

Dear Investors:

Stock prices never validate underlying business in the short-term. In poor price discovery markets, you won't be blamed for stretching that generously used 'short-term' to several quarters. Those who claim otherwise are the ones who correctly call a coin toss and then suddenly turn into supposed mandarins of market efficiency. While we reported +28% gain in C2Q, we certainly didn't see a market that delighted us as bottom-up pickers. At the height of panic earlier this year, we were essentially aggressive in adding exposures in situations where we saw substantial value and liquidity at hand to manage an extended period of cash burn, should that be the case. It's very rare for us to be in situations where we can essentially write off the next 4 quarters and yet find significant value. Within India, such asymmetric situations were and remain skewed towards the oft-maligned small and microcap universe.

Nifty Smallcap50 (ex-financials) ended the June quarter at ~13x F2021E (Mar) EBITDA¹, a sharp 25-30% discount vs. *Nifty50* (ex-financials) and *Nifty Midcap50* (ex-financials). In an environment replete with overly simplified narratives around "quality", you could be excused for missing the fact that *Nifty Smallcap50* not only outpaced pre-tax earnings vs. peers in F2020 (Mar), but it is also likely to do an encore in F2021E. No matter how we slice it, we still cannot reconcile underlying realities with the valuation differentials we see at mid-year.

While several small and microcaps have significant valuation buffer, we see perma-bulls in control of Dalal Street's F2021E earnings expectations. No BRICS market saw a sharper downgrade to F2021E revenue expectations than India², and rightly so. Our lockdown and potential for more to come (we address this later in this letter) expectedly kept the street nervy. Amazingly though, street has somehow managed to conjure a solid second half rebound narrative that appears very disconnected to us. At the end of June, F2021E (Mar) revenue estimates for headline names across India's capitalization spectrum were suggesting a median mid-single digit decline, a scenario that's mathematically impossible without fireworks in the second half of the current fiscal. The perma-bulls clearly have an elephant in the room here – an unprecedented pandemic!

We would be very curious to see how rural India spending plays out over the next year, but are somewhat less sanguine than most on this – Given the near absence of critical care infrastructure and demonstrable lack of appreciation of social distancing, we expect a sharp increase in rural *Covid-19* fatalities and, not surprisingly, overwhelming vast majority of them won't be traced to *Covid-19*. We see this as more than a mere inconvenience though within one of worst positioned areas outside sub-Saharan Africa. While MGNREGA figures from May suggest that the incremental income from this source likely more than temporarily offset the crash in urban-to-rural remittances, given the fiscal strains and potential of large spread in rural India, the widely dished out narrative of a solid comeback in rural spending doesn't get our support just yet. Over the past couple of weeks, we have noticed street chatter on, among other things, how cement demand in April and May confirmed a rural spending rebound. In sharp contrast, our checks across rural India suggest that May and early June numbers simply reflected the backlog of stalled work from pre-lockdown and rural cement dispatches are down again as we write this quarter-end update. Likewise, our checks across small businesses across industries suggest immaterial improvement in July MTD vs June. These sharp rebound theories are lazy feel-good narratives and we would urge our investors to look past these. Meanwhile, nothing changes for us - we conservatively expect F2021E (Mar) to be a maximum cash drawdown year in India's history and recalibrate our models from April 2021 onwards. We have no intention of joining the camp of a solid second half rebound just yet. Having said that, almost everything we own today more than compensates for a forgettable F2021E (Mar) and the worst is priced in for our holdings.

¹ Excluding one 3% position that asymmetrically skews our headline multiple, *India Under-served* ended June at 14.5x F2021E EBITDA.

² Median *Nifty50* component (ex-financials) reported a -16% downgrade to F2021E revenue estimate between December and June end. Only Russia came anywhere close with the median revenue downgrade at -12%.

What distress? BRICS stocks quash the narrative that balance sheets counted for much as Covid-19 raged on. While the time frame is admittedly short enough to judge how efficient C1H20 move was, it's bizarre that investors completely sidelined the thesis that balance sheet liquidity at hand would be priceless when dealing with an unprecedented modern-day pandemic. While the results we share here might appear like a curveball, they are purely incidental (might come handy in bar trivia, but nothing else) – note that the best performing BRICS indices in C1H20 were the ones where constituents had the least liquidity at hand (see **Exhibit 1a**). Mr. Market quietly chuckles. More importantly, business momentum remained the key determinant of outperformance, particularly in pockets that had witnessed the sharpest multiple contraction in recent years coming into C2020 (note the large alpha for top estimate revisions for Indian small-caps, and South Africa in **Exhibit 1b**).

Exhibit 1a – C1H20 stock performance vs. liquidity at hand

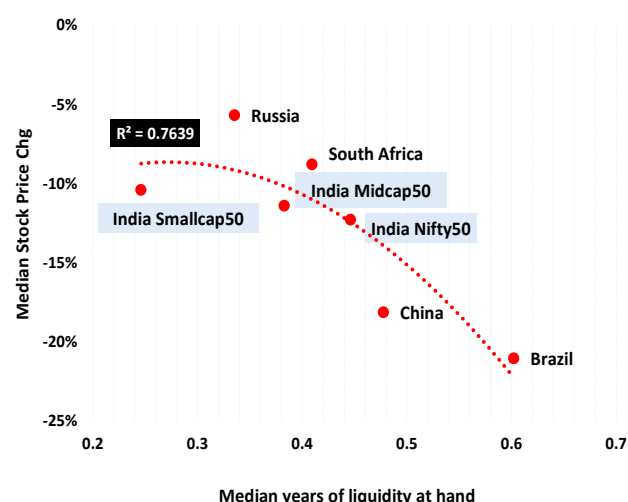
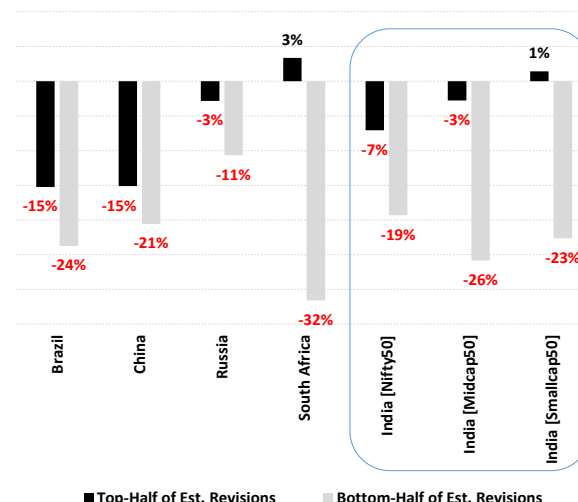


Exhibit 1b – C1H20 stock performance vs. rev est. revisions



Notes: We only picked index components that had at least one published earnings estimate; Exhibit 1b breaks down every index's median stock performance into 2 halves (top half and bottom half), based on how C2020E revenue estimates got revised from Dec 31st 2019 until June 30th 2020.

Sources: Company Reports; Reuters; NSE

As sharp as India's revenue downgrades have been YTD, we have little confidence in Dalal Street's elevated earnings expectations for second half of this fiscal. Our caution is largely driven by our expectation that our reopening would be more gradual than of most, and that several parts of the country will pursue intermittent lockdowns as infrastructure gets stretched in most poorly equipped states. Consider the following observations that collectively lead us towards this conclusion:

How are our most well-equipped cities positioned - Mapping Delhi's ventilator requirements. In ongoing antibody studies conducted in the US state of Missouri, ~4% of the samples have confirmed presence of Covid-19 antibodies. That's about 10x the reported cases (as of Jun 30th). Earlier, serological survey from Spain in second half of May estimated about 5% prevalence of antibodies, or about 8x the reported cases at the time. Predictably, denser cities such as Madrid (comparable to tier-3 Indian cities such as Jammu or Gwalior) had more than double the prevalence. Similar survey in Sweden, which never locked down, around end of April suggested around 1% prevalence³, or ~6x the reported number. ICMR's seroprevalence numbers from May meanwhile seemed much more optimistic, despite our apparent (albeit understandable) failure to maintain social distancing in denser environments – Barely 0.7% of ICMR's samples showed antibodies at the time, suggesting that actual infections in India were nearly 300x the reported cases. While the

³ Prevalence in Stockholm at the time was a materially higher 2.3%

underreporting grabs the headline here, % prevalence seemed materially lower vs. prevalence elsewhere. This could likely be a result of *ICMR*'s small sample size (1 for every 54K people across 60 districts in India, vs. 1 for every 143 people in Missouri, 1 for every 733 people in Spain, and 1 for every 4K in Sweden). Given that RT-PCR testing is unable to keep pace with the contagion, the likely differential between actual and reported infections is expectedly accelerating, making RT-PCR driven confirmed numbers effectively redundant from a policymaking perspective. While India's underreporting may very well be even higher than the astonishing 300x suggested by the first seroprevalence survey, it's clear that policy makers will be better served by conducting such surveys on a more frequent basis and using those results (as opposed to RT-PCR results) for forecasting infrastructure requirements.

If we go by Madrid's numbers from second half of May (~11% prevalence at the time), it's fair to say that given another 50 odd days since then and Delhi's far more denser environment, which gets partially offset by (arguably) more restrictive mobility, we wouldn't be particularly aggressive by assuming that about a tenth of Delhi residents would have *Covid-19* antibodies at the end of the first week of July. Interestingly, as we write this, just around half of Delhi's barely 1,000+ ICU beds (with ventilators) remain vacant, while absolute number of occupied ICU beds have declined over the past week. While that headline might serve to alleviate concerns of many, it likely also hides access challenges for many. Several credible sources indicate continued difficulty in getting access to these apparently vacant beds. What is critical for us instead is to get some sense of where we go from here, while remaining guardedly optimistic for now, on the weight of evidence. To us, the most significant bottleneck to managing the pandemic remains the availability of ICU beds (with ventilators). While many of us might argue with Delhi's disclosed numbers, and perhaps rightly so, it's notable that the supply of ventilator-beds continues to now go up at a time when absolute ventilator usage has begun to decline, with current supply more than enough to accumulate well over twice as many reported active patients as Delhi has today. Our discussions with sources at BEL and DRDO also suggest that the supply of ventilators would continue to go up, giving us increased confidence that with phased gradual reopening (and continued bans on large gatherings such as sporting events, night clubs etc.), at least India's biggest cities are finally showing signs to be able to manage a phased surge, should it occur.

We also note that while early *Covid-19* studies on intubation and ventilation suggested very low survival rates for patients, subsequent studies paint a stark contrast. Be it because of better equipped nurses with more learnings, timing of intubation, improved equipment, self-selection bias (as the most vulnerable are expectedly staying at home more), and most importantly, a more circumspect use of ventilators. Larger samples and more recent data from several sources suggest post-ventilation overall survival rates now range from 40-65%, and higher for those aged under 50.

Super-spreader events likely pose the biggest challenge to curve flattening. Continued intermittent lockdowns are more than a possibility, particularly in states that lack ventilators. Globally, empirical evidence within heavy testers suggests flattening in countries such as UK, Russia, and potentially even in Sweden, which drew significant flak for its decision to not lock down. In contrast, countries such as Luxembourg⁴ and Korea have seen a sharp second wave of infections. Critically, countries that have seen a second or third wave have almost unanimously attributed this to large close congregations – Korea clearly pointed out to nightclubs in Seoul, Hong Kong reversed its earlier decision to allow group gatherings of up to 50 people, and Luxembourg specifically called out large private gatherings and has drafted a new law that mandates seating at all events attracting 20+ people, or to compulsorily wear a mask if social distancing cannot be guaranteed. Given that the evidence at hand strongly points towards continued risks from 'super-spreader' events, we will be well served to not allow any gathering where social distancing cannot be ensured.

⁴ Luxembourg had tested about half of its population as we write this update

We know that several governments across the globe have either re-instated lockdowns/shelter-in-place or are considering it. We note that the ‘super-spreader’ theory is now widely accepted – Given that about a fifth of all Covid-19 patients account for 80% of all infections, the two most practical ways for a resource constrained economy to slow the spread are **1.** Very nimble contact tracing (which we haven’t done well), and/or **2.** A blanket lockdown (which we have already done once, albeit with poor compliance from the bottom-half). Given that we are likely still in the first innings of the first day of a 5-day test match in India, we certainly aren’t discounting the possibility of our political brass to espouse intermittent stops, particularly in states with the most decrepit healthcare infrastructure, such as Bihar, Odisha, Chhattisgarh etc. We can call it a very bitter low hanging fruit and one whose rural compliance is highly questionable, but we nonetheless find it highly likely to get plucked on an as-needed basis in these predominantly rural states.

While we did not initiate new exposures in 2Q, we reduced 2 exposures and added to 2 holdings. We cut about a fifth of our exposure in 2 names: an Internet name, where we are increasingly cautious as it’s continuously cash-bleeding private investments continue to get revalued higher in this new ‘Tesla-Nicola’ world we live in. Our second reduction was in a name that could very well continue to go higher as earnings power expands from here, but we got an opportunity to grab our current estimate of what we believe is fair value for a business with a lot of moving parts. Admittedly though, these parts are motoring along in a direction that lends us enough confidence to retain exposure here. Specifically, this business is currently world’s largest producer of a certain API that remains in supply deficit. While new capacity of this API is expected to come online over the next 2 years (in Europe and NA), our work suggests that there is more than an even chance that we wouldn’t see a glut even at that point. Further, their move into new APIs over the last 2 years is clearly beginning to bear fruit, particularly at a time when global pharma is increasingly looking to diversify their China exposure.

We added exposures in 2 existing holdings, with a particularly sharp ramp-up in a software services name, which we wouldn’t publicly discuss in this letter at this point but may discuss in more detail in our next quarterly update. Our other addition was in an existing theatrical exhibition name as investors stopped valuing the business as a going concern despite ample liquidity, and a manageable cash burn rate well into 2021. More importantly though, our work on DVOD (Digital Video-On-Demand) releases during lockdown confirmed that production houses cannot maximize their earnings by short-circuiting an exclusive theatrical exhibition period, particularly for non-animation content. We were also pleasantly surprised by the extent to which we underrate our innate instinct to get out. Consider this - We have been tracking occupancy in Hong Kong theaters from the time they re-opened in mid-May until their re-closure in mid-July. We noted a consistent and sharp increase in occupancy over these 2 months, despite a complete absence of new content. *Onward*, which was effectively a new release in Hong Kong (since it wasn’t parallelly released in HK in March), averaged north of 40% adjusted occupancy on its first Friday (June 19th). We estimate that the movie accounted for ~45% of all tickets sold during that weekend in HK, and about 30% of all tickets during the next weekend. No matter how we have tried to kill the theatrical idea, we haven’t been able to. Essentially, if liquidity isn’t a constraint to tide through an extended closure period, we conclude that theater closures won’t materially alter the operating landscape for these businesses, particularly in under-screened Indian markets.

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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