Dear Investor,

During the first half of CY16, we were up 3.6% on an average across the portfolios, broadly in-line with the overall market (Sensex) return of 3.4%. Our annual performance since we started communicating in CY14 has been as follows:

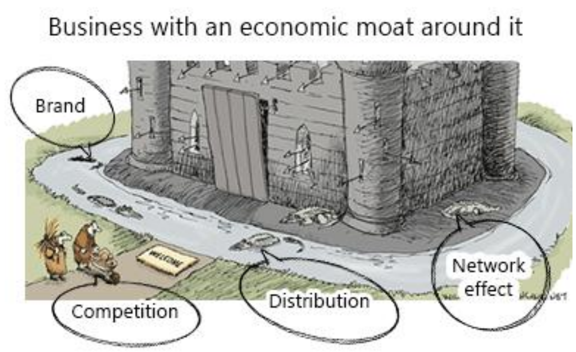
Annual Returns	Portfolio*	Sensex	BSE Mid-Cap	BSE Small-Cap
CY14	90.4%	29.9%	54.7%	69.2%
CY15	17.5%	-5.0%	7.4%	6.8%
1H CY16	3.6%	3.4%	5.2%	-0.3%

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

Before we delve deeper into our recent performance, we would like to highlight two key decision parameters which have formed the basis of our investment approach & results over the years:

- Quality of the business
- Price paid to acquire that business

Appreciating 'quality or economic moat' of a business not only requires a quantitative analysis of sustainable cash flows, return ratios, etc but also an understanding of the qualitative aspects of the business of why a consumer is buying its products or services and why will the consumer keep buying into the future. Given this quality is inherent to a business & is built over a period of time, drastic changes are seldom though instances of business' economic moat widening or narrowing are more common.



If we were to arrange all the listed companies in descending order of 'quality' (using our qualitative & quantitative metrics), then our focus would undoubtedly be on the first decile of such a list. Having zeroed on such businesses, the only other variable in our decision making process would then be the 'price'.

As Warren Buffett states, *"Price is what you pay, Value is what you get"*. For us, 'price' is transaction-based, determined in the market by buyers & sellers which in turn are affected by the prevailing sentiments, emotions, etc; whereas 'value' is more inherent in a business derived from its future cash flows and is a function of its economic durability & growth.

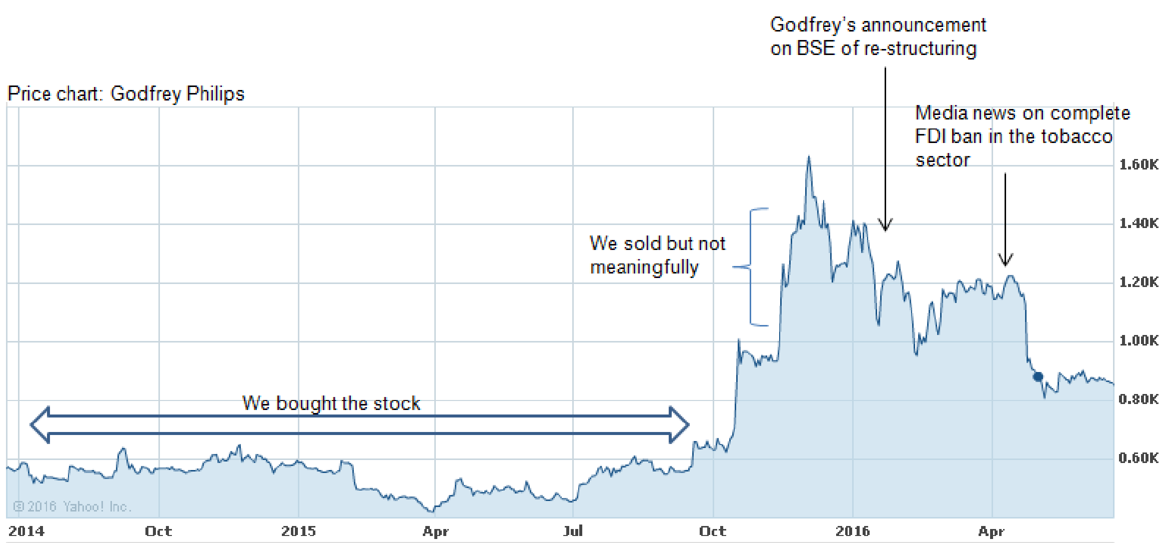
Though this should make 'value' more predictable & steady for a business (like the value of our house), it is quite common to witness substantial changes in the 'quoted price' of the same business within a year in the market. Such volatility either based on the changed perception of buyers & sellers about the business or on the back of some macro-economic event, at times provides us an opportunity to buy low & sell high. After-all like in any other business, our ROI is inversely proportional to the price paid for a particular investment.

One such opportunity presented itself recently post the 'Brexit' polls. There was a panic in the market & we were able to deploy some capital at lower prices. Though this event may lead to significant global uncertainty for an extended period of time, we are again reminded of Warren Buffett *"The future is never clear. You pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values"*

Market dislikes this uncertainty & gets driven by the prevailing emotions of greed & fear. It is as rational for a seller, who is fixated at 'price', to sell to avoid further losses as it is for us to buy, fixated at long term 'value'. This is easier said than done as this disposition often places us in a contrarian stance against the market. It is for this reason we believe that stock market investing is equally a game of temperament & character as well as of research & analysis.

Unfortunately we are not always as disciplined & at times give-in to the temptation.

Given the developments in **Godfrey Philips** from our last discussion in the Dec-15 newsletter, it seems we got influenced by the 'acquisition news flow' & did not lighten our positions meaningfully.



While Godfrey's announcement on stock exchanges of a possible re-structuring corroborated the news-flow, subsequent media reports of a complete ban on FDI in the tobacco sector added to the uncertainty. This has changed the perception of the market on the company & has driven the stock down by almost ~50% from its peak – <u>a major contributor to our performance in the current year given Godfrey's higher allocation.</u>

The potential value of the business can be gauged from the following table:

Rs per '000 sticks	FY11	FY12	FY13	FY14	FY15	FY16	5-yr CAGR	
Net Sale Realization								
ITC	1,395	1,567	1,722	1,979	2,256	2,526	12.6%	Given the product stickiness, all the companies take annual price hikes. Godfrey is the highest over 5 years (though lower in later years)
Godfrey Philips	908	1,094	1,352	1,578	1,701	1,825	15.0%	
VST	709	742	823	969	1,101	1,211	11.3%	
Costs								
ITC	665	728	747	776	840	997	8.4%	
Godfrey Philips	771	915	1,167	1,354	1,502	1,617	16.0%	
VST	542	510	604	700	787	874	10.0%	
EBITDA								
ITC	729	839	975	1,202	1,416	1,529	16.0%	Despite such favorable industry economics, Godfrey's profitability per stick is the lowest (even lower than VST which sells brands at lower price points)
Godfrey Philips	138	179	185	225	199	207	8.5%	
VST	167	232	220	269	313	338	15.1%	
EBITDA Margins %								
ITC	52%	54%	57%	61%	63%	61%		
Godfrey Philips	15%	16%	14%	14%	12%	11%		
VST	24%	31%	27%	28%	28%	28%		

Source: Annual / Media Reports

Couple of interesting observations can be made:

- Phenomenal industry economics where all the players take a monotonic annual price increase (how many such industries we know of!). Production broadly similar based on the same agricultural input – tobacco leaves
- Pecking order in terms of sales realization & brand positioning: ITC followed by Godfrey & then VST

Despite such favorable industry dynamics, Godfrey stands lowest in terms of profitability per stick with a considerable gap even with VST. Though its average ROE of 18% over the last five years is respectable for any business to earn, it is far lower than what others earn in the same industry. This gap in the performance can only be attributed towards its bloated cost structure, which is primarily in the hands of the current management.

In a scenario, where Godfrey can be envisioned to have margins in between ITC & VST (in-line with its brands & realizations) value of the business can be very different. No wonder, market had re-priced the stock on the news of current promoters selling-out, where the price captured a significant portion of the potential value (even without any confirmation by the company on such a sell-out). In spite of this we chose not to sell meaningfully hoping to capture the full value. We couldn't have been more wrong.

This entire episode will keep reminding us of our fallibility and hopefully make us better investors going forward.

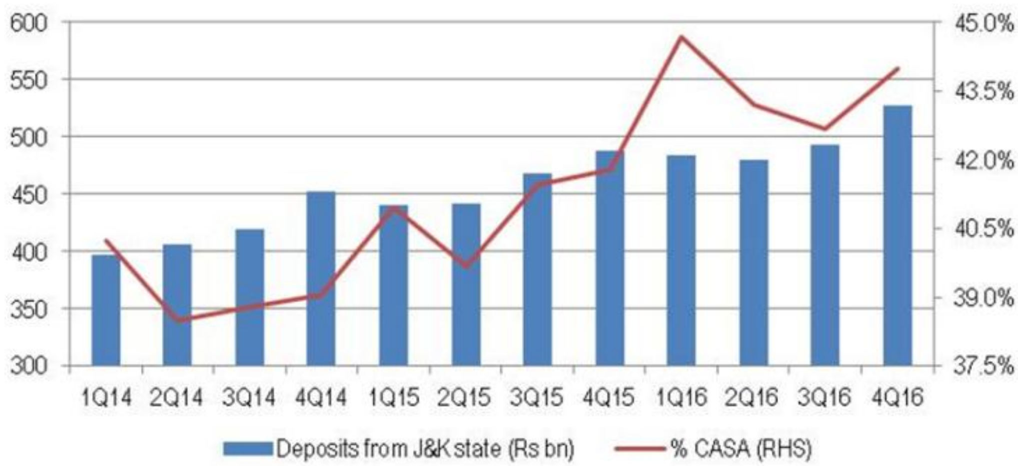
Another disappointment in the portfolio has been **J&K Bank**.

J&K Bank
Serving To Empower

We underestimated the potential size of the asset quality problem which is currently being driven by the RBI's historic clean-up exercise of banks' books. Post first three stable quarters in FY16, J&K Bank reported a sharp increase in NPAs along with a higher restructured book in 4QFY16. In the call, management further highlighted towards the possibility of some more troubled assets in its portfolio.

It is always challenging to ascertain the quantum of bad assets in a bank's books, more so if the bank has been active in the wholesale corporate side & has been caught in a tough macro environment, like J&K Bank. Notwithstanding the common knowledge of these problems, 'selling the stock' post the stock price decline may not always be prudent esp. if the problems are curable & business has the wherewithal to sustain the damage.

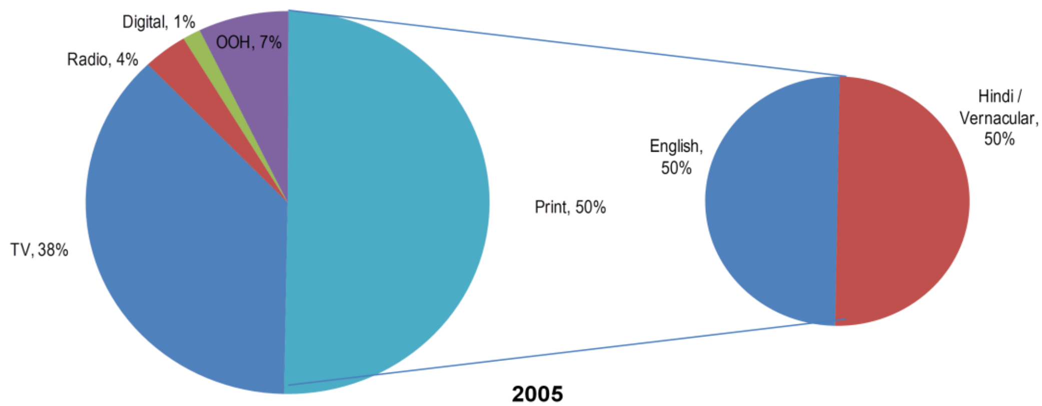
Given J&K Bank's core profitability (before accounting for troubled assets) we do believe that the bank has enough reserves to tide over the problem. Even post considering an extreme case of a complete write-off in 70% of troubled assets (Rs96bn VS declared restructured & NPAs of Rs76bn) the bank may still report a higher adjusted book value than the current stock price. This for a bank which counts four out of every five adults in the J&K state as its account holder (people seldom close savings accounts), has one of the highest CASA (low cost deposits) of ~44% and is market leader in a state (J&K) which still lags the national average in terms of per capita credit formation.

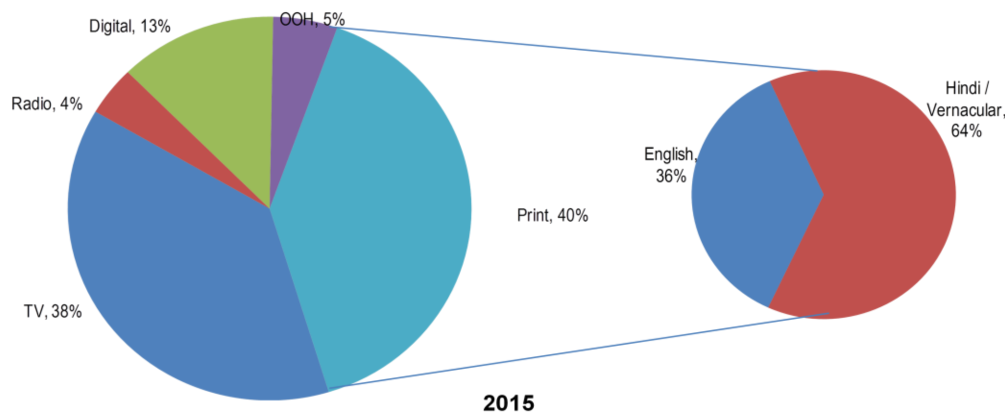


Source: Published Quarterly Results

We take comfort in the bank's growing franchise on the liability side. We are equally concerned with the value destruction that has happened on its asset side though also believe that the former is more sustaining whereas latter is transient in nature. This has helped us to add to our positions in J&K Bank at lower prices especially considering the recent disclosures by the bank & the fact that the banking industry may be at its fag-end of the cleaning exercise (RBI's deadline was Mar-16).

As highlighted in the Dec-15 newsletter, our biggest positions continue to be in Hindi print media with the publishers of Hindustan (**HMVL**) & Dainik Jagran (**Jagran Prakashan**). As per the much-tracked annual KPMG-FICCI Media reports, though the share of print in overall advertising has come down from 50% to 40% over the last decade, share of Hindi & Vernacular print has broadly remained the same at 25%. The loss has been to the English print whose share has declined from 25% to 15% over the same period.





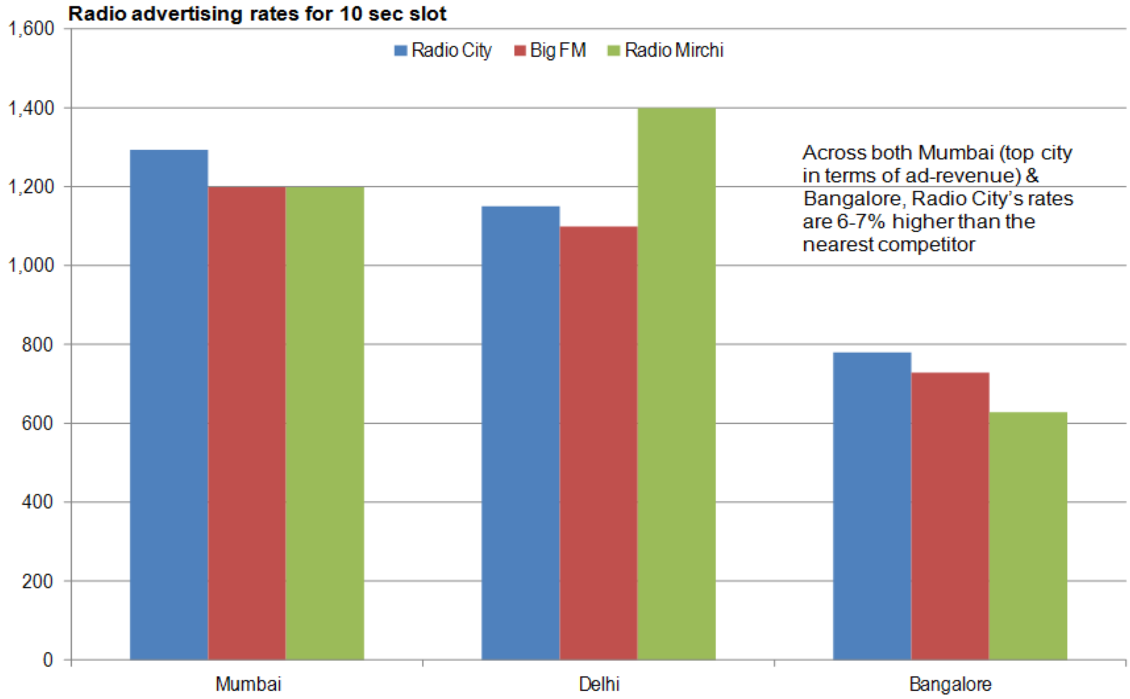
Source: KPMG-FICCI Media Reports

We have in our earlier newsletters discussed this minimal impact of digital on Hindi print & we continue to believe that it will be years before this industry sees a tangible effect.

Both HMVL & Jagran continued to do well and have posted > 30% growth in operating profits for the year FY16. Their performance even over the last three years has been quite robust.

Performance over FY13-FY16	Sales CAGR	EBITDA CAGR	Profits CAGR	ROE %	Cumulative Stock Return	TTM PE (x)
Jagran Prakashan	11%	25%	32%	24%	120%	18.0
HMVL	13%	26%	29%	21%	101%	11.1

While HMVL's growth has been more organic, Jagran has been successfully acquiring companies. Its recent acquisition of Radio City, one of the most profitable FM Radio companies, has helped Jagran to foray into the radio business. Though the acquisition price of Rs7-8bn (including migration fees of Rs2bn) seemed a bit higher for a company generating Rs450-470mn of annual profits, the premium paid may be justified when we look at the positioning of Radio City Vs other stations in the top revenue generating cities.



Source: radio.releasemyad.com

As such we continue to remain invested across both the names.

Positions exited completely

One on hand while buying, we work with an 'owner-mindset' focusing on long term fundamentals, on the other while selling we have to be equally dispassionate to cut our positions. 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

Luckily almost all are 'sell' decisions have so far fallen into the first bucket including the positions that we exited completely over the last six months like Mahindra Holidays, Indraprastha Gas among others.

Post five years of flattish numbers, **Mahindra Holidays** reported a robust FY16 with operating profits up ~40%. This was primarily on the back of all the operational improvements made in the business over the last couple of years – digital & referral based customer acquisitions (& hence lower cost), addition of rooms, member first philosophy, etc all leading to almost doubling of quarterly run-rate of member additions last year. This also got reflected in the stock price which is up ~50% over the last 12 months, valuing the company at Rs37bn with profits of Rs1.2bn only. Now, with low cost member acquisitions already accounting for almost 60% of new member additions & with more than 80% occupancy at the resorts, some of the low-hanging fruits

may have already been plucked. Future growth / improvement will be more correlated with the rooms' additions & thus may not be quite linear given the usual hurdles associated in the hotel industry. We continue to like the business & may get interested again in case there is any slip-up between expectation & execution from the company. We recorded an average ~30% CAGR in the stock over the holding period.

Market provided a similar opportunity in **Indraprastha Gas**, where we ended-up making 60% return in a year itself. When we had bought in Apr-May 2015, stock traded at a PE of 12.5xTTM on the back of uncertainty regarding the volume growth & price control (despite an already existing favorable High Court order on pricing). Though there have been some positive developments clearing this uncertainty, IGL being a monopolistic utility, there hasn't been any significant changes in the performance of the company. In fact, company reported a marginal decline in both its operating & net profits in FY16 over FY15, implying the same stock is now being valued at a PE of 21.0xTTM. This only corroborates our earlier point on the volatility of the stock prices even when there is not any significant change in

the underlying business (esp. of a utility company like IGL). Again we continue to like this business though also appreciate the lower growth-rate trajectory that the company may have given the saturation at its existing markets of Delhi-NCR. It may also be worth noting that another very similar utility Mahanagar Gas has just been listed & trades at about 20% discount to IGL.

New stocks added

Some of the new positions added in the portfolio are CARE, Merck among others as discussed below.

Credit Analysis & Research Ltd (or CARE Ratings), is India's second largest rating agency with a market share of about 25%. Like most other geographies, even in India, a majority of the ratings business gets shared amongst a couple of companies only with Crisil, CARE & ICRA together accounting for almost 85% of the market. Given the structure of the industry wherein the ratings payer (the rated client) & the ratings user (financial institution) are two different entities industry has been built on years of reputation & trust. This together with long-standing relationship with corporates makes the industry almost impregnable to newer players making it a highly profitable, cash generating business for incumbents. Even here, CARE's performance stands out – a decade back it was only 2/3rd the size of ICRA & less than 1/3rd the size of Crisil though today, CARE is bigger than ICRA (by >1/3rd) and almost 2/3rd the size of Crisil's rating revenues.

Rating Revenues (Rs cr)	Crisil*	ICRA	CARE
FY06	70	31	20
FY16	434	198	265
10-yr CAGR	**20.1%**	**20.2%**	**29.3%**

*Source: Annual Reports; *CRISIL is Dec-05 to Dec-15*

Fortunately this growth hasn't come by sacrificing quality as the disclosed average cumulative default rates and transition rates are not too different across the three players. This has further helped the company to have the largest proportion of rated companies in the ET-500, FE-500 and BS-1000 lists with a share of 54%, 52% and 45% respectively. The stock has corrected by almost 1/3rd over the last one year on the back of certain promoters selling-out (public sector banks raising cash for their balance sheet) and currently trades at a PE of 24.5xTTM, making it attractively valued VS other rating companies.

Founded in 1668, **Merck** is the world's oldest pharmaceutical & chemical company, having its presence in India since 1967. Merck India is primarily into branded generics with more than half of the portfolio coming from vitamins & minerals. Its brands Neurobion, Polybion, Evion have lion's market share in their respective categories and still continue to grow in mid-high single digits. Growth is also being aided from new branded generic launches in diabetic & cardiac therapies. With multi-vitamins now being completely out of the latest NLEM, company possibly gets another lever to accelerate growth over medium to longer term. Further Merck India is also witnessing a number of structural changes – new Indian management team (CEO & business heads), attempt to move brands from Rx to OTC, curtailment of loss-making products (even at the risk of lower sales) and focus on increasing profitability – these may go a long way in creating sustainable shareholders' value. Though it is still early days, we have bought the stock at close to 1.2x sales when such branded businesses have a history of trading at 3-4x on sales.

Portfolio Benchmarking

Given our bottoms-up approach & focus on individual businesses, composition of our portfolio is quite different from any of the indices. This also implies that the returns will also be very different – portfolio performance over a period of time will either be better if our investment process is good or worse if the process is not good.

Process Matrix	Good Outcome	Bad Outcome
Good Process	Deserved Success	Bad Break
Bad Process	Dumb Luck	Poetic Justice

This reminds me of a very fundamental concept in investing on 'Process VS Outcome' that I read somewhere. Though it may not be wrong for the industry to dwell on outcome (as finally returns matter), it may be erroneous to assume that good outcomes are the result of a good process and bad outcomes imply a bad process. Given investing is a game of probabilities, at times good decisions may lead to a bad outcome & a bad decision to a good outcome. However over the long term across numerous such decisions, process will dominate the outcome & one will either end-up on the top-left corner or on the bottom-right corner of the above matrix.

With our focus on the process & not outcome, it is quite possible to have periods of 'under-performance' and thus it would be quite meaningless to compare our portfolio returns with any benchmark across multiple time periods within a year. Nevertheless at the same time, to help investors gauge our performance, we not only compare our annual results with all the indices (including a mutual fund index) but also share their IRRs (post fees) over the investment period. While annual results highlight consistency (or inconsistency), IRR is the actual annual return that the investor would have made across all the invested tranches over the entire holding period. So far I am happy to believe & share that our process has kept us in good stead!

I sincerely thank you for putting-in your trust with us as that guides us & keeps us motivated to do our best. 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.

Also if you really think we have added any value to your portfolio so far, please do not forget to introduce us to your family or friends who might be interested in our services.

Yours Sincerely,

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