Nov 09, 2022

Dear Investor,

Initiation into a new unknown life

"*That is the beginning of a new story – the story of the gradual renewal of a man, the story of the gradual regeneration of a man, of his passing from one world into another, of his initiation into a new unknown life.*'' – Fyodor Dostoevsky, Crime and Punishment, The final paragraph

The story remains the same in case of regeneration of a nation or markets – the two most powerful mechanisms for advancement of the human society. USA in the early twentieth century, Germany and Japan in the post – second world war period, China beginning late – 1970s, and India beginning-1992 come to mind as examples over the last one century.

As of now in India, the main challenges before the nation are: (i) inflation, and (ii) stagnant level of employment and income for a large number of unskilled, and to a lesser extent for semi – skilled labour. This also creates an impression of a two – track economic progress in India, with people in the weaker sections unable to move along with better endowed citizens. We believe that improvement in institutional processes are needed for accelerating inclusion of every Indian in the overall growth process. A high rate of growth in the long-term requires shared progress all-around in the society. Shared economic growth, along with an adequate and deep welfare mechanism for all, are necessary outcomes for credible source for a meaningful societal transformation. We see the four "Moments", mentioned in previous Newsletters, as drivers of this process in India. In this Newsletter, we share some of our thoughts related to the two issues of inflation and two-track growth.

The human mind is not so good at estimating the compounding effect of human ingenuity over the very long – term. At times, we in Chanakya also get pleasantly surprised at the significantly improved organizational balance and cash flow almost each one on our investee companies has begun exhibiting over the last four years and three months of the PMS investment period! Hasn't this also been one of the most choppy periods of the world as well as Indian economy? In this Newsletter, we intend to enunciate a context for the future of growth of India and our investee companies.

Infant mortality rate and illiteracy rate – reliable measures of growth of a nation

"The lesson is obvious: the easiest way to improve a child's chances of growing taller is for them to drink more milk.

In this sense, infant mortality is a more discerning indicator of quality of life than the income average or the Human Development Index, but it still needs qualifications: no single measure is a fully satisfactory proxy for gauging a nation's quality of life.

And here, what really matters is not the size of a country's gross domestic product or the number of warheads or patents it may possess, but the variables that truly capture its citizens' physical and intellectual well-being. These variables are simply life, death and knowledge. Infant mortality is an *excellent proxy for a wide range of conditions, including income, quality of housing, nutrition, education, and investment in healthcare."* - Vaclav Smil, Numbers Don't Lie, Penguin Books, 2021

Infant mortality in Bihar continues to lag behind other states, despite showing good improvement in recent years. Even Gross Fertility Rate, GFR, has come down significantly in the state of Bihar, as well as in other states of India, as surmised in an article in the Financial Express.

"Infant- and under-5 mortality

The good news is that the infant mortality rate for India has fallen from 47 per 1,000 live births in 2011 to 35.2 in 2019-21. So too has under-5 mortality-from 55 per 1,000 live births in 2011 as per the World Bank's estimates to 41.9 in 2019-21 in NFHS-5. Moreover, as expected, states with higher per capita income tend to have lower mortality rates. However, the mortality rate for some states have remained persistently above the national averages. Regarding infant mortality, the serious laggards are Uttar Pradesh, Madhya Pradesh, Chhattisgarh, Bihar and Jharkhand. These states also feature in under-5 mortality, in addition to Uttarakhand and Tripura." – The Two Indias, Omkar Goswami, Financial Express, September 12, 2022

The combination of infant mortality rate appears to be a reliable metric for measuring prosperity and progress of nation or a region. While mobile telephones, Metaverse and EV are wonderful, any significant improvement in infant mortality rate would lead to higher demand for the traditional core businesses like cement and steel as well.

Literacy

Level of education of the citizens of our country has a significant impact on level of sophistication of demand as well as quality of governance in the nation. The new education policy, NCP, is now getting implemented in India. In recent years, coverage and quality of education in India seems to be getting measured more scientifically by credible agencies. In case of literacy across the various states in India, the following report in The Times of India is quite revealing.

"*I examined four indicators of literacy in NFHS-5.*

Women who are literate, 2019-21: Literacy implies the ability to write one's name. The all-India average was 71.5%. Nine states were worse than India. These were Rajasthan, Uttar Pradesh, Andhra Pradesh, Telangana, Madhya Pradesh, Bihar, Jharkhand, West Bengal and Odisha.

Men who are literate: The all-India average was 84.4%. Ten states were worse than that, namely, Uttar Pradesh, Andhra Pradesh, Telangana, Madhya Pradesh, Chhattisgarh, Bihar, Jharkhand, West Bengal, Assam and Tripura.

Females (6+) who ever attended school: The national average was 71.8%. Eleven states were worse off: Jammu & Kashmir, Rajasthan, Uttar Pradesh, Andhra Pradesh, Telangana, Madhya Pradesh, Chhattisgarh, Bihar, Jharkhand, West Bengal and Odisha.

"Women with 10 or more years of schooling: The average for India was 41%. Fourteen states were worse off. These were Rajasthan, Uttar Pradesh, Gujarat, Andhra Pradesh, Madhya Pradesh, Chhattisgarh,

Bihar, Jharkhand, West Bengal, Odisha, Arunachal Pradesh, Assam, Meghalaya and Tripura."– The Two Indias, Omkar Goswami, Financial Express, September 12, 2022

It is intriguing to learn that some of the economically advance states, like Delhi, Gujarat, Tamil Nadu, and Goa, or among the worst performing states in India, while West Bengal and Bihar are better performers!

We in Chanakya will keep on analyzing the underlying issues. We do believe that economic performance of India and our investee firms have a significant linkage with the socio – economic progress of India, as well socio – economic dynamics of specific regions in the country.

<u>A bit of dissection of the ongoing inflation in India</u>

"The question is where does advanced economy inflation come from, and my sense is that it largely comes from the US, including the effect of the US on commodity prices. If the US had been more careful, there would have been a much smaller increase in commodity prices. We are focusing on commodity prices at this stage, because of Ukraine, but the rise had largely happened before the war and I think you have to trace it mainly to very strong demand from the US" – Oliver Blanchard, the Financial Times

Chanakya is no expert on inflation. We have seen that our investee companies keep on improving their customer – focus and financial performance, even more during choppy times like inflationary periods. We also think that Mr Blanchard has analysed the current inflation situation in the world with precision and depth.

In the Indian context, we also saw meaningful insights in the minutes of the recent Monetary Policy Committee, MPC, proceedings of RBI, with Professor Jayant Varma and Dr. Ashima Goyal taking a stand that RBI need to pause to see effect of the recent hikes in the Repo rate, over the next 2-3 quarters. Dr Ashima Goyal has a meaningful perspective on the recent economic situation.

"*Indian monetary policy became too much in stimulus after the global financial crisis. Double deficits and various fragilities followed. It subsequently became too tight; there was over-reaction. This is what we are seeing the Fed do now. Too much stimulus after COVID-19 and over-reaction now. We are seeing a lot of problems in financial markets abroad. I think moderation is a lesson that perhaps Indian policymakers – both monetary policymakers and otherwise - have learnt. To be countercyclical and not to let the real rates become too negative or too positive. We have the policy space to do these kinds of adjustments. As long as we react but not over-react, I think we will be able to moderate inflation without hurting growth too much.*

It's also about monetary-fiscal coordination. There is continuing fiscal action on the supply side. For example, the government's targeted free-food provision is one reason why wages have not risen. In the 2010s we had second-round inflation because the rural real wages were rising in double digits. Today they are flat. We don't have those kinds of persistent inflationary pressures today. "– Dr. Ashima Goyal, Business Standard, October 16, 2022.

The ongoing high inflation seems to have affected the buying behaviour of the weaker income section in India, in rural as well as urban India. However, the key issue in India, so far, has been limited income and thereby low level of purchasing power in case of low income strata. COVID-19 has hit this section of population very hard.

"Since January 2022, rural inflation has been consistently higher than its urban counterpart implying that people in rural areas are bearing the brunt of high prices more than their urban partners."- Business Standard, Sanjeeb Mukherjee, October 18, 2022

The Government's free food scheme has not only helped to soften inflation in case of low – skilled work space in India, it also protected them from high level of food prices seen everywhere over the last two – odd years. In my opinion, the Indian economic policy makers have a better share some measures to soften impact of inflation on the vulnerable section in India – quite in sync to the analysis by Mr. Blanchard about the economic measures in his own country!

<u>The Labour Economics in and around Patna</u>

"The most interesting problems are multidisciplinary and require wisdom beyond the models and algorithms. And eventually real people will need to shake hands, sign agreements and pass laws." – Oliver Roeder, Financial Times, September 13, 2022

As per an auto – dealer in Patna, percentage of financed vehicles in Patna has now increased to 88–89%, compared to 68%, three years back. Also, due to ease of financing, customers are opting for upper – end vehicles. It needs to be mentioned that now Patna has a population over 3 million. It has become a Metro! This has catalysed improvement dynamics of its own in terms of:
(I) Sophistication and quantum of demand for quality products and services
(II) Need and availability of various civic services, including law and order
(III) A big shift is visible in the value system of its people. Increasingly, in rural as well as urban Bihar, a large percentage of young and school-level educated persons have a modern entrepreneurial outlook. We have been mentioning about this quite often in our recent Newsletters.

However, overall the state of Bihar continues to stagnate in terms of economic growth and quality life – related parameters.

"In Patna, life is very different. Even has skills, one can try to do different things or even do a bit of a small business.

Since there are now manufacturing or other service businesses coming up in Nalanda, no new jobs are getting created. The only option for one is to work as an unskilled labour in a shop or in a farm, for which one would be paid Rs.2000 –4000 per month.

In Patna, one can earn up to Rs.7000 per month as an unskilled labour. However, in view of the house rent and food expenses, it effectively doesn't turn out to be better than earning Rs.2000–4000 per month at Nalanda. In case 1 want to earn Rs.10,000 per month and above, one has to get skilled. That's why he learn driving." – Uber cab driver, originally from Nalanda, constituency of Mr Nitish Kumar, the Chief Minister of Bihar, Patna, October 3, 2022

A high percentage of population residing in Bihar, outside Patna, falls in the category of the less privileged category of citizens, whom the economic dynamism of India is yet to touch. In fact, this is the story of many other people of India:

"Let me be very, very honest; people think, you know, you will look at it, why all these people have not grown. Because the demand at the bottom of the pyramid is not there. It unfolds at its own pace" – Sudhin Choksey, ex.-MD, Gruh Housing Finance Ltd., Analysts' Concall by Ambit, Oct. 2022

"Surveys show that Covid-19 has widened the gap between the rich and the poor. Consumer-goods makers are reporting robust demand for items priced nearly $2,000, while industry data on sales of budget phones priced below $100 and motorcycles, an indicator of rural demand, are showing a weaker trend." – Business Standard, October 24, 2022

Bihar and Jharkhand are functioning like the left – out states in terms of economic and social development. This Dussehra and Diwali, rich-poor divide has been stark all across India in terms of consumer spending during the top festival period. Partly, these are outcome of real wage growth remaining flat in FY 23.

While COVID-19 might have accentuated socio-economic fault – lines, we think that these are outcomes of varying economic transformation taking place across different social groups in India. Bihar and Jharkhand are the poorest states in India. Consequently, caste and tribe continue to remain the main instrument for social security in the two states, something analysed in a masterpiece paper by perhaps the greatest of the living economist in the world.

"The second challenge to economic theory concerns the relation between marginalism and social custom. As long as most persons have positive utility for obeying social customs, and as long as activities are pursued up to the point where marginal costs equal marginal benefits, there will be rewards to breaking social customs insofar as they fail to promote economic efficiency. While such rewards occur sometimes, and they may also be spectacular, I would tend to believe that usually the greatest returns go to those who do not break social customs." – The Economics of Caste and of the Rat Race and Other Woeful Tales: George Akerlof: *The Quarterly Journal of Economics,* Vol. 90, No. 4 (Nov., 1976), pp. 599-617

To a lesser extent, the above socio – economic inertial behavior persists throughout the Indian society. This is a type of social fatigue affecting economic well – being of the weaker groups in India. Education, Direct Benefit Transfer, targeted free – food provision and the own will of specific groups to come out of the low-life morass has led many of social groups to join the economic mainstream of the society. MFIs in India have contributed a lot to upliftment of much downtrodden groups in India. A strong political will always is the tipping factor.

"Given this limited fiscal strength, India had no option but to put a lid on the components of revenue expenditure that have risen relentlessly over years. So, it sought to dispense with subsidies to the extent possible and alongside started the cash transfers, to work around the infamous systemic inefficiencies, sloth and leakage. The country's globally comparable telecom bandwidth and networks, efficiently regulated financial system, and its widespread banking facilities aided the transition, but what came as a shot in the arm was strong political will." – Financial Express, October 24, 2022

Would the "Rest of Bihar" as well as similar regions elsewhere in India continue with an anaemic rate of growth even now? Would the pace of economic growth and quality of life improves in these areas? We need to keep on watching and understanding pace of future economic growth of India, and in-turn profit numbers of our investee firms.

A lot of India is still unemployed and poor

"In 2019-20, the poorest households accounted for 9.8 per cent of all the households and only 3.2 per cent of all the unemployed. In 2020-21 and the first half of 2021-22 they accounted for 16.6 per cent of all households but still accounted for only 3.5 per cent of all the unemployed. The poorest households are not the ones that report large scale unemployment. The default explanation of this is that the poor cannot afford to remain unemployed and so are largely employed. But, this is not true. Sure, this group has the lowest unemployment rate at about 4.1 per cent before the pandemic during September-December 2019 and at 4.8 per cent during September-December 2021. But, it also has the lowest labour participation rate at 38.1 per cent and 31.3 per cent, respectively in the same periods. The employment rate was 36.5 per cent and 29.8 per cent, similarly. These are the lowest rates among all the income groups. Evidently, the poorest households suffer the worst employment conditions. They also suffer the worst wages conditions. The average wage income of a poor household at about Rs. 53,000 is less than half the average wage income of all households. Poor households suffer the double whammy of low employment rate and low wage rate. But, this is not where most of the unemployed reside." – Mahesh Vyas, Business Standard, March 28, 2022

"*Now Chhattisgarh let me be very, very honest; people think, you know, you will look at it, why all these people have not grown. Because the demand at the bottom of the pyramid is not there. It unfolds at its own pace.*

So I think this demand is there. You look at your driver or your cook or your maid, they are not in a hurry, they are comfortable. I think that their need is income and I think once the saving gets built, they will be looking at their own housing, and for this, demand moves at a slower pace." - Sudhin Choksey, Ambit Concall, Oct. 2022

Mr. Sudhin Choksi and Mr. Mahesh Vyas have deep sense of the economic realities in the hinterland of India. A lot of BNPL has facilitated consumption for the urban middle – class of India. The rest of Indians are working very hard to join their league.

The duality of pace of growth between Patna and the rest of Bihar is the fact visible all across other states in India, albeit to varying extents. Tribal villages, 30 km from Kalyan, less than 100 kms from the metropolis of Bombay, too remain economically under-developed almost as much as the rest of Bihar.

Axis Bank finally makes the cut!

In our December 24, 2019, Investment Newsletter, we had mentioned about our rationale for investing in shares of this Bank. Recent improvement in overall performance of the bank, especially those in Q1 and Q2, FY 23 has borne out our faith in the stock. We in Chanakya will keep on investing in shares of companies undergoing credible and meaningful turn – around. We also realize that fruition of such transformation will invariably take years. We invest only if risk – return equation is attractive despite associated uncertainties in cash flow as well as time period of turn-around.

Edge comes from mastery of process expertise

"*Basically the edge comes because of the process expertise. Basically, once you master a process; because forging and machining are a process, so you just have to change the application from industrial. So the movement from one industry to another is not that challenging. Of course each industry has its own benchmarking and all, but it is not that challenging to move, till the time you have the process expertise."*
– Sanjay Deshpande, ex-Vice President, Finance, Bharat Forge, September 2022.

Every organisation is a collective, dynamic entity. It cannot be judged merely by looking at individuals in the organization alone. The soul of the organisation permeates and transforms every individual, more so in case of innovative organisations. In case of routine – type organisations, it gets manifested in onset of mediocrity.

Do all of our investee companies satisfy the criterion of being an innovative company? We have a numerical measure for this, viz. margin of safety. In case of high margin of safety, it is probable that the market is yet to appreciate the degree and process of innovation the specific investee company internally has. We see this as a mathematically measurable risk – return opportunity to generate long – term return for you. In simple terms, even in case of a relatively less innovative corporation, potential risk – reward, in terms of margin of safety, is a robust and objective decision tool for investment.

Every company need not be Google for us to make money for you. What we focus on is to understand the DNA and the process of innovation in case of our investee companies. The marginal of safety is derived from our understanding of the long – term prospects of the business and organisational innovations. We do believe in our numbers, the DCF valuation and margin of safety. The outcome of investment process of ours is for you to see in the performance about investment portfolios over the last four years, as illustrated in Table – 1 below.

Table 1: Chanakya PMS – Investment Performance as on October 31, 2022*

Period	**Portfolio %**	**Sensex %**	**Nifty 50 %**
1 Month	6.91%	5.78%	5.37%
3 Months	12.72%	5.52%	4.98%
6 Months	14.56%	6.46%	5.32%
1 Year	12.77%	2.43%	1.93%
2 Years	38.85%	23.85%	24.40%
3 Years	19.71%	14.82%	14.89%
Since Inception 13.08.2018	13.39%	11.85%	11.38%

*Source: HDFC Bank Fund Accounting

During the previous Samvat Year and one more day ending on October 31, 2022, overall Chanakya PMS gave a return of 12.77%, compared to main market indices declining by 2.43%.

Portfolio composition and risk

In our portfolios, top 10 stocks accounted for 57% of the total investment, compared to nearly 58% a quarter back. The overall sectoral break-up of our investment portfolio is given in Table 2.

Table 2: Chanakya PMS – Portfolio Sectoral Allocation as on Sept 30, 2022

Sector	% of overall portfolio
Banks & NBFCs	32
Consumer goods	3
Auto & Auto components	3
Industrials	5
Metals	6
Logistics	4
Others	30
Holding companies	17

Compared to sectoral allocation at the end of June 30, 2022, percentage invested in banks and NBFCs has decreased by 2%. Percentage invested in holding companies has decreased by 2%. Industrials have reduced by 4%. During the last quarter, in order not to breach our internal risk limits, we sold some shares in the industrials segments as prices of these shares had appreciated considerably. We don't churn our portfolios. The aforesaid shifts in portfolio allocation are largely reflective of price movements of various shares in our portfolios, or re-balancing for maintaining risk limits for specific stocks.

Overall performance of Chanakya PMS compared to select indices

Over the last 52 months of our investments, the overall performance of our portfolios is given below in Table 3.

Table 3: Chanakya PMS – Investment Performance as on Sept 30, 2022

Period	Portfolio %	Sensex %	Nifty 50 %
1 Month	0.30%	-3.54%	-3.74%
3 Months	18.47%	8.31%	8.33%
6 Months	8.63%	-1.95%	-2.12%
1 Year	6.02%	-2.87%	-2.97%
2 Years	37.33%	22.84%	23.30%
3 Years	18.35%	14.09%	14.21%
Since Inception 13.08.2018	11.86%	10.60%	10.23%

Source: HDFC Bank Fund Accounting

Investment requires patience over a long -term for the core investment theme to get seasoned and fructify. Our investment theme and processes have become sharper over the four years and two months. It took three years and 10 months' time for performance numbers of our overall investment portfolio to outperformance major market indices in India.

We in Chanakya watch a potential investee firm for at least two years before investing in its shares. In fact, each of the investee companies in your investment portfolios have been intensely followed up by us for more than five years. This much of time and recursive probe of the vitals of our investee firms, helps our own process expertise.

Chanakya has faith in the long – term future and profitability of core businesses like steel and engineering. We also have faith in the service businesses that facilitate functioning of our lives and resources – allocation. At right valuation, we will also have enough faith in IT and life sciences as well. It is all about a discipline and knowledge –based calculation risk – return trade – off in a stock at a given price.

We continue to believe that given the quality and business prospects of our investee companies, their product-market performances are likely to improve significantly 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 50–75% 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, usual wisdom being 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. So far, as time progressed, so did performance of our investee companies. We focus on absolute performance of our investment portfolios, and hence we don't seek to emulate composition of any index. We have included performance of select indices only for your convenience. 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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