12 July 22

Dear Partners:

The purpose of our quarterly letters is to provide transparency in how we are thinking.

Key messages – “Keep it going”[1] and trust the process to work long term.

- Performance remains healthy at 18.8% per annum TWRR post fees/expenses vs 10.0% for NIFTY 500 over last 5 years (our preferred time horizon for performance measurement).
- In our last few communications we opined that we have borrowed returns from the future and hence one must be realistic in return expectations going ahead. What we have witnessed in the last quarter is a claim back of some of these returns.
- The era of unreasonably cheap money is over. Central Banks have been surprised by inflation trajectory and will not risk entrenched inflation. Hence, higher interest rates than the past few years will be a head wind to returns.
- Higher interest rates and lower liquidity support does not imply markets will collapse. Rather, there will be brakes on growth. One can expect vast dispersion in performance across countries and companies’ basis normalization of monetary policy required, strength of business models and starting valuations.
- There are challenges, but no reason for gloom for investors in India. We have been much more conservative in use of fiscal/monetary stimulus vs the developed world and will continue to grow even as the developed world may slip into recession.
- Earnings growth for Solidarity portfolio companies remain strong. However, one needs to be selective. For some themes, e.g. Telecom, Banking and Life Insurance, valuations are reasonable while in others for e.g. Consumer, IT Services and Asset Management, we find valuations above our comfort levels.
- We can expect reasonable outcomes if we keep long-time horizons as Earnings growth will dampen the impact of multiple decline and still deliver acceptable results. Have realistic expectations, keep it going and trust the process to work long term.

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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.

[1] Morgan Housel

Performance

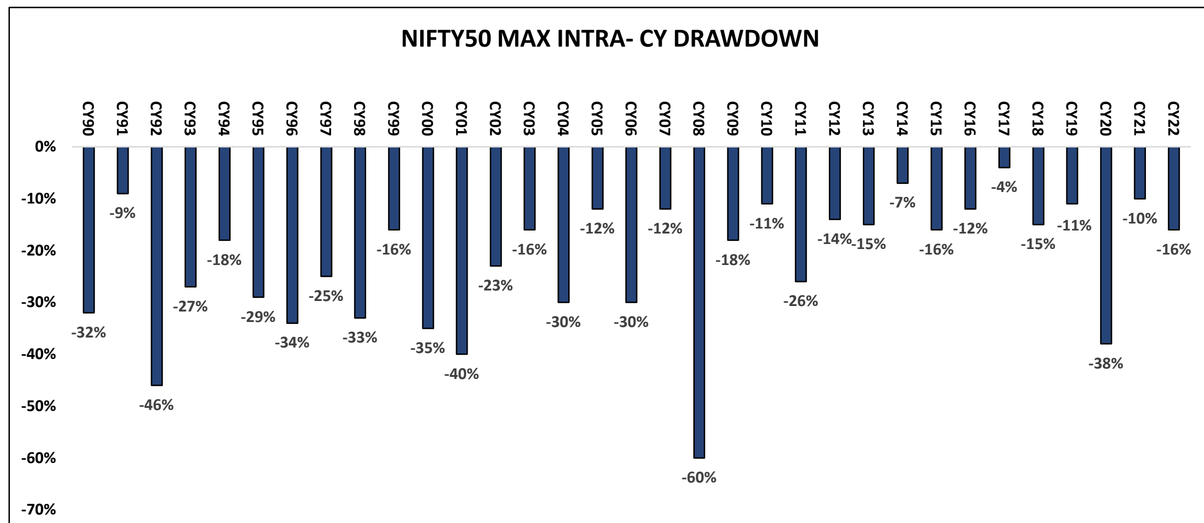
Aggregate across all partner accounts					
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception^**
SOLIDARITY	-3.4%	35.1%	20.4%	18.8%	**18.4%**
NIFTY	0.4%	23.8%	10.2%	10.6%	**12.0%**
NIFTY500	-0.6%	25.7%	11.5%	10.0%	**12.2%**
Data as of 30 Jun 2022 ^ From 11 May 2016 -Start date of PMS License Solidarity performance is net of all fees & expenses Note: Performance data provided in the above table is not verified by SEBI					

Performance over rolling 5-year basis which is our preferred time horizon.

- TWRR per annum of 18.8% post fees.
- This is 8.8% per annum over NSE 500 post fees.

Our NAV as on 30 Jun 22 has declined ~18% from its peak. The drawdown reflects what we have been writing about in our earlier letters - investors have benefitted from very loose monetary policy and borrowed returns from the future. We have given back some excess returns earned in the past.

Deep drawdowns are never pleasant but not un-usual (see chart below for intra year NIFTY drawdowns). When markets face excesses, they are healthy as they blow away the valuation froth. One needs to stay the course during such time periods by focusing on long term goals, long term time horizons and trusting the process will work long term rather than radically change strategy.



<u>The era of unreasonably cheap money is over.</u>

We are at a structural shift in Central Bank monetary policy globally in almost all countries (except for Japan). Over the past 15 years, most Central Banks, but predominantly the developed world have followed very easy monetary policy. The solution for every crisis was monetary support - flood the market with liquidity and reduce interest rates. This did not result in high inflation in the past which encouraged even more monetary expansion post the 2008 crisis. And during Covid, many developed world citizens got cheques to sit at home. Concerns that excessive stimulation would lead to inflation were dismissed as rising inflation was seen as “transitory” amidst Covid induced lock downs that created supply bottlenecks.

Interest rates reflect the opportunity cost of money over time. Low interest rates and easy availability of money resulted in an increase in Asset prices all over the world as they encouraged more risk taking. In many instances in the developed world, dividend yield on blue chips exceeded what could be earned in safe Bonds. But this also encouraged speculative bets as investors dreamt of having a position early in the next Amazon. In India too, valuations in many pockets jumped. Blue chip FMCG companies that grow PAT 10-15% which were valued at 35-40x PAT in 2014-2016 are still being valued at 50-60x today. Loss making business models, with very poor business building discipline and no visibility of break-even, listed at astronomical valuations.

The party has ended. Inflation trajectory in the US and much of the developed world has surprised Central Bankers. It is at a 40-year high (~8%) while policy rates are low. Central Bankers have personal reputations and institutional credibility to protect. They are hinting explicitly that inflation control is now top priority even if that means tipping economies into recession and putting people temporarily out of work. These concerns have caused stock markets all over the world to correct.

The wrong message to infer is that markets will decline precipitously like 2008. Markets take their cue from Earnings growth and valuations (what they are willing to pay for Earnings at any point in time). 2008 and 2020 were "cardiac arrests" to the global economy. Economic activity stalled in 2008 as Credit in the economy froze as Banks lost trust in each other. Activity came to a dead halt in 2020 due to lock downs. In both cases Earnings were severely impacted and both Earnings expectations and valuations reset dramatically resulting in steep declines.

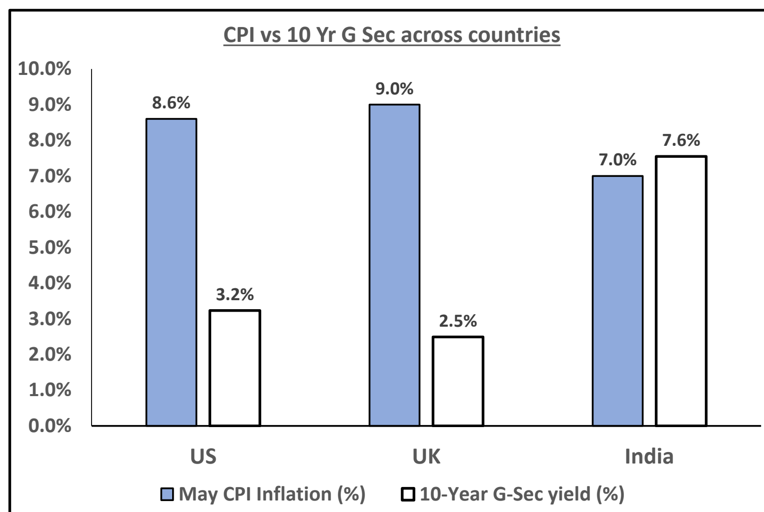
The more likely outcome this time is muted returns over the next few years. Economic activity is not collapsing. Rather, Central Bankers are applying brakes to get inflation under control. However, it is uncertain how much interest rates will need to rise. It is unclear what portion of high inflation can be explained by demand (due to very supportive monetary and fiscal policy), and how much is due to the war and supply bottlenecks[2]. There is lot of volatility and noise in the data.

While many industrial commodities have already corrected significantly from the peak, (Copper -20%, Aluminium -37%), one should assume that Central Bankers will be more conservative – at least for some time - as they have been caught off-guard and no one wants to risk entrenched inflation. Hence, we should see tighter monetary conditions in the near term which will reflect in higher interest rates than the past few years. Medium term policy (and hence interest rates) will be inflation dependent and is pure guesswork at present.

[2] For example, Gas prices in Europe are 6X of Feb 2020 and should ease over time as Gas from Russia is replaced with alternate sources (time lag needed to put infrastructure in place).

Unlike 2008/2020 where stock price corrections were correlated across the world, one should see more subtle differences across countries and across sectors based on extent of monetary policy normalization required and how Earnings are impacted.

- India has not offered as much monetary stimulation to its economy compared to the developed world and hence the scale of adjustment required is much lower. India's GDP, per IMF[3] is expected to grow ~8% this year and ~6.9% next year even as the developed world may slip into recession.
- Companies that are dependent on Capital markets for financing or companies that are at more mature stages of their life cycle while trading at heady multiples are more at-risk vs companies that are trading at reasonable valuations and are at more early stages of the growth life cycle.



Implications for Equity investors in India

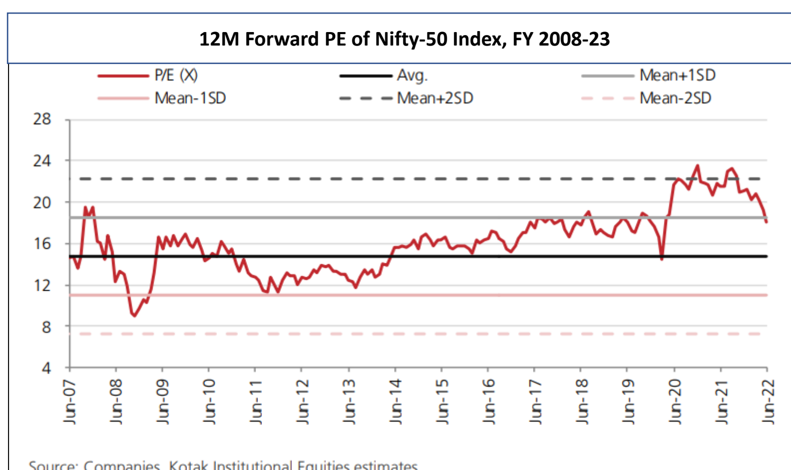
Some impact on the Indian economy is unescapable. For example, historically, the revenue of India's IT Services industry has correlated with the revenue of the US S&P 500 with a time lag. In its AGM on 23rd June 2002, the HUL Chairman remarked that inflation is now starting to weigh on consumer demand. Tile manufacturers are taking a one month shut down to normalize inventory.

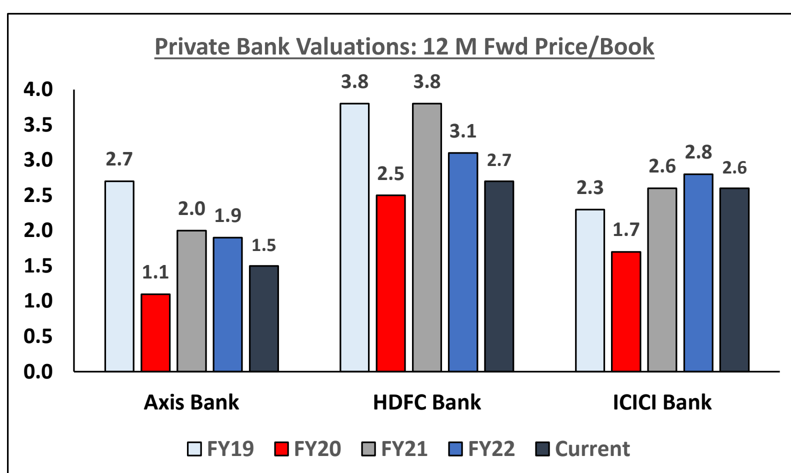
While markets have corrected, valuations are still a little higher than long term averages. Valuations in many sectors are still well above our comfort range (e.g. Consumer, IT Services, Asset Management). In some sectors, e.g. Banking, Life Insurance valuations are reasonable[4].

One needs to be selective and patient.

[3] https://www.business-standard.com/article/economy-policy/imf-may-lower-india-s-gdp-growth-projection-for-2022-to-below-8

[4] Banking valuations sourced from Kotak Institutional Equities. Life Insurance EV from company presentations.





Implications for Solidarity portfolio

Despite macro challenges, our portfolio companies should continue to deliver 15-20%+ Earnings/cash flow growth over next 5 years. Here is a sample of what some of our portfolios companies guided post their Q4 results.

Company	Management commentary[5] on future growth
Shaily Engineering	25-30% CAGR expected over next few years from base of FY21 (Revenue of 361 Cr in FY 21)
Neogen Chemicals	Revenue guidance of 725-750 Cr in FY24 (Revenue of 487 Cr in FY 22)
Ratnamani Metals	20% Volume growth for FY23
Mayur Uniquoters	Expect 15-20% volume growth in FY23 with some margin expansion
Privi Spec Chem	Expect 20-25% revenue growth with 15-18% volume growth in FY23
RACL Gear Tech	500 Cr revenue target for FY24/FY25 remains (revenue of 271 Cr in FY 22)
ICICI Pru Life	Aspiration to double the FY19 VNB by 2023, is on track
HDFC Bank	Bank to double Balance sheet every 5 years, even post -merger

[5] Management commentary on Q4 Conference calls, investor meetings or media interviews

For sure some of these companies may disappoint on these numbers as the external environment is challenging. However, these statements also reflect opportunity and management confidence in being able to grow in a tough environment.

- Export-oriented companies are in sectors where demand is resilient, they are benefitting from global market share gains (de-risking from China) and/or new opportunities (e.g. EV vehicles).
- Our domestic oriented companies are either very early in their life cycle and/or benefitting from tail winds of formalization or sector consolidation.
- Manufacturing companies have reasonable pricing power as they are either high Gross Margin (60%+) or are strategic partners where raw material prices are a pass through.

Hence, while these are challenging times, there is no reason for gloom if one keeps realistic expectations, maintains a long-term view, and is positioned in the right sectors.

In summary, "keep it going"

It is not tough to identify well run businesses. The toughest parts of investing are behavioural.

- Accepting uncertainty as the normal state of being. The human mind craves certainty; however uncertainty is the default state. We have just lived through a catastrophic pandemic and are living through a war, none of which was in anyone's imagination just 2 years ago. Life moves on as Govts, individuals and companies work through challenges.
- Understanding the role of time in wealth creation. The more we lengthen time horizons, the more dominant is the role of earnings compounding in returns with change in multiple having progressively lower impact.
- Non-linearity of returns[6] and the need to take short term pain for superior long- term returns.

There is no fundamental change to Solidarity's approach at present. Just more conservatism on fair valuations we are ascribing vs a few months ago reflecting the need to adjust discount rates. And sharper classification of names we will average down into, and where we will not (basis learnings from Solara, discussed later).

Over the last quarter we have

- Initiated new positions into Restaurants Brands Asia (erstwhile Burger King India) and Star Health Insurance.
- Added to our positions in names we are willing to average down in – for e.g. ICICI Bank, HDFC Bank, SBI Life, India Mart, Garware Technical, Bharti Airtel, RACL Gear Tech.
- Substantially exited our positions in Solara.

In the following sections, we discuss our investment thesis on RBA, share a post-mortem on Solara and answer some questions we have received on portfolio holdings.

[6] Over 80% of returns are earned in ~15% of all trading days. If one attempted to wait out bad periods, long term returns will be significantly sub-par.

Restaurants Brands Asia (erstwhile Burger King India) (Emerging Leader)

A good investment has the following attributes:

1. Large and growing opportunity size which gives long duration growth visibility.
2. Good ROIC which ensures cash generation to fund this growth internally.
3. Low disruption risk.

A well-run quick service restaurant (QSR) business in India satisfies the above.

- Eating out is a multi-decade structural growth story which will be supported by rising per capita incomes, increased absolute marketing spend by QSR players and as organised players gain market share from unorganised players. QSRs should gain higher share within the organized space vs fine dining.
- Once the business crosses a certain threshold scale, Gross Margins increase much faster than Overheads (operating leverage kicks in) resulting in significant Operating Cash Flows (high ROIC) which funds sustainable growth without equity dilution.
- As the market is large and customers enjoy different cuisines, multiple players can do well simultaneously. There is no risk of obsolescence as the product category is food, new product development is integral to QSR success, and the industry is aware about concerns on health. Hence, one does not need to worry about competitive intensity and/or disruption.

However, there are challenges to scale and a long gestation period to become self-sustaining.

- The cuisine needs to appeal to the population of the country and lend itself to customisations with local tastes of the country.
- Supply chain and restaurant operations should be able to deliver consistent quality across all outlets else customers do not trust the brand.
- Ability to lock-in good real estate locations at reasonable terms comes only when landlords see the tenant as a brand which is stable and successful across locations.
- It takes 5-10 years to become self-sustaining (Cash Flow from Operations can fund Cap Ex for growth). This means a sizeable capital requirement (~400-600 Cr is required to become self-sustaining).

Hence, only a handful of players have seen successful and scaled pan-India.

However, once a threshold scale is crossed, operating efficiencies create a virtuous cycle where more surplus can be invested in brand building and higher scale creates more efficiencies reflecting in higher ROIC and cash flow. We can see this in the economics of Jubilant Food Works which operates the Dominos master franchise in India.

Restaurants Brand Asia (Company) was promoted by Everstone in November 2013 to develop the Burger King business in India and opened its first restaurant in November 2014. In FY22, the Company bought a significant majority (~88%) in Burger King Indonesia. We see Everstone as a transient promoter (PE Funds have a finite life) and our bet is on the senior management team who has been well incentivized with stock options and have significant skin in the game. The management team has executed very well to scale Burger King India to where it is today from scratch.

The team is led by Rajeev Varman who has spent his entire career of ~30 years in the restaurant industry. He started as an Assistant Manager with a Taco Bell restaurant in the US and went on to become Vice President of Operations at one of Taco Bell's largest franchisees. From there he moved to Burger King Canada starting as a Franchise Manager for Western Canada before being promoted to National Franchise Manager. In late 2010, PE firm 3G Capital purchased Burger King and Rajeev was selected to run Northwest Europe. After 15 years with Burger King in the US, Canada and North-West Europe, Rajeev took up the mantle of CEO of Burger King India.

Our investment hypothesis rests on Burger King India (BK India), and we consider Burger King Indonesia as an optionality.

BK India ticks all the boxes that could result in a successful restaurant business we discussed earlier:

- Long growth runway – has opportunity to scale to ~1000 stores in a decade vs. 315 at end of FY22 and grow further over time[7].
- Its core cuisine (burgers) is appealing to the Indian population and has been adapted to suit local tastes.
- It has built an efficient supply chain and with scale, will deliver even higher operating efficiencies from procurement and supply chain logistics.
- Its success till date should encourage landlords to partner with them and hence they should continue to sign up good locations.

They have also had their share of luck as McDonald's in North and East India was mired in lawsuits with their Indian franchise partner which enabled BK India to scale up rapidly in these geographies.

Particulars	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Restaurants	12	49	88	129	187	260	265	315
Revenues (Rs crs)			230	378	633	841	494	944

If BK can continue to execute well, we believe it could grow to over 1000-1100 restaurants in about a decade. As the Company scales to this level, increasing revenues will give a very sizeable marketing budget (5% of revenues is mandated spend) which will help support introduction of new categories like cafes, breakfast, etc. aiding Gross Margins along with scale driven operational efficiencies from raw material costs, logistics savings and corporate expenses. This should lead to improving economics and cash generation over time.

Solidarity assumptions	FY 22 Actuals	~ 650- 750 stores	~1000 -1100 stores
Restaurants (nos.)	315	650 to 750	1000 to 1100
Revenues	944	Rs 3350 to 3900 Cr	Rs 6600 to 7250 Cr
Post tax OCF[8]	~ Rs 12 Cr	Rs 440 to 530 Cr	Rs 970 to 1100 Cr
Post tax cash ROIC	NA	22-25%	~ 30%

We think that a fair valuation for the India business five years out will be ~25-30x Cash Flow[9]. If the team continues to execute well, we should earn a good return from our entry price.

BK Indonesia

Given the size of the India opportunity, we would have preferred that the management focused on the India opportunity rather than take on the Indonesian challenge simultaneously. However, this is not a red flag for us as the Indonesian business is cash positive, its operations are run by a separate team and should not dilute any focus from India operations. One needs to trust judgement of management teams executing well.

At present we see the Indonesia opportunity as an optionality that can add a kicker to the returns with limited downside.

The management has spelled out the following challenges in Indonesia.

[7] Westlife (McDonald's) believes the market potential in West and South India is 800 McDonalds stores.

[8] Under the new accounting standard, the reported Operating Cash Flow (OCF) is overstated due to certain reclassifications of lease expenses. We have made adjustments to broadly show what the actual OCF of the business would be. In the letter we first sent out, we had made an error in this adjustment and mentioned FY22 post tax OCF as negative Rs 54 Cr which is now rectified to positive Rs 12 Cr

[9] Operating Cash Flow Less Maintenance Cap ex.

- In a predominantly chicken consuming market, they have had disproportionate contribution of beef products on their menu.
- In a country where standalone restaurants do better than malls, their restaurant mix is skewed more towards malls as the earlier promoter was one of Indonesia's largest retailers with predominantly mall presence.
- Significantly smaller scale than peers has resulted in lesser marketing investments.

However, till we see successful execution, we do not underwrite any value creation here. In our worst-case scenario, we assume that the company can sell this business and will recover their investment value as QSR as an industry has significant investor interest.

Risks

The Company will get a new promoter when Everstone's fund life expires. Hence, a key risk is poor chemistry between the new promoters and the existing management team (who we are betting on). However, one should assume positive intent that new promoters would not want to disrupt a team executing well. A change in control will also trigger an open offer which gives us a chance to exit if we are uncomfortable with the new promoters (track record or with their plans to scale this business).

Eating out at Quick Service Restaurants is largely an impulse purchase and faces a slowdown when consumer discretionary spending is impacted. Such periods are par for the course, and we should just live through them if our long-term thesis is intact. It could provide us more attractive entry points to increase our position size as well.

The Company has master franchise rights to use the Burger King brand till 31 December 2039. There is a theoretical risk of this not getting extended but is a low probability event as the brand owner would not want to disrupt a franchisee which is executing well.

Solara – a post-mortem

We have written to you about Solara multiple times in the past few quarters.

1. Our Q3FY22 quarterly letter (5 Jan 2022) detailed our investment thesis. *API is a scale business and companies needs to migrate into more value-added products. Aurore merger (approved by the Board in April 2021) de-risked Solara from Ibuprofen provided scale with complementary products, geographic footprint, cost synergies and a more advanced CRAMS franchise. Solara/Aurore could become a leading player after Divi's Labs.*
2. Our note on 10 February 2022 delved into challenges which the business was facing. *(Inventory build-up due to Covid over buying, pricing pressure in key products, sales write back on inventory return of largest product to pivot to a direct sales strategy).*
3. Our Q4FY22 quarterly letter (5 April 2022) explained why we chose to continue holding the position and added some more *(we believed the investment thesis was intact, the new CEO post-merger, Aurore founder Raj, had significant skin in the game and a 20-year track record in the industry, was candid on what went wrong and the changes that were needed).*

Solara published full year results on 29 April 2022 with a surprising announcement that the merger with Aurore was being cancelled and that Raj was resigning. This negated our original thesis and we liquidated most of our position in the next two trading sessions.

- The Aurore merger was key to our investment thesis as it would have provided scale and de-risking. Cancellation of the merger with Aurore leaves Solara sub scale, very reliant on a few products, with very low exposure to CRAMS.
- Raj's resignation means Solara will now have its 3rd CEO in less than 3 years.
- The Net Debt/EBITDA has now climbed to ~10x as of FY22 end, though on a normalized EBITDA level assuming 1600 Cr Revenue and 18% EBITDA it would be ~3.2x.

But did we sell amidst deep pessimism? When one is not confident of sustainability of Earnings compounding, low prices could be a value trap. We are willing to be patient and remain invested if financial results are weak due to environmental factors, but the business is making good progress on operating metrics. We cannot make that case with conviction for Solara at present as a sub-scale API business, over reliance on Ibuprofen, and constant CEO changes make us uncomfortable. At the same time, the market correction has provided a lot more opportunity to re-allocate capital to names where we have more conviction.

Key learnings and what we would do differently in hindsight.

- The reported financials over the last few years were strong, aided by Covid related over buying. We did not do a good job questioning whether these were sustainable. Strong financials hid the true width of the moat. The latter resulted in us paying much higher prices than were justified.
- We should be more discerning when we choose to average down on a losing position. Solara missing its very aggressive guidance, within a few weeks of providing it, was a red flag. We should have waited for more evidence of execution and completion of the merger before buying more.

Mistakes are inevitable and we will make others over time. However, we are a process-oriented firm and these learnings have been captured in institutional memory. For example, we have taken this opportunity to define more sharply conditions under which we will average down on loss making positions and where we will not.

An update on the tax issue at Team Lease (TL) (Clear Leader)
Is there any break in our thesis on TL given recent developments on taxation?

We had written a detailed note on TL in our Q1FY22 letter (pages 9-10)[10].

- Flexi staffing is a long term, structural growth story driven by increasing formalization of workforce, increasing preference for workforce flexibility and have variable cost structures and organized players gaining share of the opportunity.
- It is a "win-win-win" business model where all parties involved benefit. The Govt enhances its tax revenue through formalization, low-income employees get access to retiral and medical benefits, companies benefit from cost variabalization, faster ramp ups and no burden of regulatory compliances.
- The business enjoys a strong and growing competitive edge driven by scale, productivity, and credibility (competence to adhere to multiple, complex regulatory compliances across different states). This leads to a virtuous cycle – increasing scale leads to more market share, ability to offer better pricing to customers without compromising on account profitability, ability to reinvest in technology to improve productivity and service quality leading to further market share gains. Its low margins are a moat as the business model is very hard for competitors to replicate.
- TL's Earnings will grow faster than Revenues as margins expand from increasing share of higher margin specialized staffing in the mix and as scale results in improved Operating leverage. Over time, industry consolidation should increase Gross Margins in the core staffing business as well.
- We believe that TL can deliver ~15-20%+ Revenue CAGR and ~20-25%+ PBT CAGR over next 5-10 years[11] at a post-tax ROIC of ~25-35% as it is not a capital-intensive business and runs on <20 days of Working Capital[12].

Our long-term investment thesis on TL is not premised on tax benefits. However, tax rates affect reported profits, ROIC and hence valuations we are willing to pay.

Team Lease enjoys tax benefits under Section 80JJAA
The Govt wants to encourage formalization of the workforce as formal employees enjoy PF and ESI benefits. The Govt provides benefits under section 80JJAA of Income Tax Act. As per this section, if the company employs more associates than in the previous year, the company can claim a deduction of 30% of total additional employee salaries from its PBT in that year as well as next 2 years if a person is employed for minimum 240 days and earns less than Rs 25000/month. As a large share of its associates earn <25000/month, TL pays practically no Corporate Income tax.

Withdrawal of 80JJAAA at some point in time is a risk we called out in our original investment note. For example, tax benefits provided to the IT Sector under Section 80IA had a defined timeline of 10 years to claim exemptions and a sun set clause. Section 80JJAA does not an expiry date.

- If this section/benefit is withdrawn at any time, TL's PAT will have a ~25% negative impact as we don't believe TL will be able to increase prices to offset this impact. The ROIC will reduce and hence one would ascribe a lower valuation to this business.
- However, this may help the company revenue growth medium term from additional market share gains as smaller peers will have lower capacity to reinvest in the business. And over time, industry consolidation may help increase margins.

[10] Letter to Partners - Q1FY22
[11] TL's organic revenue and core PBT CAGR for FY15-FY20 is ~19% and ~23% respectively. Including acquisitions, the revenue and core PBT CAGR in this period was ~20% and ~21%. TL was investing ahead of the curve to build new capabilities with these acquisitions.
[12] TL's ROICs in FY16-FY20 saw a decline as they did acquisitions to get a foothold in specialised staffing

A redaction of this section soon is a low probability event as the section was introduced recently (2016) and the Government aims to increase formalization of the workforce. Governments stand to gain from higher GST collections if the share of organized players in Flexi Staffing increases and hence should continue to encourage formalization of the sector. TL made statutory remittances of ~Rs 1400 crores in FY21 and they have a miniscule share of the Flexi Staffing industry.

Update on the Income Tax issue at Team Lease

In the Q4FY22 result, the Company declared that the Income Tax authorities have disallowed the deduction u/s 80JJAA for FY19 and issued notice for reassessment for FY18 on the rationale that TL doesn't have a formal employer-employee relationship with its associates (does not supervise them) and hence the section is not applicable to TL.

The Company has challenged this assessment and believes it has a strong case to get a revised assessment in its favour. We find merit in TL's arguments:

- The Government has not enacted any law to withdraw these provisions.
- These deductions were allowed in tax assessments for FY17 and FY18 completed earlier under Section 143(3) of the Income Tax Act.
- TL issues Form 16 and pays all statutory dues related to employee laws.
- The customers of TL (for whom TL's associates are working) don't claim deductions under this Section so there is no case of double counting which would merit a disallowance for TL.

When in doubt, one should be more conservative. However, if one is too conservative, one will never be able to buy into great companies. Hence, one needs to walk the middle path. Hence, considering the ambiguity on taxation at present and the impact it can have, we have lowered the entry price we are willing to pay vs earlier.

Mayur Uniquoters (Emerging Leader)

We continue to own Mayur despite a few years of no operating earnings growth because its poor financial performance can be principally explained by the environment. The business is evolving well on operating metrics and its valuations are attractive. We also have a variance perception on key person risk. While Mr Poddar is the visionary and face of the firm, the business growth and resilience are not as dependent on the promoter as the market believes.

Over the last 7 years, the company has reported flat operating profit growth, but this was due to factors outside its control:

- Demonetization hit the footwear industry (46% of Mayur sales in FY16) disproportionately, Mayur chose to stay disciplined on profitability and working capital and chose to let go of business rather than drop margins. As the industry was recovering from demonetization, Covid lockdowns impacted revenue.
- The Automotive vertical, went through a downcycle in India starting mid FY19. 4-wheeler sales in India in FY22 were lower than FY18. By end FY20 when it seemed the auto cycle would start reviving, Covid-19 impacted demand which was worsened by chip shortages and supply chain issues.
- New programs won by in the Auto segment (domestic and exports) as well as Poly Urethane (PU) foray didn't scale up as expected due to these disruptions.
- FY22 saw unprecedented cost pressures due to RM and logistics inflation which can be passed on only with a lag.

However, the lack of earnings hides the strong operational performance of the business. They have signed up marquee customers in Automotive and have a large opportunity in PU. These should aid growth in the coming years as the business environment normalizes. Global customers have significant potential for growth as credibility builds and programs are rolled out to multiple geographies.

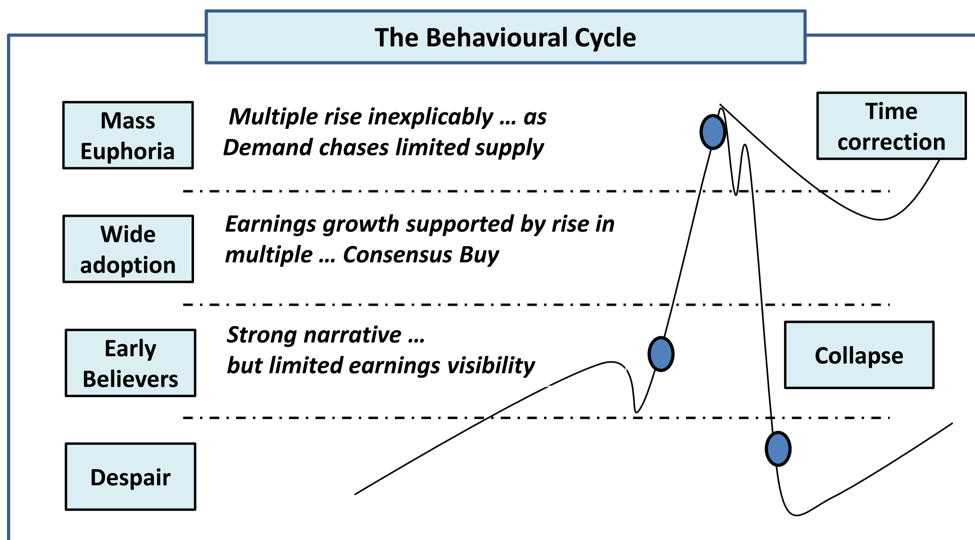
	2017	2022	Comments
Products	• PVC	+ • PU	India imports 4000 Cr of PU Leather from China. The domestic addressable market for Mayur is 2000 Cr.
New segments	• Auto • Footwear		Global brands selling bags, purses, shoes, are major users of PU; are seeking supply chain diversification from China.
New automotive logos and programs	Domestic: • Tata • Mahindra • Maruti • Honda	+ • Volkswagen • MG • Hyundai • Kia	
	Exports • Ford • Fiat -Chrysler • GM	+ • Mercedes • BMW	

Despite the headwinds for many years, Mayur has maintained its profitability, and has continued to invest in future growth. These are the hall marks of a resilient franchise.

Particulars (Rs crs)	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Revenues	496	474	570	591	528	513	658
Gross profits	218	213	246	233	220	237	259
EBITDA	129	126	150	129	103	121	125

The company remains Debt free with ~Rs 190 crores of cash on balance sheet, despite two buy backs.

The lack of Earnings growth in the last few years coupled with no immediate triggers has resulted in, not surprisingly, a reasonable valuation today as the markets tend to chase momentum. Businesses which have had a few years of low/nil earnings growth and lack immediate triggers for growth are usually shunned by investors and hence provide good entry points for long term investors. The inverse is also true where businesses which have performed very well in the recent past trade at very optimistic valuations thereby reducing future potential returns even if earnings growth is reasonable. We discussed this "Behavioural Cycle" on Pg 7 of our Q2 FY 22 Letter.



We don't see the risk of multiple de-rating in Mayur from current prices. When the Auto Cycle turns or the PU plant ramps to full capacity is anyone's guess. But when it does, all the operating initiatives taken by the company will translate into strong Earnings growth. And as Earnings rebound, the stock price will inevitably follow.

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We look forward to speaking with you on our call at 12 PM on the 23rd of July.

With our best wishes,

Manish Gupta	Manjeet Buaria	Anirudh Shetty
Chief Investment Officer	Partner	Senior Principal

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