Metis India Opportunity Fund

Passive institutional in-flows drive large-cap outperformance

April 2019 Newsletter

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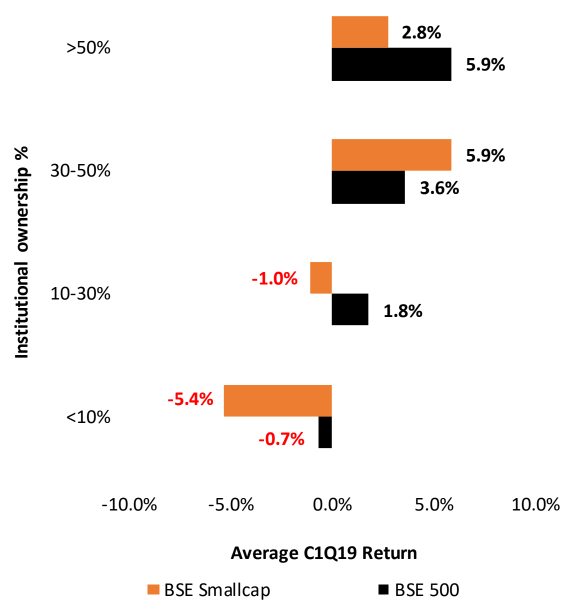
We note a somewhat 'flipping' of extreme investor behavior from 2 years ago – You may recall the disconnected performance of C1Q17 when large flow of retail liquidity ensured that names with low institutional ownership comfortably outpaced more institutionalized names, with little regard to underlying earnings. 2 years later, in sharp contrast, we noted how capital flows from institutional top-down allocators flipped the narrative - The macro trade of crowding into risk assets drove heavy disconnects between benchmark constituents and broader markets in C1Q19 - Underlying earnings considerations were set aside as offshore flows chased headline Indian listed equities with 1Q seeing the biggest ever quarterly inflow of foreign institutional capital, slightly ahead of the inflows seen in C1Q12 and C1Q13[1]. Consequently, names with higher institutional ownership were disproportionate beneficiaries of liquidity (see **Exhibit 1**).

In 1Q19, *Metis India Opportunity Fund* (MIOF) was down -2% vs. +6%, +1%, +3%, for the *S&P BSE 500 TR USD*, S&P *BSE Midcap TR*, and *S&P BSE Smallcap TR* indices respectively.

Since inception in April 2011, *MIOF* is up +81% vs. +65%, +72%, +37%, and +33% increases in *S&P BSE 500 TR*, *S&P BSE Midcap TR*, *S&P BSE Smallcap TR*, and *Eurekahedge India* respectively.

Exhibit 1 – 1Q19 Returns vs. 4Q18 Institutional Ownership



Source: BSE
<u>Notes</u>: 13% of BSE 500 constituents have <10% institutional ownership while 7% have >50% institutional ownership; 48% of BSE Smallcap constituents have <10% institutional ownership and 4% have >50% institutional ownership.

We initiated exposure in a name historically focused on a certain API in a tightly supplied environment. This name continues to morph into a pharma business from what was more of a chemicals business 5 years ago. In F2018 (Mar), API revenues made just under 2/3rd of total revenues and >90% of operating earnings. Consequently, it's legacy base isn't comparable with the business as it stands today. With the company moving into several APIs over the next few years, we expect >3/4th of the business to be API driven by F2021E (Mar). The primary API it produces today (accounting for 60% of this company's revenues) is supplied by only a handful of players globally (~40K tons global capacity) in a highly concentrated space[2], with global demand growing in the 2-4% range. Few Chinese and Indian manufacturers control more than 2/3rd of the global market for this API, with our holding owning the largest capacity globally (10K tons). It is also the lowest cost producer of this API because it internally sources more than half of the inputs[3], making it the only vertically integrated producer of this API. While Sanofi's complete global sourcing of the above API comes from this new holding of ours, their other major clients in India include Granules, Cipla, Abbott etc.

In June last year, a major US based plant of a German player (of above-mentioned API) was shut down. Given that this unit accounted for nearly 15% of this API's global production, ensuing shortage led to a sharp spike in this API's prices, with domestic prices in India spiking and prices in certain international markets rising even

[1] While C1Q19 FPI inflows were only slightly ahead of inflows in C1Q12 and C1Q13, domestic institutional selling was much lower in C1Q19 vs. those quarters. Overall, net institutional buying in C1Q19 was INR 280 Bil, well ahead of INR 175 Bil in C1Q12 and INR 68 Bil in C1Q13.

[2] Top-6 global players account for more than 80% of the market

[3] IBB accounts for ~55% of this business' primary API input cost and is manufactured internally. Captive IBB is about 7-10% cheaper vs. if sourced from market. Other inputs are procured from the likes of Grasim, Vishnu Chemicals, and imported from China. Inputs for IBB are directly linked to crude and sourced from state-owned energy companies.

higher. On our last check, domestic prices were running nearly 70% ahead of pre-shutdown prices and US prices were running 40-50% higher. Soon after the shutdown, in August 2018, a southern US based company announced a 25% capacity expansion for this API (on top of a 10% capacity expansion it completed in 1H18). This planned expansion however wouldn't come online until C2020. Earlier, the German player mentioned above had also announced capacity expansion at its German flagship plant (on-stream by 2021).

The 3 key levers of our thesis are:

1. **Significant de-leveraging as business goes debt-free by F2024E**. This business has about INR 3.3 Bil in net debt, or about 1x F2019E EBITDA. We estimate that even excluding the windfall from higher API prices, this business would still report operating cash flows of >INR 700 mil in F2019 (Mar), with INR 500 mil of that already deployed into facilities for new APIs. On a run-rate basis (assuming legacy APIs' prices decline), we expect them to report north of INR 800 mil in F2020E (Mar). With management planning incremental capex on 2-3 more APIs, F2020E (Mar) would see another INR 700 mil in capital expenditures. From next April onwards however, we see consistent debt paydowns until they go debt-free by F2024E, if not earlier.

2. **Continued mix-shift towards new APIs de-risks the business and improves profitability**. We estimate that in F2019E (Mar), legacy API would have contributed about 85% of drug segment's revenues. That would change sharply over the next few years as contributions from new APIs increase - Metformin (anti-diabetic API; capacity was 3K tons and was increased to 4K tons in F3Q19, translating into revenue potential of ~INR 800 mil); Fenofibrate (anti-cholesterol API; 90 tons installed capacity, translating into revenue potential of ~INR 150 mil); Clopidogrel (anti-platelets API; 180 ton installed capacity, translating into revenue potential of ~INR 600 mil); Pantoprazole (anti-gas API; 300 ton capacity, translating into revenue potential of ~INR 2,100 mil). We note that the global market of the above four APIs is >4x the size of their legacy API. Of the new APIs, Clopidogrel is the least commoditized and our holding's top-7 current markets (India, Spain, Hungary, Indonesia, Brazil, Bangladesh, and China) account for just under half of global sales for this API. Targeted buyers are largely the same as that of the legacy API.

3. **Material free optionality at hand**. We view the fallout of drug recalls in recent times as material free optionality in this situation. Over a period when Chinese and Indian API producers such as Hetero, Aurobindo, Zhejiang, Sichuan etc. have been involved in potential contamination related recalls, there is a definite opportunity for newer and established API producers that have steered clear of such recalls. Further, there is chatter around potential exit of what is the only other operational US producer of this business' core API (should that API prices decline, as discussed).

This stock has more than doubled over the past year but was off about 15% from its high when we initiated exposure. At current valuations, by our estimate, the existing business (legacy APIs + Chemicals) is fairly valued and potential decline in this business' core API prices (upon the shutdown facility of a competitor coming back on-stream) is also seemingly baked in. Our discussions with pharma buyers suggest that there is a substantial backlog of this business' primary API orders, with FDA approved API players booked for 3-4 quarters. Our checks with buyers suggest that prices can recede 25-30% once shutdown facility of the US competitor re-opens. We are however still working with a base case of a 35% decline in prices and not yet considering the fact that they have reduced their cost of production of this API by 10-15% vs. F2018 (by improving yield and reaction). Our upside hypothesis on this name is therefore built upon the 2 key levers mentioned above: 1. Assuming that new capacities gradually reach full utilization over next 3 years, we conservatively price these new APIs between INR 100-120/share, or more than half of current stock price, and 2. The upside on the existing business comes primarily through significant deleveraging of the balance sheet.

Assessing supply-side risk of new capacity to our paper holding: Asia Pulp and Paper's (APP) expansion on the east coast comes at a time when industry is running at near full capacity, AND raw material availability remains solidly in favor of uncoated paper manufacturers. In early 2018, *APP* had reached out to the Andhra government with a $3 Bil+ proposal to build a facility to manufacture grades such as w&p, specialty, kraft, paperboard etc. The 4-5K tons facility would export 3/4th of its production, with apparent focus on China as the destination. We do note that freight cost from India's east coast to Shanghai are lower vs. from Belawan, Indonesia. Further, even though conversion costs are very competitive in Indonesia, wood cost has traditionally been a bit higher vs. Latin forestry peers such as Brazil or Chile - Wood makes about 70% of pulp cost in Indonesia vs. a much lower 60% of pulp production cost in Brazil, widely regarded as among the lowest cost producers of pulp. Critically, over the past couple of years, cost of wood fiber has increased significantly in Indonesia (while it has fallen in India), marginally denting competitiveness.

Material requirements will be serviced by virgin pulp from Indonesia, imported waste paper, and local eucalyptus. Regulatory clearances are expected towards the end of 2019 and facility could come onstream in Ramayapatnam[4] by end-2021/early-2022. APP's proposed facility will be 1,100 kms away from our holding's flagship plant and 600+ kms away from our holding's acquired facility in Telangana, suggesting insignificant and low eucalyptus sourcing radius[5] overlap respectively.

Large recent capacity cut (within W&P paper) in US further solidifies industry pricing. Capacities across nearly all paper grades globally are running at very high utilization levels (primarily as a result of continued capacity cuts in NA and Europe, even as capacity got added in Asia). In January, a major US-based player (~15% of US capacity) announced immediate exit from the uncoated W&P market, inevitably pulling back US exports from Europe[6] and tightening the US market. For Indian players that barely have enough capacity to service the domestic market, it's as attractive a global supply-situation as it can get. We therefore see immaterial risks to our holding's uncoated W&P prices, and that's assuming that there wasn't an established floor pricing on ASEAN imports, which is the case after anti-dumping tariffs were put in place. Elsewhere, import threat is almost insignificant in high-end virgin fiber board (barely 1-3% of domestic consumption is serviced by imports). Our discussions with packaging guys across Pharma companies[7] also corroborate the fact that because of frequent overnight requirements and lack of consistency in imports, Indian paperboard is broadly preferred for converters.

We identify incremental cost benefits from the planned paperboard capacity expansion. As of now, our paper holding controls less than 10% of the 850K tons paperboard market and paperboard makes a fifth of their revenues. This would increase to about a third of their revenues in 3 years. While it's well known that domestic buyers are craving for more capacity, few appreciate how accretive this expansion would be to current paperboard margins – Two key drivers will come into play: 1. They would be installing a new recovery boiler that would double the lignin extraction rate, effectively reaping the same benefits that accrued after a new boiler was installed when the flagship plant in Eastern India went through a major expansion 5 years ago (margins had doubled within 2 years with almost flat pricing), and 2. With new chemical pulp processing capacity, their import content within paperboard pulp would drop from 75% of materials currently to under 50%. In sum, in 4 years, we expect paperboard to contribute around 15% to EBITDA vs. barely 5% currently. To be clear, we have still not priced in any impact of the paperboard expansion within our conservative valuation of this business of around INR 300/share. Herein lies our conviction within a holding that has now hit the top end of our holding exposure limit.

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[4] APP will be allocated 2 of the 5 captive births at Ramayapatnam port. Port will begin operating in 2020.

[5] For larger players within the region, there are 2 mills in AP (both of IA PPM), 2 in Telangana (both of ITC), 3 in Odisha (1 each of JKP, BILT, and Emami), and 3 in Tamil Nadu (1 each of TNPL, Seshasayee, and ITC)

[6] Nearly 30% of European paper and board imports come from US. European uncoated freesheet demand declined 7-9% in 2018.

[7] Indian pharmaceutical companies consume nearly 30% of domestic paperboard production, and their usage is expected to grow in the 7%+ range over the next 3 years.

Digital consumption has a distinct role in creating a higher 'new normal' for box office collections. If anything, 2018 and first quarter of this year has shown that content is increasingly not only attracting higher footfalls but heightened social media activity has also ensured that audience gets to screen quickly than what they used to earlier. Our discussions with certain production houses suggest that a vast majority of moviegoers are consuming trailers over YouTube[8] and basing their decisions on those.

F4Q18 (Mar) was a tough quarter to compare against for box office collections but it appears that F4Q19E (Mar) could still report same-store growth in the high-teens. Our movie exhibition holding was up +3% in the first quarter, following a +13% gain in 2018. It continues to be among our top-3 highest conviction holdings, as has been the case for most of past five years.

Our checks suggest another solid quarter for our diagnostics lab services holding. Our mid-quarter checks in February suggested that H1N1 daily volume run-rate had spiked nearly 10x vs. F4Q (Mar) last year. While our views are certainly not driven by seasonal shifts, we nonetheless note that street's expectation of +12-13% yoy volume growth for F4Q19E (Mar) might end up being conservative.

We see material free optionality (from upcoming parks) in an entertainment holding. For a certain park whose construction was supposed to begin in 2018, a certain local body tax exemption still hadn't come. We note that the total cost of the above park was estimated to be between INR 3.5-4 Bil, of which a fourth has already been incurred. It's worth noting that despite the floods in southern India in the last fiscal, our amusement park holding is all set to report INR 1.5-1.6 Bil in operating cash flows for F2019E (vs. INR 860 mil in F2018) when it reports earnings in a few weeks. Net of maintenance and refurbishment of the 3 operational parks, we conservatively expect the current business to report run-rate free cash flow in the INR 1.5 Bil range going forward, suggesting an effective current unlevered growth rate of a new park every two years for every three operational parks. At current valuations, we conservatively attribute another 20-30% potential upside from the three operational parks and another 25% conservative upside from the upcoming park mentioned above.

Please let us know if you have any questions.

8 T-Series is the most watched channel on YouTube globally

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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