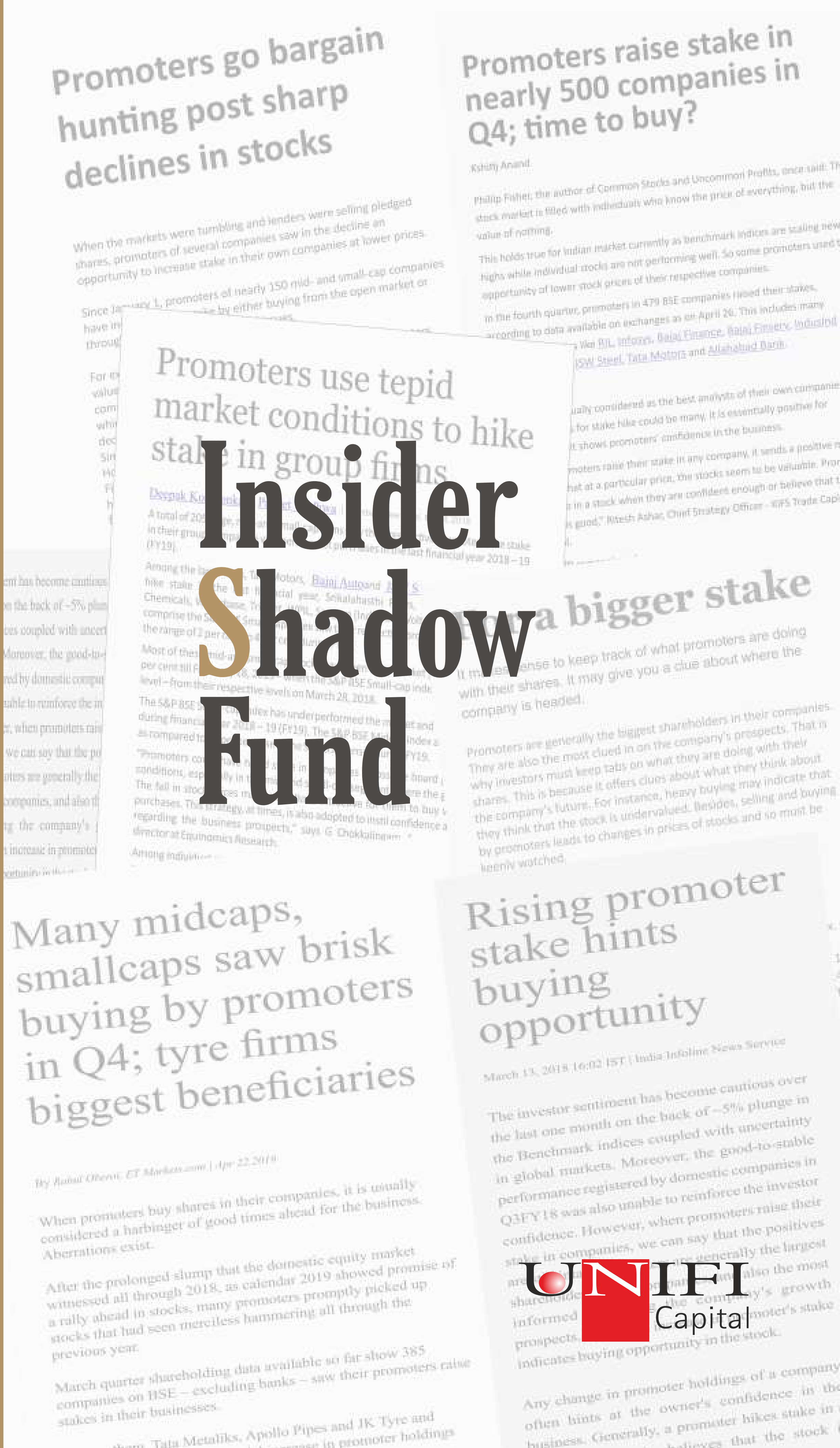
Insider Shadow Fund



UNIFI Capital

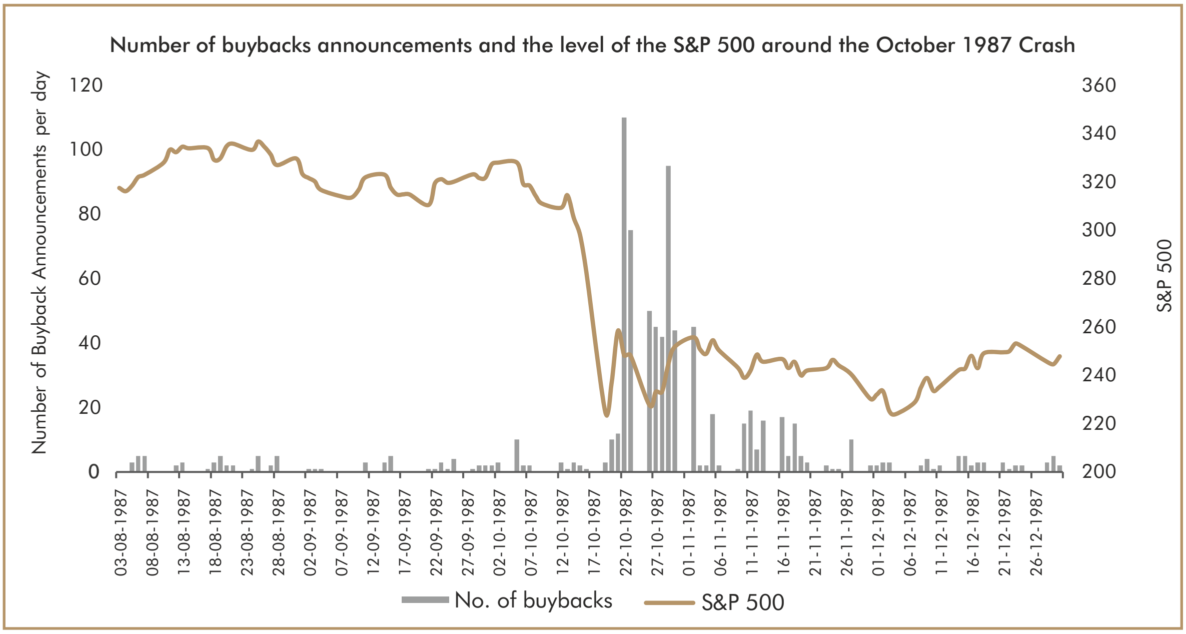
" When companies with outstanding business and comfortable financial positions find their shares selling far below intrinsic value in the market place, no alternate action can benefit shareholders as surely as repurchases" - Warren Buffet.

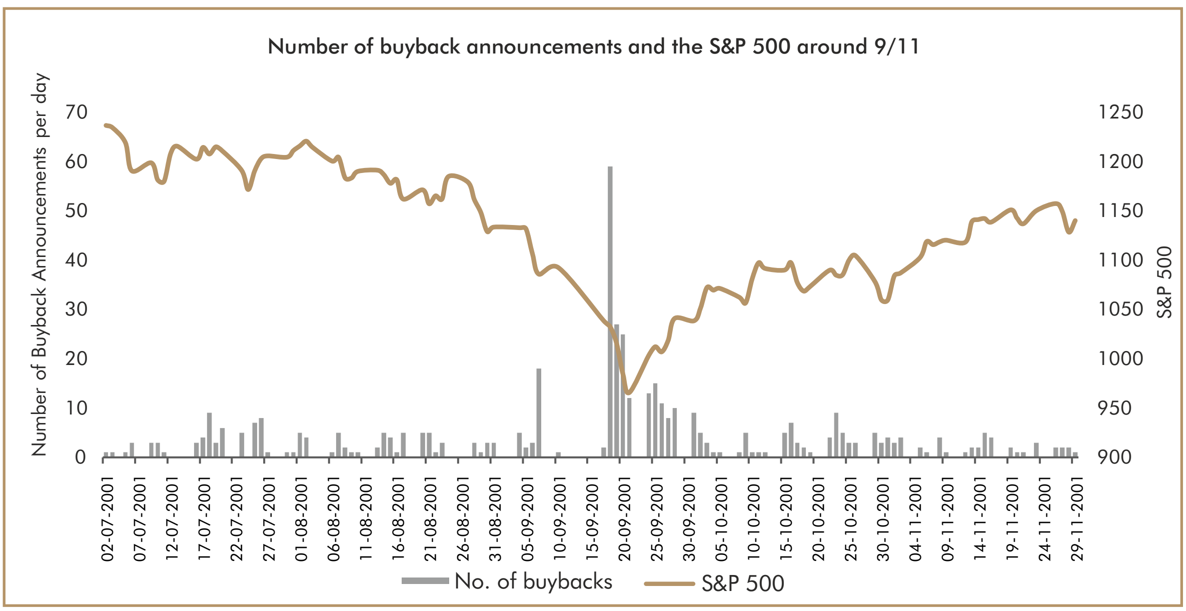
Background

Globally various research studies have shown that company buy-back and promoter buying have usually resulted in superior relative return to shareholders over a period of time. A controlling shareholder increasing his stake aggressively, through market/off-market purchases, is considered to be the ultimate proof of his belief in the stock's undervaluation relative to its current fundamentals or its business prospects. Periodically, stock markets over-react and crash without fundamental reasons and controlling shareholders react to this by buying back their own stock. Many investors / fund managers pay excessive attention only to short term performance persuaded by simplistic valuation methods such as earnings multiples. However, promoters have a long-term perspective and are better able to take advantage of the value versus price mismatch caused by short-termism. Unlike many investors who take investment decisions based on market conditions, promoters' actions are driven predominantly by investment merit.

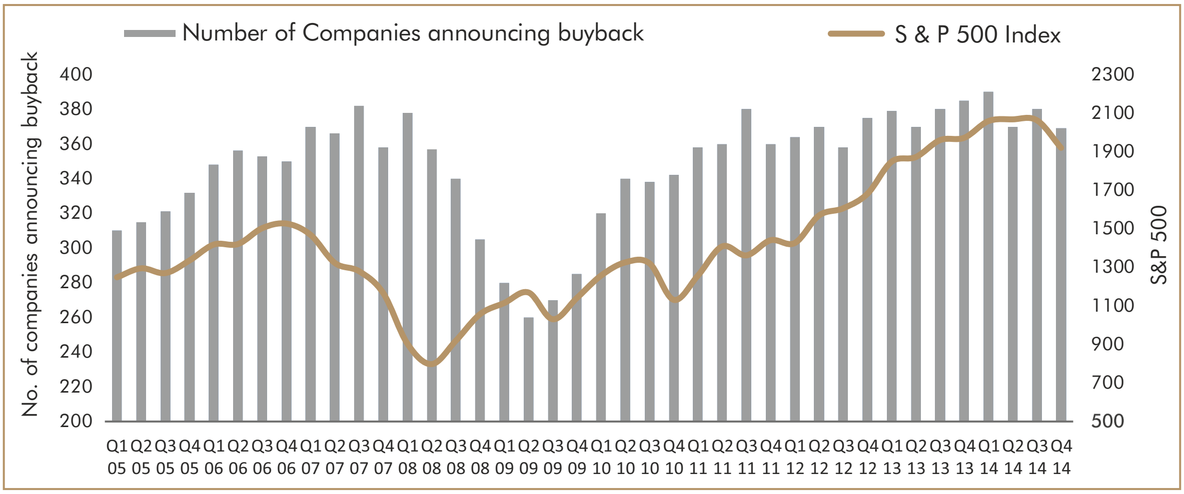
Warren Buffet, in one of his annual letters to shareholders, has said: "The companies in which we have our largest investments have all engaged in significant stock re-purchases at times when wide discrepancies existed between price and value. As shareholders, we find this encouraging and rewarding..... We searched for companies that were large re-purchasers of their shares. This often was a tipoff that the company was both undervalued and run by a shareholder-oriented management."

The phenomenon of companies' repurchasing their own shares is neither new nor restricted to select countries. It has been happening across global markets for many decades. The following pictures indicate how US corporations made use of market fall in the '87 crash and the 9/11 crash of 2001. These charts represent the number of daily buyback announcements and the S& P levels.

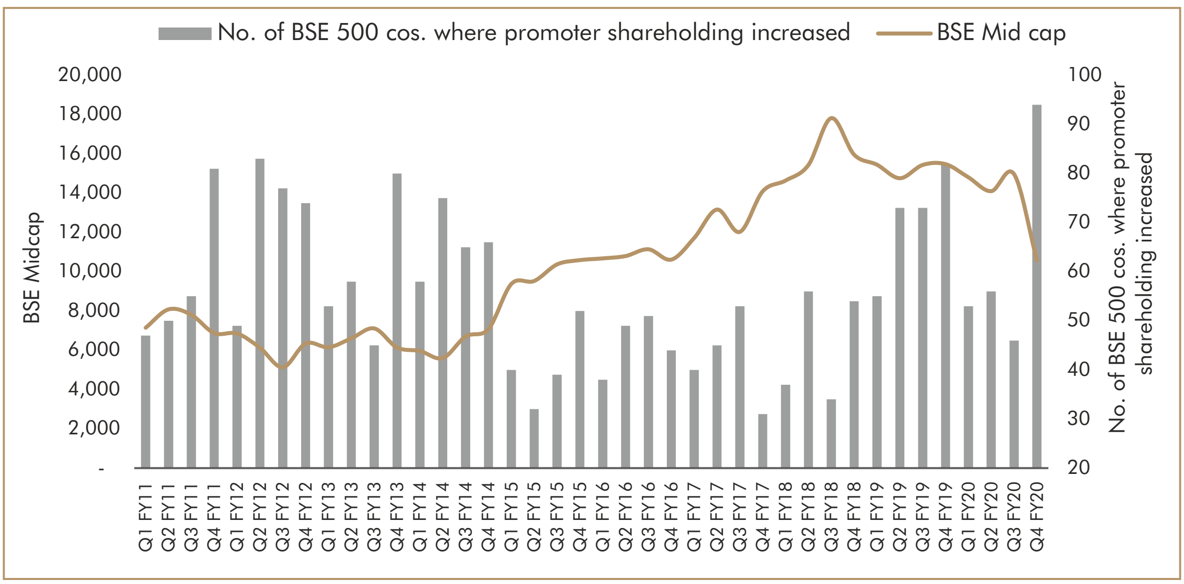




However, during the recent 2008 crash, U.S. corporations behaved differently and did not do as many re purchases as in prior crashes. This is understandable as most of them were already over leveraged and in no position to raise additional resources in a period bogged by credit crisis.



In the Indian context, the following chart shows the pattern of 'promoter stake-increase deals' over the last ten years (on a quarterly basis). It is amply clear from the chart that promoters normally time their investment decisions based on valuations and not on market conditions. In fact, they benefit from market volatility.



"Economists use statistics like drunks use lamp posts: For support more than for light" Winston Churchill

Academic studies using many years of data covering major global markets have not discovered any pattern of out-performance driven by buybacks. The test data in most such studies is predominantly company buybacks that are effectively made at inflated prices to negate the impact of constant dilution by ESOPs and warrants. Such trends are common in companies that are not managed by controlling shareholders. However, majority of firms in India are owner-managed. About 17 out of 30 Sensex companies are owner managed where the promoter holds around 50% stake unlike Dow or FTSE constituents.

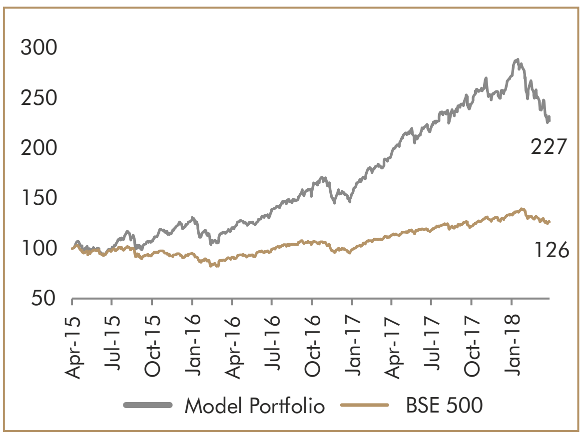
Performance Analysis in the Indian Context:

Our study over the past five years of promoter/company buyback activity in India has shown clear patterns of better risk adjusted return in aggregate. The following tables & charts illustrate the performance of a model portfolio constructed with companies where promoter shareholding has increased. Our study considered all BSE 500 companies which saw an increase in promoter holding on a quarterly basis. Model portfolios were built for quarter ending Mar'15 (35 companies) and Mar'16 (31 companies) by giving them equal weights.

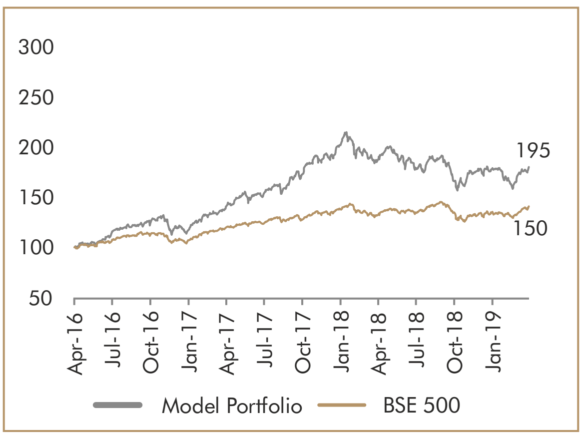
Apr 15 - Mar18	Return	Max R	Min R	Ann Volatility	Sharpe	Alpha	Beta
Model Portfolio	127.5%	13.4%	- 10.4%	22.6%	1.04		
BSE-500	26.3%	8.4%	- 8.1%	13.8%	0.01		
Sensex	16.7%	8.3%	- 7.5%	13.2%	-ve		
Model Portfolio vs BSE 500						101.2%	1.35
Model Portfolio vs Sensex						110.8%	1.17

Apr 16 - Mar19	Return	Max R	Min R	Ann Volatility	Sharpe	Alpha	Beta
Model Portfolio	98.6%	11.6%	-13.7%	20.9%	0.71		
BSE-500	50.3%	7.8%	-8.7%	13.9%	0.57		
Sensex	53.0%	7.8%	-6.4%	13.2%	0.54		
Model Portfolio vs BSE 500						48.2%	1.29
Model Portfolio vs Sensex						45.5%	1.08

Apr 15 - Mar18



Apr 16 - Mar19



While our analysis is based on data over a limited period, the argument for shadowing insiders' has made lot of sense in the past and will continue to remain valid in future as well. Promoters and executives have the most up-to-date information on their companies' prospects. Intimately acquainted with cyclical trends, supply and production bottlenecks, unlocking value out of assets and other key ingredients of business success, these insiders have substantial advantages over analysts, portfolio managers and especially individual investors.

Objective of the Fund

The fund seeks to generate superior risk adjusted returns, in relation to the broad market, by investing in fundamentally sound companies which have repurchased their own shares or where the promoters' have acquired additional shares at market prices. Typically, such an action by a company or a controlling shareholder demonstrates their conviction that the company's growth prospects or inherent value has not been captured in its stock price at that point. Unifi's proposition is to gain from the eventual balancing of the value-price mismatch in the market by identifying and investing in such companies after a detailed review of their fundamentals and corporate governance standards. .

Investment Approach

The basic approach is to invest in companies where the promoter or the company has acquired additional shares –

- At market prices either through creeping acquisition or buyback route
- That seem to be motivated either by an undervalued stock price or an impending improvement in business prospects that are still to be reflected in the market price and
- Where complete disclosures of stock purchases have been made to stock exchanges.

The underlying assumption behind this approach is that the managers and controlling shareholders have a clear advantage over other market participants and are well positioned to take sensible investment decisions especially in case of small and under-tracked companies. By limiting the investible universe to such companies, we believe that we would be able to improve the probability of achieving superior risk adjusted returns.

We find that promoters typically use one or more of the following methods to increase their stake by:

- Preferential issue of shares and/or warrants.
- Merger of promoter owned private/public companies.
- Creeping acquisition in open market.
- Voluntary open offers.
- Subscribing to the unsubscribed public portion in rights issues.
- Initiating the company to do a buyback either through market purchases or tender offer route.

While preferential issues invariably enable promoters to hike stake at a price substantially lower than the market price, mergers are also structured to get the same benefit. However, we would focus only on those companies where promoters increased stake by purchasing the shares at then-prevailing market prices or at a premium in any form, be it rights, creeping acquisition, tender offers or buy backs.

Refer Appendix 1 for recent such actions by Indian companies and its promoters.

Universe:

Our universe is built from the news flow of disclosures made by promoters/ executives/companies under Clause 7 & 8 of SEBI (Substantial Acquisition of Shares & Takeovers) Regulations and Clause 13 of SEBI (Prohibition of Insider Trading) Regulations. We will never consider companies where such disclosures are not made, thereby clearly avoiding market rumours and speculation. Such disclosures are constantly screened and fed into our internal model based on which the universe is expanded / pruned. From the universe of such companies, we would select ideas to invest based on a bottom up approach that we have been practicing over the last many years.

Sample Universe- 50 indicative firms showing insider purchases

Company Name	Mkt Cap (Rs Cr) June '20	Company Name	Mkt Cap (Rs Cr) June'20	Company Name	Mkt Cap (Rs Cr) June'20
Bajaj Auto	84,909	Atul Ltd	13,471	Zensar Tech.	2,908
Pidilite Inds.	70,620	Godrej Inds	13,257	IIFL Finance	2,805
Dr Reddy's Labs	65,170	CRISIL	12,342	Century Ply.	2,777
Berger Paints	48,896	Vinati Organics	10,215	Just Dial	2,485
JSW Steel	46,157	The Indian Hotels	9,544	Inox Leisure	2,399
United Spirits	42,763	Tube Investments	8,309	Greaves Cotton	1,989
Lupin	40,749	Tata Chemicals	7,863	Raymond	1,798
Tata Steel	37,809	K E C International	7,103	Maharashtra Seamless	1,504
Cadila Health.	37,495	Deepak Nitrite	6,531	D B Corp	1,348
Tata Motors	34,586	Kajaria Ceramics	6,373	Apar Inds.	1,268
IndusInd Bank	33,794	Aegis Logistics	5,886	Mahindra Life.	1,094
Bajaj Holdings	28,372	Laurus Labs	5,601	Greenply Inds.	1,093
MRF	28,041	DCM Shriram	5,244		
Kansai Nerolac	24,293	APL Apollo	4,442		
Trent	22,019	V I P Inds.	3,656		
Ipca Labs.	21,004	CCL Products	3,191		
The Ramco Cement	15,100	GE Shipping	3,126		
Rajesh Exports	14,276	Aarti Drugs	2,927		
Tata Power	13,510	Gulf Oil Lubric.	2,916		

The above universe comprises firms where insider buying has been evident since April 2016. It is only illustrative list and our actual portfolio may have stocks from outside the above list.

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

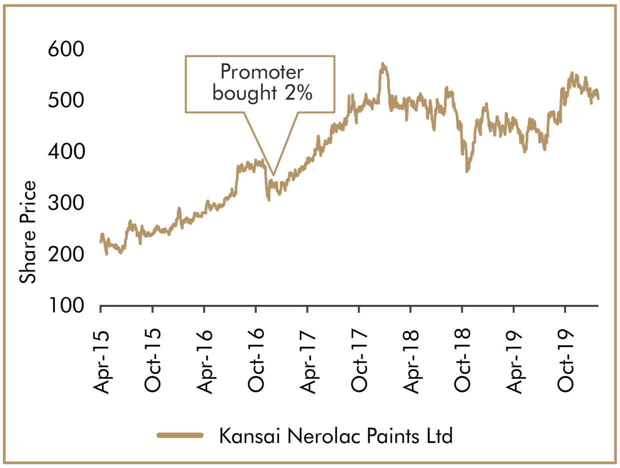
While research supports the view that insider shadowing works best in the aggregate, in few cases it could result in negative value creation. Lehman Brothers did a USD 10 Billion buyback just a few months before bankruptcy. Even in Indian context, we have had similar instances as some promoters tend to get carried away in predicting that good times will continue to persist (Appendix 2). Few promoters also just use this medium to send a signal without any genuine interest to buy (refer Appendix 2). To address such risks, we will meticulously deploy a second layer of filtering based on the merit of fundamentals and scrutiny of the promoter's behaviour.

To quote, Warren Buffet told his shareholders: "Before investing in a company that is repurchasing its own shares, you should investigate the company fundamentals and its management quality. Overall, if a company purchases its own shares on a regular basis and its fundamentals appear sound, you should consider buying shares in the company".

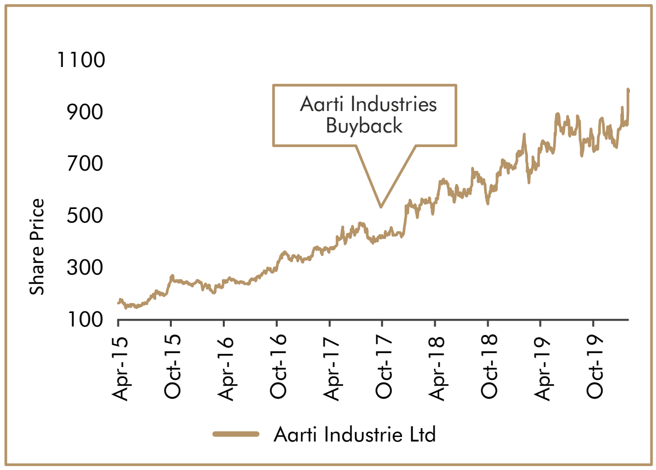
We have a 15 year track record in observing almost all open offers / buybacks and have built a library of information. The experience gained in actually investing client assets in 100+ such transactions over this period is unmatched in the industry. This strength along with our successful sector trend investing strategy will help us in creating a portfolio that offers superior returns to market at relatively lesser risk. On the whole, Unifi is well positioned in a sweet spot to achieve the desired results.

Appendix 1 - Some Company buy-backs and Promoter stake-increases in the recent past

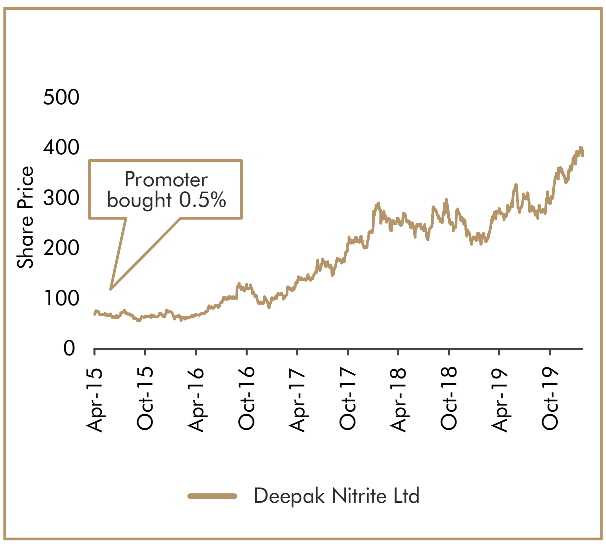
Management has bought 2% stake in the open market



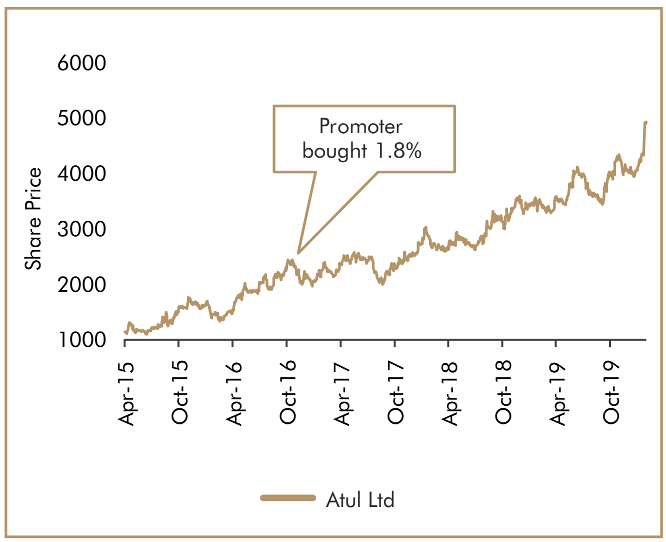
Company has done buy back and promoters didn't tender



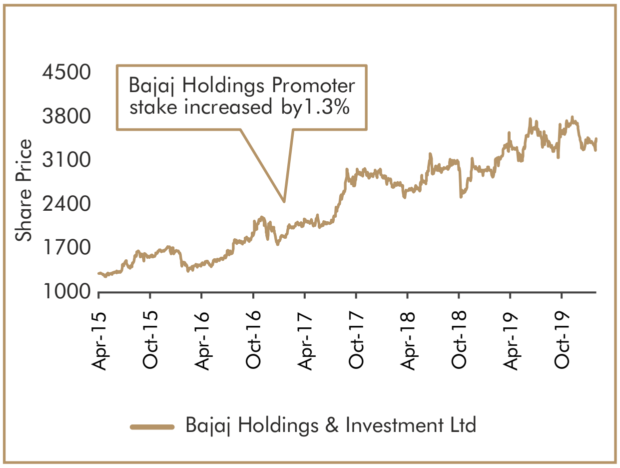
Promoters bought in the open market



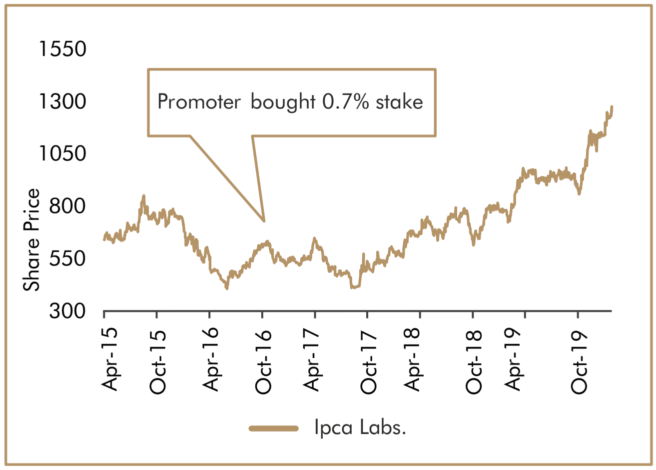
Promoters bought in the open market



Promoters bought in the market

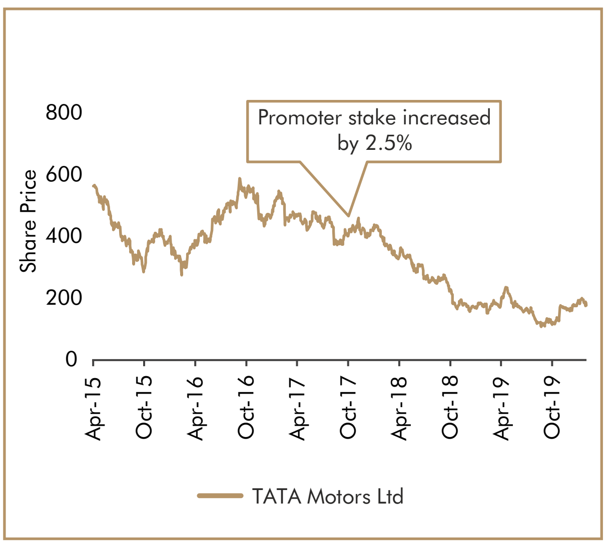


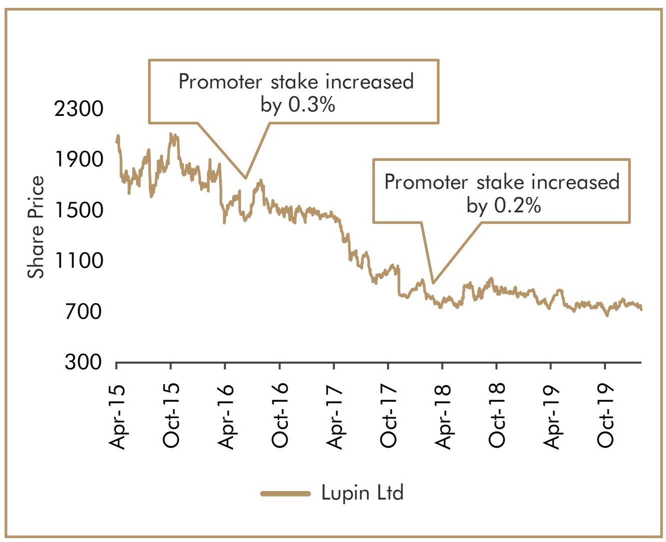
Promoters bought in the market



All the charts in Appendix 1 reveal the same story. Controlling shareholders exhibit greater confidence when their stock price is at an attractive discount to business value irrespective of market conditions.

Appendix 2 - Recent instances of promoters' increase in shareholding followed by fall in stock prices





FAQ

1. In what way is this fund associated with Insider Trading?

   The fund has nothing to do with 'Insiders' of any company except the fact that it merely tracks disclosures made by them to stock exchanges regarding their share purchases as required by SEBI (Prohibition of Insider Trading) Regulations. The fund will invest in only those companies that have seen increase in controlling shareholders' stakes and such actions have been duly disclosed to stock exchanges. The fund will not invest based on any market rumors /speculations /hearsay on direct or proxy insider activity.

2. Why would the fund buy, only shares of companies where promoters increase their stake?

   There is anecdotal evidence, both in domestic and overseas markets on the out performance of companies where controlling shareholders increase their stake. In most occasions controlling shareholders act contrarian to valuations. When equity markets do well, promoters look for an opportunity to dilute their stake through IPO's / QIP etc. When markets decline some of the promoters use the depressed valuations to increase their stake.

3. Do all companies' stock price go up immediately where promoters increase stake?

   No. While majority of companies where insiders buy outperform the broad market over a period of 2 to 3 years, they generally move in line with the market in the short-term. Hence, we may even observe such stocks falling after the promoter - buying if the markets are volatile at that point of time.

4. Are there companies where stock prices have fallen after Buyback?

   Yes, but they are few. In fact, there have been instances where companies / promoters have bought shares in the market and subsequently prices have fallen dramatically and haven't recovered even after 12 months (Tata Motors).

5. Do all companies whose stock price declines witness insider buying?

   No. Only few of these companies where stock price declines witness promoter buying. Those companies with distressed balance sheets or permanent impairment of fundamental value do not result in promoter stake increase. All insider buying can be categorized broadly into 2 types:

a. A general market decline could have pulled down stock prices of majority of companies for market related reasons. Those companies with improved cash flow, earnings and strong balance sheets may be considered by the promoters for stake increase benefitting from market decline.

b. The other category are companies whose earnings would have declined due to business cycles but the market would have punished their stock prices more than what they deserve.

6. How would you ensure that the fund does not get trapped into such companies?

We will not buy just because promoters are buying. Insiders buying activity brings such stock ideas to our universe. Subsequently, we apply our bottom-up research filter before picking an investible idea which in most cases will be validated by first hand research of a company through visits and meetings, followed by conference calls with the management on quarterly basis or on any significant development. We will consider taking exposure in only those companies where our research endorses that the stock is worth purely on its fundamentals independent of the insider activity. While proactive and disciplined research enables us to avoid getting trapped in bad transactions, it may not completely eliminate such cases.

7. Is this large cap or small & mid cap-oriented fund?

The fund does not have any size bias based on market capitalization. However, promoters' stake-increase predominantly happen in under tracked /under researched small and mid-cap stocks and rarely in large caps. Hence, majority of stock ideas could be small and mid-caps.

8. If portfolio composition is tuned towards small & mid-caps, will liquidity be an issue?

Possibly Yes. Hence, we propose to limit the fund size to below Rs. 500 Cr. The fund will also be well-diversified (across 15-20 companies). We usually eliminate companies below Rs. 1000 Cr market cap. For instance, the average market cap of our current universe is around Rs. 15,000 Cr.

9. Would it not be too late for the fund to wait until the promoter/company complete buyback instead of immediately acting on announcement?

While many companies/promoters announce their intent to buy, few do not implement or implement it partially. Reasons range from change in stock prices to change in priorities for the company/promoter. While by waiting, we may end up paying a little bit higher price but we may avoid getting trapped into companies that merely announce (may be to attract market attention) but do not act.

10. What are the risks an investor in this fund must be conscious of?

The risks are a combination of market trends, change in fundamentals and time. Even after promoters / companies demonstrate their convictions by buying, stocks could fall in a market decline without having any adverse change in their fundamentals as we have seen during 2008 global crisis as well as 2018 market fall. But over a period of time, as fundamentals consistently improve, such stocks attract market attention and gain significantly.

11. Does Unifi have an USP in implementing this style?

We have already done this theme during markets decline between Sept 2012 and Dec 2016 when we saw fewer promoters increasing stake. In that period, we were able to generate higher returns. We have analyzed promoter purchases for a long period of time and such knowledge coupled with our bottom-up research capability would help us to perform well over a period of time.

12. 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.

Notes

ABOUT UNIFI

Unifi Capital Private Limited is a specialized 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 several high net worth families in India and overseas.

Unifi offers multiple customized investment opportunities to its clients with varied levels of risks. 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.

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