

Dear Investors:

Might be semantic satiation by now but an absolute broad-brush continues to be thrown at institutionally under-owned names. Solid earnings performance in select pockets has barely managed to temper the blow but clearly hasn't been cheered enough – *India Under-served* was up **+0.1%** in 3Q, vs. **-7.5%**, **-4.8%**, and **-3.1%** declines in *BSE Smallcap*, *BSE Midcap*, and *BSE 500* respectively. Since the end of 2017, *BSE Smallcap* has lost 31% of its value (through Sept 2019), and even that is flattering on the broader index because the median *BSE Smallcap* constituent lost half of its value over this period. Despite consistent and unequivocally superior earnings performance for our book, even we inexplicably lost 12% over the past 7 quarters. As things stand, we expect earnings estimates for most of our names to either stick or get revised upwards (in contrast with the broader Indian listed universe), and expect wide earnings-price disconnects within our names to manifest in a 'violent recoil' at some point.

Structural uplift in intrinsic values doesn't always go in-line with broad-based demand uplift – Quite clearly, India hasn't been an exception when it comes to 'capex collapse', with global capex (ex-fin) peaking in 2013. For India however, the deceleration over the past 3 years has been distinctly sharp - F2019 (Mar) marked the slowest period of capex growth since well before the global financial crisis. With job creation remaining poor, just about anything that can kick start confidence would be welcome at this point. That said, we don't see announced corporate tax cuts as a large enough lever to catalyze this. To be clear, direct transmissions are as good as any but the announced cuts were aimed at corporates only. While the cuts certainly somewhat raise intrinsic valuations across the board, we definitely aren't in the camp that believes that this somehow incentivizes a broad-based capex revival or is a catalyst large enough to justify current elevated valuations. Dalal Street quite clearly disagrees, voting with its feet and the immediate cheer was deafening.

For all the rhetoric, Indian companies report among the highest profitability globally and this isn't a part of the global corporate world that is particularly cash starved to expand capex budgets. Far from it actually. In that context, we'll note two key observations from the tax-cut perspective:

1. 70% of all *Nifty 50* (ex-financials) constituents reported free cash flow in the last fiscal. For those that didn't, we estimate that potential cash savings from lower taxes would be less than a tenth of their capex budgets. Given that some of these businesses are now operating at utilization levels where it's inconceivable to see them accelerate capital spends, we don't expect the announced tax cuts to have any material influence on capex plans.
2. Except financials that often have substantial net deferred tax assets on account of large accruals on account of doubtful debt provisioning, impairment on financial instruments etc., most Indian companies have net deferred liabilities on their books. We do expect 1x write-downs of deferred tax liabilities, particularly in state-held energy companies, where one can see 3-6% increase in headline book values. The timing of these write-downs however isn't as straightforward – In cases where deferred tax liabilities are unlikely to be used up before the available MAT credits¹ are utilized, the write-down would be pushed back.

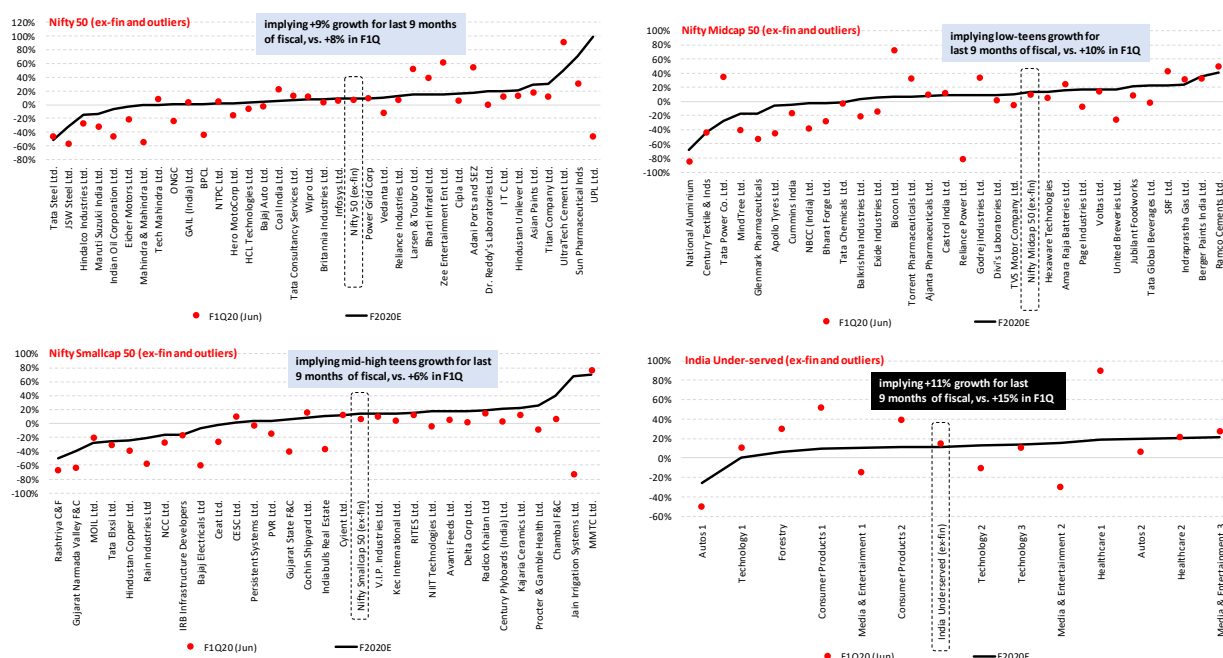
Tax-cut benefits unable to offset continued downward revisions in 3Q; Higher intrinsic values make rich optically richer. As F1Q (Jun) earnings announcements were coming to an end amidst a series of downgrades, *Nifty Midcap 50* (ex-financials), *Nifty 50* (ex-financials), and *Nifty Smallcap 50* (ex-financials) were already trading at 27x, 22x, and 20x F2020E earnings respectively, with underlying earnings estimates suggesting +10%, +7%, and +20%² growth respectively. After quarters of us howling over overly optimistic

¹ Under Ind-AS, MAT credit entitlement is presented as part of deferred tax assets

² Skewed because of Fortis Healthcare; Median *Smallcap 50* constituent was baking +13% earnings growth

Dalal St estimates, this was the first time in distant memory that we had seen expectations beginning to get at least a bit aligned with reality. The valuations however were undeniably rich and incomparable to pretty much anything else across the emerging markets landscape. With F2020E (Mar) revenue estimates continuing to get downgraded over the course of the past quarter, the benefits of lower tax rates for F2020E earnings couldn't offset continued revenue and margin downgrades and F2020E earnings growth expectations for *Nifty Smallcap 50* stood at +14% at quarter-end (+7% excluding *Fortis Healthcare*), down from +20% at the end of July (+14% excluding *Fortis Healthcare*). Estimates meanwhile were flattish at headline large and midcaps, despite lower revenue revisions - We note that *Nifty 50* (ex-financials) was baking in +8% revenue growth at quarter-end (despite the 2.5%-rupee depreciation tailwind between July and September), down³ from +9% revenue growth consensus at the end of July. Despite the drag from revenue downgrades, lower tax rate benefit on estimates ensured that F2020E earnings expectations were largely unchanged vs. at the end of July. However, with indices broadly rising 3%+ over that period, multiple for India's most widely followed large-cap benchmark remained a bit stretched but not particularly screaming 'rich' just yet. *Nifty Midcap 50* (ex-financials) however certainly appears rich, trading at just under 30x F2020E (Mar) earnings at the end of the quarter. To be clear, most of this recent upshift is merely optical since we believe that most intrinsic values have risen in the 10-20% range following the tax cut and multiples have accordingly adjusted. That said, headline midcaps trades at valuations that are unequivocally rich, albeit on estimates that aren't entirely disconnected from reality anymore (thank lord for that!!). In sharp contrast, estimates for *India Under-served* strategy suggest an unrealistic deceleration in earnings growth for the remainder of the year (see **Exhibit 1** to appreciate how our holdings are baking benign expectations, despite the much superior earnings performance, in sharp contrast to expectations at headline names).

Exhibit 1 – F2020E (Mar) earnings growth expectations vs. F1Q20 (Jun) earnings growth



Source: Company Reports; Reuters

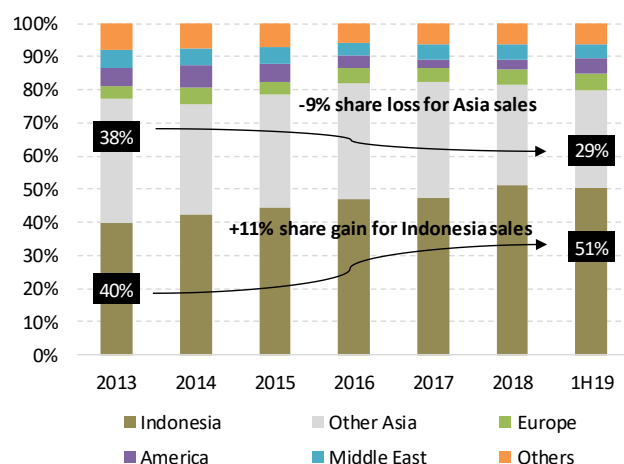
Notes: Excluding 1x items, and for continued ops only. F1Q20 (June) numbers were adjusted for the impact of Ind-AS 116 to make them comparable vs F1Q19. For Dr Reddy's (Nifty 50 constituent), we excluded one-time settlement related income of INR 3.5 Bil from Celgene. For Tata Power (Nifty Midcap 50 constituent), we excluded the litigation-related win from Adani Electricity Mumbai Ltd in F1Q19.

³ Downgrades were particularly concentrated within Consumer Discretionary and Energy

We believe that the worst of earnings downgrades are behind us (wait for the dreaded ‘but’). It’s been a while since we got remotely comfortable with earnings expectations (we are strictly referring to *Nifty 50* forecasts) and this is as close as we have got to our comfort zone. Broadly speaking, we still see downside revision risks to headline smallcap estimates but it’s 1. not nearly as much as what we have been accustomed to, and 2. largely already baked in a lower multiple. In the absence of an extraneous shock or another ill-conceived policy howler, we note that several drivers may now come together to create a bottom for downward earnings revisions. Chiefly, we allude to softer commodity prices, and low-base assisting easier comparisons in several cases. Further, while we don’t anticipate a material revival in job creation, we do note emerging signs that large job losses might be behind us. The bigger and more apparent risk still lies elsewhere in potential multiple contraction within headline midcaps.

Effectively, the field is now set in a way that the only way for an investor to see >mid-teens annualized returns over the next 3 years is to own assets that can compound cash flows at north of 20% over this period and aren’t richly valued at this point, an act that we are very confident of executing. However, contrary to Dalal Street narratives, we don’t believe that this is a particularly large pond to fish in. Our *India Underserved* strategy meanwhile has executed consistently on earnings in an otherwise dour environment [+40% earnings growth in FY19 and +14% in F1Q20 (Jun), vs. single-digit growth at *Nifty 50*]. To summarize, we see a country that undeniably has some of the most attractive opportunities globally in the small-cap and micro-cap space, incidentally our hunting ground, and very limited attractive opportunities within the widely institutionally held pockets within headline large and mid-caps.

Exhibit 2 – APP’s sales contribution shift



Continued closures of uncoated freesheet capacities in NA and Europe ensured that pricing remained stable as Asian exports continue to take share within these markets. We take note of two more large-cut announcements in C3Q – UPM’s 265K tons closure in Finland and Domtar’s 180K tons cut in US, or about 3% of the uncoated freesheet capacity in NA and Europe. Given the already executed cuts (GP took out 630K tons earlier this year in NA) and relatively high utilization levels, uncoated freesheet pricing has held well. We have also previously pointed out that Indonesian producers continue to prioritize local markets and replacing part of lost capacities in NA and Europe vs. paper exports to elsewhere in Asia – We note that share of Asian sales (ex-Indonesia) for APP dropped further to under 30% of sales in 1H19 (see **Exhibit 2**).

As far as our paper holding is concerned, our checks suggest no pricing pressure within paperboard while uncoated duties remain in place and pricing remains predictably stable. Meanwhile, retail naivety ensures that this holding inexplicably moved more with investors reacting to proposed ban on single-use plastic than on account of appreciation of the fact that this remains one of the cheapest and most profitable names (in a stable pricing environment) within the otherwise struggling global forestry universe.

Two-wheeler sales would start comping lower base from now onwards. Since India hasn’t seen such a sharp downturn in auto volumes in more than 2 decades, it’s not surprising that many are unable to have a

perspective around large volume declines. Particular attention has been given to dealership closures. Needless to say that automotive sales infrastructure (dealership count) is neither a structurally material driver nor an impediment to industry growth as cycles turn - Across geographies, dealership count and unit sales per dealership has shown a strong negative correlation and dealer profitability often goes up sharply as market sales volume gets back.

We have previously accentuated upon the benefits of exposures within well-run category leaders that source across OEMs, and are well represented within share-gaining OEMs. For an auto parts holding that is comfortably the largest lighting player within 4 of the biggest 2-W OEMs (*Honda*, *TVS*, *Suzuki*, and *Yamaha*), share shifts and increased LED content has offset broader industry weakness. Consider how the following moving parts ensured that this holding of ours managed to eke out +7% earnings growth in F1Q in an otherwise extremely challenged environment for two-wheelers - No other 2W model was as strong as *Suzuki Access* over the past year. For units with LED head-lamps, we estimate that our holding's lighting content per vehicle for *Suzuki* (it's 4th biggest OEM client) was about 30% higher vs. a comparable unit at *Honda* (it's biggest OEM client). While *Honda* was amongst the worst hurt, our holding's share of *Honda*'s headlights was barely 40% vs. 100% in case of *Suzuki*. On account of increased penetration of LED content at *Suzuki* and significant market share gains, our holding reported flattish revenues in F1Q (Jun). We note that the biggest selling model of our holding's largest client would scale back LED penetration within headlights to partly offset the sticker shock⁴ in BS-VI models. These scaled back dispatches will begin close to the end of the calendar year and we estimate that this switch would be no more than a 2% negative impact on revenues for our holding.

F2Q20 (Sept) box office collections were one for the books. We estimate that our movie exhibition holding would likely report same store footfall growth in the mid-high teens when it reports earnings tomorrow. We also anticipate a considerable build-up of deferred revenue because of advance collections of 'War', which incidentally outsold every Hindi release ever in advances (third all-time across all language formats), and was released at the beginning of F3Q20 (Dec).

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

Thanks,

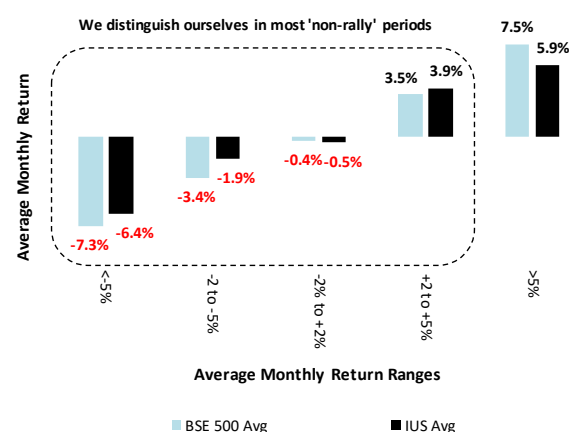
Piyush Sharma

⁴ We note that the base version of the BS6 model would cost around 4% more than the top-end of the current line-up

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	-5%	5%	3%	-4%	-9%	1%	-1%
Trailing 5 yr CAGR	8%	8%	8%	8%	5%	6%	5%
Since inception CAGR	13%	8%	8%	8%	5%	5%	7%
2019 YTD	-6%	6%	2%	-9%	-10%	-2%	-1%
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%	16%	19%	22%	13%	15%
Sharpe Ratio	0.65	0.41	0.40	0.36	0.20	0.19	0.34

Monthly return distribution



Time-window analysis

	3 Month	12 Month
Number of periods	100	91
Average period return	3.2%	16.2%
Number of profitable periods	66	78
% profitable periods	66%	86%
Best period	23.9%	55.3%
Gain Standard Deviation	5.9%	13.7%
Sharpe Ratio @10% RFR	0.10	0.38
Sharpe Ratio @5% RFR	0.25	0.69
Sharpe Ratio @0% RFR	0.41	1.00
Loss Standard Deviation	3.5%	6.7%
Downside Deviation @10% MAR	4.6%	7.7%
Downside Deviation @5% MAR	4.0%	5.6%
Downside Deviation @0% MAR	3.4%	3.9%
Sortino Ratio @10% MAR	0.17	0.80
Sortino Ratio @5% MAR	0.49	2.02
Sortino Ratio @0% MAR	0.94	4.19
Average Gain/Loss	1.5	2.6
Profit/Loss Ratio	3.0	15.3

Source: BSE, NSE, EurekaHedge, Bloomberg

Note: Returns are until the end of September 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

OFFERING DESCRIPTION: Right Horizons Minerva Funds are the PMS investment offerings of Right Horizons Financial Services Pvt Ltd, a SEBI-registered portfolio manager. Any reference to “Minerva” in this document refers to the proposed investment offering managed by a registered portfolio manager. All fees mentioned in this introduction are indicative and subject to change. Final terms and their computation will be clearly detailed in the portfolio manager-client agreement.

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CONTACT US:

Piyush Sharma piyush.sharma@righthorizons.com
Ashish Kodnani ashish.kodnani@righthorizons.com
CS Raju raju.cs@righthorizons.com

Right Horizons Financial Services Pvt Ltd.

No 6, Arekere, II Main,
Bannerghatta Road,
Bangalore – 560076
Tel: +91-80-65687503 to 65687518 [Bangalore]
+91-9833855875 [Mumbai]
+1-919-360-0359 [United States]

