Questions For Amitabh Singhi

Peter Lynch used to say that the most important organ in investing is not the brain, but the stomach. Do you agree with this, and if yes, how have you overcome this?

Well I think the ideal mental state for investments is patient alertness. Ideally you want to wait for a time when the investment jumps out at you and years of preparedness come to the fore. It's simply a no brainer. At that time your gut and mind work as one. We have situations where a company we love at certain valuations falls 50%-60% further in price because of the overall market. It does not take much thinking at that point to make the investment.

Most other times, having a stable temperament and an independent and secure mind is critical. Many times the macro picture in the overall stock market, economy or industry plays havoc with both the stomach and the brain. That coupled with the complete averseness to see marked-to-marked losses over a one month, one quarter, one year or even a three-year period disables one to act at the right time. Then the fear of being wrong and investing in a "value-trap" adds to the insecurity. One has to be able to take decisions clearly and quickly in times of turbulence and not fear making a mistake. Self-confidence is the key.

That is why they say that our business of fund management is about competing with one's self. It is about good mental habits, about an ethical mind-set and to have a very secure mind. Because an insecure mind will never be able to compete long-term and even an institutional setup or an academic mind-set does not take away that insecurity. That insecurity creeps up whether you are 25 years old or 50 years old, whether you manage $100,000 or $1 billion.

Of course, the reason why Graham is essential is because a complete internalization of his philosophy gives an immense sense of mental security. If one understands accountancy, and has a keen interest in business and has read Graham thoroughly (very helpful to have read the Security Analysis with footnotes a few times over), one can read-on endlessly about other's views and experiences and keep fixing one's self. Learning to learn continuously is key. All of this becomes much easier if you surround yourself with positive people.

What are the qualities of a "good" company in your book?

It really depends on what type of an investment we're talking about. Buffett has done almost all types of investing. "*Trade like Warren Buffett*" and the "*Snowball*" highlight some of the lesser known ones. Soros has traded currencies and shorted securities very successfully. The Magic formula throws up a totally different type of investments compared to Fisher. We have an advantage in India of having all types of markets developing. There are many "good" companies that are creating solid managements form the freshly spurned out MBAs from the country's hundreds of upcoming business schools and various other vocational schools. There are good investment opportunities in newer markets as well.

In my experience in India cigar butts and net-nets are easy and sensible to do when the capital under management is small (under $100 million). There are three net-nets in our portfolio and there are many such companies in the country.

Also there are many companies that are well run and are trading at sensible valuations. There have been times in the last year when there are companies that have very high RoEs (in the 30% range) and were trading at below 9 times earnings in India.

At the same time the distressed debt and equity markets have recently got a fillip with the SARFAESI Act of (2003). This act allows secured lenders, including banks to take over assets of the defaulter and be privy to an accelerated court procedure. We recently did a distressed transaction in which we participated in an auction of the distressed real estate asset (commercial property in Mumbai), settled the lenders (two banks), went through various legal hoops and finally sold the property. This would have been impossible to carry out even five years ago.

Tiny companies, like the ones Buffett was supposed to be buying in the 1950s and 1960s are available here. As Buffett said about Korea in 2003 –there are many such opportunities available in India. The reason is that we have the second largest (after the US) number of listed companies at about 6000 companies out of which about 2000 are actively traded in India. Also given the robust Chartered Accountancy practice in the country the quality of financial statements and numbers available is reasonably good. Also, given the impression that many companies have corporate governance issues, many honest companies trade at discounts because many investors tend to throw the baby out with the bath water. As a result there are many unknown, small companies that are like Jersey Mortgage, Bankers Commercial, Rockwood, National American Fire Insurance, Western Insurance, Davenport Hosiery, Meadow River Coal & Land, Westpan Hydrocarbon, Maracaibo Oil Exploration, National Casket Company, Sanborn Maps and others that The "*Snowball*" mentioned Buffett to have done.

There are many arbitrage and special situations available because arbitrage funds don't really exist. Buffett's returns in arbitrage are his best-kept secret (attach study). I think one can successfully do that in India. More about that later.

There are good investment opportunities in newer markets as well. For example, the high-yield debt markets are still being organized. The long-term futures and options market still doesn't exist. Stock borrowing has just started but still doesn't exist in a meaningful manner. The options market also throws up interesting mis-pricing but one cannot put in substantial capital as yet.

How do you personally calculate the value of a company?

We do basic DCFs and look for a heavy margin of safety. Typically we look for situations that can double or the underlying business can generate 25% returns. We do not make detailed models. The only companies where we have done some detailed excel modeling is for banks since the accounting is unique and the leverage is high. But 95% of the times we do very basic cash flow analysis, or sum of parts analysis and wait for a heavy margin of safety to appear in the price. The ideal situation is where the business has a long history in a business that has survived various twists (competition changes, macro industry issues, internal company problems, changes in the market etc and has maintained high returns on capital along with disciplined capital expenditures.

Do you buy technology stocks?

We don't have anything against technology per se. Any industry where things are inherently unpredictable lends itself to a venture capital type of mind-set, where funding the right leader / team becomes all-important and then a lot of randomness / luck is necessary to meet any degree of success.

However, sometimes a technology company can become cheap enough to merit a second look. We bought and sold Patni Computers, which went from being an over $1 billion market cap company to a $350 million ***net-net*** in six months. It had never lost money and the chances of losing money in the future were very low and yet it was trading below its net cash levels of $400 million with almost $100 million in after-tax profits!

A similar uncertainty exists in companies, which belong to industries that are new to the economy and are on a high growth trajectory. It is best to wait till the industry matures, and the euphoria of investors dies down, sometimes for even as long as a few decades. For instance, the telecom industry was in 2004 or the power industry today, where business opportunities are immense, but investment opportunities are few.

How much cash do you keep in the portfolio?

We hold a lot of cash. There is no one holding a gun forcing us to invest. We have been in 50% cash for years at a time. Many times we will try and find special situations to put cash to work.

Fixed income in India gives about 5% post-taxes. Commercial real-estate yields are about 8-10% pretax but the transaction costs and headaches are high.

Do you have any position sizing limits to limit the maximum size of a single position or sector?

Initially when we started out we did not have any such position sizing limits. We went 40% into one stock in our initial years (our AUM was tiny then). But now we have some sizes in mind keeping with the overall market valuation, correlation among industries and companies and general margin-of-safety principles. I do think that every manager should heavily concentrate into a few securities a few times in a decade depending on what is available. We usually keep a under 2%, 5%, 10% and a 15% limit on a stock/industry.

Over the last three years, cash has been our largest position, sometimes crossing 60% of the total portfolio.

Do you try to structure the portfolio into various strategies, such as net-nets, arbitrage, turnarounds, inevitables, etc?

We are opportunistic but our natural inclination is towards net-nets and arbitrage. We don't do many turnarounds. Also a lot of such investments can only be classified into buckets after the investment has played out. Please see a slide on Gujarat Fluorochemicals (slides are attached) we often present which shows how one company went through all different buckets in a short span of three years.

Is there any time where you could consider trading instead of long-term buy and hold?

We will trade value but not prices. Many times our positions unlock within a quarter and we sell quickly. In fact, I think tracking the market prices daily is important because even if your selling price comes for one day or one hour, and you miss it – it's a mistake. We had such a situation a few years ago in Tata Chemicals and we missed it during one quarter. We were lucky to find an exit opportunity over a four day trading session the next quarter and we sold. The stock crashed over 50% soon after we sold. That was a close shave and we learnt an inexpensive lesson.

Are you still finding opportunities in Indian equities?

They are fewer now than they were 10-12 months ago, and much less than when we started in 2001 to 2003. But I think cash is a poor substitute to doing adequate research and inertia. One must turn EVERY stone there is. Being a little paranoid to look at everything is a good habit to inculcate. Also the fear of spoiling a good track record is a terrible reason to not invest.

I understand that shorting of Indian equities is very different than in the U.S. Would you care to elaborate on some of the differences / risks involved?

Shorting is not efficient. We had written about this in a letter (excerpt is attached). Essentially, the futures market is not very efficient because stock borrowing and lending is not very prevalent. Therefore often the futures trade at heavy discounts to the spots. Another problem is that long-term options either don't exist or are not liquid for the ones for companies where the options do exist. One can look at the daily traded volumes etc at www.nseindia.com (click on the F&O section).

Another problem with going short in India is that the crooks have a pretty high chance of getting away with stealing from shareholders for long periods of time. The judiciary dispenses justice with long delays and the doses are usually very small in comparison to the crime committed. Also, often the fraudsters are powerful and rich enough to demolish adversaries be it in courts, or stock markets through market manipulation.

Nevertheless, if one really wants to go short, one can look to short index futures and roll them over every few months or short them outside India.

What is the operating environment like for hedge funds in India? Is the barrier to entry very high?

It really depends on what type of money one is trying to raise. It is easy to setup a structure for domestic money or NRI money coming in from outside the country. If one wants to manage money for non-Indians investing in India, it is a little more complicated.

Are corporate governance issues common with so many family-controlled businesses?

Clearly India is in a transition phase. Many laws are unclear. For example, giving money to the government over and above some measly amounts is illegal but in the US its legal and its called lobbying. So many things that are considered illegal are actually a result of antiquated laws. But there are many companies that gain market share or business because of doing things that are immoral or illegal and it's not limited to family controlled companies. In fact PSU and professionally run firms - all have rotten eggs. Also some of the best run companies are family owned, professionally managed.

The CA practice in our country is a double-edged sword. We have the second largest number of professional accountants in the world with over 160,000 registered members. Many companies' books are cooked up etc.

But this fear of corporate governance is what makes it exciting because there are many hidden gems that are actually honest but get a "dishonesty" discount. For any investor to operate effectively in India, getting local knowledge is most important. Scuttlebutting is key to operating in India when you look at any company. Going and meeting managements, meeting competitors, building and leveraging networks in each industry, interviewing ex-managements about a company etc. : a combination of all these work splendidly.

Are microcaps/smallcaps easily valued in India? Can their numbers be trusted?

I think they are heavily discounted. It is a lot like the US in the 1960s. We have had a lot of tiny-caps in our portfolio, the smallest of which has been a company called Compucom Software. We bought this company when the market cap was $5 million. We sold it at 2x to 3x our buying price soon after.

The thing to remember in such companies is that it is important to diversify amongst them and also allocate a fixed % of total assets in them as a group.

What are some of the resources/screens/programs that you use to search for stocks? Is there an Indian version of Valueline that summarizes several years of historical data for Indian companies?

Capitaline is a great resource. They have a few databases very reasonably priced. Sansco is another service that gives the historical annual reports in physical CDs. A free website for some annual reports is EDIFAR (http://sebiedifar.nic.in/sebi_doc_pub.asp?value=ar). Most of the large companies will mail you the annual reports if you write to them.

We screen fairly extensively, we also look at recession years in industries and we also have a screen based on how companies did during those times.

How do you measure or account for political and economic stability in the Far East regions of your investment portfolio? As well as property and shareholder rights? Do you apply a larger discount due to these factors?

Value often unlocks with change in some underlying fundamentals. There is a discount one can give, but Indian capitalism works without the government. Also the current government is quite progressive. I think changes in India will be felt every 5 years. One of the main changes is that states are competing for investments. The Gujarat government sealed the Nano (the TATA car) factory deal within a week after West Bengal made it impossible for the factory to start.

What's the investment that you consider your biggest mistake and what were the lessons from that mistake?

Our biggest mistake is probably going to be the one we mentioned in a recent letter (excerpt is attached). The stock is still 50% below our buying price.

Is there any source from where one can get historical annual reports of Indian companies, as Bloomberg only goes back 10 years and the SEBI (Indian version of the SEC) website doesn't work very well?

SANSCO and Capitaline both provide the service.

Do you see any sort of collective effort to get SEBI to require companies to submit quarterly balance sheets as part of interim/quarterly "Financial Statements"?

It would be a great move to prevent fraud. Also, many people have an unfair advantage when they know how the BS has moved when outside investors don't know. Although I don't see this as a huge dis-advantage. You pretty much know whether to trust the management looking at their performance since inception. Also, the news lets you figure out what the new cash levels, debt levels are etc. But it would be a great positive change.

Assuming your fund was of a small size when you first started, how were you able to convince management to spend time talking to you?

There wasn't much convincing required because contrary to popular belief very few people talk to managements of small companies in India! I have found most companies very responsive to investor calls. For example, one can find net-nets through basic research and then you call the CEO to go meet them, they often give a lot of time. No body calls these guys!

Although the reason we don't talk much to management is because we believe that one, it is actually detrimental in many ways and two, they don't add much value anyway. The management often doesn't realize that the stock is cheap. Other times they are so busy in running their business that they don't seem to care.

On your website you mentioned the workout with E-serve delisting which was an interesting situation. I was most fascinated by the scuttlebutt aspect of the process where you called the mutual fund houses to figure out the price they would be willing to sell at. Would you care to elaborate how one goes about doing this?

The sellers were getting together to decide what price they were going to bid for the de-listing. We got on the call and realized that the price was clearly going to be higher than what the market was pricing in. We were also going to be one of the sellers. Also, the price some of the large shareholders would sell at was public knowledge through the news. In fact, some of the large mutual funds had publically expressed their disappointment at selling their shares at Rs 800 (if I remember correctly the price that the company was offering informally).

This was a bit like what Buffett was doing with Union Street Railways (page 195 in the *"Snowball"*). The only difference was that instead of getting additional information from the company's management we sought the information from the various institutional shareholders about their talks with managements. We assessed that worst-case, the company would stick to de-list its shares at Rs 800 which was around where the market price was. So there was a very low chance that the de-listing offer would get cancelled, a slightly larger chance that the Rs 800 per share would be the offer and the existing shareholders would either accept or reject the offer. But there was a very high chance that the price would be higher. We had also done our homework in understanding how eager the new owners were in delisting the stock off the exchange. So we figured there was very little downside in buying the stock at Rs 800. What happened was something that we also had not expected. The offer finally came through at Rs 975 per share! So we made over an 18% return in 2.5 months.

On the same topic, due to lack of activity in India, there aren't many merger-arbitrage opportunities. What other sort of arbitrage opportunities do you look for to provide returns when markets are fairly or over-valued?

Primarily de-listings and buybacks. A problem in doing arbitrage in a bull market is that most of the buy-backs and de-listings are priced to perfection. Merger arbitrage is tough because of no stock borrowing and the futures are short-term (3 months). The best time to buy something is when a company announces a buy-back and it comes in our radar for a long-only position.

Recently there have been one or two circumstances where Indian shareholders have stood up for their rights (eg. GHCL). Do you see the Indian promoters evolving to a more shareholder friendly stance and shareholders demanding more from management? What are

some of the options (e.g. Corporate Law Board) that shareholders have to make sure that management doesn't rip them off?

The laws are getting more enforceable. Professional asset management is serious business now and it is evolving fast. The CLB is one such body, but SEBI and SAT (Securities Appellate Tribunal) also act in certain situations. Laws are generally generous towards minority and retail shareholders. The biggest change is that managements realize that stealing $1 translates to a valuation loss of $10 assuming a valuation at a P/E of 10. So it is better not to steal.

Most of the Indian companies seem to have a majority promoter shareholding, which does not incentivize them to be responsible to shareholders. Are there any opportunities for control situations / activist situations in Indian companies to unlock value?

Activist investing is tough to do. But control situations are easier. In fact PIPES are not necessarily control situations but high influence decisions. Check out www.vccircle.com for related news.

Managements are realizing that it pays off to get rich through valuations rather than by stealing money from the company. Also, institutional shareholders are getting more organized. Private equity firms have done a lot of good work in the last decade.

If you'd recommend one text for understanding Indian accounting standards, what would it be?

The Indian Accounting Standards are available online. Talking to some Chartered Accountants helps. I basically use my 12th grade accounting knowledge. The book that is now used in schools is by P.C. Tulsian.

Which companies do you admire the most (ones with ethical and honest management, great capital allocators) in India?

Hero Honda, Great Eastern Shipping, most Tata Companies, Mahindra & Mahindra, Marico, Infosys - there are many.

I like the TATAs for their ethics but they are financially a shade worse than Buffett. They tend to take on large amounts of leverage every five to ten years in many of their companies. But they are a long-term growth story that will grow with India. Also their trust structure of working is similar to the structure of what has evolved with Buffett and the Gates Foundation.

Each sector has some heroes. Shipping has the Sheths of Great Eastern Shipping – they have a 60-year history. Finance has some TATA NBFCs, Shriram Transport (a stock we have have owned in the past).

Which company's shareholder letters/annual reports are the best in terms of increasing one's business knowledge (excluding Berkshire)?

I think a society where the people express their views through writing is a sign of an advanced society. India has very rich literature on mythology, religion, science, maths, etc. But capitalism is a fairly recent phenomenon and there aren't many people who write on what they feel strongly about. John Maynard Keynes, Galbraith, Buffett, Graham, are gifts to society – something modern India lacks.

There are few people who stand up for their views. We had Ramnath Goenka who ran a bold newspaper; we have many RBI governors who have written well. There have been a few great speeches and books on TATAs etc. But pure Munger-like business wisdom is scarce.