

Sid Choraria on Developing a Winning Investment Process in Asia

In an episode of [The Zurich Project Podcast](#), presented by MOI Global, Sid Choraria discusses the process of intelligent investing in Asia. Sid addresses several key topics:

- Key aspects of a winning investment process
- Identifying great businesses in Asia (case studies)
- Differences in opportunity across Asian markets
- Choosing between similarly valued great businesses
- Avoiding corporate governance and other landmines
- Thoughts on the art of portfolio management

The publicly accessible episodes of the Zurich Project Podcast are available on [iTunes](#), [Soundcloud](#), and [Stitcher](#).

A transcript of the conversation is available to members of MOI Global.

The following transcript has been edited for space and clarity.

MOI Global: It is a great pleasure to welcome to this conversation Sid Choraria. Sid is a private Asian equities value investor focused on wonderful businesses at wonderful prices in Asian markets including markets in India, China, Japan, Australia, and ASEAN. Asian markets are inefficient and less competitive relative to developed markets and provide a rich and growing fertile fishing ground for global value investors. We will cover a few different topics.

In 2013, Sid, you gained the attention of Warren Buffett with a letter and investment writeup on a century-old wide-moat Japanese company. Let us start with your investment process.

Sid Choraria: I am a big believer in inversion as taught by Charlie Munger. As an active manager, you want to fish where the fish are. There is a multi-decade opportunity in Asia or the Asian century I call it: a large and growing pond combined with an inefficient market. Let us discuss the backdrop as it is important to finding winners.

China's GDP has grown to \$14 trillion from just \$1 trillion 20 years ago. That is a 14 bagger. Market cap has grown to well over \$10 trillion. Retail participation is 80%, the Chinese are gamblers, not long-term investors. This makes markets inefficient and creates opportunity.

India where I am from, GDP of \$3 trillion has grown from \$450bn 20 years ago, about 7 times. Market cap is \$2 trillion. GDP per capita is extremely low – that's low hanging fruit, it can only bode well from a long-term perspective as even small incremental changes have a big impact. India has a young population of over 700-800mm under the age of 35.

Japan GDP is \$5 trillion, it was at similar levels 20 years ago, so not a growth story like China and India. My focus here is studying the century old dominant businesses, cash cows, companies selling niche products outside of Japan to the Asian or global consumer. Like

Kobayashi. Japanese markets are inefficient – retail investors are punters and global investors lump Japan Inc. as a market with poor governance, no growth and inefficient balance sheets. This is not the case across the board and creates opportunity.

In South East Asia, GDP collectively has grown to \$3 trillion from \$600 billion odd. Here we have Indonesia, Thailand, Malaysia, Singapore, Vietnam. The region has 600 million people.

Finally, I also track global best of breed companies with large Asia growth. Facebook investing billions in India. Starbucks, Nike, Louis Vitton and Chanel in China, etc.

Compare the above to Europe. UK with a \$3 trillion GDP, Germany \$4 trillion, France \$2.8 trillion, Italy \$2 trillion, Spain \$1.5 trillion. They were at similar GDP levels even 10 years ago.

Asia has 60% of the world's population, over half the world's listed companies and so on. It is a multi-decade opportunity, large, growing, and inefficient. Fish where the fish are.

In the book, Margin of Safety, Seth Klarman discusses investing versus speculation. The Asian markets, which as I discuss offer a multi-decade opportunity have a lot of speculators pretending to be investors. This bodes well for a diligent long-term investor in the region.

Yet, this type of backdrop is complex for foreign investors, do not try it sitting in New York, Zurich or London and screening for stocks. There are big differences in transparency, governance, accounting quality, regulations, liquidity, competition. You need local knowhow and networks. You need to know the people behind the business. The political and regulatory dynamics can make or break a thesis. The culture in Asia is starkly different from the US or Europe, you cannot learn that by reading The Intelligent Investor. In Asia, experience over cycles matter enormously. Success in one market does not equate to another.

Let us now dive into the process, at the high level 3 steps:

First, I search for wonderful businesses across Asia. At a high level, there must be a clear view of the reinvestment opportunity. I have a process to uncover companies with pricing power, i.e. intangibles, companies where price paid vs value perceived is large with entrenched consumer behavior. I like cash cows in the core business. Most importantly, I prioritize predictability, how does a company perform across economic cycles, especially bad years. Finally, industry matters. For example, India, people love cricket – if you are the 20th best, you will earn a lot more than the #1 ranked hockey or soccer player in India.

The second step is to focus on discovering “Outsider” type CEOs/founders with the right incentives. How does compensation structure vary across the company? Is it determined by operating income growth, share price performance, returns on capital, revenue growth or market share? What is the culture like? I prefer to scrutinize a 15-20-year track record of reinvestment, performance in a bad year, rates of returns vs costs of capital, capital returns, acquisitions and prices paid, look at capital raises and why. I pay attention to the composition of board of directors as this says a lot about the company. Is it a bunch of “yes” men? Getting the people right is incredibly important – and particularly in Asia, where it can break your thesis as a minority shareholder.

The third step is the wonderful price. Discipline of framework is extremely important since human emotions get the best of us. This is why theory and practice are vastly different. At the core is predictability of a company, a wonderful business is one that is resilient. How predictable is the spread between returns on capital versus the cost of capital? How predictable is the reinvestment opportunity and how long? How predictable is the cash

generation? I evaluate a wonderful price in relation to the predictability and probability of outcomes. I also think about opportunity costs, interest rates, both absolute and relative. We have learned value investing in terms of asset value, cash piles, and low price-to-earnings ratios. All this is elegant in theory, but in practice, particularly in Asia, minority investors have little to no influence on assets, unless you are an influential activist (of which there are few long-term). If there is limited reinvestment opportunity, that is a value trap.

I wanted to now discuss Kobayashi Pharmaceutical (TSE: 4967) which was a company that I wrote to Mr. Buffett in a letter. Mr. Buffett wrote back “Sid – It’s a good company. We are looking for companies like this that we can buy control of on a friendly basis. Keep your eyes open!”.

Kobayashi in 2013, was hidden in plain sight with no serious coverage then when I stumbled across it.

First, it is/was a wonderful 125-year old business. The company had niche products, more than 40 brands with high market shares of 40-70%, a “big fish in a small pond” strategy but with the ability to have high percentage over 20% of revenue contribution from new products, i.e. the reinvestment I talk about.

Second, in terms of incentive alignment, Kobayashi had a great record, the compensation structure revealed that middle and senior management were aligned in terms of being compensated with their salaries with a metric capturing the spread on return on capital as well as operating profit metrics. It has increased dividends and profits for 20 years and a history of repurchasing shares timely, like the 2008-09 financial crisis. The company was divesting loss-making divisions, and the culture of empowering employees to provide new product ideas stood out.

Third and finally, Kobayashi was trading at a wonderful price, 6-8x free cash flow on my estimate. The company had limited institutional ownership then. Since that letter to Mr. Buffett, Kobayashi has increased nearly 4 times including dividends and as of yesterday Kobayashi was at an all-time high significantly outperforming not just the relevant Asian indices but also the S&P, Nasdaq, Dow which have as you know been on a tear. Inverting this lesson has taught me a lot about the importance of investing in great businesses.

MOI: Could you go into more detail about how one can identify other great businesses like Kobayashi? Will you provide a few examples?

Choraria: Inverting Kobayashi lessons, I have curated a list of 100-150 great businesses in Asia, across market caps. My focus is primarily on the undiscovered or lesser known names. You want to catch them early. It is like hiring a great superstar, hire them early, not when they are a discovered “superstar” because otherwise you will overpay for it. If one overpays, the final outcome will be predictably average or worse, you lose money. Its fine to invest in discovered great businesses, but those opportunities are typically during a crisis.

To start with, you are looking for products that are niches, do not change much at its core, Mr. Buffett says change is the enemy to investors, right? You are looking for a large runway, and you want the core business to be printing cash and make sure this is at the hands of a great outsider. This is not easy, but since the bar is high, you can focus your efforts and be the best in the world to know those businesses.

We can discuss a few names at a high level. Let us start with Japan on the back of Kobayashi.

The first company is Hoya Corporation (7741). Hoya was founded 80 years ago. Much like Kobayashi, it is an old company, which is a test of resilience. Since 1973, the company has never reported a loss. Importantly, it is an exceptional capital allocator, probably amongst the best capital allocators in Japan. It is also focused on niches with wide moats in the healthcare industry and mask blanks space. It has a Kobayashi-like philosophy, a big fish in a small pond. It has a 20-year track record of positive and growing free cash flow with a 28% to 30% return on unlevered return on equity. Eighty-three percent of directors are independent and outside directors. Hoya has paid 75% of free cash flow in dividends and repurchases over 20 years and commits to returning excess cash straight to the hands of shareholders. This is an example of an exceptional business, exceptional capital allocator, and exceptional incentive alignment. From time to time, the stock trades at a wonderful price. I suspect, given the crisis we are witnessing and likely to witness in the markets, folks should put this on the watch list.

The second example is Tsumura (4540), a 127-year-old business. It is in the healthcare segment. Japan has one of the biggest issues in the world around demographics and aging. Tsumura has a dominant 80% domestic market share of Japan's Kampo (herbal remedies & Chinese medicines) market. This is unlikely to change over the next 20 or 30 years. The game changer with Tsumura was that Ping An from China bought 10% of its business about two years ago. The partnership provides reinvestment opportunities in a market that is huge. However, since Ping An's stake, the stock is actually lower as the business has not manifested the changes yet.

The next example is Pigeon (7956), a 70-plus-year-old business with a big moat. It is the leader in baby products. Babies will not change their behavior 5 or 10 years from now, right? Pigeon has patents around its products, but the best part is it has great capital allocation. Management focuses heavily on the spread between return on capital and cost of capital which is rare anywhere but quite rare in Japan. It is still only a \$4 to \$5 billion business. It must become a bigger business over time.

Moving on to India:

The first example is Marico (531642) which is a household brand in India reaching over 200mm households. It is well known in India, not undiscovered but it is still only a \$5 billion company with a 20-year track record of positive revenue growth, net profits, operating and free cash. High market shares with 40-70% in niche segments. It makes many products one of which is its legendary coconut hair oil, any Indian will swear by it. This will not change anytime soon. It is a company that would probably meet the Buffett test for a wonderful business and wonderful capital allocation, it is a bit small for him though.

The second Indian example is NESCO (505355) which I was amongst the first analysts to present it publicly in 2014. Since then it has multiplied over 4 times. The company has a large margin of safety given its massive land bank and investments, but it has run into a temporary problem because of COVID, the exhibition business and rentals will go down significantly this year. But there is a massive margin of safety. If you add the company's cash and long-term investments, the revenue of NESCO could be zero but the company could pay for all its operating expenses for six to eight years, perhaps longer. In my view, NESCO would meet the Buffett test, if he were running a smaller partnership like \$100-500mm in his younger days.

In China, I am doing work on several mid-caps between \$1-5bn that meet my first two criteria. I will not reveal the names for this interview. But I will say that in China, the larger

businesses, like Kweichow Moutai (600519), Jiangsu Hengrui (600276), Gree (000651), Tencent (700 HK), Netease (NTES) are amazing businesses, still growing 25% plus which is rare to find given the size of the businesses.

MOI: When you have two great businesses and both are seemingly available at similar valuations, how do you decide between them? Can you explain your process on the wonderful price?

Choraria: At a high level, it centers on a few variables: predictability, reinvestment, and opportunity costs among other factors.

When deciding between two great businesses, one in Japan and one in India, remember they have different costs of capital, rates have been near 0 in Japan! If both trade at 20x earnings or 5% cash or earnings yield, they are not the same because you have to assess them in relation to opportunity costs in that particular market. The larger the spread relative to the local opportunity cost, the more interesting it is.

The second part is the predictability of revenue, profits, cash flows, capital allocation, downside risks looking at 15 to 20 years. If you look at in 2013/2014 when the Baiju companies in China were reporting negative growth, which does not typically happen, there was an anti-corruption campaign then. Kweichow Moutai still showed flat to slight growth that year, compared to the rest which declined double digits. So today, if Moutai and Wuliangye Yibin, for example were available at 5% free cash flow yield, you have to adjust such for predictability and resiliency.

I solve for “wonderful price” by ranking the reinvestment opportunity, what is the returns on capital vs cost of capital, how bad was the worst year vs its peers, etc. In this manner, given a stream of cash flows, I objectively evaluate the opportunity, without bias. This is a high-level explanation. I would be happy to at some point present a more detailed session on this topic, if it is of interest.

MOI: That will be terrific. How do you avoid landmines when investing in Asia, particularly on the corporate governance front given recent examples in China?

Choraria: You start with inversion. You study what has not worked and avoid them.

In Asia, there are several areas to avoid: obfuscated cash flows, excessive related party transactions, margins or growth that is too high and cannot be explained, muddled revenue recognition, newly listed companies with limited track record and serial acquirers.

Let us first discuss obfuscated cash flows. Without making specific comments but making observations from public sources, you look at Luckin Coffee in China. In general, when an analyst pitches an idea as China’s Starbucks, or China’s YouTube or China’s Netflix, I hit the pause button right there. For Luckin Coffee, if you just looked at the cash flow statements, it was difficult to piece together, and certainly did not come across as sustainable without lots of capital raises. Easy skip.

I will give you another live example. A few years ago, I attended a group meeting with a company called TAL Education (TAL), one of the leading education companies in China. If you look at the headline metrics, it checked the right boxes. I was probably the only Indian guy in a room full of Chinese, so I figured I would ask the dumbest question. I asked TAL why it sported a 2x market cap than the next company, New Oriental Education & Technology (EDU), although operating and free cash was consistently half that. I did not get a clear

answer. My next question was for a breakdown of the TAL's long-term investments, which was meaningful on its balance sheet and what prices they were recorded. I did not get a complete or a good answer, so after 45 minutes, I decided to skip and move on, "too difficult" camp. Earlier this year, the company publicly admitted to inflating sales and issues around revenue recognition. Muddy Waters was involved. In my own case, without doing much work, it just made common sense to move on quickly.

The next red flag for me is excessive related party transactions in Asia. There is a long list of accounting frauds that were obvious in hindsight if you just looked at the messy web of related parties. There was an explosive example in Hanergy in Hong Kong, where the founder at one point was the richest man in China, even ahead of Jack Ma! The listco had one client - its parent!

The next red flag is when companies in Asia have margins that are too high or revenue growth much faster than peers but that cannot be explained. This is actually common. A decade ago, there was a now infamous case study of Satyam Computer in India. The margins were much higher than many other leading Indian IT companies, and Satyam was much smaller. It did not have a special sauce, so that could not explain the high margins. Satyam also had related parties. Interest income on income statement did not reconcile with cash balances.

Next, muddled revenue recognition is where most of the trouble starts. If a company has an opaque business model, skip it. For example, some famous investors got entangled in an Asian accounting fraud called Sino-Forest. It was hard to understand how this company recognized revenue through its "intermediaries". You just have to take it for what it reports. Finally, serial acquirers are a skip.

MOI: Will you describe in more detail your thoughts on portfolio management?

Choraria: My goal is to own a focused portfolio, companies with pricing power, wonderful businesses but at discounted prices. Typically, between 8-15 "best of breed" businesses across Pan Asia, China, India, Japan, Australia, and South Asia.

I am long-biased, but this is not to say I would never short, it is rare though, but I do have a list of zombie businesses just for fun.

I read your conversation with Mohnish Pabrai from a recent interview. He said we should be a harsh grader of people. I would say we should also be a harsh grader of businesses.

At a portfolio blended level, the characteristics typically are:

- Profitable company with a long operating history with distinct competitive advantages
- Attractive returns on unlevered equity on the "core" business vs its cost of capital. I adjust the figures for tangible cash, non-operating assets, lazy assets.
- Businesses with attractive reinvestment opportunity, ideally 15-20% growth over a long period of time or at least 2x the country's GDP.
- I like companies with assets, cash, securities, and even better if they are hidden assets and obfuscated. I avoid companies with debt.
- Companies that have less reliance on the external environment
- I avoid investing in companies that have customer, supplier concentration
- Blended valuation: I focus on operating and free cash flow not accounting earnings. Balance sheet line items are scrutinized - liabilities are marked up; assets are revised

down.

Great long ideas are rare – when you find them, you must act aggressively. In lieu of them, be patient. Once you have done that, you want to hold the business for as long as possible.

I do not mind holding cash in lieu of great opportunities, although I prefer to hold cash-like alternative stocks of which I have developed a list. It is better to hold cash than to do dumb things, speculation vs investing.

In terms of geographies, I prefer not to focus only on one market like China or India or Japan because my experience in Asia suggests there are periods in which all the qualities I seek cannot be met.

MOI: This has been another terrific conversation. Thank you so much for sharing your insights into value investing and intelligent investing in Asia. It is always a great pleasure.

About the featured guest:

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

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

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

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

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

Sid received his MBA from New York University Stern School in 2011 and was recipient of the

Harvey Beker Scholarship. During his MBA, Sid worked at Bandera Partners, a fund focused on small mid cap activism, run by Jeff Gramm, Author of “Dear Chairman”, Greg Bylinsky and Andy Shpiz.