6 October 2023

Dear Partners,

The purpose of our letters is to provide transparency in how we are thinking.

Summary messages.

- Performance remains healthy over rolling 5-year periods. TWRR last 5 years in Prudence is 23% vs 15.1% for BSE500TRI. Our goal is to generate 15%+ IRRs every rolling 5 years post our fees. Under the assumption that the Index returns ~11-12% IRR long term, that would imply beating the BSE 500 by 3% per annum (BSE 500 TRI by ~1.5% per annum) every rolling 5 years.
- This is a tricky period to deploy capital at sensible valuations. Need for nuance on where to pay a small valuation premium for promise of asymmetric outcomes/longevity, coupled with patience to wait for better entry points.
- Despite high entry valuations in aggregate at present, we feel good about our process delivering 15%+ IRRs over next 5 years under assumption of 11% nominal GDP growth. There are no guarantees we will be successful. However, we have 100% skin in the game and alignment in underlying positions.

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Important Disclosures – please refer to disclaimer on last page.

- We disclose position names for transparency and not as recommendations to buy/sell.
- We reserve the right to change our minds and may not be able to inform you if we do.
- We construct customised portfolios based on valuations at point of entry and cash available for deployment. Hence, all positions may not be held in your account.
- Performance in individual accounts may vary from aggregate performance.
- Past performance does not guarantee future results.

Performance update[1]

Aggregate across all partner accounts					
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception^**
SOLIDARITY- PRUDENCE	10.7%	1.2%	20.9%	23.0%	**18.3%**
BSE500TRI	17.5%	8.5%	24.3%	15.1%	**15.4%**
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception#**
SOLIDARITY- EMERGING LEADERS	NA	NA	NA	NA	**14.4%**
BSE500TRI	NA	NA	NA	NA	**16.2%**
Data as of 30 Sep 2023					
^ From 11 MAY 2016 -Start date of scheme					
# From 26 APR 2023 -Start date of scheme					
Solidarity performance is net of all fees & expenses					
Performance data provided in the above table is not verified by SEBI					

Our flag ship scheme is "Prudence." Performance is healthy over our preferred time horizons of rolling 5 years with TWRR of 23.0% vs 15.1% for BSE500TRI. However, our cautious stance in a raging bull market in Micro, Small and Mid-Caps reflects in the muted near -term performance vs the benchmark. Read our perspective on this topic here, where we explain how the significant increase in valuations in many pockets are not justified on first principles, but can be explained by inflows in Small and Mid-Cap funds. Whether we have been prudent with risk taking or "this time is different" will only be known in time.

We launched "Emerging Leaders" a few months ago for existing partners where the intention is to concentrate the portfolio in companies with a Market Cap less than 10000 Cr. We are not accepting inflows in this scheme at present. It is too early to gauge performance here.

This is a tricky period to deploy large amount of Equity capital at sensible valuations in India.
On the one hand, Cost of Capital is rising across the world and is likely to stay higher for longer. Politicians in the developed world have promised their citizens pensions and other social benefits which their Govts. cannot afford just when higher spending for defence and green energy transition is needed. The bond markets will demand higher interest rates to fund these deficits. Very high bond yields should result in some accidents. As the world settles down to higher for longer on interest rates, steady state fair valuation for a given Earnings profile will be structurally lower than the last decade and hence valuation multiples will drift lower. This correction has already started in developed markets. The rise in the US market this year is very narrow, and supported only by a handful of stocks the market thinks will benefit from Artificial Intelligence. India is no exception as the starting point for global Cost of Capital is the 10 Yr. US G Sec rates, and hence fair valuation multiples for many Indian companies need to drift lower as well. We find it challenging to find "a large" number of good opportunities bottom up that provide growth with margin of safety in valuations that can generate high probability 15%+ IRRs over this decade. The highest ROE companies in India (FMCG, FMEG, Consumer Durables, IT Services) trade significantly above our buying price thresholds. As an example, the table below shows valuation multiples for many Indian IT cos at present vs 3 year and 5-year averages. On first principles, these valuations need to settle lower.

[1] We earlier reported performance vs NSE500. SEBI asked managers to choose 1 of 3 indexes and NSE 500 was not one of the options. We have chosen BSE500TRI which is BSE500/NSE 500 plus reinvested dividends.

Exhibit 57: Current valuation vs historical average (pre-Covid)

	Current P/E	Vs. Pre-covid valuations			
		3Y avg. (Pre-covid)	Premium/Discount	5Y avg. (Pre-covid)	Premium/Discount
TCS	26.2	21.1	24%	20.0	31%
Infosys	22.0	16.9	30%	16.8	31%
HCLT	18.9	13.5	40%	13.4	41%
Wipro	17.6	15.2	16%	14.7	20%
TechM	20.2	13.8	46%	13.8	47%
LTIM	28.0	17.3	62%	NA	NA
Mphasis	24.5	15.9	54%	14.5	69%
Coforge	28.4	15.9	79%	13.5	110%
Persistent	30.2	13.7	120%	14.4	109%
LTTS	32.6	19.9	64%	NA	NA
KPIT	53.9	13.0	316%	NA	NA
Tata Elxsi	52.1	19.9	162%	24.1	117%

Source: Bloomberg, Axis Capital

On the other hand, India is in a sweet spot both in absolute and relative terms vs many other large economies while being underrepresented in global allocations relative to its GDP. India's inclusion in the JP Morgan Bond Index (25 to 30 USD Billion expected inflows) is another example of the Western World recognizing India's importance and under representation in global allocations. There is also rising confidence amongst Indians and greater savings allocations towards Equity markets, with almost USD 35B expected annual inflows. These capital flows could continue to support higher prices and therefore multiples may correct slowly rather than swiftly, especially for Blue chip names. Markets don't correct significantly when there is wide consensus on the need for caution. Hence, in the quest for very attractive entry points, one could stay on the sidelines and miss out decent 15% IRR opportunities.

Our stance – need for nuance coupled with patience.

Generalizations are bad. However, broadly speaking, we are at a dangerous point in the Behavioural Cycle for Small and Micro Caps, read our perspectives here.

We see value in select pockets, example Large Cap Financials, and some "+1" themes. Hence, while we remain cautious on valuations in general, our stance has been to be willing to pay a small premium in some names where we see longevity of growth or high probability of Asymmetric returns. For companies at inflection points, trailing valuation multiples are poor reference points.

Partners may observe us willing to hold cash, while also taking more concentration risk in certain names. Cash has option value, the value of which can be harnessed during corrections.

Detailed investment thesis – IndiaMART InterMESH

We published a note this quarter on the importance of seeking Asymmetric outcomes, read here, which discusses how if even 20% opportunities in a portfolio deliver super-sized returns, one can generate significant Alpha even if other names generate an ordinary performance. One such company in our portfolio that we have owned since 2020 is IndiaMART InterMESH.

IndiaMART has runway to grow Free Cash Flow (FCF)[2] at 15-20% CAGR for long periods of time as it has multiple levers to support longevity of growth and expand margins.

- Its "core" i.e., the listing business has potential to grow revenue at 15%+ CAGR for long periods from both increase in paid supplier base and ARPU[3] over time.

[2] When we calculate FCF, we include float income on Deferred Revenue as we believe this income should be considered as core business income.

[3] Average Revenue per User

- The management is showing vision and prudence in capital allocation. They are targeting adjacencies in “white spaces” (example Accounting) which are large and growing, which have synergies with the core business, and where they could potentially emerge as #1 or #2 player.

We see scope for margin expansion in the medium and long term.

- Current EBITDA margin of 28% are not representative of true margins as the management is investing aggressively for supplier growth. Over time, EBITDA margins will trend higher from upsell, cross sell, price hikes and operating leverage.
- We believe the core business could be a 40%+ EBITDA margin business in the long term. Naukri’s job portal - which is also a winner takes all business- has seen EBITDA margins expand by ~11% over the last decade to ~60% at present.

Over 95% of businesses have FCF significantly lower than PAT as they need to re-invest for growth into Fixed Assets and Working Capital. IndiaMART is a rare exception where FCF > PAT as they are negative Working Capital and Fixed Asset light. Surplus capital is returned to shareholders via dividends and buy backs. This enables IndiaMART to enjoy an infinite ROIC, which is very rare.

IndiaMART has opportunity to generate asymmetric returns over this decade. Its prospects for growth, longevity, and dominance in a winner takes all domain justifies a ~31x TTM core FCF[4] multiple.

A more detailed investment thesis can be read here.

Perspectives on news flow on portfolio companies.

There were two noteworthy news developments this quarter in portfolio companies.

Restaurant Brands Asia (RBA)

Everstone, promoter of RBA sold 25% of its 40% stake in the company in a block deal at 119/share to a clutch of investors. RBA was on the block as Everstone had reached the end of its fund life. Private Equity ownership looking to exit acts as an overhang on the stock.

As we want to buy large quantities, we act when prices are favourable and don’t wait for such events to pass before acting because we will not be able to buy the quantity we want at the prices we want. The sale partially removes a price overhang on the stock.

RBA is a company we are very optimistic about and we see exponential profit growth ahead at very attractive prices at present. The market is divided in its view on whether the India business will be able to deliver on 12-14% company level EBITDA margins by the time they scale to 700-750 stores and extremely pessimistic about the Indonesia business. This pessimism is reflected in the price and creates the chance for Asymmetric upside if the company executes well. We have published detailed notes on this company in the past which can be read here and here.

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[4] At current market price, Market Cap is ~17400crs. We estimate core Market Cap excluding surplus cash and investments in adjacencies to be ~15,700crs and FCF (including float income on Deferred Revenues) Q2FY24e TTM to be ~500crs.

Concerns on Star Health in public domain (wrongful claim rejection, disputes with hospitals)
Star Health has been in the news[5] with concerns on genuine claim rejections and disputes with hospitals. The many nuances associated with claims make it difficult for an outsider to make an objective assessment.

While claim rejection ratios for the industry seems optically high at 18-30%[6], the number is misleading as it includes instances of claims getting rejected because customers were not eligible for pre-existing diseases during exclusion period or instances of medical history not fully disclosed by customers during medical under writing. Sometimes claims are made which are excess of sum assured.

A few sell side firms have published claim rejections data comparisons across peers basis which reveal that Star Health has broadly similar ratios. This is a useful input. However, we believe this data has a lot of noise as there is no standardized way of reporting claim rejections at present. This data also has limitations as claim ratios differ across products and hence is not a true like to like comparison as product mix varies across players. For example, "Group Health" and "Health Benefit" products (which are low share in Star Health mix) have higher settlement ratios vs "Health Indemnity". Health Benefits are for specific diseases (example Cardiac) where there is lower ambiguity around what is and what isn't covered.

More importantly, we find no incentive for a Health Insurer to cheat by denying genuine claims. The regulator allows price increases basis claims experiences and can evaluate if a company is rejecting genuine claims. On the other hand, if an Insurer allows non genuine claims, it will need to raise premiums across the board to maintain profitability[7], thus hurting the honest customer. Star's economics (at <20% ROE at present) do not suggest profiteering. Star enjoys both strong customer stickiness (~95% premium renewal ratio FY23) and strong new agent additions (~20% new agent addition CAGR since FY20). Neither would happen if customers interests were being compromised as agents will have relationships with customers in product categories beyond Health Insurance.

Based on our discussions with a few hospitals and Star Health, we believe the dispute with hospitals reflects the pains of a growing industry and mistrust due to actions of some bad players.

- Hospitals are unregulated and some do over-invoice and engage in needless procedures. This causes mistrust and a vicious cycle where Insurers try to negotiate down genuine bills.
- Often adjudication of cases require judgment[8] and submission of extensive paperwork, annoying but necessary.

We see this as a natural contest for sharing profit pools between two service providers in an industry where processes are still being built. We expect these differences to periodically surface, but to be resolved amicably over time[9].

We think Health insurance is a "win-win" business for the Insurer and the customer. Star Health with ~34% retail market share can generate ~18-20%+ IFRS ROEs[10]. The complexity of claims settlement processes with over ~15,000 network hospitals is a moat and Star Health as dominant leader enjoys

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[5] Read here and here
[6] Source: CLSA report
[7] Individual customer level repricing isn't permitted at present, it can be done at age/geography cohort level.
[8] If a patient is admitted in the hospital for an illness that should be treated as OPD, under what conditions should bills be paid by an Insurer?
[9] https://www.cnbctv18.com/healthcare/star-health-discussions-with-ahmedabad-hospitals-reached-amicable-solution-17805361.htm
[10] Under IFRS, PAT/ROE will increase as selling costs will be matched with revenues, whereas under current accounting standards the selling costs is fully expensed in year 1 itself.

strong negotiating power with hospitals. We find Star quite attractively priced at current prices. You can read our detailed note on Star Health here.

Answers to questions received from partners.

What is your outlook for future returns if you are cautious about valuations at present?
The future is unknowable and depends on multi variables, many of which are "unknown unknowns." Hence, it is foolish to forecast estimated returns. None the less, we attempt to provide a framework to think about potential returns.

Over the last decade, the NIFTY has generated ~13% IRR. However, that has been aided by significant valuation multiple expansion. Market Cap to GDP[11] was ~65% about a decade ago. Its ~110% at present (last 15 average is ~82%). The last 3-year BSE500TRI has been ~24%. Clearly, some give back of returns is required as Earnings are not growing at this pace. "In the long term, stock prices are slaves to Earnings growth."

Under the assumption that India nominal GDP growth will be ~11%, and 10 Yr. G Secs will be ~7-7.5%, this decade will perhaps generate lower Index returns than the last decade as valuation multiples will most likely mean revert lower. So at the risk of appearing foolish, we see this as ~10-11% Index return decade from these starting valuations. One of course cannot rule out a significant step up in economic growth or lower long-term interest rates, in which case, the Index returns would be higher both from growth and even higher multiples. However, that is not our base case scenario at present. While India may take all the right steps internally, a weak global economy has head winds for exports and IT Services. As we explained in an earlier blog, rising per capita incomes and the 'J" curve effect may not result in faster profit growth for companies as larger market sizes will attract more competition.

We believe one needs to be willing to do something different and accept some discomfort for increasing the odds of beating the market long term.

Our approach is:
- Exclusive focus on long term outcomes and do not get dismayed by short term results.
- Don't hug the Index sectoral weights.
- Concentrate the portfolio in best ideas. Every idea must count. Minimum 3% position size.
- Staggered drawdowns to create "win win" outcomes with partners.

The discomfort we are willing to take is:
- Be comfortable holding cash in a rising market. Don't feel obligated to be fully deployed.
- Embracing some illiquidity. ~20% of the portfolio is in names with Market Cap <2500 Cr. These names are untracked and unowned with almost no institutional ownership.
- Regulate our pace of growth by gating capital inflow to avoid putting pressure on ourselves to deploy capital at any price.
- Be willing to accepting 20-30% drawdowns in illiquid names if we see a decadal compounding story. Use uninvested cash to increase position size on drawdowns.

We feel good about our process generating 15%+ post fee IRRs over this decade (under assumptions of 11% nominal GDP growth for India and no left tail events like Covid). The returns could be better if a higher percentage of opportunities convert into Asymmetric outcomes. While there are no

[11] While Market Cap/GDP is not a precise metric - Market Cap of unlisted cos that get listed is not captured in starting valuations- it is a broad proxy.

guarantees that we will be successful in this endeavour, we have 100% skin in the game and complete alignment in underlying positions.

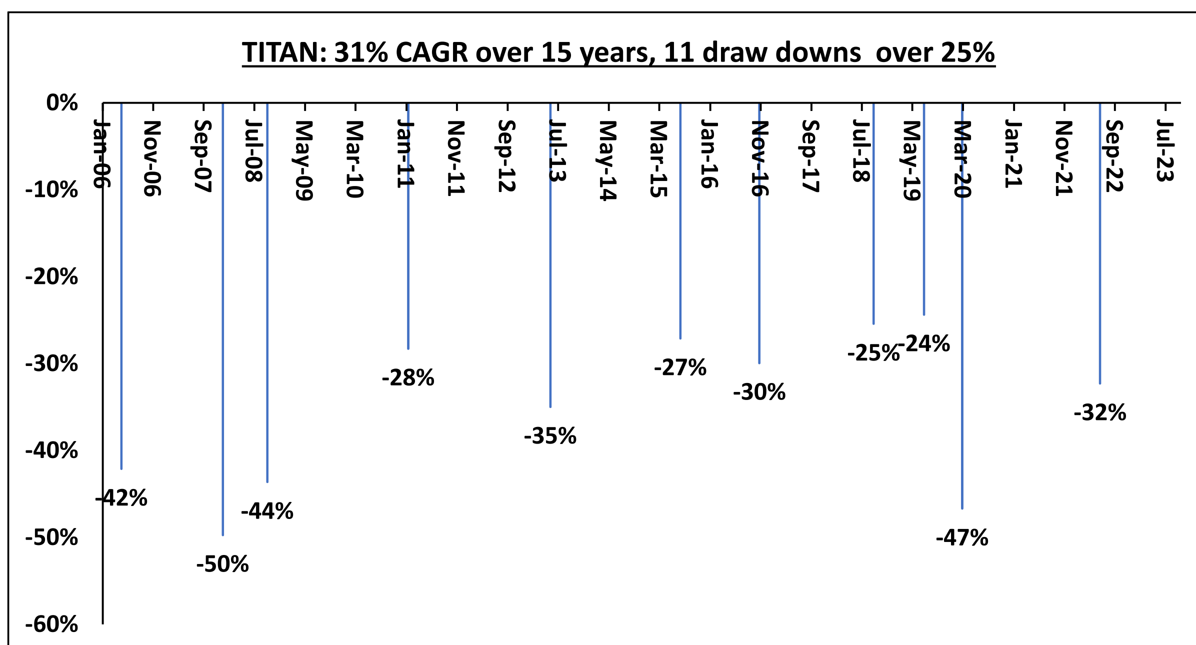
Why not sell if we are concerned that Small and Microcaps are overvalued?
In an earlier blog, read here, we discussed the importance of seeking Asymmetric outcomes, or fat right tails, as even 1 or 2 positions with such outcomes could deliver significant Alpha to portfolio returns.

Scenario A			
Position	Initial Capital	IRR	Closing Capital
1	100	11%	284
2	100	11%	284
3	100	11%	284
4	100	11%	284
5	100	11%	284
6	100	11%	284
7	100	11%	284
8	100	11%	284
9	100	30%	1379
10	100	30%	1379
	1000		5029
Compounding Time period (yrs)			10
XIRR			17.5%
Market			11.0%
Alpha			6.5%

Scenario B			
Position	Initial Capital	IRR	Closing Capital
1	100	-2%	82
2	100	-2%	82
3	100	11%	284
4	100	11%	284
5	100	11%	284
6	100	15%	405
7	100	15%	405
8	100	15%	405
9	100	30%	1379
10	100	30%	1379
	1000		4986
Compounding Time period (yrs)			10
XIRR			17.4%
Market			11.0%
Alpha			6.4%

Many of Solidarity errors are when we have exited pre-maturely and not given sufficient time for Asymmetric compounding to play out. What seemed over valued in the moment on trailing earnings was not overpriced with the benefit of hindsight as we underestimated the pace and/or longevity of growth of companies that were executing well. It is the fear of drawdowns and managing short term performance that makes one exit early. Even more so in smaller companies which are illiquid, and hence more vulnerable to steep corrections. However, drawdowns are the pain that one needs to bear. It’s the price of superior long-term outcomes.

TITAN has delivered 31% CAGR over the last 15 years, with 11 drawdowns over 25%. While this is a cherry-picked example, the point in the table above is that even if one gets 2 of 10 calls very right, one can create significant Alpha even with some errors. Hence, one needs to let performers run.



Hence, our framework for selling is to exit only if there is "significant euphoria" or if companies are not evolving per the original investment thesis. This approach has evolved over time, and we wish we had discovered this wisdom earlier.

While a few Small Cap names we own at present are above our estimate of fair value, they are not in the euphoric valuation stage at present. Many of these companies have low liquidity and it often take us months to build our positions without moving the price. It would be impossible to build these positions again if we exit to optimise shorter term returns.

Hence, we choose to stay invested. Perhaps we may not make high returns in these positions short term, but we see a longer-term compounding story ahead and perhaps one or two could become the TITANs of tomorrow.

Given the worsening macro situation in China and high interest rates in the US, at what point does such a development become a serious concern for the Indian economy and stock markets?
One can never completely ignore the macro. For example, interest rates affect growth and Cost of Capital. Hence, some calibration of stance always takes place on appropriate entry valuations. However, the challenge is that change in macro variables may not correlate with stock price performance as new ones could emerge which have more influence.

We came across an excellent blog written by Ian Cassel recently. The blog argues that you could know many macro variables for certainty and positioned your portfolios ahead of them, yet you would still have been wrong on outcomes.

The blog can be read here. https://microcapclub.com/2023/09/even-if-you-knew-the-future/. An excerpt from the blog is enclosed.

"What if you knew in early 2022 that the 30-year fixed mortgage rate was going to rise from 2.8% to 7.3%? …What if you knew in early 2022 that Russia was going to invade Ukraine and disrupt energy and fertilizer markets.

How would you position yourself? (Perhaps) Short builders, short tech, short consumer discretionary, long energy, long fertilizer. What would have happened? The largest residential home builder in the United States, D.R. Horton, is up 5% in 18 months. Nasdaq down 12%. Consumer discretionary down 15%. Oil is down 18%. Fertilizer prices are down 25%.

You got two out of the five right. Even if you knew the future, you would still be mostly wrong."

Stock prices are affected by multiple variables in the short term. Even if you could forecast some variables with perfect insight, new ones can impact the outcomes. The NASDAQ has powered higher in 2023 on the back of a few companies who are seen as big beneficiaries of developments in Artificial Intelligence which has emerged as a new theme.

Borrowing once again from the blog, *"the way you handle the macro is to handle the micro. Find companies that can grow, earn more money, and not dilute you. Buy them at good prices and wait. The returns will come to you. Don't get distracted by macro conversation or trying to pivot your portfolio based on where you think things are going. Even if you knew the future, it wouldn't help you."*

The rewards of playing the long game are significant. But to reap those gains, we need to ignore short term noise and over-come the fear of 15-20% drawdowns that can happen any time.

What will happen to the Indian markets if the BJP loses the 2024 election? How does Solidarity's process incorporate such an outcome?
This is again a question where one is trying to position the portfolio on a macro variable.

First order thinking suggests that there should be a market sell-off and PSUs and infrastructure sectors should be worst hit. However, as we discussed in the prior question, even when one can predict an event, the outcome could be very different over time. Partners may remember that the markets struggled when the NDA lost in 2004 and opened gap up when UPA won re-election in 2009. However, returns over the next 5 years were healthy and broadly in the same ball-park range.

Index performance post results announcement				
Time	**2004**	**2009**	**2014**	**2019**
1 week	-8%	15%	3%	2%
1 year	16%	38%	16%	-23%
5 year CAGR	16%	14%	10%	

We won't dig ourselves in this rabbit hole. We focus on businesses which we believe will do well over long periods, weathering different macroeconomic events and cycles. Our portfolio has no business which we would sell premised on an election outcome. And we will continue with our bottom-up approach and act when prices are in favour, without waiting for clarity on election results.

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We look forward to speaking with you on our quarterly call at 12 pm on the 14th of October 2023.

With our best wishes,

Manish Gupta	Manjeet Buaria	Anirudh Shetty
Partner and CIO	Partner	Senior Principal

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