UNIFI CAPITAL

REVIEW: Q2-FY 2024

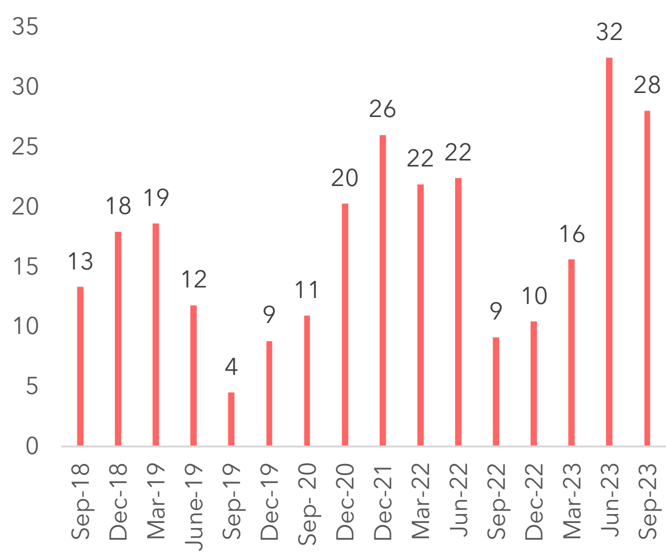
Distilling from the Noise

The modern economic environment is characterized by an abundance of data. While more information is available, the ability to distill meaningful insights is increasingly challenging. Concentrating on a few variables more reflective of India's economic reality helps construct a more coherent view of the country from an investment point of view.

Breakout in Earnings

Amidst the noise of a slowdown and general recessionary conditions, India's aggregate earnings, as indicated by the benchmark Nifty 50, have grown faster than expected. The September quarter of FY 2024 saw India Inc.'s earnings increase by 28% YoY. This is the fastest pace of growth recorded over a 5-year period and stands out all the more because of the absolute quantum of growth. For the first half of FY 2024, Nifty-50 grew earnings by 30% YoY, while excluding the oil marketing companies, grew 20% YoY.

Nifty Universe, Earnings Growth, %



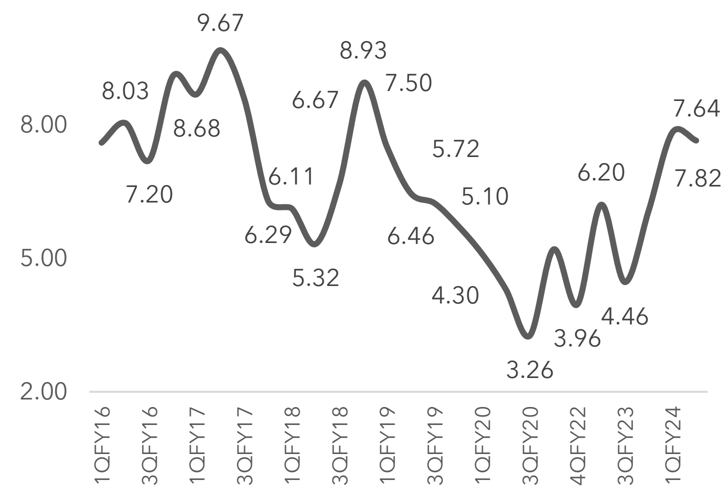
Adjusted for the Covid disrupted periods

What is driving earnings growth? India's earnings resilience is broad-based, underpinned by a combination of robust domestic demand, rising public infrastructure investment, and a strengthening financial sector, which was reflected in India's GDP growth for Q2 FY2024, providing the macro backdrop for driving earnings growth. We delve into a few of them.

India, GDP, driver of Earnings

India's real GDP grew 7.6% YoY in Q2 of FY24 (vs. 6.2% of Q2 FY23), significantly ahead of expectations of around 6.8%. While the absolute direction of growth is strong, the structure of growth is all the more encouraging. While the following is data-dense, it will lead to a finer appreciation of India's economic landscape and the sustainability of the same. GDP growth was significantly driven by investments (9.9% in Q2 FY24, highest in five quarters vs. 6.5% in Q2 FY23) and fiscal spending (+12.4% in Q2 FY24 vs. -4.1% in Q2 FY23). India's investment rate rose to 32.9% of GDP vs 32.1% YoY, while corporate investments grew 3.3% YoY last quarter after declining for two quarters. Further, with better real growth, nominal GDP growth came in at 9.1% vs. 8% sequentially, while India's industrial sector, which has consistently lagged growth, rose significantly at 13.2% YoY (vs. -0.5% in Q2 Y23 and +5.5% in 1QFY24). Acceleration in industrial sector growth was broad-based, led by lower input costs and better corporate performance. Overall, India's GDP growth is robust, led by domestic variables, and this structure will likely stay similar for the foreseeable periods.

Real GDP growth (% YoY)



Adjusted for the Covid disrupted periods

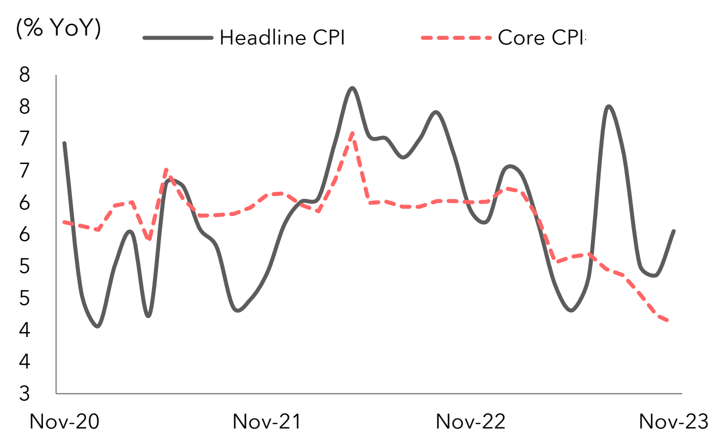
India's GDP growth is all the more positive in the context of several headwinds: fiscal consolidation at a central level, discipline with financial leverage, and prevalent high interest rates. In the pre-Covid decade, India's trend growth rate declined from 8% in 2007-12 to 6-6.5%. This was an outcome of slow capital formation (real estate and corporate capex). With the change in the pace of capital formation today, the trend towards a 7% plus scenario looks more realistic and ably supported by other structural drivers across labour growth, infrastructure, services exports, and formalization of the economy.

The structure behind the numbers

In our previous notes, we touched upon a few macros that are driving India's economic progress. We evaluate a few additional factors here. While rising corporate and household incomes are of a nature that is addressing India's generational shift in consumption, the broad contours of India's economic makeup are undergoing a shift.

Inflation | Favorable trends make capital formation easier

Systemically weak inflation is never a desirable situation. A certain level of inflation is an indication of the strength of demand salience and rising incomes. The most desirable level of inflation, i.e., change in price over a period is always positive but at a sustainable level, and what is sustainable is a function of GDP and income growth in an economy. The RBI has a medium-term target inflation of 4%, ranging from 2-6%. Over the past few months, just as India's real GDP growth has been better than expected, the headline consumer price inflation [CPI] has also been lower than forecasts. In nine of the past 12 months, the headline inflation has been in the RBI's desired range of 2-6%, with an average of 5.2% during the past three months (Sep-Nov'23). More importantly, core inflation (excluding volatile items such as food and fuel) was at a 44-month low of 4.1% YoY in Nov '23, with inflation expectations three months ahead at the lowest since the pandemic began. Overall, India's inflation dynamics are favorable, giving policymakers [RBI, Budget for FY-25] the flexibility to focus on growth without the burden of excessive oversight on interest rates and constrained fiscal flexibility.

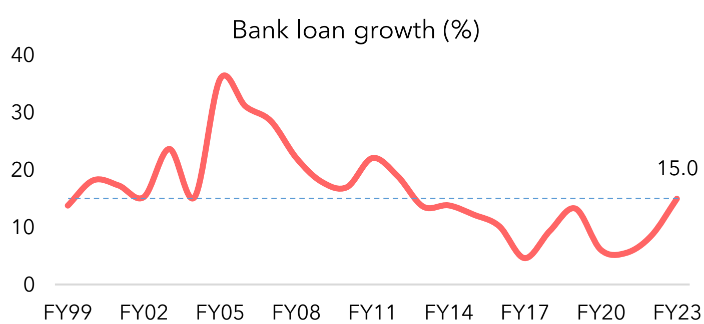


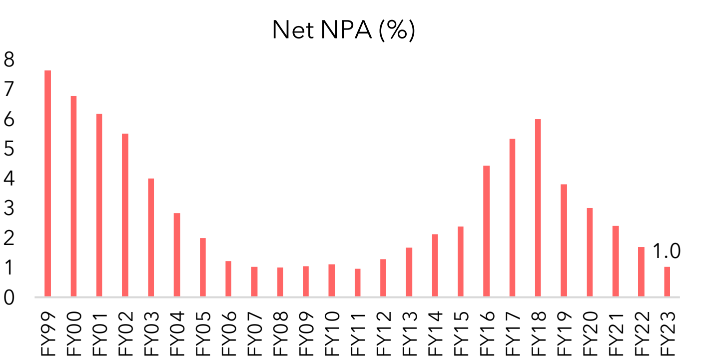
As we advance, the RBI expects headline inflation to ease towards its medium-term target of 4% by 2QFY25, which, if achieved, will be the first 4% quarterly headline inflation in five years. This will allow the RBI to manage rates better and support India's growth ambitions of close to 7.0%, plus sustainable GDP growth.

India's Banking Sector

At its cyclical best

A critical prerequisite for the revival and sustainability of an investment cycle in the economy is a comfortably positioned banking/financial sector. India's financial sector has not only seen an improvement in its financial position over the past decade but has possibly been in the best health since 1991. The structural ability to support India's vast need for building infrastructure, expand manufacturing capacities, support retail consumption, and support sustainable GDP growth of 7% plus cannot be overstated. For most of the pre-COVID decade, the financial health of India's banking sector was mediocre, with poor underwriting, rising non-performing assets, and an inability to meet the capital requirements of the industry. During the past three years, NPAs have fallen continuously to the lowest in almost three decades, underwriting standards have improved, and loan growth has picked up strongly. What has continued from the pre-COVID period is that the lenders have been growing their non-corporate loans much faster. The industrial sector accounts for only about a quarter of bank loan books now, compared to its share of 40% a decade ago and its peak of 49% in FY99.





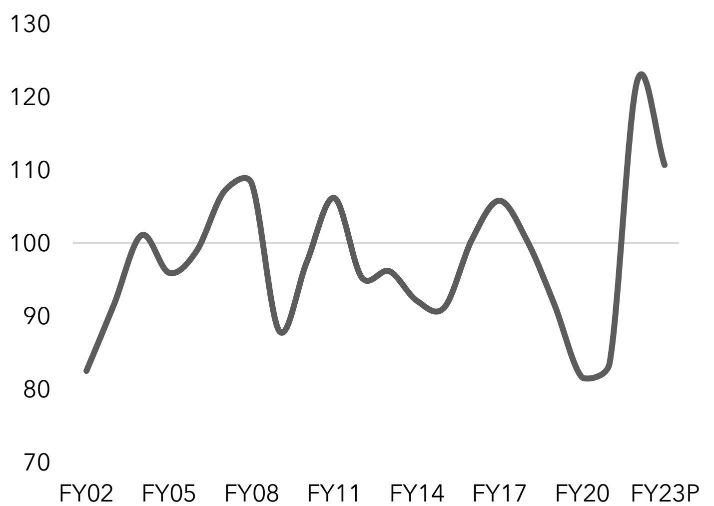
A weak financial sector constrained any economy's ability to grow and was partly responsible for slowing India down. With the change in health, the sector's ability to support the revival in the investment cycle is vital. This is reflected in Unifi's exposure to financials as a sector.

Fiscal deficit consolidation

Creates space for the private sector's growth

While a fiscal deficit enables the Government to increase spending on public services, infrastructure, and other vital areas that will stimulate economic growth, a consistently high deficit will lead to an increase in debt burden, currency devaluation, higher inflation, and structurally weaken the economy. India has always had a fiscal deficit since independence; however, it rose to the highest in almost four decades due to COVID. Since then, the Government has been consolidated the deficit well. From 7-8% of GDP, India's combined fiscal deficit widened to more than 13% of GDP in FY21, which has come down to 9.1% of GDP in FY23 and is budgeted to fall further to 6% of GDP in FY24, and trend lower from there on.

Actual tax receipts vs. Budget estimates



One of the critical reasons India has achieved this challenging combination of lower deficit and better growth is better-than-expected tax receipts for the Government. In FY22 and FY23, gross tax receipts were 10-20% higher than the budgeted amount – totaling INR5t and INR3t, respectively, indicating buoyancy of economic health. As a result, the Government has met its deficit targets without compromising on its intended spending, especially social welfare, which is critical for India. In the current year (FY24), total receipts will likely exceed the targets by more than a trillion rupees. In the coming years, either the deficit will trend lower significantly, or the Government will consider growing its spending faster than expected, and both outcomes will benefit the economy. In a nutshell, this is a critical enabler of India's domestic investment and enterprise consumption, bearing positively on earnings growth for the times to come.

Summary and Portfolio Construction

After years of groundwork, several macroeconomic trends are converging from across the spectrum. While rising incomes reflect a good quality of household consumption, the supply side is investing in a mix of import substitution, China+1 supply chain, and a supportive government policy lending to investments in broad-ranging infrastructure. Encouragingly, these translate into the most relevant lead indicators, such as GDP growth and healthy earnings growth for firms able to be a part of this. Over time, this will culminate in better growth and investment outcomes.

Over the past quarters, our exposure to firms with larger market capitalizations has risen. This is not a reflection of an expansion in our set of beliefs, but a continuation of alignment to practicing growth investing at a reasonable price [GARP]. Despite market conditions, our approach to participation in India's heterogeneous opportunities is to buy growth firms at a reasonable price, adjusted for capital efficiency and the runway of consolidation in industry leadership that is on offer. Today, the opportunities that reflect our growth philosophy are found in firms with larger capitalizations. It is an outcome of the same principle we have practiced across cycles.

From a portfolio perspective, we remain constructive on India's financial sector. As explained in the earlier sections, India is in a new cycle of economic expansion, coinciding with the end of a higher provisioning cycle, which 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 good quarter in Q2-24 with improvement across Net Interest Margins, asset quality, and healthy credit growth.

After a few years of consolidation, we believe technology spending will rebound amidst improved macroeconomic conditions in the U.S. We have increased our exposure to I.T. by roughly 10% over the past few months. We continue to align with the sector, but unlike the previous cycle, our exposure now consists of larger firms that are in a position to participate in the broader spectrum of technology spending. We continue to prospect for opportunities within I.T. and believe that firms that cut back on technology spending will risk long-term competitiveness.

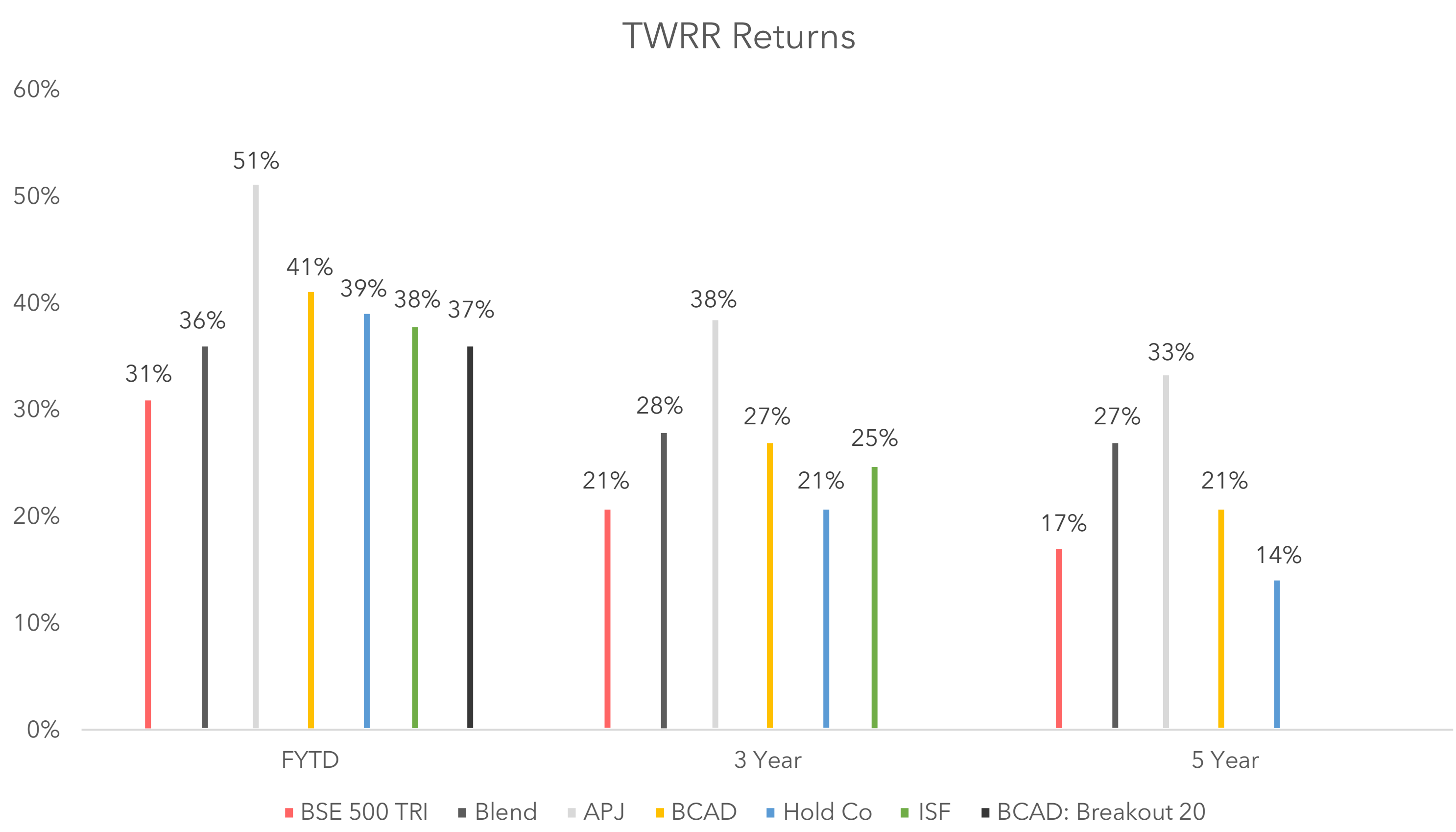
Within healthcare, we stay aligned with a network chain hospital that focuses on the midmarket and is a cost leader in healthcare, focusing on shifting to higher-margin specialties and improving their case mix. We have also taken exposure to one of India's leading generic manufacturers catering to developed economies. After years of pricing-led disruptions, the industry is entering a price consolidation phase with a better outlook on volumes and margins.

Consumption trends in the real estate industry indicate the health of the sentiment in Indian households. Housing inventory in the country suggests healthy demand traction, benefiting developers and the entire value chain of building products. As interest rates peak and the Government continues to focus on building infrastructure, the industry will continue to benefit from the trends. 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.

Our other holdings are from across industries drawn from the bottom up and experiencing fundamental strength in their performance. Where necessary, we have right-sized our positions based on the changes in their risk and reward over the past few quarters. 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. It's worth emphasizing that the current economic climate is intricate and ever-changing. As the market responds to *ongoing news, we remain vigilant, ensuring we are conscious of our investment goals amid the general sense of euphoria.*

An outline of our investment strategies has been presented in the following sections, with a performance summary for Q2 FY24. 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



Returns as of 21st December 2023
ISF tenure is <5years.
BCAD breakout tenure <3years

Review of Strategies

We have captured an outline of each of our investment strategies in the following sections with a summary of how the fundamentals of our key holdings have played out in Q2 FY24. Tail positions which are on their way out of the portfolios have not been discussed. Individual portfolios will vary in holdings and proportion based on the timing of your investment with Unifi. For a detailed review of your portfolios, please do not hesitate to contact your relationship manager.

Blend

The Blend 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.

December 2023	FY 24E
Wt. Avg PE	24.6
Wt. Avg PB	5.5
Wt. Avg ROE	23.9%
Wt. Avg Mcap (Rs. Cr)^	161,750

^ex- BFSI

BC AD

The strategy 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 near-term 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.

December 2023	FY 24E
Wt. Avg PE^	26.2x
Wt. Avg PB	8.8x
Wt. Avg ROE	27.2%
Wt. Avg Mcap (Rs. Cr)^	74,465

^ex- BFSI

APJ

The strategy 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.

December 2023	FY 24E
Wt. Avg PE^	25.5x
Wt. Avg PB	4.4x
Wt. Avg ROE	21.1%
Wt. Avg Mcap (Rs. Cr)^	15,730

^ex- BFSI

ISS

The Insider Shadow Strategy invests in fundamentally sound companies where there has been an increase in the 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.

December 2023	FY 24E
Wt. Avg PE^	21.4x
Wt. Avg PB	2.8x
Wt. Avg ROE	18%
Wt. Avg Mcap (Rs. Cr)^	107,675

^ex- BFSI

BCAD2: 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.

December 2023	FY 24E
Wt. Avg PE	25.9x
Wt. Avg PB	9.5x
Wt. Avg ROE	25.4%
Wt. Avg Mcap (Rs. Cr)^	87,045

^ex- BFSI

Risk Management

Risk	Mitigants
Coronavirus Impact	The impact from the ongoing Coronavirus outbreak in India and 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	Any geo political tensions between India and neighboring countries can disrupt 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 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 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

Baidik Sarkar
Head - Research