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Date: 19th July 2024

Emerging Corporates India Portfolio (ECIP)

Dear Investors,

Below is the performance of the Emerging Corporates India Portfolio (ECIP) as of 30th June 2024.

Portfolio Performance	Total Portfolio Returns	Benchmark
CAGR since Inception *(Annualised)*	13.4%	16.6%
FY25 YTD	9.9%	11.7%
FY24	17.6%	40.2%
FY23	-8.9%	-0.9%
FY22	8.6%	22.3%
FY21	79.2%	78.6%
FY20	-13.2%	-26.5%
FY19	13.3%	9.7%
FY18 *(Since Inception - April 28, 2017)*	9.7%	10.0%

- *Please check relative performance of other portfolio managers by clicking on this link*
- *The Benchmark has been revised from average of the BSE Smallcap Index, BSE Midcap Index and Nifty to S&P BSE 500 TRI with effect from 1st April 2023 as per SEBI/APMI circulars*
- *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 28th April 2017*

The previous quarter turned out to be another strong one for the markets with the benchmark BSE 500 TRI up 11.7%, making this the third double-digit return quarter in the last five. While the general elections added some volatility during the quarter, overall, the markets have continued to remain strong.

As for our performance, this quarter was relatively better compared to the previous few quarters with portfolio returns of ~9.9%. Though we have lagged the benchmark, qualitatively the portfolio performance has improved. Unlike the last year, where the entire returns could be attributed to just 5 stocks (1/3rd by number of stocks as well as allocation); this quarter the participation has broadened on the back of good Q4 earnings.

In the previous newsletter, we had mentioned that a lot of our stocks were stuck due to negative earnings surprises even as the underlying earnings power stayed intact, and these businesses continued to accrete long term business value. The idea of negative near-term earnings surprises and positive longer term value growth sounds inherently contradicting and therefore I would like to elaborate a bit more on it to explain our thought process with the help of a few examples.

Firstly, I want to continue with the example of an auto ancillary company that we cited in the previous newsletter when we said:

"The company saw negative earnings surprise on account of a temporary disruption in its higher margin business due to model changeover by a key client. Additionally, recognition of tooling revenues which are characteristically low/no margin in nature led to further pressure on profitability. Since we believe these shorter-term disturbances have no impact on our core thesis and the medium-term prospects of the business; we continue to hold the stock."

Due to the above disturbances, earnings were below expectations in Q2 and Q3 and as a result the stock delivered negative 11% returns in the H2 of last fiscal (benchmark was up 17.4% over the same period). In our view, these issues were transient in nature. Our core thesis on the company was reliant on below factors:

The company's product portfolio comprised of components that have a decorative and design value and helped in enhancing the look and feel of the products of its customers in the automotive and consumer products industry. These products were finding greater usage owing to the underlying trend towards premiumization and therefore driving increasing content per vehicle for the company. Additionally, the company had bolstered its product portfolio with an acquisition that gave it technological access in an emerging product category, added new customers, and helped diversify end industry exposures thereby laying the foundation of sustainable growth. The earnings disappointment in Q2 and Q3 did not challenge this thesis.

Besides the model changeover itself was a positive for the company as the new models had a higher content per vehicle. However, due to the negative earnings surprise in Q2 and Q3, the stock went down even as the longer-term business prospects had strengthened. In Q4, as these challenges subsided, earnings bounced back strongly yielding a positive earnings surprise. This then led to a +28% stock price movement for the quarter (compared to 11.7% for the benchmark).

The point that I want to draw here is that there is inherent non-linearity in stock returns and short-term returns can have material divergencies compared to the longer-term trajectory of a business. And particularly, in periods when markets are rallying one way up, the markets tolerance for earnings disappointment is low, perhaps because the opportunity cost for the marginal trader that sets the market price is too high (remember this is the third quarter with double digit returns in just the last five) and therefore relative divergence ends up being even more exaggerated.

Sometimes, these divergences correct over a few quarters as in the above example. However, at times depending on the nature of challenges these can take a few years as well. The second example I want to bring up is that of the largest private sector general insurer that we have been invested in since early 2020. Our investment in the company was premised on the following thesis:

The general insurance market in India had been growing at 16-18% CAGR, within which public sector companies had a market share of ~50% and were ceding share to their private sector peers. Therefore, the private sector was growing faster at 20-22%. Our company being the largest private sector player was a beneficiary of this trend. Profitability of a general insurance business is a sum of two parts: underwriting profits and investment income. On the underwriting side, the entire industry had a poor track record with average combined ratios of ~115-120% within which the private sector fared relatively better at ~105% and our company was amongst the best at ~100%. Consistent growth with best-in-class combined ratios in an industry which on average was making significant underwriting losses was a testament to the company's underwriting quality and risk selection. Even on the investment side, the company fared better compared to peers with nil defaults since inception. Its investment book was free of all usual suspect cases of stressed corporates that went bad during 2018-20. Disciplined underwriting performance combined with a stable investment track record allowed the company to deliver 18-20% profit compounding at 18-20% ROE in the past. In our opinion, the industry tailwinds as well as company specific strengths that drove this performance were both structural in nature and therefore, we expected the performance to continue.

As things turned out, growth in FY21 and underwriting performance in FY22 was impacted due to the Covid disruption. Also, the company had acquired a smaller peer in FY22. This acquired entity had a higher combined ratio which coupled with integration costs in the first year of consolidation put pressure on profitability. Due to Covid losses, standalone health insurance companies which have a dominant market share in the retail health business had been under pressure. Given its own under indexation in the retail health business, the company saw this as an opportunity to gain market share. Therefore, it decided to ramp up its investment in the health business. This led to additional costs in FY23. As a result, 3 Year EPS CAGR over FY21-23 was just 8%, ROE declined from 20% to 16% and the stock went sideways. However, despite the weak reported profit growth, investment book and book value per share both compounded at 16% CAGR over the same period which meant that as the underwriting performance normalized (which we thought it should as the P&L pressures were not structural in nature), the ROEs would mean revert and profit growth would converge with the growth in investment book.

Post three back-to-back challenging years, the improvement in underwriting performance commenced in FY24 as the combined ratio improved from 104.5% to 103.3%. The stock responded positively to this improvement and has gone up 67% in the last 15 months. We believe that the full normalization is yet to play out and expect the improvement to continue over the coming periods. As this plays out, we expect the EPS growth as well as the stock returns to converge with the investment book/book value CAGR of ~15-16%.

Unlike the auto ancillary company where the earnings normalization played out in 3 quarters, for the insurance company it has taken >3 years (and it still hasn't fully played out). When we first invested in the insurer, the headwinds that subsequently came about were not known to us. However, since these were not structural in nature; they did not impact the underlying compounding. Over the period of our investment, growth in underlying value as reflected by growth in investment book/book value has been 15-16% CAGR. However, as is the case generally, stock returns have not been so linear.

Regulatory developments at Kotak Bank

In late April, RBI directed Kotak Bank to stop onboarding new customers through its online and mobile banking channels and barred it from issuing fresh credit cards, though allowing it to service its existing customers. As per RBI's press release, the restrictions were imposed due to concerns with regards to the robustness of the bank's IT infrastructure and its frequent service outages. These restrictions would have two folds impact on the near-term performance of the bank. Firstly, the bank would need to make additional investments to improve its technology infrastructure to meet the regulatory requirements. Based on management estimates, this impact is likely to be ~2-3% of PBT.

Secondly, customer acquisition would be impacted till the time the bank is able to get the restrictions lifted. Digital channel (Kotak 811) has been a key source of new customer acquisition for the bank. However, as per rating agencies, the initial value contribution of savings accounts onboarded digitally from these new to bank customers is low (~15% of incremental savings account balances and less than 1% of total outstanding balances in 9MFY24). Therefore, immediate impact on growth is unlikely to be material. However, if these issues take longer to resolve, over time it can start dragging growth as the funnel of new customer addition weakens. Though we do not know how long this issue will take to resolve, similar issues at other institutions have taken between 6-15 months for complete resolution. These developments are clearly negative from a near term perspective; however, we believe the bank should be able to overcome these challenges in due course.

As for the underlying business performance in FY24, loan growth as well as deposit growth has been strong at 18% and 24% respectively (better than the Top 3 private sector peers). Further, loan-to-deposit ratio closed at ~84% for FY24 (lower than its own historical average of ~86%) and amongst the best within the private sector banks which ensures sustainability of growth going forward.

Portfolio Action:

We have initiated investment in a record label that has a dominant share of music released between 1985-2000. Historically, due to high levels of piracy, music has not been adequately monetized. However, since 2015, on the back of rising penetration of video and audio streaming services, monetization of music has been improving. Labels with existing catalogues are major beneficiaries of improving monetization as their existing repertoire is driving growing annuity cash flows with negligible incremental investments, providing them flexibility to reinvest for acquiring newer content. Additionally, streaming platforms are pushing conversion of users from ad-supported to paid subscriptions which provides incremental monetization kicker for the entire ecosystem. We believe the penetration of paid streaming is at a nascent stage and therefore expect the monetization tailwinds to continue. There is an additional company specific tailwind of improved distribution across more platforms post its recent deal with a global distribution partner that can further add to its near term earnings growth profile. We therefore believe the company is interestingly placed for growth going forward.

Thanks for reading.

Rahul Picha CA, CFA
Portfolio Manager

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

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Note:
1. All cash holdings and investments in liquid funds, is considered for calculating the performance.
2. All performance data are reported net of all fees and all expenses (including taxes).
3. The above performance numbers are not verified by the SEBI.

Disclosure as per Global Investment Performance Standards (GIPS®) –

Multi-Act Equity Consultancy Pvt. Ltd. claims compliance with the Global Investment Performance Standards (GIPS®). You can refer to the GIPS Compliant performance presentation here. Multi-Act Equity Consultancy Pvt. Ltd. has been independently verified by M/s. M. P. Chitale & Co., Chartered Accountants for the periods April 1, 2011 through March 31, 2019. The verification is available upon request. MAECL has claimed GIPS compliance for the Financial Year 2024 and such performance numbers shall be made available upon request.

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 Emerging Corporates India Portfolio was created on 28th April 2017. Performance has been compared with S&P BSE 500 TRI. The Gross Return (wherever mentioned) 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 ECIP 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 "Advantage Period Companies" which are enjoying a "competitive advantage period" that is likely to last for at-least 5 years and are available at a valuation that offers margin of safety relative to the growth opportunity landscape. 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).

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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 December 05, 2023 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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