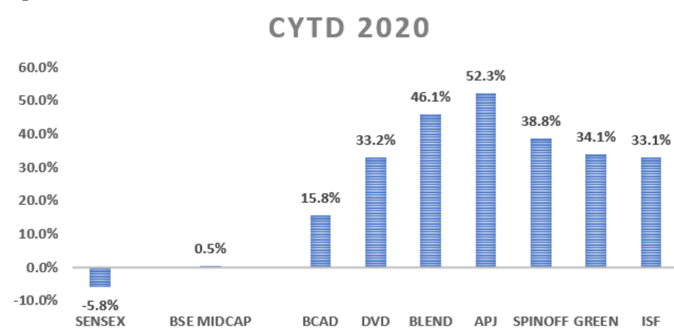
A Preamble

The last six months have been among the most absorbing and trying for us (and most) institutional fund managers. After several years of weak economic / GDP growth, we started the year with an expectation of recovery, amid signs of early green shoots. As the recovery was playing out, the blackest of all Swans hit us. The reaction of most pundits, economists, (and a few of our clients!) were on similar lines: *this will cause long term pain, exit.* We wrote to you on the 23rd of March, urging you to precisely overlook this deduction, and instead consider the actions of the institutions whose responsibility it was to step in, and handle the crisis. The power of this intervention by central banks around the world is what we are seeing in the markets, and returns today.

For most of you who have stayed invested through these trying times, we are very pleased to have delivered the returns as shown in *figure-1* below. And in the subsequent section we explain in brief how policy intervention has resulted in the divergence we are seeing today between the real economy and financial markets.

Figure 1



TWRR returns, CYTD, as on 18th September, 2020

Monetary policy has changed for good

Over the last several years, volatility occurring from exogenous events has dramatically risen and is now occurring with greater frequency. In a bid to insulate the markets from such events, central banks around the world have moved from being mere observers, to being a dominating participant in financial markets. The US Federal Reserve has championed this approach down to a fine template. Their policy basket now has two significant tools: (1) reducing the short-term rates to provide an incentive to investors to invest / bear greater risk, and (2) market stabilization programs where they purchase investments to provide investors with the confidence to follow suit.

With return expectations no longer being met with their local investments, investors are now increasingly looking at emerging markets, and willing to bear incremental risk to seek higher returns. And when large-scale participants, i.e., central banks, and institutional investors, repeat the same linear behavior with capital markets, the whole turns out to be much more than the sum of the parts. So, during the onset of the pandemic when rationalists expected economies and markets to fold, the quantum of liquidity unleashed by central banks saw the basic foundations of economic theory, i.e., demand and supply, take over. As large quantum of liquidity chased a limited pool of assets, prices rose; and as the cost of debt fell, the implied cost of equity increased asset prices further.

Given how petulant markets are today, the Fed has committed to keeping interest rates near zero till 2023, and in the process increased the role of central banks in ensuring market stability. Eventually, the effects of policy are witnessing a transmission into the real economy. The US economy posted a good recovery in August with PMI and Housing statistics beating expectations, and is set to further strengthen in the times ahead.

Domestic Macros and Markets

We are not drawing a specific reference to the several economic, regulatory, and political events that have ensued over the past few months; it may be akin to boiling an ocean. India's contraction in real GDP for Q1 FY21 was higher than expected at 23.9%, but with the 'unlock' rolling out rapidly since July, the pace of economic acceleration has been high. For instance, the peak power demand in the first week of September was higher than the levels recorded last year indicating a spurt in commercial and industrial activities. Daily e-way bills generated have also recovered sharply from April to August, indicating better mercantile traction. Collection efficiencies across segments of lending have been improving sequentially in the run-up to the end of moratorium in August 2020. With a sensible restructuring framework in place, banks should be able to address the oncoming spike in delinquencies better, as customers come out of moratorium. Further, the RBI in its latest review has kept the policy rates unchanged with a stance that is accommodative.

Where do we go from here?

Over the past quarters, much of the action has shifted to the mid-cap and small-cap space as the long-standing undervaluation in select spaces was more striking than ever. Select firms in IT Services, Pharmaceuticals, and Specialty Chemicals performed exceedingly well, driven by fundamental tailwinds. We hold quite a few companies in each of these sectors across our funds. While we note the strong performance each of these companies, we are also watchful of underlying valuations and are taking appropriate portfolio actions where the fundamentals and valuations do not offer a sustainable margin of safety. While the jury is still out on the damage caused by the pandemic to the overall economy, we are *'cautiously optimistic'* about India's prospects. On the back of good monsoons, and implementation of several policies targeted towards the agricultural segment, rural India is in the midst of the strongest demand and consumption cycle witnessed in years, providing the much-needed fillip for domestic consumption. The recent reforms in agricultural procurement, changes in Essential Commodity Act and Labor Laws can bring in the much-needed turnaround in the Agriculture and Manufacturing segments, and

support the domestic consumption thesis. Large B2Bs, where India is a significant leader, have significantly consolidated their prospects (IT Services, Pharmaceuticals and Specialty Chemicals) and the new geo-political realities have warranted a fresh look at India as a manufacturing destination. Global macro factors continue to be favorable for sustained flows into emerging markets like India, enabling RBI to continue to keep interest rates lower for a foreseeable period of time.

We are optimistic that these variables will continue to drive the consolidation of leaders within their sectors. The macros apart, we continue to be obsessively bottom-up focused, and continue to look for opportunities that will benefit from changing trends within the economy.

We have captured an outline of each of our investment strategies in the following sections with a summary of how the fundamentals of the investee companies have played out in Q1 FY21. 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.

Please note: The financial results for macro dependent companies for Q1-21 need to be seen in the context of the 40-45 days that were lost during phase-1 of lockdown in Q1 of FY-21. On an average, the days lost have resulted in a 40-50% loss in revenues for the quarter. In almost all the cases, the recovery in revenues starting June and July have been strong and are now steadily coming back to pre-Covid levels.

ISF |

The Insider Shadow Fund 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.

As on Sep 25, 2020	FY 20
Wt. Avg PE^	18.5x
Wt. Avg PB	4.0x
Wt. Avg ROE	17%
Wt. Avg Mcap	Rs.15,425cr

^ex – BFSI

BC AD |

The fund continues to invest in sectors that are currently witnessing a shift in market share from the unorganized to organized players. While the lockdown related disruption can impact the near-term demand for consumption-based themes, as market leaders with strong net-debt free balance sheets, a majority of our investee companies are likely to see an increase in their market share, as marginal players find it difficult to operate in the new environment.

As on Sep 25, 2020	FY 20
Wt. Avg PE^	38.9x
Wt. Avg PB	13.6x
Wt. Avg ROE	30%
Wt. Avg Mcap	Rs.33,008cr

^ex- BFSI

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 Sep 25, 2020	FY 20
Wt. Avg PE^	21.0x
Wt. Avg PB	5.2x
Wt. Avg ROE	25%
Wt. Avg Mcap	Rs.26,038cr

^ex- BFSI

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 Sep 25, 2020	FY 20
Wt. Avg PE^	22.2x
Wt. Avg PB	7.9x
Wt. Avg ROE	23%
Wt. Avg Mcap	Rs. 14,111cr

^ex- BFSI

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 APJ fund continues to focus on firms delivering manufacturing excellence broadly across chemicals, pharmaceuticals, materials, and infrastructure in general (IT, physical).

As on Sep 25, 2020	FY 20
Wt. Avg PE^	19x
Wt. Avg PB	5.8x
Wt. Avg ROE	22%
Wt. Avg Mcap	Rs. 24,197cr

^ex - BFSI

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 Sep 25, 2020	FY 20
Wt. Avg PE	18.9x
Wt. Avg PB	5.3x
Wt. Avg ROE	22%
Wt. Avg Mcap	Rs.6,440cr

Risk

Risk	Mitigants
Coronavirus Impact	The impact from the ongoing Coronavirus outbreak in India and rest of the World can be multifold. The lockdown related slowdown in consumption can affect several sectors. How long it takes for sentiment to return in consumption remains to be seen. A second wave of infections cannot be ruled out. Our investee companies have product & category leadership along the financial wherewithal to withstand temporary phases of demand slowdown and lead consolidation of demand. The BFSI sector could have heightened stressed assets for a long period of time thereby impacting their profitability.
Geo-political risks	The Galwan incident at the Sino-Indian border has increased tensions on both side of the LAC. Even though talks are continuing though the diplomatic channels, both the countries have mobilized troops close to the border. Any flare up can escalate into a full-scale military action between two of the biggest armies of the world, and disrupt supply chain in the region.
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, and 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 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 moment 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	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
Baidik Sarkar
Head - Research

This is neither an offer to sell nor a solicitation of any offer to buy any securities in any fund managed by us. Any offering is made only pursuant to the relevant information memorandum, together with the current financial statements of the relevant fund, if available, and the relevant subscription application, all of which must be read in their entirely. No offer to purchase securities will be made or accepted prior to receipt by the offeree of these documents and the completion of the appropriate documentation. Please refer to the Private placement memorandum before making a decision.

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