



# THE NEWSMAKER

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### **Become better, not bigger.**

**Fear, which was all-pervasive until recently, will begin to dissipate as investors recognise that it is not doomsday.**



**By Motilal Oswal, Chairman & Managing Director, Motilal Oswal Financial Services**  
(Source: *The Economic Times*, Chennai, January 5, 2009)

As we enter 2009, we can do so with the feeling that the BSE Sensex is unlikely to breach its recent low of 7,700 anytime soon. Having said that, we also need to recognise that we are in the midst of a definite slowdown and the trend of negative earnings surprises and downgrades has just about set in. While consensus estimates still indicate positive earnings growth over the next two years, there is a distinct possibility of earnings decline in the following few quarters. Yet, market indices need not necessarily move in tandem with worsening corporate performance.

The market reaction to the global financial crisis has been severe, with the BSE Sensex plummeting from a high of 21,206 in January 2008 to sub-10,000 levels. Valuations have become reasonable, inflation has fallen to single digits, crude oil prices have

declined to below \$40/barrel, and liquidity conditions have begun to improve following interest rate cuts. Fear, which was all-pervasive until recently, will begin to dissipate as investors recognise that it is not doomsday. The next two to three years will be a period of consolidation.

During the five years between April 2003 and March 2008, India's nominal GDP grew at a compounded annual growth rate (CAGR) of 14%. Against this backdrop, corporate profits grew at a robust CAGR of 32%. As a result, corporate profit to GDP moved up from 3.1% in FY03 to a high of 6.4% in FY08. Following the global slowdown, corporate profit to GDP is likely to revert to 4.5-5% over the next three years. Sensex EPS, which has grown at a CAGR of 25% over FY03-FY08, will also revert towards the long-term average CAGR of 15-17%.

Further dollar appreciation is a key risk to watch for. It can mitigate the benefits of lower dollar-denominated commodity prices, push up inflation, and impede the RBI's ability to follow an expansionary monetary policy. The recent dollar appreciation is not merely the result of flight of capital to the US. A net energy importer, the US has been witnessing an improvement in its terms of trade, supported by declining energy prices. As the US economy falls deeper into recession, its imports will decline precipitously, resulting in further improvement in its terms of trade.

Motilal Oswal Securities (MOSL) recently downgraded its Sensex EPS estimates by 11% for FY09 and by 16% for FY10. The downgrade factors the revised estimates for companies, post the results for the quarter ended September 2008, and the changes in key assumptions of commodity prices, currency impact and slowing business momentum. Given the increased uncertainty and the sharp decline in global commodity prices, we believe that earnings could see more risks over the next few quarters. The scenario appears gloomy, but let's look beyond the immediate gloom.

How ugly can it really get from here? We will probably not see double-digit GDP growth in the next two to three years. Growth could slip to 7%, may be 6%. Even then, India will be one of the fastest growing economies in the world. The balance of payments situation can worsen significantly, but the improvement will be quick once the exchange rates stabilise. More earnings downgrades are likely over the next few quarters but even the most pessimistic estimates today indicate positive earnings growth. Post the recent earnings downgrade, our Sensex EPS estimates still imply a growth of 8.6% in FY09 and a growth of 16.9% in FY10.

The dollar cannot continue to appreciate forever. Once it begins to weaken, the RBI will no longer need to take money out of the system to support the rupee. Foreign exchange reserves, which have dipped from a peak of over \$300 billion in June to under \$250 billion in November, will be easier to replenish. Current account deficit, which has ballooned during the past six months, will begin to decline. The full benefits of falling dollar-denominated commodity prices will flow in and a growth inducing monetary policy will be put in place.

Interest rates in India are clearly headed down, in line with the global trend. US 10-year treasury yields are at an all-time low of 2.7%, while the 10-year G-Sec yields in India are

6.6% - a difference of 390 basis points. We can expect an unprecedented reduction in interest rates from here. Despite the low interest rates and the likelihood of further fall in interest rates, the Sensex is trading at a trailing P/E of 11x, close to its historic lows of March 2003. The low trailing market P/E suggests that the market has already factored a sharp fall in corporate profits.

With falling interest rates, earnings yield to bond yield is currently 1.4x, close to its all-time high of 1.6x. Also, market capitalisation to GDP has corrected sharply from a high of 109% to 55%, which is closer to the long-term mean of 46%. Moderate market capitalisation to GDP and high earnings yield to bond yield suggest reasonable margin of safety for investment in equities. But does that mean you should go all out and buy all stocks? No, only the great and the good ones. That too, if they are available at reasonable prices. How do you identify such stocks?

You might be aware that legendary investor, Warren Buffett personally writes the Chairman's Annual Letter to Berkshire Hathaway shareholders. His 2007 letter has a section, 'Businesses – the Great, the Good and the Gruesome', where he discusses what kind of companies Berkshire likes and what it wishes to avoid. Buffett equates the Great, the Good and the Gruesome companies to three types of savings accounts, where the interest rate is the RoE (return on equity). He says: "Think of three types of savings accounts. The Great one pays an extraordinarily high interest rate that will rise as the years pass. The Good one pays an attractive rate of interest that will be earned also on deposits that are added. The Gruesome one pays an inadequate interest rate and requires you to keep adding money at those disappointing returns."

A truly great company must have an 'enduring moat' - long-term competitive advantage — that protects the excellent returns on invested capital. This is possible only in either of two cases: (1) it is a low-cost producer, or (2) it possesses powerful brands. Great companies tend to grow slower than their Good and Gruesome counterparts. But the key aspect of this growth is that it is achieved by consuming very little additional capital. There are just a handful of such companies in any country and they are rarely available cheap.

Over time, Great companies become significant cash machines with high and steadily rising RoE, and high dividend payouts. Investors can deploy these payouts to earn returns in other avenues. To quote Buffett: "Long-term competitive advantage in a stable industry is what we seek in a business. If that comes with rapid organic growth, great. But even without organic growth, such a business is rewarding. We will simply take the lush earnings of the business and use them to buy similar businesses elsewhere."

Good companies grow at healthy rates, but need large increases in capital to sustain growth. Like Great companies, they too enjoy competitive advantage and make healthy profits. However, they need to reinvest a significant proportion of these profits for growth. Buffett calls this the "put-up-more-to-earn-more" phenomenon, which is true of most companies across countries. Compared to great companies, return ratios will tend to be much lower, as will dividend payouts.

Gruesome companies require significant capital for such growth, and then earn little or no money. Paradoxically, such companies tend to enjoy very high growth rates; this turns out to be a trap. Buffett says: "Think airlines. Here a durable competitive advantage has proven elusive since the days of the Wright brothers. The airline industry's demand for capital ever since that first flight has been insatiable. Investors have poured money into a bottomless pit, attracted by growth when they should have been repelled by it."

Our annual wealth creation study identified Hero Honda as a Great company currently available at a good price and State Bank of India as a Good company currently available at a great price. The study also found that over the period 2003 - 2008, Reliance Industries was the Biggest Wealth Creator, Unitech the Fastest, and Infosys the Most Consistent.

During the 10-11 months of market correction, excesses have been weeded out. Corporate India's focus is shifting from becoming bigger to becoming better. Businesses are cutting costs and focusing on increasing efficiency to achieve higher profitability. A market share realignment will be visible across sectors in the ensuing quarters. New winners will emerge and established leaders might be unseated. These are interesting times, which will throw up interesting ideas. The question is: "Will you have the courage and conviction to make the most of these ideas?"



## What's Bill Gates up to now-a-days?

### 2009 Annual Letter from Bill Gates: Introduction



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This is the first annual letter I plan to write about my work at the Gates Foundation. In this letter I want to share in a frank way what our goals are and where progress is being made and where it is not. Soon after Warren Buffett made his incredible gift, which doubled the resources of the foundation, he encouraged me to follow his lead by writing an annual letter. I won't be quoting Mae West or trying to match his humor, but I will try to be equally candid.

Melinda will be sharing some of her thoughts in a video format each fall. Neither of these communications will replace the full annual report that we publish each year at [www.gatesfoundation.org/annualreport](http://www.gatesfoundation.org/annualreport).

This past July, I went from being full-time at Microsoft to being full-time at the foundation. I took a few weeks off for some family time, including a trip to Beijing for the Olympics, but I was anxious to keep myself mentally challenged and so the pause between jobs was brief.

Many of my friends were concerned that I wouldn't find the foundation work as engaging or rewarding as my work at Microsoft. I loved my work at Microsoft and it had been my primary focus for over 30 years. I too would have worried if I had paused and thought about it enough. My job at Microsoft had three magical things. First there was an opportunity for big breakthroughs - including changing computers from being expensive and only for big companies to being inexpensive and empowering to individuals with a wide range of great software for almost any task. I wanted a personal computer with great software for myself and everyone else. Second, I thought my skills would let me help create a special company that would be part of a whole new industry. I felt I belonged in the software business, having thought about the engineering and the business possibilities maniacally from age 13. Finally, the work let me engage with people who were smart and knew things I didn't. The day-to-day work always involved new problems and new ways of drawing out the best efforts from other people. We were always taking risks - some of which didn't pay off and some of which did. Most people

don't have even one job that has all those elements, and my friends thought I wouldn't be able to avoid comparing my new work to what I had had at Microsoft.

Despite that high bar, I love the work at the foundation. Although there are many differences, it also has the three magical elements. First there are opportunities for big breakthroughs - from discovering new vaccines that can save millions of lives to developing new seeds that will let a farming family have better productivity, improve their children's nutrition, and sell some of the extra output.

Second, I feel like my experience in building teams of smart people with different skill sets focused on tough long-term problems can be a real contribution. The common sense of the business world, with its urgency and focus, has strong application in the philanthropic world. I am sure I will make mistakes in over-applying some elements from my previous experience and will need to adjust. For instance, the countries where Microsoft does business are far more stable and have a lot more infrastructure than most of the places where the foundation does its work, so I'll need to better appreciate how difficult it will be to execute our strategies. However, I am equally confident that our maniacal focus on drawing in the best talent and measuring results will make a difference.

Finally, I find the intelligence and dedication of the people involved in these issues to be just as impressive as what I have seen before. Whether they are scientists at a university or people who have worked in the field in Africa most of their lives, they have critical knowledge and want to help make the breakthroughs. The opportunity to gather smart, creative people into teams and give them resources and guidance as they tackle the challenges is very fulfilling.

The foundation has learned a lot and has had a significant impact. I want to thank all of our employees and partners for what they have accomplished so far. I should acknowledge three people in particular. First is Patty Stonesifer, whom Melinda and I trusted to run the foundation and provide the leadership that built the teams and programs. The second is my dad, who plays a key role and embodies the thoughtfulness and the humility that the foundation hopes to achieve. I still have a lot to learn from him. I feel lucky that because of both of them we are already nine years down the learning curve. They both have done an amazing job. Finally I want to thank Jeff Raikes, who took over as CEO from Patty last fall, for the great work I know he will do with us in the years ahead.

There are so many interesting and important topics to write about that it's a challenge for me to keep my comments short. Each year I'll touch upon some of the things that are top of mind. In this year's letter I will share some observations and learning from the three areas we work in: Global Health, Global Development, and our U.S. Program.

Readers can see the full text of Bill Gates' annual letter at [www.gatesfoundation.org](http://www.gatesfoundation.org).



Lee High School, Houston, Texas

Bill and Melinda Gates display the same passion at their foundation as they did at Microsoft.

**Write in with your comments, suggestions and contributions to DMS Financial Services Company Pvt. Ltd. at <[dms.financial.services@gmail.com](mailto:dms.financial.services@gmail.com)>**

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