QUARTERLY UPDATE

EQUITREE
SOWING SEEDS OF GROWTH

- MARCH 2019 -

"The stock market is designed to transfer money from the active to the patient."
– Warren Buffett

Dear Investors,

Over the last 6 quarters we have been consistently sharing our thoughts every quarter – this one being the 7th quarterly newsletter. A large part of this period has been marred by a lot of pessimism at the broader investor sentiments and may be a bit of fear too!

All along this journey we have been maintaining that while we are facing short term headwinds, as a long term investor our eyes are constantly on the health of our underlying businesses rather than worrying too much about the temporary dip in the stock prices – which also should fall in place as the broader investor sentiment changes. We have also been vociferously saying that the pace of recovery could be much faster than what most people anticipate. While we still have some ground to cover, however, **we are happy to report that with a slight change in the investor sentiment over the last couple of months, we have seen the portfolio recovering ~ 10% in March alone and were picked by Economic Times (Mumbai edition dated April 09, 2019) amongst one of the better performing funds for the month!.**

We continue to be upbeat about our long term investment strategy and strongly believe that from 3-4 year perspective, we should be able to deliver our desired returns of ~ 25% IRR – **something that we have done and achieved twice over during our investment journey from FY 2012!**

In this newsletter, we once again reflect on the current market and make an attempt to star gaze for the near future.

MARKETS AT AN ALL TIME HIGH – REASON TO CHEER?

The headline indices have made a new all-time high with Nifty touching 11,810 on 16th April. The broader market has also seen some buoyancy with investor sentiments tilting with positive bias resulting in NSE Small Cap and NSE Mid Cap index gaining 9.4% and 7.6% respectively during the last month. While there has been a lot of pent up demand for equities and this kind of a pullback is not out of context, **we look at this rebound with a bit of caution. Our caution stems from the following reasons**:

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- **Lowering of bond yields in US brings sudden and significant inflows in India resulting in compulsive buying:** This quarter has seen the dollar stabilize at ~ INR 70/USD, and Brent Crude is also seen stabilizing at ~ USD 60. A 6% appreciation in Rupee coupled with a steep 30% fall in Crude prices since the last quarter augurs very well for the oil hungry Indian economy at large. We believe that this correction should show us improved quarterly earnings for a whole range of companies in the upcoming result reason.

  During the last 2 months, large chunk of FII money has come in across both Bond and Equity market as shown hereunder:

FII inflows in Bond market during the quarter	INR 4,664 cr
FII inflows in Equity market during the quarter	INR 46,939 cr

  Source: NSDL

  We understand that a large chunk of this money is from the Exchange Traded Funds (ETFs), which is generally considered to be 'hot' money creating momentum – it comes in fast and goes out equally fast. The reallocation of capital purely due to softening bond yields seem to have led in to compulsive buying of equities and one needs to wait and watch how sticky does this proves out to be.

  Interestingly during the same period, DIIs have been net sellers to the tune of INR 12,349cr. One would want to assume that DIIs would have a more on-ground feel of the economy and they being net sellers, lead us to believe that this FII buying is more compulsive in nature than driven by growth and valuations. One will need to wait and watch who has the last laugh between the two!

- **Polarization still continues:** While the last month has seen some buying happening across the broader market, however, bulk of the FII buying has been extremely polarized to the extent that of the last 900 point rally in Nifty, 300+ came from Reliance and 600+ coming from 5 stocks – Axis Bank, ICICI Bank, HDFC Bank, Indus Ind and SBI! This kind of polarized built up of positions on the back of 'hot' money leads us to reflect whether this is 'new high' is a reason to cheer or be concerned about?

- **Headline index valuation not the cheapest:** Nifty continues to be expensive at ~29x (TTM – March Ending 2019) which by far is the most expensive that it has been traded at. While analysts are rushing to peg Nifty 1 year forward earning to be around 18-19x, this translates in to analysts budgeting for ~ 25-30% growth in Nifty for FY 20! This to us sounds little unrealistic to achieve even after considering a significantly better performance from the Banking stocks (on the back of cleaning up of NPAs) and makes us little cautious on the broader indices.

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COMING BACK OF THE MICRO / SMALL CAPS – CONFIDENCE RESTORING IN SMALL DOSE

Buoyed by the increased chances of continuation of the current NDA government post Balakot strikes and the continuous flow of FII buying has had a cascading 'feel good' effect on the broader market, leading to some restoration of confidence and buying picking up in Small and Mid-caps:

- **Panic selling stops:** The panic which had gripped the Small and Mid-cap stocks in last quarter of 2018 seems to have stemmed for now. The selling pressure caused by unwinding of leveraged positions, corporate governance issues, redemption pressures seen by MFs / PMSs seem to have stopped. On the other side, restoration of confidence has seen some smart buying at lower levels pushing the NSE Small Cap 100 index up ~ 9% in March itself. **Individual stocks have seen a much sharper rebound where some stocks have recouped as much as 30-50% from their lows. Some of our own portfolio companies have seen this kind of rebound from the lower levels as shown hereunder:**

Company	52-Week Low	Date of 52-Week Low	Current Price (29th March)	% Gain
Shakti Pumps	INR 293.30	28/09/18	INR 395.45	35%
Magma Fincorp	INR 80.65	15/02/19	INR 117.80	46%

- **Buying seen even in the stocks reprimanded for corporate governance issues!:** The catch-up effect has been so high that the market seem to have forgiven even stocks reprimanded for gross corporate governance issues as shown hereunder:

Company	52-Week High	52-Week Low	Current Price (29th March)	% Gain from Lows
Manpasand Beverages	INR 458	INR 59.65	INR 116.90	95%
Vakrangee	INR 180.40	INR 22.35	INR 50.30	125%
PC Jewellers	INR 311.30	INR 46.85	INR 82.20	75%

- **Valuations correct - making them more attractive than ever:** The correction in the small and midcaps over the last couple of quarters has been quite substantial, making the valuations look very attractive as shown hereunder:

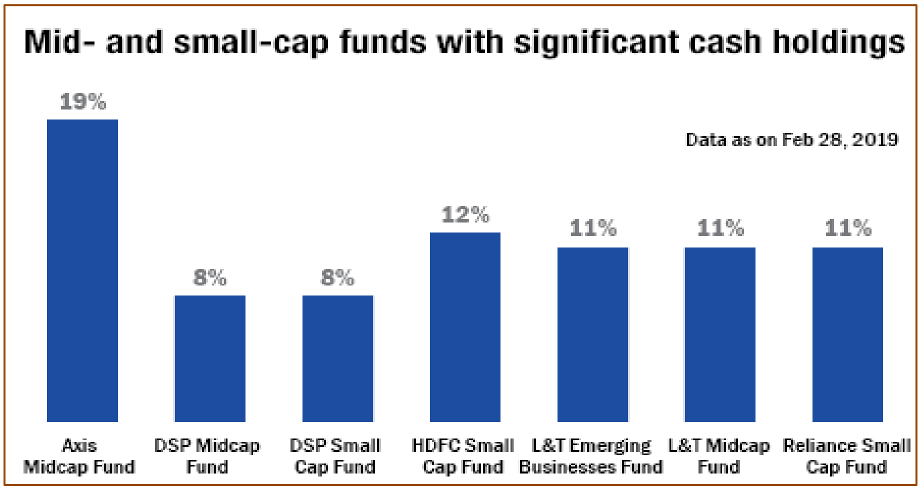
Index Performance	9mn Earnings growth	Date	Valuation
NSE Small Cap 100* (FY18)	-22%	02.04.2018	70.66x
NSE Small Cap 100* (FY19)	3%	01.04.2019	30.77x

Source: Capital Line, NSE India
** Ex Banking stocks*

The sharp correction in the valuations which has taken all the froth out of Small and Mid-caps has once again started attracting attention of the larger market participants resulting in a quick rebound of stock prices. We believe that this should continue for a while as investors look around for bargain hunting on growth stories at attractive valuations.

- **New fund launch of a series of Small & Mid cap schemes endorse the opportunity ahead:** The restoration of confidence and attractiveness of valuation has led to mushrooming of a lot of new Small & Mid cap schemes floated by various mutual funds / PMSs / AIFs. **We have ourselves upped the ante in reaching out to likeminded investors and seeking incremental funds to shore up our holdings in some of our portfolio companies as well as new ideas that we have been working on**. The writing seems to be clear on the wall that FY 20-21 should be the year of the Small / Midcaps and investments done now should see significant value accretion by then.

- **Cautiously optimistic:** While investing in Small and Mid-caps seem to be a fairly accepted market wide mantra at this point in time, however, given the volatility that may come about because of the election results and / or for the corporate earnings, most market participants are treading this investment genre with caution. A lot of small & mid-cap funds are sitting on cash and waiting to see through the volatility before committing long term investments as shown hereunder:



Source: ValueResearch

In the interim, the market has turned in to a trader's paradise seeing profit booking happening at ever 10-15% rise.

We are also building our new positions cautiously and keeping some amount of cash to take care of any volatility, should a need arise.

ELECTION OUTCOME – NEED TO GET PAST THE 'BIGGEST' EVENT SENTIMENTALLY

So after about 2-3 quarters of waiting, we are in the final leg of the BIGGEST 5 yearly event – the National Elections!

Over the last quarter, we have witnessed heightened activity on the political front and should see the culmination on May 23rd. **From the market's perspective, our sense is that people are more waiting for the uncertain event to get past rather than really being impacted about the result of the event.** We reiterate hereunder our comments from our September 2018 newsletter to echo our sentiments:

Looking into the past, in an era of coalition governments as well, the economy continued to grow at average growth rate of 6.26%, with the highest growth being registered in 2010 (10.26%) during the weakest coalition government formed by the UPA with a majority of only 145 seats.

ELECTED PARTIES VS GDP GROWTH		
ELECTED PERIOD (FY)	**ELECTED PARTY**	**AVERAGE GDP GROWTH (%)**
1992-1996	INC	5.14
1997-2004	**BJP**	**5.89**
2005-2014	INC	7.74
2015-2018	**BJP**	**7.35**

Nevertheless, purely from a stability point of view one would rather want a strong government at the center then a wobbly forced opportunistic coalition. Our take on the market under different scenario is as under:

Scenario	Potential Outcome	Probability	Our sense on the impact on market
1	NDA forms a government with BJP winning independent majority	Low	Extremely positive
2	NDA forms a government but BJP does not get an independent majority	High	Neutral to Positive
3	UPA forms a government with Congress getting a majority	Low	Positive
4	UPA forms a government with no single party getting a majority	Moderate	Neutral
5	Third Front forms a government with outside support from UPA / Congress	Low	Negative

CORPORATE EARNINGS – KEY TO DECISIVE DIRECTION

Post the biggest dance of democracy, all eyes are likely to move towards Corporate Earnings to look for a decisive direction in the market. **The current macro scenario gives a very mixed view on the economy making it more imperative than ever to focus on ground up analysis of businesses to look for investment avenues**:

- **Slowdown in PV, 2 wheeler and white goods sales does not augur well:** Auto sales – more particularly the PV and 2 wheeler as well as white goods sales are primary indicators of the health of consumer behavior and confidence as they are the lowest end of capex at the consumer level and depicts the confidence of the consumer to commit his expected future income. A consistent drop in this indicator does not augur very well for the economy at large. **It is noteworthy that for the first time in the last 13 years, India has seen a drop in scooter sales, which kind of indicates concerns at the ground level.**

Auto Sales (%)	January Growth (y-y)	February Growth (y-y)	March Growth (y-y)
PV Sales	-1.87%	-1.11%	-1.3%
2-Wheeler Sales	-5.19%	-4.22%	-8.3%

Source: Economic Times

We are watchful of these headline numbers to get a cue of what's in store for the future and hope that this trend is more of a one-off quarter and does not elongate in a long term structural down trend.

Gladly, there has been a silver lining in this with the FADA (Federation of Automobiles dealers association) suggesting that the decline in demand for autos would plateau and should see sales picking up going forward as the BS-VI norms come into force. Registration of vehicles seems to go up and consumer interest remains robust.

- **Crude inching up to hurt raw material prices of variety of Businesses:** With the OPEC's cartelization and control on the production, crude is softly inched back to US $70 / barrel from its low of $50. Despite US's effort on increasing production and bringing the price down, we are seeing crude price stabilizing at around US $70 / barrel. This 40% increase in crude price from its low is yet to get reflected in the raw material cost of companies dependent on crude price. To some extent, an appreciating Rupee will off-set this impact, however, there still seems a lot of ground to cover. We are cognizant of this and continuously keep assessing the impact on the businesses that we are looking to invest in.

- **Global slowdown / trade embargo:** While there is an increased talk on slowing down of global economy, IMF has pegged India's projected GDP growth @ 7.3% for FY19 making it the fastest growing economy in the world. Further, India being predominantly an inward focused economy doesn't get too much impacted by the ongoing trade embargoes – on the contrary it could possibly open up doors for Indian export in the global market to replace China!

- **A few tail winds as well:** While we have highlighted some issues on macro level, there are a lot of tail winds as well which should augment growth for corporate India. Some of these include:

    - Soft Inflation – Inflation has remained stable at 2.57% as on February.
    - Strengthening Rupee – The rupee has strengthened, touching a high of INR ~68.5/$.
    - Softening interest rates – The RBI has also been softening rates in order to boost liquidity; the repo-rate is now at 6% after a 25 bps cut.
    - Record GST collections – GST collections touched a record high of INR 11.77 trillion for FY19.
    - Resolution of NPA issues – Strengthening of banks with substantial resolution of NPA issues provide a solid platform for growth

- **Important not to fall in low P/E trap – Earnings Visibility Imperative:** The correction in Small and Mid-cap stocks has rendered valuations of a range of companies at seemingly very attractive levels – more so in case of Micro caps. Having found their bottoms some of these stocks have also seen some buying coming back and pushing the stock prices upwards. However, one needs to be wary of future earnings and visibility of the same for these categories of companies. While they may have had a decent past, if earnings are not sustainable then even the corrected prices may end up resulting in relative high valuation on a forward basis!

  For e.g. stock like Graphite India which saw a considerable run up in 2018, saw a 9Months growth of 417% and is currently trading at a PE multiple of 2.5x on TTM basis. However, it is expected that their FY20 PAT number will be at least 30% lower y-o-y, making it reasonably valued with a limited upside and thus not a lucrative investment option.

OUR PORTFOLIO PERFORMANCE

As is the case with the broader economy, some of our portfolio companies have also got partially impacted during the Dec qtr. Nevertheless, despite some challenge in a couple of our portfolio companies we have done reasonably well on an overall portfolio basis as compared to the broader markets as shown hereunder:

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Our Portfolio Performance for the 9months:

	9Months FY19 PAT Growth y-y	PE
Equitree Emerging Opportunities	14.48%	13.38x
NSE Small Cap 100*	3%	30.77x

**Ex Banking stocks*

We have been in touch with managements of most of our companies – including the ones which have experienced some head winds in the last quarter to understand and assess visibility of business and growth. While some head winds may remain in a few of our businesses for another quarter or so, long term prospects for most of our portfolio companies continues to be robust.

We would be happy to hear from you and answer any of your questions, if any. Please feel free to call / write in should you need any further information on any of our portfolio companies.

Warm regards.

TEAM EQUITREE

www.equitreecapital.com