April 28, 2017

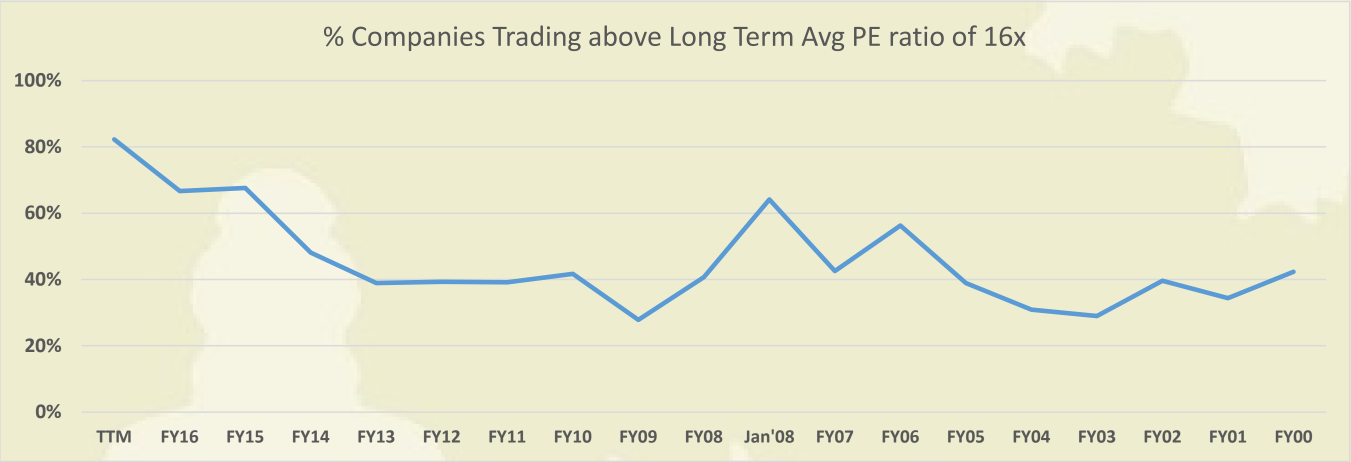
Dear Investors,

Indian equity markets had a good FY2017 and the micro, small and mid-cap stocks continued their outperformance that started in September 2013. The rally was so broad based that one's portfolio had to be a statistical outlier to have lost money. The markets rallied capturing many hurdles such as muted earnings growth, demonetization, US presidential elections and Brexit with the support of strong fund flows and optimistic view of India's future under the Modi government. Stocks are from no perspective cheap and a common question that we hear from new and old investors alike is, **"Does it make sense to invest now at such elevated levels?"** Before I provide my perspective on this investor dilemma and talk about how we are investing in such environment, let me cover couple of updates.

We have recently launched a PMS offering and have also received in principle approval for an AIF offering which will also be launched soon. AIF will be the same portfolio as our current core portfolio under Investment Advisory (IA). We generally have maintained a portfolio of 14 (+/- 2) stocks in this with a range of 12-20 positions. PMS is the same strategy except that the portfolio is more diversified with a range of 20-30 stocks and the minimum market cap of a stock would be INR 300 crs vs INR 1500 crs in AIF/IA portfolio. **The performance of both these offerings is presented as appendix at the end of this memo.**

More Perspective on Current Valuation

In my previous memo (January 2017 Memo) I have written extensively on valuation and how PEx expansion has been inversely proportional to the size (market capitalization) of the companies even when earnings have worsened for them over the last three and a half years. Let me present one more way of looking at whether valuation levels are elevated in the current markets. Long term (2002-2016) average PEx for the universe of about 553 companies we cover in our valuation analysis has been around 16x. Multiples for indices such as Nifty are weighted by float and hence are skewed by largest of companies and doesn't provide the breadth of valuation expansion. To get a sense of that, let's look at the % of companies trading above the long term average PEx of 16 over the last 17 years. Below is the graph.



You can see that on an average less than half of the companies trade above the 16x multiple. FY03 and FY09 saw the lowest levels around 28-29% and both of those were the best times for an investor to have invested. **Currently 82% of the companies are trading above 16x multiple and that's higher than what we saw even in Jan'08 peak or anytime during this century**. So there is no question that we are in an unprecedented territory and if earnings don't pan out the way investors are hoping for, we could head for some unpleasant volatility.

Current Environment is Extremely Tricky

Typically markets are euphoric near the peaks of economic cycle where sales growth is strong, margins are way above average and corporate capital expenditure environment is buoyant. This time around markets are euphoric when economic cycle is near the trough with margins below average, sales growth and capital expenditure virtually non-existent. During such environment the **valuation ratios may seem deceptively high due to the denominator (earnings) in the valuation ratios being suppressed. Margins can quickly expand and earnings can violently jump at any reasonable pickup in volume, capacity utilization and capital expenditure cycle.** If one stays out of the markets fearing high multiples, he/she may completely miss out on the big portion of the market rally. At the same time, if earnings don't pick up or if a major risk event occurs in the world, markets can correct sharply.

In every bull phase investors try and justify high multiples using different logics. Currently the most prevalently accepted logic is that Indians are extremely underinvested in equities and asset allocation shift from real estate, gold and fixed deposits will have long lasting funds flow into equities thereby maintaining high multiples. There is no denying the structural change, but **when you look at history in US and other developed markets who have gone through similar shift the valuation multiples did see short term jump, but have mostly reverted to long term averages**. There was a thesis carried out in Florida State University in 2015 to study relationship of market participation and valuation. Correlations were statistically inconclusive. Bottom-line is that the long term returns from equities will highly correlate with long term earnings growth and that will remain the hard reality irrespective of market sentiments.

During euphoric times stock rallies are broad based, it's easy to make money and in many cases you make more money if you throw caution out of the window. Everyone runs short of ideas and investors pounce on any sign of new emerging theme. IPOs seem more exciting than similar listed businesses. Whoever jumps on the idea first makes the most amount of money and ones who spend time in analyzing/understanding the business pay the penalty by buying at significantly higher levels. **When you experience the missing out feeling few times, even many experienced investors start investing first and analyzing later**. We are in such environment and it reminds me of Warren Buffet's famous words, ***"Only when the tide goes out do you discover who's been swimming naked"***. When you use short cuts and run behind quick money by relaxing your discipline, you do not realize that you are one of the ones swimming naked because the froth around you hides everything. Rising tide lifts all boats and riding high waves is intoxicating. For an investor it is extremely important to understand high Beta vs high Alpha.

Understanding high Beta vs high Alpha

It is easy to mistake Beta with superior performance. Beta is high risk high return strategy and may outperform during bull phase but significantly underperform during challenging phase. For example during the last 3.5 years if one had randomly invested in a well-diversified small cap portfolio (from a universe of bottom 1000 of the top 1500 companies by market cap), he/she would have outperformed Nifty 50 by at least 4x, but this outperformance shouldn't be mistaken with superior performance. Alpha is superior performance against the right universe and especially considering the risk employed in the strategy. Following example is a try at representing the high Beta vs high Alpha strategy.

	Year 1	Year 2	Year 3	Year 4	Year 5	CAGR Over Cycle
Market Returns	15%	25%	45%	30%	-25%	**15.2%**
Risky Portfolio	15%	30%	65%	45%	-50%	**12.3%**
Disciplined	15%	25%	45%	30%	-15%	**18.2%**

One bad year for the market and most of the outperformance vanishes. Difficult to stay away from the greed after seeing so many around you making a killing unless you have experienced multiple down cycles. Market timing extremely Important and luck plays a big part in this.

High risk high returns strategy works best in a raging bull market. This is a high beta strategy and very exciting for investors to ignore. Even the more experienced investors can't overcome the greed confusing it with high alpha strategy.

Disciplined strategy may not beat the market during a raging bull run, but handily outperforms over a full cycle. Generally not as exciting for most investors to follow in rising markets.

Easy money attracts more and more inexperienced investors into the market. **The numbers getting pulled in the 3rd year is vastly higher than in the 2nd year, similarly the number in the**

4th year is vastly higher than the 3rd year. Sadly the maximum come in the 5th year and lose major money to not ever return to the stock market.

So, is it a Good Time to Invest Now?

This is a common question asked by many new as well as experienced investors. You could fall flat on your face advising either ways as short term is highly unpredictable. Markets can swiftly move against your advice and I believe trying to predict short term market movements is a useless exercise for fundamental investors. My experience has not been that great at market timing. **If you are comfortable with your portfolio businesses and their absolute (not relative) valuations, there is no reason to exit or not add to such positions irrespective of what market valuations are**. These are times to be extremely cautious and absolutely not compromise on your business evaluation process. Being cautious doesn't always mean you have to be defensive. You just have to be extra careful in evaluating prices to pay for businesses as it is easy to get brainwashed by the relative (of already expensive peers) valuation rationale employed by analysts/co-investors and to forget about intrinsic value.

When your goal is to create significant alpha over the market, you have to think independently and differently. Investment rationale based on widely and commonly known themes such as GST, affordable housing and unorganized to organized movement will unlikely end up creating alpha. Indian markets have become extremely efficient and information arbitrage is no longer a winning strategy. I believe that the only way one can sustainably outperform (be careful in differentiating beta vs alpha outperformance) the market is by one's ability to connect the dots, and conducting thorough and superior analysis of businesses and understanding their fair value.

We continuously strive to do the above and try and stay ahead of the markets. As markets and some of our stocks have become uncomfortably expensive, we have exited such investments and have been able to find good replacements which aren't followed by the herd. This has helped us lower the valuation of our portfolio while not having to dilute the quality. Generally we are almost fully invested but have slightly below 15% cash levels currently. This is kept mainly to accommodate few interesting ideas we are working on but have not yet completed our analysis on. Following are the parameters of our core portfolio:

Metrics	SCP	Indian Market	Notes
Wtd. Avg. Market Cap	6,000 crs	15,600 crs	• 13 stocks in the SCP portfolio with smallest being around 2000 crs. • Indian market universe is of 553 cos, for which we analyse valuations.
Past 3yrs Wtd Sales CAGR	18.2%	5.5%	
Past 3yrs Wtd EBIDTA CAGR	28.2%	11.5%	
Past 3yrs Wtd Erngs CAGR	41.2%	-0.7%	
Current ROE	28.5%	13.3%	
Current ROCE	26.2%	13.6%	
1 yr Fwd P/E	20.0x	24.0x	• Assuming EPS growth proportionate to ROE i.e. 20% for SCP and 10% for the market. • This is proportionate to the ROE
1 yr Fwd EV/EBIDTA	12.5x	14.5x	

We believe that a portfolio with more than double the profitability of the market and available at a PEx below ROE/ROCE, long term expected earnings growth rate as well as market PEx is reasonably attractive even at absolute levels. For PMS offering, we are in the midst of building the portfolio for all the new clients and have 19 stocks with almost the same parameters as above at the portfolio level. Cash level is slightly higher here but as we add stocks to the portfolio, we expect to reduce the cash levels considerably over the coming months.

As finding attractive valuations become increasingly difficult, we continue our quest for outstanding investments with more vigor than ever before.

Warm Regards,

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**SageOne Investment Advisors LLP is registered as an Investment Advisor, PMS and AIF with SEBI.*

Appendices

PMS Portfolio Performance (Net of Fees)

Period (Apr 1 - Mar 31)	PMS	Nifty	BSE Midcap	BSE Smallcap	BSE 500	Validation/ Review
FY 2018 (Mar 31 - Apr 28)	6.3%	1.4%	5.0%	6.5%	2.7%	**Internal Estimate**

Investment Advisory Core Portfolio Performance (Gross Before Fees)

Below is the gross (pre-fees but excluding dividends) performance of our core portfolio in **INR** terms for the last 8 years and 1 month. For the first three years we managed proprietary funds and for the last 5 years and 1 month we have been advising external clients. Since clients have joined at various stages, individual performance may differ slightly based on the timing of purchases. For uniformity and ease we measure our performance using a "representative" portfolio (that resembles advice given to clients) and we call it SageOne Core Portfolio (SCP). **SageOne core portfolio is not a dummy portfolio but the CIO's actual total equity portfolio**.

8 Years 1 Month Gross Performance in INR (April 2009 – April 2017)

Period (Apr 1 - Mar 31)	SCP	Nifty	BSE Midcap	BSE Smallcap	BSE 500	Validation/ Review
FY 2018 (Mar 31 - Apr 28)	7.9%	1.4%	5.0%	6.5%	2.7%	**Internal Estimate**
FY 2017	31.7%	18.5%	32.7%	36.9%	24.0%	**KPMG**
FY 2016	-5.0%	-8.9%	0.2%	-3.2%	-7.8%	**KPMG**
FY 2015	116.2%	26.7%	49.5%	54.0%	33.2%	**KPMG**
FY 2014	72.2%	18.0%	15.3%	21.8%	17.1%	**KPMG**
FY 2013	29.1%	7.3%	-3.2%	-12.4%	4.8%	**KPMG**
FY 2012	14.3%	-9.2%	-7.7%	-18.9%	-9.1%	**KPMG**
FY 2011	34.7%	11.1%	1.0%	-3.8%	7.5%	**KPMG**
FY 2010	182.0%	73.8%	130.2%	161.7%	96.4%	**KPMG**
Annualized Returns	**51.1%**	**14.9%**	**22.0%**	**21.2%**	**17.5%**	
Cummulative Returns	2716.0%	208.0%	400.6%	373.5%	268.4%	

* We have consciously changed the composition of the core portfolio in terms of the average size of companies and the number of stocks in the portfolio after we started advising external clients in April 2012.
* The weighted average size of stocks at the start in FY10 was below $0.25 bn which has increased to near $1.0 bn by the end of Mar '17. Also, the number of stocks has increased from 5 (+/- 2) in 2009 to 14 (+/- 2) during the past 4 years.
* Reasonable diversification was done by design to improve liquidity and reduce volatility as a result of which annualized standard deviation has come down from 59% for the first 3 years to 20% during the last 5 years.

Core Portfolio: Latest 5 Years 1 Month Performance (April 2012 – April 2017)

Period (Apr '12 - Apr '17)	SCP	Nifty	BSE Midcap	BSE Smallcap	BSE 500
Latest 5 Years 1 Month	44.5%	11.7%	18.1%	18.0%	13.7%
Cummulative Returns	548.9%	75.7%	133.2%	131.9%	92.0%
% Positive Months	73.8%	59.0%	62.3%	63.9%	62.3%
Annualized Stdev	19.0%	14.0%	17.7%	20.6%	14.8%
Sharpe (RFR 7.5%)	**1.94**	**0.30**	**0.60**	**0.51**	**0.42**

First 3 Years Performance (April 2009 – March 2012)

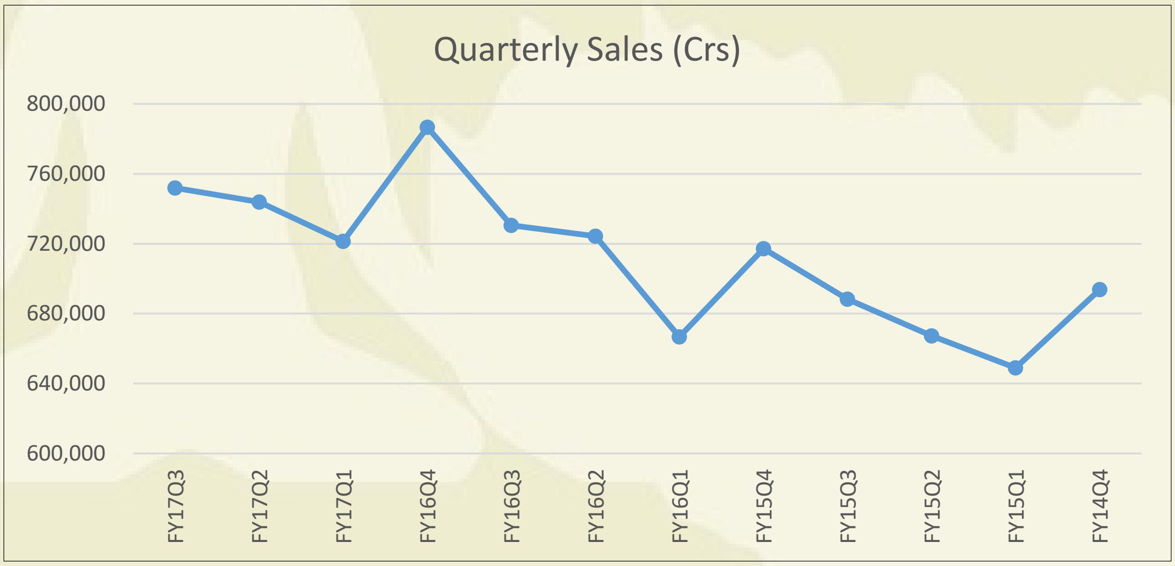
Period	SCP	Nifty	BSE Midcap	BSE Smallcap	BSE 500
First 3 Years FY10-12 (Annualized returns)	63.1%	20.6%	29.0%	26.9%	24.3%
Cummulative Returns	334.0%	75.3%	114.7%	104.2%	91.8%
% Positive Months	63.9%	55.6%	61.1%	55.6%	58.3%
Annualized Stdev	58.8%	26.4%	33.7%	40.3%	28.1%
Sharpe (RFR 7.5%)	**0.95**	**0.50**	**0.64**	**0.48**	**0.60**

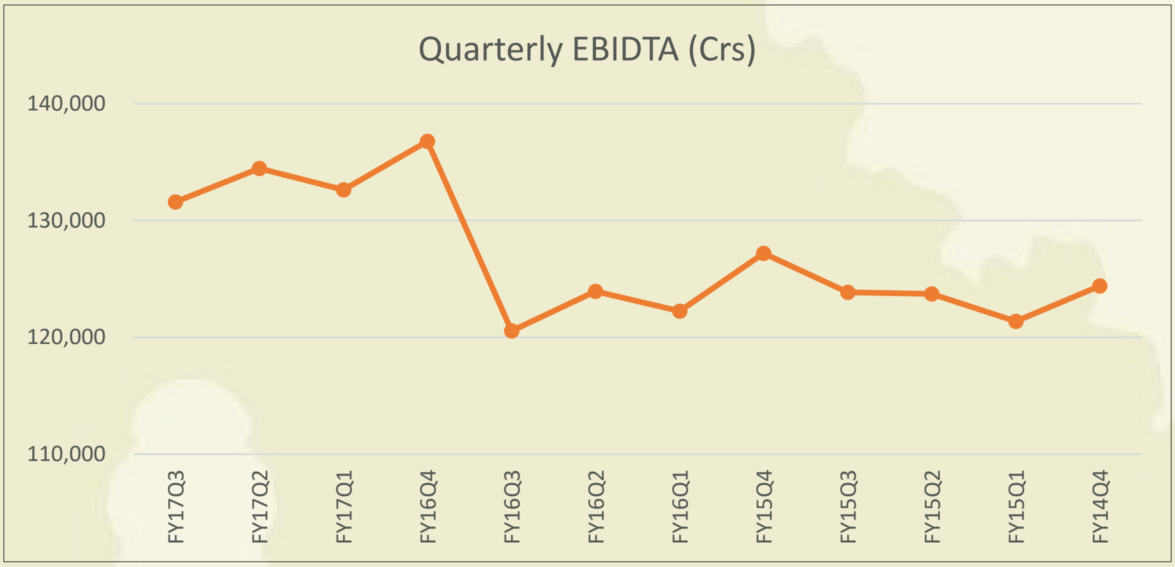
<u>Universe used for the following analysis</u>: The starting universe for the Valuation analysis comprised all the companies (872) in the BSE 500, BSE Midcap and BSE Small Cap indices. After excluding companies who do not have 14 years of listed history, we were left with 557 companies. This universe covered about 80% of the total listed market capitalization. In the current analysis, we have further excluded the following sectors/companies: Financial sector, Crude Oil sector and specific companies Tata Steel, Vedanta and Suzlon due to large exceptional items that would skew the overall results.

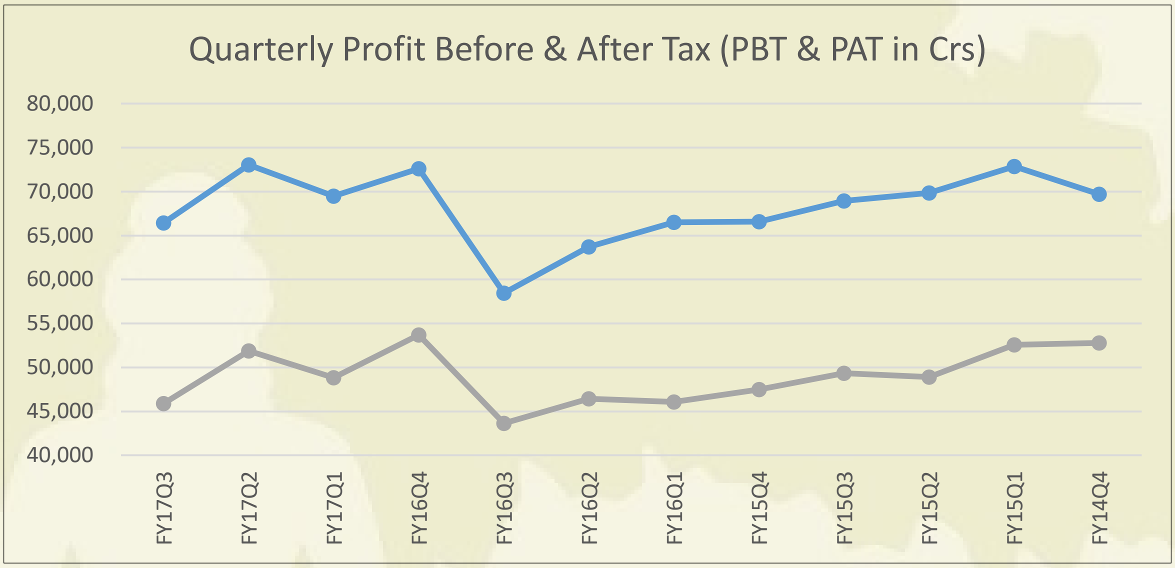
Source of all data: **Ace Equity**

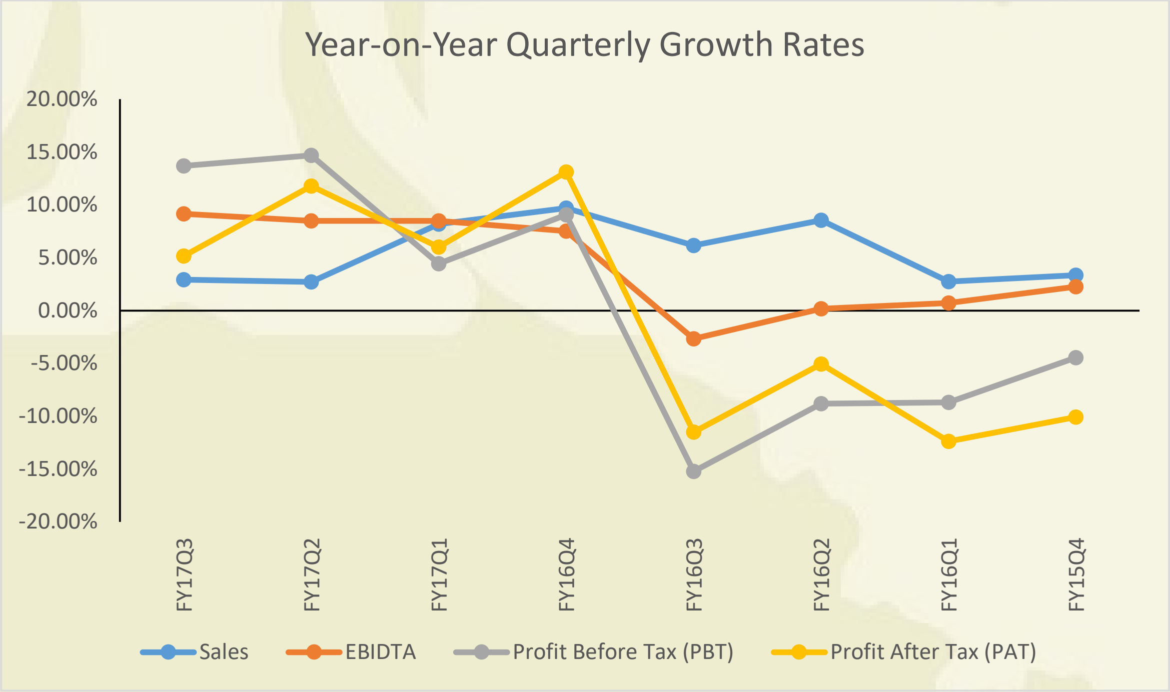
<u>Market Quarterly trend over the past 12 quarters</u>

(Latest four quarters showing Y-o-Y growth in sales as well as earnings)






Quarterly Profit Before & After Tax (PBT & PAT in Crs)
80,000
75,000
70,000
65,000
60,000
55,000
50,000
45,000
40,000
FY17Q3
FY17Q2
FY17Q1
FY16Q4
FY16Q3
FY16Q2
FY16Q1
FY15Q4
FY15Q3
FY15Q2
FY15Q1
FY14Q4


Year-on-Year Quarterly Growth Rates
20.00%
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
-20.00%
FY17Q3
FY17Q2
FY17Q1
FY16Q4
FY16Q3
FY16Q2
FY16Q1
FY15Q4
Sales
EBIDTA
Profit Before Tax (PBT)
Profit After Tax (PAT)

SageOne

Consolidated P&L for the analyzed universe

(Shows trend of various line items across the 12 quarters)

	FY17Q3	FY17Q2	FY17Q1	FY16Q4	FY16Q3	FY16Q2	FY16Q1	FY15Q4	FY15Q3	FY15Q2	FY15Q1	FY14Q4
Sales	751,900	743,923	721,378	786,772	730,576	724,307	666,719	717,151	688,266	667,220	648,963	693,861
% Growth Y-o-Y	*2.9%*	*2.7%*	*8.2%*	*9.7%*	*6.1%*	*8.6%*	*2.7%*	*3.4%*				
OthOptInc	8,190	8,648	7,958	8,041	7,577	7,124	7,190	8,320	7,955	6,840	6,037	7,231
COGS	356,804	356,079	338,360	372,998	350,083	346,329	297,345	330,295	318,673	307,377	297,847	326,401
GM	403,286	396,491	390,976	421,815	388,069	385,102	376,564	395,176	377,547	366,684	357,153	374,691
% Sales	*53.6%*	*53.3%*	*54.2%*	*53.6%*	*53.1%*	*53.2%*	*56.5%*	*55.1%*	*54.9%*	*55.0%*	*55.0%*	*54.0%*
% Growth Y-o-Y	*3.9%*	*3.0%*	*3.8%*	*6.7%*	*2.8%*	*5.0%*	*5.4%*	*5.5%*				
OpEx	249,838	237,277	236,831	268,959	252,356	246,914	239,940	251,332	237,778	229,282	223,703	235,836
% Sales	*33.2%*	*31.9%*	*32.8%*	*34.2%*	*34.5%*	*34.1%*	*36.0%*	*35.0%*	*34.5%*	*34.4%*	*34.5%*	*34.0%*
% Growth Y-o-Y	*-1.0%*	*-3.9%*	*-1.3%*	*7.0%*	*6.1%*	*7.7%*	*7.3%*	*6.6%*				
OI, etc	21,845	24,759	21,517	16,081	15,153	14,248	14,381	16,640	15,909	13,680	12,075	14,463
EBIDTA	**131,603**	**134,455**	**132,627**	**136,775**	**120,560**	**123,939**	**122,243**	**127,204**	**123,860**	**123,722**	**121,376**	**124,393**
% Sales	*17.5%*	*18.1%*	*18.4%*	*17.4%*	*16.5%*	*17.1%*	*18.3%*	*17.7%*	*18.0%*	*18.5%*	*18.7%*	*17.9%*
% Growth Y-o-Y	*9.2%*	*8.5%*	*8.5%*	*7.5%*	*-2.7%*	*0.2%*	*0.7%*	*2.3%*				
Int	28,836	28,217	27,888	27,591	24,764	25,462	24,775	25,994	24,047	23,098	21,820	21,902
Exceptional/Fx/Other	(659)	(2,633)	131	(403)	3,148	2,129	(702)	2,962	(764)	297	(3,419)	3,712
Depr	36,970	35,814	35,127	36,961	34,199	32,646	31,640	31,649	31,638	30,482	30,117	29,074
PBT	66,454	73,057	69,481	72,627	58,448	63,702	66,531	66,599	68,938	69,845	72,857	69,705
% Sales	*8.8%*	*9.8%*	*9.6%*	*9.2%*	*8.0%*	*8.8%*	*10.0%*	*9.3%*	*10.0%*	*10.5%*	*11.2%*	*10.0%*
% Growth Y-o-Y	*13.7%*	*14.7%*	*4.4%*	*9.1%*	*-15.2%*	*-8.8%*	*-8.7%*	*-4.5%*				
Taxes	20,547	21,158	20,639	18,919	14,790	17,272	20,457	19,116	19,612	20,942	20,277	16,898
PAT	45,907	51,899	48,842	53,708	43,658	46,430	46,074	47,483	49,326	48,903	52,579	52,807
% Sales	*6.1%*	*7.0%*	*6.8%*	*6.8%*	*6.0%*	*6.4%*	*6.9%*	*6.6%*	*7.2%*	*7.3%*	*8.1%*	*7.6%*
% Growth Y-o-Y	*5.2%*	*11.8%*	*6.0%*	*13.1%*	*-11.5%*	*-5.1%*	*-12.4%*	*-10.1%*				

Common Size P&L (as a % of Sales)

	FY17Q3	FY17Q2	FY17Q1	FY16Q4	FY16Q3	FY16Q2	FY16Q1	FY15Q4	FY15Q3	FY15Q2	FY15Q1	FY14Q4
Sales	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Other Opt Inc	1.09%	1.16%	1.10%	1.02%	1.04%	0.98%	1.08%	1.16%	1.16%	1.03%	0.93%	1.04%
COGS	47.45%	47.87%	46.90%	47.41%	47.92%	47.82%	44.60%	46.06%	46.30%	46.07%	45.90%	47.04%
Gross Margins	**53.64%**	**53.30%**	**54.20%**	**53.61%**	**53.12%**	**53.17%**	**56.48%**	**55.10%**	**54.85%**	**54.96%**	**55.03%**	**54.00%**
Operating Expenses	33.23%	31.90%	32.83%	34.19%	34.54%	34.09%	35.99%	35.05%	34.55%	34.36%	34.47%	33.99%
Other Income, etc.	2.91%	3.33%	2.98%	2.04%	2.07%	1.97%	2.16%	2.32%	2.31%	2.05%	1.86%	2.08%
EBIDTA	**17.50%**	**18.07%**	**18.39%**	**17.38%**	**16.50%**	**17.11%**	**18.34%**	**17.74%**	**18.00%**	**18.54%**	**18.70%**	**17.93%**
Interest Expense	3.84%	3.79%	3.87%	3.51%	3.39%	3.52%	3.72%	3.62%	3.49%	3.46%	3.36%	3.16%
Exceptional/FX/Other	-0.09%	-0.35%	0.02%	-0.05%	0.43%	0.29%	-0.11%	0.41%	-0.11%	0.04%	-0.53%	0.53%
Depreciation	4.92%	4.81%	4.87%	4.70%	4.68%	4.51%	4.75%	4.41%	4.60%	4.57%	4.64%	4.19%
PBT	**8.84%**	**9.82%**	**9.63%**	**9.23%**	**8.00%**	**8.79%**	**9.98%**	**9.29%**	**10.02%**	**10.47%**	**11.23%**	**10.05%**
Taxes	2.73%	2.84%	2.86%	2.40%	2.02%	2.38%	3.07%	2.67%	2.85%	3.14%	3.12%	2.44%
PAT	**6.11%**	**6.98%**	**6.77%**	**6.83%**	**5.98%**	**6.41%**	**6.91%**	**6.62%**	**7.17%**	**7.33%**	**8.10%**	**7.61%**

Year-on-Year Quarterl	FY17Q3	FY17Q2	FY17Q1	FY16Q4	FY16Q3	FY16Q2	FY16Q1	FY15Q4
Sales	2.92%	2.71%	8.20%	9.71%	6.15%	8.56%	2.74%	3.36%
EBIDTA	9.16%	8.48%	8.49%	7.52%	-2.66%	0.18%	0.71%	2.26%
Profit Before Tax (PBT)	13.70%	14.68%	4.43%	9.05%	-15.22%	-8.79%	-8.68%	-4.46%
Profit After Tax (PAT)	5.15%	11.78%	6.01%	13.11%	-11.49%	-5.06%	-12.37%	-10.08%

Y-o-Y Growth Trend

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