WHITE WHALE
PARTNERS

White Whale North Star Portfolio – 4Q FY23 Quarterly Letter

Dear Partners,

Greetings from White Whale Partners.

Portfolio Performance

For the quarter ended March 2023, the portfolio was down 9.2%, compared to Nifty fifty TRI that was down -4.0%. For the last 12 months, our portfolio was down 4.1% compared to Nifty which was down 0.59%. Since inception, the portfolio is up 32.5% on absolute basis [1]*, compared to 41.1% for the Nifty.

Figure 1

	3 Month	1 Year	2 Year	Inception*
WW North Star	-9.2%	-4.1%	12.7%	32.5%
Nifty 50 TRI	-4.0%	-0.6%	24.6%	41.1%

* Adjusted for cash from 11th November 2020 to 31st December 2020. Represents Absolute Returns.

Over the past twelve months, our portfolio has underperformed the broader indices by 3.5%, offsetting the outperformance in the prior period. As discussed in the previous letter, a large part of this is a sharp pull back in "deep value" stocks that don't fall within our investment frame work. For example, the government owned companies index (BSE PSU Index) was up 10% in FY23 compared to the Nifty which was down 1%. Further, the sharp monetary tightening by central banks across the world, along with RBI, has also led to a near term slowdown in certain consumer discretionary and industrial segments, impacting some of our positions in these sectors.

We continue to remain positive on the domestic growth story in India over the medium term. As we have outlined before, with healthy corporate balance sheets, banking sector NPA cleaned up and rising capacity utilization in the manufacturing sector, we believe the ducks are in a row for a turn in the corporate capex cycle. At the same time, notwithstanding the current slowdown, we are very positive on the secular trend of rising consumer discretionary spend in India, driven by higher per capita income, a demographic shift towards a more nuclear family, alongside rising youth aspirations. A large part of our portfolio remains focused on these two mega trends, which we believe will continue to play out over the next several years.

"What makes stocks valuable in the long run isn't "the market." It's the profitability of the shares in the companies you own." – Peter Lynch

One important datapoint through which we gauge ourselves is the underlying value creation in our portfolio, which is best judged through earnings growth and ROE. In the long term, this is the key driver towards healthy investment returns. Our portfolio companies have continued to deliver healthy performance. For FY23, our portfolio of companies delivered revenue growth of 22% and operating profit growth of 18% 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 17% and operating profits were up 19% on an annualized basis over this period. The weighted average ROE for our portfolio remains very healthy at 18%.

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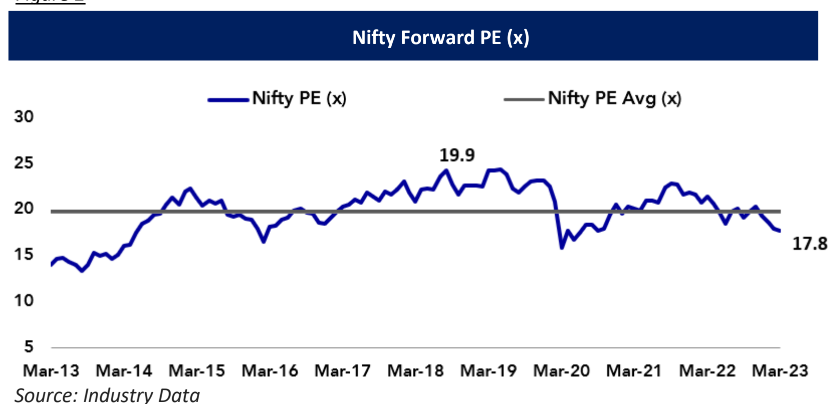
[1] Periodic portfolio performance information is calculated net of management and incentive fees. The information is unaudited and current year performance information is subject to change pending the completion of the current year audit. In addition, individual performance may vary based upon timing 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.

Despite this, the value of our portfolio has remained largely stable over the past 18 months, undergoing a healthy time correction. This is despite the portfolio enjoying superior earnings growth as well as better return on equity. 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.

The broader market has also gone through a healthy time correction. Nifty is now trading at 17.5x forward earnings, more in line with the last ten-year average of 19x (See Figure 2). From a relative perspective also, MSCI India index now trades at 60% premium to the MSCI emerging markets index in terms of forward earnings, which is again more in line with historical average.

Figure 2



Source: Industry Data

We remain firmly committed to our investment philosophy that has served us well over the last several years, and given our long-term time horizon, are willing to accept these periods of relative underperformance. 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

After increasing the repo rate by 290bps from the bottom, RBI decided to pause on further rate hikes in its most recent meeting in April, against the expectations of most economists. Going forward, the underlying inflationary pressures that India was facing over the last 18 months seem to be easing off. Oil has largely stabilised at around USD$85 levels. More importantly, India is procuring a significant part of its oil requirement from Russia at a large discount to this price. Prices for commodities such as base metals and several agricultural products have also come off by around 10%-40% from their peak, despite China opening up. Unlike the developed countries, India does not face any structural labour shortages either. Inflation for the month of March cooled off to 5.7% compared to 6.4% in the previous month. This is expected to further come down towards the 5.0% levels over the next few months. As a result, RBI should largely be done with its tightening cycle, with possibly one 25bps rate hike going forward at the most.

The lagged impact of this steep monetary tightening started to impact certain sectors towards the end of 2022, which has continued into 2023 as well. Consumer durable demand slowed down significantly, with same store sales growth for apparel stores and quick-service restaurants declining by 2%-5% over same period last year, while growth for appliances having flattened out as well. Credit growth has also come down to 16% in the last fortnight, after peaking at 18% back in October 2022. Given the global slowdown, exports for engineering goods also saw degrowth of 8%-24% across categories. On the flip side, the IIP index, which represents growth in the heavy industrial segments, is still holding up at 5.5%. The manufacturing PMI is at a three-month high at 56.4, while direct tax collections and GST collections have also remained healthy, growing by 16% and 13% respectively for the March quarter. Despite a sharp increase in mortgage rates from

less than 7% in 2021 to over 9% now, the organized real estate players have reported healthy volume growth of 10-11% in for 4QFY23 over last year.

Overall, while there have been pockets of slowdown, in the face of significant headwinds – both geopolitical as well as monetary – India has held up quite well and is among the best performing emerging markets. We remain very bullish on the medium-term growth prospects for the Indian economy. Besides, our investee companies have long term compounding potential with resilience against macro-economic variables such as interest rates and GDP growth trends, aided by a strong competitive positioning and pricing power. Therefore, while not immune, they are less impacted by macro-economic trends over our investing time horizon.

Portfolio Insights – When to sell?

"When the facts change, I change my mind - what do you do, sir?" - John Maynard Keynes

Investing in a concentrated portfolio of quality businesses that can compound capital over a long period of time comes with its own set of risks. We need to avoid complacency and stay vigilant on exiting companies at the right time to avoid mistakes. There are three main reasons to exit an investment, in our framework:

1) **Change in fundamentals** – When invested in a company over a long period of time, one runs the risk of developing a consistency bias. One tends to ignore disconfirming evidence while holding on to a previously held opinion. One way we safeguard against this is to re-underwrite our investment thesis on a constant basis, by identifying potential threats to the thesis and doing deep due diligence on these threats. However, at the same time, finding high quality businesses with strong management teams, and at the right price, happens rarely. Therefore, being trigger happy and exiting positions on the first sign of trouble would also prevent reaping the great benefits that come from steadily compounding capital over a long period of time. Distinguishing between a genuine change in the underlying fundamentals of a company versus noise is what makes this style of investing so challenging. Over several years of investing, we have realized that there are only a handful of variables that truly matter in a company. We track those very actively for any significant change that warrants us to exit the position.

2) **Excessive valuation** – When investing in great companies with strong competitive advantages, they will invariably appear to be excessively valued at some point in the investment timeframe. HDFC Bank is a great example of this. Right from its IPO, it always appeared excessively valued, trading at 4x-5x book value, while most of the other banks were at less than 2x book value. However, despite this, it delivered compounded returns of over 20% for more than two decades. The total addressable market and the runway for growth can play a vital role here. If we don't see upside potential from holding a stock over a 5 year time period after assuming more normalized valuation multiples to future earnings, we could consider exiting the position. One important caveat here is that a great management team invariably creates optionality to further enhance earnings potential, which is very difficult for us as investors on the outside to envision. Also, opportunities to invest in great companies run by incredible management are few and far in between. Therefore, the bar to exit, as far as valuations are concerned, should be deservedly high.

3) **Better opportunity** - The knowledge base on a portfolio company moves up dramatically as time progresses from the initial investment. This is because we are continuously monitoring new changes and developments within and around the company, as well as developing further comfort on the management team. As a result, the threshold to replace an existing investment with a better opportunity is quite high. Within the portfolio, we size investments on the back of the extent of conviction we have on the underlying opportunity. Therefore, even when an investment is replaced with a better opportunity, we typically start with a small position and scale it up further over time as we build more conviction.

Given our long-term timeframe and concentrated portfolio, we will have long periods of trading inactivity. However, there is a big difference between inactivity and complacency. Within the firm, there is a very important distinction between research activity and portfolio activity. There will be long periods where there is no portfolio activity but where the research momentum is sustained. In a given year, we would probably enter and exit two or three positions. However,

from a research perspective, besides actively researching developments in and around our existing positions, we would also have researched over thirty new companies in a year to identify these two or three new opportunities.

In our previous letter, we had stated that we look to invest in a concentrated portfolio of 10-15 ideas. Of this, we invest in around seven to ten steady compounders, where we have a high level of conviction on their ability to generate strong earnings growth over the next several years, without a significant change in strategy or business model. At the same time, we look to identify around three to five companies that we believe are on the verge of an inflection point in terms of growth driven by either a change in management, change in strategy or a shift in industry dynamics. One such company is ICICI Prudential Life Insurance.

ICICI Prudential Life Insurance

Overview

ICICI Prudential Life Insurance Company is a joint venture between ICICI Bank and Prudential Corporation Holdings (UK). The company began its operations in fiscal 2001 and has consistently remained among the leading private sector life insurance companies in India on an annual premium equivalent (APE) basis. ICICI Prudential was the first private sector life insurance company to cross the Rs 1 lakh crore mark in Assets Under Management (AUM) and total sum assured of Rs3 lakh crore. The Company offers a range of life, pension, and savings products across traditional and unit linked platforms. To strengthen its protection offerings, it launched new products on retail, mortgage, and group platforms. For FY23, the company is on track to generate annualized premium equivalent (APE) of Rs 8,200 Cr, Value of New Business (VNB) of Rs 2,650 Cr along with RoEV of 15%.

Pain before Gain

Before NS Kannan took over as managing director and CEO of ICICI Prudential in June 2018, the company had a very high dependence on selling large ticket size unit linked insurance policies (ULIPs) through its bancassurance partnership with ICICI Bank. In November 2016, post demonetization, there was a huge inflow of deposits into savings account of all banks. Over the next 12-18 months, ICICI Bank focused on cross selling a lot ICICI Prudential's ULIP and debt mutual fund products to these customers. As a result, ULIPs accounted for over 80% of ICICI Prudential's APE mix in FY19, of which more than 80% was driven through the ICICI Bank channels. Overall, distribution through ICICI Bank accounted for over 50% of the company's APE. Additionally, the average ticket size for these policies at over Rs 1.5 lakh was almost triple that of their competitors, implying a focus on selling these policies to a narrow group of high-net-worth individuals.

Under the new management team, the company consciously chose to diversify away from this concentrated product mix. It actively introduced several new participatory, non-participatory, annuity as well as pure protection products. Furthermore, it invested into developing new distribution channels by tying up with over 30 new banks, more than quadrupling its agency force and developing its direct channels. At the same time, ICICI Bank, under its new management, not only stopped selling participatory and non-participatory products, but as a matter of policy, stopped pushing any third party products to their customers, focusing entirely on deposit mobilization. This resulted in a radical shift in the company's business mix over the last four years. ULIPs now account for around 40% of overall premium mix, half of what they were in FY19. Additionally, ICICI Bank, which accounted for over half the premium sold in FY19, has now reduced to less than 17% of APE for 9MFY23. (See Figure 3 and Figure 4).

Figure 3

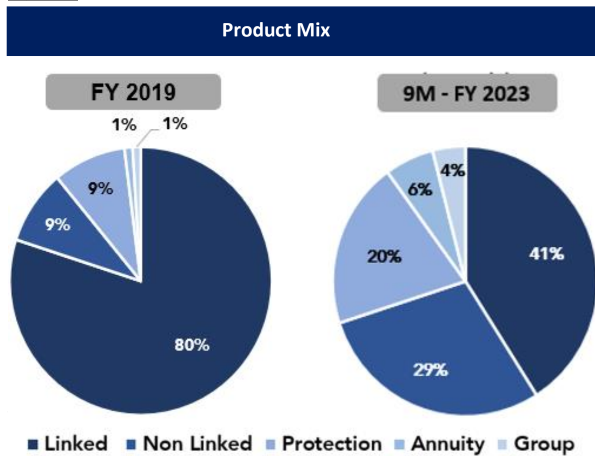
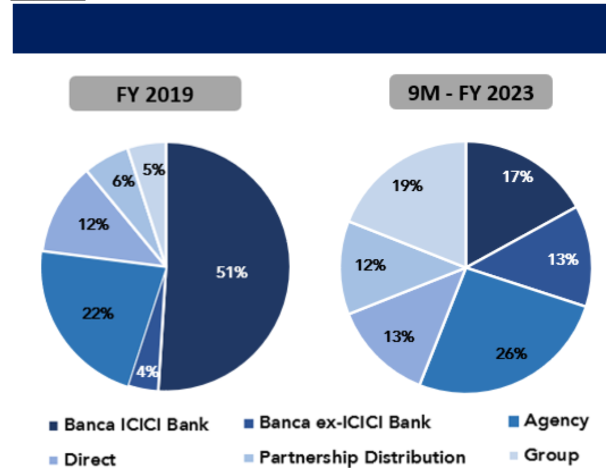


Figure 4



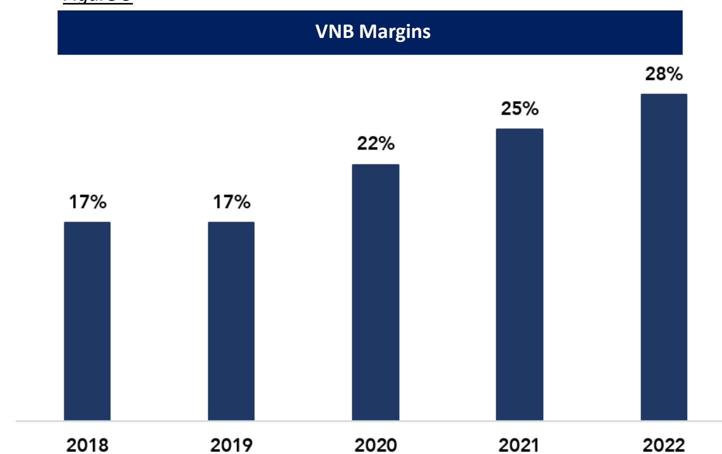
All of this came at a considerable cost. The company's APE over the past four years have been essentially flat, much lower than industry growth rate. Its RWRP (Retail Weighted Received Premium) market share has reduced from 10.3% in FY19 to 9% now. However, the company which is now a well-diversified multi-channel, multi-product company, is inherently in a much stronger position. As the investments into new channels as well as new products in the protection and annuity space gain traction, the company is well positioned to grow ahead of industry growth of 15% over the next several years. ICICI Bank, which now accounts for a little over 10% of annualized premium, will cease to be a significant headwind going forward.

Strong Execution

Back in FY19, ICICI Prudential management had stated its aspirational guidance of doubling new business achieved profit (NBAP), which in a sense is like operational profits, in four years. In spite of significant headwinds from its main bancassurance partner ICICI Bank, Covid impact, as well as high investments in building alternate channels, the company has been able to largely achieve this. While APE was flat through this time frame, the company's VNB margins increased from 17% in FY19 to 32% in FY23. This was driven by a number of factors:

- Mix shift towards protection from 9% to 20%
- Non-participatory products increasing from 9% to 29%
- Improvement in 49th-month persistency ratio from 63.8% to 66%
- Cost/Total Premium ratio improvement from 15% to 20.8%

Figure 5



Source: Company Data

While external factors were a headwind to top line growth, execution under the current management team was top notch. With NS Kannan retiring later this year, the ICICI Group has appointed Anup Bagchi as the new managing director and CEO of the company. Anup has been a veteran in the ICICI Group for over 30 years now. While he has played several roles within the group, he was instrumental in building up the retail trading business of ICICI Securities as well as the retail lending practice of ICICI Bank. With robust on-the-ground experience, we believe the company will show strong execution under his leadership.

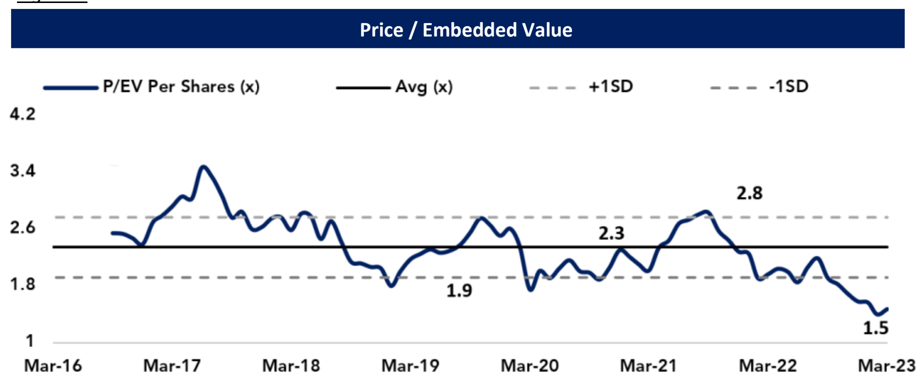
Long term trends for insurance industry remain intact

Post the recent budget, all life insurance companies saw a significant correction in their share prices. This was driven by the government proposal to make returns on non-participatory policies where premium exceeds Rs5 lakh per year taxable on a prospective basis. This raised concerns among investors with regards to impact on growth in the short term, as well as the long-term prospects for the industry given the adverse taxation stance by the government. With regards to the short-term impact, the products impacted by the recent taxation changes account for less than 10% of the overall industry premiums. For ICICI Prudential, they are only around 4%-5% of overall APE. Additionally, through various mitigation factors such as splitting of premium within a family, cross-selling other insurance products as well as restricting the ticket size to sub-Rs 5 lakh, the overall impact can be mitigated substantially. Interestingly, when the government had implemented a similar taxation rule on ULIPs with annual premium over Rs 2,50,000 in FY19, there was negligible impact on the growth rate of that segment in the subsequent year.

From a long-term perspective, we believe the intention of the government is not to curtail this sector, but to harmonize the taxation treatment for all fixed income vehicles to avoid tax leakages. For example, in the same budget, the government also removed indexation benefits for debt mutual funds. The life insurance sector plays an important role in a country like India, where there are no substantial social security benefits provided by the government. While the industry has historically been largely a vehicle to channel long term savings, over the last five years there has been a significant focus by several players to also provide pure life protection as well. For ICICI Prudential, pure protection products now accounts for over 20% of total APE (compared to 9% five years ago) and close to 50% in terms of NBAP, in our estimate. As per Swiss Re, India has a protection gap of 83%, which is among the highest in the world. With only 12% of the addressable population (people with income over Rs 2.5 lakh) holding life insurance policies, the runway for growth is still very long for this industry.

ICICI Prudential has been hit by a series of factors over the last four years – loss in market share due to diversification of channels and products, slowdown in retail protection due to Covid related hikes, increased taxation for certain products in the recent budget. As a result, valuations for the company at 1.5x trailing Price/Embedded Value is at an all-time low (See Figure 6). Going forward, as the headwinds from ICICI Bank ease, investment in other channels bear fruit, and retail protection demand picks up, we believe the company should be able to deliver APE and NBAP growth in the high teens, which along with potential for rerating makes the risk reward very attractive, at a 1:3 ratio in our opinion.

Figure 6



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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