4 October 22

Dear Partners:

The purpose of our quarterly letters is to provide transparency in how we are thinking.

Key messages – Don't let fear of short-term drawdowns interrupt compounding.

- Performance remains healthy at 20.8% per annum TWRR post fees/expenses vs 11.5% for NIFTY 500 over last 5 years (our preferred time horizon for performance measurement).
- In our last 4 letters we have repeatedly stated "we have borrowed returns from the future" and one must be realistic in short term return expectations. We continue to hold this view.
- There is a regime change underway in global markets. The two-decade peaceful co-operation between superpowers that supported win-win outcomes in globalization and the era of cheap money has ended. Central Bankers determination to bring inflation under control is causing markets in the developed world to correct significantly as cash flow expectations and Cost of Capital - cost of money - in the developed world gets significantly repriced.
- India should be a beneficiary of the changing world order as it benefits from "friend-shoring" and as Cost of Capital – basis interest rates today - does not need to be significantly repriced.
- While India stands out, it cannot be completely "decoupled." High and sustained inflation in the developed world will cause the US Fed to keep raising rates with negative implications for inflation and interest rates in India.
- One should respect challenges but not be overcautious. On the one hand, starting valuation multiples in India are higher than long term averages and there is the drag of growth from a recession in the developed world. On the other hand, we are active managers and don't hug the Index. We could be close to peak inflation in the developed world. Our portfolio companies' earnings should be resilient in a challenging environment.
- Our approach seeking resilient compounding remains unchanged. However, we need to fish where the fish are. Hence, at the margin, we will take on more concentration risk, some illiquidity risk and be willing to experiment with Special Situations.
- We discuss our Investment thesis for Star Health Insurance and explain why we have changed our recommendation on Gold and why we prefer Private Banks to PSU Banks, despite the latter being more cheaply valued.

Contents

1. Performance update P2
2. Perspective on global developments P2
3. Has India de-coupled? P3
4. Recommendation to partners P6
5. Actions taken in the last quarter P8
6. Investment thesis on Star Health P9

Answers to interesting questions we have been asked recently

7. Why we have changed our view on Gold P12
8. Why we don't own PSU Banks despite valuation differential with Pvt Banks P12

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 customised portfolios based on valuations at point of entry and cash available for deployment. Hence, all positions may not be held in your account.
- Performance in individual accounts may vary from aggregate performance.

Performance update

Aggregate across all partner accounts					
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception^**
SOLIDARITY	-7.6%	26.4%	24.4%	20.8%	**19.5%**
NIFTY	-3.0%	23.3%	14.2%	11.8%	**12.9%**
NIFTY500	-1.5%	26.0%	16.7%	11.5%	**13.5%**

Data as of 30 Sep 2022
^ From 11 May 2016 -Start date of PMS License
Solidarity performance is net of all fees & expenses
Note: Performance data provided in the above table is not verified by SEBI

Performance over rolling 5-year basis (our preferred time horizon).

- TWRR per annum of 20.8% post fees.
- This is 9.3% per annum over NSE 500 post fees.

We have underperformed the markets for the last one year. We neither celebrate outperformance nor worry about underperformance in short time horizons. Our focus is on long term outcomes. No strategy works in all environments. Hence, we encourage partners to measure performance over a rolling 5-year basis which adjusts for luck, good process, and market cycles.

Perspective on global developments

The truce between large countries which underpinned "win-win" outcomes in globalization for the last two decades has collapsed.

- China's entry into the WTO lowered prices of goods all over the world. Low labour costs, large scale manufacturing and world class infrastructure meant that China became the manufacturing factory of the world.
- Lower inflation resulted in benign monetary policy which in turn enhance demand. China and Russia bought US Treasuries which further kept interest rates low and let the Western world go on a debt binge, which in turn supported growth.

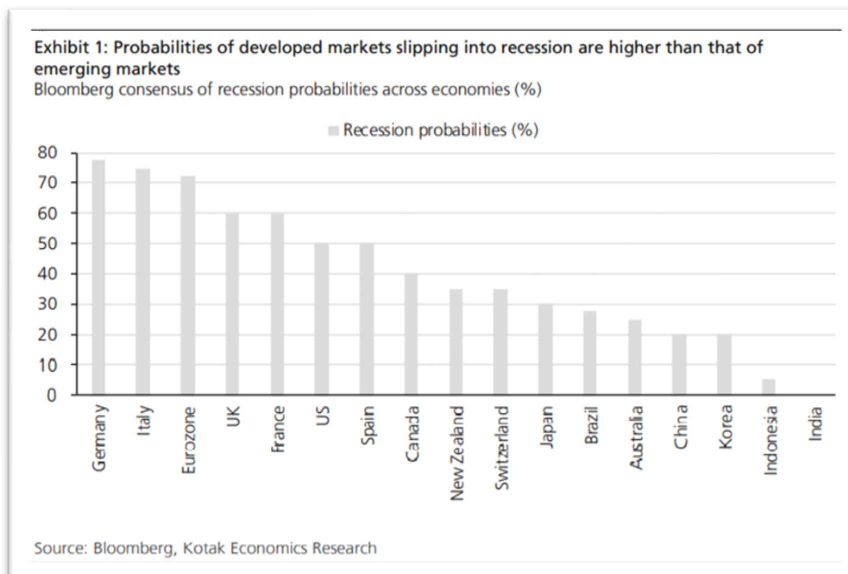
Peaceful collaboration and benign Central Bank behaviour are seeing a fundamental "U" turn.

- China and US strategic interests are colliding on core issues like semiconductor technology, human rights, and Taiwan.
- In the pursuit of cost efficiency, the world forgot resilience. Global supply chains in their existing form are ill-suited for the new world order. China is muscular in pursuit of its strategic interests and effectively blockaded Taiwan for a week. Russia has used Gas as a weapon of war by cutting supplies to Europe. The developed world has effectively banned goods produced from the Xinjiang province in China.
- Monetary tail winds of over two decades are now turning to head winds. Excessive Covid stimulus and cheap money from Central Banks has resulted in soaring inflation. Central Banks are reversing course and are determined to controlling inflation, even if it results in recession.

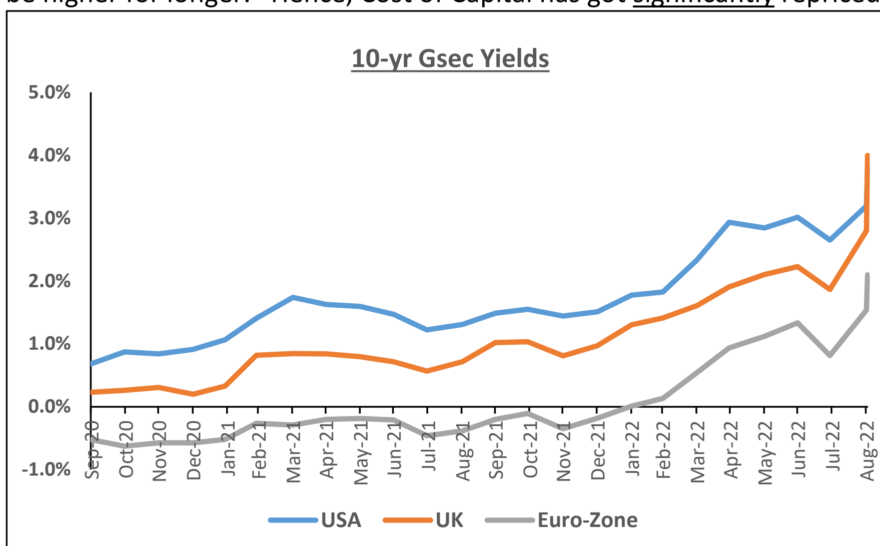
Global stock markets have corrected meaningfully as growth expectations and Cost of Capital get repriced dramatically in the developed world.

- There is high probability that the developed world will slip into a recession. China's growth is anaemic due to its zero Covid stance, crack down on businesses and a deep Real Estate crisis[1]. Germany's manufacturing industry confronts both an Energy price shock (prices up 10x) and demand challenges from stress on exports to China[2].

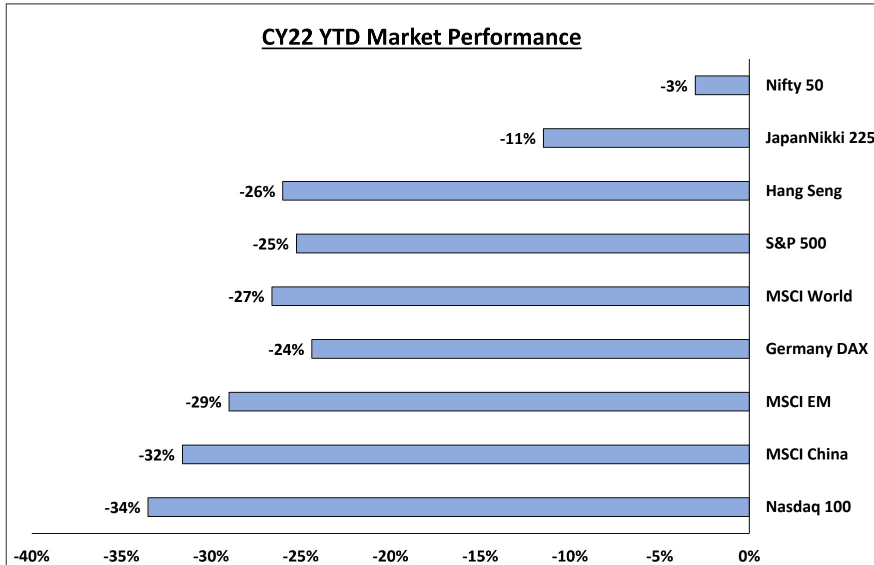
[1] Real Estate is about 25% of China's economy and 2/3rd of individual wealth is in residential real estate
[2] More than a third of aggregate sales of VW, Mercedes and BMW are in China



- Europe can no longer rely on cheap Russian gas. Environmental concerns have resulted in very low investments in fossil fuels over the last decade while renewable energy has not scaled quickly enough to fill in the gaps. Substitute sources will be more expensive. This will significantly impact the competitiveness of some energy intensive manufacturing out of Europe (smelting, fertilizers, commodity chemicals).
- While inflation as measured could reduce over time, prices of end products could remain high reducing real consumer disposable incomes. Energy costs flow almost into every product including food (Nitrogen based fertilizers are very energy intensive).
- Growth could stay muted for longer. Consumption using Debt pulls forward demand. The Western World/China growth model has been highly reliant on usage of debt to boost growth. Inability to keep expanding Debt will have severe implications for medium term growth.
- Interest rates are moving up significantly. Firm communication by Central Bankers on resolve to crush inflation is making markets "finally" believe that developed world interest rates will be higher for longer. Hence, Cost of Capital has got significantly repriced.



The scale of correction in India has been much lower than other markets[3].



Has India decoupled?
We can never be de-coupled as while we may be more resilient on growth, we are connected financially and hence vulnerable to external risks.

The India market has been broadly resilient as earnings expectations have not significantly changed.

- Real GDP is expected to grow 7%+ in FY 23 in contrast to recessionary conditions elsewhere. The NIFTY 50 Earnings are still expected to grow ~11% in FY 23.[4]
- Bank Balance sheets are clean. Credit growth is at a 9 year high. HDFC Bank's CEO is said to have said that "growth is pouring out of ears[5]" in a road show.
- India should be a beneficiary of "friend-shoring". For example, SRF (a leader in Specialty Chemicals) has announced over a doubling of cap ex in the next five years vs the previous five.
- High-capacity utilizations, currently at ~73%, will start a new Cap-ex cycle.
- Global IT spending has headwinds but should not collapse.
- The recent weakness in the Indian Rupee vs the USD is not a reflection of the weakness in the economy, but more a rush to safety of the USD. The INR has appreciated against the Euro, Yen, and the Pound during this period.

Cost of Capital in India – basis inflation/interest rates today – does not need to be significantly repriced.

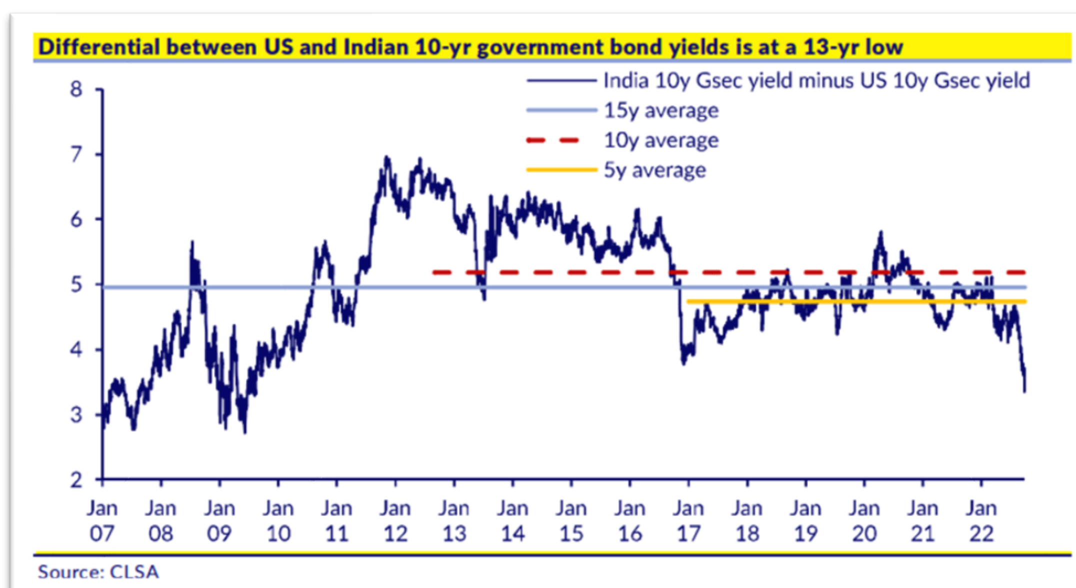
- Our inflation trajectory and long-term bond yields are not very far from long term averages – a stark contrast to the developed world.
- India's nuanced use of stimulus during Covid means we are not facing the same inflationary issues as the West.
- India is the only large country where aggregate debt burdens as % of GDP have not expanded since 2008 – when developed world Central Bankers turned on the printing presses.

[3] Source: Investing.com
[4] Source: Bloomberg consensus estimates
[5] Macquarie report, 5 Sep 2022

Cost of Capital in India does not need to be repriced significantly vs the developed world				
	India	**US**	**UK**	**Eurozone**
Avg 10 Yr G Sec Yields FY 12-22	7.30%	2.10%	1.40%	0.40%
10 Yr G Secs yield 3 months ago	7.40%	3.00%	2.20%	1.30%
10 Yr G Secs yield today	7.30%	3.80%	4.00%	2.10%
Avg CPI Inflation 2012-2022	5.80%	2.10%	2.00%	1.40%
CPI inflation today	7.00%	8.30%	9.90%	9.10%
Increase in Central Bank Balance sheets (Covid to today)	16%	114%	90%	55%
Increase in Aggregate Debt/GDP 2008 - 2022	-6%	49%	54%	147%
Source: Bloomberg; Debt/GDP data sourced from Kotak MF presentation				

However, one cannot make a case for "de-coupling" as we are vulnerable to external risks.

- India's exports/IT Services are ~20% of GDP. A recession in the developed world will impact us through linkages.
- If developed world interest rates continue to rise, it will have an adverse impact on our currency/bond yields as well. 10 Year G-Sec differentials vs the US at 3.3% are the lowest they have been in 13 years[6]. A further rise in US interest rates will result in more Rupee depreciation or higher bond yields in India as well. This will result in greater head winds to growth and inflation.
- If Oil stays above USD 100/barrel for an extended time, our Balance of payments becomes stressed.
- We cannot be insulated from any event that creates a systemic risk.



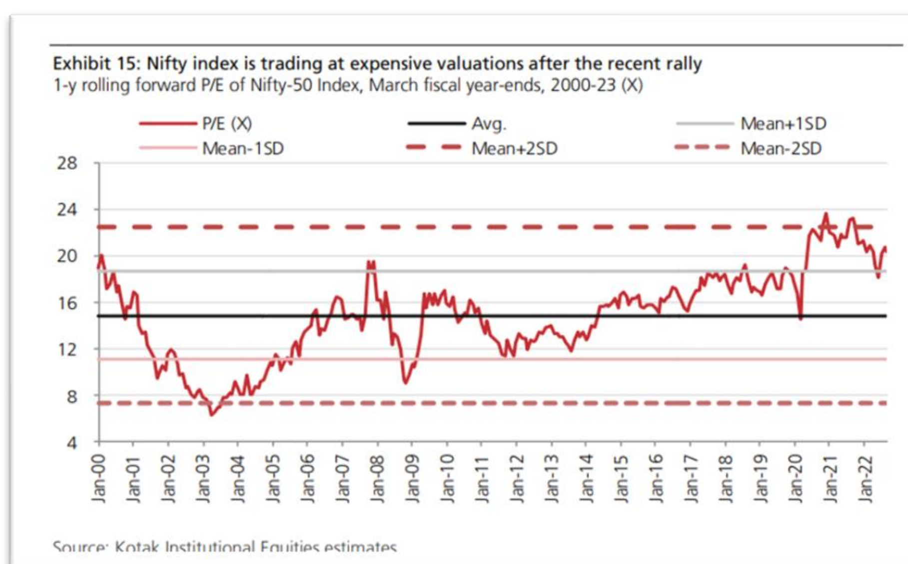
[6] Source: CLSA

Recommendations to partners

F. Scott Fitzgerald wrote: "The test of a first-rate intelligence is the ability to hold two opposing ideas in mind at the same time and still retain the ability to function."

We know the current environment is challenging. However, we can never know whether risks we see will materialize or not, or the timeline in which they strike. There could be other variables at play (discussed below) which could support valuations. But we also know there is a decadal growth story ahead for India. In waiting for the storm clouds to clear, one should not miss a decadal story. Compounding works as companies with resilient business models grow despite challenges.

Hence, its best to keep long term horizons and accept any temporary downside that may come due to events beyond our control. One needs to be realistic in return expectations as while we will benefit from Earnings growth, the market in aggregate will face head winds of multiple decline from high starting points.



Respect external challenges but do not be overcautious.

- Index valuation charts provide an important data point. However, the changing sectoral composition of the Index and strengthening of the economy over time means that they should not be interpreted in isolation.
- We do not hug the Index. As an example, we own no IT Services which are ~14% of the Index and we are significantly over-weight Financials vs the Index at present.
- Our portfolio companies are well positioned to deliver earnings growth, despite external challenges.
- We "could" be close to peak inflation – for example commodity prices have dropped ~40%. Housing prices in the US have started to fall. Freight rates from Asia to the US are down over 80% in last 3 months[7].
- Capital chases growth and stability. India may attract a larger share of global FII flows as Russia is un-investable, China's crack down on businesses and risk of war with Taiwan has increased the political risk associated with these markets.
- Inclusion in global bond indices may result in ~USD20-30B of annual inflows. This could result in some support to long term bond yields as pressure on domestic markets to support Govt. borrowing (~USD 180B a year) reduces.

[7] https://www.livemint.com/news/india/vanishing-traffic-at-key-ports-signals-demand-slump-in-west-11664581598927.html

The Index hides pockets of opportunity					
	Valuation metric	Mar 14	Mar 16	Mar 19	Current day
Illustrative names where valuations are rich					
Maruti	1 Yr Fwd PE	17	18	23	30
HUL	1 Yr Fwd PE	33	39	50	56
TCS	1 Yr Fwd PE	19	18	22	25
Illustrative names where valuations are reasonable					
HDFC Bank	1 Yr Fwd PB	3.5	3.2	3.8	2.8
Axis Bank	1 Yr Fwd PB	1.6	1.8	2.7	1.9
ICICI Pru Life	Trailing P/EV	NA	NA	2.3	2.4
Source: Kotak Institutional Equities, other than ICICI Pru Life					

Implications for Solidarity

We focus on secular trends, diversify across themes, and buy resilient companies. Over 95% of our portfolio comprises Clear or Emerging Leaders in their domains. We navigate turbulence by buying resilience, not by constantly changing what we own.

When breadth of opportunity is narrow, at the margin, we need to take on a bit more concentration risk and embrace some illiquid positions where longevity of growth, quality of franchise and valuations are compelling. Risk in the latter need to be managed through position sizing.

We also need to expand beyond our core approach to fish where opportunities are. We will experiment with Special Situations (with low weights) where compounding may be missing, but there is very high upside/low downside and governance is not a concern.

Key actions taken in the last quarter

We significantly increased our position in Star Health, the industry leader in retail Health Insurance. We share a detailed investment thesis on Star Health in the next section.

We sold our position in Kotak Bank to re-allocate to Star Health.

- There is no change in our Earnings thesis on Kotak.
- However, we believe the valuation premium Kotak has enjoyed in the past vs peers will drift lower over time as other top 3 private sector banks sustainably make 15%+ ROEs and the scarcity factor erodes.
- Hence, one risks sub-par IRRs here while capital can be allocated for better returns to companies much earlier in their growth life cycle and which enjoy industry dominance.

We bought Kama Holdings, the holding company for SRF. We will share a more detailed thesis on Kama Holdings in our next letter.

Star Health and Allied Insurance Co. (Clear Leader)

Star Health is a Health Insurance company primarily[8] focused on the retail segment. This is a business we would like to own for long periods of time.

- It offers a product which has a tangible value proposition - Health insurance is something we think everyone should own.
- Dominant leadership position in a large and growing market with a long runway for growth.
- Attractive business fundamentals supported by high repeat purchase, agent stickiness and ability to correct pricing errors through product repricing.
- Potential to grow PAT ~18-20%+ for next decade while earning 16-18% Accounting ROE and 25%+ Cash ROE with a "win-win" for the entire ecosystem.

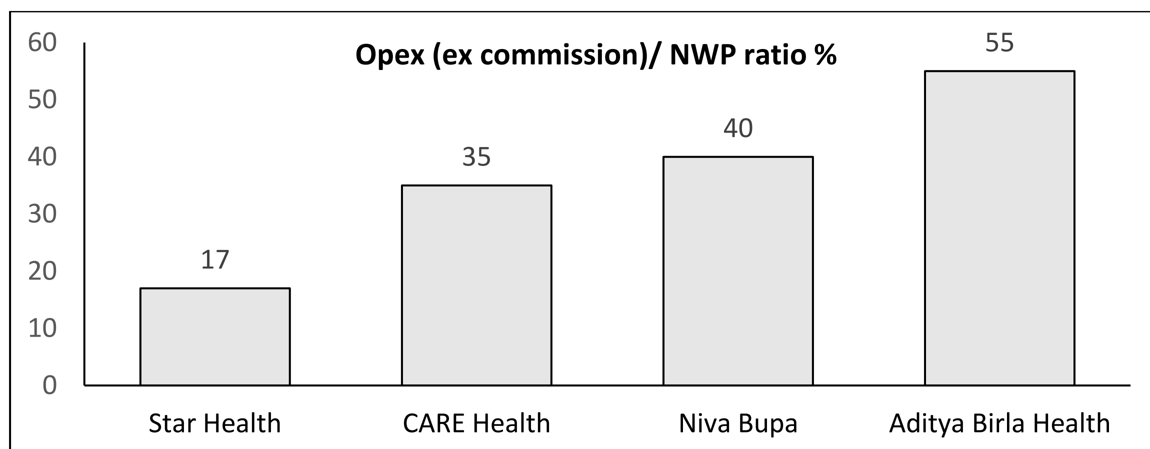
Retail Health insurance offers a long runway for growth

The Retail Health Insurance industry has grown premiums at ~20% CAGR over the last decade. It could continue to grow premiums at 15%+ CAGR for long periods of time from increase in penetration, higher unit price per policy through price increases and increase in sum assured per family as incomes increase. The category remains under-penetrated with only ~4% Retail Health insurance penetration and a large share of healthcare expenditure being incurred out of pocket (~55% in India versus 18% global average). While the Covid pandemic has resulted in losses to the industry due to higher claims, it has been a long-term tailwind as it created greater awareness on the need to own health insurance.

Dominant market leadership through largest agent base and best cost structure

Retail Health insurance is largely an assisted purchase product due to nuances around exclusions. Most customers also want an agent to help with claims in the event of hospitalization. Not surprisingly, about ~75% of industry premiums are through agents, unlike Life Insurance where Banking channels play a larger role (~55% of premiums for private life insurers). Regulations permit agents to represent at-most one SAHI[9]. Star enjoyed first mover advantage within SAHI & recognized the importance of agents early and leads the industry today with the highest number of agents.

Star has ~3x the market share of its nearest competitor in Retail Health and has increased its market share from ~13% in FY14 to ~32% in Q1FY23. Market leadership gives Star scale benefits and cost leadership (lowest Operating Expenses/premiums) over its competitors[10].



[8] Share of Group Health was ~10% of Gross Written Premium in 2022. GWP is total premium raised.

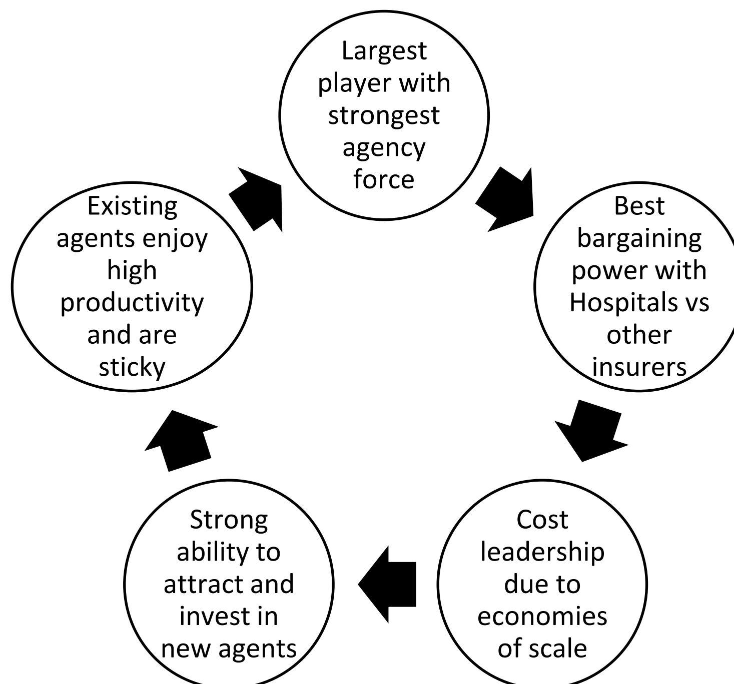
[9] Current regulations permit agents to partner with 1 SAHI, 1 Life insurer & 1 General insurer.

[10] Source: Spark Capital. NWP is net premiums retained by Insurers on their books after reinsurance.

The largest Agency network and cost leadership results in a virtuous cycle that should help defend and grow market share.

- Star has the largest hospital network amongst peers which is attractive to customers and agents and enables the most competitive rates with hospitals for procedures.
- Scale gives the ability to invest in an in-house claims team which can further help reduce Claims vs use of TPAs[11].
- Star agents enjoy 50% higher productivity [12]vs the next best SAHI Niva Bupa (1.78 lacs vs 1.19 lacs in 2022) which aids agent stickiness.
- New draft regulations around expense management are more stringent[13] and should continue to benefit larger and more cost-efficient health insurers like Star.

Hence, Star should be able to generate superior ROEs vs peers even if its claim ratios are a bit higher.



The steady-state economics of this business are very attractive

A Health insurance company makes profits from two streams - Underwriting profits and investment management of float and proprietary capital. Underwriting premiums are generated through the sale of insurance policies. Expenses mainly consists of Claims. Other expenses are commissions (Upfront & renewal), other expenses like employee costs, branch costs, technology & brand spend etc. An insurer makes underwriting profits when the premium earned is greater than its expenses.

Investing in a Health insurer is a leap of faith that economics will sustain as different expense lines evolve over time.

- Claims for each cohort tend to increase over time as exclusions wear off and propensity of medical issues increases with age. This is compensated by inflationary price increases inbuilt into product pricing and ability to increase prices for certain products which have higher claim ratios. Better risk management tools, fraud analytics and better product mix will also help.

---

[11] An in-house team has more skin in the game, better fraud analytics and ultimately lower costs and faster turn -around times. In-house claim processing costs is 1% of Net Earned Premium vs 3-4% for a 3rd party TPA.

[12] Source: HDFC Sec IC.

[13] Draft guidelines mandate that total expenses must be capped at 30% or average of actual expense ratio of past 3 years, whichever is lower. Violation of guidelines would result in additional solvency requirements.

- Operating expenses reduce with time. Customer stickiness tends to be high, with customers rarely porting. Star had a 94% renewal rate in 2022. Hence, customer acquisition costs/premium decline over time as renewal commissions are lower than first time commissions. Fixed cost operating leverage reduces expenses/customer over time.
- We believe that Accounting underwriting profits for a well-run Health Insurer will sustain at about 2-4% of Gross Written Premiums over time.

An insurer generates investment income from Investment float[14] and proprietary capital of the insurer. Investments are mainly in Fixed income instruments, with small exposure to Equities which results in a blended annual yield of ~7-7.5%.

We believe a typical Stand-alone Health Insurance player will operate at ~14-16% steady state Accounting ROE. Star being the dominant market leader with scale benefits should be higher at ~16-18%, even adjusting for higher claim ratios vs peers.

However, accounting ROE understates the true cash profits of the business. Accounting norms require Expenses (commission and other expenses) to be booked fully upfront in the year they are incurred, whereas revenue (Net Earned Premium) is recognized on an accrual basis (I.e. premium is recognized as revenue pro rata to the number of days policy was active during that year). Due to the mismatch in the timing of booking of revenue and expenses in the P&L, reported accounting profits end up getting suppressed as revenue is understated vs expenses, especially during periods of high growth. Simply, for an Insurer growing at about 20%, typically Rs 90 of every Rs 100 premium earned in a year will be recognized as revenue while almost all expenses need to be booked. If one adjusts for this anomaly and looks at the business on a Cash basis, we believe the steady state Cash ROE of this business is ~25%+. What matters is Cash profits and not Accounting profits.

With its leadership of a large and growing market that provides opportunity to grow PAT at ~18-20%+ for next decade, 25%+ Cash ROE, Star Health is a very attractive business to own at current prices from a 5–10-year perspective.

Risks

The key risk we see is of the regulator not allowing price increases despite rising claim ratios. However, the regulator wants to increase penetration and should not frown on 14-16% sectoral Accounting ROEs. Hence it should not grudge companies a fair price increase over time if claim ratios go out of hand, to encourage companies to maintain healthy solvency requirements and to continue to invest, especially as the industry is still very underpenetrated.

There are some concerns that Life Insurers may be allowed to offer Health Insurance and hence competition may increase. Under present regulation, Life insurance players aren't allowed to participate in Retail Health Indemnity[15]. We don't see a material impact on Star in case they are allowed to participate. Health Insurance, unlike Life insurance, has higher claim frequency and so requires a more intensive back-office approach for claims management, requires empanelment with Hospitals and tends to be more agents driven in sales vs more Bank channel-dominated approach in Life Insurance. Hence, Life Insurers will be structurally disadvantaged on cost structure vs Star.

[14] Investment float is the amount available to an insurer for investments as premiums are received upfront however claims are paid off in the future.

[15] In retail Health indemnity, insurers reimburse the cost of medical treatment incurred by customer, subject to the policy cover, exclusions etc.

Answers to some interesting questions we have recently received

Do we continue to have a positive view on Gold?

We have held a positive view on Gold for many years. The money printing underway had us concerned about inflation. We looked at the inflationary 1970s and that Gold had done very well during that period (~30% IRRs). Hence, Gold – as a form of currency – seemed a good hedge against geopolitical conflict and very high inflation with baseline return which would be close to index returns in India. With this backdrop, we had recommended our partners consider 3-5% exposure to gold at their asset allocation level.

However, despite ideal conditions for Gold - significant money printing, a geopolitical conflict with superpowers on different sides, Gold has not done well. This has made us introspect on what we could be missing in our thesis.

A difference in the situation today vs the 1970s was that in the 1970s Central Bankers waited too long before raising interest rates. However, at present they are signalling strong willingness to raise rates to crush inflation, even if that means a recession and putting people out of jobs. Secondly, post the high inflation of the 1970s, Gold has done well in short term spurts, but not done well consistently for an extended period. This has two implications – Central Bank determination to crush inflation and explicit communication vs the 1970s reduces the risk of very high inflation due to policy errors. Steeply rising interest rates reduces the attractiveness of Gold to a yield seeking investor. The other realisation which dawned on us was for Gold to truly work as a hedge, it would have to be at least 10-15% of the portfolio vs. 3-5% range we had recommended. Given the points discussed above, we don't think it is prudent to take such a high exposure. Hence, for an investor optimizing for long term outcomes, we are not as optimistic about Gold as we originally recommended.

Why not buy Public Sector Banks at less than Book value vs Pvt Bank at ~3X Book?

We would not disagree on a hypothesis that one can earn a higher return in some PSU Banks in the short term over the top 4 Private Banks which are of interest to Solidarity. However, we disagree with this hypothesis if one measures outcomes over 5-10 years. The choice of time horizons determines portfolio choices. The more you stretch time, the more resilience matters. The shorter the time horizon, the more probability of re-rating matters.

We believe that the top 4 Private banks are more resilient stories as they are better competitively positioned and will manage risk better than PSU peers. As private banks increase their market share of low-cost deposits and have lower credit costs across business cycles, their earnings will compound faster than PSU Banks over longer time frames. However, PSU Banks, could see an increase in valuation multiples vs Pvt Banks, whose multiples may stay broadly in the same range where they are at present. PSU Banks are also more prone to Earning surprises due to their higher vulnerability to frauds and GOI intervention in decision making. As we want resilient compounding over long periods of time, we prefer Pvt Banks. We are comfortable with the notion that PSU Banks may do better short term. However, we are playing the long game.

****

We wish you and your families a Happy Diwali. We look forward to speaking with you on our call at 12 PM on the 15th of October 2022.

With our best wishes,

Manish Gupta	Manjeet Buaria	Anirudh Shetty
Chief Investment Officer	Partner	Senior Principal

Disclaimer

The information or material (including any attachment(s) hereto) (collectively, "Information") contained herein does not constitute an inducement to buy, sell or invest in any securities in any jurisdiction and Solidarity Advisors Private Limited is not soliciting any action based upon information. Solidarity and/or its directors and employees may have interests/positions, financial or otherwise in securities mentioned here. This information is intended to provide general information to Solidarity clients on a particular subject or subjects and is not an exhaustive treatment of such subject(s). This information has been prepared based on information obtained from publicly available, accessible resources and Solidarity is under no obligation to update the information. Accordingly, no representation or warranty, implied or statutory, is made as to the accuracy, completeness or fairness of the contents and opinion contained herein. The information can be no assurance that future results or events will be consistent with this information. Any decision or action taken by the recipient based on this information shall be solely and entirely at the risk of the recipient. The distribution of this information in some jurisdictions may be restricted and/or prohibited by law, and persons into whose possession this information comes should inform themselves about such restriction and/or prohibition and observe any such restrictions and/or prohibition. Unauthorized disclosure, use, dissemination or copying (either whole or partial) of this information, is prohibited. Neither Solidarity nor its directors or employees shall be responsible or liable in any manner, directly or indirectly, for the contents or any errors or discrepancies herein or for any decisions or actions taken in reliance on the information. The person accessing this information specifically agrees to exempt Solidarity or any of directors and employees from, all responsibility/liability arising from such misuse and agrees not to hold Solidarity or any of its directors or employees responsible for any such misuse and free and harmless from all losses, costs, damages, expenses that may be suffered by the person accessing this information due to any errors.