1 October 2018

Dear Partners,

It has been a brutal quarter and year to date for Indian Equity Markets.

Summary messages

Commentary on current market correction

- The market correction being witnessed was overdue. Markets are following the time tested principle of correction of excesses by mean reversion of valuation multiples. Even for great franchises, ~10-20% correction from the highs is not an exceptional event.
- The correction has been deeper than usual as the ILFS defaults have raised concerns of a system wide contagion.
- Concerns on macro issues have also dominated headlines. Election uncertainty, rising Crude Oil Prices and Interest rates are also weighing on stock prices.
- However, we should note that what has caused the past two steep corrections were unforeseen events – demonetisation and now fears of contagion.
- Recent events provide many learnings for long term investors in Financial Services – Financial institutions are opaque, lending businesses have narrow moats, a prudent and honest management team is investors only defence, speed in lending businesses eventually kills and one must try to understand the soft culture of institutions where one has invested.
- It is futile to forecast the macro or when the correction will end. We should focus on individual company performance because in the medium term stock prices tend to correlate with earnings growth
- The current uncertainty has soured sentiment. But in the indiscriminate selling, the baby is being thrown out with the bathwater. Entry prices are in favour in many strong franchises. We are using this opportunity to add to positions

Portfolio positioning

- The market valuation cycle and the Capital cycle provide an interesting framework to identify opportunities
- The sell-off in NBFCs was waiting to happen. Most traded at euphoric multiples despite weak moats. A rise in interest rates accompanied by challenges in sourcing funds will result in lower growth rates and margins. Valuation multiples are declining to reflect the new reality. Private Sector Banks will be the biggest beneficiaries as they gain market share.
- Private Corporate Banks, Telecom, Specialty Chemicals, Power Generation and Airlines are some sectors which provide very attractive entry points at present.

The Market correction is along expected lines. Valuations are reverting to mean.

Over our last few letters, we have been emphasizing that valuation multiples were running ahead of reality and there will be a period of muted returns as earnings growth confront multiple decline.

In our Annual Letter dated 3 April 2018 we had written, *"… A large part of returns over the last few years have been driven by valuation multiple expansion which in a majority of cases is above fair value (in the kind of companies we would like to own). Most market participants, including us, have borrowed some returns from the future…. We expect returns to be muted in the short term as tail winds of EPS growth will confront head wind of multiple decline. Moreover, we expect portfolio volatility to be high. We counsel keeping some cash in liquid funds and either waiting for more favourable entry points or Investing systematically"*

Fall/Rise Since 2 April 18 till 28 Sept 18		
Extent Of Fall	**No. Of Listed Cos***	**% Of Listed Cos***
Increased > 10%	317	13%
Increased 0-10%	156	6%
Decreased 0 to 10%	266	11%
Decreased 10% to 33%	945	39%
Decreased 33% to 50%	496	20%
Decreased >50%	242	10%
Total	2422	100%

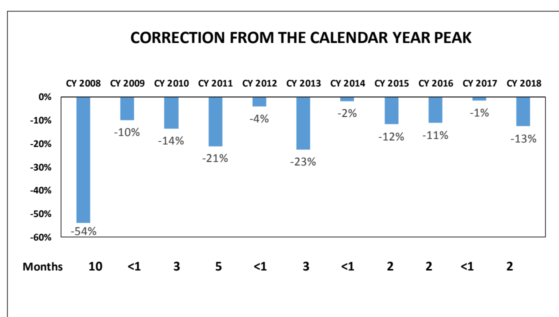
*for 2422 traded companies as on 2 Apr and 28 Sept 2018

Source: Ace Equity

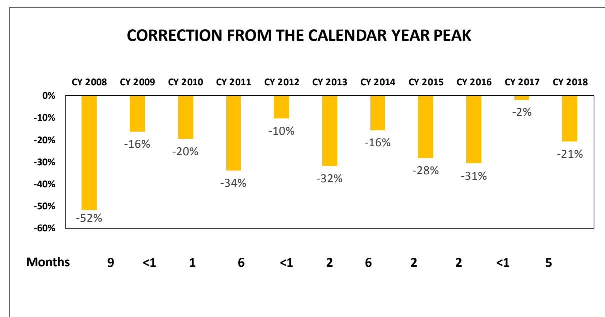
The NIFTY surprisingly has gained ~7% in the time period 1 April 2018 till date. The NIFTY performance has been supported by very few names. Skewness in NIFTY performance can be seen on the left hand panel, and is the highest it has been since 2004. The depth of the market correction can be seen in the right hand panel - ~ 70% of all listed companies have fallen by over 10% from 1 April 2018.

We would like to remind partners that such corrections are fairly regular. The chart below shows the frequency and depth of corrections for two blue chip companies in India. Losing ~20% from the peak is quite a frequent occurrence.

HDFC BANK - 17% CAGR SINCE 1ST JAN, 2008 TILL DATE



TITAN - 24% CAGR SINCE 1ST JAN, 2008 TILL DATE



A question we get quite often is that if we felt the markets were over-valued, why would we not sell and re-enter at a later date when valuations are more reasonable. In our last letter I had shared my personal experiences of trying to time markets by exiting at the first sign of trouble and trying to re-enter later. The challenge is that we can never gauge the right time or price level to re-enter. There is no reliable indicator that gives clear buy and sell signals as sentiment changes on a dime and inevitably, one ends up buying at higher than the selling prices at a later date.

Such corrections are inevitable part of the long term investment journey.

Our portfolios have not been immune to this correction. Since January of this year we have been allocating significant capital to positions where valuations are in favour; but we have witnessed significant price declines in many of these positions as well. These positions are discussed in the Portfolio Positioning sector later in the letter.

When will the current sell off end?

I wish I could tell you that the worst of the correction is behind us but I would be guessing. Short term stock price movements depend on how soon confidence is restored. There is a lot of attempt to gauge the impact of known uncertainties (the threat of contagion, Election uncertainty, rising Crude Oil and Interest rates). Ironically the two large corrections we have witnessed recently were due to unforeseen events - demonetisation (Nov 16) and the ILFS default (at present). Tail winds and head winds often come from unexpected sources.

Will the ILFS default result in system wide contagion?

Banking and lending businesses are rooted in trust between financial institutions as they have claims on each other. A break-down of trust causes transactions to stop. This liquidity squeeze, if not managed quickly, can lead onto insolvency of an Institution with contagious effects because of interdependency.

A media article reports that ILFS needs to pay 34000 Cr between now and 31 March 2019. Despite the large quantum, we believe that the ILFS default will be managed without contagion

- Media reports suggest that the Government has stepped in to supercede the board
- There will likely be a moratorium so the debt repayment schedule will be re worked.
- There will likely be hair-cuts; however, the ILFS debt is widely held and losses will not be contagious as they are not concentrated in a few entities
- However, the complexity in ILFS (160+subsidiaries) means we should not expect a swift plan as it will take time for the new board to understand the scale of the problem

However, the default has resulted in a choke up of liquidity

- Channel checks reveal that some Banks have cut down on lines committed to NBFCs. Mutual Funds are also being very selective on subscribing to NBFC paper.
- Hence, non AAA rated NBFCs will face challenges in raising money from wholesale markets

NBFCs can manage short term liquidity mismatches by slowing down growth. However, inability to access liquidity medium term can create contagion

- ILFS was rated AAA just a few weeks before it defaulted. Ratings of many other NBFCs will now be called into question.
- It is very hard to have a perfect match between the tenure of loans you have given out and the loans raised to lend.
- Inability to service liabilities due to a liquidity risk can spill over into short term default which then leads to a negative spiral into insolvency, which in turn affects other Financial Institutions causing a contagion

The ILFS default has also coincided with Governance insinuations at some other Financial Institutions. Moreover, the Govt. move to supercede the board raises a question if the mess is bigger than reported. (Remember Financial Institutions are opaque, off balance sheet liabilities are not included in the reported debt). If large surprises in NPAs manifest in multiple Financial Institutions concurrently, it could increases the scale of the problem.

All factors considered, we believe contagion risk is a low probability event

- Regulators have learnt from Lehman that you cannot let financial institutions have an uncontrolled default.
- India has experience of bailing out UTIs US 64 scheme in the past and dealing with the Lehman aftermath. The need to act with speed is a key learning.
- Our financial institutions (with ILFS as an exception) have fairly decent leverage ratios.

How will uncertainty on macro variables affect short term stock prices?

Crude Oil was USD 120/barrel on 2014, USD 30/barrel in 2016 and has risen to USD 80/Barrel at present perhaps as a result of the US edict against buying of Iranian Oil. A demand supply imbalance could result in Oil prices headed even higher. Crude Oil moving higher is sentimentally negative.

However, there is no rational reason why Crude Oil should stay at USD 80/Barrel for an extended period of time. Technological developments have resulted in the break-even prices for Crude Oil falling to USD 55/Barrel for Shale Gas and USD 40/Barrel for Conventional wells and USD 50/Barrel for Off-shore deep water drilling. As more supply comes into the market, prices should correct.

Elections are around the corner. Election results will depend on variables on which there is no certainty at present. For example, will the opposition unite to field candidates against the BJP? A coalition without a strong leader will certainly be a negative for short term price movements.

However, as can be seen from the table below, in past elections, despite surprise wins for the UPA in 2004/2009, stock prices did reasonably well over the next 5 years.

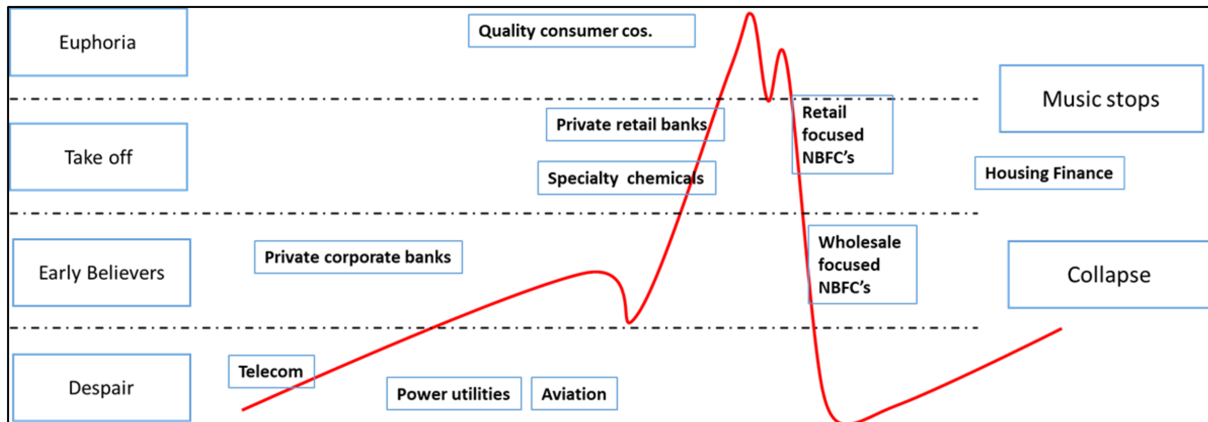
Indian General Election	2004 UPA	2009 UPA
Particulars	% Change from result day	% Change from result day
Result Day		
1 Month after	-12%	23%
5 years after	114%	96%

We would advise partners to focus on medium/long term outcomes. What matters to stock prices in the medium term is Earnings growth and entry valuations. We need to believe in the ability of management teams we invest in to navigate any storms in the external environment.

Trying to make Investment decisions based on macro variables will be getting distracted by the noise.

Portfolio positioning

Partners are aware that we look at the "Market Valuation cycle" to identify opportunities and valuation risks. Here is our view of where different sectors are placed at present.



We had explained in our letter dated (4 July 2017) why we were pessimistic about valuations in the NBFC and Housing Finance space relative to the quality of their business models. We explained our rationale for why the stock prices in these sectors are correcting in our blog published on 23 September 2018 which you can read here.

In summary

- There will be a widening gap between cost of funding for Banks and wholesale funded NBFCs
- NBFCs will struggle to raise large quantum of money at competitive rates to match their historical growth rates
- We should hence expect a slow-down in growth rates and margins
- This will affect valuation multiples, the effect of which is reflecting in stock prices at present

We would like to re-emphasize "our compass" when we evaluate Financial Institutions.

- There are narrow moats in a pure lending business
- The only sustainable moat in Banking is a low cost deposit base and the risk management culture of the firm
- While there will always be exceptions, high ROEs in Banking are mostly a function of excessive risk taking. Opacity in reporting, tendency to ever green accounts, and management incentive to keep stock prices high for future Equity issuance means it is impossible to judge the true quality of outstanding credit.

The reference to management culture may prompt questions on why we hold ICICI Bank in our portfolios given their governance track record

- ICICI Bank is a "Clear Leader" in most aspects of its business and a "Transformation" story in Corporate Loans.
- Our big leap of faith is that past governance issues are behind them and that the new approach is grounded in conservatism (more granular loans, wind down of overseas loans, over 87% of new lending in FY18 was to Corporates rates A and above).
- We could of course be wrong. However, "direction of travel" is good and the entry price compensates for the uncertainty

Partners will observe from the chart above that we believe most FMCG companies still trade at euphoric valuations. We don't expect their stock prices to collapse as, unlike NBFCs, they have strong

defensible franchises. None the less, we expect returns from them over the next three years to be muted as earnings growth confronts multiple decline.

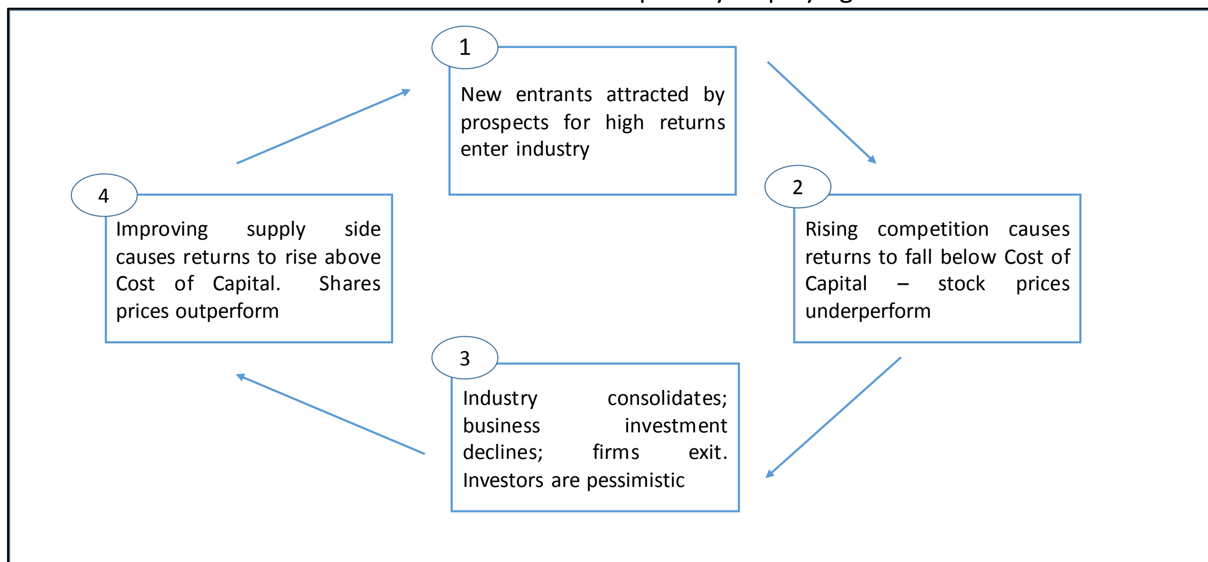
Large Private retail banks, though out of valuation comfort, will benefit from the challenges facing NBFCs as they will gain market share.

Private Corporate Banks have started to find Early Believers. The worst is behind them in terms of NPA recognition and we believe they have provided transparency on additional provisions to be expected. They should soon start to report steady state profits. As credibility is re-established, a rise in earnings growth will be accompanied by valuation multiple re rating.

Specialty Chemical exporters are poised for strong earnings growth and ROCE expansion as demand prospects look brighter and Capacity utilizations increase. Many Indian companies have tail-winds due to the need of US/European Corporates to de-risk supply chains from China, both for reasons of pollution control related issues in China and now the escalating US China trade wars.

Telecom, Thermal Power Generation and Airlines are themes which are out of favour with the market at present. We have seen significant mark downs on our Investment in these positions. We will cut our losses if we encounter insights that suggest we are wrong. However, for each of these positions, we believe current prices provide even more compelling value and they are suffering from investor apathy as they lack short term earnings visibility.

Our investment thesis is based on how we see the Capital Cycle playing out in these Industries



Source: Marathon Capital

The cycle for these businesses, and hence their cash flow generation, is poised to turn

- Sector profitability in Telecom will increase over the next few years from rise in tariffs. Telecom has become a 3 player market with very limited possibility of a new entrant due to very high barriers of minimum critical market share for viability and capital required to compete. Consumers are enjoying high speeds and binge usage without paying fair prices. All operators, including Reliance, are facing rising debt burdens and earning returns below their Cost of Capital. Jio's market share is increasing. As market share stability is achieved, tariffs are bound to increase which will reflect in a boost in cash flows which in turn will reflect in valuation multiples. The precise timing of tariff increase is of course uncertain. However, those with patience will be rewarded by a rich harvest for many years as no new entrants are

expected. We believe Bharti Airtel will be a prime beneficiary as it has successfully defended its market share amidst the Jio onslaught.

- Thermal Power producers are in the doldrums due to low PLFs and due to the Govt's push towards renewables and reluctance of Discom's to sign PPAs. However, fearing a repeat of what happened with Thermal Power, there is significant reluctance amidst Banks to fund additional capacity in Solar/Wind at present tariffs and without PPAs. At the same time, old polluting thermal plants are gradually being phased out. The demand/supply gap should compress which should result in a steep rise in Thermal PLFs over the next 3 years. Not surprisingly, Banks are repeatedly petitioning the RBI to give them more time to resolve Thermal Power Assets. As has been seen in Steel, a year can result in a significant change in fortunes. JSW Energy is already operating at 75% PLF and generating significant cash flow, has the additional benefit of a group Steel company with whom it will tie up additional capacity, has the best Balance sheet and Capital Allocation discipline in the sector and is trading at less than its Net Worth.
- A study of historical profitability of Airlines will reveal that the sector has been profitable even at high Crude Oil prices. Airlines pass along price increases slowly to prevent immediate pressure on Yields. This impacts short term profitability. However, a bad patch is inevitably followed by a strong patch as Crude Oil price increases are passed on and weaker players lose market share to the better run companies as their inefficient capacities exit the market. Indigo is the cost and market share leader and continues to gain share. It has the most fuel efficient fleet, optionality to deploy capacity on multiple overseas routes and has a debt free Balance Sheet while its peers struggle with rising debts.

The Investment Management industry is predominantly marketed based on near term performance. Not surprisingly, there is a motivation to own companies with strong near term earnings, over-looking challenges that are imminent, as long as price momentum is in favour. However, when sentiment turns, price gains are quickly surrendered. We have just seen this story play out in NBFCs.

Similarly, there is limited appetite to own companies facing short term challenges. However, when sentiment turns, prices move very quickly and can provide superior outcomes as earnings growth is supported by valuation re rating. However, these positions need patience and gradual building up of position weights as triggers for a turnaround are not always immediately obvious.

Having said that, we need to do a better job of estimating time it will take to close the gap between current prices and intrinsic value in such positions. Coming in too early is otherwise no different from being wrong.

Concluding remarks

During adverse market conditions, the present always looks more uncertain than the past. We forget we have navigated similar circumstances in the past.

The ability to keep a longer term horizon provides a significant behavioural advantage to the long term investor.

I want to reassure partners that I eat my own cooking and our Investment outcomes are fully aligned

With my best wishes
Manish Gupta
Chief Investment Officer