MARCELLUS RISING GIANTS PMS

AN INVESTMENT STRATEGY FOR INDIAN SMALL-MID CAPS
FROM MARCELLUS INVESTMENT MANAGERS

MAY 2023

MARCELLUS

MARCELLUS INVESTMENT MANAGERS PVT. LTD.

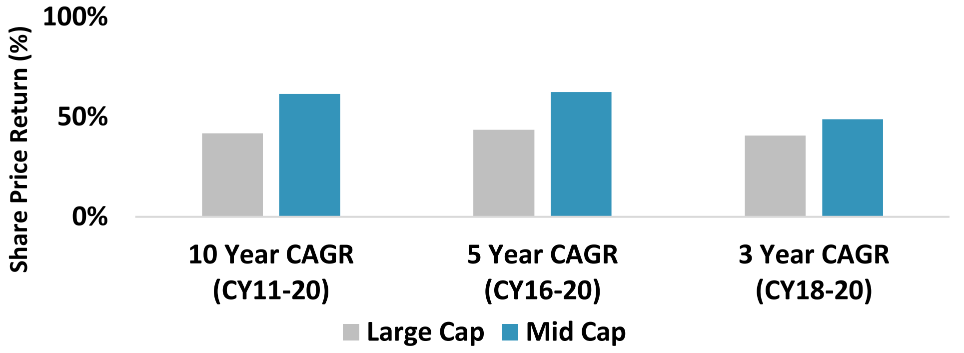
MARCELLUS RISING GIANTS PMS

- Total AUM under both AIF and PMS at INR 7.27 bn as at April 30, 2023
- Strategy under AIF was launched on 13th August 2021 and under PMS on 27th December 2021
- Investment universe: Listed companies in India in the USD 500m – 10 bn market cap range.
- Investment Framework:
  1. Clean accounts and governance.
  2. Strongly moated dominant companies in niche segments not yet well discovered by the market participants.
  3. Strong track record of capital allocation with high reinvestment in the core business and continuous focus on adjacencies for growth.

QUALITY MID-CAPS*: THE SWEET SPOT IN INDIAN EQUITIES

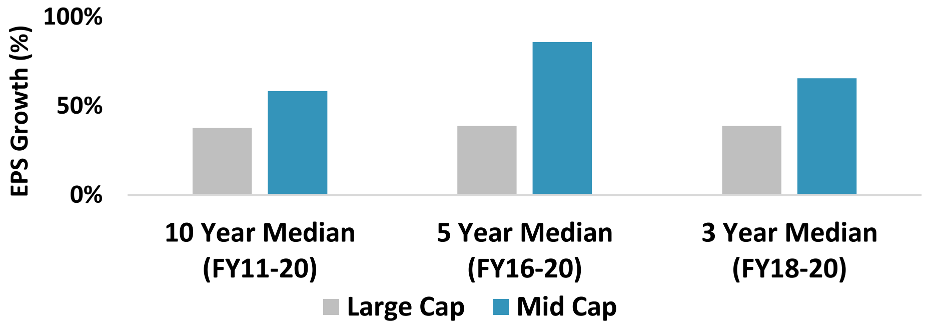
High quality mid-sized companies have been amongst the largest wealth creators in Indian equities

Top Quartile Mid Caps outperforming Top Quartile Large Caps



Source: Ace Equity, Marcellus Investment Managers. Note: (1) Calendar Year (CY) returns are calculated using average annual returns and then calculating CAGR of those annual returns over different time-periods. (2) Quartiles are based on annual returns.

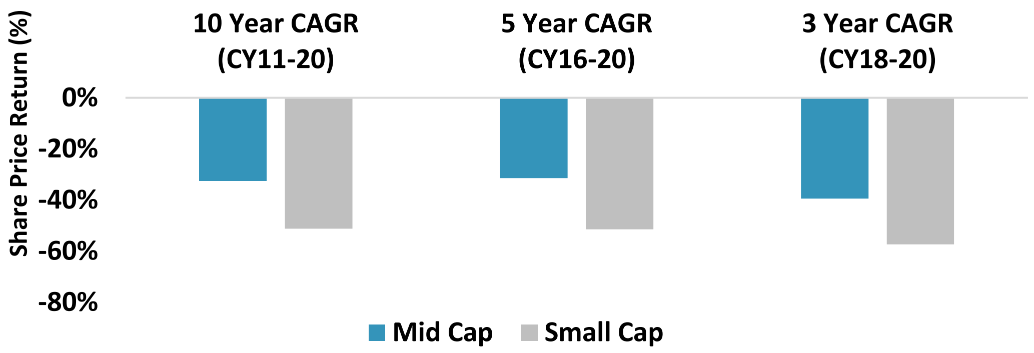
Top Quartile Mid Caps consistently generate higher earnings growth vs Top Quartile Large Caps



Source: Ace Equity, Marcellus Investment Managers. Note: (1) EPS Growth above is calculated as the median of the annual EPS growth for the different time periods (2) Quartiles are calculated based on annual EPS growth.

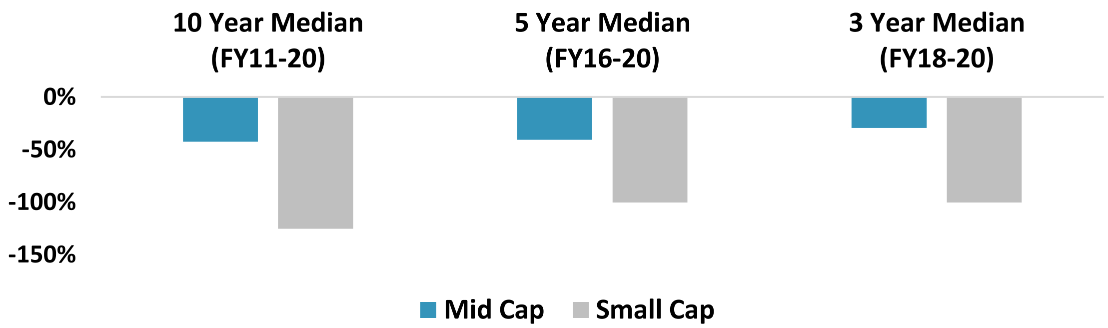
Mid-sized companies' earnings and returns are less volatile vs small companies

Bottom Quartile Mid Caps fall significantly less vs Bottom Quartile Small Caps



Source: Ace Equity, Marcellus Investment Managers. Note: (1) Calendar Year (CY) returns are calculated using average annual returns and then calculating CAGR of those annual returns over different time-periods. (3) Quartiles are based on annual returns.

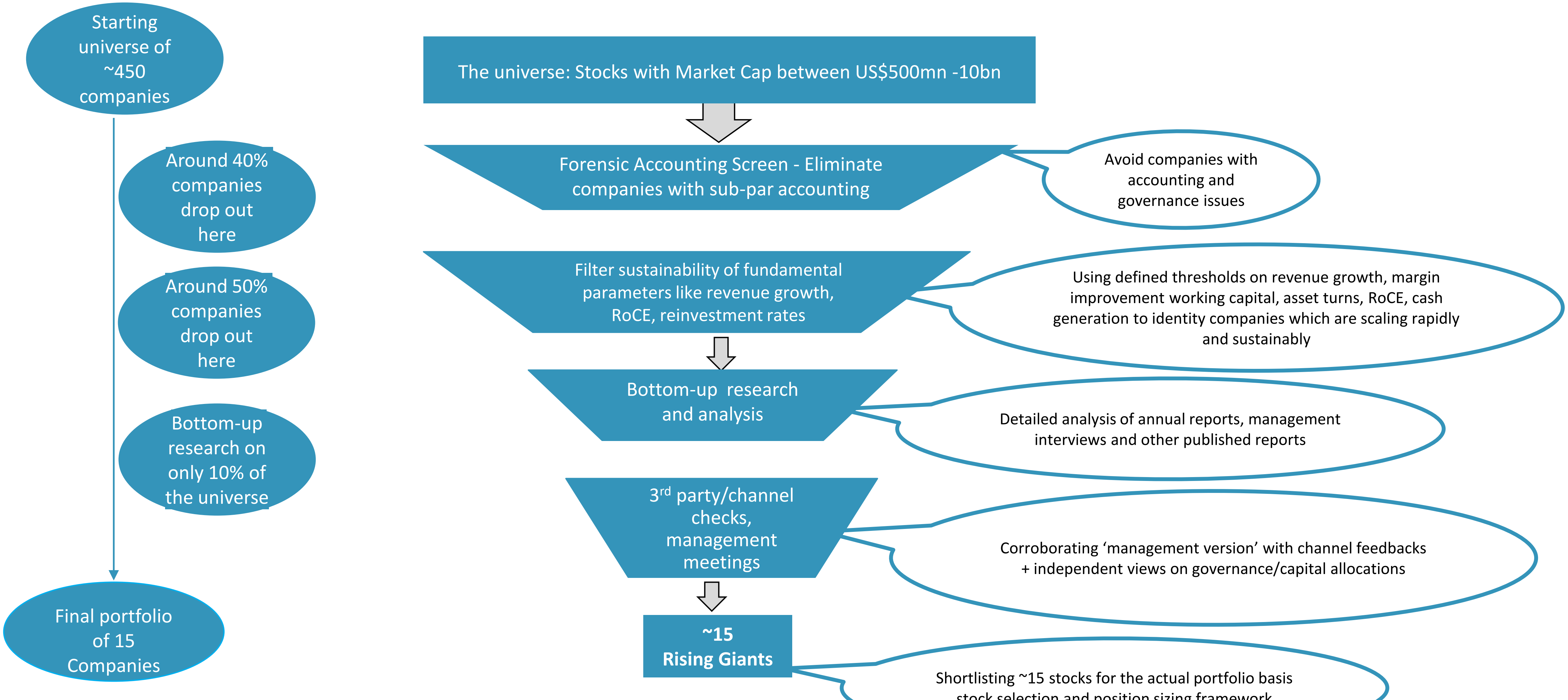
Mid-Caps' earnings decline significantly lower vs Small Caps in worse case scenarios (bottom quartile)



Note: (1) EPS Growth above is calculated as the median of the annual EPS growth for the different time periods (2) Quartiles are calculated based on annual EPS growth.

**** Note: We classify companies with market cap above Rs750bn as large cap, between Rs35bn to Rs750bn as mid cap and below Rs35bn as small cap in this presentation.***

RIGOROUS INVESTMENT PROCESS TO IDENTIFY RISING GIANTS



Note: The fund manager maintains discretion on stock inclusion in the portfolio. In case, a stock does not clear the above filters, the fund manager must record and present to the Investment committee for approval, the reasons for such inclusion

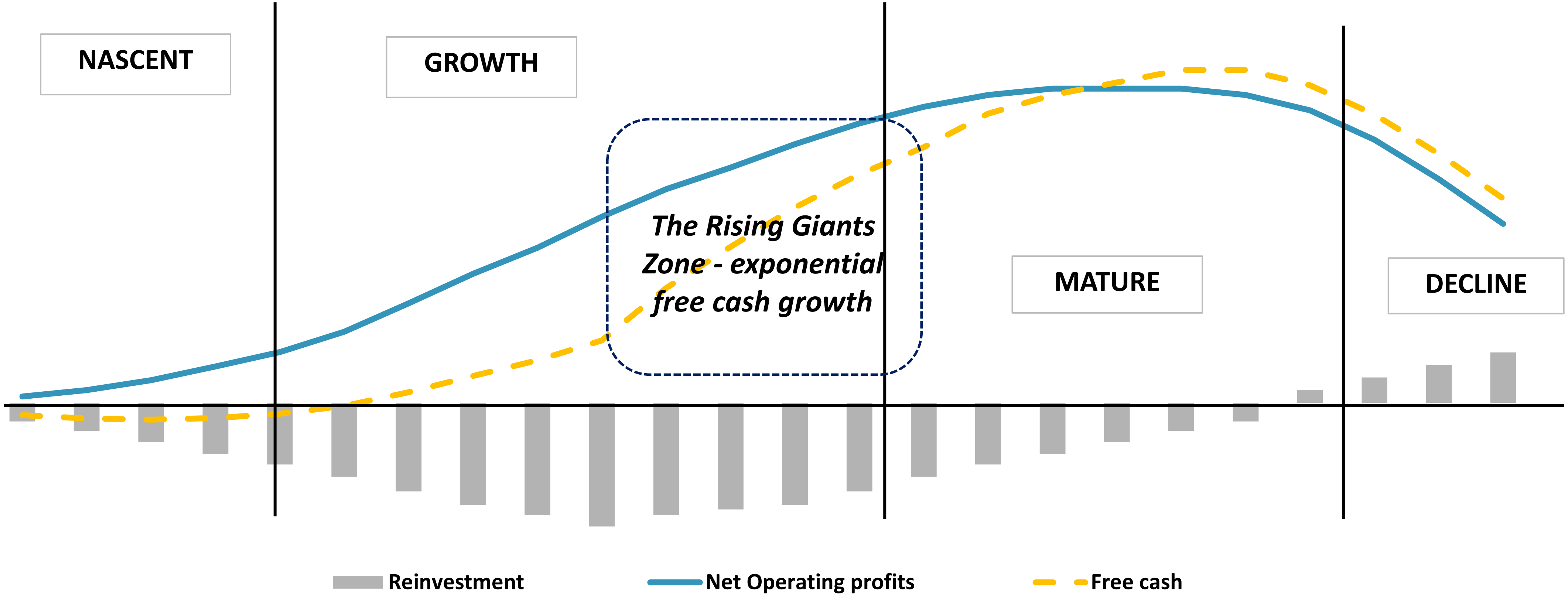
RISING GIANTS - 'EXPONENTIAL GROWTH PHASE' OF FREE CASH FLOW GENERATION

Portfolio Comp. (excluding financial stocks)	FY13-16 CAGR					FY16-19 CAGR					FY19-22 CAGR					
	Rev.	EBITDA	CFO	FCF	RoCE (FY14-16 avg)	Rev.	EBITDA	CFO	FCF	RoCE (FY17-19 avg)	Rev.	EBITDA	CFO	FCF	RoCE (FY20-22 avg)	Share price**
Galaxy Surfactants	4%	26%	26%	NM	21%	15%	14%	14%	3%	25%	10%	5%	8%	1%	23%	39%
Suprajit Engineering	27%	26%	22%	NM	25%	19%	14%	35%	NM	21%	5%	4%	6%	68%	16%	12%
Astral	27%	22%	27%	NM	26%	14%	23%	22%	NM	22%	21%	25%	30%	107%	27%	43%
Tata Elxsi	20%	50%	32%	56%	59%	14%	19%	12%	18%	55%	16%	23%	28%	26%	43%	109%
V-Mart Retail	28%	18%	46%	NM	23%	21%	29%	28%	158%	32%	5%	14%	3%	NM	17%	14%
GMM Pfaudler	11%	32%	-10%	-13%	20%	20%	30%	24%	23%	28%	72%	55%	53%	25%	21%	56%
Page Industries	27%	28%	30%	44%	63%	17%	18%	28%	34%	65%	11%	8%	17%	16%	63%	20%
Dr. Lal Pathlabs	21%	29%	24%	35%	52%	15%	12%	16%	19%	39%	20%	24%	24%	NM	34%	36%
Grindwell Norton	7%	7%	5%	44%	23%	12%	14%	3%	-3%	23%	8%	14%	29%	39%	24%	45%
Alkyl Amines Chemicals	10%	17%	36%	62%	24%	21%	22%	14%	-27%	23%	22%	26%	35%	89%	41%	105%
L&T Technology Services*	NA	NA	NA	NA	NA	18%	21%	26%	NM	42%	9%	16%	23%	26%	36%	48%
Divi's Laboratories	21%	20%	28%	61%	34%	9%	10%	6%	1%	26%	22%	27%	21%	15%	30%	37%
Median	**21%**	**26%**	**27%**	**44%**	**25%**	**16%**	**18%**	**19%**	**18%**	**27%**	**13%**	**19%**	**24%**	**32%**	**28%**	**41%**
BSE500	**10%**	**15%**	**17%**	**14%**	**15%**	**13%**	**15%**	**11%**	**12%**	**16%**	**8%**	**10%**	**14%**	**15%**	**17%**	**16%**

Source: Marcellus Investment Managers

*Note: (1) The above does not include financial services stocks in the portfolio namely – Aavas Financiers, Cholamandalam Investment, ICICI Lombard General Insurance and Info-edge since FCF is not a relevant metric (2) * L&T Tech started business only in 4QFY14, hence data not available for FY13-16. (3) ** 3-year CAGR ending March 31, 2022. (4) 3-year rolling average was used to calculate CFO CAGR, FCF CAGR and RoCEs. Portfolio composition as of April 30, 2023.*

FREE CASH FLOW COMPOUNDING – THE KEY DRIVER OF SHARE PRICE RETURNS

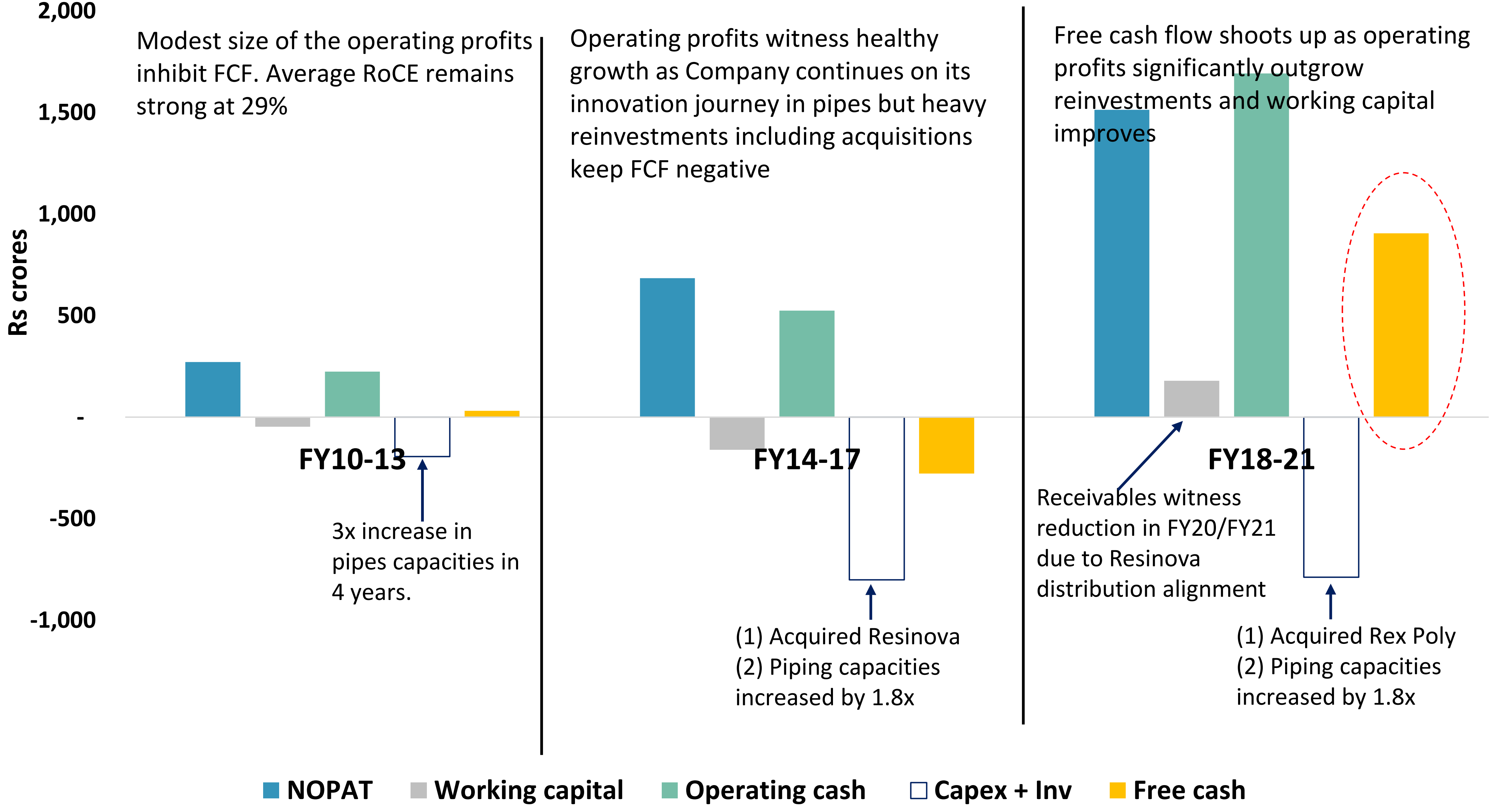


Source: Marcellus Investment managers

Zone of exponential free cash flow growth - *The longer a company stays in this zone, the higher its intrinsic value*

- Operating profits (continue to) witness a healthy growth
- Reinvestment of the operating profits remains strong for future growth in operating profits – success can be gauged through market share gains, creation of profitable new growth drivers, sustainable RoCEs
- Size of the operating profits more than covers the reinvestment needs

CASE STUDY: HOW ASTRAL TURNED INTO A FREE CASH FLOW MACHINE?



MARCELLUS RISING GIANTS – KEY PORTFOLIO STATS

Portfolio Company	Market Cap (Rs bn)	EPS CAGR (FY17-22)	RoCE FY22	FCF CAGR (FY17-22)	Net debt (cash) equity (FY22-end)
GMM Pfaudler	67	21%	16%	34%	0.3
Dr Lal Pathlabs	163	17%	32%	8%	-0.2
Page Industries	450	15%	75%	21%	-0.3
Aavas Financiers	110	36%	14%	NA	NA
Suprajit Engineering	49	9%	18%	9%	-0.1
Astral	389	27%	28%	29%	-0.2
Alkyl Amines	121	35%	32%	27%	0.0
Tata Elxsi	414	26%	44%	29%	-0.6
Info-Edge (India)	488	132%	18%	NA	0.0
V-Mart Retail	43	-25%	6%	NM	-0.2
Galaxy Surfactants	88	12%	18%	7%	0.2
L&T Technology Services	399	17%	33%	20%	-0.5
Cholamandalam Inv	716	22%	20%	NA	NA
ICICI Lombard	530	11%	15%	NA	NA
Grindwell Norton	210	20%	26%	17%	-0.4
Divi's Laboratories	868	23%	34%	3%	-0.2
Median	**300**	**20%**	**23%**	**20%**	**-0.2**

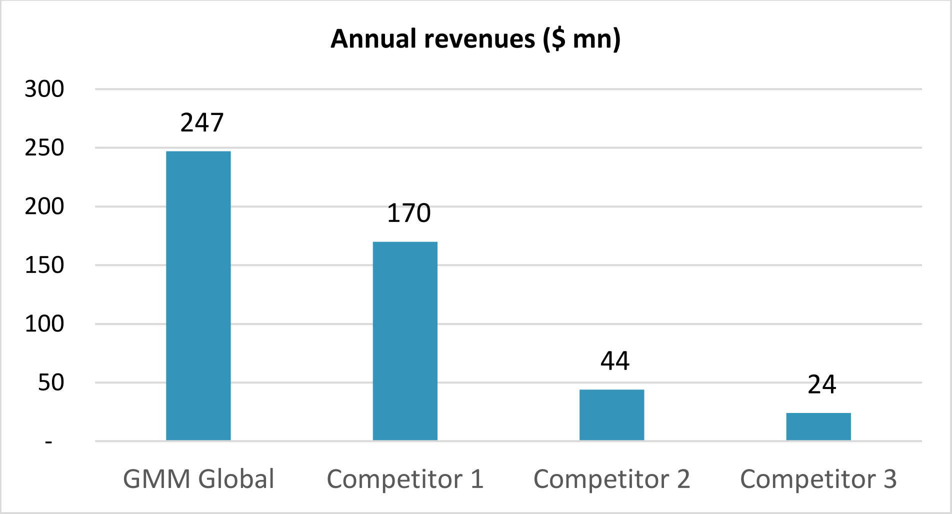
Source: Companies, Marcellus Investment Managers. Note: (i) Market cap as of April 30, 2023. (ii) RoE instead of RoCE considered for financial stocks (Aavas, Cholamandalam, Info-Edge and ICICI Lombard above). Also, FCF column is not applicable for these stocks. (iii) 3-year average was used to calculate FCF CAGR. Portfolio composition as of April 30, 2023.

CASE STUDY: GMM PFAUDLER [MKT CAP RS. 67BN]

GMM, a leader in the chemical process equipment space, is the largest glass-lined equipment (GLE) manufacturer in the world. GLE is a critical capital asset in the chemical and pharma industries. These two sectors are seeing a steady capex cycle and GMM is likely to be a key beneficiary of the same.

GMM's key competitive advantages include:

a. **Technology edge:** Pfaudler (GMM's subsidiary) was the inventor of the process of lining steel with glass for critical applications. The permanent access to technology that GMM has, is a key advantage. In India GMM is the only company with access to state-of-the-art glass-lining technology.
b. **Long-standing customer relationships:** a large part of GMM's business is from repeat customers and for them, GMM is the default choice in placing orders. The quality of equipment, execution strength and delivery assurance are the key reasons why customer prefer to deal with GMM over peers.
c. **Scale advantage:** GMM is the larger than all other GLE suppliers in India put together. The benefits of scale manifest in better margins as well as the ability to cater to larger orders from increasing project sizes. GMM accounts for 45-48% of GLE revenues of the Indian industry and 75% of the industry EBITDA.
d. **Strong capital allocation track record:** consistent investments in capacity additions, efficiency improvement and smart inorganic expansions, without diluting returns has been GMM's hallmark. The company has built a globally leading business (global mkt share 50%) with debt-equity ratio of just 0.5x.



Source: Company data; proforma, based on LTM revenues of GMM group as on May-20 and latest available numbers of competitors

Rs bn	FY17	FY18	FY19	FY20	FY21	FY22	5-year CAGR
Revenues	3.5	4.1	5.0	5.9	10.0	25.4	49%
EBITDA	0.48	0.62	0.77	1.11	1.39	2.84	43%
PAT	0.33	0.43	0.51	0.71	0.94	0.75	18%
RoCE (pre tax)	26%	29%	29%	29%	18%	15%	24%
Net debt/Equity	-0.4	-0.5	-0.5	-0.3	0.5	0.3	

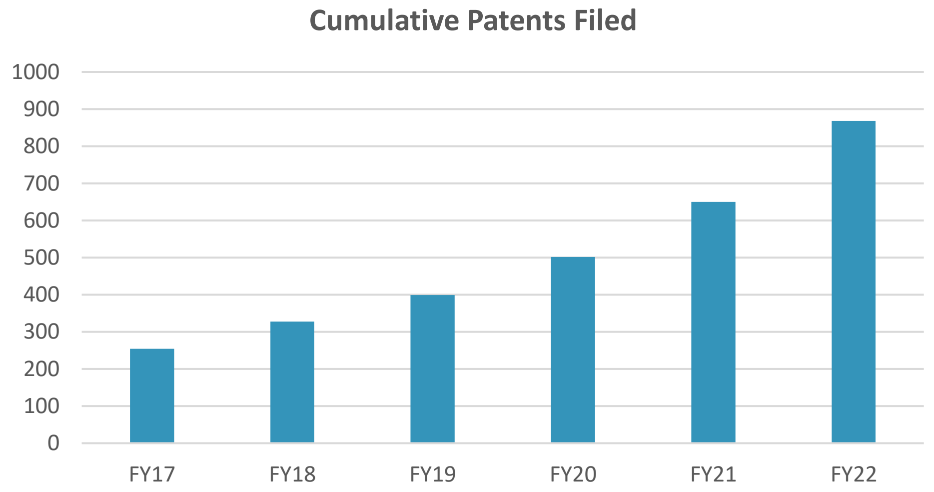
Source: Marcellus Investment Managers; Ace Equity

CASE STUDY: L&T TECHNOLOGY SERVICES [MKT CAP RS. 399BN]

LTTS, a subsidiary of Larsen & Toubro, is an engineering R&D services Co. It provides services in product development & engineering, product lifecycle management and plant engineering. Most of the largest R&D spenders globally are its clients, including 69 of the Fortune 500 companies.

The key drivers of LTTS' competitive advantages are:

a. **Strong parentage:** L&T parentage brings a core engineering DNA to LTTS, a critical aspect not just for showcasing to potential clients, but also in all areas of operations – from developing proofs of concept (a critical customer acquisition tool) to product lifecycle management.
b. **Focus on ER&D:** LTTS' focus on ER&D helps it not only to bring deeper expertise to the table, it also helps build a strong ecosystem of attracting the relevant talent interested in pursuing core engineering careers, as well as partnerships with customers in areas central to their business – e.g. setting up a dedicated lab for an auto OEM' Telematics unit in Germany
c. **Diversified industry presence:** A presence in different industry segments such as auto, telecom, process industries, power utilities etc. allows LTTS not just to diversify revenues and end user industries, but also enables cross pollination of ideas to come up with better solutions as well as cross-selling opportunities to customers. E.g. an autonomous welding robot developed for an Industrial products customer was used for a Plant Engineering manufacturer.
d. **Innovation and research focus:** LTTS has a portfolio of ~719 patents (the highest amongst peers), including the ones filed in partnership with clients. The company encourages employees to work towards research on a regular basis. These patents are not only to showcased to clients, but will also drive higher-margin revenues over the long term.



Source: Marcellus Investment Managers; Company data

Rs bn	FY17	FY18	FY19	FY20	FY21	FY22	5-year CAGR
Revenues	33	38	51	56	55	66	15%
EBITDA	6	6	9	11	10	14	20%
FCF	3	2	6	4	12	9	20%
RoCE (pre tax)	41%	38%	45%	43%	30%	35%	38%
Net debt / Equity	-0.58	-0.58	-0.71	-0.71	-0.79	-0.50	

Source: Marcellus Investment Managers; Ace Equity

CASE STUDY FOR EXIT: AU SMALL FINANCE BANK

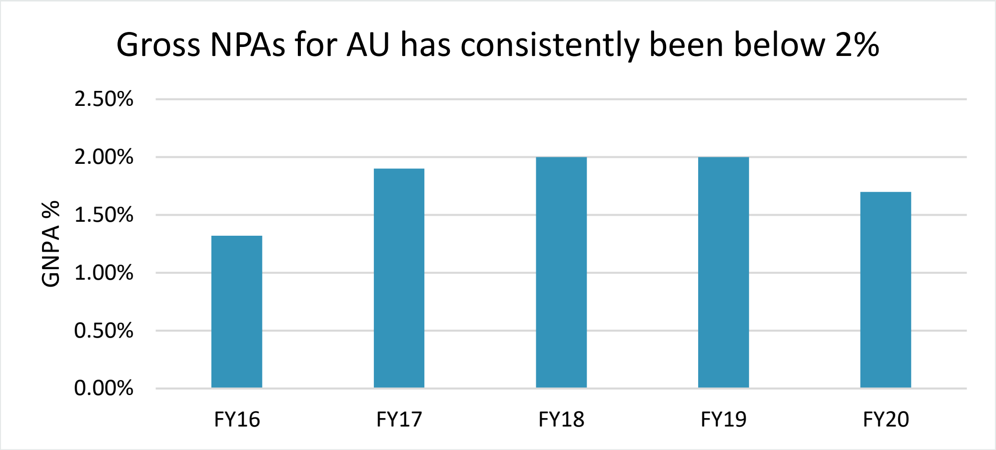
AU has built a proven track record of sustainable growth and good asset quality. It has grown its AUM at a 35% CAGR during FY16-21 despite multiple macro headwinds such as the ILFS crisis, demonetisation, introduction of GST, Covid etc. However, key man risk exemplified by recent exits at the bank led us to downgrade the position sizing score and the exit the stock from the portfolio.

Key reasons for Investment:

- Strong understanding of the environment – AU SFB has been operating in the western states since late 90s and has gained a deep granular understanding of each district which acts as a moat for its underwriting.
- Secured Lending – With close to 97% of the loan book being secured backed by strong in-house collections team, helps AU ensure recovery rates are high and keeps losses low.
- Contiguous expansion strategy – Expanded its branches in concentric circles in non-metro towns and built a B2C bank which helps it to charge higher yields and maintain high RoEs.
- Liability franchise in making – Over the last 18 months the bank has focused on building a granular liability franchise and has already reached 21% CASA ratio in Q2FY21. Cost of funds for the bank will go down further as the bank reduces the exposure to bulk deposits and increase exposure to granular CASA deposits.

Key reasons for Exit:

The key man risk at AU is relatively higher vs. larger well-established banks such as HDFC Bank or Kotak Bank leading to low succession score within our position sizing score. Furthermore, recent exits of Chief internal auditor and Chief risk officer made us downgrade the score further resulting in exit of the stock from the portfolio.



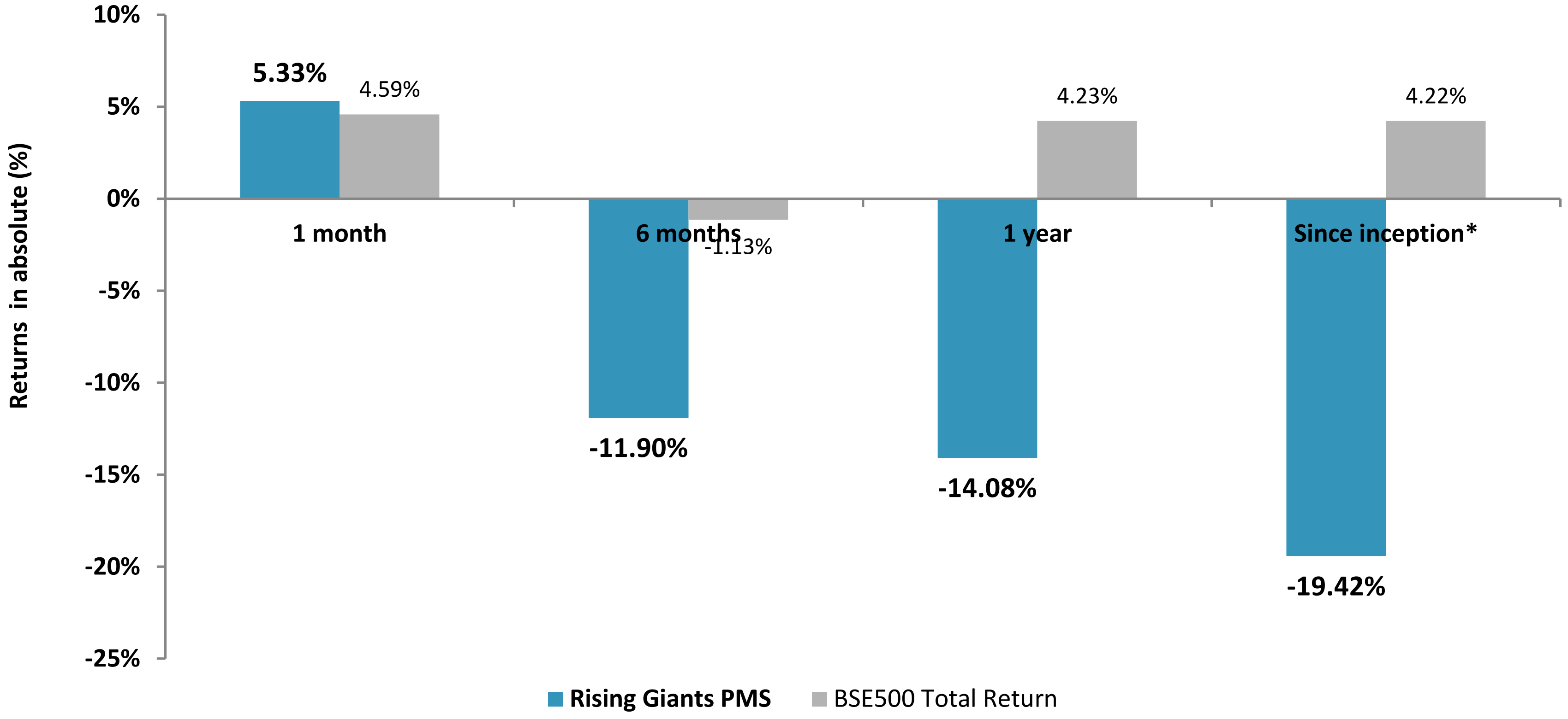
Source: Marcellus Investment Managers; Company data

Rs bn	FY15	FY16	FY17	FY18	FY19	FY20	5-year CAGR
Net Interest Income	4.2	6.2	7.8	9.4	13.4	19.1	35%
Operating Profit	2.7	3.7	12.4	5.8	7.2	12.0	35%
PAT	2.1	3.2	11.4	4.4	5.8	9.1	34%
RoE	19.9%	23.3%	54.9%	13.7%	14.0%	18.0%	
Cap. adequacy ratio	18.5%	17.1%	23.0%	19.3%	19.3%	22.0%	

Source: Marcellus Investment Managers; Ace Equity

RETURN ANALYSIS - ACTUAL PORTFOLIO VS BENCHMARK

Rising Giants PMS performance vs. the benchmark BSE500 total return index (till 30th April 2023)



Source: Marcellus Investment Managers. Note: (i) Portfolio inception date is December 27, 2021. (ii) Returns as of April 30, 2023. (iii) Performance data is net of annual performance fees charged for clients whose account anniversary falls upto the last date of the performance period. Since fixed fees and expenses are charged on a quarterly basis, effect of the same has been incorporated up to 31st March 2023. (iv) Total returns index considered for BSE500 above.

FEE STRUCTURE (REGULAR)

Portfolio Name	Marcellus Rising Giants Portfolio
Minimum Investment	50 lakhs
Exit Load	2% of AUM withdrawn if investments are withdrawn within 15 months from date of investment
Operating Expenses	https://marcellus.helpscoutdocs.com/article/43-pms-charges
Fee Structures	

Amount Slab	Structure	% Fixed Fee (p.a.)	Profit Share	Hurdle Rate (p.a.)
>1cr to <5cr	Fixed Only	2.50%	NIL	NIL
>1cr to <5cr	Hybrid	1.75%	10% & 5%	6% plus benchmark
>5cr to <25cr	Fixed Only	2.25%	NIL	NIL
>5cr to <25cr	Hybrid	1.50%	10% & 5%	6% plus benchmark
>25cr	Fixed Only	2.00%	NIL	NIL
>25cr	Hybrid	1.25%	10% & 5%	6% plus benchmark

Performance Fee (where applicable)

1. **Phase I -** If the appreciation in the pre-tax NAV (before charging performance fee) is above the 6% hurdle rate of return: 10% with no catch up
2. **Phase II -** If appreciation in the pre-tax NAV (before charging performance fee) is above the BSE500 TRI rate of return for the relevant performance period, then the Investment Manager shall be entitled to an additional performance fee of 5%

*****High water mark applies for performance fees*****

*****Clients also have the option to be onboarded directly (direct fee code)*****

STP (Systematic Transfer Plan): Clients can opt for STP using which clients can stagger their investment in tranches spread over 5months. https://marcellus.helpscoutdocs.com/article/96-stp

INVESTMENT TEAM (1 OF 2)

Saurabh Mukherjea, CFA, FRSA

Saurabh is the CIO at Marcellus. He is the former CEO of Ambit Capital and played a key role in Ambit's rise as a broker and a wealth manager. When Saurabh left Ambit in June 2018, assets under advisory were $800mn. In London, Saurabh was the co-founder of Clear Capital, a small cap equity research firm which he and his co-founders created in 2003 and sold in 2008. In 2017, upon SEBI's invitation, he joined SEBI's Asset Management Advisory Committee. In 2019, Saurabh was part of the five man Expert Committee created by SEBI to upgrade & update the PMS regulations. Saurabh has written four bestselling books including Gurus of Chaos (2014), The Unusual Billionaires (2016) and "Coffee Can Investing: The low risk route to stupendous wealth" (2018). Saurabh was educated at the London School of Economics where he earned a BSc in Economics (with First Class Honours) and MSc in Economics (with distinction in Macro & Microeconomics). He is Fellow of the Royal Society of Arts.

Pramod Gubbi, CFA

Pramod leads the business development efforts at Marcellus. He also sits on Investment Committee that discusses and approves investment strategies of the firm. Pramod was previously the MD & Head of Institutional Equities at Ambit Capital. Prior to that Pramod, served as the head of Ambit's Singapore office. Before joining Ambit, Pramod worked across sales and research functions at Clear Capital. Besides being a technology analyst, Pramod has served in technology firms such as HCL Technologies and Philips Semiconductors. Pramod did his B.Tech from Regional Engineering College, Surathkal and has a Post-graduate Diploma in Management from the Indian Institute of Management – Ahmedabad.

INVESTMENT TEAM (2 OF 2)

Rakshit Ranjan, CFA

Rakshit is the Portfolio Manager of Marcellus' flagship Consistent Compounders strategy. Rakshit spent 6 years (2005-2011) covering UK equities with Lloyds Bank (Director, Institutional Equity Research) and Execution Noble (Sector Lead analyst). Since 2011, Rakshit led Ambit Capital's consumer research franchise. He launched Ambit's Coffee Can PMS in Mar'17 and managed it till Dec'18. Under his management, Ambit's Coffee Can PMS was one of India's top performing equity products during 2018. Rakshit has a B.Tech from IIT (Delhi).

Ashvin Shetty, CFA

Ashvin is the Portfolio Manager of Marcellus' Little Champs strategy. Ashvin has more than 10 years of experience in equity research. He led the coverage on automobile sector at Ambit Capital from 2010 to 2017. He thereafter worked as a senior analyst for Ambit's Mid and Small cap PMS funds till November 2018. Prior to joining Ambit, he worked with Execution Noble as an analyst covering consumer and media space. He has also worked with KPMG's and Deloitte's statutory audit departments from 2004 to 2007 gaining extensive experience across Indian accounting standards and financial statement analysis. Ashvin is a BCom graduate from Narsee Monjee College (Mumbai). He is a qualified Chartered Accountant (ICAI India) and Chartered Financial Analyst (CFA Institute, USA).

ANNEXURES

RISING GIANTS: HEALTHY EARNINGS GROWTH IN FY23

	Revenue (YoY)				PBT (YoY)			
	3QFY23	2QFY23	FY22	FY21	3QFY23	2QFY23	FY22	FY21
GMM Pfaudler	23%	21%	154%	69%	14%	NM	13%	73%
Dr. Lal Pathlabs	-2%	7%	32%	19%	-6%	-21%	20%	27%
Page Industries	3%	16%	37%	0%	-30%	-1%	56%	-2%
Aavas Financiers	20%	21%	28%	18%	19%	16%	29%	17%
Suprajit	44%	45%	12%	5%	14%	-11%	15%	21%
Astral	15%	2%	38%	23%	-24%	-47%	20%	75%
Alkyl Amines	3%	17%	24%	25%	1%	1%	-25%	77%
Tata Elxsi	29%	28%	35%	13%	20%	28%	46%	45%
Info Edge	23%	51%	39%	-13%	14%	60%	65%	-20%
V-Mart Retail	12%	50%	55%	-35%	-65%	NM	NM	NM
Galaxy Surfactants	16%	40%	32%	7%	127%	97%	-12%	29%
L&T Tech.	21%	24%	21%	-3%	31%	24%	46%	-18%
Cholamandalam	22%	21%	18%	22%	31%	-7%	42%	29%
ICICI Lombard	14%	21%	26%	11%	11%	3%	-14%	15%
Grindwell Norton	20%	24%	23%	4%	17%	24%	25%	31%
Divi's Laboratories	-32%	-7%	29%	29%	-58%	-19%	38%	47%
Weighted Avg.	**14%**	**22%**	**40%**	**13%**	**6%**	**6%**	**21%**	**27%**
Median	**18%**	**21%**	**30%**	**12%**	**14%**	**2%**	**25%**	**29%**

*Source: Companies, Marcellus Investment Managers Note: * Including Pfaudler International's numbers which have been consolidated; #V-Mart incurred a loss in Q2FY23, Q1FY22 and FY21. Portfolio composition as of April 30, 2023.*

THE NETWORKING OF INDIA COMBINED WITH TECH CHANGES IS LEADING TO PROFIT POLARISATION IN EVERY SECTOR

The Indian economy has been 'networked' at a rapid pace over the past decade:

- The length of India's national highways has doubled.
- The number of broadband users has increased from 20 million in FY11 to 687 million at the end of FY20 (CAGR of 48%).
- Airline passenger traffic has grown at a CAGR of 16%.
- 15 years ago, only 1 in 3 Indian families had a bank account; now nearly all Indian families have a bank account.

+

The inception of a single Goods & Services Tax in 2017 has allowed companies to consolidate their supply chains (from multiple state-level structures to unified national supply chains)

+

The rise of low cost SaaS (e.g. Salesforce, SAP) alongside RFID tracking and big data gleaned from 400mn internet connected mobile phones is allowing companies to improve working capital cycles, asset turns, profit margins and hence RoCE

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Source: Marcellus Investment Managers, CMIE, Ace Equity, Bloomberg, Ministry of Aviation, TRAI, Ministry of Road Transport.

CONSISTENT FREE CASH FLOW COMPOUNDING FOR MARCELLUS' CCP COMPANIES

Stock Name	Free Cash Flow (FCFE) CAGR							Share Price CAGR						
	5-years				10-years		20-years	5-years				10-years		20-years
	FY01-06	FY06-11	FY11-16	FY16-21	FY01-11	FY11-21	FY01-21	FY01-06	FY06-11	FY11-16	FY16-21	FY01-11	FY11-21	FY01-21
Asian Paints Ltd.	19%	41%	18%	19%	30%	19%	24%	31%	31%	28%	24%	31%	26%	29%
Berger Paints India Ltd.	24%	-1%	44%	10%	10%	26%	18%	49%	11%	41%	34%	28%	38%	33%
Nestle India Ltd.	17%	15%	10%	15%	16%	12%	14%	11%	32%	9%	24%	21%	16%	19%
Pidilite Industries Ltd.	42%	4%	83%	1%*	22%	40%*	30%*	40%	23%	32%	25%	31%	28%	30%
Titan Company Ltd.	-16%	179%	-21%	62%	54%	13%	32%	82%	35%	12%	36%	57%	23%	39%
Divis Laboratories Ltd.	NA	54%	35%	9%	34%^	21%	27%^	NA	29%	24%	30%	NA	27%	NA
Tata Consultancy Services	NA	34%	29%	15%	34%^^	22%	26%^^	NA	20%	16%	20%	NA	18%	NA
Page Industries Ltd.	NA	36%	33%	39%	25%**	36%	31%**	NA	NA	50%	20%	NA	34%	NA
Dr. Lal Pathlabs Ltd.	NA	NA	49%	22%	NA	35%	NA	NA	NA	NA	24%	NA	NA	NA
Weighted Avg.	**17%**	**48%**	**31%**	**22%**	**29%**	**25%**	**26%**	**41%**	**27%**	**26%**	**26%**	**34%**	**22%**	**30%**

*Source: Marcellus Investment Managers; Ace Equity; FCFE = Operating cash flow less Capex less Investment in Subsidiaries/Strategic investments /Acquisitions less Net debt repayments less Interest Paid less Lease liabilities; *In case of Pidilite, high capex on account of Araldite acquisition skews the CAGR % making it incomparable, hence CAGR for the period FY16-20, FY11-20 and FY01-20 is considered; ^Divis' FCFE is for the period FY02-11 and FY02-21 since the company was not listed prior to FY01; **Page's FCFE is for FY04-11 and FY04-21 since company was not listed prior to FY04; ^^TCS's FCFE is for FY06-11 and FY06-21 since FCFE for FY04 and FY05 was negative*

The above does not include financial services stocks in the portfolio namely – HDFC Bank, Bajaj Finance, Kotak Bank, HDFC Life Insurance and ICICI Lombard General Insurance since FCF is not a relevant metric for financial services stocks.

USE FORENSIC ACCOUNTING TO AVOID MOST COMMON PITFALLS IN SMALL CAPS

Methodology

12 accounting ratios covering income statement (revenue/ earnings manipulation), balance sheet (correct representation of assets/liabilities), cash pilferage and audit quality checks.

Six years of historical consolidated financials.

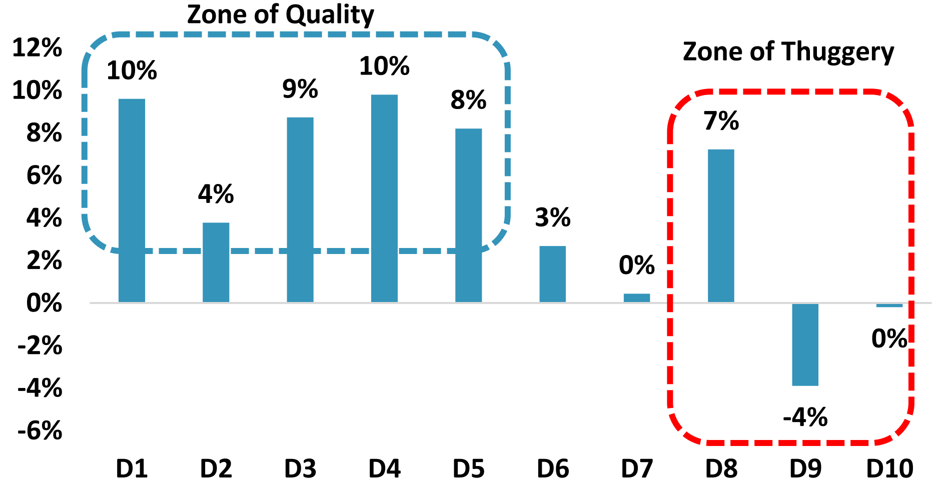
First rank stocks on each of the 12 ratios individually (some examples outlined in the table on the right). These ranks then cumulated across parameters to give a final pecking order on accounting quality for stocks –for instance D1 being the best, D10 being the worst.

Selection of these ratios has been inspired by Howard M. Schilit's legendary forensic accounting book 'Financial Shenanigans'.

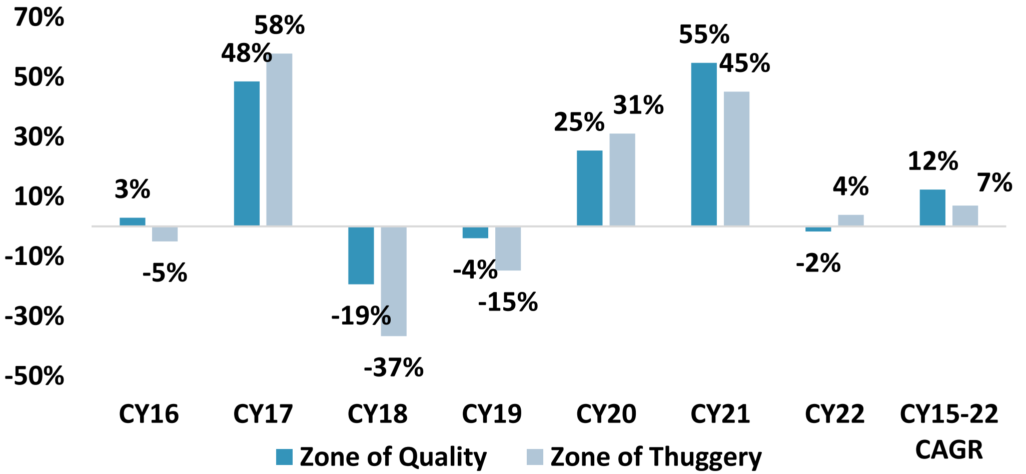
A few of our forensic ratios

Category	Ratios
Income statement checks	(1) Cashflow from operations (CFO) as % of EBITDA
	(2) Provisioning for Debtors
Balance sheet checks	(3) Yield on cash and cash equivalents
	(4) Contingent liabilities as % of Networth (for the latest available year)
Cash theft checks	(5) CWIP to gross block
Auditor checks	(6) Growth in auditors' remuneration to growth in revenues

Strong correlation between accounting quality and shareholders' returns



Quality wins and wins big over the long term



Source: Marcellus Investment Managers; Ace Equity

MARCELLUS STOCK SELECTION AND POSITION SIZING FRAMEWORK

Marcellus Research on a stock under coverage

Current competitive advantages - here and now

Earnings growth rate

Revenue growth, ROCE and capital reinvestment rate

Quantify industry demand growth, its drivers and its resilience.

Quantify revenue growth related to expected market share gains.

Profitability and asset turns - expected to improve meaningfully?

→ **Growth in cash flows**

Moat score

Strength of today's pricing power

Can a competitor offer a product which is a third cheaper and still have no impact on either the profitability or market share of our investee firm?

Longevity / Sustainability of competitive advantages

Lethargy score

Analysis based on efforts made in the last 3 years

Three aspects of lethargy tests:

1) Incremental deepening of existing moats
2) Experimentation / investments towards adding new moated revenue growth drivers
3) Attempts at radical disruption of the industry's future

Succession planning score

Softer aspects to help build an 'institution'

Four aspects of succession test:

1) Decentralised execution
2) CXOs - their quality and tenure at the firm
3) Historical evidence of implementing succession in CXO roles
4) Independence of Board of Directors

Moat score, Lethargy score, Succession planning score → **Longevity of cash flows**

Outcome: 1) Position sizing of stocks relative to others in our portfolio; and 2) Absolute valuation of stocks

WE PROACTIVELY SEEK TO INFLUENCE CHANGE

	Area of engagement	Desired outcome
Corporate governance	• Our analysts use forensic accounting to keep on eye on the diversion of cash by the 'promoters' of our investee companies	• If we spot diversion on a meaningful scale, we exit • If we spot the beginnings of what look like small scale diversion, we speak to the 'Promoter' and explain to her why her wealth creation can be compromised
Succession planning	• Thirty years from the reforms which opened up the Indian economy in 1991, many of India's leading 'promoters' are aged 70 or over. Hence, they are handing charge to the next generation.	• Through our discussions with suppliers, customers and competitors of a company, we keep a close eye on whether the 'promoter' is on top of his game. • If his successors either do not exist or have not been groomed adequately, we discuss the matter and its consequences with him.
Capital allocation	• Our investment strategy – of investing in dominant franchises with ROCE of around 40% - naturally leads us towards companies which generates heavy Free Cashflow. • If this Free Cashflow is not reinvested wisely, the compounding of the franchise suffers	• If we see a company either hoarding cash or moving into an unrelated, we engage with the 'promoter' to understand her thinking on capital allocation. • If we are not convinced about the fitness of what she's doing, we present our point of view (arguing in favour of a different capital allocation strategy) • If six months later we see that our engagement has made no difference, we consider exiting
Regulatory constructs	• Regulation – both in corporate law and in securities market law – is still evolving in India. This creates risks for the unwary.	• By being a part of multiple regulatory committees, by writing in the press and by being vocal on social and broadcast media about regulatory reform, we have sought to improve transparency in the fund management industry in India

DISCLAIMER

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