UNIFI CAPITAL

REVIEW: Q2-FY 2025

Earnings Review, Q2 2025

The Indian market has experienced a notable correction, with the Nifty-50, Nifty 500, and BSE 500 Index falling 7% from their recent peak. While not significant at an index level, the recalibration is an attempt to bridge the valuations of select firms closer to realistic levels. The previous several quarters have been driven by an almost systemic detachment between stock prices and the fair value of companies, indifferent to conventional models of valuations. While the business models of several firms with elevated valuations may be robust, investments made at high entry valuations constantly square off against the risk of multiple contractions, a critical risk in GARP [growth at a reasonable value] investing.

Corporate India experienced its weakest quarterly performance in years, indicating a broad-based earnings slowdown in Q2 FY 2025.

Q2 FY 2025	Adj PAT Growth	
Index	**YoY**	**QoQ**
NSE 500	-0.9%	-5.8%
Banks – PSU	32%	9%
Banks – Private	10%	6%
Automobiles	-1%	-15%
Consumer	1%	-8%
Consumer Durables	26%	-20%
Healthcare	19%	0.3%
Infrastructure	23%	-21%
Technology	11%	3%

Two factors contributed to this downturn: (a) Extended Monsoons, disrupting agricultural output, and consumption, while (b) a significant slowdown in government capital expenditure [down approximately 15% YoY] resulted in pockets of slowdown in various aspects of infrastructure and allied areas. This trend was observed at both the central and state levels. As an extension, high inflation, particularly in food prices, and lower availability of less-than-prime credit affected household purchasing power.

However, as noticed in our portfolios, firm's with sustainable earnings continue to be recognized for their inherent strengths, standing out as reliable performers. This underscores the market's ability to reward long-term viability over near-term exuberance.

Investment Approach

Amid these uncertainties—often clearer in hindsight—it is imperative to embrace a balanced investment strategy that continually manages risks while seeking potential upsides. In this context, briefly touching upon Unifi's core investment approach may be helpful.

The market provides different opportunity sets at varying times across traditional value, growth, compounders, and special situations, across market cycles. The opportunity is to be aware of which industry and market cycle we are in and apply traditional fundamental analysis to each of the opportunities, bottom-up, evaluating the best prospect of risk-adjusted return. As investors enabled with a thematic and generalist approach, we pivot between different sectors based on the best opportunities the market offers at any given time. The duality of this approach is complementary. While a thematic view enables us to be cognizant of broader trends and how to price them, a generalist approach lends itself to flexibility and consistency over the long term. In between both lies a view that often comes down to our judgment on assessing risk/reward across opportunities based on our learning over cycles.

This is nuanced because, in a growth-driven market such as India, all growth is not equal. While the ideal growth company has an entrenched competitive advantage, expansionary market, pricing power, and a limited need for capital, in reality, most firms tick only a few of the characteristics, making triangulation of the essential variables key. A key area of judgment here is identifying business challenges, even if they are many years out. While these headwinds may not affect profitability and metrics in the near term, multiples will decelerate at a rapid pace with time. The risk of this playing out in a high-growth market like India cannot be overestimated.

In choosing the best investment options, we prioritize sustainable earnings growth, resilient business models tested at high frequency for disruptions, and sustainable capital efficiency in making investment decisions.

Over the last two quarters, Unifi has closely monitored its investments across sectors and repositioned where necessary.

India Macro's

A key reason Indian markets are showing resilience is the significant strengthening of its financial systems, low levels of debt that do not threaten solvency, and increasingly competitive businesses. The combined effect has resulted in Indian markets having the reserves to absorb external shocks. With near term GDP growth estimates of over 7%, a favorable Balance of Payments outlook, and a manageable fiscal deficit and inflation, the macroeconomic set for India from an investment point of view seems good. An analysis of several high-frequency indicators suggests directional momentum. Pockets of slowdown within categories may indicate consolidation and shifting of demand, based on innovation from suppliers.

% YOY	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-24	May-24	Jun-24	Jul-24	Aug-24	Sep-24	Oct-24
Water reservoir levels	-15.9	-20.4	-20.5	-18.5	-15.8	-15.4	-15.1	-16.8	-20.0	-24.2	6.5	27.3	20.8
PMI: Manufacturing	55.5	56.0	54.9	56.5	56.9	59.1	58.8	57.5	58.3	58.1	57.5	56.5	57.5
PMI: Services	58.4	56.9	59.0	61.8	60.6	61.2	60.8	60.2	60.5	60.3	60.9	57.7	58.5
E-way registrations	30.5	8.5	13.2	16.4	18.9	13.9	14.5	17.0	16.3	19.2	12.9	18.5	16.9
Toll collection (Units)	13.0	12.3	13.0	10.2	8.3	10.6	7.6	3.6	5.8	9.4	6.8	6.5	7.9
FX reserves	588.5	604.2	622.5	620.0	625.2	646.4	640.2	651.5	652.0	670.6	682.2	705.8	682.6
Currency in circulation	2.9	4.3	4.0	3.9	3.7	4.1	3.2	3.8	6.0	6.4	5.5	5.9	7.0
Vahaan registrations	-6.6	19.6	22.0	16.1	14.0	3.8	27.5	3.3	1.4	14.7	3.7	-8.7	32.4
PVs sales	19.4	5.5	1.6	15.3	15.1	14.4	3.6	0.5	3.7	-5.1	-3.5	0.1	0.8
CVs sales	13.4	216.8	-4.9	-1.6	-2.3	-6.6	14.2	2.4	-4.5	-6.6	-12.5	-12.9	3.0
Air cargo traffic	23.9	13.9	1.6	17.2	20.6	10.5	8.0	14.8	10.2	6.8	-6.6	-8.9	-8.1
Rail freight traffic	8.8	3.5	-0.9	3.7	15.1	-5.5	24.1	-4.3	13.3	9.4	2.3	2.9	
Power Generation	24.8	10.7	4.8	6.5	4.5	8.3	10.4	15.2	9.0	8.3	-4.7	0.4	0.8
SCB: Deposits	13.4	13.6	13.3	13.2	13.1	13.5	13.3	14.8	11.1	10.6	10.8	11.5	11.7
SCBs: Non-food credit	20.1	20.8	20.1	20.4	20.6	20.2	19.1	20.8	17.4	13.7	13.6	13.0	11.5
Fuel consumption	4.8	-2.2	3.7	7.3	8.2	1.7	7.8	1,9	2.3	10.7	-3.1	-1.5	2.9

Interest rates and Fiscal Deficit: It is widely anticipated that the RBI will begin reducing rates in the first half of FY26, driven easing domestic inflation to c. 4.5% by mid-2025–still above the RBI's target of 4% but significantly lower than the current policy rate of 6.5%. Notably, inflation in most developed and emerging markets has sharply declined from its peak and has shown signs of steady deceleration in recent months. The easing of geopolitical tensions will likely help stabilize commodity prices, supporting inflation. Additionally, India's fiscal deficit could potentially come in below the government's target of 4.9% (vs 5.6% YoY), driven by (1) stronger-than-anticipated growth in tax revenues, and (2) lower-than-expected capital expenditure.

However, there seem to be signs of a consumption slowdown in specific segments of the economy. While we will wait for more data over the coming months before drawing firm conclusions, the softer-than-expected performance of select FMCG

firms overall has been disappointing. This trend has prompted some earnings adjustments across specific sectors while opening up an opportunity to participate in the recovery from here on.

As active managers, we closely monitor our portfolios to identify and implement necessary adjustments. These include evolving macroeconomic conditions, shifts in firm-level dynamics, and emerging valuation opportunities. Our proactive approach ensures that we remain responsive to changes. Our rationale behind our key sectoral exposures is as follows.

Credit | Over the past few months, growth of the banking system has slowed from mid-teens to c.11% (as of 15th Nov'24). This slowdown can be attributed to challenges on the liability side, resulting in a slowdown in lending towards personal loans and NBFCs. This is a significant development, as it comes in the way of funding certain aspects of household consumption. Despite these headwinds, the banking system is well poised for strong double-digit growth over the medium term, including for the current financial year. Asset quality across the system continues to be favourable with some pockets of stress in credit cards and microfinance. Banks and NBFCs with higher exposure to these areas have seen weaker earnings, though corporate and retail customers with secured products continue to demonstrate strong credit discipline. Healthy corporate balance sheets and increasing awareness among retail customers about maintaining good credit histories will make credit losses manageable in the medium term. At Unifi, our financial exposure is predominantly to lenders offering secured retail products.

We have trimmed our overall exposure to the sector over the past few quarters, reflecting our approach to growth. We have increased our exposure to the second-largest PSU bank, which has strong fundamentals, a clean balance sheet, and is reasonably valued. We also hold a position in a mid-sized bank with reasonable exposure to credit cards and microfinance. While this bank has seen some stress, largely in line with broader industry trends, we believe the pressure is transitory, and the bank remains well-positioned to deliver healthy returns over the medium term.

Technology [Products, services, Hardware] | The current environment presents a case for IT services, as global IT spending is poised for a rebound, with inflation and interest rates expected to trend lower. As global macros improve, businesses worldwide are expected to resume productivity-driven IT investments. Our portfolio reflects a diversified approach, with allocations to large Tier-1 IT services companies, which cater to broad and complex global demands, and mid-sized IT firms that address niche, specialized market segments. Additionally we have an investment in a global product major, that will benefit from the spends of the BFSI sector, globally.

On the hardware side, enterprise demand for computing power is rising due to shorter product cycles and rapid innovation, driving both obsolescence and progress. Consumers are increasingly connected, with growth across retail, education, homes, and business solutions like cloud and SaaS. There's also greater acceptance of premium products and frequent upgrades. To capitalize on these trends, we've invested in a top global and Indian IT distributor poised for growth.

Health Insurance | The investment in India's largest private health insurance company has faced challenges, primarily due to an unexpected increase in the claims ratio, impacting performance. With measures in place to address these issues, we anticipate a period of consolidation over the next two quarters, positioning the company for stronger performance and sustainable growth in the future. The heightened awareness about medical insurance has driven strong growth across the board. As the country's most profitable health insurer, this company is well-positioned to match industry expansion while consistently improving its financial performance year after year. With the sector poised for sustained long-term growth, we are capitalizing on attractive, cyclically low valuations supported by robust financial fundamentals.

Healthcare | We are positive about the growth trajectory of India's healthcare infrastructure, particularly in the hospital sector. The sector is poised for robust expansion, driven by rising demand for quality medical services, a growing middle-class population, and higher insurance penetration. Our investments are diversified across two of India's largest hospital chains, both leaders in operational efficiency, patient care, and geographic presence. Geographically, between the two investments, the hospitals are spread deep across India's National capital Region, East India and Karnataka.

Diversified Consumption | We maintain a diversified exposure to India's consumption basket, with investments spanning tobacco, FMCG, passenger vehicles, and home electricals. Our strategy focuses on identifying pockets of growth within the consumption sector and areas where a strong reversal to growth is highly probable. These targeted positions enable us to capitalize on evolving consumer trends and demand patterns. While we currently hold small positions in a few of these segments, we are actively evaluating opportunities within the broader consumption space.

Summary

We hold a broad perspective of the investment universe in our pursuit of GARP investing. This approach enables us to unlock the potential of high-quality firms that are both prominent and otherwise. Cultivating a portfolio is a process of constant calibration, underpinned by constant assessment of risks. We have consistently emphasized that market indices and aggregate earnings often present an oversimplified view of the investment landscape, condensing opportunity and complexity into a single variable. A reductionist approach can obscure the unique risks and distinct opportunities associated with individual companies. This allows us to embrace investing within a framework of standards we are comfortable. .

The following sections outline our investment strategies and provide a performance summary for Q2 FY25. 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 Q2 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

The DVD / Blend fund 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.

November 2024	FY 25E
Wt. Avg PE	25.3x
Wt. Avg PB	5.1x
Wt. Avg ROE	18%
Wt. Avg Mcap	Rs.136,577cr

BC AD

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

November 2024	FY 25E
Wt. Avg PE	23.6x
Wt. Avg PB	4.9x
Wt. Avg ROE	20%
Wt. Avg Mcap	Rs. 146,240cr

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.

November 2024	FY 25E
Wt. Avg PE	25.8x
Wt. Avg PB	4.6x
Wt. Avg ROE	19.8%
Wt. Avg Mcap	Rs.138,900cr

APJ

The fund 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.

November 2024a	FY 25E
Wt. Avg PE	24.7x
Wt. Avg PB	4.9x
Wt. Avg ROE	19.2%
Wt. Avg Mcap	Rs.150,017cr

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.

November 2024	FY 25E
Wt. Avg PE	23.7x
Wt. Avg PB	4.7x
Wt. Avg ROE	18.2%
Wt. Avg Mcap	Rs.119,971cr

RISK MANAGEMENT

Risk	Mitigants
Geo-political risks	Any geo political 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
Head - Research

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