Annual Letter to Stakeholders

2015-2016

Dear Investors,

In the midst of challenging global economic environment, it was a difficult year for investors. The year was marked by the steep decline in oil prices, a downward adjustment in Chinese currency, fed lift off, failed monsoon in India and heavy bulwark by the government to put the economy back on track, but we ended last year on a satisfactory note. Our performance is as below:

Portfolio Performance	**Vallum India Discovery**	**BSE S&P Mid Cap**
1 Year (March Year 2015-16)	**26.7%**	**0.25%**
CAGR Since Incept. (Oct 11)	**40.6%**	**13.2%**

*returns of the model portfolio, return over 1 year are annualized; return for the individual investor will differ based on entry horizon and portfolio construction.

Our strategy for stock selection and portfolio construction remains the same - invest in mid-market companies or business turnarounds and make sizable bets. Our rationale is simple – these two pools attract fewer investors and equity value is mispriced. This adequately compensates us for illiquidity, volatility, and concentration risk. We diversify ourselves in 20-22 opportunities available across sectors, companies, usually an individual opportunity with sales of more than Rs 500 crs p.a. We have no threshold of market capitalization before making the investment and fewer is merrier for us. The key thing to differentiate or think about is *distinguishing between the fundamentals of the business and the expectations built into the price*. Those are two separate things. What we're looking for is not necessarily the best companies. We are looking for mispriced companies that meet our checklists. So, a distinction between expectations and fundamentals would be the root or core of the process. With some difficulties, we have overcome confirmation bias and are ready to be investors for one full business cycle. The primary objective of this annual letter is to discuss the results of our portfolio companies and our goal is to explain the long-term investment philosophy behind the selection process for the companies in our portfolio. Over the short term, the stock market can be irrational and unpredictable, however, over the long term, the market adequately reflects the intrinsic value of companies. If the stock selection process is sound and rational, investment returns will eventually follow. Through this letter, we aim to give you the information required to understand this process. You will hopefully notice we are transparent and comprehensive in our discussion.

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Our two-year-old investments in oncology focused pharmaceutical companies are progressing well. The company has recently received US FDA for API plant and is awaiting the nod for a formulation plant. The sales will kick off in the US markets once regulatory approval is received. The packaging company is expanding its franchise to newer areas like pesticides, industrial goods including the sensational FMCG launches of Ayurveda guru. The agrochemical company business witnessed slow down due to global weather-related issues leading to slow-moving products and a declining pipeline of inventory in the business. A better monsoon in India and favourable weather for agriculture is likely to change the future course. Our investment in the company engaged in the rice business is intact and the company is progressing well on product value migration. This year, earnings of value added steel company were positively impacted by renewed thrust on investment by railways. However, the general economic conditions were not very conducive and industrial activity was muted.

Last year, I wrote to you about our investment in home textile companies, which has benefited from long-term favourable structural changes in the global home textile market. The company has performed well much beyond our expectation and generated a superlative return in short investment horizon. We forecasted reasonable uptake in bed linen business, with improving financial position, but were surprised with high expanding margins. We underappreciated the role of room night sales progress of Air BNB. It sold approx 70 mn room nights in 2015 up from 12 mn room nights in 2012, a 5x increase and the positive impact it has created on global bed linen markets. The understanding of the convergence of technology and its impact on mainstream businesses will be a milestone in investing business for many of us. In my investing career of over 16 years, I have not seen an investment turning 11x, in 18-month holding period. Our internal risk management system has alluded us to pare our exposure and we deployed this money in other opportunities. This has also reminded me about the role of luck in investing. We follow the same process while investing in companies but the outcomes for a few can be very surprising.

Middle market investing is also fraught with higher investment risk. The risk of an unproven track record of promoter intent towards minority, shorter history of corporate governance, companies susceptible to business environment changes, technological changes, sometimes political alignment (specific to India) weak second line of management, small funnel of product dependence exists in some companies. We aim for companies that are less susceptible to this risk and are able to mitigate specific risks as they progress in their business. Let me also give you a glimpse of how we are navigating through these challenges. We have invested a lot of time in putting up together a process, a proprietary framework on stock selection over these years. *I also call this mental mapping.* This has two-fold benefits; bring more objectivity and contain our individual biases, ensuring that rigidity does not compromise our investing acumen. While investing, we navigate through these challenges, balancing risk and rewards based on our experience. Let me share with you how we had a tough time dealing with the unique situation of an investee company where its parent company had passed a resolution to sell a land parcel to its subsidiary, in which we are invested. This uncalled move was vehemently resisted by us during shareholding voting. Though our investment is not under threat, due to very strong underlying business, it has led to a bitter taste for us.

In the middle market or turnaround investing, investors must recognize they need to have long investment review horizon, not only the holding horizon. The mismatch between both has often led to the mediocre performance of investment managers. As we expand our investor base, we ensure that we have communicated this to each one of you in detail.

This year, Transformer businesses have attracted our attention. It neatly fits in our investment thesis of a damsel in distress. The excess capacity build over the last few years has resulted in the industry is barely generating a positive economic return, working at 50% utilization and 10-15% of peak EBDITA/unit. The seriousness of the government to turnaround the ailing power sector has the potential to change the fortune of this industry. We made three investments in chemicals sectors, one in fluorine chemistry, aspiring to be a leader in the world in its chosen field, the second in dyes and dyes intermediate business, and lastly in a company in amines business. The sector is also playing on the transition of China from investment to consumption-led economy, upsurge in labor wages and the fight against air & water pollution. Curbing pollution is irreversible and the cost of conducting business has increased for chemical companies operating out of China. For years, the basic chemical product prices have seen the price deflation due to oversupply from China. This will change with changing priorities of the nation and we feel our investee companies will be a beneficiary. Investors have a distaste for companies that have no strong brand, intellectual property rights or deals in commodity products and sometimes, they overpay for the aforementioned attributes. Our experience suggests that every business goes through a cycle and a careful analysis gives the opportunity to make superlative returns in some business cycles. The dye company was generating a reasonable return on equity in down cycle of the product prices when we invested. As I write to you, I gather that the product prices have shot up significantly on the back of stringent pollution control norms in China. One of the overlooked investing parameters has been less time devoted to the *supply side dynamic in the industry*. We have benefitted significantly on many occasions by studying supply side dynamics as much as demand projection.

During the year, we made our first investment in Auto ancillary business. The company makes gear shifters and a variety of other products. The business is well diversified across two wheelers to four wheelers and caters to a wide breadth of customers. The company has entered various joint ventures to improve product profile, up gradation and reasonably priced. Such companies have the capacity to lead the ever-changing technological need of customers. The second generation management is very impressive and has the capacity to create sustainable shareholder value over a period of time. Before closing, we have made an investment in consumer electrical solution company with a formidable brand in domestic markets and has also achieved a leadership position in the export of its products. I have even mentioned in my earlier notes that the industrial brands will become valuable over a period of time and we believe it is better to own an industrial brand v/s apparel brand, considering the valuation difference.

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As we discussed, last time, we have stayed away from public sector banks and this was the year of reckoning when the value trap played out. We do not foresee an immediate revival of the banking sector due to the shrinking requirement of capital (working and long term) by customers. Our diligent central bank ensures that monetary transmission is passed with no leakage due to banking inefficiency. Valuation of banking stock may see an occasional bounce but underlying business metrics and stress of real estate sector is yet to surface in the banking sector. The reoccurrence of the banking crises highlights the need for strong self-induced check & balances in institutional mechanisms. The solution lies in making the dividend compulsory, which would discourage overstatement of earnings, encouraging short selling in capital markets by promoting stock lending and borrowing mechanism, sound whistle blower policy, fixing the liability of rating agencies which are supposed to take *care* of investor interest not issuer and selection of auditors and independent directors by a lottery system. This will align the interests of a diverse set of participants, giving early warning signals to those concerned and strengthening capital markets.

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As we move towards completion of five years of existence of Vallum, myself and our team would like to express our deep gratitude for being partners with us in this blissful journey. It is imperative for us to not only select good companies for our portfolios but also to remain outstanding stewards of your capital. We remain very positive about good long-term prospects of our economy and would emphasise that investors should judge the process implemented by the current government to improve prospects of the economy rather outcome on their way, but not yet there.

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A note on Portfolio construction and Performance computation: Money Advised is on the basis of master model portfolio and sub portfolio within the same based on individual entry point. The return is not comparable with Mutual fund, as they follow master portfolio approach, with no segregation at the point of entry. The illustration of performance is of fully deployed portfolio, not of client weighted portfolio return as each will have variation in portfolio.