

Cohesion MK Best Ideas

Investment Report

October 2020

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Accessing Superior Growth



We successfully transitioned to Cohesion MK Best Ideas on August 1st, amidst a volatile environment for global equities. This update shares a few thoughts on the Indian market, the investment approach and the positioning of Cohesion MK Best Ideas to take advantage of the opportunity that India presents.

Market Outlook

Global markets have shown a lot of resilience in the last few months compared to the sharp volatility and price correction seen in the early part of this year. However, recently, there has been some nervousness and declines from recent highs, driven by the uncertainty of the upcoming US elections, visible emergence of a second wave of the virus across the US and Europe, and the pullback in large US tech stocks following their substantial rise earlier in the year.

In-line with global markets, the Indian markets have remained resilient in their general direction over the last few months. Post a phased relaxation of the national and regional India lockdowns, economic activity too has picked up, with several key economic indicators back to almost pre-COVID levels

- Goods and Services Tax (GST) collections in September touched the highest level so far this fiscal year
- The Purchasing Managers Index (PMI) reached 56.8 in September, touching an 8-year high, supported by new orders and production, providing a clear indication of the prevailing direction of economic trends in manufacturing
- The unemployment rate has fallen significantly from its peak in May
- Auto sales momentum has picked up, with monthly wholesale data for auto equipment manufacturers now at pre-COVID-levels
- The surplus in India's current account balance increased further to USD 19.8bn (3.9% of GDP) in the quarter ended June 2020 from USD 0.6bn (0.1% of GDP) in the previous quarter and there is expectation of a slight current account surplus for FY21e. Forex reserves also touched a new high of USD 552bn

While globally the narrative to counter COVID-19 has been primarily liquidity and bailouts, the Indian Government has focused on a dramatically different course of action. India has used the pandemic to push through some major reforms in agriculture, labour, manufacturing, defense and corporate, among others. For instance, in the current monsoon session, the Indian Parliament passed two key bills relating to agriculture that address major structural issues for farmers and have dismantled state control over agriculture pricing in India to create a free market. The government has also introduced several measures to incentivise import substitution, create a strong export base and become self-reliant in a host of products and services, including in critical areas like pharmaceuticals.

India's strategy and action on the pandemic has also been quite robust. Despite the high absolute number of confirmed cases in India, this figure is small relative to its population size (1.4 billion people) and it has a recovery rate of more than 83%, which is much better than the global average. The mortality rate has consistently been half the global average (1.55% for India vs. 2.95% globally) and the number of cases / number of deaths per million people remains substantially lower in India than elsewhere.

While the narrative on economic activity, reforms, and healthcare response to COVID-19 all remain positive, we continue to remain cautiously optimistic on markets. There are several important events that can significantly alter the course of the markets over the next few months, with the US Elections and a second wave of COVID-19 across developed countries, along with possible policy responses to this, creating scope for volatility. In respect of this possible scenario, we will carefully monitor the overall macro environment, be measured in our portfolio execution, and combine this with strong and deep research on individual companies.

Investment Approach

The essence of our investment approach is to identify passionate entrepreneurs and companies with the right business models that can create substantial wealth for their investors through focused execution. We often patiently observe a sector for long periods and are happy to invest only once we see a clear template for wealth creation, with proper alignment of both the macro environment and bottom-up investment strategy. Pharma and telecommunications are two recent examples of sectors where the macro environment has turned favourable, where we have leveraged the network and deep sectoral understanding of our investment adviser, Madhu Kela, to identify high-quality investment opportunities with significant alpha creation potential.

We continue to be sector and size agnostic in our investment approach, preferring instead the maximisation of returns with the right risk profile, over a medium-term time frame, in-line with our investors' expectations.

A quick snapshot of some of our current portfolio holdings:

A pharma company (small cap): This company, which is one of our larger positions, has one of the best track records of wealth distribution to shareholders among all Indian pharma companies. It is also one of the few Indian companies to have successfully executed several M&A transactions and partnerships in an industry where inorganic growth is critically important. One of the strengths our investment adviser, Madhu Kela, has consistently demonstrated over his career is his ability to identify the right management team with the passion and ability to help a business meet its potential. The promoter of this business ('promoter', used throughout this document, is an Indian term used to describe the founding entrepreneur, or current controlling owner of the business) has created three public pharma companies, incubated several smaller entities, and successfully divested a lot of businesses in the past at best-in-class valuations. The promoter views business decisions with a very strict profitability lens and is happy to exit decisions where he thinks the risk-return paradigm is not favourable. The company is at the cusp of major value creation across all key business segments, the outcome of several years of investment and efforts, and we are very positive about the direction this company is taking.

A media broadcaster (mid cap): We recently initiated a position in one of India's top media broadcasters, with leading market share in four large Indian states. The company also has a strong internet streaming offering (OTT) and a large library of movies and TV shows and was one of the least-impacted companies from COVID-19 as people spent more time at home consuming their content. The company has a very strong balance sheet, huge cash reserves and a high payout ratio and we believe this sets the company up with solid foundations to continue its growth.

A telecoms company (large cap): One of our largest holdings, this company is also one of the most successful and admired telecommunications companies in India. After a decade long wait, the telecom sector in India has turned the corner for investment. It is a strong oligopoly, with a possible duopoly play, and has some of the lowest tariffs and strongest average revenue per user (ARPU), globally. It is now rising at a sharp pace, and in the aftermath of a major consolidation in the sector, this is one of the most exciting times to invest in the sector. Due to the emergence of working from home as a major theme in a post-COVID-19 world, there has been a massive surge in demand, for both mobile and fixed broadband, which presents a major tailwind for the company. Despite being a sector leader and having a credible execution track record of over two decades, the company is currently available at less than half the valuations of the key competitor, while arguably having a far superior customer profile. The stock has also corrected c35% from its peak, while the business continues to get stronger. Due to the quality of their assets, there are multiple strategic investment possibilities into the company ahead, which can act as a trigger for value unlocking.

Overall, we are very positive and excited about the prospects of all our investee companies, and we look forward to sharing more detailed insights about them over time.

Current Deployment Strategy

The new portfolio is in its nascent stages and whilst we are continually on the lookout for these standout opportunities, we are also acutely aware of the uncertainty of the path of the global pandemic and how this will influence the market.

Post the substantial falls in global stock markets in March, we have all witnessed a sharp rally across the board, driven by a benign liquidity environment and strong intervention from policy makers globally (both government and central banks) to prevent the recurrence of a collapse similar to the Global Financial Crisis. This has resulted in a sharp disconnect between the markets and broader economic activity.

We believe it is therefore prudent to build the equity exposure gradually and progressively into some of the more liquid names and market leaders that also represent a good investment thesis. Medium-term business growth continues to be a key driver for investment, however, we are also balancing it with relatively stronger market resilience and the ability to cope better with volatility in the near term.

We are also preparing to take advantage of any near-term volatility to gain access to other companies that we have earmarked for value creation. For the patient investor, we hope these will become available to us at more attractive prices as a result of temporary market setbacks. So, in summary, protecting capital and remaining highly opportunistic remains the key plan in the short term. Our objective is very much to target meaningful returns over the next 3-5 years and not to compromise this by having too short a time horizon.

Portfolio Position

The current strategy translates to a portfolio that, at the time of writing, is 60% in cash and 40% invested in the Indian market across 13 companies, of which 6 are large-cap companies (top 100 in India by market cap), 5 are mid-cap companies (next 150 in India) and 2 are small-cap companies (below top 250 by market cap).

Closing Thoughts...

The long-term goal is to have a portfolio of up to 20 standout companies, led by exceptional entrepreneurs, that in a number of cases will have the potential to benefit from Madhu's rich knowledge and diverse network. These will likely be a mix of proven sector leaders as well as unique, under-researched companies with massive growth potential over the next 3-5 years. Cohesion MK Best Ideas is currently in its early stages and will aim to deploy capital into these opportunities as they surface at attractive prices over time.

We continue to be incredibly excited about the current direction of the strategy and look forward to sharing further progress on execution, and more details on investee companies in subsequent communications.

I leave you with a beautiful closing thought:

"It is only the countless hours of toil every night, that bring us the warm glow of happiness and light".

Focus and perseverance rarely go unrewarded. So it is in markets, so it is in life...

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