ITUS CAPITAL

Dear Shareholders and Investors,

The first six months of 2023 (January – June 2023) saw the fund deliver a return of 9.92% (post fees and expenses) as against Nifty which had a return of 6.43% over the same period.

This brings the IRR since inception of Itus at 19.94% over 6.5 years as against Nifty which generated 14.08% over the same period.

In our prior letters, I have highlighted our positioning, why we continue to be overweight domestic manufacturing and auto-ancillaries from a portfolio construct currently. In this letter, I will aim to primarily communicate how we think about investing when the markets hit all-time highs.

Investing at all-time highs

The human psyche is the hardest element to train in an investing journey through public markets. One of the reasons investors can think in horizons of 7+ years in other asset classes (say private equity) is the lack of a daily price for the human mind to react to.

The concept of a new high (or valuations going higher) is treated with excitement in the private equity bucket of any investor's portfolio. However, the same aspect of a public markets' portfolio is treated with an element of caution. Every time the 'market' hits a new high, investors begin to factor in a correction – and the aspect of watching daily price moves does get vindicated from time to time. In this context, it is important to lay out a framework to explain how we view the markets today and what prudent portfolio construction means to us at the firm.

What constitutes portfolio returns?

At Itus, our aim is to buy growth at a reasonable price. Before we do any work on what growth is and what reasonable price means to us, we start our work with the people – the managements or the promoter family allocating capital, as ultimately, we are investing in them. In this letter, I will not be discussing this aspect.

I will spend time speaking about growth and reasonable prices as that's relevant for today's letter. In this context, it is important to appreciate that we buy future growth of the company. We look for businesses that can at least generate a topline growth of 15% over the next 3 years (compounding to a 52% absolute growth over the next 3 years). As for the investment team at Itus, it is imperative we have a clear path to where this growth is coming from (unused capacity, new capex, inorganic acquisitions etc).

The important question to then consider is the valuation we pay to own such businesses. While here again, there is no one metric that one can point to, as a guiding principle – we tend to not pay up more than 2x the growth rate from a cash flow multiple to own a business. For a business that grows at 16%, we would not want to pay up more than a 32x on a cash flow basis to own it. This effectively helps manage the downside from a risk perspective. Ultimately, the portfolio returns we generate are a function of the earnings growth the individual businesses generate and any multiple re-rating we get (which is a function of the market).

Over the last 6.5 years of investments at Itus, we have generated a gross IRR of 22.4% IRR (pre-fees). Breaking down the returns, the earnings of the portfolio has grown at a 17.6% annualized, and the remaining has come from multiple expansion (happens because of discipline maintained across time).

Over the same period, Nifty has generated a gross IRR of 14.08% (pre and post fees is the same here). Breaking down the returns of Nifty, the earnings of Nifty has grown at 11% and the remaining has come from valuation re-rating across the same period.

With the above as the context, I will write about my view on markets and valuations here:

The markets:

With Nifty as a proxy for the 'market', the below shows the historical range of multiples for Nifty across time.

Fig 1: 12 month Trailing PE ratio

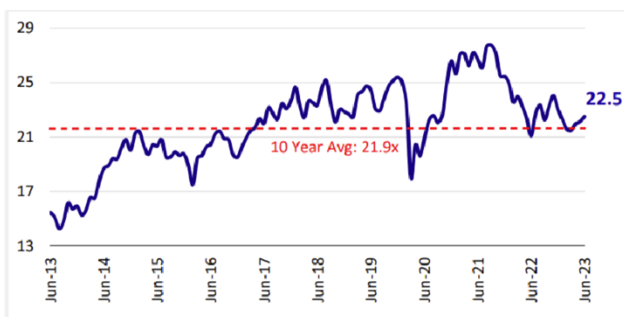
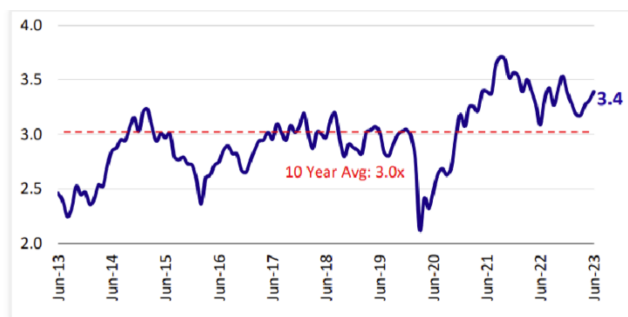


Fig 2: 12 Month Trailing PB ratio



Through this market rally, we continue to trade at a valuation of 14% discount to the peak which we saw on Sep 21 (in terms of valuation).

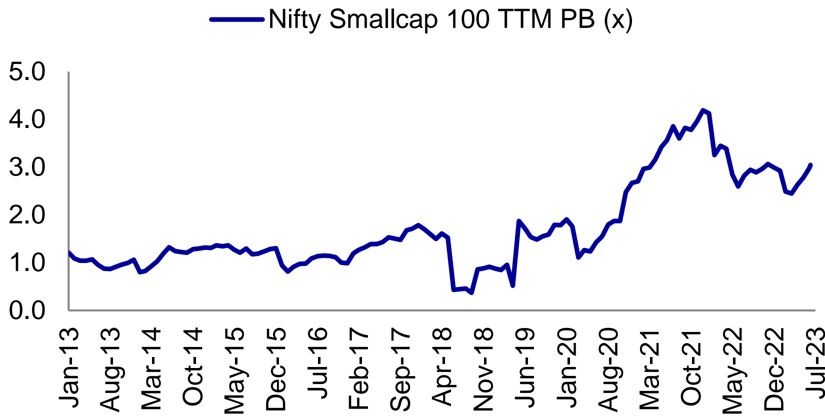
This assumes that earnings do not grow from here. With the earnings visibility for FY24, this discount could be higher.

The market microstructure in terms of sectors and valuations within each sector can look very different, but the aim of the exercise is to look at the markets and the valuations as the starting point.

As one goes down the market cap curve, into the small-cap valuation, the microstructure is very different. While there are pockets of valuation excitement building up, the small-cap index has an interesting context around it too.

It is important to appreciate that the earnings of the constituents of the small-cap index has been extremely volatile across time which translates to the 2.5x volatility that one sees in the index over Nifty. Hence we use the P/B as a proxy to look at the valuation of the index. With that as the context, the small cap index is at a 20% discount to the valuation the index saw last in its peak of Sep'21.

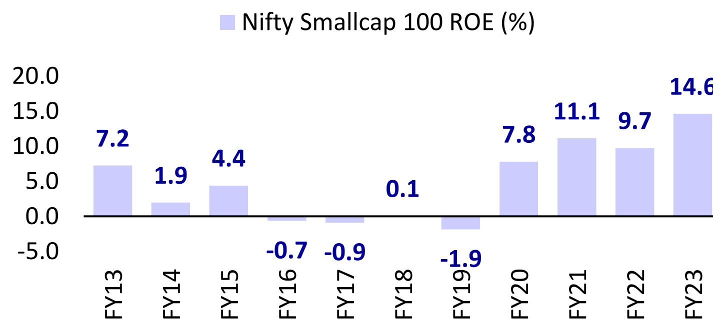
Fig 3: Small cap Index P/B Multiple across time (12m trailing Book value)



The natural question that one would think of next is the valuation difference today, between that we see in the index today, vs the peak 2 cycles ago in Dec 2017 (as the multiples have gone up 50% since).

As again, to answer this, one would have to go into the fundamentals of the index to understand the granular nature of this rerating.

Fig 4: Nifty 100 Small cap Return on Equity Across time



For the small cap index to be considered expensive, the earnings have to drop significantly, which does not seem to be the case yet.

Is it a blue-sky environment?

A significant downside of referring to markets through the perspective of indices, is they tend to average out the numbers. As is most often the case, while the markets are not expensive yet, there are segments within the market that are expensive. This continues to be an environment for bottom-up stock picking where an investor today needs to ensure they buy growth. It is imperative, more than

ever, to buy sustainable growth as that would be the core aspect that protects the portfolio in any downside.

Overall, our portfolio fundamentals continue to be strong and showed a top-line growth of 20.8% on a top-line basis in FY23. We expect FY24 to be a strong for our portfolio companies as many of them have set up capex and are in a position to sweat this out and should benefit from the operating leverage in a strong demand environment.

Portfolio Performance and Attribution

Our annual returns of the portfolio broken down since inception are as below:

Table 2: Breakdown of CY returns of the fund vs Nifty 50 on a yearly basis.

	Itus Fund (%)	**Benchmark - Nifty 50 (%)**	**Excess Return (%)**
2023	9.92%	6.43%	3.48%
2022	-2.83%	4.32%	-7.14%
2021	29.3%	24.1%	5.2%
2020	40.3%	14.9%	25.4%
2019	17.3%	12.0%	5.3%
2018	-7.3%	3.2%	-10.5%
2017	54.7%	28.7%	26.0%
Since Inception (Cumulative)	225.79%	135.31%	90.48%

Portfolio Summary:

We continue to focus on businesses that have market leadership or are growing their market share over time. This is a function of the people who we invest capital behind. This will continue to be the hall-mark of our investment philosophy.

I continue to maintain that 2023 would be a good year to deploy capital on a purely bottoms-up basis into volatility that we see in the year. I look forward to speaking with you on our call at 9:30 AM on the 22nd of July 2023.

From the desk of the CEO

Naveen Chandramohan