Investment Philosophy: Insights and Articulation

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Personality Traits

Action oriented or Strategic

- Lean towards strategic category
- Spend considerable time on
  - developing/fine tuning the framework
  - reflecting back on investment decisions to identify the emerging patterns
  - Common threads that bind the successful investment/failed investment
- Comfort level is high if the investment idea falls into one of the broad frameworks that I have dealt with in the past. Few of them are
  - Good/Great businesses facing uncertain times
  - The Challengers (second/third largest players challenging the industry leaders)
  - Standouts (Players who have done consistently well in a challenging industry)
  - Deep value buys (Companies available at discount to net cash/WC and profitable)
  - Industry leaders with pricing power

Personality Traits

Undervaluation or Conviction

- Play both the themes, however highly averse to paying too much for conviction irrespective of quality of business
- Very Difficult for me to invest in companies carrying high valuation
- Have missed many opportunities
  - Page Industries
  - Eicher Motors

Calculated Risk Taker Vs. Risk Averse

- Calculated risk taker with moderate risk tolerance
- To make any meaningful allocation, need to be convinced that odds are in our favour
- 3 out of 10 times, sheer undervaluation tilts the odds; 5 out of 10 times, combination of BQ and valuation makes the odds in investor's favour; rest of the times, the high conviction on BQ/MQ drives the odds
- Second Level thinking construct has been immensely helpful in the whole process

Investment Tenets

What are we most excited by?

- There are couple of patterns, where I have benefited significantly in the past and rationally, it makes a lot of sense to invest from long term perspective

Challengers:

Building blocks of the pattern

- Industry with long runway
- Oligopoly structure
- 2nd /3rd largest player taking away market share consistently from its industry leaders
- Market share gain not sheer outcome of pricing differential ; Good industry economics

My tryst with Challengers:

- Cera Sanitaryware –Consistently increasing market share at the expense of Parry ware/ HSIL over last many years
- Amara Raja Batteries – Giving Exide run for its money in all the segments replacement/OEM/Industrial
- Atul Auto: A small player with limited product offering- took away market share from leaders Piaggio & Baja Auto

Investment Tenets: What are you most excited by (contd..)

Fallen Angels

Building blocks of the pattern

- Great businesses with some moat/entry barriers
- Demonstrated performance record for long period
- Facing temporary challenges
- Significant undervaluation compared to its historical averages or comparable peers

My tryst with Fallen Angels:

- Piramal Enterprise– A very strong business built from scratch; Management having great knack for deal making and above average capital allocation skills – available below net cash
- MCX – A business with very strong moat and high switching cost – facing twin challenges of collateral damage and declining volume - Very attractive valuations compared to business quality
- Ipca: Lowest cost producer for number of API/formulations due to operational efficiency and vertical integration- USFDA import alert – The worst seems to be factored in the valuation- Lowest cost advantage remains

Must Haves in a business

- Except for the cases of sheer undervaluation, I do look for "quality of business" getting reflected in numbers one way or the other.
- Good return numbers are very important and sustainability of such numbers (imbibed in the underlying business model) is essential
- I would rather wait and pay slightly more than fall into a situation where the financials still do not reflect the business quality.
- Unlikely to participate in “turn around” opportunities at early stage (at the first whiff of improvement)
- This makes me averse to participate in cyclicals also
- Another show stopper of course is Management having clearly identifiable corporate governance issues However, I take vague statements on management integrity with handful of salt as it is purely perceptional and not evidential

Ignorables

- Higher management salaries; Related party transactions for business (sale of goods, purchase of goods, trading etc) if not done at the expense of the company;
- Case in point- Amara Raja Batteries
  - Very high management salary
  - Recent lease agreement for land for 50 years (though, I feel it more or less seems like arms length number)
- Important to put numbers/severity of deviation in perspective of the overall scheme of things.
  - Kitex: coexistence of KCCL and KGL – A questionable arrangement, however, the business keeps on performing
  - Management has laid a road map to address the issue
- Muted growth/no growth in near future
  - Shilpa: It was evident that the growth for couple of years at best will be modest, however considering the other factors being overwhelmingly in company's favour, I would not give much importance to it (though there is a certain opportunity cost attached with it)

Not Ignorables

- A deliberate capital misallocation decision

Case in point: Oriental Carbon & Chemicals Limited

  - One of the top 3 players in insoluble sulphur across the world
  - Operate in oligopoly industry
  - Reasonably good industry economics
  - High entry barriers (Approval with top tyre manufacturers such as Bridgestone/Michelin/Goodyear)
  - Excellent return ratios
  - Bought at decent valuation

- Management decided to by 50% stake in Schrader Duncan from its JV partner Schrader Bridgeport in March 2012. In my opinion, it was a deliberate misallocation of capital due to
  - No strategic fit with the existing business of OCCL
  - Unit was operating in highly competitive environment and was loss making for many years
  - Business dynamics and return profiles were quite different than that of OCCL

Mistakes & Key Learning

Mistake of Omission

Symphony Ltd

- Had understood the business well and was convinced about the long runway, strong business model, highly capable and ethical management, strong brand, very good financials and high probability of 25% CAGR for 3 years
- Company was available at 25 times TTM
- I thought that the company was fairly priced by the market and hence there was no MoS.
- Missed an 6 bagger in 1.5 years

Learning:

- Important to value on forward earnings where you are reasonably sure of growth
- Margin of safety does not only come from valuation but also from predictability of growth, business model and business franchise

Mistakes & Key Learning (Contd…)

Mistake of Commission

GRP Ltd

- Company was one of the largest player in the world globally in reclaimed rubber having decades old relationship with all major tyre companies
- Management was of the highest pedigree, highly capable and ethical
- 10 year financials were just about perfect, strong growth -25% CAGR top line and 38% CAGR bottom line; ROCE increase from 15% to 30% in 10 years; low leverage
- Very attractive valuation 7 times trailing P/E
- After 3.5 years, it would have resulted in 30% loss

Learning:

- Even 10 years financials will not reflect the business dynamics accurately! A cycle may outlast 10 years, befooling the investors. The only way out is to put on your thinking hat!
- Once we have understood the business, it is important to play out various scenarios and its implications for the business. (In this case, A slightly extended reasoning would have revealed that the down cycle in automotive industry + economic slowdown would have double whammy on the company (i.e. reduced demand and reducing rubber prices (as it reduced the incentive for the tyre companies to use reclaimed rubber)

Paying up for business

- In last 5 years, the thinking on this front has evolved significantly
- Moved from the sheer undervaluation guy to stingy(!) payer of fair value for high quality business
- Can pay up 20-25X for high quality businesses like ENIL/Page/Symphony/MCX

  Business Traits where I can pay up for

  - Strong franchise resulting in moderate/strong pricing power (Strong entry barriers or high switching cost or strong network effect)
  - Asset light business model generating strong free cash flows
  - Very high rate of return generated on capital employed
  - High return on incremental capital employed
  - Long runway for growth
  - Highly capable and ethical management with demonstrated capital allocation skills
- However, still reluctant to pay up 50-60X for any business
- I have heard/met lot of investors indicating that even if one pays up for a great business, one can still earn good returns. However, still not able to create sound rationale around paying up such high value for any business.

When to sell

- When started had absolutely to clue on this aspect
- Fortunately, stay put with all the investment where business was performing, riding with the business
- Though always in ambivalence was making an overkill on “riding with the wave”
- Have formed some framework/ground rules for making a selling decision- however, the effectiveness of the same is yet to be tested
- I am sure, the framework will evolve as I realize the mistakes in my thought process. However, as we say, till then, I would like to stick my neck out!

Sell/Exit in following cases

- When I realize that I have made an mistake (in understanding of BQ/MQ or investment hypothesis)
- The initial investment thesis is no longer valid (in case of undervaluation play, the gap between price and value is bridged; For opportunistic bets – when the “catalyst” has played out)
- Come across much better investment opportunity – where odds of higher returns are SIGNIFICANTLY higher than the weakest of existing positions
- When market seem to be near the undue exuberance (typically 2 standard deviation away from long term average of valuation multiple)

Proportion of Cash

- Except for the highly “bearish” and “bullish” markets, typically maintain 15% of cash to take advantage of any “extremely attractive” opportunity that I may across
- However, do not maintain any “optimal” level of cash. Cash levels are typically the outcome of the buying and selling decision hence
  - After partially/fully selling one or more of the positions, I may end up in 30%+ cash in case if I do not find an attractive opportunity to invest
  - In case of very attractive opportunity arises where I deploy 15% buffer cash, I may be 100% invested
  - However, not averse to holding cash in absence of “attractive” investment opportunity at any point of time
- Have yet to witness “undue exuberance” phase of the market, hence yet to figure out the “optimal” level of cash in such markets
- However, I do acknowledge that it will be very difficult to remain in cash over 50-60%, especially when we do not have any idea about the top and if remain disciplined, we may exit at much lower levels

Falling out of Love- Exiting the winners

- Psychologically, it has been very difficult to move out of winners ,especially if the business keeps on performing
- I have realized that I tend to "rationalize" number of things, rather than being down right objective in arriving at inferences based on facts
- At the same time, I also feel that the decision making framework for "buy" and "hold" can be very different (Prof. Bakshi, indeed wrote an excellent article on the same)
- At the moment, I follow a process to ensure, I am rational/objective
  - On half yearly basis, do the scoring of the business on various parameters of BQ/MQ/Valuation – Scoring template
  - Develop a score prospective investment on the same parameters using the same scoring methodology
  - If the score of "new entrant" is significantly higher than the "lowest" of the existing positions, the "new entrant" will replace the least attractive business in existing portfolio
  - However, I have realized that only quantitative assessment is not adequate and there is lot of subjectivity. Combination of quantitative template with template such as BQ may provide better framework
- Partially/fully exited Mayur/Atul Auto to move into/add Kaveri & ENIL

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Gazing through “Crystal Ball”

- Extremely difficult task to do for “All” the business in the portfolio with same certainty
- Have preference for businesses which have higher predictability and hence easier to visualizing the future
- Exact numbers do seem to mislead (at least to me), instead ball park numbers and big picture seem to be more workable to me (e.g. Radio industry estimated to double in 4-5 years, ENIL is likely to grow at higher pace than industry. Hence, most likely the topline is likely to double in 4 years
- Have realized, that it is important to work with few scenarios when gazing through future with some intelligent assumptions on key variables and develop 4-5 set of scenarios (We need to be cognizant of the fact that these are not the only scenarios that may play out, there may be other which we have not anticipated or can not be anticipated)
- “Stress test” the investment decision on reasonably bearish scenario. If there is limited downside there, it probably is the right investment decision
- Number of variables: Less the number of variables, higher the “confidence level” in scenarios

  e.g.: Page Vs. Kaveri Vs. Avanti

Height of Conviction

- Two businesses where my conviction is very high and the shorter term performance shocks/price levels are not very relevant

ENIL

- Radio as industry is much more mature today than it was 5 years ago
- It has profitably survived last 10 years in very challenging environment while others have floundered. Today, radio is slowly establishing itself as very important media
- Network having very strong brand, diverse listenership with pan-India network resulting in pricing power. With Phase-III, it is likely to be expanded to smallest of towns. Reach with brand is a great combination
- Cheapest medium (as compared to TV, Newspaper) when measured in cost/target audience (listener/reader/viewer)

MCX

- Very strong moat due to strong network effect and high switching cost
- Despite of all adversities (collateral damage and CTT), it has maintained above 80% market share
- Very attractive economics due to very low marginal cost of scaling up
- Highly under penetrated commodity derivative market- essential for next level of financial reform