UNIFI CAPITAL

REVIEW: Q1-FY 2025

Between June and August 2024, Unifi reoriented many of its investments across sectors. While we touched upon these changes in our previous communication, we delve further into them.

Portfolio, actions

While markets have been narrowly focused over the past year, we have continued to embrace a wide array of opportunities and believe the portfolio is well-balanced across multiple growth profiles. Our portfolio holdings are aligned with deep structural changes in several sub-sectors, with strong future growth tailwinds. We see good evidence that our portfolio is broadly executing well. The combined increase in their earnings for the previous quarter and the trailing 12 months was 11% and 14%, respectively. Our rationale behind our key sectoral exposures is as follows.

Sector #1/ Credit

India's credit cycle is primed for double-digit growth in the coming years. The system-wide expansion will benefit all industry players, including our portfolio companies. With systemic low leverage and the healthiest balance sheet in a cycle, this is the best environment for lending in many years. On the retail front, increasing awareness of borrowers about the need to maintain good credit history has led to the best quality of assets in seven years. Against this backdrop, we expect credit losses to remain manageable, driven by business mix in the near to medium term. We recently trimmed our exposure to India's largest public sector bank and a regional South-based bank. While these institutions remain fundamentally sound, we believe they are approaching fair value. In contrast, we've built a substantial position in India's second-largest public sector bank, which shares similar fundamentals, risk profiles, and return ratios but at more attractive valuations. The portfolio is well-positioned to capitalize on the credit upcycle and benefit from lower credit costs.

Sector #2/ Infrastructure

In a critical shift towards new sectoral exposure, we have invested in firms that will be a beneficiary of India's infrastructure upgrade. The sector has a broad spectrum of investments, starting with one of India's leading EPC firms geared towards civil construction across multiple industries. Alongside, there is a national mandate to deepen India's water networks, opening up opportunities across broad spectrum in the value chain, including SAW Pipes, water desalination, and water chemicals. Each of these firms is among India's largest players in their segments. The growth case in this cohort is backed by committed spending across infrastructure and water, backed by the cyclically best combination of pricing and balance sheet. A combination of volume growth and pricing power will boost profitability in the coming years.

India has 18% of the world's population but only 4% of water resources, making it among the most water-stressed in the world. Unregulated groundwater extraction has resulted in overuse, causing groundwater tables to be depleted. Correcting the water deficit is a critical ask today, and there is traction at the policy level in addressing this. As a center-stage conversation for municipalities, State governments, and the Centre in India, this results in significant opportunities across water transportation, desalination, and water treatment. Our investment companies address these solutions with their capacity to address the need for transportation and 125+ IP Rights developed in-house for water solutions.

Sector #3/Insurance

We recently took exposure to India's largest health insurance business. While the lingering effect of the pandemic had stressed the industry for a few years, realizing the increased need for medical insurance coverage has worked strongly across the industry. As India's most profitable health insurance firm, we expect the company to keep pace with industry growth while delivering on improved financial metrics yearly. As a sector with multiple years of growth ahead, we are participating in cyclically low valuations backed by strong financial performance.

Sector #4/ Healthcare

While the backdrop for healthcare businesses in India has generally been strong, our holding, one of India's largest chains in East and Karnataka, has taken a pause as it consolidated the effect of a large capital expenditure program. We believe operational progress is on track, and the company is investing well in future growth. Their infrastructure expansion in the Cayman Islands marks a strategic move toward expanding its non-India footprint. With careful planning and execution, this venture is expected to unlock new growth opportunities, adding value to their portfolio. We are in the process of initiating fresh exposure to one of NCR's large hospital chains, which is rapidly expanding across India with a focus on high-end tertiary and transplant care.

Sector #5/ Technology [Products, Services, Hardware]

The change rate and technological development underpin a growing opportunity set. We have taken exposure to one of the world's largest banking software systems firms, addressing the technology needs of the BFSI industry across a broad spectrum of their needs. As technology and the cloud become the core platform for delivering and consuming banking services, the firm's ability to address each industry's needs stands out, backed by financial performance.

Additionally, we observe a significant shift in enterprise behaviour on the hardware side, leading to a higher need for computing. The shorter product life cycles leading to innovation and advancements necessarily translate to rendering products obsolete faster. On the consumer side, there is an improving penetration of digital connectivity in retail [education, homes] and business [cloud, SaaS] and an acceptance of premiumisation and upgrades in products. Our investment is in a leading IT distributor in India and globally, which is a play on the above theme.

We are also aligned with one of India's largest IT Services companies, which is relevantly positioned to gain from the return of spending across BFSI and Manufacturing globally. The company also has a presence in an annuity-driven legacy software business.

Sector #6/ Diversified Consumption

We have exposure to India's largest tobacco company, which is demerging its asset-heavy hospitality business. This transaction is expected to significantly improve the company's Return on Capital Employed (ROCE) by freeing up capital and reducing the burden of maintaining capital-intensive assets. As a result, the core tobacco and FMCG business will benefit from better capital allocation, leading to enhanced profitability and shareholder returns. In the face of a challenging consumption environment, the company's FMCG business has performed well, while the core Tobacco business will grow in a range.

Our portfolio also includes one of India's leading home electrical firms. The company has consistently performed, benefiting from robust consumer demand in segments like lighting, fans, and appliances. With a focus on innovation and an expanding product portfolio, this business is positioned to capitalize on long-term growth in home electrification and urbanization trends.

Additionally, we hold an active position in India's largest cash logistics firm, which serves as a proxy for the growth of organized retail and financial services in the country. The company is actively diversifying its service offerings and tapping into the growing need for secure cash management, ATM services, and logistics solutions in a rapidly formalizing retail sector. This diversification strategy strengthens and aligns its business model with the broader growth of India's retail sector.

Sector #7/ Diversified Chemicals

We have taken exposure to a mid-sized Pharma API company, building an extensive product portfolio of low-volume and high-value APIs in a high-compliance environment. The company provides services throughout the stages of the product's lifecycle and allows itself to be present across the value chain. The company has been vying to leverage its client relationships in the generic API segment to foray into the CDMO segment. With the recent change in the company's ownership structure and capital allocation decisions, we expect higher growth potential. This is a firm with industry-leading margins, indicative of its positioning in the industry.

We have also taken exposure to the largest domestic agrochemical company in India, since 1958. The company has an asset-light business model with MNC parentage, primarily focusing on marketing and distributing agrochemicals and seeds in the domestic market. The company has one of the most significant field forces in the domestic agrochem business and excess to product pipeline of the parent. The company has restructured the cost structure in the last 2 years, focusing on high operating cash flow, payout to shareholders and capital efficiency.

	Sector	Investments	Exposure
1	Credit	PSU Banks, Pvt Banks	17%
2	Infrastructure	EPC, Water, Others	10%
3	Healthcare	Private Hospitals	11%
4	Technology	Product, IT Services	20%
5	Insurance	Medical Care	4%
6	Consumption	FMCG, Electricals, Cash Logistics	15%
7	Chemicals	API, Agro chem	6%
	Sub Total		83%

Across our portfolio, companies are successfully fine-tuning their operations to the present while continuing to invest in the future. Importantly, forecast earnings growth for the next three years is in a range we are comfortable with, alongside valuations.

While we maintain our current investments on a bottom-up basis, the broader macroeconomic environment is also supportive. This alignment between company-specific strength and a conducive external environment ensures that our portfolio is well-positioned to deliver sustainable returns in the medium to long term. We highlight two specific areas of Macro strength that are relevant in this context.

Fiscal deficit better than expected in FY24; Targeted to consolidate further in FY25

In its first Budget after elections in July 2024, it was learnt that the fiscal deficit in FY24 was 5.6% of GDP, better than the revised target of 5.8%. Thus, fiscal deficit was 92.5% of the budgeted target, the lowest in 16 years and the first over-achievement (<100%) in seven years. Moreover, the Government has budgeted a fiscal deficit of 4.9% of GDP for FY25, which is also lower than expectations. This means that it will achieve 4.5% of GDP by FY26, creating significant sustainability of growth. As a parallel, consolidating the Government's fiscal position allows the private sector to borrow and invest.

India's forex reserves cross US$700b | Led by low CAD and firm foreign capital flows

India's current account deficit (CAD) has been very contained in many quarters, while the foreign capital inflows have been strong. After a CAD of just 0.7% of GDP in FY24, it was 1.1% in 1QFY25. At the same time, the foreign capital inflows (including FDI, FPI and others) amounted to 1.6% of GDP in 1QFY25, following 2.5% of GDP in FY24. Accordingly, India's foreign exchange reserves have been rising continuously due to higher capital inflows than CAD. Accordingly, we are now the world's 4th highest holder of foreign exchange reserves (including Gold), behind China, Japan, and Switzerland. A lower CAD is a sign of economic stability, and it is crucial to attract external investment, keep borrowing costs low, and abetting access to growth capital.

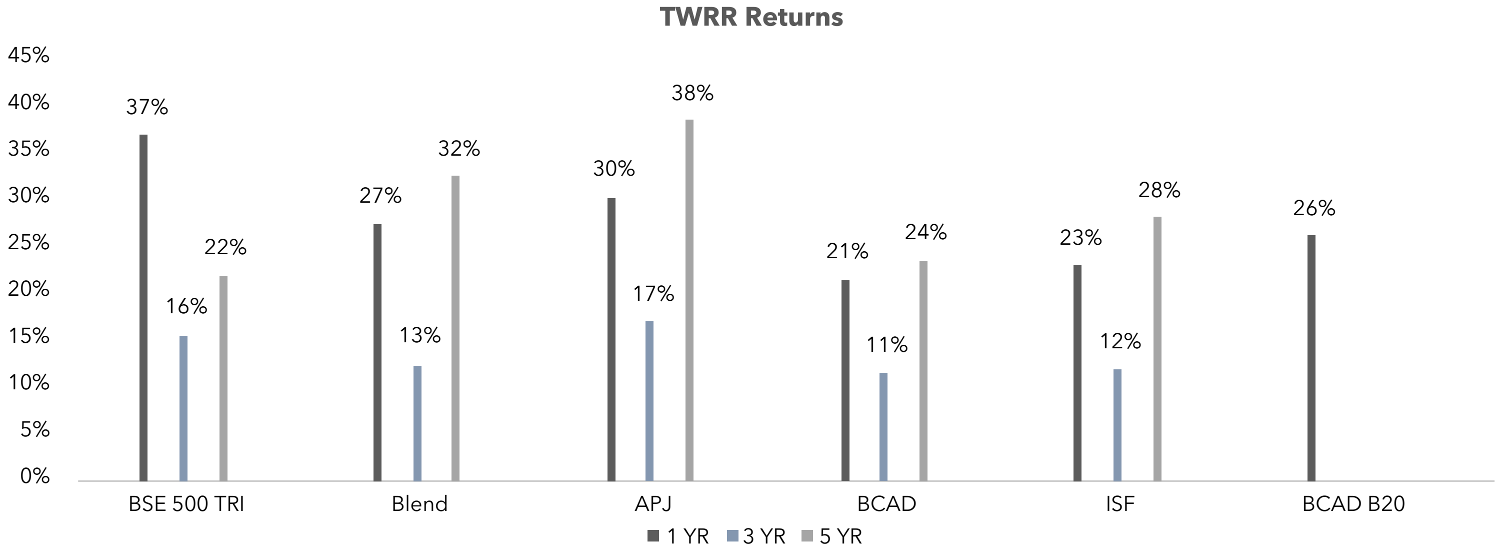
Monetary policy pivot

The key highlight of the quarter is the pivot in global and Indian monetary policy stance. Fed began the rate cut cycle with a material 50bps cut after a pause of nearly 1.5 years. This marks a decisive stance in global monetary regime where policymakers now focus on growth, versus, addressing inflation. Other large central banks like ECB, China too seemed to be focussed on stimulating growth. This is welcome as it provides elbow room for global policymakers to support growth, although the impact of monetary policy works with large and variable lags. While India is yet to experience a cut in interest rates, an expansionary world is positive for India. What this means for Indian markets is valuation comfort. This, combined with India's fiscal discipline, presents a healthy outlook for India's firms and markets.

Summary

We continue to take a wide-angled view of growth and seek to invest beyond the obvious. This allows us to harness the potential of lesser-known but high-quality growth companies. Our portfolio reflects a growing opportunity set that will deliver for the years ahead. In doing this, we are highly committed to evaluating risks associated with high valuations. This approach ensures detailed, firm-specific metrics drive stock selection and investment management.

As we have communicated earlier, index movements and earnings often oversimplify the market, reducing its diverse components to a single investment target. This obscures company-specific risks and investment potential. In times like these, we remain aligned with our process of managing risk and reward as we have over the past two decades, embracing growth investing within our framework of standards.



Returns as of 16th October 2024. BCAD2: Breakout 20 tenure < 3 years

The following sections outline our investment strategies and provide a performance summary for Q1FY25. Individual portfolios will vary in holdings and proportions based on the timing of your investments. Please do not hesitate to contact your relationship manager for a detailed review of your portfolios.

Review of Strategies

We have captured an outline of each of our investment strategies in the following sections with a summary of how the fundamentals of our key holdings have played out in Q1 FY25. Tail positions which are on their way out of the portfolios have not been discussed. Individual portfolios will vary in holdings and proportion based on the timing of your investment with Unifi. For a detailed review of your portfolios, please do not hesitate to contact your relationship manager.

BLEND/DVD

The DVD / Blend strategy continues to cherry-pick ideas from across the six distinct themes managed by Unifi, thereby investing in "the best of our best" and participating in opportunities across the breadth of the market. The ideas represent a mix of emergent themes, corporate actions, and fundamentally attractive bottom-up opportunities. We continue to focus on delivering superior risk-adjusted returns from an absolute perspective.

As of October 2024	FY 25E
Wt. Avg PE	25.1x
Wt. Avg PB	4.7x
Wt. Avg ROE	19.9%
Wt. Avg Mcap	Rs. 147,399cr

BCAD

The strategy continues to invest in sectors that are currently witnessing a shift in market share from the unorganized to organized players. As India's economy rapidly grows in scale and sophistication, several sectors are poised to undergo significant changes over the next decade. Most of our invested companies are likely to experience an increase in their market share, as marginal players find it difficult to operate in the new environment.

As of October 2024	FY 25E
Wt. Avg PE	24.1x
Wt. Avg PB	5.0x
Wt. Avg ROE	20.3%
Wt. Avg Mcap	Rs.1,68,304cr

BCAD2: Breakout 20

The BCAD 2 Breakout 20 strategy seeks to invest in sectors that are witnessing structurally high growth rates driven by demographic led consumption and larger stream of disposable incomes. The fund continues to focus on large operators with competitive advantage at scale, consolidating position in their respective categories.

As of October 2024	FY 25E
Wt. Avg PE	23.8x
Wt. Avg PB	4.4x
Wt. Avg ROE	19.9%
Wt. Avg Mcap	Rs.1,57,892cr

APJ

The strategy seeks to deliver absolute returns over a five-year horizon through investments in sectors that will benefit from the next stage of India's growth on the back of improvement in India's infrastructure, and policy climate. The APJ fund continues to focus on firms delivering manufacturing excellence broadly across technology, chemicals, pharmaceuticals, materials, and infrastructure in general.

As of October 2024	FY 25E
Wt. Avg PE	27.4x
Wt. Avg PB	5.4x
Wt. Avg ROE	19.4%
Wt. Avg Mcap	Rs.142,771cr

ISS

The Insider Shadow Strategy invests in fundamentally sound companies where there has been an increase in the promoter holding. Typically, such an action by the controlling shareholder demonstrates their conviction that the company's growth prospects, or inherent value is not captured in the stock price at that moment. Unifi's proposition is to gain from the eventual balancing of the value-price mismatch in the market by identifying and investing in such companies after a detailed review of their fundamentals and corporate governance standards.

As of October 2024	FY 25E
Wt. Avg PE	24.0x
Wt. Avg PB	4.8x
Wt. Avg ROE	18.3%
Wt. Avg Mcap	Rs.132,996cr

RISK MANAGEMENT

Risk	Mitigants
Coronavirus Impact	The impact from the ongoing Coronavirus outbreak in India and rest of the World can be multifold. The lockdown related slowdown in consumption can affect several sectors. Our investee companies have product & category leadership along the financial wherewithal to withstand temporary phases of demand slowdown and lead consolidation of demand. The BFSI sector could have heightened stressed assets for a certain period of time thereby impacting their profitability.
Geo-political risks	Any geopolitical tensions between India and neighboring countries can disrupt supply chain in the region. This might have a non-linear impact on business.
Raw material inflation	India continues to be dependent on the supply of feedstock whose pricing is global in nature. Key categories would be crude, metals, minerals, and natural commodities. Sharp movement in their underlying prices will have a short-term financial impact on the companies. The situation in China [political] has the potential to disrupt the supply chain of a few of our investee companies.
Liquidity risk (in case of NBFCs)	The NBFC led liquidity crisis in India has had a systemic effect on the entire economy. Our investee companies have been able to tap diversified sources of liquidity on the back of their long-term track record of comfortable asset quality and asset-liability-management (ALM). However, sustained deterioration of the asset quality can continue to affect our holdings in Banks and NBFCs.
Foreign Exchange risk	The foreign exchange system continues to be guided by global developments. Our investee companies in the IT sector are subject to sharp movements in the USD and GBP. They mitigate the same via hedging, but there remains a portion of revenues that continue to be subject to the vagaries in fx movements. Most of our non-IT exposure is to companies that derive their revenues from the domestic market. The revenue from exports would be minimal for each strategy as a whole, and where relevant, are adequately hedged. A sharp depreciation in the INR will affect the import of feedstock (higher prices) which can lead to a brief moment of earnings-related volatility.
Leverage risk	Except for financial companies, most of the operating companies in the strategies carry nil to moderate debt on their balance sheets with a track record of having managed leverage well in the past. Their leverage is monitored regularly.
Technology Obsolescence	Technological changes can render the products/services of a company obsolete and thereby hurt its profitability and valuation. Such a risk is generally minimized by limiting the aggregate exposure of portfolio to such investments to less than 10% of value.
Governance risk	We avoid investing in companies with a known history of corporate governance issues. If such issue arises in an existing investment, we stop additional purchases and start optimally exiting the investment.
Concentration risk	At the portfolio level, such risks are minimized by limiting the aggregate exposure of portfolio to such investments to less than 10% of value at the time of investment.
Stock Illiquidity risk	High Impact cost, due to thin trading at the time of buying or selling is endemic to small & mid-caps. We plan our investment decisions, size of the investment and trading strategies to minimize the costs due to illiquidity.
Key Man Risk	Small and mid-caps are frequently managed by a key promoter / person on whom the business is completely reliant and without whom the business would be materially inferior. We generally avoid such names and in cases where we make any exceptions, the aggregate exposure of portfolio to such investments is limited to less than 10% by value.

Slowdown in global consumption	The wallet-share of the investee companies in the global manufacturing value chain, does not pose a significant risk of loss of business to their vendors. New and high growth areas such as Lithium-Ion batteries, EV vehicles are in relative infancy stage and have a strong growth curve ahead of them.
Softness in IT product spends	The convergence to digital software solutions is a 'must do' proposition and our investee companies have exhibited significant traction in competing in this space. A combination of their recent deal wins, and current bid pipelines bode well for their future.

Thank you for placing your trust in Unifi.
Sincerely

Baidik Sarkar
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