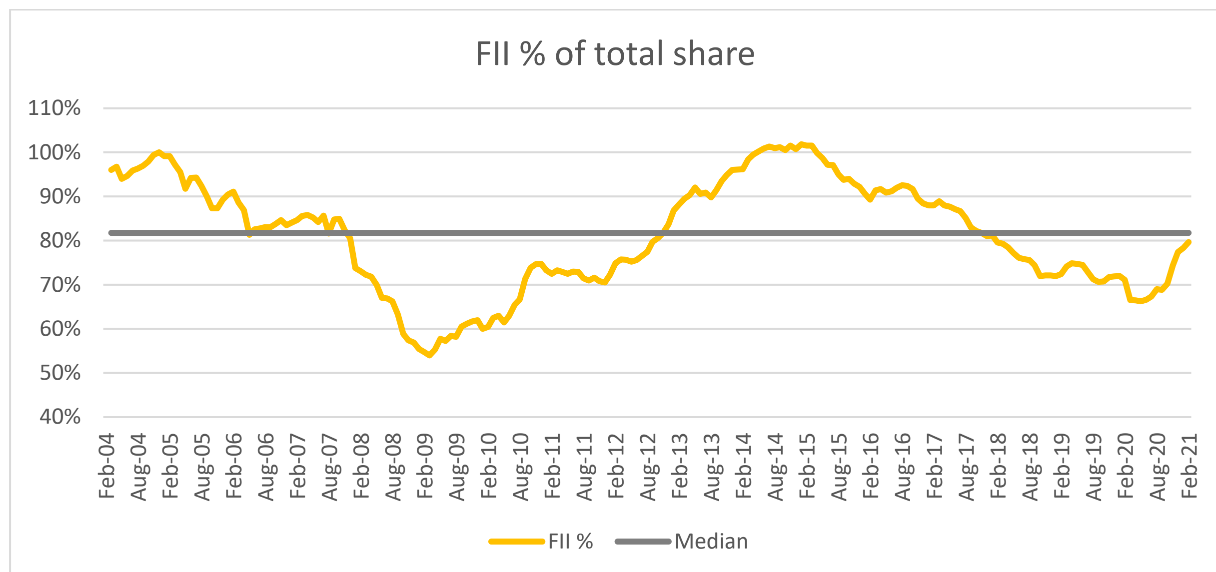
Dear Partner,

Over the last 6 months the Nifty is up 30%. Over this period, FII have turned net buyers, and domestic mutual funds and insurance funds were net sellers (the last time half-yearly domestic flows were negative was in Sep-2016). The sharp increase in FII flows and sharp contraction in domestic flows has meant that FII share of total flows since we have data (2003) rose sharply from a low of ~66% in May 2020 to ~80% in Mar-2021 (back to the long term median of ~80%). As discussed in previous letters, higher domestic share is preferred as it is more sustainable and makes the market less vulnerable to external shocks.



In this letter we touch upon some portfolio updates as well as expand on our decision to buy United Phosphorus Ltd ('UPL').

<u>Portfolio update</u>:

At the beginning of the year, we were sitting with amongst the lowest cash balances in the recent past. We decided to raise cash levels for a couple of reasons: (a) there is an exciting pipeline of IPOs that will hit the market over the medium term, and we may look to partner with some of them; and (b) the sudden second wave in COVID could lead to volatility, and we want to be in a position to deploy capital if this were to happen. We raised cash from a couple of smaller positions (Britannia, Endurance) that we are unlikely to scale up despite really liking the business (more a function of growth versus valuations). We also trimmed our largest position Tata Communications (TCOM) – we love the business and the long term return potential, especially after the government exit, but last couple of quarters in TCOM have been below our expectations and given its weight we decided to follow our discipline and trim the weight. However, we would like to reiterate that we remain excited about TCOM's potential to become a digital eco-system enabler. We marginally added to Sterling and Wilson Solar (SW Solar), as we believe that the promoters are close to solving their liquidity problems.

UPL

We added UPL in Jul-2020 as a clear leader. UPL is the market leader in post-patent segment[1] of global agrochemical industry with >8% market share. We summarize our investment hypothesis below:

1. **Excellent historical execution and unique global platform:** Initially, what caught our attention was UPL's market leadership and how it almost trebled its global market share within a period of 8 years. Post conducting a deep study and multiple channel checks, we were convinced that UPL should continue to profitably gain market share given its unique global platform and agile management. Additionally, UPL is pursuing an ambitious transformation, wherein it is gradually transitioning from selling products to bundled solutions (the latter being sticky), and use of digital technologies to optimise the offering for the farmers. We believe these initiatives will not only sustain its growth trajectory but also make its business a lot more durable and valuable.

2. **Great entry point:** However, UPL's stock had got de-rated post COVID due to its high leverage. We believed this to be an opportunity as our work indicated that agrochemicals' sales were not impacted due to lockdowns given their essential nature. This implied low revenue risk for UPL; we felt comfortable with the leverage and initiated a small position. Moreover, we believed that deleveraging over time itself could lead to significant equity returns. Of this, we anticipate UPL to repay ~400mn$+ (13% of FY21 starting debt) during FY21 taking down their Net Debt/EBITDA to ~2.3x levels.

3. **Optionalities beyond deleveraging:** In addition, we are excited about 2 optionalities: (a) Improving working capital terms of trade as share of solutions in UPL's sales mix increases; and (b) $3bn+ pipeline[2] of new products that could accelerate organic growth.

We detail out our investment hypothesis below:

1. **Faith in UPL's future prospects comes from its historical execution:** It has had best-in-class organic growth + high success rate in acquisitions, and has ascended from fourth largest to the largest post-patent company within 8 years. We believe its global distribution platform and deep research based acquisition approach will allow it to continue executing and growing ahead of the market.

   UPL has been the fastest growing post-patent company since CY12 – growing at 6.7%$ CAGR *organically* (i.e. ~13%INR CAGR) vs. 0.5%-5% for its major competitors. Apart from this best-in class growth, UPL has successfully acquired a few large companies over the last 10 years. Because of these factors, UPL has grown its revenues at 21%+ CAGR over FY12-20 (~13% contributed organically and rest via acquisitions) vs mid-single digit growth for the market and UPL's competitors. As a result, UPL achieved leadership in post-patent market, growing its market share from 3.3% in FY12 to 8.2% in FY19, and its position from number 4 to number 1.

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[1] The global agrochemical industry is broadly categorized into innovator companies (that bring new patented molecules into the market) and post-patent companies (that launch generic versions of products whose patents have expired and <u>unique combinations of multiple patent-expired products</u>).

[2] The pipeline value is probability adjusted – peak sales value of each pipeline product is multiplied by the probability of its eventual commercial launch (which in-turn depends on the stage of trials at which the product is at).

The two key factors allowing this execution are UPL's global platform and its successful acquisition track record. Additionally, UPL has been consistently transforming since decades and has already set in motion an exercise to transform its platform for the digital age with increased user engagement and customisation.

Global platform: Agrochemical business requires deep distribution infrastructure (to reach farmers at ground-level) and product registration capabilities[3] in each country of operation. Today, UPL has the widest geographical reach having extensive distribution and product registration capabilities in more than 140 countries compared to ~100 for UPL's largest competitors. UPL is the dominant leader in many small countries where innovator companies are totally absent from. As a result, UPL has been able to create the world's largest platform consisting of innovator companies[4] (Bayer etc.), scientists, R&D professionals and boutique R&D heavy agrochemical companies who want to work with UPL to take their products global given UPL's distribution and registration capabilities.

Through this platform, UPL is able to source the widest array of agrochemicals from its partners and come out with best in class combinations of products (say, by combining product X of a small boutique firm with product Y of a large innovator). A company without such a platform cannot replicate this. Moreover, given 3-4 year product registration timelines, it will take a competitor 3-4 years to copy the product once it's out in the market. This has allowed UPL to be the first to launch the most effective products in various micro-markets which its competition has failed to replicate. An example of this is UPL's Mancozeb product[5] whose successful combinations enabled UPL to create a 580mn$ business within 5-6 years.

In addition to this, our channel checks across UPL's competitors highlighted that it is the most agile company in the industry – it has been the fastest to understand farmers' problems on the ground and then use its platform to come out with effective solutions for these problems. In our mind, this platform alongside an agile organization creates a very difficult to replicate moat and will enable UPL to continue gaining market share.

Successful acquisition track record: One of the biggest concerns with UPL is that it has been a serial acquirer and not everyone is convinced about the value of these acquisitions. Our primary research with several of UPL's past employees highlights that UPL follows a very rigorous acquisition process involving an acquisition team that clearly understands UPL's strategic intent and does deep research on multiple targets fitting UPL's strategy. More importantly, the team is highly disciplined on pricing – for its largest acquisition in history

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[3] A company needs to register an agrochemical with regulatory authorities in each country where it intends to sell it – this process easily takes 2-5 years depending on country and requires proper manpower and infrastructure to effectively file the products.

[4] Innovator companies need UPL to complete their solution to the farmer – for instance, Bayer has partnered with UPL for its Mancozeb product as its own product was less effective. If Bayer were to try and register Mancozeb itself, it will take it 3-4 years which it cannot afford as it may lose part of its sales in the interim.

[5] In late 2000s, farmers in LATAM were facing problem of Asian rust for various crops that existing products were not effective against. UPL realized that its Mancozeb product in combination with other products was effective against it – over the next 5 years, UPL launched ~50 combinations of Mancozeb (courtesy, its global platform enabling it to source other's products and combine them with Mancozeb) – it worked so well that today, this product alone contributes ~580mn$ to UPL's top-line (12-13%).

(Arysta), UPL had walked out of the deal 3 times before finally acquiring it in FY19 as it was not willing to go beyond its offer price.

As a result, despite spending ~30% of its free cash on few large acquisitions over FY12-18, UPL's EBITDA margins only expanded from 18% to 20.2% and its pre-tax ROCE also stayed in the 18-20% band over this period. ROCE fell to 14% in FY19 – it was because of its single largest acquisition in FY19 that added significant quantum of goodwill to its BS. Given that synergies from acquisition will be realized over next 3 years, we expect pre-tax ROCE to jump back to ~20% by FY22; Additionally, our channel checks also highlighted that UPL has been able to beat its internally set targets (from acquisitions) for ~80-90% of its acquisitions.

Transforming the platform for the digital age with increased user engagement and customisation: UPL has been transforming since decades – during its early years (1970-2000), UPL was a manufacturer of commodity technical grade agrochemicals. Over the last 2 decades, it transformed into selling unique combinations of products (discussed before). Today, ~30-50% of UPL's revenue comes from differentiated/ unique products that are combinations of various products sourced from its global network. Now, UPL is undertaking another transformation whose success will not only sustain its growth trajectory but also make its business model more durable.

Management's ambition is to emerge as a "solutions" company to the farmer – selling a bundle consisting of all needed agrochemical/ bio-solution products for a particular crop so that the farmer doesn't need to buy anything else. This has especially been made possible by: 1) UPL's Arysta acquisition (giving it a wider product basket and leadership in bio-solution products that are an essential part of the bundle); and 2) Use of digital technologies – example, usage of sensors on farms to understand exact nature of soil/ weather etc. to optimize the offering for the farmer. Currently, these solutions contribute ~5% of UPL's India as well as global revenue and has been growing fast (this share was 2.5% in India in FY19).

2. **UPL's high leverage at 3x Net debt/EBITDA led to derating post COVID:** We saw this as an opportunity as we believed that UPL will pay down significant amount of debt over next 2 years enabling re-rating and shifting value from debt to equity.

   Post COVID outbreak, UPL de-rated sharply by 30% and was available at ~10% below its historical median multiple of 8xEV/EBITDA. This was due to COVID-led uncertainty surrounding company's cash flows given its high debt (3x Net debt to EBITDA, as UPL had completed its biggest acquisition in FY19). In contrast, our channel checks as well as commentaries from global agro-chem. companies suggested strong annual demand for agrochemicals as well as comfort on agrochemicals' positioning as "essential"[6]. UPL's 9M21 result also highlights this – despite COVID induced manufacturing and logistical challenges, the company has been able to grow sales by ~5.5% yoy during 9M and is seeing month on month recovery. In fact, UPL's ex-employees and competition, both called out UPL as an indispensable part of the global food supply chain.

[6] Checks highlighted that most countries were engaging in significant advance buying of agrochemicals as they made deliberate efforts towards internal food security. Agrochemicals production was also classified as an "essential activity" globally enabling operations to continue despite lockdowns. This highlights the essential nature of agrochemicals.

Our expectation is that as UPL realizes synergies from Arysta acquisition and monetizes its strong 3bn$ product pipeline (discussed later), it will generate ~0.8bn$ of free cash over FY21-23 and pay down ~30% of its FY20 debt resulting in leverage falling from 3x Net Debt/EBITDA in FY20 to 1.7x in FY22. Assuming rerating back to historical median, this leads to ~30% equity compounding (vs. 15% EBITDA compounding) over FY20-22 (and ~20% over next 4 years) as value shifts from debt to equity[7]. This is our base case, and we have a few other optionalities over this base case which we expand below.

3. **Beyond deleveraging:** Various drivers in place to sustain growth and make the business more durable.

    i. **Substantially lower working capital in the business**: UPL's business is working capital intensive with ~120 receivable days and ~80 inventory days as of FY20. UPL believes that today the agro-chem. industry is financing the agro-chemical distributors and aspires to lower this financing window provided to the channel. It has been able to achieve success in certain micro-markets with ~5% of its revenue coming from low working capital intensity channels.

    ii. **A 3bn$ attractive pipeline to sustain growth**: UPL has a product pipeline of ~3bn$ that it expects to monetize over next 5-8 years. We got highly positive checks on this pipeline giving us confidence that this will enable UPL to sustain its growth and expand margins. Channel check with a senior officer of UPL highlighted that this pipeline consists of highly differentiated, tried and tested products that will *substantially improve UPL's revenue mix (from 30-40% differentiated high margin products to 60-70% over next 5 years).* Competition channel checks also highlighted that over last few years, UPL has substantially increased the size of its patents team and ex-R&D head of Bayer (one of the largest innovator companies) has also joined UPL. All this highlights a quality pipeline giving us confidence to hold beyond deleveraging over the next 2-3 years.

Concluding thoughts

The resurgence of COVID cases across India is worrying. Given that we have approved vaccines, it is hopefully a question of time before the situation comes under control. We believe that while the near-term remains uncertain, leaders who can absorb this will come out stronger like the last time around. As stewards of long term capital, we will take advantage of any near term volatility to partner with fantastic companies that we believe will be relevant leaders in the digital future.

Thank you for your trust and patience, and prayers that you and your loved ones are safe and healthy.

Warm Regards
Nimit Tanna
April 30, 2021

[7] Of this, we anticipate UPL to repay ~400mn$ in FY21 leading to Net Debt/EBITDA going down to 2.3x levels.