



## Rough terrain - July 2018 Newsletter

Our previous newsletter titled 'Testing times' could ring true for the quarter under review as well. Our AIF exhibited muted performance with NAV declining a tad (~1%) compared to ~3% gain in benchmark, BSE500. However, this was better than the sharp decline of 5% and 9% in small and mid cap indices respectively, which was more representative of our portfolio (collective 75% exposure).

Since inception in end-Sept 2017, our NAV is up 8.3%, ahead of BSE500 (up 5%). Our AIF portfolio consists of 22 stocks (similar to beginning of quarter), with 8% retained as cash.

### So what hurt us?

Our skewed exposure to small and mid caps hurt us immensely, but that is stating the obvious. Notwithstanding stock performance, most of these companies continued to register strong financial results, validating our investment thesis. Also, by their very nature, these investments will likely bear fruition over longer time frame. Sectorally, construction related stocks performed poorly for us but more significantly, our IT holdings didn't perform as well as anticipated and can be cited as one of the key reasons for underperformance.

If we were to pin ourselves down to errors in investment choices, these were limited and included (1) a large cap aviation company, which disappointed on financial performance and surprised us on the lack of pricing discipline despite high utilisations, (2) a mid cap pharmaceutical company in the CRAMs space, which exhibited weak earnings with notable absence of near term earnings drivers, and (3) a small cap player in transformer business which reported muted results but sitting on record order backlog. Apart from these names, a few stocks which had performed well earlier, corrected in line with the markets so we expect those to regain value over time.

### And what performed well?

Market preference for large caps especially in select sectors like FMCG and Retail aided performance of our holdings in (1) India's largest Inner wear company, which surprised even our elevated expectations on operating performance, and thereby continued to re-rate, (2) an urban centric FMCG player, which delivered strong results driven by successful launches and margin uptick. Additionally, a small cap auto ancillary beat market trends by finally getting noticed due to sustained financial performances along with reasonable valuations. In private banks, our exposure through meagre managed to hold up well. We will continue to hold these positions despite the gains witnessed last quarter.

## Is the divergence over?

It would be impossible to answer this but the ensuing correction, especially small/mid caps has ensured that valuations are more reasonable now even as overall growth has reverted to double digits after 5 years of flattish earnings in the Nifty universe. Business optimism has not dimmed despite socio-economic uncertainties, and most companies we have interacted with are seeing strong order book position indicating better outlook. Sustained FII outflows may be tapering off given India's outperformance vis-a-vis other EMs and even the spate of selling to conform to regulations (SEBI reclassification of market cap norms, increased margin money requirement from stock exchanges) could be nearing end. So to assume that YTD trends will continue for the rest of year could be a tricky proposition. At our end, we will only make minor adjustments to our portfolio, both based on market cap and sector/thematic representation, but broadly back the bottom up ideas we have generated with detailed due diligence.

## So how are we thematically positioned?

We have been highlighting that domestic political and global economic risks will likely be critical factors to impact stock markets this year. The situation has become more grievous during the quarter gone past, which makes it imperative to build our portfolio based on the following:

### ***1. Increased probability of change in political dispensation***

Construction related sectors will be a clear avoid due to uncertainty on the sustainability of order inflows especially from public capex. We have already exited our holdings in road and railway related construction stocks during the previous quarter. Even Commercial Vehicles (CV) demand dependent on domestic infrastructure capex may come off. Our exposure is through ancillaries which have witnessed a sharp stock correction, likely discounting the tapering of growth. Given our material portfolio weight, we may look to prune holdings on a rebound. And finally, private capex recovery could be further delayed so our sizeable holding even in a highly cost efficient transformer company could pose some risk.

Consumer discretionary and FMCG sectors will be prime beneficiaries of attempts to drive rural incomes before elections. The consumption theme dominates our holdings (30% of portfolio), and our current exposure is varied and through an urban centric FMCG player, a branded air conditioning company, an electrical hardware company and a rural auto conglomerate. We could make minor additions in this space, especially to capture rural growth prospects.

Private banks will increase competitiveness at the expense of PSUs as fiscal profligacy could mark return of inflation and sustain higher interest rates. This would be unlike wholesale funded NBFCs and HFCs, whose margins would be hurt. We already own a mid-sized private bank with expanding reach and franchise and delivering above-industry growth and could increase exposure to the same name on corrections.

## **2. *Global growth slowdown a possibility, Trade war a reality***

In such a scenario, India's IT sector stands to gain due to currency tailwinds in the form of global risk aversion as well as weakening trade deficit trend. Fundamentally too, IT services continue to do well as deal flows have improved and Indian companies (including mid-sized ones) have built their digital capabilities which is enabling deal wins. Our portfolio weight in this space (15%) though reasonable, has scope to increase on favourable business prospects.

On the other hand, likely reduction in global GDP growth led by China owing to trade war is negative for commodities. Although further downside to metal prices looks less likely owing to supply side tightness, range bound prices could lead to stock de-rating. We have already lowered our exposure to commodity related sectors to a trickle.

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