21st Oct 2022

Aurum Small Cap Opportunities Quarterly Portfolio Update – Quarterly Update Q2 FY 22-23

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Dear Investor,

At the outset we wish you a happy, healthy and prosperous Diwali!

When all and sundry including the paanwala start talking about interest rate and inflation as a big concern for the markets, one starts seriously wondering if this indicates 'peaking out' of inflation and interest rate hike fears, especially in the context of Indian capital markets. On the one hand we read reports of the impending US led global recession and on the other hand we get to know that currently in the US (US labour data), for every 1.7 jobs on offer there is only 1 taker. Paradoxical as it may sound but such data points are putting classic economic theory in shambles. Efforts to contain inflation through interest rate hikes by the west hasn't yielded the desired results so far. Globally economic policy makers and central bankers seem to be scratching their heads to find out newer forms of interventions to contain inflation. UK policy makers doing an about turn in deference to their central bank points to the helplessness that prevails. Trying to second guess where the world economy is headed during these times is beyond our comprehension and a pointless exercise. We do strongly believe that India is better placed in an otherwise turbulent world and is likely to continue its healthy economic growth. Resultantly, better managed corporates have the potential to dole out robust earnings growth and keep attracting the attention of institutional capital. Therefore, we would rather spend our energies focusing on specific sectors and companies which fit into our investment themes and keep investing, albeit at a slightly more gradual pace.

The last quarter witnessed an unfortunate event with the passing away of India's most prolific public markets investor Mr. Rakesh Jhunjhunwala (RJ). Every long-term investor in this country would have learnt some key facets of investing following RJ and we are no exception. We dedicate this quarterly to the legendary investor by covering one facet of his investment strategy which we feel acted as a key value creator.

RJ and the art of identifying investment ideas/thesis early!

Much has been written and spoken about the legendary investor who, unfortunately, is no more amongst us. I didn't know RJ personally but like millions of others, was his big fan. In fact, we as a team have always pondered over his unique and often humorous one-liners looking for deeper messages being conveyed and these learning have surely helped sharpen our investment skills for better.

One factor that RJ's phenomenal success as an investor can be attributed to, is that he had this extraordinary ability to identify a solid investment thesis early

If we were asked to select one factor that RJ's phenomenal success as an investor can be attributed to, we would say that he had this extraordinary ability to identify a solid investment thesis early allowing him to capture huge 'Discovery Premium' thereby turbo charging his returns. He invested in **Titan** in 2003 when Titan was supposed to be a 'Watch' company that no other investors were watching! And the rest, as they say, is history as Titan generated ~40% CAGR since then. We have tried to imagine and present below the 'thoughts and efforts' that may have gone into early identification of Titan by RJ:

- **Building high conviction on the consolidation and formalization of jewelry business** – This clearly was easier said than done as jewelry business was opaque, driven by cash dealings and highly fragmented. To envisage people switching loyalty from their family jeweler of ages to a new entrant and willing to fork out premium for quality was unthinkable at that time and required foresight of how consumer behavior is likely to change.

- **Understanding the pain of customers and if they are looking for a more credible alternative** – Opaqueness in dealings, no standardization, compromised purity of gold, lack of design choices, sub-par workmanship and more such issues may have emerged as reasons for consumers (especially younger gen) to be unhappy about traditional jewelers.

- **Tatas mean Trust** – The fact that, first and foremost, this business requires earning unflinching trust of customers and who other than Tatas can be better placed to build that 'Trust' relationship as a credible alternative surely must have aided in building conviction.

So, in anticipating such a change RJ was early to the party!

Having taken a plunge into the stock, there would have been many instances when the conviction to 'hold on' needed validation – Lehman Crisis in 2008-09, change of political guard in 2014, demonetization in 2016, rollout of GST on Gold in 2018, Covid in 2020 to name a few! Holding on through each such rough phase would require close monitoring of the company and its business environment going beyond desk research to on-the-ground channel checking, etc. RJ created a highly committed and competent team to closely monitor investee companies and they have been strong pillars of his long-term success. **May the legacy of RJ continue to shine in crowning glory!**

Early investing & NRC

Identifying an investment thesis early on is one of the key facets of our investment strategy at Nine Rivers Capital and a major factor for our long term success! As John Tuld says in the movie Margin Call *“There are three ways to make a living in this business:* ***be first; be smarter; or cheat.*** *Now, I don't cheat. And although I like to think we have some pretty smart people in this building, it sure is a hell of a lot easier to just be first.”*

Here are some examples from many of our current and past investments which have been a part of our early investing philosophy:

1. **Ceat (May 2013)**

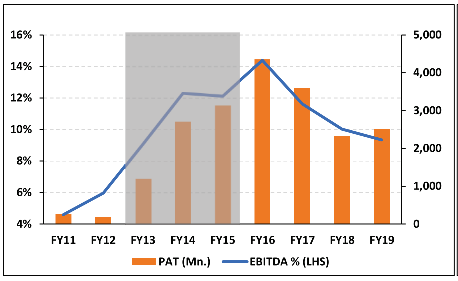
   Primary investment thesis: Strong vintage brands coming out of hibernation and headed for growth again!

   We came across a clutch of companies with strong vintage brand, like Amrutanjan, Singer, LML, Dunlop and CEAT but with relatively subdued financial performance. Ceat was a strong legacy brand in the tyre business and was a leader in the replacement market for 2W.

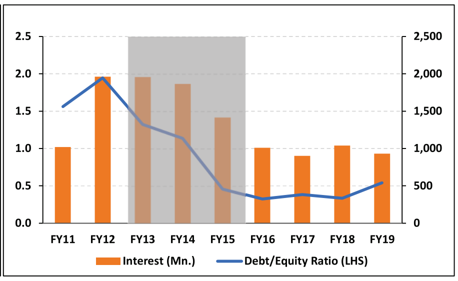
   The company had appointed a new MD in place with a clear mandate to drive profitability over growth or market share - instead of going after market share with OEM, they would seek to maximize revenue from the most profitable segments, namely; export and replacement market for 2W

   Over the next 3 years, the above strategy translated into significant margin uptick and rapid deleveraging for Ceat (Chart I)

Chart I: CEAT - Improving margin



Debt paydown & lower interest cost



Source: Company annual reports, NRC research. Marked area indicates period of investment

Exit: We exited the company in ~3 years timeframe as our exit guard rail price was repeatedly breached on the upside. Margins were at an all time high of ~12-14% (Chart I) and the company was trading at high teens PE valuation with mid teen EBITDA margins. This was is contrast to the global tyre majors who had high teen margins and trading at mid teen PE valuations. With the stock at high valuation and all the tyre companies including Ceat announcing a series of capex plans, we felt it is an opportune time to exit.

2. Alky Amines (Nov 2016)

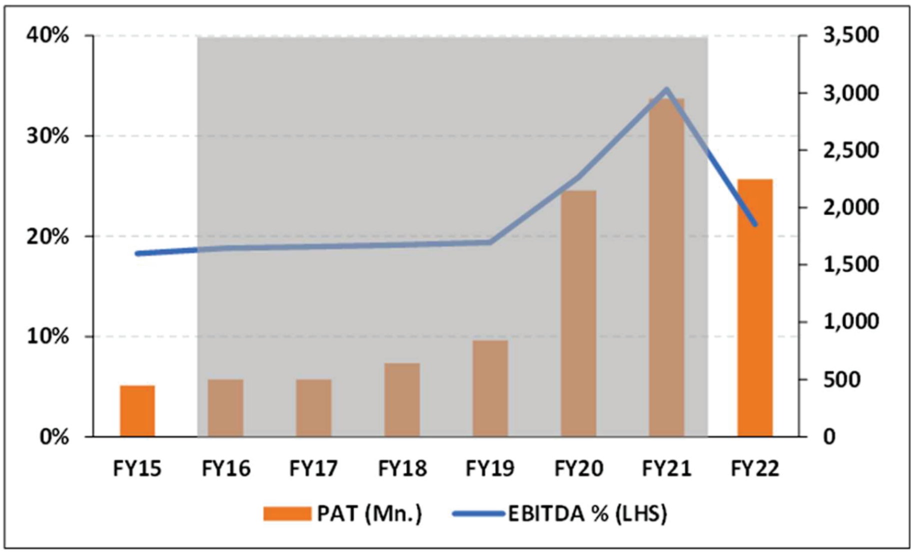
Primary investment thesis: Tailwinds for Indian Specialty Chemical companies with progressively tightening of environmental compliance frameworks in Europe and China.

Typically, Indian chemical companies have been subject to challenges such as price volatility, sub scale operations and progressively escalating environmental & pollution control costs. Keeping this in mind, we were looking for complex chemistry companies with very high environmental compliance standards. After screening and interacting with a host of companies, we zeroed in on Alkyl Amines as a specialty chemical play having an expertise in amine-based chemistry with end products finding applications across industries, including pharmaceuticals and FMCG.

Being an oligopoly, comprising of 3 players in the methyl/ethyl amine industry in India and the potential for significant margin uptick given that Alkyl Amines having made down stream and value added products further helped to build high conviction.

The company witnessed its EBITDA margins expand from ~18% to high 20s over next 4 years and even touched early 30s in the 5th year since our investment (Chart II).

Chart II: Alkyl Amines – Exit around peak margins



Source: Company reports, NRC research. Marked area indicates period of investment

Exit: With margins reaching peak levels and valuations flying through the roof, we reckoned that these high margins are not sustainable over the longer term. The stock already being a big multi-bagger for us (over all we made 11X), we gradually exited in 2021 as the valuation continued to zoom upwards.

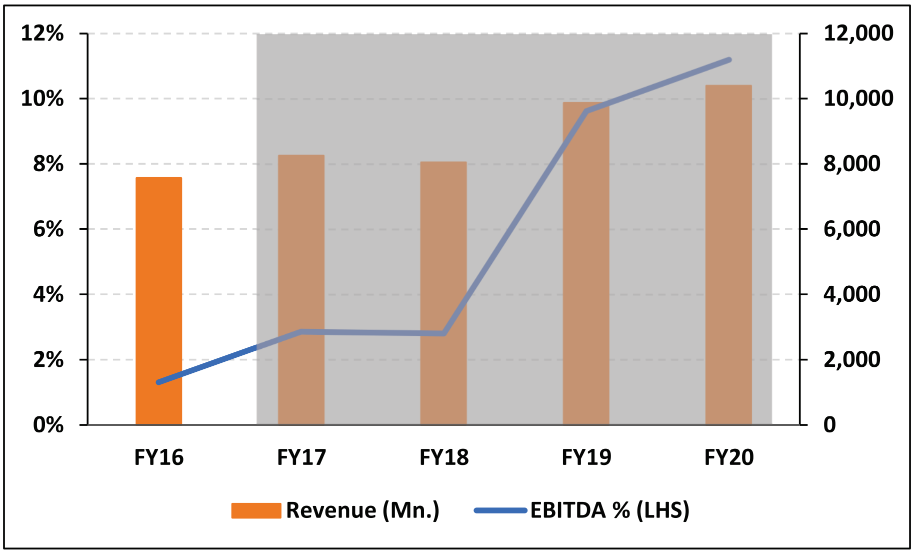
3. Majesco (July 2017)

Primary investment thesis: Rising Digital Transformation spending in global BFSI sector.

The need for creating single screen device independent digital front end to enhance customer experience, reduce customer acquisition cost and cross sell became the key driver for rapid digital transformation of global BFSI companies. Further the mainstreaming of cloud-based SaaS offerings meant that digital tech companies had a sustainable long term growth opportunity to target. Majesco, a digital IT products and solutions company, focused on the global insurance sector, was well positioned to enjoy the tailwinds on account of the aforesaid trend.

Unlike any startup, Majesco was already clocking significant revenue and racing towards profitability when we spotted the company. With a strong cloud offering deeply focused on the insurance sector, Majesco was able to differentiate itself and create traction despite its smaller size compared to larger be-spoke players.

Chart III: Majesco – Improving margin with scale



Source: Company reports, NRC research. Marked area indicates period of investment

Exit: Over the next 3 years Majesco garnered significant customer traction and also started to see improvement in their margins (Chart III). However, the promoters decided to sell the business in late 2020 to a large US PE firm and as a consequence we also had to exit making handsome returns. Had the business not been sold out, we would perhaps still be holding this company as similar businesses have witnessed huge growth in last 2 years.

4. **Praj Industries Ltd. (Early 2018, still invested)**

- **Primary investment thesis:** Reducing air pollution (cleaner environment) through increased blending of ethanol in automotive fuel

  If one would have looked at Praj when we first invested, these would be the observations:

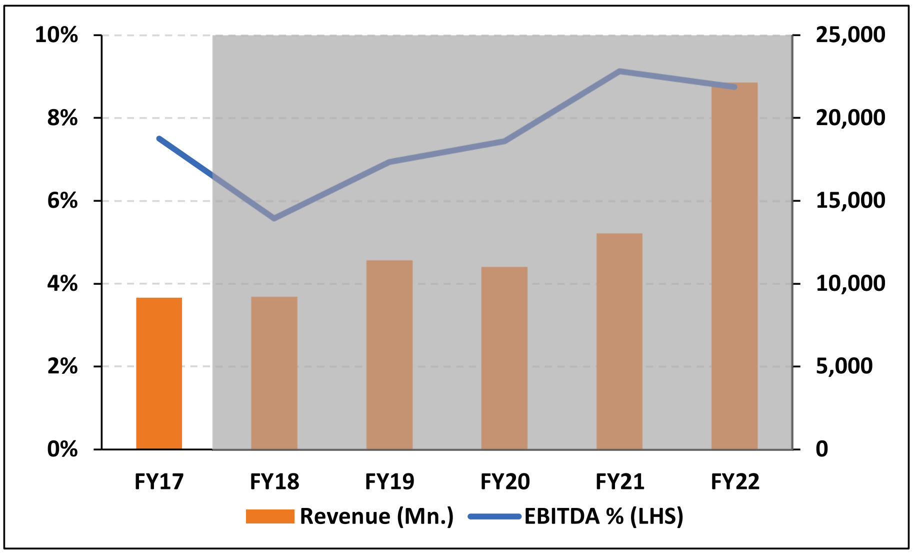
  - Tepid historical 5 year sales growth
  - Uninspiring return ratios
  - Capital goods play – avoidable as private sector capex revival visible was not visible
  - Perceived as commoditized heavy Fabrication play with single digit EBITDA margins

  So why did we like Praj? Because it fit very well in our investment thesis – if the blending of ethanol with petrol were to increase from 5% to 20%, ethanol making capacity needed to be jacked up by 4x over the next 5 years. Praj being the undisputed leader of manufacturing bio distilleries would be a large beneficiary.

  On taking a deeper dive into the company, we also became comfortable with the adjacent businesses that Praj had created including effluent treatment and waste water recycling solutions.

  Since our investment, Praj has demonstrated high sales growth as well as accretion to its margins (Chart IV) and we believe that this growth journey will sustain for next 3-4 years. We are already ~5x in Praj and still invested as the investment thesis is still playing out and we are perhaps midway in the journey.

Chart IV: Praj Industries – Policy backed execution



Source: Company reports, NRC research. Marked area indicates period of investment

In Summary

Being able to identify an investment thesis early has repeatedly helped us in discovering multi-baggers. Yet the journey to hold such companies and endure temporary setbacks require high conviction and patience – the former comes when you monitor your companies closely enough and the latter is all about temperament. Fortunately, as a cohesive team, we are getting better at both!

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