Dear Investors and Partners,

Hope you and your family are in good health.

Let us address the big event in the Indian politics first – the outcome of the General Elections. The mandate was not a clear majority to any party. The event has been dissected enough for the reasons and the possible outcomes in the next few years. One big question relevant for us is whether it will derail the development initiatives undertaken in the last few years. There are two things that we would like to highlight:

- The so-called fractured mandate this time around is the norm in India and only in the prior two elections since 1984 did the country see a full majority. The adjoining table shows that the prior two elections were more of an anomaly, given the socio-political realities of our country. Political parties with far lower seats have managed to form governments and more importantly, completed their full term.

- Irrespective of the government in power, the country's GDP has grown between 5% to 8% over the last 25 years excluding a few sharp isolated events like COVID and the GFC. Private sector has been quite resilient of the policy stability, or the lack thereof, in the past, and has managed to grow well across all political dispensations.

Election Year	Largest party	# Seats won
1989	Congress	197
1991	Congress	232
1996	BJP	161
1998	BJP	182
1999	BJP	182
2004	Congress	145
2009	Congress	206
2014	BJP	282
2019	BJP	303
2024	BJP	240

Our preliminary assessment of the outcome, as far as the impact on the corporate world is concerned, is summarised below:

- Government capex, which saw an increase in the recent past, might face some headwinds as the budget gets re-allocated to more populist measures in various forms. We do not expect a drastic change in the allocations but government capex driven industries (defence, railways, shipping, etc.) have seen a euphoric rise in their valuation over the last 18-24 months. While they might continue to do well fundamentally, the valuations in some of them already capture several years of high growth and leave little margin for error. The next few years might see fundamentals catching up to the valuations.

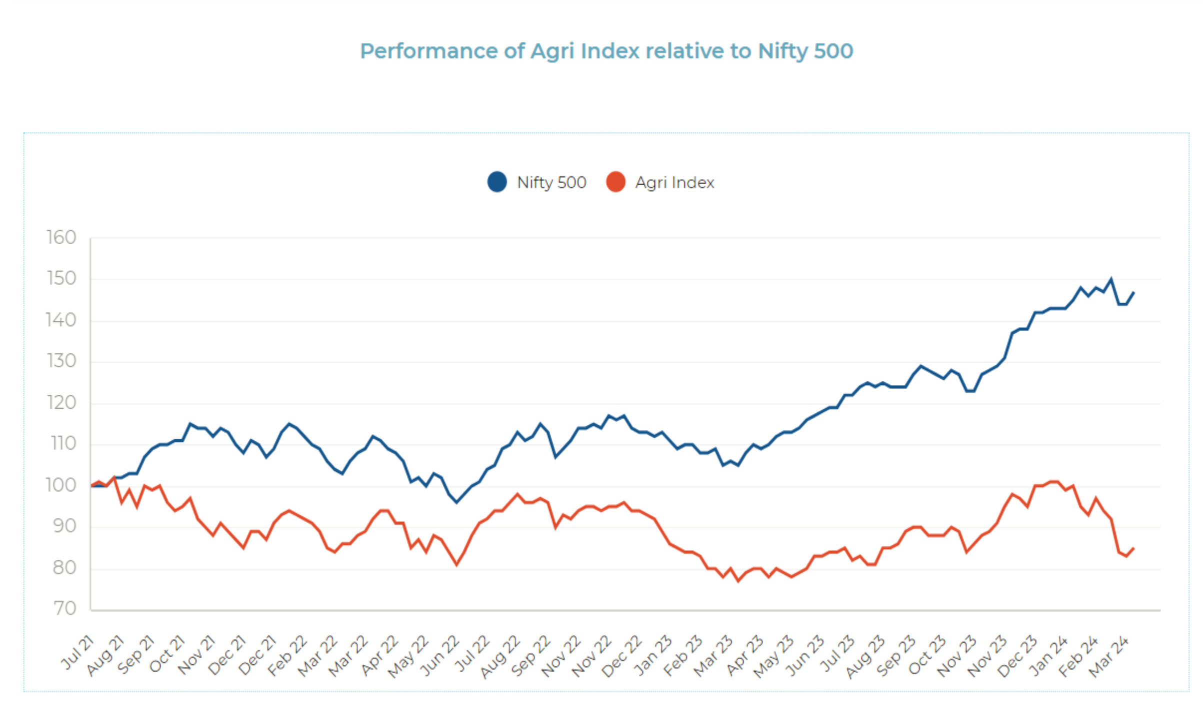
- Increasing focus on populist measures, a political reality, is likely to lift the disposable income levels and benefit consumer facing sectors (retail financiers, consumer discretionary, consumer durables, media, etc.). Valuation of some of these sectors is already beaten down, relatively speaking, and minor policy changes in their favour can lead to a good appreciation in these pockets.

However, there are multiple ways this could pan out. Prime Minister Modi, perhaps in the slog overs of his innings, might go all out in his quest to get a standing ovation and for all we know, Modi 3.0 might turn out to be Modi 2.0 on steroids as far as economic policies and development are concerned. We are not making any big re-alignment to the portfolio. Our portfolio continues to be driven by cash flows, valuations, and sentiments. The sentiment of the broader market lately has swung to the euphoric side.

Portfolio update

Before getting into the stock discussion, I want to highlight a disproportionate contrarian allocation we have made to the companies in agriculture and affiliated industries. Over the last 6-9 months, we have spent considerable time and effort on this space and we increasingly got comfortable allocating capital here because of the better risk-reward, and I want to highlight how critical this the word 'risk-reward' is for us. Our endeavour has been to generate adequate returns by minimising the risk of loss of capital.

The way equity markets have moved in the last year, there are several pockets of overvaluation in it. However, there are pockets of severe undervaluation even in this market. Specifically talking about the agrochemical sector, we prepared and tracked an equal weighted index of top 10 agrochemical companies in India. The chart below compares the returns with the broader market over the last three years. While the indices are galloping to new highs, this sector has not participated in the exuberance and has been in doldrums almost as if Nifty 50 is at 15,000 level (as against the current 24,000 level).



The agrochemical sector has been going through tough times not just in India but globally as well. We heard the following statements from the business owners and managers in this sector:

- "*This is worst time for the industry since the great financial crisis*" (2008)
- *"This is the worst cycle in the last 30 years"*
- *"I have seen many cycles but this one takes the cake"*

These kinds of statements were good enough for us to delve deeper into the sector. Some of the key issues impacting the sector are:

- There is an oversupply situation in the industry. There emerged a tighter supply chain condition post-COVID. The entire value chain from manufacturers to retailers, responded to that by stocking more inventory than the normal requirement. As situation eased on the supply chain front and the panic subsided, most players in the value chain were left hanging with an excess inventory.

- As capacities and inventory in the system increased, without a commensurate increase in demand, a slight price decline led to dumping of excess inventory by Chinese manufacturers and dealers.

- As a consequence, and there were a few other contributing reasons as well, there was a price erosion in 20-60% in some of the chemicals in a very short period of time. This impacted most of the manufactures both on the volume and the pricing fronts.

All those Buffett quotes ("*Buy when there is blood on the street*", "*When it rains gold, put out the bucket, not the thimble*") are not there just for quoting in the investor letters. Shame on me, if we do not put these in practice. We committed capital to the sector when it was being considered pariah by most.

Our approach and thoughts on the risk that we assumed in the process are summarised below:

- The biggest unknown for us is 'Time' – the recovery time, to be more precise. How long it takes for the situation to get resolved is not clear to us, but <u>we are already more than two years into the downcycle now</u>.

- In most cases, <u>we have not taken balance sheet risk</u> in our portfolio companies (except in one where the leverage is high but there are several levers of deleveraging in that case).

- The sentiment and valuations, on a normalised basis, were so depressed that a return to normalcy, even if takes 2-3 years from now, can also generate adequate returns. So, the valuation risk for us was very little unless the cycle keeps worsening for the next couple of years.

Where are we now?

- The end-product of this industry is a consumable. Like most consumables, it has a shorter cycle unlike capital goods industry which has a longer cycle.

- Our interaction with various companies operating across geographies, inside and outside India, suggests that the offtake at the final consumer level has been happening, more or less, at the same pace and seems quite normal. As a result, the inventory in the channel has been going down.

- For a lot of products in the industry, the price fall has been arrested signalling that we are close to the end of the downcycle. Price increase is still not visible in some products but that should follow a period of inventory correction.

- At the same time, there is still over supply condition (from manufacturing standpoint) in some products and we are unlikely to see a sharp reversal in those products immediately.

This just represents the broader picture. There are nuances and differences. The situation is different for different geographies and different products. Geographically, the pecking order is India (recovering faster than many other geographies), Latin America (excluding Brazil), Europe, Midwest US followed by Brazil. So, companies having higher exposure to India (our top allocation in the portfolio) have already started seeing smart recovery, more in the valuations at this point than the fundamentals. A normal monsoon, as expected at this point, should lift the fortunes and the sentiment for the sector.

While the above is a top-down view on the sector, our investments in the sector are all based on bottom-up analysis. There are company specific factors that led us to invest in those companies - change in the top management, sticky long term contract research and manufacturing business, deleveraging of balance sheet. We have spread out our investments sector for both risk mitigation and regulatory reasons.

Stock Discussion

We have made an investment in a pharmaceutical business. The key reasons for investing in this company were:

- It houses two very good and difficult to replicate businesses; one of them is a jewel which is central to our thesis and I will focus more on that.

- The management and the business falls under the 'currently hated by the street' list (but not perpetually hated, in which case, the reasons can be more permanent).

<u>What does it do?</u>

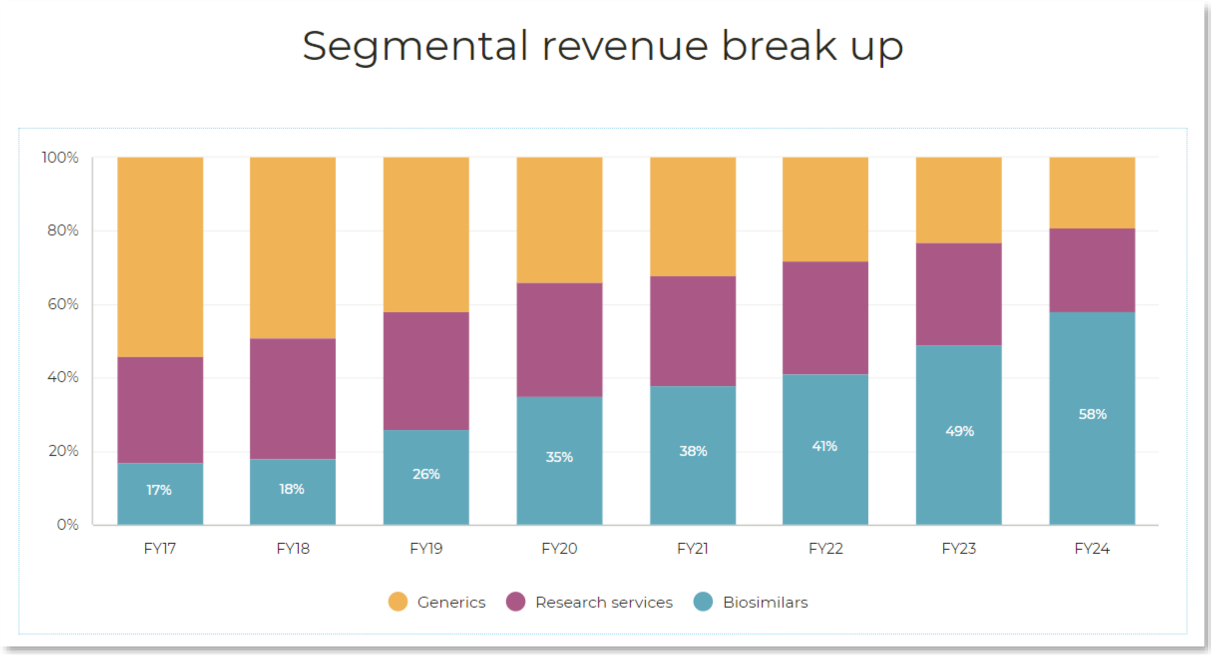
It has a diversified business model with three key verticals, with dedicated management for each vertical:

- Biosimilar division caters to the development & sales of biosimilars and novel biologics. This is the future growth engine of the company. It one of the largest global biosimilars portfolios, from recombinant human insulin, insulin analogs, monoclonal antibodies, and other biologics for diabetes, oncology, and immunology. It is operating in targeting a USD 70 billion global market opportunity which can provide sustainable growth in the years ahead.

- Generics division is involved in the manufacturing of APIs.

- Research Services division caters to CRAMS and offer research services. This segment keeps cash coming in the company. This business has a very long sales cycle but also has a very strong lock in with the innovator pharma companies. I first met its business heads around 11 years ago and at that time could only half appreciate the longevity of and moats around the business. This business, over the past two decades has successfully grown with a good client portfolio and has stabilised into late teens RoE and late teens growth profile with a long runway ahead. While we are more focused on the biosimilar business, the successful transformation of this long gestation business from its start-up phase to a mature business gives us additional confidence about the management ability to continue to grow the biosimilar business as well.

As can be seen from the following chart, the revenue contribution of the biosimilar business has grown considerably over the last 7 years. <u>From contributing less than 20% of revenue in FY17, this segment has scaled up nicely and reached almost 60% of revenue now</u>. With ~80% revenue contribution from biosimilars and high-end research services, the profile of the company has improved significantly.



<u>A word about Biosimilars</u>

Pharmaceutical companies make significant investments in R&D over many years to develop new drug combinations. This process typically spans five years for initial development, followed by up to a decade for rigorous clinical testing and regulatory approval. The capital-intensive nature of this process necessitates patent protection lasting about 20 years, ensuring companies recoup their investments by preventing others from selling the same compound during this period. Consequently, companies are incentivized to continue investing in research, ensuring a steady stream of innovative drugs.

As patents near expiration, competing firms often rush to produce generic versions of these drug combinations, bypassing the need for further R&D investment. Generics are replicas of the original drugs that can be manufactured relatively easily. To market a generic in the US, companies must secure approval from the FDA, demonstrating its interchangeability with the original drug and containing the same active pharmaceutical ingredient (API).

Historically, simple molecules have been employed in medicine to combat diseases by targeting harmful cells or foreign viruses in the human body. While effective against some ailments, these formulations have proven inadequate for treating complex diseases like cancer or diabetes. Unlike typical diseases caused by external pathogens, cancer and diabetes arise internally from malfunctioning cells or insufficient insulin production by the pancreas.

Traditional treatment approaches employing simple molecules often result in the unintended destruction of healthy cells alongside diseased ones, indicating their limited efficacy. Recognizing these shortcomings, there has been a shift towards utilizing 'biologics'—complex proteins isolated from natural sources capable of mimicking or enhancing immune responses. Vaccines, for instance, which have been in use for over half a century, fall under the category of biologics due to their complex nature, resembling disease-causing micro-organisms.

In the recent decades, advances in genetic engineering, recombination techniques, and targeted therapies have revitalized the field of biologics, paving the way for biosimilars—products highly similar to original biologics in their interactions with the human body, albeit not identical. The intricate design and production of biologic drugs ensure that biosimilars, while similar, are not exact replicas of their counterparts. Despite their complexity and innovative potential, biologics are often associated with high costs and limited patient accessibility. Biosimilars offer a more affordable alternative, sparing the extensive clinical trials typically required for original biologics.

Why do we like the biosimilar business?

Contrary to their chemical counterparts (simple molecules), biosimilars development and manufacturing poses significant challenges:

- Biosimilars require extensive non-clinical and clinical tests to prove similarities with the innovator product
- Significant investment is required for the development of biosimilars; ~USD 50-100 million versus ~USD 1-3 million for generics
- Time to develop a biosimilar product is around 5-9 years compared to 2-4 years for generics

Summarised well by Bloomberg Intelligence, “if creating a generic drug is like designing a tricycle, then a biosimilar is like building a spaceship, in terms of complexity and size.” In addition to being more structurally complex, biologics are much larger, often 200 to 1,000 times the size of a small-molecule or chemical drug. These factors create strong entry barriers for non-serious players and thus limit competition in this space. The fact that most Indian pharma companies have focused on simple generics shows that biosimilars business is difficult to build and the profitability is more sustainable. Moreover, biosimilar industry is still in early phase of growth with significant growth potential over the next decade or more.

For the company, this business has reached mid-20s growth profile with a return on capital north of 20%.

A word about the promoter's perception

We have heard several not so positive feedbacks from the market participants about the promoter and the management along the lines that they do not listen to the investors or the sell side and are quite headstrong. They even entered a verbal duel on social media with a sell side analyst. Every individual comes as a package of certain characteristics and instead of chipping away the less desirable aspects, the choices are rather simple - to reject and forget about, or to accept and align with. For us, the fact that the promoter has successfully built and delivered not one but two long gestation, difficult to build businesses, then everything else is just noise. Building long gestation projects or businesses invariably involves uncertainty. It involves sacrifice of near-term certainty and profitability but there is a proverbial pot of gold awaiting for those who can cross the threshold successfully.

This love hate relationship with the street is something that a lot of companies go through. The same company was available at EV/EBITDA of 30x less than four years ago and then it went to down to sub 11x zone. Sometimes good or bad is a function of time or perhaps the stock price that feeds into the narrative. We thought it to be a very favourable entry valuation for what we consider a very good business and acted accordingly.

What we like in this company is that it is in the late-stage of build out of the biosimilar business but was available at an early-stage valuation. It has already reached harvesting stage of many of the molecules. The initial period where uncertainty of capex, outcome and timelines is long over. The proportion of this biosimilar business is increasing in the overall revenue and EBITDA making company ripe for further re-rating.

What keeps us busy incrementally on this investment is monitoring the following:

- Progress on the new launches and market share gains in the new and existing molecules.

- Debt in the balance that has gone up after an acquisition in 2022-23. The acquired company will provide front end capabilities in Europe and the US and is being integrated in the company. Progress on the deleveraging of the balance sheet is one of the critical things to track.

- Capex on some of the biologics that are in clinical trial stages.

Before signing off, I do want to share a book - "The Story of the Wright Brothers - The Value of Patience" by Spencer Johnson. It is a 62-page illustrated book for children. I stumbled upon it while sorting books for the annual book donation drive for my daughter. We re-read it and ended up discussing it for two hours. The takeaway from the story is not difficult to understand as you would have guessed from the title itself but it is important to reinforce it whether you are trying to build an aeroplane or a biosimilar business. The right age to re-read the book is forever.

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