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Manish Bhandari on Value Investing in India

We recently had the pleasure of interviewing Manish Bhandari, managing partner and CEO at Vallum Capital Advisors, based in Mumbai, India.

MOI Global: Please tell us about your background and the genesis of your firm.

Manish Bhandari: I did my undergraduate studies in accounting and headed for post-graduate studies in business administration, with a major in finance. During my post-graduate days, I regularly followed a leading newspaper *Business Line*, which used to publish detailed industry analyses of various industries in India. I was always excited to find a treasure trove of industry information in those articles, and my inquisitiveness and desire to know more about various industries and companies motivated me to join an Institutional Broking Firm after completion of my Post-graduation.

I have worked in all three facets of capital markets – first five years of my career as a sell-side Institutional equity research analyst, subsequent six years in fund management with a global firm, ING Investments, managing $450 mn equity Asset Under Management of Mutual fund & Insurance portfolios, and the last eight years as co-founder of Vallum Capital, a boutique investment management firm managing capital on behalf of family offices in the Indian equity markets.

My six-year stint at ING gave me a good ringside view of money management, but I had a burning desire to build a firm that can overcome institutional constraints, such as disincentive for the concentration of positions, shorter review period (which hampers long-term investment results), and cherish the joy of entrepreneurship. "*Vallum fossa*", a Latin word, is synonymous with a moat (a significant concept in investing). We are obsessed with identifying and analyzing moats in not just investee companies, but also in our approach to business, engagement with clients, communication with the external world, etc.

With this background in mind, I set on my entrepreneurial journey in the Year 2010-2011 along with co-founder Madhusudan Sarda, whom I met in my first job in the Year 2000 while both of us were starting our career as equity research analysts. He is a trained chemical engineer turned equity investor and brings a unique perspective to evaluating companies.

MOI Global: How do you define your investment universe and generate ideas?

Bhandari: We are guided by our investment philosophy of investing in mispriced securities value, in reference to underlying business dynamics, available at a reasonable price. Idea generation is a wide and diverse process that fosters both independent thinking and intellectually generous collaboration with the team. We use a blend of top-down and bottom-up research methodology for our idea generation process. We look for companies with characteristics, such as an ability to gain market share, challengers to a dominant player in an industry, companies having a return on capital employed more than the cost of capital.

We have a three-tier screening process to reach our desired goal of shortlisting potential investment candidates while navigating through a chaotic universe of around 600 companies with an Enterprise value of more than $300 mn in a diverse set of industries. Initial screening of stocks is done on the basis of various balance sheet and earnings parameters. This is followed by an evaluation of the accounting practices of potential candidates.

Once we have a handful of businesses to evaluate, we undertake detailed analysis of underlying business by reading annual reports, earnings transcripts, speaking to suppliers, competitors, following industry publications, etc. Usually, 40% of ideas get to the last level for the evaluation of valuation parameter. We pay great attention to the underlying business cycle and how EBDITA multiple valuations are trading in the cycle in context to long-term EBDITA multiple with some adjustment addressing the shortcoming of this before making a final judgment.

We periodically review changing edges in research while making incremental progress in testing and employing new processes and signals. Let me admit; it's a harsh mental dialogue you are having with yourself. A decade back, there were 30-40 quarterly conference calls held while the number has crossed more than 550 this quarter in India. The access to management and information as an egdes which has exsisted, not any more. The globalization of trade and synchronization of monetary policy across the developed world is forcing investment professionals to understand the issues impacting them rather than relying solely on static information. Acknowledging this changing paradigm, we have expanded our reading horizon manifold, over the last few years.

MOI Global: What sources of competitive advantage have you found to be most durable?

Bhandari: There are different sources of the excellent performance of a company, which differs for each industry. Let me elaborate these sources: Brand and Distribution reach in consumer franchises, cost leadership in a commodity business, conservative financial management for companies in many other industries. While the sustainability of competitive advantages has become a tall order in these disruptive times, our experience suggests that *people with good intellect staying for long periods with the company and appropriate use of technology* is widest and sustainable moat (source of competitive advantage) for most of the businesses. In India, champions of wealth creation like Kotak Mahindra Bank, HDFC Ltd, M&M, and many other companies have showcased this advantage to the world. Although I fear in the rapidly changing world, this may also get challenged someday.

MOI Global: When it comes to equity analysis, how do you assess the quality and incentives of management? Which CEOs do you admire most?

Bhandari: India has a unique structure where the majority of companies are owned by the promoter or controlling families. Sponsor shareholders by virtue of their shareholding have all incentive for enhancing shareholder value. These days, many companies have emerged where professional management is leading the role on behalf of sponsor shareholders. We use a mix of quantitative and qualitative metrics to judge their incentive for value creation towards minority shareholders. We firmly believe that creating right strategy, culture, and process for running the company is a prerequisite for shareholder value creation.

Firstly, we look for intellectual fanatics who are driving companies on the best operational efficiency parameters within the Industry. This also helps us in avoiding relative value trades while evaluating companies.

Secondly, we eagerly look for data points to identify the management teams who have an inclination and the tenacity to endure short-term pain in order to gain long-term strategic advantage. We have an investment in a middle market oncology pharmaceutical company, which is expensing out Research and Development expenditure amounting to about 25% of profit before tax (PBT) for building long-term competitive advantage, much higher than industry.

Lastly, it is also about the conduct of trusteeship by managers toward minority shareholders. Our experience of managing money over the years helps in judging this aspect. An excellent balance of some of these aspects helps in judging incentive of management, which would create wealth for stakeholders. This is referred as qualitative skin in the game. Investors scanning companies on only quantitative measure as alignment of interest, have had missed one of the best compounding stories, a housing mortgage conglomerate in India, where the operating management holds an insignificant stake in the company.

I admire many CEOs and Promoters, but I would like to mention about Mr. Anand Mahindra, Chairperson of Mahindra and Mahindra Ltd for his ethics, value system, ability to spot the right opportunity, endurance in the conduct of business, and empowerment of his managers. He is an outstanding champion of shareholder value creation in business and a role model to many Indians.

MOI Global: Do you typically seek dialogue with the management teams of your investee companies? What is your view of the potential opportunities and hurdles to “activist” investing?

Bhandari: I am fascinated by your thoughtfulness for asking this question that has deep connotations. Superior access to management team does help understanding the culture, the ethos of the company, giving feedback to them and keeping a watch on understanding industry development. Institutional money managers have an advantage over boutique firms or amateur investors handling their own money.

However, I strongly believe this is not a prerequisite for *investing or harvesting* a successful Investment. When we started our firm with a meager capital under management, getting access and the opportunity to be heard was a challenge. I would call this a blessing in disguise for us. We built a wholly independent system of evaluating a company by speaking to a plethora of people like suppliers, customers, competitors, bankers, dealers of products, employees for the culture of firms and reinforcing our beliefs/opinions by reading industrial magazines, etc.

These practices gave us an excellent directional view of a company and positioned us to have far less reliance on what management, as an excellent sales person, might have to say about their company. Annual General Meetings, a less crowded platform is one of our primary engagements mediums with investee companies. It is structured events which help in gathering long-term data points and navigate through quarterly noises. Our ability to get independent evaluation has also prepared us for the possible introduction of MFID II rules, if any time in India considering negative consequences for firms’ dependent on evaluating ideas researched by broking firms.

Shareholder engagement is an evolving concept and activism is yet distant in India. The proxy advisory firms made a good beginning over the last few years. However, the progress is plodding due to inactivity of dominant pools of capital held by Mutual and Insurance Funds. The real push on the activism will come when the assets of alternative capital industry and family offices, who are far more concerned about the governance of the company, will reach a critical size. At Vallum, we actively formally communicate to the Board of our investee companies about our suggestion, grievances, giving a gentle nudge on issues concerning us.

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MOI Global: Which aspects of the investment landscape in India do you believe are overlooked or misunderstood by foreign investors? What in your opinion is the biggest investment risk that applies distinctively to India as opposed to markets globally?

Bhandari: Investing world is mesmerized by high growth and favorable demographics of India markets. Every CEO of MNC has an aspiring statement about *India's consumption* landscape. The investing landscape in the country has its own peculiarities and caveats for portfolio investors.

The earning power of demographics is unevenly distributed across the country, is growing at a slow pace, and is not a linear curve. In such case, overpaying for perceived linear or power law growth can be a graveyard for investments of growth investors. Hence, Investors must be cautious about the true potential of the growing landscape and value they are ascribing. It is an innate human nature on the part of management to communicate growth each year, especially when the world is generously rewarding growth.

Occasionally, Investors should refer to *The adventure of Silver blaze* when Sherlock Holmes hints at Watson to take a clue from *"Dog which did not bark"* to solve the mystery. Hence it is equally important to listen to guys who are cautious in their approach while conducting business in a high growth market.

Recently, Indian investors have come to terms with a BSE Sensex stock Yes Bank, widely owned by many institutional investors, growing at a frantic pace, having a charismatic promoter, with aggressive commentary but which has recently witnessed dislocation in underlying business as well as stock price. Vallum maintained a cautious approach towards such high octane growth companies as they leave less room for margin of safety and huge penalties on error.

Secondly, the country ranks low on innovation and, hence, many businesses sit on the edge of consolidation in order to achieve economies of scale, address regulatory, and technological changes. Last but not least, the country has allowed foreign direct investment (FDI) in most of the areas over the last two decades. This has a far-reaching consequence; many businesses owned by MNCs are unlisted (limited reporting of financials), while an investor with a myopic view may get *fooled by randomness* towards buying a listed business as a proxy of growth in that industry.

Consequently, it leads to a narrow set of stocks chased by a larger pool of capital leading to periodic overvaluation in pockets. I will not be surprised, over the next few years, if stock market indices cease to become proxy of a high economic growth rate of the country. Therefore, it is crucial for top-down investors to lay their feet on the ground and get a clear signal from the diverse set of data points while making investments.

MOI Global: Would you describe a case study that reflects your investment approach?

Bhandari: I will highlight two ideas in brief; one where we invested two years back and harvested this year, while the other is currently among our top position. As I mentioned, we follow a blend of top-down and bottom-up to screen potential mispricing of Ideas. Over the last half a decade, we have taken an active interest in development in China, the impact of its policies on a wide range of sectors.

We noticed an interesting opportunity emerging in likely shift from making of steel from the blast furnace to Electric Arc Furnace (EAF) in China, the rising crescendo of antidumping duties on steel across the U.S., Europe, which manufactures more than 70% of steel via EAF route. Interesting, EAF requires graphite electrodes as consumables for running furnaces. The electrodes industry, globally, went thorough tailspin, due to the deflationary impact of steel manufacture by blast furnace (an alternative to EAF Route). This led to consolidation and rationalization of the electrodes supply of around 20% of industry capacity.

The signal from bottom-up research on one among the two of the listed graphite electrode companies was very compelling: stock trading at Market cap of US $300 mn with cash of $100 mn on books, management with alignment of interest with minority, efficient operation, underlying business at cyclical low versus a bull cycle half a decade back while the stock price has remained stagnant at the same price for last five years. It was a perfect storm in the making. Subsequently, as envisaged, the electrode's prices shot up five times, EBITDA shot up forty times over the next eighteen months, and the stock price increased eight times. Let me admit; we did not envisage such a dis-proportionate positive change in earning matrix, but investing thorough *capital cycle* did reward us in the process.

We have another position in Muthoot Finance, a company that extends loan against gold. This is a unique business proposition as India is one of the largest buyers of gold in the world and more than 50% of it finds its way in rural India. The gold owner pledges gold to meet the shortfalls of expenses and company extends approx. 70% of value against the pledged gold. There are only 3 companies of meaningful size in this business, and it has a legacy of a century.

Also, the company has started benefiting from the network effect by leveraging a referral base of 0.2 mn customer visits to their branches to build Micro Finance, affordable housing, and insurance business. I believe the legacy moat will help the company to grow faster without any dilution for a considerable period of time while the market has overlooked its strong franchisee.

MOI Global: How do you think about the art of valuing a business? To what extent do industry-specific considerations or industry comparable play a role and to what extent do you focus on "shareholder earnings" or free cash flow?

Bhandari: We believe the evaluation of business is science while understanding the bridge between the performance of a business and stock price is an art. An investor may own one of the indefatigable moats with the characteristic of a compounder, but still, it may translate into subliminal stock performance. The answer lies in trusteeship demonstrated by owners, the macro cycle of the flow of money, and many such factors, which are beyond the control of any investor and difficult to judge. Experience beats quant and art beat science here. I am in favor of using multiples of EBDITA for some industries for valuation as it is less distorted over shareholder earnings. We do use free cash flow with some caution. We have been devoid of the pleasure of evaluating monopoly tech platforms in India as we have none.

MOI Global: How do you strike the right balance between being concentrated in your best ideas while remaining sufficiently diversified to keep downside risks under control?

Bhandari: We invest in 20-22 opportunities, and top 10 holdings account for more than approx. 55% of fund value. Our portfolio turnover ratio is around 20-22%, which means an average holding period of more than three and a half years, although we have held many positions for more than six years. Public equity volatility can opportunistically help to *lower* the risk of permanent capital loss by allowing us to reduce our average purchase price and avoid the temptation of employing leverage. This approach to public market investing means that volatility is welcome, and no efforts are made to smooth investment returns.

Risks of permanent capital impairment are mitigated by avoiding leverage at the portfolio and company levels, employing a long-only strategy. Since we manage an open-ended fund and our fund size is growing, I have no precise answer on concentration as liquidity and impact cost is one of the criteria while investing and while exiting positions. We are of the opinion that buying a business at a moderate underlying business cycle takes care of business risk for our portfolio.

MOI Global: What is the single biggest mistake that keeps investors from reaching their goals?

Bhandari: One of the fundamental contradictions our industry offers is that short-term outperformance is rewarded while underperformance is met with withdrawal by investors. The short-term can be defined in terms of time period up to one year. This leads to pressure on the Managers to perform in the short term and follow the herd. This phenomenon and its implication on investment performance are explained in *A Zebra in Lion Country by Ralph Wanger*. A manager should admit that styles go out of fashion in the intermediate period and suitably communicate this to prospective investors, before engagement. This built trust with clients and sets the basis of long-term engagement.

MOI Global: Which one or two recent books have given you new insights into the art of investing?

Bhandari: The book, *Capital Returns: Investing through the capital cycle – a money manager's report by Edward Chancellor* has left an indelible impression on me. The central theme of the book is that excessive investment drives down returns and leads inexorably to a boom-bust cycle. This was the case with the technology companies, the U.S. housing market, mining, energy companies globally and recently with Housing finance and Non-Banking Finance companies in India. From an investor's perspective, one should avoid investing in sectors where investment spending is unduly elevated, competition is fierce while investing where capital expenditure is depressed, competitive conditions are more favorable and, as a result, prospective investment returns are higher. I would also recommend reading *The Art of Contrary Thinking by Humphrey B Neill,* which opens our mind to a range of possibilities and how to practice contrary thinking.

MOI Global: If you had to pick another investor to manage your money, who would you choose and Why?

Bhandari: I would like to hand over my hard earned savings to Mr. S. Naren, *Chief Investment Officer* of ICICI Prudential Mutual Fund in India (since the past fifteen years). The key characteristics that differentiate him from most of the managers in India are: his unique understanding of business cycle drawn from the knowledge of various asset classes, application of contrarian approach to Investing, and an attitude of trusteeship towards investors, which makes him unique in fund management business. He rose the ranks in his firm by starting with managing one equity fund of U.S. $50 mn in the Year 2005 to an AUM of $60 bn (debt and equity) presently as a CIO. I would consider this an extraordinarily remarkable achievement and an endorsement of his capabilities. I had the good fortune of working with him and was mentored by him while I was a sell-side analyst in the Year 2002 at an Institutional Broking Firm while he was overseeing research at the same firm.