2 Jan 2020

Dear Partners,

In this letter we will

- Share latest performance report
- Share why despite a slowing economy, pessimism is not warranted.
- Share why we believe our portfolio construct will do well
- Discuss a position we have added recently
- Discuss rationale underlying exit decisions we have taken
- Answer specific queries received from partners

Summary messages[1]

- The portfolios have performed reasonably well in a tough market because we have maintained discipline and also had some luck.
- The economy's situation is challenging; however, this is reflecting in the stock prices in vast majority of the market. The NIFTY 50 performance is skewed by a very few companies and does not reflect the state of the broader market.
- We have no view on when the economy will turn. It's best to focus on what we can control and instead of trying to forecast what will happen next year, keep 3-5 year time horizons for decision making.
- We believe our portfolio construct should continue to do well. We don't own any companies with fragile business models. We are well diversified across themes - growth prospects of many companies we own are not correlated with the domestic economy performance. Our leaders are gaining market share from weaker players.
- The most attractive opportunities over the next few years are expected from Emerging Leaders. We are participating while using low position weights due to poor liquidity in these counters. Risk management is key. Our position size should allow us to correct errors.
- We have taken a new position in Garware Technical Fibres (Emerging Leader) - it is an innovation driven company with long growth runway, 30% ROIC and available at reasonable valuations
- We have exited TITAN and HDFC Asset Mgmt. where valuations were euphoric and SBI where conviction in hypothesis (sustainability of >13% ROE) was weakening.
- Max Financials and NTPC are not core to our approach (Max is not an Industry leader. NTPC is not high growth/compounding). But they provide very compelling risk return trade-offs at present. One needs to be flexible to adapt to what the market has to offer.

Performance update[2]

For Anchor partner					**Since PMS License (Aggregate across all accounts)**			
DATE	**NIFTY**	**NIFTY500**	**SOLIDARITY**		**DATE**	**NIFTY**	**NIFTY500**	**SOLIDARITY**
FY15	24.6%	30.1%	67.2%					
FY16	-7.5%	-5.9%	-0.1%					
FY17	18.9%	24.0%	22.4%		FY17 (part year)	19.2%	24.3%	20.5%
FY18	10.2%	11.5%	18.6%		FY18	10.2%	11.5%	19.2%
FY19	15.0%	8.5%	6.0%		FY19	15.0%	8.5%	7.1%
FY20 YTD	4.3%	1.8%	13.4%		FY20 YTD	4.3%	1.8%	14.1%
Cumulative XIRR	**11.2%**	**11.8%**	**20.7%**		**Cumulative XIRR**	**12.8%**	**11.7%**	**15.8%**
Note: We operated with an Investment Advisor license till 11 May 2016 post which we migrated to a PMS License								

[1] Analysis of companies shared in the letter is for purposes of Transparency. It is not a recommendation to buy or sell. We reserve the right to change our minds

[2] Solidarity constructs customised portfolios. Performance may differ in individual accounts

As on 31 Dec 2019	CAGR			
Particulars	**1 Year**	**2 Year**	**3 Year**	**Since inception**
Solidarity Advisors - Anchor client	25.3%	6.8%	16.9%	20.7%
Benchmark - Nifty	12.8%	7.8%	14.4%	11.2%

We have performed reasonably well in a tough market. We have aligned the portfolio where we see structural tails supporting growth, have been disciplined in not compromising on weak moats[3] or imprudent use of leverage. We have also had some luck where our largest positions have done exceedingly well and the positions that have not done well have been a lower weight.

Many commentators are expressing surprise on the strength of markets vs performance of the economy. These observations are misleading because the data does not back their assertions. Stock prices of the vast majority of the market reflect mediocre growth expectations and in many instances deep pessimism. <u>While the NIFTY 50 has done well, its performance may be misleading as a representation of the economy as its depth is very narrow – 8 stocks have contributed to the entire NIFTY gain in CY 19.</u>

~86% of all listed companies have lost money in the last 2 years		
Price change	**No. of listed Cos.**	**% of Listed Cos.**
Increased > 10%	257	11%
Increased 0 to 10%	74	3%
Decreased 0 to 10%	90	4%
Decreased 10% to 33%	350	15%
Decreased 33% to 50%	396	17%
Decreased >= 50%	1185	50%
Total	2352	100%

Data for Cos. which have traded on 01 Jan 2018 and 31 Dec 2019
Source: Ace Equity, Solidarity Analysis

There is no doubt that the economy is in a tough spot.

- Post the ILFS crisis, Credit growth has collapsed. Non AAA NBFCs have been devoid of funding and banks have also tightened loan standards.
- Poor sentiment and threat of loss of jobs means consumption demand has also weakened.
- GST collections are well below Govt. estimates limiting its ability to stimulate the economy.
- Rising credit risk spreads means real interest rates are high with cost of debt exceeding nominal GDP growth.

However, it is futile to forecast when the economy may turn as one cannot predict sentiment. Its best to focus on what one can control.

- Keep a medium term view (rolling 3-5 year time horizons).
- Keep enhancing understanding of companies enjoying a large and growing addressable market, with structural tail winds of growth and who are expanding their competitive position
- Ensured adequate diversification with themes that are uncorrelated (discussed below).
- Stayed disciplined on valuations and hold cash when opportunities are scarce.
- Risk Management – <u>Invest</u> in what we understand. <u>Avoid</u> weak moats, poor governance, excessive leverage, chasing momentum. <u>Exit</u> when valuations reach euphoria. Maintain <u>Discipline</u> of position sizing (concentrated bets when there is conviction supported by company maturity, liquidity in counter; smaller positions otherwise).

[3] A moat provides a competitive edge

Given current state of the economy and global geo-political dynamics, one needs to have realistic expectations of returns over the next 3-5 years so as not to over reach on risk. If India's nominal GDP growth rate does not pick up, it will have negative implications for Equity returns as it will have implications for Earnings growth and foreign and domestic flows into Equities.

However, pessimism is not warranted.

- While the short term is challenging, we expect growth to recover with some time lag as the cleansing impact of reforms is felt[4]. As we argued in our last letter, part of the slowdown is also due to inescapable side effects of the formalization of the economy.
- The Govt. and RBI are not in denial.
- If you leave Consumer and some high ROE companies, most of the market is in a reasonable valuation zone.

Our portfolio is well diversified and oriented towards growth and stability

We have invested primarily in companies benefitting from structural tail winds of growth that are Industry Leaders or dominate a niche. We don't invest in fragile business models that are available cheap (unless we believe there is a genuine Transformation story ahead)

- A large share of the portfolio is invested in the theme *"Indian companies that are playing key roles in global supply chains*" which is not correlated with current challenges of the domestic economy *(SRF, Divi's Labs, Neogen, Fair Chem Specialty, Shaily Engg and Paushak).* Specialty Chemicals remains a key area of focus for us and we continue to add positions where companies are expanding their moats, undertaking strong Cap ex programs and valuations remain reasonable
- Many portfolio companies continue to gain market share from weaker players thus delivering reasonable growth even in current market conditions. Consider Banks. Even as Credit growth has dropped precipitously in the system, the banks we own have been able to grow their Loan Books without diluting loan standards while gaining deposit share while valuations are broadly reasonable *(ICICI Bank, HDFC Bank)*
- Life Insurance companies are at a very early stage of their growth cycle and are increasing share of their business from Protection policies over Savings, which - being higher margin - is supporting New Business Margin growth. The sector has continued to deliver growth in a tough macro. *(ICICI Pru Life, SBI Life, Max Financials)*
- The Power Utilities *(NTPC, JSW Energy)* growth prospects are not correlated with domestic economic growth (to the extent their capacity is tied up via Power Purchase Agreements). However, due to investor fatigue with the sector, they are available at very cheap valuations.

We don't own many Consumption themes <u>at present</u> as valuations don't provide comfort.

Consumer companies (and high ROE companies in general) are trading at euphoric valuations with a significant share of their returns over last 5 years driven by multiple expansion. These cannot be justified by first principles. Neither the ROE, nor bottom line growth or competitive position in the market has expanded to a higher base over historical trajectory. Lowering of Cost of Capital (due to a decline in interest rates) should be a country wide phenomenon which should be applicable to many companies, not a select few. Some of the multiple expansion can perhaps be explained by a flight to pristine governance, given the scams that have been exposed in the last few years. But that too, is not a structural phenomenon but rather reflects short term flight to safety.

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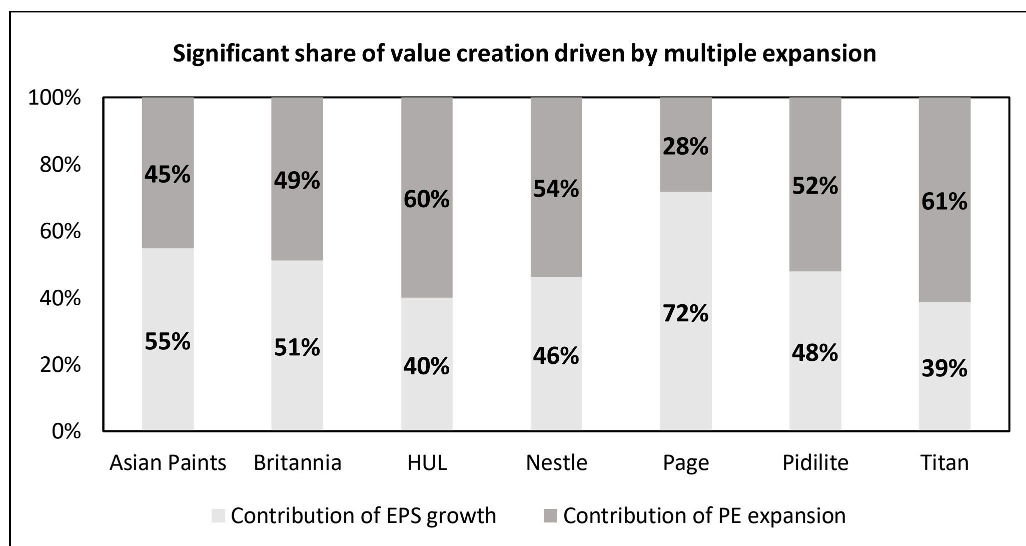
[4] A good explanation of what is happening in the economy can be found on this blog https://succinctbyvikas.wordpress.com/2019/12/29/indian-economy-is-not-going-into-icu-have-belief-have-patience-and-the-stage-is-being-set-for-a-robust-growth/

Mean reversion of valuation multiples and sectoral cycles is a truism in markets. Valuation multiples tend to bounce around from despair to euphoria but ultimately converge to fair value. When a sector is doing well, the prevailing narrative pushes sector valuations well above fair value; but after the reality check, stock prices stay subdued for long periods of time. We have seen this "Consensus buy → Euphoria → Reality Check" cycle play out with Technology in 1997-2000-2001, Power, Real Estate and Infra in 2006-2008-2011, Pharma in 2010-2014-2016 and with NBFCs in 2013-2018 -present.

As much as we love the wide competitive moats and the cash generation ability of these businesses, paying too high a price never ends in a good result. When one pays or holds onto companies at > 50x valuations, earnings growth must be highly predictable with no room for surprises, even due to factors beyond the company's control.

We have written about this in more detail in our earlier letters which you can read between Pages 3-4 here. However, these companies will always be of interest to us and may enter our portfolios at some time on more acceptable valuations.



Analysis for 5 yrs. (30 Sept 2014 to 30 Sept 2019)
Source: Ace Equity; Solidarity Analysis

As a broad generalization, Emerging Leaders (typically mid and small caps) offer more attractive return prospects over the next few years than Clear Leaders.

However, Emerging Leaders trade with poor liquidity which gets exacerbated during tough market conditions. This increases stock price volatility and short term drawdowns. Poor liquidity is a significant opportunity because it means fewer potential buyers. As the sentiment for Mid and Small Cap turns, and as these companies grow in Market Cap and become well discovered stories, they will come under the scrutiny of brokerages and MFs. The liquidity should increase over time and should be significantly higher at the end of 5 years than what it is today. We are however careful about position sizing so we can correct errors if we are wrong.

We need to have patience with Emerging Leaders that are not performing well

- *Mayur Uniquoters and Shaily Engineering* are leaders in their domain with good medium prospects for growth. They have strong balance sheets (Mayur is debt free), and both are investing in new product categories and will be even stronger franchises tomorrow.
- When stock prices do not do well, we assess whether there is something amiss with the company or the stock price reflects near term uncertainty of growth. If the issue is the latter, it typically provides a very attractive buying opportunity. When growth returns, the valuation multiples also expand leading to very favourable outcomes.
- Needless to say, there is no room for ego in our line of work. We will act if we encounter facts that suggest we are wrong. We review our thesis constantly and from what we know at present, our Investment thesis is intact and share price declines reflect both short term challenges on growth and general disenchantment with Small and Mid-Caps

We initiated position in Garware Technical Fibres (GTF) (Emerging leader) this quarter

A Technical Textile is a textile product manufactured for non-aesthetic purposes, where function is the primary criteria. GTF manufactures Technical Textiles catering to needs of the fishing, aquaculture, sports, agriculture, defence, shipping and the infra sectors.

GTF has been in the Technical Textiles business for over 4 decades. Led by Vayu Garware, it is now the largest net company globally with 2.5x scale advantage over its closest domestic peer. Over the last few years it has evolved its business model to designing more customized products for clients from just selling commodity products. ~ 70% of GTF sales in 2019 came from value-add customised products, up from 35% in 2015.

Customization is creating more end value for customers. Some examples:

- Its Fishing nets have improved yields and reduce costs for fishing trawlers – Some of its nets are as strong as steel but nearly 7 times lighter, which lowers drag helping save fuel costs by up to 40%.
- Its aquaculture cage nets reduces in site cleaning cost by 50% and ensure better cleaner fish through lower disease rate. Its predator cages protect salmon farms from seals resulting in record decrease of its licenced culling.

This has also resulted in significant market share. It is the domestic market leader in Fishing Nets (65% market share) and Shipping ropes, and has almost monopoly status in aquaculture in Scotland & Canada.

What makes GTF a core part of our portfolio is:

- The focus on customization and new product development. ~ 30% of GTF revenue is from products which are <2 years old. We don’t come across many Indian companies who are global and investing to build competitive advantage through product differentiation. Value addition through customization builds customer intimacy, which is a key differentiator in a B2B business.
- The financially attractive business model. As more value is created for the customer, there is a clear differentiator vs other competing products. Customers are more willing to allow some

pricing premium and there is higher ability to pass on RM price increases. Further, a labour-intensive product manufactured in India provides a cost advantage. This is reflected in its financial numbers as EBITDA has expanded from 10% in FY 2015 to ~18% in FY 2019 with a ROIC post tax of ~30% in FY 2019 – quite exceptional for a Manufacturing B2B business

- The growth opportunity ahead of it. GTF is still a USD 140M company while the total Technical Textiles market is worth USD 165 B. There are multiple drivers of growth – ability to expand into new segments, new markets and upsell higher margin products. GTF has ~3000 products which serve needs in 7 Sectors today.

The company's growth over the last 5 years has been tepid at 8% CAGR. This is because even though the higher margin export sales (58% of mix in 2019) has grown at 12% CAGR, domestic sales growth (more commodity portfolio) has been sluggish at 4% CAGR primarily due to delay in offtake of defence products, weak agriculture growth due to time consuming process to educate farmers and increasing competition in commodity fishing and shipping products.

Our hypothesis is that Exports should continue to grow well (as GTF continues to expand into new products and geographies). Domestic sales growth should also revive as defence spending (Surveillance balloons, sleeping bags, inflatable tents etc.) and fisheries picks up (GoI has allocated 25,000crs over next 5 years on projects to attempt l doubling of Fishermen's income). Moreover, other segments like Agriculture have significant possibilities - Agriculture nets improve crop yields by up-to 30%.

Management is stepping up Cap ex (will spend ~120-150crs over next 3 years to augment capacity versus ~75crs over last 3 years) and new product launches (Launched 28 unique products in 2018 versus 19 over 2011-16). All the above provides confidence that growth rates should pick up.

The track record of Small Caps that have been able to grow into Large Caps is poor because of inability to scale. GTF has the market opportunity, business model, segment leadership and Balance Sheet quality to make this transition (~235 Cr net cash as of 31 March 2019). Given the potential and longevity of growth (we believe the bottom line can grow at 15% CAGR over long periods with fairly high consistency), dominant franchisee with strong customer value proposition, high ROIC, and a strong Balance sheet, we find GTF reasonably priced at 18-20x FY 19 Earnings adjusted for new tax rates. We have hence taken an initial position and will look to add over time.

Our risks to the thesis are non-materialization of growth. Further, the GTF management communicates with minority investors only once a year at the AGM. While there is nothing wrong with this approach (we like managements who don't spend excessive time on Investor PR), it does create a time lag in interpretation of financial results.

Rationale for positions exited

During the last few 4/5 months we exited TITAN, HDFC Asset Management and SBI.

We don't take exit decisions easily. However, we are allocators of capital and place our bets on where we find the best risk adjusted returns. While we believe in compounding, our decision horizons are not decadal but rolling 3-5 years (depending on how well discovered a franchise is). <u>Our actions must be in sync with the time mandate we have agreed with partners.</u>

We think of "churn" as good and bad churn.

- Bad churn is when one is changing their mind too often and flirting between positions rapidly with no rationale underlying actions.
- Good churn is changing one's mind when facts change, when the compounding thesis breaks or practicing risk management when valuations become euphoric.

We have been holding TITAN since inception (over 5 years) and it has done very well for us (~4.5X returns since initial purchase). It is a fantastic company with blue chip governance and an expanding competitive edge as it extends its core competencies into adjacencies. The company has done very well over the last few years in Jewellery on the back of market share gains from weaker competitors. However, there is a broadly fair price for every narrative. One can tolerate some over valuation – however, one cannot ignore the fact that a stock trading at ~62X[5] FY20 estimated earnings; and ~45% core Jewellery ROE should grow PAT at ~15-17% for the next two decades[6], with high consistency, to justify the valuation. That is a big assumption because Jewellery is still over 85% of TITAN Operating profit, the jewellery market is not growing and TITANs growth is primarily coming from market share gains. Mean reversion of valuation multiples to fair value would mean poor return prospects over the medium term.

HDFC Asset Management too is a great cash generating business. It enjoys the credibility of the HDFC brand and has the tail winds of the "strong getting stronger" theme one is witnessing. However, moats in Asset Management are not as wide as other Financial Service businesses such as Banks (low cost deposit franchise) and Insurance companies (brand credibility, banking led distribution). Fees in Asset Management in more developed markets are on the decline. Fees are much higher in India vs developed markets and as they are regulated by SEBI, should decline over time. Hence, the sustainability of current Earnings growth/margins over long periods of time is questionable. Moreover, the scarcity premium for HDFC AMC will fade over time as more Asset Management companies get listed. We find valuation multiple at present ~40% above our assessment of fair value.

We exited SBI because we found ourselves repeatedly questioning our hypothesis that SBIs core banking business will sustainably generate an ROE of >13%. Value is created when a franchise can deliver an ROE above Cost of Capital on a sustained basis. Our bet on SBI was premised on the belief that ROEs will be > 13% and that both Earnings growth and valuation multiples will expand when NPA issues are behind them. However, we are unsure about that now because the SBI Chairman has been speaking openly about its dual mandate[7]. The valuations of SBI, supported by the value of its subsidiaries, are very compelling. But the re-rating hypothesis breaks if one does not believe that ROEs will sustainably stay above cost of capital. The stock then is a trade at best. If we find ourselves uncertain about a position, it just helps to exit and reallocate capital elsewhere.

Are Max Financials and NTPC a deviation from our approach?

We believe in compounding and buying leaders as leaders tend to have disproportionate share of the Industry profit pool. However, while we have clear boundaries on what we will not invest in, we also prize the flexibility to go where the best returns are – "at the right price, every Asset is AAA[8]". One should be able to hold opposing constructs and still function rather than be constrained to just one approach. It may interest partners that ICICI Bank first entered our portfolios as a "Transformation" story.

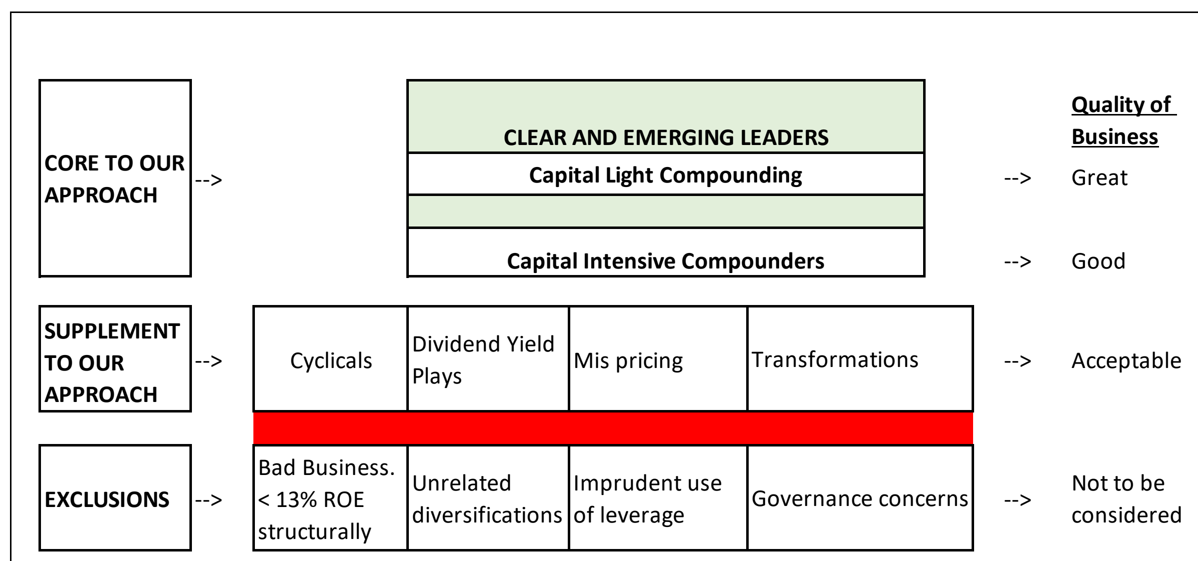
[5] Kotak Institutional Equity estimates as of 30 Dec 2019

[6] Assumption is 8% terminal growth and 12% Cost of Capital

[7] SBI cannot be like Private Sector Banks and stay away from certain segments. Being a Govt. controlled entity, SBI is bound by social objectives which may not be lucrative.

[8] Wisdom of Howard Marks

Our approach is summarized in the chart below.



Max Financials is not an Industry leader (#5 in industry), but offers an asymmetric risk-return which we find very compelling at our initial entry price (100%+ upside/-10% downside). The thesis for Max Financials is explained on Pages 6-7 of our Q letter published on 1 Oct 2019 which you can read here.

NTPC is not a high growth company. However, it offers a very attractive risk return trade-offs, especially in the current environment.

- NTPC earnings are fairly predictable as its PAT is a function of "regulated equity" on which it is guaranteed 15.5% ROE plus incentives. Over the next few years NTPCs 20 GW of Capital Work in Process should come on stream increasing its regulated equity by ~10% per year for the next 3 years, which should translate broadly into 10-13% earnings CAGR.
- It trades at ~4.0-4.5%% post tax dividend yield[9]. Owning NTPC stock is akin to owning an "AAA" Bond (provides ~4.6% post tax return at present) with a growth optionality.
- One should expect some re rating gains from valuation multiple. NTPC valuations are close to a decadal low. At ~1 Price/BV, there is no premium for terminal value or growth despite it having best prospects for organic growth amongst all Utilities in India with 50GW solar capacity addition planned.

a) A combination of 10-13% Earnings growth, 4-4.5% dividend yield and potential for valuation re-rating implies a reasonable Investment case to earn 18-20% IRR over the next 3 -5 years. This is very attractive in the backdrop of the macro where earnings visibility is poor.

What do we see here that the Market does not?

a) *Power as a sector has very little investor interest.* Investors have made no returns from NTPC over the last 10 years. Entry multiples were very high in FY 10 (2.7X P/B) and de rated to 1.2X book by FY 2014 (and hence a 13% EPS CAGR resulted in -8% price CAGR). While entry multiple were favourable in FY 2014, the regulator tightened norms on Incentive structure, sharing of fuel efficiency gains, auxiliary consumption allowances which were adverse to NTPC. Moreover, FY 18/19 witnessed coal shortages (so EPS growth over 5 years was flat). These uncertainties are behind us as in the next 5 years, we have a stable regulatory environment[10] and a favourable starting valuation multiple.

[9] Dividend assumed of 5.7/share in FY 21 per Bloomberg Consensus estimates

[10] Better coal availability and development of captive coal mines

b) *Core Regulated Equity will drop by 4000 Cr due to old plant retirals*. However, the investments for FGD[11] upgradation and captive coal mining which will get added to regulated equity in this period should be greater than 4,000 crores. Hence, this impact will be net neutral on Regulated Equity.
c) *NTPC is Govt owned and there are fears of capital mis-allocation*. There is no perfect Investment and we accept this is a risk; however, we believe this risk is already reflected in the price despite there being no evidence of misuse of NTPC resources in the past. The Govt. is short on resources and needs a strong disinvestment program. It is unlikely the Govt. will act in a manner that will affect sentiment for PSU valuations.
d) *Poor Terminal Value*. NTPC perhaps offers the best terminal value amongst all Power Utilities in India at present. State utilities are barely signing PPAs at present. The sentiment towards funding Power Generation is very poor and given current risk appetite and stress, no bank will fund Generation by a Private entity if the Power Asset is not backed by a PPA. However, as NTPC is rated AAA, and is quasi-sovereign entity, NTPC has the ability to raise Bonds to fund fresh Cap ex at interest rates that no Private Entity can match.
e) *Boycott by ESG[12] Funds*. This is a real risk that Investment funds avoid NTPC because its primary revenue comes from Thermal Power. We are not seeing this at present from Indian MF.

We believe Investors are extrapolating the past and the pendulum on pessimism has swung too far.

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You may have read about the fraud at a leading broker where client securities were pledged to raise loans. We have chosen to work with Kotak as our custodian because we believe they are blue chip in governance. Your custodial agreement with Kotak prevents any pledging of your securities by Solidarity or Kotak.

I would like to re-iterate that at Solidarity, "partners will always come first". As principal shareholder and CIO, I have complete skin in the game and aligned interests.

- 100% of my family's Equity Assets (including mother and brother) are invested through Solidarity.
- Derivatives trading is banned at our firm for all employees, including me.
- We own no listed Equity positions that are not owned for partners.
- My family and I pay the same brokerage and back office fees as our partners.
- And positions are first executed in partner accounts before my family accounts.

I welcome your suggestions on best practices you have observed elsewhere.

We look forward to your feedback and answering any queries you may have.

With warm wishes for a great 2020.

Manish Gupta
Chief Investment Officer

[11] Flue-gas desulfurization (FGD) is a set of technologies used to remove Sulphur dioxide (SO) from exhaust flue gases of fossil-fuel power plants, and from the emissions of other Sulphur oxide emitting processes such as waste incineration.
[12] Environmental, Social and Governance focused funds