White Whale North Star Portfolio – 2Q FY24 Quarterly Letter

Dear Partners,

Greetings from White Whale Partners.

Portfolio Performance

The portfolio has delivered healthy absolute returns year to date. For YTD FY24, our portfolio is up 15.5% compared to Nifty 50 TRI which was up 14.0%. On an annualized basis, since inception, the portfolio is up 15.9%[1], compared to 17.9% for the Nifty 50 TRI.

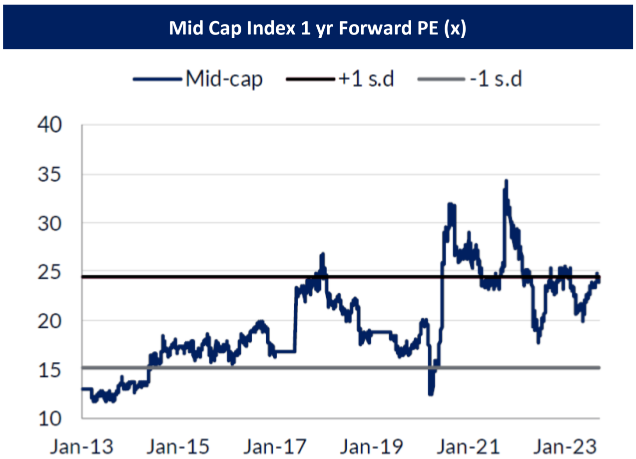
Figure 1

	3 Months	FY24 YTD	1 Year	Inception*
WW North Star	0.7%	15.5%	2.4%	15.9%
Nifty 50 TRI	2.7%	14.0%	16.1%	17.9%

** Represents Annualised Returns. Adjusted for cash from 11th Nov 2020 to 31st Dec 2020.*

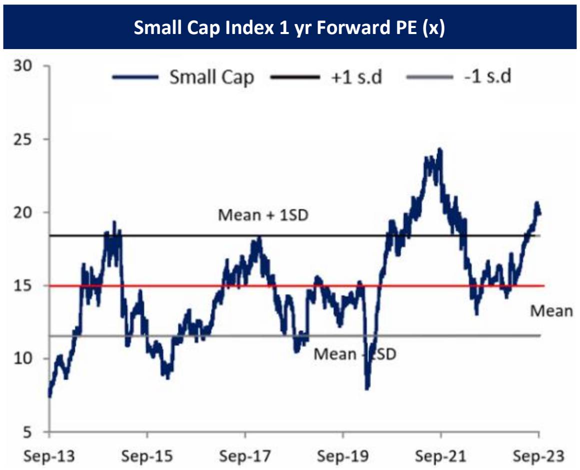
Small cap and mid cap stocks in India have seen a sharp rally over the last six months with the NSE Mid Cap Index up 33% and NSE Small Cap Index up 38% YTD. As a result, the NSE Mid Cap Index is now trading at 25x forward earnings, more than 1 standard deviation above is ten-year historical average (See Figure 2). Similarly, the Small Cap Index is also trading at 20x forward earnings, again well above its ten-year historical average of 15x (See Figure 3).

Figure 2



Source: Bloomberg

Figure 3



Source: Bloomberg

In contrast, the Nifty 50 Index is now trading at 18x forward earnings, largely in line with the last ten-year average of 17.5x (See Figure 4). From a relative perspective also, Nifty 50 Index now trades at 51% premium to the MSCI Emerging Markets Index in terms of forward earnings, which is again more in line with historical average (See Figure 5). While valuations appear full, they are not excessive, especially in the context of the healthy macro-economic outlook.

[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.

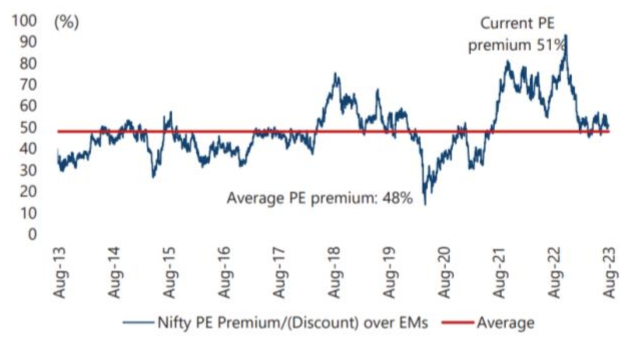
Figure 4

Nifty 50 1 yr Forward PE (x)

Source: Bloomberg

Figure 5

Nifty 50 1yr Forward PE Premium Over MSCI Emerging



Source: Bloomberg

The outlook for many of the small cap and mid cap stocks is definitely quite positive, given the expectations of a pick-up in the domestic capex cycle as well as continued robust momentum in domestic consumption. However, we also do believe some of this excessive valuation is flow driven. There has been a strong pick-up in foreign institutional investor flows of over USD$3.8 billion over the last six months. This has been alongside healthy domestic investment flows of US$9.4 billion over the same time frame. In addition, there has been a sharp shift in domestic mutual fund flows towards the mid-cap and small-cap focused funds, from 29% of total flows in FY20 to almost 55% in YTDFY24, which in turn is further driving these relatively illiquid stocks higher (See Figure 6).

Figure 6

Net Flow within Different Mutual Fund Schemes

% Net Flows	FY20	FY21	FY22	FY23	FY24 YTD
Large Cap Funds*	37.5%	54.8%	25.3%	13.5%	5.8%
Mid & Small Cap Funds	28.5%	26.1%	16.1%	28.8%	54.6%

** Large Cap Fund includes Large Cap and Multi Cap funds inflow*

Source: AMFI

We expect valuations to mean revert over time, as the technical factors driving the stocks reverse themselves. Our portfolio remains 75% in large cap names. More importantly, we maintain that in the long term, stock returns mimic returns on capital. Our portfolio companies have continued to deliver healthy fundamental performance, both in terms of earnings growth and ROE. For 1Q24, our portfolio of companies delivered revenue growth of 16% and profit growth of 19% on a weighted average basis, over the same period last year. 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.

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

There has been significant geo-political uncertainty in global economies over the last couple of years driven by rising inflation in developed countries, the Russia-Ukraine war and now more recently the Israel-Palestine conflict. Oil at one point had exceeded well over US$100 a barrel before stabilizing around the US$80-US$90 range. The global central banks have sharply tightened monetary policy. Given the persistency of healthy employment alongside sticky inflation, expectations of higher rate for longer period of time has finally set in, causing the US 30 Year Treasury bond to breach the 5% mark, which is at a 15 year high.

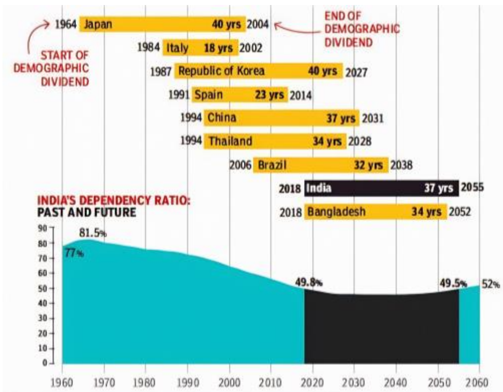
In spite of all of this, the macro-economic trends in India have been remarkably stable:
1) GDP is well placed to grow at over 6% in FY24
2) Inflation is within the RBI target band of 2%-6%
3) 10 year government bond has been largely stable around the 7.2% levels
4) Current Account Deficit for FY24 is expected to be at 1.5%
5) Rupee has been largely stable around the Rs83 to 1 USD mark.
6) While fiscal deficit is budgeted to still be high at 5.9% for FY24, buoyant tax receipts (advance tax up 20% yoy, GST collections up over 10% yoy) should help taper this down going forward

As discussed several times in previous letters, the Indian economy is well poised to finally see a pick-up in private capex cycle after more than a decade. Capacity utilization in steel/cement sectors has reached 78%/85% respectively, while demand growth remains strong. The government has been increasing its allocation and continuously announcing new PLI schemes. Unleveraged corporate balance sheets, healthy asset quality trends among banks as well as strong inflows in the equity markets clearly indicate there are no issues from a capital availability perspective. This has typically been the Achilles heel for India in the past. We believe the next three to five years should see healthy earnings growth for Indian corporates, similar to what was seen between 2003-2007, driven by a pick-up in capex spending.

Looking even longer term, we believe India is among the best positioned large economies in the world. Firstly, the country is expected to enjoy the demographic dividend of a rising working age population for the next three decades (See Figure 7). More importantly, the per-capital GDP for the country is expected to exceed USD$4,000 after FY30. In fact, certain large states like Gujarat, Karnataka, Maharashtra, Haryana, Andhra Pradesh, Delhi are expected have per capital GDP of over USD$6,000. This will lead to a significant spurt in discretionary spending, driven by an aspiring middle class. Household debt as % of GDP is only at 34% compared to 78% for the US and 62% for China. Increasing availability of finance will be an additional driver to consumption growth. Further, the increased pace of digitization, increased formalization of the economy, robust job creation driven by strong growth in the real estate and manufacturing sectors are all healthy building blocks towards continued momentum in economic growth. Strong reforms in the past, such as GST, RERA, IBC will also reap benefits going forward. Our portfolio remains well positioned to benefit from the sustained pick up in domestic economic growth over the next several years.

Figure 7

Period of Demographic Dividend in Large Economies



Source: INDIA@75 - by Michael Debabrata Patra; UN Population Database

Portfolio Insights – adaptive to change

"It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is most adaptable to change." Charles Darwin

One of the key factors that we look for in the companies that we invest in is a sustainable competitive advantage. This could be in the form of a strong brand, low cost advantage, technological edge and/or a virtuous network effect. However, sustaining this advantage over a long period of time is very challenging. These businesses enjoy returns on capital that are significantly above average. This invariably attracts the attention of competitors, who will then chip away at this competitive advantage. Further, the environment that the company is operating in is not static. New technology or product innovation can lead to new entrants who will then threaten the incumbent. As Greek philosopher Heraclitus put it best – "Change is the only constant in life."

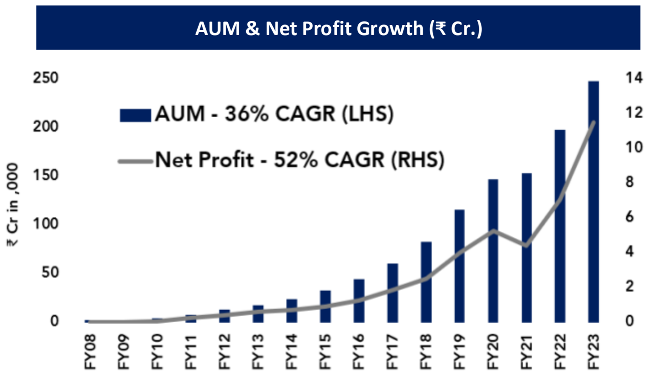
In our opinion, the rate of change is only increasing driven by the increased pace of technological disruption. A study by McKinsey found that the average life-span of companies listed in Standard & Poor's 500 was 61 years in 1958. In 2016, it was less than 18 years. One would expect that large companies would have an advantage over the challengers given economies of scale, access to more resources and better product knowledge. However, there is a sense of complacency that sets into a large company. Given their defensive position, they are not able to effectively challenge status quo, which in turn results in them undermining the potential threats that face them. The multiple layers of management make the organization increasingly bureaucratic. As a result, they end up spending more and more time managing themselves, rather than focusing on innovation, competitiveness and nimbleness.

In order to offset this threat, we actively look for management teams that realize that competitive advantage are transient. They are focused on installing a culture that emphasizes innovation and is continuously disrupting status quo. These companies have what Jeff Bezos refers to as the "Day 1" mindset, where they approach business with a sense of constant innovation and reinvention as if it were always the company's first day in operation. The management team is willing to think and act long term. They have the capacity to suffer through activities that would result in "pain today, gain tomorrow". We pay close attention to what management teams have done and are continuously doing to improve their competitive advantage. This is the only way the company can resist the market forces that would eventually result in their return on capital mean reverting over a period of time. One such company in our portfolio is Bajaj Finance.

Bajaj Finance (Market Cap – Rs 4,73,331 crores)

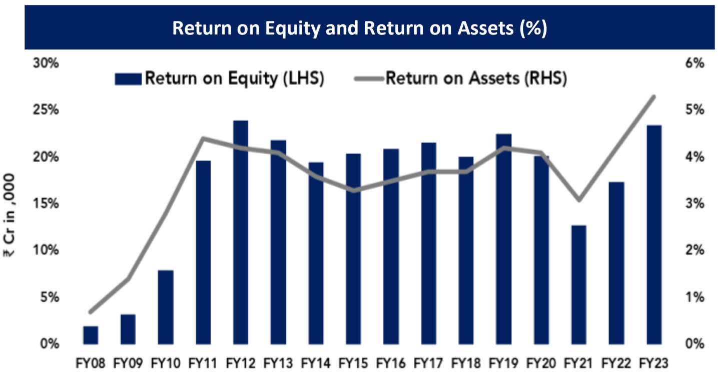
Bajaj Finance provides financing for a variety of products such as consumer durables, mobile phones, housing, two-wheelers, small businesses, construction equipment and infrastructure finance. More recently it has also announced forays in passenger vehicle, user car and commercial vehicle financing. Bajaj Finance undertook business and organizational restructuring in FY08 and re-defined small business and consumer financing as its key niches. The new initiatives began delivering tangible results since FY09, with 36% and 52% CAGR in AUM and net profit respectively over FY10-23 (see figure 8). It has also consistently delivered over 3% ROA and 20% ROE for the last 10 years, excluding the Covid years (See Figure 9). Net NPA has been less than 1% over the same period. The Company operates across 1,429 urban locations and 2,465 rural locations with over 1,81,100+ distribution points as of September 2023.

Figure 8



Source: Company

Figure 9



Source: Company

Management

Bajaj Finance transformed itself under the leadership of Rajeev Jain, who joined the company in 2007. He, along with Nanoo Pamnani (ex-Vice Chairman of Bajaj Finance, spent four decades with Citigroup,) and Sanjiv Bajaj (Chairman of

Bajaj Finance, representing the promoters of the firm, Bajaj Family) were the key brains behind the conversion of Bajaj Finance from a small captive two-wheeler financing NBFC to a leading multi-product consumer and small business financing NBFC.

Prior to Bajaj Finance, Rajeev spent several years at AIG, American Express and GE Capital on the consumer financing side. He leveraged his past experience to set up a strong base for the nascent consumer financing business at Bajaj Finance. He understood the importance of technology in ensuring a quick turn-around-time (TAT) as well as providing critical data that can continuously improve the firm's credit underwriting ability. He was instrumental is setting up a robust digital backbone within Bajaj Finance, which enabled the company to continuously roll out innovative new financing products. At one point, Bajaj Finance was the leading customer for Salesforce in India in spite of its relatively small size then.

He was also critical in setting up a deep management team that enabled the company to continuously innovate and diversify into new product areas. Many of the core management team members such as the chief financial officer, head of consumer financing, head of SME financing, head of Bajaj Housing etc have been with the Company for several years now. He also set up a culture that was very meritocratic, with ESOPs across the top management and high degree of variable pay based on performance. This enabled the company to very quickly diversify from consumer durable financing into other areas such as mobile phone financing, EMI cards, merchandise financing, LAP loans, unsecured SME loans, gold loans etc.

Incredible Business

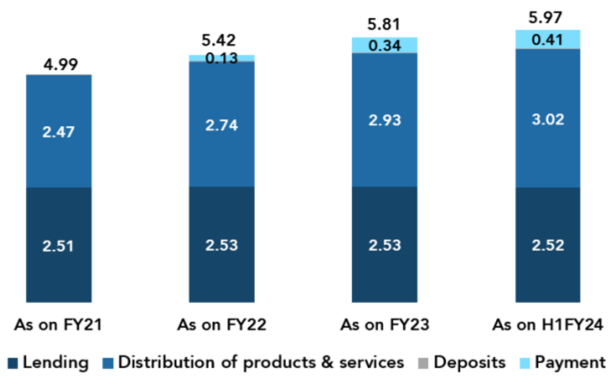
Bajaj Finance's main competitive advantage arises from its robust consumer and SME loan sourcing and credit underwriting processes, which are centred around effectively using technology to collect, analyse and process data. The company enjoyed a first mover advantage of tying up with various consumer durable brands and retailers to kick start its customer acquisition engine. Then, on the back of effective data mining from its growing customer base, Bajaj Finance has continuously evolved and innovated its product portfolio, as well as refined its underwriting processes to adapt to changing customer and product characteristics. This dynamic feedback loop has been very difficult to replicate, even for very well run banks like HDFC Bank and Kotak Bank. It has also enabled the company to avoid many pitfalls around asset quality, which other financial institutions suffered.

However, the increasing penetration of digital commerce alongside payment applications threatened the company's traditional brick and mortar customer acquisition engine. Banks and NBFCs tied up with fintech companies and payment apps such as Paytm to offer BNPL and other financing solutions online. Bajaj Finance has always had a culture of being innovative as well as nimble in its execution. It was quick to identify this threat. In order to counter it, the company utilized the downtime it had through Covid to lay out a strategy of rolling out their own app, which would provide an array of services. Besides payments, this app would also provide financing solutions, a market place for e-commerce as well as insurance and mutual fund listings. It essentially rolled out an app that would effectively compete with players like Paytm. The key difference being that financing would happen through its own balance sheet rather than them just being a middle man.

The company has already seen over 44 million net downloads of the app with over 22 million monthly average users. More importantly, this has accelerated the company's customer acquisition engine. Prior to Covid, the company's cross sell customer franchise (core customers that they want to cross sell different products to) growth had slowed down to around 15% annually. However, since the roll out of the app, over the last twelve months, this growth has accelerated to 28%. In addition, the average number of products that the company sells to these customers is also accelerating. It was at 4.99 in FY21, which has now accelerated to 5.97 in 1HFY24 (see Figure 10). These averages are understated, because the overall customer franchise is growing rapidly and many customers are still new to the company. Customers that have been on-board for over 12 months buy an average of 4.88 products currently while those that have been on-board for over 24 months buy an average of 6.5 products (See Figure 11). As the penetration of the app and its usage improves, these numbers will go up even further.

Figure 10

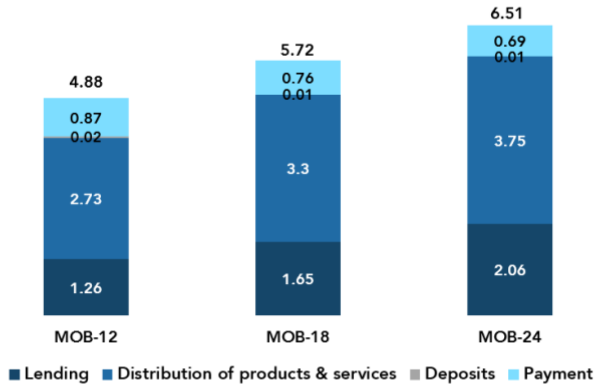
Product Per Customer



Source: Company

Figure 11

Product Per Customer – Months on Board (MOB) View



Source: Company

Longevity

Bajaj Finance currently has a 7.4% market share among NBFCs and 1.8% market share of the overall credit outstanding. The company is looking to get to 15% market share among NBFCs and 3-4% market share of the overall credit outstanding. Credit penetration within Indian household remains low. Overall system credit is itself growing at close to 15% currently, while retail credit is growing even faster at 20%. As discussed earlier, post the launch of the digital app, Bajaj Finance is growing its core cross sell customer franchise at over 25% yoy, while improving the number of products it cross sells to this customer base. As a result, we believe the company should sustain around 30% yoy AUM growth for the foreseeable future. Given the increased growth trajectory, the company is also looking to raise Rs10,000cr in fresh capital, to deploy towards new growth opportunities, reaffirming its strong visibility for growth.

Over the next five years, we believe the company should sustain an AUM and PAT growth rate of 30% yoy alongside stable asset quality with GNPA of 1.2%-1.4%. Return ratios should remain healthy as well with ROA of over 4.5% and ROE above 22%. Post capital raise, the company will be trading at 5.2x FY25 BV, which is at a discount to its historic average of 6.5x. We believe the company's culture of innovation and reinvention will enable it to generate above-average returns for several years ahead. The company remains a core part of our portfolio.

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