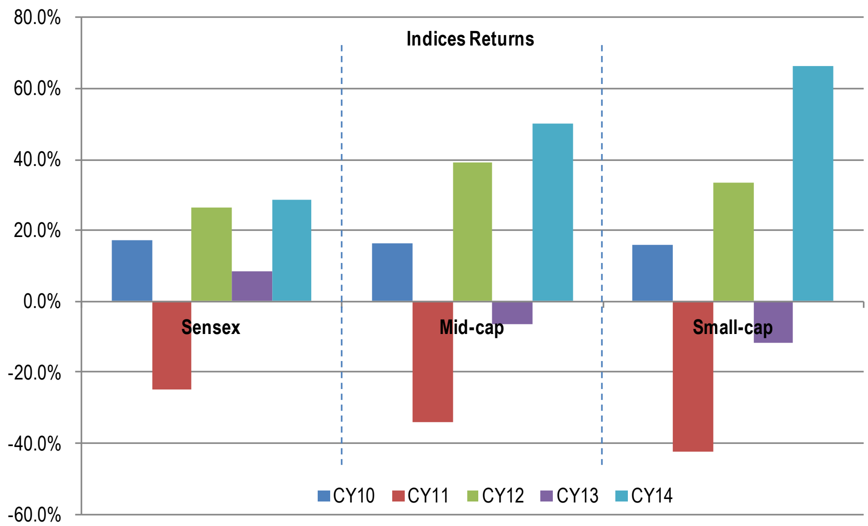
Dear investor, Jan-15

CY14 has been one the best years in the recent past for the Indian markets. Stock returns were the highest compared to the last five years across Sensex, Mid-Cap & Small-Cap indices.



Source: BSE

With a pro-business government at the center (& many states), it is being expected that various economic & social reforms would bring India back to a higher GDP growth trajectory from around 5% clocked over the last few years. And this higher growth may in turn lead to better returns in the stocks going forward.

Given Mark Twain's words *"History does not repeat itself, but it rhymes"* it might be interesting to compare historical Sensex returns with the GDP growth rates.

	Real GDP Growth*	Real Sensex Return*	Real Sensex EPS CAGR*	Year-end PE (x)
1981-84	5.2%	-3.0%	NA	NA
1984-87	4.7%	9.2%	NA	NA
1987-90	7.0%	21.9%	NA	17.8
1990-93	3.7%	33.6%	2%	40.0
1993-96	7.3%	-11.4%	32%	12.2
1996-99	6.3%	9.1%	-10%	21.7
1999-02	4.2%	-15.7%	-4%	14.7
2002-05	8.4%	35.2%	25%	18.6
2005-08	7.6%	-6.0%	9%	12.0
2008-11	8.4%	6.5%	-4%	16.4
2011-14	4.9%	11.2%	7%	18.7

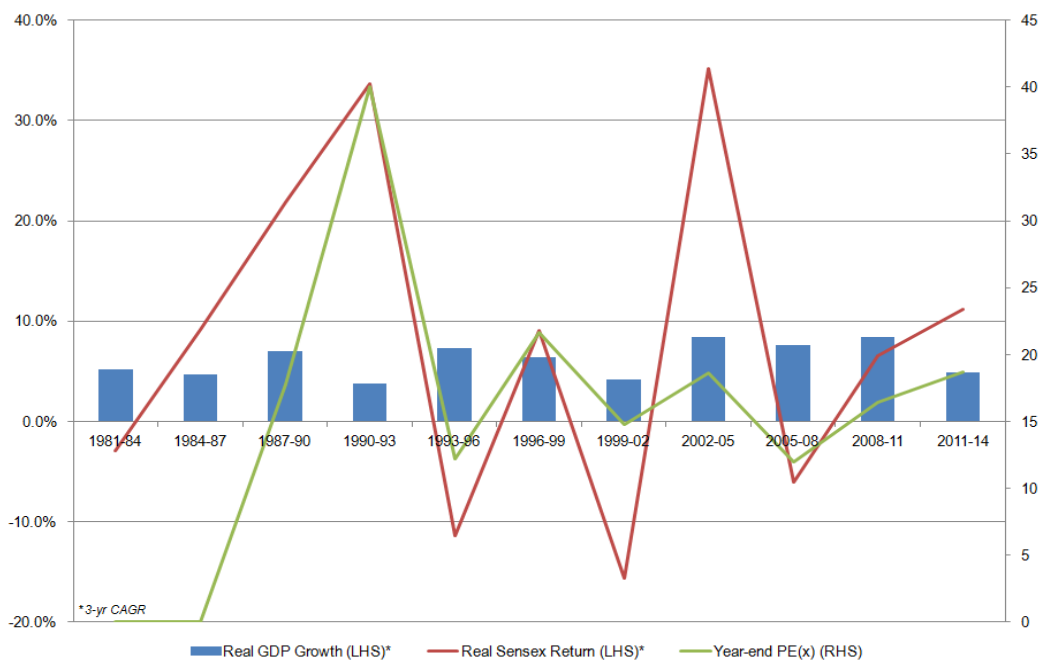
*Source: Planning Commission, BSE, Bloomberg; *3-yr CAGR; NA = data not available*

In order to even out annual fluctuations, Sensex calendar-year returns (adjusted for inflation) have been bucketed into 3-year periods for the last three decades. Along with it, Real Sensex EPS growth (earnings per share) & year-end TTM PE (trailing twelve month price to earnings) ratios are also shown.

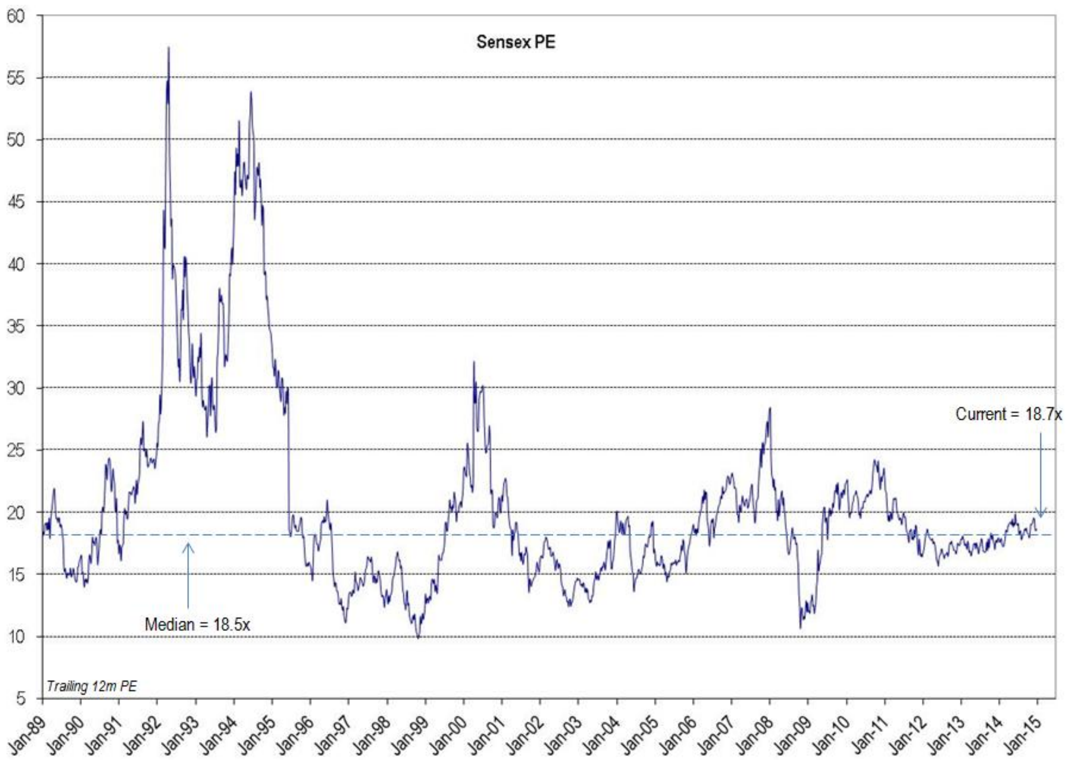
It can be observed that higher Sensex returns (during periods 1990-93, 1996-99, 2011-14) are not necessarily related to higher GDP growth & similarly lower / negative returns (during periods 1981-84, 1993-96, 2005-08, 2008-11) are not driven by lower GDP growth. It can also be seen that:

- Negative Sensex returns during periods 1993-96 & 2005-08 happen when the average GDP actually grew by ~7.4% (which is higher than the overall average of ~6.2%) and Sensex earnings showed a growth of 32% & 9% respectively. Despite such strong / non-negative earnings growth, Sensex lost value primarily driven by contraction in the PE (40x to 12.2x over 1993-96 and 18.6x to 12x over 2005-08)
- Even during negative Sensex earnings growth periods of 1996-99 & 2008-11 (GDP actually grew at a faster pace of ~7.4%), Sensex increased in value again primarily driven by expansion in the PE (12.2x to 21.7x over 1996-99 and 12x to 16.4x over 2008-11)
- Sensex grew robustly during 1990-93, 2002-05 & 2011-14 periods (average GDP growth of ~5.7%) when there was both a sharp PE expansion & positive earnings growth.

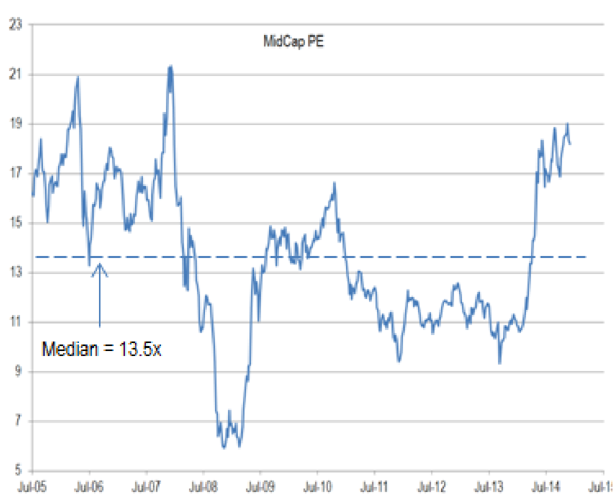
These observations seem to indicate that market returns are more driven by its earnings & entry PE rather than the GDP growth. In fact, if one were to choose the single most important factor then history suggests that the 'entry / beginning PE' of the market would be the most appropriate. As shown below, it can be seen that across all the periods market returns actually move in tandem with the contraction / expansion of the beginning PE.

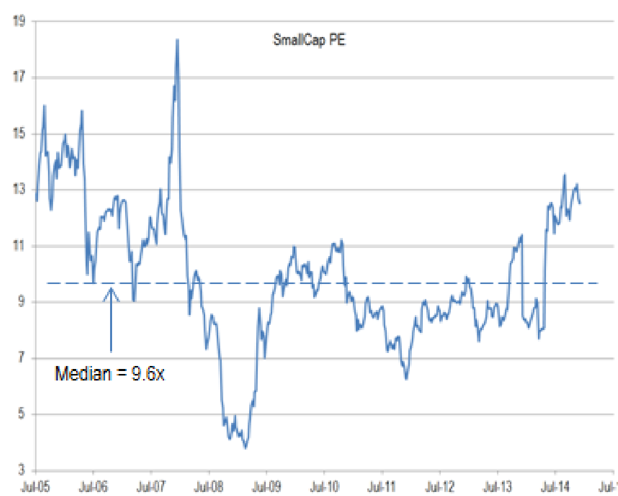


Given this significance of PE, it may be worth looking at how the markets are getting priced currently, after a great year. Again looking at history, Sensex is trading close to its median & seems to be 'fairly valued'. Such situations are more confounding than 'extremes' as the degree of under / over valuation is not quite apparent.



In comparison to Sensex, Mid & Small Cap indices post their spectacular gains in CY14 seem to be trading at considerably higher valuations than their historical medians. Such periods of over-valuations call for being cautious as any disappointment may potentially result in a loss of capital.





Source: BSE, Bloomberg

Given our focus on bottoms-up approach, our decisions get guided by the merits/demerits of individual businesses. Thus taking cue from the above indicators, whether we decide to aggressively sell our portfolio of mid & small caps or churn it to more Sensex stocks, would depend more upon how the individual portfolio companies stack with respect to their risks /

returns. Such macro trends nevertheless help us to gauge what the markets are pricing-in & appreciate over & under valuation risks & opportunities, respectively.

As highlighted in our previous newsletter, our decision to 'sell' continues to be guided by

- narrowing of gap between value & price and availability of alternate investment opportunities
- unanticipated changes in the business fundamentals
- realization of a mistake committed in our evaluation

This also determines the 'cash position' in the portfolio. Cash increases when 'sell' decisions out-number 'buy' decisions (due to unavailability of businesses at price-points we are willing to buy them at) and cash decreases when there are more buy decisions than sell decisions. Former situation typically happens when markets are ebullient & building-in significant future growth assumptions into the stock price whereas the latter when the markets are despondent. This strategy has kept us in good stead during earlier market reversals & has helped us to avoid taking naked cash calls.

Triggered by the first point above, we have been selling / lightening a few of our stock positions – this has raised some cash in the portfolios as we are finding hard to deploy such generated cash / fresh in-flows. Given our focus on value & not price, a rising market like the current one, invariably presents a bigger challenge to put capital to work. We prefer being patient & would wait for a loose ball before swinging our bat (using Warren Buffett's analogy).

Regarding our portfolio, we continue to remain invested in HMVL, GSPL & Setco – these were briefly discussed in the last newsletter. We have booked some profits in Setco given that the stock has trebled in less than a year & seem to be already pricing-in a fair bit of commercial vehicle recovery. Some of the new names that have been added in the portfolio are Godfrey Phillips, J&K Bank, Balkrishna Industries & Sun TV. These are discussed below.

Godfrey Phillips

Godfrey Phillips is the second largest player in the Indian cigarette industry with 11-12% volume market share. With iconic brands like Four Square and Red & White, it sells around 15bn sticks annually primarily in western & northern India. As the industry is broadly stagnating in terms of volumes due to higher taxes and strict regulations governing marketing and sales & promotion practices, growth has primarily been coming from price increases. Given the nature of the product with quite an inelastic demand, industry has been quite successful in passing-on more than the cost inflation to its customers annually. Godfrey's EBITDA per stick has grown at >13% annually over the last decade (& >15% over the last five years), enabling the company to increase its net profits by a CAGR of 15% over the last 10 years. Further, Godfrey has recently re-located its manufacturing to its newly commissioned factory at Navi Mumbai – this would not only make the erstwhile Andheri plant's land available for some other development (real estate?) but would also bring down the capex requirement of the business over the next few years. At the current EV of Rs3000cr, business is generating ~300cr of operating cash flows & close to 225-250cr of free cash flows giving a yield of ~8%, making it quite attractive for an FMCG business, which has been clocking 18-19% return on capital employed since last two decades!

Jammu & Kashmir Bank

J&K Bank is a mid-sized old generation seemingly private sector bank (majority owned by J&K Govt.) focused predominantly on the state of J&K, where the bank runs a near monopoly accounting for ~2/3rd of the market share in both advances and deposits. Driven by the bank's branch network in the state (which is >2x of SBI, PNB and HDFC Bank put together), the bank counts >7mn account holders out of the state's total adult population of 8.6mn. This gives the bank a perennial source of low-cost raw material (deposits) in an industry where the selling price of the product (interest charged on loans) is quite competitive. J&K Bank is also able to maintain one of the lowest operating cost structures in the industry (cost to income ratio ~ 37%) because of low branch related rental expenditure & one of the best employee productivity metrics. Despite being primarily present in J&K, the bank has also been able to grow its advances by >17% CAGR over the last decade without diluting even once after its IPO in 1998. Though its stable asset quality over the last five years (avg. Net NPA of 0.2% & coverage ratio of 90%) has recently seen some deterioration (in the corporate loan portfolio outside J&K, where the bank operates through a consortium), it seems to be more of a temporary setback given the expected recovery in the economy. Nevertheless the bank is quoting at a price to book value of ~1.1x which is quite low for a franchise capable of generating a return on equity of ~20%.

Balkrishna Industries (BKT)

BKT is a niche manufacturer of 'Off highway' tires (OHT) that are used in agricultural, construction, industrial, mining, earthmover, port & ATV (all terrain vehicles) applications. Driven by quality products (conforming to various international standards) at extremely competitive prices (lower by 25-35% compared to larger international players), BKT exports ~90% of its production to >120 countries through a network of >200 distributors across the globe. As these distributors retail ~80% of overall sales under the company's brands, business gets driven by replacement demand, making it more resilient to vagaries of economic cycles. Offering its ever-increasing range of ~2000 SKUs, BKT has adapted itself to the 'large variety-low volume' nature of the OHT industry, which makes the industry a non-focus area for many other regular vehicle tire manufacturers. Despite growing its volumes by >20% CAGR over the last decade, BKT still accounts for only 4-5% of the global OHT industry, giving it growth visibility for many more years. Though the business is capital intensive, BKT has been successfully leveraging on the back of its stable operations to generate an average ROE of ~26% over the last 10 years. At 12x trailing PE & ~10xEV/EBITDA, the stock may not necessarily be cheap (given its trading history), yet its recent doubling of capacity & future growth make it an interesting play.

Sun TV

Sun TV is the largest regional broadcaster with significant viewership market shares in southern India – Tamil Nadu (60%), Andhra Pradesh (27%), Karnataka (~40%) and Kerala (~25%). Though the company has lost some sheen over the last five years, the decline in market shares has been broadly arrested in TN, Kerala & Karnataka over the last two years (these three states account for 3/4th of the total TV advertising spend in South India). Given its share of ~70% (>2x of all combined together) in general entertainment category in TN (biggest advertising market), Sun still commands a significant premium in advertising rates compared to its peers in the state. With industry moving towards more transparency (through digitization), it is only a matter of time before subscription revenues witness a substantial ramp-up. This makes the business a cash cow with superior return ratios of ~22-23% capable of generating >700-750cr free cash flow annually. On the current EV of ~140bn, this gives it an attractive yield of >5% which together with its significant valuation gap with respect to the other broadcaster (Zee is almost twice as expensive as Sun TV), seem to be more than compensating for the uncertainty associated around its promoters.