Investment Managers Report

October 2020

Passage to India

resilience

or re·sil·ien·cy

[ri-zil-yuhns, -zil-ee-uhns or ri-zil-yuhn-see, -zil-ee-uhn-see]

noun

the power or ability to return to the original form, position, etc., after being bent, compressed, or stretched; elasticity.

ability to recover readily from illness, depression, adversity, or the like; buoyancy.

Portfolio

Our portfolio has fared reasonably well. Each of our companies has been profitable for the last two quarters ending June 30th. Although a bad quarter, or a couple, would be completely within reason given the extraordinary events, it is nonetheless a welcome position to be in.

One reason our portfolio has fared well is little to no debt. Smaller companies have a limited ability to tap Indian's somewhat undeveloped corporate debt market, making debt levels an important consideration. With factories shut and revenues near zero, the first line of defense in the face of demand destruction is a strong balance sheet. Our experienced management's long tenure also gives us a measure of confidence. Labor resizing and cost controls also served to mitigate this short-term blow.

It is important to appreciate our management teams, leaders, during such times. They have built their companies from nothing. They have seen hard times before, survived, and they will see tough times again. Specifically; aggressive cost control, cost cutting, cash management and delaying capital investments across the board, kept our companies in a solid cash position and without the need to go to the market for a cash infusion. Having experienced and seasoned management is like insurance on your car. It doesn't matter who your insurance company is while you pay your premiums and drive uneventfully. But then one fine day and some bad luck, your insurance company is all that matters.

Our companies fall into three general categories. It should be noted that none of our companies, to my knowledge, faces permanent and irreputable damage to their business model. To date none of our companies reported a net loss for the quarter. That's something.

1. Category one: Sales have continued on their growth path because a changing world benefited the company in unanticipated ways, leading to an increase, or at least a flat revenue stream in spite of the lock down. Some companies were in businesses deemed essential such as our drug manufacturer and our food packaging business. Some businesses; software and digital

transformation, found a strong tailwind as business came to them. The virus response has quickly accelerated the changes we thought the company would benefit from in the long run. Aarti Drugs Ltd and Saksoft Ltd are two notable beneficiaries.

2. Category two: The companies were adversely affected by the March lock down, its business has suffered during the second quarter and the revenues lost during the period are permanent. Freshtrop Fruits Ltd, our fresh fruit exporter had some very real challenges but were able to salvage 60-70% of their revenues during the peak harvest season. But those lost revenues will be lost, not simply postponed or delayed.
3. Category three: These companies are similar to group two in terms of the effect the lockdown had on the revenues with one difference; sales have simply been postponed and will show a recovery in the next quarter's higher growth, or when the economy recovers, making up for delayed or deferred orders or services. Mold-Tek Packaging Ltd and Control Print Ltd are in this category.

In summary: our portfolio is solid, battered no doubt, but solid and it will recover.

Macro Trend

A notable macro trend is the re-evaluation of one geographic source of raw materials or parts for a global business. Sourcing from China in everything from chemicals, drugs, to article leather, is under serious review. India will most assuredly benefit from this review and is already experiencing an increased business in chemicals. Not only from sourcing concerns but also as a result of China's enforcement of environment laws which is increasing China's production expenses. As a result, India's global market for chemical exports is in the first phase of a major change. I expect the inevitable shift to more diversification of both products and supply lines from China to India will provide opportunities in our fund for the next decade.

The June 30th earnings for our portfolio companies have been filed.

Aarti Drugs Ltd

Revenues increased 34% during the quarter on the rise of medical products sold primarily in India and throughout the Middle East, Eastern Europe and Africa. EBITDA increased 146% YOY, and PAT increased 280%. It should be no surprise the stock price has reacted favorably, up over 5X for 2020. The melt up of Aarti Drug's valuation has been fast and furious, starting 2020 at 560 Rs and currently trading at 2900 Rs. However, this melt up has been after a long period, six long years, of very little *stock* performance in the face of increased revenue and profitability. That said, we have been rewarded for our patience with an over 30% annualized return over that period of time, with most of the return in the last 6 months.

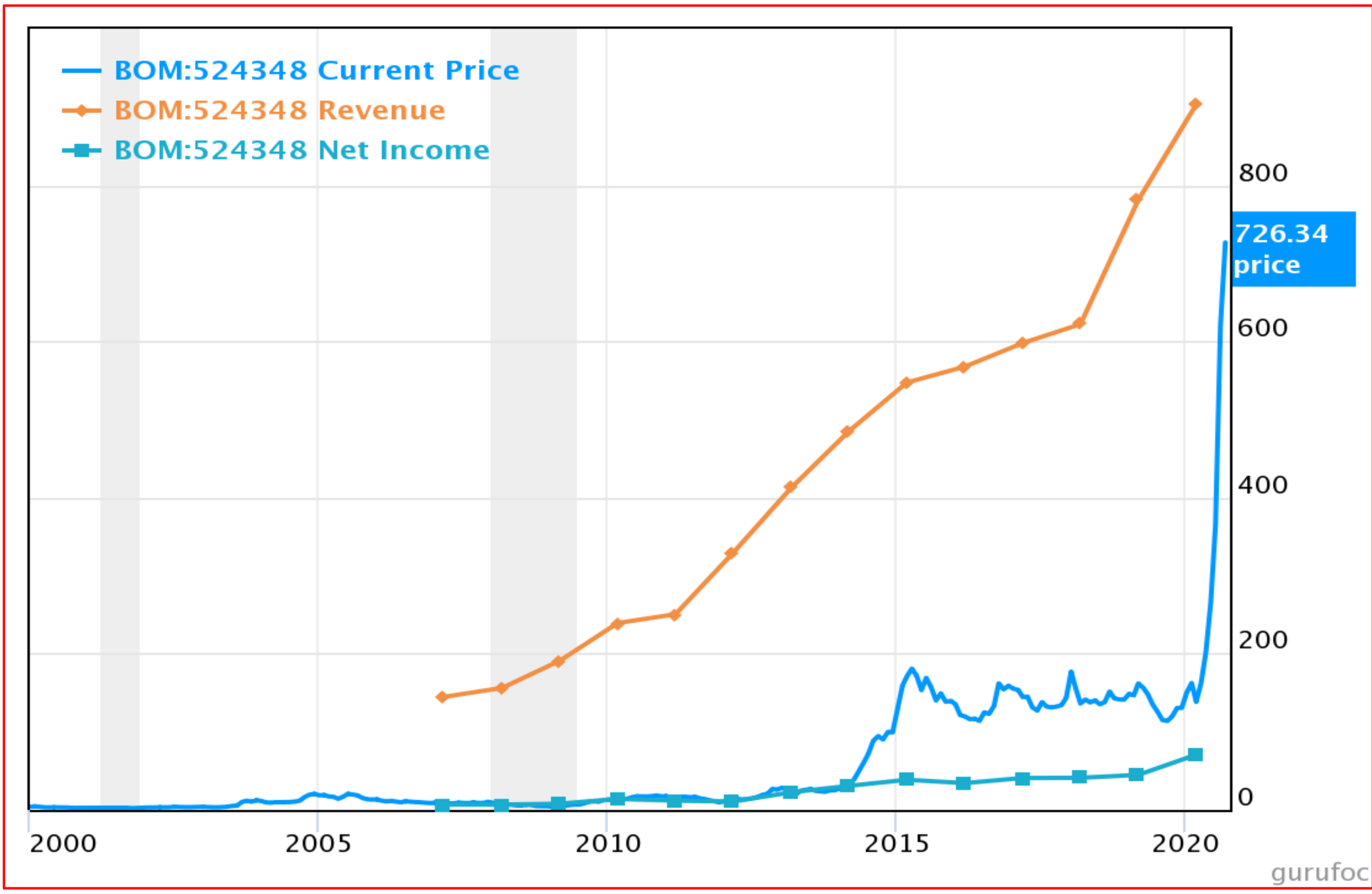
This leads me to a very important concept. Believing is one thing, the actual execution of that long-term strategy is entirely different. Viewing the chart below, you can see the *stock price* of Aarti Drugs had been essentially flat for a long 6 years. Six years is a long time to wait for a market to recognize a company. However, if you look at the increase in revenues and increase in profitability, even if the market did not recognize this improvement, the *company* was doing quite well.

But, still we had to wait a long 6 years to realize the value of Aarti Drugs. This would not have been possible with short-term oriented investors. Again, this is easy to say, but for you the investor, to hold a non performing company for 6 years is really what this is all about. Thank you for your patience.

This is the full circle between the investor, the portfolio manager, and the company management. Buying a solid, well run, low debt company that will continue to be operating well over the long term (this depends solely on management positioning the company for long term growth), hiring a portfolio manager who has the temperament to hold a good company, without stock appreciation, for the long term, and having investors such as yourselves, who share the long term outlook with both the management of our companies as well as the fund's portfolio manager, a full and balanced circle.

In this instance our strategy has paid off. We don't have to get it right all the time, but generally, over the long term, we get it right enough.

Aarti Drugs 2000 – 2020 guru focus



Full disclosure: we have done well with Aarti Drugs, but we could have done better. At the beginning of 2020 Aarti Drugs was around 570 Rs, a PE of 15, and roughly 6% of the portfolio. Today it is 2857 Rs and 6% of the portfolio. As the valuation moved through a PE of 22, and then 25, and then higher, (in the last 10 years Aarti's max PE was 28), I trimmed the holding and took profits as the price action continued to increase. The error in my analysis was threefold. (1) I did not anticipate a strong increase in the prices realized by Aarti Drug's overall drug portfolio; (2) nor the volume increase, plus (3) I did not anticipate such a strong growth in international sales with much higher prices resulting in a stellar margin expansion leading to a near tripling of profitability. Directly before the earnings call the PE rose about 30; after the earnings release, on this quarters run rate, the earnings multiple is down to 20. Today, with a very strong run up recently in share price, a cost basis of 389 Rs, and a 6.2-years hold, we still have a reasonably valued company. Aarti Drugs enjoys the number 1 or number 2 market share, either globally or domestically, in every product they sell. And, given the impact of increasing international sales because of the recent change of perception of world risk as it relates to China, the increasing use of Aarti Drugs's drugs by the domestic population metric, and given our cost basis and future growth, we will hold Aarti Drugs for another 6 years or till the company changes. As for my timing in the trimming of the company in the face of its rising share price, so much for a crystal ball.

What next? Capacity continues to increase, there is still a large amount of headroom to sell new capacity, especially internationally. Aarti's international expansion that began two years ago still has long legs left and presently Aarti Drugs has no sales in the US, the largest drug market in the world. Aarti Drugs is enroute to FDA approval for a few of its products. Furthermore, the Indian domestic market, which is why we purchased the company in the first place, continues to buy more drugs as average incomes increase, people move from rural peace to urban chaos, requiring more treatments for more aliments.
Aarti Drugs has moved from a smaller 150 M USD company, right in our sweet spot, to knocking on a billion dollars in market cap.

The funds average and median market cap will increase.

This brings up another point. If we hold good companies over the long term, 10 years, hopefully longer, the Indian economy will grow, our company's revenues and market cap will increase at a greater rate, if I get it right, resulting in our average holding increasing in market capitalization. Yes, the market cap range of small caps in India will also increase, but if we are outperforming the market then our market cap will increase at a faster rate. While our focus and our roots are in smaller companies, you will see the average and medium market cap of the fund increase over time.

Control Print Ltd

This 45M USD, 29-year-old company has been in our portfolio for nearly 5-years. Our company is engaged in the printing/labeling business in India. Control Print is an indirect player on rising consumer spending combined with increasing regulations resulting in greater use of date time stamping.

Control Print produces seven types of printers that time stamp an array of products in many industries. Control Print is present in building and construction, tires, steel, pipes, FMGC, cement, health care, electronics, packaging, and plastic bottles to name a few. Essentially, Control Prints time stamps most of the items that a growing economy will buy. We purchased the company to indirectly ride on the increasing consumer packaged goods purchases, growing infrastructure build, and favorable government regulations requiring date time stamps where little to no regulation has previously existed. The time stamp printing industry is an oligopoly with four players. Control Print is the only domestic manufacturer with 20% of the market. The market growth for the foreseeable future will support all the players with good margins. Control Print's Gross, Operating, and Net Margin are 67%, 24%, and 15% respectively. Very good margins for a manufacturing company.

Control Print has an installed base of 12,000 printers which increases by over 900 net printers annually. This quarter's printer orders were deferred, driving the high margin (80%) consumable segment of their business to a higher percentage of revenue increasing their margins to a net margin of 15.8% versus 12% last quarter. The combination of reduced printer orders, but increased consumables (ink), resulted in flat earnings.

For the quarter ending June 30th, revenue was down 24%, and earnings at 2.0 Rs was flat QoQ, but down from 5.8 Rs YoY. Two takeaways. The company reported that the orders were simply deferred with no cancellations. The quarter's revenue and profitability were generated in 45 days of work in the quarter, rather than the normal 90 days. The company has been paying an 8 Rs dividend, yielding 3.8%, and the company has over 2.0 M USD in net cash. Not bad for a pandemic in India.

Freshtrop Fruits Ltd

Freshtrop Fruits reported profit, all be it a reduction of roughly 50% from a normalized quarter. For our fresh fruit exporter, the two quarters most profitable are Q4 and Q1 (ending March 31st and June 30th respectively), fell perfectly in the middle of this pandemic.

One major adjustment to the lockdown was a switch to packing in the fields rather than loading and driving to the cold warehouse nearby. This process became necessary as a response to the pandemic restrictions, but resulted in more spoilage of the product when it reached its European buyers. This contributed to the fall in revenues because the Waitrose, Tesco, and Walmart's of the world will not pay for spoilage.
The company continues to pay workers in spite of reduced work rather than risk losing skilled labor. Additionally, Freshtrop Fruits has implemented enhanced safety measures commensurate with best in class safety procedures.

Yet, on a negative note, as a result of the pandemic Freshtrop Fruits is abandoning, in the short term, its *Second Nature* fruit juice business. Although the food processing business does continue in a higher capacity utilization with sales to domestic (35%) white label buyers, and to China and Japan, at good margins, the business itself is not adding to profitability. Management expects to be at breakeven in the food processing segment by the end of this fiscal year.

The *Second Nature* fresh fruit drink business and its potential was why we had purchased the company. The fruit business is excellent, but a slow grower at 10% CAGR. Net profit margins at 5-7% are more modest. But the opportunity in India for a fresh fruit drink is large, very large, and with higher margins. Now this is in question. Because of this development, we are reducing Freshtrop Fruits's position in the portfolio.

Ion Exchange Ltd

Is in its 56th year in the business of water, waste treatment, and environmental solutions. Results have an EPS of 17.30 Rs for the quarter versus 12.83 Rs Q120. Quarter over quarter however was lower from EPS of 23.49 Rs. Revenues were down 22% on both comparisons.

A 0.7 net debt/equity, Ion Exchange has 47M USD on its balance sheet, three revenue streams increasing at a 18% rate, EBITDA +32%, and PAT +53%.

Water and water treatment are a business that will continue to grow in relevance. Ion Exchange has been a solid portfolio holding for 3.5 years and in a world where water is becoming extraordinarily critical, it is an excellent long-term hold. Ion Exchange is one of the two listed water treatment companies in India.

Mayur Uniquoters Ltd

Mayur Uniquoters' first quarter sales declined 70%. Levered to the seriously hurt auto and two-wheeler market, plus the shoe market, Mayur Uniquoters suffered a hard quarter. That said, auto sales and shoes have begun to recover and the stock price has reflected this. Approved by VW, Mercedes, and in the final approval by BMW, Mayur is marking a new dawn for the only Indian company approved by the highly regarded German automobile manufacturers. Mayur has every Indian OEM auto and two-wheeler manufacturer as customers save two.

The company had zero profits for the quarter, but also it had a zero loss. In this industry, it's a zero we'll take.

Mold-Tek Packaging Ltd

June month was normal. July started well on par with last year; paints and lubricants still lagging but FMGC packaging doing well. Paints are catching up one by one with FMGC, recovering to pre-covid levels. That said, revenues are off by 45% and profitability suffered more. Chairman Rao expressed cautious optimism that there will be a catch up of lost revenues. The company is still profitable in these desperate times.

The company is struggling with getting employment levels up to pre covid levels, progress is ongoing. Capacity utilization is normally 70-75%. In the first quarter utilization was 42% and in July, 72%. By the end of the second quarter capacity utilization was in reach of back to normal. With some savings in transportation plus other cost savings, EBDIT margins will totally recover. With less of a work force and capacity back up to normal, employee efficiency has markedly improved. To clock revenues at 90% of normal, with a reduced workforce at 75%, is an admirable rise to their current challenge.

And Mold-Tek is doing right by its employees as well. Mold-Tek is now providing two, rather than one, healthy meals complete with vitamins which has strengthened company good will with its employees as well as the community. Many employees are pulling 12-hour shifts. This has resulted in elevated employee cost. However, Directors and managers have taken a pay cut. As volumes increase employee cost will be mitigated.

Asian Paints, a large client has recovered. The remaining paint manufacture's recovery is expected in August 2020. Overall, the paint industry will be delayed getting back to normal, aside from Asian Paint's recovery. Additionally, Mold-Tek is beginning to produce push tops and other items for disposal of sanitary bottles which will start producing revenue in October 2020, adding marginally next year.

Mold-Tek is our longest hold in the portfolio at over 8 years. Our return has been over 2000%. I expect the packaging industry to grow least as fast, if not faster than GDP for the foreseeable future. MLT is by far the market leader in rigid plastic packaging in India. A very long-term hold for us.

Kind regards,
Ralph

In memory of Shri Palem Srikanth Reddy, 1963-2020.

The most rewarding element of small company investing is getting to know the men and women who built these companies. Holding a company for 6 years is enough time to have countless conversations and eat meals with the promoters, maybe meet his family, and most certainly have enough time to appreciate the human being you happen to be invested in.

Srikanth Palem Reddy was the MD of a company we had held, until recently, for 6 years. A Stanford grad, a visionary, honest and forthcoming in mistakes and successes, Srikanth was a promoter who held all the virtues of a fine human being. He will be missed.
