MOTILAL OSWAL
Asset Management

VALUE INVESTING FORUM

Nilesh Shah

Sanjoy Bhattacharyya

Speaker Presentations & Panel Discussion

Ramesh Damani

Raamdeo Agrawal

What's Inside

Mr Nilesh Shah
Founder, Managing Director & CEO
Envision Capital

Mr Nilesh Shah is the Founder, Managing Director & CEO of Envision Capital. He has a 17 year career in corporate finance & asset management. Prior to founding Envision Capital, he was with the Kotak Mahindra group. He is widely regarded as amongst India's most prominent stock pickers and is among the most respected faces in India's electronic media. He has been featured in 'The Wizards of Dalal Street' by CNBC India and as 'The Big Fish' by NDTV India. A CFA from ICFAI and a post graduate in management from IRMA, he was recently awarded 'The Achiever Award' by Jaycees.

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4-pronged Value Investment framework

1. Be clear what opportunity the company represents
2. Look for operating history over extended time-frame
3. Look for RICE - Revenue growth, low capital Intensity, Cash flow generation and Earnings growth
4. Evaluate the management on VICE - Vision, Integrity, Competence, Energy

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Value Investing Framework

Evolution as a Value Investor

At the outset, **Nilesh Shah** outlined his evolution as a value investor -

- Early 1990s - Mainly invested in IPOs
- Mid-1990s - Inspired by Buffettology (invested in Britannia)
- Late 1990s - Consumer stocks were expensive; IT was booming and offered value
- 2002-03 - Identified deep value stocks like Shipping Corporation, ONGC and Jammu & Kashmir Bank
- Post 2003 - Saw value in emerging opportunities such as Financial Technologies, Matrix Labs and Pantaloon)
- 2008 - Steady growth stocks like Bharat Electronics and Pidilite offered value.

What is value and Value Investing?

Contrary to popular perception, book value "is meaningless as an indicator of intrinsic value", says Buffett in his Berkshire Hathaway Annual Report 2009. He further goes on to say "Intrinsic value can be defined simply as the discounted value of the cash that can be taken out of a business during its remaining life."

Going by this definition of value, Value Investing is all about estimating what a security is worth, buying into it and holding till the value is realized.

Value Investing framework

Nilesh offered a 4-pronged Value Investment framework to evaluate a company -

1. Be clear what opportunity the company represents e.g. (a) steady growth, (b) early stage thematic opportunity (could imply period equity dilutions), (c) turnaround, whether cyclical or structural, etc.
2. Look for operating history over extended time-frame - revenue and PAT CAGR, equity dilution history, does the business have defensive characteristics.
3. Look into the future; assess whether the business has RICE - Revenue growth, low capital Intensity, Cash flow generation and Earnings growth.
4. Evaluate the management on VICE - Vision, Integrity, Competence, Energy.

Case study of above framework - Amara Raja Batteries

- In operation for the last 25 years in automotive and industrial batteries
- Strong brand "Amaron"; second largest player with 25% market share
- Strong technology partner, Johnson Controls, which also has a 26% equity stake and takes no royalty payment
- Last 10-year track record - revenue CAGR 32%, PAT CAGR 25%, no equity dilution, positive free cash flow and RoE of over 30%
- Market cap of Rs14.5b for a FY10E PAT of Rs1.5b i.e. P/E of less than 10x.

In sum, value unfolds when the investor ...

- Has an open mind to all opportunities
- Does the homework well and doesn't overpay, and finally,
- Has full conviction and high patience.

Mr Sanjoy Bhattacharyya
Founder, Managing Director & CEO
Fortuna Capital

Mr Sanjoy Bhattacharyya is a Founder Partner of Fortuna Capital that manages the hedge fund - 'Aristos' based out of Mauritius. Prior to this, he was the Head of Indian Public Equity Investing at New Vernon Capital LLC. His earlier stints include key positions such as Chief Investment Officer of HDFC Asset Management Company, Head of Equity Research at UBS Warburg, and seven years as a Credit Analyst for ICRA and CRISIL. He received his BSc Statistics (Honors) from Loyola College, Madras University and his MBA from IIM (Ahmedabad).

"**The value mind-set**
1. Commit to a sound investment philosophy
2. Find a robust search strategy,
3. Value a business objectively
4. Have the discipline to say no,
5. Be patient, and
6. Be willing to make a significant bet at the point of maximum pessimism."

The Value Mind-set

Sanjoy Bhattacharyya focused significantly on the academic backdrop and first principles of Value Investing, beginning with the very definition of "Investing" itself.

What is investing?

Investing is "an operation which, upon thorough analysis, promises safety of principal and a satisfactory return" - Benjamin Graham. Thus, the three elements of investing - (1) thorough analysis, (2) safety of capital, and (3) satisfactory or reasonable return. Any buying of stocks which does not fulfill these criteria is "speculation" and not "investing".

Clearing cobwebs of the mind

A value investor needs to unlearn several popular misconceptions e.g. -

- Modern portfolio theory, which says higher the risk, higher the return. Value Investing says just the opposite: lower the risk, higher the margin of safety, higher the return.
- Efficient market hypothesis - Though all information is available, it is human beings who process the information. And since human beings are not always rational (e.g. driven by emotions such as greed and fear), stock prices cannot always be rational.

The value mind-set

(1) Commit to a sound investment philosophy, (2) Find a robust search strategy, (3) Value a business objectively, (4) Have the discipline to say no, (5) Be patient, and (6) Be willing to make a significant bet at the point of maximum pessimism.

Other golden rules for the Value Investor

- Pretend the stock market does not exist i.e. invest for the long term
- Look for companies with predictable revenues, a dominant competitive position, low costs, a strong franchise, pricing power and honest management.
- The three most important words in investing: Margin of safety. The purchase price you pay determines the margin of safety and the value you get.
- Focus on common sense and one's circle of competence in understanding businesses.
- Never get married to a stock.
- Patience is a great virtue. Sanjoy puts it as "Get it right and sit tight." Patience leads to fewer trading errors, lower transaction costs and lower taxes, all of which improve the return percentage points.
- Pessimism is a friend of the rational investor, as lower prices reduce risk, leading to higher probability of future gain. In contrast, euphoria and optimism lead to expensive valuations. The most valuable businesses often offer absolutely no margin of safety.
- The more you read, the better your strike rate is likely to be.

Putting it all together

- Invest only in a business that you understand.
- Declining equity prices are essential to find worthwhile opportunities.
- Always attach the highest priority to capital preservation.
- Be keen to hunt for bargains in neglected industries/companies.
- And even after all of this, pray for good luck!

Mr Ramesh S Damani
Member
Bombay Stock Exchange Limited

Mr Ramesh S Damani is a Member of the Bombay Stock Exchange Limited and is one of the well-known faces of the stock broking community in India. He has been a Broker for over 16 years. He has done his Bachelors Degree in Commerce from HR College in Mumbai and has a Masters Degree in Business Administration from California State University, Northridge. Today, he is a well known host of a TV Show on CNBC TV18 and is a frequent commentator on financial issues on CNBC and NDTV News. He also hosts a weekly chat show on Moneycontrol.com.

Key Lessons in Value Investing

Ramesh Damani spoke on four key principles of Value Investing -

- Stock up (i.e. place big bets) on great ideas
- Focus on or build your circle of competence
- Read, read, read
- Create long-term wealth.

Load up on great ideas

Ramesh said, "There are no mistakes in life, only lessons learnt." The most important lesson from his own experience is the need to dream big. In the normal course, the stock market does not give too many "extraordinary bargains". But when you hit upon them, the surest way to make money is to "back up the truck and load up".

Example 1: In the early part of the decade, Ramesh identified McDowell's (now United Spirits) and Bharat Electronics as great ideas. Their market cap then was about Rs2b and Rs1.6b, respectively. Currently, both are valued at about Rs170b each i.e. a combined market cap of Rs340b. Says Ramesh, "If I had stocked up 10% of just these two stocks - which I had the financial means then - today, I could have been part of the Forbes 400." Bharat Electronics was actually available then at Rs20 with a Rs2 dividend built in. Today, it actually pays dividend of Rs20 i.e. 100% return in dividend alone.

Example 2: On March 9, 2009, the global markets bottomed. If you were not aggressively buying 1/2 weeks before or after that date, perhaps "your education as a Value Investor is not complete."

Focus on your circle of competence

Investing is all about capitalizing on the price-value gap. Price is market cap i.e. what the market says a particular business is worth. Value is one's own understanding of how much the business is worth. So, how does one go about valuing businesses? Here's where focusing on - or building - one's own circle of competence helps. Consider a doctor. Instead of investing in steel or technology, if he focuses on the healthcare sector - important medicine companies, hospitals, gyms/fitness centers, etc - his understanding of the value of the business will be much higher. Likewise a banker can focus on financial stocks, an engineer on construction stocks, and so on. One may also have relatives or contacts in some businesses, which can be part of their circle of competence.

Read, read, read

Reading is a key to improve the odds of getting rich. But reading should not be with the expectation of a particular outcome, but as part of the process. The "read, read, read" process invariably throws up insights over a period of time, which can be converted into stock market gains.

Create long-term wealth

Stock markets exist for only one purpose - to create wealth over the long term. And there is only one way to do this. The Forbes 400 list of the most successful investors is unlikely to have arbitrageurs or momentum traders. They are all Value Investors.

Dream Big

The most important lesson from my own experience is the need to dream big.

In the normal course, the stock market does not give too many "extraordinary bargains".

But when you hit upon them, the surest way to make money is to "back up the truck and load up".

Mr Raamdeo Agrawal
Managing Director
Motilal Oswal Securities

Mr Raamdeo Agrawal is the Co-Promoter of Motilal Oswal Financial Services Limited. He is an Associate of the Institute of Chartered Accountants of India. An equity research stalwart, he is respected by all in the research and broking industry for his valuable insights. His firm belief in "Value Investing" forms the core of the Motilal Oswal group's investment philosophy. The investor community eagerly awaits his annual Wealth Creation studies, which he has been authoring for the last 14 years.

My Evolution as a Value Investor

10x in 10 years

Raamdeo Agrawal defines Value Investing is "buying companies at significant discount to my assessment of expected value over 3-5 years." Typically, he looks at returns of 25% per annum i.e. doubling in three years or 10x in 10 years.

Evolution as Value Investor

- No family background in stocks; got introduced to the concept of equity shares during graduation / CA.
- In 1980, bought the first two stocks - Cementation India (now Simplex) and Kohinoor Mills
- Between 1980 and 1985, read up balance sheets of about 300 companies; also, understood the concept of common sense investing from Peter Lynch's book, "One Up On Wall Street".
- 1992: The Harshad Mehta led stock market boom and crash taught how irrational the market can be in the short run.
- 1994: Got introduced to Warren Buffett through his letters, which permanently changed views on how to look at investing. Not focusing on EPS but on Return on Equity. Trimmed number of holdings from 225 to 25
- 1996: Started to write annual Wealth Creation Study. The process of each study was a great source of learning.
- 2002: Read Benjamin Graham's "The Intelligent Investor", and understood the concept of margin of safety, and the importance of purchase price.

Reading as a key learning process

Raamdeo mentioned several sources of his learning, mainly in the form of books -

- Common Stocks, Uncommon Profits by Phil Fisher - to understand what to look for in a company
- Competitive Strategy by Michael Porter - teaches you how to look at competition
- Value Migration by Adrian Slywotzky - to know that value keeps migrating from one business to another e.g. from fixed wireline telephony to wireless, from public sector banks to private sector banks, etc.
- Value Investing by Prof Greenwald - importance of growth in same franchise; and entry barrier = RoE
- Theory of Investment Value by Burr William - to learn the importance of dividend
- Security Analysis and The Intelligent Investor, both by Benjamin Graham - to understand stocks as buying pieces of businesses, and the concept of margin of safety
- Your Money, Your Brain by Jason Zweig - the importance of emotions in investing, and of buying in pessimism
- Regular reading of publications like Financial Times and The Economist for global developments.

Pet ways of finding value

- Understand the dynamics of making money in few businesses - banking & finance, auto, telecom, consumer products, cement, steel
- What to look for in companies - business where profitability is very high, or better still, likely to be very high; where competition is limited or there are entry barriers; great management team
- Stock not fully discovered by the market or suffering from pessimism or temporary setback
- Reasonable valuation

Past examples

- **Hero Honda** - value migrating from scooters to motorcycles in the 1990s; low penetration with very little competition; high profitability; stock available at Rs5b for a profit of Rs0.5b i.e. reasonable P/E of 10x
- **Bharti** - value migrating from fixed wireline to wireless telephony; mobile companies bidding for licenses in Europe at high prices; Bharti enjoying 26% EBITDA margin but no profit due to high interest and depreciation (temporary phenomena); stock available at Rs25 (Price/Book Value of 1x)
- **SBI** - Play on Buffett's line: "Change in interest rate changes the value of every single asset in the world"; India's interest rates slumped from 11-12% to 5-6% in 2002-03; huge treasury book gains for SBI; stock available at Rs220 when the book value was Rs275
- **Nestle** - Idea emerged from the 12th Wealth Creation Study which showed massive consumption boom in India's NTD era (Next Trillion Dollar of GDP) and the 13th Wealth Creation Study ("Great, Good, Gruesome"), where Nestle fulfilled all of Buffett's criteria for a great business.

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Panel discussion on Value Investing

At any point of time, you need to have ownership of a concentrated portfolio of stocks, not more than 10 or 15. What I am not too sure is whether you can permanently go on holding the same stocks

I am very clear and mercenary about why we come to the stock markets – that is, to get rich. And the secret to getting rich is NOT owning 1% of a stock. The secret is to load up when you get something cheap. If you want to get seriously rich, concentrate!

On diversification versus concentration of portfolio

Sanjoy: Let me start with something which I think is at the crux of Value Investing. There are two names most talked about when it comes to Value Investing – Benjamin Graham and Warren Buffett. Graham said you can buy a diversified basket across stocks really cheap and you will do well. An absolute contrast to that was his best student, Buffett. He said that to make big money you need to buy a basket of very few stocks, but watch that basket very carefully and then do very little. Ramesh and Raamdeo, I know, belong to the Buffett camp on this. Nilesh, where do you stand on this debate?

Nilesh: I think, finally, at any point of time, you need to have ownership of a concentrated portfolio of stocks, not more than 10 or 15. What I am not too sure is whether you can permanently go on holding the same stocks. I believe you need to have an open mind, and go on looking for new investment opportunities, and not be stuck with the same set of investments. Of course, if you find ideas which you can hold for 10, 15, 20 years ... fantastic! But I don't that's something which can be done easily, or probably the best way to do things.

Ramesh: Have only two eggs in the basket, but watch the basket! Diversification is something they teach is business school. But I am very clear and mercenary about why we come to the stock markets – that is, to get rich. And the secret to getting rich is NOT owning 1% of a stock. The secret is to load up when you get something cheap. This is something perhaps none of us here has done as value investors. My advice to the next generation is not to get stymied by our mistake. If you want to get seriously rich, concentrate!

Sanjoy: What happens if you have a concentrated portfolio, and one of them blows up? Say, like an AIG in the US? Great stock, tremendous record, etc. But bang! All of a sudden it blew up in 2008. What does it do to your portfolio? Aren't you in deep trouble?

Ramesh: Sanjoy, I think it is a failure of doing your homework. As you know, Buffett owned Fannie Mae and Freddie Mac. But he sold out a few years ago when management started guiding for numbers up to two decimal places! He said that in such a business it is impossible to predict numbers, so obviously the management is manipulating the numbers. Similarly in AIG, if you didn't know that the management was doing CDS [credit default swaps], it is a failure of understanding. There is no short-cut to understand the business and management, and you will pay a heavy price for not doing so. Of course, if you bought it really cheap, you may still manage to escape!

"I have seen India for the last 20 years and believe the next 20 will only be far more prosperous. In such a situation, some businesses will grow in a particular way. And if there are only 1 or 2 players, then unless there's something absolutely disruptive, I see no reason to sell.

On when to sell

Sanjoy: You have brought a great business, doing all the right things, etc. When is the right time to sell?

Raamdeo: I think it depends on your understanding of the competitive situation of the business. If there are strong entry barriers, and you have some macroeconomic belief ... for instance, I have seen India for the last 20 years and believe the next 20 will only be far more prosperous, even for the world. In such a situation, some businesses will grow in a particular way. And if there are only 1 or 2 players, then unless there's something absolutely disruptive, I see no reason to sell.

Sanjoy: Raamdeo, in a sense, what you are saying is if the underlying assumptions of your investment is right, the best time to sell is ... Never!

Raamdeo: Yes ... unless of course things become absolutely crazy.

Businesses go through rough patches. In such a case you need to make a judgment whether this is a cyclical or structural issue, eg, the shift from landline to wireless.

Nilesh: By and large yes; but those would be very rare situations. In the sense that most businesses go through rough patches. In such a case you need to make a judgment whether this is a cyclical or structural issue, eg, the shift from landline to wireless. Clearly, this meant a structural problem for MTNL, which was always a value stock. If you are able to decipher such shifts, that is the tipping point.

Ramesh: There are very few businesses which will outlive many business cycles. I think it is the alcohol market, Raamdeo may think it is Hero Honda. But in most cases, it is best to sell out when you think a bull market is over. Because in a bear market, stocks tend to correct at least 50%, and even up to 80-85%. So, barring a few stocks which I intend to leave for my grandchildren, if I think the bull market is coming to an end, I would dump a large part of my shareholding.

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Sanjoy: How do you identify that the bull market is coming to an end? That the mood is shifting?

Ramesh: There are signs ... valuations, sentiment, emotions ... basically, when people who shouldn't be talking stocks – say, a paanwalla – start talking stocks, that's a sure time to sell!

On dealing with noise e.g. news flow, quarterly results

Sanjoy: Should value investors be worried about interim developments – events, news flow, quarterly results? How important are these things? Is this noise?

Ramesh: I agree. You need to have a vision or a sense of the stock's terminal value, say, in India we will have 10 mugs of beer per capita from half a mug now. And then stick with that vision. There will be interim noise, and we should try not to pay attention. Like in cricket, there will be a wide ball, a no-ball, lbw appeals, etc, but the focus should be to hit six sixes out of the ball-park.

"You need to have a vision or a sense of the stock's terminal value ... There will be interim noise, and we should try not to pay attention. Like in cricket, there will be a wide ball, a no-ball, lbw appeals, etc, but the focus should be to hit six sixes out of the ball-park.

Nilesh: I think one is to have the investment thesis right. Still, you cannot afford to ignore the quarterly numbers or significant developments. But you need not react to them, you only need to be aware. In a place like India, where a lot of things happen simultaneously including policy changes, the combined impact on businesses can be significant. If this changes your fundamental investment thesis, then you must definitely react.

Raamdeo: Reported quarterly numbers can be very mischievous and can offer opportunities. For instance, last quarter, Nestle's reported profits were way below our expectations. I guessed there must have been exceptional items, but the market reacted immediately. I actually ended up buying when the stock fell.

You cannot afford to ignore the quarterly numbers or significant developments. But you need not react to them, you only need to be aware ... If this changes your fundamental investment thesis, then you must definitely react.

On the importance of macro and global trends, news, etc

Sanjoy: How important is a deep knowledge of what's happening in the world, global macro, top-down, etc for a value investor?

Ramesh: Actually, according to me, it's of zero importance. If four years ago, you told me there would be a tsunami in Asia, global markets would collapse, oil would touch 100 dollars, etc, the answer would be don't get into equities; you would get killed. But still the fact is we are at 18,000 [Sensex] not at 8,000. Ultimately, you need to go bottom-up, you know what you are buying, you know the words, margin of safety. You just need an intellectual hypothesis to help you before you go. Say, Raamdeo has given a very powerful intellectual hypothesis – and now I agree with him – that India's GDP is set to go from US$1 trillion to US$2 trillion and further on to US$5 trillion. With this in mind, you can now fill in the gaps, like whether consumption is going to grow or financial services or whatever.

Reported quarterly numbers can be very mischievous and can offer opportunities."

Sanjoy: So what you are saying is focus on the knowable rather than the unknown and the uncontrollable. Nilesh, your views?

"[Global/macro trends are] of zero importance. If four years ago, you told me there would be a tsunami in Asia, global markets would collapse, oil would touch 100 dollars, etc, the answer would be don't get into equities; you would get killed. But still the fact is we are at 18,000 [Sensex] not at 8,000.

If your time horizon is, as Buffett says, forever, then all global uncontrollable, unfathomable factors don't matter. But the time horizon of most market participants is very short; so for them such things matter a lot.

I think it is very important to understand them. You can get good opportunities in global cyclicals, for instance. Another thing is new businesses. For instance, you could identify software companies early during Y2K because you had visited Japan and understood the power of computing."

Nilesh: I think the issue is time horizon. So, if your time horizon is, as Buffett says, forever, then all global uncontrollable, unfathomable factors don't matter. But the time horizon of most market participants is very short; so for them such things matter a lot.

Raamdeo: I think getting global factors right is a different thing. But I think it is very important to understand them. You can get good opportunities in global cyclicals, for instance. Another thing is new businesses. For instance, you could identify software companies early during Y2K because you had visited Japan and understood the power of computing.

Sanjoy: So, this thought seems to be coming from the fear of missing something. But as Ramesh says, why not focus on your circle of competence?

Raamdeo: Probably, this is part of the process of enlarging your circle of competence.

On whether dividends matter

Ramesh: I think dividends matter enormously. A lot of return, over time, comes in the form of dividends. And in a country like India, dividends are tax free. Several times in the past, when markets have been flat, add up the dividends, it boosted your returns dramatically.

Sanjoy: Actually, Sanjoy has left something for me to add. If you took the top 50 returning companies in the US over 125 years, and broke up the return into dividends and capital appreciation, any guesses on how much dividends accounted for? 40%! That's how important dividend is.

Ramesh: Look at a stock like Bharat Electronics. At one time, its price was Rs20; today it pays Rs20 per share as dividend. That's 100% return. Infosys too, over time, has had significant part of return coming from dividend.

On learning from failure

Nilesh: For me the biggest failure is the Media sector where I thought the opportunity is large. And my biggest learning from this is that if a business over an extended period of time does not generate free cash flow, then it is best to give it a miss.

Raamdeo: My biggest learning is that companies which misallocate capital will get punished, at least in the medium term. My personal example was Tisco [Tata Steel, now]. They committed huge amount of capital to acquire Corus, and the company – despite being one of the best in India – had to suffer in a big way. Sure, the management may well be optimistic for the long run. But if at the personal level, you can't figure out the reason for any capital allocation, it is best to get out. I didn't do that, and that's my biggest learning.

"Infosys profit in 2000 grew 100%, so the PEG was 1x, hence cheap! Nobody bothered to say that a P/E of 100x was obscene. From March 2000 to March 2009, post office deposits would have treated you better in terms of returns! And I held Infosys during this period! So the lesson is, stay real, stay rooted to the ground. And when it is too good to be true, it probably is! So, sell!"

Sanjoy: I happen to be lucky to have invested early in Infosys. In 2000, the stock hit a P/E of 100x, which the market justified using the PEG ratio (P/E to sustainable Growth). And what is sustainable growth? The growth delivered last year! So, Infosys profit in 2000 grew 100%, so the PEG was 1x, hence cheap! Nobody bothered to say that a P/E of 100x was obscene. From March 2000 to March 2009, post office deposits would have treated you better in terms of returns! And I held Infosys during this period! So the lesson is, stay real, stay rooted to the ground. And when it is too good to be true, it probably is! So, sell!

Ramesh: My first learning, as I said earlier, is to load up on good stocks when you find them. My other lesson is that great investing decisions that you make in your career will be met with skepticism, not with applause. When I was buying PSU stocks, Raamdeo stopped speaking to me! Likewise, when he told be about Bharti, I turned my face away! But that's OK. In fact, if anybody applauds me as to what a great thing you did, I would go and re-check my investment thesis!

Sanjoy: Thank you all!

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