

DURO CAPITAL

The purpose of this letter is to provide you, our partners, with deeper insights into our investment philosophy, portfolio and performance. By investing a significant portion of our own net worth into our funds, we ensure that our interests are fully aligned with our investor partners.

At the end of Q1 2022, the portfolio included 20 long investments and 1 short investment. After being net sellers in the 2nd half of 2021, we were again marginal net sellers in the first quarter of 2022 where we exited 1 long position completely and partially sold some long positions where stock prices reached all-time highs. At the same time, we used the volatility in the second half of the quarter to add to at least 3 long positions in the portfolio where stock prices fell sharply after the commencement of the war in Ukraine.

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Indian (and global) markets have continued to deliver negative returns in the current quarter given the “uncertain” macro environment. In fact, globally, an increasing number of management commentaries appear to be starting with the words “As we enter a possibly uncertain macroeconomic climate....” We have therefore provided below select macro data points related to the Indian economy:

- India’s GDP grew at 8.7% yoy in FY2022 (ended March 31, 2022) and is expected to grow anywhere between 7% and 8.2% in FY2023, even after most projections were revised downwards since the beginning of the Ukraine conflict
- Fiscal deficit for FY2022 was 6.7% versus a budgeted 6.9% at the beginning of the year despite a sharp rise in crude prices, reflecting prudent economic management on the part of the Indian government
- Tax revenues rose by 34% yoy to INR27.07 trillion in FY2022, more than 20% above the original budget target, and also above the nominal GDP growth of 19%. We have been highlighting the potential for a structural uplift in tax collections because of the increased compliance in tax payments through initiatives like GST (goods and services tax)
- At the same time, inflation edged up in April 2022, reaching an 8-year high of 7%, breaching the central bank’s 6% tolerance band for the fifth consecutive month. CPI inflation is expected to average 6.4% in FY2023 versus 5.5% in FY2022¹
- Real central bank rates are currently negative, at -2.6%, despite the RBI’s most recent 40bps rate hike

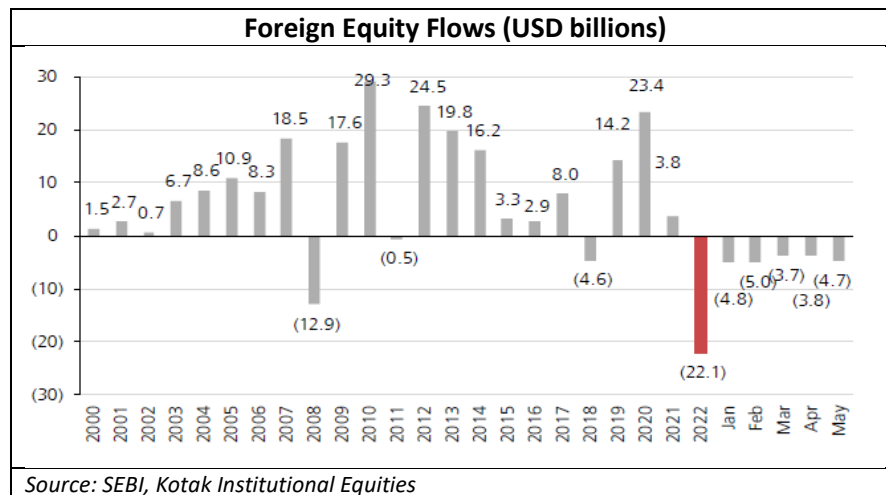
The biggest wild card for the trajectory of the Indian economy is once again the price of crude oil. Every \$10 increase in crude prices increases Indian CPI by 50bps.² Uncertainty around crude prices can lead to a wide range of potential outcomes for CPI inflation in FY2023. This makes the job of the Reserve Bank of India harder. A high crude price has also historically put the government’s fiscal math at risk. However, the structural boost that tax collections have received over the last few years from the government’s GST implementation, along with a clear plan in FY2023 for divestment of government assets has the potential to provide much needed fiscal support during this phase of higher crude oil prices. In fact, the balance of payments equation is likely to remain favourable till a crude price level of approximately \$100/bbl, making this level the new tolerance threshold for the Indian economy. Note that this tolerance threshold used to be almost 40% lower at \$60/bbl a decade ago.³

¹ Kotak Institutional Equities

² Spark Capital Research

³ Spark Capital Research

The other headwind for Indian (and global) equities is the commencement of a global monetary tightening led by the Federal Reserve. A global liquidity squeeze combined with the current set up of negative interest rates in India along with the expectation of elevated near-term crude prices is perhaps the driver for the aggressive selling that we have seen in Indian markets by foreign investors in this calendar year. Foreigners sold a record net US\$13.5bn of Indian equities in 1Q22 and another US\$3.8bn in April⁴. Yet, it is noteworthy that the MSCI Total Return Index, which fell 64.6% in calendar year 2008 after net foreign outflows of approximately \$13 billion in 2008, is down 9.1% as of May 31, 2022, when total foreign selling has equalled \$22.2 billion in the same time period.⁵ A more resilient market OR more pain to come? Take your pick!



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Now that we have duly acknowledged the pulls and pushes that are at play in the Indian economy and equity markets, I want to highlight what has not changed; and will stay constant for the next many decades. Duro Capital follows a strategy of investing in differentiated businesses in underpenetrated sectors. Our investment criteria demands that we identify companies with demonstrated competitive advantages, the ability to scale, a resilient culture of operations and corporate governance, that are hopefully available at a reasonable price. It should be obvious that differentiated businesses do not lose their edge regardless of inflation, monetary tightening or dwindling global flows. In fact, we should expect such businesses to utilize a period of uncertainty to gain share over weaker rivals. Similarly, regardless of where we are in the macroeconomic cycle, the under penetration across sectors in India continues to provide significant long-term investment opportunities. I would argue that the meaningful and determined push on economic reforms by the Indian government over the past few years (that we highlighted in our 2021 Annual Letter) will have a far greater impact on economic development that will be required to realize these investment opportunities. Not surprisingly, our investment strategy stays intact.

This does not mean that we are underestimating the potential impact of the most aggressive quantitative tightening ever attempted by the US Federal Reserve. We are also cognizant that the Fed is likely tightening into a slowing US economy, that can have severe implications globally. Such a backdrop requires that we stay ever more disciplined about following our investment framework with its three levers of (1) *why*, (2) *why now* and (3) *price/value*, while identifying and analyzing companies. The best investment opportunities are delivered when all three levers fire fully during our analysis.

⁴ Christopher Wood – Greed & Fear – “A hapless Powell and a resilient Modi” May 5, 2022

⁵ Bloomberg, Kotak Institutional Equities

1. Identifying the “why” of a business means understanding why such a business is differentiated from its competitors and how it can continue to gain market share in its sector with each passing year.
2. “Why now” can be a significant source of alpha generation in an investment if we are able to identify a substantive change in the target company’s business or in its sector that puts the company in a structurally advantageous position for the next few years. It is interesting to note here that as countries and communities globally are returning to their pre-covid ways of conducting business and leading their daily lives, some businesses have seen meaningfully change in their business models as a result of the stop-start nature of economic activity during the pandemic. E.g. we are currently evaluating a business in the food services industry that has seen its potential revenue per restaurant increase by over 20% post the reopening as a result of new measures that the company introduced to counter the drop in on-premise dining in its restaurants during the pandemic. These measures have not cannibalized existing revenue streams after the lifting of covid restrictions and have in fact helped increase branch-level ROCE structurally by over 9%!
3. Finally, the “price/value” equation keeps us focused on gaining a deeper understanding of the intrinsic value of a business. We utilize multiple methods to understand the value of any business that we are evaluating. It is fair to state that the net present value of a business will be negatively correlated to the interest rate used while discounting such business’ free cash flows. Therefore, in a rising rate environment, especially like the one that we are currently in, the “price/value” lever takes on additional significance. Today we are sitting on a longer than usual list of potential investments with well-identified “why’s” and “why now’s” but with the “price/value” not yet in our favor. I am confident that as we stay disciplined in adhering to this investment framework, it will help us identify many opportunities in what may turn out to be a buyer’s market.

Incremental opportunities have also begun emerging on the short side, especially as stock prices of mediocre businesses are losing support provided by excess liquidity in global markets. As I have mentioned in the past, India offers a smaller set of short opportunities compared to the long side. Additionally, our short positions are not meant to merely hedge our long portfolio; our aim is always to generate positive returns on standalone short positions. We have a well-defined framework to short companies. Our preferred shorts are ones in companies with structural issues that lead to significant weakness or unpredictability in earnings growth. Just like we have uncovered businesses on the long side where new measures to combat covid-led disruptions has led to structural business improvement; we are also finding business models that have been structurally impaired because of changes that occurred in their industries during the past 2 years. We initiated one such short recently in a monoline lending business that has seen competitors build up capabilities during the pandemic to compete more effectively in this company’s vertical. This is forcing yields, ROE and growth lower for the monoline lender. Legacy businesses that have dominated their segments for a long time can sometimes tend to underestimate structural threats to their businesses; this lender, too, has until now addressed this increasing competition through tactical moves versus undertaking a deeper assessment of its long-term policy. We believe this will lead to a period of inconsistent/sub-par earnings growth for the business that will disappoint the street.

In addition to the above, as is our practice, we have tactically continued to make decisions related to position sizing that we believe are necessary for prudent portfolio management. While we have been net sellers in our long book over the last 9 months, sales have primarily come from positions where stock prices reached all-time highs and at least in one position where we decided that our thesis was not likely to play out (we will discuss this in detail in a letter later this year). At the same time, we have not hesitated from adding to positions where we feel that all three levers of our investment framework are in our favor. These actions have led to some cash accretion and give us dry powder to act on the list of potential investments that I referred to earlier with well-identified “why’s” and “why now’s”. Our

goal (and test) will be to not get swayed by market narratives dictated by greed and fear, but to deploy this cash whenever the “price/value” equation comes in our favor.

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“...if the Indian government was a company, then it is surprising on the upside in terms of revenue collection while also improving the transparency of its accounting.”⁶

Upside surprises do not occur by chance. They are a result of years of groundwork; when multiple initiatives start to fire in tandem leading to a powerful aggregate impact. The path can initially be uneven, but once all systems start to reach critical mass, they overpower short-term turbulence. Not only that, but one starts to see benefits of meaningful unintended consequences/unplanned successes. One is only able to recognize a pattern of positive surprises when he/she has studied a company deeply over long periods of time to understand the underlying drivers behind its success. The record outflow in foreign equity capital from India in 2022 is perhaps driven by expectations of further market turbulence by global funds that may be looking to optimize short-term returns.

In my investment career, I have learnt that one should not bet against companies that are surprising positively.

Nishchay Goel
May 2022

⁶ Christopher Wood – Greed & Fear – “A hapless Powell and a resilient Modi” May 5, 2022

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The inception date of the Duro India Opportunities Fund (the "Fund" or "DIOF") is August 18, 2020.

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