Metis Opportunity Fund

India's 'invested' leaders often trump their 'entitled' peers

October 2014 Newsletter

October 14, 2014

The "awe" loaded chatter around elections from earlier this year has given way to an emerging consensus that it might be too late to make a quick splash. As naive as such shortest of short-term sentiment switches are, they are partly tenable. Valuation readjustments are often decidedly quick and such influenced performances can therefore only be replicated through an intense secular approach to picking assets. We don't care much for the former, preferring to allocate our workload towards the latter. As always, we continue our focus on finding clean execution stories at valuations where we aren't dependent on a 'macro dividend'.

In 3Q, more than half of our holdings outpaced *BSE 500*. This was our 14th quarter since our inception, and we have outpaced *BSE 500* in 11 of those, with 3/4th of all positions outpacing *BSE 500* since their inception.

In 3Q14, *Metis Opportunity* was up **+5.6%** (net of all fees; in INR terms), vs. **+4.6%**, **+3.9%**, **+1.6%**, **+4.7%**, and **+5.0%** increases in *Nifty, BSE 500, BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively. *Metis Opportunity* ended 3Q with a net exposure of 76%, vs. 83% at the end of 2Q. While we added 3 new names in the quarter, valuation influenced part-sales ensured that our exposure drifted lower in 3Q.

Over trailing 12 months, *Metis Opportunity* was up **+46.6%**. That compared with **+38.9%**, **+44.9%**, **+70.0%**, **+95.4%**, and **+38.7%** increases in *Nifty, BSE 500, BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively. Over this period, our volatility was **290** bps and **545** bps below that of *BSE Midcap* and *BSE Smallcap* respectively, and **200** bps and **304** bps higher than that of *BSE 500* and *Nifty* respectively.

Over the past 3 years, *Metis Opportunity* was up **+100%** vs. **+61.1%**, **+59.3%**, **+55.5%**, **+55.2%**, and **+26.9%** increases in *Nifty*, *BSE 500*, *BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively.

Our investors and prospects have often asked us how we evaluate leaders at our chosen businesses. While there really isn't a standard response that would fit each situation when it comes to assessing leadership, there are several 'quantifiable' factors that tend to influence our choice. Read on as we delve upon two critical aspects of leadership – **1**. Appropriate compensation, and **2**. Efficacy of balanced stock based compensation.

Compensation excesses on the board…… It's certainly not a thin line when it comes to appropriate and excessive executive compensation, at least when one looks at Indian businesses. Indian legacy businesses still find it hard to not get milked by the progenies of their founders. Last year, Kumarmangalam Birla got paid almost INR 400 mil in 'commissions' for his non-executive roles on boards of four listed *Aditya Birla* group companies, often significantly more than the respective CEOs. It's your call if you wish to view that as excessive compensation or not, let alone as excessive for non-exec roles on boards where he clocked about 50% attendance. To put that in context, that 'commission[1]' was as much as the combined salary of CEOs at *Tata Motors*, *L&T*, *ITC*, and *HDFC Bank* combined.

Steep commissions for non-executive roles in India aren't always restricted to trustees. For instance, we notice an alarming degree of bonhomie between certain *Tata Sons* businesses and their board members. *Tata Steel*, for instance, must view Nusli Wadia as some sort of metallurgy or strategy genius – Wadia's 'commission' for a non-executive seat on the board last year was more than CEO's base salary. It's beyond amazing how easily some of these compensation maneuvers fly past shareholders.

…..and outside. A certain drugs major within the *Nifty 100* hired its first external CEO in early 2013, when the aging son of the founder stepped down. The incumbent is a British citizen and made just under INR 200 mil in his first year (inclusive of "performance" bonus). When one includes the sign-on bonus, the CEO took home just under INR 220 million in his first year in charge. That's just under 2% of what the company paid its 30,000+ full time and contractual employees last year. In addition, the CEO was granted a million options, as much as the next 7 senior guys were offered. Most of these were granted at a 50% discount to the market price, suggesting that

[1] Indian Companies Act precludes directors who are in receipt of any commission from the company AND who are either in the whole-time employment of the company or are managing directors, from receiving any commission or other remuneration from any subsidiary of such company.

the fair value of these options was north of INR 260 mil as at the end of F2014 (Mar)[2]. That works out to a total compensation of $8 mil for the rookie CEO in the first year, or more than half of what *J&J*'s Alex Gorsky made last year[3]. In another 4 months, this CEO would finish his 2 years at this company, and would have overseen a material absolute and relative underperformance since he took control. Given that it's fairly easy to call out excessive compensation when it isn't accompanied by performance, it is puzzling how certain executives continue to get generously compensated despite an underwhelming record.

SAB-Miller and the ownership dividend. Graham Mackay, ex-CEO of *SAB-Miller*, passed away in December last year. Graham was instrumental in guiding the South African brewer through a series of acquisitions such as those of *Grolsch*, *Foster's*, *Peroni*, and *Miller*, and in transforming the business through a highly focused expansion within emerging markets. By the time he stepped down for health reasons, he had made *SAB*'s shareholders (and himself) about 100x richer over 14 years. His passing away wasn't the denouement of this story. *SAB-Miller* is ensuring that his successor, Alan John Clark, remains invested in his employer's vision, much like his predecessor. At last check, Alan held more than 260K shares of his employer, valuing his holdings at north of ZAR 160 mil. In addition, his vested options are worth north of ZAR 200 mil. This compared with his ex-stock compensation (salary + bonus) of ZAR 42 mil last year. By our estimate, within a couple of years, his stock holdings (direct + vested in the money options) could be >10x his non-stock compensation and would gradually ensure that the incremental impact (on his net-worth) of the movement in his stock holdings exceeds the impact from his paycheck.

At some point, which is often influenced by 'expected' returns within local equities, ownership to fixed-comp ratio hits a sweet-spot for shareholders (assuming the CEO remains invested). Later in this letter, we demonstrate (through a 'tech' pick) how odds of alpha generation get maximized while odds of material underperformance get minimized as holdings to fixed comp ratio hits a certain 'sweetspot' for externally recruited leaders.

India is increasingly looking outside, albeit not broadly. While it is fairly routine to find 'ex-founding family' CEOs among benchmark names in emerging markets such as Malaysia or Poland, others such as India and Mexico are still some way off in fully embracing and potentially benefiting from the hunger that non-founding CEOs[4] can often bring with them. Still others such as the Korean chaebols have limited faith in letting non-family members lead their businesses. While about 2/3rd of *Nifty* constituents (ex-state owned names) are managed by non-founding family members, it's rare to see such ownership within Indian mid and small-cap names. Larger companies however are increasingly open to looking outside, be it Shibulal stepping down at *Infosys* or Harsh Mariwala moving on at *Marico*.

However, even in situations where one sees external CEOs, it is still quite common for he/she to have little or no long-term engagement with the business he/she manages – Within *Nifty* constituents with external CEOs, only 40% have stock ownership that exceeds their annual fixed non-stock compensation[5]. That still however trumps benchmark peers in other EMs - Emerging market benchmark peers for whom compensation is disclosed, just about a third of names have external CEOs whose holdings exceed their fixed compensation (see **Exhibit 1** on next page). Indian and South African benchmark constituents stack favorably in such a distribution of external CEOs.

India of course has had its fair share of extremely successful family businesses. So, while we aren't venturing out to suggest that drawing a line between ownership and management is a prerequisite for success, to suggest that it's far more likely to succeed than not, wouldn't be an overly aggressive postulation.

It's patently clear though that even certain externally recruited CEOs are often paid at levels that are more suggestive of entitlement than performance. That often fails to optimize leadership efforts. Several examples suggest that hiring effectiveness of external CEOs is also significantly dependent on how external CEOs are incentivized and how they remain invested in the business' vision.

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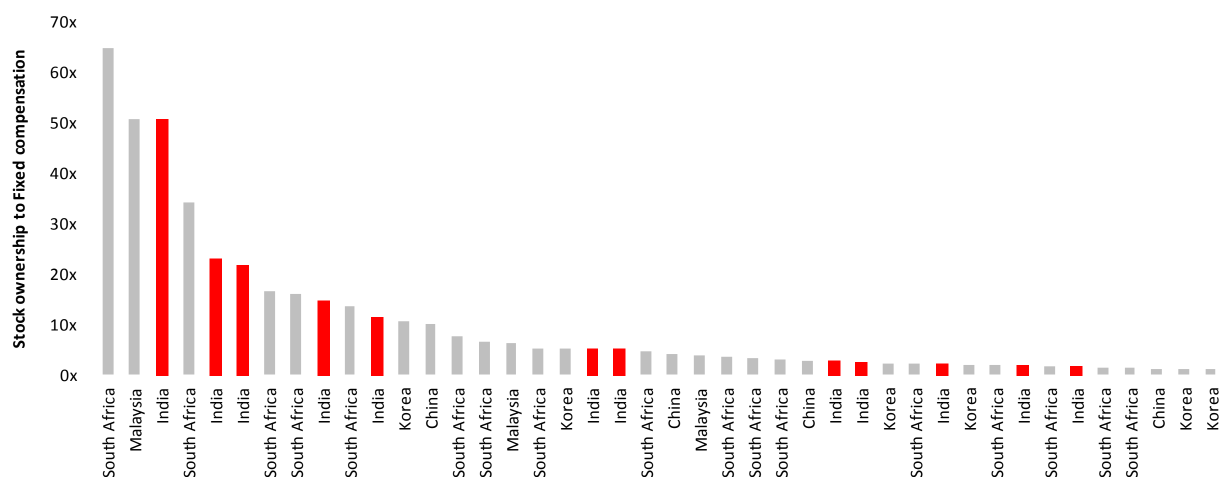
[2] Stock was flat in F2014, materially underperforming its pharmaceuticals' peers
[3] J&J's revenues are nearly 50x the Indian peer in question
[4] CEOs at businesses such as *Lupin* or *Dr. Reddy's* have a direct relationship with respective founders and are accordingly deemed 'internal'.
[5] Nearly all external CEOs within *Nifty* aren't part of their company's remuneration committee

Exhibit 1 – Distribution of EM benchmark peers that have external CEOs with stock holdings > fixed compensation



Note: We exclude state owned enterprises, companies with 'In-family' CEOs, and those with interim-CEOs from this work. Since all state owned names are excluded from this exercise, most Chinese benchmark constituents get excluded. Among those typically included are certain Chinese benchmark names that have material cross-ownership from political members of the Communist Party. That however doesn't mean that their executive compensation is in any manner reflective of state-owned enterprises.
Source: Bloomberg; Company reports

Won't eat own porridge. While granting meaningful and balanced ownership to external leaders often works in favor of shareholders, large grants often ensure that these get exercised and liquidated soon after, disconnecting CEO's net-worth with that of shareholders, which is the core rationale of the grant to begin with. Nothing demonstrates this better than a few examples within India's most generous industry for option grants, *Technology*. Case in point is a name that materially trailed its peers over considerable periods under the leadership of a long-standing external CEO. While his non-stock compensation would have never attracted attention, his grants were so lopsided that there was little incentive for him to not liquidate those within a year or two of they getting vested[6]. He eventually oversaw a 50%+ underperformance vs. tech peers before transitioning into a Vice Chairman role (at the same company). As a CEO, his stock ownership averaged nearly 38x his fixed compensation. Our work in India suggests that it's more likely than not that an external CEO would at least partly liquidate his stock holdings if they happen to be substantially larger than his/her fixed compensation, which isn't a bad thing as long as that metric gets inflated through stock appreciation, as opposed to the sheer size of stock grants.

Yet ownership nearly always pays off well even as option grants may often not be balanced. Our work across Indian businesses strongly suggests that, far more often than not, appropriate business ownership translates into substantial shareholder value creation. We have also noticed how odds of material relative underperformance diminish considerably as stock holdings get appropriately larger vs. fixed compensation (see how this plots in Indian tech names in **Exhibit 4** later in the letter). That said, one can't stress enough the importance of 'balance' when it comes to grants. As discussed above, in nearly all cases of generous option grants in India, CEOs have followed exercises by selling in the open market. Similarly, we have also failed to identify a solid winning situation among cases where vesting schedules were onerous and/or executive's salary was materially under-par.

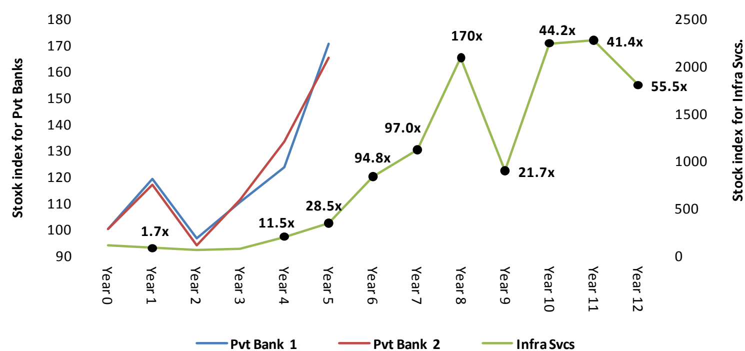
When it comes to thoughtfully balancing option grants with fixed compensation, specific examples would help explain this best (see **Exhibit 2** on next page) – Let's begin by looking at two private-sector banks, both of which were sponsored by financial institutions and received their licenses in the first phase of the licensing policy. The larger of the two was the grooming ground for two ladies, who went on to become CEOs, one of which did so at another *Nifty* competitor. While their headline fixed compensation today is nearly 35% below the average of *Nifty*'s external CEOs, consistent stock grants to the more widely followed peer, who assumed her CEO role after

[6] He liquidated 97% of his 1.5 mil+ shares between F2007 and F2010. Having exercised another tranche of 500K after he transitioned into a Vice Chairman role at this company, he has since liquidated another third.

being an Executive Director and CFO at the same bank, has ensured that her holdings have now become too disconnected from her non-stock compensation, which incidentally is 30% ahead of that of her smaller peer. Her relatively less followed peer who jumped ship in 2009 to move to this relatively smaller bank, has in sharp contrast, been a part of an employee stock options plan that has, at least so far, ensured that her stock holdings keep her increasingly engaged. Her stock holdings value (incl. fair value of vested in-the-money options) is ~10x her fixed compensation (see *Pvt. Bank 1* in **Exhibit 2**), vs. just under 30x for her more followed peer at the larger bank (see *Pvt Bank 2* in **Exhibit 2**).

Our work indicates that there is more than just good evidence to suggest that Indian businesses that **1**. Don't overpay, and **2**. Maintain balanced option grant schedules, are more often than not, creating solid environments for smart leaders to thrive. There is a thin line between thoughtful and balanced grant schedules and ones that are ill-timed or superficial. While private banks (discussed above) have had solid tailwinds over the past decade as their state-owned peers were slow to get their acts together, such dichotomy didn't exist in most other Indian industries. Let's review another example of an Infrastructure services business to drive the point on well-balanced grants. This incidentally is among the most balanced option/SAR grant program we have seen. The CEO assumed the role in 1999 and stepped aside for the Exec VC role in F2013. While the CEO, along with senior leadership, were beneficiaries of grants in the first 5 years of his role, he wasn't a beneficiary of subsequent grants. At the end of F2003 (Mar), which was the last year when he was granted options, the in-the-money value of his options and stock holdings was 0.6x his fixed compensation. If the stock had returned an annualized 20% over the next 5 years, his ownership would have been just under 10x his fixed compensation in F2008, a point around where we often note a solid engagement between external leaders and their Indian businesses. Incidentally, the stock was up more than 20x over this period (see *Infra Svcs* in **Exhibit 2** below).

Exhibit 2 – Perf. under CEOS who were recipients of balanced grants



Notes: Data labels indicate "Ownership value to fixed compensation ratio"; Ownership includes "in the money" value of vested but unexercised options and stock appreciation rights (SARs); Wherever vesting schedule of a grant was unavailable, we assumed the schedule to be the same as the prior grant.
Source: Company reports

In sharp contrast to the above two examples, consider a highly skewed options program – An Indian Consumer Staples business started running an options program under the apparent premise that the CEO is the principal (and only) driver of its growth - The first Consumer staples business in India to hire an external female CEO (not a *Nifty* constituent) saw her depart in March this year, having led this company since early 2005. When she assumed the role, this company didn't have a policy of granting options to directors or other employees. Just over a year later, the Employee Stock Option Program was approved at the AGM. One can't be blamed for stating that the option program could very well had been named after her - In early F2008, 125K options were granted, all to this CEO. In F2009, 75K options were granted, with this CEO being the only recipient. Along the same lines, 275K more options were granted between F2010 and F2013, with nearly all being for a single executive. All of those grants were exercised in C2013, as the departing CEO ended the year with 400K shares. Shareholders didn't see nearly as much value created.

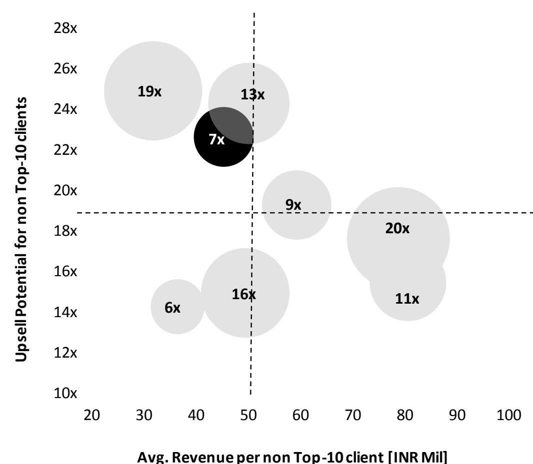
Our experience across a wide-network of industries suggests that the odds of picking winners among businesses that hire and nurture external talent are substantially higher. The odds improve even further (with concomitant drop in volatility) if external CEOs get and remain invested in the underlying business.

We initiated a 4% exposure in a software name within our *India Underserved* sub-strategy. Incidentally, this was the first time we had taken any exposure within an Indian technology name. The move, while being largely influenced by attractive absolute value, brought in much needed FX and core diversification within our book. This was yet another cash-rich inclusion, with net cash making more than a tenth of stock's value at inception.

We note that the small and mid-cap discounts (vs. the large caps) within Indian technology names contract sharply as growth picks up. While we weren't anticipating any sharp pick-up in growth, we initiated this exposure at a valuation where the stock wasn't factoring any incremental momentum in the underlying business. Accordingly, our investors weren't paying for any futuristic earnings revisions.

Indian technology services companies have largely established their service pockets. While a large enterprise application project would likely be fought between the domestic biggies and the likes of *Accenture, IBM,* or *Cognizant*, a project outside Top 100 companies is where Tier II alternatives would likely compete. The key difference comes in up-selling. Our discussions across vendors suggest that Tier II players are much more flexible on pricing during up-selling efforts vs. the Tier I players. Consequently, the biggest opportunity set for these players remains outside the largest 100, where resource constraints don't push these players out and pricing often becomes a key consideration.

Exhibit 3 – Up-selling potential and avg account size



Note: Bubble sizes indicate 'Core PEs' i.e. net of cash and liquid investments
Source: Company reports

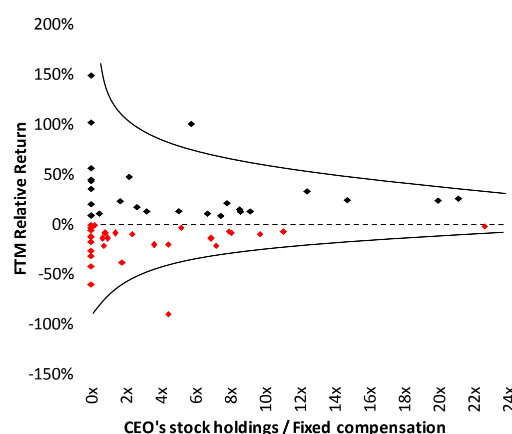
The three key reasons we initiated exposure in this name were:

1. **We believed that market was pricing this at a substantial discount on account of an historical "out of context" event.** This business' current CEO has been leading for last 15 years. Prior to that, this business went through substantial turmoil as the fledgling business lost its clients to the departing CEO's new venture. This business is 15x larger now and has created a solid footing among Tier II software businesses.

2. **Valuation showed a substantial disconnect, given the up-selling potential.** With a comparable account size vs. its Tier II peers, and an above average up-selling potential, we found it hard to reconcile the valuation disconnect (see **Exhibit 3**).

3. **We noted an engaged leader that has unassumingly created substantial shareholder value over the last decade**. Our choice to highlight compensation in this letter couldn't have been better timed. At just over 11x his fixed compensation, this CEO's ownership is firmly in the sweet spot for Indian tech (see relative FTM performance of India's tech companies vs. their ownership/comp in **Exhibit 4**). Over an extremely solid period of last 8 years (run-rate operating cash-flow has expanded nearly 8x over this period), CEO hasn't sold any stock.

Exhibit 4 – FTM perf vs. Holdings to Fixed Compensation



Source: Company Reports, Thomson Reuters

We anticipated at least 80% upside within 2 years when we initiated this exposure and continue to maintain an extremely favorable view.

We added two new positions within our *India Undervalued* sub-strategy. We bought an initial stake in a plastics packaging name in early September 2014. This business was started in 1992 (IPO in 2007) by a group of technocrats (current managing directors). It is a diversified plastic product manufacturer for industrial packaging (64% sales), infrastructure (17%), lifestyle (9%), auto (8%), and other (composite LPG cylinder/telecom/solar batteries - 2%) applications. Besides India, it has acquired and setup operations across Southeast Asia (including China), Middle East, and Eastern Europe over the last 5 years with capex of over INR 10 Bil. They have a leading position in industrial packaging (mainly plastic drums, pails, containers, and IBC's (intermediate bulk containers) with the highest market share in Asia (#4 globally, with none of the top 3 having any major capacity in Asia). End-customers are diversified across markets but major customers are chemical/textile/ FMCG firms. Their overseas sales account for about 30% of revenues. They count groups/companies such as *Tata Sons*, *Ashok Leyland*, and *Indian Railways* as ongoing customers (no customer accounts for 5%+ of sales).

By our estimate, this business can do sales of at least INR 30 Bil (+40%) with current capacities. With 30% of sales from overseas operations (growing 30-40% since last 2 years as operations fully ramp-up and capacity utilization at only ~55% in these markets), there is large scope for margin expansion (14% last FY vs. average of 17% over prior six fiscals) even with overseas margins being 2-3% lower. On the cost front, HDPE (high density poly-ethylene) is the key raw material and with major new capacities of polymer coming up/already running in ME and China with gas as feedstock vs. usual naphtha (using gas lowers cost of production by 40-50%), there is scope for improvement here as well. The firm has aggressively expanded operations to become a pan-Asian player in order to match the increased percentage of global sales of industrial packaging from Asia (from 20% to 50% over last decade due to multiple industries shifting to a lower cost base). Surprisingly, India is the leader in Asia for usage of plastic drums/containers with about 50% plastic, 50% metal. In all of Asia, its closer to 10/90, and accordingly there is big runway of growth if they are able to steadily convert sticky customers to use safer, longer shelf life, lower lifetime cost product vs. similar priced (pricing shifts based on polymer and steel prices) metal containers.

It was clear that the chairman and his management team have a passion for the business and now are clear about sweating the assets already in place to increase profitability, lower debt, and improve cash flows. The firm has good brands, distribution, and is innovative in launches (we note several new products/expansion of certain products which have large market potential). Our conservative value estimate provides for a safe 30% upside on an absolute basis. In summary, falling oil prices, a solid business model that has ways to go in terms of penetration and scale, management capability, and expansionary vision (grounded in financial reality), make this firm a likely beneficiary, even in a low growth environment.

We also bought a position that is a safe-cash substitute with high potential for capital appreciation over time. This position was initiated within a holding company that holds 60%+ of a diversified business: 5 major divisions (rev%/EBIT %): Industrial Packaging (19/16); Logistics/Infra Svcs (18/61); Travel/Tours (45/10); Grease/Lubricant (16/13); Other (2/0). The core business was started in Kolkata by two Scotsmen in 1867 as a diversified enterprise - tea trading, shipping, forwarding, etc. The firm lost the right to its tea gardens in 1969 and the management at the time decided to sell their stake to a state-held company. In 1972, when oil companies were nationalized, this business became a subsidiary of a state-owned oil business. Post de-regulation, the share of this business held by the state-owned corporation was transferred to a shell holding company that was 60% owned by the Ministry of Petroleum & Natural Gas. Accordingly, this business' only asset is ownership of 61.8% of the business described above.

The core holding is a net cash diversified company with the sum of its parts worth a lot more separately. When we initiated the exposure, the market value of the core holding was discounted by over 40% in the holding's price. This business just receives steadily increased dividends (310 mil last year vs. 280 mil in F2013) from the core holding and has no other interests. The dividend yield on last fiscal year's dividend was 5%. This is structured as an NBFC but is exempt by RBI from registration/minimum net owned funds as long as certain requirements are followed. We are not counting on divestment of the core holding because of 1. High regular yearly dividend, and 2. Conservative running of the core holding provide margin of safety.

We remain cautious as several privately-held multiplexes race towards exit. Lower equity contributions have ensured that deal multiples, which are now near multi-year highs in certain G7 markets, have escaped broader investor attention. For all the tapering chatter, Indian valuations haven't really benefitted from loose monetary taps. Accordingly, there is little logic to support Indian valuations that get disconnected from replacement cost, not that they can be universally supported elsewhere. We hear that several Indian multiplex chains want to exit as valuations for listed players have reached multi-year highs.

It seems ludicrous to us why a multiplex chain's valuation be based on 'implied per screen' valuation of certain listed businesses. Take this potential 'on-sale' target for instance (65+ properties across India) – Its ATPs are 30% below those of the two major listed players, and that's with materially lower occupancies. Accordingly, this player's EBITDA/Screen is under 1/4th of our holding's EBITDA/Screen. While we can certainly identify synergies within F&B and advertising (largely through higher ad rates), we don't view these as material, especially given market's whispered valuations. Even strategy-wise, about a fifth of this target's domestic screens are part of 1-2 screen properties, which isn't a sustainable concept to begin with. That said, pricing has room for improvement (contingent upon thoughtful renovation). By our estimate, this chain requires mid-high 20s occupancy to break even, and to our best knowledge, couldn't be currently doing much better than breaking even. That however can change through several low-hanging fruits such as F&B makeover, sponsorships enhancement, and by renegotiating producer share, even assuming stable pricing.

Between film-hires, pricing, sponsorships, F&B, and cost redundancies, we are even willing to bake in nearly INR 2.5 bil in potential synergies. To put that in context, the last major acquisition done by our holding (nearly 2 yrs ago) involved around 140 screens, with 85-90% of the INR 300 mil in synergies realized since the acquisition.

All said, this business remains extremely levered, and in our view, comes with financials that would require substantial forensic evaluation (and haircuts are inevitable). Unless, the target chain is willing to sell domestic properties on an unencumbered basis, executing this deal anywhere close to market valuations (implied per-screen valuation) is unequivocally criminal on shareholders. While there are obvious structural constraints in the build-out decision (note how retail area coming online has shrunk in frequency and size in recent years in Greater Mumbai area, this target's biggest market - see **Exhibit 5b**), it is inevitable that in the absence or scarcity of retail openings, current underlying margins are almost certain to expand if screen growth stagnates (since occupancy would inch up). Also, while we see little harm in compromising 5-10% IRR (pre-tax basis) for immediate visibility, we note that even that flexibility precludes paying more than INR 40 mil/screen for this target (see **Exhibit 5a**). To put that in perspective - We estimate that Buyout IRR would be half that of Build-out IRR if the target were acquired at INR 50 mil/screen, and that assumes total synergies (highly unrealistic, we should add) of INR 2.5 Bil.

Exhibit 5a – Pre-tax Buyout IRR scenarios vs. Buildout IRR

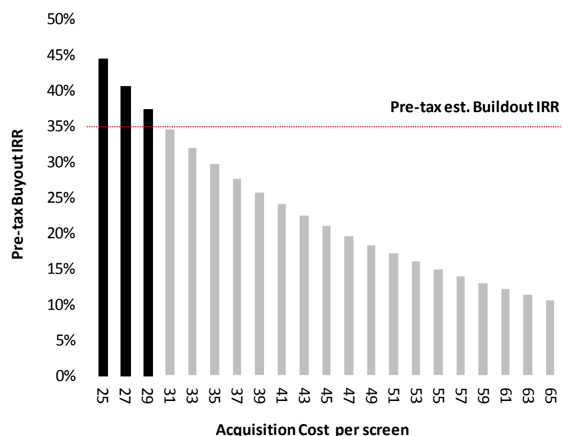
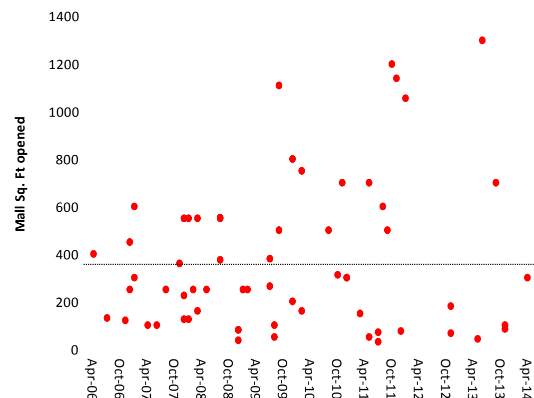


Exhibit 5b – Retail sq ft ('000) coming online in Mumbai



Note: Ongoing manpower requirements were assumed at 15/screen; area assumed at 35 sq ft/seat; Rent assumed at INR 40 per sq ft (plus service tax); CAM charges assumed at INR 10 per sq ft (plus service tax); Pre-tax cash IRR based on 7-yr ownership and subsequent sale.
Source: Internal estimates; Company reports

Performance and Attribution summary

In our 14 quarters since inception, we have only under-paced *BSE 500* on three occasions, with **-5.4%** lag in 1Q this year being the worst. However, with two subsequent quarters of nearly identical outperformance in 2Q and 3Q (**+1.8%** and **+1.7%** respectively), we are now very close to offsetting our 1Q drag. As anticipated, we continue to see gradual wind-downs within materially appreciated speculative positions from 1H14. As earnings roll-in and performance gets drawn back on the radar, we expect to recapture our historical differential vs. the broader universe over the next year.

62% of our holdings finished higher in 3Q, with little over half of all positions outpacing *BSE 500*. Our two best performing positions in 3Q were a *Medical Devices* name (**+69%**) and a *Business Services* name (**+36%**). Our two worst positions in 3Q were a state-owned *Bank* name (**-20%**) and a *Paper* name (**-16%**). For our historical position-wise benchmarking vs. peers and *BSE 500*, please see **Exhibit 6d**.

In 3Q14, *Metis Opportunity* was up **+5.6%** (net of all fees; in INR terms), vs. **+4.6%**, **+3.9%**, **+1.6%**, **+4.7%**, and **+5.0%** increases in *Nifty, BSE 500, BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively. Since inception, *Metis Opportunity* is up **+88.5%** vs. **+36.5%**, **+36.8%**, **+38.7%**, **+30.6%**, and **+9.8%** increases in *Nifty*, *BSE 500, BSE Midcap, BSE Smallcap* and *Eurekahedge India* respectively (see **Exhibit 6a**). Over trailing 12 months, our volatility was **290** bps and **545** bps below that of *BSE Midcap* and *BSE Smallcap* respectively, and **200** bps and **304** bps higher than that of *BSE 500* and *Nifty* respectively (see **Exhibit 6b**).

Exhibit 6a – Perf. since inception

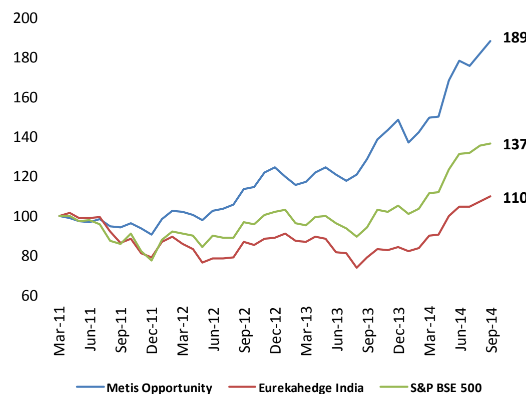


Exhibit 6b – TTM volatility

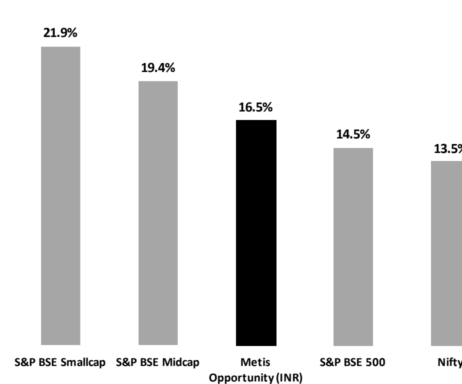


Exhibit 6c – Annual and average –ve monthly returns

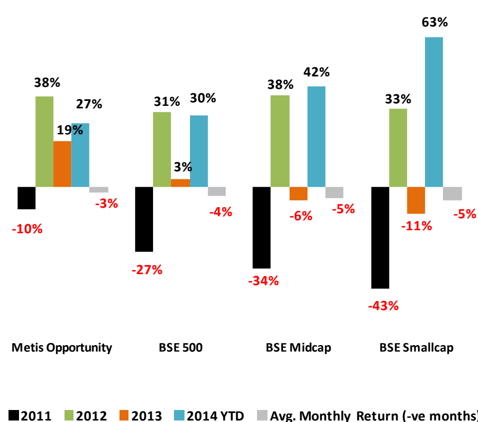
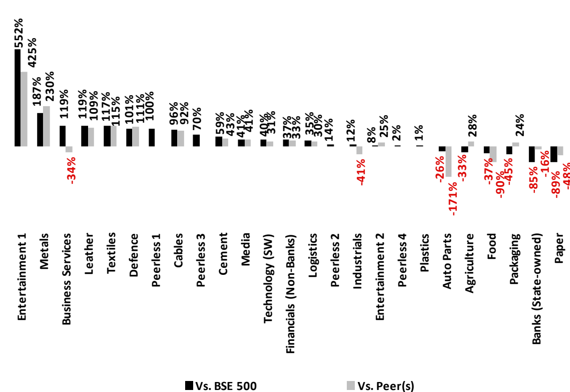


Exhibit 6d – Industry-wise benchmarking for positions



Note: Metis Opportunity went live on Mar 11th 2014; Industry-wise benchmarking compares performance from initial cost basis to present/exit.
Source: Internal Sources; NSE, BSE, Eurekahedge

Exhibit 7a – Relative rolling 12-mth returns

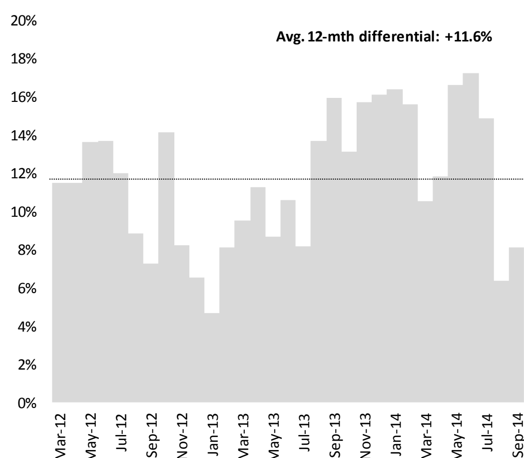
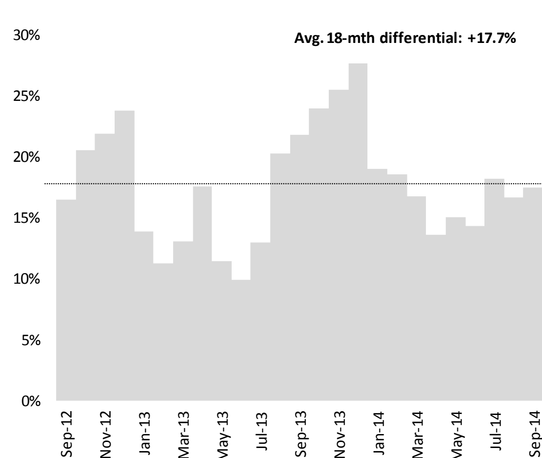


Exhibit 7b – Relative rolling 18-mth returns



Note: Relative strategy return differentials are calculated vs. BSE 500
Source: Internal Sources

Exhibit 8 – Time window analysis for our sub-strategies

	India Underserved		*India Undervalued*	
	3 Month	*12 Month*	*3 Month*	*12 Month*
Number of periods	40	31	45	36
Average period return	**5.1%**	**22.6%**	**4.6%**	**19.2%**
Number of profitable periods	26	29	28	33
% profitable periods	**65%**	**94%**	**62%**	**92%**
Best period	24%	55%	26%	63%
Gain Standard Deviation	7.2%	14.8%	7.1%	16.0%
Sharpe Ratio @10%	0.31	0.81	0.25	0.52
Sharpe Ratio @5%	0.45	1.13	0.38	0.80
Sharpe Ratio @0%	0.59	1.45	0.52	1.08
Loss Standard Deviation	2.0%	0.4%	3.5%	0.9%
Downside Deviation @10%	3.6%	3.6%	4.4%	6.3%
Downside Deviation @5%	2.9%	1.7%	3.7%	4.6%
Downside Deviation @0%	2.3%	0.2%	3.2%	3.1%
Sortino Ratio @10%	0.75	3.49	0.51	1.46
Sortino Ratio @5%	1.33	10.16	0.91	3.10
Sortino Ratio @0%	2.26	99.77	1.47	6.13
Average Gain/Loss	2.9	28.3	2.6	2.0
Profit/Loss Ratio	5.4	41.1	4.2	22.3

Note: Metis Opportunity is a direct blend of above two sub-strategies
Source: CogentHedge

Exhibit 9 – Long-book snapshot

Top position as % of book	10%
Smallest position as % of book	0.6%
Top 5 positions as % of book	38%
Avg. weighted market cap of book (mil)	$771
Avg. weighted free float of book	46%
Net Exposure	76%
# of positions	25

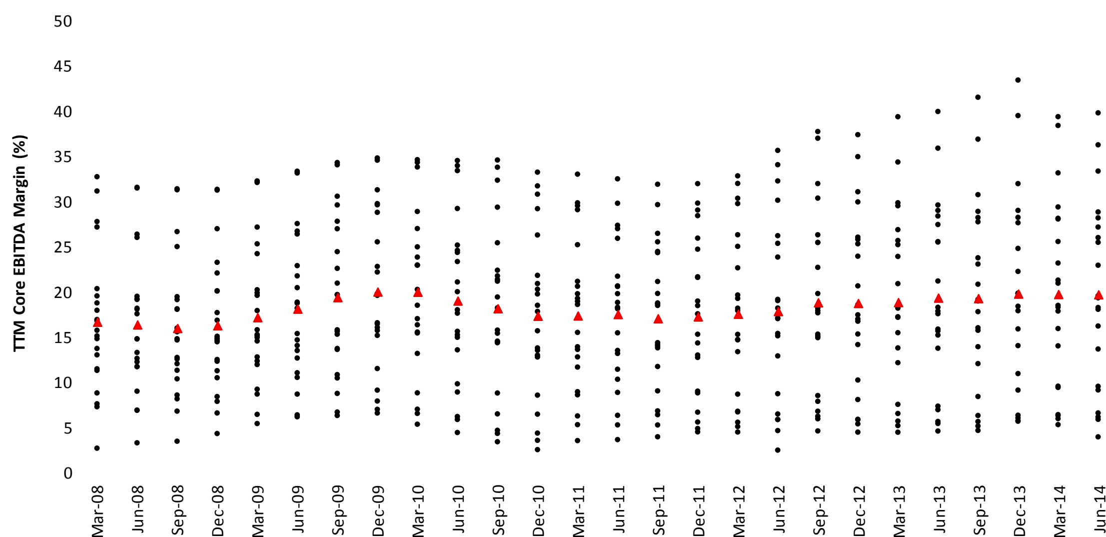
Source: Internal Sources

There is room for optimism but it isn't as broad as you might think. We have pointed out in earlier letters that we don't expect bank credit growth to recapture the high-teens kind of growth we have seen in recent years. Between underwriting readjustment at state-owned banks, substantial idle capacity, and little room for credit costs materially coming down, we fail to confidently identify highly visible macro levers. While we continue to expect solid earnings numbers off of a low base, there is little to scant evidence to support that India is set to be a major incremental beneficiary of macro tailwinds.

1. ***Limited margin upside ex-cyclicals***. While there is no denying that there is room for margin upside in cyclicals, the case for broad-based margin upside is weak at best. Take a look at core TTM margin distribution of benchmark names (across capitalization) in Autos, Staples, Pharmaceuticals, Technology, and Industrials in **Exhibit 10** below. Broadly, we aren't too far off from early 2010 median margin peak.

2. ***Still looking for 'dovish' Rajan***. It's pretty evident to us that sustained labor market expansion would require a more than subtle credit impetus. With Rajan admittedly focused on inflation, we see little chance of 50 bps+ cut within the next year. We note that employment within certain high employment generation industries in India (Autos, Construction etc) has high credit cost elasticity. Elsewhere within manufacturing, India is suffering from structural (disconnected land prices - *see our April 2014 newsletter*) and cyclical (still significant capacity remains idle) challenges.

Exhibit 10 – TTM Core EBITDA Margin distribution (all-cap) for Autos, Pharma, Staples, Tech, and Industrials



Source: Company reports

BoP movements provide solid near-term support to the rupee. While major up moves in gold (highly unlikely) and/or oil prices (not highly likely, assuming stable geopolitical conditions) can impact the BoP, current projections peg India's current account deficit between 1.5%-2% of GDP for F2015 (Mar) and even lower basic BoP deficit in F2016 (Mar). Further, we note that India's stock of portfolio flows are heavily skewed towards equity and accordingly tend to react favorably to rate cuts. While we can list down a few drivers that can materially impact absolute valuations, Fed's potential hikes in June 2015 or beyond aren't one of them.

We appreciate your engagement with us. Please let us know if you have any questions. Your fund managers are available 24/7 to address your questions/concerns.

Exhibit 11 – Historical Monthly Performance

	Metis Opportunity (INR)	*Nifty*	*S&P BSE 500*	*S&P BSE Midcap*	*S&P BSE Smallcap*	*Eurekahedge India*	*India-focused CE Funds**
Nov-10	NA	-2.6%	-3.3%	-6.1%	-7.8%	-4.3%	-2.6%
Dec-10	NA	4.6%	3.1%	0.5%	-0.8%	2.8%	-2.5%
Jan-11	NA	-10.2%	-10.5%	-12.0%	-12.3%	-6.7%	-9.8%
Feb-11	NA	-3.1%	-3.9%	-7.2%	-7.8%	-2.2%	-3.6%
Mar-11	NA	9.4%	8.6%	7.8%	4.6%	4.0%	8.6%
Apr-11	-1.3%	-1.4%	-0.1%	3.2%	6.6%	1.4%	-2.4%
May-11	-1.3%	-3.3%	-2.6%	-2.6%	-5.5%	-2.6%	-2.2%
Jun-11	-0.3%	1.6%	0.4%	-0.8%	-1.0%	0.2%	-0.6%
Jul-11	1.6%	-2.9%	-2.1%	0.9%	1.8%	0.7%	-2.8%
Aug-11	-3.7%	-8.8%	-8.8%	-9.3%	-14.1%	-7.4%	-6.9%
Sep-11	-0.7%	-1.2%	-1.6%	-2.3%	-3.5%	-6.3%	-4.2%
Oct-11	2.0%	7.8%	5.9%	2.7%	1.4%	2.1%	4.8%
Nov-11	-2.8%	-9.3%	-9.6%	-10.6%	-12.6%	-7.9%	-5.3%
Dec-11	-3.4%	-4.3%	-5.5%	-8.8%	-9.0%	-2.7%	-8.4%
Jan-12	9.2%	12.4%	13.3%	14.3%	16.5%	9.5%	10.9%
Feb-12	4.0%	3.6%	4.7%	8.8%	6.1%	3.3%	4.1%
Mar-12	-0.3%	-1.7%	-1.4%	-0.6%	-3.4%	-4.1%	-0.1%
Apr-12	-1.9%	-0.9%	-0.9%	-0.5%	2.0%	-3.4%	-0.6%
May-12	-2.5%	-6.2%	-6.2%	-6.8%	-7.3%	-7.9%	-4.8%
Jun-12	4.9%	7.2%	6.4%	4.5%	4.3%	2.8%	6.8%
Jul-12	0.9%	-0.9%	-1.1%	-2.3%	-1.5%	0.0%	-0.8%
Aug-12	2.0%	0.6%	0.4%	-0.2%	-0.8%	0.4%	1.9%
Sep-12	7.4%	8.5%	8.7%	10.1%	9.7%	10.2%	7.8%
Oct-12	1.4%	-1.5%	-1.2%	-0.6%	-0.4%	-2.1%	-0.4%
Nov-12	6.1%	4.6%	5.0%	5.1%	4.1%	4.0%	3.2%
Dec-12	2.0%	0.4%	1.5%	3.1%	1.4%	0.6%	-0.9%
Jan-13	-3.5%	2.2%	1.1%	-2.0%	-4.1%	2.2%	0.6%
Feb-13	-3.8%	-5.7%	-6.5%	-9.6%	-12.3%	-3.9%	-3.2%
Mar-13	1.3%	-0.2%	-1.1%	-2.6%	-6.5%	-0.9%	0.0%
Apr-13	4.2%	3.9%	4.2%	3.3%	3.7%	3.0%	2.4%
May-13	2.0%	1.4%	0.8%	0.7%	-1.3%	-1.0%	1.1%
Jun-13	-2.8%	-2.4%	-3.7%	-6.7%	-5.0%	-7.4%	-4.0%
Jul-13	-2.5%	-1.7%	-2.5%	-7.1%	-5.9%	-0.6%	0.9%
Aug-13	2.3%	-4.7%	-4.5%	-4.4%	-2.3%	-9.1%	-5.5%
Sep-13	6.5%	4.8%	5.2%	5.8%	5.3%	7.1%	5.9%
Oct-13	7.9%	9.8%	9.1%	8.9%	7.9%	5.1%	9.2%
Nov-13	3.3%	-2.0%	-0.8%	3.6%	3.4%	-0.9%	-0.7%
Dec-13	3.7%	2.1%	3.0%	6.0%	7.4%	2.0%	1.3%
Jan-14	-7.7%	-3.4%	-4.2%	-5.9%	-4.4%	-2.3%	-3.6%
Feb-14	3.8%	3.1%	2.8%	3.1%	2.9%	2.1%	5.2%
Mar-14	5.0%	6.8%	7.6%	9.0%	9.7%	7.2%	8.5%
Apr-14	0.5%	-0.1%	0.6%	3.4%	5.9%	0.6%	-0.6%
May-14	12.2%	8.0%	10.4%	15.6%	20.4%	10.5%	9.3%
Jun-14	5.9%	5.3%	6.4%	10.8%	13.2%	4.6%	7.0%
Jul-14	-1.5%	1.4%	0.4%	-2.0%	-2.1%	0.4%	1.7%
Aug-14	3.5%	3.0%	2.7%	1.2%	2.8%	2.3%	4.2%
Sep-14	3.5%	0.1%	0.8%	2.5%	4.1%	2.3%	4.2%
Trailing 12 months	**47%**	**39%**	**45%**	**70%**	**95%**	**39%**	**55%**
Trailing 24 months	**66%**	**40%**	**41%**	**44%**	**52%**	**26%**	**54%**
Trailing 36 months	**100%**	**61%**	**59%**	**55%**	**55%**	**27%**	**78%**
2014 YTD	**27%**	**26%**	**30%**	**42%**	**63%**	**31%**	**41%**
2013	**19%**	**7%**	**3%**	**-6%**	**-11%**	**-6%**	**7%**
2012	**38%**	**28%**	**31%**	**38%**	**33%**	**14%**	**29%**
2011	**-10%**	**-25%**	**-27%**	**-34%**	**-43%**	**-25%**	**-29%**
Avg. Return (+ve months)	**4%**	**5%**	**4%**	**6%**	**6%**	**3%**	**5%**
Avg. Return (-ve months)	**-3%**	**-3%**	**-4%**	**-5%**	**-5%**	**-4%**	**-3%**
Annualized Volatility (TTM)	**16%**	**13%**	**14%**	**19%**	**22%**	**12%**	**14%**
Sharpe Ratio	**1.15**	**0.32**	**0.26**	**0.14**	**0.02**	**-0.06**	**0.31**
Calmar Ratio (3-yr/3%)	**3.68**	**1.08**	**0.95**	**0.50**	**0.43**	**0.28**	**1.37**

*Note: Metis Opportunity Fund's INR track record was a live blend of our running onshore strategies till March 31, 2014; Fund went live on March 11, 2014 and reports net of all fees;*Close-ended funds in US, with USD returns converted into INR.*
Source: Internal Sources; NSE; BSE; Bloomberg; Eurekahedge

Investment Managers

Piyush Sharma, is the co-investment manager of Metis 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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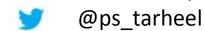
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Gaurav Aggarwal, CFA, CPA, is the co-investment manager of Metis Opportunity Fund. He was a senior analyst with portfolio management duties over $50 million in fund of fund assets at a leading regional investment bank (Global Investment House) in the 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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