Principles, first.

DSP MUTUAL FUND

MARCH 2021

In one of the most iconic movies of the 80s called The Karate Kid, the young protagonist Daniel, comes to Mr. Miyagi to learn martial arts. The master however starts him off on seemingly meaningless chores – like waxing his car (a scene famously called 'wax on, wax off'), sweeping the floor and painting his house. The student is confused, what with no apparent connection between karate and these actions. Later on though, he benefits from repeatedly practising these seemingly basic chores, having built muscle memory and these translating into excellent karate moves!

Surely many of us have also done our fair bit of chores at home (thank you, lockdown) and so what a year we have seen run by. From thinking Covid would not hit India, to going through a lockdown, to many offices still in work from home mode nearly a year later, much has transpired. No, the next line is not going to be on how markets crashed, and then rallied in an 'unpr-------ed' manner, not because that wasn't the truth, but because this was probably the most used and abused word/phrase all year.

What's happened, has happened. But where do we go from here? Many people have written and said everything there is to say on how no one can consistently predict anything. As Amit Trivedi notes in his book Riding the Roller Coaster, *"The only thing I cannot predict is the future"*. The question to us money managers then is, what are we doing with your money? We couldn't predict Covid, or the monstrous rally in the markets thereafter – so where does that leave you and your money?

'In a pretty good place', we hope would be the answer – despite there being many unknowns. In fact, it is precisely in an arena where so much noise and uncertainty exists, that the potential to generate alpha arises. If all was known and set in stone, it would also be priced in leaving little room for upside. And hence, we believe that having and living by a set of principles of investing, can help not just overcome these unknowns, but also achieve excess returns over time. How do we do this? By investing through first principles, i.e. going back to the basics, much like the Karate Kid.

Back to the basics

As Shane Parrish writes in his book The Great Mental Models, *"First principles do not provide a checklist of things that will always be true; our knowledge of the basics changes as we understand more. They are the foundation on which we must build, and this will be different in every situation, but the more we know, the more we can challenge."* This, in a nutshell is what we constantly attempt to do, i.e. to ensure we understand the business models, competitive advantages, profitability drivers and growth drivers of each of our investee companies, and to periodically review and evaluate if those still hold good. The seasons may change, but the place is still the same.

We went back to review our previous notes to you last year. We wrote first in 'C for … Calm' on 20th March 2020[1]. This was just a few days before the Covid market-bottom (Nifty: 7,610) – which we had no clue was coming, of course. Here is a relevant excerpt *"For a long-only investor looking at short term gains, the virus has indeed thrown a spanner in the works. But how about a long-only investor with a horizon of 7-10+ years? Supply chains around the world would get back on track - maybe quickly like China, or over a few quarters at least. A vast majority of corona victims would recover fully, and life would go on. Any demand that appeared to be destroyed, is in effect only delayed. Consumers may defer purchases, and businesses may get hit, but it is unlikely that we are going back to the stone age. We believe the next 3-6 months will give investors a chance to accumulate equities, as the virus related panic settles, businesses get and provide visibility, and the market finds its feet."* Quite prescient - one will agree - even if we didn't fully realize it ourselves at the time.

Subsequently in July 2020[2], when visibility into the future of businesses was hazy, we borrowed an assessment concept called "Vision 20/20" from ophthalmology. This we used to create 3 buckets of companies based on our assessment then on visibility of business model, industry landscape and customer trends. The 15/20 bucket was for those companies with higher

[1]https://dspim.com/docs/default-source/other-updates/c-for-calm---a-note-from-dsp-equity-investments.pdf?sfvrsn=2
[2]https://www.dspim.com/docs/default-source/other-updates/how-we-evaluate-the-future-of-our-investee-businesses.pdf?sfvrsn=2

visibility while the 5/20 bucket had the companies with low visibility. Even then, we did not have a 20/20 bucket, implying we would never have full clarity. However, leaning on first principles helped us. In what way?

For instance, despite 35-50% of our portfolios having companies in the low visibility bucket, we did not make any knee jerk changes. We had categorized banks/lenders into this third bucket expecting that moratoriums and restructuring of assets may not end well, especially given past experiences. But as new data and management commentary kept coming in – each more encouraging than the previous month – we were flexible to change our views. As it stands today, most private lenders would be back in the high visibility bucket, and this is reflected in our portfolios as well.

Game on

All this is not to say that we have not had our share of misses, given how sharply markets have rallied. It has been a very hard time to be a fundamental analyst or fund manager, because it has meant taking on the central banks, foreign investor flows and an army of retail traders, all at once. Sticking to the basics here too, helps. As Morgan Housel writes in Collaborative Fund, *"What you don't realize is that the traders moving the marginal price are playing a totally different game than you were. It happens all the time: if you start taking cues from people playing a different game than you are, you are bound to be fooled and eventually become lost, since different games have different rules and different goals."* We are clear about the game we are playing, which is to create wealth and alpha for our investors in the long run.

Our game though is not an easy one. It is further complicated by the fact that the result of this game will only be known in the future. But you can and should measure us on our thought process and its application, rather than an interim report card subject to the vagaries of near term market noise. Our core investment philosophy across the various fund managers revolves around varying combinations of buying good businesses with quality management, high capital efficiency, low leverage and a price/value mismatch seen over a long timeframe. The two metrics we pay closest attention to are Return on Equity and Earnings Growth. Here are how our funds stack up on these parameters, using our analyst estimates for FY23:

Fund Name	FY23e ROE	Earnings Growth*	FY23e PE	FY23e PB
DSP Flexi Cap Fund	19.2%	19.4%	24.3x	4.2x
DSP Equity Opportunities Fund	16.6%	23.9%	17.7x	2.6x
DSP Focus Fund	18.3%	15.6%	26.1x	4.3x
DSP Mid Cap Fund	18.0%	17.7%	20.3x	3.4x
DSP Small Cap Fund	17.4%	25.0%	13.4x	2.4x
DSP Tax Saver Fund	17.3%	19.5%	16.5x	2.4x
DSP Top 100 Equity Fund	18.6%	17.1%	26.4x	4.2x
DSP Quant Fund	22.7%	15.4%	27.8x	5.2x

Source: Internal, Bloomberg, based on portfolio holdings as on 26 Feb 2021. PE ratio, PB ratio are computed based on harmonic mean. EPS, BPS and ROE are based on internal analyst estimates for FY23. *Earnings growth is based on weighted average of portfolio companies' internal analyst estimates of FY23 over FY22.

While there could be a tendency to look at these metrics in isolation (either growth or valuation or profitability), this has limited value in our view. Why? Because higher valuations are often reflective of higher ROEs and / or earnings growth expectations of the companies in our funds. If these companies hopefully continue to grow and reinvest in their businesses at or above RoE, then today's valuations can be justified (i.e. compounded away). At the same time, lower valuations do not necessarily equate to weak companies – as not everything may reflect entirely in current numbers. For example, we may be investing after sufficient research and conviction that certain companies could be 'turnaround' candidates at an attractive price. To be sure, there certainly exists an element of 'execution' risk, and this is what our analysts keep tracking for each of the companies they cover.

All that glitters

While high ROE and Earnings growth seems like a good combination to have, it is not necessary that such a high quality portfolio will always do well, in the short term especially. One such example is the time since the Pfizer vaccine was announced on 8th November 2020. It is not that long ago, but the Nifty 500 Index is up ~25% since then! How have its constituents done? Here is a simple analysis: Companies were classified into 5 quintiles based on six different parameters viz. revenue growth, EBITDA margin, leverage, ROE, trailing PB and beta. Companies in each quintile were then weighted equally to form its own quintile portfolio, so one portfolio per quintile, per parameter. The performance of these quintiles is tabulated below.

	Top Quintile				Bottom Quintile
Parameters evaluated	Q1	Q2	Q3	Q4	Q5
	Returns (%) of each quintile below, from vaccine announcement till 23th Feb 2021				
Revenue Growth	17.4%	22.2%	30.3%	32.4%	38.2%
EBITDA Margin	21.1%	19.9%	28.1%	35.4%	36.3%
Net Debt to equity	20.1%	23.2%	28.8%	32.4%	36.3%
ROE	16.9%	18.7%	26.3%	32.3%	40.5%
Trailing PB	18.4%	25.5%	24.4%	31.3%	40.7%
Beta	14.8%	24.3%	23.6%	32.7%	46.0%

How to read this table: For the first row, the top 350 companies (ex-financials) were grouped into five quintiles on the basis of their last four quarters revenue growth. The companies with best revenue growth fall into Q1 while the worst go into Q5. However, in terms of performance, in an equally weighted portfolio, Q1 only returned 17.4% versus 38.2% returns for Q5. The exercise was similarly repeated for the other 5 parameters. Source: Bloomberg.

It follows from the above table, that since the first vaccine announcement, it is the bottom quintile that has outperformed. These are companies that had the lowest average revenue growth, lowest EBITDA margin, highest leverage, lowest ROE, lowest valuation and highest beta. This ties in with the broad market narrative that money has moved into 'deep value' and 'cyclicals' – but it does not worry us. Across a few of our funds, keeping the broader market in mind, we may have also moved into some tactical positions in such stocks on the margin.

Sir, market kya lagta hai

The Nifty 50 Index is near all-time highs, and trades at ~30.7x FY21e, ~22.3x FY22e and ~19.3x FY23e PE multiple. These valuations are well above long-term averages, and imply an FY22 EPS growth of ~28% over FY21, and an FY23 EPS growth of ~18% over FY22 on our estimates. Already a number of stocks are pricing in not just FY22 but also FY23 earnings. Yes 'earnings beats' certainly seem to be the flavour of last couple of quarterly earnings seasons, but that is partly because estimates were low to begin with. Since the start of 2020, the Nifty has returned ~23%, while the FY22 consensus EPS has been cut from 731, to a low of 609 in Jul'20, to now up from there to 677 (28th Feb 2021), which is a 7.4% downgrade, implying a gap of ~30%. We saw this movie play out painfully in 2017, where the market rallied in the face of earnings cuts. Hopefully *"this time is different".*

Our analyst team recently undertook a detailed analysis of various sectors and sub-sectors across the market including lending, insurance, white goods, paints, footwear, automobiles and so on. Based on current per-capita GDP for India, and considering what other large economies in the past have achieved based on their own per-capita GDP cycles, the team stitched together a conservative yet plausible growth trajectory at the sub-segment level. As an example, one outcome is that given the relative under-penetration of the categories, footwear, cosmetics, modern grocery retail, ACs and fast food can each grow 12-14% or more in CAGR terms for the next 40-50 years. So the runway for growth in the country exists, at least in many such pockets. However, 40-year DCFs (Discounted Cash Flow) for select companies even within these high-growth sectors, shows there is downside at current prices, rather than upside. This is not to say that we are macro focused – far from it. But such in-depth proprietary work offers us another perspective to view the same set of stocks, especially in fully valued markets which leave little room for companies to err on execution.

If equities are very expensive, is it time to exit the asset class then? Not at all. Rather, it is a reminder that future returns for a fixed set of cash flows from any asset, will be lower than if we could purchase the same asset for a lower price today. This warrants pragmatism more than avoidance. Beyond the overall revenue / profit pool growing, there is also the potential for winners to keep increasing market share. Consolidation across many sectors has accelerated in the last three years, and the table below is a snapshot of this trend. Anecdotally, we are witnessing this even in categories like electrical cables, tiles, batteries, pipes, luggage and grocery retail. This should eventually lead to more pricing power.

Sector	Parameter	Share of	in FY10	in FY17	in FY20	Incremental Share*
Bank Credit	Credit Market Share	Top 6	37.4%	43.2%	48.4%	68.6%
NBFCs – Housing Finance Companies	AUM Share	Top 2	76.0%	70.0%	72.0%	89.5%
Cement	Volume	Top 5	44.0%	48.0%	55.0%	91.0%
Steel	Volume	Top 5	63.0%	65.0%	90.0%	90.0%
Telecom	Revenue Market Share	Top 3	65.2%	66.3%	83.4%	100.0%
Aviation	Available Seat Kms	Top 4	75.0%	77.0%	85.0%	95.0%
Ports - Share of Non-Major Ports	Volume	Top 7	35.0%	42.8%	45.0%	69.3%
General Insurance - Pvt Sector	Gross Domestic Premium	Top 20	42.0%	47.0%	57.0%	74.0%

Source: Spark Capital, Dec 2020; * Incremental share = change in aggregate company numbers divided by change in industry numbers between FY20 v/s FY17

Are there any specific themes we are bullish on? We like some of the private banks, and this is reflected through top holdings in most of our funds. We are also closely watching the demand recovery – and whether this would continue to drive consumption beyond what is just ‘pent up’, currently visible in the autos and white goods space. A pick up in real estate and infra recovery could bode well for cement, home improvement and engineering stocks. Within these segments, we still select stock by stock, unfazed by macro themes.

Change is the only constant

One question we increasingly get asked is – “Are your funds disruption-proof?” This is an excellent question, and we take this risk very seriously. According to a McKinsey report from 2019[3] , the average age of an S&P500 company in 2027 is expected to be only 12 years, down from 83 years in 2000. There are a lot of buzzwords today like AI/big-data/ML/blockchain and more. Are our portfolios prepared to survive such changes? The Indian market doesn’t have (m)any ‘tech’ companies, i.e. most companies here don’t directly sell tech-based products or services – or at least are not publicly listed yet. So our approach is to ensure our portfolio companies have adopted tech effectively and integrated it into their DNA – even if they themselves do not create the next cloud platform or search engine. An interesting take is found in a post on Great-AI companies here[4]. While more relevant to AI, we could repurpose the concept to our investee companies as follows: a) ensure the company has a monopoly on the right type of data, and b) ensure the data is used to solve a specific/niche type of problem.

With this in mind, let’s look at the tech-readiness of some of our holdings. A fertilizer stock we own is a market leader (~70% market share) in its space, and uses soil testing technologies and drones to inform farmers about the right type and timing of fertilizer usage. They have their own retail network where they have data on farmer’s fertilizer usage and this is helping the company cross-sell non-fertilizer products like agro-chemicals, specialty nutrients, and running a platform for renting out agri-equipment. Do they

[3]Link - https://tinyurl.com/1jxyrlco [4]Link - https://tinyurl.com/k4sotjd9

have a monopoly on their data (i.e. farmers + soil knowledge)? Absolutely. And are they able to use it for a specific purpose? Again a yes. Given the limited amount of land India has, its productivity needs to be optimized, and hence the use of fertilizers is critical and cannot be disrupted away in our view, especially with a rising population.

A large NBFC we hold, has 45mn+ customers with 1800+ data points on them for customer profiling. In addition, they have been able to identify another 45mn+ 'prospective' customers where they have collected enough data to be able to make instant credit decisions at the point of sale. A telecom services company we own employs 1500 experts comprising of scientists, mathematicians, engineers and AI experts from globally renowned institutes and companies. The digital assets created by this team include a retailer app used by >1 mn retailers, a customer-facing app with >80 mn users and a music streaming app with >60 mn users among others.

Another company we hold is a premium motorbike manufacturer. They understand their customer like no other, and over the last year have added a unique 'Make your own bike' customization option. Here customers can change the logo, fuel tank design, rear view mirror, seat covers etc. from the app, out of around 500,000 different options. They have also dedicated tech teams working on their bikes providing better stability, lesser vibrations and an improved riding experience.

We own a pizza company. This company knows its customers inside and out (data monopoly: check). While they did away with their 30-minutes or free delivery offer in the US, here in India they not only retained it, but also piloted 20-minutes in select locations! Their ability to use their data on customers means they setup stores in exactly those areas where they can deliver efficiently and fast – something they have done not just for pizzas, but also to pilot new cuisine platforms (solve niche problem: check). Over 98% of their pizzas were ordered online and their app has been downloaded over 51 million times. These are just a few examples. As mentioned above, with the top players consolidating market share across segments, it perhaps follows that only market share and cost leaders are in a position to make the necessary investments in tech so that they remain ahead of the curve. This could indeed be one of the strongest areas of differentiation for these firms. Time will tell, and we are monitoring closely.

First and last

Overall, things are looking good on the economy front, and our fingers are crossed that India will come out of this pandemic much stronger than most countries. A lot of reforms have been undertaken, the Union Budget was pro-investment and schemes such as the PLI (Production Linked Incentive) have got off to a promising start. The Nifty 50 is ~2x of its March bottom, and many optimistic street estimates require picture perfect execution going forward. We certainly hope for the best, but it is easy to get carried away. Given current valuations, we do not think the path to higher returns from here is a straight line. Whether foreign portfolio investors will continue to pump money into India, or what the Fed will do to its balance sheet or where inflation will be in a few years – we have no way of knowing. But we will stick to our companies, to the basics, and to first principles.

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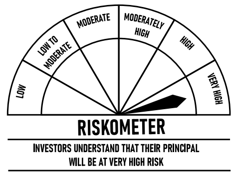
DSP Flexi Cap Fund

Multi Cap Fund- An open ended equity scheme investing across large cap, mid cap, small cap stocks

This Open Ended Scheme is suitable for investors who are seeking*

- Long-term capital growth
- Investment in equity and equity-related securities to form a diversified portfolio

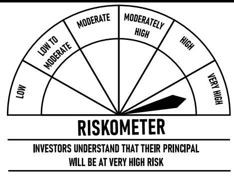


DSP Top 100 Equity Fund

Large Cap Fund- An open ended equity scheme predominantly investing in large cap stocks

This Open Ended Scheme is suitable for investors who are seeking*

- Long-term capital growth
- Investment in equity and equity-related securities predominantly of large cap companies

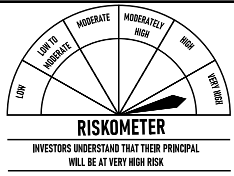


DSP Equity Opportunities Fund

Large & Mid Cap Fund- An open ended equity scheme investing in both large cap and mid cap stocks

This Open Ended Scheme is suitable for investors who are seeking*

- Long-term capital growth
- Investment in equity and equity-related securities predominantly of large and midcap companies



DSP Mid Cap Fund

Mid Cap Fund- An open ended equity scheme predominantly investing in mid cap stocks

This Open Ended Equity Scheme is suitable for investors who are seeking*

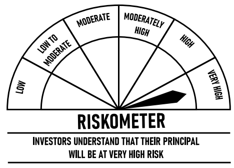
- Long-term capital growth
- Investment in equity and equity-related securities predominantly of midcap companies

DSP Small Cap Fund

Small Cap Fund- An open ended equity scheme predominantly investing in small cap stocks

This Open Ended Equity Scheme is suitable for investors who are seeking*

- Long-term capital growth
- Investment in equity and equity-related securities predominantly of small cap companies (beyond top 250 companies by market capitalization)

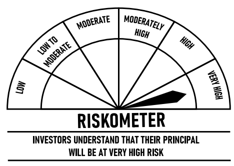


DSP Quant Fund

An Open ended equity Scheme investing based on a quant model theme

This open ended equity Scheme is suitable for investors who are seeking*

- Long term capital growth
- Investment in active portfolio of stocks screened, selected, weighed and rebalanced on the basis of a predefined fundamental factor model

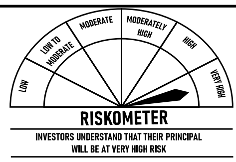


DSP Focus Fund

An open ended equity scheme investing in maximum 30 stocks. The Scheme shall focus on multi cap stocks.

This Open Ended Equity Scheme is suitable for investors who are seeking*

- Long-term capital growth with exposure limited to a maximum of 30 stocks from a multi cap investment universe
- Investment in equity and equity-related securities to form a concentrated portfolio



DSP Tax Saver Fund

An open ended equity linked saving scheme with a statutory lock in of 3 years and tax benefit

This Open Ended Equity Linked Saving Scheme is suitable for investors who are seeking*

- Long-term capital growth with a three-year lock-in
- Investment in equity and equity-related securities to form a diversified portfolio

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