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Moats & Special Situations Portfolio

Dear Investors,

Below is the performance of the Moats & Special Situations Portfolio (M&SSP) as of 31 Dec 2024.

Portfolio Performance [1]	Equity Allocation	Total Portfolio Returns	Benchmark Returns
Since Inception (annualised)		15.1%	13.4%
Dec 2024 Quarter	77%	-6.1%	-7.8%
April – Dec 2024		16.4%	10.8%

Please check relative performance of other portfolio managers by clicking on this link

In the December quarter, the market experienced a material correction after a consistent rise seen in the last two years. In previous newsletters, we discussed the issue of overvaluation, driven by consistent inflows from domestic investors through direct investments or mutual funds. The increasing supply of equity via IPOs, Offers for Sale, and QIPs has been absorbing this liquidity. So far this calendar year, the total equity supply has amounted to ₹3.35 lakh crore, closely matching the ₹3.53 lakh crore inflow into domestic equity mutual funds. Another factor supporting valuation rerating has been strong earnings momentum. However, over the last two quarters, this momentum has shown signs of faltering. Commentary from many consumer-facing companies has also been less optimistic. The increase in supply of equity and softer earnings visibility seems to have stalled the valuation rerating cycle as of now.

Historically, high-quality stocks have showcased resilience in a weak market by falling less than the broader market. However, this time, the performance of high-quality stocks has diverged from the norm, with these stocks falling more than the broader market. Our proprietary High-Quality Index, which tracks 30 companies, has recorded a decline of approximately 11%, compared to ~8% fall in the broader market indices during the current quarter.

What's Behind This Shift?

Over the years, high-quality stocks have benefited from consistent rerating, with their valuations climbing to levels that are difficult to justify using traditional discounted cash flow (DCF) models. However, recent disappointments in earnings and poor commentary regarding near term visibility, particularly among some high-quality consumer-focused names, have led to sharp corrections in these stocks.

Contrarian Opportunity?

One could argue that the current environment—a temporary slowdown in consumer demand and poor near-term visibility—presents an attractive entry point for contrarian investors with a long-term horizon. History has shown that

[1] The Benchmark of M&SSP Investment Approach has been revised from BSE 500 and BSE Mid Cap index to **S&P BSE 500 TRI** with effect from 01st April 2023 as per SEBI/APMI circulars. 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.

periods of pessimism often yield the best opportunities for value-conscious investors. However, despite the recent corrections, many high-quality stocks remain well above our buy zone.

As can be seen from the chart above, while there has been a sharp correction in valuation of High Quality stocks, they are nowhere near the historical mean.

In our opinion, a successful contrarian investment requires two key elements. First, the company or a sector should be going through an identifiable temporary challenge. The second and important aspect is regarding valuation. The valuation of the company or that sector should have corrected meaningfully to factor the negatives. This point is relevant, as it would reduce the downside risk in case our assessment of the challenge being temporary is proven wrong. And if our assessment is correct and the company or the sector bounces back, there could be material upside. Additionally, a mere correction in a stock or sector does not necessarily mean it offers an appropriate margin of safety. The measure of value is not based on how much a stock has fallen from its peak, but how far it is from its intrinsic value. If recent peak valuation multiples were excessively high, a correction might reduce overvaluation but may still not provide enough margin of safety to account for all the negatives.

Let's consider the recent example of paint sector, which is experiencing heightened competitive intensity due to the entry of the Aditya Birla Group. Historically, the Indian paint industry has seen new competitors enter with minimal impact. However, the Birla Group has entered the industry with serious intent, committing ₹10,000 crore to set up manufacturing capacity. This entry has prompted the incumbents to plan capacity expansions to maintain market share. The combined planned capacity expansion by the Aditya Birla Group and incumbents is expected to result in a nearly 60% increase in manufacturing capacity over the next few years.

However, the paint industry is not solely driven by manufacturing scale. The success of paint business depends on distribution network and dealer return on investment, which in turn rely on brand loyalty from end consumers and painters. The Aditya Birla Group's commitment to establish itself in this sector isn't merely about capacity; it involves strategic investments in branding, distribution, and engagement with the painter community. However, overcoming the strong brands and extensive distribution built by incumbents over decades is a formidable challenge. Our base assumption is that the larger incumbents will endure this disruption in the long run once the industry absorbs the initial shocks of new competition and competitive intensity settles down.

Based on above assessment, the paint industry would ideally be a good hunting ground for a contrarian investor. However, despite the recent sharp correction in these stocks, they are not yet at reasonable value. More importantly, the historical multiples that these companies enjoyed could be tested in the near term due to the disruption caused by new entrants. In the past this industry was oligopolistic in nature where the smaller players followed actions of industry leader which itself had very good pricing discipline. The historical valuation multiples that the industry enjoyed during that period may not hold going forward when the competitive landscape has changed, and industry's pricing discipline could be challenged. As contrarian investors, we would prefer a higher margin of safety rather than being anchored by recent peak prices or recent history of valuation multiples.

How is our portfolio positioned?

Over the past five years (pre-Covid to present), BSE 500 constituents have experienced an earnings CAGR of around 13%, while the stock price CAGR has been 19%. This indicates that these stocks have benefited from a valuation rerating cycle, with stock price growth outpacing earnings growth, essentially borrowing returns from the future. We may now be entering a period where the post-Covid valuation rerating tailwind is no longer present. If valuations normalize, the market could deliver lower returns than earnings growth. In such an environment, we need to position ourselves in businesses with respectable underlying business growth and limited risk of valuation derating.

Our value-focused investment process has a natural contrarian tilt. Consequently, most of our portfolio holdings are at valuation multiples lower than pre-Covid levels and are also at comfortable absolute valuation multiples. On a weighted average basis, the stocks that we hold in our portfolio today have seen earnings compound by 16% CAGR over the last five years, but their stock price CAGR has been only ~12%, indicating the valuation derating these stocks have already undergone. We believe this should help our portfolio withstand a derating cycle, allowing the stocks to deliver returns closer to their underlying earnings growth.

Asset Allocation

Our equity weight in the older accounts has increased to ~77%. For new accounts our initial weight has increased to ~55% vs 30% as of September quarter.

Portfolio Activity

Business Model Allocation	Mar-24	Jun-24	Sep-24	Dec-24
Moat	8%	13%	8%	10%
Limited Moat	62%	55%	58%	53%
Moat + Limited Moats	***70%***	***68%***	***66%***	***63%***
Special Situations	30%	32%	34%	37%
Regulated Utility	-	-	-	-
Grand Total	**100%**	**100%**	**100%**	**100%**

Sector Allocation	Mar-24	Jun-24	Sep-24	Dec-24
Financials	33%	36%	38%	40%
Financial Services	28%	20%	20%	22%
Auto & Auto Ancillary	12%	14%	17%	13%
Commercial Services	7%	8%	8%	12%
Consumer	10%	12%	6%	6%
Materials	4%	5%	4%	4%
Technology	3%	6%	7%	3%
Real Estate & Infrastructure	3%	-	-	-
Grand Total	**100%**	**100%**	**100%**	**100%**

We have exited HCL Technologies during the quarter as in our opinion the current valuation is already factoring a recovery in global IT spends and higher growth in business in the coming year and the risk of downside is material if there is a negative surprise.

Regards,
Rohan Samant Akshat Hariya

CIO **Assistant 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 Moats and Special Situations portfolio was created on 27th January 2011. Performance has been compared with benchmark S&P BSE 500 TRI. 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).

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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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