July 11, 2022

Dear Investor,

"Computers are useless. They only give you answers". – Pablo Picasso, 1964

India's next decade

We believe that meaningful questions come before any viewpoint. We believe meaningful questions come before any summary viewpoint. Recently, we came across a grudging admiration in The Economist of the ongoing transformation process in India.

"A novel confluence of forces stands to transform India's economy over the next decade, improving the lives of 1.4 billion people and changing the balance of power in Asia. Technological leaps, the energy transition and geopolitical shifts are creating new opportunities-and new tools to fix intractable problems. The biggest threat to all this is India's incendiary politics.

As the country emerges from the pandemic, however a new pattern of growth is visible. It is unlike anything you have seen before. An indigenous tech effort is key. As the cost of technology has dropped, India has rolled out a national tech stack a set of state –sponsored digital services that link ordinary Indians with an electronic identity, payments and tax systems, and bank accounts. The rapid adoption of these platforms is forcing a vast, inefficient, informal cash economy into the 21st century. It has turbocharged the world's third-largest start-up scene after America's and China's." - The Economist,

We wish they had read our investment newsletters in order to have a feel of the modern India, in terms of a sense of the key moments of India that we have been talking about all the time:

1. the SEBI Moment
2. the RBI Moment
3. the Market Moment
4. the Scientific Temper Moment
5. Significantly better risk management processes due to increased complexity in businesses

"In India, connectivity has improved; reliability has increased. One can expect deliveries in a day."– Mr. Kirit Patel, E.D., Alkyl Amines Ltd, Ambit Conference, May 2022

"If somebody had told me two years ago, that carpenters will be sitting and doing meets on Teams you would have said listen guys, are you sure this is possible put there has been that evolution. So we actually use digital very aggressively." – Bharat Puri, M.D., Pidilite Industries, Q4, FY22 Analysts' Concall

"Whether we need something like COVID to try something innovative." – Richard Thaler, Gleacher Center, June 07, 2022

The growth of an economy reflects the evolution of the socio economic processes of a country. The transformation of the Indian society has always been outcome of the conscious choices made by the people of India from time – to – time. Among the countries in South Asia, in contrast to India and Bangladesh, Pakistan and Sri Lanka present a real-life manifestation of the socio-economic evolution of the respective societies. Bangladesh has prospered despite all its handicaps Pakistan left it with in 1971. Sri Lanka excels on any life- related parameter, and yet chose not to forge an inclusive society. Right now, both Pakistan and Sri Lanka have become basket cases. About India, Mark Tully recently summed up precisely:

"But, in his forthcoming book, towards Decentralized Democratic Global Governance, economist Ramgopal Agarwala argues that the leadership India can provide would lead to the end of hegemony. He says, "India will play a lead role in creating a multi- polar world where there will be no hegemony and all states, big or small, will develop according to their lights, but an international order will exist for providing global public goods to all." What are Agarwala's reasons for suggesting this could be India's goal? They all require India to realise the values it once held - a belief in the inherent goodness of humankind, keeping a place for the transcendent in our lives, and the practice of its ancient spiritual tradition. Moreover, it stresses the importance of the immeasurable-love, beauty, divinity, awe, and humility in a world obsessed with measuring the measurable." – Mark Tully, Hindustan Times, July 03, 2022

COVID-19 accelerated the underlying processes of transformation in India. In line with the wish of Mr. Thaler, India did not wait to undertake a series of innovative transformations for the advent of COVID 19. 1991 – onward, the National kept unleashing what we have chosen to categorise as our 'Moments'. In our opinion, India's next decade is likely to see:

a. A large percentage of population moving to the middle class status
b. Significant increase in the sophistication of demand as well as quality of products and services
c. Improving governance and social harmony
d. A more educated India, and confluence of the above factors should materiality enhance business prospects of the investee firms in your investment portfolio over the long – term.
e. An increasing globalized and globally competitive economy

<u>The digital paradigm</u>

"With digital technology, innovations became become rapid and more measurable. We won't say that innovations emerge all of a sudden as the underlying need always has been there.

Domain expertise continues to be the ultimate strength." – Amit Jain, MD, L'Oréal India, March 31, 2022

"*I agree it is too early to talk about quality. But having said that, since we are using advanced techniques in terms of credit underwriting, we are fairly sure about we are onboarding. Therefore, I am fairly confident that this book will hold."* – Murali Ramakrishna, M.D., The South Indian Bank, Q4, FY22 Analysts' Concall

"*Fintech challenge is a fantasy. What players such as NBFCs, micro-finance institutions and payment entities have done is to get banks to think through their business models and get better. Fintech is likely to serve the same purpose. The notion that fintech will displace banks is a fantasy. Banks will imitate fintechs or swallow them, they aren't going to disappear."*– TT Rama Mohan, Faculty, IIMA, Business Standard, June 9, 2022

We continue to believe that feet on the street matters in any business, more so in the financial services. Evidence of this can be seen in the track – record of performance of our investee financial institutions, while deepening their manpower as well as digital resources. This may be contrasted with sacking of thousands of staff recently by the so called Unicorns, especially the ed-tech companies. We think that these firms were deficient in direct and human interface with their customers. Digital infrastructure now has become a hygiene element for any financial institution. The key dimension of their business is intelligence, comprising: a. market intelligence, b. collection intelligence, and c. analytical intelligence. So-far, only two of the Indian FIs, Bajaj Finance Ltd and HDFC Bank Ltd, have had a systematic adoption of digital analytical approach in their underwriting of retail credit. The biggest gap, in our opinion, continues to be in case of market intelligence across almost each of the Indian financial institutions. Except for select exceptions, the business heads of the lending SBUs in India remain confined to glass cabins, even while visiting the Bazaar! We in Chanakya continuously monitor this type of institutional behaviour practises in case of our investee companies, as well as their main competitors. We have always known that domain expertise continues to be the ultimate strength. Digital capabilities plus market intelligence would add to the cutting edge a FI can have.

What has changed for the Indian entrepreneurs in recent times

In the course of our recent chance interactions with the officials of GST, Maharashtra, we enquired whether recent spurt in monthly GST collections were sustainable. They told us:

"Due to lack of data earlier, no agency in India could detect tax gap. Now, compliance has become strict due to IT, policy reforms, and stronger implementation. Smart analytics is being used for compliance management." – GST officials, Maharashtra, March 2022

Similar feedback has been provided to us by some officials of other tax departments. We believe that compliance in payment of tax, whether voluntary or involuntary, plays a significant role in shaping the organisational value system as well as practises of firms in a nation. Over 30 years back, Infosys emerged as the living beacon of corporate governance in India. We don't need to mention the long list of Indian firms, which used to look the other way, and in recent years ended up turning into basket cases.

"If you want to help people to do something, make it easy." – Richard Thaler, June 7, 2022

Being a new business enterprise ourselves, we regularly keep on experiencing how tough it is to do business in India, especially if you are a small firm. Nobody listens to your pain. Yet, somehow a meaningful solution always emerges at the end!

"Serious promoters sold their land and funded the operations." – Shekhar Chakraborty, CFO, Acute Ratings, March 17 –, 2022

We believe that this is reflective of a permanent shift in the attitude of Indian entrepreneurs. Also, going ahead, cashflow-based lending is increasingly likely to dominate traditional asset – based lending in India. Asset-based lending may continue account for a large portion of retail lending, especially mortgage financing even in the future. In case of business – related lending, cashflow-based lending would more be in the future. This is because product market-related capabilities are becoming the key success factors in any consumer – oriented as well as service business in India. This should go in favour of customer – focused financial institutions, especially banks and micro finance institutions.

<u>The increasing importance of R&D in India</u>

"*Forget Web3. India is miles ahead with its UPI. Because UPI transactions are presently free and will eventually cost only a tiny fraction of what merchants and consumers pay to move money on private payment systems such as Mastercard and Visa, the UPI payment rails could boost the GDP in India by a meaningful amount. As for security, UPI was also designed to require strong two-factor authentication, making it more impervious to fraud than the older systems in richer countries."* – Vivek Wadhwa, Ismile Amla, and Alex Salkever, The Hindustan Times, July 4, 2022

"*India spends a mere 0.64% of its GDP on S&T, the lowest amongst Brics nations. The US, China and South Korea spend 2.73%, 2.4% and 4% of their GPD on S&T, respectively. As S&T research in India mostly occurs in government institutions, no surprise that cutting-edge scientific inventions continue to elude us."*– Jayant Krishna, The Economic Times, July 4, 2022

It was very interesting to come across, on the same day, two contrasting views in the Indian frontline newspapers about R&D in India! We would choose to infer that from a very low base, now onward R&D expenditure and its societal impact would see a major upward trajectory in India. While basic R&D still remains sub-scale, application – oriented R&D has begun taking strides in India. So far, India has benefited by providing meaningful R&D support – type work to many leading global corporations having R&D hubs in India. We believe that recent initiatives of the Government of India, especially the New Education Policy, and the National Research Foundation would facilitate genuine basic R&D in India. Over time, a meaningful lab – industry partnership would also help Indian firms to cope with increasing sophistication of demand, which in turn would help to deepen R&D culture within India.

"Due to availability of far more information, consumers have become far more discerning. Traditional companies also have realised importance of R&D. Ingredients are becoming very important. Consumers are willing to pay a premium for a good ingredient." – Amit Jain, MD, L'Oréal India, March 31, 2022

"India ranks 9th in research impact through citations, while the US and China are top rankers." – Jayant Krishna, The Economic Times or Business Standard

Ultimately, business model and practises of any firm are driven by the choices made by its customers. As sophistication in demand would increase in the future, we believe that customer – focused Indian firms would invest more and Meaningfully in R&D there in case of financial institutions, it may manifest in uses of analytics for design of services for customers. In case of manufacturing entities, new products and designs would see significant improvements led by R&D. In fact, COVID-19 might have accelerated this process.

"Due to COVID-19, life is going to be different because of we getting forced to do experimentation." – Richard Thaler, June 2022 Gleacher conference, June 2022

<u>The supremacy of margin of safety – what investments we still await to make in your portfolio</u>

Over nearly four years of our PMS investments, very consciously we allocated relatively small portion of your investment to sectors like FMCG and other consumer products, IT, pharma and specialty chemicals. We invested in shares of Titan and a food company, via its holding company providing a deep level of margin of safety. The sole season for this has been our adherence to margin of safety, as estimated by us, being lower than our threshold level of comfort. We believe that well – managed and customer – focused financial institutions represent an equally attractive and equivalent exposure to consumer – product firms. Based on our deep ground level research and valuation based on long-term cash flow expectations, we continue to stick to our aforesaid conviction in case of any potential investee companies. We understand these segments quite well, and are quite prepared to make investment if and when we feel comfortable in term of the margin of safety criterion.

When will things become normal?

We don't claim to have a good understanding of the time – frame, by which life for every Indian, including the ones at the bottom rung of the society and hit very hard by COVID-19, would attend normality.

"In a study published in 2014 of 100 financial crises going back to the 1890s, Carmen Reinhart and Kenneth Rogoff, two Harvard economists, found that real income per person took an average of eight years to return to pre-crisis levels." – The Economist, May 6–12, 2017

Would it take eight years in India as well? We hope it would be much quicker. Till then, demand for discretionary consumer products could lose a bit of pace. A recent observation by CMIE could be meaningful in this context.

"*The richer households suffer the least pain of unemployment. They account for about half a per cent of all households and contain a similar proportion of all unemployed. Their average LPR at 46.3 per cent is the highest among all income groups. Their unemployment rate had shot up the most among all income groups but has since declined. It was over 15 per cent during the first wave of the pandemic. But, in 2021, the rate has averaged at 5.2 per cent. The employment rate has been mostly over 40 per cent. But, during September- December 2021, it shot up to 45 per cent. This is much higher than the employment rate of the other income groups which range between 30 and 40 per cent."* – Mahesh Vyas, Business Standard, March 28, 2022

We believe that in time, the people of concern of Mahesh Vyas won't need to regress to their 'old normal' lives, but would participate in a significantly stronger entrepreneurial Indian economy.
Our hope lies in the grass – root entrepreneurship in Indian villages, and semi – urban towns. In addition to being an efficient conduit for select government schemes, MFIs and banks have been facilitating formalisation of the entire eco- system.

The South Indian Bank – the teenager finally graduates into an adult!

"We must confess that so far, SIB has been behaving like an unruly teenager, who is yet to exhibit consistency in financial results. More often than not, new mistakes made in the past in their wholesale lending book keep on getting discovered. Consequently, financial performance of the Bank has been weak during FY15-20, only due to big write-offs arising from large ticket wholesale loans disbursed till mid-2014,

before Mr. Mathew joined the Bank. Why do we still admire this Bank?" – Chanakya PMS Investment Newsletter, July 15, 2020

The Bank finally came of age in its Q4, FY22 financial results
1. Net profit of Rs.272 crores for the quarter
2. CASA touching 34%
3. NPA percentage declining to reasonable levels
4. Retail businesses, both liabilities and assets, showing consistency and growth
5. The Bank repeatedly winning top awards for digital and IT applications
6. Finally, disbursement, incremental NPAs and profit numbers coming close to the initial guidance

Strangely, share price of the Bank continues to hover around all-time low levels! We continue to have our faith in the future of SIB and our investment in the Bank.

Portfolio composition and risk

In our portfolios, top 10 stocks accounted for 58% of the total investment, compared to nearly 61% a quarter back. The overall sectoral break-up of our investment portfolio is given in Table 1.

Table 1: Chanakya PMS – Portfolio Sectoral Allocation as on June 30, 2022

Sector	% of overall portfolio
Banks & NBFCs	34
Consumer goods	3
Auto & Auto components	3
Industrials	9
Metals	6
Logistics	4
Others	26
Holding companies	15

Compared to sectoral allocation at the end of Feb 28, 2022, percentages invested in banks and NBFCs have decreased by 2%. Percentages invested in holding companies have decreased by 7%. Auto and Auto components got reduced by 1%. During the last quarter, in order not to breach our internal risk limits, we sold some shares in the metals and engineering segments as prices of these shares had appreciated considerably. We don't churn our portfolios. The aforesaid shifts in portfolio allocation is largely reflective of price movements of various shares in our portfolios.

Overall performance of Chanakya PMS compared to select indices

Over the last 46 months of our investments, the overall performance of our portfolios is given below in Table 2.

Table 2: Chanakya PMS – Investment Performance as on June 30, 2022

Period	Portfolio %	Sensex %	Nifty 50 %
1 Month	-5.58%	-4.58%	-4.85%
3 Months	-8.30%	-9.48%	-9.65%
6 Months	-11.05%	-8.99%	-9.07%
1 Year	-1.23%	1.02%	0.37%
2 Years	32.24%	23.24%	23.78%
3 Years	10.02%	10.40%	10.21%
Since Inception 13.08.2018	7.86%	9.05%	8.66%

Over the last around four years, prices of financial stocks in our portfolio still continue to lag behind increase in overall market, and also prices of stocks of metals, engineering, auto components and logistics in your portfolio, which have appreciated well. We continue to believe that given the quality and business prospects of our investee companies, their product-market performance is likely to improve further in the future.

Consciously, we have chosen to invest in shares of select holding companies of some of the finest market leaders in India. While prices of underlying shares have improved considerably in recent period, prices of the shares of the holding companies in your portfolio continue to be quoting at discount of 60–85% to the respective underlying values. We believe that over time, discounts may be expected to come down significantly, resulting in considerable boost to NAVs, and return on year investment portfolios.

Performance of any investment portfolio should be judged over a longer period. Four years is a sub-optimal time-frame for it. Knowledgeable veterans tell us that performance of any equity portfolio ought to be evaluated for a period not less than five years. It can be seen in the Table 2 that over a longer time horizon, relative as well as absolute performance of our overall investment portfolio have improved considerably. Over the longer time periods, underlying assets didn't change significant, but market prices changed materially! We focus on absolute performance of our investment portfolios, and hence we don't seek to emulate composition of any index. We believe that our investment portfolios would justify our faith and approach in the times to come.

With best regards,
Rajesh Tiwari, Gautami Desai and Team Chanakya

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