

Mr Kuntal Shah's conversation with Rohith Potti, on behalf of MOI Global

This transcript is an edited rendition of the zoom conversation between Rohith Potti, on behalf of MOI Global, and Kuntal Shah, a public markets investor investing in Indian equities for nearly three decades now.

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MOI Global: Like America has Wall Street, India has Dalal Street. Our guest Mr Kuntal Shah is widely known in the Indian investing community as one of the wizards of the Dalal Street. He wears many hats. Firstly, he is an investor. He has had a prolific track record of investing in the Indian stock market for close to 30 years now. He is the founding partner of Oaklane Capital, a boutique investment firm. In the past, he has provided strategic and board level advice to various firms. Secondly, he is an excellent teacher. He is part of the Board of Management of Flame University, a liberal arts university in India focused on providing multi-disciplinary education to its students. Thirdly, he is an entrepreneur as well. He recently became a co- founder of Needl.ai. A diligent investor, a generous teacher, and a voracious reader, there is a lot to learn from him. Thank you, Mr. Shah for doing this, it's an honour to be interviewing you.



Kuntal Shah: Thanks, Rohith for your warm and generous introduction. I hope I live up to the expectations you have set going into the meeting.

MOI Global: Mr. Shah has kindly and very generously created a presentation for our meeting today, and he will share his presentation while we go through our conversation. Mr. Shah, let's start with your background. Could you share your evolution, and how you came into investing first? Then probably you could share the evolution of your investment philosophy over the last 30 years. What were the various phases and how do you define your investment philosophy today?

Kuntal Shah: To be very honest, I stumbled upon investing as a case of pure luck and serendipity. I am an engineer by education. Please remember this was in the context of the 1990s when computers also had a maximum memory of a few KB, and there was no technology use case as it is prevalent today. We are talking of an era that is almost 3 decades old. We had extremely limited options in India back then. During the time when I was studying, there was a massive transformation in the Indian economy: the country opened up for global investments. Simultaneously, there was a securities scam, which resulted in the stock prices of certain companies which I knew intimately, to go up. When I used to ask the management what is driving growth, even they did not know the rationale behind the meteoric rise. I detected a sense of disconnect. My curiosity was aroused, and it seemed like a very great puzzle to solve. Here we were talking about managements who knew the businesses inside out but did not know what was happening in the stock market. Somehow the stock market was aware of something

major happening. And I thought if I could find the reason for this disconnect, there could be both, a profit potential, and a hugely satisfying career opportunity. That is how I landed up in the stock market, just by pure luck and serendipity.

Three Decades of Evolution as a Public Market Investor



Attribute	1990/2000	2000/2010	2010/2020
Philosophy	Statistical cheapness, Arbitrage, Event related, etc.	Valuation driven investing, Dupont, etc.	Longevity of Growth , Pricing Power, Reinvestment, Accounting, Value Migration, etc.
Edge	Scarcity of information, Relied heavily in getting right information: Relevant, Reliable, Understandable, Comparable	Plenty of information, diminishing value of information, analytical information	Information overload & negative impact of networked world, Behavioral
Volatility/ Tolerance	Negligible: Special situation, narrow range of outcomes, hard work & limited timelines	Fractional ownership of business: closing gap between price & value	Men amongst Boys: Scalability in sharp focus
Source of Capital and Structure	Family office (skipped Employment/ self employed route)	Proprietary with Private Equity stint	Public market investor with Friends & Family
Time	Short-term: Sentiment, Catalyst, Valuation	Medium-term: Cycle, Competition	Long-term: Culture, Adaptability, Pedigree, Incentives
Framework	Information	Insight (Information + Analysis)	Knowledge (Insights + Connect the dots in multidisciplinary manner)

Coming back to my philosophy, it has evolved over three decades. In the early 1990s, I was more of a “special situations” investor and arbitrageur. We are talking of an era where interest rates prevalent in the Indian market were in the high teens. You did not have to take too much equity risk to get the desired risk-reward outcome. Looking at it from multiple vantage points, the kind of capital I deployed, the investments I made, the kind of risk-reward outcomes I enjoyed, they were totally different. That geared me up to doing the hard work of evaluating companies for M&A and corporate action arbitrages, special situations, delisting from the stock exchanges arbitrages, arbitrages of securities listed in different stock exchanges. We did not require too much of a “business analytical” skills set. The biggest advantage we enjoyed then, was informational advantage, with focus on sourcing more and more information and then stitching up a picture of what could be the potential upside and downside. This kind of situation driven investing had a catalyst or a horizon in place and a very definite timeline associated with it. This was nowhere closely resembling to compounding and long-termism, which you see prevalent in the latter part of my evolution journey. The focus was short-term with a clear focus on minimizing the downside and maximising the upside in a very narrow window of inefficient domains and pockets of the market.

Fast forward, many of these opportunities ceased to exist, because of the large number of smart investors entering the stock markets post liberalisation of the capital markets in India. The focus changed to medium-term opportunities which were purely driven by numbers and the business, in terms of what could be done to reduce interest costs, reduce taxes, optimize asset turns, margins, fund the structure well. So, a basic bottom-up focus. The focus changed from information arbitrage to an analytical side, where we learnt to connect the dots and have a longer-term outlook towards the business. This coincided with capital, which was more permanent in nature, in terms that they were proprietary investments. It was during this phase, that I had the biggest learning curve of my life. I had a short stint of time as a private equity investor, which taught me a lot of things about how real businesses work and what the considerations of the management and customers are. It showed me

various vantage points of the ecosystem. I got exposed to how businesses are run at a very intricate level and that probably made me a better investor in the ensuing decade.

The last decade which was 2010-2020, marked a phenomenal change in the attitude and aptitude of my evolution. My focus turned towards intangibles and the competitive positioning of the business, the scalability aspect of the management, their drive and culture and their ability to adapt and grow. Obviously, the underlying overlay of analysing businesses and their prospects was there, but it was superimposed with more qualitative aspects. That completed the transformation of my journey from a pure arbitrageur to a pure long-term investor, focussed on long-term compounding. This was possible because I had middle-class upbringing. Early on, we were taught to have clear principles of inversion, that not everything matters but some things do. You must pay attention to who you surround yourself with and what not to do is as important as what to do. The whole trick is to have faith in your hypothesis but then to question it as well. This kind of duality in thinking enabled handling contractions and complimented the middle-class ethos of spending less money in order to save, being patient, focusing on the compounding of relationships, habits, knowledge, reputation and culture. This served me well for the time to come.

MOI Global: Thank you, Mr. Shah, that was a riveting account of the transformation you saw in the last 30 years. Here is something I wonder; all investors evolve, but habits developed over a long period of time are sticky and it is very clear that the transformation you saw over the last three decades has been quite sharp. The orientation of time horizon, the kind of investments you are looking at etc. How did you approach each transition period? Transition period definition is quite difficult. So first, probably if you could help us understand why you made the transition? What was the most difficult part of the transition? Was it redesigning the emotions, was it psychology or was it the process itself? One last question, your process for learning and unlearning anything new you enter...

Finding the Right Balance : Dealing with Contradictions



Risk	Reward
Confidence	Humility
Concentration plus cash call	Diversification plus always invested
Silo style/ limited mandate	Look for wide / flexible mandate
Aggressiveness	Conservatism
Hyper Active	Lazy
Risk seeking	Disciplined/ risk averse
Narrow specialization	Multidiscipline
Breadth	Depth
Rising valuation / dwindling opportunity estimate	Buying too soon on way down
Action	Inaction
Fully invested	Large cash
I know everything	I don't know everything

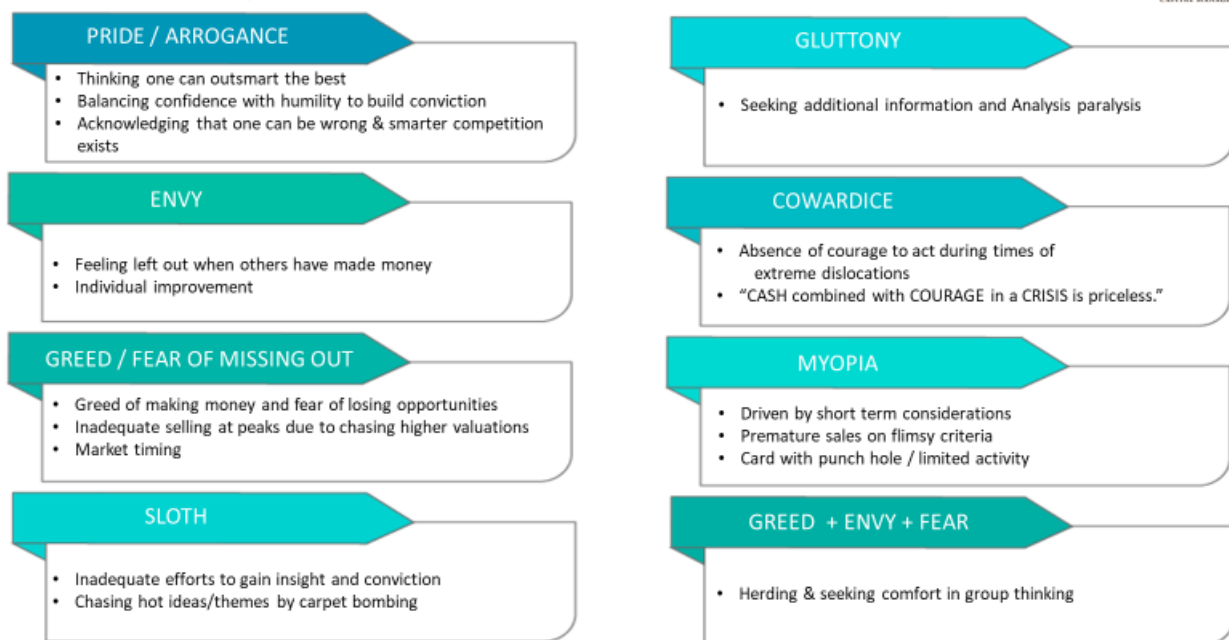
Confidence in foreknowledge	Skeptical regarding foreknowledge
Invest for one outcome	Hedge against uncertainty
Lever heavily	Avoid or limit leverage
Target maximum gains	Emphasize avoidance of losses
Conviction on narrow outcome	Probability of range of outcomes
Innovate	Optimize
Long-term	Short-term
Helicopter view	Tree view
Fear of missing opportunity	Fear of losing capital
Signal	Noise
Mean reversion	This time is different
Timing the market	Time in the market

Kuntal Shah: As I said, each decade added a different opportunity set, which I addressed, backed by a different category of capital. However, the key underlying message and theme was to first evolve myself as an individual and figure out what kind of investments I could sleep well with. The biggest challenge was handling the contradictions and finding the right balance. Investing is the last liberal

art, and first, the investor has to know thyself. Then only, come the choice architecture of which opportunities to pursue, how you define your processes, where you invest, will all evolve from there.

The single biggest issue in evolving over this time, was how to handle myself as an investor, and finding the right balance between the contradictions which are plenty in this field. Investing is a bundle of contradictions, so you must first minimise the risk, then maximise the reward. Secondly, you must have confidence in your hypothesis, but also be humble that there could be smarter people whose hypotheses are right, and what you have figured out is wrong. You have to break down your coverage siloes, and filter the opportunity set which is meaningful, yet small enough for you to cover easily. You have to be multi-disciplinary, balance aggression and conservatism, action and inaction, because quite often, nothing happens for some time in the stock market, and then there is a sudden bout of activity. Furthermore, you have to evolve your process, on how much to stay invested at differing levels of valuation. The most important, is to change the frame of mind from “I know everything” to “I do not know anything”. There should be a balance of confidence and scepticism. You have to avoid leverage, but make sure that the companies you invest in have operating leverage. You must have conviction on a narrow set of outcomes, but you have to filter out a wide range of outcomes, the odds and probabilities associated with them. In order to optimise the capital outcome, you need to handle all these bundles of contradictions, amplifying signals and reducing noise, timing in the market versus time in the market, since capital is very limited. You have to decide whether to invest closer to the catalyst happening, versus ignoring timing the market in favour of time in the market. Handling all these internal contradictions was the most difficult and challenging part of my journey. Honestly, I have made my fair share of mistakes too!

Sins of Investing Bible : Investment Implications



Here, I have what I call my biblical sins of investing, where I have been guilty, starting from arrogance where I thought I could outsmart the whole market, with conviction on a very narrow range of outcomes. I was guilty of having fear of missing out while others were getting rich. This affected my emotions in the early part of my career. There was sloth, of not doing the right homework and not being prepared when luck and opportunities came by. There was gluttony, where I would keep looking for more information and feed on the irrelevant parts. I come from an era where information was very scarce in the 1990s. Then it became abundant. Now information has become an overload. It has swung

from one extreme to another. You always keep waiting for more information and cannot make a decision, leading to analysis paralysis. There were times where absence of courage would let you down, where you had the money, but you were frozen and could not act in time. There were crises in 1997, 2000, where you just could not make a timely decision. Then there was obviously myopic thinking and reliance on short-term considerations, over-ruling long-term ones, knowing fully well that compounding works in the long-term. This combination of greed, fear, all kinds of mistakes, have been incurred in the past and I am sure they will continue to be incurred. However, I am hopeful that I have learnt from those experiences. Experience has been a great teacher, but she has given me terrific bills. The aspiration is that my next round of mistakes will be of different types and I will keep learning from them.

MOI Global: Could you speak more about personality? When you talk about these seven sins, I think, each of us have all of them, but we are more tuned towards or prone to some of them. How did you see the interplay of your personality and your pet peeves interact with your investing style? Did your personality influence your investing style, or was it the reverse? And what is your process for both to come into alignment over time?

Kuntal Shah: That is a very complex question. Investing is all about the process of tirelessly connecting the dots. I was lucky to have the right mentors, who guided me very well and I tremendously benefitted from their learnings too. People like Nemish bhai, Durgesh bhai, the other doyens of the industry I got access to. I have learnt on the shoulders of giants. Secondly, I have been teaching since the early 1990s, in some or the other form. I think, to be able to teach, you must first put down your thoughts in coherence and evolve your own framework. You have to be sure of what you are doing, with a lot of introspection to give you clarity of thought. Secondly, I was always a concentrated investor. I chose depth of analysis over breadth, and that allowed me to manage the information overload by design. I filtered out a lot of situations and businesses, as either too hard to invest in, not geared to survive, or outside my circle of competence. Moreover, the whole premise was that I had to allocate capital to protect it from inflation, friction costs, and taxes. Also, avoid bad decisions and it was not to beat an index or have some other kind of additional tangible outcomes.

If I triangulate between psychology, emotions and my investing process, how did I handle my emotions? I learnt a lot about the history of financial markets, which taught me that it is a story of cycles and human behaviour. It also taught me that all psychological and emotional stresses come out at extremes, when the fear of missing out and the melt-down occurs. I came to understand one thing distinctly, that the markets are not arbitrators of value. They have mood swings. Fear, greed and plain stupidity are continuously going to be dominant factors in the market till humans are deciding asset prices and running businesses, and those businesses are serving human beings. The investing process took care of this probabilistic range of outcomes, and I started focusing on events with low odds but high impact, along with the frequency and duration of those events impacting businesses. The desire to have long-term compounding taught me to avoid small swings and focus on the estimation of longevity of competitive power and growth while trying to avoid institutional imperatives and market inefficiencies. It taught me how to handle various stresses in crises by reminding myself—this too shall pass. So, as long as I was not leveraged, I did not lose my bearing during periods of dislocation, I was fine, and the results were quite rewarding too. I cannot overstate the role of mentors and role models enough. It was the single biggest factor which helped me tide over this complex process, despite not having any formal training in finance or investing.

MOI Global: I agree with you that the role of mentors can never be overstated and we feel the need to share it with more people who are coming up. That is what you are doing and is highly appreciated. Coming back to your investment philosophy and your focus on controlling risk and maximizing reward

simultaneously. Each investment has three legs, the business, the management and valuation. If you could talk about the business models that work best in India to protect capital, as well as compound it over a long period of time? Then the opposite, what are the patterns or businesses that you absolutely avoid?



Kuntal Shah: Focusing on what to avoid helps narrow down the addressable market. It helps to filter down and make your opportunity set meaningfully small, yet significantly large enough to make sure that you have some exceptionally good businesses to invest in. Coming to business models, I think they are still overrated in India, but the managements driving those businesses are underrated. As a simple example, education technology in India should have been a hunting ground for the right business model. We have a large population, which needs to be skilled. However, if you see, every listed company in education has fumbled on scalability, accounting or delivery. India being an emerging market is still at a nascent stage. An emerging market by virtue has low capita per GDP, so all the businesses which are listed are serving basic needs, goods and services of India. They are not serving evolved economies with high capita per GDP, where the needs are more evolved towards higher end services, frictionless delivery and business model considerations.

India has been a capital starved country and you can make adequate money by simply serving the basic needs of the nation. For e.g., almost all undergarment companies are generating 20% Return on Capital. So, since there are alternatives where providing basic goods and services creates a business model with excellent economy of scale, there is no need to take extra risk.

There isn't sufficient risk capital available for R&D, branding, and all the complexity-driven business models of product and scaling up. Simple business models delivering basic goods and services work well in India. One clear thing I tend to do, is to try and avoid all the segments where the government

is a significant influencer. The Indian economy is socialist and the government is the biggest competitor, because it is present in almost all businesses, ranging from steel to shipping, from airlines to infrastructure. We avoid businesses where the government has been involved strongly, be it as a supplier of raw material, as a customer, a regulator, or if the business is very politically driven. Let me give you an example. I had invested in one the largest private sector dairies in India, and they had set up a skimmed milk powder factory by putting a large capex overlay as a percentage of their net worth. Suddenly, the Government of India banned the export of skimmed milk powder because of rising inflation and populism consideration. Thus, there is no way you can avoid all these macro considerations in a country like India.

There are many things I avoid, like serial diluters, companies driving their businesses gaining from political patronage, companies with opaque disclosures, suspect earnings quality, excessive leverage at the end of the cycle, anything which makes the business fragile, non-resilient and difficult to compound in the long run. For long-term compounding, I have to ensure that the businesses have two important criteria – a) they are resilient to all the stresses prevalent in an emerging country like India. b) the management is good enough which gives you the optionality of reinvestment when opportunities arise. There is a very clearly laid down framework of businesses that we avoid, with a clear understanding that we might miss out on some good opportunities, but so be it. We have evolved by focusing more on the management, the execution and having a clear framework of avoiding businesses which tend to have spurts of growth, but sudden stoppages in compounding potential owing to external factors.

MOI Global: The generally accepted idea is that the business always comes first and that's what was taught, by our guru, Mr. Buffett. It is interesting that you mentioned that in India the management drives the business model and hence the management should come first. You mentioned that you avoid managements that are serial diluters, but I believe in the past, you said that there is dilution that can be advantageous to the company in specific settings. Can you talk about that briefly?

Kuntal Shah: Interesting, you just pointed out a contradiction. There are two contradictory perspectives. In businesses which don't require too much capital, or whose reinvestment rates are lower than the capital the businesses throw off, serial dilution and bad capital allocation will erode your gains per share. However, there are businesses that are growing faster than their Return on Capital Employed, financial companies being one of them, and they have no other option but to dilute. The caveat is that many of these companies have a long runway to go with large addressable markets. They are in a position where their competition is not able to cope with them. For e.g., public sector banks in India owned by the government, are not able to compete with private sector lenders who focus on service and risk management. It would then make sense for investors to pay a premium, which is a competitive advantage. In fact, Rohith, I have read a lot about businesses, and Dupont analysis teaches us that there are only five ways to earn Return on Equity. These are, a lower interest, lower tax rate, increased profit margins, increased asset turns or a favourable capital structure. In fact, there are two more situations where you can really make large gains. One of them is corporate action that repurposes assets to a higher yield. For e.g., if the Government of India, which is known to bite the bullet during tough times, goes for privatisation, and if all these assets fall into the hands of more capable private managers, those assets will give you phenomenal returns not stated in current Dupont analysis or excel modelling.

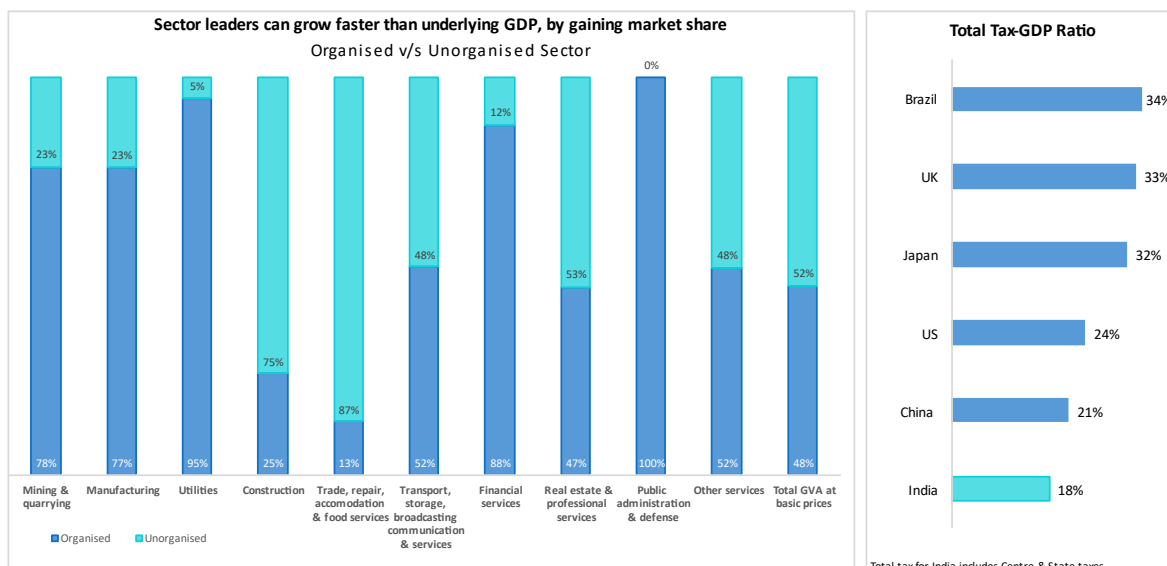
Large amounts of wealth have been created by people who can lower the cost of capital. That happens when the company has earned the trust and confidence of the investing community, both debt and equity. Dilutions at high valuations in such situations create a virtuous cycle of growth, because the company is able to grow faster than the market and take market share from the incumbent. I think

this is something most people miss out on. Another mistake made is that once such compounders reached an optimally high valuation, I would compare them with my yardstick of valuations assigning low discounting. Then I would sell them prematurely to search for cheaper businesses. Now I have concluded that it is not my opportunity cost, but the opportunity cost of the new buyer that matters the most. When companies deliver on this, they grow their operations and profitability beyond a certain scale and orbit, and then the new set of buyers with far lower expected returns come in. Thus, the company becomes a hold for a considerably long period of time until the business starts becoming mature. This was the biggest fault in my earlier investment process and over time I figured that many dynamics change as companies scale.

MOI Global: You also mentioned a large bucket of businesses that you avoid and one was where the government is involved. Now, it is well known that the government in India seems to be on a large privatization spree, and there is a “change in ownership” sort of a trigger that comes into play there. Many of them are scarce assets with large, embedded quality which are run inefficiently. In such a scenario, is it still an entire “avoid” for you till the new management comes in? How do you look at such an opportunity?

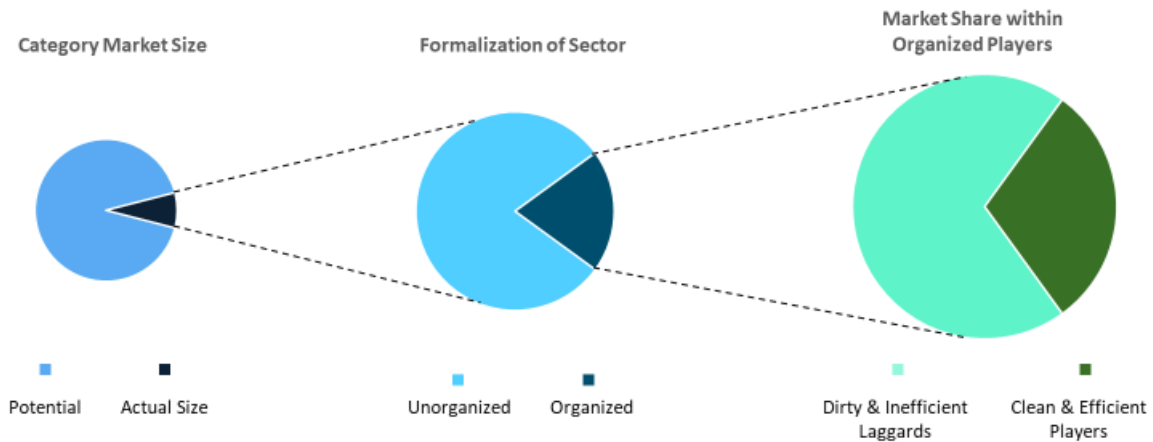
Kuntal Shah: When the facts change, you have to change your mind. The Government of India had embarked on a big privatisation drive a decade back, but it fizzled out. Indian governments tend to bite the bullet, taking difficult decisions when they are cornered and today India is facing twin deficits. We have a capital account deficit and a current account deficit. In this case, the only way the government can salvage the situation is through letting go of the assets and repurposing them for a higher use, by privatisation. If this happens, I am certain that all the government owned businesses will see a dramatic rerating. Their cost of capital will fall. They will be able to buy back shares and lower the number of floating shares. Then there are lots of investors ready to pick up these assets at good valuations because of the tremendous potential that Indian demographics have.

India : Market with a Dominant Unorganized Sector



Source : National Accounts Statistics 2019, IMF, SV Ramana Murthy, Business Today, OECD, CIA World Factbook

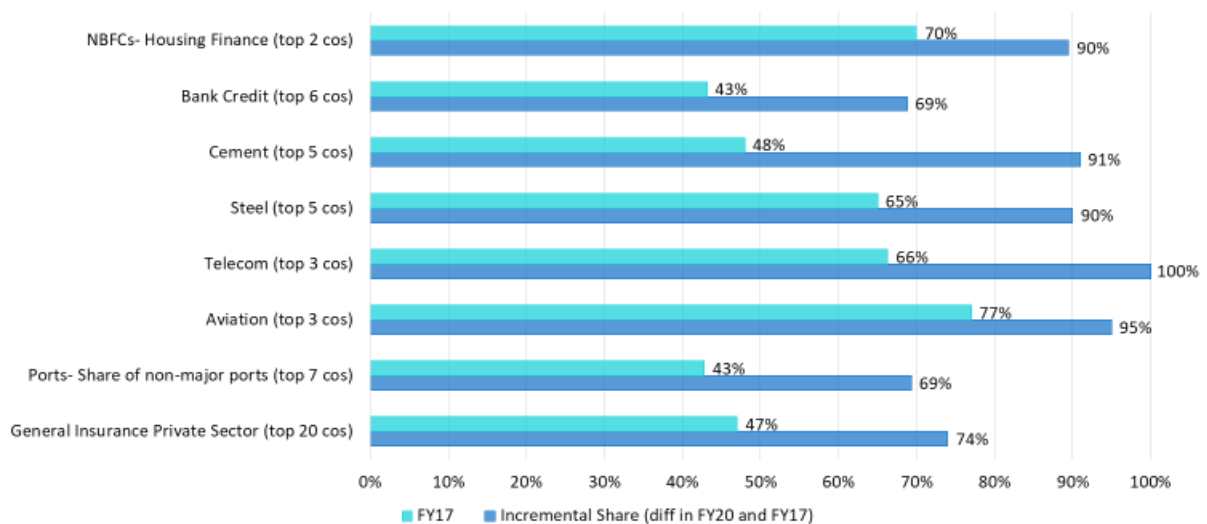
Trifecta of Growth Opportunity : Clean & Efficient Getting Bigger



The Best Time for Organized Corporate India : Strong Resilience

Category after category is underpenetrated in India. The sales of the largest footwear company are not even a billion dollars, in a country with a population of 1.3 billion. I could say the same for food and beverages etc. Sector after sector, as the GDP per capita expands from \$2000-3000 per year, to \$5000-7000, which will happen over the next decade, listed companies including PSUs will have tailwinds. I think these assets and the distribution base that the Government of India has historically created, will be highly valuable in the hands of private enterprises. This the trigger, the catalyst in waiting. You could ascribe a probability and time horizon to it based on your understanding, but if it were to happen, it will lead to a rerating of the entire Indian economy. Two important things then, India's credit rating will improve and it will then be eligible to attract more foreign flows. Please keep in mind, India has 3% of the world's GDP but only 1% of the world's capital flows. Most importantly, Indians are underinvested in the Indian equity class. They are more invested in physical assets like real estate and gold. This will create a cycle of virtue for listed companies in India.

Top Companies Gaining Disproportionate Market Share



Note: Based on volumes for aviation, cement, steel & ports; credit for banks, AUM for NBFC, revenue for telecom & gross premium for insurance

Source: DSP, Spark Capital

MOI Global: I'd like to turn to a topic which has really occupied my mind recently: long-term profitable scaling. It would be great to know the framework or mental models that you use to figure out if businesses have the ingredients to scale in India. Internally, what does the management and business structure look like? Externally, is the environment conducive to the business scaling? In the end, if revenue goes up 10x, which is quite possible in India, you tend to make money irrespective of the initial price you paid for a company.

Scaling in Country vs Scaling in Sector : Investment Implications

External considerations

- Emerging regulations
- Submerging ethics & rent seeking behavior
- Agency problems of different types
- Complexity : holding structure, compliance, tax planning, gaming the system etc.

Internal Considerations

- Soft skills
- Incentives & professionalizing management
- Hands on vs Delegation : Mastering the skills of incentivizing in tandem with hiring & delegation. If you want to 10x the business you have to 10x the capabilities of the leadership & middle management ranks, yet most companies fail to do this well.
- "The Stacked Deck" + "Controlitis" + "The Competency Trap"
- Leadership: the ability to staff/grow enough leaders throughout the organization who have the capabilities to delegate & predict
- Scalable Infrastructure: the lack of systems & structures (physical & organizational) to handle the complexities in communication & decisions that come with growth
- Market dynamics: the failure to address the increased competitive pressures that build (and erode margins) as you scale the business
- Absence of Mission Orientation
- Temptation for seeking safety of diversification
- Process driven vs Gut based decision making

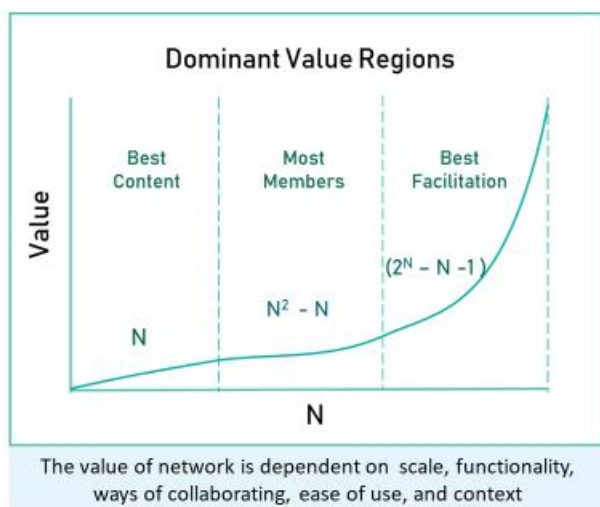
Kuntal Shah: The constraints to scaling up are both external and internal. External constraints are obviously the way the country is run, where regulations keep changing. There is some extent of submerging ethics, rent seeking behaviour and the agency related problems of an emerging market. You see this behaviour in Brazil, South Africa, Russia etc. Globally, investors are aware of what it is to invest in emerging markets, where the norms and regulations of doing business are still evolving.

Internal considerations are the most important. If you can get good Return on Capital Employed by doing basic stuff, gaming the system and focusing on efficiency, why scale? Instead, just diversify and de-risk! There is a dichotomy of scale versus profitability in the minds of Indian entrepreneurs because we are a capital starved country. There is temptation to seek the safety of diversification as a hedge against unexpected changes coming now and then. Today, all the leading groups in India have diversified themselves across a range of businesses. They are not leaders in any of the fields that they operate in, but they are in conglomerates ranging from steel to textile and software to pharma. Next, Indian operators, or operator managers or promoters as they are called, are very hands on. They find it extremely hard to delegate decision-making and execution. Their emotions and fortunes are highly intertwined in the business. This causes them to exercise a very high level of control, leading to lesser professionalism and focus on scalability. Additionally, the soft skills and market dynamics of what it takes to scale, are not properly understood.

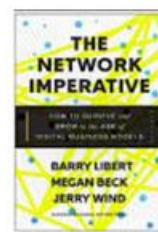
A majority of the problem resides with the entrepreneurial ecosystem. India is a very difficult place to conduct business in. I am sure that any business that does well in India, is likely to scale higher if it goes abroad. We have seen that happen in the Information Technology sector, with emerging giants like TCS, Wipro as well as the pharma sector. I am very hopeful that the situation is changing and a few of them are reorienting operations to scale.

The first generation of entrepreneurs have tasted success. They have realised that they need to scale and create disproportionate value. Market share and scale have a disproportionate linkage to high profitability. The top 2-3 companies in any sector enjoy most of the profit pool, while the bottom and mid-level companies only survive. Indian entrepreneurs get it, but it is a mindset change which will happen in the next few years, where companies will not seek unnecessary diversification. Surprisingly, sometimes unnecessary diversification is taken only for family succession planning, where one relative takes one part of the business and another takes the rest. People associate scale with a lot of Intellectual Property led industries like pharma and technology. I think there we are taking a low-risk approach, of being service providers to riskier product companies that have power laws working for them.

Network Economics & Laws of Disruption : Value Migration & Source of Value Creation



Source : www.sec.gov, Amazon



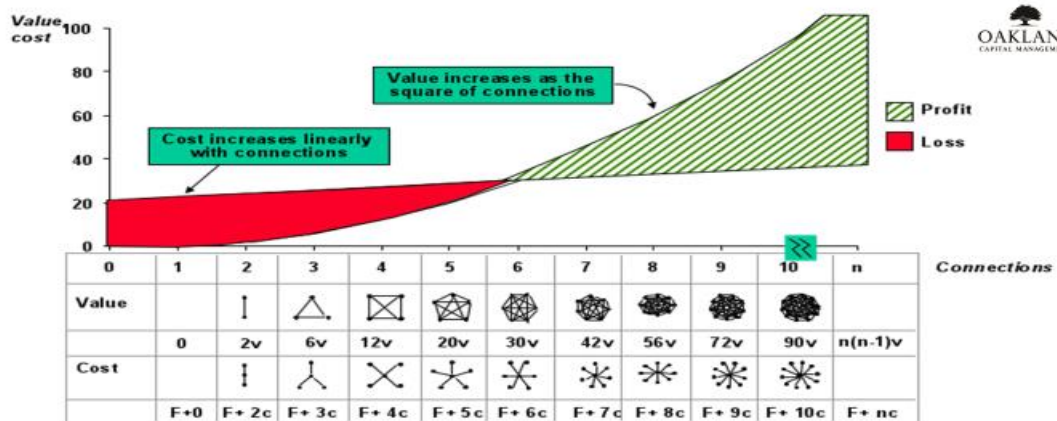
There are three famous laws of networking; Reed’s broadcasting law, Metcalfe’s Law and Sarnoff Law. Most successful platform companies are able to scale networks and benefit from network effects. We are risk averse, so we will gradually make money. However, as availability of risk capital increases, we will move towards R&D, productization etc.

MOI Global: On scaling you mentioned market share determining profitability in the future. Do you have any view on new age tech companies that are not profitable, but are spending to acquire scale? Like Paytm, Zomato, Swiggy etc.

Kuntal Shah: One important element while analysing new age businesses, is what percentage of their cash flow is an expense and what is capital assets. It boils down to how sticky the customer is to that product or service. If an alternative is easily available, and the longevity of that customer is not high, then they are expenses. You are paying an extremely high price to acquire customers that may not last. However, if there is a natural lock on the customers, by virtue of which they find it painful to migrate away, then the cost of customer acquisitions can be spread out over their lifetime value. Now the final judgement calls are how long the lifetime value, and how sticky the customers are. Here lies the single biggest disconnect in valuation and what you see as cash flows. The rest of the valuation is science. All of them are spending large amounts of time to build things, technological backends, logistical backends, branding etc. and acquiring customers with the hope that they can sell more goods and services to that customer, cross sell, upscale, monetise the customer base. It all boils down to

how sticky the customer is. When interest rates are low, markets value growth, and is forgiving on valuation. When capital becomes scarce and interest rates rise, this behaviour of spending money extravagantly to acquire customers might disappear. You have to balance it out. Something was witnessed in 2000, the dot com bubble, where many companies went out of business. Many fast-growing dotcom businesses found it difficult to fund operations when risk attitudes changed. The rate of change in this industry is so high, that the holding period of these companies tend to reflect that. You have to constantly revisit the assumption of stickiness and longevity of growth. That is where the biggest disconnect is in evaluating these new age business models.

Look at Microsoft, a classic example. Microsoft dominated operating systems, Office Suite. Companies like IBM (Drive) and Google (Drive, Sheets, Docs) tried to give it for free, but Microsoft Office is a sticky franchise. Every corporate uses it. For how long? Nobody knows, but it will be as long as it is sticky and old and new users have the same platform, the same formulas. Interoperability and formatting are key. A visionary like Bill Gates ran it in the earlier part, a mediocre Steve Ballmer in between, and yet the company did not lose its ground. A new and better management in the form of Satya Nadella fixes cloud migration and now it is almost a \$2trillion market cap company. What makes these kinds of businesses attractive is that they provide optionality and resilience. Despite a lot of mistakes, like the acquisition of Skype, many bad acquisitions and bad strategies, the core franchise was so sticky that they have been able to overcome them. You have to put in context that they have done buybacks, distributed dividends, and are one of the most valuable companies in the world.

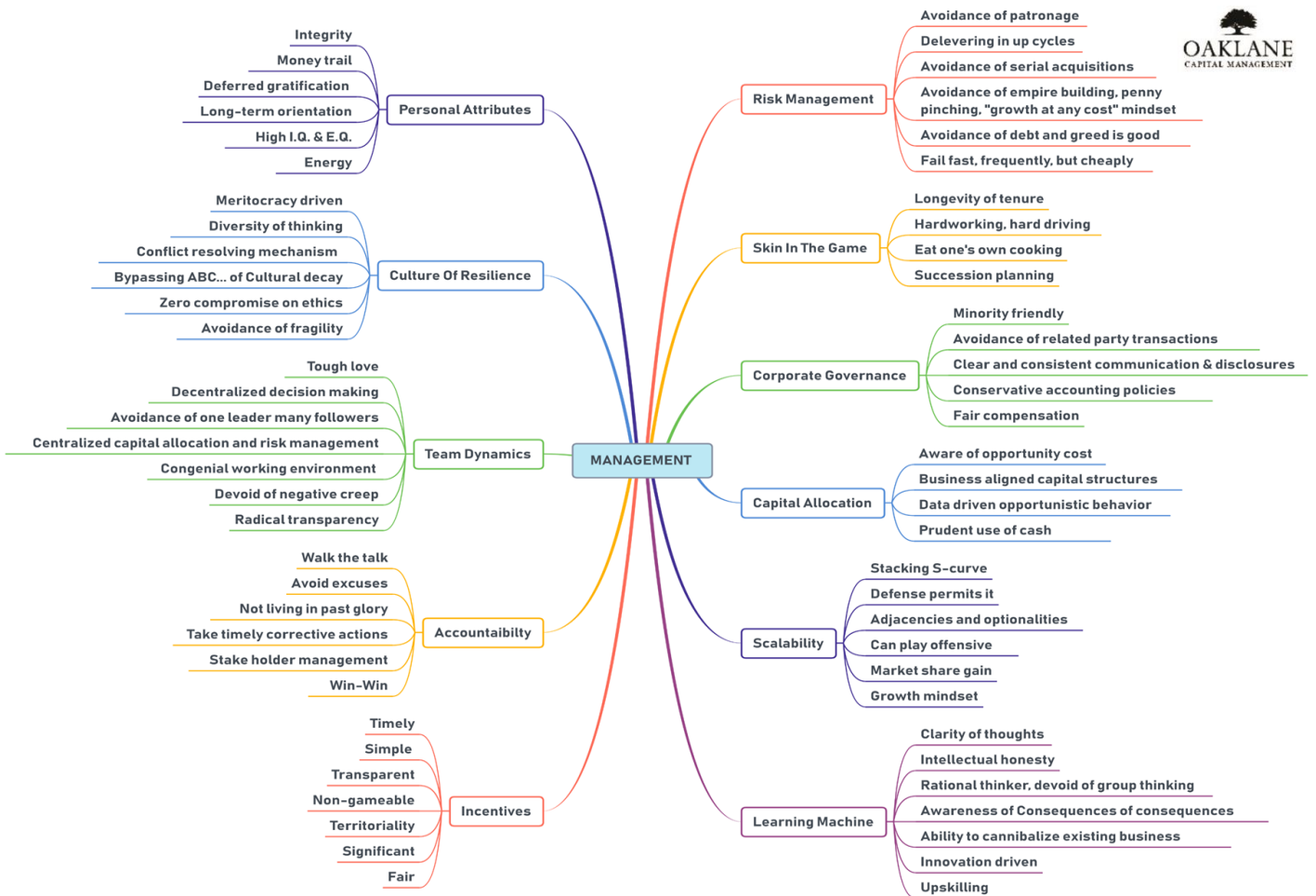


v=option value of a connection; F=fixed cost; c=incremental cost of a connection
Source: Ray Stern, Evergreen

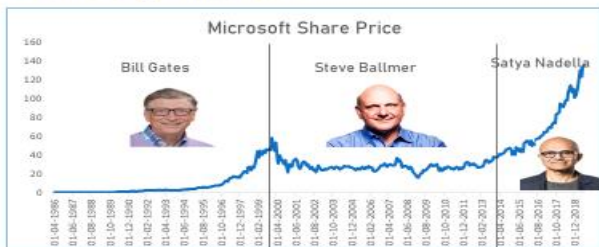
Also, Rohith, what people do not understand, is that the cost of operating falls for such companies disproportionately to the size of the customer base. The unit economics are so superior that the cost of serving incremental customers keeps dropping. That is a deadly combination – stickiness of the customer and falling unit economic costs. These are hard to dislodge unless something materially superior comes up in terms of features. It has to be a ground-breaking innovation, a new way of operating, a new way of work flow. Copying the same product will not help because they can easily replicate your features. You have to introduce a paradigm shift in the way the customers consume those products and services.

MOI Global: In Zero to One, Peter Thiel calls it a 10x difference in consumer experience, in terms of ease of experience, quality or cost and I think that is what you are referring to here as well. Once you have made an investment, how do you track their position and engage with the management? Or do you prefer to be a passive investor and let them do their work?

Kuntal Shah: My fundamental investing concept is that I am a minority investor. I don't control the business, but I have liquidity but I behave like a partner in the business. Given this, it would be unwise on my part to not know my operating partner. In every interaction with that partner, I will come up with new insights. Also, figure out the company's culture, framework of decision making, risk bearing as well as team spirit. As the people driving businesses, managements do matter. Even in technology companies like Microsoft or Apple, which incidentally had 5 bad CEOs before Steve Jobs. It is a small, determined group of people that make the impact in any business, be it commodity or technology led. So, the way I approach it, is to interact with managements prior to, and post investing.



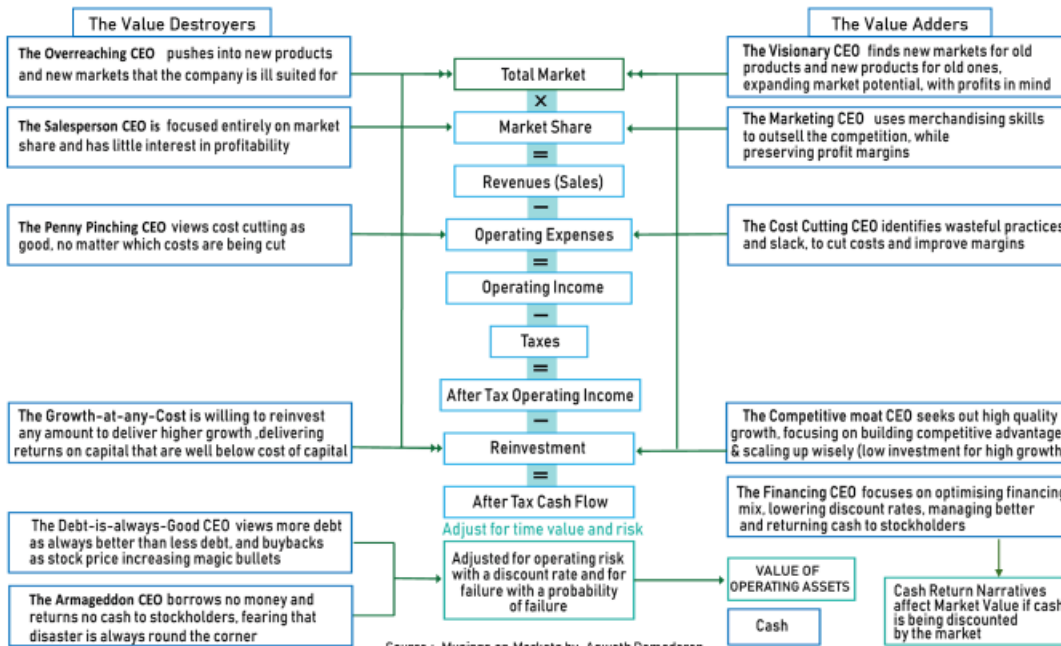
Leadership Matters !!!



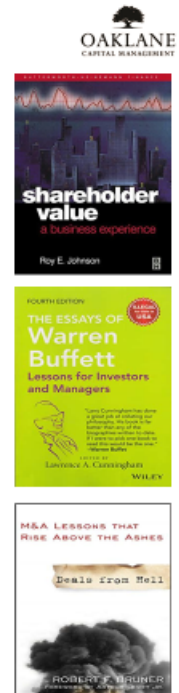
Source: The Motley Fool, Yahoo Finance, Images - Google

Your initial meetings are to create a good enough impression for you to get subsequent meetings. The quality of your research and the questions you ask are what engage the management. It is not the size of the cheque you cut. I have seen managements get put off with large institutional investors who come without adequate preparations. In fact, one of the CEOs has told me - "A stupid person can ask more questions than a wise man can answer". The other view is to not be charitable as an investor for the community at large. What I look to evaluate is whether the management is capable of reinventing itself when circumstances change. When the competitive dynamics and the reflexivity of the markets kick in, does the company have the culture to destroy their cherished ideas, and take short-term pain for a long-term gain?

Management Matters !!!



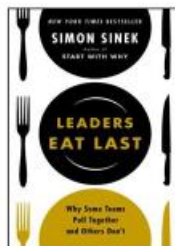
Source : Musings on Markets by Aswath Damodaran



Leadership Lessons from Military, Sports and Businesses

"Management is doing things right; leadership is doing the right things" - Peter F. Drucker

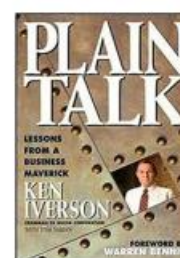
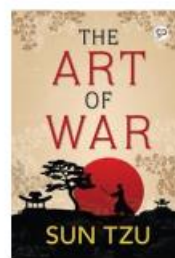
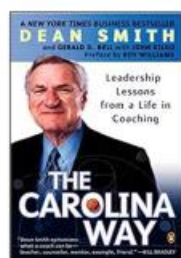
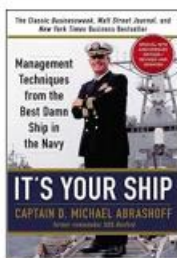
Highest possible stakes (life and death)
Lowest possible gains and personal incentives
Binary and significant outcome (winners take all)



Everybody has to come home (even if it is in a casket)
Large sample size of thousands of years across
Geographies and culture

Officer eats last and that too from surplus left if any,
After their troops' needs are taken care of.
Captain of the ship leaves last

NO your guts and my Glory mindset,
No suffering from Spotlight deficit disorders

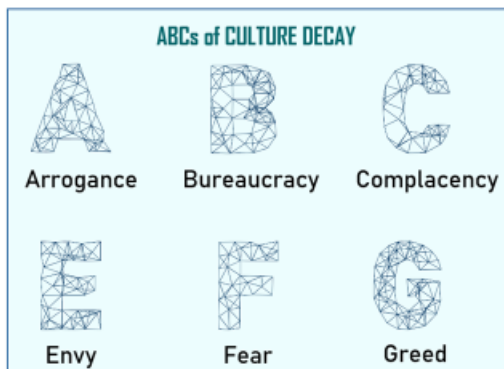


Evidently, investing is not observing still photographs but watching an unfolding movie. Things are changing and you keep monitoring the changes at margin. You trust, but verify. The influence can come by either appealing to their intellect, by data and the merits of our argument, or by appealing to their incentives. So, you could influence strategy, capital allocation, corporate governance, M&A, investor communication etc. The idea is to engage the management to learn more rather than to teach. Lastly, if you think the management is not up to the mark then you may choose to sell. In India

Culture Decay



“Culture eats strategy for breakfast, operational excellence for lunch and everything else for dinner” – Peter Drucker



“My successor will need one other particular strength : the ability to fight off the ABCs of business decay, which are Arrogance, Bureaucracy and Complacency. When these corporate cancers metastasize, even the strongest of companies can falter.” - Warren Buffett

Source: Forbes, Innovation Copilots, Research Gate

there is not much room for activism investing, just to clarify.

I am constantly monitoring culture decay and loss of agility. I have here, the ABCD of decay: Arrogance, bureaucracy, complacency, drift of culture, envy, fear, greed, hubris etc. which you must bear in mind. It is a constant periodic revaluation to make sure your original hypothesis is intact, that you want to be associated with this management and business. Again, a “trust but verify” framework of evaluating existing investments.

MOI Global: That was fascinating. Just curious to know, as part of your process, how much time do you allocate towards studying a new idea and how much of your time is spent on actively tracking it?

Kuntal Shah: Keeping track of an ongoing business is easy, because most of the work has been done prior to investment. For a long-term investor, well-bought is half sold. If you buy the right businesses, at the right prices, in the right proportions, the heavy lifting is done. The rest is maintenance support, which does not require too much time because you are just observing changes at a margin. At the same time though, the market is a pari mutuel system of reflexivity, where the odds keep changing. There is always a new business with a similar return profile, but lower risk keeps emerging. Thus, you are always searching. You have to stay within your circle of competence while slowly expanding it. Otherwise, you will be fixated on a particular category of investments, which will eventually become mature and have a very different return profile compared to alternative higher growth businesses.

Each investor has to choose his own poison, the kind of investment he can sleep well with at night, how much effort he is ready to put in to understand and develop insights about new managements and businesses. It is also a function of one’s own orientation, the size of capital and return expectations.

MOI Global: Perfect! Maybe you could speak about a couple of businesses you have participated in earlier, bringing in all of what you've talked about together and how you rode the journey over a period of time. The kind of businesses we have talked about, the scaling businesses with management, they tend to always go up over a period of time, so this average up because of anchoring bias becomes very difficult. How have you dealt with averaging up, holding on, and can you give us an example of it?



Kuntal Shah: One of my early successful investments was in the telecom space, in what is now Airtel. We invested in the holding company of Airtel when it was undergoing delisting and Warburg Pincus had invested in the company. The market cap was less than 40 or 50 million dollars. Today it is an Index constituent with a market cap of several billions of dollars. We rode the whole journey, but again, it was pure luck and serendipity. India had 27 telecom operators at the time, which reduced to two and a half by the time we exited. The entire industry got consolidated. It was a classic example of a top-down, bottom-up investment. Ironically, what helped me was the lack of liquidity. I was forced to hold it, as it was not traded on the stock exchange. So, there you go, an example of luck and serendipity leading to a more than satisfactory outcome!

Another investment, which has delivered, and continues to do so, is in the financial space: Bajaj Finance. What led me to the company was my analyst telling me that this was a business that had gone through severe stress on the one hand, but had a very credible, highly reputed and deep pocketed management on the other. They had pumped in more money to write off all the past losses. Change in management is always a time to rethink. Post moving to Pune from Mumbai in 2008, I got to observe the top management closely and that is when I figured out that they were of a rare breed, with the right leader, who was intelligent, energetic, ethical and purpose driven. And there were a lot of optionalities with a large addressable market.

The financial sector in India is 6% of GDP, but if you really look at it in terms of the profit pool, it is a high percentage of it and it has the next 2-3 decades of growth ahead.

The GDP per capita moving from \$2000-\$3000 to \$5000-\$7000 will lead to a mega trend of discretionary consumption backed by personal consumer finance, which is what this company is riding on. They have a hyper profitable scaling model, backed by a digitally oriented management, continuously gaining market share. I think the AUM of the company compounded at almost 60% plus for the 1st decade. Then Covid struck, but I think growth will revive itself. This company is tech advantaged and it had low customer acquisition and delivery costs, frictionless processing to engage customers. They were able to raise capital, both debt and equity at favourable terms. Moreover, the company had best in its class disclosure norms. Most financial companies do not disclose what the stress in the portfolio is, but here was a management disclosing every line item, how many cheques have cleared as of 30days, 90days, 120days and 360days etc. There was a very credible stewardship of the controlling shareholding family: four generations of freedom fighter's pedigree, backed by operating management of high integrity. The company played offense because its defence permitted it and high profitability allowed it to absorb shocks and invest in technology. I think it fulfilled the checklist of a desirable company, offering resilience and optionality, making you want to stay invested as long as the management is delivering.

MOI Global: A little more on Bajaj Finance, how has the market cap evolved over the last 10-12 years?

Kuntal Shah: The markets are maniacal. For this company on an average in a given year, the stock price varies 40-50%. However, the markets in the long run follow the trend of profitability and AUM growth and this has been one of the top 10 investment ideas to emerge out of India over the last decade. Going ahead, the potential looks very high, the financial sector being highly regulated in India. A lot of fin-techs are trying out new technologies and models, but they do not have customers. They are paying a high customer acquisition cost. Here is an incumbent with a large number of customers, behaving like a fin-tech, providing best of both worlds. If they can pull off this digital transformation journey, India will have an equivalent of ANT Financial of China, but with two caveats of exceptionally low leverage and far higher degree of accountability, operating in a democratic and sustainable manner. There is the potential of an outlier emerging, a super financial app and fin-tech company in India, with high profitability and scale.

MOI Global: Fin-techs came into vogue very recently, but this company has been investing in it since the beginning of the last decade, before the market even caught on to the concept. Do you have anything to share on where they got this pioneering insight to invest in data and analytics so far ahead of the competition?

Kuntal Shah: It boils down to the pedigree of the management; the owner family has done the best job of finding the right management, incentivising them well and getting out of their way. This kind of delegation is a rarity in India. They have a very young and dynamic team. They have been able to recruit talent from competitors, or companies in the same space abroad, which speaks highly of their tech-orientation and their ability to incentivise and retain talent. Lastly, their adaptability to change is noteworthy. This company was a monoline serving only the two-wheeler market, when we first invested in it. At present it is straddling almost 20-30 lines of business and counting, each capable of becoming billion dollars plus businesses. Today, "buy now, pay later" is a buzz word. You have business models like Affirm and Klarna emerging in the western world where credit card penetration in certain parts of the country is not there, but Bajaj Finance is the original "buy now, pay later" player in India. They originated customers cheaply and profitably without increasing cost overheads. Their cost to income, fell from the high forties to the high twenties. The trifecta of good management, low-cost

funds, low-cost customer acquisitions, low-cost delivery of services in a commodity business like finance is a significant take in my opinion.

MOI Global: For the listeners, Bajaj, which is the promoter group owning this company, is also the promoter group that owns Bajaj Auto, a premier two-wheeler company. The combination of a great management with a low-cost advantage and scaling of size is an unbeatable combination.

Kuntal Shah: The market cap moved from less than a \$100 million to almost \$35 billion. There have been some dilutions, but I think the company has delivered a 55-60% CAGR from 2008 till date. I could be wrong by some percentage points because the stock prices are fluctuating.

MOI Global: Considering you have averaged this over a period of time, how do you avoid falling into the anchor bias that many investors fall into when they participate in such a story?

Kuntal Shah: Somewhere in the early 2010s I realised that my whole process of selling was flawed. I used to sell a company once it reached a certain valuation. Then I'd look for new companies, as I was not aware of the fact that good businesses have a narrow window of a buy zone, a long window of a hold zone and a narrow window again of a sell zone. Your outcome can be disastrous if you get those zones wrong. But while the company is in the hold zone, it would be imprudent on your part to not average out. At any point in time, you have to evaluate whether incremental dollars should go to this company or the next best idea. If the company keeps delivering on profitability, market cap and liquidity reach a certain scale, they get included in the index and in futures trading. Factors like institutional imperatives keep their valuations elevated for a long period of time. To be clear, I am not succumbing to the greater fool theory, but it is well known that as companies scale, they attract investors with lower costs of capital. This supports valuations.

The competition, the behaviour and the industry structure have to be borne in mind. The rate of change determines the holding period. Here is a structural story in an industry where banking licenses are hard to come by. In fact, this company itself is struggling to get a credit card license because credit card approvals are under banking departments as per regulatory norms. Non-banking companies are not allowed to do it despite the fact that the top 5 to 6 credit card issuers are non-banks. If this changes, there is a long runway of growth ahead.

MOI Global: Thank you for the great summary of the business model. So next, probably if you could talk about the ideal portfolio construct.

Ideal Portfolio Construct : Barbell Approach of Resilience and Optionality



Parameter	Resilient Companies	Anti-Fragile companies : Resilience with Optionality	Only Optionality	Survival Issues / Value Traps	Mediocre : Neither Resilient nor Optionality
Allocation	Core of portfolio	Rare but large allocation	Many positions but small allocation. Maximum of this bucket is capped	Avoidable commitment	Avoidable
Valuation Consideration	Timeline of investment horizon arbitrage	Longevity of growth and level of out of the money optionality implied in the current prices	Large total addressable market and network effects	Cheap, getting cheaper due to deteriorating core business	Market performer
Investor Consideration	Sector Leadership	Take advantage of volatility to add and trim positions	Venture capitalist investing framework	Avoid commitment bias	Filter out at screening level
Investor Consideration	Markets share and adjacencies	Rare companies; should be averaged up. Risk contribution will be more equally distributed i.e. large position represents the same risk as a very small position	Extension of tail leads to minimizing of error. Foot in the door and a possibility of averaging up or trimming down depending on subsequent outcome	Alternative opportunity cost	Companies stuck in the middle, though they can give buy low, sell high, or round tripping opportunities

Source : NZS Capital

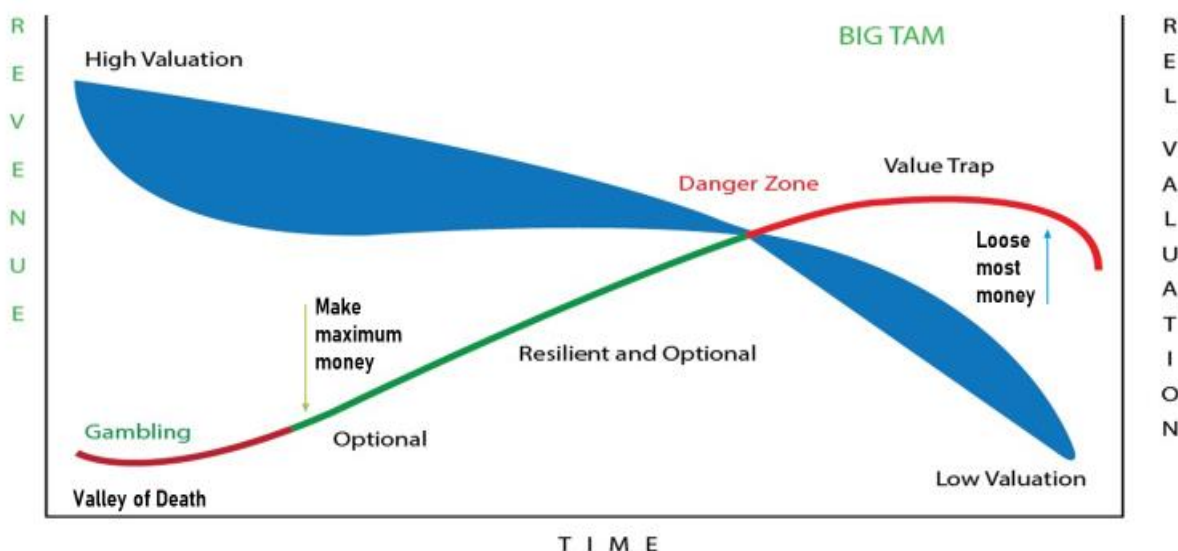
Kuntal Shah: My ideal portfolio construct is to avoid value traps and mediocre investments. Companies which are market performers, which are statistically cheap, but can never scale, eventually become either too much of hard work, or require too much of timing related luck and serendipity. These must be avoided. Value traps, non-resilient, non-optionality companies must be avoided too.

I am looking for three sets of companies, with proven resilience, optionality in the face of competition, past demonstration of sector leadership, continuous signs of market share gains. Such companies become the core of my portfolio (slightly different from NZS Capital’s framework shown in the slide). Then you overlay them with some long tail positions in companies which have only optionality, where heads I win, tails I do not lose too much. It is more of a venture capital type of investing where allocations are meaningfully small in companies without resilience. Collectively, they do not exceed 20% of your allocation at any point of time. These companies become your hunting ground to average and scale up. As the businesses and managements start delivering, you keep investing more. At some point, they move out from only optionality to resilience. If you see the S-curve, there is a valley of death initially which you try to avoid, an unproven management, unproven business. Then follow companies of decent scale, whose management, character and business resilience have been tested. In the end is the scaling curve, where companies are constantly rerated, till they hit the maturity curve. One has to evaluate companies from the perspective of maturity and reinvention ability.

This is a barbell approach is a concept which I have practiced all along, but the folks at [NZS Capital](#) have laid out the framework far better than I possibly could. You can [download](#) the paper from their website. The ideal portfolio construct is one where you have a core of resilient companies along with a long tail of optionalities.

MOI Global: How do you split your portfolio among these three buckets of resilience, anti-fragility, with optionality and then only optionality?

S Curve Lens to Visualize Resilience & Optionality



S-curve with different types of investments and valuation zones:
Source: NZS Capital

Kuntal Shah: As I said, only optionality has a very low allocation, because the companies are not proven yet. Anti-fragile companies with resilience and optionality form the bulk of the portfolio. The first bucket of resilient companies forms your bread and butter along with cash and cash equivalents. It is a quasi-debt kind of instrument for me where I may want to park additional sums, and the allocation could be meaningfully lesser than the former. Bulk of the investments are in the second bucket of very long-term compounders, worth holding for decades.

MOI Global: How many positions do you hold in the core part of your portfolio? Would you mind sharing the number?

Invest Big when the Odds are in your Favour

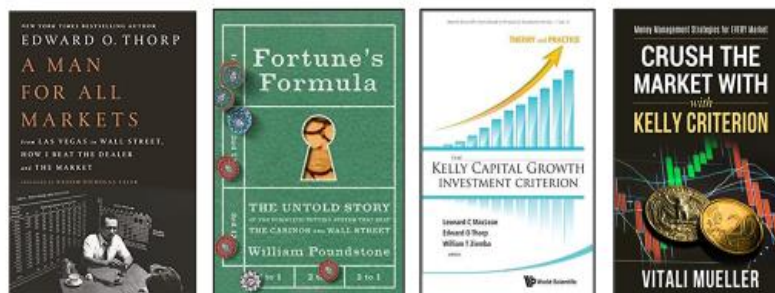
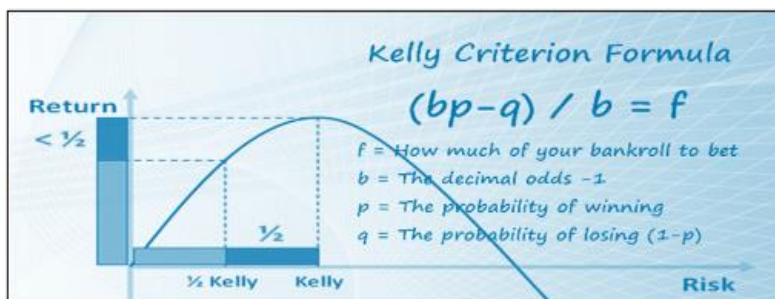


$$\text{Position Size} = \frac{\text{Expected return}}{\text{Range of Outcomes}}$$

Position Sizing

The math implies to two important points, the first being more obvious than the second

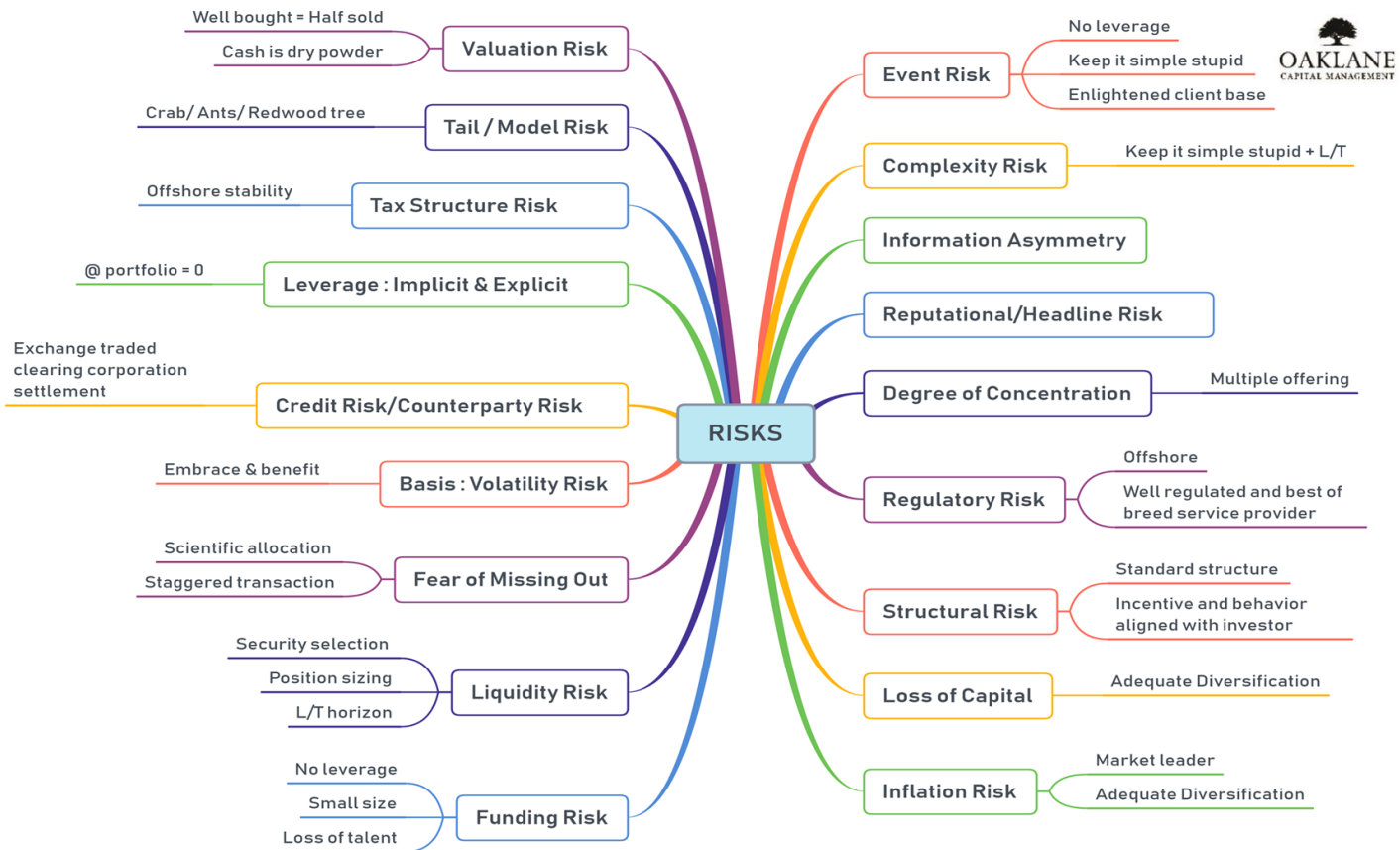
- The larger the expected return, the bigger the position should be
- The larger the possibility of ranges, the smaller the position should be



Source : VSRE Collective

Kuntal Shah: Typically, it ranges. In bull markets there are a lot of ideas and you tend to take a large number of small exposures. However, I do not exceed 14 to 16 ideas at a time, with a very big caveat that the top 5-6 ideas will be almost 60-70% of my allocation. I am a big fan of Andrew Carnegie. Concentration is the motto I have learned from him. Concentration of thoughts, capital and ideas. Why would I want to invest in my 40th or 50th best idea? My goal is to create a museum, a warehouse. I do not want to have zoos with animals of all varieties. As one of my peers, Utpal Sheth aptly says, Gorillas are rare, live longer, cannot be challenged, have dominance and outlive other monkeys. So, you have to find the right jungle, and the right Gorilla within the jungle. This analogy has stayed with me and I'm sure it will be useful for the readers.

MOI Global: A portfolio of 14 to 16 companies is quite concentrated, especially with 5 to 6 of them forming 60-70% of your allocation. Given the style of investing you have, what are the most common kinds of risks you have encountered in the portfolio that you own?



Kuntal Shah: Risk is a manifestation of adverse events that can be of varying types, like regulatory, structural, inflationary or liquidity risk. It could be a risk of levered promoters or investors selling their shares in a meltdown, or complexity risk.

One has to realise the difference between volatility, uncertainty and risk. Risk is the probability of you losing capital over a long period of time. Short-term volatility is not risk. Uncertainty is the game of life. Everything about life is uncertain. You do not know what you are going to do three years from now, but that isn't necessarily risky. As long as you are rational and hardworking, the output is going to be positive. Another consideration is that greater risk does not mean greater profit. Risk erodes returns through losses, so if returns are high, the investment will automatically be less risky.

Concepts like Value at Risk (VaR) and Efficient Market Hypothesis work well theoretically in classrooms, but break down when they meet the reality of investing. As a simple example, by mathematical convention, the events of October 2008-09, should not have occurred in millions of years, but they occurred in a span of weeks. Furthermore, the frequency of crises is increasing, but the duration is decreasing. Theoretical concepts do not work for a person like me.

Uncertainty should trigger additional due diligence and more effort. Simultaneously, volatility in thinking and personal emotions should not overwhelm you. Such times warrant legitimate reactions rather than overreactions. More often than not, people take short-term emotional decisions, or even freeze. This leads to adverse outcomes.

Risk Related Frameworks in Place

“The essence of investment management is the management of risk, not the management of returns” – Benjamin Graham

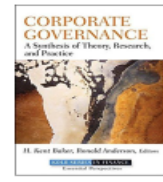


One of the key investment management philosophies is to reduce risk. Most financial parameters are mean reverting at an aggregate level. Corporate profits to GDP, corporate profits as a percentage of sales, valuation as a percentage of GDP etc. They invariably correct. It would be unwise to assume that your portfolio will be immune to an entire market correction. You have to assume a 20-30% drawdown when you are investing. Mr Market is a very erratic counterparty, to be taken advantage of, not to be subservient of. Reiterating an earlier point, well bought is half sold. Buying well eliminates most of the risk. Taking small profits off the table allows you to sell if your hypothesis turns out to be wrong, or if a better opportunity comes by. It is about mental accounting and eventually boils down to what the investor is comfortable with, hence a very personalised endeavour. Unfortunately, you cannot outsource it to a committee or a third party. There are no books written on how to ride emotions and volatility during such times. It is something you have to experience, emerge unscathed from and thereafter improve upon.

MOI Global: I found it very intriguing that most of the risks you spoke about were internal to you as a person. The emotions you faced at each point of time, like dislocation etc. You focused on how one should react while trying to remain rational and analytical. I am curious to know more on the corporate governance side, the different shenanigans that are prevalent, India having its own share of them. Do you have a framework to identify such corporate shenanigans? I believe it is a pet subject of yours as well.

Corporate Governance Matters !!!

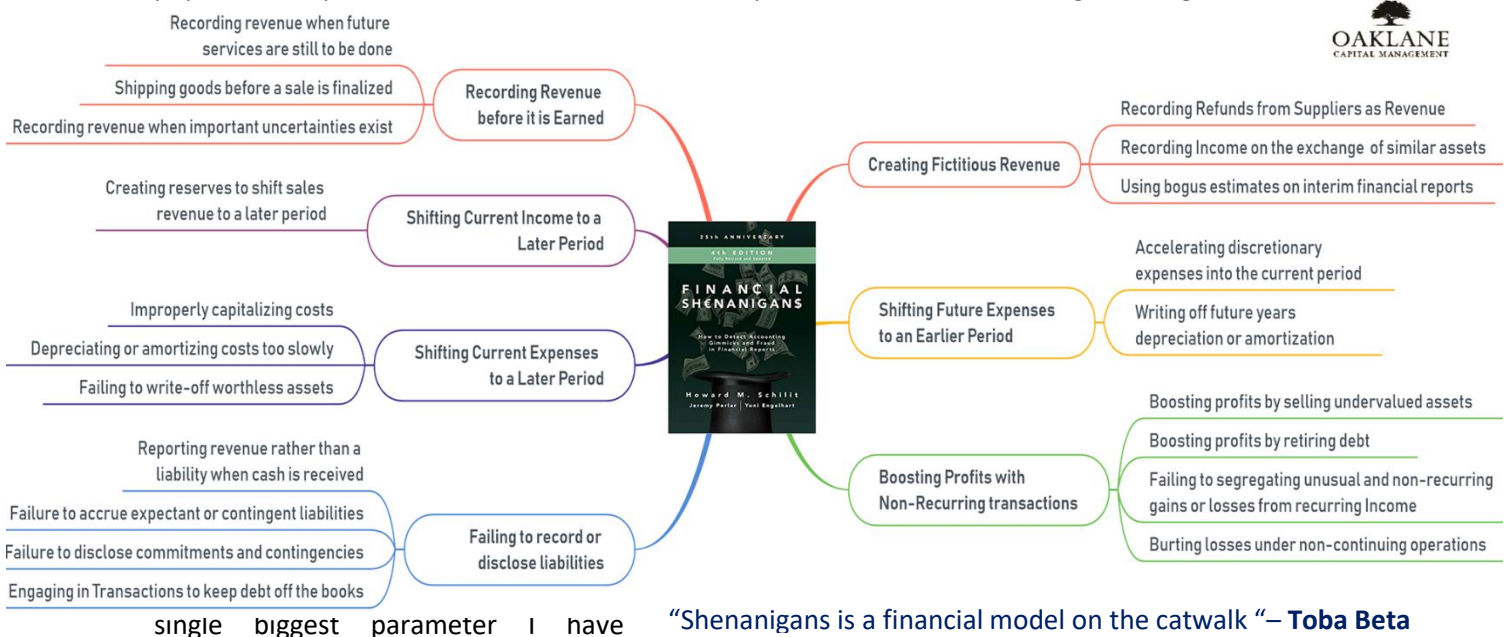
Promoter category	No. of companies in BSE Top 500	Weighted Avg. Holding by Major shareholder	Governance Issues
Government 'promoter': Public Sector Undertakings (PSU)	79	63.8 %	Inadequate disclosures, political compulsions and interference, decisions based on Inflation considerations, poor capital allocation, corruption, frequent management changes, debt write offs etc.
Entrepreneur family controlled promoter group	351	52.83 %	Minority shareholders get shafted by dominant shareholder by theft through related party transactions, complicated holding structure with non-transparent loans, corporate guarantees, cash flows and commercial transactions, M&A involving related parties consummated at unfair prices, overvaluation by poor accounting and issuance of warrants to promoters when capital not needed leading to dilution at deep discounts etc.
MNC affiliates	53	66.07 %	Instances of MNCs wishing to acquire the minority shareholders and delist, but doing so at a valuation that disadvantages minority shareholders by practicing unfavourable related party transactions with MNC affiliates.
Professionally managed company	17		Misallocation of capital, Principal agent conflict



Kuntal Shah: Listed opportunities in India comprise of government undertakings, private entrepreneur family driven companies (owner manager driven as they are known in the western world), professionally managed companies and MNC affiliates. Each has a different set of corporate governance regimes and issues. There are instances where the MNCs want to acquire and buyout minority partners. So, they over-spend, increase capex, and probably have unlisted arms. The bulk of the innovation is given to unlisted companies. They do not allow listed companies to become part of the export hub or force them to import expensive raw materials at unfair prices.

Professionally driven companies also tend to be abused at times and become empire builders. They do not return capital when opportunities do not justify it, they misallocate capital etc. Speaking of entrepreneur driven companies, minority shareholders are at times at the receiving end. This happens when the pedigree of the management is not good. These shenanigans manifest in the form of related party transactions, ambiguous earning's quality, siphoning of profits etc.

Government run companies have principal agency conflict, where the government runs the company for the greater public's benefit and not as a business. The considerations are more compulsion of populism and political in nature. These must be kept in mind while conducting due diligence.



single biggest parameter I have "Shenanigans is a financial model on the catwalk" – Toba Beta

observed is: Income is rarely understated. The corollary is that expenses are likely to be understated. Liabilities are likely to be understated too, so assets are likely to be overstated. With this basic framework in mind, you have to figure out how the three annual statements move. Most investors start with Profit & Loss Statement and are fixated with quarterly or half-yearly profits, with scant regard to long-term cashflows and strength of the Balance Sheet. On the contrary, I begin with the Cash Flow Statement, then proceed to the Balance Sheet. The Profit & Loss Statement is a passing remark in evaluation, when the basic hypothesis about the company is well understood. When you are analyzing a company for the first time, you must deep dive. The order of magnitude is different, but when you are studying the company at margin, the cash flow statement is of utmost importance. It is easy to manipulate accounting events, but cash flows associated with those accounting entries are very difficult to be manipulated simultaneously across all three statements. The Footnotes have many accounting skeletons buried in them.

It is possible to have different accounting conventions. What has helped me is, understanding accounting policies adopted by similar companies which are competitors domestically or globally and seeing where the deviation is, then going deeper into the sources of deviation. Notably, due diligence cannot be outsourced. Sometimes companies with accounting issues have been audited by very well-known auditors and it is a Caveat Emptor situation, where you trust but verify.

Complex holding structures are a big no for me. I have found that promoters sometimes infuse equity in the holding company out of the parent company's own cashflows. This practice is very common. How do owner companies scale with external capital despite not giving up managerial control and retaining high equity ownership? It is a very difficult task in the short-term. The easiest way is to have gold plated capex, siphon off the money and bring it back in the company.

There is never a single cockroach, but always an intrusion in the kitchen. Once you have walked down that path and adopted that modus operandi, it is incrementally easier. You have to be cognizant of the kind of partners you are dealing with. Hence, corporate governance, quality of earnings, quality of accounting and disclosures matter a lot. It is worth paying premium for companies that follow the path of better corporate governance and higher earnings quality standards.

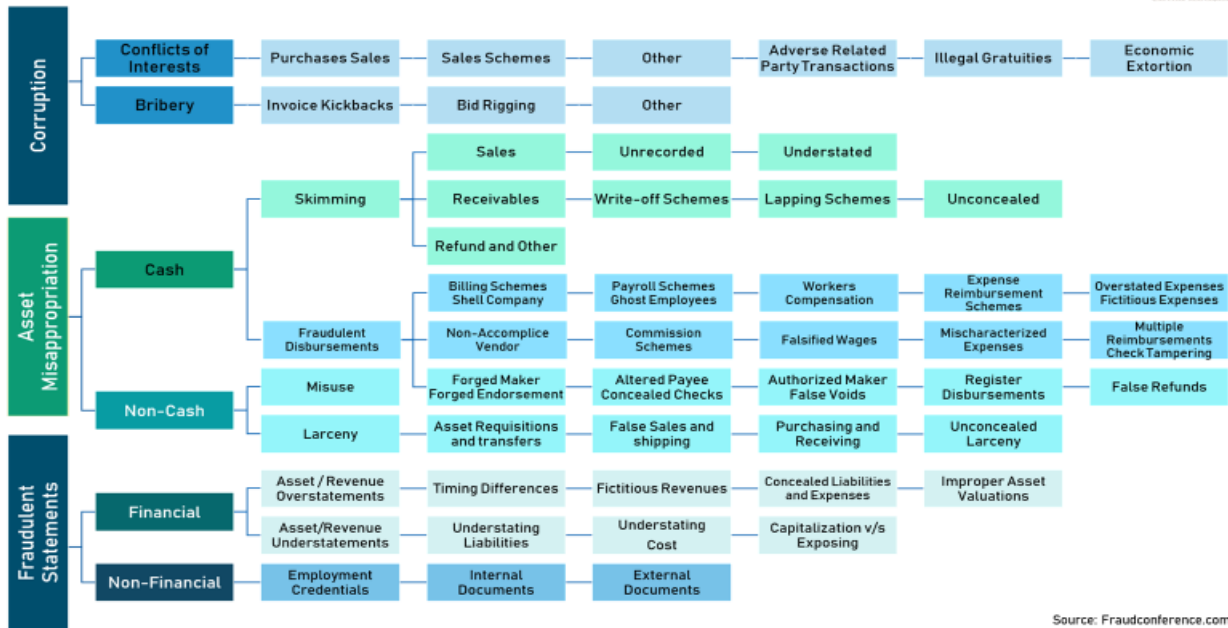
MOI Global: You said that one of the most common examples of mis-governance in India is, promoters investing in holding companies from the cashflows of the primary company itself, using gold plated capex. Is there any other way they take out cashflows? How is the capital infused back into the company? Is it through preferential issue or are there foreign entities who you do not know, but you know in the end that the promoter owns it?

Kuntal Shah: There are all shades of nuances out there. For e.g., a company in a very asset heavy industry, indulging in Brownfield or Greenfield capex, without adequate equity. I have seen expansion of the same companies having different per ton capacity costs. Then they go into smaller nuances, but it is a deviation meant to create an equity buffer which is nonexistent at that moment. It is a case of heads- I win and tails- banks lose much. We have seen many cases where Indian bankers have been taken to the cleaners. Sometimes the bankruptcy realization is less than 3-4%. This speaks volumes of the amount of gold-plated capex which took place earlier.

Quite often, money is raised abroad, diverted it into subsidiaries, which then in turn divert the money to investors who control the float. This is the modus operandi, where promoters portray a different picture of equity and how skin in the game is coming into the business. You have to carefully evaluate how the promoter is funding himself, rather than how the business is getting funded. Most analysts stop at business and capital structures. However, you must go a layer deeper, and evaluate who the

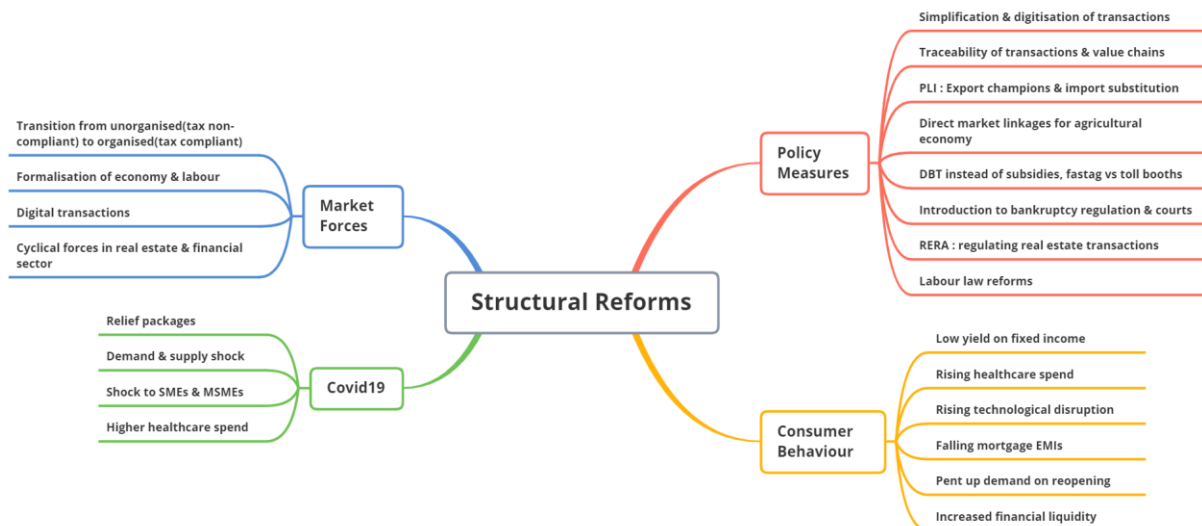
other shareholders are, what the sources of promoter’s wealth and equity in the company are. This level of analysis opens up Pandora’s box.

“There’s never just one cockroach in the kitchen” – Warren Buffett



MOI Global: In a few interviews that you have referred to yourself as a bottom-up stock picker, but a top-down worrier. I am curious to know more about the interaction between the bottom-up optimist and top-down pessimist. How do macros impact your stock picking and portfolio construction today?

Long-term Drivers in Place



Kuntal Shah: In an emerging country like India, macros can never be ignored. Prior to 2008, I was a bottom-up investor, with scant regard for macros. I was shocked with the impact of the credit bubble on the Indian equity market, given that it happened in another equity market and geography. It brought my attention to the inter-connected capital flows and global business outlook. I started looking into macro related factors like liquidity and leverage in the system, inflation expectations and interest rates. These are factors that contribute to bubbles or periods of dislocation, albeit they may happen outside your field of observation.

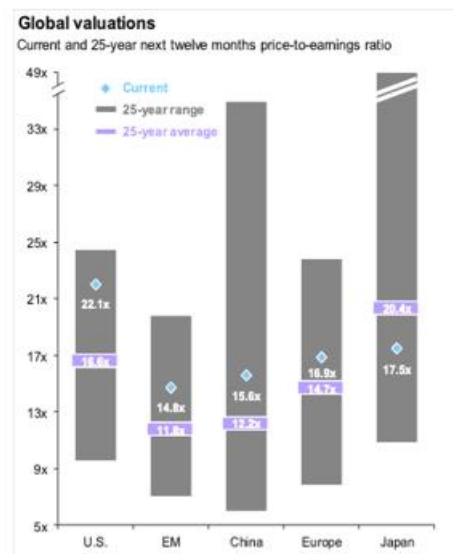
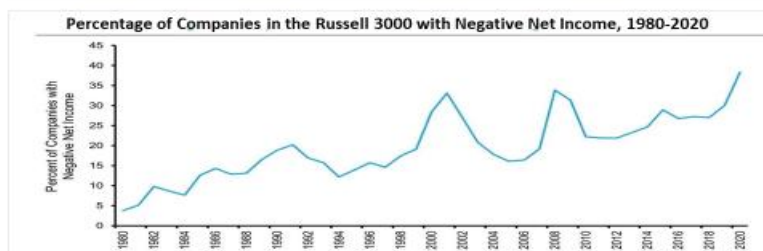
The supply situation changes dramatically when macros and regulations change. Currently, we are witnessing huge supply disruptions in sectors like chemicals, metals, commodities, complex energy etc. This is mostly because there is an emerging macro theme of environmental conservation and pollution control. Overlaying some amount of macro in your micro hypothesis will make you an aware, alert and better investor. Macro is the only game in town, for e.g. I performed a calculation where almost 40 to 50% gains since 2008 in a broad category of companies, have come from valuation changes. Macro helps you to adjust the timing, as well as rebalance the portfolio. Investors generally tend to overpay for comfort zones. Thus, valuations have runaway ahead of the underlying change in profitability, or free cash flows, or any other metrics used to evaluate corporate performance. This is partially because of the ongoing 36-year interest rate bull market abroad. Excluding that, I can justify 30 to 40% more valuation for most of the businesses I own. I have to be cognizant that valuations will revert to the mean, and then position my portfolio accordingly. Macros most certainly help me to understand the behavior of the larger economy and my fellow participants in the market rather than the underlying business.

MOI Global: I agree with you entirely that it has been a 36-year bull run, reducing interest rate cycle, which has supported higher and higher valuations over time. The recent tax cuts by a lot of countries have not helped either. You said many of your portfolio companies could take a 30% to 40% cut once the interest rate cycle mean reverts. In that case, do you take a 30-40% haircut? How do you view your portfolio in that lens?

Kuntal Shah: Mentally, I am prepared for companies being marked down in a very short period of time by a large amount. At such a time, I may choose to stay invested in those companies or invest more. Having the right mental grit and knowing that it is only the fair market value of the business that has been marked lower, helps me avoid any potential analysis paralysis. There are tax considerations, reinvestment options, restrictions etc. You may choose to do nothing, but one should be aware that this is a source of value creation and you must calibrate your portfolio positions after being fully aware of the source of returns.

MOI Global: What about the current times? What does it mean for India? These are truly unprecedented times in terms of interest rates, negative yields, the amount of liquidity etc. Given your vast experience, is there any period in the past this reminds you of and how do you think about designing a portfolio in this pandemic-stricken, liquidity-surplus world that we are in?

Low Future Rates Embedded in High Current Valuations



Source : FactSet, FRB, S&P, Thomson Reuters, JP Morgan, Robert Shiller, Bloomberg, LohmanEconometrics, Daily Shot Brief, Sober Look

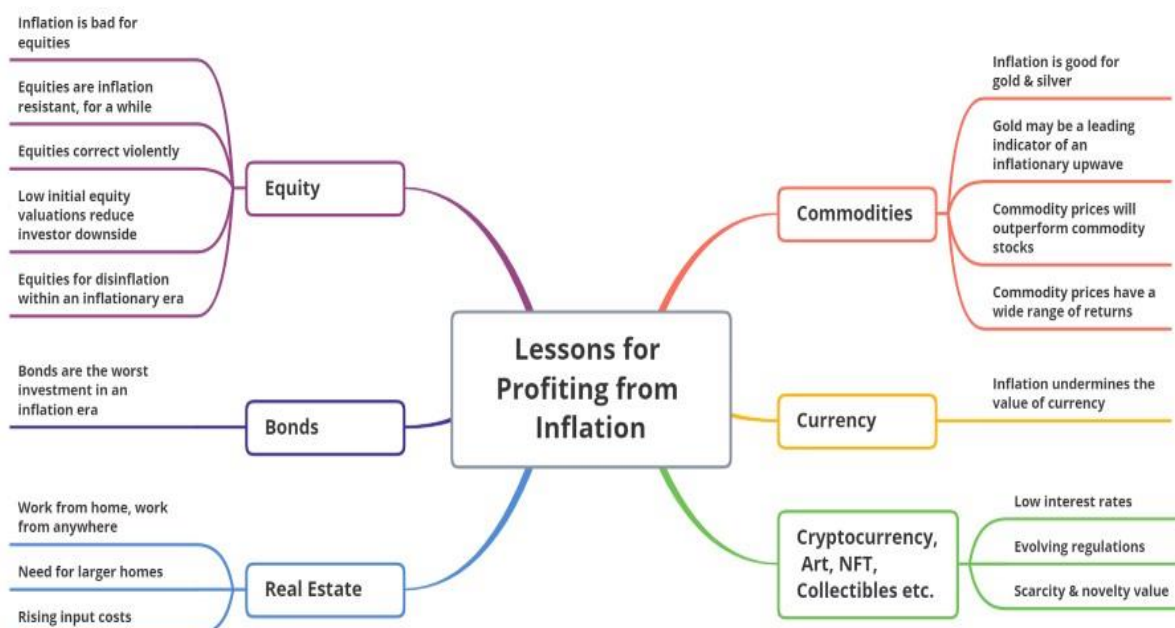
Kuntal Shah: I am comfortable with the earnings profile and quality of the businesses and managements I partner with. There is one question that gives me sleepless nights- how much debt is too much? I had the same question in 2010, that debt to GDP is out of proportion, but it turned out to be an extreme pendulum swing. Referring to a statistic, excess return over nominal GDP in this cycle has been almost 14 to 16%, which has not happened in many past cycles.

There is no doubt that unfavourable changes in the direction of interest will be unfavourable for asset prices as well. From a regulatory perspective, there is a moral hazard playing out. The playbook is very standardized, to infuse more liquidity, monetize debt and keep interest rates low. That is a known. What is unknown is the second order impact on the markets. This is the dichotomy.

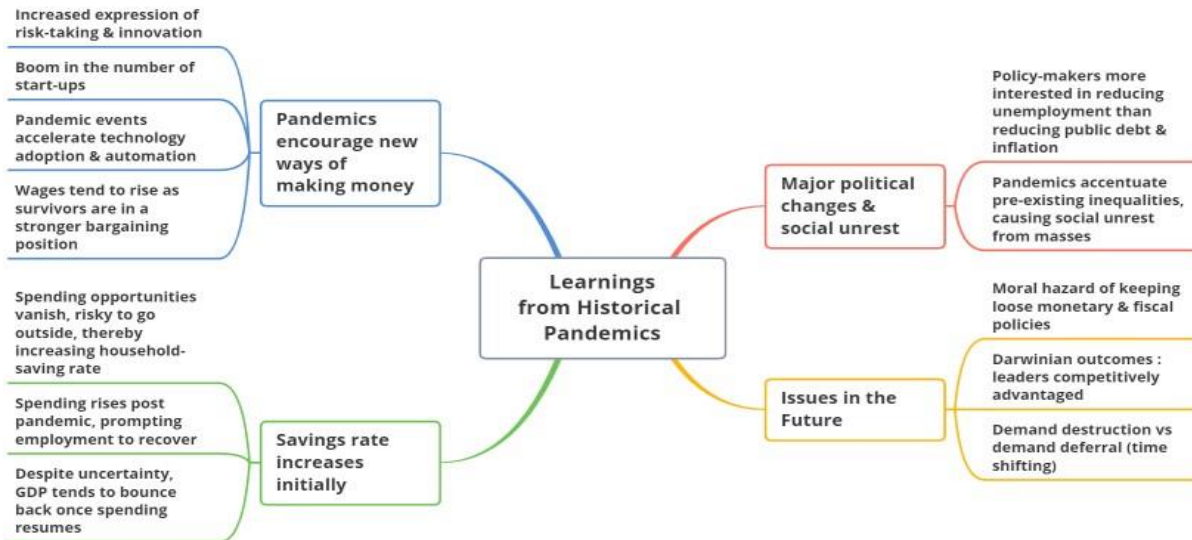
Japan has been in a continuous deflationary environment, courtesy demographics, savings and productivity gains. Small changes in investor psychology can produce disproportionate changes in valuation. We must question the downside of taking more debt and borrowing from the future. Elevated debt levels will lead to debasement of currencies and purchasing power. Nobody knows how long the party will continue for, but each day gone is bringing the reckoning closer.

MOI Global: Which inflation camp are you in? There is one group of old school economic theory concepts, who believe that inflation will come back. We have a lot of material which indicates that inflation is here to stay. On the other hand, there are modern monetary policy and economic theorists who say that inflation will not come back, owing to technological advancements and other reasons.

Inflation : It's a Matter of Degree & Persistency



Transient Demand Shock in 2020 Leading to Transient Inflation in 2021 ?



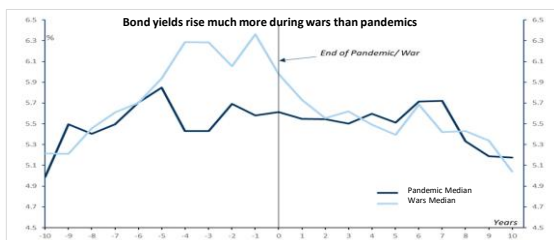
Kuntal Shah: There are two opposite forces acting in the market. Demographics for the world at large are slowing down, except for certain nations like India. Secondly, cost curves are declining. If you see computing power, renewables, energy storage, technologies etc. are ensuring that costs decline steeply.

Inflation has two dimensions, the demand side and the supply side. James Grant defines inflation very differently as- “Inflation is caused by too much money chasing after too few goods”. In 2020 and 2021, we had a very huge disconnect. 2020 witnessed a demand shock where the world had come to an abrupt halt and massive destocking took place. Today, companies are realizing the adversity of “just in time” business models and are restocking at a far higher pace. This is putting pressure on container pricing and commodities complex. The crux lies in your assessment, whether this is transient, or structural inflation. A policy error could very well transform this transient inflation into a structural one.

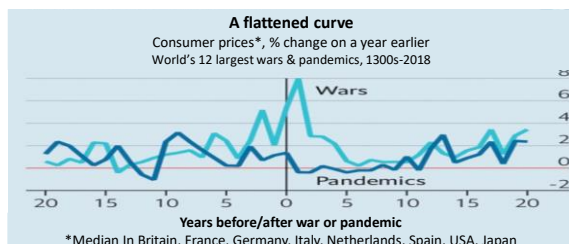
War Destroys Capital Assets, Pandemic makes them Idle (in the Short-Term)

Wars					Pandemics				
No.	Event	Years	Duration	Fatalities*	Event	Years	Duration	Fatalities*	
1	World War 2	1939-1945	6	150-250m	Black Death	1331-1353	22	2-3bn	
2	World War 1	1914-1918	4	80-120m	Spanish Flu	1918-1920	2	150-200m	
3	Thirty Years War	1618-1647	29	70-130m	Plague in Kingdom of Naples	1656-1658	2	15-16m	
4	Napoleonic Wars	1803-1814	11	35-45m	Encephalitis Lethargica Pandemic	1915-1926	11	6-7m	
5	Seven Years War	1755-1762	7	10-12m	Third cholera pandemic	1848-1854	6	6-7m	
6	First English Civil War	1642-1646	4	6-8m	Plague in Spain	1596-1602	6	8-9m	
7	Vietnam War	1963-1973	10	5-8m	Asian Flu	1957-1958	1	4.5-5.5m	
8	Korean War	1950-1953	3	4-8m	Russian Flu	1889-1890	1	4-5m	
9	American Civil War	1861-1864	3	4-6m	Italian plague	1629-1631	2	3-4m	
10	Spanish Civil War	1936-1938	2	2-3m	Hong Kong Flu	1968-1969	1	2m	
11	Franco-Spanish War	1648-1658	10	2-3m	Great Plague of Seville	1647-1652	5	2m	
12	Franco-Dutch War	1672-1677	5	2-3m	Great Plague of London	1665-1666	1	1-1.5m	
			Avg. Duration	7.8				Avg. Duration	5.0
			Med. Duration	5.5				Med. Duration	2.0

Notes: The 12 largest wars and pandemics measured by deaths, excluding regional wars and pandemics without economic data. *The fatalities data for wars and pandemics have both been re-scaled to today's global population.



Source: Goldman Sachs Global Investment Research, Cirillo and Taleb (2020), The Economist



*Median In Britain, France, Germany, Italy, Netherlands, Spain, USA, Japan

Kuntal Shah: After studying the previous twelve pandemics, I have realized that they do not destroy the manufacturing base, they only make them idle. Unlike wars, that actually destroys the manufacturing complex. What ensues is an inflationary environment and a difficult period of re-building. Most pandemics are not inflationary though. It just takes time for the supply to come in.

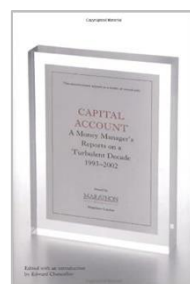
That being said, one big caveat is that every event is unique. Librarians would be the richest people in the world if history were to keep repeating itself. This time, the issue was that when the pandemic began, debt levels were already high compared to historical pandemics and wars. Today, global debt, whether in absolute terms, or as a percentage of GDP, is the highest ever in the history of humanity. This brings us back to the question- “how much debt is too much?”

Things could go either way, given that every Fed tightening results in a credit incident, throwing the market into convulsions. This is called “Taper Tantrum”. Can the Fed have a gradual and calibrated exit, and can Central Banks coordinate the exit of the stimulus provided to the market? If yes, then inflation will remain transient.

Just like a movie, this is a dynamically evolving scenario. As investors we have to keep evaluating how the markets are restricted. The bond market is losing its predictive value as an indicator of inflation. There are a lot of regulatory norms that compel the buying of bonds, even if yields are depressed. In light of Regulatory forbearance and financial repression, one must analyse the feedback the market is giving on inflation expectations w.r.t asset prices and commodities complex.

MOI Global: You mentioned how commodities tend to do well in inflation, if and when it occurs. Commodities are extremely cyclical, and are not amenable to long-term prediction and compounding. How do you reconcile the fundamental nature of commodities in your portfolio? What bucket do they fall in? How do you manage those kinds of investments?

Kuntal Shah: Edward Chancellor and the team at Marathon Asset Management have written very good books on capital cycle. Two of them are Capital Account and Capital Returns. These are some of the most brilliant books for those who want to understand capital and asset cycles.



We have under invested in capital intensive industries for some time now. The bulk of the investments have been in capital light, new business models, with new environmental cost considerations and lifecycle costs among other things. Although technology is contributing to declining costs, the cost of commodities, their extraction and processing into final goods is constantly increasing. There are supply constraints in the form of tariff barriers and the security of sourcing raw materials. Rising interest rates will make setting up new supply chains more difficult in terms of land acquisition, buying machinery etc. For perspective, the price of steel is soaring today.

Evidently, efficiency can be achieved in a commodities business only if there is meaningful capacity expansion to increase scale adequately. Capacity expansion in large amounts does not bring in demand. Thus, they will be cyclical and there will be a mismatch, because the entire industry profits

at the same time and rushes to expand. This is a cyclical industry serving basic goods and with very long lead times. This segment can be taken advantage of till supply constraints last and the markets are tight.

To answer your question, yes, we are overweight on an inflationary environment. Besides the financial sector, we have some indirect plays on commodities, because steepening of inflation and yield curves will allow them to earn higher profit margins and NIMs.

MOI Global: Thank you for recommending Marathon Asset Management's books. I have read them, and I agree with you, they are phenomenal. Can you share your thoughts on gold? You mentioned it as a predictor of inflation.

Kuntal Shah: I find that the best way to play this theme is through gold financials. Appreciating collateral value helps them in downside management. Gold financing is an India-specific business, with Indians having a well-known affinity towards gold, not only as a store of value but also for consumption. As my colleague pointed out to me, the Lindy effect is in play here, what has been around for donkey's years is ingrained in our mentality. This affinity towards gold has helped Indians in the past to protect purchasing power against debasement of the Indian currency in an inflationary environment. It has served passive investors well, with an average compounded return of 9% to 10% adjusted for debasement. The gold that Indians have, serves as collateral to borrow for working capital or emergency needs at good rates. This creates an instantaneous liquidity flow and is unique to India, where we have banks, non-banks and dedicated finance companies giving short-term to medium-term loans against the gold. It is a safe business if done well. Furthermore, rising underlying collateral prices allow companies to ramp up their AUM, because they can loan more against the collateral.

RBI, the Central Bank of India has restricted the amount of loan permitted per unit of gold, but rising prices assist in AUM creation. In the last year while gold prices have not done much, the underlying gold finance companies' valuations have almost doubled. This is a very interesting way to passively invest in gold.

MOI Global: This is a unique situation where, unlike other loans, here the collateral is with the lending institution. Due to this nature, I believe the long-term loss given default for these businesses, which are well run, has been zero if I am not wrong.

Kuntal Shah: It is quite low. In fact, the largest gold finance company has more gold than some of the central banks. It is a very unique Indian phenomenon.

MOI Global: Maybe it would help to tell the audience some more about the largest gold finance company in the country having more gold than certain central banks. Could you speak about the quantum and its distribution? I believe it has a large number of branches across the country.

Kuntal Shah: Traditionally, they have been South India dominated, but they have expanded pan India now. In fact, almost all the lenders have gold financing businesses today, be it banks, non-banks, dedicated gold financiers etc. Earlier, a lot of bankers hesitated to enter this business because of the physical nature of gold. It is the exact opposite of lazy banking, where it is easier to issue loans sitting in air-conditioned offices. Giving small gold loans is cumbersome and manpower intensive. However, the lucrative nature of the business, with lower losses and higher returns, attracted banks eventually.

MOI Global: Great, shifting gears again, Let's talk about the latest stage in your career as an entrepreneur. Could you speak about needle.ai? How did it come about? What is this startup all about?

Boundless Productivity

Get more out of your time, with your data auto organized, stitched and made shareable.



needl.ai

Needl unbundles data from various devices and apps and bundles it with cloud processing.

Our mission is to retrieve, organize and stitch **your** data from multiple sources to make it accessible and useful.

Kuntal Shah: Incidentally, this idea is the progeny of my own needs. I have high volumes of data, coming in at a high velocity. Adding to that, this data is of various types, like emails, PDFs, Word documents, Excels, chat messages, images, summarized articles etc. The biggest pain point is that all this data resides in various apps and devices. My entire process of data storing, processing, consumption, sharing with team members and people in an external environment, getting feedback etc. was extremely fragmented. There were distinct silos, devoid of data processing capabilities. This compounded the friction in day-to-day tasks.

needl.ai was born out of the need to optimize my time and improve my productivity. Aspirationally, needl.ai is a data management platform, with three components. It is a live repository of all your data, across a variety of private and public data sources. The data is unbundled from app silos onto your personal cloud, enhanced by cloud computing in the backend. This gives users the option of intelligent knowledge management and rule-based, automated data sharing. This way, it completes the entire feedback loop. I can locate what I want, process it, and share insights in a frictionless manner. Since it is a cloud, it is ubiquitous in nature.

Amplifying signals while reducing noise increased my productivity many folds. Data overload is one of the biggest challenges faced today. This creates a negative feedback loop, where incremental data has diminishing utility.

needl.ai enables extraction of relevant data and helps organize information making it more usable. Over time we realized that knowledge workers all over the world have similar issues. At the onset, we had an in-house IT division within our firm. Once we saw the value in empowering knowledge workers with these capabilities, needl.ai spun out as a different company. It has been quite serendipitous.

MOI Global: I like how some of the most formative stories you have shared have a large element of serendipity and even needl.ai comes out of an unspoken, unmet need today. I am curious to know how different it is, investing in a business versus building a business. Which one is more difficult?

Kuntal Shah: Finding the right talent has been the biggest difficulty, ranging product orientation to branding. Secondly, there has been an absence of risk capital. There is plenty of capital chasing imported business models of the West, and applying them in the Indian context, but there is hardly any capital to innovate and create a product, and scale it in the Western world.

There has been a big spin off of this, and it has made me learn a lot about SaaS and business companies abroad. I have started investing in them through the LRS route. Some of them have done extremely well. The exposure to new business models has taught me a lot as an investor.

Hiring is underrated. This business allows me to attract talent by using equity as an incentivizing tool. Being a consumer-centric technology product, cognitive diversity in thinking and experiencing the user journey are very important. You have to avoid root causes of failure and friction at the inception focus on what not to do. I am a hands-on investor, but I find myself to be a hands-off entrepreneur, delegating decision-making, with a laid-out product roadmap, a budget, and wonderful people working to make this dream a reality.

I have adequate skin in the game, with a guard against product feature creep as well as removing unwanted things. Applying my learnings from investing, have enabled me to play a very constructive role in needl.ai. However, the bulk of the heavy lifting is done by the team and my co-founders Vikram and Rachna. It has been a satisfying journey so far and I hope for it to make me a better investor.

MOI Global: Can you explain the LRS scheme?

Kuntal Shah: India has capital controls where you cannot convert your Indian rupees into dollars. There are limitations on capital and extensive reporting requirements limiting access to the Western markets. Furthermore, there are tax issues, which make investing at scale in overseas markets very difficult for Indian investors. There is also a home bias. LRS allowed me to take the plunge and start investing in a limited manner. I could expand my horizon and circle of competence. As far as my success goes, the writing is still not on the wall.

MOI Global: Great. Last question Mr. Shah. You have wide ranging interests. You are an investor, a teacher, and an entrepreneur. How do you manage your time in these three roles?

Kuntal Shah: Off late, the startup has been taking a lot of my time. I am trying to solve my own problem of data management, within the investing field. The two are complementary to each other, but my time is highly devoted to needl.ai. Apart from that, being a concentrated investor, with few positions gives me the greater flexibility of time as an investor.

MOI Global: This has been a great pleasure Mr. Shah. You have been very generous as always with your thoughts and your learnings, and we really appreciate your time. Where can the audience get to know more about you and your thought process? What are the web sources that you would recommend people check out?

Kuntal Shah: Well, looking me up on the search engine is the easiest way. But for my investing activity, we maintain media appearances and presentations on our company website- [Oaklane Capital](#). I tweet periodically at my handle [@kuntalhshah](#). For needl.ai we have a website [needle.ai](#) and a twitter handle [@needl.ai](#).

MOI Global: Thank you for your time. This was great.

Kuntal Shah: Thank you very much. And thanks to the Manual of Ideas community for giving me this opportunity. I hope you have some tangible learnings to take home from this interaction.