BUOYANT | BUOYANT CAPITAL PRIVATE LIMITED

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Letter to investors: Update for nine months ended Dec 31st, 2017

Dear Investors,

For the nine months of the year through December 31st, Buoyant PMS portfolio* gained 66.8% net of applicable fees. The Nifty-50 Index returned 15.9% and BSE 100 Index returned 17.3% during that time, including reinvested dividends.

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

Total uncompounded return (%)	Buoyant Portfolio*	Nifty 50 Index	BSE 100 Index	BSE 500 Index
Year to date (Apr17 - Dec17) (note a)	66.8%	15.9%	17.3%	19.9%
Last twelve months (Jan17 - Dec17) (note b)	106.4%	30.3%	33.3%	37.6%
Since inception (Jun16 - Dec17) (note b)	106.5%	31.5%	36.1%	42.1%

Source: Bloomberg for NIFTY 50 Index, BSE 100 Index and BSE 500 Index total returns
Note a: Apr17 to Dec17 returns are after deducting management fees for 9mFY18
Note b: Jan17 to Dec17 and Jun16 to Dec17 returns are after deducting management fees (for FY17 and 9mFY18) and performance fees (for FY17)
** See disclosures at end on how Buoyant Portfolio returns are calculated. Since inception returns are absolute, and not annualized*

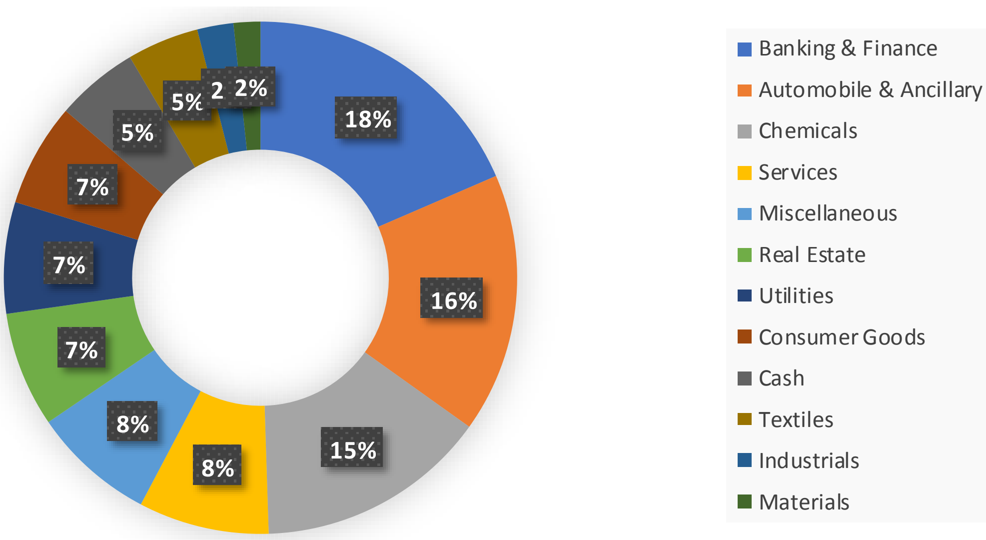
Buoyant's average cash position for the nine months stood at c9%. As mentioned in the disclosures on page 7, the composite performance is average across all client portfolios and individual returns may differ from the average reported above due to variations in holdings, the time when the account joined Buoyant Portfolio and other client-specific circumstances. Your individual account statements should have arrived by email to your addresses by now. Please get in touch with either of us regarding any questions that you may have.

At our core, we have consistently believed in running a concentrated portfolio—investing in businesses that we understand and firmly believe in, and which are available at valuations that we consider are below their fair value, irrespective of the levels of broader indices. Since inception, we have continued to own an average of ten (10) to twelve (12) businesses in individual portfolios.

For the nine months, Buoyant's portfolio turnover stood at 0.47 times (including businesses we churn out of, when we inherit an investor's portfolio) and total brokerage paid stood at 0.017% of average portfolio (see disclosures on how portfolio turnover and brokerage paid ratios are calculated). We believe the low turnover and brokerage ratio is reflective of our belief in the buying quality businesses and holding them. The weighted average market capitalization of the businesses in Buoyant portfolio as of December 31st, 2017 stood at USD1.8 billion (or, INR105.5b)

Portfolio composition

Our largest holdings are in the Banking & Finance and Automobile & Ancillary sectors; while we have chosen to have no exposure to Pharmaceutical, Information Technology and to public sector banks (within Banking & Finance) over the last nine months.



What have we added over the last quarter?

Security and Intelligence Services (India) Limited (SIS, Market capitalization cUSD1.4b)

'A hugely profitable investment that doesn't begin with discomfort is usually an oxymoron.' Howard Marks

SIS is the second largest and largest provider of security services in India and Australia respectively. In addition, it also provides cash management and facility management services in India. SIS interested us for the following reasons:

(a) With police force density in India being much lower than other emerging markets (1.4 police-men in India per 1000 people vs 3 in emerging markets), there is a sizable market for providers of security services,

(b) The security services market is rather fragmented, with organized operators forming just 30% of volumes. With more stringent enforcement of labour laws and with introduction of GST, we believe that the organized players will gain market-share over non-organized players, and

(c) SIS has a pan India scale and presence in multiple locations, which we reckon is its unique edge. Seekers of security service are looking to consolidate vendors across different locations, which allows SIS to (a) increase market-share even among organized players, and (b) acquire regional players at lower valuations than what markets are willing to pay for a pan India player.

At our average acquisition price for the business, SIS was trading at c23X FY19e consensus net income estimate, which we found attractive given the structural value drivers in the business.

What we are actively avoiding?

The tyranny of consensus

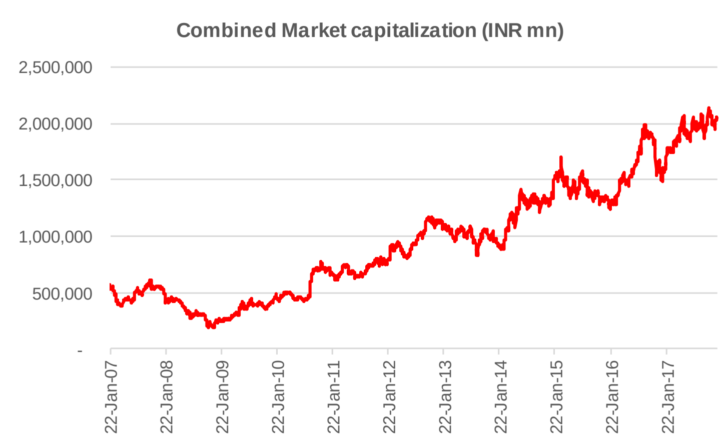
If we told you that we could predict the financials of a sector with complete certainty, and detailed below is how the combined earnings statement and balance sheet of the largest three companies in the sector would look like over the next decade, will you invest in these businesses?

Combined financials of top three companies in the sector	Year-1	Year-5	Year-10	CAGR (Y1 - Y5)	CAGR (Y5 - Y10)	CAGR (Y1 - Y10)
Volumes (million tons)	55	87	95	12%	2%	6%
Revenues (INR mn)	182,870	371,040	443,270	19%	4%	10%
EBITDA (INR mn)	57,480	80,450	80,730	9%	0%	4%
Net income (INR mn)	**40,020**	**47,480**	**42,410**	**4%**	**-2%**	**1%**
Net debt/(cash) (INR mn)	(7,380)	(20,000)	(9,810)	28%	-13%	3%
Free Cash flows (INR mn)	9,581	20,703	28,801	21%	7%	13%
Dividends (INR mn)	9,699	12,718	10,801	7%	-3%	1%
Calculations						
EBITDA margin (%)	31%	22%	18%			
Net income margin (%)	22%	13%	10%			
Dividends payout (% of FCF)	101%	61%	38%			
ROCE (%)	39%	19%	12%			

Note: Free cash flows are before working capital changes and before inter-corporate investments.
Source: ACE Equity, Buoyant Capital compilation

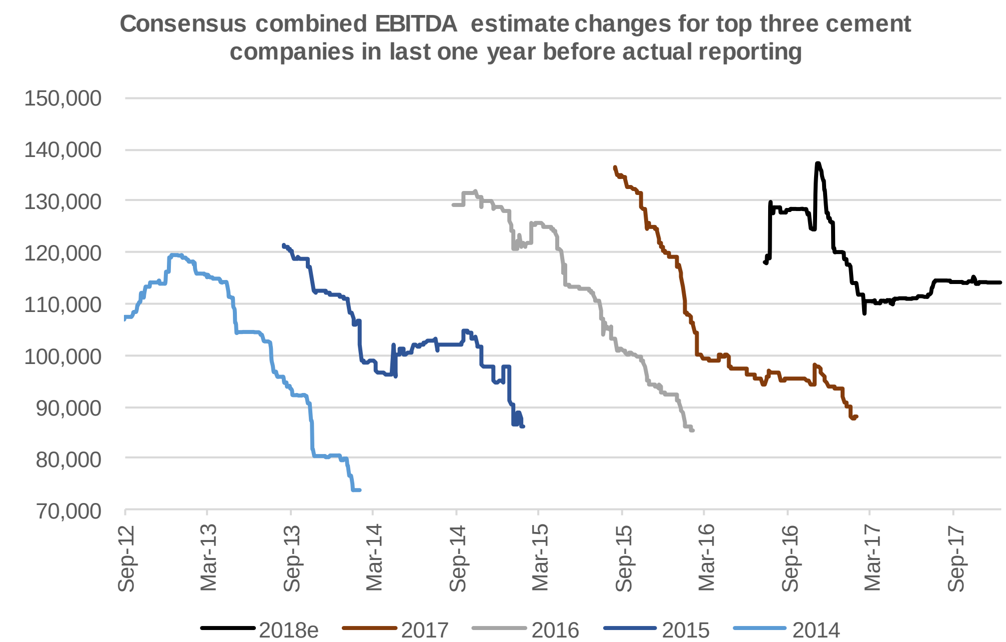
When, in theory, volumes nearly double over a decade, we would expect the operating leverage to kick-in, resulting in a superior EBITDA and net income growth relative to the revenue growth. If the business has pricing power and moats built around, we would expect to return on capital employed (ROCE) to stay higher than cost of capital – failing which, we would expect businesses to aggressively return cash (via dividends / share buybacks) to shareholders.

The table above is the compilation of historical financials of top three cement companies in India over the last decade. Arguably, we would not have invested a decade back, since none of our conditions were expected to be met. We would most certainly have missed the biggest cement bull run in India. The combined market-capitalization of the three top companies increased from USD8.6b to USD30.8b (constant currency terms) in the last decade (a whopping 15% CAGR) – almost entirely driven by re-rating in the valuation multiple (given that net income has been virtually flat).



Markets have managed to concoct many theories to justify this spectacular outperformance. Chief among them are:
(a) It is an exposure to India's infrastructure sector with an added advantage of clean and strong balance-sheet, and/or
(b) Cement is, in fact, a consumer discretionary business, masquerading as a commodity business, and/or
(c) The rate of growth in capacity addition is slowing down, such that incremental demand-supply is tilting towards a balance, thereby affording these businesses the thus-far-elusive pricing power.

While all the above arguments have some semblance of logic to it, we believe that it should eventually get reflected in stronger earnings growth and superior return ratios. As seen in the chart below, for each of the last five years, consensus analyst estimates build strong future growth, only to cut the estimates dramatically as the year progresses. The fact that markets have re-rated these businesses, in absence of earnings growth, confounds us. We do not own a cement manufacturing/distribution business in our portfolio as of this writing. We leave you with the following chart of historical consensus analyst earnings estimate changes over one year before actual results get reported.



Note: 2014 is fiscal year ending Mar-14 for one company and fiscal year ending Dec-13 for the other two companies; and so on for other years
Source: Bloomberg, Buoyant Capital compilation

The "Cocaine Brain", Checklists and just "Better"

'…the intoxicating prospect of making money can arouse the same reward circuits in the brain that are stimulated by drugs, making the rational mind ignore supposedly extraneous details that are actually very relevant. Needless to say, this mental state is not the best condition in which to conduct a cool and dispassionate analysis of investment risk' Guy Spier, The Education of a Value Investor

Among the books that have had a lasting impact on us during the last quarter, was Dr. Atul Gawande's "Better – a surgeon's notes on performance". Atul is an endocrine surgeon in Boston, Massachusetts and a professor at the Harvard School of Public Health. We were first introduced to Atul's writing when Guy Spier, in his book 'The Education of a Value Investor' mentioned Atul's *The New Yorker* article 'The Checklist' as a guide for creating his own investment checklist - to avoid what he refers to as the 'cocaine brain' (the quote above puts the principle in perspective).

When an endocrine tumor surgeon talks about 'performance', we had initially expected the book to be (a) rather technical, and/or (b) an attempt to elevate the profession of a doctor to a noble/godly standard. The book was anything but; it was a genuine attempt at reflecting on the failings and learnings from his profession. The book mentions the three, core requirement for success in medicine as:

- **Diligence**: the necessity of giving sufficient attention to detail to avoid error. It is seemingly a minor virtue (just pay attention!), but most central to performance.
- **To do Right**: Being fundamentally a human profession, medicine is forever troubled with human failing. The solutions/problems/issues are interwoven with human traits.
- **Ingenuity**: a matter of character. A willingness to recognize failure, to not paper over the cracks – arising out of obsessive reflection on failure and a constant search for new solutions.

We could not help, but draw parallels between the world we operate in, and the one that the book refers to. While describing diligence, the book mentions how doctors were, at times, responsible for being hosts for infection to travel from one patient to another. The solution, was, just 'wash your hands'. That, however, proved more difficult than one could imagine. While arriving at an investment decision, we try and stick to our 'checklist' – attempting not getting sucked into in to 'investment flavor of the day/month/year'. It is not that we always succeed in doing that.

In keeping with the concept of 'ingenuity', we wish to recognize a failure that we witnessed as part of our investment process. We had invested in Fortis Healthcare—which operates a high-quality network of about 3,500 beds across 30 facilities, primarily focused on tertiary and quaternary care. It has industry leading Average Revenue per Occupied Bed (ARPOB) and has a leadership position across specialties (such as cardiology, orthopedics and nephrology). As a business, we believe that hospitals have enough room to grow as tier-1 and tier-2 cities in India start acclimatizing to professional medical care. Fortis also owns a controlling stake in a diagnostics business (SRL Diagnostics), whose scale of operations (with four reference labs and over 370 satellite labs) and geographic presence are differentiators. Despite the current increase in competitive intensity in that business, we did believe that organized players will win over the non-organized players over the longer term. When we invested in the business, Fortis was trading at the lowest per bed valuation among all hospitals in Asia, and the announced demerger of its diagnostics business and potential change in ownership of overall legal entity were additional triggers.

However, in a separate case relating to the promoters of Fortis (Japanese drug maker Daiichi Sankyo had accused the promoters of concealing facts when they sold their stake in erstwhile Ranbaxy Labs), the Supreme Court did not allow Fortis to sell their stake in the hospital chain, which forced the share price of Fortis lower. We exited the business when it became apparent to us that underlying value of the business is unlikely to be realized till such time that the Supreme Court case was fully resolved. That, we believed, did not have a definite timeline.

As Atul writes in the chapter 'On fighting', *'…. the hardest part of being a doctor, I have found, is to know what you have power over and what you don't'.* There will always be situations over which we will have no power, but, we hope to have learned from our mistake in Fortis. The learning from this instance helped us refine our checklist further – i.e. to check for related ongoing legislative matters of promoters of the businesses we invest in.

Buoyant Investors: Thank you!

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,

Sachin Khivasara
Director

Jigar Mistry
Director

Disclosures

Average returns are calculated across all the client accounts, and are provided to us by Kotak Mahindra Bank's Fund Accounting team – the designed 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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