Disclaimer :- This was originally published on 3rd October 2020 and is part of our Q2FY21 letter. Link to the letter here

Our "Exit" process and rationale underlying actions taken in the portfolio

Unlike a MF which can churn with low consequences, every sell decision creates a tax incidence on partners. Hence, the decision needs to be carefully thought about.

We make 4 types of "sell" decisions

a) When we have made a mistake, or facts change and the thesis is no longer valid.
b) When we act purely from a risk management perspective.
c) When companies in "Special Situations" reach their price target. The above are easy to make.

The tricky decision is when companies in our core bucket ("Clear and Emerging Leaders") have good growth prospects, are performing well but are trading at euphoric valuations. We have paid the price of not selling when valuations were euphoric in the past and hence introspected significantly on designing a process we will consistently follow.

While there are a lot of books written on buying right, conventional investment wisdom does not offer clear guidance when it comes to selling. While many fund managers claim that their "biggest mistakes are selling winners too early", this view suffers from "survivorship bias" of winners. We believe lessons from history – to glean learnings on what can be a good process - should be examined at a portfolio level - and not an individual company level to separate good process from luck.

A few examples below highlight the survivorship bias mentioned above. For example, measured over last 5 years:

- Investors who held on to some good but richly valued businesses like Blue Dart, Page Industries, Eicher Motors, Cera or Symphony when valuations were euphoric would be nursing very sub-par returns.
- However, those who stayed invested in Bajaj Finance made significant returns.

Company	Trailing valuation on 30 September 2015	Subsequent 5 year IRR (excluding dividends)	Max. draw down from the peak price in subsequent 5 yrs.
Blue Dart	~110x	-16%	~75%
Page Industries	~69x	10%	~48%
Eicher Motors	~61x	4%	~60%
Cera Sanitary ware	~37x	3%	~41%
Symphony	~52x	1%	~62%
Bajaj Finance	~5x	45%	~61%

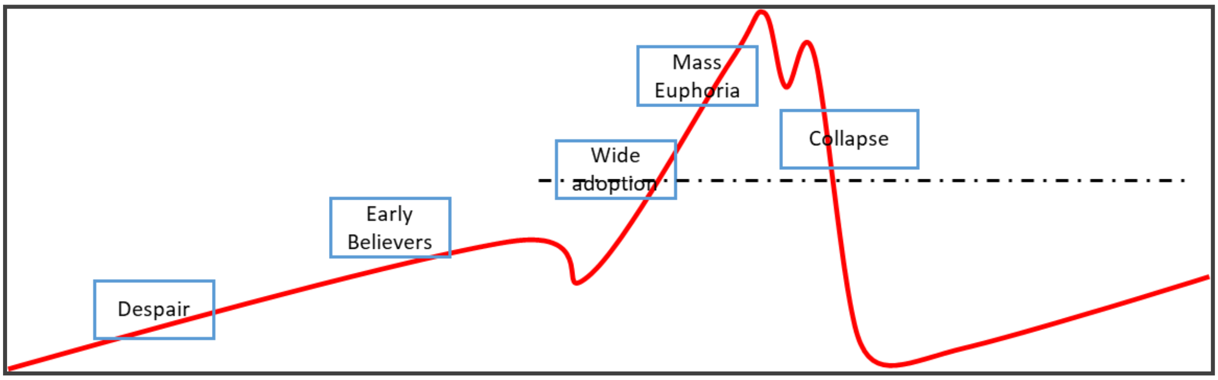
Source: Ace Equity; trailing valuation is PE ratio for all companies except Bajaj Finance for which PB ratio is used

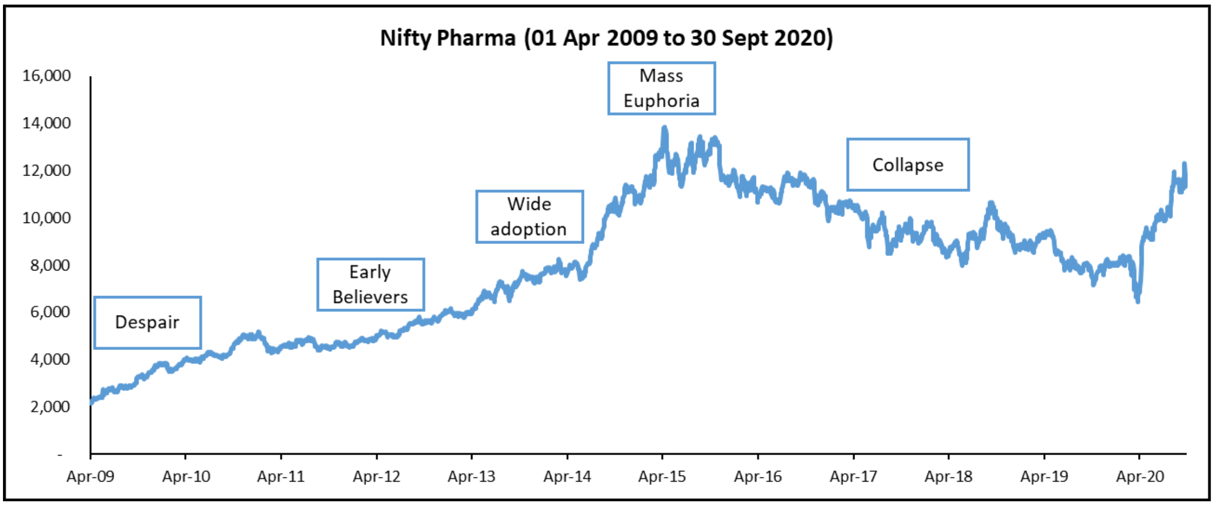
Our approach to selling is based on the following beliefs

- Portfolio choices need to be aligned with investor time horizons. For Solidarity, an investment should justify its place in the portfolio based on return prospects over every <u>incremental</u> 5- year periods. Someone taking a decadal perspective may act differently and not be wrong.

- The future is probabilistic. Every business is exposed to random events outside its control. Hence, the concept of "margin of safety" should apply not just during entry but at all times.
- A sound investing approach will also take into account human behaviour. It is very hard to hold on to an investment when confronted with large draw downs, especially when managing other's savings. Theory often does not work while confronting real world situations.
- We need to recognize the role of cycles in portfolio actions. Capital tends to chase a sector with earnings momentum. That results in valuation excesses till a trigger point causes stock prices to correct dramatically. This cycle is illustrated below with what happened in the Pharma sector between 2012- 2020. The same story played out in NBFCs (2015-2018).

Hence, we believe it is appropriate to gradually reduce positions when valuations are euphoric:





Our process for exit (and entry) decisions is as follows.

- We estimate a range of stock price IRRs over a rolling 5-year basis based on what rate we think earnings/cash flow/book value can broadly grow, and what fair range of multiples a stock should trade at the end of 5 years.
- We determine fair value multiples based on first principles (growth, longevity, ROE). We make some adjustments based on long term valuation bands (wisdom of crowds) and if we believe a stock deserves a premium due to a justified halo effect (quality of governance, past execution record).
- When rolling 5-year IRRs start dropping below our thresholds in bull case scenarios and the position weight is very high, we start to trim the position. We will trim more aggressively

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in “Emerging Leaders” (as liquidity evaporates during a crisis) and more gradually in “Clear Leaders”.
- All assumptions on earnings and fair valuation multiples are debated and updated periodically as we learn more about the company through interactions with management and quarterly updates.

The challenge in this approach is determining what defines “euphoric” valuations when a sector has earnings momentum. The argument can become circular because fair valuations are a function of growth and its longevity (terminal value), which are always an estimate.
- In certain sectors like Banking, this is not very difficult to answer as companies have stayed within historical valuation bands and growth rates/ROEs tend to remain range bound. Similarly, in manufacturing, growth is unlikely to surprise significantly because capacity acts as a constraint on growth.
- However, in sectors like Digital, longevity of growth is hard to estimate. Digital tends to be high free cash flow, has no capacity constraints and is “winner takes all” with leaders often having very dominant market share. This means companies have enormous pricing power and hence Earnings growth can significantly surprise on the upside through both volume growth and margins. For example, India Mart has an EBITDA margin of ~26% while Info Edge’s Naukri division is at ~56%. The ability to use free cash flow to enter adjacencies means one could be very conservative in assumption of terminal value. Info Edge has used the cash flow from Naukri to build new verticals in Real Estate, Matrimonial services and also via significant minority stakes in business models of the future like Zomato and Policy Bazaar. One could not have forecast all the above if one was modelling Info Edge a decade ago. Hence, there is always some judgement based on qualitative aspects.

Why trim and not sell out of a position completely?
- The market has moods of euphoria and despair. Just because a stock is expensive, it does not mean it will correct tomorrow. Stock prices can remain elevated for significant periods as long as the earnings momentum lasts. Selling too early could leave significant gains on the table.
- The table below illustrates how stock prices can continue to rally ~200-300% from expensive to euphoric valuations before they eventually correct.

Company	Trailing PE on 30 Sept. 2015	Price on 30 Sept. 2015	Highest price over next 5 yrs.	Max. upside from price on 30 Sept. 2015
Page	~69x	13,272	36,370	274%
Eicher	~61x	1,779	3,348	188%
Cera Sanitary ware	~37x	2,021	3,918	194%
Symphony	~52x	920	2,209	240%

Source: Ace Equity

- By gradually trimming over time, one also has the ability to re-examine assumptions as good companies can surprise on the upside. For example, Divi’s Labs delivered 50% PAT growth in Q1 of this year which was significantly above our estimates. Hence, one has an opportunity to recalibrate assumptions.

Why not stay invested and exit at first sign of disappointment?
- While theoretically elegant, practically this approach does not work. Firstly, one cannot conclude, for sure, whether the earnings disappointment is temporary based on macro

events, competitive behaviour or reflects a more fundamental challenge to the business.

- Participants with a short-term outlook sell aggressively at the first sign of earnings disappointment and stock prices can correct deeply – often on lower circuit- because this is the precise moment when liquidity becomes very thin because everyone rushes to the exit at the same time. And when stock prices have corrected 30-40%, the disappointment seems to be in the price and it makes no sense to exit if valuations have come in favour.

Our approach will never maximize gains on one position and will cause some regret of premature exit. However, when acted on methodically, it will provide a good balance of returns with downside protection at a portfolio level. We would like to caveat that our exit process will be a perennial "work in process". We will refine our approach over time based on our experiences and learnings of approaches used by other Fund Managers.