UNIFI CAPITAL

REVIEW : Q3-FY 2023

PERSISTENCE OF GROWTH

For those of us inching our way through the infinite gridlock at Lower Parel or Silk Board and Whitefield, imagining we are a nation running at 6.5% p.a for over 20 years is an exercise in irony. India has a habit of testing the most ardent of her backers with a poverty of aspect. India's progress is a distribution of numbers versus a single experience, which it is often confused with. This forces a restricted view of reality instead of one that merits its complexity, preventing us from grasping the magnitude of India's success with capitalism.

Since 2000, and with a generational base of 20 years, India has made the most rapid progress across all economic indicators. Moving from a $460bn economy to a $3.2trillion today, the absolute strides in each cohort of industry, services, and agriculture place it among the World's most significant on every parameter. The absolute size of progress made in each of the cohorts is self-explanatory. However, in calling out the obvious, this has resulted in vast profit pools that have consistently distilled into the creation of equity value.

Global Ranking	2000	2021
Size of Industry	12	5
Size of Agriculture	13	7
Size of Services	3	2
Consumer Spending	11	5
Savings	12	7
Savings Rate	12	4
Investment	7	3
FDI	10	4

Source: World Bank

The material jump in agriculture is critical, given the bearing of farm incomes on almost 60% of India's population. A slew of policy initiatives are underway to fundamentally strengthen India's farm income and the importance of this on India's domestic consumption cannot be overemphasized. On the industrial side, new world equations and India's strides in import substitution have re-drawn supply chain dynamics, and India will continue to strengthen its footprint herein. This is expected to have a significant multiplier effect on the tertiary side of India's economy. India has delivered well in the Services industry and continues consolidating its strength herein, given its high-quality and low-cost talent pool. While there are several other parameters on which India has made material strides, we especially call out the 3rd and 4th highest investment and savings rates anywhere in the World, a key to sustaining re-investment rates in any economy.

The accumulated data on India's progress is accurately reflected in its equity returns across long periods. India is consistently the World's best-performing equity market for 20 years [USD, adjusted].

CY22	1 year	CY19-22	3 year	CY17-22	5 year	CY12-22	10 year	CY02-22	20 year
Brazil	10.1	India	8.6	USA	7.5	USA	10.4	India	12.0
India	-6.0	USA	5.9	India	5.8	India	7.3	Brazil	9.8
UK	-9.8	Taiwan	4.7	Taiwan	5.1	Taiwan	5.7	Germany	8.3
France	-14.9	France	1.1	France	1.7	Japan	5.1	USA	7.6
Germany	-17.0	Germany	0.1	Japan	-0.3	Germany	4.0	Taiwan	6.6
China	-18.0	S. Korea	-2.3	Germany	-0.8	France	3.7	S. Korea	6.3
USA	-19.4	Japan	-2.9	Brazil	-2.1	China	-0.5	MSCI EM	6.1
Japan	-20.3	UK	-3.4	UK	-2.8	S. Korea	-0.5	Russia	5.7
MSCI EM	-22.4	MSCI EM	-5.0	MSCI EM	-3.8	UK	-0.6	Japan	5.2
S. Korea	-29.2	China	-8.1	Russia	-5.1	MSCI EM	-1.0	China	5.0
Russia	-29.3	Brazil	-10.3	S. Korea	-5.1	Brazil	-3.6	France	3.9
Taiwan	-30.1	Russia	-13.8	China	-6.4	Russia	-6.8	UK	1.8

**Annualized returns % as of 31st December 2022*

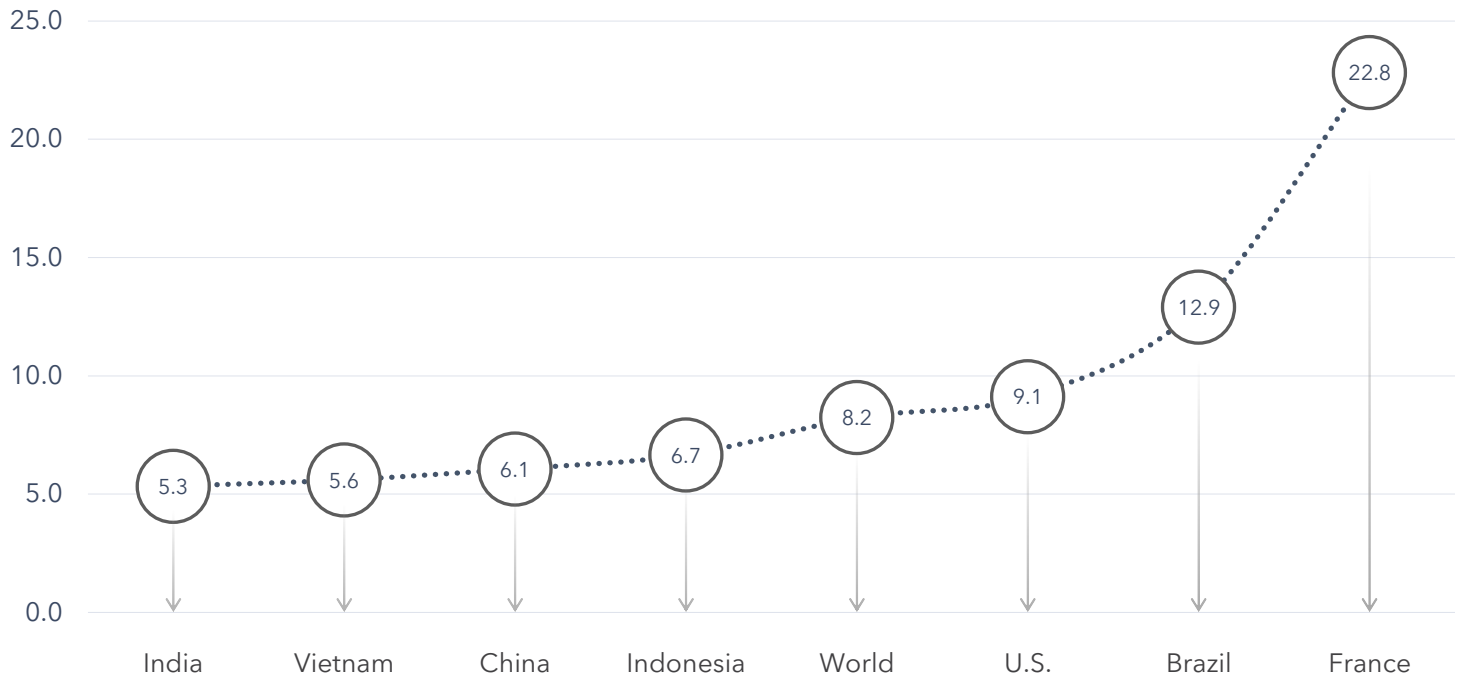
Issac Asimov said this best: it is only afterward that a new idea seems reasonable; to begin with, it usually seems unreasonable. India's progress fits the bill. The consistency in India's equity returns is not just a function of a few financial measures coming together but a combination of progress on productivity and social standards. We highlight a few of them here.

CAPITAL EFFICIENCY

India's capital-output ratio is among the most efficient in the World

The capital-output ratio is an indicator of the amount needed to produce one unit of output and is one of the most critical metrics in evaluating any economy's productivity. It explains the relationship between the level of investment and economic growth. A lower capital-output ratio is desirable as it shows capital efficiency. India has the lowest capital-output ratios compared to most emerging/developed economies.

CAPITAL OUTPUT RATIO (10 YEAR AVERAGE)



Source: World Bank, Capital output= Investment as a % GDP/GDP Growth rate

As a result, India has consistently created vast amounts of profit pools in every industry over many years. The importance of such sustainability in growth, re-investment, and development cannot be overestimated. A cursory look at Japan, West Europe, and North America's struggle with growth, despite their productivity and social infrastructure, indicates how challenging it is to maintain an elevated growth rate for long periods. Though not called out in this data set, India's firms have among the best rates of RoE the World over.

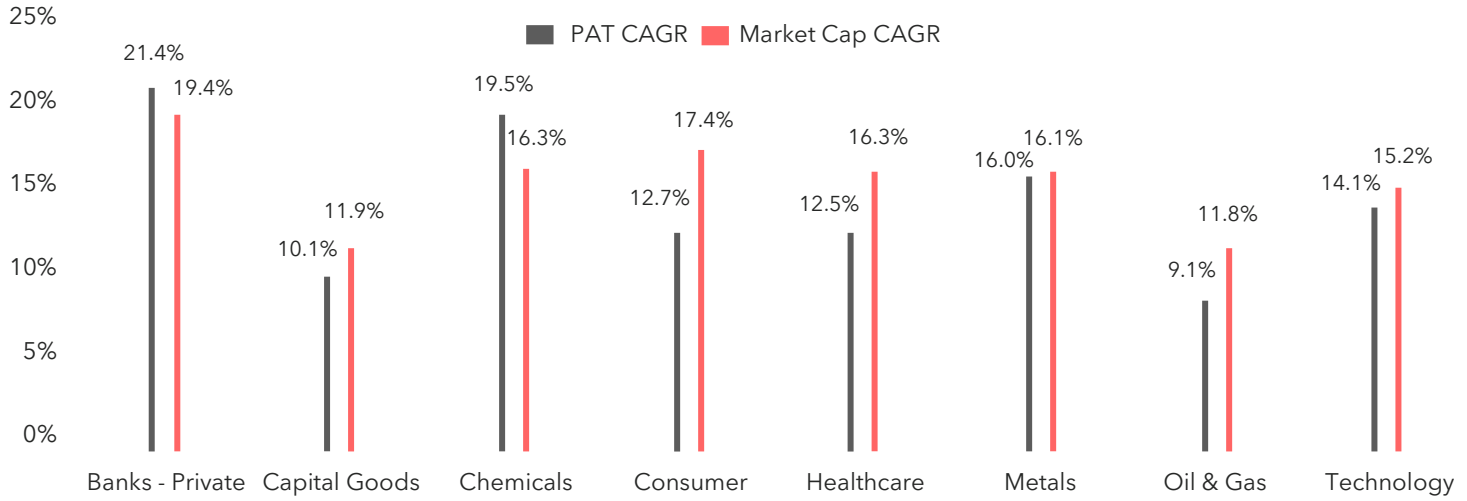
The following table captures the profit growth and market cap growth of comparable Nifty 500 companies over the last 15 years. For most of the sectors, profits have grown consistently in every block of 5 years and the same is reflected in market capitalization. The profit pool of most of the Indian corporates continue to grow at high rates given the tailwinds from raising household incomes, a favourable offshore destination for various sectors, policy initiatives digitization and rising productivity.

		CAGR FY 07-12		CAGR FY 12-17		CAGR FY 17-22		2007-22
Sector	**No of Cos**	**PAT**	**Mcap**	**PAT**	**Mcap**	**PAT**	**Mcap**	**PAT CAGR**
Banks - Private	10	31.4	19.3	9.1	22.6	21.9	15.6	20.5%
Banks - Public	10	20.4	21.0	PL	6.0	LP	13.2	10.8%
NBFCs	19	25.0	15.5	8.7	20.8	18.7	17.5	17.3%
Capital Goods	27	13.0	3.7	-5.5	9.8	9.2	11.8	5.3%
Cement	11	3.8	9.7	2.3	19.4	19.9	11.6	8.3%
Chemicals	30	19.2	18.1	5.5	23.0	21.3	23.3	15.1%
Consumer	24	16.5	21.9	12.0	18.8	10.9	13.0	13.1%
Consumer Durables	8	16.3	17.3	19.2	34.2	2.5	15.8	12.4%
E-Commerce	1	29.4	16.4	PL	19.6	Loss	43.1	34.7%
Automobiles	27	26.3	17.2	5.2	25.0	-11.5	4.1	5.5%
Healthcare	31	15.9	16.7	15.0	21.4	4.9	9.0	11.9%
Infrastructure	2	8.4	-13.4	-4.1	19.0	23.2	8.2	8.6%
Logistics	3	5.9	3.2	0.6	18.7	PL	9.7	5.5%
Media	5	19.5	2.0	15.9	30.6	0.1	-4.8	11.5%
Metals	13	1.2	13.0	-13.5	6.8	60.6	17.8	12.0%
Oil & Gas	10	7.9	6.4	9.3	11.7	11.4	15.7	9.5%
Retail	5	34.8	27.3	15.0	19.1	10.1	33.2	19.5%
Technology	17	16.9	8.4	16.2	13.2	9.2	24.7	14.0%
Textiles	9	-3.0	4.2	PL	32.9	LP	21.9	11.3%
Utilities	5	6.3	4.6	7.9	1.5	4.3	4.5	6.1%
Others	35	6.7	22.8	2.5	3.9	20.5	26.7	9.6%
Nifty-500	302	13.1	11.4	4.7	15.1	16.1	15.7	11.2%

Comparable firm with 15-year data within NSE 500
PL – Profit to Loss, LP – Loss to Profit

Adjusted for the capital efficiency of the respective sectors and the attractiveness of their terminal value, the equity value created in every sector broadly corroborates with the pace of their earnings growth over long periods.

NIFTY 50 (2007-2022)



While the direction of India's growth is not debated, from an investment point of view, the oft-asked question is, is India expensive?

IS INDIA EXPENSIVE?

This is an absolute question, best understood in a relative context.

Markets are inherently forward-looking, discounting the future value of their earnings. This discourse is especially interesting in the case of India, as the incline ahead is more reminiscent of a step well rather than linear progression. As India deals with its structural issues around income growth, inequality, and physical and social infrastructure, its growth gradient will be a series of leg-ups versus a smooth curve. Meaning, the terminal growth rates assumed today have a high probability of upgrades, and the duration of growth is likely to be significantly deeper than expectations today.

It is thus natural that the present value of the future, viewed today through the prism of a simple multiple, seems high. So, is India expensive?

The heterogeneity of the markets is a complex variable to tackle. For the sake of simplicity, let us view this through the prism of a few globally accepted thumb rules for a few industries. (A) Private banks that are capital efficient and exhibit growth rates significantly higher than systemic growth rates are typically priced in a particular spectrum. For instance, the private high-growth banks in the U.S. [average of 20 banks] are priced at a book value of 1.3x and earnings multiple of 10x, 1-year forward. However, the more well-run banks in India are valued at closer to 2x on book value and 14x on multiples, implying the incremental pace of growth and consistent market share gains. (B) In the case of IT firms that are a proxy to digitization, multiples worldwide are a combination of high earnings growth rate and capital efficiency. Such firms across the U.S. and China trade at earnings multiples of 25x and 29x, respectively, while multiples in India are roughly 22x. Note the difference? (C) While on the other hand, as commodities are inherently less secular in the predictability of their earnings and capital efficiency, they generally command low multiples.

In a nutshell, the sum total of an index is a function of the weight of different sectors, and the attractiveness of such a sector. Keeping this in perspective, let us evaluate how the frontline indices in India and China are stacked against each other.

	India			China		
	Sector Weight	Sector P/E	Weighted P/E	Sector Weight	Sector P/E	Weighted P/E
BFSI	37%	18	6.8	21%	7	1.4
Commodities	3%	9	0.3	11%	10	1.1
Consumption	12%	43	5.2	18%	18	3.3
IT	15%	23	3.5	11%	29	3.2
Pharma	4%	28	1.1	7%	23	1.5
Others	29%	19	5.6	32%	12	3.9
Index P/E			22.4			14.0

As is apparent, India and China have very different constituents in their indices, and the reasons behind the difference in the headline valuations are visible and self-explanatory. The one factor that stands out is the valuation attributable to consumption-oriented companies in India, given India's long road of consumption ahead. Is that justified?

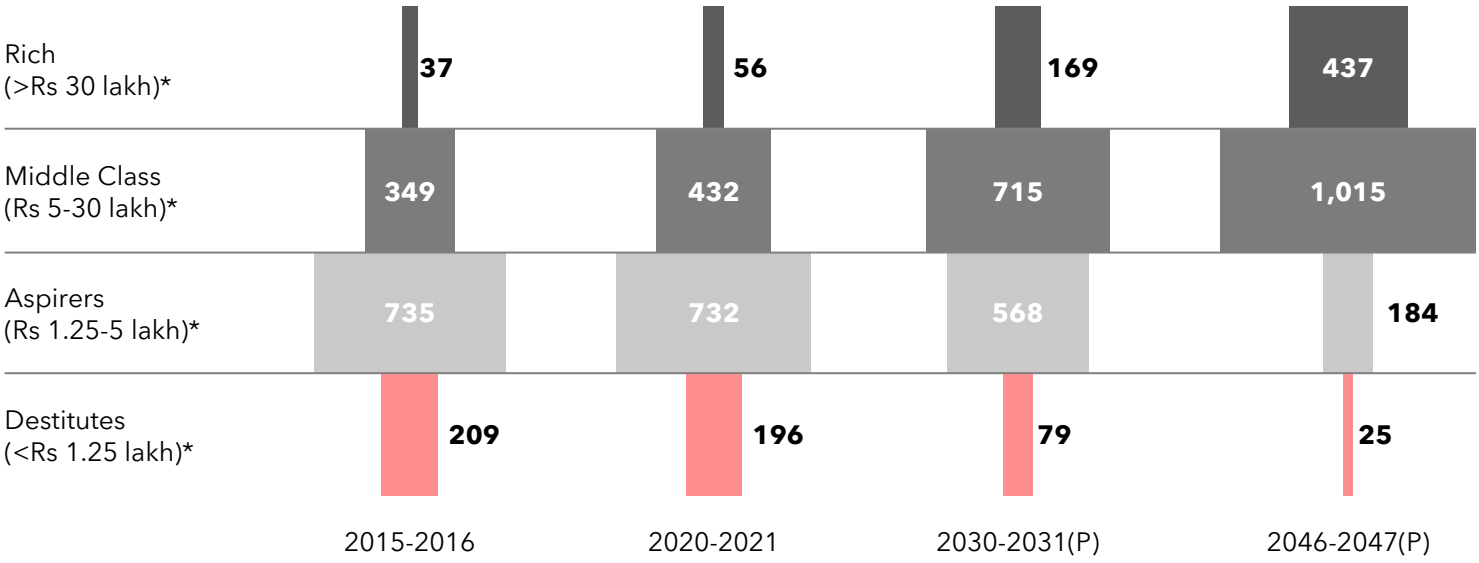
CONSUMPTION AHEAD

Since China's admission to WTO in 2001, manufacturing has driven employment growth. Manufacturing-led employment in India is finally set to grow, driven by several policy-led incentives and the re-alignment of global supply chains. This, alongside India's continued growth in services, will lead to increased employment and household incomes.

Significantly, manufacturing-led activity will drive tertiary employment, as witnessed in China, substantially boosting consumption. With a 6% growth in real economic growth between today and the next few years, Indian consumption is set to get very meaningful. This will drive a decade of robust consumption of premium discretionary products. Early signs of this trend are already visible across categories like cars, 2W, travel, etc.

INDIA'S INCOME PYRAMID

(Population in million)



This represent people in each households
**Annual household income at 2020-21 prices*
Source: ICE 360

The potential for growth at the top end of the income pyramid is staggering. The upper-income cohort is expected to compound at a CAGR of 12% over the upcoming decade, adding ~113 million people with very high purchasing power. At this end, India will likely add consumers equivalent to the population of Mexico today [population of 126mn]. In the middle class, India will likely add consumption equal to Indonesia [population 273 mn]. India will add ~400 million people with significant per capita incomes to Indian and global consumption. Whichever way this is sliced, the potential of this emerging purchasing power and profit pool is staggering. This is a significant determinant of the salience of India's consumption-driven industries. Those with the right to win in an expanding market will continue to be priced accordingly. Given how much of India's potential depends on its demographic strength, taking brief stock of its social indicators and how they are poised is also essential.

SOCIAL INDICATORS

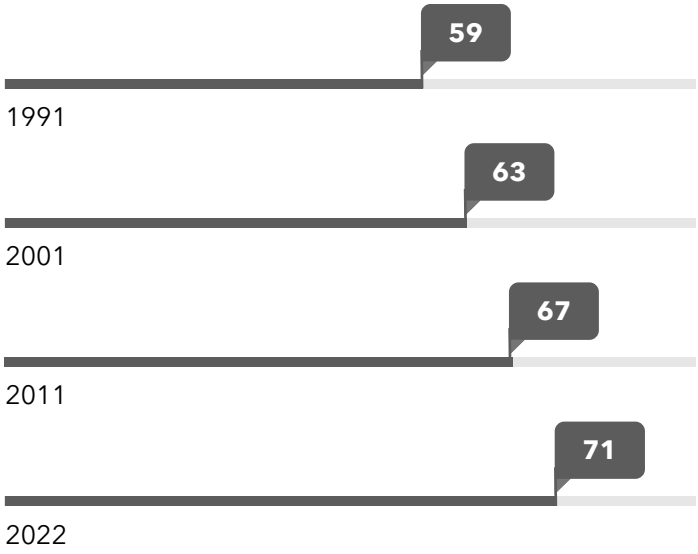
There are several; we touch upon better life expectancy, education, and internet penetration

Life expectancy, a vital human development indicator, has significantly improved over the last few years. While this is important from the perspective of social security and a sense of purpose, it is relevant in a nation's economic discourse from the standpoint of better productivity and consumption. Private investment in preventive and secondary healthcare is on the rise consistently. Over the next few years, led by increased insurance penetration, India's healthcare coverage per se will strengthen significantly.

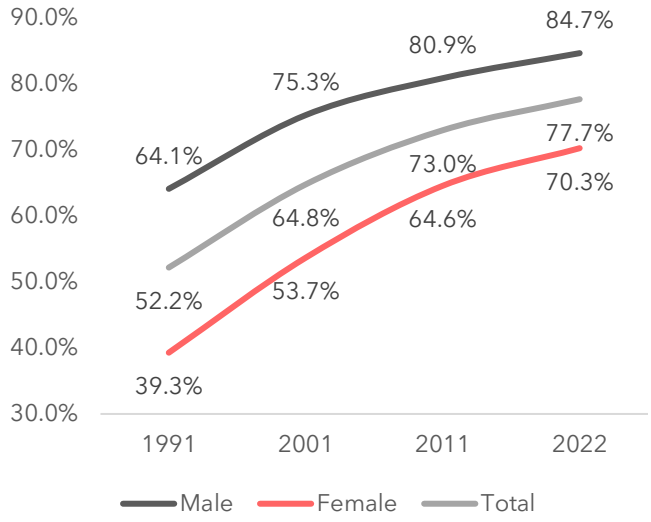
Alongside healthcare, education is the primary driver of productivity. The gross enrolment in upper primary (grades 6-8) has increased to almost 95% in FY-2022, while higher secondary (Class XI and Class XII) increased to ~60% in FY22 vs. 40% in FY13. The importance of upskilling a large part of India's demography cannot be over-emphasized from an employment perspective and is especially crucial in a largely service-driven economy like India. A slew of policy interventions at the state and central level continue to address the issue of education and upskilling, strengthening India's base of skilled manpower at scale and costs that are among the most attractive in the World.

Lastly, a combination of affordability and investments in infrastructure has significantly increased internet penetration in India over the last 10 years. Almost half of India uses the internet today, compared to just 10% a decade back, while rural penetration has increased to nearly 40% now (from 15% in 2016). This increase in internet penetration is boosting productivity gains and the growth of technology-led businesses, whose impact on the Indian economic landscape cannot be overemphasized.

LIFE EXPECTANCY (NO. OF YEARS)



LITERACY RATE



% OF POPULATION USING INTERNET

0% 1991

1% 2001

10% 2011

47% 2022

Over the next decade, India's progress on economic and social parameters will feed into one another and ultimately create a more robust domestic consumption-oriented economy.

PORTFOLIO CONSTRUCTION

Credit, Building Products, I.T., and Industries are the key constituents of portfolios.

Each of the areas discussed above feeds into how we imagine the construction of your portfolios today. While we are excited about India's macro, our bottom-up construction of the portfolios is strictly a function of our comfort with underlying earnings growth at reasonable valuations, adjusted for capital efficiency. We continue to re-look all our positions and right-sized them, given how the risk/reward has changed over the past few months.

We have taken the gains where our thesis has played out and reallocated them to positions where we believe the risk/reward is more favorable. A new cycle of economic expansion, coinciding with the end of a higher provisioning cycle, continues to result in higher credit growth for the banks. As a result, banks are a significant constituent in our portfolios. Banks have posted a strong quarter in Q3-23 with improving margins, robust credit growth, and benign asset quality. The rise in interest rates has resulted in higher earnings growth for the banks as NIMs (Net Interest Margins) have moved higher for the industry, led by its leaders. India's credit growth is now close to its long-term average of 15%.

Consumption trends in the real estate industry are indicative of the health of the sentiment in Indian households. India is historically resilient to a certain pace of inflation and interest rates; thus, the headline movement in each variable has had little or no impact on real estate consumption. In 2022, India's top seven cities delivered the highest sale of units in over a decade [c.215,000]. The supply side is supportive of this buoyancy, with new launches reflecting a decadal high. This has a significant flywheel effect on several players in the building value chain, from cables & wires, electrical durables, sanitary ware, and other building materials.

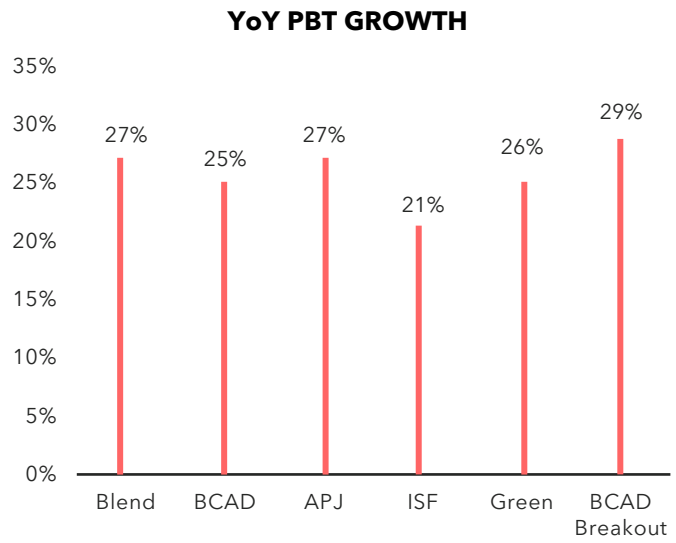
In technology, we continue to align with smaller firms specializing in enabling technologies [cloud, digital] with a track of successful execution over the past many years. We continue to prospect for opportunities within IT and believe that firms that cut back on technology spending will risk long-term competitiveness. Similarly, we are aligned with a network chain that focuses on the midmarket and is a cost leader in healthcare. Burgeoning lifestyle diseases and rising affordability are contributing to the Indian healthcare industry, delivering 12-14% CAGR growth over the last 6 years.

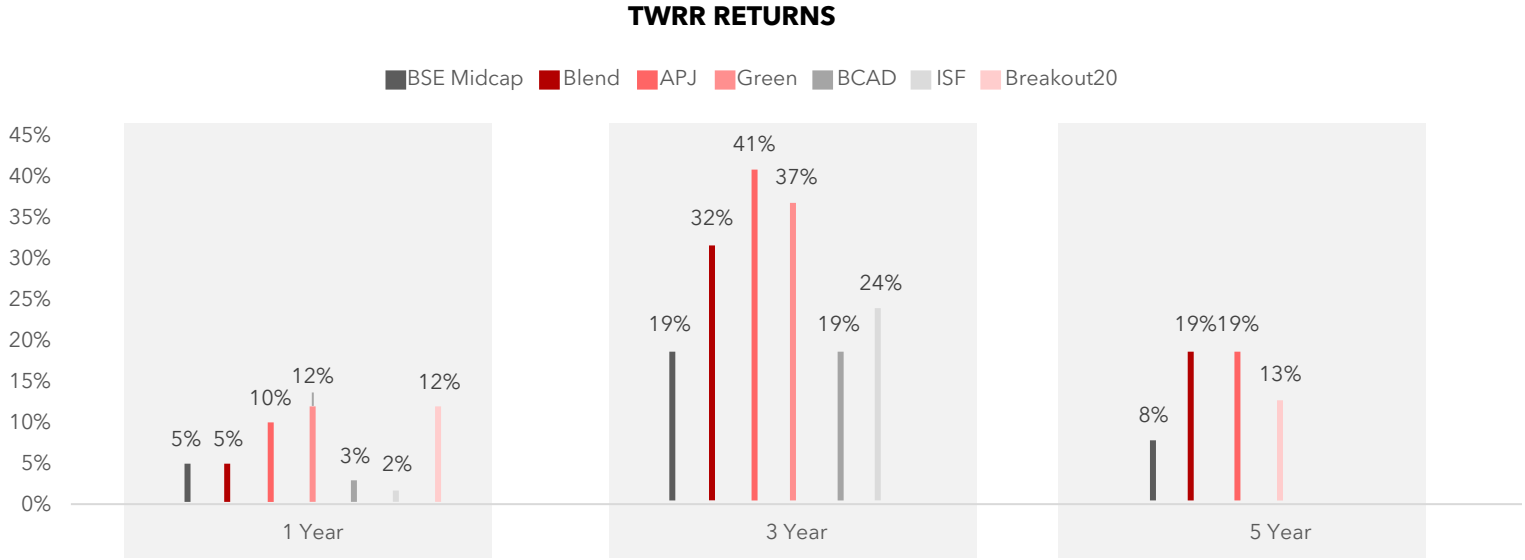
Elsewhere in the industrial economy, we have aligned with chemical companies that are either leaders in base chemicals with the self-sufficiency of feedstock with maximization of its downstream capabilities and/or leaders in areas such as fertilizers with market leadership. While in manufacturing, we are aligned with a domestic OEM leading India's progress on the import substitution of its defense forces.

REVIEW, Q3 FY-2023

The absolute reading of the numbers suggests strength in the franchise of the leaders and resilient domestic consumption demand. Barring one consumption-driven company whose operating performance we are disappointed with, the earnings salience of our portfolio companies and what they are doing to seed leadership for the times to come. Our portfolios continue to build concentration in seeking such leadership.

An outline of our investment strategies has been presented in the following sections, with a performance summary for Q3 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.





**Returns as of 1st March 2023*
BCAD, ISF tenure is <5years.
BCAD breakout tenure <3years

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 Feb 28, 2023	FY 23E
Wt. Avg PE	19.5x
Wt. Avg PB	3.7x
Wt. Avg ROE	22%
Wt. Avg Mcap	Rs.94,500cr

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 Feb 28, 2023	FY 23E
Wt. Avg PE	24.2x
Wt. Avg PB	4.6x
Wt. Avg ROE	20%
Wt. Avg Mcap	Rs.73,612cr

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 Feb 28, 2023	FY 23E
Wt. Avg PE	19.9x
Wt. Avg PB	2.8x
Wt. Avg ROE	20%
Wt. Avg Mcap	Rs.84,260cr

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 Feb 28, 2023	FY 23E
Wt. Avg PE	21.6x
Wt. Avg PB	4.0x
Wt. Avg ROE	23%
Wt. Avg Mcap	Rs.79,943cr

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 Feb 28, 2023	FY 23E
Wt. Avg PE	20.9x
Wt. Avg PB	4.0x
Wt. Avg ROE	18.2%
Wt. Avg Mcap	Rs.95,051cr

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 Feb 28, 2023	FY 23E
Wt. Avg PE	22.5x
Wt. Avg PB	4.5x
Wt. Avg ROE	19.6%
Wt. Avg Mcap	Rs.80,647cr

RISK MANAGEMENT

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	Level	Mitigants
Concentration Risk	Fund	At the portfolio level, such risks are minimized by limiting the aggregate exposure of the portfolio to such investments to less than 10% of the value at the time of investment.
Foreign Exchange Risk	Fund	Fund has invested in only Indian Listed companies and hence the fund's investments do not face any foreign exchange risk at the Fund level.
Leverage Risk	Investee Company/Fund	Fund has not taken any leverage at the Fund level. Except for financial companies, most of the investee 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.
Realization Risk	Investee Company/Fund	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, the size of the investment and trading strategies to minimize the realization risk.
Strategy Risk	Investee Company	Investments are evaluated from a bottom-up and top-down perspective. The fund investments align with the segments of the economy that are emerging and companies that have characteristics which make them the dominant participants in their industry. The investments are assessed through a detailed financial model that captures historical performance and forward estimates based on publicly disclosed documents. The investment team rigorously undertakes quarterly diligence for any change in the investment thesis.
Reputation Risk	Investee Company	Company selection starts with rigorous fundamental analysis and a historical performance review supported by a detailed financial model constructed internally. We have an internally designed governance framework vetted over many years. This governance framework helps us in evaluating companies that meet our internal guidelines. We evaluate the investee companies both at an absolute and relative level. Periodic maintenance diligence of management/ financials has been done for Investee companies.

Extra Financial Risk	Investee Company/Fund	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. Our governance framework helps us in identifying any lapses in corporate governance. We actively monitor all publicly disclosed documents regarding ESG [Environmental, social, and corporate governance]. Any reported misconduct is evaluated by the investment committee for further action.
Geopolitical risks	Investee Company	Geopolitical tensions globally can disrupt the supply chain in the region. This might have a non-linear impact on business.
Raw material inflation	Investee Company	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.
Key Man Risk	Investee Company	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.