3 October 2020

Dear Partners,

It is hard to think of a period when a health crisis created an economic crisis, with no historical playbook to navigate, and with little visibility on when the crisis will end. We have all been touched by the crisis in direct and indirect ways. And amidst the fear, anxiety and hardships we see around us, it can be perplexing why the stock market seems to be buoyant when the world seems broken.

In this note we will touch upon various subjects.

- Section 1 covers the performance update.
- Section 2 covers queries we have received on various topics with the underlying concern on economic growth and whether equity markets can generate acceptable returns amidst the current health and economic challenges.
- Section 3 explains the exit decisions we took this quarter. Our churn has been a bit higher than normal as we have made portfolio changes to reflect the new reality and acted when valuations in individual positions became euphoric. We explain the framework we use and rationale underlying these actions.

Key messages

- NIFTY performance is not representative of the economy. The Banking Index is the closest proxy to the economy and is down ~28% from 1 February 2020, reflecting the pain.
- The market valuations are not euphoric. Even as there are valuation excesses in some pockets, there are also areas of opportunity.
- Many economic indicators are gradually improving; however, a "V" shaped economic recovery is highly unlikely.
- "While we are all in the same storm, we are not in the same boat[1]". Sectors, companies, and individuals have been affected differently.
- Stock prices are slaves to earnings. Our portfolio construct is in sectors with tail winds for growth and companies with leadership positions who have opportunity to register market share gains. We believe they will be resilient and deliver earnings growth.
- One should be realistic on future return expectations. A 12-15% compounded IRR over 5 years from here may be a satisfactory outcome[2] when similar duration FDs offer ~5.5% pre-tax. This assumes gradual increase in interest rates over time which will result in head winds to valuation multiples.
- The last few months have once again reminded us that we cannot play the short and long game simultaneously. Market corrections are inevitable and we should not interrupt the process of compounding unnecessarily.

Disclosures

- In order to provide transparency and context, we explain our rationale with names of individual securities. Fund management is dynamic and we may change our opinions as the situation demands. Reference to any names is not a recommendation to buy/sell.
- Performance in individual accounts may differ from the aggregate as we don't run a model portfolio.

[1] Manish Sabharwal, Chairman Team Lease

[2] Solidarity does not promise or guarantee any return

Section 1: Performance update

For Anchor partner					Since PMS License (Aggregate across all accounts)				
DATE	NIFTY	NIFTY500	SOLIDARITY	Alpha	DATE	NIFTY	NIFTY500	SOLIDARITY	Alpha
FY15	26.8%	32.6%	67.2%	34.6%					
FY16	-9.9%	-8.6%	-0.1%	8.5%					
FY17	18.9%	24.0%	22.4%	-1.6%	FY17 (part year)	16.3%	20.8%	18.0%	-2.9%
FY18	10.2%	11.5%	18.4%	7.0%	FY18	10.2%	11.5%	19.2%	7.8%
FY19	14.9%	8.4%	6.0%	-2.5%	FY19	14.9%	8.4%	6.8%	-1.6%
FY20	-26.3%	-27.9%	-14.9%	13.0%	FY20	-26.3%	-27.9%	-15.4%	12.5%
FY21 YTD	30.8%	33.5%	52.7%	19.2%	FY21 YTD	30.8%	33.5%	49.8%	16.3%
Cumulative TWRR	**8.4%**	**9.4%**	**20.3%**	**10.9%**	**Cumulative TWRR**	**8.4%**	**8.2%**	**15.7%**	**7.6%**

Note: We operated with an Investment Advisor license till 11 May 2016 post which we migrated to a PMS License
SOLIDARITY performance is post fees
Alpha: SOLIDARITY performance beat over NIFTY 500
Data for FY21 updated till 30 Sep 20

As of 30 Sep 2020					
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception**
Anchor partner	17.2%	24.6%	15.9%	16.0%	20.3%
Index- Nifty50	-2.0%	1.4%	4.7%	7.2%	8.4%

As of 30 Sep 2020					
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception**
Aggregate across all accounts	17.2%	24.3%	16.2%	NA	15.7%
Index- Nifty50	-2.0%	1.4%	4.7%	NA	8.4%

Our performance so far this year has been reasonably good in tough conditions. However, 16% outperformance over the NIFTY 500 is not sustainable over long periods of time. While we run a disciplined process, we have also been aided by luck. We have been over-weight Specialty Chemicals since 2019 and the sector has benefitted significantly from tail winds due to Covid-19.

We recommend evaluating performance over rolling 5-year periods as that time horizon separates good process from luck. We believe 3% outperformance over benchmarks, post fees, is a good outcome. Fund management is not only about upside gains but how well one can protect the downside. We are very pleased to be performing well on both of the above as it reflects the underlying quality of companies we own and their resilience.

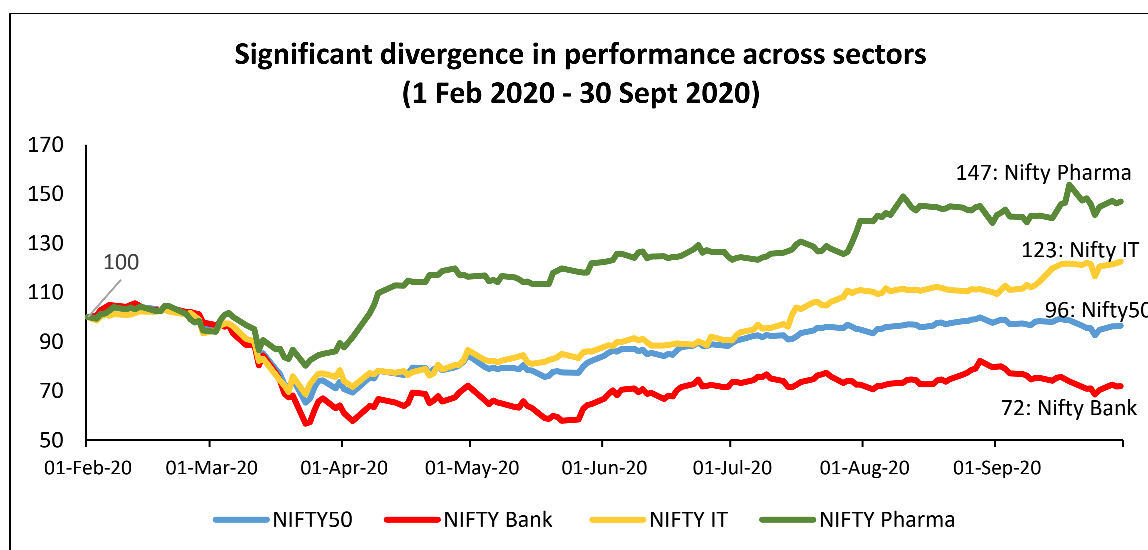
Section 2: Answers to questions we have been recently asked

Broader equity markets are doing well with the NIFTY/NIFTY 500 almost at pre Covid-19 levels while the economy is expected to contract by ~ 10% this year. Are the markets disconnected from the performance of the economy?

Markets are forward looking and are starting to believe and hence price in a gradual recovery. Key economic indicators are gradually improving even though all metrics do not point in the same direction[3].

Indicator	Comment
Movement of goods	• Daily average e-way bills almost at Feb levels • Daily average Railway freight at pre Covid levels • Container traffic improving but well below Feb levels
Steel consumption	• Significant improvement but ~10% below Covid levels
Insurance premiums	• Significant year on year growth in July/Aug vs last year
New vehicle registration	• 4W registrations in Sep at 87% of avg FY 20 levels • 2W registrations improving, much below avg FY 20 levels • Tractor registrations much higher vs avg FY 20 levels
New property registrations	• Daily avg. registrations in Maharashtra at Feb levels
Electricity consumption	• Higher than pre-Covid levels in September
GST Collections	• August collections 22% below pre-Covid levels (Jan 2020)
PMI Index	• 56.8 for September 2020 vs 52 for August 2020

The NIFTY composition does not mirror the economy and hence is a misleading proxy. The only Index that can serve as a proxy to the economy is the Banking index as Banks are a direct play on the performance of the economy. The Banking Index is down ~28% from 1 February 2020 and reflects the pain in the economy at present.



Source: NSE

[3] https://media-publications.bcg.com/BCG-India-Economic-Monitor-Sep-2020.pdf; Kotak Institutional Equities 18 Sep 2020; Spark Capital 28 Sep 2020

While markets may be a bit ahead of themselves, there is no mass hysteria.

- A very small number of companies are driving the market. Reliance alone accounts for ~50% of NIFTY gains since 1 April 2020.
- Participants are speculating in IPOs and in relatively illiquid parts of the market, but there is no investor frenzy to buy due to the fear of missing out.
- Decadal low interest rates in India and liquidity infused by global central banks' are also supporting valuations. Interest rates are inversely related to fair valuations as they influence discounting rates (lower cost of capital) as well as relative attractiveness of equities vs bonds[4] (flows).
- Global liquidity can continue to support valuations – for example, the US Fed intends to keep interest rates close to zero till 2023.

Select pockets of euphoria co-exist with opportunity

- We do see some sign of euphoric valuations in select pockets (e.g. Specialty Chemicals, Digital). Specialty Chemical companies have favourable tail winds at present. Many of them have gained ~100% from February. While opportunities for them are real, they are 20-25% ROE businesses and still have to execute on their promise. However, some of them are now trading closer to Consumer valuations.
- However, there are also very compelling opportunities at present in themes such as Leading Financials, Telecom, and in some companies in manufacturing. For example, HDFC Limited, a blue chip, is trading ~30% below pre-Covid levels and is at close to decadal low valuations despite strong possibility for growth coupled with ROE expansion over the next 5 years

In accounts commenced in July/August, we are not fully deployed (~25/45% un-invested cash)

- We seek diversification across themes and are looking for more favourable entry points in companies we don't own.
- While leading Banks/NBFCs offer compelling value, high leverage means they are always vulnerable in a weak economy. Hence, we cap their exposure at ~30% for risk management.
- We see very compelling value in some of our "Emerging Leader" positions (eg Mayur Uniquoters, Shaily Engineering, and Privi Fair Chem Specialty). However, we will maintain position sizing discipline for risk management because liquidity in these positions is low.

What is the outlook for economic growth?

We don't believe in making or following economic forecasts as track record of forecasters has been dismal. However, a "V" shaped economic recovery is highly unlikely unless the Govt. comes up with more innovative solutions to stimulate economic growth (e.g. guarantees on SME Loans).

Even as we believe that the best days for India lie ahead in the medium term, the key drivers of GDP Growth (Consumption, Govt. spending and Investments) will be under stress in the near term.

- Consumption accounts for over 60% of the Indian economy. There may be a psychological impact of the crisis on job security and hence consumer spending may be tepid[5] till confidence returns. As companies learn to operate with less staff or look for more cost efficiencies, salary increases and job growth may remain muted.
- The Govt. will be constrained for resources with large short falls in revenue at precisely the time when defence spending needs to increase and small businesses and the poor need financial support. Debt to GDP ratios will climb by ~15-20% over the next 2 year and very high fiscal deficits will constrain ability to support economic growth through infrastructure

[4] The Bank of International Settlements has estimated that close to a half of the re-bound in US equity prices can be attributed to loose monetary policy. Read more at https://www.bis.org/publ/qtrpdf/r_qt2009a.pdf

[5] https://www.economist.com/finance-and-economics/2020/08/27/psychological-scars-of-downturns-could-depress-growth-for-decades

investments. Strained resources will result in payment delays and cascading delays in working capital across the economy which in turn results in a vicious cycle. Strain on Govt. resources is visible with the Central Govt. trying to negotiate GST compensation with states citing "act of God". And as one can observe with recent events with agriculture reforms, vested interests make it very hard to undertake reforms in India.
- If spending is weak, the need for capacity additions gets postponed. Hence, Investments in capacity addition will be delayed.
- Exports may provide some tail winds as Indian companies try and gain greater share of global supply chains and the IT Services industry continues to grow as global IT spending on digital transformation remains strong.

However, growth will improve over time. During extreme conditions one tends to forget that "nothing too good or too bad stays that way forever, because great times plant the seeds of their own destruction through complacency and leverage, and bad times plant the seeds of their own turnaround through opportunity and panic-driven problem-solving"[6].

Partners should be realistic on return expectations going ahead.
- While economic conditions are tough, support to valuations from low interest rates will gradually fade and turn into head winds over time when interest rates eventually increase.
- A good batsman recognizes that a competitive score depends on playing conditions and paces their innings accordingly.
- If a 5-year FD yields 5.5%[7] pre-tax today, ~12-15% Equity IRR post fees (6-9% premium for taking risk) should be a satisfactory outcome as earnings growth will face head winds of valuation multiple decline. This can of course be higher if Central Banks continue to suppress interest rates for an extended period of time.

What happens to equity markets if a vaccine doesn't come next year?
Our portfolio construct is not hinged on the availability of a vaccine.
- Even as we remain optimistic about a vaccine, there is no guarantee that there will be one. It may interest partners to note that we still don't have a vaccine for AIDS.
- Even if there is a vaccine, it will take a long time for India to get sufficient doses and have the infrastructure in place to vaccinate 60% of the population.

We believe economic conditions – in aggregate - will gradually normalize to pre-Covid levels with or without a vaccine, but the pace of normalization will vary significantly by sector. A vaccine will give a fillip to growth as it will enhance consumer confidence.
- Covid-19 did not crash the economy. India's response to the virus - a long, yet porous lock down with very limited economic activity - crashed the economy with Q1 FY21 growth rate collapsing by 24% and causing significant job losses.
- The need to protect livelihoods, our economic reality, better knowledge of treating the virus, and the very low death rates due to the virus – compared to other diseases India grapples with - do not justify any prolonged lock downs. Sero-prevalence[8] studies indicate that the number of Covid positive cases in urban India could be 20-50x of official numbers[9]. That implies fatality rates attributable to Covid-19 may be significantly lower than 0.1%. While the loss of life due to Covid-19 is tragic, it should be seen in context that India is a poor country

[6] https://www.collaborativefund.com/blog/permanent-assumptions/
[7] HDFC Bank & ICICI Bank 5 year FD rates as on 30 September 2020
[8] The level of a pathogen in a population, as measured in blood serum.
[9] https://www.pressreader.com/india/business-standard/20200902/282071984295027

and still loses on average ~ 1530[10] people/day to tuberculosis (and even more to gastro-enteritis) vs current daily death rates attributable to Covid -19 of ~1100/day. We do not have the economic buffers to copy the lock down approach of the developed world.

However, "while we are all in the same storm, we are not in the same boat". Covid-19 will result in winners and losers across sectors, companies and individuals.

- For example, sectors that can work with social distancing (e.g. Pharma, Specialty Chemicals, Digital) will continue to grow vs sectors which will be impacted due to poor demand (e.g. Formal wear, Travel) and those which cannot operate profitably with social distancing (e.g. Hospitality)
- Covid-19 will give a further impetus to industry consolidation and hence sectoral leaders will emerge with even higher share of industry profit pools.
- The wealth of the top 1% has likely increased, even as many blue collar workers have lost their livelihoods and may have had to borrow to make ends meet.

Our portfolio choices are heavily weighted on sectors/companies which we believe will be resilient and will deliver earnings growth even if there is no vaccine.

- Indian companies have a once in a life time opportunity to take market share from China in several industries (not just Specialty Chemicals or APIs). China at present is in a quasi-military dispute not only with India but with almost all its neighbours (Japan, Australia, Vietnam, Philippines) and is using "coercive diplomacy[11]" to try and get its way even with strong countries such as Germany. US security interests are leading it to take explicit actions to de-hyphenate its economy from China. No MNC should want a supply chain deeply reliant on any one country, especially one with which geopolitical relations can be unstable.
- Even as consumer spending may remain tepid, we believe Insurance (Life and General) will gain wallet share and growth will only be marginally affected[12]. Life Insurance has a long run way for growth - less than 10% of Indians who file Income tax returns have Life Insurance protection cover[13] and Covid-19 is a stark reminder of our mortality.
- Digital business models will continue to gain market share from traditional models. While there are not too many listed companies at present, this will be a mega trend.
- Our investments are in well run Banks/AAA NBFCs with the lowest cost of funds and fundamentally conservative culture towards credit risk. They have taken upfront provisions for loan losses and moved quickly to shore up Equity capital[14] so growth opportunities are not missed when the economy recovers. While they may report muted profits in the short term, they will benefit medium term from the ongoing consolidation of deposits and loans among the strong players.

Performance and commentary from many of our portfolio companies is positive.

- Divi's Labs, SRF, Sequent Scientific and Neogen reported EBITDA growth in Q1 of this year.
- Shaily Engineering revenue run rate in July 2020 is back to pre-Covid levels.
- India Mart business enquiries were 6% higher quarter on quarter despite Covid.
- "… HDFC Bank is back to pre-Covid levels there is no strain on our balance sheet[15]"

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[10] https://economictimes.indiatimes.com/news/politics-and-nation/india-is-sitting-on-a-healthcare-time-bomb-and-no-its-not-the-coronavirus/articleshow/78051114.cms
[11] https://www.aspi.org.au/report/chinese-communist-partys-coercive-diplomacy
[12] https://www.moneycontrol.com/news/business/covid-19-impact-life-and-health-insurance-becoming-a-dominant-need-sbi-life-survey-5899481.html
[13] ICICI Pru Life Investor Presentation
[14] Excluding HDFC Bank which was already well capitalized
[15] https://economictimes.indiatimes.com/industry/banking/finance/banking/need-to-move-past-covid-and-uplift-economic-sentiment-says-hdfc-bank-chief-aditya-puri

- HDFC Limited retail home loan disbursements in July were ~ 80% of pre-Covid levels and they expect to reach pre-Covid levels by October/November of this year.
- ICICI Bank reported 18% of loans on moratorium as on 30 Jun 2020; however, 97% of all those who opted for moratorium on retail unsecured loans continued to receive salary credits.

We continue to recommend an exposure to Gold as it has multiple tail winds it its favour.

- Low, and in many cases, negative interest rates reduce the opportunity cost of owning Gold.
- Russia and China, geopolitical rivals to the US, are selling down their holdings of US Treasuries and will need to re-invest them someplace else.
- While inflation in the developed world is not a concern at present, it will become one over time. Govt. spending (via money printing) to support employment and guarantees to Banks (to lend to small businesses) will increase the velocity of money, which in turn will lead to higher inflation. If one could just print money to ease economic pain without adverse consequences, this would have been figured out much earlier. And Govt.'s may need to tolerate higher inflation in order to get rising debt burdens under control.

The only concern about Gold at present is that it is becoming a consensus trade. However, the consensus need not be wrong.

Will the financial system be constrained to lend because of high NPAs?

We don't believe the economy will be constrained for growth because Banks (in aggregate) will be unable to lend due to capital shortages.

- Unlike other crisis, poor credit growth at present (5.5%, six decade low) is because of poor demand for credit and understandable risk aversion on the part of bankers.
- Banks at present are earnings a negative return of ~140 bps on their surplus funds because they are parking surplus liquidity with RBI at rates significantly lower than their cost of deposits. Risk aversion will decline as the economy gradually recovers.

If PSUs or weaker private Banks cannot raise equity capital, that should aid market share gains for the Banks we own. Top 4 private Banks in India only have ~20% market share of loans.

What could be the impact of US Elections on the market?

Prima facie, a Biden victory should be negative for markets as he has explicitly stated he will increase tax rates which should be negative for equities. However, one can also argue that a Biden administration will result in more policy stability/predictability and therefore provide a more conducive environment for growth. Hence, the two may negate each other. Short term market trajectory is more likely to be sensitive to US Fed policy.

PM Modi has a good relationship with President Trump. However, the self-interest of countries rather than individuals determines long term global political relationships. There is no reason to believe that a Biden administration will be hostile/unfriendly to India when the US and China are embraced in a geopolitical conflict and the need to de-risk the US from China has bipartisan support in the US.

It is important that we focus on the 3-4 key variables that matter in any Investment decision because they contribute to over 90% of the outcome. From a long-term investing lens, this is a good example of noise.

Section 3: Our "Exit" process and rationale underlying actions taken in the portfolio

Unlike a MF which can churn with low consequences, every sell decision creates a tax incidence on partners. Hence, the decision needs to be carefully thought about.

We make 4 types of "sell" decisions

a) When we have made a mistake, or facts change and the thesis is no longer valid.
b) When we act purely from a risk management perspective.
c) When companies in "Special Situations" reach their price target.

The above are easy to make.

The tricky decision is when companies in our core bucket ("Clear and Emerging Leaders") have good growth prospects, are performing well but are trading at euphoric valuations. We have paid the price of not selling when valuations were euphoric in the past and hence introspected significantly on designing a process we will consistently follow.

While there are a lot of books written on buying right, conventional investment wisdom does not offer clear guidance when it comes to selling. While many fund managers claim that their "biggest mistakes are selling winners too early", this view suffers from "survivorship bias" of winners. We believe lessons from history – to glean learnings on what can be a good process - should be examined at a portfolio level - and not an individual company level to separate good process from luck.

A few examples below highlight the survivorship bias mentioned above. For example, measured over last 5 years:

- Investors who held on to some good but richly valued businesses like Blue Dart, Page Industries, Eicher Motors, Cera or Symphony when valuations were euphoric would be nursing very sub-par returns.
- However, those who stayed invested in Bajaj Finance made significant returns.

Company	Trailing valuation on 30 September 2015	Subsequent 5 year IRR (excluding dividends)	Max. draw down from the peak price in subsequent 5 yrs.
Blue Dart	~110x	-16%	~75%
Page Industries	~69x	10%	~48%
Eicher Motors	~61x	4%	~60%
Cera Sanitary ware	~37x	3%	~41%
Symphony	~52x	1%	~62%
Bajaj Finance	~5x	45%	~61%

Source: Ace Equity; trailing valuation is PE ratio for all companies except Bajaj Finance for which PB ratio is used

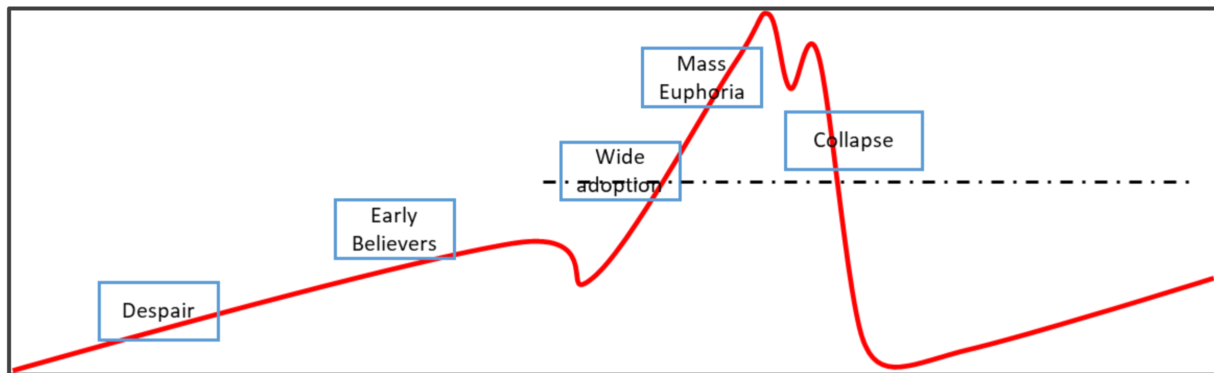
Our approach to selling is based on the following beliefs[16]

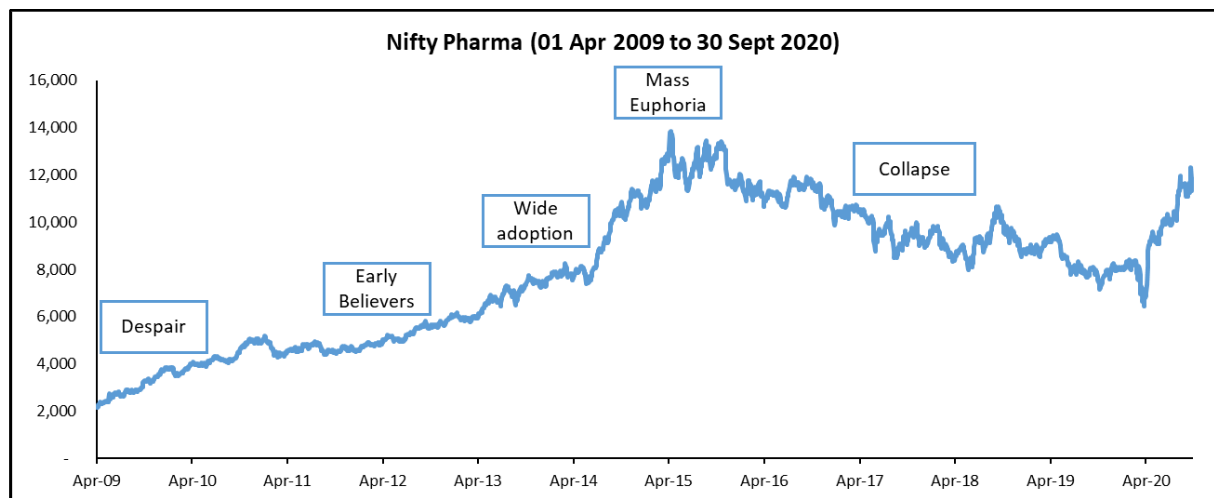
- Portfolio choices need to be aligned with investor time horizons. For Solidarity, an investment should justify its place in the portfolio based on return prospects over every incremental 5-year periods. Someone taking a decadal perspective may act differently and not be wrong.
- The future is probabilistic. Every business is exposed to random events outside its control. Hence, the concept of "margin of safety" should apply not just during entry but at all times.

[16] We have also been influenced by learnings from the book "The Art of Execution" written by Lee Freeman-Shor[16] whose book captures his experiences supervising fund managers. Please write to Naarah at np@solidarity.in if you would like to read the book and we will be happy to send you a copy

- A sound investing approach will also take into account human behaviour. It is very hard to hold on to an investment when confronted with large draw downs, especially when managing other's savings. Theory often does not work while confronting real world situations.
- We need to recognize the role of cycles in portfolio actions. Capital tends to chase a sector with earnings momentum. That results in valuation excesses till a trigger point causes stock prices to correct dramatically. This cycle is illustrated below with what happened in the Pharma sector between 2012- 2020. The same story played out in NBFCs (2015-2018).

Hence, we believe it is appropriate to gradually reduce positions when valuations are euphoric:





Our process for exit (and entry) decisions is as follows.

- We estimate a range of stock price IRRs over a rolling 5-year basis based on what rate we think earnings/cash flow/book value can broadly grow, and what fair range of multiples a stock should trade at the end of 5 years.
- We determine fair value multiples based on first principles (growth, longevity, ROE). We make some adjustments based on long term valuation bands (wisdom of crowds) and if we believe a stock deserves a premium due to a justified halo effect (quality of governance, past execution record).
- When rolling 5-year IRRs start dropping below our thresholds in bull case scenarios and the position weight is very high, we start to trim the position. We will trim more aggressively in "Emerging Leaders" (as liquidity evaporates during a crisis) and more gradually in "Clear Leaders".
- All assumptions on earnings and fair valuation multiples are debated and updated periodically as we learn more about the company through interactions with management and quarterly updates.

The challenge in this approach is determining what defines “euphoric” valuations when a sector has earnings momentum. The argument can become circular because fair valuations are a function of growth and its longevity (terminal value), which are always an estimate.

- In certain sectors like Banking, this is not very difficult to answer as companies have stayed within historical valuation bands and growth rates/ROEs tend to remain range bound. Similarly, in manufacturing, growth is unlikely to surprise significantly because capacity acts as a constraint on growth.
- However, in sectors like Digital, longevity of growth is hard to estimate. Digital tends to be high free cash flow, has no capacity constraints and is “winner takes all” with leaders often having very dominant market share. This means companies have enormous pricing power and hence Earnings growth can significantly surprise on the upside through both volume growth and margins. For example, India Mart has an EBITDA margin of ~26% while Info Edge’s Naukri division is at ~56%. The ability to use free cash flow to enter adjacencies means one could be very conservative in assumption of terminal value. Info Edge has used the cash flow from Naukri to build new verticals in Real Estate, Matrimonial services and also via significant minority stakes in business models of the future like Zomato and Policy Bazaar. One could not have forecast all the above if one was modelling Info Edge a decade ago. Hence, there is always some judgement based on qualitative aspects.

Why trim and not sell out of a position completely?

- The market has moods of euphoria and despair. Just because a stock is expensive, it does not mean it will correct tomorrow. Stock prices can remain elevated for significant periods as long as the earnings momentum lasts. Selling too early could leave significant gains on the table.
- The table below illustrates how stock prices can continue to rally ~200-300% from expensive to euphoric valuations before they eventually correct.

Company	Trailing PE on 30 Sept. 2015	Price on 30 Sept. 2015	Highest price over next 5 yrs.	Max. upside from price on 30 Sept. 2015
Page	~69x	13,272	36,370	274%
Eicher	~61x	1,779	3,348	188%
Cera Sanitary ware	~37x	2,021	3,918	194%
Symphony	~52x	920	2,209	240%

Source: Ace Equity

- By gradually trimming over time, one also has the ability to re-examine assumptions as good companies can surprise on the upside. For example, Divi’s Labs delivered 50% PAT growth in Q1 of this year which was significantly above our estimates. Hence, one has an opportunity to recalibrate assumptions.

Why not stay invested and exit at first sign of disappointment?

- While theoretically elegant, practically this approach does not work. Firstly, one cannot conclude, for sure, whether the earnings disappointment is temporary based on macro events, competitive behaviour or reflects a more fundamental challenge to the business.
- Participants with a short-term outlook sell aggressively at the first sign of earnings disappointment and stock prices can correct deeply – often on lower circuit- because this is the precise moment when liquidity becomes very thin because everyone rushes to the exit at the same time. And when stock prices have corrected 30-40%, the disappointment seems to be in the price and it makes no sense to exit if valuations have come in favour.

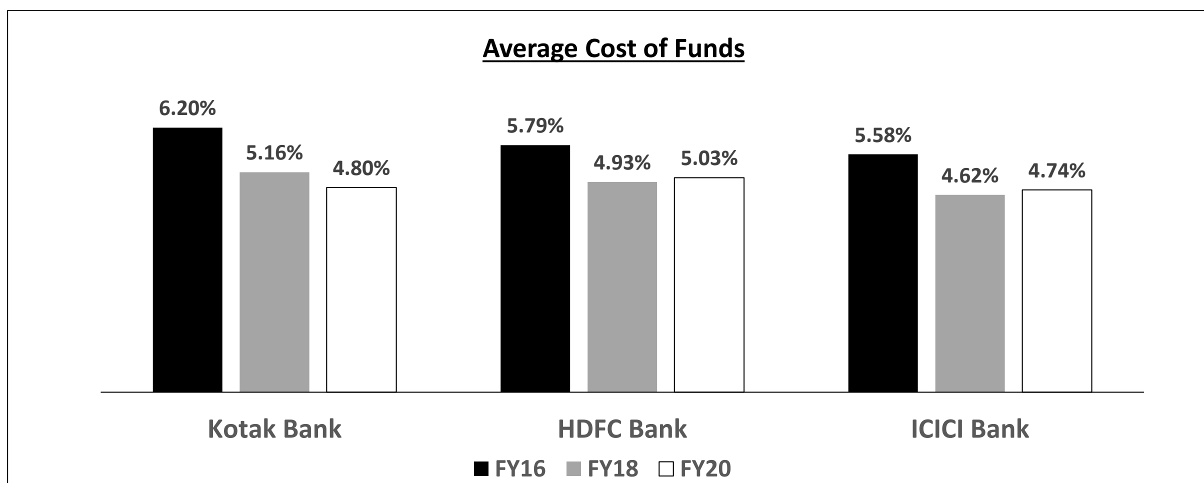
Our approach will never maximize gains on one position and will cause some regret of premature exit. However, when acted on methodically, it will provide a good balance of returns with downside protection at a portfolio level. We would like to caveat that our exit process will be a perennial "work in process". We will refine our approach over time based on our experiences and learnings of approaches used by other Fund Managers.

Brief rationale for new positions taken as well as for positions trimmed / exited in the quarter

The only new position during this quarter was Kotak Bank which was bought in lieu of the position size reduction in HDFC Bank.

- The decision to reduce our position on HDFC Bank was not due to any specific worries about its future, but more a reflection that "only the paranoid survive". If a quasi-promoter is taking significant money off the table, during tough economic conditions, we felt more comfortable reducing our risk exposures as well. We believe in "skin in the game".
- By reducing our large position size in HDFC Bank and substituting it with a mix of Kotak Bank/HDFC, we have bought equally strong franchises while spreading the risk. A mature mind should be able to operate with two opposing constructs, "we like the franchise, but we also need to think risk management".

Partners are aware that Solidarity believes that the principal edge of any Bank lies in its cost of deposits as that determines the level of credit risk it needs to take. Kotak's cost of funds[17] has reduced significantly over the years and is now almost at parity with HDFC and ICICI Bank. This will allow them to enter competitive segments such as mortgages and its much lower asset base may allow faster growth vs the leaders. Kotak is also available at 5-year low valuation multiples (Consolidated Price/Book).



We trimmed our holdings marginally in Divi's Labs, Neogen Chemicals and India Mart because valuations were assuming flawless execution unmindful of risks.

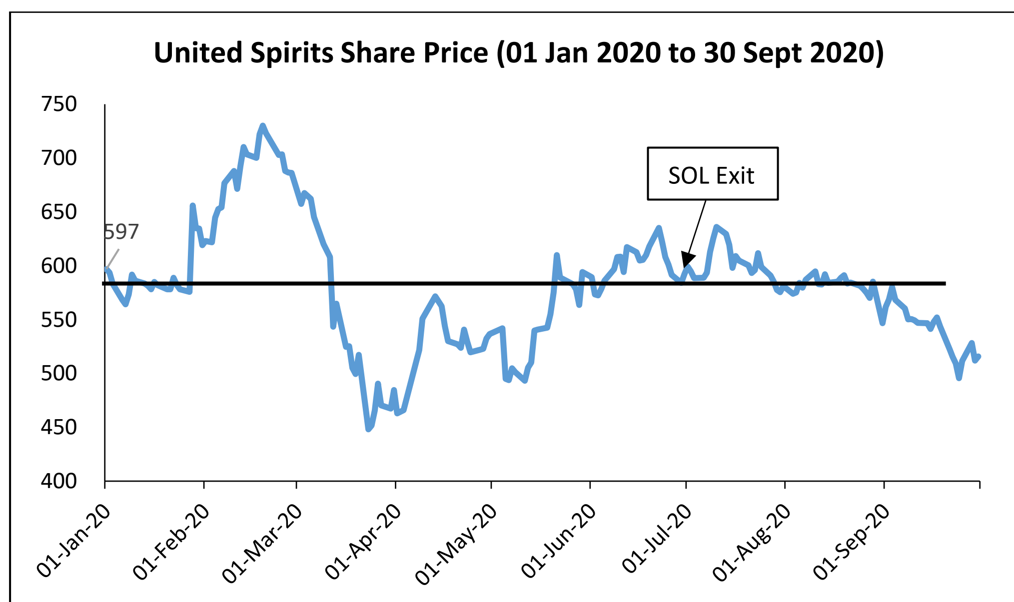
- Divi's Labs is a clear leader in Generic API & Custom Synthesis. It currently trades at 65x FY 20 core earnings which is significantly higher than its historic mean of ~25x core earnings. Current prices are building in strong top line growth driven by improvement in asset productivity and well as increase in margins. While Divi's is a great company with strong track record on growth execution, it also has very high key man risk.

[17] Banks do not disclose their exact cost of funds. We have calculated this based on average interest-bearing liabilities (Deposits, borrowings, Perpetual, sub debt and tier 2 bonds). The exact cost of funds number may differ a bit from the numbers above. Our point is to illustrate the narrowing gap.

- Neogen is an emerging leader in Bromine based intermediates. It currently trades at 55x FY 20 earnings. While growth prospects are strong, current prices are building in 25%+ top line growth over the next 5 years as well as margin expansion. While this earnings trajectory is possible, there is no margin of safety on execution risks. This is also a franchise with very high key man risk and not very high liquidity.
- India Mart is an emerging leader in B2B classified. It currently trades at ~100X FY 20 earnings (55x FY 20 free cash flow). Current prices imply 25%+ growth accompanied with significant margin expansion going forward. As its core customers are SMEs, short term revenue resilience will be tested. Medium term, India Mart still needs to prove pricing power and lower its customer churn.

Partners may note that we still retain fairly large positions in each (> 5% weight). While their valuation multiples will compress over time, we remain confident of their growth prospects and ability to execute. Moreover, in a market that is starved of earnings growth, some froth in valuation multiples in sectors which are showing earnings growth is understandable.

We sold our complete position in United Spirits in early July to re-allocate capital to other themes with more favourable return possibilities. Medium term earnings growth in United Spirits will be impacted due to Covid -19 as head winds of outdoor consumption in bars/hotels (25% of revenue), higher Govt. taxes and down-trading are stronger than the tail wind of home delivery. However, the valuations did not seem to reflect the new reality with stock prices in July at pre-Covid levels. United Spirits remains a position of interest and we may re-enter if prices decline to reflect the new reality.



Concluding remarks

The last seven months have once again reminded us that we cannot play the short and long term game simultaneously because timing markets is impossible. Compounding works its magic only over long periods of time. Hence, one should not break the process of compounding unnecessarily.

"The history of the stock market is that it goes up a lot in the long run but falls often in the short run. The falls are painful, but the gains are amazing. Put up with one and you get the other. Yet a large portion of the investing industry is devoted to avoiding the falls. They forecast when the next 10% or 20% decline will come and sell in anticipation. They're wrong virtually every time. But they appeal to investors because asking people to just accept the temporary pain of losing 10% or 20% – maybe more once a decade – is unbearable. The majority of investors I know will tell you that you will perform better over time if you simply endure the pain of declines rather than try to avoid them. Still, they try to avoid them. The upside when you simply accept and endure the pain is that future declines don't hurt as bad. You realize it's just part of the game[18]"

We look forward to answering any queries you may have on our call on the 10th of October. We will also be open to hearing your perspectives on where you disagree with our line of thinking. Do send in your questions ahead of time if possible as that will allow us to be better prepared.

With my best wishes,

Manish Gupta
Chief Investment Officer

[18] Morgan Housel, https://www.collaborativefund.com/blog/same-as-it-ever-was/