QUARTERLY UPDATE

EQUITREE
SOWING SEEDS OF GROWTH

- MARCH 2020 -

"In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497 "

– Warren Buffet

Dear Investors,

Hope all of you are safe and healthy and practicing all precautions to fight against the current pandemic COVID-19. In these unprecedented times, we take this opportunity to share our thoughts on our portfolio and the market in general.

COVID-19 EATS IN TO ALL THE GREEN SHOOTS – FEAR & UNCERTAINTY LOOMS AGAIN

There couldn't have been a worse off time for the global economy and more particularly Indian economy to be hit by the much spoken COVID-19 virus. In just about a month's time we have yo-yoed from looking set to regain the thrust in the economy TO being pushed further in to darkness of uncertainty due to absolute lockdowns.

This fear of uncertainty has led to an unprecedented sell off across global equity, bond and commodities market alike – with most equity indices correcting between 35-40% in a month and global economists raising alarms for a long drawn recession and likening the situation to the great depression of 1929!

	52-Week High	52-Week Low	% Drop since 1st Feb 2020
Nifty 50 (Ind)	12,430 (Jan 2020)	7,511 (March 2020)	35%
Dow Jones (USA)	29,551 (Feb 2020)	18,213 (March 2020)	32%
FTSE (London)	7,727.49 (July 2019)	4,898 (March 2020)	30%
CAC 40 (France)	6,111 (Feb 2020)	3,632 (March 2020)	30%

We have been no different than the broader markets with the portfolio taking a major dent of ~ 29% in the month of March alone.

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QUESTIONS GALORE AND NO ANSWERS IN SIGHT AS OF NOW – ONLY FEARMONGERING GOING ON

- How long will the lockdown last?
- What will be the economic impact of the lockdown?
- Will the businesses survive after this?
- Will we see growth coming back anytime soon?

Questions like these and many more are obviously running through minds of investors and businessmen alike and everybody is scrambling to find some answer / solace to these questions based on various historical data analysis. Various experts have tried to put together different projections on how deep the economic impact could be leading to a global recession et al, however, most interestingly almost everybody concurs that if handled well, India could emerge as the biggest beneficiary post normalization of the global lockdowns.

In our opinion, the only question to be answered is ***"Whether this virus will erase the mankind?" and thankfully, the answer is a vehement "NO"*** and that being the case, businesses will come back – the uncertainty on the timelines remains nevertheless.

In this context, we find it more pertinent to discuss two important things in this newsletter:

- Our approach to investing in Businesses rather than stocks.
- Longevity of the businesses of our portfolio companies to see through these uncertain times.

OUR APPROACH TO INVESTING IN BUSINESSES RATHER THAN STOCKS

*"**Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years**."* — Warren Buffett

Nothing can describe our approach more aptly than these famous words from the Sage of Omaha. It is widespread knowledge that the stock prices can be subjected to extreme volatilities in the short term due to various markets driven and psychological reasons – something that we are experiencing currently.

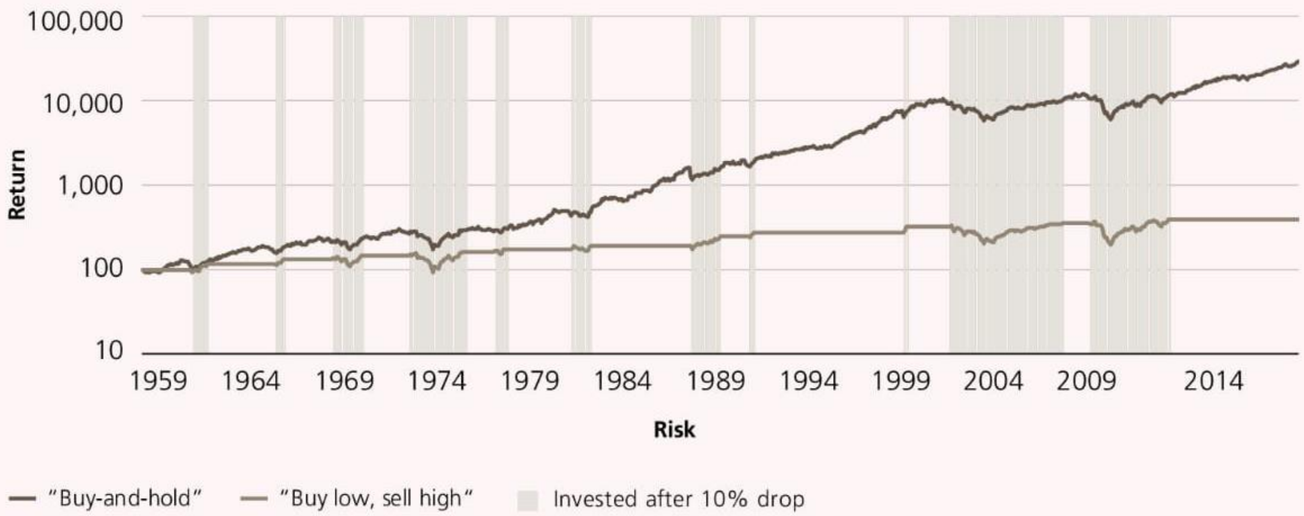
Businesses on other hand are far more resilient and long term in nature. While they indeed may have their own share of downtimes due to socio-economic reasons (again, something that we are experiencing currently) however, good businesses will always bounce back far stronger after every such extra-ordinary circumstances.

Unlike typical hedge funds, ETFs or other short-term market participants who have "hot" money chasing momentum and keep shifting from one stock idea to another, we take a private equity / partnership approach to our investing – almost assuming co-ownership of businesses that we would like to hold / do ourselves. For some of you who run businesses, am sure you would relate to our approach of not letting go a business just because it has seen 1-2 bad years (and the stock price has taken a beating), provided the drop in the business is primarily due to external environment and the business continues to enjoy a competitive edge which can be rekindled as and when the external environment becomes favorable.

Empirical evidence of market returns over longer period of time also suggest that "buy and hold" strategy far out paces the returns then "buy low and sell high" as shown hereunder:

Timing the market can be extremely costly

A "buy-and-hold" strategy vs. a "buy low, sell high" strategy



Note: Shaded areas indicate when the "buy low, sell high" strategy would have been invested. The "buy low, sell high" strategy follows a simple rule: buy stocks after a 10% drawdown, sell when stocks hit another all-time high.

Source: Ibbotson, UBS, as of 30 September 2019

It is with this phenomena that rather than rushing to book "notional" losses in the portfolio and convert them in to "real" losses in the quest for finding "better" opportunities, we have continuously been testing the longevity and competitive edge of our portfolio companies and have consciously chosen to stay invested in these with a conviction that these would indeed bounce back stronger once the external environment gets more stable and better. On an average investments in businesses with a private equity approach are done with at least 5-7 years horizon, we are about 2 years in our holding period of our investments and believe that while the holding period may get a little elongated from our earlier estimated time frame of 3 years nevertheless, we would still end up with reasonable returns on the portfolio as these businesses gain strength again. We share some of our thoughts on the portfolio companies hereunder for your ready reference.

LONGEVITY OF THE BUSINESSES OF OUR PORTFOLIO COMPANIES TO SEE THROUGH THESE UNCERTAIN TIMES.

We stress tested our portfolio holdings on some major parameters to see their longevity during these uncertain times and are happy to share our thoughts hereunder:

- **Almost all businesses that we have invested in have been in existence for over 30 years**

  Resilience of a business can best be gauged by the tenure that it has been in business. Weaker companies generally die out over 10-15 years either due to lack of focus on promoters' part or his inability to handle the changing external environment. Almost all of our portfolio companies have been in existence for over 30 years during which they have endured various ups and downs in the economy and have not only survived but have emerged stronger. We firmly believe that these promoters have enough experience to navigate through these uncertain times and emerge stronger again.

- **Mature businesses with revenues in the range of Rs. 400cr – 9000cr**

  All the businesses that we have invested in are fairly mature businesses with some of them enjoying market leadership position as well. These are not fledgling start-ups or small sized businesses which are more likely to be stressed during these times.

- **Healthy growth prior to the extraordinary external environment**

  Barring FY 20 which got impacted due to the extreme slowdown in economy, most businesses have grown PBT during the prior 3 years at CAGR of ~ 20%. *While the lockdown is expected to further slowdown the economy in FY 21 causing more challenges for some of our portfolio companies as well, however, we believe that given their long standing in the market place most of them should find their own bearing and emerge stronger as the economy inches back to normalcy*.

- **Very low leverage – average Debt / Equity is @ 0.4x**

  Most of our portfolio companies have only working capital limits with marginal or no term loans to service. Given that, we do not expect any significant duress on our portfolio companies due to debt servicing issues. Further, the low gearing ratio also provides some additional room to raise further working capital, if need arises, to tide over the potential elongated working capital cycles.

- **All businesses have a positive / healthy operating cash flow**

  As of Sept'19, most of our portfolio companies reported positive operating cash flows – which again is an important barometer to gauge health of a company's business. We believe that this comfortable cash flow position should help our portfolio companies to tide over any short-term financial stretches, if any.

- **High promoter holding with very low pledge of promoter shares**

  Higher promoter shareholding generally depicts promoters' skin in the game – most of our portfolio companies have a reasonable level of promoter holding ranging from 35-75%. Further, quite a few of these have institutional private equity funds as investors in these companies which also provides additional comfort on corporate governance and the company's ability to raise funds, if required.

  We have also been consciously monitoring another critical barometer – Promoter's Pledge of their shareholding. In volatile markets promoters' pledged shares always run a risk for margin calling as the stock prices plunges and are prone to unceremoniously be offloaded if margin calls are not met. However, one must differentiate even in the pledged shares where promoters have pledged shares for taking some personal funding (which are more prone to margin calls) as against the ones which are created to offer an additional collateral to the banks for limits availed by the Company. We are happy to report that most of our portfolio companies have marginal or no pledge on promoter holdings and even the ones which do have are largely been pledged to banks as additional collateral for banking limits availed and as such are not prone to the market vagaries.

- **Most promoters are buying from the market currently and shoring up their holding**

  It is interesting to note that promoters of most of our companies are shoring up their holding either by buying directly in the open markets and / or by announcing buy-back of shares from the market. This gesture further strengthens our belief and comfort on these companies / businesses as the promoters up the ante at a time when the weaker hands are exiting in sheer panic.

- **No corporate governance issues**

  Notwithstanding the severe drawdowns that we have seen in the stock prices of our portfolio companies, however, we haven't come across anything substantial which raises an eye-brow from the corporate governance perspective – which further make us believe that this correction is more driven by fear stricken panic selling in the market rather than any negative changes in the fundamental of the businesses that we are invested in.

SO WHAT NOW?

"Cash combined with courage in the time of a crisis is priceless" - *Warren Buffet*

In the middle of the financial meltdown of 2008, the BSE Sensex bottomed out with a correction of ~ 58% and recovered ~ 138% over the next 14 months leaving a lot of investors with a "missing the bus" feeling for this once in a lifetime opportunity where significant wealth got created for the ones who held on / invested more during the drawdowns of the market.

It is however noteworthy that the bottom of 58% in 2008 was created over a period of ~ 14 months unlike the sharp and unprecedented ~ 35% correction in a month that we have experienced now. One wonders if the recovery will also be spread out as it happened in 2009-10 or will we see an equally sharp recovery as the correction that we have experienced!

The sharp panic stricken selling in the broader markets has brought valuations of businesses to a level which was last seen in 2008 and presents a similar opportunity in our opinion. In extreme pessimism that we are undergoing currently, even a small dose of positive news flow could ignite a disproportionate buying response as the liquidity remains awash in the global markets.

Having said that, one will need to navigate the uncertainty for a while before the calm returns and accordingly we recommend our investors the following:

- A marginal increase in equity allocation – to be deployed in a disciplined and staggered manner rather than going out and buying bulk

- Activating our option of deploying 25% of allocation in Large Caps / Larger Mid-Caps – as part of our strategy we have had an option to invest up to 25% of our corpus in large caps / larger mid-caps but we never did that as their valuations were always high. The current drawdown in the large caps / larger mid-caps have brought these expensive valuations to mouth-watering levels making us activate this option to take advantage of the situation

- Stay put – most importantly stay calm and stay invested rather than panic looking at the stock prices on a daily basis. As they say – "*This too shall pass*"

Please feel free to revert in case you need any further information on any of our portfolio companies or would like to understand them in more details. You can write to us at pawan.b@equitreecapital.com / skabra@equitreecapital.com

Please take care, stay at home and stay safe.

Warm regards.

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