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CSIM

Dear investor,

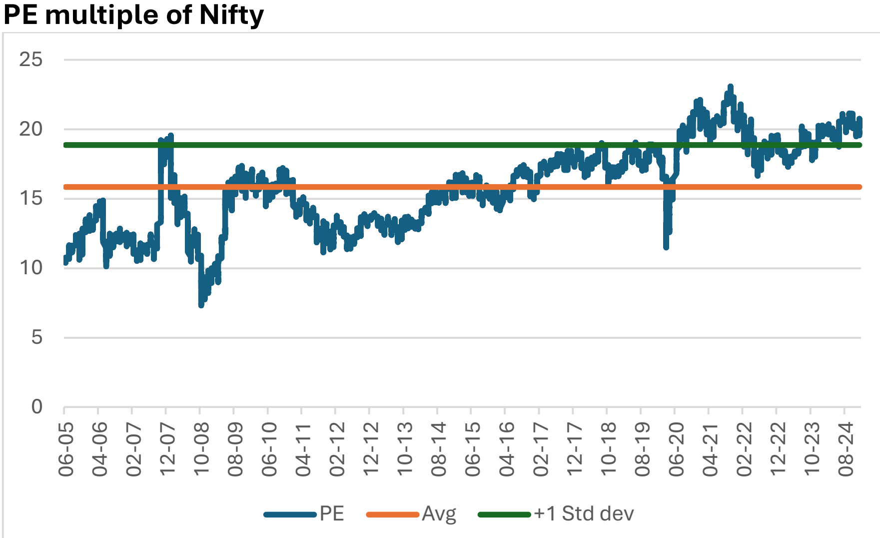
We are delighted to share our third quarterly newsletter. At the outset, we express our immense gratitude for the trust you have reposed in us. Units for CSIM India Opportunities fund – 1 were allotted on May 28, 2024. Being an open-ended fund, we had further inflows in the following months. Our stated intent is to build a concentrated portfolio of our high conviction ideas with an objective to generate healthy absolute returns in the long-term. We don't construct our portfolio with short-term return objective or benchmark ourselves to any index. In line with our mandate, we have a portfolio of 17 stocks as of Dec 31, 2024 with the top 10 stocks accounting for nearly 82% of the AUM (on a post-tax basis) and cash (excluding cash set aside for tax on unrealized profit) at 10.1% (post Dec inflows, cash levels are higher). Our performance from inception (May 28, 2024) to Dec 31, 2024, is as follows:

Class A1	3.1%
Nifty TRI	4.1%
NIFTY 500 TRI	5.3%

Note that the performance is pre-tax but post expenses and fees. We have shown the performance for class A1 – returns for other classes would be marginally higher.

As we had highlighted in our previous newsletter, market multiples remain higher than historic averages. There are still pockets of extreme overvaluation in certain sectors, though headline indices have corrected modestly. We are particularly concerned about the maniacal activity in the pre-IPO market – it is unprecedented in terms of number of retail buyers as well as the value of transactions. While India's long-term story is attractive as ever, near-term returns might be muted due to the high starting valuations. However, this could be a year which throws up opportunities to buy good businesses at reasonable valuations.

PE multiple of Nifty



Source: ICICI Securities

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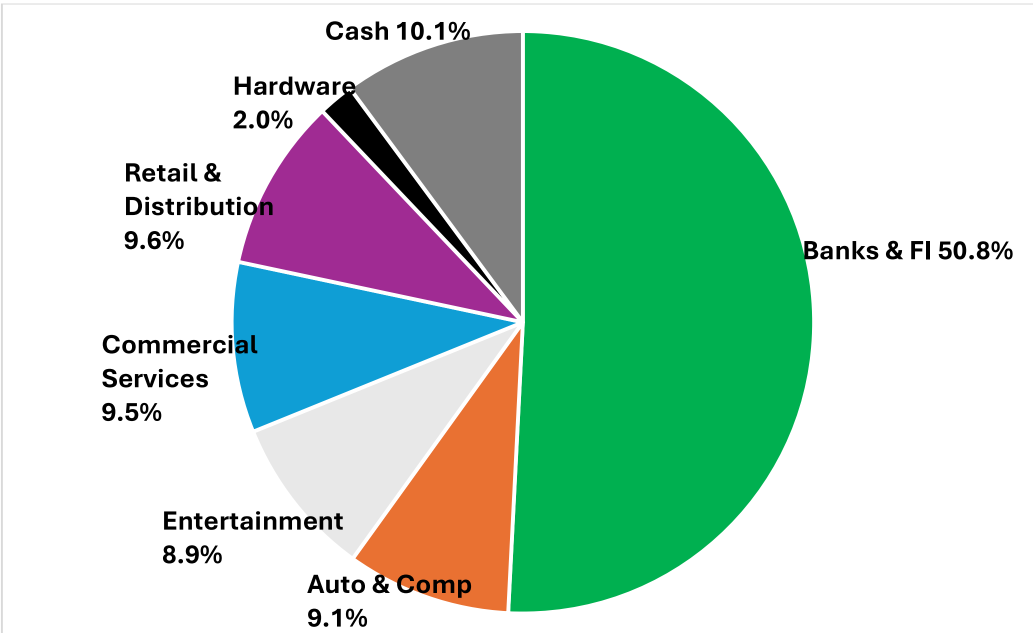
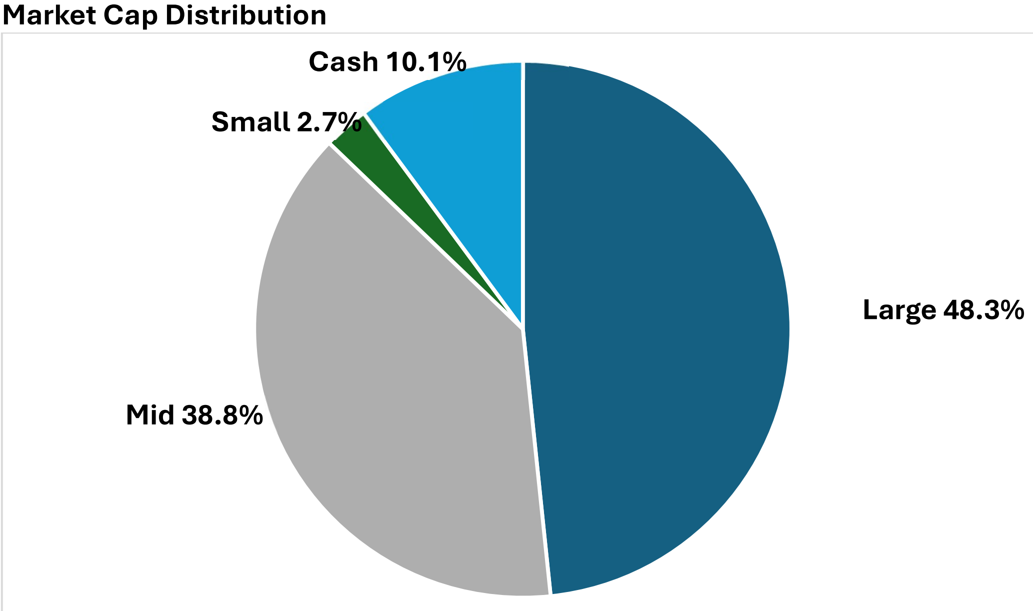
The distribution of our current portfolio across sectors and market cap is as below:

Sectoral allocation



Market Cap Distribution



We discussed private sector banks & music labels in the previous newsletter. In this note, we outline our thoughts on the pharma distribution business.

The annexure at the end of this note contains regulatory disclosures.

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Please feel free to reach out to us at csimindiaaif@csim.co.in for any further clarifications.

With warm regards,

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Consolidation of pharma distribution

The Indian pharmaceutical supply chain is highly fragmented with over 65,000 distributors and 900,000 retail pharmacies addressing a roughly Rs2.5-3T pharma plus consumables market. However, that is changing rapidly, especially with consolidation of the distribution channel, led by 3 national players that have grown rapidly, both organically as well as through acquisitions, over the last few years. These national players account for 8-10% of the market and continue to grow faster than the market even as they keep acquiring small distributors.

<u>Indian pharma value chain</u>

Player in Value Chain	Typical Functions and Role	No. of Players	Typical Margin range
Pharmaceutical and Healthcare Products Manufacturer	• Manufacturing units supplying finished products • Marketer for pharma products	Companies ~3,000 Man. Units 10,500	40 – 60%
C&F Agents	• Storage facilities to dispatched goods • Sales record and tax details to government	~3,000 – 5,000	2 – 4%
Distributors	• Key supply point for a particular area • Distribution to retail and hospital pharmacies • Inventory and order management	~65,000	8 – 15%
Retailers / Hospitals / Physicians	• Last mile connectivity in the pharmaceutical supply chain • Face of supply chain with patients / customers	~900,000	Pharmacy 20–25% Hospitals 35-40%

Source: Entero

<u>Indian pharma distribution is highly fragmented</u>

		US	China	India[1]	Germany
Share of Large Players in the Pharma Distribution		Top 3: 90 – 95%	Top 4: 40 – 45%	Top 3: 8 – 10%	Top 5: 95 – 97%
Share of Top x in Total Pharma Distribution in:		Top 3	Top 4	Top 3	Top 5 / All
	2020	90 – 95%	40 – 45%	8 – 10%	95 – 97%
	Pre-2015	85 – 90%	30 – 35%	<3 – 5%	90 – 95%

Source: Entero

By virtue of their size and pan-India presence, national players have access to a much larger number of pharmacies and hospitals and thus offer better and easier coverage for the manufacturers. This ensures these players do business with larger number of

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manufacturers and therefore offer a wider range of SKUs, which ensures better fill rates for the pharmacy clients. Having a well capitalized and large balance sheet helps the national players access working capital at cheaper rates, a key constraint for sub scale local distributors. The scale also enables the national players to invest in technology to manage inventory as well as collect data that helps achieve much better forecast efficiency (key to optimise fill rates and inventory).

Pharma distribution has a unique data issue unlike other B2C products. The decision maker is usually a doctor, the key influencer usually the pharmacist. The manufacturer has no way of having a look through at the retail data and aggregating data from small local non-exclusive distributors (key difference from FMCG is most distributors in FMCG are exclusive) and pharmacies is impossible. Large national distributors (and retail chain) have much better access to data at local and national level and that will be increasingly valuable to the manufacturers.

Increasing Compliance and regulatory requirements also require better visibility and control on data, which only the large national distributors can provide.

As a result of the all the above, national players will continue to gain share at the expense of small local players. In addition, the national players will likely aggressively buyout small players, which helps both

<u>Difference in key parameters between national and traditional distributors</u>

Parameter	Large/national distributor	Traditional local distributor
Number of retailers reached	60,000-70,000	100-500
Number of pharma companies catered	200-300	30-50
Number of SKUs	40,000-50,000	3,000-5,000
Invetory days	~30 Days	~35-40 Days
Fill rate	90-95%	60-80%
Cold chain facility	Yes, Sophisticated cold chain facility	Limited cold chain facility
Technology use	Advanced ERP,CRM and analystics tools	Basic ERP tools

Source: Entero

Many small distributors have no growth due to several issues cited above. In addition, most have succession problem, being family run. When a national player buys a small distributors, few things change for the acquired co

- Immediate access to cheaper capital and more SKUs, thereby helping increase share within the pharmacies currently being serviced
- Over a period, with more resources, access to more retail pharmacies too, helping gain new business with new clients

- Over medium term, better inventory in warehouses due to better access to data, technology and a natural advantage that large players have in better inventory management

As a result, both size and profitability of the acquired entity improves drastically. This incremental value addition is captured through low acquisition multiples (usually 5-6x EBITDA) with the seller retaining a small stake to capture upsides through milestone based buyouts. We think that most small distributors will not be able to compete in the long term and thus will choose to sell out to one of the large players.

Economics of the business

We think at steady state, the national distributors will be able to generate return ratios much in excess of cost of capital.

Gross margins are a function of (a) mix of business between price controlled drugs (low gross margins), non-price controlled drugs (better gross margins) and consumables/devices (high gross margins), (b) bulk discounts offered by manufacturers to the distributor and (c) discounts offered by the distributor to the pharmacies, which is a play between credit period and gross margin. National players have a natural sourcing advantage when it comes to consumables and devices. Building a private label in consumables and devices is another opportunity, though arguably pharmacy chains have a better chance of building private label business. Scale gives better operating leverage to the national players, defraying technology, rental and management expenses (not much fixed expenses otherwise) over a much larger base of sales. Over all, we believe net profit margins will settle at around 3.5-3.75% at steady state

The primary asset involved in this business is working capital. In the long-term, this where large national distributors can really add value as with better data comes better forecast accuracy and thus lower inventory across the system. Overall, we think large distributors can run the business most efficiently with about 60 days of net working capital (30-35 days inventory, 45 days receivables, 20 days of payables) without compromising on fill rates. Compared to this, small distributors will find it hard to operate at less than 75 days of working capital, funded by more expensive credit. Effectively, this implies an asset turn of 6 times.

Assuming an unlevered balance sheet, large national distributors can generate an RoE of c20% (6x asset turns x 3.5% net margin).

National distributors offer a combination of healthy return ratios and a long runway for growth, making them valuable assets to own.

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Risk Disclosures

1. Concentration Risk: The portfolio is somewhat diversified across sectors and key economic variables, but has some concentration to the Banking/Financial sector.
2. Foreign Investment Risk: The Fund has no investments in foreign entities.
3. Leverage: The Fund has no leverage. Lending businesses of the portfolio have capital above regulatory norms.
4. Realization Risk: All the investments are in listed entities.
5. Strategy Risk: The Fund portfolio is in line with the stated strategy of CSIM India Opportunities Fund -1. Our strategy has remained unchanged since our inception.
6. Reputation Risk: All the investments are in listed entities, our endeavour is to invest in sustainable and reasonably valued businesses.
7. ESG Risk: We adhere to standard ESG practices at Fund level. We believe, the portfolio companies also follow good ESG practices.
8. Fees: The fees ascribed to the Manager/Sponsor by the fund is as mentioned in the PPM.

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