

Expenses as a percentage of sales	FY2012	FY2016
Total Employees	3928	6153
Employee benefit expense	16.59%	24.66%
Advertising and Marketing expense	3.85%	5.81%
Depreciation and Amortization expense	4.91%	4.78%

All these actions resulted in more expenses which got recognized in the income statement immediately. But the value creation [more revenue in future] for these expenses take place over several years. There is no way to capture this value creation today in accounting. If reported profits doesn't capture this value creation then how do we check if value is being created? This question is beautifully answered by Thomas Russo. If its products and services gains market share then we know that value is being created.

	Growth Rate	
	Piramal	Market
CDMO	18%	9%
Consumer Products	18%	12%
	Piramal Market share in Critical Care	
	2009	2016
All Markets	3%	12%
US	20%	30%

The above table clearly shows that Piramal Enterprises grew faster than the market. This happens only when it gains market share from its competitors. In the Consumer Products business it has moved up from the 40th position in 2007 to 7th position currently. By 2020 it wants to be in the 3rd position. When it acquired Decision Research Group [Information Management] it had an addressable market size of $2 billion. Through organic and inorganic investments it has increased the addressable market size to $16 billion. Traditional accounting doesn't capture this value creation. So depending only on reported profits is misleading.

In order to understand the actual returns generated by the Financial Services business we need to break it down and analyze them separately. Let's start with Shriram Group investments. Take a look at the table given below. If I don't include the look-through earnings of Shriram Transport and Shriram City Union then the pre-tax ROE would come to 4 percent. With look-through earnings the ROE comes to 9.7 percent. This is not bad as the underlying earnings of these companies are compounding at double digit rates.

(in crores)	At cost	Income/Dividends	Look through earnings	Pretax ROE	Market value	IRR
Total	₹4,583	₹185.78	₹258.68	9.70%		
Shriram Transport	₹1,636	₹22.60	₹178.00	12.26%	₹2,949.00	21.70%
Shriram City Union	₹801	₹10.20	₹80.68	11.35%	₹1,315.31	28.14%
Shriram Capital	₹2,146	₹153	₹0.00	7.13%	not available	0%

Shriram Transport and Shriram City Union are kept in the balance sheet at cost. The underlying price appreciation is not captured in the financial statements. They generated an IRR of 22 and 28 percent. If you think this is low then you need to reset your expectations. The wholesale lending, which they do to real estate developers, generated a pretax ROE of 22 percent. In one speech Charlie Munger warned about loans to real estate developers. But here we have a case in which exceptional returns are generated with a low NPA of 0.9 percent. Is this luck or skill?

	FY2016				
(in crores)	Loan Book	Equity	Pretax Profit	Pretax ROE	Gross NPA
Wholesale Lending	₹13,048	₹3,441	₹745	22%	0.90%
Alternate Asset Management	₹8,717	Off-balance sheet			

I have been holding on Piramal Enterprises for 4+ years. Including dividends it has generated me an IRR of 45 percent. As a lucky idiot, I can't complain much given that this is my first investment in an Indian stock. In the last 6 months the stock almost doubled. Is it stock selling at a bubble territory? The only way to find out is to do a sum-of-parts valuation.

But how to value something when reported profits doesn't reflect the true picture. I will come up with a conservative revenue multiple to value for Pharmaceuticals and Information Management business. I will use the market value for Shriram Transport and Shriram City Union. For Shriram Capital I will go with book value. For the Wholesale lending I will come up with a fair multiple on the book value [not sure if my estimate of book value is correct]. I am going assign zero value for Alternate Asset Management as I don't know how to value it. The table given below shows the conservative value for Piramal Enterprises.

	FY2016		
(in crores)	**Revenue or Book**	**Multiple**	**Value**
Pharma Solutions	₹2,290.00	3	₹6,870.00
Critical care	₹875.80	3	₹2,627.40
Consumer Products	₹392.60	3	₹1,177.80
Information management	₹1,156.20	4	₹4,624.80
Shriram Transport At Market	-	-	₹2,949.00
Shriram City Union At Market	-	-	₹1,315.31
Shriram Capital (at cost)	-	-	₹2,146.00
Wholesale Lending	₹3,441.00	2.5	₹8,602.50
Asset Management	-	-	₹0.00
			₹30,312.81
		Less	
		Non Financing Debt	₹2,700.00
		Provisions	₹262.24
		Intrinsic Value	₹27,350.57
		Shares outstanding	172563100
		Intrinsic Value per share	₹1,585

Compared to the conservatively calculated intrinsic value of 1,585 rupees the current stock price of 1,560 rupees doesn't look expensive. In the next couple of years Ajay Piramal will be splitting Healthcare and Financing Businesses. Let's see if this could unlock more value.

References

1. Annual Reports and Investor Presentations of Piramal Enterprises.
2. IDFC Panel Discussion with Ajay Piramal.
3. ET Now interview with Ajay Piramal.
4. Warren Buffett's Look-Through Earnings.
5. Mauboussin reflections on the Ten Attributes of Great Investors.

6. Tom Russo on market share gains.

Disclaimer: As of this writing, I own shares of Piramal Enterprises. This is not a recommendation to buy, sell, or hold. I am not a SEBI registered analyst. I wrote this document to organize my thoughts and deepen my understanding about the company. I am sharing it so that you can learn something from this.

Author : Jana Vembunarayanan
Website : https://janav.wordpress.com
Twitter : @jvembuna