2 July 2020

Dear Partners,

A fund manager once described long term investing to me as “long periods of boredom punctuated by moments of terror”. It would be fair to say that we have all had a fair share of our “moments of terror” in the last few months.

The Indian economy will shrink this year. There is no firm visibility on when business conditions will normalize. Yet Equity markets have staged a remarkable rally and are now at about the same level as on 11 March 2020, the day WHO declared Covid-19 a global pandemic. Are equity markets out of touch with reality?

In this letter we will address this question and many more.

Agenda

Performance update

For Anchor partner					Since PMS License (Aggregate across all accounts)				
DATE	NIFTY	NIFTY500	SOLIDARITY	Alpha	DATE	NIFTY	NIFTY500	SOLIDARITY	Alpha
FY15	26.8%	32.6%	67.2%	34.6%					
FY16	-9.9%	-8.6%	-0.1%	8.5%					
FY17	18.9%	24.0%	22.4%	-1.6%	FY17 (part year)	16.3%	20.8%	18.0%	-2.9%
FY18	10.2%	11.5%	18.4%	7.0%	FY18	10.2%	11.5%	19.2%	7.8%
FY19	14.9%	8.4%	6.0%	-2.5%	FY19	14.9%	8.4%	6.8%	-1.6%
FY20	-26.3%	-27.9%	-14.9%	13.0%	FY20	-26.3%	-27.9%	-15.4%	12.5%
FY21 YTD	19.8%	21.1%	24.4%	3.2%	FY21 YTD	19.8%	21.1%	21.8%	0.7%
Cumulative TWRR	**7.2%**	**8.0%**	**17.2%**	**9.2%**	**Cumulative TWRR**	**6.7%**	**6.2%**	**11.1%**	**4.9%**

Note: We operated with an Investment Advisor license till 11 May 2016 post which we migrated to a PMS License
Data for FY21 updated till 30 Jun 20

Observations on performance

- We are up about 20-25% across partner accounts for Q1 FY 21.
- We construct portfolio as money comes in and don’t operate with a Model portfolio concept. Hence, performance can vary across accounts. We expect performance across accounts to converge over time.
- As we run a “multi cap” strategy, we benchmark ourselves to the NIFTY 500
- We are outperforming NIFTY 500 by ~ 9% per annum since inception.

Key messages

There are 10 key trends emerging due to Covid -19 that are of interest to us.

- The world will look to aggressively de-risk supply chains from China. India has the opportunity to be a significant beneficiary.
- Success of working from home, need for social distancing will impact industries differently. Many small businesses will permanently close.
- Market share gains of digitally enabled business models will increase dramatically.
- Govts. will become more protectionist.
- Climate change warnings may get taken more seriously. Environmental, Social and Governance (ESG) risks will come further into mainstream.
- More developmental spending to the bottom of the pyramid as the pandemic worsens inequality.
- Rising consolidation across industries. Big US Tech companies[1] will become more powerful.
- Impact on incomes and sentiment will impact discretionary spending and cause consumers to down trade to value for money brands.
- Health and Life Insurance uptake will rise.
- Rising Govt. debt burdens (Debt/GDP) will require them to tolerate higher inflation down the road. Gold will emerge as store of value.

Covid-19 does not require us to fundamentally change our portfolio construct.

- Provides tail winds to "China+1, Digital, Life Insurance, developmental spending" themes.
- Banking positions will be negatively affected due to concerns on higher bad loans.

Stock prices are not disconnected from reality

- After a correlated sell off in March, stock prices are differentiating between sectors and companies that will not be impacted by Covid 19 (e.g. Specialty Chemicals), and those who will be significantly impacted (e.g. Hospitality).
- While one tends to correlate stock prices to short term earnings growth, what often gets overlooked is the role played by the "change" in interest rates and competitive positions in assessment of fair value. Yields on India 10 yr. G-Secs have reduced by 60 bps since February.

Stock prices can remain at elevated levels if interest rates stay low, despite a weak recovery.

- The laws of capitalism are being distorted by developed world Central Banks by artificially suppressing interest rates. Like Abhimanyu, they have entered a "Chakravyu" which they do not know how to exit.
- Lower interest rates will result in lower discounting rates and hence justify higher stock prices, even if growth assumptions are moderated.

We remain constructive on our Banking choices from a 5 year perspective.

- Valuation multiples are reflecting short term earnings uncertainty.
- However, they are not factoring in recoveries from bad loans down the road, the significant improvement in competitive positions (which should result in faster medium term growth and higher ROE).

We will act as the situation changes and new insights emerge that we need to incorporate in our thinking.

[1] Amazon, Facebook, Google, Microsoft

Key trends emerging due to Covid-19

The core of our Investment process is identifying long term secular trends and companies with leadership positions who can ride these trends to generate compounding returns.

The impact of Covid-19 on business disruption was significantly underestimated during the initial period of the crisis and we were surprised by the duration of the lock down. Over time, some trends have become clearer as they in isolation or in interaction with other trends create tail winds/head winds for sectors/players.

MNCs will look to de risk supply chains more aggressively from China

Covid-19 will accentuate the cold war between China and the US and extend it to other countries. The world's alarm at China's shameful late disclosures on Covid-19, China's increasingly muscular approach to resolve conflicts means the world at large is worried about China's expansionism[2]. There isn't just talk about de-risking from China, but decoupling from China on grounds of national security.

Implications

- MNCs will look to de risk supply chains more aggressively from China to manage geopolitical risks as "resilience and reliability" in supply chains takes precedence from "cost efficiency".
- These trends will act as additional tail-winds for the "China+1" opportunity for many manufacturing companies around the world and in India.

However, there are risks to be considered. China is a large market for MNCs. It is hard to find sources as competitive as China and supply chains cannot be re-wired quickly and efficiently. Some share of supply chains may move back home for more strategic control. The ability of Indian companies to harness this opportunity will also depend on their ability to invest ahead of the demand and of MNCs to be convinced that supply chains emerging from India will be reliable.

Success of working from home (WFH), need for social distancing will impact multiple industries.

The use of video conferencing during the pandemic has proven to be productive and effective[3].

Implications

- Demand in sectors such as Commercial Real Estate and Business Air Travel will be fundamentally impacted[4].
- WFH will boost demand for Video Conferencing of high quality to boost productivity. Even schooling during the current pandemic has moved online. Hence, Home Broad Band will see a huge boost in demand as Corporates may reimburse workers for telecom costs.
- Fewer social interactions will impact demand for categories like Apparel and Footwear.
- Even as businesses put mechanisms in place, lack of trust in others hygiene standards and fear of getting infected will be an impediment to demand in sectors such as hospitality, retail and products who are dependent on them. Even once they open, the need for social distancing means their capacity will be significantly reduced as number of patrons that can be served simultaneously reduces.
- Many small businesses – who do not have an option to go virtual – will permanently close.

[2] https://www.spiegel.de/international/world/china-versus-the-world-an-emboldened-beijing-tries-to-consolidate-its-power-

[3] 75M people used Microsoft Teams in April 2020 on a single day compared to 20M in late 2019

[4] Many companies, including TCS in India, expect a large share of their staff can permanently work from home. 50% of Fortune 500 CEOs don't expect Air Travel to revert to 2020 levels ever again

Market share gains of digitally enabled business models will dramatically increase
As consumers get comfortable transacting digitally, more categories will come under the ambit of digital. For example, digital adoption in purchase of Life Insurance has seen a sharp increase[5].

Implications

- Food delivery, on line entertainment, on line grocery delivery, e-papers will witness significant gains in market share from off-line models (in-house dining, multiplexes, large format retail, newspapers).
- Data consumption will grow exponentially as demand for video conferencing, online schooling/tutorials, online entertainment via OTT channels and video gaming explodes.
- This will have negative implications for terminal value of newspapers, radio, broadcasting and outdoor advertising as online advertising replaces traditional media at an exponential pace.

More developmental spending to the bottom of the pyramid as the pandemic worsens inequality
The lowest income segments are the worst affected in any economic down cycle. The worst hit during this crisis are people employed as cooks, waiters, cleaners, Ola/Uber drivers, workers at construction sites, small entrepreneurs who cannot go digital etc. At the same time, low interest rates will boost Asset prices worsening the Income and wealth divide.

Implications

- We will see more schemes to push incomes to the bottom of the pyramid.
- NBFCs catering to urban subprime will face significant rise in defaults.
- Beneficiaries of agriculture reforms will emerge as a secular theme for investments

Govts. will become more protectionist
Multiple studies have shown that trade is net positive for job creation. However, politicians will milk sentiment against trade to attempt to create more local jobs. India is looking inwards more aggressively. For example, the US Govt. has temporarily suspended H1B Visas till the end of 2020.

Meanwhile Govts will act more aggressively to protect national industries. The UK is attempting to make it tougher for foreign buyers to acquire any assets related to the nation's healthcare self-sufficiency, artificial intelligence and other high tech. Germany bought a stake in the vaccine treatment company Cure Vac when faced with the possible threat of a US takeover.

Implications

- Export Business models based on labour arbitrage will be challenged for growth and margins.

Govt. debt ratios will grow and they will need to tolerate higher inflation down the road
Govts. are spending liberally to support incomes during the current crisis. They will have limited ability to put in place austerity measures post the crisis due to worsening inequality and as enforcing fiscal discipline will make it harder for them to get re-elected. Average Debt/GDP ratios are expected to rise ~20% in the next 2 years[6] even as the developed world faces poor demographics and declining productivity. Govts. may find it difficult to increase corporate taxes because that will further impede employment generation and economic recovery.

Implications

- Expect higher income tax surcharges on the super-rich.

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[5] https://www.business-standard.com/article/economy-policy/how-the-insurance-sector-is-likely-to-pan-out-in-the-post-covid-19-scenario-120051300839_1.html
[6] Source: Financial Times

- Govts. may need to tolerate higher inflation to bring debt burdens down.
- Gold will be in demand as it will emerge as a store of value.

Environmental, Social and Governance risk warnings may get taken more seriously.
Despite warnings, Govts. were unprepared for a new corona virus[7]. This would make Govts. more alert to the threat of climate change. Facebook's inability/unwillingness to act more quickly on hate speech/racism has led many companies to boycott advertising on its platform.

Implications

- Businesses will also be judged more aggressively on how positively they contribute to society.
- Fund Managers will be under pressure to examine "ESG" ratings before considering investments.

Rising consolidation across industries. Big US Tech companies[8] will become more powerful
A crisis results in consumers migrating to brands they trust. In addition, the lack of staying power of smaller firms, and customer concerns on their ability to survive means the big players will get stronger across industries. Large Technology companies are already benefitting as the lock down increases demand for their products and the world becomes more virtual. Digital spending on platforms such as Google, Facebook and Alibaba has now overtaken traditional media[9].

Implications

- Rising consolidation across industries.
- Big US Tech companies will use their cash flows, ability to borrow cheaply[10], and market clout to new enter new sectors.

Consumers will down trade to value for money brands.
A shock to Consumer incomes through a loss of jobs or income uncertainty results in psychological impacts on consumer behaviour. Discretionary spending will get impacted.

Implications

- In the short term, categories such as health/hygiene/which aid cooking at home and those which provide "affordable luxury" will gain share of the consumer wallet with high ticket discretionary items being postponed.
- Consumers may down-trade to value for money brands. Health concerns could see consumers looking to avoid shared cabs and buying 2W or second hand 4W instead.
- Growth of personal loans should be impacted as consumers look to re-build savings and risk aversion to lending increases. Demand for Loans backed by Gold as collateral will increase significantly.

However, after a prolonged period of self-denial, there will be expression of pent up demand[11]. Consumer behaviour will evolve as consumers get more confidence on stability of incomes and health concerns recede over time. Hence, down trading of brands and slow-down in consumption may be temporary

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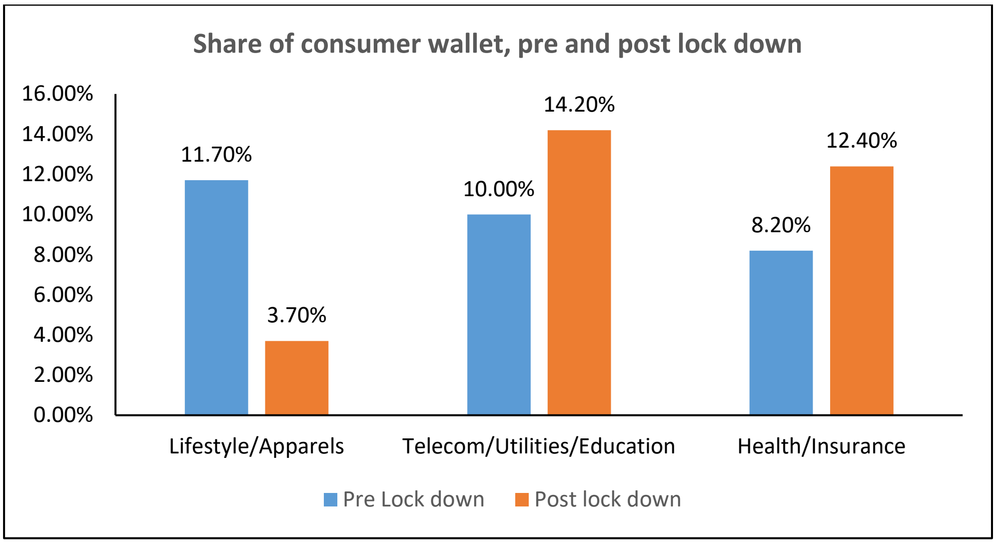
[7] Taiwan, Singapore and South Korea being exceptions
[8] Amazon, Facebook, Google, Microsoft
[9] Source: Group M
[10] Amazon raised USD 10 B of debt, at maturities between 3-15 years with coupon rates as low as 40 bps (0.4%). https://deadline.com/2020/06/amazon-raises-10-billion-in-debt-sale-with-record-low-interest-rate-1202950470/
[11] Source: https://www.ft.com/content/36580711-054c-4bbf-8191-41988f8380f9 "IKEA in talks with Governments to return furlough money"

Insurance uptake will rise

Demand for Life/Health Insurance should get an additional fillip as consumers become more conscious of the need to protect their families. This phenomenon was witnessed in China after SARS and in Saudi Arabia after MERS. Consumer surveys done by firms in India post Covid 19 also indicate an increase in consumer propensity to buy Insurance.



Source: Ambit Capital

Implications on portfolio construct

We shared analysis of the impact of Covid 19 on our portfolio construct in our webinar on 21 May.

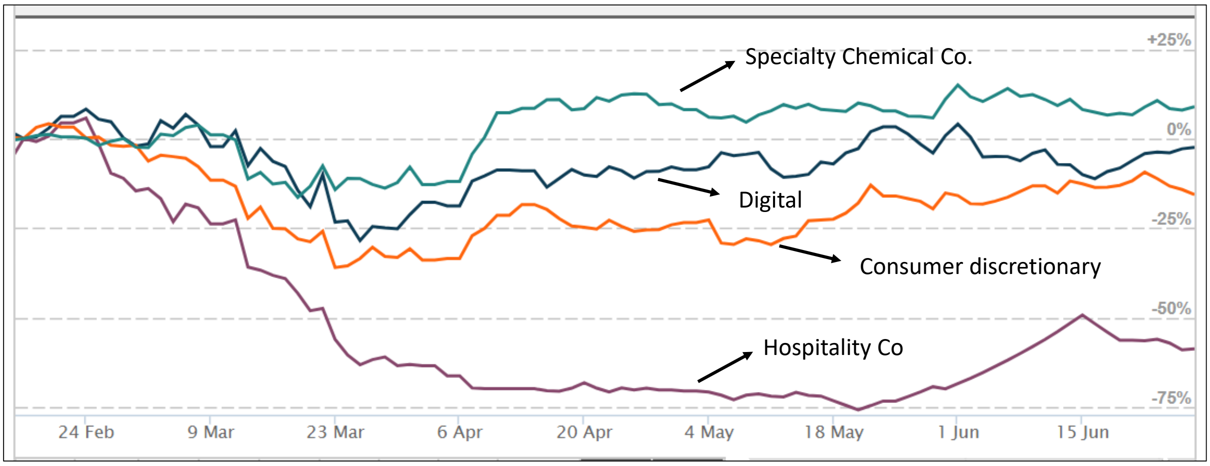
Summary

- The "China+1" theme should continue to benefit and show earnings growth in FY 21 despite the pandemic. Specialty Chemical companies will continue to build on Earnings momentum.
- "Life Insurance" VNB[12] should continue to grow as consumers adopt digital models to purchase Insurance and as the share of protection plans increases over ULIPs.
- Our investments in "Consumer" are centred on "affordable luxury". However, volume growth will be impacted as out of home consumption is impacted. We expect normalization from Q4 FY 21 as businesses explore new means to grow volumes, e.g. through home delivery.
- "Digital themes" should continue to grow as more business activities move on-line. However, some B2B companies could have a soft FY 21 as overall economic activity declines.
- The key impact on Earnings will be on Banking through slower loan growth and higher provision costs for bad loans in FY 21/22. Moratoriums on loans makes it hard to assess the impact. We discuss this in detail in a later section.

[12] Value of New Business is the life time value of new business signed up for the year. It's a proxy to Earnings growth

Are stock markets disconnected from the economy?

The Indian market has rallied sharply from the lows of 23 March 2020 despite the economy expected to contract this year. This raises the question whether stock prices are detached from reality. <u>We believe current stock prices are not irrational and have incorporated new information which is reflecting in the vast dispersion of price trajectory across sectors.</u>



Fair value is estimated by discounting multi-year "free cash flows" (DCF) which requires one to make forecasts about the future (translate the future narrative for a company into numbers)[13] on multiple variables.

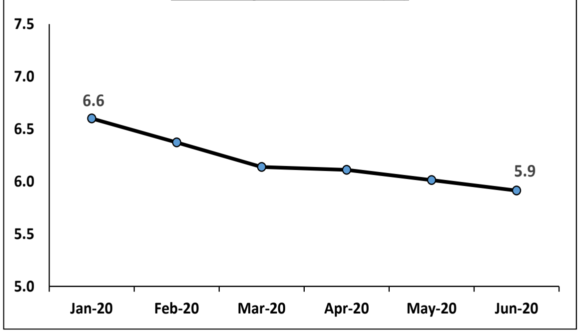
Variable	Explanation	Impact on valuation
Free Cash Flow (FCF)	Is the cash flow that remains after reinvestment for growth in Cap ex and Working Capital	Higher FCF the better assuming Cap ex for growth is not being compromised
ROE	Return on Equity is the efficiency of capital utilisation High ROE drives higher Free Cash Flow as it requires less re-investment	Higher ROE is better
Medium term growth "g"	Growth of Earnings. Without growth, a company will be valued like a Bond.	Higher growth is better (if ROE > Cost of Equity Capital)
Cost of Equity Capital "r"	The rate at which Cash flows are discounted. This is calculated by adding a risk premium to the risk free rate (10 yr. G-Sec). Solidarity uses a minimum risk premium of 6% over 10 yr G- Sec and it can be as high as 9% (based on the predictability of earnings).	Lower the Cost of Equity Capital, higher the fair price
Terminal value (TV)	Is the value of a business beyond the period where future cash flows can be reasonably estimated Terminal value often comprises a large percentage of the total assessed value of a business and is primarily a function of a business' competitive position.	Higher is better

[13] Our valuation approach borrows extensively from Prof Aswath Damodaran's remarkable book, "Narrative and Numbers – The Value of Stories in Business"

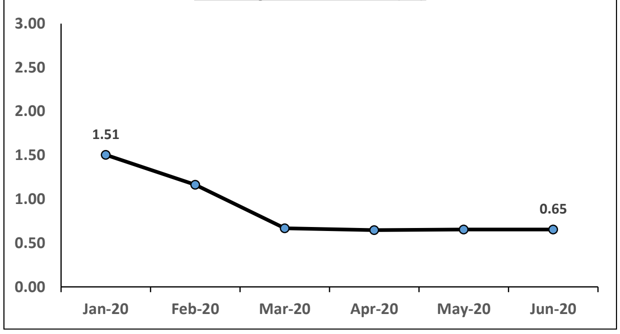
The need to make multiple assumptions, over long time frames, in a rapidly changing world means DCF as a valuation tool has its limitations and one must use multiple approaches to valuation. However, it does provide insight into sensitivity of fair value to changes in assumptions of key variables. A few examples

- Near term earnings contribute a small share to the value of a decently run company.
- Changes in interest rates (cost of capital) and competitive position (reflected in improving ROE/terminal value) make significant impact to changes in fair value.
- As interest rates decline, discount rates reduce assuming risk premiums are constant. Hence, fair value may remain the same even if “g” reduces as long as terminal value stays intact.
- Short term decline in growth need not result in significant decline in fair value if terminal value is increasing.

What has changed from February 2020 is that Covid has had differential impact on different sectors and interest rates are declining as inflation is under control and there is poor demand for credit.



India 10 yr G Sec Yield (%)



US 10 yr G Sec Yield (%)

As the future narrative on each sector changes due to the impact of Covid-19, the assumptions about the numbers that determine fair value need to change as well. The table below shows the impact on fair price due to change in assumptions on risk premiums, growth rates and terminal value for different sectors.

Illustration of change in fair price post Covid-19 for different sectors

Sector	Situation timeline	Cost of Capital	ROE Steady state	Growth 5 yr	Growth 20 yr	Terminal Value	Change to fair price
Specialty Chemicals	Jan-20	13.0%	25.0%	20%	15.0%	7%	
	Jun-20	12.5%	25.0%	20%	15.0%	7%	14%
Consumer discretionary	Jan-20	13.0%	45.0%	20%	15.0%	7%	
	Jun-20	12.5%	45.0%	12%	13.0%	7%	-8%
Hospitality	Jan-20	13.0%	25.0%	20%	15.0%	7%	
	Jun-20	14.5%	25.0%	8%	12.0%	7%	-62%
Digital B2B	Jan-20	13.0%	> 100%	20%	15.0%	7%	
	Jun-20	12.5%	> 100%	12.5%	12.0%	8%	-8%

Specialty Chemicals (Pharma, Agro Chemicals)

- Sector is expected to benefit from reducing cost of capital (reduced cost of borrowing and decline in yield curve with same risk spread).
- Short term growth rates stay intact and perhaps increase (sector serves critical industries and any slow-down could be made up by market share gains from China); while terminal value assumptions are intact.
- Hence, fair multiples should increase.

- *Many Specialty Chemical players (serving Agro/Pharma) stock prices are at the same levels or marginally higher compared to Feb 2020*

Hospitality

- The cost of capital for these sectors will increase (despite lower interest rates) as investors demand a higher risk premium. Earnings uncertainty in this sector is significantly higher due to impact on demand from lower business/leisure travel, need for social distancing and no clarity when demand will normalize. Additionally, most players are leveraged.
- Hence, the sector suffers a double impact of higher cost of capital and lower 5 year growth rates even if one assumes no change in terminal value.
- Understandably, fair price multiples should decline significantly.
- *Stock prices of Hotels are down ~50-70% from Feb 2020.*
- Any positive developments on a vaccine should result in steep price recovery as risk premiums will normalize and investors will sharply revise short term growth forecasts.

Consumer discretionary - "affordable luxury"

- The cost of capital for the sector decreases as risk premiums remain the same.
- There will be significant impact on short term growth rates as FY21 earnings are impacted due to low off-take from restaurants/bars but with no changes to terminal value. However, earnings should normalize in FY 22 as economic conditions improve and as companies start use of new distribution channels (e.g. home delivery of liquor).
- Hence, impact on fair price should be marginal.
- *Most consumer discretionary companies are ~0-10% below where they were in Feb 2020*

Digital B2B

- The cost of capital for the sector decreases as risk premiums remain the same.
- There will be negative impact on short term growth rates as overall economic activity declines, even if Digital B2B business models capture a greater share of the opportunity. However, terminal value should increase as competitive positions are significantly enhanced.
- Hence, impact on fair price should be marginal.
- *IndiaMart[14] is broadly at the same price where it was in Feb 2020*

The sharp market rally also reflects investors recalibrating their excessively bearish risk stance of March by taking a more nuanced view of the future.

- There was limited understanding of the infectiousness and mortality rates etc. of the novel Corona virus when it struck. Self-declared experts[15], further promoted by the media, predicted a horrifying number of deaths. Understandably, fear of the unknown amidst mass hysteria led to a sell-off in stock prices.
- Perception of Covid-19 has moved from "unknown with devastating consequences" to "something bad we need to live with". Govts. too are communicating that even if there is a second wave, the economy will not be shut down en masse. Calmer minds are now recalibrating their earlier response.

[14] Solidarity has a position in IndiaMart in partner portfolios

[15] https://www.opindia.com/2020/03/ramanan-laxminarayanan-coronavirus-covid-19-panic-media-promote-commercial-interest/

Commentary on US markets

The US economy, like all economics across the world, is struggling at present with the deepest recession in its peace time history. There are over 30 M working Americans or~ 20% of the US Labour force in the US on unemployment benefits. The path of recovery is unclear. Yet the US market is now trading at close to all-time highs.

The steep rally in US markets should be seen in context of US Central Bank behaviour

- Central Banks are signalling that we will be in an era of low interest rates for long periods of time. The Bank of Japan has pledged to cap 10 year rates at 0% till 2023. The US Fed also seemed to indicate that there will be no interest rate increases through 2021 and maybe through 2022.
- The US Fed is buying lower rated Corporate Bonds while the Japanese Central Banks has increased its targeted purchase of Equities and will continue its buying program ("we will not run out of ammunition"). *What is the fair price of an Asset if Central Banks signal that they will be buyers of last resort and will be indifferent to the quality of the Assets or their price?*

Additionally, a large part of the US market rise is being led by Technology stocks.

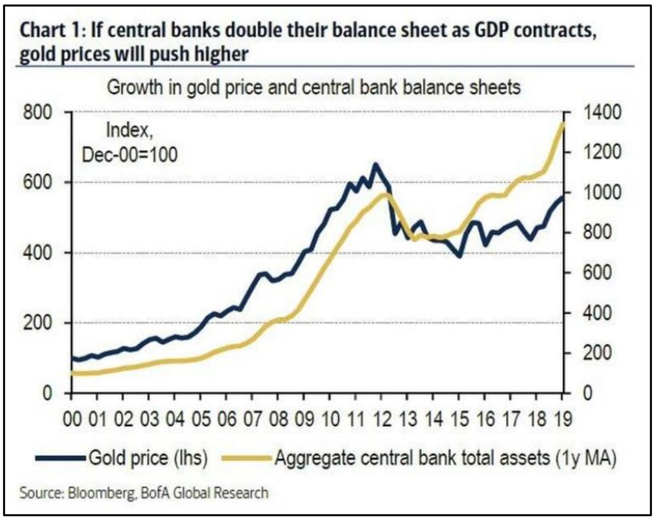
- Their core business is benefitting from the pandemic and they are generating significant amounts of cash flow compared to the Dot-com boom of 2000 when Technology companies had no demonstrable earnings.
- Technology leaders can raise debt at very cheap rates to fund buy backs and growth. Amazon has borrowed over USD 10 B of debt with maturity ranging from 3-10 years at coupons between 0.4-1.5%.
- <u>The fair value of a high ROE business, with dominance and growing cash flows rises exponentially as discount rates reduce.</u>

However, we have to ask what happens to stock prices when interest rates eventually rise?

- Developed world central banks have entered "Abhimanyu's Chakravyu". They have followed unconventional policies since 2008 to boost economic growth, but cannot seem to find a way to exit them. Every time they try and normalize monetary policies, growth rates slips and they are forced to turn on their printing presses again. They are now distorting the rules of capitalism by mispricing cost of money and kicking the unsustainable further down the road.
- Stock price multiples will decline when interest rates rise if growth rates cannot be sustained. Hence, the Western world is looking at a period of low returns in Equities going ahead.

We continue to recommend Gold as a core part of the family portfolio with at-least 5% weight

- No one knows when the unconventional monetary experimentation will end or what its unintended consequences will be. Gold will be Insurance against the side effects of money printing we don't understand. Scarcity drives value. And gold is scarce with production increasing only 1-2% per annum and finite reserves.
- Analytically, as one can see from the chart below, Gold prices from 2000 have moved broadly in line with expansion in Central Bank Balance sheets. As Central Bank balance sheets expand from money creation, Gold should trend higher.



Answers to questions we have been asked.

Economic growth potential in India has been deteriorating since 2016 demonetization. Banks as levered plays are at most risk in coming 1-2 years. Why do you still have about 25% exposure to Banks and Lending Institutions?
Short answer – we see a road map to ~18-20% IRRs over 5 years from current prices through a combination of Book Value growth and valuation multiple expansion.

Banks/Lending Institutions are leveraged plays on the economy and a shock to the economy cannot leave them unscathed. While we expect pressure on short term earnings, worries about large scale defaults/loan losses in our portfolio choices in Banks may be exaggerated.

- Due to their competitive advantage in cost of funds, their loan books are the least exposed to very vulnerable segments as they don't need to take disproportionate credit risk.
- The rural economy is doing well and is largely unaffected by Covid-19. Agriculture is expected to grow 4% this year.
- Job losses in white collar jobs have not been as high as was initially feared. *"Two major banks who have a large number of salary accounts indicated that the salary uploads into the accounts dipped slightly in April but were stable in May, and they have not seen any major decline"*[16]. *HDFC Limited Retail Loan moratoriums have declined to 7% in June from 21% in May*[17].
- The 3 Lac Cr Govt. guarantee on SME Loans will play a role in limiting NPAs in SMEs as it reduces the probability of default on existing loans as well.
- Recoveries in personal and SME loans should be higher than in the previous cycle both because of collateral (most SME loans have Real Estate as collateral) and the role of Credit Bureau's. One cannot default on a loan and avail of new loans over time unless one has settled loans with the previous defaulter as your credit history is recorded with Credit Bureaus and accessible to all lenders.

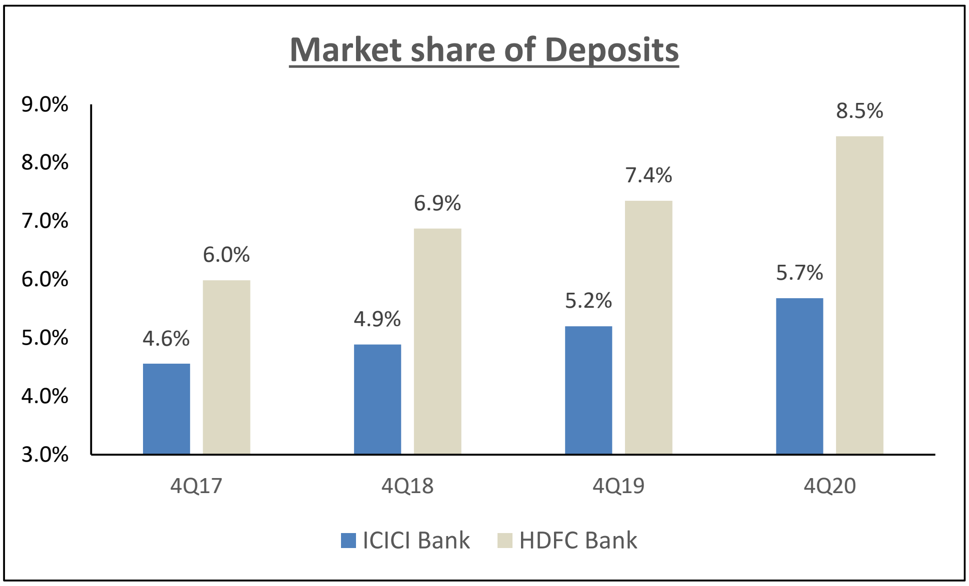
While short term earnings are uncertain, we believe Book Values of Banks will continue to grow in FY 21 and FY 22, even if there is a steep rise in defaults.

- The banks we own entered this crisis with very high provision coverage on FY 20 Loans. Hence, provisions they will need to make will primarily be for stress due to Covid-19.

[16] Macquarie Research, 17 Jun 2020
[17] Macquarie Research, 17 Jun 2020

- Pre provision Operating Profits should not be significantly lower than FY 20, and large enough to absorb a steep increase in loan loss provisions.

We believe valuation multiples for Banks 5 years out should be higher than present levels.
- Partners will be bored stiff of our constant refrain that bulk of value of any company lies in its Terminal value which in turn is primarily determined by the competitive edge of the franchise and its resilience to disruption.
- The franchise value of the companies we have bet on is increasing. They are gaining market share, not only on deposits from Smaller Banks, but also on opportunities to take market share in Credit from Bond Markets, PSU Banks, Smaller Banks and NBFCs. As we shared in earlier write ups, the principal source of competitive advantage in a Bank lies in its deposit franchise.
- ICICI Bank (without subsidiaries) is quoting at ~1.5 Price/BV. The current valuations provide a marginal premium for future value creation – despite it evolving into a stronger franchise and which we believe will offer more predictable growth like HDFC/Kotak Bank in the near future.
- Markets hate uncertainty and no one knows how to model provision costs at present. Hence, investors would rather wait at the side lines for more clarity.



Why are Banks raising Capital despite being well capitalized if they did not fear an avalanche of NPAs?
- One can never predict how bad things can get if the economy enters another period of lockdown based on how the pandemic plays out. One should never ignore tail risks.
- It is prudent to be cautious and over capitalized – both to deal with the immediate provisioning requirements and also have capital to seize opportunities that may present themselves as weaker players lose share and find it hard to raise capital.

In summary, over 5 years, our choices will benefit from Book Value growth and a re-rating of valuation multiples. Even if Book Values grow at 10% CAGR over 5 years (implies 3% Book Value growth for 2 years and 20% for later 3 years), and multiples increase by 33% from current levels, we see a road map to ~18-20% IRR over 5 years.

The best returns will accrue when our beliefs are at odds with the market, and we are right. Hence, we are not averse to having some names in the portfolio who have short term head winds as long as the opportunity for compounding is intact, the competitiveness of the franchise is increasing, and the position weight allows us to take the pain. Sentiment for a stock typically turns well before the earnings recovery is visible - partners may recall that ICICI Bank rose ~ 50% between Sep- Dec 2019 as investors started believing in the management narrative of return to normalised ROE from FY21.

We have however reduced our exposure in ICICI Bank for risk management reasons as we wanted to reduce single company concentration risk - "It's not what you know that kills you, it's what you think you know, for sure, that just ain't so"[18].

Why not have more diversification in the portfolio given the uncertainty at present?
The key to successful diversification is investments in uncorrelated themes rather than number of positions. At present the portfolio is invested across 6 broad themes which give us good diversification across the Indian domestic growth story and export opportunity, a mix of traditional and new age business models, and small/mid-caps and large caps.

A portfolio of 15-20 positions is adequate balance between risk diversification and conviction. Our minimum position in any company is 3% at inception because every position must move the needle in terms of impact on over-all returns. Beyond 20 companies the benefits of diversification start reducing and one starts replicating an Index.

Partners should note that 15-20 positions is a principle and not a firm rule. In some partner accounts we are now up-to 22 positions. This will get corrected to our sweet spot of 15-20 names over time.

Concluding remarks
"In life, the challenge is not so much to figure out how best to play the game, but to figure out what game you're playing[19]". To this philosopher's quote, I would like to add, "And have the conviction to stay the course". Human beings are hardwired to focus on negative things. The incessant barrage of news can drown the voice of reason and make one lose conviction in the long game and start optimizing for short term results instead.

That would be a mistake as one cannot optimise for short and long term gains simultaneously. No one has come up with a time tested model that spots decisive turning points in the market as the specific variables that influence short term moves cannot be known. They will be based on macro events, decisions of politicians and acts of God which no one can forecast.

The best way to navigate uncertainty is to identify themes which offer prospects for secular growth, through companies who have leadership positions and whose business models provide them an edge, and are run by management teams with prudence and discipline. And then grind out the tough time periods.

We look forward to interacting with you on our call on 11 July.

With my best wishes,
Manish Gupta
Chief Investment Officer

[18] Wisdom attributed to Mark Twain
[19] Kwame Anthony Appiah, a philosopher (https://en.wikipedia.org/wiki/Kwame_Anthony_Appiah)