Tamohara Investment Managers - Monthly Newsletter April 2016

We have repeatedly, in the past, articulated our philosophy of value creation through long term investments in high quality businesses, run by an ethical and capable management team. In this newsletter we attempt to unravel some key attributes which we look at in our investible companies and the framework on which our portfolios are built. Although we are strictly focused on individual businesses and do not spend a lot of time on trying to analyse the macro environment, we do believe that favourable macro environment can give a further thrust to great businesses. We therefore make an attempt to analyse the Indian economy through our framework of analysing companies. We do so because we think that within the challenges of the global economy, India is undergoing a restructuring exercise which is akin to a company where new management is focusing on long term value drivers at the cost of some temporary short term pain in the process.

In the latter section of this communique, we provide an update on our portfolio positioning and performance up to the quarter ending March 2016. As we had concluded in our previous newsletter, we thought the fall in the market was a good opportunity for long term investors. In putting our own words in to action, we took advantage of this opportunity to make some changes in the portfolio, which are highlighted in the paragraphs towards the end. It is in making these changes and in creating a new strategy that we skipped the communique in March 2016. We attempt to make up for it here.

Investment Process and Long Term Value Creation: Sticking to the basics

At the heart of every successful investment philosophy is a simplistic framework and uncompromised execution. A well-defined investment process is therefore a thoughtful checklist that helps investors in maintaining unwavering adherence to their framework. Built on this belief, the following are the building blocks of our framework for identifying investible businesses (our checklists cover these in much greater details):

- Strong corporate governance
- Growth opportunity and strategy to capture the same
- Prudent capital allocation and efficient use of resources
- Conservative financial management and low leverage

Often during an investment journey, one comes across businesses that, while having great fundamentals, lose track due to an error of the management – either in the form of a highly leveraged/unrelated acquisition, or bad product cycle management, or simply due to lack of focus, among other things. Usually a change in management or a re-organisation of the top leaders helps in bringing such businesses back on track. To our minds, India is akin to such a company that is undergoing structural changes with change in management. Our judgement is on the back of applying the above investment framework to understand the Indian economy.

India - An inflection point in the making?

At two separate events over the last two months, RBI Governor Raghuram Rajan has reportedly spoken positively about India’s macroeconomic policies and growth. Coming from the hard-to-please Mr Rajan (given his vociferous calls for government policy to bring economic revival over the last few years), these words cannot go unnoticed. There must be have been some concrete steps taken by the government for the central banker to say:

"Given the inhospitable world economy and two successive droughts in India, either of which would have thrown the economy into a tail spin in the past, our focus on macroeconomic stabilization must be part of the explanation why we have over 7 percent growth, low inflation, and a low current account deficit unlike some of our emerging market counterparts."

- First Ramnath Goenka Memorial Lecture by Dr Raghuram Rajan, Governor of the Reserve Bank of India, New Delhi, 12 March 2016

As we attempt to analyse the Indian economy as a company on the above set of criteria we believe that positive steps are underway. We draw an analogy to a positive change in management for a company which has a huge untapped opportunity, but has not been able to tap the potential due to strategic mistakes. We may add here that we do understand that it's not an apple to apple comparison between a company and a country as large and diversified like India. We are cognisant of the fact that there will be lot of ups and downs as we move forward, but we are also sure that we continue to move in the right direction. The following is our analysis in a nutshell:

Corporate Governance

- Improved focus on tax compliance and reducing corruption
- Transparent auctioning of coal mines
- Formation of bank board and making PSU banks independent
- Ease of doing business and digitisation of processes – major steps are being undertaken towards digitising the processes and improving transparency
- Passing of long pending Real estate regulation, Aadhar bill and good prospects of bankruptcy code being passed

Growth opportunity and strategy to capture the same

- Increased capex to meet demand: focus on infrastructure growth – Roads, Power, Railways etc
- Focus on indigenisation of defence expenditure and reducing imports
- Banking sector reforms
- Foreign policies

Prudent capital allocation and efficient use of resources

- Direct subsidy transfers in LPG to be extended to other sectors with the use Aadhar linked bank accounts- less leakage, better utilisation
- Focus on reduction of non-planned expenditure and increasing planned expenditure
- Make in India initiative- focus on job creation, skill development and import substitution
- Steps to reform power sector and reduce distribution losses through UDAY

Conservative financial management and lower leverage

- Fiscal Prudence – 2016-17 fiscal deficit target at 3.5%
- FDI infusion -long term capital for the economy

Mr Rajan's statement is thus not out of context. The impact of changes has started to becoming visible in incremental data points like IIP, Electricity production, Cement production, Jobs data, automobile growth (especially CVs), FDI numbers etc. With falling inflation, benign interest rates and improved systemic liquidity we believe that future data would further reconfirm this hypothesis. With the management (Government) is moving in the right direction, results will definitely follow.

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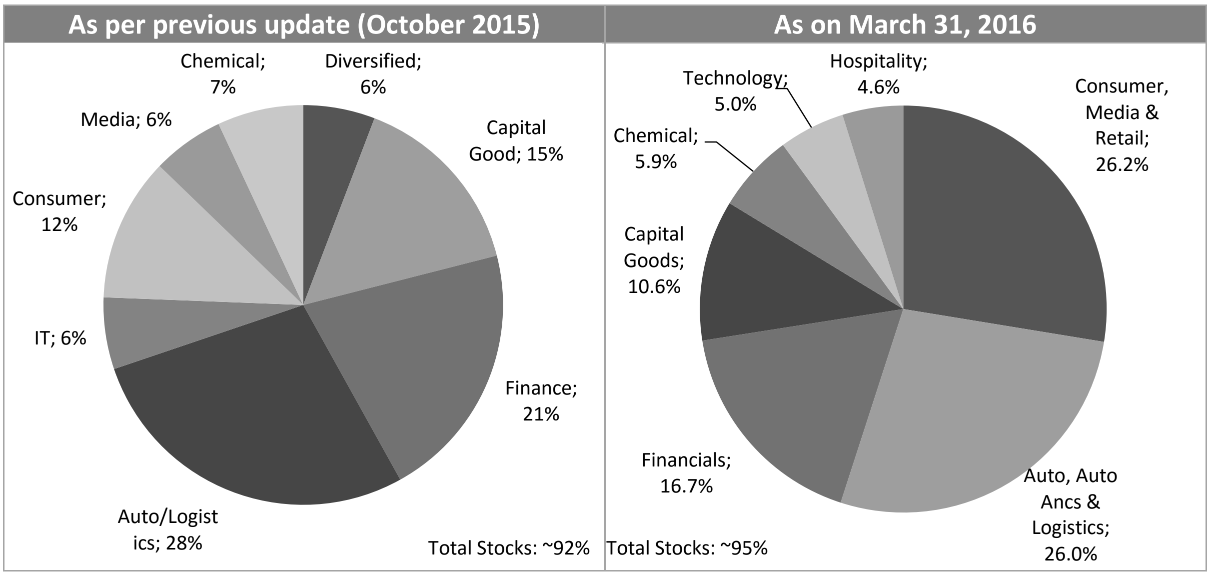
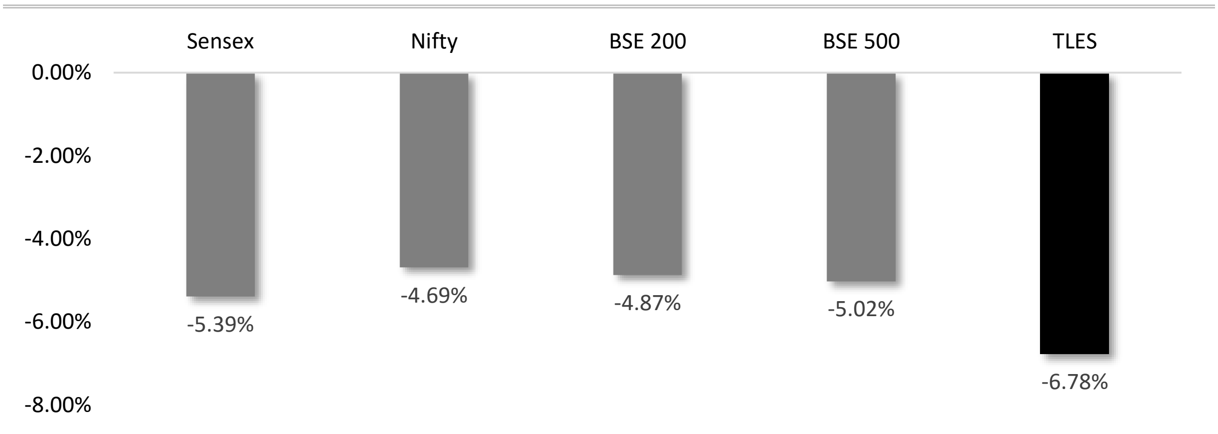
Portfolio Update

In our February 2016 newsletter – 'How Bad Is It?', we wrote *"…we believe that the across the board fall in stock prices is underestimating the ability of some businesses to generate cash flows over the medium term, and therefore offers a good opportunity to buy good businesses at lower prices*." We therefore took the opportunity to review of existing investments as well as the universe of potential investments to scan for businesses that gave the best potential margin of safety after the price fall. This exercise led to two outcomes: a change in the portfolio holdings (some exits, some entries and some rebalancing of existing holdings) and introduction of a new strategy.

In our existing strategy – Tamohara Long Term Equity Strategy (TLES) – we created cash by exiting/reducing some holdings to add to some existing holdings that had fallen sharply but continued to looked attractive as well as to add new holdings to the portfolio. We also dug in to the cash reserve that was created for such opportunities. After all these changes, the following is the portfolio composition (with some minor changes in sector classifications):



Most market corrections usually end with one sharp across the board cut in share prices. Quality, leveraged, cheap, and expensive stocks all witness selling pressures alike. Such pressure is more so in case of mid- & small-cap stocks due to lower liquidity compared to their larger parts. Thus, the major challenge in running a concentrated midcap portfolio is that it tends to underperform sharp market moves. The below performance of our portfolio is a reflection of this phenomena:



The above is based on the Time and AUM weighted returns of all clients between October 05 2015 and March 31 2016.

Indeed, this was a tough quarter as the outperformance and positive returns of the previous quarter were turned over. However, as we had highlighted at the end of the previous quarter, our focus is on the long term and we remain cognisant of short term volatilities. We also remain confident that over the course of the next few years, our portfolio holdings will deliver superior earnings and cash-flows. The following are some of the key matrices of the portfolio as per our internal estimates:

FINANCIAL SUMMARY (INR MN)

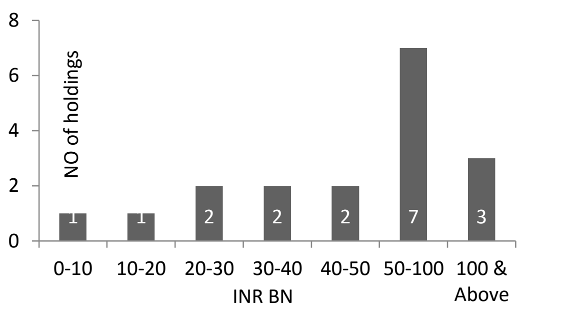
Particulars	F15	F16E	F17E	F18E	F19E	F20E	CAGR
Net Sales Growth (y/y)	N.A.	23%	16%	17%	18%	16%	17%
EBITDA Margin	15%	15%	15%	16%	16%	16%	
Net Profit Growth (y/y)	N.A.	-8%	36%	15%	10%	11%	22%
ROCE	10%	12%	15%	19%	30%	52%	
ROE	11%	12%	18%	26%	25%	25%	
P/E Ratio	22.2*	33.3*	24.9	18.0	13.6	10.9	
P/B Ratio	3.5	2.8	-0.4	6.1	3.7	2.9	
EV/EBITDA	23.4	13.9	10.8	8.7	6.9	5.7	
FCF Yield	5%	1%	3%	5%	6%	7%	

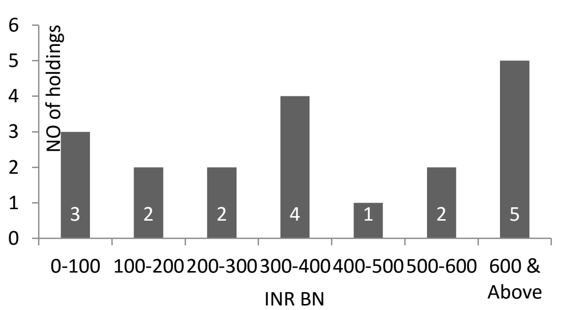
**adjusted for negative/marginal earnings.*

Lastly, we also took the opportunity to introduce a new strategy – Tamohara India Opportunities Strategy (TIOS). The following are some key attributes of the two strategies for easy comparison:

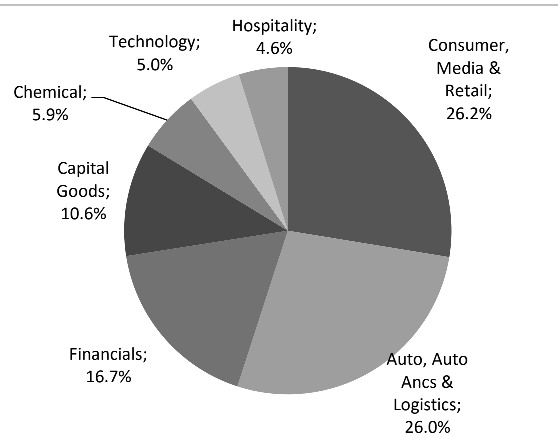
	TLES	TIOS
Positioning	***TLES*** is a long only, benchmark and market cap agnostic strategy, where 80-90% of the portfolio is mid-cap in nature with 0-20% tactical calls on larger cap companies. This is a buy and hold strategy and has been running since October 2015.	***TIOS*** is a multi-cap strategy with a mix of large- and mid-cap in the range of 0-100%; ideal mix being 50-50. This also is a buy and hold strategy; however, churn rates can be higher as volatility in large caps and larger mid-caps might see fair value targets being achieved earlier than expected.

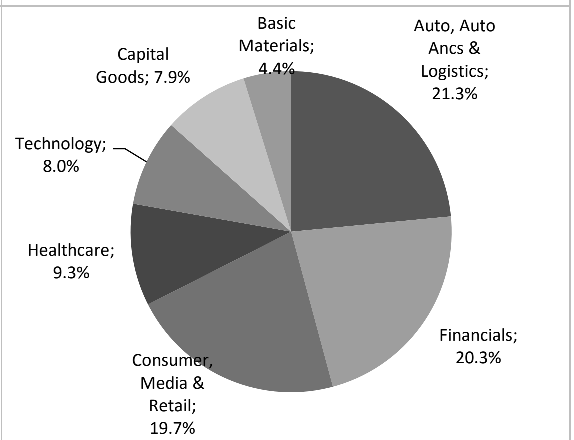
Market Cap Distribution





Sector Distribution





All Data as on March 31, 2016

To Sum IT UP….

…economic recovery continues to be underway, probably at a slightly faster pace. Markets have, and will continue to remain volatile. In the short term, prices are a barometer of sentiments while in the long term fundamentals catch up. As Warren Buffett famously wrote in his 2013 shareholder letter:

> *If "investors" frenetically bought and sold farmland to one another, neither the yields nor the prices of their crops would be increased. The only consequence of such behavior would be decreases in the overall earnings realized by the farm-owning population because of the substantial costs it would incur as it sought advice and switched properties.*
>
> *Nevertheless, both individuals and institutions will constantly be urged to be active by those who profit from giving advice or effecting transactions. The resulting frictional costs can be huge and, for investors in aggregate, devoid of benefit. So ignore the chatter, keep your costs minimal, and invest in stocks as you would in a farm.*

Until next month,

Team Tamohara

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