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White Whale North Star Portfolio – 1Q FY24 Quarterly Letter

Dear Partners,

Greetings from White Whale Partners.

Portfolio Performance

The portfolio delivered healthy absolute and relative returns for the quarter. For the quarter ended June 2023, the portfolio was up 14.7%, compared to Nifty 50 TRI that was up 11.1%. For the last 12 months, our portfolio was up 22.0% compared to Nifty 50 TRI which was up 22.9%. Since inception, the portfolio is up 51.9% on absolute basis [(1)], compared to 56.6% for the Nifty 50 TRI. On an annualized basis, the portfolio is up 17.1%, compared to 18.4% for the Nifty 50 TRI.

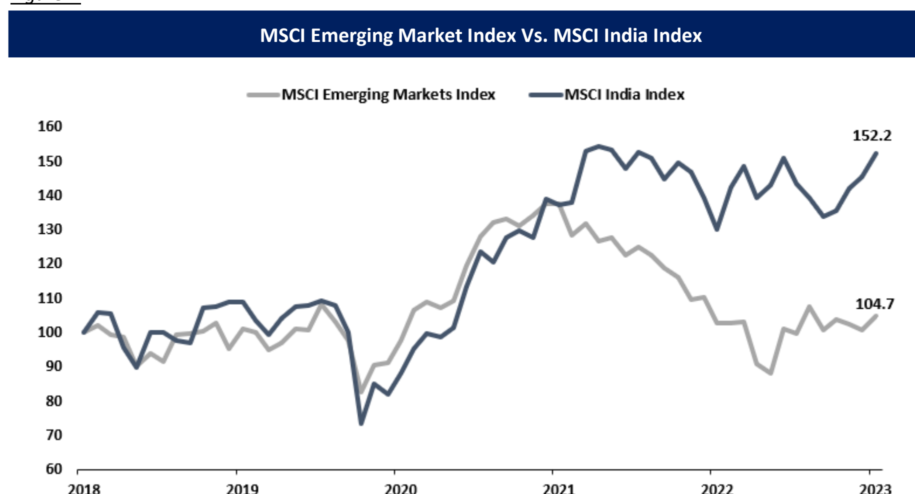
Figure 1

				Since Inception*	
	3 Month	6 Month	1 Year	Absolute	CAGR
WW North Star	14.7%	4.1%	22.0%	**51.9%**	**17.1%**
Nifty 50 TRI	11.1%	6.6%	22.9%	**56.4%**	**18.4%**

* Adjusted for cash from 11th November 2020 to 31st December 2020

After a subdued March quarter, there was a sharp rebound in the stock market in the June quarter, with the Nifty 50 up 11%. This was bolstered by a sharp pick up in foreign institutional investor flows, who invested US$13.6 billion over the June quarter. At the same time, domestic investment flows continued, primarily driven by the systematic investment plans (SIPs) of retail investors, which has now reached a monthly run rate of US$1.8 billion. While the stock markets remain volatile in the near term, what is remarkable is the significant outperformance India has delivered compared to other emerging markets. Over the trailing five years, MSCI India index is up 52.2%, in US dollars, compared to MSCI emerging markets index which is up 4.7%. (See figure 2). We believe this outperformance will continue over the next several years as India is in the early stages of a pick-up in a private capex driven investment cycle. This will result in strong earnings growth and healthy ROE, which are the key drivers for stock returns.

Figure 2



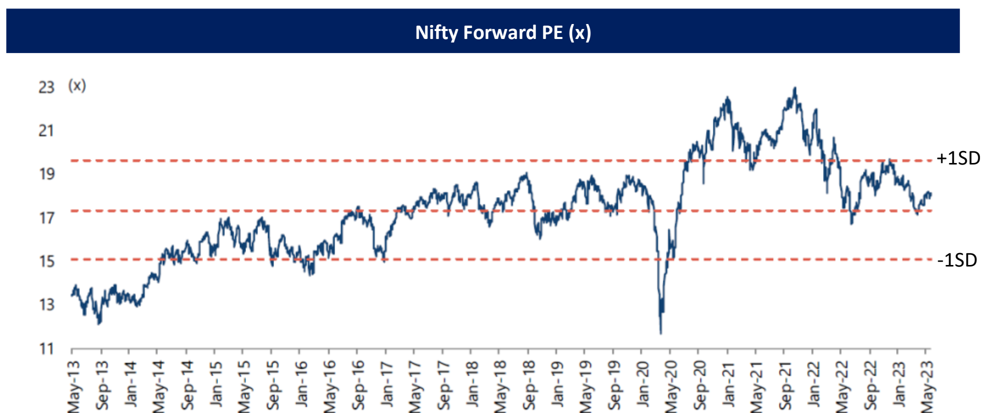
Source: Bloomberg

[1] Periodic portfolio performance information is calculated net of management and incentive fees. The information is unaudited and current year performance information is subject to change pending the completion of the current year audit. In addition, individual performance may vary based upon timing of contributions, withdrawals, participation in certain investments, and fee arrangements. For individual investor performance, investors should rely on information contained in account statements. The performance related information is not verified by SEBI.

Our portfolio companies have continued to deliver healthy fundamental performance as well, both in terms of earnings growth and ROE. For FY23, our portfolio of companies delivered revenue growth of 23% and profit growth of 27% on a weighted average basis, over the same period last year. Even on a three-year CAGR basis (excluding any varying base effect of Covid), aggregate revenues of our portfolio companies were up 15% and profits were up 20% on an annualized basis over this period. The weighted average ROE for our portfolio remains very healthy at 18%. We remain confident that our portfolio will continue to deliver around 20% earnings growth over the next several years, given most of our companies are either market leaders in nascent industries which are at an inflection point, or are well positioned to gain market share in established industries, due to their unique competitive positioning.

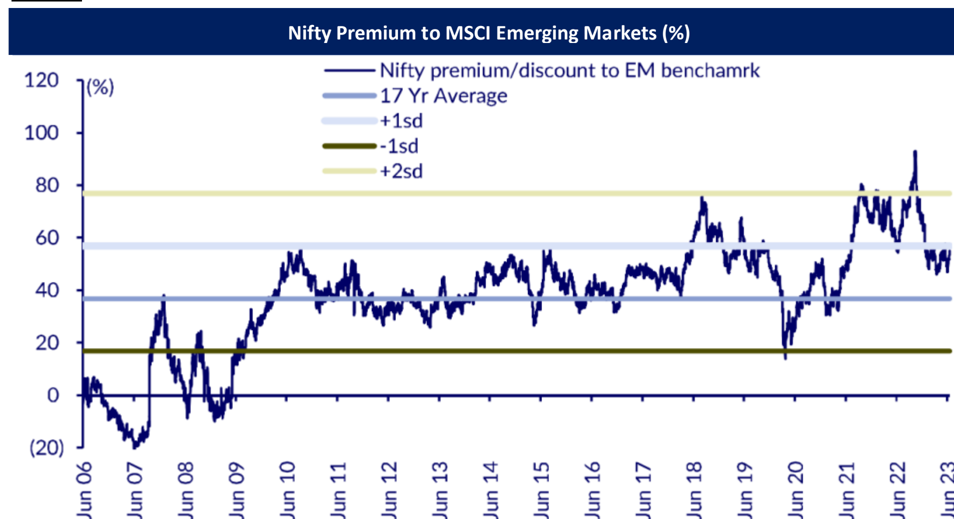
Post the recent rally, Nifty is now trading at 18.5x forward earnings, at a slight premium to the last ten-year average of 17.5x (See Figure 3). From a relative perspective also, Nifty index now trades at 73% premium to the MSCI emerging markets index in terms of forward earnings, which is again more in line with historical average. (See Figure 4) While valuations appear full, they are not excessive, especially in the context of the healthy macro-economic outlook.

Figure 3



Source: Bloomberg

Figure 4



Source: Bloomberg, CLSA

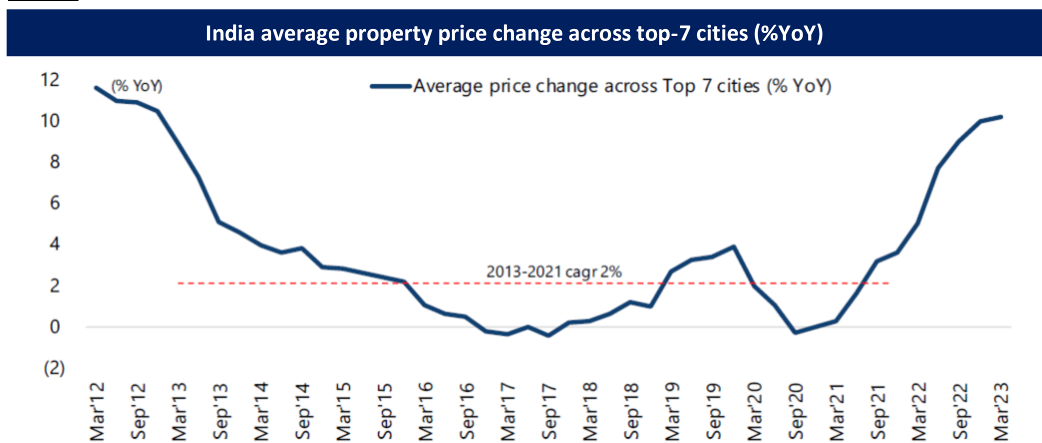
We are excited about the growth prospects in India over the next decade and believe our portfolio is well positioned for the long term. We remain focused on trying to ***identify incredible businesses backed by outstanding management teams that can compound capital over a long period of time***. We believe this is critical towards delivering healthy returns in the long term, while ensuring capital protection.

Macroeconomic Developments

With commodity prices cooling off globally, inflation in India has also seen a steady move downwards. Unlike the developed countries, India does not face any structural labour shortages and therefore inflation should be less sticky. The CPI (consumer price index) for June was at 4.8%, which is much lower than the peak seen in April 22 of 7.8%. Further, the WPI (wholesale price index) came in at -4.1%, which is the lowest level seen since November 2015. While there could be some near term volatility in inflation related to food price fluctuation and the monsoon, we believe over the medium term, the peak of inflation is behind us. As a result, RBI should largely be done with its tightening cycle.

While there have been pockets of weakness in areas such as quick service restaurants, apparel sales and consumer electronics related to the tightening monetary cycle, overall demand has held up fairly well. This is especially the case with real estate. The organized real estate players have continued to deliver very healthy double digit growth through the June quarter as well. Meanwhile property inventory continues to come down and property prices continue to rise. The residential inventory for the top cities has declined from a peak of 45 months in October 2017 to a 11-year low of 19 months of sales in March. At the same time residential property prices rose by an average 10% YoY in March quarter, the highest growth rate since December of 2012. (See Figure 5) With the interest rates close to peak and affordability still strong, we expect this trend to continue going forward.

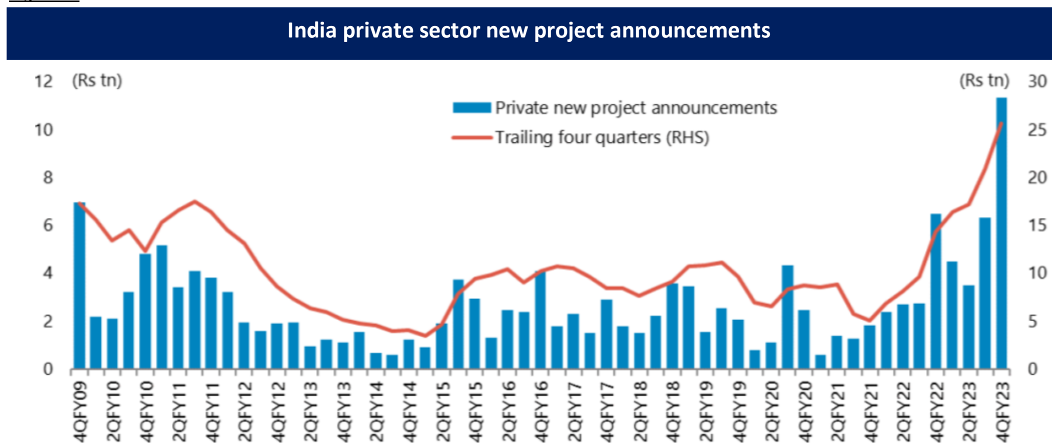
Figure 5



Source: Propequity, Cushman & Wakefield

Further, there is a sustained pick up in capex cycle for India, after over a decade. From a bottom up perspective, new project announcements in the private sector are surging. New orders jumped from Rs5.1 trillion in FY21 to Rs25.7 trillion in FY23, with 4QFY23 itself seeing close to Rs12 trillion in orders. (See Figure 6).

Figure 6

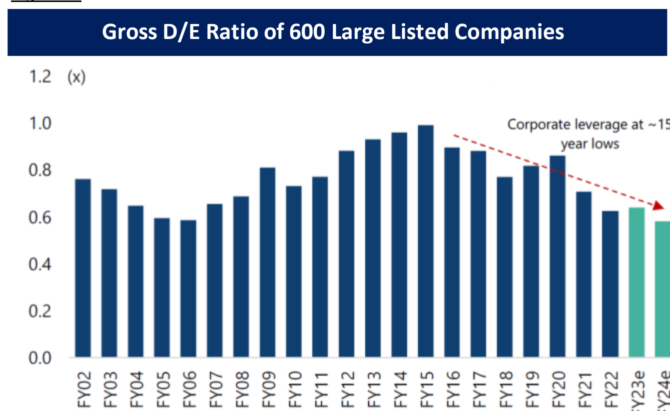


Source: CMIE, Jefferies

At the same time, corporate balance sheets have been cleaned up, with corporate debt to equity ratio down from a peak of 1.0x in FY15 to 0.6x in FY23, which is now the lowest level since FY06. (See Figure 7) Additionally, banks are very well capitalized, with capital adequacy ratio close to an all-time high at 15.7%. (See Figure 8).

Figure 7

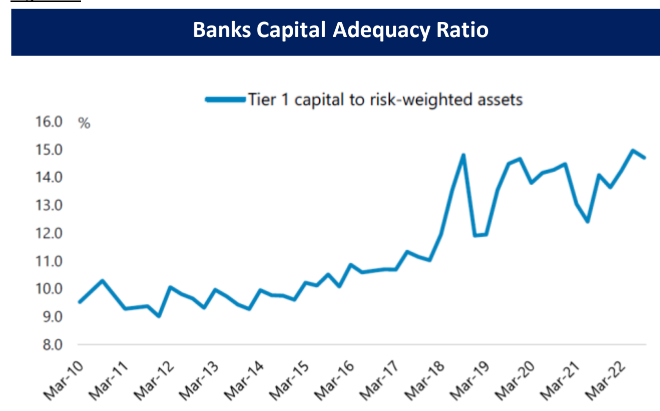
Gross D/E Ratio of 600 Large Listed Companies



Source: Ace Equity, Jefferies

Figure 8

Banks Capital Adequacy Ratio



Source: IMF

Finally, gross fixed capital formation has been in a downtrend since FY09, declining from a peak of 35.8% in FY08 to 27.3% in FY21. It has finally begun rising and has reached an estimated 29.2% in FY23, but still has a long way to go. All these trends point to a multi-year pick up in the capex cycle. Our investments in several industrial good companies as well as banks keep us well positioned to benefit from this trend.

Portfolio Insights – Idea Generation

"It is remarkable how much long term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent." – Charlie Munger

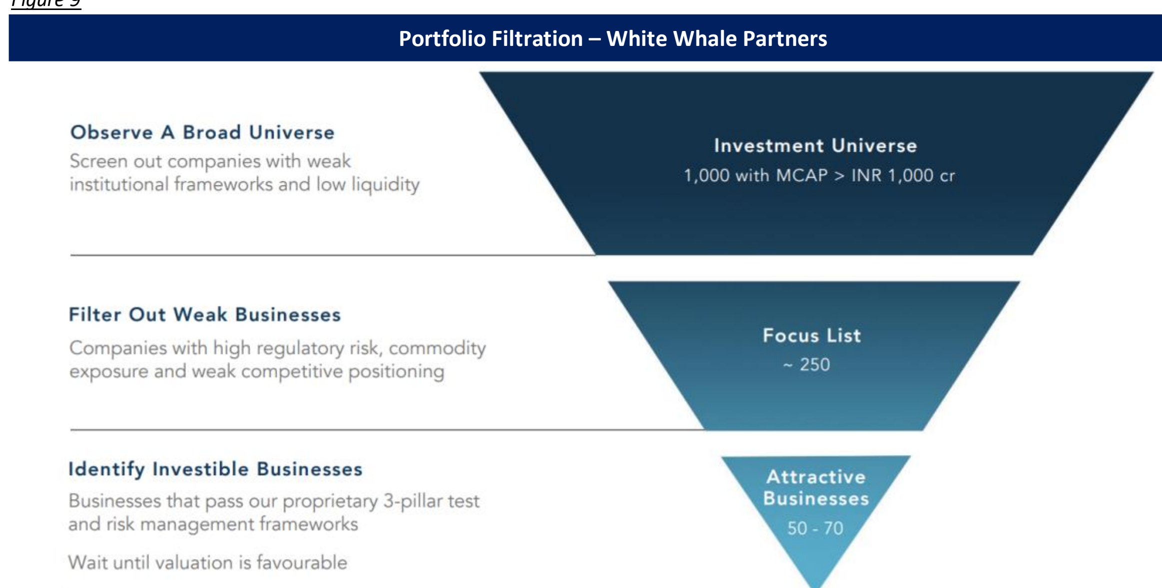
One would believe it is a relatively simple task to keep an even temperament, be rational and avoid stupidity. However, it is quite incredible to see some of the investment decisions made by even seasoned investors, which in hindsight can only be attributed to foolhardiness and irrationality. Many of these are developed due to behavioural biases such as overconfidence, herd mentality, confirmation bias, fear of missing out etc, which one must constantly be vigilant against.

One way to avoid these biases to creep in is by using a strict negative filter when looking for investment ideas. The first filter that we use is to avoid companies with market cap less than Rs1,000cr. There is a fair argument to be made in finding micro-cap companies with high potential for growth and strong financial metrics, that can deliver multi-fold returns in the future. However, in our experience, finding such companies is akin to finding a needle in a haystack. Typically, many of these companies have weak institutional frameworks, poor governance standards and are, more often than not, one man shows. This significantly whittles down our addressable universe to around 1,000 companies, from the over 5,000 companies listed on the Indian stock exchanges.

Further, there are certain industries that we completely avoid. We will not invest in companies which heavily dependent on commodity prices such as metals, oil and gas. The price of these commodities are dependent on global demand and supply trends – something which we would find very difficult to form an informed opinion on. We also will not invest into companies where the government is the majority owner. The incentives for the government are more often than not misaligned with those of the minority shareholders. Similarly, we avoid industries where there is a high amount of regulatory risk, such as utilities and power generation. Further, we also avoid industries which have long gestation capital intensive projects, especially those that are won through a tender process, such as road construction and infrastructure projects. Finally, we will avoid businesses that are particularly susceptible to technology disruption and have a weak competitive positioning. In our view, this further narrows down the addressable universe to less than 250 companies.

After applying our three pillar test on these companies (**strong management** running **incredible businesses** with a **long runway for growth**), we believe our addressable universe is essentially around 50-70 companies. Most of these companies are usually trading at premium valuations and therefore we wait for a better entry point, usually triggered by short term issues. Besides that, we actively scout for fundamental changes in the broader 250 companies bucket, that would cause them to meet our investing criteria (See Figure 9)

Figure 9



Source: White Whale Research

In terms of sourcing of ideas, most of our ideas come from talking to industry participants, be it buyers, suppliers, dealers or competitors. People in the industry are best informed about the changes happening in the industry, and therefore can identify the companies benefitting from these changes. Apart from that, we also speak to other fund managers and analysts whom we respect. A good example of this would be our recent investment into Home First Finance, which provides affordable housing loans, primarily in West and South India. While visiting companies in Ahmedabad and doing primary channel checks, we met with the ex-managing director of Gruh Finance. Under his leadership of over 25 years, Gruh Finance became one of the premier and highly respected affordable housing finance companies in the country, with an enviable track record of compounding earnings and stock returns at over 25% through this period. In conversations, he drew our attention to Home First Finance, which in his opinion had the right systems and processes on the ground to underwrite such smaller ticket size home loans. We discuss our thesis on Home First in more detail below.

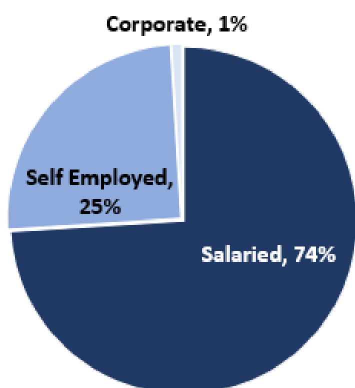
Home First Finance (Market Cap – Rs 6900 crore)

Business Description

Home First is a small affordable housing finance company with ~0.5% market share in affordable loans, catering to low- and middle-income individuals, mostly in the salaried segment (>70% of AUM). Home First's business is well spread out with share of AUM from top-4 states at 75%. It focuses on large affordable housing markets in the outskirts of larger cities and tier II/III towns. This strategy provides high growth visibility with ~40% AUM CAGR over FY2018-23 along with low credit costs. A strong technology backbone ensures faster turn-around time of ~48 hours for loan approval compared to >5 days for most peers, better early warning signals and provides higher scope to improve productivity business and scalability as competitiveness increases over time. The company has a strong historical track record, with loan book and PAT CAGR of 32% and 55% over the last 5 years. Currently, its loan book size is Rs 7,198 crores.

Figure 10

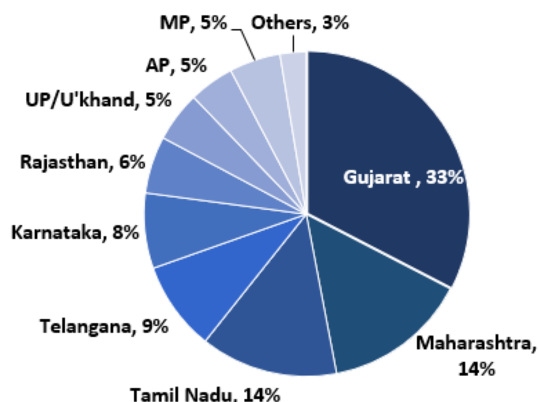
AUM by Customer Profile



Source: Company Data

Figure 11

Geographic Mix of AUM – FY23



Source: Company Data

Management

Home First was co-founded by Jerry Rao (Chairman of Mphasis) and Mr Jayakumar (Head of Citibank Consumer Banking), along with the backing of private equity firms True North and GIC in 2010. Manoj Viswanathan has been the CEO and managing director of the company, having worked in Asian Paints as well as Citibank in its personal loans department prior to that. In our meeting with Manoj, what impressed us most was his focus on building a scalable organization right from the start. There was considerable investment made into technology and digitization of processes right from the get go, ensuring continuity as the company expanded geographically. This has been the Achilles heel for many affordable housing companies once they reach a particular scale.

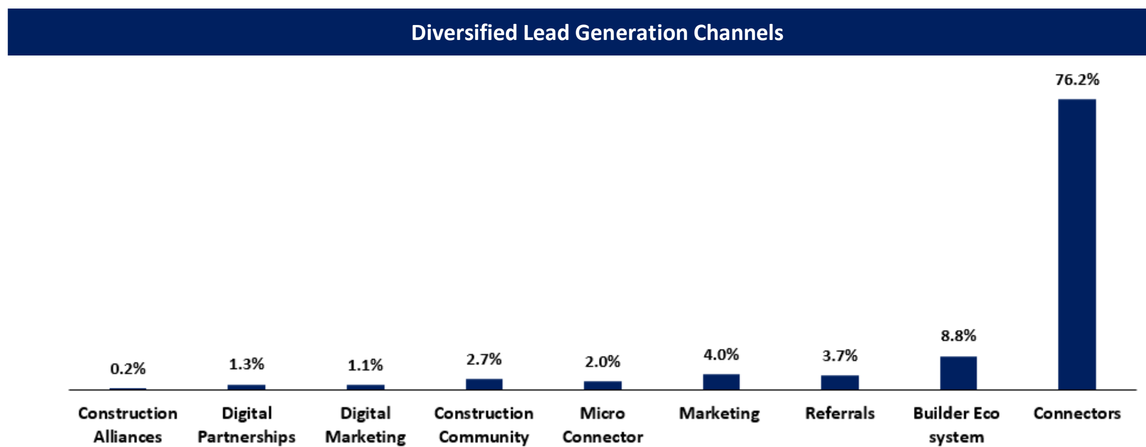
Even in underwriting, there is a high focus on data mining to ensure they continuously improve on their underwriting skills. All underwriting is done centrally. The company developed an algorithm right from inception and every file is passed through this algorithm. The decision making of the algorithm has continuously improved based on the data collected over the last 12 years, thereby continuously improving the underwriting quality. Apart from that, he understood the importance of people in a financial services organization. He has ensured his core team has been with him right from inception. He also focuses on hiring a large number of MBA graduates compared to his peers. As a result, while his average salary is 3x that of his peers, productivity in terms of loans per employee is also 3x. More importantly, the quality of loans underwritten is much better while there is better control on attrition. Also, it allows the company to have a turnaround time (TAT) of 48 hours once documentation is in place compared to up to a week for their competitors, thereby significantly improving customer satisfaction.

Incredible Business

One of the unique competitive advantages that Gruh Finance had in comparison to its competitors was the reliance on connectors to source their new loans. Connectors are essentially people who are affiliated to the real estate industry, but don't rely on it solely for their income. Examples of connectors would be chartered accountants, architects, hardware store owners, etc. They would share a lead and if that lead results in a loan disbursement, then they would earn a fee. Unlike brokers and DSAs, less than 20% of these connectors' income is typically driven by these referrals. As a result, the incentive for them to indulge in malpractice in order to get a loan approved is lower. However, building a community of connectors is a long and slow process. Home First has managed to replicate this sourcing network, by focusing on developing this model right from the start. Additionally, in every new geography, before they open a branch, they focus on building a community of connectors months in advance, to give them sufficient momentum once the branch is launched. As a result, over 70% of their loans are sourced through this channel, significantly improving the quality of the loans they source.

Apart from that, the company has developed three apps for the smartphone - one each for customers, connectors, and relationship managers. The features of the different apps are quite extensive. Connectors can track the progress of the files, be automatically notified in case of approval and receive disbursement through the app. It also has a database of the past track record of their referrals. Customers can raise service requests, pay EMI as well as avail offers and benefits using the app. The design and UI was also very simple and user friendly. In our field visits, we met with customers and connectors who had positive reviews on the app. The fact that over 95% of the customers and connectors use this app for their transactions is testament to this, especially given the profile of their customers, who would be from lower income families. In fact over 30% of their customers are new to credit. We believe the digitized sourcing, servicing and underwriting processes are a big competitive advantage for Home First, as it improves the satisfaction levels of the key stakeholders in its ecosystem, thereby enabling it to gain market share vs competitors.

Figure 12

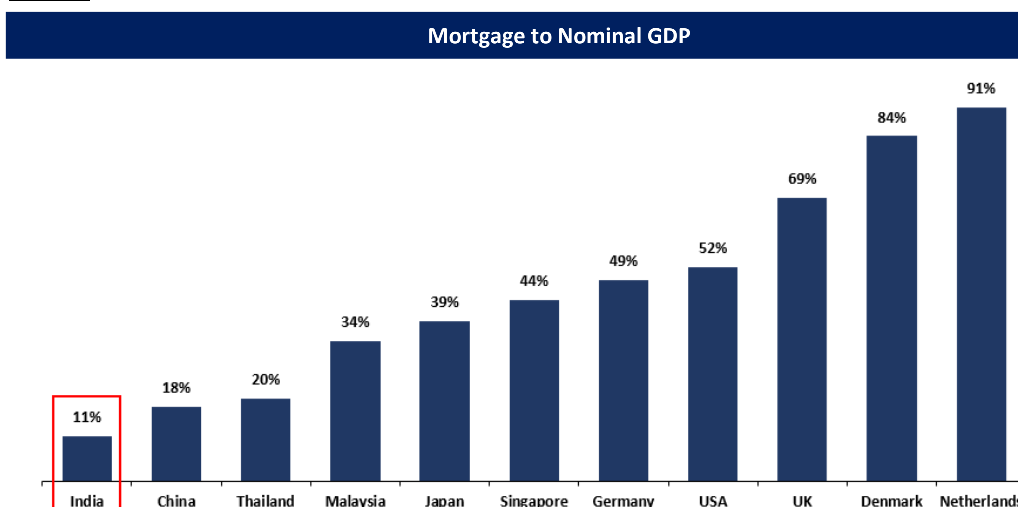


Source: Company Data, White Whale Research

Longevity

The runway for growth in housing loans is long. Mortgage penetration as a % of GDP in India is only at 11% compared to over 18% in China, around 25% for the ASEAN region and well over 50% for most of the developed countries. Additionally, as discussed earlier, the real estate cycle in India is primed for a turnaround over the next several years, driven by pent up demand and healthy affordability. Over the last decade, while nominal income per capita has increased by over 80%, average property prices have increased by less than 10%. We expect the cycle to be particularly strong in the case of affordable housing, which a significant supply planned over the next several years. We expect the overall mortgage demand to grow in mid-double digits going forward.

Figure 13



Source: European Mortgage Federation, Hofinet

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Further, as discussed earlier, given the competitive advantage that the company enjoys, it is well positioned to continue to take market share. In districts where the company has been operating for over 3 years, its market share is at close to 5%, compared to overall pan-India market share of 0.4%. Therefore a combination of robust industry growth alongside strong market share gains should drive healthy 20%-25% loan book growth for the next several years.

The company is well capitalized, with capital adequacy ratio of 49%. Further with healthy ROAs of 3.9% and increasing leverage, we expect ROE to improve from 13.5% currently to close to 20% over the next 3 years. From that perspective, we find the current valuations at 3.3x FY24 BV to be attractive.

Conclusion

In closing, we would like to thank you for your support and faith in the White Whale Portfolio Management Team. We look forward to a long and prosperous partnership together. If you have any questions, feedback, or suggestions, please always feel free to reach out. We look forward to hearing from you.

Sincerely,

White Whale PMS Team

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