UNIFI CAPITAL

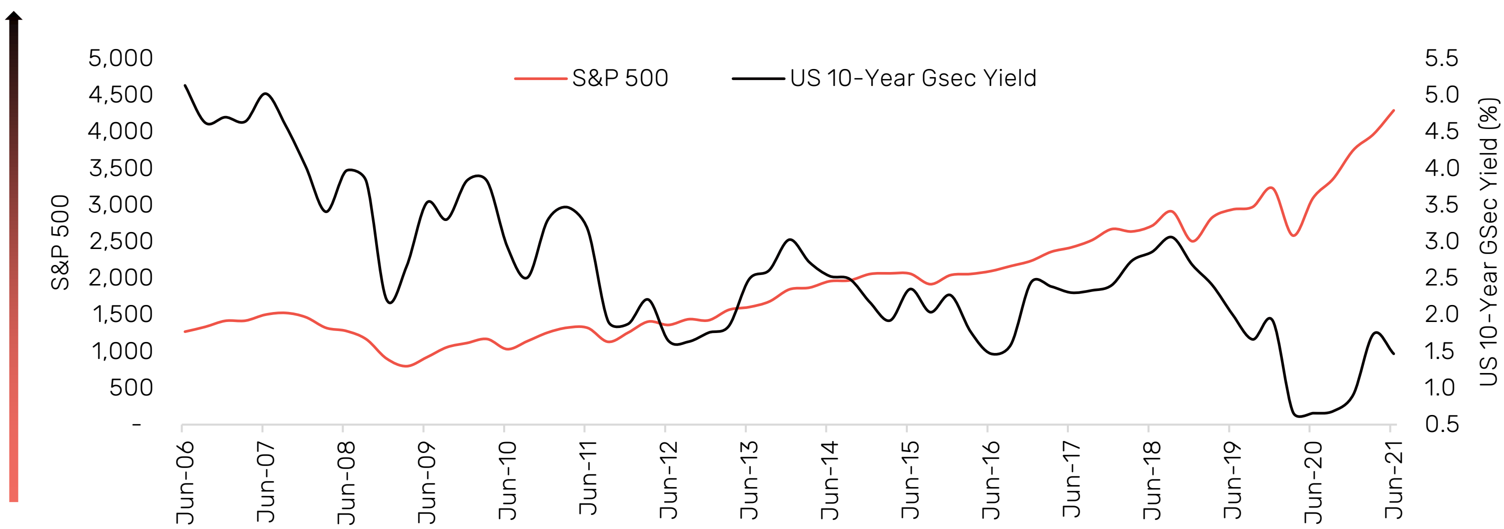
Review: Q2-FY 2023

We usually write sparingly on the Macros. Macros run a relatively low elasticity when seeking absolute returns in relatively stable emerging markets, such as India. However, 2022 has been a year of significant macro upheaval, and a moment here will contextualize the complexity of the environment. This is important to appreciate the risk/reward currently prevalent before we shift our focus back to the bottom-up.

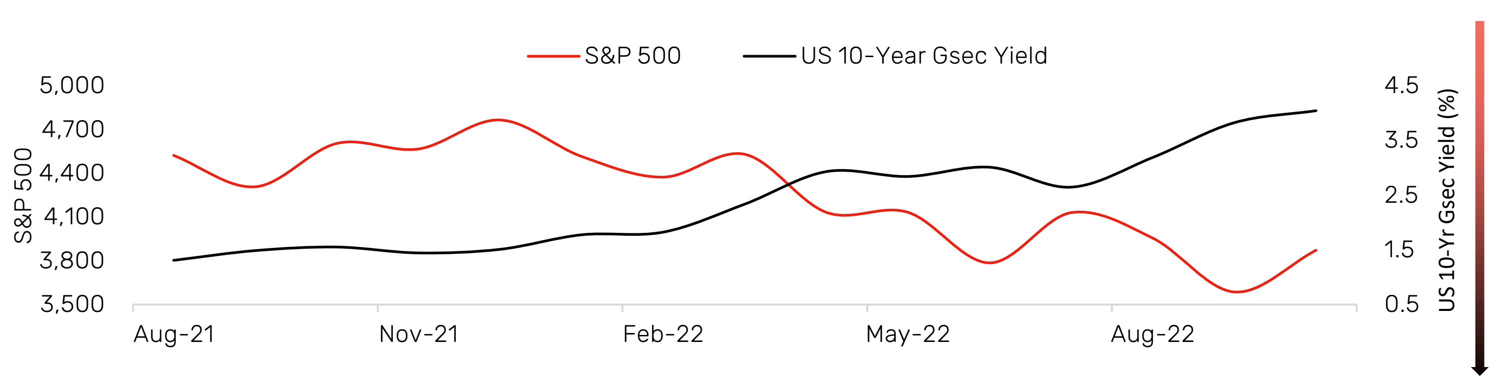
Cutting through the Macro

Over the last decade, the global monetary policy system burdened itself with the primary objective of delivering growth through a medium of very negligible cost of capital. An extended phase of such marginal costs lent to the artificial stimulation of excess demand, exerting tremendous inflationary pressure across all asset classes – physical or intangible. This spawned the beginning of economic unsustainability because when the cost of capital is cheap, in some combination, consumers tend to over-pay for all factors of an economic value chain – land, labor, and capital. Further, the forceful measures taken by central banks during the pandemic accelerated the consequences on all such assets, eventually reflecting in the inflationary value of the underlying equity holding such assets. This is essentially an economic theory, but as they were implemented with abandon over the last many years, the markets played out as they ought to have – i.e., create a period of unsustainable surplus and eventually give it up. And these trends played out equally between the primary markets [venture capital funding conceptual ideas] before transmitting to the secondary [capital] markets.

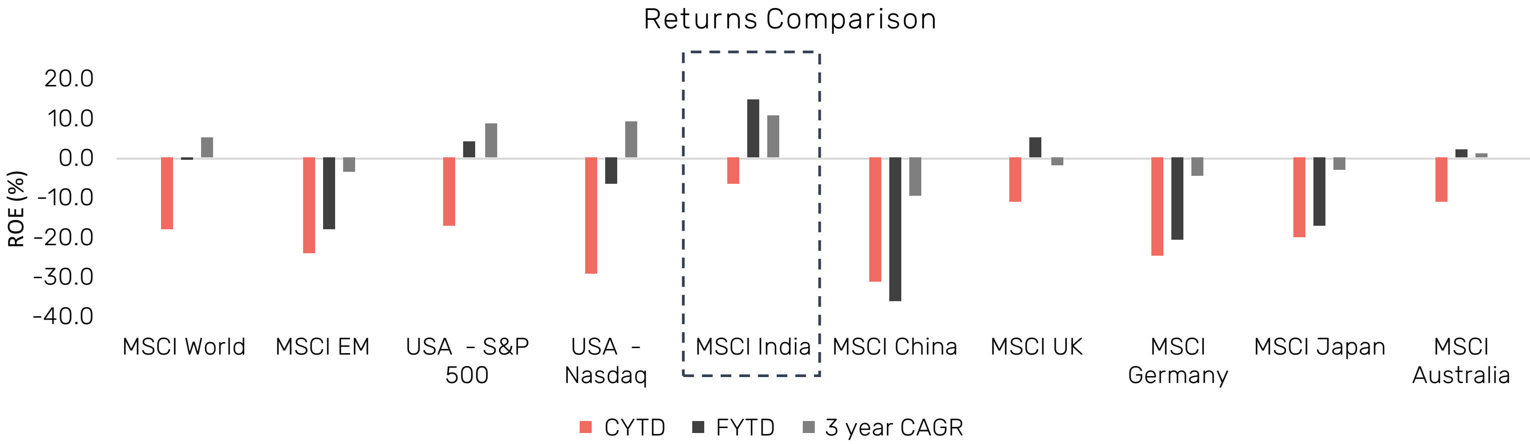
To skip the details in favor of brevity, this is how the bubble played out in the US: as quantitative easing began in the late-2010s, the US 10year GSec fell from ~4% to <1% while the S&P 500 compounded at ~12% CAGR.



When capital is cheap, all assets command a premium. When the glut recedes, interest rates rise, and risks adjust to reality. Over the past 15 months, as the FED increased interest rates, US GSec increased from 1% to 4%, while the S&P 500 gave away ~17% from its peak of the previous year. And there is more tightening to come, as evidenced by the US Fed's general guidance that intends to be "sufficiently restrictive." This means yields will rise, and it remains to be seen how much more US equities will reprice themselves.



A similar passage of play played out in almost all countries worldwide for the past 18 months. However, interest rate reversals, and money supply, are the only variables that can be formally controlled, as monetary policymakers cannot control the most integral end of the economy – demand and supply. This leaves the door open for the markets to reprice themselves. The result is a complex system of unpredictable output, constantly evaluated by the stock markets, basis the strength of each underlying economy.



As of 15th November 2022

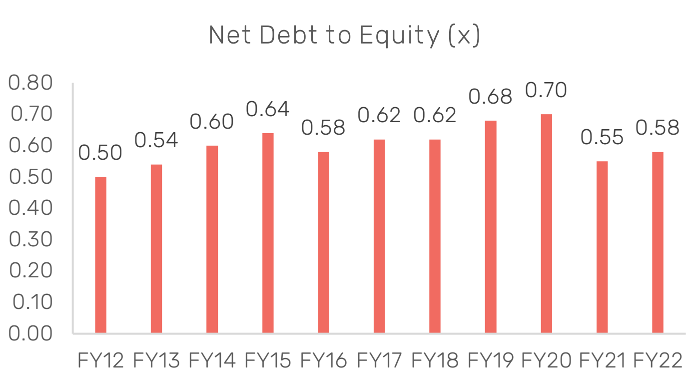
In the context of this complexity, we distill the macros into a simple framework to address what this means for managing your equity risk in India. Accordingly, we ask ourselves the following questions: How is India faring? And how are we managing your equity risk?

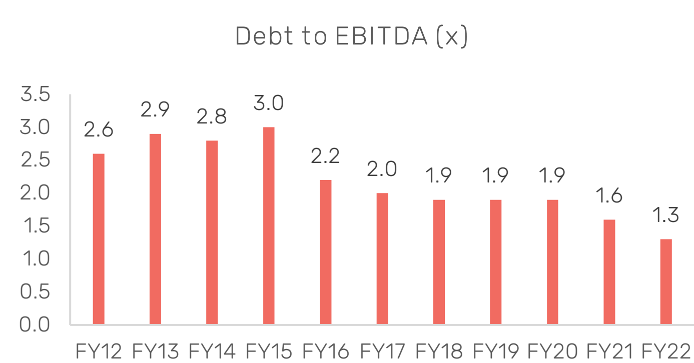
How is India faring?

As an emerging market, India cannot be immune to worsening global macros.

However, the underlying strength in a new capital formation cycle, credit growth, and a resilient domestic consumption cycle place India in a different macroeconomic trend from the rest of the World. While this is evidenced by past returns as showcased above, going ahead, this is primarily because India's credit cycle has run inversely proportionate to the West's. Between 2015 – 2021, India curtailed its lending while the West was in an expansionary phase. This resulted in negligible domestic capital formation and limited economic multiplier. The West, in this period, enjoyed a liberal flow of capital and an expansionary private sector. The situation now stands reversed. Corporate India, with its strong balance sheets and policy support across the breadth of manufacturing and agriculture, is in the midst of a new phase of growth and witnessing renewed demand within India.

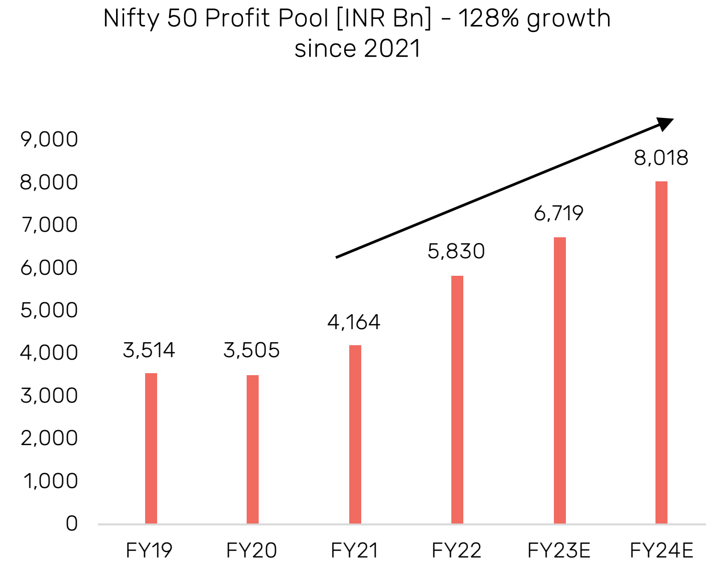
We support this with a few facts. Since FY15, Indian firms have materially deleveraged their balance sheets. The debt to EBITDA ratio of the top 500 corporates in India decreased from 3x to 1.3x. Resultantly, the rate hike cycle in India has had little or no impact on earnings or growth plans. On the other hand, India Inc has witnessed strong economic resilience post-pandemic phase, reflecting higher credit growth. India's system credit growth has touched a multi-year high of ~17% in Nov '22, led by robust consumption demand. As India's capacity utilization in the manufacturing sector is running above its long-term average, the construct of the next phase of private CAPEX cycle is robust and financially sustainable.





In FY 2022, Corporate India witnessed the best-ever delta in terms of an increase in the cumulative profit pool in the last two decades. They continue to defend that base well despite the current inflationary cycle.

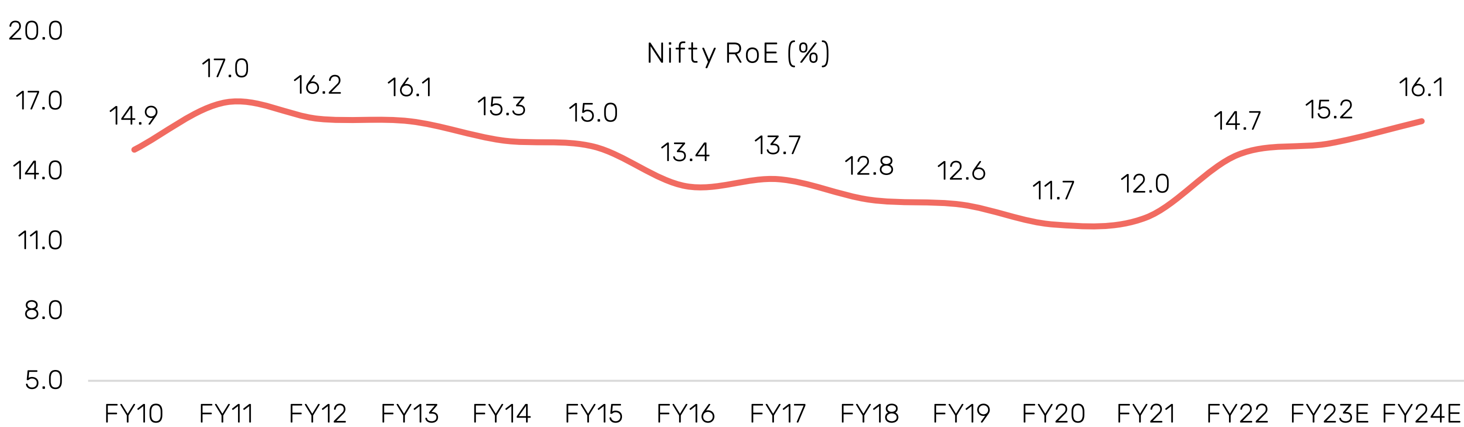
India is the only economy that provides growth rates of this magnitude at scale with greater appreciation to capital allocation, governance, and the Government's willingness to do what it takes to support the domestic industry. After going through a challenging earnings growth cycle in the last decade, Nifty 50's cumulative profit pool has doubled in the previous 3years. The last time corporate India enjoyed this fundamental strength was more than a decade back. The markets are ultimately discounting this pace of growth despite the challenging global macro environment. And this is responsible for India's equity market performance relative to other major economies.



.. and doing this with Capital Efficiency

While earnings growth and profitability metrics remain the focal point of a firm's journey, value creation is unsustainable without the discipline of capital allocation. The primary pillars of the value creation journey are earnings growth and the firm's ability to reinvest capital at better returns than the cost of capital, especially in an environment where the cost of capital is on its way up.

In a nutshell, earnings growth only creates shareholder value if a company generates returns over the cost of capital, and this is reflected in Corporate India's financials. With the corporate balance sheets today in significantly better shape, Return on Incremental capital has much been higher than historical trends, resulting in the expansion of earnings and an appreciation in the value of equity delivering such earnings.

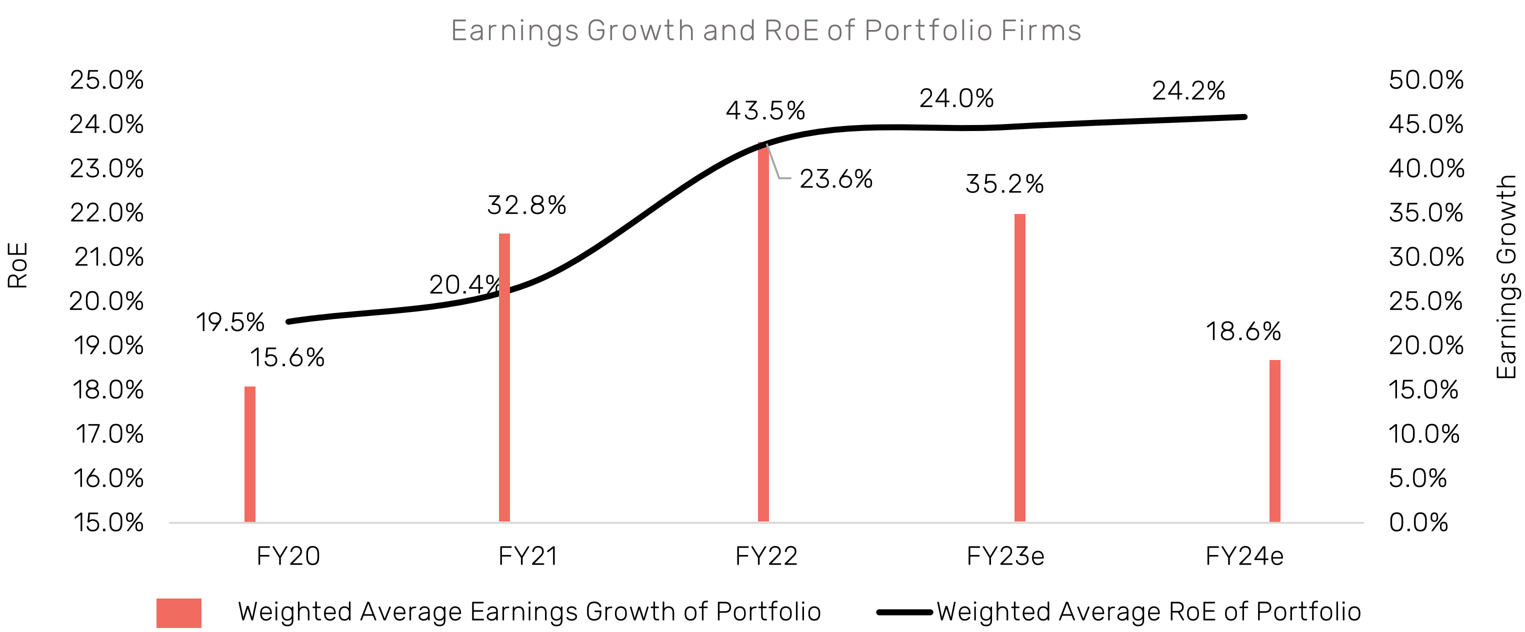


How are we managing your equity risk?

The robust offtake of credit dictates the making of a new economic cycle. And financial enterprises are the first to capture the multiplier effects, ahead of other parts of the economy. As a result, credit remains a significant part of our portfolio today. As of October, this year, India's systemic credit growth reached a multi-year high of 17%, driven by strong consumer demand. This figure is anticipated to rise with a new investment cycle. Further, a rising interest rate environment coupled with benign credit costs will help banks report robust earnings over the next few years. On average, Banks today constitute c.25% of your portfolios.

The depth of India's domestic consumption and manufacturing franchise are drawn upon to construct the remainder of your portfolios. Due to healthy wage inflation in the formal economy, disposable incomes have risen at a healthy pace. Coupled with pent-up disposable incomes over the two pandemic years, there has been a noticeable improvement in premium and discretionary consumption, property absorption, and financialization of savings. While we have mentioned this statistic in our previous notes, it may be worth repeating that the percentage of households in the upper and high-income groups grew from 8% in 2005 to 24% in 2018. And by 2030, this percentage is estimated to reach 51%. With this change in the profile of household incomes, all cohorts of discretionary consumption will grow while newer categories will be created. We are aligning with numerous companies at the portfolio level that are aligning with such change. The respective portfolio sections present a more detailed flavor of your portfolio.

We have drawn from the strength of India's macros highlighted in the previous sections and referenced it with a firm's exhibiting strength in sections of the economy described above in evaluating (A) earnings growth and (B) capital efficiency in determining if they merit a place in your portfolios. This has resulted in a portfolio with a blended average earnings growth of c.50% over FY23 and FY 24, with capital efficiencies of 24%. While the macros play a role in the regular pricing of securities, the strength in earnings and ability to defend capital efficiency will culminate in portfolio returns over the medium term.



In closing

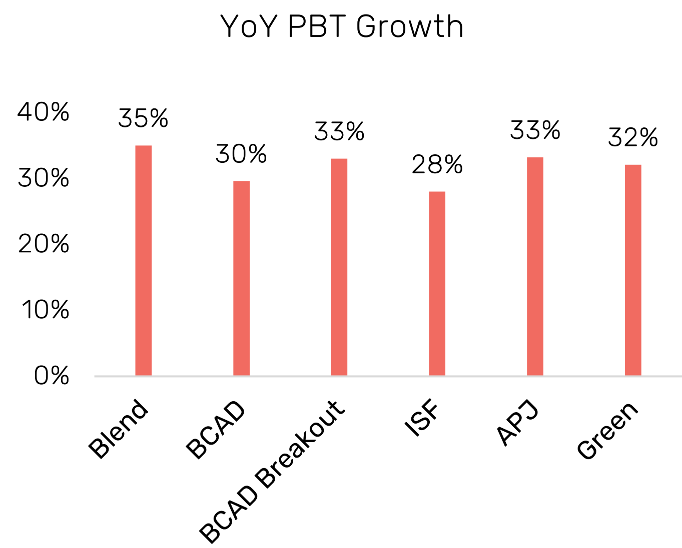
As one of the World's fastest-growing economies, India is naturally home to businesses with very high growth rates. And growth companies derive most of their value from the future, which is fair. In a cycle of monetary tightening and higher cost of capital, the premiums typically paid for growth compress, and their equities' value is drastically repriced. To us, this boils down to not evaluating companies through a prism of buying cheap or high-growth companies at all costs, which is the basic premise of value and growth. To us, high-quality growth businesses are a balance between a proven and profitable business model, a sustainable competitive advantage, financial productivity in the form of cash generation and return on equity, and the ability to sustain and compound this into the future. And in various measures, our portfolio construction is an outcome of this.

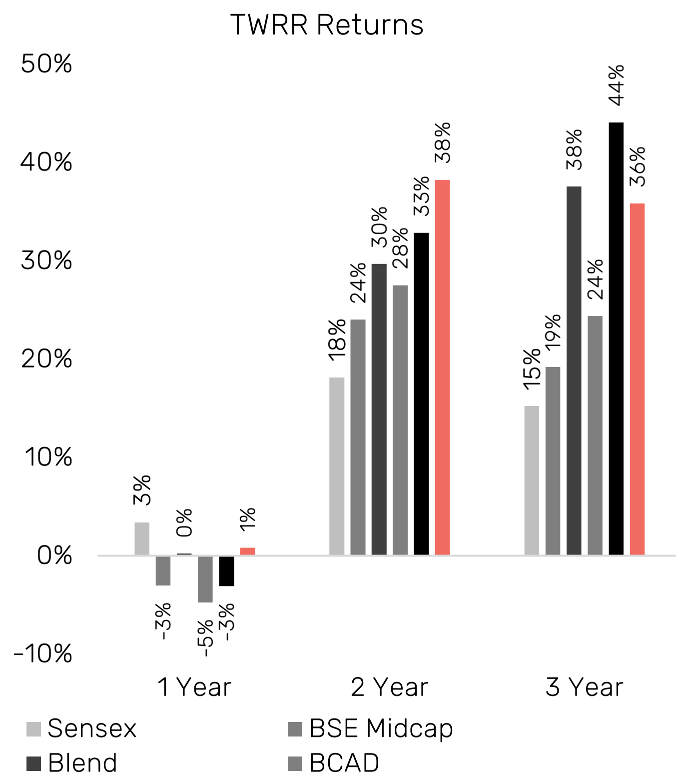
India, as a basket, has typically commanded high growth multiples as the depth of formalization and consumption the country offers is unique and truly one of its kind.

The rapid adoption of India's technology stack [digital payments, identity, formalization, payments, and tax systems] is transforming a vast, inefficient, informal cash economy into an unthinkable new-age economy, surprising even the most optimistic India watchers from a few years ago. This is creating productivity at a scale unseen before, and all of this will eventually be captured in the equity value of India's most efficient firms. This has led to investors to reimagine how they view and value India's equities. And again, in various measures, our portfolio construction is an outcome of this.

At the cost of repetition, the macros today are complex and difficult to price. As markets react to the high frequency of news flow and price them in real-time, we tread a line of caution and constantly evaluate risk and reward. In a nutshell, this means not overpaying for growth and not overstaying our welcome when an investment objective has been achieved.

Earnings Review – Q2 FY2023





As on 18th Nov'22

An outline of our investment strategies has been presented in the following sections, with a performance summary for Q2 FY23. 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 Nov 18, 2022	FY 23E
Wt. Avg PE	19.0x
Wt. Avg PB	3.6x
Wt. Avg ROE	23%
Wt. Avg Mcap	Rs.114,727cr

BC AD

The fund continues to invest in sectors that are currently witnessing a shift in market share from the unorganized to organized players. The market leaders with strong and 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 current environment.

As on Nov 18, 2022	FY 23E
Wt. Avg PE	23.7x
Wt. Avg PB	4.6x
Wt. Avg ROE	23%
Wt. Avg Mcap	Rs.89,454cr

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 operators with competitive advantage at scale, consolidating position in their respective categories.

As on Nov 18, 2022	FY 23E
Wt. Avg PE	24.8x
Wt. Avg PB	4.8x
Wt. Avg ROE	20%
Wt. Avg Mcap	Rs.103,903cr

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 Nov 18, 2022	FY 23E
Wt. Avg PE	24.4x
Wt. Avg PB	4.1x
Wt. Avg ROE	19%
Wt. Avg Mcap	Rs.150,036cr

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 Nov 18, 2022	FY 23E
Wt. Avg PE	21.0x
Wt. Avg PB	2.9x
Wt. Avg ROE	21%
Wt. Avg Mcap	Rs.96,137cr

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 Nov 18, 2022	FY 23E
Wt. Avg PE	18.0x
Wt. Avg PB	4.0x
Wt. Avg ROE	20%
Wt. Avg Mcap	Rs.68,214cr

Risk

While the environment is buoyant for India in the longer term, in the shorter to medium term, the aftereffects of unforeseen economic linkages from a recessionary West may be a risk. While India remains a largely domestic consumption-oriented economy, a rapid worsening of the economies in the West may affect their balance of trade with the World [including India] in the immediate to medium term. India's Current Account Deficit and foreign exchange reserves may be under pressure if energy prices remain elevated and rise. The recent softening of energy and commodity prices will assist India's macroeconomic case, but there remains the prospect of second or third-order impact from global macroeconomic and geo-political shocks.

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.
Geopolitical 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 an 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 and EV vehicles are in the relative infancy stage and have a strong growth curve ahead of them.
Softness in IT product spends	The convergence of 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

Baidik Sarkar

Head – Research