Dear Investors and Shareholders,

I am glad to welcome a couple more investors to Itus Capital this month. I cannot thank you enough for the trust placed in me to manage your equity portfolio.

As mentioned to many of you, I would want to move new investors to the 0 fixed fee structure as I want the flexibility to maintain cash in this market, and opportunistically ramp up the portfolio. Moving to a higher performance fee payout structure, ensures that the investor is not forced to invest at high valuations just so that the manager earns fees through the process. To repeat what I told my two additional investors, I would ramp up the portfolio as and when I see opportunities arise over the next few months, rather than do it over any 'specific' timeline which I have seen many PMS managers do.

Itus Capital was down 0.44% in the month of June, making the YTD returns (Jan – Jun' 17) at 17.6%. A few of my existing investors have asked me to discuss a few themes or stocks I like in todays market. Most investors who know me, would know that I do not like to discuss stocks publicly or to justify my investment, not because of any secrecy reasons, but more so because of commitment bias that it inherently brings in. Effectively, what I mean is, the more I talk about my stock to more number of people, the more I inherently force myself to commit to the position, and my experience with such situations has never been good.

However, its important for me to communicate to my investors and my potential shareholders as to what I am searching for in this market, and some of the sectors I see value in. Readers of my previous letters would be aware of my selective preference for private banks and real estate stocks in the market. In this newsletter, I would like to discuss one such theme that has created significant shareholder wealth over the last 5 years and which I believe will continue to, over the next 5 years.

Demerger for creating value

Investors who have been with equity markets, would know that the previous bull market in India was marked by creation of conglomerates and merging subsidiaries. Effectively companies looked at diversification as a means of expansion and were rewarded for that by cheap access to capital which was rejoiced by the equity investors. However, over time this led to actual destruction of wealth for the shareholders and fatter pay checks for the promoters and senior level executives. Some of the better managed companies were quick to realize their mistake and took action by demerging some of their businesses from their parent which has led to immense shareholder wealth in the last few years, to the extent that going for a demerger has become the flavour of the market now – herd mentality is something which will never leave our system.

Demergers historically, not just in the Indian context but globally have been value creators if done for the right reasons :

a) Freeing up capital for the core business and creating a better capital structure
b) Bringing in a more focussed management for each business area
c) Clear carve out of businesses to be operated seperately

However, there have been numerous cases of demergers being done for the wrong reasons too :

a) Siphoning off capital for the promoter
b) Led by bankers for higher fees
c) 'Chor' promoters trying to reestablish their presence in the market.

As one would be aware, markets tend to and will continue to have a short memory, which means its up to the investor to decipher which of the above scenarios he is faced with when analysing a demerger.

I would want to give a flavour of each of the above so that investors have a point of reference to what they hand they are dealt.

Demergers that have created significant shareholder value over the last 5 years :

i) Crompton Greaves which demerged its consumer products business into a separate company Crompton Greaves Consumer Electrical, have together given a return of 57% since its record date on March 16, 2016.Sensex has gained 14% during this period.

ii) Marico Kaya demerged from parent Marico , gave a 10x return on the investment in the demerged company over a period of 1.5 years since the demerger.

iii) Jindal Stainless after having demerged its 3 business verticals and list the HISAR unit has resulted in a 5x investment in the demerged company over a period of under 2 years.

However not all demergers are created for the right reason and a stand-out example is the demerger of the parent company Mandhana Industries and its subsidiary that's been listed, Mandhana Retail.

While its still early stages since the demerger, to me, this is a stand-out example of a historical wealth destruction exercise from the promoters and I believe this will continue into the demerged entity after the promoters took the parent on the verge of bankruptcy.

(P.S : Mandhana Retail has a sizeable investment from Rakesh Jhunjunwala, so there are a few sophisticated investors, who do believe that , its different this time around).

One of the primary reasons that I discuss the demerger theme, is one of the portfolio companies that Itus Capital is invested in came from a demerger theme that took place in 2016. My hypothesis around the investment, is the company is in the very early stages of wealth creation for the investors, and though the investment is up 60% since purchase, I believe that it has all the elements to create significant shareholder wealth over the next 5 years.

Another demerger theme that I am evaluating is that of a plastic and water tank company. The demerged company is pending listing and the company that is currently trading is the textile company. I continue to do my work on the demerger, but this again has the essential ingredients to be one of the portfolio companies for me.

As mentioned earlier in the letter, I do believe that demergers are going to come through more rapidly in the listed space and its important for the investor to distinguish between those which could be potential value creators and separate them from those that are created because of it being the flavour of the season.

Considering, we are moving to the GST regime this month, no letter is complete without a few words on the same. I do believe that this is a significant move by the government which will have a lot more good than bad over time. Yes the implementation like most things in our country, leaves a lot to be deserved but, don't we all need scope for improvement.

Happy reading

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