2Point2 Capital Investor Update Q3 FY25

Dear Investors,

This is the thirty-fourth quarterly letter to our Investors. Our letters to you will provide an update on our investment performance and present our views on relevant topics.

PERFORMANCE

2Point2 Long Term Value Fund

The 2Point2 Long Term Value Fund (launched in July 2016) is our only strategy under the PMS license granted to us by SEBI. This strategy focuses on generating long term returns by holding a concentrated portfolio of investments (15-18 stocks).

Returns Summary

	2Point2	BSE 500 TRI#	Out-performance
FY17*	26.8%	12.2%	+14.6%
FY18	16.6%	13.2%	+3.4%
FY19	14.4%	9.7%	+4.7%
FY20	-24.6%	-26.5%	+1.9%
FY21	73.9%	78.6%	-4.7%
FY22	17.8%	22.3%	-4.5%
FY23	10.0%	-0.9%	+10.9%
FY24	45.2%	40.2%	+5.0%
YTD FY25	12.2%	10.8%	+1.4%
CAGR Return	**20.0%**	**15.7%**	**+4.3%**
Cumulative Return*	**368.6%**	**244.5%**	**+124.1%**

**FY17 returns are for an 8-month period. Cumulative returns are from 20th July 2016 to 31st December 2024. As mandated by SEBI, returns are calculated on a time-weighted basis (TWRR) on aggregate portfolio. Returns are net of expenses and fees. Performance related information provided here is not verified by SEBI.*
#TRI is Total Return Index – includes returns from dividends received

"Link to performance relative to other portfolio managers" - https://tinyurl.com/549h8kb6

Note: Returns of individual clients will differ from the above numbers based on the timing of their investments. The above returns are on the consolidated pool of capital.

COMMENTARY

Our portfolio returned -6.4% in Q3 FY25. The BSE 500, Nifty 50 and Nifty Midcap 100 index generated returns of -7.8%, -8.2% and -4.9% in this period. As of 31st December 2024, we had a 87.6% equity exposure (ex of REITs) in the PMS on a consolidated basis (new portfolios would have lower exposure), with the rest lying in interest earning assets. Our portfolio companies reported a median YoY profit growth of 5% in Q2 FY25.

THE GROWTH MIRAGE: WHY HIGH-GROWTH SECTORS MAY NOT YIELD HIGH RETURNS

"Obvious prospects for physical growth in a business do not translate into obvious profits for investors." – Benjamin Graham

Investors often get asked questions about their exposure to the latest hot sector that is witnessing rapid growth – be it Electric Vehicles, Quick Commerce, Solar Module Manufacturing etc. It is presumed that such an exposure will lead to positive outcomes.

In the world of investing, high industry growth is often celebrated as an indicator of opportunity and potential profit. Industries that experience rapid expansion attract investor attention creating a sense of urgency among investors to seize the moment. While growth can indeed generate impressive returns in the short term, it also comes with hidden risks that can hurt long-term returns.

Intense Competition – Race to the Bottom

High growth industries attract not only investors but also competitors. The influx of new players and excess capital can lead to intense competition, driving down prices and profit margins. While this dynamic benefits consumers, it is detrimental to companies and their shareholders, as growth does not necessarily translate into profits. Intense competition can kick off a race to the bottom and turn an initially profitable industry into a highly contested battleground.

Robust investment returns in high-growth industries occur only when incumbent players possess strong moats that protect them from excessive competition. In new fast-growing industries, incumbents often do not get time to establish durable moats, such as strong brands or economies of scale. The absence of a meaningful competitive advantage makes them particularly vulnerable when competition increases. Even market leaders or first movers may struggle to maintain their dominance as new entrants innovate and disrupt existing business models. This typically results in a period of high cash burn for the industry as all players seek to grab market share at all costs.

For instance, quick commerce (QComm) has currently caught investor fancy due to its strong growth prospects. Until a couple of years ago, QComm was not considered a viable business[1]. Multiple global QComm businesses had failed after burning several billions of dollars in capital. However, Blinkit (Zomato's QComm venture) was able to demonstrate a significant improvement in profitability along with strong growth in a surprisingly short period of time. This shift changed the perception of the

[1] "The economics just don't work at 10-15 minutes, which is frankly the fact. The consumers did not want it either, it was thrust upon them and they said why not" – Hari Menon, CEO Big Basket.
"I don't think that's (15-minute delivery) the right long-term customer model" – Kalyan Krishnamurthy, CEO Flipkart

industry's viability and has resulted in multiple deep-pocketed players like Big Basket, Flipkart and Amazon launching their own QComm businesses. Other existing players like Zepto and Swiggy have raised large rounds of capital to aggressively grow in this space. Blinkit will now have to engage in an intense competitive war with multiple well-funded players. While this will surely hurt its P&L, there is now also a greater risk to its market leadership. In some respects, Blinkit's early success and demonstration that QComm may be viable may have hurt its long-term prospects. Blinkit would have preferred a benign competitive environment that allowed it to build a strong moat before competition intensified.

The 2010-2020 period had seen similar intense competition in the horizontal ecommerce industry in India. Players like Flipkart, Amazon, Snapdeal, Paytm, Shopclues, Jabong, etc burnt through incredible amounts of capital to acquire customers and gain market share. Many of the players went bankrupt in this period and even the ones that survived like Flipkart and Amazon have not yet turned in a rupee of profit.

Difficulty for Investors in Identifying the Final Winner(s)

While increased competition may cause medium-term disruption in a high-growth industry, eventually there might still be one or more winners in the long run due to various factors - some within and some beyond the control of the companies competing. These factors include the quantum and timing of funds raised, building competitive moats such as brand and cost leadership, and regulations that favor one player over the other. However, in rapidly evolving industries with limited track records, investors may not have enough information to determine who these winners will be.

For instance, the online food delivery space in India heated up in 2014, with players like Food Panda, TinyOwl, and Swiggy growing rapidly. Zomato was a late entrant in this growing market in 2015 and didn't launch its own delivery network until 2017, initially deeming self-fulfilled delivery as unviable. Several other players, like Uber Eats and Ola Café, also entered this space. Despite its late start and having previously trailed behind Swiggy, Zomato has emerged as the unexpected winner in the food delivery wars. Most investors betting on the growth of online food delivery in India probably would not have chosen Zomato as the winning horse.

Capex Binge Leading to Excess Capacity

In capital-intensive industries, high growth often triggers a capital expenditure (capex) binge, as companies rush to capitalize on perceived opportunities. These investments are typically predicated on the assumption that growth will persist indefinitely. However, when growth slows or demand stabilizes, the resulting overcapacity can lead to extensive value destruction.

A notable example is the boom and bust in India's power sector during the UPA government. During this time, the government's reforms and incentives under the Electricity Act of 2003 encouraged a wave of private investment in power generation. Developers rushed to build power plants, driven by optimistic projections of rapid economic growth and rising electricity demand. Such was the optimism that, in some cases, power plants were built without adequate fuel linkages or contractual power purchase agreements with electricity boards. Eventually, the sector found itself with significant overcapacity, compounded by unviable tariffs and financial difficulties among state-run electricity

boards. This led to stranded assets, financial distress for developers, and a wave of bad loans for banks. While some developers went bankrupt, many others saw stock prices fall by 90%+ over the next few years.

A similar scenario may be unfolding in capital-intensive sectors like solar module manufacturing, or EVs where policy support has spurred rapid growth and attracted numerous players. While some companies are enjoying supernormal profits today, excess capacity and diminishing policy support could quickly erode profitability.

Overvaluation and Speculative Bubbles

One of the most common consequences of rapid industry growth is overvaluation. As enthusiasm builds, investors often push valuations to unsustainable levels, driven more by expectations rather than fundamentals. This phenomenon often leads to speculative bubbles, where valuations far exceed the intrinsic value of companies. This can make future returns disappointing, even if the underlying business performs well. When growth slows or fails to meet expectations, the value erosion can be severe.

The dot-com bubble serves as a cautionary tale. While the internet sector promised revolutionary changes, excessive speculation drove valuations to astronomical heights. The subsequent crash wiped out trillions of dollars in market value, impacting even fundamentally sound companies.

We are seeing several such speculative bubbles fuelled by narratives of rapid growth in sectors such as solar, defence, quick commerce, EMS, etc. Valuation multiples of 100-150x P/E have become quite common in these sectors. While investors are gung-ho on these industries due to their high growth potential, many Promoters of these companies are taking advantage of these high valuations by selling their holdings through secondary or primary sales (IPO/QIP/Pref).

While high industry growth may appear to be an ideal scenario for long-term investing, it often carries risks that outweigh its benefits. By focusing on companies with durable moats, maintaining valuation discipline, and adopting a realistic view of growth trajectories, investors can navigate the complexities of high-growth industries more effectively. As history demonstrates, patience, prudence, and a focus on fundamentals remain the hallmarks of successful long-term investing.

If you have any queries (about your portfolio, 2Point2 Capital or investing in general), do reach out to us at the below coordinates. We would love to talk.

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Thanks and Regards,
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