nine rivers CAPITAL

8th January, 2020

Aurum Small Cap Opportunities & Aurum Growth Portfolio

Dear Investors,

Greetings of the new year and beginning of a new decade of 2020

Five decades ago in 1970, Milton Friedman had argued that companies' only social responsibility was to maximize shareholder value. In other words, maximise profits over everything else – be it employees, customers, suppliers, distributors, communities, neighbours or the environment. In hindsight, this toxic philosophy & culture of profit over everything else lead to corporate executives taking excessive and often imprudent risk with adverse social and / or environmental consequences and corporate frauds. From Erin Brokovich's fight against Pacific Gas & Electric Co. (https://en.wikipedia.org/wiki/Hinkley_groundwater_contamination), big brands sourcing goods from factories employing child labour (https://www.theguardian.com/sustainablebusiness/2016/feb/01/nestleslavery-thailand-fighting-child-labour-lawsuit-ivory-coast), frauds in erstwhile giants like Enron (US) or Satyam (India), closure of highly polluting chemical plants in China or the more recent VW emission scandal (https://en.wikipedia.org/wiki/Volkswagen_emissions_scandal). The excessive greed of corporates have led to catastrophic consequences and investors have suffered huge losses in the long term. Bluntly put, profit maximization strategy eventually bombed. As a consequence, over the last decade or so the concept of Responsible Investing has increasingly gained prominence. It is our endeavour to give our readers a peep into this subject matter as we believe that it will have a growing role in determining valuation of companies going forward.

Why Responsible Investing is gaining prominence?

We now live in a global village. Thanks to the internet, an event or an happening in one part of the world becomes visible in other parts of the world almost instantly. Be it a natural calamity like a Tsunami or a man made disaster such as a nuclear reactor leak or an oil spill, the cause and effect analysis by experts as well as the media is almost instantaneous. Moreover, in most of the developed world and large parts of developing world, the new generation & millennials are acutely conscious of social and environment issues and want to do something about it.

Responsible investing is in effect an integration of environmental, social and governance (ESG) factors into the investment decision making process. A company that has high ESG quotient seeks to generate profits for shareholders in a way that also factors in well being of other stakeholders like employees, environment, suppliers, customers and surrounding communities.

Thus, no longer pollution is free & labor just a 'resource', you can no longer justify destruction of forest for mining or pollute rivers, not care about what came out of your factory smoke stack or with whom you do business (eg; blood diamonds, apartheid in South Africa, child labour). In fact, to survive and thrive in the long term, you had to do exact opposite! Do business responsibly! The driving force behind this radical change is the changing demography & emergence of millennials! The bright and intelligent minds of this generation are mindful of what they consume, organizations they work for, the social and environmental footprint of the organization they are associated with and also their investment portfolios. Transparency is paramount to good governance and no longer can businesses hide behind legalese or the corporate veil, to hide their action from scrutiny of activist investors.

The above factors have created a perfect case for Responsible Investing. Companies who are high on the ESG (Environment, Social & Governance) tend to provide investors the comfort of longevity and sustenance of business.

Emergence of ESG - E(nvironment**) S(**ocial**) G(**overnance**)**

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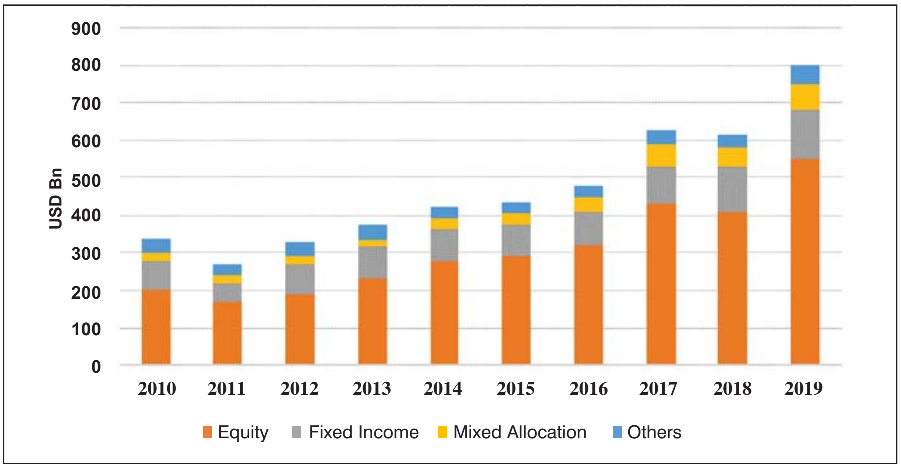
The term ESG was first coined in 2005 in a landmark study entitled "Who Cares Wins". Today, The current size of the pure ESG classified investing universe (Equity & Debt) is estimated at ~ $900 t AUM. To put in context, the entire impact investing assets (debt & equity) under management would be about USD 25 tn. Thus, ESG is about 4% of Impact Investing assets. A growing at CAGR of 14% for last 10 years making it one of the fastest growing asset category.

Chart 1: ESG AUM



Source: Bloomber, Mint

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We believe companies conscious of wellbeing of other stakeholders of the business ecosystem, ie; companies with high ESG quotient are likely to benefit disproportionately in the long run, with better profitability and sustainability. Such companies are likely to attract better talent, mitigate regulatory compliance issues and will be able to take curative steps well in advance, wherever required. High ESG standards have become indicative of a progressive management with fund managers ascribing a premium to such management quality.

What goes into determining ESG quotient?

The factors that go into determining ESG quotient cover a wide spectrum of issues that traditionally were not part of financial analysis. Yet these factors have become financially relevant in today's context. This might include how companies respond to challenges of climate change, scarcity of water & other natural resources, health & safety of workers, sourcing practices, dependence on fossil fuel, etc.

ESG Materiality Map

Any ESG assessment typically starts with building a Materiality Map (https://materiality.sasb.org/) by compiling a list of factors that can have a significant adverse financial impact on business. It is important to note that when it comes to Environmental and Social factors, not all factors impact all businesses alike and therefore material factors for one business may not be as material for another. For example, water resources management is a material factor for the Thermal power / paper / sugar industry while much less material for a packaged foods. Conversely, using single use plastic packaging is a critical material factor for packaged foods business but not for financial or sugar industry. Similarly, labour & employee welfare practices have far higher materiality in textile, garmenting, BPO and other labour intensive industries than in the modern banking industry, which is more tech driven. However, the materiality of Governance factors, remain the same for all businesses.

Further, though infrequent, there could be situations where even though some ESG factor may not matter financially, it may still be of concern to investors.

Environmental Factors

The E in ESG stands for the environmental footprint of the company, both positive or negative. Illustratively, the following environmental factors in chart II are very critical for an extractive industry but is not as critical or relevant to an insurance & banking or a food and beverage company, from a financial risk perspective .

Chart II: Comparative Environmental Materiality Map

	Heads	Extractive Industry (Mining & Metallurgy)	Financial Services	Food & Bev
Environment	GHG Emissions			
	Air Quality			
	Energy Management			
	Water & Wastewater Management			
	Waste & Hazardous Materials Management			
	Product Design & Lifecycle Management			
	Ecological Impacts			
	Raw Material & sourcing			
	Impacts of Climate Change			

	V.Important
	Not So Important
	Not Relevant

(https://materiality.sasb.org/)

Some illustrative examples are given below;

- **Raw material and sourcing:** Industries based on wood based products or mining & extractive industries are likely to progressively face steeper raw material sourcing challenges
- **Water Intensity:** Industries like thermal power plants, paper, beverage, etc are water intensive. Non availability of water or competition from surrounding communities for potable or agricultural water can impact operations. In India over 30,000 MW of Thermal Power Plants are sub optimally operational because of non-availability of water. Similarly paper mills have faced prolonged shut down in Tamil Nadu because of water scarcity.
- **Effluent & Pollution control:** Industries with high effluent profile would have to invest significantly in technology, process & effluent control capex to manage pollution and emissions. Industries like oil & gas, chemicals, power plants would require continuous investment in zero discharge process technologies to comply with increasingly stringent effluent treatment norms.
- **Regulatory Compliance:** Track record of regulatory compliance, both in letter and spirit, the latter being more difficult to assess requiring more than just paper trail analysis. History of environmental or other regulatory violation(s) or on the positive side securing accreditations or certifications such as ISO 14000 or Responsible Care certification for chemical industry also make a difference.

Absolute vs Progression

All the relevant ESG factors need to be viewed both in absolute as well as in a progression. Progressive goals, consistent reporting & transparency is important from the point of view of assessment of environmental trajectory of a company. From an investment assessment perspective, environmental positive outcomes include investment in technology to avoid or minimizing environmental liabilities, lowering costs and increasing profitability through energy and resource efficiencies, reducing regulatory, litigation and reputational risk.

<u>Social Factors</u>

The social component comprises of people-related elements like company's culture and practices that impact employees, customers, consumers, and suppliers - both within and outside the company as well as the surrounding community at large. A specimen materiality map of social factors is illustrated in table III

Chart III: Comparative Social Materiality Map

	Heads	Extractive Industry (mining & Metallurgy)	Financial Services/ Technology	Food & Bev
Social	Human Rights & Community Relations			
	Customer Privacy & Data Security			
	Access & Affordability			
	Product Quality & Safety			
	Social Impact of Product			
	Selling Practices & Product Labelling			
	Labor Practices (Health & safety, benefits)			
	Work Culture			
	Employee Engagement, Diversity & Inclusion			

The important areas of social assessment are:

- Work culture-assessing employee treatment (hire & fire), comparative pay, employee benefits, turnover/churn, open office or bureaucratic culture, shop floor working conditions, hygiene, avenues to address sexual harassment prevention, etc
- Issues like equal opportunity employer, diversity policy or signs of subtle discriminations
- Sales & marketing practices
- Supplier & vendor relationships
- Impact of product & services on the larger community
- Community outreach & development programs
- Response to consumer grievances and litigations

Most of these are softer aspects and subjective in nature. The way to assess these would be to talk to employees & suppliers. Absence of good work culture and empowerment often translate into inability of companies to attract and retain quality people. Similarly, poor industrial relations & poor shop floor discipline can jeopardise smooth functioning and productivity.

From an Indian perspective, it is also important of assess the social impact of the product/service being offered by a company. For example, liquor business can face social and political risk in the Indian context.

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Governance Factor

Governance essentially refers to what is commonly referred to as 'corporate governance' and indicates as to how well a company is run, as illustrated in table IV.

Chart IV: Comparative Governance Materiality Map

	Heads	Extractive Industry (mining & Metallurgy)	Financial Services	Food & Bev
Governance	Quality of Accounting			
	Business Ethics			
	Quality of Board			
	History of Legal & Regulatory Challenges			
	Quality of investor communication & reporting			
	Treatment of Minority Shareholders			

Apart from some of the heads mentioned in table IV, one also needs to look out for:

- Frequent change of auditor and auditor qualifications
- Other business interest of promoter family or company and conflicts thereof
- Role & number of family members in company and decision making process
- Profile of senior management team

Positive & improving governance is a pre requisite for all long term investors. Good governance standards also generally means avoidance of financial surprises and usually also translates into higher and progressive Environmental and Social business practices.

ESG@NRC

We @NRC believe,

- Going forward availability of natural resources cannot be taken for granted and sourcing them can become challenging for many industries.
- Competent human capital will gravitate towards companies that are high on ESG quotient thereby making those companies more valuable over the long term.
- Patience for corporate & environmental misconduct will be minimal and will be met with sharp social, judicial & regulatory action
- Consequently, corporates incorporating progressive & pragmatic, ESG & business practices are better placed to sustain growth & profitability

For last few years, we at NRC have incorporated a 'soft' ESG assessment framework in our investment decision making process wherein, various factors discussed above are assessed for each potential investee company.

We believe that a comfort around ESG acts as a significant risk mitigation tool and it compels us to dig deeper and develop higher conviction in our investee companies. Specifically, we lay emphasis on the following factors:

- **Management team:** Quality & composition of management team (family members or professionals) and board.
- **Accounting & regulatory filing:** Quality of accounting, any discrepancy in reported financials, regulatory filings. For example, based on certain observed discrepancy, about 5 years ago, we did not invest in a wellbeing & fitness company. Since then the company has defaulted on its debt obligations and market cap has decimated by over 95%.
- **Corporate actions and treatment of minority shareholders:** Related party transactions, M&A with related parties, preferential allotment to promoters, companies investing outside their core business, contingent liability creation outside of core business needs and such other actions are red flag for us.
- **Raw material scarcity:** We believe, availability of natural resources such as wood and various minerals will keep becoming increasingly challenging due to the adverse environmental footprint associated with them. Business' which foresee these

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challenges and plan for alternatives (such as recycled material or other alternates) find more favor with us. Thus, as an alternative to plywood, we invested in a building material company manufacturing cement fibre board which is light weight alternative to plywood and concrete, for certain applications.

- **Water and Waste management:** Availability of water for industry is becoming a challenge in India and in many other parts of the world. Water intensive industries like paper, textile, synthetic leather, thermal power plants are at substantial risk unless they use technologies to reduce their water consumption.
- **Plant location:** We try to get a sense of the sensitive issues specific to a plant location like socio – political & security challenges, bio diversity zone or arid zones, etc in our investment process. Based on such analysis, we have held off from investing in a synthetic leather manufacturer, which is a water intensive process and was based in a water deficit area. Similarly, we have avoided investing in a thermal power company because of its location in a water deficit area.
- **Energy dependence:** Energy intensive industries are likely to face both energy and emission challenges. In such cases it is important to review the energy profile of fossil fuel vs RE and also the energy intensity per unit production
- **Litigations & Liabilities:** Litigation and liabilities overview is not restricted to the potential company but covers other related companies and promoters too. Excessive litigation for or against is discomforting to us.

The list given above is only indicative of our thinking process and not exhaustive in nature. Succinctly, our belief is that high ESG quotient indicate ahead of the curve and long-term thinking of the management of the company. It helps companies to strategize, plan for the longer term and indicates a holistic outlook to business as in life.

New Portfolio Additions in FY20, Q2: 3 new companies were approved for investment in the last quarter. We are in the process of adding these new companies to the relevant portfolios. The new additions are as follows:

- **Investee company - Company 1**
  - **Industry** – Engineering
  - **Company 1** is a fractional motor manufacturing company
  - **Investment rationale:** Strong growth visibility from traditional line of business and new opportunities in consumer durable space.
- **Investee company - Company 2**
  - **Industry** – Health Care
  - **Company 2** is a medical device company
  - **Investment rationale:** Regulatory changes likely to enable sustained robust growth

Kindly note, if a stock is approved that does not necessarily mean that it has to feature in our client portfolios immediately. We will buy the stock if it is available within our 'entry guard rail' prices. In rare instances, we may not be able to buy them at all.

Looking forward to your continued support and encouragement.

Warm regards,

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