8 January 2024

Dear Partners,

The purpose of our letters is to provide transparency in how we are thinking so you understand rationale underlying our actions.

We want to play "long term games" with "long term" oriented people who seek above average long-term returns with prudent risk taking.

The following are our core investment principles with which partners must be aligned.

- 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, this aims at beating the BSE 500 by 3% per annum (BSE 500 TRI by ~1.5% per annum) every rolling 5 years.
- We primarily invest in businesses benefitting from secular growth, leaders of their industry/dominate niches, with a sustainable moat/edge, where there is high probability of earnings compounding.
- Businesses we invest in must have minimum 18% ROE at scale, with modest leverage[1].
- We prioritize resilience over speed. We will not chase what is "hot" but lacks a sustainable edge. We will not invest behind promoters who we cannot trust, irrespective of how attractive valuations are.
- Entry valuations are important. However, longer the time horizons, higher the contribution of earnings compounding in overall returns and lower the impact of valuation errors.
- The bar for churn must be high to not interrupt compounding unnecessarily.

Contents.

Summary messages.

- Performance remains healthy over rolling 5-year periods. TWRR last 5 years in Prudence is 20.5% vs 17.6% for BSE500TRI.
- Our companies have strong earnings compounding ahead. Over the long term, stock prices are slaves to Earnings growth. We don't need to make portfolio changes to chase what is running faster at present.
- It continues to be a tricky period to deploy additional capital at sensible valuations without taking significant concentration risk.

[1] Exception for Banks

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[2]

Aggregate across all partner accounts					
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception^**
SOLIDARITY- PRUDENCE	14.2%	2.4%	14.5%	20.5%	**17.8%**
BSE500TRI	26.6%	15.2%	20.4%	17.6%	**16.7%**
Performance (in TWRR)	**1 Year**	**2 Year**	**3 Year**	**5 Year**	**Since Inception***
SOLIDARITY- EMERGING LEADERS	0.0%	0.0%	0.0%	0.0%	**8.2%**
BSE500TRI	0.0%	0.0%	0.0%	0.0%	**30.6%**
Data as of 31 Dec 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					

What is happening in the markets?

Small and Micro Caps have made exponential moves. This has been catalysed by 3 events.

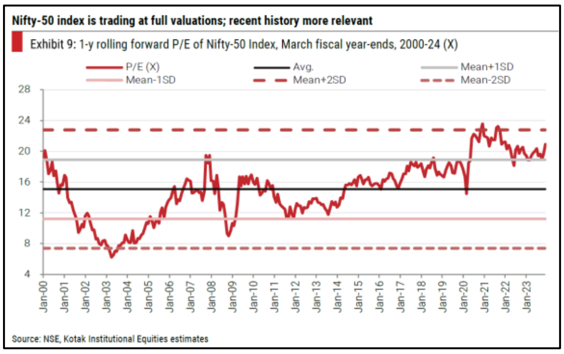
- Strong SIP flows by domestic investors, a vast majority of which is going into Small and Mid-Cap Funds (40% of incremental flows in 2023, vs 13% in 2021).
- BJPs performance in State elections which reduces political risk and encourages fresh FII flows.
- US Fed signalling that Fed rate rises may have peaked and may begin to decline next year which encourages a "risk on" environment.

Euphoria is clearly visible.

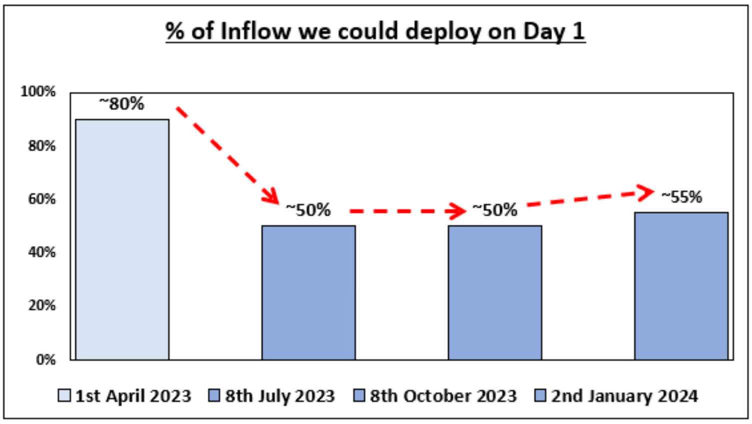
- The IPO market is hot.
- Many companies and sectors earning less than 12% ROE are doing very well. If you earn less than 12% ROE, PE should not exceed 8 under any growth outlook. The faster you grow, the more value you destroy. ~175 cos (Market Cap >500 Cr today) have more than doubled in CY23 with 10 yr. avg. ROE <12%.

[2] 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.

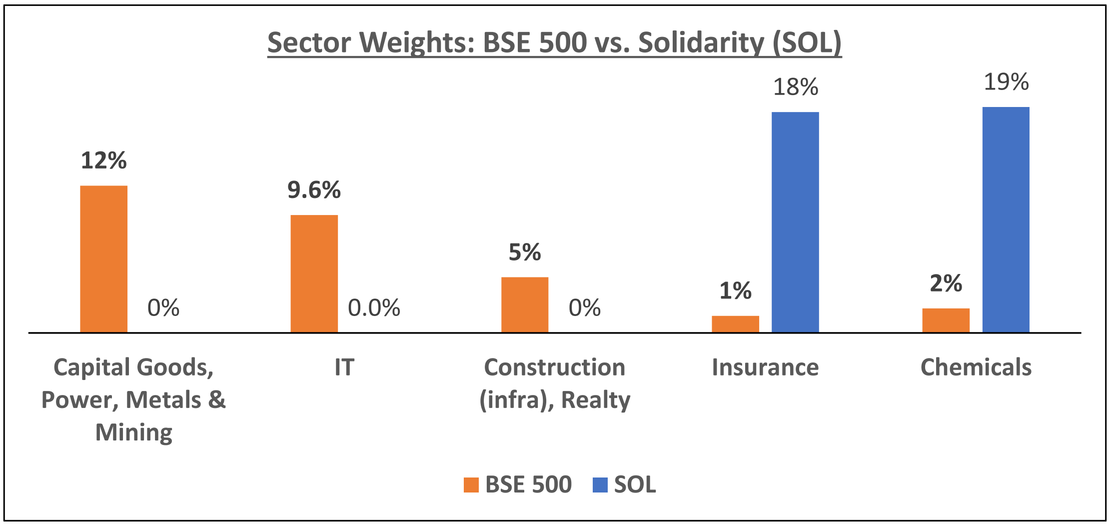
We continue to see narrow width of opportunity.
Valuation multiples in aggregate are rich. It is hard to make a case for deep value in any sector. One can expect corrections any time.



We can deploy ~55% on Day 1 in 13 companies in "PRUDENCE" and ~50% in "EMERGING LEADERS" in 5 companies at business model risks and at entry valuations we are comfortable with. Hence, we are only initiating new accounts who agree to a staggered draw down. Top ups of ~20% of NAV is welcome any time but may not get immediately invested.



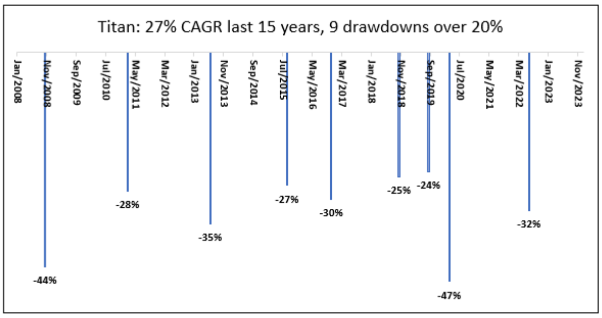
Why hasn't our portfolio ridden the crest of a short-term wave?
Performance could be vastly different in short term if our choices of Industries/themes are not in favour with markets as is happening at present. This is not unusual. Price movement is seldom linear but happens in spurts.

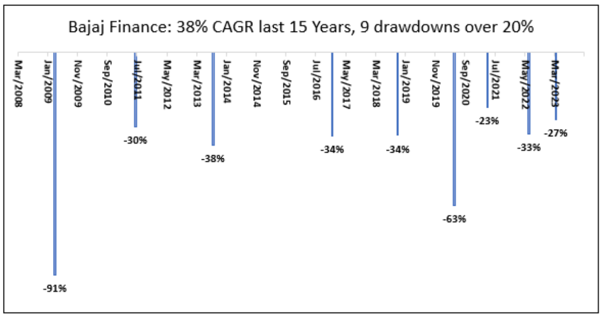


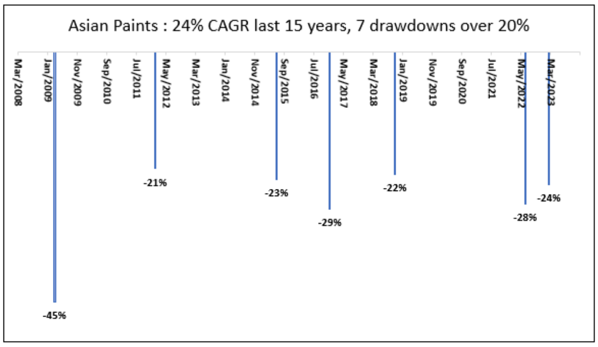
Our choice of companies is primarily basis "what will work this decade", not "what will work now".
We believe India can grow at ~11% nominal GDP for long periods of time. Secular growth tail winds for select industries/themes[3] should provide a credible opportunity of 15-20%+ PAT growth for a decade and more for sector leaders[4]. Over the long term, stock prices are slaves to Earnings growth. Why not remain invested in secular trends rather than keep changing lanes to chase something running faster in the short term? If we see a credible road map for 15%+ decadal IRRs in large caps and 20%+ in small and mid-caps, we prefer to remain invested.

We remain buyers in many of our positions today which have not done well on price in the last 2 years because we believe there is a long-term earnings compounding (15-30%+) ahead. Frequent stagnation/declines are part of the journey.

[3] China +1, Climate change, formalization of economy, digital, premiumization, need for Health Insurance, explosion in retail lending etc.
[4] We will also invest in lower growth cos at reasonable valuations if growth and FCF yield add to 15%







Company	Date of first purchase by Solidarity	Stock price/share			% price change in last 2 yrs.	Estimated EPS compounding next 5 yrs. (approx.)
		First purchase	31 Dec 21	31 Dec 23		
India MART	Jan 2020	1166	3238	2712	- 17%	20%+
Garware Technical Fibres	Sep 2019	1200	3181	3332	+ 5%	13-18%
Neogen Chemicals	Jun 2019	310	1644	1471	-11%	30-35%+
HDFC Bank	Jun 2016	585	1480	1692	+14%	15-17%
Star Health	Mar 2022	631	NA	546	-14%	18-20%+
Shaily Engineering	Jan 2018	200	387	333	-14%	25%+
HDFC Life	Mar 2020	441	650	648	0%	18-20%

IndiaMART InterMESH

IndiaMART is the leading B2B listing platform in India by a long distance. Platforms benefit from network effects and hence result in the winner capturing the entire industry profit pool. IndiaMART generates significant Free Cash Flow (~ 500 Cr TTM) due to high margins, being fixed asset light and negative working capital.

As it is early in growth life cycle, IndiaMART can benefit from longevity of growth and could compound Free Cash Flow at 15-20% CAGR for extended periods. There are various levers: growth in paying customers, ARPU increase, margin expansion. Promoters are building adjacencies in other areas their SME customers will need like Accounting which are great annuity businesses. They are also disciplined on capital allocation paying out surplus cash via dividends and buy backs.

Our variant perception is on both growth and fair valuations.

- The market is worried about slow pace of addition of paying customers. Management believes there is room for growth and is investing heavily on “feet on street”. We believe there is room for subscriber.
- There should be pricing power with its top 10% customers who are earning disproportionate ROI on listing fees paid, the best evidence of which is high renewal rates. Selling expenses should reduce significantly when new customer growth saturates. Hence, low customer addition, would be compensated by EBITDA margin expansion. Infoedge Naukri division is at 60% EBITDA margin today vs 49% a decade ago. Growth longevity + adjacencies + margin kicker could result in 20%+ PAT growth over a decade.
- The trailing PE (68x TTM Q2FY24) is misleading. True economic PAT is understated due to accounting mismatch between revenue (booked over 3 years) & selling expenses (booked immediately) and upfront discounting of long-term packages which reduce true PAT. Rightly, they are over-investing to enhance edge and boost volume growth and hence Selling expenses are elevated.

We value IndiaMART as sum of parts where the core business is valued as a multiple of FCF and there is value ascribed to real options they are building in adjacencies and cash on BS. We find the core business very attractively valued at ~29x TTM FCF. 18-20%+ PAT growth at 3%+ FCF yield with market dominance in a winner take all business and optionality of adjacencies is a very attractive proposition. We are not yet at our peak weights and will add more on price declines.

<u>Garware Technical Fibre</u>

Garware is an innovation driven technical textile company that creates products by studying unmet customer needs that creates win-win outcomes. Garware has a long history of customer satisfaction serving customers across industries such as fishing, aqua culture, sports, geo synthetics, shipping etc. It has over 20000 SKUs and dominant position in many customer segments. The addressable market for Garware is ~ USD 1 Bn but should expand over time as they enter new categories.

The business has very healthy economics: Gross profit margin was ~68% in FY23, business is debt free, ROIC is 30%+, quite rare for a B2B business. Profits remain resilient during tough conditions as ~70% of Revenue is linked to food related categories. Last 5 years Operating profit growth has been soft at ~8% CAGR as Garware faced challenges from covid led shutdowns, container shortages issues & high raw material & freight prices and regulation changes (which impacted demand in some countries).

We overpaid a little for Garware for accounts signed up in the period Jun – Dec 2021. The 10 Yr. G Sec traded in the range of 6.2-6.5% in that period (7.2% at present). Inflation globally was subdued. We felt we were using too high discount rates and we felt higher fair entry prices of ~ 15% were justified in what seemed like the new normal. In hindsight, that was a mistake.

We believe this company could deliver 15%+ PAT CAGR over long periods while throwing out Free Cash Flow. This is a rare Asset and not one we will exit easily. Rather, we have significant room to increase position size in Garware if we get it on price declines.

<u>HDFC Bank</u>

HDFC Bank is no longer a consensus bet. Its historical scarcity premium no longer holds as ICICI Bank is now executing equally well. It has also lost a little of the “X factor” it had. Its historical under-investment in technology has got exposed (now getting fixed). Post-merger with HDFC, the bank has frequently changed its goal posts on guidance. It is now ~15% of system market share hence we cannot expect it to grow significantly faster than the market while maintaining Asset Quality. The market has de-rated the company in the last 2 years.

HDFC Bank is very well competitively positioned and there are no concerns on the dominance of its franchise or to its 15-17%+ earnings growth trajectory over the next few years.

We believe we could earn 15-16% IRRs in well-run large private banks like HDFC/ICICI Bank for long periods of time[5]. This provides a very stable base on top of which we could take more risk in small and mid-caps. In euphoric environments, smaller Banks may provide the temptation of a much higher short-term gains from a multiple re-rating and as credit quality issues will not impact for a few years. However, smaller Banks face a tougher future and will likely continue to see market share declines. Over the long term, the right to win resides with scale players with the lowest cost deposit franchise.

Star Health

Star Health is trading at a very attractive price for a 18-20% ROE franchise, market leader with 33% market share (~3x its nearest competitor), that can grow Earnings at 18-20%+ for a decade. Health Insurance penetration has significant room to expand (~70 Cr PAN Cards issued in India, ~5.3 Cr lives covered by Retail Health Insurance).

The market disagrees with our optimism on Star Health. They listed at too high a price (900/share, 2 years ago) and then have underperformed guidance. The market is not confident that this could be a 18%+ ROE business because Star has not delivered on its guidance of 65% Claim Ratios[6].

The market scepticism is understandable and justified. But often, the pendulum swings to extremes (behavioural cycle at work).

Our variant perception is on a few points.

- We believe that Star Health can grow 18-20% for next few years while maintaining loss ratios in the proximity of 65%. The regulator allows prices increases when claim ratios exceed certain thresholds. So no reason why the industry leader cannot make 18-20% ROEs which is not profiteering.
- The management is making all the right long-term strategic moves: emphasizing quality of growth (pricing increases, black-listing hospitals for fraud, expanding new channels, reducing exposure to fraud prone geographies, aligning agent commissions with claim ratios). Actions to improve claim ratios, mute short-term growth, which also adversely impact claim ratios. Operating actions taken by the company should reflect in better financial performance over the next few years.
- The new “Expenses of Management” guidelines (which requires Insurance companies to cap expenses) further enhance edge of scale players like Star Health (3x scale vs nearest peer). They are the only Stand-Alone Health Insurer (SAHI) who is meeting these guidelines today.
- We don’t put too much weight on missing guidance. It is ridiculous for companies to give certainty in an uncertain world. Newly listed management teams learn how to communicate with analysts over time and should be cut some slack.

Once financial numbers start improving consistently, narratives change. The market believed ICICI Bank could do nothing right in 2017. It now believes it can do nothing wrong.

[5] An economy that is growing 11-12%, should have credit growth of 13-15% and with some market share gains, well run Banks can grow loan books at 16-18% for a decade without taking the wrong kind of risks. They have the best low-cost deposit franchise which allows them to be conservative in credit decisions. Add dividends and assume some valuation de-rating due to ROE compression, and 15-16% IRRs is a credible expectation to have.

[6] Claims paid out/Premium collected.

HDFC Life
Life Insurance in India is significantly under-penetrated in both Protection and Retirement products and offers decadal growth opportunities. HDFC Life (as well as SBI Life) are well positioned. The HDFC brand resonates trust. And the importance of Banking channels for Insurance sales means HDFC Life, majority owned by HDFC Bank, has a significant distribution edge.

HDFC life has demonstrated strong execution by growing APE[7] at 19% CAGR over FY18-23. As per capita incomes increase, this sector is a natural beneficiary. With HDFC bank as its parent, we expect more distribution support and the business to grow premiums at 15-18%+ CAGR over many years which should translate into 18-20% VNB[8] growth. While true Return on Equity ("ROE") is tough to gauge given accounting challenges, we estimate ROEs to be ~17-20%.[9]

Regulatory actions in Life Insurance in Feb 2021 and Feb 2023 budget (reduction of exemption limits for savings products) have led to valuation derating and sector underperformance in last 3 years. The regulator struck again recently with a consultation paper that proposes capping surrender charges[10] in certain products which will impact margins.

A corporate tax rate increase remains an overhang. Life insurance has low corporate tax rates (~14.5%) which could normalize to 25%. Whenever this changes, and there is no such proposal on the table at present, we expect a one-time ~15% stock price impact. It could also never change if the Govt wants to encourage the industry to keep pricing low and where it takes a decade for Insurers to break even.

We believe HDFC Life will provide very good decadal outcomes despite any adverse tax rate change.

- There is a market need, high entry barriers, and a strong moats.
- Less than 10% Indians who file Income tax returns own Term Protection. And most are under-covered.
- Over time, the industry will pass on the impact of higher tax rates and charges to customers via increased prices or lower commissions to the distributors as we witnessed in the AMC industry after SEBI reduced Total Expense Ratios of Mutual Funds.

We believe we should calculate fair entry price assuming tax rates will change in the next 5 years. This change in stance means we are more conservative on entry valuations vs 2 years ago. When the regulatory ambiguity lifts, or valuations get excessively pessimistic, we intend to add to our positions.

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[7] Annualized Premium Equivalent is a proxy to revenue.
[8] VNB – Value of New Business – is a proxy to profit.
9 SBI Life which has not raised equity since 2008 and has grown net-worth by ~18% CAGR in the last 15 years respectively, and still maintains high solvency levels despite paying regular dividends.
[10] Source: read here

Neogen Chemicals

This is a golden decade for Indian Spec Chemical players which reflects in our large ~18% allocations.

- "China + 1" and "Europe +1" are providing Indian companies strong tail winds.
- In addition, climate change is a new growth engine creating opportunities in new fields for e.g. Batteries for Renewables Storage and Electric Vehicles. Chemicals for Semiconductors could be a new vast area.
- We expect more Indian Specialty Chemicals to undertake downstream migration into more value-added products, that will aid margin expansion.
- As the India Chemical industry becomes larger, many starting materials which were imported will be manufactured cheaper domestically[11].
- We should hence see growth with margin expansion and reduced working capital cycles which should aid expansion of ROCE.

Valuation multiples in the sector are rich. Short term PE ratios need to be interpreted with nuance. They work better with more linear business models more mature on the growth life cycle (IT Services, FMCG). They could be misleading with companies early in the growth life cycle.

Neogen's existing business (Bromine derivatives and Inorganic Lithium compounds) has grown PAT at 35% CAGR in the last 5 years. This momentum will be maintained, perhaps at a slightly lower pace.

- Its business model is getting more profitable via downstream value migration (share of Custom Synthesis which is much higher margin has grown to 20%).
- Acquisition of Bu Li Lithium has brought new customers and new competencies.
- Scale results in more credibility with customers, ability to recruit better talent creating a virtuous cycle which should continue to support growth.

This part of the franchise could be a ~150-185 Cr PAT business in 5 years benefitting from growth and margin expansion.

There is a new growth engine from Battery Chemicals.

- The Govt. has announced ~ 18000 Cr of PLI incentives and players are committing significant capital across the value chain.
- BCG estimates Battery GWH demand between 87-110 GWH by 2030 basis 10-15% EV penetration of 4 Wheelers, 35-40% penetration of 2W. Niti Aayog and BCG have estimated that the market for Battery Electrolytes for Electric Vehicles could be ~4000-6000 Cr by 2030[12].
- Neogen has embarked on ~1000 Cr+ Capex over next 2 years on this project. Triangulating between management estimates, landed cost of electrolytes in India, margin guidance by peers, we estimate this plant could generate ~225-250 Cr PAT at full utilizations. The timing of this is hard to predict. "I am certain that adoption of EV technology in India will be a lot faster than what is being forecasted" (N.Chandrasekaran, Chairman Tata Sons)[13].
- The Cathode opportunity in India will be ~20000 Cr by 2030. We ignore this at present as management has not announced any plans.

Neogen is in pole position domestically vs peers in Electrolytes.

- Technology tie up with MU Ionic[14] of Japan, a global leader in electrolytes, gives it access to an experience curve on cost and plant design, and "recipes" which are the secret sauce for superior Battery performance. Peers will need to tie up technology with a credible partner or go through trial and error till they master recipes.

[11] Source: SRF to make India hub for Chemicals, read here.
[12] Source: read here, Exhibit 37
[13] Source: read here
[14] MU Ionic Solutions Corporation (MUIS) was founded in October 2020, as a JV between Mitsubishi Chemical Corporation and UBE Corporation for electrolytes for Lithium-Ion batteries.

- Two-decade history working with Lithium Salts (experience curve).
- Global supply chain tie ups for Lithium Carbonate (starting raw material in short supply).
- Sample products from pilot facilities have already been shipped to customers.

Neogen could start exporting Lithium Salts in FY25. Over 95% of global exports in Salts today are from China. The US Inflation Reduction Act prohibits vehicle manufacturers from taking subsidies if vehicles have any Chinese content thereby opening a vast non-China global market for Neogen.

The threat of substitutes is distant at present.

- Solid State Electrolytes are safer. However, they are not Commercially viable at present even in developed markets and will be more suitable for more expensive cars. These may not be viable in a cost sensitive market like India for a long time.
- Sodium Ion Batteries have low energy density and will be more used in stationary application. They also need Electrolytes where the Salt “$LiPF_6$” will be replaced with “$NaPF_6$”.
- Liquid Electrolytes cost and safety curves will also improve with time.

Even if one assumes 50% of the market is Lithium Ion, that is a very large opportunity.

This is a rare exception where we are willing to pay high trailing multiples.

- Assuming 60 Cr PAT FY24e, 65x PE for Neogen is very high, however, misleading. There is no “E” in Battery Chemicals today. It may not be as overvalued if examined via a sum of parts where a certain multiple is justified for its existing business today (~135 Cr EBITDA/60 Cr PAT FY24e, 35% PAT CAGR last 5 years) and some value ascribed to future cash flows from the acquisition of Bu Li Lithium and from Battery Chemicals.
- Neogen has the opportunity and credibility to grow profits at 30-35%+ CAGR this decade. The existing business should continue to grow PAT at 20-25%+ for next 5 years (new segments, margin expansion) and Battery Chemicals will start contributing meaningfully and PAT here could match that from the existing business in approx. 5 years. If Neogen can reach ~275 Cr PAT in 5 years from today the current price is reasonable for longer term compounding ahead. Our base case scenario of aggregate PAT is ~350-400Cr+ in FY 29.
- The market has a fair concern on lack of cash generation. Neogen Working Capital cycle has deteriorated recently. This is partly due to more variety in products/new customers which results in higher inventory requirements. And partly the impact of global inventory correction underway. We assume this normalizes in next 12 months.

Paying 65x PE and then being disappointed on Earnings growth is a recipe for disaster. But one should be willing to make rare exceptions. Margin of safety should be seen in the context of an aggregate portfolio where your choices balance stability with promise of growth. *Refer our point in HDFC Bank section of why HDFC Bank is a very good safe position to have in the portfolio.*

IRR estimates: 10 Yrs				
Change in multiple over time	PE multiple at exit	EPS compounding		
		20%	*30%*	*40%*
-25%	*49*	17%	26%	36%
-40%	*39*	14%	24%	33%
-60%	*26*	9%	19%	28%

Investment thesis: Delhivery Limited (Emerging Leader, Phase 3 company)
We took an initial position of 3% in Delhivery, a logistics firm.

- Logistics is an industry with decadal tail winds. We believe the sector will grow 12%+ and leaders can grow at 15%+ for long periods of time.
- Delhivery has a competitive edge and is investing to enhance the same.
- It can be 20% ROE business at scale.
- We are aligned with the thought process of the promoter / management team.
- We are paying a price that is broadly reasonable.

What does Delhivery do?
Delhivery is India's largest fully integrated third party logistics services provider with a nationwide network covering over 18,600 pin codes. The company provides a wide range of logistics services.

Segment	Description	Revenue share FY23	Competitive position
Express Parcel Delivery (EPD)	Caters to e-commerce players both for shipping products and managing reverse logistics.	~63%	Largest player in the third-party EPD industry (i.e., excluding captive logistics of Amazon and Flipkart) • ~40% volume market share • ~2x higher shipments than the closest competitor[15]
Part Truck Load (PTL) freight	Caters to product movement where customers don't have enough volumes to fill a truck by aggregating loads from multiple customers before shipping it to end destinations. The shipping requirements could be express (time sensitive) or normal.	~16%	Number 3 player with potential to gain market share from unorganized segment.
Supply Chain Services (SCS)	Solution for customers who want to outsource all or multiple parts of their logistics like transportation, inward store management & warehousing.	~11%	
Truck Load (TL) freight	A customer can fill an entire truck of a logistic partner	~6%	
Others	Technology services, cross border logistics services	~4%	

In this note, we focus on the 2 main segments EPD and PTL which contribute about 80% of revenue.

There are 4 key variables critical to long term success in Logistics.

- Scale: essential to have the best cost structure vs peers.
- Fastest delivery times with highest service levels, i.e., minimal misplaced or damaged deliveries.
- Technology leadership: capability to manage rapid variations in demand. Also key to improving network efficiencies on parameters such as truck turnaround time, utilization levels which allow one to operate at the lowest cost structure.

[15] Spark Capital

- A willingness to continuously re-invest to be competitive on costs and technology. Aiming to boost profitability at the expense of growth will lead to a decline in competitive position.

Early years and reaching the leadership position in EPD industry.
Delhivery was founded by five engineers[16] in 2011. Existing logistics solutions at that point were not addressing the needs of the E-commerce industry. The existing players were:

- Taking 3-5 days to deliver when E-commerce companies wanted delivery in 1-2 days to gain share from offline retail.
- Neither equipped to handle Cash on Delivery (COD) nor reverse logistics for shipments returned by customers.
- Their technology did not allow real-time order tracking.

The hypothesis of the founders was that they could build a better logistics company by:

- Building the widest coverage as Ecommerce was seeing fast adoption beyond the top cities.
- Providing fastest delivery times with highest service levels (i.e., minimal misplaced or damaged deliveries) at lowest cost by operating a mesh network[17] and making appropriate technology investments. Existing players were following the traditional hub and spoke model which was not the most cost efficient[18] and we were also underinvested in technology.
- Enabling COD and reverse logistics.

Delhivery claims it has built the lowest cost network:

- Its "mesh" network offers more flexibility, lower shipping times and lower cost vs a traditional "hub and spoke" model which follows fixed shipment paths and offers lower flexibility and higher costs.
- It is making significant investments in technology[19] which in the long run help run their operations more efficiently than peers.
- Investing in best-in-class network infrastructure such as automated sorting centers to improve overall productivity and reduce errors.

The lack of competitive data means we cannot independently verify this claim. But this hypothesis is not contested by peers we have spoken to.

By creating the fastest delivery at the lowest cost, and by sharing gains with customers, Delhivery is creating a virtuous cycle which would enable it to maintain its dominant market share.

- Widest coverage and fast delivery attract customers.
- They gain scale which further improves their cost position.
- By passing a part of scale benefits back to customers, they help reduce shipping costs for customers which help expand the ecommerce market by making more categories cost competitive vs off-line.
- This also helps them gain additional market share, which further drives down costs and helps create a virtuous cycle.

[16] Sahil Barua, Mohit Tandon, Bhavesh Manglani, Suraj Saharan, and Kapil Bharati
[17] A mesh network can directly connect to intermediate processing centres, service centres or delivery centres in real-time as opposed to a hub and spoke model which follows fixed shipment paths and offers lower flexibility resulting in higher costs.
[18] Inefficient networks meant higher costs for logistics companies which would indirectly be passed on the E-commerce companies which were loss-making slowing the pace of growth of E-commerce penetration.
[19] Applications which allowed the company to govern the transaction flows from end to end, improve precision and service levels, use transaction data and to facilitate real time operational decisions, process network data collected to build capabilities like route optimization, load aggregation, ETA prediction etc. were built in-house.

Consistent execution of this strategy over the last decade has led to Delhivery becoming the largest third-party player in the EPD industry with ~40% volume market share and ~2x the scale of the next competitor (excluding captives). EPD revenues have grown at a CAGR of 38% between FY18-FY23.

Next stage of evolution: Building PTL business to further leverage EPD industry leadership.
Delhivery is now using its scale in the Express Parcel Delivery (EPD) business to build scale in the Part Truck Load business. The PTL industry, is large (~Rs 70000 Cr) and largely unorganized[20].

If Delhivery executes well, they can gain disproportionate scale vs. its peers.

- Delhivery will operate an integrated network (common warehouse and trucks) for its EPD and PTL segment. This would result in better utilisation for existing infrastructure, leading to further reduction per unit cost.
- Unlike traditional logistics companies which run separate networks for express and non-express shipments, Delhivery's integrated network aims to run on express alone given it was built around needs of their EPD customers. Hence, many potential PTL customers who were used to time indefinite service would enjoy a much faster service at the same or better pricing vs. earlier. This could aid market share gains in a highly fragmented industry.
- Delhivery is deploying 46 feet vs. industry standard of 32 feet trailers and very large facilities[21]. These reduce costs by ~25% per unit vs smaller ones.
- Unorganized players have low overhead and therefore can be very competitive on specific dedicated routes but may struggle to keep up with investment requirements and technology integrations. Many customers don't want to work with multiple logistics players to reduce admin complexity. Hence, a larger share of PTL could shift to organized players.

As Delhivery's organically built PTL business was subscale and entry barriers were high to build a pan-India PTL business, it acquired Spoton (a leading player in express PTL) in August 2021 to build scale.

Tough to replicate Delhivery's competitive position.
Delhivery's competitive edge is tough to replicate.

- Delhivery is the lowest cost operator given its significant scale advantage vs. peers in EPD segment and this edge is improving. It can use this position to defend or gain market share. Delhivery's contention (something which we are unable to verify independently due to lack of data on other players) is that their network has the lowest cost of operations on first, mid and last mile and no aggregator can unbundle these legs of transportation to give lower prices.
- Our interactions with Delhivery's peers confirm that technology applications built by Delhivery are significantly superior to anyone else in the industry which allows them to run their networks much more efficiently[22].
- Delhivery's strong balance sheet (~Rs 5000 crores in cash) and ability to price the lowest given the lowest cost structure should act as a big deterrent for a player who wants to compete irrationally on price. Delhivery claims that its costs are even lower than that of captive players like Amazon which give the latter no incentive to attack incumbents as it has done in the US.

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[20] The PTL industry is split into economy PTL (~Rs 54000 crores) which is ~10% organised and express PTL (~Rs 16000 crores) which is ~55-60% organised per sources such as peer co. estimates, Spark Research.

[21] The mega gateway at Bhiwandi is one of India's largest logistics facilities and combines automated hub, sortation, returns, and freight operations with the capability to handle EPD and PTL freight volume simultaneously. Spread over 1.2 mn sq ft, it has 196 docking stations and is designed to transact over 8,000 tonnes of freight, with 1600 vehicles transiting through it daily, ~ a vehicle every minute.

[22] One example of this is Delhivery's technology deciding how the shipments in a truck should be loaded before the truck is filled to ensure fastest loading and unloading timelines and least potential damage to a shipment while peers use manual judgement to do the same.

The leadership team inspires confidence.
Strong management teams tend to surprise on the upside which cannot be seen today (an adjacency we couldn't imagine, superior execution vs. our expectations, etc.). We like the fact that they are focused on long-term outcomes and enhancing their competitive edge. There is consistency, clarity, and granularity in thought process and shareholder communication.

Their candour in admitting what went wrong with the acquisition of Spoton (challenges in the IT system and process integration between the 2 companies resulting in poor service levels as well as acquiring customers which they didn't want to work with led to PTL volumes dropped by ~43% in process of integrating Spoton with Delhivery) and ability to resolve this challenge give us comfort that we can trust this management team.

Even the venerable HDFC Bank has underinvested in technology which has got exposed in the last 2 years. Teams will commit errors, but willingness to acknowledge them gives comfort that management deals with reality rather than wishes it away.

Steady state economics of this business and ascertaining fair price.
Delhivery is investing aggressively in both Capex and Opex to gain market share and is not profitable at present as profits in some segments are funding losses elsewhere. Revenue growth will be accompanied by high incremental gross profit growth as seen in the last few quarters:

Particulars (Rs crores)	Q2FY23	Q3FY23	Q4FY23	Q1FY24	Q2FY24
Incremental revenue in transport segment	107	59	29	44	35
Incremental Gross Profit (GP) in transport segment	53	58	41	17	18
Incremental GP Margin	50%	98%	141%	39%	51%

We expect the high incremental gross profit margin to continue till capacity utilization normalizes. Further, there will be operating leverage on the fixed overheads in the business leading to rapid profit growth. As this plays out, it is not unreasonable to expect Delhivery to generate 18-20% ROE when it reaches critical scale as one of the largest and the lowest cost operator in the industry:

Revenues	~9000 crores	~25000 crores	~45000 crores
Freight, handling	~73%	~71%	~70%
Gross profits	~27%	~29%	~30%
Direct costs like employees, rent, etc.	~15%	~12%	~10%
Service EBITDA	~12%	~17%	~20%
Corporate overheads	~11%	~6%	~5%
Pre-Ind AS 116 EBITDA (pre-ESOP)[23]	~1%	~11%	~15%
Depreciation	~8%	~5%	~4%
Core PBT[24]	~-7%	~6%	~11%
Core PAT	~-7%	~4%	~8%
Operating Cash Flow as % of revs.	~-1%	~7%	~10%
Free Cash Flow[25] as % of revs.	~-8%	~2%	~6%
ROE	NA	~12%	~20%

Note: We use ranges for our internal evaluation and have shared midpoints for the above discussion.

[23] We build ESOP impact by assuming a fully diluted share count when thinking about our entry price.
[24] We have used Core PBT and Core PAT which is PBT and PAT excluding treasury income.
[25] Free cash flow defined as Operating cash flow less Capex.

Peer companies (FY23)	Revenues (Rs crores)	Pre-IndAS 116 EBITDA margin	PAT Margins	ROE
Safexpress (Express PTL)	3110	11%	8%	15%
TCI Express (Express PTL)	1241	16%	11%	23%
Blue Dart (Air cargo and Express PTL)	5172	13%	7%	33%

One cannot use traditional valuation metrics such as earnings or cash flow multiples to value Delhivery at this point given that the business is sub-scale. Our approach is to estimate the broad conservative Core PAT and Free Cash Flow (FCF) the business could generate in a decade and value the business then at ~30x Core PAT plus cash on books for a ~20% ROE business at that time. That would imply ~40x FCF plus cash on books. We then discount that price to today to obtain a price we are willing to pay for an initial position. Based on this approach, the current price is reasonable for our initial base position.

Risks we are aware of.
In-ability to scale the PTL business would impact profitability estimates. There are strong regional players in the PTL segment who can match speed and reliability of larger pan-India players in the region or specific routes where they operate at much lower cost structures.

While the Rail Dedicated Freight Corridor (DFC) will not be a disruptor of EPD given it may still be faster[26] and cheaper to ship EPD parcels using road as DFC can't offer the last mile connectivity[27], the express PTL business growth could be impacted if DFC becomes a cheaper option vs. road for some customers like those sending shipments to ports for exports. However, this is something we will evaluate as we go along.

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We wish you a joyous 2024. Enjoy this lovely poem (next page) by Mário de Andrade.

We look forward to speaking with you on our quarterly call at 12 pm on the 20th of January 2024

With our best wishes,

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

[26] Moving freight from California to D.C. takes 7-10 via rail; a truck driving team can shrink that to 2.5 days while offering door-to-door (The Secret Life of Groceries (p. 99). Penguin Publishing Group).
[27] Given that the last mile is the most expensive leg of a delivery, Delhivery's overall cost structures may not be significantly inferior vs transporting via rail. In this [Amazon AI Conclave 2019 - Talk by Delhivery](), they mention that last mile is 25-30% of the total cost of delivering a shipment though the distance covered in this leg of the segment is less than 10% of the total distance the shipment travels implying it is the most expensive leg.

The Valuable Time of Maturity (Mário de Andrade)

"I counted my years and discovered that I have less time to live going forward than I have lived until now.

I have more past than future.
I feel like the boy who received a bowl of candies.
The first ones, he ate ungracious,
but when he realized there were only a few left,
he began to taste them deeply.

I do not have time to deal with mediocrity.
I do not want to be in meetings where parade inflamed egos.

I am bothered by the envious, who seek to discredit the most able, to usurp their places, coveting their seats, talent, achievements and luck.

I do not have time for endless conversations, useless to discuss about the lives of others
who are not part of mine.

I do not have time to manage sensitivities of people who despite their chronological age, are immature.

I cannot stand the result that generates from those struggling for power.

People do not discuss content, only the labels.
My time has become scarce to discuss labels,
I want the essence, my soul is in a hurry…Not many candies in the bowl.

I want to live close to human people, very human, who laugh of their own stumbles,
and away from those turned smug and overconfident with their triumphs,
away from those filled with self-importance,
Who do not run away from their responsibilities ..
Who defends human dignity.
And who only want to walk on the side of truth and honesty.
The essential is what makes life worthwhile.

I want to surround myself with people, who knows how to touch the hearts of people.
People to whom the hard knocks of life, taught them to grow with softness in their soul.

Yes …. I am in a hurry … to live with intensity, that only maturity can bring.
I intend not to waste any part of the goodies I have left.
I'm sure they will be more exquisite, that most of which so far I've eaten.

My goal is to arrive to the end satisfied and in peace with my loved ones and my conscience.
I hope that your goal is the same, because either way you will get there too"

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