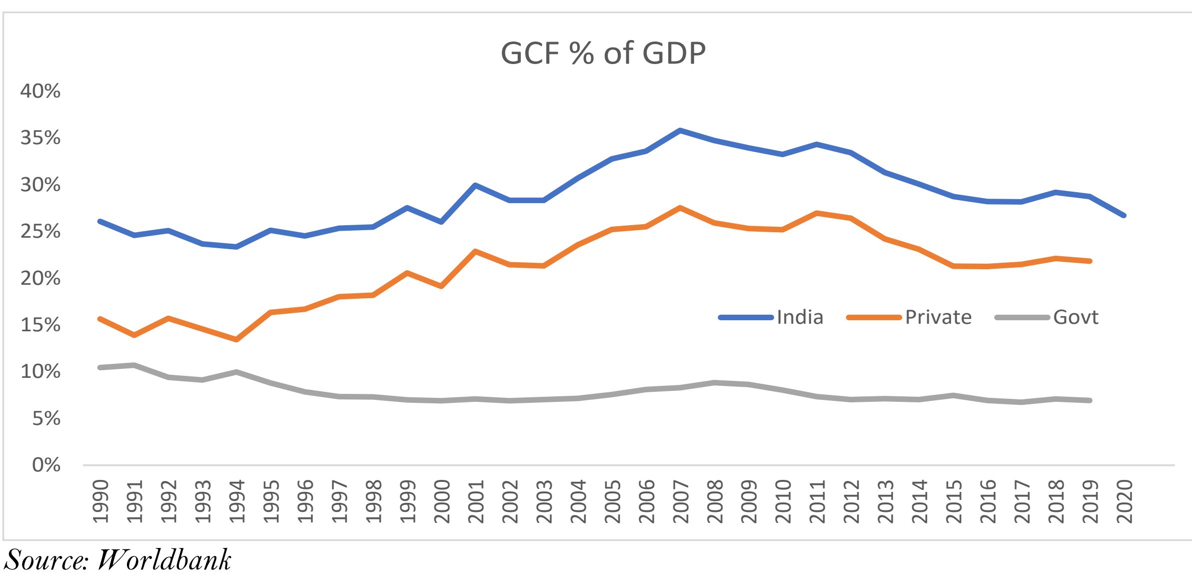
Equirus Long Horizon Fund
Investor Communiqué – Sep'21

Dear Investor,

The festive season has begun and brought with it some much-needed cheer! The pandemic seems to be fading in the background and COVID 3.0 appears to be a remote possibility as of now. However, as they say - never let your guards (and masks) down. The economy seems to be on a strong footing and the trend is only strengthening. In this letter, we discuss how economic cycles affect corporates and their behavior, and in a way provide us insights into new investment opportunities. This is particularly important when headline indices are creating new highs.

GDP comprises consumption, net exports, and capital expenditure (capex). When India started growing at a brisk pace post liberalization in 1991 (cycle peaked in 2007), capex was a key growth driver. Govt. share of capex has been on a downtrend for a long time now, even as private capex successfully held up till 2012. Since then, even private capex has started declining. We have experienced a steady contraction in the economy for past many years, which culminated in the form of lowest growth in the Mar'20 quarter (just before the pandemic hit). The exhibit below depicts the trend of gross capital formation (GCF) as a percentage of GDP over the past three decades.



Source: Worldbank

So, what has changed? The government has been trying push infra creation across multiple sectors for some years now. It found moderate success, but fiscal constraints were preventing the government from loosening purse strings. The stimulus announcements post COVID focused on driving growth through the supply side (i.e. capex) as opposed to the demand-side stimulus approach taken by most countries. An important enabler of this was doing away with the previous fiscal management regime, giving the govt. headroom to start spending a whole lot more on capex. The government even nudged PSEs to upend capex.

Another seminal factor was a change in govt. stance of openly supporting the private sector. The word 'privatization' being used instead of 'disinvestment' is symbolic of this change of heart. Successfully conducting the complex privatization of Air India is a testament of the government walking the talk. Proceeds from privatization along with creation of fiscal space should lead to massive dry powder for required capex, especially towards the country's infrastructure. While the government has announced/ implemented multiple other reforms across the board, we will save them for a discussion later.

So, why is capex important? When growth is slow and capex is on a decline, the economy needs an external stimulus. In this case, government infra spends have a multiplier effect on the economy as they generate demand for various goods & services as well as direct & indirect employment. Job growth creates more demand for goods & services, resulting in higher utilization for the private sector. Higher utilization leads to more profits, creating room for private sector capex. And so, the virtuous cycle of economic growth begins.

Advance direct tax collection for first half of this calendar year (Apr-Sep 2021) has surprised positively. At this rate, full-year collections should overshoot budget estimates by more than 20%. This is a direct pointer to growth in corporate profitability, and of course, more dry powder for the government to spend. Corporate earnings have disappointed for many years now. However, this time it seems to be real.

How does this effect with our investments? Demand feeds profitability which incentivizes capex, creating more jobs and in turn more demand. This cycle feeds onto itself till the point when corporates get greedy. This is when the cycle starts it downward journey. The inevitable capital cycle has been beautifully described in the book 'Capital Returns' – a collection of letters written by portfolio managers of Marathon Asset Management.

"High current profitability often leads to overconfidence among managers, who confuse benign industry conditions with their own skill a mistake encouraged by the media, which is constantly looking for corporate heroes and villains. Both investors and managers are engaged in making demand projections. Such forecasts have a wide margin of error and are prone to systematic biases. In good times, the demand forecasts tend to be too optimistic and in bad times overly pessimistic. High profitability loosens capital discipline in an industry. When returns are high, companies are inclined to boost capital spending. Competitors are likely to follow – perhaps they are equally hubristic, or maybe they just don't want to lose market share. Besides, CEO pay is often set in relation to a company's earnings or market capitalization, thus incentivizing managers to grow their firm's assets. When a company announces with great fanfare a large increase in capacity, its share price often rises. Growth investors like growth! Momentum investors like momentum!

Investment bankers lubricate the wheels of the capital cycle, helping to grow capacity during the boom and consolidate industries in the bust. Their analysts are happiest covering fast-growing sexy sectors (higher stock turnover equals more commissions.) Bankers earn fees by arranging secondary issues and IPOs, which raise money to fund capital spending. Neither the M&A banker nor the brokerage analysts have much interest in long-term outcomes. As the investment bankers' incentives are skewed to short-term payoffs (bonuses), it's inevitable that their time horizon should also be myopic. It's not just a question of incentives. ***Both analysts and investors are given to extrapolating current trends. In a cyclical world, they think linearly.*** *(Emphasis mine)*

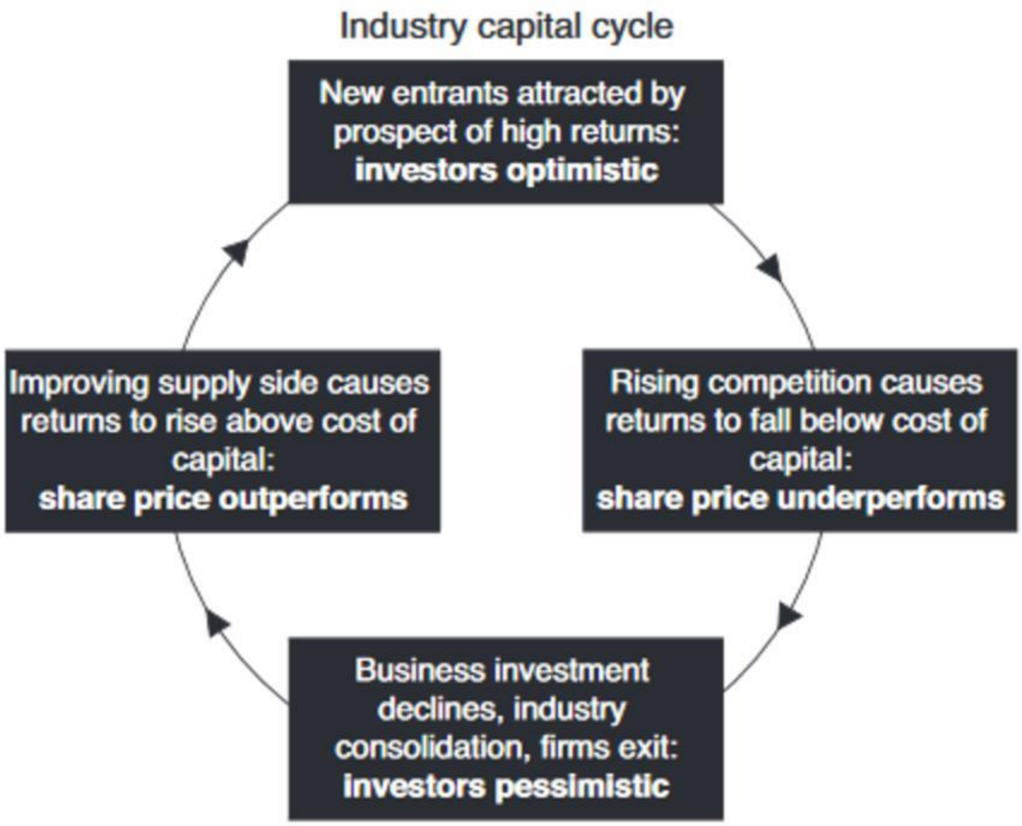


Chart I.1 The capital cycle

Source: Marathon.

The Macro example also shows the lag between a rise in capital spending and its impact on supply, which is characteristic of the capital cycle. The delay between investment and new production means that supply changes are lumpy (i.e., the supply curve is not smooth, as portrayed in the economics textbooks) and prone to overshooting. In fact, the market instability created by lags between changes in supply and production has long been recognized by economists (it is known as the "cobweb effect").

The capital cycle turns down as excess capacity becomes apparent and past demand forecasts are shown to have been overly optimistic. As profits collapse, management teams are changed, capital expenditure is slashed, and the industry starts to consolidate. The reduction in investment and contraction in industry supply paves the way for a recovery of profits. For an investor who understands the capital cycle this is the moment when a beaten down stock becomes potentially interesting."

From our understanding of this capital cycle, we believe we have just come out of the consolidation phase of the past 7-8 years and entered the profit recovery phase. Let's look at some sectors we have exposure to.

Period	FY02-07	FY07-13	FY13-16	FY16-20	Comments
Cement					
Change in Revenue (times)	3.5	2.8	1.2	1.4	
Change in Net Block+CWIP (times)	2.5	4.1	1.1	1.2	Cyclical
Change in RoCE	21.6%	-13.6%	-7.1%	2.2%	
Chemicals					
Change in Revenue	2.3	2.6	1.2	1.1	
Change in Net Block+CWIP	1.7	2.5	1.2	1.3	Less cyclical
Change in RoCE	9.4%	-2.2%	-1.5%	8.7%	
Industrial Equipments					
Change in Revenue	2.5	2.3	0.8	1.0	
Change in Net Block+CWIP	1.4	3.6	1.0	1.1	Highly Cyclical
Change in RoCE	24.9%	-16.3%	-16.6%	3.3%	
EPC					
Change in Revenue	3.6	3.9	1.1	1.1	
Change in Net Block+CWIP	3.2	7.3	1.1	0.7	Highly Cyclical
Change in RoCE	6.1%	-5.8%	-3.9%	1.9%	

Source: Ace Equity

The above table clearly outlines the high demand phase of FY02-FY07, leading to a substantial increase in ROCE during that period. This incentivized corporates to create capacity in subsequent years. And inevitably, they went overboard, leading to overcapacity and clocking lower ROCEs. Such was the excess capacity creation that even during FY13-FY16, profitability kept dropping to the point where ROCE fell below the cost of capital. As discussed earlier and as evident from the table, private capex took a hit during these years. Credit dried up and weak players threw in their towels during this phase and the subsequent one (i.e. FY16-FY20). Survivors cut excesses, sold non-core assets, and used cash flows to repay debt than create new capacities. Indian corporates have not seen such strong balance sheets in more than two decades. While consolidation was underway, demand was slowly catching up, leading to better revenues and a steady rise in ROCE over the past couple of years. This phase has just begun and should continue for the next few years, resulting in stellar profitability growth.

We are entering a phase similar to/even better than FY02-FY07, when the economy, corporate profits and markets grew in an explosive manner. The obvious implication is that private capex will kick in and excesses will be built, and the cycle will continue; but that is in a distant future for now.

Note that we have not mentioned the valuation aspect here, but – as readers are aware – it is an equally important aspect, if not more, in our analysis. Markets have scaled new highs in the past 1.5 years and growth we are talking about has been partially factored in (varies across industries). From our understanding, there are some pockets wherein the market is underestimating profit recovery; that is where we are trying to position ourselves. This is not to say that if markets correct, our stocks will not follow suit. However, if our judgement is right, a correction would provide an opportunity to buy stocks we like at even more attractive prices. From a 3–5-year horizon, these corrections will only be a small speed breaker in a long uptrend.

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%**	**58.6%**	**300.9%**		**32.4%**
BSE SMALL CAP	8.1%	17.7%	-11.6%	-36.1%	114.9%	36.0%	110.3%	190.6%	16.2%
BSE 200	6.0%	11.0%	10.7%	-26.4%	74.3%	21.1%	102.3%	198.6%	15.3%
BSE 100	6.1%	10.6%	12.4%	-26.6%	71.5%	20.3%	99.8%	201.1%	15.0%

[1] *Return figures are net of fees and as of 30th Sep' 21. Returns are adjusted for inflows/outflows and are TWRR*

[2] *Year to date performance till 30th Sep' 21.*

Current Aggregate Portfolio Characteristics

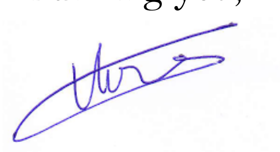
As a step towards greater transparency, we share our portfolio-level characteristics every quarter:

Number of businesses	15 companies
Current cash position	~9.6%
Last 3-year average earnings growth	8.5%
Latest portfolio ROE	14.1%
TTM (trailing twelve month) portfolio PE	24.8x
Acquisition portfolio TTM PE	12.4x
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 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.