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DMZ Partners Investment Management LLP

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First Quarter - Fiscal Year 2019-20 Investor Letter

- ***Introducing the DMZ Partners Conglomerate***
- ***Overcoming the "What's New" & "High-P/E" biases***
- ***Notes from the Royal Enfield Tech Center (UK) & The Zurich Project 2019***
- ***Investing globally - Building equity positions overseas via RBI LRS***
- ***We have 99 investors onboard and are currently closed to new investors***

Dear Partners,

In our view, large swathes of the financial services industry operate with the unspoken ethos - **"If you can't convince, confuse."** This is the anti-thesis to our investing approach. While investing isn't necessarily easy, it can certainly be kept simple. To bolster this effort, **I'd like to introduce you to the DMZ Partners Conglomerate**, an instructive concept that I have liberally borrowed from Mark Massey, who runs Altarock Partners in Boston, Massachusetts. The idea is that we ought to think of our equity portfolio as a conglomerate rather than just a portfolio comprising of individual positions. This reinforces a few concepts - 1) Our equity in businesses that comprise our conglomerate represent real economic ownership of the underlying companies and our focus ought to be honed in on the factors that matter over a multi-year time frame. 2) This moves us away from the attitude pervasive in liquid markets today that a purchase we make today can be easily sold off tomorrow and forces us to deeply assess whether we are able & willing to own businesses we buy with a true long-term lock-in. 3) We have the distinct ability to add incremental capital to (or partially take capital away from) individual constituents of our conglomerate subject to their fundamentals or the prices the market offers us; 4) We also have the advantage of entirely selling or adding new companies to our conglomerate subject to factors we hold important. This approach is useful in retaining a high threshold of what enters and remains in our portfolio.

The conglomerate model helps weed out the suboptimal and gravitates us toward the superior. It also reinforces our beliefs on valuation - all else equal (in terms of the underlying qualities of an exceptional business) the price you pay is the ultimate barometer of the long-term returns you will reap. That said, in speaking of a rare breed of exceptional companies, the longer you are willing to extend the timeframe over which you intend to hold an investment, the less demanding you can afford to be of the price you are willing to pay upfront. For example, if I had to justify owning an exceptional but expensive business for a year, it might be hard to justify as shorter-term perceptions may impair the value over a short time-span. However, if I had to justify owning it for decade, the heft of the longer-term fundamental performance will meaningfully outweigh any shorter-term gyrations. In this regard, we remain very optimistic about the underlying drivers in the earnings power growth of our conglomerate. That said, **within the conglomerate, it is likely that 2-3 businesses will exceed our expectations, 3-4 will meet them and 2-3 may fall short of the prospects we envision for them.** This is par for the course and we do not expect an error-free investment approach. To be frank, we would likely be dissatisfied with the returns that we would invariably deserve if we sought an approach devoid of any room for error.

The DMZ Partners Conglomerate earns a robust and sustainable return on equity of approximately 22% - this is the first prerequisite for long-term compounding machines. Additionally, all the constituent companies are gifted with inordinately long reinvestment runways - whereby they can reinvest the superior returns they earn on their capital back into their core businesses. This, in our view, is the second prerequisite to compounding machines. Although we are agnostic to size, over half our conglomerate has a market-cap exceeding US$10Bn; about a fourth has a market-cap between US$1Bn - US$10Bn and a fourth has a market-cap below US$1Bn. To be clear, this is purely by default rather than design.

I will add though that historically we have found an investing sweet spot in terms of initiating positions in businesses trading between US$150mn - US$1.5Bn. Some of you may argue then, that our larger positions today lack the advantage of being "less well known" and are widely acclaimed as exceptional businesses. **We firmly hold though, that this does not preclude them from being compelling investments from here on** - 1) they are not priced to a point where future returns get compromised below our threshold expectations and 2) the robustness and longevity of earnings power growth we anticipate will allow us to earn healthy returns as patient, decade-long owners despite prevailing prices. It reminds me of the phrase - **good things happen to good people** - these companies and the people that run them keep positively surprising us in terms of how they deepen their competencies in existing and new verticals and continue to extend the potential runways that we had originally envisioned. That's not to say that there haven't been times in the past where pricing has gotten way too exuberant (as was our opinion of the market's pricing of Gruh Finance a couple years ago) at which point we will be dispassionate about assessing opportunity costs given prevailing reinvestment opportunities and reallocate capital appropriately.

We have been beneficiaries of personal investments in Gruh Finance (in 2011) and Bajaj Finance (in 2013) at a time when their exceptional attributes were not as widely acclaimed as they are today. This played a large role in yielding us outsized returns as we were able to buy into these companies at very compelling valuations. However, the fact that **HDFC Bank is a very prudent and profitable underwriter with a very long reinvestment runway is hardly a secret - in fact, this hasn't been a secret at largely any point over the past two decades. Importantly, this did not preclude patient investors from reaping exceptional multi-decade returns by staying invested.** The same can be said of companies like Asian Paints, Pidilite, Nestle, Kotak Mahindra Bank and so on. We think the same is true of some exceptional performers of the past decade (like Bajaj Finance and HDFC Bank) which we will likely own over the upcoming one (barring unforeseen circumstances or incredible prices). Of course this idea cannot be extended over-simplistically to *every* well-known great business. Environments get disrupted, growth prospects taper, people in charge sometimes behave sub-optimally (or change), business models get derailed, and prices may simply get too exuberant - it remains our responsibility to pick wisely and remain dispassionately watchful of these factors.

Nonetheless, there is often an aversion among investors to buy companies that *look* expensive, which typically tend to be well known. Many **investors tend to have a fascination with finding an opportunity that no one else has** - "the next XYZ" while ignoring things that stare them in the face simply because they are already "discovered". This can be a very slippery slope. In speaking about great businesses, **how often have you heard - "it's too expensive" or "that's a well-known one, anything new?"** At such times, it's important to remember that you aren't right (or wrong) because of the number of people that agree (or disagree) with you. In our view, **high quality "expensive" businesses run by people you can trust often have a deeper margin of safety than "cheap" mediocre businesses run by people you can't.** It may not be immediately apparent but if you dig deeper it would be hard to imagine losing principal (or purchasing power) owning such companies over long periods of time. Lest you accuse me of over simplifying, this is not a case for buying every expensive, perceived high-quality business. Even we don't own a few companies we deeply admire as prices simply aren't compelling enough even from our own, arguably liberal appreciation of long-term value.

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It shouldn't come as a surprise then that **our conglomerate isn't statistically cheap** - at least not from a static, point-in-time way of thinking about value eg. 1 year forward price/ earnings (P/E) multiples. On a weighted average basis, our conglomerate trades at almost 30x of our (very) rough "guesstimate" of forward year earnings. While we concede that some of our holdings aren't deep bargains (a couple are in our view, relatively "undiscovered" which we intend to scale carefully over time), we do not find them prohibitively expensive either - what do I mean by this? By buying these businesses at prevailing prices we feel comfortable that we will be able to compound our capital well above our threshold return expectations over a decade long horizon. In general, **we think that an over-reliance (bordering on obsession) on price-earnings multiples (or equivalents) as a signal of value by investors is a heuristic that can be taken advantage of.** Just as every low P/E stock isn't cheap, every high P/E stock isn't necessarily expensive - there are two key reasons why - 1) A P/E is a static measure that fails to capture the non-linearity of compounding and the underlying attributes that allow for it to occur over decade long horizons and 2) P/E captures earnings based on accounting standards that sometimes have the effect of underestimating/ overestimating the real underlying economic earnings of the business. Both these factors can hold enormous sway when one is thinking about the price-range one is willing to pay for a business that they intend to be locked into for very long periods of time. Additionally, given our unconventional time horizon, by disposition we can afford to pay up a little more relative to peers who may be demanding of returns over shorter time horizons. Finally, in our view the quality curve drops off drastically in our environment (and perhaps in all environments) - to us, **quality refers to the characteristics of a business and the character of the people who run it**.

In terms of **portfolio changes,** in the first few days of the quarter we exited two small tail positions. One of the key tests we like to put our tail positions to is whether we can envision them as at least 5% of the portfolio over time. Despite these businesses performing satisfactorily, we realized that we would be uncomfortable scaling them to a consequential size in the foreseeable future and started weighing the opportunity costs incurred in continuing to own them. Along the same time, a consumer-oriented business that we had been studying from the sidelines for several years became available, in our view, at a compelling price. Additionally, this is likely an opportunity that we can patiently stay invested in for a substantially longer period of time - this is a characteristic we hold very dear as it reduces reinvestment risk - however, that is perhaps a discussion for another time. In our view, the two exits were an opportunistic way to fund the purchase of this business which we are comfortable positioning well above a 5% piece of the conglomerate upfront. Additionally in certain accounts as required, we also trimmed our largest position very marginally to fund two increasingly important positions that we are scaling.

There were two key highlights of our research effort from this past quarter - one was the visit to the **Royal Enfield Technical Center in Leicester, UK** where local teams provided an extensive understanding of the engineering & developmental efforts put in by the technical teams in Leicester in collaboration with the teams in Chennai. Eicher's senior management also provided deep insight on the evolution of the business over the past few years and the road ahead for both RE & VECV. It was a fantastic opportunity to gain an appreciation of the (roughly) 160 member strong team in the UK and the efforts put in to bringing new motorbikes to the market as well as revamping existing platforms through several, rigorous stages of testing & validation. I also had the opportunity to exchange notes with **exceptional globally based co-investors in Eicher** - these insights play a meaningful role in expanding our intellectual bandwidth as we increasingly allocate capital beyond our own borders. Another highlight of the quarter was **presenting at the Zurich Project, MOI Global** to a group of exceptional investors and allocators **hosted by John Mihaljevic**. I have been a beneficiary of the intellect of the membership community he has carefully curated and this occasion was no different. The meetings were an aggregation of thought-provoking presentations interspersed with informal conversations among veteran investors and emerging managers from across the world who all have an unspoken commitment to open-mindedness and intellectual humility.

Over the past 6 months we have been building exposure (in a personal capacity, through the **Liberalized Remittance Scheme of the Reserve Bank of India**) to a handful foreign listed businesses which we think have very robust business models, long-term earnings power growth potential and are run by exceptional and trustworthy management teams. To be clear though, our rationale for allocating beyond our borders is not from a viewpoint of maximizing returns as much as it is inclined toward owning a more diverse set of irreplicable assets that are less correlated to domestic occurrences. In effect, offering us the effective utility of a financial "bunker". Although we have been reading the annual reports and dynamics about the majority of these businesses for almost a decade, by disposition we prefer to dip our toes before diving in head first and will scale some of these holdings slowly over time. Over the upcoming quarter, I invite our partners to connect with us with regard to building some overseas equity exposure in their own portfolios - we would be pleased to discuss the setup process we followed as well as our overseas holdings.

We now have 99 committed accounts on our investing platform and have ceased adding new investors. We do not intend to add any additional accounts until at least September 2019. More importantly, even over a longer time horizon we don't intend to add more than 20-25 accounts in aggregate. We are blessed to have an exceptional investor base which understands our approach - a deep competitive advantage to possess as an investment manager. This is an especially critical characteristic given our approach to **invest as owners of businesses (as opposed to renters of stocks)** and give the businesses we have entrusted wide latitude to perform. We intend to retain this by ensuring that we are very mindful of the incremental accounts we initiate. **Newer accounts, if not well curated, can be a substantial source of distraction to our personal bandwidth and can be very dilutive to our ability to channelize our efforts where they are most required - research, investing & emotional fortitude.**

I am grateful to our entire team for another quarter of exceptional ownership and effort. I also remain humbled by your conviction to invest with us and strive to remain worthy of it.

Warmly,

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~On behalf of our entire team~

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