SNOWBALL CAPITAL

Snowball Capital Annual Letter 2079-80

Dear Shareholder,

It has now been two years since the markets have been in a protracted decline, down **41%** from its high of 3200 on August 2021 to 1874 as of 15 October 2023. The market must go up by **71%** from this point to recover the losses of the past 2.5 years. Your fund has largely held its value over the same time frame.

In the last fiscal year, the market remained relatively flat at **4.38%.** Your managers eked out an annual return of **7.52%** for the main fund and **5.21%** for the chairman's fund. Both portfolios were able to beat the market albeit by a small margin. Our primary goal is to generate positive absolute returns that exceed the risk-free rate and the market average comfortably over time. Here is a snapshot of our historical returns vis-à-vis FD rates and Nepse.

	NEPSE	Snowball Flagship Fund	Chairman's Fund	Fixed Deposit
73-74	-9%		3.62%	10%
74-75	-3.32%		-1.85%	10%
75-76	1.40%		13.87%	9.50%
76-77	9.30%	11.16%	2.72%	9%
77-78	111.65%	65.64%	82.62%	8%
78-79	-30.32%	-9.44%	-6.11%	12%
79-80	**4.38%**	**7.52%**	**5.21%**	**11%**
IRR	**5.97%**	**15.71%**	**11.48%**	**9.85%**

A return snapshot at any given point can be misleading depending on which point of the cycle we are at that moment. For you to better judge our performance, a look at the rolling 5-year returns (typically enough time for a market cycle to play out) will prove to be more illuminating and accurate. Here are the three rolling 5-year returns of the Chairman's funds and NEPSE.

5-year Compounded Returns			
	NEPSE	Chairman's Fund	Difference
2073-2078	15.59%	16.80%	1.21%
2074-2079	9.58%	14.50%	4.92%
2075-2080	11.20%	16.11%	4.91%
	Average Difference		3.68%

5-year Absolute Returns			
	NEPSE	Chairman's Fund	Difference
2073-2078	206.35%	217.38%	11.03%
2074-2079	158.00%	196.80%	38.80%
2075-2080	170.03%	211.03%	41.00%
	Average Difference		30.28%

The Snowball Flagship Fund has completed 4 years and the compounded annual return since inception is **15.71%**. The portfolio composition has been sent to you (shareholders), in a separate bi-yearly report. The chairman's fund virtually mirrors the Snowball Flagship Fund and will be discontinued after this year. The returns are mentioned for the purpose of demonstrating your manager's track record.

Economy at Large Vs. How Snowball Capital Thinks and Operates

The economic environment, the market woes, the liquidity crisis, the credit crisis, the fiscal shortfall, tightening monetary policy, rising non-performing loans, newspaper adverts filled with collateral auctions, demand contraction, inflationary pressures, declining consumer, and investor confidence – *it seems like our country cannot catch a break*. We will not add to the list and report what you already know and have read in every other article, newsletter, and annual report.

The question is – What do we do? How do we react and navigate the storms that we are in the midst of? Do we invest? Do we go aggressive – "the time to buy is when there's blood in the streets"? Or do we stay put, wait out the storm, 'wait and watch', and avoid catching falling knives?

The short and the anti-climactic answer is that '*it depends'*. We, at Snowball, always focus on the company first and foremost.

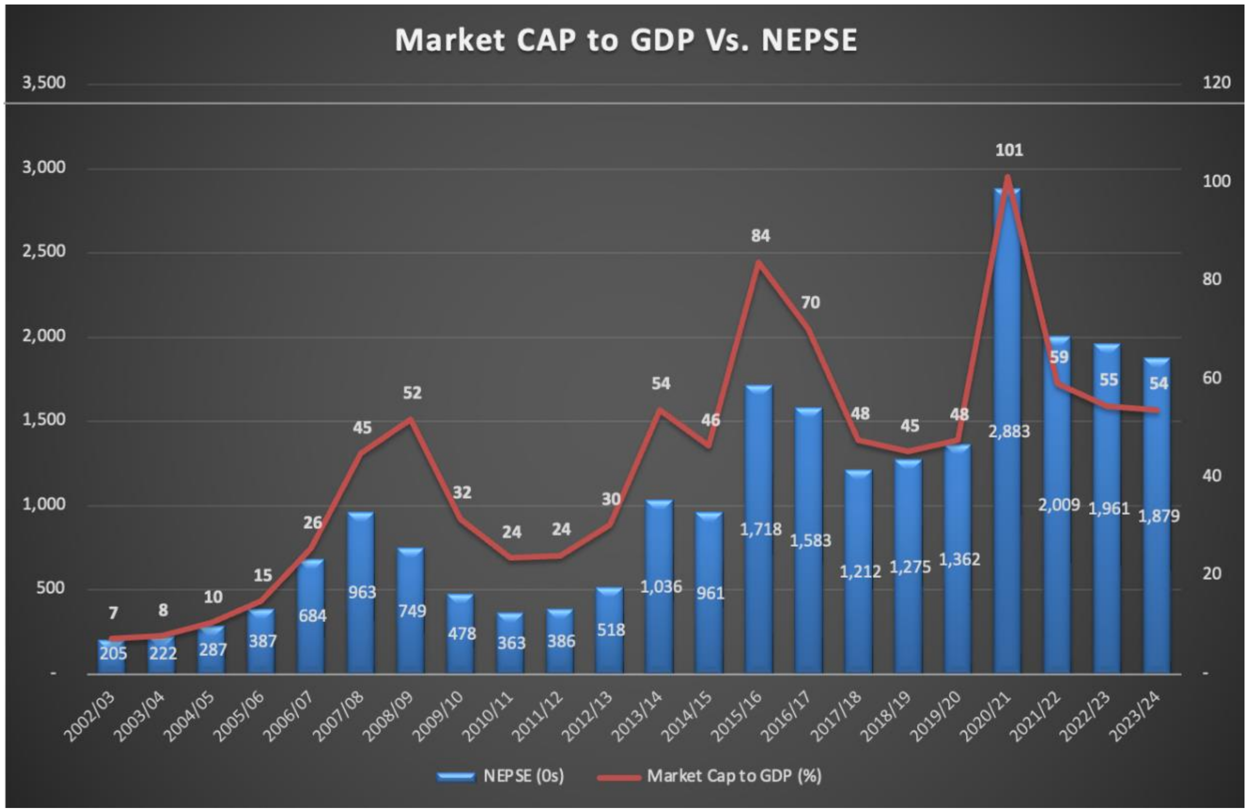
There are a few dependent factors that determine how we pick our investments.

1. Resiliency / Pro Entropic Companies
2. Price Vs. Value
3. Probabilistic Outcomes and Asymmetric Opportunities
4. Consistent Compounders

Even though the immediate economic outlook and the prevailing sentiments seem to be at a historical trough, we maintain the conviction that Nepal will persist on its trajectory toward advancement and growth in the long run. We realize that we are in the extreme minority, but we have never worried about going along with the consensus. Nepal has survived and continued to grow through countless crises in the past few decades (tumultuous political upheavals, a decade-long civil war, the great earthquake, an ensuing blockade, and a once-in-a-lifetime pandemic) and we will continue doing so. It is worth noting that some of the most substantial wealth has been generated during moments of crisis.

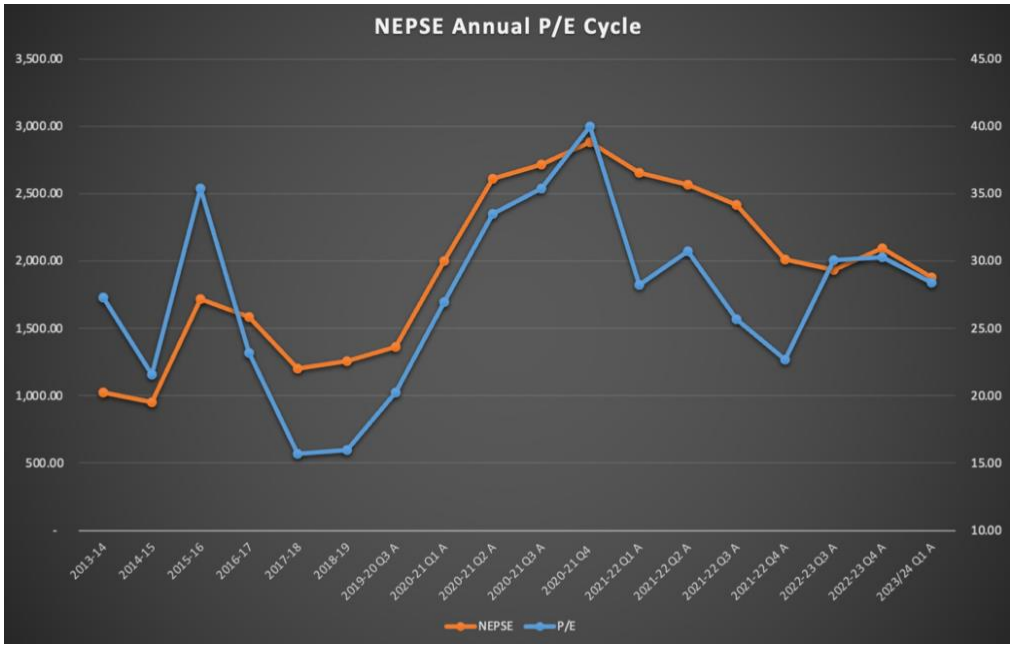
Not to completely discount the economy at large, where we are in the economic cycle (and related credit/interest rate cycle, PE and valuation cycles, etc) does help us in deciding whether to take an aggressive (heavily invested) or a cautious (invested but with caution) stance in our portfolio.

A quick look at some of the key cycles:



The current market capitalization of all the listed companies in NEPSE to GDP is 54%, down from 101% at the end of 2020-21. The historical average over the last 20 years is 42.55% and the averages for the last 10 years and 5 years is 60% and 63% respectively. The average is expected to trend upwards over time as more companies that are representative of the economy at large are listed. In other words, the highs and lows will both trend upwards in the next bull and bear runs.

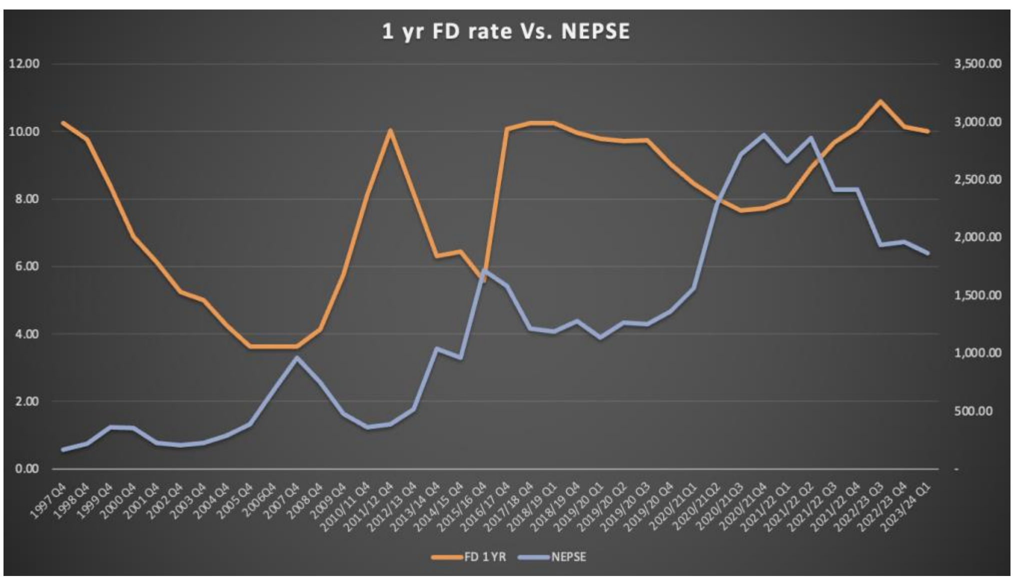
The current valuation levels in relation to the GDP indicate that the market may be undervalued when compared to its historical valuations. It's important to highlight that this observation specially holds true, with 82 out of the 300 currently listed companies having been listed in just the past 2.5 years. *This underscores a stronger probability of future valuation increases rather than declines.*



The PE ratio on the other hand (market PE at close to 28 against a historical average of 25) suggests that the market is still overvalued. There are a few key factors contributing to the high market PE.

- Few sectors highly overvalued moving the overall average (Insurance, Hydro, Investment Companies)
- Meaningfully reduced earnings of certain sectors affecting PE ratios (Microfinance)

While the overall market may be skewed due to certain sectors, we believe there is significant opportunities in certain pockets of the market.



"Interest rates are to asset prices … like gravity is to the apple" – Warren Buffett

The inverse relationship of interest rates and asset prices (specially stocks) is one of the fundamental truths of the market. The 26-year data above demonstrates this to the T. In the case of Fixed Deposit rates (the closest thing to an easily investable risk-free financial instrument), the current average is 10% (historical high was 10.88% two quarters ago) - this is still 25% above the historical average of 8%. Even if there is ample liquidity available in the market, the high interest rates remain an anchor weighing down stock prices.

In our memo during the middle of the bull of 2077-78, the cycles were breaking all-time records with market cap to GDP of over 100% and the PE cycle at the top end and interest rates at 5-year lows. We exercised caution then. **Currently, we are veering towards the aggressive**.

Stepping back from the Macro, we'd like to reiterate – if the company under question presents us with a compelling enough opportunity, that takes foremost priority and supersedes whatever the external environment may be.

What makes a good investment?

A good investment and a good business are not always the same thing, but they often are. A good business at a good price is a phenomenal investment. A bad business at a very low price can still be a good investment and a good business at too high a price can turn out to be a poor investment.

The dependent factors of how we choose the companies we invest in are based on these principles.

1. Resilient / Pro-entropic businesses

Resiliency is the ability of the company/business to survive under all scenarios – difficult economic and geopolitical environments, increased competitive threats, changing consumer preferences, and anything else that the forces of capitalism springs on them. Typically, companies with wide moats (competitive advantages), 'staying power', and able management are resilient.

- Moats (competitive advantages) come in many forms: regulatory protection/licenses, brand value and longevity, patents, unique know-how and technology, exclusive access to resources, cost advantage, economies of scale, scale economies shared, network effect, etc. But they are extremely rare to find and even more rare to sustain over long periods of time.

- 'Staying Power' largely depends on the strength of the balance sheet. A key aspect to watch out is the company's liquidity management, predictability of cash flows, and levels of leverage.

- Capable managers have the skill, determination, and resolve to swiftly adjust and adapt to changing market environments and steer the ship forward or keep it afloat until calmer weather prevails.

Unilever Nepal (UNL), a new addition to our portfolio has 'resiliency' in spades. The nature of its products (mid to low-priced FMCG), the strength of its brands, distribution networks, production capability, balance sheet strength (zero leverage, ample cash cushion, manageable working capital cycle), and world-class management (Hindustan Unilever) were all factors that ensured that UNL not only survived the economic downturn but grew.

Ron Baron, one of the most successful investors of our time, describes 'Pro-entropic' businesses:

"In times of entropy – disorganized chaos – I found many of the best companies did not just survive but thrived. They took advantage of opportunities that tough times presented. They acquired weaker competitors at bargain prices or gained market share as their rivals faltered. They accommodated customers, creating loyalty and goodwill and enhancing lifetime value. While continuing to invest in key areas …, they rooted out extra fat elsewhere in their budgets, creating long-term efficiencies. When conditions normalized, they were better positioned than ever to take advantage of their resiliency."

Such pro-entropic businesses are rare to find, and especially at a price that is attractive. Standard Chartered Bank (SCB) was another such find for us. Overvalued and slow growing for the better part of the last decade, the bank exhibited tremendous growth in business (20%+ annually for 2 years) when the entire industry was facing its most severe crisis of the past 30 years. Furthermore, as the industry's non-performing loans ballooned from 1% to 2.8% (a rise of 180 %), SCB's NPL levels were largely contained under an acceptable ratio, further demonstrating the superior credit standards and quality of the bank. SCB thrived when others faltered. To add icing on the cake, SCB was available at its 10-year low price/valuation.

2. Price Vs. Value

"The secret to successful investing is relatively simple: Figure out the value of something and then pay a lot less" – Joel Greenblatt

Every business is worth something – its intrinsic value, and as the quote stipulates, the first half of the game is figuring out what that value is. This can be simple, but by no means easy. We like to think of the value of the business as the price we would be willing to pay for the entire business if the business never traded publicly again.

The value really boils down to its earning power over time. Besides special situations like liquidation/asset sales or bankruptcy, the value of a company is largely derived from the amount of cash flow it will generate over the years for the owner of the business and the prevailing interest rate/inflation environment. Typically, we demand a higher rate of return if the inflation levels, risk-free return (FD rates), and consequently the cost of capital is higher. Given the highly complex nature of the market and the constantly changing internal dynamics of the company, figuring out the future cash flows is all but impossible, and that's the puzzle we spend the majority of our time trying to figure out.

Once the difficult part is sorted, and we have a value in mind, which is never precise and more of a range, we buy the stock if the price is below this purported value and sell if it is significantly higher. Essentially, we are trying to buy a dollar for 50 cents, the difference being the potential gain and the margin of safety.

<u>The iPhone Example & Margin of Safety</u>

If you were offered the latest iPhone 15 Pro for Rs. 75,000 (which retails at a price of Rs. 2,40,000), you'd gladly buy it, confident in your ability to sell it for a higher price. However, if the same iPhone is offered for Rs. 2,35,000, you might hesitate, wondering if you can still sell it for Rs. 2,40,000. The 2% gain might not be worth the risk. This is how we assess the price we pay compared to the value we expect.

The price-value difference should be significant enough to justify the transaction.

In the first case, even if you can't sell it for the full retail price of Rs. 2,40,000, you could likely find a buyer at Rs. 2,00,000, still yielding a substantial gain of 166%. Even if iPhone demand drops quickly for some reason, you could probably sell it for 50% of the retail price, resulting in a handsome profit of 33%. And if you were mistaken about the retail price, say it was Rs. 2,20,000, you could still sell it for a price well above your purchase price.

While this example is obviously oversimplified to prove a point, the process remains the same – determine the value and pay a lot less for it. To summarize, the margin of safety

- Protects us from any potential negative surprises concerning the company,
- Gives us enough of an upside,
- And protects us in case our analysis/estimate of value is wrong.

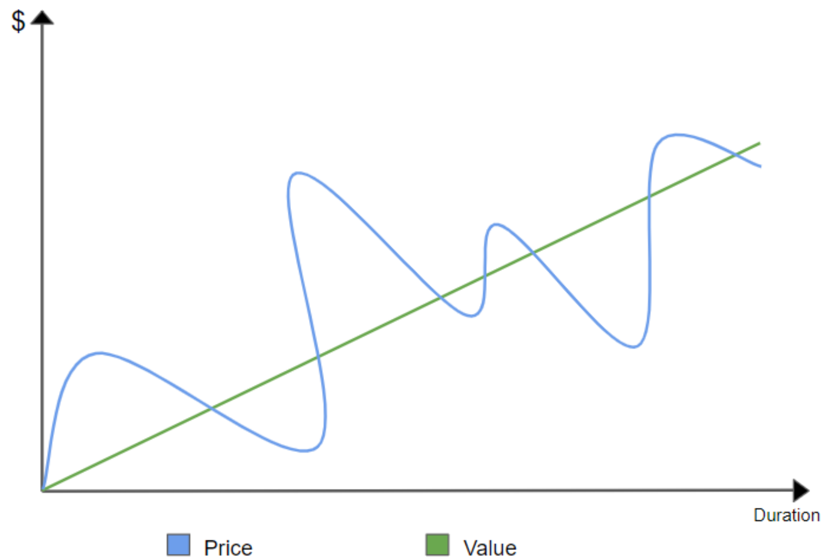
Convergence of price and value

In contrast to the prevailing academic perspective of the Efficient Market Hypothesis (EMH), which associates risk with price volatility, we strongly assert that risk diminishes in direct proportion to the deviation of price from its intrinsic value when prices decrease. Consequently, as price moves further away from its true value, though volatility may rise, risk decreases proportionally.

"In the short run, the market is a voting machine. But, in the long run, it is a weighing machine."

- *Benjamin Graham*

The oscillation of the price around the value is represented in the graph below.



Excess returns are realized when the difference between the price and value converges. Sometimes, this can take an excruciatingly long time and the value may erode before the convergence occurs, particularly when there is no catalyst. Since we are not in a position to be the catalyst ourselves, we look for companies whose values are increasing over time or if there is an immediate catalyst. This gives us an opportunity to capture the upside from two scenarios:

- The convergence of the value and price occurring through price/multiple expansion
- From the increasing value of the underlying business over time

3. Asymmetrical Probabilities (limited downside and large upside):

"At its heart, investing consists of bearing uncertainty in the pursuit of attractive returns."

"If riskier investments could be counted on to produce higher returns, they wouldn't be riskier."

– Howard Marks

Investing is a game of predicting future outcomes which is unknowable and uncertain. While we do not engage in the futile sport of predicting the future, we do look at the possible distribution of outcomes and the likelihood/probability of each of those. We look for opportunities where the likelihood of a negative outcome is slim and that of a positive one is high. In other words, we seek asymmetric opportunities where the downside is limited and digestible and the upside is attractive. We echo Marks - **higher risk does not equate to higher returns**. Higher returns are generated by controlling and mitigating one's risks.

Some of the strategies that offer such risk/return profiles are arbitrages, auctions, share structures (promoter/public), and reversion to the mean, among others.

Arbitrage

Arbitrage entails a trade where there is no chance of loss. Nepse, from time to time, does offer such opportunities where the probability of loss is 'near zero'. Arbitrage investing is largely a negative art and akin to 'credit investing'. We make sure the downside is protected and the upside will take care of itself. The key difference between investing in credit (loans) vs. investing in arbitrage trades is that the upside is not pre-determined or limited and offers rates of return far exceeding our cost of capital.

Primarily, these opportunities come up in close-end mutual funds whose maturity is approaching, tradeable promoter shares, mergers/acquisitions, and debentures. NMBHF1, NEF, and NIBLPF are the stocks in our portfolio under this strategy. In these 3 stocks, our return will remain positive even if the overall market declines by 25% (to 1420) within a period of ~6 months, which is highly unlikely. If the market stays the same (at around 1900), the average returns from these investments are 20% annualized and increases to 35% if the market goes up by 10% (to 2100). Based on various probabilities of where the market could go in the coming few months to a year, the expected returns on these opportunities are around 18%.

ASYMMETRIC RISK/RETURN: Downside: close to 0%, **Upside**: 35%, **Expected return**: 18%

18% returns with virtually no risk are the kinds of investments we would be happy making all day.

Auctions

Sizeable auctions sometimes offer interesting opportunities. Typically, shares are available at a discount of 10% to 20% of the publicly traded price and allotted within a month. We apply for auctions only if we believe that the stock will yield a positive return even if the price goes below the auctioned price within the month of allotment. The upside then becomes anywhere from 1% to 20% (12% to 240% annualized) within 1 month if the price of the stock does not move much and if it does come down, fundamentally, the company will still yield positive results. While this strategy does entail a certain amount of risk, the downside is protected, and the upside is 240% - a very asymmetric opportunity.

ASYMMETRIC RISK/RETURN: Downside: 1%+ **Upside**: 240%, **Expected return**: somewhere in between.

Reversion to the Mean

Over time, most things (but not everything) revert to their historical mean. This potential reversion is oftentimes ignored by the market. In the context of the companies we invest in, these can be reversion to the historical valuation multiples (PE, PB, etc.), to historical profit margins, to historical NPL and provisioning levels, etc. The intention behind this investment is not primarily contingent on anticipating a reversion, but rather focuses on achieving a respectable return at the current levels, while also potentially benefiting from a significant boost in the event of a reversion.

In an imperfect and complex system like the stock market, the best we can do is to determine a sense of the distribution and the likelihood of each outcome and invest when the odds are favorable. Losses cannot be avoided but as long as our batting average is positive and the size of gains exceeds that of losses, your portfolio will be okay.

4. Consistent Compounders

The final major framework that determines if a stock deserves entry in the portfolio are businesses/companies that have the ability to 'compound' for a long time. Companies in this category are of very high quality, usually with structural advantages/moats, and with a long growth runway ahead.

"Compound interest is the eighth wonder of the world. He who understands it, earns it... he who doesn't, pays it." - Albert Einstein

The table below illustrates the returns of Rs. 1 lakh invested with varying compounding rates.

	Compounding Rate			
Years Invested	**8%**	**10%**	**15%**	**20%**
5	146,932.81	161,051.00	201,135.72	248,832.00
Difference Vs Inflation Rate		*9.61%*	*36.89%*	*69.35%*
10	215,892.50	259,374.25	404,555.77	619,173.64
Difference Vs Inflation Rate		*0.20*	*87.39%*	*186.80%*
20	466,095.71	672,749.99	1,636,653.74	3,833,759.99
Difference Vs Inflation Rate		*44.34%*	*251.14%*	*722.53%*
40	2,172,452.15	4,525,925.56	26,786,354.62	146,977,156.80
Difference Vs Inflation Rate		*108.33%*	*1133.00%*	*6665.50%*
Years It Takes to Double	9	7.2	4.8	3.6

Figure: Rs1,00,000 Invested over various time periods and earning different rates of returns

The effect of compounding is exponential and not linear. Human beings are wired to think linearly and understanding compounding forces us to make the leap to thinking about exponential outcomes. Our goal is to consistently compound over 15%, given that our historical inflation rates hover around 7-8% and the risk-free rate around 10-11%.

A cursory look at the difference between a Fixed Deposit return and a compounded return of 20% is even more illustrative of the power of compounding.

An investment of Rs. 1 lakh, when held for 20 years at a Fixed Deposit rate of 10%, will accumulate to **Rs. 6.72 lakhs**. However, when invested at a compounding rate of 20%, the same initial investment of 1 lakh will burgeon to an impressive **Rs. 38.33 lakhs**, representing a remarkable sixfold difference.

Over a more extended period of 40 years, this disparity becomes even more pronounced, reaching a substantial **3200%**. With a compounding rate of 20%, the initial 1 lakh investment will flourish into a staggering **Rs. 14.70 crores**, while the same amount in a Fixed Deposit account will only grow to **Rs. 45.25 lakhs**.

For compounding to take its due course, time is paramount. As we can see, the effects of compounding in a short duration (5 years) is much lesser than for larger time period (40 years).

This poses some fundamental questions – can the company survive and thrive for a long time horizon? Is the industry facing tailwinds or headwinds? Is the market opportunity (runway) big enough for there to be consistent growth at above-average ROEs (compounding rate)? If the market is not big enough, is the board/managers of the company adept at allocating capital at high ROEs on a consistent basis?

The answer to these questions determines the attractiveness of the investment opportunity.

Capital Allocation

Companies in this category of 'Consistent Compounders' should be able to generate a high return on equity for each incremental investment. The corollary of this is that it necessitates continuous investment opportunities for growth. If growth is not available in the sector (for example, the current cement market in Nepal), then the company must have a demonstrated track record of successful capital allocation in the form of other investments or have the discipline to return the capital to the shareholders vis a vis cash dividends. Unfortunately, the majority of the companies don't even consider these factors when deciding how to allocate profits.

Investor Temperament

The other side of the equation is the temperament of the investor. Can one stomach all the highs and lows that take place over a decade or two? Undoubtedly, the trajectory (both price and value) will not be a smooth upward graph but more of wild oscillations around a long term trend. The ability to stay steadfast and have the conviction to 'hold' and do nothing as long as the thesis holds true is not easy.

"The stock market is a device for transferring money from the impatient to the patient." - Warren Buffett

We at Snowball strive for equanimity, the courage and patience to hold on to our convictions, and the ability to change our opinion when the facts change. Investing successfully is simple, but not easy.

Conclusion

There are two ways of looking at what transpired in the past two years. It has certainly been tough with no signs of the bear market letting up. However, it is markets like these that set up the stage for above average returns in the coming years. Without such corrections, there would be no opportunity, there would be no such proverbial fishes in the sea. We have now unfurled our sails, heading towards the abundant waters where fish are plentiful.

It is an absolute honor and a privilege to work for you and we consider ourselves extremely fortunate to be able to manage, protect, and compound your capital along with ours.

Sincerely,

Prashant Dangol, Analyst
Girish Lakhe, Managing Director
Yurop Man Shrestha, Chairman