Dear Investors and Partners,

Hope you and your family are staying safe and healthy.

In our June 2022 newsletter, we had highlighted that the sentiment indicators were excessively bearish. When the investor sentiment is so negative and equity as an asset class appears risky, usually, investing in such times carries a very favourable risk-reward because of the attractive entry valuations. The Indian equity market rallied sharply, forming at least a temporary bottom in May and June. While I don't want to underplay the tough conditions globally extending beyond the economic realities, the Indian economy and Indian corporates are not facing the same degree of pain and need not follow what other economies and markets are doing.

Central banks globally, particularly in the US and Western Europe, are on an overdrive to rein in the inflation. Without going into the correctness of their decisions, the banks' actions are killing the demand side without addressing the supply side issues. Banks are trying to manufacture a recession and the governments are trying to nullify the impact to protect their populace (read votes) by providing financial subsidies.

I am reminded of an old Ajit - Raabert Bollywood joke in which Ajit, the villain, instructs his henchman Robert - *'Put him in liquid oxygen. Liquid won't let him live; oxygen won't let him die.'*

Replace 'liquid' with central banks' monetary policies and 'oxygen' with governments' fiscal policies…you get the gist.

We will continue to monitor the macro landscape to the extent it has a direct bearing on the health of our portfolio companies but beyond a point, it can be a distraction.

**Thoughts on Diversification**

Diversification plays an important role in balancing a portfolio but we want to discuss some of our thoughts on diversification, more specifically, when it does not make sense to diversify. No, I am not going to repeat the done-to-death word play of 'Diversification' to 'Di-worsification' that investors world over have covered extensively. Let's talk specifics first.

IT sector is anywhere between 8-20% as a percentage in most portfolios. We were negative on the sector when we started the fund last year and we decided to keep zero exposure to it (the only exposure that we had to the sector was through the IT subsidiary of ITC that we invested in). There were several reasons for being bearish on the sector.

- Most of the companies were trading at peak multiples compared to their historical average. The table below shows the lower band, upper band and the average trading multiple since 2015. While historical average multiple might not always be the correct measure of how the future is likely to shape up and consequently, how the companies should be valued now but it does give a sense of whether the companies and the sectors are trading at attractive valuations or not; whether the risk required to earn the reward is justified or not.

- Similarly, most of the companies reported higher than historical margins in the last couple of years. While the higher demand led to some of this increase, most of the companies benefitted because of temporary reasons like lower travel and marketing costs post Covid. Stiff competition for talent and high attrition already visible in these companies was a pre-cursor to a likely increase in manpower cost in the near future. Investing in a combination of peak margin and peak multiple is akin to drinking and driving.

- Since the last year, we have talked about our short duration bias because of the likely increase in interest rates in the Western economies. To be honest, we anticipated slowdown in these economies and not recession, which looks like a more likely scenario now but when the demand generating economies for the IT sector slow down, the revenue engine for these companies is likely to slow down a bit irrespective of how much of the additional cost reduction initiative led business these companies get.

- We were negative on the US Dollar and for most of the IT companies, the US Dollar denominated revenue constitutes a significant proportion of revenue. A weak dollar would have hurt their margins. I have been terribly wrong on this front. I am tempted to add 'so far' but let me just eat humble pie.

| Company | P/E Multiple (2015-20) | | | P/E (Oct 2021) | Margin | | | Price change in last 1 year |
|---|---|---|---|---|---|---|---|---|
| | Lower Band | Upper band | Average | | Historical Avg | Last 2 FY | Delta (bps) | |
| TCS | 16.3 | 30.7 | 21.0 | 40.9 | 27.0% | 28.0% | 106 | -24% |
| Infosys | 14.0 | 24.0 | 18.0 | 37.0 | 26.3% | 26.8% | 48 | -22% |
| HCL Technologies | 13.3 | 20.0 | 16.0 | 30.0 | 22.7% | 25.3% | 260 | -31% |
| Wipro | 12.5 | 20.7 | 16.0 | 31.7 | 20.4% | 22.4% | 205 | -44% |
| Tech Mahindra | 12.8 | 24.4 | 18.0 | 29.3 | 16.2% | 18.0% | 175 | -33% |
| L&T Infotech | 12.8 | 25.0 | 17.5 | 54.0 | 18.6% | 20.8% | 219 | -36% |
| Mindtree | 10.2 | 31.4 | 19.5 | 55.5 | 15.6% | 20.8% | 524 | -37% |
| Tata ELXSI | 14.5 | 53.0 | 27.0 | 88.0 | 23.1% | 29.9% | 678 | 23% |
| Birlasoft | 5.1 | 14.0 | 9.0 | 30.8 | 11.9% | 15.2% | 330 | -37% |
| Firstsource Solutions | 7.5 | 17.2 | 9.8 | 29.1 | 13.6% | 16.6% | 297 | -51% |
| Cyient | 13.0 | 24.5 | 17.0 | 30.8 | 13.4% | 16.0% | 253 | -35% |
| Coforge | 14.0 | 29.0 | 18.5 | 68.0 | 16.8% | 16.9% | 15 | -43% |
| Mphasis | 12.6 | 27.0 | 16.0 | 48.8 | 16.2% | 18.1% | 193 | -41% |
| L&T Technology Services | 16.5 | 32.5 | 23.0 | 64.0 | 17.2% | 20.0% | 278 | -30% |
| Oracle Fin Serv Software | 19.0 | 33.0 | 24.0 | 22.3 | 41.2% | 48.7% | 753 | -40% |
| Persistent Systems | 13.1 | 25.8 | 17.0 | 55.0 | 16.6% | 16.5% | -5 | -34% |
| **Average** | | | **18.0** | **44.7** | | | **271** | **-32%** |

We have been right on three out of four counts. More important is that the call to avoid the sector completely worked out well for our investors. The table above shows the returns generated by the companies in the sector over the last year. Many of the companies have a good and sound business model and have generated significant wealth for their shareholders but there is a time to be aggressive and there is a time to be cautious. With the exception of one company, most companies have lost 25-50% of their value during the last year; the entire basket of companies has lost one-third its value. Having said that, valuations of the sector have come-off sharply now and we do not have that negative bias on the sector incrementally.

Coming back to where we started from, diversification for the sake of diversifying does not make sense. <u>Diversification is a risk mitigation strategy and not a return maximization one</u> and should be practised accordingly. Putting one leg in a sinking boat will not have a sweet outcome.

**Portfolio Update**

The larger sectoral call of not investing in IT sector and investing in four mid-cap banks tested patience for the initial several quarters but seems to have started playing out now. At the operating level, we are quite happy with the performance and outlook of the banks in our portfolio. The gold finance company that we invested in, is still facing higher competition, although the competitive intensity has gone down markedly in the last two quarters.

We have talked about several investment ideas so far in our previous newsletters. This time, we want to talk about a trade or a 'workout' that we did. Let me define the 'trade' first, before it is misunderstood. There are several criteria that we follow:

- Even though it is a trade, the underlying business has to be good. We do not want to get stuck in a company that is going downhill.
- The time frame is not days or weeks. The ideal time frame is 18-30 months. The way it is different from an investment is that in case of an investment we are prepared to hold a stock for a much longer period.
- Presence of a catalyst that can lead to a playing out of the thesis in a shorter time period.
- Asymmetric risk reward. The reward must be more than and/or the risk lower than what we would get by investing in a compounding machine otherwise there is no point in doing it. Ideally, we would like to deploy the proceeds of such workout in compounders at the right valuation.
- What if? This is important. Since this might not be a long-term compounder that can heal itself out of temporary pain, we want to be aware of the extent of damage it can do to the portfolio, if our initial thesis does not play out.

We invested in company that primarily manufactures soda ash (anhydrous sodium carbonate), a major raw material for detergents & glass industries and sodium bicarbonate. The company has one-fourth market share in the domestic soda ash market.

Some of the key reasons why we invested:

- Soda ash is a raw material intensive business. It takes about 5 tons of raw material to produce 1 tonne of soda ash. Its low value to volume ratio increases the importance of logistics cost. Due to significant logistics cost, more than 90% of capacities in India are located in Gujarat, where raw material is easily available and imports are limited to coastal areas only (South and East).

- End user industry demand is growing at mid-single digits. So, this is clearly not a high growth industry. However, supply addition has been even slower. Moreover, it takes nearly 4-6 years to set up new capacity and the projects are capital intensive. One of the competitors started setting up a greenfield capacity in 2015 and the capacity came on board in 2021. As mentioned in the book 'Capital Returns: Investing Through the Capital Cycle' by Edward Chancellor, in capital intensive industries, analysing supply side is often more important than the demand side. I cannot recommend this book enough.

- Owing to the regional nature of manufacturing and long gestation period in setting up capacities, the industry is oligopolistic in nature. The domestic soda ash industry is dominated by three large players totalling up to 75% of demand, with imports catering to remaining ~20% of demand. The profit pool of the industry is fairly concentrated and has not moved materially over the years.

- In a commodity industry, cost competitiveness is the key. The company enjoys EBITDA margins in the range of 25-30%, which is 400-600 bps higher than its peers driven by its cost leadership and backward integration. So, it enjoys higher share of the industry profit pool compared to its peers. More importantly, it is better equipped to withstand downturns.

How this stacks up on our Workouts Checklist:

- The business has earned an average return on equity of 20% plus over the last 10 years with debt reducing consistently over the last five years. Margins and return on capital employed have moved in a narrow band and the sector is not as cyclical as it is perceived to be.
- We invested with a time frame of ~24 months as the tight supply market was likely to continue in the industry. We will end up paying long term capital gain tax on this company.
- The company is demerging its two segments. The underperforming smaller textile segment will be separated out of into a new entity giving shareholders choice to invest in two pure play companies.
- With the above positives in mind, the risk can be controlled by sizing it appropriately in the portfolio. We invested ~4% of the fund in this company. Our entry valuation was P/E of 6x on average historical earnings (not projected earnings). Various scenarios involving a decline in earnings and a multiple contraction from already undemanding valuation would have meant a bear case scenario of 25% loss on this idea, translating into a 1% hit to the overall portfolio in event of the thesis failing.

The stock has appreciated meaningfully by ~70% within this short period of time. To put this in context, this is despite the headwinds that the sector faced during this phase. Most of the chemical and specialty chemical companies have declined by 20-40% during the last year. By surviving this phase and delivering appreciable returns, the trade has done its job in the portfolio. We will continue to have a few such workouts in the portfolio till the time we find our way out of this liquid oxygen state.

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