July 05, 2019

Letter to investors: Update for three months ended June 30, 2019

Dear Investors,

Buoyant PMS portfolio returned a negative 2.4% gross of fees for the three months ending June 30. The Nifty-50 Index returned 1.4% and BSE 100 Index returned 0.9% during that time.

The performance of the PMS portfolio* over different time periods since inception is reflected in the table below:

Total returns (%)	Buoyant Portfolio*	Nifty 50 Index	BSE 100 Index	BSE 500 Index
Last month	-2.4%	-1.1%	-1.1%	-1.5%
Last three months	-2.4%	1.4%	0.9%	-0.1%
Last six months	3.3%	8.5%	6.7%	5.2%
Last year	-0.1%	10.0%	8.4%	5.3%
Last two years - annualized	12.8%	11.3%	9.9%	7.7%
Last three years - annualized	21.4%	13.0%	12.9%	12.4%
Since inception - annualized	22.8%	12.7%	12.5%	12.1%

Source: Bloomberg for NIFTY 50 Index, BSE 100 Index and BSE 500 Index. Buoyant Portfolio is pre-fees and expenses

*See disclosures at end on how Buoyant Portfolio returns are calculated. More than one year returns are annualized

Buoyant's average cash position for the quarter stood at c12%. The composite performance above is average across all client portfolios and individual returns will differ due to variations in holdings, the subscription timing and other client-specific circumstances (as mentioned in disclosures on page 9). You should have received your individual account statements via email by now. Please get in touch with us with questions, if any.

For the three months ended June 2019, Buoyant's portfolio turnover stood at 17% (including businesses we churn out of - when we inherit an investor's portfolio) and total brokerage paid stood at 0.065% of average portfolio (refer to disclosures on how portfolio turnover and brokerage paid ratios are calculated). We believe the low turnover as well as brokerage ratio reflects our belief in buying quality businesses and holding them. The weighted average market capitalisation of the businesses in Buoyant portfolio as of June 30th, 2019 stood at USD8.5 billion (or, INR585.0b).

In this letter, we write about ***Indian generic pharmaceuticals*** in sectors that we are actively monitoring (pg 2), ***Banks versus NFBC/HFC*** in businesses that we have added during the quarter (pg 4) and '***Fast food versus bicycles, the Broken Window Fallacy the Growth Delusion***' (pg 5) discussing our latest book reads, Delhi government's free metro rides and our take on Arvind Subramanian's heuristics-based GDP calculations.

Actively monitoring the *Indian Generic pharmaceuticals space*

Market capitalisation of India's generic pharmaceutical companies (defined later in the write-up) has plummeted from cUSD88b in October 2015 to cUSD49b currently, a 44% dip. During the same period, their cumulative one-year forward earnings have dipped 14%, implying that the valuation has de-rated materially. Despite actively monitoring how the sector is shaping up, we have been unable to zero-in on a compelling business to own in this space yet.

The global trade of pharmaceutical products is pegged at USD400b, of which, cUSD370b is in generic drugs (generic). A generic is a pharmaceutical drug that contains the same chemical substance as a drug that was originally protected by patents. It can differ in size, shape, colour, taste and packaging from the patented drug. Generics are reverse engineered from the original molecule after proving that the drug is (a) bioequivalent (does the same job inside the body as the original) and (b) biostable (shelf life will be same under similar circumstances).

Within developed markets, the US is the largest—with pharma sales of over USD330b, of which, patented sale is cUSD240b and generic sale of cUSD70b. Generics are launched when patents expire, which results in c50-90% price erosion; and first-to-launch companies (after each product and facility is approved by the US Food and Drug Administration, or FDA) fight for market share.

Between 2000 and 2013, patents worth over USD100b were set to expire. In 2002, Ranbaxy's exclusive filing for Lipitor, the largest drug in the world, inspired many companies to consider this opportunity seriously. Majority of the off-patent opportunity was in the single-molecule space, which required relatively less investment and R&D. Consequently, Indian exports of pharmaceutical products catapulted from cUSD2b in 2003 to cUSD15b by 2013—20% plus CAGR.

By 2013, India's exports to the US were close to USD4b (of the cUSD60-70b imported, but the market share in some generics crossed 40%) and US FDA inspections, which till now were largely announced beforehand, started becoming surprise ones. Whether FDA got more serious, or Indian companies got more lax, the number of warning letters (a warning letter stops new approvals, but export of existing products can continue) to Indian companies increased dramatically (in 2013, eight warning letters were issued, compared to cumulatively ten over 2008-12 – peaked at thirteen in 2017). After warning letter is issued, companies typically spend on procedural changes and consultants, which increases costs at a time when growth from new products is absent. This was the first set of challenges for Indian companies.

The next one came from pricing pressure, which resulted first from: (a) rising approvals, especially to relatively smaller players) from the FDA, and (b) channel consolidation. The total number of approvals for new products increased dramatically from c420 in 2013 to almost c820 in 2018—almost entirely to players previously considered outside the top-20 exporting companies to the US. This resulted in a much faster fall in prices of generics once the molecule went off patent. Second, the sourcing channel in the US started consolidating with the top-three players accounting for more than 90% of generic purchases. Naturally, the seller industry was much more fragmented and lost pricing power and lost it fast. Over the past three years, sales per marketed product in the US have declined 30%. The above factors resulted in consensus earnings estimates being cut between 3% and 52% for FY17, and between 1% and 72% for FY18. Ergo, the fall of pharma equities from their highs is not surprising.

Now, companies operating in this space seem to have learnt from experience, they have automated their plants wherever possible and improved the compliance to cGMP Regulations. Although the number of warning letters has reduced to just five in CY18 (thirteen in CY17), the number of import alerts has increased (to eleven from five). In addition, Teva—the largest supplier of US generics with 15% market-share announcing that it will exit 80% products identified as unviable raises hope that the pricing fall will be arrested sooner rather than later.

Nevertheless, current challenges are different. Over the next four years, over USD100b worth of products will go off-patent (higher than USD75b in the past four years). The challenge is in the mix—small molecule products, which formed c75% of the off-patent opportunity in the past four years, will now form only a little over 35% over the next four years.

A predominant part of the opportunity will comprise inhalation, biosimilars and complex generics—an area which traditional Indian pharma companies have not serviced. Over the past few years, Indian players have started investing heavily in finding their niche in the changing environment. The return on capital employed (excluding domestic business) fell to c7% in 2018 compared to a peak of c22% in 2014). While companies have been guiding for sustained high R&D spends, products off-take in the new segments (complex and specialty generics) has failed to meet analysts' expectations, for now.

Moreover, changing business models too are throwing up challenges. In 2018, a consortium of hospitals founded Civica Rx, a not-for-profit generic drugs company. The idea was to combat shortage/high prices of generic injectable drugs. Since then, Civica has expanded its network to 800 hospitals. It will initially work with generic companies (bulk purchase and CRAMs) and later intends to file its own ANDAs (build manufacturing plants and become self-sufficient). This model is a fairly new concept, which could potentially act as a disruptor. At this juncture, we are not even getting into the debate between chemical-based one-solution-suits-all treatment increasingly moving into biologics and genetic-based solutions (that are individually developed to suit the need of one patient or a group of patients).

Analyst's recommendations compiled by Bloomberg still tilt towards BUY (54%, 191 BUY of total 355 recommendations), indicating a positive bias towards the sector. Optimists argue that the valuations have sufficiently corrected to incorporate known risks. With generic companies (Teva) moving out, bargaining power of the rest of the pack has improved after having seen sizeable pricing corrections over the past few quarters. Also, companies have learned from past FDA issues and the situation will get only better here on.

All these arguments are fair. But we are not yet convinced that the value at which the market is offering these businesses sufficiently discounts the sustainable move of the business to lower return ratios. While we are watchful, we currently have no ownership in the Indian pharmaceutical space.

Adding *banks at the cost of NBFC – Separating the Men from the Boys*

Over the past three months, among our top additions has been State Bank of India (SBI, market-cap INR3.2t) and IndusInd Bank (IIB, market-cap INR850b) and we have exited M&M Financial Services (MMFS, market-cap INR780b) and Shriram Transport Finance (SHTF, market-cap INR245b).

We had detailed our views on crises in the NBFC sector triggered by the collapse of IL&FS Financial Services (see here) in our December 2018 investors' memo. Going into the crisis, we had no direct exposure to any Non-Banking Finance Company (NBFC) – and as of writing this newsletter, we have ownership in only CanFin Homes (market-cap INR47b) in the Housing Finance Companies (HFC) space; whereas our exposure to banking equities has steadily increased over the past few quarters.

It has been a little over six months since the crisis became public, and the situation has already changed quite dramatically. Between March 2015 and August 2018, mutual funds had contributed in excess of 40% incremental financing to NBFC/HFC to become the second largest financing source for the industry (after banks and taking over insurance/pension sector). However, the crisis, following the rating downgrade, forced many mutual funds to mark down the Net Asset Values (NAV) of several of their funds that had lent to NBFC. Following this, investors realised that debt funds do not generate higher returns sans risks, and they started redeeming their money from these funds.

Cumulatively, mutual funds have withdrawn over INR1t (c20% of their exposure) in less than six months from this space. From being majority providers of incremental capital to NBFC, they started redeeming their money. The largest brunt of this was borne by wholesale funded NBFCs (mutual funds withdrew 35% versus August 18) and other than the top-2 HFC (exposure down 70%). This has not only led to slowdown in growth rates of these businesses, but with the stark differentiation in funding profile, it could also reflect in asset quality over the next few months. The boys have clearly been separated from the men.

The saving grace, however, has been that headline interest rates have fallen 100bps from highs. Nevertheless, funding rates for most of these companies have not come off as risk aversion has resulted in almost 130bps spread between 10-year AAA paper and g-Sec. Not only are banks regaining market share they had lost to NBFC over the last four years, but they are also getting a higher rate for their lending. Overall, it is advantage corporate banks.

India's central bank, the Reserve Bank of India (RBI) in June 2019 released new norms for resolution of bad loans (Non-Performing Assets, or NPA), which put into effect several checks and balances in recognition and resolution of NPA. Chief among them are that defaults must be recognised within 30 days and lenders have to report credit information on all borrowers having aggregate exposure of INR50m or more. Now, Indian banks are coming off a cycle where a large part of NPA has been recognised, resolution has been initiated in many cases and hopefully banks have learnt their lessons. And the market has handsomely rewarded those banks which have consistently reported low NPAs. Their valuation multiples are far higher than the sector as prudent managements have garnered disproportionate share in investors' mind and wallet share.

In our view, the worst of NPA recognition is behind. Majority of the stress in the system has already been identified and taken in books. Incremental areas of potential stress could be in the form of construction/builder financing as NBFC/HFC withdraw financing. However, its quantum is largely known in the banking sector today. If our assessment is accurate, that combined with the fact that the reporting system has now become strong enough to detect early delinquencies, banks with relatively inferior NPA management records could become interesting businesses to own. The Street does not completely trust that banks have fully and adequately reported existing NPAs in their books, reflected in them trading at much inferior valuations vis-à-vis peers.

Performance of IIB's stock over the past one year has been affected by exposure to stressed loans (3% of advances) and sharpening market focus on its concentrated fee income. Though management has made disclosures to that effect, the stock has corrected over 30% in the past year. Although IIB is largely a retail franchise and does not fit in to our 'advantage corporate banks' thesis; we still invested in the business, as we believe that the Street is overly concerned about its bad loans. With the acquisition of Bharat Financial Inclusion (BHAFIN), India's largest micro-finance company, IIB has strengthened its already strong asset side of the balance sheet. Despite elevated credit costs (as IIB recognizes already reported stressed assets in its books), we expect its consolidated return on equity (ROE) to rise to c20% by FY21. If that turns out to be true, IIB at our acquisition cost is trading at little over 2X adjusted book, quite attractive for a retail franchise like IIB.

Fast food over bicycles; the Broken Window Fallacies and Growth delusion

'One of the basic tenets of our economies is that, if you cannot put a dollar sign against it, it does not exist'
'The fact that an economy is growing tells you nothing about what is happening to the distribution of wealth'
'At the peak of the insanity, the three main banks' assets were worth 14.4 trillion krona, or an astonishing ten times Iceland's national income'
'In fact, there are really only two ways to produce economic growth as we now measure it. One is to add people. The other, usually achieved by investing capital, is to raise productivity by getting those people to work more efficiently'
'If you torture the data long enough, it will confess to anything' ***Ronald Coase, Nobel laureate***
Quotes from the book – *The Growth Delusion (except those specifically attributed)*

During the quarter, we came across a quite counter-intuitive line of thought. Social media has attributed it to the CEO of an international banking corporation, but we could find no direct reference of that. The story concluded that a cyclist is a disaster for a country's economy as she does not buy cars, or insurance, or fuel, or repair services and is healthy (therefore, needs doctors and hospitals less frequently). As opposed to that, a new fast food outlet supports working staff, cardiologists, dentists and weight loss experts. Essentially, more the cyclists we have, the economy is worse off, and vice-versa.

We initially laughed it off (certainly a fast-food outlet that does little for nutrition cannot be better than cycling; can it?), until we came across a book by *David Pilling* titled *The Growth Delusion —The wealth and well-being of nations*. David is the Africa editor of the Financial Times (FT). He was previously Asia editor and formerly Tokyo Bureau Chief for FT from January 2002 to August 2008; he writes about business, investment, politics and economics.

We talk more about the book later in the memo. But our thoughts were that this is a classic case of the *Broken Window Fallacy*. The expression was coined by the French economist Frederic Bastiat to make his point that destruction does not benefit the economy. In Bastiat's tale, a man's son breaks a pane of glass, and the man will have to pay to replace it. Onlookers tell the man that his son has done a community service as he will have to pay the glazier (window repairman), and the glazier will spend the extra money on something else, thereby jump-starting the economy. Bastiat highlights the fallacy in this argument—the broken window has reduced the father's disposable income , precluding him from purchasing shoes and some other luxury goods, which would have had the same effect on the economy had the glass not been broken.

Now as we overlay the Broken Window Fallacy on our cyclist versus fast food outlet's story, things start becoming clearer. Yes, a fast-food life pays for a wide array of pharmaceuticals and doctors, but that ends up leaving lesser disposable income in the hands of individuals or governments (whoever pays for the healthcare bill) to spend on other areas. This is even before considering that this logic only supports economic growth in the way we have learnt to define GDP (David argues that GDP captures only a narrow slice of reality).

Consider this—last year, the US spent over 17% of GDP on healthcare, an estimated USD3.5t. In comparison, Germany & France spent c11%, Japan c10% and China c6%. If the US could pare healthcare costs to levels in other developed markets (by maybe getting more people to go cycling), it will be able to invest close to USD1.5t in other areas. To offer some perspective, the saving alone is more than half of India's GDP.

Another case of a Broken Window Fallacy was when the Delhi government announced free travel for women on all Delhi Transport Corporation cluster buses and metros. The move is expected to cost the government cINR16b p.a. Delhi government already subsidizes electricity, which costs the government INR18b p.a. We note that residential power is already cross subsidized by commercial and industrial users. In addition, there is INR2.5b subsidy on providing free water (besides INR51b as budgetary support to Delhi Jal Board for plan and non-plan expenditures).

Note that these subsidies aren't offered to people truly in need of it (like free travel for all will certainly include women who can pay for the tickets). The three subsidies total to INR37b, which when compared to total capital outlay (expenditure which leads to creation of assets) of INR42b amounts to a staggering number. That sum could have arguably been used to increase the bus fleet size (on which Delhi government plans to offer free rides to women), which has fallen from 6,197 at March 2011 to c3,500 currently.

David writes in his book that; *"to this day sizing up an economy remains primarily an extrapolation of survey data, not a summation of gathered facts"*. Growth of an economy, as measured by GDP, simply put, is the sum of the value of all goods and services produced within a country's territory without allowing for wear and tear. While the insight that the economy is 'made up' is no longer new, David introduces us to China's accountants struggling to scrub numbers of lethal pollution, or how Nigerian economists developed heuristics to gauge the absolute size of the economy based on satellite imagery from outer space to record the intensity of lights at night (they noticed a close correlation between economic activity and corresponding change in light intensity).

Even if we set aside the thought that not all growth is good (for instance, if it leads to rising income disparity {the rich getting richer and vice-versa} or if it results in insanity on how entire countries {read Iceland at the peak of the global financial crises} change their way and reason of existence), the fact that growth as measured by GDP only includes activity that carries a monetary value is troublesome for a country like India.

For example, a Japanese housewife cooks her ageing father-in-law meals, helps him in & out of bed, washes his clothes – none of her efforts counts toward the economy. However, if she does the same for someone else's father-in-law – and earns a wage, it contributes to the national income. This creates problems for a country as complex as India where people in rural India end up doing a large part of work themselves.

Now, notwithstanding the flaws that the calculation of GDP itself has, the former Chief Economic Advisor to the Government of India, Arvind Subramanian released a working paper on India's GDP mis-estimation—essentially stating that India's GDP growth, between FY12 and FY17, has been over-estimated (at mid-point of the range with 95% confidence interval) by 250 bps (official estimates are at 7%). In order to arrive at the conclusion, his team chose seventeen 'real' indicators that have strong correlation with GDP growth for 2001-17.

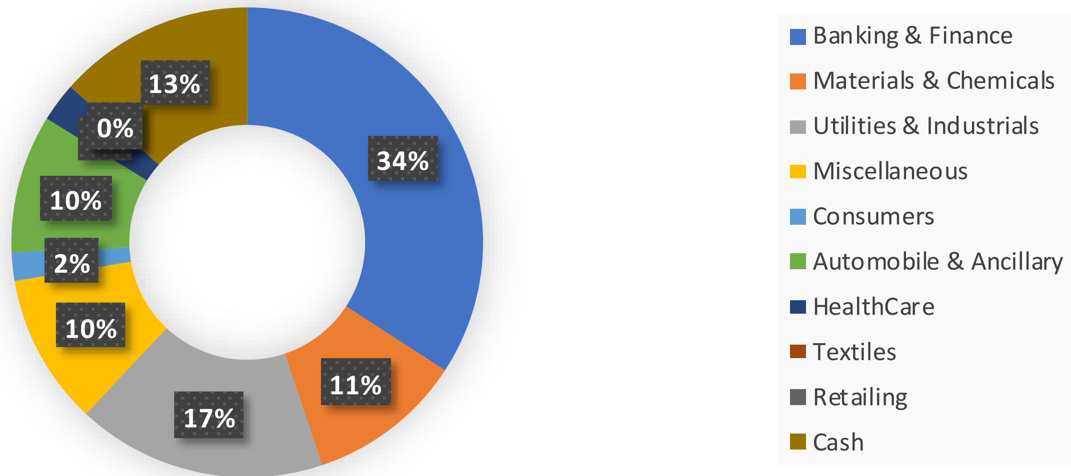
In layman's terms, the paper essentially says that if GDP growth was 'X' during FY02-12 and these indicators reported a certain number, then - if the correlation holds, GDP between FY11-18 should have been 250bps lower than the official data. There have been several counter opinions over the past few days, as to why Arvind's paper is incorrect. Given the political ramification of such claims, the ruling government (through its Economic Advisory Council to the Prime Minister) has also issued a point-by-point rebuttal to Arvind's paper.

Our take is slightly different. We concede that we do not possess the requisite understanding to evaluate the econometric analysis run by Arvind's team. However, for the sake of argument, let's agree that it is correct. Nevertheless, from an investment standpoint, we believe majority of what is stated in the paper is irrelevant.

First, just because something has happened in the past does not lead us to conclude that it will keep happening in the future as well. Just because the variables have fit in the data-series in the past, does not mean that we question validity of the current data-series if the variables do not match. Just because Indian pharma companies have, over the previous decade, gained market-share in the US, we do not automatically assume they will continue to do so going forward. For us, cyclicality in the business is a material part of analysis—and cyclical businesses (irrespective of how long their cycles are) do not go beyond a certain weight (rather, a range) in the portfolio.

Second, among beliefs core to our investment philosophy, one clearly is that we cannot know the macro-future (economics, markets or geopolitics) with any reasonable certainty. That is not to say that the macro-variables do not matter but mining them as an investment edge is nearly impossible.

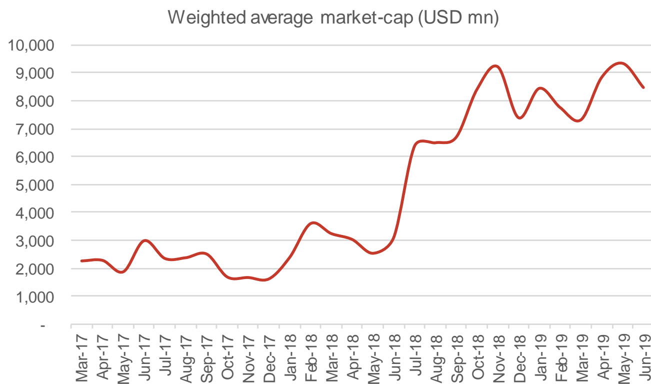
Portfolio composition and top holdings

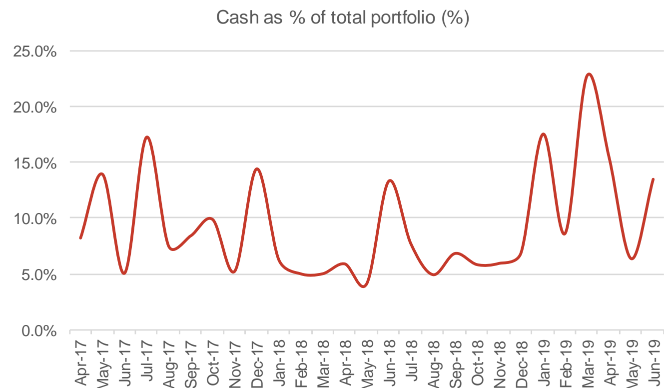


Top holdings

ICICI Bank, State Bank of India and Welspun Corporation

Weighted average market-capitalization and cash percentage





Buoyant Investors: Thank you!

As always, we would like to thank all of you for your investment and partnership with Buoyant Capital. Your collective belief in our ability to make right investment decisions, your support and patience at testing times and your overall emotional stability are extremely valuable to us. We wish and hope for our continued and lasting partnership in the coming times.

Regards,

Jigar Mistry, for Buoyant Capital

Disclosures

Average returns are calculated across all the client accounts based on underlying data provided to us by Kotak Mahindra Bank's Fund Accounting team – the designated fund accounting partner. Returns are not audited. Individual returns will differ from the average returns presented in this note depending on the composition of portfolio, timing of deposit, withdrawals and fee structure specific to each account. Please contact either of us with any questions about your statement, returns, fees or anything else related to your account.

Portfolio Turnover Ratio is the percentage of a fund's holdings that have changed in a given period. This ratio measures the fund's trading activity, which is computed by taking the lesser of purchases or sales and dividing by average monthly net assets. Brokerage ratio is the total brokerage paid (excluding securities transaction tax) and dividing it by average monthly net assets.

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Any description involving investment examples, statistical analysis or investment strategies are provided for illustration purposes only – and will not apply in all situations and may be changed at the discretion of principal officer.

Certain information has been provided and/or based on third-party sources and although believed to be reliable, has not been independently verified; the investment managers make no express warranty as to its completeness or accuracy, nor can it accept responsibility for errors appearing herein.

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