Dhandho!

by Mohnish Pabrai

Seventeen years ago, I was in the midst of completing my senior year as an undergraduate at Clemson University in picturesque South Carolina. My roommate at the time was a wonderful individual named Ajay Desai. While his immediate family was mostly in India, he had a vast network of aunts, uncles and cousins throughout the Carolinas.

Most of Ajay's Carolina aunts and uncles were doctors, however, his favorite uncle was the quintessential entrepreneur. Like many Patels who had their businesses confiscated and were thrown out of Uganda and forced to come to the US and UK as refugees, this uncle came to the United States with little in the way of assets or degrees.

Anxious to get back on his feet, he started by buying a tiny ten room non-descript motel on a highly leveraged basis. With meager means, the family lived in the motel and handled all the typical staff jobs like maid service, front desk and maintenance. They kept expenses to a minimum and maximized savings. Like many Patel motel owners, he gradually started expanding by buying additional bigger and better motels.

Ajay would return from these weekends with his uncle and we'd spend hours discussing the frugal economics of his uncle's motels versus the higher cost structure of his competitors. One time he came back and announced that his uncle had just bought a Laundromat. Another time it was a gas station. All of these businesses saw their operating costs drop and revenues rise after Ajay's uncle took over. At the end of these discussions, Ajay would usually beam a big smile at me and say just one word – **"Dhandho!"**. While the Gujarati word ordinarily meant "business", in Ajay's lingo it encapsulated the awesome cash-generating machines his uncle was buying at dirt cheap prices.

Warren Buffett, in his trademark homespun midwestern style, has often compared a given business to a castle. Its chief knight's (CEO) principal task is successfully defending the castle from the marauding invaders (competitors). The likelihood and timeframe that the knight can hold off this continuous barrage of invaders is largely dependent on the width and depth of the moat surrounding the castle. He's often described the best businesses as ones where the moat gets wider and deeper over the years with a knight that keeps adding more and more piranha to the moat! Coca-Cola is such a business with its former CEO, the late Roberto Goizuetta, being such a knight.

What Buffett describes as a "moat", noted Harvard strategist and bestselling author Michael Porter describes as "sustainable competitive advantage".

At the 2001 Berkshire Hathaway annual meeting, a shareholder asked Buffett about moats and Porter's competitive advantage thesis. Here is what the oracle had to say on the subject:

"To the extent, I've read or understand what Porter's written, we basically think alike in terms of businesses. We call it a moat and he makes it into a book…We don't give a lot of instruction to our managers. We don't have budgets. And we don't have reporting systems or anything else. But we do tell them to try and not only protect, but enlarge the moat. And if you enlarge the moat, everything else follows."

Ajay's "Dhandho!" encapsulates for me nearly all of Buffett's investment approach or Porter's competitive advantage thesis. His uncle only delved into the simplest of businesses – motels and gas stations. Ordinarily speaking, these are run-of-the-mill businesses with shallow moats. However, Ajay's uncle and the "Patel Motel" community has added massive competitive advantage by adopting cost structures that are significantly lower than their competitors. The result has been nothing short of spectacular with thousands of motels across the United States thriving under Patel ownership.

Investing is not rocket-science. It is pretty simple. It should be painfully clear how a business generates cash today, how much is it likely to continue to generate into the future and how much you're paying for that future cash flow. Think about the width and depth of the moat. Think about the knight in charge of the castle. In the rare instance where everything lines up perfectly, you might beam a smile like Ajay, exclaim "Dhandho!" and make the investment.

The public markets make life much easier for us than Ajay's uncle – if you can make them work to your advantage. You don't need to do the heavy lifting of running these businesses. A good knight does that for you. You don't need to buy the whole business – you're allowed to buy infinitesimally small fractions. You could have 10-12 good knights running a range of diverse, simple and predictable businesses while you tap dance out of bed each day with dhandho on your lips.

Eventually all businesses eventually succumb to the marauding invaders who just don't quit. In fact, the more successful the business the larger and more powerful are the invaders that get attracted to take it down. Even with the Patels, the moat will disappear when the vast majority of motels are Patel owned. When Patels compete directly with Patels, the winner is the customer and the moat just became knee-deep.

So how do we keep saying dhandho when the business is eventually left moatless? If Ajay's uncle bought a motel for six times cash flow and was able to generate that cash flow for 25-30 years before it started to erode because all his competitors are now Patels, I'd say that he did just fine. He has the choice to take that cash flow and reinvest it anywhere. And if he continues to buy 30 year moats for six times cash flow, he'll continue to do fine indefinitely.

In an era of Enrons and Worldcoms, I'd like to add that it has been my experience that most public-company CEOs are honest, hard-working individuals. The biggest thing they are usually guilty of is outsized compensation and providing earnings guidance. Both are usually out in the open and one can adjust for them. If you stick to looking at simple businesses, you'd always pass on the Enrons and if you fixate on free cash flow, the Worldcoms of the world wouldn't look so attractive either. Not all of the minefields are avoidable and occasionally one might get taken. However, I've found than in an investing lifetime, you can do quite well even with a few mistakes along the way. You'll find that most of the investments that don't work out have less to do with fraud and more to do with an error in judgment in the all-important moat.

On a different note, I'd love to rekindle my dhandho conversations with Ajay now that I've finally completed the transition from engineering to dhandho. Before I lost touch with him, he was completing his internship on his way to becoming a doctor. I do believe Ajay would have ended up pursuing dhandho while being a pretty good doc as well. So, if you happen to know a Dr. Ajay Desai who seems to fixate on saying "Dhandho!" repeatedly, send me an email.

Guest columnist Mohnish Pabrai is Managing Partner of Pabrai Investment Funds, a family of value-oriented investment partnerships. Mr. Pabrai appreciates your feedback at mpabrai@pabraifunds.com. To read his other writings, visit http://www.pabraifunds.com. The Motley Fool is investors writing for investors.