Equirus Long Horizon Fund
Investor Communiqué - Dec'17

Dear Investor,

Happy New Year!

Thank you for another successful year and for your faith reposed in us. As we step into 2018 with renewed optimism and vigor, we assure you of our dedication and commitment in handpicking quality names driven by fundamentally strong growth drivers and prudent managements.

In this fifth quarterly communiqué, we present a round-up of our performance, provide an insight into our philosophy and present our views on some pertinent issues. Here we go…

Markets end year in party mode

2017 was an excellent year for equity markets, but more so for primary markets. Data overwhelmingly supports the fact that primary markets are in a froth of their own.

- Number of IPOs: 213 (previous highest 111 in 2006)
- Amount raised: US$ 10.65bn (previous highest US$ 11.9bn in 2007)
- Use of IPO funds: 76% of money raised through IPO was OFS
- Returns on IPOs: 62% IPOs appreciated >10%
- Number of QIPs: 45 (previous highest 64 in 2010)
- Amount raised: US$ 9.4bn (previous highest USD 7.4 bn in 2010)

But we have no intention of joining this frenzy.

Even for listed markets, the party has been pervasive and we have had our share of fun - apparent from our performance this year. We sense a lot of optimism when it comes to return expectations from equities over the coming years. Flows from Mutual Funds into Indian equities have been unprecedented. Just to set the context, MFs pumped in Rs 1,130bn in equities in 2017 as against cumulative investments of Rs 1,115bn during 2000-2016. While we don't like to be a party pooper, we don't wish to be carried away by the rising tide as well.

Howard Marks in one of his memos wrote:

"Rule No. 1: Most things will prove to be cyclical. – Rule No. 2: Some of the greatest opportunities for gain and loss come when other people forget Rule No. 1." Nothing good or bad goes on forever. And yet people extrapolate sometimes as if a phenomenon will go on indefinitely."

Investors consistently seize upon above-average returns as an encouraging sign and extrapolate them, and the 17.6% compound return on the S&P 500 from 1979 through 1999 was certainly a case in point. But rarely do they ask what powered those good returns, or what it implies for the future. In essence, stock ownership conveys the benefits of owning a corporation, and stock appreciation should be driven by increases in profits. Thus, long-term returns should reflect corporate growth. But as Warren Buffett has pointed out,

". . . people get into trouble when they forget that in the long run, stocks won't appreciate faster than the growth in corporate profits." Although that growth is the underlying source of equity profits, it is often overshadowed and obscured in the short run by trends in valuation. People took that 17.6% gain as an encouraging sign, overlooking the fact that it stemmed primarily from the rise of P/E ratios described above and thus was unlikely to continue unabated. Rather than healthy performance that could be extrapolated, this swollen return should have come as a warning that valuations were unsustainable and likely to regress toward the mean. But investors consistently fail to recognize that past above-average returns don't imply future above average returns; rather

they've probably borrowed from the future and thus imply below average returns ahead, or even losses. The tendency on the part of investors toward gullibility rather than skepticism is an important reason why styles go to extremes."

Mean Reversion and how it affects us

Mean Reversion is a very powerful mental model in finance. Price (P) is a function of two variables, viz. earnings (E) and multiple (P/E). The market ride over the last few years has been driven mainly by multiple re-rating. Earnings growth has been elusive.

	Earnings			P/E			Index Returns
	2013	2017	*CAGR*	2013	2017	*CAGR*	
NIFTY	337	391	*3.8%*	18.7	26.9	*9.5%*	*13.7%*
NIFTY FF MIDCAP 100	545	402	*-7.4%*	14.8	52.6	*37.3%*	*27.2%*
NIFTY FF SMALLCAP 100	77	86	*2.7%*	44.1	105.8	*24.5%*	*27.9%*

A high multiple indicates that the market expects earnings to grow at a fast clip. If earnings growth is unable to support the multiple, there will be price and/or time correction. Either ways, earnings growth is the most important factor to support market levels.

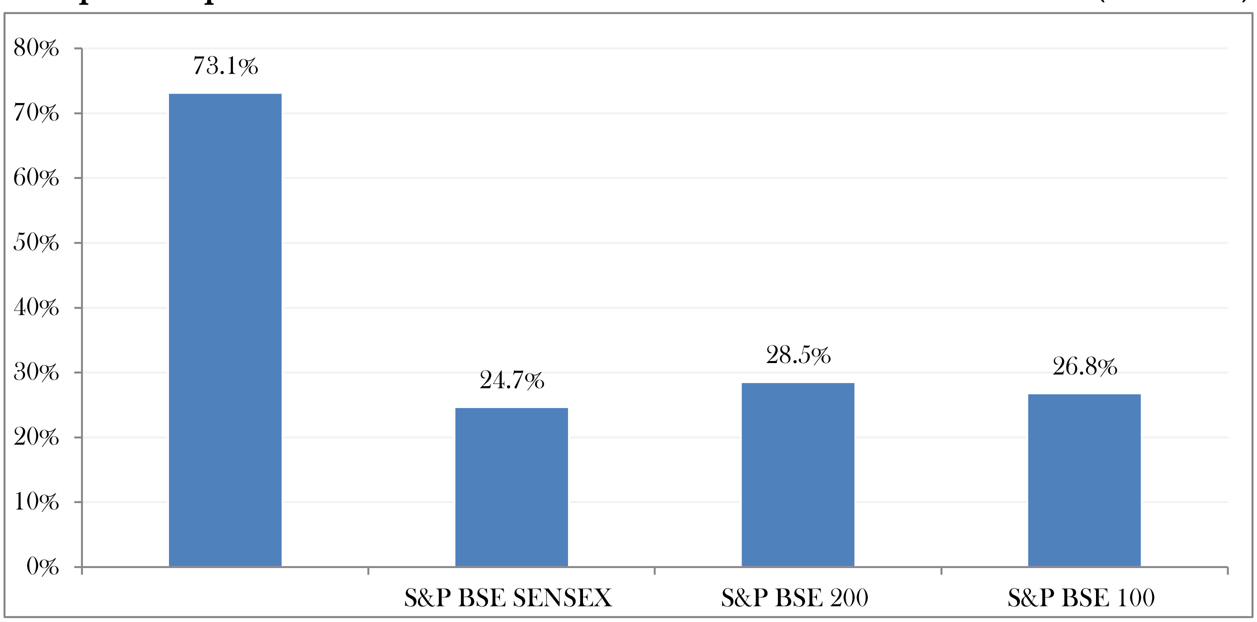
We believe the probability of multiple expansion from here on is much lower than contraction. In this light, the spectacular returns of the last few years may not be the norm for the next few years. We do not claim to know when gravity will catch up with prices, only that someday it will. In words of Herbert Stein, *"If something cannot go on forever, it will eventually stop"*.

Having injected some caution, we expect the overall direction of the economy and markets to be northwards in the long run, but the ride to be bumpy. We reiterate that our investment decisions are not based on market levels. **We are still anchored to the time-tested principles of buying quality and growth with a margin of safety.** These opportunities are few and far between, making our jobs difficult and interesting at the same time. With some patience and diligence, we are able to find investible ideas. And this, we will keep doing irrespective of market levels. One such idea is Thangamayil Ltd., which we will discuss later in this letter.

Fund performance

The Equirus Long Horizon Fund, as the name suggests, invests in listed securities with a long-term horizon of 3-5 years. Our adherence to robust processes, prudent investment strategies along with flexibility to invest in strong businesses/franchises – while a perfect recipe for above-average long-term results – has already started yielding results. With just over one year of our launch, **we have given a return of ~73%**, much higher than benchmark indices despite carrying significant cash over the same period. Returns vary across clients, depending upon their entry into the PMS.

Comparative performance of ELHF vs. benchmark indices[1] since launch (20Oct'16)



We would like to caution you against extrapolation of this performance over the short term.

[1] *Return figures are net of fees and as of 31 Dec '17. Returns are adjusted for inflows/outflows and are TWRR*

The new entrant: Thangamayil Jewellery Ltd

Thangamayil Jewellery Ltd (TMJL) is a Madurai-based jewellery retailer focused on the mid-to-low income customer segment. It has ~40,000 sq. ft of retail space across 32 stores in tier II/III cities of Tamil Nadu (TN). This state is the largest consumer of gold in India, and five southern states contribute ~40% of India's gold demand.

The Gems & Jewellery (G&J) industry faced significant regulatory headwinds starting FY13, due to a spike in the import bill which inflated the Current Account Deficit (CAD). Regulatory measures during the period included restrictions on gold imports, an increase in customs and excise duties, revocation of the gold-on-lease scheme, KYC implementation for larger purchases and curtailment on deposit schemes. Consequently, the profitability of jewellery companies was hit, with the impact more pronounced for TMJL due to additional headwinds like erratic weather and an unstable political situation in TN. However, TMJL's resilience and effective response helped it come out stronger, with improved operating and financial metrics in FY16 and FY17.

We are excited about the prospects of the G&J sector as a whole. Analysts generally tend to underestimate headwinds as a well as tailwinds. As an example, even earnings of G&J companies under our coverage, Titan and PC Jewellers, have been revised upwards by the street every quarter in last three quarters by over 20% and 18% respectively. Tailwinds in the sector are much stronger than what the street is factoring in.

TMJL is set to perform much better in the new market environment. We believe TMJL, an anti-fragile company with a prudent management, is an attractive bet on India's love for gold and rapidly increasing discretionary income, industry shift from unorganized to organized, and mean reversion in profitability. *For a more detailed reference, please refer to our article in Outlook Business, the Dec 22, 2017, edition.*

Current Aggregate Portfolio Characteristics

As a step towards greater transparency, we share our portfolio level characteristics every quarter. Our current portfolio characteristics are:

Number of businesses	14 companies
Current cash position	~8%
Last 3-year earnings CAGR	27%
Latest portfolio ROE	28%
TTM (trailing twelve month) portfolio PE	22.2x
Acquisition portfolio TTM PE	14.3x
Balance sheet strength	4 out of 14 companies are net debt free. The lowest interest coverage of our portfolio company is 1.9 times and it has grown EBITDA at 48.5% CAGR for last 3 years
Churn	6.1% (excluding the buying/selling of Liquid Mutual Funds, stocks given to us by our investors and capital redemption by investors).

I thank you for your valuable support and trust for investing in ELHF, and I reinforce our commitment to make your investment decision profitable.

For any queries, please feel free to get in touch with me or my team.

Thanking you,

Viraj Mehta
Head & Fund Manager
Equirus PMS

Annexure

In this section, we share some good reads with you. Hope you enjoy reading it.

We appeared in media here, talking about IPOs and turnaround stories. Here are some other articles that we found interesting during the quarter.

- The Trade of the Century: When George Soros Broke the British Pound by Rohin Dhar
- Decoding the genius of Roger Federer by Preethi Ramamoorthy
- Ed Thorp: The Man Who Changed Casino Gaming by Nicholas G. Colon
- How fast food reveals secrets of the economy by Chris Baraniuk

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