INVESTING

This fund had put its punt on Jet's fall. What happened next? A roller-coaster short position.

By Sidhartha Shukla Jul 16, 2019, 06:33 AM IST

A Jet Airways Boeing 737-800 is seen skidded off the runway at the Zia International Airport in Dhaka on August 17, 2009.

Synopsis

After flying through troubled times, Jet Airways came to a crashing halt in April. While many were hoping for its revival, 2Point2 Capital, which bet on the airline going bankrupt, had put its money where its mouth is. But the experience was as turbulent as Jet's own.

In the early 1990s, when India ended a state monopoly over aviation and Naresh Goyal took Jet Airways to the skies, no one saw the muck it would be in 25 years down the line. Certainly not **Goyal**, who shrugged off his humble background as a travel agent to create what till not so long ago was India's second-largest airline.

The **halt** in April was supposed to be temporary. But as lenders have now **started** bankruptcy proceedings, it looks like India's oldest private carrier is grounded forever.

"By around November of last year, Jet still had a chance of survival if it could've found a buyer, because it still had a running airline operation," says Ajay Awtaney, editor, Live From a Lounge, an Indian aviation and business-travel website.

Awtaney recalls that around December or January, Jet customers would get last-minute e-mails and SMSes saying their flight was cancelled. "It was a downward spiral for Jet once people saw that the operations were not reliable."

Till the time it had a reliable schedule, people were still rooting for it. At the end of the day, from a traveller's perspective, schedule is the most important [thing]," he adds.

But Mumbai-based portfolio management service (PMS) firm 2Point2 Capital saw the doomsday coming before anybody else.

The firm first took a call to short the Jet stock in January 2017.

"When we were shorting Jet Airways, our thesis was that it would go bankrupt. It will end up defaulting on its debt," says Amit Mantri, co-founder, 2Point2 Capital.

Though it was profitable, overall it was not one of our best trades, says Savi Jain, the other co-founder.

Like many other punts, 2Point2's gamble with Jet's failure has many ups and downs, as you will see. But what's interesting is how the fund had cut through the noise and remained focused on its thesis.

At present, Jet's stock is locked in a series of lower circuits and is trading at the INR56 levels, an 80% slide from the start of the year.

Why Jet Airways

Jain and Mantri studied together at IIT Kharagpur. After engineering, both ventured into the world of finance and worked at global private equity and hedge funds before founding 2Point2 Capital in 2016.

Both the founders, 35, wear typical engineer-like calm and speak little unless you bring the topic of their interest — stocks and markets. Their 'The Curious Case' blog series on **Kitex Garments** and **Manpasand Beverages** will stand testimony.

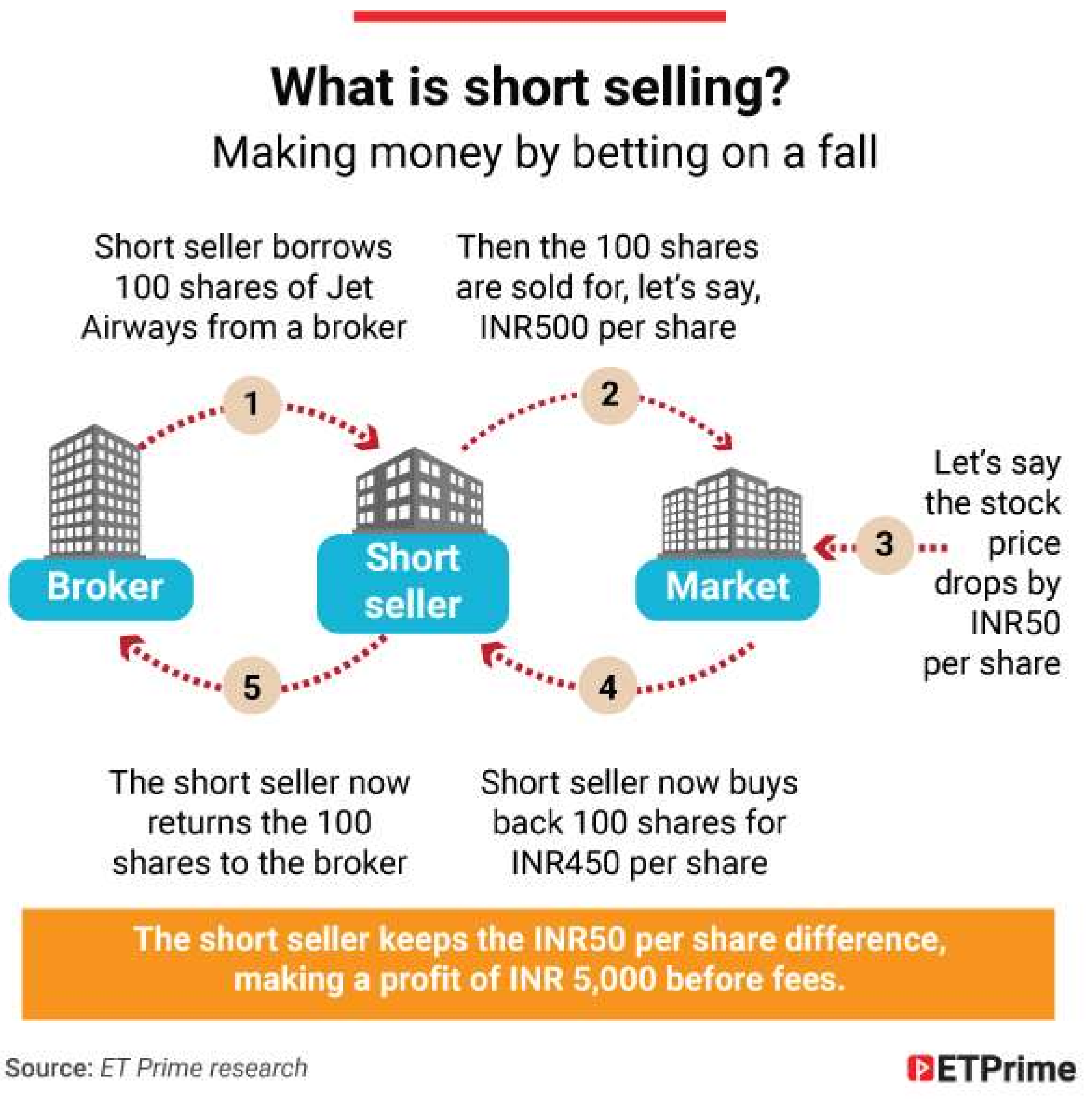
But before we tell you how the duo went on to predict Jet's fall, let's take a look at how their fund has performed over the years.

- Currently, 2Point2 Capital's asset under management (AUM) is around INR212 crore, up from INR53 crore a year ago.
- The fund has 392 investors and since inception, it has delivered 21.1% CAGR, as of June 30.

These figures pertain to the firm's 'Long Term Value Fund', which focuses on generating long-term returns by holding a concentrated portfolio of investments.

The Jet short is part of the firm's 'Long Short Value Fund', in which 2Point2 has been using futures to short stocks on which it has a fundamental negative view, using only proprietary capital, since August 2016.

Being short on a stock means that one anticipates its price will fall. The process of shorting involves borrowing shares, selling them in the market, and then buying them back in the future hoping that it'll be available at a lower price.



While discussing short ideas, both Jain and Mantri knew aviation was a sector, where companies keep going down, not just in India but also globally. The sector became the starting point to spot failures.

Why did they zero in on Jet? The rationale was simple.

"Jet was making operational losses in what was one of the best periods for the Indian airline industry, with crude at less than USD50/barrel and demand growing at 20% per annum," Mantri says.

"In this period, **SpiceJet** had come out of its troubles and emerged stronger and IndiGo was doing really well. But Jet was not making any money," Jain adds.

It was in January 2017, when the duo shorted Jet for the first time. The stock was trading at around INR360.

Mantri recalls that around this time, the market perception was that Jet was supposed to be coming out of the woods. "In its press releases, Jet would talk a lot about how much debt it had paid off," he says. "This was building a positive sentiment around the stock and there were multiple rumours of investments from foreign airlines like Delta, **KLM**, and Etihad."

Mantri adds that the core business wasn't churning out profit and paying down debt. Debt payments were made from the proceeds that came via various sale and leaseback transactions, and other asset sales.

"Even when you look at its profits a couple of years ago, they were all extraordinary profits," Jain says. "If you exclude these extraordinary items, it was in loss even at that time."

In Mantri's view these extraordinary items are finite amounts. They run out after a certain point of time.

2Point2 Capital was confident that over the next one or two years, Jet would be in serious trouble due to two reasons:

- Rivals IndiGo and SpiceJet had announced large capacity additions, which was likely to increase competitive intensity and reduce industry profit margins.
- If the economics of the industry were to deteriorate in the near future, the likes of IndiGo and SpiceJet would still be in a position to fund their expansion. But for Jet, which was making losses despite having a better position in terms of competitive dynamics, things could only turn for the worse.

"Jet was the least-efficient airline and carried over INR8,000 crore of high-cost debt, where interest costs were as high as 21% per annum. It was very clear even in

2017 that once competition intensified, Jet would run into cash-flow problems and not be able to pay back its debt that was starting to mature from 2019 onwards," Mantri says.

But not everything went to plan. After the short, the stock price kept rising and doubled to the levels of INR870 by January 2018.

2Point2 Capital was in a pickle.

Noise over reason

As the saying goes, the market can stay irrational longer than you can stay solvent. The Jet stock was defying all investment rationale.

After 2Point2 took its first short position, reports suggested that Jet might find a new buyer or was in talks with a global carrier for fresh funds. The stock price was on a tear.

"Even in 2017, the negative net worth of the company was around INR7,000 crore and someone had to fill that hole first, only after that there was any value for equity," Mantri says. Any potential acquirer had to keep in mind that the business operations were not generating any profits to fill that hole. This made it clear for 2Point2 that no investor in his right mind would put in money.

Despite having a seemingly watertight thesis, Mantri and Jain were not sure when the market would smell what they already had. They were also concerned as the short position had become a large part of their portfolio.

"The mistake we made then was that our initial allocation for the short was fairly high," Mantri says.

Statutory warning: Shorting is an extremely risky game. In theory, one could incur an infinite amount of loss if their bet on a stock-price fall goes wrong.

2Point2 was swimming against the tide. Brokerage firms such as IndiaNivesh had started putting out 'buy' calls on Jet Airways. The target price was INR1,010 a share, a 32% uptick from the price when the report was released.

Eventually, the fund had to square off its position in March 2018. It booked losses.

When logic prevails: the comeback of short

One bitten twice shy. Not if you are 2Point2. Lessons were learnt, and the fund was patiently waiting for the next trigger to short Jet.

It was a bigger sign of distress when Jet stopped paying its employees.

"This development increased our conviction and we began shorting the stock again despite the positive news flow," Mantri says.

Rumours kept coming that Etihad would bail out Jet but the fund ignored them. Mantri and the fund were of the firm belief that Etihad was in no position to bail out Jet, as the Abu Dhabi-based airline itself was running at a **loss** of around USD2 billion and had taken a huge write-off in its European investments.

In case of a bailout, you need to first pay all the employee salaries and debt holders before equity holders get anything, Jain says.

Around November last year, the Jet stock went north as news came that Tata Sons was going to **buy** it. 2Point2 dispassionately ignored that as well. "Just because it is written doesn't mean it's true. You have to rather trust the logical facts of the situation," Mantri says.

Both the partners asked a simple question: If someone had to acquire Jet, what were they going to achieve?

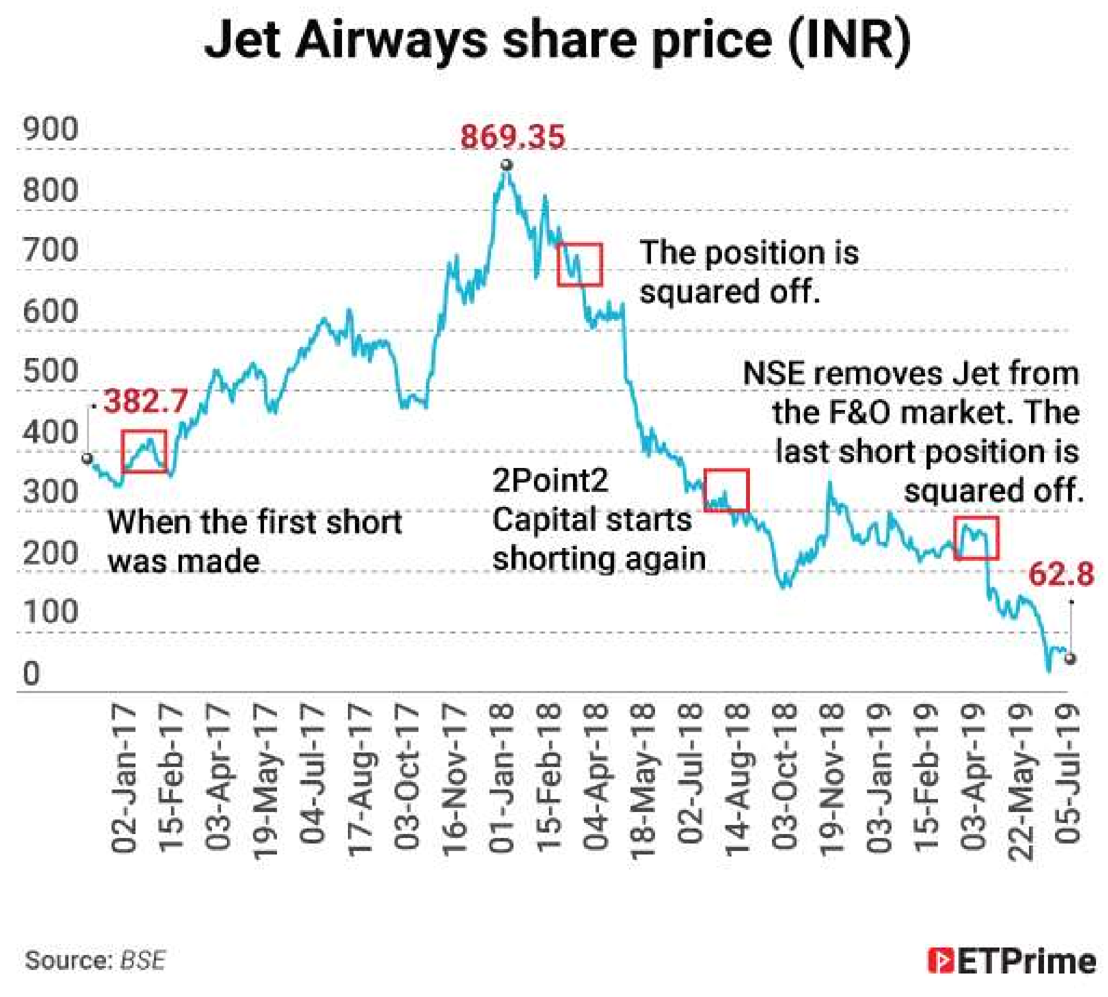
They were going to acquire more than INR13,000 crore in liabilities as of December 2018, the planes, the slots, and the employees. But the slots kept decreasing, people kept leaving, and the fleet size kept shrinking. So, the likelihood of an acquisition kept reducing.

Any buyer would have to take care of the bad business decisions of the past and the liabilities were mounting with each passing month.

If someone had to buy Jet, it had to be an irrational buyer and 2Point2 saw no such takers in the market.

"When Jet first **defaulted** on its debt payment, we further increased our exposure because it was clear that we were now at the endgame and it was only a matter of time before the airline shut down," Mantri says.

At INR300 levels, the fund began shorting Jet again in August 2018, this time with a stronger conviction on its thesis.



This time, 2Point2 made sure Jet didn't form a large part of its portfolio.

"The long position can be as much as 10% of the portfolio, but now we have a policy that a short position cannot be more than 3%," Jain says.

The fund last shorted Jet in April 2019. "We wanted to short it to zero but were not able to do that because NSE **announced** that the stock would be removed from the F&O [futures and options] segment," he adds.

Over 2018-19, 2Point2 Capital got multiple opportunities to initiate short positions as the stock was extremely volatile. Every month a rumour would result in the stock price rising and then crashing again as the business kept on deteriorating. This period turned out to be highly profitable and compensated for the earlier losses.

What makes a good short

While shorting Jet may not have yielded gold for 2Point2 Capital, there are many other punts that gave it stupendous returns, as the graphic below shows.

A few of 2Point2's more successful shorts

	Gains (%) (Approx.)
Media company with weak unit economics/balance sheet facing disruptive threat from new tech-driven business models	60
Financial-services business with governance issues and also struggling with liquidity problems	40
Richly valued auto-ancillary business suffering from a cyclical demand slowdown	30
Capital goods PSU suffering due to industry overcapacity and shift from thermal to renewable power	40
Internet-classifieds business facing disruptive threat from highly funded vertical specialists	50
Leveraged telecom player struggling in an extremely competitive environment	40

Source: *2Point2 Capital* ETPrime

So, how does one choose what to short and what not to?

2Point2 Capital broadly looks at three things before deciding to take a short position on a stock.

- The business should be going through difficulty, preferably structural problems. Or it is imminent that it will face headwinds over the time period of the short position.
- The valuation has to be crazily expensive.
- The company has corporate-governance issues.

A stock becomes an ideal short when it is entwined in all the three points.

"Our favourite shorts are where it is clear that the business will be getting into trouble over the next few quarters or years," Mantri says. "But the worst shorts are pure valuation short, where the company is good, it is growing well, and one can short it just because it is costly."

Jain says the fund doesn't look at pure valuation shorts because such companies may continue to deliver, and their valuations may continue to remain high. "There might be a time correction in them but not a price correction."

According to Mantri, when it comes to corporate-governance issues, one knows that a company will blow up, but one cannot time it. So, that is a major risk. Hence, the duo also avoids taking a short call on companies with governance issues if they see the stock is significantly owned by the promoter, making it prone to manipulation.

In favour of short selling

Short selling is highly regulated in India and 'naked short selling' is banned. The primary avenue for short selling is the F&O market, which has less than 200 entities at present out of the total 5,461 listed firms in the country. A really **bad company** might not even be in the F&O category to short, or it may be on the ban list, or may even exit the F&O category before the short thesis plays out.

These are the reasons why short selling has not taken off in a big way in India and we rarely see *The Big Short* kind of multi-year shorts playing out here.

Jain says Sebi should allow naked short selling because it keeps the prices in balance, makes the market participants more disciplined, and gives people an incentive to find out if there is something wrong with a company.

The market has a very negative view on short selling, it is viewed as unethical if one is making profit from a stock going down, Mantri says.

He believes the retail investor will benefit the most from short selling because then there will be an incentive to call out companies with corporate-governance issues. "They will be conned less if they become wary of unethical promoters and companies," he says.

2Point2 Capital recently got an alternative-investment fund (AIF) licence and is in the process of launching a long-short fund, which it was running till now using only proprietary money.

Returns on 2Point2 Capital's long-short fund

(using only proprietary money)

FY17*	FY18	FY18	Since inception#
31.10%	12.60%	18.50%	75.05%

*Beginning August 4, 2016
#Period of 32 months beginning August 4, 2016 to March 31, 2019
Returns are net of all expenses and on a pre-tax basis.

Source: *2Point2 Capital*

ETPrime

A long-short fund invests in companies, where value might be going up over the long term, and shorts the ones where it anticipates the value to go down.

The bottom line: Jet may not be the last one to fall

While 2Point2 Capital looks at the short part of their long-short fund as an alpha generator, given the constraints in India, it has a very small universe to choose its short bets.

Along with Jet Airways, NSE had removed 33 other companies from the F&O space.

This puts constraints on the fund as well. "At any point, we won't be short on more than six-seven stocks if the universe is just limited to this," Jain says.

But even in this small F&O universe, 2Point2 is confident of finding good short bets as "new additions keep happening in the F&O segment".

The good thing with capitalism is that creative destruction keeps happening. What's working right now might fail three to four years down the line, Mantri says.

Highlighting the example of NBFCs, he says till a few years ago they wouldn't have thought of shorting any company from the sector but now the entire industry is in pain.

"There will always be some sector or industry which will go through such a churn every now and then," Mantri says, adding, "It is the nature of capitalism that there will be new players taking away business or profits from the incumbents."

Kingfisher Airlines wasn't the last carrier in India to fall. And 2Point2 believes Jet won't be the last casualty in the Indian aviation market. There will be someone who will fall, too.

Short sellers will keep an eye.

(*Graphics by Sadhana Saxena*)

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