

Investor NEWSLETTER



Dear Investor,

We shall use this month's newsletter to explain the rationale for the purchase and continued holding of one of the companies in the portfolio that is yet to contribute. The stock is Cummins India Ltd (CIL).

As you are aware, our style of portfolio management is to buy the shares of a strong company when it is going through an unpopular phase. We find this method particularly acceptable, because only when the company is going through an unpopular phase, its shares are available at a not-too-extravagant price, and buying anything at a reasonable price increases our chances of success in the investment. And it is important that we stick to the strong businesses, because to persist with an unpopular stock needs the conviction that we are indeed backing the right horse, and that comes when we see the company's continued ability to compete.

First, let us look at the facts about Cummins India:

- CIL is a leader in India in the Diesel Genset Industry
- Enjoys the parentage of Cummins Inc, a global leader, thus gaining access to the latest technical knowhow to maintain best-in-class product offerings
- Has a market share of 37%
- Number of product offerings is the highest amongst all competitors in India
- Good at adapting to the change in emission norms. Fully ready for CPCB IV norms that come into effect from April 2021

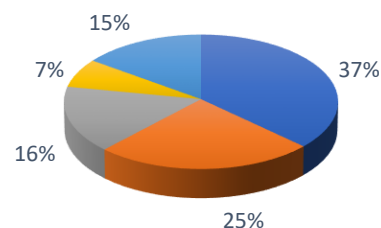
What has impacted the stock in recent years?

- Slowdown in economic activity. Manufacturing capex and infrastructure slowdown
- The Lower Horse Power (LHP) segment has been facing stiff competition from the unorganized segment
- The company, in a weak economic environment, has faced pricing challenges in the 450-750 KVA segment from Kirloskar Oil Engines (KOEL)
- Slowdown in the export markets

The company's competitive position:

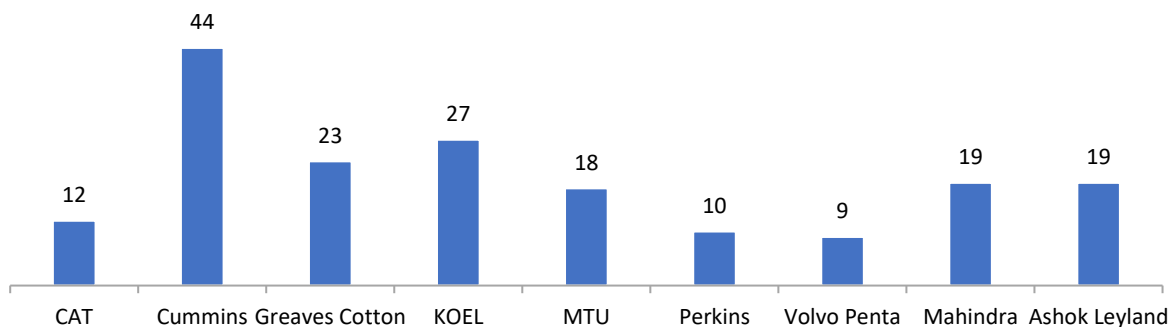
Market share data

- Cummins
- KOEL
- Mahindra
- Perkins
- Others



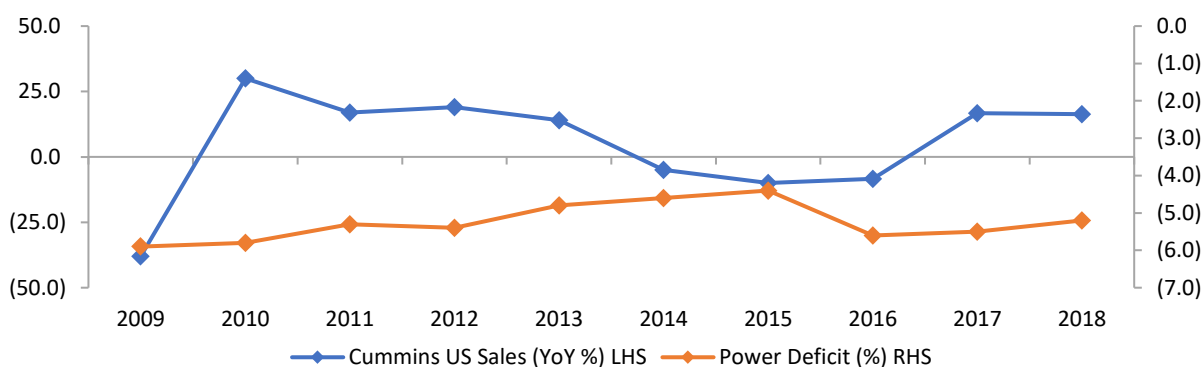
Source: Company website, brokerage reports

CIL has the highest number of product offerings



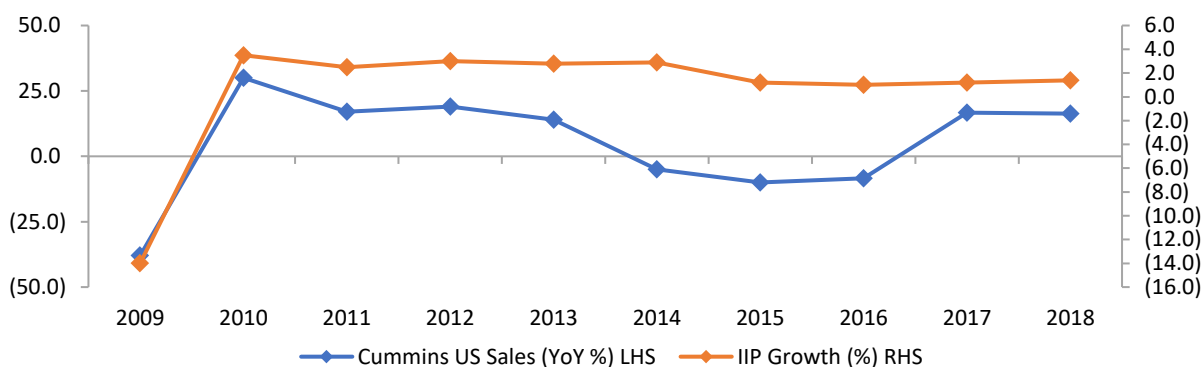
Source: Company website, Industry

One of the main arguments given against CIL is that the company tends to do badly when there is surplus power available through the grid, therefore obviating the need for installing generators. We present the data from the US market for the last 10 years, showing that there is a negative correlation of -0.02 between Cummins revenue growth and power deficit in the US. The demand for DG sets is therefore not impacted if there is excess power available through the grid.



Source: Cummins website

At the same time, Cummins' revenue growth has a correlation of 0.81 with Industrial production growth. The demand for DG sets is directly dependent on the growth in industrial activity.



Source: Cummins website

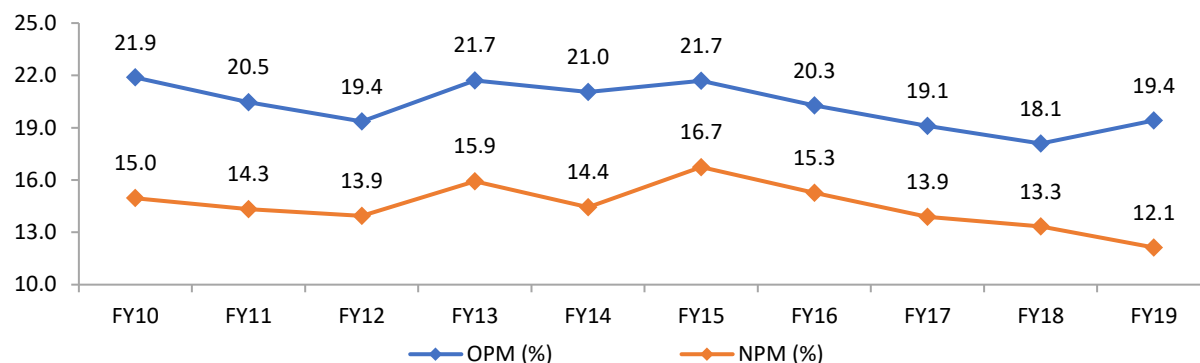
Our thesis is based on the following:

- Industrial activity and infrastructure spending cannot remain depressed indefinitely in India. The present depressed condition (the one that has caused the slump in the stock price) is providing a good opportunity to buy a stock like Cummins India at a reasonable valuation
- Railway capex is estimated at more than Rs.300 billion annually
- The growing network of Metro trains is a good opportunity as every Metro station requires a DG set for power back up.
- The country is planning 900 KM of metro construction activity
- Road infrastructure also requires DG sets for power
- We anticipate a revival in road infrastructure projects in 2020-21
- Data centres have emerged as a big opportunity for DG sets, as these centres require 24-hour power back up

- Increased urbanization is a theme in India that would play out over the next few decades – essentially good news for DG set suppliers, because that means increased need for back up power generators in places like malls, office complexes, hospitals, movie theatres and the like
- Through its parent, CIL has geared up for the adaptation of the latest CPCB IV norms
- Realizations and margin profile are expected to improve with new products with increased electronics come into play

Salient features of the track record of CIL

Margin profile:

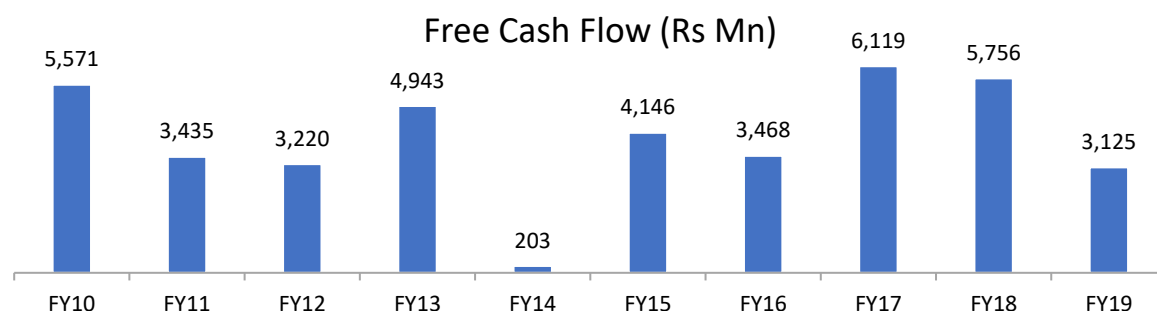


Source: ACE Equity

The operating margin is just beginning to improve from its decade low level. The net margin is at its decade low level. In our opinion, the ideal time to pick up a cyclical, capex-dependent company like Cummins.

The last 5-year average Return on Capital Employed (RoCE) for CIL has been 26.92%. The company has generated greater than 20% RoCE in each of the previous 10 years.

Ability to generate free cash flows (Rs Mn):



Source: ACE Equity

CIL has generated positive free cash flow in each of the previous 10 years, after taking into account the ongoing capex from internal accruals.

The stock is quoting at a PE multiple of 23 times earnings, compared to its 10-year average of 26.6 times earnings.

The stock fits in well with our overall theme of a strong company going through a period of temporary difficulty.

It has a strong parentage, technological skill, service network, strong product profile, and we believe, an ability to withstand the present difficult market condition and would be a beneficiary when the pickup happens in infrastructure investments and the capex cycle.

This style of investing has stood us in good stead over the past nearly 17 years. Our approach is to stay away from the hype (hence exorbitant valuations) but stick close to strong balance sheets and business models (which give us the ability to live through the temporary underperformance in the period immediately after the purchase).

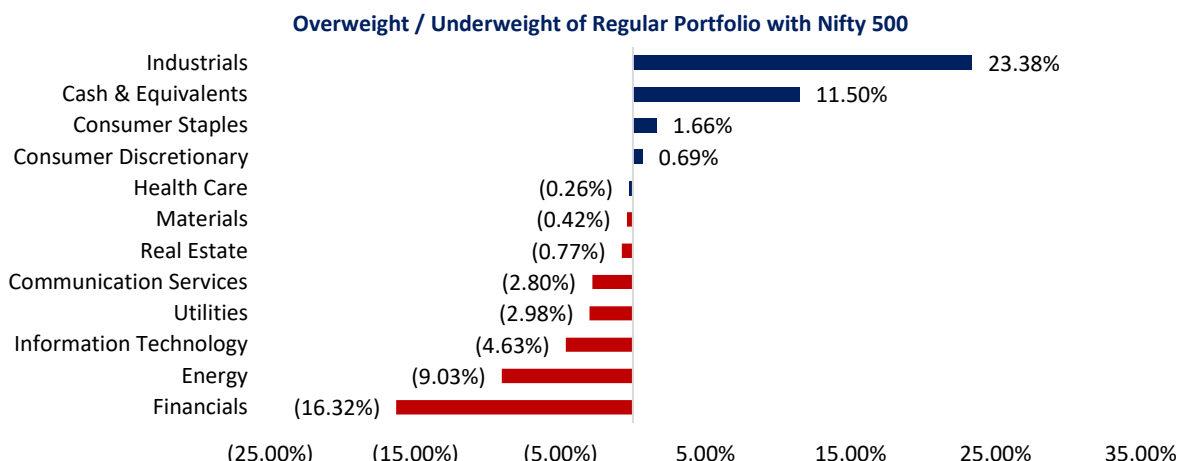
Warm regards

Yours sincerely,

(E A Sundaram)

Chief Investment Officer and Portfolio Manager

Over/Under Weight of Portfolio Compared to Nifty 500 as on 31st January 2020



Model Portfolio Details as on 31 st January 2020		Model Portfolio Composition as on 31 st January 2020	
Weighted Average ROCE	30.14%	Large Cap	35.5%
Portfolio PE (1 year forward PE, Based on FY21)	19.47	Midcap	37.0%
Portfolio Dividend Yield	1.43%	Small Cap	16.0%
Average Age of companies	61 Years	Cash	11.5%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on 31st January 2020
- Midcap: Market cap below 100th company to the market cap of the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 31st January 2020
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 31st January 2020

Model Portfolio Composition as on 31 st January 2020	
Model Portfolio Over Lap with Nifty 500	11.02%
Model Portfolio Over Lap with Nifty 50	11.12%

Consolidated Portfolio Performance of Core Value Concentrated Strategy			Consolidated Portfolio Performance of Core Value Regular Strategy		
Period	31 st January 2020		Period	31 st January 2020	
	Portfolio	Nifty 500		Portfolio	Nifty 500
1 Months	(0.17)	(0.11)	1 Months	1.31	(0.11)
3 Months	(3.26)	1.77	3 Months	(1.23)	1.77
6 Months	6.77	9.03	6 Months	10.35	9.03
Since Inception (15/04/2019)	3.43	0.81	Since Inception (14/05/2019)	7.64	7.66

- Since inception date stated is considered to be the date on which the first client investment was made under the strategy

Disclaimer: Performance depicted is based on all the client portfolios existing as on such date, using Time Weighted Rate of Return (TWRR) of each client and then computing *arithmetic* average for the overall strategy. Past performance is no guarantee of future returns. The above portfolio performance is after charging of expenses.

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