

Dear Investors and Partners,

Wish you a happy and prosperous new year, and hope you and your families are in good health.

The past six months have been dominated by headlines surrounding trade deals, tariff threats, and geopolitical tensions. It has been a period of heightened uncertainty that has persisted longer than we initially anticipated. The geopolitical sabre-rattling has not just been noise; it has had a tangible impact on sentiment and flows, testing the patience of anyone holding assets in the crosshairs. While we maintain that long-term business fundamentals eventually outweigh macro headlines, this cycle created a period of uncertainty. As we will discuss in the portfolio section, we used this extended period of dampened sentiment to make a few changes to our holdings, adding a few high-conviction names at attractive valuations, using the uncertainty as our entry window.

However, while the market obsessively tracks the *demand* destruction that might come from trade wars, we believe a more critical structural shift—one that could impact the intrinsic value of our portfolio in a meaningful way—is unfolding on the *supply* side, quietly, in China.

It revolves around a concept that has recently migrated from sociology textbooks to economic policy in Beijing: **“Neijuan” (Involution)**.

For the uninitiated, *Neijuan* describes a process of intense internal competition that yields no actual progress. A research note I read recently offered the perfect analogy: imagine a crowded movie theater. If one person in the front row stands up to get a better view, the people behind him must stand up too. Eventually, everyone is standing, uncomfortable and exhausted, yet no one is seeing the screen any better than when they were sitting.

For the last few years, the Chinese industry has been *standing up*. Encouraged by a growth-at-all-costs mandate, sectors ranging from batteries to chemicals have expanded capacity recklessly—far more than demand can absorb. The result was a race to the bottom—selling goods below cost just to maintain cash flow. It was deflationary for the world, but destructive for the capital invested.

In July, the tone in Beijing shifted. The leadership explicitly declared a drive for **“Anti-Involution”**. The mandate is shifting from “produce more” to “produce profitably”. They are looking to stop the price wars, force the exit of obsolete capacity, and prioritize quality over chaotic expansion.

You might recall our discussions on Edward Chancellor’s book, **“Capital Returns”**. The central thesis is that we often spend too much time analyzing demand (which is volatile) and too little time analyzing supply (which is structural). In asset-heavy industries, *supply* is destiny. We saw this in 2016 when China undertook Supply Side Reforms in coal and steel. Companies in those sectors eventually saw profits recover, not because the world suddenly needed more steel, but because the market stopped drowning in it.

It is worth noting, however, that policy announcements often lead actual execution by a frustrating margin. The table below highlights how this played out during the last major cycle:

Phase	The "Signal" (Policy Announcement)	The "Noise" vs. Reality (Implementation)
2014 – Mid 2015 <i>(The False Start)</i>	State Council proposed to "control total coal consumption" and improve energy structure.	Limited Implementation. Local governments largely ignored mandates to protect jobs. Capacity utilization kept falling, bringing sectors to the brink of losses.
Late 2015 <i>(The Pivot)</i>	"Supply-side structural reform" officially introduced. RMB 100bn special subsidy fund established to handle layoffs.	Financial Commitment. The central government put real money on the table to absorb the social cost of closures, signaling a shift from rhetoric to action.
2016 <i>(The Hammer)</i>	Strict "276-workday production limit" introduced for coal mines; specific capacity reduction targets defined for steel.	Aggressive Enforcement. Supply actually exited the market. Margins and stock prices re-rated significantly as the market finally believed the "put" was real.

This brings us to our exposure in **chemicals and agrochemicals**. These positions have faced headwinds as competitors flooded the global market, which was partly the reason for investing in that space. We are not betting on a sudden global consumption boom, nor do we claim to have timed this policy shift perfectly. Rather, our thesis is simply based on the inevitable return of supply-side rationality. If the "Anti-Involution" policy gains traction—and early signs in some of the sub-sectors suggest it might—a structural floor could be placed under global prices.

There is a rich irony here. While Western governments build tariff walls to stop cheap Chinese goods, the Chinese government might solve the problem for them, simply because the economics of "involution" have led to a dead end. We are watching closely to see how this plays out.

Portfolio Update

As part of our effort to not overstay a cyclical advantage, we reduced our disproportionate exposure in select chemical names. These positions, anchored in the anticipation of global supply chain recalibration, delivered strong results. Rotating out of these positions allows us to lock in gains and redeploy capital where the risk-reward skew is currently more favorable.

This disciplined pruning allowed us to utilize the market's generalized macro fear—the very trade friction discussed earlier - to build three new high-conviction positions. While belonging to distinct industries, the underlying logic was identical. We targeted businesses that sit on the upper end of the 'good to great' spectrum, with a robust execution track record spanning more than a decade. Crucially, their stock prices corrected by anywhere from 30% to 40% from their highs.

In each case, a single-digit percentage negative impact from tariffs or related macro anxieties was amplified by a few, often transitory, company-specific issues. This cocktail of temporary bad news created a pricing opportunity. Our underwriting math is simple: should the tariff issues resolve quickly, these names are poised to deliver disproportionate short-term returns. More importantly, even if the macro environment persists, our investment is backstopped by the inherent quality of a well-managed, growing business. We are, essentially, buying good businesses at bargain prices driven by external fear.

We have also planted seeds in the consumer space, making small allocations to a few select names. While these currently represent a minor portion of the overall pie, we view them as long-term compounders and intend to increase our sizing as and when we see the release of capital from our more mature positions.

Beyond these tactical deployments, we are observing encouraging trends in the financial space. Mid-sized banks and select NBFCs continue to see steady fundamental performance and, crucially, active interest from Foreign Direct Investment (FDI). This external validation of the improving health and governance within the Indian financial system is a long-term positive. Finally, while the mid and large-cap segments have seen momentum, we continue to see a profound divergence in the small-cap space. Fundamentals for many good quality small businesses remain steady and often improving, yet their stock performance has lagged significantly. We view this as a healthy opportunity for patient, bottom-up stock picking.

To illustrate our approach to finding value in boring places, we want to discuss a long-standing holding that quietly operates as the invisible infrastructure of the Indian economy. It is not an AI play, nor is it a beneficiary of a sudden consumption boom. It is a business of boots on the ground.

The company is the undisputed leader in essential business services, operating across three key verticals:

- **Security Solutions:** Providing manned guarding and electronic security to thousands of sites across India and internationally (Australia/Singapore). It is the largest private employer in the sector.
- **Cash Logistics:** Managing the secure transit of cash for banks and ATMs. If you see an armored cash van on the road, there is a high probability it is theirs.
- **Facility Management:** Offering hygiene, cleaning, and maintenance services, a segment that has seen structural tailwinds post-pandemic.

While it is often seen as a low-margin staffing company, we see a business with deep moats built on scale, network density and trust. To understand why we own it, one must stop viewing it as a "manpower contractor" and start viewing it through a different lens entirely.

Industry Landscape: Security Services as a Manpower Asset Manager

At first glance, this business can look like low-margin staffing. But in practice, the leading organized players behave more like “asset managers” of a different kind—managing a large, distributed workforce where trust, training, compliance, and execution matter far more than headline pricing.

Much like AMC businesses, security services are steady, repeat-driven, and operationally intensive. The customer is outsourcing peace of mind, not just manpower. That makes the business less discretionary than it appears, and the relationship stickier once you’re embedded. Attrition tends to be low, scale matters, and working capital discipline becomes a real competitive advantage. The parallels aren’t perfect, but it helps highlight why the category is often misclassified.

Metric	Asset Management Industry	Security Services Industry
Primary Revenue Driver	% of Assets Under Management	% of Wage Bill (Headcount x Wages)
Inflation Hedge	Yes. As asset prices rise (equity/debt), AUM fees rise naturally without volume growth.	Yes. As wage inflation occurs (gov-mandated or market-driven), the "billable asset base" increases automatically.
Market Structure	Oligopolistic (Top 7-8 players control majority)	Oligopolistic at the top, but with a massive unorganized tail. Unorganized players are rapidly losing viability due to compliance costs.
Penetration & Runway	Low penetration of financial products; long runway for financialization.	Severely under-penetrated. India has one of the world's lowest police-to-citizen ratios, creating a structural, long-term need for private security.
Client Concentration	Fragmented (Retail) to Concentrated (Institutional). High bargaining power for large institutions.	Fragmented but sticky. SME and B2B customer base provides better bargaining power for security firms. Switching costs are high due to trust factors.
Return Profile (ROE)	High (20-30%) due to low capital intensity.	Moderate to High (15-20%). While working capital is higher (pay-and-collect), return on capital improves significantly with scale and route density.
Stability of Returns	Cyclical. Revenues dip significantly during bear markets or recessions.	Recession Resistant. Security is a non-discretionary expense. Revenue and PAT increased in FY20 and FY21 (the worst of Covid)
Valuation (P/E)	30x - 40x	14x - 17x

Despite these similarities, the valuation gap is striking. Leading asset managers often trade at 30x+ P/E, while the market leader in security services trades at roughly half that. And importantly, the security business is often more recession-resistant—unlike financial assets, the need for physical security doesn't disappear when the Nifty corrects 20%.

The Catalyst: A Structural Shift via New Labour Codes

The investment case for the organized security sector has recently received a meaningful regulatory tailwind. The operationalization of the four new Labour Codes could prove to be a watershed moment, accelerating consolidation away from the unorganized security agencies.

1. **Universal Minimum Wage & Floor Wage:** The new Code on Wages universalizes minimum wages across sectors and introduces a statutory "Floor Wage". Previously, unorganized players thrived on wage arbitrage—paying guards below statutory limits to undercut organized players by 20–25%. This arbitrage should now reduce materially. When every player must pay a similar floor wage, the client's decision shifts from "who is cheapest?" to "who provides better service and compliance?", directly benefiting market leaders.
2. **Mandatory Formalization:** The codes mandate appointment letters for all workers and broaden social security coverage (ESIC/PF), including for gig and contract workers. This pulls a larger share of the unorganized ecosystem into the compliance net. The incremental cost of compliance may weaken already thin business models, pushing market share toward scaled, compliant aggregators who already have these systems in place.
3. **Pricing Power & Revenue Uplift:** Since the revenue of security firms is typically linked to the wage bill (Cost + Mark-up model), any government-led increase in floor wages should translate into a higher top line (assuming mark-ups remain steady).
4. **Decriminalization & Ease of Doing Business:** For large, compliant players, the codes consolidate multiple labour laws into four, reducing complexity across states and enabling smoother pan-India scaling.

The point of the comparison is not to force an analogy—it's to highlight that the business is frequently valued like commoditised labour, even though outcomes are driven by execution, compliance, and client trust. As the industry consolidates and regulations tighten, we believe this gap between perception and reality should narrow over time.

I want to indulge in a bit of nostalgia. For those of us who grew up with the original Star Trek, the dynamic on the bridge of the USS Enterprise was often defined by two polarizing figures: Dr. McCoy and Mr. Spock. McCoy was the heart—passionate, emotional, and irrepressibly human. Spock was the mind—logical, cold, and calculating.

In "The Little Book of Behavioral Investing", James Montier uses this duo to explain the mind's two operating modes. For the academically inclined, it maps neatly to "System 1" (Fast) and "System 2" (Slow)—made famous by Daniel Kahneman in *Thinking, Fast and Slow*. But if I'm being honest, Montier's "McCoy vs. Spock" framing is far more colorful, intuitive, and memorable than Kahneman's numbered systems.

Montier argues that as investors, we are engaged in a constant internal struggle. The “McCoy” system is our default setting—the emotional brain that evolved to keep us alive on the savannah, the part that screams “Run!” when it sees a lion (or a falling stock chart). It is fast and effortless, and very useful for survival. Unfortunately, it is often wrong in messy, probabilistic financial markets.

The “Spock” system, on the other hand, is logical and deductive. It can process complex data—like supply-side reforms in China or valuation gaps in security services—but it is slower and requires deliberate effort to engage.

The problem, as Montier points out, is that we all think we are Spock, but under pressure we default to McCoy. When headlines scream about trade wars, it is McCoy who wants to sell everything and hide in a bunker. It takes deliberate (and sometimes exhausting) effort to summon Spock, look at the data, and ask whether the noise is actually creating opportunity.

This little book is a fantastic, quick read that serves as a mirror. It forces you to ask: Who, inside you, is currently driving you?

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, Matterhorn India Fund, Matterhorn Capital Trust, or Knightstone Capital Management 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.