

SUREFIN INVESTMENTS

August 20, 2008

From: Amitabh Singhi

To: Investors in Surefin India Value Fund

Subject: June 2008 Quarterly Update

Dear Investor,

Please find the performance update on the website: <http://surefin.com/newsletter.htm>

Performance Evaluation and Mistakes

We built a large position into a company and subsequently the company has been hit by a huge foreign exchange loss. The loss was completely the fault of the company's management since they entered a position they did not understand. The downside risks were not calculable and were infinite. The company looked at the last 15 year data as justification for taking the "apparently risk less" bet.

The currency market moved against them (and against a lot of other people who took similar positions) and they compounded the problem by taking on further bets to avoid booking the loss of the first contract. Eventually, the company has challenged the bank that had sold them these positions, claiming that they were mis-sold and the risks were not explained. The matter is currently sub-judice.

What is shocking from our point of view is that, this is a company we have invested and exited twice in the past. We naturally love the business, the management, and the fiscal conservatism they had exhibited in the past since their existence. The company then underwent a cultural change where they decided to expand aggressively and forward integrate. They acquired three companies outside India, announced a large expansion into a commoditized business, linked to their business. They borrowed heavily to fund this expansion albeit at very good rates (as low as 3% per annum for five year loans), due to some special schemes given by the government. The company culture was changing from a boutique, niche business to a

commodity business. It was getting hooked on to debt, a large management team (with its bureaucracy), paper thin margins and most importantly excess focus on a fair stock price since they would constantly need equity capital. The last point is important. We look for companies that typically do not care about how certain accounting outcomes or adverse business news will affect their stock price in the short-run. Their job is to focus on the underlying business and thereby increase stock-price in the long-term.

During my years at Wharton, I was taught the merits of borrowing money in the form of a tax-shield and the additional increments to return on equity. There were classes and case studies focused on establishing the ideal level of debt a company should have. Move over to the real world, and I have noticed that the best companies refrain from borrowing altogether. Or they borrow very little. I guess the only natural explanation I can think of is straight from Ben Graham's book – it is always good to preserve for the unexpected, the never-happened-before. The company may start out borrowing some for simple arbitrage reasons. But a few good years go by, and the management starts feeling good about its own abilities and then starts planning investments assuming that the debt is almost like equity. And there is nothing wrong in that. But then a serious unforeseen event occurs and the business turns sour. The debt burden starts to pinch and the interest rate starts to become a larger part of the profit for stakeholders. Now the management has to start cutting corners, paint different pictures of optimism to different types of people and start doing desperate things in running their businesses because their room for error is very low. I might want to add here that the same logic applies to companies that get into thin margin businesses and have what finance people call “operational leverage”. That is very similar in some respects to “financial leverage” that we are talking about above.

Anyway, what is happening in our company is a mixture of all the things above. The company has now borrowed more and more money for its project, for its foreign exchange loss and for its subsidiaries' acquisition and working capital. Also, given the contingent liability of the (forex) derivative contracts, the room-for-error in this company is now very low. So, if the US slows down further and their subsidiaries, which primarily do business in the US, take a hit, they will be in trouble. If the Rs. / \$ price movement becomes volatile again, they will have a problem. If the new plant is delayed further (it is already delayed), they will have a problem.

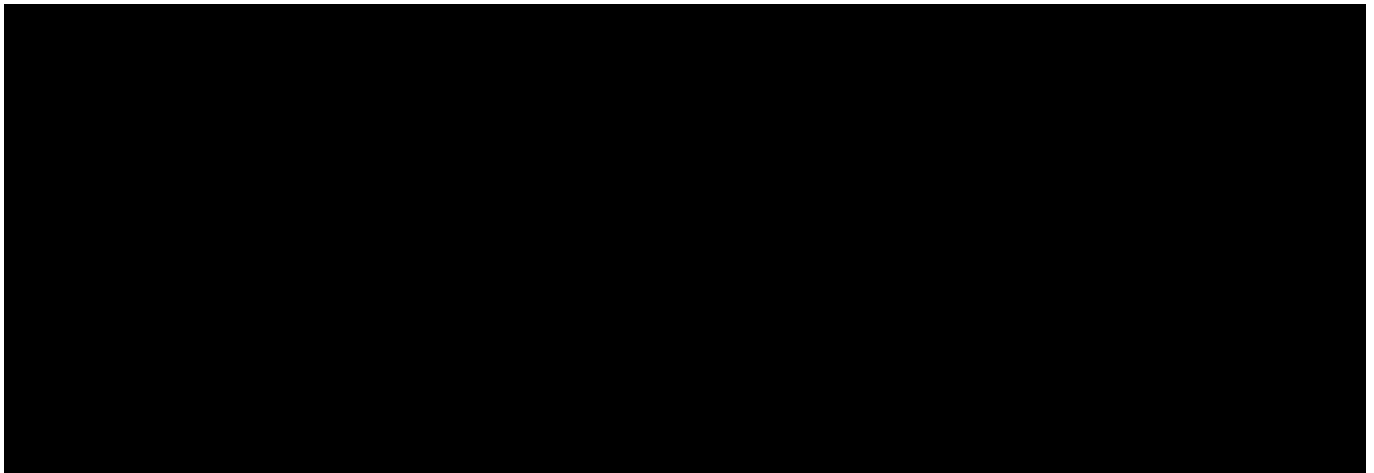
Now, have we made a mistake by buying this company at a price that was not dirt cheap, and a lot of the expansion was underway? I think we have. I think we made the mistake of thinking that the management could handle anything. And that they would have thought the steps thoroughly before doing so. I guess we were blinded by the management's previous success and also given our close proximity to them; we got

misled by their over-optimism. Of course, we are all hoping that the company comes out of all this fine and all of this just looks like it was just a few bends on the road. I think this company would be the largest loss that we have ever witnessed – almost 5% of total assets. Though we have not booked it yet, but as the Chief Risk Officer, I am preparing for it in my calculations.

Given our experience so far, it is almost certain that if we listen to the management's view on the business – there is a high chance of getting affected.

Comparative Returns of Surefin

Surefin has a longer term track record. It is interesting to note that from Jan to June, the overall market is down (34%) and in comparison Surefin is down (16%). This is how Surefin has fared since its inception:



Now the initial four years of Surefin are directly not comparable² to the other years since the returns were calculated using an XIRR method where the amount of cash invested was not kept constant throughout the year. So the cash was invested into equities and then pulled out and invested into bonds. These returns were only for the period when it was invested into equities.

But notwithstanding the above, the returns over the long-term have been satisfactory. Most importantly we have not lost substantial money and that is the key.

² Please see the website for disclaimer that explains the difference in the methods of calculating returns.

Current Portfolio and Concentration

We entered into one special situation which is a buy-back and a subsequent de-listing. We usually get into these special situations as substitutes to holding cash. Here we expect an annualized return of a little over 20% (net of all costs) over a period of 3 months. Apart from this we built positions in a few existing companies and nothing more. Our top 5 positions hold 62% of assets.

Tata Chemicals, which was a company that I talked about in my last letter (without naming it), reached our selling price for only a few days. The last time it had reached our selling price, we did nothing. This time we were not caught sucking our thumbs and acted to sell. This taught me an important lesson. Even if our selling price comes for a day, and we miss it, it is a mistake. The profit on the position was a healthy 51%.

Large companies are too expensive. See the first two table below enlisting the 30 stocks of the BSE SENSEX.

As of April 2008 in \$ Billions

Name	# of Cos.	Sales TTM	NP TTM	Mkt. Cap.
All Companies	14,638	774	62	1,419
BSE_SENSEX	30	141	26	582
Reliance Inds.		30.9	3.7	95.8
O N G C		14.2	4.1	54.3
NTPC		8.8	2.0	39.1
Bharti Airtel		5.9	1.4	39.1
DLF Ltd		1.0	0.5	27.6
Reliance Communi		4.2	0.8	27.4
St Bk of India		14.3	1.6	26.6
TCS		4.4	1.1	24.5
Infosys Tech.		3.9	1.1	23.8
ICICI Bank		9.7	0.9	23.2
B H E L		4.8	0.7	21.8
Larsen & Toubro		5.7	0.5	20.3
ITC		3.4	0.8	19.9
H D F C		1.9	0.5	17.7
Wipro		4.0	0.8	16.8
Tata Steel		4.7	1.1	13.1
Hind. Unilever		3.4	0.4	12.8
HDFC Bank		2.9	0.4	12.4
Reliance Energy		1.6	0.3	7.9
Satyam Computer		1.9	0.4	7.9
Jaiprakash Assoc		0.9	0.1	6.4
Tata Motors		7.0	0.5	6.0
Grasim Inds.		2.5	0.5	5.9
Hindalco Inds.		4.7	0.6	5.7
Maruti Suzuki		4.4	0.5	5.5
Ranbaxy Labs.		1.0	0.2	4.5
Cipla		1.0	0.2	4.3
Ambuja Cem.		1.4	0.3	4.3
M & M		2.7	0.2	3.9
ACC		1.7	0.3	3.7

As of July 2008 in \$ Billions

Name	# of Cos.	Sales TTM	NP TTM	Mkt. cap.
All Companies	14,900	648	62	1,010
BSE_SENSEX	30	155	25	442
Reliance Inds.		31.1	3.6	71.0
O N G C		13.9	3.9	43.6
Bharti Airtel		6.0	1.5	31.6
NTPC		8.6	1.7	29.6
Infosys Tech.		3.6	1.0	23.4
Reliance Communi		3.1	0.6	21.0
TCS		4.3	1.0	19.2
B H E L		4.5	0.7	17.1
St Bk of India		13.6	1.6	16.6
DLF Ltd		1.3	0.6	16.4
Larsen & Toubro		5.8	0.5	16.2
ICICI Bank		9.2	1.0	15.5
ITC		3.2	0.7	15.0
Wipro		4.1	0.7	14.6
H D F C		2.1	0.6	13.6
Tata Steel		4.6	1.1	10.9
Hind. Unilever		3.3	0.4	10.4
HDFC Bank		2.9	0.4	9.9
Satyam Computer		1.9	0.4	7.2
Ranbaxy Labs.		1.0	0.1	4.7
Reliance Infrast		1.5	0.3	4.3
Jaiprakash Assoc		0.9	0.1	4.2
Hindalco Inds.		4.5	0.7	3.9
Cipla		1.0	0.2	3.8
Maruti Suzuki		4.2	0.4	3.7
Grasim Inds.		2.4	0.5	3.6
Tata Motors		6.6	0.4	3.6
M & M		2.7	0.2	2.7
Ambuja Cem.		1.4	0.3	2.6
ACC		1.6	0.3	2.1

The one on the left was prepared in April after the market fell in January. The Sales, Net Profit (NP) and Mkt. Cap. numbers are all in \$ Billions. The table on the right is as of July. It is surprising to note that the prices and valuations of large companies have fallen as much as 30% after they had fallen about 20% from January to April. We have abstained from buying any of these companies because the valuations never made sense. There is no bigger fallacy in the stock markets than believing that “large is good” or “large is safe” or “large is less risky”. The other interesting thing about these two tables is that out of all the companies in the universe, the top 30 only constitute 40% of the market capitalization. So we still have almost \$600 Billion of market capitalization (\$1,010 minus \$442) to find my 10 stocks from. This point about India is often missed, and it is most missed in the bottom \$100 Billion of market capitalization. India is probably among a few countries where many small companies are public (that probably should never have been public) and they are typically completely ignored. This situation is similar to the situation that Warren Buffett described in South Korea in 2003 where a small flourmill company was selling at 2 to 3 times earnings and Buffett bought a diversified bunch of these. India has many regional businesses due to differences in culture, language and laws among states and regions. Another reason is that since the infrastructure to go national (roads, common tax laws, etc.) have only come into existence in the last 10 years or so, many different companies have strong and niche local businesses but have not grown substantially in size. So we can find a company that only supplies milk products to three southern states in India. Or a construction company that only makes buildings for technology buildings in southern India. These companies are typically not touched by analysts sitting in Hong Kong and Singapore (since they are not show cased enough and don’t have the cover-your-ass provisions in their marketing materials / approach) and make for some very heavy cherries to be picked.

A rough and dirty valuation sample of the same 30 companies is given in two tables below. Though the price-to-earning ratios in July have come down since April (and from the oxygen-less levels of January), they are still very far from being cheap. Especially since these are on Trailing Twelve Month (TTM) earnings which are all at all time highs. Also, the Sales, NP and Market Cap numbers are the percentage share of each company in the entire BSE SENSEX. So Reliance’s market cap constitutes about 16% of the entire market cap of the BSE SENSEX companies.

Many people talk about PEG ratios – where they justify high valuations based assured returns of growth. Though that is a perfectly sensible way to invest, we don’t think we are equipped to assess growth accurately in the future. We rather buy our margin-of-safety through tangible and liquid assets and make sure we have enough of it. This is important for you as an investor to accept since we may not buy into extremely fast growing companies.

As of April 2008

Name	Sales	NP	Share Price	Mkt. Cap.	P/BV	P/E TTM
BSE_SENSEX	100	100		100		
Reliance Inds.	19.9	13.3	2637	17	6	26
O N G C	10.1	17.1	1016	9	4	13
Bharti Airtel	3.2	4.5	823	7	14	27
NTPC	5.8	7.7	190	7	3	20
DLF Ltd	0.2	0.5	649	5	11	61
Reliance Communi	2.3	2.7	530	5	5	34
St Bk of India	8.4	5.1	1683	5	2	17
TCS	2.7	4.1	1001	4	12	22
Infosys Tech.	2.8	5	1666	4	7	21
ICICI Bank	5.3	3.4	835	4	3	25
B H E L	3.1	2.7	1785	4	10	30
Larsen & Toubro	3.1	1.5	2776	4	13	43
ITC	2.2	3	211	3	8	26
H D F C	1.1	1.7	2487	3	7	37
Wipro	2.4	3.2	459	3	7	22
Hind. Unilever	2.4	1.9	232	2	36	30
Tata Steel	3.1	4.8	715	2	3	12
HDFC Bank	1.5	1.3	1396	2	5	34
Reliance Energy	1.0	0.9	1335	1	3	31
Satyam Computer	1.1	1.6	469	1	5	19
Jaiprakash Assoc	0.6	0.5	217	1	7	47
Grasim Inds.	1.5	1.6	2569	1	4	12
Hindalco Inds.	3.2	2.8	186	1	2	9
Tata Motors	4.8	2.1	618	1	3	12
Maruti Suzuki	2.6	1.7	760	1	3	12
Ranbaxy Labs.	0.7	0.7	480	1	37	29
Ambuja Cem.	1.0	1.3	113	1	4	15
Cipla	0.6	0.7	222	1	5	26
M & M	1.7	1.1	639	1	4	16
ACC	1.2	1.4	799	1	4	12

As of July 2008

Name	Sales	NP	Share Price	Mkt. Cap.	P/BV	P/E TTM
BSE_SENSEX	100	100		100		
Reliance Inds.	20.1	14.1	2099	16	4	20
O N G C	9.0	15.4	876	10	3	11
Bharti Airtel	3.9	5.7	716	7	7	22
NTPC	5.6	6.8	155	7	2	17
Infosys Tech.	2.3	4.1	1755	5	7	22
Reliance Communica	2.0	2.4	438	5	4	35
TCS	2.8	4.1	844	4	8	18
B H E L	2.9	2.6	1500	4	6	26
St Bk of India	8.8	6.2	1128	4	1	11
DLF Ltd	0.8	2.4	415	4	6	27
Larsen & Toubro	3.7	1.9	2380	4	7	33
ICICI Bank	6.0	3.8	601	4	1	16
ITC	2.1	2.9	171	3	5	21
Wipro	2.6	2.8	429	3	5	20
H D F C	1.3	2.2	2055	3	5	24
Tata Steel	3.0	4.2	640	3	2	10
Hind. Unilever	2.1	1.6	202	2	31	25
HDFC Bank	1.9	1.5	1000	2	5	27
Satyam Computer	1.2	1.6	462	2	4	18
Ranbaxy Labs.	0.7	0.5	538	1	8	40
Reliance Infrast	0.9	1	774	1	2	17
Cipla	0.6	0.6	208	1	5	23
Hindalco Inds.	2.9	2.6	138	1	1	6
Jaiprakash Assoc	0.6	0.6	153	1	5	30
Grasim Inds.	1.5	1.9	1693	1	2	7
Maruti Suzuki	2.7	1.6	550	1	2	9
Tata Motors	4.3	1.7	401	1	2	8
Ambuja Cem.	0.9	1	75	1	3	10
M & M	1.7	0.9	475	1	3	12
ACC	1.1	1.2	478	1	2	7

Buffett on Inflation

We have given a link <http://surefin.com/newsletter.htm> of a great note written by Warren Buffet on inflation and how it affects the equity investor. This is an excellent read, especially given the current inflationary trends around the world.

Quarterly Letter and Annual Letter

I hope to make a change in the communication we send out to you. From now on, I want to write three quarterly letters, which will be brief and have an outline on the how we are doing and then write an annual letter, which will be in much more detail. If any of you have a problem, please write in to me.

Warm regards,

Amitabh Singhi.

Portfolio Manager

Surefin Investments

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