

Kotak Special Situations Value Strategy

December 2019



Dear Investor

The human mind is as much a determinant of investment success as is the ability to assess fundamentals. The mind has great **aversion to loss** and this tendency plays tricks in different ways:

- In times of market bullishness, the mind is scared of **opportunity loss**. Hence it forces us to invest so as to not lose opportunity
- In times of market weakness, the mind is scared of **capital loss**. In such times, the mind forces us to take capital out of the markets to prevent any capital loss

In reality, when markets are bullish prices are being bid-up and hence valuations are unfavorable. On the other hand, in times of bearishness, prices are being bid down and valuations are favorable. Hence wisdom would dictate taking monies off the table in bullish times and putting monies to work in times of weakness. The mind forces us to do just the opposite.

Indian markets have witnessed a period of weakness over the last 20 months, particularly in the small and mid cap space. For instance, median return is -37% in stocks ranging from 250-500 in market cap terms, in this period. This compares to the top 20 stocks having witnessed +7% returns in the same period. Such a polarization is leading to wide divergences in PER valuations, which are bound to correct over the coming months and quarters.

We look at this period as one of opportunity, since valuations are favorable in the broader markets. We are witnessing liquidity coming back and stocks getting rerated in bouts; for instance two of our largest positions – Polycab India Ltd and Bharti Airtel have hit Life Highs and 52 week highs respectively over the last 2-3 months. **Given that likelihood of a valuation expansion in the broader markets is high, this is a time to add to equities in general and existing portfolios in particular.**

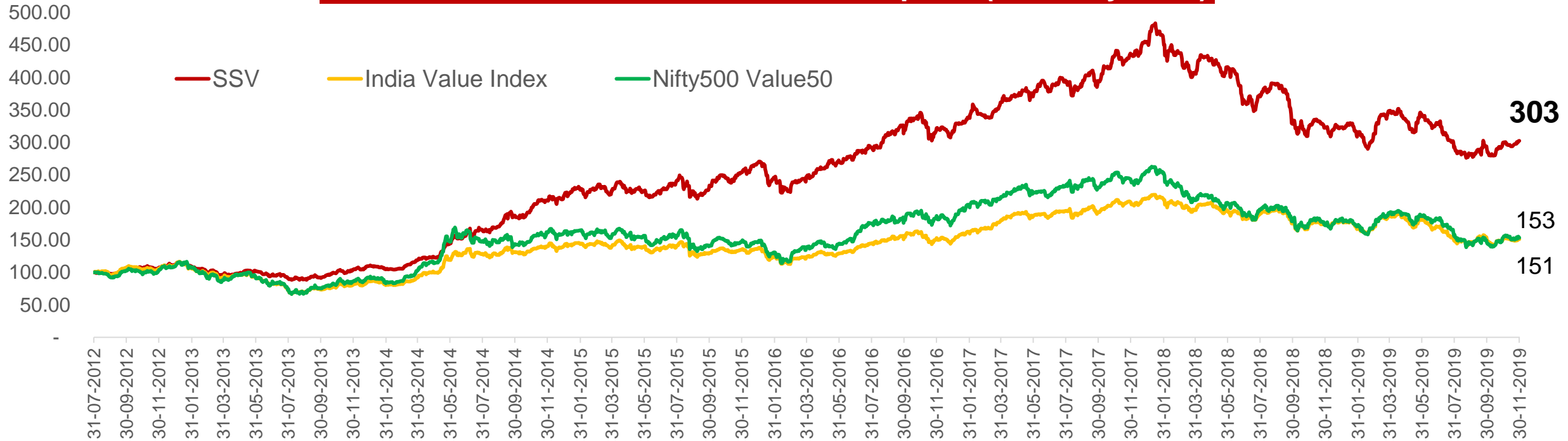
We remain confident of our portfolio fundamentals and look forward to price strength in the coming times.

Current Portfolio and Performance update

Significant outperformance over Long term

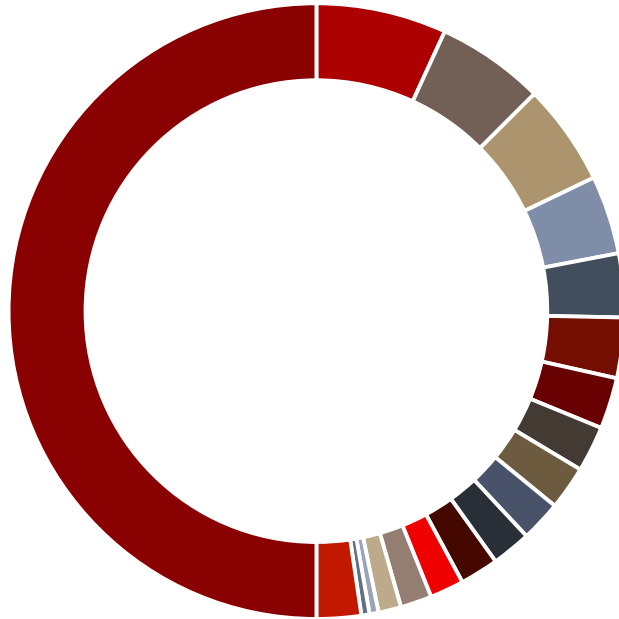


Performance of Rs 100 Invested at Inception (31st July 2012)



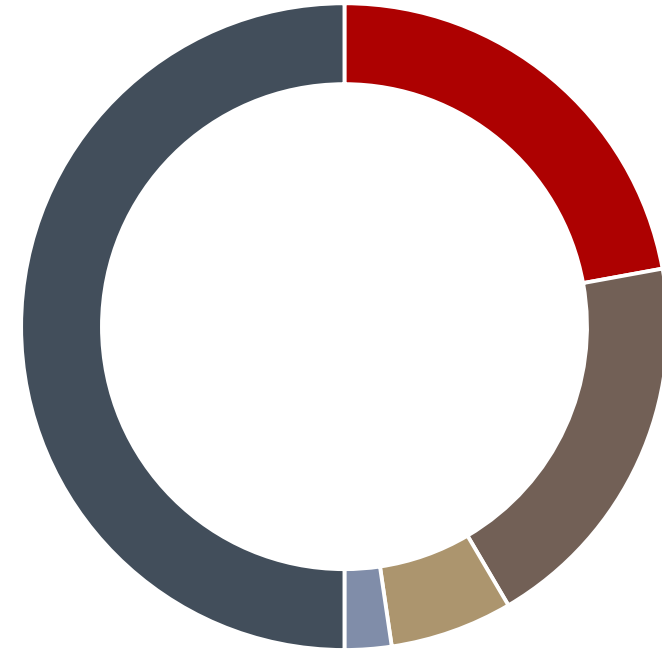
Period	Absolute %				CAGR %		
	1 Month	3 Months	6 Months	1 Year	3 Year	5 Year	Since Inception
Special Situations Value 1	1.1%	7.1%	-11.1%	-6.2%	-2.1%	7.5%	16.3%
India Value Index	-0.5%	2.8%	-16.3%	-13.1%	-0.4%	1.5%	5.8%
Nifty500 Value50	-0.8%	5.6%	-17.7%	-11.1%	-6.4%	-1.1%	6.0%

Sector Allocation



- BANKS
- CONSTRUCTION & ENGINEERING
- TELECOMMUNICATION - SERVICES
- INFORMATION TECHNOLOGY
- TOBACCO
- TEXTILES
- FINANCIAL SERVICES
- PERSONAL CARE
- AGROCHEMICALS
- ELECTRICAL EQUIPMENT
- STEEL AND STEEL PRODUCTS
- FOOD AND FOOD PROCESSING
- INSURANCE
- REALTY
- PHARMACEUTICALS & HEALTHCARE
- AIRLINES
- INDUSTRIALS
- Cash & Cash Equivalent

Market Cap Break up



- Small Cap
- Large Cap
- Mid Cap
- Cash & Cash Equivalent

Portfolio Fundamentals



Security Name	FY19 Rev Growth YoY	FY 19 PAT Growth YoY	EPS CAGR FY19-21E	FY21 E RoE	D/E	FY21E PE
POLYCAB INDIA LTD	18%	40%	22%	17.8	0.0	16.2
BHARTI AIRTEL LTD	-2%	-63%	NM	-0.2	1.3	NA
APL APOLLO TUBES LTD	34%	-6%	38%	21.6	0.7	11.5
LARSEN & TOUBRO LTD	18%	21%	14%	16.3	1.4	17.8
ITC LTD	11%	12%	11%	24.5	-0.3	20.5
FINOLEX CABLES LTD	9%	23%	14%	15.4	-0.3	11.3
ICICI BANK LTD	10%	-45%	110%	16.0	NA	14.9
ASHIANA HOUSING LTD	8%	-63%	99%	0.0	-0.1	20.7
AXIS BANK LTD	20%	1005%	59%	16.0	NA	13.7
K R B L LTD	27%	16%	15%	16.9	0.5	7.8
ICICI PRUDENTIAL LIFE INSURANCE CO LTD	8%	0%	12%	18.3	-0.1	46.5
RAIL VIKAS NIGAM LTD	17%	24%	15%	19.0	0.8	5.5
INTERGLOBE AVIATION LTD	25%	-93%	351%	31.3	-1.8	22.7
PERSISTENT SYSTEMS LTD	11%	9%	9%	15.8	-0.4	10.8
SUN PHARMACEUTICAL INDUSTRIES LTD	10%	27%	44%	11.4	0.0	16.9
WELSPUN CORP LTD	42%	40%	56%	21.4	0.1	6.1
MAGMA FINCORP LTD	11%	28%	8%	9.8	NA	3.9
EMAMI LTD	7%	-1%	43%	26.1	0.0	23.3
STATE BANK OF INDIA	11%	150%	253%	12.4	NA	8.4
RBL BANK LTD	38%	33%	22%	16.0	NA	11.0
KPIT TECHNOLOGIES LTD	NA	NA	32%	18.3	-0.3	11.0
SIYARAM SILK MILLS LTD	5%	-11%	25%	17.2	0.5	7.1
INDIAN ENERGY EXCHANGE LTD	10%	25%	14%	50.6	-0.9	17.9
HIMATSINGKA SEIDE LTD	24%	-2%	23%	14.6	1.6	4.8
ENGINEERS INDIA LTD	36%	-4%	15%	21.2	-1.2	13.0
SUVEN LIFE SCIENCES LTD	8%	-30%	35%	15.8	-0.2	22.4
HDFC LIFE INSURANCE COMPANY LTD	20%	15%	16%	19.7	-0.2	70.1
SCHAEFFLER INDIA LTD	4%	8%	13%	16.6	-0.3	25.4
COROMANDEL INTERNATIONAL LTD	19%	4%	12%	22.7	0.8	13.5
Equity	15%	48%	47%	16.7	0.1	14.8

Security Name

Rationale

ADDITIONS

ENGINEERS INDIA LTD	<ol style="list-style-type: none"> Order backlog of Rs114bn (4x current sales) and mgmt. has indicated robust pipeline for FY21E Guiding for 15% revenue growth in FY20 and sustained margins. Likely beneficiary of rising refinery capex providing healthy growth visibility with net cash balance sheet, healthy RoE/RoCE of ~19%.
ICICI PRUDENTIAL LIFE INSURANCE COMPANY LTD	<ol style="list-style-type: none"> VNB margin has improved, driven by product mix and lower expenses. Increased allocation ~ share of higher margin protection products within total APE to further lead to improvement in VNB margin.
RAIL VIKAS NIGAM LTD	<ol style="list-style-type: none"> Order Backlog of Rs 750 Bn (7.5x current sales) and order pipeline of over Rs 400 Bn Revenue growth expected to be over 20%, with commensurate profitability growth Strong balance sheet and highly attractive valuations

DELETIONS / REDUCTIONS

INDIAN ENERGY EXCHANGE LTD	Booked Profits
POLYCAB INDIA LTD	Booked Profits

Kotak Special Situation Value Portfolio Strategy

- 1. Large market opportunity** : Market size should be at least 2x company's current sales. This gives the company a long runway for future growth
- 2. Businesses with robust competitive advantages** : Strong brands, High Switching costs, Network economics , Low cost advantages or Innovative products
- 3. Strong Financials and Earnings Growth** : We prefer low debt companies and our portfolio debt to equity is under 0.5x. We prefer companies with earnings growth and margins higher than their peers
- 4. Management Dynamism and Good Corporate Governance** : We prefer companies with passionate and transparent management. Asset turns and working capital turns at industry levels or trending there
- 5. Fair Valuations** : We look to buy businesses at fair valuations, where future earnings growth is not priced in

What are Special Situations?



Investment operations whose results are dependent on happening or not-happening of one or more corporate events rather than market events

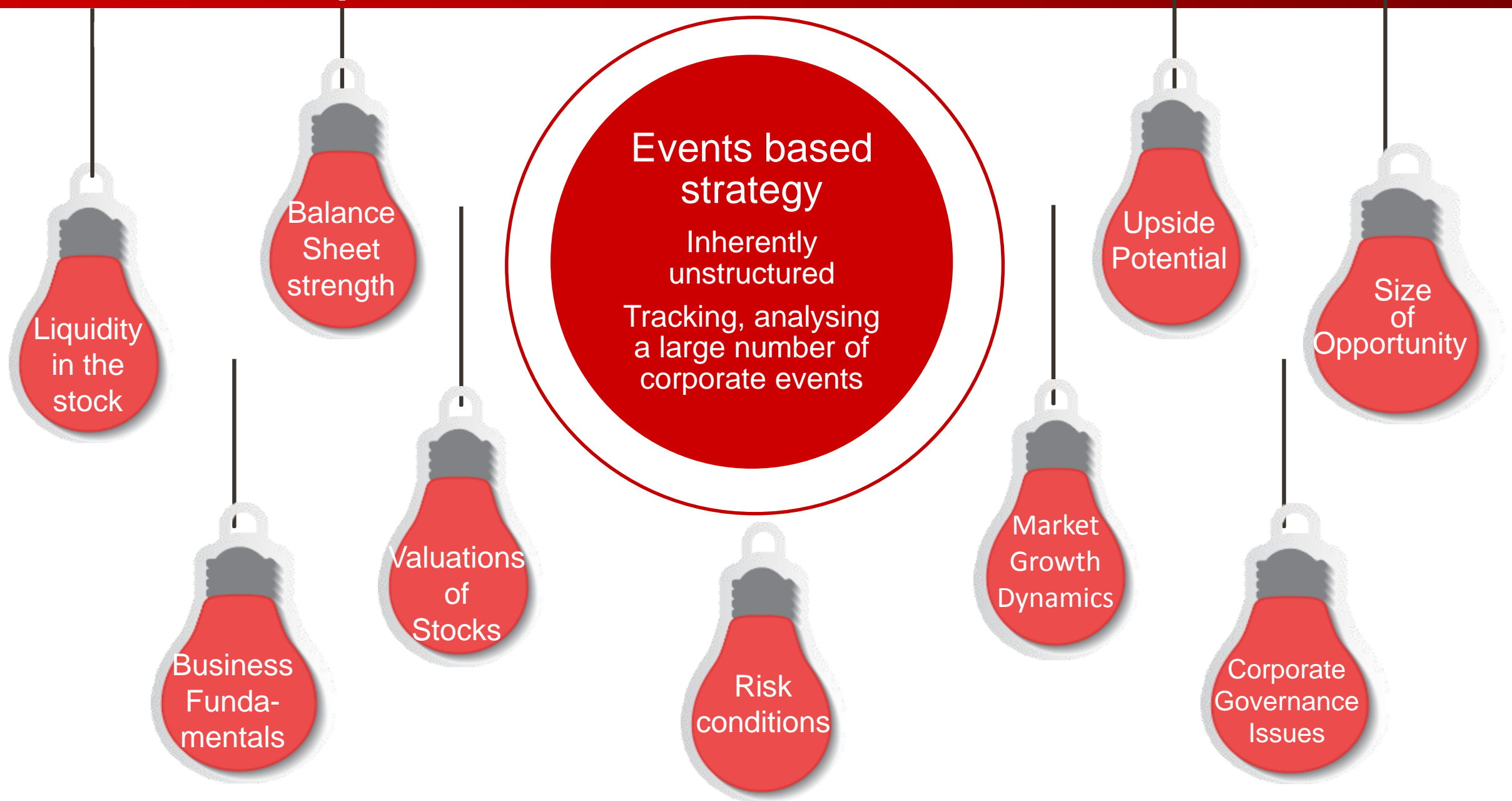
Key Advantages

- Investment results of Special Situations opportunities are largely independent of market moves

Key variants

- **Price related** : Securities bought at a discount to (expected) price guarantees by buyer in the form of de-listings, buy-backs, open offers, etc.
- **Merger related** : Shares can be created at a discount to current market price
- **Corporate restructurings** : Value unlocking due to corporate restructuring, assets sales, demergers, business triggers, etc.

The Universe - Special Situations



What is Value Investing?



“Value investing is the discipline of buying stocks at a significant discount from their current underlying values. The element of a bargain is the key to the process.”

– Seth Klarman

- **Thinking as business owners**
 - We look at stocks not as pieces of paper but as fractional ownership in the business. If the business does well, we will do well.
- **Endeavour to prevent permanent capital loss**
 - We require a significant margin of safety when we buy a stock, so that even if things don't work out as expected, downsides remain capped
- **Concentrated Portfolios**
 - We invest with conviction and hence we have concentrated portfolios with 15-30 stocks.
- **Bottom Up**
 - We believe that good quality companies will outperform the market irrespective of the sector they are in.

The Universe - Value Opportunities



1000

- Total universe of top 1000 market capitalisation companies

804

- Companies having greater than 30% promoter shareholding

536

- Rank companies based on ROE and 1/PER (Earnings Yield). Add the two parameters to arrive at a combined rank. Identify the top 2/3rd of this combination to arrive at stocks likely to perform best

421

- Capital Efficiency i.e. ROE of at least 15% trending toward and higher than 20%

227

- Compounded PAT Growth of at least 10% in the last three years

50

- Assess companies based on Management quality, Integrity, Balance Sheet strength, Capital Allocation, Execution Capabilities, Vision for the business, fairness to stakeholders, etc.

15-30

- Valuation not more expensive than peer set and Price to Value Gap of at least 30%

Above is an illustration of how various screeners are used to shortlist value opportunities which are then further analyzed in detail on their fundamentals

Fundamental Analysis Process



Management

- Is management trustworthy and rational
- Is it candid with its shareholders

Return ratios

- Is ROCE/ROE stable over the last few years? Why?
- What is the expectation of ROCE/ ROE going forward?
- Expansion or contraction in ROCE because of – a) Asset turns, b) Margin changes or, c) Leverage

Capital Allocation

- Are Asset turns optimal
- Assets tied up in non core businesses
- Revenues from core activities

Earning Power

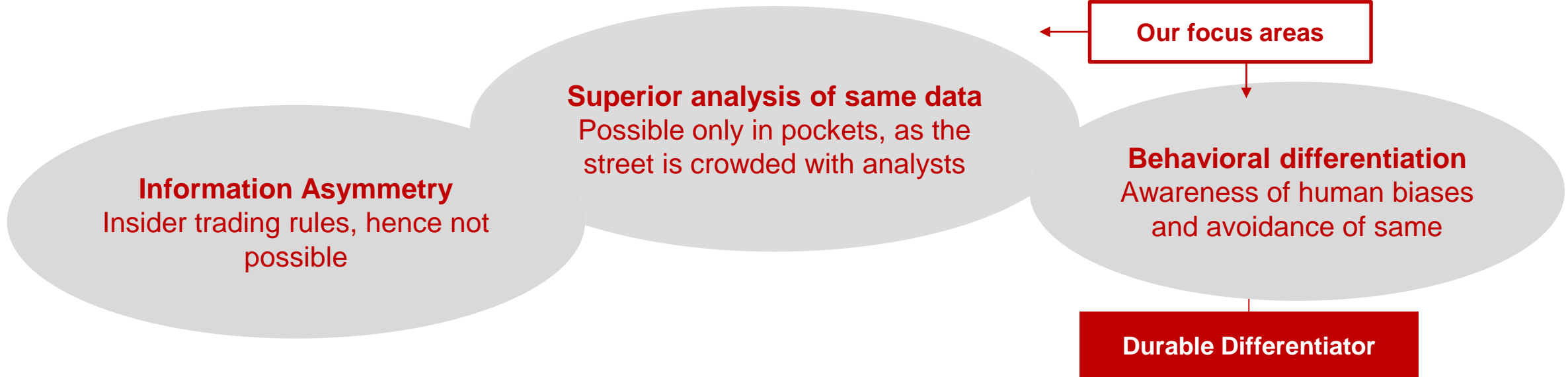
- Revenue growth expectation
- Expense trend (as % of sales)
- Margin trend
- What are the company's owner earnings i.e. the FCF

Valuation

- EV/EBITDA, PER, FCF Yield, P/B, Replacement Cost
- Comparison with other players within sector and benchmark indices
- Is the stock trading at a discount to intrinsic business value

What is the source of our edge?

There are three broad sources of outperformance on the Street



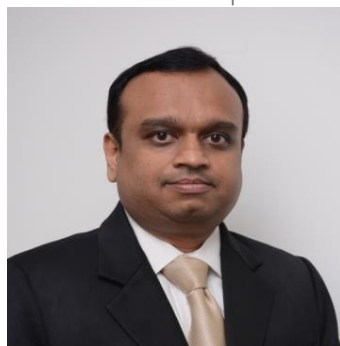
Work to consciously avoid Common human biases

- Social Proof: Herd like behavior, for safety in crowds
- Overconfidence and Over-optimism: In one's business assessment
- Present-ism: Projecting immediate past into future
- Misunderstanding randomness: Seeing patterns where none exist
- Anchoring: On irrelevant data, etc.



Mr. Anshul Saigal (Head PMS)

- Has spent close to 12 years with Kotak Portfolio Management Services.
- 18 years of industry experience including that in JP Morgan, ICICI Bank and Standard Chartered Bank.
- MBA (Finance), B.E (I.E).



Mr. Biren Dalal

- Has spent close to 12 years with Kotak Portfolio Management and Alternate Assets
- 20 years of industry experience including that in Motilal Oswal and KRC shares and Securities.
- B.Com, C.A



Mr. Ashish Jagnani

- With Kotak Mahindra AMC since November 2017
- 15 years of industry experience including that in UBS and Citigroup
- CA, Masters in Finance Management



Mr. Aditya Joshi

- With Kotak Mahindra AMC since September 2016
- 12 years of industry experience of which the last 9 years he has served with the Kotak Group.
- B.E. (Mechanical), MBA (Finance), CFP, Chartered Financial Analyst, USA (CFA)

Important Notice



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Note:

Benchmark of following strategies of Portfolio Management Services being provided by Kotak Mahindra Asset Management Company Ltd, with effect from July 29, 2019, were revised as follows:

- In respect of Special Situations Value Portfolio, the Benchmark was revised from CNX 500 Index to India Value Index.

All other terms and conditions of the aforesaid Strategies remain unchanged. This forms part of Disclosure Document of Portfolio Management Services being provided by Kotak Mahindra Asset Management Company Ltd, as amended from time to time.

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Thank You
