2Point2 Capital Investor Update Q3 FY24

Dear Investors,

This is the thirtieth quarterly letter to our Investors. Our letters to you will provide an update on our investment performance and present our views on relevant topics.

PERFORMANCE

2Point2 Long Term Value Fund

The 2Point2 Long Term Value Fund (launched in July 2016) is our only strategy under the PMS license granted to us by SEBI. This strategy focuses on generating long term returns by holding a concentrated portfolio of investments (15-18 stocks).

Returns Summary

	2Point2	BSE 500 TRI#	Out-performance
FY17*	26.8%	12.2%	+14.6%
FY18	16.6%	13.2%	+3.4%
FY19	14.4%	9.7%	+4.7%
FY20	-24.6%	-26.5%	+1.9%
FY21	73.9%	78.6%	-4.7%
FY22	17.8%	22.3%	-4.5%
FY23	10.0%	-0.9%	+10.9%
YTD FY24	52.5%	34.1%	+18.4%
CAGR Return	**21.9%**	**15.7%**	**6.2%**
Cumulative Return*	**338.5%**	**197.5%**	**141.0%**

**FY17 returns are for an 8-month period. Cumulative returns are from 20th July 2016 to 31st December 2023. As mandated by SEBI, returns are calculated on a time-weighted basis (TWRR) on aggregate portfolio. Returns are net of expenses and fees. Performance related information provided here is not verified by SEBI.*
#TRI is Total Return Index – includes returns from dividends received

"Link to performance relative to other portfolio managers" - https://tinyurl.com/549h8kb6

Note: Returns of individual clients will differ from the above numbers based on the timing of their investments. The above returns are on the consolidated pool of capital.

COMMENTARY

Our portfolio returned 10.1% in Q3 FY24. The BSE 500, Nifty 50 and Nifty Midcap 100 index generated returns of 12.4%, 10.9% and 14.1% in this period. As of 31st December, we had a 90.8% exposure to equities in the PMS on a consolidated basis (new portfolios would have lower exposure), with the rest

lying in interest earning assets. Our portfolio companies reported a median YoY profit growth of 13% in Q2 FY24.

THE FOLLY OF SELLING ON BAD NEWS

How should value investors react to an adverse event/news in a portfolio company? While it clearly depends on the exact nature of the event/news, in most cases, a long-term investor should avoid reacting impulsively.

Let us discuss the main reasons why selling based on an adverse event is often not a prudent idea:

Resilience is Under-rated: As value investors, among others, our goal is to find companies that are market leaders, have superior profitability, and have competitive moats. Typically, these companies have a track record of navigating challenges across economic cycles. The ability of such a good business to navigate an adverse event is often under-rated. While investors often contemplate worst-case scenarios, what appears as a severe setback may, in reality, only slightly dent a company's prospects. For instance, COVID was a black swan event that seemed like a death knell for certain sectors. However, the reality (with the benefit of hindsight) turned out to be quite different. Let us take an extreme example. An existing investor in an MFI (one of the worst affected sectors) company was overwhelmed with the following factors in April 2020 –

- There is an indefinite lockdown and a loan moratorium that prevents MFI companies from collecting dues from their borrowers as majority collections are in cash. Every day of delay in collecting dues makes it even more difficult to recover the dues subsequently.
- The livelihood of their borrowers is hurt, and their ability to recover even after the extended lockdown is uncertain.
- All sources of liabilities for an MFI company have dried up leading to significant asset-liability mismatch which could result in a debt default.

Based on the above, it may seem like a no-brainer idea for the investor to exit the company at even a 30% loss. However, the good companies in the sector were resilient enough to recover from the event despite some short-term pain. Most of the well managed MFI companies are currently trading well above pre-covid stock prices. In hindsight, peak COVID was probably the best time to invest in some of these MFI companies. Selling then would have been a costly mistake (unless the sale proceeds were deployed elsewhere in equally attractive opportunities).

The impact on the intrinsic value of the company may not be much: Even if the event is adverse enough to result in few years of complete washout in earnings, its impact on the DCF value of a company may not be even 10%. As value investors focused on intrinsic value rather than stock price, our goal should be to use such event driven volatility to buy companies rather than sell them.

It is already priced in: Markets often react strongly to every bit of positive or negative news. Even if there was some merit in selling the stock due to an event, it is likely that the adverse news is already priced in. Unless the event compromises the long-term investment thesis itself, we are better off not selling at an already depressed price.

The impact cost of getting in and out may be very high: Investors may want to avoid the uncertainty associated with an adverse event by exiting the stock and reinvesting when there is more clarity on the exact impact due to the event. The impact cost of buying and selling (especially for institutional investors), the taxes associated and the transactions costs involved may make it practically difficult to implement this strategy.

Potential reversal of Extreme Events: Often certain events are so extreme that their impact on the business is very large. However, such events are often reversed over time. For instance, bans on certain products or activities might be lifted or decisions undone, leading to recovery in the affected business. In May 2015, food inspectors in Uttar Pradesh banned Maggi Noodles, which contributed over 25 per cent of Nestle's Revenues in India, because it contained lead content that was beyond permissible levels. This was followed by other states also banning sales of Maggi Noodles. Subsequently, just 6 months later, the Bombay High Court lifted the nationwide ban in November. The stock fell more than 20% after the ban but completely recovered in the next 1 year. Similarly, in another incident, a BMC officer banned exhibitions at NESCO ground (~50% of revenues) in August 2018 due to the traffic snarls caused by these exhibitions. In less than a week, the decision was undone and the officer was reprimanded for her "highhandedness". We must price in the probability of the event itself being undone before we decide to sell based on the event.

Keeping the above reasons in mind, a long-term investor should be forgiving of the frequent ups and downs in a company's long-term journey. These are inevitable in the journey of every company. These events might feel catastrophic initially, but with the passage of time, we might not even be able to identify these events on the long-term chart of the company's stock price.

The intrinsic value of a company is, however, more sensitive to structural factors such as the long-term growth of a company, the riskiness of its cashflows (encapsulated in its cost of equity), the sustainable ROE of the company and the terminal growth rate. Typically, a single adverse event is unlikely to materially change any of these structural parameters. A series of similar repeat events, though, can signal a structural change in the assumed values of some of these parameters.

For instance:

1) A single failure in FDA audit may not mean much but repeated FDA issues signifies poor compliance (Ranbaxy)
2) A failed acquisition might not reflect poor capital allocation, but a repeated history of such actions, despite poor performance in core business, definitely does (a large retail company part of a conglomerate)
3) A single incidence of compliance or safety breach may not affect the investment thesis for a chemical company. However, repeated environmental and safety breaches year after year indicate a culture of poor compliance (as was the case in a popular small cap chemical company). This must be considered as a serious risk when staying invested in this company.
4) Isolated tax notices to the casino industry may not mean much, as such notices are commonly sent to various industries. But a sustained effort by government to curb gambling by imposing onerous taxes will result in a structural dent to the growth and profitability of the industry (Delta Corp).

Most single events do not impact the long-term franchise value of a company and should therefore not be acted upon. However, there may be some exceptions. An event that signals a serious governance issue is often unpardonable. A promoter who is capable of cheating minority shareholders once, maybe capable of cheating them over many times. Such instances may be sold into as although they may not result in a permanent collapse of the investment thesis, they indicate the Promoter's reluctance to share upside with the minority shareholders whenever there is any.

In our investment journey at 2Point2 Capital, there have been occasions where we made the mistake of selling on bad news. With the benefit of hindsight, it is clear that not taking any action would have been the better option in these instances. As time has passed, we've evolved into more patient investors becoming less prone to reacting hastily to adverse news that doesn't fundamentally impact the long-term investment thesis.

If you have any queries (about your portfolio, 2Point2 Capital or investing in general), do reach out to us at the below coordinates. We would love to talk.

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Thanks and Regards,
Savi Jain & Amit Mantri