5 Jan 22

Dear Partners:

Our quarterly notes are intended to share our thought process and explain actions taken over the last quarter.

In this letter we share

Key messages – believe in the India story but invest with realistic expectations

- Performance remains healthy. On a rolling 5-year basis, our preferred measure, our aggregate performance across all accounts is 25.6% post fees vs 16.5% for NSE 500, well above our 3% post fees outperformance target.
- We remain very optimistic on Indian equities from a long-term perspective. However, we reiterate that one needs to be realistic on return expectations over the next 5 years as valuation multiples should decline as monetary policy changes course and euphoric sentiment in the IPO market normalizes.
- The breadth of opportunities has expanded since September due to price corrections in many positions of interest to us.
- We continue to avoid overvalued themes such as IT and Consumer and remain optimistic on well-run Private Banks, Life Insurance cos, Steel Pipes, Flexi Staffing and Telecom.
- We have taken a new position in Axis Bank (Emerging Leader) this quarter to add to other well run Private Banks we own. Axis has amongst the lowest cost of funds which positions it very well to succeed long term. It is also transforming into a fundamentally more conservative franchise. Current pessimism can be explained by recent lower growth vs peers, some credibility deficit on not meeting an aggressive ROE guidance and a relatively new management team that is still settling in.
- Our Solara (Emerging leader) investment position has seen a sharp draw down from initial investment price. We explain our investment thesis on the tail winds for the API industry in India and why we believe Solara could emerge as the #2/#3 pure play API/CRAMS company after Divi's Labs.

Important Disclosures

- 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.
- We disclose position names for transparency and context. We reserve the right to change our minds and may not be able to inform you if we do.

Performance update

Aggregate across all partner accounts					
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception^**
SOLIDARITY	43.1%	38.7%	34.4%	25.6%	**23.4%**
NIFTY	24.1%	19.4%	16.9%	16.2%	**15.0%**
NIFTY500	30.2%	23.2%	17.8%	16.5%	**15.6%**
Data as of 31 Dec 2021 ^ From 11 May 2016 start date of PMS License. Solidarity performance is post all fees & expenses					

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

- TWRR per annum of 25.6% post fees.
- This is 9.1% per annum over NSE 500 post fees.

The need for realistic return expectations over the next 5 years

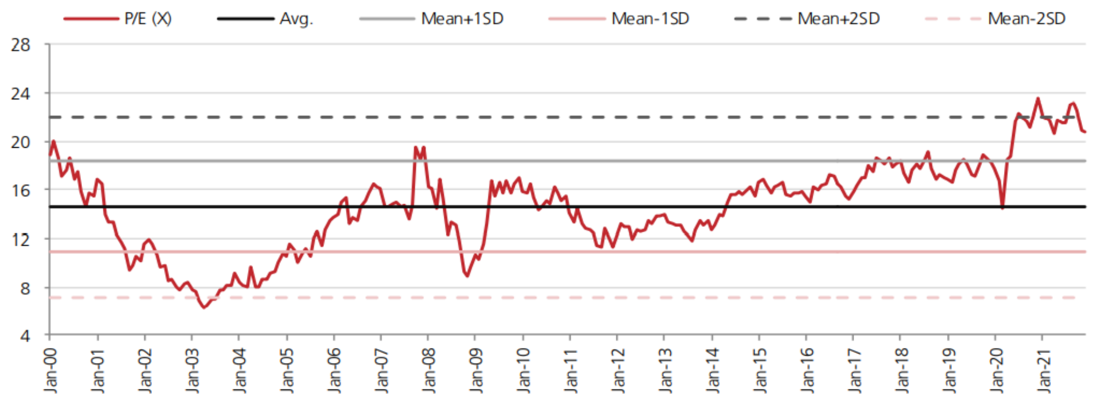
In our last letter we highlighted our belief in the Indian growth story but the high aggregate valuations as the reason why we believed we had borrowed returns from the future. We mentioned "we were cautious, but not bearish".

Key messages Q3 FY 22

- Very supportive monetary policy, that has aided Equity markets in the last few years, has started to reverse and will act as a drag on valuation multiples.
- Be optimistic on the India story but invest with realistic return expectations.
- Stretch time horizons – at minimum, keep a rolling 5-year time horizon – so Earnings compounding can absorb multiple declines.

Our optimism on India and the Earnings prospects of our portfolio companies remains unabated. However, valuation multiples in aggregate remain high with significant optimism already reflecting in prices (see chart below).

Exhibit 7: Full valuations for the Indian market
12m rolling forward PE of Nifty-50 Index, March fiscal year-ends, 2001-22 (X)



Source: Kotak Institutional Equities estimates

We believe that valuation multiples – in aggregate - should decline from current levels and act as a head wind on Equity returns.

- Fair value is principally a function of growth, ROE, interest rates and sentiment.
- Higher inflation will act as trigger for reversing Central Banks' monetary stance and interest rates should gradually rise.

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- Euphoric behaviour of participants in private markets and IPOs, which when corrects, may act as a dampener for sentiment.

Monetary policy is reversing course as rising inflation is no longer seen as transitory

Developed world Central Banks have kept interest rates low for over a decade to boost growth and employment, but inflation is now becoming a greater concern to policy makers. The US Fed has accepted that inflation is no longer “transitory”. Key Central Banks in the developed world have started a reversal of easy money policy.

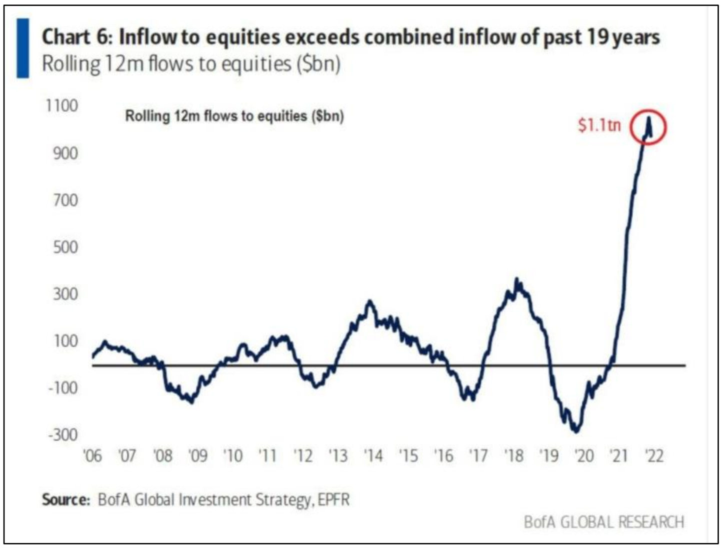
Medium term inflation is hard to estimate because of multiple factors at play – when the pandemic will end, how withdrawal of easy monetary policy will affect demand, the pace at which the supply side grows in areas such as shipping, oil, semiconductors etc.

Our base case is that inflation will be higher than the past few years and interest rates will gradually be raised to combat it. Yield on 10-year G Secs in India is almost at pre Covid levels. The pace of rise in interest rates may be gradual as monetary policy is now very sensitive to need to support growth and employment creation and that too rapid a rise can derail economic recovery.

The pessimistic scenario is stubbornly high or a sharp increase in inflation in the developed world. This will likely result in a very sharp increase in interest rates which could result in stagflation and will be very negative for Equities from the triple impact of a demand shock, higher discount rates and “U” turn in change in sentiment. If one believes in this scenario, one should preserve liquidity in short term debt instruments for more favourable entry points. This is not our base case scenario. In fact the 10-year US G Secs have barely budged and are below 2% despite the significant rise in inflation. However, this risk should not be ignored and needs to be managed by Asset Allocation.

Conditions are ripe for valuation multiples to decline.

Higher interest rates imply higher discount rates[1]. Everything else remaining the same – higher discount rates mean lower valuation multiples. Additionally, as generous liquidity support is withdrawn from the developed world, the stimulus to global risk assets from liquidity will fade.



[1] Discount rate is the minimum return an investor is seeking which is typically determined as yields on long term sovereign bonds + a risk premium for owning Equities.

While the euphoric sentiment in private markets and IPOs should moderate

Venture capitalists bet knowingly on unproven business models. The belief is that with growth in users, an economically viable model will follow. However, now excesses are being committed with investor successes being celebrated (# of companies with Unicorn valuations status) even as business successes (viable economic model) are a question mark.

The celebration of Unicorn status with no regard to cash flows is summed up brilliantly by Assem Dhru, the founder of SBFC Finance who wrote recently on LinkedIn "Today if you are not building a Unicorn, you are building a Donkey. It's easy to forget that the Unicorn is a mythical creature while a donkey is real, moves slow, but keeps plodding away."

We are not "luddites" who are dismissive of technology trends and potential disruptors. On the contrary, "Digital" is a mega theme of immense interest and we own IndiaMart, a digital classifieds company.

However, we need to be mindful of stories alone. We wonder what the unmet consumer need is in a 15 min grocery delivery over a 2 hour one? Narratives need to be accompanied by a defensible edge/uniqueness that cannot be easily replicated and a path to profitability supported by reasonable ROE. Great businesses are built on the support of their own cash generation and not through endless investor infused cash that funds user acquisition with the assumption that scale will translate into cash flow.

The euphoria in private markets is now spilling over into public markets. Many of these "new age" companies are run by excellent promoters who targeted an unmet need. We salute them for what they have built. However, they have listed too early, at outrageous valuations and with no clear road map to profitability while more competitors are entering their addressable market. Consider two examples.

- PayTMs core value proposition is payments, which are free in India. PayTMs path to profitability is premised on the belief that it can charge its user base a fee for purchase of other financial products and services. However, users now have the choice of multiple financial platforms. PayTM bleeds (Q2 EBITDA at -425 Cr) but its IPO was priced at a valuation of ~140000 Cr. Airtel Payments Bank – not a like to like comparison but with many similarities in product offerings - is breakeven and its valuation are not even considered by analysts in Bharti Airtel valuation[2]. What premium should one pay for option value when the business model lacks uniqueness/scarcity and there is no visibility to break even?
- Policy Bazaar is an omnichannel Insurance and Financial products broker. The "Fin Tech" play is a stretched narrative. It will use IPO proceeds to develop a physical channel. Policy Bazaar is competing with Banks and Insurance cos as it encourages price competition. Bajaj Finance, with over 49M customers is also launching an Insurance marketplace. Some Insurance companies eg ICICI Lombard have delisted themselves from the Policy Bazaar platform as they fear excess price-based competition leaves no room for them to differentiate. Policy Bazaar is loss making at present. Assuming 10 years out, the business generates a 15% PAT margin and is valued at 30x PAT, it would need to grow Revenue ~45x from FY 21 base to deliver investors a 15% IRR from its IPO price. The Total Addressable Market may be large but what optimism on growth, competitive intensity and margins are stock prices reflecting?

[2] Kotak sold its stake in Airtel Payments Bank to Bharti Enterprises in Sep 2021 at approx. valuation of 3400 Cr https://economictimes.indiatimes.com/markets/stocks/news/kotak-bank-to-sell-20-cr-shares-of-airtel-payments-bank-to-bharti-enterprises-for-rs-294-cr/articleshow/85789854.cms?from=mdr

IPOs tend to be pushed through on the strength of narratives via high decibel marketing. Many anchor investors and HNIs aim to flip on listing rather than invest with intent to hold long term. This supposedly “easy money” attracts new participants to this game. “Nothing so undermines your financial judgement as the sight of your neighbour getting rich (JP Morgan)”. As speculative excesses unwind, and it’s a matter of time when they do, the brunt of losses will be borne by retail investors, many of whom are young, very new to this game and have never experienced a down cycle. This could have broader implications for sentiment.

What could returns be from here over the next five years?

A natural question partners may have is what return expectations are realistic? We share two frameworks one can use to arrive at broad estimates for the Index.

In an excellent note by DSP Mutual Fund[3], they shared a chart (enclosed below) of data analysed since 2005 of future NIFTY returns from various valuation entry points.

NIFTY 1 Yr Fwd Price/Book range	Average Forward returns (CAGR)		
	1 Year	**3 Year**	**5 Year**
1x – 2x	59.2%	19.8%	15.5%
2x – 3x	12.6%	9.4%	10.5%
>=3x	4.0%	5.6%	4.8%

Note: we are at ~3.1 one year Forward Price/Book today.

It is hazardous to extrapolate from the past especially when the economy is poised to step up growth rates, companies have become more efficient, the composition of the NIFTY has evolved and long-term interest rates at present are significantly below 15-year averages. Hence, we would be a bit more optimistic than the average forward 5-year returns indicated above.

Another way to estimate returns is to assume the NIFTY can grow earnings between 13-15% CAGR over the next 5 years and adjust for some decline in valuations. Market Cap to GDP is ~125% today vs last 10-year average ~80%. Based on a combination of the above, we estimate 10-12% IRR for the NIFTY.

We hope to beat the NIFTY by at-least 3% post fees as we are active managers, can stay away from overvalued pockets and take more concentrated bets.

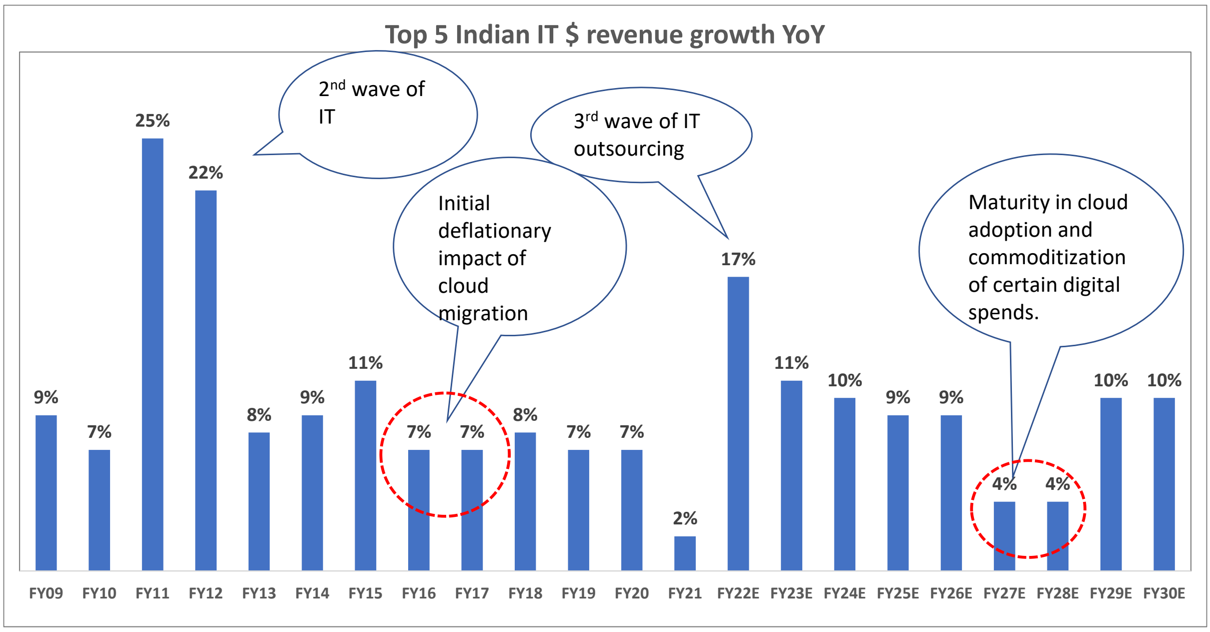
Rationale underlying portfolio construction at present

Partners may observe we continue to have no allocations to Consumer[4] and IT Services in the core portfolio (Clear and Emerging leader) as valuations here are extremely rich.

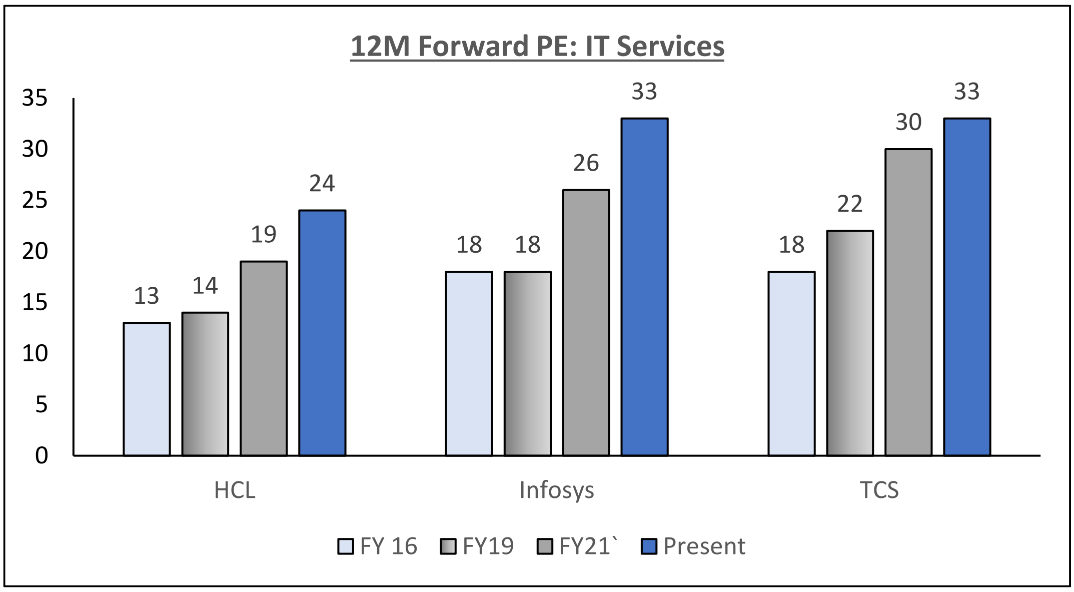
IT Services spending undergoes cycles where periods of high spending is followed by lower spending (see chart below). Moreover, we believe current margins will continue to trend lower over the next decade as they did in the last decade even if at a lower pace. However, valuations are stretched due to the high IT spends visible at present as the catch up to Digital preparedness is happening. We will be wrong here if IT spending remains elevated for a prolonged period. However, our goal is to allocate capital to earn an acceptable return. We should not fear missing out if that capital can be deployed productively elsewhere.

[3] DSP MF - 2022, Shooting for the moon

[4] ITC is a special situation position.



Source: Goldman Sachs Global Investment Research



Source: Kotak Institutional Equities

Consumer company stock prices have benefitted significantly in the last few years from valuation multiple expansion from lower interest rates and the scarcity of Earnings growth in other pockets of the economy. Both these conditions are ripe for reversal. Mature growth with high probability of multiple correction suggests that Consumer companies could generate below Index returns in the medium term.

12-m forward PE multiple	Mar-15	Mar-17	Mar-19	Mar-21	Current
Britannia Industries	38	38	53	49	48
Dabur India	35	33	40	49	49
Godrej Consumer Products	31	37	38	40	48
Hindustan Unilever	40	41	50	59	54
Marico	35	41	39	40	46
Nestle India	44	47	51	68	72
United Spirits	90	53	43	40	61
Asian Paints	38	45	51	63	75

Source: Kotak Institutional Equities

Consumer and IT Services are linear earnings growth companies with no undiscovered option value. Hence, PE multiple comparison across time is a fairly simple way of gauging how valuations have evolved. Use of FCF multiples across time will show the same result as FCF/PAT conversion rates do not change significantly over time.

We find many other themes where we believe returns over the next 5-years can be promising, even after allowing for some multiple compression. Private Banks, Life Insurance, Animal Healthcare, API, Flexi Staffing, Steel Pipes, Auto Components and Telecom are some of the sectors which offer reasonably attractive return opportunities.

Well run private Banks

We believe the threat from Fin Tech's to well-run Banks will lead to some ROE decline from pressure on Fee Incomes, but is not disruptive. The addressable credit opportunity is very large and most of the lending being done by Fin Techs at present (Peer to Peer, Buy Now Pay later) is subprime lending with a fancier name. The credit cost of Fin Techs suggests poor resilience and high fragility in their business models.

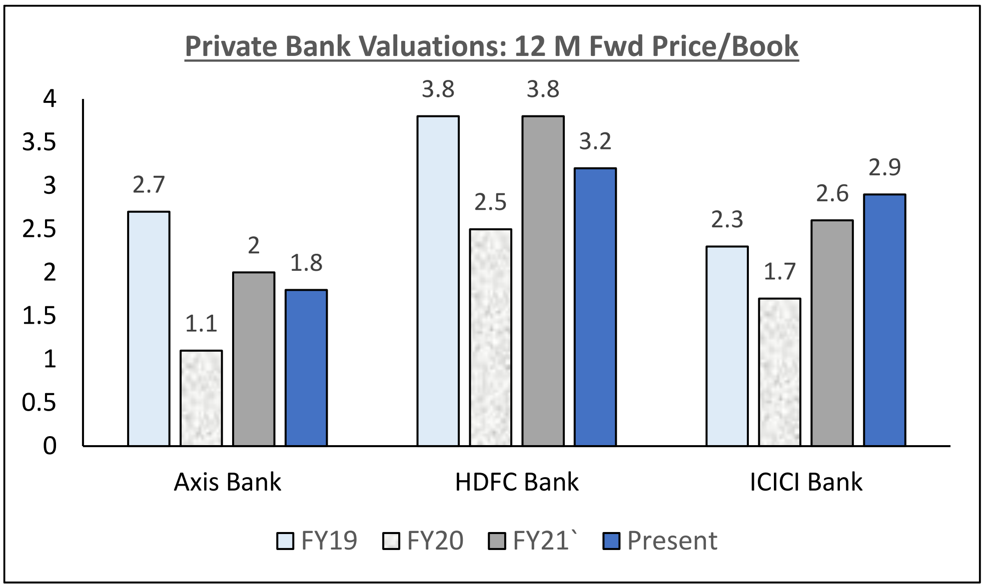
Fintech	Business Line	Asset Quality
PayU Finance	BNPL (Lazypay) and personal loans	FY21 GNPLs at **19%**. FY21 credit cost at **11%**
Mobikwik	BNPL	FY21 credit cost at **20% of GMV**
KrazyBee	BNPL	9MFY21 credit cost at **10%**. As of Feb 21, restructured portfolio is at **19%**
CapitalFloat	BNLP (Amazon PayLater), SME financing	1HFY21 credit cost at **11%**
Simpl	BNPL	FY20 credit cost at **150%** of revenues
LendingKart	Unsecured SME loans	FY21 credit cost at **7%**. Restructuring at **20%**

Source: Company data, Macquarie Research, December 2021

We believe that Financial Services will continue to be more tightly regulated in India vs the developed world and any regulatory arbitrage Fin Tech's enjoy will disappear[5] . There will be more partnerships rather than disruption. Read our blog on the threat to private Banks from Fin Tech here.

The disruptor narrative on Fin Tech's has captured people's imagination and perhaps led to valuations of well-run Banks trading at/below pre Covid valuations (ICICI an exception) while the broader market has witnessed valuation expansion. This is despite signs of revival in economic growth, uptick in credit growth, revival of the Cap ex cycle, much stronger capital positions and well provisioned books. And Banks should do well in a rising interest rate environment.

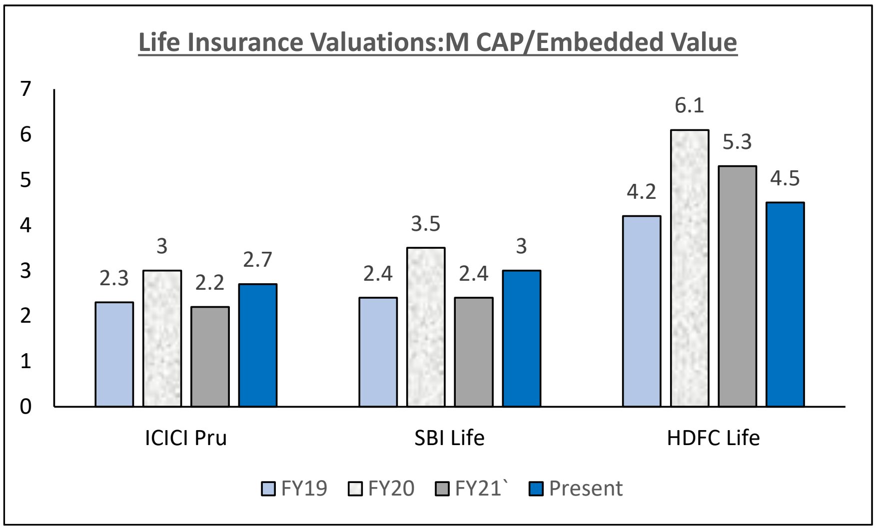
[5] FinTech regulation must be entity based: RBI Deputy Governor on Fintech Regulation



Source: Kotak Institutional Equities

Life Insurance

Life Insurance companies are at a very early stage of their life cycle both as the protection gap in India is still large at 83% and there is a growing need for a solution for Pensions. Less than 10% of Indians who file Income tax returns own Term protection and there has been a 5x jump in the last 5 years of consumers earnings above USD 2000/capita[6]. We believe this is a very high moat business with trust (brand) and banking partnerships (distribution) key to success. Moreover, Life Insurance is a high gestation business (12 years to break even) all of which combine to provide a very favourable industry structure and limited threat from Fin Tech's. Hence, the leaders will continue to get stronger and can enjoy high growth longevity. Valuations here too are at pre Covid levels[7], perhaps due to concerns on excess mortality due to Covid. This is a very good buying opportunity because any excess mortality is a one-off event and does not affect the fundamental value of the franchise and investing in the early stage of an industry life cycle allows valuation errors to be easily absorbed by growth.



[6] Source: ICICI Pru MF
[7] Solidarity Analysis

Any changes need to be made to the portfolio if there is higher inflation?

As we seek compounding, we construct all weather portfolios – boats that will be resilient in any storm. So we would not need to change the portfolio to optimise for macro variables. We believe our portfolio composition Earnings will be resilient in the event of higher inflation in the medium term even as some companies may face short term Earnings head winds as raw material prices are passed with a lag.

Should one wait for better entry points?

In the long term, "stock prices are slaves to earnings". As Indian companies grow profits, stock prices should climb higher unless of course one has paid outrageous valuations. If one has a long-term view on Equities, the bigger risk is missing out because one keeps waiting for a correction. Hence, we will act when entry prices offer a road map to acceptable returns rather than keep waiting for more favourable prices while accepting that one may see lower prices. There is no position we hold where a significant draw down would alarm us as we do not buy fragility. At the same time, we will hold cash if we do not find opportunity as we do not believe in the approach of a model portfolio where a set of names are bought at the prevailing price.

In the next section we do deep dives on our Investment thesis for Axis Bank and Solara Active Pharma

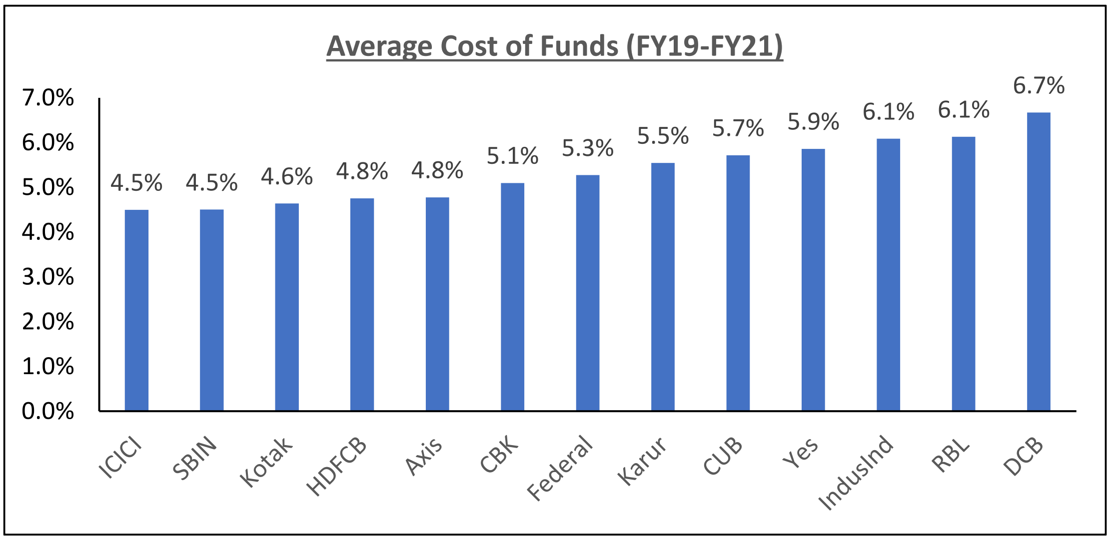
Axis Bank (Emerging Leader)

Partners are aware that we already own ICICI Bank, HDFC Bank and Kotak Bank as our core Banking positions.

Why add a 4th Bank? Banking is not a winner takes all business. The RBI ban on issuing of additional credit cards (now lifted) and repeated technology outages at HDFC Bank is a reminder that one never knows where risk lurks. If there is opportunity for multiple players to do well, one should spread the risk.

We believe Axis is amongst the 4 private Banks in India that has the right to win long term. It offers opportunity for long term compounding but where entry valuations are significantly in favour in a richly valued market.

The principal value of any Bank lies in its deposit franchise. A bank's Cost of Funds (COF) determines its right to win long term because it can choose the risk it wants to underwrite. If COF is not in the top decile, you are doomed to a vicious cycle of pursuing higher risk segments which eliminates resilience during a crisis. And it takes time to build a superior COF position. Low valuations accompanied by high COF is a high probability value trap. As one can see from the chart below, Axis's deposit franchise is amongst the best in the business, even as it has ceded some ground to its peers in the last few years.

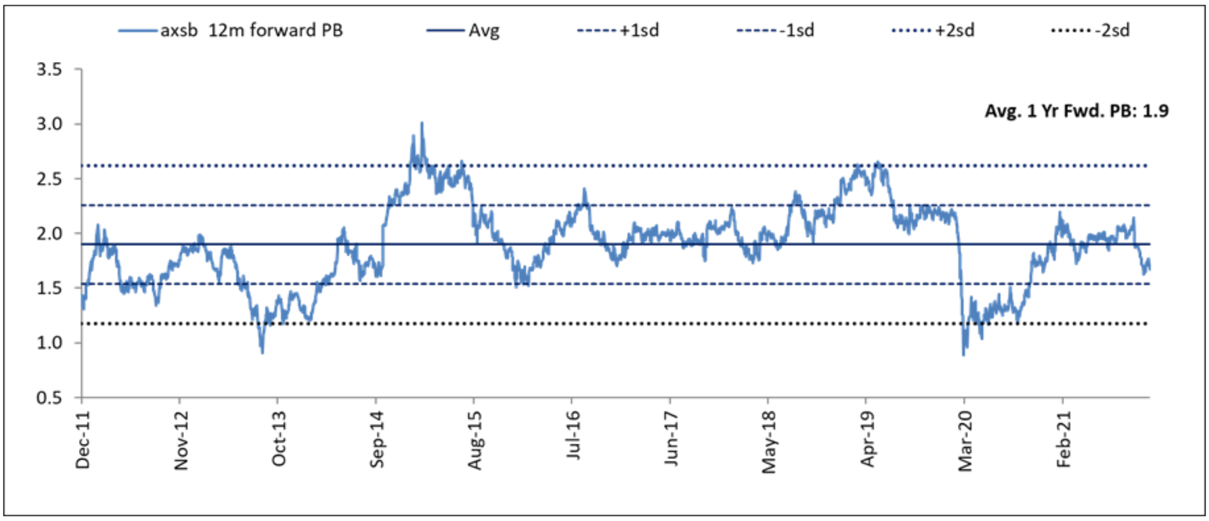


Source: Spark Capital

Financial institutions are like icebergs as the true risks in their Balance sheets are not well disclosed. Hence, a conservative mindset in credit and credibility on reported NPAs is key. Under new leadership, Axis Bank is undergoing a transformation to a fundamental culture of conservativeness with a more prudent provisioning policy, more granular loan book being built and prioritizing credit discipline over growth.[8]

[8] As on 30 Sep 2021, total restructured loans for the bank stood at just 0.7% of loans, whereas the BB and below exposures are further ~1% of loans. Restructured loans as % of respective loans across segments are 0.7% for corporate, 0.8% for retail and negligible for SME. Provision coverage on overall restructured book is 24% with 100% cover on all unsecured retail.

Why is the stock trading at close to 1 std deviation below mean valuations in a raging bull market?



Source: Bloomberg

- Axis was seen as a superior franchise to ICICI Bank till a few years ago with much lower cost of funds but ICICI Bank has now pulled ahead with more granular lower cost deposits and higher NIMs.
- Axis leadership does not seem as well settled as its peers. The top deck comprises people mostly hired from outside the bank with very low tenure at Axis vs peers. The average tenure within the group of the top leaders at Kotak, HDFC Bank and ICICI Bank is well over 20 years.
- This has led Axis to miss growth opportunities such as the one created when HDFC Bank was stopped from growing in Credit cards by regulators. And hence Axis has reported far lower growth than other Banks in H1 of this year.
- Moreover, there is also a credibility deficit that needs to be bridged. The CEO mentioned an 18% ROE target by 2022 (a CEO's aspiration is Dalal street guidance) at the start of his tenure and the bank is far from that number at present.

Despite the above, we believe Axis Bank at present provides a compelling opportunity as this pessimism is being reflected in valuations (one std dev below mean) while growth is looking up. Hence, Axis offers a rare combination of both growth and valuation re rating.

- While ICICI Bank is a superior franchise at present, (it is also our 2nd largest position), we believe that 5 years from now Axis Bank can be a 15-17% ROE business while growing Book value per share at 15%+. The bank's transformation journey is perhaps two years behind ICICI Bank, and it is well positioned to gain market share in the Banking system from weaker players.
- We don't worry about short term growth rates in credit, and these can be especially misleading in Banks when cautiousness may be prudent in an unpredictable environment. And a leadership team which is reorganizing itself after a period of credit losses will understandably be more cautious in underwriting risk. That is not a structural issue in our opinion and growth rates will inch up over time.
- The management team is not in denial as can be seen from a recent interview of Amitabh [here](#) where he concisely lays out the work to be done for Axis to catch up with its peers.

In our optimistic scenario, we assume Axis valuations re rate over time to one standard deviation higher than mean. In this scenario, the returns could be closer to what one has seen in ICICI Bank

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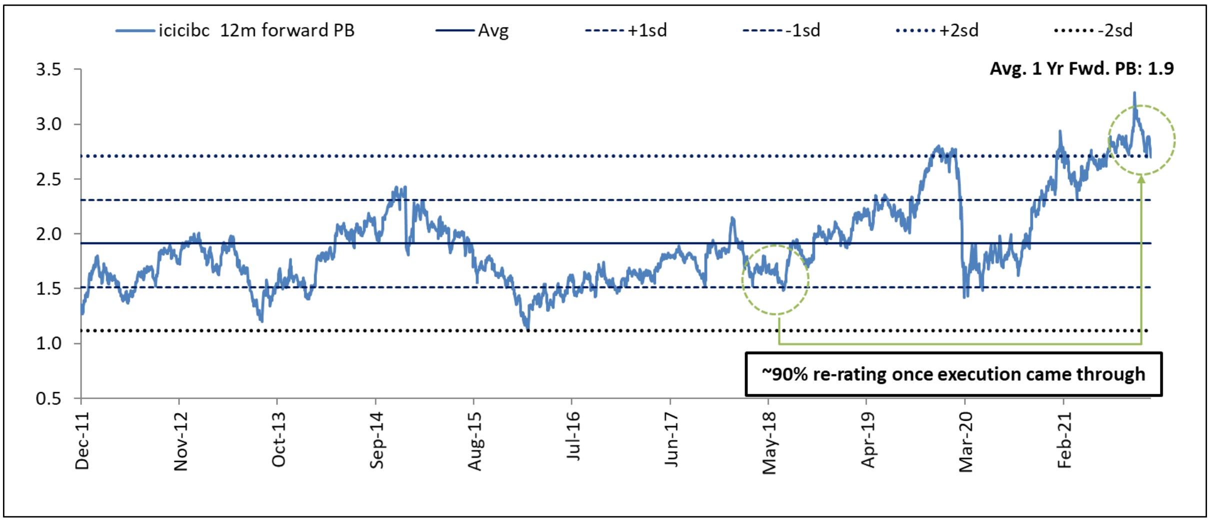
over last 3 years. When sentiment changes, multiple expansion happens swiftly (see chart below). However, markets tend to wait for certainty. Therein lies the opportunity as you can get superior outcomes by ignoring the herd if you are willing to bear short term pain and not play momentum. It was only 3 years ago that ICICI Bank was derided for having a fundamentally flawed culture and now ICICI Bank seems to be the consensus pick for the Banking stock of the next decade.



Source: Bloomberg

In our pessimistic scenario, Axis Bank's transformation remains incomplete, and its deposit franchise weakens. Or it is unable to gain market share on Assets. This could happen if the Axis senior leadership team is not stable. In this case while returns in Axis Bank will be poor, the beneficiaries of its challenges will be the other three private Banks (ICICI, HDFC, Kotak). Hence, as a portfolio play, we will do fine as we are also participating in the others quite meaningfully and they would then generate significantly better returns than our base case estimates.

Solara Active Pharma (Emerging Leader)
Solara has a strong Pharma API[9] and an emerging CRAMS[10] business. It has recently announced a merger with Aurore, a privately owned company in the API/CRAMS space. Pharma API is a USD 180B industry globally of which India has ~ USD 4B share. The developed world has been outsourcing manufacturing and India now has the additional tail wind of the developed world wanting to de risk from China (USD 35B).

Barring Fermentation based products, India has a chance to capture a larger share of the global API market. We believe the API industry should continue to do well and that Solara/Aurore could become the #2/#3 pureplay API and CRAMS company in India after Divi's Labs. As this is a regulated industry with significant risk of supply chain disruption, cost is not the primary consideration when choosing partners. The need for reliability in supply base means well run companies should be able to generate 18-20% ROE.

Solara ticks many boxes on what it takes to win in API.

- Regulatory and ESG compliance track record: clean track record except one "Official Action Indicated" at its Cuddalore plant which was not linked to quality issues in their plant but to a global issue with impurities in Ranitidine.
- Non-compete business model: Solara is a pure play API company that does not compete with its customers in formulation and has relationships with many Big Pharma customers.
- Scale and supply chain redundancy. Customers want to work with larger players in an industry that is heavily regulated by the US FDA. Solara has 8 plants, and all its key products have dual filing
- Product dominance: Solara has a strong position in some products (Ibuprofen, Gabapentin), good customer credibility (some customers paid advances to block capacity in its new Ibuprofen plant). Over 60% of revenue comes from long term contracts.
- Focus on lowest cost position: Investments in a new more automated plant at Visakhapatnam and continuous focus on backward integration in a few products to maintain lowest cost position. Merger with Aurore will provide additional cost synergies.
- Wide product basket: A wide product range that reduces compliance headaches and supply chain complexity for customers and enables cross sell. Solara has over 60 products and files for 10-12 new products every year. DMF filings have increased from 130+ at end of FY18 to 180+ currently. Aurore brings an additional 40 products into the offering
- Downstream migration: Solara's CRAMS business is <10% of its total business at present and the company is investing to increase its share in the overall mix. CRAMS is a more value-added component vs API.

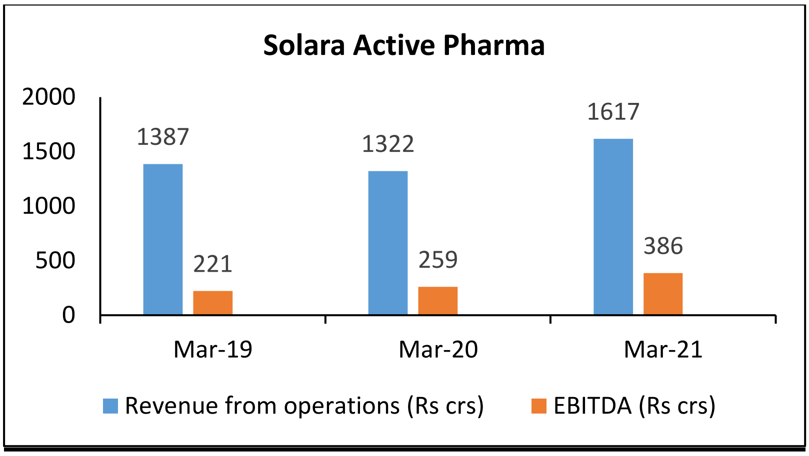
Solara has improved its financial performance over the last few years.

- Revenue CAGR (FY18 to FY21) is ~16%.
- EBITDA margin has expanded from 15% in FY19 to 24% in FY21.

And is stepping up R&D investments.

- Increasing R&D pipeline of new DMFs to 30/40 a year from about 10/12 at present
- Investing in new technology platforms
- CRAMS business is expected to grow >50% this year (though on a low base)

[9] Active Pharmaceutical Ingredient (API) is the component of a drug product (tablet, capsule, cream, injectable) that produces the intended effects.
[10] Contract Research and Manufacturing Services



Merger with Aurore will create a stronger franchise.

- Aurore and Solara have complementary products and geographies. This increases possibility of cross sell of products into each other's customer base. For example, Aurore has a much stronger presence in CRAMS in Asia Pacific and APIs in less regulated markets.
- Aurore has a more advanced CRAMS franchise.
- The business will be run by a promoter with skin in the game, track record of building API companies and interests aligned with minority investors for value creation
- Merger will bring revenue and cost synergies and more focused product development. Management has alluded to 150-200 Cr synergies.

<u>We believe Solara-Aurore can continue to grow EBITDA at 15%+ for the next decade</u>

Our numbers assumption is the merged entity can generate ~1100-1200 Cr EBITDA by FY27 from ~525 Cr (combined) in FY21 through a combination of growth and cost synergies and a larger API platform should be valued at about 12-15x EBITDA.

We believe these are reasonable assumptions as the Indian API industry has grown revenue at ~13% and EBITDA at ~17% over the last decade. "China+1" is now an additional tail wind and most players have stepped up capital expenditure reflecting their confidence in prospects.

Company	**Revenue CAGR**	**EBITDA CAGR**
	FY11-FY21	**FY11-FY21**
Aarti Drugs Ltd.	16%	20%
Anuh Pharma Ltd.	9%	10%
Divi's Laboratories Ltd.	18%	19%
Ind-Swift Laboratories Ltd.	-2%	1%
IOL Chemicals And Pharmaceuticals Ltd.	18%	24%
Mangalam Drugs And Organics Ltd.	12%	16%
Neuland Laboratories Ltd.	9%	12%
SMS Pharmaceuticals Ltd.	9%	12%
Weighted average	**13%**	**17%**

With stronger tail winds, and the investments being made to strengthen the franchise, Solara-Aurore are well positioned to grow even faster than the last few years. Under an optimistic scenario, If the CRAMS business can become meaningful, currently ~10% of revenues, there should be a meaningful upside to our growth and profit expectations as CRAMS is a higher margin and return on capital business.

So what has gone wrong since we first bought?

- The company reported poor Q2 results as sales of its key product, Ibuprofen (needed for pain and fevers) declined as Covid reduced demand. Lock downs meant fewer injuries and masks resulted in fewer people catching fever, even as customers had over bought earlier to stock up on inventory.
- The focus on regulated markets resulted in Solara ignoring less regulated markets for Ibuprofen and hence was not able to divert production to other markets. This resulted in both a drop in revenue and pressure on margins as sales in less regulated markets were made at lower prices.
- This was made worse by the fact that the management had committed the cardinal sin of over-guiding and under delivering. High expectations were met with a negative surprise.

In hindsight, we overpaid at our first entry price of about 1500/share. However, at current prices of about 1100/share, valuations at ~11x FY 21 Operating Profits/Enterprise Value are attractive. Inventory correction issues are not structural and will be solved over time. The stock price correction provides us an opportunity to add to our position.

Some of our best returns have come from positions which have corrected 20% after our initial buy. The learning for us from past experiences is not to buy too much too soon in a position when short term financials can be weak. Markets tend to wait for certainty and multiples re rate only when there is more visibility of earnings. We have a 4-5% position at present and intend to add to this position gradually over time or if we get significantly lower prices from here.

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While investment advice on the "right way" is confusing in seemingly benign conditions, the noise will be louder when a monetary policy regime change is underway. <u>All investment advice needs to be interpreted with personal context to objectives, process, and time horizons.</u> There are trade-offs with every approach and what seems smart in the short term may not be right long term. While one needs to keep an open mind on course corrections, one also needs to stay "in one's lane" and not stray from one's core to chase short term opportunistic gains. "All the benefits in life come from compound interest - relationships, money, habits[11]". We will always think exclusively long term.

We look forward to speaking with you at 12 PM on the 15th of January.

With our best wishes and gratitude for your trust,

Manish Gupta	Manjeet Buaria	Anirudh Shetty
Chief Investment Officer	Principal	Principal

[11] Naval Ravikant