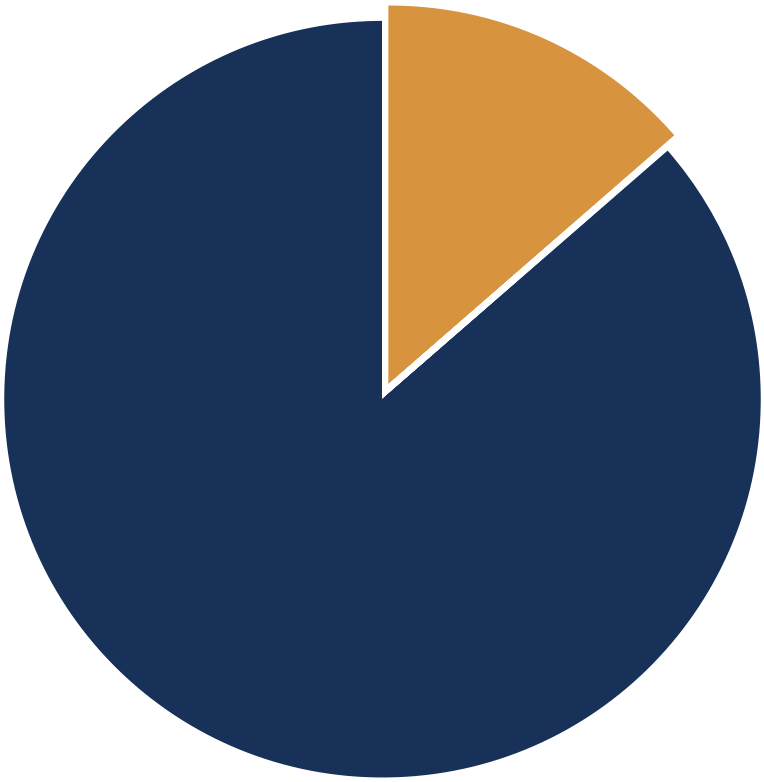
ITUS CAPITAL

2017 Annual Letter

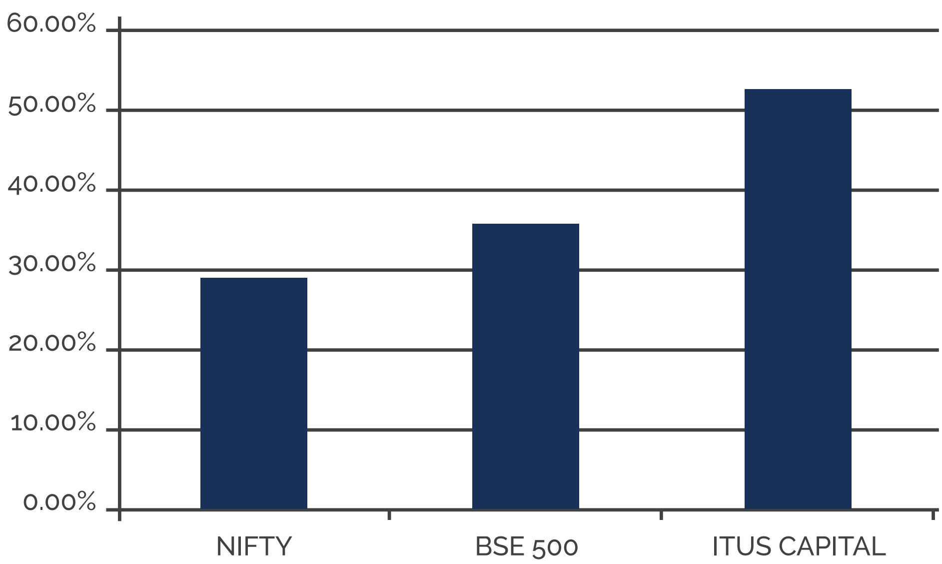
PORTFOLIO SNAPSHOT



PORTFOLIO ALLOCATION

- CASH **18%**
- STOCKS **82%**

PORTFOLIO RETURNS



PERFORMANCE FIGURES

- CY 2017

Dear Investors and Shareholders

I take this opportunity to wish you a very happy 2018. I certainly do hope that the coming year is a dawn of brighter and better things in store for the future.

To my investors, I sincerely thank you for the trust placed in Itus Capital. As of the end of December 2017, Itus Capital completes its first year of running the fund. The continued confidence placed by you has ensured that Itus has grown significantly in its AUM managed. More importantly, some of the relationships built in the process have been a lot more meaningful, and I only believe that this is the beginning of the journey I have set upon for the firm. The portfolio was up 7.8% for the month of December, bringing the YTD returns, for 2017 at 52.1% (gross).Since different investors, have chosen varying fee structures, the net returns for each would be slightly different and they would receive a separate net return for their portfolio.

I for one, am very bullish on the growth of the asset and wealth management business in the country. I feel that India is in a very nascent stage of capital market growth and this bodes very well for firms trying to create long-term value for their investors. 2017 has been a fairly unique year in a variety of aspects, from prior years I have seen in the money management industry – predominantly characterized by – low volatility through the year, very few periods of peak to trough drawdown, increased flows from retail accompanied by a huge growth in the AUM of the mutual fund industry.

In this annual letter, which will be slightly longer than normal, I will initially spend some time on the markets, what my thoughts are today and then dwell upon the year that was, in terms of what went right and wrong with the portfolio.

I have maintained from early in 2017, that we are in a structural bull market – which means that people who wait to time the market in anticipating corrections, will be left chasing valuations. I am a big believer in the cycles of markets – where markets go through a V-shaped rise, post a bear market correction (in the first stage), followed by 2-3 years of subdued returns, and the last cycle is where a chase to equity and returns is seen, followed by greed which ends in a euphoria in the market. Historically speaking, this entire 3 phased period defined above, has lasted between 7-10 years and I feel we are in the 3rd phase currently where we are seeing a chase to equity (I would wait to see how this pans out into greed before ending in euphoria). This certainly is no guidebook, but a general rule of thumb I think about when I look at and study cycles – consciously aware that I may have to change my views depending on what I see happening in the market.

The 3rd phase, which I proclaim that we are in currently, has a few attributes :

a) Investors allocating significant wealth into equities translating into

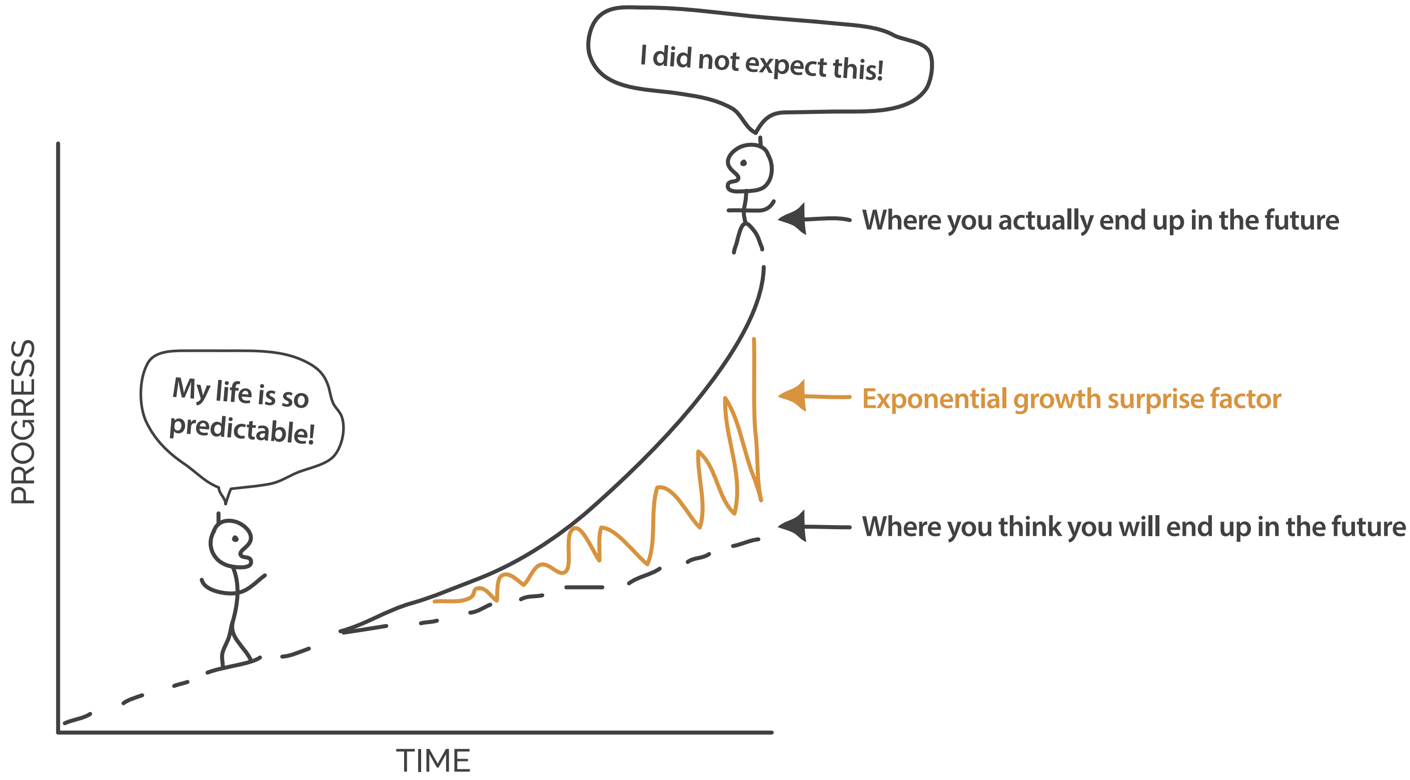
b) Every dip in the market being bought translating into

c) Confidence in the fact that every new rupee of capital being deployed will generate additional returns

d) Leading to Euphoria in valuations in specific sectors, with complete risks being ignored.

Depending on the kind of investor I talk to today, there are arguments to be made that we could be any one of the four stages described above – but I personally believe we are somewhere between a) and b). Having said this, I would not want to lose my discipline in allocating capital today. Sitting today, I do find it significantly hard in deploying capital in great risk reward opportunities. Like I have said before, it requires a very low margin of error to make the next investment in a company with marginal returns, but these are exactly the kind of decisions which would result in significant portfolio deterioration at some stage. The cash that I hold for investors today is not because I am bearish, nor is it because I am trying to time the markets but my willingness to wait for the next best opportunity to present itself. As I have maintained before, the role of a manager is not to keep investors invested in the market at all times, but to ensure that each investment in the portfolio does not sacrifice the core tenets of value that one is looking for. As one wise man said, the manager needs to have the discipline to not add a position in the portfolio, as long as it does not improve the average returns of the existing portfolio. Following this rule in a very objective way, ensures that the portfolio quality does not take a hit at any point of time across market cycles.

2018 PREDICTIONS



We are unfortunately in an industry where the views of analysts are keenly followed, and analysts love to take up limelight with views on every aspect of a company's growth with their 'price targets'. While I have maintained that making a prediction puts us in line, competing with a dart throwing monkey.

I thought I will lay out very broadly what I see for the next year – its more of a fun exercise I am undertaking rather than holding onto it objectively

- I believe portfolio returns for investors in 2018, should see 20%+ returns with good managers
- I anticipate a much higher volatility in 2018, than in 2017 pricing in a peak to trough index draw down of 10+% during the course of the year.

Beyond the two above, I would not treat any more of my 'views' seriously today. I certainly hope to review the two at the end of next year to see if I have been better than a dart throwing monkey.

2017 – The year that was for Itus Capital

I wanted to spend some time talking about my thought process behind the portfolio construction, some of the investments that worked out and those that did not, as these hold important learnings for me as I move into the next year. More importantly, it gives the investors an objective evaluation of the manager with who they have entrusted the capital with.

I have predominantly looked at building a portfolio through a mix of 3 buckets, and the allocation into each bucket has varied in the past, depending on the cycle we are in the market.

Bucket 1 : Balance sheet repair plays translating into secular growth in the industry with tailwinds
An investment into this theme has historically been avoided by most fund managers, as very few want to look at investments in a company with a levered balance sheet. Investing in companies that are in the process of de-levering, is a hard process to get right, and the risk- reward would never accrue in the investors favour, but if it is accompanied by secular tailwinds in the industry growth, this can result in significant wealth creation over a 3-4 year cycle, wherein I believe lies the opportunity. There were two companies under this bucket that the portfolio invested in.

Jindal Steel and Power

Steel industry, being a commodity has always been a cyclical industry. An investment in companies in this industry, I believe, has to happen during the middle of a downturn, when the bottomline is negative. We were in a cycle of negative returns in this sector that had fallen for over 5 years. There were a few company specific events that caught my attention: relatively transparent promoter with a clear statement to realize asset sales to cut debt, promoters in the sector buying stock, initial signs of bottoming out of the input raw material – steel, and a company which had in-house power production capacity if there was indeed a revival in the sector. There were clear signs of an investment, which had a fairly significant upside if the thesis pans out, vs the downside from where we were in the cycle.

Fast forward today, and I have learnt more about the sector, than when I first made the investment. There have been additional tailwinds in the sector come through, in the form of NCLT and consolidation. After a long time, am I seeing capex being added in this sector, and I feel this should be translated into topline growth over the next 2 years. There seems to be a consensus among the analysts of buying steel companies today, after a rally of close to 170% over the year, and I am comfortable holding onto the position at this stage. My mistake which I regret was to not scale my position higher, which I would normally do as my original thesis pans out. Investing in such opportunities where one is playing out a balance sheet de-levering story, has always been hard, which inherently means scaling a position as the original thesis plays out, requires one to go out of his/her comfort zone. This is not something I have done well yet, and this area is something I definitely need more work on.

Sintex Industries

The company came into my radar post the announcement of the management to go through with the demerger, forming a separate entity for the profitable plastics division and separating it from the legacy business that was causing the drag, the textile business.

Sintex Industries, is the entity the textile business was transferred to and was trading at cheap valuations for well documented reasons. Operating in an industry, which has globally been a low-margin, high debt business there have been very few global models of value creation in the textile space. Moreover, the management has had a historical poor record of capital allocation, with constant endeavours to dilute equity. So, was there anything interesting apart from it being cheap?

Sintex was going through a capacity expansion for which the debt was already capitalized. In the textile business, new mills are historically 8% more efficient than the old ones (the old ones were operating at a OPM of low double digits). The debt that Sintex has on its balance sheet, is serviced at 2% as it is eligible for subsidy under the TUF scheme. Moreover , the power subsidy it is eligible for should give it an improved operational efficiency for the next 5 years.

To me, we are looking at a business with the negatives which are very well documented and in the price, and the positives, which 'could' play out in the next 2-3 years. Though, an investment in Sintex Industries is not a typical balance sheet repair play in its true sense, I feel the operational leverage coming back gives a big optionality to the investor in the form of a payoff, that is positively convex. Having said this, we are looking at a management which has had a poor track record of creating investor wealth in the past, which is a factor I am very well cognizant of. To date, the position is down 15% from where I put it on, however, I am comfortable holding the stock considering the thesis of the investment has not changed thus far.

Bucket 2 : Buying growth companies without having to pay up 'too' much in terms of the premium

This has been the primary driver for FIIs and most mutual fund managers to have a long track record of index beating returns in the country. A country like India, will always be a growth market due to its sheer complexity and underpenetrated nature of most businesses which are facing the consumer. Investing in growth companies by its very definition means having to pay a higher multiple than what one is used to through their core definition of what offers value, or put another way forecasting a higher growth rate than what the market is pricing in. The same exuberance that drives growth stocks drives valuations too, which is why one needs to tread with caution when one buys growth. 2017 has been a great year for investors in growth stocks (its been a year when zero growth companies, have shown investment gains, so imagine what happened to growth stocks).

I am not averse to paying a premium to buy growth stocks, but I would not look at buying consumer stocks today, though they are great businesses and generating ROEs of close to 30% (I believe paying a multiple of 70 times forward earnings, does not give me comfort, which is one of the reasons I cannot get myself to buy a company like Maruti, though the company has had a stellar investment return in 2017). Having said this, one of the companies I did invest in early this year post the start of the fund was in Delta Corp.

Delta Corp

The company is in the casino industry and is the only listed player in the country. India is still a very nascent market with regards to the gambling industry (though one can argue about the societal impact and need for the industry in the first place, similar to smoking – this is a debate I would not look at getting into). Currently gambling in India is allowed only in Goa, Damman and Sikkim and the company has a big first mover's advantage. The management, at the top run by Jaydev and Zia Mody are a powerhouse couple with the latter being a prominent figure on corporate mergers & acquisition and private equity. The hotels and hospitality business is very nascent and is still in the red, being masked by the high ROE from gambling. The company runs at an operating margin of 35%+ today and have been consistently generating FCF through their period of expansion too. (Most global peers listed in mature markets like US and Hong Kong operate at margins close to low 30s%).

The growth levers in the company I envision coming from :

- Expansion in Nepal
- New onshore gaming zone in Goa
- Casino opened in Sikkim having an improved impact on the topline once the new airport opens up
- Growth of online gambling (though the industry is still fairly nascent).

Having said this, there will always be a regulatory overhang on the company, one needs to be comfortable with considering the nature of the business it operates in. The investment is up 140% today from the purchase price (I would not be comfortable buying it at today's valuations paying an earnings multiple of around 80x). However I do feel the company offers tremendous risk adjusted returns for me to continue owning it in the portfolio. Finally, there have been recent talks about a casino policy which is talking about moving casinos to land, which could provide multi-fold gains to the industry at large. However, considering we are talking about a policy here, I would not want to dwelve more into it, than it just being a data point to price in.

Bucket 3 : VC Like investing in a portfolio of under-researched companies

The Venture Capital industry has very interesting facets to its framework that a public markets investor can work off, but the core to it (atleast the way I would define it) is to form a portfolio of bets, on companies with great risk reward upside, where you can make multi-folds of your invested capital (in its core philosophy, its essence goes to expected odds and probability). The VC industry takes its bets based on the industry, the founders, and the core team.

The advantage a public markets investor has is data and a history through annual reports which has all the necessary data of capital allocation to go along with it. Most of the companies in this bucket would be sub 1000 cr companies by its very definition, which means it would not be covered by the analyst community at large, as their clients who are institutional in nature are not interested in investing in such companies. 2017 has been a year where I have bet on only three companies in this space, one consumer facing, a niche pharma company and an upstream oil drilling company . By the very definition in this bucket, this is an opportunistic space with a fairly targeted allocation.

Finally, before I sign off, I go into the next year with a fairly optimistic view of the markets, but being opportunistic through the process. End of the day, it's about refining your thought process through the constant uncertainties one is faced with, rather than come up with price targets. There are better paid and more qualified people to do the latter in the industry I operate in.

From the Office of the CIO

Naveen Chandramohan

ITUS Capital Advisors Private Limited

Suite no 105, Workafella, 37, TTK Road, Alwarpet, Chennai - 600018.

+91-7550055173 | naveenc@ituscapital.com | www.ituscapital.com