1 Apr 2017

Dear Partners,

The start of a new financial year is a good time to take stock of where we are in our journey and revisit how we want to position ourselves for the road ahead.

It is standard practice in the Investment Management industry to share one year performance with partners. I have never understood that. We ask you to think long term, yet keep reinforcing short term behaviour. None the less, you will observe that we are ahead of benchmarks. We are not celebrating because of this and I would not worry if we underperformed in any one year. Short term performance is mostly attributable to luck. It is akin to the timing posted between any two random milestones in a marathon. Results should always be measured over long periods of time, preferably peak to peak or trough to trough which give a better sense of performance adjusting for the risk one has taken to deliver the performance.

Before we share portfolio positioning, I'd like to re-iterate the Investment approach we follow.

Partners are aware that our underlying intent is to aim to deliver returns which are

a) ~ 4-5% above nominal GDP growth
b) Over long periods of time (3-5 years)

Under the assumption of ~ 12-14% nominal GDP growth rate, that translates into targeted compounded returns of ~ 16-19% over 3-5 year time frames

As in the long term stock prices are slaves to earnings, our approach is to invest in businesses that can <u>compound earnings</u> over multiple years. We hence seek companies that will

a) Benefit from structural trends that provide tail winds for growth
b) Have some uniqueness or dominance about them (a "right to win")
c) Which are run by management teams with a clear vision, integrity and discipline
d) These should be available at a fair price relative to the quality of their earnings, cash flow and robustness of business model.

Within the above "Quality" construct, we buy businesses across a spectrum of maturity (risk profiles). These are categorized under "Clear", "Emerging" and "Aspiring" Leaders.

We manage risk by principally understanding the businesses we are investing in. We don't invest in businesses which we find too complex to understand, where growth is not supported by a sustainable ROE that exceeds 15%, or where we see management teams being imprudent on risks in the quest for faster growth.

We don't like to churn – we like to ride our winners. We stay with loss making position if we have conviction. But we exit if we are wrong or new developments emerge which challenge our original thesis.

Our approach will work well over long periods of time. It will serve us all particularly well in challenging environments when the benefits of focus and discipline help differentiate against companies who have taken undisciplined bets. However, a consequence of this approach, especially during periods of euphoria, is underperformance of the portfolio against small and mid-cap benchmarks, when measured over short time horizons, because lower quality franchises race ahead.

Consider an example from the present.

- Banking is very clearly a scale business.
- It is not clear whether the new small private banks – clearly disadvantaged on key metrics such as Cost of Operations, Cost of funds and customer access, and with unproven Credit discipline - will ever deliver ROEs in excess of 15% when the leaders are at ~18-20%.
- The principal driver of shareholder value is spread over Cost of Capital. If your ROE is equal to or just marginally above Cost of Equity, you should trade at 1-1.5X of your Net Worth, irrespective of growth.
- Yet, many new private banks benefitting from their low base, are reporting very aggressive growth and trading at valuations which cannot be justified by their ROE even a few years out.

We will stay true to our approach and not break discipline just because companies we don't fancy are speeding along.

"Brain fades" are not restricted to Australian cricketers. Our performance would have been better this year were it not for a few mistakes of commission

- Divi's Labs provides Contract Manufacturing Services to Pharma Companies globally and has a decade record of wealth creation. The management team of Divi's does not provide adequate information to minority shareholders in either the Annual Report MD&A section or via analyst updates. We have been holding the stock since our inception for its unique non-compete business model, clean FDA record, steady 15-20% growth, 38-40% EBITDA margin, 25% ROE and debt free balance sheet. We were blindsided by the FDA insinuation of violation of "data integrity" and the opaque management response offered to minority shareholders. We have resolved not to invest in companies who operate in a black box.
- We bought into United Spirits too much, too early. United Spirts is undergoing a turnaround under a new management team. Even as we are convinced on its long term story, the delay in margin expansion has resulted in the stock witnessing price and time correction. As it is a turnaround situation, we should have added to our positions over time as the margin turnaround got more visibility.
- We got anchored to our earlier success in Kaya temporarily forgetting that this was a business model under evolution and not one where success was proven. The management team expanded their centre count aggressively and when growth slowed in the economy, the increase in fixed costs unsupported by revenue increase (Operating leverage in reverse) resulted in profit declines. This too is an example of a company which has significant long term potential but which should have been accumulated over time and at a lower price.

We have incorporated these learnings into our Investment approach. For sure we will make other errors over time, however, by reflecting on them dispassionately, we will enhance probability of superior outcomes.

Assessment of the environment within which to position portfolios

Partners are aware that while it is futile to make forecasts, it is imperative to have a broad idea of where we stand (tail winds, head winds) so portfolios are built around the new reality

Technological advances continue to take away low end jobs. While this is gathering pace, the unintended consequence of developed world Central Banks actions (keeping interest rates artificially low) has been an exacerbation of inequality. Rising inequality and under employment has opened the gate for populist political regimes and events such as the rise of Donald Trump and Brexit as politicians capitalize on the disenchantment of those left behind. Populism in the developed world is at its highest since World War 2 with strong rhetoric around economic nationalism and rising calls for protectionism.

Meanwhile debt burdens continue to rise. For eg, Italy has grown at less than 1% annually for the last 15 years. GDP per capita is the same as it was two decades ago while debt has risen from 102% of GDP in 2008 to 133% of GDP in 2015.

Compared to debt and policy challenges in the developed world, India is a relative growth haven. There is a sense of urgency this Govt. has brought to the reform agenda which was missing in earlier administrations.

The national digital backbone being put in place should unleash massive growth and productivity benefits, particularly in the lower income strata as the poor get banked, access social welfare schemes and farm incomes have more stability. GST enabled tax compliance should result in a surge in revenue collections which will provide funds for investment in Infrastructure.

What is also clearly visible are not only rising incomes but also rising aspirations and evolving social attitudes. For eg, Air Travel has grown at over 20% a year for two successive years benefitting from many first time flyers. Liquor consumption is no longer a taboo in many erstwhile conservative families. In many categories, one can witness premiumisation eg Motorcycles, and consumers preferring branded products over commodities eg Pipes

Actionable implications for portfolio construction – putting it all together

The key starting point for Investors should always be Asset Allocation and how aggressive/defensively one should position portfolios.

- We would counsel having some protection against the unsustainable build-up of debt in the developed world and the side effects of money printing. History teaches us that the only real solution will be to either default or inflate away the debt. We hence continue to recommend some allocation to Gold/Gold Miners (3-5% of the portfolio). This caution penalizes returns in the short term but is akin to an Insurance policy.
- We also recommend to keep a portion of one's Assets in liquid debt instruments for Optionality to be exercised in the event of a market turmoil. Demonetisation provided a good example of an instance when Cash combined with conviction and courage has been invaluable
- The lion's share of allocation should be to Indian Equities

Within equities, we will participate in the following structural long term themes

- Companies that will be significant beneficiary of discretionary consumption by benefitting from increased Consumer wallet share and consumer attitudes
- Companies that will be significant beneficiaries of tax reform and compliance.
- Large Private Banks as they are well poised to gain market share from the public sector
- Despite protectionism, many global themes will continue to be attractive. Many global business models are built on the back of Intellectual Property and not wage arbitrage. Such global supply chains will be hard to eliminate and rebuild locally. Eg Speciality Chemicals, Aerospace, Animal Vaccines

As we value predictability, we will wait for the fog to clear on certain sectors. For eg, we are unclear whether the current margin profile of the Indian IT leaders (TCS, Infosys at 25%) will sustain in the future.

- Accenture, arguably ahead of them in the new Digital world, operates at 15%.
- The ability to move work off-shore, which drove much of the margin differential, is less relevant in the new digital context and companies will face additional margin head winds eg the new intended visa regime

- Growth is already under pressure and if margins drift down even to ~20% over the next 5 years, current valuations do not provide attractive entry points.

The above represents our stance as of today. We reserve the right to change our minds as our perspective changes and/or valuations move significantly in or out of favour.

Should you put more Capital to work at present?

The question is a tease. While long term growth prospects are bright, traditional signals suggest froth.

- The market is trading 1 std deviation above long term averages (1 Yr forward earnings)
- Small-mid caps have significantly outperformed steadier large caps in the recent past
- There is a rush of IPOs and QIPs
- The media has turned bullish from its bearish outlook post demonetisation

However, there is some fog in interpreting fair valuations at present.

- The economy is undergoing a transformation on tax compliance. Many company earnings could grow exponentially benefitting from growth in market share and margin expansion. Hence, the earnings these companies deliver over the next few years could surprise. 1 yr forward multiples can be misleading when earnings growth will not be linear
- As an example consider TITAN. The jewellery sector was supposed to be amongst the hardest hit due to demonetisation. However, TITAN surprised the market with Q3 earnings growth as even as the overall market declined as it gained significant market share
- Credit growth in India is at a decadal low; higher multiples for banks could also reflect the higher earnings growth prospects from a revival of Credit growth and market share gains
- There is significant liquidity support. Domestic investors continued to invest during demonetisation despite the adverse media commentary.

If you would like to put more Capital to work, I will be happy to have a conversation keeping your present Asset Allocation in mind. We don't buy the market but individual companies. Amidst the euphoria, some companies continue to offer attractive entry points.

In closing, I would like to reiterate some key messages

- Our ability to keep a long term perspective will provide an edge
- We have strong conviction and belief in our "quality" based approach. This will serve us well across long time horizons. We practice what we preach– over 99% of my Liquid Assets are in the sub set of positions held for you.
- Stay invested in Indian Equities. India offers long term growth and stability

Please reach out to us on anything else we can do to address your Investments related worries. We can help with a bunch of issues at no extra cost to you. For example,

a) Analyse your Asset Allocation to ensure you are not taking too much/too little risk
b) Analyse your Insurance policies to ensure you have the right one
c) Offer another opinion on any other Investment products that have been pitched to you (Closed ended Mutual funds, PE Funds, Structured products…)
d) Suggest some overseas Investments which we cannot invest into on your behalf

Thank you once again for your support. We deeply value the trust you have placed in us. It helps us live with freedom, pride and purpose.

With my best wishes,
Manish Gupta
Chief Investment Officer