The Dhandho Investor: The low risk value method to high returns

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This handcrafted book summary will help you learn

- How an immigrant community dominated the motel segment in the US?
- What are the principles of dhandho investing?
- What is the common thread between Virgin Atlantic and Patel Motel?
- How to buy stocks that are high in intrinsic value, but at a discounted market price?

Thrown out, overnight.

From the southern part of Gujarat hails a community of landlords or patidars, popular by their common surname Patel. In the late nineteenth and early twentieth century, Patels migrated to East Africa as traders and indentured labourers, especially to Uganda. With their strong entrepreneurial spirit and a sharp mercantile sense, Patels became the dominant trading community in Uganda.

For Patels, trouble brewed in 1972 when Idi Amin took over as the dictator of Uganda and declared the *"Africa for Africans"* policy. Overnight, the Patels lost all their wealth and assets in Uganda, and worse still, were asked to move out of the country almost immediately.. The year 1972 was a also a difficult time for the country of origin for Patels from Uganda; India.

India was in a full-scale conflict with Pakistan, which lead to the creation of Bangladesh. Besieged with millions of Bangladeshis crossing over to India as refugees, the Indian government did not extend any support to the Patels expelled from Uganda. Most Patels sought refuge in England and Canada, and a few made their way to the United States. How did such a transformation take place in just over three decades? **How could a community, evicted whimsically from an African country, build such a vast pool of resources in the US?**

The answer lies in dhandho

Dhandho is the Gujarati pronunciation of the original word in Sanskrit dhan, i.e. wealth and dhan-dho is the common Gujarati speak for business.
Why did the Patels, seeking refuge in the US, pick motels as their business interest? How did they build scale and efficiency in a sector plagued with losses and poor margins? The answer to the first question lies in the economic history of the US in the 1970s, while the answer to the second question is one word – dhandho

After the Second World War, the US spent a lot of money building long roads across the country. Consequently, the automobile became a critical mode of transport for American families to travel across the country. This led to a mushrooming of family-run motels across the key interstate highways in the US. However, by early 1970s, just when the Patels were trickling into the US, the US economy got mired in a deep recession. As with all recessions, consumers dropped their discretionary spends. High fuel prices meant lesser travel by car. Motels across the country started to cave in and went bust, or put themselves up for distress sale.

Creativity in working capital management

In such a scenario, a Patel comes to the US, having been unfairly thrown out of Uganda. He has little cash, does not speak excellent English, and has a family to support. The most straightforward option for Patel would be to take up a minimum wage job at a supermarket, packing groceries in bags. However, Patel sees an opportunity in the distress sale of motels. If Patel buys a motel and runs it, there is no rental expense as his family will stay in the motel itself. The family will also contribute, in terms of daily chores at the motel. So he will incur minimum wages expenses in running the motel.

However, a fundamental question still remains- Patel does not have the money to buy the motel, even at a distress price. But the sharp mercantile thinking Patel knows that the bank is also keen to get rid of the motel, and will likely support any buyer interested in the motel. Patel is right; the bank is willing to finance 80-90% of the distress sale price. So Patel has to arrange for the balance amount ($ 5000 in most representative cases). He does so with the help of friends and family, and his own savings.

Patel is now the owner of a small motel, within a few months of arriving in the US, with very little money, in the early 1970s. His most significant concern of home rental expenses is now zero, as the Patel family stays in one of the rooms of the motel that he owns. Work at the motel is divided among the family members, and all of a sudden, the wage expenses of the motel go down, thanks to the Patel family.

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The power of low price & high margin

With lower operating expenses, Patel now has the luxury to bring down the daily rental price for the customer. Patel's motel starts offering the cheapest rates, thereby driving up occupancy. Since his wage bills are low, and the Patel family stays in the motel itself, the margins for Patel are quite healthy even at the low daily rental price. **This is where Patel starts making more money (higher occupancy rates) and higher profits (lower costs).** Other motels in the vicinity of Patel motel start collapsing as they cannot match Patel motel rates.

Having ploughed in roughly $5000 of his savings into the motel, Patel can generate about $50,000 annual revenue, even with a low rental rate of $12-13 per day and 50-60% occupancy rate at his motel. Inclusive of his interest expense on loan is taken to the buy the motel from the bank, his family expenses and other business expenses, Patel's total expense would be about $20000 to $25000 annually. Which means Patel has a profit of about $15000 annually. **This translates into an annual return of about 400 percent.** This is how Patels built their dominance in the motel business in the US.

What if Patel failed?

Now let's look at a scenario where Patel, having bought the motel with his $5000 savings, and the loan from the bank, fails. **His new motel just does not take off.** In such a scenario, the bank that had extended the loan to Patel to buy the motel will take over the motel. But then banks are not interested in running motels, especially when the motel has failed twice-once with an American owner and the second time with a recently immigrated Patel.

So the bank knows that Patel is its only hope, and it renegotiates the loan deal, with more benefits and support for Patel, so that their best, Patel, get the motel out of the crisis situation. For Patel too, this is his best bet to succeed in a new country. He has to ensure that the motel is profitable.

Scaling up

But Patel has made the motel a success story. He has steady cash flow and high margins because his motels offer the lowest rental, and his labour expenses are negligible. The Patel family now decides to invest the additional cash in another bigger motel, and this time, Patel's son manages the new motel, using the same principles that Papa Patel has drilled into him.

Then more relatives of Patel from India and other parts of the world, join the Patel family. Patel now has more labour (at cheap rates). Patel's new extended family members are glad to find a place to stay for free in a motel and manage its operations, just like Patel did a few years back.

This snowballs into a reality today where half of the motels in the US, are now owned by Patels.

The secret sauce

The secret sauce in Patel's success with motels is the concept of **dhandho, which is about minimising risk and maximising return.** Contrary to common perception, **dhandho is fundamentally about creating wealth while taking little, or no risk.** Dhandho is also about how well you manage your capital allocation.

But dhandho is not about Gujarat or India. Dhandho is a philosophy that unites many, way beyond the Patel community. One such dhandho investor is **Sir Richard Branson.** Richard Branson had built a successful music catalogue business Virgin Records, having started his entrepreneurial journey at the age of 15.

Virgin Atlantic & the dhandho way

In 1984, Branson began evaluating a business plan about starting an all business class airline between London and New York. There was a small problem, though. Virgin did not own any aeroplanes. Having decided to roll out a dual-class London-New York service, Branson now went about looking to lease an aircraft. He realised that in this business, passengers pay for tickets about 20 days before the flight date, while the airline pays for aviation fuel 30 days after the flight, and salaries about 20 days after the flight.

Branson understood that in the aviation business, the working capital requirement was low. He then called Boeing to figure out if they had an old 747 aircraft to lease out. It turns out; they indeed had one. At this stage, Branson calculated that if Virgin Atlantic failed, his liability would be about $2 million. In reality, Virgin Atlantic made $12 million in its first year itself. Just like Patel did when he bought his first motel in the US. Both Richard Branson and Mr Patel belong to this brotherhood of dhandho investor.

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The core of dhandho investor is Heads; I win; tails, I don't lose much

The nine principles of dhandho framework

1. Focus on buying an existing business

When Patel bought his first motel, or when Lakshmi Mittal bought his first steel mill, they were buying into an existing business with clear success metrics that could be analysed across an extended time period.

Richard Branson identified a new opportunity but within a well-defined and existing business. Unlike the flavour of today's times, start-up was not a hot word for these entrepreneurs. If you cannot own a business, then owning a part of the business via shares is the smart thing to do. Building ownership across a portfolio of carefully selected companies via the shares route is the right wealth building tool. Just make sure that you follow the Heads I win; tails I don't lose much dhandho investment logic while deciding your portfolio.

2. Buy a simple business

If a dhandho investor is given a choice to invest in Google or in Patel's motels, the dhandho logic will guide him towards the more straightforward choice, i.e. the motel business. Yes, compared to motels, Google is far more valuable currently with many exciting prospects ahead in this fast-changing world.

However, the future cash flow assumptions for Google are difficult to predict given the high uncertainty of how Google's business will evolve in the future. Motels, on the other day, have a very high predictability of revenue, cash flow and profitability. There is a strong correlation between predictability of cash flow and the intrinsic value of the business. The simplicity of the motel business and its inherent, intrinsic value makes it an obvious choice for the dhandho investor.

3. Buy a distressed business in distressed sectors

Do you remember that when Patel decided to buy his first motel, he was a buying a distressed business? Bad news in the steel sector was good news for Lakshmi Mittal, and he decided to buy more distressed steel plants and companies.
You can identify distressed business by reading the business headlines regularly or following reports like Value Line or Portfolio Reports or Value Investors Clubs, and many more.

4. Buy a business with a durable moat

Patel's motel has the moat of being the lowest cost player. Mittal's steel possibly also has the lowest production moat. Low production costs make low prices possible, without eroding the profitability margins. Once this moat is in place, it becomes difficult for others to compete with your low prices and high profitability.

Richard Branson's moat with Virgin Atlantic was the Virgin brand itself, in addition to low-cost operations. The Mexican food chain Chipotle operates in the competitive and fragmented Mexican fast food segment. But Chipotle has built a moat with its ability to customise your Mexican meal, using fresh ingredients, served in a pleasant ambience. Identifying the moat of a business requires a deep dive into its financial statements.

A high return on capital employed indicates a strong moat. But moats are not permanent. What used to be a strong moat for companies like General Motors, eventually withered away, making GM susceptible to competition.

5. Big & few bets; when the odds are in your favour

Keep in mind the dhandho adage of Heads, I win; tails, I don't lose much, when you bet. When Branson placed his audacious bet on starting Virgin Atlantic, he was placing a comparatively small bet, where the downside would be about $2 million, if the first flight did not take off.

Warren Buffett has mastered the art of betting few but betting big, especially when the odds are in your favour. In 1963, American Express announced a loss of $60 million, when it discovered that collateral of $60 million of salad oil was actually just sea water. Pounded by the stock market, American Express share price halved. At this stage, **Warren Buffet invested 40% of his company's assets** in American Express. Warren Buffet believed that the intrinsic value of American express was much higher than its then share price, as the core asset of American express was the trust of consumers and charge cards business and not salad oil.

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In time, we now have the Kelly Formula which helps calculate the amount that you can theoretically bet across a set of bet options available, and which is the one that you should place your biggest bet on. The Kelly Formula reinforces the dhandho principle of betting less often, but betting big, especially when your research tells you that the intrinsic value of the bet is higher than its current value.

6. Focus on arbitrage

Arbitrage is about benefiting from price difference on a commodity or instrument, basic geography, time or other parameters. Like a moat, the power of arbitrage declines over a period of time, as more and more people try to take the arbitrage advantage, thereby soon converting the arbitrage into a level playing field.

The low operating costs of Patel's motel leading to lower rentals was his arbitrage advantage over his competitors, who could not match Patel's rental rate without eating into their margins. In a traditional industry like steel, Lakshmi Mittal plays the classic low-cost arbitrage advantage by buying his steel plants across geographies.

7. Buy business at a discount to their intrinsic value

According to Benjamin Graham, the function of the margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future. Patel would have likely not read about Benjamin Graham's margin of safety, but he practised the concept.

Patel bought his first motel, which was a distressed asset, at a price far lower than its actual worth. This minimised his downside and extended him a 'margin of safety'. Contrary to popular logic, the dhandho investor believes that the lower the risk, the higher is the reward. Low risk generates high returns because when you buy an asset whose price is far lower than its intrinsic value, you are bearing a lower risk. At the same time, because you bought the asset at a discount to its intrinsic value, once the returns start coming in, they will be of much higher magnitude.

8. Buy low risk, high uncertainty business

In the interplay of risk and uncertainty, there are four possible outcomes:
- High risk, low uncertainty
- High risk, high uncertainty
- Low risk, low uncertainty
- Low risk, high uncertainty

It is evident that low risk and low uncertainty is the best of both worlds. The stock market also believes so and rewards companies which are in this quadrant with high trading multiples. The dhandho investor is not interested in this best of both worlds because the traded value is likely to exceed the intrinsic value.

The dhandho investor is interested in the third quadrant- low risk and high uncertainty. Stock markets do not like high uncertainty, so they pull down the stock of companies that are in this quadrant. This low share price does not reflect the high intrinsic value of these companies, thereby making it a lucrative low-risk buy for the dhandho investor.

Patel's motel is an example of low risk (high predictability) and high uncertainty (possible economic recession?) scenario. Even in the scenario of an economic recession, Patel's motel would continue to be the lowest cost operator thereby garnering a significant market share, even in uncertain times.

9. Be a copycat

Ray Kroc did not come up with the idea of McDonald's. He saw what the McDonald brothers had built, and decided to scale it up. Similarly, Microsoft was not the first one to roll out an internet browser. Netscape did it first, and Microsoft followed with Internet Explorer and completely dominated the internet browser space.

Lifting and scaling, or cloning, makes good business sense. The risk is lower in case of cloning, while innovation carries a very high level of risk. The dhandho way is to lift and scale. This is how Patels took the lion's share of motels business in the US, within 30 years of setting foot on American soil.

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The art of selling stock

The dhandho principles help the investor pick companies or shares in companies sticking to the adage of Heads, I win; tails, I don't lose much. But what about exiting at a profit? Like Abhimanyu in Mahabharata, entering the chakravyuh is easy, it is the inability to exit the chakravyuh that killed Abhimanyu. An important mantra to keep in mind is that you should not sell at a loss within 2-3 years of buying a stock. This 3 year time period provides enough time for the stock to determine its intrinsic value. Any shorter and you would risk selling at a loss. Any longer and your cost of waiting to discover the intrinsic value will become prohibitively high. You must sell once the market price exceeds the intrinsic value, unless there is a tax imposed on the short term sell. In which case you should hold for the long term benefits to kick in.

This book summary captures key concepts from the original book. The original books carries detailed case studies and analyses and is a highly recommended read.

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