

Waiting for Godot – June 2019 Newsletter

Tepid end to lackluster quarter

This was expected to be a defining quarter, one way or the other. However, other than customary volatility, our stock markets have gone nowhere. Economic slowdown and trade war largely negated factors such as election outcome and dovish turn of central banks, both in India and globally. Broader market continued to underperform Nifty and market breadth remained negative during the quarter. Under the circumstances, our fund performance was commendable (up 2.4%) beating the benchmark (BSE 500 was up 1.8%). We could have done much better but for small and mid-caps continuing to fare poorly, where our collective exposure stood at 50%.

Since inception on 25th September 2017, NAV is up 14.9%, well ahead of BSE500, which was up 10.6% (both as on June 15, 2019). Our AIF portfolio consists of 27 stocks and our cash surplus stood at ~18% (from ~22% in the previous quarter).

Markets searching for toehold, buy on dips

Our stock markets continue to be hampered by domestic headlines related to economic situation including rural stress, liquidity crisis, corporate defaults, promoter share pledges etc. Although Nifty being close to historic high seems inexplicable, the broader market as mentioned earlier reflects a more realistic picture. However, all this could change in the coming months as we expect earnings trajectory to accelerate from H2 FY20, triggered by beneficial impact of lower interest rates and easing of liquidity constraints. In the interim, markets could be marked down due to factors such as quarterly earnings disappointments, weak sectoral data e.g. autos, or even an uneventful budget. Our strategy would be to buy into all such possible dips to ride our expectations of much better economic environment.

Market divergence continues to pose challenge

Since early 2018, not only have large caps outperformed smaller names, but the universe of companies delivering double digit stock market returns has been limited. The numbers look better this year, but divergence still persists. In our view, select mid-caps could start to look interesting if prices (and therefore valuations) correct a tad, but small caps have limited downside.

However, such broad based participation hinges on early lifting of credit and default crisis and acceleration of earnings growth. This, as we highlighted earlier could most likely occur from H2 FY20.

Our sector preferences remain largely unaltered

In the previous editions, we had highlighted key investment themes intended to be pursued over the course of the year. Chart 1, illustrates earnings expectations across various sectors and validates our thematic choices. Based on this:

1. Financials remains our preferred investment choice, especially as banks are likely to benefit from lower NPAs and NBFCs from easing of liquidity post credit crisis
2. Select sector laggards of the past interest us, which include (1) Cement, (2) Real Estate, and (3) Pharma.

Chart1: Sector wise Earnings Growth expectations range vs our portfolio (AGOFS-1)



Source: Kotak KIE Report

Portfolio well balanced, positioned to perform better

Our portfolio construct continues to evolve on a constructive basis. Brief summary of key portfolio alterations during the last quarter as under:

1. We added building materials including cement as a sector/theme, which should benefit from better capacity utilisation, firmer prices and stable costs. Conversely, we lowered exposures in IT and consumer staples, which had already done particularly well last fiscal



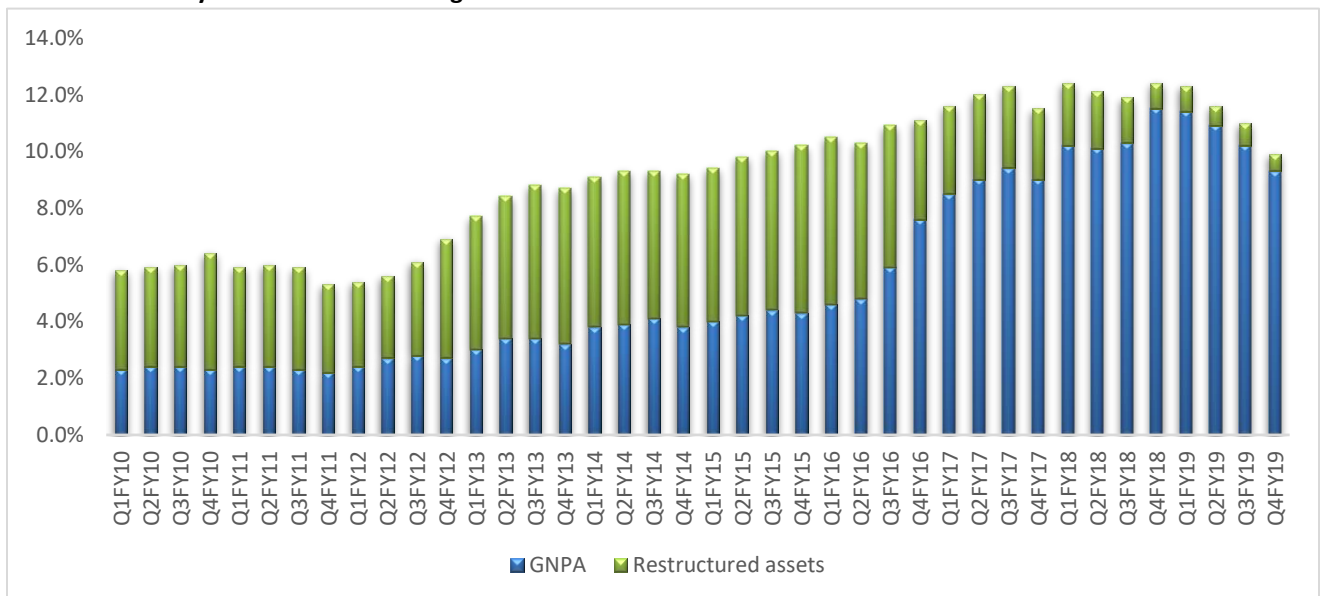
2. Banks/financials has been our single biggest portfolio addition, both in terms of number of stocks and increased exposure. We could do more if prices correct and give us such opportunity
3. Small caps require more due diligence, covering aspects of track record and scalability. We haven't moved much in this space except correcting our past mistakes, mostly related to excess exposure related to lack of stock liquidity
4. Mid-caps remain excessively valued but represent a class of companies where management capability and quality is largely not an issue. So we did manage to add a couple of new names, mostly as replacements
5. Our cash position as highlighted earlier is well above what we intend it to be. We expect to utilise this optimally this coming quarter.

Transmission of interest rate cuts is our favored macro theme

Last Oct, India was hit by the now familiar NBFC crisis, which aggravated the already elevated NPL levels in the banking system. Since Feb 2019, RBI cut REPO rates by a cumulative 75bps and also made several alterations to the regulations to improve liquidity and reduce NPL. Transmission of interest rate at just 10-15bps has been poor.

NPL Cycle from Chart 2 is summarized as follows: 1) In FY10, GNPA was about 2% of loans outstanding for all banks 2) Peaked at about 11% in FY18 3) Started falling in FY19 and stood at about 9.3% in Q4 of FY19 4) Provision coverage at 65% currently is up sharply from 40% in FY17.

Chart 2: Overall system stress is declining



Source: RBI

Our scenario analysis suggests the following:

- If advances grow by 12% per annum and NPL stays at current levels, then NPL ratio will decline to 6.4% in 3years. A faster growth in advances, say 15% CAGR, will bring the ratio to below 6%.
- Assuming 25% of NPL gets resolved through IBC through 40% hair cut, then provision coverage will rise to about 90% and NPL ratio will decline to a manageable 4.3% in 3 years.

CRISIL, a leading credit rating agency of India in its June 2019 report opined that GNPA will fall to 8% by Mar 2020. Around 50% decline in accretion of fresh NPA along with dispute resolution is driving the improvement in asset quality.

Reduction in NPL will facilitate faster transmission in interest rate cuts, and the key driver of our investment thesis in the bank/financial sector.

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