Dear Investor,

Wish you & your family a very happy & prosperous new year.

During CY16, we were up 16.2% on an average across all the portfolios VS 1.9% return given by Sensex. Our annual performance since we started communicating in CY14 has been as follows:

Annual Returns	Portfolio*	Sensex	BSE Mid-Cap	BSE Small-Cap
CY14	90.4%	29.9%	54.7%	69.2%
CY15	17.5%	-5.0%	7.4%	6.8%
CY16	16.2%	1.9%	8.0%	1.8%
Cumulative	**159.9%**	**25.8%**	**79.4%**	**83.9%**

**Avg. across all the portfolios (gross, before fees)*

If cumulative returns measure the performance over a period of time, it is the annual numbers which capture the consistency of those returns. A one-off lucky (or an unlucky) portfolio event in a preceding year can significantly affect the look-back & cumulative returns (incl. 2-year, 3-year returns) making them appear better (or worse) in comparison with the indices. Such an out-performance (or under-performance) may not necessarily reflect the true picture of the portfolio.

Consistency is important as it indicates the presence of a 'process', which if proven across market cycles, may become repeatable as one may then follow the same process over & over again. It is this process that we are attempting to adhere to while making investment decisions. In our process, we:

- Buy the business (& not the stock which goes up & down the moment it starts trading)
- Shift our focus to things that matter to the business in the long run – competitive advantage, growth run-way available, management & company's ability to generate & re-invest free cash flows
- Pay a price much lower than the discounted value of the stream of free cash flows that the business would generate in years to come

This process has been laid down by Warren Buffett innumerable number of times in his annual letters and is considered to be the bedrock of his investment success. Given his generosity to share this openly and availability of the proof that it works, one would expect a massive following. Well this is not true & luckily it limits the competition for us, as in his own words, *"Investing is simple, but not easy."* It is simple because it entails following a well-documented process or investment philosophy, yet it is difficult because of the discipline & patience required to follow it.

This relationship between discipline & process leading to repetitive success is not only limited to the field of investments. As kids most of us would remember having heard it in one form or the other from our parents. In fact today as parents ourselves many of us might now be trying to teach the same to our kids, whether for their studies or sports.

A couple of examples from distant fields may be worth noting where training / process has (had) made success repeatable:

- In the latest Hindi blockbuster movie, Dangal (based on the life of wrestler Mahavir Singh Phogat & his daughters) two sisters with very humble backgrounds & without any professional help excel in a male dominated sport, wrestling and end-up becoming national champions. In fact what is not part of the movie, there are actually six 'Phogat sisters' (four Mahavir Singh's daughters & two of his brother's)[1] who were trained by Mahavir Singh & achieved success at different national / international levels. Three of them are gold medalists in different weight categories at the Commonwealth Games, while another has won a silver medal at the Asian Championships. Fifth is a National Championships gold medalist and the last one has won medals at age-level international championships. Mahavir Singh's training was probably a process (a difficult one!) through which six girls achieved success repeatedly.

> *Her training in the initial years was very tough and demanding as her dad would ensure Geeta and her sister Babita wake up at 3:30 AM and practice in the akhada for three hours. After which they would go to school, come back and then train again for 2-3 hours in the akhada. Geeta, in a recent interview, said that the akhada and her father would be the only thing her sister and she would see at that time of their lives. According to Geeta those 5-6 years were their toughest part of lives as her father demanded they keep working hard and the concept of slowing down 'just didn't exist in his dictionary'. –From the book 'Akhada: The Authorized Biography of Mahavir Singh Phogat' by Saurabh Duggal*

- 'Super 30' is a highly ambitious and innovative educational program where it hunts for 30 meritorious students from the economically backward sections of the society and prepares them for India's one of the most difficult engineering entrance exams – JEE for getting into the IITs (Indian Institute of Technology). These students typically are from the families of rickshaw pullers, maids, vegetable vendors among others who may be least expected to clear such an exam given the lack of resources / access to quality education since childhood. A look at the Super 30 results in the graph below since inception in 2003 might challenge that view. They have repeatedly led every year more than 20 students out of 30 into the coveted IITs. The importance of the process is itself

> *What is it about your teaching methods that help students get through to IIT?*
>
> *This success is a combination of three factors. My students have junoon (passion), a fire in them to achieve. Two, our teaching approach is different. I use multimedia slides to make a little story with characters to explain maths concepts. Three, we take tests every day. Well, in a nutshell, we teach our students the how and why! That's all.*
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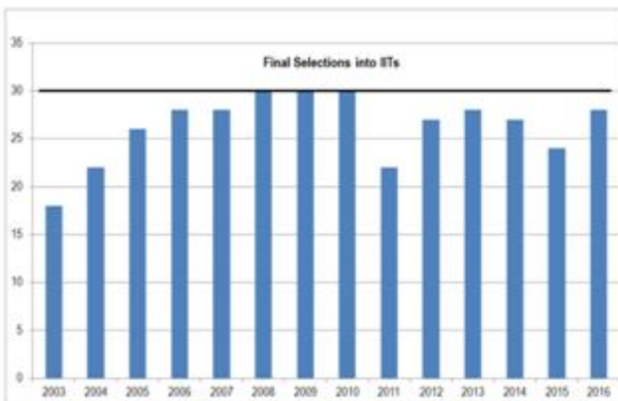
> *In an interview given by Anand Kumar, founder of Super 30*



1 https://en.wikipedia.org/wiki/Phogat_sisters

highlighted by the founder, Anand Kumar when he mentions that they teach only 'how & why' to their students.[2]

- Coming back to investing, Warren Buffett during his famous speech *'The Superinvestors of Graham-and-Doddsville'* given in 1984, listed out nine investors / funds whose returns were as shown below:

Investor	Fund Name	Period Covered	No. of Years	Net Fund Cumulative	Net Fund CAGR	Index* Cumulative	Index* CAGR
Walter Schloss	WJS Partners	1956-1984	28.3	6678.8%	16.1%	887.2%	8.4%
Tom Knapp	Tweedy, Browne Inc	1968-1983	15.8	936.4%	16.0%	238.5%	7.0%
Warren Buffett	Buffett Partnership Ltd	1957-1969	13.0	1502.7%	23.8%	152.6%	7.4%
Bill Ruane	Sequoia Fund Inc	1970-1984	14.8	775.3%	17.2%	270.0%	10.0%
Charles Munger	Munger Partnership	1962-1975	14.0	500.1%	13.7%	96.8%	5.0%
Rick Guerin	Pacific Partners Ltd	1965-1983	19.0	5530.2%	23.6%	316.4%	7.8%
Stan Perlmeter	Perlmeter Investments	1965-1983	18.8	2309.5%	19.0%	255.6%	7.0%
NA	WPC Pension Fund	1979-1983	5.0	238.3%	27.6%	120.8%	17.2%
NA	FMC Corp Pension Plan	1975-1983	9.0	360.7%	18.5%	268.7%	15.6%

* Dow Jones / S&P Index

Apart from massive outperformance by each of these funds over their investment periods, there was one more common factor – these were all run by value investors who liked to buy a $ at 60 cents. In Buffett's words *"They search for discrepancies between value of a business and the price of small pieces of that business in the market. They do not discuss beta, the capital asset pricing model or covariance in returns among securities. These are not subjects of any interest to them. The investors simply focus on two variables: price and value."* Given all these investors held different stocks in their portfolios but approached the market with the same broader investment philosophy, again corroborates how an established process can make success repetitive.

At Snowball, we are also making an attempt to follow the same proven process. One of its key parameters is buying a business (& not a stock) with an owner's mindset, which naturally orients us for a longer time horizon & enables us to only focus on matters which might have a sustainable impact on the business. It also helps us in not getting perturbed by things which may not be lasting & thus making us more objective with our decisions on cash deployment.

As aptly stated by someone, *"The stock market is the only market where things go on sale and the customers run out of the store!"*; last year presented us a couple of such opportunities where we managed to shop with lesser competition. Concerns regarding the Chinese economy in the beginning of the year, Brexit somewhere in the middle and demonetization / US elections close to the end of the year – all led to some weakness (however short-lived) in the markets. Though the jury is still out on the net impact of demonetization, anecdotally & from the widespread media coverage it does seem to have had created challenges – not only for a common man in withdrawing cash from ATMs but also for enterprises in conducting their businesses. Given 85% of transactions in the economy are on cash, it has had an impact on the sales of retailers, wholesalers, manufacturers among others across the supply chain & across categories. Lesser cash

[2] http://www.careers360.com/Universities/Road-to-IIT-Meet-Anand-Kumar-brain-behind-Super-30

prompted people to spend less[3], advertisers to cut advertising budgets[4] & companies to lower production[5].

With all these hardships along with Income Tax Dept.'s effort to track money laundering, demonetization may also affect the mindset of people. Fear of more such steps by the Govt., higher scrutiny in future may decrease the affinity towards generation & hoarding of black money, increase digitization & tax compliance leading to higher tax revenues in the system. This in itself can have a bigger trickle-down effect in the economy in terms of not only bigger fiscal stimulus but also possibly lower tax rates (& more money to spend in the hands of common man).

Well, all of this may be wishful thinking and only time will tell how it pans out. Though we do believe that looking beyond a couple of quarters, adverse impact of demonetization as being perceived currently, will be minimal. As such we might have been a little early in putting cash to work though we are again reminded of Sir John Templeton's words *"Generally value investors tend to buy too early and sell too early."*

Changes in the portfolio – exits

As highlighted in our earlier newsletters, our sell decisions are typically triggered under the following situations:

- Narrowing of gap between price & value and availability of alternate investment opportunities
- Unanticipated permanent changes in the business fundamentals or industry structure
- Realization of a mistake committed in our evaluation esp. in our understanding of the business

"Before we discuss the status of your investment portfolio, do either of you have a heart condition?"

Luckily so far all our sell-offs have been in the first bucket where we have sold on profits. Unfortunately we had to book our first loss recently when we exited Noida Toll Bridge.

As many would already know, **Noida Toll Bridge (NTB)** owns the concession for tolling & operating the 9km bridge, DND Flyover, connecting South Delhi & Noida. Given neither the construction nor any traffic risk as the bridge has been operational since 2002, we bought the company at various levels between a market cap of ~Rs4-5bn. NTB was generating a free cash flow of Rs700-750mn annually & with minimal capital expenditure requirement, was largely distributing the same as dividends to shareholders (post re-payment of debt). This gave

[3] http://www.moneycontrol.com/news/business/despite-24-falldec-honda-closes-2016highest-sales_8211461.html
[4] http://economictimes.indiatimes.com/industry/cons-products/fmcg/hul-slashes-december-ad-budget-as-cautious-consumers-hold-back/articleshow/55694159.cms
[5] http://timesofindia.indiatimes.com/business/india-business/Auto-industry-cuts-production-as-demonetisation-hurts-sales/articleshow/55628450.cms

shareholders a dividend yield of 12-13% (tax-free!). On October 26 last year, on the back of a PIL filed by local residents alleging accumulation of far higher toll revenues by NTB than the construction cost incurred by it, High Court ordered the removal of toll & made the flyover toll-free. NTB's appeal for a stay was rejected by Supreme Court though it ordered CAG (Comptroller Auditor General of India) to review the accounts since inception & present a report based upon which the final order would be given. As a result there hasn't been any revenue for the company over the last two & half months & stock has seen a correction from a price of Rs23-24 to Rs13-14.

Without really trying to speculate on the final judgment of the Supreme Court, we exited the company with a loss of 35-45% across different portfolios. Judicial intervention in an existing concession between two parties was unanticipated & it did change the structure of the business though NTB's operations were not without hiccups over the last couple of years. PIL in 2012, recurrent demonstrations at the toll booth, delayed / deferred toll rate hikes & management's proposal to alter the concession agreement in 2015 – despite being cognizant of all these, we attributed a very low probability to this unfavorable judicial intervention. <u>Though what we overlooked was the magnitude of the impact on the business even in the case of its remote possibility.</u> Unlike in other cases, where the impact of any untoward event is on one or few business metrics (in terms of lower growth / sales / profitability), in the case of NTB the impact was binary – company has had nil revenues for more than two months now.

NTB's episode has helped us add one more point to our 'Not-to-do' list – avoid companies where Govt. / judicial interference (completely outside the control of the management) can have a *significant & permanent* impact on the business, however low the probability of this event may be. This also reminds us of Charlie Munger's *"All I want to know is where I'm going to die so I'll never go there".*

Another company that we exited completely is **MOIL.** We had covered this in our Jan-16 newsletter when we had bought it for almost free; during Sept-15 to Jan-16, market cap of the company was Rs30-34bn whereas cash in the books was ~Rs30bn implying negligible value to one of the most capital-efficient producers of manganese. Today, on the back of a strong rally in manganese ore prices, the same business is being quoted at ~Rs55bn with only Rs20bn of cash (post the buy-back), implying Rs35bn value to the same business. To put it in perspective, the average realization for the company for the current year is only slightly better than what it had over FY14 & FY15 when the reported

EBITDA was Rs4.4bn & market cap of Rs43bn (average of two years). With much higher market cap currently, it seems market is expecting a far superior performance which may be challenging given the increased cost of unit production & uncertainty regarding the sustainability of higher manganese prices. With our limited knowledge on commodity prices, it seems the margin of safety equation for us has inverted.

New stocks added

Some of the new stocks added to the portfolio were Greaves Cotton, Mazda among others as discussed below:

Greaves Cotton, established in 1859 & manufacturing diesel engines since 1939, today commands >80% market share in the sub-ton single cylinder diesel engines used in 3 & 4 wheelers in the last-mile affordable transportation category. Its unit economics even led Tata Motors to outsource SCV (small commercial vehicle) engines to Greaves when it launched lighter versions of one of its most successful vehicles, ACE in both the cargo & passenger segments. Given its leadership in the engine technology, Greaves has an engine for most of the lighter applications whether it is automotive, farm mechanization or auxiliary power. Greaves' close to ~4mn engines in the market also provides the company a steady (& growing) base for its replacement business, which now accounts for almost 1/5th of its total sales. This expertise in the engine technology opens-up various growth avenues across products (launched multiple cylinder BS-IV compliant engines), applications (several products for different crops & seasons) and geographies (exports). Management has also utilized the last couple of years' slowdown to make the business more efficient. Despite overall sales coming down by 10% over the last five years (divested infra business), profits have increased by more than a quarter & capital employed in the business has come down by 15%, giving the company formidable ROCs of ~24% even in this weak macro environment. We have bought the company at a valuation of ~Rs30bn, giving us a free cash flow yield of ~6% which makes it very interesting for a company of this pedigree.

Mazda Limited is a small design, engineering & fabrication company catering to various process industries like fertilizers, chemicals, bulk drugs, refineries, paper & pulp, sugar and food processing. Its custom-built products like vacuum systems, steam jet ejectors, evaporators & condensers among others find applications in making the industrial process more efficient & cleaner. Its strategic alliance with vacuum systems technology developer, Croll Reynolds Inc. in late 1990s has helped it to have one of the highest vacuum system installations in India; this not only generates references for new business but also results into repeat business from existing customers. Company has also been successful in adding more products to its offerings – over the last decade, sales contribution from vacuum systems has come down from 60% to 40% with evaporators now accounting for 25% from a mere 7% then. Mazda's recent technology tie-up for two more products from a German & Spanish company may further help it to diversify revenues. Given the volatility in orders & resultant sales, a key characteristic of the engineering sector, Mazda's management has run the company phenomenally well – in the last 15 years, only once in 2014 has the company witnessed a decline in sales. This zero-debt company has not only had quite stable operating margins over the last decade but also >20% ROIC (excl cash) consistently. We have bought the company at a valuation of Rs1.4bn when >40% of the market cap is in cash (& investments) and the business is generating Rs110-120mn in net profits.

Portfolio Allocation

Our results in any year are not only a function of which stocks are there in the portfolio but also how much they constitute in the portfolio. While a good pick will only move the needle if bought meaningfully, a bad pick will also not have a material impact if it is a smaller position. This is how we were able to absorb the impact of Noida Toll Bridge despite losing ~40% in that position.

Post our decision of buying a particular stock we use a Q-G-V framework[6] to compute its allocation in the portfolio. In this the business is evaluated on each of the three parameters – Quality, Growth & Value to ascertain its overall attractiveness, which proportionally determines its allocation in the portfolio. A few points on the same are presented below:

Quality is the degree to which a customer is wedded to a company's product or service & its sustainability. This affinity may be weak or strong and (or) may be changing for good or worse. Our analysis is based on the qualitative understanding of the business & is corroborated by the quantitative reported financials. Along with this, we also assess risks which may have the potential to undermine the aforesaid quality. These may manifest in the form of increasing competition, changing consumer preferences, obsolescence, client concentration, Govt. strictures among others. For example, even a good (monopolistic) business like an operational toll road may carry a higher risk of Govt. intervention (like what happened in NTB)

Though we primarily invest behind the horse (business) & not the jockey (management), latter's role becomes more prominent as one moves-down the quality curve. To avoid subjectivity, we base our assessment primarily on historical facts – decisions & events which the business was made to go through. We evaluate the management on its ability to re-deploy excess cash (if any), focus in the business, execution, shareholder friendliness and related-party transactions among others.

Growth is a variable which determines how big or scalable the business can become in years to come. Though a static or low-growth good quality business is quite valuable, a good business which is also growing strongly can be far more valuable. Growth runway is primarily a function of company's current size & market share, its industry's growth rate and also management's ability to foresee opportunities & deploy excess cash in related similar quality businesses.

Value measures margin of safety – higher the discount to the intrinsic value, higher the attractiveness of the stock. This is one parameter which can make even a great business a bad stock and a lousy business a great stock. As our ROI is dependent upon the price paid, we put a higher emphasis on this factor.

Together quality, growth & value guide us to carefully build the portfolio. Larger positions are primarily placed favorably across all the three factors whereas smaller positions typically

[6] Adapted from a wonderful book Active Value Investing by Vitaliy N. Katsenelson

have one strong leg. Thankfully this process has managed to keep a check at our mistakes and has helped us to out-perform all the indices so far.

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

I take this opportunity to sincerely thank you for your trust & patience. It is your continuing support that motivates us to do our best. I 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.

Also if we have added any value to your portfolio so far, please introduce us to your family or friends who might be interested in our services.

Yours Sincerely,

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