15 May 2020

Dear Partners,

We normally write to you once a quarter. However, as we are going through quite a challenging period, we thought a mid-quarter update is essential.

Further, on 21 May 2020 (Thursday), the Solidarity Team will host a web conference between 11 am – 2 pm where we will walk partners through our thought process on portfolio construct.

What will be structural impact of Covid-19 on the world?
Covid -19 will principally accelerate trends that were already at play

- Significant back lash against China and rising geopolitical risk will add an extra impetus to companies to aggressively look for second source locations as they cannot risk their supply chains being frozen due to a geopolitical conflict.
- Rising unemployment will result in a shriller political stances on immigration, off-shoring of jobs. Countries will try and insource production of goods that are strategic or politically sensitive
- More nationalistic tendencies and state control/approval on acquisitions
- Climate change warnings will be taken more seriously
- Growth rates in the developed world are bound to slow down as Debt/GDP[1] ratios rise while demographic profiles continue to age. This will mean more money printing to try and generate growth.
- More consolidation can be expected in key industries as the strong get stronger
- The success of "Working from Home" and use of Digital Communication mediums without loss of productivity will create significant second order effects on multiple industries. The most obvious one of course is Commercial Real Estate[2] and demand for Air Travel. However, it could also affect demand for industries such as Automotive and Home Furnishings.
- The pace of disruption of off-line only businesses will increase.

However, one needs to be cautious before making a determination that a trend has fundamentally changed. Consumer behaviour is never easy to call and countries/companies attitudes may evolve from "anger towards China" to "acceptance of their current reality". Consider a few examples

- One would have expected businesses that cannot operate with social distancing to suffer; however, tickets for Disney Land Park in Shanghai were sold out for the opening day and the cruise company Carnival Liners reported a 600% surge in bookings for August.
- While there is significant global angst against China at present and one reads about moves to move production out of China, the reality is that China is perhaps the only large economy at present which is close to normalizing manufacturing operations. In the short run, businesses may actually be more dependent on China; especially when supply chains are not easy to move.

How does Covid-19 impact our portfolio construct?
We have examined each portfolio company in detail and how they will be impacted in the short and medium term on key drivers of Earnings growth.

[1] Increase in Debt/GDP ratios beyond 90% results in a drag on growth
[2] Twitter has announced a permanent option for employees to work from home. TCS believes that ~75% of its staff could work from home from the year 2025

- We don't have any position where Covid-19 fundamentally impacts the business model or medium term earnings Investment thesis.
- Our portfolio companies have leadership positions, strong Balance sheets and none of them have availed a debt moratorium. The Financial positions have strong Capital Adequacy/Solvency ratios.
- In fact, some themes will benefit from additional tail winds due to Covid-19 even in the short term. For example, the experience of countries during past epidemics (China, Singapore (SARS) and Saudi Arabia (MERS)), suggests a spurt in purchase of Insurance. Further, Specialty Chemicals should continue to see strong traction.
- Even as some of our portfolio company earnings will be impacted short term, most of them will benefit in the 5 year time horizon through market share gains, entry into adjacencies, and margin expansion.

Hence, we have not found it necessary to fundamentally alter our portfolio construct or exit any position other than the ones we exited in March due to ESG risks (JSW Energy/NTPC).

We expect the market volatility to provide opportunities to add to our positions which have a challenging FY 21, (perhaps even FY 22) but where valuations are strongly in favour. For example, valuations in our three Banking positions (ICICI Bank, HDFC Bank, HDFC) are very attractive, especially given the opportunity for them to further enhance their competitive positions. We accept that there is significant uncertainty on loan loss provisions given the job losses that are expected. However, we believe there is low probability that these names will need to raise Capital at distressed prices. While the short term earnings trajectory for these companies may be challenging, the long term risk/return trade-offs are very compelling at these valuations as they will benefit from both Earnings growth and valuation multiple expansion.

Should one allocate more Capital to Equities at present?

This depends on your Asset Allocation at present and state of mind during the market collapse in March. We don't know what the short term trajectory will be for the economy and for stock prices. One needs to be prepared to tolerate significant volatility. We would recommend that funds that you need to service any liabilities for the next 24 months should not be in Equities. We also continue to recommend an exposure to Gold. If you would like to invest more with us, we recommend you do so via a Systematic Investment Plan.

Concluding remarks

The short term will be a grind. Businesses will incur additional costs as they attempt to normalize operations and they deal with both a challenging demand side environment as well as challenges with social distancing and ensuring employee safety. We can expect periodic bouts of optimism and pessimism, which will inevitably feed into market volatility. We need to continuously remind ourselves that we are playing the long game and focus on 5 year outcomes. Market volatility will result in moments of fear that will provide the greatest opportunity.

We are aware of the enormous responsibility we have as custodians of your hard earned Wealth. We will continue to act responsibly with measured risk-taking.

With my best wishes,

Manish Gupta
Chief Investment Officer