My Experiments with Equity Investing

ValuePickr Annual Meet – July '18, in Goa

Mridul Somani
S/w Engineer, Businessman, Organic Farmer, Equity Investor
mridulsomani@gmail.com
@Mridulsomani2

Investment Journey

THE BEGINNING (Aug 2014 – Nov 2015)

•Never looked at equity markets prior to FY 14-15. Had a blue chip family pf which had never been touched from 90s. Most of the family savings were in real estate, debt, tax saving bonds & stuff.

•Started getting interested in equity and invested for the first time in Q3 FY14-15. Kicked-off with a very small playing capital!

•Knew nothing about the market dynamics. No accounts background as well. Started chasing momentum thinking I am being a value guy. (Didn't know about the keywords – momentum/value at that point.)

•Made brutal mistakes during the whole first year investing chasing fancy theme with not much analysis. Lost 35-40% of the capital in companies like Punj, Jyoti Structures, Gammon, Lycos, Lanco, NRE Coke, GTL, Kwality, Ruchi Soya…Yeah, you name it!

PAUSE TO REFLECT (Nov 2015 – Jun 2016)

•Realized I am not being up to the mark. Many others are making good money, but I am not. Never expected underperformance of this sort!

•Got my hands on a few good investment books – Lynch, Graham, Fisher. Reading that gave me a chance to reflect upon my mistakes.

•Within next few months, completely exited my crap portfolio at a substantial loss.

•Swore to invest only after learning accounting basics, and peeking through company financials and industry prospects myself.
And there it began!

• Joined VP in Dec 2016. Hockey-stick learning curve, thereafter!

PAIN + REFLECTION = PROGRESS

Knowledge

- Trusting Cyclicals as Stalwarts
- Market -cycle Agnostic
- Accounts illiterate
- No industry-level research
- Half baked knowledge
- No/Wrong Scuttlebutt

Behavior

- Saying “Yes” to everything (FOMO)
- Induction Effect
- Blindly Averaging-Down
- Fancy themes (Story Bias)
- Confirmation Bias
- Sunk Cost Fallacy
- Skill vs Luck
- Survivorship Bias
- Social Proof (herd mentality)
- Halo Effect

Vision

- Looking at the Big Picture
- Allocation & Diversification
- No second level thinking
- Order book based stocks
- Looking at P/E in isolation

Understanding Self!

• Prefer investing for medium-long term; hunting for compounders (GARP) that can grow much higher than industry averages and GDP and can offer a potential return of 2x in 3y, 3x-5 yrs, 10x in 10 years.

•Do not mind some positional trading as well due to the nature of the market we are in. Quick 10-15% gains isn't uncommon. Prefer doing this trading in my core long term bets only. Don't mind any upsets in positional trading as I am anyways in for long term.

•Maintaining 2 Demat accounts – one for positional trading, one for long term investment.

• By nature, not comfortable with cyclicals. Tried my hands on few sectors – Sugar, Hotels, Metals. I feel that as an investor, depending upon one's nature (cautious or enterprising), one cannot be 'that successful' experiencing his first commodity cycle. Learnings gained from that first cycle if employed well can give rich rewards in the next cycle. (Need to be careful of Hindsight Bias here)

•Shifting towards concentrated portfolio with longish tail.

• I believe in the "Alternative Paths" theory; we need to see what risks one took to reap what rewards. Just comparing rewards in isolation is like the game of Russian Roulette!

• I don't prefer deep value stocks. I am okay averaging both up/down (depends …head in either case needs to be in place). Charts are good help while buying/averaging. Price anchoring still haunts me but I am trying to overcome it by focusing on value. Stock can grow 5x in 5 years but can still remain cheap. On other hand, stock can correct to half but may get more expensive. It's all about value at the price it is available at.

Getting both Price & Timing right is the HOLY GRAIL!

We have two classes of forecasters – Those who don't know (A) and those who don't know they don't know (B)! My transformation - A -> B -> A

Understanding Self!

Can Ignore

- Not very presentable management (Manappuram)
- Low ROE/ROCE (Depends on the situation)
- Negative FCFs
- High promoter salary (Right way to get incentive)
- Guidance misses, if overall business seems to be on track

Cannot Ignore

- Questionable promoter actions (capex, repeated pledges, trading in own shares, etc)
- Bad promoter history
- Questionable RPTs
- Consistent High debt
- Low CFO in relation to PAT over the years
- Extremely complex businesses (Many Subsidiaries with lots of blind spots)
- Consistently high CWIP with not much change in Assets
- Bloated Balance Sheets, which keeps getting even more bloated.
- Dividends paid through debt

What has worked for me so far?

•I do not try to be the first person to unearth a story. I like stories which have substantial information for me to make 'informed' decisions. Joining the dots is okay but if the business got a very long runway (which I like), I don't mind losing on initial gains. I like kind of proven stories with unquestionable promoter integrity.

•Being with managements who walk the talk, or even better if they don't talk but keep walking making huge strides. Rare missed guidance is okay but they should not become serial offenders on this issue.

•Following a simple investing template - good businesses with visionary management (mix of conservative and aggressive), which can grow with internal accruals or debt (which they keep paying back on time). Investing in simple and easy to understand businesses has worked for me so far. (Nesco, Finolex, Dabur, Garware, TCI Express, etc)

•Rejecting/Questioning mindset has helped me a lot. Need to find reasons to say No to any idea. I often tend to take initial position if I like an idea after initial research; this helps me delve more into the workings of that business.

What has worked for me so far?

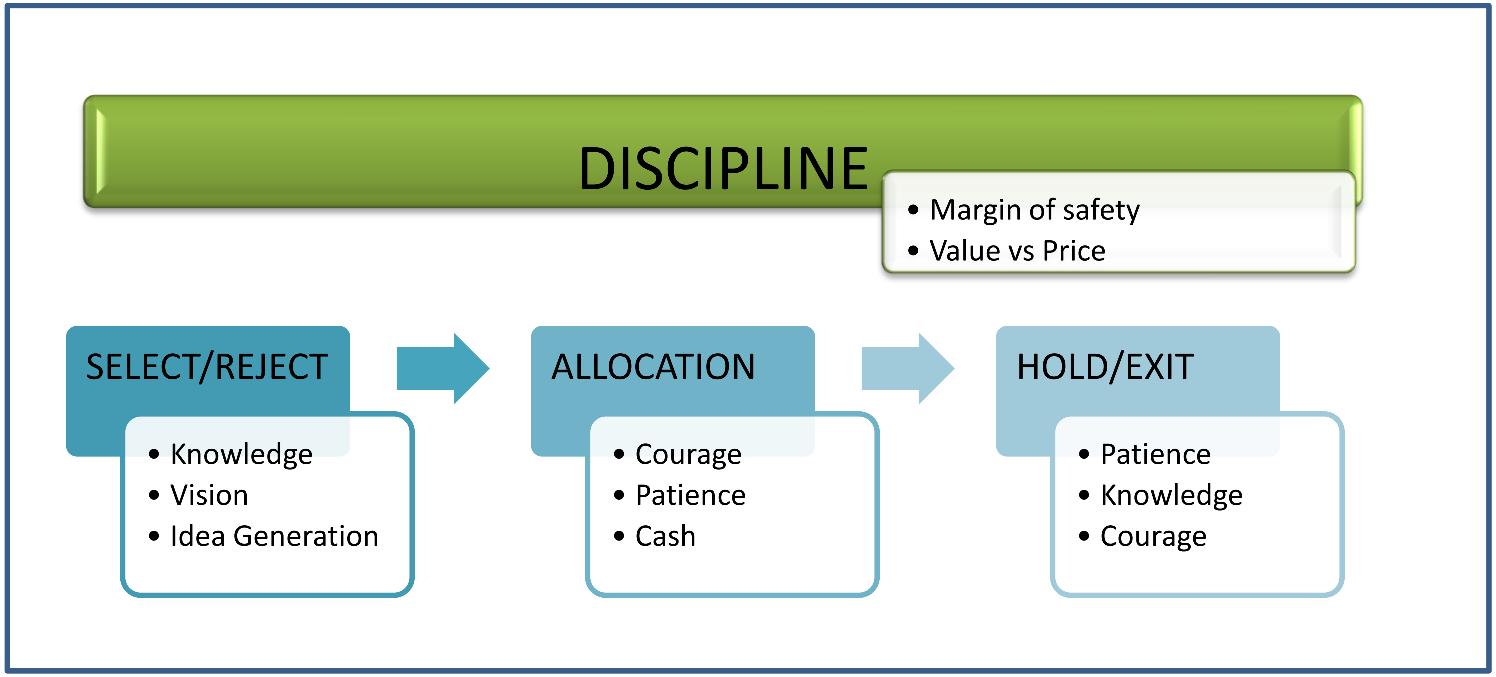
•I do not mind overpaying for an idea if I am willing to stay with that for a very long time. I tend to focus on market cap rather than p/e and the sector growth rate and size. If the story remains on track and stock despite that corrects, I won't mind adding more.

• I never go all out buying in a single tranche. There are often lots of questions and blind spots post my initial buy. I try to get as much answers as possible before building any position further. If I do not get all the answers, I don't mind selling my initial position then and there.

•I used to get emotional especially in situations where I ignored huge paper-gains with stock correcting much below my buy price. Practicing long term is tough! I do not mind booking partial gains in case stock get overvalued. I understand that during the long journey there will be phases of overvaluation and undervaluation. But I like taking some gains off the table when I feel stock is overheated.

•I prefer dividend paying stocks (even low dividend is okay). But there should be some at least. Over time, even with gradual increase in dividends with performance, the amount becomes very big. Say 1% div yield would become 10% on original capital, if capital itself grows 10x in 10 years.

Developing a Process



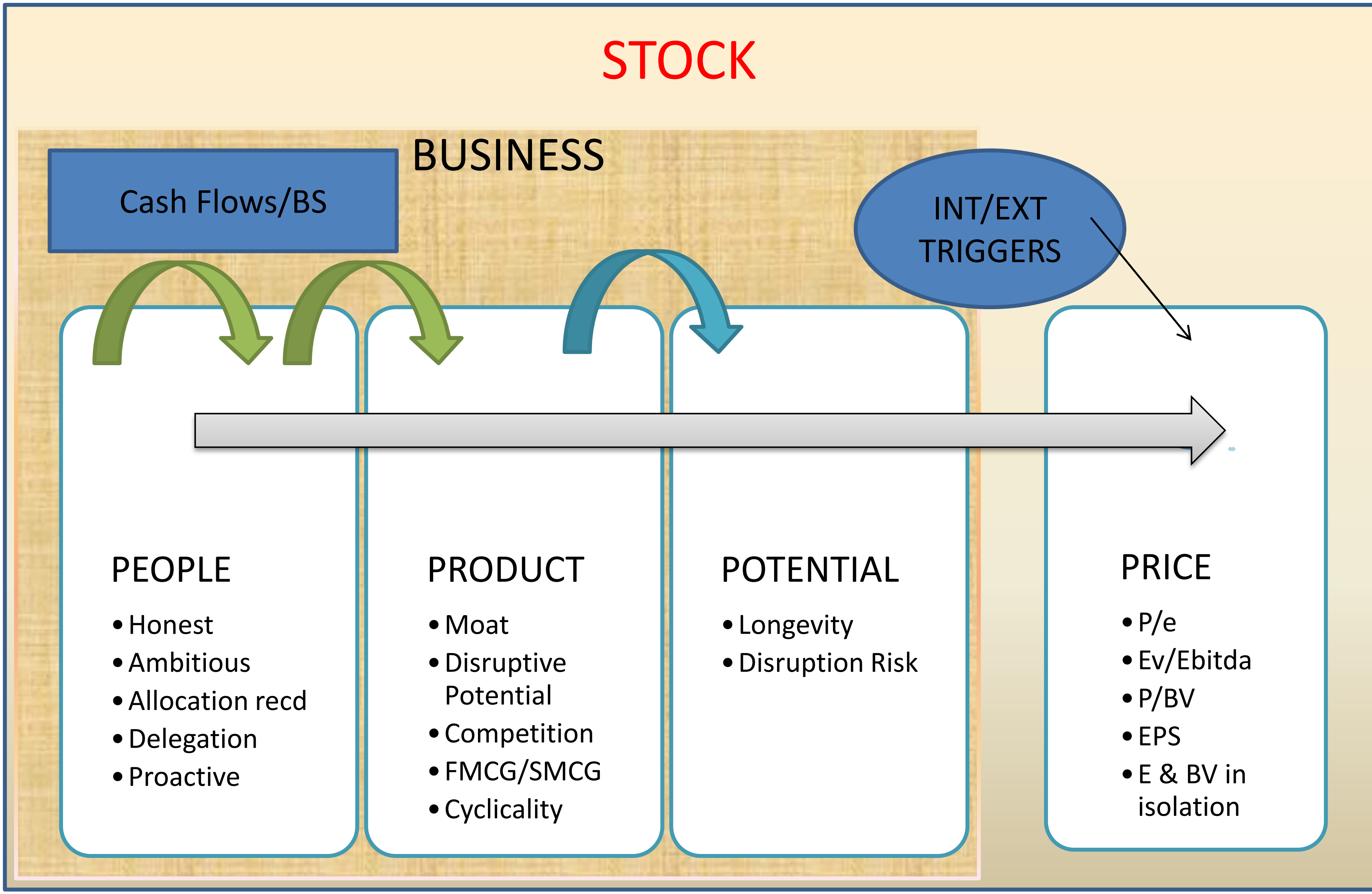
Unless the above three investing disciplines are in harmony, it's difficult to succeed!

Selection/Rejection

To generate ideas, need to read a lot. Industry reports, Annual reports, Transcripts, tracking evolving themes.

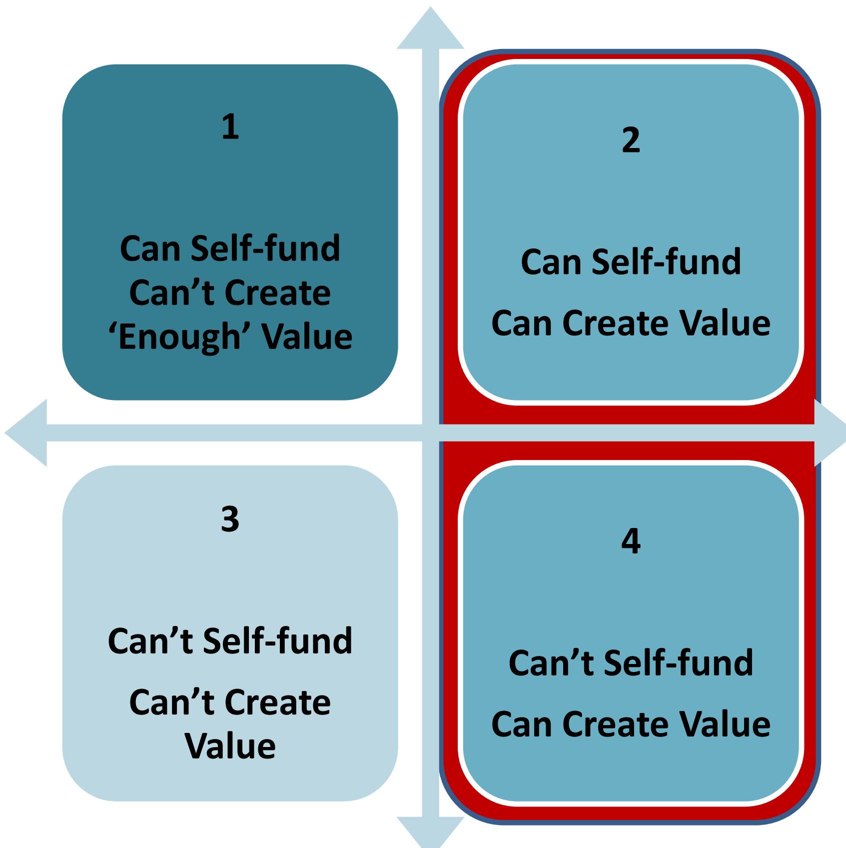
We need just one strong rejection criterion to discard a stock idea. On other hand, we need to see if all selection criteria are met before we can buy a stock. Elimination is much easier than selection. This is what I tend to focus on.

P + P + P + P -> Stock


STOCK
BUSINESS
Cash Flows/BS
INT/EXT TRIGGERS
PEOPLE
• Honest
• Ambitious
• Allocation recd
• Delegation
• Proactive
PRODUCT
• Moat
• Disruptive Potential
• Competition
• FMCG/SMCG
• Cyclicality
POTENTIAL
• Longevity
• Disruption Risk
PRICE
• P/e
• Ev/Ebitda
• P/BV
• EPS
• E & BV in isolation

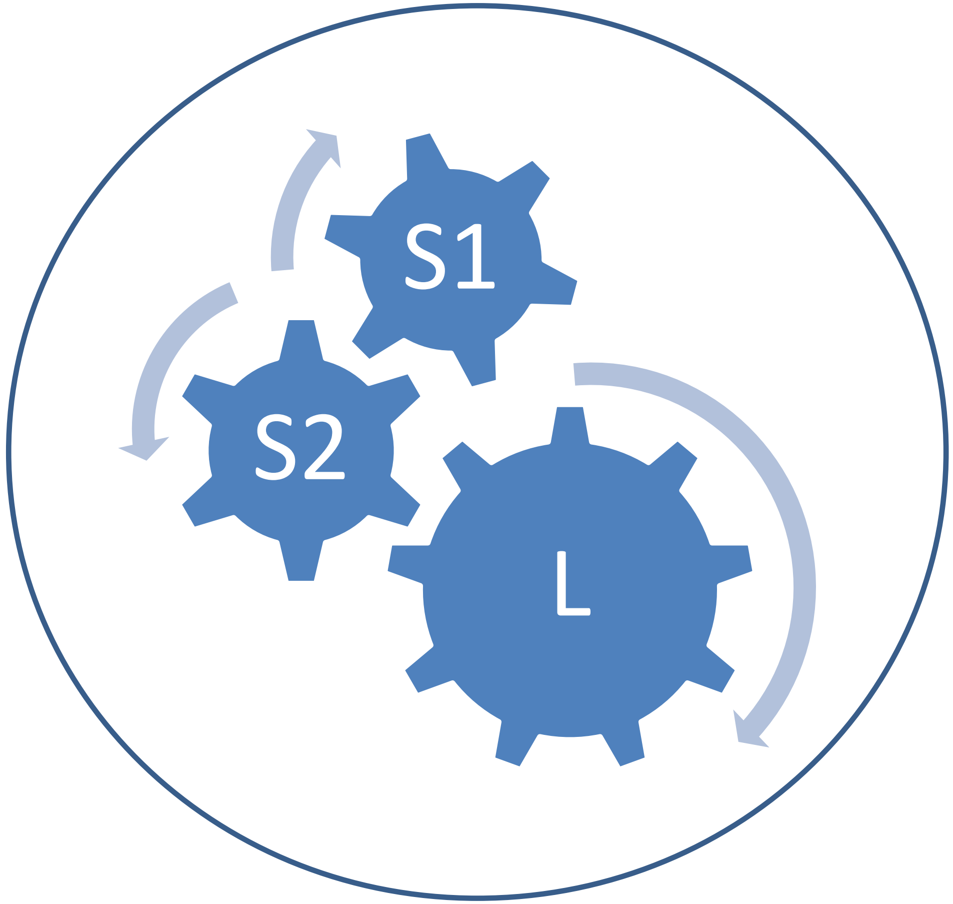
Earnings Power Box

Unless a business delivers returns better than its cost of capital, it’s a losing bet!



Self-reinforcing business models

I try to visualize a business as a system of pulleys, identify all its moving parts, their direction, speeds, etc. **Always in look out for some exceptional businesses having self-enforcing business models and ever increasing moat. Such businesses usually keep running on their own for very long times.**



Earnings Power Box

Mediocre Economics
Huge Competition
Low margins
Low/ Medium Capex intensive
Red-Queen Effect
Not much inherent strength
Mostly dependent on ext. factors
High WC req.

1

Can Self-fund
Can't Create
'Enough' Value

2

Can Self-fund
Can Create Value

Good Business Economics
Not Capex Intensive
Low/Medium Opex
Less Competition
Consistent Med/High margins
Brand play
Great inherent strength
Not much dependent on ext. factors
Low WC req.

Bad business economics
Huge Competition
Low margins
Capex and Opex intensive
Red-Queen Effect
No inherent strength
Solely dependent on ext. factors
Constantly Raise Debt/Equity
High WC req.

3

Can't Self-fund
Can't Create
Value

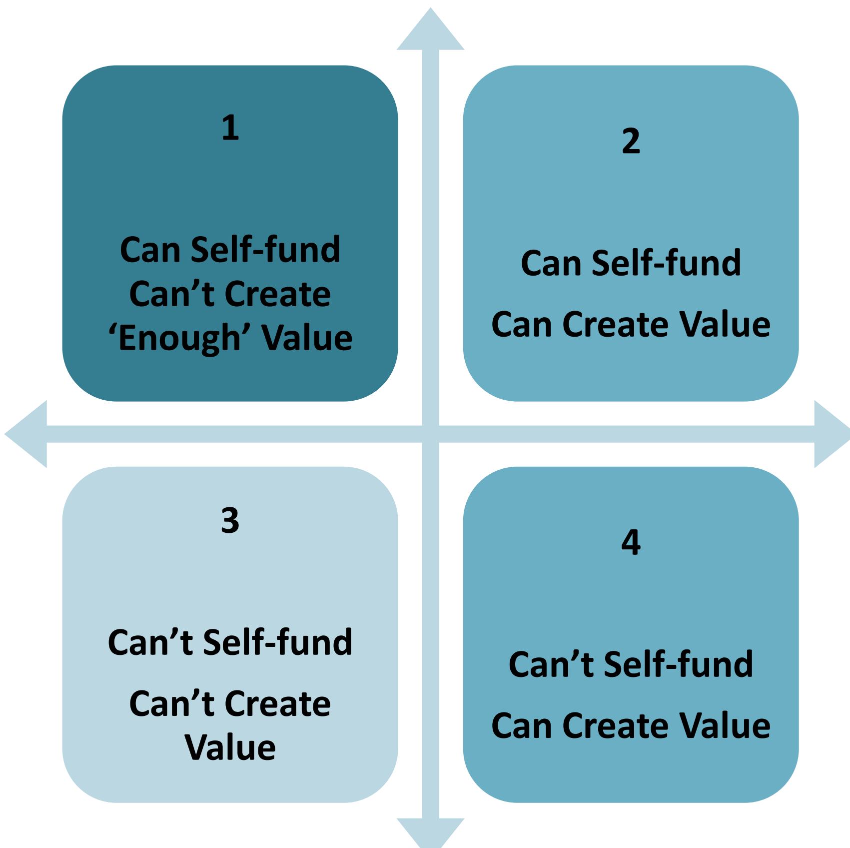
4

Can't Self-fund
Can Create Value

Good Business Economics
Less Competition
Consistent high margins
Capex intensive
Medium Opex intensive
Moat/ Good inherent strength
Not much dependent on ext. factors
High WC req.

Earnings Power Box

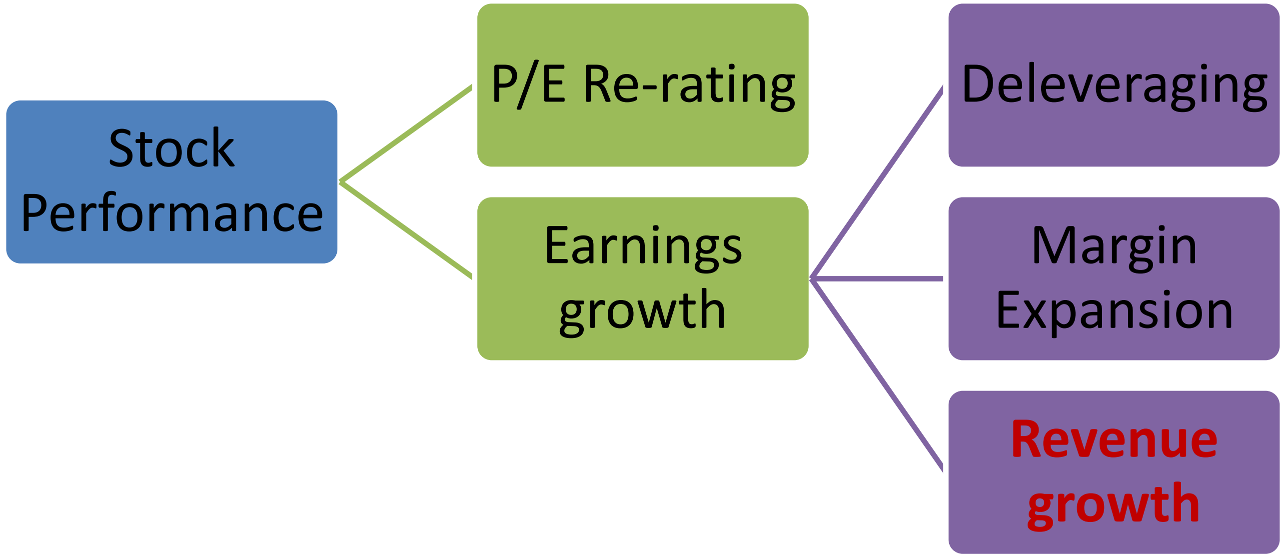
Few businesses manage this transition over time through margins improvements. Can be attained by efficiency improvements, vertical integration, economics of scale and deleveraging.



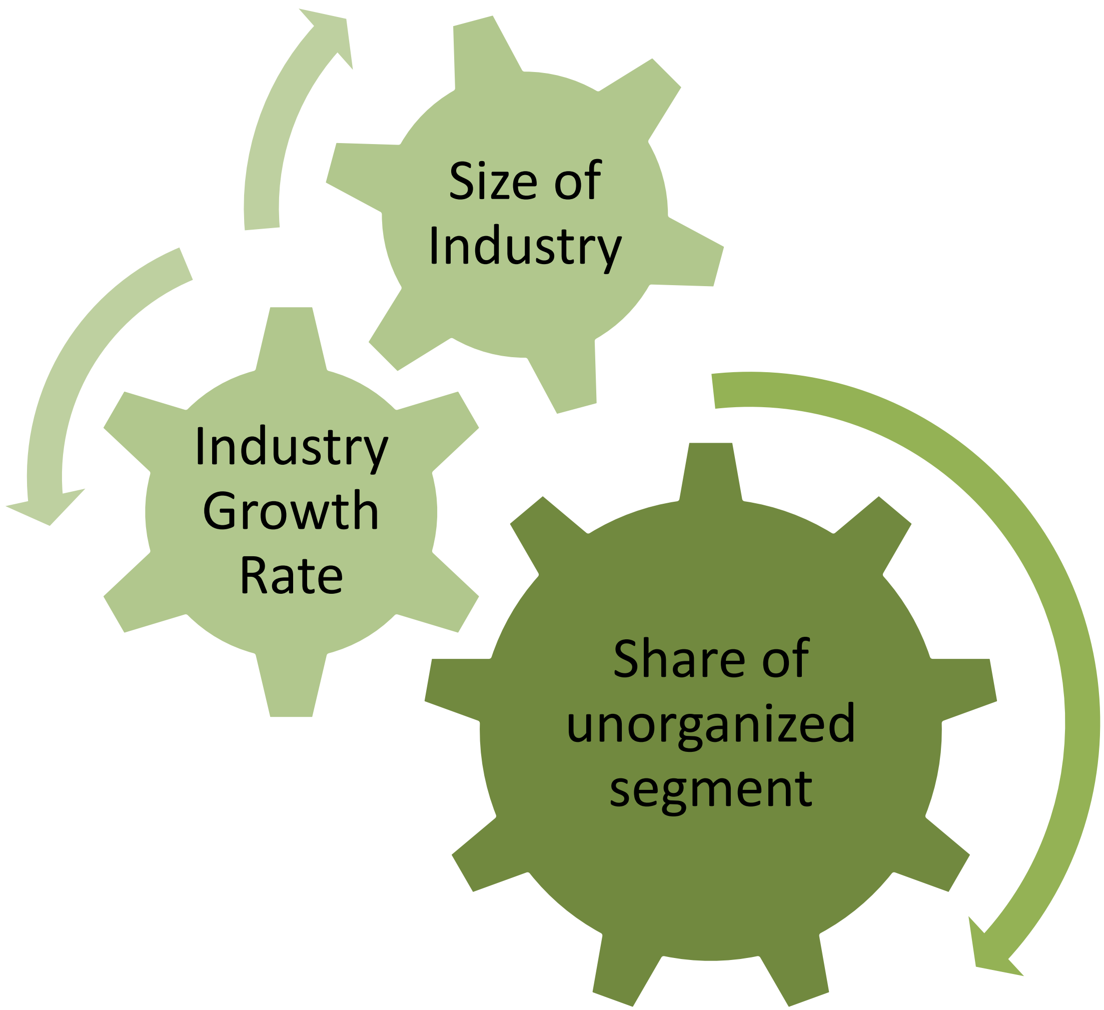
Few businesses manage this transition over time through generating better cash flows. This can be attained through better tab on WC req. and gradual capex.

How does a stock perform?

- P/e Re-rating & Earnings growth.
- P/e rerating can happen once when the stock gets discovered. But eventually p/e will return to mean (exit p/e). So we need to focus on earnings growth, which can be attained by deleveraging, margin expansion through operating leverage or efficiency, and revenue growth.
- Revenue growth is the only sustainable way as other two cannot be improved on sustainably year after year.



Identifying potential opportunities Top-down



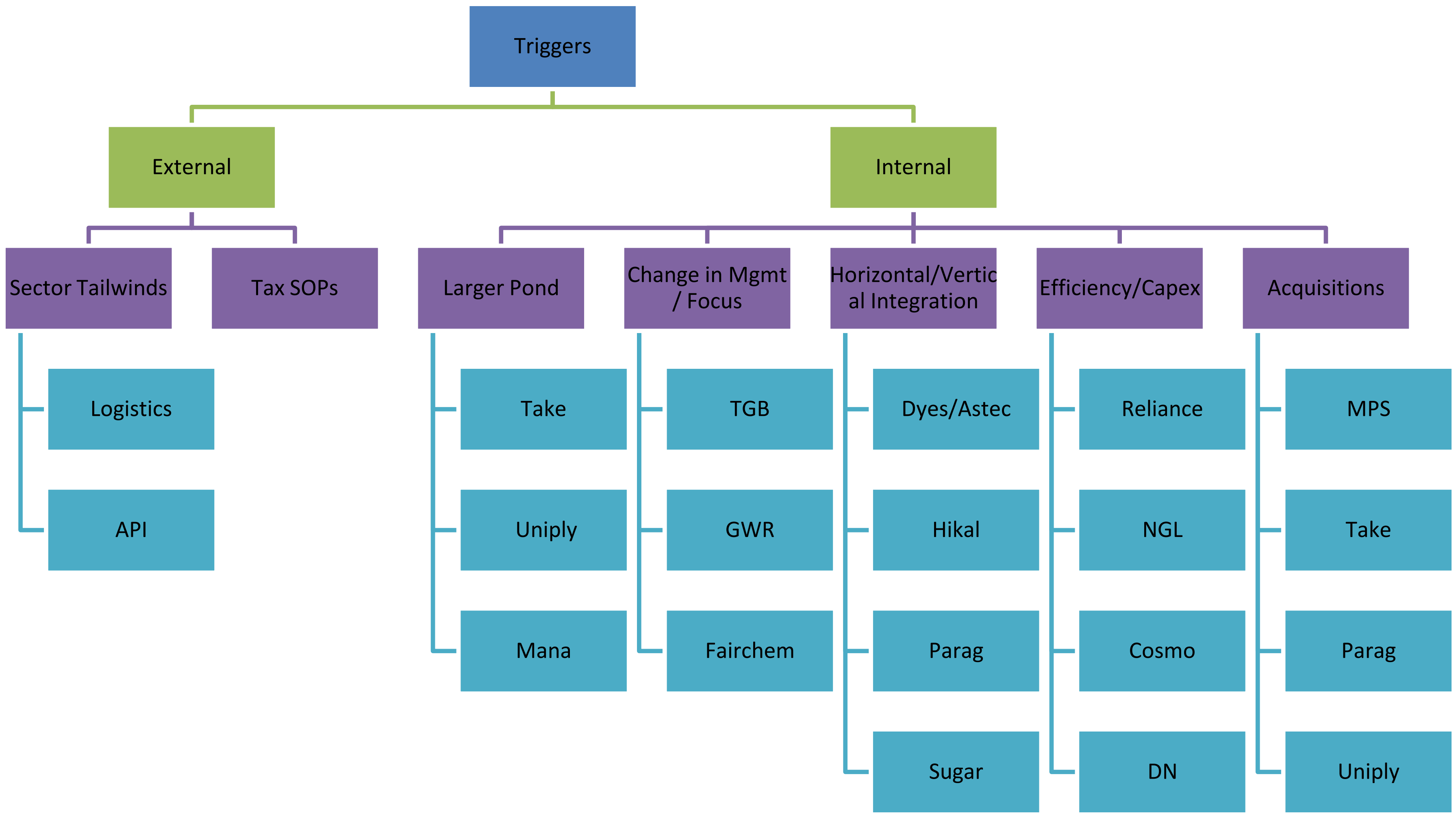
Size of underlying industry big enough?

Average industry growth rate > 7-8%?

Unorganized share in the industry >50%?

Internal/External Triggers?

Some triggers are temporary, others are more or less structural. Usually we see Bottom- formation / Break-outs patterns on technical charts around these key events, if the market acknowledges the positives.



P in p/e is sentiment and liquidity

Take for example, re-rating of Balaji Amines. This has been the case with almost all micro-caps/small-caps. Some of this was due to severe undervaluation, but a lot of it also has to do with small-cap cycle and liquidity?

'P' varies as per market conditions. Can we be completely market agnostic?
Valuations will go down the hill for most of the companies, though for some with consistent earnings growth may sustain.

Mar '14
- Mktcap~110cr, PAT~33cr, Rev~610cr, CFO~110cr
- Was available at 1.2x CFO, 3.5x p/e, 0.2x Rev.

Feb '18
- Mktcap ~2200cr, PAT~97cr, Rev~810cr.

Rerating
- So, during this period Mkt cap increased ~20x while rev increased ~1.3x and PAT increased ~3x!

I look forward to!

Reading more on behavioral aspect this year. Prepare myself for that bear market, whenever it comes.

Improving my work ethic and employing my limited time in doing research more judiciously.

Learning more about many industries which I don’t know much about.

Get better at capital allocation. Reduce churn!

Learning meditation and yoga.

Starting a food truck business.

Spending more time at my organic farm.