WHITE WHALE
PARTNERS

White Whale North Star Portfolio – 4Q FY ’21 Quarterly Letter

“Improving Fundamentals”

Dear Partners,

We are excited to share our first quarterly letter for the White Whale North Star Portfolio (the Portfolio), marking the first full quarter since we launched on 11th November 2020.

Portfolio Performance

Our invested portfolio delivered healthy absolute and relative returns. Since inception, the Portfolio is up 10.5% (1), compared to the Nifty 50 which is up 16.3%. However, this is primarily attributed to the fact that we had an average cash holding of 50% through November and December, as we gradually and opportunistically deployed capital, based on our bottom-up approach. Adjusted for cash, the Portfolio is up 18.1% (net of fees) (1), outperforming the Nifty 50 which was up 16.3% over the period. While four and a half months is a very short timeframe to judge performance, these returns are in line with our past track record of matching or slightly outperforming the benchmark when markets are up, while outperforming materially during market corrections.

Volatility is an inherent feature of all equity markets. However, the swing in sentiment from extreme fear to extreme greed over the last twelve months has been unprecedented. Liquidity has undoubtedly been one of the key drivers of this trend. Since October 1st, 2020, foreign investors have invested over USD 26 billion in the Indian equity markets, the largest inflow over a six-month period ever. In fact, this is more than the cumulative amount invested over the previous five years. On the back of this liquidity surge, even structurally weak businesses in low margin and capital-heavy commoditized businesses, or companies that face existential questions on the back of technology disruptions, have seen their stocks rally over 100%. As examples, a small auto-ancillary company providing commoditized parts for internal combustion engines has doubled in this period, as has an EPC company involved in government tendered construction contracts. **As the rising tide of liquidity lifts all boats, we remain steadfast in our philosophy of backing outstanding management teams spearheading incredible businesses that have the ability to compound capital over a long period of time.** This philosophy is essential towards ensuring healthy returns in the long term, while also ensuring capital protection, especially in times like these.

Key Macroeconomic Developments

The industrial cycle is well positioned for a turnaround

The last decade has been a tough one for India. It started with high inflation in 2012-2013, which was accompanied by policy paralysis on the back of corruption charges and the taper tantrum in the US. Subsequently, there were a series of structural reforms that were undertaken under the Modi government, starting with IBC, RERA, demonetization, and finally GST. While these structural reforms are beneficial in the long run, they induce significant short-term pain. A pick-up in growth was further delayed by the IL&FS crisis which caused significant dislocation in credit availability, followed by the Covid induced lockdown recently. As a result, corporate earnings growth has been in mid-single digits on average for the last five years, mainly due to a slowdown in corporate investments.

Over the last couple of years, the government has undertaken a series of measures to stimulate the supply side of the economy - an area that has been a perennial constraining factor for growth in India. In November 2019, the peak

(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.*

corporate tax was reduced from 34% to 25%. Over the last eighteen months, the government has introduced several production linked incentive (PLI) schemes, providing a strong incentive to the Atmanirbhar or Make in India theme. **The recent budget was a game changer, where the government has firmly committed to its growth agenda by significantly increasing capex spend, while keeping tax rates unchanged. It also plans to only gradually taper the fiscal deficit from 6.8% in FY22 to 4.5% in FY25. A stable policy making environment provides further comfort to the private sector.**

With NPA clean up behind us, credit growth is reviving

Slower economic growth over the last decade also created a large debt issue among corporates. As a result, gross NPA as a percentage of outstanding loans ballooned from around 3% of GDP to over 10%. Most corporates were focused on balance sheet deleveraging and/or bankruptcy resolution through this period. We believe that this deleveraging theme, which has been on-going for the last seven years is now largely over. In fact, over the last twelve months, many lever ed businesses with weak balance sheets have been able to shore up their balance sheets through capital raises. Additionally, non-banking financial companies (NBFCs) that were struggling with liquidity post IL&FS have also raised significant capital and increased their capital adequacy ratios, while rolling over their short-term liabilities. Over Rs 1.25 lakh c rore (USD 17 billion) have flowed into the balance sheets of corporates and financial institutions in the form of IPOs or QIPs through FY21. Wholesale borrowing rates are at multi-year low levels, with one-year commercial paper available at 3.5%, compared to 7% back in March 2020. The RBI has also slashed rates by 200 bps over the last two years and maintained sufficient liquidity in the banking system. Finally, buoyant equity markets have also helped improve corporate sentiment and risk-taking appetite. This, along with the fiscal incentives provided by the government, as discussed earlier, provide a great platform for a turnaround in the capex cycle. Given all of the above, the environment is finally conducive for credit flows into corporates seeking expansion capital.

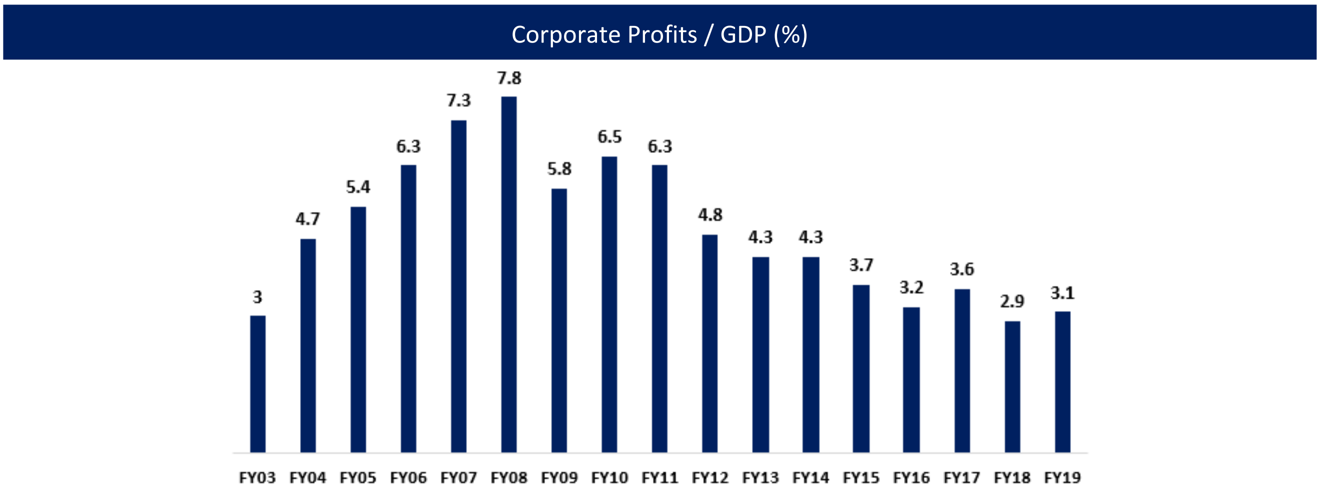
These developments make us optimistic that India is very well positioned to benefit from a multi-year cyclical pick up, driven by corporate investments and capex. Our portfolio remains very well positioned to benefit from this turn in the industrial cycle.

While COVID induced restrictions in the wake of the second wave could lead to road bumps, we don't believe these would materially disrupt the improving momentum. The resilience and adaptability of entrepreneurs should not be underestimated, as was seen post demonetization and more recently through the hard lockdown in March/April 2020. In fact, businesses are much better prepared to deal with this now compared to last year, given adoption of work from home measures and significant expenses reductions. Most importantly, with the vaccinations being rolled out across the country, there is light at the end of the tunnel.

Corporate earnings showing significant pick up

As a result of the headwinds seen over the last decade, corporate profits to GDP ratio has fallen from around 8% in FY08 to 3% in FY19, the lowest level since FY03. (See Figure 1).

Figure 1



Source: Ace Equity

As the cyclical turnaround takes shape, we believe operating leverage, coupled with top line momentum, should result in a strong rebound in earnings. In our opinion, research analysts tend to linearly extrapolate the most recent historical trends, and therefore are underestimating the extent of earnings pick up over the next few years. In fact, after 23 quarters of consistent downgrades, research analysts finally started upgrading their earnings forecast post the December quarter earnings. 3Q FY21 witnessed earnings beats in over 60% of the BSE500 stocks, driven by strong demand as well as large scale cost optimizations in the wake of COVID.

Overall, growth in 3Q earnings was the strongest it has been for Indian corporates in a long time. While the contribution of pent-up demand in certain sectors is undeniable, demand has continued to remain strong across the board through March. **In 3Q our portfolio companies delivered an average earnings growth of 26% over last year, on the back of revenue growth of 14% over the same timeframe.**

Unique digital infrastructure in India

While demonetization sowed the seeds for digital adoption in India, the Covid lockdown has served as a catalyst or inflection point, resulting in a radical change in behaviour across the economic strata of Indian households. Digital payments are now widely prevalent, with UPI transactions worth over Rs 5 lakh crore (USD 68 billion) in the month of March alone, a growth of 145% over same period last year. Entry of new entities through NUE licenses will provide a further fillip to this trend. More importantly, the government is now moving beyond just digital payments. In conjunction with Aadhar, and its biometric identification system, the government plans to use digital technology to extend education and healthcare services to its population. In a recent webinar, Nandan Nilekani talked about the uniqueness of the Indian ecosystem. **Democratization of data through Aadhar, UPI etc has ensured there is no monopoly being created in India, unlike in China or even USA, where data has been accumulated among a few technology giants.** Similar to how India skipped the wireline rollout and went straight to wireless, one can see similar trends play out in industries such as healthcare, education and other services where technological developments can leapfrog these sectors forward. We remain focused on identifying opportunities that are emerging on the back of this trend.

Portfolio Update

We are 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. This philosophy is all the more important in current times, where there is a level of exuberance in several sectors and companies. It will also help us stay away from short term noise and look at the bigger and longer-term picture. Post Covid, there has been significant disruption and realignment in various sectors, as well as the emergence of new business models. **We believe all our portfolio companies are well positioned to benefit from such disruption and deliver outperformance in the long term.**

Over the last few months, we have gradually invested in around fifteen businesses that fit within our investment philosophy and are available at reasonable valuations. In each quarterly letter we plan to discuss one such idea that can provide a better perspective into our decision-making process.

IEX – At an inflection point

Indian Energy Exchange (IEX) is India's leading energy exchange with over 95% market share in the energy exchange market. It was established back in 2008 and has been publicly listed since October 2017. It has over 6,600 participants ranging from distribution companies, electricity generators and open-access industrial customers.

Stellar People

IEX has a professionally-driven management team led by SN Goel, who is a veteran in the power sector having worked with NTPC for 29 years. He took over leadership of IEX in 2014 and is currently the company's chairman and acting CEO. The management team has been at the forefront of driving relationships with distribution companies, open-access customers and other partners as well who form an important part of the ecosystem. This is essential given the nascent stage of the energy exchange market. It has been innovative in terms of new product introduction and technological advancements. It was the first to introduce several new products to the market such as GTAM (Green Term Ahead Market) and RTM (Real Time Market), thereby cementing its monopolistic position further. IEX is also looking beyond just power and into other commodities where an exchange platform can be useful. It has launched India's first nationwide natural gas exchange which will be instrumental in transforming India's gas market, given the government focus on developing this sector. The company has also roped in key partners like GAIL, ONGC and NSE, that would go a long way in developing the ecosystem. **This culture of innovation and expansion is essential for IEX to capitalize on the large opportunity available in the nascent energy and gas exchange markets in India.**

Incredible Business

There is a strong network effect in IEX's business model, as is with every exchange business – higher number of participants results in better price discovery and deeper liquidity, which in turn attracts newer participants. The company has a 99% market share in the Day Ahead Market, which is the dominant product in the energy exchange industry currently. **It has made constant investments in technology and product innovations to stay ahead of the curve, thereby deepening its competitive advantage.** The company has also been innovative and nimble in its execution, thereby capitalizing on new opportunities. It has established a dominant position even in new products that were recently introduced such as GTAM and RTM. This positions the company very well to defend its turf even when new entrants, such as PTC, enter the market.

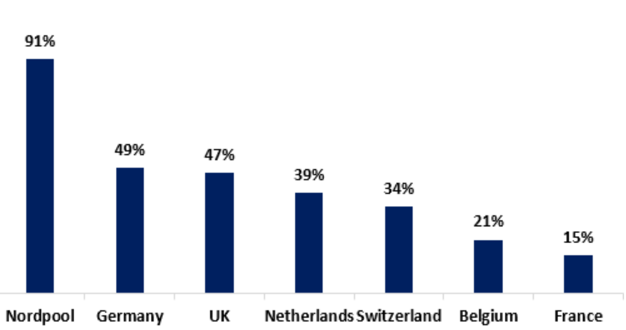
Time

Power has been India's Achilles heel throughout its history, with chronic power shortages, inefficient power grid and high pilferage losses among the distribution companies. Under the Modi government, several structural reforms have been undertaken to improve its efficiency. After several years, India is now finally a power surplus country. This has resulted in price discovery through the energy exchanges being much lower compared to long-term purchasing power agreements (PPAs) and even short-term bilateral contracts. The power exchanges are fulfilling a genuine economic need for the country - better price discovery and more efficient use of power would result in thousands of crores of savings for the leveraged government distribution companies, while making the sector more competitive.

Power transacted through energy exchanges still accounts for only 4% of the total power market in India, compared to 15%-90% for several developed markets (See Figure 2). Additionally, the power regulator has taken a series of steps to facilitate new product introductions, such as long duration contracts and cross border contracts, that would further accelerate this market share shift towards energy exchanges. In conjunction with SEBI, the regulator also plans to allow the introduction of derivatives, which then would deepen the ecosystem as financial institutions and traders can participate in this market. Finally, distribution companies that have completed over 20 years of PPAs are now allowed to exit these contracts and purchase power through the exchanges. All of this provides a very long runway for growth for IEX, where the total addressable market can increase from 4% of the power market currently to over 20% in the medium term (See Figure 3).

Figure 2

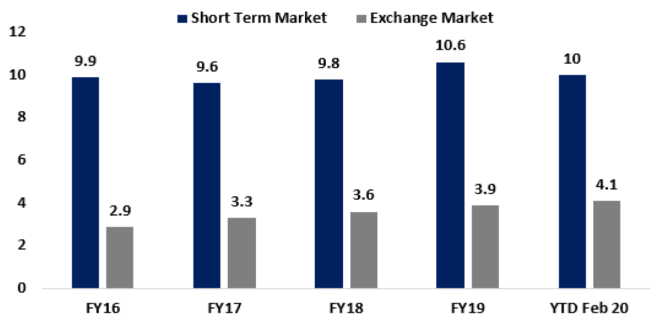
Exchange Market % of Total Demand - Global



Source: Company, Europex

Figure 3

Exchange Market & ST Market as % of Total Generation (incl Ren) in India



Source: CERC, Company

Financials and Valuation

IEX's profits have compounded at over 18% in the past 3 years with the volume traded growing at 12% CAGR. This should accelerate further, driven by new product introductions and an increase in the addressable market. EBITDA margins have complemented the robust growth and have averaged close to 80% in the last five years. The company enjoys high ROE and ROCE of 40% and 55% respectively.

There were concerns around market price coupling (establishing similar price discovery across different exchanges) and Power Trading Corporation (PTC) setting up a new exchange. This resulted in a correction in the stock price and provided an opportunity for us to invest in the company. In our view, price coupling would come alongside a significant increase in addressable market, while barriers to entry from network effects make it difficult for new exchanges to draw volumes, especially when the incumbent stays ahead of the curve in terms of product innovation and technological development. While the stock has delivered strong returns since inception, we see multiple levers for the company to deliver 20% earnings CAGR over next five years. Valuations at 32x forward earnings are at a 10%-15% premium to global exchanges, but are justified given the long runway for superior growth in a nascent market.

Conclusion

In closing, we would like to thank you for your support and faith in our new venture. 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