Buoyant Capital

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April 05, 2018

Letter to investors: Update for year ended Mar 31st, 2018

Dear Investors,

For the fiscal year ending March 31st, Buoyant PMS portfolio* gained 46.8% net of all fees. The Nifty-50 Index returned 11.8% and BSE 100 Index returned 12.1% 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 returns (%)	Buoyant Portfolio*	Nifty 50 Index	BSE 100 Index	BSE 500 Index
Last three months (Jan18 - Mar18) (note a)	-8.5%	-2.7%	-3.8%	-5.1%
Last six months (Sept17 - Mar18) (note a)	15.9%	3.9%	3.8%	4.2%
Last twelve months (Apr17 - Mar18) (note b)	46.8%	11.8%	12.1%	13.2%
Since inception - annualized (Jun16 - Mar18) (note b)	44.9%	14.6%	16.4%	18.7%

Source: Bloomberg for NIFTY 50 Index, BSE 100 Index and BSE 500 Index total returns

Note a: Jan18 to Mar18 and Sept17 to Mar18 returns are after deducting management fees for respective periods

Note b: Apr17 to Mar18 and Jun16 to Mar18 returns are after deducting management fees as well as performance fees for respective periods

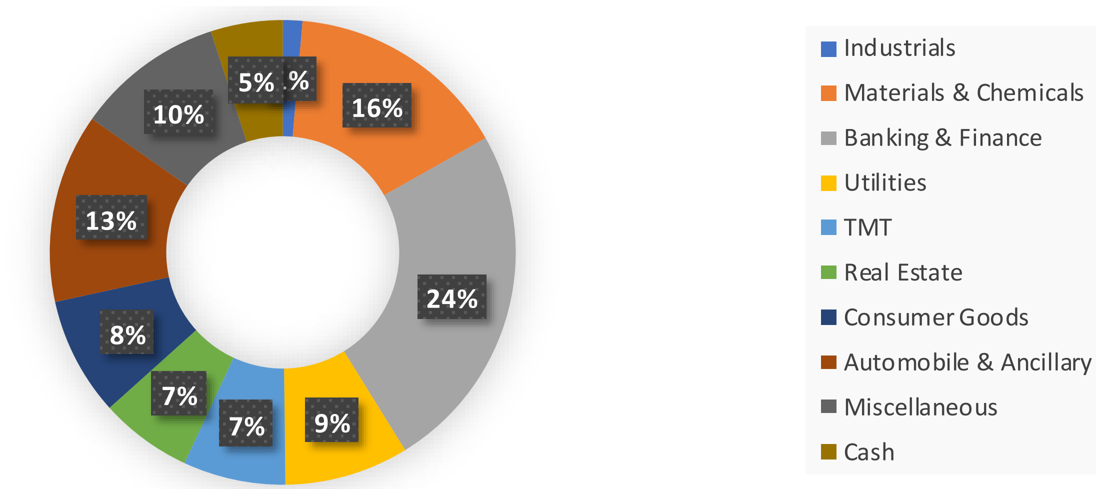
* See disclosures at end on how Buoyant Portfolio returns are calculated. Since inception returns are annualized

Buoyant's average cash position for FY2018 stood at c9%. 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 twelve (12) businesses in individual portfolios.

For FY2018, Buoyant's portfolio turnover stood at 0.57 times (including businesses we churn out of, when we inherit an investor's portfolio) and total brokerage paid stood at 0.018% 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 March 31st, 2018 stood at USD3.2 billion (or, INR208.6b)

Portfolio composition and top holdings



Top holdings are in alphabetical order

Bharat Financial Inclusion (BHAFIN, Market capitalization USD2.3b)

BHAFIN is a NBFC engaged in providing microfinance loans in India. It is currently in the process of merging with IndusInd Bank (IIB) and has received the approvals from RBI and CCI (approvals from SEBI, Stock exchanges and minority shareholders are still pending). IIB is a leading private sector bank with strong earnings track-record, stable asset quality, improving CASA franchise and an impressive growth in retail loan book.

CESC (CESC, Market capitalization cUSD1.9b)

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.

Ramkrishna Forgings (RMKF, Market capitalization cUSD0.4b)

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.

Security and Intelligence Services (SIS, Market capitalization USD1.2b)

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.

Shriram Transport Finance Company (SHTF, Market capitalization cUSD5.1b)
SHTF is India's largest financer of commercial vehicles with over 1000 branch offices. SHTF also is a play on the improving CV cycle in India. In addition, the shift that is currently underway to higher tonnage vehicles should result in higher ticket sizes and the ongoing ramp-up of branch/field offices should support stronger growth for SHTF. Lastly, despite rising bond yields, NIMs for SHTF should remain stable given its pricing power in the niche used CV space.

What have we added in the last quarter?

Hindustan Zinc (HZ, Market capitalization cUSD19.5b)
HZ, a subsidiary of Vedanta Limited, is the second largest integrated producer of zinc in the world and among the leading producers of lead and silver globally. We like Hindustan Zinc as we believe that:

(a) HZ's exploration program is very robust. Despite having mined c47 million tons of ore in the last five years, its R&R has increased during that time. That is a critical and sustainable growth measure for a mining business,
(b) Zinc's spot treatment charges (TCs) have fallen from over USD200/t in 2015 to close to USD20/t ytd-2018 (low TCs indicate impending tightness in concentrate market). This should bode well for zinc price going forward; and
(c) HZ's intends to achieve mined metal production of c1.2 million tons by 2020 from c0.9mt currently. Higher production at the time of tight concentrate supply should result in higher profitability for HZ.

HZ trades at c11.2X FY19e PER and c7.3 FY19e EV/EBITDA - higher than other commodity businesses in India. However, HZ's top quartile cost position (among lowest costs in the world) allows HZ to generate strong return ratios (last 20 years ROE average over 25% and median over 20%). That and a positive zinc outlook should result in elevated multiples of HZ.

Tata Motors (TTMT, Market capitalization cUSD16.0b)
TTMT is a global manufacturer of cars, sports vehicles, trucks and buses; and sells them in Indian, US, UK and European markets among others. TTMT has corrected over 30% from its one year high on the back of (a) a string of weak quarterly results and (b) the recent slow-down in JLR's global wholesale volume growth. We like TTMT as we believe that:

(a) JLR would continue to grow volumes following its strong launch cycle and benefit from the market shifting in favour of SUVs (where JLR has a larger share) and owing to its premium portfolio. We see the recently slowing volume growth as an outcome of one-off supply and some technical issues (software recalls)—that should get resolved over the next two months,
(b) JLR's EBIT margin has room to expand (from 4% in FY18 to close to double digits, which is the management's target). JLR's fixed-cost-per-car has increased despite rising volumes as it has invested ahead of time. With higher volumes, we believe that operating leverage would kick in resulting in higher margins, and
(c) TTMT's domestic business could finally turn around led by (i) strong volume growth in India's CV markets (TTMT is showing signs of improving market-share) and (ii) management's effort to cut costs would start showing in higher profitability. After four years of losses, TTMT's India business could report a positive net income in FY19.

TTMT trades at c8.2X FY19e PER and c3.2X FY19e EV/EBITDA, which we find very attractive for a business of TTMT's size with improving return ratios.

What we are actively avoiding?

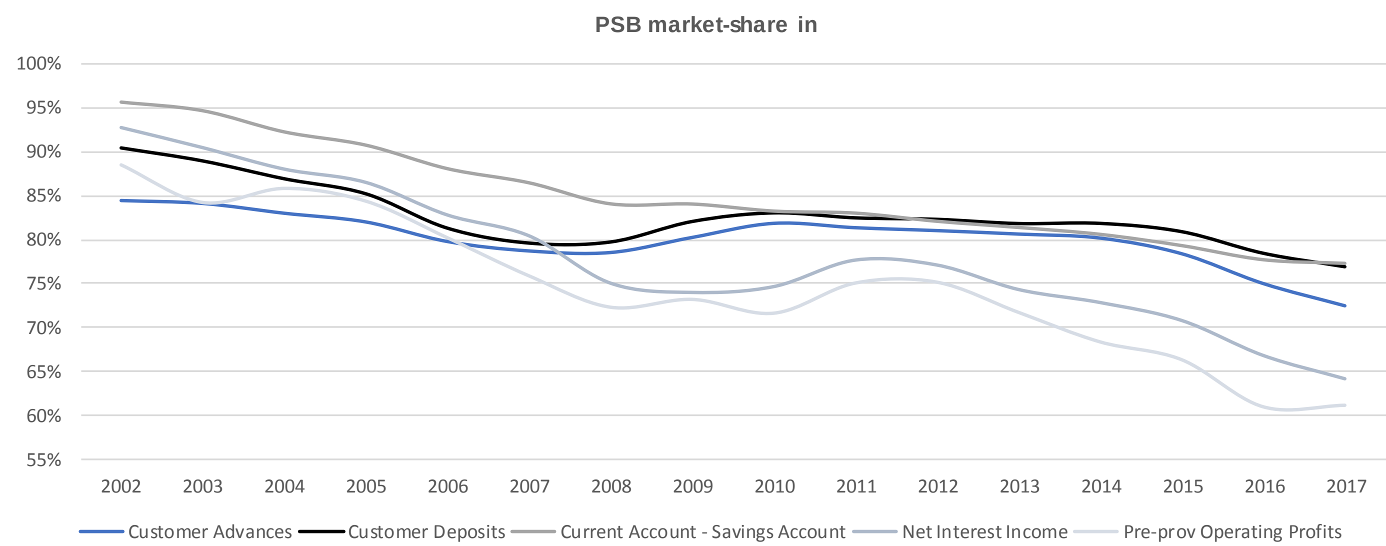
The case of 'value' being more expensive than 'price'

The last six months were an interesting period for the Indian Public-Sector Banks (PSBs). The Indian Govt. announced its intentions to recapitalize the PSBs to the tune of INR2.1t (cUSD32b)—a number so large that it would overtake the cumulative recapitalizations of the past three decades (was INR1.5t or cUSD23b), or total to c1.3% of India's GDP.

PSB equities, which were underperforming the private bank equities for more than a decade, had a stellar session in trading the day after the announcement. Weighted by market-cap, PSBs rose 33% in two days; closing at the highest market-capitalization in more than fifteen years.

Going into the announcement, based on ratio of price to reported (or adjusted for announced non-performing assets) book value, the PSBs were quoting at valuations that were much lower than their private counterparts. Despite the apparent value, we were not convinced that PSBs offered a compelling business argument on grounds that (a) They were continually losing market-share to their private peers and (b) a close-to-reality estimate for bad loans (and consequently book value) was effectively not available, or our ability to accurately calculate them was rather limited.

Based on a few assumptions that we made (shown in exhibit below), we believed the PSBs would require an incremental provisioning of more than USD40b – that would eat into the capital that they did not have. To fund the same, they would have to resort to (a) Equity raising, (b) sale of non-core holdings (like stakes in housing finance companies etc.) and (c) sale of assets (buildings etc.). In our estimates, the Tier-1 capital of PSBs would fall below the levels mandated by the RBI. Despite a c24% exposure to the financial sector in general, we continued to have zero exposure to PSBs, in the run-up to the announcement.

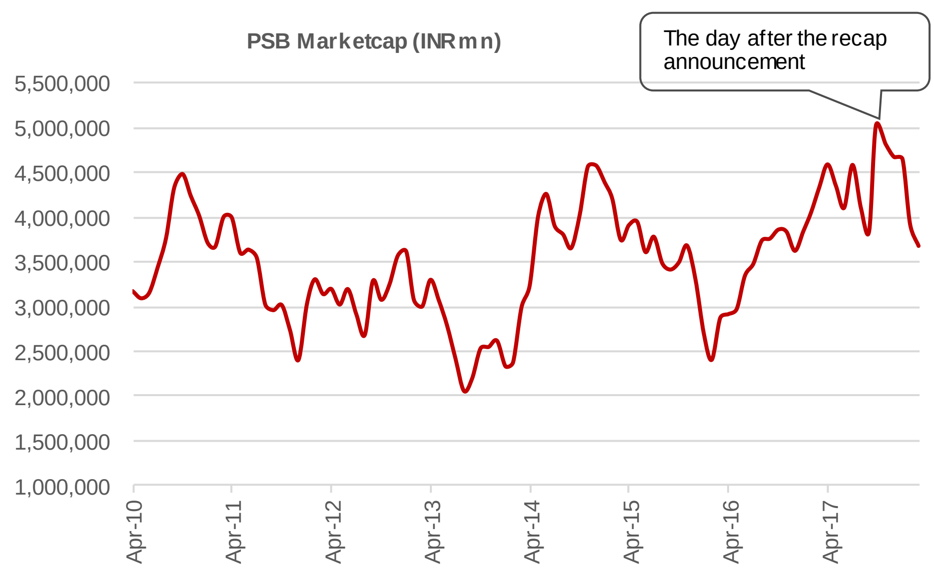


Source: ACE Equities

	As of Mar-17; when we ran the exercise	As of Dec-17 qtr
	USD bn	**USD bn**
Total Advances in system	1,043	1,123
of which, recognised as Gross NPA	89	124
Total NPA at the end of entire exercise	183	183
Loss in value assumed (assumption)	50%	50%
Loss in value assumed	91	91
Provisions made so far	45	59
Incremental provisioning required	**47**	**34**
o/w PSU Banks	41	28
o/w Private Banks	7	5
Tier-1 Capital post write-offs		
o/w PSU Banks	**5%**	
o/w Private Banks	13%	

Source: ACE Equities, Buoyant Capital estimates

Since then however, several announcements of loans that were not originally estimated as bad were made, bringing the question as to what the accurate estimate of book value is (after having adjusted for bad loans) back to investors' attention. The PSBs have fallen c27% from their Oct-17 highs, effectively giving up all the gains made on the day of the historic announcement. Our position throughout the entire episode has been rather unchanged; neither did we hold any PSBs in the Buoyant Capital portfolio back then, nor do we own them currently.



Source: Bloomberg

Combined Market-capitalization of State Bank of India, Union Bank, UCO Bank, Syndicate Bank, Punjab National Bank, Oriental Bank of Commerce, Indian Overseas Bank, IDBI, Dena Bank, Corporation Bank, Central Bank of India, Canara Bank, Bank of Maharashtra, Bank of India, Bank o Baroda, Andhra Bank and Allahabad Bank

Markets, 'fragility' of the portfolio, and 'skin in the game'

'The three most harmful addictions are heroin, carbohydrates, and a monthly salary'
'The average behavior of the market participant will not allow us to understand the general behavior of the market'
'The idea of fragility helped put some rigor around the notion that the only effective judge of things is… TIME'
Nassim Nicholas Taleb—various books

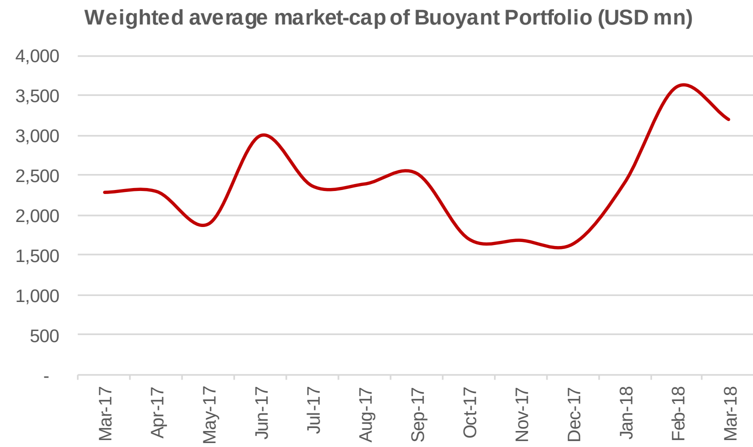
Nassim Taleb's latest book, *Skin in the game* was released in the last quarter. This book is the fourth in a series—its predecessors being *Fooled by Randomness*, *The Black Swan*, and *Antifragile*. Whereas, *Fooled by Randomness* introduced the idea of uncertainty to its readers, *The Black Swan* was more prescriptive on how to deal with it and *Antifragile* gave a practical guide on benefiting from the uncertainty. *Skin in the game* takes the idea forward to various aspects of finance, medicine, politics, religion, evolution and life in general.

What *Skin in the game* did was bring us back to the concept of 'Antifragility' – especially in the light of heightened volatile around equities (Nifty Index, BSE100 Index and BSE500 Index are down c11% from peak-to-low in the span of just the last quarter). *Antifragile* is the term Taleb uses to denote things that gain from disorder, chaos and stressors. Whereas *fragile* things are negatively impacted by the above issues, *robust/resilient* things are indifferent; *antifragile* – the opposite of fragile, indeed gains from them.

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. The easiest way to avoid getting fooled by such randomness is to NOT view the returns of a long-only portfolio over short-term. Nevertheless, when finding quality businesses at decent valuations started getting difficult, our internal debate as to how to make the portfolio more robust - offered these alternatives:

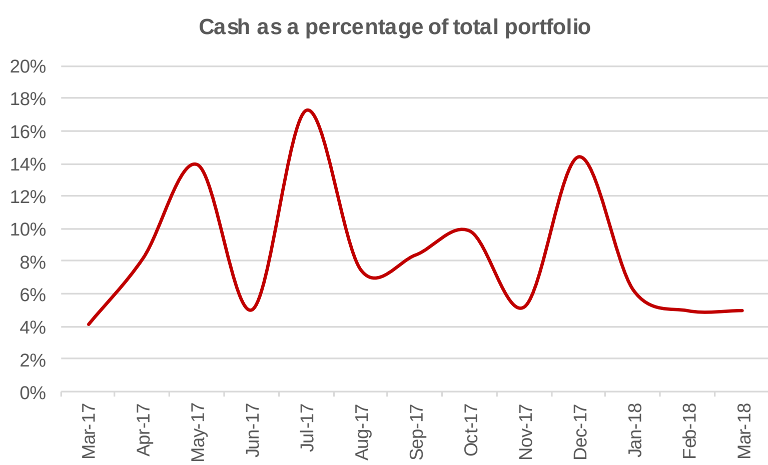
a) Short the markets / Buy protection: Our stated policy to invest in businesses that we understand and firmly believe in, and which are available at valuations that we consider are below their fair value, irrespective of the levels of broader indices. Shorting the markets (even if allowed by prevalent legislation for PMS, which it is not) is not part of our core competency. Buying protection (Index or stock-specific puts) was plausible (and allowed under prevalent legislation), but that serves the purpose of only protecting short-term returns, at the cost is paying for that time-value. Since our goal is to generate sustainable returns in longer-term, we did not engage in buying protection.

b) Buy predictable instead of growing cash flow streams: We do not segregate businesses as large or mid cap. If we get a predictable and growing stream of cash flows at attractive valuations, we invest. Nevertheless, markets corrections have historically been more severe on smaller market-cap businesses than larger ones. We did take a conscious call to place more emphasis on 'predictable' part of cash flow, rather than the 'growth' part. That resulted in the weighted average market-cap of Buoyant portfolio close to doubling between Dec-17 and Mar-18.



<u>**c) Diversify cash flow stream and increase number of businesses**</u>: We have consistently believed in running a concentrated portfolio. To diversify away the non-systematic risk, portfolios need not own too many businesses. The average number of businesses in Buoyant Portfolio as of Mar-18 stood at twelve, at the higher end of our historical range of ten to twelve businesses. Nevertheless, cash flow streams could still be diversified to avoid specific risks. To that effect, for the first time this year, we invested in businesses that offer IT services and expanded our positions in commodity and beverage businesses, while continuing to avoid Pharmaceuticals and PSBs.

<u>**d) Take cash calls**</u>: Taking cash calls (i.e. altering levels of cash in the portfolio) is a rather tricky subject. Our view is that the decision on capital allocation (including cash call) rests with the investors. Once investors decide to allocate money to equities, our job is to invest it based on our framework. Leaving the cash call to asset manager, in theory, is trusting their ability to time the markets – a skill that they have a pathetic track record in (we do not consider that our core competency either). Consequently, we do not actively take cash calls. Nevertheless, if the market does not offer us predictable and growing cash flow streams at attractive valuations, we do not rush into deploying cash. That has, on occasions, led to cash in the portfolio being at elevated levels than the average. But that, is not a conscious call - rather one dictated by our investment framework.



Owning up to our mistakes—Sold too soon!

We were convinced relatively early about the cyclical upturn in Commercial Vehicle (CV) cycle in India. Over the last five quarters, we had invested across the value chain in the CV ecosystem—viz. OEMs, Component suppliers and vehicle financiers. As recovery started getting priced in, the cumulative position in this theme exceeded a quarter of the entire portfolio—a level of consolidation we were not entirely comfortable with. We decided to sell out of Ashok Leyland (AL), based on our assessment that rising discounts following intensifying competition will eat into AL's operating margins. Although we were aware of the ongoing shift in the CV markets towards higher tonnage vehicles (where AL has the largest market-share), we could not fully comprehend the benefit that a superior mix could bring, which ended up more than offsetting the rising discounts. Although we did exit the position in profits, AL continues to be a solid business in the middle of a very strong cyclical recovery.

At the end, we still think that there is little scope to avoid erring on such events. Nevertheless, while the portfolio continues to benefit from the market's optimism around the recovery in the CV space, we wonder if we would have been better served cutting marginal positions across our holdings in the CV ecosystem, as opposed to cutting the entire position in AL. Taleb's perspective on such errors is rather useful. He says that *making some types of errors is the most rational thing to do, when the errors are of little cost, as they lead to discoveries. Most medical discoveries are accidental to something else. An error-free world would have no penicillin, no chemotherapy, almost no drugs and most probably, no humans*.

Buoyant Investors: Thank you!

In one of the quotes on page six, Taleb mentions what he views as harmful addictions. Neither authors of note have access to either heroin or a monthly pay-check; and very little addiction to carbohydrates. We would like to believe that we have a significant *skin in the game*; our upside results only after the returns cross the threshold, and quite frankly, that is exactly the way that we prefer.

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 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.

Information in this newsletter is not intended to be, nor should it be construed as investment, tax or legal advice, or an offer to sell, or a solicitation of any offer to make investments with Buoyant Capital. Prospective investors should rely solely on Disclosure Document filed with SEBI.

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