Compound Everyday Capital
Partners first

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Letter to partners CE8-Sep16 | Review of HY 2016-17

EXECUTIVE SUMMARY

- Our share in the earnings of underlying companies grew 6.5%, and our share in their net assets grew 4.5%
- Our NAV rose by 35.8%. NSE Nifty rose by 12.0%. Since inception our CAGR is 36.4%, Nifty's is 13.6%.
- The fundamentals of our businesses are playing out as per our thesis.
- We made a mistake of investing a 2% position in Treehouse Education Ltd.
- We continue to adhere to our strict investment standards even in supposedly low interest rates regime worldover.

Dear Partners,

Warm Greetings!

Through this partnership, you partly own *earnings* and *net assets* (assets less liabilities) of underlying businesses. Our focus, in long run, is to keep increasing "our share of earnings and net assets as % of our cost". Our focus on these metrics warrants a small illustration:

If we buy one share of Bajaj Auto for INR 3000 today, we will become owner of earnings of INR130– earnings attributable to one share of Bajaj Auto. We can say that for every INR 100 we spent on Bajaj Auto we own earnings worth INR 4.3 (4.3% when expressed in % terms). Next year if donot buy anything, earnings of Bajaj Auto would have grown to something more, say INR 150 (or 5% of our cost of INR 3000). Reducing to % helps in tracking the growth in earnings accruing to us on cost we paid to buy for all our businesses. Same applies to our share in net assets. The second and fourth column of the table below tracks precisely these two important metrics. Over to this period's performance:

A. PERFORMANCE

A1. Fundamental Performance of our underlying businesses

	Business Metrics of Our Portfolio				Stock Metrics of Our Portfolio			
Period Ended	" Earnings" / "Our Cost of investment"	Underlying Profit Growth	"Net Assets"/ "Our Cost of investment"	Trailing Return on Equity	Dividend Yield	Trailing P/E	Portfolio Turnover	Cash as % of portfolio
Favourable If...	↑	+VE	↑	↑	↑	↓	↓	-
Sep 30, 2016	**9.8%**	**6.5%**	**0.64x**	**20.5%**	**0.6%**	**20.6x**	**0.0%**	**5%**
Mar 31, 2016	9.2%	-22.7%	0.61x	18.5%	1.1%	16.3x	3.1%	7%
Mar 31, 2015	11.9%	0.0%	0.67x	21.9%	1.1%	18.7x	0.0%	0%
Mar 31, 2014	11.9%	18.0%	0.58x	29.0%	2.9%	12.2x	6.7%	0%
Mar 31, 2013	6.8%	20.0%	0.33x	31.6%	2.4%	14.0x	8.0%	0%

For the half year ended September 30, 2016:

- Our share of **earnings** in underlying businesses grew by 6.5%.
- Our share in their **net assets** grew by 4.5%.
- With share price growth, the P/E multiple increased from 16.3x to 20.6x.
- We have 5% of our portfolio in cash equivalents. We donot own any put options.

A2. NAV Performance

Period Ended	Compound Everyday			Nifty		Outperformance	
	NAV	Firm's Return	Return to Partners	Nifty	Return#	Firm	Partners
Sep 30, 2016	**359.3**	**35.8%**	**21.5%**	**8611**	**12.0%**	**23.8%**	**9.5%**
Mar 31, 2016 (A)	264.5	-7.6%	**-4.6%**	7738	-7.4%	-0.2%	**2.8%**
Mar 31, 2015 (A)	286.3	84.1%	**50.5%**	8492	28.0%	56.2%	**22.5%**
Mar 31, 2014 (A)	155.5	62.2%	**37.3%**	6704	19.4%	42.8%	**18.0%**
Mar 31, 2013 (A)	95.9	-4.1%	**4.9%**	5682	6.8%	-10.9%	**-1.9%**
Aug 18, 2012*	100			5366			
Cumulative		259.3%	**151.4%**		69.2%	190.1%	**82.1%**
Annualised		36.4%	**25.1%**		13.6%	22.8%	**11.4%**

*A = Audited; * Date of incorporation; # Total return including dividends*

For the half year ended September 30, 2016:

- Firm's **NAV** grew by 35.8%. The partners gained 21.5% on average this half year and 25.1% annually since our inception.
- NSE Nifty rose 12.0% with dividends reinvested. Partners' returns could outperform the Nifty by 9.5% this half year and by 11.4% p.a. since our inception.

Process Vs Outcome

Short term market outcomes may sometimes be positive despite wrong process. What is expensive may get more expensive and lead to a short term positive outcome to buyer – a *false positive*.

Conversely, short term market outcomes may sometimes be negative despite right process. What is cheap may get cheaper and lead to a short term negative outcome to buyer – a *false negative*.

No useful conclusions can be drawn if the current returns are high despite wrong process, or if current returns are low despite right process, both a possibility in equity markets. Investors focussing on immediate returns without understanding the underlying process may *cheer wrong wins* and *boo wrong losses*.

Our process is simple. We buy below intrinsic value and sell above intrinsic value. Since intrinsic values are difficult to assess, we focus on simple yet sustainable businesses, run by honest and able management and available at bargain prices. Often such businesses are not cheap. We wait for market/business dislocations or institutional compulsions/fear/ disinterest for right price. Even if rightly executed, this process will see short term wrong outcomes. However in long run, it is our firm belief, it will lead to right outcomes.

Post last year's 7.6% NAV fall – a false negative - we were happy to see our thesis playing out in the fundamental performance of our companies. Our value approach made us do the right thing to buy when mood was gloomy in Aug and Feb of the last financial year. Few partners, likewise, did the right thing by investing during those dark hours. *It pays to be greedy when others are fearful!*

We welcome one new partner who joined us during the half year. He along with existing partners introduced new capital of INR 27 lacs (INR 2.7 mn). Your managing partner and his family continues to hold most of their net worth in the firm. They have not withdrawn any money since 2012, the year we started this firm.

Your interim capital accounts are annexed to this letter. Our *Owners' Manual* – the charter that governs our firm's operating, investing and reporting philosophy – is also annexed to this letter.

B. DETAILS ON PERFORMANCE

B1. MISTAKES & LEARNINGS

When something is dirt cheap, it may well be ***dirt****.*

We made a mistake by investing in **Treehouse Education Ltd.**, a national play school chain. It was a 2% position (cost basis).

Treehouse represents a poorly managed good business. Economics of a play school are attractive. Unlike K-12 (kindergarten to twelfth) schools, play schools can run with *profit motive*. Parents' willingness to invest in their kids makes this a ***recession free*** business. With all fees received upfront the working capital requirement is negative. A play school can run in residential premises that can be rented cheaply. Montessori trained teachers are paid reasonable salaries. As a result *the costs are fixed but low*.

The bad part: Promoters' stake in Treehouse is just 20% and all pledged. Financial statements scrutiny hints of dishonesty. Receivables were high and were a cause of concern that led to 60% price fall from INR 500 to INR 200. At that moment, *Zee Learn* (another education company promoted by the Zee group) announced its intention to buy the company in an all stock deal. Treehouse also announced that they have recovered all the pending receivables.

The last two events caught our attention. At that point we felt it was a good business seeing management change and depressed prices. We thought the bad news was priced in and bought a supervisory 2% position at INR 178. The swap ratio announced post that (5 shares of Zee Learn for 1 share of Treehouse) was below expectations. Moreover, next quarter results were a shocker: despite management's assurance, receivables continued to grow and company wrote them off reporting a loss. Zee Learn revised downward the merger ratio (to 1 share of Zee learn for 1 share of Treehouse, an 80% reduction). Price fell from INR 178 to INR 30 currently, an 83% fall from our purchase price of 178 and over 94% from its all time high of 506.

The crux of our thesis was a good business seeing management change and low prices. We bought only after the Zee offer. The good thing we did was that we limited our exposure to a supervisory 2% of our portfolio (smallest position), with an intent to watch and increase it if things turned out well. Unfortunately, Zee Learn revised the offer materially downwards (it is another matter why would they quote a 5x higher offer earlier) and we stopped at that position. We have not sold it yet.

From our **past mistakes** (Cera, and 2015-16), we have learnt that unless fundamentals are extremely compelling, it is wiser to be slow and gradual, both in selling and buying. From Treehouse mistake our learning is: **Bad management deserves bad prices. It's not value, it's a value trap.**

To end this section on not so morbid note: it is comforting to be in a business where some mistakes can be made and yet a satisfactory performance can be achieved. Nonetheless, rest assured, we take our mistakes personally. Over to some good news:

C. OTHER THOUGHTS

Interest Rate Dilemma

We remain aware of low interest rates world over owing to unabashed money printing by central banks post the 2008 crisis – so far unsuccessful in its goal of inducing economic growth. This has resulted into problem of a scale never dealt before - over one third of global government bonds are currently yielding below zero percent interest.

This has led the global money to fly into risky assets including equities in search of returns, in turn raising prices. The logic given is: discounted at zero interest rates, intrinsic value of any company will be infinite (sum of all cash flows till infinite time) and hence high share prices are justified.

Indian small and midcaps shares, in aggregate, usually trade at a discount to large caps (on valuation basis). However, partly due to the global money deluge, they are currently trading at a *historically* highest premium. We, however, **donot intend to lower our standards** and take risks which we were not willing to just because of low global interest rates.

A good fall out of global low interest rates is that India has a HUGE opportunity to invest in its deficient **infrastructure** at very low cost of funds. Japanese companies have already shown interest in some projects at supposedly very low IRRs (interest rates are negative in Japan). This can have a multiplier effect on Indian economy.

When to withdraw

We congratulate partners who have successfully completed or will shortly complete 3 years with our firm and thank them for trusting a beginner firm like ours. One of the questions they will face soon is should they withdraw the money.

Those with immediate liquidity needs should not think twice about withdrawal. However those thinking of withdrawing now to reinvest later at (supposedly) lower prices should consider a trivia: NSE Nifty index has grown 8.7x in last 20 years. Of roughly 5000 days on which it traded, if we missed the 200 best days (4% of total days), we would have given away **all** the gain! Large gains can be attributed to few days (in fact few minutes when markets open) and missing them can reduce returns materially. It is impossible to time markets consistently. Unless there is an immediate liquidity need, it pays to remain invested. Your managing partners have long back completed three years, and they are happy to remain fully invested.

Investing in IPOs

Many partners whom I had opportunity to talk to seem to have this question in mind: Should they apply in IPOs? Normally, we donot subscribe to IPOs.

Till early 1990s, IPO prices were regulated and mostly set at bargain. They were rightly termed *"lotteries"*. Not any longer. Today IPO prices are market determined. In a free trade, either the buyer or the seller has to be wrong. In an IPO today, the seller (promoter or private equity investor) is well informed about the underlying business and won't do a wrong trade. He/she is assisted by investment banker(s) whose fees is linked to the deal size. There are, thus, high incentives that IPOs are priced to maximum. You would therefore see IPOs only in a rising market. This last point is of some importance now. If the markets continue to rise (I donot know if they will, but if...) you will see more issues, almost all fully or overpriced. What is

expensive may get more expensive in short run, but at a high chances of permanent loss of capital. *Caveat Emptor* (buyers beware).

We take your trust seriously and work hard to retain and grow it. Thank you for kindly recommending us in your circles. Your continued trust motivates us to work harder towards our common goal of risk adjusted wealth creation. Should you have any queries or feedback regarding above or otherwise, please feel free to share them with me.

Kind Regards

Sumit B. Sarda
Compound Everyday Capital

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