WHITE WHALE
PARTNERS

White Whale North Star Portfolio – 4Q FY24 Quarterly Letter

Dear Partners,

Greetings from White Whale Partners.

Portfolio Performance

The portfolio delivered healthy absolute returns for the year. For FY24, our portfolio is up 24%, which compared to the Nifty at 30%. On an annualized basis, since inception, the portfolio is up 15.8%[1], compared to 19.6% for the Nifty 50 TRI.

Figure 1

			Annualised	
	3 months	1 Yr	3Yr	Inception*
WW Northstar	-1.9%	24.0%	11.8%	15.8%
Nifty 50 TRI	2.9%	30.1%	16.3%	19.6%

*Adjusted for cash from 11th Nov'20 to 31st Dec'20

While the fund delivered healthy absolute returns in FY24, we trailed our benchmark index. The evaluation of this performance can be bifurcated into two parts. Firstly, the fundamental performance of the companies in our portfolio, and secondly, the relative performance vs constituents of the benchmark.

Our core investment philosophy has always been to ***identify incredible businesses backed by outstanding management teams that can compound capital over a long period of time.*** We have remained steadfast in sticking to this framework. This bottom-up approach has worked well with our portfolio companies delivering healthy revenue and profitability growth. In FY24, revenues grew by 20% and earnings by 18% on a weighted average basis for our portfolio. Given the low churn in the portfolio, the long-term growth rate of the current portfolio would largely reflect the actual earnings growth of the Fund. Thus, even from a 3-year or 5-year perspective, the companies in our portfolio have delivered very healthy earnings growth in the 25%-30% range. (See Figure 2)

Figure 2

White Whale Portfolio Companies Performance

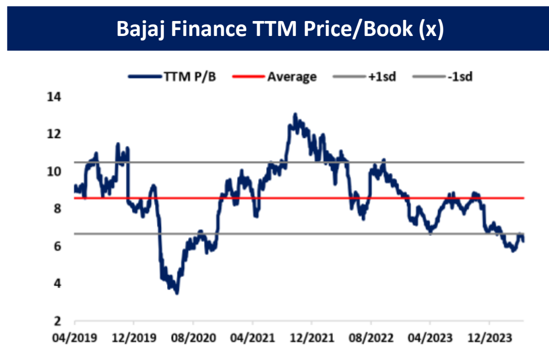
		Revenue*			EBITDA*			PAT*		
Company Name	Sector	1Y	3Y	5Y	1Y	3Y	5Y	1Y	3Y	5Y
Position 1	Consumer Discretionary	22%	20%	32%	10%	20%	33%	11%	21%	55%
Position 2	Industrials	14%	24%	41%	3%	29%	32%	-10%	23%	35%
Position 3	FMCG	9%	16%	9%	19%	23%	9%	11%	27%	16%
Position 4	Banking	19%	18%	19%	30%	18%	13%	30%	20%	20%
Position 5	NBFC	29%	25%	29%	28%	26%	19%	25%	29%	48%
Position 6	Banking	25%	18%	19%	19%	17%	12%	44%	25%	27%
Position 7	NBFC	31%	11%	24%	33%	8%	12%	22%	10%	20%
Position 8	IT Services	20%	14%	21%	12%	16%	17%	13%	13%	26%
Position 9	Housing Finance	27%	38%	36%	32%	42%	26%	31%	46%	44%
Position 10	FMEG	25%	17%	26%	32%	21%	22%	34%	28%	27%
Position 11	Hospitals	11%	9%	20%	13%	40%	33%	5%	NA	NA
Position 12	Hotels	25%	15%	63%	20%	26%	72%	29%	27%	NA
Position 13	Banking	17%	22%	23%	13%	20%	15%	24%	64%	35%
Position 14	Industrials	-1%	11%	25%	-7%	13%	20%	-9%	19%	36%
Position 15	Financial Services	32%	29%	41%	18%	40%	35%	22%	47%	47%
Weighted Average		**20%**	**19%**	**27%**	**19%**	**23%**	**23%**	**18%**	**24%**	**30%**

Source: Company Filings, White Whale Research

[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.

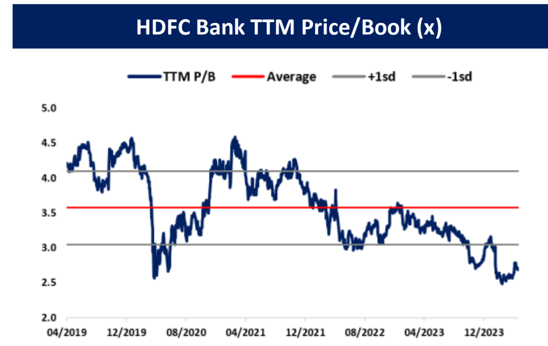
Our absolute portfolio return over the past three years at 12% has in fact trailed earnings growth, implying that the weighted average valuation of our portfolio has actually derated over this period. A large part of this de-rating can be attributed to our investments in the large private sector banks and high-quality NBFCs. As seen in the charts below (See Figures 3, 4, 5), these businesses are trading at more than one standard deviation below their historic average multiples and close to the lows seen during the Covid period.

Figure 3



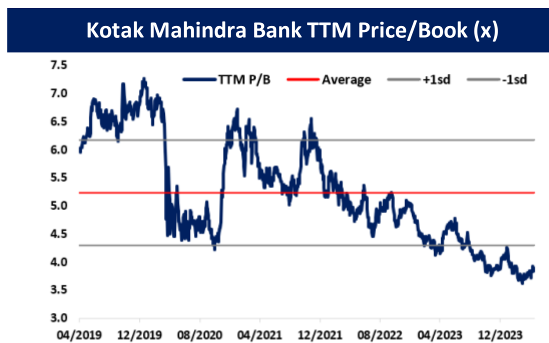
Source: Ace Equity, White Whale Research

Figure 4



Source: Ace Equity, White Whale Research

Figure 5

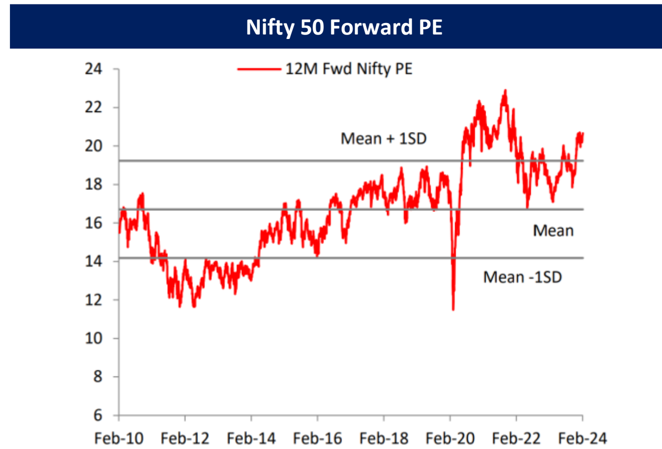


Source: Ace Equity, White Whale Research

One reason for this is that the domestic banking system is going through a very benign credit cycle where non-performing loans are at a multi-year low and corporate balance sheets are pristine. As a result, the difference between quality institutions with strong underwriting standards and the rest of the institutions has narrowed significantly. We believe that as the credit cycle turns, the relative strength of quality institutions will once again come to the fore, thereby helping the valuation differentiation to widen in favour of such institutions. More recently, there have been concerns about the slow deposit growth and tight liquidity conditions in the banking system, which would curtail loan book growth for the private banks. We believe this is a short-term issue and not a structural issue. Over the past 20+ years, private banks have managed to maintain incremental deposit market share which is almost double of their existing deposit market share, enabling them to grow their deposits at ~15%-20% CAGR. Given the investments they have made into branches and technology compared to the government banks, we expect this trend to continue over the next several years. Overall, the core fundamentals remain very strong for these businesses to compound earnings at around 20% for the next several years.

In contrast to our portfolio, the broader market indices have actually seen a significant re-rating and are trading at above historical averages. The Nifty 50 Index is trading at 21x forward earnings, at a 27% premium to its long-term average of 16.5x (See Figure 6). The NSE Midcap and small cap indices are trading at 26x forward earnings and 23x forward earnings, respectively. This is ~50% premium to historic valuations.

Figure 6

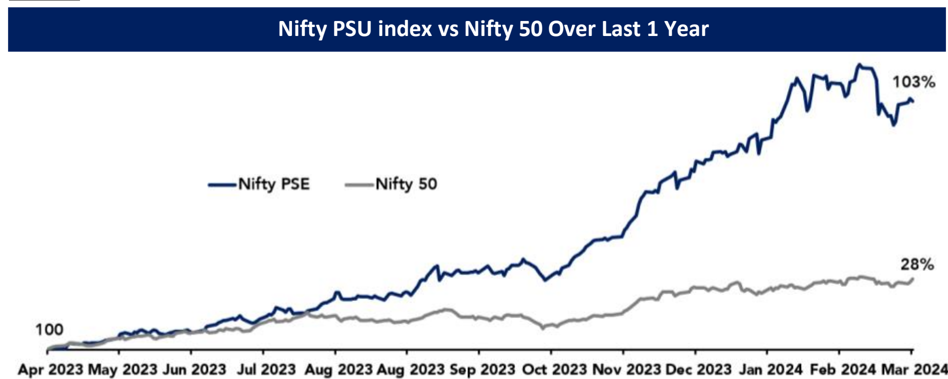


Source: Philip Capital

There have been various factors driving this. 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, a significant part of the re-rating in small-cap and mid-cap stocks has also been driven by strong flows from domestic investors into illiquid stocks, thereby stretching valuations.

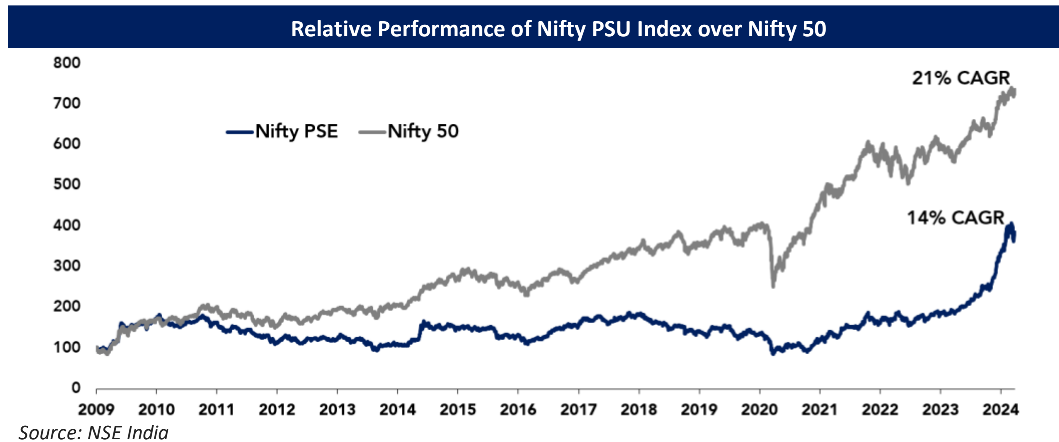
At the other end, several companies, especially PSU stocks, had been beaten down significantly over the last several years and were trading at distressed valuations. Over the last one year, many of these stocks have seen a massive re-rating. For example, the PSU Index was up 103% in FY24 compared to the Nifty being up 28% (see Figure 7). For some of these companies, the business outlook could be changing given a turn in the capex cycle, but we believe many companies with weak fundamentals and structurally low ROE businesses have also been re-rated alongside. As John F Kennedy put it – "A rising tide lifts all boats." In our view, government-owned companies don't have their incentives aligned with minority shareholders, are run by bureaucratic management teams, and also carry a high level of government intervention risk. In the past as well, we have seen such periods where these stocks have seen a sharp rally - typically when their valuations have collapsed into a deep value zone. In spite of the sharp recent outperformance over the last fifteen years, the PSU stocks have still sharply underperformed the Nifty index (See Figure 8). We wouldn't be surprised if history were to repeat itself.

Figure 7



Source: NSE India

Figure 8



Source: NSE India

"Be Fearful When Others Are Greedy and Greedy When Others Are Fearful" – Warren Buffett

During times of exuberance, such as now, it is especially important that we pay close attention to the risk guardrails that we have established as part of our investment strategy. One of the key guardrails is to use a strict negative filter when looking for investment ideas.

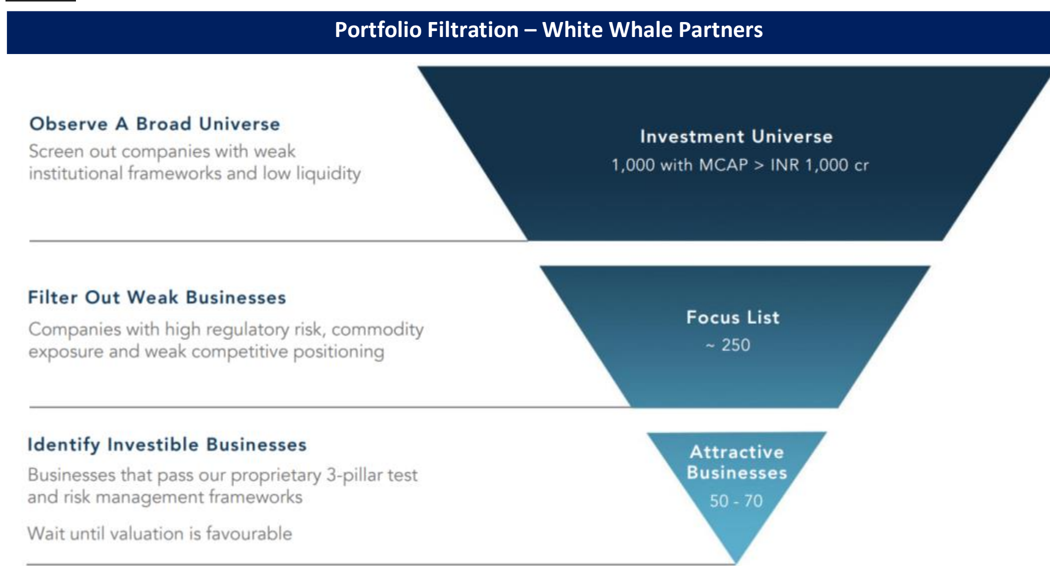
Firstly, we look to avoid investing in micro-cap companies. There is a fair argument to be made in finding micro-cap companies with high potential for growth and strong financial metrics that can deliver multi-fold returns in the future. However, in our experience, finding such companies is akin to finding a needle in a haystack. Typically, many of these companies have weak institutional frameworks, and poor governance standards and are, more often than not, one-man shows.

Secondly, and more importantly, 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 prices of these commodities are dependent on a multitude of global macroeconomic factors as well as supply/demand dynamics – something we find very difficult to form an informed opinion on.

We also will not invest in companies where the government is the majority owner, as discussed earlier. 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 a long gestation, capital-intensive projects, especially those that are won through a tender process, such as road construction and infrastructure projects as the returns profile of such projects is usually unattractive given the competitive nature of the bidding process. We will also avoid businesses that are particularly susceptible to technology disruption and have a weak competitive positioning.

Finally, we would further filter our investment universe to companies that have a long runway for growth and can sustain high ROCEs through this time frame. (See Figure 9)

Figure 9



Source: Ace Equity, White Whale Research

We remain steadfast in our conviction that while there can be phases of relative re-rating or de-rating, in the long run, stock performance is driven by the company's underlying earnings growth. We continue to believe our portfolio will deliver around 20% annualized 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 remain excited about the growth prospects of India over the next decade and believe our portfolio is well-positioned for the long term. By being true to our investment philosophy, and investing in such businesses at a reasonable price, we are maximizing our probability of compounding capital at a healthy pace over the long term.

At the same time, we do recognize that there is a significant transformation happening within the Indian economy driven by government initiatives such as "Atmanirbhar" or self-sustenance, production-linked incentives (PLI) driving the manufacturing sector and green initiatives such as the transition towards electric vehicles and renewable energy. We are on a constant lookout for companies that can benefit from these structural trends. One such company that we invested into this quarter is Polycab India.

Polycab India (Market Cap: Rs 81,600 crore)
Polycab is the largest cables & wires company in India, with a market share of ~18% in FY23, and is almost 2x the size of its next competitor. It has a variety of cables & wires in the 0.2KV to 220KV range, and over 12,000 SKUs. Its offerings include cables and wires, which are used across various sectors such as chemicals, consumer durables, defence, energy, infrastructure, manufacturing, metals, oil & gas, real estate, and telecom. In 2014, the company also entered the FMEG segment via fans, appliances, LED lighting & luminaries, switches & switchgears, and pumps. The company has 25 manufacturing facilities spread across the country, along with 4,300+ authorized distributors and more than 0.2m retail touchpoints. The company recorded revenues of Rs. 14,178 crore in FY23, PAT of Rs 1,283 crore, and healthy ROE of 21%.

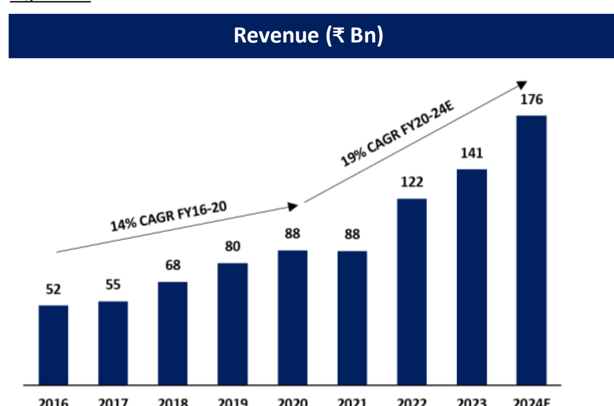
Management
Polycab was established by the Jaisinghani family back in 1983 from a small 1,000-square-foot garage. Over the last 40 years, it has grown into a leading wires and cables manufacturer in the country. Through this period, the management has done an incredible job in professionalizing the business, with only three family members now actively involved in the business. At the CXO levels, the company has hired a diverse team from companies such as Havells, Tata Motors, Hindustan Unilever, Bharti, Asian Paints, etc.

In FY21, the management embarked on a multi-year program called Project Leap, using BCG as their consultant. This program included a range of strategic teams which covered initiatives focused on growth, profitability, and long-term capability building for the organization across B2B and B2C businesses. The plan was divided into 4 parts:

- Customer centricity - several businesses were merged to create a leaner organizational structure. This reduced overlap and improved customer service.
- Go-to-market strategy – did a survey across 600 districts to identify gaps and potential opportunities to expand distribution reach.
- Product innovation - conducted surveys and research on the existing market offerings. The insights from this exercise provided strong clarity and focus on where to play and the right portfolio structure to deliver results.
- Digitalization - piloted end-to-end digitalization of front-end sales across businesses in key markets. Created a digital platform for the costing of purchased and traded items.

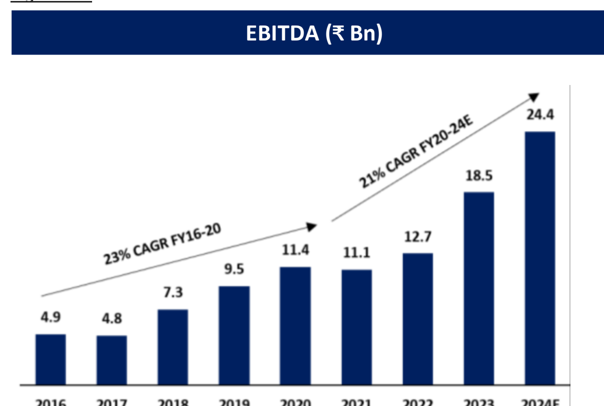
The impact of Project Leap can clearly be seen in terms of acceleration in revenue growth (See Figure 10) as well as EBITDA margin uptick (See Figure 11). The company had then stated a goal of reaching revenues of Rs20,000cr with steady EBITDA margins of 11%-13%. It is well ahead of achieving this goal, with revenues in FY24 itself expected to be close to Rs17,000cr with margins of 14%. This highlights the strong execution capabilities of the top management.

Figure 10



Source: Company

Figure 11

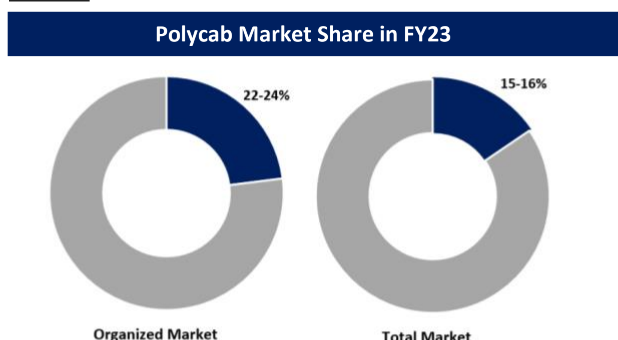


Source: Company

Incredible Business

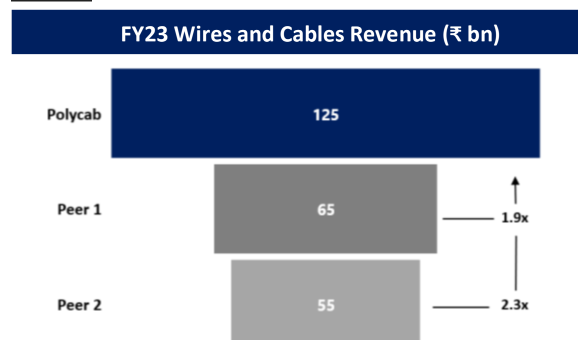
In our meetings with management, they were clear on their go-to-market strategy. They essentially wanted to be to the electrician what Asian Paints is to a painter, what Pidilite is to a carpenter, and what Astral Pipes is to a plumber. Related to this, the company has held several workshops in order to better educate the electrician with regard to its products. At the same time, their marketing initiative of roping in Bollywood actors as brand ambassadors has helped improve brand visibility. As a result, the company has been steadily increasing its market share by around 100bps every year. It currently holds a dominant position in the industry with approximately 22%-24% market share of the organized industry and 15%-16% of the overall industry (See Figure 12). In fact, Polycab is now almost two times the size of its nearest competitor (See Figure 13).

Figure 12



Source: Company

Figure 13



Source: Company

This dominance, alongside industry-leading margins, enables the company to control over one-third of the industry profit pool, which in turn allows it to further outspend its competition with regard to brand building and distribution expansion. Further, unlike its competitors, it runs an active hedging program for its key input commodity, copper, thereby ensuring stability in margins. Overall, the company has been able to maintain healthy ROCEs in the 20%-25% for the last 5 years and has a healthy cash position of close to Rs2,000cr. Polycab has been historically a B2B-driven business but has started focusing on the B2C channel over the last several years. This is visible from the share of B2C increasing in overall revenue from 34% in FY19 to 40% now. This will further improve the margin profile of the company.

Longevity of Growth

The cables and wires industry is a Rs70,000cr industry. It is very well positioned to benefit from the various structural changes ongoing in the Indian economy, given the diversity in the usage of cables and wires. It is a big beneficiary of the pick-up in the real estate cycle, supplying cables and wires to new residential buildings. Apart from that, emerging new themes such as renewable energy, data centers, electric vehicle charging, alongside traditional investments in power, railways, and defence would all need cables. Therefore the structural drivers for this business remain very strong and we expect the industry to grow at a 10%-12% run rate for several years, with Polycab continuing to grow market share.

Apart from this, there are two additional drivers that can increase the runway for growth even more. The company derives close to 10% of its revenues from exports. It is actively setting up its distribution across the middle east, US and Europe to penetrate the market there. Secondly, while their FMEG business (9% of revenues) is still a work in progress, any turnaround there can add further optionality to the addressable market size and growth potential for the company, as it is a Rs45,000cr market opportunity.

The company has delivered very healthy results for the last 5 years, with a revenue CAGR of 15%, EBITDA CAGR of 20%, and PAT CAGR of 28%. The stock saw a sharp correction in January of this year, related to an income tax raid. Valuation corrected to 32x forward earnings. However, our interaction with management and channel checks suggest there is no material corporate governance issue and the company's trade practices are in line with the industry. We used the correction as an opportunity to build a position in the name, and the stock has rallied 26% subsequently.

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

DISCLAIMER: *White Whale Partners LLP is a SEBI registered Portfolio Manager. This document has been made available solely for informational purposes and is for private circulation only. The information and opinions contained in this document have been obtained from sources believed to be reliable but no representation or warranty, express or implied, is made that such information is accurate or complete. The information and opinions are not, and should not be construed as, an offer or solicitation to buy or sell any securities or make any investments. White Whale Partners LLP and its employees will not be held liable in any way for any loss or damage, direct or indirect, arising from the use of this information*