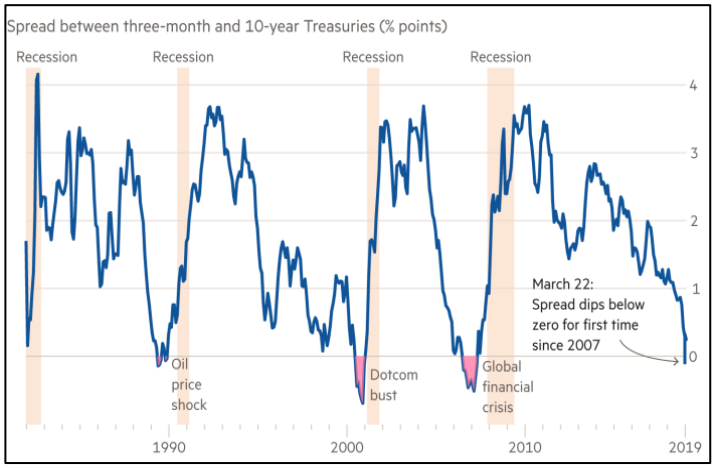
Global Economy | Slowdown on cards

The global economy is all set for a slowdown in 2019 with the IMF estimating the annual growth forecast dropping to 3.3% this year from the 3.6% recorded in 2018. In March, the world was also alarmed about the risks from the '*inverted yield curve*', a phenomenon which historically preceded recession in the US (chart as below). However, recent policy response has started to address these concerns and reduce the risk of a recession. After undertaking *four* rounds of rate hikes in 2018, the US Fed is now charting a complete turnaround in its strategy as it projects zero hikes in 2019. The Fed added that it would be slowing the shrinking of its balance sheet by decreasing the cap on monthly redemptions from the current $30bn to $15bn & eventually bringing it to zero by September. The fact that the real rates are close to zero in the US, should also alleviate any concerns of an imminent recession. The same had averaged 3% during the past 6 inversions.



The Euro zone is not looking pretty either with a clear trade slowdown and Brexit continuing to take their toll. The warning signs in the euro zone have already forced the European Central Bank to redraw its plans for exiting stimulus measures. They've also pushed investors into government bonds, sending the yield on 10-year German debt below zero for the first time since 2016. UK premier Theresa May has been struggling to get a Brexit deal backed by the parliament.

China is grappling with its own growth issues as the trade war with US looked to worsen the already slowing down economic engine. Beijing has already lowered its GDP growth target to 6-6.5%, lower than the 6.6% it clocked last year.

Emerging markets are set to benefit from this situation as capital from developed markets commence their flow towards EMs in search of higher rates. India has already started to react positively. As the outlook on liquidity developed in the US, Indian markets have been rerated positively. It is a different matter that this re-rating coincided with the geo-political occurrences in this part of the world, sending confusing signals on cause and effect to investors locally.

India | Rates, Oil, ballots and more

With the glide path on consumer inflation looking favorable, the RBI took to consensus by cutting interest rates by 25bps to 6%. The bank revised the path of CPI inflation to 2.4% in Q4 FY19 from the earlier number of 2.8%, while projecting it to be 3% & 3.7% in H1 & H2 of FY 20 respectively. The GDP for FY20 has been pegged at 7.2% with risks evenly balanced. After tight liquidity conditions in India post a mini NBFC contagion, this spells good news for the year to come. This is an economic +ve to look forward to.

Oil prices however have kept the economy nervous, with OPEC determined to shore prices artificially. As per reports, global oil demand may have peaked, and with EVs expected to displace a few thousand barrels every year, this may be the only measure OPEC has to shore prices up. While this is a pain point, the return of foreign flows has helped strengthen the INR, also cushioning the current account deficit.

And with the poll bugle on, the near-term political outcomes may affect sentiment more than the macros. Just until the fortnight after the 23rd of May (counting day), that is.

In factoring the above designs, the Indian markets reached record high levels shrugging off near term risks. While geopolitical issues rattled the street briefly, the subsequent flow of economic events has contributed to significant strength. In March-19, the benchmarks Sensex and Nifty gained 8%, while the Bank Nifty gained was the pick of the indices scaling 13%. The change in global liquidity outlook saw foreign investors pump Rs 33,980 Cr into domestic equities in March, double the Rs 17,219 Cr invested in February. These numbers are the highest ever for a single month.

The rally has definitely surprised market participants given the fact that the domestic economy is yet to show signs of strong economic growth. Auto sales, both passenger

vehicles and commercial ones, have been lackluster. The festive season related consumer discretionary spending was also on the lower side this year as seen from the Q3 FY19 earnings. Have the markets come to the conclusion that the elections will throw up a strong government at the Centre? Are they pricing a strong earnings trajectory in FY 20, driven by Banks and return of private capex? Are the strong foreign flows here to stay when the growth outlook looks bleak in the developed world? These are some of the questions that would become clearer over the coming months.

Our medium term view

We reiterate our views to you from our note of January this year: "*We expect* a *strong rebound in earnings growth of 20-25% in FY-20 on the back of the improving credit growth, stronger urban/semi urban consumption & revival in the capex cycle*". While we hope for a strong & progressive government to form at the Centre, we are aware of the fact that India's historical growth story had remained intact over the medium to long term in spite of a change in the government of the day. Also, unlike the 2014 administration, the people in power in 2019 have much better tailwinds in the form of: (A) cleaner banks with the ability to jumpstart the next capex cycle, (B) GST reforms already rolled out and early signs of improvement in collections. March 2019 saw a monthly GST collection of Rs 1,06,577 Cr, the highest ever, (C) private industry witnessing higher utilisation levels, potentially starting the next wave of private capex, (D) strong public spending in roads, railways & infrastructure which can trickle down as demand for multiple allied sectors, and (E) direct transfers being increasingly used as the preferred medium to pass on welfare benefits. A combination of these measures will significantly drive the multiplier effect, eradicate pilferage and boost consumption.

While the global slowdown may act as a sentiment dampener, India's domestic consumption should see no significant risks. A judicious mix of public and private capital expenditure can only strengthen the system from here on.

Outline of our portfolios

BCAD | BCAD continues to take exposure to themes which look poised to ride the shift in market preferences towards the organised players, primarily driven by regulatory changes, urbanization, changing consumption preferences, demographics and technology. Our deployment has increased significantly over the past quarter. The fund now has exposure to leading incumbents in sectors across *footwear, logistics, luggage, electric appliances, FMCG & branded Innerwear.* The bulk of the portfolio consists of consumer facing companies with strong brand power in their respective sectors. We have added exposure to a leading **Battery manufacturer** in the fund. With a share of 35% of the market, the unorganised battery makers have long benefitted from the tax arbitrage which ended with the onset of GST regime. We also increased our exposure to the leading **mattress maker** of the country which has recently had a successful foray into economy segment of the mattresses to compete with the unorganised players.

As the dust settles down around implementation of GST, rates move to lower levels, and implementation of the statutes improve, many of the leading players in consumption driven sectors will see the price differential between themselves & the un-organized players contracting significantly. *Our interactions with each of the incumbents have us excited about the possible disruptions in the industry and the investee companies in BCAD are well placed to benefit from this phenomenon.*

Green fund | *The Green fund has had significant headwinds over the past year, and almost all of them have been related to one-off macros. As each of these variables subside, and the operating horizon for every company in the fund looks positive, we expect them to recover significant ground in the coming year.*

We continue to stay invested in India's largest recycler of lead. Their operating profit declined sharply last year due to multiple one-offs: (a) high cost unhedged inventory in system, (b) low lead metal recovery from battery sourced through a new customer empanelment, (c) increase in mix of domestic revenue as compared to exports and (d) teething issues at their new plant in Chittoor. Each of these measures have now been addressed and we expect profitability to improve in the coming quarters.

The fund's investment in **India's largest coastal shipping services provider** was impacted by rising bunker fuel, which

is a key component of their overall operating cost. However, as shown in the chart below the bunker fuel price have declined from its peak last year and is consolidating at a lower level as compared to same period last year. This will help the company in reporting much improved numbers apart from the thrust on increased movement of cargo through coastal shipping. Our portfolio investment in this space continues to show good volume growth in range of 12-15% on year-on-year basis.

Bunker World Index:

The fund recently took exposure to India's largest manufacturer of **coal tar pitch**. Over the next 12 months, the company is entering an integral part of the green value chain, via supply of advanced carbon materials which is a key raw material in manufacturing "anode" that is used for Lithium Ion Batteries. Consumption of Lithium Ion Batteries are growing at the rate of > 20% CAGR world over and the current supply chain is a tightly controlled one, on grounds of technology as well as capability. As one of few producers of anode material through the coal tar route, the investment is expected to benefit from the exponentially rising demand.

KPIT Technologies is another recent addition to the fund and it is a play on automotive embedded electronics space. This segment focuses mainly on CASE – Connected, autonomous, sharing and electric vehicles. There is an increased thrust on CASE not just due aesthetics but also due to various emission regulations. Embedded system is also an important part of power train of an electric or hybrid vehicle. Currently 40% of company's revenue come from auto embedded products. The company also had exposure to IT services business which got demerged recently. The fund exited its exposure in IT services business.

As we write this newsletter, the fund is investing into a **leading provider for green building products & habitats** by supplying environment-friendly products. We also took benefit of the recent market rally and used the opportunity to trim exposures in investments where we believe either the valuation is rich or there is slowdown in earnings growth. These include trimming our exposures in India's largest refractory manufacturer and largest natural gas re-gassifier.

APJ | A negative parallel of commodity led volatility, and banking sector stress had significantly affected the performance of several holdings under the APJ portfolio. As things stand today, almost all of the variables stand close to being reversed. Over the course of Q4-19, we have made significant changes to our portfolios, and have consolidated the holdings significantly; 8 core positions now constitute roughly 75-80% of the portfolio. The current construct of the micros of the portfolio companies point to strong ramp up in earnings in FY-20, and core fundamental strength, as defined by the outlook of their respective businesses, supported by acceptable valuations.

While the hardening crude cycle had marred our otherwise strong thesis on the ***aviation sector,*** the reversal in prices has also led to a significant reversal in the market prices of our investee company in this sector. While we took advantage of this price action to lighten our exposure to this sector, we are monitoring the remaining exposure closely, as the industry fundamentals have witnessed a sea change over the last few months.

We continue to like India's largest manufacturers of ***fluorination chemicals*** and ***coal tar pitch*** and look forward to their strengthening business case over the coming years. The latter business has tailwinds in the form of expansion into two new high margin business segments that will materially change their profile, and future growth trajectory. Q1 FY20 is likely to see the commencement of this expansion and we expect significant financial traction to follow the event. We have significantly added to our positions in a small ***pharma player*** that will benefit from the operating leverage that will flow in from sweating the capacities that have been created for regulated markets. Each of these three businesses continue to be available at valuations that are in sync with its growth profile, with the appropriate strengthening of their balance sheets. ***Vijaya Bank*** has now morphed into ***Bank of Baroda***, probably India's best run PSB with relatively cleaner set of books, and an able leader who

has demonstrated a turnaround. At 0.8x price to book (knocking off Net NPA), we expect the coming year to provide significant fundamental tailwinds to the entity.

We have taken advantage of the recent rally in the markets to exit a few of our tail positions, and are in the process of consolidating them further. A lot of the macro and micro headwinds of the fund's investee companies are now firmly behind, as the portfolio construct has changed significantly, and new operating considerations are significantly better than the previous year.

Spin Off | Each of the constituents of the spin off fund are strongly poised to improve on their fundamentals in the coming year, FY-20. About 20%+ of the fund is deployed in **IT product** companies who have witnessed significant traction in their fundamentals over the past 12 months. We expect this trend to strengthen in the coming year. One half of a recent transaction we participated in could face possible stress over the short term. This company has merged into a company with stellar leadership and a great history of execution. As the process of amalgamation materializes, we expect synergies to emerge. We have taken some profits off from our holdings in a large **branded lubricants** company as valuations climb in anticipation of a strong quarter. While we continue to like the company per se, we are cognizant of relationship between valuation and earnings. We continue to be constructive on the *express logistics* space; the sector offers immense scope for consolidation and growth and we are playing this via the sector's most profitable player. Our positions in the **consumer electricals** space continue as they are and we are positive about their near-term fundamentals. We have commenced our deployment in a new transaction that will see a three-way demerger, resulting in a wealth management franchisee, pure play broking and an NBFC company. We are excited about the potential of each of these businesses.

Blend |The Blend fund cherry picks investment ideas from across the 7 investment strategies that we have developed since 2001. Each strategy has proven credentials and track record acting as a filter to shortlist great opportunities. From the universe of about 90 ideas, the fund manager selects 15 to 20 businesses. The strategy wise composition of the Blend fund is as follows:

Theme wise Allocation (March 2019)	
Deep Value Fund	48%
APJ Fund	33%
Green Fund	10%
Spinoff Fund	9%
Total	**100%**

**Broadly indicative*

Continued correction in the first two months of Q4FY19 ensured that cash was ably deployed at a portfolio level and opportunities were available for switching to more attractive investment in accounts with full deployment. We continued buying the largest **coal miner** in India as it saw further correction of about 10%. With Dividend yield of 8-9% and zero debt, we continue to see it as an ideal proxy to the rising power demand in the country.

We also added a **tyre manufacturer** with primary focus on two-wheeler tyres. It has a strong rural network, top quality governance and a clean balance sheet. Despite the pressure on volumes in the near term due to weak auto sales, we expect FY20 earnings to grow double digit as key raw material prices are expected to moderate and thereby lead to increase in margins. Worries in the NBFC space over last 6 months lead to a material de-rating of several of them. Among these, we believe that a particular **diversified NBFC** has potential to re-rate as regulatory headwinds recede and forthcoming de-merger unlocks value. Favorable valuations provided additional margin of safety for us to invest in this NBFC. We continue to add selectively names in IT Services and IT Products from the spin off portfolio. In addition to these fresh investments, we trimmed our exposure to a vehicle finance NBFC & an auto component manufacturer.

Our investment strategy

As we have always said, our focus remains on buying good businesses (that deliver our metrics of Growth & Capital efficiency) at a reasonable price and holding them through events that cause short term stress in the market place. The coming central government election is another potential trigger for short term pain. We intend to deal with this uncertainty as follows:

I. If a steep correction gives us an opportunity to buy more of the businesses that we hold & like, we will not hesitate to use available cash to do so.
II. We will look to opportunistically re-orient the portfolio, moving from liquid & defensive positions to deep value, high conviction midcaps.

Risk: Key risks to our portfolio would come from geo-political concerns globally, materially high foreign outflows, sharp currency movements, monetary policy announcements, global trade policies, 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. NPAs in the banking system and new IPOs 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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