Buoyant Capital

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July 05, 2018

Letter to investors: Update for quarter ended Jun 30th, 2018

Dear Investors,

For the quarter ending June 30th, Buoyant PMS portfolio* had a negative return of 4.3%. The Nifty-50 Index returned 5.9% and BSE 100 Index returned 2.9% 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	-8.1%	-0.2%	-0.5%	-1.6%
Last three months	-4.3%	5.9%	4.6%	2.9%
Last six months	-11.9%	1.7%	-0.4%	-3.2%
Last year	27.3%	12.5%	11.5%	10.2%
Last two years - annualized	33.9%	13.7%	14.2%	14.8%
Since inception - annualized	35.6%	14.0%	14.6%	15.5%

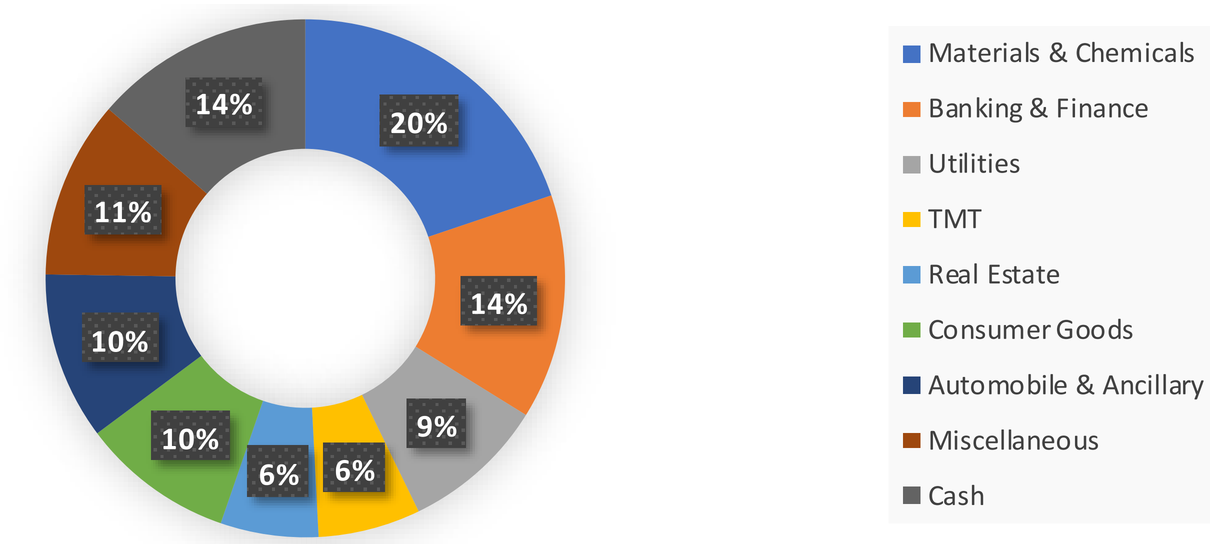
Source: Bloomberg for NIFTY 50 Index, BSE 100 Index and BSE 500 Index. Buoyant Portfolio is pre-fees and expenses
*See disclosures at end on how Buoyant Portfolio returns are calculated. More than one year returns are annualized

Buoyant's average cash position for the quarter stood at c8%. As mentioned in the disclosures on page 9, 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. Your individual account statements should have arrived by email to your addresses by now. Please get in touch with either of us with 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 thirteen (13) businesses in individual portfolios.

For the quarter ended Jun-2018, Buoyant's portfolio turnover stood at 0.18 times (including businesses we churn out of, when we inherit an investor's portfolio) and total brokerage paid stood at 0.082% 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 June 30th, 2018 stood at USD3.1 billion (or, INR213.5b)

Portfolio composition and top holdings



CESC (CESC, Market capitalization cUSD1.7b)
CESC is electricity generation and sole distribution company in the Kolkatta, serving close to three million consumers. It also owns a retailing business and has stake in Information technology business. CESC is in the process of demerging its business into four verticals, which when completed, will result in unlocking of value as investors will have an option to own the only listed profitable distribution business in India as well as a profitable retail business.

Security and Intelligence Services (SIS, Market capitalization USD1.3b)
SIS is the second largest and largest provider of security services in India and Australia respectively. It also provides cash management and facility management services in India. SIS is a recession-proof growth business which should benefit from rising demand of security services in both markets, as well as from stricter enforcement of labor laws and GST in India. Vendor consolidation is also a positive for pan-India player like SIS.

Ramkrishna Forgings (RMKF, Market capitalization cUSD0.3b)
RMKF supplies auto components to OEM of commercial vehicles (CV) in India and exports them to US and Europe. RMKF is a direct play on improving CV cycle in India and that of class 8 trucks in North America. In addition, the recently commissioned facility will allow RMKF to manufacture components with higher complexity, and a resultant enrichment of product mix should improve operating margins. New foray in sectors of Oil & Gas and Railways are added benefits.

What have we added in the last quarter?

ICICI Bank (ICICIBC, Market capitalization cUSD26.2b)

ICICIBC in 2017 was the third largest bank in India in terms of assets and fourth largest in terms of market-cap. If offers a wide range of banking products and financial services for corporate and retail customers – and is specialized in areas of investment banking, life, non-life insurance, venture capital and asset management. We like ICICIBC as we believe that:

(a) ICICIBC's operations have significantly strengthened over the last three years – (a) CASA has improved to 45.6% in FY2018 (vs 39.5% in FY2015), cost of deposits in FY2018 was less than 5% (the lowest in the decade), (b) proportion of retail loans has increased to 56.6% at Mar-18 (vs 39% in Mar-14), (c) concentration of top borrowers has reduced materially and the bank has retained a decent Tier-1 capital adequacy ratio
(b) Incremental focus of the management appears to be in the right direction, with targets to maintain CASA at 45% and proportion of retail deposit at 70%, retail loans at 60%, net NPA at 1.5% and provision coverage at 70%; and
(c) With ICICIBC recognizing USD8b in NPA and providing close to USD4.5b over last three years, we believe that a large part of recognition of NPA appears to be behind us.

Over the next two years, consensus expects ICICIBC's net income to more than double driven by decent NII growth and following lower provisioning. Adjusted for its stake in subsidiaries, ICICIBC trades below book value on consensus FY2020e estimates, which we find attractive.

Gujarat Fluorochemicals (GFLC, Market capitalization cUSD1.2b)

GFLC is India's largest producer of chloromethanes, refrigerants and Polytetrafluoroethylene (PFTE). In addition, it has stakes in film exhibition business (through Inox Leisure) and wind turbine manufacturing business (through Inox Wind), among others. We like GFLC as we believe that:

(a) In its standalone chemicals business, the contribution of value-added products will steadily increase over the next two years, resulting in better profitability. These products find application in pharmaceutical and agrochemicals, which require extensive validations – thereby creating decent entry barriers. GFLC has been investing in additional capacity, which we believe would commercialize by the end of FY2019e. Once commissioned, it will bring incremental revenues, superior profitability and result in stronger return ratios,
(b) GFLC's wind turbine manufacturing subsidiary - Inox Wind has suffered over the last year as industry structure changed from feed-in tariff to auction based tariffs, thereby resulting in historical low wind installations. That, we believe will change in the coming year, allowing Inox Wind to return to profitability, and
(c) GFLC's film exhibition subsidiary – Inox Leisure continues to be a dominant player is a growing business. We believe Inox Leisure will grow revenues and profits over the next few years, as it sets up new screens and expands it foot print

GFLC trades at c21X standalone FY19e PER and c18X FY20e standalone PER, which we find very attractive for a business that we believe is set to fire on all cylinders over the next two years.

What we are actively avoiding?

The alternative to ‘TINA’ (There Is No Alternative) is not to own it

Over the last five years, the equities of three of the largest listed television broadcasters in India have registered a CAGR of c17%. Earnings over that time grew at a CAGR of c12%, implying that close to a quarter of the stock returns were delivered following an increase in historical valuation multiple (which expanded from 32 times to 40 times now).

LAST FIVE YEARS

Revenues growth - 9% CAGR

Post digitization, broadcasters' share of collection increase

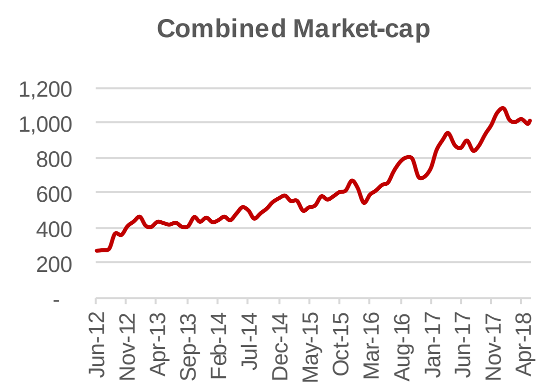
TV advertisement market growth at 12% CAGR

EBITDA - c300bps expansion

Content costs benign; less competition for content

EBITDA margin (%)	
FY2013:	33.7%
FY2014:	33.9%
FY2015:	33.2%
FY2016:	35.6%
FY2017:	34.4%
FY2018:	36.5%

Valuations - expansion of valuation multiples



Number of LCOs - 60,000 (largely unlisted)
Number of MSOs - 1469 (some listed, smaller market-cap)
Number of listed broadcasters - 6 (top three account for 90% of revenues with Mcap of USD15b)

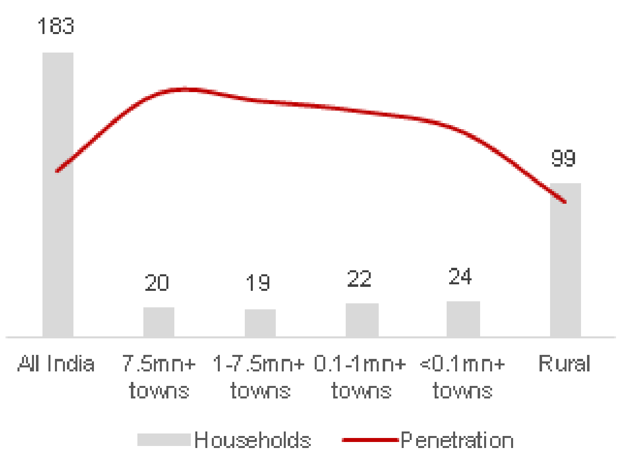
There were good reasons for these businesses to do well over the last five years, viz.

- The mode of delivery of media to households got digitized. In the pre-digitization era, broadcasters used to get between 10% and 20% of what customers used to pay to their Local Cable Operators (LCOs). A massive under-reporting by LCOs went unchecked for years. However, post digitization, that figure has increased to 20-30% as per FICCI-EY report. This resulted in higher subscription revenues for the broadcasters,
- The overall television advertisement revenue increased at a CAGR of 12% during that time-frame, resulting in higher ad revenues for broadcasters,
- Cost structures (especially content costs) were relatively benign, which resulted in expansion of EBITDA margins by close to c300bps over that time-period, and

- Absence of large and quality plays in the entire value-chain (Broadcaster – MSO – LCO) made broadcasters as favourites for investors to play the entire 'digitization' theme. Investors' truly had no other alternative (TINA), which resulted in the expansion of valuation multiples for these businesses

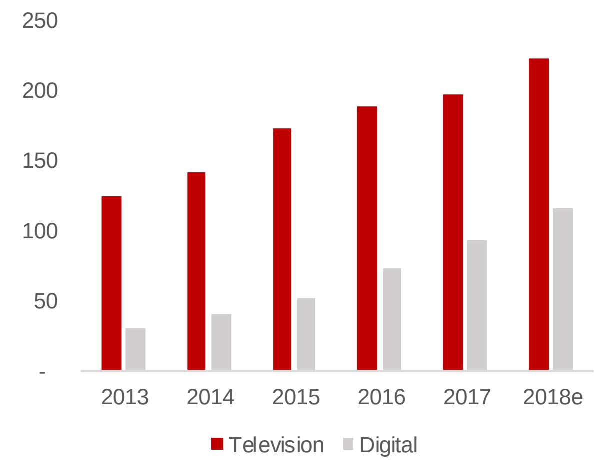
GOING FORWARD

Low rural penetration of TV



Traditionally considered addressable market. But, can access to cheap digital make them consume entertainment directly over hand-held phones?

Digital ad market is still small compared to TV



But 5-year CAGR of Digital at 31% is much higher than that of TV at 12%

Valuations

Factors that will impact valuations going forward

A) Change in landscape

- Digital now commands a higher share of incremental ad spend
- Addressable market might not result in higher revenue growth
- Content costs could increase

B) Regulations to change the contours of pricing game

- Broadcasters to have same pricing across platforms as well as across markets
- Conundrum to keep pricing i) low enough to not lose the tier 3/4 consumer and ii) high enough to not lose profits from tier 1/2 consumer.
- Revenues and margins could be under pressure

We reckon they have limited scope to expand further

Many positives are still in store for these business over the next five years, viz.

- Overall penetration of television in India is still only 64% (52% in rural India), and multiple TV penetration is a meagre 3.4%. There is a case for both numbers to eventually move up
- Although the process of digitization is largely complete, the entire benefit of the same is yet to be delivered to broadcasters, and lastly
- Advertising spend in India is expected to remain high (broadly above inflation), which implies that the ad revenue growth for broadcasters should continue for the next few years.

However, at the margin, several challenges are starting to emerge:

- Regulation could change the contours of the pricing game for broadcasters. India's Telecom regulator (TRAI) in its recent tariff order, inter-alia proposed that broadcasters charge the same fee across distribution platforms and markets. Currently, the per-user revenues (ARPU) in tier-4 market is half that of tier-1 markets. In addition, broadcasters currently charge differential fees even across platforms (cable vs DTH). The order is yet to be notified, and the on-ground execution remains challenging given the current last-mile infrastructure. But, over time, this regulation creates a large conundrum for broadcasters as to the pricing of their channels. They must keep it low enough so as not to lose the tier-3/4 customers, and high enough so as not to lose the revenues from tier-1/2 customers. We think this will eventually create some pressure on revenues for broadcasters, and
- The landscape is changing yet again, and this time, the change could be rather disruptive. The onslaught of digital access at cheap costs will certainly change the medium of delivery of entertainment over time. This has multiple implications:
    - A) The ad revenue growth for the television as a medium could slow. Television ad market is twice the size of digital market today, but digital market has had a much faster growth (Last 5-year CAGR of 31% for digital vs 12% for TV),
    - B) What is currently considered as the addressable market for TV could easily slip. Households that currently do not have access to TV could start consuming entertainment directly over the digital medium via hand-held phones instead of moving up what is considered as the typical value chain, and
    - C) Content costs should increase, resulting in a pressure on operating margins. Traditionally, the broadcasting companies were the only consumers of content. Over-The-Top (OTT) medium now has clearly emerged as a legitimate competitor – fighting for content from the same providers.

Given the changing dynamics of the sector and the uncertainty that it presents, we are not of the opinion that the valuation multiples have limited scope to expand further. Consensus earnings estimates already build c20% CAGR in earnings over the next two years, which could be challenging in the evolving landscape. We do not own any media broadcasters in the Buoyant portfolio.

Science of expertise, 'feedback loop', and the 10,000-hour rule

'This is a fundamental truth about any sort of practice: If you never push yourself beyond your comfort zone, you will never improve'
'Call it 'the New Year's resolution effect' – it's why gyms that were crowded in January are only half full in July and why so many slightly used guitars are available on Craigslist'
'In all of my years of research, I have found it is surprisingly rare to get clear evidence in any field that a person has reached some immutable limit on performance. Instead, I've found that people more often just give up and stop trying to improve'
Anders Ericsson quotes

Among the books that had a lasting impression on us during the quarter was Anders Ericsson's '*Peak – Secrets from the new science of expertise*'. Ericsson is a Swedish psychologist and Professor of Psychology at Florida State University – who is internationally recognized as a researcher in physiological nature of expertise and human performance. *Peak* was released in 2016 and had been residing in our library for a long time. We are thankful that we eventually got around to reading it. *Peak* essentially debunks the concept of prodigies or innate abilities and puts forth empirical and scientific evidence on how expertise was achieved by people who became extremely successful in their chosen fields.

Malcolm Gladwell, in his bestselling book, '*Outliers*' mentioned the 10,000-hour rule, claiming that the key to achieving world-class expertise in any skill, is, to a large extent, a matter of practicing the correct way for a total of 10,000 hours. *Outliers* cited several examples to back the thesis, but his work was essentially built on Ericsson's white papers. Nevertheless, it made the 10,000-hour rule very famous.

Peak disputes the findings in *Outliers* and suggests that in order for practice to lead to expertise, it needs to be a 'deliberate practice' (one that pushes you out of your comfort zone and involves feedback and focus) – as opposed to naïve practice (which is generic, with mindless repetition). The book is awash with fascinating examples of people that have pushed their bodies and brains to achieve results which are simply mindboggling, like

- The twenty-four kids enrolled in Ichionkai Music School in Tokyo developed a perfect pitch after a completed training, while in normal circumstances, only one on every ten thousand people have a perfect pitch, or
- How Charles Servizio of United States set the world record by doing 46,001 push-ups in 21 hours and 21 minutes in 1993, or
- How Marc Lang of Germany set the current record of forty-six simultaneous 'blind-fold' chess games (where you essentially memorize the boards and play the game without looking at it) and losing only two games.

For practice to be purposeful (which eventually becomes deliberate practice when it is guided and within a well-developed field), it (a) has well-defined, specific goals, (b) is focused, (c) involves feedback and (d) requires getting out of one's comfort zone. We could corelate to it reasonably well when applying the principles at a personal level but faced a certain conundrum when applying the findings to a professional setting – especially while dealing with the feedback mechanism.

While applying the feedback mechanism on investing, we believe that choosing where to take feedback from becomes a crucial decision. **Markets are notoriously bad at giving feedback**. William Miller, the former CIO of Legg Mason Capital Management once said that *'Great investors are not unemotional but are inversely emotional – they get worried when* *the market is up and feel good when everyone is worried'.* We had also written in our Mar-2018 memo that… "*The behavior of the markets does not represent the opinion of majority of its participants, but only that of the most desperate buyer/seller. This makes the markets irrational over the shorter term; whereas portfolios return (when viewed from a short-term time frame) is 'fragile' to such heightened bouts of volatility*".

What we do take feedback from is by comparing whether the activities on the ground (on whatever frequency that the get reported) **match up to the investment thesis we first enacted**. One of the businesses that resulted in negative returns between Jan and Jun-2018 is Bhansali Engineering Polymers Limited (BEPL, we had written about our investment thesis on the name in our Sept-2017 newsletter). Amidst turbulence in the market, BEPL got sold off and corrected 47% (peak to low) because of a fire in one of its facilities (which resulted in a production/profit loss of a month). Our interactions with several intermediaries suggested that, other than the fire, it is business as usual for the industry as well as for the company. We decided to not only stay put with our investments, but also, add to our investments – a 47% discount for a potential loss of one month's profit (and that is assuming that the production cannot be made good over the rest of the year) seemed too good to pass on.

Likewise, we do own a few businesses that are currently resulting in negative returns, but we continue to own them because we believe that our initial investment thesis still holds good, irrespective of the feedback that the market has been providing. Nevertheless, there were instances when our investment thesis does not play out as we had anticipated and one such mistake we committed was in buying Castrol. In the decade through CY2015, volumes for Castrol had been shrinking at a CAGR of c2%, driven by lengthening drain intervals [Castrol is the market leader in automotive lubricants (which is c55-60% of the overall lubricants industry) with 20% plus market-share]. Nevertheless, Castrol's per unit EBITDA margin grew at c19% CAGR driven by focus on passenger vehicles, creating a strong brand with pricing power as well as premiumization. A strong net income CAGR of c17% and 75% dividend payout ratio resulted in elevated valuation multiples. We bought into Castrol when we believed that volume growth could be materially higher given that the drain intervals had peaked and industrial usage was accelerating. Indeed, Castrol's volumes over CY2017/15 grew at 3.6% (a positive number). However, given intensifying competition amidst rising base oil prices curtailed expansion of per unit EBITDA margin to just 3.7% CAGR and growth in net income slowed to just 6%. We sold Castrol when it became apparent to us that higher valuation multiples are not sustainable for businesses with a single digit net income growth.

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,

Sachin Khivasara	Jigar Mistry
Director	Director

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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