Twitter Thread by Fundoo Professor

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One of the favourite case studies that come up in my BFBV course at MDI is Relaxo. Every year I ask students to study this case which I had done along with @ravirpurohit in 2013 by assigning these

Then I update them on my thinking about this business, management and valuation. This year, I spoke that (which I won't discuss here) and also about some additional lessons. Listing them here:

The importance of distinguishing between things that are under your control and those that you cannot control.

Things you can control include defining what kinds of business you will invest into and which ones you will ignore, how you will make conservative estimates of probable earning power a few years from now and how you will restrain yourself from projecting very high exit multiples.

The one thing over which you have no control is the changes in multiple because that will be decided by the market, which is like a very moody person.

If your expected return REQUIRES significant multiple rerating BEYOND what's warranted from a pure bond valuation (non-growing perpetuity) multiple, then you are exposing yourself to outcomes dependent on how OTHERS will behave.

On the other hand, if your expected return is coming primarily from dividend and earnings growth component and not a lot from multiple increases, then you are on much safer ground.

Expecting a great business selling at below a bond valuation multiple to sell for at least the bond valuation multiple is reasonable. Don't ask for much more and the chances that you will be disappointed go way down.

When you pay a high entry multiple for an outstanding business, then you have to count on REMAINING lucky - in the sense that you cannot really afford significant multiple declines and yet that is what happens when high PE stocks with embedded high earnings growth expectations.

Many of them end up experiencing a slow down in the growth or even a decline in earnings. If that latter situation transpires, then you will get a double whammy as EPS goes down AND PE multiple also contracts.

In contrast, when you buy a great business (Relaxo was one) at a BELOW bond valuation, then you only have to get lucky ONCE SOMETIME IN THE NEXT 5 YEARS (for the multiple to rise) to earn a good return.

It's far better to position yourself to BENEFIT from good luck than get UNNECESSARY exposure to bad luck that can result in value destruction.

If you use this framework, then you will have lots of errors of OMISSION but far fewer errors of COMMISSION. Errors of commission destroy capital and meaningful destruction can set you back by a decade or totally take you out.

It's ok to make errors of OMISSION and be paranoid about making errors of COMMISSION. And yet, no matter how careful you are, there will be errors of commission.

When they occur you have to act and you have to act fast. You know what's to be done. And then you have to move on. You will quantify the loss, frame it as a tuition fee and move on, and resolve never to make the same type of error again.