Dear Investor,

The trying times that characterised the first half of fiscal year 2020 have strongly continued into quarter three. Whatever ailments the Indian economy faces have persisted, and much to the dismay of market commentators the quick reversion back to normalcy after a ‘cyclical slowdown’ has proven evasive. Client portfolio returns have continued to be flat with average returns for FY2020Q2 at XXX. The level of cash awaiting deployment is still abnormally high at XX%. On the bright side, prospective returns are increasing and the universe of investable companies continues to expand.

[portfolio performance goes here]

Some clients may have observed the positive headlines revering the booming Indian stock market that are in stark contrast to portfolio performance and the health of the slowing Indian economy. This ‘flight to quality’ conundrum is frankly quite baffling and bears little resemblance to any market events of the last few decades.

For an Indian investor the sequence of events since demonetisation in 2016 have undoubtedly soured their market perception. The haphazard introduction and persisting distortions of the Goods and Services Tax from 2017, the collapse of NBFC lending in 2018, civil unrest, accounting frauds and stagnant credit markets in 2019, and the collapse of YES Bank and (likely collapse) of Vodafone in 2020 have all made the stock market a very risky place for business.

It is then very rational course of action for domestic and international institutional investors with a mandate/imperative to remain fully invested, who further have to deal with the global trend of higher allocations to equity, to concentrate their investments in the 50 largest companies in India. Once this “Nifty” flywheel gets going it is no longer rational for these investors to part ways with the herd. Add to this the inherent business strength of India’s largest companies (they have after all reached their size and scale due to formidable competitive advantages) and

the current flight to quality phenomenon becomes more understandable, at least in retrospect.

The result of this logic is the extreme divergence of valuation between large companies and small companies we see today in the stock market. Regardless of the valuation, it does not require a stretch of the imagination for investors to justify paying 100 times earnings for a blue-chip company like D-Mart that has the lowest overheads in the retail business, lowest priced products, and everlasting industry tailwinds behind it. Another market darling, HDFC Asset Management Company, has the gargantuan trend of financialisation driving money into its coffers, and also has the patronage of perhaps the best cross-selling operation in the world that is HDFC Bank.

With these giants of industry available, why should small capitalisation companies, beset by their own plethora of problems, receive any attention?

Any discussion of the performance of India's large capitalisation stocks is incomplete without mention of foreign investors, the primary driving force that owns more than 25% (?) of the Nifty 50. Even with a structurally slowing economy, India represents an attractive investment for foreign institutional investors that are awash in liquidity. It is immensely telling that the world's most expensive bank, HDFC bank, is 75% foreign owned.

An interesting tangent to this is the goings on of the venture capital industry. Buoyed by surplus liquidity VC assets under management have exploded, as have the valuations of their 'startup' investments. The recent debacle with SoftBank sponsored WeWork is just the latest example of the bubble that some market participants live in. Just as the key determinant of value for a public market investment is the adjudged terminal value, so too are startup companies valued on the basis of their long-run going concern value. Estimating the terminal value of a company is a process that is fraught with uncertainty, yet can be exploited by venture capital firms whose private market playground does not have the same disciplinary force that public market investors must reckon with.

To be sure, venture capitalists must eventually be able to sell their portfolio companies to public market investors should they choose to exit their investment in this way. In the case of companies like Uber, Lyft, Peloton and WeWork this led to disastrous consequences. WeWork's failed IPO laid bare the pricing game venture capitalists play, having had to write down its value from $47 billion to $8 billion(?). Note that private market investors' job is to *price* their companies in a way that is acceptable to their peers, while public market investors must *value* their companies in a way that is consistent with reality.

This digression into the realm of venture capital investors is another example of the games that institutional investors play, laying bare their institutional imperatives. Public markets too can be swayed by investors playing with other peoples' money. For small investors like Cycas, the first rule of the game is clear: *caveat emptor.*

Given the breed of crony capitalism that flourishes in India, *caveat emptor* applies to just about anyone. Stakeholders of the recently bankrupt PMC Bank, depositors of DHFL, customers of real estate developers and investors in debt markets are just some of the market participants who would do well be treading the cautious path. Even companies like Vodafone should have been careful being buying into the Indian growth story.

In times like these value investors must start increasing exposure to equities. The doom and gloom situation that has persisted for the last several quarters cannot last forever and reversion to the mean is certainly on the horizon. It is only a question of when, and of how much more pain awaits. Even as I have serious reservations about the policy-making ability of the current government, it must not be forgotten that they are doing *something.* Eventually, in a capitalist country like India, growth will find a way. Where this growth may come from is the crucial question; there is no doubt that India's largest companies will continue to grow but there is also no doubt that small companies too will rise to the challenge.

As with last quarter, Cycas' strategy going forward will still be to *move forward, with caution,* investing in companies that are available at bargain prices with strong tailwinds behind them and strong balance sheets beneath them.

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