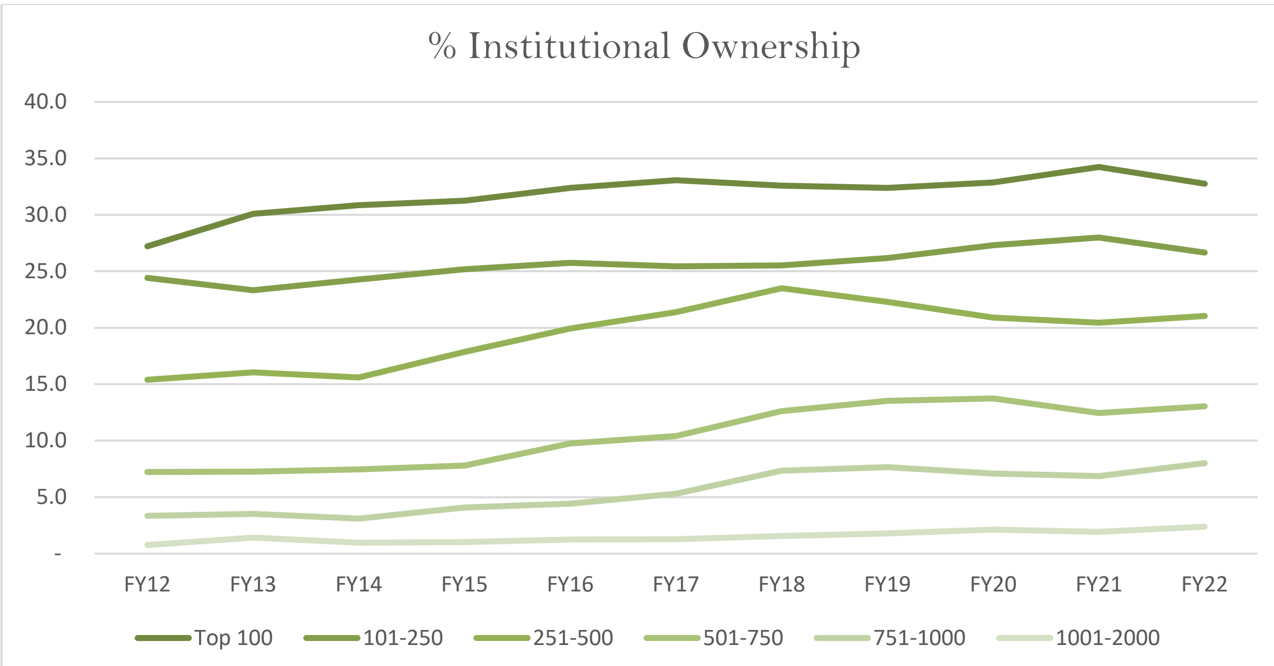
Equirus Long Horizon Fund
Investor Communiqué – Sept'22

Dear Investors

Hope you and your families had a great festive season. As indicated in our last letter, we rarely have dull times in investing especially from macro-economic environment. This makes our job extremely exciting. Its almost equivalent of riding a fast moving car with you in the back seat. Important would be understand the variables you can control and what you cant. Last quarter was no different. The central bankers continued to tighten the screw of liquidity and interest rates as inflation remained persistent. With rising interest rates in US, the USD strengthened, and Dollar index reached a new lifetime high. Many currencies corrected substantially even those of the developed economies. GBP was among the worst affected currencies. Keen observers of global developments would have noticed the upheaval in UK politics which was essentially set in motion by the economic policy. Economics and politics are like Siamese twins joint at the hip and UK was a great example of that. On that front, India has stood out for a change. While INR has corrected but is in a much better shape than its counterparts (apart from USD, of course). The differentiated approach to handling covid and subsequent stimuluses which was criticized by many a developed countries and some of the haloed economists has indeed positively surprised one and all. At present, India is the only large country touted to be able to grow while the global recessions loom large.

Globally markets continue to feel the heat led by Tech companies, while Indian headline indices are flirting around their lifetime highs lead by Financials. The small caps have substantially under performed the headline indices in past 12 months and that is very apparent from our portfolios as well. Our portfolio mainly consists of small cap names., which are generally under owned by institutions due to lack of research available and liquidity. On top of that, we have a concentrated portfolio by industry standards. Lack of institutional ownership and concentration lends our performance to be more volatile in the long run. Not that we are complaining though.

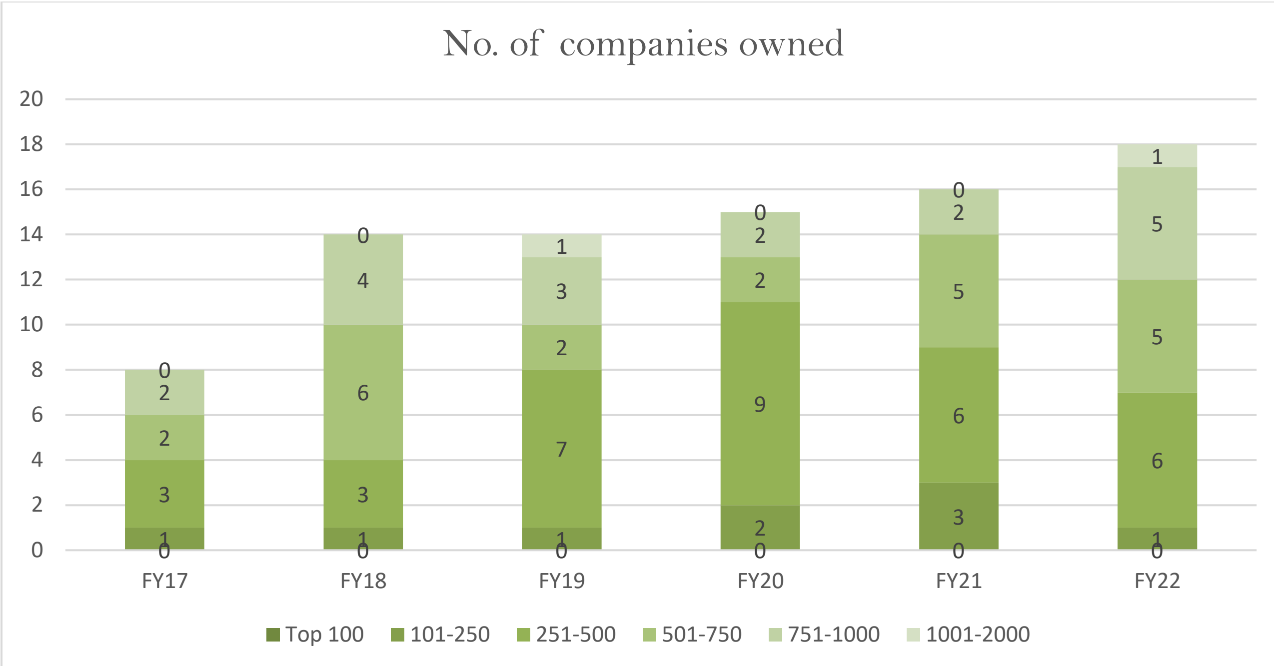
Investing in small cap is inherently favourable for us as we can invest in companies which are under the radar due to multiple reasons as indicated earlier. Our idea is to invest in under-researched and under-owned small cap names which will go on to become coveted mid-caps in years to come (Hopefully large caps one day). As the size of the company increases, more research surfaces and more institutions want (or have) to own it.



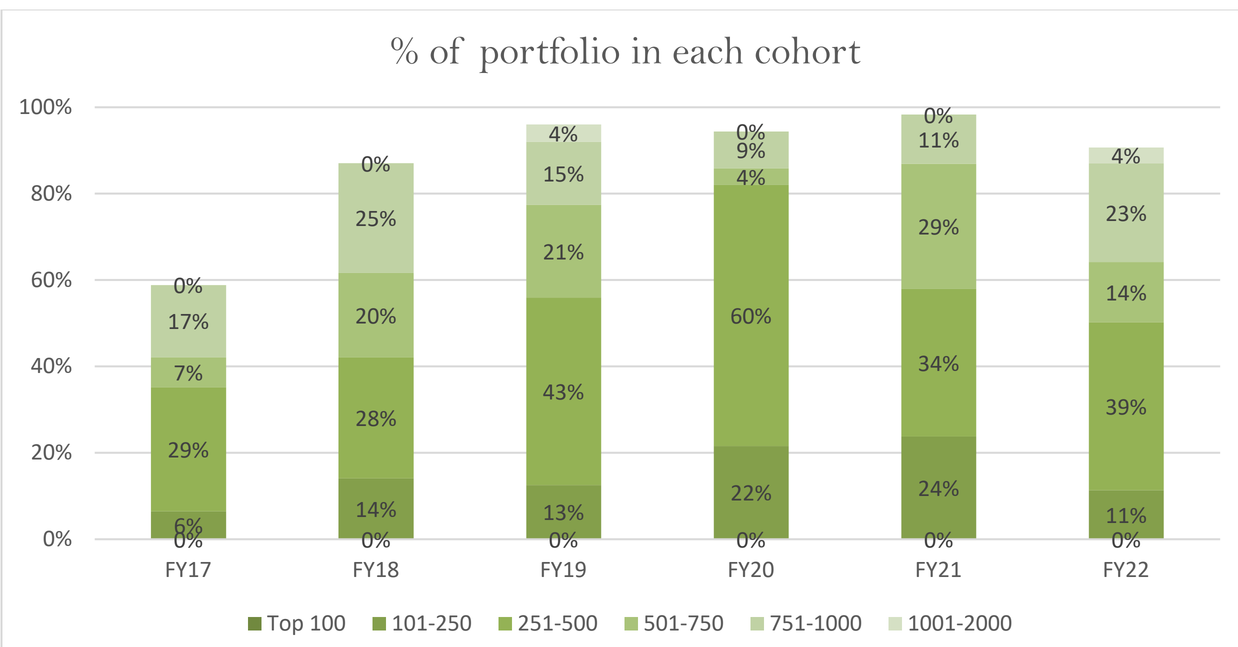
Source: Ace Equity

Above table shows the institutional ownership of companies ranked based on their market-capitalization (for eg. top-100 is a cohort of 100 largest companies in terms of M-cap in that respective year). One can clearly notice how the institutional ownership increases with the M-cap of the company.

Our sweet spot falls in the companies ranking from 251-1000 which is clear from the chart below.



The few companies which are in 101-250 cohort are the ones which were in 251+ cohort (barring one) when we first invested but improved due to price appreciation subsequently.



Portfolio allocation chart also reiterates our preference for small cap companies. Again, the ones in <250 cohort are due to price appreciation and subsequent increase in their weights in our portfolios.

One more point to take note of is we are not fully invested always. This is not due to us taking cash calls but due to lack of investment ideas at that point. We do not follow a model portfolio approach where funds must invest whatever capital comes in according to current portfolio weights. We wait for the right opportunities to invest your capital just as we would ours. This is the liberty we enjoy which few other funds have.

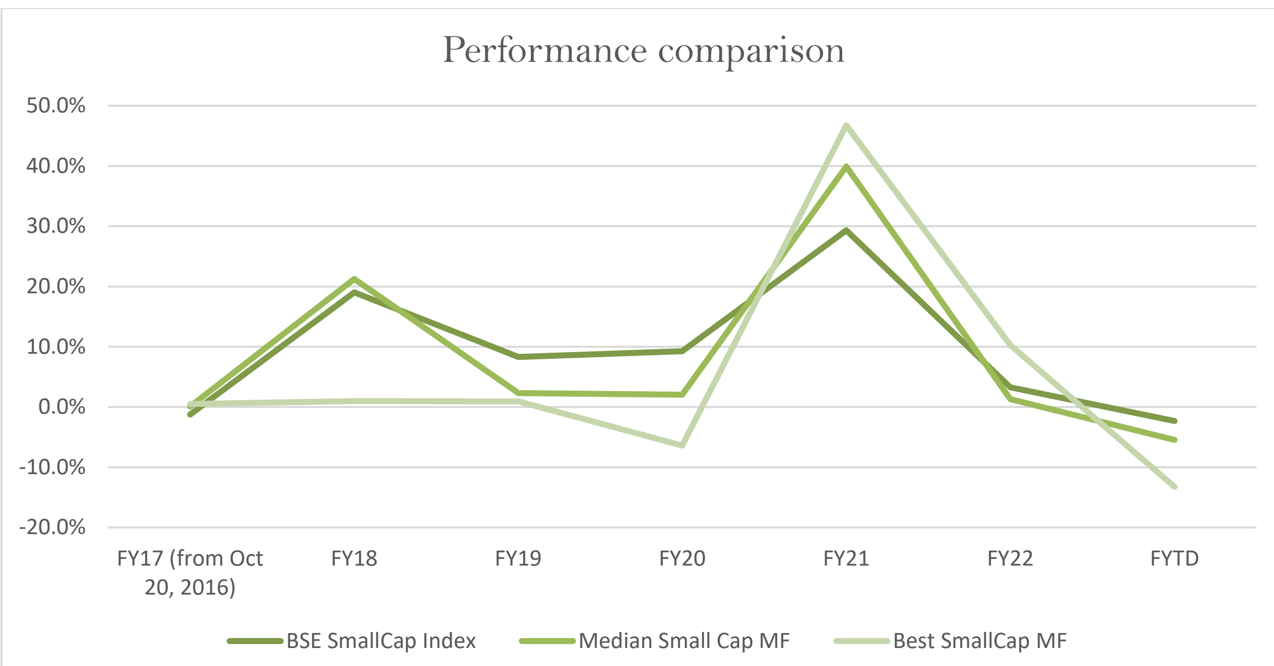
Apart from investing in under-owned companies, we tend have concentrated portfolios. This is a double edged sword. The pendulum of concentration swings on both sides equally but benefit us more when it is in our favour. This happens due to the asymmetry of being long only investors. If we are wrong, we lose 100% in the worst-case scenario (six-sigma event), however if we are right, we may make multiple times of our invested capital. So, a loss of 50% on a 10% position would end up with an impact of 5% on entire portfolio vs. a 3x or 3-bagger on a 10% position would add 20% to our entire portfolio. The math is compelling, but in investing these cases are few and far between. Most of the times we will end up somewhere in the middle. Recent names which substantially affected our performance Hikal (negatively - FY22) and Alkyl Amines (positively - FY21). With concentrated positions the performance will fluctuate sharply but with the asymmetry in our favour and the strong research team that we have built, we should have more Alkyls and less Hikals in the coming years.

The following passages sums up our thoughts well on how we think about the process of portfolio allocation.

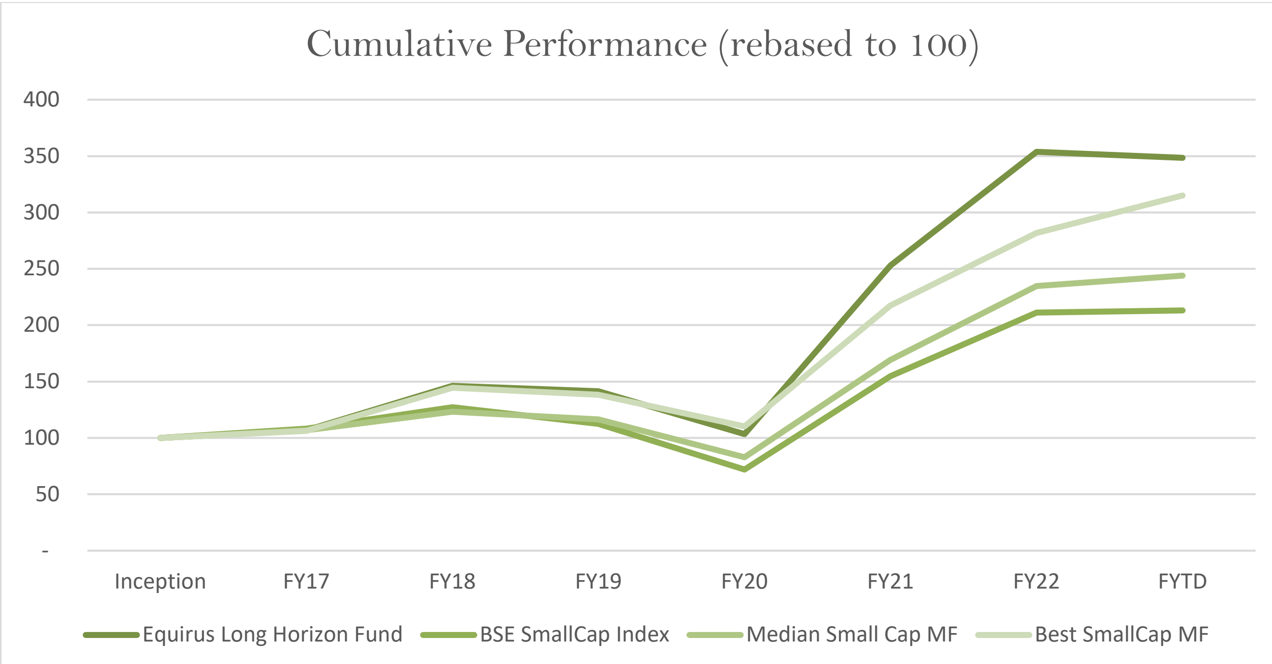
"The strategy we've adopted precludes our following standard diversification dogma. Many pundits would therefore say the strategy must be riskier than that employed by more conventional investors. We disagree. We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it." - ***Warren Buffett***

"A key component of our investment strategy is sufficient but not excessive diversification. Rather than own a little bit of everything, we have always tended to place our eggs in a few dozen baskets and watch them closely. These bargain-priced opportunities are selected one at a time, bottom up, which provides a margin of safety in case of error, bad luck or disappointing business results. However, we are always conscious of whether these different investments involve essentially the same bet. If each of our holdings turned out to involve similar bets [inflation hedges, interest rate sensitive, single market or asset type etc], we would be exposed to dramatic and sudden reversals in our entire portfolio were investor perceptions of the macro environment to change. Since we are not able to predict the future, we cannot risk such concentrations." - ***Seth Klarman***

Having discussed our thoughts on kind of companies we own and portfolio allocation strategy, we want to show how it translates to yearly performance vis a vis our benchmark and fellow small cap mutual funds.



Whenever the line is below 0% we have underperformed that category in that year (that is the case in the current year) and vice versa. A cursory look at this graph indicates the volatile nature of the returns due to (at the risk of repeating) small cap investing plus concentration. That also has resulted in being able to garner stronger overall returns compared to the same categories which can be seen in the following chart.



To sum up the discussion, we believe your journey with us will be volatile in the short run but rewarding over the long run. The best way to gauge our performance is the long term as we have been harping on since our inception. To shed more light on our investment philosophy, we are sharing an investment thesis on one of our portfolio companies Ceat.

CEAT Ltd.

Ceat is India's leading tyre company, with over 60 years of presence and a strong distribution network of 4,400+ dealers, 550+ exclusive Ceat franchisees, and 7 manufacturing facilities (at Bhandup, Nasik, Halol, Nagpur, Ambernath, Chennai and Sri Lanka). It supplies its products in 100+ countries, where products are sold with a strong brand recall. Ceat is present in all key segment namely – Truck and Bus Bias (TBB), Truck and Bus Radial (TBR), Passenger Vehicles (PCR), 2/3-Wheeler, Farm, and speciality.

Ceat is a strong player in its operating niche of 2W tyres, and in the segments of trucks and PVs, the company is a contender, as it is adding capacities, which should allow it to grow slightly faster than the overall growth in the segments. Ceat has a demonstrated track record of bringing out differentiated products and its ability to market them well through its robust distribution network.

Investment Rationale

Ceat has gained domestic market share across segments. Market share gains tend to be sticky.

- 2W/3W market share increased from 24.6% in FY 16 to 28.1% in FY22
- Cars market share increased from 7.9% in FY 16 to 11.1% in FY22
- Truck & Bus market share increased from 5% in FY 16 to 7% in FY22
- Overall market share increased from 12.3% in FY 16 to 15% in FY22

Accelerated growth in International Business:

- Ceat has been consistently investing in international markets over past many years resulting in a 71% growth in export revenue in the last year. With presence in more than 100 countries, CEAT has a strong foothold in the global market and should be able to deliver strong performance in the years to come.

Mean reversion in profit margins

- Ceat operating profitability is susceptible to volatility in prices of its key raw material that is crude oil and natural rubber. The price changes come at a much slower rate and quantum compared to RM swings. This has impacted profitability substantially in the past couple of years. With product prices catching up and RM stabilizing, the gross margins should mean revert leading to huge gains in operating profits.

Balance sheet

- CEAT has been in debt driven capex mode for the past few years to cater to demand for its products. As the margins collapsed, the leverage ratios deteriorated leading to concerns about the highly levered balance sheet. The concerns are overblown as the margins are at a cyclical bottom and we do not believe there is any balance sheet risk.

Favourable Valuation

- Ceat was trading at a 0.5x M-cap to sales vs. 1.6x for that of MRF at the time of our first purchase. With the kind of performance on market share gains, Ceat did not deserve such a huge discount to MRF based on our analysis. Given our understanding of the cycle, we were of the belief that concerns on margins and balance sheet were more than priced in. As the cycle turns for better, the margins will bounce back and the balance sheet will deleverage leading to market perception improvement and the stock rerating.

Risks

- Some of the major risks to our thesis are our misreading of the cycle and substantial rise in RM prices from current levels. Given the bargain prices, we believe the risks were already factored in and provides us a good margin of safety.

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	FY22	FYTD 23[2]	Since Inception (Absolute)	Alpha	Since Inception (CAGR)
ELHF	**6.9%**	**36.8%**	**-3.2%**	**-26.8%**	**144.2%**	**39.9%**	**-1.5%**	**248.5%**		**23.4%**
BSE SMALL CAP	8.1%	17.7%	-11.6%	-36.1%	114.9%	36.6%	**0.8%**	113.1%	135.4%	13.6%
BSE 200	6.0%	11.0%	10.7%	-26.4%	74.3%	19.9%	**-0.2%**	99.8%	148.7%	12.3%
BSE 100	6.1%	10.6%	12.4%	-26.6%	71.5%	19.2%	**-0.8%**	96.4%	152.1%	12.0%

[1] *Return figures are net of fees and as of 30th September 2022. Returns are adjusted for inflows/outflows and are TWRR*

[2] *Year to date performance till 30th September 2022.*

Current Aggregate Portfolio Characteristics

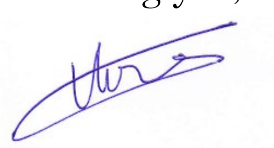
As a step towards greater transparency, we share our portfolio-level characteristics every quarter:

Number of businesses	17 companies
Current cash position	~6.4%
Last 3-year average earnings growth	8.0%
Latest portfolio ROE	9.1% (Looks low due to one off losses)
TTM (trailing twelve month) portfolio PE	21.2x (Looks high due to one off losses)
Acquisition portfolio TTM PE	15.4x
Churn	18% 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.