11th January, 2019

Aurum Small Cap Opportunities & Aurum Growth

Aurum Small Cap Portfolio Returns, 32.8% CAGR*
BSE Small Cap Index Returns, 12.4% CAGR
Since Inception – 72 months

Aurum Growth Portfolio Returns, 25.5% CAGR*
BSE Mid Cap Index Returns, 21.2% CAGR
Since Inception – 65 months

*Composite portfolio returns-net of all expenses (mgt fee & other charges) and performance fee, to the extent charged

Dear Investor,

We completed 6 years of our small cap strategy in Dec 2018. We witnesed healthy returns in the first four and half years and then a phase of underperformance in the last 18 months! The journey over last six years led to a lot of learning for us and has also helped us refine our dos and don'ts. In this update, we once again felt that need to candidly share our learning and experiences with you (without any sugarcoating).

What we think we did right

- **Company Selection:** Our investments can broadly be categorized into:
    1) Thematic, where we chose to invest in emerging trends (such as productization of software, emergence of private sector banks, water & environment engineering, etc) aided by strong macro tail winds
    2) Historically strong business franchises witnessing soft changes like nextgen management taking over reins
    3) Consumer centric businesses

  Common attributes across all our investments have been zero or low debt, ability of business to generate free cashflows (therefore, robust balance sheet), a good management team at helm and anticipated earnings growth of 20%+ CAGR over next 3-5 years.

- **Conservative Valuation:** We believe that we have remained conservative with our valuation methodology and have not chased momentum while buying stocks. In most cases it helped us limit the downside when small caps were in a free fall. However, some of our stocks also took a hard knock despite our conservatism primarily on account of dried up liquidity where even small selling resulted in disproportionately high price corrections.

- **Disciplined Buy / Sell Approach via our Price Guardrail framework:** Even though we missed on a few opportunities as stocks ran away, we have adhered to our price guardrail framework, wherein a stock is purchased only within our entry guardrail price. There have been learnings for us on the sell guardrail pricing as well, which is covered in the next section.

What we did right:

- Company Selection
- Conservative valuation
- Disciplined Buy/Sell Approach via our Price Guardrails framework
- Staying away from dubious companies/management

Where we fell short of our own expectations:

- Our rigid approach to exits at our Sell Guardrail price
- Early weeding out of underperformers
- Building mindset to stay in cash for very long periods

- **Staying away from dubious companies / management:** Despite aggressive marketing by sell side brokers, as well as IR firms, we avoided investing in companies with patchy governance or poor capital allocation track record. Resultantly, none of our investee companies turned out to be a 'lemon' later, on account of dubious accounting or other adverse management actions.

And where we fell short in our own expectations

- **Our rigid approach to exits at our Sell Guardrail price :** Our initial success of selling stocks only at (or above) our sell guardrail prices (and booking handsome returns) made us rigid in this respect and has cost us dearly in the corrective phase of the market in last year or so. We witnessed a number of instances where our investee companies were trading just 10% below our sell guard rail price with healthy volumes and then corrected significantly along with overall market correction. We reckon that we could have been more dynamic in our exit strategy. Therefore, we have now fine tuned our sell guardrail framework, wherein we factor in external market & some specific statistical parameters in the decision making process, bringing in flexibility of partial or complete sale in such situations.
- **Early weeding out of underperformers:** The toughest part of long term investing is – how much time to give to management/company to deliver on the anticipated milestones in a dynamic business environment. In retrospect, we feel that in some cases, we were too liberal in giving the managements more than adequate time and resultantly delayed exiting those companies and reinvesting in alternative opportunites. Going forward, we want to be more proactive in dealing with business underperformance and take appropriate sell / switch such investments.
- **Building mindset to stay in cash for very long periods:** As earlier mentioned, from mid 2017 to early 2018 we were exiting companies with robust returns that saw cash levels in portfolios go up. While we followed our guardrail framework to reinvest in newer opportunities, interest in small caps has remained muted for several quarters now and that's got us thinking whether there was a case to sit in cash for longer. We don't have answers yet but once again the need to factor in external market conditions & statistical tools is now a part of our thinking process.

What to expect in 2019?

This is the question being asked to all fund managers by investors!

After a roller coaster ride of 2018 and election debacle of the ruling dispensation in the recently concluded state elections, there is heightened concern about the outcome of the general elections in May 2019 and its impact on the markets. Further, turmoil in global markets and impact of global events such as US-China trade war are also playing on the minds of investors. There now seems to be a sense of caution all around. Amidst such an environment, it is difficult for anyone to predict where the markets will be headed in 2019.

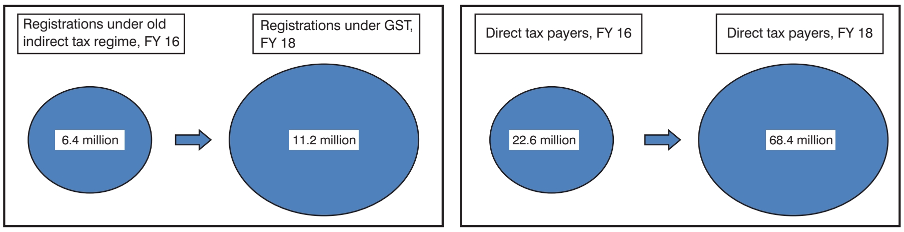
Positive macro factors going forward:

- **Structural benefits of GST & demonetization**
- **Insolvency and Bankruptcy Code**
- **Expected revival in private sector capex**
- **Benign inflation**
- **Upcoming budget: More cash in hand of citizens**

However, inspite of such uncertainties, one can look at some of the big structural positives that are likely to play out despite uncertainties of May 2019 elections, as well as other global factors, namely;

✓ **Benefits of Demon & GST -** After the initial pain over last 2 years – expanded tax base (Table 1)

Table 1: Expanded indirect & direct tax base

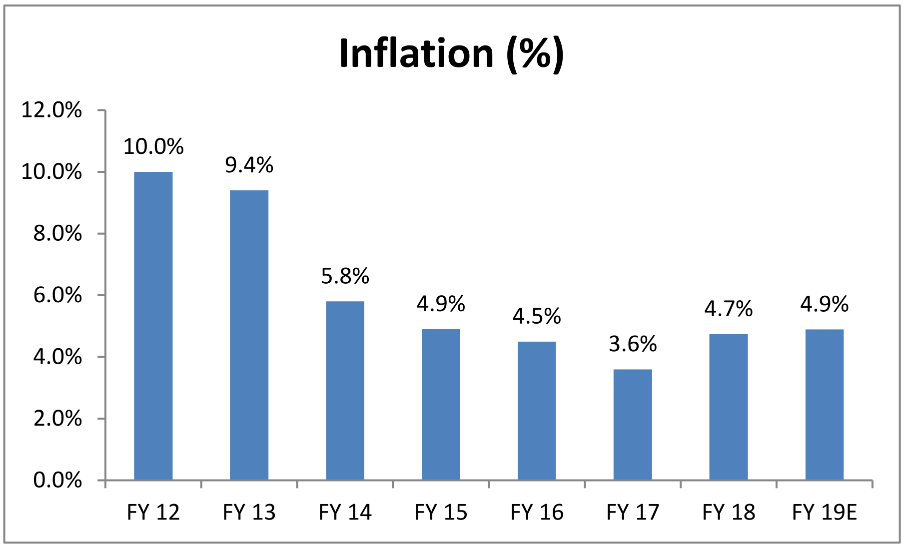


✓ **Insolvency and Bankruptcy Code** - IBC led robust resolution process enabling banks to manage existing NPA, which looks like peaking out. On the softer side, this will instill discipline amongst industry / promoters about capital allocation and capital structure

✓ **Capex revival** - Private Sector Capex revival on cards as capacity utilization in many industries at optimal levels

✓ **Benign inflation** - Inflation in range of 4-5% (Table 2)

Table 2: Benign inflation



✓ **Budget FY20** - A likely 'please all' and a relatively friendly central banker to propel Govt spending

We believe that the above factors shall help Indian economy and markets thereof find their feet in 2019. Domestic mutual funds and foreign FPIs will continue to remain cautiously optimistic. As for small caps, we believe there will be multitude of opportunities that will emerge from time to time to invest in robust businesses at reasonable valuations. Stock picking will be the key in the next two quarters.

Where do we see investment opportunities ?

*'kya accha lag raha hai yeh bazaar mein', t*hats another question asked very often! In this quarterly update, we are happy to share opportunities themes / sectors that we are favourably disposed towards at this point of time.

Theme: Domestic Healthcare

Investment Drivers

- ✓ Expected, accelerated consolidation in domestic pharma market
- ✓ Company with strong brands and a robust marketing / distribution infrastructure

Challenges: Relatively small pool of companies with domestic focus and reasonable valuation

Portfolio Investment Status: Invested in 2 companies. One of them has witnessed some management upheavel and thus tepid growth in the past 2 quarters

Theme: Software Products / Solutions in a Box

Investment Drivers

- ✓ Rapidly evolving banking & insurance service delivery space (digitization) and regulatory environment
- ✓ Large number of BFSI companies behind the tech curve and need to invest in productized solutions

Challenges: Growth or profit?

Portfolio Investment Status: Currently invested in 3 IT product companies catering to BFSI space

Theme – Financials, with focus on Small / Regional Banks

Investment Drivers

- ✓ Strong growth as large section of domestic population / SME migrate from unorganized to organized banking system
- ✓ Tech savvy, future ready banks

Challenges: Ability to manage growth & credit cost and valuation challenges

Portfolio Investment Status: Invested in 3 banks. Awaiting valuations to come within price guardrails in one more

Theme: Plastic packaging to face headwinds

Investment Driver

- ✓ Plastic packaging likely to see regulatory and social headwind, globally. Likely move towards modified paper packaging
- ✓ Ban on import of waste (paper & others) by China will ease raw material prices for domestic paper companies
- ✓ Paper (packaging) using agro waste and waste paper well placed to benefit

Challenges: Difficult to ascertain adoption rate of new packaging solutions

Portfolio Investment Status: Invested in one paper company

Theme: Branded consumer discretionary

Investment Drivers

- ✓ Progressive move towards branded products
- ✓ Strong brands translate into free cash flows
- ✓ Ecom helps 'Bharat' mimic consumption pattern of 'India'

Challenges: Valuation challenges

Portfolio Investment Status: Invested in a handful of companies

Theme: Upgrade / Modernization of Indian Defence Forces

Investment Drivers

- ✓ Dire need for continued upgrade, modernization and indegenization of IDF
- ✓ High technology and reliability entry barrier

Challenges: Lumpiness in order flows

Portfolio Investment Status: Invested in 2 companies

Theme: Water &

Air Polluiton Management

Investment Drivers

- ✓ Non linear investment in water and environment infrastructure to address environmental challenges
- ✓ Regulatory environment getting tougher with each passing year

Challenges: Working capital challenges and lax implementation at MSME units

Portfolio Investment Status: Exited two investments profitably. Invested in one. Evaluating others

Theme: Balance Sheet &

Business Restructuring

Investment Drivers

- ✓ Divestment of non core / loss making business
- ✓ Corporate restructuring (de merger) to unlock value
- ✓ Debt Pay down
- ✓ Writing off of intangibles like goodwill
- ✓ Earnings accretive acquisition

Challenges: Event driven & valuation challenges

Portfolio Investment Status: Invested in & exited a few companies. Always looking for new opportunities

Principles for successful investing never change, namely;

- Quality of management
- Macro tailwinds
- Healthy balance sheet & cash flows
- Reasonable valuations

In Conclusion

We as fund managers are constantly learning and evolving in a dynamic external environment that is often difficult to predict. However, we do not leave any stone unturned to understand our investee companies thoroughly and monitor them closely. We do believe that certain principles for successful investing never change, namely; quality of management, macro tailwinds, healthy balance sheet & cash flows and reasonable valuations. It may take more time and patience than anticipated, but we expect rewards to follow eventually

Looking forward to your continued support and encouragement.

Warm regards,

Sandeep Daga

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