

Dear Investors and Partners,

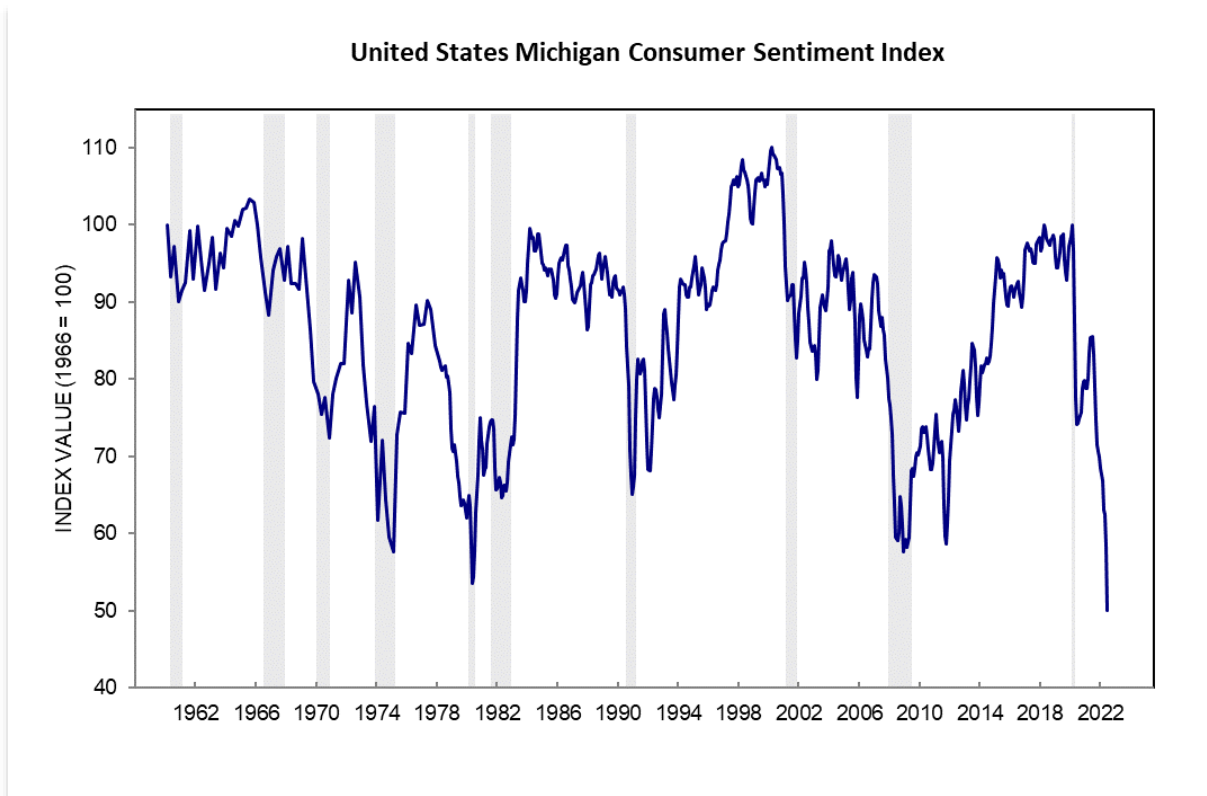
Hope you and your family are staying safe and healthy.

Let's take a quick recount of what is happening around us. Mainstream media is full of the following news articles

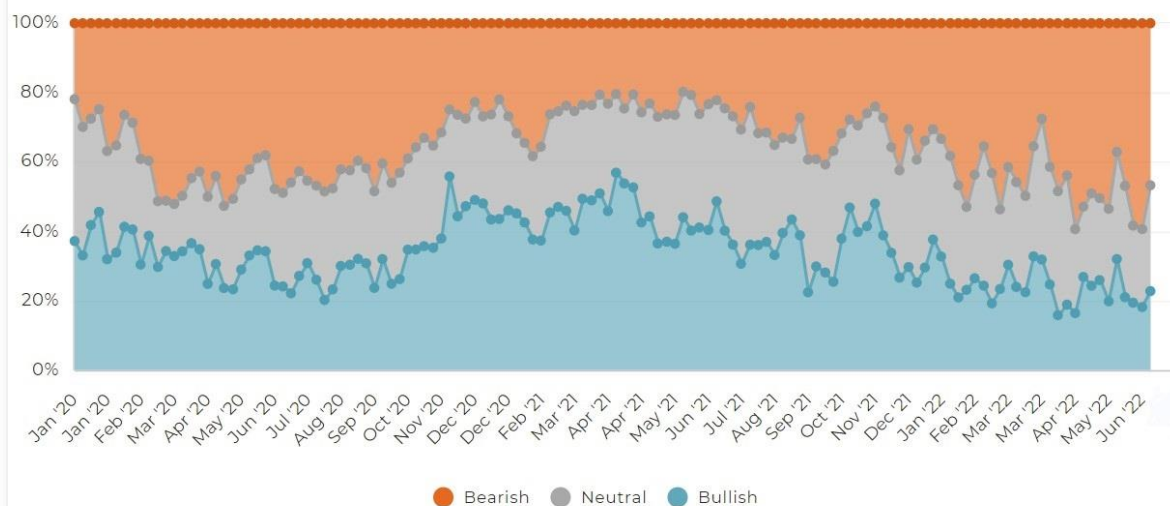
- Inflation in fuel and food price
- Recession in the US which is now spreading to the rest of the countries
- Supply chain disruptions
- Layoffs
- Stagflation
- Russia-Ukraine conflict
- Possibility of China-Taiwan tension
- A few more variants of Covid and if that is not enough something new to keep everyone on tenterhooks like Monkeypox

There is a lot of gloom and doom everywhere and a lot of of what is being reported is true. In such a scenario, it is natural to expect equity market to reflect the above pain.

Valuations are determined by two factors - cash flows and sentiment. Former determines the longer-term trajectory while the latter determines the short-term swings and gyrations. We looked at both consumer sentiment as well as investor sentiment. The charts below capture these sentiments and both are in consonance with each other showing extreme negative values.

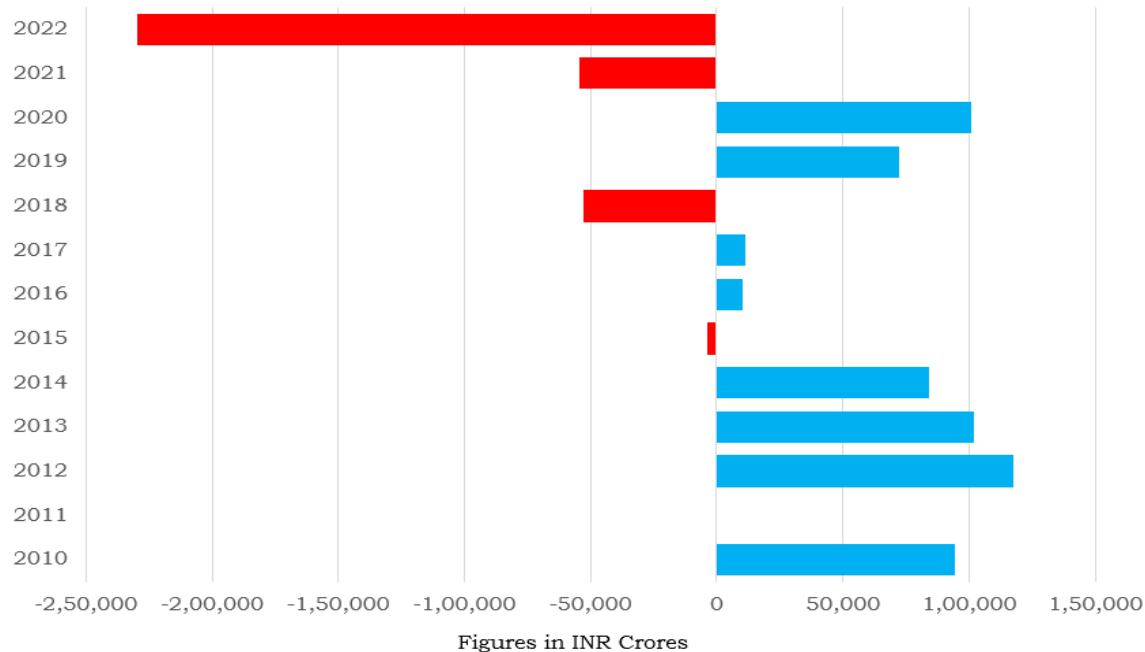


## AII Investor Sentiment Survey



We would have liked to have this data for the Indian consumers and investors but the above is a close proxy. At least in times of great panic, like the current one, people around the world react in somewhat similar fashion. Fear rubs off each other faster than good news. Fear sells. Pessimistic arguments sound intellectually more appealing. That's what has been happening for a while now. The narratives are completely one-sided; the only difference of opinion these days is the pace and quantum of decline of GDP and markets. However, like a pendulum, sentiment also moves from one end to the other. Rarely, does it stop at the centre, balanced view. Right now, as evidenced by the above studies, the sentiment is extremely negative. For context, the current sentiment is more negative than most previous slowdowns and recessions.

## FII Secondary market Inflow / (Outflow)



This is reflected in money flow numbers – As can be seen in the above chart, the secondary market FII outflow of \$40 billion during the last eight months is more than the cumulative outflow seen during global financial crisis in 2008, taper tantrum in 2013, NBFC crisis in 2018 and Covid onset in 2020. The current data might not give too much hope but we have made it past all past crises and we will this time too.

One critical thing to highlight regarding the economic data and its repercussions is that bulk of the negative commentary is originating from the US and Europe but the Indian market is reacting to it as if the same is true for our economy. Inflation, housing slowdown, recession etc., are true for the US economy but extrapolating that to a similar housing market collapse in India just because it happened in 2008 might not be the right argument. An economy is ripe to enter into a slowdown/recession after it is super-heated like the Indian economy was in 2007. Usually, for a drastic slowdown to happen, the large capital consuming sectors (like real estate, infrastructure, capital goods and manufacturing) start showing fatigue after a good run which leads to stress in the financial sector which eventually spreads the pain to almost all sectors.

- Residential real estate prices in India have seen an uptick of 20-30% from Covid lows but the market in most pockets was stagnant to declining since 2014. The eight-year annualised growth in real estate prices would not even be 3-4% in most pockets and would still be near zero in a lot of areas. The housing market in India is at a materially different stage than that in the US.
- Infrastructure sector has been dead for a decade and is showing some signs of revival now.
- A few manufacturing sectors like specialty chemicals have done really well on the back of second sourcing strategy in addition to China. A similar story is getting played out in a other sectors as well. This would be a multi-year phenomenon and is triggering orderbook built up for light and heavy capital goods alike.

The point I want to leave you with is that Indian corporate profits are not hinting at slowdown. The cash flows are robust, a lot of large balance sheets have been deleveraged in the last two years and the risk to the profits is not material. Large capital consuming sectors are getting started to perform after a long time. Is this the time to quench one's intellectual thirst in picking the exact bottom of the market or staying fully invested and waiting for the sentiment to normalise, like it always does? The market still might continue to fall further but several datapoints like increasing semi-conductor inventory, correction in energy prices, freight rates and container prices suggest that some of the concerns like supply side constraint driven inflation are getting resolved. That, along with the extreme negative sentiment, could mean that the equity market bottom is near both in time and distance, if it hasn't already been formed. Irrespective of that, valuations are favourable.

#### **Portfolio update:**

The oil and gas exploration company that we talked about in our last newsletter was successfully able to commence production of oil and gas from its block off the West Coast of the country. This marks one of the few successful oil discovery and production by a private company in India. Once the commercial production ramps up, the cash flows of the company should improve substantially. The company remains unaffected by the recent 'Windfall tax' on oil production companies. However, such an unpredictable tax regime does cast a shadow on the valuation of the sector in the near term.

Almost all the lending financials in the portfolio reported improving credit quality trends and improved outlook on growth and asset quality but all of them continue to trade below their cost. Such divergence in price and performance can test conviction but does not usually last forever.

We have made an investment in a healthcare player operating specialty hospital chain in India. Healthcare is considered an evergreen sector. There are multiple demand drivers like low per capita bed availability, potential for increase in healthcare cost as percentage of GDP, increasing out of pocket spends, increasing health insurance coverage, underdiagnosed market, etc. These arguments could have been made any day of the year in the last twenty years and would have held true. However, top-down view alone is not sufficient to generate good returns. During 2015-19 period, for example, almost all listed Indian hospital companies lost 30% to 60% of their market value.

One thing that affects the returns significantly, especially in asset intensive industries, is the supply addition rather than just the expected growth in demand. This concept is captured very well in the book 'Capital Returns: Investing Through the Capital Cycle' by Palgrave Macmillan and Edward Chancellor. The listed private hospital sector in India witnessed bed addition at annualised growth of 9% from 2013 to 2017. Post 2018, this growth in hospital beds came down sharply to 3% CAGR. What led to this change?

- Expansion in tier-2 markets were not as successful as everyone expected them to be.
- The industry has suffered from oversupply of beds in certain clusters.
- Competition on the talent front kept the margins in check.
- Pricing regulations curtailed the expected margin expansion. Uncertain government policies (like price controls) led to lower incremental capacity addition.
- Balance sheets got stretched because of the supply addition in the last 4-5 years. Companies looked to reduce their borrowings after a period of sustained capacity expansion.

Most of the players reduced the pace of bed addition and focused on improving their balance sheets. The slowing supply addition in the industry led to higher pricing power of the existing players and consequently the return on capital has started improving for the entire sector.

The company operates the largest cancer care network in India in terms of total number of cancer centres in operation. It has a network of 25 hospitals across 19 cities with a 'Hub and Spoke' model that provides comprehensive services at the spokes in tier 2 and tier 3 cities and with higher end procedures done in the tier 1 hubs.

During 2015-18 phase, similar to rest of the industry, it embarked on an aggressive expansion plan and started eight oncology hospitals almost at the same time. Oncology focused hospitals are more capital intensive than multi-speciality hospitals. High upfront cost, long gestation period and delay in ramp up led to high leverage and balance sheet stress in 2018-20 period.

This was followed by a change in ownership and change in management. A private equity player infused capital and took control of the company having strong track record of investing in nine other investments in healthcare industry globally. New CEO was brought in with experience at two of the leading hospital chains of the country. Together, they shifted the focus of the company on generating free cash flow. The company is in its final stages of turnaround having successfully steadied an almost faltering business in 2019. It has seen a sharp improvement in leverage with Debt / EBITDA coming down from 4.5x three years ago to 1.2x now. The key elements that are likely to drive further improvement in the profitability metrics are as follows:

- Proportion of capital employed in mature hospitals Vs. new hospitals is 55:45.
- Mature hospitals are operating at EBITDA margin of 20% and return on capital of 20-25%.

- New hospitals were loss making till last year and have seen a clear improvement in margin trajectory with most of them breaking even to being profitable now. So far, this investment in new hospitals wasn't yielding anything and was depressing the overall return on capital. This set of new hospitals is growing at a fast pace of ~23% and now accounts for a quarter of the total revenues.
- Mature hospitals are not exactly 'mature' in terms of growth. This set of hospitals is also growing at 12-13% in line with the market growth. Operating leverage in these hospitals is contributing to higher cash flow generation.

The focus of the new management is on brownfield expansion and improvement in operating efficiency in the near term which is much more capital efficient than greenfield expansion.

We have been closely following the developments in the company and we expect the hospital to generate strong free cash flow starting this year; something that it hasn't done for ten years. Based on the steps taken by the new promoters and the management, we expect the company's second innings to be much more profitable and rewarding for the shareholders. Our entry valuation was 13x EV/EBITDA and we believe that once the turnaround is complete and cash flow generation improves, the valuation can catch up with its listed peer group. There is also a small fertility clinic business in the company that can offer an added upside at some point.

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

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