CONSISTENT COMPOUNDERS

AN INVESTMENT STRATEGY BY

MARCELLUS INVESTMENT MANAGERS

MARCELLUS

ABOUT MARCELLUS

Marcellus Investment Managers was founded in 2018 and currently has c.US$950m in assets under management and advisory. The founders have worked together for the past 15years

Saurabh Mukherjea, CFA – Chief Investment Officer

- former CEO of **Ambit Capital**, assets under advisory were $800mn.

- Author of three bestselling books: Gurus of Chaos (2014), The Unusual Billionaires (2016) and “Coffee Can Investing (2018).

- Co-founder of **Clear Capital**, a London based small-cap equity research firm which he and his co-founders created in 2003 and sold in 2008.

- MSc in Economics from **London School of Economics**

- Member of SEBI’s Asset Management Advisory Committee.

Pramod Gubbi, CFA - Head of Sales

- Formerly, MD & Head of Institutional Equities at **Ambit Capital**
- CEO of Ambit Singapore
- Tech analyst at **Clear Capital** and also worked in the tech industry - HCL Technologies and Philips Semiconductors
- Post-graduate in Management from **IIM – Ahmedabad.**
- B.Tech from Regional Engineering College, Surathkal (NIT, Karnataka)

Rakshit Ranjan, CFA – Portfolio Manager

- Formerly, Portfolio manager of **Ambit Capital**'s Coffee Can PMS, which was one of India's top performing equity products during 2018
- **Ambit's** consumer research head, voted as No.1 for Discretionary Consumer and top-3 for Consumer Staples
- At **Clear Capital**, ranked amongst the top-3 UK Insurance analysts
- B.Tech from **IIT (Delhi)**

MARCELLUS

KEY STEPS FOR IDENTIFYING CONSISTENT COMPOUNDERS

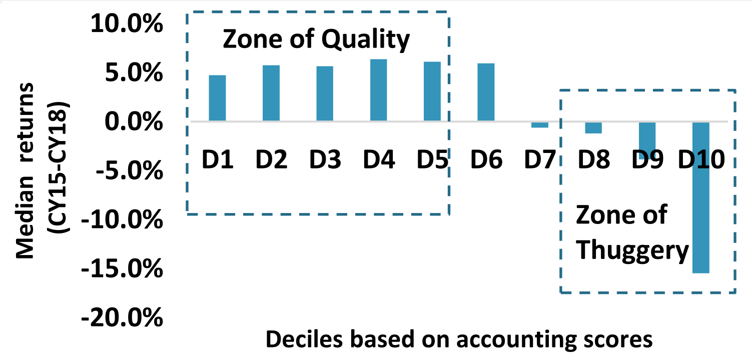
1. Identify companies with clean accounts
2. Identify companies with track record of superior capital allocation
3. Amongst companies which pass steps 1 & 2, identify those with high barriers to entry

STEP 1: IDENTIFY COMPANIES WITH CLEAN ACCOUNTING

Ten forensic accounting checks used to identify naughty companies

Category	Ratios
Income statement checks	(1) Cashflow from operations (CFO) as % of EBITDA
	(2) Volatility in non-operating income
	(3) Provisioning for doubtful debts as a proportion of debtors overdue for >6 months
Balance sheet checks	(4) Yield on cash and cash equivalents
	(5) Contingent liabilities as % of Networth (for the latest available year)
	(6) Change in reserves explained by the profit/loss for the year and dividends
Auditor checks	(7) Growth in auditor's remuneration to growth in revenues
Cash theft checks	(8) Miscellaneous expenses as a proportion of total revenues
	(9) CWIP to gross block
	(10) Free cash flow (cashflow from operations + cashflow from investing) to median revenues

Strong correlation between accounting quality and shareholders' returns



Note: Returns above represent median of decile-wise median returns calculated for every year from CY15 (accounting scores based on FY15 financials) to CY18 (accounting scores based on FY18 financials).

Methodology

We look at over six years of consolidated financials for the universe of firms.

We first rank stocks on each of the 10 ratios individually (outlined in the table on the left). These ranks are then cumulated across parameters to give a final pecking order on accounting quality for stocks.

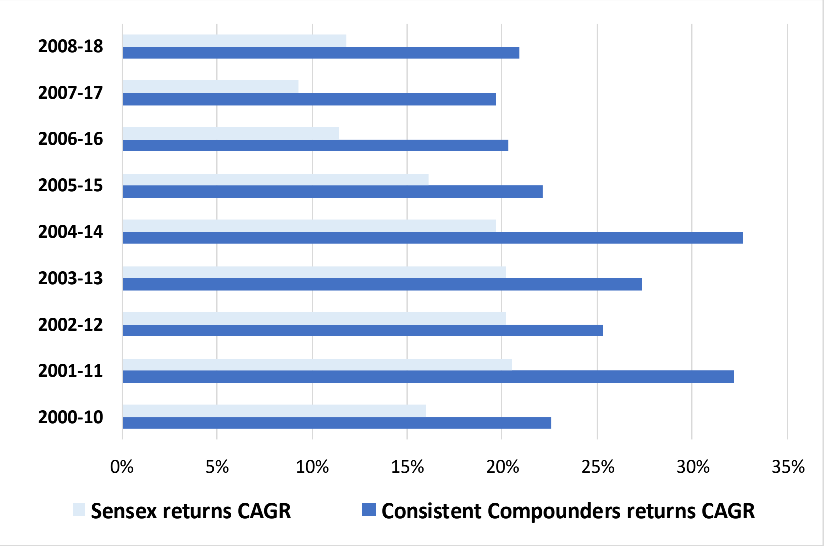
This framework draws upon Howard Schilit's legendary text on forensic accounting, "Financial Shenanigans".

STEP 2: IDENTIFY COMPANIES WITH SUPERIOR CAPITAL ALLOCATION

We create a list of stocks using a twin-filter criteria of double digit YoY revenue growth and return on capital being in excess of cost of capital, each year for 10 years in a row.

Next, we build a portfolio of such stocks each year and hold each of these annual iterations of portfolios for the subsequent 10 years (without any churn).

The bar chart on the right shows the back testing performance of such a filter based portfolio.



Source: Bloomberg. Note: Only the Consistent Compounder Portfolios which have finished their 10 year run have been shown. Note: These are total shareholder returns in INR terms.

There are two conclusions from this exercise:

- This filter based portfolio delivers returns of 20-30% p.a. (of INR returns) and 8-12% outperformance relative to the Sensex.
- The volatility of returns of such portfolios, for holding periods longer than 3 years, is similar to that of a Government of India Bond

Returns here (both for our portfolio and for the Sensex) are on a Total Shareholder Return basis i.e. all dividends are included in the returns.

STEP 3: IDENTIFY COMPANIES WITH HIGH BARRIERS TO ENTRY

In-depth bottom-up research of companies which pass our filters to assess sustainable competitive moats and build a portfolio of 10-15 stocks which consistently compound earnings.

What do we look for in our research?

- **Look for managements with an obsessive focus on the core franchise instead of being distracted by short-term gambles outside the core segment.**
- **Look for companies which relentlessly deepen their competitive moats over time**
- **Look for promoters who are sensible about capital allocation, i.e. refrain from large bets (especially those outside core franchise) and return excess cash to shareholders**

'Most companies tend to focus on short-term results and hence that makes them frequently do things that deviate away from their articulated strategy . . . these diversions take them away from the path they have to travel to achieve their long-term goals...'—**Rama Bijapurkar, leading market strategy consultant**

In Most Sectors, the top 1-2 Companies Account for 80% of the Profit Pie

Sector	Top 2-3 players Accounting for 70-80% of the Profit Pie
Paints	Asian Paints, Berger Paints
Small cars	Maruti Suzuki, Hyundai
Biscuits	Britannia, Parle
Cigarettes	ITC
Adhesives	Pidilite
Cooking oil	Marico, Adani
Hair oil	Marico, Bajaj Corp

THE POWER OF A FILTER BASED APPROACH

Unique DNA of these companies: By "filtering in" companies with a history of very consistent fundamentals over very long time periods, the portfolio is skewed towards companies with a DNA built around relentlessly deepening their competitive moats despite disruptive changes taking place both inside as well as outside the organization. More often than not, such DNA sustains over the subsequent 5-10 years investment horizon of the filter based approach.

Power of compounding: Holding a portfolio of stocks untouched for 10 years allows the power of compounding to play out, such that the portfolio becomes dominated by the winning stocks while losing stocks keep declining to eventually become inconsequential.

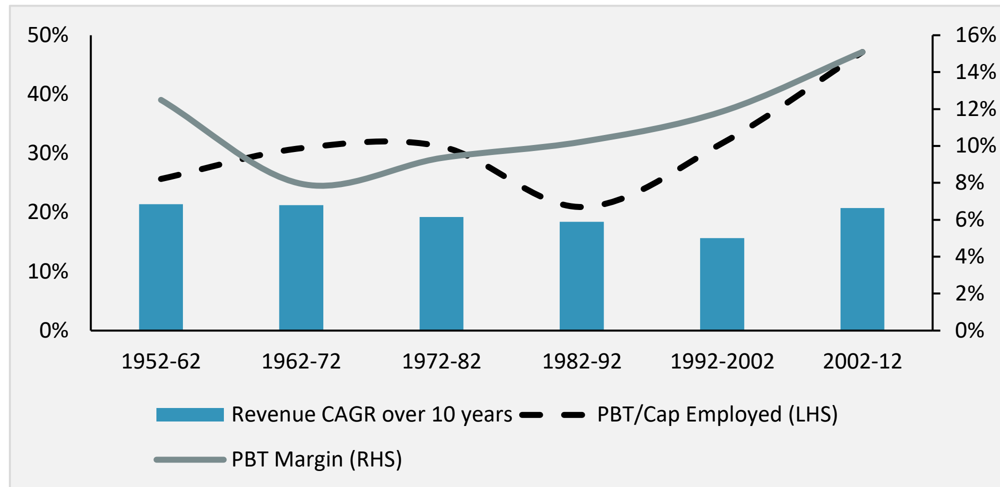
Avoiding the pitfalls of psychology and reducing transaction costs: Being patient with a portfolio helps cut out 'noise' of trying to time entry / exit decisions. With no churn, this filter based approach also reduces transaction costs. Consider two data points: (a) In a portfolio with 70% churn (average churn of large cap mutual funds), 20bps broking cost and 30bps impact cost, churn reduces the terminal value of the portfolio (after 10 years) by <u>10%</u> (i.e. a drag of 120bps on the 10-year CAGR); and (b) deferring the 10% long term capital gains tax payable on the portfolio by 10 years enhances the terminal value of the portfolio by <u>8%</u> (i.e. 100bps increase in the 10-year CAGR) vs a portfolio where capital gains are paid each year.

CASE STUDY: ASIAN PAINTS

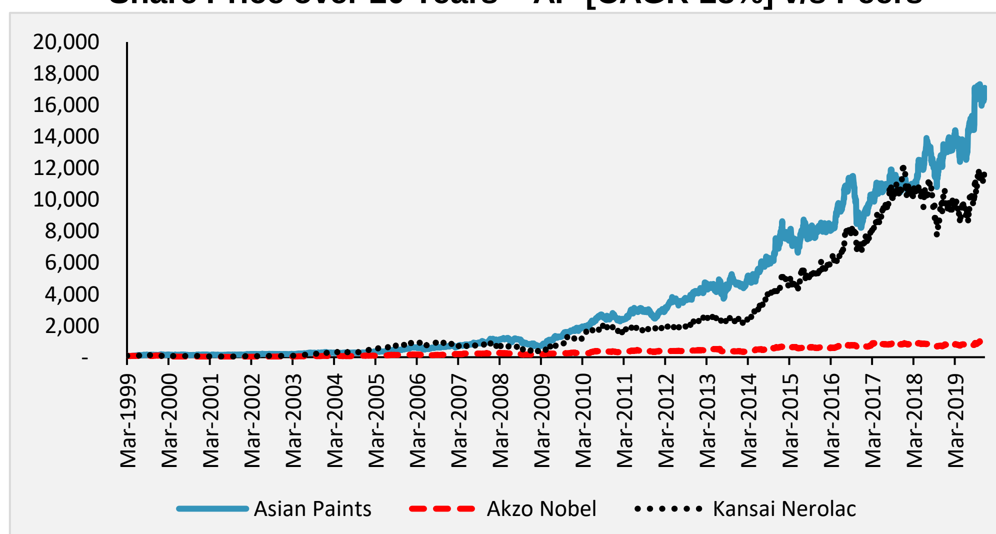
‘We have been lucky to have new jewels in the form of professional managers who attempted to do things that haven’t been done before, and lucky to have a management that allowed them to do so’
— K.B.S. Anand, MD & CEO, Asian Paints

- Moats built predominantly around supply chain efficiencies; no room for competition to disrupt through better product quality or high trade margins
- Attracts top quality talent from the most prestigious institutions and then grooms and empowers them. Result –talented & independent professional management team.
- Makes use of technology to improve operating efficiencies, which helps in three ways – a) shape up moats around systems and processes (e.g. demand forecasting); b) suffocates competition through fewer price hikes; and c) disrupts itself once every 2-3 decades

Sales Growth, PBT Margin and ROCE from 1952



Share Price over 20 Years – AP [CAGR 28%] v/s Peers



CASE STUDY: HDFC BANK

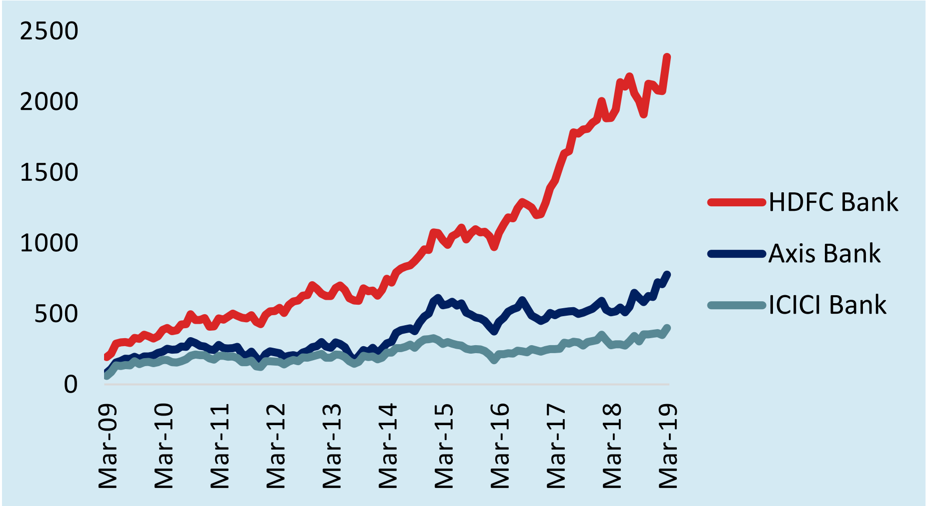
"When we came here, we had foreign banks with products and services and nationalized banks with brand and money — and we said we will bring both together."
— Aditya Puri, MD, HDFC Bank

- Strategic focus on building a low-cost franchise – first to build low cost CASA franchise, first to introduce "at par cheques" for cooperative banks in return of these banks keeping interest free deposits with HDFC Bank.
- Heavy focus from 2000 on building a market leading position retail franchise – pioneer in mobile banking.
- Learns from others' mistakes before venturing in any new segment - started pushing credit card business post Lehman crisis and is now the market leader in segment.

Key Performance Matrices: HDFC Bank vs Peers (FY 2015 -19)

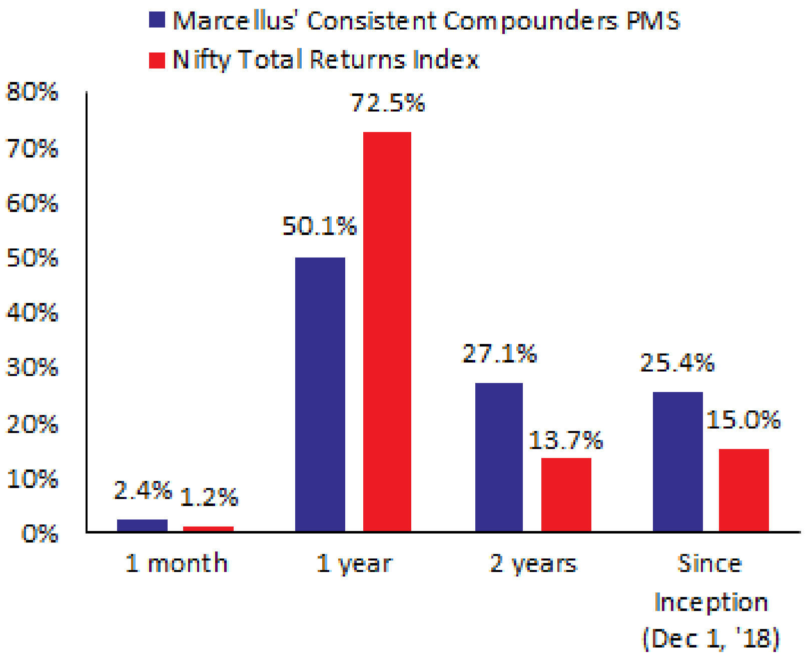
Indicators	*HDFC Bank*	*ICICI Bank*	*AXIS Bank*
Net Interest Margins	4.13 %	3.00 %	3.25 %
Gross NPA to Gross Advances	1.12 %	6.99 %	4.05 %
Avg. ROAs	1.88 %	1.07 %	0.96 %
Avg. ROEs	18.48 %	10.55 %	10.18 %

Share Price over 10 Years- HDFC Bank vs Peers [CAGR 30%]



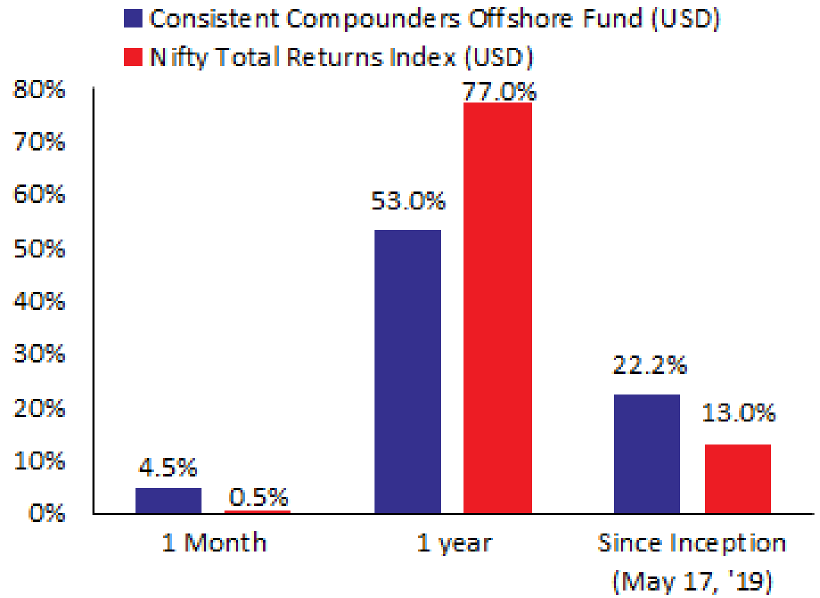
FUND PERFORMANCE (AS ON 31ST MAR'2021)

Exhibit 1a: Marcellus' Consistent Compounders PMS performance as on 31st Mar'21 (INR)



Source: Marcellus, Bloomberg; All returns are net of fees and expenses (TWRR); 2 years and since inception returns are annualised; Other time period returns are absolute

Exhibit 1b: Consistent Compounders offshore fund advised by Marcellus - as on 31st Mar'21 (US$)



Source: Marcellus; All returns are net of fees and expenses (TWRR); Since inception returns are annualised; Other time period returns are absolute

At Marcellus we don't believe in timing the market and hence deploy the money into our strategies as soon as the investor transfers the funds to us. However, we do recognise the emotional aspect of loss aversion in the short term and have launched **STP (Systematic Transfer Plan)** plan using which clients can stagger their investment in tranches spread over 5 months.
For more details please refer to our FAQs https://marcellus.in/wp-content/uploads/2020/11/STP-FAQs.pdf

FUND STRUCTURE

Marcellus offers Consistent Compounders Portfolio with a zero fixed fees option

The Consistent Compounders PMS comes with ZERO entry load/exit load and with no lock-in. Our clients can choose any of the following fee structures:

1. a fixed fees model (2% p.a. fixed fees + zero performance fees) or
2. a variable fees model (zero fixed fees + performance fees of 20% profit share above a hurdle of 8%, no catch-up)*
3. a hybrid model (1% p.a. fixed fees + performance fees of 15% profit share above a hurdle of 12%, no catch-up).

Clients also have the option to be onboarded directly (without intermediaries/distributors). Such clients can choose from any of the following fee structures:

1. A fixed fees model (1.5% p.a. fixed fees + zero performance fees) or
2. A variable fees model (zero fixed fees + performance fees of 20% profit share above a hurdle of 8%, no catch-up)
3. A hybrid model (0.75% p.a. fixed fees + performance fees of 15% profit share above a hurdle of 12%, no catch-up).

High water mark applies for performance fees

Minimum investment: INR 50 lacs

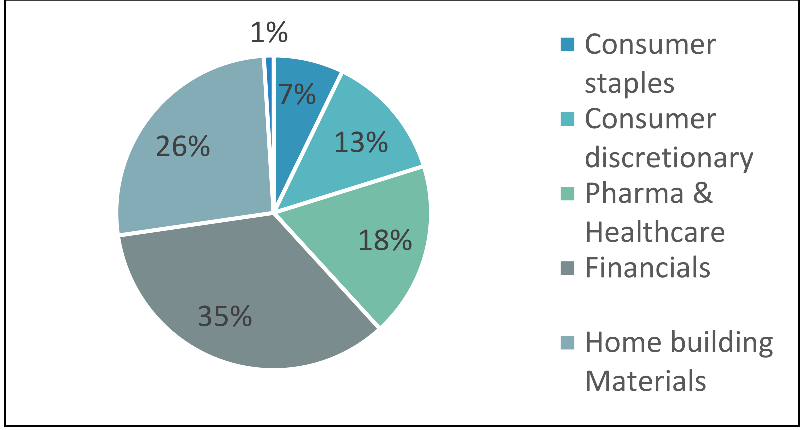
CCP FACTSHEET (1/2)

Fund Details	
Strategy Name	Consistent Compounders
Fund Manager	Rakshit Ranjan, CFA
AUM In INR Crs	3,370
Category	Large Cap
Benchmark	Nifty50 Total Return Index

Top 5 Holdings (accounts for ~50% of allocation)	
Asian Paints	Home Building Materials
HDFC Bank	Financials
Bajaj Finance	Financials
Pidilite Industries	Home Building Materials
HDFC Life	Financials

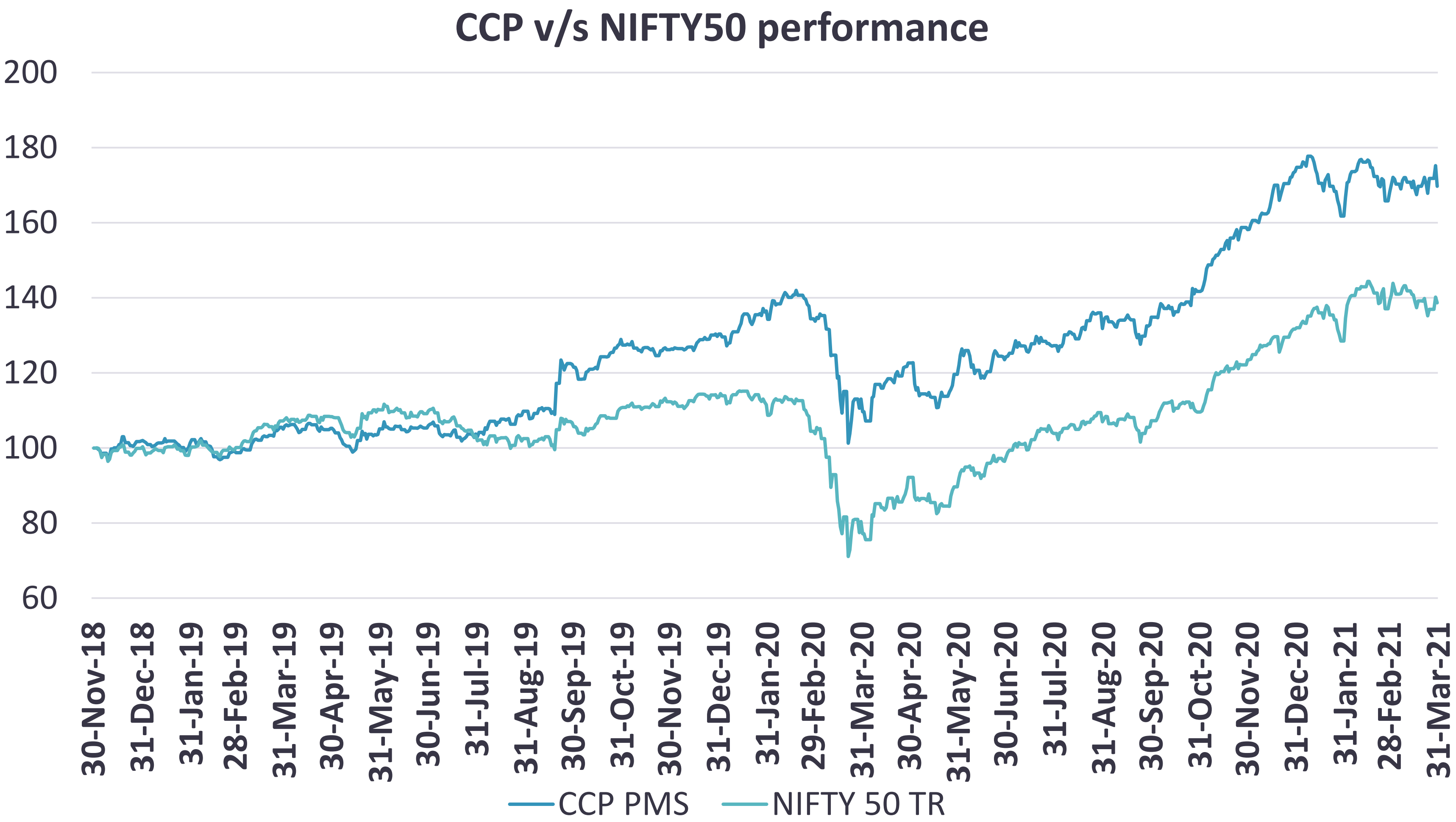
Market-Cap Wise Allocation	
Large-Cap	79%
Mid-Cap	20%
Cash	1%

Sector Wise Allocation



Portfolio Metrics	
Wtd. Avg. Market Cap (INR Cr.)	2,14,828
Portfolio P/E (FY20)	78.18x
Dividend Yield	0.7%
Churn Ratio (since inception)	20%
Std Deviation (12 month rolling)	10.6%
Sharpe Ratio (12 month rolling)	1.6236

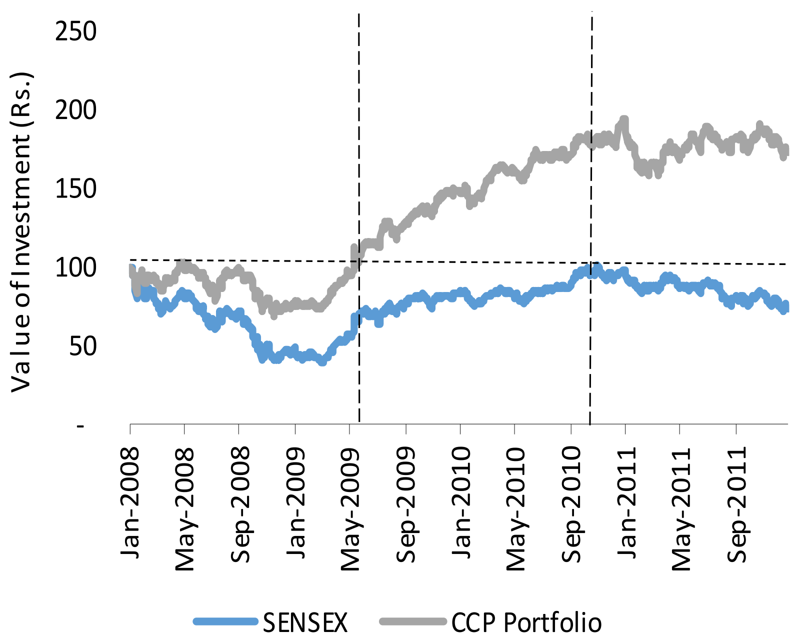
CCP FACTSHEET (2/2)



*** Based on NAV's rebased to 100**

CONSISTENT COMPOUNDERS FALL LESS AND RECOVER SOONER AND SHARPER

Exhibit 2: CCP portfolios recover much sooner and sharper compared to the broader stock market



Stock name	% fall between Jan'08 to Mar'09	Time to recovery (in months)
Asian Paints	-42%	4
CIPLA	-4%	1
HDFC bank	-53%	7
HDFC ltd.	-59%	18
Hero Motocorp	35%	N.A.
Infosys	-28%	3
SENSEX	**-61%**	**20**

Source: Ace Equity; Marcellus Investment Managers; CCP portfolio (chart of the left) is an equal weighted portfolio of Asian Paints, CIPLA, HDFC bank, HDFC ltd, Hero Motocorp and Infosys

SHOULD YOU INVEST IN CCP NOW OR WAIT GIVEN THE COVID RELATED STRESS ?

Timing entry /exit from CCP does not make sense, while trying to time Sensex / Nifty might make a lot of sense

Ebhibit 3a: Framework to decode whether timing the enrty makes sense or not

Type of company	Drawdown	Long term earnings growth	Does timing makes sense?
Mediocre quality company	High	Low	**Yes**
High quality company	Low	High	**No**

Source: Marcellus Investment Managers

Exhibit 3b: Impact of timing entry into SENSEX & CCP during 2008 crash

Investment type	Entry price	Exit price (10 yrs later)	Performance (CAGR)
SENSEX (Pre 2008 crash)	100	300	**12%**
SENSEX (bottom of the crash)	30	300	**26%**
CCP (Pre 2008 crash)	100	1,000	**26%**
CCP (bottom of the crash)	70	1,000	**30%**

Source: Marcellus Investment Managers

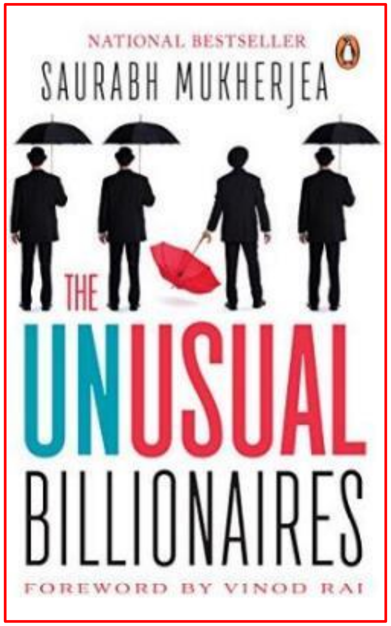
- **Mediocre quality stocks** = high drawdowns, low long term earnings growth = **makes sense to time as CAGR shifts from 12% to 26%!**
- **High quality stocks** = low drawdowns, high long term earnings growth = **makes no sense to time as CAGR shifts from 26% to 30% only**

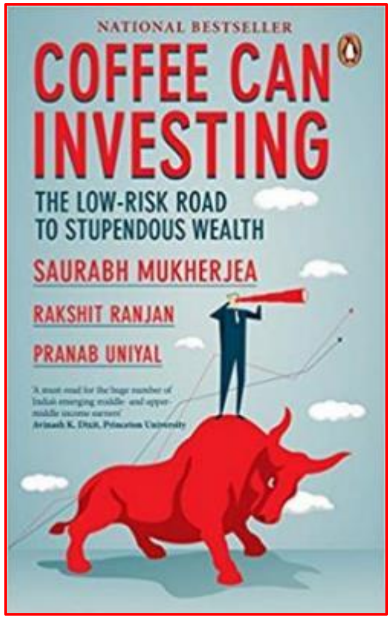
Icing on the cake when invested in high quality companies

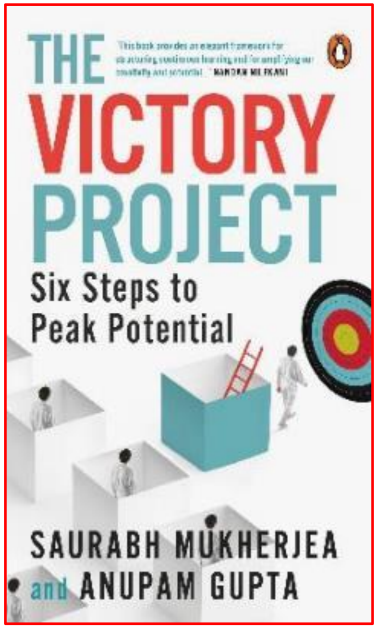
After 2008-09 crash , CCP companies recovered within ~4 months from the bottom of Mar’09 v/s ~20 months taken by SENSEX. This makes timing the entry into high quality companies even more futile

THE TRILOGY IS COMPLETE

"….a simple strategy is easy for people to follow. When you deviate from the strategy, the in-built simplicity itself ensures that the deviation is spotted early, course corrected, after which the team gets back on track."*







*Source: 'The Victory Project: Six Steps to Peak Potential'

MORE RESOURCES

Marcellus Investment Managers Pvt Ltd

http://marcellus.in/

Our newsletters are available on:

http://marcellus.in/newsletters/

Our research is available on:

http://marcellus.in/resources/

Marcellus Sales: sales@Marcellus.in

ANNEXURE
PORTFOLIO FUNDAMENTALS

PORTFOLIO HAS DELIVERED A HEALTHY AND BROAD BASED EARNINGS GROWTH, SIGNIFICANTLY AHEAD OF THE MARKET

Fundamentals of Marcellus' CCP portfolio

Marcellus' CCP PMS stock	Sales Q3FY21 YoY	Earnings Q3FY21 YoY	Earnings 9MFY21 YoY	Earnings FY20 YoY	Earnings FY17-20 (CAGR)	Earnings FY15-20 (CAGR)
Stock 1	25%	62%	2%	25%	12%	14%
Stock 2	20%	-29%	-29%	32%	42%	42%
Stock 3	25%	51%	-8%	33%	12%	20%
Stock 4	17%	14%	17%	22%	21%	21%
Stock 5	20%	5%	6%	2%	14%	11%
Stock 6	14%	11%	11%	19%	20%	23%
Stock 7	19%	29%	-14%	21%	9%	17%
Stock 8	9%	2%	3%	23%	25%	11%
Stock 9	2%	-5%	12%	32%	29%	21%
Stock 10	12%	66%	9%	29%	24%	17%
Stock 11	22%	31%	50%	2%	9%	10%
Stock 12	17%	77%	-28%	-13%	9%	12%
Stock 13	38%	75%	7%	13%	13%	19%
Overall portfolio (Wtd avg.)	**19%**	**29%**	**2%**	**19%**	**19%**	**19%**
NIFTY 50		**22%**	**4%**	**-2%**	**0%**	**1%**

Source: Marcellus Investment Managers; Ace Equity

PORTFOLIO'S HEALTHY COMBINATION OF HIGH ROCE AND HIGH REINVESTMENT RATE UNDERPINS LONG TERM SUSTAINABILITY OF EARNINGS GROWTH

ROCE and Reinvestment rate of Marcellus' CCP stocks for last 5 years

Marcellus' CCP PMS stock	ROCE* (FY20)	Avg. ROCE* (FY18-20)	Avg. Reinvt. rate (FY18-20)**
Stock 1	35%	35%	57%
Stock 2	20%	21%	90%
Stock 3	30%	30%	64%
Stock 4	17%	17%	86%
Stock 5	14%	14%	99%
Stock 6	32%	35%	67%
Stock 7	89%	72%	0%***
Stock 8	37%	38%	50%
Stock 9	25%	27%	87%
Stock 10	25%	25%	69%
Stock 11	56%	63%	40%
Stock 12	33%	35%	70%
Stock 13	21%	24%	83%
Overall portfolio (Wtd avg.)	**33%**	**34%**	**66%**

Source: Marcellus Investment Managers, Ace Equity; *ROE considered instead of ROCE for banks and NBFCs ; **Reinvestment rate = (1 - dividend payout ratio(%)); ***Reinvestment rate is 0% due to hefty special dividend announcement at year end. Avg. Reinvt. rate (ex-spl dividend) would be 72%

STRONG 10 YR EARNINGS GROWTH MAKES P/E REDUNDANT

$$P = P/E \times E$$

DOES NOT COMPOUND OVER TIME

COMPOUNDS OVER TIME

STRONG 10 YR EARNINGS GROWTH MAKES P/E REDUNDANT

		ΔP	=	ΔP/E	+	ΔE
A for Airlines (e.g. Telcos)	P/E doubles	+7%	=	+7%	+	0%
	P/E halves	-7%	=	-7%	+	0%
B for Buffett (e.g. Maruti, HUL)	P/E doubles	+19%	=	+7%	+	12%
	P/E halves	+5%	=	-7%	+	12%
C for CCP (e.g. Asian Paints, HDFC Bank)	P/E doubles	+32%	=	+7%	+	25%
	P/E halves	+18%	=	-7%	+	25%

FY14-19: HIGH QUALITY STOCKS WERE IN VOGUE

- BSE100 index delivered earnings CAGR of 4%, but underwent a 50% expansion in its P/E multiple from 18x to 26x
- Despite it being a phase of significant P/E expansion for the index, share price outperformance was driven by earnings growth

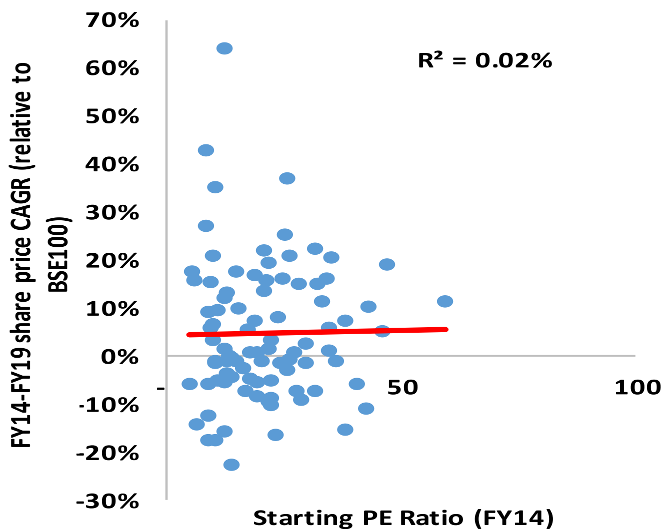
PE Multiples for FY14 and FY19 and EPS and Share Price CAGR from FY14 to FY19

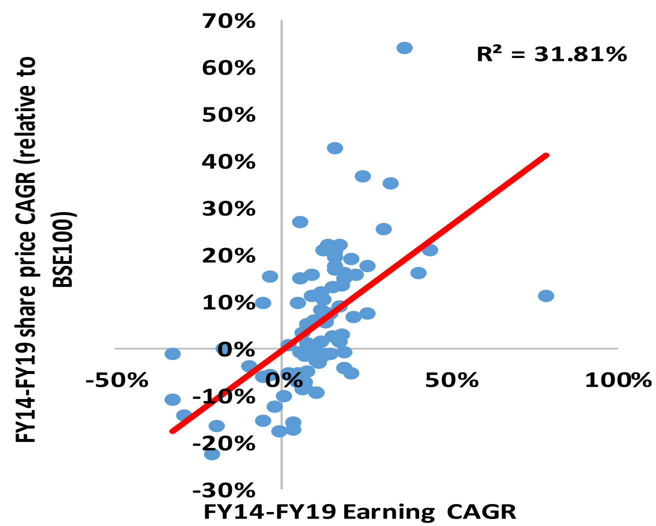
	PE - FY14	PE - FY19	EPS CAGR (FY14-19)	Share price CAGR (FY14-19)
BSE100	18	26	4%	12%
Asian Paints Ltd	43	66	12%	22%
HDFC Bank Ltd	21	28	18%	25%

Alpha in EPS = alpha in share prices

Source: Ace Equity, Marcellus Investment Managers

Correlation between relative share price performance with starting PE and EPS CAGR





Source: ACE Equity, Marcellus Investment Managers;
Correlation analysis has been done for the constituents of today's BSE100 index companies, hence companies which were unlisted at the start of the period are excluded;
Companies with negative EPS or where EPS isn't available in the start or end period have been excluded;
Companies with EPS CAGR >100% or opening PE >100 have been excluded.

FY04-08: CAPEX & INFRA BOOM

- Earnings growth was broad based with only a narrow gap between quality stocks & not-so-quality stocks. P/E expanded at modest pace.
- Despite it being a phase of broad-based earnings growth, share price outperformance was driven by earnings growth rather than starting P/E

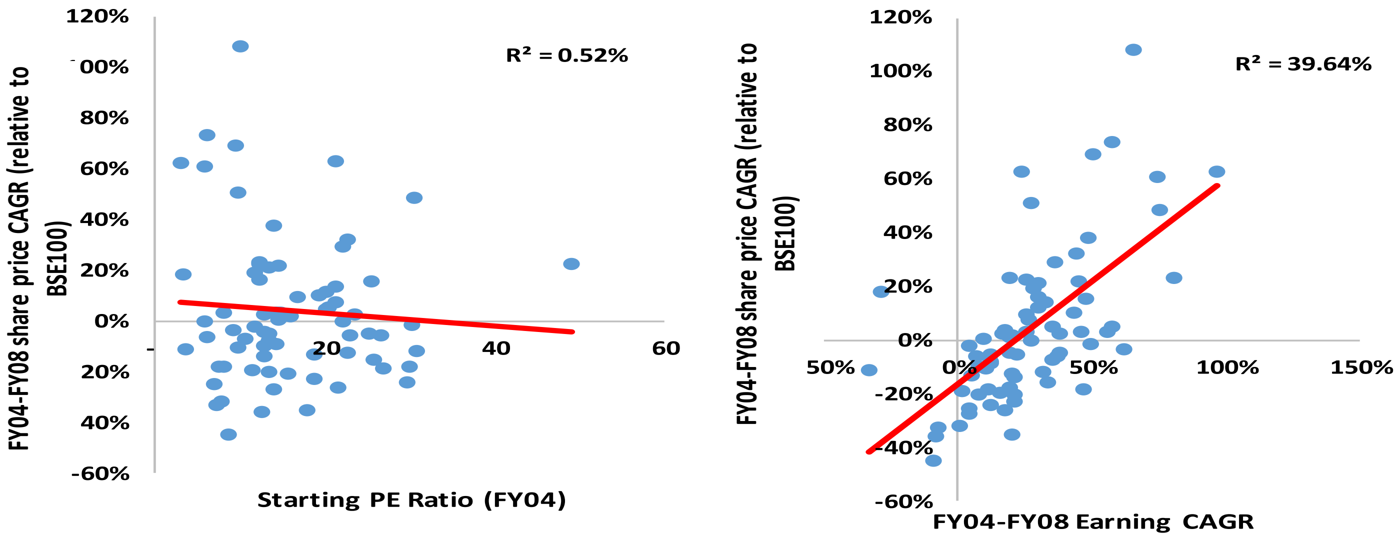
PE Multiples for FY04 and FY08 and EPS and Share Price CAGR from FY04 to FY08

	PE - FY04	PE - FY08	EPS CAGR (FY04-08)	Share price CAGR (FY04-08)
BSE100	16	20	22%	29%
Asian Paints Ltd	20	28	30%	41%
HDFC Bank Ltd	21	29	26%	37%

Alpha in EPS = alpha in share prices

Source: Ace Equity, Marcellus Investment Managers

Correlation between relative share price performance with starting PE and EPS CAGR



Source: ACE Equity, Marcellus Investment Managers;
Correlation analysis has been done for the constituents of today's BSE100 index companies, hence companies which were unlisted at the start of the period are excluded;
Companies with negative EPS or where EPS isn't available in the start or end period have been excluded;
Companies with EPS CAGR >100% or opening PE >100 have been excluded.

FY94-04: P/E MULTIPLES HAVE HALVED

- BSE100 underwent a massive compression in P/E from 47x to 16x. This P/E compression was broad based including quality stocks also
- Despite it being a phase of significant P/E compression, share price outperformance was driven by earnings growth rather than starting P/E

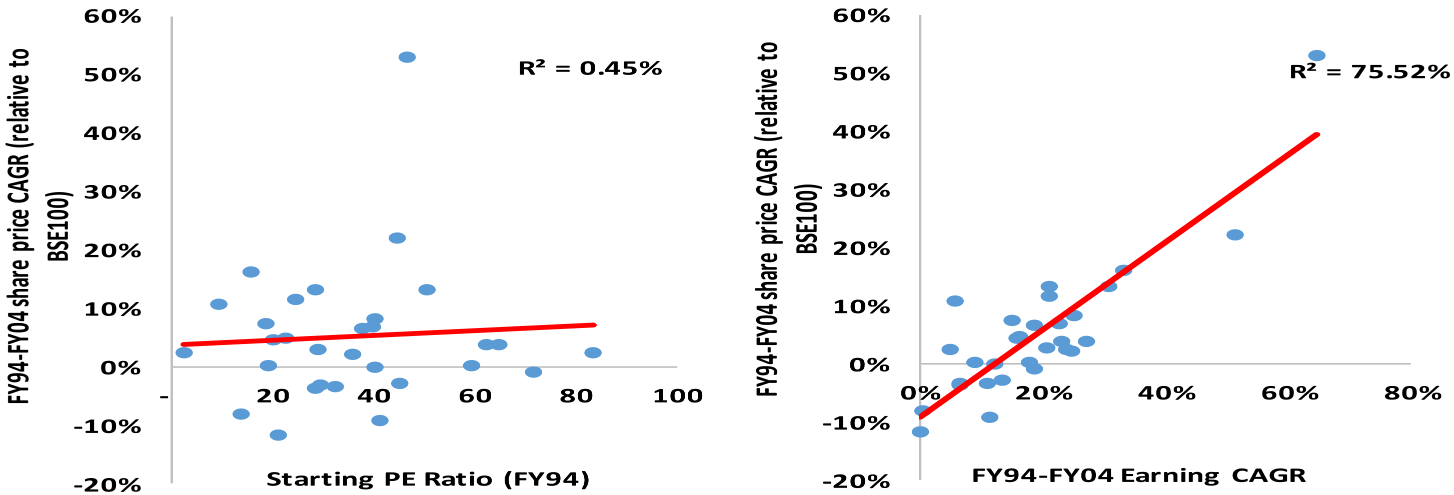
PE Multiples for FY94 and FY04 and EPS and Share Price CAGR from FY94 to FY04

	PE - FY94	PE - FY04	EPS CAGR (FY94-04)	Share price CAGR (FY94-04)
BSE100	47	16	17%	5%
Asian Paints Ltd	38	20	19%	12%
HDFC Bank Ltd**	32	21	43%	35%
ITC Ltd	40	16	23%	12%
Nestle Ltd*	64	22	20%	8%

Alpha in EPS = alpha in share prices

*Source: Ace Equity, Marcellus Investment Managers; *Period considered is from CY94 to CY04; **Starting PE multiple is from FY96 and EPS and Share Price CAGR is for 8 years from FY96 to FY04.*

Correlation between relative share price performance with starting PE and EPS CAGR



Source: ACE Equity, Marcellus Investment Managers;
Correlation analysis has been done for the constituents of today's BSE100 index companies, hence companies which were unlisted at the start of the period are excluded;
Companies with negative EPS have been excluded;
Companies with EPS CAGR >100% or opening PE >100 have been excluded;
For 5 companies EPS from FY95 and EPS CAGR for 9 years have been taken due to non-availability of data.

FY04-19: THE LONG TERM STORY

- On a long-term period covering the different market phases, it is the earnings growth which drives the returns
- 70% of the index returns is explained by earnings & less than 30% by P/E expansion

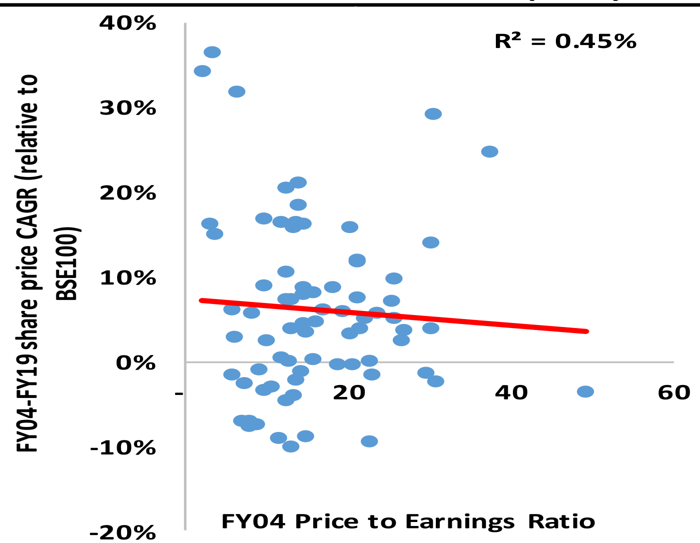
PE Multiples for FY04 and FY19 and EPS and Share Price CAGR from FY04 to FY19

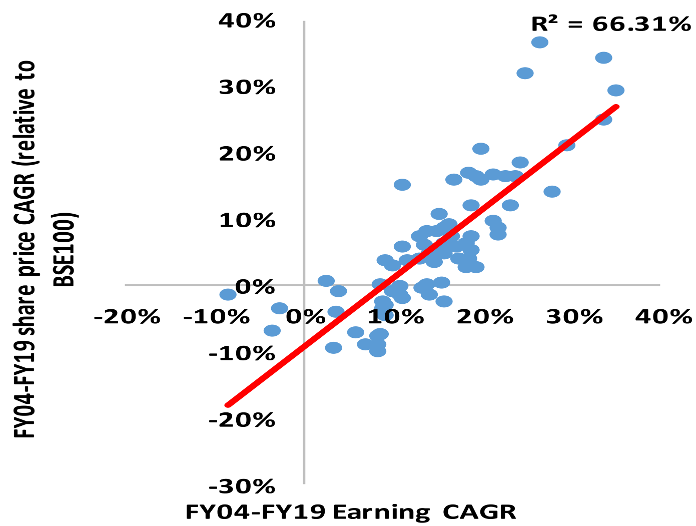
	PE - FY04	PE - FY19	EPS CAGR (FY04-19)	Share price CAGR (FY04-19)
BSE100	16	26	10%	14%
Asian Paints Ltd	20	66	20%	30%
HDFC Bank Ltd	21	28	23%	26%
ITC Ltd	16	29	14%	19%
Nestle Ltd*	25	67	13%	20%

Alpha in EPS = alpha in share prices

*Source: Ace Equity, Marcellus Investment Managers; *Period under consideration is from CY03 to CY18*

Correlation between relative share price performance with starting PE and EPS CAGR





Source: ACE Equity, Marcellus Investment Managers;
Correlation analysis has been done for the constituents of today's BSE100 index companies, hence companies which were unlisted at the start of the period are excluded;
Companies with negative EPS or where EPS isn't available in the start or end period have been excluded;
Companies with EPS CAGR >100% or opening PE >100 have been excluded.

DISCLAIMER

"This document has been made available solely for informational purposes and is for private circulation only. Neither the transmission of this document nor the transmission of any information contained herein is intended to create, and receipt hereof, does not constitute formation of any relationship between Marcellus Investment Managers Private Limited ("Marcellus") and the recipient and shall not entitled the recipient to circulate, share or rely upon the information contained herein for any other purpose other than the limited intended purpose only. Marcellus disclaims any and all liability arising from actions taken or omitted to be taken based on the contents herein."