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LETTER TO INVESTORS| MARCH 2020 - EXTRACTS

EXECUTIVE SUMMARY

- TTM earnings of our portfolio companies grew by 16.3%. That of Nifty 50 & Nifty 500 grew by 6.7% and -8.7% respectively.
- Aggregate portfolio NAV fell by 9.5% YTD with 77% funds invested on average. NSE Nifty 50 and Nifty 500 *fell* by 23.5% and 23.6% respectively.
- Earnings of our portfolio and broader markets were buoyed by corporate tax rate cuts that were announced in Sep 2019.
- COVID-19 pandemic rattled all asset classes including equities everywhere including India. While all companies will be affected, long term fundamentals of our portfolio companies remain robust.
- Stance: Aggressive.

Dear Fellow Investors,

If you can keep your head when all about you are losing theirs

Poem "IF", Rudyard Kipling

The Coronavirus has caught the world by surprise. Global lock downs and social distancing has led to supply and demand disruptions. There will be spill over economic effects. This, together with uncertainty about the virus, and panic selling by passive and quant funds explains the steep fall of over 30% across markets including India in shortest *ever* time. Not financial excess, not war, but a virus has ended one of the longest bull-runs (2009-2019) in global equities since the Industrial Revolution.

A 20-40% fall in portfolio values can induce fear in our hunter-gatherer minds and prompt us to sell everything and run. Before pressing the panic button and converting paper losses into actual losses, looking back into financial history can offer some guidance. Thanks to the pursuit of prosperity and better life, the multi decade trend of markets and economic activity world over has been upwards. The excesses in this upward trend have self-corrected by one or two recessions/ depressions per decade with 20-60% fall in headline indices. However, *all* such falls have been followed by rapid rise. In *every* such case those investing/staying put in right companies during the throes of darkness and despondency have made great returns. The reason is that during crises, perceived risks become very high, but actual risk get *low* owing to **attractive buying price**. The idea of selling now and catching back a rising tide looks enticing but is practically difficult. Bottoms are made in hindsight. Illiquidity and ego remain high during rise.

Humanity will find a cure to COVID-19, however long it may take. Shops, factories and offices will re-open. Businesses will reboot. Till then, however, we must be ready for hardships and surprises. There may be second or third wave of infections. People may be afraid to step out even if new cases subside. Summers will be followed by winters. What looks like a quarter phenomenon can stretch to one or two years. Investment actions should be cognisant of many such second and third order consequences and unprecedented policy responses to those. The virus is going to test weak immunity and weak balance sheets alike. Only businesses with sustainable demand and balance sheet strength to survive interim cash burn will be better placed to survive/thrive. We should restrict ourselves to such companies. Caveat here, as always, is not to overpay.

Our portfolio companies fall in this category. As we detail in a latter section, except a few portfolio companies that may be *temporarily* impacted adversely, most of our portfolio companies remain neutral to or stand to be positively affected by the current concoction of Coronavirus + Crude Oil + YES bank scare. Prices of most of them have fallen indiscriminately, in line with market; even building in zero sales growth for next 10 years in few cases. Thankfully, our aggregate portfolio was 20% in cash going into March helping us to fall less than indices. Our current stance has changed from caution to aggression. Of course things may get worse before getting better. We are therefore putting the cash to work, gradually.

A. PERFORMANCE

A1. Statutory PMS Performance Disclosure

Portfolio	**3m ended Mar'20**	**6m ended Mar'20**	**Current YTD Jul 24, 2019 to Mar 31, 2020**	**Outper-formance**	Average cash bal.
CED Long Term Focused Value (PMS)	**-21.3%**	**-14.0%**	**-9.5%**		**23%**
NSE Nifty 500 TRI *(including dividends)*	-28.9%	-24.7%	-23.6%	**14.1%**	NIL
NSE Nifty 50 TRI *(including dividends)*	-29.1%	-24.7%	-23.5%	**14.0%**	NIL

Note: As required by SEBI, the returns are calculated on time weighted average (NAV) basis. The returns are NET OF ALL EXPENSES AND FEES. The returns pertain to ENTIRE portfolio of our one and only strategy. Individual investor returns may vary from above owing to different investment dates.

For the year to date March 31, 2020 our NAV was down 9.5%. NSE Nifty 500 and Nifty 50 were down 23.6% and 23.5% respectively. We were invested in equities, on monthly average basis, to the extent of **77%**.

IMPORTANT: On Jan 20, 2020 NSE Nifty 500 touched it's all-time high of 10,175. On that day, on YTD basis, Nifty 500 was up 8%. We were up 19%. Since that day, Nifty 500 has fallen 31.2%. We have fallen 24.0%. We were partly *lucky*. We started in July 2019 when markets were going down - luck. And we held more cash going in to March - deliberate. Nonetheless, this – rising more and falling less – may be due to looking at a very short period and will be a difficult feat to repeat. Realistic long term expectations can be that we will be rising at par/ less and falling lesser.

A2. Performance Disclosure pre-PMS

Portfolio	**Since Inception (CAGR) Aug 2012-Mar 2019**	**Outperformance (Annualised)**
Erstwhile Multi Family Office (7 yrs)	**17.4%**	
NSE Nifty 500 *(including dividends)*	14.5%	2.9%
NSE Nifty 50 *(including dividends)*	13.7%	3.7%

Prior to launching our Portfolio Management Services, we were running a private multi family office. The above are its audited returns net of expenses and equivalent fees over 7 years of its operation (Aug 18, 2012 to Mar 31, 2019).

A3. Underlying business performance

Period	Past twelve months[1] Earnings per unit (EPU)[2]	FY 2021 EPU (expected)[3] Earnings per unit (EPU)
Mar 2020	**5.7**	**UE[3]**
Dec 2019	5.1	-
Annual Change (vs Mar19)	16.3%	-
CAGR since inception	-	-

[1] Last four quarters ending Dec 2019. Results of Mar'20 quarter will be declared by Jun'20 only.
[2] Total adjusted earnings accruing to the aggregate portfolio divided by units outstanding.
[3] Please note: the forward earnings per unit (EPU) are conservative estimates of our expectation of future adjusted earnings of underlying companies. In past we have been wrong – often by wide margin – in our estimates and there is a risk that we are wrong about the forward EPU reported to you above. UE – Under evaluation

Trailing Earnings: As against our expectation of earnings per unit (EPU) of Rs 5.3, Mar 2020 trailing twelve months EPU came in at Rs 5.7, higher by **16.3%** over last year (including effects of cash equivalents that earn 5% net of tax). In comparison, the adjusted earnings of Nifty 50 and Nifty 500 companies grew by 6.7% and -8.7% respectively in the same period (source: Capitaline).

1-Yr Forward Earnings: Owing to coronavirus pandemic, assessing the forward earnings for FY 2021 remains challenging. We will introduce FY 21 earnings estimate after one quarter. We report this number to help you decide whether the NAV fall is in anticipation of earnings fall. If it isn't, it is usually good time to top up or stay put. We can confidently report that while our NAV is down 24% from its top, earnings for next two years will not be down that much.

A4. Underlying portfolio parameters

Dec 2019	Trailing P/E	Forward P/E	Portfolio RoE	Portfolio Turnover[1]
CED LTFV PMS	**15.9x**	**NA**	**19.8%**	**3.7%**
Median	-	-	-	-
NSE 50	19.4x[3]	-	13.7%[4]	-
NSE 500	21.8x[3]	-	8.9%[4]	-

[1] 'Higher of purchases or sales of equity shares' divided by 'average portfolio value' during the period. We built our portfolio this quarter and did not sell anything.
[2] Monthly average
[3] Source: NSE
[4] Source: Capitaline

OVERALL INTERPRETATION: Table A1, A3 and A4 tells us that despite clocking better earnings growth, higher return on equity and lesser price fall (indicating better quality), our portfolio is relatively cheaper than broader benchmarks.

B. DETAILS ON PERFORMANCE

B1. MISTAKES AND LEARNINGS

DB CORP

We have fully exited from DB Corp at a marginal loss of 0.4% of AUM.

Mistake: While Indian regional print media is growing and earnings may pan out as per our thesis, they may not translate to substantial share price improvement owing to *structural decline* of print media. We were waiting for two catalysts to support share price – over 40% fall in raw material (newsprint) prices and rise in dividend payout ratio. Both have played out and, contrary to our expectations, failed to rerate the stock. In fact the stock has fallen 50% since the latest results forcing promoters to increase their pledged shares from 33% to 40% of their stake which is a red flag. Markets remain sceptical of print readership growth sustaining and believe that ad allocations to print will continue to shrink led by rise in digital advertising. We have realised that markets are right and we are wrong. The company may transition to digital subscription model *ala* international print peers, and we may be proven wrong by selling now, but the chances are slim. Let's cut losses and move on.

Key learning – Industries in structural decline will fail to get high multiples even if the industry is consolidated, competition limited and free cash flows healthy.

Past 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. In **Dish TV** we underestimated the competitive disruption but thankfully sold at breakeven. **Tata Motors DVR** taught us that cyclical investing requires a different mindset to moat investing and one needs to be quick to act when external environment turns adverse. In **Talwalkars**, we learnt that assessing promoter quality is a difficult job and we should err on the side of caution irrespective of how cheap quantitative valuations look.

B4. FLOWS AND SENTIMENTS

Foreign investors sold around $10bn worth of Indian equities since Feb 24, 2020, leading to **highest monthly outflows ever**. Most of them would have been *forced* to, for example, owing to redemption, window dressing or algorithmic reasons. Virus led global risk-off sentiments drove money out of risky assets towards government securities and compressed equity valuations world over. The sentiments have changed, in a month, from optimism to fear and the same is reflecting in sharp fall in prices. Volatility indices, as a result, have risen sharply and touched their all-time highs.

Central banks have announced unprecedented rate cuts and liquidity infusions in markets to pump up sentiments. The liquidity will, at some point once coronavirus panic settles, will be back to risky assets and lead to reversal in flows and sentiments.

TACKLING FEAR

"The investor's chief problem — and even his worst enemy — is likely to be himself."

-Benjamin Graham, The Intelligent Investor

Fear is evolution's survival gift to humans. Those who were not afraid, passed away. We are, as a corollary, decedents of those who were fearful. It is biological to get afraid in these times. Two data points can offer antidotes:

Business Value: Value of a business is the present value of all future free cash flows (cash profits less cash investments in working capital and fixed assets). Life of most good businesses can be safely considered to be 20 years or more. Even if we knock off the next two years of cashflows of such businesses or assume them to be negative owing to coronavirus, our study suggests that the impact on present values will be in the range of 10%-20%. Share prices of many of these are down 20-50%. Most of the virus led hardships are priced in and in some cases, overdone. Selling now will tantamount to selling low, not a good way to make money.

Position in Cycle: While comparing the current crisis with the 2008 global financial crisis, we should remember that India is at exactly inverse position today going in to the crisis vs 2008. Year 2008 was preceded by four years of sharp rise in economic activity. Corporate profits and market capitalisation were at all-time high of 7.8% and 158% of GDP (nominal) respectively. We were at cyclical top. In contrast till Feb 2020, entering into coronavirus crisis, India was going through a slowdown reflected in corporate profits and market capitalisation at 3% and 65% of GDP respectively. Post virus led market falls, India's market capitalisation to GDP has further fallen to 49% of GDP, lower than 2008 lows (54%). Moreover governments, having learned their lessons of economic management during the 2008 crisis, have done and will do *whatever it takes* to restore stability and growth.

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SHOULDERS OF GIANTS

We take a moment to stand on the shoulders of giants and revisit what they have said about panics and fears:

In the **Bhagvad Gita**, Shri Krishna tells Arjun -

"दुःखेष्वनुद्विग्नमनाः सुखेषु विगतस्पृहः ।

वीतरागभयक्रोधः स्थितधीर्मुनिरुच्यते ।।"

"He whose mind is undisturbed in the midst of sorrows and is free from desire amid pleasures,

He who is free of attachment, fear and anger, is called the sage of equanimity (sthit dheer muni)."

-Chapter 2 Verse 56, Shrimad Bhagvad Gita

Charlie Munger, Warren Buffett's partner, was once asked by a journalist about how worried he was on seeing stocks falling 50%. His reply –

"Zero. This is the third time Warren (Buffett, Chairman Berkshire Hathway) and I have seen our holdings go down , top tick to bottom tick, by 50%. I think it is in the nature of long term shareholding of the normal vicissitudes, of worldly outcomes, of markets that the long term holder has his quoted value of his stocks go down by say 50%. In fact if you can argue that if you're not willing to react with equanimity to a market price decline of 50% two or three times in a century you're not fit to be a common shareholder and you deserve mediocre results compared to rational people."

In an investor letter, **Boupost's** second in command – Brian Spector reflected the following on going through the pain of Dot Com bubble:

"It turns out buying a dollar for 50 cents is a lot harder than it seems. Every day we added to these positions, thinking we were getting an even better bargain than the day before, only to wake up and watch prices drop further….While both exhilarating and painful at the same time, what I remember most vividly is exhaustion. After countless late nights at the office, I would head home, collapse on my couch and stare at the ceiling. I was unable to read, watch television, or fall asleep. All I could do was worry about what we might have missed in our analysis. It turned out we did not.

Investing in bear markets takes chutzpah. To do so effectively, you need to fly in the face of public opinion, you have to fight normal human emotions, and you have to be prepared to double down on your bets when your conviction is most in question."

Late Mr. Chandrakant Sampat on investing during crisis:

"Don't expect any rationality from markets, they are frequently irrational. You have to take advantage of bad times for good inevitable companies, when general public throws their stock in uncertain times."

Warren Buffet on the 2008 crash:

"Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497."

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While prices can fall 50%, intrinsic values of most of the good businesses donot fall to same extent. Our job in the letter was to apprise you of the inherent characteristics of our businesses so that you feel good about holding them and get greedy with such a mark down in their buying price vs value.

With our wellbeing aligned with yours, we wake up everyday to do better for you: to study and review businesses and profit from mispricings. Of course we make mistakes and deserve your brickbats. But often, interim outcomes are worse despite correct process. In those times we seek your objective assessment and little patience. These are those times and thanks for holding tight. Please feel free to share your thoughts, feedback and criticisms.

This too shall pass…

Kind regards,
Team Compound Everyday Capital
Sumit Sarda, Surbhi Kabra Sarda, Saloni Jindal, Sachin Shrivastava, Sanjana Sukhtankar and Sumit Gokhiya

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