Metis Opportunity Fund

Broad-based margin expansion isn't always the same as aggregate expansion. The case for former is weak.

July 2016 Newsletter

July 27, 2016

On the day following Brexit, opportunistic diggers went about picking names such as *Groupe Eurotunnel*, arguing that the market was exaggerating the impact on inter-Europe travel. Meanwhile, NA focused managers were busy picking names with limited exposure to Europe. In India meanwhile, businesses with no direct or any material multiplier linkages with EU were trading lower around the same time. Undeniably, there could be a marginal impact on the currency. To the immaterial extent that any underlying demand for any of our holdings depends on trade volume or underlying operating costs are non-INR denominated, those names could be arguably impacted. That's really all there is to it. You can discuss third and fourth degree multiplier effects but you'll still be hard pressed to identify material impact on hardly any of our holdings. Yet, the 9:15 AM to 3:30 PM theaters had to entertain their viewers for the day. If only fiction influenced reality……

Just as first calendar quarter has historically been our worst quarter in relative terms, second calendar quarters have historically been one of our strongest. 2Q16 wasn't a departure – Following what was our worst absolute return quarter (second worst in relative terms) since our inception in early 2011, *Metis Opportunity* strategy rebounded **+11.5%** (net of all fees; in INR terms) in 2Q, vs **+7.7%**, **+8.7%**, **+5.3%**, **+10.5%**, and **+12.0%** gains in *Nifty TR*[1], *BSE 500 TR, Eurekahedge India, BSE Midcap TR*, and *BSE Smallcap TR* respectively. Within our book, gains were very broad-based – Except for a *Media* name, which incidentally is among our top 5 holdings, every name gained in 2Q. Our net exposure at the end of 2Q was 94% vs. 99% at the end of 1Q. We didn't initiate any new exposure during the quarter, with part liquidation of a bank name and pruning of positions to bring them in line with the model more than offsetting gains during the quarter.

Over trailing 12 months, *Metis Opportunity* was up **+14.0%** (net of all fees; in INR terms). That compares with **+0.3%**, **+2.6%**, **+7.7%**, **+11.3%**, and **+4.1%** increases in *Nifty TR, BSE 500 TR, BSE Smallcap TR*, *BSE Midcap TR* and *Eurekahedge India* respectively. Over this period, our volatility was **246 bps** below that of *BSE Smallcap TR*, and **279 bps**, **209 bps**, and **858 bps** ahead of *BSE 500 TR*, *BSE Midcap TR* and *Eurekahedge India* respectively.

Over the past 3 years, *Metis Opportunity* is up **+87.2%** (net of all fees; in INR terms) vs. **+47.0%**, **+60.7%**, **+105.1%**, **+117.4%**, and **+54.2%** 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 **+123.9%** (net of fees; in INR) vs. **+53.9%**, **+60.8%**, **+76.2%**, **+45.6%**, and **+24.6%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respectively.

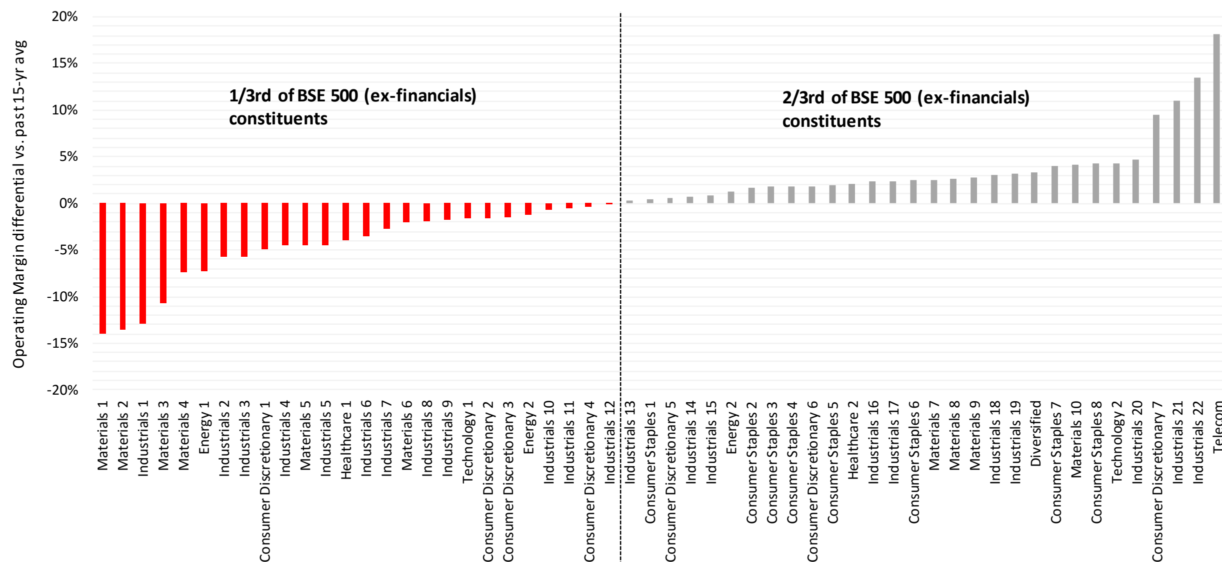
As we write this letter, south-west monsoon is running at-par. July and August, which account for nearly 2/3rd of all rainfall, are expected to report above normal rainfall. With rural demand all set to revive, rate cuts increasingly likely, and earnings continuing to rise from troughs, India is about as attractive a place to be in as any. We of course are at odds vs. the street when it comes to the extent of earnings rebound (please refer to our April 2016 letter). While underlying leverage and margin expansion is nearly certain to drive earnings within select industrial pockets, core operating margins across majority of the industries remain near all-time highs. Accordingly, our expectations for gains aren't nearly as broad-based as those of the street.

For a while now we have noted that there has been more than ample chatter around how one should anticipate broad-based operating margin expansion over the next several quarters. Usually, this argument is based on a highly misrepresentative 'corporate profit to GDP' multiple. Many cite this relationship to suggest that we are pretty much entitled to eke out more operating profits at current level of output. Admittedly, on an aggregate level that might be true. However, that's largely because this depressed multiple is heavily skewed by *Materials* names, which today account for around 16% of *BSE 500* (ex-financials) revenues but only about 8% of operating profits. In terms of net earnings, these names would be an even larger drag on corporate profits, given underlying leverage. However, if horses weren't added up with cows and then divided by GDP above, it would be pretty clear

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

that majority of *BSE 500* components (ex-financials) reported their highest operating margin on record in F2016 (Mar), rendering the case for broad-based operating margin expansion extremely weak (see **Exhibit 1**).

Exhibit 1 – F2016 (Mar) operating margin differential vs. past 15-year average (sub-industries classified as per GICS sectors)



Note: All current BSE 500 constituents (ex-financials) that have been public since F2000 were included in the above exercise; all sub-industries are shown as per their GICS sector classification
Source: Company reports

Laggards even include sub-industries whose historical average is skewed by a few 'bubblicious' years. Certain industries that have seen their profitability erode in recent years have been at the receiving end of adverse structural changes vs. simply facing cyclical erosion. Take *real estate*, for instance, where substantial margin erosion is more structural as input costs have predictably moved higher and asset affordability is just beginning to catch up with very slow absorption on the back of 'bubble-like' unrealistic realizations of prior years. With the 'undisclosed capital' spigot running dry, marginal arguable benefit from lowering circle rates just can't be enough to offset what is a triple whammy of low affordability, extremely high inventory, and enormous debt burden.

Select pockets within industrials clearly have a relatively solid case for profitability revival. Sub-industries such as *Abrasives*, which have had substantial capacity ramp-ups in recent years, besides facing industrial slowdown, have had a sharp contraction in margins and could therefore make a fair case for material margin expansion. Similar argument, albeit case for demand growth is weaker, could be made for pockets such as *Cement*[2] where utilization was at an anemic 70% in F2016 (Mar).

Extreme polarity across industries. Collectively, F2016 (Mar) margins for about 54% of sub-industries within *BSE 500*, accounting for ~2/3rd of constituents, were at their highest since we started tracking from F2000 (Mar) onwards (see **Exhibit 1**). In sharp contrast, the other 46% of sub industries, accounting for a third of constituents, collectively reported their lowest profitability since F2000 (Mar). Predictably, the 8 sub-industries that reported their highest ever margins in F2016, including industries such as *CPG* and *Auto OEMs*, often utilize operating and capital inputs from the 5 sub-industries that reported their worst margins in F2016[3]. On average, 2 names reported their highest ever margin in F2016 for every 1 that reported its lowest. To make a case, howsoever simplistic, for expansion in the latter should be coupled with making a parallel case for margins in the former set

[2] Not that underlying demand for housing is expected to improve anytime soon but even our checks within the industry suggest that the end-market is not in a position to absorb any further material price increase, on the back of INR 30-50 per bag pan-India increase in F2017 YTD.

[3] These two sets of sub-industries have historically reported a -0.7 correlation in profitability.

receding. Regardless of how one evaluates the constituents, the case for broad-based margin expansion rests on overly simplified farcical logic.

After what is now become a near-routine underperformance of ours in first calendar quarters, we bounced back rather nicely in 2Q as solid earnings helped us back on track as we widened the differential vs. the broader markets.

The regional the better. When C2Q started, we were staring at very tough comps for Hindi box-office collections. While movies such as *Fan* disappointed, regional content such as *Sairat* more than made up for that. That C2Q16 collections outpaced even elevated comps from last year was as much driven by higher influence of regional content as it was by increased household expenditure on outdoor entertainment. For our holding, non-Hindi collections likely made up nearly 60% of overall collections in C2Q16E, vs. 45% in F2016 and 35% in F2015. Digitization has obviously been a huge driver behind this shift. The mix-shift away from traditional Hindi content also has an obvious benefit on underlying margins since producer share in collections tends to be lower. We also note that strong Hindi box-office collections in F2016 (Mar) weren't driven by 'Khan' banners – Just about a fifth of F2016 Hindi box office collections for multiplexes came from movies starring the 3 major Khans, and that's in a year that had 2 of Salman Khan's biggest all-time grossers.

In late June, cabinet approved the *Model shops and establishment bill*, which allows, subject to permission by state governments, malls, other retail locations, banks, and cinema exhibitors to operate around the clock. As things stand, our holding screens most of its first shows around 9:30 AM with most evening shows ending around 2 AM. Quite clearly, the above bill, assuming its passed within state jurisdictions, wouldn't drive increased screenings. However, there is potential benefit from increased 'impulse' footfalls. In about 30 weeks of a year when a major release isn't being screened, this impact could be most visible – Typically, during these times, nearly 50% of footfalls happen to be 'impulse' i.e. come from patrons that hadn't planned on watching a movie when they came to the retail location. To the extent that retail footfalls increase late evening, we should expect occupancy in the last evening show to move higher. As things stand, we aren't building any material benefit from this ruling into our expectations.

Our early expectations on LED margins (for *EESL* supplies) have proved conservative. When we initiated exposure in a new auto parts name in late 2015, at expected *EESL* bid prices, we did not expect any material EBITDA contribution from the LED business. In fact, with the exception of F2019E and F2020E, when we expect utilization levels to peak, we didn't expect this piece of the business to post double digit margins at any point within the next decade. We were certainly surprised when this fledgling piece posted mid-teens EBITDA in F2016 (Mar). Even though we notice aggressive bidding and sliding prices within LED bulbs, it's evident that our margin expectations were hugely conservative.

Hyderabad park launch has been solid; Chennai plans on track. For our 'outdoor entertainment' holding, our thesis remains firmly on track – Hyderabad park recorded footfalls of ~200K in the first two and a half months, which is in line with our expectations, and ahead of Bangalore's first quarter footfalls nearly a decade ago. Barring extreme weather-related disruptions, we expect the park to comfortably outpace its 700K footfall target in F2017E (Mar). For the proposed park in Chennai, land approvals should be secured by October with target launch in mid-F2019E (Mar).

Radio station launches (post Phase III auctions) going as per schedule. While the government PR machine is in full force when it comes to wooing overseas investors, we would much rather prefer this translating into broad based investor friendliness on the ground – It's now been more than a year since *ENIL* bid on *TV Today*'s radio assets and the lingering issue of sale of 3 stations is still being drawn out in courts. Elsewhere, our holding has launched 4 of the 17 frequencies won at Phase III auctions and remains on course to conclude the launches in F2017 (Mar), which should temporarily drag the EBITDA margin lower by 200-300 bps in the current fiscal.

Performance and Attribution summary

2Q16 was our third best quarter since our inception and our best since the 15% gain in 2Q14. It incidentally follows our worst quarter on record in 1Q. As earnings across a vast majority of our book executed strongly in April/May, our YTD differential was pared substantially over the course of the quarter. Just as in each of the past 5 years, we expect continued execution to drive outperformance in 2H16 – We have averaged just under **+9%** differential vs. *BSE 500 TR* in second halves in past 5 years.

All except one of our holdings gained in 2Q. Our two best performing positions in the quarter were an *Entertainment* and a *Medical Devices* name (both up **+38%**), with the latter solidly rebounding off a poor 1Q. Our two worst performing positions during the quarter were a *Media* name (down **-4%**) and a *Packaging* name (up **+3%**). Incidentally, both our best and worst performing names feature among our top-5 holdings. For our historical position-wise benchmarking vs. peers and *BSE 500*, please see **Exhibit 2d**.

In 2Q, *Metis Opportunity* strategy gained **+11.5%** (net of all fees; in INR terms) vs **+7.7%**, **+8.7%**, **+5.3%**, **+10.5%**, and **+12.0%** gains in *Nifty TR, BSE 500 TR, Eurekahedge India, BSE Midcap TR*, and *BSE Smallcap TR* respectively. Since inception, *Metis Opportunity* is up **+123.9%** (net of fees; in INR) vs. **+53.9%**, **+60.8%**, **+76.2%**, **+45.6%**, and **+24.6%** 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, our volatility was **246 bps** below that of *BSE Smallcap TR*, and **279 bps**, **209 bps**, and **858 bps** ahead of *BSE 500 TR*, *BSE Midcap TR* and *Eurekahedge India* respectively (see **Exhibit 2b**).

Exhibit 2a – Perf. since inception

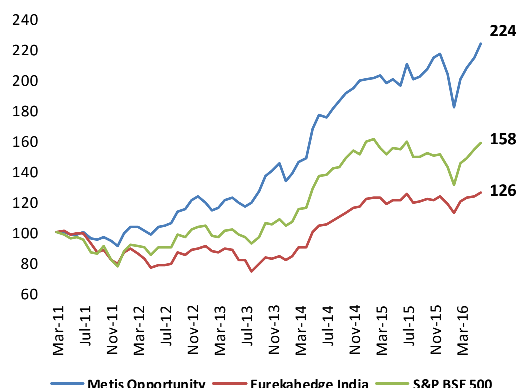


Exhibit 2b – TTM volatility

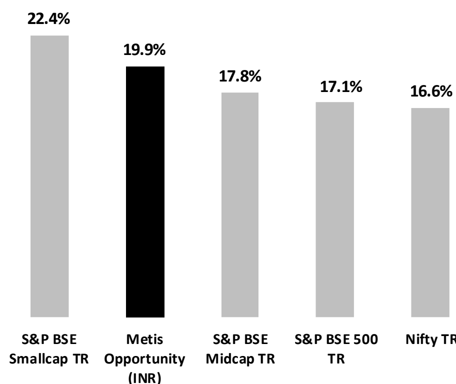


Exhibit 2c – Annuals and average –ve month returns

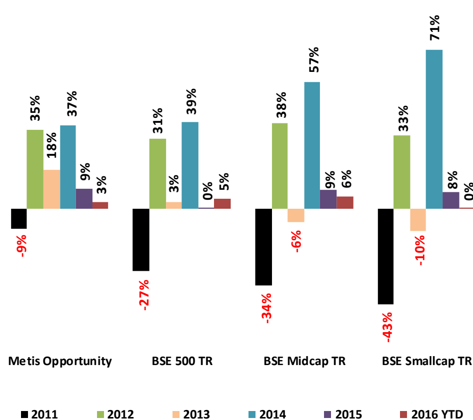
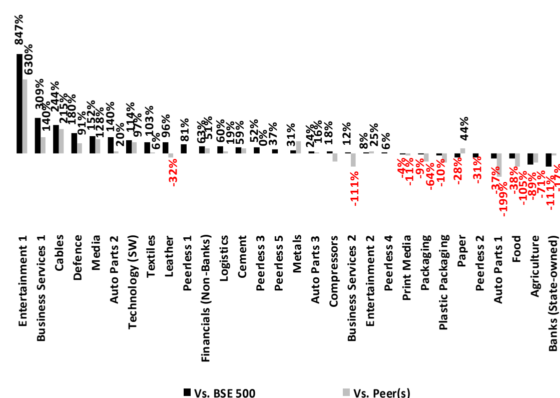


Exhibit 2d – Industry-wise benchmarking for positions



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

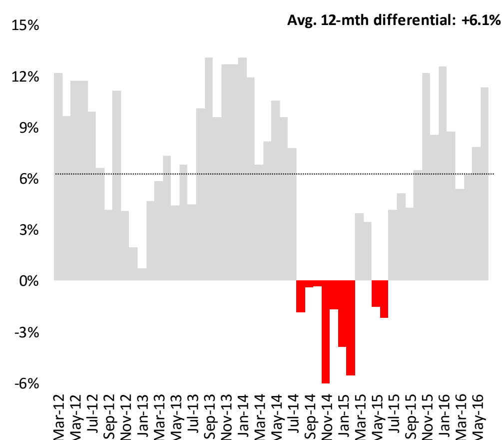
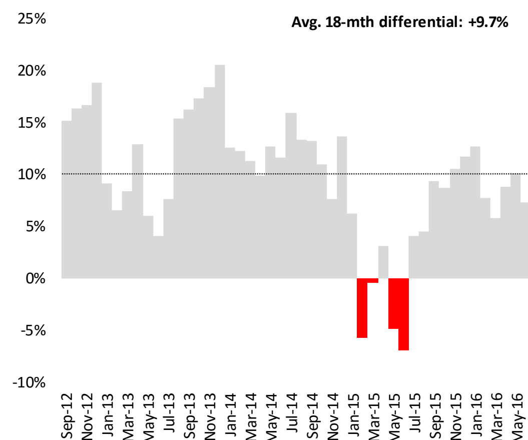


Exhibit 3b – Relative rolling 18-mth returns



Note: Relative return differentials are in INR terms and are calculated vs. BSE 500 Total Return index
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	60	51	65	56
Average period return	**4.9%**	**23.5%**	**3.5%**	**19.4%**
Number of profitable periods	43	49	39	47
% profitable periods	**72%**	**96%**	**60%**	**84%**
Best period	24%	55%	26%	66%
Gain Standard Deviation	6.5%	14.1%	6.8%	18.6%
Sharpe Ratio @5%	0.47	1.26	0.26	0.68
Sharpe Ratio @3%	0.53	1.40	0.31	0.78
Sharpe Ratio @0%	0.62	1.60	0.39	0.92
Loss Standard Deviation	2.7%	0.4%	4.4%	5.8%
Downside Deviation @5%	3.0%	1.4%	4.6%	5.8%
Downside Deviation @3%	2.8%	0.9%	4.3%	5.1%
Downside Deviation @0%	2.4%	0.2%	4.0%	4.0%
Sortino Ratio @5%	1.22	13.08	0.50	2.46
Sortino Ratio @3%	1.50	23.89	0.63	3.22
Sortino Ratio @0%	2.01	132.91	0.88	4.81
Average Gain/Loss	2.2	28.6	1.9	2.9
Profit/Loss Ratio	5.6	700.8	2.9	15.3

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

Exhibit 5 – Long-book snapshot

Top position as % of book	10%
Smallest position as % of book	0.8%
Top 5 positions as % of book	46%
Avg. weighted market cap of book (mil)	$728
Avg. weighted free float of book	47%
Net Exposure	94%
# of positions	20

Source: Internal Sources

Exhibit 6 – 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**
May-11	-1.4%	-3.1%	-2.5%	-2.6%	-5.5%	-2.6%	-2.5%
Jun-11	-0.3%	2.0%	0.8%	-0.8%	-0.8%	0.2%	-0.4%
Jul-11	1.6%	-2.8%	-1.9%	0.9%	2.3%	0.7%	-2.7%
Aug-11	-3.8%	-8.7%	-8.6%	-9.3%	-13.8%	-7.4%	-7.1%
Sep-11	-0.7%	-1.1%	-1.4%	-2.3%	-3.2%	-6.3%	-5.5%
Oct-11	1.9%	7.8%	6.0%	2.7%	1.4%	2.1%	5.7%
Nov-11	-2.9%	-9.3%	-9.5%	-10.6%	-12.5%	-7.9%	-5.7%
Dec-11	-3.4%	-4.3%	-5.5%	-8.8%	-8.9%	-2.7%	-8.6%
Jan-12	9.1%	12.5%	13.5%	14.3%	16.5%	9.5%	10.4%
Feb-12	3.8%	3.6%	4.7%	8.8%	6.2%	3.3%	3.5%
Mar-12	-0.2%	-1.6%	-1.3%	-0.6%	-3.3%	-4.1%	0.8%
Apr-12	-1.9%	-0.9%	-0.9%	-0.4%	2.1%	-3.4%	-1.6%
May-12	-2.6%	-5.9%	-6.0%	-6.4%	-7.3%	-7.9%	-4.6%
Jun-12	4.9%	7.6%	6.8%	4.4%	4.5%	2.8%	7.8%
Jul-12	0.8%	-0.8%	-0.9%	-1.8%	-1.0%	0.0%	-1.7%
Aug-12	1.9%	0.7%	0.6%	0.1%	-0.6%	0.4%	1.8%
Sep-12	6.7%	8.5%	8.8%	10.1%	10.1%	10.2%	6.7%
Oct-12	1.3%	-1.4%	-1.2%	-0.6%	-0.4%	-2.1%	0.1%
Nov-12	5.5%	4.7%	5.1%	5.3%	4.2%	4.0%	3.5%
Dec-12	1.9%	0.5%	1.5%	3.1%	1.5%	0.6%	-0.5%
Jan-13	-3.6%	2.2%	1.1%	-2.0%	-4.1%	2.2%	0.0%
Feb-13	-3.8%	-5.6%	-6.5%	-9.5%	-12.2%	-3.9%	-4.4%
Mar-13	1.2%	-0.1%	-1.0%	-2.5%	-6.4%	-0.9%	1.1%
Apr-13	4.2%	4.4%	4.3%	3.3%	3.8%	3.0%	3.1%
May-13	2.0%	1.3%	1.1%	0.8%	-1.2%	-1.0%	0.3%
Jun-13	-2.9%	-2.2%	-3.5%	-6.3%	-4.9%	-7.4%	-3.9%
Jul-13	-2.5%	-1.5%	-2.2%	-6.6%	-5.4%	-0.6%	0.8%
Aug-13	2.3%	-4.6%	-4.3%	-4.1%	-1.9%	-9.1%	-5.0%
Sep-13	6.5%	4.9%	5.3%	5.9%	5.7%	7.1%	4.8%
Oct-13	7.5%	9.9%	9.2%	9.0%	7.9%	5.1%	8.7%
Nov-13	2.9%	-1.9%	-0.7%	3.6%	3.6%	-0.9%	-1.0%
Dec-13	3.3%	2.1%	3.1%	6.0%	7.4%	2.0%	1.7%
Jan-14	-7.7%	-3.3%	-4.1%	-5.7%	-4.4%	-2.4%	-4.0%
Feb-14	3.7%	3.1%	2.9%	3.2%	3.0%	2.1%	5.8%
Mar-14	5.0%	6.9%	7.7%	9.0%	9.7%	7.1%	8.0%
Apr-14	1.8%	-0.1%	0.6%	3.4%	5.9%	0.6%	-0.9%
May-14	12.8%	8.1%	10.5%	15.7%	20.4%	10.5%	9.2%
Jun-14	5.8%	5.6%	6.7%	10.9%	13.2%	4.6%	6.6%
Jul-14	-0.9%	1.7%	0.8%	-1.7%	-1.8%	0.4%	1.4%
Aug-14	3.0%	3.1%	2.9%	1.4%	3.0%	2.4%	4.6%
Sep-14	2.9%	0.2%	0.9%	2.7%	4.3%	2.8%	4.3%
Oct-14	2.7%	4.6%	4.2%	3.2%	2.3%	2.5%	3.1%
Nov-14	1.9%	3.2%	3.4%	4.5%	3.2%	2.9%	5.5%
Dec-14	2.2%	-3.5%	-2.1%	1.0%	-1.6%	0.2%	-2.5%
Jan-15	0.5%	6.4%	5.8%	3.6%	2.2%	4.8%	6.2%
Feb-15	0.6%	1.1%	1.0%	0.7%	-0.5%	0.6%	2.4%
Mar-15	0.7%	-4.4%	-3.4%	-2.0%	-3.3%	-0.1%	-2.1%
Apr-15	-2.3%	-3.6%	-3.2%	-1.7%	0.5%	-3.2%	-5.6%
May-15	1.3%	3.2%	3.2%	3.0%	3.1%	2.1%	4.7%
Jun-15	-2.2%	-0.4%	-0.8%	-0.2%	-1.7%	-0.1%	-0.6%
Jul-15	7.3%	2.2%	3.3%	6.0%	7.1%	3.0%	3.3%
Aug-15	-4.8%	-6.5%	-6.1%	-4.7%	-7.1%	-4.4%	-6.4%
Sep-15	1.1%	-0.2%	-0.2%	0.8%	0.6%	0.4%	0.6%
Oct-15	2.5%	1.6%	1.7%	1.6%	2.7%	1.5%	0.2%
Nov-15	3.4%	-1.6%	-0.8%	0.2%	2.9%	-0.4%	-1.9%
Dec-15	1.2%	0.1%	0.5%	1.4%	1.7%	1.8%	-1.5%
Jan-16	-6.0%	-4.8%	-5.8%	-6.5%	-8.2%	-3.9%	-4.0%
Feb-16	-11.0%	-7.6%	-8.0%	-7.9%	-12.1%	-5.2%	-6.8%
Mar-16	10.5%	11.0%	10.9%	11.2%	10.7%	6.6%	9.5%
Apr-16	3.7%	1.4%	2.2%	4.0%	4.6%	2.2%	1.6%
May-16	3.2%	4.1%	3.5%	3.0%	1.1%	1.0%	5.0%
Jun-16	4.2%	2.0%	2.8%	3.1%	6.0%	2.0%	2.6%
Trailing 1 year	14%	0%	3%	11%	8%	4%	1%
Trailing 2 years	26%	12%	16%	28%	18%	21%	24%
Trailing 3 years	87%	47%	61%	105%	117%	54%	73%
Since inception	**124%**	**54%**	**61%**	**76%**	**46%**	**25%**	**61%**
2016 YTD	3%	5%	5%	6%	0%	0%	5%
2015	9%	-3%	0%	9%	8%	6%	-1%
2014	37%	33%	39%	57%	71%	39%	49%
2013	18%	8%	3%	-6%	-10%	-6%	6%
2012	35%	28%	31%	38%	33%	14%	28%
2011	-9%	-25%	-27%	-34%	-43%	-25%	-31%
TTM Volatility	20%	17%	17%	18%	22%	11%	16%
Sharpe Ratio	0.94	0.38	0.43	0.48	0.29	0.17	0.42

*Note: Metis Opportunity's INR track record is a live blend of our running onshore strategies; Fund went live on March 11, 2014 and reports net of all fees; *Close-ended funds in US, with USD returns converted into INR.*
Source: Internal Sources; NSE; BSE; Bloomberg; Eurekahedge

Investment Managers

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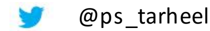 @ps_tarheel

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