October 2, 2013

Introduction

A large number of India's listed companies are controlled and operated by owners and/ business families of the original founder(s). This document will focus on such companies, the types of managers they have, and what investors should watch out for when thinking about investing in such companies.

There is a general perception that investing in such companies is riddled with unacceptable risks. We do not agree with this perception because (1) there are instances of Indian family owned businesses which have been run in the interests of all stakeholders (and not just the controlling stockholders) and which have created enormous value for shareholders; and (2) there are instances where minority investors of even MNC's companies in India have been hurt because of corporate mis-governance.

In our view, long-term investors should avoid buying into companies controlled by promoters with a poor track record in corporate governance, *regardless of their pedigree.* This view has been formed by us over two decades of experience of investing in the Indian public markets.

Our lesson is clear: we are unlikely to get good long-term results by partnering with promoters with a poor track record in corporate governance. Moreover, this is true *regardless* of the quality of the business. Our conclusion is a simple one: a solid investment *process*, doesn't permit *higher quality* of a business to offset a *poorer quality* of management.

A Framework for Classifying Types of Owner-Operated Business

We find it useful to classify owner-operated businesses into three categories[1]:

A. Owner-Operator 1 (OO1): An ideal manager to partner with in a business, OO1 not only has genuine passion for the business, he is extremely focussed on profitable growth and value creation. Moreover, he pays himself only a nominal salary. He is not in the business for the money. Rather, he wants to create something grea— something that will make people remember him, long after he has gone. OO1's don't cut corners. They are extremely ethical and long-term oriented.
   - Examples: Sam Walton and Warren Buffett.
   - In India too we have a few OO1s for example Narayan Murthy of Infosys and R. Thyagrajan of Shriram group.

B. Owner-Operator 2 (OO2): An owner-operator who is passionate about running the business profitably but is also attracted to creating wealth for himself. He will receive higher compensation than OO1s but is not a crooked person.
   - Example: Ajay Piramal.

C. Owner-Operator 3 (OO3): An owner-operator who is passionate about the business but primarily runs it for his own benefit. He does not take minority shareholder interests into consideration. He is quite likely to be very aggressive when it comes to expansion is likely to make large gambles. When these gambles go right, he is likely to be treated as a hero, but it will only take one big mistake to destroy his career. He is quite open to using political clout to further his interests. He is also open to recklessly use huge amounts of borrowed money to expand his empire. His focus is more on expire expansion, instead of low-risk expansion of per-share intrinsic business value. It is *this* type of owed-manager who is to be avoided at all costs. Becoming partners with such a a person is *risky*. Investors, however, often ignore this risk and get carried away by an OO3's charisma, grand vision, and the crowds (investment as well as media) which follow him.

Capital Stewardship

We believe that the absence of a sense of "capital stewardship" in OO3s make the idea of investing in businesses run by such persons, a highly risky venture.

In order to identify whether or not an owner manager has a sense of capital stewardship we have to watch what he *does*, not what he *says*. Additionally, we should also watch what he does *not* do.

Managers with a a strong sense of *capital stewardship*, focus on *per share intrinsic business value*. They want to see their businesses grow, but not just for the sake of growth and not at *any* cost. They want to grow profitably where *profitability* is directly linked with per-share intrinsic business value. Such a manager will:

1. Walk away from a potentially attractive acquisition transaction because the asking price is too high;
2. Never over-use leverage and will focus on growth while maintianing a strong balance sheet;
3. Will never gamble his company's fortunes on a single venture, which, if it went wrong, will destroy the company (i.e. he will have a strong sense of risk management);
4. Won't ignore the possibility of share buybacks as a means to increase per-share intrinsic business value; and
5. Avoid coming too close to politicians for business gains. We strongly believe that *political clout* is *not* a *sustatainable* source of competitive advantage for businesses. We have seen numberous instances in the past where investors bought into shares of companies run by OO3's who delivered exceptional earnings growth driven by licences etc acquired through *political clout.* The *quality* of such eaarnings was poor because they were *unsustainable* and when the politican influence waned, this poor quality became apparent. Investors lost huge sums of money by investing in such companies.

In our own experience, we have found that by simply *avoiding* investing in companies run by OO3's, we materially *reduce* risk of permanent loss of capital.

In his 1993 letter, Warren Buffett explained how he thinks about risk. He wrote:

> *In our opinion, the real risk that an investor must assess is whether his aggregate after-tax receipts from an investment (including those he receives on sale) will, over his prospective holding period, give him at least as much purchasing power as he had to begin with, plus a modest rate of interest on that initial stake. Though this risk cannot be calculated with*

engineering precision, it can in some cases be judged with a degree of accuracy that is useful. The primary factors bearing upon this evaluation are:

1) The certainty with which the long-term economic characteristics of the business can be evaluated;

2) The certainty with which management can be evaluated, both as to its ability to realize the full potential of the business and to wisely employ its cash flows;

3) The certainty with which management can be counted on to channel the rewards from the business to the shareholders rather than to itself;

4) The purchase price of the business;

5) The levels of taxation and inflation that will be experienced and that will determine the degree by which an investor's purchasing-power return is reduced from his gross return. (Emphasis Mine)

We strongly believe that that while evaluating managements, investors should focus on points 2) and 3) emphasised above. Doing so in a systematic manner will reduce the possibilities of investing in companies run by OO3's and therefore materially *reduce* long-term investment risk.

Unitech vs. Hawkins

We cite here a study of outcomes in contrast by showing what happened to the the long-term stockholders of two companies.

Unitech Limited was high-profile real estate and telecom company was run by over-aggressive promoters who used *political clout* and large amounts of *leverage* for what we believe was reckless expansion.

Unitech's stock fell 86% over the last five years while Nifty rose 36%. The company's promoter also went to prison.

Hawkins Cookers, on the other hand, is a low-profile, and highly profitable branded pressure cookers manufacturer run by promoters who have not only practice conservatism while running the business, they also refused to give in to "unwarranted pressure from certain authorities" who tried to blackmail the company.

Over the last five years, Hawkins Cookers' stock soared by 949%.

Many years ago, the Chairman of Hawkins Cookers delivered a talk titled "The Seven Strands of the DNA of Hawkins" to his company's shareholders. In the pages that follow, we reproduce the transcript of that talk, which we believe, reflects the quality of an OO1-type onwer manager.

Annexure

The Seven Strands of the DNA of Hawkins

Mr. Brahm Vasudeva
Hawkins Cookers Limited

Annual General Meeting
July 31, 2009

Speech of the Chairman

The Seven Strands of the DNA of Hawkins

My dear shareholders, ladies and gentlemen:

I am very pleased to extend a warm welcome to each of you to the forty-ninth Annual General Meeting of our company. I trust all of you are pleased with the results for the year ended March 2009 and our recommendation for a dividend at the rate of Rs.20 per share – which will be the highest dividend ever declared in the fifty-year life of our company.

In my speech to you today, I shall not speak about our company's financial performance.The Annual Report has been with you for some time and, in any case, as the lawyers say, res ipsa loquitur – "the thing speaks for itself". Instead, having just completed our Golden Jubilee Year, I would like to talk to you about the DNA of our company, about our nature and our character, about what makes the Team Hawkins tick. I prefer to do so because I believe a Jubilee should be not only a time for celebration but also for reflection– reflection on who and what we are, a time to look back on history, before we look forward to what will be in the future.

To begin this quick survey of our company over the last fifty years, I can do no better than to quote to you one paragraph from the Directors' Report in our Annual Report 2008-09:

"In the year of our Golden Jubilee, it is fitting to thankfully remember our founding directors, Mr. and Mrs. H. D. Vasudeva, who started your Company in 1959 with an equity capital of Rs.20,000. More important than the money that they brought to the business was the vision of the need of crores of Indian homes for the convenience and economy of the pressure cooker – at that time an unknown product in India. That vision and the values, energy and tact of Amrit and Hari Dutt Vasudeva are, to a great extent, responsible for what your Company is today. Their son, Brahm Vasudeva, the present Chairman of the Board of your Company, had the good fortune to join his parents in Hawkins as Managing Director in 1968 and to benefit from the guidance of his father for many fruitful years. The survival and growth of your Company for fifty years, and its future promise and potential, are a tribute to the vision and values of our founding directors."

So what were those values of our founding directors that have taken root in our company and govern its actions today?I would like to present to you what I may call the operating values that have emerged in the actual conduct of our company over the last fifty years. As I look back on the last forty years that I have been privileged to work in and for Hawkins Cookers, I see seven strands in our DNA. These seven strands are not from any hallowed mission statements – in fact, they have been put together in writing for the first time specifically for the purpose of my speech to you today. These are principles deduced inductively after studying the behaviour of our company over its first fifty years.

Principle No. One: Follow the Golden Rule: "Do unto others as you would that they do unto you".

Since we want to be treated fairly and reasonably by all who deal with us, this rule obliges us to deal equally fairly and reasonably with all who come into contact with us. This includes employees at all levels, vendors of goods and services, dealers and consumers. We do it because we believe it is the right thing to do. It also tends to build positive relationships and trust in all who deal with our company and with our brands.

Principle No. Two: Ends and Means.

We are not so results-orientated that we will use any means to achieve them. All our people are instructed time and again that the results have to be achieved and the means have to be right. It is not a question of doing one or the other – we have to do both. Each manager, each worker is made aware of his or her responsibility to ensure that the results are achieved only through using acceptable processes that meet our professional and our ethical standards and the country's legal requirements.

Principle No. Three: Seek the Best.

The pursuit of excellence informs all that we do – from the choice of materials and machines to the selection and promotion of our people, we choose to work with the best we can get or create. For example, in the nineteen seventies, when imports were severely restricted and we needed a special purpose flow-forming machine to make a heavy base pressure cooker, we collaborated with the Central Machine Tools Institute in Bangalore to design and produce the machine. Incidentally, for that achievement, we received a Silver Shield from the Government of India for import substitution in machine tools More recently, last year, when the galloping prices of nickel led a number of manufacturers to downgrade the quality of stainless steel, we chose to maintain our nickel/chromium levels and bear the high costs. For the selection of workers in our three plants, in Maharashtra, Punjab and U.P., we use written tests and physical endurance tests (a five kilometer run) along with hand-eye coordination tests and interviews to select the best workers. For managers at all levels, we use written tests conducted at ten or twelve centres all over India and group discussions and final interviews conducted in Bombay in which top management participates. In the case of both workers and managers, we advertise extensively in the press to invite applications and carefully process each of the many thousands of applications that we receive from time to time. Salary progression and promotions are on the basis of a well-structured appraisal process in which top management participates.

Principle No. Four: Hot Focus.

We are a stay-close-to-the-knitting kind of company. It was not always so. Before he started Hawkins in 1959, my father, who was 54 years of age at that time, was already a serial entrepreneur:he had started a general insurance company, a pan-Indian distribution business for imported radios and refrigerators and a company that aimed to manufacture cold storage units. By 1959, he had disposed off his other businesses and was uncharacteristically concentrating solely on pressure cookers. By the time I joined in 1968, there was within our company a division trying to manufacture optical-medical instruments – which we closed down after a few years.

Nevertheless, we produced and marketed Four Seasons, a quarterly magazine in four languages, four types of spices specially formulated for pressure cooking and two types of electrical kitchen appliances, the Inframatic and the Simmermatic. All these products were not commercially viable and were closed down almost 25 years ago. Since then, we have diversified only into cookware which is an area where the technology and distribution channels are closely allied to our original business of pressure cookers. I am glad to say that the cookware diversification is successful. Today, we know as much or more than any other manufacturer in the world about pressure cookers and cookware. Our products compare favourably with pressure cookers and cookware manufactured anywhere in the world. Our policy of Hot Focus applies not only to our choice of diversification – it applies to the way we work in the company. For example, we have the practice of gathering relevant managers along with top management in groups ranging from 15 to 30 people for a week at a time on various topics such as technical development, marketing and advertising, once or twice a year. There have been over 50 marketing seminars. Such seminars are held in residential locations outside Mumbai and permit undisturbed concentration for 10 to 12 hours a day on pre- prepared agendas and presentations. They result in greater clarity on policy issues and better operational decisions.

Principle No. Five: Be Prudent.

This principle applies to our financial operations as well as general expectations. We are conservative to the point of being stodgy. We do not issue 'detailed guidance' to investors. We do not seek out analysts or journalists. We don't "Bet the Company" on anything, no matter how exciting the prospect is. We believe in vigorous preparation and planning and we never forget the importance of the unforeseen and the contingent.

Principle No. Six: Where an Important Principle is Involved, Be Bold, Brave and Resolute.

There have been a few occasions when we have faced situations fraught with consequences. It may be a hugely important customer or a state government or even the Government of India who has in some matter treated us unjustly to the extent that it hurts us in a major way or involves important principles which would prejudice us in the future. In such cases, we have never shied away from representing our case directly to the party concerned or, if all else fails, taking the matter to the appropriate court. I am pleased to report that, in such cases, the authorities have eventually seen reason and have not acted vindictively. I am pleased to say that our principled stand on various issues with various authorities has always benefited us in the long term.

Principle No. Seven: Do Your Best and Leave the Rest to God.

This most important principle prevents us from developing an exaggerated view of our own importance and allows us to sleep soundly at night. It also enables us to enjoy our work without undue anxiety. Nothing more is expected of any of us than we work sincerely and to the best of our God-given abilities. It enables our employees and our associates to work in an open and collaborative atmosphere, free from fear. It enables people at all levels to freely contribute to decision making and implementation without being unduly anxious about how they will be perceived or the final outcome. It enables all to give of their best.

Based on an historical analysis, those are the seven strands of DNA that I see in our company. As to the future, based on all that I know, I feel optimistic and confident. I feel the first fifty years have laid a good foundation and created good work habits in the Team Hawkins. I know the future will call for the best efforts of all Hawkins employees and associates and the continuing grace of God. You, dear shareholders, will draw your own conclusions – based more on what we deliver than on what we say.

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[1] "The Investment Checklist" by Michael Shearn