

Sid Choraria Shares His Insights into Investing in Asia

We recently had the pleasure of interviewing Sid Choraria, Asian Equities Portfolio Manager. Based in Hong Kong, Sid applies a bottom-up value approach, including extensive scuttlebutt research, to investing in Asia.

Sid Choraria is an Asian Equities Portfolio Manager focused on identifying exceptional businesses, cultures and CEOs/management teams to invest like a business owner, preferably for 10 years or longer.

The typical company Sid prefers is a business that can endure the risk of impermanence over decades. His research indicates that over 98% of investable companies fail the test. The culture must be unquestionably superior. Such companies are customer obsessed and have strong non-transactional relationships with constituents. Sid prefers early-stage pricing power that is not discovered. The universe is limited to exceptional Asian businesses and great global companies with significant revenue and cash flow from Asia very material to shareholder value.

In Aug 2013, Sid elicited a rare response from legendary Warren Buffett with a letter and thesis on an under-followed, 135-year-old Japanese company. The company, Kobayashi Pharmaceutical (4967 JP) founded in 1886 is as old as Coca Cola and Wrigley's chewing gum but with poor coverage when Sid discovered it. He presented the idea on MOI in 2013. Since the letter, business value has quadrupled compounding roughly 26% outperforming the S&P, NASDAQ and respective Asian indices. The inversion lessons influenced Sid's journey to focus on less followed companies, great cultures and businesses that can endure the test of time.

Sid enjoys mentoring young talent and giving back knowledge by speaking at the world's top universities like Harvard, Princeton, Columbia Business School, NYU Stern, LBS, USC and Brown. From 2014-2016, he consistently won a few research awards for probing research on Asian companies judged by over 70 judges. His contributions have featured in Goldman Sachs Alumni Network, CNBC, Sydney Morning Herald, Alpha Ideas India, Value Spain, Intel and GIC.

Sid has worked in Asia for 15 years and grew up in the region. Previously, he has served in senior investment roles in Asia, at multi-billion long-only and long-short funds. He worked at Goldman Sachs technology investment banking in Asia. These experiences taught him the significant importance of teams, culture and incentives.

Sid received his MBA from New York University Stern School in 2011 and was recipient of the Harvey Beker Scholarship. During his MBA, Sid worked at Bandera Partners, a fund focused on small mid cap activism, run by Jeff Gramm, Author of "Dear Chairman", Greg Bylinsky and Andy Shpiz.

MOI Global: Please tell us about your background and how you became interested in value investing. Which people or events have influenced your investment thinking the most, and why?

Sid Choraria: Firstly, I grew up in India around an entrepreneurial family from the region of Marwar (Rajasthan), where I learned about business as my father, a first generation entrepreneur, worked hard to start and grow his company. Though I did not know it at the time I was learning, at an early age, the importance of returns on invested capital, free cash flow, and the power of compounding.

Second, early in my finance career, I read the early partnership letters (late 1950s - 1970) of

Berkshire when Mr. Buffett was in his 20s. I was immediately struck by the simplicity and elegance of value investing. Outside of my family, these letters have had the single biggest influence on my life which has led to a deep interest in value investing. The letters sparked my interest to read constantly, be curious, and engage in something you love. Along the way, several investors have further shaped various aspects of my thinking, like Peter Lynch on finding niche ideas in day to day life, Munger on incentives, Fisher on scuttlebutt research, Mohnish Pabrai's book *The Dhandho Investor* and the annual letters of Third Avenue, Baupost and Dalton Investments.

In terms of my background, I have spent most of my career in Asia at Goldman Sachs and Merrill Lynch. Prior to Goldman, I worked at a value fund in New York for a Columbia adjunct value investing professor and an NYU alumni analyzing under-researched small and mid-cap companies and special situations. I have an MBA from NYU Stern, where I was a Harvey Beker Scholar and member of the Michael Price Value Fund (part of the university endowment fund). I have been incredibly lucky to meet mentors in my career along the way who have encouraged me – it is the people that we meet that make a difference!

MOI: Please describe the opportunity set for a value investor in Asia. What are some key differences between the Asian and U.S. equity markets? Which aspects do you think are generally misunderstood by U.S. investors who invest in Asia? Also, how should one think about the differences across the various Asian equity markets?

Choraria: Asia is a rich fertile hunting ground for bottom-up, value investors willing to conduct primary investigative research. The investing opportunity set is huge with more than double the number of listed companies than in the U.S. Moreover, hedge fund assets in the region are a mere fraction of global assets, which creates significant opportunity. A large number of companies in Asia have practically no dedicated sell-side research coverage providing a disciplined analyst an immediate edge. The opportunity set in Asia today reminds me of a quote by legendary value investor, Michael Price “In 1984, very few investors in London looked at securities like in New York. Many companies in London would have no analyst visit them. Invest where others are not looking.”

In addition, perceived differences in regulations, language, culture, corporate governance and accounting standards across the myriad countries in the Asia Pacific region create the perception of the opportunity set in Asia as “too far, too hard” amongst U.S. investors. While there are differences across various Asian markets, the same bottom up principles to understanding the competitive position of a business and the capital allocation record of management apply.

MOI: How do you generate investment ideas?

Choraria: I concentrate my idea generation efforts within the under-researched areas of the market, typically small and mid-cap companies in Asia Pacific, which tend to be ignored, misunderstood and provide the most interesting opportunities. I like generating original ideas, companies that are off the beaten path and with potential to grow but the underlying theme is always finding value.

I look to source ideas constantly, through a variety of sources that keep me intellectually curious. Some of my ideas can come from just paying attention to companies in Asia in day to day life. I developed an exhaustive screening database that assists me for key factors I look for in a forensic way, quantitative and qualitative. These can include return on invested capital, quality of earnings and free cash flow, significant share repurchases, insider buying, brand, customer captivity and pricing power. I also generate leads by asking companies “Which of your competitors do you fear the most?”. Finally, I regularly read value oriented publications.

Once I narrow it down to a certain set of opportunities, my investment process is driven by a bottom-

up, fundamental research approach. I like to spend a substantial amount of time understanding the business, specifically its competitive position (i.e. pricing power, economies of scale, customer captivity). Then I look for an alignment with and incentives of management with shareholders (i.e. capital allocation, compensation, sticking to core competency, etc.). Finally, I look for opportunities to purchase companies at a substantial discount to the price a rational private owner would pay for the business.

I keep a watch list and add companies when they pass the first two criteria but do not meet the price. Accumulated knowledge about the business, industry and management often lead to additional opportunities. I also follow some prominent value and private equity investors to see if they might be shareholders in the business. While their presence is not necessary, if the value discrepancy is large, it can be an advantage to have an informed investor engage in value creation and invest alongside them.

MOI: What are some major sources of equity mispricings that occur in Asian equity markets and that you are looking to exploit?

Choraria: In looking for mispriced stocks, I pick my spots and do research where the general consensus is not – a differentiated portfolio is key to generate alpha. The Asia Pacific small and mid-cap segment is naturally an exciting place to be as it is less followed by informed investors, typically unrelated to the merits of investing in the business, which offers scope for material inefficiency. Additionally, Asian markets can be a lot more inefficient in the short-run, as markets tend to be focused on the short-term and fixated on growth. There is also a big premium on liquidity and one can be paid handsomely for taking a longer term view and position in “temporarily” illiquid stocks. I also tend to look at out-of-favor industries and stocks as well as special situations and try and understand if there exists a large gap in valuation to the underlying value of the business. All this creates a time arbitrage by taking a longer term view. An example of a mispriced stock in an out-of-favor sector was Tata Sponge (India: TTSP), where the market was valuing the company for less than 0.5x FCF despite being profitable every year for 20 years and with strong management, given the “Tata” corporate governance.

MOI: Would you elaborate on the previous question by way of a past case study and lessons learned from it that you can apply to future investment opportunities?

Choraria: An illustrative past case study of a mispriced stock was Clear Media (Hong Kong: 100), a Hong Kong listed small cap company with majority ownership by US listed, Clear Channel Outdoor (CCO) and with value oriented shareholders, International Value and Bain Capital on the Board. The company has a predictable business with long-term contracts and is the dominant outdoor bus shelter advertising network in China with over 75% market share in key cities. The company has a track record of prodigious free cash flow generation through several market cycles. Just a little over a year ago in January 2013, the company’s shares traded around HK\$4.1. The company at HK\$4.1 had a market capitalization of approximately US\$300m and enterprise value of US\$140mm with a strong balance sheet with over 50% in net cash. The stock was available at less than 1.5x EBIDTA, 2.8x EBIT and a 35% free cash flow yield all this time while the company on earnings call (that few investors were listening in to!) was intent on returning some excess cash to shareholders. Fast forward to March 2014, at recent share price of HK\$7.20 and including the special dividend of HK\$1.32 paid to shareholders in August 2013, the shares have more than doubled with a market capitalization currently of \$500mm.

Several reasons unrelated to Clear Media’s business contributed to the stock being mispriced. First, the stock was not covered by the sell-side community (Morgan Stanley discontinued coverage in 2012 due to allocation of internal resources, while admitting to undervaluation with their last report titled “Ad sales to climb, yet valuation at historical low”). Second, the shares were relatively illiquid, and

institutional constraints prevented most large cap funds from covering the name, again unrelated to the business. Third, uninformed investors were likely incorrectly valuing the stock on P/E instead of cash flow due to non-cash amortization charges given Clear Media's business model. Finally, the sector was oversold with the common perception that corporate governance broadly was poor, incorrectly in the case of Clear Media with value oriented management, shareholders and board members.

Another example is Mayur Uniquoters (India: MUNI), an under-followed gem in India with a niche in artificial leather (India's largest manufacturer of synthetic leather with ~25mm linear meters installed capacity). Mayur was off the radar with limited institutional ownership. Just a little over six months ago, the shares traded at INR 260 (pre 2:1 stock split in March 2014) at US\$100mm market cap at an undemanding valuation of 7x EBITDA with only one local analyst covering the name when I spoke with the CEO who is based in Jaipur, Rajasthan, India. Mayur had already demonstrated consistent earnings power (net profit positive every year for 14 years and free cash flow positive for 10 out of the last 14 years), high returns on tangible capital employed (over 80%) and a competitive moat due to local economies of scale, 2.5x larger than the next competitor in terms of production capacity and significantly higher operating margins. Mayur also had an impressive client list including Bata, Ford and Chrysler and was voted in Forbes Best Under a Billion in 2012. Fast forward, to April 2014, the company's shares have doubled and institutional ownership rising with the company recently securing an important investment of approximately \$20mm from well-known private equity firm, West Bridge Capital.

MOI: What is the biggest mistake foreign investors make when investing in Asia? What do you do to avoid making the same mistake?

Choraria: An inherent bias foreign investors perhaps have is characterizing certain Asian markets as "value traps" and or the overall opportunity set as "too far, too hard". There are several reasons for that initial bias, which include perception about corporate governance. Another common mistake any investor can make is to accept accounting earnings at face value without a deep understanding of business drivers, competitive advantage, and profits. It is important to do your own work and understand how companies generate cash flow and if it is sustainable. It is critical to evaluate management alignment with shareholders and be wary of promotional management. Good management will be equally as forthcoming about mistakes and I look for that more often than the successes. It is not just about investing alongside "excellent" management - but studying the capital allocation record and seeking out owners that eat their own cooking, either through ownership, repurchases, compensation alignment, etc.

An example is Japan, a market that is often characterized as a "value trap" where perception is that management is not focused on value creation. I would like to highlight Kobayashi Pharmaceutical (Japan: 4967), an under-researched Japanese mid-cap, despite a market capitalization of over \$2.5bn and with a rich 125 year old history of dominating niche markets with limited competition and products with sustained market share over 40%. I am a captive customer myself of several Kobayashi products. Kobayashi is not your typical Japanese value trap with the company having grown net income and dividends for 15 consecutive years. The core business has returns of tangible capital employed in excess of 50%. Management have a track record of good capital allocation and have actively divested off two non-core divisions (wholesale and medical devices) which were lower margin businesses to focus on their core cash cow business (divestments led to a large drop in total sales while core group sales increased and margins expanded). Finally, the company has had six CEO's in their 125 year history (average tenure over 20 years). Impressively, Kobayashi instituted a proprietary management index indicator (adopted from EVA of Stern Stuart) called Kobayashi Value Added (KOVA) starting FY2002, which measures the efficiency of capital employed and capital efficiency in working capital. KOVA is reflected in the performance appraisal of officers and those with senior titles,

so that the entire group will fully appreciate the cost of capital. Management have skin in the game with insider ownership and were buying back stock at the depth of the financial crisis in 2008.

MOI: If valuation were not a factor currently, which is one of your favorite companies and why?

Choraria: One of my favorite companies in Asia is Tsui Wah (Hong Kong: 1314), a Hong Kong-style fast casual dining restaurant chain, the leading “Cha Chaan Teng” chain operator in Hong Kong based on revenue and market share. Cha Chaan Teng, or Hong Kong-style restaurant, is an iconic representation of Hong Kong’s dining culture. The company traces its humble roots to 1967 in the bustling streets of Mongkok in Hong Kong. At its current share price, Tsui Wah has a market cap of nearly \$800mm. As of January 2013, the company has 22 stores in Hong Kong, 1 store in Macau, and 5 stores in China. The company’s operational effectiveness, sales floor efficiency and per store EBITDA is higher than most restaurant operators globally. Tsui Wah has incredible pricing power, very low payback period for each incremental restaurant and strong customer captivity. The company has a significant growth opportunity ahead of it as the company expands in China, where it currently has only 5 stores. Admittedly, I visit Tsui Wah several times a month as I am a captive customer. For those that have not been to Tsui Wah, take a look at the [“Top 10 Dishes”](#) - (I recommend the milk tea for new comers to Tsui Wah and to Asia).

MOI: Would you briefly share one of your favorite current investment ideas - what were the key criteria for assessing it?

Choraria: I like Nesco (India: NSE), an underfollowed mid cap in India. The company is a mispriced stock providing downside protection given its huge asset value and significant upside due to its core exhibition and IT park business (with EBIT margins over 70%). In addition, the market has not caught on to future earnings potential which further accentuate the Heads you win, Tails you don’t lose much investment thesis with Nesco. Nesco owns a 70 acre plot of land with close proximity to the Mumbai airport, which the company bought in the 1950s. This provides the company’s core business with a wide and enduring moat and is currently held at cost (approx. \$1mm) on the balance sheet. However, the asset value of Nesco alone is conservatively worth 2.5-3x times the current market cap of the company (\$180mm market cap; \$140mm enterprise value, \$40mm net cash).

Further, the core business has high barriers to entry and is a cash cow currently available for under 6x EBIT. On this 70 acre land Nesco owns, the company has developed and operates India’s largest private exhibition centers, a 450,000 sq ft exhibition center which is booked a year or so in advance counting blue chip global companies as its customers. Additionally, Nesco owns two IT park buildings that it leases to blue chip clients like Tata Consultancy on a long-term basis. The company just finished development of IT Park 3, which is 660,000 sq ft and is expected to grow revenue conservatively by 25% in FY 2015. The exhibition and IT park business historically have had EBIT margins over 70% as they own the land. There has been talk of supply with the BKC center, but that has had ongoing delays since 2006 and land cost prohibitively expensive providing some guidance on the asset valuation of Nesco. In sum, to compete with Nesco’s exhibition and IT park business, a competitor must i) secure a large space in Mumbai, ii) with proximity to an attractive location, iii) pay almost zero for it to have a similar margin profile and iv) secure long-term clients. Even one of these would be difficult, all four highly unlikely. Mr. Sumant Patel, Chairman is educated at Penn and his younger son, Krishna Patel has joined the business and the board. Capital allocation has been good with capex funded entirely through cash flow. Insiders are paid conservatively and eat their own cooking.

MOI: Are there any instructive English-language resources that you could refer investors to who are interested in learning more about Asia and related investment opportunities?

Choraria: I think investors looking at learning about Asia can learn a lot by reading the letters and

following investors who have been in Asia for a long time through market cycles, including Third Avenue, Dalton Investments, APS Asset Management, Value Partners, GaveKal Research etc.

MOI: Thank you very much for your time and insights.

This conversation was recorded in 2014.