



## 2Point2 Capital Investor Update Q2 FY20

**Dear Investors,**

This is the thirteenth 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 (maximum 15 stocks).

#### Returns Summary

	FY17*	FY18	FY19	H1 FY20	CAGR	Cumulative Returns*	Out-performance
<b>2Point2</b>	26.8%	16.6%	14.4%	0.8%	<b>18.1%</b>	<b>70.5%</b>	
NIFTY 50 <sup>#</sup>	8.3%	11.8%	16.4%	-0.5%	<b>11.2%</b>	<b>40.3%</b>	+30.2%
MIDCAP 100 <sup>#</sup>	22.2%	10.3%	-1.9%	-11.5%	<b>5.0%</b>	<b>17.0%</b>	+53.5%

\*Cumulative returns are from 20<sup>th</sup> July 2016 to 30<sup>th</sup> September 2019. FY17 returns are for an 8-month period. As mandated by SEBI, Returns are calculated on a weighted average basis. Returns are net of expenses and fees.

<sup>#</sup>Total Return Index includes returns from dividends received

As of 30<sup>th</sup> September 2019, 86.9% of the total capital was deployed in equities with the rest lying in interest earning assets. **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.

#### **2Point2 Long Short Value Fund**

The 2Point2 Long Short Value Fund (launched in August 2016) is our long/short equity strategy using **ONLY** proprietary capital. We had plans to launch a long/short Alternative Investment Fund (AIF) that could accept external capital and had received an AIF license from SEBI a few months back. However, recent tax and regulatory changes have negatively impacted long/short AIF's ability to generate alpha. We now do not plan to launch a long/short fund and will stop reporting the returns of this strategy from next quarter onwards.

	CAGR*
2Point2 Long Short Value Fund	22.3%

\*Period of 38 months beginning 4<sup>th</sup> August 2016 to 30<sup>th</sup> September 2019. Returns are calculated on a weighted average basis on only the invested corpus (gross long + gross short). Returns are net of all expenses.

## **COMMENTARY**

In Q2 FY20, the overall market saw high levels of volatility. The July budget, economic growth data and NBFC crisis negatively impacted market returns while the corporate tax cuts boosted stock prices. Our portfolio returned -3.1% in the quarter. The Nifty 50 and Midcap 100 index generated returns of -2.2% and -8.7% in this period. We now have an 86.9% exposure to equities in the PMS on a consolidated basis (new portfolios would have lower exposure).

The operating performance of our portfolio companies has weakened in this quarter. On aggregate, they had one of their weakest quarterly operating performance in recent times. Median YoY earnings growth of the portfolio fell from high-teens growth of the last few years to single digit growth in this quarter. The low earnings growth is understandable given the current economic slowdown. We expect the operating performance to start improving soon. Portfolio valuations have become attractive with a median TTM P/E multiple of 16.8x.

## **IMPACT OF TAX CUTS ON INTRINSIC VALUE**

The government surprised the markets last month by cutting corporate tax rates to 25.6% from 34.9% (all inclusive) earlier. All else equal, the future profits of a company currently operating on a full tax rate should increase by ~15% and therefore the intrinsic value should also go up. However, the reality is a bit complicated. We share below our thoughts on the impact of tax cuts on different companies.

### **Non-Event for Most Players**

Companies that lack pricing power are unlikely to benefit a lot from the tax cuts. In most industries, competitive forces will ensure that all the gains from the tax cuts are transferred to the customer through price cuts over time. Just like a big decline in raw material costs doesn't result in a sustainable improvement in profitability, gains from the tax cuts will also be competed away. Only companies with pricing power can retain the higher profits due to lower taxes. The reality however is that there are very few listed companies in India that have any meaningful pricing power.

A company has pricing power if it can raise the price of its product/service without a significant impact on its sales. These are typically dominant companies with a strong customer lock-in (could be due to strong brands, high switching costs, network effects or proprietary IP). Pricing power is not a function of the number of players in the industry but the nature of the product/service. There are certain industries like aviation where even the market leader (Interglobe Aviation) may not have much pricing power despite having a 45%+ market share. All players in aviation must match their fares to the competitor fares.

The below table gives a snapshot of companies / industries in both categories:

<b>High Pricing Power</b>	<b>Low Pricing Power</b>
Cigarettes (ITC)	Chemicals
Baby Foods (Nestle)	Generic Pharma
Toothpastes (Colgate)	Aviation
Branded Pharma (Sanofi)	Real Estate
Personal Care (Gillette)	Auto
Internet (Naukri)	Banks/NBFCs
Exchanges (MCX)	Capital Goods/Infrastructure

It is often not as binary a classification as shown in the table above. There might be certain companies which have some pricing power even in sectors which have very little pricing power and vice versa. For instance, Godrej Properties in Real Estate, SBI in Savings Deposits, Maruti in Auto etc. The above classification is only used for an ease of analysis.

### Companies with Pricing Power benefit the most

Companies that have pricing power can retain bulk of the benefits from tax cuts as the price elasticity of demand of their product/ service is low. This category of companies will see a two-fold benefit of tax-cuts – 1) Future profits can increase by ~15% due to the decline in taxes; 2) There is a permanent increase in the ROE of these companies as the same capital employed now generates higher profits. Both these factors result in higher future free cash flow (FCF) generation for the same level of growth resulting in an increase in intrinsic value of the company.

#### a. How does Growth and ROE impact the Intrinsic Value?

For companies that can retain the tax cut benefits entirely, the increase in intrinsic value depends on the ROE and growth profile of the company. A high growth company benefits from deploying the tax savings towards growth opportunities thereby creating a compounding effect on earnings and cash flows which is missing in low growth companies. Therefore, higher the growth, higher is the increase in intrinsic value as shown in the table below.

Increase in Intrinsic Value for Companies with Pricing Power\*

		Current ROE				
		20%	25%	30%	35%	40%
Growth	5.0%	20%	19%	18%	17%	17%
	10.0%	26%	23%	21%	20%	19%
	15.0%	33%	26%	23%	22%	21%
	20.0%	39%	29%	25%	23%	22%
	25.0%	43%	31%	27%	24%	22%

*\*This is based on a 20-year DCF projection period of growth with a Cost of Equity assumption of 14%; After the 20-year period, the company is assumed to grow at the same 5% terminal growth in all combinations of Growth / ROE.*

The impact of ROE however is slightly less straightforward. It is a widely held belief that companies that have higher ROEs will benefit disproportionately (vis-à-vis companies that have a lower ROE) because the increased profits can be reinvested at higher ROEs to generate even higher profits and so on and so forth, thereby creating a virtuous cycle. However, this is an unlikely scenario. Companies that have very high ROEs (typically strong consumer franchisees) are cash rich with growth opportunities lower than their internal cash accruals. Their growth is not constrained because of a lack of capital. Rather, they are paying out large dividends because of an inability to reinvest their profits in the business. Therefore, the benefits from a tax cut for these companies will be limited to an increase in dividends and not an increase in growth.

In fact, counter-intuitive as it may sound, a company with a **lower** ROE (but with an ability to retain the tax cut benefits) should see a **higher** % increase in intrinsic value than that with a higher ROE (as shown in the DCF sensitivity table above). For the same growth, a HUL which is already at 80%+ ROE benefits less in % increase in intrinsic value than say a Marico with 30%+ ROE (assuming both have similar growth). This is because the present value of the tax cut benefits is the same for both companies. However, it is a larger % of the intrinsic value for a lower ROE business than it is for a higher ROE business.

The above may not be true for industries with players that do not have pricing power as shown in the next section, as the efficient player will take price cuts to capture volume growth thereby nullifying the increase in profits for the inefficient players.

### The Strong become Stronger, the Weak become Weaker

Because most of the companies in India operate in ultra-competitive sectors and have no pricing power, these companies will have no option but to pass on bulk of the tax-cut benefits to the consumers. Therefore, there may not be any benefits to most of these companies other than perhaps an increase in volumes over the long term (due to lower prices). However, there are still a few companies that benefit due to the tax cuts despite having no pricing power. This is because the tax cuts benefit the most efficient players more than the weaker players (even if both pay the highest tax rate). In fact, over the long term, the inefficient player might see an erosion in profitability because of the tax cut. Here's how.

	Company A		
	Pre Tax Cut	Post Tax Cut	Post Price Cut
<b>Sales</b>	100.0	100.0	98.1
<b>Expense</b>	85.0	85.0	85.0
<b>PBT</b>	15.0	15.0	13.1
<b>Tax</b>	5.2	3.8	3.4
<b>PAT</b>	9.8	11.2	9.8
<b>PAT Margin</b>	9.8%	11.2%	10.0%

	Company B		
	Pre Tax Cut	Post Tax Cut	Post Price Cut
<b>Sales</b>	100.0	100.0	98.1
<b>Expense</b>	90.0	90.0	90.0
<b>PBT</b>	10.0	10.0	8.1
<b>Tax</b>	3.5	2.6	2.1
<b>PAT</b>	6.5	7.4	6.0
<b>PAT Margin</b>	6.5%	7.4%	6.2%

Company A and Company B operate in the same industry and pay the same tax rate of 35%. Company A is more efficient than B with higher profitability. On a sale of 100 Rs, Company A and Company B make a PAT margin of 9.8% and 6.5% respectively. Post the tax cut, Company A's PAT increases from 9.8 to 11.2. Company A can now reduce its selling price by 1.9 and still generate the same profits as earlier. Company B will be forced to match this price cut. This will result in Company B's PAT falling from 6.5 to 6.0. Due to its lower profitability, Company B will see a decline in profits if Company A decides to pass on the tax cut benefits. The tax cut is therefore bad news for the weaker players in all industries.

### Indian Companies benefit in areas which have Foreign Competition

Companies that face a lot of foreign competition will benefit from the tax cuts. The tax reduction will make Indian players more competitive vs foreign players. The benefit will be particularly high for companies that only have foreign competition and little competition from other Indian companies. They can either retain this benefit or gain market share from foreign competitors through price cuts. For specialty chemical companies that are the only Indian exporters of the chemicals that they manufacture, there might be a permanent benefit on margins and ROEs from the tax cuts. However,

for IT companies that also face a lot of Indian competition in foreign markets, the impact may be much lower.

### **Formalization of the Economy as Unorganized becomes less Competitive**

Companies that have a large degree of unorganized competition may gain significant market share as the tax arbitrage between organized and unorganized sectors reduce. The organized players may not retain the excess margins/ROE but they may see volume gains from the unorganized sectors. The lower tax rates should lead to further formalization of the economy as unorganized players lose a part of their edge stemming from tax evasion. For instance, retailers like D-Mart in the highly competitive grocery retail benefit as their competitiveness vis-à-vis unorganized players increase.

Summarizing, the tax cut is a positive for corporate India but not everyone benefits. Surprisingly, there will be some losers as well. In most industries that are competitive, the benefits of the tax cuts are passed on to the consumers in the form of lower prices. The biggest beneficiaries of the tax cuts are companies that have pricing power. Among them, those companies that have reinvestment growth opportunities benefit the most.

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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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