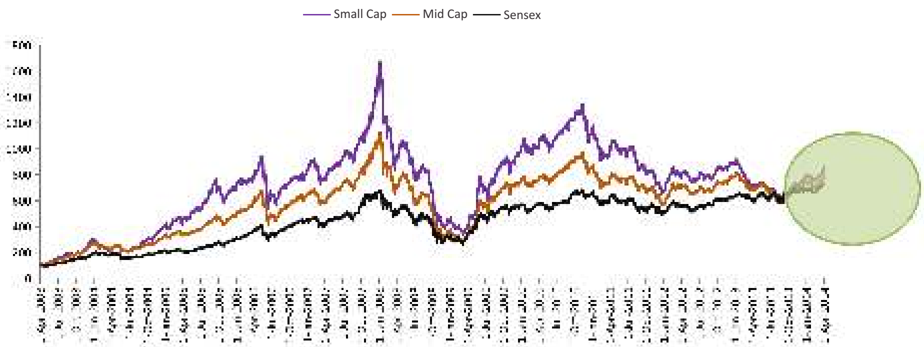
7th April, 2014

Annual Update

Dear Investor,

This is the 5th quarter together and we hope we have been able to live up to your expectations.

Stock Picking & Portfolio Discipline – Key to out performance



Allow me to take this opportunity to share the above chart with you that indicates that we may be at the cusp of a new upward cycle in equities. It is a comparative chart of three key indices viz Sensex (large cap), Mid Cap and Small cap. As would be evident from the chart, small and mid-cap indices tend to significantly out-perform the larger market during a market up-move but also tend to lose most of such gains during a market down turn. As portfolio managers, it is our purpose to capture this potential upside and to subsequently preserve the gains. This, we believe, can only be done by exhibiting strict discipline not just at the time of buying a stock but more importantly at the time of taking a sell decision as well. More often than not, it is the inability to take a timely sell decision in a 'greed cycle' that impacts portfolio returns. We follow this process diligently with strict buy / sell guard rails for each of our portfolio companies and believe that the same will allow us to optimize portfolio returns.

The stock prices of most well managed companies in our universe (including those in our portfolio) have started to firm up and have started migrating to higher valuation bands. While this is a welcome scenario, this also makes a case for our team to work harder and dig deeper to uncover robust new investment ideas, at reasonable valuations.

Global Economy

We remain a keen observer of global events. While we note the significance & implication of global events like 'taper', 'bond defaults in China', 'annexation of Crimea by Russia', we do not pretend to be able to accurately assess the impact of the same on global economy or polity. Thus, we prefer to hold our counsel and stick to our knitting. However, we are hearing disturbing things about Japan (recently) and of course about China since long. Credit default, asset bubble burst, hard / soft / managed landing, etc. Any such event becoming a reality in either of the economies can have serious global implications.

In the longer run, we believe, investments will flow to economies which hold promise of better quality growth, relative to other investment destinations. In other words, each economy is like a company and investment managers keep on recalibrating their portfolio in line with relative opportunities (growth & valuation).

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Indian Economy

As of now, Indian democracy is in full bloom with rosy cheeks, warts and all.

In our last communication, we exulted about the *'new way to do polity'* being successfully showcased by AAP. While we are still hopeful that they will eventually mature and behave with grace, we had spoken a trifle too early. In a hurry to create a national footprint, AAP seems to be losing its focus and credibility. This is akin to a regional brand like 'Sosyo' (no offence intended) trying to challenge & upstage Pepsi Co and Coca Cola pan India, in say 6 months flat. In investing parlance, without corporate structure, management bandwidth or systems in place, it is bound to implode!! However, we still remain hopeful, on the longer term impact of AAP's early vision on the polity of the country.

At the larger business front, two things of note are playing out currently, namely; divestment of assets by corporate houses (to reduce their debt) and continued absorption of credit losses by PSU banks in the form of CDR and NPA. These banks in turn are clamouring for recapitalisation by the government. In a closed system, this is tantamount to the taxpayer (you and me) being made to pay for the bail out of industrial houses.

In late 90's, we had NPA in range of ~10% of bank books. Fifteen years later, we are back to square one as far as the PSU banks are concerned. Last time around as well, the defaulting promoters / corporates got away with their shirts intact (corporate assets, bank balance, jets & farm houses) and mildly bruised egos. This time around, we do hope that RBI and other regulators will embrace this opportunity to ensure that the PSU banks are not the only fraternity to absorb the losses but the promoters & corporates also feel the heat of their over ambitious investment decisions. Forced loss of ownership by promoters would be a move in right direction, though agencies & structures to manage such assets in transition are not yet in place in India. Otherwise, it will be business as usual and India will have the dubious distinction of featuring time and again on the cover of Economist (latest as on March 15th-21st 2014 issue), as the new face of crony capitalism!

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Looking Ahead: Crystal gazing is a hazardous business. Rather, we believe in history continuing to repeat itself, in cycles. In India, economic woes have often been followed by vigorous policy initiatives and reforms. Going by that, in the immediate future, we expect some long held up policy issues like implementation of GST to get resolved, accompanied by another flurry of reforms. Also, going forward, we expect the BFSI space to continue to see robust structural reforms led by RBI. Environment and resource efficiency continues to be an area of interest for us and we proactively try to factor it in our investment decision making process.

We are actively looking at companies in the capital goods, engineering, infrastructure and allied spaces. However, we are still largely averse to infrastructure companies with significant asset ownership profile. Similarly, we are still uncertain about debt laden real estate companies.

Given the slowdown in the economy, even good quality company have seen revenue or margin contraction. However, such companies have been steadfast in maintaining the robustness & integrity of their balance sheet. We look for such quality companies and believe, they would be best placed to capitalise on the turnaround in the economy, as and when that happens.

Please feel free to call or write to me for any further information.

Warm regards,

Sandeep Daga

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