

Looking out for the babies that get thrown out along with the bathwater.

Dear Investor,

It is very likely that you have heard of the phrase about identifying “undiscovered rough gems” which the investor or portfolio manager would identify before they turn into glimmering diamonds. The implication is that it is the skill of the investor/portfolio manager in identifying such rough stones before they turn into diamonds which leads to capital appreciation or a profitable investment program.

The stock market is nothing if not a melting pot of different approaches. Dozens of approaches work well in the stock market. The important thing is to remain consistent, even in the face of temporary underperformance. **Our approach is to look for opportunities when “fully polished gems” get misplaced (ignored or neglected), leading to them being available at acceptable, or sometimes very attractive prices.**

This happens more often than you think.

In this newsletter, we shall talk of several such examples over the past many years, as well as discuss a couple of recent examples from our own portfolio.

Time period	Stocks that were neglected	Reasons
1999-2000	Nestle, L&T, Bharat Electronics, SBI	The “hot sectors” at this time were the “new economy” stocks in IT, Telecom and Media. All companies considered as “old economy” were viewed with disdain.
2007	P&G, Hindustan Unilever, Hero Motocorp, Eicher, Page Industries, Maruti	The demand was for infrastructure, real estate and power sectors only. Stocks in the FMCG sector were derided and therefore neglected.
2017	Infosys	Infosys was available at a PE multiple of 12.5 but was shunned because of very temporary reasons.
2019-20	State Bank of India	Derided as a “Sarkari bank”, SBI was ignored despite trading at a Price to Book value of 0.8, and despite showing improvement in market share across different business verticals.

Remember the derisive memes about ITC just over a year ago?

We have held ITC as one of the top positions in our portfolio for sometime now. We remember the memes ridiculing the lacklustre movement in ITC’s stock, but we continued to hold on. The sheer strength of the company and the stark contrast between the fundamentals and perception around the stock were the primary reasons for our confidence.

Particulars	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21
Revenues (Rs. Cr)	27309.78	32540.46	36288.03	40173.26	40728.40	44538.14	45285.62	50533.42	52004.62	51906.50
EBIT (Rs. Cr)	9270.19	11213.78	13080.72	14453.01	14937.20	16075.35	17524.12	19221.22	20115.95	17996.14
Net profits (Rs. Cr)	6322.39	7693.58	8990.62	9765.63	9500.86	10477.23	11492.68	12835.90	15592.78	13382.88
Debt to Equity (x)	0.01	0.00	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.00
ROCE(%)	51.52	52.61	51.77	48.72	39.99	36.03	35.40	34.42	32.33	28.65
Free cash flow (Rs. Cr)	4027.43	4807.53	5224.02	7524.74	7953.60	8552.79	11587.14	10587.86	15092.68	12778.93
Market Capitalization (Rs. Cr)	177360.40	244244.64	280708.19	260864.45	263988.40	340673.83	312308.04	363712.66	211425.84	268947.28
Market Cap / Revenues (x)	6.49	7.51	7.74	6.49	6.48	7.65	6.90	7.20	4.07	5.18
Price / Earnings multiple (x)	28.34	32.10	31.57	27.00	28.25	33.11	27.71	28.88	13.81	20.43

Source: ACE Equity

First, let's look at the strengths of the company.

- A company with a nationwide distribution reach
- A company that was making a mark in the FMCG space with successful product introductions, and improving profitability
- A consistently profitable company
- A zero-debt balance sheet
- Consistent generation of free cash flow
- High ESG rating
- Highly liquid stock

There were other announcements from the company that were reassuring. In 2021 and early 2022 (when the stock was at the peak of its unpopularity), the company was already the No.2 FMCG company in the country, with the following improvements in fundamentals:

- Steadily improving profitability in the FMCG business
- Many new product introductions, several of which were successful.
- An announcement by the company that future expansions in the hotel business would primarily be on a management contract basis, and that the company was open to the idea of hiving off the hotel division
- Continued good profitability in the agribusiness and steady growth in the paper and packaging business.

Now, let's remember the various memes about ITC that were doing the rounds about a year and a half ago. The stock was subjected to such ridicule simply because it had "underperformed" for a few years. The "market" does tend to forget that "underperformance" has affected hundreds of stocks, including all the blue chips and favourites of today.

The ITC stock was trading in early 2021 at a valuation of about fourteen times earnings and 14 times Free cash flow. Other companies in the same FMCG space, even ones that had far weaker financials than ITC, were trading at more than twice the valuation of ITC.

Our view is this: When we get strong, competitive companies like this when they are ridiculed and disliked, and therefore available at a very acceptable price, there is a clear case of a perception being far too negative compared to the reality. That is usually a worthwhile entry point, when we are confident that the underlying company has lost none of its competitiveness.

We are happy and gratified that our trust in ITC has been justified. We recently entered another strong company after a significant price correction. We think it fits in well with our scheme of things.

Divi's Laboratories – a new entrant in the Core Value PMS portfolio

We have been long-term admirers of Divi's, but stayed away from the stock for the previous few years because the stock, in our opinion, became expensive.

But after the recent 50% price correction, the stock has come into the valuation zone that we find acceptable.

There are enough reasons to conclude that Divi's has lost none of its competitiveness, and that the slowdown in the profits is a temporary issue.

Track record of the company

Particulars	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22
Revenues (Rs. Cr)	2189.65	2602.74	3159.64	3873.80	4139.23	4004.93	5101.89	5584.05	7032.07	9075.73
EBIT (Rs. Cr)	783.83	993.87	1074.96	1397.59	1398.70	1233.70	1859.75	1826.60	2668.14	3685.50
Net Profits (Rs. Cr)	602.01	773.34	851.52	1125.78	1060.42	877.01	1352.74	1376.54	1984.29	2960.45
Debt to Equity (x)	0.01	0.01	0.01	0.01	0.01	0.01	0.02	0.00	0.00	0.00
ROCE (%)	33.21	36.04	33.06	35.57	28.75	21.68	28.50	25.36	32.07	35.06
Net profit margin (%)	27.87	30.32	27.10	29.59	25.82	22.41	27.15	25.23	28.38	32.94
Free cash flow (Rs. Cr)	152.83	320.61	554.75	693.19	769.91	526.51	288.73	161.27	1065.61	1188.31

Source: ACE Equity

Divi's Laboratories Ltd. - 5-year Price Chart

Source: ACE Equity

The primary reason for the stock's correction is that the last two quarterly numbers were not so enticing as the corresponding two quarters of the previous year. In the previous year (FY 2021-22), the company had extraordinary profits thanks to the anti-viral medications that were very much in demand during the Covid-19 pandemic. In comparison, the September and December quarterly numbers of Divi's for FY 2022-23 seem paler. The important point, however, is that we are confident that the company has lost none of its long term competitive advantage.

Divi's has a great track record in collaborating with the pharma innovators (the company NEVER goes against the patent of any company), and their skill is primarily in lower cost and high-quality manufacturing, which is in the interest of the innovator company. This makes it an ideal candidate for Active Pharmaceutical Ingredients (API) manufacturing, and this unflinching focus of the company on this has made it a great company.

The problem over the last couple of years was that the stock had, in our opinion, risen to levels beyond what made us comfortable. But the recent price correction (please see chart above) has eased that tension.

We may have to wait for some time before the stock gives us the kind of returns that we would be satisfied with. But waiting with a strong company makes it a wait without any major tension, and the satisfaction of not paying an exorbitant price eases the tension a little more.

We shall remain faithful to this approach – that of buying strong businesses when they are ignored, or unpopular.

Warm regards

Yours sincerely,

E A Sundaram

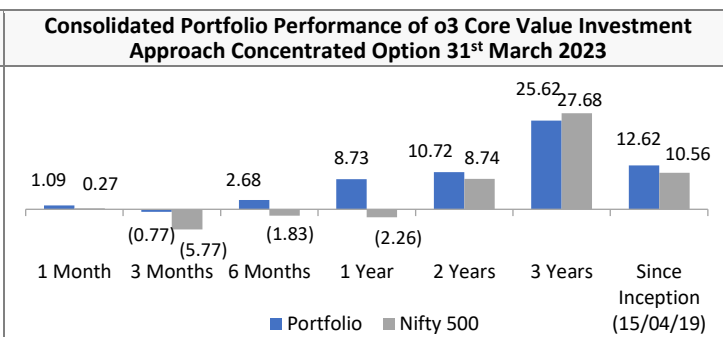
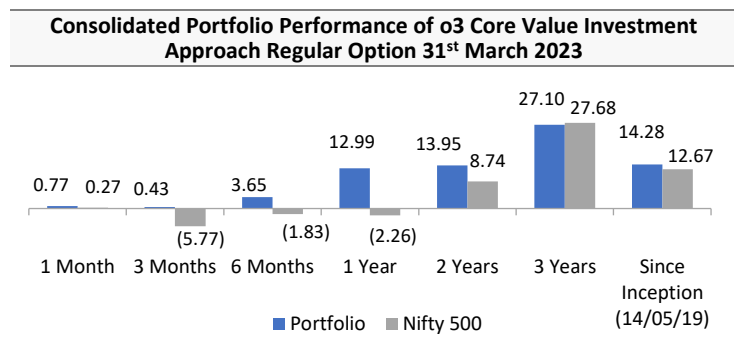
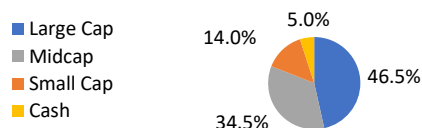
Chief Investment Officer and Portfolio Manager

"It is far better to buy a wonderful company at a fair price, than a fair company at a wonderful price." - Warren Buffett

Investment Objective: The investment objective is to achieve capital appreciation through investment in a diversified portfolio of high-quality companies, purchased at reasonable valuation.

o3 Core Value Investment Approach			Regular Model Portfolio Data	
Name	GICS Sector	Weight	Underweight	Overweight
ITC Ltd	Consumer Staples	6.00%		9.47%
HDFC Ltd	Financials	5.31%		6.02%
Bosch Ltd	Consumer Discretionary	4.71%		6.00%
Indraprastha Gas Ltd	Utilities	4.69%		3.70%
Bharat Dynamics Ltd	Industrials	3.88%		0.66%
Divis Laboratories Ltd	Health Care	3.87%		0.43%
Titan Company Ltd	Consumer Discretionary	3.84%		
Asian Paints Ltd	Materials	3.76%		
MCX	Financials	3.57%		
Thermax Ltd	Industrials	3.50%		
43.13%			Real Estate	(0.77%)
			Communication Services	(2.62%)
			Materials	(6.40%)
			Energy	(8.85%)
			Financials	(12.63%)

Performance Description	Regular	Concentrated	Nifty 500	Regular Model Portfolio Composition	
Largest Monthly Gain	12.51	11.41	14.52	Weighted Average ROCE	24.80%
Largest Monthly Loss	(20.53)	(19.19)	(24.25)	Portfolio PE (1 year forward PE, based on FY24)	28.49
Beta of Portfolio	0.76	0.73		Portfolio Dividend Yield	1.60%
Standard Deviation (Annualised)	16.34	15.94		Average Age of companies	58 Years
Correlation	0.93	0.92		Overlap with Nifty 500	21.04%
				Total Debt/Equity	0.42
				Debt/Equity (Excluding Financial Stocks)	0.09
				Sales Growth	18.92%
				EPS Growth (FY24 over FY22)	22.32%



- Benchmark is Nifty 500, the portfolio is spread across different market capitalization, hence Nifty 500 is chosen as benchmark
- Since inception date stated is considered to be the date on which the first active client investment was made under the investment approach
- Industry Classification as recommended by AMFI, all the above data are as of 31st March 2023

Disclaimer: Performance depicted is based on all the client portfolios existing as on such date, using Time Weighted Rate of Return (TWRR) of each client for the overall investment approach. Past performance is no guarantee of future returns. The above portfolio performance is after charging of expenses. The performance related information provided here is not verified by SEBI nor has SEBI certified the accuracy or adequacy of the contents of this Document. Beta, Standard Deviation & Correlation are from Since Inception period.

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