4 July 2017

Dear partners,

The purpose of this note is to share our thought process on portfolio positioning at present.

Equity returns are the interplay of two key variables: expected earnings growth, and the change in the valuation multiple of the stock. The change in multiple principally reflects the change in the market's perception of the attractiveness of a stock (the "narrative").

Aggregate earnings growth has been tepid with companies who have reported strong growth have been supported by market share gains (example private financials taking share from the public sector). The reported GDP growth number of ~7% for FY 14 - FY 17 are an enigma to us if we contrast them with other growth data from other sectors of the economy: cement production, power generation, credit growth, 2 W sales. One explanation for this could be that economic growth has been lack lustre as the economy went into a funk due to the paralysis in the last 2 years of the UPA and the recovery was further pushed back by demonetisation and slow action on NPAs. As fiscal decisions impact with a lag, growth rates could step up soon, aided by the Govt. capacity for additional fiscal stimulation from enhanced tax compliance post GST. However, for growth to pick up decisively, private sector investment in the economy has to increase significantly – which is yet elusive.

Despite tepid growth, aggregate valuations are well above long term averages, but with wide dispersion across sectors. Valuations in domestic themes are significantly higher than long term averages while global themes like Pharma and IT trade lower than long term averages. One needs to keep in mind that lower valuations in Pharma and IT also reflect the industry moving from a high growth to a slower growth trajectory.

The higher than average valuations for domestic themes are reflective of the strong underlying narrative for long term growth for the Indian economy and liquidity support

- India is a growth haven further supported with the confident reformist image portrayed by PM Modi sharply contrasted with the drift under ex PM Manmohan Singh. Perceptions matter.
- India's macro-economic situation at present is the best it has been in a while with low Crude prices, low inflation, a stable currency and reasonable reserves
- India is moving to a lower interest rate regime and hence a lower Cost of Capital justifies higher PE multiples. Historical averages can therefore be mis-leading if interpreted in isolation
- Global and domestic flows are strong

An expected step up in earnings growth is already built into stock prices in most domestic consumption themes. If the expected earnings growth does not come through, valuations could correct. Further, themes where valuations are supportive, don't have earnings momentum and the narrative here may take time to change. Hence, while we are strong believers in India's long term growth story, <u>we expect returns to stay muted in the short term. One needs to be patient and it would be prudent to deploy incremental capital over time rather than at one go</u>.

Our portfolio positioning is as follows

- Exit positions where valuations are well above fair value "and" there are concerns on the business model
- Trim positions which are significantly over weight, where no tax would be payable on exit, and opportunity to redeploy capital exists
- Over weight high conviction positions where valuations are in favour

- Hold onto positions which are not overweight where valuations may be stretched, but where a real long term compounding story exists
- Add to weights gradually where markets are selling positions because of near term uncertainty on earnings – but where valuations are covering for risk
- Dig deeper to seek value in sectors we have erstwhile ignored

Exit positions where valuations are well above fair value and there are concerns on the business model

A sector where valuations worry us particularly is NBFCs, especially Urban focused Housing Finance. The prevailing narrative here is one of strong tail winds due to the low home ownership and mortgage penetration relative to other economies. A flurry of entrants (~80 at last count) and renewed focus from Banks has resulted in declining spreads in the core Retail business. In the quest for higher profitability, most housing finance companies have diversified into higher margin "Loans against property" and "Developer financing". Now we know that finance companies are very opaque/creative with NPA reporting as one recently discovered with Yes Bank where its assessment of NPAs varied to the tune of 5X from that of the RBI, or more recently with Religare. We would venture that reported Asset quality in many companies could be suspect given the state of Real Estate developers and prices in India and tightening regulations and pressure on SMEs/entrepreneurs post GST. If margins in the core retail business stay muted and NPAs in LAP/developer loans come to the fore, there would be hell to pay. Yet, market momentum is the highest in Housing Finance companies which have on average risen 75% in the last 12 months and where valuation multiples are at an all-time high. "It is only when the tide goes out will we realize who is swimming naked"

Trim positions which are significantly over weight, where no tax would be payable on exit, and opportunity to redeploy capital exists

For most partners, our largest holding is HDFC Bank. Over the last 10 years, this has typically trades in a range of 3.1 to 3.5X estimated Book Value (Net Worth) one year out. As we write this note, the valuation is about 3.8-4.0 X. While this valuation reflects market share gains from a weak public sector and an incredibly well run franchise, investors must reflect what it takes to grow a bank 20% year on year on a much higher base and the incremental market share of loans HDFC Bank has to garner if credit growth remains weak, and whether that incremental share can come without compromising Asset Quality. A significant share of HDFC Bank growth is already coming from unsecured loans. One of the eternal truths of long term investing is mean reversion of multiples. Further, our view is that ROEs in banking will steadily decline. Hence, even as we have firm belief in HDFC Bank's long term value creation story, we think its prudent to trim exposure in accounts where there will be no Capital Gains Tax implications, the position was significantly over-weight, and where capital can be redeployed to other favourable opportunities. HDFC Bank will however remain a core holding in our portfolio.

Over weight high conviction positions where valuations are in favour

Specialty Chemicals, is a sector on the rise benefitting not only from India's advantage in low cost fabrication, labour and chemistry skills, but also the need of MNCs to de risk their global supply chains from arbitrary political decisions of the Chinese Govt. SRF is an emerging leader in Fluorine based chemistry – an area with a very favourable industry structure (large entry barriers, only 3 players in India). It has invested heavily in R&D over many years and has a large pipeline of proprietary processes. SRF has significant head room for growth as it's a USD 100M player in a USD 8000M market. After a strong period of growth between FY 12-FY 16 in Speciality Chemicals (35% CAGR), growth plateaued in FY 17 due to extended weakness in the Agro-commodity cycle. Despite the slow down, management has continued to add capacity demonstrating long term orientation and confidence in growth prospects. When growth returns, SRF is well positioned to resume the earnings

trajectory demonstrated earlier. Within our position limits for "Emerging Leaders" SRF is an over-weight position.

Hold onto positions which are not overweight, where valuations may be stretched, but a long term compounding story exists

Valuations in our Consumer discretionary positions are well above historical averages. But, we will hold onto these positions for two reasons. A long term compounding story exists and a period of indifferent stock price performance should be tolerated for the longer term gains to follow. One must highlight that what is a "fair valuation" in select Consumer stories which will be beneficiaries of GST are harder to gauge because many players will make significant market share gains post GST/demonetization. Many leading companies recognize the frailty of their competitors who were evading taxes and are using this window of opportunity to step up customer acquisition through greater Advertising spends (eg Symphony) and/or promotional offers (eg TITAN) or by strengthening distribution (eg Exide). While these initiatives would impact short term earnings, they result in significantly stronger franchises with far superior earnings trajectories in later years. Valuations here while appearing optically rich, could continue to find support. It should be noted that we will not be over weight in these positions at current valuations.

Be contrarian where markets are selling positions because of near term uncertainty on earnings – but where valuations are covering for risk

The worst performing positions we own are Lupin and Dynamatic Technologies.

We recognized the challenge faced by the Pharma sector and had published a blog on this in August 2015. Unfortunately, we underestimated the scale of the pricing challenge and in hindsight were way too early even when we bought into Lupin at that time.

At present, most Pharmaceutical stocks are trading at near 3 year lows with valuations significantly below long term averages. The industry is undergoing an immediate earnings challenge (enhanced pricing pressure in the US from buyer consolidation, enhanced competitive intensity and enhanced regulatory scrutiny from the FDA). However, we believe this is a pause in the industry's long term growth story rather than an existential challenge. Unlike the Indian IT industry that paid back its profits as dividends or hoarded cash instead of investing more aggressively to build capabilities required in the next stage of growth, leading Pharma companies have been aggressively re investing in R&D to prepare for the situation they find themselves in today. Moreover, the supply side response of leaders – cost cutting measures, improvement in compliance standards, market share gains from sub-scale and poor compliance players is being ignored as typically happens when an industry loses favour.

We have chosen to stay invested in Lupin as it has scale in generic products (#1 in 45, among top 3 in 83 products in the USA), a good compliance track record with a management team genuinely interested in higher compliance standards, a good pipeline of speciality products backed by healthy R&D spends and acquisitions. Lupin spent 2300 Cr in R&D in FY 17, up from 700 Cr in FY 13. Despite near term challenges, Lupin seems well positioned to gain share from weaker competitors. At current market prices, we believe risk and reward is deeply in favour with simple discounted cash flow analysis suggesting the price reflects cash flow per share growth to perpetuity of 8%!

Further, we have recently included Jubilant Life Sciences in the portfolio due to its strong position in the Niche area of Nuclear Medicine, and a high visibility earnings profile in Contract Manufacturing of Steriles and very attractive entry valuations.

Dynamatic Technologies has two contrasting narratives. One is of a company at the fore front of Aerospace outsourcing – an industry which is poised for decades of growth as Indian IT was in 1990 and Pharma in 2000. The other is of a young promising business leader who is sitting on a Gold Mine but cannot unlock its full value as his non performing Automotive business acts as a drag on value creation and he is not dealing with that decisively. We believe in some time, Dynamatic will emerge as a focused Aerospace outsourcing story with 15% growth, 25-30% ROCE and a highly visible earnings profile (its unexecuted order book is ~15X revenues). However, one needs to be patient till the evidence of action leads enough players in the market to start believing in this narrative. Please write to us if you would like to read our detailed investment thesis on Dynamatic (or for that matter any other position we hold on your behalf).

Its pertinent to note that being contrarian is never easy. A truism in investing is to "buy great businesses when available cheap" – but that advise is as easy to follow as eating less carbs. When great companies are available at cheap valuations – as one believes with Lupin and Dynamatics at present, one is gripped with fear and one starts questioning the sustainability of a business model. One tends to stay on the side lines and is more comfortable participating at higher prices when the sentiment/narrative has turned. Investments made in bear markets test our patience as valuations can stay suppressed for long periods of time while over-valued sectors (eg Housing Finance) tend to move even higher. However, when sentiment turns back in favour, one benefits both from earnings growth and multiple expansion. We need to recognize and profit from this behaviour and the pain it requires us to bear.

The curse of the value investor is that they are always too early and key to success will be position sizing such stories.

Dig deeper for value in sectors we have erstwhile ignored

One can build a very high quality portfolio when the starting valuations are reasonable. However, at present, most quality franchises are significantly above our comfort zone on valuations. We hence either need to wait for these valuations to come in favour, or relax some quality constraints.

We have come across a few example of companies with significant tail winds but with narrow moats reflected in a combination of poor pricing power (and hence poor margin predictability) or high Working Capital. Future returns on these opportunities will be a function of the interplay between growth and risk of margin decline, which may or may not happen. And even budgeting for some margin decline, very high growth rates could result in significantly high stock price IRRs if entry valuations are cheap. Rather than exclude these, we have invested in these with a position size not exceeding 2.5% per opportunity and a 5% max weight and to add to these positions over time as we get more comfort with execution and margins. The low weight means they act like "Options" – we earn significant returns if we are right, yet can absorb losses if we are wrong.

Some examples of positions we have taken are Geojit Securities, whose business model is transforming from a low cost broker to a Distributor of Investment products and Intrasoft Technologies, a play on E-commerce growth in North America.

Closing remarks

A consequence of our conservative stance could be portfolio underperformance if the markets continue to move higher and we do not participate in over-valued sectors due to concern on valuations or because we increase our position in themes out of favour. One may experience heart ache and a sense of missing out. But investors must remember that prices reflect reported earnings and the prevailing narrative, both of which can mask the scale of operational challenges in the underlying business.

No investment manager can claim monopoly on insight. The only sustainable sources of advantage investors can have is a disciplined process, a long term perspective and control on behaviour. We will be disciplined in the risk we take on. Specifically, we will not compromise on process discipline and chase momentum in the pursuit of higher returns.

I will be delighted to have a personal conversation

Sincerely,

Manish Gupta
Chief Investment Officer