

1 July 2019

Dear Partners:

It is hard to escape bad news at present. Contested GDP growth numbers, a slowing economy, Credit rating agencies asleep on the wheel, Auditors in cahoots with Management, trade wars, Oil price spikes...

Reported data suggests the economy is slowing down. Sentiment affects how freely people spend. And the last 18 months have certainly not been positive for the “Wealth Effect” with falling Real Estate prices, lacklustre performance of Small and Mid-Caps (hunting ground for many investors), and losses for investors even in Debt Instruments.

Part of the pain the economy is experiencing can be explained by the concerted effort being made by the Govt. to steer the economy towards better regulatory compliance and governance (Demonetisation, GST, Bankruptcy Law, RERA, scrutiny on Auditors). This has been compounded by execution issues (example the administrative complexity of GST for SMEs, delays in NCLT) and liquidity/solvency issues affecting some NBFCs which have choked credit flow in the economy.

NBFCs accounted for 33% of the incremental Credit in the economy in FY 18. Some NBFCs have committed the cardinal sin of borrowing short term to invest in illiquid long term Assets¹. After the ILFS default, funds flow to non-genuine AAA NBFCs has reduced considerably due to concerns on Solvency. This in turn has affected Working Capital disbursements to many segments of the economy like SMEs who are deeply reliant on NBFCs for funds. The funding problem is most acute in Real Estate, which directly and indirectly contributes a large share to GDP growth.

In a tough market environment, like at present, especially when Governance issues are coming to the forefront, capital migrates towards Quality names and where there is higher “relative” visibility of growth and abundant liquidity. This has resulted in a wide dispersion in valuation multiples and stock prices as the market separates the wheat from the chaff.

- Companies who are showing Earnings growth and have no concerns around Governance are trading at close to all time high’s (HDFC Bank, Bajaj Finance, TITAN)
- Companies where governance and quality of books is suspect are trading close to 3 year lows (Yes Bank, DHFL, PC Jewellers)

When will growth turn around? Is it a good time to deploy incremental capital? No one, without exception, knows what can cause economic conditions or sentiment to change or what the market will do in the short term. We need to keep focus on the larger prize ahead of us and construct portfolios comprising well run companies who will benefit from secular tail winds of growth² and can thus provide broadly predictable earnings/cash flow growth. Markets have always lived with uncertainty and eventually what matters in the medium term is earnings growth.

The pain of transition to a more tax compliant economy is not something we can escape if we want a stronger future. The Govt. needs more tax revenue to fund Infrastructure and social programs to mitigate inequality. If the Govt. attempt on “governance renaissance” sustains, and we don’t revert

¹ Called “Asset Liability duration mismatch”

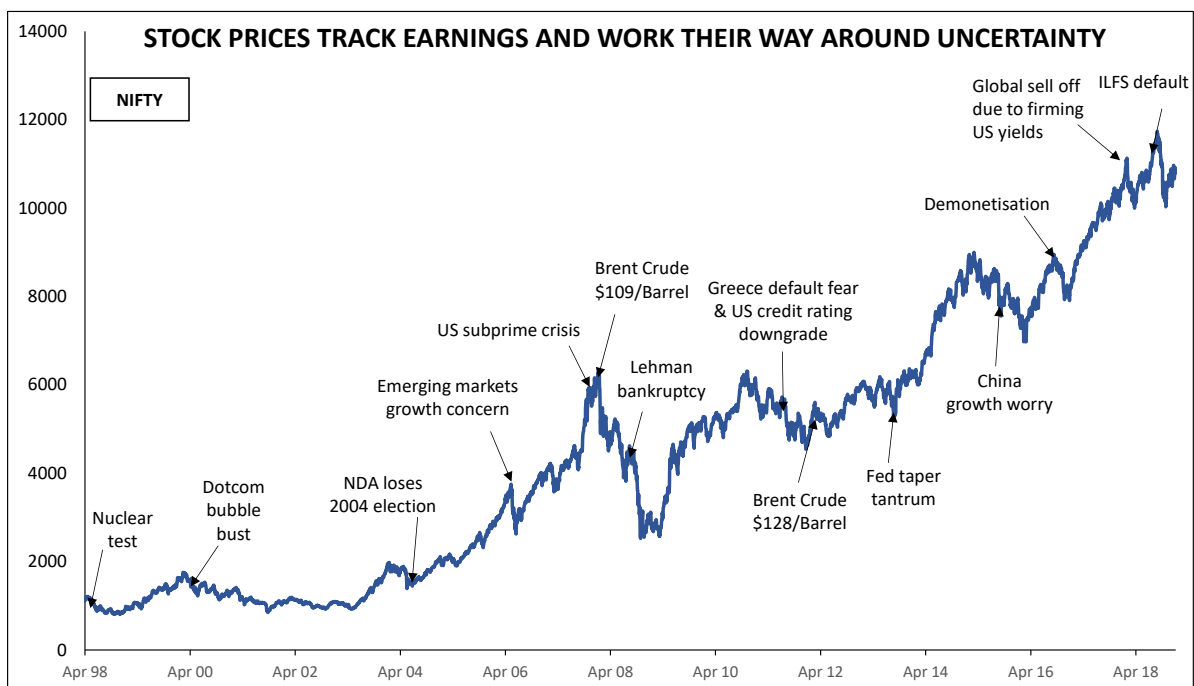
² We shared the secular themes of interest to us in our Annual Letter published on 3 April 2019 which you can read [here](#)

to bad behaviour, it will benefit the economy as formalization of the economy increases tax collections. And over time, Banks and genuine AAA NBFCs will move to fill in the funding void.

The impetus towards formalization favours the kind of companies Solidarity invest in – well run companies built on pillars of good governance and prudent risk taking - as it provides them additional tail winds to gain market share from competitors who need to adjust to a new way of doing business even as their historical unfair cost advantages get negated. Not surprisingly, many companies we own are beneficiaries and are trading close to life time highs with our portfolio NAVs up approx. 8% in Q1³.

Hence, while we have no opinion on when economic conditions will improve, or what the markets may do in the short term, we remain optimistic about prospects for Earnings growth and hence stock prices for our portfolio companies over the next 5 years.

We recommend you continue to participate systematically, rather than through large one time commitments, and be disciplined on Asset Allocation.



Portfolio Actions

The breadth of opportunities in which we would like to commit additional capital is narrow at present. Partners who have recently begun accounts with us may note that we have only done partial draw - downs as we await more attractive entry points. One needs to be patient when valuations are not in favour. (Example, Consumer Discretionary).

However, ascertaining fair valuations for pristine quality companies is getting challenging.

- One can underestimate the depth of competitive advantage and hence pace of market share gains for well-run companies in an economy undergoing transformation and hence be wrong on the estimated Earnings growth. A noticeable miss for us has been Bajaj Finance.

³NAV increases may vary by account as we don't have a Model portfolio but construct personalized portfolios based on time of entry

- Secondly, fair valuation multiples are also a function of interest rates. Over USD 12 Trillion of Bonds globally now trade at negative interest rates and Austria just issued a 100 Year Bond at 1.1% coupon. One can make an argument that for a foreign investor, a 60X multiple is not expensive on a relative basis if one sees opportunity for growth and governance is not a concern.

However, the above arguments can be made for very few companies and one should not use them to justify buying Quality at any price. If one is willing to pay a premium valuation multiple, one has to be sure that Earnings growth will not disappoint, even due to factors beyond the company's control. Mean reversion of valuation multiples is a truism. If earnings disappoint, valuation multiples correct very aggressively.

We find buying Opportunity at present in select companies in the following sectors: Banks, Specialty Chemical players and Power Generation

- We believe select Banks (strong deposit franchise resulting in low cost of funds, conservative culture of lending, non-aggressive ROE targets) have good opportunity for 20%+ Earnings growth rate over the next few years from additional tail winds of market share gains from weaker PSU Banks and NBFCs. Going forward, greater regulatory supervision on Rating Agencies should result in relatively more honest ratings due to which Credit risk will get more accurately priced, and should result in a structural increase in cost of funding for non-genuine AAA NBFCs. In conjunction, Capital Adequacy requirements and liquidity requirements for NBFCs are increasing. This would mean non AAA NBFCs will find it harder to compete with Banks on Retail lending products like mortgages and asset backed loans. We believe this narrative of stronger growth without need for excessive risk taking is still not reflecting in Valuations of many names at present.
- The US China trade war is not just about tariffs – but of the US reaction to China challenging its hegemony and influence. This has coincided with the pollution crack-down in China which has resulted in an increase in cost structure for Chinese players as they invest to upgrade facilities and hence their cost differential with Indian companies has narrowed. Both of these create a huge impetus for MNCs looking to diversify their supply chains from China⁴, providing an opportunity for Indian companies to gain market share by providing a dependable sourcing alternative, especially in sectors which have regulatory oversight and where supply sources need to be stable and not frequently changing. We acknowledge that India also has simmering issues with the US on trade, and an unpredictable US President. But “genuine” Speciality Chemicals requires skills where India is uniquely positioned with cost as an added advantage. The West is moving away from Dirty Chemistry and manufacturing capacities/skills cannot be built overnight in other countries.
- Uncertainty in regulatory environment around Power PPAs is resulting in a significant slow-down in new capacity addition. Meanwhile, demand for power is growing. Well capitalized players can benefit from acquiring Power Assets in NCLT as well as re rating of sector multiples as the Demand/Supply comes more in Balance

Some “Emerging Leaders” we own or which are in our watch list are fundamentally attractive businesses but are facing short term growth challenges. As capital chases momentum, these have become unloved and are witnessing a sell off. Partners may observe that we have been adding to

⁴ Apple has asked its suppliers to evaluate cost implications of shifting 15-30 per cent of their production capacity from China to south-east Asia ... the request was triggered by the protracted trade tensions between Washington and Beijing, but sources say that even if the spat is resolved there will be no turning back. The risks of relying so heavily on manufacturing in China are too great and rising. Source: Financial Times

these positions gradually. However, we cannot be over weight in these positions due to the poor liquidity in these companies.

In the section below, we discuss the rationale for a new portfolio addition (Sequent Scientific) and explain why we exited Tata Steel.

Sequent Scientific⁵ (Transformation → Emerging Leader)

Many Indian companies have created large Human Pharma businesses out of India. However, other than Hester Bio Sciences⁶ (focus on Animal and Poultry vaccines), there are no Pharma companies with a global footprint out of India focusing on Animal Health. Sequent's strategy is to create an Integrated (formulations + API) Animal Health care company out of India.

In buying Sequent, we are also aligning interests with an entrepreneur (Arun Kumar) with a strong track record of value creation in Pharmaceuticals and Life Sciences⁷.

Animal Health is an attractive business segment. Compared to Human Health (USD 1000 Bn), Animal Health is a much smaller market (USD 42 Bn), with favourable implications for competitive intensity. However, leading Animal Health care companies have margins⁸ which are significantly higher than leading Human Health care companies. Animal drugs/products in the Developed markets are primarily sold as Branded products, which need to be prescribed by Vets, akin to how drugs are sold in India. Most Human Pharma products are primarily sold as Generics. Animal Healthcare requires limited innovation or new product development as the goal is not to prolong life but more to enhance productivity/safety of Animals. Hence, R&D expenses are much lower vs. Human Generics. At the same, regulatory scrutiny is intense.

It takes time to build an Animal Health business organically and reach meaningful scale. Existing brands and relationships are moats to be overcome by a new entrant. Hence, M&A for a new entrant as a way to achieve scale cannot be wished away. Product registrations are required by country, front end relationships need to be created with vets in each market. While an M&A led strategy is inherently risky, there are examples of Management teams that have made it work and created significant value by being disciplined on acquisition prices paid and through a process of rapid integration.

Over the past five years, Sequent has been transformed into a focused Animal Healthcare franchise.

- Sequent was a portfolio of unrelated businesses prior to 2014 with Animal Health ~38% of revenue. All non-Animal Health businesses have either been divested (Specialty Chemicals, Women Health), demerged into other companies (Human API) or shut down (Penems).
- API Facilities were upgraded for compliance with developed world regulatory standards.
- Formulations: Over 9 acquisitions (of which 3 were material) have been completed. Acquisitions were of sub scale businesses where promoters lacked Capital for growth, but had access to registrations, distribution and/or manufacturing facilities. Sequent has invested growth capital in the Businesses and ensured that erstwhile promoters retain some minority stake for continued engagement. Sequent now is present in over 100 markets across the world and has Manufacturing sites not only India, but also Brazil, Germany, Spain and Turkey which provide local market proximity and a de-risked manufacturing footprint.

⁵ We are sharing the Investment rationale as this is a recent addition to the portfolio. We reserve the right to change our opinion and not intimate the same publicly

⁶ Hester has just started to build a footprint in Africa

⁷ <https://the-ken.com/story/strides-sequent-solara-an-indian-entrepreneurs-ingenious-pharma-spiderweb/>

⁸ Zoetis, the industry leader is at ~34% EBITDA margins

Sequent's API facilities in Visakhapatnam are a hugely advantaged Asset in today's environment.

- Sequent already supplies APIs to the top 10 Animal Health care companies globally, is the only USFDA approved uniquely Animal API facility in India and has the highest number of Animal API filings in the US amongst all API players globally.
- The upgradation of Infrastructure and compliance standards in Sequent's API facilities has coincided with tail winds of increased FDA scrutiny on API players⁹, China's crack down on pollution and US China trade and geopolitical tensions. Many API players in China have to invest in zero liquid discharge facilities which reduce their historical cost advantage over India. Geopolitical issues are making US companies look to diversify their sourcing from China¹⁰.
- When supply stability is threatened, supply availability becomes paramount and pricing is secondary. This has created a significant opportunity for Sequent to gain market share in APIs with developed world companies while earning its fair share of the margin in the entire value chain

After 5 years of grind, we believe Sequent earnings/cash flows are now poised to break out over next few years. The API business should deliver very strong cash flows in the short term with Formulations picking up pace in about 2 years

- We expect the API business to register robust top line growth and even stronger bottom-line as lower margin developing world business is replaced with higher margin business from the developed markets. In addition, the API business has significant Operating Leverage. Growth with some pricing power without proportionate increase in Fixed Expenses should translate into a big boost in EBITDA growth.
- The Formulations business is growing at ~10% (constant currency) with some infusion of Working Capital into acquired companies. R&D investments being made (35 products under development), more control on Manufacturing facilities located within the same geography should help step up growth rate over the next few years.

Progress on the transformation is visible in FY 19 results

- API business grew 38% in FY 19 over FY 18. The top 5 customers from Developed markets have grown their API sourcing from Sequent 2.4X in FY 19 over FY 18
- Formulations growth has been steady
- Operating cash flows were 115 Cr in FY 19 compared to 56Cr in FY 18 and -10 Cr in FY 17
- Debt reduced significantly from 5x Debt/EBITDA in FY 16 to 1.5x Debt/EBITDA in FY 19. If monetizable investments¹¹ are included as Cash equivalents, Sequent is practically debt free with Debt/EBITDA < 0.2x

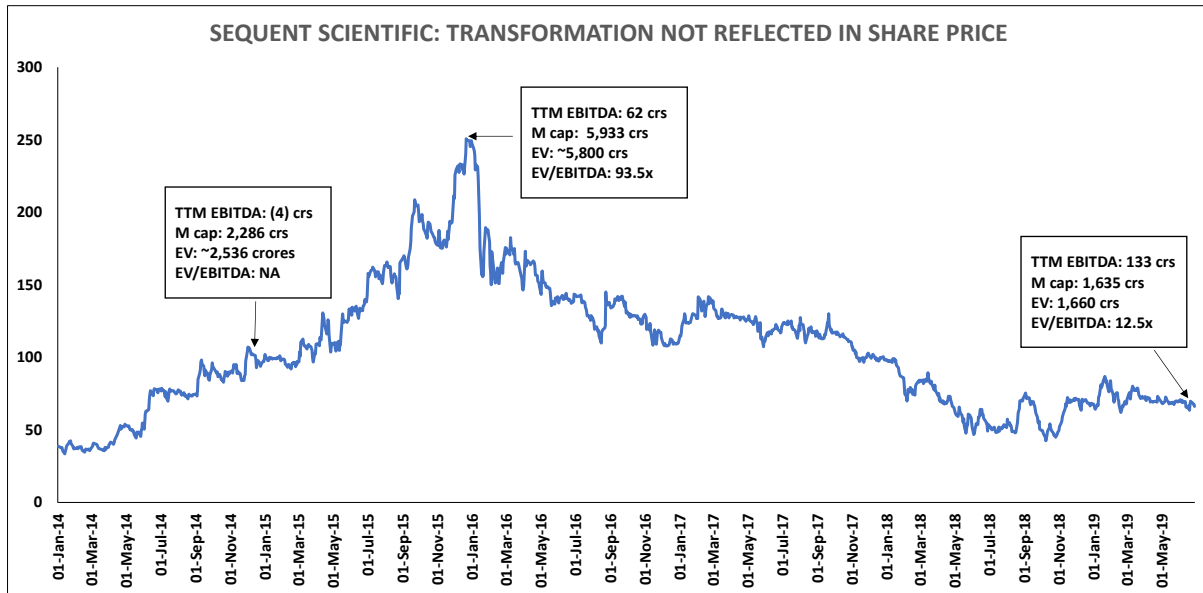
The company now has a credible global distribution network for formulations which will be enhanced with entry in the US markets by FY 21. The strong cash flows in the API business over next 3 years will help expedite investments in R&D and product filings across multiple geographies leading to strong growth in formulations FY22 onwards. This would make it a very valuable platform for a potential acquirer.

⁹The API industry was in the dog house for many years as low regulatory oversight led to a proliferation of suppliers and a collapse in margins. Over the last few years, the US FDA has increased scrutiny on API and intermediate suppliers. It becomes unviable for API players to supply both regulated and unregulated markets from the same plant as compliance costs don't justify unregulated market margins. Many players have chosen just to focus on unregulated markets.

¹⁰API business models that are more reliant on selling in spot markets or developing markets, rather than regulated markets will be vulnerable when China supplies return.

¹¹ Sequent's equity stake in Strides and Solara post demerger of the Human API business is valued at ~180 Cr

We believe the current stock price is not reflecting the transformation delivered by the management in the last few years, the fact that a lot of the M&A risk is behind us or the prospects for incremental cash flow growth and ROCE. Sequent had a massive stock price run up between 2014- 2016 (see chart below¹²) perhaps driven by the value creation reputation of Arun Kumar. Despite a confused business portfolio and no profits, the promoters’ track record catapulted the stock to a peak Market Cap of 6000 Cr. When the numbers did not live up to the narrative, the stock declined over time. Pessimism often becomes deeply rooted. Even though the numbers are now supporting the growth narrative, there is insufficient interest with very limited Institutional holding or broker coverage. This provides an opportunity to ride both earnings growth and valuation re-rating



Even as the narrative for Sequent is strong, future cash flows will be a function of how well the management team executes in building the Formulations franchise, and also how the sourcing environment for APIs for regulated markets evolves in China (which will influence market share and margins in APIs for Sequent). The competitive moat is not very wide at present, but is being built. We have hence taken our first “foot in the door” position and will build it further over time as we see evidence of execution. Partners interested in a deeper understanding may write to us for a copy of our detailed Investment note.

Tata Steel

We seek compounding and therefore don’t take exit decisions easily. But we will act if we are wrong, and for purposes of risk management (if valuations are euphoric)

Our Investment thesis on Tata Steel was critically dependent on improved ROCE driven by visible actions towards deleveraging of its Balance Sheet and its pivot towards an India focused business. Tata Steel was a debt free company in 2007 before it embarked on a massively value destroying acquisition of Corus in Europe which saddled it with significant debt and poorly performing operations. Incremental Capital which should have been invested in India, a very attractive market for Steel, and where Tata Steel has cost and market leadership, was diverted to support Corus.

We bought into Tata Steel in 2017 when they announced a JV with Thyssen Krupp for their European operations with the intent to deleverage and focus their Capital Allocation on the Indian market. When

¹² Net Debt used for EV calculation considers monetizable Assets as Cash Equivalents

the EU Competition commission rejected the JV with Thyssen Krupp in April 2019, the core argument around which our Investment decision was based was no longer valid. When facts changed, we chose to exit and reallocate Capital to other more promising opportunities.

Uncertainty is always rife and the present always seems more uncertain than the past. Our ability to invest patient capital permits us look to the future with optimism.

We will be happy to receive your perspective on where you disagree with our thinking, and good practices you have observed at other Investment firms we should emulate.

With my best wishes,

Manish Gupta
Chief Investment Officer