

Dear Investors and Partners,

Wish you happy and prosperous new year and hope this one is more fulfilling and enriching than ever before.

A quick personal update - I cleared the SEBI mandated AIF Managers exam in first attempt, aced it, if I may add. I haven't appeared for an exam in last two decades, so this was a bit different. I am happy, of course, as it allows us to continue to earn our bread. But in all honesty, I am also quite sad that there is so much of BS still left in my bloodstream even after twenty years of formal education (efficient market hypothesis, capital asset pricing model, efficient frontier and what not). There are a lot of theoretical concepts, devoid of reality, that are forced down the throats of most finance professionals in the making, as if the earth will stop revolving if you don't learn those. I have been in the investment management industry for close to two decades and I have managed to survive and do reasonably well without using most of these concepts.

I have little respect for any text that starts with defining risk as variability of price. It might work for mathematical models in some fields but for what we do and practice, it is what Buffett calls 'mumbo-jumbo'; his late business partner and friend Charlie Munger was less forgiving in describing modern portfolio theory as 'disgusting'. To teach such concepts is one thing but to make it a bar to clear if you want to earn your living is whole another level of *torture*. I remain old-fashioned in reading risk as the possibility of a permanent injury or loss. Volatility is not a bad thing. Au contraire, volatility is a friend for the long-term oriented investor. It implies that the market is considerate enough to offer you two widely different quotes for the same underlying asset to be bought or sold. To exercise or ignore that option is the prerogative of the investor. So, how can short term variability of prices be defined as risk? For the mathematically oriented, the following equation will put the debate to rest:

$$NW \text{ (Buffett)} > 10 \times \{NW \text{ (Sharpe)} + NW \text{ (Treynor)} + NW \text{ (Jensen)} + NW \text{ (Lintner)} \dots + NW \text{ (a few more statisticians)}\}$$

NW: Net worth

For some reason, our profession earns a disproportionate distrust from regulatory bodies. It almost competes with the world's oldest profession in reputation. While we work for money, that is where the similarity ends; frankly, who doesn't.

Having said that, I am completely in agreement with periodic checks for professionals in order to continue practicing (clear exam every three years or you are out on the road). It matters more than practical experience that one may have gained over the years. It keeps us on our toes. It is such a good practice that it should be made mandatory for all professionals - bankers, consultants, other financial intermediaries, legal advisors, etc. It might not be bad idea to make such practices mandatory for even regulatory bodies as it will keep the entire system functioning at high efficiency.

#sarcasm

<end of the rant>

Portfolio update

The last quarter of the year saw an overdue consolidation and a correction across the board. The froth that had built in some segments has come off. In a way, it is healthy. The portfolio largely remained steady during this phase. Our first fund was down 1% while second fund was up 1% during the last quarter when Nifty 50 and Nifty 500 were down by about 8%. While short term moves will be transitory, some of the names that we discussed in our last couple of letters have done well and that has helped the portfolio.

Our agrochemical and agri-dependent investments have worked out reasonably well so far. The investments are up in the range of 25% to 130%. More importantly, the risk assumed in these investments was quite low. We think that the cycle has barely started reversing back up and there is still scope in some of these investments to offer reasonable upside over the next couple of years. Our investment in the payment processing company is more than 2x, in good measure helped by a good entry point. The biosimilar story is panning out well - the business has seen positive outcomes on several fronts and the stock price has moved in line. On the negative side (from returns point of view), our investments in the lending financials continue to test our patience. While the entry valuation for some of the new names has been extremely favourable from risk-reward standpoint, this bucket has been a detractor from the overall returns.

The Indian equity market has been seeing a correction driven by FII outflow (FII outflow of INR ~246,000 cr. in the last four months is already nearly two-thirds of the total outflow that we saw in 2021-22). At the same time, the US market sentiment by The American Association of Individual Investors is pointing to very bullish sentiments. Such divergences in sentiments across geographies usually don't occur but in this case are largely resulting from the flow of capital from India and a few other emerging markets to the US. The US capital market has been seeing positive capital flows since October in anticipation of business-friendly environment and changes in the US trade policy under the current Trump administration. We haven't made any meaningful change to the portfolio because of that and we continue to believe that the businesses we have invested in will eventually move towards their intrinsic value zone. Normalcy in the market might have to wait for the capital flows to settle down but from the sentiment point of view, at least, the investor panic has started setting in, in several pockets now.

Before jumping into the stock discussion, I want to highlight that, while I have mentioned learnings from Warren Buffett several times in the past, our investing style has been equally influenced by the learnings of Howard Marks ji. He has been quite liberal in sharing his learnings. I have his books in the office, at my home and in my Kindle. While Buffett's learnings provide the quality foundation for the investments, Marks' teachings have been instrumental in building the overlay structures. The attempt is always to create skewed Gaussian castles with high cases of meaningful positive outcomes. Our more recent investments, especially our work on the agrochemicals theme was partly influenced by his writings and I thank him for that.

What is keeping us busy are companies in the consumption sector like apparel and quick service restaurants. Low discretionary spend over the last two years is presenting good risk-reward opportunities

in the sector. Microfinance sector has become interesting due to the significant challenges in the sector. However, this sector has been a cyclical one where some of the deep shocks in the industry have led to complete balance sheet annihilation in the past. We have started building positions in the sector but I don't see ourselves getting too aggressive in that space.

The company that we are discussing below is, perhaps, the riskiest one in our portfolio. The company is in housing finance sector and this is a company that I wouldn't have touched just a few years ago for a variety of reasons, governance being one of them.

However, there have been several changes in the company in the last five years. Leaving the governance aside, let me quickly share the lay of the land. Retail housing loan market is very attractive business for the following reasons:

- **Granular book:** Small home loan ticket size keeps the overall exposure very granular which restricts the risk of a sudden default in the book.
- **Appreciating asset:** While consumption loans are taken towards depreciating or depleting assets, the asset in the case of a housing loan appreciates over time.
- **Safer collateral:** Default on the primary residence is amongst the last ones that any household does and is generally not wilful. This makes housing loan far safer than business loans or consumption loans / microfinance loans. Moreover, once part of the loan has been repaid for the initial 2-3 years, the loan to value goes down significantly. The incentive to default wilfully goes down considerably for the borrower.
- **Long tenor product:** Since the loans are generally repaid over a period of 7-8 years, the cost of originating the loan gets distributed over a long period and hence the operating expense as a proportion to assets is low especially for a large player.

It is difficult to build a retail housing loan franchise. Building local presence in tier 2 to tier 5 cities takes time and effort and whoever can build it without compromising the underwriting standards, stands to enjoy a reasonable spread. Building the collection infrastructure, both physical and digital, with appropriate geographical coverage, often differentiates one company from another in the sector.

There are several secular growth factors for the industry providing tailwinds to any player executing well in the industry:

- Estimated shortfall of ~100 million houses in India
- Low penetration of housing finance (low Mortgage-to-GDP ratio) compared to peers
- Government's impetus to the low-cost housing market
- Increasing market share of housing finance companies (HFCs) compared to public and private banks

Developer or builder loans, on the other hand are not as good a product. It is large ticket size loan and hence it is easy to grow fast with a small team in a considerably lesser period. However, it comes with its own set of challenges. In good times, this business appears to do well, until it doesn't. The counterparty is generally an over-smart lot and wilful defaults are aplenty in the industry.

A quick comparison of the two businesses is shared in the table below:

Parameter	Retail housing loan	Developer loan
Granular loan book	Yes	No
Wilful defaults	Low	High
Possibility of collusion with counterparty	Lower	High
Cyclicalilty of earnings	Low	High
Sustainability of earnings	High	Low
Moats around the business	High	Low

Till 2018, both retail housing and developer loan markets were doing fine. It was easy to raise capital and distribute loans. Almost all listed companies in the sector were showing glowing results. IL&FS crisis led to sudden change of scenario for these companies. Post IL&FS crisis, the companies with poor underwriting on the developer book suffered a huge setback. In a nutshell, defaults in the developer book came to the fore. Capital availability to these housing finance companies almost dried up. Non-completion of under execution building projects increased the defaults further. Borderline questionable asset quality also slipped into defaults as a result and the downward spiral continued. This company too suffered during this phase.

What changed?

The company undertook several steps during this phase, some voluntary, some forced by circumstances:

- Leverage in the balance sheet has been brought down from 8x in FY18 to less than 2.5x now.
- Developer loan book portion, that had collection issues, has largely been provided for. This is significant as the probability of incremental credit loss on this legacy book is low.
- Recovery effort from old portfolio has been yielding results. A lot of old chunky loan cases are getting resolved leading to cash collection from these accounts. So far this year, recoveries are more than 10% of the total loan book. These efforts might lead to recoveries exceeding the credit cost in the near term.
- Retail loan book (securitized and otherwise) has been good during this time. We have had positive feedbacks from multiple touchpoints about its quality. This becomes the cornerstone of the thesis that if and when the problem elements are taken out, the underlying retail loan business is a good business to build scale upon.

Where are we now?

Over the last 5 years of effort, there has been a lot of cleaning done and the legacy loan book issues are largely resolved. In terms of valuation, it still trades at ~0.6x book value. The valuation provides further cushion for absorbing additional credit cost, if any.

Potential upside:

That is not all that has changed. The company has started co-lending to retail borrowers. Under this model, loans will be disbursed in 80:20 loan ratio by the company with the company retaining 20% of the loan in its books while the 80% of the loan stays on the books of the co-lending partner bank. The earnings model for the company is as follows:

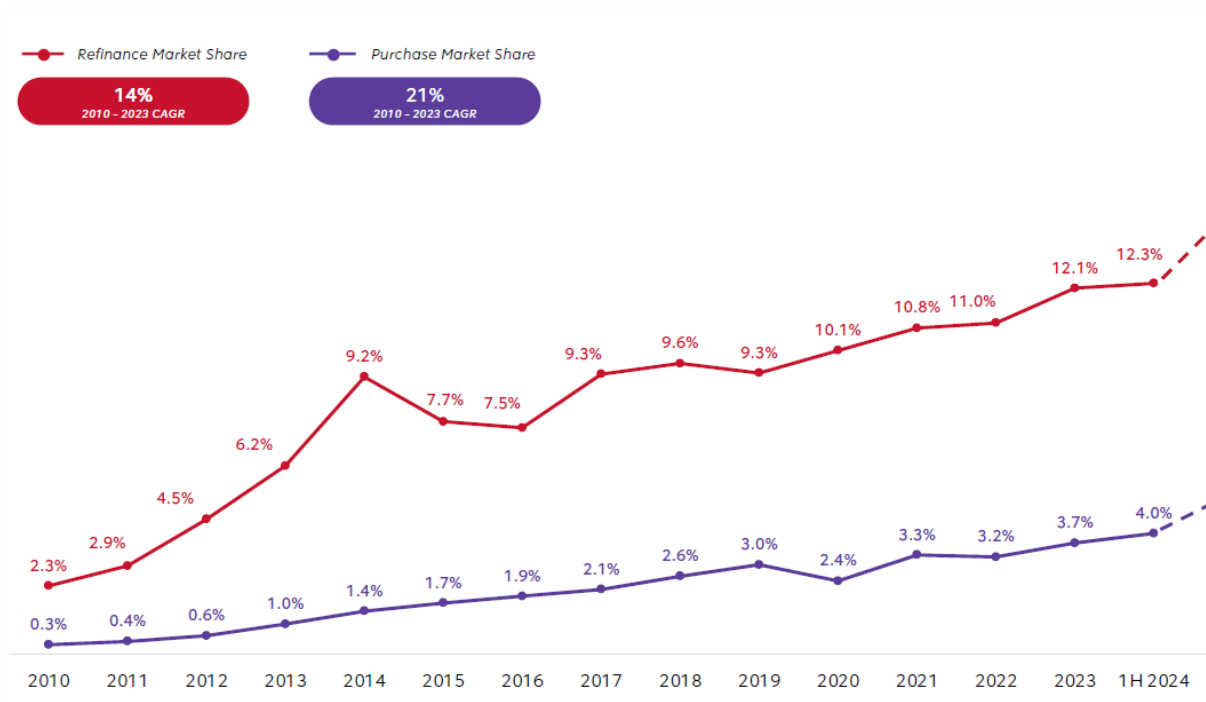
- It earns a fee which is a percentage of the total loan originated. This revenue stream does not pose a risk to the company's balance sheet.
- In addition, the company makes a spread on the loan that stays on its balance sheet. This is like the regular net interest margin that any bank of NBFC makes on the loan.

With limited balance sheet risk, the upside on the model is sales or loan origination driven. The skill needed matches with the DNA of the organization. The one thing that they are good at is aggressively building a sales engine. If you take away (or lower significantly) the balance sheet risk, this new foray can become a meaningful driver of return on equity going forward.

The company entered into agreement with the big daddy of the Indian mortgage industry (HDFC Bank). In addition, it has signed up agreements with a mix of private and public sector banks and has already started disbursing loans under this arrangement. These are early signs that things are moving in the right direction.

Two scenarios emerge from the changes so implemented:

1. The new co-lending model clicks: The mix of having multiple co-lending partners in place, demand tailwinds in the industry and an aggressive sales-driven organization, can lead to this business becoming a loan origination machine. The business model as described above can lead to high returns on capital with low balance sheet risk. The chart below shows the market share of a company that focused on loan origination and refinance market in the US mortgage market. If anything similar were to happen, the upside can be quite meaningful.
2. The new co-lending model doesn't work: We are left with the existing business where balance sheet issues have largely been fixed and the business is currently valued at a significant discount to its book value. Probability of losing much is limited in this case.



The presence of this name in our portfolio must have raised a lot of eyebrows. The journey from raised eyebrows (poor governance, poor legacy book, untouchable at any price) to raised eyebrows (High RoE, platform business, high valuation multiple) won't be an easy one or even smooth or linearly predictable. We think that the risk is not as high as it is perceived to be and potential reward outweighs the risk undertaken. The first step for the company to get the right valuation is to get its respect back in the form of additional equity and debt capital. It seems to be moving in the right direction.

The question is: Can leopards change their spots? More often than not, they don't and that is the risk we are carrying in the portfolio in this stock.

Since we are discussing risk, there is one book that I want to recommend on the topic - "*Against the Gods: The remarkable story of Risk*" by Peter Bernstein. There are a several other good books on developing probabilistic approach like 'Thinking in Bets' by Annie Duke and 'Fooled by Randomness' by Nassim Taleb but this book is more foundational and not necessarily about probabilistic approach. If one can get past the initial errors of provenance and there are several of them, then it is a good book, if you want to immerse yourself into the how and when and why we, as human beings, attempted to assess risks in our life.

As a follower of Howard Marks, I consider it quite important to develop a probabilistic approach in a somewhat detached manner, to the extent practicable. What adds to the charm of the book is that the author himself was an investment manager and did quite well during 1960s and a lot of what he writes is very practical. His words:

"After 28 years at this post, and 22 years before this in money management, I can sum up whatever wisdom I have accumulated this way: The trick is not to be the hottest stock-picker, the winning forecaster, or the developer of the neatest model; such victories are transient. The trick is to survive. Performing that trick requires a strong stomach for being wrong, because we are all going to be wrong more often than we expect. The future is not ours to know. But it helps to know that being wrong is inevitable and normal, not some terrible tragedy, not some awful failing in reasoning, not even bad luck in most instances. Being wrong comes with the franchise of an activity whose outcome depends on an unknown future. Look around at the long-term survivors at this business and think of the much larger number of colorful characters who were once in the headlines, but who have since disappeared from the scene."

The book manages to trace the *journey of unwoven threads*¹ of philosophy, historical accounts and probability so effortlessly that you cannot not want to know more about the origins of risk.

We thank you again for your trust. Please feel free to reach out to us, should you have any suggestions, questions, or feedback.

Best regards,



Parag Jhawar

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¹ Shameless self-promotion of my daughter's book: [Jhawar, M. \(2022\), Journey of Unwoven Threads](#)