Soumil Zaveri of DMZ Partners discussed India-based case studies in investing in compounders and finding great businesses early at Best Ideas 2021.

The following transcript has been edited for space and clarity.

Soumil Zaveri: It's always a pleasure to spend time with you and the incredible community you've painstakingly curated. Every time I spend time with you and the rest of the colleagues at MOI Global, I appreciate that I should be talking less and listening more.

I always enjoy sharing how I think about things, not necessarily because I think it'll add much value to anyone listening, as much as it helps us rechallenge and reanalyze and reassess our strongest-held beliefs, which usually get us in the most trouble.

Having said that, I'm here to speak a bit about this idea of stalking Indian 10x10s. The focus on India is clear because I'm domiciled here, so I tend to spend the majority of my time on the Indian opportunity set. When I say 10x10s, I'm referring to companies that have historically, or have the capacity, to compound earnings in the range of 8x to 10x over, say, 10 to 12 years. I've always been fascinated by this topic of buying exceptional businesses and staying put. Of course, implicit are all the biases that come with that.

Let me take you through my thoughts in pursuing opportunities like this.

First off, this is not a stock-specific idea or presentation. The key reason I have veered away from that is I've come to appreciate, based on the historical track record, that my best idea for any given year is usually of little relevance for that year itself, given that a big piece of our approach is to say we have no ability to have an opinion on how something will do over the year. It's more a story on my investing journey so far of allocating capital in India for about a decade, and my experience with these kinds of compounders here in India.

Ideally, it's a format for me to invite and initiate any discussion on my blind spots. I have to be clear that there are no strong verdicts or declarations here as much as what's worked for me, so please take everything I say with that disclosure or disclaimer in mind.

The presentation highlights my approach and my inspirations. A lot of my inspirations come from the businesses that have kept me company over the past few years, some of which tend to be these earnings power compounders. I also find it to be a fitting time to speak about how valuations always matter, but that you can give yourself a little leeway with what I call "time and price warps" — probably not the best terminology. I speak a bit about some of the biases implicit in the compounder world and some of the abating factors. Finally, I discuss decompounders, or compounders gone wrong, and the guardrails that perhaps one should keep in mind with letting compounders run. Hopefully, that stimulates some nice Q&A.

Any talk on compounders or compounding machines is incomplete without me naming some of the investors and writers who have influenced me. Apart from my father, who I've learned a lot from, I've been heavily influenced by what I've read about Chuck Akre and Akre Capital, Mark Massey at AltaRock, and of course (referring to page 5 of the slide presentation), some of the authors here. You'll see that kind of terminology and ethos in my presentation.

I largely view our investing style as a large insurance policy against my own personal inadequacies, and the approach we follow is, to use Mark Massey's term and to borrow it liberally, the conglomerate approach. That tends to be the best common ground between my skill set and mindset. A big component of my approach, as you will come to see, is me trying to protect against what I view as my handicaps or inabilities. I have identified six such "inadequacies".

There's my inability to deal with regret, and my lack of competency with timing. You may rightly argue that value investing is not really about timing, but when I say timing, I mean it in the deeper sense of the word. I even hint at the idea of valuation, for example, where I don't necessarily have a strong view on whether something is worth x, or x plus 20%, or x minus 20%. I tend to be focused more on what is the reasonable range of outcomes at prevailing prices that I can expect over a period of time.

I'm also be terrible at reinvestment, where I buy something at $0.50 on the dollar and sell it at $0.90 on the dollar, because the burden or the onus of putting that $0.90 back to work would rest on my shoulders. I'd probably not be able to do justice on that journey of $0.50 to $0.90.

I'm also completely unable to discount for mediocre or poor businesses which might have drastic changes in earnings power from year to year, and I'm absolutely unable to discount for suboptimal people. Maybe that comes from the ecosystem in which I allocate capital, but I've never been successful in putting a 30% discount on people I can somewhat trust.

There's an implicit compromise in having all these inadequacies or all these blind spots: valuation analysis for us is more a function of implied returns at prevailing prices as opposed to desired returns. I know of many people who say, "If you're looking for compounding machines, and implied returns don't meet thresholds, do something different." Our approach is more disciplined. We say, "I wouldn't be any good at doing anything different. I'd probably do more harm than good, and we'd prefer to wait rather than change course."

I'll start with one of the early examples of a company I was fortunate to be in the company of, so to speak, early in my investing career. That early wind in the sail — the foundational investments with which you've been successful — form a big piece of your framework or your mental model. It's like what Morgan Housel says in his book. This was a business called Gruh Finance, which I looked at in 2011 when I first moved back to India. It was an affordable housing finance company focused on providing low-ticket-size, affordable housing loans to "informal" members of the economy. These are typically people that you would consider subprime in the Western world, but given that in the Indian ecosystem, a large percentage of your population doesn't file tax returns, a big piece of the economy is informal in nature. It served a critical role in providing credit. The parentage of the business was HDFC Limited, which is one of the most prudent underwriters of credit in our ecosystem.

Looking at the annual report In 2011, and looking back 10, 15 years, you saw this exemplary rate of growth of, whether you call it assets under management or profitability, etc. It was compounding at, call it 25%, 30% year after year after year. Yet in 2011, the assets under management were less than $500 million in an ecosystem where total banking-system credit was INR 100 trillion, so the opportunity set was large. What this business achieved over the next 10 years wasn't too different from what you saw in the previous 10. There was this steady compounding of profits again, from 2010 to 2019, which is when it merged with a bank.

The simple point here is that early on in my investing approach, being comfortable extrapolating recent performance — and when I say recent, I mean in the past 3, 5, 10 years — has usually yielded good results. Clearly, that's not always the case, and you can't have this straight-line analysis forever, but given that you're in an ecosystem where per capita consumption of some things is low, and where certain businesses have formed incredible moats in little niches — whether it's in the lending ecosystem, whether it's in the financial services ecosystem — it has paid well to keep an eye on what's been doing well over the past half-decade or a decade, and honing in in that space.

Another company we've been fortunate to be invested in is Bajaj Finance. When we first bought this business in a personal capacity, looking at the previous five years, you saw this incredible growth in assets under management, strong return-on-equity metrics, low non-performing assets, and a management team that spoke with exemplary clarity of thought, and backed that clarity of thought with consistency of execution quarter after quarter after quarter. They did what they said they would do, and they continue to say the same things. That in itself puts them in the minority of founding families and management teams in the financial services ecosystem. In 2014 they were managing 25,000 crores — forgive the Indian denominations I often use, but let's call it about $4 billion — of assets in an ecosystem which would peg them at less than 1% of the total consumer credit system. Unsurprisingly, because of the prudence in underwriting which was evident from the consistency of communication each quarter, and consistency in execution quarter after quarter, you have this exemplary outcome. Every couple of years, these are the kind of management teams that add 100, 200, 300 feet of reinvestment runway by engendering new verticals and new product lines. That isn't evident just from looking at the backward numbers as much as you get hints of it from listening to Rajeev Jain speak on it on the quarterly commentary.

Moving away from the financial services space, another business which I've been inspired by is the Royal Enfield motorcycle brand which is owned by Eicher Motors. Again, if you'd looked at this business in 2014 you'd have seen this exemplary rate of growth from 40,000-50,000 motorcycle sales annually in 2008 and 2009 to a little over 300,000 bikes in 2014. Even in 2014, this was a tiny niche of the broader commuter motorcycle segment. Since then, they've been able to grow to 2.5x that size, albeit, of course, with a bit of stumbling in the COVID year. Just to see the impact of that on profitability, you had this incredibly robust rate of growth in terms of profits, with steady ROEs and whatnot.

Another source of inspiration for me has been to look at "vintage" annual reports, as I call them. I like seeing the simplicity in a 28-page Nike annual report from the 1980s. Doing this gives you context, especially when you see some of these US-listed or European-listed businesses. You get an appreciation for scale. Nike had this hockeystick-style growth in revenues between 1976 and 1981, but anyone who thought that there'd be saturation for some time now, because these growth rates can't persist forever, was in for a bit of a shock. One of the things you see in Phil Knight's communication, both in his book and in his annual reports since, is an incredible consistency in clarity of thought which would make anyone that sees it as a static business at any point in time underappreciate the non-linearity of partnering with exceptional people.

Another vintage annual report I take particular joy in reading is HDFC Bank in India. For a bank to have a 42-page annual report in 2000 speaks volumes of the simplicity of the business. What is today one of the largest private-sector lenders in the country had a market cap at the time of just about $1 billion, earning short of $20 million of profits, with 100-odd branches, and all this in an ecosystem where the government-owned entities were (and sometimes still are) incredibly inefficient. You had these new private-sector banks that had come on the block and were punching out returns on equity of 20%, 25%, 30% with very low delinquencies, and evidence of clear underwriting discipline. It makes for really interesting reading, to see how small these businesses were then, and to appreciate how these compounding machines have played out over time. This business that earned less than $20 million 20 years ago, is earning 26,000 crores today, which is about $4.5 billion, $5 billion. A lot of that is driven by the reinvestment opportunity of nibbling at the public-sector ecosystem or the public-sector banking system. Even today, you have single-digit penetration of the broader banking-system credit.

In speaking of multi-decade compounders, I cherrypicked three or four examples, but you'd be right to point out that there are many such potential compounders that no longer exist. At the other end, there was this exemplary benefit of very low base effects, very low market shares, and nominal-sized businesses. Even today, think about which companies have profits exceeding at least $500 million in India for the preceding two financial years. There are only 19 such companies in India. If you take $250 million, there are 36. If you take $150 million, there are 60-odd companies. My point is if you think of some of these companies as having existed a decade ago, and if you think of which were $50 million profitability companies that have at least compounded profits tenfold in 10 years, it can only be 19 businesses. It's a relatively small subset of companies (if you exclude these Indian government-sponsored entities) that have been able to compound at scale or that had any scale to speak of a decade or two ago and compounded say 50x or 100x since. That is interesting to me when I see it in the US context of scale at least, especially when I see market caps over $500 million, ROEs consistently above 15%, and profit growth consistently over 20%. It's interesting that there are just 30-odd businesses that have been capable of doing that in a country where there's perhaps 6,000-odd listed companies.

This is a messy slide here (page 18 of the presentation). It's an internal slide I use sometimes. Early on in my investing career, I was fixated on the rates at which I could compound and there was this fascination with 25, 26, 28, 30 percentile growth because it seemed like that's the only way you could have hundred-baggers in a reasonable period of time. I've since come to appreciate how you can use time to your advantage if you're not fixated on absolute rates of return. You realize you can be patient because this is a business which has unusually long reinvestment runways — clearly I am guilty of projecting reinvestment runways for 24 years, and the ridiculousness of doing that is not lost upon me, but just bear with me! The point is that you can settle for five percentage points of slower growth over a 10-year period or a 12-year period. If you're looking for that 10x earnings compounder, five percentage points of slower growth can get you there if you're patient for two more years. Similarly, over a two-decade timespan, if you're patient, three or four more years can get you there with five percentage points of slower growth. Of course, what's critical — the one non-negotiable — is that reinvestment runways — or let's call them scalability runways — need to be really long.

I often hear of the ludicrousness of projecting growth at 20% forever. It's not the smartest thing to do. Even if you take this mindset (and now I'm on the right-hand side of this table of breaking up growth into multiple phases) — and I've done it into only two phases here for illustration purposes — sure enough, if something's gone from a nominal size of the market to a somewhat larger single-digit, or high single-digit, percentage of the market of the industry it occupies, perhaps you expect it to grow a tad bit faster than the industry going forward, and that's fair. When you break up these growth factors into one, two or three phases, you can still get to these 100x-type earnings compounders even though they might be growing at 16%, 17%, 18% in the latter phases of their growth cycles. The key point here is that the long reinvestment runways help compensate, to some extent, for price indulgence precisely because they add a couple of years of compounding to earnings power. Also, these long reinvestment runways improve your prospects of a soft landing. Because the runways are long enough, you're not necessarily settling for exit multiples which tend to be compressed. If, however, you happen to pick poorly or if the business dynamics change materially, some of those advantages disappear quickly.

Moving on to price warps. I spoke about time warps with a positive connotation, to nudge one to think more about compounders being able to compensate over time. Price warps are quite the opposite. Over the past decade, the experience in a number of interesting, compelling Indian businesses has been the table on the left (referring to page 19 of the presentation). Let me explain it a bit, because these are all internal tables I've quickly thrown in here: if you enter a business at 15x earnings and exit at 30x earnings, you only need earnings to compound at 13% to compound your capital at 20%. Note that these are compelling businesses; they are extraordinary businesses in terms of the economics, the growth prospects, the quality of management, etc., but over the past decade, you've had this situation where 30x, 35x earnings have ballooned to, at times, 70x, 80x, or 90x earnings, and earnings growth for many of them has been low teens. You take that combination and you see that companies which barely grew earnings 4x often give investors 8x, 10x returns. If you're parallel projecting for businesses like these, you can be in a bit of trouble because either earnings have to materially accelerate for the coming decade, or you're going to see some sort of compression risk. That's the table on the right, which shows that if you enter at ranging from 30x earnings to 100x earnings, all the heavy lifting is going to be earnings growth, and earnings power conviction is critical to compound from there on. Note that this is just for stalling multiples, not true contraction.

I see what's happening with some of the US-listed businesses — and I don't understand that space so I won't comment on it too much — but in the Indian ecosystem, you have some of these incredible businesses trading at 80x and 100x earnings, but in the past decade, they haven't shown earnings growth at rates which are commensurate with those kinds of multiples. So either incremental owners have very differentiated theses on where that growth is going to come from, or perhaps incremental owners are buying for substantially shorter time horizons.

I have a short case study on a business called Page Industries. (As a disclosure, my clients and I are investors in the business.) Page owns the Jockey franchise in India, and it's been an incredible earnings compounder. If you compare what revenues looked like in 2009/2010 versus 2018/2019 — and I've cherrypicked that year for a reason — you had 8x growth in revenues, 9x growth in EBITDA, 10x growth in profitability. Page is the exclusive licensee of Jockey apparel in India. In 2010, they had 50 exclusive outlets in addition to the other channels they distributed through. In the 2010 annual report, they showed profits going from INR 40 million in 2004/05 to close to INR 400 million. From 2010 to nine years out, that same 10x happened again. The company had incredible ROEs — 40%, 50%. The quality of the business was so exceptional that it paid out 90% of the market cap in the subsequent nine-year period. The market cap was about INR 1,000 crores, so you were still buying in at close to 30x earnings but on a very low profitability base. If you exited in 2018/2019, you exited at 60x earnings, which gave you a nice multiple expansion to add to that tailwind. You're at 20x growth in the value of your position. Of course, the multiple expansion did a lot of work for you, but the business also compounded extremely well.

Interestingly, from 2018 to 2020, there was this period of time fatigue because there was a bit of a stagnation in the growth rate. An incremental investor in 2017 or 2018 was paying a fee of over 100x earnings, which compressed to close to 60x in 2019/2020. There's this time fatigue associated with paying ludicrous multiples: when your conviction is most likely to get affected because of a stumbling growth rate, that is exactly when it's the most expensive to have that fatigue. A similar experience happened between 2014/2015 to 2019/2020, but you were bailed out to a large extent because even though you paid 80x earnings, growth over time bailed you out. You can lengthen your time runway, but the fatigue associated with that is unlikely to be too forgiving over shorter timeframes. Late 2017 buyers got back to par only three years later, and 2018 buyers are yet to get back to par. Growth over time, or frothy consensus for growth over time, is the only way to "grow out" at times.

As passionate as I am about these earnings power compounders, I tend to be paranoid about these painful long stretches of time fatigue. One of the ways I like to think about it — and again, at the risk of doing this straight-line proforma projecting type analysis — is to compare the past 10 years with what potentially one can expect over the next 10. Because I don't want to project for any specific company, I've made this (referring to page 22 of the presentation) a generic table of what I call "Apparel Company". If, over the past 10 years, you say you've been able to compound profits at 24%, you may have reason to believe that this business has a differentiated approach to distribution or branding or operational efficiency or what have you, which allows you to make some of these relatively ambitious assumptions, but one place I prefer to be conservative is on the exit multiple where I'll be able to get out, and to call 30x earnings a conservative exit multiple is not even close to fair. Having said that, let's say you have this blue-sky scenario where the fundamental economics and the superiority of the business model remain intact over a 10-year period, you still have a 40% compression in the multiple, but that strong earnings growth rate you expect can still bail you out for 50x times P/E, and you're still projecting profit growth a couple of percentage points lower, albeit on a substantially higher base. A deep conviction is required of reinvestment opportunity, together with an appreciation for why you might be a small percentage of that specific industry today, and why you might be able to take a couple of percentage points more share over time, and that can suffice to create an outcome like that.

The other example I use is of a building materials company. Again, I'm keeping this generic because my intention is not to condemn any investment or opportunity, but there's an exemplary building materials company that trades over 90x earnings. Over the past 10 years, revenues have compounded 12%, 13%, as have profits. If you are liberal on all these assumptions, you could forecast that growth will be 50% or 100% faster than over the past 10 years. Maybe you have a differentiated opinion why that's likely. Even then, if you consider an exit multiple of 35x or even 40x earnings, which is a liberal multiple to expect, assuming everything's just as intact 10 years from now, that might still make it difficult for you to compound capital at over 8% or 9%. I find these overly simplistic threshold return analysis tables useful in at least contextualizing, by virtue of making an investment, what I might be expecting of businesses.

This is an interesting appreciation of business models that has been a meaningful takeaway for me through COVID. I guess others might have learned this much earlier. One of the unique aspects of the ecosystem in India is that you have these two distinct sets of opportunities. One is the levered compounders — the guys like Bajaj Finance, Kotak, HDFC Bank, etc. — that are levered 5x, 6x by virtue of being banks or lenders, but they give you this regular growth reaffirmation quarter after quarter because there is a strong value migration theme underway of public government-owned to private in an ecosystem where even a lot of the private players have recently stumbled, so the exemplary private players have a bigger playing field, so to speak. Nonetheless, they are levered businesses. The great thing is that they give you regular reaffirmation each quarter because the runway is long, but if you consider the range of alternative outcomes over a decade from any point in time, ranging from exemplary blue-sky scenarios to the most bottom-decile events you can think of — and we all agree that COVID has been one of those black swan events — that's precisely the time corridor in which you lack a lot of visibility on these levered businesses. Will moratoriums be 10%,15%, 20% of book, of loan assets? It's impossible to know. Most of the wise and disciplined management teams will tell you that they are flying blind, and rightly so.

There's this tussle between levered businesses with a lot of growth reaffirmation, and unlevered consumer-style businesses which don't give you that regular reaffirmation each quarter — for example, some of the platform-style businesses in our portfolio. You have some quarters or years of stumbling growth or stagnation for various reasons. The longer-term growth opportunity is intact, but it requires a bigger leap of faith because you can't afford to have fatigue along the way. If you lose that conviction, that's not something that's going to be easily provided to you based on each quarter's release. On the flip side, in these bottom-decile events, the outcome ranges in these kinds of businesses tend to be narrow. Colloquially, we call them "shutter up, shutter down" style businesses: if things go bad, you pull the shutters down; when things get better, you pull the shutters back up and you're back in business. That's not an advantage that levered entities have. COVID has given me a deeper appreciation of having a portfolio approach which allows your unlevered compounders, which may not necessarily give you that regular reaffirmation, to play a key role in both your emotional and mental stability, as well as the stability of the portfolio, even though growth may be lumpier or returns may be somewhat lumpier at times.

One of the things I tend to think about is what can go wrong for compounders, especially by looking at companies that had always been considered compounders. It seems to be three key factors can explain things that go wrong with compounders.

The first is fraud or manipulation, in which case, you have a complete write-off. You have allegations rolling in and insiders rolling out in terms of selling stock and moving on. I don't want to criticize by name, but you have certain events in US pharma or German Fin2ech recently which show these types of outcomes.

The second is leverage. What I worry most about with some of the levered compounders is that you can come out of these black swan events with what I call a broken spine, where you don't have a bankruptcy event, but let's say you used to own 1% of a business, and now you own only 0.1% because, a, you are heavily diluted, and b, the market perception is impaired about the underlying resilience of those businesses which were always assumed to be extremely resilient. There were plenty of examples of this in 2008 and 2009.

The third big one tends to be disruption. This is the initially slow and then sudden burn, where those accretive economics and earnings power are demolished. These are all of yesterday's wide moats. You need to have one eye open for all these things. As investors, if the people we have entrusted with managing our capital by virtue of investing in specific companies, have steered clear of these three key buckets, and the business dynamics are compounding machines, then there are only two things we can be guilty of: either overpaying or overacting. I think both of those are well covered.

Some final points. Validly, I hear a lot about hindsight bias and survivorship bias associated with looking at things conveniently over the past 10 or 20 years and simply projecting ahead with a straight line. To some extent, though, you can get away with that in certain ecosystems where runways are long, and total addressable markets are a fraction of what you might initially perceive them to be. The way I like to think of it is that you're not locked in. While you're looking at these 20-year stories, it's always glamorous to think about getting in in year one and exiting in year 20, but you didn't have to do it that way. You could have gotten in in year seven and gotten out in year 15 and still had an exemplary outcome. You can always add, reduce, or eliminate positions as the business, the pricing, the sizing, the management evolves.

The second thing is people undermine that we're speaking of a portfolio approach where there's no guarantee on a specific 10x to 100x compounding event, but rather a basket approach to potential candidates based on the business quality, the runways, and of course, the quality of the people at the helm.

Another thing that sometimes gets undermined is looking at things in terms of a static point in time rather than as dynamic — evolving as things progress. If you look at some of the exemplary or successful companies in India over the past 5 or 10 years, a lot of them had products or verticals today that didn't exist — and even the management teams didn't know they would exist — five years ago. If you had an appreciation for the unusual attributes of some of these managers, you had to throw in a bit of leeway in paying 25x earnings instead of 15x. Recognizing those qualitative aspects may have added a lot of non-linearity which we couldn't envision back then. As Marc Andreessen says time and again: "Strong opinions loosely held." It's important to stay open to changing your mind. I've come to appreciate that this is particularly important subsequent to compounding meaningfully in a particular business because, a, you have the most to lose, and b, you have this strong bias working against you because you've compounded capital 20x, 30x, 50x in a specific opportunity so it can be hardest to change your mind. These are some of the things I've been thinking about more closely recently. Morgan Housel's words of caution fit in well here: creating and protecting require distinctly different skill sets.

I've also thought a fair amount about letting winners run. I used to be very allergic to selling — and even today I rank pretty high on the allergic-to-sell spectrum — but perhaps at times, one needs to think of formulaic size cut-offs. Maybe for some, it's a threshold beyond which they are not happy to let a position run. In other situations, perhaps a case-by-case cut-off is warranted. Maybe you do it based on whether it's a levered business or not. For me, sizing and managing risk has always also been a function of paucity of ideas. I own 11 companies. At the right price, I'd be willing to own maybe 15 or 16, but that's about it. Predominantly, this is because I don't understand too many things other than financials — and when I say financials, it's banks, asset managers and so on — consumer-oriented businesses, and some of the platform style companies. One of the aspects that is not spoken about too much is the nature of the LP and capital base that plays a critical role in whether you are comfortable in letting winners run. That's one of the fronts where I personally have been more cautious in terms of making sure it's capital that resonates with the mindset and the approach I deploy. It's a limited number of relationships, but it's capital that is likely to be stickier. Of course, time will tell.

I've meandered on through a number of different thoughts here. I hope at least some of it was value add. I'm happy to take any thoughts or questions.

The following are excerpts of the Q&A session with Soumil Zaveri:

John Mihaljevic: Thank you so much, Soumil, for a fascinating presentation. You've shared a lot of wisdom and insights with us. Could you talk a bit more about the valuation aspect and avoiding that time fatigue of paying too much? How do you set that boundary for yourself?

Zaveri: That's a great question, John. It's case by case in many ways. Before I even answer that, one of the things which I should disclose upfront is that when they were originally initiated, a lot of these ideas didn't necessarily involve paying 30x earnings or so. Many of them were 12x, 15x, 20x earnings. For me, buy decisions and hold decisions are slightly different, psychologically. You may argue that's not always rational and you're perhaps right about that. A lot of the time, when it involves these expanded multiples, it's been more a function of deferring selling as opposed to necessarily buying.

Having said that, I've not always been allergic to paying high multiples. For example, we own two alcoholic beverage businesses based in India, both of which look like they have, statically, high price-to-earnings multiples. If there is a strong thesis on why operating leverage may play a key role, or distribution may play a key role, in a relatively non-linear earnings outcome, I might be a bit more liberal upfront on price. To make sure I don't suffer from that kind of time fatigue, I make sure I have discipline on the sizing front. My largest positions tend to be what I call "tightly wound", which implies not necessarily that they're the cheapest but that they have what I perceive as the most tangible long reinvestment runways ahead, whereas the smaller positions are sometimes the ones where, perhaps at a static level, the multiples look high, but there may be reasons to believe that over a three-year or five-year period, there might be a non-linear outcome on earnings. However, if that takes longer than expected, I'm compensated somewhat by not sizing too large.

I don't know if that answers the question entirely, but it's not a perfect or rigorous science. It's as much about a lot of the qualitative aspects associated with assessing market opportunity and assessing quality of people that I'm entrusting with decision making in terms of the management team. If they are stewards who seem likely to understand and appreciate, let's call it "wallet share" — Bajaj Finance is a great example of a company that has maniacally pursued customer "wallet share" — that adds a ton of non-linearity to what that company will do over three or five years. If that kind of narrative is consistently clear, not just in what they say every quarter but how they execute every quarter and by virtue of their quality of decision making, especially the decisions that they get wrong and then they revise, those things speak volumes as to whether you can be a little indulgent at times or not. Because it's different thresholds for everyone, the conviction level can often be fine-tuned by sizing rather than by entirely sitting it out. I've always found if I own a little bit of something, I'm likely to scale it up when it's available 20%, 30% cheaper, whereas I'm unlikely to sell a position to fund a new position 20%, 30%, 40% cheaper in the midst of a crisis, for example. I'd also be hesitant to sell 20% down. What works for me is being mindful of my biases and my irrationalities, and that's helped at least manage regret.

Mihaljevic: That's very helpful. The case studies you've provided give some context as to the types of businesses or industries where you found these kinds of compounders in the past. Can you shed a bit more light on your search for these kinds of companies going forward? How do you find them, and are you focusing on specific sectors or industries where you believe the likelihood is greater?

Zaveri: I don't have a strong thesis on whether the likelihood is great in specific industries. I tend to stick to areas where I feel I have the ability to understand the basics. For me, that has been financials, consumer — and I define consumer very broadly: it could be a motorcycle business, or it could be an apparel company, or what have you — and the third one is some of these platform style businesses in terms of immense operating leverage by virtue of being a marketplace, for example. There are some interesting listed marketplaces in India. The opportunity set for me has been focusing on pockets like that, but not in a fashion that is dogmatic. I tend to spend a bit of time screening, but not in a rigorous way because I feel some of the most compelling opportunities today won't necessarily be captured by screens. As Chris Mayer nicely wrote in his book, the objective is not to find each 10-bagger, because there will always be companies that are turnarounds that no one could have expected. That's not the kind of thing I'm trying to catch in my fishing net. For me, it's more about things that seem inevitable. The trick, of course, always becomes that what's inevitable to you is likely inevitable to others, but for whatever reason, at times you might be able to buy these things at price because people are hesitant (rightly so, perhaps) to not let things create sometimes over 25x, 30x earnings, whereas time arbitrage allows you to partake at those prices and still have exemplary outcomes. Some of those learnings of mine are not as valuable in an ecosystem like today where everything seems like it's at 30x earnings or higher. That has been an interesting aspect of the approach.

I also listen in to management teams that I appreciate and respect, and to quarterly calls of companies I don't necessarily own. Above and beyond the 11 companies I own, there are 8 to 10 companies which are typically on my watchlist. Either it's a function of price or it's a function of the business evolving to a position where I feel they're getting closer to being inevitable opportunities. I don't seek just optionality value. I'm not looking for a bunch of stuff that I can own as just 1% positions and where perhaps there's optionality value, because that kind of stuff takes up a lot of space. You soon find yourself with a quarter of your portfolio made up of "might-be"s. For me, even if it's a minimum size, it's critical that there's a demonstrated track record of having walked the talk, so to speak, for the past three or five years.

Mihaljevic: In terms of the sustainability of compounding, those tables were fascinating where you showed the historical growth of a few businesses. When you looked at them, they had already posted such nice growth, and one might have said, "Who knows what happens in the future?" Please reiterate for us the key variables or criteria that you use to gauge how sustainable that growth will be going forward.

Zaveri: On the qualitative front, a lot of it has to do with appreciating management, coming to realize the new products, the new opportunity sets that they might engender over time, appreciating how they think of customer wallet share, whether they define themselves narrowly as an XYZ business or they define themselves more broadly, not just necessarily for investor appeal but truly by virtue of their past actions. Some of those things help add conviction in reinvestment opportunity because compounding at 24% from single-digit million-dollar profitability over 10 years is very different from doing that again at scale.

On the quantitative side, one of the things that we look for is large market size. In India, you have that opportunity set of companies being 1%, 2%, 3% of the industry size but with differentiated products, differentiated services, or differentiated technologies. For example, there’s a power exchange listed in India on which, currently, 3% of India’s electricity consumption is transacted. If you think of the longevity of such platform style businesses, perhaps there’s a case for that to grow a couple of percentage points over time and there’s a tailwind associated with single-digit electricity consumption growth over time. When you take some of these things together, you come to appreciate that this is a small business given the ecosystem. Even though it might have compounded beautifully as a private business over the past 5 or 10 years, it still can be regarded as in its early years given some of the product innovation, newer verticals, or newer exchanges that the business is actively pursuing, as opposed to just necessarily resting on their laurels, enjoying the free cash flows and paying it all out.

I wish I had a more concrete answer, but it tends to be more of the qualitative stuff associated with how management behaves and acts and thinks, and how large the opportunity set can be. A good example is Eicher Motors, which is the company that makes the Royal Enfield motorcycles. If you narrowly define Eicher Motors’ market as midmarket motorcycling in India, they have a 90%-plus market share in that space. However, that’s a narrow definition. Every year, there are hundreds of thousands of consumers who are upgrading from commuter motorcycles to something slightly more highway worthy and indulgent. This is not a thesis on road infrastructure in India, but as the road infrastructure improves, people want slightly more indulgent and powerful motorcycles which play a more indulgent role than just getting you from X to Y. Thinking about total addressable markets a bit more liberally rather than using a narrow definition in line with what published market-share studies or industry-body studies say, has helped create that conviction in some of the companies we own. It’s allowed me to be patient, even with time fatigue. Eicher Motors today is a portfolio company, as it was three years ago. It hasn’t done much as a stock over three years, but management isn’t obliged to match expectations implicit in the stock price. We’re happy to be stagnant for a one or two or even three-year period — provided we’ve sized correctly of course — if we have a strong viewpoint on why that business can be significantly larger over a decade, because growth is lumpy. Look at Sherwin-Williams. I don’t think Sherwin-Williams had consistent 20% growth year after year after year. It can be lumpy at times. I have no differentiated opinion or thesis which can give me an insight on when that will happen as much as a broader long-term conviction on the fact that it’s likely to happen over time, in the case of Eicher, as people upgrade. I hope that answered the question a little.

Mihaljevic: Thank you so much, Soumil. I would encourage our members to feel free to follow up with you with their own thoughts or questions.

About the instructor:

Soumil Zaveri moved to the US in 2005 to study Economics and Biology at Duke University. He had the good fortune of being taught by phenomenal professors including Dr. Emma Rasiel. In the summer of junior year, He interned with Goldman, Sachs & Co. in New York on the healthcare team within the Research division. He was extended a full time offer and joined the banking team there after graduation. Given the magnitude of changes affecting the western economies, the resilience of Asian ones and his desire to be back home, after a few years in New York, he moved back to Mumbai to start his own investment firm, and to work directly on allocating personal and family capital. He founded DMZ Partners in early 2011 with his father, Sanjay who has played a key role in shaping his investment philosophy. DMZ Partners has recently transitioned from allocating only family capital to a SEBI Registered Portfolio Manager. Soumil & Sanjay intend to cautiously curate their investor base to ensure that their investors' philosophies and expectations are well aligned over the long-term.