Metis India Opportunity Fund

Stocks continue their re-alignment from disconnected valuations

October 2018 Newsletter

Oct 31, 2018

As we write this, there is a distinct feeling on the street that we are on the middle of an 'indiscriminate selling' and that it's apparently overdone. As is often the case, the street was largely mum last year when the 'buying was decidedly 'indiscriminate and overdone'. Street (then) was consumed with potential goldilocks of margins expanding further on historically high bases, growth accelerating despite a muted jobs market, and continued depressed material costs. Predictably, the re-adjustment to reality has been hard, as it should have been. As always, despite the long-only orientation, your managers distinguish themselves during such periods.

In 3Q18, *Metis Opportunity* was down **-10.4%** (in USD), vs **-3.2%**, **-5.6%**, **-9.1%**, **-14.5%**, and **-3.9%** declines in *Nifty TR*[1], *BSE 500 TR, BSE Midcap TR*, *BSE Smallcap TR*, and *Eurekahedge India* respectively.

Over trailing 12 months, *Metis Opportunity* was down **-17.3%** (in USD). That compares with **+1.9%** gain in *Nifty TR*, and **-3.2%**, **-12.6%**, **-9.9%**, and **-2.7%** declines in *BSE 500 TR, BSE Smallcap TR*, *BSE Midcap TR* and *Eurekahedge India* respectively. Over this period, our volatility was **282 bps** and **652 bps** below that of *BSE Midcap TR* and *BSE Smallcap TR* and **862 bps** ahead of *Eurekahedge India*.

Over the past 3 years, *Metis Opportunity* is up **+7.3%** (in USD) vs. **+29.6%**, **+29.5%**, **+32.8%**, **+30.7%**, and **+24.5%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respectively. Since inception in April 2011, *Metis Opportunity* is up **+81.2%** (in USD) vs. **+42.8%**, **+48.0%**, **+61.9%**, **+34.2%**, and **+34.3%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respectively.

Decade long multiple expansion cycle coming to an end. While earnings-stock disconnects have partly unraveled, it's critical to appreciate that we have just come off of a decade long cycle of multiple expansion. Midcaps were already trading north of 20x earnings at the end of FY08 (Mar) on a solid earnings base, which certainly can't be argued as patently cheap to begin with. Over the next decade, multiples continued to expand further with stocks sharply disconnecting from underlying earnings over FY14-FY18 (see **Exhibits 1a** and **1b**). Typically, our best periods are during market drawdowns and post draw-down catch-ups. Given the large underlying earnings-valuation disconnects, we expect to deliver material alpha vs. the broader markets over the next 2-4 years.

Exhibit 1a – Extended midcap multiple expansion cycle….

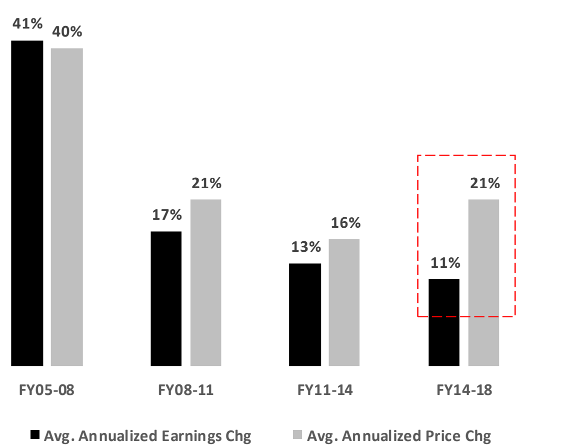
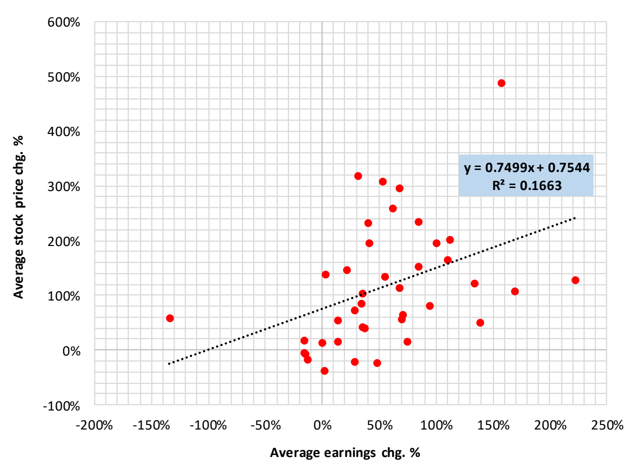


Exhibit 1b - ……was aided by sharp disconnects over FY14-FY18



Source: Company Reports
Note: Above data is for current constituents of Nifty Midcap 50 (ex-financials)

[1] 'Total Return' indices are used for comparison

We increased our allocation to our biggest position; we see potentially lumpy but highly likely substantial value capture over next 3 years at this paper holding. Lockout announced by few contractual workers[2] in August led to a 9-day shutout at our paper holding's flagship plant in Eastern India. We utilized declines over this period to further add on to this position.

Importantly, this paper holding of ours acquired a Telangana based paper facility off of NCLT proceedings. As things stand, we expect the acquired facility to hit full capacity within 3 years of commencement. Our holding would spend little over INR 4 Bil to restructure the operations of this facility[3] – this would happen over a 3-yr period, with the first phase of 6-8 months absorbing about 3/4th of the restructuring budget. The second phase (executed over 8-9 quarters) would involve raising cogeneration of power from 60% currently to 100% of requirement. Overall, these acquired ops have every shot of reaching high-teens EBITDA margin within 3 years.

We conservatively value the overall current business at INR 300/share and the acquired facility in the INR 20-25/share range. Separately, we estimate that the value of planned packaging board expansion (150K tons and pulping facility of 140K tons; likely start in C2021) at between 60-80/share. We note that over the next 3-4 years, another 300K tons of packaging board capacity would come into market. This includes ~200K tons from *Emami*[4] in Gujarat (likely to begin in late F2021) and about another 100K tons from *ITC*. Incrementally (also not priced) is our estimate of another 1.5-2% margin expansion as sourcing radius reduces further over the next 2-3 years (from current 2/3rd being sourced from <200 km to ~80% sourced from <200 km).

We estimate that in the very near-term, there might be a slight drag on margins because of the lag in pass-through of material INR depreciation[5]. Given the supply environment however (industry-wide, packaging board utilization is running in the 85-90% range), they are in a comfortable position to pass through most of the impact. We note that F2019E (Mar) YTD, they have already raised board pricing by nearly 8%.

Excluding the acquired entity, we expect at-least low-teens revenue growth for F2019E (Mar), and at least high-teens/low-20s EBITDA growth. Given that annual debt-paydown of at least INR 3 Bil is a near certainty, we conservatively expect this holding (excluding the acquired entity) to report earnings growth at least in the mid-20s. We also expect the acquired ops to get earnings accretive in about 2 years.

We also increased exposure in an auto parts name. Our investment in this name has suffered previously as their LED Luminaires business got hurt as EESL tenders got bid on aggressively towards end of C2016. With cash earnings drag having coming to an end and only depreciation optically dragging headline earnings, our most conservative valuation on the name suggested no less than 70% upside in early September. We have gradually increased this exposure to ~5% of the book. While there is typically a 2 quarter lag in escalating material inflation, we note limited scale elsewhere in this part sub-category for material costs to be a sustainable headwind. With several potential catalysts on the horizon (1. LED Luminaires capacity could be utilized for retail LED sales by leveraging existing warehouses across 10 states; 2. Assuming full conversion to LEDs, lighting content per vehicle can nearly double to INR 1.4-1.5K per vehicle from just over 0.8K per vehicle currently; and 3. Increasing traction in after-market within a category that practically call their own), our conviction on this exposure has grown meaningfully in recent times.

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[2] About 2/3rd of the plant's workers are contractual.

[3] The deal was closed for INR 3.7 Bil, of which 45% was in cash (INR 340 Mil paid to operational creditors and INR 1.4 Bil paid to financial creditors). Of the rest, INR 1.6 Bil was in 0.01% preferreds issued to creditors, and INR 430 Mil is in new stock, which can be repurchased within a year.

[4] Emami's current board capacity, second highest in the industry, stands at 180K tons. ITC is the largest with ~500K tons. Our holding owns about 10% share of the packaging board market.

[5] In F2018 (Mar), this business imported about a fifth of its material requirement (primarily BCTMP pulp).

Inventory cuts at a radio holding have led to listenership share gain at our radio holding. We note significant pullback in a radio holding of ours, despite extremely solid earnings traction as newer stations continue to ramp up. Our recent discussions with media agencies suggest that premium pricing can presently only be justified by allocations to the #1 station in any market. As this holding of ours has cut ad inventory over the past year, its listenership share clearly seems to be on an uptrend in top-3 markets – RAM listenership share up from 12.1% to 13.4% in Delhi YTD, from 12.9% to 13.8% in Mumbai YTD, and from 16.4% to 17.4% in Bangalore YTD. We strongly believe that within a market where pricing has largely been stagnant for nearly a decade (and well-priced into stocks), improved content and listenership may surprise dour consensus expectations on this name.

Please let us know if you have any questions.

Exhibit 5 – Historical Quarterly Performance

	Metis Opportunity	*Nifty TR*	*S&P BSE 500 TR*	*S&P BSE Midcap TR*	*S&P BSE Smallcap TR*	*Eurekahedge India*
2Q11	-4.1%	-4.2%	-4.5%	-5.8%	-8.2%	-1.1%
3Q11	-4.0%	-13.5%	-13.0%	-11.9%	-16.0%	-13.5%
4Q11	-5.4%	-7.8%	-10.8%	-17.5%	-20.5%	-7.5%
1Q12	12.0%	13.1%	15.6%	22.1%	17.9%	9.6%
2Q12	-0.8%	-0.9%	-1.8%	-4.0%	-2.3%	-9.3%
3Q12	9.3%	7.1%	7.1%	6.9%	7.0%	12.4%
4Q12	8.7%	2.4%	4.1%	6.5%	4.0%	1.9%
1Q13	-7.0%	-4.9%	-7.6%	-14.7%	-22.4%	-4.9%
2Q13	1.9%	1.7%	0.1%	-4.1%	-4.2%	-7.1%
3Q13	4.8%	-3.1%	-3.1%	-6.7%	-3.6%	-7.1%
4Q13	14.0%	8.3%	9.9%	17.9%	18.2%	8.0%
1Q14	-0.9%	4.8%	4.5%	4.3%	6.3%	7.5%
2Q14	21.7%	14.1%	18.7%	32.8%	44.6%	15.9%
3Q14	3.2%	2.4%	1.9%	-0.2%	2.8%	3.1%
4Q14	5.3%	1.3%	2.6%	5.9%	1.1%	4.4%
1Q15	3.7%	3.9%	4.5%	3.4%	-0.5%	4.5%
2Q15	-5.0%	-2.8%	-2.7%	-0.8%	0.0%	-1.4%
3Q15	0.4%	-7.6%	-6.1%	-1.2%	-3.0%	-2.2%
4Q15	6.7%	-0.8%	0.6%	2.4%	6.5%	3.1%
1Q16	-8.5%	-2.4%	-3.8%	-4.3%	-10.6%	-4.1%
2Q16	8.6%	5.7%	6.6%	8.4%	9.9%	5.6%
3Q16	12.0%	5.8%	8.0%	14.5%	10.3%	6.8%
4Q16	-7.4%	-6.6%	-7.4%	-10.2%	-7.5%	-5.2%
1Q17	15.3%	17.8%	20.3%	23.3%	25.7%	12.4%
2Q17	2.2%	4.4%	4.9%	4.3%	7.0%	4.8%
3Q17	0.1%	2.3%	2.7%	4.9%	4.1%	2.9%
4Q17	13.4%	10.1%	12.8%	18.1%	22.1%	8.3%
1Q18	-11.2%	-5.2%	-7.2%	-11.8%	-13.1%	-4.3%
2Q18	-8.4%	0.9%	-2.1%	-4.8%	-3.7%	-2.4%
3Q18	-10.4%	-3.2%	-5.6%	-9.1%	-14.5%	-3.9%
Trailing 1 year	-17%	2%	-3%	-10%	-13%	-3%
Trailing 2 years	-10%	20%	16%	9%	13%	12%
Trailing 3 years	7%	30%	29%	33%	31%	25%
Trailing 5 years	59%	62%	76%	132%	138%	82%
Since inception	**81%**	**43%**	**48%**	**62%**	**34%**	**34%**
2018 YTD	-27%	-7%	-14%	-24%	-28%	-10%
2017	34%	38%	46%	59%	71%	31%
2016	3%	2%	3%	7%	0%	3%
2015	5%	-7%	-4%	4%	3%	4%
2014	31%	24%	30%	46%	60%	34%
2013	13%	1%	-2%	-10%	-15%	-11%
2012	32%	23%	27%	33%	28%	14%
2011	-13%	-24%	-26%	-32%	-39%	-21%

Note: Fund went live on March 11, 2014
Source: Internal Sources; NSE; BSE; Bloomberg; Eurekahedge

Investment Managers

Piyush Sharma, is the co-investment manager of Metis India Opportunity Fund. Having spent time with Citigroup and Bombay Stock Exchange in India, he moved to United States in 2002, where he covered stocks within Business Services, Autos, Consumer Products and Financials with Sanford Bernstein, Longbow Research, and Avondale Partners, working in teams that received accolades by leading institutional research arbiters, including Institutional Investor (II) and Greenwich Associates. Piyush received an MBA from University of North Carolina at Chapel Hill, MS from MNNIT, and BS in Accounting from University of Allahabad.

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Gaurav Aggarwal, CFA, CPA, CIPM is the co-investment manager of Metis India Opportunity Fund. He was a senior analyst with portfolio management duties over $50 million in fund of fund assets at a leading regional investment bank (Global Investment House) in the Middle East. Prior to this, he was with Bay Harbour Management, a $1.2 billion distressed debt and equity hedge fund in New York City. He has also served as an analyst with Polen Capital Management, a $2 billion long-only value money manager in Florida. He received an M.S. in Accounting (specializing in Finance) and B.S. in Business Administration from the University of North Carolina at Chapel Hill. He is a Chartered Financial Analyst and a Certified Public Accountant.

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