8 Jan, 2015

Aurum Small Cap Opportunities & Aurum Growth Portfolio

8th Quarterly Update – QE December 2014

Dear Investor,

Wishing you a year full of good health and progress!

What started as a concept eight quarters ago, namely; '*private equity approach to investing in small and mid-caps*' is now in full bloom, with robust performance to boot. Thank you for your faith in us and we do hope that we have lived up to your expectations.

The last eight quarters have been witness to significant events impacting investor sentiments and equity markets, both globally and locally *(turmoil in middle east, Indian general elections, series of QEs and simultaneous tapering, commodity price crash, etc.),* triggering both panic and exuberance. During this entire period of volatility we remained steadfastly committed to our disciplined investment process. Resultantly, much to our surprise, the composite portfolio returns have beaten our own expectations and is perhaps best in class within the comparable universe. It would be our honest endeavour to continue to adhere to this process and invest in high conviction ideas. However, at the cost of repetition, we would like to temper the expectations of our investors with regard to future returns and remind them yet again that past performance should not be the basis of future expectations.

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Ways of the market...

The market has seen euphoria in the past one year, followed by nerve wrenching contractions. Of late, we have often been asked, '*Will the market continue to rally or will there be a correction?*' Our honest submission is that we do not know which way the markets will go in the short term. While we keep an eye on the macros, we do not predict the market and our investment strategy remains independent of any short term market movements. In the longer term, we remain extremely bullish and in fact look for any short term corrections as an opportunity to acquire quality stocks at reasonable valuations.

Global Economy

In our September '14 update, we mentioned that the commodity cycle is moving southward and countries like India would stand to benefit significantly from the same. We, however, did not anticipate the kind of correction that we have seen, particularly in crude oil. This commodity down trend has significant geo political ramifications.

At current price range of USD 50-60/bbl of crude, the budget of many countries like Russia, Iran, Saudi Arabia, Venezuela, etc. are totally out of kilter. At these levels of crude oil prices, ability to subsidise the population and invest in future infrastructure gets significantly compromised and can have long term socio-political impact for these countries. The US shale gas story also risks losing some of its sheen if the price of crude continues to spiral downwards or settle at the above mentioned price range. Moreover the huge impetus on renewable energy that was witnessed over last many years will also suffer if this trend continues.

From an Indian perspective, however, the decline in crude price and other commodities is a welcome respite from the inflationary pressures that we had witnessed in the past. On the flip side, Indian EPC companies like L&T, Voltas, Shapoorji may see a more tempered growth in their Middle East business. Also, the blue collar Indian population in Middle East may also be adversely impacted and so would be their remittances back home.

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Indian Economy

Overall, the above mentioned deflationary impact of commodities will benefit the domestic industry and provide the much needed elbow room to RBI to gradually cut rates with higher levels of conviction vis-à-vis inflation management. Combination of lower input cost and interest rate augurs well for the manufacturing / engineering and other interest rate sensitive sectors in India.

Post the judicial pronouncement on coal block allocation, government is moving towards a transparent and prioritised system of auction of coal assets. This is a welcome step for the long term but in the short term it is likely to put operational or proposed merchant power plants at immediate financial risk. Further, we also firmly believe that the time is conducive (given the deflationary commodity cycle) for the Govt. to encourage underground coal mining, which will minimise the environmental impact & human conflict that is now evident in most coal mining areas. Although, the upfront cost of underground mining is high, the long term affirmative impact on environment as well as reduced human conflict (especially reduced naxalism and the savings that would accrue on that account) would definitely make it a viable proposition. As per industry estimates, on an aggregate basis about, ~60% of coal produced globally is from underground mines.

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GST - a potential game changer

GST is expected to be a big game changer for the Indian economy wherein its implementation will reduce the cascading impact of multiple taxes and also enable a more efficient re-configuration of the logistics infrastructure of companies and the country, alike. Indications are that its implementation will be a gradual process extending over 3-5 years with cost savings gradually seeping through the economy. The outstanding contentious issues that remain are largely with regards to state taxation of petrol & diesel, tobacco & liquor products and local body taxes, which currently account for significant portion of state revenue. We hope that the final version of GST is not a fatally diluted bill.

The larger impact of GST will be indirect as the logistics infrastructure (soft & hard) is re-configured and becomes more efficient.

Overall, logistics costs in India are substantially higher at ~14% of GDP than those in developed economies (~9% of GDP). Moreover, in India only ~5-10% of the logistics market is organized with remaining being contributed by small fleet owners, warehouse operators, etc. Even the organized space is highly fragmented, dictated by differential & multiple local tax structure & collection mechanism, contributing to inefficiencies in operations.

As a result, freight that moves across the country is taxed multiple times with long delays at inter-state and inter- city checkpoints. This, combined with other delays, keep trucks moving only 50-60% of the total transit time. Furthermore, ~65% of India's freight moves by road, which points to criticality of GST for India. Thus, we believe, uniform GST implementation will prima facie, significantly improve the usage & efficiency of the current logistic infrastructure asset base, including that of medium and heavy commercial vehicle fleet. It will change the way business/logistics decisions are taken – and possibly reduce tendency to engage with the unorganized players for tax considerations. Depending on the final rate of GST, the immediate pricing of goods and services may see significant downward bias, case in point being the auto industry and the entertainment industry with high applicable entertainment/service tax. The deeper and more significant indirect cost benefit will follow more gradually.

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We have seen cases where stock prices have sprinted away beyond our price guard rails even as we patiently went about our investment process. With some, our patience paid off as we got an opportunity to buy them on corrections, while with some others we are still waiting patiently. We have also missed some investment opportunities where our understanding of the underlying businesses was sub optimal. That being said, we continue to diligently pursue new investment ideas, tempered by our elemental conservatism and with measured success.

We would be happy to hear from you of any new industry trend or development that you would like to share with us.

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

Warm regards,

Sandeep Daga

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