



DMZ Partners Investment Management LLP
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Third Quarter Fiscal Year 2018-19 Investor Letter

4th January, 2019

Dear Partners,

It's been another interesting quarter as we continue to get comfortable in our role as portfolio managers for our family and friends - this comfort finds its roots in our focus - not wanting to be everything to everyone has tangible benefits. We'd much rather be a source of rational insights on equity allocations for our investing family - i.e. everyone on our portfolio management platform. While we write to you with a quarterly frequency, as you may appreciate, we don't really share conventional market commentary or updates on a quarterly basis. Although we are always active in terms of research, and if required, fine-tuning the portfolio, in most cases, we are rather passive in sharing views on the ups and downs of markets or special events which transpire in the course of a quarter. In our experience, a majority of such events may not be of significance over time. Also, we rarely have differentiated views about these events which might be worth sharing. **In our view, deep conviction is a finite resource** - you can have shallow opinions on a lot of things or meaningful insights on a few. This ought to explain our silence on the vast variety of topics. This is not to say we are completely dismissive of data or events which may be of lasting consequence to our businesses - some of which have compelled us to act decisively in the past - whether it involves eliminating a position or building a new one. We reserve our conviction for situations like these. This attitude has bolstered our ability to act with decisiveness when required rather than wallow in denial or doubt. This is often referred to as *sadhbudhi**, which in our view, is a critical ingredient in a robust long-term investment record.

We view a succinctly worded letter as a very potent tool to build or fortify ideas and reiterate our approach among our investor base. In the three month intervals between quarterly letters, Dad and I routinely make notes on interesting anecdotes related to our philosophy or approach that we'd like to share with our partners - this quarter we would like to share with you a few ideas related to our portfolio construction, **qualitative arbitrage, optionality value and non-linearity**. These are complicated words for very simple ideas which I think all of you will be able to relate to intrinsically in your own professional and business matters. I will also elaborate on our rationale and conviction in one portfolio company which has been facing a few, well publicised, headwinds in recent times and also why we think it is poised for success over the longer run.

While we invest with a bottoms-up approach without deliberate thematic considerations, by default rather than design one could view 9 of our portfolio holdings as fitting in one of three key buckets (with approximate portfolio weights in brackets) - Banks and Financials (~50%); Discretionary Consumption (~20%) and Platforms/ Marketplaces (~20%) - the remaining three holdings (~10%), while valued constituents of the portfolio, don't quite fit neatly into any of these (rather arbitrary) buckets or are, what we view as, "quasi-cash". In addition, as elaborated in past letters we think of our portfolio as comprising of two components - a core (~90%), which is comprised of what we perceive as high conviction, "tightly wound" positions and a tail (~10%), comprised of merit-worthy ideas that need to cross certain milestones, subject to which we are likely to either scale or eliminate them over time. A tightly-wound idea refers to an opportunity which, based on our research, has a high degree of certainty in long-term profitability and an unusually compelling long-run return potential based on prevailing market prices. The tail may have two types of opportunities - 1) exceptional businesses which may not currently be available at rational prices; or 2) investments where our probability of success may be somewhat lower relative to the core - though the payoff in case of positive outcomes may be substantially higher.

**Sadhbudhi is a Marathi & Gujarati term which loosely translates to "right-mindedness"*



Since we first wrote to you, four tail positions have/ are being scaled to become part of the core. In case of two positions this was driven by deeper insights we have gained in witnessing these businesses evolve. In case of the other two, this has been a function of more rational market prices giving us the opportunity to add to these positions. These scale-ups have been funded either by additional investor inflows or liquidation of quasi-cash positions. We originated the portfolio with a ~70% core and ~30% tail mindset but select pieces of our tail have proven much more worthy over time. We continue to closely assess the merit-worthiness of the remainder of the tail. As we have made clear over the partners meetings, we are not prone to waddling in denial and will act decisively if we find certain holdings to be falling short of characteristics we seek. That said, **we do not seek an error-free investment approach**. If we wanted an error free portfolio we wouldn't have ventured out of our comfort zone to own many of the positions which were subsequently exceptional performers and powerful contributors to our returns. **In hindsight, many of our greatest errors have been errors of omission** - being too dismissive of opportunities that didn't fit our exact mould has been a source of many lessons. Having said that, **we prefer to dip our toes in the pool before diving in head first!** Although not dogmatic, initial ideas usually first come onto our watchlist where they are vetted for a sufficient amount of time - it can take us anywhere from 6 - 15 months to initiate a position after we start studying it.

We have often encountered a thought provoking question from our global investing colleagues - "What is your competitive advantage?" Dad and I have put some thought to this. In our humble opinion, a key edge we bring to the table is our focus on qualitative arbitrage - simply put, this involves **appreciating things that don't fit well on a spreadsheet**. Of course, drilling down on business models, appreciating valuations and regularly assessing fundamental performance are critical elements of the tool-kit. However, with easy availability of information, these tools are largely democratized. Hence, as long-term allocators **we have to be good at assessing characteristics that are of critical value but are rarely studied with the same degree of diligence by the broader investing community**. An example of this would be identifying a "purpose-driven" entrepreneur - we've found passionate, clear-thinking leaders to be exceptional value creators over time - this, in our view, helps partially explain the unusually long growth runways of their companies - think of Phil Knight (Nike), Mark Leonard (Constellation Software), Joe Mansueto (Morningstar) among many others. In the early years of all these businesses, qualitatively-blind investors (those focussed purely on quantitative metrics) may have found these companies irrationally expensive. However, investors who dug deeper and appreciated the nature of these founders could foresee the long runways ahead. **While "vision" is a much misused term, we like the phrase "clarity in thought & capability in execution"** - this can only be assessed with a qualitative filter and those solely focussed on quantitative measures may tend to dismiss unusually compelling opportunities.

In our view, one of the most undervalued aspects exceptional founders or managers bring to the table is what investors like to call "**optionality value**". We believe that partnering with trustworthy and capable partners will be the most value-accretive investment irrespective of future alternative outcomes. On the other hand, **partnering with suboptimal partners may cost us dearly in even the best of circumstances**. This aspect also, does not translate well on a spreadsheet. Most conventional analysts will struggle to assign a valuation premium above the value of a business today taking into account the potential actions of an exceptionally opportunistic capital allocator - maybe she will decide to buy a deeply undervalued competitor when the industry is in distress, leading to a step-jump in the earnings power of the business. These may be very value-accretive activities, which would be largely overlooked by a static analysis without consideration to the optionality value contributed by highly unusual leaders at the helm. We actively seek this optionality value in our businesses and find many of our managers to be of the same knitting.



Another characteristic which is difficult to put a price to is **avoiding commitment and consistency bias** and having the ability to change one's mind - a trait we think many of our companies' managers have nourished well. In underwriting decisions - ranging from relatively mundane operational decisions to large capital allocations which may dramatically alter the road ahead for a company - anyone running an operation of scale is forced to make several of these routinely. One of the aspects we've come to admire in leaders who run our businesses is their ability to change their minds when the facts change or upon the realization that their initial opinions were misplaced. While it isn't quite rocket science, there is something very powerful about the ability to backtrack and reverse a faulty decision especially when one may have been its strongest proponent in front of an entire board/ management team a few quarters earlier. This requires a culture where no one is waiting around the corner to tell you, "I told you so...". We think this can be a very powerful sign of both enterprising corporate cultures curated by founders and the mental and emotional agility of the managers making decisions. We cherish the opportunity to partner with people who have both underwritten some great decisions that have played out well and some not-so-great decisions that they have backtracked from as opposed to staying irrationally committed to. Many a successful business groups would still be flourishing if their founders were not stubborn in staying the course contrary to dispassionate, rational thought.

We've not spent enough time discussing certain attributes of platform style businesses in our portfolio. One of their characteristics that even we've only come to appreciate relatively recently is the level of **"non-linearity"** embedded in these business models. These are largely software or technology enabled businesses with very low current market shares or adoption rates in their industries - they are gradually evolving to become very efficient marketplaces for buyers and sellers to meet and eventually transact - earning the platform a thin but reliable spread along the way. We see quite clear and tangible reasons why they are going to be able to scale meaningfully over the upcoming decade as their industries evolve from informal to more formal. As they grow, the bulk of the benefits of a larger scale flow directly to their profitability. As they go from 1x million revenue to say, 7x million their operational cost footprints will not need to grow at anywhere close to a similar pace - in fact as a corollary to this, in our view, some of these businesses may eventually have the highest core profitability margins among publicly listed Indian companies. A critical indicator to monitor for these platforms will be how respectful they remain of capital - in terms of redistributing or reinvesting the free cash flows that do not need to be ploughed back in the existing business in a rational and accretive manner.

Eicher Motors is a holding that we have started to scale. The share price has seen a decline post the release of their monthly motorcycle sales data. These are the kind of opportunities we await. In our view, a transient lull in demand may certainly be a contributor to the weaker monthly sales given headwinds ranging from floods in one of their large markets to more cumbersome insurance requirements and transition to ABS braking, which has the impact of increasing all-in purchase costs. The supply-side has also had transitory hiccups - ranging from a recent strike to limited availability of certain parts. This is entirely natural in the process of scaling up from 50,000 bikes to >900,000 across platforms in a short time span. **Transitory lulls in demand are natural in the evolution of any consumer business and companies we own are not obliged to give us monthly/ quarterly confirmation of their longer-run prospects** - we may miss out on some of the best opportunities by holding such irrational, exacting standards. One could have drawn premature conclusions as an investor in say, Sherwin-Williams if they published litres of paint sold each month and we passed actionable judgements on the releases. It would be a pyrrhic victory to call a lull in paint demand and cash out at any point over the past decade! To put Enfield's scale in perspective, Hero first crossed the milestone of selling a million two-wheelers in 1994 in an industry a fraction of today's size. Nike has a very different set of challenges today



than it did a decade or two ago - with each phase having its own set of hurdles. If stewards of the business and brand are competent, in terms of clarity of purpose and capability of execution, we have little to worry about in a market the size of ours. **Certain brands are unusually resilient in remaining relevant and are a source of immense earnings power for their custodians over time. We think Royal Enfield is a strong contender for such an outcome.** We see a lot of optionality value in the leadership - growing the middle-weight motorcycle market globally involves creating a new market as opposed to infiltrating an existing one - while the latter may seem like low-hanging fruit, the former is far more lucrative. It may be difficult for us to envision what the product stable may look like a decade or so from now and the inroads they may have made in larger domestic markets as well as wealthier international ones.

While very premature to comment, our anecdotal conversations at several dealers across the country also suggest that there may be a mild element of cannibalization afoot - Enfield recently launched two, more powerful, higher-value products and we think that some of the aspirational demand (which may materialize with a lag) may have moved here. A 35 year old likely to buy a Classic 500 this month may now prefer to indulge in an Interceptor 650 by delaying the purchase and saving up for say another 12 months. While this is purely hypothetical, it is probably reminiscent of the situation a company like Maruti Suzuki may have faced ~15 years ago, when simpler, economical models like the 800, Esteem and Zen were key sales contributors. Today a larger portfolio of more upmarket, powerful products have taken their place and the older staples are intentionally redundant. **Kodak's history is a sombre reminder that if you don't cannibalize your products, someone else will** - it was among the first to develop the digital camera in 1975 but didn't scale the project out of concern that it would hurt its own photo-film business. A decision which perhaps among others, one could attribute to the company's eventual downfall. While **there is always the possibility our opinions are misplaced**, weaker monthly sales may be a blessing for truly long-term and patient investors. Eicher has a very long runway ahead given its limited size in the 2-wheeler industry, the premiumisation drive afoot domestically, retail credit availability and stronger disposable incomes which are likely to drive more aspirational and discretionary consumption across segments over the upcoming decade.

Gratitude - Our sincere appreciation to everyone who took the time to attend our inaugural partners meeting. It was a great opportunity to exchange insights, and go over all our holdings. We elaborated on how we view the opportunity set in India over the upcoming decade irrespective of political or macroeconomic variances and why we think investing in carefully selected equities is one of the best capital allocation decisions families can make. We cherish the opportunity to do this and look forward to continuing the tradition in the future. We continue to owe deep gratitude to our team, many of whom you may have interacted with at the partners meet. Their sense of ownership allows Dad and I to use our undiluted bandwidth to make the kind of investment decisions you expect of us. We remain humbled and motivated by the conviction you have in us and strive to remain worthy of it.

Warmly,

A handwritten signature in black ink, appearing to be "S. Zaveri", written over a horizontal line.

Soumil S. Zaveri

~On behalf of our entire team~



DMZ Partners team (listed alphabetically)

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