Annual Letter to Stakeholders

2018-19

Dear Investors,

After six years of outperformance, the portfolio underperformed the indices in 2018-19. Periods of outperformance almost inevitably lead to periods of underperformance: this is a part of the long journey of wealth creation. The economic commentary on trade war between the US and China, slowdown of economic growth in India dominated the headlines. We have mixed feelings on this year results. As we take a look at our portfolio as a whole, the earnings of the companies we own have grown meaningfully (we expect them to grow further by 22%+ YoY in FY20). If we were a private equity fund evaluating our stocks using a pricing model based on their fundamental values, we would be reporting a healthy positive result.

Portfolio Performance#	Vallum India Discovery	BSE S&P Midcap
FY 2012	1.1%	3.8%
FY 2013	(0.4%)	(3.2%)
FY 2014	53.7%	15.3%
FY 2015	96.7%	49.6%
FY 2016	22.6%	0.3%
FY 2017	48.1%	32.8%
FY 2018	23.5%	13.3%
FY 2019	(8.4%)	(3.0%)
CAGR Since Incept. (Oct 11)	28.4%	13.4%

All returns for this strategy since inception are 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.

The divergence from the index can be traced to three key sources: First, the change in definition of Large, Mid and Small cap by regulators in Q1 of CY2018 - this led to a sharp selloff in small-cap shares by institutional investors (70% of our assets were in this segment); Secondly, operational challenges leading to underperformance of few portfolio companies' businesses and lastly, lack of investment in Information Technology sector (IT) which produced superlative returns during the last year. To highlight, around 78% of BSE Small cap scrips, 63% of BSE Midcap scrips and 43% of Sensex scrips ended in negative in 2018-19 and a significant concentration of capital happened in the few Financials, IT, Consumption oriented names.

Volatility in mid and small caps has historically caused many investors to leave equities as an asset class. However, volatility should not be confused with risk of principal loss by investors. We did a study of the volatility of Mid and Small cap scrips over the last 8 years. Ignoring the 100 largest companies, we reviewed the subsequent 400 companies (101-500) by size which corresponded to market cap range of Rs 1500-30,000 cr in India. Around 65% of these 400 companies had their High and Low prices vary by more than 40% each year. The increased transaction efficiency and near instantaneous access to information has dramatically changed how investors approach the market since 2007, just after the large-scale implementation of the Internet. But what has not changed is human nature.

We are glad to report that our low portfolio turnover ratio of 20-22% p.a, catapults us among top quartile in comparison to similar midmarket mutual funds. With less churn, this approach also reduces transaction costs meaningfully. Let me share same statistics: In a portfolio with 60% churn (average churn of mid-cap mutual funds), 20 bps broking cost pre GST and 30 bps of impact cost, and long term capital gain taxes, reduce the terminal value of the portfolio by 5.5 per cent over half a decade of investing. Portfolio churn should be one of the key criteria for you to evaluate before investing.

This year's stakeholder letter takes a deep dive on some of our portfolio companies.

Every investment has loss risk; you don't need to read even the offer document for knowing this. Indian investors experienced this after the IL&FS debt crisis. This episode raises serious questions on whether the regulator, credit rating agencies and the regulated entities were sharing their toothbrush and if their interests were aligned with depositors. The ripple effect of the liability shock exported by the IL&FS debt crisis has unnerved debt market investors and the contagion has spread to NBFCs, HFCs and leveraged promoters. The dislocation in debt markets exposed the asset-liability mismatch of many NBFCs. The headline news was dominated by a downturn in the business cycle, the shift of customer's market share to NBFCs, mounting Non-Performing Assets (NPAs), IBC resolution stuck in red-tape, resulting in a grim situation for corporate banks. Seizing this opportunity, Mutual funds were progressing to become lenders of last resort to all bankable customers over the last few years. The peak of pessimism was reflected in stock prices for corporate banks - ignoring their superior liability mix, and their technology-led retail franchises which were far superior to dozen of NBFCs put together. Our counter cyclical way of investing allowed us to approach investing in two of the foremost corporate banks in India. The liability shock turned the attention of the market to banks with Current/Savings Account (CASA) franchises, with decades of vintage in the industry. Meanwhile, the light at the end of tunnel was evident in terms of improvement in resolutions of bad accounts and upward slope of earnings. The cumulative slippages over FY14-19 stood at ~32% of the FY14 loan book, a year when asset quality problems started for banking sector, reflecting the magnitude of clean up undertaken by both these.

Here is a recap of how value migrated during the years 2014-19: PSU banks ceded their market share to the private sector at an unprecedented pace, there was a deep cyclical down-turn in corporate banks and a regular occurrence of controversy surrounding the key management personnel of corporate banks led to a lot of capital getting concentrated in few select retail focused private sector banks and NBFCs, giving the impression that banking is a duopoly market. Now, with the change of guard at these corporate banks and improving business cycle of corporate lending, we believe the real value of such franchises will emerge, rewarding shareholders.

During the course of the year, we made significant investments in a company which is a global leader in fluorine chemistry, having applications in refrigeration gases and the agrochemical industry. There is a considerable and structural shift of chemical business from China to India underway, concurrent with a revival in the global agrochemical cycle. We already had a foot in the door two years back, but liquidation by one of the market participants gave us a compelling opportunity. As we have maintained in our previous letters, a decade of deflation exported globally in chemicals products is now reversing due to regulatory changes by China. Indian companies with high competence in handling complex chemistry are emerging as major beneficiaries of this structural change. Simultaneously, the global agrochemical cycle has started witnessing a revival on the back on improving Agri-product prices and the end of the liquidation of finished product inventory in Latin American countries. The capital expenditure over the last few years in our company's chemical division had dragged returns in the past but will likely result in non-linear earnings over the next few years. The market leadership of the company in refrigeration gas used in air conditioning (AC) is a proxy consumable play on rising global temperature and sale of ACs. We have previously had favourable outcomes investing in industrial consumables, and we expect our present investment to reward our stakeholders well.

We have increased our stake in the largest multiproduct pipe manufacturing business in the country which is benefiting immensely from the upcoming infrastructure boom in setting up of gas grids, increasing number of oil exploration projects, expansion of CNG distribution across cities, setting up of new refineries and ambitious river linking program envisaged by the government. The recent change in NELP regulation leading to auction of sixty six oil fields of ONGC, and incentives suggested by Group of Ministers (GOM) will usher boom in oil and gas exploration capex in India. Let me remind you that in the great California gold rush in Year 1848-54, shovel suppliers made more money than gold miners. Over the years, the product profile of the Company has changed materially moving into high value add products. In a significant positive development, the company won a long drawn much awaited arbitration award of Rs. 2000 cr (excluding interest & penalties) against NTPC for disputes related to supplies of coal by one of its subsidiaries. The company is set on course to grow its sales by CAGR of 12%, earnings in a non-linear fashion with ROCE of 16%, and currently trades at half of its book value, a value buyer's delight.

Another portfolio company, a basmati rice leader, witnessed a difficult time in a trial by media. A previous director of the company, who had left the Board in 2013, rubbed shoulders with regulatory authorities during the course of the year. This perception gap, coupled with liquidation in small-cap space took off significant sheen from the stock price. Market participants overlooked the improving competitive positioning of business over the last few years. The moat of this company rests in the power of its brand, global supply chain & distribution expertise for procuring a million tons of paddy and rice as well as superior financing capabilities for its inventory. The ballooning of inventory during the paddy procurement cycle of Nov – May harvesting season and subsequent aging of rice for maximum up to eighteen months, gives the impression to financial analysts that the company generates low free cash flow, while the reality is quite different. The external borrowings cycle of the Company approaches nil by end of September quarter when sales are converted into profit. A recent hour long documentary by the Discovery Channel (*Grain of God*) is a strong representation of the inherent strengths of the company. We used the market dislocation as an opportunity to enhance our shareholding in the company.

My bullishness on the underlying business also stems from my observation of what has been happening to the competition. Various basmati players have, over the last few years, succumbed to financial distress on account of manipulation of finished and raw material inventory for accessing bank funding. This is reducing competitive intensity and opening the road to gain market share for highly efficient players like our company. The misconstrued perception of market participants on the regulatory "issue" has clouded its duopoly position in the global basmati market while earnings are compounding in excess of 12% p.a throwing Return on capital employed in excess of 35 per cent, net of their investment in renewable energy business. The company is trading at price to book value of 3x in comparison to 15-18x for other branded FMCG companies. The market has extrapolated the company's perceived troubles into perpetuity and valued the company like a melting ice cube, ignoring the fact that the company had enjoyed decades of organic, double-digit growth, led by its founder and family as a majority shareholder. We believe this duopolistic consumer Indian brand would be highly valued in the due course of time.

The common denominator among the majority of these investments is the opportunistic building and nurturing of companies by owners and managers who eschew typical investor "short-termism" and build high moat businesses. Many of their most successful manoeuvres were accomplished during periods of economic or market stress. It is important to continue to hold, or to buy more of, these companies' during the scariest part of bear market.

The Raichur based oncology API & Formulation Company is progressing well with more than 25 Oncology/Non-Oncology filings for the regulated markets. It is also in the process of building a strong pipeline for the Rest of the World market. It has an enviable standalone infrastructure for Oncology : 9 Oncology Blocks – the Largest in Asia. The company has taken a lead in filing for products under the 505(b)(2) route, which is a capital intensive process and requires tremendous R&D capabilities. Considering the potential complexity and risk, payoffs in a 505(b)(2) molecule are manifold in comparison to a traditional ANDA filing. We must highlight to you about the progress at a jewel of the company, the biologics division, which is working on multiple promising projects. Its lead product candidate includes NavAlbumin, a recombinant human Albumin. It has developed a novel method for efficient purification of human serum Albumin. Currently, commercial production of human serum Albumin is primarily based on collected human plasma, which is limited in supply, but has high clinical demand. Globally, Albumedix, a global biologics leader spun off from Novozymes has progressed in this area. It is in the process of setting up a world class biologics manufacturing unit at Hubli, Karnataka. The company has invested about 32% of Pre-R&D EBDITA over the last 4 years, amounting to an investment of ~400cr, on regulatory filings, exhibit batches for R&D and building a commercial pipeline, without any commensurate earnings yet. This percentage is the second highest in India among noticeable Pharma Companies, the first being Lupin. As the strategy matures this year, the earnings of the company will see non-linear rise over the next few years.

This also brings us to a paradoxical situation for innovative companies in the listed world -***the* Owner's *Dilemma***, an eclectic mix of balancing short term-long term earnings goals, stakeholder expectations of linear return and communication with them. Private equity players have time-duration advantage and the ability to sift through quarterly noise which distracts mutual fund/institutional shareholders. The US administration is taking a serious note of the negative impact of quarterly noise of earnings and conference calls on the terminal value of the economy and debating scrapping this practice at the behest of various studies and advocacy by marquee stakeholders. In his 2017 annual letter[1], Jamie Dimon, CEO of JP Morgan, wrote about this problem in detail. It is a becoming a rarity, to find companies taking long-gestation innovation-led risky projects in India and withstand the inevitable gyrations and sometimes – hammering of their share price.

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We mentioned to you last year about our investment in the market leader of sugar and ethanol manufacturing in India. The sector went through difficult times due to surplus production in Maharashtra and resultant over-supply of sugar cane. Institutional shareholders under various competitive pressures reacted impatiently by liquidating approx. 15% of the shareholding in this deeply cyclical business eroding 60% of price in matter of two months, ignoring upcoming long term positive structural changes. As envisaged, the government formulated sugar cane to ethanol conversion policy and laid the foundation of one of the biggest reform of this sector. In Brazil, on an average 55% of sugarcane finds its way in ethanol production, balancing the surplus/deficit of sugarcane. This policy will substitute imported oil, save precious foreign exchange and counterbalance production cycle of sugarcane thereby profits for the companies would become far more sustainable. Moreover, the higher coverage area of better quality seeds in UP has resulted in significant improvement in yields and operational parameters resulting in cost leadership in Industry of the company. This debt free company is likely to achieve earnings more than Rs 600-700 crs - in a depressed sugar price cycle, and is available at market cap of Rs 3,000 crs. The business value has crossed our initial purchase price by a margin. The company is in the midst of its third consecutive buyback plan in year 2019, to utilize its free cash flow for shareholders. We believe our investment should reward us, suitably.

Lew Sanders in one of his communiqués spoke about mean reversion being an interesting aspect of investing in a world where the principal dynamics in the world's capital markets revolves around a tug of war between feeling secure and actually making money. In the end, the feeling generally wins out. Substantial amount of money can be made if a value investment manager is willing to spend the bulk of his or her professional life feeling depressed, isolated, and afraid - waiting for the forces of mean reversion to relieve the stress. At that point the manager can sell and use the proceeds to rebuild portfolios, and engage yet again with anxiety. This question, of course, is philosophical, depends on one's investing style and temperament.

Our auto ancillary company performed well and is in a sweet spot of gaining volume traction from one of the key two wheeler (TWs) customers; Bajaj Auto's strategy to increase the volume by promoting entry level motorcycle has met with success. However, operational challenges related to LED lighting will lead to loss of business from one of the customer. However, our portfolio company plans to make up for this loss of business by organic growth, new product introductions and growth in after markets sales. The sales of auto ancillary industry are dependent on sale of TWs, Four Wheelers and Commercial Vehicles. In order to gain better understanding of trends, we need to understand the *acceleration phenomena,* which is a key to understanding how consumer markets in developing economies evolve and the observation that household spending on particular products and services does not increase smoothly with smoothly increasing incomes. Instead it surges in discrete leaps and bounds. This is because households earning just above a critical threshold are far more likely to purchase certain products than households earning just below the same level. The car sales in China moved 3x in a span of 10 years to 24 mn in CY 2018, where large number of households became able to afford a car at around the same time. The trajectory of the income pyramid in India suggests a similar phenomenon will more likely play out in the growth of TWs in India, rather in the passenger car segment.

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During the course of the year, we met many of you, and had an opportunity to have detailed discussions on various aspects of the market and in the process gather valuable feedback. In the interest of everyone, let me highlight few important ones: One discussion has been around our communication frequency - which is limited to once a year - in an era of hyper communication. Frequent communication gives the impression that a manager is on top of the situation, and is “hands on”. Let me assure you that frequency of communication is no barometer for our efforts on managing the portfolio. During the course of the year, we invested in five new opportunities, increased our holding in three existing companies, trimmed two and divested three portfolio companies. We wrote four letters to Boards of Directors of our investee companies and participated in voting on three occasions. The first two letters were regarding our views on strategic issues while the other two encouraged them that a buy back would be the most prudent allocation of capital in the absence of any superior opportunity. During the period 2004-09, I managed money as a mutual fund manager, and ended up writing more than 70 monthly letters to scheme holders. I experienced first-hand how meaningless the short-term updates had become. Every 2-3 weeks it was time to start thinking about what to write that could be genuinely relevant – and as you may guess, there isn’t much. This short-termism in another sense also limited reflections on the business cycle and over a period of time discouraged discussing long range data points and the shifting trends in business and investing. Some of you may be interested in reading the book *Ground Rule*, to understand why Berkshire Hathaway communicates only, annually. I believe ten well-thought out pages of an annual letter would be more meaningful than four three-page quarterly letters.

This is why we have chosen to continue writing our letters, annually. However, you should hear from us during the year on various topics of interest – on many platforms.

Secondly, we are making some tactical changes, making concentration of our top 10 positions accounting to 60% of the portfolio, drawing money in tranches while investing and an important decision that cash should attract zero fees for investors. This should help in further efficient allocation towards equities. Finally, a business cycle is of generally five years and portfolio consists of mix of various business cycles; hence three years is reasonable time frame to look at factsheet again. We aspire to beat the benchmarks by 3-5% over three to five year review horizons while things may change intermediately.

Our investment process is not static but rather, evolves over time. We continuously strive to evaluate our style, results, successful and unsuccessful transactions or approaches. It can be very dangerous when an investor like us stops questioning his or her own approach. We constantly strive to learn new things and hope that you are enjoying the *weekend reading* we send you by email. We also post these findings on our website. These readings have helped us a lot in increasing footprint of our understanding of many asymmetries which exist in the world we live. At the end of every year at Vallum, our team assembles and reviews the mistakes we committed during the course of the last two years.

This year, the gold medal goes to our investment in a fertilizer and chemical company. The company has a duopoly position in the chemical business of Rs 2,000 crs, growing at 10% p.a with return on capital employed of 22%. Reinvested proceeds from this business are building out a meaningful NPK fertilizer business. Our bet was on the inevitable shift of volume from Urea, a highly subsidized product to NPK, subsequent to the commitment of our present government to improve productivity of soil to increase the agriculture income. The work in progress to achieve this by distribution of Soil Health Cards, DBT by the government, was moving in right direction but remained inconclusive. Meanwhile, the management announced backward integration to set up an ammonia project costing Rs 2000 crs - much before new NPK facility could settle operationally. The insufficient operating cash flow, operational challenges on capacity expansion and financing limitation led to significant downslide in the stock price. The announcement and severity of the problem caught us on the wrong foot. However, the company learned its lesson and decide to bring in a strategic partner to the fertilizer business, with a preferential allotment to promoters, thereby exploring various methods of unlocking value for the investor. We would decide our onward course of action in the coming months after reviewing the corporate announcement on induction of a financial partner.

Last year, we set our foot in one of the most cost efficient players in the hospital industry run by a stellar promoter; while the business went through challenges on few issues related to delayed breakeven of newer hospitals and pricing disadvantage due to government intervention. We divested our position realising that this can be a very long gestation opportunity.

Outlook

The outlook for India markets is quite dependent on global monetary events which took an unprecedented turn with the pause on Quantitative Tightening (QT) and rising speculation that Fed will in fact resort to Quantitative Easing (QE) due to the high likelihood of economic recession hitting the US in the Year 2019. This has far reaching implications, signalling peaking of the US dollar and tectonic shift in valuation of many assets classes, going forward. The debasement of US dollar is backed by many fundamental undercurrents. A quick recap to the Year 2017-18, the European, Japanese bonds and banks were witnessing negative interest rate while the FED rates were positive. This coupled with the incentive to bring back capital by US corporations and record gains in S&P have led to the US dollar becoming the magnet for attracting capital from across the world. Globally, around $11 trillion or 22% of total debt outstanding is yielding negative yield, reinforcing limited avenues of deployment of money.

However, we are also experiencing global uncertainty related to trade wars and the transition into a multi-polar global economy, whose second biggest player, China, a strategic rival to the US, has no interest in being a tributary to the US Treasury via the dollar system. It has initiated Yuan payment to its key oil suppliers like Saudi Arabia, Russia and many other small players. The world is moving into regional blocks with trade in regional respective currencies and the hegemony of the US dollar as a sole currency of trade settlement is going to be seriously challenged. Europe and Russia have moved towards dislodging the SWIFT payment system owned by US Banks. Secondly, the demand of US Treasury is dissipating as the key holders Russia, China and Japan have turned net sellers over the last two years. Economic history suggests that Gold, Oil, Precious Metals, Emerging markets indices, and currencies could be key beneficiaries of the reversal of the US Interest rate cycle.

Gold Prices in dollar terms have remained range bound for the last seven to eight years while the global monetary base has increased manifold. Central banks across the world have accelerated shifting of their reserve towards gold inorder to delink from the US dollar. They made a cumulative purchase of 600 tons last year (up 71% YoY), and the highest amount since 1971. It has also been observed that Chinese currency is far less volatile against gold for the last one year, encouraging trading partners to enhance their trade in yuan. In a recent report, Gold 2048: The Next 30 Years for Gold, the World Gold Council (WGC) noted that production costs have risen just under 10% a year over the last 15 years, and resource discovery and mine construction costs have also risen rapidly. The WGC estimates a price of $1,500 an ounce is required to maintain production at current levels and earn a 15% ROI. WGC also notes the dearth of 'world class' discoveries, i.e. discoveries over 5 million ounces in size, capable of supporting large mines that can produce 250,000-plus ounces a year. The average reserve grade has also fallen by about one-third over the past decade, which implies higher production costs. A decade of under investment in gold mining is leading to huge supply side contraction. Having read the tea leaves, we loaded up investment in the largest gold financing company. The history suggests that rising gold prices impact their ability to increase the gold loan growth and valuation improves. The company which has an asset liability surplus (unlike HFCs), a leverage ratio of just 3x, has started its journey of diversifying is product line into two wheeler, micro loan financing and affordable housing to not so easily poachable customers by competitors.

India is a beneficiary of the re-emergence of Emerging Markets (EMs) as an asset class. In the backdrop of a peak of the US stock market, and likely depreciation of the USD, we observe that around 90% of global incremental EM money flow is happening thorough Exchange Traded Fund (ETFs). Large cap companies are natural beneficiaries of ETF flows while mid and small cap companies will close the valuation discount, going forward. However, we must highlight two risks that persist in the market for long term allocators. First, the likely rise in oil prices due to above mentioned scenario and adverse demand supply balance. Oil exploration activity has not witnessed any expansion in the last decade to bring any meaningful reserve to the global market. A closer look at demand and supply is suggesting that oil prices will inch higher. The global demand for oil grew by 1M barrels/day in 2018 despite the attention on renewables and electric vehicles. Economic growth in Asia is driving higher oil demand. On the supply side, OPEC constitutes only 35% of the total oil supply of the world, a number which has remained constant for the last two decades. This indicates that the supply side has expanded outside OPEC. The problems at Iran and Venezuela have reduced supply of 2M barrels/day from their peak supply capacity, balancing the demand-supply situation in oil markets. A recent study suggests that additional shale gas drilling near existing wells is having a marginal supply impact in the US. In this backdrop, we are avoiding exposure in companies which can be negatively impacted due to rising oil prices and believe that rising oil prices with impact on current account deficit, balance of payment, interest rate cycle, subsidies, and government finances can restrict the rally in the stock market. Finally, Indian equity markets are witnessing a unique phenomenon. Under liberalised FDI rules since last two decades, many companies have chosen to remain private. A closer look suggest that a decade back that BSE 500 companies use to account for 55%, a decade back while now it accounts for 35% of aggregate of all the corporate tax collection in India. This signifies that a lot of value is getting created outside listed entities, hence the listed firms end up as limited proxies of India's economic progress. This suggests that equity capital will likely remain concentrated in limited set of listed opportunities.

Year 2019 will be decisive as India will vote for an economic ideology, not a party. In the case of a progressive government, the sectoral leadership in the market will change from consumption to infrastructure and capital goods businesses, which are available at a reasonable value. Vallum is confident that our investment framework is prepared for harnessing pockets of opportunities and this process will help us generate a superior risk adjusted return in the long run.

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1. Link to JP Morgan 2017 Annual Report: https://reports.jpmorganchase.com/investor-relations/2017/ar-ceo-letters.htm?1