

Dear Investors:

If you opened your brokerage statements in NA or EU at the end of the year, you probably wouldn't be asking too many questions even though the situation probably warrants more questions than at any point within the last several years. While the likes of *United Technologies* or *Novartis* or several names within India's *Nifty50* rose sharply despite unremarkable earnings, even sustained solid earnings momentum in several parts of the emerging market small cap landscape yielded nothing or worse. It's very hard to argue against the fact that a vast majority of C2019 global value creators created value (most likely froth in several situations) despite poor or mediocre earnings and this (almost) never ends well.

For what it's worth, excluding one name (~3.5% of the book), *India Under-served* began the new year at around 18x C2020E earnings, a bit below *Nifty Smallcap50*, about in line with *S&P 500*, and a bit ahead of *Stoxx Europe 600*, which began the year at ~15x C2020E earnings. Clearly, these headline multiples don't reconcile with our far superior earnings growth (be it for C2020, or for past several quarters, or over just about any time frame), which is attributable to our idiosyncratic stories with a mostly low economic beta. It is critical to appreciate that earnings always matter, no matter who designs the narrative to the contrary. Prices always converge with solid earnings and investors almost always miss this established outcome, either on account of exasperation or on account of consuming narratives that engage in self-corroboration. Two things have always held true across borders – The richly valued don't get richer indefinitely despite mediocre earnings, and undervalued don't get cheaper indefinitely despite posting solid earnings. Effectively, clean sustainable earnings growth is always the ultimate arbiter of sustainable value creation.

Only 4 of the 14 names we held at the end of December gained over the course of 2019. Incidentally, we booked some gains in 2 of these 4 positions as the year progressed. Even as our holdings continued to handily outpace earnings growth just about anywhere else, it clearly didn't manifest in prices as smaller names¹ (particularly within emerging markets) continued to get ignored, creating what we believe is a multi-year opportunity to trade small vs large and EMs vs G7 securities. Nothing illustrates this 'overstretched' differential better than our biggest holding (please refer to **Exhibit 2** later in the note). *India Under-served* closed the year with a **-9.7%** decline (net of mgmt. fee and all transactional charges), with nearly 2/3rd of this attributable to a single Media holding which drew down in sync with the rest of the Media space in what turned out to be an extremely brutal year for Media names. Despite continued solid execution on earnings elsewhere, even as we decelerated in line with the rest, *India Under-served* has clearly faced collateral damage from broad-based drawdown within the Indian small and microcap space. While we have been very vocal about our concerns on optimistic earnings expectations from mid-2017 until late-2019, we expected continued earnings growth for our book to somewhat insulate us from the expected widespread panic elsewhere. This obviously hasn't happened to the extent we expected – Since the end of 2017, *India Under-served* has been dragged back by **-15%**, vs. the **-28%** decline in *BSE Smallcap*, which by itself is extremely skewed with the median index constituent losing more than half of its value over this period.

While we are capitalization-agnostic, we simply haven't noticed material value in India's headline large-caps at just about any point over our 9-year existence, and that includes this past year when these names charted their own disconnected path. On the contrary, we view most of these securities as grossly overvalued as these are effective proxies for top-down FPI capital allocators within an otherwise under-institutionalized Indian listed universe. We are simply unable to factor in any sort of conceivable material deceleration or contraction while trying to reconcile market pricing with fair values for most of these headline names. We are also cognizant of the fact that we participate within a micro and small-cap space where price discovery is such that widespread panic can lead to bizarre disconnects between underlying cash flows and valuations. That being said, despite having always been camped in the micro and small-cap space, our annualized

¹ At the end of C2019, a third of our book was sub-\$200 mil, ~60% of the book was sub-\$500 mil, and ~70% of the book was sub-\$1 bil.

volatility is almost incomparable within this space and is actually ‘Nifty50 like’. Also, it's critical to note that what we witnessed over the last couple of years has been different from our prior experience – Typically, clean earnings growth has dictated pricing for most of our holdings but we noticed an almost broad-brush approach to investing over the course of last two years, with earnings considerations swept aside.

500 or bust: How a SEBI directive influenced distorted price discovery outside India's top-500 names. In late 2017, SEBI rightly hammered down on Indian AMCs that used to routinely peddle certain funds as ‘large-cap’ even as they had a very generous allocation to mid and small-caps. In doing so however, they offered the least flexibility to those allocating to the largest listed space in India i.e. large-caps – While small and mid-cap funds were allowed to invest up to 35% of their capital outside their core mandate, large-cap managers are now supposed to restrict themselves to allocating no more than a fifth of their capital outside top-100 securities. The subsequent rejig of books until mid-2018 meant that stock prices disconnected with earnings meaningfully on either side of the 100th biggest listed name, with capital shifting towards the top-100 securities. Given that a vast majority of FPI flows are top-down in nature and chase only the most liquid and large assets, hardly any institutional capital offset the lost AMC ownership outside *BSE 500*.

If you were to put aside the claptrap narrative of superior earnings growth at these “quality” headline names and stack earnings growers and decliners against their comparable peers across the capitalization spectrum, you should be able to appreciate the sheer magnitude of disconnects that have got created over the past 2 years. See **Exhibit 1** below and note how significantly better earnings growth in buckets 501-750 and 751-1000 could still not prevent these names from significantly underperforming their peers within the top-100. Similarly, investors were far less forgiving on names that saw earnings declines beyond *BSE 500* even though often materially poorer earnings performance within top-100 saw a relatively muted reaction. It's critical to point out that even the below illustration doesn't fully reflect the level of underlying disconnects - Since we excluded names that didn't have published earnings estimates for this exercise (notice the much lower sample size beyond top-500 securities in **Exhibit 1**), this significantly understates the magnitude of the disconnects outside *BSE 500*, since ‘retail-panic’ had far more influence on the ticker tape in such names. Effectively, the worst of disconnects aren't even captured here.

Exhibit 1 – Median cumulative Stock performance [4Q17-4Q19] vs. Median cumulative Earnings performance [F2018-F2020E]

Group	Earnings characteristic	Median earnings growth	Median stock performance	Filtered* sample size	Notes
1-100	Earnings Growers	25%	0%	46	Very skewed stock performance within top-100
	Earnings Declines	-27%	-31%	20	Shift of local AMC capital towards top-100, regardless of earnings
101-250	Earnings Growers	35%	-7%	64	
	Earnings Declines	-17%	-40%	19	
251-500	Earnings Growers	30%	-30%	93	
	Earnings Declines	-20%	-54%	38	
501-750	Earnings Growers	37%	-32%	51	Shift of local AMC capital away from 500-750, regardless of earnings
	Earnings Declines	-29%	-59%	21	
751-1000	Earnings Growers	44%	-37%	14	By far, the biggest earnings-stock disconnect within top-1000 securities
	Earnings Declines	-14%	-57%	5	
India Under-served	Earnings Growers	52%	11%	8	Handily outpaced earnings growth elsewhere; Lower AMC ownership
	Earnings Declines	-41%	-54%	2	These 2 names were 15% of the book at the end of Dec 2017

Notes: The following filters were applied to the top-1000 listed securities: 1. Only names that had at least some institutional ownership at the end of C2017 were chosen; 2. Financials and outliers were excluded; 3. Only names with at least one published earnings estimate were included. Sources: BSE; Bloomberg

As we had pointed out in our last letter, it's increasingly evident that the risk-adjusted upside remains heavily in favor of Indian small-caps. Unsurprisingly, the best valued stories with idiosyncratic catalysts also lie within this space (simply a function of breadth). While earnings expectations across the capitalization spectrum, chiefly driven by the tax cut benefits, remain as realizable as they have been in recent memory, we note that both earnings momentum and valuations remain heavily in favor of the broader small-cap space:

1. **Estimates momentum shifting in favor of small-caps.** *Nifty Smallcap50* saw 1.4 earnings upgrades for every downgrade² in the last quarter. Even as investors continued to eschew smaller names, earnings momentum was clearly better within these names - *Nifty 50* and *Nifty Midcap50* saw a much lower 0.8 and 0.7 earnings upgrades respectively for every downgrade in C4Q19. In sharp contrast, earnings estimates at 13 of our 14 names (mostly outside *BSE 500*) were either unchanged or upgraded in the last quarter.
2. **Comfortably the most compelling valuations across the capitalization spectrum.** While F2020E (Mar) earnings expectations across the board remain in the 9-12% range, multiples for headline small-caps began the year at a significant discount vs. headline large-caps (~15%) and headline mid-caps (~40%). Remember that above are headline multiples of top-50 components and valuations beyond *BSE 500* look even more appealing.

All said, the listed Indian small and micro-cap universe comes with an expectedly high failure rate and it's ludicrous to take a broad-based approach similar to what investors have done over the past 2 years. Our stance on earnings recovery remains largely unchanged – While we do see selective growth situations coming off of low bases, we don't see anything on the ground that is suggestive of any sharp broad-based earnings recovery (ex-tax cuts). The relatively muted expectations and associated valuation comfort beyond headline names remain our chief sources of optimism. Our focus, as always, would remain on idiosyncratic situations, and selectively, on situations where valuations more than compensate for a material extraneous shock.

We also wanted to share some quick thoughts on 4 of our 5 top positions:

The erratic rainfall ended up hurting the largest location of an amusement park holding of ours in F2Q (Sept) – Nearly entire rainfall at this location was concentrated over 2 months in August and September, with August being 80% above long-term average, making it the rainiest month in more than a century. Given that August and September accounted for nearly a third of all school holidays at the flagship location for the 2019-2020 school year, erratic monsoon was a significant drag on footfalls (down 22% yoy) in Sept quarter. That said, F2Q (Sept) is by far the seasonally weakest quarter for this holding of ours, averaging about a tenth of annual pre-tax earnings in recent years.

We conservatively estimate that the value of the three operational parks alone for this business is somewhere close to INR 350/share, or about 40% ahead of where they are valued. This is based on our premise that their most recent park launch (in 2016) would breach 900K annual visitors mark within the next 3 years (vs. ~700K in F2019), if not earlier. To add a perspective here - their only other comparable operational park had its first full year in F2007 (Mar) and, despite the subsequent financial crisis headwinds, crossed 900K visitors in its 5th full year of operation. Incrementally, we value the new park (construction in progress; expected launch in July 2021) at around INR 50/share. We also note that feasibility of the 5th park (East India location³) is underway and comes with INR 150 mil in cash incentives offered by the state.

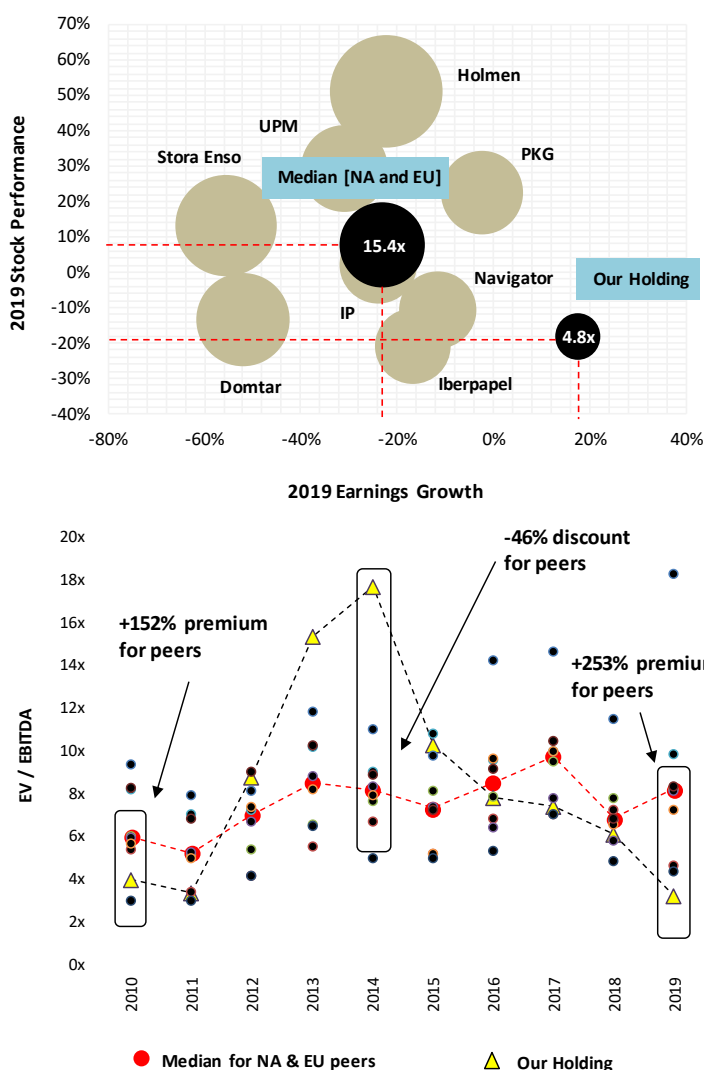
² Excluding financials

³ This would be a departure from prior launches. It would be a 90-yr lease and associated capex would be much smaller vs. prior parks (expected to be in the INR 1 Bil range).

The ‘Reliance effect’ - We see limited efficacy of disruptive pricing within B2C diagnostics at national scale players; B2B pricing should continue to remain intense. We believe that going ballistic on pricing in this space would only leave money on the table and would be an irrational move on the part of anyone who inexplicably chooses to go down that route. Why so? - Our research across standalone labs suggests that their pricing (at comparable locations), on average, already runs 40-50% below that of national organized players. We expect this highly fragmented and distressed space, which is already constrained on pricing and resources and accounts for nearly half of the market, to continue to shrink as scale players grab share over the next several years. We don't expect any rational player to engage in price competition at this end of the market - Our checks on the walk-in clients at such stand-alone centers yields an extremely price sensitive consumer i.e. he/she is highly unlikely to switch even if the pricing premium at national players gets sharply cut to say 10-15%. While there might be room to use pricing as a tool to acquire customers at the other end of the demographic (at large national players), we believe that even the results there wouldn't be particularly impressive within walk-in customers, who in sharp contrast, aren't driven by pricing – About half of walk-ins are referrals and ~80% of the rest are driven by location and brand awareness. While we question the efficacy of aggressive pricing within the B2C market, we expect the B2B market within healthcare diagnostics to remain intense, as has been the case. Please note that 2/3rd of our holding's business is B2C. Also, we do note that one can see potential business attrition at pick-up points of GPs (switching to a new player because of potentially higher sharing %) but these aren't a material source of business for our healthcare diagnostics holding.

Our paper holding continues to execute in an expectedly stable pricing environment for locally produced paper. While pricing weakness in categories such as ‘coated’ paper (~10% of the business) was expected, we have maintained that anti-dumping duties on uncoated paper and deepening penetration of packaging paperboard usage would hold pricing even as uncoated pricing remains under pressure elsewhere. Meanwhile, our agri-checks in Telangana and Odisha suggest that pricing for cloned eucalyptus and subabul remain in the INR 4.3-4.7K/ton (realization for farmer at the mill gate) and are unlikely to go up. If anything, we note a somewhat muted downward pressure on wood prices (for the mills) in the recent past (net cost of ~INR 6.8K/ton in F3Q vs.

Exhibit 2 – Valuation disconnects: Our Paper holding vs NA and EU peers



*Note: The size of bubbles in the above exhibit refer to C2019E PE multiples
Source: Bloomberg; Company Reports*

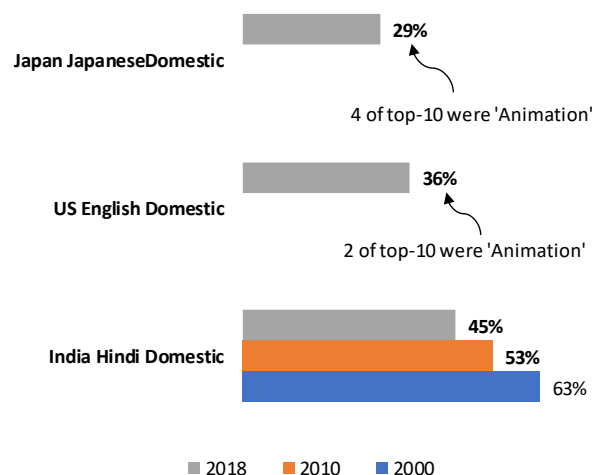
~INR 7K/ton in F2Q) as sourcing radius continues to be cut.

Further, as we write this quarter-end update, trial-runs on the 4 machines at the acquired facility are about to end and full production about to begin. Given that the industry is starved of uncoated capacity, we expect 100% utilization at this facility within a quarter at most.

Within a country where several consumer staples names are the priciest such assets to be owned on the planet, some of the best managed names in institutionally under-owned pockets inexplicably remain among the cheapest vs. global peers. This paper holding of ours is a great case in point – Widely institutionally held peers in NA and EU now trade at an unprecedented premium (>250%) over this name, despite posting underwhelming earnings and not being competitive vs. our holding on just about any relevant value driver over just about any time frame (see **Exhibit 2** on the previous page). Incidentally, this is only the second instance over our 9-year existence that we have hit our upper allocation limit on a single position.

We might already be past a tipping point in the Hindi movie theatrical market. While India remains well behind peers on theatrical consumption⁴, domestic admissions for Hindi movies had still remained stuck in the 300-mil range for some time, with multiplexes expectedly continuing to gain share within what still is a significant single-screen market. With single-screen closures largely offsetting multiplex screen openings, theatrical exhibition reach hasn't really expanded – India has around 9K screens today (less than a third of those are multiplex screens) vs. around 10K screens in 2010 (less than a tenth of those were multiplex screens). However, even as reach hasn't expanded,

Exhibit 3 – Box-office % of top-2 actors within top-10 movies



Sources: MPPAJ; Box-Office India; IMDB

we are noticing a sharp increase in box office collections in the recent past that is short circuiting the content supply constraint. Our work clearly suggests that Hindi box-office collections are increasingly trending in line with how collections had moved globally as domestic movie industries matured - 'Content' is increasingly trumping 'Cast'⁵ and has de-bottlenecked box office capacity as a result – See **Exhibit 3** and note how contribution to top-10 Hindi movies collections for top-2 actors has dropped from 60%+ in 2000 to 45% in 2018. The headline would be even starker but for the skewness on account of Akshay Kumar, who continues to churn apparently in-demand content at a very high rate.

This transition is particularly critical for Indian movie exhibition because of the following:

- 1. Continued content diversification.** With audience shifting markedly towards content, genre-focused actors are finding it increasingly hard to pull theater footfalls. This has clearly diversified cast and genre within blockbusters.

⁴ Admissions per capita in Korea is nearly 10x that of India, while US is nearly 20x that of India

⁵ The competition not only progressively increases within casting, but also across the entire value chain. Direction is another case in point - empirical evidence in Hollywood also suggests a sharp decline in number of directors who get to direct a second movie following their debut.

2. **Hindi blockbuster potential expands as ‘cast’ gets gradually de-emphasized.** With the exception of Akshay Kumar, hitherto ‘in-demand’ Hindi movie actors rarely shoot more than 2 movies a year. Historically, for an industry that hardly makes any Animation⁶ blockbusters, this effectively meant that the industry had created an annual ‘quasi-capacity’ for itself as far as blockbusters were concerned. The explosion of indi-content on digital platforms however has catalyzed a clear shift in audience demand for content, debottlenecking the theatrical box office that can now deliver blockbusters that aren’t as dependent on release schedule of a handful of legacy actors.

We believe that the street doesn’t fully appreciate that the industry is gradually creating a higher new-normal for itself. Likewise, we expect most premium formats to be margin and ROIC accretive as the theatrical mix continues to shift in that direction (please refer to our last quarterly letter for a more detailed explanation on this). For a business with an optically higher PE, we conservatively estimate another 25% multiple expansion to go with what we believe could be accelerated earnings growth as Hindi box office collections get increasingly driven by content.

While we remain very excited about our micro and small-cap holdings as we begin the new year, as always, we aren’t painting our views across this landscape. With earnings traction limited to select situations, and G7 equity valuations being stretched, it doesn’t take much for an extraneous shock to set another brain-freeze in motion in an institutionally under-owned space. Despite a decidedly small-cap focus though, we don’t participate in the underlying gyrations of this space as most do and have nearly incomparable volatility within this space.

It’s unprecedented for us to see earnings outperformance not manifesting in stock outperformance. Accordingly, that this can continue, remains a very low-probability scenario in our view. As a wise man said “Almost everything is outside of your control. You may take all the right actions and fail. You may take no action and win. All you can do is put yourself in positions to win. Be consistent. Patience will eventually get luck on your side”.

Wishing you a great 2020!

Please let us know if you have any questions. Your managers are available 24/7 to address your concerns.

Thanks,

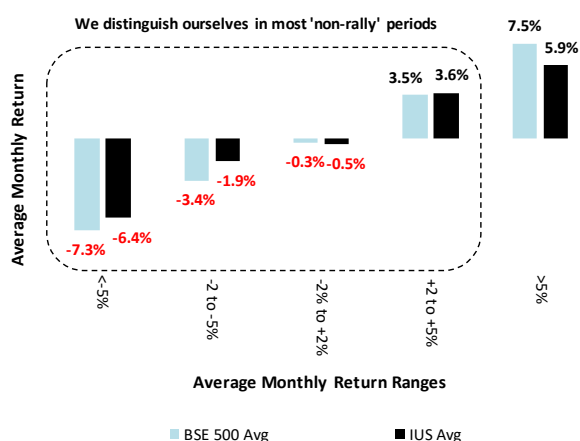
Piyush Sharma

⁶ Note that in markets such as US and Japan (more so in Japan) where now it’s rare to see actors featuring in more than one big blockbuster in a year, some of the blockbusters are ‘Animation’ as well, further de-emphasizing cast as a driver of box-office.

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	-10%	12%	8%	-3%	-7%	1%	7%
Trailing 5 yr CAGR	6%	8%	8%	8%	5%	6%	6%
Since inception CAGR	12%	9%	9%	9%	5%	5%	8%
2019	-10%	12%	8%	-3%	-7%	1%	7%
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	16%	15%	15%	19%	21%	13%	15%
Sharpe Ratio	0.60	0.44	0.43	0.38	0.21	0.21	0.39

Monthly return distribution



Time-window analysis

	3 Month	12 Month
Number of periods	103	94
Average period return	3.2%	15.3%
Number of profitable periods	68	78
% profitable periods	66%	83%
Best period	23.9%	55.3%
Gain Standard Deviation	5.8%	13.7%
Sharpe Ratio @10% RFR	0.10	0.32
Sharpe Ratio @5% RFR	0.26	0.62
Sharpe Ratio @0% RFR	0.42	0.92
Loss Standard Deviation	3.5%	6.2%
Downside Deviation @10% MAR	4.6%	8.5%
Downside Deviation @5% MAR	4.0%	6.2%
Downside Deviation @0% MAR	3.4%	4.3%
Sortino Ratio @10% MAR	0.17	0.63
Sortino Ratio @5% MAR	0.49	1.67
Sortino Ratio @0% MAR	0.95	3.57
Average Gain/Loss	1.6	2.4
Profit/Loss Ratio	3.0	11.6

Source: BSE, NSE, Eurekahedge, Bloomberg; Hedgealytix

Note: Returns are until the end of December 2019; All since-inception numbers above are since inception of India Under-served in April 2011. 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.

Meet your investment manager

Piyush Sharma, born and raised in India, is investment manager of Right Horizons 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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