Investor Letter Vol III

July 2019

"Most people are too fretful, they worry too much. Success means being very patient, but aggressive when it's time. The big money is not in the buying or the selling, but in the waiting." Charlie Munger

First Things First

Our average return across portfolios for quarter ended June 2019 was 3.8%. This compares favourably with the broad market indices (1.9% for BSE Sensex and 0.8% for Nifty) and average of Mutual Funds (0.7%) for the same period. Our average trailing twelve-month return is 12.9%, again higher than broad market indices (11.6% for BSE Sensex and 9.9% for Nifty) and average of Mutual Funds (7.4%).

We have recently launched our PMS platform. We believe that this is a much better platform for our investors. It will reduce transaction costs, require lesser administrative work from you and will provide you with much better standardized reporting by an independent fund accountant. Standardization and outsourcing of operations will also help us scale up much faster and all our investors will benefit from the economies of scale.

We will be in touch with you soon, in case we have not been already, to migrate your accounts to the PMS platform.

Portfolio Activity

We have increased the total number of investible stocks in our portfolio to 45 from 40 as at the end of last quarter. We have added 6 stocks and removed 1. As you are aware, we add a stock if our proprietary model to check for the competitive edge of the company rates the stock at a score of 7 or higher. A score less than 7 leads to deletion from the list.

Notable deletion is of an auto major that does not seem to have a clear strategy of emerging stronger from the current industry downturn. It continues to bet on a large portfolio of diesel vehicles, and we are not comfortable with that. It continues to allocate capital to a bunch of non-related and non-core businesses without any clear plan of unlocking shareholder value. Overall, the company has eroded its competitive edge.

We have done a fairly in-depth analysis of residential real estate industry. We wanted to check if there are signs of turn-around and which of the companies would be potential winners. We looked beyond near-term demand and inventory data and liquidity issues faced because of the NBFC and HFC crisis. It looks like the industry is close to a turnaround. This conclusion is predicated on:

- Higher affordability – the affordability index is at 8 year high.
- Lower cost of borrowing for buyers – expected to fall further as rate cuts are transmitted to borrowers.
- Reduction in inventory – small and mid-sized developers are vacating the market. Large developers are better equipped to manage inventory.

Our interaction with real estate developers, suppliers, buyers and housing finance companies shows that there is a pick-up in demand as buyers are now looking beyond rent vs. buy metric. This demand pick-up has not yet translated into a price pick-up because of a slowdown in lending by HFCs. The time taken to sanction and disburse loans has gone up. We believe this is a temporary phenomenon and as the lending activity picks up so will be the number of transactions that will ultimately lead to a price increase. This will create a virtuous cycle.

Based on our Porter model analysis we believe that the biggest beneficiary of this virtuous cycle will be Godrej Properties. The company has the biggest pan-India presence amongst all its peers and has an asset light model leading to higher ROCE. It uses technology efficiently to ensure faster and higher quality construction. Its transparent customer engagement has already created a strong brand. This resulted in its highest ever sale by volume in the last quarter. It has a rock-solid balance sheet and most importantly has learnt how to sell in various micro-markets all over the country. Therefore, it is not dependent on a particular micro market to grow its sales. Along with Godrej Properties we have added another company to our portfolio that is smaller but has very effectively used the industry downturn to become a pan-India developer.

The pick-up in real estate demand will also benefit ancillary home-improvement businesses like tiles, fittings, paints, ply and laminates etc. We already have an investment in the leader of each of these industries.

Another interesting addition includes two leading NBFCs that have the same parent. At not very distant future both will merge with the parent to create the largest NBFC in the country. The promoter group has blue-chip reputation and the businesses are run efficiently and with transparency. We are buying both these companies at all time low valuation. The opportunity has arisen because of crisis faced by their weak peers, cyclical weakness in the industry one of them lends to, exit by one of their large shareholders (faced by its own liquidity issues) and lack of clarity about the merger timing. We believe that once there is clarity on these issues the markets will reward the companies for running the excellent franchises that they run.

Other notable portfolio inclusions are that of the largest contract staffing company and a domestic formulations company that has highest market share in its therapeutic segments.

Our core portfolio companies like UPL, Titan, Info Edge, APL Apollo, HDFC Life, ICICI Lombard, Apollo Hospital, etc. continue to do well and continue to get rewarded by the markets for their outperformance. We are not surprised by the number of earnings upgrades our portfolio companies continue to get from analysts.

Outlook

Discretionary consumer demand continues to be under pressure especially in autos. Auto industry is seen as an indicator of overall robustness of the economy. However, in the current situation there has been a slowdown in auto demand because of very rapid change in regulatory environment and a squeeze in liquidity and not only because customers do not want to buy new vehicles. We expect these issues to auto-resolve over the next couple of quarters and sales to pick up. Indian four-wheeler sales are still only about one-sixth of the Chinese four-wheeler sales and we expect that gap to continue to close despite periodic slowdowns like the current one. We are less optimistic on two-wheeler sales since we believe that India may have already hit the peak demand as far as two-wheelers are concerned.

There has been a sharp fall in interest rates. The 10-year G-Sec yield at 6.6% is at a multi-year low and is expected to fall further. With a reduction in interest rates the P/E multiples go up so we will not be surprised to see the Nifty P/E multiple to rise rather than fall. A steady INR, improvement in corporate earnings, increase in free float of stocks and continued inflows into equity mutual funds should override the near-term pressures of global trade wars, waffling tax-related changes and NBFC crisis.

It is the nature of the markets to be volatile. We look at volatility as an opportunity to invest in our portfolio companies at lower levels. Mr. Market has more depressive days than manic and we like to use the depressive days to invest rather than worry. This strategy has contributed to our market beating returns. Whenever there is any doubt, we refer to the quote by Mr. Munger at the beginning of this letter.

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