Compound Everyday Capital
Partners first

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Letter to partners CE9-Mar 17 | Review of 2016-17

EXECUTIVE SUMMARY

- Our share in the earnings of underlying companies grew 10.6%, and our share in their net assets grew 12.9% this year
- Our NAV rose by 46.7%. NSE Nifty rose by 20.2%. Since inception 5 years back in 2012, our CAGR is 34.1%, Nifty's is 13.8%.
- We reacted well to volatility caused by Brexit, Donald Trump Presidency, Demonetisation and BJP's UP win this year.
- We made a mistake of investing a 1% position in Treehouse Education Ltd.

Dear Partners,

Warm Greetings!

Political and macro economic developments, drum beaten by 24x7 news media, often lead to financial volatility. As long term value oriented investors, we love volatility. It allows us to buy bargains or trim expensive positions. There was much to our liking this year. Brexit & Trump presidency abroad and demonetisation & BJP's huge UP win at home – all unprecedented events - caused wide market swings. A look at our portfolio changes *(pg 9)* will show that we did well to benefit from them. To clarify, while we keep a fleeting glance on such developments, our focus remains on evaluating businesses – bottom up, one at a time.

A. PERFORMANCE

A1. Fundamental Performance of our underlying businesses

	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	↑	↑	↑	↓	↓	-
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%

Few partners urged that interpreting "Earnings as % of cost of investment", a metric we have been using to track earnings of underlying businesses, was a little confusing. We have simplified the metric by replacing it with **Earnings Per Unit (EPU)** – where *"earnings"* represent earnings of underlying companies accruing to us and *"unit"* represents total of units we issue to partners when they subscribe capital in the firm. This measure is similar to "earnings per share" if our firm was one company instead of portfolio of companies. Likewise we have replaced "net assets as % of cost of investment" with **Book Value Per Unit (BVPU)** where *"book value"* represents net assets of underlying companies accruing to us.

The above new metrics – **EPU** and **BVPU** will be relatable to our firm's NAV just as EPS and BVPS are to the share price of a company. To the extent new capital remains uninvested, the new metrics will slightly differ from older metric. To correct this anomaly, we will include the effect of spare cash in EPU and BVPU. The old metrics had a problem - they misled true earnings picture whenever original cost changed due to buying or selling large positions. The new metrics correct that bit as well.

For the year ended March 31, 2017:

- Our share of **earnings** in underlying businesses, now represented by Earnings per Unit, grew by **10.6%.**
- Our share in their **net assets**, represented by Book Value per Unit, grew by **12.9%.**
- With share price growth, the P/E multiple increased from 16.5x to **22.0x**
- We have **8%** 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
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		287.9%	**164.8%**		81.5%	206.4%	**83.3%**
Annualised		34.1%	**23.5%**		13.8%	20.3%	**9.7%**

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

For the year ended March 31, 2017:

- Firm's **NAV** grew by 46.7%. The partners gained 28.0% on average this year and 23.5% annually since our inception. All of this is without use of leverage, derivatives or shorting and after having 8% of portfolio in cash equivalents.
  - Return to few partners could differ from the average owing to differences in dates of investing.
- NSE Nifty rose 20.2% with dividends reinvested. Partners' returns could outperform the Nifty by 7.8% this year and by 9.7% p.a. since our inception.

Cash as a primary hedge

Partners will notice our cash balance has gradually risen in last 2 years. This is residue of our value seeking investment process. When prices are high and margin of safety low, as they are now, we will be okay with letting some spare cash accumulate. We may lose out marginally on a continued bull run, but that is a low price to pay for making our portfolio more robust. This cash will become valuable when sentiment reverses and margin of safety increases.

Technology and derivatives have made markets all over the world closely linked to each other. Bad news in any part of the world could rattle markets everywhere, however temporarily. In last five years we have learnt that cash becomes valuable in such times.

Low interest rates that have led to asset price bubbles around the world, justifiably so, look to rise. Of course we cannot time these things and may be proven wrong, it's wiser to hold some cash today especially when valuations leave less margin of safety. To clarify: while we remain open to use put options opportunistically, cash will remain our first hedge tool.

Your managing partner and his family continue to hold most of their net worth in the firm. They have not withdrawn any money since 2012, the year we started this firm. In fact, they have loved putting in more and will do it again at the right time.

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

B. DETAILS ON PERFORMANCE

B1. MISTAKES & LEARNINGS

A stock that has fallen 90%, first fell 80% and then halved

In last letter I shared my mistake of investing a toehold 1% of our AUM in **Treehouse Education Ltd.**, a national play school chain.

Things continued to worsen at Treehouse and Zee Learn withdrew its buyout offer. As discussed in the last letter, that offer was the one of the cornerstones of our investment thesis. We admitted our mistake and sold entire position soon thereafter at an 84% loss, in hindsight at 48% above current market price. Adjusting for tax benefits on loss, the Treehouse saga cost us around 0.8% of our NAV for an important lesson learnt- **A business run by poor management deserves low price. It's seldom a bargain.** Of course, we prefer learning from others' mistakes – that's cheaper and without its emotional-rollercoaster!

From our other **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 respectively.

C. OTHER THOUGHTS

Doing less to earn more

Partners will be surprised to know that, over 50% of their returns since firm's inception came from just two businesses. The dual effect of earnings growth and multiples expansion led to their 4-5x growth over our average cost. Importantly, we got out of their way and allowed them to go over 35% of our AUM.

Good ideas are rare. We must wait for the right ones and bet heavily when we find one. We, thus, need to remain concentrated and liquid. Importantly, if fundamentals remain good, it's our prime duty to leave them alone to grow big. We made just 8 trades this year. We will be happy to take that number even lower. Nowhere in the world will you find a vocation which paid more for doing less!

A negative fallout of pursuing above course of investing style is that our investment results can be volatile if looked annually. But in a 5 or 10 year period, if done the right way, we will come out well. It is where your role has been of tremendous help.

Five years of doing what we love

Destination is an illusion, journey is the joy

As we pass through the 5-year milestone of our shared value investing journey, we pause to record deep gratitude and appreciation towards you - our partners for your trust and long term orientation. Right partners are *sine qua non* of a value oriented concentrated investment operation. We can't be more proud of your patience and support. Thanks to you - we are able to continue working the way we love to.

Few key things worked in our favour in last 5 years. First was pure luck - we started in 2012 when general mood was pessimistic. We invested with a margin of safety in quality businesses that we honestly understood and held them for long term. Lastly, our incentives were aligned. We will be happy to keep doing what has worked. If in the process we get lucky – that would be a bonus!

The mistakes which we made *en route* had one common underlying cause – human emotions. We were either greedy or fearful, and acted based on those emotions. We have learnt from those episodes and made changes that make us more tranquil. One is very simple – just becoming more aware of emotions. Others are more structural – not raising cash during high markets and being comfortable in holding cash in absence of margin of safety.

We understand that the only way to sustain next five years, like the previous five, is to keep your interests first. Your trust is our asset and your money our liability. We take that trust seriously and work hard to retain and grow it. Thank you again 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