Value Investing

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IIM Lucknow
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BACKGROUND

- Rajeev Agrawal – A Value Investor
  - Did personal investing for a decade in US
  - Since 2012 focused on India and helping with equity investments for friends & family

- Founder and Managing Partner, DoorDarshi Value Advisors

- Worked in US for 12 years with the best financial firms
  - Goldman Sachs 2007-2012
  - Bank of America 2005-2007
  - JP Morgan 2002-2004
  - Dresdner Bank 2001-2002

- Strong educational background
  - Completed CFA certification in 2014
  - MBA from IIM Calcutta in 1998
  - B. Tech from IIT Bombay in 1995

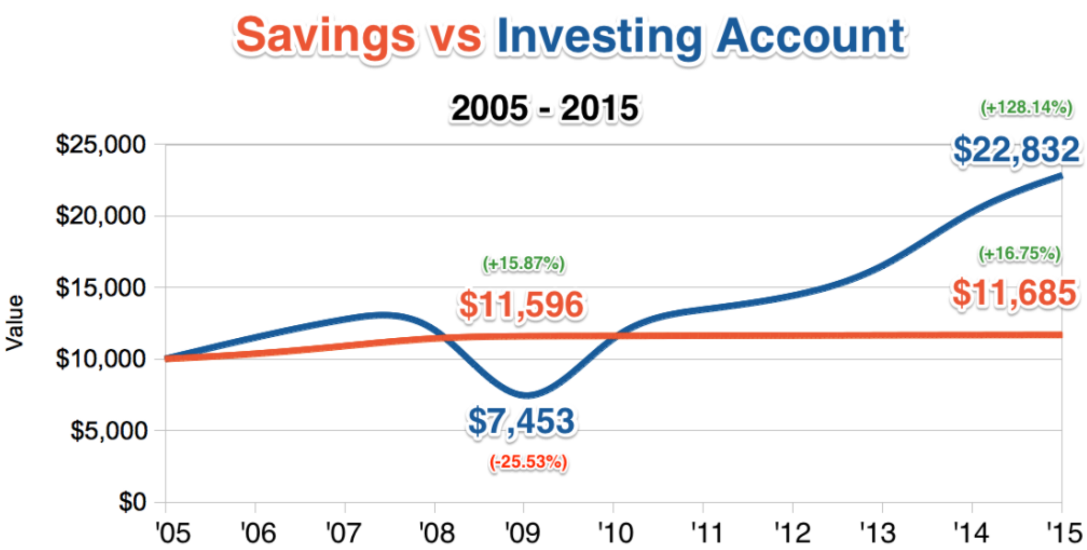
Agenda

- Value Investing – An Introduction
  - What is Investing and why is it important?
  - An Investing Framework – Value Investing
  - Stock Investing – Common Myths
- Value Investing – In Practice
  - DoorDarshi's Investment Approach
  - DoorDarshi's Investment Process
  - Case Studies
- Journey of Value Investors
  - Mohnish Pabrai
  - Rajeev Agrawal

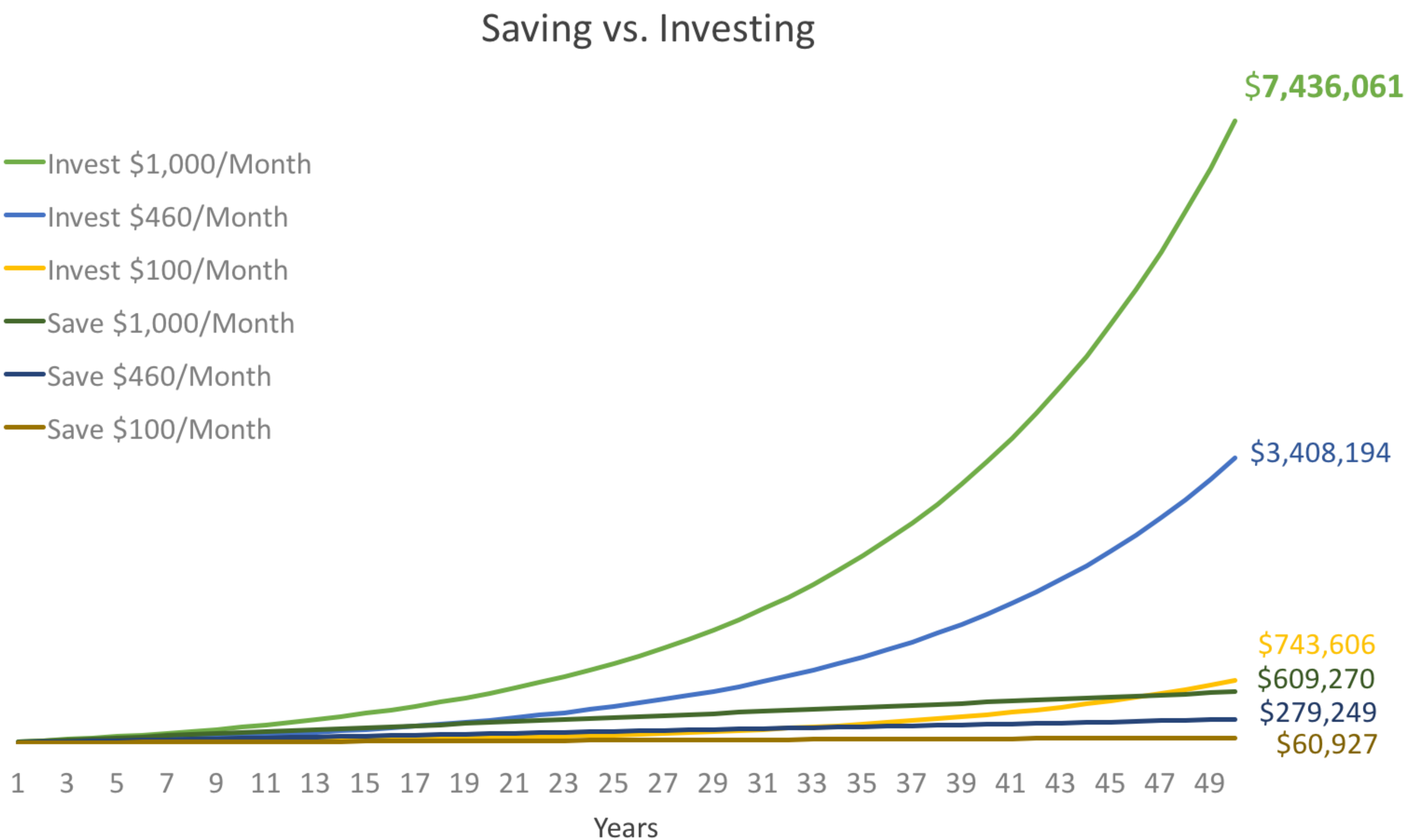
Savings vs Investing

What is Investing?

- Investing is <u>not</u> Savings
  - Savings is money that you earn but don't spend
  - A portion of the Savings should be Liquid – Emergency Reserve
  - Remaining should be invested based on needs and abilities
- Investing is the process of putting your money to work to make even more money for you over long-term.

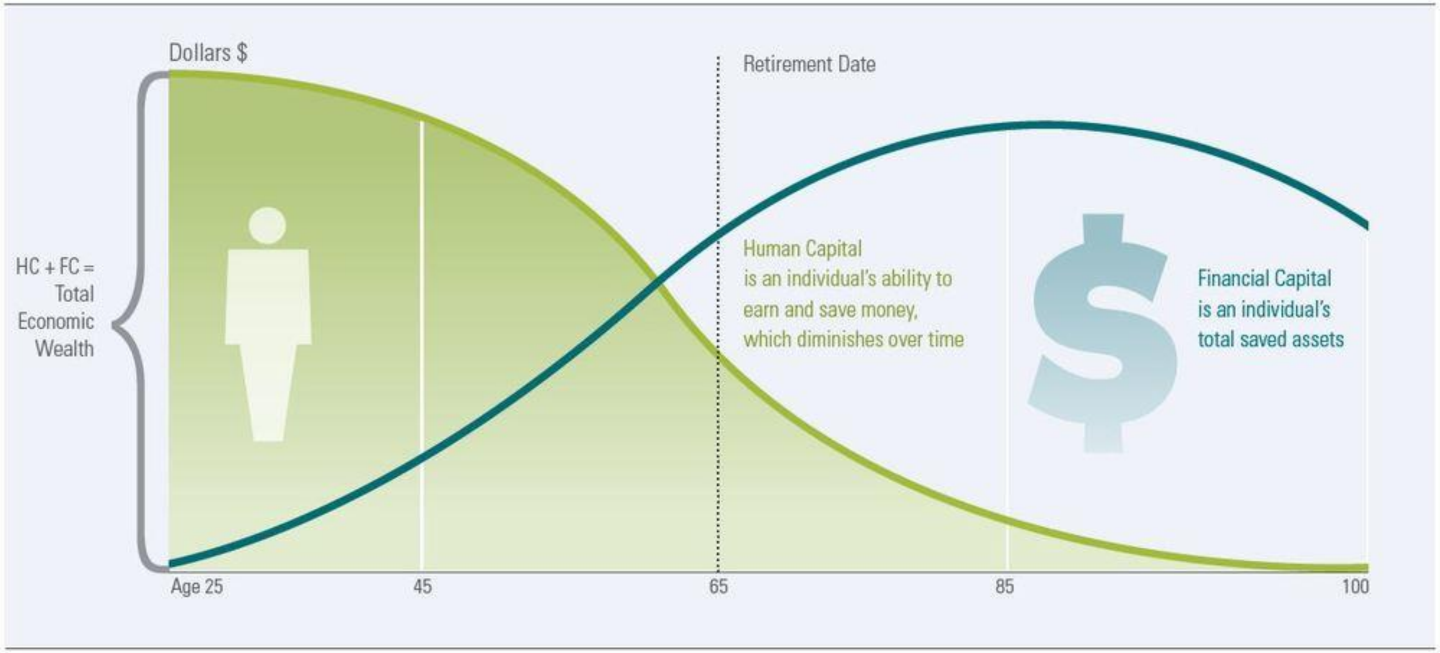


Saving vs Investing



Why is Investing important?

- Human Capital goes down over-time. Financial Capital goes up.



Source: Ibbotson Associates.

- Keep-up with Inflation & Improve Standard of Living
- Power of Compounding
  - Albert Einstein "Compounding is the 8th wonder of the world"

Value investing – an introduction

Value Investing concepts

- Margin of Safety
  - On a bridge which allows 30 Ton load you only allow 15 Ton vehicles to go
  - Buying a $ for 50 cents

- Warren Buffett's rules
  - Rule #1: Don't lose money
  - Rule #2: Don't forget rule #1
- To Increase Return, reduce Risk
  - Focus on not losing money and the upside will take care of itself
- Equity Investing is being a part-owner in a business

Case for Value Investing

- Value Investing is getting more than you give
  - Works across time periods

Investor	Period	CAGR	S&P	Out-performance
Walter Schloss	1956-84	21.3%	8.4%	12.9%
Tweedy Browne (Tom Knapp)	1968-83	20.0%	7.0%	13.0%
Buffett Partnership	1957-69	29.5%	7.4%	22.1%
Sequoia Fund (Bill Ruane)	1970-84	18.2%	10.0%	8.2%
Charles Munger	1962-75	19.8%	Dow (5%)	14.8%
Pacific Partners (Rick Guerin)	1965-83	32.9%	7.8%	25.1%
Perlmeter Investments (Stan Perlmeter)	1965-83	23.0%	Dow (7%)	16%
FMC Pension Fund	1975-83	17.1%	15.6%	1.5%

WHY IS EVERYBODY NOT A VALUE INVESTOR?

- Value Investing doesn't work all the time
  - Value investing can barely keep up during Bull markets.
  - In 1998-99 tech stocks did way better than Value approach
  - Value of this approach is seen in Bear markets, where portfolio losses are much less

- Requires patience
  - Most people like activity and find it difficult to do nothing!

- Requires lots of work
  - Main activity is to read a lot.
  - Reading Annual Report itself will allow you to be ahead of most of the analysts!

- Requires Discipline and Emotional fortitude
  - Fear is the foe of the faddist and a friend of the fundamentalist

Traits of a successful investor

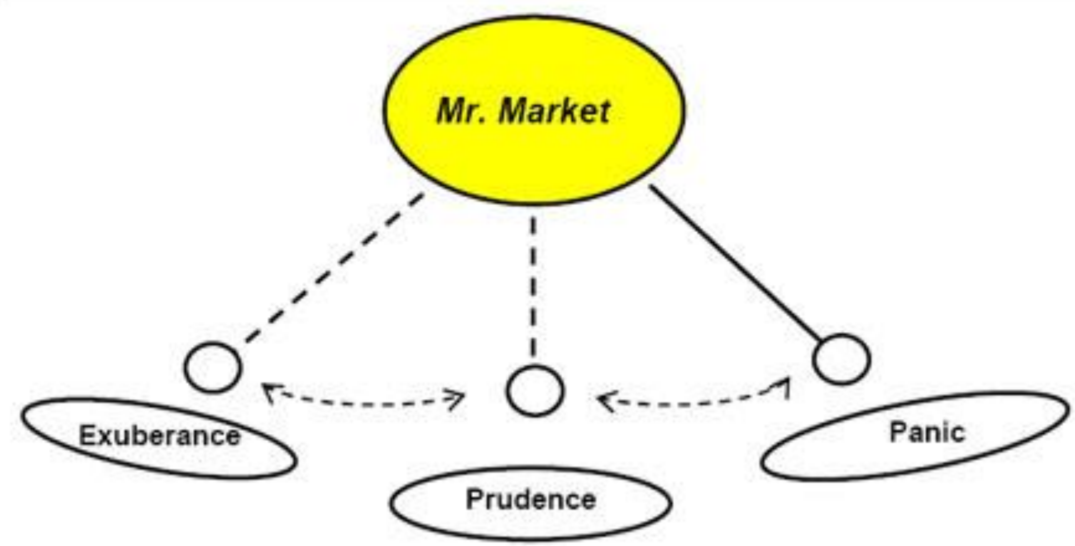
- **Contrarian**: Don't feel pain in buying things that are unpopular / selling things that are popular
  - Stock price fall for a reason – there is bad news.
  - Trick is to judge whether market valuation is significantly lower than the intrinsic value.

Traits of a successful investor

- **Emotional Fortitude**: Take advantage of Mr Market – a manic, depressive, emotional fellow
  - Mr Market is there to serve you, not to guide you.

Exhibit 4

***Mr. Market*'s Mood Swing – From Exuberance to Semi-panic**



Source: Morgan Stanley Research.

Traits of a successful investor

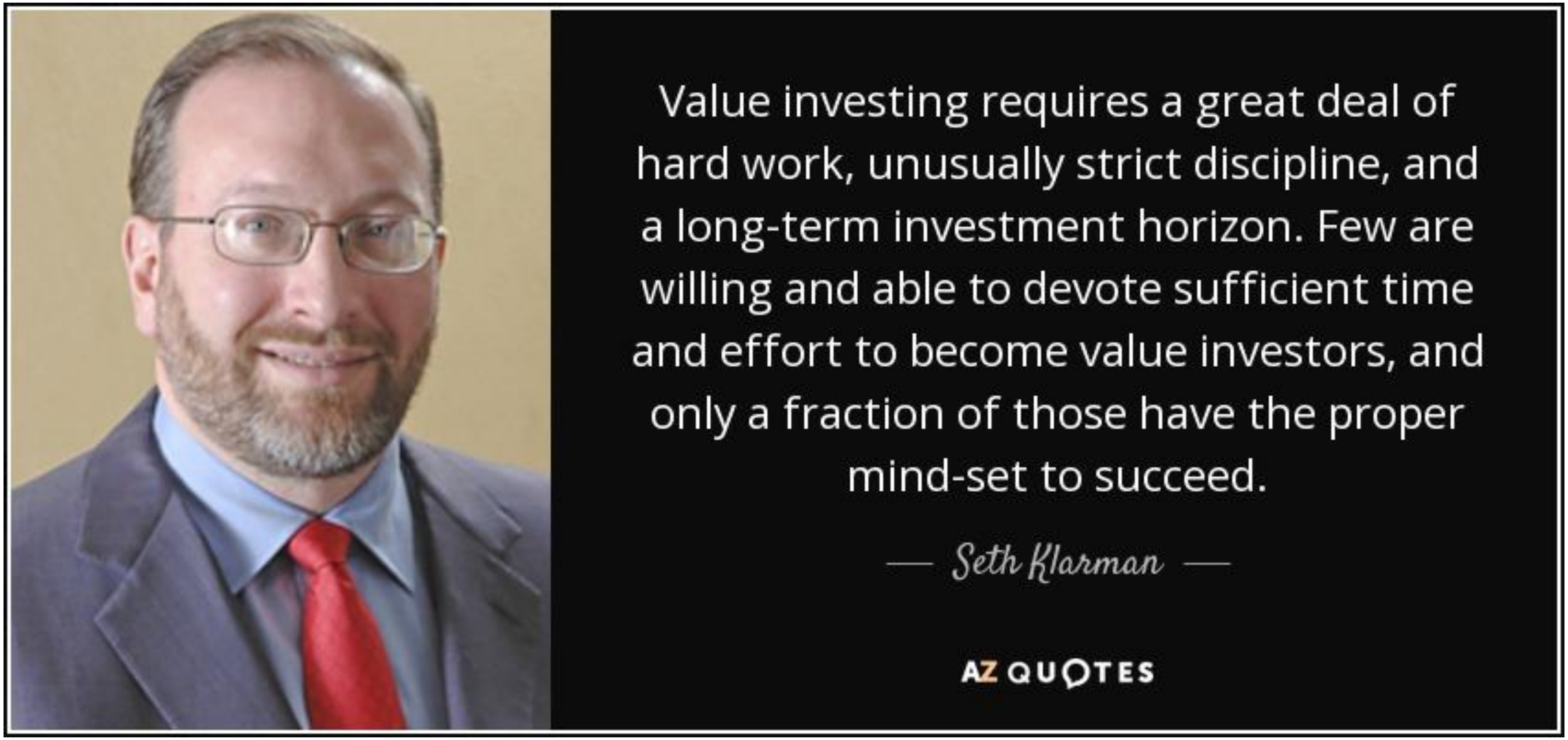
- **Skip Envy**
  - Don't have to keep up with the returns of the next person you meet
  - Have an approach that you can live with and stick to

Traits of a successful investor

- **Think like a Businessman**

Investment
is most intelligent
when it is most
businesslike
Benjamin
Graham

TRAITS OF A SUCCESSFUL INVESTOR



Stock Investing – common myths

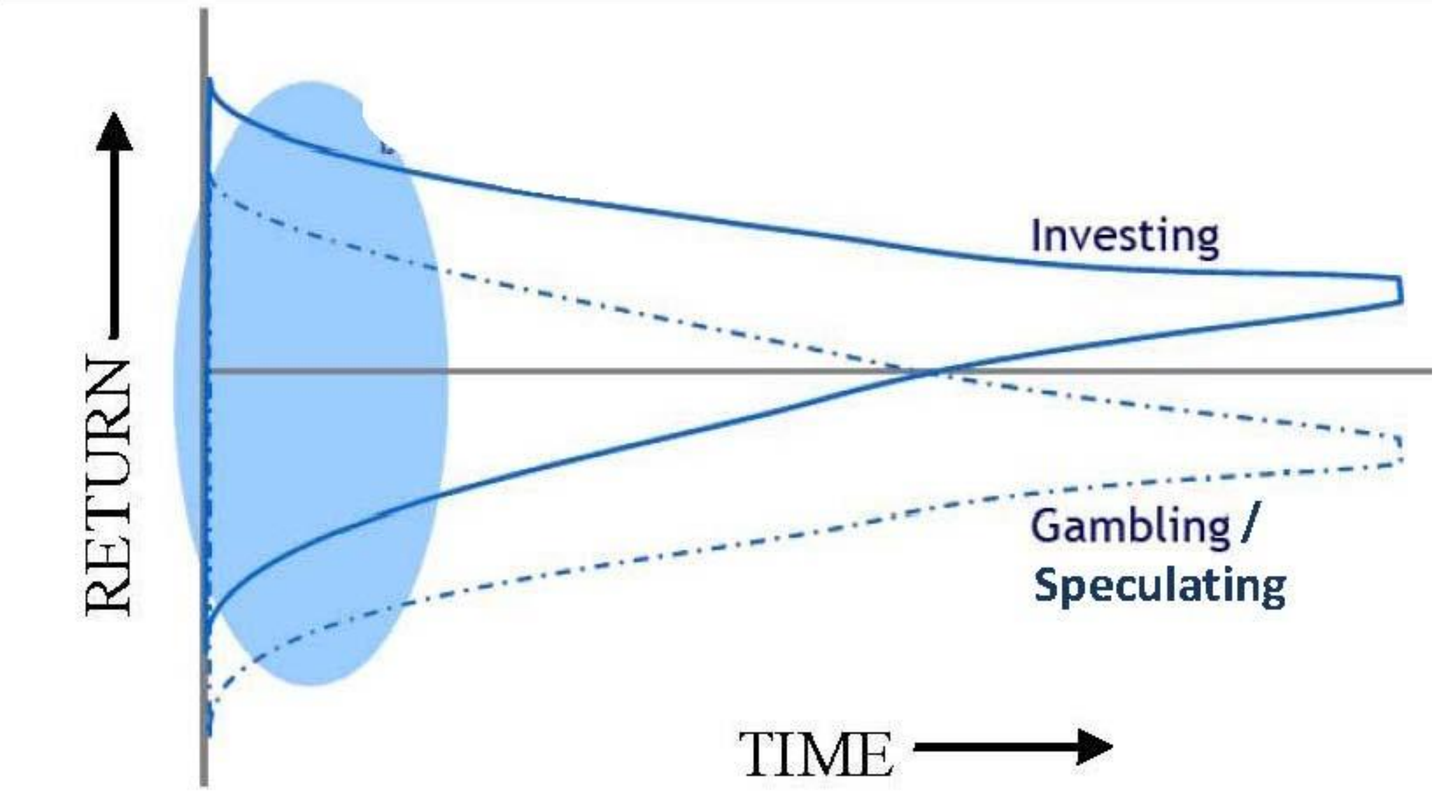
Myths of stock investing

- Myth #1: Investing v/s Speculating
- Myth #2: Markets are always efficient
- Myth #3: Investing is easy
- Myth #4: Standard deviation and Beta are good proxy of Risk

Myth #1 – Investing v/s Speculating

- Anybody with a brokerage account and money to invest is an investor!
  - People confuse investing with speculating
  - In short-term the distinction is not apparent because of the role of luck

Myth #1 – Investing v/s Speculating



: LMFM analysis.

Myth #1 – Investing v/s Speculating

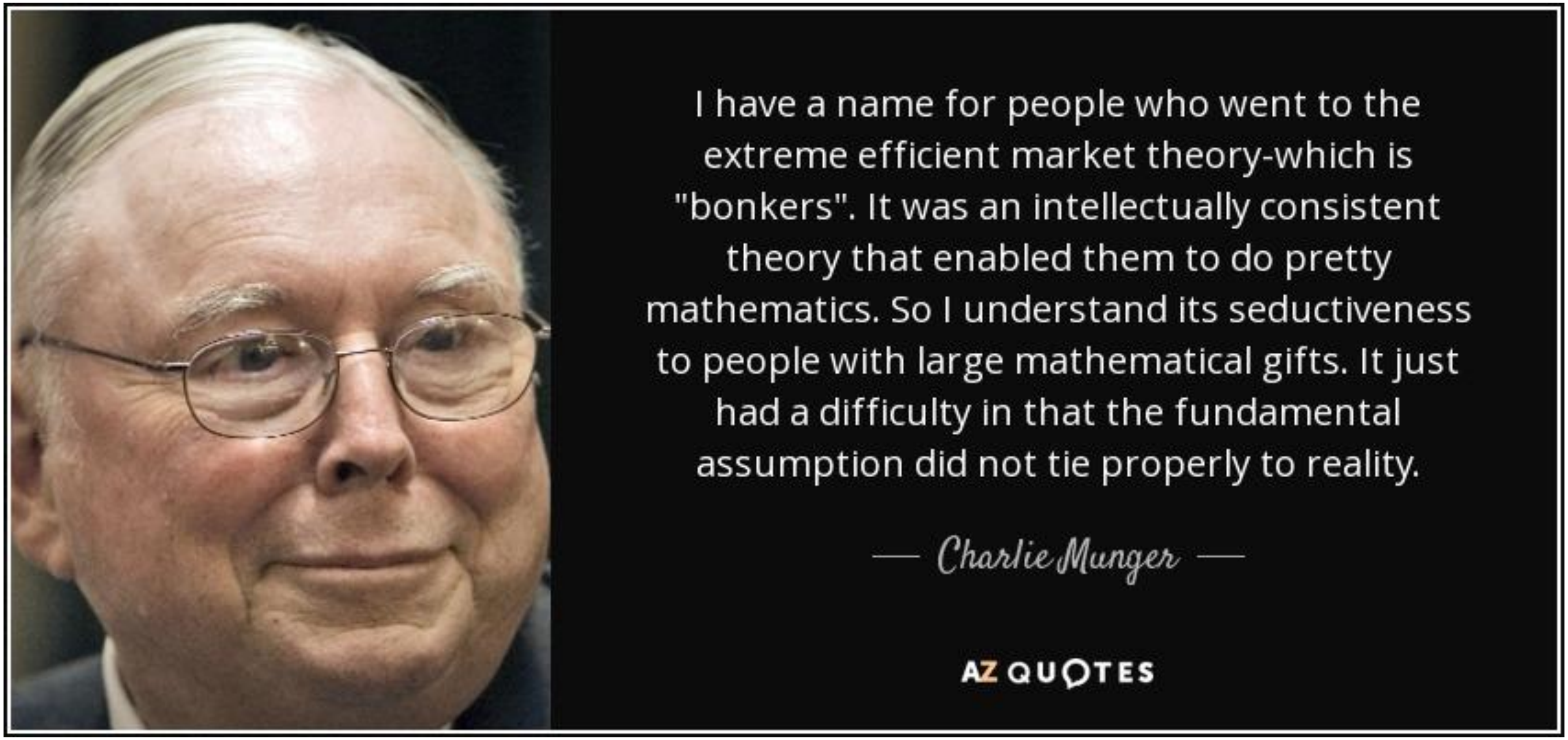
- Investors purchase an asset for the cash flow that it will generate
  - Returns received are driven by the financial performance of the asset
  - Returns received are driven by narrowing of the gap between market value and intrinsic value
- Speculators purchase asset because they believe other investors will pay more
  - Returns received are driven based on other actions / gullibility

Myth #2 – Markets are always efficient

- Efficient Market Theory says that Markets are always efficient
  - Impossible to beat the market
  - Hence no point in doing Stock Research!

- Proof by Inversion: If Markets are always efficient we will not observe the following
  - Net – Net
  - Debt capacity bargains
  - Over and under reactions

Myth #2 – Markets are always efficient

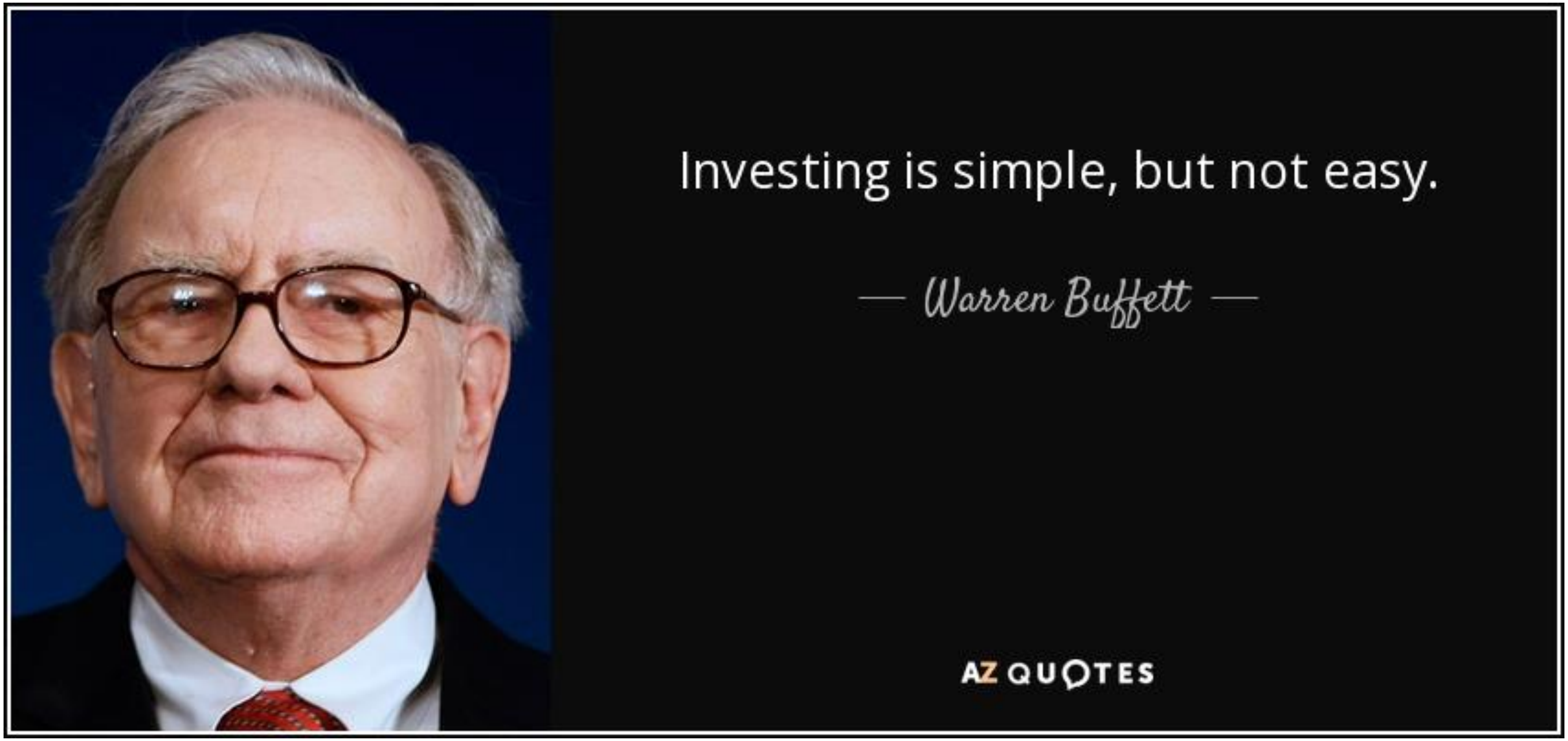


Myth #3 – Investing is easy

- In short-term anybody can make a lot of money because of the role of luck

- However, Investing requires traits that human beings find difficult
  - Indifferent to Herd Mentality
  - Micro vs Macro
  - Patience
  - Diligence

Myth #3 – Investing is easy



Myth #4 – Standard deviation and beta are good proxy of risk

- CAPM suggests that higher the Risk, higher the Return
  - Above implies that if I take Risk I should be well rewarded.
  - However, if Returns are guaranteed to be higher then is it really Risky?

- Empirically, higher beta stocks don't out-perform the indexes

Myth #4 – Standard deviation and beta are good proxy of risk

- Risk instead is in
  - Our understanding of the business
  - Our confidence of the future outcome

- Thus it embedded in
  - Circle of Competence
  - Time Horizon
  - Quality of Business
  - Quality of Management

Value investing in practice

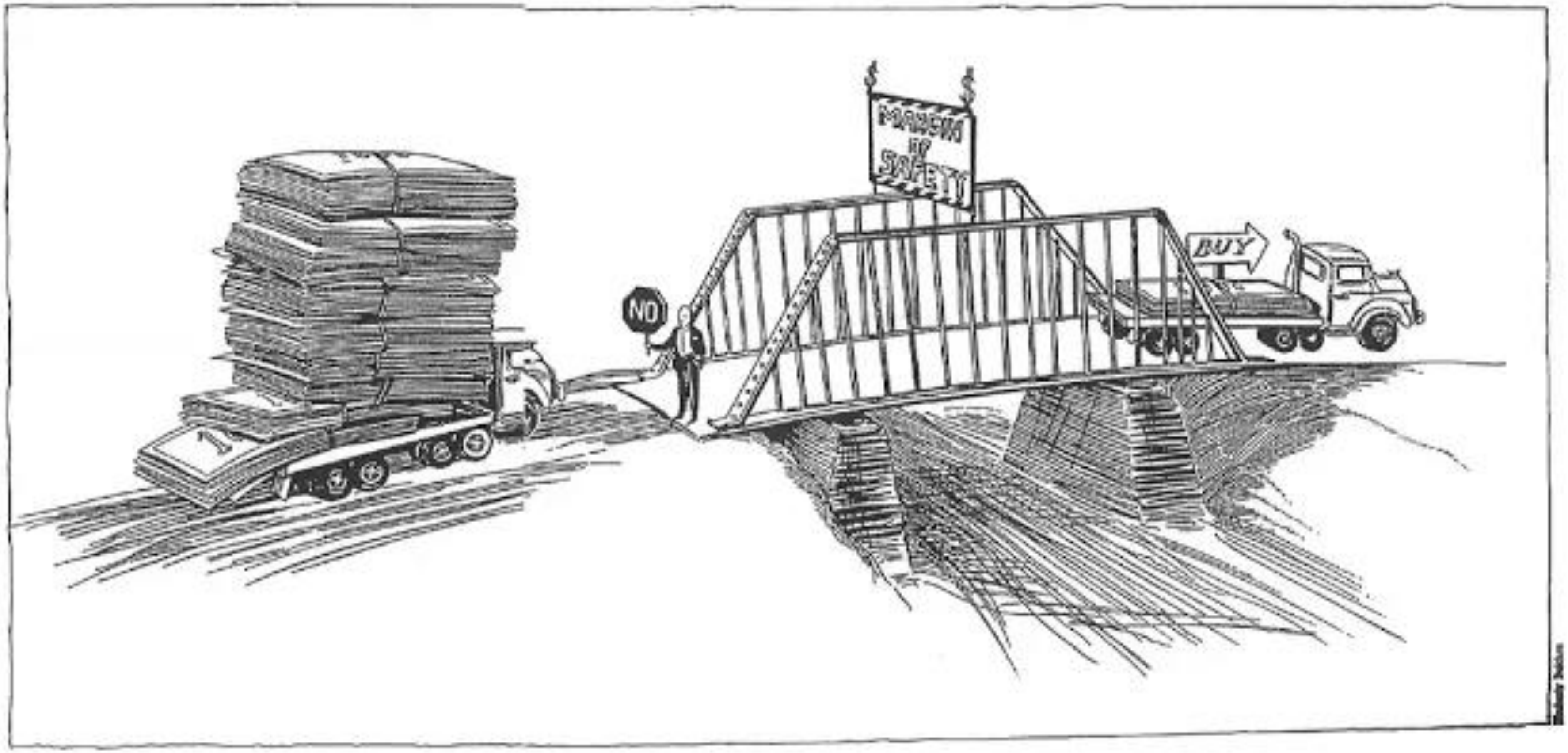
Investment Approach

DoorDarshi Advisors' Approach

Objective	Seek superior capital appreciation over long time period
Investment Approach: Value Investing	- Buy with significant Margin of Safety - Concentrated portfolio - Long-term orientation - Leverage our competitive advantage - Focus on Business & Mgmt Quality

DoorDarshi Advisors' Approach

- Buy with significant MOS (Margin of Safety)
  - To increase Return reduce Risk



DoorDarshi Advisors' Approach

- Concentrated Portfolio
  - Invest more in our best ideas
  - Know our positions better than most – extensive diligence initially and ongoing maintenance diligence

- Number of positions in the portfolio is around 20
  - Top 5 positions > 60% of the portfolio
  - Top 10 positions > 85% of the portfolio

DoorDarshi Advisors' Approach

- Long-term orientation
  - Gardening analogy
    - Right time to reap
    - Right time to harvest
  - In short-term returns may look volatile. Over long-term, returns dominate volatility
  - Leads to better decision making – noise is reduced
- >90% of the returns are long-term and hence tax-free

DoorDarshi Advisors' Approach

- Leverage our competitive advantage
  - **Illiquid stock**: We capture illiquidity premium
  - **Smaller Cap**: Companies with limited analyst and institutional interest. Capture small-cap premium
    - 47% of the portfolio is in Small cap
    - 25% of the portfolio is in Mid cap
  - **Variant perception**: Understand Mr Market point of view and how/why our view is different
  - **Focus on Balance-sheet**: Markets are too focused on quarterly earnings

DoorDarshi Advisors' Approach

- Patience
  - Most ideas take a few years to play out. Short circuiting can reduce returns
    - Comfortable getting into stocks which don't have immediate triggers
  - Reducing activity reduces expenses thus resulting in better returns
  - As comfort with business and management increases threshold at which a position will be sold goes up

Value investing in practice

Investment Process

DoorDarshi Advisors' Process

DoorDarshi Advisors' Process

1. Idea Generation

- Screen on financial metrics
  - High Return on Capital – ROE, ROCE, EBIT/(NFA + WC)
  - Low Leverage – D:E, Interest coverage
  - Reasonable valuation – P/E, EV/OCF, EV/EBIT
  - Good management and business – Rev, PAT, CF growth rate, past return to shareholders

DoorDarshi Advisors' Process

1. Idea Generation

- Look at positions of other successful value investors
  - These positions have already gone through a layer of diligence
- Companies with similar themes / ideas as what we are familiar with
  - Understand the industry / thesis relatively quickly
- Continuously search for new trends / opportunities
- Revisit old investments that may provide new opportunities

DoorDarshi Advisors' Process

2. Idea Investigation

- Understand the business
  - Read last 10AR in the reverse chronological order – from the oldest to the latest
  - Read Quarterly reports for the last few years
  - Read research reports & blog postings
- Assess how management reacts to questions
  - Hear investor conference calls & read investor presentation
  - Listen to management interviews

DoorDarshi Advisors' Process

2. Idea Investigation

- Summarize key takeaways
  - Make notes as an idea is investigated.
  - Assess whether management does what it says it will do
  - Put aside the notes for a few weeks, come back and read the notes again – ensure we are not being swept away

DoorDarshi Advisors' Process

3. Idea Ranking

- Once an idea is investigated, it falls in 3 buckets:
  - Interesting opportunity
  - Not now: re-visit later if not as compelling
  - Never: Bad management, improper governance
- Interesting opportunities then go through future return analysis
  - Estimate how the business looks a few years out
  - Any gaps in assessing the future require further research
  - Use reasonable assumption to estimate future stock value
  - Derive forward return based on current and future (expected) price

DoorDarshi Advisors' Process

3. Idea Ranking

- All existing positions and new ideas are then stack ranked by:
  - Future Returns CAGR over the next few years
  - Confidence in the idea (how long I am willing to hold)

DoorDarshi Advisors' Process

4. Idea inclusion/addition in portfolio

- Once an idea has high future returns v/s existing holdings it is gradually added to the portfolio
  - This assumes that there is cash available to buy

- Percentage allocated to the idea in the portfolio increases as:
  - Confidence in the idea increases
  - Market price of the idea falls and future return increases

Ideally both happens

DoorDarshi Advisors' Process

5. Position Maintenance

- All positions in the portfolio are continuously assessed against other positions in the portfolio with respect to Future Returns
- All positions are regularly reviewed for company and sector results and aspects that can impact its value

DoorDarshi Advisors' Process

6. Position Selling

- Positions are added and sold gradually
  - Main driver is to have size of the position match with the conviction
  - Ensure we keep buying and selling reserve
- Position is sold if future return of the position is significantly below other options
  - Better opportunities elsewhere
  - Stock price increases dramatically
  - Poor performance of the company which causes future valuation to shrink

Investment Process

6. Position Selling

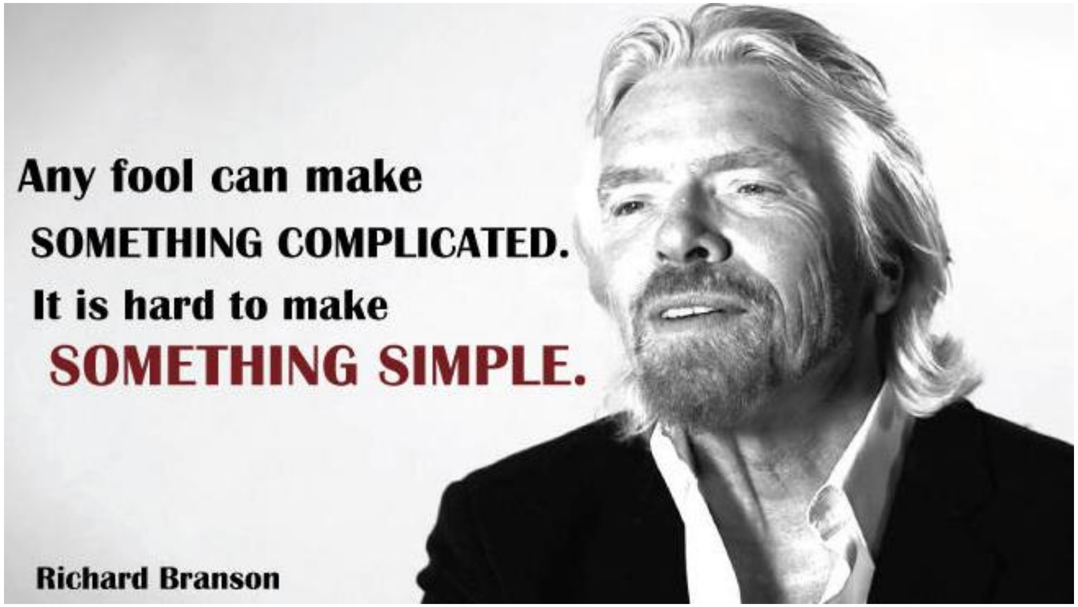
- Position is also sold if
  - Company's management is unfriendly to minority holders
  - New facts come to light which dramatically changes the value of the company

Advantages of the Process

- Provides a guide post for buying and selling
  - Set of steps acts as brakes to natural inclination towards activity
  - Makes us likely to buy low and sell high: Higher price reduces forward return and lower price increases forward return

ADVANTAGES OF THE PROCESS

- Manage complexity
  - Comparing across securities becomes easier – look at forward return comparisons
  - Better prepared to act during times of volatility as forward return adjusts quickly with market moves

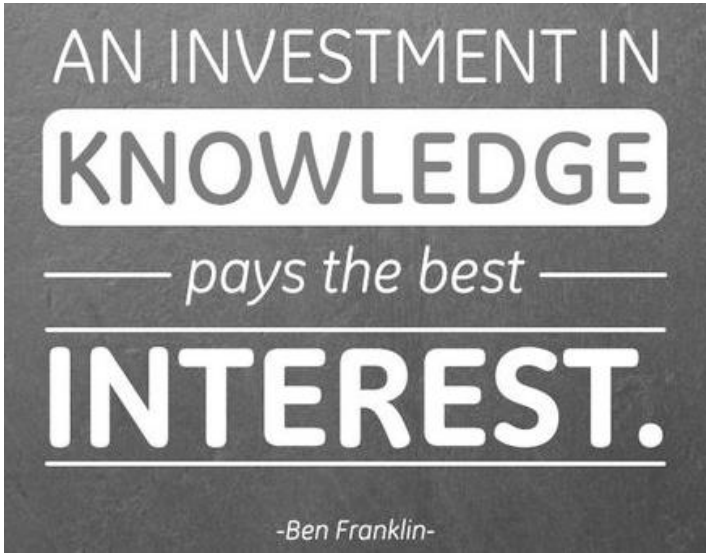


ADVANTAGES OF THE PROCESS

- Feedback loop
  - Comparing projected forward returns with actual returns helps in assessing our analysis and being humble!
  - Creates rich data set to reflect on

Advantages of the Process

- Knowledge compounds
  - Assessing a previous analyzed company is quick
  - Leverage patterns / similarities from previously assessed company in analyzing new companies
  - Set of rules / checklists are put in place to learn from our mistakes / successes and keep improving



Case Studies

Case Study – Stock 1

Looked at the stock first in 2011

- Co had sold half its business and all the cash had come into the company
- Co was selling for <50% of the cash
- Co was selling for 60% of the buy back price (buyback in 2010)
- Management had great track record of value creation over the previous 20 yrs
  - CAGR of Sales 29%
  - CAGR of PAT 35%
  - CAGR of Market Capital 40%

Theme: **Good management, Uncertainty**

Case Study – Stock 1

Bought initially in 2011

Kept buying more as conviction grew with management

Current Status

- Stock price is >5X from 2011 buy price
- >300% returns over the entire history of buying
- Largest position in the portfolio
- Management thinking of kicking next leg of value creation – spinning off various businesses

Risk: If something happens to management

Case Study – Stock 2

Looked at the stock first in third quarter of 2015

- Co had already done multiple buybacks since going public
- Cash raised in IPO has already been returned through buyback and dividends
- Co had 20%+ CAGR on Revenue over the 5 years
- PAT and EPS had not grown at the same rate as company was investing in building products and expensing these investments
- Co was selling for <10X PAT
- Low volume meant that institution ownership is low

Theme: **Good mgmt, Financials not reflecting value**

Case Study – Stock 2

Bought in 2016 Q1 and have been buying since

Current Status

- Stock price is up 20% since the initial buying
- Among the most appealing stock in the portfolio from forward return basis
- Investments in products should start getting reflected in earnings in the next few years
- 2^{nd} largest position in the portfolio

Risk

- Products don't perform as expected in the market

CASE STUDY – STOCK 3

Looked at the stock first in last quarter of 2014

- Co had generated >20% ROE over 5 years
- Co had 20%+ CAGR on Revenue and PAT over last 10 years
- Co was selling for 3.5X PAT
- Other competitors in the space were selling for >10X
- Low volume meant that few institutional investors participated

Theme: **Cheap stock. Heads, I win. Tails, I don't lose much.**

Case Study – Stock 3

Bought in 2014 Q4 and kept buying in 2015 Q1 and Q2

Current Status

- Stock price is >5X from 2014 buy price (stock split 5:1 in 2015 H2 + 1:10 bonus in 2016)
- >400% returns over the entire history of buying
- 3rd largest position in the portfolio
- Reducing position size as price increases, lowering the forward return of the position

Risk

- If earnings fall in a quarter stock price will follow

Case Study – Stock 4

Looked at the stock first in 2015

- Co stock had been bought by a prominent investor
- Co has a near monopoly in its business in a particular region
- Co was reasonably priced (not cheap)
- Other competitors in the space were selling at higher multiples

Theme: **Other Successful Investor(s), Near monopoly**

Case Study – Stock 4

Bought in 2015 and early 2016. Sold partly in late 2016

Current Status
- Stock price has fallen by >45% from the original buy price
- Incurring losses currently
- Value will take multiple years (>3) to play out
- 4th largest position in the portfolio

Risk
- Stock closely associated with economy of the region

Journey of value investor(s)

MOHNISH PABRAI

https://www.youtube.com/watch?v=xa1CH2nK1cM

Start from 23:40 – 5 mins video

http://fundooprofessor.wordpress.com/2014/01/15/mohnish-pabrai-lecture-mdi/

Start from 3:30 – 5 mins video

Rajeev Agrawal*

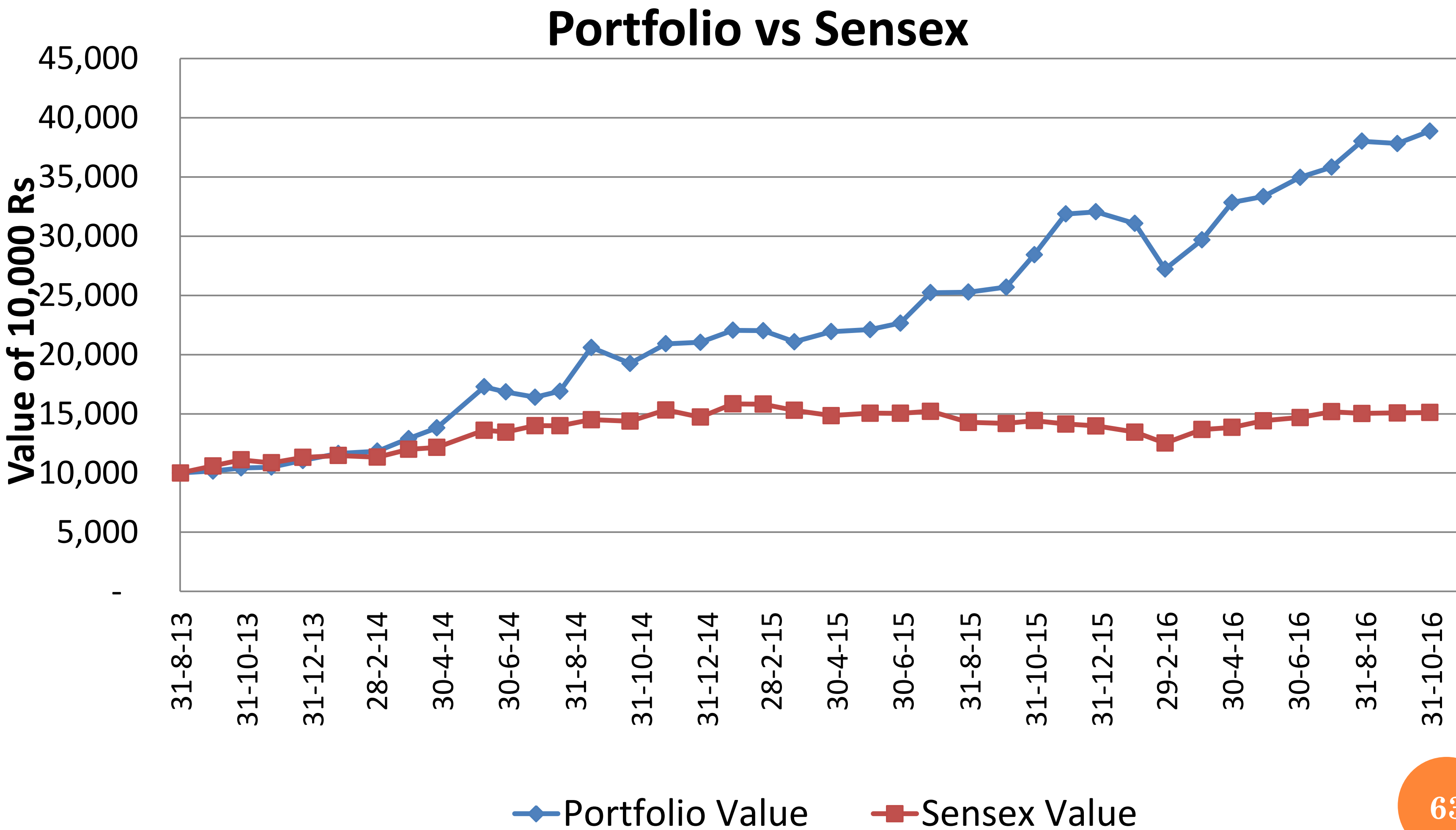
- Good returns since returning from US at the end of 2012

Year	Portfolio Returns	Sensex Returns	Relative Returns
CAGR (Sep '13 – Oct '16)	**53.5%**	**13.9%**	**39.7%**
Cumulative (Sep'13 – Oct'16)	**288.8%**	**51.1%**	**237.6%**
2013 (Sep '13 – Dec '13)	10.7%	13.2%	-2.5%
2014	89.2%	30.0%	59.2%
2015	52.2%	-5.0%	57.3%
2016 (till 30th Oct)	21.3%	8.1%	13.1%

- Significant out-performance v/s Sensex for most calendar years and over the entire history

* Past returns are not a good indicator of future performance. Past returns helps in assessing how the advice has performed historically

Rajeev Agrawal*



* Past returns are not a good indicator of future performance. Past returns helps in assessing how the advice has performed historically

Indian Landscape

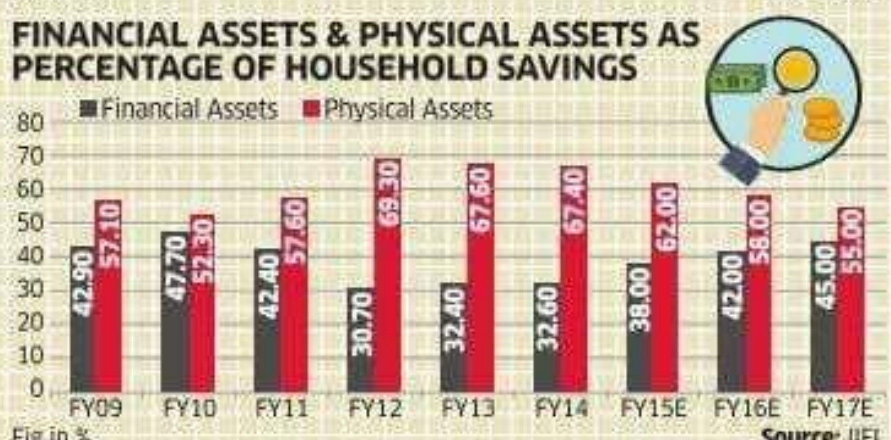
POST-TAX RETURNS (CAGR) OF ASSET CLASSES

	5-year	10 year	15 year	20 year
Equities	11.0	17.0	13.6	12.9
Gold	9.0	12.9	11.0	8.4
Bank fixed deposit	5.7	5.2	5.1	5.5
Property	8.0	13.4	10.8	6.2
CAGR in WPI index	6.2	5.9	5.7	5.5
Avg Inflation for the period	7.4	6.3	5.9	5.7

in % **Source:** Morgan Stanley

ESTIMATED EQUITY INVESTMENTS BY HOUSEHOLDS

FINANCIAL ASSETS & PHYSICAL ASSETS AS PERCENTAGE OF HOUSEHOLD SAVINGS



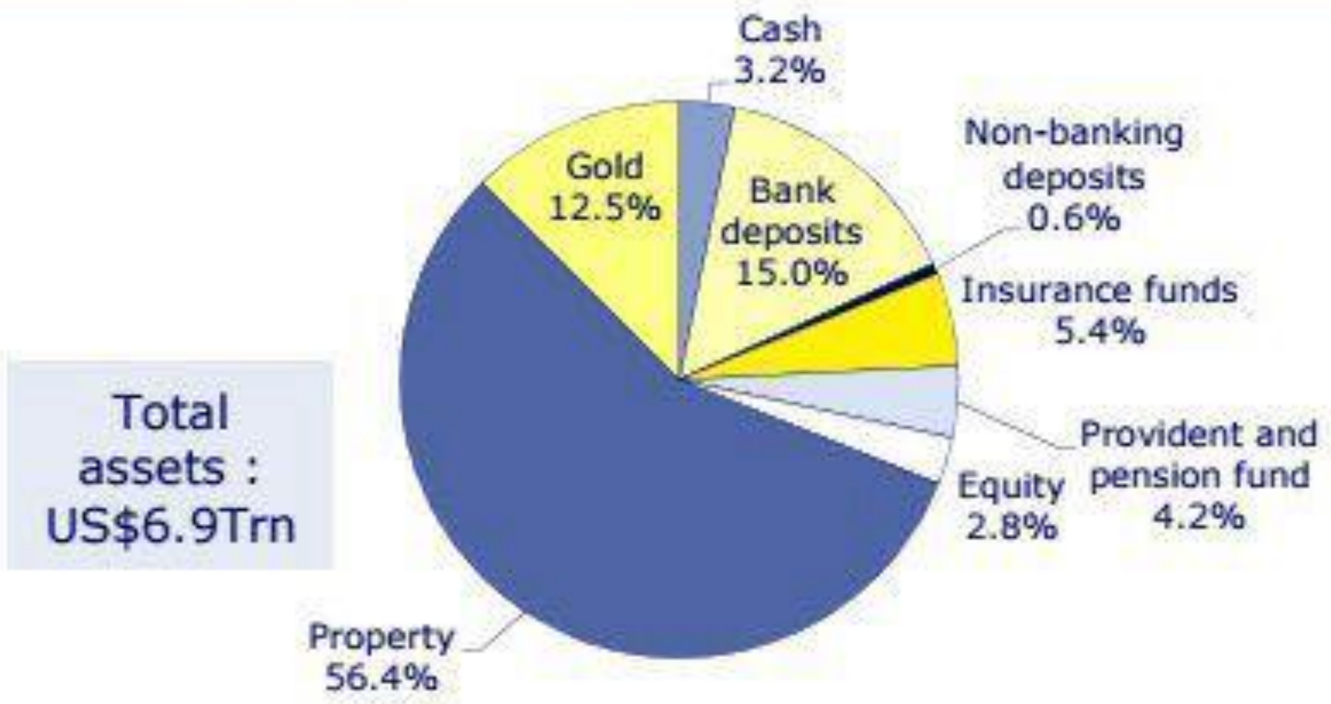
Text: ASHUTOSH R SHYAM

Returns in India

- Over all time periods, Bank Fixed Deposit have given negative Real return (Bank Fixed Deposit Return – Avg Inflation)
- Highest return asset class – Equities – has only 6.1% of the household investment in 2014.
- Too much of wealth is tied in physical assets rather than financial assets

ASSET WISE BREAK-UP OF WEALTH IN INDIA

Indian household assets as of Mar'16



Source: CLSA, RBI

APPENDIX – EQUITY INVESTING

Case for Equities

- History favors Equities
  - Returns observed in major markets from 1900 – 2010

COUNTRY	Equity Return	Standard Deviation	Bond Return	Standard Deviation
Australia	9.1%	18.2%	2.3%	13.2%
Canada	7.3%	17.2%	2.6%	10.4%
France	5.7%	23.5%	0.8%	13.0%
Germany	8.1%	32.2%	0.8%	15.7%
Japan	8.5%	29.8%	1.6%	20.1%
UK	7.2%	20.0%	2.2%	13.7%
USA	8.3%	20.3%	2.3%	10.2%

- Over the last 35 years, Sensex has returned 17% p.a.

Case for Equities

- Tax policy in India favors Equities
  - 0% L-T Tax on Gains for Equities held > 1 year.
  - 15% S-T Tax on Gains for Equities held < 1 year.
  - Compare this to up to 34% tax for Fixed Income investments.

- Helps protect purchasing power
  - High inflation in India. Equities act as a natural hedge.
  - Ownership of business that can withstand vagaries of time.

- World is getting smaller and India is getting prosperous
  - Provides participation in upside of business.
  - Massive migration of people into middle class with higher disposable income.