INVESTMENT PHILOSOPHY

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Manages:
DSP Healthcare Fund

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DSP MUTUAL FUND

Core Philosophy

I believe in buying businesses that are trading at below their intrinsic values as measured by company's growth prospects and management's ability to address the potential opportunity. A part of the portfolio may be in turnaround companies where there is a mismatch between near term performance and long-term potential and capabilities.

Ideally I prefer companies with at least 12% ROIC, >10% EBITDA growth and OCF of >50% of EBITDA. However, I may also actively look for change in ROIC. Often companies invest ahead of time in projects which temporarily hurt ROIC but boost future growth prospects. I would look to invest in such companies

While a lot of time is spent on generating positive return ideas, I believe it is equally important to avoid accidents in the portfolio. One of the ways this can be done is by avoiding a stock which is trading at peak multiples on peak earnings. Understanding where a company is currently vs. the opportunities available to it over the foreseeable future enables one to identify how close the company is to its peak earnings potential.

Given the sector mandate, I may want to own a mix of value, growth, stability and turnaround companies and not tilt the portfolio is favor of any one style.

DSP MUTUAL FUND

Investment Framework

Contents

I. Entry Process

a. Quantitative Matrix

I prefer companies with >12% Return on Invested Capital (ROIC), >10% EBITDA growth and Operating Cash Flows of ~50% of EBITDA.

In a sector mandate, the criteria based selection approach may not always work as the universe of stocks is relatively smaller. Pharmaceutical business can have long gestation periods due to high Research & Development as well as dependence on regulators for product approvals. Consequently, different companies could be at different points of their investment cycle. In many cases large investments could be leading to low ROIC in the short term. It is therefore important to know the reasons behind the numbers. Understanding the rationale behind the numbers also allows us to identify turnaround in businesses.

b. Expected change in ROIC

Generally, businesses with higher ROIC are preferred over those with lower ROIC. It is important to have respectable ROIC of approximately 12% (or approximately 5% above the risk-free rates). However, it is also critical to look at change in ROIC and not just the absolute number. Improving ROIC lead to improving multiples. Weak ROIC due to investments in seeding new business or due to temporary downtrend in margins and not due to any structural reasons is acceptable. In such cases the profitability ratios improve, as new businesses and investments start contributing to earnings. I look to pre-empt such movements where currently low ROIC is on path to recover to >12% over the next 2-3 years.

c. High Operating Leverage

Companies incur operating expenses to run businesses. Such expenses are either variable (depends on revenue) or fixed (doesn't depend on revenue). All else being equal, if revenue growth is faster than growth of fixed expenses then margins expand and vice versa. It is thus critical to evaluate where the company is in terms of its operating leverage. Counter intuitively I look for companies that have lower PAT/EBITDA margins despite gross margins that are in line with peers.

d. Difference between Intrinsic Value and Quoted Price

Often companies invest in business segments that can be a large opportunity over the longer term but put pressure on near term profits and return ratios. This could lead to stocks trading below their intrinsic values. Case in point – Indian formulation majors having made significant investments in exports markets, which are still to payoff meaningfully. This leads to inferior return ratios and valuation multiples in the near term, which offers opportunity to invest in good businesses at a discount to fair value.

Assessing the Intrinsic Value

Identifying the "true" addressable market opportunity

In India, there is large potential in most products/services. However, it is pertinent to adjust the addressable market for a company's capabilities, strengths, and execution skills. If a company needs to substantially change itself or its products to address a new sub-segment, then that entails execution risks which ought to be factored in the multiples. For e.g. a large API manufacturer who is trying to forward integrate into formulations may need to change itself to tap this opportunity. The true market opportunity for this company may not be the entire formulations market but only the formulations market of the APIs that it makes.

Understanding the DNA (core characteristics) of the company

Every company has its DNA which can be studied based on its historic performance vs guidance, capital allocation, strategic business decisions, trust of market participants and the potential growth opportunity. Sometimes there is a divergence between the long term value and price due to short term events like quarterly results, news flows etc. I actively seek such divergences.

Due diligence

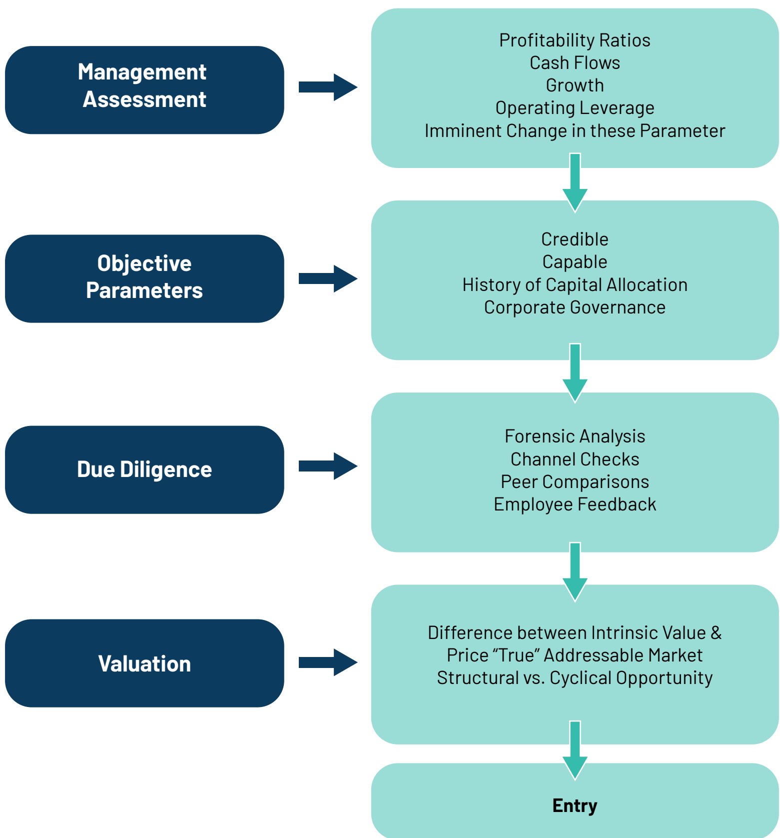
We carry out detailed due diligence to eliminate any governance risk. Simple checks like taxes paid, capitalization of expenses, related party transactions etc. backed by detailed forensic analysis, if required is what we do to derive comfort on company managements and their policies. We also get a 360-degree feedback on companies from other stakeholders of the business – like customers, unlisted competitors and global /international peers.

Management quality and alignment of objectives

Great people build great businesses. Businesses today are perhaps more dynamic than ever. In such a scenario people running the business have to take decisions that create long term value. We look for managements that are capable and honest about their ability to deliver. Incentives of the management needs to be aligned with those of minority shareholders. For example, when a professional CEO is given equity option of the company at or near market prices, his objectives are then better aligned with minority investors.

We look for management with prudent capital allocation track record. This can be judged from history of capital raising, ROIC of the business and management's focus on ROIC. For e.g. acquisitions can lead to immediate profit accretion, more so in current low interest rate environment. However, if the acquisitions don't add strategic value, they eventually end up being value destructive. Consistent allocation to assets that have poor capital efficiency may eventually lead to a de-rating in multiples of any business.

Summary of the Entry Process



II. Valuations

Avoid accidents

Medical community follows this old adage of "do no harm". It means that nothing you do should harm the patient. The concept is relevant to investing as well. Using this analogy in the investing would mean avoiding big losses and managing risks.

What this means is:

a. Avoid giving peak multiples to peak earnings.
b. Avoid making large allocations to companies that have poor cash flows conversion despite healthy profits.
c. Look at product concentration for earnings given that in US generics in particular profitability on some products can be very high for a short time and markets tend to misread the longevity of such opportunities.

Look at various aspects of valuations

I don't look at just one metric of valuation. Looking at different aspects like Enterprise Value (EV) /Sales , EV/EBITDA, Price /Earnings, Free Cash Flow (FCF) yields, replacement value and long term Discounted Cash Flow (DCF) and comparing them to other sectors as well as global companies in the same sector gives a better perspective. In my view, looking for disconnect between what the market is factoring in and what the objective data is showing is key.

III. Portfolio Construction

Identifying stock/ business cycles

Most stocks go through cycles. For stocks in different phases in the cycle one needs to monitor different factors. I broadly divide companies in 4 buckets of business cycles – value, turnaround, growth and stability.

- **Value** – these stocks are cheaper relative to their peers due to multiple reasons including weaker cash flows (historic), inefficient capital allocation or business being more complex. I try to identify changes in the underlying performance in such cases. Monitoring cash flows regularly and looking at reasons for improvement provides key insights here.
- **Turnaround** – These are typically over-invested companies that have been enjoying poor return ratios due to large investments. Markets penalize such

companies with lower multiples till such time that their investments start to bear fruits. It is worth monitoring the developments around the newer investments to be early in spotting turnarounds. Having tracked these companies for many years and having fairly good understanding about the management, I believe I have a fair chance of understanding these trends in the companies I track.

- **Growth** – Such companies operate in a high growth segment and have a favourable macro environment. It is likely that such stocks enjoy high multiples. Factors to monitor here would be actual addressable market opportunity, aspects of execution on the opportunity and incremental capital efficiency. My endeavour here is to stay invested till the factors are in favour and valuations are reasonable. The right understanding of the total addressable market comes in handy in identifying very expensive valuations.
- **Stability** – Such companies have seen a strong growth in the past and have now stabilized at low but sustainable growth rates. It is likely that financial ratios like ROIC/ROE etc. are high/stable. Factors worth monitoring are dividend pay-outs and capital allocation towards inorganic opportunities.

Our allocation to above buckets as on 30th May 2021 is Value - 18%, Turnaround - 13%, growth - 37%, Stable - 28%, Cash 4%.

Maintain judicious balance between sub-segments

India healthcare sector has the advantage of having several sub-segments like domestic formulations, APIs, export formulations, custom synthesis & manufacturing, hospitals, diagnostics etc. Each of these subsectors have different drivers and growth potential. Idea of the healthcare fund is to have a well-diversified portfolio by choosing to invest in the stocks that offer less risk and high reward potential within each of these sub segments. It is essential to maintain a judicious balance of each of these sub-segment to generate consistent returns.

Table below summarises the various segments and important aspects

Business Segments	Market size (US$ bn)	Apprx growth	Valuations v/s history	% of AUM (#)(*)
Generic API	$14bn	high single digits	High	9.40%
CDMO	$120bn	early double digits	High	4.80%
India Formulations	$20bn	early double digits	Around average	22.60%

Business Segments	Market size (US$ bn)	Apprx growth	Valuations v/s history	% of AUM (#)(*)
Exports Formulations	$20bn	early double digits	Around average	28.50%
Hospitals	$70bn	high single digits	Around average	15.30%
Diagnostics	$11bn	early double digits	High	3.10%
Global Medical Equipment	$430bn	high single digits	Around average	9.90%

based on portfolio as on April 30th, 2021; For companies involved in multiple segments we have included proportional sales from various segments for FY20

*Balance in form of cash

Sources – detailed in the annexure for each of the segments

Market capitalization doesn't matter much, liquidity relative to our ownership matters more

Given the sectoral mandate market capitalization doesn't matter much. I want to own good businesses, run by capable managements and that are trading at valuations lower than the intrinsic values irrespective of their market capitalization. Market capitalization has bearing on liquidity of a stock. Liquidity is a factor in position sizing.

IV. Exit Process

High valuation alone is not a good reason to sell a stock. Business cycle being close to peak or narrative around the growth potential being flawed is important in exit decisions.

I may sell stock when:

1) Investment thesis does not play out as anticipated in the expected time frame
2) Stock is near peak earnings and peak multiples.

3) Mistakes in capital allocation
   i) a large and expensive acquisition with synergies that are difficult to achieve
   ii) a large capital expenditure without line of sight to a reasonable return on investment
   iii) capex in unrelated activities that have questionable odds of success

V. My Claim on Alpha

My edge is my focus, experience and understanding of the healthcare sector.

I look at different themes within healthcare like domestic formulations, APIs, export formulations, custom synthesis & manufacturing, hospitals, diagnostics, international companies etc. For alpha generation it is important to identify the cycles of each of these themes and size them optimally in the portfolio. I may identify businesses that are changing from one phase of the business cycle to the other. Tracking management actions and developments in external environment can provide early signs of change. Because of my focus I plan to buy a theme before it becomes popular for the diversified equity managers. I would like to maintain judicious balance between currently popular themes/stocks and future ones.

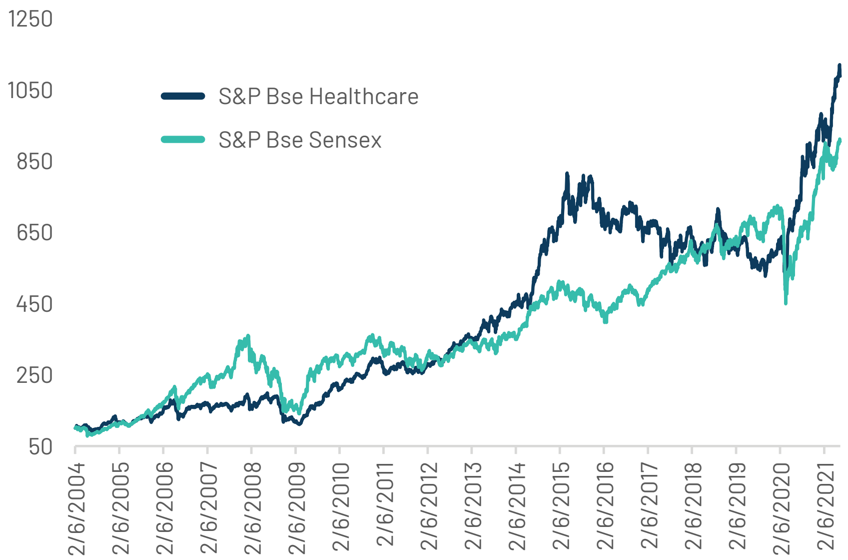
The sector has many companies operating in different segments, therapies, products, markets etc. They all behave differently. The universe I look at is wider than what diversified equity participants are looking at in the sector. This enables not only in better understanding of industry trends but also provides a wider basket of stocks to participate in.

VI. What Can an Investor Expect?

Given that I give a lot of importance to fundamental research and valuation framework, it is possible that I may be early in selling stocks that are “in favor” and early in buying stocks that are “out of favor”. This can lead to near term underperformance. It is also possible that turnarounds take time and again lead to near term underperformance.

The fund is enabled to invest upto 25% in global stocks and currently it has approx 10% of AUM (as on 30th May 2021) in global stocks. BSE Healthcare index has high skew towards the US generics sector which is cyclical. In periods that the US generic industry does well the fund may underperform the indices (like in recent past between Dec 2020 to May 2021). However, over longer term a diversified portfolio generates better risk adjusted return.

Investors should also be ready to see underperformance v/s the broader markets if the US generics sector enters a weak phase like in FY15-19.



(Source – Ace Equity)

The Chart above exhibits the change in value of S&P BSE Healthcare index and S&P BSE Sensex with the respective indices being indexed to 100 as on April 1st, 2010. As can be seen, above BSE Healthcare index has outperformed the BSE Sensex over most periods except for FY15-20. The FY15-20 underperformance was driven by down cycle in the US generics market pricing. This was driven by not just increasing competition but also increased customer consolidation in US distributors where the numbers of distributors shrunk from >8 to now just 3 large buying consortiums having more than 80% purchasing power in US generics. Further consolidation may not pass through regulatory scrutiny.

VII. Appendix

Appendix A

We summarise some of the important drivers, outlook for each of the sub-segments in healthcare

Generic Active pharma ingredients (APIs)

- Overview

- o India's API industry is world's third largest market for both domestic and exports stands at Rs.96000cr (Source - Neuland Laboratories FY20 annual report) . India's API industry is world 3rd largest with 57% of WHO qualified API sites in India. Despite this dominance India imports API/intermediates worth $3.5bn of which $2.5bn is from China (source – media articles). However, this is a fragmented industry with a long tail of small companies and few large companies.
- o Inherently like most other chemicals, APIs are asset intensive businesses. Thus free cash generation has been low. As Indian players integrate backwards to make own intermediates and achieve higher scale in existing products it is reasonable to expect margin (except for companies that have seen large price hikes in old APIs during Covid) and ROIC improvement. However free cash generation may remain low in this segment.

- Growth drivers

- o New capacity addition for older products
- o Market share gains from China as more customers want to de-risk supply chains
- o New product filings and approvals

- Outlook

- o Indian API players have created reasonable presence in their chosen molecules due to India's superior chemistry capabilities. We believe this basket of products may expand and India's dependence on China (currently 70%) for APIs /intermediates may reduce. Government's plan to give production linked incentive to local manufacturers will further boost this trend.

- **Fund positioning and reasoning**
  - As on 31st May 2021, 1.8% of our fund has exposure to pure API companies. Additionally, most of large formulation companies do external sales of their chosen APIs. Including proportional API sales, the funds exposure to API business is around 9.2%
  - Currently most pure API players are trading at premium to their own history. Moreover, we expect prices for some APIs that have increased significantly during Covid to come off over the next 2 years thereby impacting margins. We therefore have a lower exposure at this stage.

Contract development and manufacturing (CDMO)

- Overview

- Currently Pharmaceutical outsourcing (including discovery services, clinical trials, synthesis and commercial manufacturing of both biologics and small molecules) is $120bn market at ~26% of manufacturing/R&D activity being outsourced (Source - Piramal Entreprises).
- India's largest discovery services company has sales of $250m revenue while the largest custom synthesis manufacturer has sales of $400m indicating the kind of opportunity in this segment.

- Growth drivers

- Increasing outsourcing by innovators as against in-house manufacturing of APIs for innovative drugs
- India taking share away from Europe and China.
- Successful commercialization of customers drugs in market

- Outlook

- Currently this segment is at a very early stage in its evolution with only a few companies from India having large sales from this segment. We find more innovators wanting to look at India as a credible vendor and hence believe that this segment has a long run way to grow. This is however also reflected in the valuation of companies (significantly higher v/s past) in this segment.
- CDMO has a high gestation period and hence scale and maturity of the business brings sustainability as well as higher margins / ROIC. However free cash flow generation will always be low due to the need to invest to grow in capacity as well in newer capabilities.

- Fund positioning

- As on May 31th 2021, , ~ 4.8% of our fund is invested in this segment. We are cognizant of the run up in valuations of these companies and feel comfortable with our current exposure to this segment
- CDMO business is tough to predict as products launched by customers(innovator pharma companies) don't have a ready market. Even the customers themselves may not be accurate in predicting product specific growth. Moreover supplies tend to be lumpy. In such an environment giving high multiples to high earnings expectations (with low visibility) may not be prudent.

Generics formulations exports

- Overview

- India exports pharma products worth $20bn (Source - commerce ministry data) annually across the world including exports to large regulated markets like US, Europe

- Growth drivers

- Volume growth driven by increasing penetration of generics
- Approvals for new products especially complex generics
- Price erosion in base business

- Outlook

- IQVIA data suggests that Indian players have a significant 45% share in oral solid generic market in US. Oral solids contribute ~ 50% of the $35-40bn US generic market at company prices (DSP estimates). There is significant opportunity to grow in non-orals solid formulation which includes injectables, dermatology, inhalers etc which is the other half of the market. This $17-18bn opportunity will grow as new products loose patents and become available for generic launches partly offset by price erosion of existing products. As can be seen in the table below non oral solids contribute higher to the pipeline than to the existing product base for the larger US focussed companies.

As of CY20	Non OSD approvals as a % of currently approved	Non OSD ANDAs pending as a % of total ANDAs pending
Cadila	18%	35%
DRRD	28%	45%
Lupin	27%	30%
Cipla	22%	25%
Glenmark	33%	39%
Sun Pharma	42%	39%
Aurobindo	32%	35%

Source – Nomura research

- This is where a lot of investments have been made in the last 5 years and we believe that these investments may bear fruits over the next 3 years.

Top 6 Indian companies in US	FY11-15 (Rs. Mn)	FY16-20 (Rs. Mn)
Cumulative Capital expenditure and acquisitions	2,93,956	6,75,086
Cumulative R&D Spend	1,98,275	4,64,759

(Source – company data aggregated for Sun Pharma, Cipla, Dr Reddy, Lupin, Cadila and Aurobindo)

- As such we believe we are in a middle of an interesting uptrend in US generic market for Indian companies driven by scale up in complex generics. These products are difficult to manufacture and hence higher margin.
- Investments in R&D, capital expenditure on factories and operating expenses on manufacturing facilities for pipeline products for the US generics are front ended. When products are actually launched operating leverage will lead to higher profitability and accordingly ROIC.

- Fund positioning and reasoning

- Most of our top holdings are in this segment and our fund is poised to benefit from an uptick in new launches
- Including proportional revenue from exports for diversified companies, ~28.9% of our fund is exposed to formulation exports opportunity as on 31st May 2021

India formulation market

- **Overview**

  - India's formulation consumption as measured by AIOCD is ~ Rs 1.5 Lakh cr and has grown at 12% CAGR over the last 8 years. This consumption is evenly split between Acute (45%) and chronic (55%) with chronic growing faster than acute.
  - There is also a market in alternate channels like hospitals and government supplies and alternate distribution models like trade generics.

- **Growth drivers**
  - Volume growth driven by increased penetration/access in market.
  - Launch of newer treatment / medicines / products
  - Inflation linked price growth

- **Outlook**
  - IQVIA expects the India formulations market to grow in 9-11% over the foreseeable future.
  - Indian formulations business is a high operating cash flows generating business with low capital intensity and high ROIC. Due to this India focussed companies are valued at higher multiples than exports based companies. Most companies use the cash flows from India to build high gestation exports businesses.

- **Fund positioning and reasoning**

  - As on 31st May 2021, 13.3% of our fund exposure is to pure Indian formulation business. Over and above this we also own companies that have an India business while they are building exports. Including such exposure, 24.1% of our fund is exposed to the Indian pharma formulations market.
  - Pure Indian formulation players enjoy high cash flows and ROIC which are also reflected in their valuations. This can be seen in the multi-national pharma companies. We prefer to play this theme through the geographically diversified players as we find that intrinsic value of their India business is higher than what current prices are implying.

Hospitals

- **Overview**

  - Hospitals account for 70% of healthcare expenditure. Hospitals are also most capex intensive segment in Healthcare sector. Moreover, initial losses need to be funded. It takes 2-3 years to construct a hospital and another 2-3 years for that hospital to make profits.
  - World Health Organisation (WHO) data on hospital beds available per 10000 shows India's bed availability at 12 is lesser than that of countries like Thailand (21) or China (42).

- **Growth drivers**
  - Capacity addition at new facilities or expansion at existing facilities
  - Pricing, efficiency and mix changes in mature hospitals
  - Growth in adjacencies like pharmacies, pathology labs, home care etc

- **Outlook**
  - Having spent a lot on capex at newer hospitals over FY13-18, capex has come down in FY19-20 as most hospitals are now focussed on expanding only existing hospitals. We believe capex may come down even further over the next 3 years and hence free cash flow generation may improve substantially.

	FY13-18	**FY19-20**
Average annual capex by large hospitals (Rs mn)	12,853	8,484
Average annual Capex by large hospitals as a % of sales	11%	5%

Source – company reports, combined for Apollo Hospitals, Fortis (ex REIT acquisition) and Narayana Healthcare

  - Demand has suffered during covid times as patients postponed elective surgeries. It is reasonable to expect a recovery in near future

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- **Fund positioning and reasoning**
  - As on 31st May 2021 we own ~13.1% of our AUM in large hospital chains. Hospitals owned in the fund are leaders in their selected markets. They are building adjacent businesses in tele-medicine, home care, pathology etc thereby creating significant option value that can be unlocked later. With a strong healthcare brand, they have a right to win in these adjacencies.
  - To benefit from the huge penetration led growth opportunity in India's health insurance sector we also have 2.7% invested in general insurance.

Diagnostics

- **Overview**

  - India's diagnostics industry including pathology and Radiology is Rs 80000cr (expected to grow 10% as per Dr Lal's FY20 annual report) with unorganised sector accounting for 48% of this market. National & regional chains are just 15% of the market and continue to gain market share.

- **Growth drivers**
  - Shift of market share away from unorganised to organised chains
  - Increased penetration of testing
  - Increased panel of tests which advance medical treatments

- **Outlook**
  - Current Covid crisis has hurt the non Covid business as doctor practices have suffered. However, it is reasonable to expect a pickup in activity as economy opens up
  - We expect increasing competitive intensity from 1) Private equity funded small regional players trying to expand nationally 2) Hospitals chains building pathology businesses and 3) new players like online aggregators

- **Fund positioning and reasoning**
  - This segment has high free cash flows and ROIC. These cash flows have historically been used to do acquisitions of smaller chains thereby augmenting market share. Thus these businesses trade at high multiples.
  - As on 31st May 2021 we own ~2.9% of our fund in Pathology as we are cognizant of high valuations along with looming risk of increased competition. Moreover, with 3 chains listed and enjoying high multiples seller may also ask for higher prices thereby reducing the opportunity to create value.

As seen above the drivers of growth for each of these sub-segments are different. Having an optimal mix of businesses in each of these segments may allow de-risking and generate consistent returns. With this optimal mix our portfolio has 25% in stable cash flow generating businesses with high ROIC, 20% in low ROIC but potential turnaround candidates.

Overseas investments

- **The idea of investing in overseas securities is to**

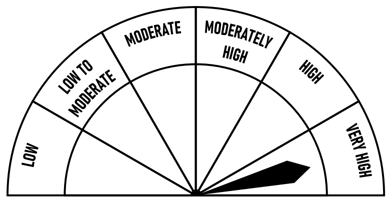
    - Diversify the risk of depending on the generics industry which forms a large part of the BSE Healthcare index. Global Healthcare sector has sub-segments like medical equipment/devices, biopharmaceuticals, genetic research where companies are driving innovation. These sub-segments have historically shown low correlation with Indian healthcare sector.
    - Provide opportunity to invest in businesses that are involved with innovation - a segment where Indian players have lagged. We want to participate in the value creation through these innovations globally.
    - within similar industries, buy stocks with better risk reward i.e cheaper valuations and better quality of business. Global markets (particularly the US) are more mature and have more companies that could benefit from the same secular trend. This enables investing in better companies at lower valuations
    - Table below gives the correlation of BSE Healthcare index with the S&P Healthcare index and S&P medtech index in US (source Bloomberg).

Index	Correlation Coefficient with BSE Healthcare index (#)	Comment
S&P 500 (US)	0.354	Weak correlation of returns with the BSE Healthcare index
S&P Healthcare (US)	0.346	
S&P MedTech (U1S)	0.270	

(# Weekly return from Jan 2011 onwards)

- **Fund positioning and reasoning**
  - Our exposure to global companies is restricted to <25% of assets. Currently we own ~10% of assets in 4 US listed companies. Over time we intend to increase this proportion.
  - Our portfolio companies have RoEs>15%, have significant growth prospects, potential to generate strong cash flows and have cash on balance sheet to execute on the growth opportunities available to them.
  - These companies are at the forefront of innovation in medical devices and equipment segment. While Pharmaceuticals account for 14% of the US healthcare spends, medical devices/equipment are also large opportunity at 6% of the spends. As per Bernstein research, Medical equipment and devices is a $430bn market globally and $190bn in US. Not many Indian companies operate in this segment. Infact the Indian market for medical devices and equipment is also addressed mostly through imports from such companies.
  - We could avoid companies that's are single asset companies and those assets are at very early stage of the regulatory process. Such companies carry significant regulatory risks along with commercial risks.

Product labeling of the Scheme:

DSP Healthcare Fund An open ended equity scheme investing in healthcare and pharmaceutical sector	This open ended equity Scheme is suitable for investors who are seeking* • Long term capital growth • Investment in equity and equity related Securities of healthcare and pharmaceutical companies * Investors should consult their financial advisers if in doubt about whether the Scheme is suitable for them.	 **RISKOMETER** INVESTORS UNDERSTAND THAT THEIR PRINCIPAL WILL BE AT VERY HIGH RISK

For more information on DSP Healthcare Fund, click here

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