

# Annual Letter to Stakeholders

2017-18

Dear Investors,

The year under review will be remembered for implementation of the much-awaited tax reform of India, i.e. the Goods and Services Tax (GST), decline of the US Dollar, implementation of long term capital gains tax, political upheaval by rearranging alignments and the start of an era of de-globalization by the US towards the end of the year. The middle market companies thrive on certainty and the uncertainty caused during the last quarter led to huge volatility in the stock prices thereby impacting our short term performance. In midst of this we present our performance for Financial Year 2018:

| Portfolio Performance              | Vallum India Discovery | BSE S&P Midcap |
|------------------------------------|------------------------|----------------|
| <b>FY 2012</b>                     | <b>1.1%</b>            | <b>3.8%</b>    |
| <b>FY 2013</b>                     | <b>-0.4%</b>           | <b>-3.2%</b>   |
| <b>FY 2014</b>                     | <b>53.7%</b>           | <b>15.3%</b>   |
| <b>FY 2015</b>                     | <b>96.7%</b>           | <b>49.6%</b>   |
| <b>FY 2016</b>                     | <b>22.6%</b>           | <b>0.3%</b>    |
| <b>FY 2017</b>                     | <b>48.1%</b>           | <b>32.8%</b>   |
| <b>FY 2018</b>                     | <b>23.5%</b>           | <b>13.3%</b>   |
| <b>CAGR Since Incept. (Oct 11)</b> | <b>35.3%</b>           | <b>16.1%</b>   |

# All returns for this strategy since inception are restated this year to reflect client wt. return. (Computed by Time Weighted Return TWR method) net of fees expenses. Return of investor will differ based on investment timings and series method their investments are bucketed. Return for 2012 is for 5 months, only.

Our strategy is to diversify in 20-22 opportunities available across sectors with each bet constituting around 5-5.5% of the portfolio value. Our strategy for stock selection and portfolio construction is to invest in mid-market companies having a competitive advantage as well as industry turnarounds available to us at a fair business value. Our framework offers a margin of safety for our investments and adequately compensates us for any illiquidity, volatility and concentration risk. However, a wrong business judgment will still cost us dearly, which is discussed later in this report. Every human activity involves risk, and investing of course is no exception. We do not mind undertaking risks, but we want to have our clear definition of risk so that we can be compensated for it with sufficient reward.

As I have discussed in my previous letter, an investor should have a minimum review horizon of three years while investing in such a strategy. Such strategy requires investing and harvesting over one full business cycle.

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A brief review of our companies:

Let me abreast you with business results of our long-term investment with an auto ancillary company whose product basket has expanded significantly due to various strategic tie-ups with foreign collaborators. This will expand their margin, customer segment and reach. They have added few more products addressing transition of 2W/4W industry from current state to BS VI norms in India. There is an immense opportunity thrown in the aftermarket after Demonetization and Implementation of GST and the company has made a rapid stride in this direction. The market has finally recognized the strength of the business, its impeccable management bandwidth and its strategy to embrace the changing future landscape.

The Raichur based pharmaceutical company, where we have a long-term investment, faced business hurdles due to delay in receiving regulatory approval from the US FDA. Towards the end of the financial year, the company received the Establishment Inspection Report (EIR), a precursor to plant clearance from US FDA. We anticipate the launch of a key drug Imatinib, with a generic market size of \$350mn and other 3-4 key launches during the year. The company has a vantage, benefit of integrated manufacturing operations from API to Formulation, uncommon for the majority of its competitors in the US markets. The high standard of ethical conduct, commercial acumen and ability to balance risk-reward by the management is exemplary. We have used the weakness in the stock price as an opportunity to enhance our economic interest in the company.

The market leader in Basmati rice of India grew its profits due to the increase in sale of its branded products. This year also witnessed new products launches Quinoa, Chia Seeds, crude rice bran oil in the domestic and the international markets. Good quality basmati rice requires 18 months of aging of paddy or rice to improve its aroma. This requires huge investment in inventory and the company has necessary financial strength to achieve this. The enhanced business value did not get reflected in the stock performance of the company this year.

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After being in the business for around two decades, I have started enjoying the period of lull or inactivity in investing. You remember our sustained negative views on the business structure of PSU banks over the last five years. There are around 25-26 occasions when the PSU banking index has increased or decreased by at least 25%, in the course of a week. I must admit a decade back I could have fallen into the trap of hyperactivity, but as I reflect back, I am glad that I am aging, gracefully.

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The study of tail risks, the shift of terminal values are an important aspect of investing. A few days back it appeared to me that investors in Broking and Asset management businesses should carefully study the negative impact of Markets in Financial Instrument Directive (MIFID-II), implemented by the European Union. The regulation is very progressive and I would strongly advocate its implementation in the interest of all the investors in India.

India has made its decisive journey to digitize its various financial and other assets like stocks, bonds, insurance, educational certificates, etc. During the year, we found an opportunity to invest in a proxy play, on rising financialization of India, a depository business expanding its operations and gaining market share. The possibility of digitization of 400,000 private companies and One-Demat for all financial assets, once made mandatory, should open new business opportunities for the company.

The imperativeness to develop water, oil, and gas infrastructure has directed us to an interesting company which is manufacturing a wide range of Oil, Water, Gas pipes and Iron pellets. Iron pellets have witnessed a sustained demand from China. The pipeline business has a tailwind of infrastructure spending by the government and cash flow available from the business for deleveraging of the balance sheet.

During the year, two key investments were influenced by the opportunity addressing the expanding and improving the purchasing power of middle and rural India. Having seen career journey of my doctor father, general surgeon, I had a very strong appreciation of the value of trust in the medical profession. We invested in one of the most efficiently run organized hospital business of the country, run by owner-doctor, a role model for millions of Indians. Our study of hospital businesses in various countries, the post-implementation experience of national health policy did allude to the importance of possible future of value creation for the stakeholder by owning such business over next 5-10 years.

While researching the company, it struck me that India faces a trust deficit by business leaders thereby restricting entrepreneurs emerging as role models for the future generation, one of the conditions for the success of entrepreneurship in life of the nation. A generation has grown since the last set of role models appeared during IT boom during the Year 1995-2005 and very few outside the IT Industry.

Another noticeable investment has been Electrical and Steel tubes major with around US\$800 mn of revenue, having a very strong brand in the hinterland of India. The company has achieved a dominant market share in LED and steel tubes manufacturing. Our investment is influenced by the strength of brand which we understood by weeks of on-ground consumer research. The renewed focus to generate a better return on capital will lead to re-rating of the company.

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During last year, I did write to you about our investment in graphite electrode business, a strong proxy play on squeezed supply-side dynamics and cleaner China. What appeared as a mundane and non-descriptive business, turned out to be an extremely profitable opportunity for us. The earning expanded by 20 times in a span of one year. Such extreme nonlinearity is rare to come by in such a short run and reminds me that luck, apart from a sound framework and process, plays a vital role in outcomes. Such unprecedented price rise and over-optimism by market did warrant a partial sell trigger by us. The key reason is that business faces raw material constraint and holding of unprecedented prices is the key for sustainability of earnings.

The year under review would not be conclusive without discussing a business misjudgment on our part. We invested in India's foremost integrated and efficient sugar company, having economic interest in power and ethanol manufacturing. The company was trading at 40% less than its intrinsic worth. We anticipated tight sugar supply, tariffs to protect the domestic farmer from cheap imports, rising oil prices encouraging production of ethanol, and progressive policy to correct structural imbalances in the offing. The solid free cash flow would have offered safety of buyback by the company. However, the untimely spell of rain, in the last week of December 2017, in the state of Maharashtra (originally, a sugar deficit state), led to more than 50% increase in yield of cane thereby sending sugar production of India in surplus (by 5 MnT to 30 Mnt). Amidst, difficult business conditions the buyback price and quantum was reduced significantly, reducing the safety net for us. We are watching two key developments, the announcement from the government on subsidy for export to reduce the farmer distress and large-scale shift of sugar to ethanol in Brazil.

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This year equity market took a bit of a pause from relentless rise witnessed over the last few years. Rally of last few years, created a false impression in mind of investors that one can assume linear return each year from equities. Market returns are cyclical in nature, a period of lull returns succeed period of high return.

Let me also abreast you some of the headwinds faced by Indian equities. In many of my writings on the blog and ^public discussions. I have sounded a note of caution that Indian economic growth and its reflection in the stock markets is masked more by economic value shifts rather sustained value creation by the economy. The shift of value from PSU Bank to Private Sector Banks and NBFC, MTNL/BSNL to private telecom players, Air India to private aviation players, Railways to private logistic players, SME/MSME to large Industrial duopolies, etc. The market economics should have had addressed supply constraint in each industry.

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Secondly, over that last one and half decade, our country has become a sustained consumer rather the producer of technologies thereby leading to ever-increasing trade deficits. Such inefficiencies and inability to create cutting-edge businesses are reflected in the jobless growth of India. Thirdly, Indian equity market is facing a shortage of regular supply of high quality globally competitive businesses. On the domestic front, many MNCs are on the path to delist, and upcoming global businesses in India are held in the private domain. In many cases, MNCs operating in private domain are gaining market against much-listed entities. *The money is getting crowded into a fewer set of listed opportunities.* I should put this Ancillary Conundrum; where ancillary businesses have started trading at a huge premium as the main businesses are not listed. Let's take the example of Car or TV, Consumer durable business manufacturers. As many of them are not listed, a market participant is left with no choice to pay a huge premium to ancillary businesses. Lastly, the convergence of technologies like Artificial Intelligence, Gene Technology, 3D printing, Robotics, etc. with manufacturing and services have started invading traditional businesses. India has also missed the evolution of new edge technology and commercializing on a global scale. You all may be surprised to know that Softwear Automation Inc. has developed a robotic table which uses machine vision to adjust to fabric stretching. Assisted by this technological innovation, a Chinese apparel manufacturer has opened a factory in the US which will produce 23 mn T-shirts/p.a at a cost of Rs 25 per T-shirt. I would call this as the emergence of Made in the US by China. This indicates deflation of wages for many industries to come by. An estimate suggests that worldwide only 1600 out of 1.63 mn robots were engaged in textile and leather trade. This sends a shiver down my spine, when I think of the full-scale impact on emerging economies like India, in future. The challenges of rising Current account deficit leading to capital account imbalances also exist for India.

The above backdrop leads us to conclude that investors should brace for moderate returns from equities, lower than what has been achieved over the last few years. Vallum is confident that our investing framework is prepared for harnessing pockets of opportunities and this process will help us generate a superior return over our reference benchmark in the long run.

**Manish Bhandari and Vallum Team**

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^1) Blog on Value shift and why long term capital gains are coming (Date 31<sup>th</sup> Jan 2018). 2) Discussion on Morning Star forum on Role of Technology hosted by Mr. Ramesh Damani 2) A note on Portfolio construction and Performance computation: Money Advised is based on Time & Money Weighted Portfolios of all clients under advisory; based on inflows and outflows of funds throughout the year. The return is not comparable with Mutual fund, as they follow master portfolio approach, with no segregation at the point of entry. Return of investor will differ based on investment timings and the series under which their investments are bucketed.