Metis Opportunity Fund

When siphoning strikes

July 2014 Newsletter

July 11, 2014

What began in March continued through 2Q – rampant speculation across India's small and mid-cap universe. On average, the worst names that get consistently flagged on our forensic screen handily outpaced the clean ones. For most of these names, sub-par C1Q earnings came and went, with nearly no impact on how their valuations trended. There was an unquestionable element of hope in how several names moved in 2Q. While this could last longer than conventional wisdom would suggest, it would be foolish to blink.

In 2Q, 80%+ of our holdings outpaced *BSE 500*, with no holding reporting a decline. *Metis Strategy* finished 2Q with a net exposure of 83%, a bit lower vs. 88% at the end of 1Q. Substantial sale in an open offer considerably reduced our net exposure, more than offsetting the 25%+ rise in our long book.

In 2Q14, *Metis Strategy* was up **+20.1%**, in INR terms and net of all fees, as all of our holdings gained. That compared with **+13.5%**, **+18.0%**, **+32.4%**, **+44.3%**, and **+23.2%** increases in *Nifty, BSE 500, BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively.

Over trailing 12 months, *Metis Strategy* was up **+48.1%**. That compared with **+30.3%**, **+36.7%**, **+57.2%**, **+80.8%**, and **+35.2%** increases in *Nifty, BSE 500, BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively. Over this period, our volatility was **10**, **729**, **862**, and **345** bps below *BSE 500, BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively, and **157** bps higher than *Nifty*.

Over the past 3 years, *Metis Strategy* was up **+84.4%** vs. **+34.8%** increase in *Nifty* and *BSE 500*, and **+36.8%**, **+25.1%**, and **+11.8%** increases in *BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively.

F4Q (Mar) earnings for our holdings were characterized by substantial earnings upsides. About 2/3rd of our holdings beat earnings estimates, with nearly all of them outpacing consensus estimates by a double-digit margin. This however was largely driven through cost control and improved operating leverage vs. revenue beats. Yet, just under half of our holdings still outpaced consensus revenue estimates, with about 15% of holdings reporting a double-digit revenue surprise.

Overall, our long holdings outpaced consensus earnings by about 14% in F4Q, despite a low single-digit revenue beat. Only one name (an infrastructure SPV) reported a double-digit beat on both top-line and earnings. Far more prevalent was the theme of top-line beats not translating into earnings surprises – Some of our strongest executing names (in *Entertainment*, *Internet*, and *Business Services*) reported 5%+ beats on the top–line but couldn't translate that into solid earnings beats. While easy comps are expected to provide tailwinds through at least 1H of F2015E (Mar), we are still awaiting signals that can propel a broad based move in valuations from here.

In our marketing trips, we have often told investors how we routinely monitor cash outflows from core businesses to subs in India. In this letter, we would provide a few illustrations of how subsidiaries are used to siphon capital, or occasionally to park overstated earnings that get "invested" in closely held businesses.

When siphoning strikes. While having cross-transacting businesses operate off of separate tax jurisdictions isn't uncommon, a far larger network of such businesses within a single tax jurisdiction certainly is. For Indian businesses with massive swathe of cross-holdings (through listed and unlisted entities), one can't help but ask why most related parties (where material linkages exist) listed to comply with AS-24 of Indian GAAP are opaque unlisted entities. While we aren't making an allegation, we note that several transactions don't appear to take place at arm's length and in several cases parent's continued "support" of the subsidiaries is perplexing.

Unlike in the US where the 382 limitation and continuity-related carry-forward restrictions don't incentivize "tax-influenced" acquisitions of NOLs, one can note several instances in India where loss-saddled entities get acquired for tax purposes. This strategy of utilizing loopholes however is certainly in sharp contrast with that followed by a major Indian Energy conglomerate, an household name that enjoys considerable political patronage - While subs bleed cash here too, parent's hugely disproportionate capital support for subs is more suggestive of capital siphoning than of tax optimization. While investors often (certainly not always) rightly value these businesses on

their enterprise-wide cash generation ability, to back teams that flagrantly allocate "reported cash" to consistently bleeding unlisted subsidiaries is suicidal, in our view.

While it's evident that several Indian conglomerates don't quite impress us with their investing discipline, even these can be broadly categorized under two classes – Those that have been burnt by bad equity choices in non-core subs, and those that go a step ahead by "doling" out subordinate debt (either real cash or reported earnings ?) to incessantly cash-bleeding subsidiaries. In several cases, this capital allocation seems an even far poorer choice than one could have made by picking some unsecured "C" rated paper in US in 2007. Often, its more than just a bad investment choice.

The cash sucking conduit black-hole. Let's evaluate the case of the major Energy conglomerate mentioned above. Its subsidiaries have collectively burnt nearly INR 1.3 Bil in operating cash (pre-financing and pre-tax) over the past 5 years and do so with remarkable consistency. Since that burn is barely 9 bps of parent's cash generation, it doesn't attract much interest. Until of course, you focus on capital "support". At the end of last fiscal, there were INR 220 Bil in outstanding loans from the parent to these subsidiaries. Not surprisingly, this capital "support" is equivalent to nearly 2/3rd of all debt at these subs. Consider a transaction where this Energy conglomerate gives an advance/loan to an unlisted "investment" conduit sub, which then reallocates that to another unlisted subsidiary. Subsequently, these advances are converted into equity. Such unsecured loans from parent are covenant-lite at best and require just a board resolution to be restructured into equity. Since financials of subs with second and further degree of separation only get rolled into an "investment" conduit, whose financials are then rolled into the parent, the asset-specific deployment of capital at these far-flung subs is extremely cumbersome to audit and resources don't allow auditors to focus their efforts this far[1]. In fact, in most of the cases, financials of these subs are audited by auditors other than the statutory auditor. So, while this isn't an allegation, to suggest that there is a high probability of siphoning capital or creating a route to flow through overstated earnings in this manner isn't a far cry.

A large portion of opaque sub assets are hard to value. Take another case of a major port in Western India for instance, where the promoter enjoys a solid relationship with one of India's political heavyweights. While its understandable that a port business could have associated logistics subs[2] to fully capitalize on existing infrastructure, the extent of parent support to several of the subs is more than questionable. While existing non-INR denominated debt and INR term loans to these subs are comfortably secured by a tangible asset base, these asset-heavy subs are cash bleeding and require a running cash spigot. In this case, nearly half of all tangible assets reside within subs, which collectively burnt about 5% of the operating cash (pre-tax and pre-financing) that the core business generated over the past five years. Despite immaterial revenue contribution and continuous cash burn, just over a quarter of external debt is housed within these subs. In addition, parent's unsecured debt support is about half as much as the external debt of these subs. If this "cash support" is deemed worthless (or superficially restructured into arguably dead equity), a fifth of the port's reported book value effectively gets wiped off.

In subs with no tangible assets, it's even harder to eye-ball capital deployment - A Southern India-based networking company operates 6 subs, including a material 4G equipment manufacturer. Amazingly, these subs collectively have no fixed assets on the books (talk about a "cloud" business!) and have collectively burnt nearly 90% of the operating cash generated by the core networking business in the past 5 years. It is in such cases, that true exposure of the parent business, inclusive of contingent liabilities such as guarantees, is often very substantial and easily ignored.

Even debt restructuring candidates could be siphoning cash and/or parking overstated earnings. Consider a major North-Indian residential real-estate business that operates fewer than 10 subs, which in turn have 50+ step-down subs for asset "allocation". These subs have bizarrely burnt nearly 60% of the operating cash of the parent

[1] Our sources indicate that the 3 statutory auditors for this business allocate 50-75 people on the statutory audit (combined) for 45-50 days.

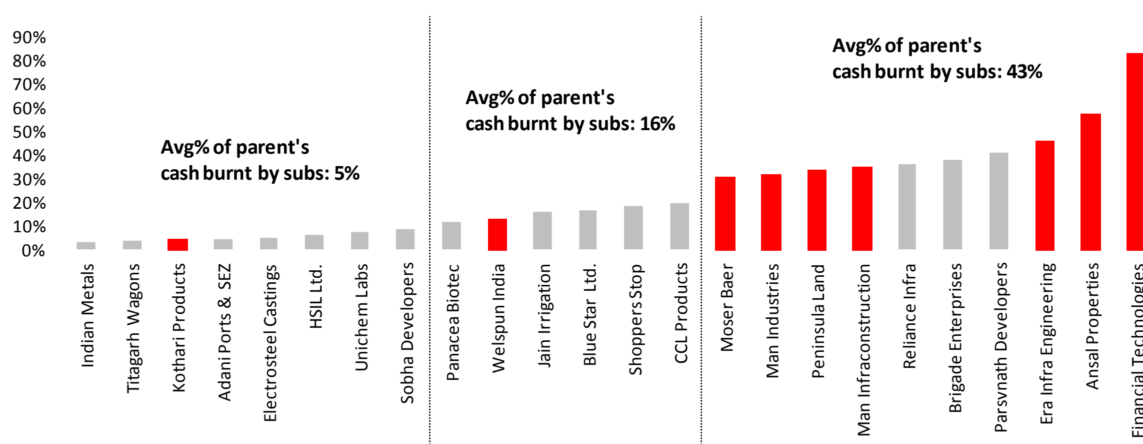
[2] About a fifth of subs' sales (including transport, warehousing etc.) are to the parent.

over the past 5 years. Despite that, in last fiscal year, about INR 380 mil of parent debt was still outstanding, even as the parent had requested banks for INR 112 mil of outstanding external debt to be restructured.

Overall, the list of most profligate parents is predictably replete with real estate and infrastructure names, particularly among those where subsidiary cash burn is the highest and exposure to these businesses (looks more reported than real in several cases) is inexplicably high (see **Exhibit 1**). In yet another example of the extent of speculative activity in 1H14, the set of stocks in the attached exhibit returned nearly 75% in 1H, with a fourth of these names more than doubling over this period.

It amazes us how certain investors/analysts often use book value discounts on names such as *Financial Technologies*, *Ansal Properties*, *Era Infra*, or *Moser Baer* to make a valuation case. Parent's true exposure to the highly opaque subs at these and several other businesses is nearly as much or more than the enterprise's market valuation. These reported book values are therefore more imaginative than real.

Exhibit 1 - % of parent's operating cash flow burnt by subsidiaries



Note: Cash bleeding subs at each of the above businesses burnt 5%+ of parent's operating cash flow (before interest costs and taxes) over the past 5 years. Red bars indicate names where reported exposure (common stock, preferreds, debt, and guarantees) to bleeding subs is more than half of current market capitalization; Our work excluded businesses where sustained subsidiary cash burn can be reasonably explained ex. a steel business acquiring a listed overseas mining explorer (with nonoperational coal blocks), where pre-operating expenses are material and may last for a while. We also excluded businesses where one-off extreme cash burn years at subs accounted for most of the burn in last 5 years. Our work also excludes names where subs haven't burnt cash over the last 5 years, but haven't contributed anything material either. That approach admittedly misses names such as a Mumbai based apparel business, where the parent has extended more than INR 3 Bil in loans (~40% of consolidated pre-financing and pre-tax cash flows of the parent) to a group of subs that barely have 4% of all tangible assets (incl. ongoing projects) of the consolidated business. As always, these subs are supposed to sustain by themselves (inter-group revenues are immaterial).
Source: Company Reports; Internal research and analysis

While consistently cash-bleeding subs do attract our attention, it is equally critical to pay attention to subsidiaries where operating cash flows, while not being a material drag on parent's cash flows, might be disproportionately off relative to what the parent has "supposedly invested" in them[3]. Despite not reporting any subsidiary as 'material unlisted', several businesses have material assets housed within these far flung unlisted subs. In several instances, these subs have had no material equity for several years and yet investments haven't been impaired.

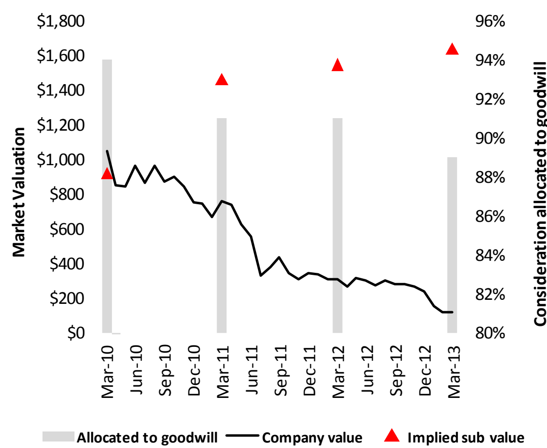
"Goodwilling" parent's capital. An education name is an interesting case in point, where assets at 40+ subs (none audited by the statutory auditor) are more than 6x their combined revenues. Just over the past two fiscals, the parent has invested north of INR 4 Bil (net of closures) into these subs[4]. Nearly 11 Bil in goodwill on books (as of last FY end) was generated in consolidating these entities, >2x the current market capitalization of this business.

[3] This approach needs to exclude certain infrastructure names that have several asset holding subs for BOT projects with verifiable assets.
[4] Total direct equity investment into these subs is north of INR 16 Bil. This excludes capital awaiting conversion from dud loans.

More than 85% of this was generated through consolidating one subsidiary (its only material unlisted sub), which filed for restructuring in CDR a year ago[5].

Consider this – By the end of F2009 (Mar), this company was valued north of $750 mil. At the time, parent's stake in the above mentioned sub was just above 69%. This asset heavy sub's pretax earnings have been less than a tenth of company's pretax earnings since then. Since F2009 (Mar), the parent has consolidated its holdings to nearly 84% by investing another $165 mil in this sub. More than 90% of all incremental investment in the above series of transactions was allocated to goodwill. Effectively, parent's average implied valuation of this sub was north of $1 Bil over a time period when the market valued the entire company, on average, at about half that (see **Exhibit 2**).

Exhibit 2 - Real parent's valuation vs. Implied sub's value



Sources: Company reports; Internal research and analysis

Even if the parent were to make a case that substantial real estate was held at the sub level and that sub wasn't being valued as a going concern, the valuation differential by itself suggested that it would unquestionably be more efficient to buy back listed stock to take advantage of market valuations vs. assigning ludicrous valuation to the sub and consolidating parent's holdings. Not surprisingly, MCA records indicate that parent's founder and Chairman (and his spouse) own about 3/4th of the minority stock in the above mentioned sub. Certain shareholders of this particular sub have stuffed parent's shareholders in broad daylight, to put it mildly. Essentially, parent's capital was "goodwilled" away.

In both the situations discussed above i.e. where cash burn was apparent vs. where it wasn't, investors need to realize that not all investments in subs are obviously made with a view to bleed cash or to park overstated earnings. However, often the low-hanging fruit of siphoning cash drives the greed involved in these "reported" investments - Several promoters wouldn't mind siphoning off half or more of reported opaque investments while only participating in a share of a gradual cash burn over several years, assuming that cash burn is even certain.

Managing disclosures is crucial but FASB isn't an example to follow. While it is in no one's interest to increase filing and disclosures to the extent that it overly draws on key resources within F&A[6], it is critical to recognize the associated risks in further curbing disclosures in what in several cases is already a pretty opaque network of subsidiaries. In our view, Indian GAAP requires to address this loophole and possibly require businesses to report financials of 100% owned subs as part of 'standalone' financials. Also, wherever an investment conduit is used for linking 'step-down' subsidiaries with the parent, disclosures on specific investment in subsidiaries, along with a broad breakdown of fixed assets and intangibles at step-down subs should be made mandatory. Shareholders would certainly be a happier and more informed bunch, if this happens.

[5] INR 1 Bil pvt placement of this sub's non-convertible debentures (guaranteed by parent) was rated A+ barely 18 months prior to CDR filing.

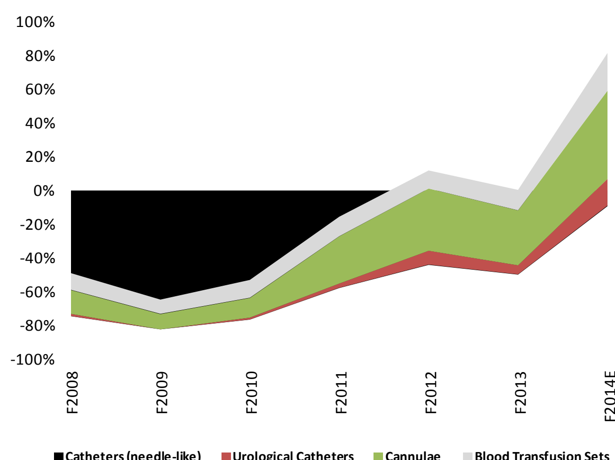
[6] MCA, through its general circular No. 2 /2011, had exempted holding companies from attaching specified particulars of its subsidiary companies with the balance sheet of the holding company.

Towards the end of 2Q, we initiated a small new exposure, within our *India Underserved* sub-strategy, in ~$180 mil disposable surgical devices name. This business came up on our screen late last year, but, at the time, we were evaluating substantially more opportunities with more attractive absolute upsides. That situation changed significantly as valuations strengthened in 1H14. With the stock under pacing the broader small cap universe, its potential absolute upside started looking more material.

Over a 3 months plus due diligence, we had an opportunity to gauge this business' competitiveness through extensive discussions with surgeons, distributors, and vendors. Before we elaborate on specifics, let's briefly run you through the Indian surgical devices space.

Disposable surgical devices are largely locally sourced. India's ~$5 bil medical devices market has registered growth in the mid-teens. Our pick's broader operating focus is in syringes, needles, and catheters, which make up about 12% of the overall devices market. While imports accounted for nearly 3/4th of all Indian device requirements, majority of disposable devices (i.e the operating space of our pick) are locally sourced. In fact, India's trade deficit within the sort of disposable devices manufactured by this player has very quickly turned into a surplus (see **Exhibit 3**), with products retaining their impressive price and quality competitiveness in even far-off export destinations such as Latin America.

Exhibit 3 – Relative trade bal. contribution of surgical devices



Note: Breakdown given for products manufactured by the company
Source: Ministry of Commerce & Industry

We note that compensation cost for manufacturing employees within India's healthcare industry only trails a handful of industries such as energy and technology hardware. Still, the industry remains extremely cost competitive globally. Further, for an industry with material FX linkages on sourcing, excise duties continue to soften. Most recently, excise duty on materials such as Polypropylene and stainless steel capillary tubes used in manufacturing syringes, needle, catheters, and cannulae was reduced to 6%.

3 major domestic surgical device players. There are 3 major domestic players that compete alongside the likes of *Braun* and *BD* within disposable devices. The biggest local disposable devices company (privately held) generates INR 5 Bil in revenues in India, but most of it comes from syringes. In terms of product relevance (other major manufacturer of IV Cannula), our pick's direct competition comes from an INR 4 Bil family owned business. However, in sharp contrast with our pick, most of this competitor's revenues are generated within India. While domestic players are substantially more price competitive, their traction hitherto has been largely limited to 'general ward' usage, with critical drug delivery and ICU usage still largely controlled by the likes of *Braun*.

Our chosen pick has a widely spread export mix (about 60% of sales come from exports) – Europe accounts for just under half of its exports, followed by Latin America, Asia, and US. While their prices (vs. *Braun* or *BD*) are considerably cheaper within India, they still remain well under half of *Braun*'s price points even as far as Latin America, despite competing with established local sourcing infrastructure. Their pricing in India, even in products with substantial import material content (eg blood bags), is about in line with the Chinese peers.

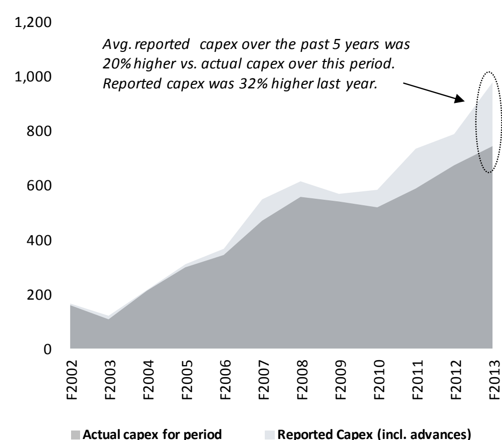
Three key reasons we initiated exposure in this name were **1**. Solid potential to grow within the more attractive domestic market, **2**. Impressive and understated cash generation ability, and **3**. Capacity expansion firmly in place within a business where their global cost competitiveness remains extremely strong.

1. **Domestic demand remains largely untapped**. Just as in China[7], imports are getting rapidly displaced by local players. Not only is the local market growing at a substantially faster pace than elsewhere, margins are considerably higher vs. exports (+10% higher EBITDA margin). Our chosen pick has historically suffered from two challenges: **1**. Perception on the part of distributors that they primarily sell their export marked surplus into the domestic market, and **2**. Perception on the part of surgeons that quality of domestic producers is subpar. Those challenges have been steadily overcome by this business as domestic revenues have now come to account for 40% of the business vs. just over 20% a decade ago. Our discussions across surgeons suggest that while the quality perception still holds, it has declined in recent years as cost considerations get embraced widely. Also, most surgeons rate our pick amongst the best when it comes to rating quality within domestic suppliers. So, while we don't expect usage to grow substantially within ICU or Pediatric surgery[8], we don't see credible challenges that could materially decelerate the underlying growth here.

2. **Substantial cash generation capability**. This business has consistently converted 60%+ of its EBITDA into operating cash, which has accordingly averaged 20% ahead of reported earnings. That impressive conversion is despite 20%+ top line growth in recent years.

   While there is little doubt about the very impressive cash generation ability here, it is critical to point that the reported free cash flow for this business substantially understates the 'actual' periodic free cash – As inter-state labor migration dwindled in recent years, their plants were substantially automated. Their equipment providers in Korea and Taiwan insisted on advances as their requirements were highly customized. Accordingly, reported capex in recent years has increasingly factored in 'advances' to these providers. To put that in perspective, their free cash flow (adjusted for advances) was INR 350 mil over the past 5 years, >4x their reported FCF of INR 80 mil.

Exhibit 4 - Impact of 'advances' on reported capex



Source: Company reports

3. **Expansion strategy well in place**. Having reached nearly 90% utilization at its 3 connected facilities near Delhi NCR, they opened their new facility in a Rajasthan based SEZ. The new manufacturing unit in Jaipur cost them INR 380 mil, of which INR 210 mil was funded by a term loan. This plant only became operational in the first quarter of the current fiscal. Accordingly, only about 1 acres of the 4 acres earmarked for expansion has been utilized. That compares with about 3.5 acres of existing facilities in Haryana. The current set-up capacity at the SEZ facility is only a sixth of the Haryana facilities and they conservatively expect to utilize about 25% in F2015E (Mar). With no dedicated shared service overheads at this new facility, we expect immaterial drag on margins this year, and don't see them shopping around for locations in the near future.

The stock had appreciated more than 3x over the past 5 years, but absolute valuations still weren't stretched when we initiated exposure. We expect at least 40% upside within the next year on this position as this business continues to build its traction within the more attractive domestic market.

[7] Imported drug-eluting stents (DES) made 3/4th of the Chinese DES market as early as five years ago. That share has completely reversed since then, with local manufacturers now accounting for 75% of the market.

[8] Surgeons often cite how pain suffered by patients while administering mini-punctures in pediatric surgery is a key consideration while selecting IV cannulae.

Government set to collect close to INR 10 Bil (net) from radio license migrations. With all due respect to TRAI, their recommendations on migration for frequencies in 'Group X' cities (17 cities where no frequency is available for auction) effectively forces all existing stations in these cities to fork up high migration fees, just because of irrational bids from certain players in Phase II[9] auctions. That said, it's equally commendable that they have ensured that migrations in 'Group Y' cities (26 cities where a third or less of all frequencies are available for auction) get another chance to get aligned with market forces - TRAI recommends that migration fees be below the Phase III auction prices in these cities. We note that the average differential between highest and lowest bids in these cities during Phase II auctions was about 120%, suggesting misinformed bid dispersion. Not surprising then, that in real terms (adjusted for 5 more years on new licenses, and inflation), we do not expect government to mop up more in migration fees in 'Group Y' than they did from bids in Phase II auctions. Since migration fees of 'Group Z' cities is anyway based on Phase III auction prices (going by TRAI recommendations), we doubt that, in real terms, they would be higher than Phase II bids.

In total, we estimate that the government can end up collecting close to INR 10 Billion (net of refunds) as more than 200 frequencies migrate after Phase III auctions (see **Exhibit 5a**).

Exhibit 5a – Est. Migration cost (net) for radio players

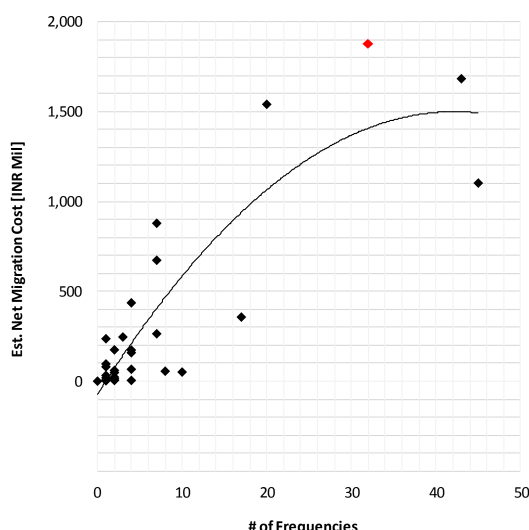
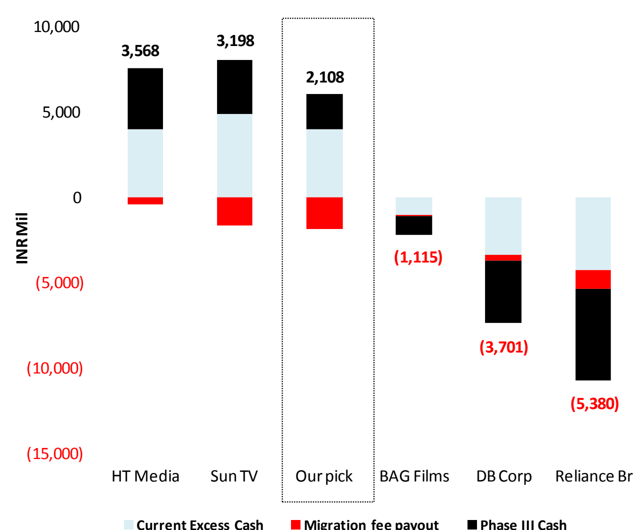


Exhibit 5b – Est. cash available for bidding in Phase III auctions



Notes/Assumptions: We assumed that Phase III auctions would take place in mid November, 2014; Current collateralization levels were estimated from F2013 (Mar) financials; Minimum cash requirements were estimated based on respective cash cycles; Our chosen pick currently has a free cash flow run rate of >200 mil/quarter.
Source: Internal Research & Analysis; TRAI; MIB; Company Reports

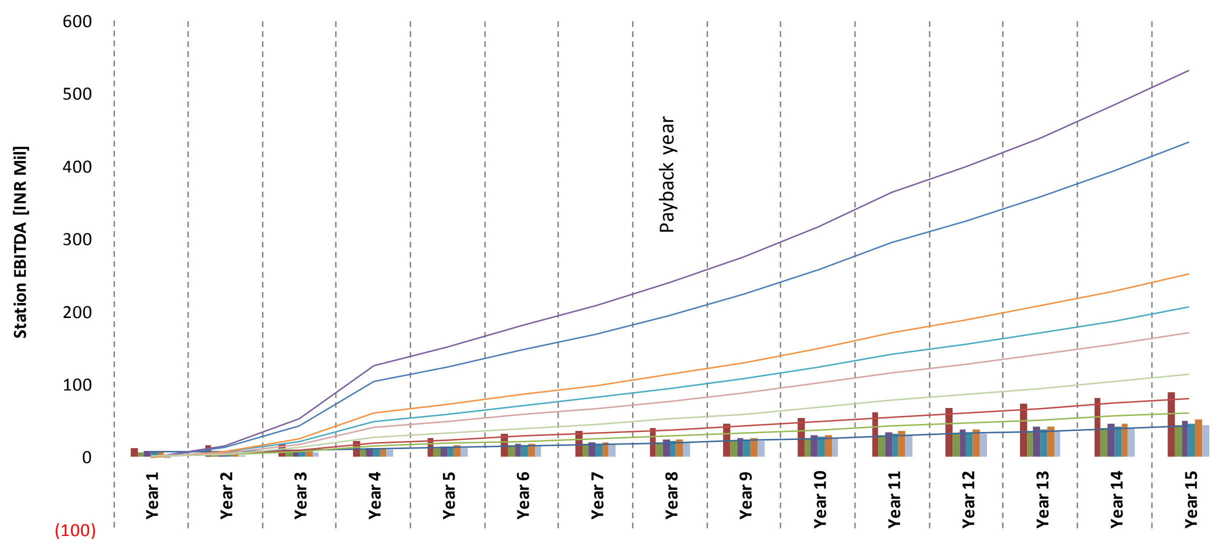
Why cash is the supreme king in radio (in anticipation of Phase III auctions). Given that migration cost by itself would be a substantial burden on several balance sheets, cash rich unencumbered balance sheets would be key to a meaningful participation in upcoming auctions. We note that several radio businesses have had poor economics and don't have adequate assets for hypothecation. So, one would have to expect banks to continue to create pari-passu charges on an already secured asset base if these radio businesses have to retain their current frequencies, let alone meaningfully participate in the upcoming Phase III auctions. One glance at finances is telling - The 5 competing radio businesses that are part of listed or recently delisted businesses would account for just under 1/2 of all migrating frequencies and, by our estimate, just over 1/3rd of net migration fee would be paid out by them post Phase III auctions. Despite the fact that radio is barely a small part of this collective competing set, their total current net cash position is just about 2x their expected migration fee payout. However, 3 of the 5 names are already at cash levels that are barely enough for their current working capital requirements (see **Exhibit 5b**). Given

[9] The differential between highest and lowest bids in Phase II auctions was 86%, 121%, and 88% for X, Y, and Z group cities respectively.

their current working capital cycles, this collective set currently needs to retain much more in liquidity than they have. That leaves them with a big hole to fill when their balance sheets remain highly hypothecated.

Post Phase II auctions, our chosen pick's stations had broken even within a year of broadcasting. This team is very clear that they need to achieve similar economics in order to engage in Phase III bidding. By our estimate, they would likely have north of INR 2.1 Bil in excess cash left for Phase III bidding and setting up new infrastructure, after accounting for migration fees. Our fairly conservative assumptions on unlevered Phase III bidding throws up fairly promising results - Assuming that they network 6 stations from Phase III and establish new frequencies in another 9 cities, by our estimate, the real value of this incremental deployment (only over a 15 year license period; no terminal value assumed) should be easily north of INR 3.1Bil, about 15% of current market value (see **Exhibit 6**). We assumed that among the major markets where only 1 frequency would come up for bidding, our pick would only target 2 cities and would potentially bid as high as 50% over the highest Phase II bid. It is critical to appreciate that this ignores leveraging an unlevered balance sheet to take advantage of industry distress, which is something we strongly recommend.

Exhibit 6 – What our pick's >INR 2 Bil in excess cash (after paying for migration) could yield in EBITDA post Phase III auctions?



Notes/Assumptions: 'Lines' reflect EBITDA of non-networked studios, while 'Bars' reflect EBITDA of networked studios; We assumed that new frequencies in non networked cities require a new studio (regardless of prior presence); For non networked cities with only 1 additional frequency in auction, winning bid was assumed at 50% higher than the highest Phase II bid; For cities with more than 1 frequency in auction, bid cost was assumed o be equal to the highest Phase II bid; For group 'Z' cities, bid value was assumed as average winning bid of Phase II times assumed escalation multiplier; New frequencies are assumed to gather a par share of the market in first year, grow at 20% in next 5 years, and decelerate from there onwards; Non networked studios are assumed to break even on EBITDA in under 2 years.
Source: Internal Research & Analysis

We exited a vast majority of a *Business Services* position in an open offer. Elsewhere in our book, we substantially pared our exposure in a *Business Services* name, where we tendered a vast majority of our holdings in an open offer. While we had tendered about half of our holding earlier, we exited 80%+ of our holding after the offer was revised upwards by another 20%. The new parent now owns just over 50% of the stock. The remaining holding has benefited substantially since then as the stock is now trading well ahead of the raised open offer price, which we believe is likely a result of speculation around a possible delisting move in the near future.

We also pared our position in an *Entertainment* name. In another "valuation influenced" move, we cut our holding in a core entertainment holding. This was purely influenced by valuation and we don't intend to materially cut our exposure to what we believe is an extremely solid and clean entertainment franchise. As at the end of 2Q, this name still accounted for about 8% of our book. As a result of selective selling, our overall exposure trended down in 2Q despite solid gains across our holdings.

Performance and Attribution summary

We handily outpaced *BSE 500* in 2Q, nearly offsetting our entire 1Q drag. While mid and small-cap names continued to comfortably outpace *Nifty* constituents, there was a prevalent disturbing trend of forensically suspect speculative names reporting solid gains. While unsophisticated investor participation is clearly on the rise, valuations aren't yet overwhelmingly expensive, even as they are arguably stretched on realistic growth assumptions.

All of our holdings finished higher in 2Q, with more than 80% of our names outpacing *BSE 500*. Our two best performing positions in 2Q were a *Cables* name (**+62%**) and a *Packaging* name (**+92%**), the latter being among our major laggards over the past two years. Our two worst positions in 2Q were an *Agriculture* name (**+10%**) and a *Food* name (**+2%**).

In 2Q14, *Metis Strategy* was up **+20.1%** (net of all fees), vs. **+13.5%**, **+18.0%**, **+32.4%**, **+44.3%**, and **+23.2%** increases in *Nifty, BSE 500, BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively. Since inception, *Metis Strategy* is up **+64.9%** vs. **+26.5%**, **+23.2%**, **+13.5%**, and **+3.4%** increases in *Nifty*, *BSE 500, BSE Midcap,* and *Eurekahedge India* respectively, and **-3.4%** decline in *BSE Smallcap* (see **Exhibit 7a**). Over trailing 12 months, our volatility was **10**, **729**, **862**, and **345** bps below *BSE 500, BSE Midcap, BSE Smallcap*, and *Eurekahedge India* respectively, and **157** bps higher than *Nifty* (see **Exhibit 7b**).

Exhibit 7a – Perf. since inception

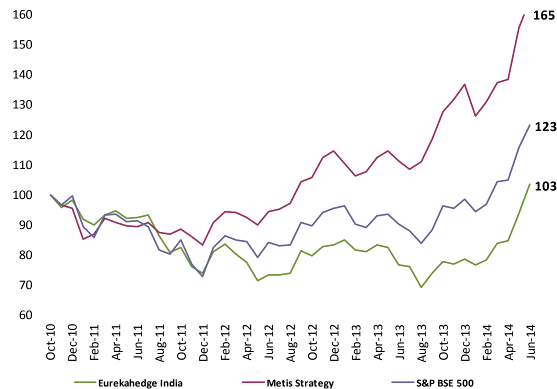


Exhibit 7b – TTM volatility

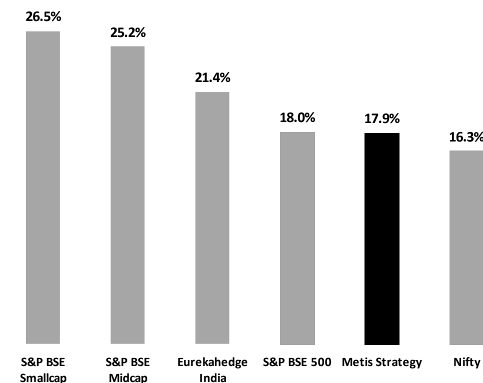


Exhibit 7c – Annual and average –ve monthly returns

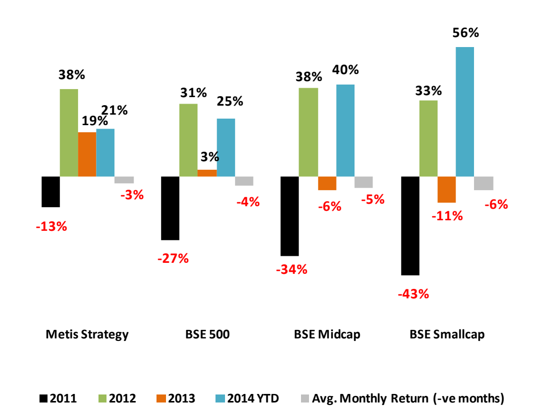
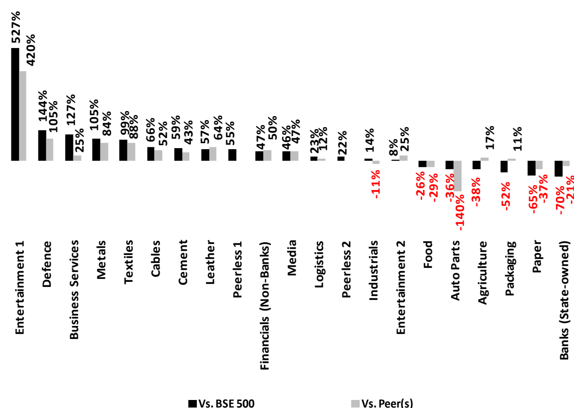


Exhibit 7d – Industry-wise benchmarking for positions



Note: Metis strategy went live on March 11th 2014; Industry-wise benchmarking compares stock's performance from initiation to present/exit.
Source: Internal Sources; NSE, BSE, Eurekahedge

Exhibit 8a – Relative rolling 12-mth returns

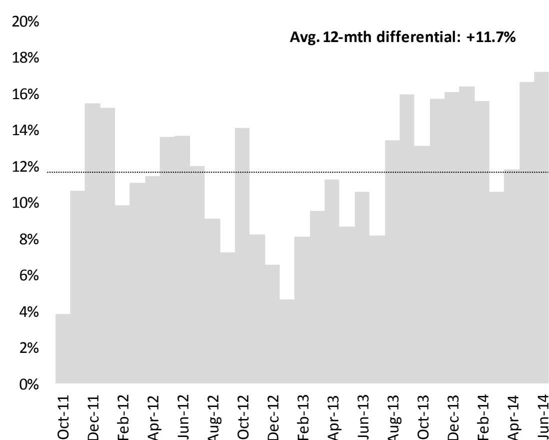
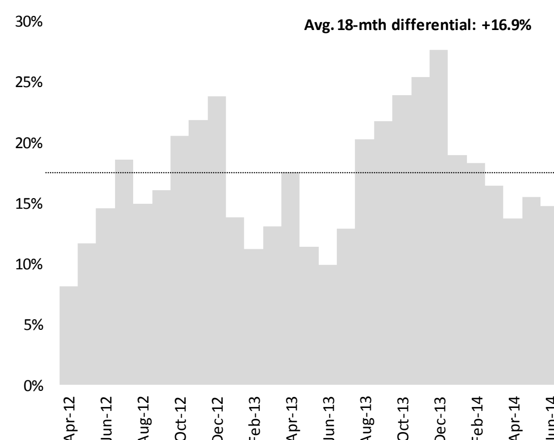


Exhibit 8b – Relative rolling 18-mth returns



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

Exhibit 9 – Time window analysis for our onshore strategies

	India Underserved		*India Undervalued*	
	3 Month	*12 Month*	*3 Month*	*12 Month*
Number of periods	37	28	42	33
Average period return	5%	20%	4%	16%
Number of profitable periods	23	26	25	30
% profitable periods	62%	93%	60%	91%
Best period	24%	55%	26%	53%
Gain Standard Deviation	7%	12%	7%	11%
Sharpe Ratio @10%	0.28	0.73	0.17	0.41
Sharpe Ratio @5%	0.42	1.12	0.31	0.78
Sharpe Ratio @0%	0.56	1.50	0.45	1.15
Loss Standard Deviation	2.0%	0.4%	3.5%	0.9%
Downside Deviation @10%	3.7%	3.8%	4.5%	6.6%
Downside Deviation @5%	3.0%	1.8%	3.9%	4.8%
Downside Deviation @0%	2.3%	0.2%	3.3%	3.3%
Sortino Ratio @10%	0.65	2.50	0.33	0.84
Sortino Ratio @5%	1.19	7.96	0.69	2.20
Sortino Ratio @0%	2.06	8.19	1.19	4.75
Average Gain/Loss	3.0	24.7	2.4	16.8
Profit/Loss Ratio	4.9	32.0	3.5	16.8

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

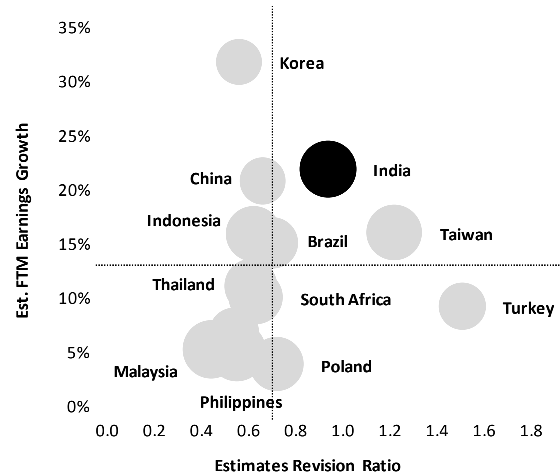
Exhibit 10 – Long-book snapshot

Top position as % of book	11%
Smallest position as % of book	0.5%
Top 5 positions as % of book	46%
Avg. weighted market cap of book (mil)	$761
Avg. weighted free float of book	44%
Net Exposure	83%
# of positions	22

Source: Internal Sources

Sharp rise in earnings estimates but odds of upside surprises drop. Within the broader emerging markets landscape, only Taiwan and Turkey have reported better estimates momentum vs. India over the past 3 months (see **Exhibit 11**). Indian upside earnings revisions are now about in line with downside revisions, even though F4Q (Mar) earnings didn't quite blow away consensus estimates – In what appeared strikingly similar to what we are accustomed to seeing in *S&P 500* components, *Nifty* constituents' (ex-financials) F4Q (Mar) revenues were about in line with expectations, even as earnings showed a marginal beat. That said, with material prices dropping substantially, capacity utilization inching up, and long due cost control in full motion, the 20%+ expectation of broad-based earnings growth doesn't appear as farfetched. Let's be clear though that we don't fall in the camp of those who view the current upside in equities as indicative of a "structural bull run". For that to happen, we need to see real top-line growth and sustained labor market expansion.

Exhibit 11 - FTM PE vs. Earnings Growth and Est. Revisions



Note: Bubble sizes indicate FTM PEs; All numbers (including multiples) are market-wide and do not reflect benchmarks. Source: Thomson Reuters

Expect ~50 bps cut to F2015E (Mar) GDP forecasts. We were touring Western Uttar Pradesh a few weeks ago and farmers didn't appear particularly jittery. But then fields of *Bijnaur* and suburban *Meerut* are largely sugarcane reliant and weren't representative of the broader kharif sowing woes. Soon after we returned to Delhi, we noted how IMD's first week's precipitation numbers showed 40%+ shortfall, and the trend has worryingly sustained since then[10]. IMD's second forecast for this season (on June 9th) had projected about 7% national shortfall and while the state department still remains sanguine, third party weather forecasters are decidedly gloomy.

Current season's shortfall numbers are unequivocally disastrous and it would be naive not to bake in adverse effects into forecasts. Consensus suggests that a widespread drought poses a likely 250 bps hike in CPI inflation, pushing back any possibility of near-term RBI easing, and likely driving ~50 bps cut in F2015E (Mar) GDP forecasts. Regardless of how merciful rain gods get, we'll continue to focus on our core strength of identifying clean secular stories with significant absolute upsides.

Before we sign off, we want to extend our best wishes to PMO's new flag bearers as they set about their task of reigniting confidence within India Inc. There is a massive shift from coalition politics and it offers substantial room for incremental action.

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.

[10] June reported 43% deficit. IMD has forecast that precipitation will improve to 93% of long period average in July and 96% in August.

Exhibit 12 – Historical Monthly Performance

	Metis Strategy	*Nifty*	*S&P BSE 500*	*S&P BSE Midcap*	*S&P BSE Smallcap*	*Eurekahedge India*	*India-focused CE Funds**
Nov-10	-3.5%	-2.6%	-3.3%	-6.1%	-7.8%	-4.3%	-2.6%
Dec-10	-1.0%	4.6%	3.1%	0.5%	-0.8%	2.8%	-2.5%
Jan-11	-10.7%	-10.2%	-10.5%	-12.0%	-12.3%	-6.7%	-9.8%
Feb-11	1.8%	-3.1%	-3.9%	-7.2%	-7.8%	-2.2%	-3.6%
Mar-11	6.0%	9.4%	8.6%	7.8%	4.6%	4.0%	8.6%
Apr-11	-1.3%	-1.4%	0.3%	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%	0.2%	-0.2%	-0.8%	0.4%	1.9%
Sep-12	7.4%	8.5%	8.9%	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%	-2.5%	-3.6%
Feb-14	3.8%	3.1%	2.8%	3.1%	2.9%	2.1%	5.2%
Mar-14	4.8%	6.8%	7.6%	9.0%	9.7%	7.3%	8.5%
Apr-14	0.9%	-0.1%	0.6%	3.4%	5.9%	0.9%	-0.6%
May-14	12.4%	8.0%	10.4%	15.6%	20.4%	10.7%	9.3%
Jun-14	5.9%	5.3%	6.4%	10.8%	13.2%	10.3%	7.0%
Trailing 12 months	**48%**	**30%**	**37%**	**57%**	**81%**	**35%**	**42%**
Trailing 24 months	**74%**	**44%**	**47%**	**52%**	**56%**	**41%**	**52%**
Trailing 36 months	**84%**	**35%**	**35%**	**37%**	**25%**	**12%**	**40%**
2014 YTD	**21%**	**21%**	**25%**	**40%**	**56%**	**32%**	**28%**
2013	**19%**	**7%**	**3%**	**-6%**	**-11%**	**-6%**	**7%**
2012	**38%**	**28%**	**31%**	**38%**	**33%**	**14%**	**29%**
2011	**-13%**	**-25%**	**-27%**	**-34%**	**-43%**	**-25%**	**-29%**
Avg. Return (+ve months)	**4%**	**5%**	**5%**	**6%**	**7%**	**4%**	**5%**
Avg. Return (-ve months)	**-3%**	**-3%**	**-4%**	**-5%**	**-6%**	**-4%**	**-3%**
Annualized Volatility (TTM)	**18%**	**16%**	**18%**	**25%**	**27%**	**21%**	**18%**
Sharpe Ratio	**0.77**	**0.27**	**0.23**	**0.13**	**-0.02**	**-0.03**	**0.19**

*Note: Metis Opportunity Fund's INR track record was a live blend of our running onshore strategies till March 31, 2014, and was net of execution and management fees (USD Fund went live on March 11, 2014); Metis strategy performance from April 2014 onwards is 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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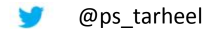
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Gaurav Aggarwal, CFA, CPA, is the co-investment manager of Metis Opportunity Fund. He was a senior analyst with portfolio management duties over $50 million in fund of fund assets at a leading regional investment bank (Global Investment House) in the 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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