

Dear Investors:

May this festive season bring you and your loved ones happiness and prosperity!

Minerva India Under-served was up **+42%** (net of all charges and mgmt. fees; in INR terms) in the last quarter, comfortably outpacing *Nifty50*'s **+12%** and *BSE Smallcap*'s **+11%** gain. That brought our YTD (through September) gain to **+94%**, vs. *BSE Smallcap*'s **+55%** and *Nifty50*'s **+26%** gain. Since inception in April 2011, *Minerva India Under-served* is up **+19%** annualized (net; in INR terms), vs. **+11%** for *Nifty50* and **+12%** for *BSE Smallcap*. Importantly, this alpha wasn't driven by a skewed asset-class driven print in 2014 or 2017.

Let me begin by sharing something about one of my favorite athletes of all time, Eliud Kipchoge. Kipchoge is arguably the greatest marathon runner to come out of the seemingly endless pipeline of Kenyan athletes. In 2019 while preparing to defend his London marathon title, Kipchoge said in an interview "If you concentrate on the rear mirror, you'll crash and cause an accident." Soon after, Kipchoge ran the second fastest marathon on record – As he crossed the Victoria embankment on race day, he cranked it up and never bothered checking over his shoulder. He ended up beating his 2018 time by nearly 2 minutes as he stormed to his fourth title in London. Likewise, our investors should 'do a Kipchoge' and wipe off the sharp up-move over the last year from their memory, and kick on with their investing marathon. A more critical question should revolve around an evaluation of our positioning to generate alpha over the next 3-5 years, and further – Over this past quarter, we ended up selling majority of our holding in 2 positions (one each in Healthcare and Technology). In both cases, the market essentially compensated us for most conceivable upsides to our expectations over at least the next couple of years. Between these cuts and 2 new exposures, we have considerably shifted the potential upside in our book, while fairly pricing uncertainties – At the beginning of October, *Minerva India Under-served* was trading at merely 12.8x F2022E (Mar) EBITDA, or at a sizeable 40% discount vs. *Nifty50*, and nearly 50% discount vs. *Nifty Smallcap50*, despite materially better and comparable earnings traction respectively. Critically, during a quarter when 2/3rd of *Nifty Smallcap50* constituents and just under half of *Nifty 50* constituents saw downward revisions to F2022E (Mar) estimates (see Exhibits 1a and 1b), more than 80% of our book either held or raised estimates.

Exhibit 1a – Nifty50 FY22E est revisions in F2Q

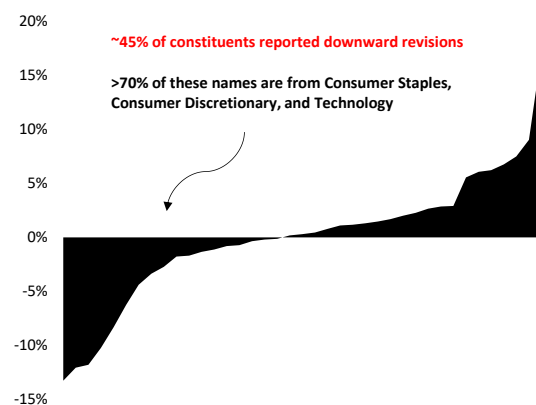
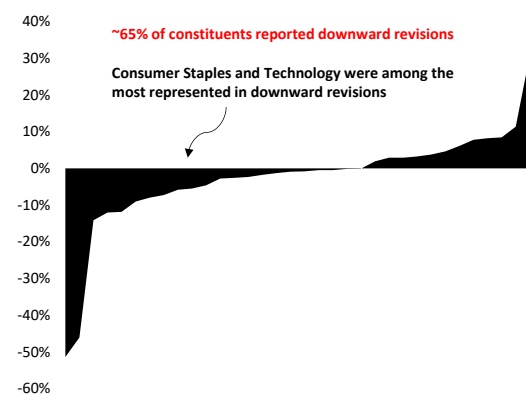


Exhibit 1b – Nifty Smallcap50 FY22E est revisions in F2Q



Source: Reuters

Note: Financials and outliers were excluded; Margin pressures were highest within Consumer Discretionary names within Nifty50, with a -7% downward revision in FY22E estimates in the last quarter. However, the larger weight of Materials in Nifty50 more than offset this decline – EBITDA estimates for Materials constituents, on average, were up +6% in the last quarter.

Inflation pass-through is getting increasingly challenging when selling within domestic markets. In F1Q22 (Jun), headline constituents across the capitalization spectrum reported 300-500 bps margin pressure on account of material costs, which was partly offset by cost controls elsewhere. So, while most businesses

were able to temper the sticker shock in F1Q, we note that the limited scale and breadth of subsequent downward revisions to F2022E (Mar) estimates suggest a surprisingly sanguine street. It's hard to not conclude that the street has largely looked past the possibility of continued elevated freight costs and supply chain bottlenecks. We aren't able to reconcile with street's cost optimism at this point.

While several exporters are struggling on container availability, they are nonetheless still better positioned to pass through recent costs – Thanks to a nearly synchronized pressure on Chinese exports, selling into west has held well because in several cases the buyer markets either don't have any scale or enough scale (to be competitive) to service local consumption. Consider this – As we write this, a large auto parts holding of ours is now shipping 40 ft containers of its core part to the gulf coast in the US, with freight cost being 50-60% (!!!) of the parts realization value. OEMs continue to bear the freight costs here because there isn't a competitive alternative. While selective businesses such as these are better positioned, we struggle to reconcile with street's broad-based optimistic bent on passing through cost inflation in 2HFY22E.

Taper brouhaha 2.0. While sucking liquidity from a 'steroidal' market (across asset classes) is more than just a legitimate excuse to cut this seemingly endless ride upwards, we are absolutely not in the camp (almost never are) that has been a beneficiary of liquidity driven disconnects.

For all the headline sideshow, India has arguably retained among the most fiscally unyielding stance globally since the pandemic began. Inevitably therefore, the source of the key liquidity surge here was offshore capital, which routinely chases larger liquid investments. From our perspective, the entire taper tantrum chatter is little more than noise - Since the beginning of 2020, foreign institutional ownership within our holdings has actually declined, even as it clearly expanded across widely-held headline names across the capitalization spectrum. Unsurprisingly, while multiples had broadly expanded coming into F2022E, we weren't the beneficiaries of this largesse – Other than in case of a healthcare diagnostics name, multiples had bizarrely contracted across our book, often with large disconnects vs. clearly superior underlying earnings¹. Surely, we can't help but end the taper talk here with a necessary 'meh' it deserves as far as implications for our positioning is concerned. If we have to bother about Christine Lagarde's next tweet or FOMC minutes, we are failing our mandate to pick significant value within a largely uncrowded listed space. We can't state the same for street darlings though - While estimate downgrades in the last quarter were most prevalent within India's headline Consumer discretionary and staples, absurd valuations of *Nifty50*'s staples pack stand out among the industries that have been a clear beneficiary of offshore liquidity². Watch this space!

If one isn't in the business of chasing the 'flavor of the quarter', one needs to be very cautious in an environment where assets have reflat in near unison. Little is suggestive of a structurally sustainable expansion globally, even as domestic employment is catching up with pre-pandemic levels – While Chinese clampdown on emissions is a massive headwind to expanding metals output in China, and predictably led to a spike in metal prices, it does little to help us reconcile with any structural shift in demand outside China. At current utilization levels, we are also unable to reconcile with the narrative that domestic private capital expenditure could be a material tailwind, particularly at a time when employment-creation efficacy of the marginal dollar employed today is under pressure, with newer assembly lines being increasingly automated. As we write this quarter-end update, the widest gauge of India's listed universe is up >50% since the beginning of 2020, making it hard for us to reconcile this expansion with anything incrementally material over this period. If recapturing legacy earnings run-rate (and a bit more) were to create such levels of incremental value, we are living in a rather generous world. All that said, it's critical to appreciate (and we have

¹ Over F2019-F2022E, *Minerva India Under-served* would conservatively compound EBITDA at +15%, handily outpacing +11% for *Nifty50*.

² *Britannia*, *Hindustan Unilever*, and *Asian Paints*, on average, have seen a +300 bps increase in FPI ownership since the beginning of 2020. Incidentally, all of them had 1-3% reduction in F2022E (Mar) EBITDA estimates in last quarter.

maintained this for some time) that India's failure to manage the pandemic has inadvertently led to seroprevalence levels that have largely made the issue of vaccine shortage somewhat redundant in the near-term (unless we see variants that can drive serious re-infections). Undeniably, that now places India in a relatively favorable situation vs. most emerging market peers.

As is always the case, our highest conviction positions are all concentrated in situations where the underlying hypothesis is built upon one of the following – low-hanging incrementally profitable mix shift driven by either a material accelerated shift in consumer preferences or new significant export opportunities; clearly visible revenue grab post a planned capacity expansion in an undersupplied situation; or favorable positioning to clearly benefit from emerging new parallel categories.

We initiated a new exposure in a beverages name in July. It has always been hard for us to identify material mispriced/underpriced levers within Indian spirits businesses. Other than the widely known industry-related consumption tailwinds, which are arguably more than priced in, we haven't historically been able to identify situations that provide more than ample valuation wiggle room to wager against industry's inherent uncertainties. While this name had been on our radar for years, it's only recently that we derived enough conviction to conclude sustainability of a significant profitability shift in this business. For those that aren't acutely aware of this space, two aspects are critical to note:

- a. The underlying taxation structure ensures that several non-national players largely operate in intra-state markets, and
- b. Regional players are mostly unable to replicate asset-light franchise bottling models of national brands.

Like most regional distillers, this spirits business also engages in franchise bottling. However, unlike many others, they are positioned very nicely within some of India's biggest IMIL (Indian Made Indian Liquor) markets. They also have a significantly large presence in ENA (extra neutral alcohol) production, which has historically been mostly sold to external distillers or used internally for franchise bottling.

The two key reasons we initiated exposure in this situation were:

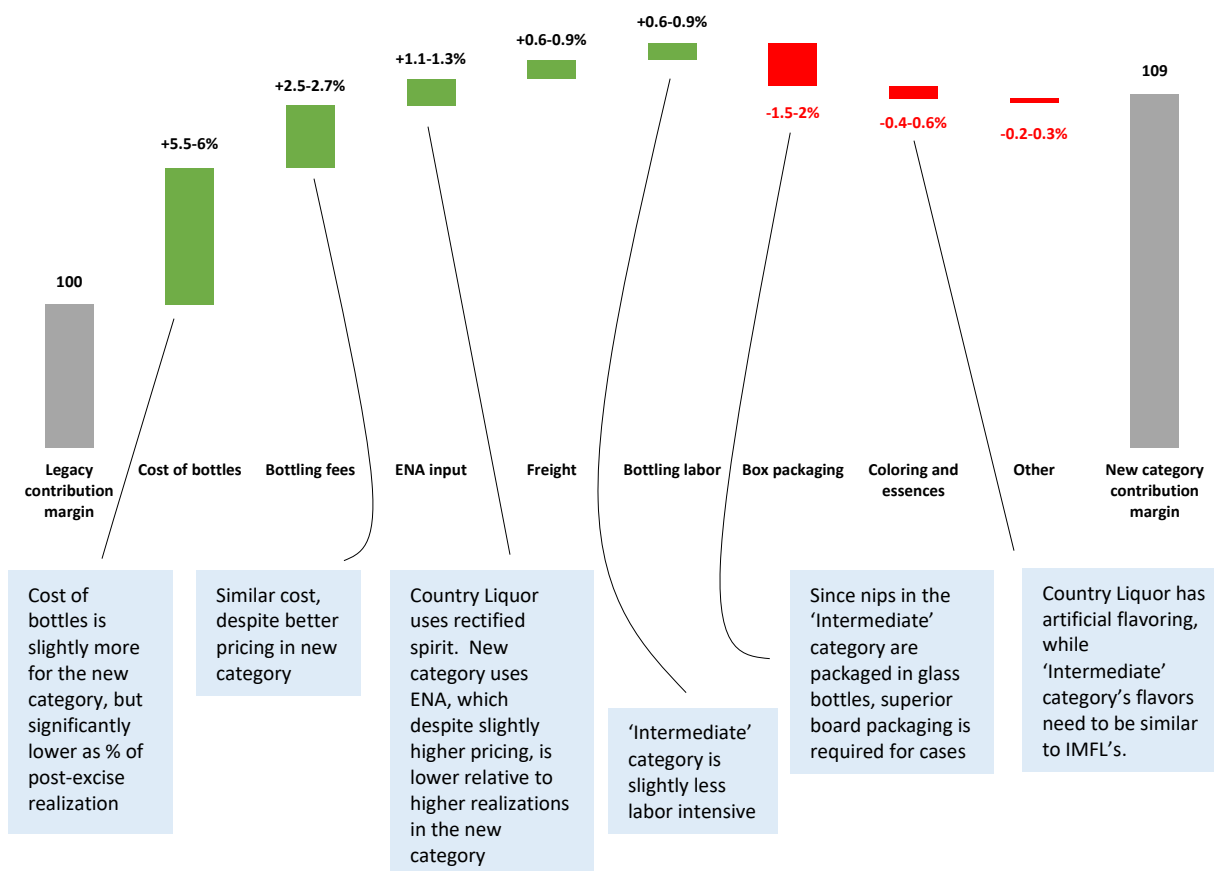
1. **Creation of an 'intermediate' liquor category in a major consumption state helped us capture a significant and nearly unpriced margin accretive mix shift.** In order to shore up excise revenues, a major country liquor consumption state had recently experimented with launching a new 'intermediate' category between country liquor and IMFL (Indian Made Foreign Liquor³). By our estimate, this new category's contribution margin should be 8-9% ahead of their country liquor margin (see **Exhibit 2**).

In the June quarter, about a fourth of their consumer-business revenues (aka from 'owned brands' and 'franchise bottling') came from this new 'intermediate' category. Effectively, barely a tenth of their overall revenues (and more than a fifth of EBITDA, by our estimate) came from this new revenue source in the June quarter. Our checks across their biggest market meanwhile suggested significant continued traction in this business, which is barely 3-4 quarters old. Critically, the details of this shift from legacy Country liquor to this 'intermediate' category pleasantly surprised us – While it was anticipated that certain consumers will shift from country liquor to this essentially affordable and repackaged 'IMFL' category, it wasn't expected that there could be a meaningful trade down as

³ The word 'foreign' in this category does not strictly refer to international brands. The differentiation between the two is primarily on account of inputs used, and alcohol content.

well. Since the price of entry-level IMFL brands such as *Officer's Choice* etc. went up by more than 50% over the last couple of years, we noticed a material consumer shift downwards. Our checks suggested that about a third of recent consumers of the new 'intermediate' category were those that were trading down from discount IMFL brands (where the company doesn't have a presence). We now believe that this new category can comfortably double from here within a couple of years, if not sooner, driving up margins by another 200-250 bps. For context, that would translate into a +15% expansion in margins between F2018-F2023E. This part of our thesis alone suggested more than doubling from our entry point, and we are still >25% off from there as we write this letter.

Exhibit 2 – Indexing margin expansion walk from legacy contribution margin to margin of new category



Source: Internal estimates based on channel discussions

Note: Comparison was made on case of nips. The indexation essentially suggests that underlying contribution margin of the new 'intermediate' category is ~8.5-9% higher vs. contribution margin within the legacy country liquor business.

- 2. Expansion in 3 eastern states within 2 years will expand current capacity by 75%.** While this scale of capacity build will obviously not translate into a concomitant scale up in a business that often requires 2-4 years of brand building for consumer buy-in, the ramp-up might be easier in this situation (relatively speaking) - The reason is India's plan to increase ethanol blending (using grain-based molasses) in fuel, and we note that the new capacity will be entirely fungible. That said, we view the ethanol blending opportunity as little more than an optionality in this situation, which simply somewhat tempers the unused capacity as these new markets get built. Accordingly, we prefer to value this expanded piece separately since profitability and revenue mix can potentially change dramatically here, moving from ethanol and ENA towards distilled spirits over a period of time.

We estimate that operating cash flows of F2022E and F2023E should almost completely fund this expansion. While we aren't yet pricing this new business, we estimate that this expanded piece should conservatively (i.e. ignoring that this will ever be used for own brand distilled spirits) be valued in the INR 3.5-4 bil range, or about a tenth of current consolidated value.

To summarize, despite a significant value capture over the past quarter, we can still conservatively identify at least 35%+ upside in this holding.

We also initiated a new position in a packaging name that is nicely straddled between the most sustainable packaging alternatives (on either side of the cost spectrum). Over the past few months, we engaged with some of the best placed packaging professionals globally, including with senior leadership within India's marquee CPG names. While it is amply clear that rigid plastics will consistently lose share within CPG packaging, it isn't clear as to how much of that will be to flexibles and how much to paperboard. Globally, thoughts around packaging are bouncing somewhere between carbon print and recycling, depending on the quality of waste collection infrastructure. There is also the added unknown around local regulations on imposing plastic bans (particularly in countries with poor collection infrastructure). Regardless, it's hard to not get excited about situations where one can identify exposures across both paperboard and flexible packaging (especially mono-material flexibles⁴). Let's address the two pieces of this holding separately:

- 1. Paperboard packaging.** Their current paperboard conversion capacity (>80% of current business⁵) can potentially generate >INR 10 billion in revenues, or +30% vs. their F2021 (Mar) revenues. This is a fragmented space with only 4 players having scale and national presence to sustainably compete. We note that average run lengths have been declining as packaging gets increasingly customized, further squeezing smaller converters. Unlike plastics, this part of the business tends to be far less volatile on pricing, particularly since board prices are negotiated directly between the client and the mill in nearly 40% of the cases.
- 2. Flexible packaging.** This was ~15% of the business in F2021 (Mar), but will be contributing close to 25% by F2023E as a new flexible packaging line ramps up. Across the world, the market for flexible packaging is somewhat comparable (and often bigger) than the rigid plastic packaging market, with food being the primary end-market category. Our discussions with packaging professionals globally suggest that the increased attention on mono-material and lighter flexible packaging is here to at least stay, if not accelerate from here on. Improved recovery rates (assuming a robust waste collection infrastructure is put in place) on mono-material flexible packaging addresses the sustainability challenges while containing costs, suggesting that mono-material flexible packaging will increasingly take share from multi-polymer packaging. While headline margins in flexible packaging are a bit lower vs. paperboard, ROICs are similar, since flexible packaging process tends to be more automated.

For F2023E (Mar), we are conservatively estimating a highly visible INR 1.6 Bil in EBITDA (largely driven by very conservative expectations⁶ of natural growth + 3 extra quarters of the new flexible packaging line), or around +20% vs. F2021. Between likely multiple expansion and highly visible EBITDA growth, we expect to conservatively capture at least 40% upside within the next 15-18 months, assuming no acceleration in what

⁴ Mono-material flexible packaging is not only affordable, but is also easier to sort (making it easily recyclable). In sharp contrast, multi-polymer flexible packaging mostly ends in landfill. For context, even in EU today, less than a fifth of all flexible packaging gets collected and recycled.

⁵ Majority of business comes from CPG.

⁶ We conservatively assume some drag from lower grammage in packaging as clients look at alternatives to temper cost pressures.

appears to us like a visible natural shift towards paperboard. A likely third flexi-line launch (wouldn't require additional land), and cutback in paperboard pricing are unpriced optionalities here.

We bizarrely live in a world where comparable private assets cost meaningfully more than their listed peers, and this is evident in this space as well. Consider this – The largest domestic player in paperboard packaging was acquired by a financial sponsor in an INR 23 bil deal earlier this year, or ~INR 185K for every ton of board conversion capacity, vs. our entry point of under ~INR 90K/ton for this business. To be clear, the flexible packaging piece (set to be a fourth of this business in F2023E) isn't even part of the discussion here. Regardless of how one prefers to adjust for the 'control premium' in the above deal, it's nearly impossible to reconcile with some of these valuations.

These two new positions make close to 15% of our book today, and (still) provide us with significant upside at a time when solid argument can be made otherwise for most headline names in India, and certainly for their peers in the US and select parts of the Eurozone.

Considerable liquidation in our technology and healthcare holdings. We sold majority of our June-end holding in a technology and a healthcare name. While it is evident that the smaller tech services names have disproportionately benefited from digital capability ramp-ups beyond Fortune 500 clients (and this is likely to continue for 1-2 years), the 6-7x stock run-up since March 2020 has resulted in valuations that aren't pricing uncertainties effectively. Similarly, we liquidated majority of a healthcare diagnostics position, which we had been gradually liquidating this year. While the diagnostics landscape remains ripe for organized players to keep grabbing share within a mostly distressed unorganized industry, we see limited pricing power in an increasingly crowded space. In most of these situations, we now see underpriced uncertainties. These two positions made 17% of our book at the end of 2020, vs. ~6% now.

We also sold nearly a fourth of our top auto parts holding in August on account of internal risk-management thresholds. There is no adverse structural change in our underlying thesis here. If anything, a potential acquisition out of bankruptcy court could provide a significant upside revision to our post-F2022E (Mar) estimates, partly offset by what could potentially be a low-mid single-digit downward revision to our near-term revenue expectations (purely on account of stretched global chip fabrication capacity). Regardless, in an otherwise somewhat indiscriminate market, we expect north of 50% upside on very realizable expectations in these positions.

Stay safe! Feel free to reach out if you have any questions. We are available 24/7 to address your concerns.

Thanks,

Piyush Sharma

Performance benchmarking

	India Under-served	Nifty	S&P BSE 500	S&P BSE Midcap	S&P BSE Smallcap	EurekaHedge India	India-focused CE Funds*
Trailing 1 year	142%	56%	65%	79%	101%	40%	53%
Since inception CAGR	19%	11%	12%	13%	12%	8%	10%
2021 YTD	107%	30%	37%	49%	66%	26%	30%
2020	18%	15%	17%	20%	32%	20%	12%
2019	-10%	12%	8%	-3%	-7%	1%	3%
2018	-6%	3%	-3%	-13%	-22%	-7%	-5%
2017	17%	29%	36%	48%	60%	29%	31%
2016	9%	3%	4%	8%	2%	3%	1%
2015	22%	-4%	-1%	7%	7%	6%	-1%
2014	34%	31%	37%	55%	69%	39%	49%
2013	21%	7%	3%	-6%	-11%	-6%	6%
2012	39%	28%	31%	38%	33%	14%	28%
2011	-11%	-25%	-27%	-34%	-43%	-25%	-31%
Annualized Volatility	21%	17%	18%	21%	24%	13%	17%
Sharpe Ratio	0.80	0.54	0.56	0.56	0.48	0.45	0.48

Source: BSE, NSE, EurekaHedge, Bloomberg

Note: Returns are until the end of October 15th 2021; Our performance is net of execution charges and mgmt. fees, but before incentive fees; Our management fees are accrued monthly for reporting purposes. Since the fee is actually charged and calculated quarterly, compounding of the fee charge leads to us conservatively reporting slightly lower returns vs. client actuals.

*US-based close-ended funds, with returns adjusted for INR/USD movements.

Strategy Snapshot

Characteristic	IUS	Notes
Top 5 positions as % of book	62%	
Avg. weighted market cap of book (mil)	\$623	>> Median holding's market cap is \$470 mil
Avg. weighted institutional ownership	12%	>> Median institutional ownership of current holdings is also 12%
Avg. weighted free float of book	42%	
Net Exposure	90%	
Avg. weighted F2022E (Mar) EV/EBITDA	12.8x	>> vs. 25.2x (Nifty Smallcap 50), and 21.7x (Nifty 50)
# of positions	15	

Note: Characteristics are as at the end of September 2021

Meet your investment manager

Piyush Sharma, born and raised in India, has been running the India Under-served strategy for more than a decade. The strategy focuses on investing in uncrowded and institutionally under-owned situations within Indian micro and smallcaps. Having spent time with Citigroup and Bombay Stock Exchange in India, he moved to United States in early 2000s, where he covered stocks within Business Services, Autos, Consumer Products and Financials with Sanford Bernstein, Longbow Research, and Avondale Partners, working in teams that received accolades from leading institutional research arbiters, including Institutional Investor (II) and Greenwich Associates. Piyush received an MBA from University of North Carolina at Chapel Hill, MS from MNNIT, and BS in Accounting from University of Allahabad.



@ps_tarheel

OFFERING DESCRIPTION: Minerva India Under-served is offered on the Right Horizons Financial Services Pvt Ltd.'s platform, a SEBI-registered portfolio manager. Any reference to "Minerva" in this document refers to an investment offering managed by a SEBI-registered portfolio manager.

DISCLAIMER: The information, opinions, estimates and projections contained in this newsletter were prepared by managers of Minerva Funds and constitute its current judgment as of the date of this note. The information contained herein is believed to be reliable and has been obtained from sources believed to be reliable, but we make no representation or warranty, either expressed or implied, as to the accuracy, completeness or reliability of such information. We do not undertake, and have no duty, to advise you as to any information that comes to our attention after the date of this fund brief or any changes in its opinion, estimates or projections. Prices and availability of securities are also subject to change without notice. This is not a prospectus and does not constitute investment advice or an offer or solicitation to buy or sell any designated investments discussed herein. Neither Right Horizons, nor its officers, directors, agents, employees, Minerva Funds' managers makes any warranty, express or implied, as to the suitability of any fund as an investment or of any kind whatsoever, or assumes any responsibility for, and none of these parties shall be liable for, any losses, damages, costs, or expenses, of any kind or description, arising out of this newsletter or your investment in any fund. You understand that you are solely responsible for reviewing any fund, its offering and any statements made by a fund or its manager and for performing such due diligence as you may deem appropriate, including consulting your own legal and tax advisers.

CONTACT US:

Piyush Sharma piyush.sharma@righthorizons.com
Aneel Chitazhi aneel.chitazhi@righthorizons.com
CS Raju raju.cs@righthorizons.com

+1-919-360-0359 [United States]
+91-9567398469 [Gurgaon]
+91-9739010590 [Hyderabad]

