REVIEW : Q4-FY 2023

SUSTAINABLE & PRODUCTIVE

Over the last many years, and especially post-Covid, India's growth drivers have notably changed. While several factors have driven this transformation, we examine two vital areas of change: (A) India's systemic need for low leverage [low debt/GDP] and (B) Gradual improvements in productivity. Sustainable levels of debt and productivity are among the crucial factors of a nation's economic sustainability, ultimately reflected in corporate earnings. Today, India's standing on both these fronts provides an environment for delivering sustained economic growth in the times to come. This translates into the necessary framework to attract equity capital and deliver positively.

India's growth is organic, not levered.

Does optimal debt-to-GDP ratio result in better investment outcomes?

While excessive caution on debt will limit a nation's potential for growth, excessive debt is not a sustainable proposition. The optimal level of debt lends itself to the rate and quality of economic growth and vice versa. Higher debt [and interest payments] leave little space for productive spending on growth and crowd out the necessity for productive investments. Once consensus builds around excessive debt, the concern about a financial crisis generally weakens the investment climate and percolates to a systemic level in an economy, eventually hurting the country's ability to invest and re-invest optimally.

India's optimal debt-to-GDP

India's national debt is around 170% of GDP, roughly distributed equally between the government and the private sector (households + corporate). A comparison of the national debt of major nations in the World reveals that India's debt of 170% of GDP is among the lowest, compared to about 270% of GDP in China and the US and more than 400% of GDP in Japan.

% of GDP	Household Debt /GDP	Corporate Debt /GDP	Government Debt/GDP	Total Debt/GDP
CY10	37.5	77.1	68.2	182.8
CY11	35.8	77.2	66.5	179.5
CY12	35.2	77.8	66.8	179.8
CY13	34.5	69.6	67.1	171.2
CY14	33.8	72.1	66.4	172.3
CY15	33.7	67.9	68.3	169.9
CY16	33.3	57.5	68.8	159.6
CY17	34.5	58.3	69.6	162.4
CY18	34.9	48.9	69.4	153.2
CY19	37.0	54.5	74.3	165.8
CY20	40.2	59.2	88.7	188.1
CY21	36.0	53.0	85.1	174.1
CY22	36.4	53.6	82.6	172.6

[Source: Bank for International Settlements, MOSL]

Between 2012 and 2023, India's nominal GDP has risen by $2 Trillion or 10.7% CAGR.

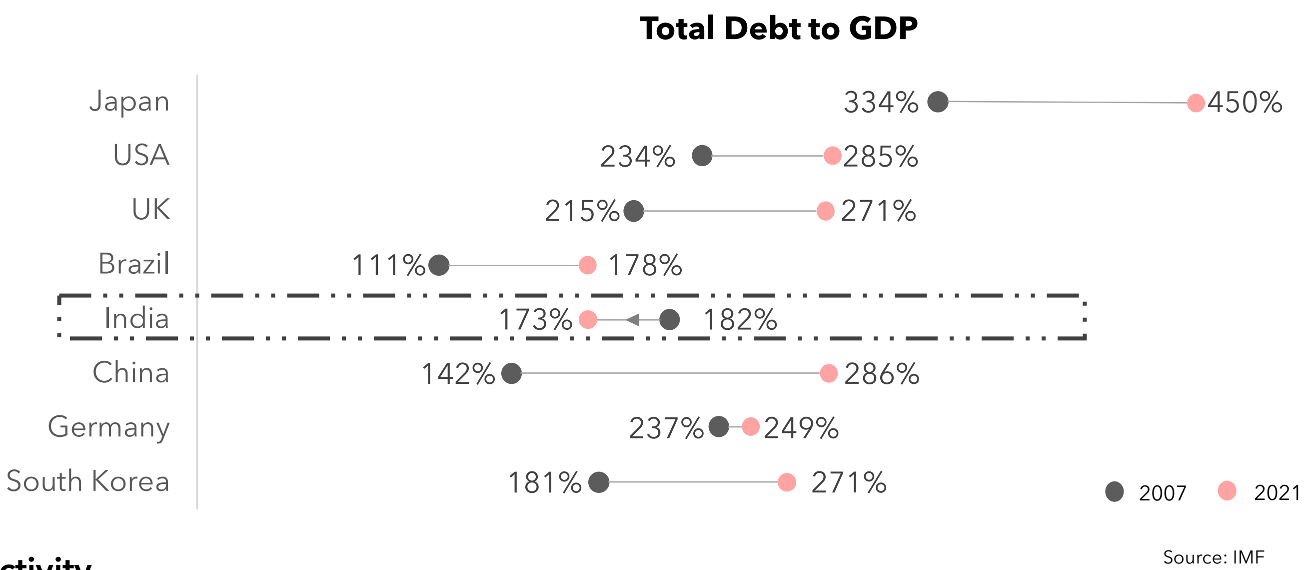
This is translated to equity returns of 11.9% CAGR; as growth has been funded organically, and not through financial leverage.

India's private debt is among the lowest, with a household debt of just 35% of GDP and corporate debt of 50%. This is an important metric for investors, indicating that India's consumption-oriented economy is funded through sustainable end-user demand and not financially amplified. This structure is also sustainable at a national [government] level. As per a recent paper [click for link] by the Asian Development Bank (ADB), in the event of a possible triple shock, i.e., real GDP growth is 1 std deviation lower, while the primary deficit and interest rates are one std deviation higher than the baseline, India's debt would still fall from 89.6% of GDP in FY23 to 86.7% of GDP by FY27.

Why is this important?

This is critical in today's environment, as India's growth momentum is not subject to monetary policy outcomes. As a domestic consumption-oriented economy that is incrementally more self-reliant, *India's ability to grow depends on factors within its control*. As investors in India, this is an important variable to consider. This frees India's monetary authority to determine interest rates as the environment demands, enabling it to manage an economy's key risks -- systemic financial stability and inflation. From an investor's perspective, these arguments are pivotal to the macroeconomic stability of India and its ability to attract and deliver returns on capital. Over the previous two decades, this has been an enabler of India's quartile-one equity returns relative to global markets.

As India's debt to GDP has declined over the last fifteen years, it has risen significantly for several other nations. India's resilient economic growth has led to a positive growth-interest rate differential and sustainable Government debt to GDP levels.



Productivity

Productivity growth is one of the most critical indicators of an economy's health: it drives real incomes, inflation, interest rates, profits, and, ultimately, equity returns. While the value or risk in any investment lies in determining its ability to stay continually 'productive' [or innovative], the template is no different for a country. America's culture of productivity has driven its economic strength; its buoyant equity markets are an outcome. In contrast, European economies have been relatively less productive, given their policies and demographic limitations. As investors in India, we evaluate India's progress across a few enablers of productivity parameters. This will assist in appreciating probable outcomes a few years from here. For the sake of simplicity, we distill them into two broad areas:

A. Infrastructure

a) *Social, Education, and Health:* Over the next two decades, India's working-age population [25-64] will rise significantly, against a decline in all major economies, implying a significant improvement in competitiveness and consumption. Strides in better education and healthcare will abet incrementally better social and economic outcomes.

b) *Digital:* India's progress in creating a unique digital infrastructure of scale has been substantial. The ability of Aadhar and UPI to solve for authentication and allow the entire cycle of transactions to be virtually enabled has birthed a massive new transaction economy that has aided businesses across India. This has given companies that can consolidate demand, and market share, a competitive advantage.

c) *Physical:* India has rapidly expanded all forms of its physical infrastructure and continues to invest significantly in the same, creating one sizeable unified market. [Expanded further in the next section].

B. Policy

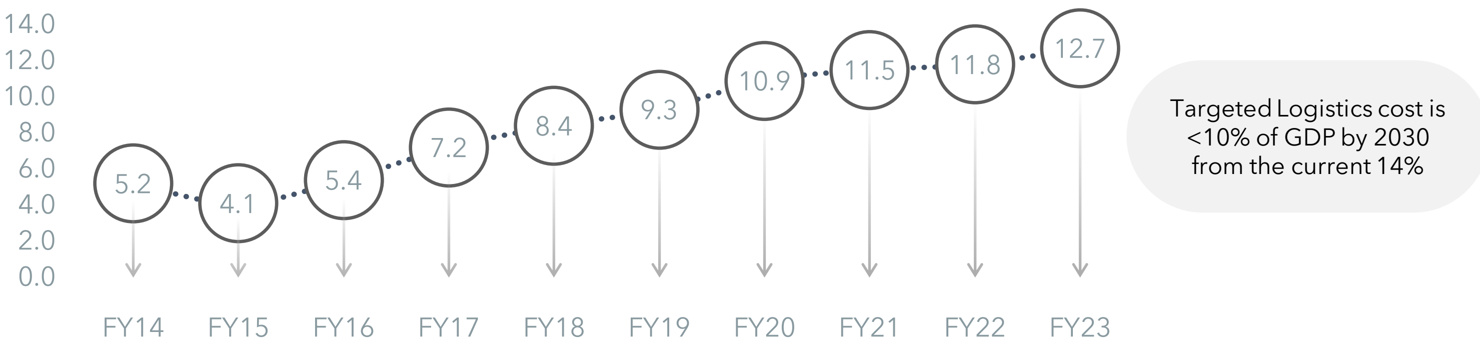
a) Manufacturing-led reforms, the key to furthering India's structural strengths
b) Others that abet increased economic activity across several sectors

Why is understanding the drivers of infrastructure and manufacturing essential? An expanding manufacturing base has been the most crucial driver of a nation's growth throughout modern economic history. The development of post-war Japan, ASEAN economies, and China indicates this without uncertainty. However, with its demographic and cost advantages, India has not fulfilled its manufacturing potential, primarily due to the absence of reforms. Limited investments in infrastructure and poor connectivity have hampered the efficiencies needed for industrial growth.

Infrastructure | Infrastructure is critical to linkages of an economy and widening the market size. Today, India is rapidly experiencing an infrastructural change, broadening the economy for all market participants. This is reflected across a broad spectrum, such as high-speed train connections, new freight corridors, new ports, and highways. The 50,000+km of national highway India has added in the past ten years is twice as much as it managed in the previous decade, while the number of airports with civilian flights has grown from 74 in 2014 to 148 this year, bringing one unified market closer to every participant.

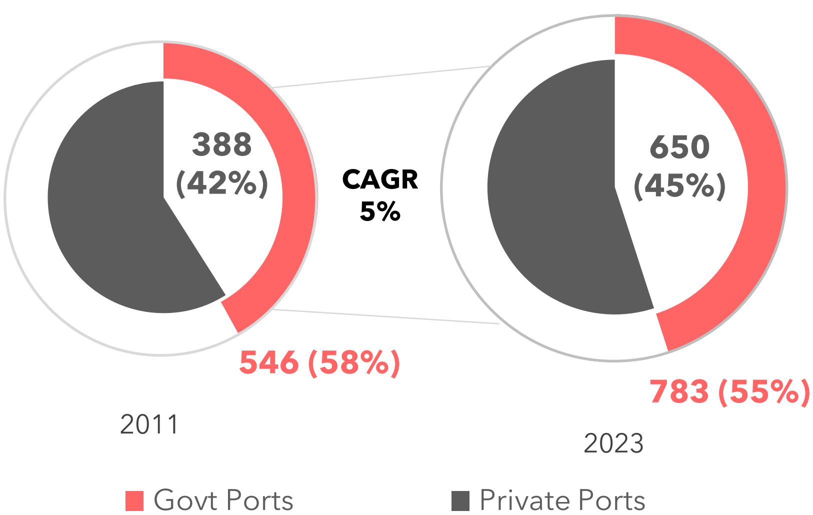
Road to Growth

Roads constructed/day (No. of Kms)



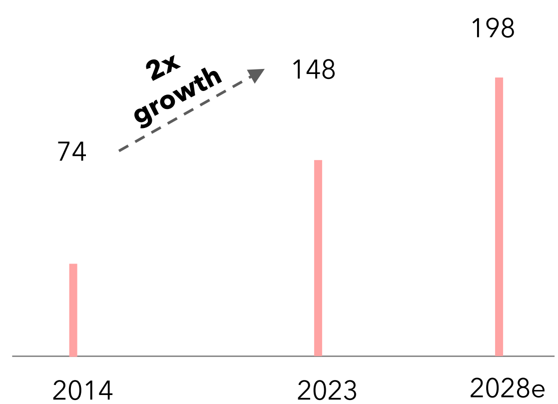
Port Infrastructure

Volumes in Indian Ports (MMT)



Airport Infrastructure

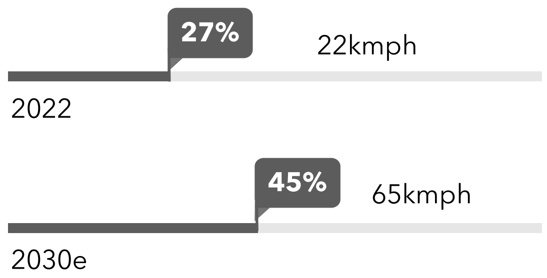
Number of airports



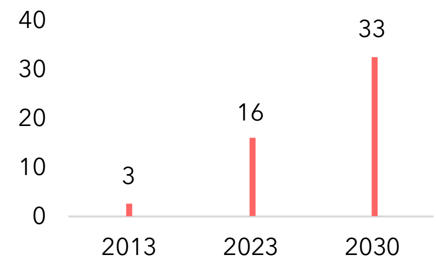
The number of domestic passengers has more than doubled from 60 Mn in FY14 to about 137 Mn in FY23

Rail Infrastructure

Share of railways in freight transportation



Number of Indian cities with metro rail connectivity



Dedicated Freight Corridor: 24hrs-48hrs lesser freight travel time between northern India & ports in western India

[Rs.10 lakh crore (3.3% of GDP) allocation towards infrastructure in the 2023-24 budget is an increase of three times from 2019; while the Ministry of Railways received its highest-ever allocation of Rs.2.4 lakh crore, approximately nine times the allocation in 2013-14]

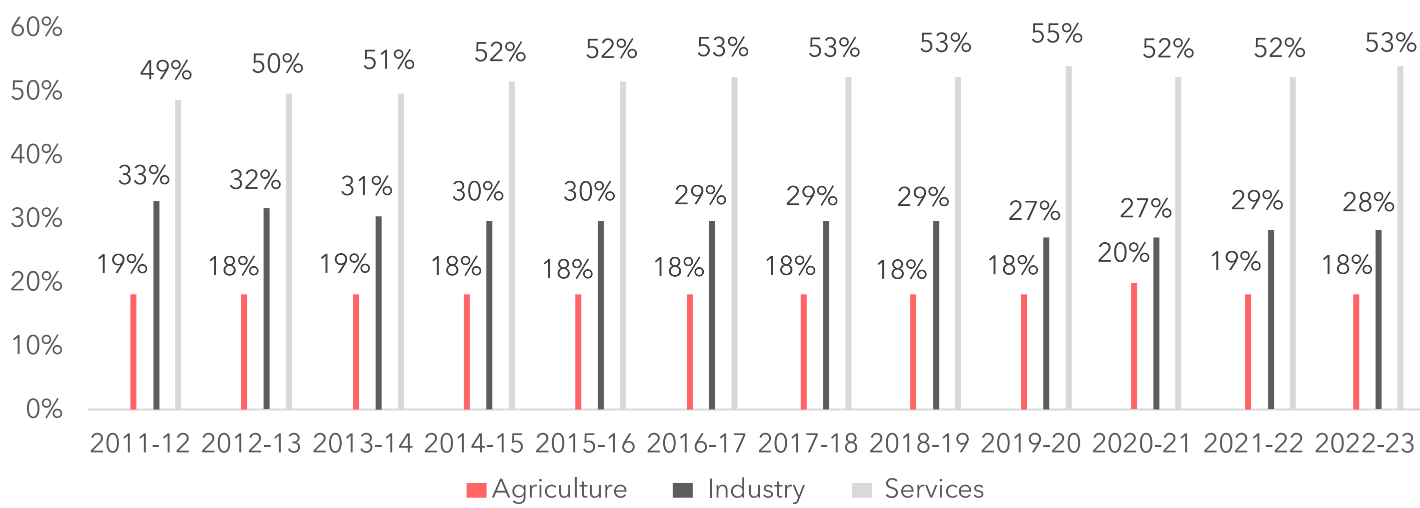
The consequence of lowering the cost of logistics, economies of scale, and access to markets are significant. The logistics cost in India, at 13% of GDP compared to 8% in the rest of the World, has made it difficult for Indian exports to compete globally and locally. With the support of significantly better infrastructure today, the ability to better India's growth rates is significantly robust. This has been bolstered by strides in India's digital economy -- UPI & Aadhar. The birth of a new transaction economy has accelerated momentum at a scale that many have not been possible before. This has given companies that can consolidate demand, and market share a competitive advantage.

Developments in these areas have led to increased logistics needs across the country, and players across the roadways, railways, and airway ecosystem are benefiting. Unifi has investments in this space via industry and cost leaders, who are driving efficiency for the sector as a whole.

Manufacturing productivity | A structural transformation in any economy witnesses a reallocation of growth drivers across its three main components: agriculture, manufacturing, and services. This transformation occurs in two stages: firstly, labour moves out of agriculture into manufacturing and services; and then labour moves out of agriculture and manufacturing into services. India's transformation on this count has been in the middle, where services took off firmly while manufacturing stagnated.

Since 2012, India has added $2 trillion to its GDP to become the fifth-largest economy in the World today. While India has played well to its strengths in the services sector, the share of manufacturing within the country has stagnated. As a result, India's share of global trade has dropped. At the same time, the increase in import reliance has resulted in an opportunity cost for the economy.

India, Share of GDP



Today, India is reworking its effort to accelerate the manufacturing mix via a Production Linked Investment scheme to make India more self-reliant. This is among the most significant policy tailwinds of recent times and an inflection point for the nation, if executed well, given its ability to increase employment and gain from the multiplier effects of domestic industry. This is beginning to result in an expansion of economic activity for several industry players, expanding the scope of their operations and re-investing at a profitable scale.

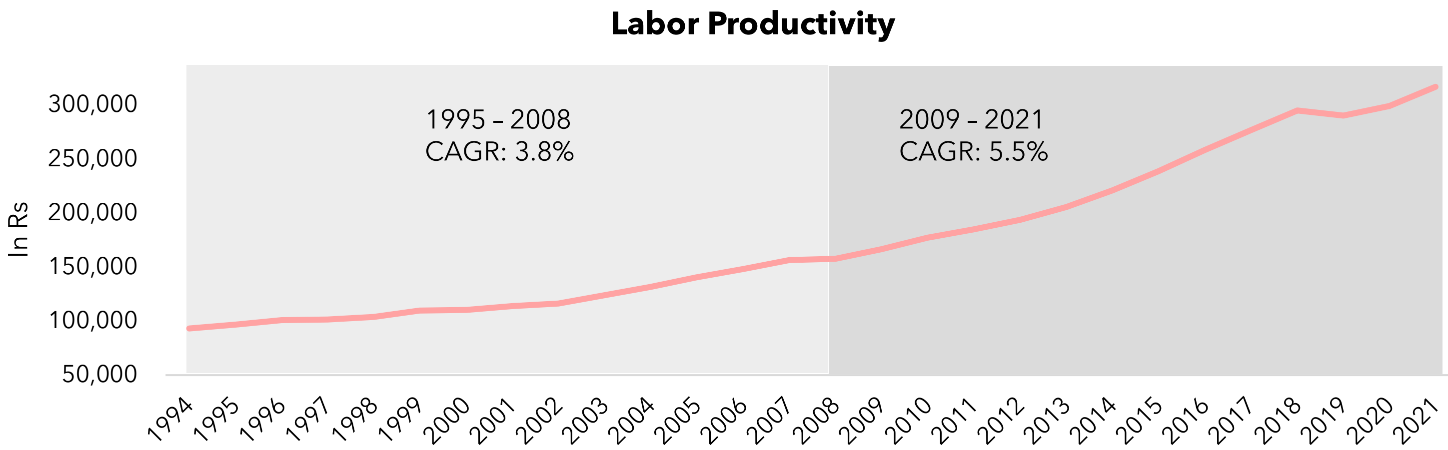
Sectors/Industry	Total outlays [INR Bn]	Expected/Actual investments [INR Bn]	Expected/Actual job gains
Mobile Manufacturing and Specified Electronic Components	410	110	2,00,000
IT Hardware	74	25	36,066
Critical Drug Intermediates; Active Pharmaceutical Ingredients (APIs)	69	54	12,140
Medical Devices	34	9	4,212
White Goods	62	62	5,522
Solar PV Modules	45	172	30,000
Food Processing	109		2,50,000
Telecom and Networking Products	122	33	40,000
Pharmaceuticals	150	150	1,00,000
Auto and Auto Components	261	799	7,60,000
Advanced Chemistry Cells	181	150	
Textiles	107	191	2,40,000
Steel	63		
Total	**1,687**	**1,754**	**16,77,940**

[Source: Motilal, PLI]

The overarching focus here is to encourage a combination of high-end manufacturing and import substitution to move the manufacturing sector's contribution to GDP to 25%. This will significantly affect all parts of the economy and show up as investment opportunities across sectors.

Unifi continues to evaluate investment opportunities in this space closely; and has exposure to pick-and-shovel players in the building products industry who benefit from the pace of new project developments. It is important to note that the financing needs of these developments percolate to various parts of the value chain, and the credit growth cycle in India is a beneficiary of this.

Demographic productivity | Over the past decade, India has made progress in labour productivity. Given its favourable demographics, the recent structural reforms around infrastructure and manufacturing will continue to aid productivity per capita.



Source: World Bank, RBI; Labour Productivity = Real GDP / Labour Force

Particulars	1995	2021	Growth
Labour force(Cr)	33.1	47.1	1.6X
Real GDP(Rs. Tn)	32.2	149.3	5.9X
Labour productivity, Rs.	96,712	316,698	3.7X
Per capita income USD	374	2257	6.1X

Why is labour productivity important? With increased access to higher education, India is expected to have a bigger tertiary-educated population than China and a significant rise in urbanization. As a result, income levels in India are expected to rise significantly, leading to a corresponding increase in consumer demand, further strengthening India's consumption-based economy. Beyond consumer goods, the other sectors that stand to gain from an acceleration in structural reforms include financials, discretion, and healthcare.

High productivity helps accomplish more with less. Over time, it has a powerful impact on all metrics, notably inflation, and lower interest rates, ultimately driving capital efficiency at a national and corporate level. This is eventually reflected in investment returns.

Others | Over the years, there has been a spate of reforms that have contributed to improving rates of systemic growth across several industries. We draw reference to the two most important ones.

Real Estate Regulation Act (RERA) Bill, passed in May '16, is among the most significant reforms in India. Among many others, updated construction information for home-buyers and separate bank accounts for construction costs are a few benefits of the Act. This was followed by SWAMITVA, a little talked-about reform aimed at providing rural citizens with the right to document their residential properties to be used for economic purposes. This has led to buoyancy across the construction industry per se, reflecting improved prospects for the building materials industry and off-take of credit linked to properties as collateral. These measures have led to buoyancy in the building materials industry and the retail lending segment, and Unifi has significant exposure to both these emergent areas.

Further, the Insolvency and Bankruptcy Code, enacted in May 2016 against mounting non-performing loans, has significantly bettered underwriting standards in the banking industry. Today, the systemic levels in asset quality are at an all-time low, along with healthy traction in the off-take of credit. This and better retail economic conditions have birthed a new credit cycle, providing the macroeconomic backdrop to Unifi's exposure to credit as an industry.

From an investment point of view, the beneficiaries will be those that execute well in the current phase of India's structural growth, improve the penetration of their products and services across India's markets, and gain market share from lesser efficient peers. A significant part of Unifi's investments shares these overarching attributes across strategies, apart from having fundamental bottom-up drivers of growth.

In our next quarter's communication with you, we look forward to continuing this dialogue and touching upon the other facets of India's productivity and economic sustainability.

Portfolio Construction

While Unifi's portfolio construction is an outcome of the bottom-up, it has drawn from a favourable macroeconomic environment. We reference the key components of our portfolios here, while their quarterly performance is reviewed in the later sections. Please note individual portfolios will vary in holdings and proportion based on the timing of your investment.

Credit | 25-30% of the Portfolio

Post-COVID, India has witnessed a sharp rebound in credit demand led by strong consumption demand, government-guaranteed loans to MSMEs, and higher working capital requirements by corporates. Over the past two years, retail loans have grown almost by almost 2x of overall loan growth. Early trends in FY24 signal strong system credit growth for FY24 as well. The health of the Indian banking system is robust and evident in decadal low non-performing loans and adequate capitalization. Successful implementation of the Insolvency and Bankruptcy Code has led to improved financial discipline

in the corporate sector. Overall, the profitability of the banking industry is trending to a cyclical high, aided by marginal credit costs. Credit costs are currently running lower than normalized levels, led by higher recoveries, and most of the banks have sufficiently provided for their NPAs.

Unifi's exposure to larger banks augurs well with the improving outlook for the sector. Despite having a larger balance sheet, the investee banks have gained loan market share gains in FY23. In addition to the systemically best underwriting practices, their asset quality performance during COVID was better than the industry. Unifi's strategies also have exposure to a few small and mid-sized retail heavy banks. These banks are gaining incremental market share due to their size and product offerings (primarily retail). These banks have largely provided for their existing stressed loans. As these banks scale in balance sheet size, their profitability will improve significantly over the next 2-3 years. During FY23, the investee banks have gained market share and have exhibited loan growth in the range of ~17-28% vs. systemic loan growth of ~15%, while the net NPA of most of these banks is largely below systemic net NPA of 1%.

Building and Consumer products | c.20-25% of the Portfolio

To enhance the country's growth potential and aid job creation, the government's thrust towards physical and digital infrastructure development has seen a multifold increase in the last decade. Residential development, construction of Metro's, and upgrade in the technology cycle are at highs. In 2023, India's top seven cities delivered the highest sale of units in over a decade [c.215,000], while railways and roadways have been beneficiaries of increased budgetary allocation. 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.

Unifi has exposure to the largest cables and wires firm in the country, which has scaled revenues [almost 2x of peers], growing ahead of the competition and gaining market share. This is in addition to an investment in one of India's most profitable players in the consumer durables space with best-in-class margins and capital efficiency amid a change in management and improved execution. Given the execution and leadership of these firms in their respective categories, we expect them to benefit from this consolidation phase and growth in household & enterprise consumption. We also have investments in a leading global IT products distribution company that addresses diversified IT product needs of retail and enterprise. The company's dominant and financial positioning gives it a significant competitive advantage in a business with high entry barriers. They are benefitting from the sector tailwinds of technology modernization.

Healthcare | 7-10% of the Portfolio

At 1500 beds per million people, India is underinvested in healthcare, with structural deficiencies in supply, resulting in hospital infrastructure lagging the global median. Inversely, the industry has structural demand drivers with an increasing burden of lifestyle diseases in Urban India, rising insurance penetration, and improved affordability. This has created a supply-demand gap, reinforcing the need and providing potential for private hospital chains to put up appropriate infrastructure with the necessary investment. And as a result, it provides an opportunity for large players to scale up pan-India & consolidate market share.

Several pan India hospital chains expanded capacities significantly between FY13 to FY19 and are now treading a path of consolidation, focusing on sweating existing assets and adding capacities selectively through brownfield expansion. Considering the business's asset-intensive and long gestation nature to achieve optimum unit economics, the profitability growth lagged the volume and revenue growth in the CAPEX phase due to low occupancies in the new assets. Unifi's investment in the sector is with one of India's largest affordable healthcare providers, which will benefit from the consolidation phase. With an emphasis on advanced medical care and procedures, better utilization, and sweating of the existing asset base, the company has improved Average Revenue per Occupied bed [ARPOB] at 10% CAGR in the last 3 years with a negligible increase in the cost of healthcare services. The business has the longevity to grow with a strong and principled management team at the helm.

IT Services and Products | c.10% of the Portfolio

Increased digital adoption in India has seen robust demand for cloud space from all hyper scalers [Microsoft, Amazon, Oracle, etc.]. As an annuity business, the prospects for re-sellers of cloud products in India are recurring. Globally, while there are pockets of a slowdown in discretionary IT spending, the development of digitally native applications continues to rise and is expected to be so for the next many years.

Unifi has exposure to a firm with legs in the IT products space in India and the global IT services space. IT product re-selling contributes to about 25% of the firm's earnings and has grown 2x over the last two years. While in the IT Services space, they have grown from strength to strength, growing revenues by 50% over the last two years, supported by organic and inorganic initiatives. A change in their management in FY23 has paved the way for increased market share on the small base, and early signs are visible.

Others

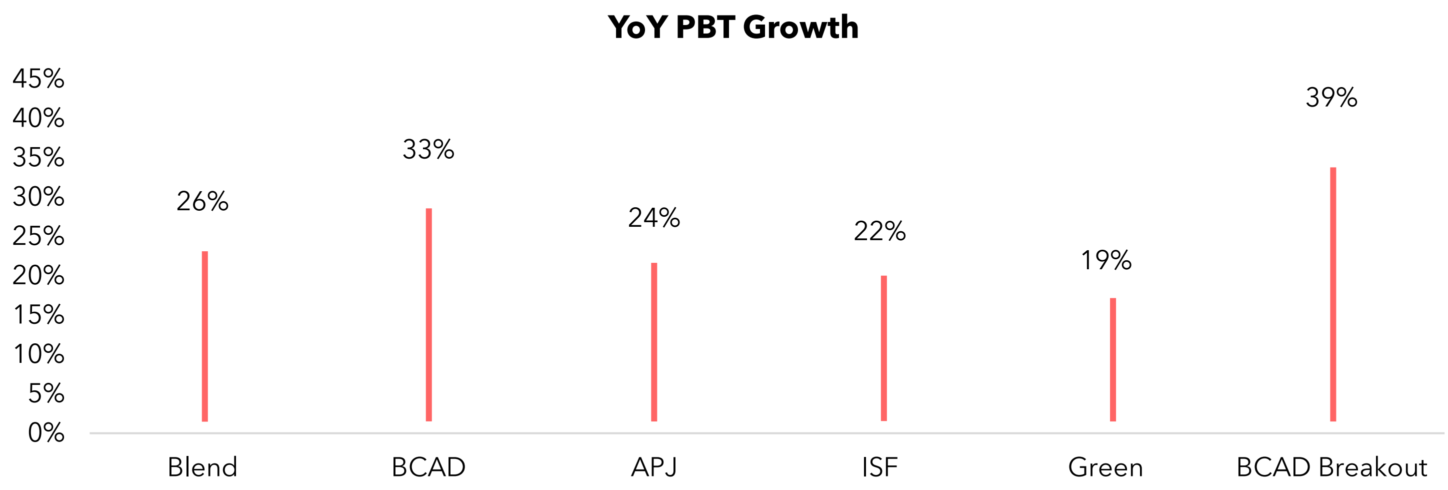
The key components of Unifi's holdings are diversified across firms benefiting from the financialization of savings, a key player in the defense sector aiding the forces' technical capabilities, and select firms in Chemicals, Consumption, Realty, and Hospitality that are poised to gain from investments made behind their execution in FY2023.

In Closing

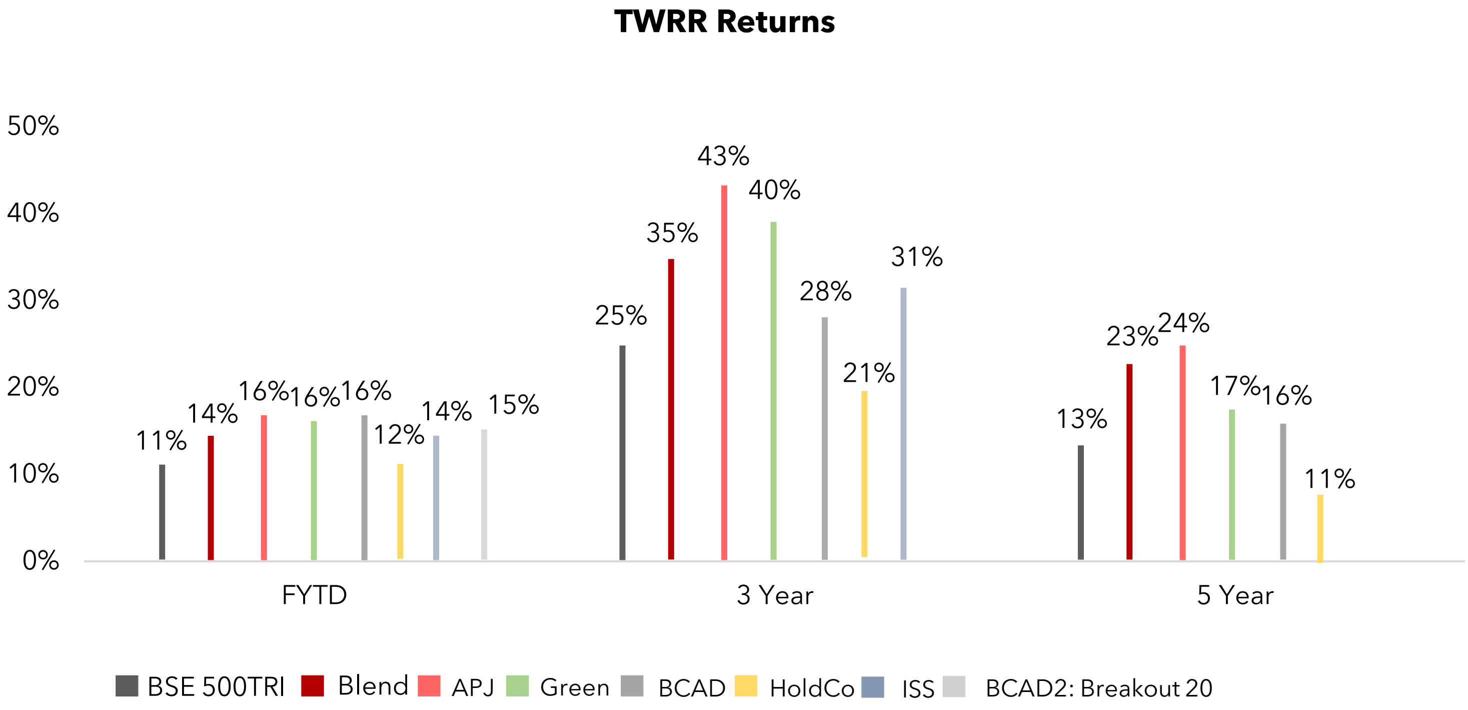
As we write this, India's equity market has scaled to all-time highs. Our approach of demanding growth at reasonable value has held us in good stead across cycles, and we continue to stand by those tenets. Resultantly, we continue to re-look at all our positions and right-size them, given how the risk/reward 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 favourable. While our exposure to larger firms has grown significantly, our framework of seeking value has remained steady.

Review, Q4 FY-2023

The absolute reading of the numbers suggests strength in the franchise of the leaders. The earnings salience of our portfolio companies is broadly on expected lines, along with their initiatives in 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 Q4 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 26th June 2023
ISF tenure is <5years.
BCAD breakout tenure <3years

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.

Thank you for placing your trust in Unifi.

Sincerely

Baidik Sarkar
Head – Research