UNIFI CAPITAL

FIRST-PRINCIPLES

QUARTERLY REVIEW

Q4 FY22

FIRST-PRINCIPLES

A fundamental proposition that serves as the foundation for a chain of reasoning.

We count the privilege of managing risk capital seriously. As we round off the financial year and re-group for the next many, it is a good time to emphasize our core principles that define how we think and manage capital.

NON-PRESCRIPTIVE

We invest across a vast range of industries and firms at very different stages of evolution. We appreciate the heterogeneity and uniqueness of India's investment universe and are wary of assigning simplistic rules, boxing our style of investing. Our approach favors the identification of the value and their margin of safety over everything else. This means the dispersion of themes at a portfolio level will likely be high and consistent around a risk and reward equation that is favorable.

MARGIN OF SAFETY

India's lack of complete capital convertibility has resulted in valuations of some of India's finest firms reaching levels that cannot be theoretically justified. As leaders, a few of these companies will continue to consolidate their position of dominance and grow. We are comfortable not aligning with such opportunities and prioritize the discovery of value over the temptation to hold great companies that do not offer a margin of safety in terms of *price and time*. Our strategy of looking thematically at the evolution of India's industries and households enables us to discover opportunities that are beyond consensus.

THE LONG TERM IS A SERIES OF MEDIUM TERMS

We monitor the journey to our investment outcomes very closely and do not feel obligated to stay invested in firms we like without regard to their growth and valuations. While our objective is to generate absolute long-term performance, our instincts are to implement the logical next steps [buy, hold, sell] as our investment journey evolves. This is a corollary to maintaining the margin of safety at a stock and portfolio level.

SUSTAINABILITY

Governance is key to realizing an entity's true value in letter and spirit. We look for companies that have acted consistently on all financial and qualitative facets of governance. Long-term business, and equity value creation, are sustainable when a business checks these boxes. We are uncompromising in the evaluation of this facet and comfortable bypassing opportunities that seem financially attractive but questionable on governance.

PEOPLE

Our strong investment team combined with our working relationships with entrepreneurs, experts, and market intermediaries help navigate the breadth and depth of India's investable universe. We invest in each of these relationships consciously.

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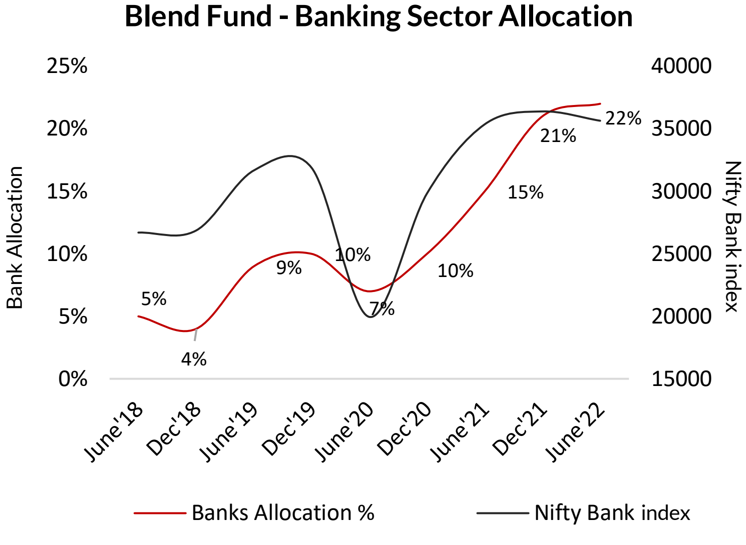
ANATOMY OF A PORTFOLIO

In keeping with the first principles, our responses to the market are never static

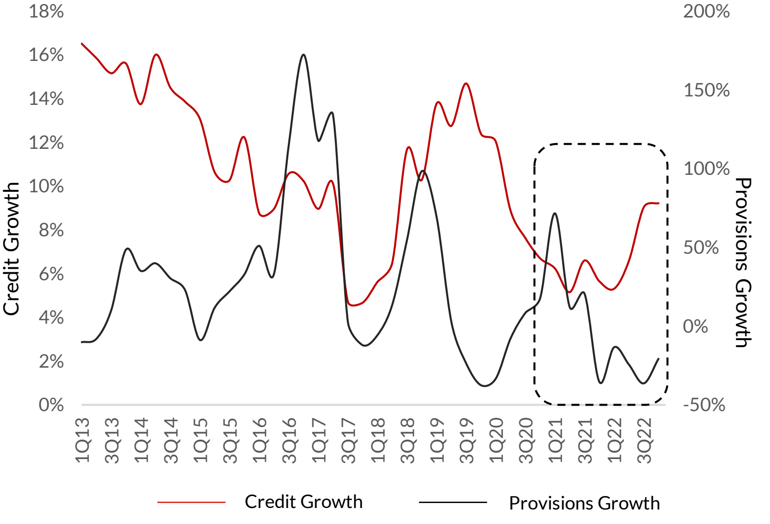
Cyclicality and evolution of the markets are a reflection of the society they represent and therefore no one answer works forever. A common mistake made at the turn of a cycle is the assumption that the market will revert to how it was immediately before, which is unlikely over time. Maintaining an updated prognosis for the future is critical, especially when the current one is working well. In other words, the portfolio composition must reflect our view of the future and manage the risk of being early appropriately.

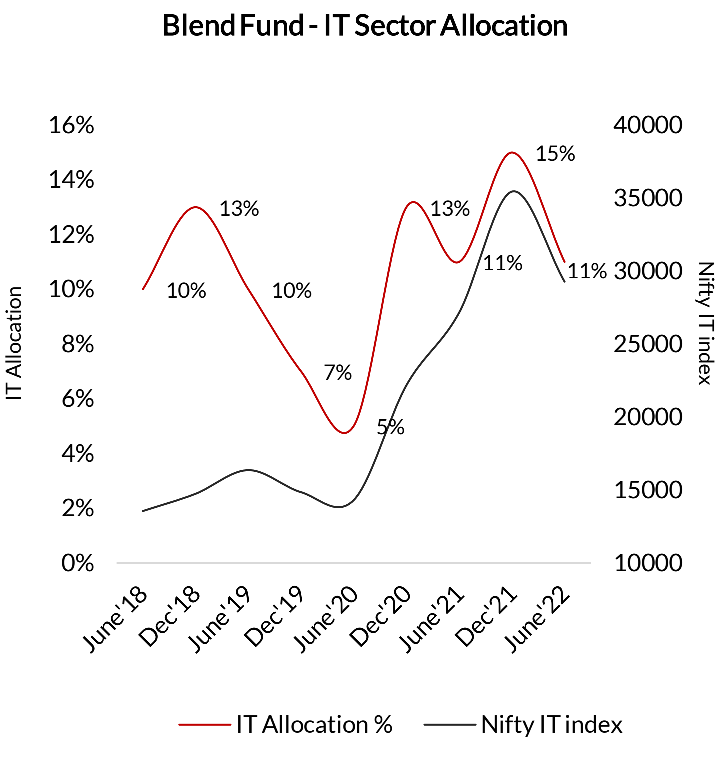
This is a representative sample of how there are sub-cycles within cycles and how our funds have navigated this over the past 4 years.



A moment of inflection in India's **Banking** system is finally underway. After 10-years, there is a clear divergence today between the systemic growth rate and credit costs. Today, an extended period of provisioning has led to credit costs below normalized levels while a higher nominal-growth environment supports credit growth. Given that India's private consumption expenditure (in real terms based on 2011-12 prices) in FY22 was below FY20 levels, we are yet to witness a complete revival in demand.

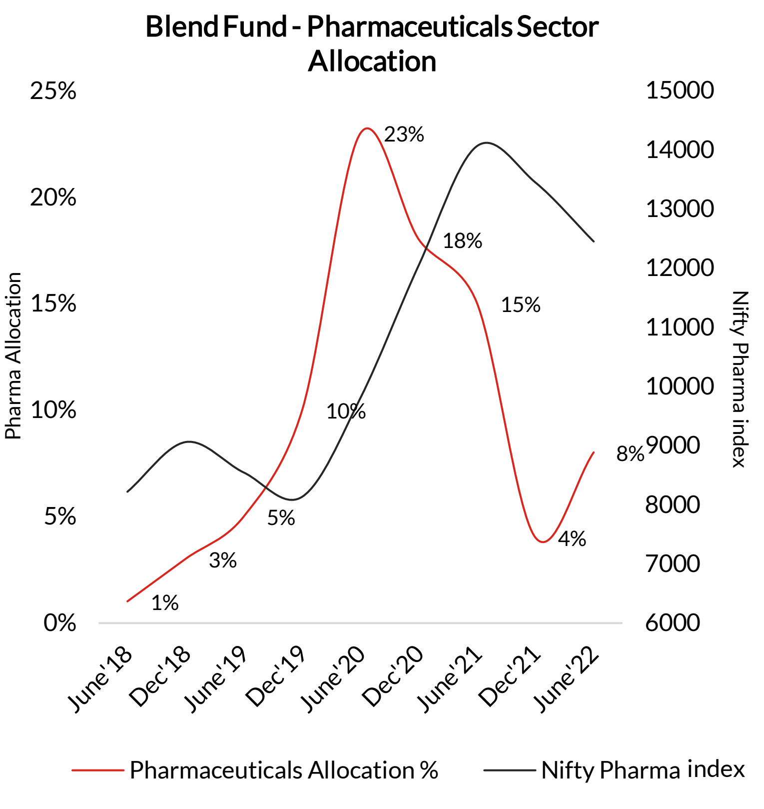
Despite the circumstances, the industry is now clocking double-digit credit growth. As policy measures to seed a new cycle of growth fructify and private consumption surpasses pre-pandemic levels, further offtake in credit is anticipated. There is an added angle of the rate-environment. As RBI reverses the low-rate regime, industry margins will gain as interest rates rise. *With this in perspective, our exposure to India's banking sector is the highest ever in recent years, at c.25% vs negligible exposure in the previous sub-cycle.*





Technological change today is exponential. This rapid change lies in the advances of enabling technologies ranging from computing power to data storage to the scale and performance of the Internet. These advances create tipping points — moments when technologies cross a threshold and trigger sudden and significant change, making them a systemically important part of society. And firms that choose to cut back on technology spending will risk long-term competitiveness. **Despite the inflationary environment, this explains the lack of slowdown in the appetite for server and cloud spending**. Productivity gains from technology are eventually a key driver of growth and sustainability. We continue to see opportunities in the technology space and maintain exposure to the sector, driven strictly by the bottom-up, in areas where growth visibility is long tailed.

We view India's pharmaceutical industry with a strict bottom-up lens considering the industry's diverse segments and geography-specific challenges. India offers a structural pathway and investment case given lifestyle-led chronic diseases, but most firms in the industry operate in multiple geographies, with US generics being a key market. The US Generics business faces a prolonged fall in profitability due to severe pricing pressure led by the consolidation of buyers, stiff competition, legacy products, and regulatory hurdles. We have refrained from underwriting equities in businesses operating under such circumstances. Today, our alignment is a bottom-up one pursuing complex products with low competition, niche therapies, a long gestation period, and a large market size. We have managed our exposures here accordingly.



The rest of our portfolio composition continues to draw from the breadth and strength of India's domestic consumption franchisee. India's household consumption expenditure has grown at a CAGR of 8-10% p.a. over the last few years, driven by higher disposable incomes and urbanization. A sharp rise in pent-up disposable incomes over the two pandemic years has resulted in visible betterment across premiumization, non-discretionary consumption, property absorption, and financialization of savings.

The number of households in the upper and high-income brackets increased from 8% in 2005 to 24% in 2018, and this is expected to touch 51% by 2030. This shift in household incomes will accelerate underlying consumption across all cohorts and create newer categories. At a portfolio level, we are aligning with various businesses that would likely benefit from this consumption trend. We have captured this in detail in the later section.

Alongside, we increased our exposure to India's largest private sector manufacturer of Phosphatic fertilizers. With backward integration of scale and an unprecedented rise in input costs, the subsidy mechanism of the Government of India will enable them to capture significant spreads in a positive demand environment. While in chemicals, we have exposure to names that are catering to India’s need for import substitution and are category leaders who are backward integrated and moving up the value chain.

CONSUMPTION AHEAD

India remains a significantly domestic consumption-driven economy. We present a few data points highlighting a few of India's consumption drivers and how they come together as a flywheel.

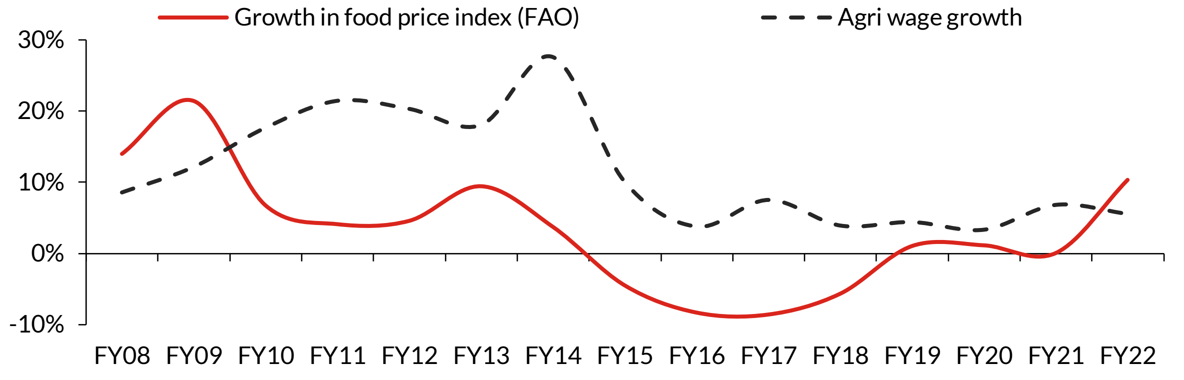
RURAL CONSUMPTION

Transfer of income is an essential tool to eliminate structural imbalances in an economic value chain. This is true of productivity and output [and hence GDP] between urban and rural India. 65% of India stays in the hinterlands, where the majority of consumer spending is driven by farm income.

The government's policies toward increasing farm incomes via better minimum support prices are birthing a new rural income growth cycle. In our opinion, a tempered and real inflation in farm income is one of the most significant policy initiatives at play in the current times.

This has a flywheel effect on multiple segments of the economy with two primary trends: (a) increases access to agricultural inputs and mechanization, enabling increased productivity, and (b) the incremental incomes help households move up the chain of Maslow's hierarchy of needs.

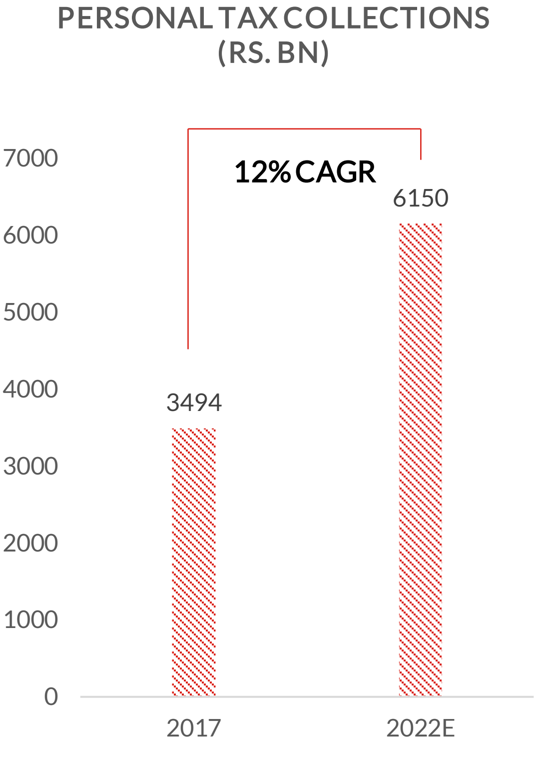
Increased consumption, premiumization, and an uptick in discretionary goods and services directly benefit from better farm incomes. It is clear from the previous cycle that the correlation played out, and we see a repeat of this cycle again. The impact of this on the Indian economy cannot be overemphasized.



URBAN CONSUMPTION

Anecdotal flows on urban income growth have been positive for a while: heightened IT wage inflation, manufacturing resurgence, incremental construction activity, etc. Another strong proxy that captures urban consumption potential is the strength of personal tax collections. This number captures both the fundamental ideas of (a) the supply side: i.e., an expansion of the tax-payers base through the formalization of the economy, and (b) the demand side, i.e., an increase in the number of consumers translating into the increased per capita spend.

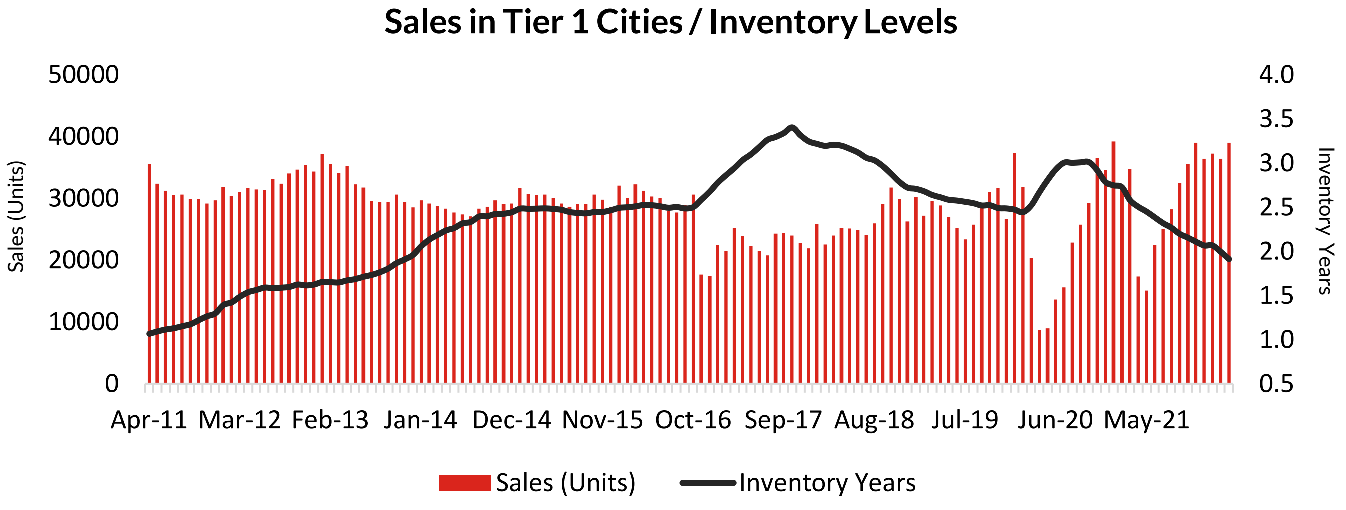
With several sectors seeding a new wave of growth and the emergence of peripheral cities, the rise in personal disposable incomes will have a multiplier effect at scale, creating new patterns of consumption.



EARLY SIGNS OF HOUSEHOLD ASSET FORMATION

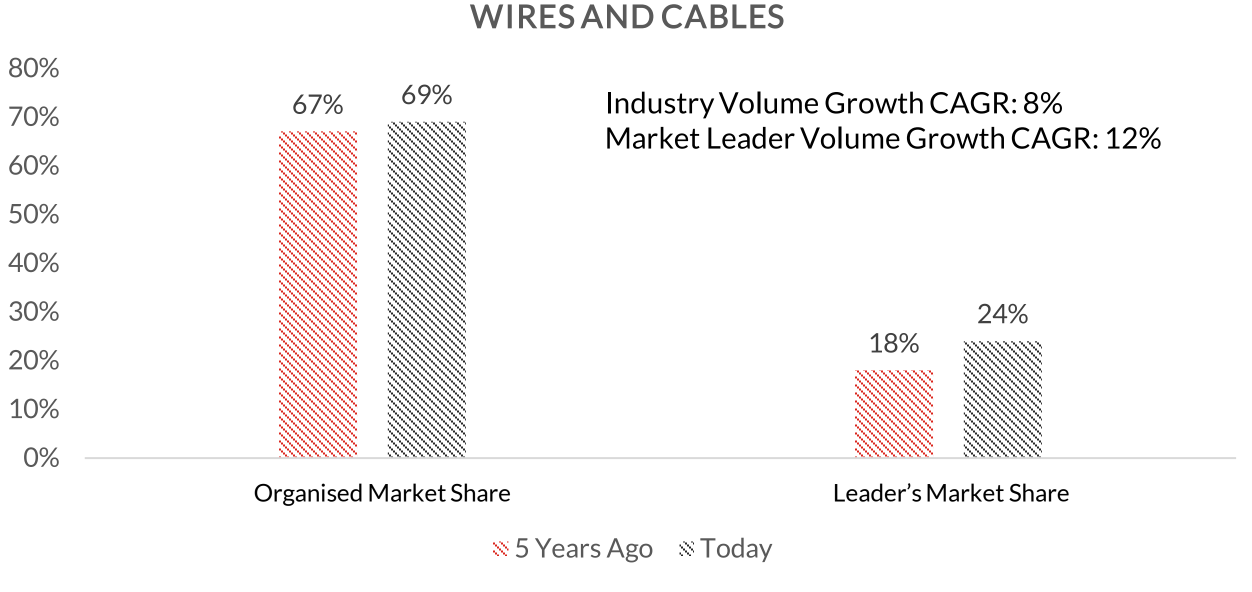
It is early days, but a multi-year unit price stagnation and pent-up savings have made their way into India's household capital expenditure. Real Estate is the largest constituent of the household balance sheets and higher discretionary incomes are showing up in better realty consumption. This has resulted in the lowest levels of inventory in Tier-1 cities over the last 8-10years. In the current financial year, the housing sales in the top-7 cities have rebounded to pre-pandemic levels and new launches have surpassed pre-2020 levels.

The importance of the real estate sector to the Indian economy cannot be over-emphasized: realty consumes 65% of India's cement production and 40% of iron & steel, and each has a large flywheel of its own on the economy as a whole.



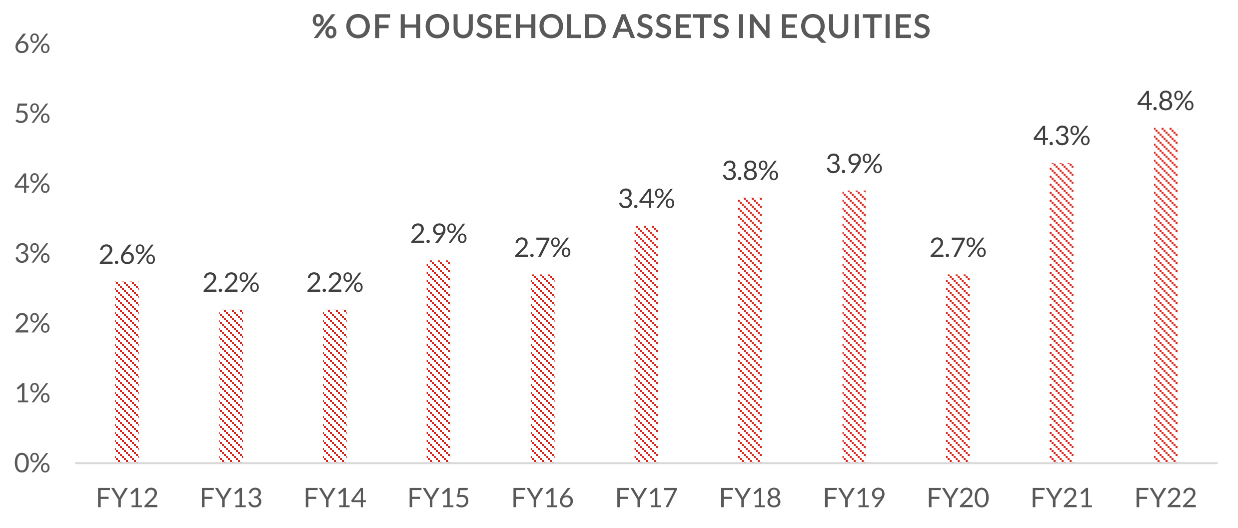
An example of how Realty feeds into the value chain – Consolidation

The private household-capex influences the entire building value chain from cement, iron & steel, cables & wires, paints, pipes & fitting, to sanitary ware, tiles, and wood panels. While this offers a huge set of heterogeneous opportunities in different categories, it is to the discretion of investors to play the best proxy which offers the collective prospects of high-volume growth, consolidating industry structure, favorable unit economics, and reasonable valuations. We present an example of a proxy to the sector, and how in a phase of high growth, the leader consolidates its market share significantly.



FINANCIALIZATION OF SAVINGS

In keeping with the trends of consumption, the nature of how India is saving has witnessed a paradigm shift. A cursory glance at various asset classes indicates how the average savings dashboard has moved over the past 5 years: (a) SIP AUM now forms ~30% of equity AUM vs ~20% of equity AUM; (b) Share of equity AUM has increased to c.48% vs c.32% and (c) the number of demat accounts have grown over 3.5x. These trends are likely to continue as financial literacy and access to financial products are significantly higher than in the previous generation.



Source: RBI

Overall, the path to increased consumption and premiumization is not just paying for rational product attributes or functional benefits, but also for social and psychological reasons for which a customer consumes and pays a premium. Over the past two years, the intensity of how India consumes has pivoted. A new wave of growth capital has entailed a variety of investments that lower the friction in paths to consumption. Despite the inflationary environment, demand expansion across categories is throwing up opportunities for us to underwrite. The long-term drivers that will now shape India's consumption will be very different from what we have witnessed over the last many years, and we see growth emerging from several frontier business segments that will generate significant earnings over the next five years.

IN CLOSING

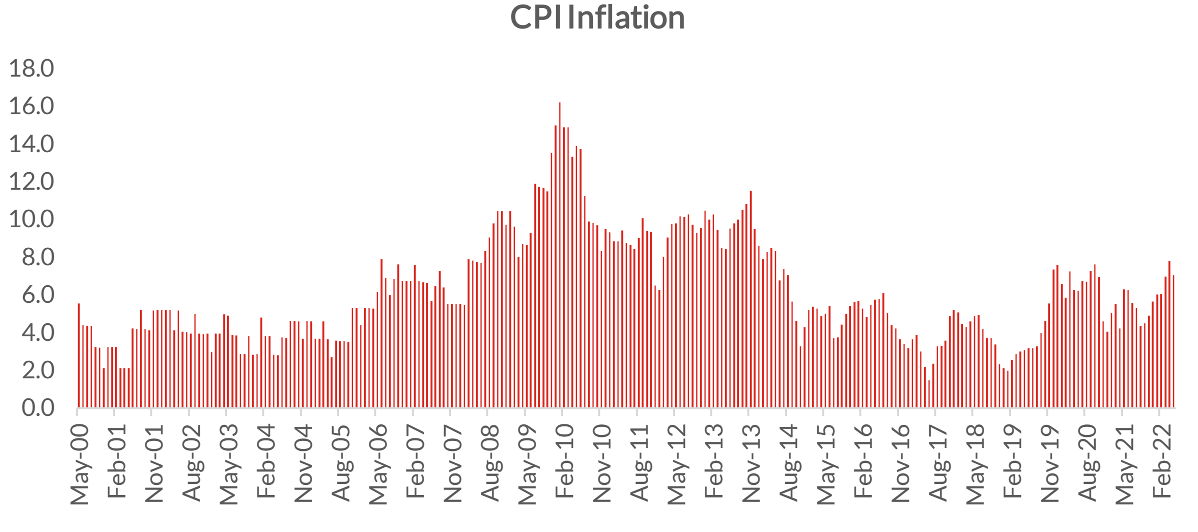
Uncertainty is inherently unmeasurable. In the long run, investment outcomes will continue to be a function of their earnings growth, adjusted for capital efficiency. While in the interim, divergence in how various stakeholders measure and react to risk will affect stock prices.

GROWTH

Contraction in growth rates is as much a logical phase of an economic cycle as is expansion in growth rates. What is difficult is timing the slowdown, especially given the nature of false alarms that are endemic to the industry. Over time, our assessment of the market's cyclical phase will significantly impact our portfolio returns since it determines our stance of either being defensive or investing opportunistically. Let's bear in mind that India's demographic picture fundamentally underpins its growth rates. In a nutshell, the aspirations of 2/3rd of India's consumers aged below 30 and their rising incomes are driving a wave of demand for certain products and services. And there is the added impetus of a manufacturing resurgence. Our job is to identify firms in these sectors available at a reasonable price.

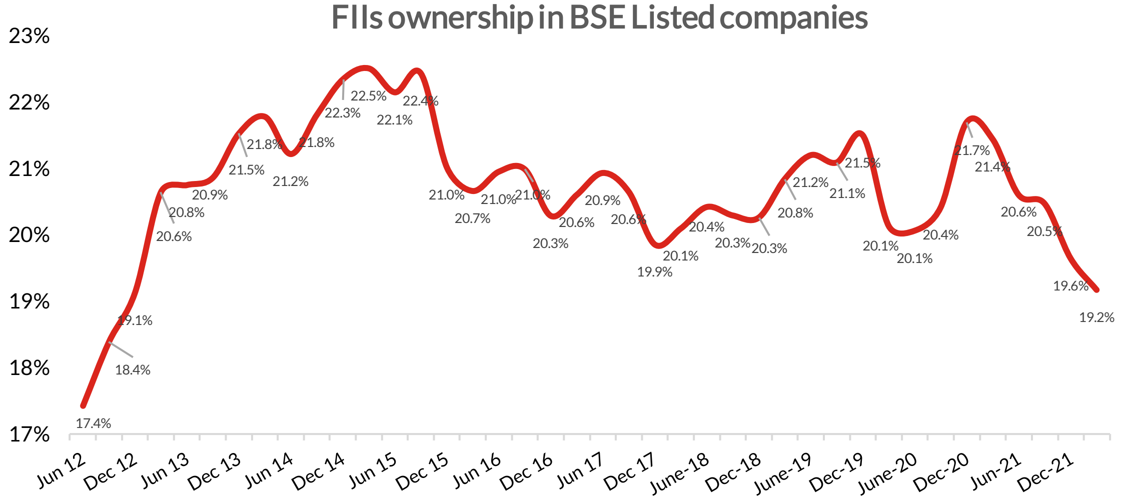
INFLATION

The powerful force of inflation influences demand; low and stable inflation accentuates growth while rising inflation contracts pricing spreads for firms and purchasing power for consumers. The question is, how long will inflationary prices prevail before supply catches up as it always does? Getting this forecast right is essential as it influences interest rates and our choice of asset classes. Today's environment is dominated by jams in container shipping, the war in Ukraine, and the reversal of the benefits of globalization due to geopolitics and rising trade barriers, presenting India with serious challenges and great opportunities. While we face uncertainties, the macroeconomic stability of the country's overall debt and foreign currency flows/balances are foundational to our view as investors.

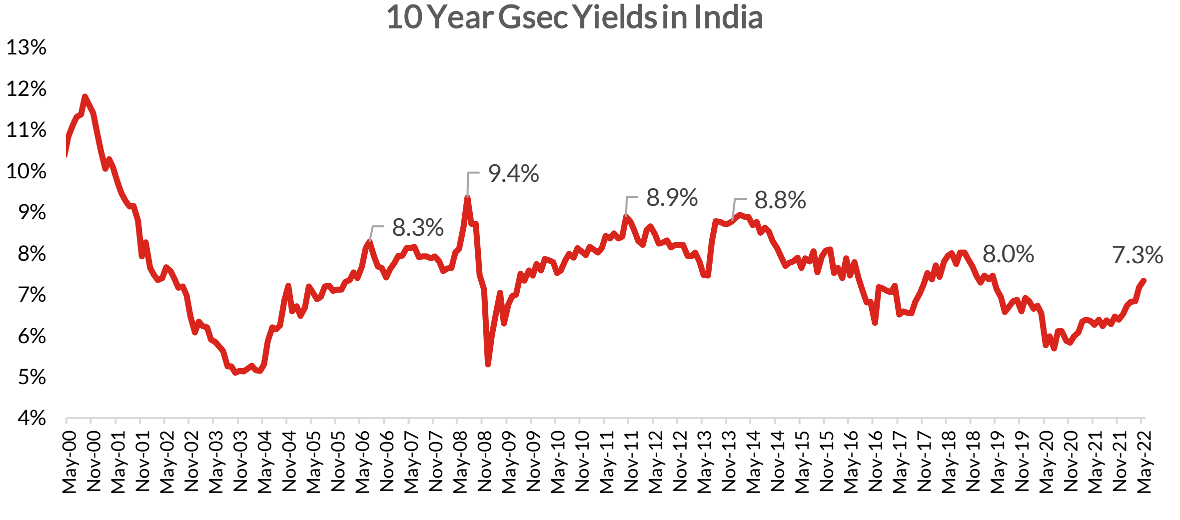


OURVIEW

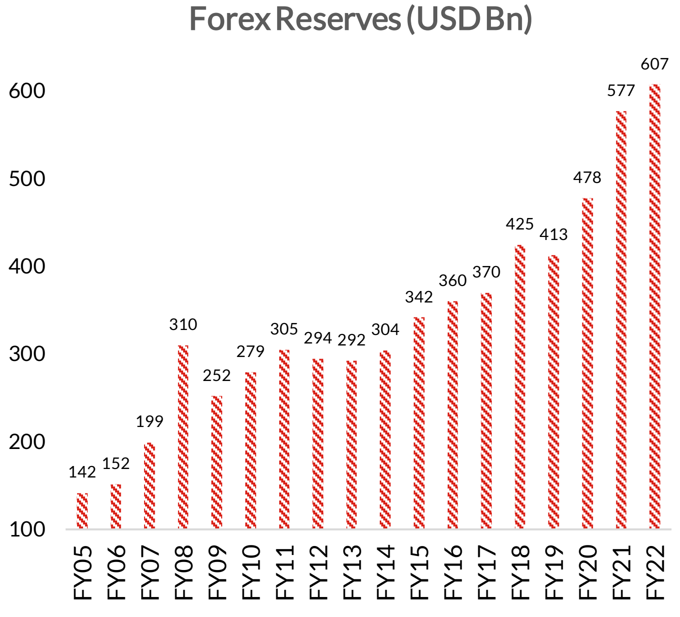
Asset prices are determined by how investors expect growth and inflation to trend. And this is reflected in our current portfolio construction. The demographic picture in the developed world is dominated by high base effects of incomes and consumption and their low and falling birth rates of around 1.5. The selling by foreign investors and the hysteria observed in the western media is a reflection of this. The collateral impact on Indian stock markets has been quite significant, especially on those firms that were over-valued or whose prospects are weak and unclear.

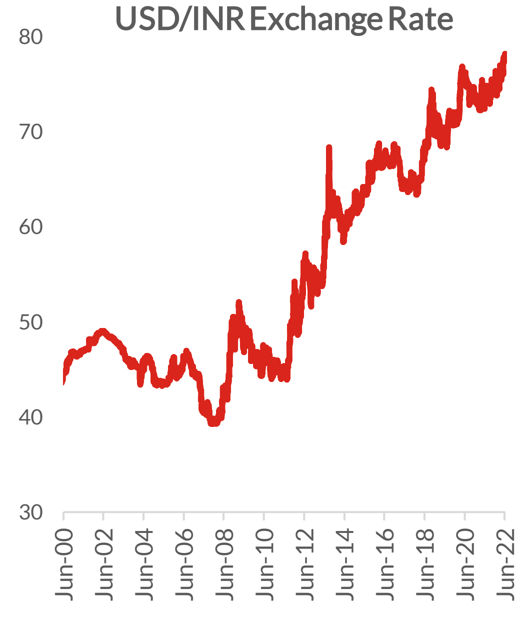


Inflation is impacting firms and consumers, but not equally. It is important to bear in mind that the absolute cost of money is more important than the direction of cost, i.e., interest rates. It is clear that interest rates are still at a reasonable level relative to our past.



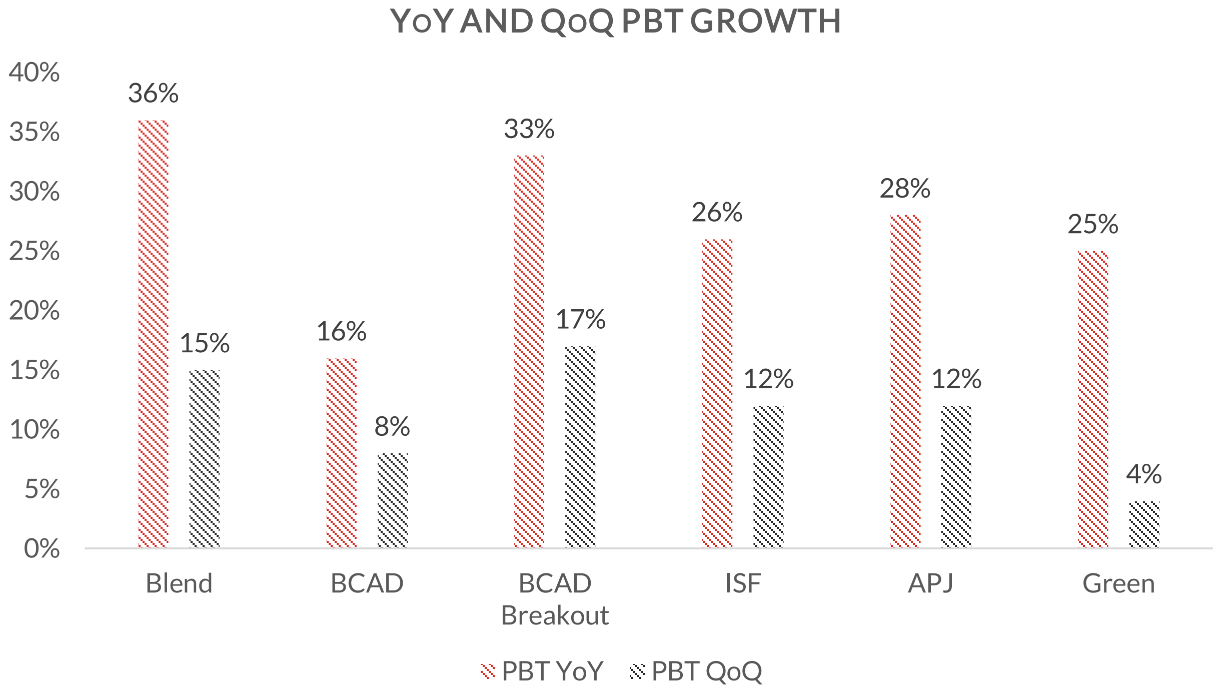
And alongside, the probability of a sharp fall in the rupee exchange rate as we suffered in 2014 is low.

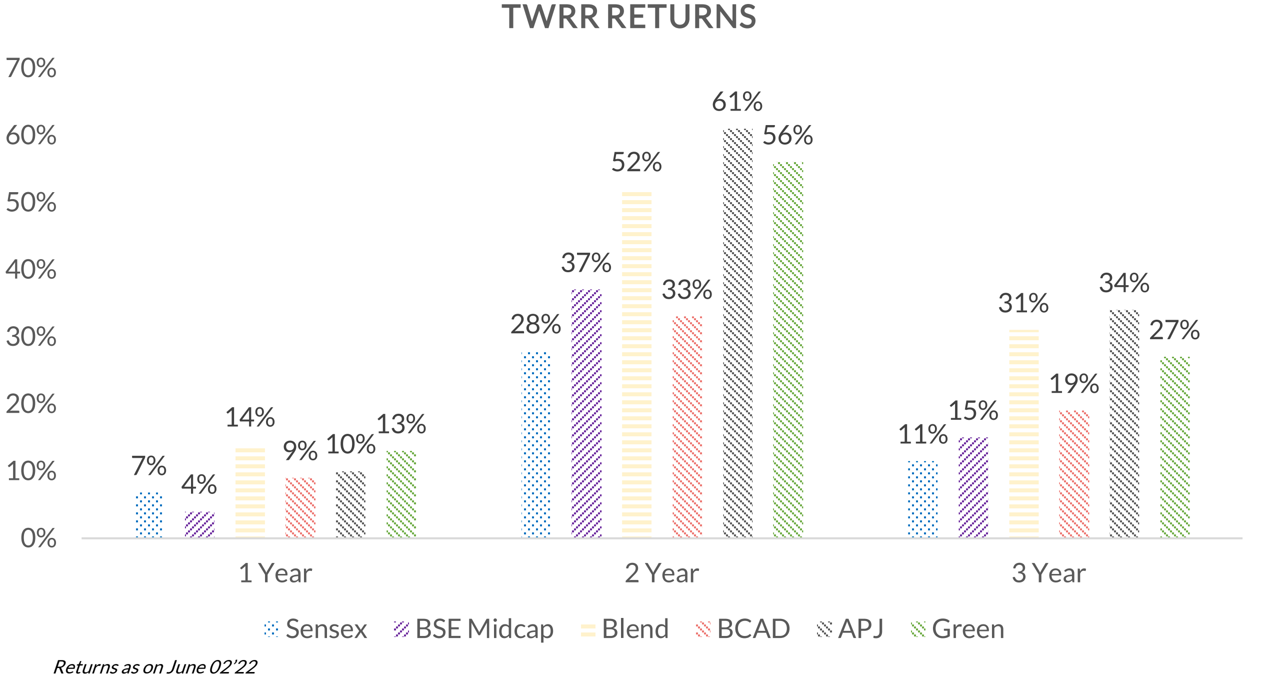




Different sectors are coping with growth and inflation using the tools at their disposal to optimize their growth and earnings. Certain sectors will do well and others poorly, and we are focussed on identifying this accurately and early.

Finally, valuations. As prices have dropped across the board, there are more well-run businesses we have the option to buy vs. the same period last year. We find sectors like consumer staples still over-valued relative to their growth and capital efficiency and resist the temptation to take shelter under the comfort of brand names that represent good past performance. Instead, we are taking advantage of reasonable valuations in emerging sectors and firms catering to India's discretionary demand for healthcare, building products, home appliances, and agri-chemicals, and globally competitive firms in technology, KPO, chemicals, and specific aspects of pharmaceuticals. We cannot over-emphasize India's demographic strength, the depth of its consumption franchisee, and the resurgence in manufacturing. The rising income of 26cr households is driving a wave of demand for certain products and services, and we are excited by the opportunities available to us.





Returns as on June 02'22

An outline of each of our investment strategies has been presented in the following sections with a summary of performance for Q4 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.

DVD / BLEND

The DVD / Blend 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 June 4, 2022	FY23E
Wt. Avg PE	**18.3x**
Wt. Avg PB	**3.8x**
Wt. Avg ROE	**23%**
Wt. Avg Mcap	**Rs.80,652cr**

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 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 June 4, 2022	FY23E
Wt. Avg PE	**21.9x**
Wt. Avg PB	**4.2x**
Wt. Avg ROE	**23%**
Wt. Avg Mcap	**Rs.70,826cr**

BCAD 2 BREAKOUT 20

The BCAD 2 Breakout 20 strategy seeks to invest in sectors that are witnessing structurally high growth rates driven by demographic led consumption and larger stream of disposable incomes. The fund continues to focus on large formal operators with competitive advantage and scale, consolidating its position in their respective categories.

As on June 4, 2022	FY23E
Wt. Avg PE	**28.0x**
Wt. Avg PB	**4.7x**
Wt. Avg ROE	**20%**
Wt. Avg Mcap	**Rs.69,110cr**

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 June 4, 2022	FY23E
Wt. Avg PE	**17.9x**
Wt. Avg PB	**3.9x**
Wt. Avg ROE	**21%**
Wt. Avg Mcap	**Rs.84,724cr**

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 June 4, 2022	FY23E
Wt. Avg PE	**19.3x**
Wt. Avg PB	**3.2x**
Wt. Avg ROE	**20%**
Wt. Avg Mcap	**Rs.67,230cr**

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 June 4, 2022	FY23E
Wt. Avg PE	**15.0x**
Wt. Avg PB	**3.0x**
Wt. Avg ROE	**16%**
Wt. Avg Mcap	**Rs.69,679cr**

RISK

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 continue to 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.
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 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 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.
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.

Thank you for placing your trust in Unifi.
Sincerely

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