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The season for mea culpa

The Occasional that talks sense… most of the time

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Hand it to Ramalinga…now suddenly, there are companies that are coming out and saying the unspeakable…no, not that they cooked their books or that they rode tigers on the weekends or some such thing…but that they had essentially lied to the public for the past many months, when swirling rumors of their business troubles first emerged.

Subhiksha, a major aspirant to the crown of India's Wal-Mart, is a good case in point. Mr. Subraminam, an IIM-Ahmedabad graduate, Subhikhsha's promoter, sent out a 9-page press release last week, and handed out interviews to just about any newspaper that employed a journalist. The sum and substance of this unbelievable PR campaign is that: "***We are near bust. We have no money. We have unpaid salaries of Rs.180 mln or so, due since last October. We haven't paid vendors or store rents for weeks/months. Operations are at near standstill. We are talking to PEs and Banks to raise money. We need lots of money, and it doesn't matter whether it's debt or equity…***"

Well, well.

Rumors of Subhiksha's cash crunch have been around for the past 6 months at least, and have been hardly of the nudge and wink variety. They have been on TV and in newspapers. And what was management's response to these rumours? They flatly denied that any such problems at all existed.

And now we have DLF. Through 2008, they were the ones with the most upbeat view of the world (Sorry. Satyam did raise its guidance on an occasion or two, in 2008). Slowdown? *What slowdown*? Cash crunch? *What cash crunch*? *Can't you see that we have just announced a buyback?* (Quite another matter that DLF almost simultaneously announced a fund-raising program). Home prices can fall? *What utter rubbish.*

And now? They come out and say: *Hey, we saw the slowdown coming in…December 2007*! That, *ipso facto*, puts them in the elite category of fund managers anywhere in the world, who saw a slowdown coming as far back as December 2007. No wonder DLF has started an asset management business.

DLF management now further goes onto say that margins in the real estate business are illusory because they reflect historical cost base being monetized at current prices. As per DLF management now, the real estate business is hardly the sexiest business around. It is normal, pedestrian, and suffers very long cycles. And still does not deliver Return on capital that is any better than what can be expected from virtually any other business.

Did we hear them say all this on the IPO roadshow?

And then there's this little thing about DLF Assets. I mean, Ramalinga is inside simply because he didn't disclose this sort of things in his filings. It is ridiculous how the marquee names of investment banking went around the world with accounting of this kind from DLF, and sold this rubbish to fund managers who profess to doing a lot of *"deep study"* before they *"commit capital"*. If your commission dollars are still headed largely towards these investment bankers, then even God won't forgive you.

Frankly, I have no problems whatsoever with DLF or K. P. Singh. They did what was their *dharma*: To sell their stock at the highest price possible to gullible hedge funds and institutional investors. And they did this with accounting that was so transparent in its audacity that it made me stand up and applaud them. Nothing wrong with that in this capitalistic world.

As an aside, a strange, selective amnesia appears to be pervading the buy-side's collective consciousness. Almost nobody now admits to having applied for the Reliance Power IPO. "We don't do this kind of thing"; "We are purely fundamentals driven", or some such garbage. Beats us how that IPO built a book of many billion dollars when nobody seemed to have applied…and it's the same now with that crap offering, Future Capital (again, Mr. Biyani, like Mr. Ambani did absolutely the right thing…sell stock at an amazingly absurd valuation. I mean, if Future Capital was worth a billion dollars at its IPO price, all with some $700k of profits, then I'm richer than Bill Gates). Nobody now admits to having bid for its IPO. Point is: our investing mantra is Momentum triumphs Morality. So why be coy in admitting that bidding for all these IPOs was nothing but a pure momentum, buy-to-flip strategy?

(Separately, in our humble view, the only larger, cosmic purpose Real Estate listings served was to give short-sellers a great basket to be short on. Nothing else.)

And we still maintain our 12 month old view that DLF is a mid-double digit stock (just as Unitech is a single digit stock), in line with The First Global Theory of Secular Compounding, which borrows extensively from the concept of Radioactive Decay and Half-Life, ie, the mass of radioactive substances keep halving consistently through their lives. Many stocks in Emerging Markets (and in the US, in the tech boom) belong to this category, wherein their stock prices halve, then halve again, then halve again, and again, and again…so these stocks will be secular compounders on the reverse side…just like Half Life.

So Ramalinga has sparked off a purging of sorts among Corporate India, wherein folks who denied that they ever even suffered as much as a toothache, are now coming out and saying that their businesses are in tatters.

Go, Ramalinga, go!

Why is the world so fascinated with Retail and Real Estate

Reliance goes and sinks in a gazillion dollars into this business called retail. Sunil Mittal wants to do the same. The Goenkas too.

And on the Private Equity side, dozens of Real Estate PE deals have happened, and I suspect, some more will happen.

Let's take Retail first. It is a rubbish business, in large part. Folks look at Wal-Mart, and then rush out to announce their own retail plans. What they forget is the very high mortality and near-mortality rate in this business in the US. Sears has been in and out and back in ICU for many, many years, Eddie Lampert's Buffetesque magic notwithstanding. Montgomery Ward, Macy's, Bloomingdale's, K-Mart: all have flirted and worse with bankruptcy filings. Even Wal-Mart has struggled in many overseas markets. You are lucky if you can manage a moderately high single digit EBITDA margin. Then there are the massive capital outlays And the processes. And the customer's varying tastes (and the consequent inventory obsolescence). And the logistics. Even if you get all of it right, there is still no guarantee that you will survive the next cycle.

But try telling that to any Indian group. They'll come up with some report by somebody called McKinsey or some such name, who has predicted that retail in India will be worth some mind-numbing number of dollars 25 years out or something. If our memory serves us right, it was the same McKinsey who said back in 1996 that the branded staples (rice, pulses, etc) business would become an industry worth many billions of dollars. Many years later, Hindustan Unilever, who had embraced this report totally, quietly exited parts of its branded staples business, which had given it nothing but trouble, and all for a lousy few million dollars of sales.

And it's the same thing with Real Estate. I have been astounded at the number of real estate funds that cropped up last few years. Most of them entered into something called "structured deals" with the developers. "***I'll get a minimum pre-determined rate, irrespective of whether the bugger can sell anything or not" "I have come up with a damn' innovative structure…I get a protected downside, and a lion's share of the upside***"**.**

Capped Downside? Unlimited Upside? Signed Agreement? With Real Estate developers? You may as well have signed a deal with the Mujaheddin.

Look: Real Estate, in aggregate, is a no-win business, save for, for the developer. First of all, Real estate has very long cycles, and if you enter somewhere in the middle of the up-cycle, given the gestation of the typical project, by the time it hits the market, a typical 5 year cycle will have been over. And then starts the long wait for the next up-cycle…something that could be 10 years away. As a PE investor, you will squirm and twist as illiquidity comes and bites you in the ass.

So you are gonna invoke the "put option agreement" you have with the builder? Good luck. If a stage has been reached that the developer cannot honour his commitment as per the agreement, then forget about getting him to honour it through legal action. The unwritten law of India (and for that matter, any country) is: In India, don't f—k with the Indians (or locals). They'll tie you up courts for the rest of your sorry little life. Remember, the first and last rule of gambling is: The House Always Wins.

Here, the House is the guy who builds houses for a living. He always wins.

So it's hard to feel any real sympathy for Real Estate PE investors. Most of them wouldn't have been able to see a slowdown even if it lay next to them all night.

What's with Educomp?

Now, this is a company we don't cover. But we have analysed it in the past. The company has been in the news lately because the promoter, Shantanu Prakash, also an IIM-Ahmedabad graduate, has alleged that a cartel has been trying to spread rumors about the company to drive down the stock price. And apparently, the rumors have been serious enough for the Ministry of Company Affairs to order a probe into the accounts of the company. Well, in the past year or so, many companies in India and abroad have gone to town about how a mystical bear cartel is going around killing perfectly legitimate businesses. Quite honestly, while there may well be the occasional sharp practice here, it is almost impossible that mere rumors can destroy a great business or company. As ICICI and Unitech found out, it is better to concentrate on one's business issues rather than the stock market, for if there is indeed a cartel out there doing silly things like shorting a truly great company, then guess what…they are going to be wiped out real soon.

We have seen the anonymous mails/faxes circulating around. Never mind the bad English. Some of the points raised in the mails are interesting. And actually it is wrong to call them rumors. They are actually based on publicly available documents like the annual reports, regulatory filings, etc. And we have been engaged in discussions with management to gain better understanding of Educomp's business model, as also to get them to clarify the issues raised in the anonymous communications.

And to their credit, Educomp management have been very forthcoming in responding to our queries, which is something to be commended.

That said, while our analysis is still half-baked and work-in-process, fact is that Educomp's business model is "unique"…and in fact, we have almost never come across anything like it before. It is a curious mix of a hardware leasing business, coupled with on-site education, all of which combine to make a business that has never ever earned a buck of cash flow ever in its entire life, and by the looks of it, never will, if the model remains the same. The growth in EBITDA is more than matched by growth in debtors, leading to negative cash even at the operating level, pre-capex. This results in pretty hairy-looking financials that will fly very well in a bull market, but how they fare in a bear market is quite another thing. And the trouble always is that the harsh glare of a bear market exposes the warts in any company's business model, specially one of cash deficiency, and this deflates high valuations faster than a cold shower deflates…well, you know what….

This apart, the fact that the CFO has sold off 100% of her stock does not appear very kosher, even while being perfectly legal. But like we said, we are still getting our heads around this one, for in a super-charged environment like this, it pays to go back to the basics of securities analysis, rather than churn out bull market fluff like we all did in the good old days.

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