Compound Everyday Capital
Investors first
SEBI PMS Regn. # INP000006633

www.cedcapital.in

"Sakar Bhawan" 2nd Floor
21/4 Ratlam Kothi Main Road
Indore (M.P.), India – 452001
sumit@cedcapital.in

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LETTER TO INVESTORS | SEP 2020

EXECUTIVE SUMMARY

- TTM earnings of portfolio companies were up 2%. That of Nifty 50 and Nifty 500 *fell* by 14.6% and 19.5% respectively.
- Our NAV grew by 31.8% YTD with 75.7% funds invested. NSE Nifty 50 and Nifty 500 grew by 31.5% and 34.2% respectively.
- Markets continue to believe that despite current economic pain, things will get back to normal soon. We don't know.
- Temporary hardships make good companies available at reasonable prices. Caveat is an understanding of the business.
- Stance: Cautious

Dear Fellow Investors,

What's already in the price?

At first glance it seems surprising that the NSE Nifty 50 index is up 48% since March lows when economic data on incomes, jobs, consumption, and production is showing clear signs of Covid-19 inflected pain. However, if we recall that stock markets are future-discounting machines and stock prices are meant to reflect the future and not the present, this seeming *Dalal street-Main street* disconnect looks less puzzling.

Solutions to Covid-19 will be found and economic activity will recover swiftly thereafter. At most one year's earnings will be washed out - not material to the intrinsic values of most of businesses. In hindsight, current prices will not look inefficient or irrational if this scenario plays out without any hiccups.

But what if it doesn't?

Uncertainties still remain elevated. While there is month on month improvement in economic activity since April lows, Covid-19 has still not peaked out. It remains a bottleneck to supply-chains, incomes, consumption, and debt repayments. Globalisation - the fountainhead of global prosperity- is under threat due to unequal distribution of its proceeds. Unbridled money printing – probably the only economic balm to Covid distress- keeps the risk of all-illusive inflation alive even if it may be years or decades away. And the world continues to remain susceptible to geopolitical shocks. These and more continue to remain adverse, uncertain and non-zero portability events.

It seems that prices today are building in only the former optimistic version of the future and assigning zero probability to latter. Margin of safety stands reduced today and this requires us to **change our stance from neutral to cautious**.

Of course, different companies are affected by Covid-19 differently. Most of those favourably placed but seen sharp price rise as well as most of those structurally disrupted and seen price fall, both leave little margin of safety. Those affected temporarily but where prices are discounting permanent damage, present opportunity if one understands the underlying business. We are focussing our energies here without compromising on business and management quality.

A. PERFORMANCE

A1. Statutory PMS Performance Disclosure

Portfolio	FY 2021 YTD Sep'20	FY 2020*	Since Inception*	Outper-formance	Avg YTD'2021 Cash bal.
CED Long Term Focused Value (PMS)	**31.8%**	**-9.5%**	**19.2%**		**24.3%**
NSE Nifty 500 TRI *(including dividends)*	34.2%	-23.6%	2.5%	**16.7%**	NIL
NSE Nifty 50 TRI *(including dividends)*	31.5%	-23.5%	0.6%	**18.6%**	NIL

**From Jul 24, 2019; 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. Annual returns are audited but not verified by SEBI.*

For the half year ended Sep 2020 our *aggregate* NAV was up 31.8%. NSE Nifty 500 and Nifty 50 were up 34.2% and 31.5% respectively in the same period. We were invested in equities, on *monthly* average basis, to the extent of **75.7%**. In line with your mandate, we will act when things make sense to us, until then we will be happy to wait. Individual client's NAV and cash balance may differ from the above depending on their date of investment.

A2. Underlying business performance

Period	Past twelve months Earnings per unit (EPU)[2]	FY 2021 EPU (expected) Earnings per unit (EPU)
Sep 2020	**5.1**[1]	**4.0-5.0**[3]
Jun 2020	5.3	4.0-5.0
Sep 2019	5.0	
Annual Change	2%	
CAGR since inception	-	

[1] Last four quarters ending Jun 2020. Results of Sep quarter are declared by Nov only.
[2] Total normalised 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 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.

Trailing Earnings: Earnings per unit (EPU) for trailing twelve months Sep 2020 EPU came in at Rs 5.1, higher by **2.0%** over last year (including effects of cash equivalents that earn ~5% pre-tax). In comparison, the adjusted earnings of Nifty 50 and Nifty 500 companies *fell* by 14.6% and 19.5% (35.2% if we include Yes Bank, Vodafone Idea and Reliance Communication) respectively in the same period (source: Capitaline).

1-Yr Forward Earnings: Predicting FY21 earnings continues to remain difficult. Going by the in-line June quarter results of our companies, we maintain our broad estimate for FY21 earnings at Rs. 4.0-5.0 per unit. Please treat this estimate with caution. Depending on how the pandemic unfolds, it can be off reality by wide margin. Nonetheless, FY22 looks normal year as of now.

A3. Underlying portfolio parameters

Jun 2020	Trailing P/E	Forward P/E	Portfolio RoE	Portfolio Turnover[1]
CED LTFV	**23.4x**	**23.8x-29.8x**	**16.1%**	**2.1%**
NSE 50	32.7x[2]	-	11.0%[3]	-
NSE 500	40.6x[2]	-	8.3%[3]	-

[1] 'sale of equity shares' divided by 'average portfolio value' during the period.

[2] Source: NSE [3] Source: Capitaline

B. DETAILS ON PERFORMANCE

B1. MISTAKES AND LEARNINGS

Assessing management quality is an important but difficult part of investment process. It cannot be reduced to numbers and remains a qualitative endeavour. Getting better at it is a continuous process and rewarding too - it aids long term returns by avoiding landmines.

One important input to assessment of management quality is **capital allocation decisions**. Equity value increases when management is able to invest its free cash in projects that can earn returns above the overall cost of capital. Many times, assessing this *ex-ante* is fogged by sweet talking optimist management whose incentives are mostly linked to growing the size of the company and not shareholder returns.

Normally, investing in (1) same line of business, (2) organically and (3) using internal accruals has shown to be more return accretive. Conversely, (1) diversification or (2) growth through expensive acquisitions, (3) that are debt funded has proven sub optimal. Of course, there can be exceptions but broadly this has held true over time and geographies. And then there are outright burglaries done using related party transactions and/or accounting jugglery.

When there are no value accretive investment projects, next best capital allocation decision is to distribute the cash back to shareholders through dividends or buybacks. Normally when share prices are low, and company has excess cash, buybacks have proven to be a better option than dividends.

We have exited from a minor position last quarter where we sensed that above cardinal rules of efficient capital allocation were violated. You will read more about it further. We hope that this sensitivity to capital allocation has helped us avoid a potential mistake.

Like always, in this section we continue to remind ourselves about past mistakes. It deflates our over confidence, warns us to remain humble and refreshes the important lessons.

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. From **DB Corp** we learned that industries in structural decline will fail to get high multiples even if the industry is consolidated, competition limited and free cash flows healthy.

B2. MAJOR PORTFOLIO CHANGES

We have completely exited from **Bajaj Consumer** at a loss of 0.7% of NAV. There were no other material additions or deletions to our holdings.

As we wrote in last few letters, Bajaj Consumer (the maker of Bajaj Almond Drops hair oil) was a minor position which we looked as optionality. While stock rose 50% from its Covid lows and earnings fell only 4% in Covid affected Jun quarter due to cut in marketing spends, company's recent **capital allocation decisions** disappointed us and we thought it prudent to move out:

> *Dividend policy:* The company cut down its dividend from Rs. 14 per share in last year to just Rs. 2 per share despite having surplus cash of Rs. 450 cr (Rs. 30.5 per share) as of March 31, 2020. That this happened soon after promoters reduced their pledged shares to *nil*, makes us more worried. In retrospect, the erstwhile high dividend payout looks like a means for personal debt service of promoters and not a shareholder value creation policy.
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> *Buyback:* The company had a great opportunity to do a buyback given its stock was trading at less than 10x trailing earnings. Even now at 14.7x it's not a bad proposition. Moreover this could also have led to rise in promoter's stake (now reduced to 38% after they sold 22% stake to reduce promoter pledge) without any cash outflow from their pocket if they chose not to participate. They repeatedly opposed doing a buyback, despite stated intent of increasing promoter stake in the company.
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> *Keenness to M&A:* Instead of maintaining the dividend payout or buying back bits of their own undervalued company, management is keen to grow via acquisitions including international ones. These almost never come cheap and almost never add value.
>
> *Active capital misallocation:* Management is spending over INR 70 cr in constructing a corporate office for entire Shishir Bajaj group (including Bajaj Hindustan and Bajaj Energy). Rental yields, even if struck at arm's length, will be around 7-8% pre-tax – not the best use of surplus cash.

While the company owns a popular hair oil brand (~10% market share), has been generating good RoEs (33% +) and looks cheap (14.7x trailing earnings), the above acts (post our purchase) reduce the probability of rerating of the company. **In past we have seen that when managements undermine minority shareholders' interests, business quality and valuations become less important.** The right thing during such times as minority shareholders is to take the money and run!

Of course, if management learns from feedbacks and pivots from the current stance, things may improve however we want evidence before committing money. Till then it goes back to our watchlist.

B3. UNDERLYING FUNDAMENTAL PERFORMANCE

Temporary Hardships

Good businesses seldom trade at bargain prices. However some times, very rarely, they are struck by adversity that hurts earnings. In our experience the immediate price reaction to any sudden negative development for good business is mostly negative. If on a calm analysis we can conclude that the hardships are temporary and less impactful than the price has discounted, such bloopers can be a good opportunity to pick good businesses at good prices.

The obvious mistake that can be made is to misjudge permanent hardship as temporary, and structural headwinds as cyclical shifts. The only antidote against making this mistake is a sound understanding of the business and its industry.

So long as demand continues to remain robust, business debt free or has access to capital, raw material or end product prices are cyclical, and remedial measures remain in control of management, the hardships are temporary. However if there is challenge to long term sustainability of demand, or new technology brings in better and/or cheaper solutions hardships are permanent. Curiously temporary hardships have higher visibility, permanent hardships are less noisy. Management and media miss the latter or hope it to be temporary. Nonetheless, ability to distinguish between the two can be profitable. Covid-19 is a temporary hardship for many companies. Wherever prices are misjudging it to be permanent can prove to be good opportunities.

B4. FLOWS AND SENTIMENTS

Global markets continue to remain linked to the behaviour of US markets. Thanks to fiscal and monetary stimulus, liquidity remains abundant. US Dollar's weakness against major currency basket had also increased the flows towards emerging markets including India. FIIs invested 6.3bn$ in the month of August (a decade high) in India and a total of ~11bn$ from April-Sep 2020.

US Fed revised its policy framework and announced that it is will target "average" inflation and will tolerate higher inflation for periods following period of low inflation. Further, it will not pre-emptively raise rates on reaching high employment unless the inflation rises. This, in effect, implies that US Fed is likely to maintain low rates for longer and will not be raising rates proactively to curb inflation.

Back in India, eight IPOs were launched in the month of September and seven more are slated in 2020 raising a total sum over 2.5bn$. Many of these have seen subscription to the extent of 74x-150x and opened 70%-123% higher than IPO price on listing days. Similar frenzy has been seen around the world. Either the bankers, private equity selling shareholders, and promoters to the issue (whose are insiders and incentivised to maximise the issue price) are missing something or, the investors are. No prizes for guessing who it will turn out to be.

After rising for over 24 months, net mutual fund equity inflows fell for two months in a row (July and Aug) by Rs.2,480cr. and Rs. 4,000cr respectively . SIP flows fell marginally from Rs. 8,500cr run rate pre-Covid to Rs. 7,792cr. in August.

The US is entering presidential election season and history suggests that months before the election remain volatile. This is not a bad thing given our spare cash.

C. OTHER THOUGHTS

CAPITAL AND ITS COST

For valuation purposes we are concerned with average interest rates expected over the *future*. Near zero interest rates and abundant liquidity in most advanced nations has lowered cost of capital and supported equity valuations over the last decade. **Is it reasonable to expect interest rates to perpetually remain close to zero?**

It's an important but tough question to answer. Trajectory of future interest rates will influence future returns from equities.

Policy interest rates in **Japan** have been zero since over two decades without igniting inflation. Higher doses of liquidity and fiscal and monetary stimulus were the only options available to the world during the 2008 Subprime crisis and the current coronavirus crisis. The costs of not infusing relief would have been fatal. Today, there are political incentives to keep kicking the liquidity can down the road to avoid/ delay recessions. Is the world, then, moving on a dismountable liquidity-tiger in the Japanese direction?

Japan may be an exception to the world today. With highest share of senior citizens, Japan faces **demographic** headwind – stagnant productivity, higher savings and lesser consumption. Its **GDP growth** rate is low and that's why Nikkei 225, the Japanese stock index, is roughly at the same lever today as it was in 1991 despite near zero interest rates. Moreover, Japan also has one of the **lowest unemployment and inequalities** in the world.

Even if we believe that the EU is seeing demographic headwinds similar to Japan, the average age of the world, thanks to India and China, is still low. Youth in developing world seeks employment and improved living standards that accrue from jobs and consumption. Addressing the rising inequality is gaining political currency too. Globalisation is on retreat and producing more at home will raise cost of production. Moreover the fiscal doleouts given to the weaker sections worst hit by the pandemic will maintain demand for goods and services. US Fed has announced its tolerance for 2%+ inflation to get to full employment. Thus unlike Japan, there remains a non-zero chance that inflation can rise and ignite a rise in interest rates around the world. The timing and quantum remains uncertain.

When interest rates are low, present value of profits far into the future are roughly equal to current profits. But when interest rates are high, future profits are less valuable than today's. What should be the fair P/E multiple for equities therefore depend on where the interest rates will be in future. Honestly we don't have an answer. **However not knowing the answer is itself an answer**. It's not 100% certain that interest rates will remain so low for such a long period. We should keep this mind and not lead the past decade to mislead about the future.

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LESSONS FROM THE PANDEMIC

Humility and margin of safety: Covid-19 has put a spot light on our ignorance- both known and unknown – things we know/don't know that we don't know. In investing and in business, despite all the research, there will be things that we will not be able to know/ plan for. This calls for humility and need to have a margin of safety. In business, this means (1) having a balance between efficiency & resilience, and (2) being prudent with debt. In investing, this means not overpaying, however rosy the future may look today.

Timing is difficult – No one can pick bottoms sustainably. Right time to buy is when things are going down even at the risk of near term mark downs. When Nifty50 touched the lows of 7500 in March, the general expectation was that prices will continue to go down further and there was reluctance to invest. It looked like extremely uncertain time to invest. Certainty and low prices donot go together. If we wait for clouds to clear, prices will move up.

Change?: The virus has and will change many things. It's tempting to accept everything in a flux. But that will be a wrong lesson. There will be many things that the virus will not change. Human propensity to prosper will not change. People will continue to move in the direction that makes their lives easier. This will ensure that businesses that cater to meeting growing needs will remain in force. Consumer behaviour including socialising will also not change materially. The chains of habit formed over decades will be difficult to break by what looks like a 2-3 years virus outbreak. Investor behaviour will also not change materially. Greed, fear, envy, ego and institutional limitations will continue to make prices more volatile than fundamentals.

Health is wealth – In these pages we keep talking about ways to sustainably grow financial wealth. However, as the pandemic has shown, such prosperity is incomplete without good health. It's important to focus on health equally, or more. Eating responsibly, being physically active, taking adequate sleep and reducing stress should be paid as much attention as wealth building.

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Last six months have not been kind. Hopefully the worst is behind us. Thanks to your rational behaviour, we have made a good use of this pandemic. We continue to do what's best for you. That's how our incentives are designed. Thank you for your trust. Stay safe.

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

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