Sept 13, 2023

Dear Investor,

In this newsletter, we discuss select interesting complexities of the interface between the Indian caste system and Indian business, crazy as much it may sound! We also explore folds of demographic dividend of India for the clarity it adds to our world view. In this newsletter, we focus on the steel business in India, in contrast to that in China.

Did you realise that now we have been managing money for you for over five years!

"So, is it about electronics or system integration?

It is about knowledge. Actually, here people are there who are ISO certified; means in the process of safety. Means, defining what standards should be there, how should we iterate on them. Our people are already on-board there. So, we are in knowledge business. All better knowledge is with us. Right now also, two-three people who have already left the organization. They came and told me right now that our things are very much better than the other people because we have good knowledge. Knowledge is selling. We are selling knowledge." – Hemant Kaulgekar, Regional Manager, PILZ India, Aug 25, 2023

We came across Mr. Kaulgekar recently in an industry exhibition in Bombay. The above statement, from a middle manager of a MNC engineering company operating in India, came as a pleasant surprise to us. Time and again, we have been seeing knowledge and service as the mantra in case of each one of your investee engineering companies.

Of course, we in Chanakya PMS have a very big bias in favour of knowledge – oriented businesses, especially leading Indian financial institutions. However, due to inadequate margin of safety as per our internal estimates, IT, Pharma, speciality chemicals, and media companies are hardly there in your investment portfolios. Cost – arbitrage, rather than innovative use of knowledge, characterises many of the Indian companies in these sectors. For such companies, size becomes important in order to have the advantage of cost-arbitrage. Listed media companies in India somehow keep us unsure of their institutional aspects. Every business is now becoming a knowledge business. True innovation requires creative use of maths and science beyond cost-arbitrage. We keep on studying long – term prospects and estimate future cash flows of select companies in these businesses. Hopefully, some of these companies would be in your investment portfolios at a right price, at some point of time.

Silence of the Market

"Thanks GOODNESS for the enthusiasts and the obsessives. If everyone always took a balanced view of everything, nothing would ever get done. But when campaigners' worldview seeps into the staid apparatus of policymaking and global forums, bad decisions tend to follow." – The Economist, July 1-7, 2023

At present in India, sophisticated products and services cater to a very small elite set of consumers. In contrast, in recent years percentage of consumers of similar products and services has been much larger in developed markets and even China. In our field investigations, and scan of advertisements in media in India, we keep on getting baffled by the extent of mis – information about many products and services. These are more prevalent in case of sectors like education, healthcare and financial services – the most vital for the progress of India. This mis – selling adds considerably to the level of risk for the Indian families. While regulators like RBI and SEBI have done a commendable job of improving transparency in the financial services, absence of a strong consumer movement has allowed coaching institutes in Kota get away with despair and even suicides among their students. Only just now, a politician in Rajasthan spoke about it.

"Kota institutes highlight their toppers, but don't say how many students they have… This is fraud'- Rajasthan Higher Education Minister." - Indian Express, Sep 05, 2023

While social media has helped to enhance salience of the Indian consumers, considerably, it still might not be helping its listeners as much in term of reliability of information. In case of a range of beauty products, social media has enabled new set of focused marketers to provide new offerings. However, credibility of claims made by many of such marketers lacks a verifiable track – record. Hopefully, consumers will become more discerning with experience and increases in higher disposable income. That would hopefully lead to a better-quality market in India for consumer products.

"Content on social media — which is an important but still relatively small part of the way people get news and information is very different. You don't have gate-keepers here. This world is much closer to gossip. Anyone can broadcast messages which are consumed as disembodied bits of content where people aren't very aware of the source and there isn't the same drive to build trust with readers over time. That dials up incentives to produce content which gives clicks or short-term engagement and lowers the incentives to care about whether that material gives people value in a longer run sense."-, Srijana Mitra Das, The Times of India, Aug 03, 2023

The Indian markets may be high – decibel, but quite often fall short of needs of its consumers. Many product that markets in India suffer from low quality of competition. Consequently, the voice of Indian consumers gets subdued in such instances. India needs to spawn an industrial cultures throughout the nation as a part of the necessary solution.

Looking around we find that organised businesses, not fragmented manufacturing units, bring industrial culture to towns in India. A large number of small powerlooms didn't considerably upgrade industrial culture in Bhiwandi. But even a HEC, closed now, did raise level of industrial conscience in Ranchi.

Sustained GDP growth and better use of technology, including AI, would help accelerate the process of enhancement in demand for quality goods and services in India. Hopefully, it would also facilitate emergence of a strong consumer movement in India.

Caste and Politics in India - A Market Perspective

"Today, in the parlance of our elites, expressions like caste, casteist, and casteism are derogatory and deemed to have a flavor of wicked primitivism associated with them." – Jaithirth Rao, Print, Aug 21, 2023

Jerry Rao, ex – CEO of Citibank India and a promoter of Mphasis, is known to be thoughtful as a business person, and also as a thinker of societal issues. In a recent insightful article, Jerry has made this thought provoking observation. In this article in Print, Jerry quoted some micro – economic facts from a recent book by Professor R.Vaidyanathan.

"Did you know that the bulk of the electrical appliance stores in Bangalore are run by Mewaris (Yes, Mewaris, not Marwaris) and that the "helpers and assistants" they employ and who tend to be from Mewar, frequently go on to set up their own businesses? Clearly, the Mewari network out here appears to be superior to business schools in training entrepreneurs.

The Dravidian political parties talk of being against caste and yet, two of the most successful and fascinating caste clusters are the Gounders of Tiruppur, who are today a global force in the manufacture and supply of knitted garments and the Nadars of Sivakasi, who dominate the national market for match boxes. Many thriving centers of economic activity in India — Surat for diamonds, Namakkal for truck-building and borewell services, Rajkot for engineering, Jamnagar for brassware and Agra for footwear have caste networks as their foundation. Incidentally, all these centers have been founded by persons without much formal education and have grown without the active presence of MBAs. Perhaps they have grown precisely because of the paucity of MBAs. Incidentally, these entrepreneurs almost always belong to castes which were in earlier times associated mainly with farming. The vertical social mobility that prevails is astonishing. In the truck business it is not unusual for drivers and cleaners to become business owners; it is also quite common for diamond polishers to become big traders.

Did you know that the kite-making business in Gujarat, which had a top-line of 35 crores rupees in 2001-02 is now up there at 800 crore rupees? The state government's active promotion of the Uttarayan festival has been a critical factor in its growth. Did you know that Muslims are involved as entrepreneurs and workers and 70 percent of these workers are Muslim women?

Did you know that most of the plumbers in our metro cities belong to OBC castes from Kendrapara District in Odisha? And plumbers operate not just as workers, but as entrepreneurs in their own right! The far-sighted government of Odisha (Surprise, surprise! Some state governments are on the ball) has started a State Institute of Plumbing Technology in Kendrapara.

Did you know that the microscopic Chinese minority (another Caste, I guess) pioneered the Beauty Parlor business in the country and today this business and the related spa business is dominated by Northeasterners, especially Khasis from Meghalaya? " – R. Vaidyanathan, Caste as Social Capital, the Complex Place of Caste in Indian Society, Peguine

Interestingly, as per the recent report, Tamil Nadu employs around 50% of women in India working in the manufacturing sector. Karnataka employs the second highest number of women in manufacturing in India. There is a metamorphosis seen at the level of women workers in manufacturing in there two states.

"Tamil Nadu has the highest number of working women in India. At 7.08 lakh, the state is home to nearly half of India's 15.93 lakh working women, as per the Annual Survey of Industries (2017-18). This is three times higher than Karnataka, which ranks second on the list. TN has the highest number of direct women employees in manufacturing, particularly in textile and footwear industries, says statistics of Guidance Tamil Nadu."- Nandini Sen Gupta and Sindhu Hariharan, Times of India, July 04, 2022.

Tamil Nadu, and to a lesser extent, Karnataka, have been harnessing skilled women in manufacturing. Enabling factors like a large manufacturing – based job opportunities and skill upgradation eco-system has led to this phenomenon. We also note men plumbers from Kendrapara in Odisha, being the dominant Plumber – entrepreneurs in the Indian metros and Muslim women dominating a near Rs. 1000 crores business in Gujarat! Drivers and cleaners are becoming truck – owners! Women from the North Eastern states are being are leading beauty parlour entrepreneurs in India! Diamond polishers are becoming diamond traders! While job opportunities remain largely localised in case of manufacturing, in case of the services business opportunities are becoming increasingly available at a pan- India level. Don't these evolutions characterise emergence of a modern Indian society and business eco-– system? We would like to view this development as sub – stream of the "Market Moment."

Demographic Dividend in India – More Than a Story

"Because people's economic behavior varies at different stages of life, changes in a country's age structure can have significant effects on its economic performance.

Nations undergoing this transition have an opportunity to capitalize on the demographic dividend offered by the maturing of formerly young populations. The demographic dividend is not, however, automatic. Given the right kind of policy environment, this demographic dividend can help to produce a sustained period of economic growth, as it did in several East Asian economies. The critical policy areas include

- *Public health*
- *Family planning*
- *Education*
- *Economic policies that promote labor-market flexibility, openness to trade, and savings.*

However, this demographic dividend is not inevitable. It has to be earned. Without the right policy environment, countries will be too slow to adapt to their changing age structure and, at best, will miss an opportunity to secure high growth." - "Bloom, D.E., Canning, D., and Sevilla, J. Economic Growth and the demographic transition, NBER working paper W8685, 2001

We often hear in the media that India has been wasting its demographic dividend. The detractors paint a gloomy picture on the following lines:

India is not able to capitalise the potential of its demographic dividend due to:
1. Fall in labour participation rate in India in recent years
2. Inability to move the rural population into decision productivity non – rural jobs
3. Inadequate skill training and upgradation programmes
4. Slow pace of expansion of manufacturing

However, proponent of the above logic usually don't check empirical facts at two levels:
A. Experiences of other nations at a similar juncture
B. The fact that demographics should be looked in a near-term, mid-term and long– term basis, a view very well articulated by Dr. Amlan Roy, my IIMA Batchmate, and now a seasoned demographic economist. We will discuss this more in the future newsletter.

The Numbers of: (i) women working in manufacturing in Tamil Nadu, (ii) IT professionals in India, and (iii) new category of skilled workers and entrepreneurs mentioned by Mr. Vaidyanathan reflect that India actually is a beneficiary of the demographic dividend, though much more ought to be accomplished by means of appropriate designs. This requires significant scaling up of societal as well as physical infrastructure in India. It will help in qualitative upgradation of mindset, of Indian people and organisations. This, in– turn, will refine institutional and social behaviour.

Role of demographic dividend in the economic progress of a nation becomes visible more in case a nation attains sustained and high GDP growth rate per capita. Over very long-term consequently high level of disposable income and wealth in the hands of middle-aged and older people, who can afford and demand, sophisticated products and services, help a nation to climb multiple orbits of prosperity. Western nations, Japan, Far Eastern Asian countries and recently China are as the living example of this.

At 1.9, current Gross Fertility Rate GFR in India has already come below the sustainable GFR 2.1 p.a.

Consequently, upgradation of social infrastructure becomes vital for India now. One of the crucial enablers for all this is improvement in the power sector – physical, as well as behavioural.

Behavioural Upgradation of the Indian Electricity Sector

"Resilience is one of the core strands that comes out of our work: the resilience of your military, the resilience of your industrial base, but fundamentally the resilience of your society." – The Economist, 03 July 2023, Pg.12

We agree that only a resilient society can have a robust industrial base. We think that recent regulatory initiatives in case of the Indian power sector are an outcome of the new resilience of the Indian society.

"Power generating companies (gencos) recovered half of their legacy dues from distribution companies since the implementation of late payment surcharge (LPS) rules in June last year. The dues came down from Rs 1,20,540 crore in June 2022 to Rs 61,025 crore in July 2023, according to PRAAPTI portal.

There has been a strong recovery of outstanding dues of power suppliers including generating and transmission companies from discoms after the Electricity (LPS and related matters) Rules, 2022 were enforced last year," said an official of the power ministry.

The total legacy dues, comprising dues of gencos, transmission companies (transcos) and traders, which stood at Rs 1,39,747 crore in early June 2022, fell to Rs 69,957 crore by end of July 2023 after payment for 12 equal monthly installments (EMI).

The aggregate technical and commercial (AT&C) losses of discoms, which was 22.32% in FY21, fell to 13.5% in FY23. Besides, the gap between average cost of supply (ACS) and average revenue realized (ARR) has reduced from Rs 0.54 per kWh in FY15 to Rs 0.15 per kWh in FY22. "Reforms have been brought in with legal backing and there is strict implementation. Financial health of discoms have improved. Apart from clearing legacy dues, they are also clearing their current dues in time to avoid regulations," the official said, adding that even the states are clearing their dues to discoms for the subsidies." – Manish Gupta, Financial Express, August 7, 2023

We don't think any of us would have realistically expected reduction in ARR from Rs.0.54 per KWH in FY 15 to Rs.0.15 per KWH in FY 22! This represents the behavioural upgradation of the Indian electricity sector. Much more than that, this helps India to enhance accomplishing various possibilities, including arising from the demographic dividend. This also creates an enabling environment for increasing more number of Indians to move to the beneficial site of demographic dividend.

The Steel Sector: China vs. India

Your investment in steel and related stocks has yielded good return, and enhanced our comfort with our investment process. This smokestack set of business has been out of favour in the media and markets. Steel has been a highly volatile business in terms of demand, price realisation and profitability. At the same time, no nation ever attained prosperity without consuming a lot of steel. We know that India has to consume a lot of steel over many decades to come. We have mentioned in quite a few of our newsletters about why we chose to invest in steel and related stocks.

A comparison of sector – wise steel consumption in China and India in recent years, given in Table 1 below, is quite revealing.

Table 1: Sector-wise Steel Consumption

Year	China Steel Consumption (in Mn. Tonnes)	India Steel Consumption (in Mn. Tonnes)
2017	774	84
2018	835	90.7
2019	912	97.5
2020	995	100.2
2021	1025	94.9
2022	1035	105.8

Sector	% Consumption (China)	% Consumption (India)
Construction	53.5	43
Machinery/Engineering & Packaging	22.6	22
Automobile	5.7	9
Infrastructure		25
Energy	4.5	
Home Appliance	1.4	
Ship Building	1.4	
Others	10.9	1

Source: Steel Mint

China, which is the largest steel producing country in the world, consumed around 1,025 mn tonne of steel in the calendar year 2021, as per the World Steel Association (Worldsteel). A look at the country's sector-wise steel usage reveals that china's construction sector has been biggest user of steel, accounting for a 53.50% of steel consumption equivalent of a mind-boggling 535 million tonnes of steel!

India consumed only one– tenth as much steel as consumed by China! Our long-term annual demand forecast for consumption of steel in India doesn't indicate even one–fourth of the steel consumption by China recently. We believe that this scale of consumption of steel by China may not be sustainable in the long – term. We would like to believe that the Indian steel business would face a significantly lower level of volatility in imported input costs as well as sales realisation in the long – term. How much, when and at what pace – we will keep on analysing for you.

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 2.

Table 2: Chanakya PMS – Portfolio Sectoral Allocation as on August 31, 2023

Sector	% of overall portfolio
Banks & NBFCs	46%
Holding Companies	15%
Auto & Auto components	7%
Metals & Minerals	7%
Industrials	6%
Consumer Goods	2%
Logistics	2%
Others	14%

Source: HDFC Bank Fund Accounting

Compared to sectoral allocation at the end of May 12, 2023, percentage invested in banks and NBFCs has increased by 6%. Percentage invested in holding companies and metals has dereased by 1% and 2%, respectively. Percent invested in auto and auto components has gone up by 4%. 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 Benchmark

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

Table 3: Chanakya PMS – Investment Performance as on August 31, 2023

Period	Portfolio %	Nifty 50 TRI %
1 Month	0.73%	-2.30%
3 Months	13.37%	4.38%
6 Months	23.29%	12.14%
1 Year	29.12%	9.53%
2 Years	18.91%	7.32%
3 Years	32.59%	20.60%
4 Years	22.83%	16.30%
5 Years	14.48%	11.84%
Since Inception 13.08.2018	15.23%	12.22%

Source: HDFC Bank Fund Accounting

Chanakya PMS invests money for decades. We find absolute joy in ensuring fulfilment of aspirations of our investors, and their needs relating to health care, post – retirement expenses, children's education, foreign travel and overall maximisation of wealth. For this, we aspire to be the most knowledgeable about our investee companies. For us, the mind of management and margin of safety matter, nothing else really.

On August 12, 2023, we completed full five years of our operations as PMS. Our sincere and heart – felt gratitude to you, our investors and our enablers! Without your trust in us, we wouldn't have reached here and accomplished performance milestones mentioned above.

Many veterans of the stock – market earlier told us that a minimum five years of track – record is needed for credibility. We believe that our past five years are just the beginning of our discovery of the new times, new knowledge and money – making opportunities for you.

The last five years helped us to refine our choice of investee companies. We are not going to look at any management we are not absolutely comfortable with, irrespective of upside potential return. We are now very sure of our DCF valuation process and margin of safety investment criterion. Maths doesn't mislead.

We do regret not investing more in our turn – around stocks. We went deep in case of these companies. You allowed us to wait for five years for visibility of turn-around. The likes of CG Power and South Indian Bank have added conviction in our investment process.

There never are low hanging fruits in the investment business. Understanding mind of the management, risk in business and organisation, intensity of knowledge and service element in case of a specific company are the factors we analyse while trying to make money for you.

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

Consciously, we have chosen to invest in shares of selected 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 45–70% 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 your investment portfolios.

With Best Regards,

Rajesh Tiwari, Gautami Desai and Team Chanakya

Disclaimer: