ITUS CAPITAL

Annual Investor Letter 2023

Dear Shareholders and Investors,

The year of the global bull market

2023 has been a pivotal year for the Indian markets with strong growth across sectors. This has underpinned the strong domestic inflows into the Indian markets that has crossed INR 3L cr (USD 50bn) this year (This compares to the same number at INR 70,000 Cr last year which is ~1/5th of the 2023 number). The Foreign inflows into India has been relatively muted in comparison in 2023 and has been a lot more sporadic (the number being at USD 12bn in 2023).

There are two levers for equity markets' performance – strong earnings growth backed by strong flows (liquidity). We are in one such phase today which has underpinned the returns of the markets this year. I had written about the structural importance of this in our article which can be read here (https://ituscapital.com/articles/fiis-and-flow-of-capital-how-important-will-this-continue-to-be/).

The third leg of any market is the valuation where there is a qualitative aspect to what one may consider cheap or expensive. However, history gives us a perspective on where we are vs mean. It is important to understand that traditional measures of quantifying valuation have meaning only when looked at in conjunction with future growth. The table below gives the breakdown of the last 7 years of Nifty's valuation (measured by trailing PE) alongside the earnings growth the Nifty has seen.

Table 1: Nifty's past valuations compared to the growth rate in earnings of the corresponding year.

	FY17	FY18	FY19	FY20	FY21	FY22	FY23	Dec-23
PE	20.3	20.9	24.3	15.9	20.2	21.7	17.4	19.4
Growth	7.60%	5.80%	7.10%	-1.40%	13.50%	34.20%	10.90%	21%

Measured by history, Nifty continues to trade at the average of the last 15-year mean (in terms of multiples). Moreover, the 1Y forward earnings are expected to grow at 13% from here, which means the multiples would look lower if the earnings growth rate matches expectation.

With this as the background, it is imperative that portfolios are positioned towards the right sectors and companies which can continue to show growth over the next cycle. Benchmarking valuations of Nifty, the market is priced neither expensive or cheap today.

Our Return & Portfolio Profile – Dec 2023

At Itus, our fund has delivered an IRR since inception (Annualized) of 20.62% (net of fees) (Jan 17 – Dec 2023) as against Nifty which has delivered an IRR (Annualized) of 15.11% over the same period. This healthy outperformance of 5.5% (since inception CAGR) is net of fees and expenses. In 2023, the fund generated a return of 25.35% in the year as against Nifty which had a 21.1% over the Calendar year. The detailed performance of our fund is shown below in the table in a granular form:

Table 2: Breakdown of CY returns of the fund vs Nifty 50 on a yearly basis since inception of the fund

	Itus Fund (%)	**Benchmark - Nifty 50 (%)**	**Excess Return (%)**
2023	25.35%	21.13%	4.22%
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)	*271.5%*	*167.8%*	*103.73%*

In 2023, the fund has seen a churn rate of 20% where we have exited a few positions and reduced our exposure in small caps. Some part of the cash generated has been redeployed in select large caps in pharma, power, and capital goods. We continue to maintain cash across portfolios and be prudent around deployment.

The portfolio has shown a strong growth in earnings in the last year, with the last year's cash flow growing at 19.2% on a portfolio basis. The Return on capital has been consistent at 21% and we expect this trend to continue within the portfolio. 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 – with this regard, the portfolio continues to be underweight financials.

Our Portfolio Positioning

Over the last year, the core sectors our portfolio has been positioned in have not changed significantly. We increased our exposure to power generators (on the supply side) where we continue to believe the demand will outstrip supply and where additional reinvestment continues to go into expanding capacity in renewables. This is a theme that we continue to like from a structural perspective where we would like to increase our exposure from the current levels, though at the right valuations.

One of the questions asked most often in connection with our running non-model portfolios and maintaining cash is "Are we timing the market?" – and hence "why did you do it?"

The answer goes back to why we created Itus as an investment house when we started the fund in 2017 - is that we concluded we had an opportunity to create our own investment management firm, all of which would run our way, according to our philosophies, beliefs, and standards.

So, what do we mean when we say, "our way?"

Well, an article about sports in the April 2 New York Times Sunday Magazine provided an excellent metaphor through which to illustrate the point. In it, the author wrote Babe Ruth that he represented.

> . . . The Credo of the Home Run: A man can never be faulted, even if he's wrong, for the bold, aggressive action in pursuit of victory; a real man must be willing to strike out, to go down swinging.

I believe this is the way much of the investment world thinks, but it's the opposite of what we believe in. Many investment managers who run small cap funds have commented widely on the fact of accepting volatility as par for the course to invest in small caps which effectively goes back to the investment credo - "If you want to be in the top 5% of money managers, you have to be willing to be in the bottom 5%, too."

"Our way" is never to tolerate poor performance, and certainly not to consider it an acceptable side-effect of swinging for the fences. While we strive for consistency, our philosophy mandates that we put the greatest emphasis on trying to avoid losing our clients' money.

And that brings me to what I feel is a much more appealing sports metaphor, which I clipped from the Wall Street Journal in 1992: the story of golfer Tom Kite. The article was about Kite's having won a major tournament, but the part that interested me dealt with his record up to that time:

> The bespectacled 42-year-old had won ... over the past 20 seasons some $7.2 million in official prize money, more than any other golfer -- ever. But [he had never before won] one of the sport's "majors" (the U.S. and British Opens, Masters and PGA Championship).

That's the way we think it should be done - by consistently looking at outperformance, but with no need for headline-grabbing victories of trying to be the best return fund on any given year. What we think matters isn't whether you hit a home run or win the master’s on any given day, but rather what your long-term batting average is.

To maintain consistency our approach has always been to be patient in searching for opportunities where valuations are in your favour, investing behind good to great capital allocators who are focused on incrementally increasing the return on invested capital and in the process maintaining or growing margins. As you can imagine, these are not daily, or monthly events and we do not mind being patient to search for these as we take time to get ourselves fully deployed.

Our response on this subject is simple:

(1) We accept that while we have strong views, we will be flexible to change it as the world changes

(2) It is for this reason that we invest in inefficient markets where specialization, skill and hard work can add value and lead to above-average performance over time – with valuation comfort being an essential ingredient for this

(3) Lastly, we feel that because we're not clairvoyant, it's important to acknowledge our limitations and put the highest priority on avoiding losses, not executing bold strategies where we sacrifice liquidity.

Our holding cash at any given time is not related to timing the markets but our “game plan” being directed towards avoiding strikeouts and not looking at maximizing short term returns. Instead, it is with the approach of building a strong batting average with time, and not at hitting a few home runs.

Position Sizing and framework:

In the thrilling world of investing, where headlines scream about soaring returns and daring plays, a crucial element often gets relegated to the sidelines: position sizing. While captivating trade ideas and market predictions grab the spotlight, it's this silent, behind-the-scenes player that can truly make or break your portfolio. At Itus, position size of any investment is based on several characteristics and upsizing/downsizing is a journey with evolves with changing business dynamics and external factors.

We all have heard about the circle of competence and why it is important. The inverse of the circle of competence is the circle of ignorance. What it means is that, despite investing in things that we only know, the planned outcome may not be in line with expectation. For example, Warren Buffett who’s been renowned to pick financial stocks well, still went wrong in his bet in the Irish Banks and similarly he read IBMs annual report for over 50 years and believed he understood the business well, but the growth didn’t play out as he visualised. Hence, allocation/weights are the bridge between circle of competence and circle of ignorance. Today, we highlight the characteristics we look out for while taking different position sizes.

Our position size is a function of the growth visibility of the company alongside valuation comfort that the investment is available at. As one can imagine, very rarely do you get both aligned – but its only during such times, would we concentrate holdings (15-18 investments). Otherwise, our portfolio would be a mix of 25-30 investments at any point in time.

A starter investment is one where we are building our thesis over time. We have initial signs of the company's growth and execution to back this growth. The execution to continue could be a variable and we would want to size up this position over time depending on capital allocation and competition. Such companies would merit a starter position (between 2.5-3.5% typically)

Many companies would have an allocation between 4-6% over time. These could either be scaled into depending on execution or companies where growth visibility is stronger and slightly more structural.

The final bucket would be businesses having 8-10% weights. These would be few and far between but would need to have growth visibility align with valuation comfort. There are certain characteristics we look for in such businesses (like gross margin protection and limited competition too). These companies have the ability to protect margins in a protracted down cycle and grow it in upcycle and have great efficiency in cost of capital employed. Most importantly, the downside is limited if we get it wrong.

Hence, while we invest in companies which are growing their free cashflows and back promoters with strong capital allocation and corporate governance practices, the portfolio sizing and allocation helps maintain discipline, protect downside and building a long-term portfolio.

Reviewing the micro

In this letter, I would like to review two of our positions, one in a sector where we are underweight, but where we took an exposure in a non-consensus bank and we continued to add exposure in the year, which gave us the best return in the banking sector stocks this year. The other where we made an investment in the power sector and explaining our rationale on the same.

IndusInd Bank

The thesis around the position was driven around the stability of the management (led by Sumant's leadership and how he had transformed the retail franchise of the institution from the time he had taken over. The focus on retail (excl. housing) and microfinance was a significant lever for growth over the next 3-5 years and the loan book growth of ~20% was executing well.

The other major lever for growth is on MSME loans. MSMEs are growing at >30% growth rate in the country, on the back of increasing domestic demand. However, given the high growth rate in MSMEs coming off a low 4-year cycle, I had expected this to follow through to loan book growth in the segment for IndusInd. The reason I justify this is spends/card for IndusInd is far higher in card spends than other banks. Catering to and being the preferred choice of small business and premium card category. They are better positioned to make the best of this tailwind.

The bank was available at a trailing multiple (of P/B) of ~1.2 when we bought the position. We were pricing in a 25% IRR on the position over the next 4 years in the base case.

As we end the year, the bank has continued to show a strong growth on their loan book and we expect the investment to continue to show strong growth in the current capex cycle.

NTPC:

Our investments in NTPC have been shaped by data we have seen on the ground. Between 2007 and 2017, the increase of capacity kept pace with the annual growth in demand for energy at about 8%. The government's target to reduce emissions and reach renewable capacity to 500 GW by 2030 has come at the expense of minimal thermal power capacity expansion since 2017.
As a result, consumption growth has surpassed capacity addition, resulting in shortages during periods of high demand. To elucidate, February 2023 had a 9 GW shortfall in produced electricity vs demand.

Installed Capacity	***FY07***	***FY12***	***FY17***	***FY23***
Thermal (GW)	*86.0*	*131.6*	*218.3*	*237.3*
growth % (cagr)		*8.9%*	*10.7%*	*1.4%*
Renewables (GW)	*42.4*	*63.5*	*101.1*	*172.0*
growth % (cagr)		*8.4%*	*9.8%*	*9.3%*
Total Installed Capacity (GW)	***132.3***	***199.9***	***326.8***	***416.1***
growth % (cagr)		*8.6%*	*10.3%*	*4.1%*

Exhibit 1: Installed Power Generation Capacity in India and growth

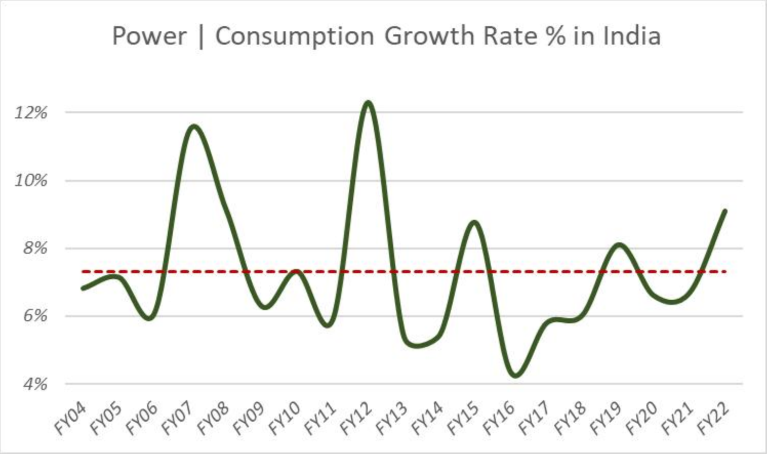

Exhibit 2: Power Consumption Growth in India in last 20Y

The pace of renewable power capex has not picked up significantly to match the demand. Today, Solar is only 7% of installed power capacity in India. This has led to thermal plant load factor increasing from ~57% in 2018 to ~68% in 2023.

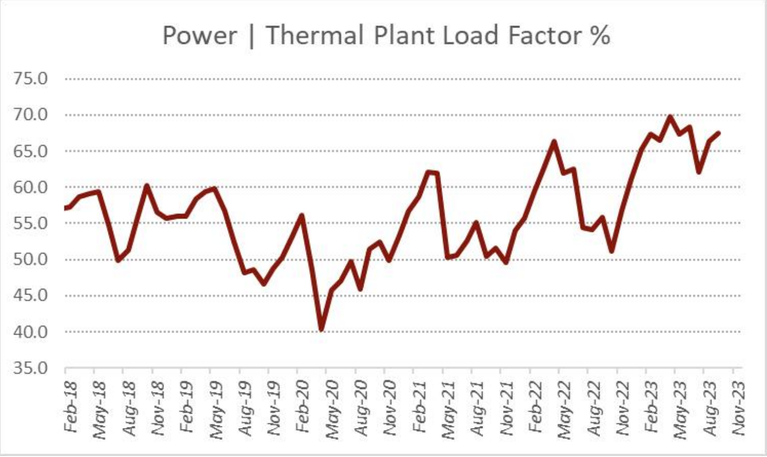

Exhibit 3: Power Consumption Growth in India in last 20Y

Our investment in NTPC is an extension of the trend we highlighted in the power sector and is supported by new capacity expansion in the thermal and renewable energy that is ongoing/expected.

Given the limited downside, we do not expect further de-rating from here

i. Electricity prices will be unlikely to decline in next 6 months
(Coal shortage despite Coal India capex which would take time + govt. asking power gens to buy international coal)

ii. Mismatch in demand and supply growth in India will ensure NTPC's electricity volume generation should not decline

Evaluating the Risk Reward into 2024

As discussed in the first section of the letter, at a time when valuations are neither cheap nor expensive, I have been looking at trimming risk in pockets where we believe returns have been more front ended in some of our investments. We are confident in the continuation of the strong growth our portfolio continues to show today from a longer-term perspective but want to be cognizant of the liquidity environment we are in today, from a global perspective.

Fig 1: Investor money on the sidelines in US Money Market funds (as central banks continue to print more money)

While the liquidity in the global markets is at levels, never seen before, and the Fed can continue to print more money (by expanding its balance sheet) or be monetarily less prudent by cutting rates aggressively, we would want to be mindful of the risks we take in the market.

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 and position ourselves in pockets of future growth. We continue to manage risk through position sizing. To illustrate, we have attached a summary of how we are positioned today across sectors along with brief comments on the same.

Name	Sector	Position	Weight	Comments
Maruti Suzuki India Ltd. Suprajit Engineering Ltd. RACL Geartech Ltd. *Others* **Total**	***Auto & Auto Components***	*Overweight*	**22.4%**	*Strong OEM volume growth in PVs and M&HCVs; bodes well for ancillaries.*
Syngene International Ltd. Dr. Reddys Laboratories Ltd. Indoco Remedies Ltd. **Total**	***Healthcare***	*Overweight*	**9.5%**	*CDMO focus: strong growth outlook benefitting from low-cost manufacturing*
RHI Magnesita Ltd. AIA Engineering Ltd. ABB India Ltd. Bharat Forge Ltd. **Total**	***Capital Goods***	*Overweight*	**9.5%**	*Good outlook for capex. Supportive policies, operating leverage*
HDFC Bank Ltd. IndusInd Bank Ltd. **Total**	***Banks***	*Underweight*	**8.0%**	*Bottoms-up outlook on lending growth*
L&T Technology Services Ltd. HCL Technologies Ltd. CE Info Systems Ltd. **Total**	***IT***	*Underweight*	**7.0%**	*Focus on ER&D and differentiated IT companies*
Indian Energy Exchange Ltd. NTPC Ltd. **Total**	***Power***	*Neutral*	**6.5%**	*Growing power consumption trend; thermal generation capacity increase*
Sumitomo Chemical India Ltd. **Total**	***Chemicals***	*Overweight*	**5.0%**	*Strong parentage; expect recovery over next 6-12 months.*
HDFC Life Insurance Co Ltd. ICICI Lombard General Insurance Company Ltd. **Total**	***Insurance***	*Overweight*	**4.5%**	*Low penetration of financial products; good growth prospects*
Jubilant FoodWorks Ltd. Titan Company Ltd. **Total**	***Consumer Discretionary***	*Overweight*	**4.0%**	*With rishing disposable income, we expect growing retail consumption.*
Ahluwalia Contracts (India) Ltd. **Total**	***Construction & Realty***	*Neutral*	**3.6%**	*Strong infra spends by Centre and State governments*
Cera Sanitaryware Ltd. **Total**	***Building Materials***	*Overweight*	**3.5%**	*Healthy Unit sales across real-estate developers; Should lead to volume growth.*
Computer Age Management Services Ltd. **Total**	***Financial Services***	*Neutral*	**1.5%**	*Growing financialisation in the country*

Note: *The sum of above weights would not total up to 100%; remaining would be our cash holdings.*

We wish you and your families a wonderful new year in 2024. We look forward to speaking with you on our call at **9 AM on the 13th of January 2024.**

From the desk of the CEO
Naveen Chandramohan

Risk Factors and Disclaimer

Risk arising from the investment objective, investment strategy and asset allocation.

Equities as an asset class carry a higher risk in comparison to debt. While risk cannot be totally eliminated, it can be mitigated through a well designed investment strategy. ITUS Capital seek to mitigate risk and deliver superior returns through research-based investing. However, this objective may not be fully achieved due to various reasons such as unfavourable market movements, misjudgement by portfolio manager, adverse political or economic developments etc. The PMS is run with an objective to achieve reasonable returns consistently. Given this background the investor investing in the PMS faces the following risks

i. Political, Economic and / or Related Risks

The Asset Value of the portfolio and the liquidity of the shares may be affected by changes in government policy, taxation, interest rates, social and religious instability and political, economic or other developments in or affecting India.

ii. Industry Risk

The value of shares of companies in a particular industry may be affected due to factors affecting the industry like changes in government policy on duties, FDI or a foreign country, which is a big market for the industry, may impose restrictions on import etc.

iii. The Indian Securities Market

The Indian stock markets in the past experienced substantial price volatility and no assurance can be given that such volatility will not occur in future. Actual market trend may be in variance with anticipated trends hence, the decisions of the Portfolio Manager may not be always profitable.

iv. Liquidity Risk

Some stocks that the investor might be invested in might not be highly liquid. Though it will be the PMS service providers endeavour to restrict investments in less liquid stocks to a lower limit, there is an exposure of liquidity risk to the investor

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