

From the CIO's desk – June 2019 newsletter

Greetings!

To look forward or look back?

This is the dilemma that stares us in the face as investors. All the weak data that we see on the screen (and no doubt, the data is ugly) is the tail risk playing out from a set of events that transpired over the last several years – scams under the UPA, policy paralysis, fiscal slippage, death of the investment cycle, bad loans, NPA contagion, demonetisation and a GST implemented in a high-handed manner. The list is long but is all in the past. The tail risk has hit us and perhaps hits us hard.

We say it is a tail risk because most of these events have passed and things are on the mend. Therefore, to look forward is a logical sequel to the slowdown.

What is the market smoking?

Must be something heady as it seems to be ignoring the poor data print. But then, the market may be looking forward in its own uncanny manner and the windscreen shows some green shoots, if not a pasture. Inflation is down, interest rates are finally cooling off, bank NPLs have all but bottomed out and GST is settling in. We have a majority government, though no one seems to agree. We even have relatively low oil prices for the second NDA term all over again. The global economy, while not on a roll, is marking time in a cyclical journey and central bankers are supportive. It appears that the market is dividing the sum of all these with its own expectations to arrive at the current P/E; this high P/E is seen as a matter of concern. While we should care, this is not a metric with which we can understand the current market well enough to take investment decisions.

Which is why we believe making a market timing call and expecting a sell off (everyone calls it a correction, but many stocks need to lose 30% before reaching mean valuations and that cannot be called a correction) is an increasingly infructuous exercise. It makes more sense to look at companies and themes that can take India

forward and see whether there is reasonable value over there. We have realised it is a more rewarding exercise, even from the point of view of valuations.

Why do we own NTPC?

This is one of our key investments in the client mandates. In short, NTPC presents value and favourable risk-return trade off. It belongs to the endangered species of stocks in India that offer a respectable dividend yield. NTPC sells energy and India has enough and more demand for it. At present, it generates an ROE that is lesser than the regulated ROE one would expect to see from it. Mainly because dislocations and bottlenecks have led to various levers of the core economy punching below their weight.

We believe this will change. In part because we have a government with a mandate. In part because some of the adjustments the economy had to make, in terms of GST, a nasty bad loan cycle and self-inflicted injuries such as demonetisation, are now mostly done. As infrastructural bottlenecks ease, the ROE for NTPC should trend up. The stock trades at a price-to-book multiple which is well below its long-term mean and not far from its all-time low of 1.0x. The main point is that this is neither because the leadership position of the company is in threat nor because the business is at risk. It is a classic cyclical low.

On the other side, the investors will get over the extreme obsession with expensive stocks. Performance in the market has been narrowing to fewer names every quarter and is now limited to companies that have made a fine art of winning a zero-sum game in a floundering economy. Of course, they are highly efficient companies and are great allocators of capital. But one wonders whether some of the excess ROCE is because of the funk the economy is in and consequent inability of competitors to put up even a half-decent fight. One also, therefore, wonders whether the ever-expanding valuations in these names will further defy gravity. We will hold our horses here.

We do not believe that investors will avoid PSUs to perpetuity. Over a longer timeframe, investors will follow (have done that in the past as well) fundamentals and not the colour of ownership. The current aversion towards PSUs started building up from 2010, when the role of the government became a question mark (with scams all over the place). The rather lacklustre growth record of the NDA government over the last five years made the market even more bipolar. We see an unwind in this as we go forward. PSUs such as BHEL and oil marketing companies have created serious shareholder value in the past from crucial inflexion points, and that too for a good bit of time. NTPC is certainly in line to create some serious value.

Our investment in small caps

We have an allocation of about 21% to small caps (below Rs 8,500 crore of market cap) in most of our accounts spread across 6 names. Let us put out below the broad thought process behind this:

1. To begin with, we have not invested in illiquid names in the small-cap space. The weighted market cap of our small-cap holdings stands at about Rs 4,550 cr.
2. We have kept a check on the unit exposure towards the small caps, recognising the possible volatility in the asset class. Our portfolio does not have a concentration risk on any small- cap name (weight of between 1.75% to 5% per stock)
3. Our small caps are not turn-around stories. They are leaders in the specific segment/area they operate in (by definition, small caps cannot be market leaders in big industries). They cater to markets that have a sizeable end-market demand and are not in niche products or services
4. They are companies that are run by competent managements, have solid balance sheets behind them and follow sound accounting policies. We see no governance risk in these names.
5. If they have debt, they have access to it on good terms (a sign of strength in these times). Where there is debt (which, we believe, is manageable), we see fair amount of improvement as we go forward. There is no

promoter pledge of equity holdings in any of the names (excepting one, where there is a small leverage that has been reduced recently)

6. We like the businesses that these names operate in and rate the managements high in terms of their competency to run these businesses. We see earnings prospects in these names to be bright over the next 1-3 years
7. In most of these cases, valuation comfort has been high. We have bought most of these after a price correction of between 20-30% and/or some time correction
8. So far, these investments have shown reasonable traction and we believe we are on the right track here

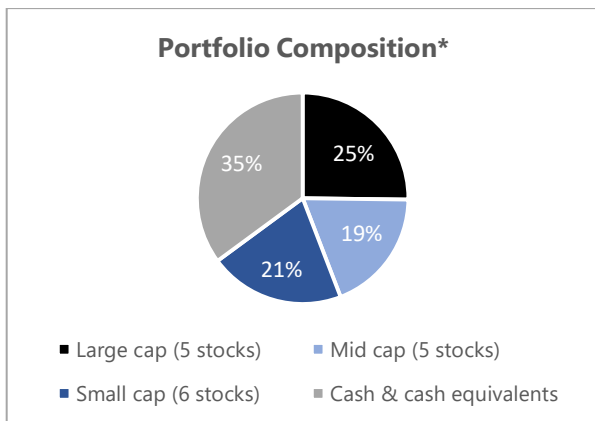
In summary, our allocation to small caps is part of an overall portfolio strategy as much as it is about stock picking. We will, of course, monitor stocks on a continuous basis to get the best out of this strategy.

Risk assessment

Amongst the various parameters we monitor, the concentration risk is moderate to low in the portfolio as our largest single stock holding is at about 7%. The portfolio is well diversified across sectors as well. We monitor liquidity in the portfolio stocks very closely and our observation is that the portfolio is highly liquid in terms of the traded volumes in individual stock holdings. The balance sheet leverage of our portfolio companies also remains comfortable at 28% (weighted, ex-financials)

The portfolio remains vulnerable to a sell off in the broader market especially driven by FII/DII selling. Further, given that our stocks have been chosen with certain earnings expectations playing out, this is one metric which we will need to watch out for very closely as the year progresses.

Where are we invested



**represents portfolio of a typical investor onboarded in June 2019; actual portfolios may vary depending on timing of entry into the scheme.*

Note: Market cap as per SEBI guidelines

We have invested close to 65% in stocks. Broadly, our position is that there is no great value to timing the market. We have already stated that a lot of the bad data on which sceptics expect a sell-off are backward looking. We will deploy the balance in a calibrated manner, even as we state that some cash in the portfolio always gives firepower in case of a market sale.

Warm Regards

P Krishnan (CIO) and Team Spark PMS