India, Global and 中国的灾难

The barrage of high frequency data on global macroeconomy, domestic policy initiatives, and industry level indicators have led to a range of conversations about possible outcomes. The key principles to apply in interpretation of these datapoints are caution, reliance on most fundamentally plausible expectations, and analytical humility.

India

Expectations in the run up to the union budget were sky high. But with limited elbow room in terms of fiscal deficit, the government could only do so much. While the impetus on infrastructure spends were notable *(Rs. 1.7 Tn on infrastructure development for transport sector, expansion of National Gas Grid from 16,200 Km to 27,000 Km, Rs. 3.6 Tn allocation to water sanitation and pipeline projects, 100 more airports under UDAN)*, we are mind-full of the challenges in their execution. The adoption of lower tax slabs in lieu of waivers is a signal for the eventual migration to the Direct Tax Code which should be a favorable outcome for India the long term. Overall, measures which could be seen giving an immediate boost to domestic consumption were limited. However, we believe FY-21 will be moderately better due to base effect *(BS-6 transition, weak rural incomes in FY-20, and disruptions due to the general elections)*. Beyond that, challenges to all the major drivers of GDP remain: with low household income growth, weak government consumption (high fiscal deficit) and cautious corporate balance sheets. These factors are unlikely to change quickly. The RBI in its monetary policy meet has kept the rates unchanged at 5.15% but has committed to maintain the accommodative stance to revive growth. In a positive surprise, RBI exempted the need for maintaining Cash Reserve Ratio for 5 years in the case of incremental loans disbursed to Automobiles, Residential housing and MSME sectors. While there is no firm indicator of a wide-ranging economic recovery, there are select pockets of bottom up opportunities with the right mix of valuations and margin of safety in which we continue to participate.

中国的灾难 | Disaster in China

The nature of any pandemic is such that a huge amount of uncertain, and (largely) inaccurate information floods global media. India is a net importer of several varieties of feedstock from China and as things stand today, there is likely to be a disruption in supply chain. Whether this is marginal or not will be determined in the next few weeks. We are cognizant of the effect of the fall-out on all our positions and are taking appropriate actions where required. After clocking the lowest economic growth in a decade at 2.9%, the global economy was expected to improve to a 3.3% growth rate in CY 2020. However, the situation in China (19% of global growth) will push growth rates down and one hopes this is transient.

Consolidation

Two thought processes have been the overarching drivers in India Equity markets off late: (a) firm visibility of growth; and (b) the perception around quality. While not novel, coming off a trough of falling earnings and valuations, the narrative around both growth and quality have shaped the current phase of markets. In several cases, these have translated into valuations that are lacking in Margin of Safety, but such is the nature of the markets. Every cycle comes with a new narrative, and as prices change, the narrative around the prices change. In the just concluded 3rd quarter of FY-20, most of our holdings across strategies have delivered earnings on expected lines, and we expect them to consolidate their position within the industry in the times to come. Where necessary, we have trimmed exposure to positions that have exhibited a run up that far exceeded their fundamentals. We notice renewed appetite for firms in specialty chemicals, niche NBFCs and high growth consumption franchisees. We will continue to align with firms that exhibit a high quality of earnings growth, capital efficiency and governance without compromising on the margin of safety.

Review of Strategies

We have captured an outline of each of our investment strategies in the following sections. Please click on the links provided under the relevant strategies for a detailed summary of how the fundamentals of the invested companies have played out in Q3 FY20. The earnings review for the quarter have been presented at a PBT level so as to give a true measure of their growth in profitability, given the material impact of the one-time tax cuts. Kindly note that 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.

BC AD | The fund continues to invest in sectors that are currently witnessing a shift in market share from the unorganized to organized players. With regulatory compliance like GST & RERA getting stringent by the day, it will be incrementally tougher for the unorganized and marginal players to continue benefitting from tax and/or regulatory arbitrage. Shifting consumer spending patterns towards branded goods are also helping the respective sector leaders increase their market share and deliver growth that is higher than that of their industry.

As on Feb 19, 2020	FY20E
Wt. Avg PE	40.4x
Wt. Avg PB	10.6x
Wt. Avg ROE	29%
Wt. Avg Mcap	Rs. 19,936 cr

DVD / Blend | The DVD / Blend fund strategy continues to cherry pick ideas from across the seven 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 on Feb 19, 2020	FY20E
Wt. Avg PE	21.4x
Wt. Avg PB	3.9x
Wt. Avg ROE	19%
Wt. Avg Mcap	Rs.11,680 Cr

Spin Off | The spin off fund seeks to generate superior risk adjusted returns relative to market indices by investing in stocks of companies that are undergoing a corporate demerger. Typically, in a transaction such as this, the sum of the parts of valuation of the different companies that are undergoing a separation is higher than the market cap of the de-merged entity. The fund's proposition is to gain from the fundamental asymmetry linked value-price mismatch, by closely tracking the entire Spin-Off process and investing in such companies, subject to a comfort from bottom up fundamentals.

As on Feb 19, 2020	FY20E
Wt. Avg PE	21.0x
Wt. Avg PB	5.2x
Wt. Avg ROE	23%
Wt. Avg Mcap	Rs 10,831 Cr

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, economic and policy climate. The fund continues to consolidate its exposure among its top holdings that are expected to have significant fundamental and operating tailwinds in the times to come across sectors such as chemicals, packaging, logistics and manufacturing.

As on Feb 19, 2020	FY20E
Wt. Avg PE	23.6x
Wt. Avg PB	4.5x
Wt. Avg ROE	21%
Wt. Avg Mcap	Rs 8,509 Cr

Green | The fund continues to invest in sectors that would benefit from India's evolution towards a more "sustainable economy". The investment universe would comprise of well managed businesses offering best in class solutions to address challenges in the areas of Energy, Emissions, Waste and Water.

As on Feb 19, 2020	FY20E
Wt. Avg PE	13.5x
Wt. Avg PB	2.7x
Wt. Avg ROE	17%
Wt. Avg Mcap	Rs.5,313 cr

Risk

Risk	Mitigants
Coronavirus Impact	The impact from the ongoing Coronavirus outbreak in China can be multifold. Companies which are dependent on China for their raw material supplies may see supply chain disruptions leading to lower output. The scarcity of raw materials can also lead to price inflation leading to erosion in margins. A prolonged lack of production in China can potentially bring down the global economic growth.
Consumption slowdown	The Indian economy has witnessed a general softness of demand across all non-discretionary categories of consumption for the whole of FYTD-20. Reversal of the same will depend on the recovery in economy, better disposable incomes and the willingness of consumers to increase their non-discretionary spends. How long it takes for sentiment to return to consumers remains to be seen. Our investee companies have product and category leadership and the financial wherewithal to withstand temporary phases of demand slowdown, and lead consolidation of demand.
Raw material inflation	Indian 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 (Corona Virus) 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 cycle can continue to affect our holdings in Banks and NBFCs.
Foreign Exchange risk	The foreign exchange system continues to be guided by global developments spanning Brexit, US-China trade war, OPEC related developments, and other geo-political issues. 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 moments of earnings related volatility.
Leverage risk	Except for the 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. Further, in case such issue arises in an existing investment, we stop additional purchases and start optimally exiting the investment.
Concentration Risk	High concentration of holdings is a recurrent feature among small and mid-caps. 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 single 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.

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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