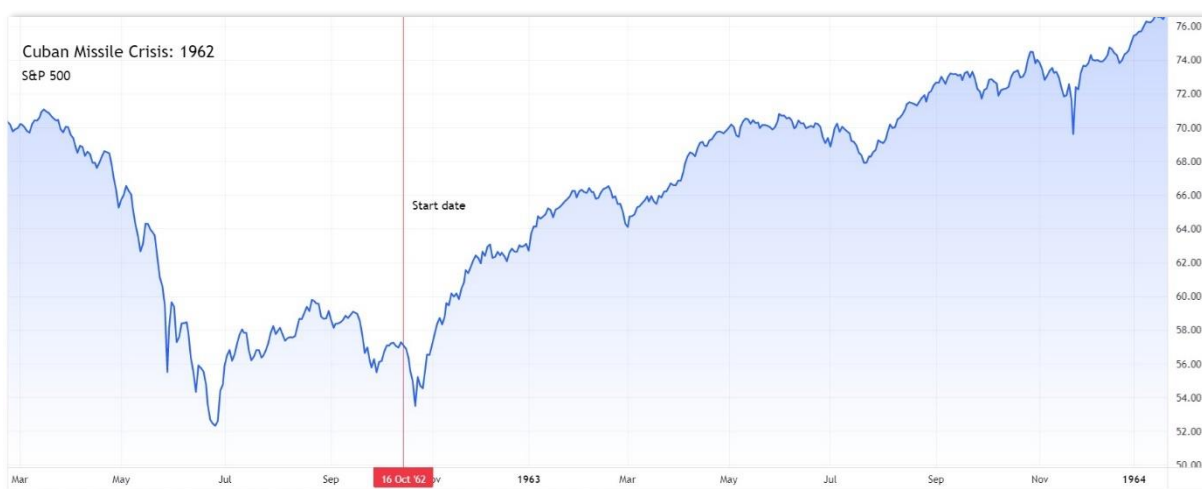
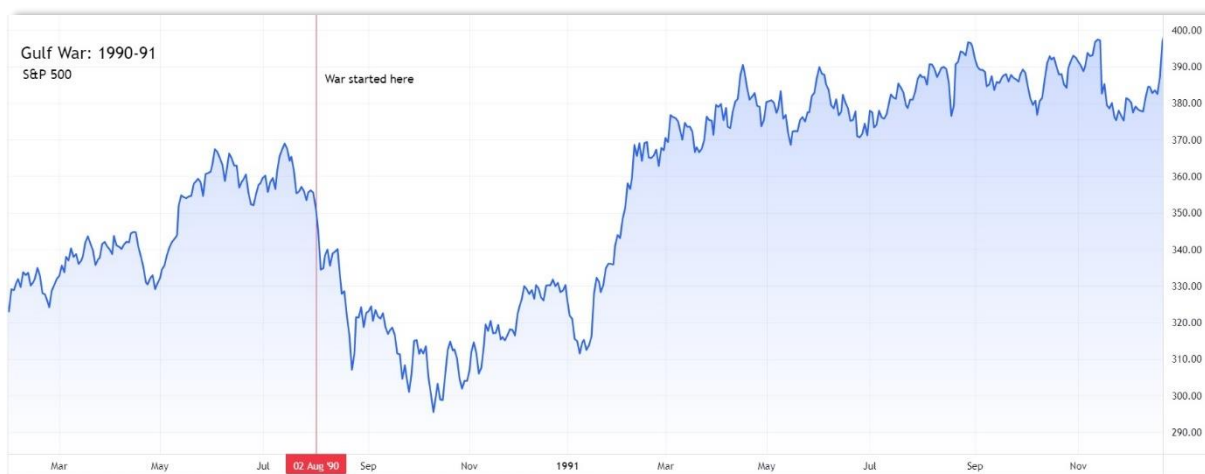
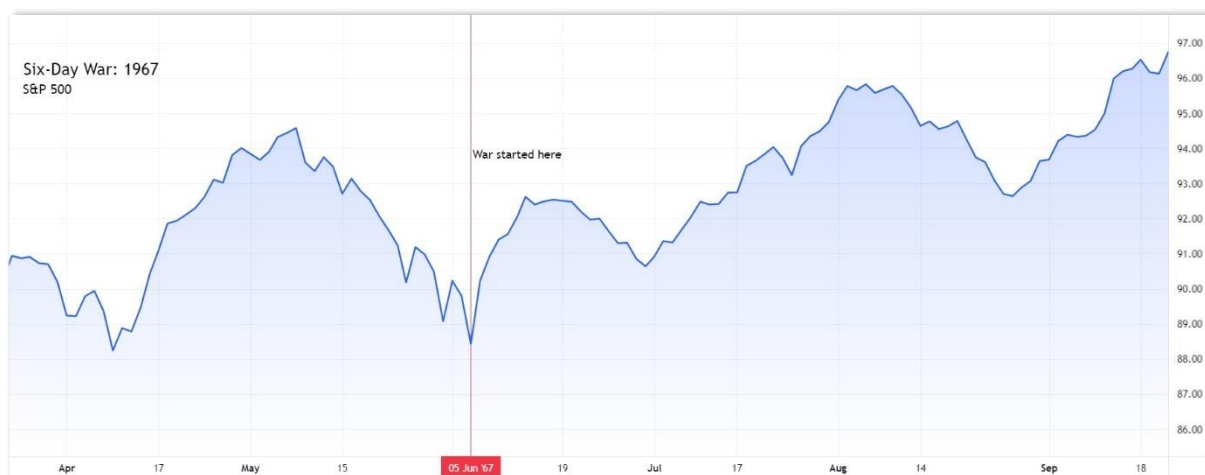


Dear Investors and Partners,

The last few months have seen a lot of activity in stock market because of a multitude of factors. This has led to an elevated level of volatility. Volatility in the short term can be gut-wrenching but we should see it as one of our best friends as long-term investors in businesses. It affords us opportunity to invest in good businesses at attractive prices. In rear view mirror, this period might look like a good one. We thank you for your patience and support during such times.

Let us address the elephant in the room first – Russia-Ukraine conflict. As far the equity markets have behaved, the war started and has already nearly ended even if the real war is still going on. History provides instructive examples of how the stock market behaves during war times or similar such conflicts. We evaluated several cases and the reaction of the US stock market to four such events – Korean War (1950), Cuban Missile Crisis (1962), Six Day War (1967) and Gulf War (1990-91) – is shown in charts below. During most of the past localized wars and conflicts, the market made a bottom within the initial few days of the beginning of the crisis. In almost all the cases, the market made newer highs as soon as the conflict got resolved.





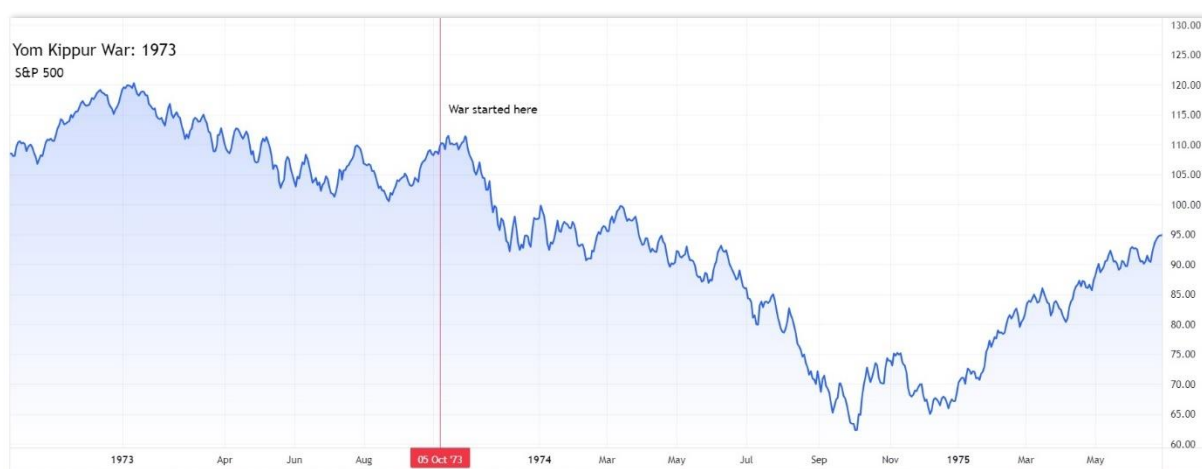
However, before we get too complacent, let me also highlight the exception – the Yom Kippur War of 1973. The chart below shows that the war was just the beginning of the fall and the market kept falling for almost 12 months. It is not just what happens during the war but also how participants (affected directly and indirectly) react after the war. The geo-political and global economic backdrop at that time is similar to the current one:

- Soviet oil undermined the market dominance of the Seven Sisters (the seven vertically integrated oil companies that controlled nearly 85% of world petroleum reserves)
- Formation of OPEC cemented the shift in balance of power in the global oil economy
- Inflation was already high and stayed high for an elongated period
- Nationalistic fervor was finding greater voice in many geographies over free trade. The 'Wind of Change' speech¹ by British Prime Minister Harold Macmillan was reflective of the prevailing change in attitude.

¹ In his speech in 1960s, British Prime Minister Harold Macmillan said, "The wind of change is blowing through this continent. Whether we like it or not, this growth of national consciousness is a political fact. We must all accept it as a fact."

The result can be seen in the chart below. The war was the starting point and the markets kept drifting lower over the next eighteen months.

In this context, I would not underestimate the actions of the land of a million chess players that thinks, plans and acts in decades in comparison to most other countries that are bound by *Election se Election tak* mindset. An anecdote and a lesson from the history - In 1972, to tide over its own grain shortage, Soviet Union negotiated multiple secret deals with independent traders in the US to legally buy 30% of wheat harvest of the US, its biggest geo-political rival, at rock bottom prices. The exports were even subsidized by US tax payers while the ordinary consumers in the US ended up paying 3x the price paid by the Soviets! The current conflict is part of the larger game that started more than a decade ago and whichever way it ends in the near term, would most likely not be the end of it.



During the ongoing Russia-Ukraine conflict, global fault lines have been exposed. Countries that were not seeing eye to eye earlier are now standing together (similar thing happened in late 1960s when Israel and Iran, otherwise at odds, came together to form a pipeline to bypass the Suez Canal). Even the definition of green energy is being tweaked. These are not normal things. The world order, as it has been for a while, is being challenged. As far as the end result is concerned, I readily acknowledge that I don't have the mental wherewithal to predict that and we are not even beginning to speculate what that would be. While history does not always repeat, it does rhyme and it might take several years for the end game to unfold. Such process is usually not conflict-free. What we plan to do is to prepare for the course but not predict the outcome.

In the current scenario, the idea is to protect the portfolio generating adequate returns rather than maximizing the returns. Some of the thoughts that will influence our investing decisions are as follows:

- Asset light businesses generate high return on capital but asset heavy businesses have sustainable return. This is particularly true in times when supply chains have been disrupted. Near shoring of manufacturing, whether its semiconductor chips in Ohio or specialty chemicals in Dahej, is likely to increase in the future. We have a bias towards asset heavy businesses in the current scenario.
- Downstream businesses provide higher return but control over upstream business provides ability to handle supply shocks.
- Asset ownership in inflationary period gives an ability to generate higher returns as there is a 'rental' built in the price charged especially when there is a pricing power in the industry. Return on capital catches up faster during inflationary periods. Hotels, amusement parks, hospitals and energy infrastructure are some of the examples of such assets with pricing power.

- The way geo-political landscape is evolving, the world might move from a single reserve currency to multiple reference currencies with gold and crude oil playing a meaningful role in that. We will try to limit our exposure to a single currency in the portfolio, particularly to the US Dollar.

Many of these guidelines are in line with short duration bias that we discussed in our December 2021 newsletter. These are just a few top-down thoughts. Our investing decisions will continue to be based on bottom-up analysis. We are happy to go against these biases if there are interesting opportunities on the basis of bottom-up approach like we did last month. The valuation of one of the extremely well run, consistently profitable private general insurance companies corrected by nearly 30% partly because of some temporary factors but largely because of the prevailing sentiment in the equity markets. We were able to build a position in that franchise at, what we believe to be, an attractive price. We think that it can be a long-term compounder. While the business, in and of itself, is of very high quality, it is also a proxy to the automotive demand in the country owing to its strong presence in the auto-insurance segment and it will benefit from automotive demand without facing the risk of electric vehicle transition, as and when that happens. We'll discuss the thesis of and thoughts around this investment in greater detail in our subsequent newsletters.

We have an investment in the energy sector in our portfolio. Before getting into specifics of the company, let me share the landscape briefly. The traditional energy sector has seen a long period of underinvestment globally. There are several reasons for that. Price of crude oil for example has been all over the place in the last twenty years. Such volatility of prices scares off allocation of long-term capital to the sector particularly when the upstream projects have a long gestation period and need stability of prices to commit capital. An equally or perhaps more important reason has been the decarbonization theme which has led to very low incremental capital flowing towards the traditional energy sources. In India, many of the multinationals have found it difficult to operate in the upstream projects because of the regulatory challenges and have curtailed or exited their operations over the years and this has led to substantially lower competition in the area as compared to the North American market. Very few companies have the expertise in the area of offshore development globally and especially in India because of even lower competition.

The company that we are invested in is one of the first private companies in India in the oil and gas exploration space. Its portfolio comprises 10 oil & gas blocks of discovered resources and 1 exploratory block. It is engaged in ~~exploration~~, development, production of crude oil and natural gas in India. Founded by late H. T. Parekh (founder of HDFC Ltd) and nurtured by global oil giant Eni SpA, the company has over the decades developed strong processes, systems and project execution skills in offshore drilling and ranks very high on S and G parameters of ESG. Seven years ago, Eni exited the Indian market and a few financial investors backed a couple of industry veterans in the change of ownership. The current management is central to the long-term success of the company.

The key elements of their strategy have been:

- **Focus on D&P (Development and Production) and not E&P (Exploration and Production):** The name of the company mentions the word 'exploration' but this is a development company. It bids for discovered oil and gas blocks and then develops them. It seems like a small difference but changes the character and risk profile of business completely. The nature of risk in exploration vs. development is akin to IF vs. WHEN. One carries existential risk and other one has timing risk. Risk and cost involved in development are far lower than that involved in exploration. After the current management took charge, the company exited two of its exploratory blocks to focus on the development of discovered oil blocks.

- **Efficient portfolio management of onshore and offshore blocks:** Offshore drilling requires deeper expertise, higher capital commitment and carries risk. While the company has the expertise, the professionals-turned-entrepreneurs, in their fifties, have been calibrated in their approach of managing risk and cash flows. The company started with developing low risk onshore blocks in North East India where sub-surface challenges are low. After having successfully brought the block to production, it started focusing its attention and capital to the discovered offshore block in Mumbai offshore basin. The risk to the balance sheet has been kept to a minimum during the whole process.
- **Asset light approach (*relatively speaking*):** Working out of limited resources, it has been capital conscious in committing capital for the development of the blocks and keeping costs low and variable to the extent possible. For instance, instead of having a fixed platform in its offshore block, it converted an old rig into a mobile offshore production unit which is much more cost effective in a marginal oil field. Moreover, it outsourced non-core activities like processing of oil and gas in the unit, while handling the core-activities in-house.

The company is in the final leg of delivering its 'first oil' from its offshore block in the Mumbai offshore basin. After production starts from this field, the oil equivalent production of the company will increase by almost 130%. The proportion of gas and oil in its portfolio, which is currently skewed towards gas (85:15) will be more evenly placed (60:40). The oil and gas from the new field can be sold at near market price as against its old blocks where the selling price is highly regulated and is significantly below the current market prices. Moreover, it will put the company in a different league both financially as well as in terms of project management capability. It will have the resources to undertake projects of similar and larger size in the future.

The business doesn't come without its set of risks.

- One of the critical risks is the move out of fossil fuels and the switch to renewable energy. Wind and solar energy have been gaining traction but are still perhaps a couple of decades away from reaching critical mass. The switch will likely take more time than expected and what we might wish for. Continued demand for hydrocarbon-based energy is the reality and the existential risk to the business is most likely not a near to mid-term risk.
- Oil block development projects can see significant delays. It is dependent on 'weather window' for timely completion. Moreover, there are other teething issues in the initial stages. In fact, its block in Mumbai offshore basin has already seen a delay of more than 18 months. This is a real risk and we have to be prepared for that.
- Its biggest strength is possibly the biggest risk - the management. The top two people are of very high calibre with more than 30 years of experience each in the industry. The current CEO of the company was the CEO of Cairn India before joining this company. The good thing is that both of them have significant ownership in the company and their interests are completely aligned with the minority shareholders.

One thing I want to highlight is that the thesis of this investment is **not** predicated on the price of crude oil and is not an opportunistic bet on the currently prevailing high prices. We are working with a range of \$50-\$80 of oil price in our different scenarios. The company's cost of production in the new block is very low and is expected to be profitable even at \$30-35 of crude oil price and hence limits our downside. In India, upstream companies have to pay royalty and revenue share to the Government which increases progressively as the oil realisation

increases. So, this puts a lid on the upside from the higher oil prices. Our investment thesis rests on the management's capability to increase volumes from existing and new energy blocks; higher oil price currently just adds to the margin of safety. Incorporating the earnings oil and gas from its new block, which should happen soon, it is trading at EV/EBIT of ~5-6x.

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

DISCLAIMER: This document has been made available solely for informational purposes only. The information and opinions contained in this document have been obtained from sources believed to be reliable but no representation or warranty, express or implied, is made that such information is accurate or complete. The information and opinions are not, and should not be construed as, an offer or solicitation to buy or sell any securities or make any investments. No responsibility or liability is or will be accepted by, any member of Knightstone Capital LLP or by any of their advisers for any loss or damage, direct or indirect, arising from the use of this information. Investors should understand that all investments involve risk and there can be no guarantee against loss resulting from an investment in the Fund.