May 12, 2023

Dear Investor,

In this Newsletter, we discuss what makes a society happy, and also recent decline in rate of suicides in the world, and more so in India! We also delve into some of the recent developments adding to the strengths of the Indian society and businesses. As usual, we also share with you some insights about one of the businesses we have invested your money into. Please share your thoughts about our ideas here.

"You have to believe that you can do something great because you can't prove it in advance." – Conversation with John Kao, C. Otto Scharmer, Volume, Numbers 4, REFLECTIONS, 2001

Be it the Indian society, Indian business or Chanakya PMS – each one had to believe in themselves long before a new Era dawned.

In the long – term, the compounding effect of social innovations becomes magical. I often wondered how come Costa Rica, a country with a population of five million, made it to the quarter – final of the 2014 FIFA World Cup! I came across a good explanation in an old issue of National Geographic:

"In 1869 Costa Rican law made primary school mandatory for every child, including, notably, girls. By 1930 the literacy rate was among the highest in Latin America. At the same time, the nation invested in supplying clean water for rural villages, stemming deadly childhood illnesses, such as cholera and diarrhea, and ensuring children's lives got off to a healthy start. The 1940s brought the beginnings of social security and an end to the army. By 1961 came legislation on universal health care, leading to free primary care clinics in most villages." **- National Geographic, Nov. 2017**

The Indian society has been woefully deficient in making social investments Costa Rica initiated in 1869. The year 1992, known more for economic reforms in India, also accelerated social reforms under the visionary leadership of then Prime Minister late Mr. P.V. Narsimha Rao. Long back, as the Education Minister of Andhra Pradesh, Mr. Rao had initiated the Navodaya School chain in every district of Andhra. Later on, when he became the HRD minister of India, Navodaya schools were established in every district of India, except Tamil Nadu. Every school admits 100 students every year through a competitive test. These residential schools provide quality education, and wholesome development facilities to children without charging any fee. As of now, around 50,000 children, largely belonging to under – privileged and middle – class of India, join these schools every year. I urge our investors and other readers to themselves explore more about the impact Navodaya schools have been making.

Of course, anyone can enumerate glaring gaps in any aspect of life or governance in India. We in Chanakya also are well aware of many of these gaps. We have chosen to study the ongoing societal transformation helping to plug these. We keep on sharing our field – level information with you in our newsletters.

<u>Very pleasantly surprised to discover that rate of suicides has come down a lot In India!</u>

Indian media is almost awash in reports of suicides in India – in IITs, among farmers in Maharashtra, dowry-related suicides in comparatively more prosperous states of India. Hence to me, a big surprise came in a series of coverage in The Economist:

"What does seem sure is that suicide rates will continue to fall, perhaps dramatically. The ubiquity of televisions and mobile phones has diminished individual isolation, for example for wives oppressed by demanding mothers-in-law. It has also made more Indians aware and accepting of ways to seek help for mental problems." – The Economist, Sept 22-28, 2018

"There is stark geographical variation among Indian states (see chart). A woman in the southern state of Tamil Nadu, for example, is ten times more likely to commit suicide than one in jungle-bound Mizoram in the North-East. Men in the poorest state, Bihar, kill themselves at a quarter of the rate of those in bustling Karnataka, the heart of India's technology industry.

- The Economist, Sept 22-28, 2018

In Chanakya, we look at competitiveness of our investee firms at a global level. We also go deep into key social trends, in India and elsewhere. A look at global trends often adds clarity to our Indian perspective, as the above information on rate of suicides did to our optimism about the socio-– economic evolution of India.

"Between 2020 and 2021, too, there was a 7.1 per cent increase. In 2021, 1.64 lakh people took their own lives, according to the NCRB. The suicide rate jumped to 11.3 in 2020 and was at a record high at 12 in 2021. According to the WHO estimates, India has the 41st highest suicide rate globally, as of 2019." - The Hindu Business Line, March 23, 2023

Rate of suicides is much less in Bihar than in economically advanced states of India! Coming from Bihar, this doesn't surprise me at all. The cultural traditions in the poor state of Bihar make undue pressure from close relatives, leading to suicides, socially abhorrent. The poverty in Bihar feeds criminal activities and caste politics as a desperate defence mechanism. Economic progress in Bihar has already led to significant decline in the atmosphere of terror and fear prevalent earlier. Not to provide any mental comfort about rate of suicides, but it is comforting to realise that causal factors underlying suicides are a lot universal.

"Why are these people now less likely to take their own lives? Urbanisation and greater freedom have helped. Accounts of those who attempt suicide, and of the relatives of those who succeed, suggest that many young Asian women were driven to despair by violent husbands and overbearing in-laws. As people move to cities and the grip of tradition loosens, women have more choice about whom they marry or live with, making life more bearable. Leaving the village helps in another way, too. Because farming involves killing things, rural folk are likelier to have the means to kill themselves—guns, pesticides—to hand.

Social stability is also a factor. In the turbulence that followed the collapse of the Soviet Union, many middle-aged people saw their sources of income and status collapse. Unemployed people kill themselves at around two-and-a-half times the rate of those in work. The financial crash of 2007-08 and the resulting recessions are reckoned to have caused an extra 10,000 or so suicides in America and western Europe. As crises recede and employment rises, so suicide tends to ebb. And falling poverty rates among the old, which have declined faster than among other groups globally, are reckoned to have contributed to the drop in the number of elderly suicides.

But the decline is not just the consequence of big social trends. Policy plays a role, too. When Mikhail Gorbachev restricted the production and distribution of booze in the mid-1980s, both drinking and suicide fell sharply. The collapse of the Soviet Union swept those regulations aside, and both drinking and suicide shot up again. Restrictions introduced by Vladimir Putin in 2005 are reckoned to have contributed to the recent decline." - The Economist, Staying Alive, Nov 27-30, 2018

Despite Covid 19, rate of suicide in India remains at a moderate level compared to global standards. A lot more needs to be improved in the Country, beginning with a much more conducive environment for business.

<u>Not in Panchayati Raj, but in commerce lies the engine of growth for the rural India</u>

"A society based on trade, where people are insuring against risks thus, has a strong incentive to invest in human capital which helps trading — this includes literacy, numeracy and contract writing. It has a second incentive to invest in institutions which facilitate trade, like commercial and property registers, police to enforce agreements and courts to adjudicate disputes. Its third incentive is to control these very sources of official power — because people here invested in literacy, numeracy and the sophistication of negotiating and writing contracts, they could write rules to constrain government itself. It's no accident that England and the US evolved based on a rule of law, literate and numerate societies and governments with limited authority and discretion." - Stephen H. Haber, The Economic Times, April 13, 2023

Our four 'Moments' resonate with the above thoughts of Dr. Haber. Over the last three decades, economic and commercial eco – system in India has become more rule – based. Of course, in order to enhance its appropriateness and sophistication for a modern economy we aspire to be, we need further fine-tuning of rules and regulations in light of recent experiences. Our Ram Rajya has to be a futuristic one, not rooted in one of the yester years like Panchayati Raj, being mentioned in the media in recent times as a panacea for grass -root governance in India.

"First, as Ambedkar argued, there is an absence of fraternity at all levels of Indian society. People of an Indian village or town do not have a shared sense of civic community. There is, instead, an intense inter-group competition for resources, status, power and opportunities. Politics is primarily devoted to pursuing and managing this competition and, as a consequence, is poorly equipped to manage common resources or delivering quality public services. Can panchayati raj create the fraternity that is essential to its success? The empirical evidence suggests it does not: on the contrary, to the extent that caste and community identities are poles around which political mobilization takes place, it has perhaps created the opposite. Second, the claim that local politics will lead to better governance must contend with the reality that Indian voters do not connect their electoral decisions with the delivery of better public services or economic development. The number of politicians who have been re-elected based on their track record of improving law-and-order, building infrastructure and raising growth is small. Populism, corruption, caste and communal mobilization are far more effective in winning elections at the state and national levels. Why should it be any different at panchayats or municipalities? After all, it's the same electorates. Third, people don't expect panchayati raj institutions to be accountable because the link between paying them direct taxes and receiving public services is weak.

As Arvind Subramanian told me, "The closer the government is to the people, the more unwilling it is to raise taxes." The downside is that broadening the tax base is tantamount to narrowing the electoral base. Why would panchayati raj be more accountable for its governance responsibilities?

Finally, the lack of a republican consciousness among our citizens cannot be ignored. Democratic institutions are about role-playing: mayors, officials and magistrates are not exemplary individuals parachuted from another planet. They are ordinary citizens given constitutionally ring-fenced roles to play. It is not that we are incapable of playing these roles, but rather, nobody spends any effort educating citizens on their roles and responsibilities. Civic education is woefully short of demographic growth." – Nitin Pai, Mint, March 13, 2023

It looks like that nostalgia-based devolution of power and funds to local self – government has led to enhanced political power – sharing at the grass – root level in India. Absence of social fraternity type of idealism has often resulted in poor selection of Panchayati Raj leaders, interested more in personal benefits, even at the cost of electorate.

Why is this important for our investment portfolios?

In recent years, DBT has resulted in significant reduction in leakage in case of various social welfare schemes, especially the ones administered through Panchayati Raj grass – root functionaries. Before DBT became effective, a good part of the leaked money used to be utilised for purchase of SUVs and 2 – wheelers in the rural India. Recent decline in sales of these vehicles may partly be attributed to better administration of benefit transfers, despite many of Panchayati Raj functionaries continuing their old way.

“Criminals are always in favour of shrinking government-particularly the part that polices them and will of course take advantage of opportunities to pass themselves off as part of a crowd interested in efficiency.” - George A. Akerlof, Paul M. Romer, The Economic Underworld of Bankruptcy for Profit, 1993

We believe that in due course, economic and educational progress in the rural India will help Panchayati Raj institutions to become a lot more effective. That could be our their fifth “Moment.” We believe in rule – based society, not in diminution in the role of governance. We in Chanakya are hopeful about significant improvement, in the long-term, in quality of regulatory enforcement in India. What we aspire for is precision in design of regulations.

A decadal high for the Finance and Banking Sector, FBS, in India

"Depressions uncover what the accountants miss and that looting-type behavior was widespread but not discovered until the depression in real estate.

In the nineteenth century, Eichengreen added, government guarantees of railroad bonds led to sweetheart deals between promoters of railroads and construction companies in Canada, India, Australia, and Africa, which were probably responsible for the widespread failures of railroad enterprises. Fewer failures occurred in the United States, where bond guarantees were less prevalent.” - George A. Akerlof, Paul M. Romer, The Economic Underworld of Bankruptcy for Profit, 1993

Aren’t depressions wonderful tools for revealing uncomfortable truths! We have seen our four “Moments” emerging out of depressions and ultimately catalysing a significant re – engineering of the India regulatory infrastructure. In a recent series of webinar held by CRISIL, one came across a well – researched catalogue of current state of things in case of select sectors in India.

Crisil Webinar on the Capital Goods Sector, March 23, 2023.

- *India is a competitive market from cost angle. Technology is not a headwind.*
- *PLI: Indian companies struggle in case of a proven track – record.*
- *Unless full value chain gets established, finished goods and branded goods will take time to attain significant competitiveness.”*

The good news is that India is finally getting its act together in case of manufacturing.

CRISIL Webinar on the Hospital Sector:

Pandemic led to flight to quality. The recent Universal Health Care schemes of the government, especially the National Healthcare Mission of India, have done a lot on the demand – side, not on the supply – side. This requires creation of a lot of health, infrastructure, education and modernisation of healthcare facilities in India. Obviously, this also indicates significant investment opportunities for business in the future.

- New Developments: Tele – Medicine
Robotics surgery
Digitisation of health care records

National Healthcare Mission of India
AI and machine learning – CRISIL Webinar On Hospital Sector, March 09, 2023

We think that over two decades of reasonably high rate of growth of GDP, along with many improvements in governance, including our four "Moments", have enabled India to attain food security at the grass – root level, a necessary condition for more progressive social initiatives like the ongoing healthcare measures. Digital lockers and digital health records can add a lot to cost and quality of living in India. It has now become feasible due to grass – root health assistance system for the masses of India, getting in – place.

"PM Jan Arogya Yojana has become a support system for the poor helping them save Rs. 80,000 crores....the Jan Aushadhi Kendras helped the middle class save Rs. 20,000 crores," Modi said speaking at an event in Guwahati.

PM-JAY was launched in September 2018 and the scheme covers 107 million poor and vulnerable families covering the bottom 40% population of the country. These families were identified based on select deprivation and occupational criteria in rural and urban areas respectively as per the socio –economic caste census (SECC) 2011." – Financial Express, April 14, 2023

CRISIL – Rating Outlook Webinar, April 06, 2023

Finance and banking sector helps to allocate resources of the society. Strength of FBS is a lot determined by the character of the underlying economy, and also the other way around to an extent. In the above Webinar, CRISIL made select meaningful observations about FBS in India.

- "Gross NPAs have come down to 3.8% and are currently at decadal low.
- MSMEs lack bargaining power, leading to rating downgrade overall.
- Have seen continued deleveraging over the last few years

A lot of credit for improved robustness in performance of leading banks and NBFCs in India ought to be given to the regulator, RBI. A recent article by Tamal Bandyopadhyay brings it out quite lucidly.

"Believe it or not, the regulator is even stretching its arm to identify stressed borrowers and gauge the distance to default" as a measure of a particular bank's fragility.

The Reserve Bank of India (RBI), over the past few years, has goaded them to shift to the system of automated recognition of bad loans in contrast to a manually-driven process. This helped reduce the divergence between the bad loan figures reported by a bank and the RBI's assessment. Financial reports are more credible now. Today, a bank can intervene only selectively, and that too under the eyes of the board's audit committee. It was not easy to convince the banks. The RBI had to slap penalties of hundreds of crores of rupees on a few banks. This "penalty" is not in the public domain as it was handed out in the form of higher provisioning. And, believe it or not, the regulator is even stretching its arm to identify the stressed borrowers and gauge the so-called "distance to default" as a measure of a particular bank's fragility. It has also made a beginning in tapping market intelligence properly. Until recently, the RBI's market intelligence was limited to keeping paper clippings and reading the banks' regulatory filings. Now, it keeps close tabs on social media, news services, and regional media, besides interacting with rating *agencies and analysing brokerage reports. It's a sort of sentiment index designed to ring alarm bells. The other part of the story is that the RBI itself is changing. It is learning how to use data. Until recently, the offsite monitoring mechanism was using only 20 per cent of the available data. Now, the RBI is going deeper and creating a dashboard.*

The prime focus of supervision now is onsite, being supplemented by offsite data. The plan seems to be reversing this — offsite analysis combined with onsite validation.

This is why the RBI is not only keeping close tabs on the banks but also on the health of their borrowers. Risk management, risk pricing, audit and compliance — all are in the regulator's surveillance parameters.

It is taking the assurance functions in banks seriously — for creating value for a financial institution, strengthening public confidence, preserving and enhancing its reputation, and maintaining the integrity of its business and management.

In the banking industry, the regulator is the fifth in the line of defence — after business, risk and compliance, internal audit and central/statutory audit. But the new RBI doesn't want to wait till the end to do post-mortems. It will never be the first line of defence, but it wants to be proactive to ensure financial sector stability.

If the "movement" succeeds, investors will be able to take the banks' balance sheets at face value and the *regulator as well as the regulated entities can have a good night's sleep. "*- Tamal Bandyopadhyay, Business Standard, March 12, 2023

In recent years, we think that India has managed its financial economy with care even while hand – holding the weaker section of the society. This indeed has enabled India to avoid some of the serious economic imbalances being currently seen in case of many developed economies. A recent article in the Financial Times was insightful in this respect.

Global savings glut is more ephemeral than we think!

"The world's "savings glut" is ephemeral. The amounts available are lower than assumed. Savings are represented by assets — cash, bank deposits, debt securities, shares, real estate, collectibles — or their derivatives. The amount available for exchange into real goods and services depends on the realisable value of the asset and the cash income from it. Over time, interest coupons and dividend yields have decreased. The shift away from income reflects low rates, the concessional taxation of capital gains, the ability to defer tax, businesses that do not produce distributable earnings or cash flow, and low earnings on cash discouraging monetary distribution unless needed. This means much of the world's savings — estimated at more than $500tn — are unrealised "paper" capital gains.

This scenario may force holders — reluctant to sell and lose price upside — to borrow against the value of an asset to generate cash flow. Where income is below loan servicing costs, this may set off a cycle of rising borrowings over time, creating significant economic and financial risks. The lack of cash flows and reliance on unrealised capital gains means it is unclear how much money is actually available for consumption and investment. In an exaggerated wealth effect, spending becomes increasingly linked to asset value movements. The lack of income and available cash flow increases debt. This exposes owners to fluctuations in asset values.

The uncertain value of saving limits policy options with central banks needing to support asset values that act as collateral for loans to avoid financial stability risks. The lack of income affects tax revenues that require realisation events. Recent US proposals to tax share buybacks and unrealised gains are responses to this problem. In Martin Scorsese's Mafioso films, the boss traditionally keeps the proceeds of crimes safe for his "wise guys". If anyone asks for their share, he kills them. No one can ever access their money. As the unwinding of the "everything bubble" illustrates, the accumulated wealth of the world may be similarly illusory with savings rendered incapable of realisation at their paper value." – Satyajit Das, Financial Times, April 13, 2023

Mr. Das provides a plausible explanation for the above mentioned problems in some of the western nations. It needs to be noticed that the Indian economy is not having this same set of stress. Of course, India has other stresses of its own making!

We believe that, in the long-term, pace of the Indian economy will be determined largely by Indian innovativeness, societal upgradation and quality of governance. In some way, fate of the steel industry of a nation mirrors these aspects.

The Indian Steel Industry – taking its place under the Sun

India is now the second largest producer of iron and steel in the world. Availability of low-cost and good quality iron ores is a major advantage India has. Over the last decade, enhancement in size and upgradation of technology of Indian steel plants have significantly enhanced competitiveness of the Indian steel sector. That's why we have chosen to invest around 4–5% of your investment portfolios in Indian steel and related businesses in India. We are not discussing the specific investee companies here. We have done our homework for these investments. In our future newsletters, we would be sharing our thoughts on select business sectors in India, much less about specific investee companies.

Portfolio Composition and Risk

In our portfolios, top 10 stocks accounted for 57% of the total investment. The overall sectoral break-up of our investment portfolio is given in Table 1.

Table 1: Chanakya PMS – Portfolio Sectoral Allocation as on May 2, 2023

Sector	**% of overall portfolio**
Banks & NBFCs	40
Consumer goods	3
Auto & Auto components	3
Industrials	5
Metals	5
Logistics	3
Others	25
Holding companies	16

Compared to sectoral allocation at the end of Jan. 31, 2023, percentage invested in banks, and NBFCs has increased by 3%. Percentage invested in holding companies has increased by 2%. 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 the Chanakya PMS compared to select indices

Over the last financial year the overall performance of our investments portfolios is given below in Table 2.

Table 2: Chanakya PMS – Investment Performance as on March 31, 2023

Sector	% of overall portfolio
Banks & NBFCs	40
Consumer goods	3
Auto & Auto components	3
Industrials	5
Metals	5
Logistics	3
Others	26
Holding companies	15
Bajaj Holding	13.11

Source: HDFC Bank Fund Accounting

Over the last four years and nine months, overall performance of our investment portfolios is given in Table 3.

Table 3: Chanakya PMS – Investment Performance as on May 11, 2023

Period	Portfolio %	Nifty 50 TRI %
1 Month	6.66%	3.39%
3 Months	3.37%	2.68%
6 Months	3.44%	-0.05%
1 Year	27.45%	14.64%
2 Years	17.91%	12.37%
3 Years	38.54%	27.04%
Since Inception 13.08.2018	12.59%	11.70%

Source: HDFC Bank Fund Accounting

It took three years and 10 months' time for performance numbers of our overall investment portfolio to consistently outperform major market indices in India. This is an outcome of our investment theme and process getting sharper over time.

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 has been intensely followed up by us for more than five years.

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.

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

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