NINE RIVERS CAPITAL

14th Jan 2022

Aurum Small Cap Opportunities
Quarterly Portfolio Update – Q3 FY 22

Our Small Cap strategy - Nine years and going strong!

Dear Investor,

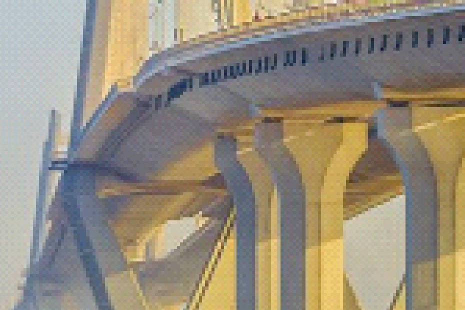
At the outset, wishing you all a healthy and happy 2022!

The quarter gone by is special to us as we completed NINE successful years of our small cap strategy last month! Over these nine years we have seen many bull & bear phases in the market but we haven't wavered from our disciplined strategy of investing in fundamentally strong businesses that exhibit healthy growth prospects and run by competent management teams, that too at reasonable valuations only.

As we step into a new calendar year, the Omicron variant is all over the place! While it is too early to say how disruptive the impact of this variant will be, most medical experts have opined that though highly transmissible, this variant is milder and does give hope for being less disruptive than Delta. Some experts have also opined that this may be the beginning of the end of Covid-19. We are keeping our fingers crossed!

2020 and 2021 may well be recorded as the lost years of modern history. These were also the years that saw trends like online ordering of grocery, meals and medicine alongside digital payments accelerate to hyper mode. Contrary to initial expectations, during this period most organized businesses withstood the Covid-19 storm resolutely and churned out record profits. Yet, supply chain disruption witnessed the world over in last six months and resultant input cost inflation that businesses are having to endure makes the case for being cautious as we assess the future of corporate growth and profits.

The markets exhibited bullish undertones for most part of last calendar year and many stocks have scaled new valuation peaks. As conveyed in Sep '21 quarterly update, given our patient investment style, we had to be mentally prepared for some short term under performance in a run away market. We were fortunate



to see some stock specific valuation rationalisation in the Oct-Dec quarter allowing us to buy into newer ideas and also catching up on our performance to match with that of the benchmark.

Going ahead, we continue to expect volatility in the markets with taper tantrum, some key state elections and budget round the corner. As always, we will remain patient in our approach and look at one company at a time rather than the market in general while taking investment/exit decisions.

Dodging the Duds!

'How has your private equity approach saved you from investing in dud companies?' –In the past this question has been asked by some of our existing as well as prospective clients. We want to share some of our experiences over the last nine years in this respect for our readers to better appreciate our private equity approach.

Case Study 1

Business Description: Wellness / Fitness

The company was brought to our notice by its one of its existing large shareholder. We were positive on the business as a consumer discretionary thesis and this was an established brand growing aggressively. As we took a deep dive into the numbers, the following red flags unnerved us:

(1) Unusually high capex of ~INR 5mn per centre (FY10-13 average) and

(2) Depreciation charged at ~5%, pegging life of fitnes equipment at 20 years!

We found both these factors unreasonable and decided to validate through 'on the ground' channel checks which is a part of our investment decision making process. Our team members went across to standalone and other branded fitness centers to understand the unit economics of the business and also ascertain the capex needed to build similar sized centers and came to conclusion that the capex required is less than 50% of what the Company has been spending. Further, anybody who spent some time in a fitness center would know that most equipment is subject to significant wear and tear and typically needs replacement in 3-5

'On the ground' diligence is a part of our private equity approach to small cap investing

years. No way can it last for 20 years and if the depreciation acceleration as required were to happen, all reported profits will vanish. We decided to stay away despite the obvious attractiveness of the sector and the brand. The stock price of the company rose astronomically as we passed the opportunity almost giving us a 'missing the bus' feeling. Later however, reality came to the fore with burgeoning debt, defaults to lenders and criminal proceedings initiated against the promoters. Market cap tanked by over 95%! The 'on the ground' diligence which is part of our private equity approach saved us the blushes.

Case Study 2

Business Description: Housing Finance

We were looking to invest in a good housing finance company in the small cap universe in early 2014. We came across a few companies and ultimately had to decide between Canfin Homes (which eventually became a very successful investment of ours) and this one other private company that was available at a more compelling valuation and on the face of it looked like a much better prospect. On taking a deeper dive into financials, we had two major observations:

a) The company had a growing share of riskier developer loan book (5% to 13% from FY11 to FY13, respectively)

b) Disconnect between its sub 1% GNPA profile vis a vis it more riskier customer profile

To understand this bit and after digging into the financials further, we came up with a set of queries pertaining to few asset side balance sheet items in the books of the company and its subsidiaries. In our meeting with the senior management folks, these queries were brushed off as something that they can answer later over an email. We sent across our queries over email too but never heard back from the management. Somewhere we got the message that something is amiss and we gave this company a pass while going ahead with our investment in Canfin Homes. Over the next 2-3 years this company's stock price skyrocketed as the company went about doing some acquisitions and exhibiting high growth. But when the ILFS scam opened a can of worms, this company also got exposed leading to total value destruction for shareholders. A forensic audit laid bare a trail of fake accounts created under PMAY to siphon off money and

dubious loans given to shell companies. We finally got the answer to our queries! Not shying away from asking difficult questions is a part of our private equity approach to investing.

Case Study 3

Business Description: Content – Educational Publishing

This company was a PE-funded, education content & collateral publishing company that went IPO. Given the PE legacy and it being a play on education piqued our interest. The company was pursuing an acquisition led growth strategy and was guiding high growth on the back of acquisition of many regional publishing houses prior to its IPO. The management sounded aggressive / confident and looked to cross sell, roll out its books through inventory push like a FMCG company and optimize printing costs through centralized printing. All of this sounded like a great story! But we needed validation of this growth strategy. We did extensive channel checking reaching out to regional publishers to understand the dynamics of doing text book business with state governments, cross selling, distribution outreach and much more. Through these interactions our one key fundamental finding was text book publishing companies grew by acquiring one school/ one standard / one subject at a time and not through aggressive expansion of distributors or cross selling. We also learnt of major integration issues of various acquired businesses that the company was grappling with and weren't convinced of the management's capability to deliver on its growth plans. We passed the opportunity at that time for a future review after a few years. We re-assessed the company again 2 years later when its market cap had collapsed by 65%. Here is what we found;

1. Net revenues had declined 45% from the time we first took a look

2. Acquisition led growth led to a 17% CAGR growth of its balance sheet from FY13 to FY20. During the same period, its revenue de-grew at -6% CAGR.

3. Content cost was being capitalized big time and yet, the company had significantly lower margins that its peers.

This experience, reinforced our belief to stay away from purely balance sheet driven businesses and also focus on understanding the consumer psyche rather than just relying on

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the company's narrative. Doing thorough 'channel checks' is again a part of our private equity approach.

To Conclude

The private equity approach entails looking at business and people from all relevant angles and to try validate management assertions & guidance through methods and thought processes such as the ones described above. It is not a 'one size fits all' approach but tweaked to specific business case. Not only has this saved us the blushes but it has also allowed us to pick up some great winners. We would endeavor to cover those success stories as well in a future quarterly update.

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,

Sandeep Daga

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