

Annual Letter to Stakeholders

2021-22

Dear Investors,

The biggest story of the year 2022 is not “the gyrations of the market,” but rather a significant shift in market leadership from growth to value investing, currently unimaginable to many investors. The year separated the *wheat from the chaff*, companies disguised as high growth Innovators and Disruptors companies having so-called unique Intangible assets, destroyed shareholder value. The value has started shifting to cyclical, downtrodden energy and real assets. History suggests that such rotations can be powerful and can provide considerable investment opportunities to those who are able to foresee these tectonic shifts. The year was also marked by the Xi Jinping-led, Chinese government’s Common Prosperity goal, the ongoing war in Ukraine and its cascading impact on various asset classes. The performance of Vallum’s strategy of buying growth companies at a Reasonable Price (GARP) was satisfactory, beating its relevant index by 800 bps, considering the dramatic changes in the investing landscape during the course of the year.

For most Westerners, the March 2022 images of Russian tanks rolling into Ukraine have been more traumatic than the March 2020 images of Italian and Chinese patients overflowing local hospitals. Europe has become the epicentre of energy crises, hyperinflation. More on this topic stakeholder can read here on this [Link](#). Parallels, the US Federal Reserve has already begun raising its interest rates and will begin shrinking its balance sheet at its next meeting in May. This tightening will be resulting in volatility in the risk based assets in the US and outside. Outside the US, it is already leading to serious problems in countries like Sri Lanka, Pakistan and Peru.

For the last two years, the impact of repressed interest rates on asset prices and has led to revival of real estate and buoyancy in equity markets. Similar to the FED, the RBI is also behind the curve, in containing inflation. The mutual funds saw a record Rs 4 trillion inflows into risk-seeking schemes in FY22, nearly thrice the Rs 1.4 trillion equity outflows from the foreign investors. Keeping in mind the various counterbalancing forces acting in the market, we made a tactical shift to a higher market cap over the course of the year. Our weighted average market cap of the strategy increased by more than 50% in the last two years.

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Our key holdings in the two large lenders (corporate and PSU) of India performed very well during the course of year. The private sector lender gained market share in advances on the majority of the counts, by 60 bps to 6.8% in overall credit, and by 1.5% to 11.3% in mortgages. Noticeably, the trouble of competitors helped the private sector lender in gaining a substantial market share in credit card spending by around 12%, leading to a 21% market share. Both these lenders have very large mortgage assets on their books are leading market share gain in the mortgage sector. The enjoy very low cost of liabilities on their book.

Our PSU lender has improved significantly on the provision coverage ratio and has a favourable credit to deposit ratio. This will assist in funding a long term credit growth cycle. Our both investee lenders reduced non-performing assets, gliding to a sustainable path of Return on Equities (excess of 15%) for their stakeholders. Around three years back, both the lenders represented a dislocated investment opportunity and we made a bold bet that they would make the transition to sustainable earnings in the future. We were proved right. The commodity boom is ensuring a healthy credit growth in working capital for the lenders. According to our PSU lender, the working capital limit utilization for corporate has improved by around 9% to 43% indicating a credit offtake. Furthermore, its technology platform has seen a stupendous success, with more than 45 million registered users and approximately 18 million salaried users for Xpress credit. We remain bullish on both the lenders.

Our premise of investing in a Small Finance Bank (SFB) has played out well relative to other SFB lenders. The bank underwent a massive business transformation on the asset and liability sides in the last five years - reducing microfinance share from 54% as of March 2016 to 18% as of December 2021. It transformed itself from a wholesale funded NBFC to a retail funded bank with retail deposits at 60% of deposits, unimaginable few years back. We had debates internally on whether to pick up an SFB which has a portfolio dominated by microfinance or a SFB which is diversifying its assets portfolios. The experience of living through erstwhile SKS microfinance post crises, helped in shaping our choices in favour of investing our investee company. The profile of our SFB customer is not cannot be easily attracted by other big banks. Our decision proved to be the right one, with the loan growth CAGR of 25% between March 2016 and December 2021 while the cost of funds for the bank has declined by approximately 400 bps to 6.5% p.a. This was accompanied by low delinquency relative to the industry while improving core operating Return

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of Assets of 4%. It has built an enviable liability franchise at CASA at 50% and retail deposits at 60%. This is a real testimony to the robustness of its business model and the trust of its customers.

Investors need to recognize how interlocked energy markets have become. A crisis in one market is all but certain to spill over to another. European utilities are desperately switching from burning expensive natural gas to the much less expensive crude oil, increasing demand by over 500,000 b/d. When it comes to energy prices, one of the oldest dictums in the book is that "*the solution to a high oil price is a high oil price.*" This is on account of two clear reasons: demand destruction and increased supply. Typically, increased supply takes time (three to seven years), while demand destruction tends to be immediate. The energy crises have brought manufacturing sector to grinding halt in many countries. India has an advantage in the metal value chain due to a backward integration on resources, energy and manpower. The MNCs operating in India, having leadership position in their product line and using the country as an export base, are going to be significant beneficiaries in such a scenario. Our currency has depreciated by 12% over the past three years against the Chinese Yuan, our key competitor, giving additional room for the growth of export to the developed world. We have made a investment in one of the technological advance auto-ancillary company which has a dominant position in the commercial vehicles space (CV). The tail wind of revival of CV in the domestic market and the commitment to make the country an export base, is expected to create value for the shareholders.

Many a times, when analysts say markets/stocks are expensive, they only look at it in the context of historical valuations. Assuming the 'E' or earnings are depressed, in some cases that means we need to look at the normalized earnings rather than the cyclical earnings. While there are pockets of overvaluation as we are yet to see the mean reversion of earnings, there are other stocks that are reasonably priced based on the full business cycle profit analysis. This process has worked well with us over the years.

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An interesting opportunity in Compressed Natural Gas (CNG) business was thrown into our hands, when an unexpected turn of events led to a miss on the quarterly earnings by the company. The market missed the forest for the trees by ignoring the accelerating penetration of CNG in passenger cars, commercial vehicles etc. The high return on investment for fleet owners is very high, due to a 47% cost advantage of CNG over petrol. The largest car manufacturer in India, Maruti is committed to selling 40% of all vehicles as CNG fitted for the year 2023. Today, more than 16% of all CVs sold are CNG fitted compared to the 4% in the last few years. Today, most of the vehicle manufacturers have more than 80% of their basic models available in CNG variants. The company has expanded the Geographical Area(GA) of operation from four to fourteen. Close to 0.7 mn vehicle will be completing 10 years and likely available for scrappage policy in the GAs where the company is likely to operate. We believe that all these things will create huge a network effect for the volume growth for the company.

Our thesis is also shaped by an interesting concept of Energy Return on Energy Invested (EROEI). For example, for every unit of energy “invested” in the natural gas eco-system (to drill the well, process and transport the gas, build a CCGT power plant, and generate electricity), 30 units of usable power is released in the form of electricity. Natural gas power generation is said to have one of the best EROEIs at 30:1. Nuclear power plants have the highest EROEI of any energy source (100: 1), while coal-based steam power has an EROEI of 10:1. Unfortunately, the EROEI of both wind and solar are approximately 3.5:1 (after adjusting for intermittency and redundancy). This is not some abstract academic concept and it has huge impacts on a country’s economy and its ability to grow. I am worried that our policy makers have not paid enough attention to this concept.

Staying on the same train of thought, we made another investment in Navratna, a Public Sector Undertaking (PSU) which is in the business of transporting goods by containers for export-import and domestic cargo. Our thesis is based on a revival of exports, shift of business mix to domestic cargos and the productivity growth in transportation, due to linkages of the Dedicated Freight Corridor (DFC) with various ports, which will accelerate business growth. On the DFC network, trains can run at a speed of 100 km/hr while carrying 80 TEUs versus an average Indian Railway train that runs at a max speed of 30 km/hr while carrying 65 TEUs. The double stacking has improved productivity and asset utilization. We also see this as an interesting ESG play, as the movement done by rail versus road reduces CO₂ emission by around 36 gms per tonne per km. During the year

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2020-21, the company transported around 42 million tonnes of cargo over an average distance of approx. 778 km using rail infrastructure. This effort by the company has helped in the reduction of CO₂ emissions by 1.2 million tonnes. The earnings of the company will see a non-linear growth and we believe that optionality of privatization is an added advantage for the shareholders.

Apologies to anyone unfamiliar with the world's greatest sport, but building a portfolio is like putting together a good soccer team: you need different players to do different jobs, under different conditions. The presence of a goalkeeper provides the foundation upon which the defenders, midfielders and forwards play. Thus, each one can play turns when situation demands. Thus, each one can play turns when situation demands. My learning is that a portfolio should be a mix of anti-fragile, defensive, price sensitive as well as volume sensitive securities to navigate long term value creation.

Our existing position in an engineering and design IT company did remarkably well during the course of the year. The earnings momentum led to a reflexivity in price and rich valuation. We trimmed our position meaningfully. Our oncology pharma company struggled with revenue growth due to a pending inspection of its formulations facility. The company has decided to demerge the API business and attract external investors to fund the other high growth businesses. We believe that this year's earnings will normalize post, FDA clearance of the facility.

Prior to the pandemic, I participated in an International Investment conference in Zurich, Switzerland. One of the participants opened a debate on whether a portfolio manager should buy popular stocks, regardless of whether they believe in them in order to increase the inflow of assets into the fund or whether one should stick to a strategy one believes in, even at the cost of losing some assets. Opinions varied and tended to reflect participants' priorities. Speak for ourselves, if we had to choose, we would rather lose some of the investors who feel that we are making money too slowly for some period of time, than to lose their money by taking excessive risk and chasing after returns. In other words, I would rather, in the extreme, lose my career as a professional investor than expose the money entrusted to us to too much risk.

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This is an attitude we have always admired in the greatest and most successful investors and consider it to be the only defensible one. As Robert Olstein, the founder of Olstein Capital Management said, "*The desire to perform all the time is usually a barrier to performing over time.*"

Outlook

In wake of the Russia-Ukraine war, the response of the western world in seizing and confiscating assets of Russians and Russia has created chaos among the central bankers. In retaliation Russia is indirectly ensuring that gold is likely to emerge as a medium of trade for its exports. Back home, the government's policy thrust to lift the share of profits in GDP and thus attract private investments, growth and jobs may have gotten a further boost from the recent election outcomes. In a multipolar world thesis, our government's thrust for investment in our country has improved MNC's sentiment towards India to an all-time high. It has rolled out total life cycle incentive of USD 35 billion of all 15 announced PLI schemes. We estimate the total incremental revenue generation potential to be in the range of USD 470-500 billion, attracting a total investment of USD 62 billion and directly generating 3.1 million jobs. This should reduce current account deficit, materially. We expect for a secular rise in FDI which again, is likely to lead to a new corporate Capital Expenditure cycle. There is evidence that a new profit cycle may have commenced after a hiatus of nearly 15 years and we are on cusp of solid economic growth for the next one decade. The tug of war between rise of interest rates and shift away from the US dollar as a medium of trade in the multipolar world is setting stage for new monetary order. However, the outcome will be positive for our country and will accelerate flow from Institutional Investors in the years to come.

In conclusion, thank you for your trust and fortitude. There have been and always will be ups and downs, and we will experience them together. As I always tell my daughter, if everything was always good you wouldn't know what good was. She is grappling with a problem of whether two 5 inches' pizza are a better deal than a 9 inches' pizza, she had ordered. It's the contrast that makes life worth living.

Manish Bhandari & Vallum Team

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