UNIFI Capital

# APJ 20

# 2020 VISION

In 1998, Dr. APJ Abdul Kalam co authored a book "India Vision 2020" along with eminent scientist, Y.S Rajan. The book was a result of an extensive exercise spanning the involvement of about 500 experts with unique expertise across industry, academic and government institutions besides inputs from about 5000 experts who contributed indirectly through responses to questionnaires and other inputs.

In about 300 pages over 13 chapters, the authors have discussed how institutional capacity building in a few sectors and consolidating their strengths there upon could help the Indian economy gain momentum and maintain sustainable growth for the coming decades and beyond. The resultant focus industries that held the potential for non-liner growth were are as follows: (a) agriculture & food processing, (b) power & infrastructure, (c) specialty manufacturing & chemicals, (d) IT and (e) health care. In the subsequent year 1999, BJP formed its first full term Government, implemented some the suggested initiatives and honored Dr Kalam by inviting him to become the President of India.

# BEYOND 2020

In 2014, before BJP returned to form the government, the same authors wrote a sequel titled as "Beyond 2020". They reviewed the performance of each sector since the time of Vision 2020; though India did well in IT and Healthcare, growth in other verticals was hamstrung by missed opportunities and slowdowns in project execution.

> *"A renewed policy focus is needed now for agriculture, manufacturing & engineering, mining, chemicals, healthcare and infrastructure to invigorate these sectors and boost economic growth" –*
>
> *Dr. Kalam & Y.S Rajan Co Authors of "Beyond 2020"*

The recent initiatives by the present Government like "Make in India" focusing on manufacturing and the successful implementation of several policies that go a long way in enabling the same indicate the relevance of the above argument of Dr. Kalam. Hence, we believe it is time to revisit the investment opportunities in all the identified business sectors as above that could benefit from a new thrust and tailwinds not just from Government action but also from the way such businesses have evolved over the years.

## Investment Theme: APJ 20

Unifi was fortunate to have forged an acquaintance with the co-author of the book Mr. YS Rajan and was privy to the thought processes behind inferences made on the businesses highlighted in the book, backed by elaborate study by both the authors over the years. We also undertook an independent research exercise of listing out the specific companies operating in all the sub segments discussed in the book page by page. We developed a probable universe of investment ideas from the following sectors:

### AGRICULTURE:

The entire eco system across Seeds, Food Processing, Irrigation systems, branded sellers etc.

### MANUFACTURING:

Essentially engineering companies like power, auto ancillaries, defense, etc.

### SPECIALTY CHEMICALS

The entire gamut of core and specialty chemicals

### MINING:

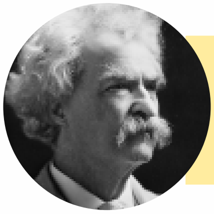
Rather than just mining companies, focus on businesses that would facilitate the initiative like explosives manufacturers, wagon builders, evacuation and safety equipment makers as well as beneficiaries like power etc.

### INFRASTRUCTURE:

Select subsectors like suppliers to the railways, downstream power industry & construction equipment makers.

Over the years, each of our target sectors has built a niche set competencies that have bordered on being disruptive. This has translated to them enjoying a quasi-oligopolistic status in their industry. However, these developments in absolute terms are at a small number. The evolution of the end user industry is such that, this base is poised to experience high growth and operating advantage over the next few years. In other words, each of these firms, have a high inbuilt option to participate in a disproportionate pay off.

Our endeavor is to participate with concentrated positions across sectors that will be a direct or proxy beneficiary to the growth in the specified industries. While our study of the opportunities reveals the underlying and obvious risks that could play out in future, we believe the risk reward equation is favorable to an equity investor at current valuations considering the next 5 years' potential growth.



*"During the gold rush, it's a good time to be in the pick and shovel business"*
*– Mark Twain*

## *THEME APPROACH*

During the famous California gold rush in 1850s, while the initial miners made significant profits due to limited competition and easier mining, the late arrivers made only modest profits. As the rush became intense in later years, more than half of the miners made nil or negative returns. However, entrepreneurs who were in the business of transportation, equipment rentals, hospitality and retail made a greater return overall.

This is not unique to one incident or one country but several examples in most businesses universally. Our thoughts in this theme are similar. For example, our bullish view over the positive transformation of mining industry post the recent Government initiatives would make us consider opportunities among explosives manufactures, wagon makers, crane and earth moving equipment makers, evacuation facilitators, coal washeries, mine safety appliance companies rather than just mining companies.

An equities investor could approach these "Pick & Shovel" businesses through any one or a combination of the following three categories of stocks:

1. Invest in large companies with established businesses across several segments, few of which could benefit from the new initiatives (like Tata's, M&M or L&T benefiting from new thrust in domestic sourcing for India's defense requirements; each of them are into areas such as armament technologies, ship building, etc)

2. Consider companies with established businesses but pursuing newer opportunities in related fields opened up by these new initiatives (like Rallis that has an established pesticides business but would benefit from the new thrust in productivity in agriculture through their seeds foray a few years back which currently constitute 30% of revenues)

3. Evaluate companies with one or two products which are in a fundamentally transformative phase due to the current policy initiatives (like Premier Explosives who have built more than one franchisee across mining explosives & defense and could benefit from better demand in the sector)

While the first category appears safe, potential return could be moderate as the incremental impact will be marginal. The third category is exciting but also bears great execution risk given the size of the company and their ability to bear policy shocks. The second category constitutes medium sized companies with an established record of execution and balance sheet strength and is best suited to pursuing opportunities privy to evolving demand tailwinds.

APJ 20 would mostly have names from the second category and few from the other two. As our intent is to build a universe of ideas that offer growth prospects at reasonable price, it is safe to assume that the portfolio would mostly constitute midcaps though we will be open to look for opportunities in other categories as well. In addition, the mix may undergo changes dynamically as the risk / reward proposition changes in the market.

*"Bull markets are born in pessimism, grows in skepticism, matures in optimism and die on euphoria"*
*– Sir John Templeton*

## *THEME RISKS*

The above quote is the most important one in investor's life. It is not only relevant for markets but holds good for business sectors as well. Investor skepticism is all around in these businesses that APJ 20 intends to invest. We may be ahead of time but would like to invest before optimism sets in the price. We will ensure to exit when euphoria returns. Investing in businesses currently not fancied by the market but looked with skepticism, require high conviction not only from the fund manager but equally by the investor as well. In absence of such a temperament on the part of the investor, considering themes like APJ 20 may hurt the investor return due to early termination decision by the investor.

Companies in sectors like IT, Pharma, FMCG and private banks have had excellent performance in the recent past and hence have gained heavy weightage in all major indices. They are currently fancied by the market as reflected in expensive valuations. APJ20 may avoid these businesses. On the other hand, the businesses APJ20 strives to look for as detailed above, would have had volatile or uncertain growth trajectory and hence might not have offered great shareholder returns in the recent past.

As in any contrarian approach, high conviction level and longer time horizons are essential to allow them to perform. Investor temperament to tolerate the divergence in portfolio return from that of major indices is equally important and therefore APJ 20 may not suit investors who have a penchant need to benchmark their portfolio returns in line with indices at regular intervals.

## Tenure & Commercials

Though we do not intend to have any lock-in, only those investors with five years outlook are suggested to consider allocation to this theme. Our investee companies could regain earnings momentum as some of these new business initiatives take shape. PE (Price/Earnings) valuations could improve as earning momentum sets in, resulting in potentially outsized return.

## The Unifi Advantage

Owner earnings, (Warren Buffet's term for shareholder returns), is always higher in "Pick & Shovel" businesses than the primary end user industry as past evidence proves. Many such companies pursuing the above said businesses remain in "Small & Medium Capitalisation" range.

Unifi has 15 years of experience in managing concentrated portfolios in the "small and medium" space, which is traditionally where most of value mispricing occurs. We have had a successful bouquet of niche themes specializing in small/midcap space like "Insider Shadow Fund - ISF", "Deep Values @ Discount - DVD", "Spinoff Fund", "Holding Companies Fund - HOLDCO", "Delisting Fund" etc. Each of these themes has had an exceptional track record as evidenced by the performance numbers both in absolute and relative terms.

Malcolm Gladwell beautifully portrayed in his recent bestseller "David & Goliath", in the balance of power between the small and the mighty, the giants always lose in any unconventional war or game. The same holds true in niche investing themes as well.

Our evolution over these long years has clearly demonstrated the need for process driven research backed with in-house research to validate the underlying companies' performance at regular intervals. Institutional research in this space is anyway far and few. Our insistence on management meetings in order to gain a significantly broader understanding of the business and its nuances has paid of handsomely at troubled times when we take high conviction calls.

## Structure

The portfolio is likely to have around 15 to 20 stocks in the PMS platform. The investor's assets will always remain in the investor's name with ILFS as custodian. While the tracking and monitoring of the investments will be active, the activity level of trades will be passive, resulting in lower transaction costs and better post tax return. For the existing clients, as the existing PMS platform is being used, there is no need for any further documentation other than an email exchange confirming the interest and commercials. For new investors, the PMS platform could take about 1 to 2 weeks to set up.

## FAQs

01. There have been many authors/economists/radical thinkers who have written numerous books on India's future potential etc. So why APJ? What exactly is the inspiration you have derived?

Unlike other books of this genre, the books "Vision 2020" and its sequel "Beyond 2020", authored by Dr. Abdul Kalam and Dr. YS Rajan not only provide a macro observation of businesses in which growth opportunities exist but focus on hard facts that highlight the relative merit of these businesses. Instead of making sweeping generalizations, both the books chartered the path of documenting the progress made in improving the "eco system" in various sub sectors of these businesses. In addition, the clear foresight behind the observations on how well such businesses are likely to evolve in the coming years, is backed by strong homework that is evident with the way facts are provided in the two books.

When we undertook a detailed study of validating some of these observations with current status of such businesses, we could find an interesting universe of investment ideas which otherwise would not have come into our radar and investment horizon. They might not currently exhibit the kind of underlying performance that markets are looking for but posses all the characteristics to deliver such performance in near future.

When we build a portfolio of investment ideas based on such inferences expressed in a book or theme, we run the risk of being well ahead of the time. We are conscious of the "ahead of the curve" timing risk and hence seek 5 years mandate.

02. What are the 'trigger points' when considering a stock idea for APJ 20 besides their sector?

Instead of depending on any specific triggers to spot investment opportunities like we have done in the past in Spinoff/Holdco/Insider Shadow themes, in APJ 20 we strive to look for those specific companies that have evolved in their business domain as detailed in the theme note and are currently in an inflection point of growth either by pursuing the same business in a grandeur scale or undertaking business opportunities in related field that have opened up recently.

03. This theme appears similar to the infrastructure story which everyone was talking about in 2007 and investments made then are still in red.

Between 2003 and 2007, Sensex rallied from 3000 to 20,000. During this rally, industrials, infrastructure, real estate stocks outperformed FMCG, pharma and other defensive stocks. In the last leg of the rally in 2007, mutual funds collection in Infra funds were 10 times more than that of the previous year. Infra was the best performing sector within indices. Based on the positive order flow, Infrastructure companies were able to build massive balance sheets with both equity and debt funding.

The absence of risk capital post 2008 financial meltdown, excesses in bidding wars in infrastructure projects at "sure to make losses" prices by corporate entities, insanity behind extrapolating the revenues of PPP model without accounting for project delays, scams that broke out in subsequent period resulting in chaotic conditions with regulatory and court interventions and a chain of other endless reasons are the reality behind the much hyped "infrastructure" story.

Unlike 2007, there are no signs of investor hype behind the businesses that we are considering in APJ20. Based on the recent strong performance of companies and their stock price, such excesses could be seen in some cases FMCG, Pharma and private banks but not in businesses that we are looking at. Neither the balance sheets of companies we are considering are as leveraged as the Infra companies of 2007 and nor do current valuations reflect any sign of exuberance.

### 04. If the sector/stock selection is based on current or expected Policy initiatives of the Government, won't a change in the policy affect the merit of such a selection

No. There are two layers of care we have exercised while building the universe of ideas to make investments. One, many of the businesses in APJ universe have become attractive independent of Government policies. For example, sectors like Auto ancillaries have grown in size and are in a cusp of major growth in coming years due to expanding potential both in domestic and overseas markets. Their growth mostly depends on engineering quality and scale of economy benefit accruing to them rather than any specific policy initiative. Second, even in companies where policy initiative carries an incremental weight in their investment merit, we strive to look for opportunities that have been opened where long period of seasoning in implementing such initiatives have lapsed. For example, though the "defense sourcing offset" policy has been initiated a long while back, they are yet to reflect meaningfully today.

In any case, we will avoid companies whose survival is a function of Government policies and change in such initiatives could significantly hurt the underlying companies' fortunes.

### 05. When you have many successful themes like DVD, Insider Shadow Fund why one more theme? How is APJ distinctly different from the rest?

One of the curses in fund management industry is "Style drift". Raising an IT fund because IT is currently in market's favor but finding an investment merit in ITC because market interest has shifted is in a sense "playing to the gallery". Just because "Deep Values at Discount" theme has worked well by delivering above 50% CAGR over the last 3 years doesn't mean any investment idea can be pursued as Deep value. Our DVD portfolio companies have had lean balance sheets with debt levels less than 0.5, have high current earnings growth of more than 20%p.a. but still trade at reasonable multiples around 15 times. Many ideas we intend to pursue in APJ theme may not have these characteristics. Such companies in our APJ universe may neither be a spinoff nor a holding company. Hence it requires a separate theme to accommodate such ideas.

It is easier convincing an investor about a theme that is currently fancied by the majority investors like FMCG, Pharma, IT and Private Banks as evidenced by the expensive valuations larger companies in this space are trading at. We believe in the relative merit of businesses APJ would pursue and hence willingly venture out to take a contrarian stand.

### 06. How often are you going to measure interim progress of this fund? Will the investments be held passively or have active churning?

Each of the ideas selected would be based on the long term trend emerging in the businesses and the company's ability to harness the positive trend. The investment positions will be actively monitored on regular intervals, quarterly/annually.

We believe the theme would not require any active churns in ideas for few years. In cases where market provides alternate ideas with better pricing, we may occasionally consider them. Low churn results in lower transaction costs and better post tax return.

Ideal frequency of review of the interim progress of the theme would be done annually after the results season in June. While we may consider stock specific review internally from time to time based on the evolving developments, we intend to provide bi annual review to clients with a presentation by fund managers as we have done in the past for our other themes as well.

### 07. Will the portfolio be fully invested always?

Given the long investment horizons and concentration risks in sectors that are currently not fancied by the market, it is critical that the fund manager be free to cherry pick specific opportunities after conducting a thorough due diligence. Unlike businesses like IT, Pharma, Banks and FMCG, most businesses we are considering in this theme require extensive primary research in absence of Institutional research.

Absence of adequate research coverage is probably one reason why the attractive pricing exists in many of these opportunities currently. It is certainly probable that we might prefer to hold cash and wait for interesting opportunities to ripe rather than overly focused on being fully invested immediately after the capital infusion by the investor. Though we would desist from market timing, time gaps in implementing investment plans may result in cash from time to time.

:

## 08. How will you benchmark performance?

Since most companies will tend to be from the midcap space, it would be appropriate to benchmark with the BSE Midcap index. However, it is important to recognize that most indices including Sensex, Nifty and midcaps are tilted in favor of stocks belonging to businesses that have done well in recent years like IT, Pharma, Banks and FMCG. Their exposure is as much as 2/3$^{rd}$ of the index.

Since the businesses that APJ stocks belong to are poorly represented in major indices, active benchmarking would exhibit significant divergence in portfolio return. For investors who aspire to beat benchmarks at constant intervals like every year, this theme could disappoint. It may be worthwhile to remember what the legendary Warren Buffet quoted regarding benchmarks. "If you disregard benchmark orientation, you will eventually beat it". We completely agree.

## 09. Why Unifi? When there are so many similar themes available across various funds with cheaper fee and tax efficiency?

Unifi has three distinct advantages. Though Unifi is large in its sphere of niche investment themes, its relatively smaller size as compared to mutual funds and other larger managers enable it with a larger pool of investment ideas to choose from. Unlike other trades, in fund management "being smaller" has its own advantages.

As the pool of ideas are likely to come from various businesses that are not correlated to each other and such businesses are not currently fancied by the market, the returns could be bumpy and deviate significantly from the benchmark indices. More over high cash levels from time to time could make the return divergence lot sharper making active benchmarking in the short term quite misleading.

It is essential to help the investor understand the reasons for such prolonged return divergence and appreciate the merit of such contrarian approach. Unifi's active engagement with each investor client directly at constant intervals backed with research presentations on one to one basis helps retain the investors through the full cycle of the theme and achieve better investor return.

# Notes

Disclaimer

Securities, investments are subject to market risks and there can be no assurance or guarantee that the objectives will be achieved. As with any investment in securities, the value of the portfolio under management may go up or down, depending on the various factors and forces affecting the capital market. Past performance of the Portfolio Managers is not an indication of the future performance of the Portfolio Managers. Investors in the fund are not being offered any guaranteed / assured returns.

This information has been compiled from sources we believe to be reliable, but we do not hold ourselves responsible for its completeness or accuracy. References to actions of specific companies have been made as a matter of fact but the comments on such actions represent only our judgment and analysis and not that of the specific companies. This material is not an offer to sell or a solicitation to buy any securities or any financial instruments mentioned in the report. Unifi Capital Pvt. Ltd. and their officers and employees may or may not have a position with respect to the securities / other financial instruments mentioned herein. Unifi Capital Pvt. Ltd. may from time to time, have a consulting relationship with a company being reported upon. All opinions and estimations included in this report constitute our judgment as of this date and are subject to change without notice.

# CONTACTS

| | | |
|---|---|---|
| Mumbai | Harshawardhan Agarwal | 99301 12828 |
| | Chandni Shah | 99205 25910 |
| Chennai | Maran Govindasamy | 98410 96034 |
| | Krishna Prasad | 98947 40044 |
| Bangalore | Christopher Vinod | 96322 44747 |
| Hyderabad | Prabhakar | 98496 69488 |

UNIFI Capital

Unifi Capital Pvt. Limited, 11, Kakani Towers, 15, Khader Nawaz Khan Road,
Nungambakkam, Chennai - 600 006.
Tel: +91-44-28331556, +91-44-28332732 Email: info@unificap.com
www.unificap.com

Mumbai | Chennai | Bengaluru | Hyderabad