15th July 2020

Aurum Small Cap Opportunities
Quarterly Portfolio Update – Q1, FY 20-21

Dear Investors,

In the beginning of this financial year as the Covid-19 pandemic was flaring up, several people, including our clients and wealth advisors, reached out to us to know our thoughts as to how this unprecendented event will impact economy and markets. Our response then, that we don't have an exact answer to this question except the fact that it would be hugely disruptive for businesses in the short term had disappointed almost all who spoke to us. We wish to humbly submit that even today we don't have an exact answer to the same question although we can definitely say that the the virus is here to stay much longer than anyone of us had anticipated and living with it is the new normal that may continue to impact on our day to day life for many more months. On the business front, we are clearly seeing the short term impact on almost all businesses and long term fundamentals compromised for a host of businesses.

This almost sounds like a very pessimistic commentary! Then how does one explain the significant out-performance of our small cap portfolio amidst this enviroment in Apr-June quarter?

We believe that the out-performance has been on account of the following:

1. Our continued emphasis on investing in companies with robust balance sheets and defensible business franchises, at reasonable valuations is bearing fruit once again. Many of our portfolio companies are standing out in terms of their operating performance and future outlook amidst these uncertain times.

2. Undertaking a measured re-jigging of the portfolio over last 6-8 months by weeding out underperformers and replacing them with better quality businesses at attractive valuations when the markets witnessed signifcant corrections.

3. Staying consistent with our long term investment strategy of investing/staying invested in a reasonbaly concentrated portfolio of 12-15 high convcition stocks for our clients even during periods of underperformance.

So, where do we go from here?

We can no way breath easy with the stupendous performance catch up witnessed in our small cap portfolio! Rather the last cycle of small cap fall made us learn several new lessons; the most important of them being to remain more agile in buy/hold/sell decisions by staying closely clued to the fast changing dynamics of portfolio company businesses. During this period, we have progressively honed our internal decision making framework and processes so as to enable us to monitor our portfolio companies more objectively through a prism of broader lense, that includes operating as well as external capital market parameters.

The aspiration for owning bigger houses (difficult to manage without servants) is dwindling

We have been keenly observing the subtle and not so subtle behavioural changes as the pandemic spreads. Some of these changes are:

- *The aspiration for owning bigger houses (difficult to manage without servants) is dwindling*
- *Do It Yourself (DIY) is now becoming almost a necessity inside homes leading to a surge in sales of products like Robotic / Automated floor cleaners and Dishwashers amongst others.*
- *The big city charm is on the wane as we see a large young tech workforce working from home in their hometowns largely with same effectiveness and efficiency. With e-commerce and OTT, they seem to be missing on nothing that the big city folks have.*
- *Mental health, a subject that has always been taboo to be even discussed, is increasingly finding mention in social conversations*
- *Social ceremonies (marriage, birthdays) are being celebrated over video calling platforms with great fervour. Even prayer meets are being organized in similar fashion*
- *Teens and youngsters are getting hooked to e-sports as much as they are getting used to e-classes*

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Such behavioural changes and many more are likely to have a lasting impact on the economy going forward and we strive to remain watchful of the same.

Can the Covid uncertain times turn into a huge value creation opportunity for investors?

Yes, we strongly believe so!

Covid uncertain times can be a large opportunity for long term investors

A catastrohpic world event such as this pandemic has always triggered radical changes in human behaviour resultantly creating growth opportunties for many businesses while decimating many others. This kind of an event also triggers a wave of consilidation wherein the fundamentally robust companies with strong financials get the opportunity to gain market share at the expense of weaker players from the organized or unorganized sectors. Such companies end up becoming serious value compounders over the next growth cycle! For illustration, in the aftermath of Lehman crisis, a financially strong but relatively small company like Bajaj Finance which was trading at Rs. 28 in Feb 2010 got the opportunity to grow its lending business manifold over next ten years in the new post Lehman era and investors got the opportunity to make humongous returns with stock price touching Rs. 4800 in Feb 2020.

The post Covid world will throw such high growth opportunities again for a certain set of companies which today may look relatively small in size and market cap. Investors who end up buying such companies in current times are likely to see their portfolios deliver superior returns over the next 5-7 years despite shorter term ups and down due to market volatility. We do hope that our discipined process of identifying and investing in financially strong companies with robust business fundamentals should allow us to capitalize on such high growth opportunities in the post Covid world.

How are we managing our Portfolio at this time?

Ever since the Covid-19 breakout, we have held the belief that in the short term (two quarters, Apr-Sep 2020) most business will be deeply impacted. The sole goal, therefore, of every business owner in the short term should be to survive/navigate these two quarters without a body blow. Companies with little or no debt and a healthy cash holding are best poistioned to do that regardless of which business they are in. In this respect, all our current portfolio companies score in the top quadrant. Almost all our investee companies have no to low debt and healthy cash reserves to manage their liquidity.

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Next, as an investor, we spent time ascertaining the medium to long term impact (beyond two quarters) of the pandemic on the businesses we are invested in. While assessing the same we have borne in mind certain positive and negative macro factors, namely;

Positives

- Low oil prices will help India manage its Current Account Deficit well in FY 20-21

- A 1.3 bn strong, relatively young population who will continue to consume goods and services, though composition of same may change in the post Covid era

- Acceleration of digital transformation initiatives by global companies will be positive for Indian technology sector

- With a proactive policy, including 15% income tax for greenfield investments in manufacturing, India is well placed to attract investments as global companies de-risk their China sourcing dependence.

- The world is likely to remain awash with liquidity as developed countries indulge in never before seen QE to help their respetive economies.

Negatives

- India is capital starved and it doesn't have the elbow room of larger developed economies to indulge in unbridled printing of money. Without external capital, we may face challenges to fire up the economy onto a high growth trajectory.

- Our banking / shadow banking industry is grappling with its own set of challenges in managing past NPAs and now have to grapple with Covid related provisions making them reluctant to lend to businesses. Resultantly, in the short term, the NPA situation may worsen, with further rise of corporate NPAs and a rise of delinquencies in retail book.

- Unemployment likley to witness a steep rise as travel, tourism and allied sectors (which employ large no. of people directly or indirectly) are hugely impacted along side many other sectors that may face temporary slowdown.

Against this backdrop we believe that our current portfolio companies are well placed to ride out the short term with their long term fundamentals remaining intact or looking better in some cases.

The 'Survive & Thrive Quotient' quotient of our top 13 companies that represent over 90% of our portfolio value as on 10th July 2020 (ex cash) is presented below in three tables:

- **Table 1:** Company details, covid impact & investment thesis
- **Table 2:** Historical growth
- **Table 3:** Health of balance sheet

Table 1: NRC Portfolio Companies - Description, Covid-19 Impact & Future Outlook

Sr. No	Company Description	Covid-19 impact: Short Term	Covid-19 impact: Long Term	Commentary & future outlook
Co 1	**Consumer discretionary:** Dominant brand in lab glassware, kitchen glass storage & table ware space.	-ve	Neutral	Growing trend of replacing plastic based table and storage ware with healthier alternates. Benefits of consolidation / unorganized to branded organized shift.
Co 2	Engineering: Leading process & project engineering company in ethanol & water space.	-ve	Neutral	Beneficiary of mandated higher ethanol blending in India and other countries. Project locations and plant operations have been impacted. Large saving by domestic OMCs from crude price drop overwhelmingly negates cost impact of higher ethanol blending
Co 3	**Auto, 3-Wheeler:** Market leader in commercial three wheelers in Gujarat, with pan India and overseas presence. Recent entry in passenger 3 wheeler & EV segment.	-ve	Neutral	After doing well for the 1st 9 months of FY20, sales were impacted in Q4 FY20. Growth may continue to be under pressure in short term as 3W financing gets impacted. The future prospects in medium and long term remain bright as 3W will remain vital to last mile connectivity for people and goods in emerging economies
Co 4	**Health Care:** Disposable medical device manufacturer with a global footprint.	Neutral	Neutral	Some short term impact is expected as the non-urgent patient interventions get pushed out and hospital occupancies fall. Wider acceptance of company's products in Europe and US will translate into continued robust export growth. In India too, expected policy changes to cap product trade margins are likely to benefit the company the same way as in case of stents
Co 5	**Defence:** Specialized defence electronics & engineering company.	Neutral	Neutral	Covid related restriction had a slight impact in Q4 FY20 as production and inspection of systems was hindered towards March end. With policy focus on indigenization, being a supplier of mission critical sub systems that are a part of strategic defence shield that country is building / upgrading, outlook for this company remains robust for current year as well as next 3 years.
Co 6	**Engineering**: Leading manufacturer of transformers with strong financials	-ve	+ve	Paucity of labour & product inspection related challenges caused some execution delays. We may also see some margin pressure in the immediate future. Long term remains intact as the company is expected to benefit from govt's continued investment in T&D infrastructure including green corridor, expected revival of greenfield investments in manufacturing sectors and announced privatisation of power distribution companies.
Co 7	**Speciality Chemicals:** Manufacturer of amine based bulk and specialty chemicals.	-ve	+ve	Company posted healthy performance in FY20 as user industries like pharma, agro-chem, plastics, water chemicals, continue to do well. However, supply chain issues can have a near term impact. Continued structural shift in localization of Chinese imports to directly benefit the company in longer term.
Co 8	**Consumer Discretionary:** Subsidiary of a US based MNC. Primary products include edible oils and packaged snacks.	Neutral	+ve	Company's snack portfolio growing at healthy double digit while commoditised edible oil revenue is on decline. Going forward should translate into steep growth in profitability as food portfolio continues to becomes larger share of the revenue pie.

Sr. No	Company Description	Covid-19 impact		Commentary & future outlook
		Short Term	Long Term	
Co 9	**Digital infrastructure for Financial Infrastructure:** Company provides electronic depository & related services for financial securities, warehouse receipts, other e-assets & data.	Neutral	Neutral	During March & April 2020, 6.4% or 1.2 m new d-mat accounts were opened by the company and currently has about 50% market share. Expect this trend of financialization to continue. Moreover, company has multiple revenue streams & ~60% of FY20 revenues are de-linked from equity market transactions volumes. The company is expected to see robust growth as more financial and non-financial instruments / documents need to be dematerialized. Diversification into new growth areas such as ware house e-receipts for agri trading (E-Nam) can provide further growth impetus.
Co 10	**Technology:** Global provider of digital banking software product & solutions to banks & financial cos.	Neutral	+ve	After relatively weak Q2/Q3, company posted healthy Q4 in FY20. Going forward, new IT capex may see delayed decision-making in Q1/Q2. However, existing order fulfilment largely on course & Cloud sign ups growing steadily enabling company to build a growing & stable 'annuity' revenue model. Covid -19 is expected to further accelerate movement to cloud, open banking & digitization of BFSI operations.
Co 11	**Consumer Discretionary:** 3+ decade old aspirational apparel brand with a mix of winter-wear & summer wear	-ve	Neutral	Company posted healthy double digit growth in FY20. While the covid-shutdown happened in Q4 FY20 & Q1FY21, we expect FY21 to be a subdued year for the company because of lower footfalls in retail stores. Strong cash position will help company emerge healthy to benefit from any post Covid-19 consolidation on account of other competing brands dying/languishing and unorganized sector feeling the heat.
Co 12	**Technology:** Global insurance software product company, positioned in Gartner leader quadrant, alongside only 2 peers globally.	Neutral	+ve	FY20 was a healthy year for company with accelerated cloud wins & continued expansion of margin profile. Stable, annuity-type revenues make-up nearly 40% of total revenues & growing. Strong order book covering ~60% of our FY21E revenue estimate. Apart from secular global insurance IT-capex cycle, post Covid-19, we expect accelerated adoption of Cloud / SaaS solutions.
C. 13	**Telecom / Data Network Equipment:** Provides critical equipment for high-speed optical networks & data centres	Neutral	+ve	Logistics disruption due to Covid-19 has had a short-term impact on ability to ship orders. In Long-run, Covid-19 had overseen an overnight shift to "tele-committing / work from home" & digital entertainment leading to explosion in data-centres & broadband demand. Company is well placed to cater to urgent need of Indian & global Telcos / Data-centers to upgrade infrastructure, and to replace Chinese equipment in critical areas of networks. This company is an established global supplier of equipment with own-IP, debt-free & cash-rich *(sufficient cash to meet 2+ years opex).*

Each of the above mentioned companies enjoy overall or regional dominance in their business and have exhibited fiscal prudence. Further we believe they do have a future-relevant business model.

Table 2: Company Fundamentals - Historical growth

Co	3 Year CAGR (FY17-20)			Current P/E
	Sales	EBITDA	EPS	
Co 1	4%	14%	2%	NA *
Co 2	6%	5%	14%	17.0
Co 3	10%	6%	13%	6.8
Co 4	15%	21%	20%	27.0
Co 5	6%	-7%	-8%	20.1
Co 6	12%	22%	7%	12.5
Co 7	26%	41%	54%	25.0
Co 8	1%	-3%	5%	37.1
Co 9	15%	4%	11%	27.2
Co 10	10%	*na***	*na***	92.1
Co 11	8%	17%	14%	5.4
Co 12	8%	70%	*na****	15.0
Co 13******	-25%	*Na*	*na*	*na*

Co1: *Awaiting listing post demerger

Co 10: ** FY17 EBITDA & PAT was -ve being in early cycle of product development. Hence CAGR is not relevant

Co 12: ***PAT in FY17 was negative. Hence CAGR is not relevant

Co 13: ****Fy20 saw a sharp decline in revenue & profitability. We invested post the results

The reported numbers of Company 1 (Consumer glass ware) that recently underwent a corporate event are without the numbers of business that was demerged into a separate company.

Table 3: Company Fundamentals – Balance Sheet health

Company	ROCE	Cash & Equivalent (INR Mn)	Net Debt: Equity	Cash & Inv. (FY20) / MCap
Co 1	12%	1,330	0.0	NA
Co 2	7%	2,069	0.0	17.9%
Co 3	21%	127	0.01	3.4%
Co 4	20%	441	0.40	1.6%
Co 5	8%	532	0.0	6%
Co 6	13%	4,772	0.0	42.9%
Co 7	37%	323	0.0	0.8%
Co 8	10%	55	0.0	0.4%
Co 9	62%^	7075	0.0	24.5%
Co 10	0.1%	1,063	0.1	7.2%
Co 11	13%	1,463	0.0	43%
Co 12	8%	4,175	0.0	39.1%
Co 13	na	1,942	0.0	44%

^ Note: ROCE is ex-cash for this Co

Growth is often a fair-weather friend and seasonal in nature. The foundation to sustainable growth is health & quality of balance sheet. A healthy balance sheet is very important to survive a crisis as the one we are living through today. As would be evident from **Table 3**, most of the top holdings are either debt free or have low leverage. Moreover, most of the companies have healthy cash positions (cash & investment). Average ROCE is at a healthy 17%.

Warm regards,

Sandeep Daga

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