Metis Opportunity Fund

# Heavy retail influence continues to drive price disconnects

July 2017 Newsletter

**July 28, 2017**

Since we started allocating capital in late 2010, we do not recall a more disconnected market than what we se today. For months now, we are noting high deliverable volume in highly suspect businesses as retail participat within Indian listed equities takes multiples into orbit. Earnings meanwhile remain unremarkable and expectat remain elevated. Despite the backdrop, street discussion continues to focus on incoming liquidity vs. the valu disconnects that are resulting from it. Perhaps a valid discussion could involve the size of the disconnect at th point when (not if) retail spigots slow down and, without stratospheric earnings growth to support, how long ar deep the required adjustment would need to be.

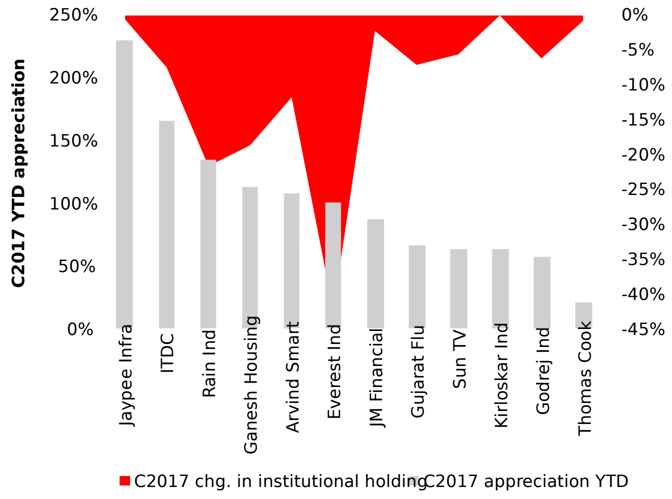
We typically underpace in the sort of environment we are currently in and it's therefore not surprising, even as painful, that we continue to slightly underperform YTD. Historically, our relative performances have been mo distinguished during periods when value dislocations correct and underlying cash flow growth determines outperformance. *Metis Opportunity* was up **+2.33%** (in INR terms) in 2Q17, vs **+3.78%**, **+4.71%**, **+4.13%**, and **+5.28%** gains in *Nifty TR*[1], *BSE 500 TR, BSE Midcap TR*, *BSE Smallcap TR*, and *Eurekahedge India* respectively. Just over a third of our positions gained in 2Q. Our net exposure at the end of 2Q17 was 86% vs. 89% at the e 1Q17. We added no new position during the quarter and had to reduce exposure in select positions on accour risk management thresholds.

Over trailing 12 months, *Metis Opportunity* was up **+21.0%** (in INR terms). That compares with **+14.9%**, **+2** **+31.4%**, **+26.5%**, and **+14.9%** increases in *Nifty TR, BSE 500 TR, BSE Smallcap TR*, *BSE Midcap TR* and *Eur India* respectively. Over this period, our volatility was **342 bps** and **220 bps** below that of *BSE Smallcap TR* a *Midcap TR* respectively, and **216 bps** and **665 bps** ahead of *BSE 500 TR* and *Eurekahedge India* respectively.

Over the past 3 years, *Metis Opportunity* is up **+55.1%** (in INR terms) vs. **+28.2%**, **+40.1%**, **+62.3%**, **+55.4** **+45.6%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respecti

Since inception in April 2011, *Metis Opportunity* is up **+184.3%** (in INR terms) vs. **+74.2%**, **+91.6%**, **+119.9** **+90.2%**, and **+97.9%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge* respectively.

**Exhibit 1 – YTD chg. in institutional holdings vs. Price chg.**




*Source: BSE; Bloomberg*

**Price disconnects continue as retail participation remains disturbingly elevated.** For all the talk of Systematic Investment Plans (SIPs), Indian retail investors continue to mostly trade through independent brokerage accounts and that participation has ensured that price discovery remains muddled in an overly euphoric environment.

Of the top-200 gainers YTD, 2/3rd have had little[2] to no institutional participation. Among the rest, just under a fifth of the names reported unremarkable earnings in past 2 quarters, and saw institutions offload stock. Amazingly, several of these names have more than doubled as retail engagement has comfortably absorbed offloaded institutional stock (see **Exhibit 1**).

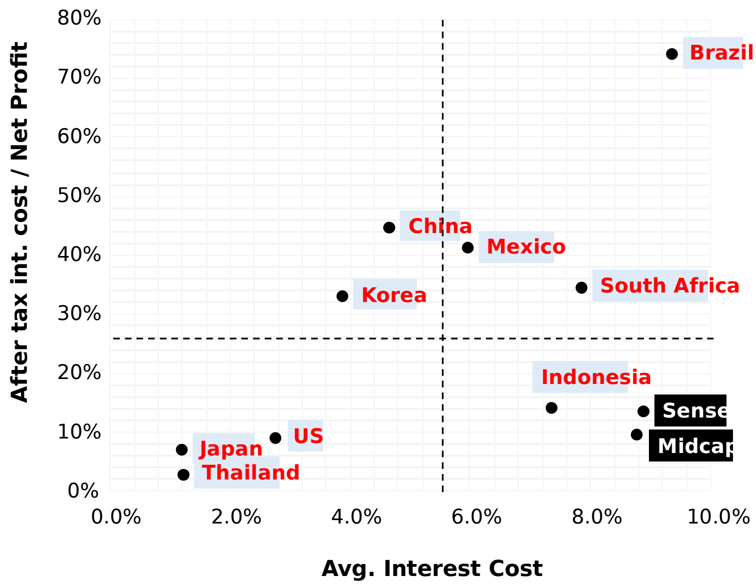
[1] 'Total Return' indices are used for comparison
[2] <3 rupees of institutional ownership for every 10 rupees from individuals

**Focus on uncrowded trades ensured that we haven't benefited nearly as much from retail engager** the end of June, institutional investors , on average, held just under 30% of the stock in our names, which is considerably higher vs. the broader small and midcap space. Within our entire book, there was only one name where earnings declined, barely so, in the past 2 quarters, and where institutions offloaded significant stock, b the stock still appreciated. In sharp contrast, cons ider a key paper holding of ours – Earnings have been very for past few years, were up another 50% over past 2 quarters , is among the extremely rare breed of names t still suggest material multiple expansion, and yet this name was up <6% in 1H17 (vs. +19% for *BSE 500*) as institutional ramp-up has been muted and retail investors sold.

**We expect earnings within our book to comfortably outpace broader stretched expectations**. Larg of continued deceleration in China, 2016 was the slowes t growth year in recent memory. Not surprising ther forecasts, as per usual, called for some acceleration in growth in 2017. That said, the chatter around synchror upswing in global growth seems a bit overdone, with US and UK projections shaved a s we write this letter, wh Japan and EU expectations getting revised a bit higher. We continue to believe that expectation for 'broad -ba 20%+ earnings growth in India over the next year seems to be born more out of the 'classic mean reversion' t than any material change in underlying fundamentals - Earnings, particularly for midcaps, were very poor for m of F2017 (Mar) and haven't set the street alight so far in F1Q18 (Jun) YTD.

Excluding commodities, margins contracted[3] for the third straight quarter in F4Q17 (Mar), revenue growth remained stuck in the low-mid single digits, and earnings declined. Even though it's early in the ongoing earni season, *Nifty* components (excluding commodities) are averaging flat revenues, low single digit decline on the operating line, and about -2% earnings decline vs. last year (-3% overall earnings decline, including *Bharti Airt* commodities). Midcaps are faring even worse in the ongoing season, averaging about -10% yoy decline in earnings (mid-teens earnings decline after including *MRPL*). While GST rollout transition could account for some revenue headwinds in F1Q (Jun), there is little doubt that commodity prices continue to pressure margins across nearly all industries, with operating margins now contracting for the fourth straight quarter. Given the anti - profiteering clause, material GST-related margin impact would likely be limited to logistics related benefits in the near-term. Any way you slice this, the 20%+ broad-based expectation for earnings growth is hard to reconcile with. Furthermore, while real interest rates still remain elevated in markets such as Brazil and India, Indian benchmark constituents aren't as levered as their emerging markets peers to make monetary easing a material driver for earnings growth (see **Exhibit 2**).

**Exhibit 2 – Avg. interest cost and burden on earnings**



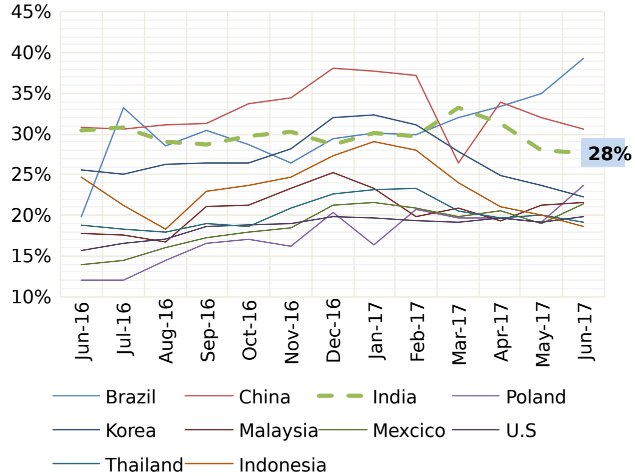

*Note: Only benchmark constituents were considered; Net-cash benchmarks such as Malaysia and Poland were ignored in the exercise; Outliers were excluded.*
*Source: Company Reports*

In our 6+ years since inception, one thing has held constant – Ability of our book to execute on earnings with or no support from macro tailwinds. That story is set to play out again - With major expansions taking place in

[3] Names such as Marico were outliers (marketing spends were unexpectedly slashed)

parts of our book over the past 2 years (new radio frequencies at a media name, new locations for an outdoor entertainment name etc.) and several one-offs (provisioning required for prior tax contingencies etc), key hold within our book face low comps in F2018E and we expect to comfortably outpace broader earnings growth. O the past 3 months, average FTM earnings estimates for our book constituents have drifted lower by just under primarily because of a sharp revision in a logistics name. Excluding that position, earnings estimates have bee revised lower by less than 4% (off of a much higher growth base vs. broader markets), about in line with the 4% average downward revision on much lower FTM earnings growth base across Indian listed equities (see **Exhibi**

**Exhibit 3 – FTM Earnings estimates drift in past 1 year**




*Source: Bloomberg*

**Post-GST transition visibility impacts pric in select positions**. On a certain outdoor entertainment holding, there is some perceptib street concern on how the GST transition will o given that local bodies are allowed to levy incremental taxes. While it's possible that ther might be some immaterial near-term impact (e no state has levied any incremental local tax y likely to be very muted because 1. As things st the end of this past quarter, less than 10% of th business' existing locations were fully exempt f entertainment tax and only about 6% were ben from partial exemption, and 2. Historically, the power has been strong enough to pass what w potentially be a small required pass-through, if

**Refinancing move at our paper holding ensures that barring a crisis of sorts, F2018E would be another 20%+ growth year for this name**. A new raise of NCDs from a multilateral institution (with a 5-year morato and a very strong pricing environment means that this holding of ours is extremely well placed to post yet ano 20%+ earnings growth year in the current fiscal. With no new capacity coming up elsewhere and benefits of reduced transportation cost (inward cost as distance to plantations reduce + faster truck movement post-GST EBITDA margin should conservatively breach 21% in F2018E (Mar). Further, potential industry consolidation is free optionality at current valuations.

**It's rarely this hard to identify sustainable growth stories at compelling valuations**. We were sittin at the end of 2Q and it's partly on account of being unable to find enough compelling stories to add in our boo Case in point is our recent work on an Industrials name, which drives a vast majority of its revenues from the industry. While we identified a material growth catalyst in the form of a horizontal expansion move, this new li of business has too much dependency on cost-focused government tenders. While we haven't shelved the id yet, it has certainly forced us to further evaluate this name's potential competitiveness within an entirely new of business with no competing local player. While the biggest upsides admittedly come from being able to ide free optionality in obscure situations, we have noticed that risk isn't being priced appropriately in most such situations where one can create a decent hypothesis around material embedded optionality.

## Performance and Attribution summary

Around 2/3[3] of our holdings declined in 2Q, with the biggest drag coming from an Outdoor Entertainment positi where a new location is ramping up. Our two best performing positions in the quarter were an Internet name (**+29.1%**), which bounced back after a weak 1Q, and an Industrial packaging name (**+28.8%**). Our two worst performing positions during the quarter were a Technology name (down **-12.1%**), and a Cables name (down **-11.7%**). For our historical position-wise benchmarking vs. peers and *BSE 500*, please see **Exhibit 4d**.

In 2Q17, *Metis Opportunity* was up **+2.33%** (in INR terms), vs **+3.78%**, **+4.71%**, **+4.13%**, **+6.84%**, and **+5** in *Nifty TR*[4], *BSE 500 TR*, *BSE Midcap TR*, *BSE Smallcap TR*, and *Eurekahedge India* respectively. Since inceptio April 2011, *Metis Opportunity* is up **+184.3%** (in INR terms) vs. **+74.2%**, **+91.6%**, **+119.9%**, **+90.2%**, and increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR*, *BSE Smallcap TR*, and *Eurekahedge India* respectively (see **4a** and **4c**). Over trailing 12 months, our volatility was **342 bps** and **220 bps** below that of *BSE Smallcap TR* *Midcap TR* respectively, and **216 bps** and **665 bps** ahead of *BSE 500 TR* and *Eurekahedge India* respectively **Exhibit 4b**).

**Exhibit 4a – Perf. since inception**

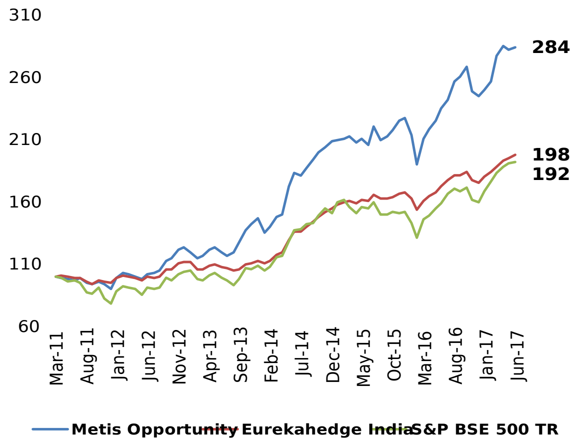



**Exhibit 4b – TTM volatility**

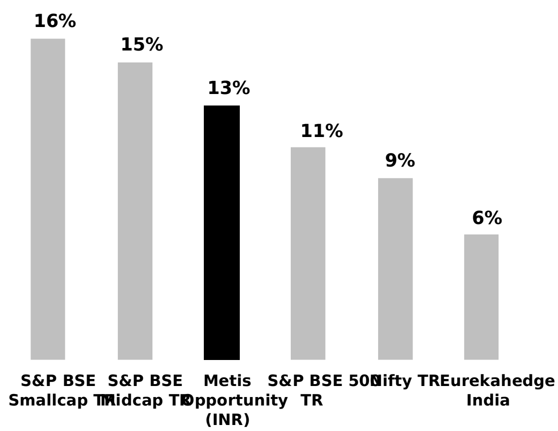



**Exhibit 4c – Calendar year benchmarking**

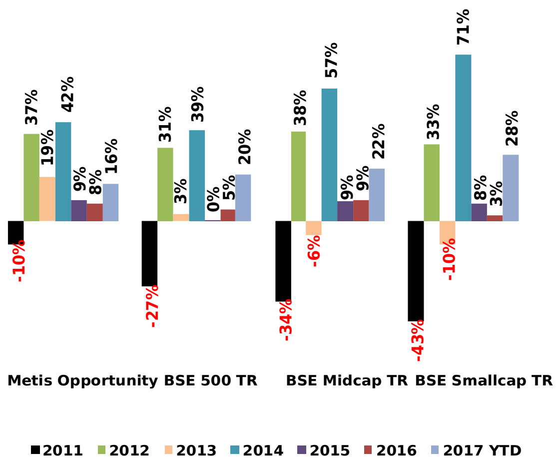
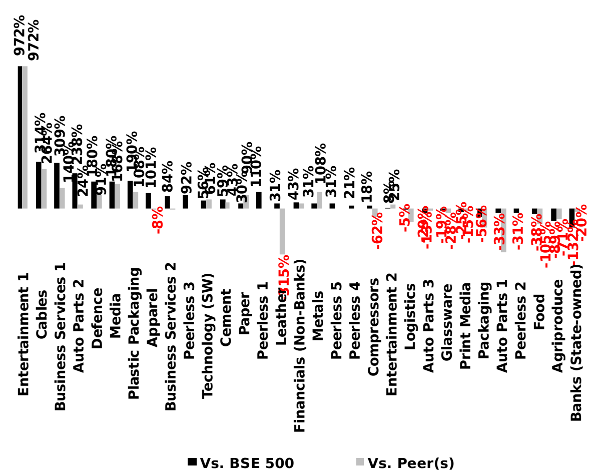



**Exhibit 4d – Industry-wise benchmar**




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

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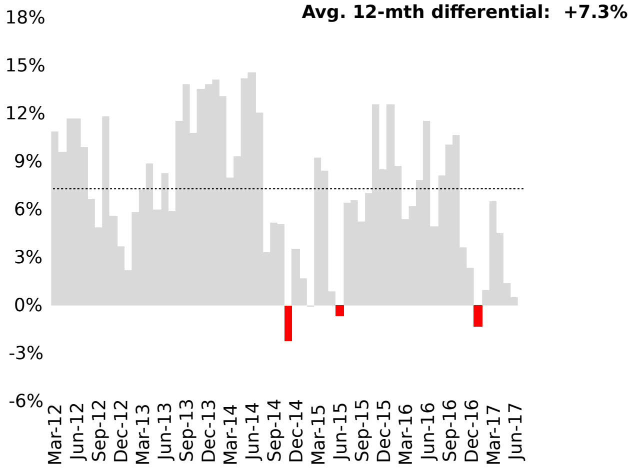
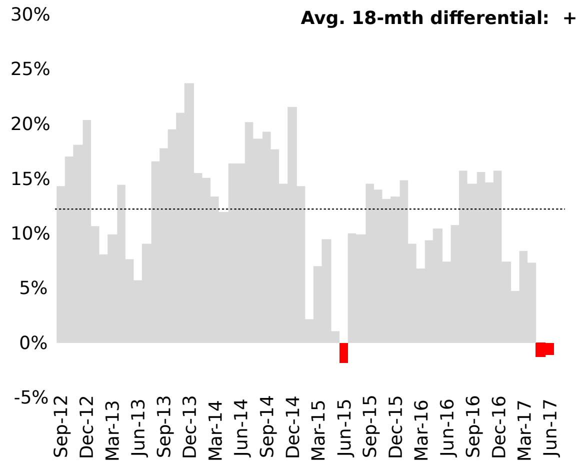
[4] 'Total Return' indices are used for comparison

### Exhibit 5a – Relative rolling 12-mth returns




### Exhibit 5b – Relative rolling 18-mth re




*Note: Relative return differentials are based on INR returns, and are calculated vs. S&P BSE 500 Total Return index returns*
*Source: Internal Sources*

### Exhibit 6 – Time window analysis for our sub-strategies

| | *India Underserved* | | *India Undervalued* | |
|---|---|---|---|---|
| | ***3 Month*** | ***12 Month*** | ***3 Month*** | ***12 Month*** |
| **Number of periods** | 73 | 64 | 78 | 69 |
| **Average period return** | **5%** | **23%** | **4%** | **19%** |
| **Number of profitable periods** | 52 | 62 | 49 | 60 |
| **% profitable periods** | **71%** | **97%** | **63%** | **87%** |
| **Best period** | 24% | 55% | 26% | 66% |
| **Gain Standard Deviation** | 6.1% | 13.1% | 6.5% | 17.6% |
| **Sharpe Ratio @10% RFR** | 0.31 | 0.94 | 0.20 | 0.48 |
| **Sharpe Ratio @5% RFR** | 0.46 | 1.31 | 0.33 | 0.73 |
| **Sharpe Ratio @0% RFR** | 0.63 | 1.68 | 0.46 | 0.98 |
| **Loss Standard Deviation** | 2.7% | 0.4% | 4.3% | 5.8% |
| **Downside Deviation @10% MAR** | 3.6% | 2.7% | 5.1% | 7.4% |
| **Downside Deviation @5% MAR** | 3.0% | 1.3% | 4.5% | 5.3% |
| **Downside Deviation @0% MAR** | 2.4% | 0.2% | 3.9% | 3.6% |
| **Sortino Ratio @10%** | 0.64 | 4.67 | 0.35 | 1.28 |
| **Sortino Ratio @5%** | 1.17 | 14.09 | 0.66 | 2.72 |
| **Sortino Ratio @0%** | 1.94 | 144.38 | 1.07 | 5.34 |
| **Average Gain/Loss** | 2.2 | 27.5 | 2.0 | 2.8 |
| **Profit/Loss Ratio** | 5.4 | 852.5 | 3.4 | 18.6 |

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

### Exhibit 7 – Long-book snapshot

| | |
|---|---|
| Top position as % of book | 11% |
| Smallest position as % of book | 1% |
| Top 5 positions as % of book | 42% |
| Avg. weighted market cap of book (m$) | 855 |
| Avg. weighted free float of book | 42% |
| Net Exposure | 86% |
| # of positions | 20 |

*Source: Internal Sources*

**Exhibit 8 – 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 CI 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% |
| **2Q17** | 2.3% | 3.8% | 4.7% | 4.1% | 6.8% | 5.3% | 4.1% |
| | | | | | | | |
| **Trailing 1 year** | 21% | 15% | 21% | 27% | 31% | 15% | 12% |
| **Trailing 2 years** | 38% | 15% | 24% | 41% | 42% | 23% | 13% |
| **Trailing 3 years** | 55% | 28% | 40% | 62% | 55% | 46% | 39% |
| **Since inception** | 184% | 74% | 92% | 120% | 90% | 98% | 75% |
| **2017 YTD** | 16% | 16% | 20% | 22% | 28% | 13% | 19% |
| **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** | 13% | 9% | 11% | 15% | 16% | 6% | 12% |
| **Sharpe Ratio** | 1.01 | 0.46 | 0.54 | 0.60 | 0.44 | 1.00 | 0.46 |
| **Calmar Ratio (5-yr/3Y)** | 1.18 | 0.52 | 0.70 | 0.73 | 0.59 | 0.62 | 0.66 |

*Note: Metis Opportunity's INR track record is a live blend of our running onshore strategies; Fund went live on March 11, 2014; *CI 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 a Bombay Stock Exchange in India, he moved to United States in 2002, where he covered stocks within Busines 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 Instituti Investor (II) and Greenwich Associates. Piyush received an MBA from University of North Carolina at Chapel H 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 ser analyst with portfolio management duties over $50 million in fund of fund assets at a leading regional investm bank (Global Investment House) in the Middle East. Prior to this, he was with Bay Harbour Management, a $1 billion distressed debt and equity hedge fund in New York City. He has also served as an analyst with Polen C 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 Carolin a at Chapel H He is a Chartered Financial Analyst and a Certified Public Accountant.

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