19 September 2023

Dear Partners:

Subject: Is it different this time?

Like most valuation conscious investors at present, we too are grappling to deploy capital at acceptable valuations. In many new accounts opened since January 2023, we continue to hold 20%+ uninvested cash. While we are not accepting capital from new partners at present[1], if we did, we would be able to deploy only ~40% in Week 1, most of it in Large Caps.

Our uninvested cash prompted a partner to ask us recently whether we are missing "something". Sentiment for India is very positive. There is a wall of FII money waiting to enter India. SIP flows continue to be strong. Hence can't valuation multiples continue to climb higher? Is it different this time?

Its not different this time, just the behavioural cycle at play in Small caps and select sectors. However, some nuance is required on ascertaining fair value. One should be willing to pay a "small" premium for "certain" companies at present. But for most companies in the market, one should not break valuation discipline and wait out the euphoria.

Why is it not different this time?
If one believes higher valuations vs earlier are justified, the argument is essentially that:

a) Earnings growth rates for Indian companies will be structurally higher this decade.
b) Structurally, FCF generation or ROCE/ROE will be higher.
c) Discount rates for Equities should reduce as lower risk premiums are justified.

There is no doubt that India stands out from most large economies at present on growth prospects, resilience of growth and Debt burden. There are many new investment themes: "+1" giving a boost to exports, massive thrust on defense and infrastructure creation, green energy etc. Rising per capita incomes should also result in a "J" curve impact on consumption as a larger share of income goes into discretionary consumption.

We believe the strong narrative will not translate into an across-the-board step change in Earnings growth for India but will be restricted to select pockets.

- The "+1" boost is structural only in product categories which are strategic to customers. A delay in a product launch in an IP protected product can result in Billions of lost Revenues. Hence, buyers will want to lock in secure suppliers from another geography. Examples innovator supply chains in Pharma, Agro chemicals. For products that are commodity and quality is not a huge differentiator, multiple vendors can be used. Buyers will be tactical and will continue to buy from the cheapest source, including China. Examples, Toys, Generics in Pharma and Agro Chemicals.
- The "J" curve effect in consumption should result in an increase in market size but may not result in a faster growth in company profits. A larger market attracts new entrants. If a category is well penetrated, new entrants do not expand the market size, but rather take market share from existing players. Hence, the profit growth trajectory of incumbents in an oligopolistic industry structures may not increase. Good examples at present are the Fast-Moving Electrical Goods category where players dominant in 1 or 2 categories are trying to enter other

[1] We are making exceptions where partners are agreeing to a staggered draw down plan.

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categories, Paints (Grasim, JSW) or Mutual Funds (Jio Blackrock, Zerodha, multiple other players). And at 60+ PE ratios, the expectations of an Earnings boost from the "J' curve are already in the price leaving only room for disappointment.
- The feel-good factor in the economy is only in select pockets. While Capital goods companies have rallied significantly, Banks are still not seeing a large pick up in Corporate Capex.

Many companies benefitting from Govt Capex will benefit from higher growth, but it is unclear whether they will migrate to higher ROE businesses over time.

- What matters for value creation is not only growth, but growth with ROE > Cost of Equity. The faster you grow but at ROE less than 12%[2], the more value you destroy.
- For example, most Railway Wagon suppliers have seen their stocks rallying significantly over the last 6 months. However, their average ROE in the in the last decade would be <5%. "If this time is different", it assumes the Working Capital cycle for this sector will shrink considerably and sustainably allowing ROEs to expand. It could well happen – but would this be a base case assumption to support a 3x valuation re-rating?

<u>No rational reason for Investors to reduce discount rates.</u>

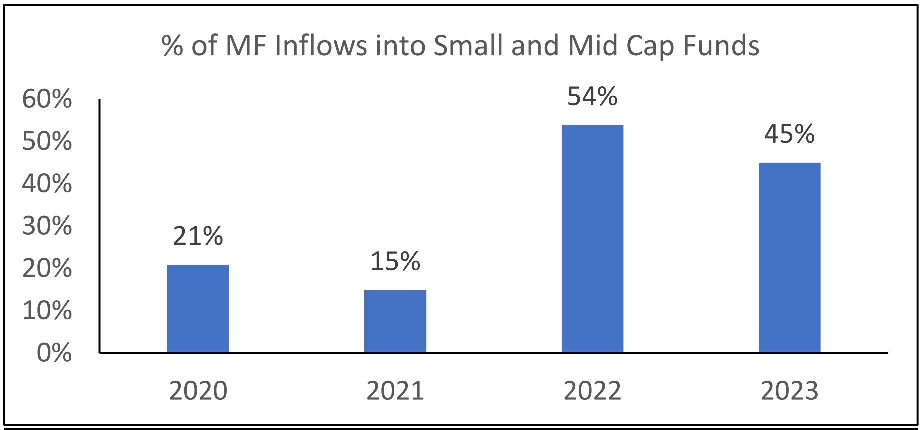
Discount rates are proxies to the opportunity cost of capital, the starting point of which is the long-term risk-free rate (i.e. 10-year G-Sec). One cannot make the case today that long term G Sec rates in India will be structurally lower than where they are today. Governments all over the world are running out of real money as they are struggling to balance budgets as they fund ageing infrastructure upgrades, higher defense spending, transition to clean energy and pensions due to demographics. What is clear they cannot print money any more due to inflation. The 10 Yr. US Secs are at a 30 year high. In India too, some state Governments, are resorting to populism. The yield curve slid downwards during Covid but is now back to where India's long-term rates are.

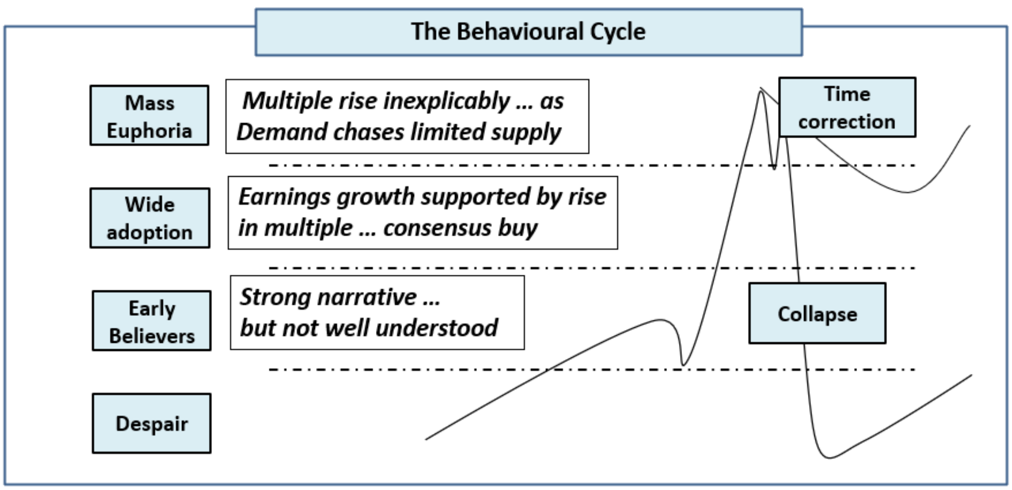
We buy businesses primarily with an ownership mindset. The promoters we invest in look for 3-5 year pay-backs on their capital investment or 18+% ROE. We don't want them to dilute their return expectations or hurdle rates. Hence, why should the long-term risk premium for owning Equities decline for an investor? Indian indices have delivered 11-12% returns over long periods of time. An active manager should not be using lower discount rates than historical Index returns to justify higher PE ratios.

[2] We use 12% as Cost of Equity in India reflecting 7-7.5% as long-term G Secs and 4.5-5% as risk premium for owning Equities. This is also the median return earned by investing in Indian equities over long periods of time.

So what is happening?

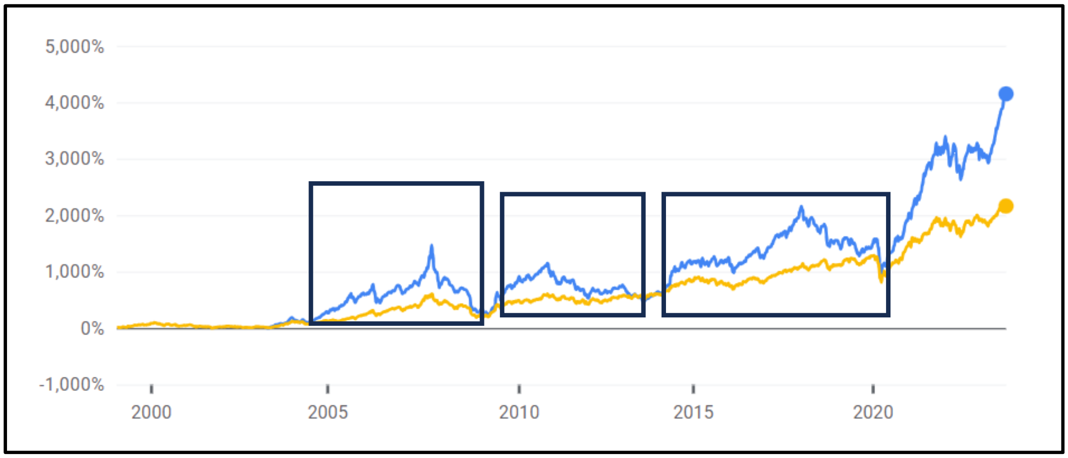
It is not different this time. Rather, money is gushing into Small and Mid-Caps[3] and mostly in sectors that will benefit from Govt Cap ex. In the last 6 months, the BSE Small Cap Index is up ~40% vs ~ 18% for the NIFTY 50. At the same time, the NIFTY 250 Microcap Index is up ~55%.





One cannot escape cycles. As one can see from the graph below, the BSE Small cap returns (blue line) tend to converge with the NIFTY (yellow line) over time. We are closer to the peak of the Behavioural cycle in Small Caps, but we cannot say for sure how much further prices can extend before the cycle turns as the downturn is typically basis a trigger that one cannot see ahead of time. However, the cycle always turns. Exclusively small cap portfolios face a reckoning when the cycle turns because the poor business model resilience of many Small Caps gets exposed and investors rush to a small exit simultaneously. One can see the steep drawdowns that occurred historically (blue line).

[3] Data in chart below sourced from AMFI. Calendar years. 2023 is from January – July



Actionable Implications – nuance and patience

Some Fund Managers are gating flows into Small and Mid-Cap funds. Being cautious is fairly consensus now. At the same time, there is a wall of money waiting to be deployed in corrections. Solidarity too has significant undrawn commitments. Broad markets do not correct steeply when the overwhelming sentiment is cautious. Hence, one must participate where one spots value.

Fair value depends on multiple variables, including soft variables such as sentiment. Hence, fair value is a range rather than a precise number. Knowing what end of the range to apply to a business requires nuance and judgement – of the environment, business, promoter, and specific situation. We are willing to pay a "small" premium for select companies at present.

- Leaders with dominance and longevity of growth.
- Those with asymmetric return options, 18%+ ROCE, and where we believe management teams have exercised significant judgement as they have built the business, and where the liquidity is poor vs the quantum we want to buy. If we see an opportunity for 8-10x returns over 10 years, one should be willing to pay ~15% higher than the preferred price as fair value is a range. And reduce position size a bit to be able to add on declines.

However, for most companies we would like to own, we prefer waiting for better entry points. Very few companies will deliver Asymmetric outcomes and valuations eventually mean revert to fair value. While sitting on cash feels uncomfortable in a rising market, "the rewards go to those who patiently stay rational in an irrational market"[4].

With our best wishes,

Manish Gupta (CIO)
Manjeet Buaria (Partner)
Anirudh Shetty (Senior Principal)
Pratik Jain (Senior Analyst)
Aman Thadani (Senior Analyst)

[4] Naren Sankaran, ICICI Mutual Fund

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