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CONTENTS

Part A: ARTICLES / CASES

1. HOW FINANCIAL INSTITUTIONS AND THE PLANNING COMMISSION DEFINE CASH FLOWS
2. THE DHANDHO INVESTOR
3. ON BEING AN ENTREPRENEUR

Part B: SNIPPETS

1. WHY ACQUIRER HAVE DIFFICULTY IN CREATING VALUE FOR SHAREHOLDERS
2. CORPORTE SOCIAL RESPONSIBILITY (CSR)
3. NEED FOR WIDER DIVERSIFICATION IN INDIA
4. WHY IS CAPM SO POPULAR

Part C: WIT AND WISDOM

1. HUMOUR
2. WISE SAWS
3. PERSPECTIVES

Part A: ARTICLES / CASES

1. HOW FINANCIAL INSTITUTIONS AND THE PLANNING COMMISSION DEFINE CASH FLOWS

This article discusses how financial institutions and planning commission define cash flow.

Financial Institutions

In evaluating project proposals submitted to them, financial institutions define project cash flows as follows:

Cash outflows

Capital expenditure on the project (net of interest during construction)

+

Outlays on working capital

Cash inflows

Operating inflow : Profit after tax [1]
+ Depreciation
+ Interest and lease rental

Terminal inflow : Recovery of working capital (at book value)
+ Residual value of capital assets (land at 100% and other capital assets at 5% on initial cost)

For calculating the IRR the cash flows are considered for a maximum project life of 12 years. For certain industries which are subject to a faster rate of technological obsolescence, a shorter life is considered.

From the above, it is clear that financial institutions look at projects from the point of view of all investors. It is instructive to compare the cash flow stream defined by the financial institutions with the cash flow stream relating to all investors defined by us earlier in this chapter.

[1] If there are losses in the initial years the tax shield arising out of losses can be added back to the cash flows only if the existing operations of the company are liable for tax of that amount. In case of new companies, tax shield cannot be added back to the cash flows.

	Cash flow stream defined by financial institutions	*Cash flow stream relating to all investors*
Initial investment	Capital expenditure on the project (net of interest during construction period) + Outlay on working capital	Capital expenditure on the project (net of interest during construction period) + Outlay on working capital
Operating cash inflow	Profit after tax + Depreciation + Interest	Profit after tax + Depreciation + Interest (1-tax rate)[2]
Terminal cash inflow capital	Recovery of working capital (at book value) + Residual value of capital assets (land at 100% and capital assets at 5% of initial cost)	Recovery of working (at book value) + Expected net salvage value of other assets

From the above, we find that:

- The initial investment is defined identically in both the cases.
- Institutions add back interest without adjusting for taxes whereas in our definition interest is added back after adjusting for the tax factor.
- The residual value of capital assets is defined by the institutions in a very conservative and mechanistic fashion whereas in our definition it is based on expected net salvage value.

Planning Commission

As per the *Manual for Preparation of Feasibility Reports* developed by the Planning Commission, the following rules should be observed in defining costs and returns (cash flows in our terminology).

1. Interest during construction should not be allowed for in the year-wise capital expenditure figures since it is implicitly taken into account by the discounting

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[2] Note that :

$$\text{PBIT}(1-T) = (\text{PBT}+I)(1-T)$$

$$= \text{PBT}(1-T) + I(1-T)$$

$$= \text{PAT} + I(1-T)$$

procedure. If replacement expenditure is likely to be incurred during the life of the project it should be allowed for in the year in which it will occur.

2. Returns should be defined on a gross basis as operating revenues minus operating costs. Depreciation and financial charges on capital expenditures covered by the capital cost figures should not be deducted in defining returns. *They are allowed for implicitly in the discounting procedure*.
3. Capital cost estimates generally do not allow for funds required for working capital purposes, which are assumed to be borrowed, but only for the margin on working capital. In this case the operating cost estimates must include interest payments on funds borrowed for working capital.
4. In some cases involving the use of fixed-interest term loans for capital expenditure, an internal rate of return on own funds (equity) may need to be presented. In such cases the initial capital cost figures should cover only the expenditures out of equity capital. Repayment of term loans and interest due on them should be allowed for in the subsequent years as and when they are expected to arise.
5. Costs and returns should be calculated over the entire life of the project or over 25 years whichever is less. The returns should allow for a salvage value of assets at the end of the period.

Based on the above description, the following observations may be made:

1. A project may be viewed from the point of view of equity capital or long-term funds.
2. Cost and return (benefit) streams have been defined consistently with the point of view adopted. Further, they are defined in pre-tax terms.
3. A fairly long planning horizon is envisaged. This perhaps reflects the fact that the projects considered by the Planning Commission, in general, have a long economic life.

2. THE DHANDHO INVESTOR

Mohnish Pabrai, a successful entrepreneur who set up TransTech in February 1990 with a meager capital of Mohnish Pabrai set up TransTech in 1990 at a young age of 25 with a meager investment of $30,000. TransTech, which provided client-server computing, scaled up nicely and was recognised in 1996 as one of the 500 fastest growing businesses in the U.S. In 2000 he sold the entire business for several million dollars. His investment of $30,000 fetched him nearly $4.5 million.

Inspired by Warren Buffett, he founded Pabrai Funds in 1999 modeled after the original Buffett Partnerships of 1950s and 1960s; Pabrai Funds has the following characteristics:

1. Investors pay no management fees. They only pay a performance fees which kicks in only when the return exceeds 6 percent a year.
2. Its investment team consists of just one person, Mohnish Pabrai
3. Mohnish Pabrai, the managing Parma, ploughs back virtually all the fees he earns back into the fund.
4. Unlike other hedge funds, it does not discuss its portfolio positions in real-time with its investors. This helps in keeping noise and distractions down to a minimum.
5. It has a small number of holdings.
6. Starting with just eight investors, Pabrai Funds has (in 2007) about 400 families as investors. This is perhaps the only hedge fund with $300 + million in assets belonging to about 400 families all over the world, with virtually no participation from institutional investors and mom-and-pop investors.
7. It focuses on value investing.

From 1999, the year when Pabrai Funds was set up, to 2007 (the year when Mohnish Pabrai published his book The *Dhandho Investor*) Pabrai Funds delivered an annualised return of over 28% (net to investors), achieving extraordinary success.

The Dhandho framework of investing is based on nine principles.

1. Focus on buying existing businesses which have a well defined business model and a long history of operations
2. Buy simple businesses in industries with an ultra-slow rate of change
3. Buy distressed businesses in distressed industries. In such circumstances, the odds of finding bargains are high.
4. Buy businesses with a durable competitive advantage – the moat
5. Bet heavily when the odds are overwhelmingly in your favour
6. Focus on arbitrage
7. Buy businesses at big discounts to their underlying intrinsic value
8. Look for low-risk high-certainty businesses.
9. Invest in copycats rather than innovations.

3. ON BEING AN ENTREPRENEUR

Many persons have an entrepreneurial urge to set up their own project and be on their own. Hence, it may not be out of place here to discuss the questions every entrepreneur must answer and the qualities and traits of a successful entrepreneur.

The Questions Every Entrepreneur Must Answer

According to Amar Bhide[3] the following are the questions that every entrepreneur must answer:

(i) Are my goals well defined?

- Personal aspirations
- Business sustainability and size
- Tolerance for risk

(ii) Do I have the right strategy?

- Clear definition
- Profitability and potential for growth
- Durability
- Rate of growth

(iii) Can I execute the strategy

- Resources
- Organisational infrastructure
- The founder's role

Qualities and Traits of a Successful Entrepreneur

What qualities and traits are required to be a successful entrepreneur? While it is difficult to answer this question definitively, it appears that a successful entrepreneur has the following qualities and traits:

- Willingness to make sacrifices
- Leadership
- Decisiveness
- Confidence in the project
- Marketing orientation
- Strong ego

Willingness to Make Sacrifices A new venture is often plagued with numerous difficulties and unanticipated problems. To nurture it in such an inhospitable environment, the entrepreneur has to be prepared to sacrifice his time, energy, and resources. He must be willing to struggle, sacrificing personal comforts and

[3] Bhide, Amar. "The Questions Every Entrepreneur Must Answer", *Harvard Business Review*, 1996.

conveniences, against seemingly endless odds. An entrepreneurial job is not like a typical nine-to-five executive job. It tends to be far more demanding, requiring total commitment – and sometimes, even obsessive preoccupation - on the part of the entrepreneur.

Leadership Successful entrepreneurs generally have strong leadership qualities. They are able to inspire ordinary persons to accomplish great feats. Even though outwardly they may show bizarre signs (they may be whimsical, timid, or even cantankerous) they are able to fire people with their zeal. They have the flair for galvanising their team to successfully cope with the challenges and frustrations inherent in a new venture.

Decisiveness A fledgling enterprise has to accomplish many things in an atmosphere of uncertainty. Numerous decisions have to be taken in quick succession on the basis of limited information. The firm does not have a history to fall back on or a well-organised data base to rely upon. Unless the entrepreneur is decisive by nature, he would not be able to cope with the enormous burden of decision making. If he procrastinates, he may court disaster; if he dilly-dallies, he may miss valuable opportunities. The fluid situation of a new enterprise calls not only for an ability to decide quickly but also an ability to revise the decisions to adapt the enterprise to an environment in which it has not established proper moorings.

Confidence in the Project An entrepreneur should have unbounded faith in his project. This helps him in instilling confidence in suppliers, creditors, customers, employees, and others. Without unflinching conviction in the project, it would be difficult for the entrepreneur to withstand the failures and frustrations that form the new venture diet.

Marketing Orientation A strong marketing orientation is critical to a new venture. An entrepreneur who is skillful in exploiting market opportunities has the best chance of success. Irrespective of the professional guise he wears (whether it be that of an engineer, inventor, production technologist, accountant, or any other), the entrepreneur must have marketing talent. Edwin Land of Polaroid is widely recognised as an ideal example of disguised marketing talent. Land, an engineering genius, had superior marketing skills and perhaps this was the most critical factor in the outstanding success of Polaroid. Land could inspire the technical and financial world, thanks to his marketing abilities. If an entrepreneur lacks marketing skills, he must find a partner who can remedy this deficiency. Otherwise the venture will be severely handicapped because of its inability to exploit the marketing opportunities.

Strong Ego Setting up a new enterprise is like riding an emotional roller coaster. There are days which bring jubilation and the there are days which cause despondency, as the enterprise is buffeted by environmental forces, which tend to have a strong influence on the nascent venture. The entrepreneur needs a strong ego to bear with such ups and downs. To endure periods of adversity and to maintain proper perspective when events

cast shadow over the enterprise, the entrepreneur needs a strong identity and self-image.

Part B: SNIPPETS

1. WHY ACQUIRER HAVE DIFFICULTY IN CREATING VALUE FOR SHAREHOLDERS

Why acquirers have difficulty in creating value for shareholders? There are several reasons why acquirers have such difficulty in creating value for shareholders:

1. Since the acquirer usually pays an acquisition premium of 20 to 60 percent or even more, the performance bar, ab initio, is very high. Even when there is no acquisition premium, the prices of both the acquirer and the seller would incorporate expected performance improvements.
2. The purchase price is driven more by the pricing of 'comparable' acquisitions and less by a rigorous evaluation of where, when, and how real performance gains would be achieved.
3. Acquisition benefits are likely to be replicated by competitors as they will not stand idly. Indeed, the acquirer may be more vulnerable to competitive attack because the demands of integration will divert attention from competition.
4. The entire payment has to be made upfront and hence the financial clock starts ticking right from the beginning.
5. If a merger goes wrong, it is really difficult and expensive to undo it as indicated by the Daimler Chrysler deal.

2. CORPORATE SOCIAL RESPOSIBILITY (CSR)

MCA had introduced in 2009 its voluntary guidelines on CSR where the focus was on the quantum of money to be spent on social causes. In its revised guidelines, issued in July 2011, the MCA has shifted the thrust from the amount of money a company spends on social causes to the ethical conduct of business operations. The new norms require companies to behave in an ethical manner in dealing with all its stakeholders, including governmental agencies. These norms have been jointly prepared by the Indian Institute of Corporate Affairs and Germany-based international enterprise GIZ. The salient features of new guidelines (or norms) are:

- The new norms focus on social, environmental, and economic responsibilities of the business and require companies to behave in an ethical manner in dealing with all stakeholders, including government agents.

- While the new norms are voluntary, a strict process of reporting has been devised. Companies are required to report on their activities in their annual reports. While larger companies are required to follow the global reporting initiative (GRI) format, an internationally recognised format on sustainability reporting, smaller companies have the option of just declaring that they accept the norms in principle. It is instructive to note that rating firms have already started ranking companies on environmental and social norms. Crisil, for example, has launched its Environment, Social, and Governance (ESG) index, which measures company performance based on voluntary disclosures on governance and environmental issues. Based on publicly available information, the index picks India's top 500 listed firms to measure their performance. Interestingly, since June 2009, the ESG index has outperformed the Nifty 50. This suggests that investing in environment friendly companies with good governance generates good financial returns as well.

3. NEED FOR WIDER DIVERSIFICATION IN INDIA

In many developing countries, a substantial part of the volatility of individual stocks is accounted for by the volatility of the index. This means that the R^2 (the proportion of total risk that is explained by the fluctuations of the market index) values for stocks is fairly high. In these countries perhaps the major risk factor is country risk. The problem is further aggravated by poor corporate disclosure practices which hinder attempts by analysts to identify idiosyncratic risks associated with individual companies. Under such circumstances, diversification does not provide much benefit.

Indian stocks do not seem to display these characteristics. A study by Ajay Shah et al found that half the values of R^2 in the market model fall between 0.04 and 0.22 and the highest R^2 value was 0.60.

This implies that there are substantial unique or company – specific risks that can be washed away with diversification. As Ajay Shah et.al say: "In most emerging markets, fund managers are used to thinking that a 10-stock or 20 – stock portfolio exhausts opportunities for diversification. In the Indian case, there are substantial gains to diversification even in going from 50 stocks (Nifty) to 100 stocks (CNX - 100), as shown earlier."

Ajay Shah et.al anlaysed the average portfolio volatility (on an annualised basis) of random portfolios of various sizes. From the universe of the CMIE Cospi stocks, for each portfolio size, thousands of equally weighted portfolios were formed at random. Exhibit shows the average volatility of these randomly chosen portfolios.

4. WHY IS CAPM SO POPULAR?

The Capital Asset Pricing Model (CAPM), despite its limitations, continues to be the most popular risk-return model in practice. The reasons for its popularity are:

1. Beta can be estimated with short data.
2. Risk free rate can be easily established,
3. The market risk premium can be computed, as information is available for a long period.
4. It is theoretically elegant.
5. The distinction between unique risk and systematic risk is intuitively appealing
6. There is lesser room for judgement

<u>Part C: WIT AND WISDOM</u>

1. HUMOUR

- An American woman telephoned her bank manager and asked to dispose of a $10,000 bond. "Are you referring to the bond meant for redemption or conversion?, " enquired the manager. There was a pause and then the woman asked, "Am I speaking to the First National Bank or the First Baptist church?"

- "You are a cheat!" shouted the defence lawyer at his opponent. "You are a liar!" charged the other lawyer. The judge banged the gavel and said dryly, "Let's proceed with the case now that the attorneys have been properly identified."

2. WISE SAWS

- Civilisation is just a slow process of learning to be kind

  C. Lucas

- No one can make you feel inferior without your consent

  Eleanor Roosevell

3. PERSPECTIVE

"At the root of America's economic crisis lies a moral crisis: the decline of civic virtue among America's political and economic elite. A society of markets, laws, and elections is not enough if the rich and powerful fail to behave with respect, honesty, and compassion toward the rest of society and toward the world. America has developed the world's most competitive market society but has squandered its civic virtues along the way. Wit out restoring an ethos of social responsibility, there can be no meaningful and sustained economic recovery. I find myself deeply surprised and unnerved to have to write this book."

Jeffry Sach's in The Price of Civilisation