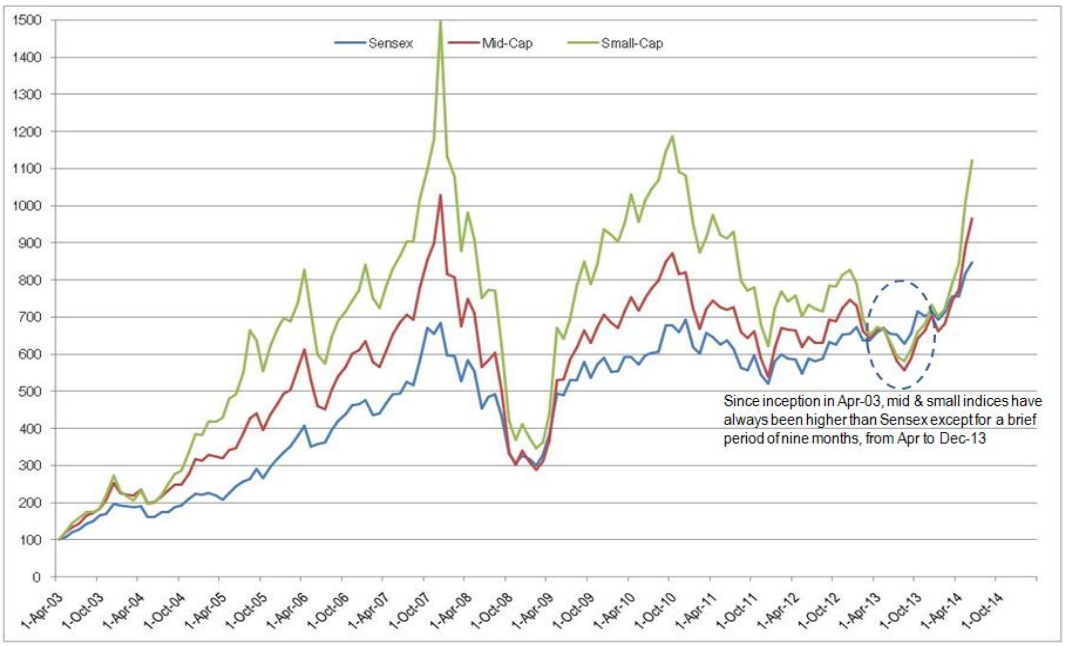
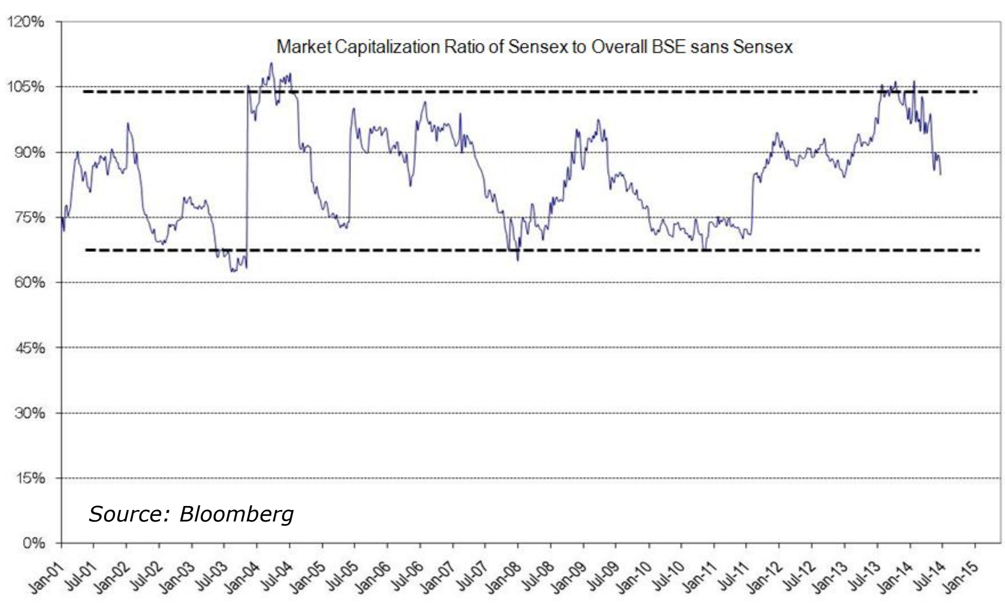
Dear investor, July-14

Last 10 months have clearly been a mid & small cap favorite. From the market lows of August-end last year, BSE Mid-Cap index has given more than 2x of Sensex's return whereas BSE Small-Cap has been only a little short of 3x return. This outperformance has also helped both the indices to continue to post superior returns to Sensex since their inception in Apr-03. It was only during Apr to Dec-13, a brief period of 9 months out of 11 years, when Sensex stayed above the mid & small cap indices, as shown below.



Source: BSE (Indices re-based for comparison since the formation of mid & small cap index in Apr-03)

With the benefit of hindsight, this pessimism for non-large cap stocks around August last year also becomes quite evident by analyzing how the markets were relatively pricing Sensex and non-Sensex stocks then.



Ratio of market capitalization of Sensex with respect to that of BSE (without Sensex) seems to have followed a tight band of 70% to 105%. Here the upper-band denotes relative preference for large-cap stocks (pessimism for non-large cap stocks) and lower band reflects preference for non-large cap stocks.

The ratio touched its high around Aug-13 when the negative sentiment for mid & small cap stocks was probably at its peak. This clearly signaled an opportunity in such stocks though we never imagined such a sharp reversal to mean. As it is always hazardous to guess the direction of the market & we never do it, but if history is anything to go by, there always seems to be a tendency to overshoot the mean on either side.

Though we are a pure bottoms-up value investor driven by the qualities of individual businesses, such macro trends help us to gauge what the markets are pricing-in & appreciate over & under valuation risks & opportunities, respectively. Given our focus on value (& not price), a rising market invariably presents a bigger challenge than a falling market due to the narrowing of gap between value & price. In such euphoric times, we make all the more effort to remain value-focused & not get carried away by the ensuing momentum. We are quite hopeful of the new govt. & the structural changes it can induce to make our economy grow faster, but we are also cognizant of the fact that markets are anticipatory in nature and there could be periods of volatility due to any slip between the cup & the lip.

This also ensures a constant deliberation on our 'sell' decisions, which continue 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

Triggered by the first point, we have raised some cash in our portfolios (newer portfolios were never fully invested in the first place). This may seem a little counter-intuitive given rising markets though we cannot help but remember Warren Buffett's *"Be fearful when others are greedy, & greedy when others are fearful".*

Some of our biggest positions in our portfolio are as under:

HMVL (Hindustan Media Ventures Limited)

Established in 1918, this Hindi newspaper is a market leader in the states of Bihar & Jharkhand and is also one of the fastest growing in UP. HMVL is not only a sticky business (reading a particular newspaper is more of a habit) but also a business which is difficult to replicate (given its numerous editions & sub-editions covering the length & breadth of the serviced regions). Unlike English newspapers in metros & tier-I cities, where advertising is moving from print to internet, HMVL's regional presence in some of the least developed states, helps it to remain largely unaffected by this. Further, its higher dependence on the local advertisers makes the business model more robust & has helped it to grow its profits by more than 25% CAGR over the last three years despite overall slower economic growth. We initiated our position when the market was selling the whole business at less than Rs900cr, which had 300cr of cash in the balance sheet & was generating an annual free cash flow of 60cr. With the market now pricing it at ~1300cr, it may not be as cheap as it was then, but it may still not be expensive either.

GSPL (Gujarat State Petronet Limited)

A natural monopoly, GSPL owns the largest gas pipeline network in Gujarat, a state which accounts for ~40% of the overall gas demand in India. In effect, GSPL is into quite a simple business of transporting gas from a seller to a buyer without taking any gas-price risk. Further GSPL's historical capital cost (2/3rd of its grid is more than 5 years old) makes it almost unviable for any competition to duplicate the network at the current cost. Though this does not lead to free-pricing as the business is regulated, yet recent clarity on tariffs has gone a long way in addressing the uncertainty around pricing. We bought into the stock when the entire company (including debt) was being quoted at 4000cr, was generating an annual cash flow of >600cr and already had a gross block of 5000cr (at historical costs!). Given increasing energy requirements by a developing country like India & gas still accounting for only a miniscule share in the total energy pie, GSPL really offers a long-term play on the back of India development story.

Setco Auto

Setco is the largest supplier of clutch systems to the medium & heavy commercial vehicle market in India, controlling 80-85% of the overall supplies to the OEMs. Though a cyclical business, Setco has been able to make the business more resilient by growing its replacement sales (clutch plates' life is ~2 years in a CV), to more than 50% of the overall revenues in FY13/14. As a result, its sales over the last two years (FY12 to FY14) have seen a cumulative decline of just 10.6% when the CV industry has declined by over 38% over the same period. We bought into the company when it was selling at an EV of 325cr & had generated an average EBITDA of 65cr over FY12 & FY13, implying an EV / EBITDA of ~5x, a ~30% discount to its long-term average. With the stock up 85% in less than six months, we are keeping a close watch on the value-price equation though we also appreciate that the expected rebound in the economic growth (on the back of a pro-business govt.) and the fact that we are still selling lesser M&HCVs than what we sold in FY07, industry could witness a significant comeback from the lows of FY13 & FY14.