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Dear Investors,

Performance

Below is the performance of the Emerging Corporates India Portfolio (ECIP) as of June 30th, 2019. Our closing equity allocation as on June 30th, 2019 is ~*80%* spread into 14 companies and balance is in liquid schemes.

Portfolio Performance	Total Portfolio Returns	Benchmark Returns
Since Inception *(Annualised)*	13.38%	-0.69%
Q1 FY2020	5.71%	-4.65%
FY19	13.3%	-6.5%
FY18 *(Since April 28, 2017)*	9.7%	10.5%

- *Benchmark is an average of the BSE Smallcap and BSE Midcap Index*
- *Returns are time weighted and after management and performance expenses.*
- *Management and performance fees are deducted as and when due*
- *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*
- *Benchmark calculations reflect total returns (including dividends)*
- *Returns for less than 1 year are not annualised*
- *Inception Date is 28thApril 2017*

As we have stated in the past, we will judge ourselves based on at-least three years of performance as our strategy is designed to capture opportunities that, in our understanding and estimation, should work over a three to five-year period. As you would be aware, we started the scheme on April 28, 2017. Ignoring dividends, over the last 26 months from our start date till yesterday, the BSE Small cap return has given an absolute return of -6.8% and BSE Mid Cap return has given an absolute return of 0.2%. And at the individual stock level, there has been carnage. Thus, as a Portfolio Manager pursuing opportunities in the Small and Mid-cap space, it has been turbulent weather.

Now, the flavour of the markets and especially the small and mid-cap space has gradually shifted from “believe anything” to almost “believe nothing” and hence, all those Companies that had inflated values based on “hope” of a great future have had a fall from grace. The flavour has also shifted from “Only Income Statement matters; Balance Sheet is irrelevant” to “Balance Sheet is critical” and all those Companies that had multiples based purely on Income Statement (*ignoring the Balance Sheet*) have again fallen from grace.

Having said that, the market has become extremely discerning and is willing to handsomely reward Companies that have “quality” and “growth” while heavily punishing the “perceived” second-tier companies. Thus, the market is divided into two extremes today. Companies that are cheap, but we don’t want to buy because they do not meet our “quality” and “growth” benchmarks on one hand and companies that we want to buy but are “very expensive” on the other.

While the election results have been a reason to rejoice from the market standpoint, the economy is giving out signals of a slowdown. Be it autos, MHCV or FMCG companies’ volume growth, the numbers look weak. One of the important reasons for the slowdown seems to be a tight liquidity condition in the economy. The IL&FS crisis seems to have opened a can of worms and dried up the liquidity for many NBFCs. According to a recent report by credit bureau CRIF Highmark and industry body Finance Industry Development Council (FIDC), NBFC credit disbursals have dropped 31% y-o-y in Q4FY19. Segments like auto loans and business loans/ cash credit facilities have been the worst hit. NBFCs contributed ~18% of the credit mix *(with Pvt sector Banks at 24% and PSU Banks at 47%)* as of March, 2018 – compared to 12% of credit mix as of March, 2008. NBFCs has a 10 Year credit outstanding CAGR of 19% compared to 17.5% for Private Sector Banks and 11.4% for Public Sector Banks. The point being that NBFCs, as a sector, is currently large from an economic standpoint. The rise of NBFCs, over the years, has created a lot of demand and fuelled consumption and its slowdown is now having serious repercussions. Many companies/ sectors are directly or indirectly linked to the issue. Even for "high quality" companies who might have their channel *(distributors)* borrowing from NBFCs or customers borrowing from NBFCs, the crisis has had an impact on growth.

While the problem is serious, there are no easy answers. While RBI can reduce interest rates or infuse liquidity all it wants into the system, if there is a general mistrust and fear in the system about credit risks in NBFC portfolios, the liquidity gets clogged in the pipe without reaching the distressed NBFCs. And if you let some of these large NBFCs go bust, you risk a domino effect with difficult to identify collateral damage *(and its impact on the real economy)*. Our understanding is that some of these NBFCs need urgent recapitalization and if that does not happen, the economy could get more stressed.

While the NBFC crisis is in some ways healthy for the system in the long run as it curbs excesses, improves credit standards, ensures better regulations and eliminates the inefficient, it has negative short-term repercussions.

As far as the companies in our portfolio are concerned, our endeavour has been to identify high quality companies where the "competitive advantage period (CAP)" is coinciding with a "growth advantage period (GAP)". Except one investment that we have in a Bank *(with a microfinance tilt as was highlighted in June'18 newsletter)*, all our investments are into Companies that have "near Zero Net debt" or a "Net Cash Balance Sheet". Thus, our portfolio companies are self-sustaining in terms of their ability to fund growth. In terms of indirect linkage of the NBFC crisis on our portfolio is concerned, our assessment suggests limited impact – even the three real estate companies that we have – are Net Cash themselves – and their customers also largely borrow from Banks and not NBFCs.

While we are on the NBFC crisis, let us talk about an NBFC we had in the portfolio which merged into a Bank in December'18. Post Q4 results, the Bank reported stressed book of INR 2800 crores. Our view until then was that the MD of the NBFC *(who is now the head of the Bank)* had received a clean book to start with. Thus, this incremental data-point disturbed us. We had a relook at the advances mix of the Bank and felt increasingly unsure of other stressed exposures that the Bank could have that we might not be aware of as on that date. And when we thought through this in context of the liquidity crunch in the system, we decided to exit our holding. While we did not lose money on this, we think being attracted to the cheapness of a lending institution was a mistake. When a lender becomes very cheap, there is generally a scare in the market about its inability to recover money from its borrowers. And this scare *(be it true or not)* leads to the lender finding it difficult to also raise funds *(on the liability side)* to sustain and grow. As investors, it is extremely complex to figure out if there is substance in the rumour and take a contrarian call *(because of leverage, small exposure as a % of assets can wipe out the net-worth)*. Thus, the reality of financial institutions is more "subjective" than "objective".

In context of what is happening today, it is worthwhile to understand George Soros's theory of reflexivity: -

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Soros's theory of reflexivity is centred on there being two realities; objective realities and subjective realities.

Objective realities are true regardless of what participants think about them. For example, if I remark that it's snowing outside and it is in fact snowing outside, then that is an objective truth. It would be snowing outside whether I said or thought otherwise — I could say it's sunny but that would not make it sunny, it would still be snowing.

Subjective realities on the other hand are affected by what participants think about them. Markets fall into this category. Since perfect information does not exist (i.e., we can't predict the future and it's impossible to know all the variables moving markets at any given time) we make our best judgements as to what assets (stocks, futures, options etc) should be valued at. Our collective thinking is what moves markets and produces winners and losers. This means that what we think about reality affects reality itself. And that reality in turn affects our thinking once again.

Source: https://macro-ops.com

Thus, if the market at large believes that an NBFC can go bust, this belief itself will shape the reality of the NBFC. And on the other hand, if the market at large believes that a Bank is great, this belief again will shape the reality as the market will allow the Bank to dilute at 4x or 5x book – thus giving it access to cheap capital versus peers.

While beliefs will always shape the reality in terms of stock prices, for companies that are self-funding, beliefs do not shape fundamental reality. For example, a Company that plans an expansion based on its free cash position and internal accruals and has no requirement of external funding – can sustain and grow irrespective of what the markets at large think about the Company. And this ability to self-fund gives such Companies the tenacity to withstand tough economic or sectoral environments that one encounters from time to time. This is the reason why we have a strong preference for self-sustaining companies.

The other stock we exited is a specialty chemicals company we had bought in Q1FY18 as per June'17 newsletter. We had a 70%-100% return in various accounts in this stock based on the date of purchase. While we still like the Company and the prospects, valuations have now reached a level where even if all the positives possible play out, the returns are sub-par. As we have stated in the past, while we are reluctant sellers, we will nevertheless sell even our most loved ideas if it makes no sense to us from a best-case prospective return perspective.

While we have increased weights in ideas where we think we have high conviction, we have not added any new names in the quarter.

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

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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.

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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.