2POINT2
CAPITAL

2Point2 Capital Investor Update Q2 FY21

Dear Investors,

This is the seventeenth 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	FY20	H1 FY21	CAGR	Cumulative Returns*	Out-performance
2Point2	26.8%	16.6%	14.4%	-24.6%	42.1%	**15.2%**	81.2%	
NIFTY 50	8.3%	11.8%	16.4%	-25.0%	31.5%	**8.1%**	38.9%	+42.3%
MIDCAP 100	22.2%	10.3%	-1.9%	-35.1%	45.7%	**5.5%**	25.1%	+56.1%

**FY17 returns are for an 8-month period. Cumulative returns are from 20th July 2016 to 30th September 2020. 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.*

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 12.3% in Q2 FY21. The Nifty 50 and Midcap 100 index generated returns of 9.6% and 15.9% in this period. We now have an 85.3% exposure to equities in the PMS on a consolidated basis (new portfolios would have lower exposure) with the rest lying in interest earning assets. Equity allocation has decreased as we trimmed few of our existing positions.

The operating performance of our portfolio companies in Q1 FY21 was weak but better than expectation with a median PBT decline of 11%. Despite the lockdown impacting sales, companies were able to limit the profitability hit through aggressive cost cutting. Given the external environment, we expect the weak operating performance to continue over the next few quarters. We will continue to evaluate the medium to long-term impact of the Covid-19 pandemic on our investments and take suitable actions when required.

OUR WORST INVESTMENTS (SO FAR)

2Point2 Long Term Value Fund completed 4 years this quarter. The fund performance in this period has been reasonably good considering the tough market conditions (particularly for small and midcap stocks). While we have made many successful investments, the overall portfolio performance was dragged down by some laggards. Since inception, we have made 31 investments (25 core investments and 6 special situation positions) out of which 5 investments had losses of more than 15%. We discuss below these 5 investments – ***the investment thesis, what went wrong and learnings if any***.

Interglobe Aviation

We invested in Interglobe Aviation ("Indigo") after the collapse of Jet Airways. While we had a general negative view on airline businesses, we believed Indigo would be an exception. Indigo was a dominant player in Indian domestic aviation with near-50% market share and with a lower cost structure than any of the other competitors. In addition, most other competitors had weak balance sheets resulting in subdued competitive intensity over the medium to long term. Our view was that domestic air travel was a long-term structural growth story as Indians start making the shift from rail to air. Our expectation was that Indigo would be the biggest beneficiary of the growth in the Indian passenger air traffic. We expected Indigo to be among the few airlines globally that create value for shareholders over the long term.

The exit of Jet resulted in a brief period of windfall profits for the company due to a supply demand mismatch. Soon thereafter, Indigo's operating performance deteriorated. A company which was known for operational excellence seemed to now be struggling with excess manpower which impacted productivity and hurt margins. Indigo also reported accounting surprises which suggested that its sustainable maintenance costs were far higher than our estimates. Competitive intensity which was expected to be benign also soon increased as passenger traffic growth was subdued. Despite all the negative incremental data, we believed that the long-term investment thesis in Indigo was still broadly intact.

Then Covid struck. Aviation has been one of the most affected industries. It is also likely to be among the last to recover with a complete recovery probably taking a couple of years. High fixed costs also limit the ability of airline businesses to cut costs. In Q1 FY21, Indigo reported a 2849 cr loss – its worst ever quarter. It is likely that without government support, Indigo's FY21 losses will completely erode its networth. Indigo may be the last man standing due to its strong balance sheet but will be badly bruised by this crisis.

Sometimes external events like Covid-19 can overwhelm your investment thesis. However, our inability to anticipate the higher maintenance costs and Indigo's other pre-Covid problems also reflect a lesser than ideal understanding of a complicated business model. We seemed to have strayed beyond our circle of competence here.

Saregama India

We invested in Saregama India in 2018. At that time, Saregama had begun to make waves with the launch of its Carvaan product, a portable pre-loaded music player with retro looks. Carvaan at its peak accounted for more than 50% of Saregama's sales and was selling more than 250,000 units a quarter.

Our investment thesis however did not ascribe much value to Carvaan. Our view was that Carvaan may be a fad and not yield sustainable revenues/profits. Our investment thesis was entirely based on the vast music IP that Saregama owned. We believed that the rise of OTT music streaming apps like Amazon Music, Saavn, Gaana, Youtube, etc would result in a significant increase in legal music consumption in India. Saregama which owns the rights in perpetuity to most of the old Hindi songs would now be able to monetize its IP which in the earlier era of pirated music consumption had little value. This was already visible in the rising share of digital licensing revenue for Saregama. Globally, Universal Music (world's largest music company) had seen a 6x increase in valuation over a 5-year period largely due to the tailwinds provided by rapidly growing streaming apps like Spotify. While we were not enthused by the track record of the Sanjiv Goenka (SG) group in other group companies, we were impressed by the complete professionalization of Saregama management led by Vikram Mehra, erstwhile CXO of Tata Sky.

Post our investment, both Carvaan and the Music Licensing business showed good growth for a few quarters. However, Carvaan soon started to stagnate despite new product launches and increase in marketing spends. We had anticipated this, and our channel checks already showed that retailers like Croma were selling far fewer Carvaan units than before. This did not worry us much because we believed that Saregama would still be able to run Carvaan profitably at a smaller scale. However, the Management / Promoters seemed to view the slowdown as a minor blip. Instead of cutting costs, Saregama ramped up its sales and marketing spends even resorting to expensive media such as TV (Carvaan's initial success was largely driven by word of mouth virality). Carvaan from being a profitable business was now expected to lose money if sales did not pick up. This concerned us. Saregama already had another print publishing segment which had been losing large amounts of money for years. It seemed that Carvaan was set to suffer the same fate. Such poor capital allocation did not seem entirely implausible given the SG Group's track record of aggressive capital allocation in other businesses.

The increasing likelihood that the good cash flows from the Music Licensing business would be used to subsidize other bad segments forced us to rethink our investment. We decided to exit at a loss (stock had tanked as the Carvaan problems impacted overall financials).

What has happened since our exit has been even more painful. As per our expectations, Carvaan sales continued to decline despite aggressive marketing. However, the Licensing business did exceedingly well with 22% YoY revenue growth in FY20 with expanding margins and new tie-ups with Spotify, FB and Instagram. The good financial performance of the Licensing business was able to offset the weakness in Carvaan. The stock is more than 50% higher than our exit price.

The key learning from this investment was that it is important to also consider the Promoter's track record of capital allocation in other group companies to take an informed decision. And that if you do invest despite these concerns, you must be patient and give time for the core investment thesis to play out.

CARE Ratings

CARE has been one of our most painful and controversial investments (among our investors). We have always liked credit rating businesses as they are oligopolistic (3 players account for substantial majority of the market share), have strong entry barriers and excellent financial characteristics. At the time of our initial investment, ratings growth was negatively impacted by slowdown in private capex (which in turn impacts industrial credit demand). The investment in CARE was predicated on the thesis that over our investment horizon, when private capex picks up in the country, CARE will be a beneficiary. An increase in private capex results in increased issuances of bank loans and corporate debt ratings. Because, credit rating business is a high operating leverage business, any pickup in revenues results in a disproportionate increase in profitability (as fixed costs make up for majority of costs). The choice of CARE vs CRISIL/ICRA was driven by valuations. As CRISIL/ICRA traded at more than twice the valuation multiples of CARE, we believed only CARE offered good absolute risk-reward.

Our macro thesis of eventual private capex pickup hasn't materialized and industrial credit growth has been subdued over the last few years. This has negatively impacted all credit ratings businesses. CARE's role in the rating of IL&FS group, Reliance-ADAG group and some other defaulters has also raised concerns on the quality of its rating process. These issues have led to SEBI levying fines on CARE and a change in management.

While we were aware of the inferior quality perception of CARE, we had failed to anticipate the extent to which CARE's business was dependent on rating weaker corporates. We had drawn comfort from CRISIL's large stake purchase in CARE at a price of Rs 1660 (vs CMP of ~360). Weak external environment coupled with internal issues have led to a significant decline in revenues over the last 3 years. The operating leverage that we believed would benefit CARE has instead led to a steeper decline in profitability.

Despite the challenges and large loss, we haven't sold any of our CARE investment over the last 4 years. The reluctance to sell has been primarily due to our view that despite the challenges, CARE's intrinsic value is much higher. We will only find out a fewer years later if this was sound long-term thinking or foolish thumb-sucking.

DCB Bank

DCB is our oldest PMS investment. Till 2009, DCB was a struggling private bank with asset quality issues and poor underwriting culture. Mr. Murali Natarajan then became the CEO of DCB and revamped its business model with a focus on small ticket secured loans to the self-employed segment. Under the new management, DCB showed an improvement on all operating parameters. In 2015, DCB announced an ambitious plan to double its branch network in two years. This was viewed negatively by the investing community due to the negative impact on return metrics as the cost-to-income ratio would rise in the investment phase. Our investment thesis was based on a positive view of the management team, its risk-averse underwriting culture and cheap valuation. We also considered the large branch expansion as a good long-term business decision even if it hurt in the short term.

Post our initial investment, DCB continued to execute well with asset quality being maintained despite the challenges posed by demonetization/GST implementation to its core SME/MSME customer base. However, growth began to slow down in FY20 as the economy weakened. The management had chosen to focus on asset quality rather than growth in a tough economic environment. Low growth meant that the return ratios of DCB did not show the improvement that was expected.

The Covid-19 lockdowns have further raised concerns on DCB's future asset quality as its customer base is expected to be stressed. Growth revival is also unlikely to happen in the short term. These issues have led to a significant compression in DCB's P/B multiple from 1.9x to 0.8x. While we believe that DCB's asset quality should be less impacted due to a largely secured loan book, the actual impact will only be known over the next few quarters.

DCB has been one of our worst investments as it was one of our highest allocations in the portfolio. Next time, we will probably be more conservative in making a large bet on a turnaround opportunity like DCB.

Ujjivan Financial Services

In the financial services space, microfinance has been an area of interest for us. We have had three highly profitable investments in this space and Ujjivan has been our only loss-making MFI investment.

We liked Ujjivan because we believed it had a competent management team with a long successful track record, a geographically diversified loan book which reduces risk of an AP-like blow up and an SFB-license which would lead to lower cost of funds. At the time of our investment, Ujjivan was in the transition phase from an MFI to an SFB. This had impacted its cost-to-income ratios as the SFB setup required significant upfront investments. Ujjivan was also then dealing with the fallout from demonetization which had hurt asset quality and loan growth for most MFIs. We considered these to be temporary problems. We believed that as growth and asset quality normalized and cost of funds declined, Ujjivan's ROEs would structurally increase to 18%+.

Ujjivan's FY18 was impacted by the SFB transition and demonetization-related credit costs. FY19 and FY20 showed a strong recovery. As expected, profitability was showing consistent improvement. However, the stock price got hit due to the market suddenly ascribing a large Holdco discount (50-60%) to the holding company. For multiple reasons, we believed that Ujjivan should not trade at a large discount as it is materially different from other Indian Holdcos (we still maintain this view). The market thought otherwise. Despite the business doing well, our investment struggled.

In March 2020, even the business took a hit due to the stringent national lockdown announced to deal with Covid-19. Microfinance is expected to be one of the worst impacted lending segments due to its unsecured nature. Ujjivan is expected to be particularly worse off due to its high urban exposure. Urban areas have been more impacted by Covid-19 and have required longer lockdowns. It is likely that high credit costs coupled with weak core profitability will lead to networth erosion for Ujjivan. All these concerns have led to a 40% fall in the stock price in 2020.

Our key learning from the Ujjivan investment was that idiosyncratic issues (like Holdco discount) can matter a lot in the short-term. Also several uncorrelated events that may each have a low likelihood (demonetisation, pandemic, natural disasters, political interference) do not remain as rare in occurrence when the probabilities are added up. The valuations of businesses such as microfinance that are susceptible to such externalities should therefore be accordingly adjusted.

Investment losses happen for various reasons. Sometimes it is due to flawed assumptions and analytical blindspots. Sometimes it is due to external events which can only be weighed on a probabilistic basis at the time of the investment. Dispassionately studying why an investment didn't work out can be a great source of learning and can help prevent repeat mistakes. It is certain that many more of our investment bets will go bad in the future. As long as these are few in number and are adequately compensated by the good investments, our portfolio should do fine.

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.

Savi Jain	savi@2point2capital.com
Amit Mantri	amit@2point2capital.com

Thanks and Regards,
Savi Jain & Amit Mantri