Dear Shareholders and Investors,

The Calendar Year (CY21 – Jan to Sep 2021) continues to be a strong year with the fund up 29.5% in the year. This puts our absolute performance of the fund since inception cumulatively at 205.5% beating the index by 90.4% on a cumulative basis. On an annualized basis, the fund has beaten the benchmark by a healthy 9% since inception (IRR). This was our endeavor when we started the fund in 2017, and I believe our process of investing in cash flow growth will ensure consistency in performance as we go further in time too.

The price at which a business is available in the markets has a direct correlation to our perception of the markets. It is only fair to say that the optimism in the Indian markets is at a high alongside the expectations of growth. Looking at the fundamentals - the private capex in many of the old school businesses are picking up (In the last quarter, we saw an estimated capex of INR 50,000 Cr being announced by the 10 largest private sector old-school businesses), consumption demand being robust, wage inflation picking up in pockets and flow of capital being robust. This combined with a low interest rate regime has the ingredients for a long-term sustainable compounding effect on good businesses in India.

However, within this, the markets are driven by the sentiment of the participants and the ingredients above has resulted in laxity in the investing cycle that one sees on the ground. The marginal capital entering the markets today is chasing short term returns and the mindset of the investor has moved on to the 'next trade'. The headlines around China and the negative sentiment in the country seems to have a direct relation to the additional positive sentiment in India which impacts the way an investor looks at risk.

In this letter, we throw further light on some of the above trends after studying the fundamentals of our portfolio. We also cover how capital has been allocated across businesses in our portfolio.

**Portfolio Performance – Yearly Breakdown of Returns since Inception**

| | Fund Return (%) | Benchmark - Nifty 50 (%) | Excess Return (%) |
|---|---|---|---|
| 2021 | 29.5% | 26.0% | 3.5% |
| 2020 | 40.3% | 14.9% | 25.4% |
| 2019 | 17.3% | 12.0% | 5.3% |
| 2018 | -7.3% | 3.2% | -10.5% |
| 2017 | 54.7% | 28.7% | 26.0% |
| **Since Inception ( Cumulative)** | 205.5% | 115.2% | 90.4% |

- The fund has outperformed Nifty by 9% on an IRR basis since inception (Our objective has been to beat Nifty by 6% measured in 5Y Buckets).
- Cumulatively the fund has outperformed the benchmark by 90% (1 Cr invested in the fund would be worth 3.05 Cr Today)

We measure our performance by our consistency – how often does the fund outperform the index during up and down markets – to minimize the drawdowns investors experience.

**Granular breakdown of the fund performance**

| UP MARKETS | | DOWN MARKETS | |
|---|---|---|---|
| **Fund Return** | **Benchmark Nifty Return** | **Fund Return** | **Benchmark Nifty Return** |
| 9.60% | 8.41% | -4.46% | -9.15% |
| | | | |
| Average Alpha | 1.19% | Average Alpha | 4.69% |
| Fund Return | 9.60% | Fund Return | -4.46% |
| Benchmark Return | 8.41% | Benchmark Return | -9.15% |
| Average Alpha | **1.19%** | Average Alpha | **4.69%** |

- Our fund has outperformed Nifty on 8 out of 15 quarters where the benchmark return was positive in the quarter – the average out performance during this *period was 1.19*%
- Our fund has outperformed Nifty on 3 out of 4 quarters where the benchmark return was negative in the quarter – the average outperformance during this *period was 4.69*%

(The above table explains to investors the concept of downside protection the fund has provided during down markets).

**Portfolio Construct**

At Itus, we do not adopt a buy, hold and forget style of investing. Every business goes through cycles, and we would be actively trimming or reducing the holdings where there are structural headwinds or where our framework (centered around GPCG) sees deviation. Effectively, redeployment of capital (akin to running a business, where a CEO has an active role in reinvestment of capital) is an important aspect of our risk management process.

In the quarter, there were three broad trends that emerged in the Indian capital markets:

- Banks being enabled by Fintech players with the credit growth (in the retail loan book) coming from BNPL like schemes. Globally, we have seen this trend play out in the early stages where BNPL accounts for ~2.4% of the US ecommerce payments (Ecommerce as a category is 20% of the total retail sales and growing). Clearly BNPL is in the early stages of growth and will drive retail credit growth in the next few years. Its important that while growth levers are sound, as a prudent investor, we need to monitor the NPAs over time.

- Financialization of the country, becoming more aggressive, seen from the trends in new account openings with brokerage accounts, SIP into mutual funds and retail participation in the equity markets.
- Pricing pressure emerging in pockets in Generic pharma emerging from the US

Our portfolio is positioned across businesses which stand to benefit from the themes and also has very little exposure to the generic side of the business with a US exposure.

## Portfolio Quality

The recent quarter earnings (1QFY22: Mar- Jun quarter) saw our portfolio companies expand margins alongside grow market share. There are multiple industries where the supply chain disruption has caused significant price increases on the input cost side (arising from logistics, container / shipping costs, packaging and raw material price increase across commodities). In the current market, where passing on costs cannot be done by all companies, we saw our portfolio companies grow their gross margins alongside volume expansion.

The below table breakdown the strength of the portfolio alongside the pricing power of the businesses we own alongside the growth we saw in the businesses:

| | Itus 1Q FY22 |
|---|---|
| GP Margin | 51.13% |
| Revenue (YoY growth) | 29.48% |
| PAT (YoY growth) | 32.63% |

Our portfolio companies continue to execute well as their history of converting their profits into cash flows has been robust. This comes through because of a superior balance sheet management where working-capital lock in efficiently managed.

### *Portfolio Discussion*

In the quarter gone by, we made a new addition in many of our portfolios, where we made an investment into Nazara Technologies.

At Nazara, the founder and the management have a vision to build a gaming infrastructure platform in India. They have built this platform predominantly on acquisitions. Under normal circumstances, I would be weary of companies going through growth only through acquisitions, however, the model that Nazara has built has made it unique.

Being an infrastructure streaming platform, Nazara has the ability to work with gaming companies across India (either gaming creators, streamers, developers or real-money gaming companies). This gives the company an insight into who they want to partner with in the long term. Moreover, the structure of acquiring the target companies is with a mix of cash and equity which incentivizes the potential founders of the acquiree to stay on for longer. Today, Nazara has built its business on 3 key verticals – Kidopia, which is their gamified learning platform for kids, Nordwin – which owns the streaming infrastructure for esports and Openplay, which is their recent acquisition in Real Money Gaming.

The management team is building an eco-system around the acquisitions by acquiring companies in the talent acquisition and management space which can potentially build synergies over time. Its important to realize that their foray into Real Money gaming will always have risks from the regulatory front which one needs to face with legal court rulings. Though this is not an immediate risk, considering there was a clearance from the State governments in the South prior to the acquisition, we would position the investment appropriately pricing in the potential downside.

Within our existing portfolio positions, we have been trimming our exposure in HDFC AMC recently. While the business will continue to be the best-in-class brand in the industry (known for its longevity of the fund manager and CIO), the business has lost market share over the last few years. Since Jan 2020, the investment has underperformed in our portfolio, and we did not want to be hasty in our decision-making process (considering we are talking about the most efficient business in the AMC industry – measured by the expense ratio as a % of AUM).

There have been multiple changes made on the management, fund manager side of the business and some of the flagship funds have recovered its performance to become the top performing funds over the last year. However, the loss of market share in the business has been noticeable from an AUM and a wallet share of the SIP business. Considering we have a significant exposure in another AMC, we felt it prudent to trim our position in the business.

**The China+1 Story and Flows**

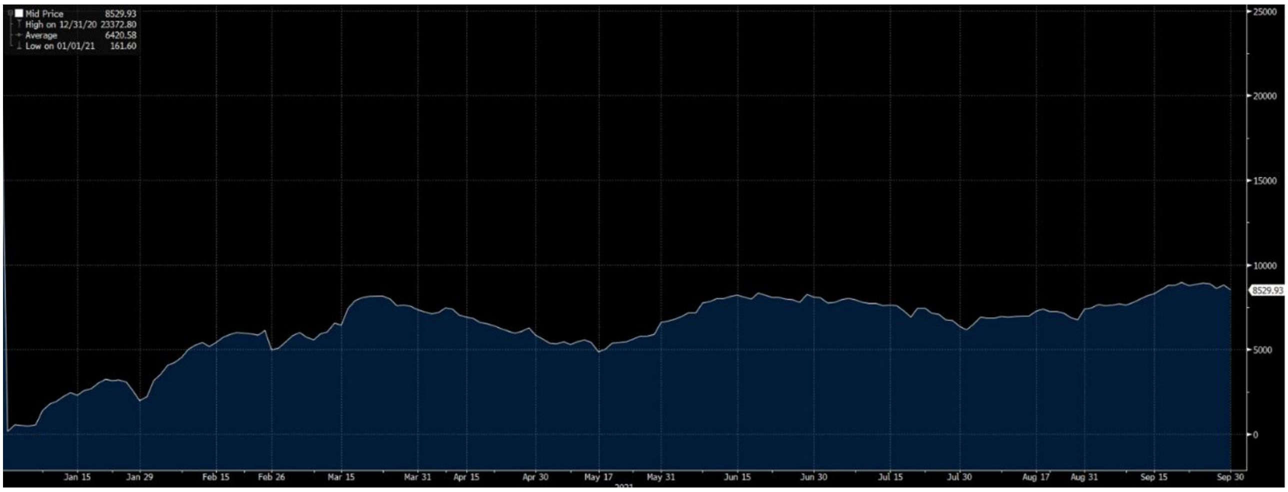
The recent narrative over the last couple of quarters has been that of India being the beneficiary of the global flows because of the sequence of events around China (starting from the edtech ban, centralization of government policy and the shortage of power due to factories shutting down). Its important to distinguish narrative and facts and look at the same in terms of numbers around the flows in India.

**Narrative 1:** India is the biggest beneficiary due to FPI flows due to the new risks seen from China on the ground

Table 1: India Net Foreign Equity Investment YTD ( USD)

*Source : Bloomberg*

The table below shows that the net Inflow into India has not changed materially in the last 6 months.




**Narrative 2**: Foreign Money is leaving China and the additional $ is making its way into India

Table 2: Flows into China and India

Despite the narrative, China has seen the highest inflow in the last 10 years. Indian inflows are robust but that's not at the cost of money leaving China

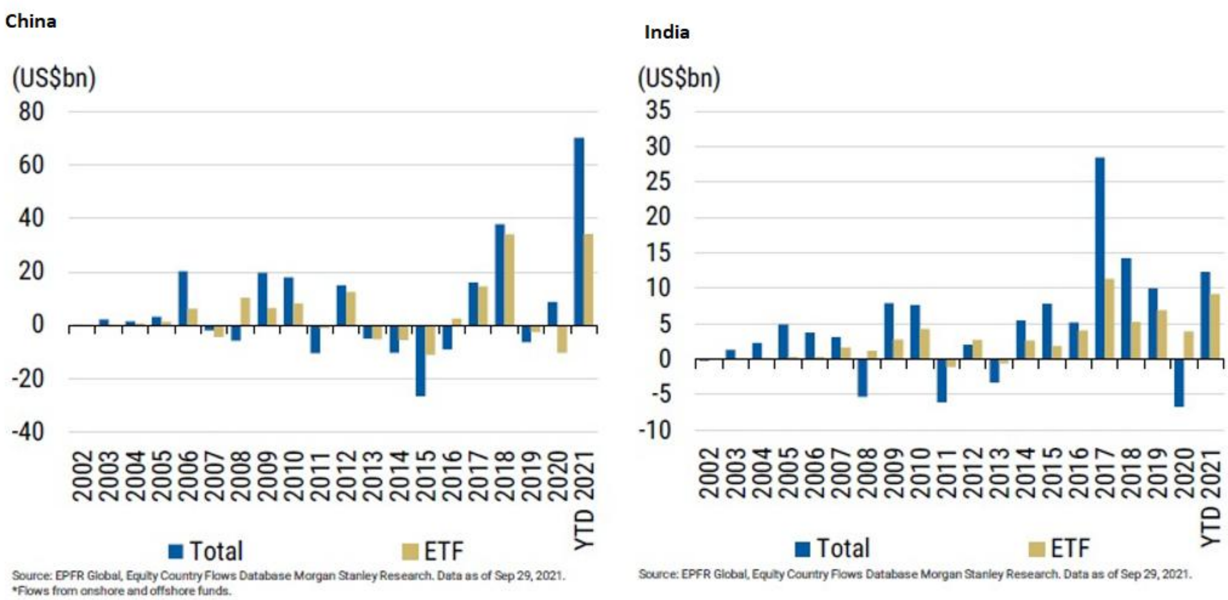
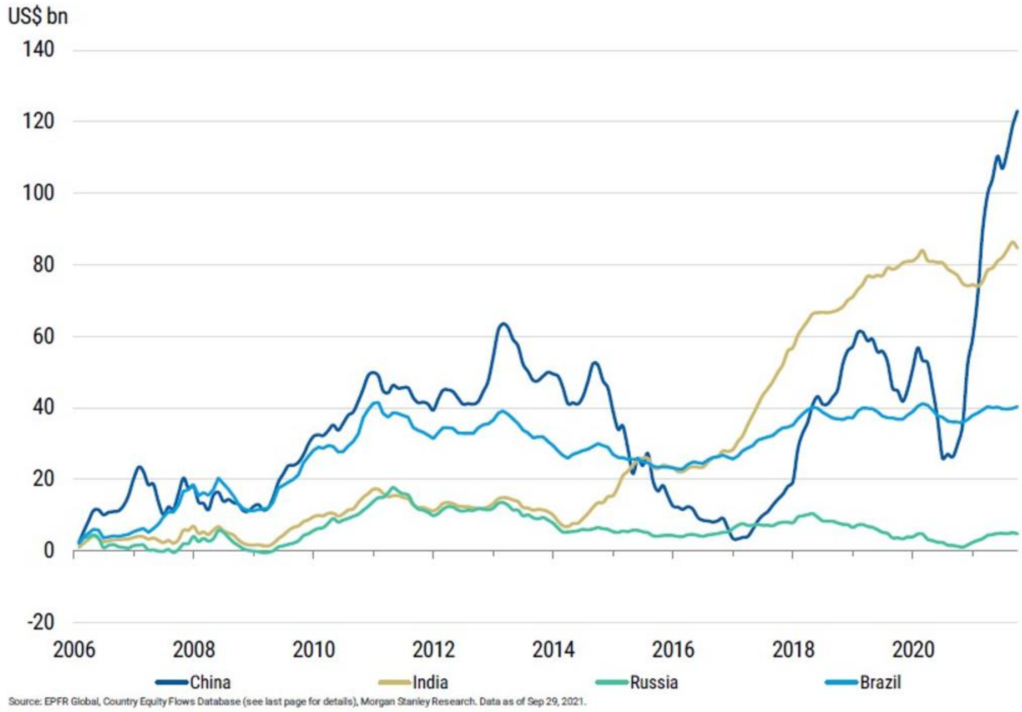


Table 3 : Cumulative Flows since 2006 ( US Bn $) – BRIC




While the flow of money from the marginal FPI buyer has not been as robust as what the media narrative is, the Indian markets continue to be robust and buoyant. This has been driven by the domestic participant (retail and HNI) whose flows into the market has been at an all-time high.

Its important to set the context right around narratives to understand the flows into the market and clarify the same with data.

**New Portfolios Construct**

It is important to spend some time to discuss how we think about deploying new money in the markets today. As supply chains across industries are facing supply side constraints, this adds to the risks on the ground. Its important more than ever to have discipline in the capital deployment process today. At Itus, we do not take market cash calls, but how aggressive we are around deploying capital and buying businesses of our choice depends on the margin of safety we find in the businesses we like.

We do not manage risk with the view that, it is fine to buy good quality businesses at any price and the shareholder returns will compound over the long term (atleast not at the 18-20% IRR we target for investors, with the assumption that Nifty compounds at 10-11% IRR). I do expect to maintain a higher-than-normal cash balance in this market as we look to deploy the capital over time.

**Framing the Risks today**

Its an easy endeavour to look at the markets and be bullish today. However, that's not why our investors look to us for adding value in the investment management business.

In our view, our role is to bring in a disciplined process to the investment management alongside structuring a portfolio which continues to show cash flow growth across time. Over the last 1.5 years, I have been extremely positive the market – this was due to a combination of the investment activity on the ground, the portfolio companies' growth that we saw alongside the sentiment on the ground which showed fear and caution.

Today for the first time, I see laxity in discipline and capital allocation among investors. The conversation quickly revolves around new themes to make money, rather than a focus on fundamentals and cash flow. Today for the first time in 1.5 years I see lack of prudence in capital allocation. While sentiments like this can last longer than one can stay rational, I would take longer than normal to fully allocate capital in new portfolios.

We look forward to speaking with you on our call at **10 am** on **9th October 2021 (Saturday)**

From the desk of the CEO

Naveen Chandramohan