DMZ Partners Investment Management LLP

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Fiscal Year 2020-21 Annual Letter to Partners

- ***DMZ Partners Conglomerate***
- ***Levered vs. Unlevered Compounders***
- ***The privilege of being perpetually hesitant to sell***

Please Note: *This is a* ***redacted version*** *of our letter to partners. This version has been edited to remove any references to security-specific opinions and investment actions. As a matter of prudence, we prefer not to share security-specific information pertaining to our investment operations widely so as to minimize chances of misinterpretation by a reader.*

Dear Partners,

I hope that you and your loved ones remain healthy and well. The constituents of the DMZ Partners Conglomerate continue to perform robustly and remain unchanged since I last wrote to you. Given that the ongoing pandemic has prevented us from meeting in person, either individually or by means of our annual partners meeting, I'd like to provide you with a brief qualitative update on our holdings in a simplified top-down format given the unconventional environment which we continue to navigate. Please note that for the sake of brevity and ease-of-reading, I've omitted the more involved nuances of our investment theses on each of our conglomerate constituents. Additionally, the commentary that follows refers specifically to the state of the underlying businesses we own as opposed to their stock price movements through the past year. Also, true-to-tradition, I will refrain from annual investment performance related comments – your individual statements speak for themselves. I prefer to remain steadfastly focussed on the process that is likely to sustain such outcomes over long periods of time and hence align my communication to be consistent with that.

For the ***Financial Lenders*** of our portfolio, while the year gone by has likely been among the most challenging that they have ever witnessed, it is becoming increasingly apparent that each of them is likely to benefit from a meaningfully advantaged competitive landscape as lower resiliency peers are emerging from the crisis with broken or damaged spines. In effect, several weak players are ceding ground to a few highly resilient players who are likely to gobble up larger chunks of the profitability-share. This is largely driven by their superior asset quality, prudent underwriting, maniacal aversion to tail-risks, undiluted customer focus, flush liquidity and surplus capital buffers. Our holdings are likely to be disproportionate beneficiaries due to this accelerating value migration. Additionally, the consistent profitability of our businesses (each earning superior returns on assets and equity) gives them an unique and rare privilege of investing upfront and at scale in technology and digital assets to continue to make the user experience seamless with low friction, quick turnaround times and to acquire high-quality customers profitably at scale – the technology-enabled products and services that these companies engender may lead to some pondering by several fintech players, in my humble opinion. ***The lending industry has developed a storied and gnarly reputation for teaching several new-age players a few profound age-old lessons!***

While we like to think of all our companies as compounding machines. The above businesses are ***Levered Compounders***. What this implies is that while they possess all the exceptional attributes we typically seek[1], by virtue of being levered, they do go through phases of elevated uncertainty at times of extreme distress. In fair weather they provide steady and comforting reaffirmation of their growth trajectories, ticking-off all the qualities we treasure about them. However, in extreme crises, one must deal with very low visibility and heightened uncertainty on just how rough the seas may get over the near-term. Additionally, at precisely the most critical times, one suddenly

1. I have refrained from the usual listing of characteristics we seek in businesses and managements/ owner-operators for the sake of brevity as these factors are discussed at length in prior investor letters

becomes dependent on external factors, over which, even the managements that we have entrusted, may have very little control – will the reserve bank compensate for liquidity shocks, will there be moratoriums, will there be credit guarantees, how large will stimulus packages be, so-on-and-so-forth. One is, to an extent, at the mercy of rationality prevailing among the regulatory & bureaucratic machinery. While these risks are abated by partnering only with the best, they do not entirely go away. However, the players that come out of such crises with minor bruises tend to dominate the post-crisis landscape. It is fair to surmise that while the pandemic left all players in the industry battle scarred, the advantages that will accrue to thriving survivors who have created differentiated products & who maintain a maniacal focus on risk will likely be enormous.

In the ***Asset Management*** industry, misadventures of certain participants have continued to widen the trust deficit in the minds of the average individual mutual fund investor, this plays to the benefit of our holding in this industry. In such a scenario (barring exceptions), one tends to witness a consolidation of market share as investors become wary of trusting even worthy newcomers and flock to well-regarded incumbents as they reassess the threshold of financial guardrails they can depend upon. This risk aversion implies that investors are even happy to forsake a few percentage points of incremental potential returns provided it affords them the mental satisfaction (and the good night's sleep that accompanies it), that the invested principal is relatively safe.

Our ***Consumer*** businesses are an ideal play on rising discretionary spends over time – they control the proverbial pinch in the hourglass when it comes to capturing disposable income "wallet share" of potentially millions of mass-affluent, middle-class and high-income Indians. The managements of these businesses are chasing "white-spaces" for growth by attempting to create new niches as opposed to chasing a few incremental points of share in well-established market segments. While the payoff of such a strategy is hard to quantify upfront, it could likely be substantially larger than is widely expected over time. The irreplicability of their product portfolios and distribution capabilities combined with the per-capita usage scalability prospects that lie ahead position them uniquely to grow profits sustainably over unusually long time-frames, in our judgment.

Our ***Platforms & Marketplaces*** holdings had a particularly robust year. Platform companies tend to have winner-take-all dynamics especially as both sides of the platform are seeking to transact in the most efficient manner. This implies that although multiple challenger platforms may arise over time, they would typically find it very difficult to add depth and liquidity to their marketplace as buyers go to the markets where the most sellers already are and vice-versa. Given the lower penetration rates of our business (low single-digit) relative to the large addressable market opportunities that lie ahead, we assess their scalability runways to be unusually long. Technology-embracing, prudent allocators of capital, who remain focussed on the opportunity-set are likely to emerge as substantially more profitable at the expense of smaller, less-efficient competitors who find it difficult to scale given their constrained ability to invest upfront in technology and inadequate management bandwidth. The operating leverage embedded in these business models will likely lead to very non-linear outcomes in terms of profitability growth over a decade, in our judgement.

Excluding the financial lenders in our portfolio, we consider the rest of our Conglomerate constituents to be ***Unlevered Compounders***. While they do not offer the regular reaffirmation of steady quarterly growth that their levered siblings offer, they tend to add an immense level of resilience at the portfolio-level. On the flipside, their growth patterns tend to be lumpier, with erratic step-growth as opposed to steady straight-line growth. However, at times of extreme crisis, the range of outcomes for these businesses tends to be relatively narrow (from unaffected to mild-headwinds). They tend to be, what we call, "shutter-up/ shutter-down" businesses – if times get tough, they have the ability to pull the shutters down temporarily and hunker down for a while and

(relatively) simply dust-off and resume once things normalize. Levered compounders do not have this immense privilege. Unsurprisingly though, only truly patient and permanent capital is likely to be afforded the luxury of benefitting from the potentially multi-decade-long optionality-rich runway that such businesses provide as growth can be lumpy with market sentiment oscillating between euphoria and doubt. Trying to time the high growth phases of these unlevered compounders as opposed to patiently partaking in their ownership as they continue to compound (lumpily) is a folly many investors commit – we strive to actively avoid belonging to that category, given our deep conviction in both their long-term trajectories and in their managements' abilities to build substantially larger businesses as they maniacally capture more-and-more customer wallet-share!

It is worthwhile to note that the price at which we choose to buy (or hold) businesses will play a critical role in the returns we achieve over time. The wealth to be created in a stock is usually locked in at the time of purchase rather than at the time of sale. ***I am particularly pleased that almost all our holdings continue to trade at prices which allow us to be incremental buyers as opposed to being hesitant holders.*** While this seems like a subtle point, it isn't. This is a rare privilege that only a select group of companies are capable of providing. What it implies is that we are completely at ease buying into the majority of our holdings despite the significant appreciation many of them may have witnessed over the past year. Given their consistent earnings growth and the optionality value they have continued to create through new products, services and business verticals, their reinvestment runways keep getting longer. ***The DMZ Partners Conglomerate consists only of companies with irreplicable business models, run by exceptional management teams who will likely do more than our overly-exacting, overly-rational and likely, overly-restrictive expectations lead us to believe. Our managements are participating in playing-fields, which by virtue of their moats, are tilted against their competitors, and are filled with unusually large opportunity-pockets affording them the luxury to continue to earn and redeploy capital at superior rates of return for unusually long periods of time.***

As investors in companies with such irreplicable characteristics we often have to worry a lot more about ourselves than our holdings. The mind plays tricks on even the most tempered investors. Earning 20% in a month can be far more intoxicating than earning 800% over a decade. The 20% outcome seems easily gained (and will likely be as easily lost in pursuit of future "quick pops") whereas the 800% outcome entailed you to stay invested through at least 5 separate 30% corrections and at least 1 major 50% correction, while the quantum of capital kept getting more consequential. It demanded you to navigate through decision points through which you had to conscientiously choose to remain invested. You had to make that choice in stormy weather, during the most uncertain of outlooks and contrary to the sage advice of several learned doomsday-mongers. In effect, you earned that 800%. ***Well-earned returns are well digested whereas undeserved returns usually have to be returned!***

As an extension to this idea, I'd also like to disappoint you upfront in case you expect us to partake in the kinds of opportunities that multiply 5x in a single year. The kind of companies that tend to do this are either the ones that have the most radical changes in fortunes (which means they were in close-to-dire straits and unlikely to survive or thrive to begin with) or which find themselves subject to frenzied speculative activity. We intend to partake in neither, ***as these kinds of returns are not consistently replicable and are often solely outcomes of good luck as opposed to the results of a good investment process. Over years, it can prove to be a great misfortune to be fortunate in games of luck! One is quick to justify the luck involved as one's own skill, which is usually the source of eventual ruin.***

A peek into the future – ***two compelling opportunities*** befitting of our conglomerate ***(one consumer & one technology business)*** have continued to flow downstream through our research pipeline. Subject to a few factors, including pricing, they may be inducted into the Conglomerate over the next 6-12 months. Barring errors in our judgement, I also find it unlikely for the portfolio to be devoid of any existing holding. In accounts with fresh inflows new positions will be directly funded, alternatively, we will likely seed entrants by trimming some of our larger holdings. ***Although some of you have recommended it, as a matter of principle we will never "call" for incremental capital from you – we think it can be erosive to the kind of relationship we share with each of you.***

Pounding-the-table regarding one's own opinions while simultaneously discarding opposing views as ill-informed is getting commonplace across disciplines – this is the anti-thesis of our philosophy. ***Dad doesn't mince words in reminding me that having the ability to change your mind in the investing business is not just a superpower but also a prerequisite to remaining solvent. Given that he has navigated more rough seas than I have fair, I take his advice to heart.*** By virtue of which, I am entirely respectful of world-views that differ from my own, and invite them from you over a call, if you should so wish, in lieu of our usual annual partners gathering Q&A session. That said, I look forward to enjoy a drink with each one of you in person at our future annual gatherings as we hopefully get closer to normal later this year. As always, I remain humbled by your conviction to invest alongside us and strive to remain worthy of it. Please stay safe and retain caution in these unprecedented times.

Warmly,

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