compound everyday

Compound Everyday Capital
Partners first

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Oct 01, 2018

Letter to partners CE12-Sep 18 | Review of HY 2018-19

EXECUTIVE SUMMARY

- Underlying twelve months earnings in the two funds grew by a healthy 22% and 20% respectively.
- NAV of the first fund, fell by 22%. NAV of the second fund, 30% in cash, fell by 14%. NSE Nifty rose by 8.7%.
- High volatility in last six months allowed us to deploy our rising cash in attractive opportunities.
- We have exited completely from Dish TV as rising digital competition makes assessing future cash flows difficult.
- We change our overall stance from defence to cautious offense.

Dear Partners,

The year when value looks foolish

Broader markets witnessed elevated levels of volatility in the last six months. We could find attractive investment opportunities and put our rising spare cash to good use. The NSE Nifty 50 and NSE 500 indices trade at a P/E of 26.4x and 30.2x respectively and their last twelve months earnings grew by 7% and 4% respectively (source: NSE). With earnings growth of ~22%, trailing normalised P/E multiple of 13.1x, and return on equity 15%+, our fund looks undervalued today.

Value strategy - buying assets for less than their worth- has underperformed globally in last few years. In India, off late, high domestic mutual fund flows have rewarded *momentum* investing- buying when prices are rising and vice versa – at the cost of value. This is a normal liquidity driven cycle that reverses over time. While we cannot pinpoint the exact time, all we can do is invest sensibly without assuming that rising prices will keep on rising and falling keep on falling. Interim pain and neighbour's envy may entice you to jump the value ship and the join the momentum bandwagon. We believe that will be a trap. The litmus test of our wellbeing will always be long term growth in earnings per unit and book value per unit and never annual NAV changes. As you will see below we are doing well on that count despite short term NAV volatility.

A. PERFORMANCE

A1. Fundamental Performance of our underlying businesses *(see annexure 1& 2, pg 09-12 for details)*

First Fund

	Business Metrics of Our Portfolio				Stock Metrics of Our Portfolio			
Period Ended	Earnings per Unit (EPU) #	Earnings Growth	Book Value per unit (BVPU) #	RoE#	Dividend Yield	Trailing P/E#	Portfolio Turnover	Cash as % of portfolio
Favourable If...	↑	+VE	↑	↑	↑	↓	↓	-
Sep 30, 2018	**22.5**	**22.3%***	**154.4**	**15.7%**	**0.8%**	**13.1x**	**10.2%**	**0%**
Mar 31, 2018	21.0	18.6%	150.7	14.8%	0.6%	18.0x	11.1%	9%
Mar 31, 2017	17.7	10.6%	132.1	14.2%	0.6%	22.0x	3.7%	8%
Mar 31, 2016	16.0	4.6%	117.0	15.6%	1.1%	16.5x	3.1%	7%
Mar 31, 2015	15.3	27.5%	88.4	20.4%	1.1%	18.7x	0.0%	0%
Mar 31, 2014	12.0	84.6%	58.8	26.7%	2.9%	13.0x	6.7%	0%
Mar 31, 2013	6.5	-	31.1	20.8%	2.4%	14.8x	8.0%	0%

** As compared to EPU of 18.4 on Sep 30, 2017 # Includes impact of cash equivalents*

Second Fund

Period Ended	Business Metrics of Our Portfolio				Stock Metrics of Our Portfolio			
	Earnings per Unit (EPU) #	Earnings Growth	Book Value per unit (BVPU) #	RoE#	Dividend Yield	Trailing P/E#	Portfolio Turnover	Cash as % of portfolio
Favourable If...	↑	+VE	↑	↑	↑	↓	↓	-
Sep 31, 2018	**5.8**	**20.8%***	**60.0**	**9.6%**	**0.5%**	**14.9x**	**4.2%**	**30%**
Mar 31, 2018	5.7	NA	68.7	8.4%	0.5%	17.7x	3.0%	43%

** As compared to EPU of 4.8 on Sep 30, 2017 ; # Includes impact of cash equivalents*

For the half year ended September 30, 2018:

- Our share of trailing 12-months earnings in underlying businesses, represented by **Earnings per Unit**, grew **22.3% and 20.8% in the two funds.** Nifty's earnings grew by 7.6% in the same period.
- With earnings growth and price correction, our **P/E multiple** reduced sharply from ~18.0x to 13.1x and 14.9x in the two funds. Nifty's P/E stands at 26.4x, just *double* of the first fund.
- **At ex-cash RoE of 15-16%, (Vs Nifty 50's 13.4%), our businesses are earnings more on equity despite being 50% cheaper than NSE Nifty 50.**
- We have **nil** and **30%** of the two funds in **cash equivalents**. At ~5% post tax return, our cash equivalents have a P/E of 20x and its effect is captured in EPU, BVPU and P/E values in the tables above. The cash levels have come down in six months as we deployed them in attractive opportunities.
    - Ex-cash the RoE of second fund is 15%. And second fund's ex-cash book value per share has grown 40%.

A2. NAV Performance

First Fund

Period Ended	Compound Everyday			Nifty		Outperformance	
	NAV	Firm's Return	Return to Partners	Nifty	Total Return#	Firm	Partners
Sep 30, 2018	**294.8**	**-22.2%**	**-13.3%**	**10930**	**8.7%**	**-30.9%**	**-22.0%**
Mar 31, 2018 (A)	378.8	-2.4%	**-1.4%**	10114	11.5%	-13.9%	-13.0%
Mar 31, 2017 (A)	387.9	46.7%	**28.0%**	9174	20.2%	26.5%	**7.8%**
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		194.8%	**126.3%**		120.0%	74.8%	**6.3%**
Annualised		19.3%	**14.3%**		13.8%	5.6%	**0.5%**

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

Second Fund

Period Ended	Compound Everyday			Nifty		Outperformance	
	NAV	Firm's Return	Return to Partners	Nifty	Total Return#	Firm	Partners
Sep 30, 2018	**86.6**	**-14.3%**	**-14.3%**	**10930**	**8.7%**	**-23.0%**	**-23.0%**
Mar 31, 2018	101.0	1.0%	0.9%	10114	8.5%	-7.5%	-7.6%
May 12, 2017*	100			9422			

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

For the half year ended Sep 30, 2018:

- NAV of the first fund, currently fully invested, fell by 22.2%. Since inception in 2012, the returns to partners have been higher than Nifty by 0.5% p.a.
- NAV of the second fund, 30% in cash, fell by 14.3%. After patiently waiting for over 12 months for paucity of opportunities, we have now started raising and deploying meaningful cash in this fund.

Opportunities amidst broader market selloff

Non fundamental events aggravated the panic in broader markets in last nine months. Since January 2018, NSE Nifty 50 grew by 4% where as mid and small caps represented by NSE Midcap 100 and NSE Small cap 100 fell by 19% and 32% respectively. The mid and small caps have had a dream run over large caps in last 5 years – compounding at around 20% (Nifty midcap 100 and small cap 100 full indices) annually till Dec 2017, higher than NSE Nifty's 12% p.a. And a correction was natural. Four non-fundamental reasons magnified the fall:

First, In October 2017, SEBI released a circular on re-categorisation and rationalisation of Mutual Funds Scheme. To oversimplify, it barred large and mid cap schemes from investing in small caps. By current SEBI definition small caps are over 60% of actively traded companies on the NSE. Mutual funds were compelled to sell these stocks amidst narrowing liquidity that amplified the fall.

Second, the SEBI came out with an ASM list (Additional Surveillance Measure) to curb volatility in prices of some small and mid cap stocks. Ironically, exactly the opposite happened. The measure *inter alia* required 100% margin for trading in these stocks. Significant liquidity dried post this announcement and further accentuated the fall. The ASM list is not a vote on fundamentals of the company. One of our stocks that was included in ASM offered us attractive opportunity to add.

Third, in April 2018, NSE announced changes to NSE Midcap 100 constituents whereby 46 of 100 stocks of the then mid cap index were excluded from index. This is significantly large number. Many mutual funds that mimic index, sold these excluded stocks causing corrections.

And lastly fourth, in late September as an overreaction to loan default event at an infrastructure NBFC (non banking finance company) , there was a scare in the entire NBFCs space including housing finance about asset liability mismatch (crudely, debt repayable being higher than collections on advances) and stocks fell over 40% in a day. In a second order effect, many mid caps became small cap necessitating sell offs from large cap and midcap mutual fund schemes (first reason above).

Value often emerges when everything gets painted by same fear brush. We eagerly became counterparty to this non-fundamental based selling. While such price corrections do cause temporary pain, they also give one of the best times for a discerning stock picker.

B. DETAILS ON PERFORMANCE

B1. MISTAKES & LEARNINGS

Making fewer mistakes is one of the important and underappreciated sources of investment returns. We try very hard to make fewer mistakes. Despite all the care, if we do make mistakes, you will find them discussed in detail here.

Few developments forced us to revisit our thesis on **Dish TV** and change our stance. The risks that we thought were possible emerged early and together. Their combined impact, we believe, will lead to higher capex and/ or lower ARPUs (per customer revenue crudely). Moreover, we found more lucrative alternative and hence decided to switch. This switching action has already added 1% to our NAV. You can learn more about it in the later section. We leave it you to decide if it's a mistake or investing as usual.

In last six years, we have had our fair share of mistakes and learnings. From our two past mistakes- **"Cera Sanitaryware"** and **"2015-16"** - we learnt that unless fundamentals are extremely compelling, it is better to be gradual in selling and buying respectively. From our past mistake on **"Treehouse Education"** we have learnt that bad management deserves a low price, it's seldom a bargain. Partners may refer to the details of past mistakes in respective letters.

C. OTHER THOUGHTS

Volatility and Bargains

The key to discovering bargains is an understanding of value/ worth of a business. Prices often over or undershoot conservatively assessed value for various reasons. Future uncertainty and over reaction to continuing developments is one of the sources of this volatility.

Indian is entering a busy election season amidst macros that are not as bright as last election. We recall what we said in Mar 2014 letter about the then upcoming Lok Sabha elections:

"Going by past elections, the few days before and after elections generally see a lot of market volatility. A rise will obviously be good for us; however a fall may not be bad either unless any partner wants to redeem owing to pressing needs of cash. Again going by past elections, either sudden rise or sudden fall will be temporary. We will be greedy when markets will be fearful and vice versa."

Since the launch of the BSE Sensex in 1986, India has witnessed eight Lok Sabha elections and four economic events of seismic proportions – the 1991 Economic Liberalisation, the 1997-98 Asian Crisis, the 2000 dot-com bubble and the 2008 sub-prime crisis. Market movements during each of those times were characterised by very high volatility – rising and falling over 50% in short term. Even after these upheavals the Sensex has compounded by 20% annually in the last 32 years.

One key factor in climbing these walls of worries has been **human tendency to fight, survive, adapt and prosper**. The need to keep improving one's life conditions amidst all hardships will always exist – more so in India today as it stands at under 2000$ per capita GDP. So long India remains a democratic nation and a free market economy, good businesses that can cater to the demand of a prospering India profitably will prosper despite who remain in power at the Centre. All we have to do is buy sensibly without overpaying. Volatile periods like this year might be an opportunity to do just that.

Your marked to market statements are annexed to this letter. Also annexed is Our *Owners' Manual* – the charter that governs our firm's operating, investing and reporting philosophy.

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We thank you again for your continued trust and long term investment horizon. We can sleep well knowing that, thanks to you, we can keep doing the *right thing* despite short term unfavourable outcomes that are a norm in pursuit of value. You can be absolutely sure that we keep your investment interests at the fore of everything we do at this firm. That is the only way we will continue to be worthy of your trust. Please feel free to share your thoughts, feedback and criticisms.

Kind Regards

Sumit B. Sarda
Compound Everyday Capital
