

Dear Investors:

As we write this quarter-end letter, the dominant narrative on Dalal Street is that we are in a market where bottom-up investors are thriving. Broader view of the listed universe however certainly doesn't sync with this narrative. In sharp contrast to this overarching perception, we haven't witnessed such disconnected polarity since we began allocating capital to India in early 2011. For truly bottom-up investors to thrive, liquidity shifts should be moderate and not overly skewed. Bottom-up investors simply cannot distinguish themselves during periods of poor price discovery, be it a result of misplaced optimism as in 2017 or at a time like now when 'big' is wrongly (and uniformly) associated with 'low risk'. While Indian stocks routinely disconnect with underlying earnings over periods of panic and unrealistic exuberance, the polarity we have seen in the recent past is new to us (larger institutionally widely-held names charting their own path with little correlation to underlying earnings or valuations). Over the past 2 fiscal years, the disconnect between earnings growth and stock prices for our holdings has been at unprecedented levels. Take our top two holdings for instance – Earnings at our biggest 2 positions over this period were up +139% and +53% respectively, with stock prices trailing well behind at +50% and +15% respectively. Earnings for our book continued to be robust in F4Q19 (Mar), much in line with previous quarters – *India Underserved's* earnings (ex-financials) grew north of 50% in F4Q on +19% revenue growth in an otherwise muted earnings environment. Be it on earnings growth, or valuation on grounded expectations (~19x on conservative F2020E earnings expectations), our book stacks comfortably vs. the broader market and *Nifty 50*. Despite that, given the continued bunching (capital flows skewed towards higher institutional ownership names), our book has been unable to handily outpace the headline indices. Consider this – Over the past 12 months ending June 2019, our book is down 9%, a bit better than the 11% decline in *BSE Smallcap*. Over this period however, earnings for our book grew by almost +40%, following up on +19% earnings growth in F2018 (Mar). That was comfortably ahead of *BSE Smallcap's* earnings growth of +22%¹ and well ahead of *Nifty 50's* single-digit growth, but the extent of outperformance has obviously not yet reflected in our holdings. As earnings begin to roll out for F1Q20 (June), we note continued earnings outperformance for our book.

YTD, besides initiating a new position in an established API manufacturer that is expanding into newer APIs, we did a small re-allocation within our book - As the street consensus became increasingly bearish towards Autos, we exited a print media name and re-allocated the proceeds to an existing auto parts position that is primarily focused on 2W lighting and one that operates on very sticky margins (cost plus contracts) because of long product life cycles. We intend to selectively increase our exposure to this space if such names continue to diverge from underlying earnings². Meanwhile, our discussions across media agencies suggest that print as a medium would continue to bleed as other mediums continue to attract higher budgets, and we now view this space as a classic 'value trap' with limited upside in readership and consistent pressure on pricing.

We also partly pared an internet position (sold 1/4th of exposure) largely to book some long overdue gains (up >5x in past 6 years of ownership) at a time when valuation was running a bit ahead of our estimates, even as earnings traction remains solid.

Where is the wage growth unicorn? If corporate jobs can be used as a proxy, wages (in real-terms) in the formal sector have averaged mid-single digit growth over the past 5 years, with wages within non-bank financial companies being the lone exception (recorded double-digit growth over this period). With non-bank financials taking a backseat and the informal sector having taken a structural beating, there are limited pockets that can absorb that kind of slack and drive broad-based wage growth. Further, while we see

¹ Just under 40% of BSE Smallcap constituents reported earnings declines in F2019 (Mar).

² Between FY17 (Mar) and FY19, this auto parts name has seen earnings expand by ~25% while the stock has been cut in half.

selective pockets of job creation, there are only a handful of businesses that aren't overly saddled with idle capacity and even fewer that are launching new facilities – *FoxConn* in TN might create as many as 20K+ jobs while *Hero's* plant in AP might increase capacity by ~20% but associated hiring might be slow given inventory levels and disappointing start to monsoons. *Eicher's* commercial vehicle JV in Bhopal would add some headcount too but these are isolated situations³ within autos and aren't really representative of India's manufacturing situation as new investment announcements fall to multi-year lows.

Based on what we are seeing, the bottom half of urban India, the group that has been most impacted by the ongoing distress in the informal economy, is hurting at least as much as rural India - While a radical step such as demonetization was bound to accelerate formalization of the economy, it was more akin to going on a purge to control population. In a country where GVA per employee for formal sector is ~9x that for employees in the informal sector, labor re-allocation is impossible given the lack of un/under skilled labor and a hiring system (or lack of it) that has promoted a gargantuan expansion in contract labor usage. All that said, the larger impact of some of these hasty measures are behind us and while we don't subscribe to broad-based material earnings acceleration forecasts (we see lower interest rates neither making any material impact on ex-financial earnings growth nor drive new investments by itself), we certainly see limited earnings downside vs. majority of the world⁴ and extremely attractive pockets of value in select under-owned small-cap names.

Given the environment, our focus would remain within low economic beta exposures such as movie exhibition, exposures within top of the pyramid categories, names benefiting from low-bases in recent years, or in situations that have material idiosyncratic tailwinds (shift because of quality issues within drug APIs in China, a paper name where we expect material accretion from a newly acquired facility at a time when the industry is starved of capacity, ongoing shift from mom-and-pop B2C healthcare diagnostics to larger players etc.). That said, we do have select exposures in areas such as Autos that are closely tied to the broader economy and are predictably hurting. We do note however that all of the near-term pain and then some is more than reflected in valuations of several such names. Even within Autos, we are more constructive on two-wheelers than passenger vehicles (please read below for our holding-specific thoughts).

Indian 2Ws are about mobility and the category isn't as discretionary as some believe. Outside of territories that sell under say 300 2W units/month industry-wide, Indian 2Ws is a mobility category⁵ pretty much everywhere else. Industry in general received a bad sticker shock after insurance regulations changed amid informal sector distress. There is now ample evidence, anecdotal and otherwise, to suggest that part of the displaced labor force from the informal sector has been forced back to farms (largest target market for entry-level motorcycles). Urban categories such as scooters are in fact under more pressure as the urban jobs environment continues to be weak – Over the past 6 months, scooters as a category has witnessed unit decline of -15%, comfortably worse than the -8% decline seen in sub-150cc motorcycles. Accordingly, as far as mass consumption categories (non-staples⁶) are concerned, we are at least as concerned about consumption within the bottom third of urban India as in rural markets.

Given that certain OEMs have been aggressive on discounting, it's critical that we break down unit sales by segment in order to better identify pressure pockets. A deeper look into pan-OEM data⁷ clearly suggests that

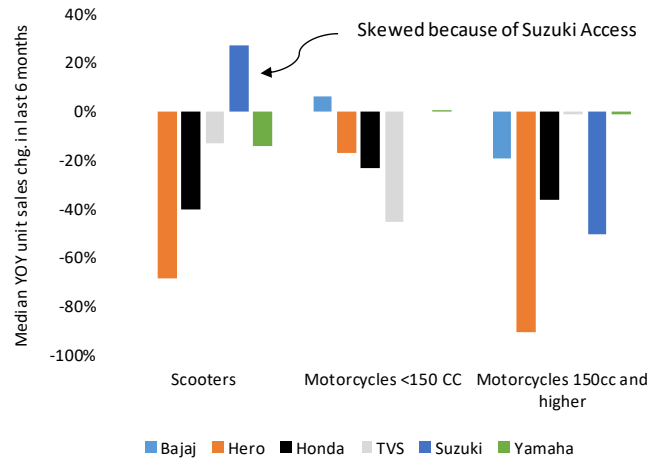
³ Overall, India's auto industry drives 15-20% of India's non-agri employment

⁴ Our discussions with businesses that are not only cost competitive on exports but also have a large domestic revenue base overwhelmingly suggests that exports are hurt more than domestic sales in recent months.

⁵ More than half of all households in 4 of India's top-6 most congested cities own two-wheelers.

⁶ Our discussions with key channel sources within consumer staples don't yet suggest a definitive broad-based divergence in demand deceleration between rural and urban markets.

⁷ We excluded models where monthly unit sales run-rate is under 500 and those that weren't available in the year ago comparable period.

Exhibit 1 – OEM's Engine-wise yoy sales chg. in last 6 mths

Source: Monthly sales releases

the scooter segment is hurt the most. Optically, the 150CC and higher segment appears worse but that is because *Bajaj Auto* is the only OEM that focuses on the space (nearly 60% of *Bajaj's* motorcycle revenues come from 150 CC+ models) and has expectedly gained share at the expense of others in the current period (see **Exhibit 1**). Importantly, nowhere is the impact of SME and informal sector distress more meaningful and visible than in the Scooters segment. This space is still a largely urban segment⁸ and one where purchases are relatively more cash-based vs motorcycles and has fared worse than the entry (and mostly rural) sub-150cc motorcycle segment (see **Exhibit 1**). *TVS* did relatively better (median model unit decline over past 6 months was -13% vs. -41% for *Honda* and -69% for *Hero*).

As at the end of 2Q, about 8% of our book was in Autos, with about 5% of that in a parts business that is focused on 2Ws and services majority of lighting requirement of OEMs that primarily use external suppliers. To that extent, OEMs such as *Hero* (nearly all lighting requirement is sourced from fellow group companies) losing share partially offsets industry-wide pain for a parts business that essentially dominates the part requirement elsewhere (and operates on 'cost plus' contracts).

We expect localized tailwinds within our amusement park holding. This business largely services the top of the pyramid within geographies where offshore-focused services-led white-collar job creation is driving growth - It runs 3 parks in Southern India, where the average household incomes of visitors range from INR 1-2 Mil, with the average age of the decision maker in the early-mid 30s. At a time when manufacturing continues to be a laggard and traditional IT services job creation has decelerated, we note that Bangalore, Hyderabad, and Chennai are expected to account for nearly 60% of jobs created by influx/expansion of GICs (Global In-house Centers) in the country over the next two years⁹, offsetting the slack at IT services. This is a very specific situation in a very localized business that we believe is not only largely shielded from the broader economic weakness but now also trades at what we believe are rather unreasonable valuations (~8x run-rate operating cash flows from its operational parks).

In a year when political advertising spends fell across all mediums, radio bucked the trend as major political parties chased the masses following radio's expanded reach after Phase-3 auctions. As a category, only Digital and Cinema would outpace radio in 2019E, with print likely to continue its share loss. Price shocks aside, no name in our book is likely to show more operating leverage over the next few years than our radio holding.

Production efficiencies ensured that our paper holding continues to report solid profitability in C1H19. Adjusted for the 9-day shutdown at its flagship Eastern India plant, we estimate that EBITDA margin for this

⁸ For the largest scooter OEM in India, scooter sales breakdown is ~65:35 in favor of urban markets

⁹ While IT services created 20K fewer jobs in the country in C2018, GICs created about 60K more jobs during the year vs. C2017.

business was around 28% in F4Q19 (Mar), or about 70-100 bps ahead of the reported figure. In F1Q20 (Jun), further reduction in sourcing radius more than offset pricing pressure and further expanded margins on an already high base. We have maintained that with anti-dumping duties on uncoated paper being in place, and no upward pressure on material costs, domestic uncoated producers are positioned strongly to sustain high profitability levels, with coated paper (~1/5th of EBITDA of our holding¹⁰) being the only likely sub-category where material price erosion risk could be factored in. Incidentally, coated paper pricing is typically most aligned with broader economic growth and we note that India recently slapped a 10% duty on the coated W&P category. It is also critical to add that with only 2 domestic producers, coated paper remains in deficit (1/2 of domestic sales are serviced through imports) and incremental opportunity for re-selling imported coated paper always exists, thereby providing a vital partial offset to any price erosion. Elsewhere, our latest checks with large domestic paperboard buyers suggest that prices have remained firm across grades. On the uncoated side, domestic prices are already running 2-3% below the ADD price vs. what is typically an equilibrium premium of 2-3% vs. imports. In particular, we make the following 2 observations on global pricing and trade:

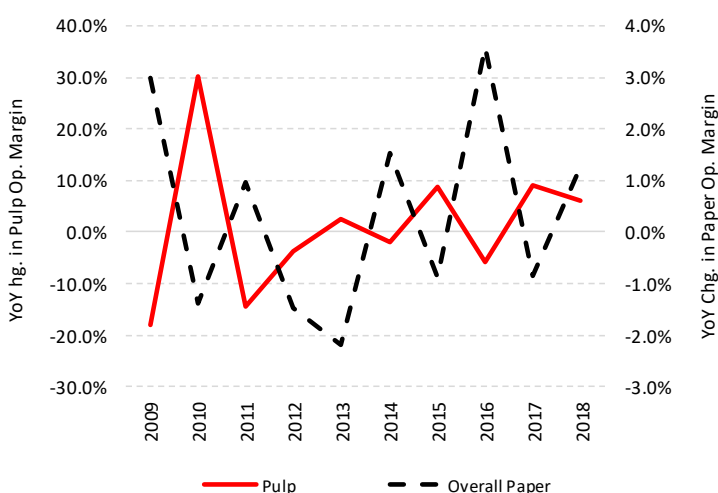
1. **Global pulp market is running at relatively high utilization levels and potential price risk**

transmission to paper couldn't be nearly as much as in 2008. With nearly 2/3rd of global virgin fiber pulp requirement coming from captive pulping facilities and paper grades being more differentiated vs pulp grades, paper margins are predictably less volatile vs. pulp. Regardless, to some extent, paper prices are a function of pulp prices (see **Exhibit 2** – note that both are plotted to different scales). In that context, two things are critical to note in the current environment: (A). At the end of 2007, nearly a fifth of global

pulping capacity was idle vs. nearly full utilization prior to even the Chinese recycling import ban in 2018, and (B). Despite the Chinese slowdown and *Suzano-Fibra*'s decision to cut production by ~1 mil tons in 2019 (implying a reduced ~84% capacity utilization this year), the pulp market held up relatively well in the first half of the year. To some extent, that was driven by *Suzano*'s decision to build stocks vs. reducing prices.

2. **Indonesian paper peers are increasingly looking westward.** Realistically, the most competitive uncoated paper imports into India come from Indonesia¹¹ and anti-dumping duties on uncoated copier paper are now in place. In parallel, we note that Indonesian paper exports are increasingly taking share in larger Western markets. In fact, no country grew its paper exports faster over the past 5 years than Indonesia, with capacity additions (to partly offset continued capacity closures in

Exhibit 2 – Historical yoy shifts in global paper and pulp margins



Note: Global pulp peers were picked from Portugal, Poland, Austria, Finland, Brazil, and Chile. Global paper peers were picked from Sweden, Spain, Portugal, Poland, Indonesia, Austria, Brazil, Finland, and Japan

¹⁰ Half of our holding's coated paper revenues come from internal production and another half from re-selling imports

¹¹ <5% of Indonesia's paper exports come to India, with Japan and China accounting for nearly 40%.

NA¹² and Europe) and cost (currency-driven) tailwinds in place. Consider the following to appreciate how cross-continental trade in paper has become attractive for Indonesian producers. Take *PT Indah Kiat* for instance - Over the past 5 years, Indonesian rupiah has depreciated nearly by a fifth vs. the USD. That has seen its operating expense per ton of production decline by 11% (in USD terms) over a period when *Domtar's* (largest uncoated freesheet manufacturer in NA¹³) operating cost per ton declined by 8.5%. In 2018, even as its overall exports to Asian markets declined and overall export revenues were flattish, revenues from Europe and NA increased by more than 30%. Nonetheless, final paper product isn't frequently cost competitive when exported across continents and local cost differentials aren't the driving factor of the share capture being discussed here. Persistently low single-digit operating margins at the large export-oriented Indonesian W&P paper manufacturers clearly corroborates this, with average pricing simply tracking operating costs in recent years.

For all the trade rhetoric, unless INR appreciates considerably, we don't see Indian uncoated and paperboard producers to be uncompetitive vs. imports. Also, we don't view current global pulp markets to be comparable to anything we saw in 2007 and accordingly our worst case for paper pricing cannot reconcile with what's implied by current valuations.

Impact of expanding premium formats in movie exhibition cannot be overstated. About a tenth of our movie exhibition holding's screen count at the end of F2019 (Mar) came from premium formats (*IMAX*, exclusive Luxury seating formats, *4DX* etc.). This contribution will continue to expand and premium formats/screens are expected to be a fifth of all screens in 5 years. We spent considerable time this past quarter in trying to better understand pricing, occupancies, and overall economics of different formats. We are briefly sharing our thoughts on economics of some of these formats¹⁴:

1. **Frequency of IMAX content has made the format attractive for exhibitors.** *IMAX* format revenues make 5-10% of box office collections for Hollywood titles, with blockbusters making closer to 10%. In contrast, *IMAX* screens contributed under 2% of admissions and under 5% of net collections for the biggest Hollywood blockbuster in India to date. As we write this, there are just around 15 titles YTD that have been released in *IMAX* format in India, or about 2-3 titles a month, with no title running for less than 2 weeks. Collectively, this set has accounted for about a fourth of domestic multiplex collections YTD (across all screening formats), suggesting that in terms of both frequency of content (4-6 Hollywood titles and 1 Indian title every 2 months, on average) and collections, there is definitely room for *IMAX* collections to grow as more screens come online. It is highly unlikely for an Indian movie with production budget of under INR 1 bil to be shot in *IMAX* format, effectively suggesting that around 5-7 domestic titles a year can be released in *IMAX* format.

In our view, no available premium format has as much loyalty as *IMAX* – We note that the demand for standard screenings for any title at the same property is limited when *IMAX* screenings are on offer, despite the typically observed 20-30% price premium (on comparable seats). Even if we conservatively assume similar number of screenings per day, we estimate that a 5-screen theater (with 1 *IMAX* screen) would report run-rate margins 400-500 bps ahead of a theater with 5 standard auditoriums, with comparable returns on invested capital.

¹² NA's UFS production has declined by 24% over the past 5 years vs. a 21% decline in demand.

¹³ Domtar accounts for more than 40% of NA's uncoated freesheet production.

¹⁴ Our work suggests that number of shows per screen for *IMAX*, *XL*, and *Luxury* are similar to that at standard screens, while screenings at *4DX* format are half as many. SPH/ATP ratio was assumed at 56% for *IMAX* and *XL*, and 66% for *Luxury*. Format-specific costs include bulb costs for *IMAX* and AMC costs for *4DX*. For *4DX*, price premium and screen costs are shared between exhibitor and CJV.

2. **Luxury theaters have similar run-rate profitability as at IMAX but have the best returns on invested capital across formats.** Unsurprisingly, about half of all premium screens today for our holding are exclusively luxury seating formats. Our work suggests that luxury theaters, which are distinguished formats and do not necessarily come with differentiated screens, have yield premiums (vs. standard theaters and screens) similar to that for *IMAX* theaters (lower occupancy¹⁵ but higher prices vs. *IMAX*). However, given the smaller sizes of luxury formats and higher F&B consumption, we estimate that run-rate margins of a 5-screen property with one screen exclusively marked for luxury format are similar to that of a 5-screen property with one *IMAX* screen. ROICs however are 300-400 bps higher, in our view.
3. **D-box could radically change underlying profitability of the 4DX format.** As things stand in India, viewers aren't allowed to take food and beverages inside *4DX* theaters. A newer version, *D-box*, now allows for motion sensor de-activation, and takes care of the currently low SPH for *4DX* screens. By our estimate, hypothetically speaking, if SPH/ATP ratio for *4DX* screens were similar to what we see at standard screens, we estimate that run-rate EBITDA margin of a 5-screen theater (with 1 *4DX* screen) would be at least 50-100 bps ahead of comparable 5-screen standard property, with competitive ROICs.
4. **The XL format likely has lower profitability vs. the above-mentioned formats.** *XL* uses 2 4K projectors to exhibit on extra-large wall-to-wall screens. We have observed that *XL* format yields (realization per sq ft) run about 40% ahead of standard screens with run-rate profitability of a 5-screen property (with 1 *XL* screen) about 150-200 bps ahead of a standard 5-screen property. Returns on invested capital on such properties are comparable with standard 5-screen properties.

Above are the formats that clearly add value to enterprise-wide profitability while adding a critical new dimension to cinema experience. Predictably, they make nearly 90% of our holding's current premium screen network. Other formats such as '*Onyx*' or kid-specific formats don't appeal to us as much, given either low yields, lack of content synchronicity or both. Overall, while we see the premium formats improving profitability and returns on invested capital, we don't see a concomitant drag elsewhere – We note that our holding has started a new brand that is specifically targeted at Tier 3 and 4 towns with ATPs in the INR 110-150 range and about 30% lower cost per screen. While there is only 1 theater at the moment under this format (restricting reliable observations), we are told that returns on invested capital for this format are in line with current company average.

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

Thanks,

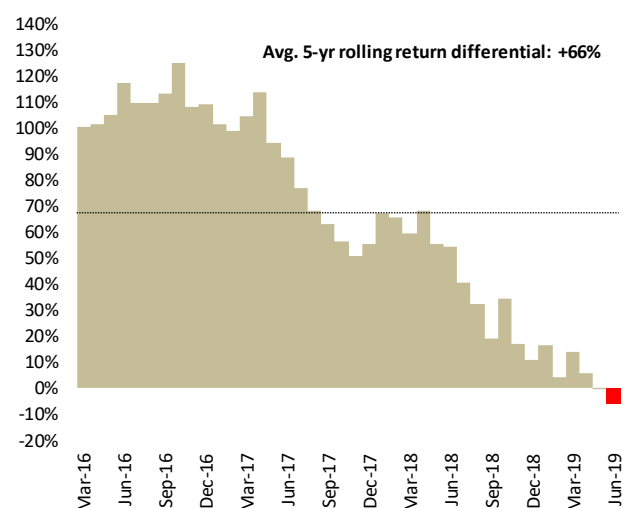
Piyush Sharma

¹⁵ Currently, only one property has all luxury theaters and its occupancy is reportedly in line with our holding's national average.

Performance benchmarking

	<i>India Underserved</i>	<i>Nifty</i>	<i>S&P BSE 500</i>	<i>S&P BSE Midcap</i>	<i>S&P BSE Smallcap</i>	<i>EurekaHedge India</i>	<i>India-focused CE Funds*</i>
Trailing 1 year	-9%	10%	5%	-4%	-11%	1%	-2%
Trailing 5 yr CAGR	8%	9%	9%	10%	7%	8%	8%
Since inception CAGR	13%	9%	9%	9%	6%	5%	8%
2019 YTD	-7%	9%	5%	-4%	-3%	2%	2%
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	15%	15%	16%	19%	22%	13%	15%
Sharpe Ratio	0.69	0.45	0.44	0.40	0.25	0.24	0.38

Relative 5-yr perf vs BSE 500



Time-window analysis

	<i>India Underserved</i>	
	<i>3 Month</i>	<i>12 Month</i>
Number of periods	97	88
Average period return	3.6%	17.3%
Number of profitable periods	65	78
% profitable periods	67%	89%
Best period	23.9%	55.3%
Gain Standard Deviation	5.8%	13.7%
Sharpe Ratio @10% RFR	0.16	0.47
Sharpe Ratio @5% RFR	0.32	0.80
Sharpe Ratio @0% RFR	0.49	1.12
Loss Standard Deviation	2.6%	4.5%
Downside Deviation @10% MAR	4.0%	6.2%
Downside Deviation @5% MAR	3.4%	4.1%
Downside Deviation @0% MAR	2.8%	2.4%
Sortino Ratio @10% MAR	0.29	1.17
Sortino Ratio @5% MAR	0.69	3.02
Sortino Ratio @0% MAR	1.29	7.07
Average Gain/Loss	1.8	3.5
Profit/Loss Ratio	3.7	27.0

Source: BSE, NSE, EurekaHedge, Bloomberg

Note: Returns are until the end of June 2019; All since-inception numbers above are since inception of India Underserved 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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