Equirus Long Horizon Fund
Investor Communiqué – Dec'21

Dear Investor,

Trust you are doing well! After two testing years 2020 and 2021, 2022 has begun on somewhat sombre note. The country as well as the world is caught in yet another Covid wave. While the number of cases has spiked very fast, the number of hospitalizations and deaths seem to be much lower compared the previous waves, especially the Delta wave. This might be due to the presence of antibodies due to previous infections and/or a very strong vaccination program carried out by the government. Whatever the reason, we hope this wave subsides without causing much impact to the lives or livelihood.

In [Dec 2020 letter], we were talking about the Sensex hitting 50,000 marks. This seems to be a distant past as the Sensex was trading well above 60,000 levels in 2022. These levels by themselves don't mean much and we pay very little if any attention to them. These numbers, however, bring out various emotions among the market participants.

Investing increasingly becomes more challenging behaviorally. These words by Rudyard Kipling in his poem 'If' are apt here. "If you can keep your head when all about you are losing theirs". At this point it is of utmost importance to keep a balanced perspective rather than being swayed away by euphoria of the market participants and our own past performance. The opportunities that market presented in last few years have been soaked up. New opportunities are few and far between and even the ones that are available are not straight forward. We will discuss one such recent investment in this letter. Before that I would like to reproduce one of our recent media write-ups here.

The meagre mention of ‘finance’ and imageries of calculations, statistics, figures, rush as a flashback in our minds. Eventually, emotions, feelings and any other aspects take a backseat. However, what often goes unnoticed is that our behavioural trait has an important implication on our decision making in our financial endeavours. The envy and angst generated due to external situations can impact our financial decisions significantly.

The impact of behavioural traits on our financial decisions

Consider this thought experiment as an example. Mr. A and his family invested in a PMS (Portfolio Management Services) with an expectation of earning a 15% CAGR. The fund manager surpassed their expectations and delivered a 17% CAGR over a 3-year period. Mr. A and his family were ecstatic with the results until they came across an advertisement by another PMS provider indicating it successfully delivered a 22% CAGR over the same period. This made Mr. A envious, regretful and even furious at their fund manager. The sole reason for this is that our minds have been wired in such a way that we always want to be in the top position in all our endeavours. Hence, we want the best of the deals and the highest ROI especially when it comes to finance management and investing our savings. Due to this very reason, A pulled the money out and invested in the fund they saw in the advertisement.

This behaviour is especially visible when we allocate funds to a Mutual fund or a PMS. We easily start second-guessing our decisions when the fund manager is going through a lean patch or is not acing the performance charts. On the other hand, the funds that we allocate ourselves especially to illiquid assets like real estate or gold do not undergo such levels of scrutiny. Even if our fund managers underperform all other asset classes, we tend to hang on to those. We do not give a long enough rope to the fund managers we select even after a thorough research.

The outperformance of funds and their effective management by Fund Managers: The key elements in investments

It usually happens that the funds that have outperformed in the past few years end up attracting a lot of capital. The outperformance happens due to the equities/sectors/securities that the funds were invested in, performed well due to margin improvement and valuation rerating. Higher valuations of these securities are detrimental to future performance. With a huge fund inflow, the fund manager must allocate a lot more funds. But they should keep in mind not to overdo in the lure of attractive valuations as this could lead to underperformance in the next few years!

Furthermore, the Net Asset Value of the fund may look promising even after a few years but the new capital that was put in might not get similar returns. In the example quoted above, when Mr. A is lured to switch to the outperforming PMS nudged by his envy, he is not only risking underperformance in new PMS but is also foregoing the outperformance that could have happened in his original PMS due to the market's cyclical nature. These cycles play out inevitably and there are numerous such anecdotes in the market.

Summing up

However, this does not imply that one should stick to their fund managers even if they are underperforming. But whenever and wherever you plan to invest, it is advisable that you first understand the investment philosophy as well as the mandate of the fund manager. Apart from looking at the performance outcomes, one should keep a sharp eye on the process of the fund manager as well. You should monitor their progress to check if they are sticking to the mandate. If your fund manager deviates from the mandate due to the latest fad in the market or other external factors that could affect your investment; then it might be a good time to consider a new fund.

However, in case, the fund manager is sticking to the mandate and performing well but is not in the prime position, then, the next logical step would be to give this manager a longer rope and consider associating with another expert. The bottom line is that our behavioural biases might pose a hindrance and we should be conscious as well as cautious of these while deciding to investing in or switching to a new fund. In financial matters, patience can be a good behavioural antidote to envy!

The idea of reproducing this article here is twofold. One, obviously, is to drive home the understanding that any investment styles will not permanently outperform markets or other styles. So, it makes sense to stick with a style through its ups and downs. Two, though not obvious, is to tone down the expectations of our partners. The good run that we have enjoyed over past couple years might not be repeatable in the years to come. This is not to discourage you from making more commitments but to keep expectations in check. So then let's move on to what we have been upto in the past quarter. We invested in a company called Prataap Snacks Ltd. The company was on our radar for a long time but the opportunity to invest only cropped up recently.

Prataap Snacks Ltd.

Set up in Indore in FY03 by Arvind Mehta, Apoorva Kumat and Amit Kumat, Prataap Snacks has become one of India's leading snack foods companies. It manufactures and markets both savoury (potato chips, namkeen & extruded snacks) and sweet snacks. Product portfolio is spread over 100 SKUs. PSL sells ~11 mn packets every day and is the market leader in rings. The products are marketed under multiple brands 'Yellow Diamond' & 'Avadh' for savoury portfolio and 'Rich Feast' for sweet snacks portfolio. Products are marketed across India via super stockists & distributors to more than 1.7 mn retail touchpoints. It operates 15 manufacturing facilities. PSL is 48.39% owned by Sequoia and 23.1% by founders.

Investment rationale - Our thesis for PSL hinges on three main pillars:

- **Sector undergoing stress** –
    - The industry growth had come down during past few years along with weakness in the country's economy prevailing before Covid. Covid exacerbated this weakness as large part of the revenues for the snacking companies come from impulse purchases of small packs (Rs. 5). The sales growth came down across the sector.
    - Further there has been tremendous pressure from the cost side. The prices of major input materials like agri inputs (imported palm oil due to govt import taxes, potatoes), crude oil related packaging laminates, paper related corrugated boxes, etc. have shot up substantially over past few years. The impact on gross margin has been substantial. The effect will slowly wear off as the industry corrects the prices either through increasing the prices or reducing grammages.
    - We believe both these factors i.e. sales growth and gross margins will normalize in coming years and the economy starts reviving. The sector looks to have bottomed out.
- **Structural changes in the company –** PSL is undertaking steps to improve the profitability structurally. Among them two major initiatives are:
    - Focus on improving product mix by increasing the share of sweet products in the revenue base. Sweet products currently contribute only ~3% which management wants to expand to 10%. Sweet products bring with them much better gross margins. Product mix will further improve by increasing revenues from the larger SKUs (bigger packs) which has been a focus area. Both these steps should result in superior gross margins.
    - PSL is fundamentally altering its distribution model which currently has three layers: Super stockists, distributors, and retailers. PSL has decided to eliminate super stockists from the chain thereby saving 2-3% of stockist margins which should flow to the company. Further PSL has already decreased distributor margins by 2-3% and is further planning to reduce it by the same amount in next 2-3 years. These steps should cumulatively result in a big improvement in the operating margins.

        - Initiatives have also been taken to widen the reach as well as establishing a stronger connect with the existing distributors for better sales and efficiency of the distribution network.
    - These steps in conjunction should lead to a much better profitability and hence improvement in return ratios over the years.
- **Low valuations:** Given the balance sheet of the company and the track record of management, PSL trades at a much cheaper valuations compared to its smaller peers or even its own valuation in the past.
    - At 1.5x sales, PSL is much cheaper than its peers in the range of ~3x sales and ~4x sales at which it was valued by the market in the past. It is ripe for rerating, if the management initiatives play out and/or the sector performance mean reverts.
    - The margin of safety is built in the price, just as we like it.

As indicated in the past, we like plays in which there are two legs through which we make our returns: earnings growth and valuation rerating. This approach gives us both margin of safety in price as well as strong return potential. PSL with its clean balance sheet, top notch corporate governance and potential tailwinds is one such opportunity that has been added recently to our portfolios.

Fund Performance

We present below the performance of ELHF in comparison to benchmark indices. Returns vary across clients, depending on their entry into the PMS.

Comparative performance of ELHF vs. benchmark indices[1]

	FY 16-17 (20Oct'16)	FY 18	FY 19	FY 20	FY 21	FYTD 22[2]	Since Inception (Absolute)	Alpha	Since Inception (CAGR)
Equirus Long Horizon Fund	**6.9%**	**36.8%**	**-3.2%**	**-26.8%**	**144.2%**	**53.6%**	**288.5%**		**29.8%**
BSE SMALL CAP	8.1%	17.7%	-11.6%	-36.1%	114.9%	42.7%	120.6%	167.9%	16.4%
BSE 200	6.0%	11.0%	10.7%	-26.4%	74.3%	19.8%	100.2%	188.3%	14.3%
BSE 100	6.1%	10.6%	12.4%	-26.6%	71.5%	18.6%	96.9%	191.6%	13.9%

[1] *Return figures are net of fees and as of 31st Dec' 21. Returns are adjusted for inflows/outflows and are TWRR*

[2] *Year to date performance till 31st Dec' 21.*

Current Aggregate Portfolio Characteristics

As a step towards greater transparency, we share our portfolio-level characteristics every quarter:

Number of businesses	16 companies
Current cash position	~11.5%
Last 3-year average earnings growth	9.3%
Latest portfolio ROE	14.0%
TTM (trailing twelve month) portfolio PE	28.2x
Acquisition portfolio TTM PE	17.4x
Churn	20% per annum (excluding the buying/selling of Liquid Mutual Funds, stocks given to us by our investors and capital redemption by investors).

I thank you for your valuable support and trust for investing in ELHF, and I reinforce our commitment to make your investment decision profitable.

For any queries, please feel free to contact with Siddhartha (siddhartha.grover@equirus.com). And if you happen to be in Ahmedabad, me and my team will be happy to host you at our office.

Thanking you,

Viraj Mehta
Managing Director
Equirus PMS

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Returns are net of fees and is calculated as per TWRR. Trading and investment in equities is subject to market risk, there is no assurance or guarantee of the returns, it will be purely a target return rather than guaranteed return. Past performance may or may not be sustained in future and should not be used as basis for comparison with other investments. Performance data provided is not verified by SEBI.