Metis Opportunity Fund

As earnings-valuation disconnects correct, unraveling gets overdone in select pockets

July 2018 Newsletter

Jul 31, 2018

In investing, the destination must be constantly validated as the market is unforgiving to those who lack conviction in their estimate of intrinsic value and perhaps even more importantly, their own investment holding period (i.e. their time frame). Simply stated, investors must have clear sense of their time frame and objective although it is natural that each person's definition of each will be different. We would like to elaborate a bit on the critical time frame issue. Due to the lingering effects of millions (13.8b years since big bang to be exact - thanks to David Christian of "Origin Story") of years of evolutionary history where the early humans literally "ate what they killed" and did whatever else required to survive, the fundamental nature of the human brain is to think and thus act short-term. After advent of agriculture a mere 10,000 years ago there has been consistent increase in long-term thinking and action but there is a long way to go. Unfortunately, this unconscious bias for short-term action- what kept early man alive, is not optimal to get consistently better than average long-term return in stock market. This universal trait of average stock market participant has daily impact on every stock market participant in every stock market in the world.

What does this have to do with our fund and our recent performance? A heck of a lot! For our strategy to effectively and optimally work, as we have constantly hinted at or stated, we require committed investor-partners to join us for the $2.5 trillion Indian economy journey. This means investors who have a clear sense of their objectives and have the holding power (financially and fortitude) to ride out the inevitable volatility. Now, we all say we are long-term investors but as in many things in life, there is a huge yawning gap between what people say and what their portfolio action over time shows they have actually done. Our portfolio has since inception turnover of under 20%, holds 20 businesses currently, and our personal/family investment in the strategy is majority of our net worth- clearly showing our "skin in the game" and staying true to our high conviction, low-turnover investment strategy.

In 2Q18, *Metis Opportunity* was down **-8.35%** (in USD), vs **-2.14%**, **-4.80%**, **-3.69%**, and **-2.84%** declines in *BSE 500 TR, BSE Midcap TR*, *BSE Smallcap TR*, and *Eurekahedge India* respectively and **+0.90%** gain *Nifty TR*[1]. We did not initiate any new position during the quarter but added exposure in 3 holdings. Meanwhile, we completely exited 2 positions in our *India Undervalued* sub-strategy.

Over trailing 12 months, *Metis Opportunity* was down **-7.6%** (in USD). That compares with **+7.7%**, **+5.3%**, **+6.4%**, **+4.0%**, and **+3.6%** increases in *Nifty TR, BSE 500 TR, BSE Smallcap TR*, *BSE Midcap TR* and *Eurekahedge India* respectively. Over this period, our volatility was **351 bps** and **184 bps** below that of *BSE Smallcap TR* and *BSE Midcap TR,* and **32 bps** and **682 bps** ahead of *BSE 500 TR* and *Eurekahedge India* respectively.

Over the past 3 years, *Metis Opportunity* is up **+20.2%** (in USD) vs. **+23.7%**, **+28.7%**, **+44.3%**, **+48.3%**, and **+26.1%** 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 **+102.2%** (in USD) vs. **+47.4%**, **+56.8%**, **+78.1%**, **+56.9%**, and **+39.1%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respectively.

Elevated earnings expectations left little room for error. We certainly aren't trying to be a Monday morning quarterback when we state that throughout 2017 we had been accentuating on growing disconnects between earnings growth expectations and valuations within Indian small and midcaps. C1Q earnings showed precisely why it'll be unrealistic to expect 20%+ earnings growth once the low-base benefit wears off - While headline operating income and earnings for *Nifty Midcap 50* (ex-financials) showed C1Q growth in the early 20s, it came off of highly depressed C1Q17. Recall that in C1Q17, average operating margins had contracted more than 400 bps sequentially (post demonetization). Had it not been for the low margin base

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

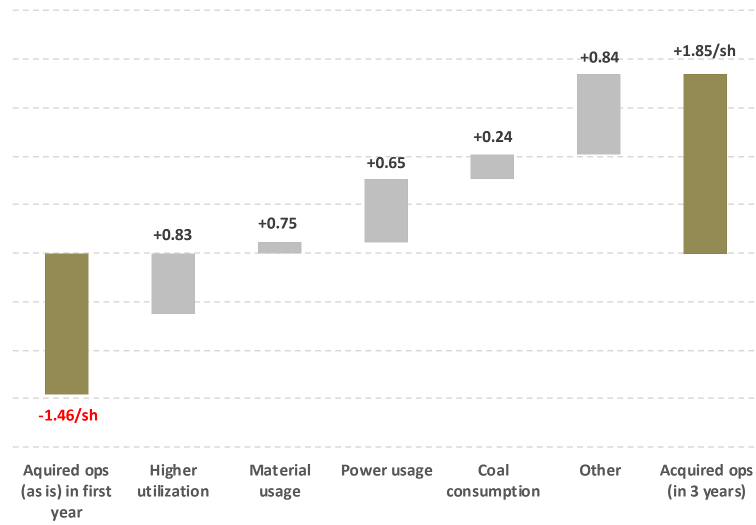
of C1Q17, operating earnings for this group would have shown no better than low-teens earnings growth, or essentially well off of mid-20s or higher growth expectations for F2019E (Mar) and beyond. Ignoring FX-impact, with margins clearly under pressure and limited below the operating-line leverage, it's hard to see broader markets reporting earnings growth materially ahead of revenue growth over the next few quarters. In sharp contrast, our holdings are solidly positioned to benefit from idiosyncratic earnings catalysts over this period.

Meanwhile, the near-term sharp pullback in the INR, even though expected, certainly can't be extrapolated. As much as near-term sharp moves tend to overwhelm us, it's critical to note that **1**. INR has barely depreciated 3% over the past 5 years, **2**. While INR has inherently been a volatile currency (just like ruble, rand, real, or rupiah) because of portfolio flows influence, this is gradually shifting as 'sticky' FDI flows decidedly at least match portfolio flows, and **3**. While remittances have been flattish for past 4 years, even elevated current account deficit in F2019E (Mar) will likely not surpass these. All said, despite our capital account stability, crude and/or portfolio flows fluctuations impact us in the short-run.

While it was apparent that there were, and in several pockets still are, wide disconnects between expectations and reality, it appears obvious to us that in several situations the unraveling has gone the other way. This is particularly pronounced in liquid names with low institutional ownership, where the most conservative of projections cannot reconcile with current valuations as retail selling hasn't been countered by institutional players coming in. We will categorize about 1/4th of our current names in that category. Here are our thoughts on a few such positions:

A movie exhibition holding dropped after noise around rumored F&B state intervention. As we write this, the first hearing of the PIL (on allowing external F&B on multiplex premises) is still to take place. Our discussions with attorneys and judges suggest that multiplexes have a strong case and they have every right to price their services within the terms and conditions of their operations. That said, there is an apparent need to be sensitive to certain facets of F&B pricing such as differential MRPs. We estimate that about a third of patrons consume F&B on premises and a vast majority don't consume packaged foods (i.e. don't consume anything with a printed 'mrp') – Just about 5-7% of total F&B revenues at our exhibition holding come from packaged F&B, with most of it coming from packaged water. Realistically, assuming that differential MRPs are done away with, the impact on underlying margins and our value estimate is largely immaterial. Furthermore, even if multiplexes drop prices across the board to temper down this issue, we don't see how the impact could drag underlying margins to anywhere close to what current valuations suggest. While it is clear to us that such outcomes are typically favorable for businesses in Supreme Court, the appeal process could be an overhang on the stock in the near-term.

Exhibit 1 – Earnings accretion from a recent NCLT acquisition



Notes: Capacity utilization is expected to hit 100% in 3 yrs; Blended wood cost assumed at 7.5K/ton, which includes transportation cost over 200-250 km and is net of Rs. 300/ton of subsidy; Wood cost inflation assumed at 4%; Interest subsidy of 2% has been factored; 1,200 employees are hired within 3 years of operations.

Names with limited institutional presence have been disproportionately hurt. The cheapest name in our book (a paper holding) by any measure and under nearly all scenarios of realistic deceleration in demand and/or contraction in margins is incidentally one that has very low institutional ownership. Incidentally, it is the only name where we have added exposure recently to capitalize on the broader panic. As we write this update, this stock is down -17% YTD. This comes at a time when the stock is trading at around 7x our conservative F2019E (Mar) earnings forecast. With almost no pressure on the materials cost side, a very tight supply situation in the end-market, and ample cash to drive 'below-the-operating-line' leverage, the only overhang on the stock is low institutional ownership and resulting impact from retail selling. On top of the clearly apparent upside, we note material embedded optionality in the form of a recent acquisition of a defunct facility that got sold out of NCLT bankruptcy proceedings. By our estimate, this acquired facility by itself could potentially be worth a third of the current stock price within 3-5 years (note earnings accretion from the deal in **Exhibit 1**). This is on top of what we believe is potential doubling just off of multiple expansion over the next 2 years.

We continue to back names that can sustain solid growth with little or no dependence on macro tailwinds. Consider an auto parts holding of ours - This company produces automotive lighting and, given long product cycles, works on cost-plus contracts. India's second-biggest 2W manufacturer is its biggest client and it services most of the rest too. Despite post-demonetization drag, this OEM did another 22%+ year of unit growth in F2018 (Mar), while gaining share in domestic 2W market and benefiting from continued traction in key export markets. This has continued into the new fiscal. This stock meanwhile is down 25% YTD and our most conservative estimate suggests that it should be up at least 50% within 2 years.

Along similar lines, we expect solid growth to be sustained at a diagnostics lab position. This stock is basically flat YTD but there are several underlying catalysts that have and will continue to drive growth for a long time. Overall, for F2019 (Mar), mid-teens revenue growth seems very doable, largely driven by growth in the under-penetrated East region, where a new reference lab has opened. Even in well penetrated markets such as Delhi NCR, low double-digit revenue growth is expected in the near-term, with about 3-4% of that coming from higher number of tests per footfall. Even with no change in macro-conditions, this position would almost certainly report 20%+ earnings growth this year, something one can't expect in vast majority of the world today.

In Q2, in our Undervalued sub-strategy we decided to sell entire position in 2 businesses - one a leading global poly film manufacturer and the other a 100-year-old public sector bank HQ in South India. Both these positions were in the strategy since 2011 and, in a word, have been disappointing. Although there was no total loss on the poly film business, we have taken material loss in the public-sector bank since first purchase.

In mid-2016, our India Under-served sub-strategy had sold out of this bank fully but we held 2% position in India Undervalued with belief that it traded like an option on eventual recovery in the vast public-sector bank universe (conservatively adjusted book value continues to be ~2x the market price). This recovery has kept being pushed back and we finally fully threw in the towel. Loss was largely limited due to position being pared over the years and was lowest weight in the sub-strategy upon sale in mid-May. The further loss from our earlier 2016 sale price would be limited to under 25bps in the sub-strategy - clearly something the portfolio could absorb but nonetheless not something we are proud of or count in our reel of greatest hits. Several lessons were learnt by us from the full sale of these businesses. The chief being that there can never be compromise in management quality, ethics, passion, and the size of gap (expectation vs. delivery) cannot grow too large - unfortunately this last point is more subjective than we would like. Bottom line: the management of these businesses were not well positioned to deal with the underlying challenges each business faced and were not communicating frequently, openly, and consistently with the analyst community. We were confident and actually still believe that the margin of safety the valuations provide are worth noting but we did not want to keep waiting indefinitely while our opportunity cost kept growing (alas timing is important for some businesses that might be worth heck of a lot more than market currently values but timing of this gap correction is so uncertain/delayed as to reduce overall margin of safety from relative investment attractiveness standpoint).

Performance and Attribution summary

Just under half of our positions declined during the quarter, including our biggest holding, which incidentally was the worst performing position in our book. Our best performing positions were a software services name (up **+42%**) and a movie exhibition name (up **+13**. Our two worst performing positions during the quarter were a packaging name (down **-27%**), and a glassware name (down **-17%**). For our historical position-wise benchmarking vs. peers and *BSE 500*, please see **Exhibit 2d**.

Since inception in April 2011, *Metis Opportunity* is up **+102.2%** (in USD) vs. **+47.4%**, **+56.8%**, **+78.1%**, **+56.9%**, and **+39.1%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR*, *BSE Smallcap TR*, and *Eurekahedge India* respectively (see **Exhibit 2a** and **2c**). Over trailing 12 months, *Metis Opportunity* was down **-7.6%** (in USD). That compares with **+7.7%**, **+5.3%**, **+6.4%**, **+4.0%**, and **+3.6%** increases in *Nifty TR, BSE 500 TR, BSE Smallcap TR*, *BSE Midcap TR* and *Eurekahedge India* respectively. Over this period, our volatility was **351 bps** and **184 bps** below that of *BSE Smallcap TR* and *BSE Midcap TR,* and **32 bps** and **682 bps** ahead of *BSE 500 TR* and *Eurekahedge India* respectively (see **Exhibit 2b**).

Exhibit 2a – Perf. since inception

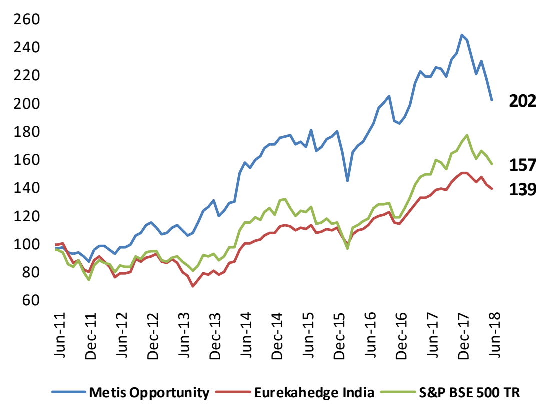


Exhibit 2b – TTM volatility

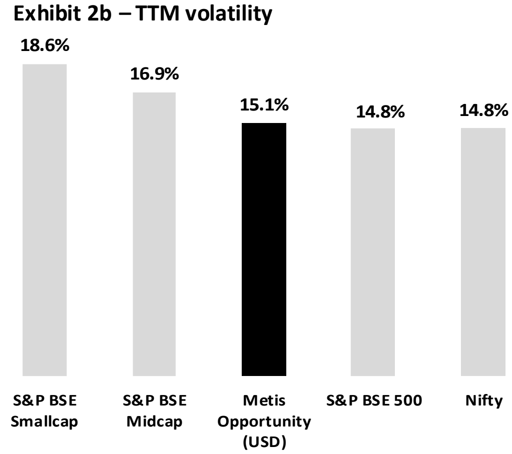


Exhibit 2c – Calendar year benchmarking

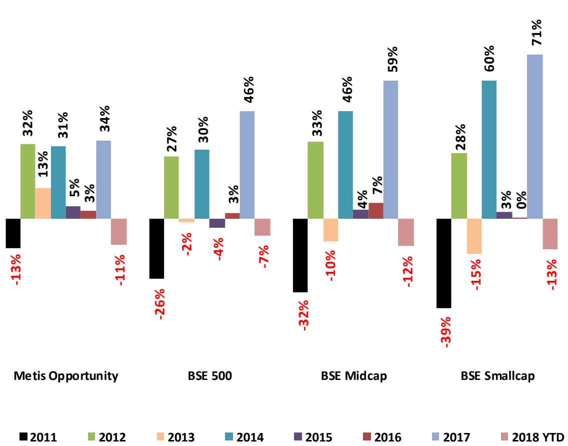
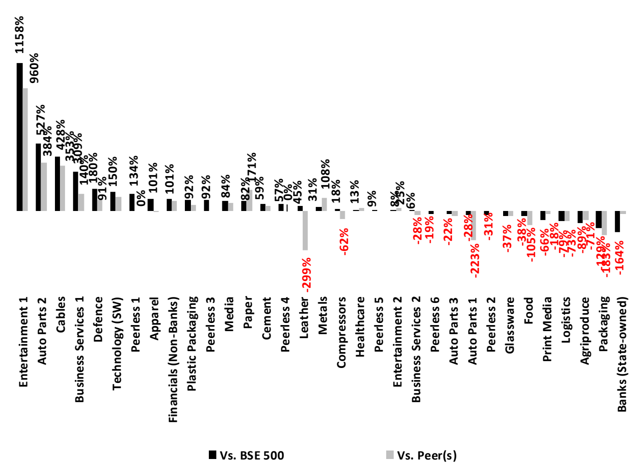


Exhibit 2d – Industry-wise benchmarking for positions



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 3a – Relative rolling 12-mth returns

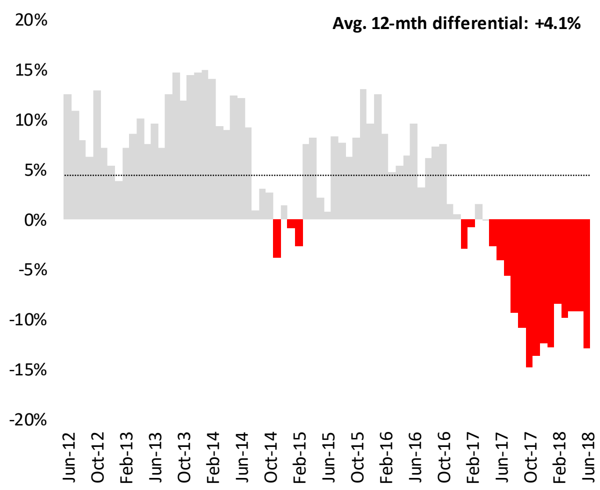
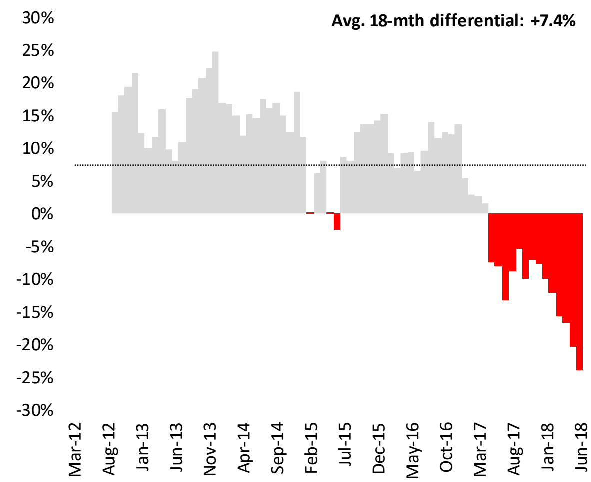


Exhibit 3b – Relative rolling 18-mth returns



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

Exhibit 4 – Time window analysis for our sub-strategies

	India Underserved		*India Undervalued*	
	3 Month	*12 Month*	*3 Month*	*12 Month*
Number of periods	85	76	90	81
Average period return	**4.4%**	**20.5%**	**3.7%**	**19.5%**
Number of profitable periods	60	73	55	71
% profitable periods	**71%**	**96%**	**61%**	**88%**
Best period	23.9%	55.3%	25.9%	66.0%
Gain Standard Deviation	5.9%	13.4%	6.4%	17.0%
Sharpe Ratio @10% RFR	0.27	0.76	0.15	0.50
Sharpe Ratio @5% RFR	0.43	1.12	0.28	0.76
Sharpe Ratio @0% RFR	0.60	1.48	0.41	1.02
Loss Standard Deviation	2.4%	0.8%	4.3%	5.5%
Downside Deviation @10% MAR	3.5%	3.3%	5.4%	7.2%
Downside Deviation @5% MAR	2.9%	1.4%	4.7%	5.2%
Downside Deviation @0% MAR	2.3%	0.2%	4.1%	3.5%
Sortino Ratio @10%	0.56	3.22	0.25	1.31
Sortino Ratio @5%	1.08	10.89	0.53	2.81
Sortino Ratio @0%	1.89	87.29	0.91	5.55
Average Gain/Loss	2.1	22.1	1.9	2.7
Profit/Loss Ratio	5.1	537.9	2.9	19.5

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

Exhibit 5 – Long-book snapshot

Top position as % of book	10%
Smallest position as % of book	2%
Top 5 positions as % of book	41%
Avg. weighted market cap of book (Mil)	$1,060
Avg. weighted free float of book	45%
Net Exposure	88%
Number of positions	20

Source: Internal Sources

Exhibit 6 – 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	-4.1%	-4.2%	-4.5%	-5.8%	-8.2%	-1.1%	-6.1%
3Q11	-4.0%	-13.5%	-13.0%	-11.9%	-16.0%	-13.5%	-21.9%
4Q11	-5.4%	-7.8%	-10.8%	-17.5%	-20.5%	-7.5%	-16.4%
1Q12	12.0%	13.1%	15.6%	22.1%	17.9%	9.6%	20.0%
2Q12	-0.8%	-0.9%	-1.8%	-4.0%	-2.3%	-9.3%	-8.0%
3Q12	9.3%	7.1%	7.1%	6.9%	7.0%	12.4%	14.1%
4Q12	8.7%	2.4%	4.1%	6.5%	4.0%	1.9%	-0.8%
1Q13	-7.0%	-4.9%	-7.6%	-14.7%	-22.4%	-4.9%	-2.6%
2Q13	1.9%	1.7%	0.1%	-4.1%	-4.2%	-7.1%	-9.5%
3Q13	4.8%	-3.1%	-3.1%	-6.7%	-3.6%	-7.1%	-4.5%
4Q13	14.0%	8.3%	9.9%	17.9%	18.2%	8.0%	11.0%
1Q14	-0.9%	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%
2Q18	-8.4%	0.9%	-2.1%	-4.8%	-3.7%	-2.8%	-5.3%
Trailing 1 year	-8%	8%	5%	4%	6%	4%	-1%
Trailing 2 years	13%	31%	33%	37%	46%	24%	16%
Trailing 3 years	20%	24%	29%	44%	48%	26%	11%
Trailing 5 years	86%	63%	81%	138%	169%	75%	78%
Since inception	**102%**	**47%**	**57%**	**78%**	**57%**	**39%**	**20%**
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	32%	23%	27%	33%	28%	14%	25%
2011	-13%	-24%	-26%	-32%	-39%	-21%	-39%
Sharpe Ratio	0.50	0.22	0.27	0.35	0.25	0.18	0.08

*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.

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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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