Metis India Opportunity Fund

Indiscriminate carnage in small caps

July 2019 Newsletter

July 31, 2019

As we write this quarter-end letter, the dominant narrative on Dalal Street is that we are in a market where bottom-up investors are thriving. Broader view of the listed universe however certainly doesn't sync with this narrative. In sharp contrast to this overarching perception, we haven't witnessed such disconnected polarity since we began allocating capital to India in early 2011. For truly bottom-up investors to thrive, liquidity shifts should be moderate and not overly skewed. Bottom-up investors simply cannot distinguish themselves during periods of poor price discovery, be it a result of misplaced optimism as in 2017 or at a time like now when 'big' is wrongly (and uniformly) associated with 'low risk'. While Indian stocks routinely disconnect with underlying earnings over periods of panic and unrealistic exuberance, the polarity we have seen in the recent past is new to us (larger ,widely-held institutional names charting their own path with little correlation to underlying earnings or valuations). Over the past 2 fiscal years, the disconnect between earnings growth and stock prices for our holdings has been at unprecedented levels.

We expect localized tailwinds within our amusement park holding. This business largely services the top of the pyramid within geographies where offshore-focused services-led white-collar job creation is driving growth - It runs 3 parks in Southern India, where the average household incomes of visitors range from INR 1-2 Mil, with the average age of the decision maker in the early-mid 30s. At a time when manufacturing continues to be a laggard and traditional IT services job creation has decelerated, we note that Bangalore, Hyderabad, and Chennai are expected to account for nearly 60% of jobs created by influx/expansion of GICs (Global In-house Centers) in the country over the next two years[1], offsetting the slack at IT services. This is a very specific situation in a very localized business that we believe is not only largely shielded from the broader economic weakness but now also trades at what we believe are rather unreasonable valuations (~8x run-rate operating cash flows from its operational parks).

In a year when political advertising spends fell across all mediums, radio bucked the trend as major political parties chased the masses following radio's expanded reach after Phase-3 auctions. As a category, only Digital and Cinema would outpace radio in 2019E, with print likely to continue its share loss. Price shocks aside, no name in our book is likely to show more operating leverage over the next few years than our radio holding.

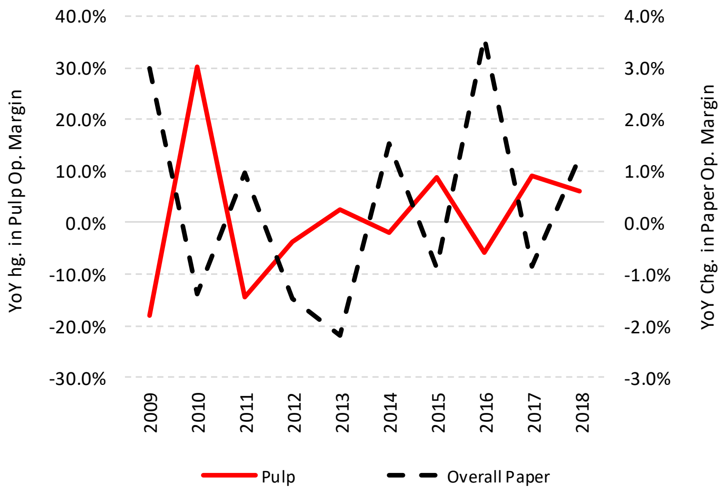
Production efficiencies ensured that our paper holding continues to report solid profitability in C1H19. Adjusted for the 9-day shutdown at its flagship Eastern India plant, we estimate that EBITDA margin for this business was around 28% in F4Q19 (Mar), or about 70-100 bps ahead of the reported figure. In F1Q20 (Jun), further reduction in sourcing radius more than offset pricing pressure and further expanded margins on an already high base. We have maintained that with anti-dumping duties on uncoated paper being in place, and no upward pressure on material costs, domestic uncoated producers are positioned strongly to sustain high profitability levels, with coated paper (~1/5th of EBITDA of our holding[2]) being the only likely sub-category where material price erosion risk could be factored in. Incidentally, coated paper pricing is typically most aligned with broader economic growth and we note that India recently slapped a 10% duty on the coated W&P category. It is also critical to add that with only 2 domestic producers, coated paper remains in deficit (1/2 of domestic sales are serviced through imports) and incremental opportunity for re-selling imported coated paper always exists, thereby providing a vital partial offset to any price erosion. Elsewhere, our latest checks with large domestic paperboard buyers suggest that prices have remained firm across grades. On the uncoated side, domestic prices are already running 2-3% below the ADD price (what is ADD price?) vs. what is

[1] While IT services created 20K fewer jobs in the country in C2018, GICs created about 60K more jobs during the year vs. C2017.
[2] Half of our holding's coated paper revenues come from internal production and another half from re-selling imports

typically an equilibrium premium of 2-3% vs. imports. In particular, we make the following 2 observations on global pricing and trade:

1. **Global pulp market is running at relatively high utilization levels and potential price risk transmission to paper couldn't be nearly as much as in 2008.** With nearly 2/3rd of global virgin fiber pulp requirement coming from captive pulping facilities and paper grades being more differentiated vs pulp grades, paper margins are predictably less volatile vs. pulp. Regardless, to some extent, paper prices are a function of pulp prices (see **Exhibit 2** – note that both are plotted to different scales). In that context, two things are critical to note in the current environment: (A). At the end of 2007, nearly a fifth of global pulping capacity was idle vs. nearly full utilization prior to even the Chinese recycling import ban in 2018, and (B). Despite the Chinese slowdown and *Suzano-Fibria*'s decision to cut production by ~1 mil tons in 2019 (implying a reduced ~84% capacity utilization this year), the pulp market held up relatively well in the first half of the year. To some extent, that was driven by *Suzano*'s decision to build stocks vs. reducing prices.

Exhibit 2 – Historical yoy shifts in global paper and pulp margins



Note: Global pulp peers were picked from Portugal, Poland, Austria, Finland, Brazil, and Chile. Global paper peers were picked from Sweden, Spain, Portugal, Poland, Indonesia, Austria, Brazil, Finland, and Japan

2. **Indonesian paper peers are increasingly looking westward**. Realistically, the most competitive uncoated paper imports into India come from Indonesia[3] and anti-dumping duties on uncoated copier paper are now in place. In parallel, we note that Indonesian paper exports are increasingly taking share in larger Western markets. In fact, no country grew its paper exports faster over the past 5 years than Indonesia, with capacity additions (to partly offset continued capacity closures in NA[4] and Europe) and cost (currency-driven) tailwinds in place. Consider the following to appreciate how cross-continental trade in paper has become attractive for Indonesian producers. Take *PT Indah Kiat* for instance - Over the past 5 years, Indonesian rupiah has depreciated nearly by a fifth vs. the USD. That has seen its operating expense per ton of production decline by 11% (in USD terms) over a period when *Domtar's* (largest uncoated freesheet manufacturer in NA[5]) operating cost per ton declined by 8.5%. In 2018, even as its overall exports to Asian markets declined and overall export revenues were flattish, revenues from Europe and NA increased by more than 30%. Nonetheless, final paper product isn't frequently cost competitive when exported across continents and local cost differentials aren't the driving factor of the share capture being discussed here. Persistently low single-digit operating margins at the large export-oriented Indonesian W&P paper manufacturers clearly corroborates this, with average pricing simply tracking operating costs in recent years.

[3] <5% of Indonesia's paper exports come to India, with Japan and China accounting for nearly 40%.

[4] NA's UFS production has declined by 24% over the past 5 years vs. a 21% decline in demand.

[5] Domtar accounts for more than 40% of NA's uncoated freesheet production.

For all the trade rhetoric, unless INR appreciates considerably, we don't see Indian uncoated and paperboard producers to be uncompetitive vs. imports. Also, we don't view current global pulp markets to be comparable to anything we saw in 2007 and accordingly our worst case for paper pricing cannot reconcile with what's implied by current valuations.

Impact of expanding premium formats in movie exhibition cannot be overstated. About a tenth of our movie exhibition holding's screen count at the end of F2019 (Mar) came from premium formats (*IMAX*, exclusive Luxury seating formats, *4DX* etc.). This contribution will continue to expand and premium formats/screens are expected to be a fifth of all screens in 5 years. We spent considerable time this past quarter in trying to better understand pricing, occupancies, and overall economics of different formats. We are briefly sharing our thoughts on economics of some of these formats[6]:

1. **Frequency of IMAX content has made the format attractive for exhibitors**. *IMAX* format revenues make 5-10% of box office collections for Hollywood titles, with blockbusters making closer to 10%. In contrast, *IMAX* screens contributed under 2% of admissions and under 5% of net collections for the biggest Hollywood blockbuster in India to date. As we write this, there are just around 15 titles YTD that have been released in *IMAX* format in India, or about 2-3 titles a month, with no title running for less than 2 weeks. Collectively, this set has accounted for about a fourth of domestic multiplex collections YTD (across all screening formats), suggesting that in terms of both frequency of content (4-6 Hollywood titles and 1 Indian title every 2 months, on average) and collections, there is definitely room for *IMAX* collections to grow as more screens come online. It is highly unlikely for an Indian movie with production budget of under INR 1 bil to be shot in *IMAX* format, effectively suggesting that around 5-7 domestic titles a year can be released in *IMAX* format.

   In our view, no available premium format has as much loyalty as *IMAX* – We note that the demand for standard screenings for any title at the same property is limited when *IMAX* screenings are on offer, despite the typically observed 20-30% price premium (on comparable seats). Even if we conservatively assume similar number of screenings per day, we estimate that a 5-screen theater (with 1 *IMAX* screen) would report run-rate margins 400-500 bps ahead of a theater with 5 standard auditoriums, with comparable returns on invested capital.

2. **Luxury theaters have similar run-rate profitability as at IMAX but have the best returns on invested capital across formats**. Unsurprisingly, about half of all premium screens today for our holding are exclusively luxury seating formats. Our work suggests that luxury theaters, which are distinguished formats and do not necessarily come with differentiated screens, have yield premiums (vs. standard theaters and screens) similar to that for *IMAX* theaters (lower occupancy[7] but higher prices vs. *IMAX*). However, given the smaller sizes of luxury formats and higher F&B consumption, we estimate that run-rate margins of a 5-screen property with one screen exclusively marked for luxury format are similar to that of a 5-screen property with one *IMAX* screen. ROICs however are 300-400 bps higher, in our view.

3. **D-box could radically change underlying profitability of the 4DX format**. As things stand in India, viewers aren't allowed to take food and beverages inside *4DX* theaters. A newer version, *D-box*, now allows for motion sensor de-activation, and takes care of the currently low SPH for *4DX* screens. By

[6] Our work suggests that number of shows per screen for IMAX, XL, and Luxury are similar to that at standard screens, while screenings at 4DX format are half as many. SPH/ATP ratio was assumed at 56% for IMAX and XL, and 66% for Luxury. Format-specific costs include bulb costs for IMAX and AMC costs for 4DX. For 4DX, price premium and screen costs are shared between exhibitor and CJV.

[7] Currently, only one property has all luxury theaters and its occupancy is reportedly in line with our holding's national average.

our estimate, hypothetically speaking, if SPH/ATP ratio for *4DX* screens were similar to what we see at standard screens, we estimate that run-rate EBITDA margin of a 5-screen theater (with 1 *4DX* screen) would be at least 50-100 bps ahead of comparable 5-screen standard property, with competitive ROICs.

4. **The *XL* format likely has lower profitability vs. the above-mentioned formats**. *XL* uses 2 4K projectors to exhibit on extra-large wall-to-wall screens. We have observed that *XL* format yields (realization per sq ft) run about 40% ahead of standard screens with run-rate profitability of a 5-screen property (with 1 *XL* screen) about 150-200 bps ahead of a standard 5-screen property. Returns on invested capital on such properties are comparable with standard 5-screen properties.

Above are the formats that clearly add value to enterprise-wide profitability while adding a critical new dimension to cinema experience. Predictably, they make nearly 90% of our holding's current premium screen network. Other formats such as '*Onyx*' or kid-specific formats don't appeal to us as much, given either low yields, lack of content synchronicity or both. Overall, while we see the premium formats improving profitability and returns on invested capital, we don't see a concomitant drag elsewhere – We note that our holding has started a new brand that is specifically targeted at Tier 3 and 4 towns with ATPs in the INR 110-150 range and about 30% lower cost per screen. While there is only 1 theater at the moment under this format (restricting reliable observations), we are told that returns on invested capital for this format are in line with current company average.

Please let us know if you have any questions.

Investment Managers

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