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Teaching Note

The Importance of Unconventionality

As of this writing, I do not own any business whose stock is represented in either of the two broad based indices — Nifty or Sensex. I don't mimic the broad indices because I believe that if I have to beat them over time, I must do things differently. Consequently, I will often (though not always) own positions which appear *unconventional* but are, nevertheless, deemed by me to be *conservative*.

Sometimes, there is a tendency to equate conventionality with conservatism — an issue which Warren Buffett wrote about in a letter to his partners in January 1965.

"It is unquestionably true that [our competitors] have their money more conventionally invested than we do. To many people conventionality is indistinguishable from conservatism. In my view, this represents erroneous thinking. Neither a conventional nor an unconventional approach, per se, is conservative."

"Truly conservative actions arise from intelligent hypothesis, correct facts and sound reasoning. These qualities may lead to conventional acts, but there have been many times when they have led to unorthodoxy…"

"We derive no comfort because important people, vocal people, or great number of people agree with us. Nor do we derive comfort if they don't. A public opinion poll is no substitute for thought. When we really sit back with a smile on our face is when we run into a situation we can understand, where the facts are ascertainable and clear, and the course of action obvious. In that case — whether conventional or unconventional — whether others agree or disagree — we feel we are progressing in a conservative manner."

One "unconventional but conservative" investment I made in May 2014 was in an exceptionally well-run, profitable, but obscure business called Kitex Garments.

Kitex Garments

My investment in this business was unconventional because at the time of purchase, there was, to my mind, no analyst coverage on the stock. Today, there are at least five sell-side brokerage firms which cover Kitex.

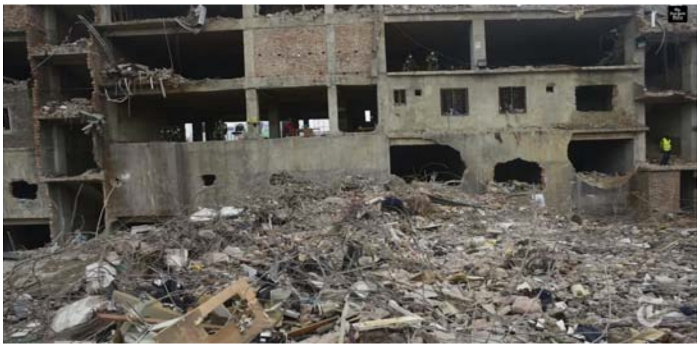
Kitex is also unconventional in other ways. The business operates out of Kerala — a South Indian state which is not considered as a business friendly destination. Despite that handicap, Kitex manufacturers and sells a large volume of the highest quality baby (0 to 24 months old) clothes to global buyers like Gerber, Toys"R"Us, Carter's, Kohl's and The Children's Place.

Garment manufacturing is a labor intensive business and Kitex employs approximately 4,000 workers to do the job. Most of these workers are young women who are paid more than twice what garment workers are paid in Bangladesh — which is one of the world's lowest cost countries in this business. Kitex's higher cost of labour, however, is more than offset by increased productivity of its workforce, and other cost advantages it enjoys.

Manufacturing high quality baby clothes in large volumes is a very specialised business. Babies lick their clothes, leak from many places, and sometimes bite on the buttons and swallow them if they break. A company like Toys"R"Us *cannot* afford to have even *one* of its customers' children become sick or die because she swallowed a button or ingested a toxic chemical. Nor can it be seen to be sourcing garments from Asian sweatshops which treat their workers inhumanly as per global standards.

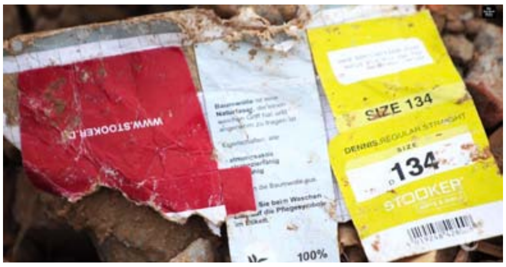
The manufacturing facilities of Kitex about 12 miles outside Cochin adhere to the highest standards of quality, safety, and social compliance in the world. It's 4,000 workers (most of whom are young women) enjoy a safe, hygienic, and comfortable environment. They also live on the campus. Many of them come from villages more than 1,000 miles away. When they arrive, they are often found to be malnourished. Kitex provides them with tasty, nutritious food, which I ate when I visited the factory. I also got an opportunity, along with other stockholders of the company, to see the superbly constructed and maintained factory premises as well as the dormitories for the women workers.

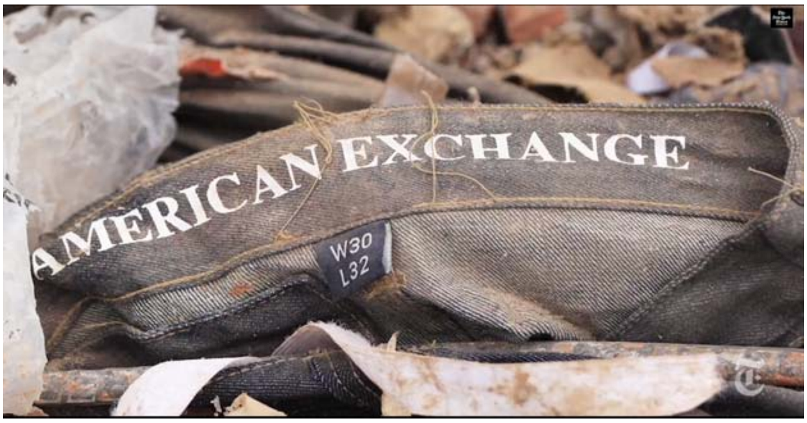
Adherence to global quality, safety, and social compliance standards in garment factories is increasingly becoming a critical factor in choosing vendors by the western retail chains. In a tragic incident in Dhaka, Bangladesh in April 2013, a poorly constructed garment sweatshop called Rana Plaza collapsed. More than 1,100 workers died.



Graphic images of this tragedy were screened on TV in the US.

The American public saw footage of labels on garments destined to be sold in US lying in the debris next to bodies of dead workers.





If you're trying to build a brand, one thing you *don't* ever want your customers to see is an image of your product lying next to a dead body in debris. The Children's Place used to sources garments manufactured in Rana Plaza. Today, it's a Kitex client. My guess is that it chose Kitex because it figured that what happened to Rana Plaza can never happen to Kitex. Indeed, the website of Children's Place now focuses quite a bit on factory standards.

After Rana Plaza, safety, human rights, and social compliance have become very big issues for western buyers of garments. The problem, however, is that social compliance costs a lot of money and western retailers do not have the power to increase prices.

It is *here* where Kitex excels. It's fully compliant, large scale operation (the company can manufacture about 250,000 pieces of infant-wear every day), its fair treatment of employees, its focus on automation, and other factors gives it a *low-cost advantage* over its competitors which is hard to replicate. For example, given its large business volume, the per-unit cost of social compliance for Kitex is much smaller than that of thousands of sweatshops, most of whom simply can't afford to comply. Kitex will continue to gain market share from them because— thanks to its low cost advantage — it can charge the same price for its products than it's non-compliant competitors and yet earn healthy profit margins.

Another source of Kitex's competitive advantage is *high switching costs* for its customers. Large buyers of garments spend significant amount of time and resources in selecting and approving vendors. Once a vendor has been selected and approved, then so long as it's compliant with quality, safety, and social compliance standards, its very difficult and costly to switch to another vendor just to save some money.

Besides, there aren't very many vendors like Kitex out there. There are only 12 companies of comparable size in the world which can meet the business volume requirements of large buyers without compromising on quality and safety standards. Kitex is one of them and is likely to become *much* larger in the future as its clients give it a higher proportion of their total sourcing requirements. For example, Carter's, which is just *one* of Kitex clients buys garments worth $1.5 billion every year, while the aggregate revenues of Kitex for FY14 were *only* about $75 million. The Annual Report of Carter's for 2013 states:

"We source products internationally, primarily from Asia. One sourcing agent currently manages approximately 70% of our inventory purchases… Our goal is to shift the mix of our direct sourcing from approximately 30% in fiscal 2013 to 50% by 2017 in an effort to improve the performance of our supply chain."

As gigantic customers like Carter's, Toys"R"Us, Gerber, and The Children's Place divert more of their sourcing requirements to Kitex, I expect the company's revenues and earnings to grow manifold over the next decade.

Despite its tiny size, the company enjoys significant power over its much larger customers which is reflected in improvement in its profitability and working capital situation. EBITDA margins have improved from 16% in 2008 to 24% in FY14. Working capital turns have improved from 4x to 11x over the same period. In FY14, Kitex delivered a 60% pre-tax return on equity with no net debt.

One of the wonderful aspects of the baby clothes business is that it's virtually recession proof. During tough times, people cut down on other expenses but they don't cut spending on baby clothes. Moreover, babies outgrow their clothes fast. From birth to age 6 months, a typical baby grows between 1.5 to 2.5 cm a month. Between 6 to 12 months, she grows about 1 cm a month. I love fast growing babies. The more the better.

I acquired the Kitex position in May 2014 at an average cost of Rs 164 per share. I paid less than 8 times pre-tax annual owner earnings of the business — a bargain price in my judgement.

As I write this, the current market price is Rs 492 per share. I have no target sell price, and I haven't sold a single share. Moreover, I feel good that I invested in this pro-social, and yet highly profitable business — a combination I absolutely love.

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Issues to Think About

1. In my note above, I have written about extensively about two sources of competitive advantage for Kitex: (1) A low cost advantage; and (2) High customer switching costs. I want you to think about those two sources of competitive advantage.
2. I haven't written much about the quality of the management. That will form part of a separate discussion in the class. There are important factors to consider and I wanted to focus on the business in this note instead of management. Can you come up with the critical issues about management quality that one should study?
3. I have written just *one* sentence on valuation. Why did I do that? Where is my excel model? Where are the elaborate projections about the future performance of the business?
4. How scalable is this business? That's a very important questions and I want you to think about it. What are the constraints to growth for Kitex?
5. What models from social psychology discussed in class did you relate to, while you read this note and watched the three videos in the embedded links?
6. Why am I not talking about selling the stock? After all it has trebled in a short time. More importantly, if I bought it for 8 times pre-tax annual owner earnings, then it must be selling at 24 times those earnings. Isn't that expensive?
7. What could prove me wrong in this investment?

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