The Blackest of Swans

We started 2020 with one of the biggest crisis mankind has ever faced post World War-II. As we write this note, the total number of cases across the globe has already crossed 12 million with 5.5 lakh deaths. The rapid spread of the virus and the ensuing fall in equity markets initially lead to comparisons with the GFC of '08, and the dot-com-bubble of '00, which in hindsight were clearly far more easily navigable.

Markets

It was one of those rare occasions in economic history when all the asset classes had a significant correlation in depth and direction. Gold, Equities, Fixed Income, and several market neutral and risk parity funds were down at the same time. The *VIX*, a measure of expected price fluctuations in the S&P 500 over the next 30 days, at 90, was the highest ever in the history of its existence. While virologists waged their own battles, the Fed knew better than to compound a pandemic with economic misery. Apart from throwing its weight behind *good* securities, the Fed for the first time in history made known it's outright support for *non-investment grade* debt, thus overwhelmingly showing its intent to do whatever it takes to back stop an economic melt-down. Soon, every central bank around the world followed with its own version of a stimulus to get their economies back on track. *From being crippled due to fear of solvency, markets around the world thawed gradually.*

Understanding the direction and magnitude of liquidity is very critical today. Once a new kind of stimulus is tested, it becomes a template of how future downturns are handled. And given the back to back successes of how monetary policy has worked in 2008 and now 2020, *more liquidity* is the likely baseline assumption of policy response for future moments of stress.

India

Between the 12th Feb and 23rd Mar, the NIFTY gave up 38% [12,201 to 7,610] as panic turned de rigor. With policy actions, the recovery was equally swift as the NIFTY climbed back 35% from the lows [10,300 by 22nd June]. Following the global template, RBI reduced the repo rate to 4% in two tranches, cutting rates by 115 bps. This is the lowest interest rates in the last 20 years.

For the academically inclined, a 1% reduction in interest rates, increases equity value by 10%+, assuming a nominal 5% risk free rate.

Where do we go from here?

A crisis is prima facie a conundrum. While the magnitude of near-term pain cannot be estimated, with asset prices factoring in the worst and a return to normalcy becoming more certain, the margin of safety in valuations is at its attractive best. We have seen across cycles, how a bottom up and calibrated approach in moments of panic is a key driver of subsequent outperformance. To be able to take such a calculated risk, it is imperative to weigh the knowns against the unknowns and their likely outcomes.

For instance, the following questions still do not have answers

- *How fast and deep will the pandemic spread?*
- *How long will this necessitate a sustained lockdown?*
- *How long will the vaccine take?*
- *Can economies return to being healthy soon enough?*

In the same breadth, we had answers to the following

- *Led by a good Rabi, rural India is in the midst of the strongest demand and consumption cycle in years*
- *The headline stress reported in Mumbai, Chennai & Delhi were not indicative of stress in other parts of India. Lead indicators such as supply chain logistics and rural facing industries showed a sharp recovery*
- *Large B2Bs, where India is a significant leader, remained relatively unperturbed and consolidated their prospects (Specialty Chem, IT, Pharma)*
- *Interest rates and inflation were expected to be benign for the foreseeable period*
- *Retail borrowers are now more aware of the long-term implications of defaulting on their loan obligations*
- *The probability of a vaccine in the next 6-12 months increased significantly*

Our understanding of the above variables determined our course of action in the key months of April and May of 2020.

Clarity is expensive

In an environment where participants are emotionally shaken, it is easy to lose sight of the fact that the markets price the future. Depending on how the variables change, it is difficult to say if the markets are pricing in 6 or 24 months into the future, but it can be said that right now, it is looking past the near-term economic decline.

It was our belief (conveyed to you in our letter dated 23rd March 2020) that the steep correction in March is likely to be transient. Our conviction was strictly bottom-up and around businesses in sectors (Pharmaceuticals, Specialty Chemicals,

Gold finance, etc.) that we knew will demonstrate resilience even under the prevailing environment. In fact, given the circumstances, the leaders are likely to consolidate their position. As markets turned, the fair value of our holdings recovered on expected lines along with a premium for their potential gain in market share that was becoming evident. In the times to come, we believe the pace of consolidation will gather pace, as marginal players find it difficult to survive in periods of crisis.

These trends were already underway before the virus, but adoption has been accelerated by the 'forced' need to operate under this new-normal. In a nut-shell, we have been able to take advantage of the volatility and are seeing this reflect positively in our numbers.

Review of Strategies

We have captured an outline of each of our investment strategies in the following sections with a detailed summary of how the fundamentals of the investee companies have played out in Q4 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.

With 130 vaccines under development, and various permutations of molecules being introduced by the day, we hope we are in the 'midst' of the pandemic, rather than below the median. And we truly hope that you and yours are keeping well, in health and spirit.

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 Jul 10, 2020	FY20
Wt. Avg PE	34.3x
Wt. Avg PB	11.3x
Wt. Avg ROE	29%
Wt. Avg Mcap	Rs. 31,554cr

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 Jul 10, 2020	FY20
Wt. Avg PE	26.6x
Wt. Avg PB	5.5x
Wt. Avg ROE	24%
Wt. Avg Mcap	Rs.19,889 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 Jul 10, 2020	FY20
Wt. Avg PE	28.5x
Wt. Avg PB	6.1x
Wt. Avg ROE	24%
Wt. Avg Mcap	Rs 12,131 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 APJ fund continues to focus on firms delivering manufacturing excellence broadly across chemicals, pharmaceuticals, materials, and infrastructure in general (IT, physical).

As on Jul 10, 2020	FY20
Wt. Avg PE	24.8x
Wt. Avg PB	5.5x
Wt. Avg ROE	25%
Wt. Avg Mcap	Rs 12,880 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 Jul 10, 2020	FY20
Wt. Avg PE	14.9x
Wt. Avg PB	3.6x
Wt. Avg ROE	21%
Wt. Avg Mcap	Rs.6,412 cr

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 to consumers remains to be seen. While a second wave of infections cannot be ruled out, we believe our investee companies have the product and category leadership along with the financial wherewithal to withstand a temporary phase of demand slowdown.
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	India continues to be dependent on the supply of feedstock whose pricing is global in nature. Key categories here would include crude, metals, minerals, and natural commodities. Sharp movement in their underlying prices may have a 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.

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 them.
Softness in IT product spends	The convergence to digital software solutions has resulted in a favorable business environment for our IT companies.

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.

CHENNAI:
11, Kakani Towers
15 Khader Nawaz Khan Road
Nungambakkam High Road
Chennai - 600 006. INDIA
Ph: +91-44-3022 4466, 2833 1556
Fax: +91-44-2833 2732

HYDERABAD:
H No. 6-3-346/1, Road No. 1
Banjara Hills
Scotia Bank Building
Hyderabad – 500 034. INDIA
Ph: +91-40-6675 2622/23

BANGALORE:
1109, 11th Floor
Barton Centre
84, M.G. Road
Bangalore - 560 001. INDIA
Ph: +91-80-255 9418/19

MUMBAI:
Shiv Sagar Estate,
A-Block, 8th Floor,
Dr. Annie Besant Road
Worli, Mumbai - 400 018.
INDIA
Ph: +91-22-2492 7671

DELHI:
No.818, International Trade
Tower, Nehru Place.
Delhi - 110 019.
INDIA
Ph: +91-8800333799