



## Taking guard - Jan-Mar 2018 Newsletter

We commenced AIF operations with Ampersand Growth Opportunities Fund - Scheme I (AGOFS) in late-Sept, even as markets were coming off yearly highs. Now here we are with our first newsletter when markets have scaled yet another peak. Henceforth, every quarter we will pen our thoughts on the market, investment strategy and portfolio movements.

### The “3Cs” and Portfolio Rationale

Our investment strategy in AGOFS1 targets companies with sustainable growth in earnings and free cash flows. To narrow down our universe, we have picked the '3Cs', namely Construction, Consumption and Commodities, as our dominant investment theme. Key rationale for this is the positive outlook for pricing in commodities (also supported by stronger global demand) and pro growth stance of Central banks, which favours capacity creation and job growth and thereby providing tailwinds to Construction and Consumption.

Construction-led sectors are the largest constituent of our portfolio with 41% exposure. Stocks we own operate predominantly in the Roads, Urban Infra and Power T&D segments. We would extend this positivity to Railways and Ports as well. Strong order position along with execution capabilities would drive sustainable earnings growth well into next fiscal and beyond. We also have exposure to plays in Commercial Vehicle business, which feed into capex related economic activity (collectively around 16%).

In the Consumption space, our investment exposure is 32% and picks are diverse ranging from consumer discretionary (17%), financials (10%) and to lesser extent staples (5%). Historically, this space has displayed secular growth characteristics and we expect that to continue.

In Commodities, exposure is modest (13%), although we did take profits partially in one of the ancillary names due to disproportionate returns in a short period. Our picks include a leveraged player in the long steel products business and couple of ancillaries/ & consumable companies which should benefit immensely from the respective price cycle.

### Hits and misses so far

Commodity stocks in our portfolio have done well and contributed meaningfully to AGOFS performance. Despite strong showing, we intend holding on to existing positions as price and demand dynamics continue to be favourable.

Construction related segments have met with our expectations but we expect next fiscal to be much better as execution picks up along with sustained order inflows. However, we could limit our already sizeable portfolio exposure to existing levels.

In the consumption space, the collective performance so far has been tepid which can be attributed to demand seasonality (especially autos, durables), inflationary trends (which significantly reduces competitiveness of NBFCs, our principal holding in financials), and shift in valuation paradigm in the one life insurance company we own. The company in question however continues to execute well and surprise on growth in premiums and market share gains. We will however evaluate our holdings in financials in the coming quarter.

## Rationale for key holdings

A brief investment rationale on some of the key portfolio holdings:

1. Ramkrishna Forgings, with its timely expansion and new customer additions, is leveraged to recovery in truck demand, both in India and globally (mainly US); strong earnings growth should narrow valuation differential vs. the market leader
2. KEI is a major beneficiary of electrical T&D network upgradation and consequent improvement in electricity supply to households; should sustain 20-25% growth and therefore see valuation re-rating
3. HEG is witnessing a sizeable reversal in fortunes of its graphite electrodes business, due to supply constraints and rising demand on shift in steel production through relatively inexpensive and less polluting EAF route. Extended visibility of upcycle will likely show in earnings surprise as well as expansion in valuations
4. NRB Bearings is a leading manufacturer of customised needle roller bearings for automobile power trains. The company is at the cusp of leveraging its technological capabilities by adding new products and customers which should drive acceleration in earnings growth and therefore support valuations
5. PNC will witness accelerated execution of its order book in road construction (5.5x FY18 sales) in the quarters ahead. Clean balance sheet will allow company to participate in the upcoming tenders in this financial year and in the medium term under Bharatmala.
6. Page Industries' leading franchise in inner wear and cost advantage should see it continue to gain market share and create brand extension opportunities. Valuation premium is justified by the company's ability to maintain secular growth.

## We are looking for opportunities to add new names

AGOFS so far has invested 85% of its corpus across 22 stocks. This deployment would have been higher but for the 2nd round of fund raising which concluded in mid-December. Given the rising challenges of identifying newer ideas, incremental investments have been largely aimed towards increasing allocation to existing names within our portfolio.

## Markets generated solid returns last year

Stock markets had a great 2017. Despite having to negotiate several issues towards the latter half namely, weak GST collections, sticky retail inflation, surge in crude price and a critical state election, the solid performance continued well into the last quarter. AGOFS too has benefited with portfolio return of 19.8% since inception (Sep 25<sup>th</sup> 2017) comfortably beating the benchmark, BSE 500 (up 9.9% in the same period). This performance has been achieved with

relatively low level of portfolio risk (Sharpe ratio of 3.66). One word of caution though, these are early days still and the performance may not be extrapolated into the future.

### There are reasons to stay optimistic...

In 2018, most of the concerns which could potentially peg back markets are likely to reverse. We note the following:

1. Latest lead indicators (IIP, Manufacturer PMI Index) suggest economy is turning the tide
2. GST collections most likely has bottomed, and introduction of e-way bill from 1 Feb 2018 boost compliance
3. Inflation likely to remain range bound, thanks to strong INR, falling food inflation
4. Bond yield may peak soon, as government taking adequate measures to reverse trends (cut in interest rate on small saving schemes)

### ... but moderate market returns likely

Valuations suggest that stock markets are already discounting possibility of acceleration in GDP, driving strong corporate profits next fiscal. As such, further re-rating is practically ruled out, in our view. We therefore moderate return expectations on the broader market. The BSE 500 (and other all-cap and mid cap indices) should fare better, but likely to be modest compared to last year.

### Market volatility likely to be higher

Unlike 2017, when our stock market corrections never exceeded 3% in any single month, we expect increased volatility ahead. For starters, in the lead up to Union Budget in Feb, markets could focus on possibility of imposition of 'long term capital gains tax'. If that passes off as a non-event, the next couple of months would be largely uneventful (read positive) for lack of news flows. However, we then face yet another state election in April (Karnataka) followed by the customary monsoon expectations. As we get to the second half and closer to the next general elections, market volatility could heighten. So while we expect positive returns overall, several events could make it an uneven path for our markets. In such a backdrop, we believe that our philosophy of bottom-up growth-focused investing will be well placed to weather the volatility.

Top 10 Positions	% weight
Ramkrishna Forgings	7.48
KEI Industries	6.13
NRB Bearing	5.91
HEG Ltd.	5.80
Page Industries	5.22
PNC Infratech	4.86
Jindal Steel and Power	4.34
MM Forgings	4.29
Timken India	3.87
Capital First	3.85
<b>Total no. of Holdings/ Stocks</b>	<b>22</b>

Industry Exposure	% weight
Financial Services	9.78
Materials	13.08
Consumer	12.82
Auto & auto ancillaries	21.88
Construction& Infrastructure	11.91
Industrials	16.01

Market Cap Distribution	% Weight
< INR 5.0 billion	-
INR 5.0 – 20.0 billion	19.75
INR 20.0 – 50.0 billion	25.26
INR 50.0 – 100.0 billion	23.91
>INR 100.0 billion	16.56
Cash & liquid investments	14.52
<b>Weighted avg. market cap (INR bn)</b>	<b>115.7</b>

## Risks

Concentration risk is in auto & ancillaries, which constitute around 22% of portfolio. However, there is diversity through segmental exposure i.e. CVs, two wheelers, railways. Also, most of the portfolio stocks in this segment have exposure to the favourable demand cycle in domestic CVs to varying degrees, while remaining insulated from persistent competitive price discount offered by the OEMs.

In terms of sectoral risks, our portfolio is devoid of IT and Pharma, as they do not qualify on growth expectations, although certainly do so on the ability to generate strong cash flows. Also, that these sectors have hugely underperformed last year could work in their favour in 2018. We have been monitoring this space continuously and may look to add a name in the ensuing quarter.

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