Annual Letter to Stakeholders

2019-20

Dear Investors,

As we sit down to write this, we cannot help but feel like we spent a few rounds in the rings, with a boxing heavyweight. COVID-19 has burst the bubble of wealth in the financial markets and convenience that has shielded so many people from the harsh realities of the natural world. The world is in a complex, dynamic process of chaos. Cause and effect don't align together linearly. In almost all cases, the interplay of hundreds or even thousands of cases leads to an event, yet this event is often attributed to only a few causes. Many times, investors are given the illusion that the world is simpler and more explicable than it is. We are in an uncharted policy territory. Never before have governments all over the world actively discouraged production, bringing their domestic economies to a simultaneous standstill, caused GDP contractions, unprecedented surges in budget deficits, amidst extreme uncertainty about our collective futures. The fast-changing economic developments led us to throw away the original version of our letter and write an entirely new one dedicated to changing events in the markets. The performance updates, as per the new SEBI performance standard, are enclosed in your appraisal report. We admit that the letter is longer than usual, and have *more thoughts than answers for you,* today.

The worldwide advancement of COVID cases by February 2020 led to a sell-off in the debt and equity market by FIIs, although our country was relatively insulated till then. Many debt mutual fund schemes gave negative returns; one has frozen redemption on the back of solvency crises and liquidity crises of the instruments. The relentless and continuous selling of equities for more than two weeks led to liquidation by leveraged players and brokers in anticipation of defaults by the end of March. The severity of liquidation led to stocks of mid and small-cap companies beaten down like a rented mule. The stock prices of many companies recovered back from their lows, in the month of April.

In this challenging environment, asset managers must ask if their portfolio companies will not only survive but will further prosper when these crises come to an end. Under normal circumstances, we are looking for companies with some competitive advantage. Today, we are interested in another kind of advantage – of the Darwinian suggested advantage of the survival of the fittest.

Investors are not overly interested in fundamentals right now but in this Darwin advantage. We have reviewed our investments in light of this new paradigm shift and are making tactical changes wherever necessary.

One of the largest private sector banks, our largest investment position, is the best-placed amongst all other private sector banks to bounce back the fastest. Each crisis exposes the faulty lines of the economy and its impact on the underlying businesses. Historically, in India, when the cash flow of Indians is affected, people usually start defaulting first on their unsecured loans, like credit card loans and personal loans, but the last to default on is their own house. The bank made a tactical shift a few years back and has the highest share of mortgages in their book compared to all other private banks, close to ~31% of its overall book and with low unsecured portion while competitors have pumped unsecured credit to improve their ROAs and NIMs. Its corporate book, which forms 40% of assets, has 70% of portfolio rated A- and above, along with a retail NPA of around 2%, comparable to the top two players in the industry.

A finance company, in simple words, is the business of raising short-term money to lend long-term. The chaotic condition in the financial market and challenging economic situation exposes the liability structures of the financial companies. Today, the bank has the lowest cost of funds among all the private sector banks in India - a rare feat achieved, a swing of 380 bps points in the last 10 years in comparison to the comparable top bank in the country. The lowest cost liability franchise acts like a beehive - full of delicious Turkish Honey, attracting high-quality borrowers to access the best quality funds and de-stresses risk management departments of the bank. The market will take a strong cue from this fact that incremental book is among the safest in the industry, and this will turn out to be one of the most valuable banks in the process. Many of you may be wondering that you have not heard enough from the leadership team of this bank in the media. The financial media, in its quest to produce regular sound-bytes, has pushed the business leaders far, and many of them have succumbed to this tactic with damage to their reputation. We wish to emphasize that we have high gratitude for leaders who have delivered above the rest but have spoken only occasionally - on issues that are matters of interest.

The largest state lender in the country, which has shown the maximum positive delta on all eight key banking metrics, such as NIMs, Credit Cost, ROA, etc. over the last half a decade, also has the distinction of being the owner of the lowest cost fund in the banking sector. There are times when a low-cost liability is an asset, and a high yielding asset is a liability; this is one such case. It has created immense value in its life insurance, general insurance, asset management, credit card business of the bank, a true reflection of the network, and brand effect of the bank. It is a unique play on the recovery of the economy and is suitably positioned to deploy large scale capital for the upcoming infrastructure spending by the government.

The tail risk of failure of large NBFC started with IL&FS tenterhook on the financial market for the last two years, and this year, we saw the failure of a key lender, Yes Bank. The investment by state-owned banks, along with the private sector, was an exemplary demonstration of the private-public partnership in a value creation strategy. Kindly refer to our note released during that period titled *"Yes Mam Game."* Initially, this led to widespread fear that post the Yes bank fiasco customers will be losing confidence in new age private sector banks and Small Finance Banks (SFBs), resulting in the flight of deposits from these institutions. History suggests that such issues are short-lived. India has seen over 300 co-operative banks fail in its lifetime, along with the failure of a scheduled commercial bank, Global Trust Bank, failing in 2005. The deposit growth did fall for a few months, but its memory was short-lived, recovering thereafter. Hence, we do not foresee any failure due to the withdrawal of liabilities from such institutions.

Financial companies are a levered bet on the growth prospects of the economy. The lockdown in the economy led to selling off in financials as investors started staring at the diminishing prospects in an already fragile state. During the year, we invested in a well-diversified Small Finance Bank, engaged in the business of microfinance, small business lending, and CV financing, which has seventy-five percent of its asset-backed by collateral and growing over 40% p.a. It runs one of the most conservative microfinance books, with one of the lowest outstanding debt per borrower along with a history of having cyclically adjusted credit costs of lower than 1% in the business. The perception of investors towards SFBs, post the Yes Bank debacle, and the subsequent lockdown changed dramatically, leading to apathy towards the stock price. We believe investors are missing the forest for the woods in the process. Investors pushed back by capital losses in debt markets, and weak equity markets are likely to rush to the regulatory safety of FixedDeposits. This SFB has a unique advantage of deploying assets at a higher interest rate due to its business structure and thereby allowing them to offer higher pricing for liabilities to retail lenders. The lending boom of India in the last few years saw heightened competition intensity by NBFCs and Fintech companies - all eager to offer unsecured/secured loans to consumers, to small businesses, etc. Capital from private equity taps was flowing freely in such companies, though many such businesses have not seen even one full business cycle, and often the combined age of two co-founders is less than banking experience of the top management of SFBs. The current crises will change the landscape in favor of deep domain experience of banking.

Our holding gold loan company and the thesis of holding it have done well during the year as the loan growth accelerated from an average of 10% to 22% p.a. Gold loan companies have an inherent advantage of a secured self-liquidating loan, appreciating asset in chaotic market condition, a granular portfolio with average loan disbursement of Rs 30,000, diversified funding base, positive asset-liability of 28%, minimalistic leverage of 3x with no requirement of equity capital in perpetuity. The company has witnessed maximum write off of approx. Rs 40 crs. in a year over the last 20 years, less than 15 bps of its assets book. The NPA numbers for them are an accounting entry, but write-offs reflect the true statement of accounts. This reflects a goldilocks situation for such types of lenders. In a distressed economic environment, the demand for such loans will likely accelerate further.

We believe Gold should be awarded a Nobel Peace Prize for its service to humanity for an entire generation. In our previous annual letter, we had written about the upcoming bull market in precious metal like gold last year. It is up about 30% in FY2020 and has outperformed all financial assets in the world. It maintains its calmness during the most distressing economic situations, preserves the purchasing power of individuals against the debasement of global currencies, and can stand up to the King Dollar. Gold reserves relative to the global monetary base, and gold to the S&P as a ratio are at their lowest. The global economic situation and steep decline of interest rates in the U.S. have reinforced the case for investing in favor of gold, and the best is likely yet to come. Investors under-allocated to this asset class should not miss the last chance of the decade, in the age of abundance of fiat money.

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During the year, we have increased our shareholding in the second most valuable pharmaceutical company in the country. The industry in the last years was fraught with regulatory challenges in the key markets, deteriorating economics of new product launches, the rising cost of product launches, and payments to FDA accredited consultants. However, amidst this, what was brewing is also interesting; cumulative withdrawal of more than 50% of ANDA (withdrawn total 1258 ANDA) filed with FDA in the immediate past three years, thereby paving way for improvement in profitability, globally competitive dynamics, and accelerated growth rate in the domestic markets. This was superimposed by dislocated valuation opportunities. The confluence of three made an attractive investing opportunity. The global COVID situation has accelerated the plant clearances in the key markets, and we are hopeful that this industry will help us in improving our trade imbalance with China, shortly.

Our portfolio company was among the fastest to adapt itself to the new reality, especially after bringing a new CEO on board, driving massive improvements in the company's operations by cutting costs, revamping management teams across divisions, divesture of plant, sweating assets and partnering with other companies on launches of proprietary products and focus on volume growth across geographies, de-risking from key markets. The erosion in the U.S. market has bottomed out, and the company is now the fastest-growing generics company in India, Europe, Brazil, Russia, and key ROW Markets. While we were buying, the sell rating outweighed the buy rating by more than 60%, triggering a wider debate aboutthe collective wisdom of institutional analysts while fundamentals of the company were improving. The company is practically debt-free and generates an enormous amount of free cash flow, which could be successfully deployed towards high growth avenues.

It is widely acknowledged in the investment world that one needs to think and act in a contrarian manner to achieve outsized returns and differentiated results. There is also something called faux contrarianism. Here the investor sees themselves as going against the crowd in buying a stock that has recently fallen, but they are buying a popular, expensive stock that has been mostly rising over the past few years; has merely become slightly less expensive/popular; and are relying on a highly-consensus assessment of the historical strengths of the business (already well known and priced in), rather than understanding and reacting to new information that may be calling that prior assessment into question. Real contrarianism involves focusing on areas of the market that are genuinely cheap and neglected, and have typically already delivered poor outcomes for many years but have underappreciated mean-reversionary/recovery potential.

Our long-term investment in Raichur-based oncology company is progressing well with the company receiving 5 approvals from the US FDA during FY2020 and filing ANDAs for 8 high-value products. Overall, the company has 58 filings across US & Europe out of which 22 filings are pending for approval and 3 have been tentatively approved. The company has completed the construction of its Biologics plant at Hubli, Karnataka, and is in the developmental stage of about six biosimilars/fusion proteins (Adalilumab, Albumin, Etanercept, Aflibercept, Darbepoetin Alfa and one more). These products would enter clinical trials in India in the next twelve months, addressing the commercial launch in India and the Rest of the world markets and thereafter to the developed markets over the next few years. The pre-genericized global sales of these five drugs are approximately $40 billion. The company was granted patents in the US& Europe for its manufacturing/purification process for Recombinant Albumin. Our internal estimate suggests that the company has made R&D investments of Rs 350 cr, and 30% of cumulative PBT has been invested in R&D over the last five years; that's quite a huge punch for a company of this size. The company has done mid-course correction of asset sweating strategyby monetizing products worth Rs 70 crs, taking more CRAMS projects this year, and we expect this to continue in the likely future. They have also launched cancer drugs in the domestic market at a fraction of the innovator cost. This should yield benefits to shareholders. In case you are en-route to Raichur, do visit the shining stars, the second generation of the company.

We have increased our stakes in the design-led IT company having exposure to automotive, media, broadcasting, and medical equipment businesses. The elevation of a young team in management role last year has led to substantial progress in shifting project-based work to longer lead time, deeper customer engagement in the media, and broadcasting business, which is witnessing explosive growth in the Over The TOP (OTT) segment due to lockdown. Our company assists medical and health companies across the globe, assisting in the launch of innovative equipment, and its services are in huge demand. COVID has led to a realization that countries are severely underinvested in healthcare, and we are on the cusp of a tsunami of investment in this segment. Our company is likely to be the prime beneficiary of this changing trend.

We zeroed in on a sizable investment in a power exchange, reflecting the changing preference of the country to bring efficiency and transparency in power purchase for consumers, SEBs, and producers. The exchange has a 90% market share in the short-term power market. The short-term market accounts for 15%, and new regulatory changes will expand the scope of the company to 30% of the total power market of India. The long association with power utilities and State Electricity Boards results in a unique advantage for the company. Global experience suggests that more than 50% of the country's power is traded via a power exchange to meet the short- and long-term needs. Recently, the exchange has sensed an opportunity in rising gas consumption of the country and has forayed in setting up a gas exchange.

Our investment in the largest sugar company is progressing well, as it produces daily consumable commodities. It is on course to convert 30% of its sugar into C/B Heavy ethanol, thereby ethanol accounting for 40% of profit before tax. The recent steep fall in the prices of oil raised some doubt about the viability of ethanol procurement and the conversion of sugar to ethanol in the global markets. The ethanol blending target of 20% is part of the economic priority of the policymakers, and the procurement prices are fixed on an annual basis based on the Minimum Selling Price (MSP) of cane, thereby insulating the profits. Any change in ethanol prices will be in conjunction with a change in cane prices. We foresee that approx. 20% of India's cane will get converted into ethanol over the next three years, balancing the sugar output of India, permanently. The export market is challenged in the short term due to additional conversion of sugar of around 5-7 million tons in the global markets due to steep fall in the oil prices, which would have earlier found its way to ethanol in Brazilian markets. This does not have a material impact on the profitability of the company. As the situation normalizes, so should the demand-supply in the global trade.

The brutal decline in oil prices posts the tiff or collusion between Russia and Saudi Arabia, and the woes compounded by the lockdown of economies remind us of the 1980s when the U.S. colluded with Saudi Arabia to bring down the USSR. After the secret pact between both countries at the time, Saudi oil extraction rose from 2 million to 10 million barrels a day, and prices plummeted from $32 a barrel to $10. For the USSR's economy - already accustomed to exorbitant incomes from its oil, this was a death blow, resulting in the huge budget deficit and ultimately break up of the USSR. We are students of economic and political history, and cannot help notice anypattern repeat. The current debacle of demand and prices e of oil should inch toward normalization, once the world re-opens for business. There is a general belief that falling oil prices are good for economies like India. This may not be true in all circumstances. The falling oil prices tend to lead to a "dollar squeeze," thereby adversely impacting Emerging markets that have dollar liabilities. The Sovereign Wealth Funds (SWF) owned by a dominant oil economies resort to the sale of their financial assets in the key markets for bridging their budget deficits.

We invested in a leading apparel brand, which has withstood 20 years of evolution and presence across the various formats in India. In the last three years, the company turned around its value format and is on course to build an enviable innerwear business. They have a low-cost franchisee model in tier IV towns to expand the appeal of their portfolio of brands. It is, in our view, a wonderful play on expanding demographics, consumption, and the service sector of the country. However, the investment came just a quarter before the COVID situation and is facing a challenge. We have immense faith in the ability of the management to handle this extremely difficult environment related to discretionary consumption and wait for further business commentary to evaluate the situation.

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As market prices of the businesses go disarray due to illiquidity, economic mayhem resulting in a preference for holding certain securities, we evaluated companies based on a simple internal model to judge all companies on the implied growth rate of cash flow discounted by the current capitalization of the company. We also compared this implied expected growth with the growth achieved by them over the varied period in the immediate history. This serves as a navigator towardsgetting a direction for the value one wishes to pay for future growth and helps us better understand the growth expectations embedded in the present market valuation of the company.My colleague Madhusudan Sarda, a value hawk, and proponent of this model, convinced all of us for increasing our investmentin the pharmaceutical sector, which gave strong buy signals as per the price-value relationship shown by this model.The model extrapolates the implied growth rate for the next 10 yrs and assumes a fixed terminal growth rate for all the companies, discounted by the required rate of return.

Table: Implied Cash flow growth in the Current Business Value

Expected Cashflow Growth				Historical Cash flow Growth		
Portfolio Companies	Credit Rating	Implied Growth in Cashflow	Interest Coverage	Growth 3 Yr	Growth 5Yr	Growth 10 Yr
FMCG	-	20.5%	124.9	6%	11%	14%
Energy Exchange	-	18.0%	97.5	22%	14%	38%
Large Pharma	ICRA AA+	17.5%	23.4	-3%	1%	11%
IT & Digital	ICRA AA	12.0%	57.2	17%	24%	16%
Oncology Pharma	ICRA A	9.0%	41.4	-3%	5%	25%
Fluorine Chemical	IND AA+	7.5%	7.1	11%	23%	14%
Large Apparel Brands	ICRA AA	5.5%	4.0	26%	66%	n/a
Niche Chemical, Amines	IND AA-	1.0%	8.6	12%	23%	18%
Rice Brand and Exporter	ICRA AA	-0.5%	13.4	25%	14%	21%
Cement Manufacturer	IND A	-2.0%	2.5	75%	43%	15%
Auto Ancillary	CRISIL A+	-6.0%	11.3	22%	14%	20%
Sugar & Ethanol Manuf.	ICRA AA	-9.0%	11.4	18%	36%	6%
Electrical and Pipe		-22.0%	3.2	21%	16%	12%
Oil, Gas & Water Pipes	CARE AA-	-28.0%	2.5	335%	28%	

Source: Vallum Research

The findings are the following:the market has a strong preference for holding large-capitalization low gearing companies, and severely penalizing small-cap value stocks, suggestingthat the cashflows of such companies will degrow for the coming decade.All are companies are solvent and enjoy good credit ratings by rating agencies. The model helps us in understanding what the market is thinking today and in which direction are the votes being cast by the voting machine.

We made a partial exit in the life insurance and Fluorine chemistry businesses based on the realignment of weightage to other opportunities. The thesis on the wagon manufacturing business, which we had invested three years ago, did not pan out per our expectations and called for an exit. We are focusing on the business we own and are on the lookout for other opportunities that meet our criteria.

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The crises of the Year 2020 might well lead to a fundamental reset to the global economic order. There are only three instances in the last century when global output has fallen. Each one of us is going to be affected in multiple ways. There has been an intense debate over the various styles of investing (value/growth or value/quality) and the divergence of the outcome it has produced over the last decade. There is a multitude of factors that led to the underperformance of value vs. growth and high-quality stocks. First, the emergence of China as a global manufacturing hub led to the migration of the value from the rest of the world to state-sponsored entrepreneurs from China. The massively subsidized exports from China decimated local manufacturing industries that competed with it. Secondly, the global financial crisis set the pace with the declining cost of capital for financial assets. This led to the rise of long duration investments in high growth companies. Thirdly, the rising indebtedness of the global economies has resulted in the preference of bondholders to allocate to equities exhibiting low volatility - in anticipation of better yield and lower probability of default. Finally, the rise of passive funds (ETFs), now accounting for more than 70% of all incremental inflows in financial assets across the globe, has supported and fueled momentum-based investing. The fall of double (2x) leveraged gold ETFs in the month of March and USO oil in the month of April 2020 is testimony to this.

Such developments have seriously challenged active fund management as well as value investing. The relentless rise of prices has a circular relationship between cause and effect, and it is called Reflexivity. People who invest based only on "fundamentals" don't often consider price changes to be one of the key drivers of fundamentals. Price drives perceptions that drive changes in fundamentals. This process can create a positive or negative feedback loop that will continue until it reaches a breaking point. This concept is well explained by George Soros. We have witnessed many examples in the Indian market, such as the NBFC with leadership in consumer loans, the market leader in luxury motorcycles, etc. All of them have gained tremendously due to perception, leading to earning as well as the price to earnings multiple expansion.

This reset in the economic landscape is likely to change the underperformance of value. The world is going to witness an accelerated path of de-globalization on the back of supply disruption, backlash due to COVID issues related to China, and rising protectionism across the world. Such a condition usually leads to a repricing of local assets. The world is going to witness degrowth rather than growth; hence the premium of growth should shrink relative to value. The financial world is organized around two axes: time and risk. If some authorities manipulate the time axis by an interplay of interest rate and other factors, the effect will be to compromise the risk axis. We have witnessed a low inflationary scenario for a considerable part of the last two decades, on the back of globalization.

At the crucial juncture of such a catastrophic economic event, the choice of policy measure undertaken decides the destiny of the economy. Keynesians and Wicksellians believe that manipulating interest rates downwards stimulates capital spending. It doesn’t – our view is that it encourages/incentivizes a massive increase in leverage to buy existing assets. In the last eight years along (2012-2020), U.S. corporations have repurchased $4.6 trillion worth of their shares – boosting share prices to thunderous applause from shareholders. This is capital that could have been invested in equipment, expansion projects, and people, or to reduce their indebtedness. Very few businesses took the risk (and the right approach) of building productive new assets. The Zero rate interest regime attempts to bring future consumption today, but we forget that in such an endeavor, our monetary policies are tied up to past monetary actions.

In domestic markets, the RBI has responded to this unprecedented situation, and its efforts are commendable - introducing TLTRO, LTRO, and other measures to release liquidity by reducing the repo rate. However, the risk aversion in the banking sector is at its peak, and close to Rs 6.5 trillion is parked with the central bank. In contrast, today, Indian fiscal policymakers are facing a dilemma like Alexander standing at Guardian knot. How to revive the economy with diminishing resources? The world witnessed the New Deal by Roosevelt in 1930 to rebuild the U.S., the economic rise of Germany and Japan post-devastation in world war when their economies were weakest in the history of their country. It is the foremost question in everyone's mind today - how a diverse country like us will handle such a catastrophic economic challenge. The thoughtful choices we make today will play a large role in deciding the economic future of India.

The best way forward, in my view, is to formulate a policy to borrow up to $500 billion from the international and domestic markets at a competitive rate - to be paid by next decade, to jumpstart the economy. We should invest a third of this principle in the infrastructure sector, a third for setting up and encouraging a globally competitive new-age export-oriented industry, and a third for implementation of recommendations of a High-Level Advisory Group (HLAG), overseen by an eminent practitioner to direct the revival of the Indian economy[1]. We should not try to replicate the China model which has its benefit of a conducive ecosystem and superior investments in infrastructure. The connotation of globalization in the coming decade will be different from the last decade. This financing could be offset by introducing a COVID tax on discretionary consumption (yes I mean discretionary), and austerity in the salary of public servants to service this borrowing. This will help in warding off the adverse impact on the sovereign rating. The government should also become an enabler for buoyancy in the capital markets by reducing long-term capital gain taxes to attract long term savers in capital-starved risk-bearing instruments. The corporate sector started deleveraging around four years back and is in far better shape today. Things could have been far more challenging if this pandemic would have struck us four years back. The Indian monetary policy has a lot more room to accommodate lower interest rates, even if the fiscal does not have enough space. As global liquidity is looking for a safe parking space, our country has the brightest chance to leapfrog to the Industrial Development 4.0, led by strategic support of global partners leaning away from other countries.

The year 2020 will be fraught with a challenge on multiple fronts, and we see a meaningful recovery in the year 2021 only.

It is often said that the four most dangerous words in the investing world are "this time is different," but perhaps so are the most important "this too shall pass." In times of crisis and uncertainty, it is easy for investors' time horizons to shrink to mere months. However, taking the long view, human societies are resilient and adaptable - history proves that, and while humanity and the global economy are in for a very difficult year ahead, we will find ways to manage the impact, adapt, and get through this.

Manish Bhandari and Vallum Team

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1. **Report of the High Level Advisory Group**
   https://commerce.gov.in/writereaddata/uploadedfile/MOC_637084607407371826_HLAG%20Report%20.pdf