July 9, 2024

Dear Partners in AAFI,

We finished the first quarter of year 2 on a good note with the fund up 25.9% during the quarter (up 25.3% net of fees and all expenses). We outperformed the Nifty during the quarter by 18.3% & 17.8% respectively.

17 of the 22 positions we held at the end of the quarter outperformed the Nifty. We sold out of 1 company during the quarter. The company we sold significantly outperformed the market. In fact, we sold it because the stock went up too quickly in too short a time for our comfort; the stock went up 65% from where we bought it in just 2 months, without any change in fundamental outlook.

The fund had an average cash balance during the quarter of 4.5% (end of quarter cash was 2.6%).

Inception to date 14 out of the 22 positions in the portfolio beat the Nifty.

Q1FY25 - Class A	**Returns**	**Excess Returns**
AAFI - Gross returns	25.86%	18.32%
AAFI - Returns net of fees & expenses	25.30%	17.77%
Nifty	7.54%	
FY24 - Class A	**Returns**	**Excess Returns**
AAFI - Gross returns	49.01%	20.66%
AAFI - Returns net of fees & expenses *	39.48%	11.14%
Nifty	28.34%	

** Please note that for the full year return net of fees & expenses we have factored in the impact of performance fees as well*

During the quarter we made 1 new investment and added to 4 existing investments.

We had 59 management interactions during the quarter. 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.

Please find below the portfolio as if it were a single stock.

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Portfolio ex-Financial companies

Growth *(% YoY)*	FY22	FY23	FY24E	FY25E	FY26E	FY27E	CAGR (FY24-27)
Sales	*37.0%*	*11.1%*	*2.3%*	*15.3%*	*13.5%*	*11.7%*	*13.5%*
EBITDA	*26.9%*	*10.0%*	*5.9%*	*25.0%*	*19.5%*	*17.3%*	*20.6%*
PAT	*192.3%*	*38.9%*	*-2.2%*	*36.5%*	*33.4%*	*27.5%*	*32.4%*
Margins							
EBITDA	*12.8%*	*12.7%*	*13.1%*	*14.3%*	*15.0%*	*15.8%*	
PAT	*4.6%*	*5.8%*	*5.5%*	*6.5%*	*7.7%*	*8.8%*	
Leverage ratios							
Leverage (Net Debt to EBITDA)	*1.5*	*1.1*	*1.3*	*0.8*	*0.3*	*-0.1*	
Leverage (Net Debt to Equity)	*0.6*	*0.5*	*0.5*	*0.3*	*0.1*	*-0.1*	
Return ratios							
RoE	*19.7%*	*18.7%*	*16.5%*	*19.6%*	*21.5%*	*22.3%*	
RoCE	*11.5%*	*13.5%*	*12.4%*	*15.3%*	*17.3%*	*18.9%*	
Valuation Ratios (x)							
PE (i)	17.6	31.8	28.4	24.0	17.5	14.7	
PEG	0.1	0.8	-13.2	0.7	0.5	0.5	
PB	5.3	5.4	5.4	4.5	3.6	3.0	
EV/EBITDA	8.4	13.1	12.9	11.5	10.5	8.4	
P/Sales	3.9	3.3	3.5	2.7	2.0	1.6	
FCF Yield (%)(ii)	1.8	4.1	0.7	1.9	3.8	5.3	
Dividend Yield (%)(ii)	2.5	0.7	1.0	1.1	1.2	1.3	

Notes: (i) we have excluded three company's P/E for FY22 to FY24 as these companies have gone from losses, to break even to small profits in these four 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.

If we analyse the table above, it indicates that we own steady growth companies, with high return ratios and safe balance sheets (ie comfortable net debt to EBITDA ratios) that faced margin headwinds in FY23 / FY24 which we believe will normalise in FY25 and improve further in the years beyond, driving strong EBITDA growth. Further, the portfolio will witness balance sheet deleveraging leading to earnings growth which is even stronger than EBITDA growth.

Financial companies

Fundamentals	FY22	FY23	FY24E	FY25E	FY26E	FY27E	CAGR (FY24-27)
AUM Growth	14%	20%	14%	15%	17%	17%	17%
NII Growth	14%	30%	17%	15%	17%	16%	16%
PPOP Growth	6%	-25%	86%	13%	22%	21%	19%
PAT Growth	97%	71%	14%	7%	19%	22%	16%
NIM	7.3%	8.4%	8.5%	8.5%	8.3%	8.3%	
PPOP	4.0%	4.6%	5.5%	5.5%	5.5%	5.5%	
Gross NPA	3.8%	2.5%	1.9%	2.1%	2.2%	2.3%	
Credit cost (on avg AUM)	2.7%	1.1%	1.5%	1.4%	1.3%	1.3%	
ROA	1.0%	3.0%	3.0%	3.0%	3.1%	3.1%	
ROE	8.0%	18.5%	17.6%	16.9%	17.3%	17.9%	
Valuations							
PE			13.8	12.0	9.8	7.9	
PEG			0.7	1.2	0.5	0.3	
PB			2.1	1.7	1.5	1.2	
Dividend Yield			0.1	0.1	0.2	0.2	

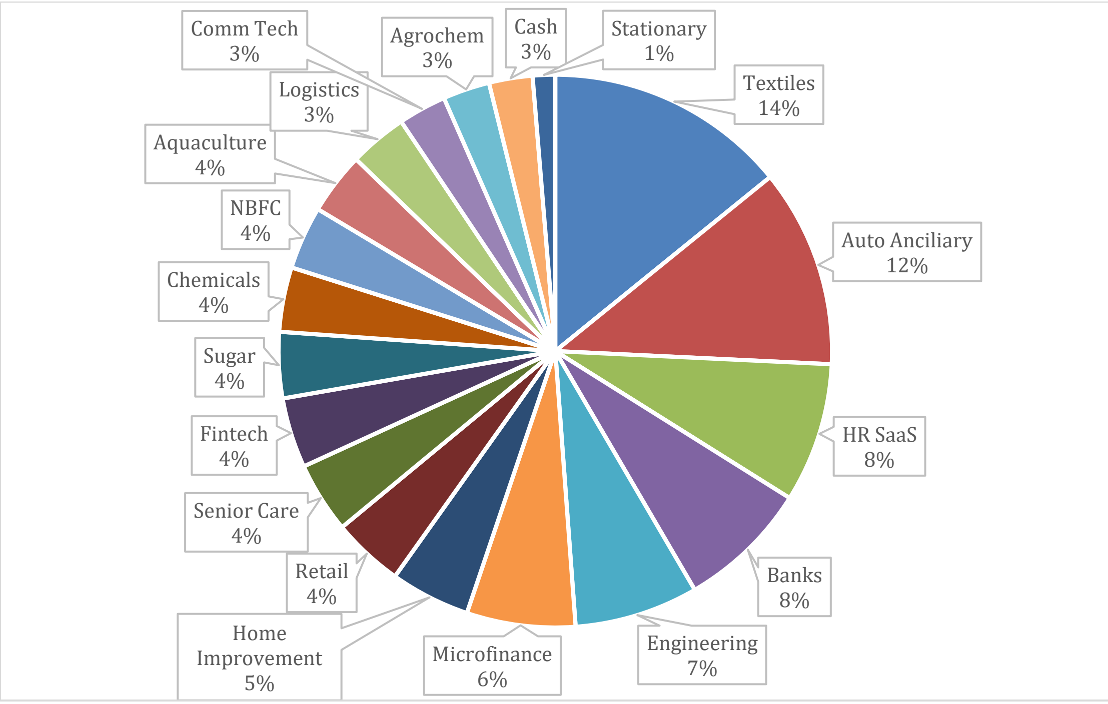
Notes: (i) One of the company in our BFSI basket IPOed less than a year ago and hence we do not have historic valuations.

Similarly, if we analyse the table above for financial companies, it indicates that we own high growth lenders, with high margins, operating leverage (visible from PPOP growth higher than NII growth), low GNPAs and high return ratios. Despite that - these companies are trading at very attractive valuations.

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; and low GNPAs / credit costs in the case of the lenders) we believe the portfolio's valuation is extremely attractive.

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



This quarter we are sharing our thoughts on Pitti Engineering. We bought this company about a year ago, and the stock is up 165%. Despite such a sharp rally, we haven't sold a single share as we believe this company could be a significant long-term compounder.

Do keep sharing your feedback and comments and we will try and incorporate 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.

Yours Sincerely

Kuleen Tanna
Founder & CIO

Annexure I

Pitti Engineering (CMP: 994; Market Cap: Rs34bn; ADT: Rs 119mn)

Pitti engineering (PEL) was founded in 1983. The company specializes in manufacturing value-added motor/generator sub-assemblies for ~40 years. The company's key product lines include sheet metal, precision machining, and assemblies. PEL's products are sold across 5 continents from its 3 domestic state-of-the-art manufacturing plants. The company's customer portfolio boasts several marquee clients, such as ABB, Siemens, BHEL, Wabtec, Cummins, CG Power, and others. These esteemed clients signify the company's strong reputation and credibility in the electrical laminations and motor assemblies sector.

The arrival of a decadal opportunity

Despite enjoying an early mover advantage, PEL's profit stagnated for nearly 20 years in the absence of meaningful industrial opportunity in India and the prevalent practice of global industrial leaders like ABB and Siemens **keeping mechanical installation and assembly inhouse.** Earnings of PEL started gaining traction as clean energy and energy efficiency drove significant increase in capital allocation for global OEMs (i.e ABB, Siemens) thus leading to increased outsourcing of activities which were not considered core. By then, the move towards clean energy has sparked off a global capex cycle for strengthening grid and revamping distribution infrastructure. Around the same time, we have seen a serious impetus from the US to revamp the road and rail infrastructure – the trend only strengthened post Covid with US allocating ~ US$1trn of federal investments for roads, bridges and rails.

Simultaneously, Indian public capex cycle also started to turn with notable increases across road, rail, transmission and renewable capex budgets. e.g. GoI rail capex increased from ~ Rs400bn in FY14 to Rs2,650bn in FY25 (Budgeted).

While global (and India) capex was firming up in the key end user segments for PEL, world witnessed a material supply chain shock with the start of the Russia- Ukraine war. Ukraine was the global factory for supplying key engineered products and components for rail coaches and rail infrastructure and the start of the war severely impeded Ukraine's ability to keep matching increasing US capex demand.

Strong customer connects allowed PEL to keep abreast of a changing opportunity landscape and create timely and state of the art capacity in Maharashtra and Hyderabad in CY17 to capture the same. Management was focussed on putting PEL firmly in place as a national leader and a global aspirant. PEL also enjoyed state incentives as Indian federal and state governments have embraced the idea of India as a manufacturing hub; PEL is expected to receive ~ 100% of its investment (over 12 years) in the form of incentives for the Aurangabad facility in Maharashtra under the Package Scheme of Incentives-2019.

PEL's journey to capture the opportunity

The global traction motor industry was US$25bn in FY23 and is projected to grow at a CAGR of 20.8% to reach US$36.6bn by FY25E. PEL has placed itself as prime beneficiary of increasing opportunity in the sector; **Railways and Power generation jointly account for ~ 50% of the PEL's total revenues**.

In the Railways sector, PEL is a key supplier, producing essential components such as traction motors, drive components, stator assemblies, laminations, and alternator sub-assemblies for the Indian Railways.

For the power generation sector, the company manufactures *stator assemblies* and *rotor assemblies* used in DG sets and generators. The company's export segment makes up 33% of its total revenues. The impressive list of clients that PEL serves speaks volumes about the exceptional quality and reliability of its products.

With renowned names like Siemens, ABB, GE, Wabtec, Caterpillar, and BHEL relying on PEL's offerings, the company has earned a reputation for providing top notch solutions in the industry. PEL's standout feature lies in its ability to offer a rare and unique combination of three critical capabilities within a single entity i) sheet metal fabrication, ii) machining, and iii) components manufacturing.

At first glance, the electrical lamination business may seem like a standard and commoditised business. However, PEL has distinguished itself within this sector by developing a vast array of more than 6,200 products over the course of 40 years. By providing a one stop solution, PEL eliminates the need for customers to engage with multiple suppliers for different applications, simplifying their supply chain management. The advantages of consolidating manufacturing processes with PEL have resulted in stronger customer loyalty and a competitive edge in the market. Recognizing the challenges faced by customers in the past, PEL took proactive measures to address quality and timely delivery concerns. The company made strategic decisions to establish in house manufacturing processes for high pressure die casting, shaft manufacturing, assembly, and air gap turning. By bringing these critical steps in the production chain under its direct control, PEL ensured superior quality products and reduced dependency on external suppliers.

The introduction of ready to use rotors with shaft assemblies has been a game changer for customers, as it enables them to access high quality products more efficiently and cost effectively from a single trusted supplier.

Another significant advantage that PEL enjoys is the high entry barrier for new players in the market. The intricate combination of capabilities and expertise possessed by the company cannot be easily replicated. New entrants would require a considerable amount of time, ~ 4 to 5 years, to establish themselves and deliver end products of comparable quality and efficiency.

Components business to add additional revenue stream

PEL is in the process of merging with its group company, Pitti Castings (PCPL). PCPL was valued at Rs1bn. PCPL serves major clients such as Caterpillar, Wilo Mather, Schwing Stetter, Armstrong, BEML, SIEMENS Gamesa, Atlas Copco, Alstom, Saini, and GE Renewable Energy. The merger will allow PEL to secure a consistent and high-quality supply of casting products, which is critical for achieving the company's target of generating 40% of its revenues from the components business in the next four to five years. [To outline the opportunity here, in the railways sector, the replacement market is five times larger than the orders for new diesel and electric locomotives in India and North America.]

PEL has made strides in expanding its components business, supplying products directly to Indian Railways and securing contracts with other clients like Caterpillar and GE Gamesa. The company aims to grow its components business to Rs3bn in the next three years. PCPL's approval as one of the two Class A precision castings companies by Indian Railways is a significant accomplishment, as this sector involves a long and challenging approval process and has high entry barriers.

Consolidating the market

Consolidation in the laminations sector is a global trend, with the organized sector holding a larger share worldwide compared to the unorganized sector. In the United States, the laminations market is dominated by a single major player, Temple Steel, which has a significant presence in the auto and consumer durables businesses. Similarly, in European markets, there are only three major players, with the largest one consuming a substantial 0.4mnte of electric steel. This trend of consolidation is also expected to play out in the Indian laminations market. PEL, is preparing for inorganic growth by pursuing acquisitions. As PEL gathers economies of scale, we expect PEL to consolidate its leadership position and inorganic means will be a major strategic lever to accelerate the same.

Earnings and valuation continue to impress

We believe that PEL can achieve a ~30% EPS CAGR over FY24-27E driven by ramp up in existing capacity and higher value add driving margins up, PCPL merger helping to drive up components business and inorganic efforts, making PEL still attractively valued. In a sector where hopes and themes have driven valuation to obscene levels, we still see value in an industry leader expanding its domestic and international footprint and witnessing significant demand tailwinds. All these, while maintaining a healthy balance sheet and RoCE profile.

Table 1: Valuation comparison with some of domestic sector peers

	EV/EBITDA (x)				PE (x)				PB (x)			
	FY23	FY24	FY25E	FY26E	FY23	FY24	FY25E	FY26E	FY23	FY24	FY25E	FY26E
Pitti Engineering	**24.3**	**21.6**	**16.9**	**13.2**	**54.2**	**37.7**	**31.0**	**21.5**	**9.5**	**8.2**	**6.6**	**5.1**
Cummins India	78.5	55.1	48.1	39.6	87.1	60.0	54.7	46.2	18.5	16.1	14.5	12.6
CG Power	59.9	73.2	60.5	44.0	80.9	98.3	81.9	59.7	46.6	27.7	21.9	17.0
TD Power	48.5	36.5	30.8	25.2	70.2	53.4	46.7	38.7	10.5	9.0	7.6	6.4

	RoE (%)				RoCE (%)				Net Debt/EBITDA (%)			
	FY23	FY24	FY25E	FY26E	FY23	FY24	FY25E	FY26E	FY23	FY24	FY25E	FY26E
Pitti Engineering	**17.6**	**21.7**	**21.1**	**23.6**	**17.0**	**13.3**	**16.9**	**21.4**	**1.5**	**2.4**	**1.5**	**0.8**
Cummins India	22.3	28.8	27.9	29.2	37.1	51.5	51.7	56.4	-1.7	-1.4	-1.4	-1.6
CG Power	53.3	35.3	29.8	32.1	38	36.3	35.1	37.5	-0.6	-0.7	-0.7	-1.0
TD Power	14.9	16.8	16.2	16.4	17.5	21.3	20.4	21.1	-1.3	-1.3	-1.2	-1.2

Source: Bloomberg, Aionios Alpha research

Aionios
Alpha