

“The best time to get involved with cyclicals is when the economy is at its weakest, earnings are at their lowest, and public sentiment is at its bleakest” - Peter Lynch

Dear Investor,

We have recently added a cyclical stock in your portfolio – Maruti Suzuki India Ltd (MSIL). This may appear counter to the general sentiment that was prevalent about the company but is very consistent with the approach that we follow, that of buying a strong business when it is not very popular.

The dominant feedback about MSIL during the last year is that the company’s margins have come down significantly during the last few years, and that they have not been successful in Utility Vehicles (UVs), and therefore their chances of improving the margins in future are bleak.

Permit us to explain the logic of why we chose MSIL in your portfolio.

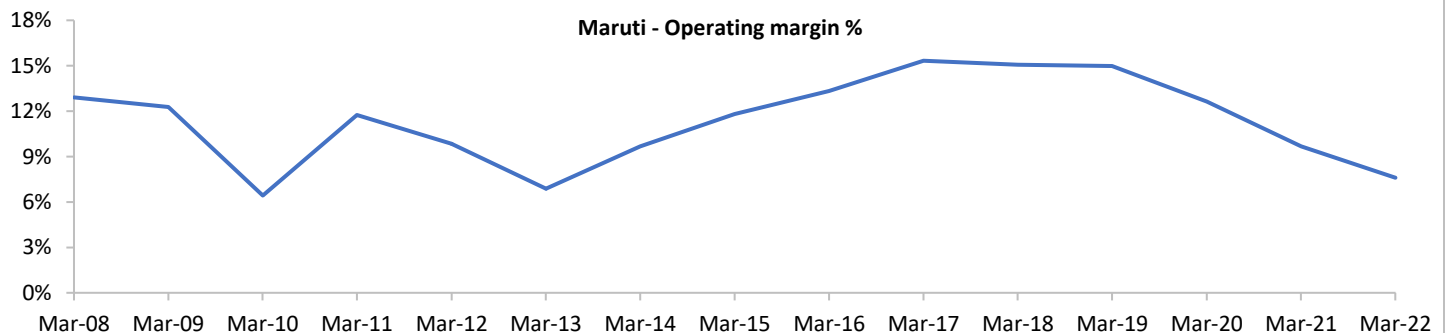
Broadly, the chain of thoughts goes like this:

- a) The operating profit margins of Maruti have taken a hit in the last few years
- b) Maruti has in the past seen a strong correlation between volume growth in vehicles sold and operating profit margins; volume growth has been negative in the last few years, leading us to believe that with a revival in volume growth, we shall see a revival in profit margins
- c) There are strong reasons to expect a revival in volume growth in Maruti
- d) With the exception of the category of UVs, the company’s market share in the categories in which they compete has been enhanced over the years, and there are reasons to believe that this would also be corrected in the foreseeable future
- e) Many of the materials for which the costs had risen sharply (as a result of the Ukraine-Russia war) have shown signs of fall in the last few months, and this should help improve margins
- f) The company has a strong set of financials, a strong distribution and service network, and its stock is available at a discount to its 10-year average valuation.

Margins of MSIL

The operating profit margins of MSIL have taken a turn for the worse in the last few years (See Chart 1). From 15.33% in FY 2016-17, it has come down to 7.60% in FY 2021-22, and this has caused consternation in many circles.

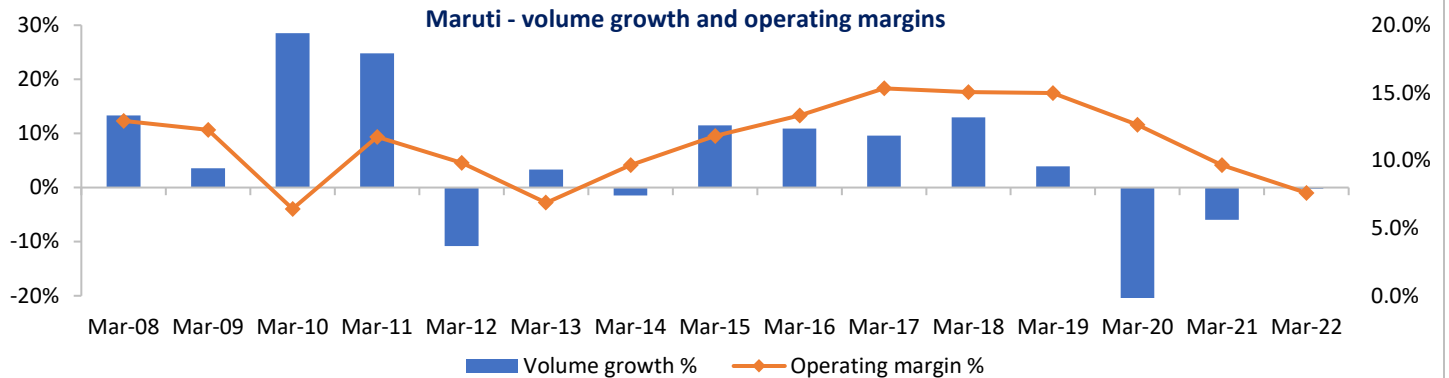
Chart 1 – Operating profit margins of MSIL



Source: ACE Equity

(b) MSIL's margins are correlated to volume growth, and volume growth has been below par in the last few years

Chart 2 – Maruti's volume growth in vehicles sold and operating profit margins



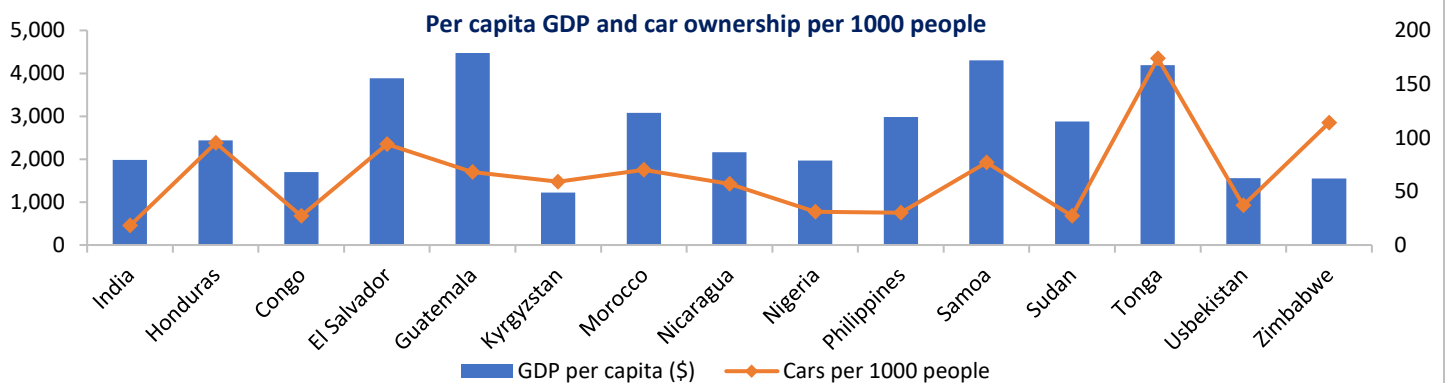
Sources: (1) Company data (2) ACE Equity

The Chart 2 provides data on Maruti's volume growth and operating margins. Please observe that in the period after the Lehman crisis in 2008, and in the slump period between 2012-2015, and after March 2019 (and till March 2022), the company's volume growth has been on the wane. Especially in the last three years, the company's volume growth has been negative. It can also be observed that with robust volume growth, the operating margins improve because of the benefits of operating leverage.

The best time to buy a strong cyclical stock is after a slump in volume growth and a slump in margins (provided there are reasons to believe that things would improve).

(c) Why do we believe that car sales would show better volume growth in India in the foreseeable future?

Chart 3 – Car ownership in various countries with similar per-capita GDP compared to India



Sources: (1) Our world in data (2) Worldometer

The data in Chart 3 is quite interesting. We have not compared India with countries such as USA or Germany. Most of these countries in the chart have per capita GDP similar to, or lower than that of India, but they have car ownership that is higher than what is seen in India. For instance, India (with a per capita GDP of \$1980) has 18 cars for every 1000 people, while Nigeria (with a per capita GDP of \$1969) has 31 cars per 1000 people. Nicaragua (per capita GDP of \$2164) and Zimbabwe (per capita GDP of \$1548) have 57 and 114 cars respectively for 1000 people.

We find it incredible especially when we see bullish reports about the prospects of real estate, or other consumer discretionary spending where Indians are supposed to “upgrade” their purchases, but also witness less sanguine reports about car ownership in India. Are the same Indians who are expected to upgrade on all other consumer products, expected to remain muted when it comes to their first car purchase?

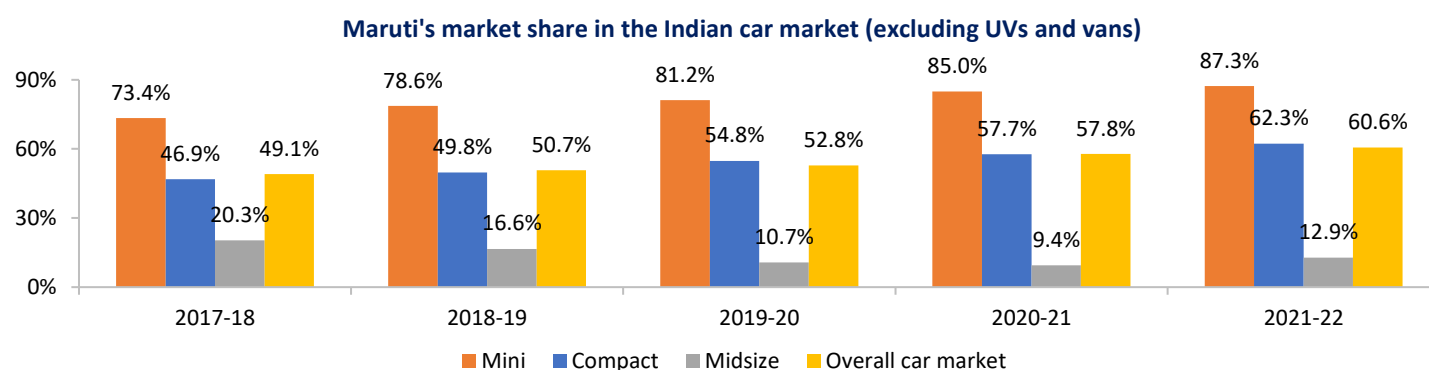
Here are a few other countries which can be described as one step higher (in per capita GDP terms) compared to the countries specified in Chart 3. These are still not “rich” countries, but the car ownership is much higher. This is the general direction we expect India’s car ownership pattern will traverse when the per capita GDP rises over the next decade or so.

Country	GDP per capita (\$)	Cars per 1000 people
Tonga	4,173	174
Bolivia	3,351	68
Cape Verde	3,298	101
Peru	6,723	73
Paraguay	5776	54
South Africa	6,120	165
Tunisia	3,494	125
Ukraine	2,521	173
Turkmenistan	6,587	106

Sources: (1) Our world in data (2) Worldometer

(d) Maruti can be expected to be the first choice for a bulk of first time car buyers

Chart 4 – MSIL’s market share in the Indian car market



Sources: (1) Company sources (2) SIAM

Note: Mini : < 3600 mm length
 Compact : 3600 – 4000 mm length
 Super-compact : 4000 - 4250 mm length
 Mid-size : 4250 – 4500 mm length
 Executive : 4500 – 4700 mm length
 Premium : 4700 – 5000 mm length

In passenger cars (excluding utility vehicles and vans), Maruti is a very strong competitor in the Mini and Compact categories and a decent competitor in the Mid-size category. It has no presence in the Super-compact, Executive or Premium categories. For instance, in the Mini category, the company’s market share over the last 5 years (2018-2022) has improved from 73.39% to 87.25%. In the Compact segment, Maruti’s market share has improved from 46.87% in 2018 to 62.33% in 2022. In the mid-size category, the market share slipped from 20.31% in 2018 to 10.71% in 2020 but has since improved to 12.86% in 2022.

There is a very strong reason to believe that for a first-time car buyer in India, who will most likely buy the sub-Rs.10 lakh category car, and in Tier II and III centres, Maruti will be the first choice. India, that has a car ownership proportion of just about 20 cars per 1000 people, is estimated to have overall vehicle ownership of 225 per 1000 people. We think that

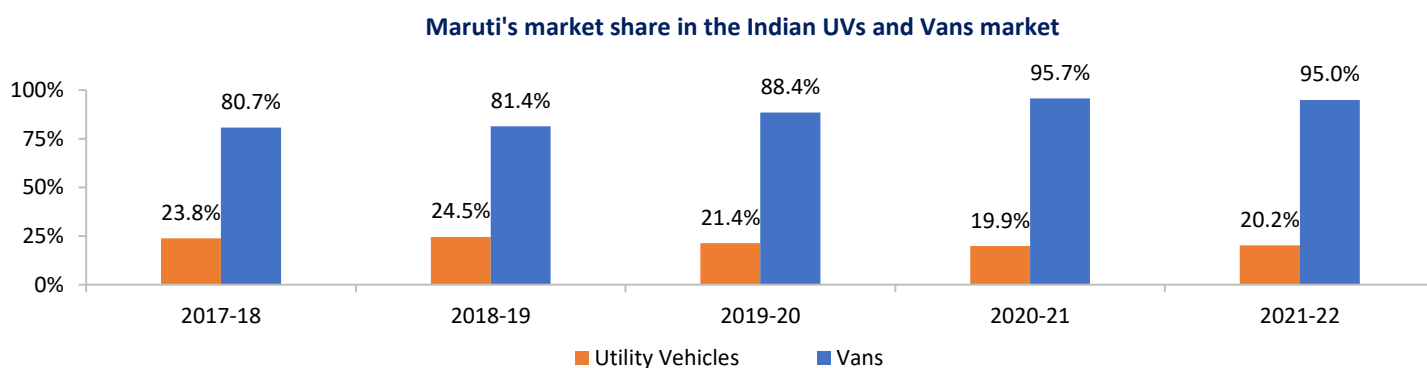
this predominantly 2-wheeler owning population, when upgrading to a car ownership, is unlikely to begin with an executive or premium category car.

MSIL has the strongest distribution network and service network and is amongst the cheapest when it comes to total cost of car ownership.

It is also pertinent to note that in the mini and micro car categories, several other contenders in that space like GM India, Nissan and Datsun, and the Tata Nano have either completely given up on that category or are now having significantly less presence.

(e) MSIL's share in Utility Vehicle (UVs) is not as weak as is made out to be

Chart 6 – MSIL's market share in the Indian UV and Vans market



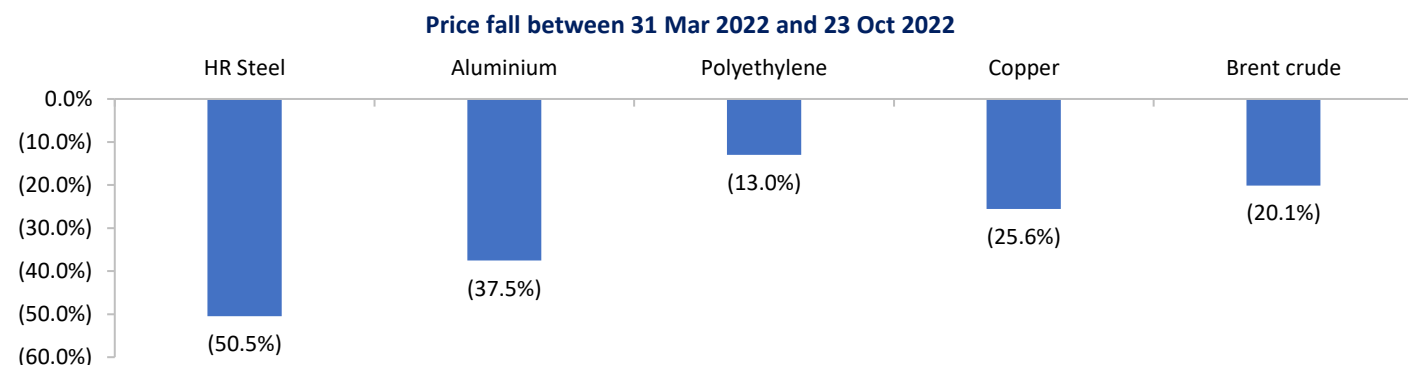
Sources: (1) Company sources (2) SIAM

As can be seen from the Chart 6, MSIL has maintained a market share of around 20% in the faster-growing UV market.

While it is true that MSIL did not have a very exciting product in the UV market until now (compared to, say a Creta that Hyundai introduced), we are optimistic regarding the prospects of their new launch “Grand Vitara” looking at the reviews that the car has received, as well as the encouraging booking numbers. Very recently, in its interaction with analysts, the management of MSIL indicated that the new car has received more than 75000 confirmed bookings, and that 30% of the outstanding bookings are for new models launched.

The pressures of chip shortage, as well as the pressures of raw material prices, are easing

Chart 7 – Changes in costs of major raw materials over the last 6 months



Source: www.tradingeconomics.com

After the war broke out in Ukraine, there was a very sharp rise in almost all commodities. However, over the last few months, there has been a trend of easing. The Chart 7 above shows that steel costs have fallen more than 50% between March and October 2022. Aluminium prices have fallen 37.5%, Copper prices by 25.5%, and polyethylene prices by 13% during the same period.

2021 saw the automobile industry badly affected by the shortage of semiconductor chips, but this situation has since improved.

Looking at all of these factors, we are confident that the margin profile of MSIL will improve over the next few years.

Financial track record

	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22
Net sales (Rs. Cr)	44,304.4	44,541.8	50,801.4	57,589.0	68,085.0	79,809.4	86,068.5	75,660.0	70,372.0	88,329.8
EBIT (Rs. Cr)	2,314.4	3,436.4	5,656.8	7,024.7	8,674.3	9,179.5	7,849.7	11,891.9	14,320.6	17,156.4
Net profit (Rs. Cr)	2,448.6	2,831.6	3,790.6	5,378.3	7,338.2	7,717.4	7,494.9	5,559.2	4,220.1	3,717.6
Earnings per share (Rs)	81.8	94.5	126.1	182.0	248.7	260.9	253.3	187.9	145.3	128.5
Return on Capital Employed (%)	18.4%	18.7%	22.2%	27.3%	29.7%	28.5%	23.5%	14.8%	10.3%	8.6%
Free cash flow (Rs. Cr)	(2,054.6)	2,510.9	3,808.7	22,276.2	8,076.9	9,083.1	3,914.0	3,500.7	10,838.9	3,329.8
EBIT margin (%)	7.2%	8.6%	10.0%	12.8%	14.3%	13.8%	11.9%	9.0%	7.2%	5.2%
Net profit margin (%)	5.4%	6.2%	7.3%	9.1%	10.4%	9.4%	8.4%	7.0%	5.8%	4.1%

Source: ACE Equity

MSIL has generated free cash flow in 9 out of the previous 10 years and has had an average Return on Capital Employed (RoCE) of 20.21% for the last decade, although its RoCE has dipped in the last 3 years (one of the reasons we think that the stock should be purchased now).

The management has changed course when they realized their mistake

Their decision a few years ago to get out of diesel vehicles raised eyebrows, but the management has made amends by aggressively pushing more fuel efficient and environmentally friendly vehicles such as CNG and smart hybrid vehicles. The smart hybrid vehicles such as the Grand Vitara are expected to give better mileage compared to diesel cars and are in the same price bracket. Let us not forget that Suzuki and Toyota, a company with which Maruti has a strong tie-up, are leaders of smart hybrid car technology. We are confident that until electric cars become highly prevalent in India, the route for Maruti is through smart hybrid and CNG technologies.

Encouraging September quarter results

Just as we were writing this newsletter, the company had announced its quarterly results for the September 2022 quarter, and they are very encouraging.

- Revenues for the quarter are at Rs.29930 crores, a rise of 13% q-o-q and 45.7% y-o-y
- EBITDA margin at 9.3% is higher by 2.1% q-o-q and 5.10% y-o-y
- Profits after tax are at Rs.2060 crores, up 103.5% q-o-q and 333.7% y-o-y

The company has reiterated its market share target of 50%, compared to 42.9% it achieved in FY 2022.

Conclusion

Our bet is on a company with a dominant market share (and expected to remain so), purchased when the margin profile has slipped because of cyclical reasons, but where there are strong reasons to believe that these margins would improve along with volumes over the next few years, and available at a 28% discount to its 10-year average valuations.

Warm regards

Yours sincerely,

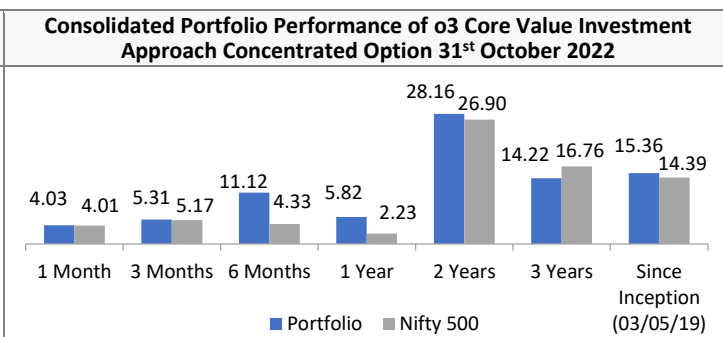
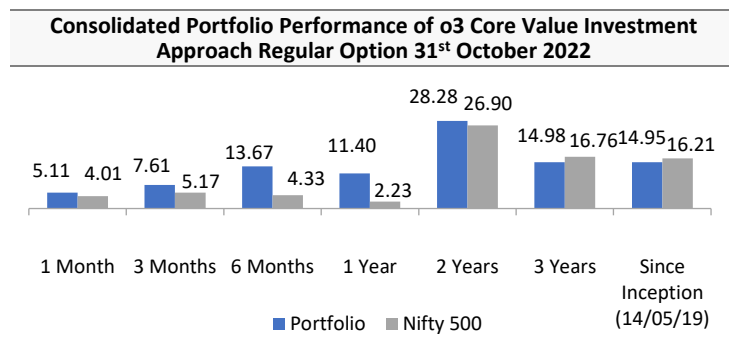
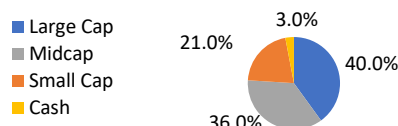
E A Sundaram

Chief Investment Officer and Portfolio Manager

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	Consumer Staples	6.94%		
Indraprastha Gas Ltd	Utilities	5.20%		
HDFC Ltd	Financials	4.91%		
Bosch Ltd	Consumer Discretionary	4.30%		
Asian Paints Ltd	Materials	4.20%		
Cummins India	Industrials	4.18%		
Titan Company Ltd	Consumer Discretionary	4.01%		
Larsen & Toubro Ltd	Industrials	3.76%		
Sun Pharmaceutical	Health Care	3.60%		
Maruti Suzuki India Ltd	Consumer Discretionary	3.43%		
44.53%				
	Industrials			12.38%
	Consumer Discretionary			10.45%
	Health Care			5.93%
	Information Technology			3.89%
	Consumer Staples			1.42%
	Utilities			0.24%
	Real Estate		(0.79%)	
	Communication Services		(2.86%)	
	Energy		(9.04%)	
	Materials		(9.66%)	
	Financials		(14.95%)	

Performance Description	Regular	Concentrated	Nifty 500	Regular Model Portfolio Composition	
Largest Monthly Gain	12.51	11.41	14.52	Weighted Average ROCE	23.76%
Largest Monthly Loss	(20.53)	(19.19)	(24.25)	Portfolio PE (1 year forward PE, based on FY24)	26.87
Beta of Portfolio	0.76	0.74		Portfolio Dividend Yield	2.05%
Standard Deviation (Annualised)	17.04	16.61		Average Age of companies	59 Years
Correlation	0.93	0.92		Overlap with Nifty 500	18.88%
				Total Debt/Equity	0.42
				Debt/Equity (Excluding Financial Stocks)	0.10
				Sales Growth	19.70%
				EPS Growth (FY24 over FY22)	20.50%



- 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 October 2022

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 and then computing arithmetic average 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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