Piper Serica Leader Portfolio Strategy™

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Portfolio performance

The since-inception (June 2019) TWRR for the PMS is 13.6% (post fees and expenses) compared to Nifty that returned 13.1% over the same period. Our standard deviation is almost at the same level and CAPM beta is well below that of the benchmark and our Sharpe ratio is at par.

Market update

The global and Indian markets corrected in December as volatility made a return. Overall, the Indian markets managed to generate 4% positive returns in the year 2022 making it the longest stretch of 7 years of continuous positive returns. However, the global markets, across asset classes had a tough time with significant losses across the board as can be seen in the attached chart.

Asset Class	1-Year Trailing Return as of 12/31/2022
Total US	**-19.5%**
S&P 500	-18.2%
Total International	**-16.1%**
Int'l Developed	-15.4%
Emerging Mkts	-18.0%
REIT	-26.2%
Broad US Bond	**-13.1%**
Short Treasuries	-3.9%
Long Treasuries	-29.4%
TIPS	-12.2%
Gold	-0.8%

Even the Nifty, while closing the year positive in INR terms, was down almost 10% in terms of USD due to a sharp correction in the INR against the USD in 2022. Over the last 12 months, large caps and midcaps have risen 4% each, while small caps have declined 14%. During the last five years, mid-caps and small caps have underperformed large caps by 23% and 65%, respectively. PSU Banks (8%) and Metals (2%) were the only gainers. While Utilities (-7%), Media (-6%), Technology (-6), Oil & Gas (-5%), and Telecom (-5%) were the key laggards.

Going into 2023, investor expectations are muted. We believe that this is a good opportunity for long term investors to add high quality stocks to their portfolio at a very reasonable valuation. At times like these, adding 10-15% further allocation to the existing portfolio is a good strategy to improve long term returns.

Portfolio update

We are seeing very interesting investment opportunities in small and mid-cap space. There are some excellent companies that have created a very solid presence in high growth sectors. However, the markets have been so focused on large cap names that they have neglected these companies. As a result, these companies, with 15-25% annualized growth rate over the next 3-5 years are now trading at very attractive valuation multiples. At the same time, investing in small and mid-cap companies is a tricky business and requires in-depth research. It also needs the investor to stand away from the crowd and patiently wait for markets to catch up with the real value of the company.

Our strong belief is that high growth small and mid-cap companies, with predictable growth drivers, strong balance sheets, good brand / franchise, high energy culture driven by new management and in a high growth industry will create high returns for shareholders. However, investing in these companies increases portfolio volatility in the shorter durations since they are exposed to higher volatility due to low liquidity. Any profit booking in these stocks by a large investor can lead to a sharp correction. Therefore, it is very important to make sure that the investment in these companies is made at a very favorable valuation which provides cushion against volatility. One needs to look at non-consensus opportunities to make these investments. That is where deep research and wide coverage becomes a competitive advantage for astute investors. Our research team is always looking for and tracking these companies and then adding them to the portfolio at a valuation that is lower than the fair value calculated by our models, as soon as the opportunity to do so presents itself.

Investing in small and mid-cap companies that are competitive leaders in their business niche is a very remunerative strategy over the long term. However, it requires a private equity kind of investment approach to make it work. Therefore, looking at short term returns from such a portfolio is not a good idea for investors.

It is also imperative to ensure that there is adequate diversification in the portfolio. Our approach always has been to ensure that we have a portfolio that has the right mix of stability and growth. We track our portfolio to always ensure that at the portfolio level the returns outweigh the risks.

In November, we had added two small cap companies to the model portfolio – South Indian Bank and Greenpanel and shared our investment thesis in the last month's note. In December we have added 2 more small cap stocks to the model portfolio – CSB Bank and Spandana Sphoorty. You will find a summary of our investment thesis in the following section.

To make room for these stocks in the model portfolio we have removed Reliance, Bajaj Finserv and India Grid Investment Trust. While the former two companies are strong leaders in their own right, we believe that returns from their stock will be muted and we will be better off redeploying our capital in more lucrative opportunities.

We are continuously expanding our research in the small and mid-cap space as we believe that the large cap rally is overdone and sooner than later the investors will start looking for undervalued fast growth small and mid-cap companies. We are at an advanced stage of completion of our research in two more companies and will add them to the model portfolio at an appropriate time.

Additions:

CSB Bank:

CSB Bank Limited provides various banking products and services for small and medium enterprises, retail, and NRI customers in India. It is the oldest private sector bank in Kerala and has a sizable presence in Tamil Nadu, Karnataka, and Maharashtra. It has 608 branches and 507 ATMs/CRMs. The bank's portfolio mix consists of 43.7% gold loans, 12.5% MSME loans, 23.3% corporate loans, 20.5% agriculture, retail, and other loans. Due to a deteriorating economic climate and policy changes that had an adverse effect on corporate and SME cash flows, the bank's asset quality declined from FY14. However, NPAs have decreased since FY19 after purchase of controlling stake by Fairfax. During H1FY23, gross loan book grew 22% YoY to INR 18,374cr, most of which was driven by gold loans. CASA ratio increased by 169bps YoY to 34.3%. As a result, the Deposits increased by 10% YoY. The company has a NIM of 5.5%, GNPA of 1.65%, NNPA of 0.57% and a Provision coverage ratio of 90% leading to RoA of 1.8% (H1FY22; 1.53%). The capital adequacy ratio is almost 25% which means the bank will not need to raise new capital to fund its rapid growth.

New retail products are expected to be launched by end of this financial year. Loan book is estimated to grow at a rate of around 20% in FY23E and FY24E. The gold loan share is expected to increase to half of the gross loans and then gradually come down as some of the other products start picking up. Management expects the bank's advances to grow at 1.5x the industry growth rate. Furthermore, the management targets 100 branches to be added every year for next five years and simultaneously invest in technology for customer acquisition. The bank has partnered with OneCard and Mastercard to launch new co-branded credit cards.

The bank is headed by Pralay Mondal, a highly experienced banker. He was appointed as the MD of the bank in September 2022 for a period of three years. Prior to joining CSB Bank, he was Executive Director and Head, Retail Banking at Axis Bank. He has around 30 years of banking experience across businesses and functions, including retail assets, retail liabilities, business banking products and technology. Before Axis Bank, he was the senior group president and head of retail and business banking at Yes Bank, wherein he was instrumental in setting up the entire retail franchise in a short period of time. Prior to Yes Bank, he has worked at HDFC Bank, Standard Chartered Bank, Wipro InfoTech and Colgate Palmolive.

Our investment thesis is that under the new leadership CSB Bank will emerge as a very competitive and high growth retail bank. The valuation of the bank at about 1.5x book value provides an opportunity to make returns through earnings growth as well as multiple expansion. We will continue to track the performance of the bank to ensure that there is no deterioration in asset quality and the growth is in line with the guidance provided by the management.

Spandana Sphoorty Financial Ltd. (SSFL)

SSFL is a leading Micro Finance company that provides small-value unsecured loans to low-income customers in semi-urban and rural areas. With its existing infrastructure of 1,115 branches and 6,374 loan officers, SSFL has operations in 18 states and Union Territories across 300 districts with an AUM of INR 57.8 billion. It aims to achieve INR 150 billion AUM by FY25. With the revival of its disbursements and restructuring of old loans (INR7 billion; 11% of the AUM pre-write-off) made in the pre-March 2021 book, the legacy stress book's share (i.e., pre-March 2021 originated restructured loans) decreased to 3% at the end of September 2022 (from 15% at the end of March 2022). Additionally, the ratio of gross non-performing assets (NPAs) dropped to 7.47% in 1HFY23 (FY22: 17.7%; FY21: 6%), and the ratio of net NPAs dropped to 3.96% (FY22: 9.7%; FY21 3.3%). The provision coverage ratio slightly improved to 52.2% in 1HFY23 (from 45.3% in FY22 and 47% in FY21). The company raised about INR 3.0

billion in equity capital in March 2022 and INR 10.8 billion of borrowings with a reduced cost of borrowing of 11.2%, down from 14% in Q4FY22, resulting in a NIM of 13% (Q1FY23:9.9%). Its capital adequacy has improved to 45.3% allowing its leverage to stay low at 1.5x in 1HFY23 and giving it the balance sheet strength to finance the company's growth. New customers made up 46% of the company's disbursements in the second quarter. With a 16% increase over the previous quarter, SSFL added 1.23 lakh new clients and the overall collection efficiency in FY23Q2 improved to 101.3% (incl arrears) & 93.3% (excl arrears).

SSFL has appointed Mr. Shalabh Saxena as its new Managing Director and CEO, and Mr. Ashish Damani as the President and CFO, post the amicable exit of its founder Mr. Padmaja Reddy. With over 26 years of experience in retail finance, Mr. Saxena served as the MD and CEO of Bharat Financial Inclusion Ltd. (BFIL), one of India's largest micro finance companies and a subsidiary of Indus Ind Bank.

Our investment thesis is that with a sharp pick up in credit growth, restructured balance sheet and new leadership Spandana will be able to double its size over the next three years. With an attractive valuation of about 1.2x forward book value we believe that there is adequate margin of safety as the multiple is close to historical bottom.

We will continue to track the company for any deterioration in asset quality or any detrimental change in regulations.

To conclude

Investing in equity should be looked at only as a way of savings management by investors. Therefore, it is very important to take a long-term approach to investing and building portfolios. While investing, one takes market risk as well as business risk. The market risk resolves itself with long duration. The business risk is managed by astutely tracking the performance of the company. While we are always keen to be opportunistic in managing additions and exits in our model portfolio, we prefer to spend most of our time in business diligence and research to uncover new investment opportunities.

In line with the industry practice, we will reduce the frequency of the investor letter to quarterly. Our investors understand we are quite communicative and always available for a discussion and that will never change. Rest assured, that through various channels we will always update you on our strategy and any major change in the model portfolio as and when it takes place and the reasons for the same.

On behalf of our team, we would like to wish you a very happy 2023!

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Founder & Fund Manager

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