

Investment Framework: Durable Businesses, Able Managers, Superior & Sustainable ROEs

(For Vinit Sambre, and DSP Small Cap Fund and DSP Mid Cap Fund)

March 2019

“Investment is most intelligent when it is most businesslike” - Benjamin Graham

“It will be difficult for a lay man to pick a stock which would give him the top returns; but if one were to ask him about good business, in most probability he would say it is the one which has long durability and would give him the superior return on the capital invested, much higher than bank FD for the risk he is assuming. **This is exactly where the genesis of good investment lies.**” – Vinit Sambre

Investment success lies in the ability to identify sustainable and durable businesses run by able managers with ability to generate superior ROEs (or ROCEs) over long periods of time.

Why ROCE or ROE? Put simply, ROCE (return on the capital employed)* is the profit generated during the year divided by the total capital employed by the company. A higher ROCE means higher profit in the hands of the investor per unit of capital employed. ROCE is an important metric to focus on versus only considering profits a company is churning out each year, **because ROCE shows how the company manages its money even taking into account its previous years' savings** (retained earnings). Further, if the company is able to reinvest the incremental profit back into the business and generate similar or better ROCE it could potentially lead to huge amount of wealth creation. On the contrary if the company consistently does not generate ROCE which is in excess of returns from safer alternatives (such as fixed deposits), the capital employed by the firm is NOT generating appropriate returns and is better off getting re-deployed elsewhere.

ROCE is like the return on fixed deposits; only difference being the number is not static, which makes the investment journey unpredictable yet exciting. **The success really lies in the ability to identify businesses which could probably generate superior ROCEs on a sustainable basis.** This involves the element of predictability, and the better one is at predicting the higher the chances of success. This is true for companies across market capitalizations. It's a bit more challenging to identify such companies in the small and mid cap space due to the nascent nature of the businesses, the lack of prior history and limited predictive power.

DSP's Style for the Small cap and Mid cap Arena:

Small cap and Mid cap stocks by nature have the potential to grow at exponential rates but are also highly volatile. Mid and small cap stocks are more susceptible to economic cycles than their large cap counterparts – stocks in these categories are less likely to weather an economic downturn than large, well-established businesses. They are generally under researched and under owned. These companies require a **long-term perspective** as value creation takes time. The small cap category demands intensive research to identify stocks and constant vigilance throughout the journey to 1) build conviction on the thesis and the value proposition, 2) increase exposure or even eliminate, if required.

We aim to pick management teams that would generate considerable alpha over the long term. Hence, investors with a long-term appetite and the ability to stomach volatility should invest and continue to remain invested in these strategies.

To create long term wealth for our investors in these categories we follow **a simple investment philosophy of buying and holding companies which would potentially create value over time and eliminate companies which would detract value.**

*We have used ROE (Return of Equity) as one of the metrics to evaluate stocks under the investment framework. ROE considers return only on Equity capital, excluding debt from total investments.

What companies do we buy?

What do we consider when we select which companies to invest in? We look at three broad parameters viz. **business, management and valuation**, which we discuss below in detail:

Business model. We invest in simple businesses (focused mono-line businesses or few complimentary businesses) with good predictability and high growth potential. We look at the following factors while researching the investee companies:

1. What are the business's competitive advantages? (Is it a simple and niche business? Has it maintained market dominance and remained ahead of its competition? Is its market position sustainable? Is it an innovator?)
2. Is the business in a large and high growth sector? Is the company well positioned to capture growth (Maintain and grow market share)? Can the company scale and grow and in what time frame?
3. Does the business generate or have the potential to generate positive and predictable cash flows and superior ROE? How capital intensive is the business (both fixed and working capital)?
4. Is the business at the cusp of a turnaround, where ROEs / other financial metrics are slated to move up in the foreseeable future?

Once we have broader industry conviction and have evaluated company specific factors (our process includes having detailed due diligence conversations with competitors, vendors, customers, auditors, ex-employees, plant managers to source information and also validate information provided by the company management), we dig deep into the company financials. We evaluate the company's historical financials for the last 5 to 10 years to understand the company's cash flows, cyclicalities of revenues and profits, strength of balance sheet, working capital requirements. We also aim to police for any abnormalities within the financials. We typically steer away from companies that have had unusual and too many related party transactions which we consider to be a red flag indicating potential source of leakage of funds from the business. We try to avoid companies with complex shareholding structures, with many subsidiaries or associate companies as these obscure entities are frequently used to avoid tax or siphon off cash.

We believe good companies pass the threshold on below financial metrics which we focus on during our evaluation.

Metrics for non-financial services businesses:

Metric	Threshold	Importance	Rationale
3 Yr. Avg. ROE	>16%	High	Long-term consistency is very important. 16% provides a fair margin over the risk free rate and adequately covers for the risk undertaken in the business.
5 Yr. Avg. EBITDA Growth	>13%	High	Growth higher than nominal GDP growth ensures outperformance over index.
5 Yr. Avg. PAT Growth	>13%	High	
Margin Increase: EBITDA Growth > Sales Growth	>1	High	Indicates operating efficiency and operating leverage potential.
Tax Rate	>20%	High	Lowers risk of accounting misrepresentation. Tax payment is one indicator of clean accounting.
Earnings per share (EPS) Growth Variability	<100%	Low	Indicator of stability of earnings. Helps to size positions.
Payout Ratio	>15%	Low	Indicator of cash generation in the business and profit sharing mindset of the management.
Net Debt/EBITDA	<3x	High	Lower ratio depicts less leverage indicating strength of the business and makes business less vulnerable during economic downturns.
Valuation	High ROE justifies higher P/E (Trailing 12M)	High	Will pay higher valuations for businesses with high ROE provided other metrics are also strong.

Metric	Threshold	Importance	Rationale
Free Cash Flow Yield	Positive	High	Explains quality of operating earnings especially in the context of working capital and capex.
Receivable days variability	<30 days	High	Lower variability (not the absolute days) in receivable days suggests strong bargaining power of the business.
Inventory days variability	<30 days	High	Lower variability suggests lower cyclical of business.
Payable days variability	<30 days	High	Lower variability indicates bargaining power of the management and reduces the risk of high debt disguised as payable.

Metrics for financial services business:

Metric	Threshold	Importance
3 Yr. Avg. ROE	>16%	High
Tax Rate	>20%	High
Gross NPA	<2%	High
5 Yr. Avg. PAT Growth	>13%	High
EPS Growth Variability	<100%	Low

Statistics at aggregate level for both funds on the framework criteria is as follows:

Metric	Threshold	DSP Small Cap Fund	Top 10 Stocks (Weight: ~32%)	DSP Mid Cap Fund	Top 10 Stocks (Weight: ~35%)
3 Yr. Avg. ROE (All companies)	>16%	16.4%	15.9%	17.3%	17.3%
5 Yr. Avg. PAT Growth (All companies)	>13%	17.6%	22.0%	19.5%#	19.0%
5 Yr. Avg. EBITDA Growth (Ex-financials)	>13%	14.6%	15.2%	13.9%	18.5%
Margin Increase: EBITDA Growth > Sales Growth (Ex-financials)	>1	1.3	1.3	1.3	2.0
Tax Rate (All companies)	>20%	28.6%	29.3%	27.6%	29.2%
Earnings per share (EPS) Growth Variability (All companies)	<100%	57.7%*	33.8%	33.4%~	30.2%~
Payout Ratio (Ex-financials)	>15%	16.5%	12.0%	23.9%	24.7%
Receivable days variability (Ex-financials)	<30 days	10.6 days	5.5 days	8.1 days	6.7 days
Inventory days variability (Ex-financials)	<30 days	8.1 days	6.3 days	9.9 days	7.6 days
Payable days variability (Ex-financials)	<30 days	7.4 days	4.7 days	8.9 days	9.5 days
Net Debt/EBITDA (Ex-financials)^	<3x	1.9x	2.2x	2.9x	1.2x
Valuation (Ex-financials)	High ROE justifies higher P/E (Trailing 12M)	21.3x	24.3x	30.3x	33.5x
Free Cash Flow Yield (Ex-financials)	Positive	0.09	0.34	0.86	1.31

Source: Factset. Portfolio considered at a point in time in end September 2018

#Excluding Sterlite Technologies (-1231.3%)

*Excluding Varroc Engineering (1428.9%), Sterlite Technologies (2743.9%), Galaxy Surfactants (13335.9%)

~Excluding Sterlite Technologies (2743.9%)

^Negative EBITDA companies excluded (as it would artificially lower Net Debt/EBITDA)

Credible and capable management team. **Credibility** is a matter of trust and ethics. **Capability** is the ability to drive business growth. These are subjective factors that go beyond traditional parameters such as vintage, qualifications, etc. Individual judgment plays a key role in evaluating management. For small cap companies, assessment of management is difficult, as the information availability is limited. However, management review is crucial as they are often the force driving growth. Some of the key parameters / attributes which we assess are:

- **Passion and ownership.** A high degree of management passion allows the company to remain ahead in fiercely competitive environments. High promoter ownership is one factor which could ensure high involvement and “skin in the game” which aligns shareholder and management goals.
- **Past track record.** Historical track record of management’s projections and degree to which they have been met. We typically avoid companies where management has consistently not met their guidance / projections. We also assess how management has acted / performed during adverse business cycles.
- **Prudent capital allocation.** We favor management who have a proven track record of prudent capital allocation. Prudent capital allocation ultimately drives ROE which is a key factor in long term future wealth creation.

Valuation. Finally, we combine our assessment of the strength of the business and quality of the management team to determine a **reasonable valuation** for our investee companies. We do not look at valuations in isolation; but in conjunction with the growth, return ratios, management quality, earnings stability, cyclicalities, optional drivers, etc. The higher the consistency in growth and ROE, the higher multiple a business can command.

When good companies that fall within our framework start trading at expensive valuations (calendar year 2017 was a prime example), we may invest in companies on the borderline of our investment framework due to valuation comfort. This may cause the quality of the portfolio to become diluted and also often lengthens the tail of the overall portfolio. Furthermore, during raging bull markets increasing relative valuations make stocks “hyper” expensive, rendering it difficult to find strong businesses and build positions at reasonable valuations. In such situations we will not shy away from taking bold decisions such as stopping fresh investments into the fund (like we did in February 2017) as we aim to be prudent and act in the best interest of our investors.

On the other hand, market corrections give us an opportunity to consolidate our portfolio: sell our “mediocre” holdings, and add to our holdings in good companies as they become more reasonably priced. We use valuations and market pricing to balance and strengthen the overall portfolio.

Our thought process on few top holdings across DSP Small Cap Fund and DSP Mid Cap Fund:

Few top holdings	Rationale
Atul Limited	<ul style="list-style-type: none"> • Competent management has grown business whilst maintaining strict financial discipline • Competitive advantage: Significant knowledge and experience of working with multiple & complex chemistry serving diverse industries • Focus on ROE: Delivered superior ROCE over last few years; 3 yr avg: 17.3% • Growth: Visibility on growth due to large capex in the last few years
IPCA Laboratories	<ul style="list-style-type: none"> • One of the best managed mid-sized pharma companies • Superior management strategy: Rationalized & optimized operations to expand profitability despite no revenues from profitable US markets for last few years • Low leverage
Aarti Industries	<ul style="list-style-type: none"> • Leadership in benzene based chemistry • Superior pricing power: Expanded margin over cycles – Avg. 5 yr PAT growth/ Avg. 5 yr Revenue growth: ~1.5x • Growth: High capex in last few years provides good growth visibility • Consistent track record of superior ROE

Few top holdings	Rationale
DCB Bank	<ul style="list-style-type: none"> • Consistent loan growth while maintaining good asset quality • Run by a capable management • While, ROA is suboptimal currently – due to aggressive expansion of distribution footprint – it provides visibility of scaling up over next few years
SRF Limited	<ul style="list-style-type: none"> • Strong management pedigree with superior capital allocation strategy, enabling the company to diversify from technical textiles (commoditized) to high entry barrier businesses such specialty chemicals and refrigerant gases
Exide Industries	<ul style="list-style-type: none"> • Leader in the battery segment: Strong brand provides pricing power • Superior ROE in the core battery business • Strong cash generation and lean balance sheet • Growth: Good visibility of demand in the aftermarket segment
Ramco Cements	<ul style="list-style-type: none"> • One of the best managed cement companies in India • Lowest cost producer in south India • Strong cash generation and lean balance sheet • Growth: Capacity addition in the east provides growth visibility
Supreme Industries	<ul style="list-style-type: none"> • Leader in plastic moulding products • Strong focus on ROE coupled with low leverage • Growth: Large capex in the recent past provides growth visibility

Source: Internal, Factset. The sector(s)/stock(s)/issuer(s) mentioned in this document do not constitute any recommendation of the same and the Schemes may or may not have any future position in these sector(s)/stock(s)/issuer(s).

What is our holding period?

Patience is a virtue and Long holding periods are often required to nurture businesses.

Both DSP Small Cap Fund and DSP Mid Cap Fund are actively managed; and portfolio companies are selected after a detailed fundamental analysis of the business, management and valuation. We avoid worrying about short / near term volatility in the portfolio caused by global concerns, slower than expected earnings momentum and other transitory factors. Businesses do not become big overnight. It takes years to build a successful business and hence we also align our portfolio construction approach to this thought. **We buy a stock to hold it for the entire business cycle and also want investors to invest in this segment with a similar time horizon.** When we have confidence that our companies remain on their growth trajectories and have solid management teams fuelling this growth, we ignore market noise, exercise patience and hold the investments. If business fundamentals remain intact, we will stomach short term volatility.

Below we highlight the long holding period required to generate multi-fold returns on investments. The top 5 gainers – in terms of returns – in both DSP Mid Cap Fund and DSP Small Cap Fund have generated these returns over holding period of 4+ years.

List of Top 5 Companies	Return Multiplier	Holding period in years	Period Held	Avg. weight during holding period	Present in portfolio as on Feb 2019?
DSP Small Cap Fund					
Excel Crop Care Ltd	30.8x	5.4	Aug'12 to Jan'18	1.40%	✗
Atul Ltd	11.1x	5.4	Jul'13 to Dec'18	2.47%	✓
SRF Ltd	9.7x	5.1	Nov'13 to Dec'18	3.25%	✓
Symphony Ltd	9.6x	5.0	Jan'13 to Feb'18	2.29%	✗
Bajaj Finance	8.9x	4.6	Jun'10 to Feb'15	3.31%	✗

List of Top 5 Companies	Return Multiplier	Holding period in years	Period Held	Avg. weight during holding period	Present in portfolio as on Feb 2019?
DSP Mid Cap Fund					
Eicher Motors	29.7x	5.0	Mar'09 to Apr'14	2.82%	✗
Bajaj Finance	27.1x	5.4	Nov'08 to Apr'14	1.48%	✗
Bayer Cropscience India Limited	20.4x	10.1	Nov'08 to Dec'18	2.28%	✓
SRF Ltd	14.4x	9.4	Jul'09 to Dec'18	2.58%	✓
Gruh Finance Ltd	8.6x	4.2	Nov'08 to Jan'13	2.08%	✗

Source: Factset. The sector(s)/stock(s)/issuer(s) mentioned in this document do not constitute any recommendation of the same and the Schemes may or may not have any future position in these sector(s)/stock(s)/issuer(s).

We hold higher concentrations in companies where we have high conviction; and we may even add to our high conviction bets during market corrections. The confidence to increase weight – in a category which is fraught with so much risk – comes from our evaluation methodology. We believe that when companies with strong businesses – run by quality management – are available at a reasonable valuation, we'll certainly not be afraid to “double down.”

For example, one of our portfolio holding companies, Symphony Ltd, fit our investment framework perfectly. It is a mono-line business with high degree of management focus and aspiration. It was a market leader with ~50% market share in the organized air cooler market and operated with an asset-light strategy (both investment capital and working capital) generating very high ROEs. Post evaluating the company we bought it at a trailing P/E of ~14x in December 2012. Earnings did not grow during the year and the company's share price remained flat for the next ~10 months. However, we held our investment as the business fundamentals were strong. Our patience was rewarded as the company generated EPS growth of over 35% for the next five quarters (Q1 FY14 to Q3 FY15), which led to a rise in valuations from 14x to almost 90x. Again, all through the rise in the valuation we held onto our position as the business was doing absolutely fine. However during 2015, when the valuation scaled to unprecedented levels and concerns around growth rose due to early onset of monsoon, we trimmed our position marginally to reflect the concerns over the continuity of high growth. The trimming decision worked well in our favor.

When do we Sell/ Book Profits?

As seen with Symphony, when we feel valuations have risen to unsupportable levels we will trim/ exit holdings and book profits. There are also times when our investment thesis doesn't play out the way we had envisioned. In such situations, we will “cut our losses” and sell instead of incurring further losses.

In the following cases we will quickly exit a stock position by booking a loss:

1. Significant deterioration in the business fundamentals potentially due to regulatory changes, management strategy shift, deterioration of cash flows, etc.
2. Surfacing of corporate governance issues which we were not able to anticipate at the time of investment.
3. Fraudulent activity or misrepresentation of facts with respect to the financials of the company.

For example, with Ashapura Intimates our investment thesis was focused around the passion with which the promoter was running the business. The business seemingly had good potential for growth and did well for a few years after we invested. However, we were unable to judge the likely financial dressing which was undertaken by the company. The sudden disappearance of the promoter further accentuated the problem and made our investment defunct.

Our mistakes are also a source of learning, helping us build checks and balances into our investment principles. In the case of Ashapura Intimates, we recognize that we should have focused more on deteriorating working capital metrics and not relied so heavily on the guidance provided by the promoter. On the whole, our misses have been contained within a reasonable range and have not had a large impact on our long-term performance.

Do we buy stocks outside the framework and how do we manage risk?

Do we hold stocks in our portfolio which do not fit perfectly into our investment principles? YES!

Transitions can be opportune times to enter and support good companies especially those with strong management teams. We will invest in companies that are on the periphery with regards to our investment framework criteria or if the company is going through a transition and we believe in the management's ability to successfully manage the turnaround.

The relatively higher degree of frugality in the mid and small cap space warrants prudence while building positions in a stock. At times, when we have invested in companies – outside of our framework – in expectation of likely improvement/turnaround in the business, we have controlled our risk by having lower exposure in such names. This has enabled us to contain the impact of our failures to a reasonable extent.

Below are examples of top 5 losers – in terms of returns – in both DSP Mid Cap Fund and DSP Small Cap Fund. While it is impossible to eliminate risk of investing in the small and mid cap space, we would like to highlight the smaller allocations made to these companies which helped to contain the loss to portfolio to less than 100 bps in most of these cases.

List of Top 5 Companies	Price decline	Holding period in years	Period Held	Avg. weight during holding period	Present in portfolio as on Feb 2019?
DSP Small Cap Fund					
Tecpro Systems	-97%	4.2	Oct'10 to Dec'14	1.92%	✗
MBL Infra	-82%	3.2	Jun'14 to Aug'17	0.57%	✗
Career Point	-76%	7.8	Feb'11 to Dec'18	0.48%	✓
Arrow GreenTech	-76%	1.2	Jun'17 to Aug'18	0.36%	✗
Quintegra Solutions	-73%	0.3	Nov'08 to Mar'09	0.10%	✗
DSP Mid Cap Fund					
Ashapura Intimates Fashion Ltd	-95%	1.3	Jul'17 to Dec'18	0.85%	✗
Pennar Engineered Building Systems Ltd	-79%	3.2	Sep'15 to Dec'18	0.65%	✓
Titagarh Wagons Ltd	-77%	2.3	Mar'11 to Jul'13	1.23%	✗
Navkar Corp Ltd	-72%	2.6	Mar'16 to Dec'18	0.68%	✓
Indo Count Industries	-66%	2.2	Oct'16 to Dec'18	0.81%	✓

Source: Factset. The sector(s)/stock(s)/issuer(s) mentioned in this document do not constitute any recommendation of the same and the Schemes may or may not have any future position in these sector(s)/stock(s)/issuer(s).

We also have to consider other factors when managing the broader portfolio. We must consider liquidity risk from the perspective of portfolio size. As the portfolio size grows, we make sure the portfolio has enough liquidity to service redemptions by either maintaining a reasonable cash position or holding highly liquid mid-cap or even large-cap securities.

Has this framework helped us in creating alpha?

We are confident of the companies we hold as well as their ability to deliver high earnings growth going forward. When the framework is followed we expect the portfolio to generate return / alpha.

% weights that meet stated framework*		
	DSP Small Cap Fund	S&P BSE Small Cap TRI
2018	76.4	55.2
2017	74.6	44.4
2016	75.6	50.1
2015	53.3	44.6
2014	47.7	36.5
2013	57.5	32.1
Performance CAGR		
2013-2018	20.2%	13.3%

Source: Factset, MFIE. * Portfolio considered at a point in time in end September every year. **Past performance may or may not be sustained in the future. There is no assurance of any capital protection/capital guarantee to the investors in the Scheme. For Scheme performance in SEBI prescribed format refer product page for DSP Small Cap Fund: [click here](#)**

From CY 2013 to 2018, for the S&P BSE Small Cap TRI, the portfolio of strategy framework companies returned **23.9% CAGR**; thus, comfortably beating the portfolio of companies outside the framework which underperformed significantly with **8.6% CAGR**.

% weights that meet stated framework*		
	DSP Mid Cap Fund	NIFTY Mid Cap 100 TRI
2018	70.3	60.6
2017	67.9	47.1
2016	64.7	52.5
2015	42.0	55.6
2014	46.3	61.5
2013	54.4	56.9
Performance CAGR		
2013-2018	17.3%	14.5%

Source: Factset, MFIE. * Portfolio considered at a point in time in end September every year. **Past performance may or may not be sustained in the future. There is no assurance of any capital protection/capital guarantee to the investors in the Scheme. For Scheme performance in SEBI prescribed format refer product page for DSP Mid Cap Fund: [click here](#)**

Similarly, from CY 2013 to 2018, for the NIFTY Midcap 100 TRI, the portfolio of strategy framework companies returned **17.0% CAGR**; thus, beating the portfolio of companies outside the framework which underperformed significantly with **12.4% CAGR**.

Investment Multiplier (Since inception to 28 Feb 2019)	Fund	Benchmark
DSP Small Cap Fund*	5.0x	2.2x
DSP Mid Cap Fund*	5.1x	3.9x

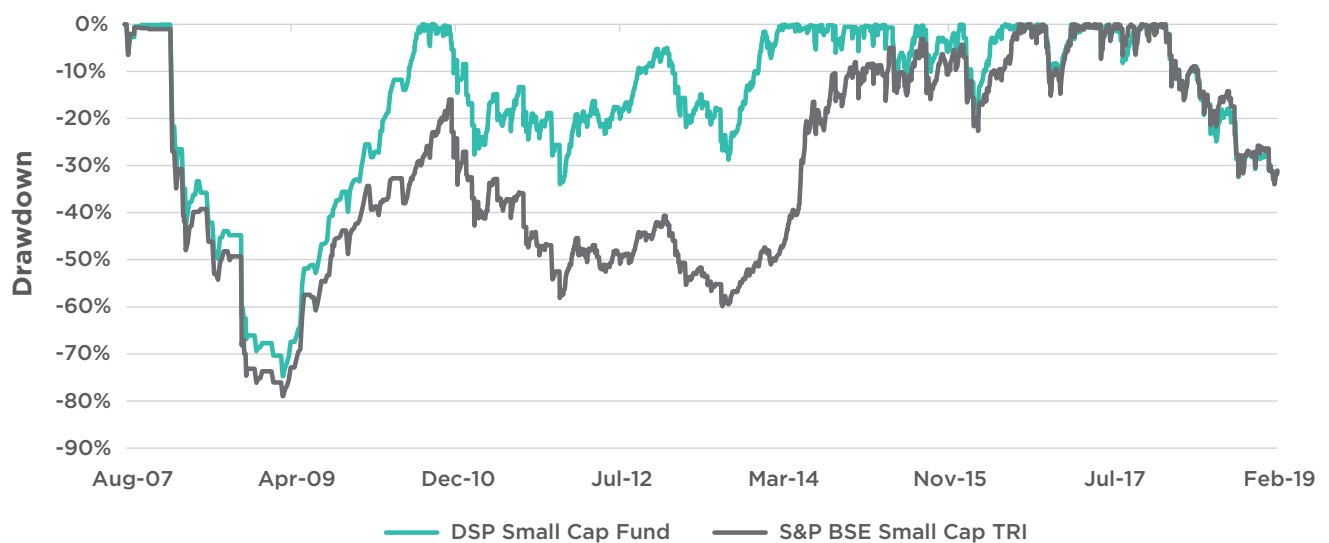
Source: MFIE. * Inception for DSP Small Cap Fund and DSP Mid Cap Fund is 14 June 2007 and 14 November 2006, respectively.

Year-on-year, both the Funds significantly outperformed the portfolio of stocks that did not meet our framework (except in 2017). **The framework helps to build portfolios of stocks that have resulted in consistent outperformance over the benchmark.**

How have the funds fared in drawdowns?

DSP Small Cap Fund has fared better than the benchmark in deep drawdowns, where it has fallen less than the benchmark. During the 2008-2009 drawdown post the financial crisis, the fund fell 75% whereas the benchmark fell 79%. Post this during the period 2011-2014, the fund faced two drawdowns between 28-34% whereas the benchmark fell lower by 57-60%.

On an average, DSP Mid Cap Fund has also managed to fare better than the benchmark during drawdowns.



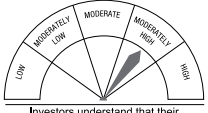
Source: MFIE.

Parting Thoughts:

We believe **durable businesses** run by **able managers**, with ability to generate **superior ROEs sustainably, are sources of alpha**. In order to create wealth and have a good investment experience, **investors must stay invested for the long term** as our underlying investee companies are strong businesses that need time and nurturing to reach their potential.

Be Patient and think long term!

Product Labeling

<p>DSP Small Cap Fund (An open ended equity scheme predominantly investing in small cap stocks)</p> <p>This Open Ended Equity Scheme is suitable for investors who are seeking*</p> <ul style="list-style-type: none"> • Long-term capital growth • Investment in equity and equity-related securities predominantly of small cap companies (beyond top 250 companies by market capitalization) 	<p>RISKOMETER</p>  <p>Investors understand that their principal will be at moderately high risk</p>
<p>DSP Mid Cap Fund (An open ended equity scheme predominantly investing in mid cap stocks)</p> <p>This Open Ended Equity Scheme is suitable for investors who are seeking*</p> <ul style="list-style-type: none"> • Long-term capital growth • Investment in equity and equity-related securities predominantly of midcap companies 	

*Investors should consult their financial advisors if in doubt about whether the product is suitable for them.

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