Rethinking Risk

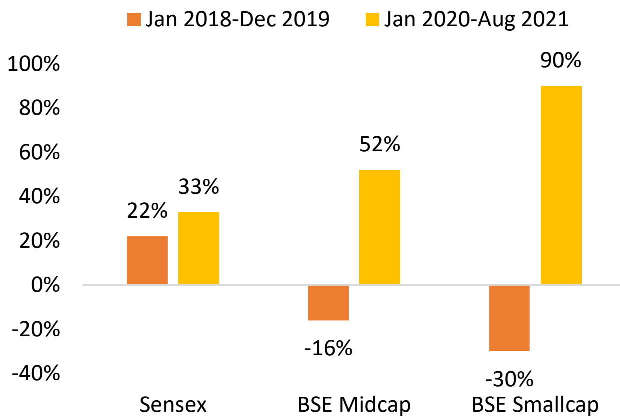
Do complex risk models reflect how humans behave?

Between estimating the fall of Kabul a few days back to the fall of the world's financial system last year, analysts have too often put complex risk models ahead of a simpler understanding of what is going on. Complex estimates of odds create an envelope of confidence/fear. In truth, but mostly in hindsight, they are far removed from reality. And subjective probabilities that are at the core of such analysis are often irrelevant in the real world.

What makes risk easier to theorize than predict is that it is in a constant state of disequilibrium. 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?
- Is fund's current capitalization exposure across small, mid, and large caps optimal?
- Are the new names coming to the portfolio just representative of value or do they also offer the prospects of growth that will capitalize on unlocking of the value?

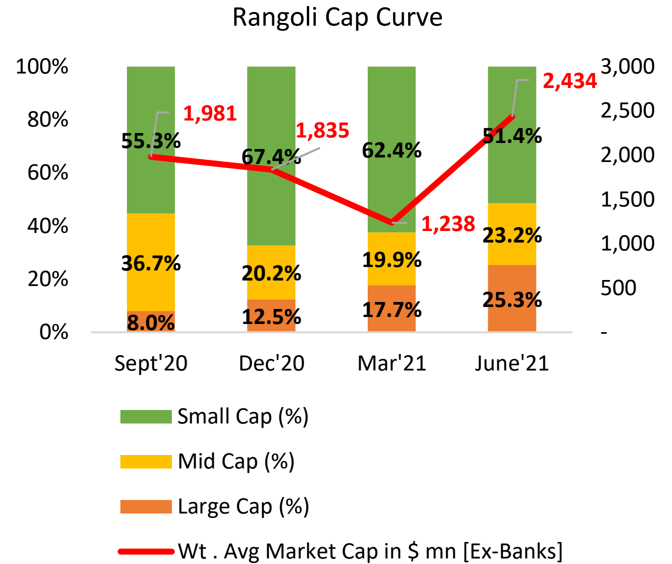
In answering these questions, we look at the 3:1 outperformance of India's small caps in conjunction with the steep earnings upgrades they have delivered over the last few quarters. In our view, a large part of this performance has been driven by the assumption that the recent phase of high earnings growth can be sustained. We believe this is unlikely. We took cognizance of this trend a few quarters back and advised to move to pastures that had a better construct of risk/reward, both at the firm and sector level.



As a result, the weighted average market capitalization of the funds has changed over the past several quarters.

Cap Curve

The following chart captures the market cap movement of Rangoli strategy, over the last few quarters. The market cap classification in the following chart is as per AMFI's definition.



While the allocation to larger firms has grown significantly, our advice on the framework of seeking value has remained steady. Given where we are in the cycle today, there is reasonably attractive upside in the larger companies relative to their performance and valuations. The size of capitalization does not determine the cognitive slant and irrespective of the cohort we are present in, our quest for value [risk/reward] is steadfast. As you may have already noticed in your portfolios, stocks that have performed well in the 2020-21 cycle have given way to the new names, and we are now seeding growth for the next cycle.

Corporate India is amid its finest earnings growth cycle witnessed in the last 12 years and the portfolios are optimized to capture this in the best risk/reward possible.

The macro's [rates, inflation, money supply] continue to be what they are – unpredictable. We defer to what Warren Buffet summarized in a manner only he could: *for a piece of information to be desirable, it has to satisfy two criteria; it has to be important; it has to be knowable*. The macros belong to the latter camp and to that extent while do not seek to predict the unknown, we seek to prepare. Which loops us back to one of reasons why old names have given way to the newer names, and sectors. And by way of repetition, this doesn't come in the way of seeking, and identifying value.

The Investment theme wise composition of the Rangoli Strategy is as below.

Theme wise Allocation (5th Sept 21)

Deep Value Fund	31.85%
Insider Shadow Fund	23.76%
APJ	21.44%
HoldCo Fund	10.88%
BCAD Fund	8.51%
Cash	3.56%
Total	**100%**

Q2-CY21 | Results summary

The second wave meant curtailed operating conditions, and as a result, rendered both YoY and QoQ comparisons unhelpful. However, an absolute reading of the numbers suggests strength in the franchise of the leaders, and resilient domestic consumption demand. We are comfortable with the earnings salience of the companies and what they are doing to seed leadership for the times to come. The strategy continues to build concentration in seeking such leadership, delivering results above expected lines, consolidating their position, and delivering industry leading growth.

At 20%, IT forms largest exposure. Deep cloud adoption is critical for staying relevant today. Newer technologies and abundant computing power are driving a new phase of technology consumption and the industry is in the midst of a multi-year demand cycle today. The investee companies are capturing spend from Cloud applications, ERP and growing newer practices of big tech in US and Europe. The last few quarters have been transformative. We have advised for 7.5% exposure to Wipro, 5% to Eclerx and 2.5% exposure to Mastek.

At 15%, financials constitute the second largest segmental exposure. The retail focused institutions, ICICI and Axis Bank and India's largest bank by balance sheet size, SBI are having lower than anticipated asset quality challenges and are poised to emerge stronger. We believe that these lending companies are at the cusp of the upcycle in terms of capital efficiency and profitability and would benefit from the revival in the credit cycle post the clean-up of the stressed loan book.

Other major sector exposure includes Fee-based financials (14%), Materials (11%) and Chemicals (10%). We have advised taking 5% exposure to Hindalco based on a broadly constructive macro backdrop over the upcoming 2-3 years allowing global aluminum market to move into a strong profitable cycle. Hindalco is well poised to reap the sectoral tailwinds given the significant forward integration they have achieved through Novelis. We have also advised taking exposure to GSFC, a Gujarat state PSU company with a strong balance sheet and advantageous business cycle. In addition, we advised taking exposure to Bajaj Holdco, given the strong underlying business available at favourable discount.

At the consumption end of things, from groceries, savings, electronics, and now electricity, India is increasingly emerging as a digital-first consumer. We are excited about the opportunities in this cohort as the financialization of savings and the consumption of exchange-traded power break out into new territories. In other select industries [paper, non-ferrous, building materials, etc] developments in the supply side are driving a very profitable cycle. They fall in a very comfortable venn of value / growth, explaining their presence in the portfolio today.

During the quarter, we also recommended trimming the exposure in Suven Pharmaceuticals and JB Chemicals to fund the new purchases, aligned with philosophy of constructing the portfolio with a favorable risk-reward equation.

The following annexure presents a brief on the top holdings

Company	Brief background and Investment rationale
State Bank of India	SBI reported NII growth of 4% YoY and 2% QoQ to Rs.27,638cr on account of improvement in NIMs sequentially. Advances grew by 6% YoY to Rs.25.3 Trillion with retail advances forming 41% of the same. Operating profit was up by 5% YoY down 4% QoQ at Rs 18,975cr and PAT was up 55% YoY & 1% QoQ at Rs 6,504cr. The bank surprised positively on asset quality with annualized net slippages of 1.7%, which came in much lower than large private banks. The restructured book was also low at 0.7% of the book. Overall, GNPA stood at from 5.32% compared to 5.44% in Q4FY21. The bank made provision of Rs.10,000cr to increase the coverage to 68% on GNPA. With an additional COVID-provision buffer of Rs.11,000cr, the bank is in a comfortable position to take care of any incremental stress in asset quality in FY22. Given the superior performance in controlling stress and improving asset quality in a covid hit year, the bank is expected to deliver on all parameters from the forthcoming year, and eventually migrate to higher double-digit RoEs. The bank has cleaned up its stress in corporate loan book and will be a likely beneficiary in the upcoming credit cycle, thanks to its strong franchise and better underwriting practices. Key risks would include deterioration of asset quality leading to higher-than-expected credit costs and decline in NIMs due to falling yields.
ICICI Securities	ICICI Securities delivered a good quarter, with the broking segment growing by 11% YoY to Rs.395cr despite the covid related challenges. The company surprised positively with strong client additions at 389,000 clients, primarily through the digital channel. The distribution revenue was up 58% YoY led by improvement in both mutual fund and non-mutual fund revenues. Several new initiatives such as open architecture to onboard different insurance partners and sell through channels beyond ICICI Bank continue to be on track. On the back of robust revenue growth and measured operating expenses, PBT was up 61% YoY at Rs.417cr., and PAT was up by 61% YoY at Rs.311cr. I-Sec is a leading tech-based securities player offering a range of financial services including brokerage, financial products distribution, and investment banking, with focus on both retail and institutional clients. As of June 2021, the proprietary electronic brokerage platform ICICI Direct had approx. 5.8 Mn operational accounts of whom about 2.2 Mn had traded on NSE in last 12 months. I-Sec is also the second largest non-bank MF distributor with an AUM of Rs.440 Bn. We like the business due to its absolute technology leadership, continuing consolidation of user base, high RoE of more than 50%+ and access to ICICI Bank's franchise for customer acquisition. Key risks would arise from a prolonged downcycle in equity markets leading to lower turnover, and heightened competition leading to loss of market share.
Wipro	Wipro delivered YoY Revenue/EBIT/PAT growth of 22%/ 30%/34% to Rs. 18,467 / 3,356 / 3,238cr. The organic growth of 4.9% QoQ was one of the highest in past many years. EBIT margins were lower by 100 bps QoQ at 17.2% due to the acquisition made earlier this year. The margins should rise going forward supported by tailwinds from efficiencies, offshoring and currency benefits. Except manufacturing, all other industry segments posted healthy growth of 2.6-22.4% QoQ in CC terms. For the quarter, PAT came in at Rs.3,238cr (34% YoY). Wipro's focus on driving consistency in deal wins, sales growth and margin prospects is improving. Key risks: It is important to note that product sales cycles are binary in nature and conventional metrics of earnings over the short term is not the right measure of performance.

Tata Communication	Tata Comm's revenues were flattish at Rs. 4,102cr (up 1% QoQ), led by 5.5% growth in the Voice business, while Data revenue was flat. Usage-based revenues were impacted by the lockdowns affecting collaboration traffic in the data segments. EBITDA declined 3% QoQ to Rs. 986cr, primarily due to the impact of Rs. 33cr worth of provisions on account of an 8% license fee. EBITDA margin contracted 90bps to 24%. Normalized for the provision impact, EBITDA would have been flat QoQ at Rs. 102cr. Tata Comm's PAT was at Rs. 296cr (-1% QoQ), whereas PAT adj for exceptional items stood at Rs. 290cr (down 3% QoQ). Data revenue/EBITDA remained flat sequentially at Rs. 3,104cr/ Rs. 931cr, with margins at 30%. Revenue was lower QoQ due to moderation in collaboration traffic, which had peaked in the last quarter. Adjusted for provisions towards the newly implemented 8% license fee on ISP revenues, EBITDA was up 4% QoQ. Within Data, revenue/EBITDA for Core Connectivity (the Traditional segment) declined 2% QoQ to Rs. 2,230cr/Rs. 951cr. The EBITDA margin remained flat at 42.6%. Digital Platform & Services (the Growth segment) – which contributes just 8% to EBITDA – saw 3%/34% revenue/EBITDA growth to Rs. 836cr/Rs. 75cr. The EBITDA margin partly recovered 210bp to 9% (peak of 14–15% in 2Q/3QFY21). The deal funnel has improved and is expected to drive revenue. Besides competing for large transformation deals the company is also focusing on smaller margin neutral deals which should aid growth. As Covid retreats the company also expects to see traction in its growth segments including international travel (global SIM), IoT, live streaming of sports events etc. The capex guidance for FY22 stood at USD250mn driven by new orders, maintenance capex (2% of revenue), and strategic capex. It may spend higher to tap growth opportunities. Key risks would be slower to negative growth in the data segment on account of covid related stress and lower usage of Tata Comm's services e.g., data streaming of live sports or reduced international travel or delays in deal conversion or new technologies come in to replace fiber at reasonable cost.
JK Paper	Given the lockdown induced operating environment, JK Paper reported revenue decline of just 26% QoQ to Rs.661cr, supported by volume recovery and better realizations. Realizations improved by 13% QoQ leading to better EBITDA margins sequentially. As a result, EBITDA decline was lower at 17% QoQ to 190cr. The company continued to perform well and there is turnaround in the business at its subsidiary- Sirpur Paper Mills. Overall, PAT came at Rs.104cr compared to Rs. 136cr in Q4FY21 and Rs.3cr in the previous year. JK Paper is play on revival on domestic paper consumption driven by reopening of offices and educational institutions. Further the company is increasing its capacity from 4.36 lakh tonne to 7.42 lakh tonne driven by green field packaging board expansion in Gujarat with capacity of 1.7 lakh tonne and addition of 1.36 lakh tonne from inorganic acquisition of Sirpur paper mills. The medium-term earnings growth would be driven by volume increase, cost optimization and better realization. Key risks would be delay in capacity addition, decline in realization and extended impact of COVID-19.
IEX	IEX delivered revenue growth of 34%YoY on the back of strong volume growth across products to Rs.91cr. DAM and TAM volumes were up 7% and 60% YoY respectively. RTM, launched in June-20, formed 22% of volumes in the quarter growing at more than 22% on a sequential basis. EBITDA and PAT registered a growth of 56% YoY and 49% YoY to Rs.75cr and Rs.62cr respectively on the account of favorable operating leverage. IEX is India's largest electricity exchange, and we believe it will be at the core of India's Power sector in the times to come as SEB's move to consuming power from the exchanges vs bilateral contracts. The company has introduced many products such as Real-Time, Green Term Ahead Market, Cross Border Contracts and Gas Exchange over the last one year, which has helped the company in gaining market share from other short-term market players. In addition, the company plans to launch Long duration contracts in this financial year. With the government's commitment towards power sector reforms to reduce the role of DISCOMs and optimize the cost of energy, IEX is likely to see a multi-year encouraging growth. Key risk: Unexpected regulatory environment and slowdown in industrial activity.

Sonata Software	Sonata delivered revenue growth of 33% YoY driven by products division that grew 39% YoY growth, while the IT services segment mildly recovered 1.6% sequentially. Overall EBIDTA margins declined sequentially by 160 bps to 8.0% due to products segment with services business reporting higher 30% margin sequentially and overall remained flattish YoY. As a result, earnings at Rs.87cr was up 66% YoY and 4% QoQ. The outlook for each of their segments in the times to come are good driven by normalization in the European travel industry, traction in Microsoft's' core business, and enterprise investment in new age cloud and IT products. Sonata is a key partner to Microsoft in their global product development initiatives and has strong domestic products re-selling business. With the worse of the pandemic induced stress in their travel business behind them, we expect the traction in earnings to return sequentially over the next few quarters. There is a trend of better off-shoring that is being witnessed on the back of industry wide work-from-home initiatives, and this is likely to be margin accretive in the times to come. Risks: Slower than expected economic recovery in Europe and cuts in discretionary IT spends by enterprise clients.
Hindalco	Hindalco reported revenues of Rs. 41,358cr (up 64% YoY and 2% QoQ) and EBIDTA of Rs. 6,790cr (up 187% YoY and 16% QoQ). PAT (continuing ops) was at Rs. 3,254cr (up 67% QoQ) as against a loss YoY. Novelis reported shipments of 973kT (up 22% yoy). Sales were at USD 3.9Bn (up 59% YoY) and were driven by increased shipments, improved product mix and higher aluminium prices. EBIDTA was USD 555Mn, up 119% YoY. In the domestic operations Aluminium metal production (319KT) was almost in line with previous quarter and up 9% YoY, Aluminium VAP (value added) production at 86KT higher 150% YoY. Domestic sales were 44% of total metal sales (vs 20% in YoY) while VAP sales 27% of total metals sales (vs 11% YoY). AL India's EBIDTA was a record Rs. 2,352cr up 142% YoY. In the domestic copper business, revenues were Rs. 7,094cr (up 134% YoY) on account of higher copper prices. EBIDTA was Rs. 261cr (as against Rs. 66cr YoY) Consolidated net debt increased to Rs. 51,913cr from Rs. 47,419cr in Q4FY21 due to build-up of working capital led by higher metal prices. Leverage declined from 3.83X to 2.36X YoY. Standalone net debt stands at Rs. 11,100cr. Management expects aluminium prices to sustain at higher levels due to supply side measures taken in China. The company would focus management bandwidth on downstream VAP products rather than expanding upstream despite LME AL prices being elevated. Board has approved 170ktpa of FRP (Flat rolled products) capacity at Hirakud and Aditya at INR3000cr investment. Project is expected to be commissioned by FY25. Capex plan for India is about Rs. 2,700cr in the current financial year (last year capex was Rs1600cr). Key risks would a steep decline in LME AL prices, increase in used beverage can prices (leading to increased costs at Novelis) and continued chip shortage impacting auto volumes for Novelis.
DCM Shriram	The company reported Revenue, EBIT and PBT YoY growth of 2.5%, 80% and 120% respectively. The revenue growth in this quarter was primarily driven by Chemicals and Plastics (with sustained higher realization) but sugar segment had mildness in volumes. This was a seasonally moderate quarter for Agri-segment but much better YoY leading to improvement in consolidated EBIT margin by 500 bps YoY. The PBT YoY was higher on account of truncated quarter last year. Overall, sugar volumes were lower and expected to bounce back in coming quarters leading to better numbers. Realizations in caustic and plastic segments continue to be strong. DCM Shriram is predominantly present in chlor-alkali and sugar segments along with agriculture products like fertilizers, bio seeds and other farm solutions. Sugar segment consists of sale of sugar, ethanol and power which has hit stable demand through the year with improved realizations. Further, the company has announced entry into chlorine/hydrogen downstream products like Epichlorohydrin, Hydrogen peroxide and Aluminium chloride. These are value added segments within the chlorine value chain and hence will contribute positively towards overall profitability. Key Risk: Unexpected regulatory developments in Sugar/Ethanol business and decline in caustic soda prices in the international market.

PORTFOLIO VALUATION METRICS

Weighted	FY 21	FY 22E
Earnings Growth*	42.9%	43.7%
Price to Earnings Ratio	28.8	21.0
ROE	25.9%	28.4%
Price to Book Ratio	6.5	5.2
Weighted Avg Market cap (USD Mn)	14,352	

TOP 10 HOLDINGS

	Weights %
Position 1	9.55
Position 2	8.51
Position 3	8.08
Position 4	6.98
Position 5	5.88
Position 6	5.56
Position 7	5.42
Position 8	5.33
Position 9	5.09
Position 10	5.08
Total	**65.47**

SECTOR EXPOSURE

Sector	%
IT	20.36%
Financials	15.43%
Fee-based Financials	13.93%
Materials	11.33%
Chemicals	9.96%
Others	7.48%
Digital Connectivity	6.98%
Paper & Paper products	5.88%
Insurance	5.09%
Total	**100%**

OTHERS INCLUDE MEDIA AND HOLDING COMPANIES.

CLASSIFICATION OF MARKET CAP

Segment	Basis	%
Large Cap	> $2000mn	56.46%
Mid Cap	> $200mn < $2000mn	43.54%
Small Cap	> $50mn < $200mn	0.00%
Microcap	< $50mn	0.00%
Total		**100%**

LIQUIDITY ANALYSIS

Segment	% of portfolio
Less than 1 day	97.76%
Between 1 & 3 days	2.24%
Between 3 & 5 days	0.00%
Greater than 5 days	0.00%
Total	**100%**

Portfolio metrics are as of 5th Sept 2021.

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. The 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 the investee companies.
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 the 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 advise not to invest 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.