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Apr 05, 2019

Letter to investors: Update for the year ended Mar 31st, 2019

Dear Investors,

For the quarter ending Mar 31st, Buoyant PMS portfolio* generated a return of 5.8%. The Nifty-50 Index returned 7.0% and BSE 100 Index returned 5.8% 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	10.1%	7.7%	7.5%	7.8%
Last three months	5.8%	7.0%	5.8%	5.3%
Last six months	8.2%	6.3%	6.0%	5.9%
Last year	-2.1%	14.9%	12.4%	8.3%
Last two years - annualized	22.6%	12.6%	11.5%	10.1%
Since inception - annualized	26.1%	13.3%	13.4%	13.2%

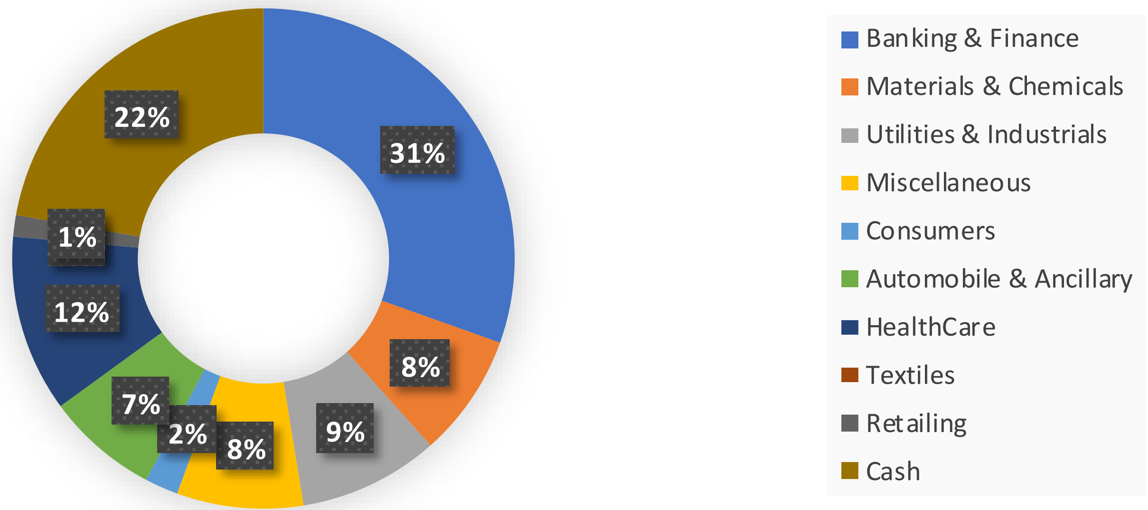
Source: Bloomberg for NIFTY 50 Index, BSE 100 Index and BSE 500 Index. Buoyant Portfolio is pre-fees and expenses
*See disclosures at end on how Buoyant Portfolio returns are calculated. More than one year returns are annualized

Buoyant's average cash position for the year stood at c9%. As mentioned in the disclosures on the last page, 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.

For the year ended Mar-2019, Buoyant's portfolio turnover stood at 1.0 times and total brokerage paid stood at 0.32% of average portfolio (see disclosures on how portfolio turnover and brokerage paid ratios are calculated). The portfolio turnover was higher than the previous years as we received sizeable inflows towards the end of the year in the form of ownership interest in businesses (instead of a credit in the pool bank account), and we decided to exit them (which also resulted in higher year-end cash balance than the historical average). Our historical turnover has been lower (FY2019: 0.59X), which reflects our belief in buying quality businesses and holding them for longer. The weighted average market capitalization of the businesses in Buoyant portfolio as of Mar 31st, 2019 stood at USD7.6 billion (or, INR523.8b)

Portfolio composition and top holdings



ICICI Bank (ICICIBC, Market capitalization cUSD36.4b)
ICICIBC in 2018 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. Over the next two years, consensus expects ICICIBC's net income to more than double driven by decent NII growth and following lower provisioning.

Welspun Corporation (WLCO, Market capitalization cUSD0.6b)
WLCO is the second largest manufacturer of large diameter pipes in the world; with capacity to manufacture longitudinal (LSAW), spiral (HSAW) and ERW pipes. Sustained crude oil prices will result in higher capital spending by oil majors to transport crude and products. This is beneficial to all line pipe manufacturers, including WLCO. WLCO's order backlog has increased materially over the last year, and we believe that new orders, arguably at higher profitability will drive earnings growth over the next couple of years.

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. 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.

Cycles—of earnings, markets, elections and investing

- *'Given the non-scientific nature of investing, there is no such thing as being finished with your learning, and no individual has a monopoly on insight'*
- *'One of the most important foundational elements of my investment philosophy is my conviction that we can't know what the "macro future" has in store for us in terms of things like economies, markets or geopolitics'*
- *'The greatest way to optimize the positioning of a portfolio at a given point in time is through deciding what balance it should strike between aggressiveness and defensiveness'*
- *'Markets rarely go from "underpriced" to "fairly priced" and stop there'*
- *'We have two classes of forecasters: those who don't know – and those who don't know they don't know'*
- *'In real world, things fluctuate between "pretty good" and "not so hot". In financial markets, perception swings from flawless to hopeless'*
- *'The greatest source of investment risk is the belief that there is no risk'*
- *'Superior investing doesn't come from buying high-quality assets, but from buying when the deal is good, the price is low, the potential return is substantial, and the risk is limited'*
- *'The worst loans are made at the best of times'*
- *'What a wise man does in the beginning, the fool does in the end'*

Quotes from the book – *Mastering the market cycle: getting the odds on your side by Howard Marks*

We could have probably kept going on with more quotes from the book Mastering the market cycle by Howard Marks, if it were not for the constraint of space. Howard Marks is the co-founder and co-Chairman of Oaktree Capital Management and has written three books on investing. Nevertheless, Howard is known in the investment community for his 'Oaktree Memos' to clients in which he details his insights. In what we can categorically classify as a must-read book for any investor (aspiring, budding or seasoned), Howard talks about different cycles – including, but not limited to – the economic cycles, profit cycles, cycles in investor psychology, credit cycle — how to read the cycles, and how to cope up with them. We have followed Howard's memos regularly for quite some time now, but a reading of the book still brought us to consider several questions—especially with general elections around the corner, and markets swinging from 'hopeless' to 'flawless' and back - all within the span of just a few weeks.

Among the first questions we asked ourselves was: ***Does a strong governments lead to stronger corporate profits growth?*** Many commentators, while trying to arrive at a top-down corporate earnings growth story, tend to err in resorting to the heuristic which compares corporate profit growth to nominal GDP growth.

GDP comprises of Agriculture, Manufacturing and Services, and historically, agriculture has grown at a pace much slower than overall GDP (its share in GDP has come down from above 50% in 1950-51 to below 20% now). So, whereas in theory – corporate profits (which are represented more by manufacturing and service-oriented companies) should grow at a stronger pace than GDP growth – it does not always happen, especially in the short term.

Ruling coalition	Years	Nominal GDP growth	Corporate profits growth %
Third front	FY97-98	12.7%	12.0%
NDA-I	FY99-04	9.5%	18.9%
UPA-I	FY05-09	14.7%	21.7%
UPA-II	FY10-14	15.6%	12.9%
NDA-II	FY15-18	10.3%	5.3%

Several reasons account for this – and, chief among them are: (a) A large part of Indian corporate revenues is linked to global growth. In our estimate, closer to 60% of Nifty revenues are derived from outside India (or is linked to global commodity cycle); slower growth elsewhere in the world also results in slower profit growth in India, (b) after a turn of cycle, earning growth only accrues with a lag and definitely does not follow election cycles, and (c) specific issues result in lop-sided earnings growth (like banks recognizing bad assets in their respective P&Ls. Profits accrue for one year, whereas bad assets created over many years get written off over specific few years).

So then, ***if the corporate earnings growth is not necessary linked to strength of governments, why do markets constantly take cue?*** That is because whereas earnings may not be linked, the price-to-earnings ratio increases with a stronger government (among other things). Higher returns are generated through PER changes vis-à-vis earnings changes.

Ruling coalition	Years	Corporate profits growth %	Avg Price-to-earnings ratio (X)
NDA-I	FY99-04	18.9%	14.6
UPA-I	FY05-09	21.7%	15.9
UPA-II	FY10-14	12.9%	17.6
NDA-II	FY15-18	5.3%	21.0

The logical question then is: ***How is the electoral math stacking up and what are the potential outcomes?*** We have specifically tried not to answer the question as to who would form the next government? We simply do not know – and doubt if anyone can assert that with a reasonable degree of confidence. India has a diverse voter base and a first-past-the-post system, which implies that you could win a constituency with 35% vote share (if the other candidate polls less than 35%) or could lose a constituency with 49% vote share (if the other candidate polls more).

Opinion polls for the general elections in India are modelled as a sum of state elections (which in turn, are sum of constituencies within). The psephologists start the process with vote shares, convert them into seats and add them up to a national number. Historically, given too many moving variables, the opinion polls have been off by 10–20 seats in 98/99 elections, by about 25-60 seats in 2009 elections and 50-100 seats in 2014 elections. Given that a party needs 273 seats to form a government, a miss of 100 seats (or even 50, for that matter) is a big miss.

Now, as difficult as the job of arriving the electoral math already is, what makes it even more interesting are the following assertion and thoughts:

- In 2014, in almost what was a wave-election, BJP won 71 off the 80 seats in the state of UP. Since then, the parties that were no2 (SP) and no3 (BSP) in vote share have decided to fight the elections together. If the vote share is exactly as it was in 2014, BJP stands to lose 36 seats (a rather heavy loss for the party). However, a 3% vote share swing in favour of BJP will bring them to 50 seats and a 5% vote swing will bring them to 58 seats. The key question is: whether the swing will happen away from BJP (because 2014 was a wave election) or will it happen in favour or BJP (as SP & BSP factions, that have been fighting against each other for vote share do not see seamless transfer of vote to the one candidate that they field per constituency).

- In 2014, BJP won one out of 39 seats in the state of Tamil Nadu (ADMK won 37). For 2019 general elections, BJP has entered-into a pre-poll alliance with ADMK. However, this is the first election where the two rival parties in TN political spectrum (ADMK and DMK) are going into elections without their tallest leaders.

- TDP was a part of NDA in 2014 general elections, and had won 16 of the 42 seats in AP. Since then, the state of AP was split into two (AP and Telangana), and TDP parted ways with NDA. TRS, which had won 11 seats in 2014 general elections swept the Telangana assembly polls after the split. How will AP + Telangana vote will be crucial as well.

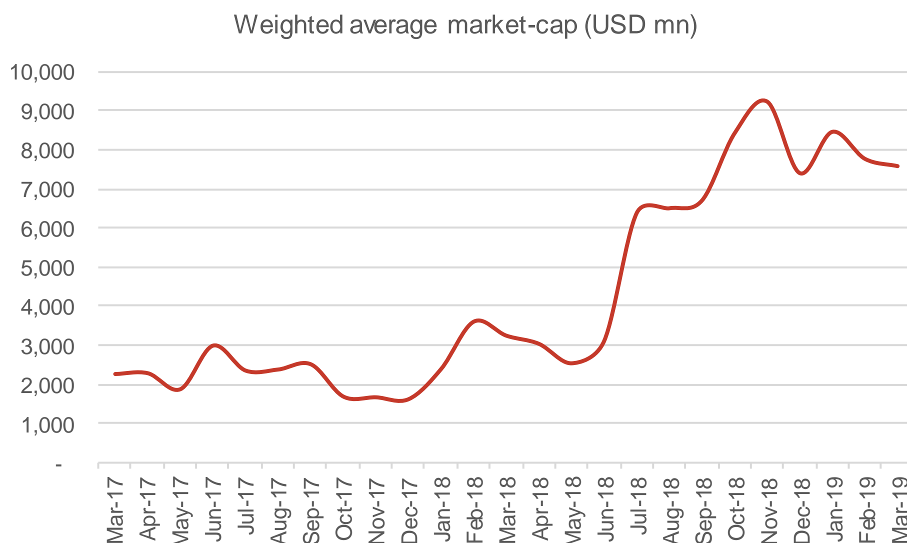
- Whereas, BJP had won only 2 off the 42 seats in West Bengal – unlike UP, a larger vote share swing will be required for the party to break into. Our calculations show that a 10% vote share swing in favour of BJP will still get them only 12 seats (an addition of 10 seats).

- Last, but certainly not the least is the addition of new voters. An estimated 81m voters are eligible to exercise their franchise for the first time in this general election. Whereas the constituency-wise addition of new voters is not available (it is only available state-wise), if one were to average it out over each constituency – a total of 282 seats had winning margins less than the average addition of new voters. Put another way, if all new voters voted en-masse for the runner up, they would beat the incumbent if 2014 vote share was replicated. Considering the seats required for majority are 273, quantifying the impact of this eventuality is both – difficult and unpredictable.

The widely ranging outcomes from the probabilities above suggests that calling this election is going to be difficult. The news channels will have to come up with a number (or a range) for how the different parties will fare in the elections; thankfully, we don't have to. Our approach, as we have highlighted in many previous memos is one of bottom-up. We are reproducing our thought-process on coping up with cycles, first written in Mar-2018 memo, below (with updated charts – and additional text which is put out in black ink vs the grey ink for Mar-18 replication).

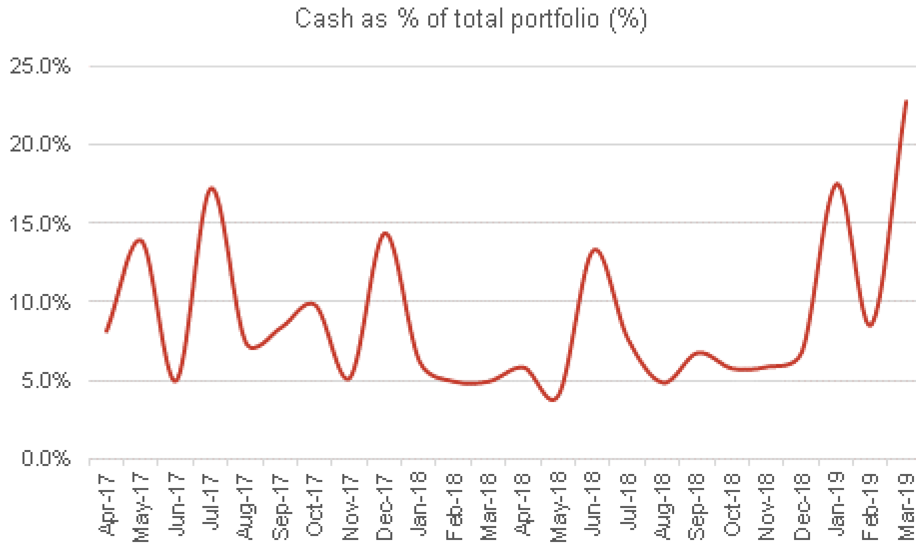
a) Short the markets / Buy protection: Our stated policy is to invest in businesses that we understand and firmly believe in, and which are available at valuations that we consider are below their fair value, irrespective of the levels of broader indices. Shorting the markets (even if allowed by prevalent 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. That stays elevated in the run-up to Mar-2019 as well.



c) Diversify cash flow stream and increase number of businesses: 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. (and has since increased to eighteen as of Mar-19). 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.

d) Take cash calls: 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.



Note: Cash as a percentage as of Mar-19 is higher due to large inflows towards to end of year

What worked, and what did not?

As the financial year FY2019 comes to an end, we reflect on what we did right, as well as what we failed to recognize during the year. Among our best decisions has been our investments in ICICI Bank, CanFin Homes and Gujarat Fluorochemicals. Businesses that have resulted in major drawdown in portfolio value this year have been Bhansali Engineering, Ramkrishna Forgings and SIS. We are reproducing our original investment thesis for each of them below, as well as present thoughts on businesses that haven't done very well for the portfolio in the last year (new comments are in black; comments reproduced from previous memos are in grey)

What worked?

ICICI Bank (ICICIBC, Market capitalization cUSD26.2b) — written in Jun-18 memo

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.

CanFin Homes (CANF, Market capitalization cUSD0.6b) — written in Dec-18 memo

CANF is among the larger housing finance companies in India, promoted by Canara Bank in the year 1987, and is registered as a deposit taking HFC with NHB. CANF's focus is on housing loans to individuals (90% of loan book) and has pan-India presence with 152 branches, 21 affordable housing loan centers and 14 satellite offices spread over 21 states.

CANF has had a strong loan book growth (24% over last three years) and 90% of the loans as housing loans and a very negligible (below 0.1%) builder loan book. More than 70% of its loans are to the salaried class, thereby reducing future potential risks of defaults, which is evident from the sub 1% GNPA that CANF reports despite the strong loan book growth. CANF's capital adequacy also remain strong (19% in 2QFY19). CANF has a relatively high exposure to market borrowings (46% of overall, split 15% in CP and 30% in NCD), which is higher than what we would normally prefer. And although CANF has not disclosed its ALM by time-buckets, the presence of higher share of market borrowing for a housing finance company would indicate a mismatch at the shorter-end, which could pose refinance risks. However, the stock had corrected c64% from its recent highs, which we believed was excessive given that CANF has a solid book and only runs liquidity risks (which could possibly be arranged by a strong parent in the event of crisis).
At our acquisition price, CANF traded at 1.8X FY20e Price to adjusted book and 10X FY20e PER; which we believed was attractive.

Gujarat Fluorochemicals (GFLC, Market capitalization cUSD1.2b) — written in Jun-18 memo

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 did not?

Bhansali Engineering Polymers (BEPL, Market capitalization cUSD250m) — written in Sep-17 memo

BEPL is one of the two companies in India that manufactures ABS (Acrylonitrile Butadiene Styrene), which is a raw material for composites used in automotive, home appliances, telecommunications and others. Currently, India imports about 45% of its ABS consumption, which is largely of 'commodity grade'. Given peculiar industry dynamic (small batch size and large number of variants), India has not traditionally imported 'specialized grade' ABS, which gives companies operating in India a unique edge.

Superior balance sheet, high return ratios and a strong free cash flow yield is what attracted us to BEPL initially. At the time we considered BEPL, it was the lowest market-capitalization business we had ever invested in. We went ahead when it became clear to us (a) that China appeared increasingly resolved to curtail pollutive and loss-making industries, resulting in the ABS spreads doubling over the last year, and (b) BEPL announced in its 2017 Annual Report that it intends to become the lowest cost, number one domestic ABS producer by FY2019, which would entail capital spending that the company would fund entirely out of internal accruals. With expanding capacity, and better spreads, we reckon BEPL's net income could more than double over FY2017-19e, and the stock traded at one year forward price-to-earnings multiple of 13 times.

At its peak, the market valuation of BEPL's business more than tripled since we first bought into the business. Quarterly earnings improved materially as BEPL's mix richened (of specialty grade vs commodity) amidst stable gross margins. However, since then, BEPL had several challenges – (a) Fire at its intermediates plant, (b) Falling raw material and finished good prices, resulting in lower margins and inventory losses, and (c) INR depreciation. Quarterly earnings dropped significantly on a year-over-year basis, and the stock more than halved from highs. Going forward, however, the high-cost inventory should run through the P&L by fourth quarter of this fiscal, the finished goods prices appear to have stabilized, and INR has stopped incrementally depreciating. In the meanwhile, BEPL's mix has gotten richer still – and volumes are rising. Despite the drawdown in this business for FY2019, we continue to own BEPL.

Security and Intelligence Services (India) Limited (SIS, Market capitalization cUSD1.4b) — written in Dec-17 memo

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:

(d) 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,

(e) 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

(f) 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.

At its peak, SIS almost doubled from our acquisition price as it reported stellar growth in earnings following decent volume growth and higher pricing. Since 1QFY19 however, volume growth slowed and margins shrunk following higher competition, as well as valuations corrected; and normalization of valuation multiple resulted in the stock correcting back closer to our acquisition price. Nevertheless, we continue to believe in the structural story that we had highlighted above, and SIS seems to be getting back to stronger margins and higher volumes in India starting 3QFY19. We continue to own SIS.

Ramkrishna Forgings (RMKF, Market capitalization cUSD0.4b) — written in Mar-18 memo

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.

We have held RMKF since the inception of the fund, and at its peak, it had more than doubled our acquisition price. Over the last one year, RMKF has delivered on our expectations of volume growth, improvement in margins as well as in higher return ratios. However, the markets have not rewarded it – possibly on account of its expectations that (a) the CV cycle in India, which has been in a cyclical upturn since the last six years, appears to have peaked now, and (b) Class 8 truck new orders in the US have slowed down materially. We are not of the view that the CV cycle in India has peaked – given that the change in emission norms (from Apr-2020) will drive pre-buying demand. In addition, if the Govt. approves the scrappage policy, that could be an added benefit. In addition, RMKF's rising focus on creating superior mix (or, more component per vehicle, as the company puts it) could negate part of the potential slow-down in Indian CV cycle. Lastly, RMKF's focus on (a) judicious capital spending plan and (b) de-risking current business with expansion in Indian Railway business would add further stability. We continue to own RMKF.

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. We are keenly looking forward to the year 2019, as India votes for the Parliamentary elections. Please cast your votes - it is not only a democratic right, but equally also a democratic responsibility. Let us exercise the same caution in choosing our nominees, as we exercise in choosing our investments.

Regards,

Sachin Khivasara
Director

Jigar Mistry
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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