

Letter to Stakeholders

2022-23



"Do the difficult things while they are easy and do the great things while they are small. A journey of a thousand miles must begin with a single step,"

Lao Tzu, an ancient Chinese philosopher, and founder of Taoism.

Dear Investors,

Our posture of patience, conservatism, and emphasis on good decision-making, bore fruit in FY23. It has been more than a year since Russia attacked Ukraine and every time I sit down at the keyboard, I have a troubling time typing about the stock market and the economy when people are dying just a few thousand km away from here. The geopolitics associated with the war has brought about a remarkable change in the energy landscape of the world. Different regions of the world are now paying widely different prices for their energy consumption. Since the cost of primary energy is the main driver of economic growth, such fragmentation will therefore have a very big impact on a country's growth prospects. Before the War, the European Union would import 50-60% of Russia's oil output. One year on, that figure has slid to less than 10%. India and China have now emerged as key buyers to substitute those lost quantities. Oil import by India from Russia has gone up by 4x in the last year, after receiving a discount of approximately \$20 a barrel over WTI prices.

Coming to our fund's structure, approximately 45% of the fund has been invested in quality, difficult-to-copy consumer brand names, 37% in deep value where earnings cycles are recovering from prolonged business downturns where prices are temporarily depressed because of short-term factors, and the remaining 18% has been invested in discounted asset-based businesses where fixed assets account for a large portion of appraised value. It is the first and third category that contains our current winners and the losers lie in the middle. We believe, over time, all will be winners.

Some statistics on the fund's performance during the year: We have beaten the benchmark by 296 bps net of fees. At a granular level, 97% of client assets and 95% of clients are beating the benchmark. Adding further to this, approx. 87% of client assets are beating the benchmark by more than 300 bps net of fees.

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During the year, we hosted a celebrated global macroeconomist, Louis Gave, partner at Gavekal, on Vallum's platform for an interesting discussion on megatrends shaping up globally. Louis made an interesting case for re-allocation of money to China/India due to China re-opening post covid, de-dollarisation of the global economy and its positive impacts on the emerging markets and commodities and inflation, and I would request you to kindly refer to the detailed transcript available on our LinkedIn account or at the Vallum URL ([Click Here](#)) for the detailed discussion.

Review

Our sizable investment in two MNC plays, a gen set behemoth and a technology leader in commercial vehicles played out successfully. Our thesis of taking sizable bets during the business down-cycle got reinforced. The five-year earnings and stock price CAGR of the Genset behemoth during the period 2013-2019 was approx. 1%. With the expansion of data centres, recovery in construction activities and export-related businesses during the period 2021-2023, the earnings of this behemoth shot up by 27% and the stock price by 37%. While the technology leader in commercial vehicles gained from the recovery of its underlying CV and aftermarket business and made a dazzling recovery of CAGR near earnings and a stock price of 35% over the period 2021-2023. We rode on the tailwind of earnings, driven by the economic wave, for both of these companies.

A key position on City Gas Distribution (CGD) network initiated by us, when raw material prices of companies were at their peak and earnings at the bottom of its intermediate cycle, did well during the year. The government has the ambitious goal of taking CNG penetration at 18% of the energy basket from the current 6%. They walked the talk, by approving the revised domestic natural gas pricing guidelines for gas produced from nomination fields of state-run companies, at 10% of the Indian crude basket, benefitting CNG players. These reforms will lead to a significant decrease in the prices of Piped Natural Gas (PNG) and Compressed Natural Gas (CNG), for households and transport respectively, making them competitive against alternate fuels. The deep moat of this business rests on three strong pillars:

1. Network effect due to the expansion of gas in the country, thereby increasing and accelerating the conversion of vehicles.
2. It's capital allocation policy; ability to pick up profitable Geographical areas for future growth. the business is likely to witness earnings growth of 15% for the next three years and we remain invested as our core holding.
3. Likely, Consolidation of Geographical Areas (GAs), in hands of strong and experienced CNG players.

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We are glad to share our investing framework because it is important to us that you understand not only what we do, but why, what and how. There are three competitive advantages in investing: informational (our team knows more than others); analytical (superior-conclusion from publicly available data) and behavioural or temperamental (controlling human emotions, biases, and cognitive errors).

The regulatory-led data explosion has reduced the informational advantage, significantly. Sustainable competitive advantages are usually a product of analytical and or psychological factors. We strive for a sustainable advantage which has kept us in the business for over a decade. Apart from this, Vallum's competitive advantage over peers has come from the capital allocation skills of your manager (if any) and the patience of our investor base. We welcome several new investors who have joined the Vallum family this year. In the near term, our results are likely to be as bad as they may be good, but we are confident that in the long run, they will prove to be satisfactory.

Corporate actions in portfolio companies

Our position in a leading sugar company did moderately well during the year on the back of ethanol expansion as well as improvement in global sugar prices. It expanded its profitable ethanol division by 2x, undertook a corporate action plan of liquidating its holding in its associate for Rs 1,800 crs in the turbine business and undertook a massive buyback to reward shareholders. Today, buyback is the most tax-efficient way to return capital to the owners, thereby improving the return on capital. The company has two more value-creating divisions: Gear manufacturing and Water projects, which it has nurtured over the last decade and has reached a critical size. We believe the company is on the cusp of re-rating on the back of improving fundamentals in the sugar sector and value creation in other divisions.

A Small finance bank (SFB), we invested in, has witnessed significant positive developments on account of its merging with its subsidiary, the underlying bank. Subsequently, you all became direct shareholders in a small finance bank. The illustrious founder who took a charitable detour made a strategic comeback this year to nurse the company back to a greater height. Recently, we had an opportunity to spend some time with the founder, concluding that our bank is compassionate in action. The book by C K Gariyali "Bank with a Soul" has explained this in great detail. The management team has built a formidable moat around secured Small Business Loans (37% of its asset), addressing a market size of 45 mn self-employed households with products like merchant overdraft, payment ecosystem and digital onboarding. On aggregate, the bank is expected to witness the highest growth rate in advances, enviable ROA and ROE in the next three years. A rare blue diamond in our portfolio. The management also is embarking upon conversion into a Universal Bank (UB). The UB has the advantage of lower regulatory capital (9% v/s 15%

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today) leading to better leverage, lower adherence to Priority Sector loans (40% v/s 70% today) and better cost of funding, thereby improving Return on Equity for the common shareholders.

The phrase “business moat” is often banded around when discussing the absolute or comparative strength of a franchise. That there are businesses with defensible positions is of little doubt; but what these discussions often lack is any empirical method by which the size of the moat or its longevity can be measured, compared to or monitored over time. In addition, stock investors (particularly those who, for their sins, have been labelled growth investors) face an important task, namely, how can one recognize the creation of a business moat well in advance of its value being discounted in the stock market? Our framework of growth at a reasonable price has come in handy to us in such circumstances. A business ought to be able to self-fund its growth, and if the opportunity set is large, then the return on capital needs to be suitably high. Secondly, barriers to entry should increase with size; that way a company’s moat is widened as the firm grows. Our SFB investment neatly fits into this definition.

We bid farewell to our investment in an ERD Information Technology company after making an average 6x return over four years of the investing cycle. It was a wonderful lesson for us about what patience can do in the investment management business. This remarkable accomplishment of value creation is a testament to the innovation, strategic partnerships, and expanding customer base coupled with the hard work & dedication of the management team. The new investors had augmented their assessment of the business and traded the business at exalted value. We chose to part away in search of better value.

During the year, we evaluated investment ideas in the 2-wheelers (2Ws) space. This industry has a huge brand appeal and operates at a variable cost model, enjoying negative working capital with a focus on research and development, and marketing. One of the common traits across all players is the success of two or three products in the domestic markets in the last decade after scaling up in different geography, segments etc. One of the incumbents lost the initial battle when we saw the 2W leader with a rural footprint takes Tiger Woods, a golf icon as its brand ambassador in the year, 2014. I saw this as a colossal mistake in strategy, and communication with its rural audience.

The hard choice was narrowed down between a south-based manufacturer, strong in marketing and distribution or a Pune-based manufacturer strong in engineering. The former has milked its successful brands in every possible way by successfully expanding its portfolio and presence in the two-wheeler space (domestic and exports) by introducing and scaling products targeting specific demographic (urban, rural, millennial, couple, male, female, etc.) characteristics of a target group along with permutation and combination of design, colour, mileage, engine performance, power, features and comfort. It took on the gearless scooter market by the horn

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and took lead in the launch of electric TWs also. The company follows a more personalized way of marketing as its products have a universal appeal. However, the company's expansion into the above-mentioned segments in the last decade through aggressive marketing (average branding expenses around 9%, highest in the industry) and competitive pricing strategy has resulted in lower operating margins compared to peers but created a long-term sustainable advantage for the business. Whereas the latter, a Pune-based 2W, aspiring for engineering excellence, has a marketing strategy that seems to be inward-focused, wherein customers are made for the products and not vice-versa.

Our reading of Isaiah Berlin in "The Hedgehog and the Fox: An Essay on Tolstoy's View of History" came in handy in deciding between the two. The author has classified people as Hedgehog individuals/organizations who have a single, overarching view or theory that they apply to all aspects of life. They have a rigid and consistent worldview. In contrast, the foxes are individuals who approach the world with a more diverse and adaptable perspective and do not rely on a single principle to understand the complexity of the world. Berlin used to highlight the differences between these two approaches and to discuss Tolstoy's view of history, suggesting that Tolstoy was more of a hedgehog, believing in a singular theory of history, while other thinkers, such as Shakespeare, were more like foxes, considering the diversity and complexity of human experience. This reading remained with me and helped immensely in our understanding of the organizational culture, and strategic viewpoints of both companies and making the right bet on the company which is investing heavily in segmentation of the markets. The stock we chose is up 55% vs 10% for Pune-based manufacturers in the last year.

We again landed at crossroads, of a different nature, with our investment in a pipe and electrical company, where the divergence of opinion on the issue of running the company took place between the professional CEO and a next-generation scion. The investor sentiment took a beating in the intermediate period and the reptilian brain was pushing for flight rather than fighting or holding on to the investment. We reassessed the merit of business, and its competitive positioning and took the road less travelled, by staying with it. The business merit warranted shoring up our holding during this turbulent period and we are glad that we did. In the end, both sides buried their hatchet for a better tomorrow and to achieve a common goal. The stock is the best-performing portfolio company this year. I also reflected upon the issue of alignment of the financial interest and blurring of positions between Promoter and Professional CEOs with Employee stock options schemes/trust. At the last count, around 223 companies, having more than Rs. 2,000 cr market cap, have either an ESOP plan or an investment in an ESOP trust. This has resulted in a huge change in the way a professional CEO looks at his duties and a lot more alignment of interest.

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Outlook

The future of India is powered by multi-fold growth engines. One, the FDI in manufacturing has increased by ~80% from USD 9 billion in FY21 to USD 16 billion in FY22, as the post-COVID world looks for building supply chain security with friendly countries. We have witnessed India entering FTA with Australia and UAE and are currently in discussion with other countries like UK, EU, and GCC. Countries across the world are looking at China+1, and Europe+1 from a supply chain perspective and these agreements will allow India to easily integrate into the Western manufacturing supply chains. Two, we have noticed that the Indian corporates have improved their cash flow position (PAT + depreciation), substantially. BSE 500 PAT has increased to Rs. 14,600 bn in FY22 from Rs. 7,600 bn in FY18, while the capital expenditure has remained constant at around Rs 4,000 bn for the last three years. This has meant that the CAPITAL EXPENDITURE/PAT ratio, which has ranged from 80-100% for BSE500 companies, has collapsed to an all-time low of ~48% in FY22E, creating room for the private Capital Expenditure cycle to take off. Lastly, the Normalization of COVID subsidies is creating space for Increased Central Government Capital Expenditure, powered by election cycle spending in the coming years. We are going to witness 13 state elections and a general election from now, till 2024.

Mid-market space remains accused of underperformance for a second consecutive year (CY) which we term a 'Deployment' year. Cycle analysis does suggest that Mid-cap / small-cap strategies with stock-picking abilities are likely to reap benefits in the coming years. We continue to put our nose on the grindstone with a relentless focus on a single strategy that has helped us stay nimble and adaptable, and better navigate the challenges and opportunities that come our way. You would see another non-correlated strategy launched this year by us. Don't miss participating in that.

Finally, we at Vallum are excited to announce that we have updated our company logo by adding

the golden character eight . The reflects facets of wealth & spirituality as well as a new chapter and direction of the . In many Asian cultures, the number eight is considered lucky because it resembles "prosperity" or "wealth" in Chinese, Japanese, and Korean. In Christianity, the number 8 is associated with rebirth and renewal because the resurrection of Jesus is said to have taken place on the eighth day. The core teachings of Jainism and Buddhism are embodied in the Noble Eightfold Path, which includes eight steps to achieve enlightenment: right understanding, right intention, right speech, right action, right livelihood, right effort, right mindfulness, and right concentration. Jainism also recognizes eight auspicious symbols (Ashtamangal), which are used in religious ceremonies, and rituals and is associated with the vastness and complexity of the universe, the interconnections of all forms of life, and the purification of the soul through the process of karmic purification. These lines may seem odd to you when intertwined with capitalism, but let me admit, that as we reflect on the blessings of financial abundance, practising gratitude can also help us to recognize the blessings that come

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with financial abundance. All you of have been wonderful partners in this journey and we remain committed to your financial well-being.

This year, we see more opportunities knocking on our door and we would be opening the gates a bit wider for additional funds to be invested with Vallum India Discovery Scheme. All prospective investors can connect with us. Also, some of you have nudged me to write more about our investment and other reflections which I have gathered over these years. You will hear more often from Vallum.

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Success is not just about finding opportunities, it's also about seizing them. And with the gates now wider open, we invite all prospective investors to connect with us at connect.vallum@vallum.in and join our journey to success.