MASTERCLASS WITH SUPER-INVESTORS

INSIGHTS FROM INDIA'S LEADING INVESTORS

VISHAL MITTAL
SAURABH BASRAR

www.altaisadvisors.com

Stocks discussed are for illustration and academic purpose only.

Please do not construe them as recommendations.

Please check with your own financial advisor, before initiating any action.

Views on individual stocks or sectors could have changed or can change at any point of time.

All financial numbers are based on reported consolidated numbers, where available. Otherwise Standalone numbers are used.

RAMESH DAMANI

Let's talk about some of your successful investments.

In the 2008-09 period, we made two bets that are still working out.

We got very bullish on media stocks as they were great franchises but were still available cheap. We bought companies like TV Today, Sun TV, and Zee Entertainment. TV Today was the leader in Hindi news for the past 15 out of 15 years in India. When I bought it, the market cap was around Rs.350 crore. It has gone up 8x in nine years since then – 25%+ compounder. India is majorly a Hindi speaking country. You knew that there will be upticks in the advertising spend and it was just so cheap. They had proved their leadership for the past 15 years. The good thing with India is that everything can get bigger with time. By comparison, the viewership of Fox News in America is small – just a few millions and yet their revenue is USD 2 billion, with a bottom line of USD 1.2 billion. That's the power of brand that Fox News has. Indian markets have not yet evolved as much. At that market cap, it just seemed like a no brainer kind of investment. We also bought stocks of other media companies, but our big investment was in TV Today. We knew the issues and triggers. Cable operators were not giving fair share of money. So with pay per channel, after digitization, they will get the money. Some triggers played out and some are yet to play out. Broadcasting is a great business – news happens every day in this country. They don't need much to cover the news – just camera and crew. Once it reaches scale, money starts flowing to the bottom-line. Plus it's not like content, which can slip away. People are addicted to some brand of news. Now the things have turned around – we bought the company for Rs.300 market cap and they are making profit of Rs.150 crore a year now.

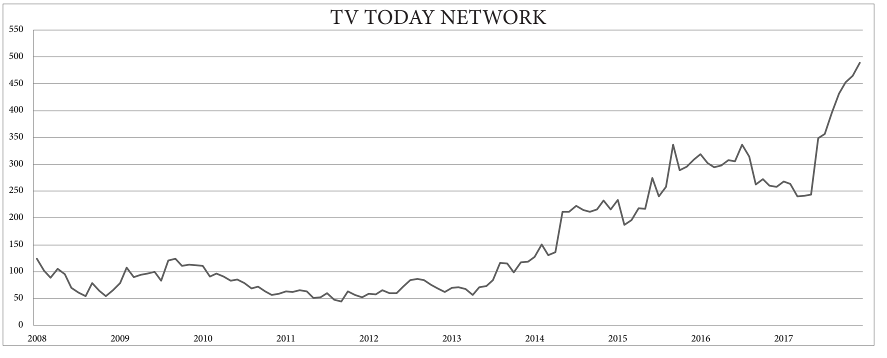
So we bought it at such a cheap rate that even if they miss a quarter or two, it does not matter.

Today, the big question is whether there is an existential threat to these companies from social media, as people don't watch live programming now.

The business strength is not as much as it used to be in the 1990s. But I think they will figure out how to monetize social media, how to monetize news on the internet, because content is still driving this business.

All Numbers in INR Crores

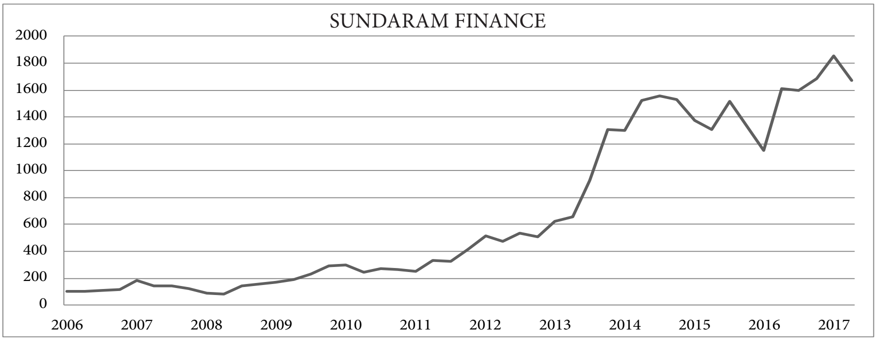
TV TODAY	Mar/2009	Mar/2010	Mar/2011	Mar/2012	Mar/2013	Mar/2014	Mar/2015	Mar/2016	Mar/2017	Mar/2018
Net Sales	250	285	293	308	313	389	477	582	652	721
Growth %		*14%*	*3%*	*5%*	*1%*	*25%*	*22%*	*22%*	*12%*	*11%*
PAT	34	31	12	11	12	61	81	63	102	119
PAT %	*13%*	*11%*	*4%*	*3%*	*4%*	*16%*	*17%*	*11%*	*16%*	*16%*
Growth %		*-8%*	*-60%*	*-15%*	*16%*	*402%*	*32%*	*-22%*	*61%*	*16%*
RoE	11	10	4	3	4	17	20	13	19	19
Debt/ Equity	-	0.2	0.1	0.2	0.2	-	-	0.1	0.1	-
Dividend Payout	13	14	36	42	37	10	11	17	11	11
Market Cap	382	645	350	307	372	703	1290	1845	1539	2922
Growth %		*69%*	*-46%*	*-12%*	*21%*	*89%*	*84%*	*43%*	*-17%*	*90%*
P/E	11	21	28	29	30	11	16	29	15	25



At the same time, we found opportunities in the logistics space. The first reason was the huge e-commerce boom that we saw coming, with smartphone penetration and better internet speed. The second reason was an uptick in the economic and infrastructure activities like the Delhi-Mumbai corridor, etc. So we bet on logistic stocks. Both these investments are still work in progress.

The purpose again is to illustrate that it's a bottom up process, but you think top down as well. I take the following approach. I start with the market cap or EV (Enterprise Value) of the company. Then I see, if as a businessman, I am willing to buy the whole business at that market cap or EV. If I can get TV Today at Rs.300 crore, will I buy? Yes, I will buy. Even if you wake me up at 2 a.m. in the morning, I will give you the same answer. Hindustan Unilever (HUL) is spending a few thousand crore on advertisements, while you were getting the entire news brand at a Rs.300 crore valuation. HUL could buy the leader in Hindi news out of their advertising budget and label it 'Hindustan Unilever AajTak' – it was that cheap. The same logic was for the logistics companies. They were so cheap. We felt that e-commerce will give them a one-time opportunity to boost their business. So in 2009-10, as the bear market was getting over, we bought these companies.

Then there are some companies that I have been able to hold over the years without selling or buying them because the business opportunity is too great. For example, Sundaram Finance. I must have bought this company in 2001 – from the proceeds of Infosys. We have held it for 16 years now – whether it's bear market or bull market. The opportunity in the financial space is so great, and here you have a business that is as good as gold. The brand name in the south is so strong. Even though the stock has fallen 50-60% from the top at times, I never have been tempted to sell it. I knew that it was just a market overreaction. During the 2008-09 financial crisis, the stock went from Rs.700 to Rs.250. Normally I tend to get out of stocks when the bull market is over. But there are some stocks like ITC, Sundaram Finance, which I have been able to hold.



What were your key learnings from the big misses or losses?

A key learning is - as Benjamin Graham quoted Horace – 'Many shall be restored that now are fallen and many shall fall that now are in honour'. Temperament wise, the key learning has been of doing your own homework and having the integrity of independent thought. Those are the two things that I would emphasize. No one rings a bell when a great investment idea comes. In fact if everyone disparages it, probably you are on to a good investment idea! If everyone applauds you for your pick – it's probably not a great idea. There has to be scepticism in what you are buying. Finding picks is a lonely road – that integrity of independent thought that you need is very lonely. When RK Damani was buying HDFC Bank, it was at 100 P/E. There were so many other good banks but he had the vision to see 10 years out into what the bank could be. The point is, to be great in the stock market – and you want to be 'great' - you need to find your own path. You can't piggyback on someone else's thoughts and conviction. Do I regret that I did not buy HDFC Bank? Yes, I do regret it but it was his pick. The point is, if I had my own independence of thought, my own integrity of opinion, and had done my own hard work, I could have found it. I found lots and lots of 100 baggers in my career – sounds really stupid to say it, but I have been blessed. So it's not that I lacked the opportunity - I had enough on my plate. If you get 8 hundred baggers in your life, you don't need more in your life. You are actually set in life with only two hundred baggers. The question is how much money you put in. That has been the lacuna in my career - not putting in large sums of money when I could have.

The way you do it is – you keep a circle of competence and do your homework, don't get complacent and lazy, which we tend to be after sometime. If you are generally a smart person, then there will be tons and tons of opportunity. Here is the thing that RK Damani told me. I used to ask him in the 1990s, after he had made tons of money and I hadn't. I said "you people are lucky that you bought Indian stocks in the 1980s. *Aap logon ka paisa ban gaya. Mein abhi aaya hoon. Mera Nahi Banega*" ("You people have made money. I have just come. I won't make money.") He said, "Ramesh, I am telling you this today. The opportunity in the next 20 years will be far greater than those in the past 20 years. Trust me on that." He has been proven absolutely correct. Recently, in December 2016, there was a conference in Kolkata. Someone asked him the same question and he answered the same – "The best time to invest in India is today. The opportunity of the last 30 years will be dwarfed by the opportunity of the next 30 years." I also truly believe that.

See, you have to have some set of belief constructs. He was bullish on India 20 years ago, he is bullish on India today, and he will be bullish on India 10 years from now. You can't be ambivalent and run at the first sign of trouble, like rats run from a sinking ship. You have to come up with a statement like 'I think that India will be among the top 5 nations in the world'. If you don't believe it will be India, but it's going to be Cambodia, then go to Cambodia. It is a matter of your own belief process. It took me years to get that into my head even though he had told me. Not till I had imbibed it could I act on it accordingly. But remember that there will be setbacks. I have always believed that to be a great investor, which is what we all try to do, you need independence of thought and a firm belief set. There is no point in regretting – there are so many stocks that I have missed. How can you be so stupid, I ask myself! Despite that, it doesn't matter if you can double your money every three years – then it's pretty cool.

The second thing is that the general public doesn't have that basic belief in equities. It's a very charmed circle that believes in equities. I know so many people who make Rs.5 crore in equities and then buy a house or jewellery to make it safe. If they don't believe that they can make Rs.50 crore from that Rs.5 crore, then how will they do it?

RAJASHEKAR IYER

How do you generate investing ideas?

I used to look at lots of companies. The initial names are generated either from screens, by someone else telling us that a company is interesting, through news reports/ advertisement that triggers interest, and multiple other sources. After quickly scanning relevant information like annual reports, management interviews, presentations etc; I would have a mental picture of the business and company, and decide whether it was worth spending more time on. Probably the most important aspect in finding good ideas is to eliminate bad ideas fairly quickly. If you are able to look at 100 companies faster than others, you can find the two good companies which are really interesting. If you are slow in rejecting, you will only be able to look at 10 companies. It's like reading. If you read 20 books in a month, you may find two good books. If you just read two books in a month, you may find only two good books a year. It is similar in stocks. So if you tell me that you like a particular stock – how much time do I have to spend on the company before I can say it's not for me? If I can do that fairly fast, then I can look at more ideas in the time available.

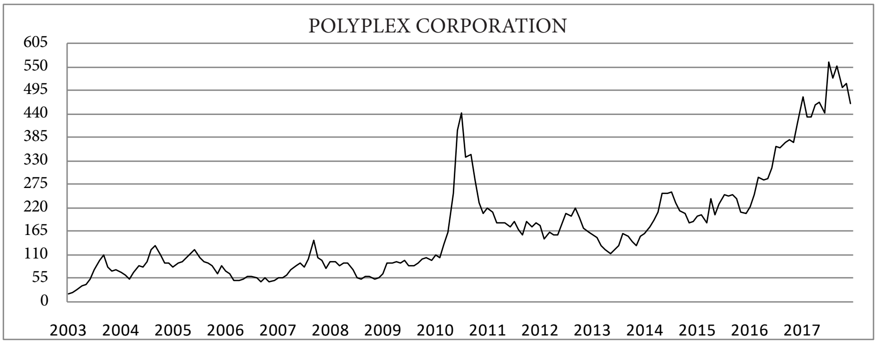
That's the first most important thing – you should look at a lot of companies, and we are lucky in India that there are literally hundreds of stocks to choose from. That is not true for many other stock markets in the world.

One should have acceptance and rejection criteria for investing, but to start looking at a stock, you don't need hard and fast rules. For example, in 2002, someone asked me to look at Garware Polyester and tell him if it was interesting. When I looked at it, they were making EBITDA of Rs.90 crore, and had a market cap of Rs.200 crore. That looked interesting. But their borrowings and interest cost were really high, and while the polyester films business was doing well, there were other businesses in the company that were problematic. But the interesting thing was that the polyester film business was doing well. So I looked at the other companies making polyester film. Of the others, Polyplex Corporation was outstanding. Polyplex had started at a 1,500 tons capacity, and went to 18,000 tons capacity without diluting equity! That's a quick filter - companies which have grown well over a 10-year period without diluting equity and without getting seriously in debt are always interesting. With the tailwinds of a good polyester film market, the company and the stock did really well.

All Numbers in INR Crores

POLYPLEX CORP	Mar/1997	Mar/2002	Mar/2007	Mar/2012	Mar/2017
Net Sales	108	126	768	2,426	3,208
5 year CAGR %		*3%*	*44%*	*26%*	*6%*
PAT	9	-1	45	208	351
PAT %	*9%*	*-1%*	*6%*	*9%*	*11%*
5 year CAGR %		*NA*	*NA*	*36%*	*11%*
RoE	11	-1	12	12	15
Debt/ Equity	1.0	0.5	0.8	0.4	0.3
Dividend Payout	16	-	18	14	10
Market Cap	23	25	151	591	1,340
5 year CAGR %		*2%*	*43%*	*31%*	*18%*
P/E	2	NA	3	3	4
Gross Block	145	184	827	2,173	3,818
5 year CAGR %		*5%*	*35%*	*21%*	*12%*
Equity Capital	15	15	15	32	32
5 year CAGR %		*0%*	*0%*	*0%*	*0%*

*Bonus shares in 2010



To find one good investment like that, there could be twenty other companies that you see and reject. There might even be some good companies that you end up rejecting, but it doesn't matter. The ones you find and invest in are what matters.

How do you value a company?

There are only three variables to determine the value of a business – how much they grow their sales, how much profits they can make, and what kind of capital they need to generate that sales. Of course, the additional variable is how they treat the minority shareholders.

Let me take an example. Somebody recently asked me about Avenue Supermart (D'mart). I said it was a valuation challenge. Amazon was a valuation challenge earlier, as it had strong growth but was not generating cash. But the difference with D'mart is that it is generating cash. Last quarter, they had sales of Rs.4000 crore, so let's say the annual sales are Rs.16000 crore. Their net margins is about 6-7%, so they can make profit of Rs.1000 crore. To generate Rs.16000 crore of sales, they only require Rs.2000 crore of capital. Let's assume that they can grow at 25% for the next 10 years and maintain these margins and capital turnover. So the sales will reach Rs.160,000 crore and they will generate Rs.10,000 crore cash in 10 years. They will also have some cash on the books, as they will not invest all the cash flows. A company like this, which generates Rs.10,000 crore of cash, can easily be valued at Rs.250,000, plus they will have cash. The current market is Rs.80,000 crore. So it can be 3-4x in 10 years – which is better than keeping money in the bank – but I think there could be better opportunities over time. But you have to keep thinking and valuing businesses. If you think 10 times, you will know what to do when opportunities come.

So if you break up the value of the business – the first is how much sustainable money they are making. Like D'mart is making Rs.1000 crore profit now, and you think that is sustainable. Now if you put money in a bank today – you get 6% interest rate, so the value of that Rs.1000 crore is at least 16x (~100/6%), so Rs.16,000 crore. The second is, what is the minimum growth that you can project over the next many years? I take that at a nominal GDP growth of 12-15%. That will give another Rs.15,000-20,000 crore of value. So you can attribute Rs.30,000-35,000 of value to these. Then there will be other opportunities that the company can exploit – that the market is valuing at Rs.45,000 crore today. The composition of these three changes over time. At some time, the first component accounts for 70% of the market cap and the second component accounts for 35% of the market cap of the company. Which means the third component is negative 5%, which the market is not willing to value. In bear markets, the market cap might even be lower than the first component of the value, and you find that the second component definitely has some value. So one can wait for situations where working backwards one has to make less assumptions on the second and third components. If one has to make detailed calculations to justify valuations, then it's probably not worth it.

I don't use DCF directly, as it creates more problems than it solves. Professor Bruce Greenwald said it well in a speech – "DCF is putting actual data and projections together, which is like putting clean and dirty water together, you will only get dirty water as a result." So I try to value based more on clean data, and look for situations where I don't have to pay a lot for the projections. I am more comfortable when the first component is large and the rest are small components of the market cap.

When I missed Infosys in its early days, I did not think among these lines. It was already making money, and since it was already growing at 70% a year, the first and second bucket accounted for most of the value. Investing in it should not have been an issue. Even if the growth fell from 70% to 30%, it would not have been an issue at the initial level of valuations, as the first component accounted for 70% of the value. The balance 30% would have been at risk, which would have got covered in one year, at 30% growth also. But I did not have that clarity at that time.

Today, when I look at expensive stocks, I try to see how many years ahead I have to project to see sustainable minimum earnings. If I have to project beyond three years, then I am not comfortable investing in that stock. We all can do these back-of-the-envelope calculations to see that we don't go majorly wrong on a stock.

HIREN VED

You have been investing for the last 25 years. What has worked in different markets?

The best time to buy is when the macro is bad. That's when you get the cheapest valuations. Growth and quality has always worked in India. Also in times like these, when the growth is not broad based, quality outperforms. When growth becomes broad based, value will start outperforming. Now that the markets are getting more institutionalized, if you think there is a thematic or sectoral play, you should just buy the best and the largest company. You will make the fastest money on a risk-adjusted basis. That will hold true unless you have a small/ mid-cap company, where the growth is really disproportionate as compared to the industry, or it is highly undervalued.

When markets become expensive, going down the market cap or quality curve has generally been a mistake. However, it could also be about how you allocate capital. We would have higher allocation to the market leader. Then we could have a flanking strategy where we buy a basket of these second tier companies that are like a leveraged play on the main theme. But we won't sell the leader and buy the second tier. You can invest 60-70% in the leader and the rest in the second tier stocks. But you can do this in homogenous industries like sugar or steel, not in specialist sectors like pharmaceuticals. In 2002-07, we bought many EPC companies like Gammon/ IVRCL/ Jyoti, etc. and didn't buy L&T! We were lucky that we sold most of these in time. But in hindsight, after a detailed analysis, we realized that we should have done the flanking strategy where we bought the best quality leader as the main engine and then balance allocation to the smaller companies.

When managing external money, I have realized one thing - keep the beta of the portfolio low and you will be happy. People fear the downside more than they applaud the upside. So if you can protect the client's downside, it has a wonderful impact on your business.

What are your learnings from the market cycles in India?

Every few years, or once in a decade, we get into a macro crisis in India. When you try to solve the macro crisis, the micro gets impacted. I came to the stock market in 1991. We had a foreign exchange crisis. Then PM, Narasimha Rao and FM, Dr. Manmohan Singh, started the reform process. After the first phase of reforms, everyone got euphoric. Harshad Mehta took advantage of the market, but the numbers didn't follow, so the whole house of cards came falling down. If you look at the numbers between 1991-93, the earnings growth was flat to negative. The markets took off in September 1993, and earnings started to spike from September 1994, so the markets pre-empted the earning recovery. Now, let's come to the current period. 2013 was the low point. Then FM, P. Chidambaram and RBI Governor, Raghuram Rajan, did a few things to start correcting the macros. Then PM Modi came, and the markets started rallying on the expectations that everything will be good. But when you are pulling back to improve the macros, it takes a few years to get it correct. The scale is also much bigger now. The earnings growth has been low till now but the markets are probably pre-empting a recovery, a year down the line.

People talk about P/Es, but you have to understand where you are in the profit cycle. Risks to the markets are the highest after you have gone through an earnings up-cycle, because people tend to project the growth into the future. In the period of 2004-07, the earnings grew at a tearing pace – around 28% CAGR. On top of that, a higher P/E was assigned. So people were giving a higher P/E on a rising curve, and then if something happens to the earnings – it is a disaster. Right now, earnings are at a trough and the markets have gone up. There is risk of a pullback. But overall, expensive valuations have no meaning because there is no earnings growth on an aggregate basis. There are always a few sectors that do well. The aggregate earnings growth has a certain story to tell – whether the breadth of the economic recovery is big or not. The breadth is always narrow at the start and then it builds and broadens. When it broadens, you are in the mid-section of the bull market. I still think that we are yet to cross the first section of the earnings recovery – the P/E expansion has happened.

The interplay of EPS and P/E is beautiful. Most people tend to just look at the earnings. But P/E is the leading indicator and not the EPS, which is the lagging indicator. But P/E is a very ephemeral concept – it has to be seen in a context. P/E goes up because there is liquidity, or there is confidence about the future, or it is pre-empting an earnings recovery. Even during market downturns, like in 2008, the companies initially were not much affected in terms of earnings, but the P/E got compressed. Companies said that there is no problem here in India; the problem is in the US. The actual earnings fall happened in the last quarter of FY2009. But the markets bottomed out much before the earnings fell. So I think where people get blindsided is that they look at earnings and earnings have no meaning at turning points – either from top to down or the other way round. Earnings have a meaning in the middle part of the cycle, when the trend has already established itself. Then you can look at the trajectory and project forward. One of the advantages of being around for 25 years in the market is that you can step back and look at the whole picture. In the initial stages of investing, you are every bit part of the picture – there is no historical context on how to see the environment.

To that extent, the US is a great market, because there is so much data and history. For example, I never thought about when value outperforms and when growth outperforms. Classical wisdom says that you have a certain style – stick to it and it will work out over cycles. With the benefit of hindsight, I would say my philosophy is not rigid and we have to be adaptive. Today, when the growth is not broad based, quality will get disproportionate value, so I should keep that in mind when taking a decision about the time to sell quality stocks. I should not be extremely hasty in selling quality stocks that have become expensive. All the liquidity will chase the same high quality companies. The context is different now as the quantum of liquidity is much higher now. The earlier norm was 25 P/E, but the new norm could be 45-50 P/E. I am not justifying it. I am just saying that you have to keep the context of the macro in mind– what I call 'contextual investing'. So you keep your style of investing intact, but are aware of the context in which you are investing. There is a layer of global macros, your country macros, and where you are in the market cycle. If you can broadly get that, you can invest accordingly.