2Point2 Capital Investor Update Q1 FY20

Dear Investors,

This is the twelfth 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 (maximum 15 stocks).

Returns Summary

	FY17*	FY18	FY19	Q1 FY20	CAGR	Cumulative Returns*	Out-performance
2Point2	26.8%	16.6%	14.4%	4.0%	**21.1%**	**75.9%**	
NIFTY 50#	8.3%	11.8%	16.4%	1.8%	**13.0%**	**43.4%**	+32.5%
MIDCAP 100#	22.2%	10.3%	-1.9%	-3.2%	**8.8%**	**28.1%**	+47.8%

**Cumulative returns are from 20th July 2016 to 30th June 2019. FY17 returns are for an 8-month period. As mandated by SEBI, Returns are calculated on a weighted average basis. Returns are net of expenses and fees.*
#Total Return Index includes returns from dividends received

As of 30th June 2019, 83.2% of the total capital was deployed in equities with the rest lying in interest earning assets. **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.

2Point2 Long Short Value Fund

The 2Point2 Long Short Value Fund (launched in August 2016) is our long/short equity strategy using **ONLY** proprietary capital. The "long" part of this strategy is similar to our 2Point2 Long Term Value Fund portfolio. In addition to the long portfolio, this strategy also uses futures to "short" stocks on which we have a fundamental negative view.

	CAGR*
2Point2 Long Short Value Fund	24.6%

**Period of 35 months beginning 4th August 2016 to 30th June 2019. Returns are calculated on a weighted average basis on only the invested corpus (gross long + gross short). Returns are net of all expenses.*

COMMENTARY

In Q1 FY20, the overall market saw a divergent performance with the Nifty 50 and Midcap 100 index reporting returns of +1.8% and -3.2**%** respectively. Our portfolio appreciated by +4.0% in the quarter. We now have an 83.2% exposure to equities in the PMS on a consolidated basis (new portfolios would have lower exposure).

The operating performance of our portfolio companies continues to be good. In Q4 FY19, the median YoY earnings growth of our portfolio was 21%. Overall portfolio valuations continue to be attractive (median TTM P/E of ~19x) and we expect strong earnings growth to drive stock price performance.

Over the last 18 months, some of the biggest wealth destroyers in the Indian equity markets have been companies with serious corporate governance issues. Instances of cooking of books, auditor resignations, GST fraud, siphoning of sale proceeds and unexplained large write-offs have come to the limelight and led to stock prices falling by more than 90% in many cases.

We are starting a new section ("Avoiding Landmines") where we highlight (1) tricks that companies use to commit fraud and (2) methods to identify corporate governance issues. In the first post, we discuss a 40-year old technique that is very commonly used by Indian companies to con minority shareholders.

AVOIDING LANDMINES: THE PANAMA PUMP

In 1969, Eddie Antar opened a consumer electronics store in New York. Eddie's stores (later renamed as Crazy Eddie) became popular for selling electronics at deep discounts to their competitors.

During this time, consumer electronics retailers were subject to "fair trade" laws. These laws forced retailers to sell at the price dictated by the manufacturers. Discounting by individual retailers was not allowed. Crazy Eddie violated fair trade laws by selling products at a discount and attracted the ire of manufacturers who subsequently stopped supplying to them directly. Crazy Eddie continued to operate by buying products from other retailers and from the grey market. Eventually, fair trade laws were outlawed, and manufacturers could no longer force retailers to sell at the same price. Eddie Antar became a hero for his role in standing up to big manufacturers and abolishing fair trade[1].

Crazy Eddie's business continued to grow rapidly as consumers found great deals on electronics products in their stores. The company launched an ad blitz which is still well remembered for its loud tagline – "Crazy Eddie, his prices are IN-S-A-A-N-E". For a while, Crazy Eddie had a higher brand recall than even Coca Cola in New York!

[1] https://whitecollarfraud.com/crazy-eddie/. This website maintained by Sam Antar (Eddie Antar's cousin, CFO of Crazy Eddie and one of the masterminds of the fraud) is our main source of information on Crazy Eddie. Sam had confessed to his role in the fraud and turned a government witness in exchange for leniency. Today, Sam works as a forensic accountant and advises law enforcement agencies about white-collar crime.

While consumers loved Crazy Eddie, they didn't know the source of its deep discounts. Crazy Eddie's competitive advantage was **Fraud**. Right from its inception, Crazy Eddie was indulging in multiple fraudulent tactics which allowed it to sell products at deep discounts and yet make a profit for its owners. Some of these tactics were:

- Revenue skimming – Crazy Eddie was under-reporting its sales which allowed it to save on both sales tax and corporate tax.
- Cash compensation – A large part of employee compensation was paid in cash (generated from skimming). Cash compensation which was unreported to the authorities reduced the tax liability of employees. Employees were willing to accept lower wages in cash as their overall post-tax income was higher.
- Mis-selling – Crazy Eddie had aggressive sales culture and salespeople were expected to keep closing at any cost. It was common for customers to be sold even defective/repackaged returned products.

Eddie Antar deposited the ill-gotten gains from these tactics into Israeli bank accounts. The scale of Crazy Eddie's fraud was still quite small and primarily limited to tax evasion. Like any ambitious fraudster, Eddie Antar was not satisfied and decided to "make it large" by going public with an IPO. Over the 1980-84 period, Crazy Eddie gradually reduced the skimming to show high revenue and profit growth. The IPO was a huge success as investors and analysts lapped up a widely loved electronics retailer that was also showing extraordinarily high revenue/profit growth.

Crazy Eddie didn't stop there.

Over the next few years, Crazy Eddie begun inflating its sales by bringing back the laundered money stored in Israeli accounts. The money came back into the company as fake revenues through bank accounts in Panama. This was the Panama Pump. Even when actual sales were weak, the company kept reporting high same store sales growth. Inflating earnings and selling stock at a high price was believed to be a more profitable strategy than mere tax evasion. Crazy Eddie's fiction was aided by the incompetence of the auditors who kept on signing off the financial statements despite several red

flags. The Panama Pump worked very well. In two years, Crazy Eddie's stock went up 10x to 80 $ from the IPO price of 8 $. The Antar family sold as much as 90 million $ of stock in this period.

In late 1986, Crazy Eddie's stock tanked as earnings began to disappoint. The fraud had become unsustainable. A turnaround specialist soon acquired the company in a hostile takeover (he thought Crazy Eddie was undervalued!). Within a few weeks of the takeover, the new owners uncovered the entire scale of the fraud. Crazy Eddie filed for bankruptcy in 1989. Eddie Antar was eventually arrested and received 8 years imprisonment.

Why this long history of Crazy Eddie and the Panama Pump?

A large number of Indian companies resemble Crazy Eddie and routinely employ the Panama Pump to defraud shareholders. Many of these companies have no competitive advantage and generate profits for the owners primarily through tax evasion and other financial shenanigans. For long periods, these companies do not show any meaningful profits. However, in bull markets, these companies suddenly start reporting an improvement in operating performance. Growth comes back and margins expand. What earlier seemed like a dead business suddenly finds its mojo.

The turnaround in financial fortunes is typically accompanied by a clever narrative explaining the change in fortunes. Sell-side analysts come up with detailed initiating coverage reports with high target prices. In bull markets, these narratives and target prices are easily bought by investors hunting for the next multi-bagger. Frauds thrive in an environment where there is a willing suspension of disbelief. Once the pump is complete, margins revert back to normal levels or even lower depending upon the level of "skimming".

The Panama Pump is often seen in play in companies going public. Companies start growing rapidly along with profit margin expansion just a few quarters before the IPO. The IPOs tend to be heavily subscribed. A few quarters down the line the same companies start struggling and come up with new excuses to explain their inability to sustain their stellar pre-IPO performance. Many of the value-destructive IPOs of the last few years have followed a similar script.

Let's look at one Indian Panama Pump case study (Note: Financials have been changed intentionally to prevent stock identification) –

	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Revenue	436	670	1,161	1,270	2,012	2,438	2,847	3,376	3,403	3,081
Expenses	527	692	1,092	1,233	1,894	2,184	2,491	2,709	2,886	2,821
EBITDA	-90	-22	68	37	118	254	357	667	518	260
EBITDA Margin	-21%	-3%	6%	3%	6%	10%	13%	20%	15%	8%

The above company which operates in an unattractive industry has been listed for several years in the public markets. Till FY13, its operating performance had been sub-par with single digit EBITDA margins and low ROEs. However, when the bull market started roaring in FY14, the company saw a big jump in its profitability. EBITDA margins expanded from 6% in FY13 to 20% in FY16. When asked whether these margins were sustainable, management gave guidance that 20% margins were the "new normal" and could possibly increase further.

As investors bought into the turnaround narrative of the company, the stock price jumped by 20x in 18 months. However, the euphoria was short-lived. As the bull market in mid/small caps stared fizzling out, so did the company's operating performance. By FY18, EBITDA margins were back to single digits. In FY19, earnings fell another 50%. The stock has lost more than 85% of its value in the last 2 years.

We believe that the Panama Pump is used in India by big and small companies alike. It is often driven by the need to show good numbers ahead of events such as a fundraise (QIP), strategic sale, impending secondary sale by promoters, avoiding margin calls on pledged shares etc. What often starts as a temporary quick-fix, often ends up becoming a habit.

Investors should be careful when investing in companies with a poor historical track record which suddenly start reporting good numbers. While occasionally there may be genuine reasons of a turnaround in a company's fortunes (e.g. Graphite stocks), very often it's just another Crazy Eddie.

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,
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