Investment Framework:
Durable Businesses, Able Managers, Superior & Sustainable ROEs

(For Vinit Sambre, Head of Equities)

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“Investment is most intelligent when it is most business like” - Benjamin Graham

“It will be difficult for a lay man to pick a stock which would give him the top returns; but if one were to ask him aboutgood business, in most probability he would say it is the one which has long durability and would give him the superiorreturn on the capital invested, much higher than bank Fixed Deposits for the risk he is assuming. **This is exactly wherethe genesis of good investment lies.” – Vinit Sambre**

Investment success lies in the ability to identify sustainable and durable businesses run by **able managers** with abilityto **generate superior ROEs (or ROCEs)** over **long periods of time.**

Why ROCE or ROE? Put simply, ROCE (return on the capital employed)* is the profit generated during the year divided by the total capital employed by the company. A higher ROCE means higher profit in the hands of the investorper unit of capital employed. ROCE is an important metric to focus on versus only considering profits a company is churning out each year, **because ROCE shows how the company manages its money even taking into account its previous years’ savings** (retained earnings). Further, if the company is able to reinvest the incremental profit back into the business and generate similar or better ROCE it could potentially lead to huge amount of wealth creation. Onthe contrary if the company consistently does not generate ROCE which is in excess of returns from safer alternatives (such as fixed deposits), the capital employed by the firm is NOT generating appropriate returns and is better off getting re-deployed elsewhere.

ROCE is like the return on fixed deposits; only difference being the number is not static, which makes the investment journey unpredictable yet exciting. **The success really lies in the ability to identify businesses which could probably generate superior ROCEs on a sustainable basis.** This involves the element of predictability, and the better one is at predicting the higher the chances of success. This is true for companies across market capitalizations. It’s a bit more challenging to identify such companies in the small and mid cap space due to the nascent nature of the businesses, thelack of prior history and limited predictive power.

DSP’s Style for Mid cap Arena:

Mid cap and small cap stocks by nature have the potential to grow at exponential rates but are also highly volatile. Mid and small cap stocks are more susceptible to economic cycles than their large cap counterparts – stocks in these categories are less likely to weather an economic downturn than large, well-established businesses. They are generallyunder researched and under owned. These companies require a **long-term perspective** as value creation takes time. This category demands intensive research to identify stocks and constant vigilance throughout the journeyto 1) build conviction on the thesis and the value proposition, 2) increase exposure or even eliminate, if required.

We aim to pick management teams that would generate considerable alpha over the long term. Hence, investors with a long-term appetite and the ability to stomach volatility should invest and continue to remain invested in thesestrategies.

To create long term wealth for our investors in these categories we follow **a simple investment philosophy of buying and holding companies which would potentially create value over time and eliminate companies which would detract value.**

**We have used ROE (Return of Equity) as one of the metrics to evaluate stocks under the investment framework. ROE considers return only on Equitycapital excluding debt from total investments.*

What companies do we buy?

What do we consider when we select which companies to invest in? We look at three broad parameters viz. **business, management and valuation**, which we discuss below in detail:

Business model. We invest in simple businesses (focused mono-line businesses or few complimentary businesses) with good predictability and high growth potential. We look at the following factors while researching the investee companies:

1. What are the business's competitive advantages? (Is it a simple and niche business? Has it maintained marketdominance and remained ahead of its competition? Is its market position sustainable? Is it an innovator?)
2. Is the business in a large and high growth sector? Is the company well positioned to capture growth (Maintain andgrow market share)? Can the company scale and grow and in what time frame?
3. Does the business generate or have the potential to generate positive and predictable cash flows and superiorROE? How capital intensive is the business (both fixed and working capital)?
4. Is the business at the cusp of a turnaround, where ROEs / other financial metrics are slated to move up in theforeseeable future?

Once we have broader industry conviction and have evaluated company specific factors (our process includes having detailed due diligence conversations with competitors, vendors, customers, auditors, ex-employees, plant managers to source information and also validate information provided by the company management), we dig deep into the company financials. We evaluate the company's historical financials for the last 5 to 10 years to understand the company's cash flows, cyclicality of revenues and profits, strength of balance sheet, working capital requirements. We also aim to police for any abnormalities within the financials. We typically steer away from companies that have had unusual and too many related party transactions which we consider to be a red flag indicating potential source of leakage of funds from the business. We try to avoid companies with complex shareholding structures, with many subsidiaries or associate companies as these obscure entities are frequently used to avoid tax or siphon off cash.

We believe good companies pass the threshold on below financial metrics which we focus on during our evaluation. Metrics for non-financial services businesses:

Metric	Threshold	Relative importance to DSP	Rationale
3 Yr. Avg. ROE	>16%	High	Long-term consistency is very important. 16% provides a fair margin over the risk free rate and adequately covers for the risk undertaken in the business.
5 Yr. Avg. EBITDA Growth	>13%	High	Growth higher than nominal GDP growth ensures outperformance over index.
5 Yr. Avg. PAT Growth	>13%	High	
Margin Increase: EBITDAGrowth > Sales Growth	>1	High	Indicates operating efficiency and operatingleverage potential.
Tax Rate	>20%	High	Lowers risk of accounting misrepresentation. Taxpayment is one indicator of clean accounting.
Earnings per share (EPS) Growth Variability	<100%	Low	Indicator of stability of earnings. Helps to sizepositions.
Payout Ratio	>15%	Low	Indicator of cash generation in the business andprofit sharing mindset of the management.
Net Debt/EBITDA	<3x	High	Lower ratio depicts less leverage indicating strength of the business and makes business less vulnerable during economic downturns.
Valuation	High ROE justifies higher P/E (Trailing 12M)	High	Will pay higher valuations for businesses with highROE provided other metrics are also strong.

Metric	Threshold	Relative importance to DSP	Rationale
Free Cash Flow Yield	Positive	High	Free cash flow yield is defined as (Free Cash Flowless tax and working capital before capex / Market Cap.) This ratio explains the quality of operating earnings especially in the context of working capital and capex.
Receivable days variability	<30 days	High	Lower variability (not the absolute days) in receivable days suggests strong bargaining powerof the business.
Inventory days variability	<30 days	High	Lower variability suggests lower cyclicality ofbusiness.
Payable days variability	<30 days	High	Lower variability indicates bargaining power of the management and reduces the risk of highdebt disguised as payable.

Metrics for financial services business:

Metric	Threshold	Importance
3 Yr. Avg. ROE	>16%	High
Tax Rate	>20%	High
Gross NPA	<2%	High
5 Yr. Avg. PAT Growth	>13%	High
EPS Growth Variability	<100%	Low

Statistics at aggregate level for both funds on the framework criteria is as follows:

Metric	Threshold	DSP Mid Cap Fund
3 Yr. Avg. ROE (All companies)	>16%	18.6%
5 Yr. Avg. PAT Growth (All companies)	>13%	24.36%
5 Yr. Avg. EBITDA Growth(EX-financials)	>13%	9.7%
Margin Increase: EBITDA Growth >Sales Growth (Ex-financials)	>1	2.2
Tax Rate (All companies)	>20%	21.5%
Earnings per share (EPS) GrowthVariability (All companies)	<100%	45.0
Payout Ratio (Ex-financials)	>15%	28.6
Receivable days variability(Ex-financials)	<30 days	9.6days
Inventory days variability (Ex-financials)	<30 days	10.2days
Payable days variability (Ex-financials)	<30 days	8.1 days
Net Debt/EBITDA (Ex-financials)^	<3x	-0.12
Valuation (Ex-financials)	High ROE justifies higherP/E (Trailing 12M)	51
Free Cash Flow Yield (Ex-financials)	Positive	5.16%

Source: Factset. Portfolio considered at a point in time in end Aug 2022

Credible and capable management team. **Credibility** is a matter of trust and ethics. **Capability** is the ability to drivebusiness growth. These are subjective factors that go beyond traditional parameters such as vintage, qualifications, etc. Individual judgment plays a key role in evaluating management. For small cap companies, assessment of managementis difficult, as the information availability is limited. However, management review is crucial as they are often the forcedriving growth. Some of the key parameters / attributes which we assess are:

- *Passion and ownership.* A high degree of management passion allows the company to remain ahead in fiercely competitive environments. High promoter ownership is one factor which could ensure high involvement and "skin in the game" which aligns shareholder and management goals.
- *Past track record.* Historical track record of management's projections and degree to which they have been met. Wetypically avoid companies where management has consistently not met their guidance / projections. We also assesshow management has acted / performed during adverse business cycles.
- *Prudent capital allocation.* We favour management who have a proven track record of prudent capital allocation. Prudent capital allocation ultimately drives ROE which is a key factor in long term future wealth creation.

Valuation. Finally, we combine our assessment of the strength of the business and quality of the management team to determine a **reasonable valuation** for our investee companies. We do not look at valuations in isolation; but in conjunction with the growth, return ratios, management quality, earnings stability, cyclicality, optional drivers, etc. Thehigher the consistency in growth and ROE, the higher multiple a business can command.

When good companies that fall within our framework start trading at expensive valuations (calendar year 2017 was aprime example), we may invest in companies on the borderline of our investment framework due to valuation comfort. This may cause the quality of the portfolio to become diluted and also often lengthens the tail of the overall portfolio. Furthermore, during raging bull markets increasing relative valuations make stocks "hyper" expensive, rendering it difficult to find strong businesses and build positions at reasonable valuations. In such situations we will not shy awayfrom taking bold decisions such as stopping fresh investments into the fund (like we did in February 2017) as we aimto be prudent and act in the best interest of our investors.

On the other hand, market corrections give us an opportunity to consolidate our portfolio: sell our "mediocre" holdings and add to our holdings in good companies as they become more reasonably priced. We use valuations and market pricing to balance and strengthen the overall portfolio.

Our thought process on few top holdings across DSP Mid Cap Fund:

Few top holdings	Rationale
Atul Limited	• **Competent management** has grown business whilst maintaining strict financialdiscipline • **Competitive advantage:** Significant knowledge and experience of working withmultiple & complex chemistry serving diverse industries • **Focus on ROE:** Delivered superior ROCE over last few years; 3 yr avg: 24.4% • **Growth:** Visibility on growth due to large capex in the last few years
IPCA Laboratories	• Globally the largest and cheapest manufacturer of its APIs – Also market leaders in their branded generics • One of the best managed mid-sized pharma companies • **Superior management strategy:** Rationalized & optimized operations to expandprofitability despite no revenues from profitable US markets for last few years • **Low leverage**
ICICI Bank	• It is the **2nd largest private sector bank** in India with a pan India presence. The bank's loan book is growing at ~**18% YoY** (vs. industry average of ~6%) which depicts the strong footprint of the bank in retail loan, business loan/SME and ample presence in the wholesale segment.
Bata Limited	• Largest retailer and **leading footwear manufacturer** in India with pan India presence. It is a classic example of a cyclical play in a structural story as reflected in its last three decades of history.
Supreme Industries	• **Leader in plastic moulding products** • **Strong focus on ROE** coupled with **low leverage** • **Growth:** Large capex in the recent past provides growth visibility

Source: Internal, Factset. The sector(s)/stock(s)/issuer(s) mentioned in this document do not constitute any recommendation of the same and the Schemes may or may not have any future position in these sector(s)/stock(s)/issuer(s).

What is our holding period?

Patience is a virtue and Long holding periods are often required to nurture businesses.

DSP Mid Cap Fund is actively managed; and portfolio companies are selected after a detailed fundamental analysis of the business, management and valuation. We avoid worrying about short / near term volatility in the portfolio caused by global concerns, slower than expected earnings momentum and other transitory factors. Businesses do not become big overnight. It takes years to build a successful business and hence we also align our portfolio construction approach to this thought. **We buy a stock to hold it for the entire business cycle and also want investors to invest in this segment with a similar time horizon.** When we have confidence that ourcompanies remain on their growth trajectories and have solid management teams fuelling this growth, we ignore market noise, exercise patience and hold the investments. If business fundamentals remain intact, we will stomach short term volatility.

Below we highlight the long holding period required to generate multi-fold returns on investments for **DSP Midcap fund.**

The top 5 companies in the last 5 year.

List of Top 5Companies	Return Multiplier	Avg. weight during last 5 year	Present in portfolio as on Aug 2022?
Srf Limited	6.94x	2.55%	✓
Atul Limited	3.75x	2.92%	✓
IPCA Laboratories Limited	3.19x	3.26%	✓
Coromandel International Limited	2.24x	2.59%	✓
Supreme Industries Limited	1.9x	3.05%	✓

Source: Factset. The sector(s)/stock(s)/issuer(s) mentioned in this document do not constitute any recommendation of the same and the Schemes may or may not have any future position in these sector(s)/stock(s)/issuer(s). Return numbers are calculated in USD.

We hold higher concentrations in companies where we have high conviction; and we may even add to our high conviction bets during market corrections. The confidence to increase weight – in a category which is fraught with somuch risk – comes from our evaluation methodology. We believe that when companies with strong businesses – run byquality management – are available at a reasonable valuation, we'll certainly not be afraid to "double down."

For example, one of our portfolio holding companies, Symphony Ltd, fit our investment framework perfectly. It is a mono-line business with high degree of management focus and aspiration. It was a market leader with ~50% market share in the organized air cooler market and operated with an asset-light strategy (both investment capital and working capital) generating very high ROEs. Post evaluating the company we bought it at a trailing P/E of ~14x in December 2012. Earnings did not grow during the year and the company's share price remained flat for the next ~10 months. However, we held our investment as the business fundamentals were strong. Our patience was rewarded as the company generated EPS growth of over 35% for the next five quarters (Q1 FY14 to Q3 FY15), which led to a rise invaluations from 14x to almost 90x. Again, all through the rise in the valuation we held onto our position as the businesswas doing absolutely fine. However during 2015, when the valuation scaled to unprecedented levels and concerns around growth rose due to early onset of monsoon, we trimmed our position marginally to reflect the concerns over the continuity of high growth. We did not exit the entire position becuase the business, in our opinion, still had some potential to grow and there wasn't sufficient liquidity in the market to exit completely. The trimming decision workedwell in our favor.

When do we Sell/ Book Profits?

As seen with Symphony, when we feel valuations have risen to unsupportable levels we will trim/ exit holdings and book profits. There are also times when our investment thesis doesn't play out the way we had envisioned. In such situations, we will "cut our losses" and sell instead of incurring further losses.

In the following cases we will quickly exit a stock position by booking a loss:

1. Significant deterioration in the business fundamentals potentially due to regulatory changes, management strategyshift, deterioration of cash flows, etc.
2. Surfacing of corporate governance issues which we were not able to anticipate at the time of investment.
3. Fraudulent activity or misrepresentation of facts with respect to the financials of the company.

For example, with Ashapura Intimates our investment thesis was focused around the passion with which the promoterwas running the business. The business seemingly had good potential for growth and did well for a few years after weinvested. However, we were unable to judge the likely financial dressing which was undertaken by the company. Thesudden disappearance of the promoter further accentuated the problem and impaired our investment.

Our mistakes are also a source of learning, helping us build checks and balances into our investment principles. In the case of Ashapura Intimates, we recognize that we should have focused more on deteriorating working capital metricsand not relied so heavily on the guidance provided by the promoter. On the whole, our misses have been contained within a reasonable range and have not had a large impact on our long-term performance.

Do we buy stocks outside the framework and how do we manage risk?

Do we hold stocks in our portfolio which do not fit perfectly into our investment principles? YES!

Transitions can be opportune times to enter and support good companies especially those with strong managementteams. We will invest in companies that are on the periphery with regards to our investment framework criteria or if the company is going through a transition and we believe in the management's ability to successfully manage the turnaround.

The relatively higher degree of frugality in the mid and small cap space warrants prudence while building positions in astock. At times, when we have invested in companies – outside of our framework – in expectation of likely improvement/turnaround in the business, we have controlled our risk by having lower exposure in such names. This has enabled usto contain the impact of our failures to a reasonable extent. Furthermore, investments outside the framework are giventwo to three years to fit into the framework otherwise we sell.

Below are examples of **top losers** – in terms of returns – in **DSP Mid Cap Fund**. Whileit is impossible to eliminate risk of investing in the mid and small cap space, we would like to highlight the smaller allocations made to these companies which helped to contain the loss to portfolio to less than 100 bps in most of thesecases.

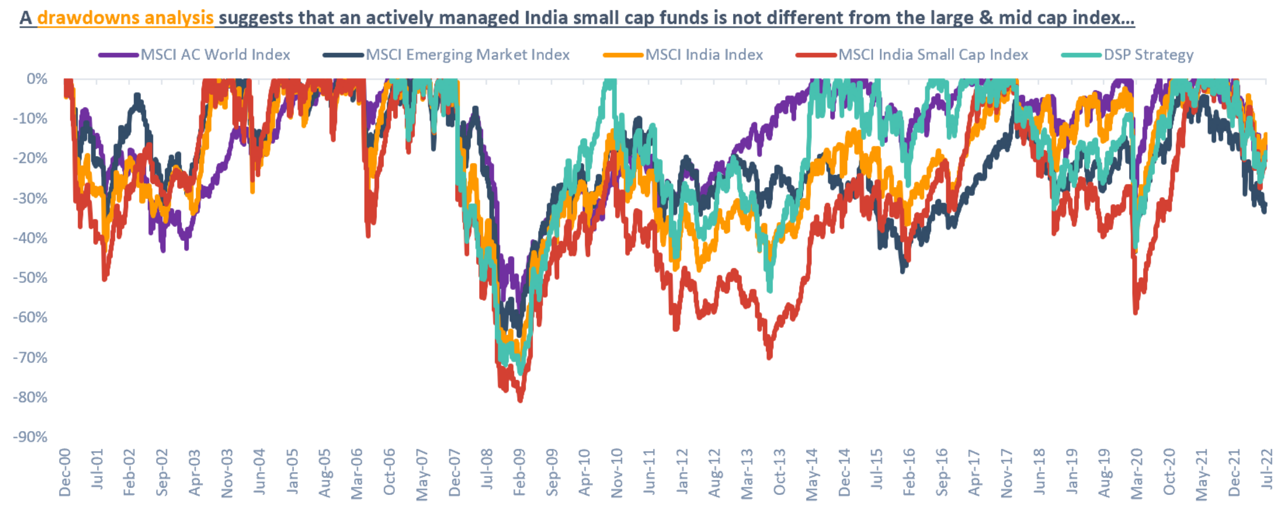
List of Losers	Price decline	Holding periodin years	Period Held	Avg. weight during holdingperiod	Present in portfolio as on Aug 2022?
DSP Mid Cap Fund					
Navkar Corporation Ltd	78%	1.8	Mar'17 to Dec'18	0.20%	×
Indo Count Industries Limited	72%	1.8	Mar'17 to Dec'18	0.31%	×
Aarti Surfactants Ltd.	70%	0.8	Sep'19 to Jun'20	0.00%	×
Repco Home Finance Ltd.	65%	3.8	Mar'17 to Dec'20	0.81%	×

Source: Factset. The sector(s)/stock(s)/issuer(s) mentioned in this document do not constitute any recommendation of the same and the Schemes may or may not have any future position in these sector(s)/stock(s)/issuer(s). Return numbers are calculated in USD.

We also have to consider other factors when managing the broader portfolio. We must consider liquidity risk from the perspective of portfolio size. As the portfolio size grows, we make sure the portfolio has enough liquidity to service redemptions by either maintaining a reasonable cash position or holding highly liquid mid-cap or even large-cap securities.

How has the funds fared in drawdowns?

DSP Midcap Fund has fared better than the benchmark in deep drawdowns, where it has fallen less than the benchmark. During the 2008-2009 drawdown post the financial crisis, the fund fell 70% whereas the MSCI India small cap 80%. Post this during the period 2011-2014, the fund faced two drawdowns between 45-50% whereas the benchmark fell lower by 65-70%.



Maximum Drawdown	MSCI AC World Index	MSCI Emerging Market Index	MSCI India	MSCI India Small Cap	DSP Strategy*
Since 2000	60%	66%	73%	81%	74%

Parting Thoughts:

We believe **durable businesses** run by **able managers,** with ability to generate **superior ROEs sustainably, are sources of alpha.** In order to create wealth and have a good investment experience, **investors must stay invested for the long term** as our underlying investee companies are strong businesses that need time and nurturing to reach their potential.

Be Patient and think long term!

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