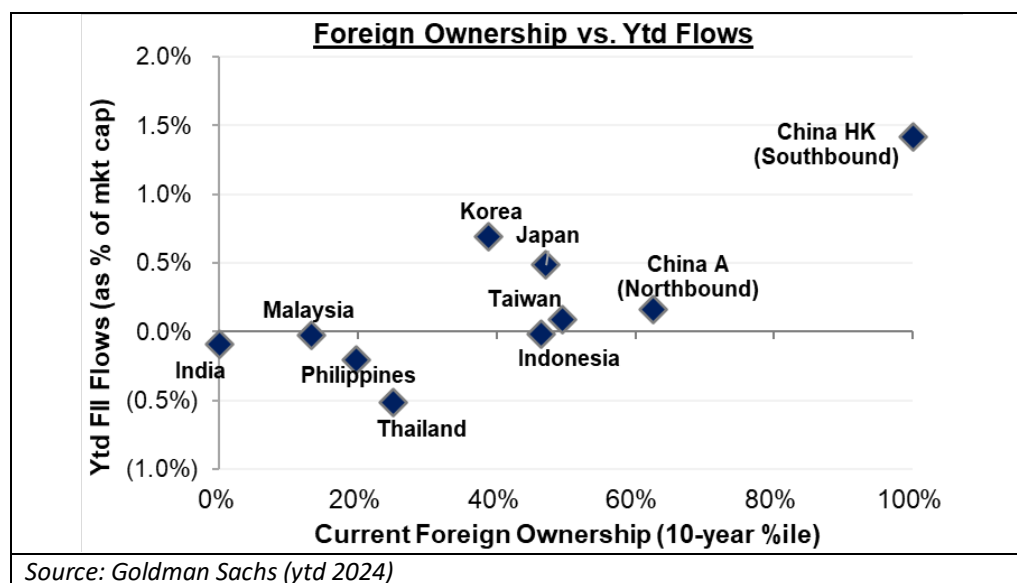


DURO CAPITAL

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.

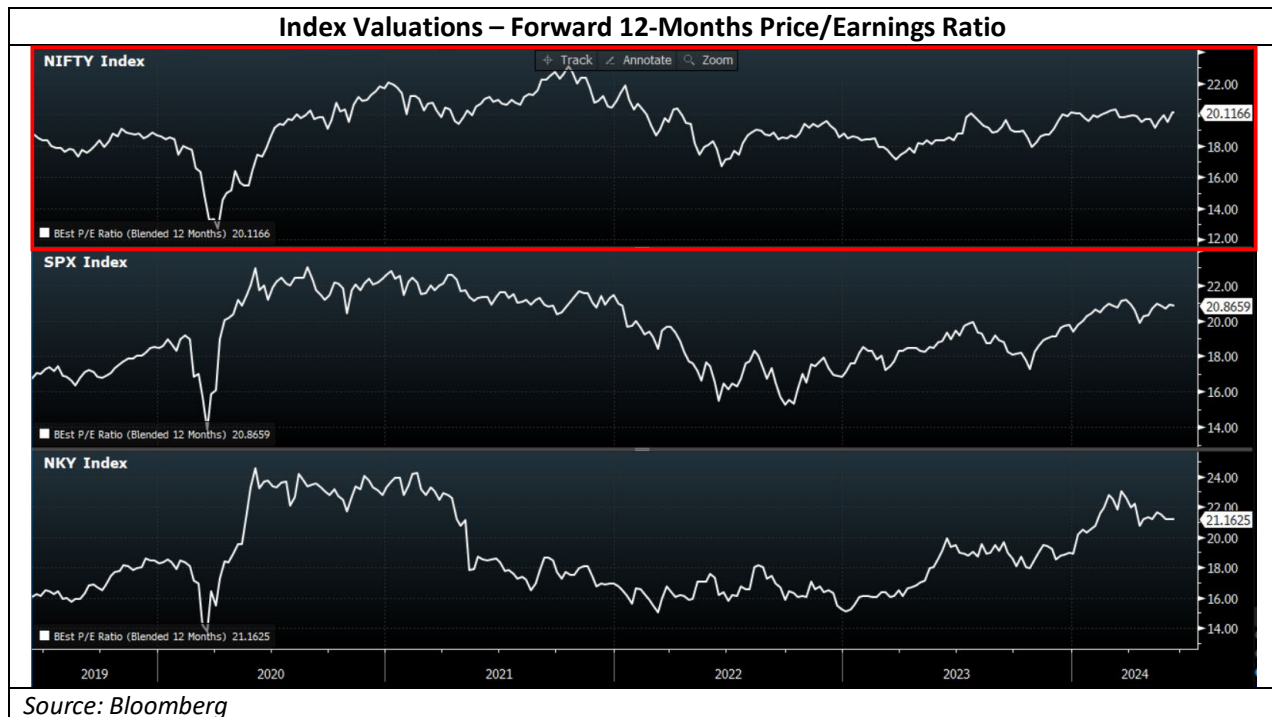
Since the covid lows of March 2020, Indian equity markets have experienced a strong 4-year uptrend. With the exception of a ~20% drop in the broader Nifty50 index (in USD terms) from the highs in October 2021 to the lows in June 2022; an investment into Indian equity markets has led to fruitful results even for short and medium-term investors. Yet, concerns around relatively high valuations have deterred foreign investors from deploying meaningful new capital into India over this time period. In fact, as of May 31, 2024, just before the national election results were declared, Foreign Institutional Investors' (FIIs) positioning in India, measured by total FII holdings as a percentage of overall market value, was running at its lowest level in over a decade. FIIs pulled out over \$3 billion from Indian markets in the month of May 2024 alone. Perhaps some of this was also driven by fears around a less than favorable election outcome.



On the other hand, domestic institutions have already invested close to USD26 billion of new capital into the market in 2024. This is more than 6x the amount of capital that foreigners have pulled out over the same time. Slightly longer-term data, since the beginning of CY2021, suggests that domestic institutions have deployed USD92.4 billion in new capital into Indian equities. Foreigners meanwhile have deployed an incremental USD3.4 billion. The Nifty50 index during that period has seen an increase of 41% in USD terms. Small and midcap index returns have been higher. Incremental domestic flows do not show any signs of slowing. In fact, total domestic mutual fund inflows surpassed an annualized rate of \$50 billion in May 2024. This reflects the growing conviction in Indian equities domestically along with a shift away from more traditional asset classes. Indian households still have only 6-7% of savings in equities and mutual funds, compared with more than 40% in Brazil and China and 50% in the US.¹

¹ Source: Bloomberg

Meanwhile, if the fear around high equity valuations was the primary reason for the lack of incremental participation from foreigners, then data suggests that India's Nifty50 valuation is currently lower compared to both the S&P500 and Nikkei225. The Nifty50 index also has the highest estimated earnings growth of the three indices; giving it an implied PEG of 1.2x. For comparison, the Duro portfolio currently trades at a 1.1x PEG and 23.3x forward PE.



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A developing area of concern in India might be the recent results of the national general election. The result of this election was supposed to be a forgone conclusion. Prime Minister Modi's party was expected to win with a very comfortable majority, which was then expected to provide a significant boost to the economic reforms that his government has unleashed in India over the last decade. The final outcome turned out to be rather unexpected with PM Modi's party, the BJP, failing to secure an absolute majority on its own in parliament. While Modi has again been sworn in as Prime Minister for a record third term, he will now lead a coalition comprised of several smaller parties to form the government under the National Democratic Alliance (NDA).

It is important to note, however, that while the BJP has enjoyed an absolute majority over the last decade, it is not that coalition governments are an anomaly in India. In fact, absolute majorities have been rare in Indian politics and the country saw only coalition governments in power for more than a quarter century from 1989 through 2014. The track record of economic growth under coalition governments in India has been quite favorable as well. Even the Congress party-led coalition government that took over after the surprise defeat of the BJP in 2004, managed to keep the average real GDP growth rate at over 6% during its 2 terms in power. Moreover, PM Modi is a reformer and in his victory speech after the election results, he reiterated his mission to drive forward with economic reforms. Quoting from his speeches, "NDA's 3rd term

will see a new 'Golden Chapter' in India's development and this is Modi's guarantee.....We don't want to waste time – we want to take India from the 5th largest economy to the 3rd largest economy."

Yet, the political dispensation in the country is perhaps set to change to one with more consensus building, which can sometimes take time. How will this change Duro's investment approach? Fortunately, the first pillar of Duro's investment framework, i.e. determining the "Why" of the business, does not care for which government is in power. We evaluate businesses on their ability to protect their profit pools even in the face of irrational competition. This makes "the government of the day" less relevant for the Duro strategy. Every business in the Duro portfolio has a "Why" that we have painstakingly identified and that provides these businesses the ability to compete and grow. The second pillar of our framework, the "Why Now" of the opportunity, is based on identifying long-term, structural changes that drive superior earnings growth at our portfolio companies during our holding period. We do not expect this to change unless these companies are specifically targeted through detrimental regulation by the new government. We do not believe that will be the case for any of the companies in our portfolio. Finally, we invest in businesses when we see a favorable mismatch between the intrinsic value of a business and the price at which its shares are quoting on exchanges. Our underwriting process relies on the bulk of upside for our investments coming from earnings growth, which is aptly covered by the first two pillars of our framework. Valuation re-rating is welcome, but not necessarily relied upon.

Nevertheless, in the short term, the change in government structure may impact valuations of certain sectors positively/negatively. E.g. the consumer staples index in India saw an immediate uptick post the election results given the consensus view that the coalition government will resort to welfare economics, which could lead to an increase in staples consumption. Organic revenue growth for fast moving consumer goods (FMCG) companies in Goldman Sachs' coverage universe has ranged between 5-7% over the last 4-5 years; and the MSCI India consumer staples index trades at >50x PE. We refuse to be driven by short term performance; in fact, we will double down on our disciplined framework-based investment approach during these times of change. I am confident this approach will continue to serve us and our investors well.

I am also hopeful that the unexpected election outcome will impact the froth that has built up in certain pockets of the market, where stocks are trading not based on earnings, but on narratives. These narratives have resulted in the market attributing the entire value of earnings that some businesses will generate in future years (and perhaps decades), to the underlying stocks today. Some pause and reflection on these valuations is warranted and will be healthy for the market. For example, the BSE Power Index today trades at 3x its pre-covid valuation and very close to the level it traded at during the peak of the market seen in January 2008 (pre-GFC peak). The power sector has multiple tailwinds (e.g. renewable power development, transmission capex, data center power requirements, etc); but all of these will take time to play out, perhaps even more so now without PM Modi's proverbial magic wand.

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One of our recent investments is in a leading pharmaceutical company that is a dominant global supplier in a narrow set of high-volume molecules. Since its inception 30 years ago, the company has maintained a maniacal focus on low-cost production. In fact, the company does not commercialize a new molecule unless its products can be priced 20-30% cheaper than competition. This low-cost capability, which is also the "Why" of the business, was developed by focusing on building exceptionally large facilities since the very inception of the company. Over time, the company has forward integrated within its core molecules to realize greater value in the market. It has steadily invested in R&D and developed capabilities to operate across the value chain to identify novel cost optimization avenues, be it through a better process, catalyst

or dispersion method; thereby continuing to strengthen the “Why” of the business. This cost differentiation has led to the business growing revenue at a 17% CAGR over the past decade, while simultaneously expanding EBITDA margins by ~600 bps as the business has scaled. Even more remarkable is the fact that molecules that typically grow 3-5% per year globally have grown at ~20% for the company over this time period.

Going ahead, we expect the company’s revenue mix to tilt more favorably towards formulations versus active pharmaceutical ingredients (APIs). In fact, FY24 is the first year where a majority of the company’s revenue will be generated by formulation sales. Having seen the company build a thriving US formulations business, we are even more confident that formulation sales can continue to grow at a healthy pace with the company’s increased focus on formulations for Europe. The gross margin potential for formulation sales is 2x that for APIs; and higher value capture potential also leads to greater stability in earnings. Furthermore, while the past decade has seen revenue growth come primarily from the company’s dominance in its core molecules, it has also simultaneously developed a portfolio of new molecules, which should start contributing more meaningfully to revenue and profit after tax going forward. While ~85% of revenue came primarily from core molecules for the better part of last decade, the company has already moved up new molecule contribution to 25% in the last quarter. A combination of these “Why Now’s”, i.e. a higher formulation mix and greater new molecule contribution, will also lead to the company to be recognized as a multi-product formulations player versus just a niche API company.

We believe that the company can compound earnings at ~30% over the next 4 years driven by the factors that we have just highlighted. Yet, we have bought the stock at ~16.5x forward earnings despite expected earnings growth of ~30%. While the market should attribute higher valuation multiples in the future for a diversified formulations player versus that for a niche API company, we believe that this investment has the potential to generate a 30% IRR on our investment solely driven by earnings growth. A relevant question would be – why was this attractive opportunity even available to us in the market? We believe there are a couple of reasons for this: (1) this investment is not driven by any narratives that project exponential earnings growth for the industry based on exogenous variables in the future. It required a deep understanding of the business and risks prevalent in the industry and how this business will be able to generate the earnings growth that we have underwritten amidst these risks. I believe that perhaps a large part of the market is currently focused on theme/narrative-based investing, and so, such opportunities are being overlooked; and (2) While we have been tracking the company for a few quarters, our “Why Now’s” will only really start playing out over the next few quarters. I think that market participants were unwilling to wait for this. Being long-term investors has therefore helped us capitalize on this opportunity.

As with any pharmaceutical business, the key risk to this company can emerge from regulatory violations. Such violations can delay product launches, lead to product recalls, and increase compliance costs. It is therefore comforting to note that this company has never received a USFDA or DEA warning letter in its 30+ year history. Another company specific monitorable is free cash flow generation. Large capacity installation requires significant capex. While the company’s debt to equity ratio is at a comfortable 0.3x and operating cash flow has grown at an impressive CAGR of 23% over the past decade, free cash flow generation has been less than desirable because capex has averaged 14% of sales over that period. We believe that the company has reached a scale where additional capex required for core molecules (~75% of the business) is not significant going forward. Yet, incremental capital expenditure and fixed asset turnover remain key monitorables for us. Lastly, the likelihood of any unexpected slowdown in India’s reforms by a new coalition government negatively impacting this company’s earnings growth is minimal.

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The Last Word

Whatever the outcome of the Indian election and its economic impact; one thing that the Indian national election of 2024 has shown the world is that India remains a vibrant, diverse and robust democracy. Modi had often been called a “strongman” and compared to other emerging market leaders with strongman characteristics who try to stifle democracy. Yet, the Indian voters showed the world that the final say on how they wish to be led and who they wish to be led by, lies firmly in their hands. Around 640 million people (of ~900 million registered) voted over 45 days across 29 states under India’s sweltering summer temperatures. The elections were peaceful and well-organized. We didn’t even hear the usual clamour around faulty electronic voting machines (EVMs) from the losing side this time. In fact, the winners look like losers; and the losing side is rejoicing like winners. This reflects the true power of the Indian voter and the deeply rooted democratic values of India.

Nishchay Goel
June 2024

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