Deep Value @ Discount Fund

UNIFI Capital

The future is never clear; you pay a very high price in the stock market for a cheery consensus.

- **Warren Buffett, Forbes Magazine Article dated August 6, 1979**

Background

Various studies have empirically demonstrated the advantage of pursuing a value-based investment approach. These have been buttressed by the real investment records of various value-oriented investment managers over a long period of time, through either running private investment partnerships or holding companies across the world.

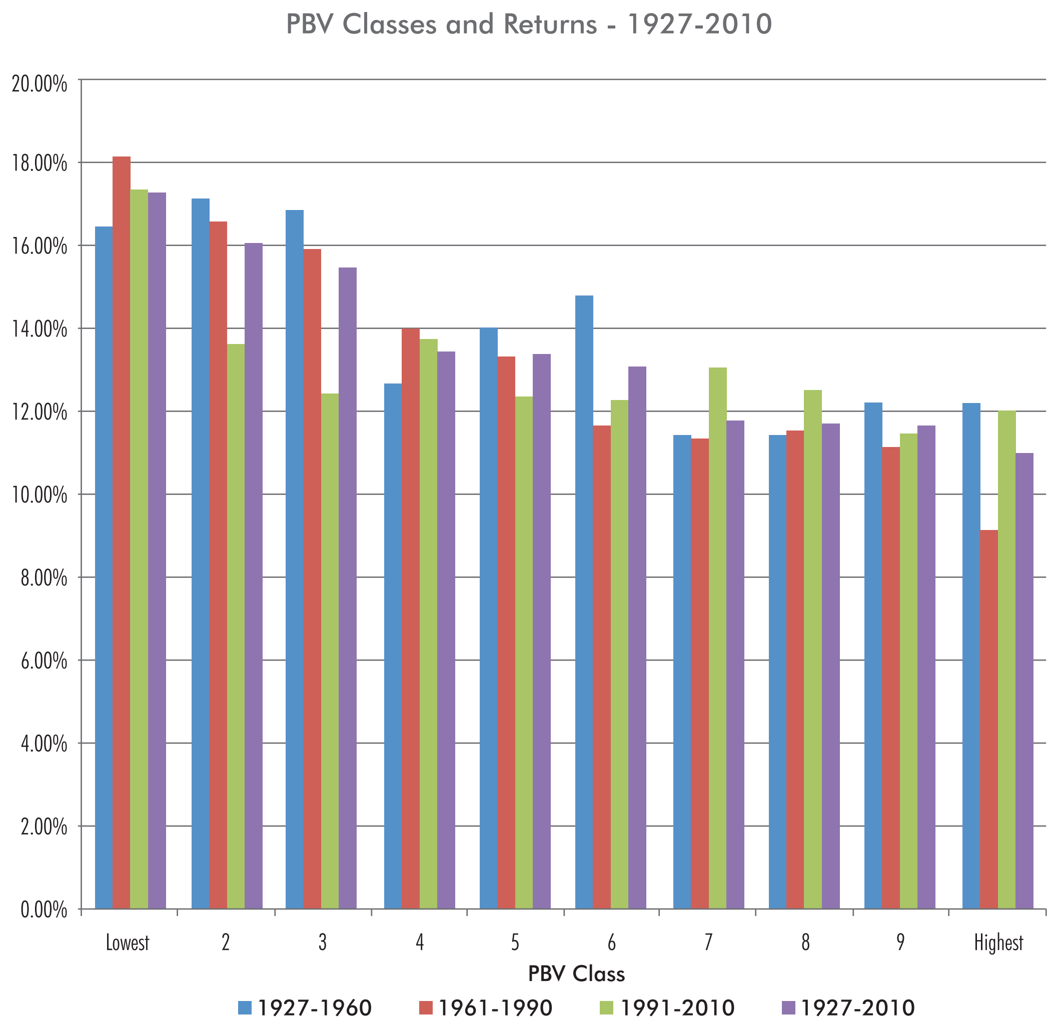
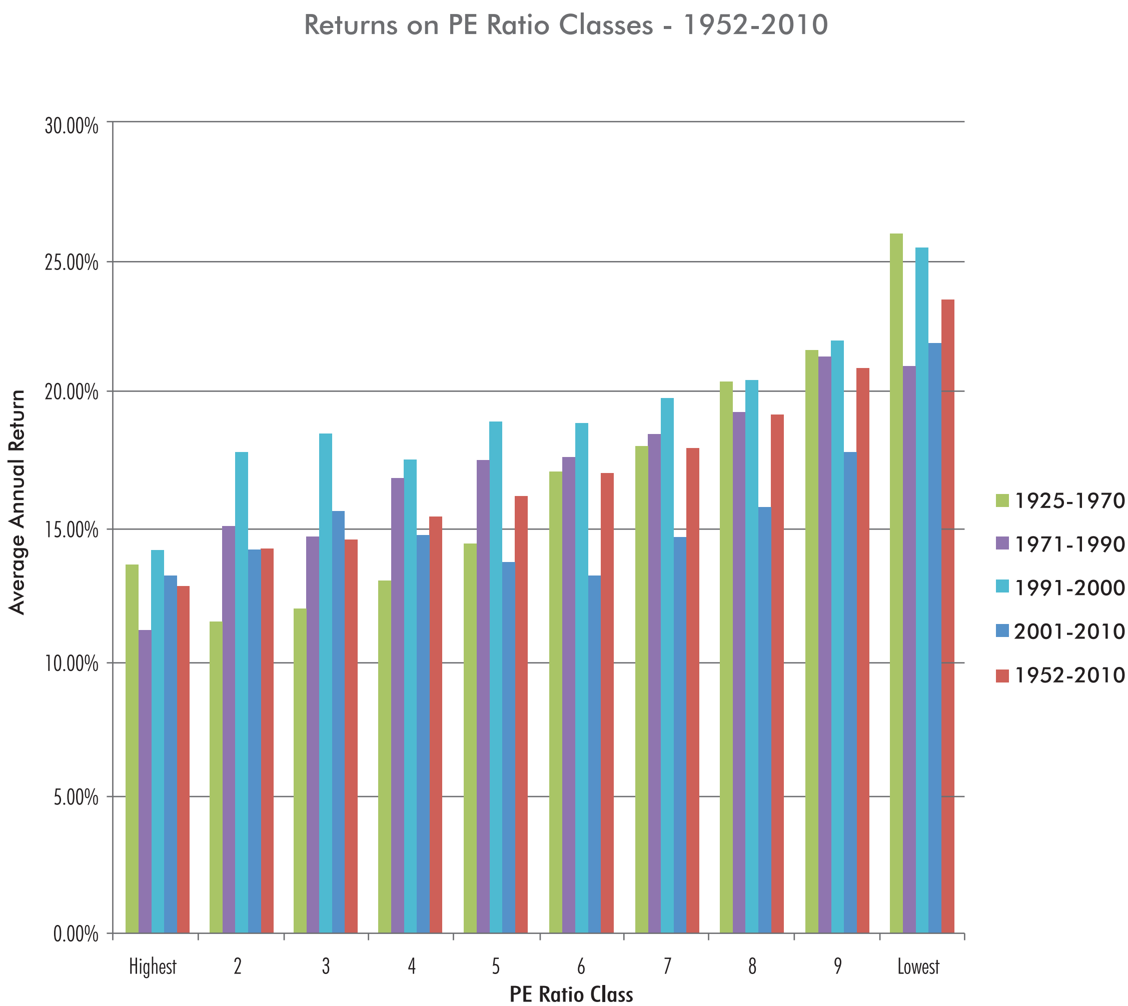


Table reproduced from Ashwath Damodaran's April 2012 paper titled 'Value Investing: Investing for Grown Ups?'

Stock returns pertain to US listed stocks.



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Stock returns pertain to listed US stocks.

While there are many value approaches, value investing fundamentally reduces to buying something for less than it is at least worth. It's easy to see why value investing should work: buying a piece of a business for less than it is intrinsically worth should naturally produce profitable results. As we will see in the following section, this is easier in theory than in practice.

Value Investing: Easy To Understand, Hard To Practice

The idea of buying a part ownership in a business for less than it is intrinsically worth, on a conservative basis, is not revolutionary; the concept itself is simple. And there is a fair proportion of people to whom the approach both appeals and registers immediately.

Why then is it so rare to see value investing applied in traditional money management? The answer: Incentives.

Traditional money management relies on relative performance of the managed portfolio versus the index as a measure of investment performance. The shorter the frequencies of such 'appraisal', greater are the odds of underperformance. Underperformance attracts the risk of flight of capital, so it becomes harder for managers to employ, and more importantly, stick to a value-based approach as career risk takes centre-stage.

In a 1986 Columbia Business School's Hermes magazine article titled 'ARE SHORT-TERM PERFORMANCE AND VALUE INVESTING MUTUALLY EXCLUSIVE? THE HARE AND THE TORTOISE REVISITED', V.Eugene Shahan found that none of the seven managers profiled by Warren Buffett in his May 1984 'Super Investors of Graham and Doddsville' lecture outperformed the S&P 500 every year. In fact, while the overall outperformance versus the S&P over time was significant for each manager, 6 of those managers had underperformance ranging from 28.3% to 42.1% for one or more years during the period referenced. And the underperformance spanned multiple years.[1]

Value investing demands extraordinary emotional equanimity from both the manager and his / her clients. A successful practitioner of value must be as judicious with investment selection as she is with client selection. Equally, it is important for clients to understand and accept the manager's investment philosophy before committing capital. In the investing world, neither comes easy.

In addition, the standard practice of charging a management fee, as a percentage of assets managed, and the lack of restriction on fund size skews the manager's incentive towards gathering assets.

Deep Value @ Discount (DVD) Fund has been structured in a manner that remedies the aforementioned deficiencies of the traditional structures.

[1] What Has Worked In Investing: Studies of Investment Approaches and Characteristics Associated with Exceptional Returns by Tweedy, Browne Company LLC

Why Does Price Catch Up With Value?

Benjamin Graham, widely regarded as the father of value investing, was invited to a US Congressional hearing in March 1955 on the factors that affect the buying and selling of equity securities. An illustrative snippet from the dialogue that ensued follows:

THE CHAIRMAN: When you find a special situation and you decide, just for illustration, that you can buy for 10 and it is worth 30, and you take a position, and then you cannot realize it until a lot of other people decide it is worth 30, how is that process brought about by advertising, or what happens?

Mr. GRAHAM: That is one of the mysteries of our business and it is a mystery to me as well as to everyone else. We know from experience that eventually the market catches up with value. It realizes it in one way or another.

Objective

The Fund seeks to achieve above-average returns with below-average risk. The market's current focus is on short-term issues, rather than on a long-term structural shift. Today's valuations allow for exceptional returns along with substantial downside protection. The Fund aims to double investors' capital in 36 months or less.

Philosophy

- Focus on absolute returns.
- Intrinsic value is not a single, precise number. Rather, it is a range.
- Buy at a discount to intrinsic value, conservatively calculated.
- Look for situations where the market is not only ignoring the future, but also a bit of the present.
- The combination of both a bargain price at the time of purchase and the value add from retained earnings over the holding period will contribute to investment returns.
- Aim to be rational, not merely contrarian.
- Cheap price in relation to value is often the single biggest catalyst.

Strategy

The Fund concentrates on exploiting inefficiencies in the market. Market inefficiencies typically arise in the following situations:

a. Over-reaction to a short-term negative event, a poor earnings report for example.

   From Contrarian Investment, Extrapolation and Risk (Lakonishak, Schleifer and Vishny):

   "Putting excessive weight on recent past history, as opposed to a rational prior, is a common judgment error in psychological experiments and not just in the stock market."

b. A sector that is currently temporarily depressed.

c. A business that is in the midst of a turnaround.

d. Widespread market dislocation driven by a geo-political/economic shock.

e. Institutional imperative of benchmarking that causes portfolio managers to chase businesses with good recent business performance and sell those that haven't.

f. Large corpuses under institutional management that suppress the incentive to seek out small companies that aren't widely followed or understood.

g. Institutional reluctance to purchase, and disclose, companies with recent 'negative' headlines.

h. Indiscriminate selling, e.g. a margin call on a promoter pledge.

i. Corporate restructurings such as demergers or spin-offs.

j. High-uncertainty but low-risk situations.

In summary, to borrow from a wise saying: *We look to buy from pessimists and sell to optimists*.

Universe

The Fund's investment universe is the set of all listed companies whose market capitalization ranges between ₹2000 mn. and ₹50000 mn.

Pockets of Pessimism

The Fund will source potential investment ideas from a custom screener that is designed to filter companies whose stock performance has lagged the change in the intrinsic value of the business over a 5-year time period. Benjamin Graham and David Dodd's text titled 'Security Analysis', often labeled the Bible of Value Investing, starts with this Horace quote that is appropriate in this context:

"Many shall be restored that are now fallen and many shall fall that are now in honour."

Corporate Restructurings

In this category, the Fund will mostly source ideas from spin-off announcements from companies that have been disclosed to the exchanges. While companies spin-off entities for a variety of reasons, historical evidence suggests that spin-offs are an especially fertile source of mispricing, resulting typically from the following factors:

- Indiscriminate selling without regard to value by investors who are interested mainly in the parent company's business.
- Forced selling by managers whose mandate is restricted to stocks listed in a specific index and where the spun-off entity is not a constituent.
- A lack of clarity on the spun-off entity's historical economic characteristics.
- The relatively smaller scale and therefore potentially higher perceived business risk for the spun-off entity.

Unifi Capital's study of around 70 transactions between 2005 and 2010 revealed that the spun-off entity underperformed the BSE500 index for the first year post listing by 27%, lending support to the idea that the mispricing is likely to occur in the spun-off entities.

Equity carve-outs, where the parent offers shares to the public in a majority-held subsidiary, is unlikely to be a attractive source of ideas for the Fund, as the primary motivation in such a move is the raising of capital for the parent as opposed to any desire to remove part of the "conglomerate discount".

Insider Purchases

Another source of ideas will be news flows of disclosures made by insiders/companies under Clause 7&8 (Substantial Acquisition of Shares and Takeovers) and Clause 13 (Prohibition of Insider Trading) of SEBI Regulations.

A meaningful promoter stake increase via an open market acquisition is usually a good sign as to his/her evaluation of the value of the company vis-à-vis the current market price. Given the information edge that they possess over the rest of the investing world when it comes to understanding their company, it is clear that this category deserves active monitoring in the pursuit of value.

Buybacks are not nearly as indicative of value as stake increases are. Nevertheless, a buyback announcement from managements that have shown themselves to be excellent allocators of capital over time should be rigorously evaluated, especially if it is accompanied by a past history of follow-through on such announcements.

All ideas that have been so sourced will be subject to the rigorous, bottom-up, fundamental analysis that Unifi Capital has been practicing over the last decade.

Investment Risks

While the approach itself is rooted on buying at a discount to conservative valuation, there nevertheless exist possibilities for negative surprises in individual securities including, but not limited to:

- An issue that had been assessed as being temporary morphing into a long-term fundamental deficiency.
- Erosion of a moat that had previously been assessed as being durable.
- Value-destroying acquisitions.
- Change in business strategy/management behavior that is at odds with prior communication.
- Deterioration in macro-economic conditions.
- Regulatory changes that impact business fundamentals.

However, the emphasis on price paid for each individual security should protect the overall portfolio from the possibility of a significant permanent loss of capital.

Structure

The Fund will hold a concentrated portfolio of about 8-10 stocks, across various sectors. There is likely to be low turnover in the Fund. There will be no benchmarking over the life of the Fund. While the Fund will be open-ended, the expected time horizon for an investment in the Fund is 36 months.

The Unifi Advantatge

Unifi has a long, demonstrated history of investments in the small/mid-cap space which is traditionally where most of the value mispricing occurs. Unifi Capital's investment approach is process driven. Qualitative criteria are as meaningful as quantitative criteria in investment idea selection. Particular emphasis is paid to regulatory, political and corporate governance risks.

Unifi's evolution over time has clearly demonstrated the need for in-house primary research and less reliance on 3rd party research. Unifi believes that being able to reference the quality of management/promoter is a key ingredient for successful investments in small/medium-sized companies. Unifi also believes that meeting with management is important in order to gain a significantly broader understanding of the business and its nuances than may be available from reading annual reports.

Unifi has a research team of 5 analysts. Potential ideas are presented by research analysts from amongst their sectors of expertise and evaluated by an investment committee. While the work in ferreting out an investment idea is collaborative, the responsibility for the Fund's performance ultimately results with the Fund Manager.

Unifi's active insider activity filter has kept track of all insider activity over a 2-year time period for companies comprising the BSE 500 index. Fundamental, bottom-up research has led to a basket of 100 companies that are actively monitored. This experience of following insider purchases will stand us in good stead as we seek out potential value candidates which likely reside in these cases.

Unifi made an extensive study of around 70 spin-off transactions that occurred in the 2005-2010 time-frame. This rich repository of knowledge was the backbone for the Unifi Spin-Off Fund that was launched in December 2010. Several opportunities were evaluated as part of this Fund's operations, with 5 spin-off transactions resulting in investments.

The operation of the Spin-Off Fund has provided valuable learning, right from the mechanics of the spin-off process. We are now better positioned to appreciate the risks associated with this style (e.g. timing risk as a result of management indifference) and what drives performance, i.e. fundamental business performance post event.

Performance Analysis

The following assumptions pertain to the constituents of the Model Portfolio below:

- The portfolio is equally weighted.
- Stocks in the portfolio bought and held for three 3 years.
- Only companies that had market capitalizations between ₹2000 mn. and ₹50000 mn. as of the date of the construction of the portfolio were considered eligible for inclusion.

Change in intrinsic value outpacing change in market value

Unifi's proprietary screener that seeks out companies whose change in intrinsic value has exceeded the stock's performance over a 5-year period would have produced the following results over the 3-year period from 30th October 2009 through 31st October 2012.

Date	30-Oct-09	31-Oct-12	Returns
Model Portfolio			58.04%
BSE Sensex	15896.28	18505.38	16.41%
BSE SmallCap	6989.17	7058.72	1.00%
BSE MidCap	6014.3	6565.99	9.17%

Source: Capitaline data

It must be emphasized that the DVD Fund will not employ a mechanical approach to investing. These returns are merely illustrative of the attractiveness of the ideas that ought to accrue from the custom screener and should not be construed as indicative of potential performance of the Fund.

Unifi's successful approach to Client Management

Ongoing Relationship Management

To keep things simple for the customer, we assign ownership of each customer to a Relationship Manager (RM). It is the RM's responsibility to co-ordinate internally to exceed service requirements of the customer. Unifi's RM's have proven track records in capital markets and are capable of experienced advisement in line with Unifi's market view and investment philosophy. While the RM is accountable on a day to day basis, the CEO retains overall accountability and is available to assist in any situation.

Reporting

Unifi's back office operations are equipped with appropriate technology and processes to handle accounting, settlement, custody and reporting in a totally secure environment. At the end of each working day, we have the capability to provide a 100% up-to-date statement to the customer. While interim reports are available on request via e-mail, Unifi maintains a monthly reporting cycle for all customers. The monthly report, containing a transaction statement, bank statement and securities custody statement, provides confirmation of holdings as well as comprehensive and up-to-date status of an account's performance. Confidentiality of client information is assured through multiple levels of security.

Audit

All customer accounts are audited annually by one of India's oldest and most reputed CA firms. An audit certificate from them along with detailed financial statements is provided to the client.

Performance Review

A quarterly meeting is scheduled between the client and RM to review the performance for the quarter and the year to date. Significant transactions and positions are discussed. Unifi's market view and its near-term plans are presented. Customer feedback and specific requests can be recorded and handled. If the customer is located abroad, the review happens over a call. Unifi believes that nothing can replace human contact and strives to organise in-person meetings to the extent feasible.

Process

While Unifi provides a wide range of customized solutions to help address a variety of situations, the following are common across all of them:

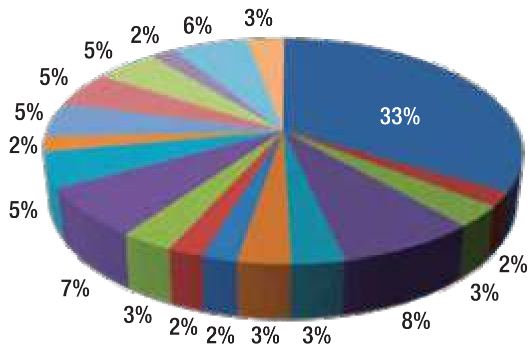
- We leverage the latest technology and best practices for providing high-quality service.
- We make decisions and advice based on research, never on hearsay and tips.
- Safety of capital and a low-risk approach is our prime concern.

About Unifi

Unifi Capital Private Limited is a specialized portfolio management company based in Chennai and has offices in Mumbai, Bangalore, Hyderabad, Mauritius and the UAE. It is managed by a core team of 5 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 several high net worth families in India and overseas and advises international institutional capital managed by its Investment Management subsidiary in Mauritius.

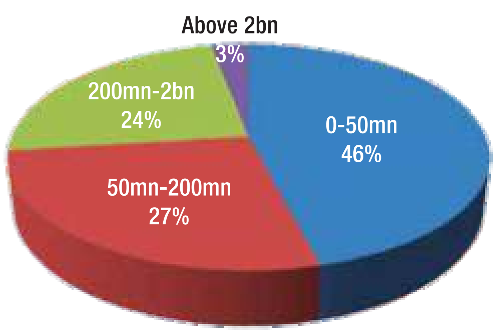
Unifi offers multiple customized investment opportunities to its clients with the low risk, moderate return 'Event Arbitrage' style being its flagship offering. Building differentiated styles that offer stable absolute returns or superior relative returns with high levels of personalization and customer service is fundamental to Unifi's portfolio management service. It rigorously follows a disciplined investment process and places utmost focus on safety of client capital. Unifi is regulated by the Securities and Exchange Board of India and its overseas subsidiary is regulated by Financial Services Commission Mauritius.

Appendix 1: Distribution of promoter stake increases since June 2010 (sector basis)



- Auto Ancillaries - 2%
- Banks - 3%
- Capital Goods - 8%
- Cement - 3%
- Chemical - 3%
- Construction - 2%
- Consumer Durables - 2%
- Entertainment - 3%
- Finance - 7%
- IT - Software - 5%
- Packaging - 2%
- Pharmaceuticals - 5%
- Realty - 5%
- Steel - 5%
- Sugar - 2%
- Textiles - 6%
- Trading - 6%
- Others - 33%

Appendix 2: Distribution of promoter stake increases since June 2010 (market capitalization basis)



Appendix 3: Insider Purchase Model Portfolio

The model portfolio below is assumed to be constructed on 1st January 2009 based on examining promoter purchase increases in the quarter prior to the Sensex bottoming out in February 2009.

Date	01-Jan-09	02-Jan-12	Returns
Model Portfolio			62.61%
BSE Sensex	9903.46	15517.92	56.69%
BSE SmallCap	3810.41	5556.48	16.79%
BSE MidCap	3319.1	5131.6	54.61%

NOTES

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Disclaimer

Securities, investments are subject to market risks and there can be no assurance or guarantee that the objectives will be achieved. As with any investment in securities, the value of the portfolio under management may go up or down, depending on the various factors and forces affecting the capital market. Past performance of the Portfolio Managers is not an indication of the future performance of the Portfolio Managers. Investors in the fund are not being offered any guaranteed / assured returns.

This information has been compiled from sources we believe to be reliable, but we do not hold ourselves responsible for its completeness or accuracy. References to actions of specific companies have been made as a matter of fact but the comments on such actions represent only our judgment and analysis and not that of the specific companies. This material is not an offer to sell or a solicitation to buy any securities or any financial instruments mentioned in the report. Unifi Capital Pvt. Ltd. and their officers and employees may or may not have a position with respect to the securities / other financial instruments mentioned herein. Unifi Capital Pvt. Ltd. may from time to time, have a consulting relationship with a company being reported upon. All opinions and estimations included in this report constitute our judgment as of this date and are subject to change without notice.

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