7 October 2024

Dear Partners:

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

Key messages.

- Our portfolios have done 21.2%+ TWRR in the last 5 years vs 22.4% for BSE500TRI and 17.6% for NIFTY50.
- Have faith in India but temper return expectations. Markets are significantly above fair value. We estimate a ~10-11% IRR decade for the NIFTY due to mean reversion in valuation multiples and lower for the BSE500.
- Re-iterate our commitment to "resilience over speed" and following a "concentrated" approach.
- A fair portion of our positions are also at valuations which seem a bit silly. However, we would not exit these as they are very well positioned for longer term earnings growth. What seems euphoric today may not seem so in hindsight. Taking cash off for small gains and attempting re-entry is not a prudent approach.
- We explain why trailing PE is only useful for companies with linear growth prospects, late in growth life cycle and could be misleading in many instances.

Topics

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.
- Past performance does not guarantee future results.

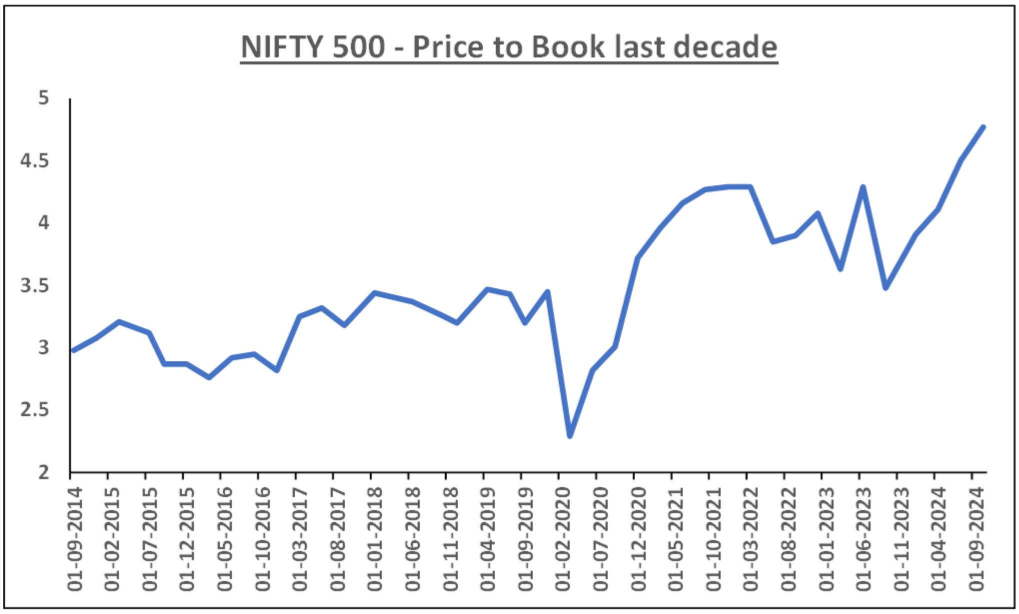
Performance update

Period	Solidarity PRUDENCE performance %	BSE500TRI performance %	Alpha % over BSE500TRI
FY17^	18.0%	22.3%	-4.3%
FY18	19.2%	13.2%	6.0%
FY19	6.8%	9.7%	-2.9%
FY20	-15.6%	-26.5%	10.9%
FY21	98.4%	78.6%	19.8%
FY22	26.5%	22.3%	4.2%
FY23	-8.9%	-0.9%	-8.0%
FY24	20.3%	40.2%	-19.8%
FY25 YTD	21.9%	20.2%	1.7%
Last 5 years	**21.2%**	**22.4%**	**-1.2%**
Since PMS Inception^	**18.8%**	**18.2%**	**0.6%**
Anchor since inception*	**20.8%**	**17.2%**	**3.6%**
^ From 11 May 2016 -Start date of scheme			
* From 1 May 2014			
Data as of 30 Sep 2024			
Returns are post fees and expenses			
Performance data provided in the above table is not verified by SEBI			

Our performance last few years has been affected by some errors in the period 2022 (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.

Have faith in India, but temper return expectations

In our last letter we indicated we were not finding adequate width of opportunity at prices and position sizes we were comfortable with. That stance has not changed. Valuations (in aggregate) in India continue to be significantly above fair value.



In Q2, the markets have climbed higher with the NIFTY500 climbing an additional 8% in Q2 FY25. In September, sentiment was boosted by the US Fed cutting short term rates by 50 bps and from the massive stimulus announced by China.

Valuations have been stretched particularly by excesses in some pockets of Small and Mid-Caps. These have commanded the lion's share of new inflows, a lot of which are valuation agnostic- creating a virtuous cycle. Flows resulting in higher NAVs, in turn driving higher flows.

Retail investors are pouring money into mid/small-cap. and thematic funds in India

Exhibit 2: Net inflows to various categories of domestic mutual funds in India, calendar year-ends, 2020-24 (Rs bn)

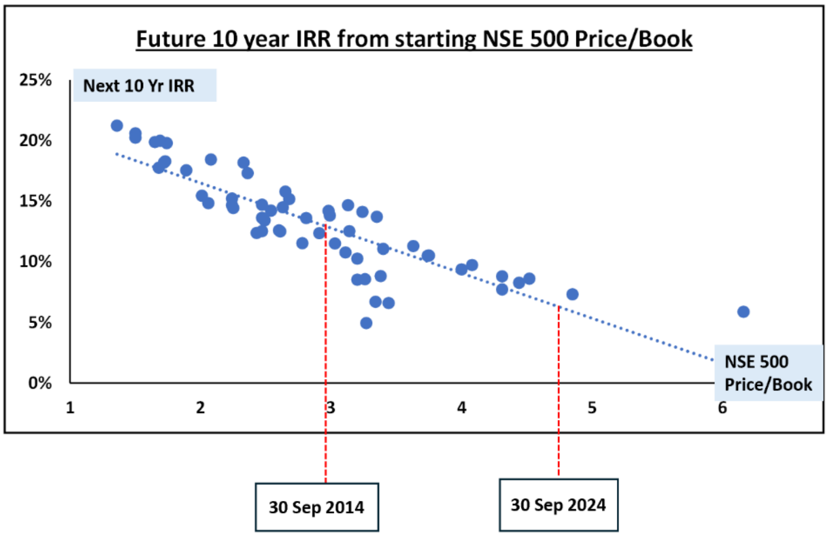
	2020	2021	2022	2023	Jan-24	Feb-24	Mar-24	Apr-24	May-24	Jun-24	Jul-24	Aug-24	CYTD24
Flexi cap. fund	-	179	220	116	24	26	27	22	32	31	31	35	228
Large cap. fund	(24)	29	137	(30)	13	9	21	4	7	10	7	26	96
Large & mid Cap. fund	18	87	200	189	23	32	32	26	24	29	26	33	226
Mid cap. fund	5	106	205	229	21	18	10	18	26	25	16	31	165
Small cap. fund	14	38	198	410	33	29	(1)	22	27	23	21	32	186
Sectoral/thematic fund	83	255	209	308	48	113	79	52	192	224	184	181	1,072
Value/contra/focused	(3)	60	184	92	16	13	18	17	11	17	16	16	124
Dividend yield/ELSS/multi cap. fund	(3)	213	258	300	40	28	39	29	28	48	71	28	311
Total	**91**	**967**	**1,610**	**1,616**	**218**	**269**	**226**	**189**	**347**	**406**	**371**	**382**	**2,409**

Source: AMFI, Kotak Institutional Equities

<u>A common question we get is about outlook for future returns</u>

Future returns are a simple Mathematical derivation: Change in Earnings Growth * Change in valuation multiple + dividends. While there are reasons to justify some premiums for India vs historical long-term averages, valuations multiples – in aggregate - should decline. This implies that returns in the coming decade in India will be lower than the previous decade.

What is a realistic number? The future is unknowable. However, one can make a guesstimate. Aggregate earnings could grow 12-14% CAGR (slightly above nominal GDP) but should face drag of multiple decline. Hence, our considered estimate of IRRs next 10 years for the NIFTY is in the range of ~10-11%, slightly below nominal GDP growth[1]. Returns for the NSE500 may be lower due to far more elevated starting valuations. *See chart below.*



[1] Data in the chart of NSE 500 returns from starting Price to Book is quarterly from 31 Mar 2000 to 30 Sep 2014, sourced from Ace Equity.

Implications

Realistic return expectations.
Our approach remains to not over-reach on risk but target 15%+ IRRs with longevity and beat the BSE500TRI by 1.5% per annum post fees. We feel good about achieving this goal, barring a tail risk event. Note, we have returned 20%+ IRR in the previous decade and while there are no guarantees, we are aligned in underlying positions with complete skin in the game.

We re-iterate our commitment to "resilience over speed" and following a "concentrated" approach
On our long voyage, storms are certain. One must be on resilient boats. Resilience (sturdy boats) result in a drag on speed and this is why "Quality"[2] companies tend to underperform in a raging bull market when risks are an afterthought. But resilience should deliver over longer periods of time as one what loses in speed during euphoric periods, will be made up by stamina (more consistent earnings compounding) during difficult time periods.

And as a boutique, we don't need to feed a beast, especially as we believe in taking concentrated bets. We need ~15-20 well researched ideas from 5000 listed companies. We are willing to take material positions in smaller companies where larger firms may not be able to invest. And there are quite a few positions in the portfolio where Solidarity owns over 5% of the free float. *In the section below we share an example of RACL Gear Tech, ~1050 Market Cap company which has no MF or FII shareholding at present.*

Why not take cash calls at present?
A few of our positions are at valuations which look a bit silly. We will not buy them at these valuations due to lack of margin of safety. And we have trimmed some very overweight positions in select cases, (>10% in an account).

However, they are also not at prices at which we would want to book profits and sit on cash. A mature mind should balance two opposing constructs: while these positions could correct deeply any time, it is not in our long-term interest to try and dodge this bullet to play for short term gains, especially if positions are early on growth life cycle.

Fair value assessment for companies at the early stage of life cycle, with prospects for exponential growth and where the business model is not easily replicable requires a lot more nuance. The human mind finds it very hard to process duration. Short-term valuation metrics are misleading, and one could make the mistake of exiting prematurely and miss a winner which can make a huge impact on overall portfolio returns.

Consider two examples. GLP-1[3] drugs are a big opportunity for Shaily, Battery Chemicals for Neogen. Neither of these opportunities was visible 3 yrs ago but each of them by FY29 could generate 3-4x the total revenue of these companies in FY24[4]. GLP-1 drugs go off patent in various markets starting FY 26 and could become mainstream, where Shaily is the key filing partner for many generic pharma firms. The Inflation Reduction Act means Neogen has a shot at a reasonable market share in the US market for Electrolyte Salts which Chinese players cannot serve and could have 65-80% market share

[2] Our definition of "Quality" is a business model that can deliver ~18%+ sustainable ROE with moderate leverage, promoter that thinks long term, prioritizes resilience over speed and aligns interests with minority shareholders. Our entire portfolio is in businesses that will benefiting from tailwinds and hence will be secular growth, industry leaders/dominate niches, and expanding moat/edge.
[3] GLP-1 drugs, also known as glucagon-like peptide-1 receptor agonists, are a class of medications used to treat type 2 diabetes and obesity
[4] Solidarity estimates

in the Indian market for Electrolytes. Additionally, both these companies have real visible options of new business lines. Shaily is working on Consumer Electronics and Neogen is already generating revenue from Semi-Conductor Chemicals – both of which could become additional meaningful contributors of revenue 5-10 yrs out. Hence, there is a credible hypothesis that their profits could be 10-12x of today in 10 years. What seems euphoric and silly at present basis trailing multiples, may not be so in hindsight if they keep executing well and re-investing in growth.

Broadly, if a company has a high trailing valuation, but we believe there is potential for longevity or an Asymmetric upside and a credible road map to 15%+ IRRs over next 5 years, we will stay invested. We will sell/reduce exposure if the position is significantly over-weight (minimize regret) and if we need cash to fund even better IRR ideas.

We must emphasize that any process for "selling right" requires a lot of judgement: it depends on the position size, the strength of the narrative, the past track record of the management team, the width of the moat in the business, prevailing valuations, alternate opportunities competing for allocations etc. We may change our stance as new facts come to light.

Investment thesis – RACL Gear Tech, ~1050 Cr Market Cap, Emerging Leader.

Manufacturing from India for the world promises to be a decadal theme. We favour categories that are strategic to customers supply chains and which are more immune to dumping from China.

- Rising geopolitical tensions between the West and China have prompted MNCs to strategically reevaluate their high dependence on China and seek alternative supply chains for derisking.
- European manufacturing faces structural challenges (low-cost competitiveness, long lead times for environmental clearances). Current macro challenges are driving higher outsourcing to players in low-cost destinations like India.
- Manufacturing may not offer as high ROCEs as IT Services/Consumer. However, they offer 15-20% growth with longevity at 18-20% ROCE. When growth slows down, their ROCEs could further expand as useful life of plants is greater than life over which they are depreciated.
- China's dumping in certain categories alongside current inventory de-stocking challenges has created short term earnings growth challenges. This is leading to cynicism around whether theme has legs. Price volatility could provide attractive entry points.

We are participating in this theme via many names[5].

Portfolio company	Key end-user industries
RACL Geartech	Auto Components
Neogen Chemicals	Pharma, Agri, Battery Chemicals, Semi-Conductors
Yasho Industries	Lubricant Additives, Rubber Chemicals, Consumer
SRF (Kama Holdings)	Agri, Refrigeration, Consumer, Pharma
Shaily Engineering Plastics	Healthcare, Consumer
Garware Technical Fibres	Fishing, Aquaculture, Sports, Infrastructure
Shivalik Bimetal Controls	Auto, Real Estate, Infrastructure

We have been investors in RACL Geartech since Oct 2021. The indifferent results in Q1FY25 due to inventory corrections at European clients and a poorer product mix affected EBITDA margins. This caused a steep stock price correction (~30% decline from peak). We used the opportunity to add to our positions.

[5] Positions which are >2% of Solidarity AUM.

Summary thesis

- RACL Geartech offers growth longevity. There is a large and growing market opportunity. RACL can extend its competencies (precision engineering) into new products and segments (Automotive and non-Automotive) even as it enhances wallet share with existing clients.
- RACL is a well-run Auto Comp co. which we believe can generate 18-20% steady state ROCE, translating to 18%+ ROE with moderate debt.
- At ~22x FY25e PE basis normalized earnings,[6] we find valuation comfort as we believe in possibilities of profits compounding at ~15-20% CAGR over a decade, which should result in broadly similar share price compounding. The human mind struggles to process duration and therefore longevity of growth is undervalued. Companies that demonstrate longevity get a valuation premium by markets when credibility is established.
- We believe this is an attractive investment story in an environment where the index is likely to deliver ~10% returns this decade.

Large expanding market opportunity	Demonstrated execution	Structurally a 18-20% ROCE business	Promoter an "Intelligent fanatic" we can trust	Reasonable valuations	Risks we are willing to underwrite
+1 tailwinds (Europe and China)	Scale up from ~15 Cr EBITDA to ~100 Cr over past decade New customers, some with sole supplier status New product segments Impeccable quality record Consistent wallet share gains	22% +/- EBITDAM 2x NFA turns at scale ~160 NWC days 18%+ long term ROE with some debt	Technocrat who led turnaround of company from bankruptcy Willingness to invest ahead of curve in new technologies Strong alignment with minority	22x PE basis FY25e normalized PAT	We prefer lower Debt/EBITDA. Willing to make exception due to promoter Key man risk.

Brief background of company and history

- RACL Geartech is an Auto Components supplier that specializes in manufacturing high precision products like transmission gears[7], shafts etc. RACL is primarily an export driven co (~73% of sales FY24) largely catering today to the auto industry (mainly premium 2W bikes, recreational vehicles, tractors etc).
- RACL is led by promoter Mr Gursharan Singh and his son Mr Prabh Mehar Singh. Mr. Gursharan Singh joined the company as a plant head in 1983. The company (formerly known as Raunaq Auto) went bankrupt and was referred to the erstwhile BIFR in 2001.

[6] Normalized means steady state annual margins adjusted for quarterly fluctuations. We think RACL is a 22% EBITDAM and ~10% PAT margin business.

[7] The transmission or gearbox adapts the engine output to suitable speed and torque to be transferred to the wheels.

- Mr Gursharan Singh orchestrated a management buy-out and successfully took RACL out of the BIFR purview in November 2007. The turnaround was accomplished by a strong dedication to quality, focusing on niche, low volume products, and exiting low margin categories.
- RACL has pursued a strategy that focuses on difficult to manufacture niche luxury products (like export premium 2W vehicles). This has resulted in a higher margin profile than most Auto Component players while also protecting the business from recessionary pull back in demand.
- Its first big export break came from Kubota Japan for tractors in 2004. The Kubota relationship was used to develop technical competencies and build a reputation for quality and reliability before attempting rapid growth.
- Since then, their reputation for quality has added other marquee customers over time like KTM, BMW, BRP Rotax, ZF, MAN trucks.
- At 430 Cr Sales FY24, RACL is quite derisked (no customer > 25% of Revenues, presence across multiple end segments and geographies).

Large and expanding market opportunity

RACL primarily manufactures transmission gears. However, we see it as a precision engineering company with competencies that can extend to new product categories. Over the years, RACL has built strong technical competencies (8 core competencies such as precision machining, forging, heat treatment, design engineering, gear assembly etc) that have been used to expand its product portfolio. RACL has expanded from primarily making transmission gears/shafts to a basket of 11+ products and 900+ SKUs such as chassis, suspension, steering, part lock wheels etc.

Well positioned to capture + 1 market share gains

Auto Comp manufacturing in Europe is facing a very challenging period at present (slowing customer demand, higher inflation & interest rates, shift to Electric vehicles, greater Chinese competition, higher energy costs). A loss in competitiveness is resulting in many Auto companies downsizing, vendors shutting down and OEMs aggressively looking for skilled vendors in lower-cost geographies.

- Volkswagen for the first time in history will be considering closing German factories, having flagged 1 car and 1 component plant as obsolete.[8]
- Continental (Germany's third largest supplier) has decided to exit its car parts business.[9]

As the European vendor base shrinks, it opens a window of opportunity for well-run Indian Auto Component suppliers to gain market share in the global landscape. Consider a few examples

- Germany's ZF Group to expand India sourcing to 2 billion euros a year by FY30[10]
- Stellantis plans to use India as an export hub to manufacture Electric vehicles.[11]

There are also some opportunities to gain share from China as global MNCs look to derisk for geo-political reasons. India has an existing Auto Component ecosystem and can benefit from friend shoring. The way global customers look at India is fundamentally changing. Perception takes time to change, but once trust is established in B2B businesses, pace of scale up can be rapid. RACL and other Indian Auto Comp suppliers are seeing a jump in RFQs for both new models as well as existing models.

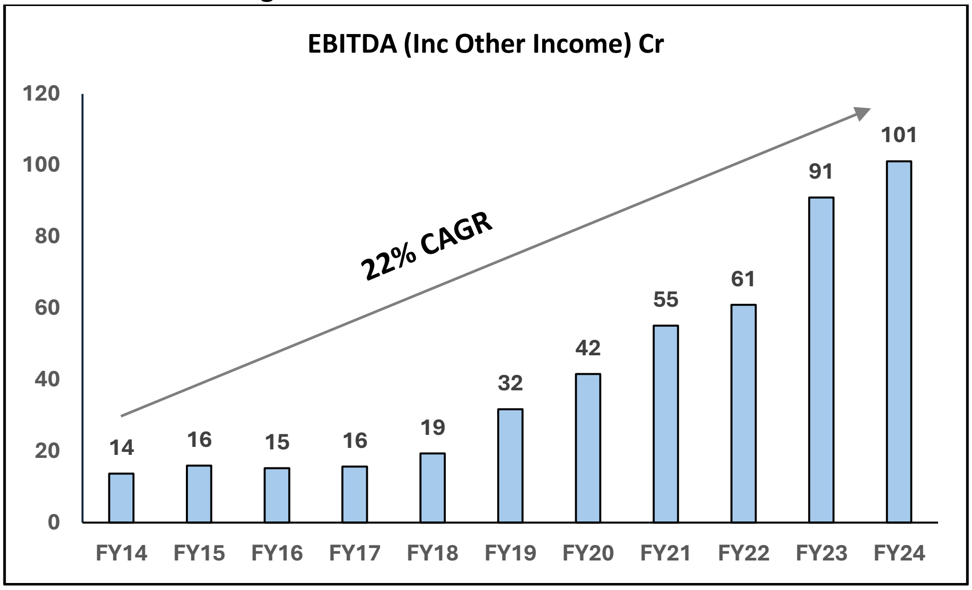
"Maybe not 10, maybe 15 years back. Nobody could imagine that the European customer will buy gears from India. 20 years back no European customer would have even thought to buy even the plastic component from India. So gradually, India is also gaining much respect and command into a global

[8] Reference Reuters, here
[9] Reference FT, here
[10] Reference ET, here
[11] Reference India Today, here

market and if India is gaining interest in the only global market" - RACL Geartech management "(Q1FY24 concall)

RACL is competitively well positioned to capture market share as it has a strong track record on quality/delivery with marquee global customers (no product failures, very low rejections), strong willingness to invest in Cap ex and sustainability initiatives, 30+ years domain expertise (gears, precision engineering) and offers one stop shop technology solutions. RACL enjoys strong customer trust which reflects in sticky long-term customers and wallet share gains.

RACL Geartech has a good track record on execution



RACL Geartech has demonstrated good growth accompanied by business model de-risking.

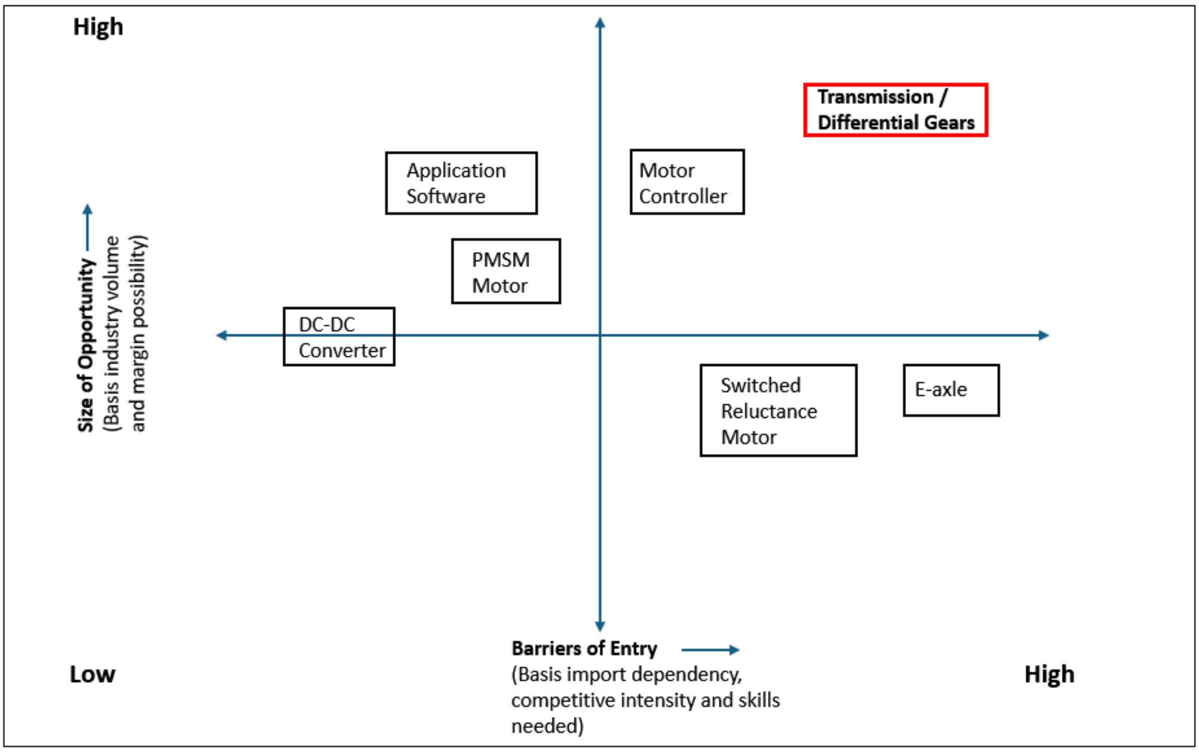
Particulars	FY14	FY24
Customer logos	Kubota KTM BMW BRP-Rotax Piaggio	+ MAN Trucks ZF Porsche Moto Guzzi Yamaha Vespa etc. JV with CF Moto Kubota JV with Escorts in India
End industries	2W Agri CV 3W Industrials	+ Recreational vehicles Passenger vehicles E bikes Electric scooter (10 year project)
Geography Mix	~45% of sales are exports	~73% of sales are exports (Higher margin)
RACL supplier status	Tier 2 supplier	Tier 2 supplier Tier 1 for passenger vehicle OEM

Over the last decade, quality of earnings has improved:

- Superior mix (increase share in higher margin exports, reducing share of lower margin segments like 3W vehicles).
- More value products (increase in share of complex parts, forward integration from loose parts to gear assembly, higher share of concurrent engineering[12]) which has resulted in improvement in numbers.
- De-risking across products/customers.

Key financial metrics	FY14	FY19	FY24
Gross Profit margin (%)	60%	66%	72%
EBITDA margin (%)	13%	17%	25%
PAT margin (%)	2%	5%	10%
ROE (%)	5%	15%	19%
Pre-Tax ROCE (%)	13%	16%	16%
Net debt/EBITDA	2.8	2.7	2.8
Gross Fixed Asset Turns	1.1	1.4	1.0
NWC Days[13]	58	132	176

Despite differentiated product, this is not a wide moat business.
RACL core products are differentiated (transmission related parts have more stringent vibration/noise parameters so need high-precision engineering) and should command healthy economics over time.



Note: Simplified chart sourced from Sona Comstar IP

However, while competition is not intense, there is no unique technology edge that others cannot replicate. Rather, the moats are soft, i.e. customer trust – that goods will be delivered as per agreed specifications and on time. And the incentives are for customers to give higher wallet share to trusted

[12] Work with customer from design stage where RACL gives value add inputs on best practises for commercial manufacturing.
[13] Higher share of exports translates to longer NWC cycle due to larger inventory in transit.

vendors to reduce complexity in their own supply chain and get better pricing in return for scale. Auto is a Just in time business. The fact that marquee global brands will trust RACL, a relatively small Auto Comp vendor located thousands of Kms away, to be a sole supplier speaks highly of the trust RACL has established.

We believe RACL can be a 18-20% ROCE business that could deliver ~18% ROE with some debt
In an industry where product price transparency is high, vendors cannot make super normal profits. Hence, vendors with some technical differentiation should be able to earn 18-20% ROCE, which would translate to ROE of ~18%+.

In the short term, "reported" ROCE can be misleading. RACL promoters are focused on long-term outcomes and hence have been investing ahead of the curve in new technologies. Hence, plants are not operating at optimal capacity utilization today (Gross block has expanded by ~26% CAGR over last 3 years) which we believe they will be able to sweat for higher turns over time.

	At present	**Steady state long term**		**Comments**
		Scenario 1	**Scenario 2**	
Sales	100	100	100	
EBITDAM % incl other income	25%	21%	23%	Margin fade as niche/mass products mix reduces
EBITM %	19%	16%	18%	
PATM %	10%	10%	11%	
GFA turns	1.0	1.20	1.25	More efficient production runs Better capacity utilisations
NFA turns	1.4	2.00	2.00	
NWC days	175	140	160	Fewer but larger volume SKUs means shorter inventory cycles
Net debt/EBITDA	2.8	1.7	2.0	Lower debt as pace of growth moderates
ROCE pre-tax %	16%	18%	20%	Improvement in ROCE even with some margin fade as asset efficiencies kick in
ROE %	20%	18%	22%	So current ROE % is broadly sustainable

Promoter an "Intelligent fanatic[14]" we can trust
In long term investing, the principal bet is always on people. At RACL we are backing a technocrat promoter, with an exceptional track record, who inspires a lot of confidence and trust. A technocrat promoter who leads sales efforts gives immense comfort to customers. The passion for quality and ambition to create a large organization is palpable from consistency of messaging on conference calls. Promoter has shown strong alignment with minority shareholders by keeping managerial salaries low. Transparency with investors is high and management calls out challenges with candour.

RACL Geartech trades at broadly reasonable valuations post correction.
RACL has zero institutional ownership and negligible sell side coverage. So, we cannot point to a specific variance perception we have vs other investors.

[14] Intelligent Fanatics are the world's greatest business builders. They create companies and organizations that dominate and stand the test of time. Charlie Munger was the first person to use the term Intelligent Fanatic.

RACL grew Revenue at 17% CAGR and EBITDA at 26% CAGR in the period FY19-FY24. In the last 2 years (FY24-25e), company has faced temporary growth headwinds (inventory reductions by customers due to weak end demand, slowing EV sales, longer lead time for critical equipment etc). These challenges have led management to lower their growth guidance.

Long term compounding is seldom linear and even high growth companies face short term cyclical challenges. We remain confident on RACLs long term prospects: the + 1 opportunity exists, RACL enjoy strong customer credibility and continues to win new projects even in a challenging environment. Even if the end industry goes into a recession, as there are market share gains at play, company is well positioned to grow.

Basis normalized profit margins and the mid-point of their revised FY25 guidance of 460-490 Cr Revenue, RACL trades at ~22x normalized PE. We find this attractive in the context of ~18% ROE and longevity of growth of a small base.

Why do we believe in longevity of growth?
Trust scales exponentially over time once a reputation for quality is developed. No customer will risk integrating an untested supplier strategically into a supply chain as the cost of a failed product/stalled manufacturing line is significantly higher than any cost savings. However, it is not worthwhile to have a supplier irrelevant in your larger scheme of things. Hence, while trust is established slowly, it scales exponentially via larger share of business from existing customers and the credibility extends to new customers.

Consider RACL history.

- Kubota initially started in 2004 with 2 SKUs and 1 location. This grew to 110 SKUs across 110 locations by 2019[15].
- Historically RACL has added a large customer every few years, with whom they have expanded wallet share over time.

Are debt levels at present too high?
RACL investor calls always have minority shareholders urging the management to raise some Equity to reduce debt. We prefer companies that have low debt. We seek resilience and debt amplifies fragility.

However, we are willing to make exceptions in specific situations and manage the risk of higher debt by position sizing. If we want to hold companies for long periods of time, we need to think like business owners. An analyst worries about volatility of short-term earnings which are amplified by debt. An owner wants to optimize ownership if debt can be serviced in the event of a shock.

Taking an owner's perspective, RACL's current debt levels (~282 Cr vs FY24 EBITDA of ~100 Cr) are not a significant concern.

- B2B businesses with strong growth runway but moderate ROCE require debt to fund Cap ex. The only option for promoters is to either reduce growth rates or dilute Equity. If we think as business owners, neither of these options is in our interest.
- Auto Components is not a business with high tail risks where profits can implode (US FDA ban, or steep price fall as in generic Agri Chemicals).
- In the last decade, RACL has rarely see a sharp fall in earnings and was able to grow profits even during Covid without availing any loan moratoriums.
- They work with very marque global OEMs, some business lines are recession proof, and the business is well diversified (customers/geographies).

[15] Company con calls

We don't see rapid adoption of EVs as a threat

RACL primary product at present is transmission gears. EVs also need transmission gears which are almost the same value per vehicle as ICE (fewer parts but higher value per gear). RACL is present in categories such as high CC bikes, recreational vehicles and tractors where scope for EV is still a distant possibility. Finally, RACL is not limited to gears and will continue to leverage skillsets to expand into newer products which will further diversify business mix.

Is there key man risk?

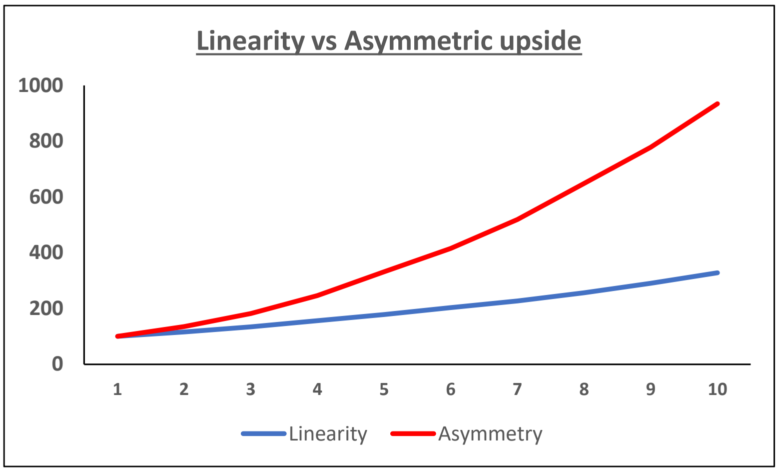
One cannot avoid key man risk in Small Caps. They are the nucleus around which the company is built. RACL story has been no different. The differentiated products that RACL has cannot be designed by one person alone, clearly there is professional depth which is not visible to outsiders. We believe with larger scale there is greater ability to expand management depth. We are already seeing progress (current CFO who joined recently is ex Citi). These tail risks cannot be wished away but need to be managed by position sizing.

Answers to interesting questions we have been asked.

What is the PE of the portfolio at present?

Snapshot PE[16] is often used as short cut to gauge how expensive a company is. For many companies in our portfolio, PE is not a useful metric (we explain via some examples below). Hence, this is not a metric we track at a portfolio level.

Our portfolio choices are grouped in 3 buckets – Linearity, Longevity and Asymmetric upsides. We find PE ratio useful only for linear growth stories, more mature on growth life cycle.



Where trailing PE works

HDFC Bank is a linear earnings growth story. We expect earnings to grow in the range of 13-15% over time. At its scale, the Bank may surprise by growing 17-18%. However, it is unlikely to grow 25%. HDFC Bank has a very good track record on NPAs and hence results are not affected by volatility in credit costs. Hence, PE is a very useful metric to gauge HDFC Bank valuations.

Where trailing PE is misleading

Some companies can potentially deliver Asymmetric growth as they are early on growth life cycle and have a small base from which to grow. They have strong tail winds for example energy transition (Neogen) or potential for enhanced market share in global supply chains Shaily, Yasho). Hence, earnings could grow exponentially on a small starting base. Moreover, reported Earnings could be

[16] Price to Earnings

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misleading if a company has done a large Capital expansion as Depreciation and Interest costs hit upfront while plant utilization follows with a lag.

Our approach in above cases is to run scenarios of what Earnings a company can generate 5 years out, assign multiples in the exit year, and then discount back to the present to gauge potential returns across scenarios.

Here are a few examples where trailing PE will lead to wrong conclusions.

Company	TTM PE	Why is the TTM PE or PB not appropriate?	Metric we find useful
Bharti	87x	Earnings will rise exponentially from tariff hikes, op. leverage and lower interest costs as FCF reduces Debt.	~18x FCF multiple at a FY28 estimated ARPU (300-320) for India wireless business + sum of parts for others.
IndiaMART	48x	PE is misleading because Selling expenses are booked upfront. Hence FCF > PAT in core business due to negative working capital. Does not capture upside from strategic investments.	30x TTM FCF multiple on core business + Book value for key investments made + Cash on books.
Yasho Industries	56x	Large capacity expansion leading to operating costs, depreciation and interest hitting upfront while the plant will reach full utilization in 18-24 months.	25-35x PE on PAT in different scenarios basis when the new plant reaches full utilization.

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We look forward to speaking with you at our quarterly call on the 19th of October at 12pm IST.

Thank you for the trust,

Manish Gupta
Manjeet Buaria
Anirudh Shetty
Pratik Jain
Aman Thadani

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