



## INVESTOR NEWSLETTER – QUARTER ENDED SEPTEMBER 2023

### A. PAST PERFORMANCE:

Period:	Last 3 Months	Last 6 Months	Last 1 Year	Last 2 Years	Last 3 Years	Since Inception Jan-20 to Sep-23
<b>Cumulative Returns</b>						
Portfolio	5.1%	21.2%	33.1%	29.0%	157.0%	234.2%
Sensex	1.7%	11.6%	14.6%	11.4%	72.9%	59.6%
Outperformance	3.4%	9.6%	18.5%	17.7%	84.0%	174.7%
<b>Annualized Returns</b>						
Portfolio			33.1%	13.6%	37.0%	38.0%
Sensex			14.6%	5.5%	20.0%	13.3%
Outperformance			18.5%	8.1%	16.9%	24.7%

**Notes:**

- 1) Performance details for the Portfolio are before taxes, fees and expenses to make it comparable to Sensex
- 2) AIF license received in Q3 C21. Assets have been transferred into AIF as of 01/11/2021. Returns from Nov-21 onwards are for assets in the AIF
- 3) Before Nov-11 returns are for capital invested through the Sponsors' account, with HDFC Bank as Custodian providing performance statements

Our performance remains steady. Our Portfolio returned 5.1% this quarter as against Sensex which returned 1.7%. Since Dec-21, when market sentiment last turned south, we have outperformed the market in 6 of the 7 quarters, with the 7th being similar to the market. Life to date (15 quarters), we have outperformed the market in 11 quarters, been similar in 1, and underperformed in 3.

Our approach of keeping risks low while looking for “cheap” opportunities in the market has been richly rewarded. Our stock selection focuses on minimizing errors. So far, we have made 36 investments since inception – all of them (other than the most recent investments) have returned a minimum of 20%. The outcome is that we have generated a 38% annualized return since inception. This is ~25% higher than Sensex’s annual returns. Importantly, this means our total cumulative outperformance is now 175% in just 3.75 years!

While Sensex returns were muted this quarter the real activity was in the Small Caps. The BSE Small Cap Index was up 15.2% this quarter, and this is after a 20.9% increase last quarter! We have done a deeper dive on the Small Cap price movement later in the document. Our analysis suggests that this is most likely a case of market euphoria and overvaluation. We have started reflecting this view in our Portfolio by reducing Small Cap exposure, which will likely continue.

#### *Key outperformers:*

- Cipla: We just bought last quarter. Strong operating numbers coupled with news around the promoters selling to PE investors helped the stock price this quarter.
- Shriram Finance: Last quarter we saw Piramal and TPG exiting, which removed the supply overhang, and the stock continued its path to normalization this quarter as well.
- Emami: After underperforming for a few quarters, the stock moved up sharply with volume and margin improvements visible in the last quarterly results.
- Aster DM: Operating numbers remain strong, and news around the impending PE transactions in both the Middle East and the India businesses caused it to move up sharply. We believe there is significant upside still.
- PNB Housing: With completion of its rights issue in the previous quarter, and strong disbursement numbers finally leading to a growth in the overall loan book, stock performance remained strong this quarter as well.

#### *Key underperformers:*

- HDFC Bank: We expect a few quarters of merger related news to keep the market on tenterhooks, but HDFC Bank remains one of our highest conviction positions.



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### *Changes to the Portfolio in the last quarter:*

We have been reshaping the Portfolio in the recent past:

- Reducing Small Cap exposure: This had peaked at 38.2% and stands at 30.9% at the end of this quarter. We expect this to further decline as many names have performed, also supported by the Small Cap rally, and we are in exit mode on multiple names.
- Morphing our Financials exposure: We have been strongly overweight “lending” financials for many quarters. Many of the names have given us strong returns and we have made partial exits in some and are in exit mode on a few others. We have added Kotak Mahindra Bank this quarter (but as a relatively small position) and have scaled up Federal Bank. But overall, our exposure to “lending” financials is now lower than in the recent past. We are increasingly finding opportunities in “ancillary” financials. We entered life insurance stocks about 6 months ago and are deep in research on other opportunities in such “ancillary” financials. Hence, even though our Financials exposure stands at nearly half our book (48.2% at quarter end), which is consistent with our approach for the last few quarters, the composition within Financials has changed and will likely change further.
- Increasing Services exposure: Services companies in India tend to be darlings of the markets and offer opportunities for our “buying cheap” style sporadically. We have entered Business Services companies (CMS Info, Quess, SIS) over the last few quarters as market concerns on growth / margins caused stock prices to correct. Business Services exposure stands at 10.8% of the Portfolio. We are ready with our research on multiple IT Services companies, and weak quarterly earnings could make these fall further to get them to our Target Entry Prices.

### *Specific position changes:*

- Exited Indraprastha Gas: We had identified IGL as a cyclical play on gas prices. Increased gas prices about 6 quarters ago caused margins to fall sharply. EBITDA / scm which used to be in the INR 8-9 range had fallen towards the INR 5-6 range. This improved sharply last quarter towards INR 9 again. Stock prices moved up and gave us a 26% return in just over a year. We retain our position in Mahanagar Gas as we think there is further rerating potential there.
- Exited Bajaj Consumer: We had invested in Bajaj Consumer partly as a multiple normalization story as the cheapest Consumer name, and partly as a margin recovery story as margins had been impacted by rising commodity prices. For a while this was the worst performing name in our book. This was because of the company’s (and the sector’s) inability to show margin and volume growth despite commodity price normalization. This changed last quarter when the company reported an 8% volume increase yoy (highest in recent past), and EBITDA margin improved 450 bps from the point we bought it. We made a 28% return in just over a year.
- Partially exited Manapurram: Our thesis for entry was that the market was incorrectly assuming that the fall in yields on gold loans due to increased competition was permanent. Our detailed on-the-ground diligence convinced us that this was temporary, and competition was waning post Covid. Yields recovered quickly, but volume growth has been lukewarm. The company’s overall growth remains impressive but has been driven more by its microfinance business. Our entry was at 0.9x P/B and our recent partial exit at INR 142 share price was at 1.3x P/B giving us a ~50% return. While the original exit price target was INR 190 per share, we may exit this position earlier as the growth is being driven by the higher risk microfinance business.



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### *Specific position changes: (continued)*

- Partially exited PNB Housing: Our entry here was at 0.6x P/B where the stock had languished for a while. We saw the developer loan book being worked through and/or written off to convince ourselves that the business was regaining focus on its core business of retail home loans. The entry of a new CEO, the completion of the rights issue, and the final proof to the market in terms of growth in its loan book, all happened over the last 2 quarters. The stock has moved up sharply and we have sold about half our position at over 1.0x P/B. This position has given us a ~100% return and is performing to our upside case.
- Bought SIS: We have been looking at the whole universe of Business Services companies as they have derated due to margin concerns. 2 quarters ago we bought CMS Info (a slightly different thesis), last quarter we bought Quess (same thesis as SIS) and this quarter we bought SIS. We have studied both the sector and the name in detail, including multiple interactions with the senior management. In our view the margin fears are overblown. Our entry is at 17x P/E against its historical average of 24x.
- Bought Kotak Mahindra Bank: KMB is trading at near all time low P/B and P/E multiples. Core bank trading at 20x fwd P/E, and our exit is priced at 23x. At 23x this would be in line with our view on HDFC Bank, (a lot lower than Kotak's 31x average historical valuations). In our view the transition of leadership will likely be smooth given the depth of professional experience in the bank. Additionally, the growth seen in the retail book gives us comfort that market concerns of below par growth is likely to dissipate over multiple quarters of the bank continuing to deliver. We have a small position for now and would look to scale this if valuations go down further.
- Scaled up Federal Bank: We have had a small position in Federal Bank for some time now. We scaled this up meaningfully this quarter. Strong and consistent quarterly performance, its move towards lending its balance sheet to fintechs, and the likely timing of events like its impending equity raise and subsidiary listing, all contributed to the decision. We believe this is a rerating candidate and can move to a price band of higher than its historical 1.1x fwd P/B.

### *Small Caps:*

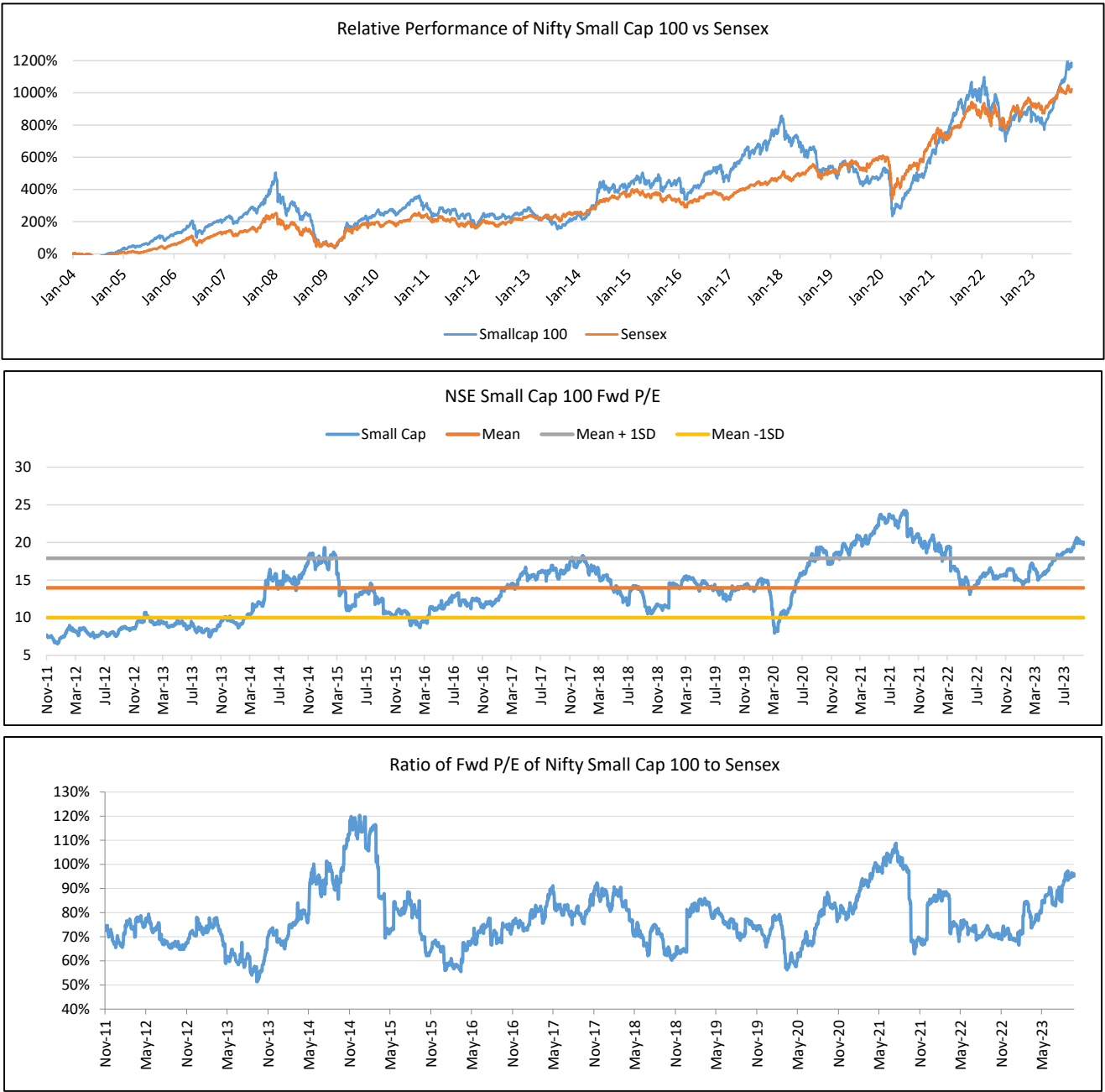
The staggering performance of Small Caps has made us question whether this is a broader trend, or is this a market anomaly which will normalize, akin to retail participation which goes up every bull market and then fizzles off.

#### I. First the facts:

- The Nifty Small Cap 100 (primarily comprising larger Small Caps) went up 41.7% between 31-Mar-23 to 30-Sep-23! In the same period the Sensex went up 16%.
- The Nifty Small Cap 100 is now trading at a fwd P/E of 19.7x. That's almost the same as the P/E of Sensex at 20.3x. This should not be the case as Small Caps inherently carry more risk.



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II. Then an anecdote:

We have a Private Equity pipeline approach to studying Small Caps. Desktop work (2-4 weeks) only causes a name to become a part of our pipeline, which then requires on the ground interaction with promoters, suppliers, customers, promoters of competitors, etc. This latter part takes us many months (3-6 months) before we finally invest. In one such interaction with the management of a name we have been studying and like, the promoter was candid with us on why the business had outperformed in the recent past, primarily driven by past capacity expansion which was finally getting near full utilization. He laid out how he saw market growth, and within it the company’s growth, which we already thought was bullish.



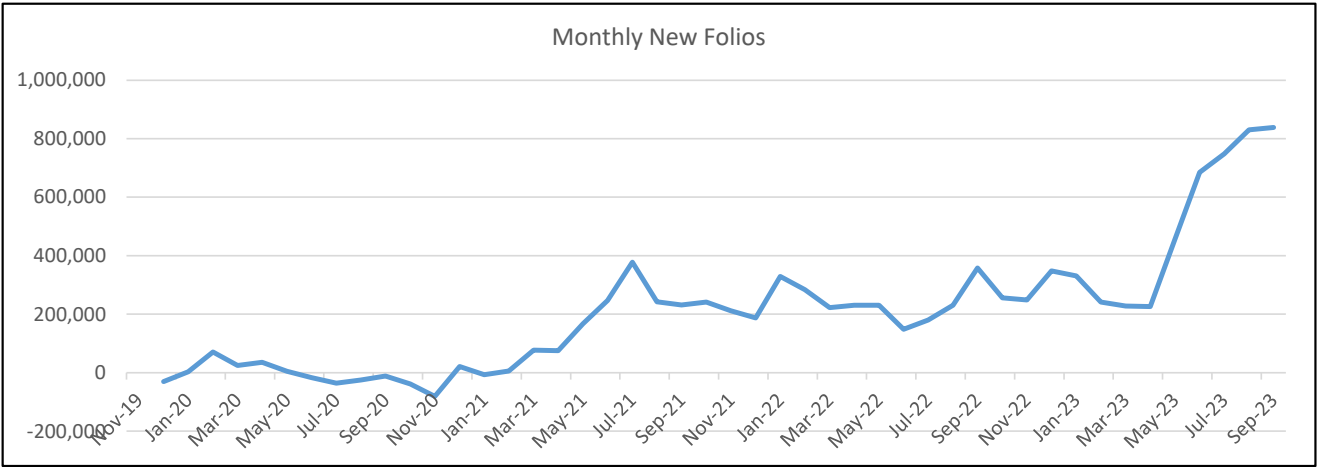
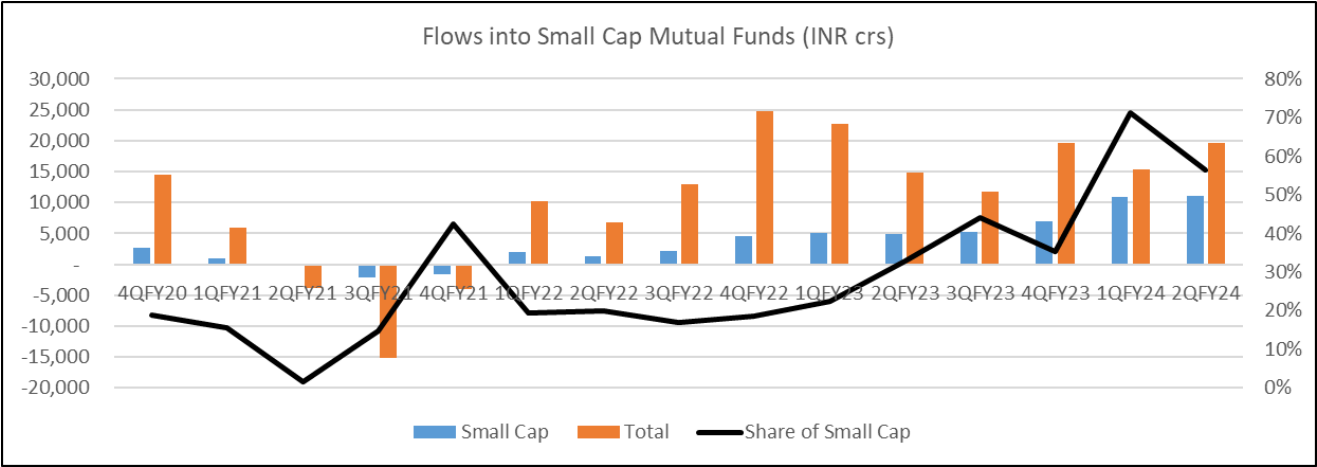
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Only one broker covers this name in detail. Looking at the brokers numbers we were surprised to find almost 2x the growth that the company itself was guiding to. Speaking to the broker, our reading between the lines was that he was trying his best to justify the recent price action by moving up growth numbers, which had now reached an unattainable level!

This is not the only instance where we have seen this. We do not want to generalize and hence this remains anecdotal, but there is clearly an extrapolation of recent positive news to unattainable levels in some of the Small Caps. The market seems to have forgotten that execution risks to management vision are much higher for Small Caps.

III. Our analysis:

- Why did this outperformance happen: The answer is not straight forward. General bullishness? Flows? The answer is possibly both. We can point to flows very clearly as a large contributing factor. You will see, from the graph below, that mutual fund flows into Small Cap funds (as % of funds into capitalization based mutual funds) are running at 60-70% in the last 2 quarters. As context, Small Caps are about 15% of the total market cap of the country, and historically they get about 15% of the flows as well. This same anomaly is visible in the number of mutual fund folios of Small Caps per month. This was running at 200-400k and has suddenly shot up to 800k per month.





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- Will this outperformance continue? Crystal ball gazing is tough. At best we can point to the past. The Nifty Small Cap 100 index is trading at well above its mean, in fact higher than 1 standard deviation above mean. There are 3 times this happened in the last 10 years. Each time the returns for next year were negative, as shown below. Is there a reason to believe that this will be different this time?
  - Jan-15: next 12 months returns were -8%
  - Dec-17: next 12 month returns were -29%
  - Jul-21: next 12 months returns were -13%

### IV. Our conclusions:

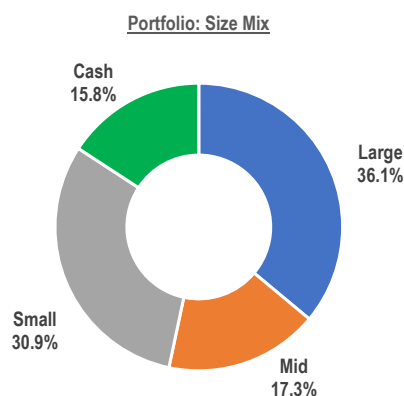
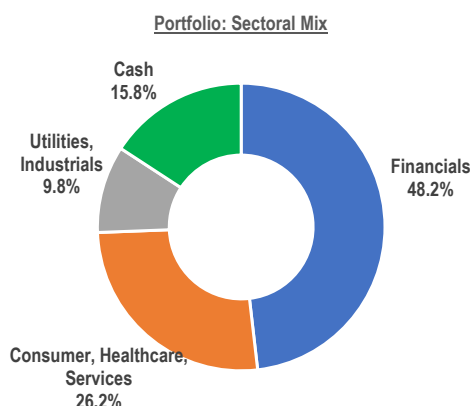
We are not macro analysts but remain macro aware as macro trends affect bottom up investing as well. So really this macro work is to inform us as to whether the increasing anecdotes we see in real life, in terms of the Small Cap companies we are meeting, have a bigger backdrop. Our takeaway is that there is clearly at least flow data which is responsible for this bubbly pricing environment. We can also see that historically these valuation levels, both at an absolute level (~20x fwd P/E), and on a relative basis (almost 100% P/E of large caps), have not sustained for any meaningful period. This leads to us to become cautious and take clear investment calls:

- Sell down Small Caps as they get to exit price targets, and sometimes even at discounts to our price targets. Some of this already happened last quarter and will likely continue this quarter.
- Raise the bar in adding new Small Cap positions.

### Portfolio Characteristics:

	P/E (forward)	12m EPS Growth (consensus)	PEG Ratio	P/B (trailing)	RoE % (trailing)	Sharpe Ratio (3 yr)	Beta (ex-cash)
Portfolio	14.9x	24.5%	0.6x	2.9x	16.9%	208%	0.69x
Sensex	20.3x	14.9%	1.4x	3.1x	13.5%		

Note: Portfolio details are ex Life Insurance

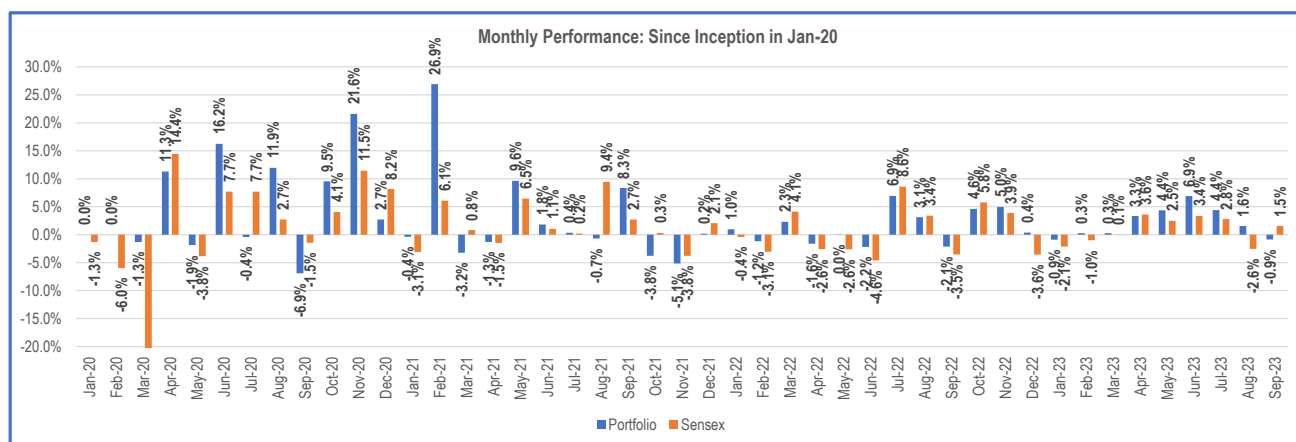
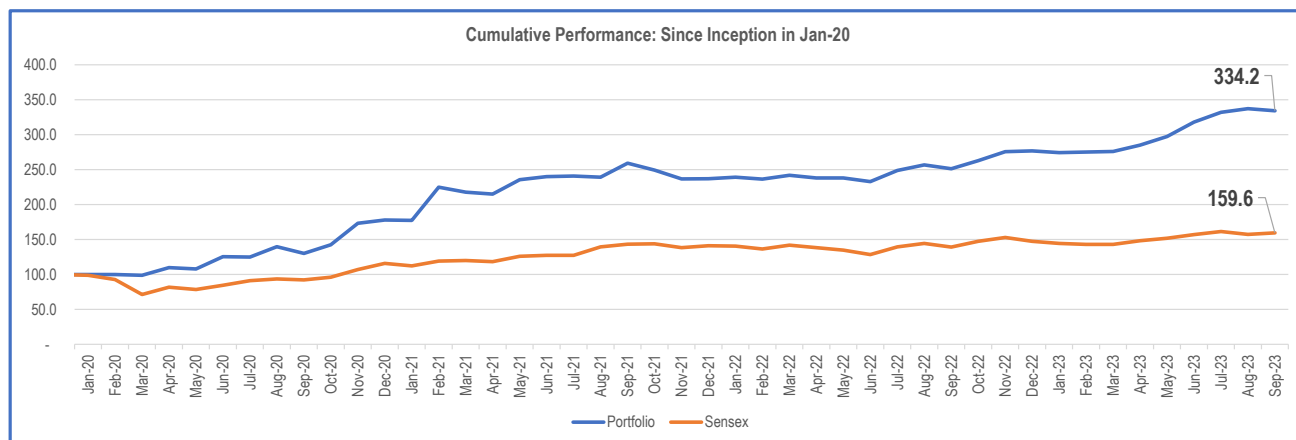


### Top 10 Positions: (of 21 total positions)

Shriram Finance	Aster DM	CMS Info	Axis Bank	ICICI Pru Life
HDFC Bank	Cipla	Federal Bank	IOC	PNB Housing

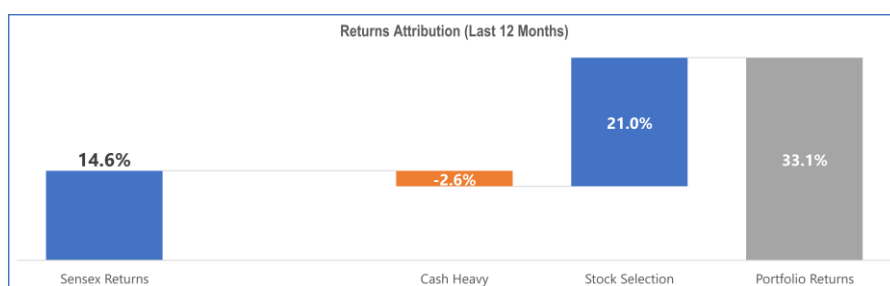
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### Detailed performance charts:

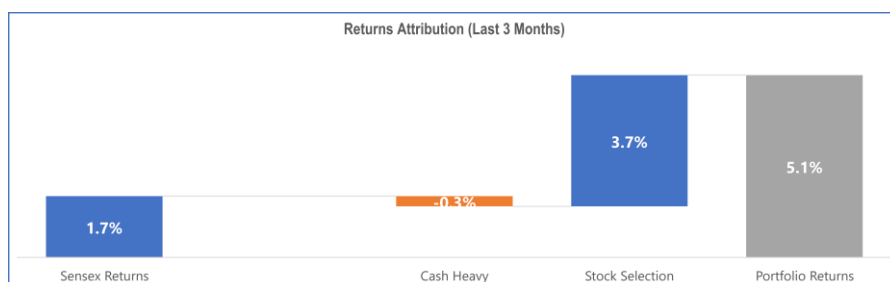


### Returns attribution:

Outperformance  
For Last Year:  
+18.5%



Outperformance  
For Last Quarter:  
+3.4%



#### Notes:

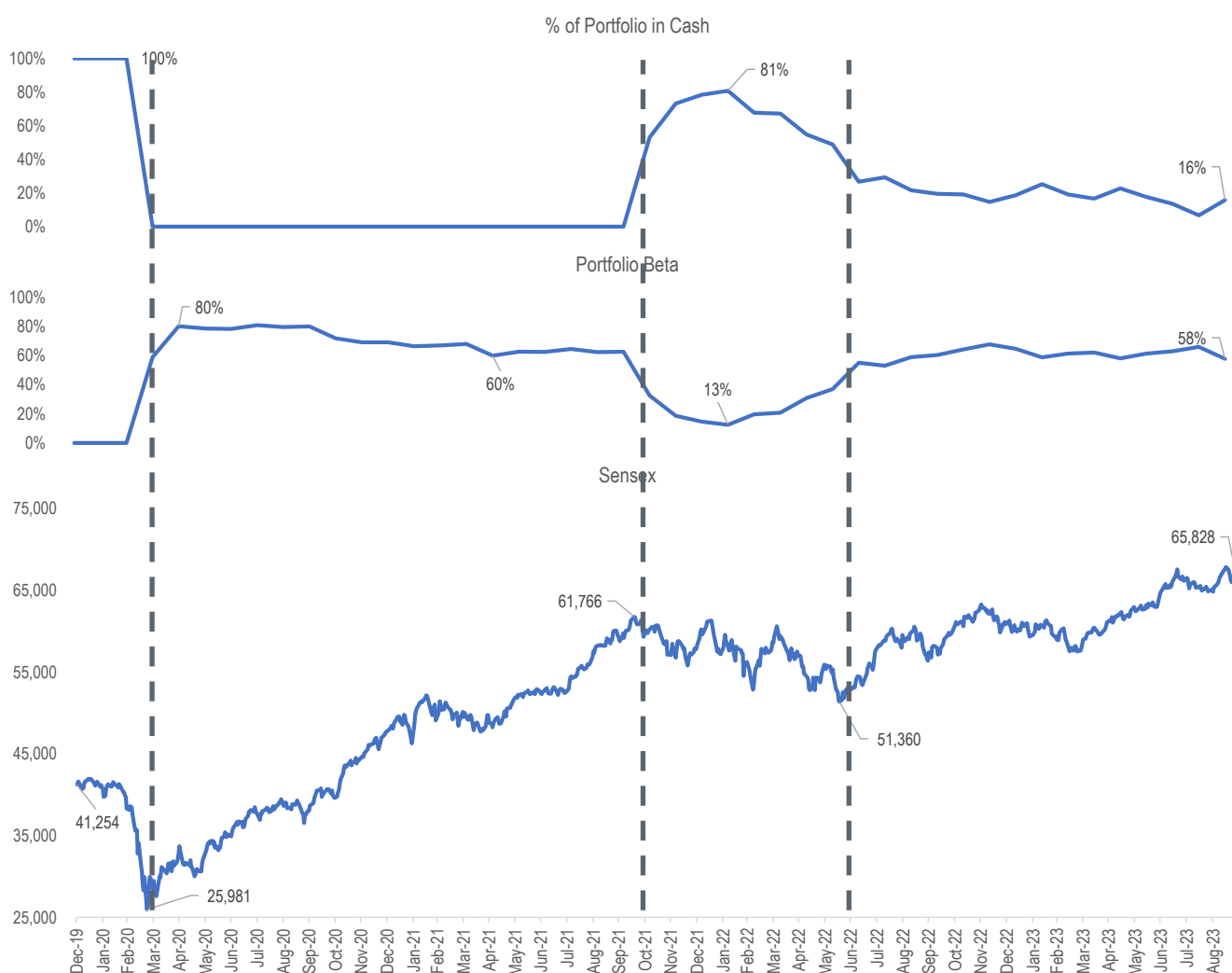
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### Our strategy in action:

Our strategy is to buy good companies if they are cheap, and ONLY if they are cheap. If they are not cheap we stay on the side-lines in cash for periods. Especially for large cap companies we buy them when they trade at discounts to their long term average valuations and exit them when they start trading above long term average valuations without waiting for peak valuations.

This allows us to capture up market moves (High Up Capture Ratio), reduce our risk positions when markets are expensive, and wait in cash for opportunities when markets become cheap. We have been able to remain in cash for 2 down markets because of this strategy: i) before Covid, and ii) From Oct-21 to Jun-22. And this ensures that in down market moves our Portfolio falls less than the market (Low Down Capture Ratio). A high Up Capture Ratio and a low Down Capture Ratio combine to provide our Portfolio with meaningfully higher returns than the market and a high Sharpe Ratio.



<b>Pre-Covid</b> (Jan-20 to Mar-20)	<b>100% in cash before Covid</b> Down Capture Ratio = 0% = Fall in Portfolio / Fall in Sensex = 0% / -29%
<b>Market Bounce Back</b> (Mar-20 to Oct-21)	<b>100% in equity, with Portfolio beta gradually reduced as the markets rallied</b> Up Capture Ratio = 151% = Rise in Portfolio / Rise in Sensex = 153% / 101%
<b>Market Correction</b> (Oct-21 to Jun-22)	<b>Up to 80% in cash</b> Down Capture Ratio = 63% = Fall in Portfolio / Fall in Sensex = -6.7% / -10.6%
<b>Market Bounce Back</b> (Jun-22 onwards)	<b>21% in cash on average</b> Up Capture Ratio = 181% = Rise in Portfolio / Rise in Sensex = 43.7% / 24.2%



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### B. OUTLOOK:

We have turned more bullish over the last 3 quarters as has probably been evident both from our newsletters and our portfolio construction.

We start the coming quarter with Sensex at ~66k. The fwd P/E of the Sensex is 20.3x, higher than its 17-18x history. We think the Sensex deserves a small premium to its historical levels given 1) that India is benefitting from the global move away from China, both in investing flows and in setting up of the factories of tomorrow, and 2) strong earnings momentum in the near term.

With the US rate cycle expected to turn over the next 12 months (has not been true this last quarter), we expect there will be more money chasing EMs, and given the lack of large EM markets to deploy funds, India could stay at elevated P/E levels. The market is offering mid teen IRRs even if markets were to shed part of the over-pricing in P/E terms, which is higher than historical return levels.

Geopolitical risks went up recently with the Israel-Palestine conflict. So far, we have not seen this broadening out to bigger macro risks, but we remain watchful. The risks are crude oil and commodity prices rising, and / or risk aversion causing flight of capital to Developed Markets.

The bubbly Small Cap valuations are a clear risk in our minds. We have already course corrected for this, and more is on the way in terms of portfolio construction.

Importantly for us, while the Sensex remains above average multiple sectors are now trading below, giving us opportunities. Just in the last 2 quarters we have entered 2 large sectors – Life Insurance and Pharma. And we remain hopeful that IT Services will come our way.

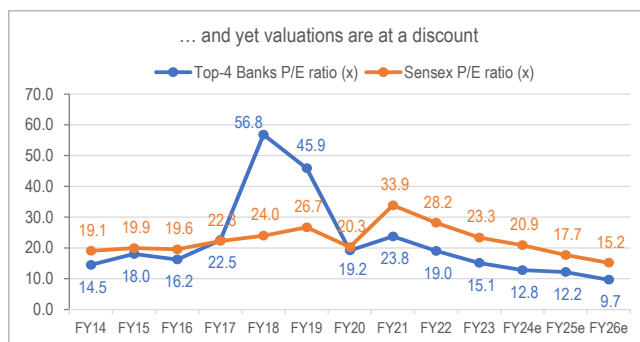
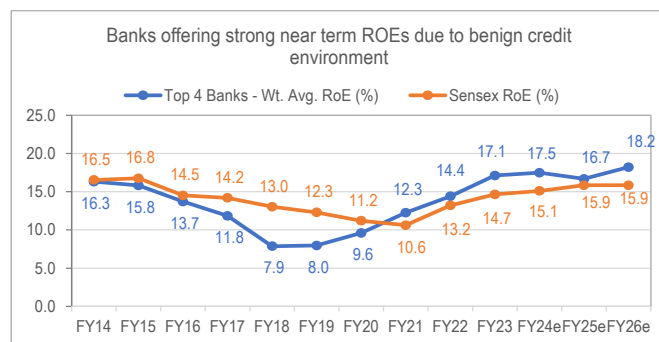
Sector	P/E Sep-23	P/E Sep-22	P/E 10 Yr Avg	vs Sep-22	vs 10 yr Avg	Our View
Auto	20.9x	21.2x	26.7x	-1%	-22%	We are studying this sector, especially 2 wheelers, where new introductions and EVs are causing market disruption
Banks - Private	15.3x	18.3x	20.8x	-16%	-26%	This is our largest sectoral position in the fund
Cement	28.7x	24.9x	26.5x	15%	8%	Still expensive
Consumer	41.7x	43.3x	40.0x	-4%	4%	Very expensive, but we have positions in the cheaper names positioned to benefit from margin improvements post rural demand recovery
Healthcare	27.0x	24.8x	26.4x	9%	2%	We recently entered into the sector after many months of research. Sector offering sporadic cheapness in the largest names principally
Infrastructure	16.9x	14.9x	9.2x	13%	84%	Still expensive
Media	20.2x	17.5x	25.1x	15%	-20%	While it looks cheap we have studied the companies here and have decided to pass due to risk in business models and / or due to corporate governance
Metals	11.1x	6.9x	11.3x	61%	-2%	We have studied the names here, and the cheapness is an illusion due to high commodity prices. Once normalized many of these names are not cheap
Oil & Gas (ex RIL)	5.9x	6.2x	9.2x	-5%	-36%	We have positions in the sector in O&G consuming / distributing companies as beneficiaries of normalizing commodity prices
Specialty Chemicals	32.5x	40.0x	20.6x	-19%	58%	Very expensive, we are staying away
IT Services	23.2x	30.6x	19.6x	-24%	18%	Had corrected a lot, but moved up recently. We spent a lot of time researching the sector recently. One bad quarterly earnings cycle could make price correct towards our entry prices

Data Source: Motilal Oswal

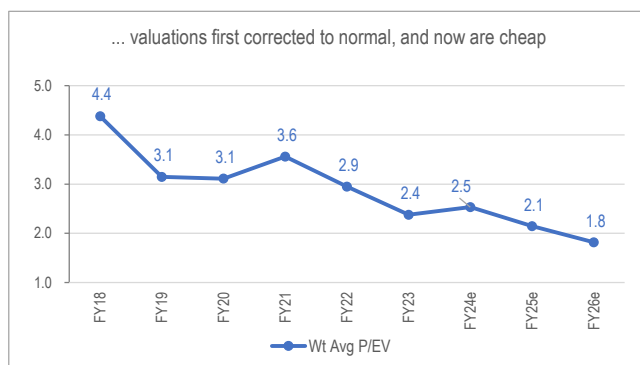
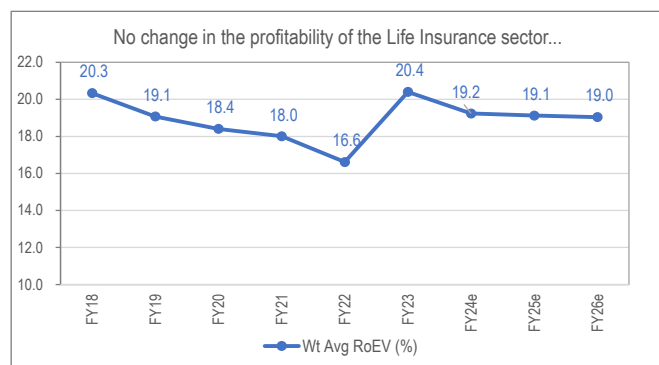
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### Portfolio positioning:

- 1) Continue to be long Big Banks and select NBFCs: Despite strong returns in the last year we think there is a long way to go on many Financials. You will see below that the credit cost environment in the near term is benign, keeping risks low in the sector. And given our style of investing in names trading at discounts to their long term valuations, we believe that the risk adjusted return profile of our Financials names is very attractive still.



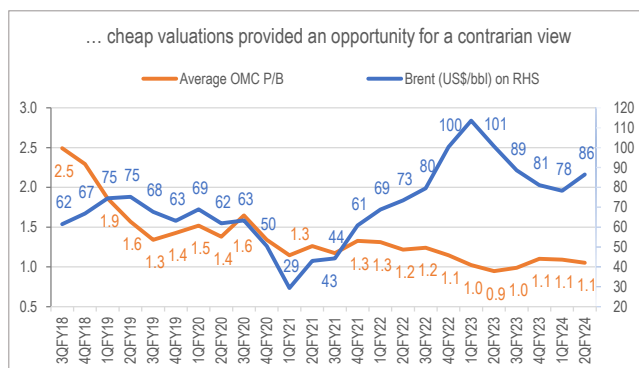
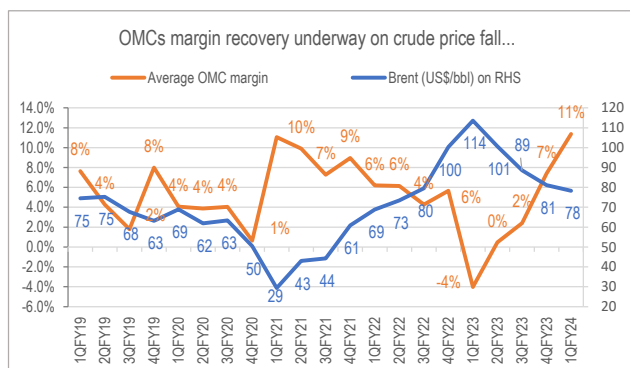
- 2) Recent entry into Life Insurance: The Life Insurance sector had been correcting downwards through much of 2022, and we had initiated our work. The final catalyst for our investment came through the breakdown in valuations post the budget announcement which removed tax benefits for non-ULIP life insurance policies with annual premiums of more than INR 5 lakhs. We do not believe this changes the longer term growth outlook of the sector. Analyzing the direct impact of the new regulation we see that just 5-10% of the annual premiums fall in the affected category. It is also worth mentioning that the highest post-tax return method of participating in the Indian debt markets (for the below INR 5 Lakh ticket segment) remains the insurance sector, after the changes made to the tax structure for debt mutual funds recently. We benefitted from our timely entry in the sector in the sharp correction which followed the budgetary announcements, and since then there has been a sharp recovery in stock prices. That said, there is a lot of upside still left.



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### Portfolio positioning: (continued)

- 3) Continue to be long commodity consumers: Commodities have corrected across the board. The passthrough to the ultimate consumers takes many quarters and we believe the equity markets will reward these companies when they see this come through the numbers over the next few quarters. There is a risk to commodity prices rising again due to increased geopolitical risk, and with Indian general elections around the bend we could see OMCs and CGDs being made to take price cuts affecting their margins, but we expect this to be transitory.



- 4) Researched and ready on IT Services, if prices come our way: We think that the recessionary environment in the Western markets could lead to a meaningful further correction in IT Services, making it attractive to us in the later stages of this year. IT Services company have corrected but further corrections are warranted. This last quarter these companies move further away from us, but we remain hopeful.

