Equirus Long Horizon Fund

Investor Communiqué – July' 21

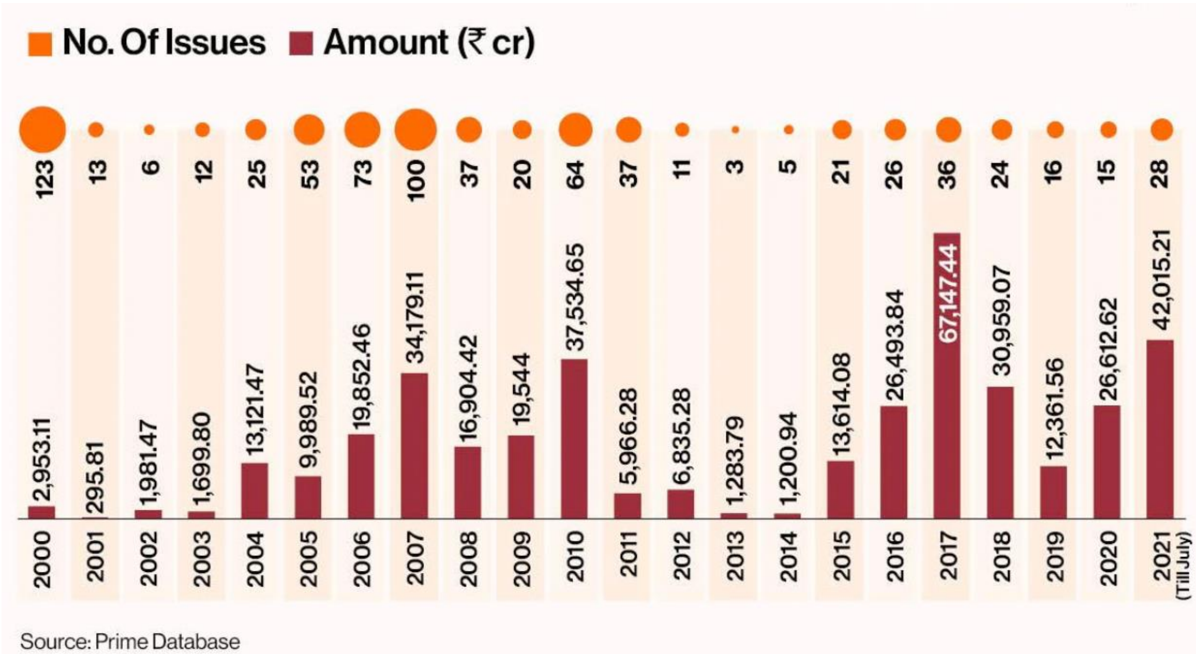
The second wave seems to have relented barring in certain parts of the country. Globally, the cases have shown an increasing trend however the number of deaths has been much lower compared to previous waves. This shows that the healthcare infra is in better shape and more importantly vaccines have been instrumental in reducing mortality. These are good signs for India as well. The third wave if it comes hopefully should be much milder than the second one. On economic front, if third wave does not derail things, we are on a very strong footing.

So, is India at the cusp of an economic boom? Will the US$ 5 tn GDP number become reality in next few years? The signs are surely in place. Capital formation (capex) cycle has seen revival backed by government spending. Commodity prices are rallying with demand driven by global infra spending. Corporate earnings are showing excellent growth. Job growth is on an upward trajectory. The tax collections numbers are buoyant. Residential units are selling like hot cakes. New unicorns are being created every other day. Stock markets are at their life highs. Demat accounts are being opened at an unprecedented pace.

While on the healthcare front the situation has been gloomy, it has been great time for asset owners especially equities. Equity owners in any form be it promoters, institutions, or small shareholders have created incredible wealth over the past year. The equity party has been all encompassing with valuations going up across the board from initial stage start-ups to massively funded unicorns in private space and from highly illiquid micro-caps to widely held mega-caps. Low interest rates have driven liquidity rich funds from developed markets to chase returns in emerging markets like India. The obvious implication of this has be a rush to raise money by especially by start-ups striving to acquire customers/market share at any costs. This has been encouraged by the newfound ability of companies to tap public markets in India and provide an exit opportunity to the investors. The clear example of this has be the IPO of Zomato which was subscribed by more than 3.0 million retail investors. With Zomato's IPO, India has clearly entered a new phase in IPO markets.

Dhirubhai Ambani kicked off the IPO market in late 70s with Reliance public offering which was priced at par with face value. There is little doubt that this was the real starting of retail participation in Indian markets. In 1992 SEBI was constituted essentially replacing Capital Controller of Issues (CCI) which used to set the price for IPOs. The pricing was then deregulated. This ushered in a new phase in Indian capital markets led by Infosys IPO in 1993. Implausible as it may seem, Infosys public issue was undersubscribed. Infosys since then has been the poster boy of wealth creation. Hundreds of IPOs happened in the few years post deregulation of pricing. Many of them were outright frauds. SEBI over time developed mechanisms to prevent such scams. Regulations also evolved to incorporate globally accepted practices like book building to make the entire process more transparent.

IPO market is instrumental in functioning equity markets which help minority shareholders own part of the business and participate in wealth creation as the company grows. IPO's generally fulfil two major objectives: (i) Bring in the risk (equity) capital to the companies for growth (ii) Provide exit to promoters/early investors which further encourage investment environment. However, IPO market is highly cyclical and fluctuates lock-in step with the fortunes of secondary markets. As it happens when stock markets are doing well (effect), liquidity is abundant (one of the causes) which leads to more companies seeking capital from primary markets. With abundant liquidity and euphoria in the markets the level of scrutiny that new listings have to go through is much lower compared to other times. Hence it is clearly visible in the following chart that when markets are doing well the number of IPOs and amount of funds raised is much higher. Year 2007, 2010, 2017 are prime examples.



Source: Businesstoday.in

Is the same true for current IPO boom? The answer is unequivocally yes. 2021 is slated to be the largest year in terms of fund raising and this may continue in year 2022.

The question then arises: Should a investor one participate in this IPO party? If yes, how, and when? To answer these questions, one must understand the incentives of the key players involved in this game: Promoters/Investors and Bankers. When promoters/Investors are selling/diluting their stake, it is in their interest to gain maximum value for their shares/stake. Investment bankers are interested in making maximum fees (generally is a percentage of the funds raised) which again incentivises them to help promoters garner maximum valuations. Hence incentives of both these parties are aligned to sell the issue at maximum valuations possible. From our communications in the past, you would be aware that valuations are one of the cornerstones of our investment philosophy. More on this later. We are firm believers that 'Good company many not necessarily be a good investment.' This can be articulated better than what Howard Marks wrote in one of his best memos:

"For a value investor, price has to be the starting point. It has been demonstrated time and time again that no asset is so good that it can't become a bad investment if bought at too high a price. And there are few assets so bad that they can't be a good investment when bought cheap enough.

When people say flatly, "we only buy A" or "A is a superior asset class," that sounds a lot like "we'd buy A at any price . . . and we'd buy it before B, C or D at any price." That just has to be a mistake. ***No asset class or investment has the birthright of a high return. It's only attractive if it's priced right.***

Hopefully, if I offered to sell you my car, you'd ask the price before saying yes or no.

Deciding on an investment without carefully considering the fairness of its price is just as silly. But when people decide without disciplined consideration of valuation that they want to own something, as they did with tech stocks in the late 1990s – or that they simply won't own something, as they did with "junk bonds" in the 1970s and early 1980s – that's just what they're doing.

During the course of my 35 years in this business, investors' biggest losses have come when they bought securities of what they thought were perfect companies – where nothing could go wrong – at prices assuming that degree of perfection . . . and more. They forgot that "good company" isn't synonymous with "good investment." Bottom line: ***there's no such thing as a good idea regardless of price!***

On the way to work the other day, I heard an "expert" tell a radio commentator how to invest in today's stock market. "Figure out which industries have been doing best, and pick out the leading companies in those industries. The professionals know which they are, so their stocks will sport P/E ratios that are higher than the rest. But that's okay: do you want the best companies or the worst?" ***My answer's simple: I want the best buys.****"*

Another important aspect to consider is the information asymmetry. To continue with the car example, a seller of a used car who has owned it for many years understands the car well and the snags that I may have. However, it is highly likely that the buyer of this car might not be apprised about these. Even if informed, buyer may not be able the grasp the magnitude and effect of those snags on car's performance in the future. The same is true for the company being IPOed. Though the bride/groom has been dressed up for the IPO, the real character will only be apparent in the years to come. An interesting data point: While retail investors flocked Zomato IPO (>7x subscription), employee category was not even fully subscribed (~0.6x). Unfortunately, the unsuspecting retail investor equipped with euphoria, FOMO (fear of missing out), envy, and surplus liquidity ends being caught on the wrong foot in the long run.

So, is the entire concept of IPO is flawed? Should one never invest in an IPO? The answer is no and no. The most important considerations here are the ability to understand business including its future possibilities and the valuation at which shares are being offered. Without understanding the business there is no investment case. If the company falls under the circle of competence, then at attractive valuations, the returns are generally worth the risk. Readers of this letter also know that investing is a game of probabilities and not certainties. With valuations on your side, even if things don't work out to your expectations, the losses should be restricted. The table below indicates the returns that IPOs generate over a longer term.

To gain some insights on how the companies that IPOed since 2010 have done over the years we did some number crunching. There have been a total of 293 IPOs on mainboard till July.

- 133 have given negative returns compared to their issue price; ~45% chance that you picked a loser
- 87 are down more than 50%; ~30% chance that you picked a big loser
- 84 have returned more than 10% cagr; ~29% chance that you at least matched Nifty ***(Nifty50 returned 10.3% Jan 1, 2010 till Aug 5, 2021)***

- 71 have returned more than 15% cagr; ~24% chance that you picked a winner

- 49 have returned more than 25% cagr; ~17% chance that you picked a big winner; However, 18 of these winners have been listed for less than 3 years

These number get even more interesting when we remove recently listed companies (<3 years since listing) from the data. 227 companies remain. Here are our findings:

- 125 have given negative returns compared to their issue price; ~55% chance that you picked a loser

- 85 are down more than 50%; ~37% chance that you picked a big loser

- 66 are down more than 70%; ~29% chance that you picked a big loser

- 63 have returned more than 10% cagr; ~28% chance that you at least matched Nifty ***(Nifty50 returned 10.3% Jan 1, 2010 till Aug 5, 2021)***

- 50 have returned more than 15% cagr; ~22% chance that you picked a winner

- 31 have returned more than 25% cagr; ~14% chance that you picked a big winner

The data above clearly shows that one had barely 28% chance of bettering Nifty and more than 55% chance of picking a loser. The base rates are heavily stacked against making money from IPOs.

There will be some massive winners emerging from new IPOs but they are few and far between. Those winners can be picked even from secondary markets which give you time to analyse and opportunity to buy at a time and price of your choosing. Investing in an IPO to generate long term returns is like a wild goose chase. So don't be in a hurry to join the party. Look before you leap!

Fund Performance

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

Comparative performance of ELHF vs. benchmark indices[1]

	FY 16-17 (20Oct'16)	FY 17-18	FY 18-19	FY 19-20	FY 20-21	FY 21-22[2]	Since Inception	Alpha
Equirus Long Horizon Fund	**6.9%**	**36.8%**	**-3.2%**	-26.8%	**144.2%**	**48.0%**	**274.3%**	
BSE SMALL CAP	8.1%	17.7%	-11.6%	-36.1%	114.9%	29.7%	100.6%	173.7%
BSE 200	6.0%	11.0%	10.7%	-26.4%	74.3%	9.4%	82.7%	191.7%
BSE 100	6.1%	10.6%	12.4%	-26.6%	71.5%	8.4%	80.0%	194.4%

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

[2] *Year to date performance till 31th July' 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	~6.2%
Last 3-year average earnings growth	14.6%
Latest portfolio ROE	15.1%
TTM (trailing twelve month) portfolio PE	23.5x
Acquisition portfolio TTM PE	11.9x
Churn	22% 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 get in touch 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.