



## The heat is on - April 2017 Newsletter

It has been a year since we at Ampersand started penning our investment related insights through monthly newsletters. In this edition which heralds the fiscal ahead, we reflect on the past and once again attempt to highlight (1) broader market outlook for FY18, and (2) key investment themes and ideas within.

### Markets likely to again generate positive returns in FY18

This is similar to our expectations for previous fiscal, despite the unforeseen events our markets had to contend with respect to demonetisation. Although the corporate earnings situation is still uncertain and valuations clearly a tad expensive (18x 1-year forward P/E, which represents 25% premium to historic average), our current view is based on a much improved political environment which would help drive reforms and speed up economic revival.

### Mid caps could outperform, but marginally

Ampersand's investment approach is mainly aimed at identifying bottom-up opportunities (or themes). Last year, the Nifty Midcap 100 index delivered 35% return vs. 19% for Nifty50, in line with our expectations. As markets continue to present bottom up opportunities, we anticipate mid caps to fare well even in the coming year. However, the valuation premium of mid caps (vs. discount historically) leaves limited scope for further re-rating notwithstanding the steady inflow of domestic savings into equities. We therefore believe large caps could also perform in tandem in FY18.

### Thematically similar but more broad based

Our preferred sectors/themes last year were NBFCs, Cement, Speciality Chemicals and select Autos as we felt this universe offered a combination of growth and financial stability. As it turned out, other than commodities, these segments went on to deliver superior returns relative to the market. In fiscal 2018, while we continue to like domestic-centric names over exporters, our choices are more broad based and include some mainstream sectors as well. Our themes mainly revolve around the following

1. **Infrastructure** – We liked public infrastructure capex as a theme last year also, but restricted ourselves to employing cement stocks as a proxy play on reasonable valuations. While we continue to like select names in the Cement space, we believe the better way to play the infrastructure spend/ public capex theme would be through Engineering & Construction (E&C) companies or even Real Estate developers. We briefly discuss few names in the sub-sector of road construction space in the next section below

2. **Financials** – As highlighted earlier, our focus last fiscal was on NBFCs as we were not comfortable with the NPA situation in the banking space. Since then, NBFCs, have not only delivered but undergone significant re-rating, which is one of the reasons for diverting focus on emerging conglomerates (IIFL/Edelweiss) and relatively inexpensive names within NBFCs (viz. SCUF, Magma). We expect banks catch up and perform in sync led by decent liquidity, growth pick-up and lower credit costs

## The road to recovery

KNR, with its super-efficient working capital management (NWC of 45 days vs. 100-150 days for others), lean balance sheet and conservative management has provided a good investment case over the last 2 years. However, given the change in the industry outlook and momentum, we prefer Dilip Buildcon and PNC Infratech now. Not only do the two companies have higher risk appetite (participation in HAM projects being an indicator), we also see execution at a similar inflexion point where KNR was 6-9 months back.

It is also interesting to note the different models at work within the road companies. While Dilip Buildcon is vertically integrated (with virtually no outsourcing) and hence balance sheet heavy, it compensates it with higher EBITDA margins (20%). On the other end of the spectrum are companies like PNC Infratech and KNR Constructions where asset turnover is much higher (5.5-9.0x) vs. Dilip Buildcon (3.3x) but consequently lower EBITDA margins (13-15%).

In the past, exposure to BOT projects and equity commitment has been a negative factor. We think there is now an evolving ecosystem to ring-fence the equity commitment in the operational projects.

1. Financial closure of HAM projects are now happening more frequently after the initial reluctance of the banks.
2. Infrastructure Investment Trusts (InvIT) will provide an opportunity to the road EPC companies to transfer their operational BOT assets and hence free up their equity for new round of HAM projects, thus not impacting their free cash flows any further. There has also been some interest from financial investors to participate in the execution stage of the HAM projects as well.