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Macro outlook

A tale of two ideologies: Surfers versus Sailors

"Leave enough money on the table so that investors are there not to finance you but to make a return."

- *Deepak Parekh, former chairman, HDFC*

Considering the house that Deepak Parekh built is now the world's fifth-biggest bank by market capitalization, it is safe to assume that enough money was left on the table for investors to make handsome returns over a long period of time. Despite being more than 50 times oversubscribed, HDFC Bank's 1995 IPO was priced at face value (Rs 10 per share) rather than extracting a premium from incoming shareholders. The result: that one share's value has now grown to ~Rs 15,000, a staggering 29.2% IRR over 28 years. The bank continues to outperform despite its scale with profits having grown 21.0% and a return on equity averaging 17.0% over the past 10 years.

What Parekh and HDFC Bank also symbolize is a mindset obsessed with building fundamentally strong businesses that execute reliably on their vision and stand the test of time. This 'sailor' mindset stands in stark contrast to a different one that has captured the popular imagination in recent years: that business success is defined by achieving the highest valuation as quickly as possible. This 'surfer' mindset is typified by the short-term thrill of achieving unicorn status at the earliest, with only cursory attention paid to building a lasting business.

The DNA of business-building

Apart from evolution, another biological theory also resonates well with the investor-business dynamic: mutualism. This concept describes mutually beneficial interactions between two or more species. Bees and flowers are a prime example – bees suck nectar from flowers, while flora use bees as a means of conveyance for their pollen.

Sailors subscribe to this mutualistic mindset, imbibing it into their DNA. By diluting infrequently but leaving money on the table on each occasion, they are rewarded by access to capital when needed, hence reliably steering their vessel to the horizon and beyond.

Sailors

Sr. No.	Company	Year of Listing	Closing price as of November 1st 2003[1]	Closing price as of October 30th 2023	Multiple of Money[2]	CAGR (%)[2]
1	Hindustan Unilever	1956	182	2,479	13.6x	13.9%
2	Titan	1993	6	3,116	534.6x	36.9%
3	Reliance Industries	1977	77	2,313	30.0x	18.5%
4	Asian Paints	1982	28	2,967	105.1x	26.2%
5	Kotak Mahindra Bank	1992	18	1,718	97.2x	25.7%
6	HDFC Bank	1995	32	1,485	46.5x	21.2%
7	ICICI Bank	1998	47	925	19.6x	16.0%
8	Infosys	1993	78	1,377	17.7x	15.4%
9	TCS	2004	38	3,379	88.0x	25.1%

Source: Stock exchange filings and Yahoo Finance [1] Adjusted for bonuses and splits [2] Excludes dividends and buybacks

Many examples abound of Indian companies that embody the sailor mindset. Asian Paints, India's largest home décor company, has grown revenues and earnings per share annually by 13.0% and 14.0% respectively over the past 10 years. In this period, return on capital employed has averaged ~37.0%, while dividends paid have grown by ~15.0% annually. Investors have been rewarded by an 18.0% annual appreciation in stock price; painting a very pretty picture indeed!

The mutualistic ethos is harder to find with surfers. Many young companies have used technology as a pretext to demand extraordinary valuations and undergo frequent dilutions, despite having no earnings whatsoever. Zomato, a restaurant aggregator, was valued at over $5 billion ahead of its 2021 IPO, but has posted no profits since it began operations in 2008. Its stock price is down ~57.0% from its all-time high in November 2021, while its first-ever profitable quarter (a mere ~$244,000 as of June 30th 2023) was largely on account of deferred tax credits.

Needless to say, there is nothing wrong with a business seeking a valuation for itself. Among other things, investors pay a premium for expectations of future growth, and belief in this growth comes from the story that a company can tell (and sell). Surfers usually exhibit the advantage of having newer, 'sexier' stories to tell. While these stories are designed to create excitement and hype, they also prey on several of the most basic human instincts – mentalities that can be described as "get rich quick", FOMO[1] and the "greater fool theory".

[1] FOMO, *noun*: the fear of missing out. Similar to how the word unicorn has been redefined in the modern lexicon, we propose that FOMO should be officially entered into the dictionary as a word rather than remaining just an acronym.

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Hype and hyped valuations

"Discipline is the greatest thing in the world. Where there is no discipline, there is no character. And without character, there is no progress…"

- *Jim Collins, Author of Built to Last: Success Habits of Visionary Companies*

In an ideal world, no valuation should be attached to a startup venture until it has proven itself. The assignment of a premium should be gradual and allow enough headroom for investors and management teams alike to participate in the upside generated by the company's business activities.

If run conservatively and with a capital efficient mindset, large amounts of external fundraising might never be necessary to achieve business success. Examples of bootstrapped success abound, including Zerodha, an online discount brokerage that has been profitable since it commenced operations in 2010. For the year ended March 31st 2023, the company reported net income of ~$353 million despite never having raised a penny of capital!

In sharp contrast is Paytm, a "fintech" company that listed on the stock markets in November 2021 in what became India's largest IPO at the time. The company, whose high-profile investors included SoftBank and Jack Ma's Ant Group, billed itself as India's first wallet, bank, and bill payment platform. Yet, Paytm has never reported a profitable year since beginning operations in 2010. For the year ended March 31st 2023, Paytm reported losses of ~$216 million. Hence, unsurprisingly, since listing at a market cap of ~$14 billion (~40.0x its revenues!), Paytm's shares have lost more than 40.0% of their value resulting in a massive erosion of wealth.

Surfers

Sr. No.	Company	Year of listing	Closing price as of: Day of listing[1]	Closing price as of: October 30th 2023	Multiple of Money[2]	Percentage change (%)[2]
1	Zomato	2021	126	108	0.9x	(14.5%)
2	Nykaa	2021	368	140	0.4x	(61.9%)
3	PolicyBazaar	2021	1,202	706	0.6x	(41.3%)
4	Paytm	2021	1,560	923	0.6x	(40.9%)
5	Tracxn Tehnologies	2022	93	70	0.7x	(25.1%)
6	Delhivery	2022	536	420	0.8x	(21.7%)

Source: Stock exchange filings [1] Adjusted for bonuses and splits [2] Excludes buybacks

In our experience, surfers love to generate buzz around themselves, often through optimistic predictions about India's 1.4 billion potential consumers and how they have a "secret sauce" and technology that can change the world. Self-promoters to the core, they often portray themselves as visionaries and self-styled valuation experts. The 'newness' of their stories gives them a sheen and apparently makes them attractive to a certain segment of like-minded investors, all the while de-emphasizing the inherent risk associated with young companies that are yet to prove themselves in even one business cycle.

Fool me once…

Of course, businesses built with a surfing mentality need to make a return on investment (at least for a motivated few initial investors into these companies). Two behavioral factors help deliver the returns they seek – FOMO and the greater fool theory. With the benefit of hindsight, it is easy to forget that the excitement caused by surfer's hubris can cause even the most rational investors to second guess themselves in a moment of greed.

In recent years, more than 100 investors have invested more than $5 billion into Byju's, an education technology company. By October 2022, the company was valued at over $22 billion. Since then, the company has been accused of outright fraud since accounts haven't been closed in several years while misappropriating more than $530 million by lending it to a hedge fund allegedly run out of a pancake store in Florida! Investors have subsequently slashed Byju's valuation to $5 billion; a short seller's dream if only it were public.

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Standing the test of time

“I focus on the real capital and I ignore the questions of valuation.”

- *Sridhar Vembu, CEO & Co-Founder of Zoho, a software-as-a-service company*

Sridhar Vembu, just like Deepak Parekh, puts his money where his mouth is. Founded in 1996, the same year that HDFC Bank went public, Zoho has remained a consistently profitable business. For the year ended March 31st 2022, the company recorded revenues of $890 million, with profits of $363 million. Zoho, which has remained privately-held since inception and has never raised any capital, is yet another example of a sailor mindset and a fundamentally strong business that has endured over the long-term.

Companies with a relentless focus on fundamentals and building for the long term are ones that are more likely to deliver outsized returns for their stakeholders over a multi-decadal period. Businesses run with a thrill seeking or surfing mentality may be based on solid fundamentals, but will sooner or later be derailed by their own focus on valuations and short-term growth.