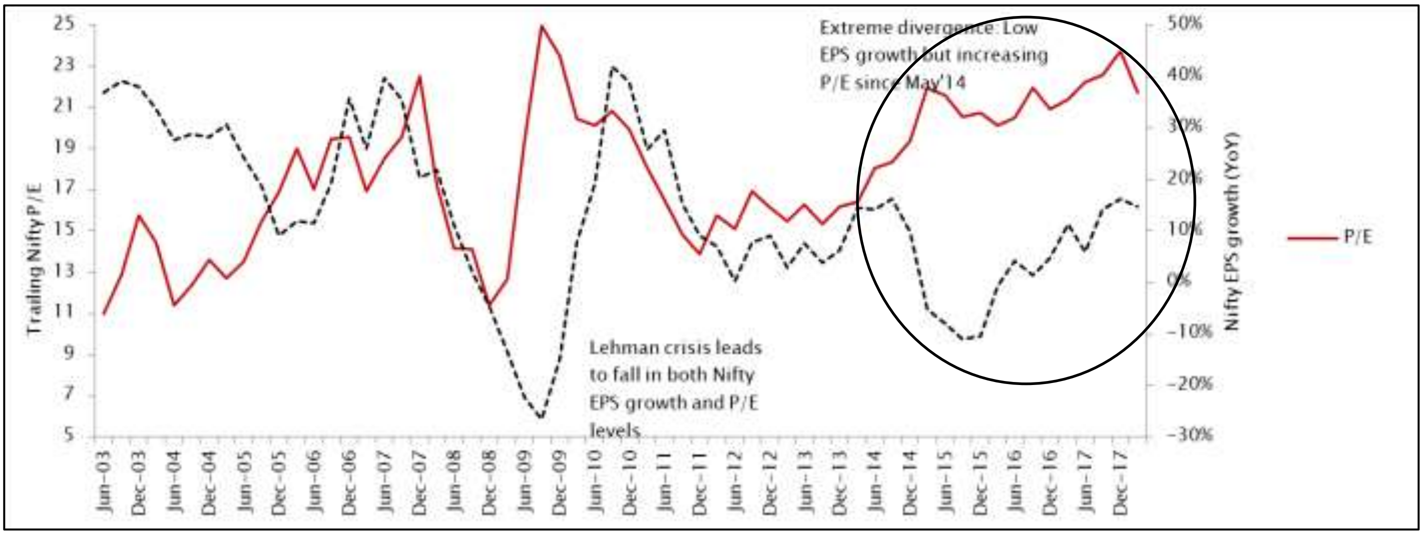
5 July 2018

Dear partners,

We had mentioned in our April communication that all of us have "borrowed returns from the future" and markets need a period of consolidation/correction. Stock prices typically track earnings growth. However, returns over the past 4 years have been juiced up by across the board valuation multiple expansion. One can see from the chart below that this is a divergence from historical market trend.



Source: Ambit; Data from June 2002 to March 2018

What we are undergoing at present is a "healthy" correction of excesses. The intensity has been severe due to an avalanche of bad news – governance issues leading to auditor resignations, BSE surveillance measures on many small and mid -caps, escalating trade wars, sharp increase in Oil prices accompanied by a falling Rupee and tightening liquidity and a rise in global and local interest rates.

While the NIFTY is up ~5% since end of Q4, it masks the scale of the broader correction. The NIFTY has been supported by a few names – mostly pristine quality which have high weight in the Index. However, 88% of all listed companies have corrected by more than 15% from all-time

Correction from 52 Week High Price	No. of Cos.	% of total
0% to 15%	199	12%
15% to 30%	429	26%
30% to 45%	521	32%
45% to 60%	351	22%
60% to 75%	97	6%
75% and above	32	2%
TOTAL	**1629**	**100%**

Data: BSE Companies with Market Cap >100 Cr

Long term interest rates impact Cost of Capital and hence are key to valuations. Globally, these rates have been artificially depressed by Central Banks for approximately a decade. As the Central Banks stop large scale intervention in markets, these should gradually rise. As valuation multiples expanded during the period of interest rate repression, it is only natural that higher interest rates will act as head winds on valuation multiples. Hence, we continue to expect muted short term returns as tail winds of earnings growth confront multiple decline.

Positioning for the road ahead

Partners are aware that we allocate capital into buckets - Clear, Emerging Leaders, Transformations and Deep Value. Quality is our North Star and hence there is always priority to Clear and Emerging Leaders.

The good news is that we see confidence of good earnings growth in the vast majority of the market and in our portfolio positions. The challenge in allocating capital at present is the sharp contrast in valuations.

- Pristine quality (typically Clear Leaders) are trading at valuations which are the highest levels they have been in 7 years with multiple expansion contributing significantly to shareholder returns. These multiples have further expanded over the last few months even as the broader markets have corrected. These are remarkable franchises, but in a vast majority of cases, valuations defy logic. An increase in valuation multiples should happen either due to a step up in expected long term growth rates, an improvement in ROE (which leads to better cash conversion) or from significant reduction in interest rates. As you may observe from the table below, for most franchises where re rating has happened, none of the above has taken place. Investing in pristine quality franchises carries, for some time now, the risk of overpaying for quality. This leaves one exposed to poor outcomes when the eventual mean reversion of multiples happens. And mean reversion of multiples is a truism in financial markets. Of course, in the short term, momentum and market psychology may ignore valuations, but mean reversion will eventually happen.

	PE or PB Ratio (Trailing)				ROE		Operating Profit CAGR		Share Price CAGR	
Company	FY 11	FY 14	FY 18	30 Jun 2018	FY 11	FY 18	FY 11-18	FY 14-18	7.25 Years	4.25 Years
Leading paint co.	28.7	43.1	52.7	59.5	45%	26%	13%	12%	25%	22%
Leading building material co.	9.2	33.2	61.1	69.0	25%	19%	28%	19%	65%	41%
Leading adhesive co.	24.4	35.0	48.4	56.1	32%	27%	16%	19%	31%	34%
Leading FMCG co.	33.1	25.6	59.4	74.1	44%	33%	30%	24%	47%	60%
Leading FMCG co.	26.8	33.1	55.3	68.0	86%	75%	16%	12%	27%	27%
Leading Apparel co.	31.0	47.1	72.9	89.4	53%	46%	29%	21%	48%	41%
Leading automobile co.	15.3	20.9	34.0	33.8	17%	19%	18%	23%	31%	42%
Leading jewellery co.	39.1	31.7	73.9	69.0	49%	24%	15%	12%	23%	33%
Leading consumer electric co.	19.1	24.4	42.8	47.6	20%	20%	17%	13%	32%	29%
Leading NBFC	1.9	2.2	6.1	8.0	20%	20%	44%	36%	62%	82%
Leading retail bank	4.3	4.1	4.5	5.2	17%	18%	24%	24%	23%	28%
Leading retail Bank	3.2	3.1	4.5	5.0	19%	16%	30%	27%	32%	37%
Leading retail bank	3.1	3.1	4.0	6.8	17%	14%	23%	26%	28%	34%

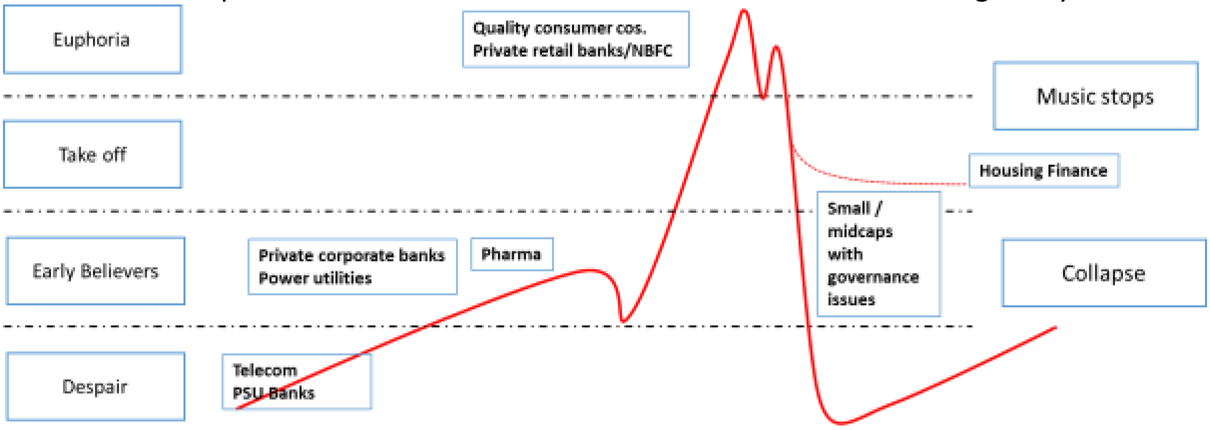
Source: Ace Equity, Solidarity analysis
Note: ROE for FY18 not adjusted for Ind-AS impact

  The valuation multiple expansion of pristine quality companies in India should also be seen in context of the fact that over the last few years, the vast majority of shareholder returns of the top five technology companies in the US (Apple, Amazon, Microsoft, Google and Facebook) has come from earnings growth and not multiple expansion.

- Emerging leaders (small and mid-caps with large growth opportunity, niche domination and good governance) also look very expensively priced at present. However, these are harder to value as they are on a fast growth trajectory and their financial metrics can be very different in a few years as their business models are evolving.

- On the other extreme, we find many strong underlying franchises that are unloved because they face uncertainty in short term prospects, despite having positive direction of travel (Transformers). These could be attractive opportunities if one is compensated for the uncertainty with an attractive entry price and if one believes that earnings, and hence sentiment, will recover in due course. Unlike Clear Leaders, they will provide both earnings growth and a multiple expansion when earnings and sentiment recover. The risk here is coming in too early as earnings recovery could take longer than expected, and/or error in identification of companies where hypothesized princes turn out to be frogs in disguise.

The chart below picturises some of the extremes in valuations we are facing today:



Certainty of earnings and reasonable entry valuations seldom come together. Hence, in the context of a richly valued market, we have

- Allowed our Clear Leaders to compound. Returns in this bucket over the next 3 years will perhaps be lower vs last 3 years as earnings growth confronts multiple decline. However, there is a longer period of growth to follow. We may trim these positions in accounts where the position weight is too high and if no additional Capital is being infused to reallocate to other opportunities.
- Been adding to existing/new positions in “Emerging Leaders” and “Transformations” where valuations have been in favour. At risk of repetition, by virtue of their stage of evolution/uncertainty, these positions will be more volatile.
- We also continue to hold a large amount of cash (in liquid funds) in new accounts as it provides Optionality for a better entry point when we are not seeing opportunity to deploy capital at 18%+ IRRs.

As fund managers, we take inspiration from the words of Andy Grove that “only the paranoid survive”. While re-evaluation of thesis is a continuous process, significant declines below our purchase price merit introspection – do they reflect a mistake on our part, market sentiment or investor disenchantment/fatigue. We look at the underlying performance of the business to gauge if the Investment thesis is on track rather than act based on the stock price. We will not hesitate to act if new facts negate our hypothesis. The few poorly performing positions we hold have demonstrated significant improvement in their franchise over the last 12 months which may not reflect in current reported earnings. Based on what we know today, we feel these are >25% IRR opportunities over 3 years from today's prices and we will look to add to these over time. We will be happy to discuss each position we hold in more detail. But partners must remember that the "curse of the value investor is that they are always too early"

****

As we come closer to national elections, and with external risk such as high Oil prices, threats of trade wars etc. one should expect volatility in stock prices to continue. However, I would like to remind partners that we have lived with significant uncertainty through the past few years (fear of collapse of Euro zone, Brexit …). The present always seems more uncertain than the past.

It is futile to base long term investment decisions on forecasts of macro variables as these can change quickly. The market collapsed by 12% in a month in 2004 when UPA won and gained 22% in a month when the UPA won in 2009 – same political party but with a very different market reaction. About 15 months ago, the BJP won a thumping majority in UP state elections, Brent Crude was at USD 51/barrel and yield on 10 Yr. GOI bonds was at 6.9%. The BJP's electoral majority looks uncertain at present, Brent Crude is at USD 79/barrel and yield on 10 Yr. GOI bonds at 7.9%. We cannot forecast where the market will be in 12 months – and companies we invest in, don't plan their future based on macro-economic forecasts.

This is a pertinent time to share one of the biggest mistakes I have made in my journey as an Investor – frequently interrupting the process of compounding. Partners are aware that I had the privilege of working and learning under Mr Rakesh Jhunjhunwala for 8 years before setting up Solidarity. In 2006, he advised me to put a fair share of my savings in TITAN. I did. However, I did not have the stomach to tolerate mark downs and exited at every sign of dark clouds - gaining short term emotional relief – only to buy the shares back at a higher price at a later date. Wisdom only dawned in 2012 that to get best results, you cannot interrupt the process of compounding. Uninterrupted, the initial investment would be 30X today. However, such phenomenal results require tolerance for mark downs - one would have needed to tolerate mark downs of up-to 20% from the high price in 6 of the 12 years, and also tolerate long periods – at times of over 30 months - of zero stock price growth. This is obviously not easy – but this is what it takes. Returns in equity markets are non-linear. A long time horizon, ability to stay the course amidst short term uncertainty provide a seldom appreciated competitive advantage, all in our control.

We would hence counsel staying invested. If you are looking to increase exposure, do so systematically and not in one large instalment. Stay true to your Asset Allocation.

We will be delighted to share these perspectives and discuss individual positions in a meeting.

With best wishes,

Manish Gupta
Chief Investment Officer