Annual Letter to Stakeholders

2016-2017

Dear Investors,

A lot of interesting events played out throughout the year 2016. Brexit in June, Trump as president of the USA and demonetization of high value currency in Nov. This provided fodder to various market commentators and in particular, to those so-called "perma-bears" who have for long; had a negative outlook on the market and termed any short-term drop as return of crises similar to the one in 2008. The interesting song lyrics "*Life is what happens to you while you're busy making other plans*" has a philosophical discourse which is quite similar to investing in some sense. The investment outcome depends upon future developments, which are fraught with uncertainty. In midst of this we present our performance for Year 2017.

Portfolio Performance	Vallum India Discovery	BSE S&P Mid Cap
FY 2012	**1.1%**	**3.8%**
FY 2013	**6.7%**	**-3.2%**
FY 2014	**55.5%**	**15.3%**
FY 2015	**113.7%**	**49.6%**
FY 2016	**26.8%**	**0.3%**
FY 2017	**51.4%**	**32.8%**
CAGR Since Incept. (Oct 11)	**42.5%**	**16.6%**

*returns of the model portfolio net of fees, investor will differ based on investment timings and series method their investments are bucketed. Client weighted return of 46.4% for FY2017.

Our strategy for stock selection and portfolio construction is to invest in mid-market companies or business turnarounds and make concentrated bets. We diversify ourselves in 23-24 opportunities available across sectors, companies, an individual opportunity with sales of more than Rs 500 crs p.a. Each bet is around 5% of portfolio value. Our rationale is simple – these two segment attract fewer investors, equity value is mispriced thereby offer better margin of saftey for our investments and adequately compensates us for illiquidity^, volatility, and concentration risk. Investors should have more than three years of review horizon for such kind of strategy. On weighted average basis, portfolio for current financial year has sales of Rs 3,000 cr, with trailing PAT growth of 20%, market cap of 6,000 cr with return on equity of 17%.

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Our key holdings, basmati rice leader has done much better than expected on all key metrics. The prices of paddy, raw material for basmati rice has swung from abysmally low level to far better remunerative prices for farmers over the last 18 months. The company has improved its brand positioning, retained market leadership, and launched a new high protein diet product for health conscious customers. We strongly believe the best is yet to come for this business and this represents one of the significant undervalued FMCG opportunity in your portfolio. Hanging around in investing for shade less than two decades has taught me ample lessons in this field, one of them is that successful investments passes thorough a litmus test, which has four corner stone, and is fusion of art and science of investments. Each investor has strength in some segment and investors who can fold all four corners together are rare. The first one is art of buying; buying an investment at bargain. Secondly, science of evaluation of business; Third is selling a position when irrationality sets in and the last but not the least, is about the sizing of the bet. The market cycle dictates which corner stone will have an edge in that cycle. If you step back and think about various peak and trough of market cycles since Year 1997, it will be easy for you to relate to these corner stone of investing.

Our key holdings in auto ancillary company, market leader in gear shifter has remained intact and has contributed to our financial well-being. The Oncology-led research pharmaceutical company, has received US FDA approval for commercial start of their formulation plant and rolled in two high potential acquisitions with itself. As an appreciation of their work in diversifying revenue from high-value addition products, I have thanked management of both the companies, on your behalf, in the last AGM. Our bet in transformer sector has not yet played out due to the slow pace of investment-led revival of business cycle led by state utilities. We are monitoring the situation, carefully. The business has cash and liquid investments equivalent to the market capitalization of the company. It has designed innovative product in electrical motor business and we have suggested them to get into smart meter business.

During the year, we have made investment in electrode business, market leader in India, a proxy to the recovery of steel manufacturing by Electric Arc Furnace (EAF) business, globally. The EAF has witnessed an onslaught of cheap steel making by Mini Blast Furnace (MBF) by china over the last one decade. We are witnessing capacity closure of MBF due to capacity realignment, stringent measure to control pollution, improving availability of scrap in China and rebuilding of the US infrastructure, going ahead. The supply side dynamics of electrodes has seen rationalization of mothballing of 10% of global capacity. Going ahead, we have improving pricing and volume on our side over the course of the next three years. This investment has neatly fitted in our contrarian bet with a business cycle recovery ahead.

We have made another investment during the course of the year in the leading battery producing company in India, a duopolistic industry. The change of guard in professional management with superior addressable market share gaining strategy in battery and among few with 100% ownership in growing insurance business has contributed in generating returns during the course of the years. The management will be firing from many cylinders; this company will see remarkable turnaround. We have made investment in one of the leading private sector bank, whose charismatic founder has been able to navigate the bank thorough most difficult times of the economy. The bank is a powerhouse in arranging the bouquet of a diversified financial product in front of customers; while gaining markets share. We have also refrained from investing in PSU banks till date. Our investment in a packaging supplier, a proxy play to chemical industry has paid good dividend during the course of the year. The company is upgrading its product profile towards superior, higher margin products with a duopoly situation in India.

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I must bring an interesting observation I have been having for some time to your notice. India is likely to witness shortage of quality investable companies in the future. The seeds were sown few years back with the scrapping of press note, allowance of 100% FDI in most of the sectors, buy back by listed MNCs and regulatory arbitrage available to do buy back rather than paying dividend. Moreover, in many cases Initial Public Offers are from companies that have been, private equity funded leaving less room for upside for secondary market players. All these factors are compounding the valuation for high quality companies to stratospheric height, leaving less room for error, if forecasted earnings are not met. Moreover, my observation is that in many areas, MNC with technological edge, global relationship, brand, superior business processes have an edge, emerging as leaders or have gained dominant markets share in respective field. Many such, not represented in the listed equity universe of India. The classic example is the compressor industry, where the world technological leader is not listed anymore. This sets us in dilemma of how to invest in an excellent business, which is not listed, or invest in a second rung, average business as proxy play. Therefore, relative value trade, pitting one company against another without a deep dig, is not going to yield sustainable return. Such scenario also reinforces, hold on to the good companies you have discovered rather attempting to find new gem.

Another investment opportunity, which found its way in our portfolio, is a company that is likely to be a serious challenger to lubricant industry leader. The company is growing 2x faster than industry growth rate on the back of superior distribution strategy, under penetrated product lines and highly motivated team. We also made investment in another auto ancillary company, which is at the forefront of making exhaust system for passenger car, commercial vehicle and non-auto component. It has invested substantial resources in addressing BS IV and BS VI opportunity while competing head-on with Multi National Companies with years of technological edge. The business of exhaust system offers a good long-term opportunity with high growth possibility as more vehicle platform adopts cost-effective, indigenous technology.

This also reminds me of sharing with you how fast the sources of alpha generation are waning away with each passing decade in our markets, and how we are challenged to find newer sources. The first decade of evolution of market Year 1992-2002 were dominated by insiders, assets managers flashing management access and making a living out of it. With no material detail available in Annual report to dissect for analysis by ordinary soul, and make an informed judgment on the business. This waned in the decade starting Year 2004-2014, with improving regulatory supervision, publishing of quarterly earnings coupled with superior disclosures in the annual reports. We should call this phase democratization of information. To stay afloat and succeed in investing, one is required to have a finer framework of business evaluation and solid framework of valuation. By avoiding turning points of real estate, infrastructure companies during turning point of Year 2008, and PSU banking sector in Year 2014, which did not require an insider’s edge, proved this hypothesis. The coming decade will demand deeper understanding of global macroeconomics coupled with superior skill of business evaluation due to disruption dots impacting literally every industry. My recent visit to Singularity conference has reinforced my belief.

The democratization of information will pose a serious challenge to money management business. Recently, my team brought to my notice that in the Dec 2016 quarter, there were more than 450 conference calls held by corporate bodies discussing quarterly results, with discussion note available while I remember less than 50 per quarter a decade ago. Institutional Investors with their superior management access will not offer any distinction in investment performance though may suffer from their herd behavior. Moreover, the possibility of Fox (Fund Manager, who has wider subject knowledge) and Hedge Hog (Analyst, who has deeper domain knowledge) dependent model is equally susceptible to suffer from advancement of technology in our business. The sorry state of mutual fund industry in the US is a prime example in front of us. In this backdrop, I foresee smart young brains yet unburdened by professional deformation pursuing an interest in equities investing. Having recognized the coming storm, we have started building the ark and our endeavor is to adjust the sail in the direction wind would blow.

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This year we made investment in pig iron and casting makers for tractors and commercial vehicle. However, the changing business dynamics of raw material forced us to sell our holding midyear, albeit at profit. We had no gumption to handle huge volatility of Raw Material and underlying earning risk in the portfolio. We are baffled at our misjudgment on business dynamics of the company.

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Our existence in corporate entity, as of today, represents more than 2000 days of continuously interacting with the market, accumulating experience, progressively learning from mistakes committed during this time. Literally, countless investment decisions and iterations, each of which brings feedback which can be used in future. We have expanded the family of our investors manifold this year. Unfortunately, I have not met many of you, personally. My colleagues may have come out with compelling reason why we should be your preferred advisors/managers however; I must say there are more reasons why you should not choose us over others. Even if I assume our investment, philosophy and observations are correct; this still does not guarantee a good investment outcome. We are not perfect machines without emotions; we are just ordinary people with all the usual human shortcomings. Chance can sometimes (and especially in shorter time horizons) produce results of almost any sort.

We acknowledge that Investor should also consider the fees charged by a comparable product like Mutual Fund (MF) operating in a similar category to make an informed judgment. We are comparable to a Mutual fund until a Compounded Annual Growth Rate (CAGR) of 16%-18% p.a is achieved for you, this has hurdle rate with high water mark, aligning our interest in a down turn. Let's take an example, If I were to regress the fee structure on 5 good mid cap mutual fund, a proxy of mid cap performance, which has been in existence since Year 2000 onwards, in 7 out of 17 years, we have charged less than a mutual fund. In years of outsize returns, generosity of investors will reward us. Mutual funds are also insulated from taxes on short-term trading undertaken by them.

Indian market is on a high-charge octane, gushed by domestic liquidity, driving financial migration in the financial products especially equities. The assets classes like real estate, gold, self financed small and medium businesses are witnessing diminishing return. In the last few years, equity return has been very encouraging; enticing many to knock the door of investing for the first time. All of us acknowledge that market price is slaves to earnings and return on capital employed, however, latter two don't gallop like former. *The relative undervaluation of cos. already been captured over the past four years, going forward, therefore, it is important for investors to have lower return expectations and hope for pleasant surprises, rather than get a shock later.* The government is very sincere in their efforts to put economy back on track and measure like direct benefit transfer, benefits of demonetization, GST, work in power; agriculture etc are quite laudable. The jobless growth is the missing piece of the great Indian economic story. The IT was the last organized industry that has created jobs for graduates. Parallels are astonishing; China has moved from Textile to Chemicals, Solar panel and Electric Vehicles, and now to Industrial Robots-Artificial Intelligence (AI). They are the largest market for and marker of Industrial robots, with 27% market share and recently acquired leading German robotic company, KUKA. Chinese researchers are accounting for 40% of all AI research papers in the world. In Year 2015-2020 five-year plan, Beijing plan to increase Research and Development investment to 2.50% of GDP from current level of 2.05%. It is unfathomable to think that we can lead the world with sewing garments and some chemistry skills while the world needs smart not extra pair of hands. The country needs to prioritize the direction of job creation, with utmost urgency.

I must share with you with the satisfaction that we have extensively written to the board of few portfolio companies as fiduciary on your behalf, with our suggestion and viewpoints on enhancing business value of the company. The response is not very encouraging but we will strive. After persuading for more than half a decade on making dividend compulsory, SEBI, directed top 500 companies to disclose dividend policy to its shareholders in June 2016. For us it was a battle won. Vallum team, look forward to meeting you during the course of the year and keeping you abreast with the progress of Vallum and your portfolios.

Manish Bhandari

April 2017
manish.bhandari@vallum.in

^illiquidity: Our 10 largest position makes around 50% of our portfolio weights. Assuming 25 positions with each position of Rs 25 cr comprises portfolio. Liquidation of 10% of portfolio at any given point of time can take 1-2 days.

A note on Portfolio construction and Performance computation: Money Advised is based on 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's weighted portfolio returns; each will have variations in the portfolio.