Metis Opportunity Fund

Frothy as it goes

April 2017 Newsletter

April 28, 2017

While there was little surprising about our slight underperformance in 1Q17 (of the 6 underperforming quarters since our launch in April 2011, 5 are first calendar quarters), the fact that the strategy 'only' underpaced *BSE 500* by 130 bps in an unequivocally disconnected and frothy environment for small and midcaps was a pleasant surprise.

While our 1Q underperformances are well documented, it is more critical to appreciate that **1**. *Metis Opportunity* strategy has rarely underpaced *BSE 500* over 12 month periods, and **2**. By extension, the strategy has outpaced *BSE 500* by an average of +10% in the last 9 months of calendar years, ranging from as less as a +7% outperformance during the 2012 rally to as much as +14% outperformance during the small and mid-cap drawdowns in 2013. *Metis Opportunity* was up **+13.5%** (in INR terms) in 1Q17, vs **+11.5%**, **+14.8%**, **+17.6%**, **+20.0%**, and **+7.2%** gains in *Nifty TR*[1], *BSE 500 TR, BSE Midcap TR*, *BSE Smallcap TR*, and *Eurekahedge India* respectively. 80% of *Metis Opportunity* constituents rose in 1Q, including our top-5 positions. Our net exposure at the end of 4Q16 was 89% vs. 92% at the end of 3Q16. The reduction in exposure was largely driven by us completely exiting a 'surgical devices' position within our *India Underserved* strategy and some selective liquidation in our *India Undervalued* strategy.

Over trailing 12 months, *Metis Opportunity* was up **+32.1%** (in INR terms). That compares with **+19.3%**, **+25.5%**, **+37.8%**, **+34.3%**, and **+17.1%** increases in *Nifty TR, BSE 500 TR, BSE Smallcap TR*, *BSE Midcap TR* and *Eurekahedge India* respectively. Over this period, our volatility was **239 bps** and **189 bps** below that of *BSE Smallcap TR* and *BSE Midcap TR* respectively, and **103 bps** and **778 bps** ahead of *BSE 500 TR* and *Eurekahedge India* respectively.

Over the past 3 years, *Metis Opportunity* is up **+88.6%** (in INR terms) vs. **+40.9%**, **+58.6%**, **+106.8%**, **+110.1%**, and **+60.1%** 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 **+177.8%** (in INR terms) vs. **+67.8%**, **+83.0%**, **+111.2%**, **+78.0%**, and **+88.0%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respectively.

Disconnect between midcap earnings and stock prices stands out in the FY14-FY17 period. When it comes to the midcap space, the just concluded 3-year period (FY14-FY17) stands out while identifying disconnects between earnings and stock prices[2] – While earnings for top-50 names averaged annualized growth of 15% over last 3 years (slowest among prior recent 3-year periods), underlying stocks averaged a materially higher 24% annualized return, indicating a sharp disconnect between stock prices and earnings (see **Exhibit 1a**).

While 57% average return CAGR during the FY05-FY08 period was still accompanied by an equally sharp run-up in earnings, the near doubling of midcaps and smallcaps over the past 3 years has clearly not been accompanied by equally impressive earnings growth. Majority of midcap constituents reported growth deceleration during FY14-FY17 period, with muted revenue growth finally giving way to recent margin contraction even as revenues have benignly accelerated off of a low base.

1Q17 likely witnessed the most disconnected rally in recent memory. While we have identified growing froth within small and midcaps previously (continued retail inflows and high delivery% in forensically suspect names), we don't recall such active participation by retail investors at any point since our inception 6+ years ago. Retail ownership attribution by itself could explain material alpha creation in 1Q17 (see **Exhibit 1b**).

Revenue growth is gradually inching up again but earnings are facing off very high expectations. As we write this, F4Q (Mar) earnings trickle in. Even though it's very early in the season, early indications suggest mid-high single digit average revenue growth but continued margin compression has ensured that earnings beats only narrowly outpace misses. That said, the extremely heavy weight of expectations around small and mid-caps

1 'Total Return' indices are used for comparison

2 For top-50 midcap names that have been listed since at least F2005 (Mar)

(valuations are running north of 30x and even higher on 'cash basis') is bound to take a toll at some point. With far superior earnings to cash conversion, we remain very confident in our current book even as we are cognizant of some collateral damage in the event of a selloff.

Exhibit 1a – Earnings vs. Stock price CAGR over 3-yr periods

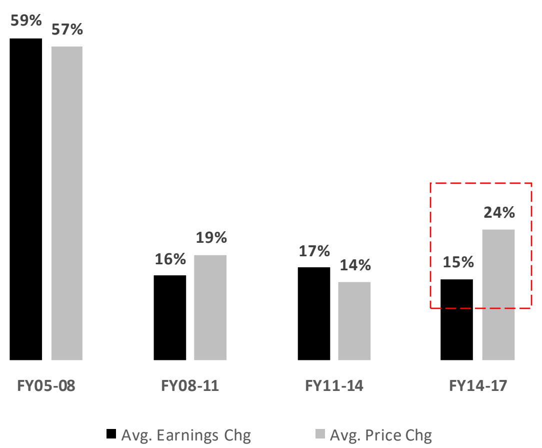
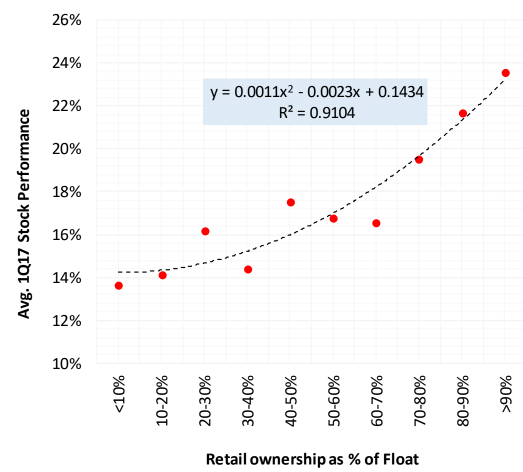


Exhibit 1b – Retail ownership vs. Stock performance in 1Q



Source: Company Reports, Thomson Reuters, NSE, Bloomberg

As we close another 1st quarter, we are reminded of the old saying "the more things change, the more they remain the same". India is going through changes which economists would say are "transformational" and many would not have expected any government to pull off these politically risky moves, mainly demonetization and nation-wide GST (Goods & Service Tax). These long-term socio-economic movements, in tandem, will increasingly formalize the economy (75-90% of labor pool is doing informal work) over time, channel savings to financial assets, and lead to better tax compliance - it still has to be seen how effectively GOI can spend this extra revenue! Yet our biggest concern remains the approximately 12m/year youth entering work force and given that average skill level is low and overall job growth is in low single digits, these young men and women will continue to face difficulty in reaching their own high aspirations in a digital world. The need for drastic jump in low-skilled job creation should be the primarily goal of current dispensation to ensure that demographic dividend does not become demographic nightmare. A lot more needs to be done and there are still a lot of 1-foot hurdles left to clear.

We are confident that our 20 diversified businesses, each with excellent management/promoters, will get more than their fair share of the long runway of growth that is to come as India continues its unstoppable, messy march from socialism to capitalism in economic sphere and from a feudal to an unforgiving delivery based democratic model in the political sphere. Fortunately, a large part of Indian population, just like good value investors, are mentally suited to handle short-term pain for truly meaningful long-term gain (especially when the stakes/challenges are so high for the world's youngest population). Regardless, we don't rely at all on the macro/political picture and value each holding given our latest critical view of its long-term prospects in its competitive universe.

Thanks to the continuing support of our existing investors and new interest from partners (onshore and offshore) who wish to join our disciplined, sustainable approach to wealth creation.

Our radio broadcasting position is all set for post Phase III expansion. All but 3 of the frequencies that our radio broadcasting holding had secured in the first batch of Phase III auctions are now operational. In addition, this broadcaster has secured another 21 frequencies in the second batch of the Phase III auctions, most of which we believe will be 'networked'. Our recent industry-wide checks on ongoing station ramp-up further strengthens our conviction on this core holding within our *India Underserved* strategy. We are now conservatively estimating a 25%+ earnings CAGR in this position over the next 3 years, helped by around INR 1 Bil contribution in F2020E (Mar) from the already rolled out first batch frequencies (see **Exhibit 2**). Critically, we believe that the street could be missing the earnings upside here by extrapolating the muted post-Phase II ramp-up. We note 4 critical differences between now and beginning of F2009, when Phase II frequencies started rolling out.

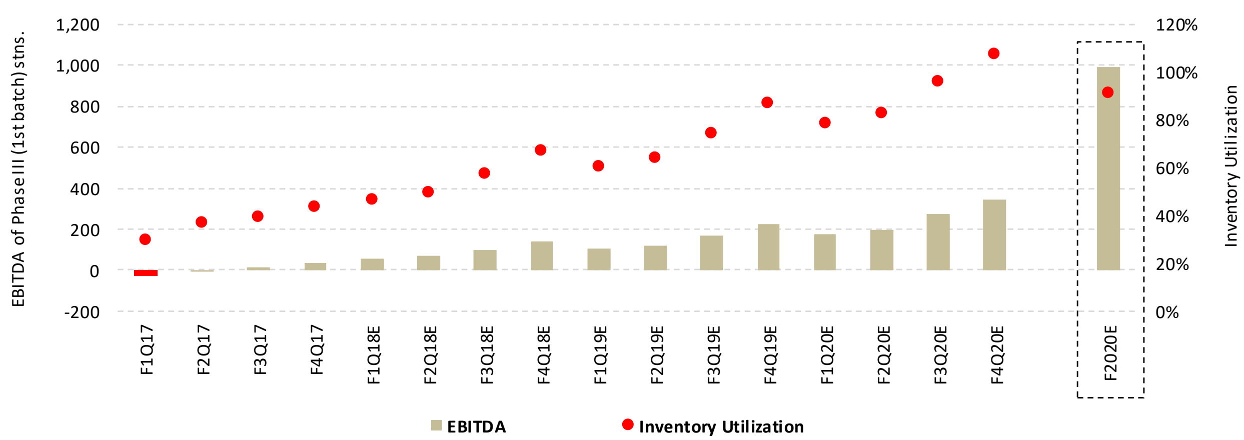
1. **New supply isn't disruptive to impede pricing growth**. In sharp contrast with post-Phase II rollout, incoming airtime supply can be comfortably absorbed. In 3 of the 4 new stations launched (where our broadcaster didn't have presence until Phase III), it is the only bidder that won a frequency and 1 of 2 winners in the fourth city. In the cities where our broadcaster already had a presence, on average, it accounted for 70% of new air-time supply coming in.

2. **Immaterial inventory overhang for Phase III launches**. The industry-wide utilization situation is sharply different vs. before Phase II stations launched. Consider Delhi (India's biggest radio market) for instance – Prior to Phase II station launches, Delhi's legacy stations were operating at utilization levels in the 60-70% range. In sharp contrast, industry-wide, Delhi's utilization was almost 2x prior to Phase III auctions in late 2015. To make matters worse post-Phase II expansion, the global financial crisis sharply decelerated the inventory utilization build-up. Presently, far lower supply coupled with already stretched airtime inventory almost certainly establishes ground for a much quicker inventory ramp-up in new launches across most cities auctioned in the first batch. Our estimates assume that inventory utilization across new stations builds up about twice as fast as what we witnessed post-Phase II auctions.

3. **Royalty payments are materially lower now**. Prior to launch of the Phase II frequencies, our broadcaster was paying out 5.6% of its revenues as royalty payments. Subsequent court judgments ensured that the royalty burden came down to below 3%.

4. **Overheads are being absorbed in several cities with dual frequencies**. Among the 14 stations already launched by our broadcaster in F2017 (Mar), 10 were in cities with prior presence. In nearly all the cases, dual frequency infrastructure was built on the same premises, and in majority of the cases, limited incremental sales team expansion has taken place. Lastly, a material portion of programming on new frequencies is being produced centrally.

Exhibit 2 – Est. EBITDA (in INR mil) contribution from the already rolled out frequencies acquired in first batch of auctions



Note: We have assumed no price increase until new frequencies breach the 100% utilization level
Source: Internal estimates

Performance and Attribution summary

4/5th of *Metis Opportunity* holdings gained in 1Q17, with half of our positions outpacing *BSE 500 TR* index. Our two best performing positions in the quarter were a *Plastic Packaging* name (**+35%**) and a Business Services name (**+30%**). Our two worst performing positions during the quarter were an *Auto Parts* name (down **-15%**), which was among the worst hurt from the demonetization exercise, and an *Internet* name (down **-11%**). For our historical position-wise benchmarking vs. peers and *BSE 500*, please see **Exhibit 3d**.

In 1Q17, *Metis Opportunity* was up **+13.5%** (in INR terms), vs **+11.5%**, **+14.8%**, **+17.6%**, **+20.0%**, and **+7.2%** gains in *Nifty TR*[3], *BSE 500 TR, BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respectively. Since inception in April 2011, *Metis Opportunity* is up **+177.8%** (in INR terms) vs. **+67.8%**, **+83.0%**, **+111.2%**, **+78.0%**, and **+88.0%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respectively (see **Exhibit 3a** and **3c**). Over trailing 12 months, our volatility was **239 bps** and **189 bps** below that of *BSE Smallcap TR* and *BSE Midcap TR* respectively, and **103 bps** and **778 bps** ahead of *BSE 500 TR* and *Eurekahedge India* respectively (see **Exhibit 3b**).

Exhibit 3a – Perf. since inception

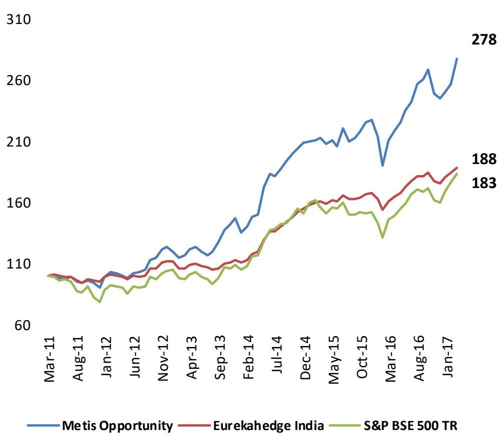


Exhibit 3b – TTM volatility

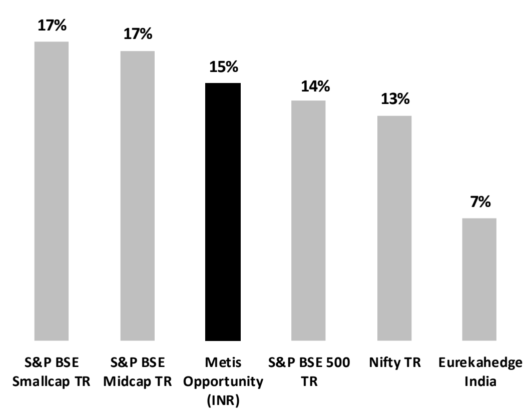


Exhibit 3c – Calendar year benchmarking

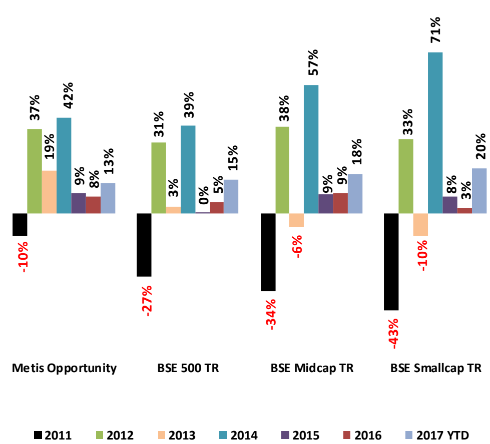
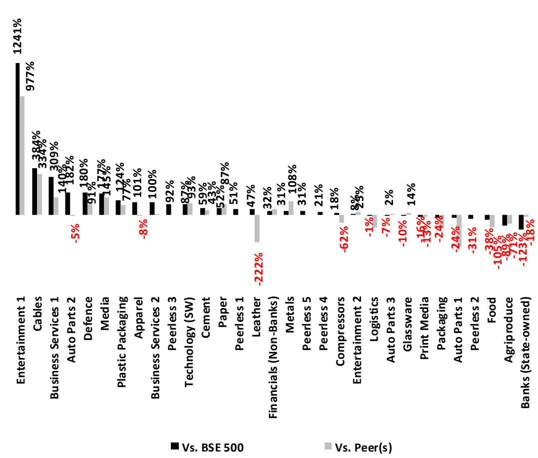


Exhibit 3d – Industry-wise benchmarking for positions



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

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3 'Total Return' indices are used for comparison

Exhibit 4a – Relative rolling 12-mth returns

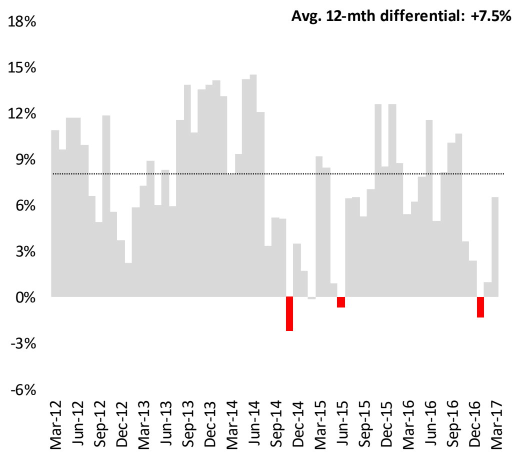
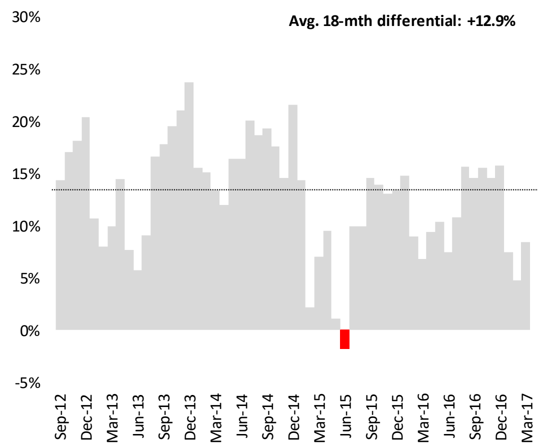


Exhibit 4b – Relative rolling 18-mth returns



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

Exhibit 5 – Time window analysis for our sub-strategies

	India Underserved		*India Undervalued*	
	3 Month	*12 Month*	*3 Month*	*12 Month*
Number of periods	70	61	75	66
Average period return	**5%**	**23%**	**4%**	**19%**
Number of profitable periods	50	59	46	57
% profitable periods	**71%**	**97%**	**61%**	**86%**
Best period	24%	55%	26%	66%
Gain Standard Deviation	6.2%	13.2%	6.6%	17.9%
Sharpe Ratio @10% RFR	0.31	0.96	0.17	0.45
Sharpe Ratio @5% RFR	0.46	1.33	0.30	0.69
Sharpe Ratio @0% RFR	0.62	1.69	0.43	0.94
Loss Standard Deviation	2.6%	0.4%	4.4%	5.8%
Downside Deviation @10% MAR	3.7%	2.8%	5.2%	7.5%
Downside Deviation @5% MAR	3.1%	1.3%	4.6%	5.4%
Downside Deviation @0% MAR	2.5%	0.2%	4.0%	3.7%
Sortino Ratio @10%	0.64	4.75	0.29	1.18
Sortino Ratio @5%	1.15	14.07	0.59	2.56
Sortino Ratio @0%	1.91	143.54	0.98	5.08
Average Gain/Loss	2.1	28.1	2.0	2.7
Profit/Loss Ratio	5.3	827.5	3.1	17.4

Note: Metis Opportunity is a direct blend of above two running onshore sub-strategies
Source: HedgeAlytix

Exhibit 6 – Long-book snapshot

Top position as % of book	10%
Smallest position as % of book	1.0%
Top 5 positions as % of book	42%
Avg. weighted market cap of book (mil)	$896
Avg. weighted free float of book	43%
Net Exposure	89%
# of positions	20

Source: Internal Sources

Exhibit 7 – Historical Monthly Performance

	Metis Opportunity (INR)	*Nifty TR*	*S&P BSE 500 TR*	*S&P BSE Midcap TR*	*S&P BSE Smallcap TR*	*Eurekahedge India*	*India-focused CE Funds**
2Q11	-3.0%	-2.8%	-3.1%	-4.7%	-6.8%	-0.9%	-5.9%
3Q11	-3.0%	-12.2%	-11.6%	-10.6%	-14.6%	-5.1%	-14.5%
4Q11	-4.4%	-6.4%	-9.4%	-16.2%	-19.2%	0.8%	-9.0%
1Q12	13.1%	14.7%	17.2%	23.7%	19.6%	5.5%	15.2%
2Q12	0.2%	0.4%	-0.5%	-2.7%	-1.0%	0.0%	1.2%
3Q12	10.3%	8.4%	8.5%	8.3%	8.4%	5.5%	6.8%
4Q12	9.7%	3.7%	5.4%	7.8%	5.3%	5.9%	3.1%
1Q13	-6.1%	-3.6%	-6.4%	-13.5%	-21.3%	-5.6%	-3.3%
2Q13	3.2%	3.4%	1.8%	-2.4%	-2.6%	2.1%	-0.6%
3Q13	6.2%	-1.4%	-1.4%	-5.1%	-1.9%	-2.0%	0.4%
4Q13	15.4%	10.1%	11.7%	19.8%	20.1%	6.5%	9.4%
1Q14	0.5%	6.5%	6.2%	6.0%	8.1%	4.5%	9.7%
2Q14	24.5%	14.0%	18.6%	32.7%	44.4%	15.8%	15.4%
3Q14	5.5%	5.1%	4.6%	2.4%	5.5%	5.9%	10.6%
4Q14	8.0%	4.1%	5.5%	8.9%	3.9%	7.4%	6.1%
1Q15	1.7%	2.7%	3.2%	2.2%	-1.7%	3.7%	6.4%
2Q15	-3.2%	-1.0%	-0.9%	1.0%	1.9%	0.4%	-1.7%
3Q15	3.2%	-4.7%	-3.2%	1.9%	0.1%	0.7%	-2.7%
4Q15	7.2%	0.1%	1.4%	3.3%	7.5%	3.4%	-3.1%
1Q16	-7.6%	-2.4%	-3.8%	-4.3%	-10.6%	-4.2%	-2.0%
2Q16	11.7%	7.7%	8.7%	10.5%	12.0%	7.3%	9.5%
3Q16	11.2%	4.3%	6.5%	12.9%	8.7%	5.3%	3.9%
4Q16	-6.2%	-4.8%	-5.6%	-8.5%	-5.7%	-3.3%	-9.2%
1Q17	13.5%	11.5%	14.8%	17.6%	20.0%	7.2%	14.1%
Trailing 1 year	32%	19%	26%	34%	38%	17%	18%
Trailing 2 years	31%	10%	17%	37%	35%	17%	7%
Trailing 3 years	89%	41%	59%	107%	110%	60%	54%
Since inception	178%	68%	83%	111%	78%	88%	68%
2017 YTD	13%	12%	15%	18%	20%	7%	14%
2016	8%	4%	5%	9%	3%	5%	1%
2015	9%	-3%	0%	9%	8%	8%	-1%
2014	42%	33%	39%	57%	71%	38%	49%
2013	19%	8%	3%	-6%	-10%	1%	6%
2012	37%	28%	31%	38%	33%	14%	28%
2011	-10%	-25%	-27%	-34%	-43%	-25%	-31%
TTM Volatility	15%	13%	14%	17%	17%	7%	15%
Sharpe Ratio	1.02	0.44	0.51	0.59	0.41	0.93	0.44
Calmar Ratio (5-yr/3%)	1.15	0.48	0.64	0.67	0.52	0.56	0.62

*Note: Metis Opportunity's INR track record is a live blend of our running onshore strategies; Fund went live on March 11, 2014; *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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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.

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