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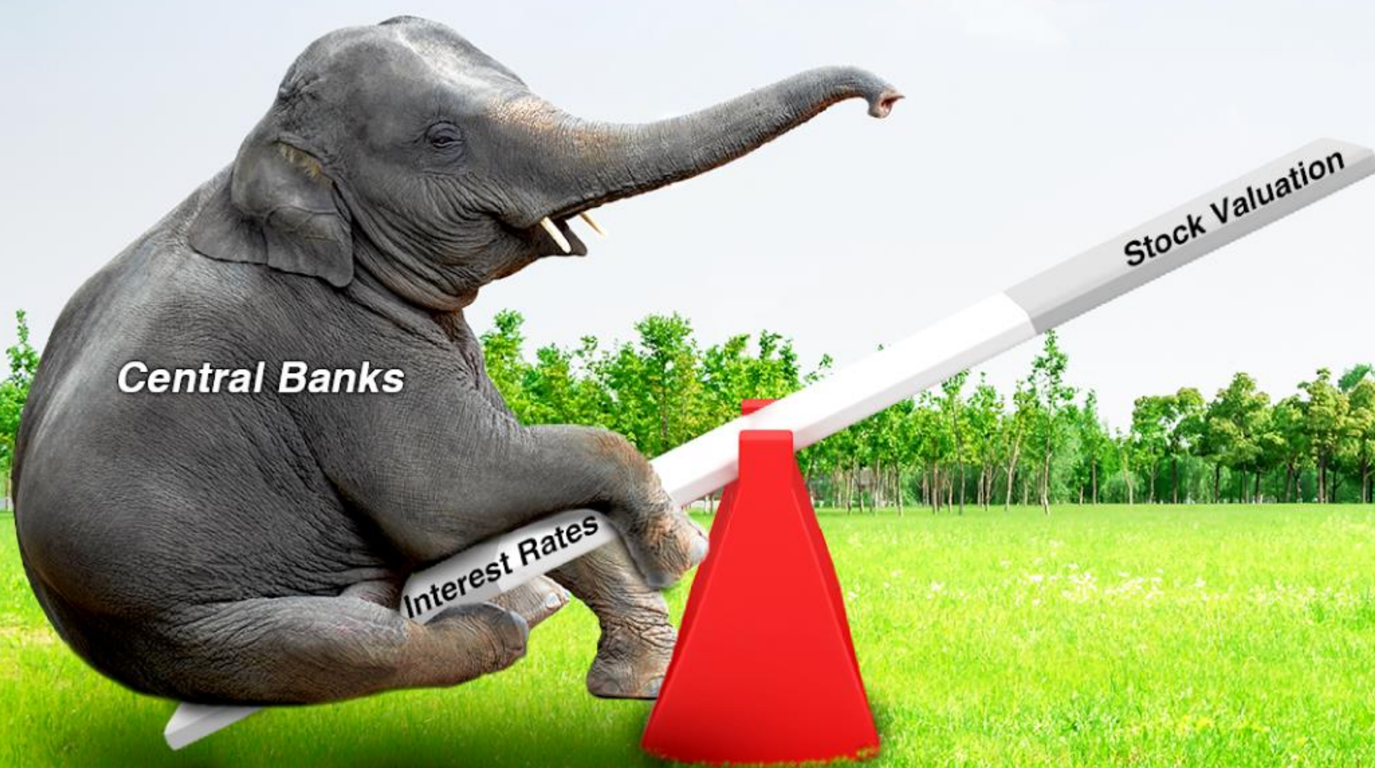
Emerging Corporates India Portfolio



Multi-Act Equity Consultancy Pvt. Ltd.

10th floor, The Ruby Tower, 29 Senapati Bapat Marg, Dadar (W), Mumbai- 400028
Tel +9122 61408989 www.multi-act.com CIN: U67120PN1993PTC074692

Date: 8th Oct 2020

Dear Investors,

Performance

Below is the performance of the Emerging Corporates India Portfolio *(ECIP)* as of Sep 30th, 2020. Our closing equity allocation as on Sep 30th, 2020 is ~74% spread into 18 companies and balance is in cash.

Portfolio Performance	Total Portfolio Returns	Benchmark Returns
CAGR since Inception *(Annualised)*	14.4%	0.6%
FY21 YTD	47.2%	47.6%
FY20	-13.2%	-33.0%
FY19	13.3%	-6.5%
FY18 *(Since Inception - April 28, 2017)*	9.7%	10.5%
Latest Quarter – Q2 FY2021	16.8%	16.7%

- *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*

If one looks at our FY21 YTD performance, we are up only as much as the benchmark *(~47%)*. Generally, portfolios that fall less in a crash also tend to rise less in an up-trend. However, the ECIP portfolio has managed to rise as much as the benchmark in-spite of falling much lesser in FY20. Having said that, our cash allocations have increased steadily over the last six months *(just about ~9% end Mar'20 to 20% end Jun'20 to 26% end Sep'20)*. Further, our Day 1 equity allocation for a new client is just 45% currently. This suggests that "if" the market continues to keep moving higher, we are likely to underperform the benchmark in the near-term. But it is not our pursuit to outperform every quarter.

Our pursuit is only to buy stocks when we think that the estimated prospective return *(calculated based on realistic estimates of estimated profits over the next 3-5 years and the multiple the market is likely to apply to these profits)* offered by the stock over a three to five year period is higher than the cost of equity *(cost of equity loosely defined as the return that an equity investor expects from assuming equity risk)*. And this, we think will slowly but surely build healthy outperformance. There are times when we see a plethora of opportunities and there are times when there are very few. Our equity allocations are a by-product of the bottom-up opportunities that we see. This process has worked well for us over the last three and half years and we intend to continue with this approach. While a combination of "high cash allocations" and "rising markets" add to anxiety and create FOMO *(fear of missing out)*, it's important not to succumb to this temptation. As Buffet says, *"the trick is, when there is nothing to do, do nothing"*.

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Thank God we did not have a crystal ball in Mar'20

Imagine we had a crystal ball which made accurate predictions *(on everything except stock prices!)*. It's the 24th March'2020. Late evening that day, a nationwide lockdown has been announced for 21 days. India has 469 confirmed cases and 10 deaths. Nifty has closed at 7800 for the day. Just after the announcement, you gaze at the crystal ball to see **a.** how many days will India be locked down? **b.** how many cases and deaths India will have in six months? The crystal ball says a strict lock down will last well over 2 months and not just 21 days with very gradual unlocking and the country will have 63 lac cases and 99 thousand deaths by Sep 30, 2020. Now, equipped with this perfect foresight, you have to decide on portfolio actions to be taken tomorrow *(March 25'2020)*. What would you do? I strongly feel most people would have been scared to death of an imminent crash *(at-least I would have)* in the market and reduced equity weights further. And here we are. Six months have passed, and the dire predictions of the crystal ball have come true. And what has the Nifty done? It has returned a cool +44%.

Some learnings from the last six months:

1. Market measures reality as "good" or "bad" relative to expectations it has of the outcome and not on an absolute basis.

2. As analysts, it is imperative for us to understand the expectations built-in to Companies at current market prices. And then assess, whether in our judgement, the reality is likely to be better or worse than the built-in expectation. Reverse engineering stock prices to understand embedded assumptions is one of the most important and often overlooked aspect of valuation. Our mind is more tuned to look at reality in absolute terms and ignores this fundamental pricing mechanism of the market, especially when the outlook looks bleak.

3. One cannot ignore the impact of liquidity and discount rates owing to Central Bank actions worldwide on the stock market movement over the last six months. Discount rates have an important bearing on valuations and hence prospective returns. A cash-flow stream of INR 100 growing at 5% is valued at INR 1111 when the discount rate is 14% and valued at INR 2000 when the discount rate is 10%. Thus, with no change in operational assumptions, just a drop in discount rates from 14% to 10% increases the value by 80%. And you can be right about everything else but wrong about the discount rate that the market participants want to use for that income stream – and be completely disconnected with market's valuation on the Company. You might say you will use a discount rate of 18%. But, if the market at large is working with lower discount rates, you might just be outbid by others for such time as others are happy with lower discount rates. And more importantly, the stocks that offer a 18% return may be those with structural headwinds and a high probability of estimates being wrong. This does not mean *"buy expensive"* but it only means perform a valuation exercise with realistic discount rates to not be outbid by everyone in the scanty universe of high-quality growing companies. While there are precise formulae for arriving at discount rates in theory, this is far more a complex *(and behavioural)* subject than what these formulas suggest. Different market participants working with different discount rates find the same stock at the same price extremely cheap or extremely expensive.

4. A connected point to the above is that sensitivity of discount rates to high-growth Companies is far higher than low-growth Companies. This is because a large part of the required return comes just from growth. A cash-flow stream of INR 100 growing at 4% is valued at INR 1000 when the discount rate is 14% and valued at INR 1667 when the discount rate is 10% which is an increase in value by 67%. However, if the cash flow stream is growing at 8%, the change in value owing to reduction in interest rate from 14% to 10% is +200% *(value of the stream moves from INR 1667 to INR 5000)*. And therefore, high-growth Companies become especially valuable *(on conventional valuation metrics)* in low interest rate environments *(P/E multiples look crazy!)*.

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5. People adapt. As people realise that the virus will not go away anytime soon, they are slowly beginning to accept it as a part of their life and go about their activity, albeit with some modifications. A new normal has emerged. Some companies benefit from the new-normal and some are hurt, but the overall economic activity is better than the fear reflected through stock prices end of Mar'20.

6. Companies adapt too. The good ones focus on eliminating unnecessary cost; think of new ways of reaching the customers; push their digitisation drives, etc. Some of these changes are likely to benefit the Companies permanently. We have been surprised by the resilience shown by most of our Investee Companies in adapting to the new environment despite the challenges.

7. Crisis has helped accentuate some trends. Online spends have shot up; protection life insurance policies have seen a spike; health insurance has seen a spike; shift from unorganised to organised has seen a spike; digital on-boarding of clients in the financial services space has seen a spike. These trends can be sticky even post crisis and can prove to be a boon to the beneficiary Companies. Off-course, there are a few fleeting trends as well unlikely to last beyond the crisis. It is important for us to be at the right side of trends that are "structural" and "irreversible".

8. The most important thing is to be always prepared for a crisis. When we now look back at prices that were available in Mar'20, so many high quality high-growth Companies were available at cheap valuations. But only those who had worked on them pre-crisis could take advantage of them. A lot of research activity is focused on *"what is cheap now?"*. In my opinion, research resources should also be equally focused on *"what would you love to buy?"*. But, since these stocks are expensive currently, one tends to ignore them. And so, one is not prepared enough to act when they suddenly fall 40%-50% in a crash *(it is a small window of opportunity in terms of time available to pull the trigger)*. Having a deep conviction universe of Companies with an always updated *"ready to buy"* price for every stock is vital.

Lastly, it is also important to not think that you can know everything. One needs to analyse but it is also important not to be paralysed by it. Who would have thought that the COVID crisis will lead to sharp uptick in "demat" accounts in the country and retail investors trading from home *(as they do not have bosses looking over their shoulder asking them what are they doing)* benefiting Companies operating in that space? Who would've thought that COVID will actually benefit motor insurance Companies *(albeit temporarily)* in-spite of new cars not being sold because COVID led to a lockdown and a lockdown led to less cars on roads and less cars on road meant less accidents and less accidents meant less claims for already sold policies? Who can now say with any confidence if air travel growth rates are permanently affected or is it a blip? Or who can say, is "work from home" temporary or permanent – is commercial office space dead? There is a huge recency bias in the way we think. And so, a lot of our analysis gets predicated on an assumption *(made unknowingly)* that COVID will last forever. But some of the "during COVID" trends can change drastically "post COVID".

For example, I deeply regret reducing weight sharply in an IT Company in Mar'20. We thought that their exposure to automobile R&D globally would hurt them badly, given the discretionary nature of such spending. We did not wait for management commentary or the results and reduced weights after the stock had already corrected 45%. While the automobile exposure faced growth headwinds *(though nowhere as bad as we had thought)*, other segments picked up sharply. Further, the margins improved as lack of travel, work from home and delayed employee hikes helped cost savings. Also, as the market realised the temporary nature of the growth blip, the stock bounced back. Today, it is up 125% from the price we sold. To me, the lesson is this constant temptation to reshuffle the apple cart needs to be given up. If you have identified high quality companies with strong growth runways, one needs to give these Companies time to either perform or fail.

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Lets us now move to our portfolio actions during the quarter

We exited our holding in a pharmaceutical Company providing outsourced R&D services to the Innovator Pharma companies globally. We also reduced our weight to a CRAMS pharmaceutical player. We owned three pharmaceutical stocks end of Jun'20 with an aggregate weight of 19.8%. As of end Sep'20, we now own two stocks with an aggregate weight of 9.1%. Thus, there is a portfolio level reduction of more than 10% to the pharmaceutical sector. This is through exit of one stock and weight reduction in another. For the stock we exited, we think that even if we take optimistic growth assumptions and apply very high multiples to these earnings, prospective returns from today's prices look very low. And for the stock where we reduced weight, our allocation to this stock was very high owing to a sharp run up in the price *(at ~13% of portfolio end of Jun'20)*. We decided to re-calibrate weight downwards *(at 6.5% of portfolio end of Sep'20)* based on a revised assessment of "Reward: Risk" ratio factoring the current price. Given the sectoral momentum, the stocks might continue to run, but we decided stick to our process of calibrating weights or exiting based on estimated prospective returns.

We added weight in the Asset Management Company we already owned. Our brief thesis is as follows:

1. Indian Asset Management Industry growth runway is intact – at 21m unique MF investors versus 59m tax returns and 440 m PAN Cards, there is huge scope for account addition. Plus, given the low financialisaton of savings, existing MF investors can allocate far more to MFs (equity and/or debt). Thus, this is likely to be a growth industry when looked from a 5 Year CAGR basis *(though growth will be non-linear).*

2. While there is near-term slow-growth/ outflows - its more to do with sharp rise in the market where people like to book profits than to do with people investing directly – in our understanding.

3. Our Investee Company's equity MF performance has been poor. This has led to a loss of market share in its equity schemes. We think this issue is important but solvable - management is acknowledging and trying to get over the issue through new hires/ style diversification.

4. ETFs/Passive in India is still some time away. The numbers visible in ETFs currently are owing to EPFO flows and retail interest in ETFs is negligible. Off-course, it can be a threat over the long-term, but we need to track ability of Fund Managers in India to beat benchmarks on a 3-5-year basis for this threat to be a reality. Last three years have not been good from this aspect but we think that its more a phase than a permanent feature.

5. While the market seems to be focused on equity flows, the debt story is equally compelling. At low savings and FD rates, there is a good chance of some money flowing into Debt MFs seeking higher yields. It might not happen right now owing to a risk-off attitude, but it can happen over the next 12-18 months as people are willing to take some risk.

We also added a Private Sector Bank with interests in the wider financial services space *(AMC, Insurance, etc)*.

1. We really like this Bank for the "cost of funds" advantage it has built slowly over the last decade. Today, its "cost of funds" is amongst *(if not THE)* lowest in the Industry.

2. On the asset size, it is still a small Bank *(~1/5th of the largest Private Sector Bank).* This implies huge growth opportunities for the Bank in the coming decade.

3. There is a section of the market that argues that this Bank does not have the "advances growth" DNA owing to extremely conservative nature of the management. However, we think that the opportunity landscape for

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the Bank is so large now that it's a matter of time before the management turns optimistic as this new-found cost advantage opens-up more avenues for growth where the Bank could not compete hitherto *(home loans, AAA Corporates, PSUs, etc).*

4. The Bank has built an excellent non-risk business (AMC/ Insurance) where its customer franchise can be monetised. Growth does not necessarily have to come through lending. Earnings growth through its subsidiaries can be growth with low risk.

5. Whatever the regulations by RBI around the current CEO continuing, we think this Founder/ Promoter will have some oversight on the operations – if not the CEO, then as a Board Member. We also feel comfortable about its second line of management *(most top management been with the Bank for 20 years).*

Thanks for taking the time out to read.

Regards
Rohan Advant, CFA
Sr. Portfolio Manager
and Associate Director
rohan.advant@multi-act.com

Regd. Office: "Katariya Capital", A-19, Vidyut Nagar Society, Lane No. 5, Koregaon Park, Pune – 411 001
Telefax: +91 22 2615 3738, www.multi-act.com

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The Composite representing the Emerging Corporates India Portfolio was created on 28th April 2017. Performance has been compared with Total Return of the Index. For Emerging Corporates India 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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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 November 24, 2017 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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