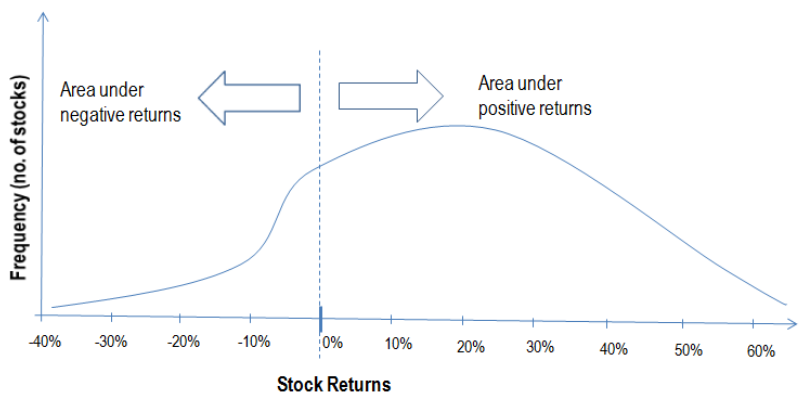
Dear Investor,

Wish you & your family a very happy new year.

We were up 17% on an average across portfolios in CY15 VS the overall market (Sensex) decline of 5%. Out of the 20-odd stocks in the portfolio, five ended in the negative zone whereas on the balance 15 we were in green. Obviously what we made in these 15 stocks was higher than what we lost in those five stocks.

Though these statistics are valid only as on the closing day of CY15 & may change as CY16 unfolds, under normal circumstances we would ideally like our portfolio to have more winners than losers – both in terms of number of stocks & absolute $ amounts. This also implies that we strive to have not only lesser number of losers but also restrict the quantum of losses on those losers. A frequency distribution of this can be broadly represented as:



Left hand side area of the above graph represents losers – value that has been lost. Given that a portfolio will inevitably have a few losers, we do lose our sleep over that. We instead aim to minimize the area under it so that the value lost is only a fraction of the value gained, represented by the area on right hand side.

Though simple to understand, it is difficult to execute consistently given distractions & noises in the market. It is here that we depend entirely on our process to select investable stocks. We spend significant time studying businesses / companies behind these stocks to understand:

1. Why are customers buying the product / service from the company and why would they keep buying into the future. Or in other words why would it be challenging for a competitor to take those customers away
2. Can we pay a price to acquire the above business where we do not really have to think or worry too much about the earnings growth rate in the future

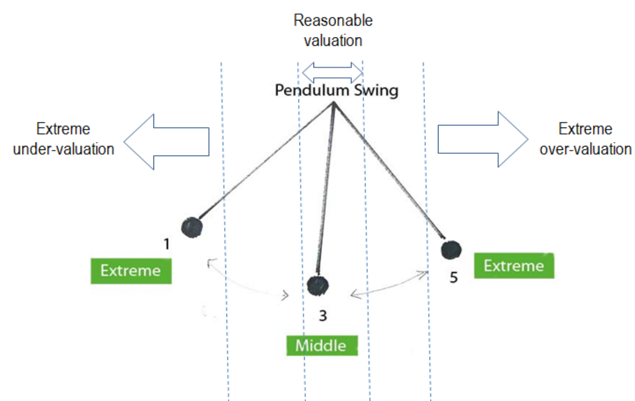
This process has so far kept us in good stead – value lost due to our mistakes (either in the choice of business or in its acquisition price) has been fairly low. Taking cue from Benjamin Graham's saying, *"Limit your downside & upside will take care of itself"*, occasionally, we end-up holding a couple of companies where the realized upside eventually exceeds the original estimated upside at the time of acquisition. Such 'lucky' stocks typically show-up on the extreme right of the above graph. This is what happened in one of our holdings in CY15 – Godfrey Philips.

We first bought into the stock in August-14 and then kept adding it below Rs600 over the next 12 months across some of the newer portfolios.

Our original thesis, as discussed in the last newsletter, was based on the fact that customers seldom change their cigarette brands and this gives cigarette companies enormous pricing power. Unfortunately given issues around the industry (higher excise / VAT rates, etc) & the company (management quality), market provided enough opportunity to buy the business at an attractive valuation. In fact around Apr-15, we were down ~25-30% from our acquisition price; we kept faith in our thesis. Though our expectation was a very healthy return from the stock at the time of buying, we have been pleasantly surprised by the swift price discovery in the market.

It is quite difficult to say if anything has materially changed; at times cheap valuation itself becomes a trigger & market re-prices the stock even at the remotest whiff of any positive change.

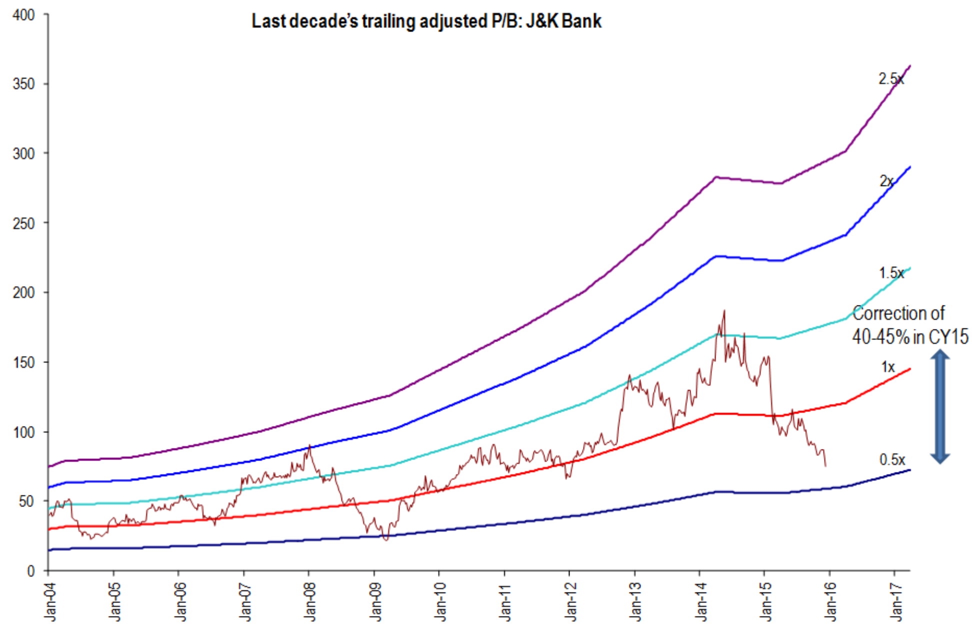
As stated by Howard Marks, Oaktree Capital, *"Investment markets follow a pendulum-like swing between euphoria & depression, between celebrating positive developments & obsessing over negatives, and thus between overpriced & underpriced."*



Given that only in hindsight one may know when the reversal in the swing happens, we have been slowly selling our positions in the stock.

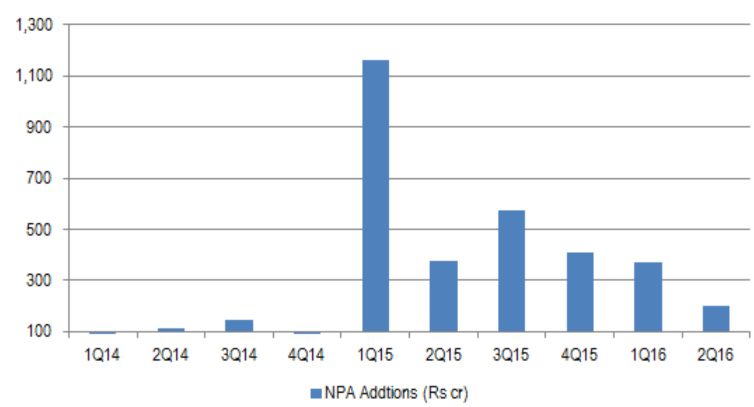
If market's pendulum is probably swinging towards right in the case of Godfrey Philips, it may be swinging towards left in the case of J&K Bank.

As highlighted in the previous newsletter, J&K Bank has been facing the brunt of bad economy (& some bad lending too!) on its assets. Bank's gross NPA increased from 1.6% in FY14 to 6.5% of advances in 2QFY16 due to which its ROE has dropped from 22.3% to 12.3% over the same period. As a result the stock has been in a correction mode and now trades at ~0.68x book value adjusted for NPAs & restructured assets. Only once has the stock traded below this valuation (during GFC) in its last decade's trading history.



Again, as it is only in the hindsight that we would know when the pendulum reverses, we have been slowly nibbling into the company. We are again reminded of Howard Marks, *"There are a few things of which we can be sure, and this is one: Extreme market behavior will reverse. Those who believe the pendulum will move in one direction forever – or reside at an extreme forever – eventually will lose huge sums. Those who understand the pendulum's behavior can benefit enormously."*

We are further encouraged to see some improvement in fresh NPA additions in J&K Bank which have been steadily coming down over the last few quarters. Though this does not mean that the bank is out-of-the-woods & there could be a few surprises down the line, there has been a conscious effort by the management to restrain lending outside J&K. Advances within the state now account for more than half of the total advances, up from 40% in FY14. This would be beneficial to the bank's asset quality, given its strong presence in J&K where its NPAs (%) are far lower than the peers, implying much superior credit management within the state.



NPA outstanding (%)

	2011	2012	2013	2014	2015	2QFY16
J&K Bank	2.6	2.9	2.8	2.1	2.4	2.5
SBI	8.1	9.2	8.1	7.8	4.5	4.4
PNB	11.9	13.3	17.1	16.7	16.6	18.8
HDFC Bank	3.4	1.0	1.7	2.5	3.7	1.9
ICICI Bank	—	—	—	—	—	—
Total	4.2	4.3	4.6	3.7	4.2	4.5

Source: Company filings & public documents

As the problems are associated with the balance sheet, we do not expect any quick turn-around though we do believe that with its pivotal role in the state economy & its deposits franchisee strength, there seems to be a good probability for the bank to come out stronger once the present issues get addressed.

As an investor, such situations may test our patience & thus it is extremely important for us to have a longer term orientation while investing. In fact it is this long term approach which helps us to control our emotions, disciplines our thought process & provides us an edge especially when things may not be going in our favor. We continue to hold-on to our position.

Our biggest sector exposure remains to be Hindi print media through our holdings of HMVL & Jagran Prakashan. Both these businesses have been performing well & grew similarly by ~11% & ~35% on sales & operating profits respectively in the first half of FY16.

Given their dominance in non-metro & non-tier-I cities, regional print media (like Hindi) continues to be the preferred choice of both the national & local advertisers to reach the growing hinterlands of India. Whether it is Bajaj showcasing its latest launch or it is a local real estate developer with its new project, they necessarily have to go through the city newspaper. Even the new-age digital companies like Flipkart or Amazon had to run full front page advertisements on these newspapers to get sales from such cities.

Source: E-papers – Ayodhya edition (a tier-III city in UP)

As discussed in the last newsletter, we continue to believe that Hindi newspapers (like Hindustan & Dainik Jagran) are on a strong wicket & it will be years before there is a perceptible impact of digitization on their business. Despite the stocks of HMVL & Jagran being up 36% & 17% in CY15, they continue to trade at ~13.0x & 14.4x FY16 earnings respectively. Further both the companies are recording a healthy >20% ROEs. As such we continue to hold these stocks.

Some of the other new positions added in the portfolio over the last six months are discussed briefly below.

Nucleus Software

How many times have we changed the operating system on our laptop / desktop? A majority of us would have probably never changed it though we might have upgraded to a better version! This is the level of stickiness with some of these softwares as we get used to their interface. A similar dependence gets created at an enterprise level where such softwares end-up controlling certain very critical functions of the enterprise. Nucleus develops such specialized software for financial institutions like banks & NBFCs which supports almost 2/3rd of the Indian retail lending transactions on its platform, FinnOne.

If on one hand this stickiness leads to predictable & recurring revenues from maintaining & servicing existing customers, on the other hand it also makes future growth un-predictable & lumpy, as that becomes a function of new licenses sold. Nucleus is no exception – though its avg. ROIC (excl cash) over the last five years is a very healthy ~38%, its top-line growth (CAGR) has been a meager ~4% over the same period. This lower growth is expected to get addressed by the company's new product – FinnOne Neo where Nucleus is actually transforming itself into a pure product company. It is actively showcasing FinnOne Neo to its existing customers (who are on different versions of FinnOne) & exploring possibility of their upgrade. As these migrations are big decisions for the banks, and are also a function of existing references, this journey may again be a little bumpy. Given company's domain expertise & its long-serving senior professionals, we do believe that Nucleus will be successful in migrating a number of its existing & new customers. Such product companies typically trade at 3-5x sales though Nucleus with Rs3.5bn sales & similar cash in the balance sheet, trades at <1.5x sales (excl cash), which makes it quite attractive for such a steady business.

Mahindra & Mahindra Financial Services

MMFSL, a Rs135bn market cap NBFC, is the second largest company under the Mahindra Group and focuses on auto lending in semi-urban & rural markets. Despite >1150 branches across the country it has been able to cover only a third of ~0.65mn Indian villages, indicating the penetration potential that may be possible. This reach not only helps the company to work as an enabler to the auto dealers / OEMs who get higher sales through MMFSL but also facilitates multiple visits to its customers to part collect EMIs, during a macro slowdown. With 60-65% of company's collection in cash, it becomes quite difficult for banks to really compete with the company.

Though MMFSL has grown its advances, sales & earnings at >20% CAGR over the previous decade, last two years have been quite patchy. Rural as well as overall macro slowdown has had a negative impact on its assets – gross NPAs have increased from <4% in FY13 to >9% in 1H16, leading to a spurt in the credit cost. Despite all the lending being asset-backed (with an LTV of 65-70%), the current economic slowdown restricts the company from selling the assets in the secondary market. Instead MMFSL has decided to stand by its customers & focus on increasing its penetration further to help achieve better collection efficiencies. These problems have led a stock price decline of 30-35% from its peak which currently makes the company available at ~2-2.1xTTM consolidated book, making this franchise attractively valued from a longer term perspective.

MOIL

Originally set-up in 1896, Manganese Ore India Limited is a Mini-ratna PSU engaged in the area of Manganese (Mn) mining across its 10 mines located in the states of Maharashtra & MP. With almost 90% of Mn being used for production of steel, globally manganese markets get quite linked with the steel markets. As such Mn ore prices are down ~25% since the start of the year & are now quoting almost at a level seen a decade back.

MOIL is no exception. In the first half of FY16, driven by falling prices its sales & operating profits were down 25% & 49% respectively. Though MOIL is not the cheapest producer & stands somewhere in the middle of the global cost curve, it is still one of the most efficient in terms of the capital employed. Eramet, a French mining major, owning some of the lowest cost mines in Gabon, reported a single digit ROIC in its Mn business in CY14 compared to >50% reported by MOIL (excl cash). Given further deterioration in CY15, some of these global companies would be in severe stress whereas MOIL may still report >10% ROIC. This may restrict any significant decline in global Mn prices going forward – also helped by the fact that almost half of the global Mn production is controlled by only six mining groups. Driven by this uncertainty on Mn prices, market is pricing MOIL almost at the cash levels in its books, giving the mining business free. Though we were a little early when we started buying MOIL, we have been again nibbling into the company at lower price points.

CY15: Learnings

"I like people admitting they were complete stupid horses' asses. I know I'll perform better if I rub my nose in my mistakes. This is a wonderful trick to learn."

Following Charlie Munger, it may be worthwhile to reflect on some of the mistakes we committed last year.

Drawing an analogy from the game of cricket, there are a couple of ways through which a batsman can hurt the scorecard (in the order of significance):

"If we learn from our mistakes, shouldn't I try to make as many mistakes as possible?"

- Misjudging a ball & getting caught (hence loss of wicket)
- Selection of a wrong shot leading to a lower score (which could have been a boundary or a six)
- Letting go-pass a 'full length' ball (completely missing the opportunity to score)

The first category refers to decisions which could lead to a permanent loss of capital. This is typically led by an error in the choice of the business itself – either the business was misunderstood in the first place or certain un-anticipated adverse developments changed the structure of the industry permanently. This error also results into maximum loss as the probability of the declined stock to go back to its earlier levels becomes lower in the wake of the changed business scenario.

Luckily our process has helped us to filter such businesses out – so far we have not seen any permanent loss of capital though again borrowing from cricket, we might have got 'retired-hurt' in the case of J&K Bank & MOIL. We were clearly impatient & under-anticipated the potential problems and ended-up swinging our bat early. Though our initial acquisition price could have been lower by 30-35% across both the stocks, we have lately been adding to our positions at reduced prices. We do believe that issues across both these businesses are cyclical in nature (they repeat every few years depending upon macro / global conditions) & are also not isolated to these companies in particular and hence temporary, at best.

The second category of mistakes is about 'sizing' of a position in the portfolio. We seem to have missed Warren Buffett's saying *"Opportunities come infrequently. When it rains gold put out the bucket, not the thimble."* This happens typically whenever we have been influenced by not-so good performance of the business (& the stock) in its recent past and have taken our eyes-off, of the long term potential in the business. As such we fail to double-up our positions & miss an imminent opportunity.

Especially true for a business like Mahindra Holidays where we have not only been tracking the company for the last few years but also have been using its products (I am a member since 2011). Though a very unique business model based on the float generated from customer advances, company has been recording flat profits since last five years despite improving its various operating metrics. This clearly confounded us & we did not add meaningfully to our existing positions despite the company reporting ~50% growth in member additions in the first half of FY16. As a result, we could not participate fully in the recent ~75% stock rally which was quite an expensive mistake given our understanding of the business.

The third category is really an 'omission' mistake which is never visible in the portfolio. These result from either inaction or very slow action – typically when, even after spending an inordinate amount of time researching a business, we are unable to decide & let the opportunity pass. This is despite understanding the company well and also recognizing the fact that there is nothing like 100% information on any business.

We missed swinging our bat on Indag Rubber, one of the fastest growing tire re-treading companies. Despite doing most the work, we kept still, only to watch the stock price appreciate by almost 50%! Luckily, given the way markets behaved in CY15, such cases have been limited & we might get an opportunity to buy into this company again.

Historically, though our biggest mistakes both in numbers & quantum have been due to 'selling early'. This typically happens when there is a swift price discovery in the market – more led by a PE expansion rather than earnings upgrade (which may follow later). Being a keen observer of how the markets have historically valued the business, we at times fail to appreciate the 'new normal' and end-up selling early. We believe that somewhere it is also driven by our conservative forecasts – probably an inherent feature of value investors. As

Seth Klarman puts it *"How do value investors deal with the analytical necessity to predict the unpredictable? The only answer is conservatism."*

Such re-rating happened in couple of our holdings like Godfrey Philips & ZF Steering and we part sold both the stocks leaving at least 40-50% on the table. Though we can never predict (& we don't want to) the extent of stock rally, we have been tweaking our selling process to minimize such opportunity losses. We also take solace in Sir John Templeton's words *"Generally value investors tend to buy too early and sell too early."*

CY16: New Opportunities?

For us, the New Year is just a new accounting year – there is no change in our process or methodology of doing our business. We will continue to remain focused on our approach of 'Quality' & 'Value' though we have also started paying a lot of attention to 'Growth', especially after having sold a few stocks too soon. Our philosophy on the portfolio cash (un-invested amount) again continues to be the same – we would invest only if we get opportunities with the right combination; we would not invest just because the investor has given us the mandate to invest. We do understand that in this endeavor there could be a few misses though over a period of time, our process should help us to present a good report card.

We also like to highlight that our well-being is entirely linked with the stocks that we choose in our investors' portfolio. Not only our compensation is linked with just the stock profits, but also our & our family savings are in the same stocks. Thus our interests are almost 100% aligned with the interests of our investors.

I also look forward to have a discussion with you over the next few weeks on the performance. Please feel free to write back in case of any suggestions / feedback. It would also be my delight if you could refer your friends or family who might be interested in our services.

Yours Sincerely,

Shalabh Agarwal
shalabh.agarwal@snowballcapital.in