White Whale Partners

White Whale North Star Portfolio – 1Q FY23 Quarterly Letter

Dear Partners,

Greetings from White Whale Partners. We are pleased to update you on our performance for the quarter ended June 30, 2022.

Portfolio Performance

For the quarter ended June 2022, the portfolio was down 9.8%, largely in line with the overall markets with the Nifty down 9.1%. For the last 12 months as well, our portfolio is down 1.0% compared to up 1.7% for the Nifty. Since inception, the portfolio is up 24.6%[1], compared to 27.4% for the Nifty (net of all management and incentive fees and adjusted for our average cash holding through November and December 2020 as we gradually built out the portfolio).

Figure 1

	3 Month	6 Month	1 Year	Inception*
WW North Star	-9.8%	-15.4%	-1.0%	24.6%
Nifty 50 TRI	-9.1%	-8.4%	1.7%	27.4%

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

In our previous investor letters, we had highlighted headwinds to investment returns from rising inflation, driven by surging commodity prices, disruptions in the supply chain from lockdowns in China and geo-political uncertainties related to the Ukraine-Russia war. This has played out over the last quarter, where global markets have corrected 8%-15%, and the Indian markets seeing a 10% correction as well. Tightening of liquidity by central banks globally is having a massive impact on foreign flows in India. Foreign investors have sold an unprecedented US$35 billion from the Indian equity markets since October 2021. Even as a percentage of total holdings, foreign investors have now sold 5.3% of their total holding over the last 10 months, exceeding what they sold in the Global Financial Crisis. However, this has been partially offset by steady inflows from domestic institutional investors. We believe the increasing acceptance of equity as an investment asset by domestic investors is a secular trend and structurally positive for the economy, which has traditionally been starved of risk capital. On the flip side, post the recent correction, valuations, that were two standard deviations above historical average, are now closer to historical average (See figure 2). **We continue to believe India is in the early stage of an upcycle in economic growth, driven by a pick up on capex spending after almost a decade of pain, and the current correction provides an opportunity to further invest in the India growth story.**

[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.

Figure 2

Nifty Forward PE (x)

Source: Bloomberg, CLSA

As seen by the sharply contrasting trends over the last couple of years, global macro factors and liquidity can act as headwinds or tailwinds to valuations in the short term. However, it is earnings growth that is the key driver of investment returns in the long term. Our portfolio companies in aggregate delivered healthy performance in FY22, with revenue growth of 24% and operating profit growth of 29%, over the same period last year. Even on a three-year CAGR basis (excluding the varying base effect of covid over the last couple of years), aggregate revenues of our portfolio companies were up 17% and operating profits were up 23% over this period. Our portfolio comprises mostly of companies that are either market leaders in a nascent industry which is at an inflection point, or companies that are well positioned to gain market share in an existing industry, due to their unique competitive positioning. As a result, we remain confident that our portfolio will to continue to deliver over 20% earnings growth over the next several years.

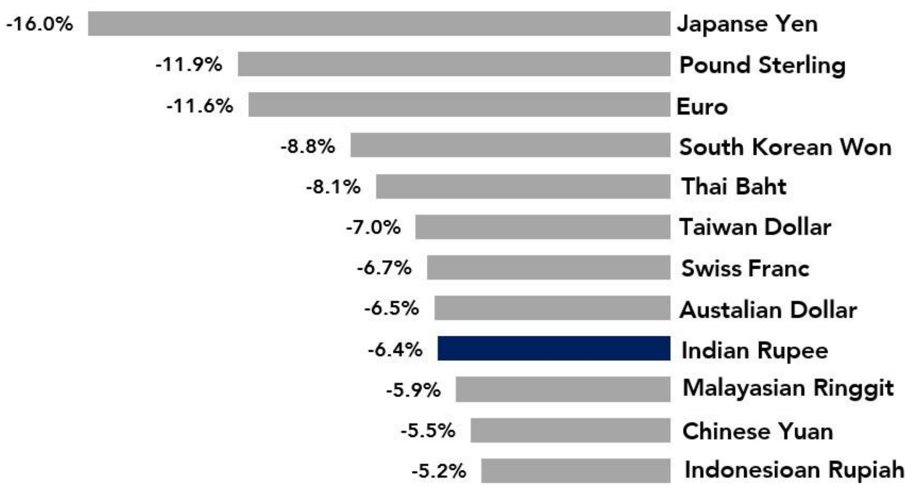
As always, we remain focused on trying to identify *incredible businesses, backed by outstanding management teams that can compound capital over a long period of time*. We believe this is critical towards delivering healthy returns in the long term, while ensuring capital protection.

Macroeconomic Developments

Inflation is seeing a surge across the world. In the US, it has surged to a 40 year high, with the consumer price index (CPI) coming in at over 9% for the month of June. Labour participation has dropped significantly, unemployment rate is at an all-time low and wage inflation is picking up. This raises concerns related to inflation expectations becoming unhinged and structural. The Fed has rightly moved away from terming inflation ”transitory” and is looking to front load interest rate hikes by another 175bp-200bps over the next twelve months, after having already increased interest rates by 150bps this year. In India as well, the CPI index was up 7% for the month of June, above the RBI range of 2%-6%. As a result, the RBI is also expected to hike rates by another 120bps over the next 12 months. However, we believe the situation in India is different from the developed world. The high inflation levels in India are more directly a function of the surging commodity prices, rather than structural constraints arising from low unemployment and capacity utilization. Commodity prices are already seeing a significant correction over the last few months on fears of a global recession. Prices of base metals such as copper, lead and aluminium are down 24%-37% from their peak. Prices of agricultural products like palm oil, wheat, corn and soybean have also corrected by 18%-48%. Oil is still over US$100 a barrel and remains the key risk not only from an inflation perspective but also puts pressure on higher trade deficit. The purchase of cheaper oil from Russia provides some relief out here. 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

Another topic that has been dominating headlines recently is the depreciation of the rupee against the dollar. Year to date, the rupee is down 7% against the dollar, hitting Rs80 for one US dollar. However, this has more to do with the dollar strengthening than the rupee weakening. In fact, against a basket of the top 10 heavily traded currency (referred to as the G-10) the rupee has actually appreciated by 3% year to date. The rupee has performed better compared to most developed country currencies and performed in line with most Asian currencies (See figure 3). This is in line with our view that India is much better positioned this time, compared to the monetary tightening scare in 2012-2013. India's foreign exchange reserves has swelled to USD$580 billion from USD$207 billion back in 2013. For FY23, current account deficit is expected to remain under control at around 3%. With the recent government push on domestic manufacturing, foreign direct investments are expected to further surge over the next several years. While many emerging economies are facing havoc in the face of tightening global liquidity, India has been and should remain much more resilient.

Figure 3

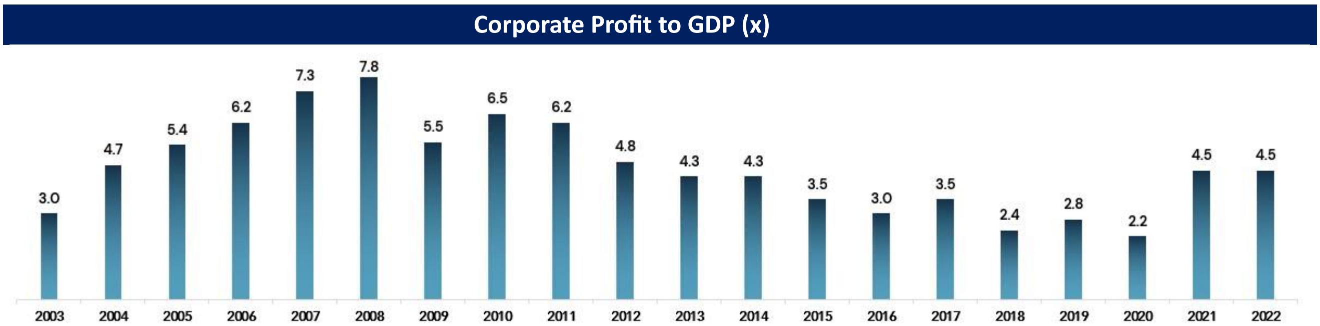


Source: Bloomberg

In spite of the macro-economic turbulence, both government and corporate capex has continued to gain momentum.
Cumulatively in April-May 22, government awards at Rs 923 billion are up 183% YoY, while government tenders at Rs 1,295 billion are up 108% YoY. Driven by the PLI schemes as well as the Make in India theme, the risk appetite of Indian corporates towards investing in capacity expansion is also improving. Private sector projects under implementation are up 9% YoY in FY22, which is the highest growth recorded since FY11. In fact, new investment announcements by private sector in FY22 was ~2x that of pre-Covid FY20 level. From a balance sheet perspective as well, there has been significant deleverage among Indian corporates. Net debt/equity for Indian manufacturing companies is down from 0.68x in FY20 to 0.41x in FY22 and the lowest since 0.36x recorded in FY11. Similarly, Net Debt/EBITDA declined from 2.5x in FY20 to 1.21x in FY22 and the lowest level since 0.88x in FY11. RBI's Manufacturing Capacity Utilization (CU) in December 2021 quarter has increased 410 bps qoq to 72.4%. Overall credit growth has increased to over 14% yoy, a level not seen since 2014.

More importantly, large corporates credit growth is at 7%, an eight year high. With significant disruption happening across industries such as green renewable energy, electric vehicles and digital transformation, several catalysts are in place to drive this capex growth further. Therefore, despite the near team headwinds, we believe these structural drivers will play a more dominant role helping corporate India tide over a tighter liquidity environment, driving healthy earnings growth over the next several years. This is already apparent in the corporate profit to GDP ratio, which has seen a healthy uptick over the last couple of years, a trend we believe should sustain over the next several years (See Figure 4).

Figure 4



Source: Ace Equity

.

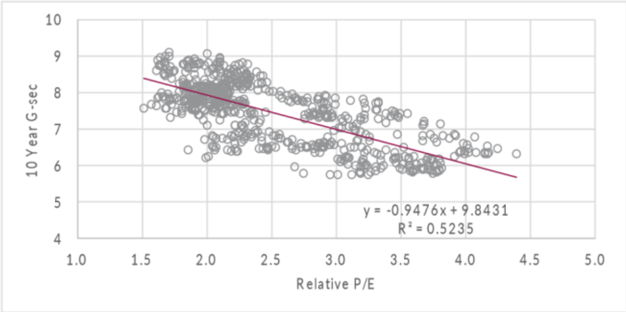
Portfolio Insights – Growth vs Value

There has been a major shift in factor performance away from growth stocks and towards value stocks over the last few quarters, on the back of increasing concerns around a rising interest rate environment that we discussed before. Digital companies that went public recently, such as Paytm, Zomato, Policybazaar, Nykaa, are down 32%-62% over the last six months, while government owned stocks like NTPC, Powergrid, ONGC are actually up 6%-14% over the same timeframe. The logic behind this is simple – as cost of capital increases in a rising interest rate environment, the present value of the future cash flows being projected in growth stocks comes off significantly, thereby resulting in a de-rating in the earnings multiple of these stocks. At the other end, the shift in fund flows towards value stocks actually results in a re-rating for some of these high dividend yield, low P/E stocks. A recent strategy note by Axis Capital ran a regression on the impact that interest rates have on the valuations of certain growth and value stocks. While there is a sharp negative correlation between interest rates and P/E for growth stocks like Titan, it was actually the other way around for a value stock like ITC. (See Figure 5 and Figure 6)

Figure 5

Titan P/E Correlation to Interest Rates

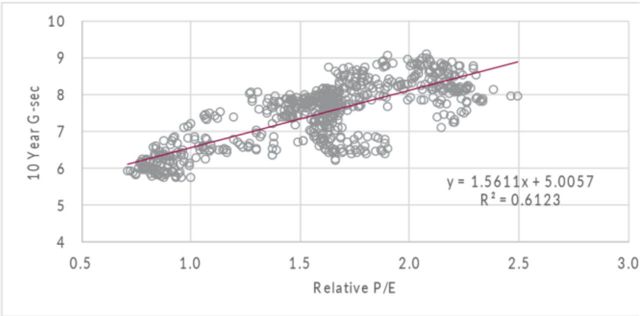
Exhibit 11: …as does Titan's…



Source: Axis Capital

Figure 6

ITC P/E Correlation to Interest Rates



Source: Axis Capital

In our investing experience of over 20 years, we have observed multiple such phases in the Indian markets. However, we remain steadfast in our conviction that while there can be phases of relative re-rating or de-rating, in the long run the stock performance is driven by the company's underlying earnings growth. As a result, we continue to look for companies that are at an initial stage in their growth cycle, with a long runway for growth ahead and can deliver healthy earnings growth over a long period of time.

At the same time, we are not valuation agnostic. To mitigate the risk of high valuation that persists amongst quality companies, we first look for certainty of high earnings growth over several years. This again ties into investing within our circle of competence, and having a detailed understanding of the company's management, competitive edge and addressable market size. We then assume a reversion of valuation multiples to a reasonable level over a five year time horizon, to calculate the implied rate of return. A healthy implied rate of return alongside strong conviction of high earnings growth drives our investment decisions.

As always, we plan to discuss one idea that can provide a better perspective into our decision-making process.

Timken India

Timken India (market cap USD$ 2.7 billion) is a 68% owned subsidiary of Timken USA. In the Indian bearings market, it is the 4th largest player with more than a 13% market share (~₹ 105 bn industry size). However, the company is a global leader in tapered roller bearings, which is commonly used for heavy load applications where durability is required. As a result, the company enjoys a leadership position in the domestic railway business, particularly in the high haulage freight wagons and high-speed passenger wagons. Apart from that, it also caters to the commercial vehicle industry, as well as heavy industries, like cement, steel and mining. It is a preferred supplier because of low failure rate and cost leadership. In fact, in certain products the company holds a virtual monopoly. The company reported revenue of ₹2,203 crores with PAT of ₹327 crores in FY22. It also enjoys ROCE & ROE of 18% and 22% respectively.

Stellar People:

Timken's positioning in the tapered roller bearing market actually originates over a hundred years ago. In 1890s, Henry Timken (a carriage maker) recognized that heavy freight wagons had a difficult time making sharp turns. To solve the problem, he applied a tapered roller bearing design that could handle both radial (weight) and thrust (cornering force) loads. Timken patented this in 1898 and since then it has instilled a culture with a singular focus on continuously improving this product line. By 1920, Timken was supplying bearings to 80% of America's cars. Since then it has further expanded the use case to industrial applications. Today, the company offers the world's widest variety of tapered roller bearings and dominates the rail industry globally.

Timken India is headed by Sanjay Kaul, who has been with the company for over two decades. He joined Timken in 1990 as product engineer and steadily rose through the ranks, finally being appointed as managing director in 2012. Under his leadership of over a decade, the company has always strived to keep themselves ahead of the curve by identifying emerging trends in the industry. ABC acquisition back in 2017 is a great example of that. Although Timken enjoys strong share in tapered roller bearings, it has been largely non-existent in the wheel-end bearings segment. ABC acquisition marked Timken's entry into this segment, which is focused on trucks and tractors. Furthermore, management revamped the entire production unit of ABC in Bharuch, implemented its global standards of production and upgraded the manufacturing abilities of the facility from commoditized wheel-end bearings to high-tonnage spherical bearings. This opened up export opportunities for the company in segments such as European and North American heavy haulage commercial vehicles. Thus, through opportunistic acquisitions, quick execution and a culture of innovation, Sanjay and his team have significantly expanded their total addressable market.

With multinational companies in India, an archetypal issue has been presence of multiple subsidiaries in the same country. This typically raises the risk of business being diverted to a different subsidiaries where the parent has a higher ownership. However, Timken has ensured there is no conflict of interest, by operating its entire manufacturing operation in India under one subsidiary, which is Timken India. The company has had a stellar corporate governance track record.

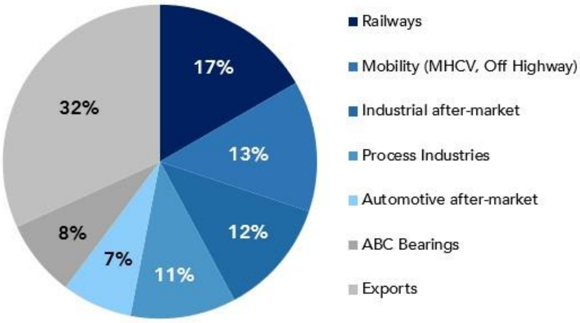
Incredible business:

As discussed, Timken has ensured global dominance in the tapered roller bearing market for over a hundred years now. Given the strong R&D in its specialised product, wide variety as well as backward integration, Timken ensures it has a dominant position in each end market that it is present. Within railways, Timken India remains the market leader in the freight wagons and high-speed passenger coaches segment, with over 50% market share. In fact, in spite of the general practice by the Indian railway of procuring equipment through tendering, as far as tapered roller bearings are concerned, Timken is a preferred supplier for the railways because of the lower failure rate and long durability as compared to peers. This enables the company to exercise its pricing power and earn healthy margins on this business.

Apart from railways, Timken caters to the commercial vehicle (CV) segment to a large extent, where it again has a dominant market share in supplying bearings for the axles that handle heavy load. Post the ABC acquisition, it has further solidified its positioning with the large CV players, by cross selling the wheel-end bearings as well. As the commercial vehicles implement the BSVI norms and adapt towards regulatory requirements on high axle loads, the content per vehicle for Timken will only increasing. Unlike other bearing companies, they have very limited exposure to ICE engines, and therefore do not face any disruption from the shift towards electric vehicles. On the industrial segment, the company has a strong presence in wind bearings, which it imports from Europe. This now accounts for almost half of the revenues that the company derives from the process industry segment. Given its dominant market share across various segments, driven by technical expertise and economies of scale, it would be very difficult for competitors to dislodge them.

In order to further solidify its positioning, over the last five years, the company underwent a large backward integration project. It has invested in augmenting its manufacturing capacity. At the same time, it has improved its manufacturing capabilities to manufacture several products in-house, which in the past it would import from its global parent. High focus on best manufacturing practices has also resulted in a significant reduction in wastage, thereby saving costs. As a result of this, operating margins have improved from 13% in 2018 to over 23% currently. As a result of this, ROE and ROCE is also very healthy over 25%.

Figure 7



Source: Company

Time

As discussed earlier, we believe that India is in an early stage of a pick-up in the investment cycle. Any pick-up in capex activity, be it building of roads, port and airports, or building of new manufacturing plants – this will involve an increase in movement of goods across the country. Timken, with its dominant position in tapered roller bearing, is well positioned to benefit from this increased activity, regardless of whether it comes thru railways or commercial vehicle. Additionally, as heavy industries such as cement and steel increase their capex to supply goods for these capex projects, that will lead to higher demand for Timken's bearings as well.

In any case, both the railways and the commercial vehicle industry are at an inflection point. The Indian government is planning aggressive spending towards adding new wagons and upgrading the existing ones. The government is planning to add 90,000 freight wagons within 3 years to the existing fleet, compared to current manufacturing capacity of 15,000 wagons a year. It is also planning to replace ~7000 conventional passenger coaches with modern LHB (Linke Hofmann Bosch) coaches, which need tapered roller bearings. Apart from that, the government is working towards developing the Dedicated Freight Corridor (DFC), which will double the tonnage carrying capacity from ~5400 tonne to 13,000 tonnes, and require several new freight wagons. Even in the commercial vehicle space, due to deferment of demand through covid times, the average age of fleet in India is almost at 10 years, which is close to an all-time high. As economic activity picks up, there can be a surge in replacement demand for commercial vehicles.

However, in our view, the biggest opportunity for growth from Timken India is on the export front. Timken India is one of the most efficient among all manufacturing hubs globally, the parent company is using Timken India to export to other geographies. This is coupled with declining cost advantage of sister units in China amid rising labour costs and companies looking to diversify their supplying base. To cater to such demand, Timken is looking to double the capacity of the Jamshedpur manufacturing unit. Given this focus on exports, management expects exports to double from 25% of sales currently to 50% over the next few years.

Thus in our view, a combination of these factors ensures that the company is very well positioned to compound both revenues and earnings growth at over 20% for the next five to ten years. While valuations at 35x forward earnings are full, we believe the certainty of growth and strong competitive positioning will sustain high valuations in the future as well. It remains one of the core positions 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.

Sincerely,

White Whale PMS Team