Waiting for the "Ugly ducklings" to transform

Dear Investor,

In any portfolio, not all stocks will move in the same direction together, nor in the same proportion, nor at the time of our choosing. Some will move faster, and others more slowly. Some may be stagnant for some time. The general tendency, however, is to be impatient with the ones that are not moving (especially when the overall market is bullish!!). The investor must control this urge to "do something with the laggards" and carefully see whether fundamentally there is any problem with the companies behind such stocks.

In our own portfolio, the following have been the price movements of various stocks in the past 6 months (January to June 2021). This is not the exhaustive list, but we have taken 15 stocks from the portfolio. As can be seen from the table below, many of them have done well, but there are some that have not. Those note on this list have either (a) spent too little time in the portfolio or (b) will fall in one of these two categories. Stocks like Asian Paints and Titan have risen less than the Index, while stocks like SKF and United Breweries have done better.

Company	Price (Dec 2020)	Price (Jun 2021)	% change
Container Corporation	399	700	75.4%
Cummins India	574	902	57.1%
CAMS	1,805	2,795	54.8%
State Bank of India	274	419	52.9%
Sundaram Finance	1,804	2,675	48.3%
Blue Dart Express	4,097	5,810	41.8%
Kaveri Seeds	520	729	40.2%
CRISIL	1,921	2,553	32.9%
Sun Pharmaceuticals	592	674	13.9%
Oracle Fin Services Software	3,212	3,650	13.6%
HDFC Bank	1,436	1,497	4.2%
Rites	271	275	1.6%
ITC	209	203	(3.0%)
Sanofi India	8,326	7,720	(7.3%)
MCX	1,730	1,525	(11.8%)
Nifty 50 index	**13,981**	**15,722**	**12.4%**

Inevitably, the attention is drawn to the ones that have still not moved up in price. Should we continue to hold them? Are they "dead-weights" that are dragging the overall portfolio returns? Should we sell them now and buy them when they start to move up?

Before we discuss the "laggards" and why we are holding on to them, let us rewind our memories a year and think about the comments that we were hearing about State Bank of India, that used to be one of our top holdings about a year ago. The comments heard usually were:

(a) Public Sector (PSU) banks are inefficient and will constantly have governmental interference.

(b) Non-performing Assets (NPA) problems are huge.

(c) These banks are not market savvy.

The fact is that in the last year, SBI stock has risen by 137%. Much more than its many other and more-fancied banks of last year. SBI was a laggard last year.

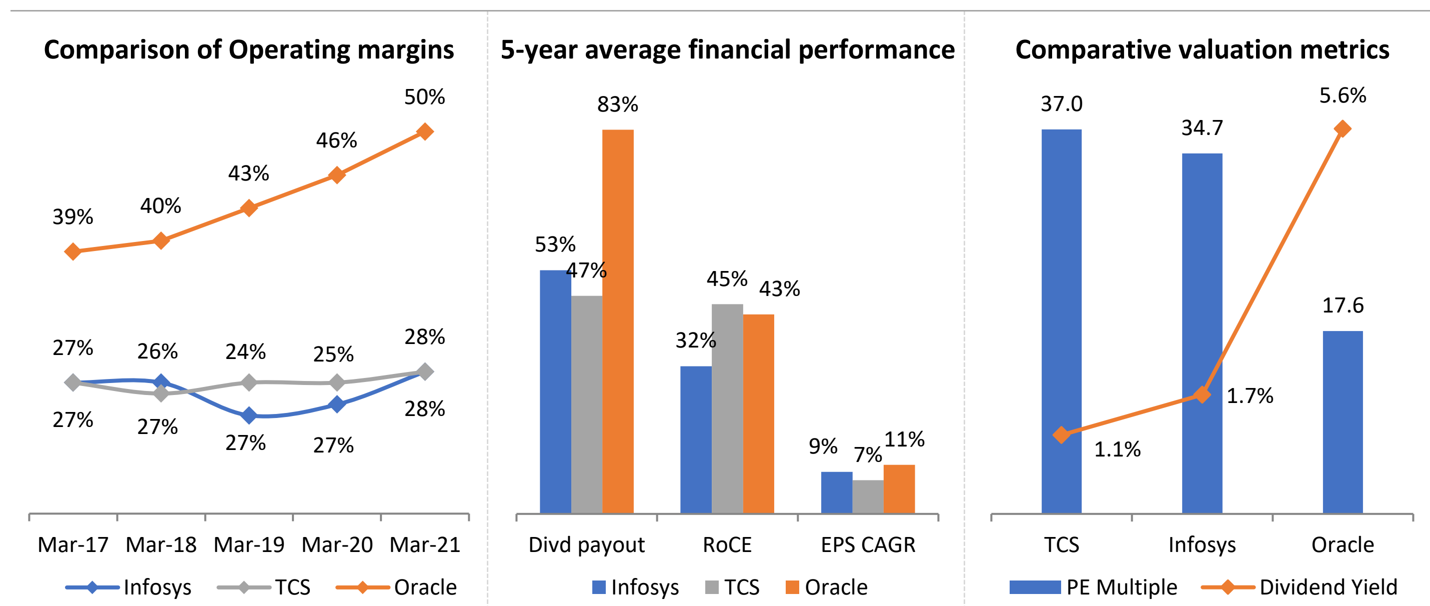
A stock rises in price when the demand for it goes up, and that happens only when many investors/traders begin to believe that the price rise is imminent. Our approach has always been to buy it **BEFORE** the stock achieves such popularity. What is most important, however, is to satisfy ourselves that the business we choose to invest in remains competitive, the balance sheet remains strong, and the long-term prospects are not seriously diminished in any way. It is also important that we, in our impatience to change the portfolio and buy some "stocks on the move", dilute the quality of the portfolio by buying into some eminently avoidable companies.

All too often, the price of a strong company's stock is stagnant for reasons that have nothing to do with the underlying company's innate ability to compete in the marketplace. The stock just gets ignored. Some friends are surprised when we point out that Hindustan Unilever share stagnated for 9 years between June 2000 and June 2009 with a compounded annual growth rate (CAGR return) of -0.69% (not counting dividends). Similarly, the stock of Reliance Industries Ltd gave a CAGR return of -1.41% for an 8-year period between June 2008 and June 2016.

Let us now look at the few companies that are the so-called "laggards" in our portfolio. We wish to share with you our reasons for continuing to remain bullish on them.

Oracle Financial Services Software (OFSS)

OFSS is a 73.2% subsidiary of Oracle of US and is one of the world's leaders in providing core banking and other related software products to the financial services industry. The company has a sterling track record of profitability, and we believe that it is inevitable that continuous modernization of systems keeps happening in the banking industry. Let us look at the comparative data for OFSS and two giants of the Indian IT industry, viz., Infosys and TCS:



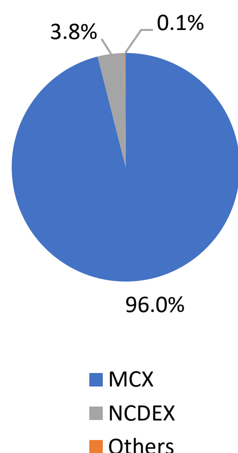
Data source: ACE Equity

These tables reveal that the operating profit margins of OFSS has been much better (5-year average of 43.6% compared to 26.2% for Infosys and 27.0% for TCS). The company has delivered higher earnings growth, has a higher dividend payout ratio, has a comparable Return on Capital to TCS (better than Infosys), **but is trading at a valuation that is just about half that of Infosys, and less than half of TCS**.

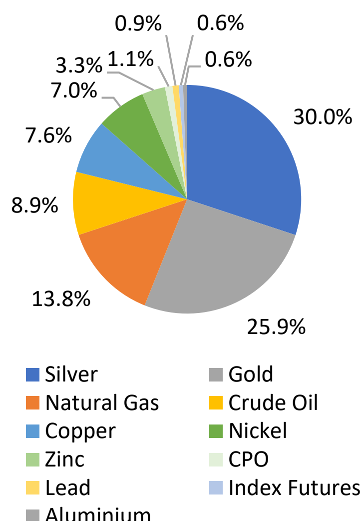
Multi-Commodity Exchange (MCX)

Let us look at (a) the overall market share of the company in commodity derivatives trading (b) the break-up of various commodities that contribute towards MCX's revenues and (c) let us look at the respective market share of MCX within the major commodities that contribute to its sales:

Commodity derivatives market share FY2021



MCX major commodities turnover FY2021



MCX: Market share in key segments FY2021

Commodity Segment	MCX Market Share in Indian Commodity Futures space	Proportion of MCX's turnover
Precious Metals & Stones	99.97%	56.39%
Energy	100%	22.74%
Base Metals	100%	19.61%
Agri Commodities	23.49%	1.26%

Source: www.mcxindia.com

MCX has more than 99.97% market share in commodities that contribute more than 98% of its turnover.

We believe there is a great scope for growth of commodity trading and commodity derivatives in India. Even now, the total trades in commodity futures accounted for only Rs.84 trillion, and this is less than the Rs.149.32 trillion achieved in this country in 2011. Commodity derivatives trading is very likely to grow strongly because of the entry of institutional players in the commodities trading market (Mutual funds, PMSes and more recently FPIs). Also, steps taken in including smaller denomination contracts in bullion, and the permission of Indian Banks to act as professional clearing members should improve the trading volumes further.

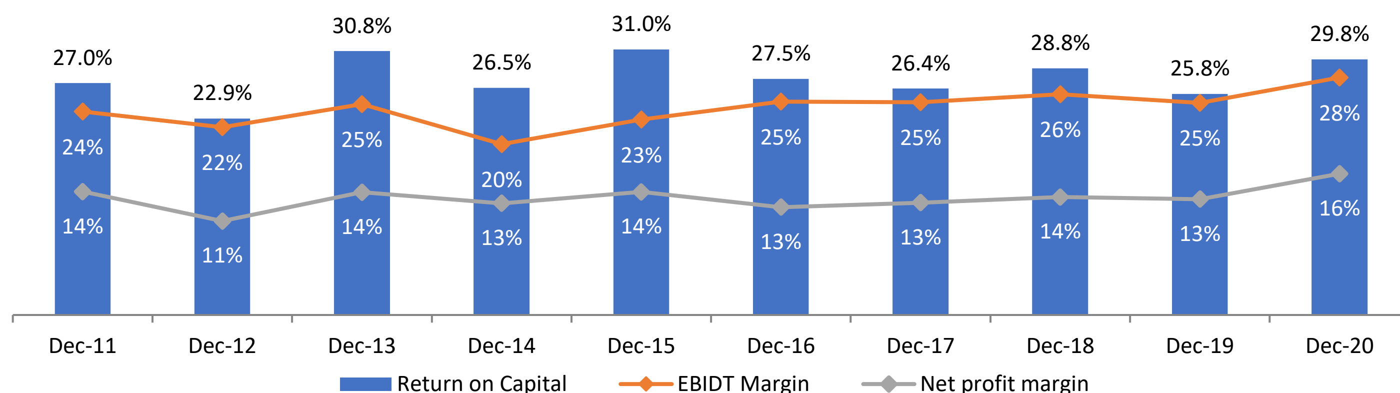
The company has shown a steady improvement in PBIDT margins from 63% three years ago to 75% now. Net profit margins have improved from 41% to 63% during the same period.

A bet on MCX is essentially a bet that commodity trading and commodity derivatives trading would rise in the years to come, and as an overwhelming market leader, MCX should benefit.

Sanofi India Ltd

We like the business model of Sanofi, one of the leaders in chronic therapies of anti-diabetes and cardiovascular diseases. The company has a steady track record, good profitability (10-year average net margin of 13.6% and average Return on Capital of 27.6%), is friendly towards shareholders, and has a good dividend pay-out ratio.

Sanofi India - Profitability indicators



Source: ACE Equity

The company has generated positive free cash flow continuously for the previous two decades and more.

Our pharma sector exposure has one company in (predominantly) chronic therapies, one company in (predominantly) acute therapies, and one speciality generics company.

RITES Ltd.

Our portfolio has an overweight position on Industrials/auto related stocks. This is an extension of our style which buys strong businesses when they are ignored. Just look at the relative weight of industrials/auto stocks in the Nifty 50 Index. They are at a multi-year low:

Nifty 50 Sector Weight

Sector	Dec-02	Dec-07	Dec-12	Dec-17	Jun-19	Dec-20	Jun-21
Auto	5.6%	3.4%	8.8%	10.6%	5.7%	5.4%	5.3%
Capital Goods	3.1%	10.5%	5.9%	3.8%	4.0%	2.6%	2.7%
Cement And Cement Products	2.4%	2.1%	4.2%	1.6%	1.7%	2.2%	2.5%
Consumer	17.9%	3.6%	12.3%	9.2%	10.7%	11.5%	11.1%
Financial Services	11.7%	12.0%	29.5%	35.0%	40.4%	38.8%	37.2%
Health Care	8.3%	2.2%	5.0%	4.0%	2.2%	3.6%	3.6%
Media & Entertainment	1.2%	0.4%	0.0%	0.8%	0.4%	0.0%	0.0%
Metals & Mining	2.9%	9.0%	3.8%	4.5%	3.6%	2.5%	3.6%
Oil & Gas	17.6%	25.4%	12.3%	12.7%	12.1%	12.5%	11.7%
Others	0.9%	2.3%	0.3%	1.5%	1.4%	1.0%	1.4%
Technology	24.2%	9.5%	11.4%	11.4%	13.7%	16.3%	17.4%
Telecommunication	2.6%	11.4%	2.0%	2.4%	1.8%	2.0%	1.8%
Utilities	1.6%	8.2%	4.5%	2.4%	2.3%	1.6%	1.7%
Auto & Capital Goods	8.7%	13.9%	14.7%	14.4%	9.7%	8.0%	8.0%

Source: NSE

There is reason for us to believe that significant investments are lined up in the infrastructure space of roads, railways, airports, and ports. Primarily these will be driven by the government. We have dealt with this issue in detail in our November 2020 newsletter. We request you to please have a glance at that issue.

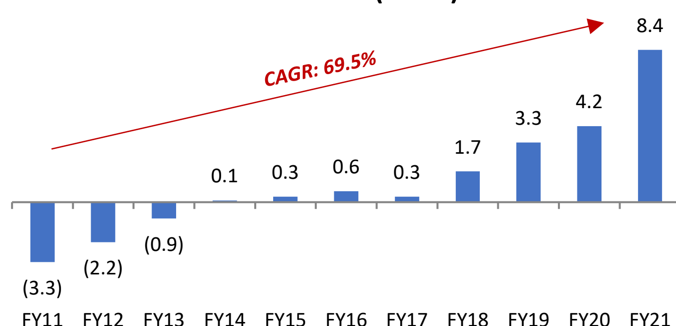
Rites is a company with a steady track record of profitability and cash flows. There are strong reasons to believe that Rites will be one of the primary beneficiaries of an increased capex in the Railways. The stock is still quoting at a low multiple compared to its estimated earnings growth, has a Return on Capital of over 23% and has a dividend yield of over 5.5%

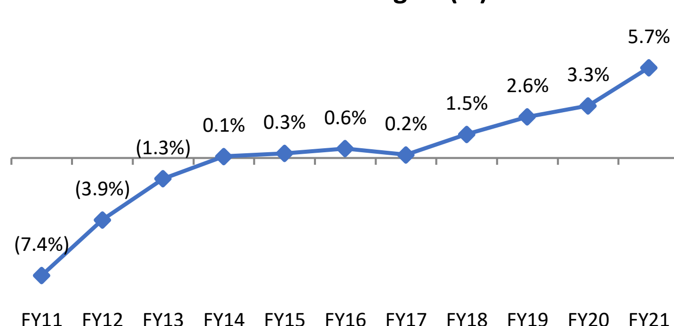
ITC Ltd

We are aware that this company is the butt of several memes and jokes because its share has not moved much for a few years now. We have studied it carefully and we are confident that the price at which it is quoting is far too low for a company of this caliber.

ITC's progress in the non-tobacco FMCG business

From a negative EBIT of Rs.330 crores in FY 2011, the company has traversed to a positive EBIT of Rs.840 crores in FY 2021. In the last five years, the compounded annual growth rate in EBIT (albeit from a low base) has been 69.5%.





Improvement in margins

We do concede that the EBIT margins of ITC's FMCG business have not reached the levels of its more established competitors. However, the trend is certainly encouraging. And we are confident that things can only improve with improved volume growth when the benefits of operating leverage will inevitably kick in.

The company has set up 13 factories for food products and 3 factories for other FMCG products. Consider the following points:

- In many categories, the company has established Rs.1000 crore+ brands in the last few years.
- Its distribution reach extends to all parts of the country. They have also a strong presence in e-commerce platforms.
- The brands are owned by ITC and no royalty is paid.
- Recently, several senior-level lateral entries have come into ITC (including from companies like Britannia, Dabur, HUL and Marico). In our opinion, this is a welcome change.
- After many years, the company has publicly articulated a dividend distribution policy. At least 85% of the net profits of each year will be distributed as dividend. This year it was 100%.

There is a perception that the company scores poorly on ESG parameters. The fact is that in two separate ratings (MSCI and Sustainalytics, ITC scores highly and better than many of its competitors).

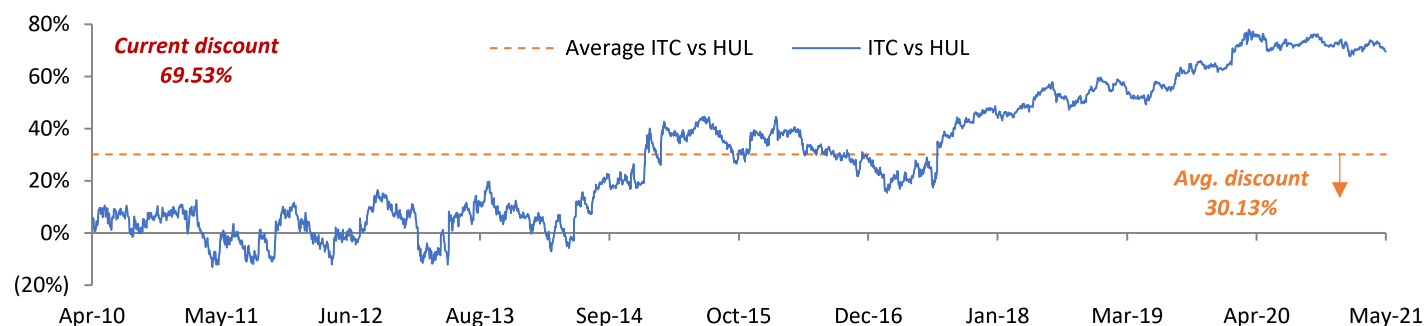
ESG Ratings of Some Prominent Companies

Company	MSCI ESG Rating	Sustainalytics ESG Rating	Score
ITC Ltd	AA	Medium Risk	26.7
Hindustan Unilever Ltd	A	Medium Risk	25.9
Nestle India Ltd	AA	High Risk	30.8
Britannia Industries Ltd	BB	High Risk	31.7
Reliance Industries Ltd	BB	High Risk	35.0
Asian Paints Ltd	AA	High Risk	30.6
Maruti Suzuki Ltd	BB	Medium Risk	25.9
Pidilite Ltd	BB	High Risk	35.0
Bosch Ltd	BBB	Medium Risk	22.6
Ultratech Cement Ltd	B	High Risk	34.1
Tesla Inc	A	High Risk	31.1
Apple Inc	A	Medium Risk	23.6

Sustainalytics - ESG Classification
Score of 0 - 10 - Negligible Risk | Score of 10 - 20 - Low Risk | Score of 20 - 30 - Medium Risk | Score of 30 - 40 - High Risk | Score of 40 + - Severe Risk
MSCI – ESG Classification | AAA – Highest; CCC – Lowest
Data Sources: 1. www.msci.com/esg-rating 2. www.sustainalytics.com/esg-rating

Let us not forget that the company has a zero-debt balance sheet, consistently generates free cash flow, has a consistently high Return on Capital, and to top it all, it quotes at (in our opinion) a ridiculously low valuation.

ITC 1 Year FWD PER Discount vs HUL

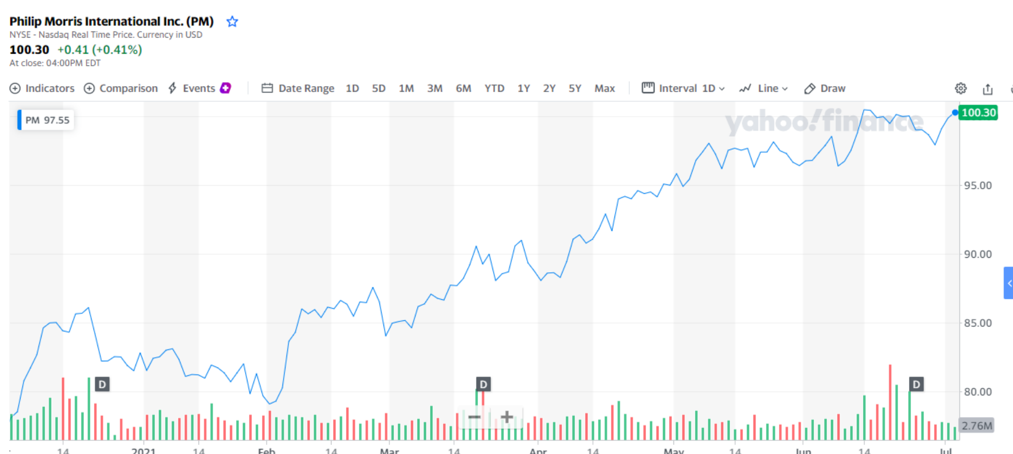


Data sources: Company's website and ACE Equity. Prices updated till May 31, 2021.

Just about 6 years ago, ITC stock traded at a premium to that of HUL. Today it trades at a discount of 70%. The average discount that ITC has traded to HUL (over the last 11 years) has been 30.1%, compared to 69.53% now. In our opinion, this discount is unsustainable.

The movement in Philip Morris stock presents interesting reading. The stock, over the last one year, has returned 42%. The company in its recent presentation has mentioned that 23% of its revenues were "smoke free products" and that includes smoke free cigarettes. In comparison, 62% of ITC's gross revenues in FY 2020-21 were non-tobacco.

1-year stock price movement of Philip Morris



Source: Yahoo Finance

For all those who say that ITC "deserves to trade" at a low valuation, our request is that they just see the fate that HUL suffered between 2004-2009. It was a stock that was shunned and ignored by almost everybody during the boom period of 2005-2007. It is also our request to once again re-visit the opinions expressed about State Bank of India, just over a year ago.

It is also our submission that the best time (or price) to buy into a strong company is when nobody else wants to buy it.

Yours sincerely,

(E A Sundaram)

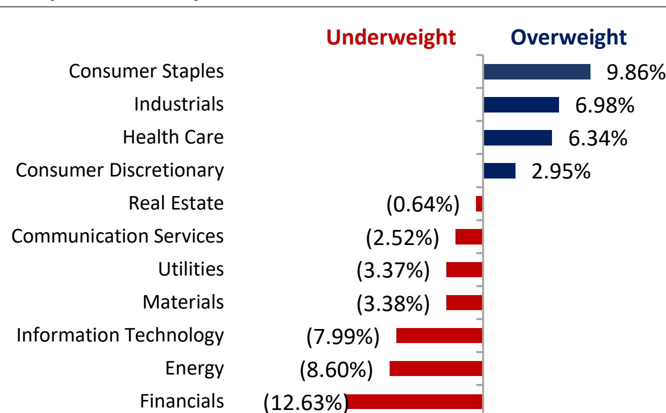
Chief Investment Officer and Portfolio Manager

"If I had to choose a great single fallacy of investing, it's believing that when a stock's price goes up, then you've made a good investment".

- Peter Lynch

Top 10 Holding of o3 Core Value Investment Approach - Regular Option as on 30th June 2021		
Name	**GICS Sector**	**Weight**
ITC	Consumer Staples	5.99%
Oracle Financial Services Software	Information Tech	5.29%
Asian Paints Ltd	Materials	4.77%
Colgate-Palmolive (India)	Consumer Staples	4.24%
Computer Age Management Services	Information Tech	3.99%
HDFC Bank	Financials	3.75%
Sanofi India	Health Care	3.72%
Container Corporation of India	Industrials	3.67%
Cummins India Ltd	Industrials	3.67%
Bosch Ltd	Consumer Discre	3.51%
		42.60%

Overweight / Underweight of Regular Model Portfolio Compared to Nifty 500 as on 30th June 2021



Investment Objective: The investment objective is to achieves capital appreciation through investment in a diversified portfolio of strong businesses, purchased at reasonable valuation.

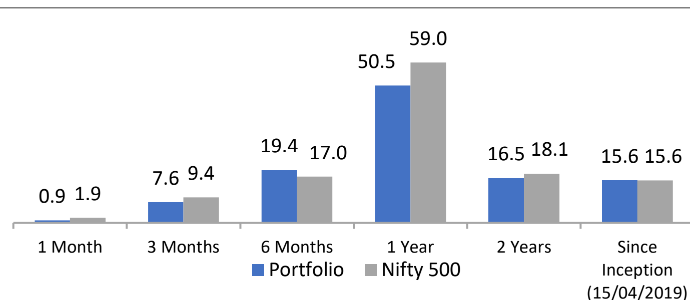
Regular Model Portfolio Details as on 30th June 2021	
Weighted Average ROCE	24.64%
Portfolio PE (1 year forward PE, Based on FY23)	23.80
Portfolio Dividend Yield	1.79%
Average Age of companies	65 Years

Regular Model Portfolio Composition as on 30th June 2021	
Large Cap	42.5%
Midcap	34.0%
Small Cap	10.5%
Cash	13.0%

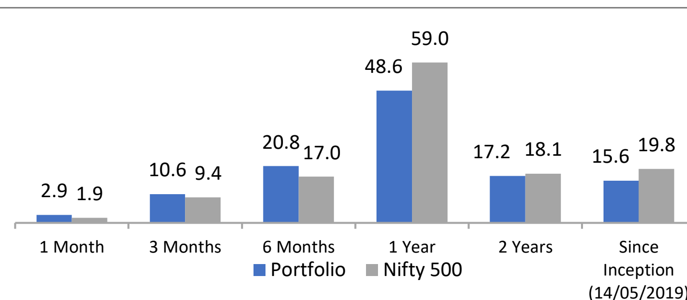
- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on 30th June 2021
- Midcap: Market cap below 100th company to the market cap of the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 30th June 2021
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 30th June 2021

Regular Model Portfolio Composition as on 30th June 2021	
Model Portfolio Overlap with Nifty 500	16.44%
Model Portfolio Overlap with Nifty 50	19.00%

Consolidated Portfolio Performance of o3 Core Value Investment Approach Concentrated Option 30th June 2021



Consolidated Portfolio Performance of o3 Core Value Investment Approach Regular Option 30th June 2021



- Benchmark is Nifty 500, the portfolio is spread across different market capitalization, hence Nifty 500 is chosen as benchmark
- Since inception date stated is considered to be the date on which the first client investment was made under the investment approach

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 (Custody Fee adjustment is pending, the performance may change to it for some basis points). *The performance related information provided here is not verified by SEBI nor has SEBI certified the accuracy or adequacy of the contents of this Document.*

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