

DURO CAPITAL

The purpose of this letter is to provide you, our partners, with deeper insights into our investment philosophy and portfolio positioning. 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.

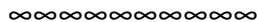
Travel to Asia by global investors has continued to increase this quarter and this has led to several in-person meetings in our offices. Most conversations have touched upon investors' recent experience in China. A simple, yet insightful, comment made by one of our visitors was that the autocratic nature of government decision making in China sets up the possibility for a wider range of outcomes for the Chinese economy. This has the potential to lead to greater dispersion in investment returns of portfolios invested in that country. Our visitors expressed that the situation in India on the other hand appears to be directly opposite to the one in China; and greater predictability and consistency in government decision-making should support Indian investment portfolios in the long run. Most investors from my generation grew up hearing that "India grows in spite of its government, not because of it." Therefore, a growing realization today around the predictability, consistency and long-term vision of the Indian government's decision making is a welcome change; and it is a meaningful change. At Duro, we look to identify the "why now," of an opportunity, which is typically driven by structural changes in businesses and industries. Such structural changes can lead to investment opportunities that can generate significant alpha. The structural change of predictability and support from the government towards corporate India, in our opinion, is creating a significant long term, "why now" investment opportunity in India.

A recent Morgan Stanley report pointed to a key change in the Indian government's strategy towards supporting the economy. For decades, the Indian government focussed on growing India's GDP by supporting wage growth through social spending programs such as the rural employment guarantee scheme. In most countries, a focus on wage growth may be appropriate because it leads to higher demand, which in turn leads to higher corporate profits. However, in India, the appropriate trigger for higher corporate profitability appears to be different. India is a country with surplus labour and uneven supply of goods and services. Higher wages, without a commensurate focus on supply side productivity, can quickly lead to a rise in consumer price inflation and even stagflation, rather than an increase in real growth. A more durable and effective policy for India is to focus on boosting corporate profitability, which leads to greater investments (especially given the pervasive under penetration across most industries in India), and which in turn has the potential to create jobs and lead to robust wage growth. The Indian government now appears to be firmly on this path. It has attempted to boost corporate profits through carefully crafted strategies and at the same time, continued with government investment programs that directly impact the well-being of its large underprivileged population through targeted programs like the Pradhan Mantri Awas Yojna (Housing for All).

A meaningful boost to corporate earnings came in 2019 through a reduction in the corporate tax rate, making Indian corporate taxes one of the lowest across Asia. The corporate tax rate was reduced from 30% to 25%, with a special lower rate of 15% for new manufacturing companies. Recent initiatives like the Production Linked Incentive (PLI) scheme, while promoting the government's mission to increase manufacturing as a % of GDP from a current low of 17% to 25% by 2025, also help corporate profitability. Through the PLI schemes, the government will provide 4-6% of incremental revenue as incentive to eligible manufacturing companies over a 5-year period in order to facilitate the creation of a large-scale

manufacturing ecosystem and also reduce dependence on imports. A 5% incentive has the potential to boost net profits for a manufacturing unit by up to 200%! Given that this incentive is provided after incremental revenue generation has started, it automatically supports new employment generation. In fact, schemes like the PLI have the potential to trigger a cycle of greater corporate profitability with higher employment.

It is not merely policy changes that have a direct impact on corporate profitability. For an economy to thrive, it is essential that regulation is designed to promote ease of doing business, consistency in reform and availability of suitable infrastructure that businesses can utilize. The Goods and Services Tax (GST) regulation, the Real Estate Regulation Act (RERA), Labor Reforms, the Bankruptcy Code (IBC) and the new Inflation Framework are examples of steps taken by the government that are significant confidence boosters for businesses in India and promote risk taking under well-defined parameters.



In this letter, we want to specifically highlight the efforts of the India government in the telecom sector as it relates to our investment in Bharti Airtel, India's second largest telecom services company.

Telecom companies in India experienced a very difficult time for over a decade. The problem started in the late 2000s because of adverse government policies that led to hyper-competition (>10 players). This was further exacerbated in 2016 by the entry of a new, well capitalized player, Reliance JIO, which drove data tariffs down by >90% in order to gain market share. ARPUs in India fell by more than 60% to the lowest levels worldwide because of severe competition. Despite this, pay-outs to the government in the form of fees, taxes and levies remained amongst the highest in the world. In fact, a combination of extremely high levies (spectrum usage charges, licence fees) and taxes meant that about 38% of revenue for a telco was going to the government! Moreover, incremental spectrum sales were done at uneconomically high prices. The government's disregard for profitability of the telcos was apparent when a former telecom minister claimed that the severely reduced ARPUs in India were a result of his policies and were in fact good for the nation's underprivileged population. This led to a spate of bankruptcies and consolidation in the industry from 12 private players to just 3, by 2019. As a result, total telecom industry revenue declined from 2% of GDP in FY 2009 to a mere 0.7% of GDP in FY2019.

This attitude has seen a marked shift during the second term of the Modi government. A very large majority of data traffic in India is carried over mobile networks given the lack of fixed broadband penetration in India. Perhaps it was an appreciation of the criticality of mobile services, brought to the forefront during India's severe Covid-19 lockdowns, that triggered a change in the stance of the government. We have listed below some of the significant changes brought about by the government in the telecom sector over just the past couple of years:

- More spectrum at cheaper prices:** Historically, telcos were starved for spectrum because the regulator released limited spectrum in each auction. This led to fierce bidding in auctions driving up prices. The high spectrum costs were a major concern for the industry especially given the low ARPUs prevailing in the country. The spectrum policy has seen a remarkable shift with the recent 5G spectrum auctions. The regulator increased the availability of spectrum substantially for the 5G auctions – over 50GHz of spectrum was auctioned – almost 9 times the spectrum held by telcos previously. This led to essentially all 5G spectrum being won at the reserve auction price (no increase due to bidding) by telcos. Other than the quantum of the spectrum, the regulator also made other changes in favor of the telcos including (1) an increase in the life of the spectrum by 50% from 20 years in previous auctions to 30

years now, (2) lowering the interest rate on spectrum payments from benchmark + 4% to benchmark + 2% for the 5G auctions, and (3) no bank guarantees were required from winners for payment of the spectrum won.

- **Waiver of spectrum usage charges:** Another change made by the regulator in the 5G auction was that the acquired 5G spectrum and ALL future auctioned spectrum would no longer carry a spectrum usage charge, which resulted in savings of ~4% of revenue for the telcos. Notably, because the amount of 5G spectrum auctioned was a multiple of all previous spectrum won by telcos, the weighted average of spectrum usage charges for telcos will fall to approximately 0.5% of revenue going forward. This change in spectrum usage charge essentially means that 5G spectrum has been awarded at a heavily discounted price to telcos. For example, the annual payment amount for 5G spectrum for Bharti Airtel (INR 38.5 billion) would be offset by a huge saving on spectrum usage charges (of approximately INR 29.7 billion); implying that the effective annual cost of 5G spectrum for Bharti Airtel is a substantially reduced INR 8.8 billion, compared to ~5x that amount in past auctions.
- **Support for tariff hikes:** Perhaps most importantly, the government has displayed absolutely no objection or resistance to tariff hikes in the sector. This is despite the fact that mobile access today is considered a basic need and impacts people at the bottom of the pyramid as well. The government has acknowledged that a USD2 ARPU in India is abysmally low and telecom companies must be able to earn their fair share in order to provide robust services. This is a far cry from previous populist regimes where the regulator would warn against tariff increases. In fact, the 20% tariff hike in the sector in 2019 was pushed by the government itself. This was followed by another 20% hike in 2021. Our on-ground interactions suggest that the government will continue to be accommodative and let the market decide where ARPUs settle.

The “why now” of our framework for our investment in Bharti Airtel is primarily driven by (1) the significant opportunity that lies ahead for Bharti in terms of converting several hundred million voice-only customers to data, (2) the potential for up to a 100% potential increase in ARPU from current levels over the long term, and (3) the weakening position of the third private telecom player in India. However, the support provided by the government to undo previously detrimental telecom policies, in our opinion, is equivalent to a once in a decade, structural change that will also lead to multiple years of strong earnings growth for Bharti Airtel.

Below, we briefly discuss why we are bullish on Bharti Airtel.

The “Why” of Bharti Airtel: Reliance JIO spent USD50 billion to disrupt a fully penetrated, primarily voice-driven Indian mobile market through its data-based network in 2016. JIO utilized ultra-low pricing as a tool to garner market share. This destroyed the competition, and several telecom players exited the market. Even the once formidable combination of Vodafone-Idea (VI) in India lost 2000 bps of market share over 4 years. Meanwhile, during the same period, Bharti Airtel continued to invest heavily in its pan-India 4G network. Bharti Airtel’s high-quality network along with its focus on customer satisfaction enabled Airtel to not only retain its market share, but also increase its market share to a now lifetime high (36%+ revenue share). Airtel has consistently grown faster than JIO over the past 12-15 months despite its tariffs being at a 15-20% premium to JIO; demonstrating the strength of its network and successful execution of its strategy to retain high-ARPU customers via bundled offerings (combination of mobile, direct-to-home, broadband helps increase stickiness). Furthermore, with Airtel launching 5G at the same time as JIO (Airtel played catch up on 4G) and with a like to like spectrum footprint, there is limited incentive for Bharti and JIO to use pricing as a tool to compete with one another; this should lead to a continued supportive tariff environment.

Drivers of Airtel's growth: Within the mobile business, Airtel has multiple avenues for growth:

- Just ~65% of Airtel's subscriber base uses data versus 100% for JIO. ARPU for a data user is ~2x that of a non-data/voice-only user, implying a long runway for organic ARPU growth for Airtel via conversion of its voice-only user base to data.
- VI currently has a ~20% market share in the Indian mobile market. Given its weak balance sheet (25x debt/EBITDA) and years of underinvestment in its network (e.g. VI did not bid for 5G spectrum), VI should continue to lose subscribers, especially as Airtel and JIO launch their 5G networks. We believe that Bharti Airtel will be a preferred alternative for dissatisfied VI subscribers because of Bharti Airtel's high-quality network.
- Tariff hikes – Industry ARPUs currently stand at USD2 and are among the lowest in the world. This is despite an average Indian's data consumption being among the highest in the world (the average Airtel user consumes 20GB a month!). Not only do we believe that tariffs will continue to move up, but 5G will also lead to increased data usage, which should further support ARPU growth.

Non-linearity from Bharti Airtel's non-mobile businesses: Non-mobile businesses account for close to 25% of Bharti Airtel's EBITDA from India. While Airtel's mobile business profitability should increase sharply because of the reasons provided above, Airtel's non-mobile businesses should also help it better utilize its network infrastructure, which should lead to non-linear earnings growth. Airtel currently has the ability to service 50 million Indian households through its home broadband/IPTV offerings to cater to these households' growing home broadband and digital entertainment needs. Airtel is also leveraging the connectivity relationship that it has with over 1 million Indian enterprises to provide ad-tech, CPaaS, cloud and cybersecurity services to enterprise customers. The company has made rapid progress in these verticals and believes these new segments will enable it to tap into an INR 500 billion market opportunity over the next 5 years with limited incremental investment.

Upside: Our "why" and "why now" assessment makes us confident that Bharti Airtel is a rare case globally of a telco that should continue to experience robust "growth" for many years to come. We believe that our Airtel investment can generate 20%-25% IRR over at least the next 3-4 years. This expectation does not assume any multiple rerating for the company's stock. The above return also does not include (1) the potential for nonlinear growth from VI completely exiting the market because of its over-extended balance sheet, and (2) additional optionality from monetization of Airtel's non-mobile businesses mentioned above.

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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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