Dear Shareholders and Investors,

The year of re-pricing

The year 2022 has been a pivotal period as a shift in the central bank driven liquidity regime and an increased interest rate environment has created an environment where risk assets need to be repriced. It is during such periods that the fundamental aspects of valuation of the business take precedence over macro factors that determine asset pricing.

At Itus, we had first written about this shift in asset pricing in December 2021 (Source: https://itus-capital.com/long_and_short/diversification-and-us-exposure/), where we had spoken about the US markets entering into a period of structural underperformance over the medium to long-term. I continue to believe that the next period of 3-5 years will be driven by strong EM outperformance over the US (**India and China** being strong beneficiaries) accompanied by USD depreciation (from a currency perspective).

As we end 2022, I aim to look at the Indian markets and comment on our positioning in the fund, alongside our performance.

Evaluating Risk from a 360 bird's eye view

The word 'market return' is associated with the coming together of 3 factors – macro, earnings growth, and valuation.

The word macro is associated through a combination of interest rates, liquidity cycle and government balance sheet strength. While the credit growth in India (for the first time in almost 10 years) has been robust at 15-18% annualized growth, on the back of the bank balance sheet being cleaned up, the government needs to provide excess liquidity in the system today to offset the slower growth from the deposit growth. Moreover, the government balance sheet (accounting for oil prices at USD 75) would require additional borrowing to fund the gap created from FII outflows over the last 6 months. I do not see this change in a hurry today.

Earnings growth in the country has been extremely robust, supported by financials and I expect that to continue into the medium term. Consumer discretionary, Capital goods and manufacturing have shown robust growth over the last year, and this is something I expect to fundamentally support the market today.

While valuation is an outcome that is a function of the market and future growth, today, the room for margin of safety is low. There are 3 sectors that are priced lower than mean valuations – banking, metals, and cement – whereas most of the other sectors reflect the valuations that prices in robust earnings growth.

Combining risk as a function of the 3 factors above, I do believe it is prudent to go into 2023 with higher-than-expected discipline in portfolio construction and deployment. You would find this reflected in a higher-than-average cash balance in the portfolio across clients.

Our Return & Portfolio Profile – Dec 2022

At Itus, our fund has delivered an IRR (Annualized) of 19.9% (net of fees) since inception (Jan 17 – Dec 2022) as against Nifty which has delivered an IRR (Annualized) of 14.14% over the same period. This healthy outperformance of 5.6% (since inception CAGR) is net of fees and expenses. We ended 2022 with a return -2.83% in the year as against Nifty which had a 4.32% over the Calendar year. The detailed performance of our fund is shown below in the table in a granular form:

Table 1: Breakdown of CY returns of the fund vs Nifty 50 on a yearly basis

	Itus Fund (%)	**Benchmark - Nifty 50 (%)**	**Excess Return (%)**
2022	-2.83%	4.32%	-7.14%
2021	29.3%	24.1%	5.2%
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)	*196.4%*	*121.09%*	*75.31%*

This is the second year in the last 6 years of starting the fund, we have seen an underperformance in the fund returns vs the benchmark. We do not run a benchmark-based fund at Itus, which means, we will deviate significantly from the index and sector weights and invest in businesses where we find growth and the ability to grow market share – hence, underperformance during years would be part of the process of investing in Itus. However, one of the key aspects of evaluating underperformance is to understand the fundamental shape of the portfolio and from where it came from.

One of the reasons for a strong performance of Itus since inception has been our process and our philosophy of investing in businesses which have the following characteristics:

a) Ability to generate strong cash flows
b) Promoters / Management teams which reinvest the cash flows into areas which have incremental Returns significantly higher than the cost of capital (typically we look for 1.5x)
c) Businesses which have pricing power that typically lead to market share gains over time.

When we construct portfolios with businesses having the above characteristics, outperformance is an outcome that eventually follows. However, the nature of equity markets has and continues to be such that the returns will not be linear. More importantly, they test your conviction with periods of underperformance like we saw with our fund in 2018 and again in 2022. Its during these periods where our process helps us build more conviction in our thought process to ensure we continue our path of investing and communicate the same to our investors and partners (As a fund, we would want our investors to be adding capital with us when we underperform – the same is explained below).

Today, the cash flow growth of our portfolio companies is growing at a CAGR of 23.1%, which is one of the highest it has been since inception. While it may not be prudent to run this analysis, in the last 1 year (because of the base effect and the growth we have seen over the last 1 year), rebasing the growth of a 2019 base has also seen our portfolio growing the cash flows at a CAGR of 21.8% (annualized). Typically, this should translate into returns if the capital allocation of our portfolio companies is sound.

The RoCE of our portfolio continues to be higher than 20% on a consolidated basis and this has stayed consistent over time. When you combine the above, the return expectations of the portfolio (net of fees) should normalize to this level.

If the consistency in the growth of our portfolio is strong and robust, as highlighted above, why should the portfolio underperform in a year like 2022?

This goes into the last part of the puzzle – valuation, which is a metric determined by the market. Valuations are a number which are backward looking in nature and is an estimate at best. Hence, we always look at this from a risk reward perspective when we look at buying a business. Today, the valuations of our portfolio are ~23% cheaper than what it was in the beginning of 2022.

Should this normalize and does it mean much?

Normalization would happen if the growth in our portfolio continues – at the end of the day, the only aspect the market rewards as shareholders of the business is earnings growth. This goes back to the process of the kind of businesses we invest in (as highlighted above). We saw a similar trend in 2018 and we are seeing the same in 2022.

Outperformance and Underperformance – Why?

While we do not look at the index as a benchmark for investing, one of the aspects of the investing industry which would not change anytime is comparing the returns to the benchmark. With passive investing as an alternative, it is imperative that I as an active manager look at the outperformance, we generate against the low-cost passive benchmark available to investors. Hence, I want to spend some time breaking down the returns of the benchmark, specifically in 2022.

The returns of Nifty in 2022, were driven by the following:

1. Lending Financials and Banks (Private Sector): At Itus, we have reduced our exposure in this space. Our underperformance of 2% contributing from being underweight lenders was a conscious decision on our side purely because of the valuation comfort for future growth we see and the margin of safety we expect for taking this risk.
2. Lending Financials and Banks (Public Sector): The contribution of the index from this space was to the extent of 2.3%

While I have spoken about this earlier, I am not comfortable investing in PSUs purely from the point of capital allocation for future growth. This is a bucket we will continue to stay away from as I see this difficult to stay invested from a long-term perspective.

3. Other PSUs (Oil and Gas, Power, Cyclicals): The contribution of the index from this space was to the extent of 4.4% this year.
   I do not look at this sector as fitting our process of investing in businesses with good capital allocation and reinvestment profile. These businesses do not have characteristics of pricing power, though they could be monopolies as they operate in a regulated market with control from the government.

It is important for me to highlight the kind of risk we would not take so that investors are aware of what kind of businesses they would own as a part of investing in Itus.

Our Portfolio Positioning

There are 5 core sectors our portfolio would be positioned towards from an equity exposure allocation – B2B Manufacturing, Consumer Brands, Niche IT Engineering and Financial Services (Lending and Non-Lending).

We continue to believe the growth of the country into the next leg of growth where the GDP per capita expands will come from various aspects of manufacturing. Studying history, it is anecdotal that a country's path of a typical growth trajectory from USD 2,000 (GDP per capita) to USD 3,000 happens around growth in manufacturing. I expect India to be no different. More importantly, B2B is an extremely long gestation and relationship driven business which gives it sticky characteristics around scale. We would continue to invest in businesses which have developed strong niches which are promoter-run (with a technocrat background) and where the expansion opportunity is predominantly funded through internal accruals.

Looking at our portfolio from a top-down basis, our new additions over the last 6 months have been in consumer discretionary brands across footwear, QSR, Jewelry, Hospitals and Healthcare. We continue to believe that the share of wallet into discretionary brands will increase in segments and businesses which can expand store count (offline) through internal accruals and prudent capital allocation will be significant beneficiaries of this migration. Today, we would want to be a bit prudent on valuations here but would look at increasing our exposure if we get any valuation-based corrections in the interim.

Reviewing the micro

One of our largest portfolio companies' exposures across the fund has been Sumitomo Chemicals. In the previous quarter, there were specific headlines on the company specifically about one of its products which has a 15% contribution to its topline

Background: Sumitomo Chemicals has been our largest position in the portfolio and has fit many of the unique characteristics we look for in a business – ability to generate and grow cash flows consistently, a unique product portfolio with the R&D benefit accruing from the Japanese parent, strong pan-India distribution translating into an expanding margin profile which has helped maintain its pricing power. Its very rarely do we get all these characteristics in a business run by a strong execution driven management team.

One of the primary reasons to write a note on the company today was a government circular that came out (Govt Circular on Glyphosate) would have an impact of glyphosate sales in India. In this note, we go deeper into this and how we think about this risk.

The background behind the circular

Glyphosate is a herbicide which is used by farmers globally especially to remove the weeds in the farmland. Glyphosate has been a product which has been known to have the highest benefits at the best price / efficiency and there has not been a suitable replacement for the product. Globally, Monsanto has had a significant % of its revenues come from Glyphosate which led to Bayer acquiring the company. Glyphosate has made the headlines as there have been allegations of the product causing cancer in humans – while there has been not a single case proven to substantiate this claim. Monsanto has had a total of 200,000 cases registered in the form of suits on the company which Bayer had to take up. While Bayer has settled more than half of them out of court with a settlement, there has not been a single case lost in court which has shown that the product has caused any harm (Bayer Monsanto continue to sell Glyphosate and it accounts for a meaningful % of its revenues even today globally). Moreover, farmers globally want the product due to its efficacy.

What has the Indian Government done through the circular

It is important to highlight that the Indian government has not banned the sale of glyphosate but has mentioned that the sale of glyphosate can be done through PCOs (Pest Control Operators). The government has taken a stance that the farmers cannot spray the drug themselves but would need PCOs to be doing this. The issue with the circular is it puts the onus on PCOs (who are largely unorganized and few) to spray the drug. The farmers and the industry trade body are lobbying against this as it creates a layer of friction for them to access the product when they need it and this may have impact on the sales of Glyphosate in the short term (15% of the sales of Sumitomo Chemicals comes from Glyphosate, and 80% of this comes from the domestic market).

What we are seeing on the ground – As with most, there is confusion on the ground as what this means to the sale of Glyphosate. Each state is taking its nuanced stance on this – for eg: TN has made it clear that glyphosate must be sold through PCOs whereas other states are debating how they can protect the farmers in the interim by working with industry bodies and representing this to the government.

Any precedent to this?

If investors remember the crisis in Sri Lanka, this happened 1.5 years back (or rather started) around the decision of the government to sell and procure only organic food (the government had gone one step further in banning all fertilizers and pesticides). While this was done under pressure from global activists, this had ramifications for the macro on the ground – where the food inflation spiked, the people on the ground could not afford the products and many farmers' income got severely stressed. This was the onset of a crisis that hit their macroeconomic debt and currency.

Today, the government has reversed their stance and not strangely enough removed the ban of glyphosate.

<u>Our View</u>

While the government has come out with a circular which has caused some confusion, the following are our thoughts

- This is not a ban on glyphosate
- This may cause a temporary slowdown in the worst case till each state figures out how they want to react
- The company is working through the solutions vs the various stakeholders
- Finally, I believe that the government will be forced to come out with clarity on the circular.

I continue to believe the market reaction to Sumitomo is an opportunity to add risk and see continued tailwinds for growth of the business over the next 3 years in continuation with the record quarter numbers they came out in the Sep Quarter FY2022-23.

Reviewing the Exits

Fine Organics

Through our holding period, Fine Organics grew its topline and cash flows at a compounded growth of 27.5%. One of the reasons for this high growth of the business came from the quick time the business was able to sweat its capex. The demand cycle for its product continues to be robust and the execution by the management was one of the best. Over the same period, the investment gave us an IRR of 69.1% (weighed average). We expect Fine Organics to continue to grow at a 20% growth rate in an optimistic environment. While the demand cycle for the product (the additives they manufacture) seems robust, we believe the valuations at a 60x multiple for a B2B business reflects the optimism. This was a complete exit across all clients in the fund.

Infosys

Through our holding period, Infosys grew its topline and cash flows at a compounded growth of 18.2%. Over the same period, the investment gave us an IRR of 31.2% (weighed average). We expect Infosys to continue to grow at a 15-16% growth rate in an optimistic environment. Infosys continues to have its growth closely linked to the IT spends from a global perspective and we would not be willing to own this at a multiple of 28-30x (on a trailing basis).

Today, there continue to be risks to the growth rate the management is guiding for especially with global earnings that we believe are optimistically priced and we believe it is prudent to exit the investment at the realized return generated.

Nykaa

Our thesis around NYkaa was predicated in the growth of their BPC (Beauty Products & Cosmetics) which they continue to be India's largest online and offline retailer of. Globally, gross margins at scale operate between 65-80% depending on the scale of the private brand contribution. Nykaa was a market leader in this space, with positive unit economics and running at a Gross Margin of 44% (2.5x the next competitor in India)with adequate scope for expansion coming through their private label brand. While the valuation was expensive, what gave us comfort to build a position was the category, market leadership, ability for the founders to scale the B2b business alongside and a large market. We saw the potential for the BPC category grow the topline 3x in the next 4 years (Nykaa generates Rs 6 of cash flow for every Rs 100 of Average Order value which generates a positive accretive business). Prior to our decision to exit, there were a series of capital allocation decisions and a few exits at the top that made us uncomfortable with the reinvestment decisions and reconsider our holding. Nykaa has been expanding aggressively in ancillary categories including fashion, tying up with athletic leisure sports brands for topline growth (all of these in our mind are margin dilutive). Their expansion has moved away from the core BPC category where our thesis was to building and scaling offline salons which again is not cash accretive to the business in the short term. Moreover, there were a few key exits in the private label category (which we believe should continue to be their highest gross margin category expansion), which was the basis for our investment thesis to play out from a margin expansion perspective. Finally, the board decided to declare a bonus which we find strange as a capital allocation decision. Bonus is generally issued by companies to reward their minority shareholders. Here the company chose to declare one where the stock was down 34% over the last 9 months which we believe is a step to increase the liquidity of the stock and to increase retail participation.

Evaluating the Risk Reward into 2023

As discussed in the first section of the letter, at a time where macro is uncertain and valuations have a low margin of safety, I have been cautious around deploying capital aggressively. Over the last 4 months, the capital invested in Itus has been deployed at ~50%. The capital deployed has been specifically in those companies where we would be looking at increasing our exposure if we do get any market – driven valuation correction.

As I write this letter, I believe there is a non-trivial probability of a valuation-based correction over the next 2 quarters. The reason I make this statement is a combination of liquidity, flows, macro, and the positioning I see in the market. While the market has its way of making a manager look stupid, I believe it is prudent for me to be cautious and maintain discipline today based on the view I have.

Having said that, if I do see a valuation-based correction in the markets, I would use it to aggressively get invested across all client portfolios at Itus.

I continue to be extremely optimistic on the growth of the portfolio companies and the earnings driven cash flow generation over the next 3 years. I want to ensure this optimism is combined with realistic expectations on the returns that I expect at current valuations. As a portfolio manager, I maintain that we at Itus have a dual pronged responsibility

a) Invest in good businesses with durable franchise value that expands over time
b) Invest in the above at the right valuation

Following only one of the above, has and will continue to be sub-optimal for future returns.

We continue to focus on secular trends, diversify across themes, and buy strong companies with robust cash flow generation. We continue to manage risk through position sizing which limits our downside when we are wrong.

We wish you and your families a wonderful new year in 2023. We look forward to speaking with you on our call at 4 PM on the 11th of January 2023.

From the desk of the CEO

Naveen Chandramohan