

Letter to Stakeholders

2023-24



七転び八起き (nana korobi ya oki)

“Fall seven times, get up eight.”

Old Japanese Proverb

Dear Stakeholders,

Writing an annual letter can be viewed as either a chore or a challenge: a chore when the year has been uneventful, a challenge when the news flow is overwhelming, with many moving parts pulling in different directions. This year, however, it has been a delight. The Indian economy, brimming with confidence, achieved several notable feats. It emerged as the fifth-largest economy in terms of market capitalization and boasted the third-highest number of unicorns globally. Our economy, which has experienced many false starts in the past, now stands on firm footing for the eighth time. Despite these accomplishments, Indian markets remain underpenetrated, with just 5% of India's household savings invested in equities and mutual fund assets accounting for only 16% of GDP. In comparison, the global average of mutual fund assets to GDP is approximately 60%. The Indian market cap represents only 2% of the Bloomberg world market cap, indicating a long runway for wealth creation.

Amidst this backdrop, the Vallum India Discovery strategy has outperformed the benchmark by 553 basis points net of fees, generating a return of 45.7% for the fiscal year 2023-24. As I pen this letter, at a granular level, 83% of client assets and 72% of clients are outperforming the benchmark. Additionally, approximately 68% of client assets are surpassing the benchmark by more than 300 basis points net of fees. We believe these results are commendable, especially considering that the spectacular rally in public sector undertakings contributed to more than 30% of the benchmark returns, which many of us did not fully participate in. The return of individual investors will differ based on time for your joining the strategy.

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Through the year, we embarked on a significant venture with India's premier thermal boiler and turbine manufacturer, a stalwart in the public sector. While the global gaze fixated on renewable energies, the augmentation of thermal power sources languished in neglect. The disproportionate surge of renewables within the global energy landscape precipitated grid destabilization. Initially discerned by the Chinese, they spearheaded the resurgence of thermal power initiatives within their borders in the year 2022. A meticulous examination hinted at a renaissance of thermal power worldwide, India included. We pinpointed a thermal power enterprise poised on the precipice of a resurgence; its trajectory illuminated by a promising future. During the tumultuous downturn, a multitude of players in the thermal power sector vacated the arena, dwindling the pool of bidders from eleven in 2012 to a mere two by 2024. Since 2011, the Power Equipment Industry, comprising boilers and turbines, found itself embroiled in fierce competition from private and Chinese enterprises, devouring a substantial 35% market share until 2012. Through judicious governmental intervention, the industry transitioned into a duopoly, with our PSU emerging as the last bastion, entrusted with the critical supply of power equipment.

Enduring a lean phase akin to a bird's *Molting*, the process of shedding old feathers and growing new ones, the company diversified its revenue streams towards non-power projects, with the order book poised to surge to Rs 150-200 billion at its zenith. Facilitated by ventures like the Vande Bharat propulsion system, defense sector artillery guns, hydrogen electrolyzers, and storage battery systems, the company pivoted amid the ebb and flow of market dynamics.

During the pinnacle of the power cycle, the company undertook thermal projects worth Rs 400 billion in FY13, a figure that dwindled to Rs 110 billion by FY21, burdened by staggering fixed costs that obscured potent operating levers. However, spurred by the resurgent imperative to bolster thermal power capacities in the nation, this PSU is primed to execute thermal power orders worth Rs 550 billion by FY26, buoyed by soaring metal inflation over the decade. This company epitomizes the archetype of a turnaround narrative, even amid its fiscal struggles when our investment was seeded. Remarkably, it has yielded returns exceeding 125% from our initial stake.

A sound investment is a convergence of three pivotal factors: the identification of a robust business, management whose objectives resonate with those of the shareholders, and acquiring such a business at a price undervalued by the market. The acumen to discern which

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factors are discounted or not by prevailing prices is as imperative as the former two. Without this alignment, investment returns may fail to materialize as envisioned. Our meticulous scrutiny of earning cycles has been instrumental in making investments at equitable valuations.

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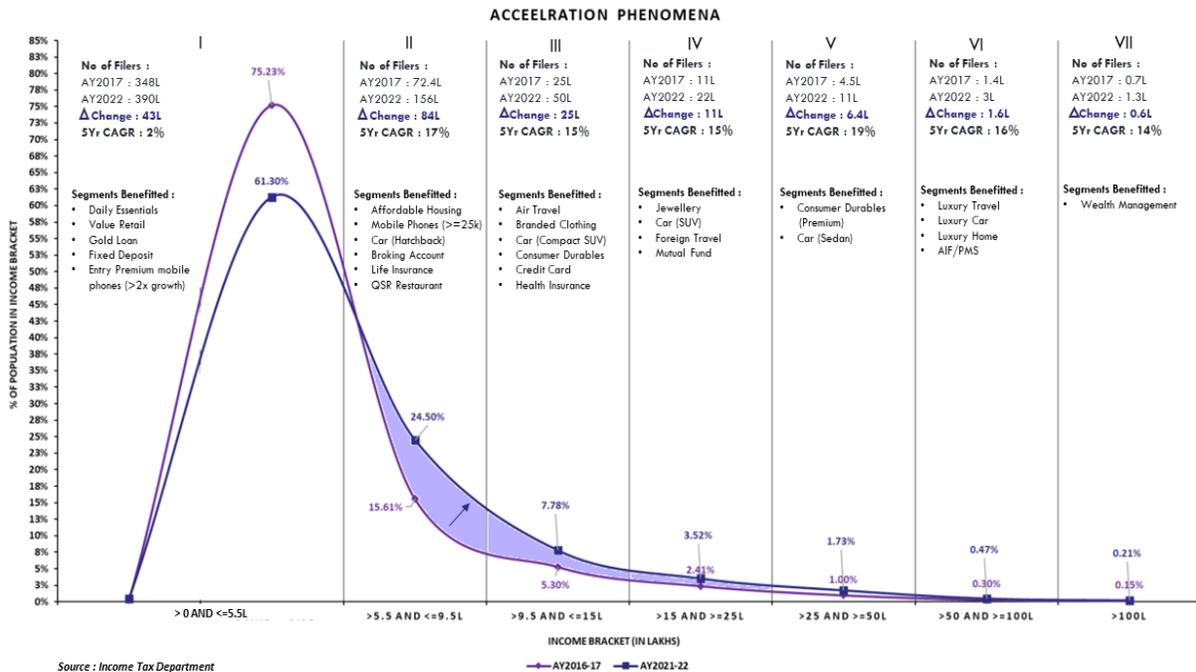
The Indian economy is poised for a prolonged period of high growth, mobilizing its land, labor, capital, and natural resources to deliver infrastructure at an unprecedented pace. Our physical and digital public infrastructure development programs are among the most ambitious in the world. Each stride in progress, and the associated network effect of such investment, will drive accelerated and sustainable economic growth. This network effect can be illustrated by the development of a road or railway expansion between two cities, requiring just one link to connect them. However, as the economy encompasses more cities, the number of required connections rises exponentially. For any number of cities (N), the number of links needed to connect each city to the others is given by the formula $N(N-1)/2$. As more cities or countries join the system, the number of links rises at an accelerating rate.

India has recently opened 70 new airports and plans to commence construction of another 50, aiming to reach a total of 220 by 2025. As more cities establish direct connections, we anticipate increased productivity and accelerated growth. This Ricardian growth, stemming from falling trade barriers, new infrastructure, and improved transportation and communication, is inherently sustainable. These investments have ignited a growth momentum, placing us on the cusp of the Acceleration Phenomenon (AP), where heightened economic activity leads to income growth and an expansion of the population within relevant income segments. Consequently, the demand for services associated with these segments will experience exponential growth. This phenomenon underpins our investment thesis for several ventures made this year.

Tracking the distribution of Income Tax filers in India over time, we have estimated growth under each income segment and its network effect on relevant industries. The bell curve analysis reveals intriguing insights.

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In the first income segment (I), we observe a significant acceleration in new income tax filers, with a net addition of 4.3 million filers (gross 11.3 million addition estimated), marking their initial introduction to the IT department. These 4.3 million filers are poised to join the acceleration phenomenon in this decade. This growth has a ripple effect on segment II, which has seen a remarkable increase of 8.4 million filers (net) to a total of 15.6 million in the last five years. This segment has overcome challenges such as high costs of daily essentials, food inflation, and healthcare expenses, leading to an acceleration in services such as discount brokering, entry-level phone sales, affordable housing, and products catering to this income bracket. The surplus income in higher brackets drives broader discretionary spending, further boosting consumption. For example, in segment III, 2.5 million new consumers have entered the market for premium apparel purchases.

This explains why four-wheeler passenger car sales have surpassed pre-COVID levels, while two-wheelers continue to face challenges. As economic momentum builds, consumption patterns shift, leading to a significant consumer surplus and increased discretionary spending. While human thinking tends to follow linear patterns, it often overlooks the non-linear growth in industries associated with the Acceleration Phenomenon. The crux of economic growth is propelling traditional businesses and startups, job markets, and wealth creation in the stock and real estate markets. A case in point is the acceleration seen in car

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sales in China over the past decade, from two million cars in the early 2010s to 18 million in 2013. Similar trends are emerging in India's consumption landscape.

We have invested in one of the largest luxury car dealerships in the country, anticipating non-linear growth in luxury car sales over the next decade. The dealership's revenue streams include sales and servicing of new and pre-owned cars, car accessories, insurance, and financing solutions. As more cars are sold, the associated activities (service income) become increasingly valuable, creating a long tail of income. Despite India selling only 0.03 million luxury cars (ASP > Rs 50 lakhs) last year out of a total of 3.8 million units, compared to China's 4 million units out of 30 million sold, there is immense potential for growth. Our investee company has established a strong franchise, with a market share indicating significant dominance in the regions it operates. With an average of 15 cars serviced for every new car sold, this segment is poised for growth. Additionally, the sale of pre-owned luxury cars, an aspirational product, presents significant opportunities. Our investee company has recently introduced this segment to its dealership, doubling its Total Addressable Market size (TAM).

The auto dealership sector, currently fragmented with numerous small players, is witnessing a shift due to rising real estate prices and a shortage of trained manpower. This favors economies of scale, hinting at a future of consolidation. Our luxury auto dealer, through roll up merger, has acquired 11 dealerships of premium brands across India in recent years, demonstrating its agility and market dominance. The rise of electric vehicles (EVs) and hybrids is also challenging the traditional internal combustion engine (ICE) automobile service operations. However, the increased complexity of these vehicles presents an opportunity for dealerships to capture service market share from independent repair shops.

Another investment we've made is in a company that owns five apparel brands, including US Polo, Calvin Klein, Tommy Hilfiger, Arrow, and Flying Machine. The company has undergone a remarkable transformation in the last two years, focusing on its power brands and divesting non-profitable ones. Their strategic efforts in product, pricing, and format, along with a strengthened balance sheet, have positioned them for success. The premium apparel sector is thriving, driven by the addition of organized retail space and the success of brands like US Polo, which has achieved Rs 20 billion in sales. The introduction of US Polo women's wear is expected to further accelerate revenue growth. The company's pivot towards a franchise

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model has resulted in a top quartile return on capital employed (ROCE) in the retail industry. Their innovative concept of an 'all-brands under one roof' store has also been well-received, promising further growth.

Our investment in a leading music content company reflects the changing landscape of music consumption in India. Music consumption in India has seen an accelerated trend (thanks to cheaper data) from 21 hours per week to 26 hours a week (The global average is 32 hours per week). With the advent of streaming apps and cheaper data, music consumption has increased significantly. Our investee company has leveraged data analytics and artificial intelligence to enhance the commercial success of music label acquisition, placement, and monetization. They have diversified their revenue streams by venturing into music for OTT platforms, live events, short-format videos, and producing web series, capitalizing on the growing trend of digital entertainment.

We also invested in a corporate-backed Non-Banking Finance Company (NBFC), which has transitioned from a wholesale to a retail lender. This strategic shift, coupled with a strong parent company and recent regulatory actions favoring stronger NBFCs, has positioned them for market share gains in areas such as affordable loans, microfinance, two-wheelers, rural, equipment, and MSME/SME financing. The company's lower cost of borrowing and management's expertise in digital loans and cross-selling further enhance its competitive advantage.

In line with the accelerating income trends, we invested in a scalable affordable housing loan business model that leverages digital infrastructure to disburse loans. The affordable housing loan segment has seen a >17% CAGR in the past five years, aided by government initiatives and digital infrastructure. The company's unique business model, focusing on home loan influencers rather than traditional distributors, has resulted in high branch-level productivity and cost efficiencies. Their under-leveraged balance sheet allows ample room for growth, leading to higher returns on equity (ROE). During the year, we have bid goodbye to both the large banks which we have held for the last four year and that gave us stupendous return during our holding period.

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Our long-term investments in Oncology API, Formulation, Biologics, Peptides, and CDMO business have begun yielding results this year. The past three years were challenging for the business, marked by regulatory actions on the formulation plant by the USFDA and delays in its remediation. This led to a significant cash flow mismatch, impacting key project completions and accumulating debt. The high-cost base became a drag on earnings as a series of unfortunate events unfolded rapidly, making it difficult to assess the dent in earnings. Nonetheless, we persevered patiently.

This situation recalls an interview with the leading superstar Shah Rukh Khan, who was asked about his favourite movie among those he has acted in. He responded that his favourite movies were the ones that had not done well in his career. He justified this by explaining that he had worked equally hard on all of them, yet some had failed due to reasons beyond his control.

Despite facing questions about holding onto this investment during a prolonged period of suboptimal returns, we maintained our position to capture the full earning cycle of the business, typically spanning 4-5 years. We made a fair judgment on the price, considering the business potential (which was significant) and believing that the worst was behind us. The promoter fought back vigorously, implementing serious cost-cutting measures, expediting stalled projects by raising cash, and expanding business opportunities in adjacent areas. We anticipate operating profits to triple from current levels over the next three years, driven by the commercialization of facilities, new product launches, better utilization, and monetization of deep research pipelines. Seeing light at the end of the tunnel, we have increased our stake in the business.

These days, most discussions on investing conclude with a debate on the stock performance of Public Sector Units (PSUs). In my two and a half decades of investing career, I have witnessed over ten bubble bursts, starting from the IT bubble in 2000, followed by the Media and Retail Bubble in 2007, Real Estate in 2014, Pharmaceuticals in 2015, NBFC in 2019, Chemicals in 2021, and Mid-cap IT again in 2022. After a burst, it typically takes four to seven years for the sector/industry to regain its previous peak market capitalization. Currently, we observe similar signs of a bubble forming in the Railway PSU packs, characterized by a single customer, limited opportunity, low float, and narrow ownership. I would refrain from investing in such a scenario.

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All professional investment managers, including myself, navigate through a series of hurdles. We undergo a fire ordeal on stock selection, sector identification, and market cycle judgment. It is imperative to be correct in all three aspects most of the time. In a domain where the quality of a decision cannot always be assessed by its outcome, a good process is one that distinguishes oneself.

Outlook

One of the paramount economic accomplishments of the current governing administration lies in the enactment of three robust foundational policies. Foremost among these is the "Atmanirbhar Bharat policy," its essence resonating within the realm of ethanol policy, bolstering capital expenditure in oil and gas, ensuring thermal coal self-sufficiency, fostering import substitution in pivotal sectors such as chemicals, electronics, and defense equipment, among others.

The tangible outcomes of these policies are increasingly apparent. Secondly, the efficient allocation of public resources and the phased-out subsidies, exemplified by the introduction of NANO Urea, have significantly contributed to this economic stride. Finally, the implementation of the Digital Public Infrastructure promises a marked reduction in the frictional costs associated with conducting business and acquiring customers, thereby amplifying the economy's agility. These decisive measures are poised to fortify India's fiscal standing, precipitating a cascading effect of prosperity. Our projections indicate that India is poised to transition into a Current Account Surplus status within the next three years, barring any unforeseen escalation in oil prices.

Recently, on the 90th foundation day of the Reserve Bank of India, the Prime Minister articulated aspirations of enhancing accessibility and global acceptance of the INR. Endeavours to promote UPI as a payment conduit and to facilitate bilateral trade settlements in local currency have garnered traction among trading partners. This prompts a pertinent observation regarding the imminent appreciation of the INR against global currencies. Reflecting on historical economic precedents, the preceding NDA regime (1999-2004) laid the groundwork for a Current Account Surplus, catalysing an appreciation of the INR between 2004 and 2008, coinciding with a surge in export growth. These economic dynamics underscore the propensity for global investors to channel funds into capital markets during

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sustained periods of economic buoyancy, particularly favouring mid and small-cap enterprises.

On a personal note, this year has been enriching. I contested for and secured a seat as a Board Member of the Association of Portfolio Managers in India (APMI), the apex body representing all Portfolio Management Services (PMS) in the country. Our concerted efforts have been directed towards fostering an environment conducive to Ease of Doing Business within the PMS domain, benefiting participants, clients, and stakeholders alike. Additionally, the year has been marked by cherished memories of my visit to Japan after a hiatus of two decades.

Interestingly, the perplexing scenario of the pizza conundrum, which I shared with you two years ago, has resurfaced albeit in a different context, for my daughter. The curiosity regarding the inexplicable affordability of a pizza dinner for a family of four in Tokyo, a perceived expensive place, compared to Mumbai prompted an insightful dialogue. It took some effort to elucidate to my thirteen-year-old daughter that Japan's three decades of deflation across the job, stock, and real estate markets have eroded the purchasing power of its industrious and disciplined populace. Consequently, Japan stands as a unique travel destination among developed nations, experiencing a significant depreciation of its currency against the INR. As we traverse diverse landscapes, it becomes increasingly evident that while India was once seen as emulating the West, the tides have turned, with the West now embracing facets of "Indianness."

Our investment portfolio remains steadfastly concentrated on opportunities that promise an optimal balance between anticipated returns and associated risks.

Regards



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April 2024

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