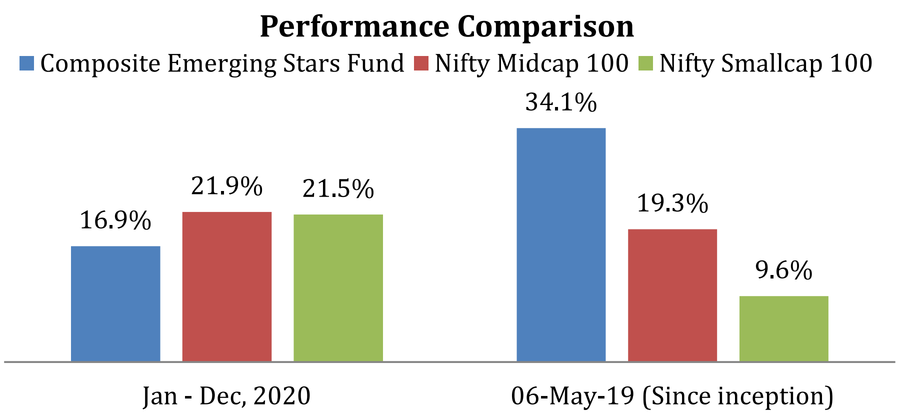
Newsletter
Composite Emerging Stars Fund
January, 2021

Most important question on everyone's mind right now is – have the markets peaked? We ended the previous newsletter with Peter Lynch's quote - "More people have lost money waiting for corrections and anticipating corrections than in the actual corrections" - and that holds true even in the current scenario. We did get a big correction during the year (2020), followed by a massive rally. Magnitude and pace of neither were anticipated. What could have helped in such a scenario is – sticking to the basics of investing – focusing on investing in companies with clean earnings growth.

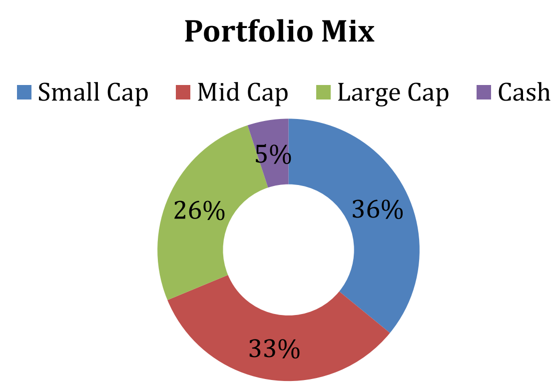
There have been hits and misses during the year as is always the case in markets. One is always learning in the markets and the endeavour is to make the process robust with these learnings. In this newsletter we will cover what went right and also what went wrong with us during the year. We will also cover some of the trends that we were able to pick up from the recently quarterly results of the companies.

The fund returned 16.9% during the calendar year (Jan-Dec 2020) and returns since inception i.e from May, 2019 have been 34.1% at an IRR of 19.3%. The alpha since inception is ~14.7% and 24.5% wrt Nifty Midcap 100 and Small Cap 100 indices respectively. We are lagging the markets during the last two months (Nov-Dec) post the surge in the markets after the vaccine news. But we have been adding into the names which are positioned for recovery in the economy – financials, building materials and consumer durables and have cut down on our pharma exposure where we still maintain a healthy +20% exposure in the portfolio.



Returns are absolute not annualized

Portfolio Mix



Top Performers	**Returns**
Syngene International	166%
KPIT Technologies	146%
Info Edge	140%
Shaily Engineering	107%
Mphasis	99%

Themes/Trends that we are invested in

The numbers below must be looked at in the context of GDP de-growing ***23.9%*** in June quarter and ***7.5%*** in September quarter. Against that backdrop some of the companies, as shown below, have done remarkably well. A few of them are expected to do exceptionally well in the coming years. The tailwinds have been identified and categorized as below.

1. API/CRAMS/CDMO

Revenues, in Cr	Q2 FY21	Q2 FY20	YoY	Q1 FY21	Q1 FY20	YoY
Aarti Drugs	578	478	**21%**	545	405	**35%**
Divis	1749	1446	**21%**	1731	1163	**49%**
IPCA - API	381	314	**21%**	513	298	**72%**
Cipla - API (in $ M)	25	22	**15%**	24	22	**11%**

It is not just China +1 strategy by the customers that is driving the growth for these companies. They have achieved global scale by investing in manufacturing and technical capabilities that is helping them to deliver at competitive prices.

Invested in Aarti Drugs and Divis Laboratories

API = Active Pharmaceutical Ingredient
CRAMS = Contract Research and Manufacturing Services
CDMO = Contract Development and Manufacturing Organisation

2. Outsourcing of manufacturing

Revenue Growth, YoY	FY22 E	FY23 E
Dixon	86%	26%
Amber	34%	33%
Hindustan Foods	65%	35%

PLI (production linked incentive) schemes by Government of India have been a game changer for some of the companies in India. For example, Dixon is expected to triple its revenues in three years. Likewise, outsourcing of manufacturing is a trend that is expected to play out in different segments including FMCG. Companies are no longer guided by tax holidays to set up manufacturing units. Private label contribution to sales for retailers and e-commerce companies is still at a nascent stage in India.

Invested in Hindustan Foods

3. Market share gains and improved working capital/balance sheet for large organized players

Revenue Growth, YoY	Q2 FY21	Q2 FY20	**YoY**
Tata Consumer	1736	1427	**22%**
Whirlpool	1599	1393	**15%**
Astral Poly Technik	752	681	**10%**
Havells	2452	2230	**10%**
Asian Paints	4527	4278	**6%**

The results by the market leaders has reinforced the learning that leaders emerge stronger out of difficult times. They not only gain market share over unorganized and also smaller companies but also improve upon their working capital and balance sheet through cost rationalization.

	Working Capital Days		Net Debt/Equity	
	Q2 FY21	Q2 FY20	Q2 FY21	Q2 FY20
Kajaria Ceramics	50	64	-0.20	-0.08
APL Apollo Tubes	7	21	0.20	0.80

Invested in Tata Consumer and Asian Paints

4. Faster digitalization

Revenue Growth, YoY	Q2 FY21	Q2 FY20	**YoY**
L&T Infotech	5948	5056	**18%**
Persistent	1008	885	**14%**
Affle	135	85	**59%**

Digitialization is also evident from:

- ✓ Growth in companies like Amazon, Big Basket, Netflix etc
- ✓ Reduction in cost to income ratios of Banks – digital adoption leading to smaller branches and lesser manpower requirement at branches
- ✓ Increased sourcing of customers digitally by companies including ICICI Lombard, HDFC Life etc

Invested in Persistent and ICICI Lombard

Further tailwinds that are driving growth for some of the companies are:

5. **Demand recovery led by low interest rates** *and*

6. **Reforms by the Government – labor, agriculture, ease of doing business etc**

Most important learning reinforced by the events during the year

Time not timing is important: Probability of losing on an investment reduces as the amount of time spent in the market increases. The limiting factor is of course the quality of companies invested.

What went right

Most important thing that went right is that we were almost fully invested right through the pandemic. We have been +80% invested since April, 2020 and +90% invested since August, 2020. We are currently at 95%. It wasn't an easy decision to stay fully invested right during this testing period. But what helped were the following:

1. Re-orienting the portfolio towards segments that were showing signs of doing well during the pandemic like Pharma and showing signs of faster recovery like IT.
2. Taking smaller position sizes and diversifying the portfolio. We are currently at 29 stocks vis-à-vis 20 stocks during the early part of the year. We are likely to continue holding around 25-30 stocks.

What went wrong

1. Late in selling and re-orienting the portfolio. Took time to understand the nature and impact of the pandemic.
2. Some of the companies we sold went on to recover strongly, helped by news of vaccine as well as by government interventions like PLI schemes etc. But the mitigating factor has been that some of the names we have entered into have also returned 2-3x. These were names that we were comfortable holding during the time of the pandemic and if things took longer to return to normalcy.

Portfolio Stock

'Flywheel' investing

- We are in the lookout for companies that are relentlessly taking small steps in the right direction that in turn builds on itself and gains momentum and produces more and more positive results, just like a flywheel.
- Focus is on to position the flywheel in a conducive environment where it is easier for the effects to take place.
- We also want the wheel spinning for a long time and hence look for long term structural trends.

One of the examples of our 'flywheel' investing in our portfolio is **Shaily Engineering**

High Revenue growth + Operating leverage + Financial Leverage + PE Re-rating

When we first bought the stock in June, 2020, the market cap of the company was ~300Cr (currently ~620Cr). During the last two years (i.e FY19 and FY20) it had generated cash flow from operation (CFO) of ~65Cr annually. This translates to CFO yield of ~20%. And we expect the CFO to increase to ~90-100Cr pa by FY23, which gives us CFO yield of ~15% even at current market capitalization.

With the commercialization of new projects and contracts, we expect the revenues to grow by atleast 75% by FY23. Add to it the financial leverage (and keeping the margins constant conservatively) and it would lead to earnings growing by ~2x.

With CFO yield of ~15% and expected PE of ~12x based on FY23 earnings, we continue to stay invested in the company. The stock has historically traded at 30x trailing earnings, translating to a target price of 2.5x in two years.

Apart from the numbers, what is it that attracted us to invest in Shaily Engineering?

Coming out of temporary problems: The company has ten year earnings CAGR of ~28% but earnings stagnanted during the last two years. A number of temporary problems were bunched together – labor issues, power supply issues, inventory correction by one of the largest customer, under utilization of a project, etc. Due to these temporary problems the stock de-rated to ~12x trailing PE (historically traded at 30x).

Increasing management bandwidth: The company was under invested in human resources which led to execution challenges and lost opportunities. It has acknowledged the same and as part of corrective steps recruited a new CEO in June, 2020 who has previously worked at a ~$7B auto ancillary company. It is also in the process of recruiting additional manpower in engineering services and business development.

Long standing relationships with reputed global companies: It has +10 year relationships with its customers including one of the largest home furnishing companies, leading FMCG companies, global pharma companies etc

Venturing into adjacencies leveraging its core competency, which is process engineering: The company has historically been supplying plastic moulded consumer products and contract manufacturing for pharma and auto companies. It is now venturing into manufacturing toys, IP led pharma products and steel furniture (catering to one of its existing clients).

Lastly coming back to numbers again -

Earnings growth with minimal dilution, high returns and improved leverage: During the last 10 years the earnings have grown at ~28% CAGR, while leverage ratio (D/E) has come down from 2.3x to 0.8x. The company has maintained +15% RoCE all through this period.

What has pandemic taught us?

Simple things matter. In Life and in investing. A mask, hand-wash and social distancing were all that mattered. Similarly, all that matters in investing is as Charlie Munger says "All I want to know is where I'm going to die so I'll never go there"

Wish all our readers a very happy and prosperous new year !

Sincerely,
Vinod Jayaram
Composite Investment Pvt Ltd.