

From the CIO's desk - March 2019 newsletter

Greetings!

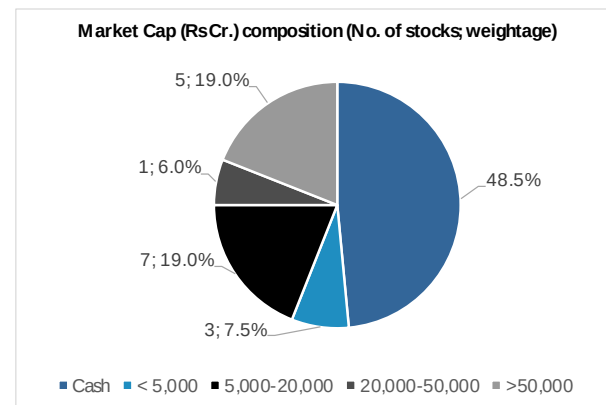
Markets don't cease to surprise in the short term and March proved the point. The market clawed up the wall of worries and got within a short distance away from an all-time high. The proximate cause was the de-escalation in the border situation and the consequent improvement in the poll prospects for the Modi government. India also made up for some of the lost ground relative to its emerging market peers over the last quarter. While we have no views on politics, policy stability will be viewed as a relief by the market and it appears the market is discounting this ahead of the event. Thus, a stable government is now increasingly in the price. We, however, do not want to take any decision based on potential poll outcomes.

At the outset, we had a list of stocks we wanted to invest in, based on our assessment of fundamentals and in line with our process. Once we saw that the market was willing to put the geopolitical and poll uncertainties behind it and was inclined to go higher, we put some capital to work in those names. This is in line with our broad deployment strategy. The 16 stocks that we have invested in are across the market cap spectrum; businesses that we like from a multi-year perspective; run by solid managements; and are well distributed over some key sectors/risk characteristics. We also believe we have managed to buy stocks at a price range where there is comfort.

We are on track to deploy upwards of 80% of the strategy over a four-to-five-month period (which, in effect, started from February), give or take. Since the market has run up a fair bit, we will be cautious and choosy on deployment. Given valuations, which are again beginning to run ahead of themselves, there is no room for a P/E re-rating merely because we get a stable government. Unlike in 2014, we believe the

market will take stock and assess the prospects for economic growth and, more pertinently, earnings growth. Thus, caution is still warranted on stock selection and deployment discipline.

The portfolio distribution across market cap for our portfolio is as follows:



Is debt good for companies that you own?

This is a question we have been asking ourselves as we seek to build a robust portfolio for the long haul in our flexicap strategy. Our take

In the last ten years, debt has become a bad word and we have now got to a point where if a company has any debt at all, there is a red flag. While we agree that debt has caused a lot of issues for shareholder returns, all debt is not bad. An acceptable level of debt should be positive for shareholder returns if:

- The level of debt is reasonable in relation to equity;
- The debt goes to finance asset building (or working capital) in the core business;
- The timing of debt raise is sensible and is within an overall capital structuring framework; and
- The business tends to be asset heavy and requires creation of capacities ahead of business ramp up.

It helps if the company in question is capable of getting debt on good terms. This is usually a function of management credentials. Thus, we have seen that a company such as Ramco Cements has always funded its growth with debt and never had a problem. The short point is that cost of equity tends to be higher than the cost of debt over the long haul but the risk that debt brings needs to be managed properly.

We believe we are coming to the end of a decade where corporate debt was created in India and a chunk of it did not get repaid. The economy is coming out of this overhang. We are ready for a new credit cycle. While corporate banks will no doubt be beneficiaries of the credit growth that we see ahead, select companies with reasonable debt and good capability/intention to service the same will also generate value.

While debt in the balance sheet of a company can be analysed and factored in, debt at the promoter level is a riskier proposition. Thus, we have been very wary of promoter leverage. Even at the company level, most of our investments are in companies with no or low debt. Outlined below are some metrics in this regard:

Weighted portfolio level debt:equity	<0.5x
Promoter pledge as a percentage of weighted equity at portfolio level	<1%
Cost of debt service at portfolio level	4%-9% pa

If we factor in the debt of NTPC, which is a utility with a legitimate reason for debt on its books, the D/E will be even lower.

We will continue with our cautious approach while examining balance sheets and selecting opportunities where financial and operating leverage can result in substantial earnings upgrades in coming years.

In summary, from an overall portfolio standpoint, we think that with the current run seen in equity prices since mid-February, the risk-reward trade-off has a skew towards the former. Our attempt will be to mitigate it by a)

judicious stock selection and b) an approach of staggered purchases, which helps us take advantage of bouts of market volatility.

Warm Regards

P Krishnan (CIO) and Team Spark PMS