

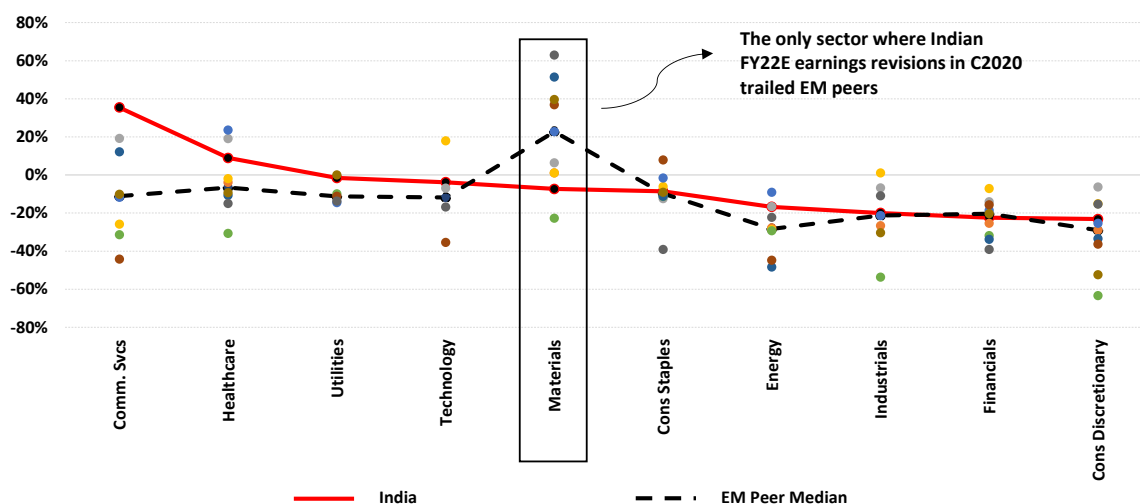
Dear Investors:

The sense of entitlement and instant gratification is deafening! While we grabbed the panic-induced opportunity in March of last year, we have been increasingly skeptical of the indiscriminate stock selection in the more recent past. Everything around us unmistakably smells of froth. Well, almost everything - While US listed equities and private assets are among the frothiest assets, Indian listed microcaps in particular, and smaller names in general, have been through an unremarkable 3-year run, the sharp move over the last 3 quarters notwithstanding. Essentially, we are positioned to go against the ‘froth release’ trade – We will actively engage if/when our names see any collateral damage alongside an intelligible *Nifty50* drawdown.

Peppiness, peppiness, peppiness. NYC tunnels have some of the worst traffic bottlenecks in US, but few are naïve enough to forecast weekday midnight exiting traffic from say Lincoln Tunnel by extrapolating traffic emerging out of tunnel congestion during rush-hour the same day. Dalal street effectively did that by creating such read-throughs from F2Q (Sept) earnings, even though the evidence points towards some of F1Q (Jun) consumption clearly getting pushed into F2Q (Sept). Consider the parallels with Mexico (minus the exuberance), which incidentally was the only major emerging market that adopted, in the face of the biggest modern-day pandemic, as unyielding a fiscal stance as India did, despite losing more employment. It’s mobility pattern during the Sept quarter was also similar to India’s. We also note that Mexico got hurt more than most countries and reported among the highest case fatality rates globally. Unsurprisingly, *IPC Mexico’s* earnings handily outpaced those of *Nifty50* components during the September quarter. Interestingly, nearly half of *IPC* components saw earnings downgrades post earnings, vs. under a fifth of *Nifty50* components.

While arguably patchy implementation issues (eg. Brazil keeping small and medium enterprises out of the purview of emergency assistance) tempered the effectiveness of the massive direct cash stimulus in certain markets, in other countries, such as Korea and Malaysia for instance, household-cash transfers were highly effective in containing the panic. India, in sharp contrast, today not only deals with one of the biggest excess capacity drags globally, but also isn’t creating enough jobs. We therefore remain puzzled on how Dalal Street’s perennially sanguine minds pegged back India’s F2022E (Mar) expectations less than their peers did within EMs elsewhere, with the exception of Materials, where India’s expectations got revised downwards more than at their EM peers (see **Exhibit 1**).

Exhibit 1 – Dalal Street’s F2022E (Mar) earnings revision activity in C2020 appeared disconnected to us



Source: Bloomberg; Reuters

Notes: Nifty50 GICS sectors were compared against similarly concentrated large-cap benchmarks within EM peers (China, Brazil, South Africa, Russia, Korea, Mexico, Thailand, Indonesia, and Malaysia); Outliers were excluded.

As we write this quarter-end letter, smaller names in India trade at or close to possibly the sharpest discount we have seen vs. *S&P 500*. Also, in contrast to Indian micro caps (say under \$150 mil), and to some extent small caps, India's headline large-cap names trade at valuations that continue to appear disconnected to us, and remain at distinct risk of F2022E (Mar) earnings downward revisions.

We would be distraught if values don't catch up with underlying earnings within our book in 2021.

Typically, unless value is compromised, operating earnings should dictate shareholder value creation over meaningful holding periods. In my two-decade investing career across geographies and industries, this is one tenet that has always held true over any 5-year period. It is therefore bizarre that the relationship significantly decoupled within our book over F2015-F2020 – Operating earnings for *Minerva India Under-served* book were up nearly +80% over this period, nearly twice *Nifty50*'s +41% and comfortably ahead of *Nifty50*'s much-loved Staples constituents' +58%. Despite the comfortable earnings outperformance, our book declined -16% over this period, vs. almost no change for *Nifty50*. Essentially, our +12% alpha vs. *Nifty50* in the first 9-months of F2021 (Mar) barely makes a dent in the massive disconnect that we had seen over the prior half-decade and we accordingly expect a bigger catch up over the next few quarters.

We initiated a large exposure in an auto-parts name that would be a leading beneficiary of a visible tipping point in consumer preferences for a certain part. Given both underlying froth in headline valuations globally, and our expectation that India's headline F2022E (Mar) earnings revision activity will likely trail EM peers over the next year, we were hard pressed to find situations that are likely to remain disconnected with the broader economy over the next few years, and yet come with a free call option on the potential recovery. Like just about any other Indian auto parts business, this one isn't particularly tech-intensive either. We aren't discussing powertrain, energy, or lighting systems here. Ongoing research efforts globally on this part are largely limited to weight optimization. Predictably, cost efficacy is the primary determinant of operating success. While product focus (to a large extent) and geographic focus (to a slightly lesser extent) have always been sticky within the global automotive supply chain, few parts have such sticky profitability as the one our latest holding focuses on, since the biggest players in the space are either all from emerging markets (primarily Latin America or emerging Asia), or developed market players who have almost entirely offshored their manufacturing footprint to the former. For instance, nearly all of incremental production of a large German company in recent years has been in Poland, while NA's biggest player produces nothing north of the Mexican border.

Our thesis here is primarily built upon a large evident shift in consumer tastes – newer material composition and casting technology of this part is creating a much higher new normal for earnings power: newer part is 4-4.5x pricier and significantly more profitable than its legacy version. Before we lay out the specifics of this thesis, it would be helpful to understand recent industry developments to better appreciate the broader tailwinds – shift in consumer taste, supply situation, and import substitution.

- A. OEMs are rapidly shifting away from legacy parts.** Since newer parts can be cast in full, they provide OEMs with more design flexibility vs. having to use hubcaps for aesthetics earlier. Moreover, since these are lighter and stronger, they also provide better car control and steering, more acceleration, less effort for braking, and improved fuel economy. Unsurprisingly, these have largely been standard options in EU and NA passenger vehicles for some time. That's not the case in India though, where more than 2/3rd of all passenger vehicles still use the legacy part. Our discussions across OEMs suggested that consumer preference have clearly 'tipped'¹ and this has begun to manifest in order books of Tier-1 parts manufacturers. In particular, we note that more than 3/4th of

¹ Models priced above INR 1.5 mil have newer parts as standard in the base model versions, while even those priced below INR 1.5 mil now increasingly have this newer part in most models except the base version.

all domestic SUV/MUV models now have this newer part as standard and penetration of these premium models is expanding even in an otherwise muted passenger vehicle market – SUV/MUVs made nearly 30% of Indian PV unit sales in C2019, vs. barely 12% in C2015.

- B. Changes in casting technology means that we see a shortfall between new capacity and rapidly emerging demand.** While the order books have recently expanded considerably (and continue to do so), we note that a significant portion of current industry capacity is legacy technology (old casting technology) while newer parts increasingly prefer a newer form of casting that leads to lower casting scrap and improved weight optimization. Since a considerable part of the Indian installed capacity at the beginning of last year used the old casting technology, we expect those with newer casting facilities to have more than an even chance of gaining share over the next few years.
- C. Import substitution is another low-hanging fruit as domestic capacity builds up.** India had imposed ADD of \$2/kg on imports from China, Korea, and Thailand for this new part. That effectively makes the landed price of imported parts nearly 40% pricier vs. where our new holding supplies the OEMs. However, lack of domestic capacity had previously led OEMs to resort to costly imports. Consider this – *Hyundai Motors*, which sells every 6th car in the country, imported around 90% of its requirement in the last fiscal. Our checks across OEMs predictably confirmed that cost leadership is the primary determinant of vendor choice. As the only bottleneck i.e. domestic capacity gets addressed, the massive import substitution in this situation is nearly certain. We estimate that 20-25% of India's OEM requirements for this new part last year were serviced by imports. We expect this piece to be largely picked by domestic players within the next couple of years.

We had previously never initiated a new exposure through a double-digit allocation, until we added this name in mid-October. 3 key reasons we gathered an unprecedented conviction while initiating this exposure were:

- 1. Aligned strongly on domestic and export models across OEMs.** Be it *Maruti*, domestic CV OEMs, or just about any major PV OEM, this parts business is still the vendor of choice when it comes to servicing the legacy auto part that we had mentioned earlier. We believe that they also currently service around 15 of the top 25 export models. Given their current order book composition of the new part, which is increasingly replacing the legacy part, we have no reason to believe that they cannot translate their leadership in the legacy part to the new part. By our estimate, this business barely had a low double-digit share of this fledgling industry space (domestic manufacturing of the new part) in F2020. It's current order book for the new part however suggests that it'll likely have about a third of the domestic produced volume in the next fiscal.
- 2. We expect to see a massively higher new normal for sales.** The Gujarat-based plant responsible for supplying the newer part mentioned above is set to have a capacity that is more than enough to service the order book until at least the middle of this decade. While this newer part accounted for barely mid-single digit contribution in F2020 (Mar), the installed capacity for this part (as at the end of F2021)² translates into INR 10+ bil in potential sales contribution, or >70% of what the entire company would likely report in the current fiscal. There is simply no overstating the impact of this shift, with most of it being driven by the business gaining share in the rapidly growing market for the newer part – Elsewhere, export revenues of legacy part (primarily serving the trailer market in EU and NA) are showing rapid growth as they pick the low hanging fruit in US, with Chinese players having been priced out because of 450%+ anti-dumping duties imposed in 2019. This business will report export growth of 40%+ in F2021E (Mar), despite a 45-day *Covid* induced shutdown at the

² We estimate that this business would have about 30% of industry-wide capacity of this newer part by the end of this year.

beginning of the current fiscal, with most of incremental growth coming from US, and recent order activity suggests material acceleration in order sizes.

- We anticipate material expansion in margins as mix continues to shift.** As product mix shifts away from the legacy part business in domestic market, and towards the higher margin new part and exports of the legacy part, we expect underlying margins to expand by at least +200 bps over F2020's low double-digit levels.

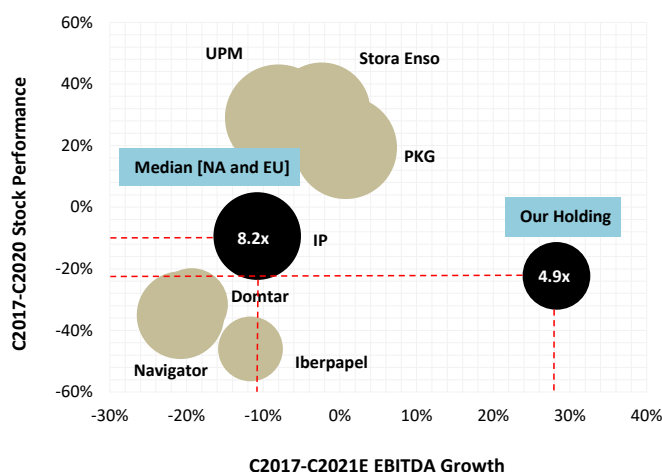
Even conservatively assuming that Indian passenger vehicle SAAR remains depressed around 2.8 mil units, the accelerated import substitution of new part in play, coupled with increased overall penetration of the part in PV models, and higher exports in the mix, means that the legacy low-margin business (~80% of the company in F2020) will drop sharply to around half of the business by F2022E (Mar). With at least +200 bps of underlying margin expansion coming in, we would be surprised if EBITDA doesn't at least double over the next 2 fiscals. We conservatively see 2.5-3.0x upside on this position (assuming a muted PV market) from where we allocated in mid-October, and north of 3.5x if the passenger vehicle market sustains its recovery.

No name in our book is as much a value outlier (or better reflects the overdone MSCI World vs MSCI EM trade) as JK Paper is/does; Global paper pricing is highly likely to be supportive over the coming quarters. This position of ours undeniably reflects the extreme nature of skewed and often disconnected capital flows over the past 3 years - Despite EBITDA comfortably outpacing NA and EU peers, this name has materially underperformed global peers over the prior three-year period, and now bizarrely trades at more than 40% discount to its NA and EU peers (see **Exhibit 2**).

While paper board demand has significantly recovered, capacity cuts in W&P have ensured that price environment continues to be favorable in uncoated paper. We are in the middle of the third straight month of pulp prices hardening, and likes of *Sappi*, *Navigator* etc. have announced another mid-high single digit increase in UWF prices from beginning of March in Europe. No matter how we model out pessimistic scenarios, even a large structural decline in uncoated volumes (assuming half of pre-pandemic private enterprise demand disappears, and we see deceleration within an otherwise robust paperboard environment) cannot reconcile with these valuations.

While we don't quite share street's 'China+1' exuberance on APIs, we certainly see select beneficiaries, including our only holding in the space. Ironically, Dalal Street clamoring for 'China+1' is happening at a time when Indian generic players are increasingly looking to expand presence in China³. Also, there have been more reshoring initiatives being discussed/initiated in EU than 'China+1' diversification in Asia. Be it *Sequens*

Exhibit 2 – EV/EBITDA vs C2017-C2021E growth



Note: Bubble-sizes indicate EV/C2021E EBITDA
Source: Reuters

³ In F2020 (Mar) alone, Sun Pharmaceuticals announced licensing agreements in China, and Cipla announced plans to set-up manufacturing facility for respiratory products. Elsewhere, Aurobindo is in the process of setting up an oral solids formulation plant.

planning on beefing local capacity of paracetamol, or *Sanofi* announcing launch of a new API business, there is undeniably a more tangible multipronged focus within EU on reshoring than on 'China+1'. That is not to say that India wouldn't be a beneficiary at all. However, the underlying sentiment on street appears rose-colored vs. our industry view. While India is well integrated and already the dominant supplier in likes of Clopidogrel, Finofibrate, etc., in certain other large APIs (Ibuprofen, Metformin etc.), we anticipate incremental shift from China, even as Indian domestic players are already well-entrenched in these APIs. We note that our API holding would generate INR 4-5 Bil from newer APIs in F2022E (Mar), with Metformin alone contributing around a third of that. As we write this, we conservatively value these new APIs between 170-200/share, suggesting at least 35-40% upside on a position that was already up >4x in 2020.

We cut our healthcare diagnostics position by a third in 2021, as the trade got increasingly crowded. When we initiated this diagnostics position a few years ago, it was fairly evident to us that they would be beneficiaries of the healthcare diagnostics volume gradually moving away from distressed mom-and-pop standalone diagnostic players. It was also evident at the time that the B2B diagnostics business would continue to face margin pressures (primarily at state-owned hospitals). While pandemic has accelerated the shift towards national/regional chains (our recent checks suggest that 40%+ of standalone players have either fully exited, entered into a tie-up, or have become franchisees of a national chain, vs. a fourth of such standalone centers going down the same route 3 years ago), we have also noted heightened price competition in the B2C space and we see little reason to believe that this pricing pressure would relent in the face of increasing regional and national competition. The weight of evidence made us pare this position by nearly a third over the course of the past year. While we still see material upside, we increasingly see better opportunities elsewhere.

Sans an indiscriminate panic, we believe that this is as good a time for stock pickers as we've seen in distant memory. While it's hard or mostly inconceivable for us to see froth building further in most headline assets globally, we see an extremely attractive micro and smallcap field in India, albeit one where the "now forgotten cash flow growth" will again be the arbiter of value creation.

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

Thanks,

Piyush Sharma

Meet your investment manager

Piyush Sharma, born and raised in India, is investment manager of RH Minerva Funds. Having spent time with Citigroup and Bombay Stock Exchange in India, he moved to United States in 2002, 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

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