

Dear Investors:

While it's true that the *India Underserved* strategy often underpaces during manic liquidity-driven rallies, it is equally well documented that over 7+ years, the strategy has always outpaced peers during drawdowns and has also nearly always outpaced during flattish-moderate markets. While long-term investors benefit from superior absolute and risk-adjusted performance over a full cycle, it is understandable that those that allocated to us towards the end of 2016 or early 2017 failed to fully appreciate that attribute of the strategy by the time 2017 came to an end. Hopefully, most such allocators would have noted how the disconnects have unraveled this year and froth of 2017 has at least partly disappeared, which is in sharp contrast to our 1H18 performance – As we write this, Smallcap index has lost more than **-20%** YTD but even that headline performance isn't representative of the majority, with more than half of smallcap constituents down more than **-30%** YTD. Meanwhile, *India Underserved* ended 2Q18 down **-2.97%** for 2018 YTD. In 2Q18, your strategy was up **+2.1%** vs. **-3.2%** and **-4.2%** declines for *BSE Midcap* and *BSE Smallcap* respectively.

As has been the case since strategy's inception, despite the long-only orientation and small-cap focus, the strategy still manages to cap volatility at or below Nifty's levels, something that to our best knowledge, isn't matched by any other Indian small-cap focused strategy (please refer to the attached document titled 'India Underserved vs BSE Smallcap during drawdowns').

Elevated earnings expectations left little room for error. We certainly aren't trying to be a Monday morning quarterback when we state that throughout 2017 we had been accentuating on growing disconnects between earnings growth expectations and valuations within Indian small and midcaps (read this [interview](#) from the end of 2017). C1Q earnings showed precisely why it'll be unrealistic to expect 20%+ earnings growth once the low-base benefit wears off - While headline operating income and earnings for *Nifty Midcap 50* (ex-financials) showed C1Q growth in the early 20s, it came off of highly depressed C1Q17. Recall that in C1Q17, average operating margins had contracted more than 400 bps sequentially (post demonetization). Had it not been for the low margin base of C1Q17, operating earnings for this group would have shown no better than low-teens earnings growth, or essentially well off of mid-20s or higher growth expectations for F2019E (Mar) and beyond. Ignoring FX-impact, with margins clearly under pressure and limited below the operating-line leverage, it's hard to see broader markets reporting earnings growth materially ahead of revenue growth over the next few quarters. In sharp contrast, our holdings are solidly positioned to benefit from idiosyncratic earnings catalysts over this period.

While it was apparent that there were, and in several pockets still are, wide disconnects between expectations and reality, it appears obvious to us that in several situations the unraveling has gone the other way. This is particularly pronounced in liquid names with low institutional ownership, where the most conservative of projections cannot reconcile with current valuations as retail selling hasn't been countered by institutional players coming in. We will categorize about 1/4th of our current names in that category. Here are our thoughts on a few such positions:

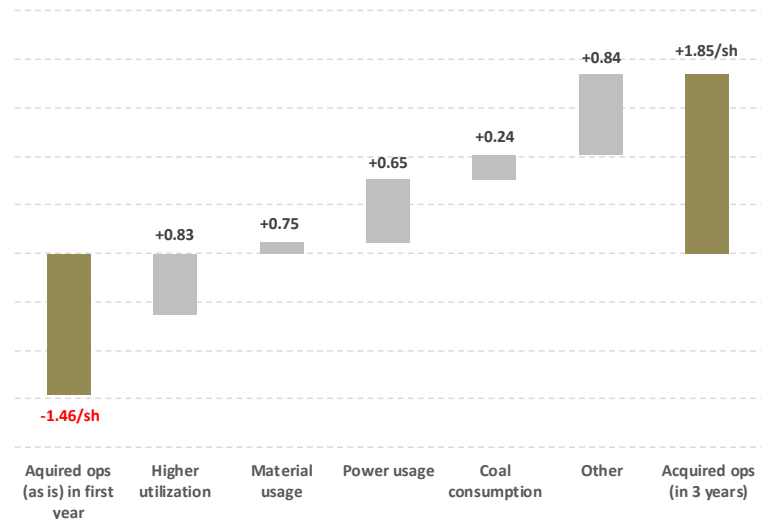
A movie exhibition holding dropped after noise around rumored F&B state intervention. As we write this, the first hearing of the PIL (on allowing external F&B on multiplex premises) is still to take place. Our discussions with attorneys and judges suggest that multiplexes have a strong case and they have every right to price their services within the terms and conditions of their operations. That said, there is an apparent need to be sensitive to certain facets of F&B pricing such as differential MRPs. We estimate that about a third of patrons consume F&B on premises and a vast majority don't consume packaged foods (i.e. don't consume anything with a printed 'mrp') – Just about 5-7% of total F&B revenues at our exhibition holding come from packaged F&B, with most of it coming from packaged water. Realistically, assuming that differential MRPs are done away with, the impact on underlying margins and our value estimate is largely immaterial. Furthermore, even if multiplexes drop prices across the board to temper down this issue, we

don't see how the impact could drag underlying margins to anywhere close to what current valuations suggest. While it is clear to us that such outcomes are typically favorable for businesses in Supreme Court, the appeal process could be an overhang on the stock in the near-term.

Names with limited institutional presence have been disproportionately hurt. The cheapest name in our book (a paper holding) by any measure and under nearly all scenarios of realistic deceleration in demand and/or contraction in margins is incidentally one that has very low institutional ownership. Incidentally, it is the only name where we have added exposure recently to capitalize on the broader panic. As we write this update, this stock is down -17% YTD.

This comes at a time when the stock is trading at around 7x our conservative F2019E (Mar) earnings forecast. With almost no pressure on the materials cost side, a very tight supply situation in the end-market, and ample cash to drive 'below-the-operating-line' leverage, the only overhang on the stock is low institutional ownership and resulting impact from retail selling. On top of the clearly apparent upside, we note material embedded optionality in the form of a recent acquisition of a defunct facility that got sold out of NCLT bankruptcy proceedings. By our estimate, this acquired facility by itself could potentially be worth a third of the current stock price within 3-5 years (note earnings accretion from the deal in **Exhibit 1**). This is on top of what we believe is potential doubling just off of multiple expansion over the next 2 years.

Exhibit 1 – Earnings accretion from a recent NCLT acquisition



Notes: Capacity utilization is expected to hit 100% in 3 yrs; Blended wood cost assumed at 7.5K/ton, which includes transportation cost over 200-250 km and is net of Rs. 300/ton of subsidy; Wood cost inflation assumed at 4%; Interest subsidy of 2% has been factored; 1,200 employees are hired within 3 years of operations.

We continue to back names that can sustain solid growth with little or no dependence on macro tailwinds.

Consider an auto parts holding of ours - This company produces automotive lighting and, given long product cycles, works on cost-plus contracts. India's second-biggest 2W manufacturer is its biggest client and it services most of the rest too. Despite post-demonetization drag, this OEM did another 22%+ year of unit growth in F2018 (Mar), while gaining share in domestic 2W market and benefiting from continued traction in key export markets. This has continued into the new fiscal. This stock meanwhile is down 25% YTD and our most conservative estimate suggests that it should be up at least 50% within 2 years.

Along similar lines, we expect solid growth to be sustained at a diagnostics lab position. This stock is basically flat YTD but there are several underlying catalysts that have and will continue to drive growth for a long time. Overall, for F2019 (Mar), mid-teens revenue growth seems very doable, largely driven by growth in the under-penetrated East region, where a new reference lab has opened. Even in well penetrated markets such as Delhi NCR, low double-digit revenue growth is expected in the near-term, with about 3-4% of that coming from higher number of tests per footfall. Even with no change in macro-conditions, this position would almost certainly report 20%+ earnings growth this year, something one can't expect in vast majority of the world today.

Meanwhile, the near-term sharp pullback in the INR, even though expected, certainly can't be extrapolated. As much as near-term sharp moves tend to overwhelm us, it's critical to note that **1.** INR has barely depreciated 3% over the past 5 years, **2.** While INR has inherently been a volatile currency (just like ruble, rand, real, or rupiah) because of portfolio flows influence, this is gradually shifting as 'sticky' FDI flows decidedly at least match portfolio flows, and **3.** While remittances have been flattish for past 4 years, even elevated current account deficit in F2019E (Mar) will likely not surpass these. All said, despite our capital account stability, crude and/or portfolio flows fluctuations impact us in the short-run. Likewise, poor price discovery in Indian small and midcaps ensure that excess liquidity or lack of it often drive these names materially over or under intrinsic valuations.

Please let us know if you have any questions.

Thanks,

Piyush Sharma

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.

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