3 Jan 2019

Dear Partners

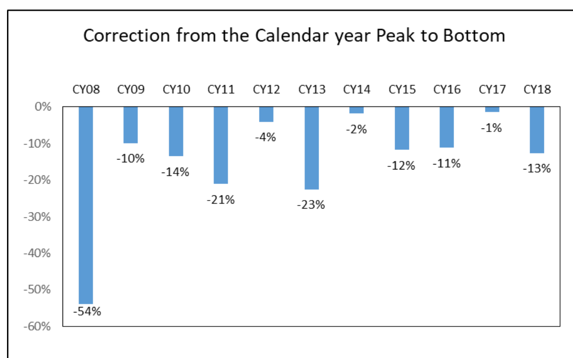
In our letter published a year ago on 4 Jan 2018, we had highlighted valuations were very high and one needs to have muted short term return expectations. Quoting from the summary:

- *At present, for the market in aggregate, the story is running ahead of numbers – valuation multiples are very high.*
- *…One needs to have muted expectations of short term returns and have longer investment time durations so earnings growth can beat the impact of valuation multiple decline*

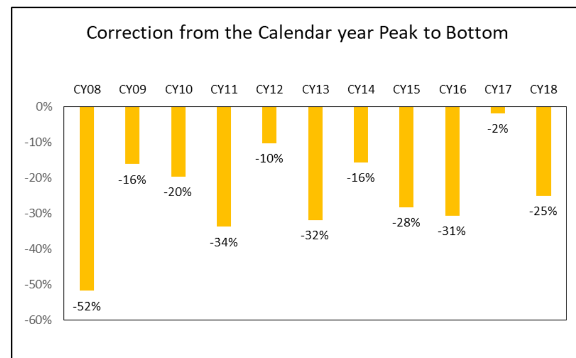
2017 was a year when those who invested unmindful of risks were amply rewarded. 2018 reversed that with the NIFTY Mid cap & Small cap Indexes dropping 15% and 29% respectively this calendar year. The year has been poor for Equities across the world with the lowest yearly returns in over a decade in most major world markets. Many global stock markets have entered bear market territory (correction of 20% from the peak).

There have been significant learnings for us this year. We primarily seek multi-year compounders and are guided by the wisdom in the charts below. Even very well run companies witness frequent and deep corrections, but if held for long periods of time deliver great outcomes.

HDFC Bank 18% CAGR from 1st Jan 08 till 31st Dec 18



Titan 25% CAGR from 1st Jan 08 till 31st Dec 18



However, what the last 12 months have taught us is that while one needs to allow the process of compounding to happen uninterrupted, it is also wise to practice it in context of risk management. Hence, with perfect hindsight, perhaps it would have been wiser for us to take some profits off the table in names (especially Mid caps) where position weights were high and valuation multiples were in euphoric zone.

The road ahead

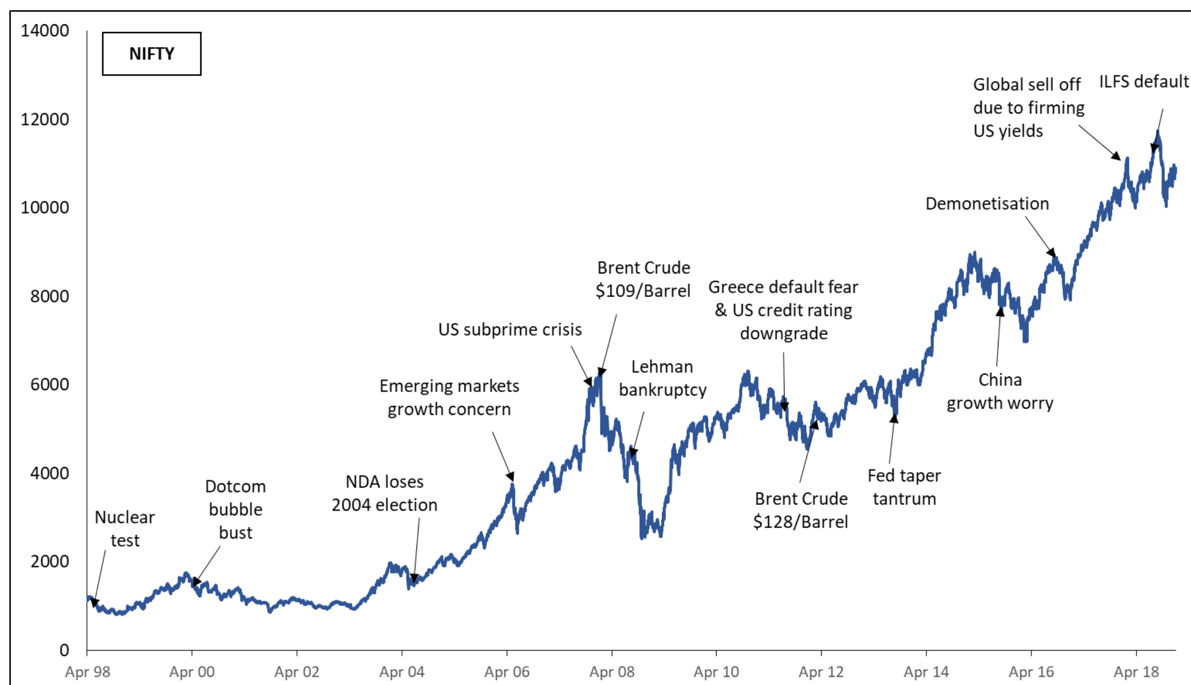
A few known risks are affecting market sentiment at present

- A decade of low interest rates in the developed world have started to reverse. Rising interest rates will increasingly act as head winds on global valuation multiples
- Rising global geopolitical tensions threaten to make the world more nationalist, insular and protectionist. Lower trade will impact global growth.
- The current optimism about India is certainly lower than 5 years ago – there is a whiff of populism in the air which threatens to derail fiscal prudence, there is rising inequality and poor employment creation.
- The political formation for the next Central Govt. is wide open. Could a rag tag coalition come to power and reverse key policy decisions?
- Will the tension between the Govt and the RBI affect India's credibility with foreign investors and hence FII flows?

The world is always brimming with uncertainty. It attracts less discussion during periods of euphoria when risk appetite increases. And pessimists tend to quote sources of uncertainty a lot when risk aversion is in the air. However, history teaches us that it's the unanticipated events (e.g. ILFS default) that tend to trip markets as known risks are always priced in.

We can never truly gauge when uncertainties will strike, or how steep their impact will be. However, what we know is that, over time, markets move higher powered on by the earnings growth delivered by companies.

THE MARKET CARES ABOUT EARNINGS AND WORKS ITS WAY AROUND UNCERTAINITY



Hence, we should focus on what we can control – what medium term Earnings growth individual companies can deliver and what we are willing to pay for them in the context of risks we observe.

India has delivered a 7%+ growth rate in challenging environments and with different political formations. And, If India continues to grow at 7%+, there will be significant opportunity for Corporates to grow their Earnings/cash flow, and this will eventually reflect in higher stock prices if a reasonable price is paid on entry.

Portfolio stance

A large share of the portfolio is invested in companies which will benefit from themes that have secular and structural tail winds. A few examples

- Categories benefitting from changing attitudes, rising aspirations and opportunity to finance the same
- Implementation of Bankruptcy Code to bring about a structural change in borrower behaviour
- Increase in financial savings as a share of total savings
- MNCs looking to de risk supply chains from China

We see no change in drivers of growth, or in the optimism on growth prospects communicated by our portfolio companies in the above themes.

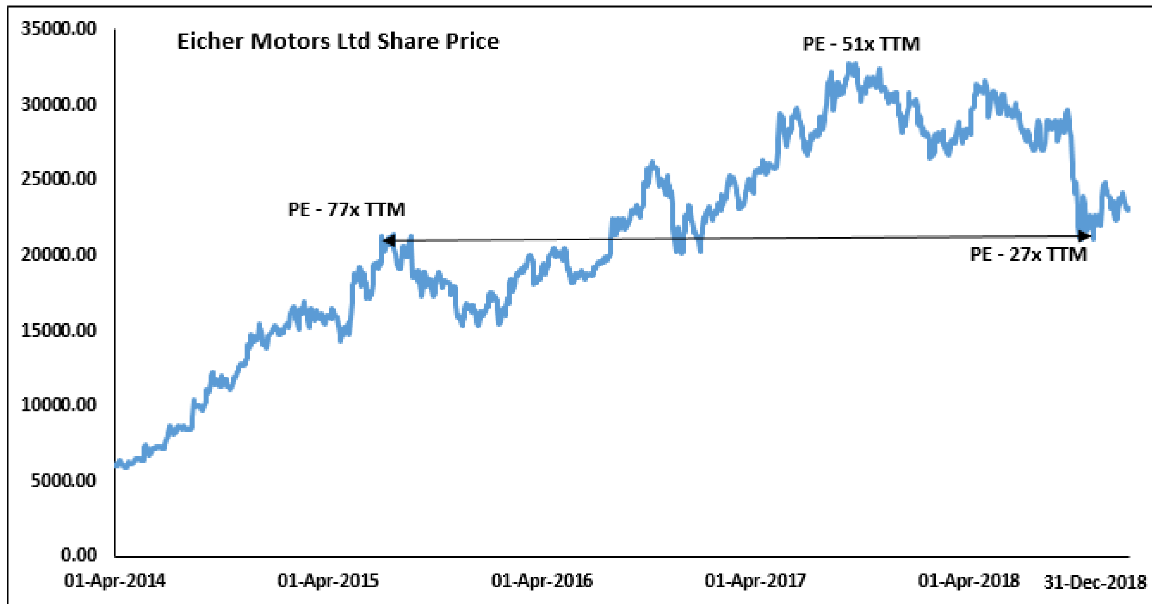
However, we see significant dispersion of valuation multiples across sectors.

- There are secular growth sectors where valuations offer reasonable to attractive points of entry (Specialty Chemicals, Corporate Banks, Retail Banks, Life Insurance etc.)
- However, we continue to be confounded by the valuations in most FMCG and Consumer Discretionary names. In many such names, valuations have risen significantly over the past few years without step up in earnings growth rates or ROE. Current valuations therefore imply significantly higher earnings growth over the next decade than delivered in the past despite rising competition.

	PE (Trailing)			ROE			Earnings CAGR	
Particulars	**FY 11**	**FY 14**	**FY 19e**	**FY 11**	**FY 14**	**FY 19e**	**FY 11-19**	**FY 14-19**
Asian Paints Ltd.	29	43	57	40%	31%	26%	13%	14%
Astral Poly Technik Ltd.	9	33	63	22%	25%	18%	26%	21%
Pidilite Industries Ltd.	24	35	55	28%	23%	26%	16%	18%
Britannia Industries Ltd.	33	26	61	41%	50%	32%	21%	9%
Hindustan Unilever Ltd.	27	33	63	89%	118%	83%	13%	10%
Page Industries Ltd.	31	47	61	47%	53%	47%	29%	24%
Nestle India Ltd	45	46	65	96%	47%	46%	9%	8%
Havells India Ltd.***	19	24	49	18%	22%	18%	17%	13%
Source: Ace equity/Solidarity analysis	Note: ROE for FY18 not adjusted for Ind-AS impact					***Standalone Data has been used		

There is no debate that these companies are great franchises. However, it may interest partners to note that other great franchises such as Google currently trade at ~20X CY 18 earnings without accounting for the value of its stake in Waymo and YouTube. Is the greatness premium justified or are these valuations ripe for correction?

A truism of markets is mean reversion of valuation multiples and growth rates. And if one pays too high a price for Quality and Growth, one is exposed to poor outcomes as any earnings surprise is accompanied by a very steep decline in valuation multiples (e.g. Eicher). A great franchise will not be a great investment if made at the wrong price. You can read our perspective on FMCG here.



Consumer names are among the most attractive long term Investment story in India both due to the growth opportunity, the quality of management, the high ROE and free cash flow, and low risk of disruption.

Hence, while we seek to participate in Consumer Discretionary names, we are very selective at present as we continue to seek more favourable entry points.

- Companies we have invested in (TITAN, Symphony) are category leaders with large growth opportunity and dominant share of the industry profit pool. Further, not only do they have a strongly growing core but significant optionality for growth in new categories or geographies.
- We believe their strong earnings growth will cover for risk of multiple declines (we assume 20-25X FCF on exit) and our time horizons here are at least 5 years.
- However, we must remind partners that no matter how great a franchise, at multiples exceeding 45x earnings, there is never any protection from earnings surprises which could come from events beyond the company's control. E.g. Symphony was hit by two consecutive moderate summers and TITAN has historically been impacted by Govt. regulations on Gold. Hence, one should always be mindful about position sizing when multiples are high.
- These are great names to enter when they are temporarily out of favour due to an earnings surprise. We took large positions in TITAN during demonetization and recently added to our positions in Symphony when the stock price was <40X FY 18 earnings. We discuss Symphony later in the letter.

Investment firms should have consistency in adherence to a good process. In our book, good process also means being flexible on nature of opportunities being pursued by adapting to changing market conditions. This need not mean compromising on Governance, or compromising on long term thinking – rather, casting the net wider for other opportunities which permit a healthy risk adjusted return. When "secular and structural" themes are out-priced, we seek value in "Transformations" and "Cyclical" plays.

- Transformations are potential Clear Leaders who are working through errors made in the past.
- Cyclical companies are in industries whose economics are more vulnerable to a business cycle as industry demand/supply gaps are not in their control and can affect margins significantly. When earnings in cyclical companies pick up, they are accompanied by rising ROEs which causes valuation multiples to expand resulting in very attractive Investment Outcomes. Returns here on 5 years' time frame can be significantly higher than our IRR ask in Secular

themes. However, these need more patience as the lack of near term earnings triggers means there is no momentum in the stock price.

Investment returns here are likely to be more back ended. One therefore should not be at full position weight till the promise of earnings plays out in reported results.

We believe there are opportunities to deploy Capital at present in Transformation and Cyclical themes at very attractive valuations.

- In Transformations, select Corporate Banks will surprise on their earnings growth in future as they are migrating to lower risk business models. We discuss SBI later in the letter.
- In Cyclicals, the narrowing of the Demand/Supply gap in the next few years is expected in sectors such as Power Generation and Steel. This should result in a better earnings profile over the next few years. Yet, blue chip promoter backed companies in these sectors like JSW Energy and Tata Steel trade close to Replacement cost as the market waits for more certainty on earnings. We discuss JSW Energy later in the letter.

Solidarity will focus on what we can control

- Buying well run companies, where promoters act with prudence and integrity, at what we believe is a reasonable price
- By maintaining flexibility across approaches but within the confines of a good process.

Key Portfolio actions during the quarter

We have used the market correction to add into existing names and initiate new positions. In the section below we will discuss actions on a few positions

While HDFC Bank and ICICI Bank remain high weight positions, we initiated positions in SBI

- When one finds opportunities where there is high probability of both earnings growth and multiple expansion, and downside risks are negligible, one must take large positions.
- Banks with significant Corporate Lending exposure should do very well over the next few years benefitting from strong loan growth, enhancement of NIMs and lowering of provision costs which should translate into strong earnings growth. Further, they should also benefit from a multiple re rating (return ratios expand to normative levels and uncertainty on provisions is behind them, structurally NPAs to be lower as the Bankruptcy Code results in better borrower behaviour)
- Partners are aware of our view that are there are no sustainable moats in lending businesses (Bajaj Finance an exception primarily due to its technology edge and culture) and our preference for institutions with a strong low cost deposit franchise – where moats are large. Further, partners are also aware that we prefer conservatism in lending businesses as rapid growth hides lax lending practices which can be hidden by opaque accounting and creative work arounds.
- We believe the market is not appreciating changes in SBI (and ICICI Bank) approach to lending which should result in structurally lower loan loss provisions over time. Both banks have been successful in growing/maintaining their low cost deposits and hence driving down their Cost of Funds. Simultaneously, they are migrating their loan mix towards more granular Retail Assets and higher Credit rated Corporates. As they have the lowest Cost of Funds in the market, they can earn a very decent Return on Equity without over reaching for yield but with the option to step up higher yield unsecured loans over time.
- The market is still valuing SBI with significant caution at <1 X FY 20 Book Value (adjusted for value of subsidiaries). This implies no premium for growth. This assumes either there are significantly more negative surprises and/or the operating culture which led to poor decision making in the past will not change, or their Core ROE will equal to Cost of Capital

We added to our position in Symphony.

- The best businesses one can own are those which are simple to understand, solve a key customer need without profiteering, can grow without reinvestment of cash flow, and don't face risks of disruption or Govt. intervention. Symphony ticks all the above boxes.
- We believe Symphony has the potential to grow cash flow by over 15-20%+ for over a decade. The unorganized sector still has over 70% of the Air Cooler market, the category penetration is still under 15%, and Symphony has meaningful adjacencies (Industrial Cooling) but also new geographies (China, US, Australia) to grow and de risk the business from the vagaries of the Indian summer.
- Symphony has category dominance with over 50% market share (and increasing) of the organized market in Air Coolers while its nearest competitor is at ~15%. Category focus results in a virtuous cycle of higher Gross Margin which can be re invested in Innovation and brand building resulting in higher consumer pull and higher market share, which in turn leads to high Gross Margin.
- We estimate Symphony earns ~80% of the category profit pool. It earns an Infinite core ROE in its India business as its Capital Employed is negative (outsourced manufacturing and negative working capital).
- Two back to back moderate summers have resulted in poor Sales this year for all AC and Air Cooler players. Symphony's stock price dropped over 60% from its peak offering a great opportunity to add to our positions when we got valuations which were <40X FY18 earnings

We initiated positions in Life Insurance through ICICI Pru Life and SBI Life

- At USD 2000/capita, India has reached the inflexion point where Life Insurance protection picks up pace as the consumer has Income that they need to protect. The current protection gap in Life Insurance (value that should be insured vs what is at present) is >90%.
- Additionally, Insurance in India is also a way to participate in the secular trend of increasing Financial Savings as ULIPs serve the Indian consumer need to get something back for the premiums they pay.
- Both the above companies are Clear Leaders in their field with a decade and more of strong growth prospects in an industry where the regulatory road map is quite clear. Both are owned by their parent banks which provide strong sales partnership through their Banking channels. ICICI Pru Life, in our opinion, is following a more conservative strategy by minimizing sale of products that are not in the customer's interests while SBI Life has potential for faster growth as over 50% of its branches remains unpenetrated.
- We believe both the companies can grow their premium incomes at ~15-18%+ for over a decade benefitting from multiple tail winds (nominal GDP growth, rise in Financial Savings, increase in Life Insurance market share of Financial Savings, increase in share of private players from LIC). The profitability should grow at a higher rate as the product mix becomes more favourable (protection is higher margin vs ULIP) and Operating efficiencies kick in with scale (higher agent productivity, lower per unit Advertising/Marketing costs)
- Secular profitability and Valuations in Life Insurance are tough to gauge. Indian Accounting standards require Insurance companies to write off cost of customer acquisition in the first year itself despite Life Insurance being a multi-year business. Hence, the faster you grow, the lower will be reported profits. Moreover, reported profits need to be adjusted every year based on recalibration of key assumptions on persistency (how many years a customer held the policy) and costs. Hence, reported profits is not the right metric to value Insurance companies – rather valuation terminology is an alphabet soup of concepts such as Embedded Value and Value of New Business. What makes Valuing Insurance companies additionally

tricky is that the industry is in a fast growth phase and the product mix is evolving, which means that short term forecasts could be widely off the mark.

- ICICI Pru Life is available at approx. the same price it listed over 2 years ago while its EV has grown 16% over FY16-18. At ~2.1x Market Cap/EV valuations are reasonable. Suffice to say, that on a 5 year period, even if valuations were to correct 10% from current levels, the high growth rates being witnessed suggests a satisfactory outcome with no hesitation to add on declines. The key risk to our thesis in Life Insurance is mis-selling (which results in lower persistency) and an unexpected increase in corporate tax rates. These risks cannot be modelled and need to be managed by position sizing.

We added to our positions in JSW Energy

- We believe the Thermal Power Generation sector's economics are about to turn decisively because of favourable demand/supply dynamic. Demand for power is increasing at over 7-8% per year. Lack of PPAs and assured coal supply has resulted in very low thermal capacity being added over last few years. However, scarred by NPAs in the Thermal power sector, declining tariffs with fear of irrational bidding has led to reluctance in Bankers to fund renewable energy projects. In 3 years, PLFs of the thermal plants should exceed >80% levels to address peak demand from approx. 65% today which should result in significant increase in reported profits and cash flows.
- JSW Energy has very low leverage on its Balance Sheet, has strong visibility on Cash flows (~2000 Cr Free cash flow per year post interest payments) as it has 80% of its capacity tied up in PPAs. This will increase this over time through tie ups with group companies taking FCF at full capacity to ~2500 Cr/year. Yet, sector pessimism has resulted in it trading at ~6X Free Cash Flow/Equity and 1X Book Value. Partners should note that assuming 13% Cost of Equity, a fair "no growth" multiple is 7.5X Free Cash Flow.
- We believe other than sector pessimism, the other risk reflecting in the low multiple is fear of capital mis-allocation due to its intended foray into Electric Vehicles and intent to invest 6000 Cr behind the venture over the next few years. We concede this is a significant risk as the group has no Right to Win in this space
- However, one must pause and reflect on the group's historical discipline in capital deployment rather than take the announcement at face value. The group has always been very prudent in Capital outlays – it was very conservative in building new power plants when competitors raced ahead; its first bid for most large Steel Assets have been significantly lower than competition and its recent bid for Monnet Ispat Energy was rejected as too low by Creditors. Moreover, the group has rolled back previously announced plans when they were not seen to be viable e.g. JSW had formed a JV with Toshiba for manufacturing of Power Generation Equipment and had invested 100 Cr in the same. However, this was put on the backburner and investments written off when the market situation changed.
- Given the large core opportunity ahead of it in bidding for stressed Power Assets and a self-imposed discipline on Balance sheet quality, it is hard to understand why the company will invest 6000 Cr behind an opportunity where it has no Right to win, other than to be a partner for an overseas company where it brings in its India expertise and the foreign partner brings in technology. In which this case, this should be seen as an Option in an area which is definitely the future and where the playing field is wide open in areas like Storage. It may interest partners to know that total capex on this venture till 30 September 2018 was less than Rs 10 crores
- No opportunity is without risks and we should be willing to embrace uncertainty if entry valuations compensate for the same. We could of course be wrong, but in this case we believe the upside/downside is firmly in our favour.

We exited our position in Bharti Airtel

- Our original Investment thesis on Bharti was based on the premise that “data consumption” was a secular growth theme and the resulting favourable industry structure and stressed balance sheets across the sector, including Reliance, would result in the ARPU increasing, helping all players earn a healthy Return on Capital. Further, we expected Bharti’s Operating Cash Flows to support capex and interest payment obligations such that net debt would not meaningfully increase
- However, we discovered two errors in our thesis. The intensity of price war led to further deterioration in Bharti’s balance sheet as its Operating Cash Flow was not sufficient to service Interest and Cap ex needs. This increased the risk of further increase in Debt which would result in a declining share of Equity in the overall Enterprise Value and potential equity dilution
- Further, we realized that Jio’s ambitions were no longer restricted to a dominant share of the telco market, but it wanted to be a “platform player” that provides consumers not just communication but also content and commerce. “Communication” could be a low margin business to build a large consumer base, which are then upsold commerce. This would imply that the low pricing environment could persist for much longer.
- While short term prospects for Bharti were cloudy, the market correction provided other opportunities which offered a better risk/return perspective in both short and long term. In hindsight, we were too early and should have waited for more pricing certainty rather than try and weather a tsunami.

Concluding remarks

India’s path to prosperity is frustratingly slow, but the process of checks and balances makes it surer. Hence, despite all our contradictions and imperfections, we believe in India’s future.

We see multiple opportunities to deploy capital at present. There are significant dispersions in valuations at present with pristine quality trading at euphoric levels. Hence, one needs to be flexible on approach and not be wedded to pristine quality as the highest quality companies could be carrying the highest stock price performance risk at present.

The world will throw many surprises at us in 2019. These will manifest through stock price volatility. But we don’t need to fear volatility if we understand it to be an integral part of the wealth creation process.

There are however a few things you can be certain about. We will continue to manage your savings with prudence, integrity and transparency.

We wish you a great year ahead.

With my best wishes,

Manish Gupta
Chief Investment Officer