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October 04, 2017

Letter to investors: Update for half year ended Sept 30th, 2017

Dear Investors,

For the first half of the year through September 30th, Buoyant PMS portfolio* gained 31.6% net of applicable fees. The NSE 50 Index returned 7.6% and BSE 100 Index returned 8.1% 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 uncompounded return (%)	Buoyant Portfolio*	Nifty 50 Index	BSE 100 Index	BSE 500 Index
Last six months (Apr17 - Sep17) (note a)	31.6%	7.6%	8.1%	8.6%
Last twelve months (Oct16 - Sep17) (note b)	53.2%	15.1%	16.3%	17.8%
Since inception (Jun16 - Sep17) (note b)	63.0%	22.1%	25.3%	28.8%

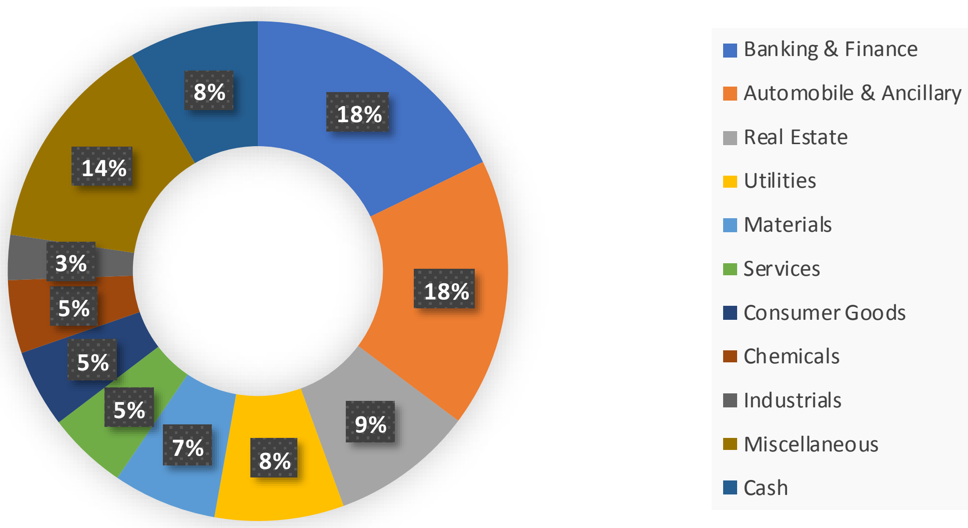
Source: Bloomberg for NIFTY 50 Index, BSE 100 Index and BSE 500 Index total returns
Note a: Apr17 to Sep17 returns are after deducting management fees for 1HFY18
Note b: Oct16 to Sep17 and Jun16 to Sep17 returns are after deducting management fees (for FY17 and 1HFY18) and performance fees (for FY17)
** 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 first half was at c10%. As mentioned in the disclosures on page 6, the composite performance is average across all client portfolios and individual returns may differ from the averages reported above due to variations in holdings, different times 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.

Portfolio composition

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



What have we added over the last six months?

Over the last six months, among our largest additions have been Ashok Leyland and Bhansali Engineering Polymers.

Ashok Leyland (AL, Market capitalization cUSD5.5b)
India's commercial vehicle demand has stayed subdued for the last seven years. It is our opinion that an effective GST implementation should lead to higher demand of Medium and Heavy Commercial Vehicle (M&HCV) despite rising efficiencies (due to lower idle time at state-border checks) as inter-state traffic would eventually increase over time. Also, the pent-up demand (from mining and road construction) would add to the recovery. AL is the way to play it, as:

- It is the best available pure-play in the commercial vehicles (CV) segment,
- Following the success of AL's BS-IV vehicles and superior product pipeline, AL's market-share has continued to improve (from a low of c20% in FY12 to over 34% in YTDFY18), and
- Following stricter enforcement of overloading restrictions, we expect market-share of AL to increase further as the CV market itself moves to higher tonnage vehicles (AL has the highest market-share in >26 tons vehicles).

AL trades at consensus FY19e price to earnings of c20.5X, which is broadly in line with its historical average. Should M&HCV cycle turn as we expect it to, and AL is able to retain/increase market-share, we believe there is upside to consensus earnings estimates as well as room for valuation multiples to expand.

Bhansali Engineering Polymers (BEPL, Market capitalization cUSD250m)
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.

What we are actively avoiding?

'This paradox exists because most investors think quality, as opposed to price, is the determinant of whether something's risky. But high-quality assets can be risky, and low-quality assets can be safe. It's just a matter of price paid for them… Elevated popular opinion, then, isn't just a source of low return potential, but also of high risk' Howard Marks, April 26th, 2007

Over the last six months and one year, the Housing Finance Companies (HFCs) in India have on average (on market-cap weighted basis) returned 19% (range -10% to 51%) and 36% (range -23% to 96%) respectively. These are truly strong returns and as such, there is clearly a case to be made for listed HFCs to gain market-share over the next few years as:

- India's mortgage penetration (to GDP) is among the lowest in the developed/developing world,
- The Central as well as State governments appear quite committed to facilitate affordable housing, and
- Low cost-to-income and faster Turn-Around-Time (TAT) for HFCs give them an edge – even over private banks.

We have chosen not to have exposure to any HFC, despite having c18% exposure to financial services sector, as

- In our opinion, the business model for many of the new entrants in the housing finance sector is still untested. With increasing competition, HFCs are competing on TAT and ease in documentation to gain market-share. In our opinion, non-performing assets staying benign (as it has in the past) should not be the base-case scenario,
- Current valuations build-in continued strong growth in loan book, net interest margins (at 3.3%) staying strong and credit costs (at 0.3%) remining benign despite rising competition. It assumes that the size of the housing loan market would grow to INR40 trillion compared to INR14 trillion today. To put it in perspective, the size of all outstanding banking loans (and not just mortgages) in India as of Mar 31st, 2017 was INR79 trillion.

The size of the opportunity is large; but, with rising competition and changing landscape of housing market in India, we believe there are bound to be execution challenges. With HFC stocks posting strong returns over the last one year, we believe that the margin of safety around these names is low, and choose to wait for a more opportune time.

	2017	Steady state
Size of Mortgage market (INR bn)	14,405	40,256
Listed HFC mortgage size today (INR bn)	**5,330**	**14,895**
Market-share of HFC (%)	37%	37%
Net interest income of HFC (INR bn)	221	528
Net income of HFC (INR bn)	**146**	**323**
Unadjusted net w orth (INR bn)	805	1,783
Market-capitaliization (INR bn)	**3,232**	
Valuations		
Price to book multiple (X)	4.0	1.8
Price to earnings multiple (X)	22.1	10.0

Source: RBI Database, NHB Reports, IndiaBulls Housing
Market-capitalization is excluding valuation of non-mortgage subsidiaries

The Halo Effect and recent events

The eminent social psychologist, Eliot Aronson, observed that people are not ‘*rational beings’* so much as ‘*rationalizing beings’*. Quoting Aronson, Philip M. Rosenzweig, in his book ‘The Halo Effect’ noted, that we want explanations; that we want the world around us to make sense. He further goes on to criticize several pseudoscientific tendencies in the explanation of business performance – while highlighting the nine ‘delusions’ or mistakes of reasoning that undermine the recipes of business success.

We think that Philip’s work is closer in ideology to the works of Nassim Nicholas Taleb (someone we ardently admire) – and diagonally opposed to heavy ‘survivorship-bias’ laden works (like ‘Good to Great’, ‘Built to Last’, and ‘In search of excellence’). This subject is very close to our hearts as well. Warren Buffet once noted that ‘When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact’.

Financial Times (FT), on Aug 22nd, 2017 ran a story along similar lines, titled *‘Provident Financial and the myth of the miracle-working CEO’*. It highlighted the case of Peter Crook, the erstwhile CEO of a British sub-prime lender, Provident Financial. Mr. Crook was seen by the company’s board as a bit of a superstar, piloting its affairs as share price more than tripled. Over last five years, he had earned close to GBP30m. He was widely credited with replacing the army of old fashioned door-to-door agents with a smaller number of full-time, technology-enabled employees – with the aim to reduce costs. The initiative, in FT’s opinion, achieved the opposite. Two profits warnings and a scrapped dividend led to a rout in share price, when Mr. Crook left ‘with immediate effect’.

In light of this report and the recent events at one of India's largest technology companies, we read Philip's book again. The departure of the CEO after a very public (and ugly) spat with the founding member of the company resulted in the stock falling c15% over two trading days. The shareholders in the company lost USD5.4b in market-capitalization in those two days – over the resignation of the CEO at a company that houses over 200,000 employees, and has been in existence for over thirty-five (35) years. We did not own the business before the announcement, and despite the sharp drop in share price, we did not buy into it on day two. To us, bad business economics still trumps cheap valuations.

However, this reminded us of another incident of similar nature – this time with India's Pizza delivery company. The stock fell c10% on the day the CEO's resignation was announced to the markets. Here, the celebrated CEO was at the helm for over eleven (11) years, and widely credited as being responsible for making the company 'India's largest fast-food chain'. The business was reeling under negative same-store sales growth at the time. It has been about one year since the resignation, and with some pick-up in the same-stores sales growth, the stock is up c47%.

Romanticizing managements is par for the course with a certain section of investors in India; we, respectfully, do not count ourselves among them. We keep reminding ourselves of our continued belief in the BMV (Business-Management-Valuation) principle of investing. We spend most of our time understanding the economics of business, lesser time understanding and meeting with the managements and even lesser debating about right valuations. We hope that it continues to work for us as well as it has over this last one year.

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.

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