

Trial by fire – October 2018 Newsletter

Maiden year: promising start, sobering end

We have completed just over a year since inception. During this difficult period for EMs including India, our fund NAV rose a modest 6.5%, but ahead of benchmark BSE 500, which was up 4.4%. The month of Sept (through to early-Oct) was particularly horrific for our markets. As we pen this piece, we continue to face collateral damage. In this edition of newsletter, we discuss equity prospects, particularly our portfolio positioning amidst weak macros and other challenges.

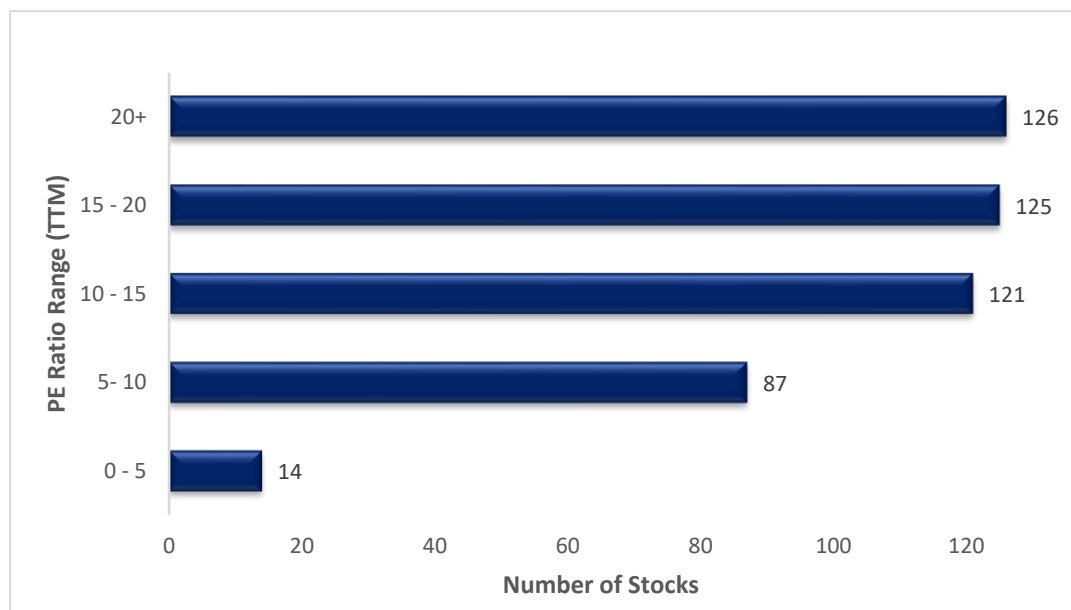
Macro situation has made things tougher

India's macros have weakened considerably in recent times with sustained increase in global crude and sharp depreciation in rupee. As if this was not enough, bunched up events such as the collapse of IL&FS, liquidity tightness and excise burden imposed on Oil marketing companies have impacted financial markets. At the margin, these issues may not deteriorate further, or at least not at similar pace. But then we have to also contend with key state and national elections. Considering the calendar ahead, we expect another tough year for markets, possibly with marginal returns.

Valuations corrected, but pockets of excess remain

Markets have corrected from peak levels (Nifty down 7.1%), and mid and small cap indices are down 21.3% and 35.6% respectively. Still, valuations do not seem compelling at 16x one year forward P/E due to perceived risks over growth, but several stocks have become attractive now.

Chart 1 : Several stocks trade <15x trailing PE



Source: Screener.in

We continuously run screens to identify investible names, and our observations on stocks with over Rs 5bn market cap, at least 10% RoE and P/E under 30x are as follows:

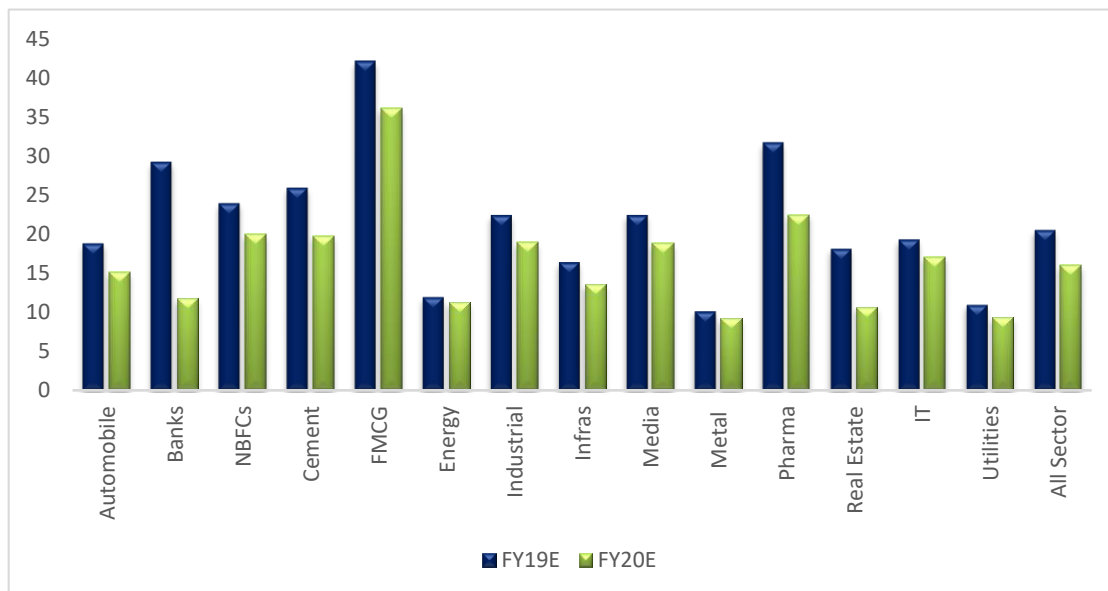
Over 40% of stocks are valued under 15x P/E

- Post underperformance, sectors like autos, infrastructure and cement are relatively inexpensive, although there could be downgrades to consensus forecasts
- IT despite outperformance is well below peak valuation
- Banking/Financials space looks interesting with strong earnings expectations in select names
- Consumer staples still seems relatively expensive despite correction, and so do NBFCs

We have represented the observations in **Chart 2** below.

Based on the indicative valuations, this could be correct time to invest with a 2-3 year perspective.

Chart 2: Interest Rate sensitives seem attractive on PE



Source: Screener.in

We would need a mixed strategy to maximise returns

Typically, our investments are planned for the medium to long term, but with narratives changing so rapidly, we may have to tweak this strategy. While we will continue to retain significant portion of our holdings, we could assign some portion to short term themes. The other aspects which need redressal (if not achieved already) are (1) diluting exposure to illiquid names, mostly small caps which bear the brunt of market volatility (we already are down to a more manageable 25% currently, compared to 39% couple of quarters ago), and (2) raising cash position to ~15%, nearly 2x last year's average levels, primarily to use steep corrections to enter (again we have partially succeeding in doing this by taking cash surplus to over 12% currently).

Consumption theme is sustainable

Our portfolio is domestic centric, and dominated by the consumption theme. Our 30% exposure is varied and through durables, discretionary and staples, mostly leaders in the business segments they operate. This space has seen sizeable correction since Sept, on concerns over slower demand due to inflationary pressures.

In Consumer durables, we have invested in a company with impeccable track record in the white goods segment, and in Consumer discretionary, our investments are mainly in autos, including a leading auto conglomerate with significant rural standing. While there could be immediate headwinds due to financing concerns and higher interest rates, both the themes are everlasting in terms of business prospects, and the companies chosen will be key beneficiaries in our view. However, there could be temporary disruption in terms of growth, and therefore stock performance as we are already experiencing.

In Consumer staples, our investments are represented by a combination of relatively undervalued companies which we believe are in the bottom of margin cycle, as well as a multinational with solid growth prospects thereby deserving its premium valuation status. The sector has seen a uniform 15% de-rating over the past couple of months, somewhat correcting past outperformance. However this does not seem entirely warranted given the secular nature of business. We will continue to hold on to our investments as risks of further downside is extremely low and upsides could be reasonable.

Banking/Financials is a space we need to build exposure

Our current exposure is limited at ~6%, only through a mid-sized private bank which is delivering above industry loan growth and devoid of legacy NPA issues. We didn't venture beyond this mainly due to challenging environment of rising bond yields (which makes NBFCs, HFCs less competitive versus private banks), enhanced NPAs and valuations. This proved to be a blessing given the sectors performance, particularly in past one month and half. We do however recognise that private banks with CASA and some leading NBFCs could benefit in this situation and would therefore look at building exposure at some stage. Leading and more dependable names could become part of our core holdings.

Auto ancillaries have underperformed despite strong performance

We have invested in few Auto ancillary companies catering to the domestic CV space, also with export capabilities. This has not worked out well for us so far, both due to new axle load norms for trucks creating uncertainty over domestic demand as well as expectations of cyclical peak approaching in global markets. We may choose to ride through this phase as we believe domestic concerns seem overdone and new emission norms would propel stronger growth next year. In the interim, these stocks may continue to underperform, although our exposure is now down to below 9% of corpus.

IT has more legs to perform

Our second largest exposure is in IT (21%), all through small and mid-caps. When we started to invest, sector was recovering with improved business traction across verticals, and valuations were compelling given prolonged period of prior underperformance. The investment case has now got stronger due to currency tailwinds and improving capabilities in the digital space which has aided stronger deal flows, thereby ensuring growth visibility for at least another year. Despite YTD outperformance, we expect valuations to sustain on expectations of double digit growth with sustainably high RoCEs. We will therefore ride through for at least a couple of quarters or whenever alternative growth options become more attractive, whichever comes earlier.

We may need to look at other export oriented sectors

Pharmaceuticals is a sector which has performed well in recent times, but not represented in our portfolio. We could consider it but at appropriate valuations.

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