

# SUREFIN INVESTMENTS

May 5, 2009

**From: Amitabh Singhi**

**To: Investors in Surefin India Value Fund**

**Subject: March 2009 Annual Update**

Dear Investor,

Please find below the performance of the fund. This is the performance of the overall portfolio. Each of you will receive your individual performances separately.

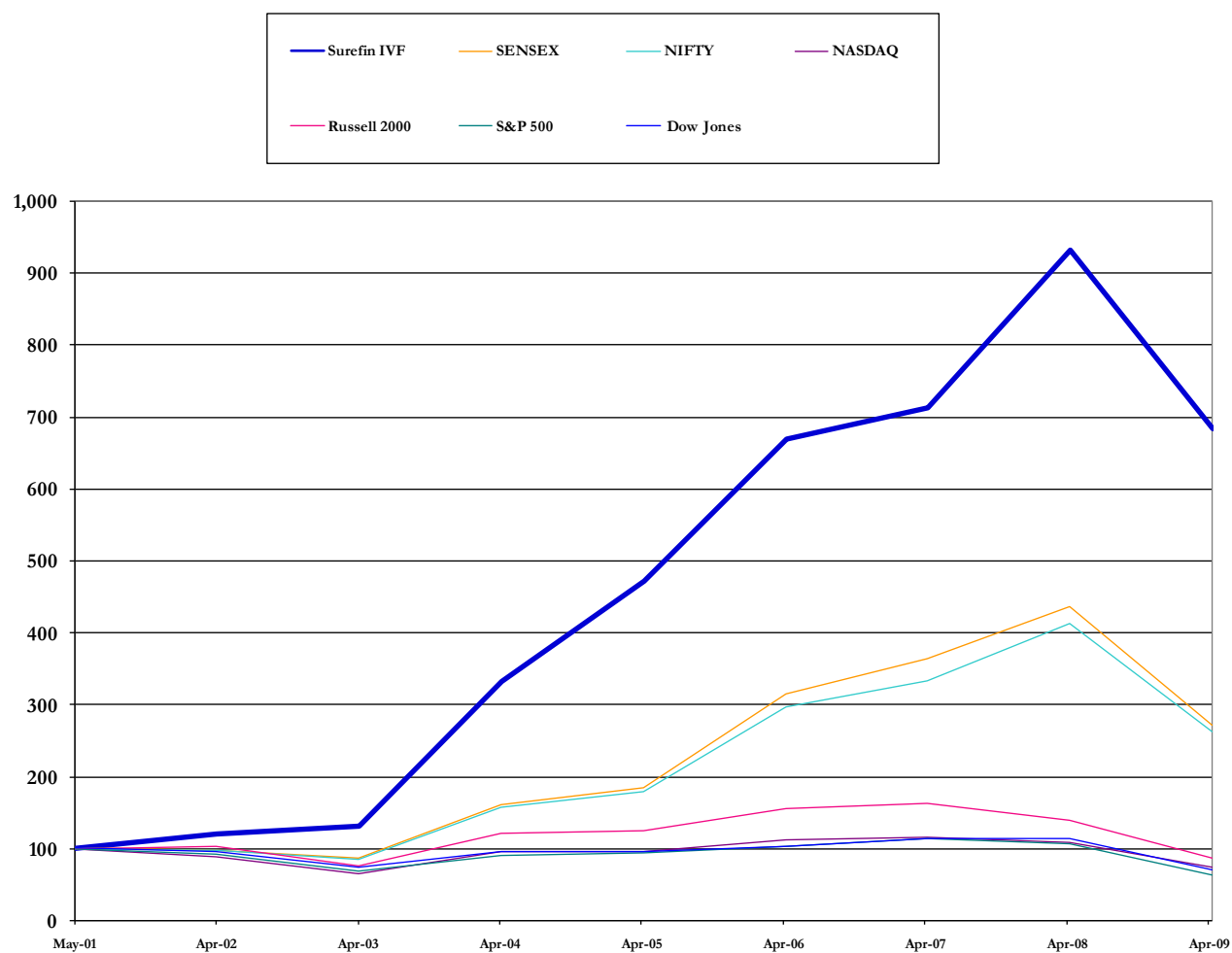
## Percentage Returns

Date	Surefin IVF	SENSEX	NIFTY	NASDAQ	Russell 2000	S&P 500	Dow Jones
May 15, 2001	-	-	-	-	-	-	-
April-02	20.0%	(2.1%)	(0.6%)	(10.7%)	3.0%	(8.2%)	(4.7%)
April-03	9.0%	(12.0%)	(13.6%)	(27.6%)	(26.9%)	(25.1%)	(22.1%)
April-04	154.0%	86.3%	84.9%	49.4%	61.5%	31.9%	28.5%
April-05	42.0%	15.1%	13.6%	(1.5%)	2.7%	3.6%	0.3%
April-06	42.0%	70.8%	64.6%	17.9%	25.1%	10.4%	6.8%
April-07	6.4%	15.9%	12.3%	3.5%	4.6%	9.7%	11.2%
April-08	30.9%	19.7%	23.9%	(5.9%)	(14.1%)	(6.9%)	(0.7%)
April-09	(26.7%)	(38.3%)	(37.5%)	(30.8%)	(27.4%)	(31.7%)	(28.4%)
<b>Percent Change</b>	<b>584.6</b>	<b>169.7</b>	<b>158.4</b>	<b>(24.4)</b>	<b>2.0</b>	<b>(27.7)</b>	<b>(19.3)</b>
<b>CAGR</b>	<b>27.6%</b>	<b>13.4%</b>	<b>12.8%</b>	<b>-3.5%</b>	<b>0.3%</b>	<b>-4.0%</b>	<b>-2.7%</b>

\* The returns till 2005 are calculated on an XIRR basis.

\* XIRR is the internal rate of return of an investment that does not necessarily have periodic payments. This function is closely related to the net present value function (NPV). The IRR is the interest rate for a series of cash flows where the net

\* FY is from 1st April to 31st March.



The fund has returned a CAGR of 27.6% over the last 8 years after taking out fees & other expenses<sup>1</sup>.

<sup>1</sup> Fees are calculated differently for different clients, depending on when they entered the fund. However, now fees are charged at 0% management fees and 25% carry, over a 5% hurdle rate, with high water marks.

## Portfolio Evaluation and Mistakes

We apologize for the delay in the annual update. We plan to get this out to you soon after the year ends in March every year.

We had moved a large part of our portfolio into cash by mid 2008 because we could not find enough things to buy. Of the stocks that we held, all have fallen on an average by little under (50%) from our purchase price. The one influencing factor in our portfolio is that stocks have fallen on low volume and relative illiquidity. As far as this factor is concerned we are not unduly worried. In fact, we feel good about holding illiquid securities that are heavily undervalued compared to the value that a business owner would be willing to pay. For such positions, we are not sellers at the current market price, or even at a price two times the current price.

Most people are willing to pay a hefty price for liquidity in markets and underestimate low liquidity listed equities that can be excellent investments much like distressed real estate, or cash strapped private companies. The upside in these cases is that once prices rise and as the market realizes its gross undervaluation of some of these securities, liquidity follows in huge spurts. For instance, we sold one such position late last year, where we made over a 200% return in a short span of time. This was a company that was selling below Net Cash on its books even while the underlying business was making money. We have discussed this opportunity in detail in our previous letters. About 15% of our portfolio is illiquid, and would take about 5 trading days to liquidate if the need arises but we feel comfortable with our relatively illiquid investments since we bought such companies at very good prices.

Fortunately we have not erred on any of our investments except the textile company that we have already discussed in detail in our previous letters. We did however commit some errors of omissions because we debated for too long on which out of the many cheap investments to focus on, since we wanted to buy only one stock/company within the same industry.

Some of the contrarian bets that we missed were a cheap shipping company, a two-wheeler auto manufacturer, a few finance companies, banks, and Net-nets are some of the contrarian bets that we missed<sup>2</sup>. But we're certain that similar opportunities will come in the near future and we won't be trigger-allergic then. As they say, there is a fine line between fishing and just standing on the shore like an idiot.

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<sup>2</sup> A Net-net is when the market capitalization of the company is below the liquid investments on its book minus all liabilities.

From the time we bought them some of the companies have fallen in price but not as much in intrinsic value. Our estimate of the fall in intrinsic value of these companies is a maximum of about 25% in a few cases. But since we had bought them very cheap, the additional fall in prices of over 50% have made some of these extremely attractive buys/options.

### **Asset Allocation and Position Sizing**

Our thoughts on asset allocation have under-gone some change but not because we think there is a high risk in running a concentrated portfolio. We believe that spreading your bets across too many things gives a false sense of security. On the other hand, the fear of holding say only 10 stocks is that such diversification may not be enough. For example, if something unforeseen goes wrong with one company, then the hit is 10% for each of the 10 companies in the portfolio. But the reverse is also true and if something good happens, we run the risk of missing the upside.

There may be a factor that we take for granted that doesn't play out as is expected. It may well be something that has never happened before in our life-times or has a very low probability of happening and may affect *all* our companies similarly. Diversification in such a situation is of little help because events of a larger scale and magnitude like frozen credit markets, labor troubles, run-away inflation, high-interest rates etc occur affecting all companies across the board. What happens to ten companies can happen to thirty as well.

Decisions on diversification must be steeped in practicality and depend on the environment one is in. Our decision to diversify is greatly based on what is available. Since in this market we are finding many 20-cent dollars, we are not going to be debating on which is an 18-cent dollar and which is a 22-cent dollar in order to stick to the rule of buying only one stock of a kind. We have decided that in such a situation we will simply buy both. As a result, we are now likely to find at least 20 ideas enabling us to move out of cash and start investing. We will however continue to try picking these stocks as far as possible from different industries.

We would be equally open to investing a large part of the fund into a single investment if it is a no-brainer. In the mean time, doing special situations and fixed income type investments is a great way to diversify some risk and is better than keeping cash in many cases.

## **Opportunities in FY 2009**

We currently have 10 holdings. We made about 9 new investments during the year out of which 7 new holdings have been added very recently.

We added two companies whose respective market caps were equal to the net cash on their books and whose underlying businesses were generating very high cash flows. The stocks were down about 75% and 85% respectively from the peak about a year ago. As it often happens, they fell even more after we bought them. In fact, they fell below Net Cash levels for almost a month after our initial purchase!

The first one went from over a \$1 billion market cap to under \$300 million and it had about \$300 million of free cash that was accumulated from the business and no debt. Its net profit in FY2008 was \$95 million!

The other one went from a \$400 million market cap to under \$40 million. The cash on its books was close to \$50 million and it made a shade under \$20 million of net profits. The profits in this case were expected to go down significantly and maybe also result into a small loss. But both these companies were trading at prices far lower than what a private seller would sell at. These stocks have (sadly) risen since but we did manage to build some positions in these and will eventually benefit from them.

## **Currency Devaluation**

Currency devaluation is something that India will need to recon with every year going forward. The two forces that according to us will affect the movement of INR / USD are a) difference in future expected interest rates and b) the rate at which the US prints dollars and de-bases the USD (incrementally over what India does to fund its deficit). At the onset we must tell you that predicting this either way is in the “too-hard” pile.

Theoretically speaking, the forward rate must adjust itself for any arbitrage available in interest rates, after correcting itself for credit risk. So, if the 5 year government bond in India is yielding an 8% return and the same bond in the US is yielding a 1% return (borrowing cost in the US would be 3%), and we expect the country risk-premium to be about 2%, there is still a gap of 3% that someone can arbitrage. All he has to do is borrow in the US and lend in India, and buy dollars one year forward. This way he can capture the 3% risk-free, and more importantly, without putting much capital (apart from margin requirements) of his own.

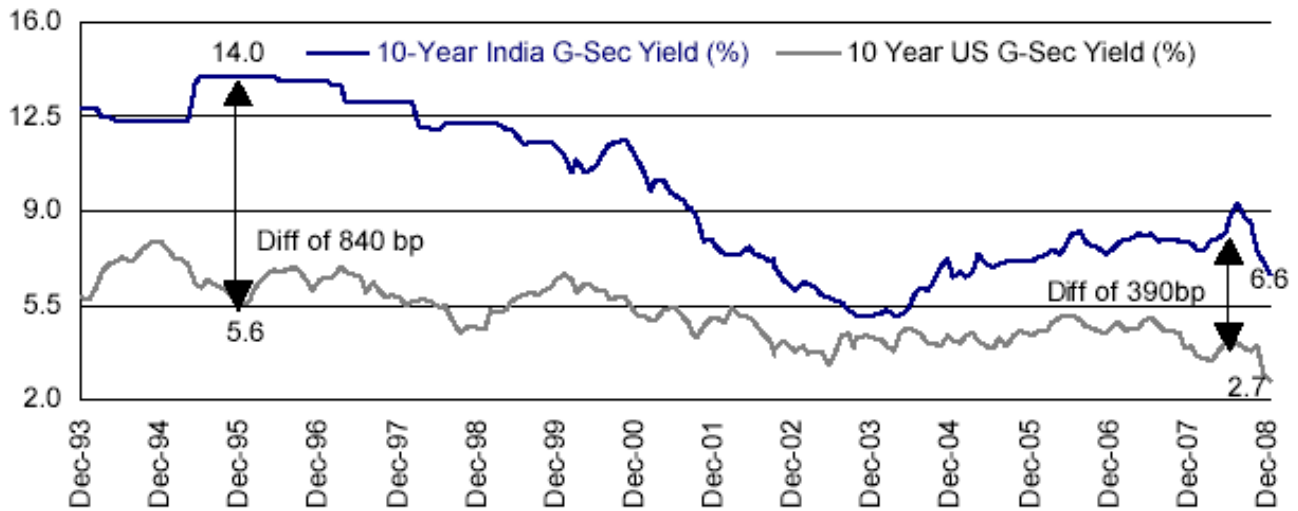
So in the real world, the forward rate of the INR/USD would be 3% lower than the current rate (the INR would be expected to depreciate in one year). And that takes away the arbitrage.

The current situation is a little similar between the US and India. The difference in the yields between the two countries is about 4%. Therefore, over the long haul, the INR should depreciate. Of course the country risk-premium, the restrictions on capital flows etc. make the market far from being perfect but this is one force that will lead to the INR depreciating in the long run.

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INTEREST RATES IN INDIA AND ELSEWHERE IN THE WORLD ARE FALLING

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Source: MOSL

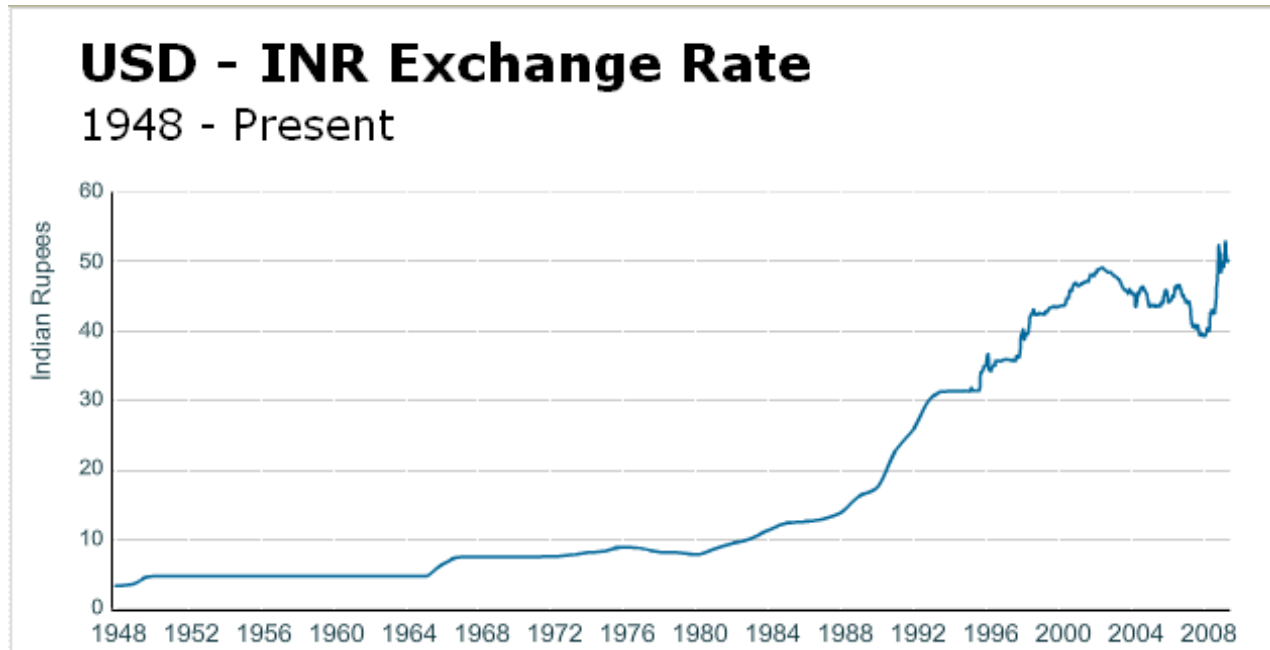
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The force acting on the other side is the current situation in the US. Both countries have high deficits. But the US is probably printing more dollars relative to its GDP than India is. Also, the slow-down in the US is more severe. If this persists and more money moves out of the US, and comes to emerging economies, including India, the INR would get stronger. We believe this is only a shorter term-phenomenon but no one really knows. Of course we will benefit from such strengthening of the INR but we should also be prepared for a long-term depreciation in the INR.

Apart from these there are countless number of theories that are expounded on currencies and their movements, which we either do not understand or don't think are too relevant.

As we said earlier, these issues are not possible to predict with any sensible accuracy. The relevant take-away for us is that there is a chance that the INR will continue to depreciate against the USD and if we need to have

an Indian portfolio, we will have a natural disadvantage over time of about 3% per year purely because of the currency we operate in compared with global peers. Of course, the higher growth in India should off-set this disadvantage over time.



Just to get a sense of how much currency movements can affect returns, consider this - the BSE SENSEX started in 1979 at a level of 100. Over the last 30 years, the SENSEX has delivered a CAGR of 16.5% in INR where as in USD terms the CAGR is only 9.7%. The difference can be attributed to the respective interest rates and inflation levels in each country.

### **Inflation** - “A nickel ain't worth a dime anymore”

Most fear inflation as a nasty outcome in the coming years and Warren Buffett recently confirmed it as a probable threat going forward. While an inflationary trend almost seems like a certainty, what is less certain is its degree and what is definitely uncertain is how one can hedge against it, especially in the Indian context. Even if we assume that buying agricultural / mining companies is the way to go, we have no listed timber companies or well run agricultural commodity companies that are cheap. Also, Indian mining and exploration companies are generally very low on corporate governance making them unattractive. Buying gold is not something we think makes sense either because of the low utility of the metal.

The only option left for us is to buy good quality companies, that don't need capital to run their businesses or have already invested in the past and don't need much more for the future. These are, of course, rare to find cheap. Also, given how the crazy environment in the last 5 years has had a lollapalooza effect on everything, it is very hard to know which of the businesses also have good moats. So clearly there are no easy solutions for hedging against inflation.

Another way to combat inflation is to buy companies that make high RoEs at below 70% of P/BV. So if the business makes a RoE of 15% and we buy it at 60%, our effective return becomes 25%. Even if inflation goes to 15%, and as a result the RoE comes down to 8%, our effective return on the buying price will still stay at a decent 13%. Though not ideal, this investment will do way better than bonds or other fixed-income type investments.

Hyper-inflation is when you put a dollar bill in the change machine and you get the same bill back. If we get situations of extreme inflation then everything we do will be in trouble. The best option there would be to move money out to only a handful of businesses that require very little incremental capital, like a monopoly toll-road or an efficient distributor. However, we cannot fully plan for such outcomes today. Ideally we would like to buy inflation-indexed bonds, but they do not exist (in a material way) in India.

Obviously, we do keep the inflation factor in mind while making decisions. The following are a few instances. A commodity company that we're considering makes fertilizers, soda ash, salt etc. and has a subsidiary that invests in the rural markets. A company that is operating in the agricultural space is a smart choice, since agriculture products will have good pricing power (with some help from the government). Also, the rural business does not take too much incremental capital, and can leverage the existing in-roads that the fertilizer business has made. We expect the rural-focused subsidiary to grow much faster than inflation, on little capital over the next five years. Also, the parent business is fairly backward integrated and supplies essential commodities, with decent market shares finding it easier to pass on the increased prices to customers.

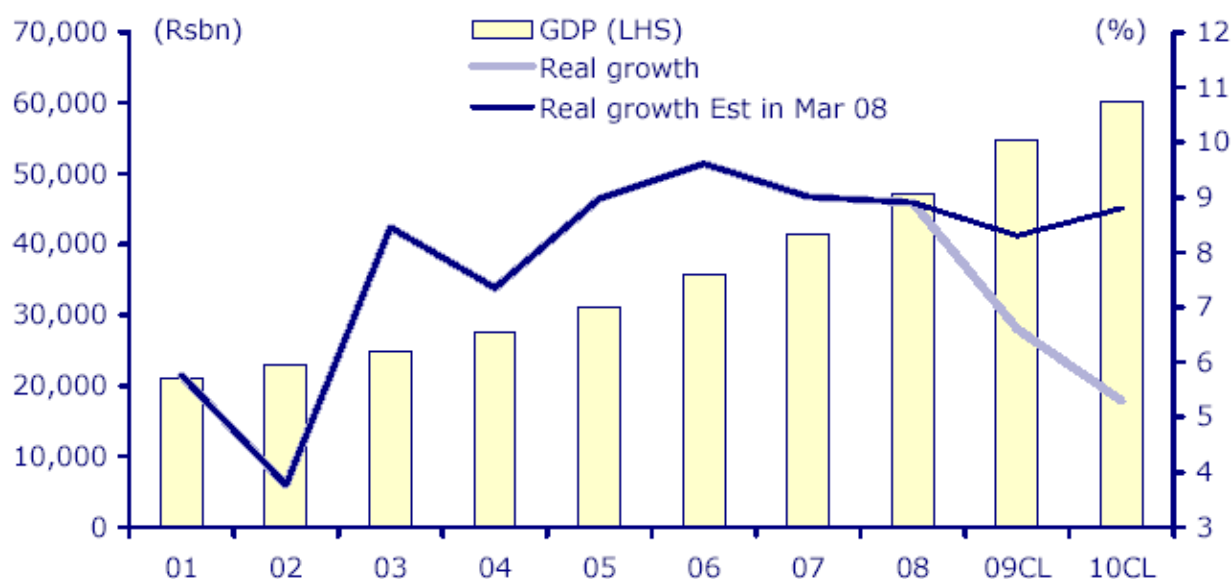
The rural market in India is very interesting because it represents huge pent-up demand for the organized players. Although new entrants into many of these areas have realized that much of this demand is being met for many decades by fairly efficient local players. Therefore, a cookie-cutter approach is unlikely to work. This bodes well for companies that have been operating in the rural environment in areas other than agriculture, and thus know this space intricately.

We look for companies that have the above-mentioned characteristics, and also have a high post-tax dividend yield of over 5%. In this case, we get a return equal to bonds, get to re-invest the cash in other situations every year and get the upside from the underlying business for free. Obviously, the big unknown is how high the inflation number will go.

### The Environment We Operate In – Why India Cannot Be Ignored For Long

India is a big country with tremendous depth in terms of the number of fast growing cities it has, the middle class population and the country's swift move towards more mature capitalism. The GDP growth in real terms has been encouraging. Although per-capita GDP would be about 2% lower than the GDP growth rate for the entire economy, it is still a good situation compared to what is happening around the world. The Left Hand Scale denotes the absolute GDP. So, Rs. 60,000 billion is about \$1.2 trillion.

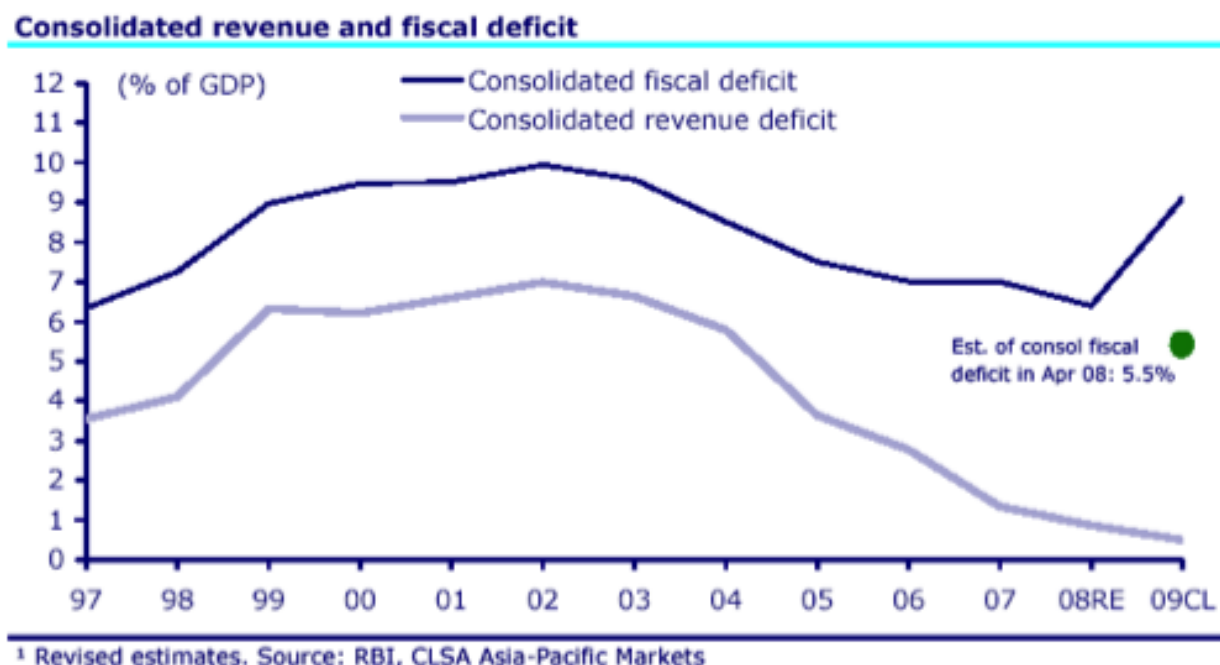
#### India's nominal GDP



Source: Ministry of Finance, CLSA Asia-Pacific Markets

The two worrying things about the growth of the Indian economy in the future are its dependence on rainfall and the heavy borrowing undertaken by the government. Since 1985, the GDP and rainfall in any given year are *heavily* correlated. This makes sense when you realize that 60% of India's population works in the agriculture sector.

The combined state and central (plus off-balance sheet) fiscal deficit at well over 10% of GDP is also worrying. In a poor country like India, running a deficit is almost necessary, but one would like to see fiscal prudence of a higher standard than what exists today.



What is encouraging on the other hand is that Indian companies have improved their financial discipline considerably over the years and many of the companies are truly world-class. The RoE numbers like in the table below do not exist in many other parts of the world and are unknown to many people who don't know India well.

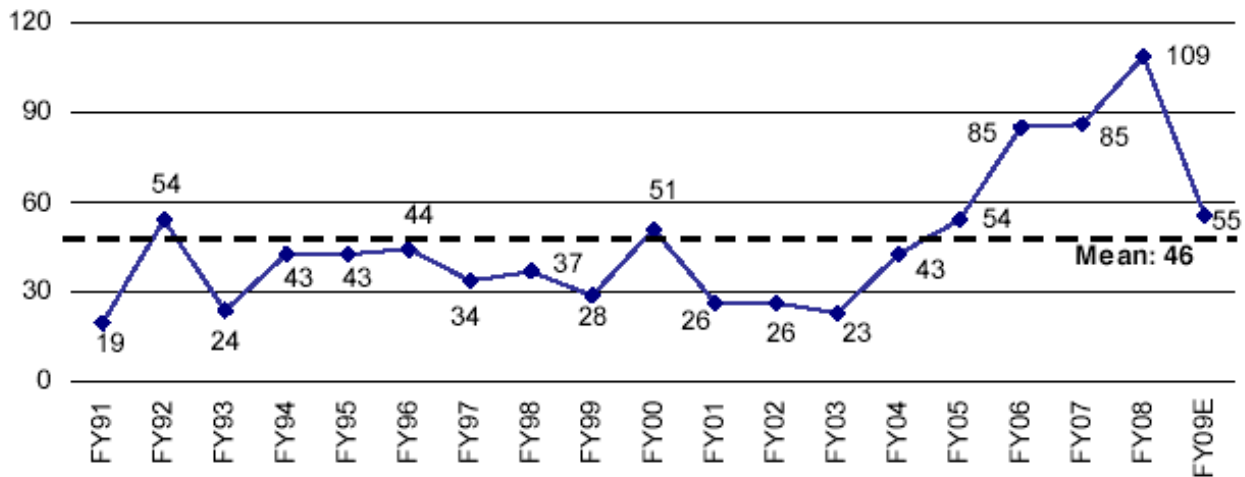
#### DuPont Analysis for India's Top 200 Companies

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
<b>Aggregate for 200 companies</b>													
Net Margin	6.6%	9.2%	9.5%	7.7%	8.2%	7.1%	6.3%	6.9%	6.7%	9.2%	10.5%	11.2%	10.1%
Asset Turn	0.94	0.90	0.92	0.92	0.87	0.91	1.07	1.20	1.20	1.20	1.24	1.36	1.34
ROA	6.2%	8.3%	8.7%	7.1%	7.1%	6.5%	6.8%	8.3%	8.1%	11.1%	13.1%	15.2%	13.5%
Leverage	2.15	1.90	1.85	1.91	1.88	1.80	1.73	1.68	1.68	1.55	1.50	1.44	1.45
ROE	13.3%	15.8%	16.1%	13.5%	13.4%	11.7%	11.7%	13.9%	13.5%	17.2%	19.6%	21.9%	19.6%
<b>Aggregate Ex-Energy</b>													
Net Margin	8.0%	10.9%	11.5%	9.2%	9.1%	7.8%	7.4%	8.8%	7.7%	9.6%	12.0%	13.7%	12.9%
Asset Turn	0.76	0.77	0.79	0.78	0.75	0.75	0.83	0.88	0.93	0.91	0.98	1.06	1.04
ROA	6.1%	8.3%	9.1%	7.2%	6.8%	5.8%	6.1%	7.7%	7.2%	8.8%	11.8%	14.5%	13.4%
Leverage	2.16	1.93	1.88	1.93	1.92	1.87	1.76	1.70	1.70	1.60	1.52	1.46	1.43
ROE	13.1%	16.1%	17.2%	13.8%	13.1%	10.9%	10.7%	13.2%	12.2%	14.0%	17.9%	21.2%	19.2%

Source: RARE Presentation, August 2007

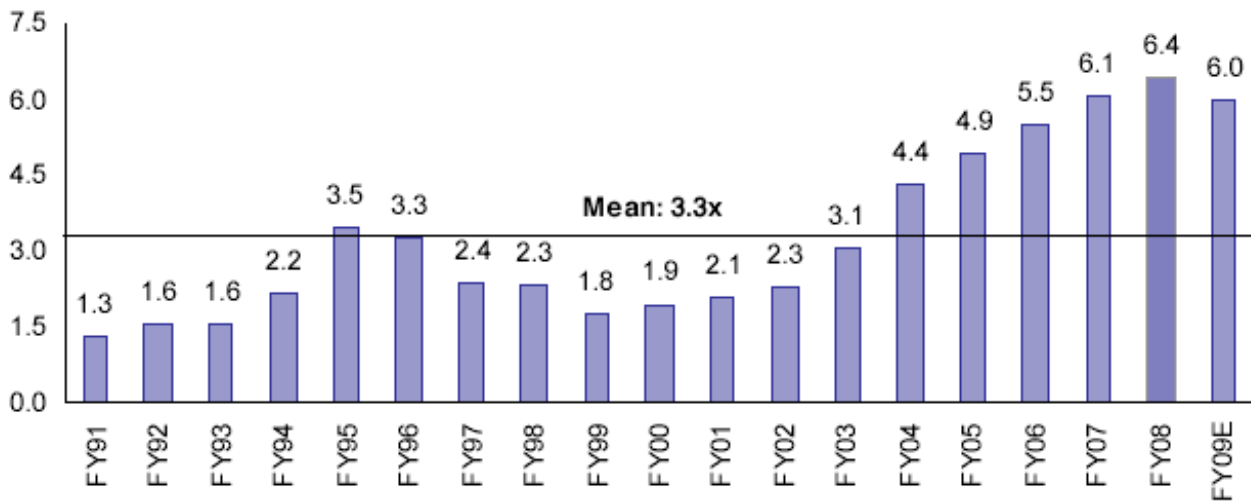
We do not focus too much on the macro picture but the two matrices that are interesting are Market Cap / GDP and Profit / GDP of Indian companies. It is always comforting to allocate a larger portion of capital to equities in an environment where you know that the overall market is not expensive.

INDIA'S MARKET CAP TO GDP (%) HAS CORRECTED SHARPLY



Source: MOSL

INDIA'S CORPORATE PROFIT TO GDP (%)



Source: MOSL

The savings rate in India is very high compared to western countries. And this number does not even include the un-accounted for “black” money, which is such a pervasive part of the economy. Since people cannot

borrow on their “black” money, ironically it protects them from extreme downfall in asset values and credit contractions!

#### Savings Composition

USD Bn	1994	1995	2004	2005	2006	2007	2008	2009	2010	2011
<b>GDP</b>	<b>274</b>	<b>323</b>	<b>601</b>	<b>694</b>	<b>798</b>	<b>904</b>	<b>1,026</b>	<b>1,163</b>	<b>1,319</b>	<b>1,496</b>
Gross domestic savings	62	80	174	202	235	271	315	365	425	494
Savings to GDP %	22.5%	24.8%	28.9%	29.1%	29.5%	30.0%	30.7%	31.4%	32.2%	33.0%
Financial savings	35	46	83	97	133	156	184	216	253	299
- % of GDP	12.8%	14.4%	13.8%	14.0%	16.7%	17.3%	17.9%	18.6%	19.2%	20.0%
<b>Savings in Equity/Deb/MF</b>	<b>4.7</b>	<b>5.5</b>	<b>0.1</b>	<b>1.1</b>	<b>6.5</b>	<b>5.9</b>	<b>11.8</b>	<b>21.2</b>	<b>34.0</b>	<b>44.9</b>
<b>- % of Financial Savings</b>	<b>13.5%</b>	<b>11.9%</b>	<b>0.1%</b>	<b>1.1%</b>	<b>4.9%</b>	<b>3.8%</b>	<b>6.4%</b>	<b>9.8%</b>	<b>13.4%</b>	<b>15.0%</b>

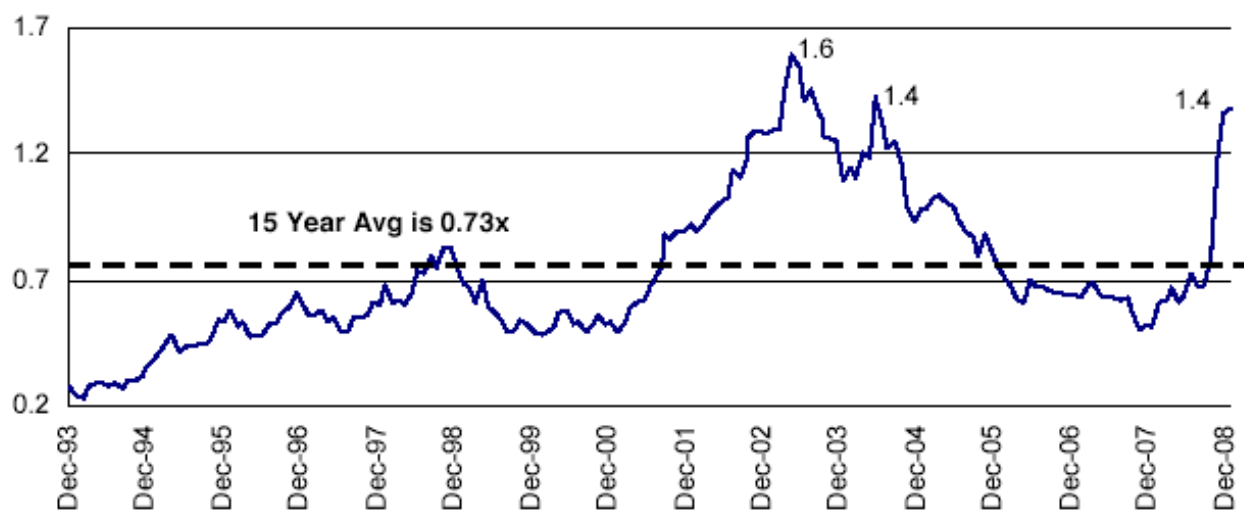
#### Fund flow for market

USD Bn	1994	1995	2004	2005	2006	2007	2008	2009	2010	2011
<b>Sources of funds</b>										
Domestic savings	4.7	5.5	0.1	1.1	6.6	5.9	11.8	21.2	34.0	44.9
FII investment	3.6	3.8	11.4	8.9	12.5	8.0	10.0	13.0	16.0	20.0
<b>Total</b>	<b>8.3</b>	<b>9.4</b>	<b>11.5</b>	<b>10.0</b>	<b>19.0</b>	<b>13.9</b>	<b>21.8</b>	<b>34.2</b>	<b>50.0</b>	<b>64.9</b>
<b>Uses of funds</b>										
Domestic equity issues	3.2	5.5	4.8	6.5	7.1	6.5	7.5	10.5	14.8	20.7
Secondary market	5.1	3.8	6.7	3.5	11.9	7.4	14.3	23.7	35.2	44.2
<b>Total</b>	<b>8.3</b>	<b>9.4</b>	<b>11.5</b>	<b>10.0</b>	<b>19.0</b>	<b>13.9</b>	<b>21.8</b>	<b>34.2</b>	<b>50.0</b>	<b>64.9</b>

Source: RARE Presentation, August 2007

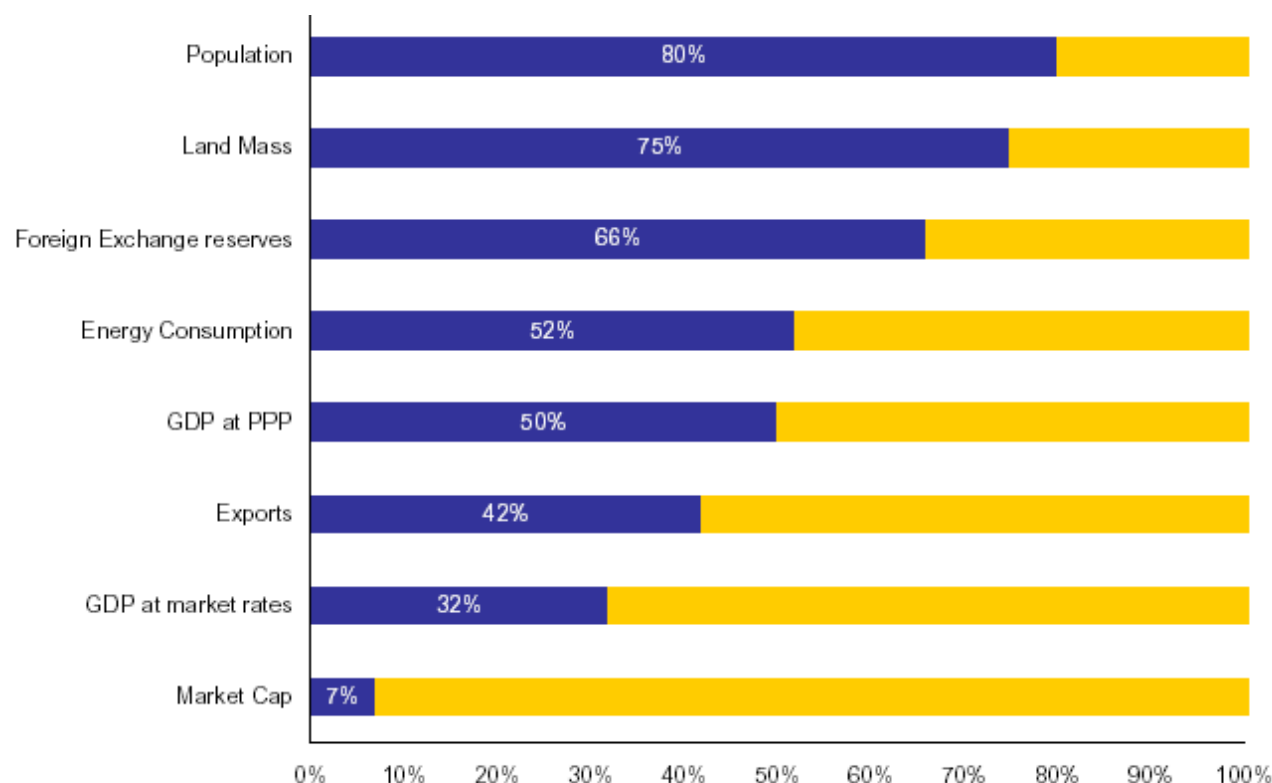
Another good way to think about value is in relation to bond yields. Ideally we look for an earnings yield of twice the amount of bond yields. But when the equity yield of the entire index is trading close to 1.5 times the bond yields, it is a comforting sign for a long-term buyer of equities.

#### EARNINGS YIELD (TRAILING) TO BOND YIELD (X): COMFORTABLY HIGH



Source: MOSL

This chart is particularly insightful. The blue colour in each bar represents emerging economies and the yellow colour represents developed economies. Clearly, some of the emerging economies have been under-represented and under-sold for a long period of time.



Source: RARE Presentation, Jan 2007

We are very excited about the future of Indian equities, especially since prices have come down considerably. A few months ago the markets closed on an upper circuit of 20% for the first time in the history of the country in reaction to the UPA's sweeping victory in the general elections, which is being seen as a sign of unprecedented political and financial stability. It reminds us of the situation when a father tells his son, "son, if you really want something in life, you have to work for it. Now quiet! They're about to announce the lottery numbers". We are sure the euphoria set by high political expectations will settle down soon.

We will get enough opportunities to put our money into many other cheap companies, as we have been able to do so far.

### **Quarterly Letter and Annual Letter**

We are going to write one annual letter at the end of March, which will discuss our investments and our thoughts on related issues in greater detail and the others (including this one), are going to be briefer. If you have any questions, doubts or concerns, please feel free to get in touch with us. We appreciate your support and interest in us.

Warm regards,

Amitabh Singhi.

Portfolio Manager,

Surefin Investments

[www.surefin.com](http://www.surefin.com)