HoldCo Fund

UNIFI Capital

How few companies evolved to be holding companies?

Why stocks of such companies always trade at a huge discount to their value?

What has changed now for them to deliver exceptional returns in future?

What is Unifi's Advantage in pursuing this theme?

How Holding Companies (HoldCo) evolved?

Over the years, Corporate India has had three types of holding companies.

- Operating companies whose cash flow was used by promoters to acquire stakes in group companies.
- Investment holdings in operating companies that subsequently were demerged and got listed separately.
- Companies operating distinctly different businesses in one corporate entity deciding to bring focus by separating businesses and spin-off each business into separate companies but retained cross holdings.

Why they trade at discount to fair value, always?

Usually stocks of holding companies, whether they hold investment stakes in companies or assets (financial, real estate or brand) trade at discount to their underlying value.

The main reasons are:

- Distribution tax if assets are to be distributed.
- 'Lack of control' discount because minority shareholders can't exercise control over the method and timing of distribution.
- Uncertainty over future growth of the underlying assets.
- Tendency of the controlling promoter to unlock value but instead of distributing to shareholders, re-invest in building his kingdom etc.

Globally such discounts typically range between 20% and 40%. How different is this in Indian context?

In India, the discounts range are wider, between 30% and 80% and in few cases even more than 80%. Why is the Indian context unique?

- The promoter holding is very high, above 50% in most cases, unlike global peer groups.
- Most of the underlying investment holdings are in group companies controlled by the same promoter resulting in a perception that it will be perennially held as such with no intent to monetize.

- Most such companies are small caps with capitalization lower than ₹ 1000 Cr resulting in daily trading value of less than ₹ 1 Cr. Neither Institutions nor large investors are active in this space leaving price discovery mechanism to promoter and smaller group of non-institutional / retail investors.

- Disclosure standards in such companies are lower than desired level resulting in information asymmetry and hence the wider discount.

What has changed post 2013?

Companies Act, 2013 – a game changer for Public Shareholders

Companies Act 2013 that replaced Companies Act 1956 is a landmark legislation and is likely to have far-reaching consequences on all companies operating in India. Some of the defining changes in the Companies Act 2013 are:

Related party transactions

Under the Companies Act 2013, specified related party transactions require prior approval of public shareholders by way of a resolution. To pass a related party resolution, the votes cast in favour of the resolution must be more than the number of votes cast against it. In most cases the related party who is a promoter cannot vote on such a resolution and hence the non-promoter shareholders can objectively review such cases and make their decisions heard.

For example, (i) An MNC's proposal to hike payment of royalty to its parent would attract this provision. (ii) A company's proposal to extend a guarantee covering the borrowings of its associate company would need to clear this hurdle. Subsequent to companies act 2013 coming into effect, there have been several instances of related party transactions involving even well-known companies like Maruti Suzuki, Ambuja Cements, United Spirits, Raymonds etc being put to vote and decided by the majority opinion of the non-promoter shareholders. Accordingly, it has become essential for the promoter shareholders to establish that the related party transactions are fair to the company and all its shareholders otherwise they will not be able to get the required consent for such resolutions.

Class action suits to fight mismanagement and oppression

The most talked about provision of the Companies Act 2013 has been the introduction of a very powerful American legal concept called Class action. One or more members or class thereof can apply to NCLT for orders to prevent management from running the company in a manner that is prejudicial to the interests of the company.

As per the extant regulations, an application for class action can be filed by –

I) At least five percent of the total number of members of the company or one hundred members of the company (whichever is less)

(or)

II) Member or members holding not less than 2 percent of the issued share capital of the company, in case of a listed company. (5% if it's an unlisted company)

SEBI regulation on mutual fund participation in corporate democracy i.e. Voting.

In the past institutional investors typically conveyed their objections to managements discreetly behind closed doors. This has often been ineffective in conflict resolutions. SEBI's emphasis on corporate governance and Mutual Funds participation in voting process, the growing institutional ownership in listed firms and the growing influence of proxy advisory services will make it harder for managements to act in a manner that is not in the interests of minority shareholders.

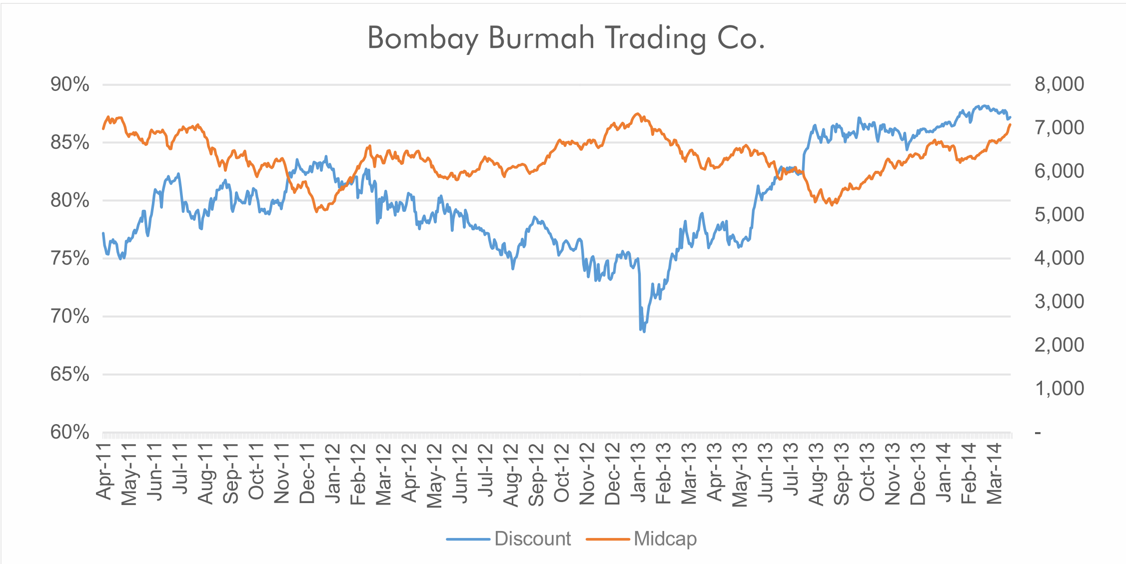
Going forward, from the management perspective, flexibility is lost as related party transactions will no longer be easily possible along with the looming threat of class action suits. Minority shareholders (hitherto with no recourse except to ask for a vote and lose) now have the veto power to prevent unilateral conflict of interest situations that would disproportionately affect their interests.

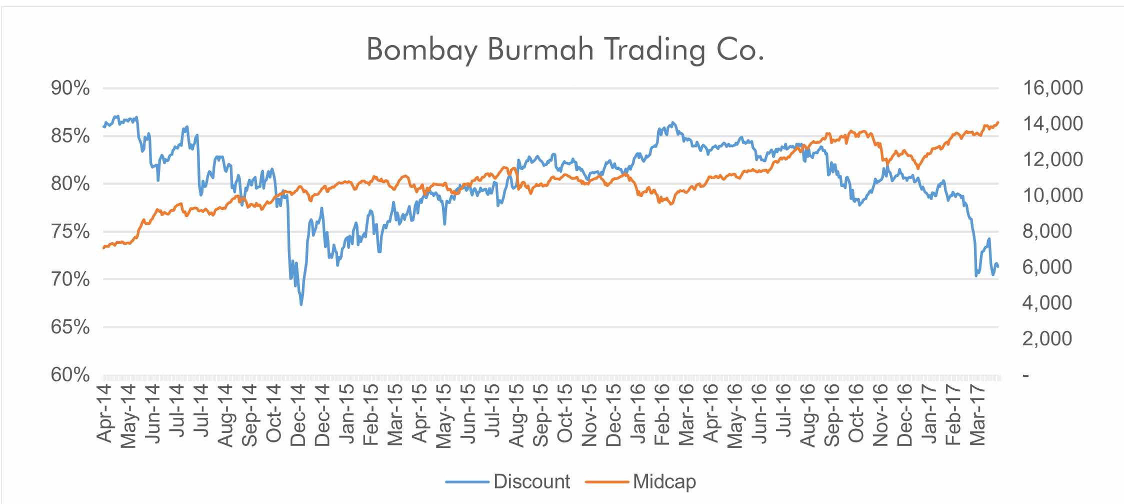
Drivers of Discount in Holding Companies:

There are various academic studies in global markets on the pattern of holding companies discount movements over time and the events that triggers significant swings in the discount rates. We have had extensive studies on this subject in the Indian context.

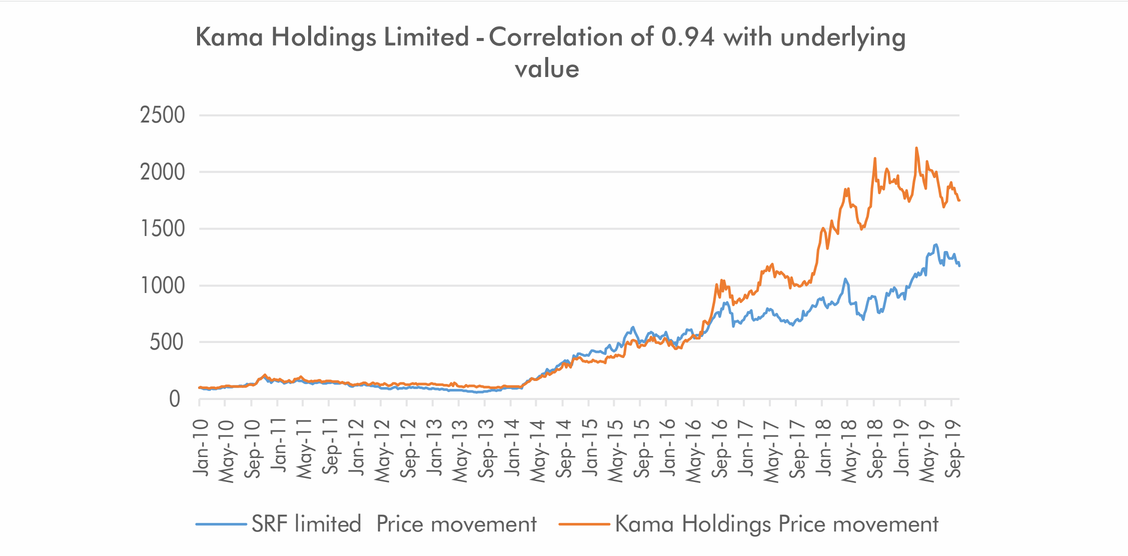
Our observations are as follows:

- Market Cycles - Holding companies trade at a steep discount in bear markets and at a significantly lower discount in bull markets.

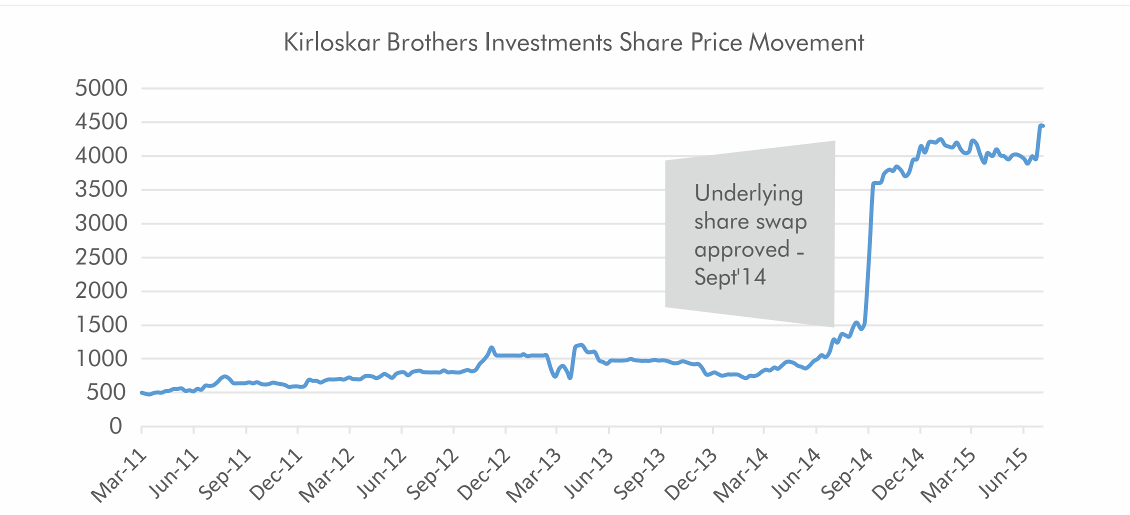




- Change in the value of holdings - Even if the discount remains the same, a holding company's stock would appreciate or decline in line with the price performance of its underlying assets; particularly where the underlying companies are listed.



- An event like distribution of income, value unlocking in underlying assets held, M&A in investee companies result in sudden but varying level of discounts narrowing down. Delisting or share swap typically leads to rapid convergence of stock price towards the net asset value.



Current Opportunity: Holding companies @ 2019

Equity markets have been sideways for the last few years. While the large caps have scaled to higher levels, the small and midcaps have fallen off considerably from the highs of 2017. It is at such times that the discount at which holding companies trade, start widening only to narrow down at a later stage when markets do well and trend upwards. It provides discerning investors an opportunity to build positions as the discounts widen and make good gains by exiting when the discounts contract. The important point to remember is when we buy a holdco stock at 90% discount, we would make 100% return even if the discount falls by just 10%.

Additionally, as the economic activity picks up, earnings and market sentiment improve and enhance the valuation of the underlying companies. Accordingly, stocks of holding companies tend to move up even if their discount to their NAV representing the valuation underlying listed companies remains the same.

The regulatory changes (Companies Act 2013) have enabled certain shareholder rights and brought sweeping changes in how companies approach "Related Party Transactions". The renewed thrust of SEBI in ensuring higher level of corporate governance would induce the promoters to unlock value through corporate actions like delisting, share swap, increased dividends, buybacks etc.

Strategy

Unifi would focus on holding companies which are sub-scale and run as group holding companies rather than strategic investment companies. These companies that otherwise have stakes in strong operating businesses but are typically run by, for and of the promoter are the most likely ones to feel the heat of change in regulatory landscape and increase in investor activism. There is a clear opportunity to plan well and buy assets with a fair value of ₹100 at ₹30 or lower. Unobtrusive nudge will be pursued as a catalyst to induce the promoters to de-merge valuable assets and /or de-list as the case may be.

Even if they pay a considerable premium to current market prices, the promoters would still acquire the required stake at a meaningful discount to its fair valuation.

Universe

As we reckon that large holding companies administered with strategic intent are unlikely to be delisting candidates, we would like to focus on mid-sized holding companies that

- Offer deep value i.e. where their current market capitalization is just a fraction of the market value of their investments.
- The underlying companies/assets that holding companies own offer an attractive proposition as regards earnings growth and valuation gains;
- Deal in related party transactions where seeking approvals could get complicated going forward.
- Seem likely to be the focus of delisting attempts by the management either for the aforementioned reasons or other explainable grounds.

We would also focus on a select few operating companies with investments that hold no strategic value to their core business and have not yet considered demerger. We believe that these companies have to address the problem of valuation gap sooner or later. In any case, we intend to steer clear of managements who have a reputation for brazen acts of self-enrichment at the cost of the company, outright impropriety and a “don't care” attitude towards compliance and governance.

Risk Dynamics

Illiquidity is the biggest risk beckoning the investor considering exposure to Holding Companies. Most of value unlocking in holding companies will exhibit a “pressure cooker” effect in price whereby a single event can fast-track the valuation convergence. Till then the stock may remain sideways or even drop in a rising market. Price volatility is also an unavoidable phenomenon where the discount between fair value and market value converge in a bull market and widen in a bear market in addition to volatility in fair value itself.

Sophisticated investors tend to measure the risk as the probability of the absolute loss of the capital. Since each stock is bought at a steep discount to current price of a growing asset, chances of a capital loss are quite less. On the other hand, if we define risk as measured by standard deviation of the stock, then such stocks would fall under the high risk category.

Structure & Fees:

The fund will operate on the PMS platform where the investor's assets will remain either in cash with a bank/liquid fund (pending deployment) or if deployed, in the form of stock with CDSL. In either case, the assets will be in the name of the investor. While the tracking and monitoring of the investments will be active, the account level movements will be passive, resulting in lower transaction costs and better post-tax return. The theme is not predicated on “activism” lines requiring extensive legal and incidental costs. However, it does require services at constant intervals from legal/regulatory experts to engage with the investee companies and hence would have ongoing costs.

Tenure & Commercials

ONLY FIXED FEE

1. Tenure of 5 years or 200% absolute return whichever is earlier.
2. Management fee of 2% p.a. of the AUM will be charged on a monthly basis on the last working day value.

OR

PROFIT SHARE

1. Tenure of 5 years or 200% absolute return whichever is earlier.
2. Management Fee of 1% p.a. of the AUM will be charged.
3. Unifi's share of profit will be 20% of profits above 12% p.a. compounded return.
4. Profit share is payable only on exit.
5. Unifi will adjust the Management Fee with the profit share and hence it is NOT both.
6. In case of pre-closure, the hurdle rate will be reduced from 12% p.a. to 10% p.a. and fee offset benefit is not available.

The Unifi Advantage:

Over the years, Unifi has had a successful investment track record in niche themes centered exclusively on delisting, open offers and spinoffs. We have an 18-year track record in investing in open offers/buybacks for our flagship event arbitrage theme and have built a huge repository of relevant information. The experience gained in actually investing client assets in 200+ such transactions over this period is unmatched in the industry.

The fund management experience of our Delisting Fund, India Spinoff Fund and Holdco Fund have provided valuable learnings right from the mechanics of the process to the nuances that drive the valuation and management behaviour.

Qualitative insights are more important than quantitative facts in evaluating investment opportunities in such themes. While the investment approach is process driven, particular emphasis is given to regulatory and corporate governance risks.

This rich repository of our actual investment experience combined with the practical insights gathered therein is the backbone for the launch of this Holding companies theme.

As most of such valuation gap opportunities exist in small cap companies with lower liquidity, size obsessed Institutional interest would remain low. Unifi being a boutique firm have successfully pursued such niche themes in the past. Investor returns from such themes of Unifi were superior both in absolute terms as well as relative to relevant benchmarks.

CONTACTS

Mumbai	Harshawardhan Agarwal	99301 12828
	Chandni Shah	99205 25910
	Amit Kumar	96192 24149
Chennai	Krishna Prasad	98947 40044
	Anto Vinesh	98431 08007
Bengaluru	Christopher Vinod	96322 44747
Hyderabad	Prabhakar	98496 69488
Kolkata	Krishna Prasad	98947 40044
Delhi	Harshawardhan Agarwal	99301 12828
	Rovindkumar	92050 71210
	Nisha Kakran	77188 11182

Unifi Capital Pvt. Limited, 11, Kakani Towers, 15, Khader Nawaz Khan Road, Chennai - 600 006.
Tel: +91-44-28331556, Fax:+91-44-28332732, Email: info@unificap.com
Chennai | Bengaluru | Delhi | Hyderabad | Kolkata | Mumbai