16th July, 2018

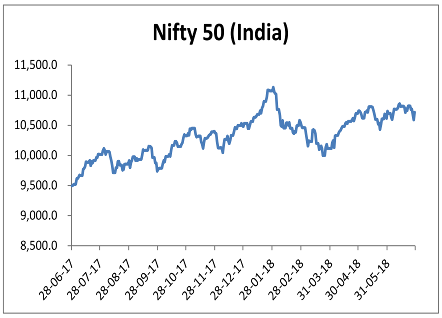
Aurum Small Cap Opportunities & Aurum Growth

22nd Quarterly Portfolio Update – QE June 2018

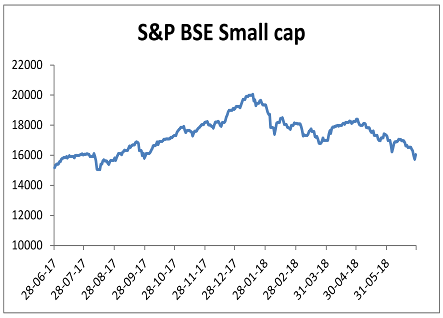
Dear Investor,

As you are aware, the last quarter has been brutal for small and mid caps, especially the small caps! During this period stocks from this universe witnessed steep draw down from their 52 week highs, compounded by instances of poor corporate governance. Thankfully, none of our portfolio companies threw up corporate governance surprises. The ~20% correction seen in the S&P BSE Small Cap Index (Chart 1) is deceptive and hides the real carnage.

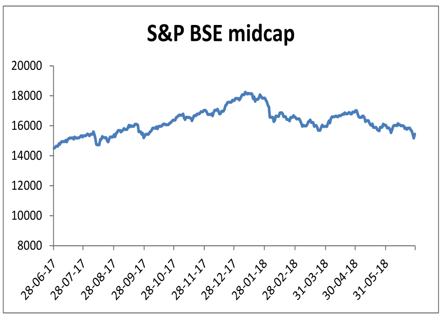
Chart 1: Indian Indices' data



Drawdown from peak -3.7%



Drawdown from peak -20.0%



Drawdown from peak -15.3%

Source: Yahoo Finance

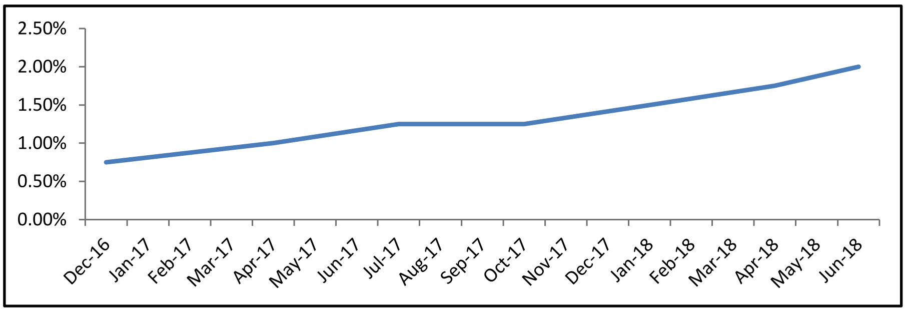
In this market wide carnage, our portfolio stocks were not spared either and faced drawdowns in varying degrees. While our mature portfolios have seen contraction of up to 30% from their peak, (resulting in loss of profits), the relatively newer portfolios (<1 year) have either seen drawdown of principal (2-10%) or continue to be in slightly positive territory. Honestly we did not expect such a fall of prices in our portfolio companies as we believed (and continue to believe) that our portfolio of companies, with robust fundamentals, low debt and a good growth outlook are better placed to weather such a storm. However the larger market proved us wrong. Along the way, we also learnt some valuable lessons which we hope shall aid us in future – especially when it comes to taking 'sell' decisions. We had touched upon this subject even in our last update and since then we have been working hard to create a more flexible 'sell guardrail' framework.

In our assessment the reasons for such a steep stock price correction was the '*perfect storm*', a confluence of global and local events, namely;

- **Global reallocation of assets:** QE tapering and rising interest rates in US
- **Fear of a trade war between US & Rest of the World (mainly China)**
- **SEBI's new classification norms for large, mid and small caps leading to realignment of portfolios in various mutual fund schemes**
- **Concerns over corporate governance (triggered by spate of auditor resignations without satisfactory explanation)**

Global reallocation of assets: The QE Tapering was initiated in October 2017 and is likely to continue till 2020, wherein the balance sheet of Fed is expected to shrink from ~USD 5.4 t to about USD 3 t. During this period of 15 months (since announcement), 10 year US T Bill yield have gone up from 1% to ~2%.

Chart 2: US Fed rate (%)



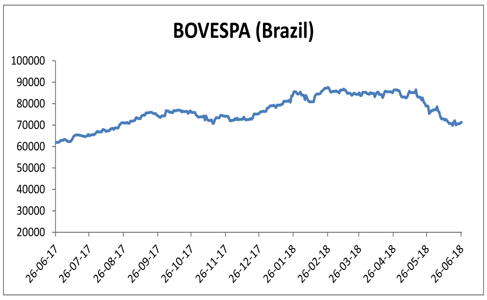
Source: Trading economics

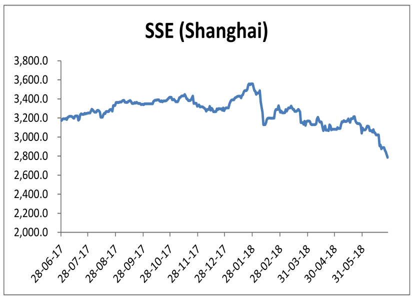
The FED taper has put brakes on the cheap money era, leading to reallocation & migration of capital to USD assets and out of emerging markets. A typical 'flight to safety' response.

While EM Indices saw a 15-20% correction, the Nifty has seen a relatively net minor correction of 4% during the same phase, indicating inherent and relative strength of the Indian economy, further supported by strong domestic capital inflows.

During this phase, large cap, global indices (Bovespa/Brazi, SSE/Shanghai, BIST/Turkey) have corrected in range of ~20% from the crest (Chart 3). However, the Nifty (Chart 1), has seen a relatively net minor correction of 4% during the same phase. This may be indicative of the inherent & relative strength of the Indian economy, further supported by strong domestic capital inflows. To be fair, as we speak, Bank of Japan, European Central Bank and People's Bank of China are continuing with easy money policy.

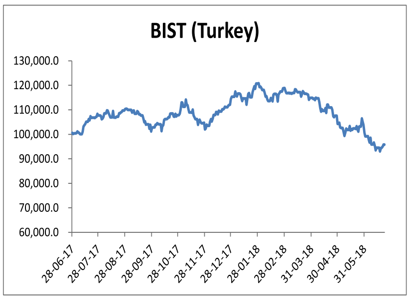
Chart 3: Emerging market Indices





Drawdown from peak -18.5%

Drawdown from peak -21.7%



Drawdown from peak -20.7%

Source: Yahoo Finance

Fear of a trade war between US & Rest of the World (mainly China): Initially, most analysts felt that Trump's threat of imposing higher tariffs on Chinese goods may be just tokenism to address his electoral constituency. The reality, however, has been quite a surprise. Trump has been unpredictable and swift in imposing punitive tariffs on wide ranging imports from China as well as other countries. (China exports ~ USD 500 b to US and import ~USD 150 b of goods. Currently, punitive tariff has been imposed on USD 50 b of Chinese imports.) Trump has threatened to escalate it further and rapidly. Further, he has also restricted investments by Chinese companies in high tech businesses in the US and virtually brought ZTE to its knees by refusing to sell high end telecom network chips from Qualcomm. China (and others) have responded by imposing tariffs on US goods and suddenly there is a fear of full blown trade war. While the impact on India seems marginal until now, it is the worsening sentiments of global equity investors that is a worry as

SEBI mandated reclassification (large, mid, small, multicap, thematic) of MF schemes has largely been concluded in Apr-June 2018 quarter and this has led to a significant recalibration of mutual funds portfolios.

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this further accentuates 'flight to safety'.

SEBI's new classification norms for large, mid and small caps leading to realignment of portfolios in various mutual fund schemes: In Dec 2017, SEBI announced that mutual funds would be allowed to have only one scheme per category (large, mid, small, mutlicap or thematic) and also the way large, mid and small cap stocks would be defined. Adhering to the new norms required many mutual funds to recalibrate their scheme portfolios and sell small and mid caps, which were being held in larger cap schemes. This exercise has largely been concluded in Apr-June 2018 quarter. Coinciding with dampening sentiments due to other global/local factors, this rebalancing exercise further added to the woes of small/mid caps. With very high volatility in the universe, the stock exchanges also introduced stringent surveillance measures applicable to many small and mid cap stocks from time to time, requiring higher margins for trading in such stocks (along with other caveats). Locally, this has further impacted general investor sentiment.

Concerns over corporate governance (triggered by spate of auditor resignations without satisfactory explanation): Recently we saw a spate of statutory auditors resigning from listed companies just before finalization of accounts and refusing to sign off on final numbers. In some cases, the auditors clearly ascribed non-availability of material information as the reason for resignation. This has definitely unnerved the investor fraternity and as a result there is increased caution when it comes to looking at small and mid caps.

Resignation and change of auditors can take place for a variety of reasons but this is perhaps for the first time in Indian corporate history that auditors are resigning not as last resort but as first resort! The genesis of audit firms suddenly becoming proactive can be found in;

(a) **Change in Companies Act, 2013** which penalizes the audit firm in case of frauds (dereliction of duty by individual partners)

(b) SEBI's order barring a big 4 from auditing listed companies for two years

(b) **Proposed National Financial Reporting Authority (NFRA)** to oversee auditing profession

We strongly believe that while this has spooked the markets in the short term, a more responsible auditor bodes well for the long term, catalysing better governance and reporting.

Governance in our portfolio companies

We have always had a strong emphasis on governance as a part of our screening process while making investment decisions. In fact, we have an ESG (environment, social and governance) filter for all our investee companies. Fortunately and in line with our ESG filters, we have not witnessed any glaring mis-governance issues with any of our portfolio companies.

We did have a statutory auditor resignation in one of our portfolio companies. However, that took place after completion of final audit and signing of the accounts. The reason given by the auditor was 'internal restructuring within the audit firm'. We did an extensive check and found out that the local partner of the audit firm had parted ways and that led to the resignation. Similar resignations were offered by the audit firm in two other companies from the same city citing same reasons. Another reputed audit firm was onboarded by our portfolio company immediately thereafter.

In one of our old portfolio companies, a lapse of governance came to light when a potential contingent liability was not reported. Only when an order was passed for the same, against the company, it came to light. While the company has appealed against the order and hopes for a favourable resolution, we do believe that this reporting lapse should not have taken place in the first place.

While Individual stocks have been impacted due to market – wide price correction, qualitatively, our portfolio companies are -

- Mildly leveraged
- Largely free cash flow positive
- Likely to post topline growth in range of 20% CAGR (3 years)

In Conclusion

As we endure this volatile phase of the market we remain committed to the two pillars of our investment philosophy, namely; 1) capital preservation and 2) power of compounding. We believe that they will enable us to generate superior risk adjusted long-term returns.

While individual stocks have been impacted due to market-wide price correction, the underlying growth story of our portfolio companies remain intact. Qualitatively, our portfolio companies are mildly leveraged and largely free cash flow positive. They are likely to post topline growth in range of 20% CAGR over the next 3 years, with margin profile improving ahead of topline growth.

In the current corrective phase of the markets, we continue to gradually and cautiously buy stocks where the underlying performance continues to be healthy and priced within our conservative buy guard rails. While the main body of correction may be over, we believe, volatility is likely to continue for some more time and in various degrees, specific to stocks. In good quality investee companies, where stock price stagnate or correct, we believe the cookie is crumbling in favour of patient investors such as us.

Portfolio Performance

Since the beginning of our portfolio in Dec 2012, every year we have had a few multi bagger in our portfolios. CY17 was the first year when none of our ideas, approved in the said period, gave multi bagger returns. That is not to say that they did not perform in line with our expectations. Most gave robust double digit returns. In CY18, these investments and stocks of earlier vintage saw significant contraction in the ongoing correction, as evident in the chart below. We believe, as these companies continue to boringly churn out growth numbers, valuations will again catch up and will lead to healthy portfolio returns going forward.

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