3 October 2017

In our last letter shared with you on 4 July 2017 we had opined that the economy was not growing at 7% and hence earnings growth would be tepid without strong tail winds. We counselled deploying Capital gradually rather than in one hefty chunk and being more realistic on return expectations.

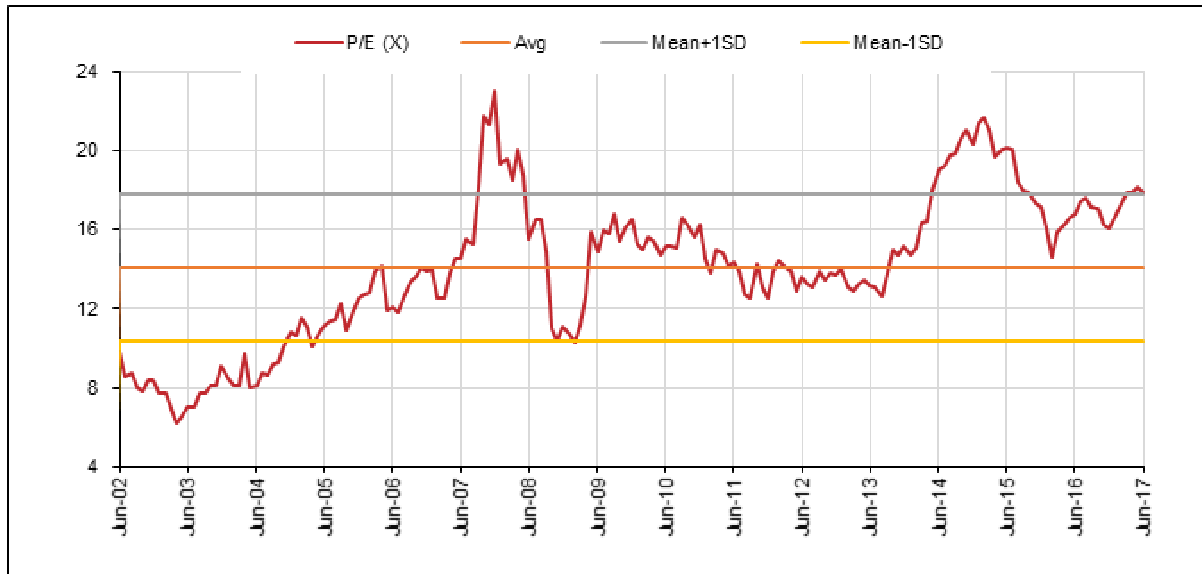
Subsequent earning releases for Q1 in aggregate were lacklustre (with some noticeable exceptions).

However, shrugging off disappointing earnings, market --multiples have held with an aggregate ~2% gain for the NIFTY last quarter signalling confidence in near term earnings revival.

The outlook for domestic economic growth continues to be "foggy" with mixed signals. It is hard to be certain exactly when growth will pick up

- Demonetisation and GST were strong medication for the economy. They promise to make the economy stronger in the medium and long term. But it is hard to predict how long the side effects and challenges in migration will act as drag on short term economic growth
- The economy needs exports and private sector Capital Investment to move to a higher growth trajectory, which have been poor. However, there is a pick-up of Corporate cap ex revival in some sectors e.g. Airports and Metals
- Commodity prices are picking up – typically these are a sign of rising global growth rates which should aid Exports. However, this is not yet reflecting in Exports revival.

Meanwhile valuations in aggregate and for select domestic themes in particular are expensive In aggregate, the NIFTY One year forward P/E[1] ratio still trades at 1 standard deviation above long term average.

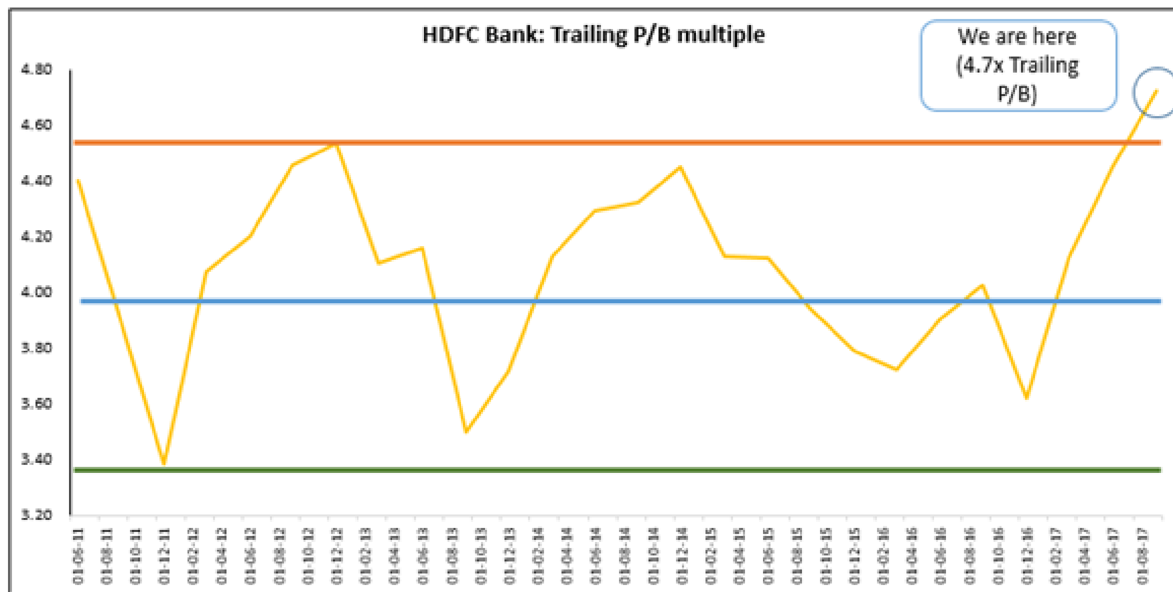


Source: Kotak Institutional Equities

The recently concluded IPOs of ICICI Lombard and SBI Life offered shares to retail Investors at ~50% higher valuation than a secondary transaction concluded between savvy institutional investors just 4-10 months ago with no meaningful change in fundamentals.

[1] *PE Ratio is a commonly used valuation metric which is calculated as Market price divided by estimated profits*

Valuations are high also in many stocks in our portfolio. For example, HDFC Bank, trades well above the upper band of valuation multiple[2] it has traded at since 2011



Source: Ace Equity database; Solidarity Analysis

While valuations are rich, there are credible reasons why they may sustain. Hence one should resist the entry to sell and try and re-enter at a later date (avoid "reinvestment risk")

- Part of the sub-par economic growth is due to interest rates which have not declined in line with inflation. A further reduction in interest rates will support multiples (however, this argument assumes that inflation will continue to be in a comfort zone)
- Domestic liquidity into MFs continues to be strong and they are sitting on a lot of dry powder which is counterbalancing FII selling
- If stock prices move side-ways for a few months, even a moderate growth in earnings removes much of the valuation froth
- If companies trading at rich valuations can compound earnings at strong growth rates, they may justify their rich ask. And many companies will be market share beneficiaries of the transformations in the economy which will result in them becoming far stronger franchises. Hence, historical trading bands cannot be used as benchmarks in isolation when the quality and quantity of earnings may change.

Evidence of the above market share gains can be observed in Banking. The incremental market share of Public Sector Banks in Credit has dropped to 21% in FY 17 vs 74% in FY 12, resulting in more entrenched positions for Private Sector Banks. That is a staggering change of fortunes within 5 years.

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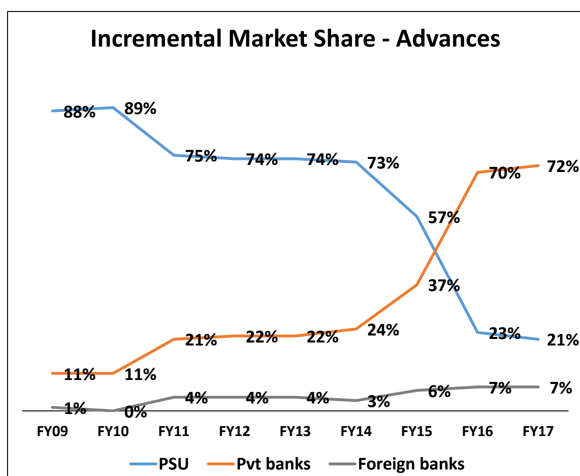
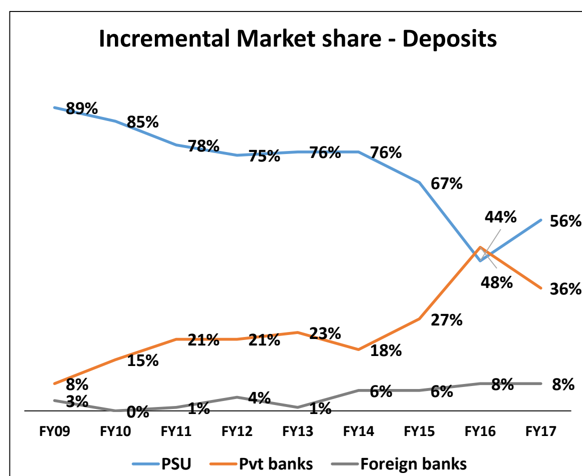
[2] *Price to Book is a commonly used metric to evaluate the valuation of a Bank. It reflects the market price divided by the Net Worth of the Bank*





Source: Macquarie

Our investment stance

We remain very optimistic on India's long term story. The Govt. is taking the tough decisions we should have taken many years ago and we will reap the benefits of these with a lag for many years to follow. So one should be wary of excessive pessimism around an "economy in tailspin". For sure there is short term pain at present, but we often tend to extrapolate near term trends into the immediate future

For those with a long term perspective, with tax free bonds yielding ~6.5%, Indian equities, offer a compelling wealth creating avenue. The best for Indian equities is yet to come.

We however remain cautious about incremental Capital deployment in the near term

a) No one can predict when growth will pick up as it is a confluence of multiple unpredictable variables; hence it is important to focus on what one can control, i.e., the entry price one is paying.
b) Valuation multiples tend to mean revert. Hence, a narrative of structurally higher multiples needs to be viewed with caution.
c) One's approach to risk cannot be static; rather it must be a function of the playing conditions. When momentum is driving stock prices, risk management tends to become an after -thought. Even for someone with appetite to take on more risk, frothy valuations with an uncertain economic outlook warrant more caution.

India's consumption story is an ever green Investing opportunity because a greater share of growing income will be deployed into discretionary consumption. We too subscribe to this narrative and many such themes find place in our portfolio for the long term compounding they offer. However, valuations in most such companies are already assuming 20%+ compounded earnings growth for many years leaving no room for execution slippages and leaving one exposed to –poor returns when the earnings don't match the narrative. Some of these companies – especially where moats are predominantly distribution led - will be challenged over time as new entrants will use E-Commerce to build reach and scale.

The risk of participating in such stories – without having a 5+ year perspective - is illustrated by the example of HDFC Bank, one of India's best run companies.

Investors who have participated in a great franchise like HDFC Bank, at very high entry multiples, have made sub-par returns over the subsequent 3 years. But have been compensated well if they held on to positions for longer periods of time.

HDFC Bank					
Entry date	1 yr Forward P/B	1 Year IRR	3 Years IRR	5 Years IRR	7 Years IRR
30-09-10	4.16	-6%	6.0%	16.5%	20.1%
31-12-10	3.73	-9%	12.4%	18.2%	
31-03-11	3.68	11%	16.9%	18.0%	
31-03-12	3.42	20%	25.3%	22.6%	
30-09-12	3.72	-6%	19.3%	23.4%	
30-09-13	2.94	47%	29.1%		
31-12-12	3.79	-2%	16.8%		
31-03-14	3.03	37%	24.4%		
30-09-14	3.22	22%	27.2%		
31-03-15	3.56	5%			
31-03-16	3.06	35%			
30-09-16	3.32	41%			
31-03-17	3.45	NA			
30-09-17	3.96	NA			

Source: Ace Equity database, Solidarity Analysis

One may argue that for a truly long term investor, a 2-3 year non-performance should not really matter as long as the competitive position of the business is unaffected and there is visibility of long term earnings growth. That argument is very true if your definition of long term is beyond 3 years and you will have the patience to bear indifferent performance for 2-3 years. However, investment mandates seldom exceed 3 years which is often not long enough for a high PE stock to weather a valuation decline and still provide adequate returns. However, over longer time horizons, the compounding of earnings has a more dominant impact on returns compared to change in multiple between entry and exit. If one can keep a 5+ years perspective and not lose patience, the compounding of earnings can make Quality franchises safer and more productive investments compared to cheap companies

We hence remain "Cautiously Optimistic". Partners should invest additional capital systematically over time, have muted short term return expectations and most importantly continue to keep a long term perspective.

Why participate cautiously and not wait for the fog to clear?

a) We don't buy the market, but individual companies. There will be themes that offer compelling value because they are out of favour – for example, many export themes at present and within Private Banking ICICI Bank (discussed below). However, they cannot be the sole constituents if the intent is to construct a well-diversified portfolio.
b) Stocks can correct swiftly offering entry opportunities. For example, Inter Globe Aviation (Indigo) corrected 16% in the last one month offering an entry point in portfolios where we had cash

We will revisit our stance when the fog clears or if valuations come in favour either due to earnings growth, or price/time corrections.

Portfolio positioning

Partners are aware that our approach is look for "compounding stories" with a focus on "Quality franchisees available at a fair price". As we have explained above, most quality franchisees are priced well above our perception of fair value. As many more Investment Managers start believing in the above approach, Quality Assets will always be richly priced.

We will not abandon our core (Focus on Quality franchises at fair valuations). However, when we don't find enough opportunities in our core approach, we believe we should experiment with other approaches to broaden our opportunity set.

We have created 3 additional buckets for Investments other than "Clear and Emerging Leaders"

a) Transformation stories– under evolution to Clear Leaders under new management or transformation of business model
b) Options – stories that show remarkable promise, but lack a moat at present
c) Deep discount bets – not secular compounders, but available cheap relative to earnings potential or Asset value

As companies under these buckets carry more risk than Compounders, we typically take far lower position weights but have higher IRR expectations when we invest into them. And we will raise our exposure as we get more confidence on execution.

In a market where value is hard to find, one must take meaningful positions in a Quality franchise with moats when risk and return trade-offs are very strongly in favour – "we earn great IRRs when we are right but don't lose much when we are wrong". An example of this is the high position weight for ICICI Bank at present where we believe the market is rightly reflecting its NPA issues, most of which are already known problems, but ignoring the positives – the quality of franchise on all aspects other than Corporate NPAs, market share gains from a crumbling Public Sector, the transformation underway at the Bank and the fact that the Bank can absorb losses from bad loans from regular profits without having to raise Capital.

Due to excessive short term orientation, many market participants take more comfort from visibility of near term earnings and tend to avoid companies with grim near term prospects. If we are to earn superior returns, we must take a longer term perspective and back that up with a tolerance for mark downs and patience. The price for complete clarity before entry is very high valuation multiples.

Please reach out to us to have a discussion on the Investment thesis for any positions we hold on your behalf.

Thank you for the trust you have placed in us.

With best wishes for a Happy Diwali,

Sincerely,

Manish Gupta
Chief Investment Officer