UNIFI CAPITAL

REVIEW: Q3-FY 2024

Outside the anxiety of the World's economic environment, India's enduring performance has been a constant. While there are several components, the simplest driver of incremental progress is an aggregate of the Government's massive push on building infrastructure, expansion of the manufacturing economy, rapid indigenization, and technology-led productivity. This is in addition to India's traditionally deep consumption market, which is progressing from unorganized to organized at a population scale. Each of these may not stand out as being individually exceptional in a normative sense, but in a descriptive sense, their effect on the conduct of India's commerce has been compelling.

Economy, buoyant

For the third consecutive quarter, and despite expectations of a lower growth rate, the Indian economy delivered a better-than-expected set of data, growing 8.4% YoY in Q3 and with upward revisions in H1-24. This is as versus the consensus expectation of c.6.5% and is a stand-out piece of statistic, as it is a number that has been hit very few times since 2000. This suggests an annualized growth rate of c.8.0% for FY 2024, and only the 6th instance of such growth in the past 24 years.

A key trend that has played out this year is healthy Fixed Capital Formation but relatively soft private consumption growth. India's Fixed Capital Formation is expected to grow in double digits for FY24 (only the 3rd time in the past 6 years). As a result, India's investment-to-GDP ratio will likely rise to 31.5% of GDP in FY2024, marking the highest rate in the past decade. A large part of this investment surge is directly led by the efforts of the Union Government, which has increased its capex at a CAGR of 37% in the past three years (FY22-FY24) and is budgeted to increase by another 16% in FY25. This presents a good setup for India's manufacturing and allied economy. However, consumption growth of c.3.5% YoY is less than ideal, but hopefully a passing phase.

Underpinning the broader trend is RBI's understanding that India's economy continues to remain extremely strong in the near term, and inflationary concerns are firmly behind. Accordingly, the RBI has introduced its estimated growth rate of c.6.8% to 7.0% for FY 2025 without the urgency to cut interest rates in India. This gives policymakers depth in their reserve to utilize monetary levers to aid growth in future years. This translates to nominal GDP growth of roughly 10-11% in the year ahead, providing the base for India's domestic-focused firms to execute on earnings at a healthy economic multiplier.

Earnings, buoyant

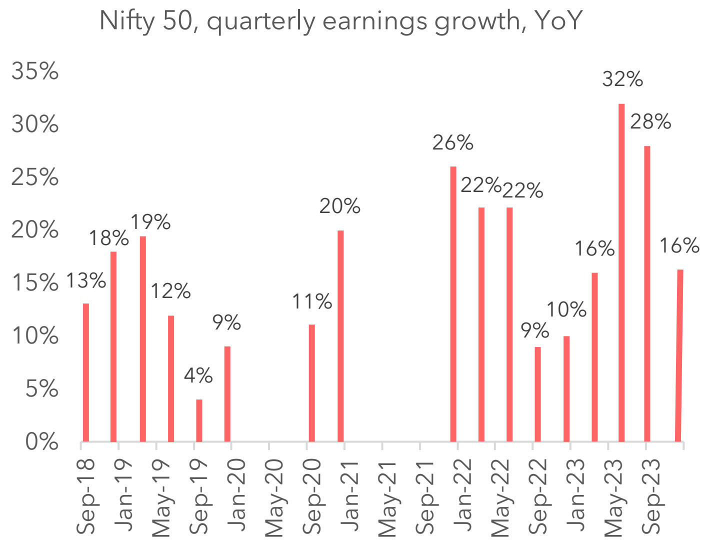
Led by favorable macros, shifting consumption habits, and, more importantly, execution at a firm level, India's aggregate earnings for Q3-2024 across the spectrum of benchmarks Nifty 50, Nifty 100, and Nifty Midcap grew 16%, 24%, and 36%, respectively. As averages homogenize much of the data, the sectoral breakup of the broader Nifty 100 is as follows. Notwithstanding the vagaries of the commodities basket [Oil & Gas, Metals, etc.], earnings growth of the broader sectors spanning Banks, NBFCs, Automobiles, Healthcare, Realty, etc., are in the range of comfortable double digits and running at anywhere between 1.5x to 2.0x of Nominal GDP. This is in parallel to maintaining discipline at a Balance Sheet level.

Title: Sector wise Q3 earnings growth of Nity-top100 firms

Sector, Nifty 100, INR, Cr	Dec-22	Dec-23	YoY
Automobiles	11,669	18,581	59%
Banks-Private	33,637	41,368	23%
Banks-PSU	23,524	27,330	16%
Capital Goods	5,008	5,919	18%
Cement	4,400	4,816	9%
Chemicals & Fertilizers	1,454	-752	-152%
Consumer	13,210	14,577	10%
Healthcare	5,585	6,914	24%
Infrastructure	1,316	2,208	68%
Insurance	8,505	10,817	27%
Metals	3,201	9,222	188%
Misc*	2,633	5,684	116%
NBFC	9,962	11,832	19%
Oil & Gas	30,440	43,405	43%
Real Estate	519	657	26%
Retail	1,661	2,118	28%
Technology	26,878	26,604	-1%
Telecom	2,063	2,533	23%
Textiles	511	253	-50%
Utilities	17,734	19,854	12%
NET EARNINGS	2,03,908	2,53,941	25%

[*Zomato, IRCTC, Info Edge, etc]

For the 9 Months of FY 2024, Nifty-100 and Nifty-50 grew reported earnings by c.30%.



Adjusted for the Covid disrupted periods

Broader market earnings are an indication of the overall health of corporate earnings in an economy. It is however important to note that index earnings tend to reduce a large part of the market to one potential investment target, excluding them of their complexity. This is especially key in the context of investing, as aggregate earnings abstracts away firm specificities around risk, reward, and consequently, invest-ability. For absolute return-oriented fund managers such as Unifi, bottom-up risk/reward metrics at a firm specific level continue to be the driver of stock selection, and investment management.

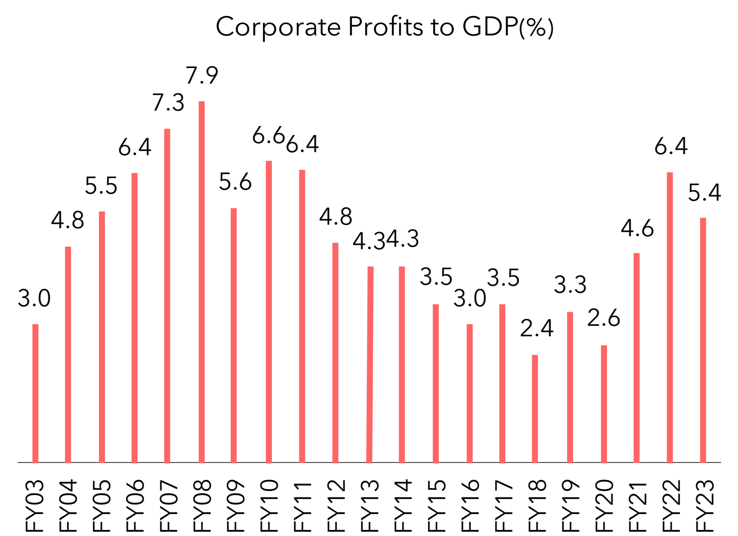
The structure behind the numbers

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.

Improvement in India's twin balance sheet

The importance of credit multiplier on an economy cannot be overstated. In the years prior to the pandemic, India's economic growth was seriously constrained by very weak balance sheets of the country's banking and corporate sector. While Banks faced headwinds in the form of low asset quality, high non-performing assets, weak returns and tepid efficiency, the corporate sector was amidst a cyclical phase of low growth, which extended their de-leveraging cycle. This restrained the industry's ability to invest in growth.

This situation has changed tremendously in the past few years. At about 4.5% of GDP for the fourth consecutive year in FY24, aggregate profits of listed companies are above the decadal usage, and almost double the low of 2.4% of GDP seen in FY18. The improvement is not concentrated, and more broad-based with financial and non-financial sectors experiencing higher profits. At the same time, India's listed firms, a proxy for India's organized players, are gaining market share and are amidst of one their best liquidity positions. The banking sector has come out completely from one of its poorest cycles, with record low NPAs and very strong credit growth. This is numerically evident in the systemic credit growth of 14-15%, with 9-10% growth in nominal GDP, for FY24. We note that the higher credit growth is largely led by the retail/personal sector, while the corporate sector is yet to participate significantly. This is in part a function of a conservative approach to building capacity, aided by a higher share of retained earnings. This credit multiplier of 1.6x-1.7x in bank credit growth-to-GDP growth was last seen in the mid-2000s, when India, along with the rest of the world, was going an expansionary cycle.



As we step into a new financial year, we re-examine what we mean by risk/reward. While this is something we have written about a few times in the past, we revisit them as they constitute the basic principles that govern our approach to Investing.

Margin of Safety

India's decadal high nominal growth rate of 10%+, coupled with fast formalization in select sectors has resulted in some of India's finest firms delivering a high rate of earnings growth. However, the valuation expansion in many of such firms has been significantly higher than that of their earnings growth. While it is possible that a few of these companies will continue to consolidate their position of dominance and grow, we are not be comfortable aligning with such opportunities, where valuations are significantly higher than earnings growth, unless they are significant disruptors/innovators. We prioritize value creation at a portfolio level over the temptation to hold great companies that do not offer a margin of safety to valuations.

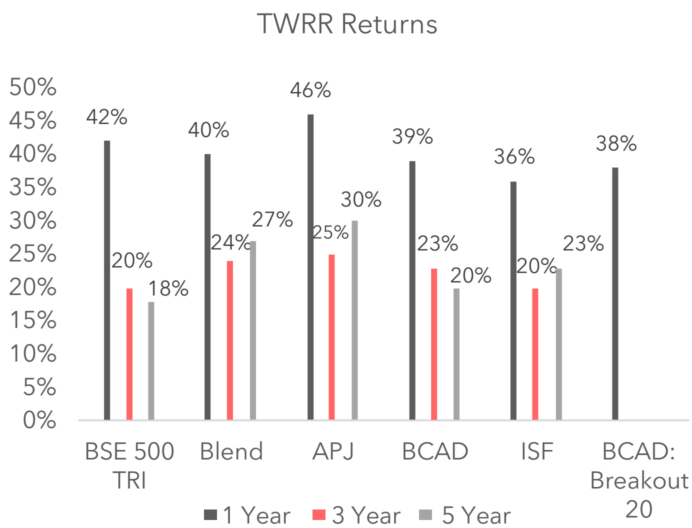
The long term is a series of medium terms

The best of firms experience periods of stunted growth, and we do not confuse the need to stay invested in good companies, or firms we generally like, without regard to growth + valuations. Our objective is to generate absolute long-term performance, and our instincts are to implement the logical next steps and sell when an investment thesis is met. To this extent, we closely monitor the journey to our investment outcomes. This is a corollary to maintaining the margin of safety at a stock and portfolio level, and not just at the time of initial portfolio construction.

Sustainability

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

Unifi's investment outcomes are a function of the above.

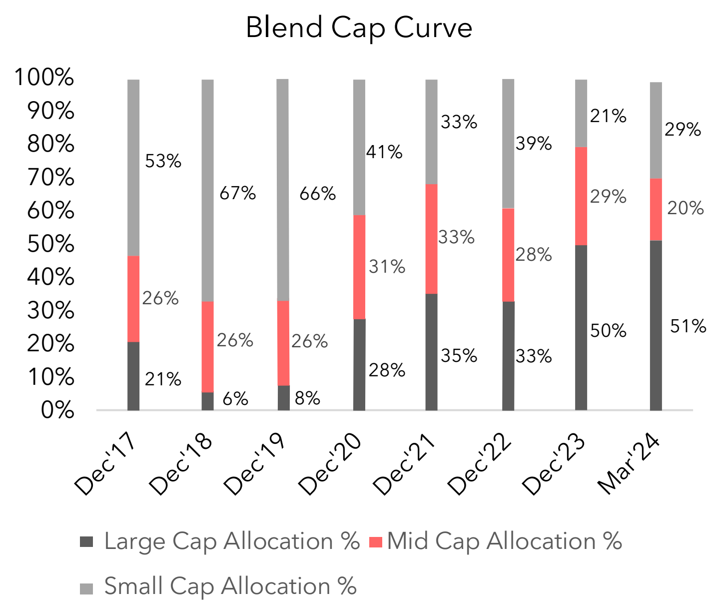


Returns as of 31st March 2024; BCAD breakout tenure <3years

Summary and Portfolio Construction

What makes risk easier to theorize than predict is that it is in a constant state of change. As we come off one of the finest of market cycles, we ask ourselves a few questions: Will the outperformance of the small and mid-caps revert to mean? At a portfolio level, are our current capitalization exposure across small, mid, and large caps optimal given their risk/reward?

In answering these questions, we look at the roughly 2:1 outperformance of India's mid and smaller cap's in conjunction with their earnings growth vs that of the larger caps. In our view, a large part of this performance has been driven by the assumption that the recent phase of high earnings growth can be sustained. While the higher quality firms will continue to consolidate their position and deliver on growth, it is possible that the extent of earnings growth may not merit their forward valuations, in many cases. As we took cognizance of this trend across FY 2024, we moved our investment exposure to firms that had a relatively better construct of risk/reward. The outcome was that such firms were more representative among the large caps.



The size of capitalization present in our portfolios today is not an indication of a bias towards a certain market capitalization. This is a continuation of alignment to practicing growth investing at a reasonable price [GARP]. Given where we are in the cycle today, we see a reasonably attractive upside in the larger companies relative to their performance and valuations.

We continue to be optimistic about India's financial industry from a portfolio standpoint. The industry has entered a new cycle of growth led by several factors and Q3-24 saw progress for the industry in most of the key parameters. We have trimmed our exposure in a few firms where the thesis has played out while we retain investments in those that have a good risk/reward metric.

Following a few years of stagnation in IT spending, with better macroeconomic circumstances in the United States, we believe IT spending will rebound. Over the previous few months, we have expanded our exposure to IT across firms that engage in a wider range of technology spending.

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

In others, we have taken exposure to a Pharma API company. The company's emphasis is on building a large product portfolio of low-volume and high-value APIs while maintaining high standards of compliance. The company provides services throughout the stages of the product's lifecycle and allows itself to be present across the value chain. The company has been vying to leverage its client relationships in the generic API segment to foray into the CDMO segment. With the change in the ownership structure of the company and hence capital allocation decisions, we expect higher growth potential.

We have also added a LAP financier (NBFC) to our portfolio. The company caters to the financial requirements of customers who are unaddressed by banks and require faster end-to-end turnaround time. The company has a strong parentage as it is being promoted by a bank which also helps in having an edge in cost of funds compared to its peers. The company has invested heavily in expanding its distribution over the past 3-4 years, which shall enable it to report higher growth numbers over the next 2-3 years. The asset quality performance of the company has been commendable over the past 4-5yrs.

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 Q3 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.

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 Q3 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.

As on Mar 31, 2024	FY 24E
Wt. Avg PE	23.4x
Wt. Avg PB	5.0
Wt. Avg ROE	22.1%
Wt. Avg Mcap^	Rs.178,859cr

^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.

As on Mar 31, 2024	FY 24E
Wt. Avg PE	22.7x
Wt. Avg PB	4.6x
Wt. Avg ROE	22.9%
Wt. Avg Mcap^	Rs. 124,270cr

^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 strategy continues to focus on firms delivering manufacturing excellence broadly across technology, chemicals, pharmaceuticals, materials, and infrastructure in general.

As on Mar 31, 2024	FY 24E
Wt. Avg PE	26.0x
Wt. Avg PB	3.4x
Wt. Avg ROE	20.4%
Wt. Avg Mcap^	Rs. 64,577cr

^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.

As on Mar 31, 2024	FY 24E
Wt. Avg PE	21.2x
Wt. Avg PB	3.3x
Wt. Avg ROE	17.6%
Wt. Avg Mcap^	Rs. 113,636cr

^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.

As on Mar 31, 2024	FY 24E
Wt. Avg PE	24.0x
Wt. Avg PB	5.4x
Wt. Avg ROE	22.6%
Wt. Avg Mcap^	Rs.143,295cr

^ex- BFSI

Risk

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 geopolitical tensions between India and neighbouring 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