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PMS NEWSLETTER – Mar 2020

Moats & Special Situations Portfolio

WHEN ALL YOU SEE IS RISK

Once in a Decade Event | Extreme Pessimism | Time to Focus on Opportunities

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Date: 5th April 2020

Dear Investors,

Below is the performance of the Moats & Special Situations Portfolio (M&SSP) as of 31st Mar 2020.

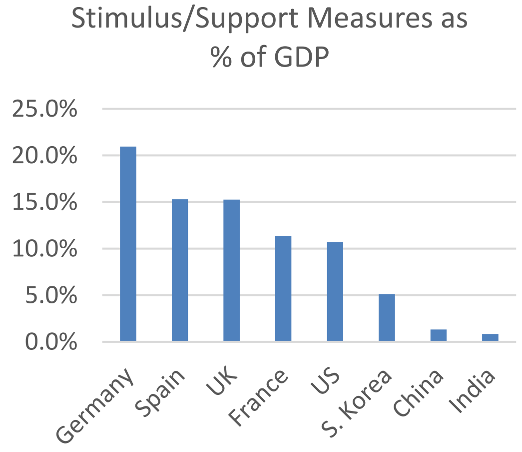
Portfolio Performance	Equity Allocation as on 31.03.2020	Total Portfolio Returns	Benchmark Returns
Since Inception (annualised)		10.9%	5.8%
Mar 2020 Quarter	91%	-22.5%	-29%
1 Apr 2019 – 31 Mar 2020		-20.7%	-28.6%

- Benchmark is an average of the BSE 500 and BSE Mid Cap index. Benchmark Performance is calculated using Total Return Indices.
- Equity allocation mentioned above is for older accounts.
- The above returns are consolidated for all clients, time weighted and post management and performance expenses.
- The actual returns of clients may differ from client to client due to different portfolio and timing of investment.
- Past performance is no guarantee for future performance.
- Inception Date is 27th January 2011.

We are going through "a once in a decade" event, post the Global Financial crisis. Most of you would have read extensively about the Covid-19 crisis and the very varied scenarios that are being forecasted by experts. Not being experts in epidemiology, we would prefer to refrain from forecasting how this situation will evolve. Instead we will focus on assessing the risk to the portfolio and how we plan to navigate the portfolios through these testing times.

The lockdown in India and similar measures that have been taken in other countries, though at varying degrees, are unprecedented. We are also witnessing global travel restrictions and impact on supply chain due to plant closures and other logistical issues. Needless to say, all these factors are going to have a severe impact on economic activity in the short term. But the pertinent question is how long would this situation continue. The best-case scenario from all that we have read, is that the virus reaches some sort of a "peak'' within 60 to 90 days of its start and then naturally recedes. From our limited understanding, the real solution to this pandemic is either a vaccine or medication. But since vaccines/medicines will have to go through clinical trials, we maybe a year away from a conclusive solution. In the meantime, we will have to go through measures that restrict the collateral damage and ensure that the healthcare ecosystem is not overwhelmed.

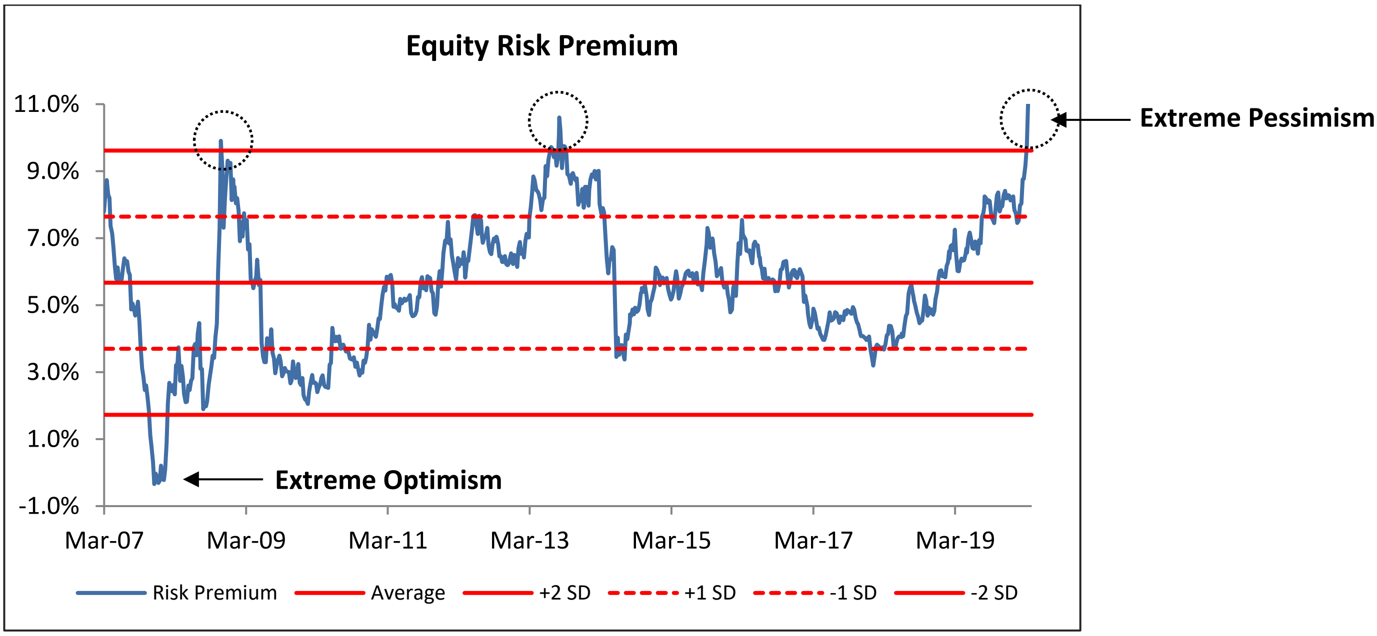
While governments globally are taking a concerted action in their fight against the virus, they have tried to restrict the damage to the economy by announcing massive stimulus/support measures. The jury is still out on the effectiveness of these measures in alleviating the short-term hardship that economies will have to go through fully. India has limited headroom for doing the same and thus our measures have been understandably muted. But in these times of economic uncertainty, India has been blessed with an indirect stimulus through fall in Crude Oil Prices which have more than halved. Based on the numbers available, India has been relatively better-off so far (in terms of number of cases and deaths).



When all you see is RISK

Currently everyone is focused on risk – The risk of Covid-19 lasting longer than anticipated, the risk of global recession, the risk of financial contagion etc. In fact, as a house we have been constantly communicating the risk of financial contagion due to stretched balance sheets of Global Central Banks. To that extent the economic pain that will be experienced could be far higher than would otherwise have been the case.

By no means are we trying to belittle these risks. But sentiment has turned extremely pessimistic and market participants could be overweighting the risks while ignoring potential opportunities, certainly in selective securities. We track multiple indicators to gauge optimism/pessimism in the market. We believe some of these indicators are suggesting extreme pessimism and risk aversion, like what we had seen in 2008-09 during Global Financial Crisis. Our proprietary indicator of Equity Risk premium factored in the valuation of Regulated Utilities is one such indicator. The higher the Risk premium, higher is the pessimism and vice versa. As can be seen from the chart, at the peak of the market in 2007-08, the risk premium was almost zero, suggesting regulated utilities were valued almost on par with Risk Free government bond. Conversely in 2009, 2013 and currently in 2020, the risk premium assigned is very high.



Explanation & Interpretation of the Chart: Regulated Utilities like Power Grid, NTPC etc have reasonably predictable cash flows and stable business models. Thus, they should be virtually valued like a bond. But these stocks are more volatile than bonds and thus reflect market sentiment. To segregate the movement of these stocks due to changes in interest rates vs purely due to sentiments, we reduce 10-year Government Bond yields from the expected returns that are being built into the stock price based on estimated long term cash flows. Thus, the spread that we get over the 10-year Government bond yield essentially reflects the sentiment due to change in equity risk premium. We track the average equity risk premium across all listed regulated utilities as reflected in the chart.

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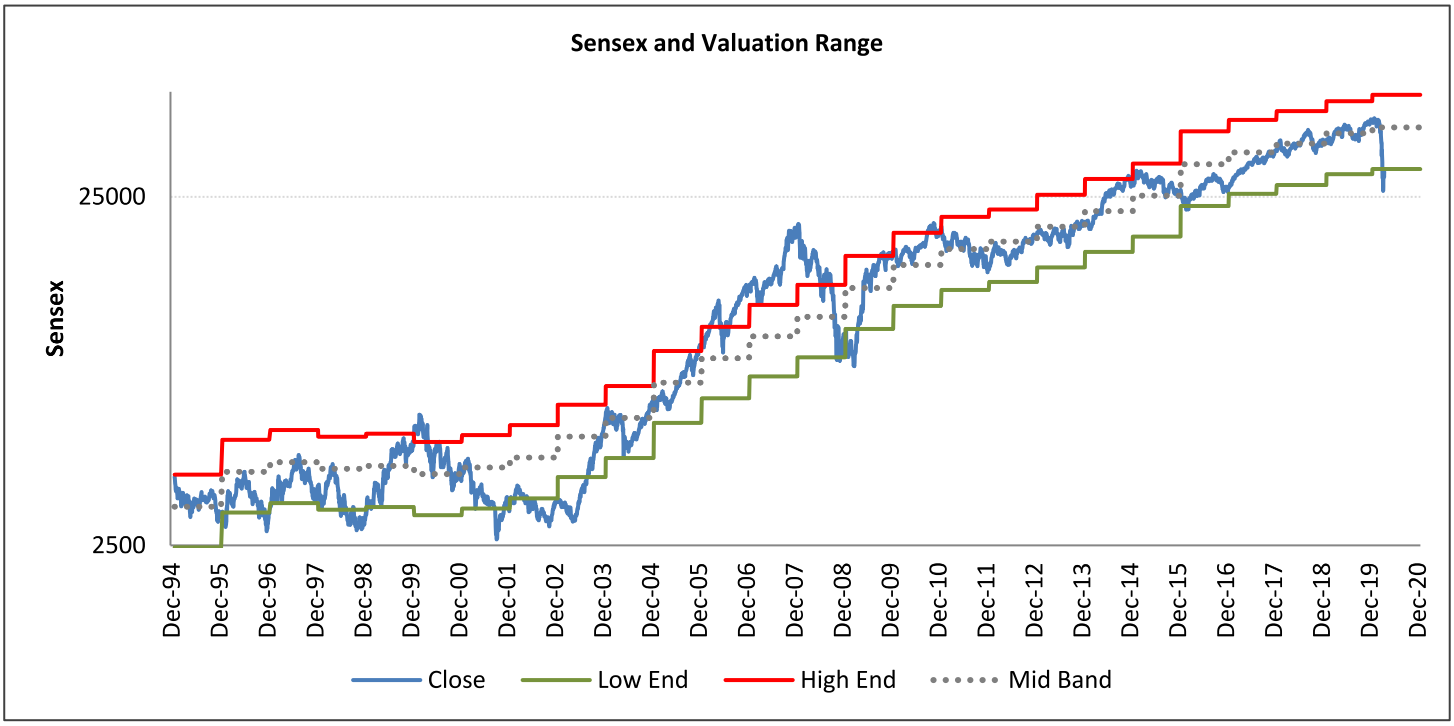
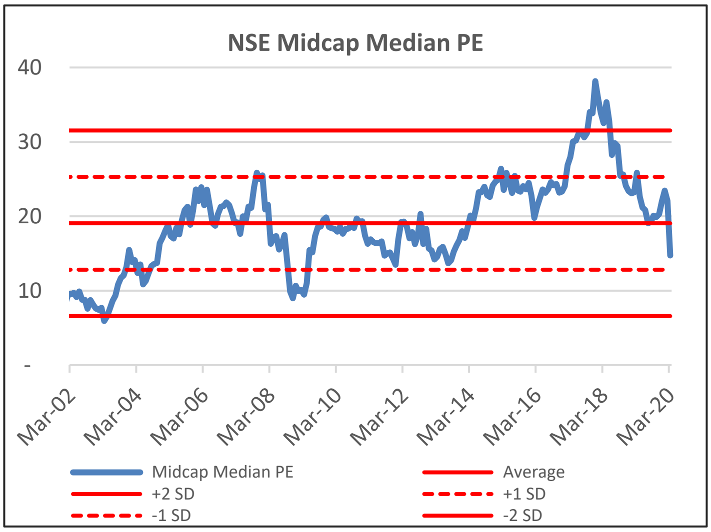
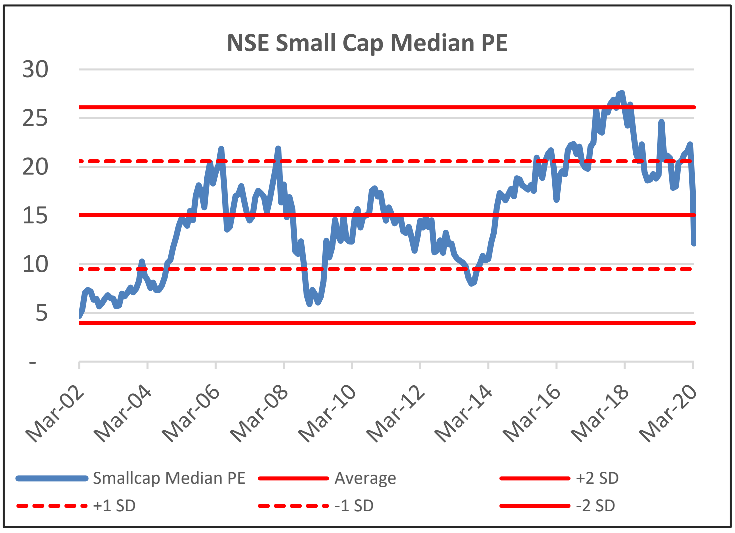
When the whole world is focused on risk, the prices of securities start to reflect the same. I.E most of the negative scenarios and outcomes start getting priced in. As can be seen from the chart below, SENSEX has fallen below our valuation range. It has breached these valuation bands to the downside only in 2009 and 2002-03 period.



And while Midcap & Small Cap valuations (See chart below) are not at historic lows, on an absolute basis from a long-term perspective they are substantially off their highs.





<u>At the same time, one needs to be careful and not conclude that Peak pessimism and Cheap valuations suggests that we might have reached the bottom.</u> It only indicates that the prospective return for the long-term investor has gone up meaningfully. And an investor who is willing to go through near term volatility (read further fall) could be rewarded handsomely when we are out of this crisis.

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The Crisis is real, the economic impact is real. But there is also a "sell-by" date to this crisis. The question is not if, but when we would get out of this crisis. Our job therefore is to identify opportunities that are able to sustain through these testing times and bounce back when the crisis abates.

Time to Focus on Opportunities

In times of near-term uncertainty, we should go back to the basics of investing. There are two points we should remember; we are owning a piece of business rather than a piece of paper. Secondly, we are not buying the business for next year's earnings, but for long term cash flows that the business is expected to generate. The relevance of this point can be explained with a simple illustration.

Impact on next Year Earnings	Impact on Intrinsic (DCF) Value of business
-15%	-1%
-25%	-1%
-50%	-3%
-100%	-5%
-150%	-8%
-200%	-10%

Assumption: A hypothetical company which is expected to grow its earnings (FCF) at 10% CAGR over next 10 years and after that at 5% CAGR in perpetuity. Discount rate used is 13%. We have assumed 1-year earnings would be impacted negatively and have calculated its effect on original DCF value without changing the cashflows for the rest of the years.

Above table represents how the impact on earnings for one year for a hypothetical business would have a resultant impact on its intrinsic value (calculated by Discounting long term stream of Cash Flows). As can be seen, even a sharp erosion in earnings for a single year does not materially change the intrinsic value of the business.

<u>But there is a caveat:</u>

This theory holds true as long as such events don't materially change the direction/trajectory of the business. There would be a lot of businesses which would witness an impairment in their intrinsic value especially 1. Businesses with weaker balance sheets and 2. Businesses with weaker business models (i.e. those that don't generate enough cash flows). Leverage is the biggest enemy of a business during such times. Highly levered companies would find it difficult to survive or maintain their scale of business. Secondly businesses that depended a lot on access to the capital markets for growth (e.g. startups) rather than internally generated cash flows, would find it difficult to maintain their scale or grow in the current environment if capital market access dries up.

As investors, we have to assess the ability of the business to not only survive such an event, but bounce back to historical trend growth rate when we recover to normalcy.

We have always stayed away from companies with leveraged balance sheets. In fact, more than two third of our portfolio is invested in those companies that have net cash balance sheet (i.e. have zero leverage). And we have followed this policy irrespective of whether we are in a crisis or not. Balance of our portfolio are either Financials or Utilities. The financials that we own have adequate capital to sustain their business and have proven track record of superior asset quality across cycles historically. The utility that has debt on its balance sheet is a virtual

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monopoly and is allowed a fixed rate of return on its assets and which would continue to run irrespective of lockdown/slowdown.

In the time of extreme pessimism, it is important to not get paralyzed either. Our investment process helps us to navigate through such times. Our opportunity set has improved significantly. But while valuations have corrected across the board, we are being careful not to use the cash position without considering carefully what set of businesses we are adding in the portfolio. Before this crisis started, we were getting opportunities in High Quality companies that had poor earnings visibility but where our assessment was that earnings would return to long term trend, as we have discussed in the past newsletters. But times have changed, and this is not the time to add more of those stocks. The current healthcare crisis is going to affect earnings visibility for most companies in the near term. But there has been indiscriminate selling across the board and some companies with relatively stable earnings profile and those which might not be affected by this event, have also corrected with the rest of the market. We believe this is a good opportunity to identify such businesses that have relatively inelastic demand for their products/services, or those that have business models not linked to the economy at large (Local/Global). We believe these companies would be the fastest to bounce back from a stock price perspective when sentiment improves, as market participants realize the limited impact that these businesses could witness. Also, there are a set of companies that could have near term impact on earnings but have very strong long-term tailwinds from a business standpoint and thus should see a quick bounce from a business perspective when things normalize. We have discussed the companies that we have added recently in the correction that would help you to get the flavor of our approach.

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Asset Allocation:

Our overall equity weights stand at around just under 91% for older accounts. This is the highest equity weight we have gone up to since inception of the PMS. For new accounts our initial weight is around 65%.

Portfolio Activity:

Business Model and Sector Allocation:

Moat/Limited Moat	Jun-19	Sep-19	Dec-19	Mar-20
Moat	23%	33%	30%	33%
Limited Moat	46%	38%	44%	39%
Moat + Limited Moats	***69%***	***71%***	***74%***	***72%***
Special Situations	27%	26%	22%	24%
Regulated Utility	4%	3%	4%	4%
Grand Total	**100%**	**100%**	**100%**	**100%**

Sectors	Jun-19	Sep-19	Dec-19	Mar-20
Financials	15%	18%	16%	22%
FMCG	10%	10%	8%	14%
Auto & Auto Ancillaries	8%	16%	17%	12%
Information Technology	18%	12%	16%	11%
Pharma	17%	16%	15%	10%
Financial Services	-	-	4%	9%
Materials	12%	10%	10%	8%
Utility	4%	4%	4%	7%
Capital Goods	9%	8%	8%	6%
Media	3%	3%	3%	2%
Logistics & Transport	4%	4%	-	-
Grand Total	**100%**	**100%**	**100%**	**100%**

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Portfolio Activity during the quarter:

We added **ITC** to the portfolio after we saw a correction in the stock price, post budget. The government increased excise on Cigarettes which led to the sharp correction in the stock price. ITC has historically been able to pass on tax increases to customers. And while there is a near term impact on volumes after a tax increase, the volumes do normally come back over a period of time. While Cigarettes is still the main business in terms of profits, the company has created a sizable franchise in FMCG segment (Close to 13,000 Cr Revenue). FMCG segment of ITC houses brands like Ashirwad Atta, Sunfeast Biscuits, Bingo Snacks under Foods; Savlon, Engage Perfumes, Vivel etc in personal care segment. The FMCG segment turned profitable a few years back. The profit of the FMCG segment is growing in excess of 40%, albeit on a relatively small base. We also appreciate the recent change in capital allocation policy wherein, more than 75% of the profits would be paid out to shareholders. The company has indicated it would not be pursuing to invest more capital in the Asset heavy Hotels business. We added to our position as stock the corrected further during the fall in the market due to Corona virus crisis.

Central Depository Services (India) Limited (CDSL) is one of the two depositories in India. Thus, it's a duopoly. While NSDL is strong on the institutional side of the business, CDSL is strong in the retail depositories segment. Most of CDSL's segments have annuity-based revenue model. In addition to securities depository services, it undertakes common Know Your Client (KYC) services for investors in the capital markets, including the mutual fund industry. Its subsidiary CDSL Ventures is the largest KYC registry in the country. The company has recently also entered other business lines like digitization of academic records, insurance policies, e-warehouse receipts etc.

United Spirits is the market leader in the alcoholic spirits segment with a market share of roughly 35%. We believe the business is strong because of the large regulatory barriers to entry, the economies of scale the Company enjoys being the largest player, and consumer preference increasing the stickiness of brands. Over the last few years, post the takeover by Diageo, we have seen substantial changes taking place in the Company on Corporate governance, capital allocation and operating strategy. The decline in related party transactions, operation through largely a single entity, franchising of popular segment brands, focusing on increasing market share in the higher end of the value chain, and bringing Diageo's global brands to India are key indicators of this change. We believe there is evidence to show that the current strategy has led to improvement in the market share and profitability of the Company and we would expect this improvement to continue.

We added **Petronet LNG** to the portfolio. More than 50% of India's gas requirement is imported and this would continue to trend upwards as the demand increases, given India has very limited domestic reserves. On the demand side, the demand for natural gas in India has been increasing and would continue to increase with the large number of CGD auctions recently. All imported gas in India comes in liquified form which needs to be reconverted to gas through regasification. Petronet's facilities are the largest and the lowest cost re-gasifier in India primarily because of the vintage and location of the terminal. Additionally, the Company has back to back contracts for both procurement and offtake of LNG, meaning it does not take price risk of gas or capacity risk on these contracts. Thus, there is a strong annuity like revenue stream for the company. Another positive trigger for the Company is the completion of the construction of the Mangalore- Kochi pipeline, which would enable the Kochi terminal, currently unutilized, to be utilized by around 25-30% and break even in the current year.

We took an initial weight in a Pharma Contract Research (CRO) business that caters to some of the largest global pharma innovator companies. As global innovator companies try to optimize their R&D budgets to ensure better

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Return on Investments (RoI), the relevance of CROs has gone up over the years and thus provides a good long-term tailwind to the business. This company has been able to add new clients and mine existing clients to capitalize on this opportunity.

We added **HDFC Standard Life Insurance** Company to the portfolio. While LIC is still the leader in the segment by a big margin, the better run private sector Life Insurance companies have been gaining share over the years. Within the private sector we like HDFC Life due its superior product mix which is largely focused on protection and non-Ulip side of the business. We believe HDFC Life is best placed to capitalize on the value migration that is happening in this sector.

We also added **Kotak Mahindra Bank** to the Portfolio. KMB is a financial conglomerate, offering complete financial solutions from commercial banking, stock broking, mutual funds, life insurance, to investment banking. We like KMB for its granular and well diversified book. The bank follows conservative underwriting pratices, which can also be verified from the fact that it is one of few banks that has managed to stay out of most high ticket corporate NPAs that have soured over the last 12-18 months post the IL&FS crises. Kotak Bank has one of the highest CASA ratio in the banking industry owing to its strategy of offering higher savings interest rate compared to its competition. Within the private sector we believe, other than HDFC Bank, KMB is the best placed to capitalise on value migration away from PSU banks.

We initiated a weight in **SBI**. Amongst PSU banks, SBI has the widest branch network and very strong liability franchise which helps to keep the cost of funds low. Also, it is a banker to most state governments, and has a dominant share of government fee business. The bank over the years has leveraged on its vast distribution network and built some strong financial businesses. Amongst these are SBI Life Insurance, SBI Funds Management (AMC), SBI General Insurance, SBI Cards (credit cards business), SBI Caps, etc. They are professionally run by competent management teams. SBI may not have had the best asset quality i.e. they have witnessed elevated NPAs in bad cycles, but the worst of the non Covid-19 related NPA cycle could be behind us as we witness recoveries through NCLT process. If we separate the value that the market has assigned to its listed subsidiaries and possible value that would be assigned to other unlisted subsidiaries, the core banking business seems to be trading at a significant discount even after writing-off all potential bad assets.

Bandhan has been operating a micro-finance business in the eastern part of India since 2001, first as an NGO, later as an NBFC since 2006 and finally as a Bank since 2015. In a short period of time, the bank has been able to create a liability franchise wherein its low-cost Current and Savings Account (CASA) stands at 35.2% of deposits. It has managed to achieve this feat through a bold step of investing in a large branch network of 501 branches on day one, which today stands at more than 1000 branches. This gives the Bank significant advantage over other MFI competitors. The cost of operations is also significantly lower than peers. Bandhan is thus able to charge relatively lower interest rate to its customers while still making (MFI) Industry leading margins. In the 19 year of operating history, Mr. Chandra Shekhar Ghosh has run a tight ship with industry leading asset quality (GNPA maintained below 1%) across multiple crisis that the industry has gone through in the past (Andhra MFI Crisis, Demonetization, Floods etc). Bandhan acquired Gruh finance Ltd. (erstwhile a subsidiary of HDFC Ltd.) which focuses on lending low ticket size housing loans to salaried and self-employed individuals mainly beyond tier-1 cities. Post this acquisition micro-finance stands at 61% of the book, housing loans are 29% while balance 10% are other advances. This acquisition provides the much-needed diversification to the book.

If you would have noticed most of the stocks that we have added have business models that are either with annuity/utility characteristics (CDSL, HDFC Life, Petronet), or strong consumer preference (ITC/United Spirits), or

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de-linked from global economic activity in general (Leading Pharma CRO). We believe these stocks should be able to bounce back the quickest as sentiment improves. Our assessment is that the weakness in their stock prices are more a reflection of sentiment and heightened risk premiums rather than business risk. The financial stocks that we have added would face headwinds if it takes longer than our assessment to get out of the current crisis. But most of them enjoy strong liability franchises in urban or rural areas, and are the beneficiaries long term value migration tailwinds, which should help them to bounce back from a business perspective when economic activity normalizes.

We exited **Divis Laboratories**. While we continue to like the business, we believe the valuations at the price we exited, were factoring most of the upside opportunity from recent capacity expansion leaving very low margin for error.

We exited **Lupin**. We had bought Lupin as we believed US Generic pricing environment had bottomed out and Lupin should benefit from the recovery. But in the last one year, Lupin has faced a lot of issues in terms of USFDA regulatory compliance. Almost a third of their plants came under regulatory action. We were not comfortable with the frequency of the plants facing regulatory action in a very short period of time and thus decided to exit.

We exited **Oracle Financial Services Software**. In the global banking products segment, they were leaders at one point. But over the last couple of years one of its largest competitor Temenos has been able to outpace them meaningfully which suggests a loss of market share. While high cash flows and good dividend payout was the only saving grace for the business, they discontinued the dividend last year, even while they continued to generate significant free cash. With consistent poor performance of license fee growth and what we deemed were shareholder unfriendly actions, we decided to exit OFSS.

Regards,

Rohan Samant
Sr. Portfolio Manager

Rohan Advant
Sr. Portfolio Manager

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Statutory Details: Portfolio Manager – Multi-Act Equity Consultancy Private Limited (Registration No. INP000002965)

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Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

The Composite representing the Moats and Special Situations portfolio was created on 27th January 2011. Performance has been compared with Total Return of the Index. For Moats & Special Situations Composite, blended benchmark of BSE 500 (50% weight) and BSE Mid Cap Index (50% weight) has been used. The Gross Return is before all expenses (except Brokerage). Net Return is after all actual expenses. A complete list of composite descriptions, policies for valuing portfolios and calculating performance fees are available on request.

Multi-Act Equity Consultancy Pvt. Ltd. is an independent SEBI registered Portfolio Manager. The firm maintains a complete list and description of composites, which is available upon request. This MSSP Composite includes all discretionary fee paying portfolios that are being managed with the objective of generating capital appreciation by investing in companies that in the opinion of the Portfolio Manager are of high quality Moat or Limited Moat businesses at fair value or discount to fair value OR in Non Moat businesses at deep discount to fair value as special situations. The portfolio manager has also the discretion of not being fully invested if he is not able to find ideas that meet the above criteria along with valuation criteria, thus, indirectly taking an asset allocation call between Equity and Cash (& Cash Equivalents).

The information provided in this document should not be construed as a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in the composite or that the securities sold will not be repurchased. The securities discussed do not represent the composite's entire portfolio. Actual holdings will vary depending on the size of the account, cash flows, and restrictions. It should not be assumed that any of the securities transactions or holdings discussed will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

Risk factors
General risk factors

a. Securities investments are subject to market risks and there is no assurance or guarantee that the objective of the investments will be achieved.

b. Past performance of the Portfolio Manager or its affiliates does not indicate its future performance.

c. Investors are not being offered any guaranteed or assured returns i.e. either of principal or appreciation on the Portfolio.

d. As with any investment in securities, value of the Client's Portfolio can go up or down depending on the factors and forces affecting the capital market.

e. The Portfolio Manager is neither responsible nor liable for any losses resulting from the operations of the Portfolios.

f. The investments made are subject to external risks such as war, natural calamities, and policy changes of local / international markets which affect stock markets.

g. The Portfolio Manager has renewed SEBI PMS registration effective October 14, 2014 and has commenced its portfolio management activities with effect from January 2011. However, the Portfolio Manager has more than 10 years of experience in managing its own funds invested in the domestic market.

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