STAKEBOAT CAPITAL
NAVIGATING LEVEL NEXT

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Newsletter

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"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price"

- Warren Buffett

From the Founder's desk

Dear Reader,

Stakeboat Capital was founded in 2016 with a vision to bridge the funding gap between VCs and PEs. We see immense potential in Micro-cap companies which we refer as "Little Giants" but given their scale and stage of funding, they find it challenging to raise capital from an early stage VC or a late stage PE fund. The founding partners of Stakeboat Capital have a strong investment track record in multiple domains like Financial Services, Healthcare. Technology etc. and have added significant value to the companies they have invested in thereby creating a combined market cap in excess of USD 8bn with some of these companies have proceeded to IPOs or are contemplating IPOs.

Today, we are delighted to introduce to you our first edition of Stakeboat Capital's newsletter which we intend to make it a regular publication going forward and use it to keep you in touch with important news, trends, opinions and developments in the world of financial markets and we believe you would appreciate our efforts.

In this edition, we bring you thoughts from industry veteran, Mr. Samir Patel (CEO, Sankalp Semiconductors), our opinion on "Trade Protectionism", update on Indian public equities and excerpts from our Investment Team. Later, we touch upon news that made headlines like RBI's framework for resolving stressed assets. Finally, we cover PE/VC activities and conclude by giving a flavor of what direct listing on exchanges holds for the future.

We hope you would find our newsletter insightful and we would be pleased to take any feedback from you and look to implement those in our subsequent issues.

With Best regards,

Chandrasekar Kandasamy

Managing Partner, Stakeboat Capital LLP

Cup of coffee with Sankalp's CEO

Mr. Samir Patel
CEO, Sankalp Semiconductor

Sankalp Semiconductor is one of the largest independent analog and mixed-signal semiconductor design services companies in India. Sankalp has operations in the US, Canada, Malaysia, Bangalore, Hubli, Ahmedabad and Kolkata.

How do you think the chip design industry has evolved?

Texas Instruments started the trend, opening a design center in Bangalore in 1986. Intel followed in the mid-1990s, creating a tipping point. Now almost every U.S. and European chip vendor and even Taiwanese and Korean companies have design centers in India.

In the 1990s, a wave of local companies rose up, mainly offloading verification and peak demand for the big chipmakers. Verification was easy to outsource because it is most like software with little tool costs involved, and you don't want your designers to verify their own logic.

After the dot-com bust, chipmakers started moving full analog digital design to India to lower costs. Acquisitions of eInfoChips by Arrow and SmartPlay by Aricent showed that the sector had spawned some gems.

Way forward for chip design segment?

There are about 200–400 design service companies, and half of them are in Bangalore. To provide more efficiency the sector will get more "Uberized". Just as Uber defined the new market of ride-sharing, design companies need to create new business models to deliver services faster and more cheaply. As the standalone, people-intensive part of the semiconductor industry, design services are ripe to be "Uberized".

By when do you expect the transition to happen?

The change may come more slowly than the dramatic rise of Uber. It will be motivated by the growing demand of application-specific SoCs. The days of standard products are going away. More and more designs are for chips with customizations for a given app.

Where do you see Sankalp heading?

We see potential in this sector for more acquisitions or maybe even an IPO on India's stock market like the successful public launch in 2017 for optical specialist Tejas Networks.

We believe in providing our customers value though Just-in-time services with quality and cost advantage. Sankalp employs about 800 engineers and began its life as an analog specialist. We are building a chip design factory.

Macro trends

Rise of Trade war?

With the recent global cyclical recovery led by developed economies trade protectionism across the globe is on the rise. During his election campaign in 2016, U.S. President Donald Trump committed to solve the U.S. trade deficit and blamed his own predecessors for the enormous trade deficit that U.S faces year after year. During the first year of Trump's presidency, the deficit grew by 12.1% and the US trade shortfall in goods with china surged 8.1%, reaching a record of USD 375bn.

India has had also resorted to a fair bit of protectionism. Apart from the sobering impact on growth, protectionism can lead to higher inflation.

The Trump administration has been developing anti-China protectionist measures. It revealed that China had been asked to formulate policies to enable USD 100bn reduction in trade deficit. In March 2018, Trump enacted steel and aluminium tariffs aimed to constrain China. China retaliated with tariffs on 128 American products. Trump then announced 25% tariffs on another 1,300 Chinese products, representing USD 50bn worth of its exports. In response, China threatened 25% tariff on 106 US exports to go in to effect whenever the US tariffs do.

If these measures go in to effect, it will give rise to a trade war, with the major economies of the world moving towards protectionist policies in an attempt to boost their domestic markets while losing out on the benefits from free trade and globalization. International Monetary Fund's (IMF) MD, Christine Lagarde, warned that the escalating tensions sparked by the potential trade war could impair the global economic growth. In the long run, serious damage to the investors' confidence could have catastrophic impact on the global growth.

As a sign of relief to the fear of trade war between the world's biggest economies and a step towards resolving trade disputes, World Trade Organization (WTO) was requested by China to intervene in the trade dispute and sought consultations with the US over its decision to impose "additional ad valorem rate of duty on imports of certain steel and aluminium products".

Impact on India?

India is one of the countries that were mentioned by the Trump administration to be on the list of counties with which it runs a large deficit. US trade reps reveal that the deficit between India and US dropped by 5.9% in 2017. US continues to mention India on issues of market access, high tariff and protection of Intellectual property. Generally speaking, decline in trade openness will lead to drop in sales growth of Indian companies. On the other hand, reduction in import tariff hurts them on the demand front because of competition from imports. With India being fairly active in initiating protectionist actions and as some of the recent measures like "Make in India" and other budgetary measures indicate, the trend towards domestic-centric policies in India is likely to gather more steam.

Investors' wealth surged INR 20.70Tn (USD 318bn) during 2017-18 fiscal helped by robust broader market sentiment.

Public Markets

Benchmark equity index Sensex rose 11.3% in FY18, with a weak 4th quarter taking away some of the strong gains, as turmoil in global markets weighed on investor sentiment. The domestic institutional investors (DIIs) invested a net INR 1.1tn (UDS 17bn) in equities, a record high infusion which was powered by strong investments in mutual funds' equity schemes, a trend that is expected to continue. On the other hand, foreign institutional investors (FIIs) invested a mere USD 3.3bn, which was less than half of such inflows in the prior year.

From the Investment Team

"A perspective on Home Healthcare in India"

- by Praveen Lodha

Is it an exciting space for entrepreneurs to enter?

Yes, according to our research. According to reports, India's home healthcare market is pegged at between USD 2-4bn and is growing at 18% annually. Despite multiple players entering the market in the last 5 years, the need of HHC is still largely being addressed by nursing bureaus, old-age homes, NGOs, and the informal sector (maids, family members, relatives, etc). One interesting fact to note is that, the top 15 organised players form less than 2% of the total market size. Does this imply, the market is underpenetrated, unorganised or over-estimated? It possibly is a combination of all three.

Praveen Lodha
Investment Analyst,
Stakeboat Capital LLP

What is driving the market?

Today, India's elderly population is ~103mn (about ~8% of population) which is estimated to grow at 12% by 2025. Increasing elderly population and changing life style will contribute to rise in chronic diseases which are 40% of the reasons for hospitalization. India doesn't have the required healthcare infrastructure - with just 0.9 beds per 1,000 people. Today, even the post-surgery recovery happens at hospitals which can potentially be serviced by nurses/caretakers at home. It is a win-win situation for both hospitals and HHC service providers, as early discharge shortens the average length of stay (ALOS) for the hospital which in-turn generates revenue for HHC companies.

Is it really a "need" or a "luxury"?

Whether home healthcare is a "need" or a "luxury" is debatable, the numbers suggest that the average spending per patient per month is approx. INR 20k, which could be above the affordability of the lower and middle-income classes. Today, HHC services are not covered under insurance. Having said that, the total elderly healthcare expense in India is estimated to be USD 24bn of which as high as 96% are borne out of pocket despite having an insurance coverage. What that goes to show is that people will spend on healthcare irrespective of their purchasing power. But that also means that introduction of insurance schemes covering HHC service may not necessarily be a significant driver for growth in this sector.

So this industry albeit growing exponentially, has its own challenges!

So, on the demand side, there are obvious challenges such as the expenses which will lead consumers to continue to look for cheaper alternatives in the informal sector. But what about challenges on the supply side? Managing a work force of caretakers and nurses is not an easy task as attrition rates are as high as 60%. Low entry barriers make it over-crowded but given the lower pay compared to hospitals, especially globally, they are constantly looking for greener pastures.

From the Investment Team.... continued

US companies operate at thin margins, despite economies of scale at multi-billion dollar revenues; would India stand a chance?

If the large matured market of USD 88bn in the US is able to achieve an industry EBITDA margin of only 5.6% (Source: Ibisworld Industry report) then it raises doubts on whether Indian companies could ever be profitable in such a nascent market? Especially, given the price-sensitive nature of the Indian customer. It may not be an apples-to-apples comparison as the U.S. model is quite different (Insurance covers their healthcare cost; agencies get reimbursed from government at a fixed base rates with adjustments etc.) So, can India innovate and outperform despite these challenges? We will have to wait and watch!

Things go well till you've your health in place but one fine day all of us have to experience the dark side of ageing.

Our perspective on this sector

There has been some serious fund raising in this sector in India at high valuations but this euphoria does not get reflected in the financials with player's struggling to scale-up and bleeding cash for various reasons. In my view, the industry needs a serious rethink of the business model including some innovations which will make it work for the Indian scenario. It could be leveraging the franchise model or Working on a catchment area model (one nurse to multiple patient logistics) etc.? Will all that work in India? Perhaps, but we are closely watching this space for further development.

As always we are open to feedback and thoughts.

Interesting read this quarter

RBI's revised framework for resolving stressed assets

The RBI has issued various instructions aimed at the resolution of stressed assets in the economy, including the introduction of certain schemes (e.g. – JLF, SDR) at different points of time. In view of the enactment of the IBC, it has been decided to substitute the existing guidelines with a harmonised and simplified generic framework for the resolution of stressed assets.

The new framework puts down strict timelines over which insolvency proceedings must be initiated. These timelines come into effect starting 1 March 2018.

• For accounts with an exposure of INR 2,000 crore or more, banks will have to ensure that a resolution plan is in place within 180 days after a 'default'

• If the resolution plan is not implemented within 180 days, the account must be referred to the IBC within 15 days.

• For accounts with exposure of INR 100 crore to INR 2,000 crore, a timeline for resolution will be announced over a two-year period.

The streamlining of the NPA resolution process affords simplicity, timeliness and credibility, and is long-term positive for the banking sector. This framework has the potential to bring about a big change in the approach of banks to monitor their exposures and resolution of non-performing assets. The timelines will lead to a speedy recovery of the loan from the borrower.

There will be greater prudence in lending. Cowboy lending, especially towards larger projects where banks lack the capacity to conduct proper appraisals, could be on its way out. Finance teams will read loan covenants more carefully because the tolerance for defaults is being lowered considerably. They will need to ensure loan repayment terms are more realistic. The entire process should involve a high degree of transparency and precision.

While the new rules provide a cleaner framework for stressed asset resolution, there may be some transition pain for banks. Although, this may be positive for the banking sector in the long run, in the short run, banks may come under additional pressure. Banks are likely to become more cautious and risk-averse, particularly on the long-term funding in sectors such as power, steel and infrastructure.

The RBI move has come at the right hour because the asset quality pressures are near their peak and it will improve the ability of banks to transit to the new regime.

Banks (INR in Crs.)	Gross NPA	GNPA %
State Bank Of India	199,141.34	10.35
Bank Of India	64,248.58	16.93
Punjab National Bank	57,519.41	12.11
IDBI Bank Ltd.	50,621.75	24.72
Bank Of Baroda	48,480.44	11.31
ICICI Bank Ltd.	46,038.70	7.82
Union Bank Of India	40,988.35	13.03
Axis Bank Ltd.	25,000.51	5.28

Links:

RBI's revised framework for resolving stressed assets

PE/VC activity in India

PE/VC investments in India during the FY 2017-18 witnessed a sharp increase and is estimated to be over USD 30bn (approx. 60%+ increase from previous year) with six deals of value USD 1bn and above. However, in terms of deal volume, there was a dip to about 1,100 deals this Financial Year as against 1,700 deals in FY17.

PE market kicked off this quarter with an Investment of USD 1.7bn in India's largest mortgage lender HDFC Ltd from PE giants like GIC Singapore, KKR, Canadian pension plan Ontario Municipal Employees Retirement System, Carmignac Group and Premji Invest for a stake of 3.87%. This was followed by Online retail firm Paytm Mall raising USD 450mn from Japan's Softbank Group Corp. and their existing investor Alibaba Group Holding Ltd.

PE/VC investments in India during the FY 2017-18 increased to USD 31.4bn and exits to USD 9.2bn.

The leading sectors in terms of deal value in FY18 were Financial Services with USD 9bn across 100+ deals, Utilities with USD 7bn across 10+ deals, Consumer discretionary with USD 6bn across 180+ deals and Information Technology with USD 6bn across 500+ deals.

India's VC market got off to a great start in Q1CY18, seeing a strong rebound in investment. Food and grocery delivery was the hottest area of investment this quarter, with unicorn company Zomato raising USD 200mn and BigBasket raising USD 300mn — both deals led by Chinese tech giant Alibaba. Swiggy also raised USD 100mn in Q1 of CY18 from Chinese company Meituan-Dianping. The large investments from Chinese giants highlights the perceived value of the food delivery space in India and the heating up of competition.

In terms of exits, PE/VC exits in India during the FY 2017-18 remained muted and is estimated to be around USD 9bn with couple of deals of value USD 1bn and above. In terms of deal volume, there was a sharp dip to approx. 220+ deals as against 300+ deals in the previous year. From an exit perspective, the highlight of this quarter remains the acquisition of Arcinet Inc. a design and engineering services firm by a French engineering, research and development (ER&D) company Altran Technologies SA for a deal value of USD 2bn where in KKR and Sequoia among others investors made an exit from the company.

Global Trends

Takeaways from the Spotify IPO – what does it mean for us?

– by Vinay Subramanian

The leading music streaming business in the U.S., Spotify had its initial public offering (IPO) recently on the NYSE exchange. Spotify is one of those rare European companies that has successfully moved across the pond to take on the might of the behemoth Apple at its own game and built a credible brand in the digital music business. Spotify has 75mn paying subscribers, an active user base of 160mn, a database of 35mn songs and generates revenues of over USD 5bn, operating in over 65 countries. Not bad for a VC backed company that is not Google, Facebook, Apple or Amazon! There is also a small matter of operating losses at USD 300mn a year, but that's a subject of discussion for another day……

Do-It-Yourself (DIY) direct listing strategy adopted by Spotify to register on the bourses.

Global Trends…. continued

Technology companies such as Spotify, Netflix and Dropbox going public is nothing new but what was different this time was the Do-It-Yourself (DIY) direct listing strategy adopted by Spotify to register on the bourses. What that meant was that there were no investment bankers to under-write the IPO, no roadshows to drum up investor interest and certainly no symbolic ringing of the bell by founders. But more importantly, Spotify had to spend lower than usual to fund the IPO since they didn't need to pay those expensive investment banking fees. This also created an active debate in Silicon Valley and elsewhere about the traditional role of Wall Street as market makers and stabilizing agents during the stock pricing process. The listing did see more volatility than usual, got priced at the lower end of the range and didn't have the "pop" typically expected of tech IPOs.

Mr. Vinay Subramanian
Investment Director,
Stakeboat Capital LLP

However, the real changes driven by the direct listing approach was the fact that there was no lock-up period for existing shareholders and no preferential share allocations by underwriters. The outcome was a truly free-market dynamic on both the supply and demand sides. So, anybody could sell their shares, whilst anyone could buy them – a true demonstration of liquidity and democracy, much as god intended! As much as 90%+ of the Spotify's shares were tradeable. But as Spotify's IPO filing states, the risks associated with investing in a loss-making entity can be substantial, bordering almost on the speculative. Still, that has not stopped Spotify from going ahead with this revolutionary route to create more liquidity for their stock, even though they have not raised any primary capital.

But what does this mean for Indian IPOs? Could growing Indian companies that are still turning the page on profitability contemplate such outcomes? Is a DIY listing process even possible with no-lock up periods and true retail investor participation? India generally has much more stringent norms when it comes to IPO registrations and more so when it comes to retail investor participation, even bordering on protectionist tendencies. As per the stipulations of market regulator Securities and Exchange Board of India (SEBI), a typical IPO candidate needs to have a minimum of INR 15 Crores (USD 2.3mn) of Pre-tax operating profit in at least three of the previous five years. For companies that don't have this track record, the retail participation has been reduced to 10% with a bulk of the allocation going to Qualified Institutional Buyers (QIB) and Non-Institutional Investors (NIIs) which can end up limiting the vibrancy of a stock and hence the upside or "pop" achieved by a stock on the opening day. Furthermore, stocks with good pre-IPO buzz end up getting oversubscribed several times over, given the meager retail participation allowed, leaving the majority of retail applicants with empty hands. Even the specialized Small and Medium Enterprises (SME) route to IPO requires a track record of positive cash flows for at least 2 years out of the last three. And when companies do qualify, individual investor participation is allowed but at lot sizes that are larger than for a normal IPO thus limiting the involvement of truly retail investors.

On the flipside, 2017-18 has seen multiple instances of mid-market sub-USD 100mn IPOs (Initial Public Offers) of companies adding vibrancy and excitement to the public stock markets. Stakeboat's investment criteria targets companies with USD 10-20mn revenues that we will help grow to the scale of the aforementioned companies. Could the mid-market IPO then become a viable option for our portfolio in a few years? We will explore that thought in our next opinion piece.