8 July 2023

Dear Partners:

The purpose of our quarterly letters is to provide transparency in how we are thinking and share our responses to a few interesting questions we have been asked.

Summary

- Performance remains healthy with Solidarity portfolios in aggregate delivering 20.5% TWRR post fees over the last 5 years vs 13.9% for BSE 500 TRI. Our goal is to beat the BSE 500 by 3% per annum every rolling 5 years (which implies beating the BSE 500 TRI by ~1.5% per annum).
- India remains a bright spot in the world economy. As Market Cap/GDP is ~100% at present (long term average 80%), we expect returns generated by the Indian market over this decade to broadly track nominal GDP growth.
- A strong market move in the quarter ended 30th June resulted in a narrowing width of opportunity in companies we would like to buy. In our recently launched "Emerging Leader" scheme, we have deployed capital in only 3 out of 8 positions.
- We added to our positions in Restaurant Brands Asia and Star Health Insurance this quarter and bought a new position in Yasho Industries, an emerging leader in Specialty Chemicals.
- We trimmed our Life Insurance weight to ~15% for risk management.
- We discuss our portfolio construction approach that balances well discovered companies with emerging leaders.
- We also explain why focusing on poor Free Cash Flow for manufacturing companies early in their growth cycle can lead investors to wrong conclusions.

Contents

1. Performance update P2
2. What has changed since last quarter? P2
3. How do we think about small/mid/large cap composition? P3
4. Actions taken in the last quarter P5
5. Additional perspectives on Restaurant Brands Asia P5
6. Brief Investment thesis on Yasho industries P6
7. Rationale for trimming Life Insurance positions P6
8. Why the interest in manufacturing when it generates such low Free Cash Flow? P8

Important Disclosures – please refer to disclaimer on last page.

- We disclose position names for transparency and not as recommendations to buy/sell.
- We reserve the right to change our minds and may not be able to inform you if we do.
- We construct customised portfolios based on valuations at point of entry and cash available for deployment. Hence, all positions may not be held in your account.
- Performance in individual accounts may vary from aggregate performance.
- Past performance does not guarantee future results.

Performance[1]

Aggregate across all partner accounts					
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception^**
SOLIDARITY- PRUDENCE	19.6%	7.5%	29.8%	20.5%	**18.6%**
BSE500TRI	24.0%	11.7%	26.4%	13.9%	**15.1%**
Data as of 30 Jun 2023					
^ From 11 MAY 2016 -Start date of scheme					
Solidarity performance is net of all fees & expenses					
Performance data provided in the above table is not verified by SEBI					

We want to play "long term games with long term oriented people". A good outcome for us will be to beat the BSE500 by 3% p.a. (or BSE500TRI by 1.5% p.a.) every rolling 5 years post all fees and expenses, and with prudent risk-taking.

Over the last 5 years, Solidarity has generated net annualised returns of 20.5% vs 13.9% generated by the BSE 500 TRI index and 12.4% by the BSE/NIFTY 500 index.

What has changed since our last letter in April?

We reiterate our messages from past letters which can be accessed from our website, www.solidarity.in. India is a bright spot in the world economy. The Indian economy is growing at ~7% p.a. (real). Inflation is not that much of an issue in India whilst it remains a very significant issue in the US/Europe which in turn has driven interest rates higher by ~4% in the US, from less than 1% in 2022 to over 5% presently. Global leaders want to engage with India for access to our homegrown technologies, access to our markets, for India to be a counterforce to China and to use India as part of their service and manufacturing supply chains.

However, over the past six months, there is renewed interest amongst global investors in India from a low starting point of allocations while domestic flows continue to be stable. ~USD 11 billion of FII flows have come into India this past quarter resulting in steep stock price movements. The market is now at ~100% Market Cap to GDP (long term average is ~80%). India deserves some premium to long term averages. This looks like an environment where, barring significantly adverse events, the market should deliver returns over the next decade which are broadly in line with nominal GDP growth.

The market breadth has narrowed in the kind of companies we would like to buy. If everyone likes a company that is trading at very expensive multiples, all the optimism is perhaps already in the price. The probability of making a good return then depends on the company delivering numbers even stronger and for longer than market estimates. While there will always be exceptions, if a company is trading a very high valuation multiple, and you have no unique insight on the company relative the market (no variance perception) total returns on that position, over a full cycle, will trend lower than or close to index returns.

As we are unwilling to over-weight the portfolio with Financials (a pocket where value exists) or make shorter term opportunistic trading bets in low moat businesses, we find opportunity to deploy only ~50% at present for new money on day 1 in "Prudence". We launched our "Emerging Leader" scheme in April. We have been able to deploy only ~30% in this scheme to date. Between the announcement of the

[1] We earlier reported performance vs NSE500. SEBI asked managers to choose 1 of 3 indexes and NSE 500 was not one of the options. We have chosen BSE500TRI which is essentially BSE500/NSE 500 plus reinvested dividends.

scheme in February and the launch, many of our shortlisted names ran up over 60% in price. The BSE Small Cap Index is up ~23% this quarter.

We have stopped accepting inflows from new partners in both schemes and will re-open when we can deploy ~75% on Day 1[2]. In the "Emerging Leader" scheme we have offered to return un-invested capital to partners rather than hold it in Liquid funds. In case you missed our email on this, please write to us. Top-ups from existing partners in "Prudence" of up to 20% of current portfolio are welcome any time.

Before we discuss the rationale underlying our key actions this past quarter, we share our thought process on portfolio construction to provide some context.

How do we decide composition of small/mid/large caps in the portfolio.
The context of this question is to gauge the level of risk we are taking. Too low? Too high?

We manage your money as we manage ours. We are not attempting to deliver the highest returns in the short term, rather we aim to deliver consistent returns that outperform the index over the long term. Hence, our guiding framework is resilience over speed.

Small/Mid/Large composition is misleading to gauge underlying portfolio risk. As a group, Small Caps tend to be more volatile with higher drawdowns during periods of market stress. However, Small Caps do not necessarily equate with higher risk and Large Caps with lower risk. Some small caps dominate niches, are debt free and high ROE businesses.

We do not track the traditional Mutual Fund Small/Mid/Large categorization. Rather, the portfolio is constructed by organizing companies in 4 phases of their evolution basis the maturity (and hence implicit risk) of their business models and liquidity relative to our AUM.

- A ~10000-15000 Cr company (small cap in traditional MF definition) could be a large allocation for us (7-8%) in our context (1700 Cr AUM). Kama Holdings, India Mart are a few examples of Small caps with large weights.
- However, a ~2000 Cr Market cap company would never be more than a 3-4% weight as liquidity would be poor relative to our AUM. We would not hold more than 20% in relatively illiquid names in aggregate.

[2] Exceptions for families making >10 Cr commitments where we are doing staggered draw downs. We customize for time of entry. Customization on partially drawn portfolios increases complexity and hence we limit this option only to accounts over 10 Cr.

The criteria used for categorization of companies across 4 phases is as follows:

	Phase 1	Phase 2	Phase 3	Phase 4
Category	Special Situation	Emerging Leader	Almost Clear Leader	Clear Leader
Rationale for inclusion in portfolio	Very cheap. But not compounding stories at present	Potential to become compounders. But still need to demonstrate the ability to execute at scale.	Strong business model and moat visible.	Strong moat and clear competitive edge. Growth fly wheel is spinning
Position size per company	~3%	~3-5%	~6-8%	~8%+
Aggregate weightage in SOL portfolios at present	< 4%	~25%	~32%	~40%

We design portfolios to have a mix of smaller positions in Phase 1 and 2 companies that are "Emerging" (~25-30% of portfolio) and larger positions in Phase 3 and 4 companies which are "Clear" leaders (~70-75% of portfolio).

- We take smaller positions in Phase 1 and 2 companies (3-5% allocations) as there are higher chances of errors here and it is not easy to exit without moving the price due to poor liquidity. A change in environment could impact these companies more as they will be over-reliant on a few products/customers or people. No amount of analysis can tell us which of these promoters will evolve from "Ranji players to playing for India" and those who will not make the transition. Often the head and the heart are not in sync. For example, while a promoter will accept the need to attract talent, they may not be able to let go of micromanagement and hence not attract or retain good people. One truly understands companies and promoters only after having invested in them for a while post which the probability of future evolution becomes clearer.
- Phase 3-4 companies have more stable business models where there is more proven track-record. One can take bigger positions here as well as average down on price declines.
- Phase 3-4 will provide stability to the portfolio with Phase 1-2 providing the return kicker as they can both grow faster and have potential for re-rating if they evolve into more robust business models. Good examples of Phase 2 to Phase 3 evolution in the recent year have been Axis Bank, RACL Gear Tech – where strong execution resulting in enhanced market credibility and hence higher valuation multiples.
- Our bias is to let our Phase 2 winners grow into higher position sizes while exiting Phase 1 and 2 companies where we see promoters not evolving at the appropriate pace and we can allocate capital into more promising ideas.

Our key holdings mapped to this framework at present are as follows:

Themes	Phase 1	Phase 2	Phase 3	Phase 4
Banks			Axis Bank	ICICI Bank HDFC Bank
Manufacturing	MAN Industries	Mayur Uniquoters Shaily Engg. Hester Bio Yasho Industries	Kama Holdings RACL Gear Tech Neogen Chemicals	Garware Technical
Life Insurance		ICICI Pru Life		SBI Life HDFC Life
Health Insurance			Star Health Insurance	
Digital and enablers			Indiamart	Bharti Airtel
Consumption		Restaurant Brands Asia		

Based on the MF industry categorization, Large Caps are ~60% of the portfolio today. As we intend to allocate more capital to non-financials over time, we expect this ratio to gradually decline. However, it would depend on where we see the best opportunities.

Please note that the above names could change, and we will not be able to inform you till the changes are complete as that would be against the aggregate interests of the partnership.

Key actions taken this quarter.

- Increased our position in Restaurant Brands Asia to ~4-5%.
- Increased our position in Star Health Insurance to ~7-8%.
- Bought a new position in Specialty Chemicals, Yasho Industries to ~3%
- Reduced our position size in Life Insurance to 15% for risk management and to increase positions in companies listed above.

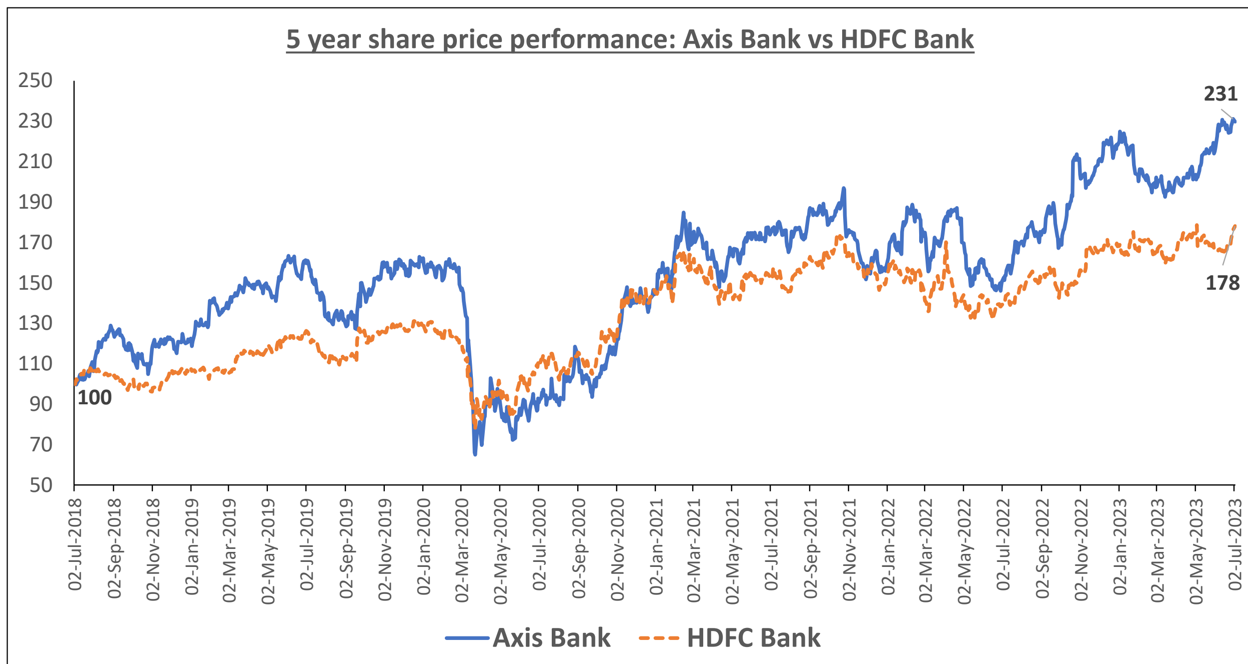
Restaurant Brands Asia (RBA)

We shared a more detailed note on RBA on 20 June 2023. Read here.

The key question we get on RBA is that Westlife (Mcdonald's South & West India) is a superior franchise. We do not contest that. Westlife is a Phase 3-4 company trading at ~50x Operating Cash Flow[3]. However, one should not buy a well-positioned company at any price. Further, if it is not a winner take all sector, buying a Phase 2 company can be rewarding if we believe the company can transition to Phase 3 and deliver 15%+ earnings compounding with steady state post tax ROCE of 18%+. If our variant perception on RBA plays out, we earn high returns on the investment as we get growth and multiple re-rating.

HDFC Bank was a superior franchise to Axis Bank 5 years ago and still is. However, over the last 5 years, Axis Bank has delivered significantly higher returns than HDFC Bank. This is as Axis Bank is a far better franchise than it was 5 years ago, and it has been re-rated to fair value while HDFC Bank multiple has declined. See a comparison of the share prices over five years on the graph below.

[3] pre-IndAS



As a Phase 2 company, RBA is an emerging leader, much as Axis Bank was 5 years ago. Our thesis is that the RBA team will make the Phase 3 transition over the next 5 years which would result in very attractive returns for us. Of course, there are no guarantees that this transition will be made. If we find RBA is not making the transition at the desired pace, we will exit. However, from the current prices, even if it does not make this transition, we don't expect to do badly on this investment.

Yasho Industries

We are very optimistic about prospects of Indian companies in Manufacturing. De-risking of supply chains is now on every CEOs agenda.

Many Indian manufacturing companies we meet tell us a version of the following narrative - "*We have customers who respect our technical skills. But we had a low share of their wallet. Covid was a trigger point when we could deliver when many of their existing suppliers could not. There is more interest in sourcing from us now than ever. We are confident that any capacity we bring on stream can be quickly utilized*".

It is our belief that Specialty Chemicals is where the Indian IT industry was in 2000 with potential to grow for 15-20% CAGR this decade. Chemicals need an ecosystem (raw material, effluent treatment, learning curve) and India will be the primary beneficiary as Europe will have higher energy costs affecting competitiveness and other Asian countries lack this ecosystem. India should win big in Chemicals. Hence, Specialty Chemicals are about 15% weight in our portfolios at present (Kama, Neogen, Yasho).

Yasho is primarily an Industrial Chemical company in Phase 2 of its evolution. It has a very low market share in key product lines and hence the opportunity to grow to 10x of its current size in a decade if it executes well. For example Lubricant additives was a USD10 M business for Yasho in FY 22 in a USD 10 Billion market. However, it needs to prove its ability to execute at higher scale. Plants need to come up on time (400 Cr cap ex is being done on existing Gross Block of 270 Cr), organizational depth needs to be built for quality and delivery timelines to be delivered at significantly higher scale. This is where many companies are unable to make the transition to Phase 3 as they fail to manage the significantly higher complexity.

The promoters have a good track record. They are strengthening the team (board composition, new CFO). We like the energy and the granularity with which they are thinking. We like the balance of the long and short term – a clear vision but also the caution that they need to get the current capital expansion right before thinking further ahead. Our initial position (3% for a Phase 2 company) has been bought at between 23-27x FY 23 Earnings with the hypothesis that these earnings could double by FY26 and that this team will make the Phase 3 transition. If the company does not make the Phase 3 transition, we could have paid 18-20x earnings and still been wrong. If the company makes the transition, even if we paid 30x earnings we will get a good result.

We will publish a more detailed note on Yasho in a few weeks.

Rationale for trimming position size in Life Insurance to 15%.

We had an overweight position in Life Insurance (up to ~20% allocations in some accounts). We find this to be a very attractive industry and found valuations strongly in favor when it was hard to find value elsewhere. However, the industry has seen two regulatory actions in the last 24 months on tax-saving products. There are concerns about some pending regulatory actions in Life Insurance (discussed below) the timing and scale of which are unclear at present, but which could have a material impact on stock prices. Considering we take rolling 5 year (and not decadal views), we considered it prudent to reduce our position size.

The Life Insurance sector is well positioned to grow in the long term due to under-penetration in Term Insurance and Retirement products. Less than 10% of Indians who file tax returns own Term Insurance. Leading private insurers could grow premiums at 15%+ CAGR for long periods as they enjoy strong moats (brands that can be trusted/distribution through bank branches). The risk of technology disruption risk is low.

Complicated accounting (mismatch between revenue and costs) means true PAT and ROE of the business is hard to gauge. We believe for sector leaders (SBI life/HDFC life), true ROE will be ~17-20%. Businesses that require regulatory capital need to raise equity if growth> ROE. SBI Life has not raised equity since 2008 and has grown net-worth by ~18% CAGR and net written premium by ~18% CAGR in the last 15 years respectively, and still maintains high solvency levels despite paying regular dividends over time. This is a very attractive business to own from a permanent ownership mindset.

Some of the pending regulatory concerns are as follows:

- Life insurance has low corporate tax rates today (~14.5%) which could normalize over time.
- Some products are mis-sold while also having high surrender penalties. These could attract regulatory scrutiny (the Finance Ministry issued a circular to PSU Banks to curb mis-selling in Dec 2022)
- The regulator is trying to discourage Life Insurers from selling saving products.

Our view on these issues is as follows:

- Preferential corporate tax rates for the sector cannot continue indefinitely. However, we believe these may not increase in the short term and are a medium-long term risk. Having recently listed LIC, the Govt would send the wrong message to investors by changing tax policy so soon. Normalizing tax rates wouldn't be very tax accretive for the Govt as the PBT of the private players (ex LIC) in aggregate is ~6,600crs in FY23 which would imply ~1000 Cr additional tax collections from private players. LIC is ~85% of overall Life Insurance profit pool and any increase in tax rates

would adversely impact valuations at which the Govts would further reduce its stake (96.5% at present).

- Some mis-selling does exist, and customers suffer from high surrender penalties for some products. One of our colleague's house-help who earns ~2.5 Lacs a year was sold a policy with an annual premium of ~60000. ICICI Bank does not distribute guaranteed or participatory return products of ICICI Pru Life for this reason. However, not all sales in guaranteed return products can be attributed to mis-selling as some customers appreciate the ability to lock in interest rates for long periods. However, for leading players, mis-selling has reduced over time (persistency rates have climbed higher).
- Some surrender penalties are justified - customer acquisition costs are paid upfront.
- We do not believe the regulator is discouraging the sale of savings products. Changes in regulations in the Life Insurance sector have been brought about to close tax loops for the super-rich, not to discourage long term savings. (Capital gains tax exemption under Sec 10 (10D) for ULIP < 2.5 lacs p.a. and < 5 lacs p.a. for other savings products still exist). The country needs savings that are "locked in" to fund long gestation infrastructure projects.
- Insurance is not bought primarily to save tax as the 1.5 Lac limit is already exhausted by other products such as PPF, MF tax saving investments, principal repayment on housing loans etc.
- Finally, Life Insurance companies are already preparing for the new era by focusing on lower ticket size policies and revamping product mix towards product segments with lower surrender charges.

None the less, regulatory risks are binary. Just because something should not happen, does not mean it will not happen. The industry needs to show more purpose in curbing mis-selling. And unlike AMFI, which aggressively promoted the "Mutual Fund Sahi Hai" campaign, the Life Insurance industry forum is not moving with enough intensity and purpose to promote Term Insurance. Any regulatory action on surrender penalties and taxation taken together could have a meaningful impact on stock prices.

While we don't believe this action is imminent, we believe it is prudent to reduce the sectoral position size to something more palatable today and wait for regulatory headwinds to pass before increasing our stakes.

Why are you so optimistic about Manufacturing when these businesses are lower ROEs relative to Consumer companies and hardly generate any Free Cash Flow.

The 3 key variables that matter in value creation are longevity of profit growth, sustainability of ROE above Cost of Equity (12% in India) and entry prices paid. Traditional wisdom to buy only high ROE and high Free Cash Flow generating businesses ignores 3 key variables:

- Where the company is in its growth life cycle.
- The important of entry valuations paid.
- That low reported Free Cash Flow today in many manufacturing businesses is just delayed gratification and that reported ROCE is understated.

Our threshold of a good business is one that can generate 18% ROE+ with prudent leverage. The 6% spread over 12% Cost of Equity creates immense value even with 15%+ growth. Hence, a 18-20% ROE business is very attractive and merits consideration in allocation of capital over a 40-50% ROE business basis other factors such as long-term growth prospects, disruption risks, entry prices etc.

Many Consumer businesses which are high ROE today are likely to see greater competitive intensity as competitors attempt to enter adjacencies. Consider Air Conditioners: Voltas market share has dropped

from 25% to 22% in last 3 years due to intense competition (Source: Kotak Institutional Equities). Many FMCG businesses are also seeing their high value customers being targeted by D2C brands and launch of Private Labels by organized retail. Paints has seen the entry of Grasim and JSW. This could result in lower margin and hence lower ROE profiles of these businesses in future vs today as they will need to give up margins to defend market share. FMCG businesses may increase ROE by outsourcing Manufacturing – but they give up some strategic control over pace of new product introduction/experimentation.

While Manufacturing businesses tend to be lower ROE than Consumer (they are more capital intensive and have lower pricing power), they could deliver higher and more sustainable growth than some Consumer businesses this decade due to the de-risking tail winds at play and as MNCs should not grudge their Indian partners a 18-20% ROE for reliable supply. Hence, a manufacturing business that can grow at ~15% PAT growth for 2 decades at 18-20% ROE may be a more attractive investment proposition than a Consumer business than can grow PAT at ~10% for 2 decades at 40%+ ROE.

The low Free Cash Flow (FCF) of many Manufacturing businesses today is just delayed gratification.
The aim of a business owner needs to be to maximize "long term" Free Cash Flow. Reported Free Cash flow should be examined in context of where a company is on the growth life cycle and the opportunities it has to re-invest capital. This is not very different from a graduate who goes on to take an advanced degree rather than immediately accepting a job. They are postponing a salary they could earn today, for higher skills and hence better job prospects and a higher salary two years down the road.

Poor FCF in the high growth stage of a company is perfectly normal if the business is re-investing all profits for growth at incremental ROE above Cost of Equity. One is essentially sacrificing dividends today for much higher dividends down the road.

SRF generated no FCF in the period FY2013-2023 because all Operating Cash Flow was reinvested in new capacities. This resulted in SRFs PAT growing from ~250crs to ~2150crs from FY 2013 to FY 2023. They could have been more conservative on investments, reported higher FCF which they could have paid out as higher dividend, but then the profits today would be significantly lower. Focusing on short term Free Cash Flow would have led to the wrong long-term decisions.

The reported ROCE of a manufacturing business that is investing in growing capacity aggressively is understated and not reflective of its true ROCE.
The useful life of many capital-intensive businesses is higher than the timelines on which they are depreciated. Maintenance capex is typically much lower than depreciation. Hence, reported ROCE expands over time as Sales/Net Block expands.

Steep increase in capital expenditure depresses reported short term ROCE as new plants will typically take 3-5 years to reach full utilization. So the reported ROCE of the company is a mix of very high ROCE of old plants and low ROCE of plants that have not reached full utilization.

Finally, a business that is growing rapidly will over-invest to gain credibility with customers. They may choose to build capacity ahead of demand, choose to keep higher inventories to buffer against unreliable raw material supply, keep inventory closer to customers, have higher Work in Process inventory if they are increasing number of SKUs. All these aspects depress reported ROCE which is temporary. These inefficiencies will be eliminated with time.

Manufacturing businesses in India have a great opportunity to capture market share of global supply chains. Leaders with vision will invest ahead of the curve to establish credibility amongst global customers. This will depress reported ROCE but is the right thing for them to do and we will look at such companies with significant interest.

****

We look forward to speaking with you on our quarterly call at 12 pm on the 22nd of July 2023.

With our best wishes,

Manish Gupta	Manjeet Buaria	Anirudh Shetty
Partner and CIO	Partner	Senior Principal

Disclaimer

The information or material (including any attachment(s) hereto) (collectively, "Information") contained herein does not constitute an inducement to buy, sell or invest in any securities in any jurisdiction and Solidarity Advisors Private Limited is not soliciting any action based upon information.
Solidarity and/or its directors and employees may have interests/positions, financial or otherwise in securities mentioned here. This information is intended to provide general information to Solidarity clients on a particular subject or subjects and is not an exhaustive treatment of such subject(s). This information has been prepared based on information obtained from publicly available, accessible resources and Solidarity is under no obligation to update the information. Accordingly, no representation or warranty, implied or statutory, is made as to the accuracy, completeness or fairness of the contents and opinion contained herein. The information can be no assurance that future results or events will be consistent with this information. Any decision or action taken by the recipient based on this information shall be solely and entirely at the risk of the recipient. The distribution of this information in some jurisdictions may be restricted and/or prohibited by law, and persons into whose possession this information comes should inform themselves about such restriction and/or prohibition and observe any such restrictions and/or prohibition. Unauthorized disclosure, use, dissemination or copying (either whole or partial) of this information, is prohibited. Neither Solidarity nor its directors or employees shall be responsible or liable in any manner, directly or indirectly, for the contents or any errors or discrepancies herein or for any decisions or actions taken in reliance on the information. The person accessing this information specifically agrees to exempt Solidarity or any of directors and employees from, all responsibility/liability arising from such misuse and agrees not to hold Solidarity or any of its directors or employees responsible for any such misuse and free and harmless from all losses, costs, damages, expenses that may be suffered by the person accessing this information due to any errors.