08 January 2025

Dear Partners:

The purpose of our letters is to provide transparency in our thinking.

Key message: Temper return expectations

- Solidarity "Prudence" has generated 19.6% TWRR in the last 5 years vs 19.1% for BSE500TRI. Our goal is to beat the BSE500TRI by 1.5% every rolling 5 years with prudent risk taking.
- Broader markets have declined 8% in the last quarter but are still trading well above fair value. The one truism in markets is mean reversion. Hence, one must continue to have realism in return expectations. We believe this will be a less than 10% IRR decade for the BSE 500 TRI and hence a ~15% IRR with prudent risk taking will be a good outcome this decade from current levels. As a boutique firm that does not need to chase too many ideas, we will be disappointed if we do not deliver on the above goal.
- The current environment needs patience. The momentum trade is at work in Small/Mid-Caps. Valuations in many pockets reflect irrational earnings growth assumptions over the next decade. Momentum is a dangerous strategy to pursue as liquidity can evaporate quickly when sentiment turns resulting in an inability to exit.
- How does one target a better return from the market? ~33% of the portfolio is in non-consensus ideas which are out of favour at present. These are in companies facing some growth challenges at present or getting punished due to a strategic error, but with strong market positions/ability to correct errors. Over time, we believe these companies will fix their current growth issues. They will then benefit from both growth and multiple re-rating as the current pessimism is re-priced. This should provide the Alpha kicker to the portfolio.
- Trump's election – and the threat of higher tariff's – does not invalidate our hypothesis on any position at present. At Debt/GDP of 120% and 6% fiscal deficits, the US Debt poses huge constraints on what they want to do vs what they can do. Tariffs are inflationary. Manufacturing competitiveness cannot be achieved quickly. Future supply chains will be more closely linked in companies less likely to go to war with each other and India should be a natural beneficiary.

Topics

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Answers to interesting questions we have been asked.

5. Threat of higher tariffs by Trump administration on our Manufacturing positions P8
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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 customized 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 depending on start date.
- Past performance does not guarantee future results.

Performance update

Aggregate across all partner accounts					
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception^**
SOLIDARITY- PRUDENCE	21.4%	17.7%	8.4%	19.6%	**18.0%**
S&P BSE 500 TRI	15.8%	21.0%	15.4%	19.1%	**16.5%**

Data as of 31 Dec 2024
^ 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

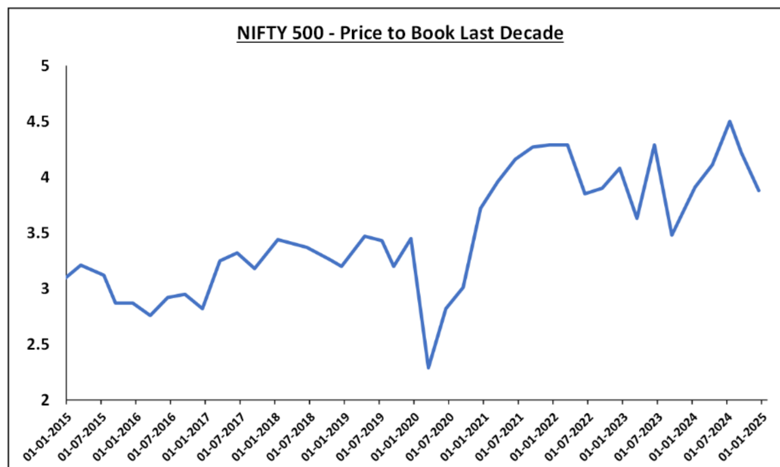
Aggregate across all partner accounts					
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception^**
SOLIDARITY- EMERGING LEADERS	30.6%	NA	NA	NA	**22.7%**
S&P BSE 500 TRI	15.8%	NA	NA	NA	**27.8%**

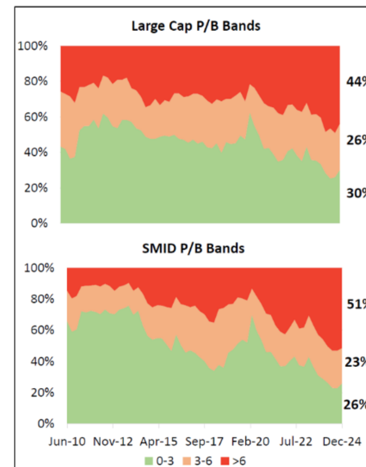
Data as of 31 Dec 2024
^ From 26 APR 2023 -Start date of scheme
Solidarity performance is net of all fees & expenses
Performance data provided in the above table is not verified by SEBI

Our 3-year performance has been affected by some errors in FY2023. It has also been affected by our reluctance to buy into pockets carrying risks we were not comfortable with in FY24, but which the market handsomely rewarded. We have written about this in our past letters.

Market valuations are still pricing in excessive optimism.
In our last letter we mentioned the lack of width of opportunity given extremely high aggregate valuations. in India were above fair value. In the last quarter, the BSE 500 TRI has corrected ~8%.

Valuations are still elevated vs history even as growth in aggregate remains challenged. Width of opportunity is still narrow. There is a steep decline in share of companies trading at <3x Price/Book[1] (see graphs below[2]).

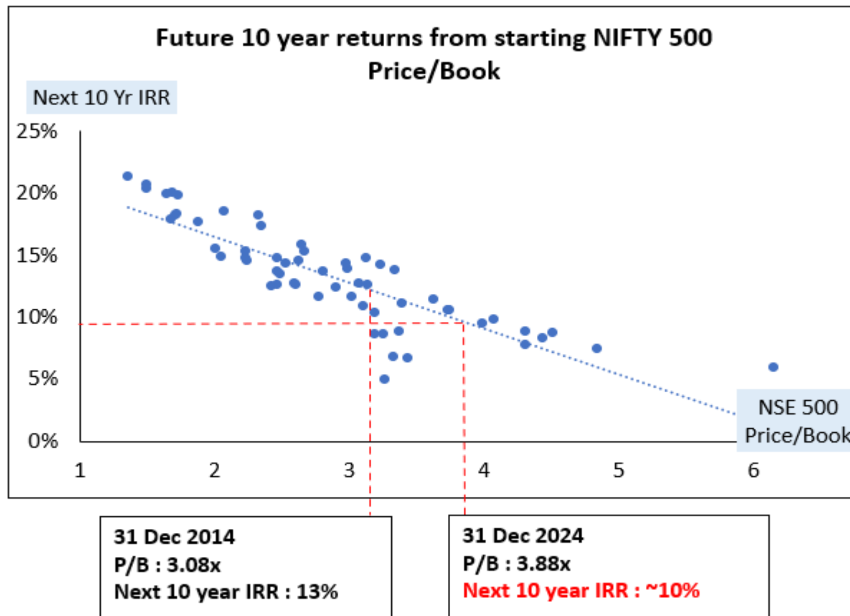




Investment implications
Temper return expectations.
The higher the starting Price to Book Multiples, the lower the future return as multiples eventually return to mean. Unless earnings growth in aggregate move to a 15%+ CAGR trajectory (earnings

[1] Source: DSP Netra
[2] Source: ACE Equity

broadly track nominal GDP growth over long periods which is ~11% at present), starting valuations in the graph below suggest we are entering a <10% return decade for the NIFTY 500 because Earnings growth will be accompanied by multiple decline. This is simple Mathematics.

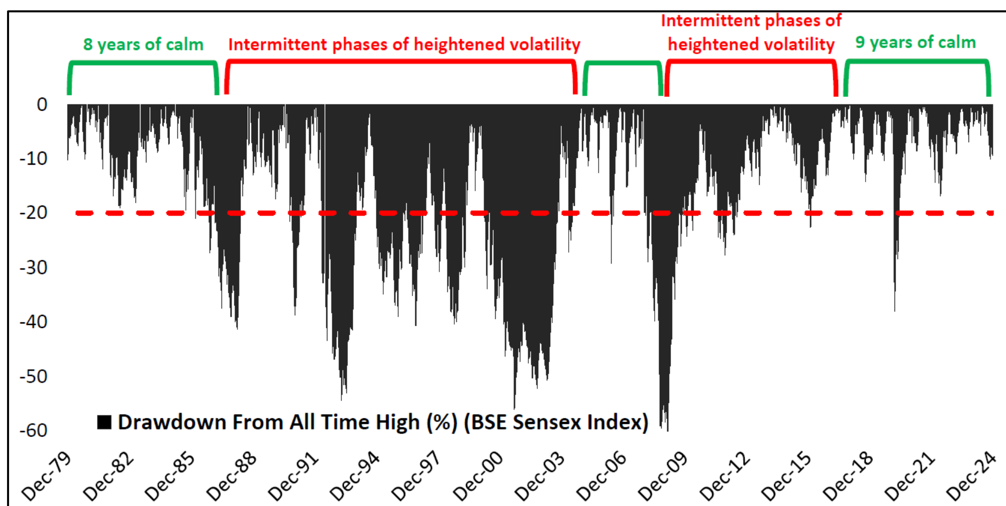


How does a manager target superior returns without underwriting imprudent risks?

- Patience.
- Discipline on process.
- Long term "stillness" orientation but also exiting where valuations are euphoric.
- Boutique – fish in shallow waters (low liquidity) where others may not want to venture.
- Stretch time so one can take non-consensus/out of favour calls.

Patience

We need to be patient till valuations/prices come into favour. Irrational earnings expectations are built into prices and volatility will provide opportunity. Markets have been significantly less volatile this past decade vs history with lower drawdowns, see chart below[3].



[3] Source: DSP Netra

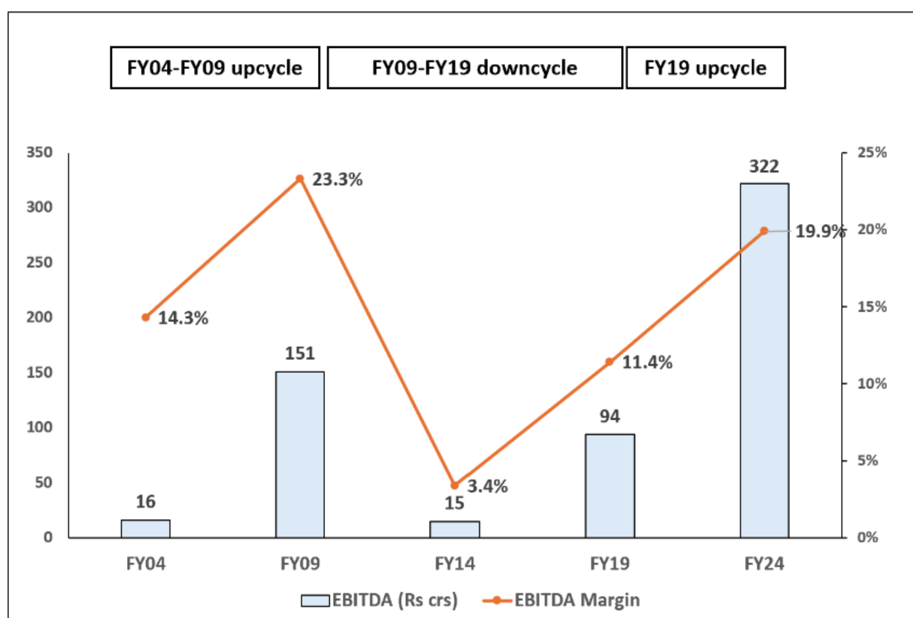
Discipline on process

We will not be opportunistic and abandon our longevity and 18% sustainable ROE framework[4]. "Flexibility" sounds great in theory, but it leads to a lack of confusion on what to do when confronted with price volatility. The toll is poorer long-term outcomes.

Sectors doing well at present are those benefitting from strong earnings driven by a surge in Govt capital spending (Capital Goods, Railways, Defence) and/or lack of new capacity additions over last decade. Some of these sectors could have strong tail winds of Demand that have longevity. For example, Transformers which have the tailwind of mega trends like renewables. However, valuations in most names are hard to justify.

Most of these companies are Small/Mid-Caps. Sectors doing well tend to attract price agnostic flows (momentum). Hence, we see a deluge of flows into Small/Mid-Caps and thematic funds (e.g., Defence). These attracted ~40000 Cr in CY 2021 which has grown to ~200000 Cr in CY 2024. The consequence of this inflow is euphoric valuation multiples.

For example, two transformer companies trade at TTM PE of 58 and 152, respectively. Assuming one targets a 15% decadal return and PE multiples normalize to a generous 25x over time, these companies need to grow profits at 25% CAGR and 38% CAGR, from peak margins at present to justify current valuations. Possible, but with incredibly low probability. Especially when one considers margins in this industry are very cyclical because there are low entry barriers and new capacities come in whenever industry becomes very profitable. This is visible in the results over decades of a leading transformer company in India shared below.



As players add more capacity over time, especially in poorly differentiated product categories, we expect margins will decline to more normalized levels. Margin decline will result in muted profit growth vs market expectations and could de-rate multiples very quickly. The virtuous cycle can then turn vicious as disappoints trigger redemptions and forced selling feeds on itself. Momentum is a dangerous strategy in Small and Mid-Caps where liquidity vanishes quickly.

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[4] 16% for Financials

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Taking some chips off when valuations get euphoric.
We want to invest with long-term horizons. But we need to recognize greed and act on the same. There are some trade-offs between these two objectives because one risks exiting too early. Great businesses can keep entering new adjacencies and extending growth runway and hence ascertaining fair valuations can be a circular argument.

Our overarching goal is prudence and risk adjusted returns, not maximising upside. It is extremely hard for any company to grow profits at over 25%+ CAGR for a decade. These are always exceptions, but these are only clear in hindsight. Hence, we have been slicing position sizes in names where we think valuations are euphoric.

Look for non-consensus ideas by willing to stretch time.
Staying invested in out of favour ideas is never easy, especially in a raging bull market. But why will the market permit easy Alpha unless one is willing to take some pain? We are willing to be contrarian where businesses are temporarily challenged for earnings growth or have a credibility deficit without having a structural impairment issue[5] while valuations reflect the pessimism. When earnings growth returns – principally a matter of time - multiples will get an additional boost (momentum players enter or stock gets re-rated) resulting in good to great outcomes.

Approximately a third of the portfolio is in positions which are out of favour at present.

- Slowdown along with a capital allocation error (Restaurant Brands Asia).
- Ambiguity on Industry steady state economics (STAR Health).
- Slowdown in the end user industry (Kama Holdings, RACL Geartech).
- User addition challenges (IndiaMART).
- Concern on credit costs vs peers (Axis Bank).

Our variance perception on out of favour names.

Restaurant Brands Asia (RBA)
RBA is getting punished because the market is ascribing a negative value to its Indonesia business which is still burning cash ~3 years after RBA acquisition. It still needs cash support from India which has also been affected due to the slowdown in the QSR industry. We bought RBA for its India opportunity and track record and were willing to take a leap of faith that the Indonesian business will be worth at least its acquisition price. In hindsight, Indonesia was a capital allocation error by the management, and we erred as well in investing despite it breaking our "stamina over speed" framework. The Indonesian business was profitable pre Covid. However, with the large opportunity in India, there was no need for a distraction in a country with a different culture and consumer behaviour. The Indonesian economy has been slower to recover post Covid. The Middle East war has hurt sentiment for American brands because of which profitability remains elusive for the Indonesian business despite management taking the right operating steps. *Our contrarian view at present is that the management team are entrepreneurs and do not have an endless supply of cash. Their mistake is resulting in them getting diluted. The Indonesian business is a good Asset in the hands of an owner who better understands Indonesian consumers and can support the business with patient capital as building any QSR is a 7–10-year journey. Unlike other peers in India like Westlife (McDonalds), Sapphire (KFC) and Jubilant (Dominos), RBA is yet to prove its steady state economics in India as it is still subscale, and hence trading at a significant discount to these peers (see chart below)[6]. If our thesis is right, Burger King India will see significant operating leverage as it scales resulting in healthy OCF generation of Rs*

[5] Barring RBAs Indonesian Assets
[6] Note: We ascribe zero value to RBA's Indonesia business and 1x TTM sales to Sapphire's Pizza Hut business when computing TTM Price to Sales.

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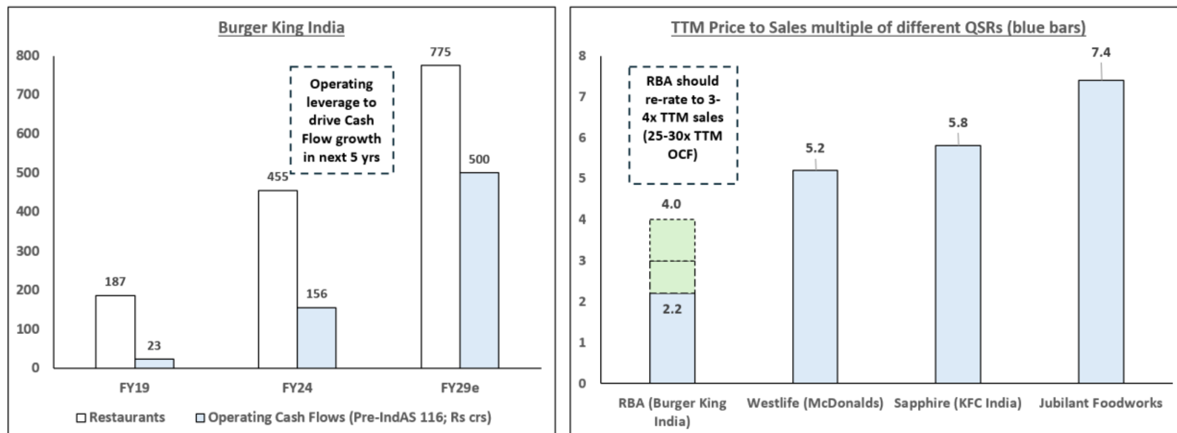
480-560 crores by FY29e. Over time, we expect the India business to be valued at 25-30x TTM OCF (3-4x TTM sales) when the Indonesian capital allocation error is corrected.



STAR Health

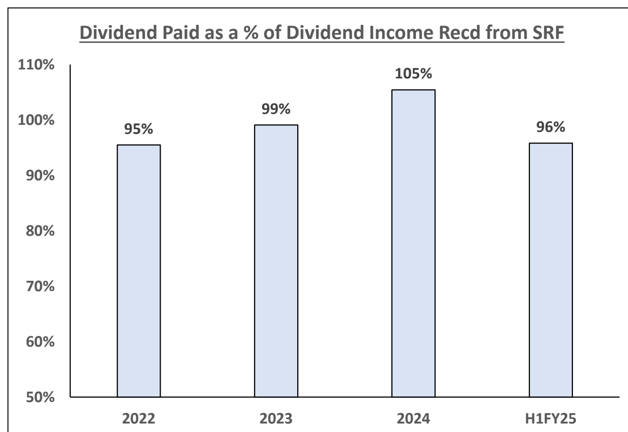
The Health Insurance industry is getting impacted because of both higher medical inflation[7] and higher frequency of claims post Covid. STAR Health has consistently missed the Claim Ratios guidance they believe the business should operate at. Hence, the market is unclear about the steady state economics of this business and is questioning the credibility of the management team. There is complete investor apathy.

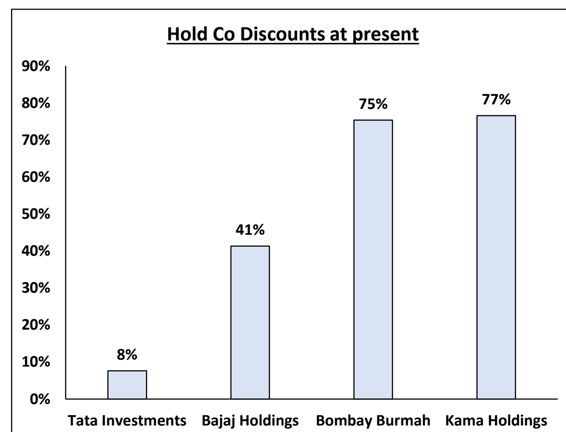
Our contrarian view is that high Claim Ratios are not a STAR issue alone but an industry wide issue. This is not well understood as STAR has been the only listed Health Insurer and accounting practices differ across insurers making comparisons hard. More Hospital bed additions should reduce medical price inflation and price increases should bring Claim ratios to normalized levels over time. There is excessive pessimism in the price for a high Terminal Value business which can grow profits 15-18% for extended periods of time. STAR Health can be a ~16-18% ROE business vs the ~18-20% ROE business on IFRS that we originally believed. Once steady state economics are established, high Terminal Value deserves a 22-25x PAT multiple on IFRS profits.

KAMA Holdings

Is the Holding co of SRF Ltd. SRF derives bulk of its value from its Chemical segment which is facing short cyclical growth headwinds from slowing global Agri demand, inventory rationalisation and China dumping. Near term growth remains weak. Kama trades at a poorer Hold Co discount than Bombay Burmah where, unlike SRF, historical dividends from Britannia have not been shared with minority shareholders.

[7] Average Revenue Per Operating Bed for Apollo, Narayana Hrudayalaya and Fortis Healthcare increased by 11% CAGR in the period FY21-FY24 vs 6% in the period FY18-21





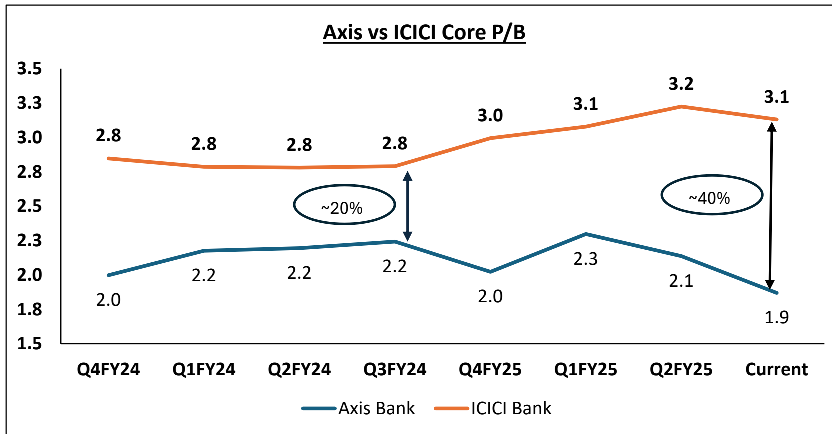
Our contrarian view is that SRFs Chemical business enjoys strong edge (leadership in high entry barrier Fluoro chemicals, strategic manufacturing relationships with Global Agri majors) and the current earnings pressure is temporary reflecting the business cycle and Chinese dumping. SRF continues to make large Cap Ex investments which can deliver >15% earnings CAGR this decade.

Hold Co discounts reflect market confidence on capital allocation keeping in mind interests of minority shareholders. KAMA Holdings Hold co discount of ~77% is close to its all-time high. Almost all dividends received from SRF are being passed onto Kama shareholders. There is no reason to doubt capital allocation discipline. Hence, we believe the Hold Co discount should narrow over time to broadly where Bajaj Holdings trades at present. As the intrinsic value of Kama should increase with SRF earnings, we have an Asset with an extremely high margin of safety.

Axis Bank

Axis Bank has significantly improved its Deposit franchise over the last few years with now only a marginal difference in Cost of Funds vs ICICI. However, the market still believes their Credit underwriting needs more discipline as their communication at present indicates more stress in Unsecured Loans vs their peers (ICICI/HDFC Bank).

Our contrarian view is that Axis is evolving into a more conservative lender supported by amongst the lowest Cost of Funds in the industry, and lower base vs larger peers which allow it to choose its risk profile. It has significant provision buffers which should allow it to double profits every 5 years while maintaining ROEs of ~16%. Hence, there is a credible road map to 15% IRR over 5 years from profit growth trajectory alone without the aid of any valuation re-rating. However, there is a reasonable possibility of a better upside. While Axis Bank rightly deserves a discount to ICICI, the 40% discount reflects excessive pessimism. If Axis can follow the transformation of ICICI, we can expect a significantly higher IRR as multiples will re-rate higher than the 1.9x Core Price/Book today.



IndiaMART, RACL Gear Tech

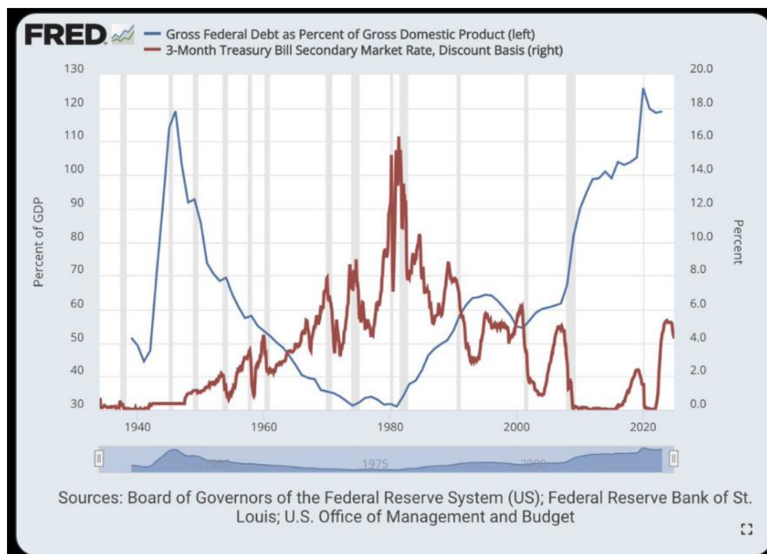
We recently published detailed notes on IndiaMART (link) and RACL Geartech (link) in which we explain their near term challenges and why we remain optimistic long term.

The incoming US President has threatened higher tariffs on friends and foes alike. What implication does this have on our choices?

Any trade strategy that the US follows must be seen in context of its other geopolitical objectives and fiscal constraints.

A key constraint for the US at present is its rising Debt burdens[8] and deficits.

- The US Debt to GDP has reached 120% and is climbing (blue line in graph below) while Fiscal deficits are 6% of GDP.
- Demand for US Debt has head winds. China, erstwhile largest buyer, is selling down its stock of US Debt holdings (USD 800B today vs USD 1300B in 2012). Freezing of Russian reserves by the US is resulting in Central Banks diversifying reserves away from the USD and should be a drag on long term Dollar demand.
- Lower demand for US Debt means higher interest rates to attract more buyers.
- Meanwhile, the 10 Yr US Bond Yield is rising because of worry on Trump's intended policies which will widen the deficit and be inflationary. The US cannot afford a selloff in its Bond markets which will dent confidence in the USD.



Our hypothesis is that.

- Tariffs (along with tax cuts) will be inflationary and will nudge long term US interest rates higher. Due to this constraint, we expect more targeted tariffs in industries of national interest to the US rather than across the board increases in sectors where US industry is not competitive.
- Outsourcing of manufacturing over two decades has eroded competitiveness of US manufacturing companies, especially in sectors that were not very technology intensive[9]. One cannot just set up plants and make them competitive quickly. Manufacturing requires both a hard edge (economies of scale) and soft edge (engineering talent, process know how).
- It is unlikely for US CEOs (who are evaluated basis shareholder value created) to commit capital to manufacturing in low technology sectors which will reduce ROCE and be a drag for their

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[8] Read here

[9] For example, the US had 295K+ small and medium manufacturing shops in 2001 which has reduced by ~25% by 2023 as the next generation is not keen to continue in this field. Over 65% of machine shops still use CNC equipment purchased before 2005.

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stock prices. Especially with uncertainty if trade policies will be reversed under a new administration in 4 years.
- Despite Trump's tirades, the US needs allies. Global trade supply chains will now be strongly linked between countries which are less likely to go to war with each other. India should be a beneficiary as it is a partner to the West and not a geopolitical rival. Anecdotal evidence in portfolio companies also suggest high level of interest with US based buyers even at present.

The bigger risk to Indian companies is not tariffs in the US but dumping by Chinese companies in other markets. Hence, our export focused manufacturing names are businesses which have more strategic integration into value chains and therefore are better positioned vis-à-vis commodity products more exposed to dumping.

Hence, there is no change in positions basis imagined fears that may not materialize.

Is there a threat to Bharti Airtel from Starlink's entry in India?

Per recent media reports[10], Elon Musk's Starlink has taken a step closer towards its ambition of launching Satellite based internet services in India.

Starlink is a satellite-based internet service provider that delivers high-speed, low-latency broadband via low orbit satellites[11]. The biggest advantage of satellite-based internet over traditional telecom providers is greater coverage. Satellite networks can provide connectivity in remote, rural, or geographically challenging regions (mountains, deserts, oceans) where terrestrial infrastructure like fibre or cell towers are impractical or expensive to deploy.

Starlink relies on low orbit satellites, which require advanced materials, custom chips, and phased-array antennas. Each satellite is costly to build, launch, and maintain, with thousands needed for global coverage. Therefore, pricing for Starlink is extremely expensive vs the internet service provided by Indian telcos. Starlink has 4.6M global subscribers at present – which seems to suggest it has a niche subscriber base.

Fixed site/Fibre plans	Cost/Month (US$)	Speed (mbps)	Data allowance	Hardware cost (US$)
Starlink (Fixed site plans)	120-500	25-220	Unlimited	349-2500
Indian Telcos Fibre To The Home (Bharti, Jio)	2.3-101	10-1000	Unlimited	0
Indian Telcos Fixed Wireless Access (Bharti, Jio)	7.1-47.4	30-1000	1000 GB	0

Source: IIFL Securities

Satellite internet providers	ARPU (US$)	
Starlink	138	
Indian Telcos	**Mobile ARPU (US$)**	**Broadband & Fibre ARPU (US$)**
Jio	2.3	5.8
Bharti Airtel	2.5	6.7

Source: IIFL Securities

[10] Link

[11] Low Earth Orbit (LEO) satellites orbit at 500–2,000 km above Earth, offering low-latency, high-speed communication.

India has very deep mobile coverage, with top players covering 99.5% of the population and unlike many developed markets, rural India has higher population density, making rolling out mobile networks economical. So Indian rural areas are fairly penetrated which again reduces the use case of Satellite communication. Indian telecom providers offer high-speed, unlimited data at prices 80-98% lower than Starlink.

Therefore, Starlink may attract a niche elite in India who need 24/7 connectivity in areas not served by traditional telcos. It is unclear why Starlink should pose a threat in a value conscious market like India.

However, technological advancements and scale may dramatically reduce the pricing and speed offered by Starlink over time. There may be other services provided which we do not see or understand at present. We will track this closely. However, Starlink does not change our stance on Bharti Airtel at present. The bigger risk to the Bharti thesis is delayed ARPU increases via market expectations due to irrational pricing adopted by players to try and gain market share.

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We look forward to speaking with you on our Quarterly call on Saturday, 18th of January at 12 pm.

With our best wishes

Thank you for the trust,

Manish Gupta
Manjeet Buaria
Anirudh Shetty
Pratik Jain
Aman Thadani

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