Calendar Year Ended' 2018
Adviser Clientele Communique

Dear Sir & Madam,

"The truly big investment idea can usually be explained in a short paragraph."
-Warren E Buffett

We have finally reached the end of this year (2018) and I believe most of us have learnt a lot of very valuable lessons. Quite a few, we have already implemented in our portfolio and diligence process and a lot of them we intend to in due time. In my experience of as little as 7 years in value hunting and investing, I haven't seen a year with such volatility across all asset classes alike. However, statistics dictates that very high volatility is often preceded by a solid bull run like the ones right after the *Credit Contagion of 2007*. Either ways, we are proud to have outperformed peers even in a market like this which is self-explanatory to the entire theory of Quality vs Quantity. Last year towards the end we had decided to fly into quality and heavily cut diversification which one year hence seems like the perfect thing to have been done. I strongly feel this market should be bought into at these valuations since its very rare to find alpha so easily available. Markets last year have even proved how little the PE continues to be relevant in a day and age when analysts can in real time compile financial statements of companies. We, however, continue to stick to our portfolio of selected stocks that have performed in the past and we strongly believe they will continue to do so in the future. Most of this year has been bad in terms of performance as far as stock prices are concerned, however as long as the businesses have grown I believe the prices will catch on too.

Views on Sectors that we were and continue to shy away from

Finance & Banking

We remained uninterested in the Indian Banking and general finance space for the past three years, however last year this idea made lesser sense looking at the phenomenal returns these companies made. *2007 had clearly taught us that housing was in fact not all that evergreen as it looked from afar.* Houses that sell post financing sell at heavy rather very

heavy premiums compared to what happens to them in case the borrower defaults. Given the default, the finance company must pay for upkeep and costs to find a buyer to sell the house to or risk piling on the inventory. All of that for a very thin Interest Income Margin. We too made our bets on sustainable housing and real estate last year (2017) which were **Nitco** and **Prestige Estates**[1]**.** We prefered buying companies that would gain when the houses were sold and on the upkeep, opting for solely the business risk of the industry. We also steered clear from the Retail Banking space for the basic reason that most banks in India have a chunk of their revenues from corporate loans. Corporate loans would basically imply a bank giving out a loan for a risky business or venture in which if the business works out the bank gets a thin margin (NIM) and in case the business does not, the bank loses the principal or gets into litigation etc. Similarly, with AMC (Asset Management Companies), I would prefer to selectively take the market risk instead of investing in a company whose operations are highly correlated with the market.

Pharmaceuticals

As much as we like pharmaceuticals as an industry owing to its defensive non-cyclical nature we have maintained a very cautious opinion in the sector. We were selectively and temporarily exposed to companies like **Pfizer** and **Abbott India.** While Pfizer was simply to diversify our pharma basket, we held Abbott to be exposed to the revenue stream of the drug **"Thyronorm"** which has a dominant market position in Thyroid Drugs. The risk/ reward rationale in the pharma sector did not make sense to me three years ago, does not make sense to me currently and I doubt if it would eventually. There is much alpha around the markets to be earned without the high levels of contingent risk factors needed to be hedged or work with in the pharma space.

Aviation

To quote a paragraph from the book **"The Intelligent Investor"**

> *"The pitfalls have proved particularly dangerous in the industry we mentioned. It was, of course, easy to forecast that the volume of air traffic would grow spectacularly over the years. Because of this factor their shares became a favorite choice of the investment funds. But despite the expansion of revenues—at a pace even greater than in the computer industry—a combination of technological problems and overexpansion*

[1] We booked profits in the stock at 135% returns, since we realised the property value underlying nor the business would sustain such valuations

of capacity made for fluctuating and even disastrous profit figures. In the year 1970, despite a new high in traffic figures, the airlines sustained a loss of some $200 million for their shareholders. (They had shown losses also in 1945 and 1961.) The stocks of these companies once again showed a greater decline in 1969–70 than did the general market. The record shows that even the highly paid full-time experts of the mutual funds were completely wrong about the fairly short-term future of a major and non esoteric industry." *-With reference to a comparison between aviation and computer industry in the year 1970*

We strongly believe this is somewhat similar to the situation of the aviation industry in the current market scenario moreover the rewards earnt from the aviation industry over the past hasn't been worth risking the uncertainties surrounding the aviation industry. Especially when there is much better alpha opportunities around the Indian Capital Markets. (illustrated below)

Approach

We maintain a **Core- Satellite Approach** towards the subtle art of Portfolio Management. While the **core portion** works more like a single company with multiple business verticals in the form of investments in stocks of companies. The **satellite portion** has a much shorter term approach like arbitrage or seasonal bets. However, given the scepticism surrounding the markets last year our satellite portion was majorly arbitrage in the form of buybacks apart from which we added a small basket of **Panic Stocks-** *Which currently is only a mild exposure to Daawat (LT Foods), Tata Sponge and Thirumalai Chemicals.* We have added on our exposure and weights towards our Core Portion owing to the amazing valuation rationale. The only new addition to the same is **JK PAPER.** A lot of our core companies that had become mildly overvalued last year due to operational outperformance are now available at much cheaper valuations even after having continued to outperform this year.

What makes our Core Shine

Our core portfolio has seen multiple modifications since the inception of the concept. The core portfolio generally has a longer-term horizon of close to 1/ 3 years, unless the idea or the company gets adversely impacted or it gets abnormally overvalued like in the case of a lot of companies last year- (RPP INFRA, DEEPAK NITRITE, VGUARD, MINDA CORP, ESCORTS, EXIDE Industries to name a few).

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What we currently hold, since when and in what weights are illustrated below.[2]

1. **AUTO & AUTO ANCILLARY (45%)**

India has been on the cusp of growth over the past three years positioning itself to soon break out. The automobile penetration in India is one of the lowest among emerging economies, the ever-changing preference and taste of the end consumer makes it difficult for us to pick the right auto player so we chose a basket of stocks which are positioned in a way to gain and grow as the **Indian Auto Story unravels.**

a. BALKRISHNA INDUSTRIES (12%) - 2015

Our investment in BKT was not intended to bet on the India Story but instead, hedge it. BKT derives 85% of their revenues from Exports, a chunk of which is from OEMs. BKT has grown from strength to strength over the past few years positioning themselves with a 6% market share in the **Off-Highway and ATV Tyre market.** Higher margins, clean Balance Sheet and fundamental strength have ensured our confidence in the growth story of the company.

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b. MINDA INDUSTRIES (10%) - 2015

Minda has established itself as the market leader in nichè ancillary products (viz.- LED Lights, Horns, Switches, Air Bags & Alloy Wheels) which have high margins and little impact from future prospective disruptions.

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c. NOCIL (14%) - 2016

Nocil, an Arvind Mafatlal brand that has established itself as India's largest rubber chemical manufacturer. It has a very strong market share in Tyre Manufacturing Chemicals and is in a position to grow faster than its global competition **China Sunsine.** Nocil has managed to consistently grow with high ROEs and has defended a superior profit margin over the past few years and will continue to do so owing to the US-China Trade war[3] and anti dumping duties imposed on China.

d. ASHOK LEYLAND (9%)- 2016

The Company is the second largest commercial vehicle manufacturer in India, the fourth largest manufacturer of buses in the world and 12th largest manufacturer of trucks globally. However, our investment in Ashok Leyland was inspired by the increase in road construction across India and an unprecedented increase in **Luxury Road Travel.** Ashok Leyland has established itself as a dominant player in the Luxury Busses and Defence Verticals.

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[2] Weights mentioned are those in which we suggest new investments, hence the original weights in the portfolio is different due to returns and dividend reinvestments.

[3] Given the USA duties on Chinese products, Nocil would be able to serve USA Tyre manufacturers better and at cheaper costs.

2. **CONSUMPTION, CEMENT & INFRA (36%)**

India is an emerging economy with a population of close to 130 Cr thus we had to focus on sectors which are very specific to the population at large, moreover their spending habits.

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a. JK PAPER (12%)- 2018

Established itself as a dominant player in the printing and copier paper market along with a key player in the paper and cardboard market. JK Paper has immensely cut debt and improved margins. Looking at the recent paper consumption and dependence on printing paper we believe JK Paper has a long way to go in the near future, also keeping in mind the Elections Next Year.

b. BAJAJ ELECTRICALS (7.5%) - 2016

If we were to believe the govt has actually managed to electrify most of the villages as they and the statistics strongly suggest. The company is a market leader in fans and luminaries like LED to cater to the budget and rural markets. Bajaj Electricals has established itself as a key player in the northeast and the rural market, both of which have suddenly seen an increase in spending and better electrification should continue to aid growth. Also, the homely brands they distribute like Nirlep and Morphy Richards have been doing good and we see people making a shift to the non-LPG and IoT Based kitchen appliances.

c. HEIDELBERG CEMENTS (7.5%)- 2016

The company was originally bought in the satellite portion in the year 2016 since they showed very strong signs of a turnaround. Since FY16 the margins have expanded more than 3 folds to 7% in FY18 from 2.2% then. With major operations in the rural markets of Central and South India, the company sells cement under the brand **"MYCEM".**

d. LARSEN & TOUBRO (9%) - 2017

Our investment and selection of LT does not need much of an introduction. Investing in the Indian Infra growth story cannot happen with LT being around. Increased Capital Spending by the government has triggered growth in LT which we believe has a long way to go in the years to come.

3. **INFORMATION TECHNOLOGY (10%)**

Recent times have seen an increase in R&D and IT spending. However, most major companies now prefer having an IT Division instead of outsourcing services to larger IT Companies viz.- we decided to end coverage on all large-cap IT and move focus on new age IT and KPO businesses like automation, augmented reality, robotics etc.

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a. MPHASIS (10%) - 2016

We first invested in MPhasis when one of the world's largest PE fund (The Blackstone Group) decided to take over a controlling interest in the company from HP Enterprises. Since then MPhasis has developed into one of the leading players in nichè IT segments like automation, AI (artificial intelligence), Augmented Reality and Risk Management specifically catering to the BFSI segment. The way ahead we strongly believe IT will play a major role in finance and banking. Mphasis is very well positioned to cash in on any such global boom.

4. CASH & CASH EQ (9%)

Even though we don't buy nor recommend buying anything which even to the slightest seems overvalued or has wide uncertainty regarding major future cash flows like in the case of Aviation and Pharma. We still prefer holding at least 5% -9% of the portfolio as cash which allows us to buy during panics or deep undervaluation. One such time was when the media released the information regarding the Surgical Strikes.

The Satellite

The year 2017 saw very minimal satellite operations since originally we presumed the market heavily overvalued. Post the LTCG we had a bearish view on the market and at an average PE of 30x not much alpha was around to be made. Major operations this year was in the BuyBacks which made themselves available in the IT space which was aided by the USD strengthening towards the year-end. Post the September Quarter we were getting our Core stock at much better valuations and stronger fundamentals, thus we chose to add on to the stocks we already held- illustrated above.

Our investments generally flow along with the Multi Factor Model - namely the Carhart Model. Which gives higher weights to Momentum, High Book Value/Price, Small Market Capitalisation as opposed to peers. Such factors and models have proven to generate alpha for the past 50 years, have done so for us over the past 3 and we are positively hopeful they will continue to do so for many years going ahead.

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Disruption & Uncertainties

We do not like losing money, just like everybody else. So we do not invest in anything which may have even the slightest probability of disruption or may have too many factors affecting the revenue as we illustrated in the cases of a few industries. We can never forget what the past has taught us namely in the “Tulip Boom”, “Case of Kodak’s Collapse”, “The Dotcom Bubble” and the “2007 Credit Contagion”. We look at the Startup Phase as a legit threat and make sure all of our investments are as far away from such a threat as they can be. Most of the companies are being led by strong management who know how to turn such disruptions to their benefit.

Balkrishna Industries- Like all tyre makers was being hit by extreme price increases and decided to make their own carbon black rather than buying it at such prices when the prices continued to increase they announced a capex to be able to make more carbon black and plan to eventually sell it to other tyre makers.

Nocil- Used the antidumping sanctions on China to their benefit. Initially, rubber chemicals were made in China and dumped into India. Post the anti-dumping regulation, Nocil went into expansion to cater to most of the companies in India, the current capex will allow them to go global. Given the USA- China trade war does not subside, Nocil will be able to supply to Major American Tyre Makers growing market share and sustaining margins. While there is the major scope of disruptions in the space of IT and Automobiles, our investments are certain to aid such disruptions instead of being hit by.

Going Forward

We do not look at the Lok Sabha’ 2019 elections as a major cause to worry. Quality has outperformed in the best and the worst case scenarios all along and I’m sure it will continue to do so. Most of our investments are backed with strong revenue and solid market positioning. Headwinds are what explains the superior returns we make as investors at large.

Having said that, you can rest assured that your capital is being advised under safe hands. We do not like unnecessary diversification nor do we like to churn out of stocks since the conviction we enter one in goes through multiple levels of diligence.

Sincere Regards,

Mayank

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Disclaimer:

The portfolio in focus represents that of Mayank Mehra and related party till the commencement of the advisory services in March' 2018 after which clients with eligible risk/ return characteristics were advised to invest in the ***Legacy 10 Portfolio.*** *However, not all clients of the advisory have the same portfolio due to each risk/return rationale. This communique has been issued only with regard to our focused* ***Legacy 10 Portfolio****. If you are reading this via the newsletter or on the blog please view this as marketing material for our focused portfolio.*