nine rivers CAPITAL

14th January 2021

Aurum Small Cap Opportunities
Quarterly Portfolio Update – Q3, FY 20-21

Dear Investors,

It gives us immense satisfaction to have completed 8 years of our small cap investing journey in Dec 2020, consistently generating robust out-performance along the way, amidst market conditions that remained highly volatile most of the time!

Our Small Cap portfolio performance continues to deliver robust out-performance:

Reflections of our 8 year journey!

Despite the stellar long term performance, our small cap investing journey has had its fair share of ups and downs comprising short periods of under performance as well. We felt that, in this quarterly update, it would be good to objectively reflect on our investment decisions over the last 8 years and share with our clients and readers many lessons that we have learnt.

In these 8 years, we invested in a total of **72 companies** as a part of our small cap PMS. Of these 72, 23 are currently being held in our client portfolios, while 49 have been fully exited. (Note: We've also ***rejected*** or ***missed investing (a few)*** in more than twice as many companies after detailed evaluation. That would be a subject for reflection in another of our quarterly updates in future)

Stumbles are a part and parcel of any investing journey, especially long ones such as ours. Claiming perfection would mean deluding ourselves and our investors too. In Table 1 below, we have honestly attempted to objectively assess our successes and failures creating broad buckets of reasonability. We do strongly believe that this exercise shall also help us in reducing our judgemental errors going forward and improve our decision making process.

Table 1

Category	Company Performance:	# of cos	% of cos	Avg Share Price Growth ^	Avg Holding Period
A	As per Investment Thesis	39	54%	2.7x	2.5 yrs
B	Temporary Underperformance	6	8%	0.77x	3.2 yrs
C	Declining Governance Quotient	6	8%	0.80x	2.0 yrs
D	Impacted by External Headwinds	6	8%	0.95x	2.8 yrs
E	Impacted by co-specific issues	15	21%	0.81x	2.4 yrs
	Total:	**72**	**100%**		

^Note: This represents category-average growth in share prices from initial purchase prices to final selling price; or in case of still held (un-exited) companies, to CMP as of 31st Dec 2020.

As can be seen, 39 of our investment calls have gone as per our original investment thesis and have generated a healthy multiplier leading to the overall robust returns of the PMS. Another 6 companies in our current portfolio are also on track to deliver the originally envisaged investment thesis, albeit with some delays due to temporary setbacks (mainly Covid-19 related). Combining the aforesaid two categories, at this point in time we seem to have taken the right investment decision in respect of 45 companies (62% of total companies invested since inception)

Where did we go wrong is more important to analyse than what we did right!

Declining Governance Quotient (6 companies):

6 companies that had ticked our governance filter at the time of making the investment saw decline in their governance quotient post investment in next 2-3 years.

Some of the governance issues that got red flagged in these companies are:

- Value destructive business restructuring
- Deterioration in Accounting quality
- Increase in material related party transactions
- Poor risk management and declining business ethics

Over the years, the team time spent on establishing governance comfort has significantly gone up while evaluating investment ideas and its testimony is the fact that we had 2 governance dilution cases in last four years versus 4 in the initial four years.

External (Macro) Headwinds: (6 companies)

6 companies saw serious external headwinds post our investment. These were companies with good governance and competent management, but changes in external factors outside their control disrupted their business plans & growth visibility. They were affected by factors such as

- adverse regulatory changes (education & liquor industry)
- technological disruption & changing consumption patterns (print news & publications)
- stress in end-user industries (Oil & Gas, Packaging amongst others)

Company-specific issues: (15 companies)

Over the past 8 years, 15 companies, disappointed us, due to the management's inability to effectively compete / execute their growth plans.

Key reasons why companies failed in delivering growth were:

- frequent changes in strategy
- inability to hire/retain senior talent
- over conservatism and not taking prudent risks
- loosening cost or working capital controls
- inability to implement M&A plans
- tepid response to new product /service launches
- wrong technology / marketing channel bets

While we have clearly improved our ability to assess businesses and their growth potential in the latter half of our existence (11 cases in the first four years and 4 cases in the last four years), occasionally we will have to contend with businesses where one or more such execution risks will come into play. The quality of leadership and the organizational set-up plays a big differentiating role in navigating such risks. We have continually been upping our management quality benchmarks while evaluating new investment ideas and this remains a continual learning process for us.

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'Bigger Lessons' from our 8 years journey!

1. Business Fundamentals are more important than macro-economic and geo political developments

In the last eight years there have been many macro-economic and/or geo political warning bells that have been sounded by analysts and economists alike, painting a gloomy picture of the economic outlook. From global macro-economic events like Grexit, Brexit, Oil price crash, US China trade war and many others to domestic macro-economic events like Demonetization, PSU Bank NPA crisis amongst others. On the geo political front there has been action all around with elections in India in 2014 / 2019 and surprise Trump victory in 2016, confrontation with China in Ladakh, Saudi - Qatar rift, Iran sanctions amongst many others. Not to forget several earthquakes, cyclones, forest fires and tornadoes.

In retrospect, most of these events had an inconsequential effect on the markets and multitude of companies continued to grow their top and bottom lines at a healthy rate creating huge value for its shareholders while the world witnessed these huge 'earth shattering' events. We reckon we have no control whatsoever on such events that keep happening from time to time. Instead what has paid off for us is to focus on business fundamentals of companies we are invested in.

Quoting Warren Buffet from his 1998 lecture to MBA students, when he was asked about his views on the then "tenuous economic situation and interest rates". He responded:

"I don't think about the macro stu . What you really want to do in investments is figure out what is important and knowable. If it is unimportant and unknowable, you forget about it. What you talk about is important but, in my view, it is not knowable.

Understanding Coca-Cola is knowable or Wrigley's or Eastman Kodak. You can understand those businesses that are knowable. Whether it turns out to be important depends where your valuation leads you and the firm's price and all that. But we have never not bought or bought a business because of any macro feeling of any kind because it doesn't make any di erence"

2. Reasonable valuation is a function of quality of business and not absolute P/E multiple

Over the years the one hot discussion which never leads to any firm conclusion amongst our team members is 'what determines valuation reasonability'. Two companies doing similar business and of nearly similar size can trade with a huge variance in their earnings multiple.
Our key learning here has been that business of high quality run by good set of people can make all the difference to the growth prospects of the business over the long term. Be it Apple on NASDAQ or HDFC Bank on NSE, these companies have demonstrated robust growth under all economic conditions and therefore command the valuation multiple higher than their peers. The same is also true for the small and mid cap universe and I have no shame in admitting that we have often struggled to justify entry valuations in many of our companies once the stocks ran away though there was still a very long runway ahead. This is an area which we are still learning to deal with.

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3. Patience pays!

The great Charlie Munger has on more than one occasion said that the key to investing success is *"sitting on your ass"*. We can't agree more!

Over the last eight years we have witnessed both sharp upcycles and sharp down cycles in small caps and that can unnerve even a seasoned investor. However, exhibiting patience and holding on to your investments based on high conviction has handsomely paid off for us and so also for our clients who chose to remain patient in the challenging phases of the market cycles.

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4. The biggest moat for any company is its Leadership & Management team

While its customary and normal for any analyst to look for economic moats in a business in characteristics such as having a network effect, being a low-cost producer, delivering a product or service that carries a high switching cost for customers, owning intellectual property and having efficient scale in production, what we have learnt from our Private Equity investing days is that the biggest moat that any company can have is their Leadership and Management team. One can afford to misread other moats but not this one. Time and again this has got proven in our own experience as well as in external case studies.

Managements create moats in business and not vice versa!

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5. Be humble – you don't know a lot even though you think you do!

We humbly and unashamedly accept that be it markets or businesses we invest in, there is so much that we don't know about. More than once we have been value trapped in seemingly good company run by good set of people where we thought we know a lot of that business and why markets will reward such a company. On the flip side, more than once we also have been proven wrong with companies we chose to let go and they turned out to be multi-baggers!

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6. Like money, knowledge also compounds over longer periods of time

The fundamental principal of compounding works as well with knowledge as with money. The more you read, the more you deliberate amongst team members and peers, the better you would become at taking investment decisions. The most important time spent by our team is in the morning meets that we do every day (over video since Covid-19) sharing our thoughts on what we read and learnt and playing devil's advocate to one another.

7. Listen to your 'gut'

As much as this is true for other walks of life, listening to your gut does help in being a better investor. It's the gut which says something is amiss despite all things looking rosy and makes that reject decision and the same gut says I know I don't have all the answers but I am confident of the management.

We are a learning organization and will continue to sharpen our qualitative, quantitative and emotive capabilities to improve our decision making process while remaining focused as long term patient investors.

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