White Whale North Star Portfolio – 3Q FY22 Quarterly Letter

Dear Partners,

Greetings from White Whale Partners. We are pleased to update you on our performance for the quarter ended December 31, 2021.

Portfolio Performance

Our portfolio has delivered healthy absolute and relative return this fiscal year. For the quarter ended December 2021, the portfolio was down 2.3%, compared to down 1.3% for the Nifty. For the first nine months of FY22, our portfolio is up 25.30% compared to 19.3% for the Nifty. Since inception, the portfolio is up 47.3%, compared to 39.1% for the Nifty (adjusted for our average cash holding through November and December 2020 as we gradually built out the portfolio).

Figure 1

	3 Month	6 Month	YTD FY22	Inception**
WW North Star	-2.3%	17.1%	25.3%	47.3%
Nifty 50 TRI	-1.3%	10.9%	19.3%	39.1%

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

Over the last quarter, the India stock markets have been consolidating, after the steep run up seen over the previous eighteen months. This has been primarily driven by continued foreign selling, even though domestic flows remained strong. For 3QFY22, FII saw a net outflow of Rs.1,00,966 crore, partially offset by domestic inflows totalling Rs 52,008 crore. Valuations remain above historical averages, with the Nifty trading at 22 times forward PE, (see figure 2 below), which is almost two standard deviations above historical averages.

Figure 2

Source: Kotak Institutional Equities

[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.

Accommodative monetary policy globally has provided strong tailwinds for stock markets over the last 12 months, and has even driven pockets of speculative bubbles across several asset classes. With rising inflation and tightening monetary policy, the rerating phase would now be behind us and it would be reasonable to moderate our return expectations for the stock market as a whole, going forward. Bottom up stock picking becomes even more crucial in this environment. For example, between 2015 and 2020, while the Indian markets delivered a 7% annualized return, 92 stocks in the BSE500 delivered over 20% annualized returns. Thus, rather than focusing on the overall market returns, 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

While the second wave had a limited impact from an economic perspective, we expect the impact from the third wave to be even lighter, given the mild nature of its health effect as well as the adaptability that businesses have shown to the new environment. As a result, we do not view the current wave to have any significant impact on the 2022 outlook for the Indian economy. The macro-economic environment continues to remain robust. We are particularly excited about the prospects of the Indian economy entering into a new investment cycle after almost a decade. In a recent survey done by Economic Times among Indian corporates, almost 70% of the corporates indicated that their capacity utilization was over 70% and 94% of the respondents are looking at new capital expenditure between 2022 and 2025. Further, banks that were reeling with NPA problems for the last eight years, are now well capitalized (average capital adequacy ratio of 16%) and non-performing loans are at a five year low. Interest rates are also at multi-year lows. Large corporates have also significantly deleveraged their balance sheets, while corporate tax rates have been lowered to 17% for new manufacturing units. The production linked incentive scheme along with the global shift in supply chain away from China, in itself should trigger private capex of over $50 billion over the next 4-5 years. Real estate demand continues to be very strong and should be a big driver of growth across several ancillary industries. Finally, large government spending towards infrastructure projects over the last few years has significantly addressed India's supply side structural issues. For example, the average distance covered by trucks in India has increased from 300 km per day in 2011 to 500 km per day now; major port turnaround time has reduced from 5.3 days in 2011 to 2.6 days now and peak power deficit has reduced from 12.5% in 2011 to just 0.6% now. With significant disruption happening across industries such as green renewable energy, electric vehicles and digital transformation, we expect strong foreign direct investment (FDI) into India over the next few years. FDI has already increased from US$55.6 billion in 2016 to US$82 billion in 2021. We believe all of these building blocks should help drive a healthy capex cycle over the next five years. Several companies in our portfolio are well positioned to benefit from this pick up in capex cycle.

On the other hand, an increase in inflation is a rising concern. On the back of higher commodity costs and supply chain bottlenecks, the consumer price index in month of December stood at 5.6%, at the high end of RBI's targeted range of 2%-6%. Rising interest rates and a tighter liquidity environment would help in easing of the speculative bubble seen in several digital companies as well as the IPO frenzy seen in 2021. While we are firm believers in many of these digital companies - especially those with strong unit economics, a long runway for growth and stellar leadership teams - we have been circumspect on the underlying valuations. We continue to track this space closely and would use volatility in stock prices to add to our portfolio. With regards to our overall portfolio, we remain focused on investing in companies that have long term compounding potential with resilience against macro-economic variables such as inflation and interest rates in the medium term, aided by a strong competitive positioning and pricing power.

Portfolio Insights – How do we define an incredible businesses?

We remain firmly committed to our investment philosophy of *backing outstanding management teams spearheading incredible businesses that have the ability to compound capital over a long period of time*. 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.

One of the key pillars of our investment strategy is to invest in *incredible businesses* – businesses that have a competitive advantage that can be sustained over a long period of time, and thereby enable the company to generate high return on capital which is significantly above cost of capital. This would lead to significant shareholder value over a period of time.

These businesses typically demonstrate strong bargaining power over their suppliers or customers, which enables them to earn superior margins. This advantage could be driven through being the lowest cost, albeit best quality producer for a B2B business or having a strong brand name in the case of a B2C business. These businesses either have a dominant market share that enables economies of scale, or are gaining disproportionate market share due to an innovative product or a differentiated distribution set up. Thereby, they garner the majority of the profit pool of that industry, making it difficult for incumbents to enter. They have a history of efficient capital allocation and balance sheet discipline. As a result of this, these companies have the ability to deliver financial outperformance through economic cycles.

The increasing pace and innovation and disruption caused by technology

While identifying these businesses based on past performance is easy, the key challenge lies in identifying the sustainability of this competitive advantage. Globally, most businesses have a low probability of an enduring competitive advantage. In 1935, the average lifetime of a large cap company in the S&P 500 was 90 years. By 1960s, that had declined to 61 years. It further declined to 25 years by 1980. In 2020, the average lifetime of a company on the S&P 500 was only 18 years. This essentially means that half the companies that were there in 2010 in the S&P500 have now fallen out of the index. If this trend continues, approximately 75% of companies that are in the S&P 500 index will be replaced by 2028. Therefore, finding these "incredible businesses" is becoming increasingly challenging, as the rate at which this competitive advantage or moat is withered away is only accelerating.

There are several reasons for this – an increasingly connected world, regulatory intervention, change of management focus, to name a few. However, the biggest reason for this trend is technology disruption. We believe this disruption is at an inflection point and spreading to sectors that have typically seen only slow and incremental change. Questions around the durability of the moat make it even more difficult to extrapolate historically strong financial performance. The width of the moat in itself is no longer sufficient. Companies need to embrace an innovative mindset, with bold management decisions to continuously disrupt their own business models to protect their competitive advantage. As technology disruption impacts industries, a company needs to demonstrate an innovative mindset. Besides understanding the competitive advantages of businesses, we spend a significant amount of time questioning the sustainability of these moats. Furthermore, we recognize that finding such companies is becoming increasingly difficult. Therefore, once we identify such businesses, we intend to hold on to these positions for a long period of time.

A great example of an incredible business with sustainable competitive advantage is Jubilant Foodworks.

Jubilant Foodworks

Jubilant Foodworks is the market leader in the Indian pizza segment with a network of over 1400 Domino's Pizza restaurants across over 300 cities in India. The Company operates the Domino's Pizza brand with the exclusive rights for India, Nepal, Bangladesh and Sri Lanka. It has these rights till December 2024 and renewable for another decade post that. With exclusive right to develop and operate Dunkin' Donuts restaurants in India, the company currently has 27 restaurants under this brand. It has recently started new formats - Hong's Kitchen (HK) and Ekdum! Biryani, besides taking over the master franchise for the international burger chain - Popeyes. From FY17-FY20, the company reported strong financials with revenue CAGR of 15%, high EBITDA and PAT margins of ~24% and ~7% respectively coupled with high ROE and ROCE of ~24% and ~48% respectively.

Stellar People

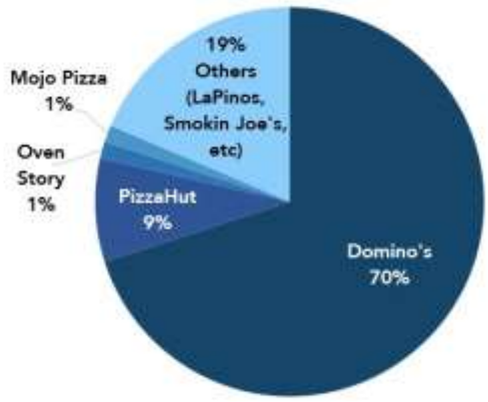
The company had a stellar track record since the time of its IPO in 2010 through 2015, with rapid store expansion and same store sales growth. However, between 2015 and 2017 its incessant focus on chasing top line growth through store expansion proved imprudent, causing a sharp dip in profitability. Jubilant went through a change in management in 2017, when the CEO was replaced by Mr. Pratik Pota. He had a stellar track record for over a decade in PepsiCo prior to that, with positions in Bharti Airtel and Hindustan Unilever at the start of his career. Under this new management, there was a significant change in strategy, shifting focus from revenue expansion to profitability. Jubilant had opened new stores at an annual run rate of 110+ stores for Dominos and 10+ stores for Dunkin' Donuts between 2012 and 2016. However, under Mr. Pota's leadership, unprofitable stores were shut down and the new store growth plans were tempered down to get to zero net store additions in FY18 and only 88 net store additions in FY19. There was also an increased focus on using technology to drive the digital delivery channel, such as launching a new Dominos app and using data to realize better cost efficiencies. The new management also took several other steps like simplifying the menu, refreshing the product offering and introducing the affordable 'Everyday Value' range, which resonated well with consumers. Even through the Covid pandemic, Dominos was the first to introduce contact-less delivery and was one of the only QSRs to introduce delivery of other essential products through their own platform. This itself speaks to the fast paced, innovative and opportunistic execution of the current management team. Since the time the current management took over, same store sales growth improved from -2.4% to 14.1%, operating profit margins expanded from 10% to 24% and ROCE improved from 11% to 48%.

Incredible Business

Jubilant Foodworks has done a stellar job in growing the Dominos franchise in India over the last 25 years. It is by far the largest quick service restaurant (QSR) chain in India with 1435 outlets, with the next largest franchise being Subway at around 550 outlets and McDonalds at 500 outlets. Even within the pizza category, they have a dominant 70% market share (see Figure 3), which they have defended in spite of the entry of several players fueled by the growth of food aggregators like Swiggy and Zomato. This is primarily because of the company's constant focus on innovation and customer satisfaction. Driven by their tight control over the delivery chain, they were the first company to come out with a 30-minute delivery guarantee in India, which was very well received by consumers. Given the dominance of Dominos in the pizza category, Swiggy and Zomato are dependent on Dominos as an anchor while entering new markets rather than the other way around. This gives Dominos tremendous bargaining power over these aggregators, as is evidenced by commissions charged to Dominos of <10% compared to average commissions of >20% charged to standalone restaurants.

Figure 3

Indian Pizza Market – Organized Players



Source: Company

Are Jubilant's moats sustainable?

The company has shown a remarkable ability to continuously adapt to new developments and disruption in the industry, as well as constantly innovate internally to set new benchmarks for the industry. Under the new management, they rehauled their entire menu and launched everyday value meals, which further saw significant traction among the consumers. Post the 30-minute delivery guarantee, the company is working on a 20-minute delivery guarantee in certain metros and large cities. Using its "fortressing" strategy, it is doubling down on neighborhoods which are already successful for the company, by opening a new delivery-oriented outlet right next to the existing outlet. This strategy helps reduce delivery times, make larger number of deliveries in a period of time, gives better visibility of orders through GPS tracking, and provides better quality of ordering experience. The company took this playbook from Domino USA which has implemented this successfully in several markets globally. Apart from this, the company recognized the potential threat from Swiggy and Zomato early on, and invested significantly behind its own app, as well as ensuring control over customer data and delivery network right from the start. As a result, the company has seen over 71 million app downloads to date. Impressively, its monthly active users are 25% of Swiggy's monthly active users, in spite of serving only a single cuisine. As a result, over 50% of the company's sales come from its own app, while only 23% come from food aggregators. This not only allows them strong bargaining power over the aggregators, but also gives them access to valuable customer data. Jubilant can use this data to improve customer service and also cross sell its other formats such as Hong's Kitchen and Ekdum! Biryani to these customers. We believe these steps taken in the face of technology disruption has in fact widened the company's competitive advantage over others.

Figure 4

% Of Jubilant Sale from Different Channels

Source: Company

Source: Company

Time

The penetration of QSRs into tier 3 and tier 4 towns in India is only just beginning. Management believes Domino franchisees can be scaled up to over 3,000 outlets over the next few years, which is over 2x the current levels. With over 70% of their revenues coming from deliveries, they would be a big beneficiary of growth in the food delivery business. Post large capital raises by Swiggy and Zomato, we expect them to significantly expand their distribution reach beyond the ~550 cities currently. Besides that, we expect them to drive significant incentives and promotions to encourage a shift in consumer behavior. As per analyst expectations, Zomato is expected to increase its delivery volumes by <45% CAGR through 2025. Dominos, given its dominant position in the pizza category, will be a natural beneficiary of this trend.

As per Technopack BoK, pizza accounts for only 7% of the total food delivery in India. North Indian and Chinese account for 27% and 19% respectively. With the scale up of Ekdum Biryani and Hong's Kitchen, the company is essentially expanding its addressable market by over 7x. Given vast amount of customer data, potential to set up cloud kitchens using its fortressing strategy as well as distribution reach, Jubilant has a fair chance to succeed in these categories. Overall, we believe the QSR industry and the food delivery business has hit an inflection point, with a long runway for growth ahead. Jubilant is very well positioned to benefit from this trend.

The company enjoys very robust unit economics. Over 80% of its revenues are deliveries or takeaways, which enables strong capital efficiency. The company has industry leading EBITDA margins of over 24%, while ROCE is well above 40%. With same strong sales growth in mid to high single digits as well as rapid store additions, the company should generate revenues and earnings growth at over 20% for the next five years. While valuations at 65x 12-month forward earnings are high, they are still in line with historical average. Given the long runway for growth within the pizza category, possible optionality from its new ventures as well as healthy return on capital, this remains a core position in 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. i

Sincerely,

White Whale PMS Team