

Annual Letter to Stakeholders

2020-21

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair."
Charles Dickens, "A Tale of Two Cities"

Dear Investors,

"It was best and the worst of times..." Indeed COVID-19 was havoc for some and boon for others. Moreover, one of the key lessons that I learned in 2020 was the futile ritual of market forecasting by the experts. Nobody could have ever imagined the ripple effect caused by a pandemic like COVID-19. For example, during the first quarter of Fiscal Year 21 there was a huge divergence between the intrinsic worth of middle-market businesses and their quotation prices in the market. This reminds me of a quote by the GMO viz., "The cruel logic of being a value manager is that at the very time when your opportunities are at their best, your credibility with clients is at its lowest ebb." The roller coaster ride of the market normalised in the first half of FY21. Our strong belief in the thesis of depreciation of the US dollar, its positive implication on inflows into the emerging markets and careful selection of strong companies has helped us to weather this storm. The infrastructure-led revival plan proposed by the government also helped our portfolio which was tilted towards domestic cyclical stocks. For your reference the portfolio performance has already been sent to you.

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Digital Enterprises and Platforms

Our portfolio of investments in digital platforms and companies has done well during the year. Our foremost holding, a design-led IT company has a unique business model of partnering with innovators for design, automation and IT services. The renewed thrust on growth by the management team and the company's ability to participate in growing areas of healthcare, OTT and communications has helped to change its growth trajectory. Incidentally, the company had limited disclosures on its business activities till the last year. Persistent efforts at annual general meetings and a gentle nudge to the group chairman changed the trajectory of disclosure levels and thereby attracted a newer set of long-term investors.

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We are shareholders in India's largest energy exchange, which at its core is a convergence of the perennially important power and technology sectors. The company introduced many products such as Real-Time, Green Term Ahead Market, and Gas Exchange during the year, which has helped the company gain market share from other short-term market players. Moreover, the government has an unparalleled commitment to power sector reforms, diminishing the role of cash guzzling state DISCOMs. The government acknowledges the change required to reduce the cost of energy as a prerequisite for the revival of manufacturing in India. These initiatives by the government are anticipated to help the company increase revenue generation.

Another of our profitable investments is in a depository, an asset-light move, which is gaining market share against its competitor. The company has 59% market share and is partner of choice for traditional and discount online brokers. The earnings of the company accelerated due to the activation of new business lines like margin income from pledging/re-pledging, commodity repository, transaction fees from the revival of IPO markets, and lastly, the dematerialization of MFs. The substantial increase in the company's value, free cash flow building up as cash on our books, and the resulting decline in our return ratios motivated us to book partial profit of our stake.

Lastly, we have invested in the foremost telecom player which is gaining market share consistently and has the balance sheet strength to withstand the competitive landscape. For years, the asset-heavy players in the sector suffered due to deflationary pricing and high competition, while the asset-light businesses built on the foundation of telecom services have enjoyed manifold growth, with strong cash flows. Post-consolidation in the industry, the revenue per customer has increased due to more usage of data, thus improving smartphone penetration. For instance, the company owns unique customers and can sell many value-added services (advertisement, data center, cyber security, cloud communication), thus diversifying possible revenue streams. These services, although are still at a nascent state, will be meaningful in the next few years, with the possibility of monetization. We believe our company is at a sweet spot for harnessing the growing digital economy of the country.

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Business Play on Revival of the Domestic Economy

The low interest rates for corporations, and mortgages, coupled with pent-up consumer demand and the government's commitment to infrastructure is resulting in a revival of growth in the economic activities. It also appears to me that policymakers, in agreement with the central bank, are extending real negative interest rate to engineer revival in the economy. This is surely a tax on financial savers to accommodate lower borrowing cost for the government. Such a scenario, however, favors investment flows into physical asset (real estate) and the infrastructure sector (close proxy of the years 2009-2014).

Companies in the building material space are beneficiaries of such macroeconomic back drop. Our investment in the tile cum cement manufacturer is witnessing a managerial-led turnaround in the tile business, which is its key division. The early signs are visible that it is regaining its market leadership position with enhanced profitability. Also, its cement division has gained cost leadership with the installation of waste heat recovery and other efficiency measures. Currently, the business is in a sweet spot to harness the free cash from the cement business and to retire all its debt in the next few years. We have a very bright forecast for this company. Our investment in the steel pipe cum light business has gained traction on the back of renewed interest in *HarGharNaYojna*, along with a surge in construction activities across the country. The surge in construction activities has swiftly translated into value-added products in the pipe business, thereby improving its return on capital employed significantly. The company has a state-of-the-art lightening plant and made significant gains from the revival of the lightening business due to a change in the duty structure on imports of parts from China. Moreover, it is at the forefront in benefitting from the Production Linked Incentive (PLI) scheme of the government in the manufacturing of LED parts.

As mentioned above, the real negative interest rate is advancing a revival of the housing sector and property prices after a gap of seven years. We invested in a housing finance company operating predominantly in the southern market and so far have gained traction from a revival of the real estate market. Our housing finance company has an advantage in raising resources due to its PSU parentage and is gaining market share in comparison to other NBFCs. The company's impeccable business track record and the expression of divestment by its parent few years ago makes it a valuable target for a takeover.

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Also, this year we have witnessed recovery in one of the largest private banks, as well as the largest state-owned bank, which are part of our portfolio. At the start of the year, RBI's on-demand liquidity windows have benefitted these banks immensely and helped them to protect their margin. For the last few years both these banks, based on their strength and their low cost of liabilities have built a huge lending franchise in the retail segment. Today, retail lending accounts for more than 50% of their book. The average delinquency in the retail sector is less than 1% of the outstanding loan, in comparison to 3-4% for the total loan book. The changing complexion of the business will help in steady earnings growth for both the banks.

Divestment Play

Divestments and ownership changes in the private sector are going to throw up many interesting opportunities. This year, we made investments in undervalued refinery and marketing business, with interests in gas pipeline, city gas operations, and the LNG business. The company is on an active list of divestments and has received few serious bidders. The global retail outlets have a substantial contribution from non-fuel revenues and we are reimagining these marketing outlets as a nationwide chain that are working as a store for financial services, co-branded credit cards, ATMs, integrated fleet management, grocery and other convenience goods to its loyal customers. It currently has one million and six lakh members owning loyalty cards due to the strategic locations of this marketing infrastructure, with ownership changes likely to bring high growth in the non-fuel revenue. The business is currently trading at the lower end of the valuation range.

Our investment over the last four years in a company that is a market leader in the production of amines paid off well this year on the back of accelerated demand from its user industry (pharma, agrochemicals, and other downstream chemicals). The shortage of solvents, anti-dumping duty on DMF (dimethylformamide) and earnings from acetonitrile gave a strong boost to the earnings trajectory. This is one of the best performing investments for this year.

This letter cannot be complete without the sincere admission of our misjudgments during the year. We would like to mention two holdings: a branded basmati rice company, and an oncology drug company that met with regulatory hurdles. The market participant's rush to exit resulted in a diminution

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of the quoted value of the companies. However, the diminution in the quoted value of these companies is sometimes temporary when it's a business-related problem (like in our case), and most especially, when it is situation faced by many other competitors. Our experience suggests that affected companies typically bounce back with vigour when corrective actions are taken.

Reflection: The journey of a decade of Investing

This letter comes across as a special one because *Vallum* is celebrating a decade of its foray into the investment world. It is indeed a time to reflect on the thoughts, principles, beliefs and approach that has defined our company as it relates to the investment management business. I am glad that we have beaten the odds, while many new funds have succumbed to failure. What's more, we have continued to thrive with a top quartile performance in the last decade.

Investing is an art form, and like any artist guiding their brush over canvas, the investor weaves together facts and observations to create their vision of the world. Greatness comes from redefining the game rather than simply playing it. Since art and investing are acts of self-expression, the limitations in these fields are largely self-imposed. To combat these boundaries, tools like self-reflection and introspection are vital. These tools can help us unlock our innate potential. We remember the greatest artists and investors in the world because, for a time, they stood alone.

On the bright side, let me present some interesting statistics: Our clients who have joined us since inception have witnessed a total investment in approx. 75 companies; currently 19 of them are still with us, while the remaining 56 have been exited. We have held 64% (or 36 stocks) of the stocks for a period of more than 1 year, and sold only nine stocks in a period of less than six months. This journey also witnessed around 34 stocks yielding positive returns with CAGR of 15-50% during the holding period return. We sold three stocks at around 50% of their value, and seven stocks at losses of between 20-50%. Regardless, a low portfolio turnover reveals our investment approach to be rather thoughtful.

We divide our portfolio construction and sizing into three parts based on our fundamental analysis of a company's profit cycle and valuation. Investments which are done in the early part of their profit cycle deserve less allocation in

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the portfolio and may warrant more sizeable allocations as their profit cycle accelerates. Secondly, for investments moving through the strongest part of their respective profit cycles, we increase their weight to the maximum weight possible. Finally, there are investments where positions are being reduced as they near our estimates of full valuation or when their profit cycles have begun to decelerate. Our main vectors for evaluation and selection of portfolio companies rest on the following: companies investing in Innovation and automation, companies gaining market share, albeit profitably, and companies making new product introductions or upgrades, and companies witnessing earnings turnaround due to any catalyst etc. all leading to acceleration in their earnings. Our experience and analysis suggest that such companies produce superior shareholder value in the long run.

When I started my entrepreneurial journey, I was often asked, how I, a former Mutual Fund Manager, was going to produce a superior return for the investors in a business which is dominated by institutional investors and mutual funds who have large resources at their disposal, with cadres of analysts, unlimited research budgets, experienced brokers and cross-discipline pollination capabilities. Our answer was, “Flexible *and focused beats large and approval-seeking.*” The large institutions suffer from “institutional imperative,” the tendency for large organizations to mimic each other. Meanwhile, the sole manager in a boutique has their time to think and the mental space to focus on important things. At Vallum, we ensure a long-term mind-set and ensure we create time for contemplation. As you all know, I only write to you in detail once in a year, maintain only a limited presence in financial media and we closely guard against all other commitments that imperil our ability to be thoughtful.

One of the most common problems in our business is ‘alignment of interest’ between investment management and various intermediaries. The economic compulsion and chaotic interplay between them are bound to produce suboptimal investment returns. I am often reminded about and draw some inspiration from the exceptional investing track record of Berkshire Hathaway (BH) over many decades. However, many observers of the superior track record of BH do not contemplate on the superior business architecture of BH.

My observation on this is that they have a permanent source of capital because of an insurance float, and accruals of profits of private enterprises due to their full ownership. For example, unlike a mutual fund, BH does not raise capital from the public at different points of time. Secondly, the investing acumen of its

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founders run in two different directions to cover a very large investing landscape: 1. Vertical axis (understanding the depth of business, accounting issues, alignment of interest of professional managers, etc. and 2. Horizontal axis (understanding of various disciplines of knowledge and finding cross-pollination of ideas and mitigating risk).

Such business and investing architecture is unparalleled in the history of investing. No other institution or manager can be close to this, but all of us should consistently attempt to learn from them and improve our structures, with a view to improving our investment returns. At Vallum we have worked hard over these years to gain an edge in the time duration of money invested by our investors.

As the dynamics of the market change, we believe the investment manager required will be a “foxhog”, i.e. one who has the cognitive abilities of both a fox and a hedgehog. The fox knows many things, but the hedgehog knows one major thing, and that’s how to survive. Hedgehogs have a single grand idea that they apply to everything, while foxes come up with a new idea for every situation. At Vallum, in-depth scrutiny of macroeconomics, together with a bottom-up selection of stocks shapes our vision of the world and provides guidance in our portfolio construction. This ideal combination helps in the proper sizing of bets in the portfolio, whilst securing ourselves the means to adapt to every changing economic situation.

Over these years, I have often disagreed with my friends in the industry who have vehemently advised me to onboard all clients I meet on my way. Many of them make regular appearances on financial media dishing out tips to gullible investors in a bid to attract a wider audience. My two decades of experience in the capital markets has taught me that one should ask any potential client or wealth manager how they would handle a situation in which the onset value of the portfolio is down 30% before producing any meaningful return.

Most of us investment managers suffer from various biases. Personally, I suffered from the most common one. In hunting for value trades, I looked for a huge gap of intrinsic worth to actual value, ignoring the power law dynamics at play in the markets. Let me explain the power law. The market a decade back used to be more mean-reverting, where stocks and industries went up and down, but things always reverted to the mean, i.e. returned to a competitive balance. However, at least since the last few years, it appears that the Internet

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has upended this pattern, thus enabling breath-taking scale and dominance, which is referred to as the power law. Tina Arena's melody, "*Winner takes it all*" has said it gracefully.

Moreover, the valuation of companies is not a natural science that is able to provide objectively precise results. On the contrary, it is always an estimate with an added layer of subjectivity. Secondly, the *disposition effect*, i.e. aversion to loss realisation has led to few occasions of selling winners early, while holding on to losers too long.

Finally, there is *recency bias*. Recency bias is often exhibited when we are more likely to buy certain stocks when their prices are rising in hopes that they will continue to rise, in contrast to buying when markets are down severely. However, proper research and adequate knowledge can help combat recency bias.

Outlook

The crisis of 2020 has exposed the faulty debt-laden lines of developed economies. The excess money in the global monetary system is creating asset inflations, with its associated domino effect. The result may be that inflation in asset prices will spill over strongly into consumer inflation and accelerate the environment of real negative interest rate. As we peep into the post-COVID world, i.e. the years 2022-23, accumulated pent-up demand, the strong psychological effect of the newly acquired freedom, and continuing enormous government budget stimuli will most likely result in a great boom in spending on infrastructure, consumption etc. This will be supported by accumulated excess savings in a synchronised way across the world. For example, rising demand trends in consumption of commodities and prices has started signalling an upcoming boom.

In conclusion, the economic foundation of India is resting on the strength of the response by policymakers to both the 2008 global financial crisis and 2020 COVID-19 pandemic. The policy prescription in both the crises was the same — monetary and fiscal stimuli, but the intensity was different in both cases, thereby leading to different outcomes. The overdose of these measures in the year 2008 led to huge depreciation of Re/\$ (CAGR of 6.4% between the Year 2009-2014), while in contrast, the Rupee has depreciated by only 3.0% from the

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start of the COVID-19 crisis till date. The strong long-term foundation of fiscal architecture, along with the renewed thrust on manufacturing with production-linked incentives and other benefits will lead to a resurgence of the economy in the next few years. Moreover, as economic activities gather momentum and accelerate, there will be dispersion of capital to the middle-market companies, thereby creating value in them.

I must admit that it was not easy gathering my thoughts and putting them into writing in the face of strong emotions necessitated by the alarming state of rising cases of COVID in the country. As we know, the fate of the market hangs delicately on the extent to which we can control the spread of COVID, with familiar economic implications staring us in the face if we fail to. Moreover, if the current trend of increasing cases of COVID-19 continues unabated, we are sure to see fresh restrictions on economic activities and mobility throughout India.

However, I am optimistic that as vaccination progresses in the next few months, the economy will move towards normalisation. As a country, we have faced difficulties in the past and have overcome them. Once again, the time has come draw on the strength of our past successes in our quest to overcome the challenges posed by the COVID-19 pandemic. I believe we shall see the sun rise again, and I am positive that the economic outlook of India post-COVID-19 will be far brighter than what we experienced in the last decade. Stay invested.

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