Unifi Quarterly Review - June 2018

Macro Developments: Rising rates & Trade wars

For the second time in the year, the US Federal reserve raised its benchmark rate by 25 bps to a range of 1.75-2.0% and signaled two further hikes in CY 2018 followed by three hikes the next year. Buoyed by the stronger economic indicators and the inflation inching up towards the 2% mark, the Fed is determined to harden the rate cycle. As a result, yields in the US have begun to look attractive, thereby putting pressure on foreign inflows into emerging markets, including India. Parallelly, higher crude prices combined with a weakening domestic currency make have made the macros all the more challenging for an oil importing country like India. A combination of these events has accentuated the stress in Indian equities that are on parallel dealing with a trinity of earnings catch up, steep valuations and a toxic banking sector. Foreign inflows in the near term is thus expected to be subdued.

On the political front, trade wars between the East and the West continue to go on with both US and China slapping one another with additional tariffs. And while OPEC had agreed to increased oil production by 1mn bpd which partly unwinds the 1.2mn bpd production cut enforced by the cartel in 2016, oil prices continue to trade higher as geo-political issues over Iran & Venezuela dominate the supply-demand dynamics. These developments have kept global sentiment wary.

Coming to India, the adverse macro conditions are having an impact on the markets on the back of higher input costs and a weakening currency, resulting in the markets seeing a valuation reset as investors take into account short- term concerns on macro parameters over longer-term trends which are favourable for a certain set of companies. As a result, there is a flight to safety as investors look for defensive positions with strong leadership. These have meant that the already expensive became a tad more so.

Fund Strategies

BC-AD - We have commenced deployment of funds in our latest thematic offering: BC-AD. In line with our investment theme of migration of market share from unorganised players to the organised ones, we have identified several stocks across sectors like Footwear, Logistics, Retail, Home accessories & Branded Innerwear that are seeing this in play. The majority of our portfolio today consists of consumer facing companies with strong brand leadership in their respective sectors. Our interactions with each of these companies have reinforced our conviction on their steady volume growth and their ability to gain market share from the unorganised space. One of our investee companies is a leading player in the **Footwear** industry. In an industry worth around Rs 40,000 Cr, heavily dominated by the unorganised players with almost 80% share, this company is a leading organised player that has doubled its revenue over the last 5 years while quadrupling earnings and has done so with healthy balance sheet discipline, maintaining an RoE profile of > 20%. With a uniform tax structure in the form of GST in place and a strong distribution network built over decades, this player is well poised to take up market share from unorganised players who would struggle to comply with recent changes in GST/E-way bill regulations. The growing aspirational demand of the Indian consumer for branded products also helps create strong demand for such organised players. In multiple sectors, such transition of market share to the organised segment is likely to happen due to triggers across regulatory actions, taxation changes, increasing urbanization, demographic changes and evolving consumer habits.

Green fund – Green fund's underlying investment themes continue to see good tailwinds due to changing industry dynamics and/or regulatory actions. The shift to **Natural Gas** is accelerating driven by environmental as well as economic reasons. The Supreme court has recently banned the usage of pet coke and furnace oil by industries in Haryana, Rajasthan and Uttar Pradesh. This augurs well for demand of Natural Gas within the NCR region. The latest round of city gas distribution auctions for 86 districts in India has also begun. As more and more geographies are covered with natural gas supply, it is estimated that gas would be accessible to 29% of India's population from the current 19%. The recent inclusion of natural gas under GST would help commercial users avail the 'Input tax credit' for their fuel usage thus making it economically more feasible. **Lead recycling** is another theme which is gaining traction. Our investee company in this segment has recently signed an agreement with one of India's leading battery manufacturer to collect lead acid battery scrap and recycle the same. **Coastal shipping** continues to be a key focus of the government of India. We had invested in the country's largest operator of coastal shipping and continue to be positive about the sector's growth potential. The average growth rate of cargo moved through costal waterways had increased sharply to 14.2% during FY 15-18 from just 1.4% during FY 10-14.

APJ - We are consolidating our positions in the APJ fund. Our largest holdings in this strategy is one of India's largest **fluorination** companies which has had a good year, recording earnings growth of over 30%. We have been invested in the opportunity since 2015 and continue to like them on the back of their absolute growth potential that they continue to offer. This company is one among the few oligopoly players in the industry and offers a unique platform to play the consumption story in increased demand for cooling refrigerants, and metals on the back of the successful acceptance of their inorganic fluorides. Over the years they have strengthened their capabilities in advanced chemistry and have now made inroads into the CRAMS business, which is doing well on the back of new age pharma production practices. We expect this business to deliver earnings growth in upwards of 25%, as it has been doing in the past few years. Moving on, our thesis on **Indian aviation** continues to remain strong. Passenger growth for a few years now has been higher at 15-20% and the operationalization of new airports under UDAAN scheme has buoyed further traffic, which will continue to aid growth numbers. However, the sudden hardening of the crude cycle has temporarily marred the economics of this industry and we have not hesitated to trim our exposure to the industry. We continue to monitor the space closely. A position we have added to materially in this past month is India's largest **manufacturer of coal tar pitch** that is now foraying into the specialty carbon space which is seeing increase in global demand driven by rising EM consumption. This is a product segment that offers a margin of profitability that is significantly higher than their existing product lines. As a parallel, the company is also investing in a new product line of advanced graphite materials that brings with it a high option value in the years to come. Another position that we have added to off late is one of India's largest **manufacturers of molded packaging** that has strong tailwinds of volume growth in the times to come. In the ensuing market conditions, we are steadily buying our favorite companies.

Rangoli/Blend - The fund's exposure is spread across sectors like Chemicals, NBFCs and Technical Textiles which are playing out as per expectations and in some cases have posted earnings better than our expectation. The **Chemicals** sector is witnessing good tailwinds for players who have diversified their procurement base like one of our investee companies in the fluorochemical space which saw an EBITDA growth north of 20% consistently throughout the year. Companies which are into specialty chemicals and are suppliers to domestic consumption stories, whether metal or tyres are expected to do well which is why we have enhanced our exposure in our current holding. One of our other positions is India's largest gold financing **NBFC**. We like the time tested secured nature of gold as an asset class. The gold loan business with LTV ratios at 70%, NIMs of above 10% and strong growth potential provides an attractive investment opportunity. After consolidation of the segment over the past 4 years, the AUM growth is expected to gain traction in the coming quarters. We also own a **Financial holding company** which holds stakes in a vehicle finance NBFC and a general insurance company. Both these underlying companies have been posting excellent operating parameters within their respective segments. We have also increased our exposure to **Lubricant** space where we have invested in a high-quality player who is adding incremental capacity in South India and taking market share away from other incumbents. This is expected to fuel their earnings growth in the medium term. Our holding in **Technical textiles** has delivered a 26% earnings growth in FY 18 which was higher than our expectations closing with Q4 earnings growth north of 50% lead by good exports' traction and enhanced value-added portion of the portfolio despite disruptions in domestic markets due to GST implementation. We believe that the momentum in the technical textile space will continue based on its diversified demand base ranging from Fishing, Infrastructure, Agriculture and Defense. Apart from these plays we continue to have tactical exposure to the **Technology** space.

Unifi Strategy

Near term macro-economic developments have turned challenging for the economy and this is now reflected in the higher volatility. However, the broader economy continues to perform well as some of the lead indicators like auto sales continue to register strong growth in their month-on-month sales numbers. The early onset of monsoon has bolstered hopes of a good agrarian season this year and this is a key pivot point for Indian consumption. The higher MSPs (minimum support prices) announced for agricultural produce should also lead to higher spending in the rural hinterlands. The World Bank has pegged GDP growth expectations at 7.3% for FY 19 and 7.5% for the next two years which makes India the fastest growing economy in the world. The NIFTY earnings growth in FY 19 is expected to be 20%+. The recent correction in the market especially in the midcap and small cap space offers a unique opportunity for aligning with opportunities that will benefit from this cycle of healthy economic growth post demonetization and GST. We are making of this opportunity to add to our high-conviction ideas which meet our internal criteria on growth, capital efficiency and valuations.

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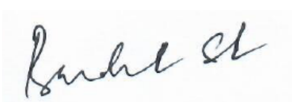
Risk: : Key risks to our portfolio would come from geo-political concerns globally, materially high foreign outflows, sharp currency movements, American and Fed policy announcements, steeper Chinese devaluation, spike in commodity prices and a prolonged delay in fiscal reforms. Global re-allocation of equity, which is not India centric will continue to happen and may result in turbulence from time to time. Indian markets as well as the INR will continue to remain vulnerable to global events, however unrelated to India. Interest rate hikes in the U.S may be a huge event risk and affect liquidity conditions domestically. NPA in the banking system and new IPO's may also hamper liquidity in the market.

Please do let us know if you'd like any clarifications regarding your Portfolio account with us. Thank you for placing your trust in Unifi.



Yours truly

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