UNIFI Capital

INITIAL OBSERVATIONS RETAIN THEIR TRUTH

QUARTERLY REVIEW

Q3 FY22

Initial observations retain their truth

Twenty years back, on the 24th of April 2002, Unifi invested its maiden tranche of investor capital. Records indicate an investment of Rs.5 Lacs, or $18,000 in equivalent. India's $300bn markets were experiencing their initial burst of economic expansion since the '91 reforms, and Unifi's approach of participating in this expansion was based on a firm bottom-up focused approach of buying growth at a reasonable price.

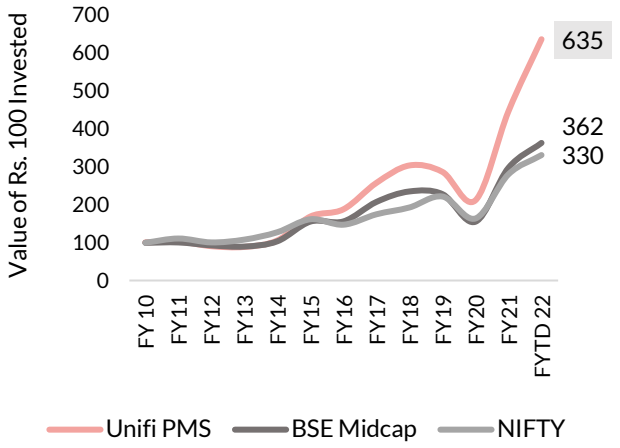
Since then, India has strengthened its domestic franchise of consumption-led growth, achieved global dominance in several sectors, and is today birthing a renaissance in manufacturing while rapidly formalizing. Ergo, vast pools of profit that did not exist until a few years ago are now emerging. In parallel, India grew 10x to a $3 trillion market today. In that journey and for the first time in modern economic history, interest rates fell to near zero [in the West], completely changing how growth assets are valued.

Unifi has been an active participant in this journey of India from a $300bn to $3trillion market, representing over 2/3rds of India's modern economic history and underwrites more than $1.5bn in investor capital today. What has not changed all this while is Unifi's approach to investing. Over the past twenty years, Unifi has stayed firm with its initial philosophy of aligning with growth firms at a reasonable price. And this is as good a time as any to reemphasize our philosophy in simple terms.

With the right framing, narratives tend to become an asset. It is irrelevant how great a business model is if the equity premiums expected to underwrite them are excessive and do not explain in simple terms how the rewards from such an investment will be significantly higher than the risks it will entail. While this seems simple, it isn't easy to practice in a growth-focused market like India, as valuations often discount the most optimistic outcomes. And investors with options tend to gravitate to the strongest narrative presence. Such investments are unlikely to merit our attention if it does not favor the right mix of risk and reward.

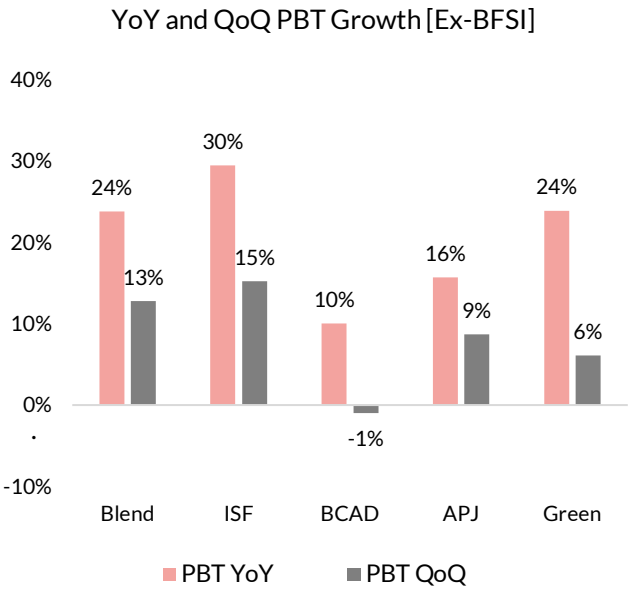
Often, this will result in significant divergence from consensus. Ideas that challenge consensus-held assumptions can feel lonely, but in our opinion, this is all the more reason they merit closer attention. It is our experience that this is typically where asset mispricing resides. And is the precursor to absolute returns.

We have written about our approach to you multiple times over the past. And it is likely we will continue to emphasize this over and again because it is the core guiding principle of who we are, and how we manage capital. Twenty years on, our initial observations on how to manage risk and reward retain their truth. And we remain a student of the market more than ever.



Q3 FY 22 and Inflation Positioning

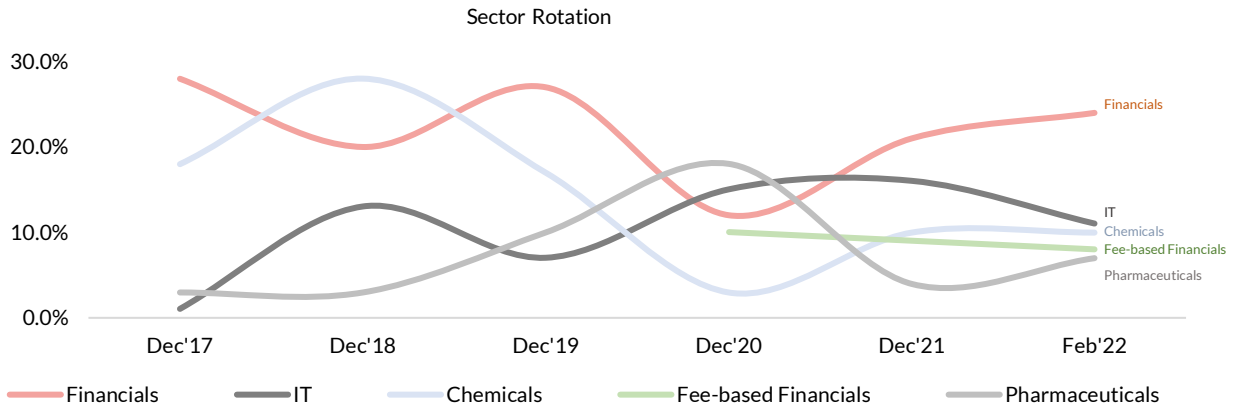
Managing inflation is not a one-size-fits-all approach. There is a stark difference in how product and category leaders navigate such a cycle, and this eventually plays out in a manner that strengthens their proposition. We are deeply vigilant of the current inflationary cycle in preserving our underlying principles of curating portfolios with the right risk reward. From what we have seen so far, we are comfortable with the earnings resilience of our portfolio companies given the environment.



These are our broad thoughts on how we are navigating this cycle

Key Sector	Allocation	Comments
Credit	25%	India is early days into a new cycle of economic expansion, coinciding with the end of an aggressive provisioning cycle. Given inflation today, higher nominal rates of growth will result in the expansion of bank balance sheets earlier than later. Given the cycle the industry is coming out of, the health of the end-user industry, and vastly different underwriting practices, India's well-managed banks are optimally poised to benefit from this trend. Entry valuations are attractive to capture a new cycle of growth. Operating profit expanded by 16% YoY on an average in Q3 22 with an expansion in Net Interest Margins for the quarter. PAT grew 2x on an average for the portfolio companies led by improvement in incremental slippages and hence provisioning.
IT	15%	Global spending on cloud adoption is below the halfway mark, pointing to a significant runway of growth for the next many years. The companies here have exposure to wage inflation as a challenge and that has been managed well given the demand environment. The supply side is expected to get significantly better over the next 3-quarters. Otherwise, technology spending is anti-inflationary with continuing high levels of capital efficiency. For the quarter, the average EBITDA growth of Portfolio companies was 21% YoY in Q3 22 while more or less defending their operating margins.
Chemicals	10%	We have allocated to companies with the following characteristics: (a) base Chemicals with the self-sufficiency of feedstock with maximization of its downstream capabilities, (b) diversified earnings base, and (c) Leadership position in key chemistries/products with exposure to multiple end-use industries. India is in the midst of a new wave of import substitution, and we continue to like the space for the runway of growth it offers for multiple years ahead. For the quarter, the average EBITDA growth of Portfolio companies was 25% YoY in Q3 22 while margins were maintained.
Pharma & Healthcare	10%	We have negligible exposure to Commodity API / Generics and have instead allocated towards Branded Pharma, Complex Generics & Healthcare Services with negligible risk of Material and Energy Inflation. The average EBITDA growth of portfolio companies was 35% in Q3 22 with expansion in margins.
Consumer-durables and others	10%	India's household spending on consumer durables continues to be strong, led by a new wave of home modernization and expansion. As wage inflation and rural incomes continue to remain supportive, we believe this is early days into India's journey of premiumization of consumer durables. Our investee companies here are price and cost leaders and have the best right to win given the environment. For the quarter, the average EBITDA growth of portfolio companies was 13% YoY in Q3 22 while more or less defending their operating margins.

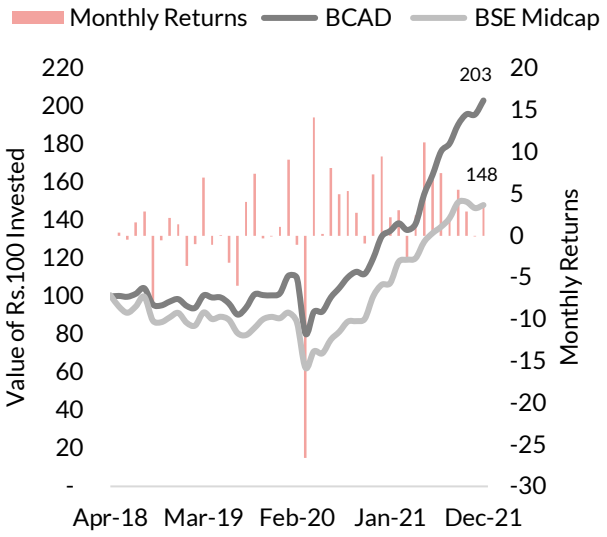
Over the past four years, different sectors have ebbed and flowed depending on the cycle they are in. And this is how we have broadly reflected them in our portfolio construction.



*The above rationale with regards to Inflation and sector allocation is specific to Unifi's Blend Fund and broadly indicative of APJ.

Consumption Ahead

After India's first tryst with formalization [GST reforms, demonetization] Unifi launched its maiden consumption fund, BCAD, in April 2018. [BCAD = Business Consolidation after disruption]. The mandate was to participate in the formalization of the Indian economy as consumption moved from unorganized to organized players. Our performance since the inception of the BCAD fund is as follows.



Over the past two years, the intensity of change in India has pivoted how India consumes. As the pandemic-led disruption progressed, conventional old-economy supply chains folded. The organized players after years of execution consolidated their place in a new and slightly better organized India. Consequently, India's rate of formalization has significantly accelerated on the supply side. While on the demand side, a combination of a buoyant agri-economy, the resurgence in India's manufacturing industry [China +1], and the continued growth of India's services economy [technology, retail credit, others] have resulted in a significant surge in disposable incomes. These trends are visible across property absorption, financialization, non-discretionary consumption, and premiumization. The long-term drivers that will now shape India's consumption will be very different from what we have witnessed over the last 70 years, and we see growth emerging from several frontier business segments that will generate significant earnings over the next five years.

As India's household income continues to grow, underlying consumerism across all cohorts and categories will continue to expand. We are nurturing the seeds of this growth, through **our new fund BCAD-2: Breakout 20.** Please talk to your relationship managers for more on this.

Internal dialogues

Good investment research is analogous to investigative journalism. It is a dynamic and iterative process. Expecting a crystal-clear idea of thought to play out is not just academic but perhaps also a failure to appreciate a dynamic asset class. The fundamental investigation of the business, the people running it, and the valuations we choose to participate in are under continuous diligence. Over the years, we have continued to add layers to our assessment. Many of you have asked us what is it exactly we cover here? We take the liberty of sharing our basic governance framework with you.

Management Competence & Governance Scorecard

Capital Allocation & Business Model

- Long Term Capital Efficiency - ROCE & ROE
- Incremental Capex - Core or Non-Core
- Dividend Policy & Consistency
- Cashflow from Operations & Margin management - Long term record

Quality of the Board and Executive Team

- The credibility of Independent Directors
- Relevance of their Qualification & Experience
- Presence in other boards & Compensation level
- Salaries of Key Executives, ESOPs
- HR element - Feedback on work culture

Promoter / Management Quality, Compensation & Activity

- Qualification/Experience, family involved
- Salary – Performance-based and fixed
- Other Business Interests
- Overall Stake in the company – History of dilutions/warrants
- Pledge of Shares - Quantum / End-use of Funds, insider buying/selling

Transparency & Governance

- Related party transactions, Disclosure - Subsidiaries, Associates, JVs
- Annual report commentary & consistency
- Quality of Auditor, audit qualifications
- SEBI / Regulatory Compliance track record
- Industry / Peer group Feedback
- Credit Rating History & Comments
- Feedback - Bankers / Suppliers / Customers / Former Employees

Overall Score

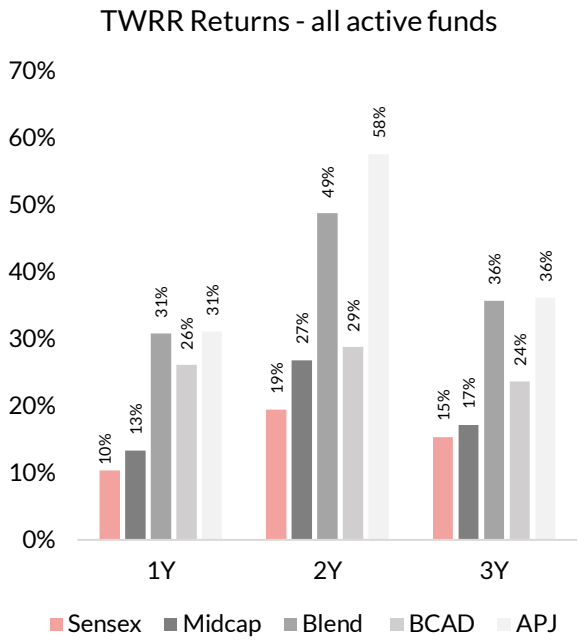
Note: For a proper perspective of the target and its promoters, we construct a picture using these data points over the long term and apply proper context. We relate each point with the other, to test for validation; in isolation, they mean little. These parameters are weighted and scored on a case-to-case basis.

In closing

Doubt is not a pleasant condition. And the last two years, in particular, have made it clear that certainty is absurd. We are in an industry where uncertainty is the basic premise of everything we seek to do. As fund managers, it is a part of our mandate to weather uncertainty. And as investors, it is essential for you to be appreciative of this phenomenon for very long periods of time.

We refrain from commenting on the current geopolitical situation while closely watching for linkages to our investments. War is painful. To add to it is near meaningless, as the event in itself.

While investors will judge us on the outcomes, we continue to judge ourselves based on our processes. Given where we are in the uncertainty matrix today, our internal process of diligence is the single biggest piece of variable we rely on. Across cycles, our underlying principle of seeking absolute growth at reasonable valuations remains constant, and the process of underwriting is responsible for delivering them. Adherence to the correct process will eventually result in intended outcomes.



An outline of each of our investment strategies has been presented in the following sections with a summary of performance for Q3 FY22. Individual portfolios will vary in holdings and proportion based on the timing of your investment. Please do not hesitate to contact your relationship manager for a detailed review of your portfolios.

Blend/DVD

The Blend/DVD fund strategy continues to cherry-pick ideas from across the six 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 March 4, 2022	FY22E
Wt. Avg PE	21.0x
Wt. Avg PB	5.3x
Wt. Avg ROE	20%
Wt. Avg Mcap	Rs. 96,750cr

BCAD

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 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 March 4, 2022	FY22E
Wt. Avg PE	25.7x
Wt. Avg PB	4.9x
Wt. Avg ROE	23%
Wt. Avg Mcap	Rs. 93,995cr

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, and policy climate. The APJ fund continues to focus on firms delivering manufacturing excellence broadly across technology, chemicals, pharmaceuticals, materials, and infrastructure in general.

As on March 4, 2022	FY22E
Wt. Avg PE	21.0x
Wt. Avg PB	5.1x
Wt. Avg ROE	25%
Wt. Avg Mcap	Rs. 62,305cr

ISF

The Insider Shadow Fund invests in fundamentally sound companies where there has been an increase in 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 March 4, 2022	FY 22E
Wt. Avg PE	22.0x
Wt. Avg PB	3.8x
Wt. Avg ROE	18%
Wt. Avg Mcap	Rs. 58,659cr

Green

The fund continues to invest in sectors that will 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 March 4, 2022	FY 22E
Wt. Avg PE	25.7x
Wt. Avg PB	4.9x
Wt. Avg ROE	23%
Wt. Avg Mcap	Rs. 93,995cr

Risks

Risk	Mitigants
Coronavirus Impact	The impact of the ongoing Coronavirus outbreak in India and the rest of the World can be multifold. The lockdown-related slowdown in consumption can affect several sectors. 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 certain period of time thereby impacting their profitability.
Geo-political risks	Geopolitical tensions globally can disrupt the supply chain in the region. This might have a non-linear impact on business.
Raw material inflation	India 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 [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 can affect our holdings in Banks and NBFCs.
Foreign Exchange risk	The foreign exchange system continues to be guided by global developments. 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 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.

Risk	Mitigants
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. If such issues 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 key promoter / 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 the 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 the relative infancy stage and have a strong growth curve ahead of them.

Thank you for placing your trust in Unifi.

Sincerely

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