Dear Investors and Partners,

Wish you and your family a healthy and happy new year.

While the debate between soft-landing and hard-landing of the US economy is getting heated, Indian economy continues its smooth journey to the next trillion. The equity markets have started pricing in the general election verdict in favour of the industry-friendly BJP government. The valuations have run up and there seems to be some froth in pockets of the market. While the steep run up does look concerning, two things need to be kept in mind while looking at this –

- Nifty Smallcap 100 P/E was at 15x in March 2023 when the current rally started, which was quite an attractive valuation (P/E of less than 12x is beg, borrow and steal level)
- Earning expansion has been strong and is supporting the valuation increase

Rather than taking a market call of moving to cash, we continue to take bottom-up portfolio company specific decisions based on their respective growth outlook and the valuations, and have exited two of our top ten holdings.

General Insurance

We have had somewhere close to 25% to 30% exposure to lending financials (banks and NBFCs) though currently it is down to less than 20% of the portfolio. Well run banks can offer good long runway for creating shareholder value but general insurance business is one step ahead. Some of the differences, from investment standpoint, between the two are:

Parameters	Banks	General insurers
Cost of deposit / Float	High	Low
Long tenure risk	High	Low
Customer stickiness	Moderate	High
Market penetration	Low	Lower

The first two elements are quite critical and are elaborated later. If insurance companies were available at comparable valuations, we would switch the entire basket of lending financials in favour of general insurers, as the risk reward is far better in the general insurance space.

We have a general insurance business in the portfolio. A discussion on insurance business is not complete without the mention of Warren Buffett. Not only did he make tremendous wealth by investing in insurance businesses, he was also quite generous in sharing his thoughts and wisdom with others. I am happy being a 'Copy + Paste' artist, when he has painted the picture so beautifully; and he has done that many times from 1951 to 2016 in his annual letters.

He explains one of the key advantages that the insurance companies have is their ability to collect now and pay later. **Collect now, pay later** implies that insurers receive full premiums in advance before undertaking any risk on behalf of a policyholder, irrespective of the tenor of risk coverage. Upfront payment for all types of coverage, including multi-year products, boosts free float generation capacity of the business and ensures zero capital consumption and risk on account of receivables. This is the '**float**' that they generate and the cost of this float is the amount of loss they incur on the insurance policies.

From Berkshire Hathaway's Annual Report 2002:

The Economics of Property/Casualty Insurance

Our core business — though we have others of great importance — is insurance. To understand Berkshire, therefore, it is necessary that you understand how to evaluate an insurance company. The key determinants are: (1) the amount of float that the business generates; (2) its cost; and (3) most critical of all, the long-term outlook for both of these factors.

To begin with, float is money we hold but don't own. In an insurance operation, float arises because premiums are received before losses are paid, an interval that sometimes extends over many years. During that time, the insurer invests the money. This pleasant activity typically carries with it a downside: The premiums that an insurer takes in usually do not cover the losses and expenses it eventually must pay. That leaves it running an "underwriting loss," which is the cost of float. An insurance business has value if its cost of float over time is less than the cost the company would otherwise incur to obtain funds. But the business is a lemon if its cost of float is higher than market rates for money. Moreover, the downward trend of interest rates in recent years has transformed underwriting losses that formerly were tolerable into burdens that move insurance businesses deeply into the lemon category.

The company that we have invested in is a private general insurer with a history of more than two decades. Close to 40% of its premiums come from the Motor insurance segment and around half of that comes from private cars, which as discussed later is the better sub-segment within the motor insurance segment. This is followed by the fast-growing health insurance segment which contributes to 27% of total premiums.

As explained above, the float is an advantage available to all insurers. However, what differentiates one company from another is the cost it pays for this float. Cost of float is determined by its core insurance operations which boils down to the underwriting standards of the company.

Underwriting standards is one of the key determinants of profitability for an insurance company – whether the premium adequately prices in the risk being taken. Reserving triangle of insurance companies gives a good insight into their underwriting practices. The nature of the business is such that the company has to provide for claims that might arise in the future. The uncertainty regarding the extent of claims is relatively higher in long tail products like the motor-third party segment because of the long legal process involved for claims settlement. The actual claims might be higher or lower than the reserves made for this segment. The company's loss-reserving triangle, which involves actuarial estimates, indicates that it has maintained adequate reserves in the past as it has been releasing reserves in the last few years. On an average, the company's reserves built in a redundancy of ~3% over the last decade to cover its losses.

However, this float generation capability of insurance is not something new. Players in the industry are aware of this key feature - are almost addicted to it - and typically go on an overdrive in selling more policies, particularly in good times. The competitive dynamics usually results in high loss ratio leading to a loss in underwriting and effectively, increasing the cost of the float.

From Berkshire Hathaway's Annual Report 2016:

Unfortunately, the wish of all insurers to achieve this happy result creates intense competition, so vigorous indeed that it sometimes causes the P/C industry as a whole to operate at a significant underwriting *loss*. This loss, in effect, is what the industry pays to hold its float. Competitive dynamics almost guarantee that the insurance industry, despite the float income all its companies enjoy, will continue its dismal record of earning subnormal returns on tangible net worth as compared to other American businesses.

The company has managed to keep its underwriting strong across years, and its all-in cost of float has averaged around 2-3% over the last decade. Compared to that, the best banks in India have cost of deposits alone at 4%, and then there is a whole network cost that has to be taken care of. An under-appreciated aspect of this float generation machine is that the company does not have to assume large ticket concentrated risk to generate this level of float. The exposure is granular which makes its risk profile comparable to GEICO, Berkshire's auto insurer.

When the cost of float remains under control, this amount can be invested at a yield of ~9% without a significant investment risk. Leverage of 2.5-3x can create a steady RoE of late teens {2.5 x (9% - 2.5%)}. It is largely because of good underwriting, at scale, that <u>the company has been able to generate an average return on equity of 19% over the last decade.</u>

The premium received by insurers is not free money and the risk-events, for which protection has been purchased, are usually bunched up together and occur every few years. Not much can be done about it except staying disciplined in underwriting throughout.

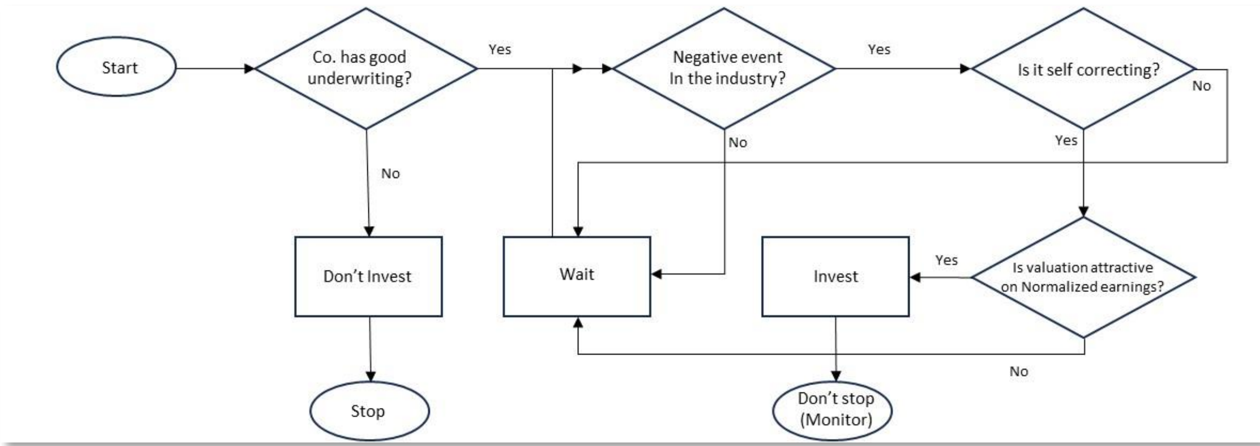
> Historically, Berkshire has obtained its float at a very low cost. <u>Indeed, our cost has been less than zero in many years; that is, we've actually been paid for holding other people's money. In 2001, however, our cost was terrible, coming in at 12.8%, about half of which was attributable to World Trade Center losses. Back in 1983-84, we had years that were even worse.</u> There's nothing automatic about cheap float.

The good thing from insurers point of view is that usually such events are self-correcting. Post such events, two things happen:

- Consumers' willingness to buy and pay up for protection against that particular risk goes up (increase in demand)
- Pricing discipline amongst the insurers goes up and it becomes easy to take price hikes

The company's cost of float increased to 9% in FY2022 mainly because of higher claims in the health insurance segment and partly because of higher competitive intensity in the auto insurance segment. The contraction in earnings was coupled with a contraction in earnings multiple leading to an almost one-third reduction in the market value, thereby creating an attractive entry valuation point.

A simplified framework we follow for investing in insurers (partly because these are perpetually expensive):



There is an added cushion in the valuation as the reported earnings are lower than the real earnings of the business. In addition to the redundancy in the provisions that this company creates, insurers have to recognize deferred claims (incurred but not reported) on nominal future value basis rather than its discounted present value (INR 100 to be paid three years from now is still provided as Rs 100 and not at its present value). This higher provisioning is available to be invested and optically reduces the reported earnings.

Risks

The execution has been very good so far but one of the key risks remains the **competitive intensity** in the industry. Motor insurance is one of the key business segments for the company. In the past few years, this segment has seen intense competition levels, especially from new age technology companies like ACKO, Go Digit, and Navi. That will be one of the key things to monitor.

Web aggregators are also leading to higher competition in retail insurance products by reducing the advantage of distribution that the incumbents have. Our interaction with Policybazaar, the leading web aggregator in the insurance space, suggests that the hand-holding required in different products is different as stated in the below diagram. The factors that affect the selling process are the ticket size, complexity of the product and the contextualised selling.

The easier the product is to sell, the more amenable it is to online selling. It is for this reason that most online insurers are starting from auto insurance with focus on two wheelers as it acts as a wedge for further selling. Higher proportion of four-wheeler insurance in the portfolio is a benefit for the company.

Retail health insurance is a relatively better business with higher degree of stickiness and is less prone to disruption than auto insurance. The company in our portfolio is a challenger in that segment and has become more aggressive off late. We have been evaluating other retail health insurance options. High entry valuation was keeping us at bay so far. With moderating valuations for standalone health insurance companies, we will be focusing our effort there as well.

A quick word on Life insurance:

Life insurance is an attractive segment and a lot of investors have made good wealth in it. The moats around this business are real and it is difficult to displace an entrenched player in this space. While we understand the rules of thumb followed for evaluating the attractiveness of a company vis-a-vis another, I have not been able to grasp some of the conceptual elements specifically around the risks involved. It is a long tenure product and relies more heavily on actuarial estimates. An inaccuracy in estimate can come to bite later in the future. Moreover, since the claims payments are far out in the future, the earnings can be 'managed' to some extent. Maybe, I am worrying more than I should but we will consider investing in this space, if and when, we are able to get a grasp on some of these basic issues. Till that time, we are happy to give it a pass.

While we have learnt a lot from Buffett and have copied his style, we are also evaluating something that he sold recently (not all we do is Copy + Paste). Taking a counterparty position against your guru is always a challenging task and building conviction on this business is in 'Work in Progress' stage.

Some of the other additions to the portfolio are from sectors that we mentioned in our last newsletter as the ones not doing well currently. When the equity market is buoyant, the downside in contrarian bets is low, compared to the ones where the business is seeing momentum, as the valuation difference between the two is significant in such times.

Book Recommendation

I want to share a book that I recently read. Let me give you the prishthbhoomi, the background. In this world of hypercompetition, multi-tasking and achieving more and even more is considered the ultimate measure of success. Getting up early, hitting the gym, preparing for a marathon, finishing mails before others even get to their office is the hygiene. Regular work aside, half a dozen meetings and calls a day, taking your daughter for squash lessons, socialising with your friends in the evening and still taking time out for late evening business calls is part and parcel of the modern corporate life; anything less and you are not a well-rounded complete individual. People share all kinds of achievements on LinkedIn and other social media – successfully closing a deal, managing x number of people, y amount of money, elevation of role and responsibilities, starting new venture, reaching certain milestone. And this is all good but I have never seen anyone mention one thing – I slept for eight and a half hours yesterday! That's such a non-starter idea. No one wants to be seen as a sloth. Still, I strongly recommend reading the book "Why We Sleep: The New Science of Sleep and Dreams" by Matthew Walker.

The book goes beyond why we should sleep and its *eye-opening* benefits. It breaks down the peaceful nocturnal activity into its core components in a rather non-technical way. One interesting thing from the book was the invention of fire. Besides making the food tastier (a fairly important thing, if you ask me), it afforded us the liberty to sleep on the ground instead of a tree and get REM (Rapid Eye Movement) sleep. Our body enters into a state of paralysis during REM sleep. REM sleep on the branch of a tree is a quick way to bring an end to our species. REM sleep is what makes us who we are. So, the invention of fire was, in some ways, one of the key triggers in our ability to climb the evolution ladder. REM sleep not only activates intelligent information processing by blending elemental ingredients but also blunts emotional trauma. Some of the most important leaps in human evolution have come in human sleep whether it's creativity (Paul McCartney of the Beatles composed "Yesterday" in his sleep)[1] or problem solving (Dmitri Mendelev, a Russian chemist, formulated the Periodic Table of elements in his dreams after days of continued failure to crack the code while being awake)[2]. Non-REM sleep is equally important as it refreshes memory, empties memory recycle bin and keeps the file cataloguing system of the brain running efficiently.

If the author, a neuroscientist, with more than two decades of research experience in the field is even half right about the importance of sleep (or the lack of it), it has direct correlation with and causal links to a lot

[1] For the musically inclined, the chords of the song in his own words: "I got out of bed, sat at the piano, found G, found F sharp minor seventh – and that leads you through then to B to E minor, and finally back to G".
[2] For those interested in the logic and the chemical properties, I don't remember a thing. My NREM sleep has been quite efficient in wiping the slate clean.

of health factors. Besides the obvious lowering of productivity, it increases the risk of hypertension, diabetes, dementia, cancer and shrinks life span (consequently, the time available with the loved ones) as also the gonads. Not sleeping enough can even modify the genome code.

By now you must be thinking that I have lost it completely, talking about sleep in the investor letter. Well, the Marwari gene in me is appealing to the capitalist in you – this is directly and highly connected to the amount of wealth you can create for yourself and your family.

The formula that our entire industry worships is:

> Future capital = Amount invested x (1 + rate or return) ^ n

This small 'n' in the equation represents the number of years and is the most potent of all variables. You would have seen or read somewhere that Warren Buffett earned 99% of his wealth after the age of 55. That is how this formula works, that is how compounding works. Wealth grows significantly when compounded over long periods of time and it is for this reason that Albert Einstein called it the eighth wonder of the world.

If sleeping for an extra couple of hours can increase your wealth by a multiple, why not? What you do with that wealth is of course your prerogative and your dharm, but it can lead to a higher level of being[3]. Whatever appeals to you, this book does warrant a read, at least once.

Wish you plenty of sleep in the year ahead and a healthier life beyond. We thank you again for your trust. Please feel free to reach out to us, should you have any suggestions, questions or feedback.

Best regards,

Parag Jhawar

[3] पात्रत्वात् धनमाप्नोति धनात् धर्मं ततः सुखम् (*Patratvat-dhanmapnoti, dhanaat-dharmam, tatah-sukham) - Hitopadesh by Narayan Pandit, 1675*