Metis Opportunity Fund

Our focus remains on idiosyncratic catalysts amidst elevated expectations elsewhere

April 2018 Newsletter

Apr 29, 2018

When S&P 500 had lost more than a tenth of its value in the first week of February, Wall Street analysts dismissed it as a minor blip in an otherwise 'entitled' eternal rally that'll supposedly make us all uber-rich. The fact is that at the end of the first week of Feb, little over half of S&P 500 constituents had reported 4Q17 earnings, with S&P 500 earnings ('as reported') suggesting just under 11% growth, making 4Q the fourth straight quarter of earnings deceleration, with 3-4% earnings growth in the quarter attributable to stock buybacks alone. On 'as reported' earnings basis, the index began Feb at already stretched ~21x C2018E earnings, predicated upon +33% earnings growth! With 4Q17 operating margins in US at the highest levels we have seen in well over a decade, and USD unlikely to be a tailwind, it is remarkable that street could somehow project 30%+ earnings growth for C2018E. Add in the fact that we have seen a largely uninterrupted rally over the past few years and to call a selloff at those valuations as a 'minor blip' was laughable. As we write this, 1Q18 earnings for *S&P 500* constituents are rolling out, with earnings averaging 6-7% outside Financials and Tech. Similarly, *Nifty 50* would hardly show any material earnings growth outside Commodities for C1Q18. Given that earnings have been largely lackluster for 4+ years now, our performance is a reflection of our ability to pick solid clean businesses at valuations that aren't predicated on unrealistic acceleration in earnings growth. Be it the case of a media holding reporting solid growth as new stations (launched a few quarters ago) get profitable, or the case of an amusement park comping high precipitation levels from last year, or a healthcare diagnostics position benefiting from acceleration in ongoing shift away from informal players, or several similar stories, near-term earnings upsides within our book are largely decoupled from the broader economy as material idiosyncratic tailwinds drive growth. This is particularly critical today when key risks to global markets come from elevated valuations and estimates for heady earnings growth on already elevated margins across most sectors, with growth increasingly concentrated within fewer pockets. Much doesn't need to go wrong in such situations for investors to lose. It increasingly feels like investors are so busy looking at the relatively clear road ahead, that they may not be mindful of the fact that they may have already used most of the gas in the tank.

In 1Q18, *Metis Opportunity* was down **-11.23%** (in USD), vs **-5.25%**, **-7.17%**, **-11.84%**, **-13.07%**, and **-4.29%** declines in *Nifty TR*[1], *BSE 500 TR, BSE Midcap TR*, *BSE Smallcap TR*, and *Eurekahedge India* respectively. Only 3 of our 22 positions avoided the broad drawdowns in the quarter. We did not initiate any new position during the quarter but selectively added to two holdings.

Over trailing 12 months, *Metis Opportunity* was up **+3.0%** (in USD). That compares with **+11.4%**, **+12.8%**, **+18.2%**, **+14.0%**, and **+11.7%** increases in *Nifty TR, BSE 500 TR, BSE Smallcap TR*, *BSE Midcap TR* and *Eurekahedge India* respectively. Over this period, our volatility was **507 bps**, **373 bps**, and **131 bps** below that of *BSE Smallcap TR, BSE Midcap TR,* and *BSE 500 TR* respectively, and **562 bps** ahead of *Eurekahedge India*.

Over the past 3 years, *Metis Opportunity* is up **+24.6%** (in USD) vs. **+19.1%**, **+28.0%**, **+50.4%**, **+54.0%**, and **+28.0%** 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 **+117.3%** (in USD) vs. **+46.1%**, **+60.2%**, **+87.1%**, **+62.9%**, and **+43.2%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respectively.

Tale of two markets. Currently in India, we have *Nifty 50* on one side and everything else on the other end of the 'froth' spectrum. While we view *Nifty*'s valuations as a bit stretched, small and midcap valuations (as a universe) are unequivocally rich. It seems like institutional participants are finally jumping on the earnings growth bandwagon and stories are being created around a bullish narrative that has already catapulted a large part of this market into orbit. From where we stand, while mid/high-teen earnings growth can support

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

Nifty's valuations, one would need to see an extended run of clean 20%+ broad-based growth to support current valuations in the small and midcap universe. With profitability across most industries at or near their peaks, and material costs beginning to weigh on most names, it is hard to see how *Nifty 50* (ex-financials) can clock 20%+ earnings consensus growth in FY19E (Mar). While small and midcap earnings are likely to be a bit better, most stocks are already pricing in unrealistic growth expectations. Over the course of the next couple of quarters, we expect *Nifty*'s FY19E (Mar) expectations (ex-financials) to likely get cut towards at least mid-teens from 20%+. A glance at F3Q (Dec) numbers should have corroborated what increasingly appears to be a market creating a 'top' - In F3Q, *Nifty 50* (ex-financials) posted ~9.5% earnings growth when comping a weak demonetization-hit quarter from last year. Even this headline performance was replete with drivers that aren't reflective of any broad-based turnaround - In names such as *Asian Paints*, almost entire earnings growth was attributed to spending cutbacks and process changes even as volume growth was mediocre. Excluding the windfall from the IUC fee cut, *Reliance Industries*' F3Q earnings growth would have been 15% (vs. the headline 25% growth). Overall, 70% of *Nifty 50* constituents (ex-financials) missed their estimates and that's when we count names like *Infosys* among the ones that beat consensus, where the beat would have been a miss if it hadn't been for reversal of prior tax provisions. In a quarter that was supposed to deliver clean and solid earnings growth off of a low base, *Nifty*'s numbers were unequivocally poor. Given that FY19E wouldn't have as much of a poor comparison to benefit from, given that weakness in the informal economy is real, given that materials costs are a clear headwind almost across the board, and given that (excluding Commodities and select Industrials) most industries are already at or close to record high margins, it is puzzling to identify the next leg of growth to reconcile with street's FY19E 20%+ earnings growth at the beginning of the year. Anything other than a very solid revival on the topline and continued expansion in margins cannot support such expectations. F3Q (Dec) earnings for *Nifty Midcap 50* (ex-financials) meanwhile grew at a healthier ~23.5% in F3Q (Dec), but headline was skewed by a handful of names (half of that growth was attributable to 3 of the top 8 components).

We had been stressing upon risks of earnings cuts within mass consumption categories such as two-wheelers and telecom services. Consider last quarter results of *Nifty*'s two 2W components, *Bajaj Auto* and *Hero Motocorp*, both of which were fairly hit in the post-demonetization period. While the street was rightly not baking incremental margin expansion in these names for FY19E (Mar), margin contraction risks were largely ignored. As the year began, FY19E (Mar) consensus revenue growth for these names was in the low-teens, a bit higher than what these names averaged in Dec quarter when comping the low base from last year. Meanwhile, their FY19E earnings were being forecasted to grow in the 10%-15% range, a sharp acceleration from the 4% average growth in the past quarter, even as materials costs are clear headwinds going forward. Similarly, *Bharti Airtel*'s FY19E (at the beginning of the year) was built on high single-digit growth in revenues amid continued ARPU pressures. In F4Q (Mar) earnings last week, *Airtel* posted another 6% sequential decline in ARPU. All said, based on recent earnings, ~2/3rd of *Nifty*'s components (ex-financials) need to show material acceleration in earnings growth to come in line with street's FY19E expectations.

Within our India Under-served sub-strategy, we gained further conviction within specific catalysts that are likely to drive near-term earnings growth and/or keep a lid on margins as inputs costs rise.

In December, Supreme Court reaffirmed that diagnostic lab reports can only be signed off by individuals who have an MD in Pathology. Subsequently, we have noticed that organized players have extensively lobbied to enforce this requirement. We note that this requirement has certainly forced several players to engage pathology doctors to sign off on reports. Depending on the location, we estimate that this requirement costs labs an incremental INR 10-20K/month. For a typical stand-alone lab that processes 40 samples/day, we estimate that this could potentially wipe out half of that lab's EBITDA, potentially accelerating the ongoing shift towards organized scale players.

Another recent event with implications for our diagnostics lab holding was a proposal from the Delhi government to put price caps on diagnostics services at hospitals/clinics. In doing so, the govt wants to ensure that hospitals/clinics don't price their diagnostic services at more than 15% premium over what is charged by national diagnostics services labs in the region. Our checks within Delhi suggest that diagnostic tests at hospitals with 100+ beds are, on average, priced at 75%+ premium over national diagnostics lab operators, suggesting significant compression in their margins if they choose to continue to conduct tests in-house. To put that in perspective, at several large hospitals in Delhi[2] that do limited outsourcing of diagnostics, EBITDA contribution from diagnostics makes majority of their EBITDA. We estimate that about a third of the total volume of tests at hospitals with 50-100 beds are outsourced to specialized diagnostic labs within Delhi. Hospitals with 100+ beds meanwhile currently outsource, on average, a much lower 15-20% of their volume. Given that hospitals with 100+ beds account for about half of all private hospital beds in Delhi, we would expect increased outsourcing to diagnostics specialists (if the above proposal goes through), particularly those that can process samples within the region.

Cost pressures likely to remain muted for our paper holding. In recent years, hardwood pricing in the state, where our holding's flagship plant is located, has been driven by sourcing by 4 players, including our holding. With one of them shutting last year and another player already delinquent on sourcing (as per our discussions with the associated agri-cooperative), our holding remains one of only two players that could dictate pricing. With imported BCTMP pulp pricing also likely to remain moderate, we are convinced that 20%+ EBITDA margins in this position will be held going forward. With ahead of schedule debt paydown, we also expect another 2 years of 20%+ earnings growth, with little assistance from overall demand acceleration or inorganic expansion.

Mall supply is unlikely to be a bottleneck for our movie exhibition holding. One of the perceived challenges to growth for a certain movie exhibition holding of ours remains mall supply. Our conservative forecast for mall openings in India suggest that multiplex properties would at least double over the next decade. Even disregarding footfall shift from continued closure of single-screens, it's hard to work with a base case worse than at least tripling of industry revenues over this period.

In our India Undervalued sub-book we added 3.5% exposure to two of our existing holdings. In the number two only pure-play credit rating agency in India we added 2% based on the valuation and post-management meeting conviction. This company's market value has lost nearly 25% since mid-2017 even while (in a weak bank loan volume environment) the top-line and operating profit have grown a steady double-digit YTD. Due to a 5cr hit on account of ESOP to employees the net profit growth was not as strong but we view this as positive development that management is sharing ownership with the employees. The operating margins at 65%, net margin at 50% remain steady and best in class. The management discussion with CFO and senior economist was high-quality and didn't raise any red flags (owned office space in a pretty low-key building in suburb of Mumbai). Firm is celebrating 25 years (IPO in Dec 2012 at nearly 50% of CMP) and has demonstrated a strong and growing business model – although to get high double-digit growth the loan volumes (bond and bank) must rise with economic growth/investment pickup. Overall, given the 450cr cash on balance sheet (market value of 3700cr), 9% investment by key competitor at 25% higher price, and conservative 30% upside on our DCF estimate we felt it deserved higher weight in our book. The remaining additional exposure was in our holding of the leader in Indian synthetic leather manufacturing. We had added to this holding in Q3 2017 also (although at ~25% lower price) and the rationale remains largely same- after expected blockbuster Q3 (YoY recovery from demonetization quarter along with GST effects getting regularized- especially on the footwear market) the company is poised to deliver steady 15-20% topline & bottom-line growth as it expands into PU leather and picks up more auto OEM customers in the export market, among other drivers.

[2] Delhi accounts for more than a third of revenues for our healthcare diagnostics holding

Performance and Attribution summary

Nearly all of our holdings declined in 1Q. Our best performing positions amidst broad declines were all flattish – A Software services name that's coming off of a 6% decline in 2017, a recently initiated position in Healthcare diagnostics, and an Auto Parts name. Our two worst performing positions during the quarter were a Logistics name (down **-26%**), and a Packaging name (down **-25%**). For our historical position-wise benchmarking vs. peers and *BSE 500*, please see **Exhibit 1d**.

Since inception in April 2011, *Metis Opportunity* is up **+117.3%** (in USD) vs. **+46.1%**, **+60.2%**, **+87.1%**, **+62.9%**, and **+43.2%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR*, *BSE Smallcap TR*, and *Eurekahedge India* respectively (see **Exhibit 1a** and **1c**). Over trailing 12 months, *Metis Opportunity* was up **+3.0%** (in USD). That compares with **+11.4%**, **+12.8%**, **+18.2%**, **+14.0%**, and **+11.7%** increases in *Nifty TR, BSE 500 TR, BSE Smallcap TR*, *BSE Midcap TR* and *Eurekahedge India* respectively. Over this period, our volatility was **507 bps**, **373 bps**, and **131 bps** below that of *BSE Smallcap TR, BSE Midcap TR,* and *BSE 500 TR* respectively, and **562 bps** ahead of *Eurekahedge India* (see **Exhibit 1b**).

Exhibit 1a – Perf. since inception

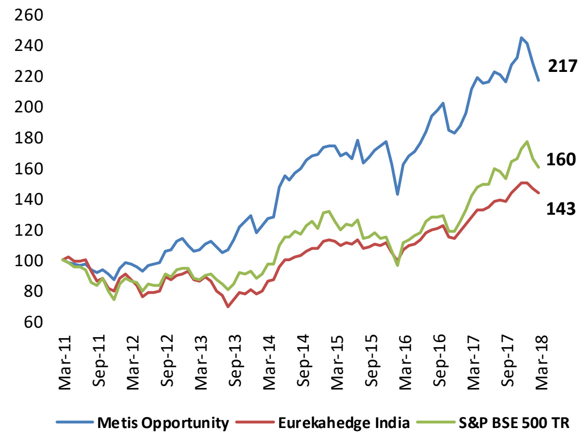


Exhibit 1b – TTM volatility

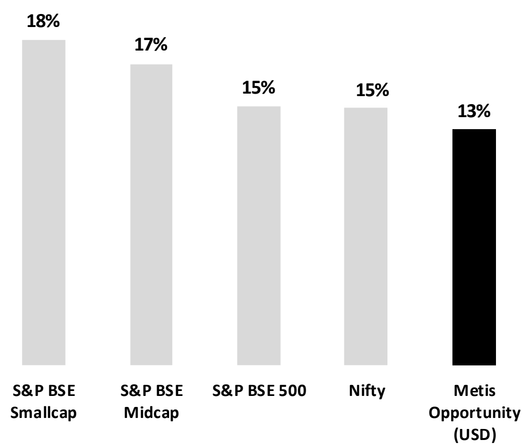


Exhibit 1c – Calendar year benchmarking

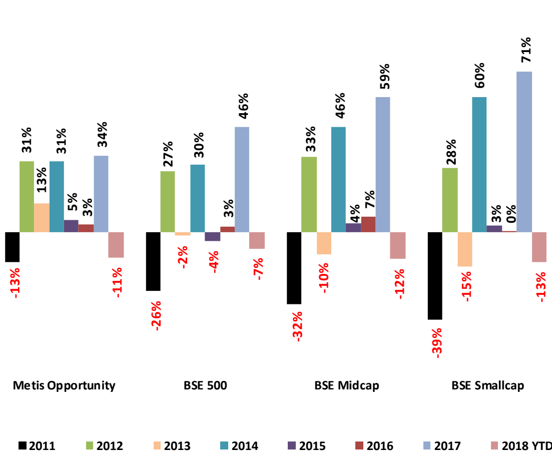
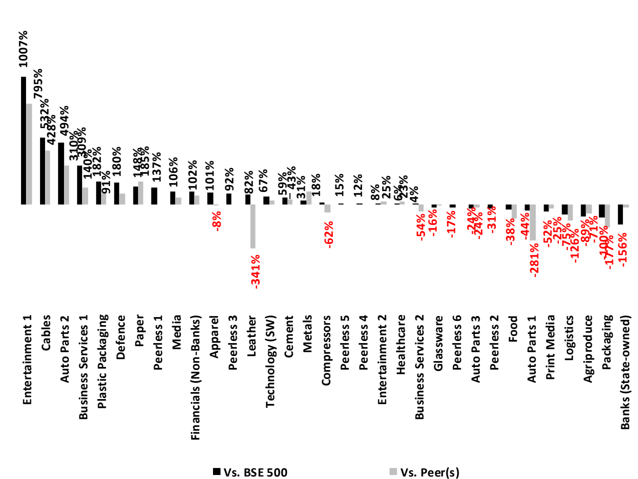


Exhibit 1d – Industry-wise benchmarking for positions



Note: Metis Opportunity went live on Mar 11th 2014; Industry-wise benchmarking compares position-wise performance (relative to BSE 500 and Industry-peers) from initial cost basis (NOT average cost basis) to present/exit.
Source: Internal Sources; NSE, BSE, Eurekahedge

Exhibit 2a – Relative rolling 12-mth returns

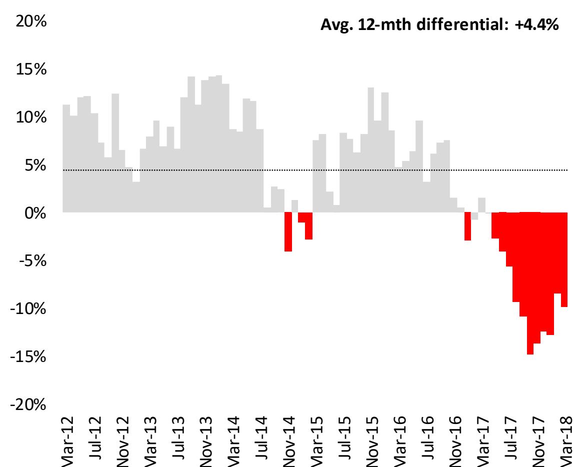
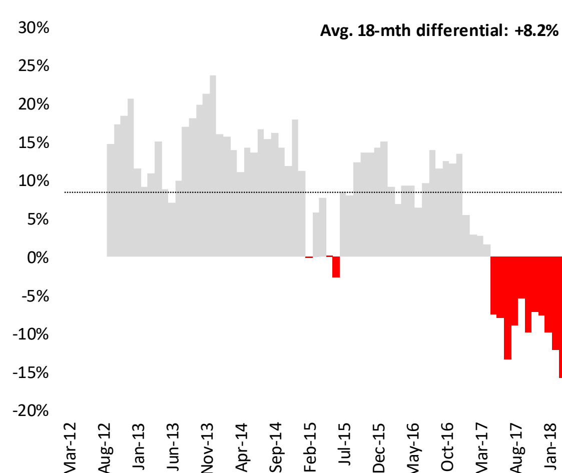


Exhibit 2b – Relative rolling 18-mth returns



Note: Relative return differentials are calculated vs. S&P BSE 500 Total Return index returns
Source: Internal Sources

Exhibit 3 – Time window analysis for our sub-strategies

	India Underserved		*India Undervalued*	
	3 Month	*12 Month*	*3 Month*	*12 Month*
Number of periods	82	73	87	78
Average period return	**4%**	**21%**	**4%**	**20%**
Number of profitable periods	57	70	55	69
% profitable periods	**70%**	**96%**	**63%**	**88%**
Best period	24%	55%	26%	66%
Gain Standard Deviation	5.9%	13.3%	6.4%	16.9%
Sharpe Ratio @10% RFR	0.28	0.80	0.19	0.54
Sharpe Ratio @5% RFR	0.44	1.16	0.32	0.80
Sharpe Ratio @0% RFR	0.60	1.53	0.46	1.06
Loss Standard Deviation	2.4%	0.8%	4.5%	5.8%
Downside Deviation @10% MAR	3.6%	3.2%	5.2%	7.0%
Downside Deviation @5% MAR	3.0%	1.5%	4.6%	5.0%
Downside Deviation @0% MAR	2.4%	0.2%	4.0%	3.4%
Sortino Ratio @10%	0.57	3.43	0.32	1.48
Sortino Ratio @5%	1.09	11.07	0.63	3.06
Sortino Ratio @0%	1.89	87.99	1.03	5.92
Average Gain/Loss	2.2	22.8	1.9	2.8
Profit/Loss Ratio	5.1	531.4	3.3	21.7

Note: Metis Opportunity is a blend the above onshore sub-strategies
Source: HedgeAlytix

Exhibit 4 – Long-book snapshot

Top position as % of book	11%
Smallest position as % of book	1%
Top 5 positions as % of book	41%
Avg. weighted market cap of book (mil)	$977
Avg. weighted free float of book	47%
Net exposure	94%
# of positions	22

Source: Internal Sources

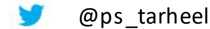
Exhibit 5 – Historical Quarterly Performance

	Metis Opportunity	*Nifty TR*	*S&P BSE 500 TR*	*S&P BSE Midcap TR*	*S&P BSE Smallcap TR*	*Eurekahedge India*	*India-focused CE Funds**
2Q11	-4.2%	-4.2%	-4.5%	-5.8%	-8.2%	-1.1%	-6.1%
3Q11	-4.1%	-13.5%	-13.0%	-11.9%	-16.0%	-13.5%	-21.9%
4Q11	-5.6%	-7.8%	-10.8%	-17.5%	-20.5%	-7.5%	-16.4%
1Q12	11.8%	13.1%	15.6%	22.1%	17.9%	9.6%	20.0%
2Q12	-0.9%	-0.9%	-1.8%	-4.0%	-2.3%	-9.3%	-8.0%
3Q12	9.2%	7.1%	7.1%	6.9%	7.0%	12.4%	14.1%
4Q12	8.6%	2.4%	4.1%	6.5%	4.0%	1.9%	-0.8%
1Q13	-7.1%	-4.9%	-7.6%	-14.7%	-22.4%	-4.9%	-2.6%
2Q13	1.7%	1.7%	0.1%	-4.1%	-4.2%	-7.1%	-9.5%
3Q13	4.7%	-3.1%	-3.1%	-6.7%	-3.6%	-7.1%	-4.5%
4Q13	13.9%	8.3%	9.9%	17.9%	18.2%	8.0%	11.0%
1Q14	-1.0%	4.8%	4.5%	4.3%	6.3%	7.5%	13.0%
2Q14	21.7%	14.1%	18.7%	32.8%	44.6%	15.9%	15.5%
3Q14	3.2%	2.4%	1.9%	-0.2%	2.8%	3.1%	7.8%
4Q14	5.3%	1.3%	2.6%	5.9%	1.1%	4.4%	3.2%
1Q15	3.7%	3.9%	4.5%	3.4%	-0.5%	4.5%	7.7%
2Q15	-5.0%	-2.8%	-2.7%	-0.8%	0.0%	-1.4%	-3.5%
3Q15	0.4%	-7.6%	-6.1%	-1.2%	-3.0%	-2.2%	-5.6%
4Q15	6.7%	-0.8%	0.6%	2.4%	6.5%	3.1%	-3.8%
1Q16	-8.5%	-2.4%	-3.8%	-4.3%	-10.6%	-4.1%	-2.0%
2Q16	8.6%	5.7%	6.6%	8.4%	9.9%	5.6%	7.3%
3Q16	12.0%	5.8%	8.0%	14.5%	10.3%	6.8%	5.3%
4Q16	-7.4%	-6.6%	-7.4%	-10.2%	-7.5%	-5.2%	-11.0%
1Q17	15.3%	17.8%	20.3%	23.3%	25.7%	12.4%	19.6%
2Q17	2.2%	4.4%	4.9%	4.3%	7.0%	4.8%	4.8%
3Q17	0.1%	2.3%	2.7%	4.9%	4.1%	2.9%	2.2%
4Q17	13.4%	10.1%	12.8%	18.1%	22.1%	8.3%	8.8%
1Q18	-11.2%	-5.2%	-7.2%	-11.8%	-13.1%	-4.3%	-5.8%
Trailing 1 year	3%	11%	13%	14%	18%	12%	10%
Trailing 2 years	34%	37%	45%	57%	67%	34%	32%
Trailing 3 years	25%	19%	28%	50%	54%	28%	13%
Trailing 5 years	105%	64%	80%	140%	167%	67%	70%
Since inception	**117%**	**46%**	**60%**	**87%**	**63%**	**43%**	**27%**
2018 YTD	-11%	-5%	-7%	-12%	-13%	-4%	-6%
2017	34%	38%	46%	59%	71%	31%	39%
2016	3%	2%	3%	7%	0%	3%	-1%
2015	5%	-7%	-4%	4%	3%	4%	-6%
2014	31%	24%	30%	46%	60%	34%	45%
2013	13%	1%	-2%	-10%	-15%	-11%	-7%
2012	31%	23%	27%	33%	28%	14%	25%
2011	-13%	-24%	-26%	-32%	-39%	-21%	-39%
Sharpe Ratio	0.59	0.22	0.30	0.39	0.29	0.22	0.12

*Note: Fund went live on March 11, 2014; *Close-ended funds in US*
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.

piyush@metisopportunity.com
+1-919-360-0359 (Cell-US)


Gaurav Aggarwal, CFA, CPA, CIPM 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.

gaurav@metisopportunity.com
+1-919-665-0696 (Cell-US)

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Metis Opportunity Fund
c/o Equinoxe Alternative Investment Services (Mauritius) Ltd.
12th Floor, Raffles Tower
19 Cyber City, Ebene, Republic of Mauritius
T: +230-468-1291
F: +230-468-1219

Metis Management Pvt. Ltd.
Level-12, Building No. 8,
Tower-C, DLF Cyber City Phase II,
Gurgaon-122002, Haryana, India
T: +91-124-4696636
F: +91-124-4696970

www.metisopportunity.com