October 6, 2023

Dear Partners in AAFI,

Our second quarter seemed to go by even faster than the first. We are extremely grateful for the way this quarter panned out, as it honestly turned out to be way better than what we could have ever imagined. The fund has delivered a 28% return during the quarter (27.5% net of fees and all expenses) beating the Nifty by 25.7% & 25.2% respectively, despite the fund having an average cash balance during the quarter of 22% (end of quarter cash is at 20.3%).

Returns during the quarter continued to be broad based, with 17 of the 20 positions (we say positions & not stocks as we own one warrant) in the portfolio individually beating the Nifty. We fully sold out of 2 stocks and trimmed one stock during the quarter. All three stocks significantly outperformed the Nifty as well.

Year to date the fund has delivered a 48.2% return (47.1% net of fees and all expenses) beating the Nifty by 35.3% & 34.2% respectively. Average cash balance for the first six months was 39.4%. Year to date 18 out of the 20 positions in the portfolio individually beat the Nifty.

Q2FY24 - Class A	**Returns**	**Excess Returns**
AAFI - Gross returns	27.97%	25.67%
AAFI - Returns net of fees & expenses	27.51%	25.22%
Nifty	2.29%	
H1FY24 - Class A	**Returns**	**Excess Returns**
AAFI - Gross returns	48.15%	35.25%
AAFI - Returns net of fees & expenses	47.12%	34.21%
Nifty	12.90%	

While we couldn't have asked for a better start, we truly believe that two quarters is too short a period to judge us by, and that the outcome of such a short period is luck and not skill. We humbly request you to judge us on at the minimum 1 year's investment returns, but ideally 3 years investment returns, since we invest with a ~3 year horizon.

During the quarter we made 8 new investments (including the two pipeline investments we spoke about in our previous letter) and added to several existing positions. For the IPO we subscribed to, unfortunately demand was way higher than we anticipated (QIB part was 99x oversubscribed) so our allocation was extremely small (less than 30 bps weight in the portfolio). On listing the stock opened up over 50% and we were not buyers at that price. The position was too small (given the concentrated approach) to leave as is and we were not looking to add at the listing price and hence we decided to sell the stock on listing day itself.

The other stock we sold out of, was one we bought in June 2023. In fact, the stock was rallying hard while we were buying it and we could not build a full position. Beyond a certain price we backed off and were hoping to build our full position as and when the stock cooled off. Unfortunately, the stock kept rallying, and by August the stock more than doubled from our entry price. Incremental returns were not as attractive and hence we decided to sell out of the stock.

With regards to the stock we trimmed, it is a company we really like from a long-term perspective. However, the stock was up more than 3x in 3 months and incremental returns were not as attractive. More importantly, the position size became too big for our comfort and over a few weeks we sold over 70% of our position into strength in the name.

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We had 110 management interactions during the quarter and conducted 7 plant visits & field trips. This is over and above dozens of earnings calls each of the six investment team members attended during results season and ad hoc calls hosted by companies.

As promised, we are sharing below the portfolio as if it were a single stock.

Portfolio ex-Financial companies

Growth *(% YoY)*	FY21	FY22	FY23	FY24E	FY25E	FY26E	CAGR (FY23-26)
Sales		*17.9%*	*14.5%*	*12.4%*	*14.8%*	*15.7%*	*14.3%*
EBITDA		*11.9%*	*2.8%*	*18.4%*	*25.3%*	*20.1%*	*21.2%*
PAT		*50.0%*	*6.9%*	*24.4%*	*40.0%*	*30.6%*	*31.5%*
Margins							
EBITDA		*14.4%*	*12.9%*	*13.6%*	*14.9%*	*15.5%*	
PAT		*5.9%*	*5.5%*	*6.1%*	*7.4%*	*8.3%*	
Leverage ratios							
Leverage (Net Debt to EBITDA)	*1.9*	*1.6*	*1.5*	*1.2*	*0.8*	*0.5*	
Leverage (Net Debt to Equity)	*1.1*	*0.9*	*0.7*	*0.6*	*0.4*	*0.3*	
Return ratios							
RoE	*-7.7%*	*31.5%*	*21.5%*	*21.0%*	*23.6%*	*25.2%*	
RoCE	*10.6%*	*12.2%*	*12.4%*	*14.6%*	*17.2%*	*19.7%*	
Valuation Ratios (x)							
PE (i)	15.7	29.9	39.5	26.9	18.6	13.0	
PEG		0.6	5.7	1.1	0.5	0.4	
PB	24.2	5.9	5.7	4.7	3.8	3.1	
EV/EBITDA	11.5	11.6	13.8	11.2	10.1	7.8	
P/Sales	2.6	2.2	2.2	1.8	1.5	1.2	
FCF Yield (%)(ii)	2.6	3.2	4.0	1.5	4.4	6.3	
Dividend Yield (%)(ii)	0.4	1.3	0.7	1.4	1.6	2.0	

Notes: (i) we have excluded one company's P/E for FY21, FY22 and FY23 as the company has gone from losses, to break even to small profits in these three years which skews the data; (ii) we have excluded a fintech company for the purpose of calculating FCF since the business has a lending arm and for lending businesses FCF is meaningless.

Financial companies

Fundamentals	**FY21**	**FY22**	**FY23E**	**FY24E**	**FY25E**	**FY26E**
AUM Growth	29%	46%	37%	31%	32%	30%
NII Growth	38%	26%	68%	37%	33%	31%
PPOP Growth	10%	42%	42%	28%	29%	28%
PAT Growth	-37%	-50%	1680%	32%	38%	32%
NIM	12%	11%	14%	14%	14%	14%
PPOP	6%	6%	9%	9%	9%	9%
Credit cost (on avg AUM)	5%	6%	2%	3%	3%	3%
ROA	1%	0%	5%	5%	5%	5%
ROE	4%	2%	21%	20%	22%	23%
Valuations	**FY21**	**FY22**	**FY23E**	**FY24E**	**FY25E**	**FY26E**
PE	-	-	15.5	11.7	8.5	6.4
PEG	-	-	0.9	36.2	22.1	20.2
PB	-	-	2.6	2.1	1.7	1.3
Dividend Yield	-	-	-	-	-	-

Notes: (i) This company IPOed less than a year ago and hence we do not have historic valuations.

If we analyse the tables above, it indicates that we own high growth companies, with high return ratios and safe balance sheets (ie comfortable net debt to EBITDA ratios) that faced margin headwinds in FY23 – which we believe will normalise in FY24 and improve further in the years beyond, driving strong EBITDA growth. Further, the portfolio will witness balance sheet deleveraging leading to earnings growth being even stronger than EBITDA growth.

For the growth rates and more importantly quality of growth (ie growth coming without taking balance sheet risk, or diluting return ratios and also generating strong FCF at the same time) we believe the portfolio's valuation is extremely attractive. If this was a listed company, this would definitely be a top holding for us!

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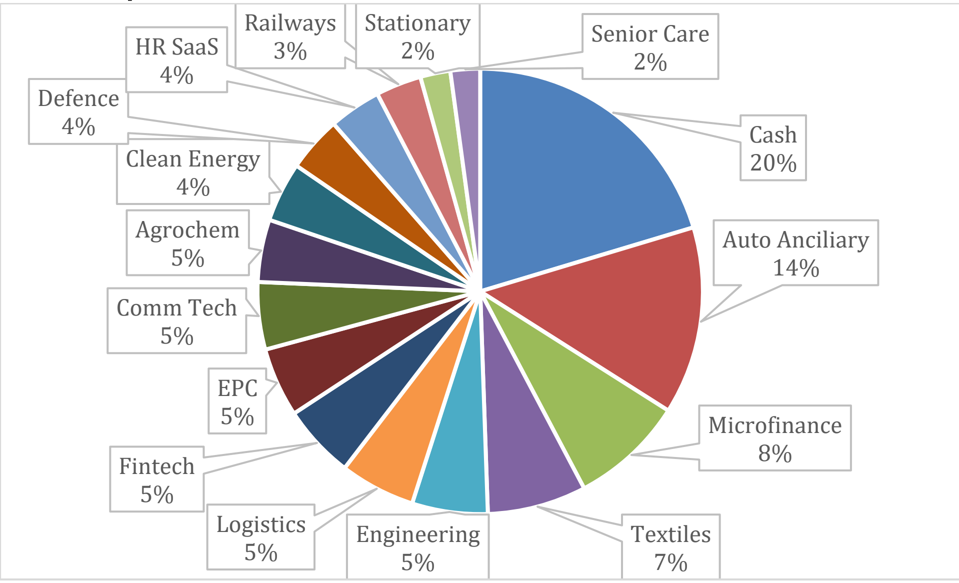
To give you more flavour of the portfolio, and to demonstrate how well diversified the portfolio is, we are sharing below a pie chart that shows our sector exposures.

Sector exposure of AAIM



Based on your feedback from last quarter, we have decided to share a brief memo on one of our investee companies every quarter. This quarter we are sharing our thoughts on Fusion Microfinance.

Do keep sharing your feedback and comments and we will try and incorporating as much as possible in our future letters.

We thank you for trusting us as stewards of your capital and assure you that we are working tirelessly to find the best investment opportunities for the long run.

PS: Our website has finally gone live few days ago and we would love to hear your feedback

Yours Sincerely

Kuleen Tanna
Founder & CIO

Annexure I

Fusion Microfinance Ltd (CMP: 595; Market Cap: Rs60 bn; ADT: Rs154 mn)

Strong drivers for growth: Fusion has been the fastest growing NBFC-MFI with an AUM CAGR of ~43% over FY18-23. Bulk of this growth (28% CAGR) has been driven by new customer additions versus increase in average outstanding per borrower at merely 12%, which is a very healthy growth mix and the best in the industry. Over the last few years, Fusion has continuously invested in people and distribution by tripling its branch count and focussed on remaining geographically diversified.

In a bid to create a level playing field for the industry, the RBI revised MFI regulations (LINK). One of the key changes was the removal of the spread cap for NBFC-MFI's which gave them the ability to price risk better. The regulator also mandated household income assessment and capped overall MFI loans as a % of income which creates guardrails against over-leveraging. Given these positive changes, the industry is poised for sustainable growth. We believe that Fusion will continue to deliver industry leading growth driven by 1. Strong presence in relatively under-penetrated states like UP and Odisha, 2. Increase in average ticket size which is still lower than peers and 3. Entry into new geographies like AP and Telangana.

Improving asset quality metrics: MFI is a high touch business model and collections are at its core. With the physical restrictions and moratorium in the early part of COVID, the industry took a hit with total portfolio at risk (PAR) going as high as ~25% post the second wave. Since then, the industry has continued to see a steady decline in PAR numbers and collection efficiency has moved up. Fusion was no different as collection efficiency stood at 97.3% in 1QFY24 (excluding prepayment) versus 87.8% YoY and same day dues collected in the range of 94-95% and expected to move upwards.

Fusion's well diversified portfolio (geographically), credit assessment guardrails and effective risk management policies resulted in asset quality outcomes better than industry peers during COVID. This was visible as Fusion saw the lowest average write-offs over FY20-23 versus other large comparable peers.

Diversified liability profile coupled with pricing power to aid margins: Fusion has witnessed a steady moderation in its cost of funds given its well diversified borrowing profile and balanced ALM. Despite being in a rising interest rate environment, Fusion has seen a steady decline in marginal cost of funds. With each rating upgrade, the company consciously kept moving away from pricy NBFC borrowings to private, public, and foreign banks.

Under erstwhile regulations, the Reserve Bank of India had imposed a spread cap of 10% on NBFC-MFI's. This not only restricted MFIs from pricing risk correctly, but also allowed banks to generate significantly higher profits from the same customers given their cost of funds advantage. All this changed as the RBI removed this spread cap. We have seen a consistent improvement in yields given the pricing power available in this segment. With improving yields, further fall in funding costs, and benefits of rating upgrade cycle coming through, we believe margins for Fusion could continue to inch up in the medium term.

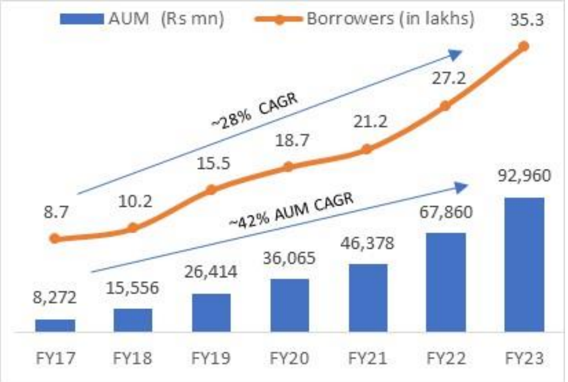
Operating leverage should keep costs under control: Unlike most lenders, Fusion continued to expand its branch network through COVID – branch network tripled over FY18-23. While this has led to robust customer acquisition, branches with lower vintage continue to be under-utilized. While a scaled branch typically services 5-6K customers, almost 50% of Fusion's branches have less than 3.5K customers and contribute only ~28% to the overall AUM. Fusion should see two-fold benefits on operating leverage as the under-utilized branches focus on new customer acquisition and older branches scale up ticket sizes to higher vintage customers.

Compelling Valuations: Despite industry tailwinds and stock specific differentiators, Fusion trades at discount to comparable peers. We believe the stock should re-rate as the company delivers on key metrics hereon.

PEER COMPARISON

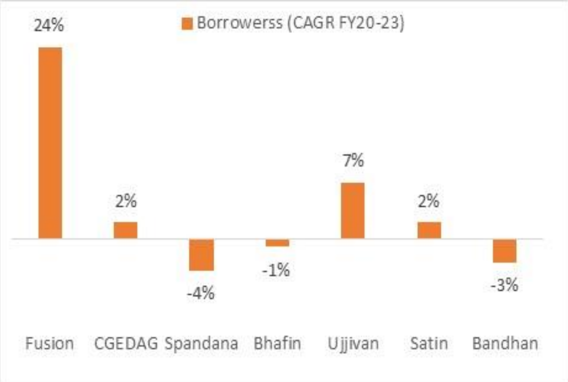
Particulars	CMP	Market Cap (Rs bn)	PER (x)			P/BV (x)			ROA (%)			ROE (%)		
			FY24E	FY25E	FY26E	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E
Pure Play MFIs														
Fusion	587	59	11.5	8.3	6.3	2.1	1.7	1.3	4.7	4.9	5.0	19.9	22.2	23.3
CREDAG	1,301	207	16.2	13.2	11.0	3.3	2.6	2.2	5.1	5.0	5.0	22.3	21.6	21.1
Spandana	797	57	NA	8.5	6.5	1.8	1.6	1.4	-0.1	3.9	4.4	-0.3	11.4	15.9
Arman	2,341	20	19.2	13.3	10.6	3.8	2.6	2.2	5.1	5.3	5.2	19.2	20.0	20.7
Other Comparables														
Equitas SFB	92	103	13.0	10.0	7.7	2.3	2.0	1.7	2.0	2.0	2.1	14.2	16.6	17.7
Ujjivan SFB	59	115	9.7	8.8	7.5	2.3	1.9	1.5	3.2	2.9	2.5	25.7	23.0	21.3
Suryoday SFB	165	17	7.0	6.1	5.3	1.1	1.0	0.9	0.7	1.9	2.1	4.0	10.6	13.9

Robust AUM CAGR driven by borrower addition



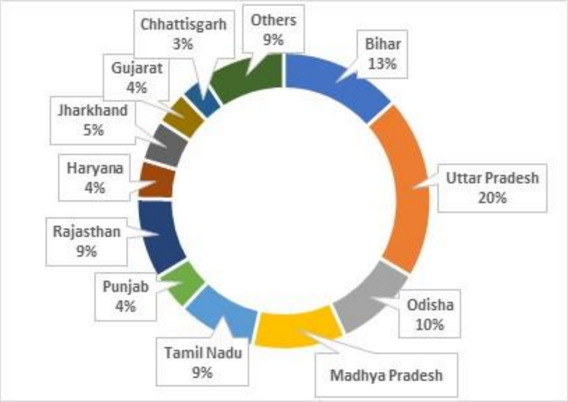
Source: Company data

With Fusion significantly outpacing the industry



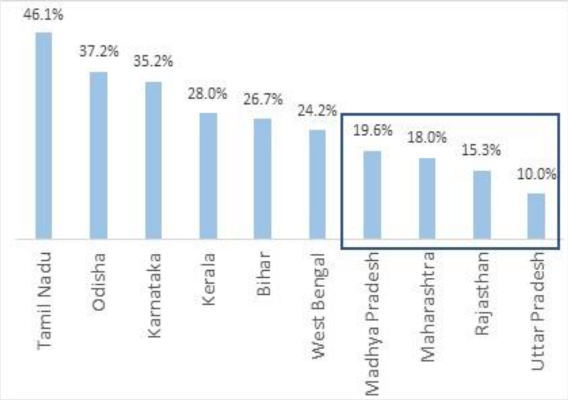
Source: Company data

Well distributed presence



Source: CRIF, Company data

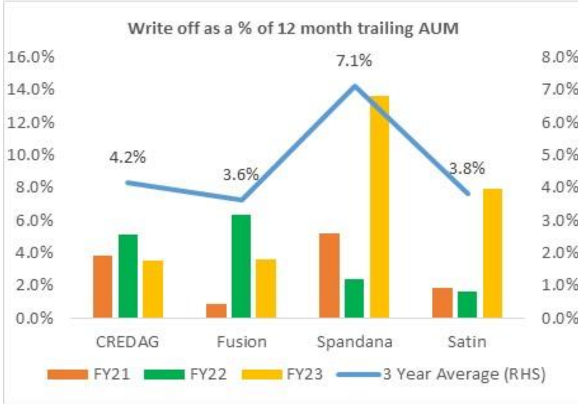
Massive under-penetration in key states



Source: CRIF, Aionios Alpha

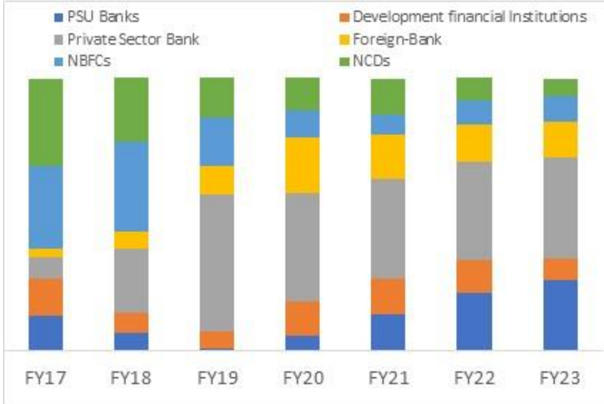
Note: Borrower data is based on 3QFY23

Lowest average write-offs vs peers



Source: Company data, Aionios Alpha

Well diversified borrowing mix



Source: Company data

Our field visit.

As a part of our constant effort to delve deeper into our investee companies, we spent a day in the outskirts of Bhubaneswar doing some branch visits, and engaged with customers, field officers, zonal head as well as the state head for Fusion. Our visit helped us understand a few things better as outlined below:

- The ground level work that is done to shortlist locations for new branch openings.
- The process of group formation, group recognition tests and continuous group trainings undertaken
- While the company is trying to adopt digital collections through UPI but feet on street remains very important.
- There is a clear focus on keeping costs under control.

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