



Contagion to Cure – March 2020 Newsletter

Contagion led destruction

A global pandemic like no other seen in the past century has wiped out over 30% of market cap across markets. In less than a month, most stock markets have capitulated from historic peaks to multi-year lows. In India, we fared no differently with our benchmark index (BSE 500) declining 29.2% during the quarter, and 24.1% just in March. Our fund fared much better with a 23.7% decline to fund NAV during the quarter, but that is hardly an aspect to rejoice.

Our portfolio consists of 30 stocks and our investible cash surplus stands at 17.1%.

Financials, amongst others took severe pounding

Our fund performance during the quarter also needs to be reviewed in the context of dominant ~30% exposure in the Bank and Financial services sector. Investment strategy in this space has been consistent over the past year and driven by expectations of stable credit growth and improved asset quality. However, Bank and financial services indices declined the most at 46%, and had the most significant impact on our fund performance during the quarter. Going ahead, the altered situation would require reassessment of risk, and we have already initiated steps in this regard (as discussed later).

Impact could be significant and long lasting

Over the past month, global agencies and independent experts have spelt out the likely economic impact of the pandemic. It is estimated that the global economy will see the worst recession since the financial crisis in 2008, perhaps comparable to the Great Depression in the 1930s. Following contraction in H1 CY20, growth is expected to return only from Q3, but even that is not assured. For CY21, estimates point to sharp pull back, but again it is dynamic situation. The complexity arises due to the cost associated with both, saving human lives as well as the subsequent new world order even as situation normalises. So the impact of Contagion to cure could be long lasting, possibly beyond a year. In the interim, much depends on how various countries handle this crisis in arresting the contagion.

For instance, although China seems to have got the pandemic under control within a fortnight of lockdown and has resumed operations in most parts, rest of the world is still grappling due to late realisation of enormity of the disease. In India, the situation is slightly more tricky in that although we identified the problem early, our testing process has been slow and the population size and density would make it even more challenging. A clearer picture could emerge by mid-April when the government reviews the lockdown.

Post steep correction, market could turn indecisive

A sharp and swift ~35% decline in Indian equities would in normal circumstances make it an attractive investment proposition. But this time one cannot be sure since the economic



downturn is without precedence and could stretch far deeper. From an investment perspective, markets in the current state could both be an opportunity missed or a value trap, depending on how the pandemic pans out and its aftermath. In the interim, markets will continue to react to the pandemic progress, alternating between skepticism and hope.

Let us review some past data. Our stock markets have seen 35%+ declines from peak levels several times. NIFTY trades at 1-year forward PE at about 11x, similar to some of the earlier phases but still higher than the 7.6x PE witnessed during 2008 crisis. However, like we mentioned earlier, there is downside risk to earnings which suggests a 25% downside to Nifty is possible in the worst case. Alternatively, given the challenges of estimating earnings, PB is deemed a better valuation metric to assess the situation – and at 1.9x trailing PB, NIFTY trades at an 18-year low. Also, past situations have shown that rewards clearly outweigh the risks from a price perspective, although returns could accrue over next 2 years. So the conclusion one can draw from the above is that it should be time to increase equity allocation, preferably during the course of corrective process which should ensue in coming weeks or months.

Cash best defensive, sector preferences not affirmed yet

Markets are in uncertain terrain, so retaining high levels of cash is best form of defense, in our view. What constitutes 'adequate' is somewhat difficult to assess as cash offers both, protection and flexibility to re-invest, either on possible declines or into leadership change, in the event of market recovery. We think at least 20% cash retention should be par for the course.

No stock or sector can be called out. Over the past fortnight, markets are seen shifting to defensive sector plays such as Pharma and FMCG, and shunned financials and autos. While we may agree with the same, it may or may not be a sustainable trend. Pharma companies may be restricted by export curbs as well as be impacted by lower doctor visits for fear of contamination. FMCG too may be impacted from logistics disruption, change in consumer behavior, and front-ended demand which could taper post normalcy. On the other hand, an early end to the pandemic and resumption of economic activity will see better than feared asset quality for financials and pent up demand for consumption, thereby aiding autos.

Portfolio rejig and diversity a necessity

Our portfolio prior to the pandemic was based on certain set of growth assumptions over our investment horizon. However, these may no longer hold, at least near term. We may have also lost some opportunity to rejig our portfolio to mirror the altered environment, as the fall has been too sharp and swift. Still, we did manage to do few things which should hold us in good stead (1) raised cash levels to 17%, which is nearly 2x compared to a month ago, achieved by partially lowering perceived high risk sectors, and (2) diversifying our sector and stock exposures.

To start with, we bit the bullet by reducing our exposure in financials, a sector most at risk due to NPA concerns - by one-third (to 20%), exiting couple of private bank names, including a corporate bank which delivered decent returns over the past year. We however continue



to hold on to some lenders including India's top tier retail bank despite collateral damage which we cannot avoid. Insurance, stock broking and other such non-balance sheet service providers should do relatively better and we continue to retain our holdings representing these themes.

Our diversification drive commenced sometime last year. Pharma is our second largest holding with 15% exposure. This was higher but for a force majeure event which resulted in us exiting a position. We continue to look for opportunities in this space as faster clearances and strong demand should also improve pricing outlook, which should favour domestic generic companies.

FMCG exposure is reasonable (9%) but may not be adequate in the current circumstances. Within this space, we prefer personal hygiene, health supplements and food.

IT contributes 9% to our holdings, which has hurt us particularly last month mainly due to travel restrictions and shutdowns affecting new deal wins. Our rationale for continuing to ride this exposure is due to sector characteristics of sound financial health, clean receivables (owing to high quality customers) and currency tailwinds (should offset lower utilisation rates in the near term). Also, structurally the sector should benefit from the need to enhance digital technology further to mitigate similar occurrences in the future.

We also own some auto names to participate in potential recovery post pandemic. We expect pent up demand to be fuelled by cheap loans but partially tempered by ensuing job losses. Our biggest position however is through a highly cost competitive exporter of off-highway tyres, where demand concern should be made up partially through market share gains.

In Cement, we cut sharply during the quarter (just ~2%) but continues to hurt us with construction activity unlikely to see pick up for a while. But we don't own anything in metals, after exiting our one position which hurt us briefly. Overall, we expect capex cycle to be likely delayed which would hurt industrials and commodities.

Mid/small cap accounts for just over 50% of our portfolio – higher than warranted, but every name has minimal or no financial leverage and also decent execution record. Our largest sectoral exposure is in the speciality and agro chemical space (collective exposure 8%) which seem well placed due to (1) resilience in agri demand as the pandemic hasn't hurt food production in India, and (2) monsoon situation remains promising for the season ahead.

So overall, our portfolio is adequately diversified and both, sector and market cap agnostic. This, and our reasonable cash position should stand us in good stead during these uncertain times, allowing us to capitalise on emerging opportunities from this Contagion to its eventual cure.



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