Equirus Long Horizon Fund

Investor Communiqué - Jun'19

The narrative of election is a thing of past now. With a stable government in place and the budget announced, the tone is set for the next 5 years.

Ms. Nirmala Sitharaman's maiden budget was more about incremental changes and implementation of past policies vs. expectations of big-bang reforms to kick in animal spirits and drive GDP growth. While it was reassuring to see the fiscal glide path being adhered to, we feel tax collection estimates might be highly optimistic, especially with growth weakening across the board. It was also somewhat disappointing to see more taxes and surcharges being imposed on the so called 'super-rich' and FPI investments. Often, these segments are the country's job creators and disincentivizing them may not augur well for growth or the vision of quickly transitioning India into a US$ 5trn economy. This disappointment was reflected in the market, which – in the post-budget session - responded with one of the steepest one-day falls in the last decade.

Having said that, not everything is negative. We Indians are a resilient and enterprising lot. The growth story is still intact, albeit with a few caveats. The macro environment continues to be stable with currency, inflation and crude oil prices under control. This sets a base for a rate cut in the next RBI monetary policy review. Rate cuts may aid to restore consumption as well as encourage capital investments, resulting in bringing back GDP growth to the levels we aspire for.

As we have discussed in our past letters, mid and small-cap companies continue to underperform. Also, the divergence in performance continues to exist, with a handful of companies trading near their life-highs driving the headline NIFTY and Sensex numbers, while a significant part of the market trading near its multi-year lows. The situation should correct itself in the long term, but these dislocations are an inseparable part of markets. In fact, these dislocations and anomalies provide long-term opportunities. On that note, we discuss one of our recent investments to give you a flavor of our investment thought process.

Our recent investment – A snapshot

Ujjivan Financial Services (Ujjivan) was founded in 2004 by Mr. Samit Ghosh with initial capital from his savings as well as friends and family. Ujjivan raised PE capital in 2005 to obtain a NBFC license from the RBI. It was one of the first for-profit organizations to enter microfinance. Other microfinance institutions (MFIs) like SKS and Bandhan were incorporated as NGOs and later converted to for-profit companies.

From the very start, Mr. Ghosh had a vision of providing a full gamut of financial services to the underserved category. While other MFIs were operating mostly in rural regions, Ujjivan's focus was on the marginalized urban poor. Hence, operations started from Bengaluru. Cognizant of the geographical concentration, Ujjivan diversified into the NCR region as soon as the operations were off-the-ground by 2008. Within another 3-4 years, it ventured to east and west as well. Ujjivan became a NBFC-MFI in 2013 and later received the Small Finance Bank (SFB) license from the RBI in 2015. It launched banking operations in Feb'17 in the aftermath of demonetization.

What do we like about the company?

- **Customer focus:** Mr. Ghosh, with banking experience from Citi Bank and HDFC Bank, inculcated customer focus as a key value.

- **Best Employer:** Mr. Ghosh borrowed the culture of employee care from Citi Bank but excluded the culture of competition. Over the years, Ujjivan has received many awards for being one of best employers across industries.

- **Upfront technology investments:** By virtue of being in Bangalore, Mr. Ghosh wanted to have a very strong technology backbone for Ujjivan, so he did not shy away from investments in technology.

What is the investment case?

- **Win-win:** While SFBs face more stringent regulations than normal banks, especially on asset side, they have established a profitable business model by catering to the pyramid base profitably. This is in line with India's financial inclusion objective and related policy actions like setting up of MUDRA bank, and Pradhan Mantri Jan Dhan Yojana.

- **Opportunity size:** India, with over 400mn of the world's unbanked population, provides a huge opportunity. Microfinance-focused SCBs and NBFCs stand to benefit the most as they operate in a space which other banks and have not been able to venture into profitably. The MFI industry is expected to grow at over 25% CAGR for many years.

- **Operating leverage:** We expect Ujjivan's assets to grow at more than 25% CAGR over many years. With most of the physical and technological infrastructure in place, topline growth should outpace fixed expenses, resulting in a sharp increase in profitability. This will be aided by a reduction in borrowing costs as the proportion of deposits and CASA increase on the liability side.

- **Credit costs to normalize:** In FY17 and FY18, NPAs spiked as a result of demonetization. These have already been provided for. Given the nature of business, NPAs can be cyclical; we expect these to be much more moderated in the future as Ujjivan diversifies into more secured products.

What is the overhang?

- **Holding Structure:** As a condition for license, RBI mandated the listing of SFBs within 3 years of achieving Rs 5,000 mn of net worth. As a result, Ujjivan must list its SFB by Jan'20 while maintaining promoter holding at 40%. As Ujjivan has no promoters, the currentlylisted entity will become a holding company with a >40% stake of the SFB (to be listed separately). The dual listing may hit shareholder value of the holding company. However, management has made its intent clear to merge the holding company as soon as it is allowed by the regulator. We expect the holding company discount if any to be meagre.

- **Misperception:** Microfinance is still at a nascent stage in India with barely two decades of history. During these years, it has been affected by many adverse events (Andhra crisis, demonetization), which has hit the financial health of MFIs. Despite this, the industry has thrived to become an integral part of the financial system. Due to bitter experience, investors are wary of investing in these businesses. However, we believe that the industry is much more mature now and resilient to ride any future mishaps.

- **Management change:** With Mr. Ghosh set to retire from active management, Mr. Nitin Chugh would take over as MD and CEO starting 1 Dec'19. Mr. Chugh has led digital banking in HDFC Bank and comes with over 20 years of rich banking experience. We expect a smooth transition of management.

At a market cap of ~Rs. 34,500mn, we are getting an SFB which has a huge runway for growth with costs/capacities in place to capitalize on that opportunity at ~1.8x FY19 BV. At this valuation, we believe the risks are largely factored in. Industry tailwinds should sustain for many years to come, resulting in handsome returns for shareholders.

Fund Performance

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

Comparative performance of Model portfolio vs. benchmark indices[1]

	FY 16-17 (20 Oct'16)	FY 17-18	FY 18-19	FY 19-20[3]
Model Portfolio[2]	7.8%	38.9%	-4.2%	-3.2%
BSE SMALL CAP	11.4%	17.4%	-11.6%	-7.4%
BSE 200	8.5%	11.0%	10.7%	-1.4%
BSE 100	8.4%	10.6%	12.5%	-0.9%

Comparative performance of ELHF vs. benchmark indices[1]

	FY 16-17 (20 Oct'16)	FY 17-18	FY 18-19	FY 19-20[3]
Equirus Long Horizon Fund	9.8%	29.4%	-4.1%	-3.7%
BSE SMALL CAP	15.5%	11.9%	-12.2%	-6.2%
BSE 200	11.4%	7.6%	10.3%	-0.2%
BSE 100	11.2%	7.2%	12.1%	0.2%

As discussed before, we think this is a good time to increase allocation to existing portfolio stocks.

[1] *Return figures are net of fees and as of 30th Jun' 19. Returns are adjusted for inflows/outflows and are TWRR*

[2] *Model portfolio is the portfolio of first investor in the fund*

[3] *Year to date performance till 30th Jun' 19*

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Current Aggregate Portfolio Characteristics

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

Number of businesses	15 companies
Current cash position	~3.2%
Last 3-year average earnings growth	96%
Latest portfolio ROE	20%
TTM (trailing twelve month) portfolio PE	17.1x
Acquisition portfolio TTM PE	15.9x
Churn	24.9% (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
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