Annual Letter to Partners FY 19

3 April 2019

Dear partners,

In this letter we
1. Share an overview of FY 19 and an update on our performance
2. Recap our Investment Approach
3. Share the key Investment themes of interest
4. Share rationale underlying our largest positions
5. Discuss a few mistakes made during the year and what we learnt from them
6. Provide an outlook for the road ahead

Overview of FY 19 and Performance update

While both the NIFTY 50 (up ~15%) and NIFTY 500 (up ~8.5%) were positive this year, they hide the scale of correction witnessed in the broader market. Only 23% of the listed universe had positive results this year and ~39% of the listed universe lost over a third of its value.

The chart below shows the performance of broader markets

Fall/Rise Since 2nd April 18 till 29th March 19		
Extent of fall	**No.of listed cos***	**% of Listed Cos***
Increased > 10%	393	16%
Increased 0-10%	174	7%
Decreased 0 to 10%	250	10%
Decreased 10% to 33%	683	28%
Decreased 33% to 50%	528	21%
Decreased > 50%	453	18%
Total	2481	100%

*for 2481 traded companies as on 2 Apr 2018 and 29 Mar 2019

Source: Ace Equity

After a strong FY 14-FY 18, FY 19 was particularly cruel on Small and Mid-Caps as their valuation multiples corrected while earnings growth remained tepid resulting in steep stock price declines. Fund Managers running exclusively Mid/Small Cap strategies would have performed poorly in FY 19 while Fund Managers running exclusively Large Cap (and particularly Large Cap with over weight on Consumer strategies) would have performed extremely well. Neither have the former lost their mojo, nor did the latter achieve an act of genius. No approach works in all environments and performance over short time horizons is significantly influenced by whether a particular approach is in favour with markets at that point in time. Hence, it's best to evaluate performance over 5 years which is a good time frame to smoothen out the impact of cycles.

Solidarity Performance update[1]

For Anchor partner					Since PMS License (Aggregate across all accounts)			
DATE	NIFTY	NIFTY500	SOLIDARITY		DATE	NIFTY	NIFTY500	SOLIDARITY
FY15	24.6%	30.1%	67.2%					
FY16	-7.5%	-5.9%	-0.1%					
FY17	18.9%	24.0%	22.4%		FY17 (part year)	19.2%	24.3%	20.5%
FY18	10.2%	11.5%	18.6%		FY18	10.2%	11.5%	19.2%
FY19	15.0%	8.5%	6.0%		FY19	15.0%	8.5%	7.1%
Cumulative XIRR	**11.9%**	**13.2%**	**21.1%**		**Cumulative XIRR**	**14.6%**	**14.2%**	**15.2%**

We ended FY 19 with an aggregate portfolio performance of ~7% across all accounts. The "Multi cap" approach followed by us – discussed below – provided stability in a very tough year. Most of our Clear Leaders witnessed steady gains and cushioned the drawdowns from the Emerging Leaders/Cyclicals.

Since inception (~5 years) our IRR post fees has been about 21%. We would have performed better were it not for a few errors which we discuss in a subsequent section.

Recap of Investment approach

Our goal is protection and compounding of capital to generate 3-5% above nominal GDP growth with prudent risk taking. Under assumption of 12% nominal GDP growth, we target approx. 15-17% IRR post fees measured on a rolling 5 year basis.[2]

We aim to do this by constructing "Multi Cap" portfolios. An exclusively Small/Mid cap portfolio works spectacularly well in "risk on" environments, but is much more volatile and causes significant declines on the way down as sellers rush simultaneously to a small exit due to very poor liquidity. A "Multi Cap" portfolio provides more moderate growth, but with significantly lower volatility. While theoretically volatility should not matter, practically it does as excessive volatility can make one stray from an intended course. We hence find the Multi Cap portfolio approach more suited with our temperament.

Our approach to portfolio design is guided by the following beliefs

We believe protection and compounding of Capital is best obtained by buying companies whose long term growth and Operating Cash Flow are fairly predictable within a band.

- We hence, seek to be overweight on companies serving a Large Market opportunity, benefitting from structural tail winds of growth, have leadership of their industry or dominate a niche, are run by disciplined management teams and are available at a broadly fair price range relative to their growth rates and cash generation.
- We classify them as "Clear and Emerging" Leaders based on the maturity of their business models, predictability of earnings and use of debt
- Clear and Emerging Leaders always get top priority in capital deployment and account for ~85% of the aggregate portfolio at present

We believe in mean reversion of valuation multiples.

- A great company may not be a great Investment over a 5 year horizon if bought at the wrong price as earnings growth will be negated by valuation multiple decline.
- However, great companies in the past few years have seldom been available cheap. Success means learning to manage this paradox, especially so in the current environment.

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[1] We operated with an Investment Advisor license till 11 May 2016 post which we migrated to a PMS License

[2] Partners should note that we don't guarantee outcomes and this is an intent balancing opportunity with risk

When valuations for Clear and Emerging Leaders are not in favour, rather than sitting on cash, we believe one should be flexible and adapt to prevailing market conditions.

- This does not imply compromising on Governance, or attempting to generate trading profits. Rather, casting the net wider for other opportunities which may not be compounding stories at present, but permit a healthy risk adjusted return. Hence, we also seek value in "Transformations" and "Cyclical" plays.
- Transformations[3] are potential Clear Leaders who are working through errors made in the past. These are often available at significant discount to fair value as the market waits for clear evidence of a turnaround.
- Cyclical companies are in industries whose economics are more vulnerable to a business cycle as industry demand/supply gaps are not in their control and can affect margins significantly.

Our bias is to invest in companies who have leadership positions in their industry or those that dominate a niche. Leaders with significant market share advantages over other players enjoy a disproportionate share of the industry profit pool which propels a virtuous cycle leading to unchallenged dominance.

We prefer companies who are focused rather than those who are diversified.

- Focused companies are more disciplined on Capital allocation which results in higher ROE. They diversify into adjacencies only when they believe they can build winning positions and not be also ran players
- Diversified companies run the risk of empire building and getting distracted from their core. It's rare to find diversified companies with high ROE as Capital allocation discipline tends to be poor.

We manage risks by investing in what we understand and by sizing positions relative to quality of franchise, growth outlook and entry valuations.

- The future is uncertain and hence risk cannot completely be eliminated. Our position sizes reflect our confidence in expected outcomes.
- We believe one should take concentrated positions when circumstances are deeply in favour. However, we cap position weights at cost at 15% for Clear Leaders[4], 8% for Emerging Leaders and have lower weights for Transformations and Cyclicals due to higher uncertainty implicit in these companies

We seek compounding. However, we believe it is prudent to start taking capital off the table when multiples get exuberant – especially if the stock is relatively illiquid and if alternative opportunities for Investment are available.

Key themes of interest

<u>The largest share of the portfolio is invested in Clear and Emerging Leaders which will benefit from themes that have secular and structural tail winds</u>. A few examples are

- Discretionary consumption – Our focus is on categories that will not only gain greater share of the consumer wallet of discretionary consumer spending but also benefit from market share gains from the unorganized sector; and Banks that will finance this consumption

[3] ICICI Bank first entered portfolios as a Transformation story and we now categorize it as a Clear Leader

[4] We have held a 15% position weight only twice in our five year history. With HDFC Bank during demonetisation and with ICICI Bank at present

- Implementation of the Bankruptcy Code and the role of Credit Bureau's will bring about a significant change in borrower behaviour which should result in a structural decline in new NPAs for Banks
- Increase in share of financial savings in total savings and the need and ability of Indians to protect themselves via Life Insurance as per capita incomes exceed USD 2000/capita
- India's opportunity to be a strong second supply source for MNCs as they look to de risk supply chains from China due to trade and geopolitical tensions and China's crackdown on pollution
- Rising inequality necessitating Govt spends to increase incomes at the bottom of the pyramid

We are also participating in Power and Steel as part of our Cyclical bucket. We expect a sharp boost in profits and cash flow in our chosen companies over the next few years (NTPC, JSW Energy, Tata Steel) but are not in favour with the market at present despite trading at close to Replacement value

- We expect the PLFs[5] of Thermal Power producers to increase over the next few years as demand increases while supply of additional renewables/thermal capacity lags demand
- We expect the Govt. to continue to support the Steel industry with Minimum Import Price protection to encourage Steel producers to add capacity to make India self-reliant in Steel[6]. Additionally, limited capacity addition in the last few years accompanied by 7%+ growth will result in high Capacity Utilization and cash flow for Steel producers over the next few years

We are cautious on sectors which could face regulatory head winds or challenge to terminal value

- Amongst the greatest challenge of our times is managing rising inequality[7]. The spoils of economic growth are being disproportionately cornered by the very affluent. Govts. all over the world cannot seem to find a way by which they can deliver on simultaneous challenges such as growth, employment creation, while maintaining fiscal prudence. The anger of those left behind is resulting in events such as Brexit and rising nationalism and protectionism.
- We fear that rising Inequality will have implications and risks for sectors perceived to be profiteering at the expense of the poor (as they will attract more political scrutiny) and also for trade models built on cost arbitrage rather than an edge on technology or skills. Why should regulators permit Micro Finance companies to earn >20% ROEs? Could maximum permitted spreads (10%) in Micro Finance further decrease? Why will developed countries not impose additional tariff/non-tariff barriers to preserve jobs in Industries e.g. Textiles where skills are fungible and cost the primary basis of competition?
- Cheap and abundant bandwidth is enabling/accelerating disruption in many Industries. While this topic is too large to be covered in the letter, one must question terminal value assumptions being ascribed to business models at present in industries such as Multiplexes and Broadcasting

[5] PLF – Plant Load Factor, or simply Capacity Utilization

[6] It may interest partners to note that India is amongst the most protectionist countries in the world

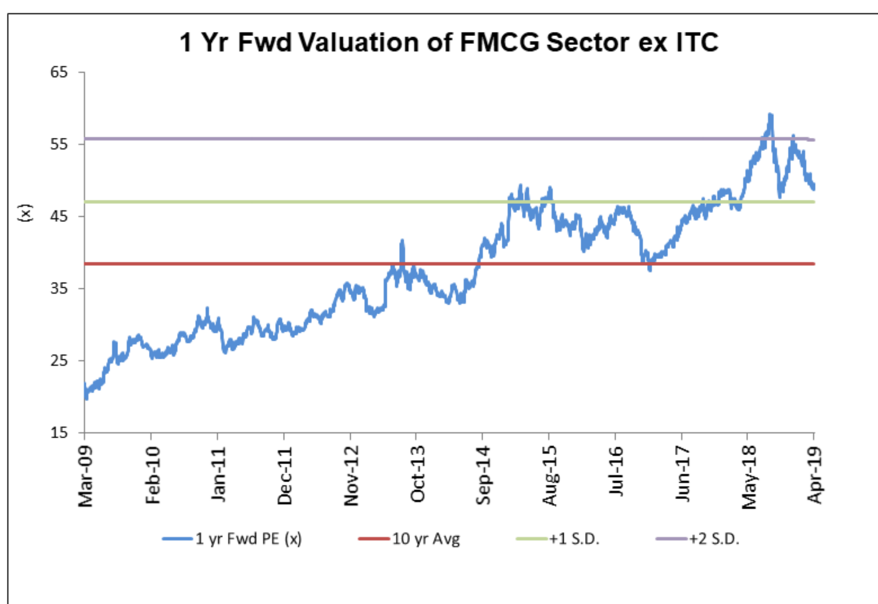
[7] Inequality in not an India problem alone. Over 45% of US households claim not to have USD 400 liquidity for use if faced with an emergency

Investment rationale underlying our largest positions[8] [9]

Our 6 largest positions account for about 55% of our holdings. Our 5 largest positions have remained unchanged over the last year. Before we delve into these positions, I would like to address a question we get very often from partners is why our allocations to Consumer themes is low.

Consumer companies are among the most attractive long term Investment story in India due to the growth opportunity, the quality of management, high free cash flow conversion, and low perceived risk of disruption. Our cautiousness is due to the valuations in most FMCG and Consumer Discretionary names which have risen significantly over the past few years (see chart below) without step up in earnings growth rates or ROE. Current valuations imply significantly higher cash flow growth over the next decade than delivered in the past despite rising competition. In FMCG, Digital technologies are allowing challenger brands to reach consumers bypassing the historical challenges of access to national media for brand building and need to have access to wide distribution. Read our blog on FMCG here

Exuberance never ends well. When sentiment turns, the price correction is brutal. We have witnessed the story unfold in Technology Media and Telecom (TMT) in 2000, Infrastructure/Real Estate in 2008, Pharma in 2015 and NBFCs in 2018. Any correction in valuations will imply mediocre returns over the next 5 years. Partners may note that Hindustan Unilever (then HLL) delivered flat stock price returns between 2000-2010.



Source: SBICap Securities

Hence, while we are participating selectively, we continue to seek more favourable entry points.

[8] We don't operate with a model portfolios but develop customized portfolios depending on valuations prevailing at time of entry. The six largest positions discussed are the largest in aggregate across all Solidarity managed accounts and may not be the six largest for all partners due to differences in timing of signing up

[9] We discuss our Investment Rationale to share our thought process. This is not a recommendation to buy at the current price. We reserve the right to change our minds.

Our largest sectoral position is in Banks

Banks are not very high ROE businesses. However, they can be an attractive investment despite not being a very high ROE because well run Banks have a natural tail wind for growth (~1.5X of nominal GDP) and large amounts of Capital can be reinvested at 3-5% spreads over Cost of Equity (13%). However, historically this has not translated into reality. Over the last two decades, only HDFC Bank and Kotak Bank have been able to deliver on the combination of 15%+ growth, and 15%+ ROEs consistently. Together, these Banks account for less than 10% of the Banking system Assets. Clearly, running a Banking franchise well is easier said than done.

Our portfolio choices in Banking are based on the following core beliefs on Banks and NBFCs.

The only sustainable advantages in Banking are a low cost deposit franchise and a fundamentally conservative culture of lending. Lending franchises do not have sustainable moats.

- There is low Brand loyalty in Credit. We shop for the best interest rate on loans. However, we don't readily move funds lying idle in Savings Accounts. Similarly, cash management for corporates is sticky. Hence, the low cost deposit ratio, or share of Current Accounts and Savings Account deposit in the overall deposit mix is the key source of advantage.
- Banks are highly leveraged companies. Leverage causes errors to get amplified. Hence, pursuit of rapid growth in Banking has never ended well because it is most often accompanies by laxity in risk underwriting standards.
- Moreover, Accounting for NPAs in Banks is very judgemental and hence opaque. NPAs always hit with a lag post disbursal and hence reported financials and ability to ever green loans never provide a true/fair picture of the underlying state of affairs.
- Hence, the only defence for an investor is to understand the deeply held beliefs, incentives and hence future behaviour of the senior management team – what kind of risks will they take and not take, and how openly will they share the true quality of Assets they hold. One has to be wary of management teams who communicate aggressive growth and ROE targets

Well run Banks should gain market share from Non AAA rated NBFCs[10] over the next few years

- NBFCs have structurally weaker business models than Banks as they don't have access to fee Income or low cost funds. They are therefore compelled to pursue Business segments that Banks willingly cede either due to unwillingness to take Credit risk in that segment or if that segment is too costly to serve e.g. Gold Loans. As they are reliant on funding from Banks and whole sale markets, most NBFCS face challenges in accessing funding every time a mini crisis hits the economy. As most of them borrow short term and keep rolling over financing, a crisis forces them to slow down incremental lending to meet their repayment obligations.
- Most NBFCs have had significant market share gains in the last few years as they were able to raise funding from Bond Markets at lower spreads as liquidity flowed into Mutual Funds post demonetization, PSU Banks vacated spaces due to lending restrictions imposed on them by the Central Bank, and many large Private Banks and PSU Banks were distracted by their NPA issues.
- Many of these tail winds have reversed. Non AAA NBFCs are likely to see an increase in their credit risk premiums as rating agencies become more discerning on who is a genuine AAA borrower. Read more on this topic on our blog here. More tempered access to capital is already making many NBFCs slow down disbursements.

[10] Well run Private Banks will also gain share from not so well run PSU Banks

- NBFCs will thrive in niches that Banks cannot serve effectively. However, over time, Banks will gain share from NBFCs and enter many segments where NBFCs dominate. For example, GST related compliances will result in many SMEs becoming Bankable.

NPAs for Banks should be lower over the next business cycle.

- Historically some promoters have siphoned capital to fund Equity investments in their projects. The over investment results in projects not being viable when a down-cycle hit but politically connected promoters managed to evergreen loans.
- The Insolvency and Bankruptcy Code will result in better Corporate Borrower behaviour. Promoters who bet that nothing in India will change and who could game the IBC process have lost control of their company. Moreover, after we pass through the initial teething pains, execution of the Code will be faster as judicial precedence will exist. History teaches us that the percentage of recovery in a loan going bad is strongly correlated with the pace at which Banks act on recovery. Our hypothesis is that the share of loans that go bad because of poor intent should decline while recoveries from loans which have gone bad due to genuine business decline should increase.
- Many Banks went wrong in taking excessive concentration risk. This has been fixed by regulators with more stringent caps on group exposures and requirements that large companies access Bond Markets
- Historically, unsecured personal loans were based on credit scoring and algorithms developed independently by banks and did not have full access to a borrower's credit history or current level of indebtedness. Credit Bureau's are now able to provide real time data on borrower history, level of indebtedness and current credit seeking behaviour. This provides better quality data to take credit decisions and the speed at which this data can be accessed provides the ability to act faster to correct credit growth in segments where default risk is rising. We believe that this should result in better credit costs in the Retail segment as over leveraged borrowers don't get access to credit and frivolous defaults reduce as borrowers are aware that any default will affect their ability to access Credit in the future.
- Banks have been provisioning aggressively for the current Bad Loans and the high point of provisioning is behind them

The three positions we own are HDFC Bank, ICICI Bank and SBI

HDFC Bank (Mcap: ~Rs 6,25,650 crs; Clear Leader)

HDFC Bank is perhaps India's most secular compounding story with over two decades of superior growth backed by prudent risk taking on the back of a strategy which can be summarized as "common sense rigorously applied". While their peers have been grappling with Bad Loans over the last few years, an undistracted HDFC Bank has been making strong advances in Digital enabled Consumer Lending with dominant positions across most consumer loan products; all of this achieved while maintaining its low cost deposit franchise. HDFC Bank's market share positions will be hard to dislodge as they are backed by the best cost structures – hence, we expect HDFC Bank's dominance to continue. The risks we see to our thesis here is cultural and execution focus continuity post Aditya Puri's retirement and the risk of a valuation de-rating of multiple over time from both a decline in ROE and a decline in scarcity premium if more Banks successfully emulate its practices.

ICICI Bank (Mcap: ~Rs 2,56,000 crs; Clear Leader)

ICICI Bank's roots are that of a development bank which needed to make a transition to a commercial Bank in the late 90s. It however was competing with Banks with no historical baggage who had a head

start. The need to be relevant perhaps sowed the seeds of a culture that prioritized growth above all else. The late start meant that it also had significantly higher cost of funds vs peers. This necessitated the Bank to pursue higher yield loans (higher risk) in the quest to earn a decent ROE – there was an aggressive foray into unsecured loans in the 2004-2008 era, an overseas foray in 2004 and large project loans in 2010-2014 – none of which ended well.

ICICI Bank started the process of "back to basics" a few years ago – focus on controlling Costs, building CASA and Credit discipline and maintaining strong Capital Adequacy. This strategy is also being pursued by the new CEO - reflected in a clearly stated policy of conservatism in lending, modest ROE aspirations (15% ROE by Q1 FY 21) and more aggressive provisioning upfront. ICICI Bank's transformation over the last few years has led to a sharp increase in the share of low cost deposits, greater focus on more granular Retail lending, higher share of incremental credit to higher quality Corporates and a lowering of Operating cost structure. As the new path is not based on a pursuit of higher risk Credit, hopefully past mistakes should not be repeated. Moreover, at present there is a significant opportunity to take market share from NBFCs and ramp up Retail growth in segments of choice where Credit risk is acceptable. As credibility is gradually rebuilt, and the Bank's key metrics start converging with those of HDFC Bank, we expect to see a gradual expansion of multiple and narrowing of the discount vs HDFC Bank.

ICICI Bank also has subsidiaries in Life Insurance, General Insurance and Asset Management which account for about ~25% of Market Cap and which have high growth prospects, high ROE and have leadership positions.

The risks we see to our thesis is whether our belief in cultural transformation will play out. While we acknowledge that cultures are hard to change, we also believe that direction of travel is key and one should not be trapped in dogma. Our belief stems from the fact that the process of transformation started a few years ago, results of progress are visible, and the new CEO knows the Bank, its history and what needs to change well as he has been associated with the Institution for over two decades.

State Bank of India- SBI (Mcap: ~Rs 2,93,200 crs; Cyclical)

The investment thesis for SBI mirrors that of ICICI Bank as the transformation is along similar lines. However, the risk in SBIs makeover is higher due to its Govt. ownership and concern whether the Govts. will use PSU Banks to achieve political objectives- we are watching carefully whether SBI will see a new cycle of Bad Loans in the Mudra Loans scheme formulated by the Govt. or whether SBI will be used to bail out a weaker bank. We think this is a low probability event as SBI is already too large in India's banking system and regulators need to guard against "too large to fail" risks. Moreover, we believe that SBI has a very respected management team and sensitive decisions are taken by committees to insulate against political interference.

Even as we are tracking risks outlined above, the question we must ask is what expectations are embedded in the price. We purchased SBI at less than its core Book Value (adjusting for the value of its subsidiaries) which implied that the market expected no change in the way the Bank will operate in the future and hence would continue to earn an ROE below its Cost of Equity (13%) indefinitely.

Market participants may also be overlooking the fact that SBI is a stronger and more trusted brand than many Private Banks in smaller towns. Its margins (NIM%) have room for expansion as even though SBI has the same low-cost deposit ratio as HDFC Bank and ICICI Bank, its loan to deposit ratio is lower at 65% vs 85-90% for private banks. In addition, its subsidiaries have dominant positions in their franchises. Post the last bad credit cycle (2001-2004), the valuation of SBI expanded aggressively

and the re-rating accompanied by Earnings growth generated a return of ~3X in 2 years. We believe the risk return profile at present is strongly in favour.

We will track execution and risk of political interference over time and will either upgrade to Clear Leader for secular compounding or exit when our price target has been reached to allocate to other opportunities.

Hester Biosciences (Mcap: ~Rs 1,300 crs; Emerging Leader)

A key global challenge at present is rising inequality – and various Govts, aid organizations and philanthropists are looking for sustainable solutions to increase Incomes at the bottom of the pyramid. We expect the GoI to increase developmental spends in Rural India and put more money into schemes that help the poor increase the productivity of their farm animals through vaccination. Poultry/Animal Vaccines are very low cost products with exponential impact on Farmer incomes as it results in significantly reduced mortality. The barrier to adoption by farmers is not cost but awareness and availability. India has amongst the largest farm animal population in the world but its Animal Healthcare market is only 2-3% of the global industry. Hence, current market sizes could be very misleading about how large the business can be.

Additionally, a global initiative is being pursued by the Food and Agriculture Organization (FAO) to eradicate goat plague (Peste des Petit Ruminants – PPR) by 2030. PPR is a highly contagious disease affecting farm animals like sheep and goat which can eliminate over 90% of a flock and cause havoc with livelihoods. FAO plans to spend USD 7.6-9 Bn USD over the next decade to eradicate this disease of which USD ~150mn will be spent over the next 3-4 years on vaccines alone

The poultry and Animal vaccine industry has high entry barriers due to biohazardous manufacturing involving viruses, tough distribution economics for a low-cost product, tedious product registration requirements by country & need for scale. Not surprisingly, there are very few serious Animal vaccine players globally and this provides a significant growth opportunity for Hester.

Hester is led by a visionary promoter who has maintained focus on Animal and Poultry Vaccine and Healthcare products. The company is a leading player in India in key vaccine segments where it competes (Poultry, PPR, Brucella, Goat Pox) and has exhibited good discipline - the pursuit of growth has been accompanied by strong Working Capital improvement.

We believe Hester is well poised for growth in the years ahead as it has multiple avenues for growth. As the Govt. of India does not allow the Nigerian strain of PPR vaccines to be manufactured in India, Hester has recently set up a Nepal plant for exports of PPR vaccine to Africa. While initially benefitting from technology transfer, it has undertaken development of vaccines in house e.g. thermostable poultry vaccines which are even effective at high temperatures. It has invested many years building distribution deep in the hinterland in India and it is now leveraging this network to push Poultry and Animal Healthcare products through the same even as it expands the distribution network to more states. It has built good credibility with donors and aided by a grant from the Bill and Melinda Gates Foundation, Hester is setting up a plant in Tanzania to manufacture Animal vaccines for the African market which as of now relies completely on imports.

The risks to our thesis is time frame in which opportunity translates into higher profits. The company should have delivered better results than it has in the last two years – but it has been stymied by external factors. The Nepal plant is operating significantly below capacity as PPR orders have been delayed. The business is partially dependent on Govt. Tenders which are lumpy. As the market leader

in India, Hester's role is to grow the market, and not just serve the market. As a small company operating across continents, Hester management bandwidth could be stretched as it looks to execute a tall agenda while simultaneously de-risking the company from over reliance on any one product/geography.

SRF (Mcap: ~Rs 13,780 crs; Emerging Leader)

Over the last few years China has witnessed wide spread governmental crackdown on its chemical industries due to pollution & environmental concerns, which has resulted in arbitrary shutdown of entire chemical belts (including non-polluting manufacturers). Further, fear of trade wars with the US has led to MNCs looking to de-risk their supply chains.

Indian Chemical players with a track record and culture of environmental compliance, and who have invested to build a technology edge should benefit structurally as India is home to strong chemistry and process development skills, low cost manufacturing & good track record of respect for customers IP. Many players have witnessed a short term growth and margin boost as they benefit from short term supply scarcity. However, in the absence of any unique technology edge, this momentum will fade. SRF is one of few who are very well positioned for future growth.

Fluorine based chemistry is seeing greater application in Agrochemicals & Pharma industry due to its higher efficacy and environmental compatibility. It is a USD 8 Billion Market of which SRF is < USD 100 Mn and other than SRF, there are only 2 players in India who have a meaningful presence. Fluorine is a highly reactive element requiring specialized equipment. The need to develop expertise in handling Fluorine, developing competencies and then building credibility with clients can take as long as 8-10 years. Relationships are sticky as the outsourced process and location becomes part of the client's Drug Master File which is filed with the FDA and acts as a barrier to changing suppliers.

SRF invested money received from Carbon Credits into developing capabilities in Fluorine based chemistry. Approx. 470 Cr was invested into R&D (Cap ex and Revenue) between 2012 and 2018. It is now the clear market leader in India with 135 patents filed till FY 18 and with a rich pipeline of products ready for commercialization. Over 80% of its revenue in Specialty Chemicals is from proprietary process technology.

The last couple of years witnessed a downtrend in the Agri Cycle causing Specialty Chemical Revenues of SRF to decline. However, keeping focus on the long term, SRF continued investing in product development and capacity creation to be ready when the cycle turned. It also used this time period to de-risk its business model with a more balanced customer mix between Innovators and Generic manufacturers. With the Agri Cycle poised to turn and visibility in customer orders, SRF should witness strong growth over the next few years.

The Indian refrigerant market is poised to grow strongly as penetration of ACs and refrigerators increase. Despite being a very hot country, India's refrigerant market is less than a tenth of the US market. SRF is the domestic market leader in refrigerants with > 40% market share and the only Indian player with a basket of all 3 next generation gases (mainly self-developed).

SRF also has two other business lines.

- It is the market leader in Nylon Tyre Cord, a legacy business which is treated as a cash cow
- It has a Packaging Films Business, select parts of which (BOPP) are not very high ROCE "at present" due to lower differentiation vs peers. Management's attempt is to leverage its

technology capabilities to introduce differentiated products in Films which will enhance margins over time.

Solidarity believes that businesses should have very strong reasons to diversify from their core. Too often companies open multiple fronts with the risk that the core gets starved of both capital and management attention as too many balls need to be juggled. We hence prefer buying Focused companies.

We however believe SRFs IP track record in Specialty Chemicals gives its Films strategy credibility.

- If the management did not spend money to develop process technologies in Fluorine a decade ago (in what then was an adjacency), it would not have the franchise it has in Specialty Chemicals and Refrigerants today.
- The Chemicals/refrigerants business is not being starved of Capital to expand the Packaging films business.
- Management bandwidth is not a constraint as there are separate CEOs for each business unit.

Key risks to our thesis at SRF is the capacity build up in Specialty Chemicals not translating into growth and continuing to maintain a strong culture of environmental compliance[11]. Management also needs to demonstrate its strategy in Films is working by boosting the Films ROCE to >15%. We hence classify SRF as an Emerging Leader to see more evidence of execution before upgrading to Clear Leader.

TITAN (Mcap: ~Rs 98,800 crs; Clear Leader)

A secular and structural, multi-decadal theme playing out in India at present is discretionary consumption. As per capita Incomes grow, discretionary consumption grows exponentially. TITAN is a huge beneficiary of this theme further supported by other secular trends – the organized sector gaining share from the unorganized share, premiumisation, rising pride in buying Indian, and the growing independence and purchasing power of women.

Set up 3 decades ago as a watch company, TITAN is a multi-product mass/premium retailer with competencies in Designing aspirational products, building brands, merchandizing, franchising and retailing. TITAN at present earns most of its Operating Profit from Jewellery where it is the industry leader and dominant player. However, with its significant Free cash flow and competencies, it has entered adjacent categories which are large and growing, many of which are at present dominated by the unorganized sector and where it has potential to become the largest organized player over time – Eye wear, Fragrances and lately Sarees.

The Jewellery industry in India is highly fragmented and despite being the leader TITAN has <5% market share with significant headroom for growth. Demonetisation led to a huge market share boost as business practices of many peers and the unorganized sector were exposed while TITAN also simultaneously began to address its historically lower market share in the Wedding segment and in Tier 2 cities. Over the last few years it has also de-risked its business from Govt regulations on imports of Gold by diversifying its sources for purchase of Gold

A key challenge with owning TITAN, like many Consumer names in India discussed earlier, is coming to terms with its expensive valuations (~65x FY19 estimated earnings). There are reasons why these valuations could sustain. Unlike other consumer names, TITANs valuation re-rating has been accompanied by growth acceleration over the past few years. It has been reinvesting its cash flow in adjacencies and hence can positively surprise on longevity of growth and Option value from creation of new business lines. Increasing reliance on Gold Exchange can increase ROCE. Hence, a stronger

[11] SRF received a closure notice for environmental violation for its Dahej Facility on 29 Mar 2019

than expected performance could justify current valuation multiples. Valuation multiples tend to sustain as long as the narrative and earnings growth is on track.

However, we need to be mindful of what valuations are implying. Current valuations imply that free cash generation will compound at ~20% for over two decades with no surprises[12]. That is possible but would not be our base case assumption as the jewellery market is witnessing flat to low growth and TITANs growth is primarily from market share gains. We believe in holding positions if valuations are about 15-20% above fair value. That may result in a year or so of flat performance if valuations revert to fair zone – which is acceptable when owns a great franchise as we are looking for compounding. However, when valuations are significantly above comfort zone, as at the present juncture, we believe it's best to use the wisdom of position sizing and gradually trim exposures, especially so when we find other opportunities for reallocation of Capital.

Other key portfolio constituents

In our last quarterly letter we touched briefly upon other themes and companies of interest. Symphony is the market leader in Air Cooling with over 50% market share and we estimate 80% share of profit pool. We also have good sized positions in JSW Energy (Power Generation Company) and in ICICI Pru Life, a life Insurance company. You can read about the Investment rationale underlying these positions here

Mistakes made during the year and what we learnt from them

Mistakes are an inevitable part of the Investing process. We are our own harshest critics and while I am certain we will make other mistakes in times to come, we are determined not to repeat errors.

Bharti Airtel (Mcap: ~Rs 1,42,800 crs; Transformation)

Our original Investment thesis on Bharti was based on the premise that backed by high speeds and very reasonable prices, data consumption would grow exponentially as a secular theme and the sellers of bandwidth would be akin to those who sold equipment to Gold Miners. Consolidation was resulting in a very favourable industry structure and stressed balance sheets across the sector, including Reliance, would result in the ARPU increasing, helping all players earn a healthy Return on Capital. Further, we expected Bharti's Operating Cash Flows to support capex and interest payment obligations such that net debt would not meaningfully increase.

However, we discovered two errors in our thesis.

- We realized that Jio's ambitions were no longer restricted to having a dominant share of the telco market, but it wanted to be a "platform player" that provides consumers not just communication but also content and commerce. "Communication" could be a low margin business to build a large consumer base, which are then upsold commerce. This would imply that the low pricing environment could persist for much longer till its market share aspirations were met.
- We realized that a favourable industry structure does not necessarily imply stable competitor behaviour. With Jio aspiring for 50% market share and two strong incumbents willing to infuse Capital to protect their share, the stage is set for a prolonged battle. Competitive behaviour is only stable if there is a dominant player with significant market share advantages over others.

[12] Under assumption of 13% Cost of Equity, and 9% terminal value growth and gradual increase in conversion of PAT to Free Cash Flow to 70%

Subsequent to our investment, the intensity of the price war led to further deterioration in Bharti's balance sheet as its Operating Cash Flow was not sufficient to service Interest and Cap ex needs. This resulted in an increase in Debt and Equity dilution. While short term prospects for Bharti were cloudy, the market correction provided other opportunities which offered a better risk/return perspective in both short and long term. In hindsight, we were too early and should have waited for market share stability.

Shaily Engineering (Mcap: ~Rs 630 crs; Emerging Leader)

Shaily Engineering is a supplier of high precision injection molded plastic components and assemblies. Shaily's products are differentiated from commodity injection moulders and that is reflected in significantly higher Gross Profit margins which are almost 50% higher than some other publicly listed injection moulding companies in India.

Shaily Engineering is on a high growth path (EBITDA CAGR of 21% between FY 13-FY 18). However, it has high customer concentration risk with IKEA accounting for ~50% of its Revenues. Shaily's growth momentum was interrupted by power availability issues in Q1 and Q2 and inventory rationalization by IKEA in its global supply chain in Q3. Valuations were building in a continuation of strong growth momentum and disappointment resulted in a significant stock price decline. Clearly, <u>we overpaid for high growth expectations which did not materialize.</u>

We were cognisant of the customer concentration risk when we bought into Shaily. We believe such risks should not be avoided as many B2B companies in their early stage of growth are built on the back of credibility with one or two anchor customers. With scale and credibility, these risks reduce. We use position sizing to manage these risks as the risk event materializing is a binary outcomes. Hence, Shaily was a ~4% weight in the portfolio at purchase.

For Emerging Leaders, progress on Operating variables serve as a better lead indicator of progress rather than Financial metrics. Shaily continues to add new customer logos and win more programs from existing customers including IKEA. Based on what we know at present, nothing fundamental has gone wrong in the business – there is a pause in growth due to customer circumstances which should be addressed in a few quarters.

We expect more Capital Allocation discipline and increase in return ratios in the year ahead. The initial growth of a company is driven primarily by the need for customer conversion with ROCE taking a back seat. As companies grow, more financial discipline gets built in from learnings, better systems, scale based synergies in procurement, overhead and Asset productivity and ability/courage to refuse low margin business. We expect the ROCE of Shaily Engineering to inch up to 20%+ in two years.

We believe in the growth opportunity, Shaily's differentiated offering, credibility with customers and management's execution capabilities. We see the correction as an opportunity to add to our holdings on continued price weakness and/or improvement in execution.

Outlook

Over the next decade, India is expected to be amongst the fastest growing large economies in the world. While economic growth rates over the past few years have been sluggish, growth rates must be seen in the context that the economy has witnessed the shock of demonetisation and three significant reforms in less than 36 months – RERA, GST and the Implementation of the Bankruptcy Code. Multiple reforms enacted almost simultaneously have unsettled the normal rhythm of the economy and one should see the intended impact of these reforms translating into stronger economic growth in the next few years. Over the medium term, healthy economic growth should translate into stronger earnings growth which in turn should reflect in healthy stock prices

Partners should not be deterred from their long term investing path because of volatility caused by any surprise verdict in the National elections. The market appears to be pricing in a BJP/NDA victory as the BJP Govt. is perceived to be more market friendly. However, it would be interesting to note that the absolute market returns over the BJP tenure (2014-2019 till date) have been lower at 61% than either during UPA 1 (114%) or UPA 2 (96%). What eventually matters is earnings growth- everything else is noise.

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Our Investing approach has evolved since we started 5 years ago through our experiences and will evolve further over time – however, the key principles which are the foundation on which we are building our franchise will always be constant: focus on capital protection, partners interests always come first, complete alignment of my family's interests, transparency in thought process and to never compromise on integrity in the pursuit of commercial gains.

I will be delighted to have a personal conversation

With my best wishes
Manish Gupta
Chief Investment Officer