# Annual Letter to Stakeholders

2013-14

**Dear Investors,**

Indian capital markets ushers into interesting times marked by political upheaval in run up to general election of 2014. India will vote in April-May'14 and elect a new government. Investors, media and general population are forming their views and placing their bets. However, the worries of reversal of easy global monetary accommodation and slowdown of growth rates of GDP, have receded in short run before they resurface again.

We ended last year with a good note. Our performance is as below.

| Fund Performance | Vallum India Discovery | BSE S&P Mid Cap |
|---|---|---|
| 1 Year ( Year 2013-2014) | 55.7% | 15.3% |
| Since Inception (Oct 2011)* | 23.6% | 6.2% |

*returns over 1 year are annualised

Our strategy for stock selection and portfolio construction remains the same, I communicated to you last time we look for *investing in mid market companies or large-cap business turnarounds*. The rationale of this strategy is simple, the value of equity value is mispriced and also there is less competition from other capital allocators. Institutional Investors suffer from confirmation bias, while we have overcome over these years. We get adequately compensated for illiquidity and concentration of portfolio.

Like a *Zebra** yearning for grazing greener grass outside the herd, we invested in India's leading Microfinance Company. It has excellent value proposition for its customers but fraught with regulatory uncertainty. The stock tanked more than 45% in a week, post our initial purchase, without any corporate development. If life is counted by the moments which takes away your breath this was one for us. After hours, sanity of my colleagues prevailed, who looked at this business as a valuable franchise of distribution rather than just money lending. This over powered my negative emotions and we added more stock to portfolio at lower levels. It will be interesting to know that company is back in fashion with capital market participants and we have made more than 100 percent on our original investment. This reinforced our belief that investing is more of a behavioral science and our conviction will be put to test.

I reiterate my extreme bearishness on real estate prices in India (kindly refer to our newsletter: *Collapse of Real Estate Prices in India*, if you have missed reading it) and have resisted from investing in businesses dependent on real estate. If real estate prices do not correct as envisaged, India will face serious problem of competitiveness v/s other emerging and developed nations. We have already priced ourselves out in comparison to others. All the factors of production; Land (artificial high prices), Labour (NREGA problem has stopped the migration of labour and created artificial shortage in agriculture and manufacturing sector), cost of capital (persistent inflation due to various factors has kept domestic interest rate very high), entrepreneurship (crony capitalism has created an artificial barrier for new entrepreneurs to flourish in the country). In addition to these, Governance is an important corner stone for an enterprise to flourish and good governance is in short supply in private and public enterprise. The general state of governance has changed my view of investing dramatically over these years. The equity participants like us have to pay a substantial premium for better governed companies and traditional yard stick of value investing on basis of relative valuation does not hold good while investing in Indian markets. Many a times *"value trap is a governance trap."* The valuation difference between Public Sector Unit Banks (PSU Banks) v/s Private Sector Banks or NBFCs demonstrates the same. Our investments in one of the largest private sector lender is motivated by our learning that PSU Banks will struggle to shrug baggage of the last credit cycle for next 2-3 years and an efficiently run Private sector banks will outpace others lenders. (*Kindly refer to our previous newsletter: How making dividend compulsory will solve lot of corporate governance problem*)

Over the years, I have grappled with the complexity of understanding where does science end and art start in investment management. It is quite challenging to determine where these factors would trade-off in certain investments. We invested in a Non-Banking finance company, which is on cusp of positive change in the cost structure because of the market leadership it has attained in the niche segment. Our original thesis was of economies of scale leading to operating leverage, start of decline of interest rate cycle and enough incentive for the promoter to enhance its engagement with towards equity capital markets. Although, our trade is profitable but thesis has taken more time to play out. This year was also eventful with our very profitable investment in niche artificial leather business, which has paid handsome rewards to us. I am surprised by the management's measured pace of growth despite competitive advantage in garnering market share in the global markets. This taught us that while investing in middle markets companies, we are heavily buying into personality traits of the business leaders.

We pay our regular gratitude to a Pesticide Company which has exceeded our expectation, year after year. I see a similar spark and thought process to create superior ROCE in a Specialty Pharma company, in which we invested last year. It has helped me to reshape my broader thinking on how many years are required to be ahead of others to create a sustainable competitive advantage or moat in a business. The answer lies somewhere around a decade of head start in thought process, putting execution and another five years to gain scale, which finally results in superior ROCE for business. If you look around successful companies around you the all were ahead of others or the business model were unique by a decade.

Thereafter, the herd takes over the economic logic. The best example in recent time is of promoters queuing up to set up merchant power plant in 2007, struggling to lift the mess by 2014. Such events reinforce my strong thesis and belief of contradiction while investing. Our ability to see through regulatory framework was challenged this year when our investment in an Active Pharmaceutical Ingredient (API) company received US FDA violation notice. Although it had limited impact on portfolio but it has set my ears on regulatory risk on overseas markets.

The domestic economy is yet not out of woods and we have ushered into age of deleveraging by Indian corporates. This will ensure that investment cycle remains weak for some more time, even despite strong formation of government at the centre thereby limiting a broad markets rally as the Indian election exuberance ends. Hence, we are not buying deeply into cyclical recovery investment theme yet. However, there are lots of profits making opportunities in the market for zebras like us who wish to graze outside the herd and not afraid of eaten by predators. Investors have various aspirations like meeting their financial goals of retirement, children's education; children marriage etc. This gives us a framework to think long-term while investing act with responsibility for selection of good companies which will meet the same.

**Manish Bhandari**
April 2014
Manish.Bhandari@vallum.in

You can follow us on Facebook, Twitter, Linkedin, Blog - Valuenomics, for regular commentary and insight on economy and markets.

*Zebra in Lion country by Ralph Wanger