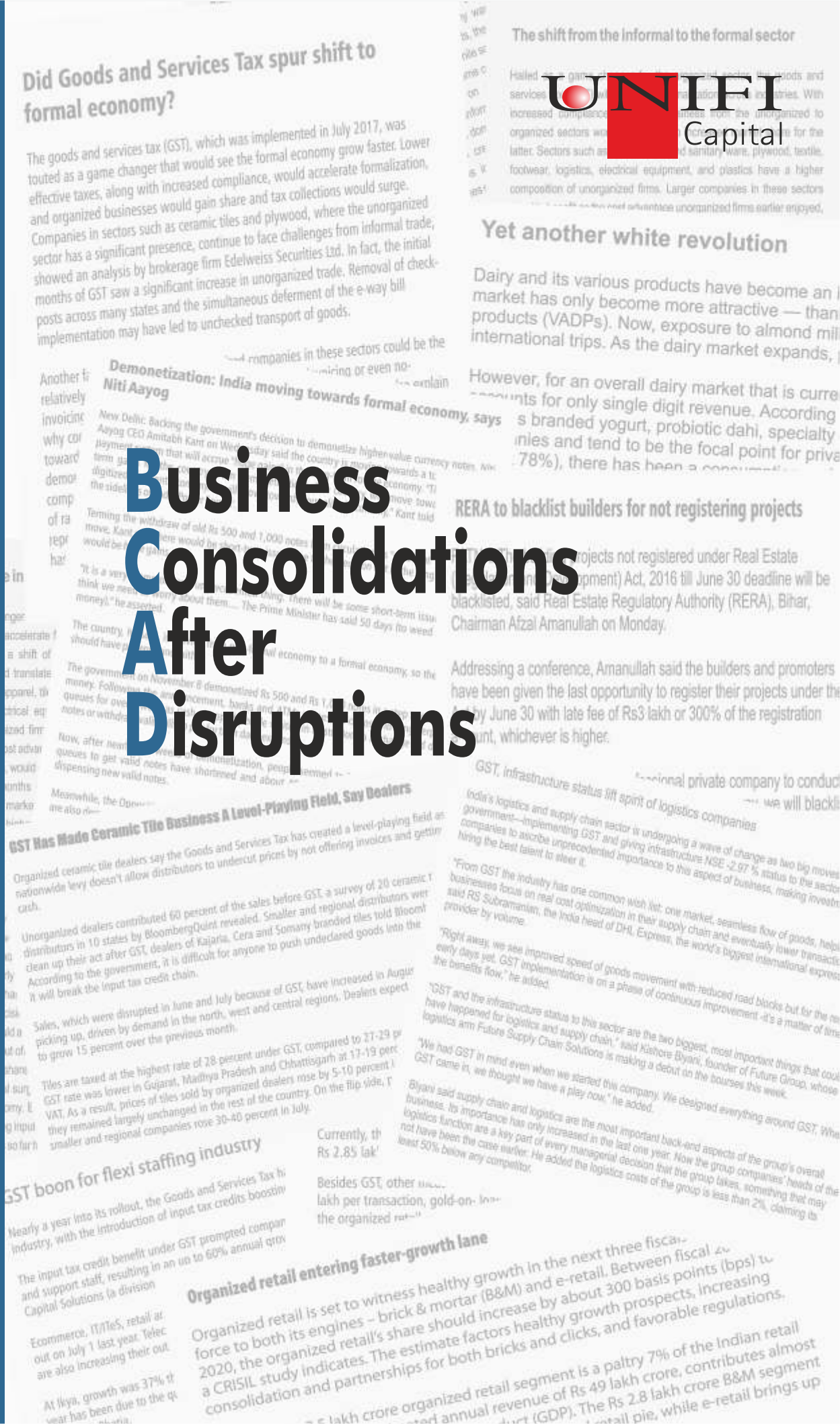
UNIFI Capital

Business Consolidations After Disruptions




Personal grooming
Retail
Luggage
Dairy

Investment Thesis

Businesses usually take shape in a fragmented manner when they are set up by aspiring entrepreneurs pursuing their passion. As these businesses grow larger, few of the successful entrepreneurs grow faster than the rest and become dominant players. They derive strength from economies of scale as well as the ability to invest in branding and expansion. When compliance requirements get robust, it is these larger players who have the capability to comply early and grow by acquiring smaller players who could neither comply nor compete. Thus, as time progresses the market share gets consolidated in fewer hands.

Different businesses have different factors to drive consolidation. Globally there are various studies on how various economies became formalised mostly by businesses consolidation. The drivers of such consolidation differ from country to country. Currently, the presence of unorganised business in the Indian economy is about 30% - 40% though the actual numbers differ from sector to sector. Most of the businesses represented in Sensex and Nifty are dominated by sectors that are all organised and consolidated. Banking, IT, Pharma, Telecom, Oil and Auto (about 2/3rd of the indices) are already organised and consolidated but they constitute less than 20% of our GDP. Businesses like Construction / Building materials, Retail, Logistics, Jewellery, Dairy are equally significant for the economy but continue to have high share of unorganised segment. While the academics and regulators define the unorganised sector based on the employee count or based on rural/small scale business orientation, the Industry Associations count them based on their non-compliance and hence on absence of data, we define "Unorganised players" as the entities that are non-compliant with any regulations related to Taxation, Environment, Labour laws etc., or those entities that are marginal players in fragmented businesses.

Business consolidation plays out when a dominant player gains market share from weaker hands. Broadly, there are two types of business consolidations. One is a type where it happens amongst organised businesses while in the second, the unorganised segment shrinks allowing organised players to grow faster than the rate at which the industry is growing. Both the cases deliver operating leverage benefits to the remaining players and shareholders in such companies tend to make exceptional returns.

Indian Telecom Industry is an example of Business consolidation among organised players. When the industry was opened up for private players, there were 20 to 30 players, each strong in their respective regions/circles. Over the next 20 years, the industry consolidated among top 5 players through acquisitions and exit of weaker players. Entry of Jio further consolidated the industry among 3 major players.

Building materials industry is an example of Business consolidation due to shift of business from unorganised sector to organised. For instance, take the case of the paints sector. About 20 years ago, the industry size was only Rs 5,000Cr, and had about 20+ players with strong brands, some national and many regional. It also had 1000s of small scale players catering to unorganised sectors. Only 1/3rd of the industry volume was with organised players. In the subsequent years, due to economic growth of about 4 times driven by Services sector (IT included), the housing industry grew and participated in the urbanization trend. Paint Industry grew more than 10 times and organised players now constitute more than 75% of the industry. Aided by the operating leverage characteristics of the brand driven businesses, net earnings of organised players grew exponentially. Some of the stocks in the industry became 100 baggers with the tailwind of the shift of demand from unorganised to organised.

There are innumerable examples of such 50x / 100x shareholder wealth creators from the businesses that have already shifted from fragmented/unorganised sector to a more organised and consolidated space. They are heavily represented in all major indices in India. Most portfolios built to outperform such indices are dominated by such companies that have already benefited from the consolidation drive. From here on, they may grow only at the rate at which their Industry is growing while shifting market share among the existing players, much like a musical chair competition.

In BC AD, we intend to build a portfolio of listed companies that belong to businesses that still have dominant unorganised presence and the drivers of the shift from unorganised to organised already exist. Such companies though being leaders in the organised sector of these businesses are still not that large in terms of market capitalization. They are unrepresented in major stock indices and hence under invested by Institutional investors. When drivers shift businesses from unorganised players to organised ones in a growing industry, the organised players grow faster than the industry. Few of such businesses have strong operating leverage characteristics (like a typical consumer business usually has) where earnings grow faster than sales in the later part of their growth chain.

We don't intend to identify companies that are future 100 baggers. Such an exercise requires identifying massive trends in the industry landscape as well as identifying the companies that are marginal players today but have strong tailwinds to push them forward and the management bandwidth that can exploit such an opportunity. This would require us to assume risks that we are not ready to accept on behalf of our investor clients. On the other hand, we intend to build a portfolio of companies that are already leaders in their business segments where their leadership is already built over many years of existence, with somewhat a proven model.

But they are in business segments that have lots of marginal players in a fragmented manner. The growing demand of their consumers, brand loyalty, increasing compliance requirements, urbanisation and demography trends can act as disruptors to the unorganised players necessitating shift of their business to organised players like the ones that we choose to invest

Factors triggering shift from unorganised to organised

The shift from unorganised to organised in the selected sectors can be triggered by various factors. Few of these factors are as below.

- **Regulatory Changes** – Change in regulations such as GST, RERA (Real Estate Regulatory Authority), Demonetisation can challenge the 'status quo' of the sector and render the business environment adverse for non-compliant unorganised players.
- **Demographics** – About 50% of the Indian population is less than the age of 25 years while 65% is below the age of 35. As a result, sectors which derive demand from younger sections of the population can witness exponential growth.
- **Urbanisation -** It is estimated that about 31% of the population of India resides in urban areas. While the overall population is growing at 2% per year, the growth of urban population is in double digits due to migration from rural India. The sectors catering to urban markets are likely to witness higher demand.
- **Consumer behaviour -** With burgeoning middle class and increase in per capita income, the share of household expenditure towards discretionary premium items is increasing and necessary food

expenditure as a percentage of total expense is decreasing. This is leading to increasing preference for branded goods and value-added products.

- **Technology** - With technological implementations, organised players are able to cater to customers in a more efficient manner than unorganised players causing the demand shift towards organised players.

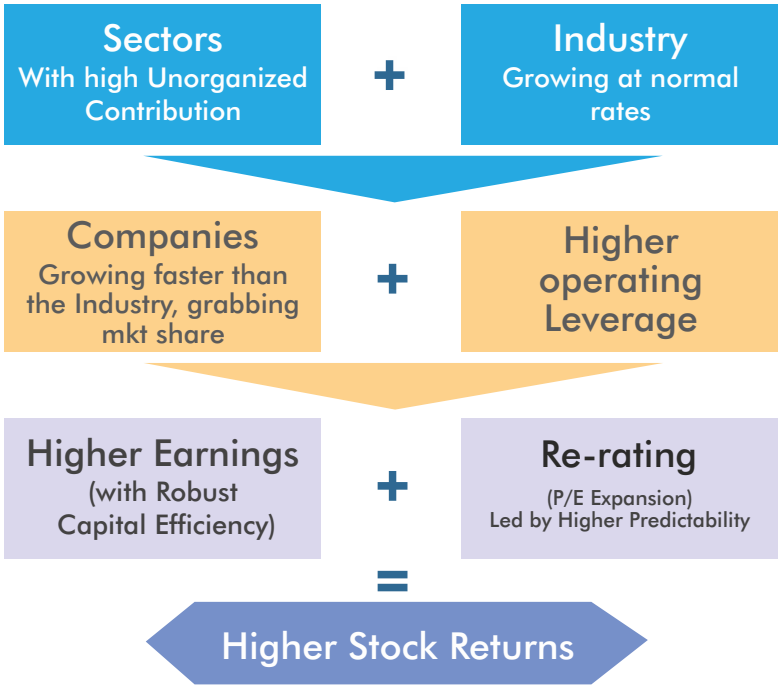
Investment universe

The fund would be investing in companies which are operating in the following sectors.

Building Materials	Consumer Durables	Logistics	Personal Grooming & Hygiene	Dairy	Retail	Healthcare	Hospitality	Entertainment	Finance	Real Estate	Jewellery	Others
Tiles & Sanitary ware	Electrical Goods	Logistics and Warehouse	Hair oil	Milk & Value added dairy products	Beverages/ Plantation owners	Hospitals	Hotels	Entertainment	Micro finance	Real estate	Retail jewellery chains	Residential and Agricultural Pumps
Wood/ Plywood	Footwear	Air/Rail/ Road/ Ship transport	Shaving related, Cosmetics		Apparel	Diagnostics	Restaurants/ QSR Chains		Gold loans			Automotive batteries
Piping solutions	Kitchenware		Beauty treatment		Retail Chains		Travel services					Staffing solutions
Roofing solutions	Luggage		Sanitary pads		Branded Retail- Apparel & Food							Animal feed
	Mattress makers		Wellness Centres		Building material retailing							
	Plastic furniture											

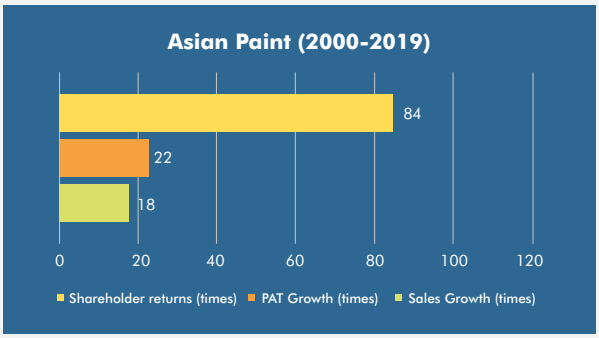
Note: We have identified the above list of sectors as the ones which have strong potential of witnessing the migration of market share from the unorganized space to the organized space within the next few years. Based on our continuous research efforts, we may amend the above list by adding/removing sectors as we gather further market insights on the underlying dynamics of each sector in the Indian economy.

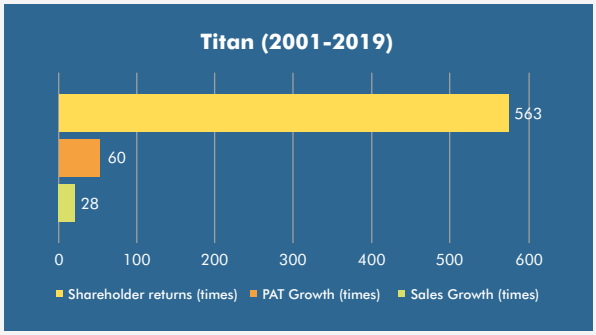
Pictorial representation of Investment thesis of BC AD

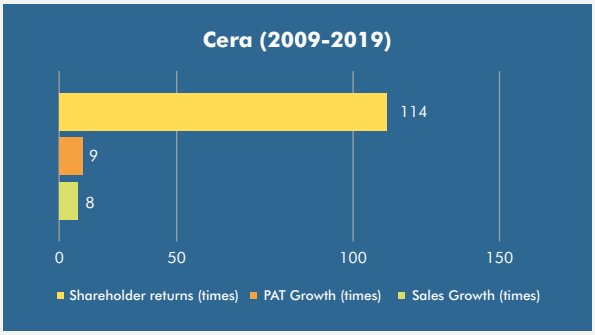


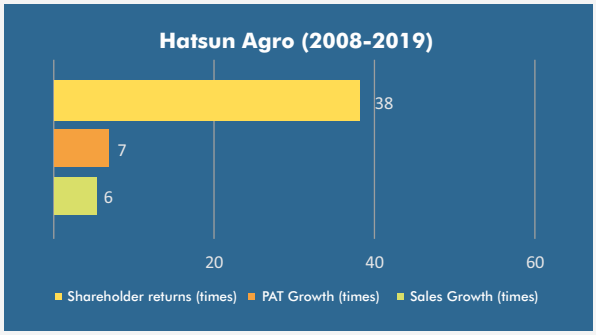
Past instances of superior returns from market leaders in Organised Space

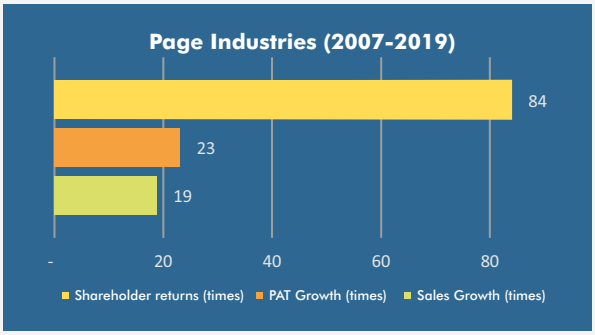
Past instances of superior returns from market leaders in organised space











Why Unifi?

Since inception in 2001, Unifi has specialized in niche and boutique themes and sectors. Such themes, appear contrarian in the beginning but, have done well as demonstrated by the exceptional returns, earned, both in absolute and relative terms.

At Unifi, we have few unique strengths:

1. Our relatively smaller size helps us focus on niche areas of the market wherein 'Institutional' type of capital can't be deployed,
2. A strong research team that believes in primary research and doesn't hesitate from initiating research into companies/sectors that lack analyst coverage and/or prone to information asymmetry,
3. Our direct engagement with each of our investors at regular intervals enable us to pursue strategies that are not benchmarked with major stock indices,
4. Our alignment of interest model of commercials bring clarity on absolute return targets as well as long term outlook in returns measurement.

Investment Risks

The fund would focus on companies in sectors where it expects a gradual shift in consumer demand from the unorganized players to the organized players. The investment process would involve analyzing multiple sectors and drawing up the list of factors which would be triggers for the migration of demand to the organized space. The key risk would be the time required for the transition to start playing out within the selected sectors. There might be stocks/sectors wherein the anticipated migration might take longer than the initially estimated time periods. Thus, it is suggested that investors take a longer term view when investing in this particular theme.

The unique characteristics of BC AD ideas ensure its alignment with our strengths. BC AD ideas are not well represented in stock indices and hence returns could diverge from the performance of the broader indices. Exponential growth would be some years away and therefore a long-term outlook is required to evaluate returns. Also, the universe of ideas converge around the small and midcap space wherein it is difficult for 'Institutional' type capital to invest.

FAQ

1. How is BC AD different from Manufacturing or FMCG themes run by Mutual funds? There are several FMCG schemes run by mutual funds and also many consumption oriented thematic funds. Is BC AD similar to them?

Consumption (FMCG) themes differ materially from business consolidation. Most of the FMCG schemes invest in companies that benefit from consumerism but could be a part of the already consolidated sectors, like telecom, auto, soaps, tooth paste, cigarettes etc. These schemes are benchmarked to FMCG Index or BSE Consumption Index and hence invest in stocks and sectors that are dominant in such indices. About 75% of such stocks in these indices are not in the universe that BC AD proposes to invest in. On the other hand, our universe essentially consists of businesses that are fragmented with significant contribution from unorganised sector and few organised players. We plan to select a few of these organised players.

2. Which are the sectors in India where such a shift has already happened? As per your study have you found any sectors which are likely to consolidate in the near future?

Over the last 30 years various businesses in India have already been consolidated. Most of the businesses that are dominant in Sensex, Nifty, Midcap, MSCI are examples of businesses that are already consolidated. The top 5 sectors that constitute about 2/3rd of these indices are Banking, IT, Auto, Oil & Telecom. Top 5 banks do more than 70% of India's banking, top 3 companies do 70% of India's auto sales in each sub segments (TW/4W/HCV), top 5 IT companies are about 50% of Indian IT industry, top 3 telecom companies have a 75% share of the Indian Telecom industry & top 5 Oil companies have more than 80% of oil trade.

The businesses where we have already seen shift from unorganised to organised especially in the last 10 to 15 years are paints, inner wear, sanitary ware, gold retailing and value added dairy products. Case studies of these sectors and shareholder returns in the leaders are explained in greater detail on Pg.4. From our initial study on Indian economy, we have identified 30+ subsectors that are listed on Pg. 3.

3. BC AD has compared the factors that brought change in developed markets/economy i.e. GDP increased from $2 trillion to $5 trillion, but considering Indian market/economy being different does this theme see changes coming in a time span of just 5 years? What if the change doesn't happen, then what?

It is true that Indian economy's characteristics differ from those of global markets. Copying a strategy in India that worked in global markets has not delivered expected returns. Business consolidation is not a western phenomenon. It has been happening in India over the last 10, 20, 30 years in many sectors driven by several factors. Business consolidations that have happened in India in the past, the timing and the nature of those consolidations differ from sector to sector. We are conscious of the risk that some sectors we choose to invest may take longer than 5 years to consolidate. We prioritize those sectors where the drivers of consolidation already exist or are in some stage of progress. We hedge the timing risk by diversifying across 15 to 20 stocks in 5 to 10 sub sectors.

4. The fabric of Indian economy largely consists of small entrepreneurs/small farmers, won't business consolidation hurt their interests and result in an economic slump?

The phobia similar to the one expressed in the above question made Governments to reserve several sectors for small entrepreneurs resulting in market inefficiency. As global markets integrate, businesses that remain fragmented in the hands of several small entrepreneurs plagued by inefficiency get disrupted by global companies who have scale and access to technology to compete successfully. One common trend in businesses that have already consolidated is that the unorganised players instead of competing with organised industry became sub-agents/ job work providers benefitting all stake holders.

In several businesses the drivers of consolidation already exist, though the timing of shift is unknown. BC AD proposes to invest in such businesses. The socialistic fallout of such business consolidation is not in the purview of this theme.

5. Consolidation happens in value migration as well. Why isn't value migration a central theme to this product?

Consolidation happens in different businesses based on different triggers. Value migration is just one of them. For example, in the early 90's, before the advent of SEBI and NSE, the broking industry had thousands of stock brokers in BSE and various regional stock exchanges. Most of these stock broking firms had a decent business model. Those days there were not much margin requirements, brokers had 3 weeks' time to settle or square off the position. Irrespective of the size, each entity could have only 4 brokers executing trades in the trading hall of respective stock exchanges. Large institutions used to execute their trades by spreading among many brokers.

When NSE came along in the late 90's enabling nationwide trading through satellite links, those few broking entities that were tech savvy and had the capital to invest in infrastructure flourished. The last 20 years of improving compliance standards of SEBI favoured only well capitalised firms to handle large volumes due to strict margin requirements. Hence, brokerage business moved from 1000's of broking firms to those few firms that were tech savvy and well capitalized.

Such handful of firms who control more than half of the business volumes have delivered exceptional shareholder return. Whether value migration happened in this consolidation or not is a different debate.

6. What would be the impact on BC AD performance in case if Government regulation changes on taxation, GST etc.?

Even though our research project that eventually led to this theme began with the implementation of GST, this is neither a GST centric theme nor focused on government regulations. The drivers of consolidation as mentioned on Pg.2 include demography, urbanisation, technology, global environmental compliances etc. While one of the drivers of consolidation is government tax regulations, that is not the only driver of consolidation across sectors. There are several businesses in India that have got consolidated in the last 20-30 years independent of GST or any regulatory changes. Hence the merit of this theme is unlikely to be impacted by a change in government or policies. Out of a limited observation in this context, since liberalization in 1991 none of the new governments reversed prior government policies that were critically important (like GST) even though markets had its own fears.

7. What should be the tenure for Investment? I can invest money only for 3 years. Should I invest in BC AD?

There are 3 major risks we assume in picking stocks for BC AD:

(1) Our ability to size the unorganised sector in several businesses that we choose to invest in.

(2) The time it takes for the businesses to consolidate through shift from unorganised to organised sector.

(3) The companies we choose to invest benefiting from the consolidation.

While the first and the third risks remain in a portfolio evaluation over a 3 or 5 year period, the second risk reduces when the time period of evaluation is longer. As the fund manager believes he has a 5 year period to perform, there would be several picks he would have made that would not deliver desired results in the shorter period the investor contemplates. Hence it is advisable for the investor with a short term investment horizon to avoid considering BC AD.

8. Will BC AD have stocks from previous themes?

In the past 19 years we have done several themes and lived true to each of the underlying themes. We have never deviated away from the set theme. In certain situations where a company is undertaking a Spin off exercise and promoters of the same company have increased stake, we might have held the same stock in both Insider shadow theme as well as Spin off theme. To the extent possible we have avoided similar portfolios across themes except in situations as described above. Blend is the only theme where we hold stocks that we have held in other themes.

In BC AD we build a portfolio of stocks of companies who are leaders in the organised sector of a business with significant unorganised presence. If such a leader is undertaking a spin off or belongs to one of the sub segments we invest in, we may then have similar stocks.

9. What will be the trigger points for sale in BC AD? Will it be a very passive low churn buy and hold strategy?

BC AD will be a portfolio of 15 to 20 stocks that belong to 10 different sectors, each of them hand- picked with a 5-year earnings growth perspective. The anticipated earnings growth comes from the consolidation tailwinds such businesses have, which can't be validated on quarterly basis. Our intent is to prioritize businesses where the pace of consolidation is sharp in the given time period. As long as the earnings growth momentum is in line with our expectations, we will continue to hold them. From time to time we may observe few situations that can delay consolidations or few companies failing in the execution part. In such situations we may consider exit in favour of other opportunities. It is therefore fair to expect this portfolio to be a low churn one.

10. What are the risks that would hurt the return from investing in such stocks?

There are two types of risks to the investor: one from anticipated earnings growth and the other from PE. Of these two variables, PE in the long term follows the earnings growth and so long-term portfolio risk come from anticipated earnings growth not materialising, while in the short-term PE volatility can be driven by various reasons like broader market factors, liquidity, elections, etc.

In BC AD we are investing in companies that are already leaders in the organised sector with proven business models, established credentials and demonstrated management capabilities to grow businesses. In the past, consolidation in certain businesses have created many 100 baggers, but most of them have come from modest beginnings that had significant earnings risks before they became multi baggers. We don't strive to identify such companies as we are neither mandated to assume such risks nor to identify 100 baggers. Nevertheless, we will closely monitor the earnings growth regularly driven partly by the industry consolidation in their favour and the operating characteristics of such businesses. With significant stake in each of the companies our investment decisions are supported by a combination of primary and secondary research.

11. While I do have a long term view with regard to my overall portfolio with you, how much portion of my Unifi portfolio can be invested in this theme?

Unlike our other themes which took opportunistic calls aggressively, in BC AD majority of the companies we invest have strong brands with proven business models and leadership positions. Though execution risk remains in benefitting from the structural tailwind of consolidation, we neither take business risk nor balance sheet risk in our portfolio. Hence this portfolio must deliver exceptional value over long period of time with minimal churn, unlike our other themes that were opportunistic. Capital allocation is partly a function of merit of the product and investor's overall portfolio allocation mix. Kindly consult your financial advisor before taking allocation decision.

12. How should one decide which fee model works best for him out of the two i.e. Fixed fee and Profit sharing? Please highlight the difference and advise the merit of both the structures in detail.

Say under the distributor option, the fixed fee model of 2% p.a. brings clarity on the cost in the initial phase itself, whereas the actual cost in the profit share option could differ from 1.5% p.a. to 3% p.a. or more. Since we provide the offset benefit of management fee, the profit share option begins to work only above 17.5% p.a. The threshold of investor returns beyond which the profit share cost is higher than 2% will be around 19% p.a. For illustrative purposes, in case of 3x returns over 5 years which is 25% p.a. compounded, the profit share cost would be 3% p.a. Those investors who have an inclination to pay more when they earn more but prefer to have less fees when they earn less will find the profit share option interesting. Some of our existing investors who have observed higher profit share cost due to higher return in our earlier themes might find the fixed fee more economical.

13. Is this theme similar to other themes in the past where you have pursued low PE opportunities?

The perception that Unifi has always followed low PE investing is not fair. In each of the themes that we have pursued in the past, the parameters we have used to find value are different. For example: Holdco theme had high PE companies but we justified them based on the discount to the holding value and the theme has done exceptionally well.

Whereas in Spin off fund there were quite a few high PE opportunities where we invested based on the benefits of value unlocking through a demerger. In other themes like APJ20 & DVD we avoided high PE opportunities where the expected earnings growth did not justify the same. Hence the PEG (PE/Earnings Growth) always remained less than 1. In BC AD we may consider stocks with a PEG range of 1 to 1.5 partly due to the high ROE nature of these companies and partly due to momentum in earnings growth from anticipated business consolidations.

Nevertheless, the valuation paradigm of BC AD will be higher than most of our other themes, but so is the quality of earnings and the growth potential.

14. What is the fair return one can expect from the fund? Is 200% a target or a guarantee?

Stock price is a factor of valuation the market gives (PE i.e. Price to Earnings multiple) to the earnings of the company (EPS). In general, stock price = PE x EPS. While valuations can swing based on the quality of the business, management and more importantly, the mood of the market, we fundamentally believe that our investment returns (over time) will correlate with the growth in earnings per share of our portfolio.

The 200% return is not a target or a guarantee. Investors should not invest in the fund expecting 3x at the end of 5 years. However if the portfolio achieves 3x under 5 years due to wide expansion in valuations driven by positive sentiments and outlook, we would like to capitalise from an early closure. We may then review objectively if the opportunity persists to continue and in such cases, the portfolios are renewed for another term with after-profit-fee NAV as revised capital. Valuations tend to mean revert and we prefer to capitalise on high valuations considering mutual interest. As far as return expectations are concerned, one can expect the returns to correlate earnings growth of the portfolio.

15. Given that the fund was launched in April 2018, how have the portfolio companies fared during the subsequent economic slowdown that the country witnessed?

It is true that the economic slowdown led to lower sales growth for bulk of the companies in the Indian economy. Given that most of the BC AD companies are consumer facing in nature, their earnings would depend on the overall consumption driven spending in the economy. In FY 20, these companies saw lower sales growth compared to their historical averages, primarily due to consumption slowdown. At the same time we have seen them consolidating their market position at the cost of their unorganised peers. As a result, these companies displayed a typical defensive characteristic and outperformed the rest of the market during this tough period. Their strong operating cashflows, superior capital efficiency, zero debt on the balance sheet, minimal capex requirements and market leading brand presence, enables them to retain the trust of the investors even during downturns. When the economy rebounds, these companies are best placed to grow their sales faster than their respective peer-group and driven by their strong operating leverage, post superior earnings' trajectories over the next growth cycle.

About Unifi

Unifi Capital Private Limited is a specialised portfolio management company based in Chennai and has offices in Mumbai, Bangalore, Hyderabad, Kolkata and Delhi. It is managed by a core team of 4 experienced capital market professionals who co-founded the company in 2001 along with the principal founder and Chief Investment Officer, Sarath Reddy. Unifi manages funds for high net worth families in India and overseas.

Unifi offers multiple customised investment opportunities to its clients with varied levels of risks. Being differentiated styles that offer stable absolute return or superior relative returns with high levels of personalisation and customer service is fundamental to Unifi's PMS. It rigorously follows a disciplined investment process and places utmost focus on safety of client's capital. Unifi Capital is regulated by Securities Exchange Board of India.

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