

Dear Investors:

At the expense of being blasphemous towards today's social-media market gods, we yet again caution investors from veering towards a supposedly new investing world order where stocks apparently don't skip a beat, have amazingly shrugged off their relationship with cash-flows or their sustainability, and unicorns walk on glittering gold-covered sidewalks. The fact is that the proverbial tail never wags the dog, even as this one (so far) has made a pretty compelling attempt at disproving that fact.

Comping weak 'pandemic' earnings masks lack of sustainable growth levers. Pick a market out of a hat and it's unlikely that you wouldn't have seen a handy expansion in EBITDA over the last two quarters, even as revenue growth largely remained elusive. There is little surprising about steamed-in demand from the first half of the fiscal showing up in the second half, but it tells us precious little that would lead us to conclude that it's more than a low base effect, coupled with expected operating leverage.

At current capacity utilization rates, we don't value the marginal utility of infrastructure spending as highly as the street does. While government's recent infrastructure spends announcement¹ received pretty loud cheers, we note that the association between infrastructure spending and Indian earnings growth is tenuous, at best. Earnings growth is more a function of aggregate disposable incomes, input costs, and operating leverage vs. infrastructure spends. In the 3-year period ending F2020 (Mar), India's daily road construction rate was ~28 km, 60%+ higher vs. ~17 km run-rate in the prior 3-yr period. Cargo processed at ports meanwhile increased by more than +20% over the same period. Despite continued builds, capex announcements and project completions both crashed over this period, while employment plateaued. As things stand, with nearly 30% idle capacity, we believe that it's pretentious to expect any near-term turnaround in capex budgets by drawing public spending associations.

Pandemic 3.0. It's seemingly that time of the year again, with investors jittery as *Covid-19* cases re-surge, only this time apparently more 'vertical' than we have been accustomed to. It's practically undeniable that Indian cities and villages have among the highest seroprevalence in the world. Different surveys might differ in extent of prevalence differential between urban slum, urban non-slum, and rural areas, but just about any sero-survey with a large enough sample has confirmed wide prevalence across India. Let's work on the premise that implied seroprevalence based on prevalence within more dense cities globally and several of our own surveys are syncing correctly to suggest that we were already widely infected by the end of 2020. If we then lay out the potential variables at play here to explain the latest surge, the critical ones are:

1. **Possible changes in mobility patterns.** Both quantitative and anecdotal evidence on mobility suggests that mobility hasn't dramatically changed over the past few months (even as case numbers clearly have). That said, our checks do indicate that given the re-opening, RT-PCR sample collections have an increased mix of higher-income households, suggesting that the upper decile has possibly become slightly more mobile in the recent past. BMC's observations in Mumbai also sync with this. However, mobility patterns suggest that while increased mobility might partly explain the surge, it's highly unlikely that this is the material driver at play here.
2. **Testing number variations (and their veracity).** Given India's heavy reliance on rapid antigen testing and extreme sensitivity variations between the batches, it's often hard to interpret case data. As it stands, ICMR's guidelines allow the 'positive' result of a rapid antigen-test to be counted as 'Covid-19 positive'. Further, ICMR's apparently aggressive protocol for approving these kits makes the data

¹ Govt's highways spending plan alone for next 5 years is ~40-45 kms/day. While that is unprecedented planned acceleration, some of the underlying assumptions in these estimates aren't really conservative - For instance, this assumes that over a fifth of this spend will be funded through non-government sources, vs. a low-mid teens historical contribution from such sources (that too with patchy toll-roads PPP experience).

even foggy². However, since BMC segregates positivity by test-type, we note that rapid antigen positivity rates in India typically run at around 1/2 of RT-PCRs. In that context, while Delhi's case numbers show a clear resurgence, to a large extent it's a function of increased testing volume (+160% RT-PCRs in the first week of April vs. November's second week, despite ~55% fewer reported cases vs. November). Even though headline positivity number appears lower vs November, adjusted positivity rate is sharply lower (sub 10% vs. 20%+, assuming all tests were RT-PCRs in both periods) vs. in November. Even in other cities such as Bangalore or Mumbai, where headline infection numbers continue to surge, adjusted positivity rate is significantly below what we noted in C4Q surges last year. These are in sharp contrast to elevated positivity rates we have seen in places such as Poland and Turkey.

3. **Potentially more infectiousness of new strains.** It is our understanding that in the absence of real-time genomic surveillance in India, it is not possible to confirm if the surge could be attributed to spread of mutated strains. However, limited genomic sequencing information released so far, such as the sampling done in Punjab and Telangana, suggest that majority of recent cases can be attributed to mutant strains. Sequencing data elsewhere outside India has flagged this trend as well.
4. **Potentially higher re-infection rate.** While research that pre-dated the spread of new strains suggested immaterial re-infection probability, there is limited research at this point to either embrace or dismiss the possibility of higher re-infection rate as a result of mutated strains. There are however studies that lean either way. Such research isn't possible in India in any case since we have missed more prior *Covid-19* infections than most.

Latest surge is converting into more hospitalizations vs. what we saw in earlier surges; Delhi appeared an exception in early April. Consider Delhi's case numbers in the first week of April vs. the last surge that happened a couple of weeks after Dussehra last year – We adjusted reported infection numbers³ to make them comparable (since % of RT-PCR tests had increased to 2/3rd of tests vs. 1/3rd back in November). We estimate that while 'adjusted' infections were 60% lower in April's first week vs. the November surge, hospitalizations were down sharply (well under half as many beds were occupied in April's first week vs. during November's surge). In contrast however, both Mumbai and Pune have seen much higher utilization of ventilators in the current surge, even though adjusted positivity rates remain lower vs. the November surge. Poland is also seeing a similar trend of elevated hospitalizations.

Expect selective lockdowns, but also more effectiveness. In our view, the clearly evident key difference between this surge and earlier ones is likely the rate of transmissibility, which despite the convenient narrative, cannot be largely attributed to higher mobility. Since studies on re-infections, albeit limited so far, suggest that they are still rare, to a large extent this surge is likely driven by more infectious mutant strains, whose presence is now being increasingly confirmed through genome sequencing sampling. In India's case, the increase in RT-PCR testing also significantly explains the ongoing headline case number surge. Essentially, despite significantly fewer people left to apparently infect, increase in transmissibility from mutated strains, coupled with much higher RT-PCR testing, is what is likely driving a 'vertical' surge in Indian reported case numbers. Weight of evidence also disturbingly suggests that given quicker transmission and arguably higher hospitalization rates, we might see another run on our ventilator capacity in many places. We therefore see more than a reasonable chance of selective lockdowns, if current measures don't yield sustainable results

² At the beginning of this month, around 25 vendors were approved for test kits as long as their sensitivity was >50% and specificity was >95%, vs. WHO's >80% sensitivity requirement used for approving kits. Sensitivity refers to the probability of determining 'positive' as positive. Specificity refers to the probability of identifying 'negative' as negative. While a similar sharp surge has been seen in Poland and Turkey, we caution investors from drawing parallels here - India's positioning on accepting low sensitivity for approving rapid antigen test kits, and then accepting the positive results as confirmed 'positive' means that it's positivity rates aren't comparable to most.

³ Assuming RT-PCR positivity rate at about twice that of rapid antigen tests, and assuming 85% sensitivity of RT-PCRs.

within the next few days. Critically, we do believe that **1.** Lockdowns of today will be much more effective vs. what we saw at the beginning of the pandemic, and **2.** It would be easier and quicker to break this chain, given seroprevalence breakdown between top quintile and the rest. Our belief is borne out of the fact that seroprevalence is lowest within demographic where compliance was the highest last year and predictably case-load is the highest now, lending current environment far more favorable for lockdown effectiveness than in March last year.

We see as compelling a case for the institutionally orphaned small names as we have seen in years. While larger names typically are, and have been, beneficiaries of excess liquidity in most markets, the sheer dichotomy in valuations today is undeniably among the starkest we have witnessed in distant memory. Inevitably, the nearly unprecedented inflow of retail capital into securities has played its part as well. To be clear, we are discussing differentials attributed to size here, and India's index categorization often masks this - While *BSE Smallcap* has run up +115% over the last 12 months, the \$1 Bil+ index constituents have materially outpaced others. Be it *Nifty 50*, or the \$1 Bil+ smallcaps, the widely institutionally held universe now trades at a hard to reconcile premium over the sub-\$1 Bil smallcaps. While India is arguably the poster-child for how liquidity has driven sharp disconnects between 'institutionally covered' securities and the smaller 'institutionally orphaned' names, such disconnects are visible across similar poor price discovery pockets within EMs – Note the valuation premiums for larger names within the top-3 markets within *MSCI EM SmallCap* (Taiwan, Korea, and India) in **Exhibit 1** on next page. What differentiates India vs. EM peers however is that India's small-cap benchmarks are hardly representative of smaller listed names, with several larger names stashed into a smorgasbord called *BSE Smallcap*. Consider this – Not a single institutionally covered *KOSPI Smallcap* constituent is valued north of \$1 Bil. In sharp contrast, around a third of *BSE Smallcap* constituents with institutional coverage were valued at \$1 bil+. To view this concoction of an index as representative of India's smaller listed universe is an exercise in self-deception.

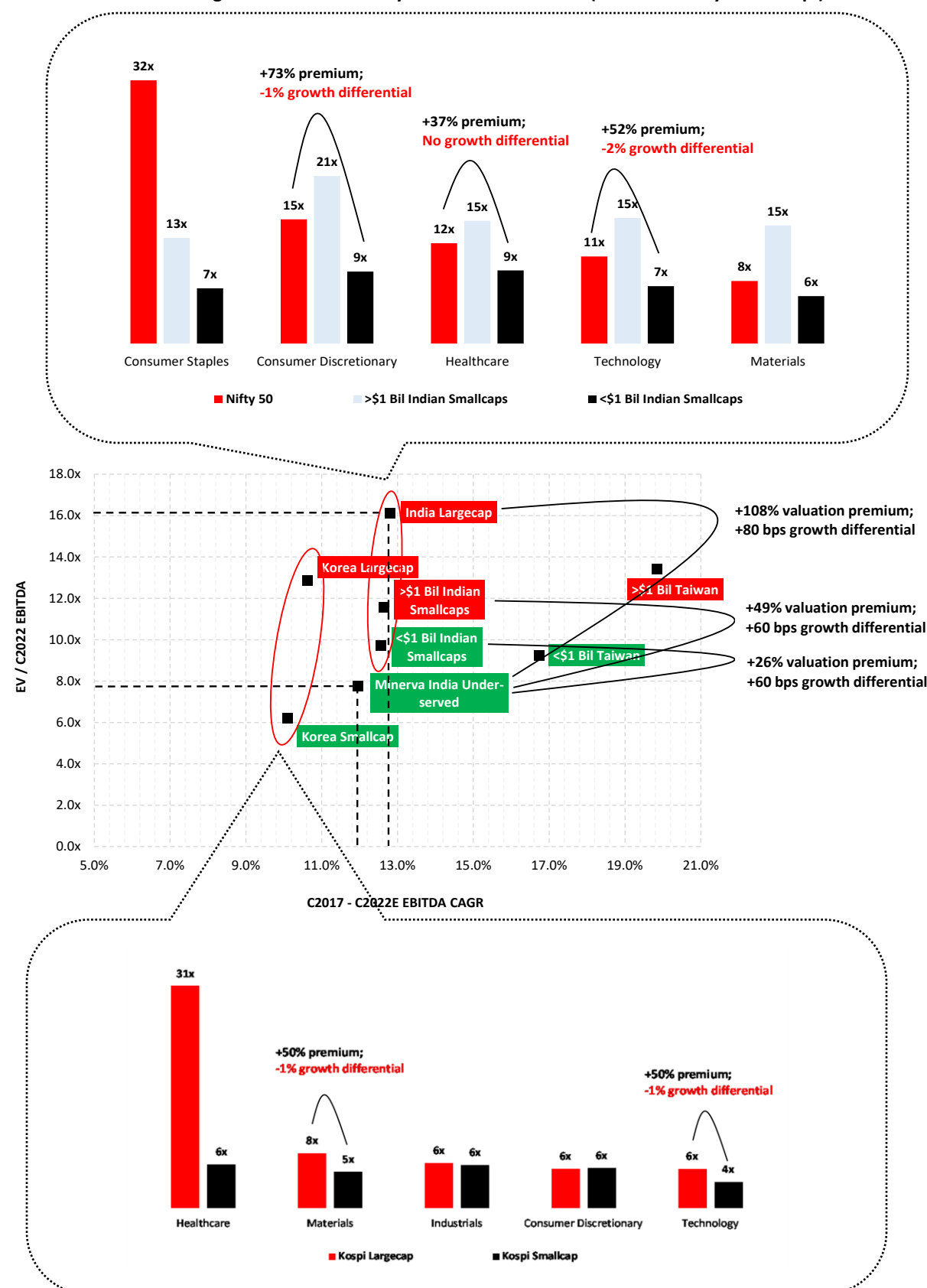
A size and sector-wise cut-through of EM peers throws 2 key observations:

- 1. India's intra-market lopsided size premium has nothing to do with Nifty50's superior growth; Charting Nifty's 'Unremarkable' Growth at Ridiculous Price.** At Dalal Street's perennially sanguine post-pandemic F2023E (Mar) expectations, *Nifty 50* trades at around 16x EBITDA. With comparable growth⁴, that reflects nearly +60% premium over India's sub-\$1 bil smallcaps and more than +105% premium over our *Minerva India Under-served* book. While larger names are trading at premiums just about anywhere, the size premium in India is materially larger. Within *Nifty 50*'s Consumer Discretionary, Technology, and Healthcare names, we see +73%, +52%, and +37% premiums respectively, despite a -ve growth differential vs. sub-\$1 bil smallcap peers. The valuation premiums in Consumer Staples names remain absolutely irreconcilable (see **Exhibit 1** on next page).
- 2. With the exception of Consumer Staples, the institutionally covered \$1 Bil+ Indian "smallcaps" actually trade at a material premium over Nifty 50.** While smaller names (institutionally unowned or under-owned) continue to trade at massive discounts across sectors, India's \$1 Bil+ smallcaps, in sharp contrast, actually trade at a significant premium over their *Nifty 50* peers, which in most cases however might be arguably justified by higher underlying growth. The smaller institutionally orphaned names meanwhile are where large fundamental disconnects are clearly visible.

As always, the uncoil trade required to correct these sharp liquidity-driven value disconnects shouldn't require much institutional participation.

⁴ Despite our book having nearly 14% exposure to amusement parks and theatrical exhibition, where near-term earnings power has been temporarily dragged back, optically depressing C2017-C2022E CAGR.

Exhibit 1 – Benchmarking India’s institutionally under-owned ‘small’ (not necessarily ‘small-cap’) securities

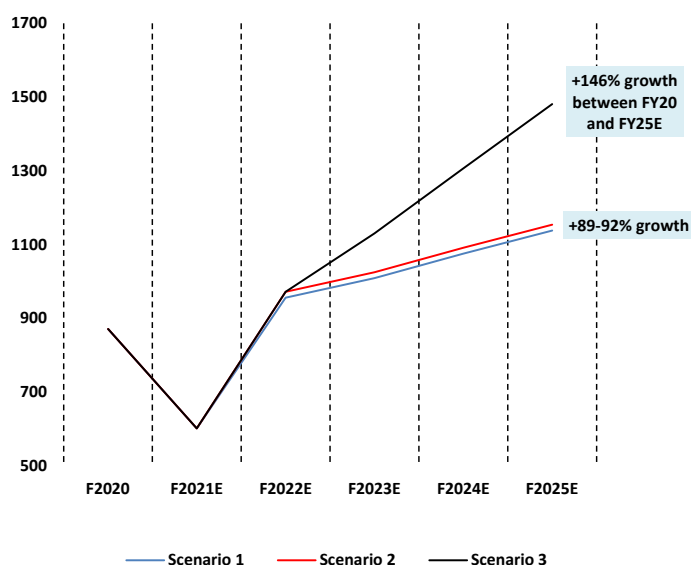


LED penetration in vehicle lamps: design preferences, electrification, and more. The headline around a sharp increase in LED lamp penetration within Indian two-wheelers massively understates the potential upside. While on the face of it, nearly 40-45% of all two-wheeler units sold today have LED lights somewhere on the vehicle, that stat is misleading since barely 5% of all units sold use LED lamps entirely across the vehicle (i.e. content per vehicle of >INR 2,300) and barely 10% of all units have LEDs in headlamps. We estimate that the two-wheeler domestic lamps market in India would more than double at full LED penetration, even assuming flat pricing and vehicle unit sales at F2020's depressed levels. Essentially, our thesis on our lamps' holding (our third biggest position today) is built on 3 key catalysts:

- 1. Continued increase in lamp content per vehicle (with a long runway) more than offsets muted 2W sales.** Between F2015-F2020, lamps' revenues for our holding grew at an 11%+ CAGR, handily outpacing the <2% annualized pace of two-wheeler unit sales. This is largely driven by **1.** Increased LED penetration within models, and **2.** Underlying mix shift towards higher-end models and EVs. We note that there are 25+ 2W EV model launches in the current calendar alone (vs. ~35 models on sale for whole of last year), with nearly a third of them from *Hero Motocorp*.
- 2. Material embedded optionality from industry rebound.** Given pandemic's impact on the unorganized economy, it would certainly be remiss if we don't identify the Indian 2W space as one that would likely be among the sharpest potential rebounders over the next few years. If this year's monsoons are anywhere near last year's, we see incremental tailwinds in F2022 (Mar) – We note that there are twice as many 'marriage days' in the current fiscal, and nearly 3x as many in the second half of the current fiscal as in 2HFY21.
- 3. Potential distress at Hero Motocorp's key vendor provides a 'free call' on adding a large OEM.** We estimate that ~30% of India's 2W lamp revenues come from *Hero Motocorp*, and as is typical in several of *Hero's* parts, sourcing is often focused on manufacturers with linkages to founders. It is our understanding that their key supplier for lighting is under stress and the OEM is expectedly looking at diversifying.

We broke down the Indian two-wheeler market into 6 categories. Cat-6 vehicles had all lamps (head, tail, and winker) as LEDs in their base versions, while head and tail lamps were LEDs in Cat-5's base versions. By our estimate, nearly 18% of Indian two-wheeler lamp revenues came from these two categories in F2020 (Mar). Given the ongoing shift, we would be surprised if at least a fourth of industry lamp revenues don't come from these categories by F2025E (Mar). That is despite assuming deceleration in recent shift trends. With substantial increase in content-per-vehicle, this auto parts

Exhibit 2 – Conservative pre-tax scenarios for our 'lighting' holding (without industry growth or margin expansion)



Notes: Scenario 1 assumes +20% 2W unit sales growth in F2022E (Mar), and no growth going forward; Scenario 2 incrementally assumes that 10% of all 2W unit sales by F2025E are electric vehicles; Scenario 3 incrementally assumes that 2W unit sales annual run-rate gets back to F2019 levels by F2025E.

Source: Internal estimates

position is therefore uniquely decoupled to nearly double earnings over the next 3-4 years, without having to call upon secular growth tailwinds at OEMs (see **Exhibit 2**).

Paper pricing continues to solidly rebound, even as domestic demand is slow to come back. Despite educational demand still well off of baseline, we noticed domestic uncoated paper demand in the March quarter at its highest level since the pandemic, with a mid-single-digit sequential growth in pricing. Between even moderate improvement in demand, and continued mix shift towards packaging board, we believe that *JK Paper* continues to offer not only one of the most asymmetric payoffs in our current book, but potentially the most attractive within the global forestry universe.

We took more chips off the table within our healthcare diagnostics holding. The ‘convenient’ narrative of this holding benefiting in the near-term from RT-PCR testing because of a third *Covid-19* wave reflected in a 15%+ move in March alone. With a sharp cutback in test pricing, scanty global evidence of re-infections, high seroprevalence in our holding’s key markets, and (more importantly) continued pricing pressure elsewhere within diagnostics, we decided to re-allocate capital into positions where we have far more earnings growth and visibility at a more comfortable price. To be clear, while we aren’t dismissive of them being near-term beneficiaries of RT-PCR testing, both due to surge and access⁵, we don’t view this as a structural value creation driver going forward.

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

Thanks,

Piyush Sharma

⁵ Access to healthcare services and travel. By our estimate, at least a third of all RT-PCR testing prior to the recent surge was on account of this.

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	90%	71%	77%	91%	115%	46%	66%
Since inception CAGR	13.0%	9.7%	10.0%	10.9%	8.9%	7.1%	8.0%
2021 YTD	9%	5%	7%	12%	14%	8%	6%
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	20.1%	17.5%	18.1%	21.1%	24.3%	13.3%	17.0%
Sharpe Ratio	0.57	0.45	0.46	0.46	0.35	0.36	0.39

Source: BSE, NSE, EurekaHedge, Bloomberg

Note: Returns are until the end of March 2021; Our performance is net of execution charges and mgmt. fees, but before incentive fees;

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

Strategy Snapshot

Characteristic	IUS	Notes
Top 5 positions as % of book	64%	
Avg. weighted market cap of book (mil)	\$708	>> Median holding's market cap is \$315 mil
Avg. weighted institutional ownership	16%	>> Median institutional ownership of current holdings is 19%
Avg. weighted free float of book	41%	
Net Exposure	94%	
F2022E (Mar) EV/EBITDA	14.7x	>> vs. 17.7x for Nifty Midcap 50 and 15.8x for Nifty Smallcap 50
# of positions	13	

Note: Returns are until the end of March 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.



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