Strategy Communique

Q2

CY 2022

UNIFI INVESTMENT MANAGEMENT

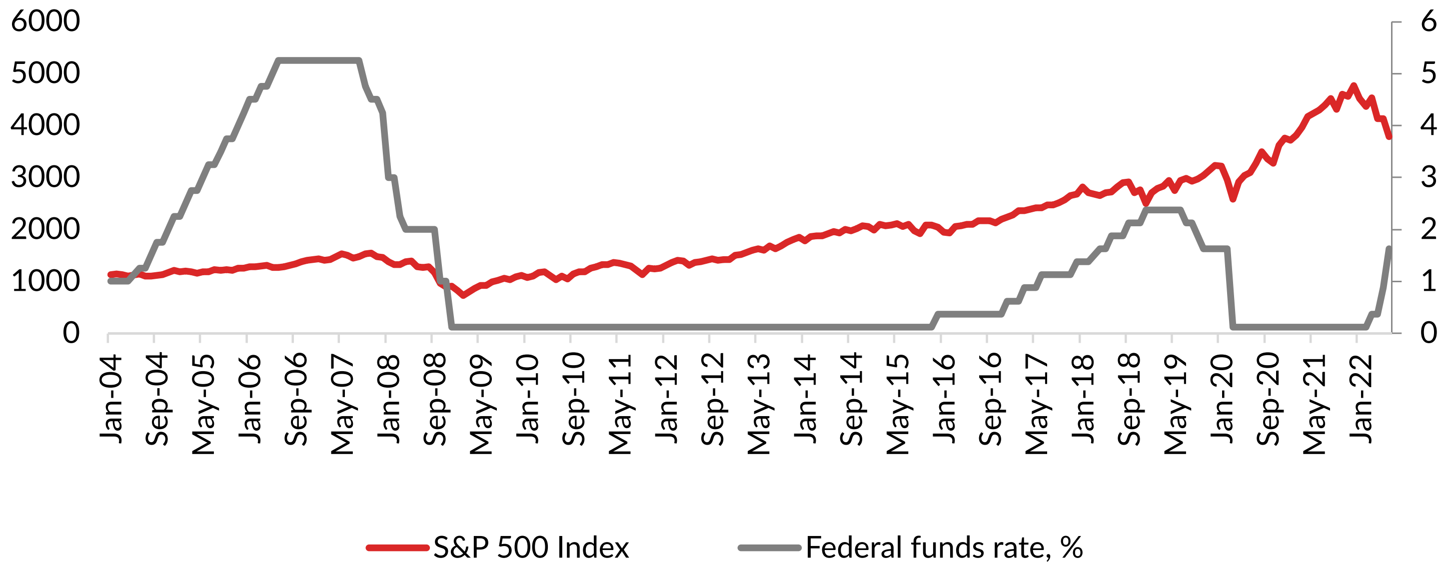
Unifi Rangoli India Fund

Q2: CY 2022

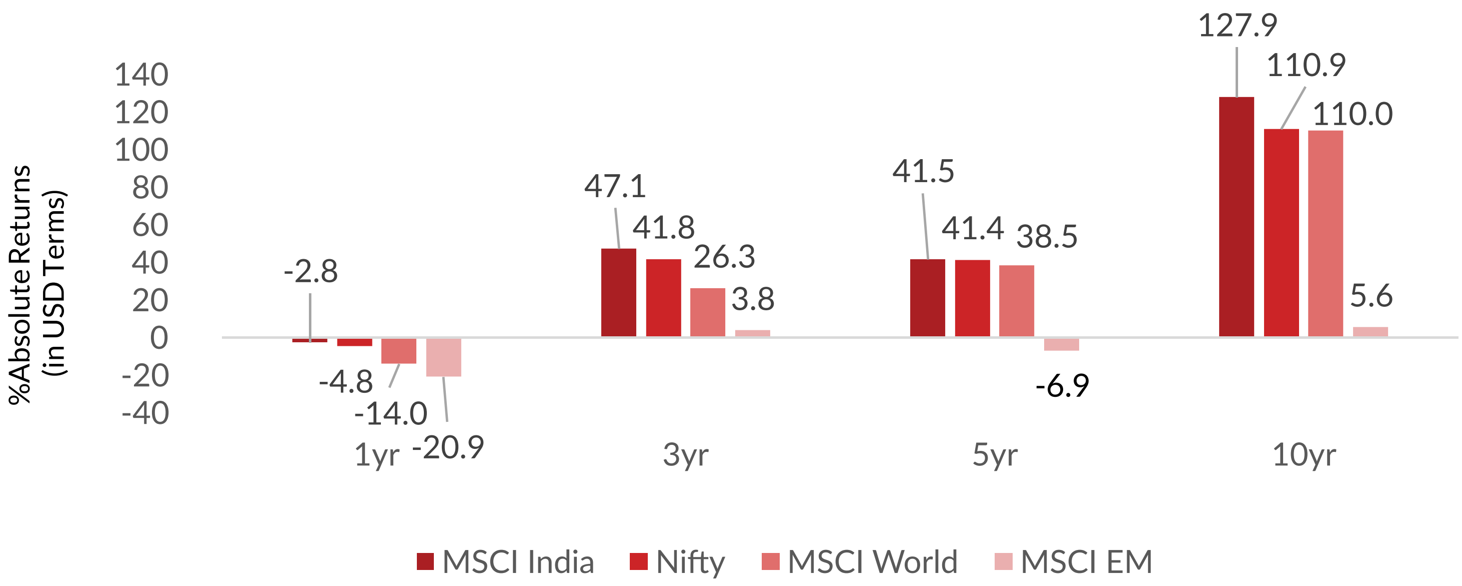
Stability and Divergence

After many summers of liquidity and the virus, this is the summer of economic rationality. By accelerating the pace of interest rate hikes, central bankers worldwide have returned to their primary mandate of ensuring financial stability via aggressive inflation management in lieu of their decade support of economic growth. This is more important than the subject of growth today because anything apart from a minor or steady adjustment in average prices will significantly impact business and household financial decision-making and ultimately affect the economic cycle of consumption and re-investment. The force of economic expansion over the last few years has been so strong that today's overwhelming mandate is to preserve this financial status. Else the specter of inflation risks taking it all away.

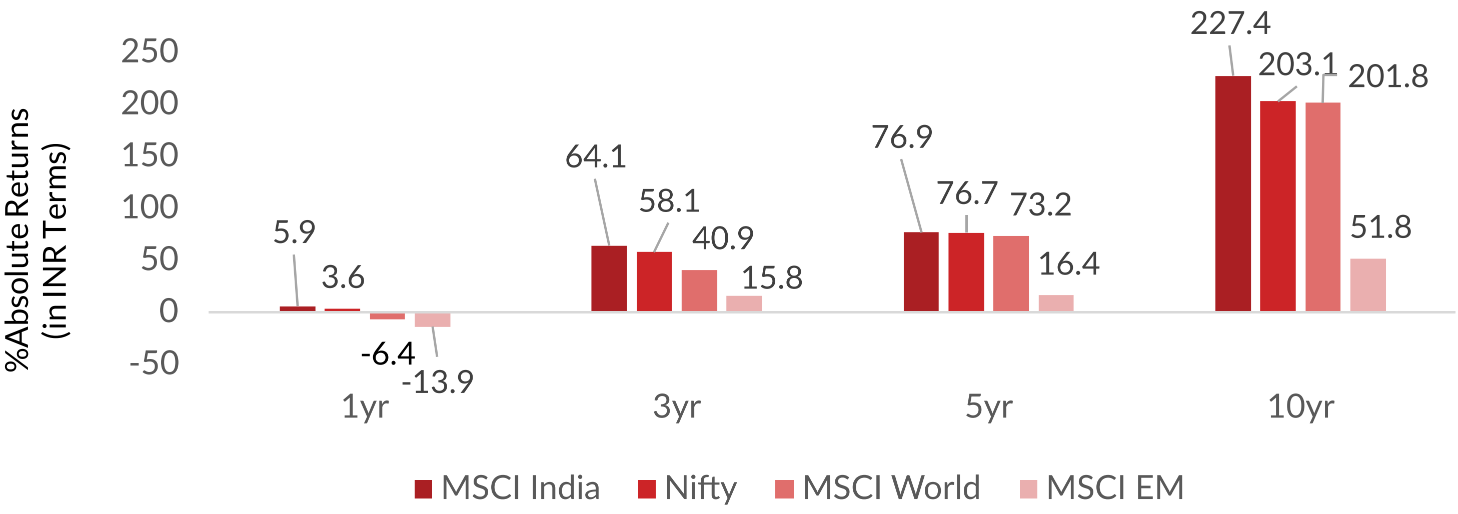
The decadal surge in liquidity has strengthened inter-linkages among most financial markets and unwinding this will have consequences on any real economy. As is visible in the chart below, rising rates and the increased cost of capital have lowered the value of equity in the USA and most other global markets.



While most markets have toed this line, India is seemingly writing a different template and is an exception in an increasingly complicated world. To put this in context, Shanghai and the MSCI Emerging Market are yielding little or no returns for ten years now.



UNIFI INVESTMENT MANAGEMENT



Over the last few years, Indian equities have significantly pulled away from most global markets. It is crucial to appreciate the makings of this, or else we risk misinterpreting the sustainability of this direction. Imagining the delta of change underway in India has probably been the most significant challenge on our side of the table.

What is Fueling India ?

The transformation of India as a canvas is reminiscent of the 19th-century West. A vast domestic market, the only one of its size and depth anywhere in the world, allowing sector leaders to benefit from the size of consumption and create economies of scale. India's rural economies are strengthening at a rapid scale, alongside internal migration, creating a new consumer class, pivoting from consuming sustenance to consuming discretion.

Sensing this depth, India's corporates are embarking on a new scale of investments for the first time in a decade. This phase of expansion is hedged from the excesses of the previous cycle through the visibility of domestic demand and international appetite for sourcing from India. A combination of these events are leading to several areas of the economic multiplier, and for simplicity's sake, they can be attributed to the following.

Magnitude of Earnings growth

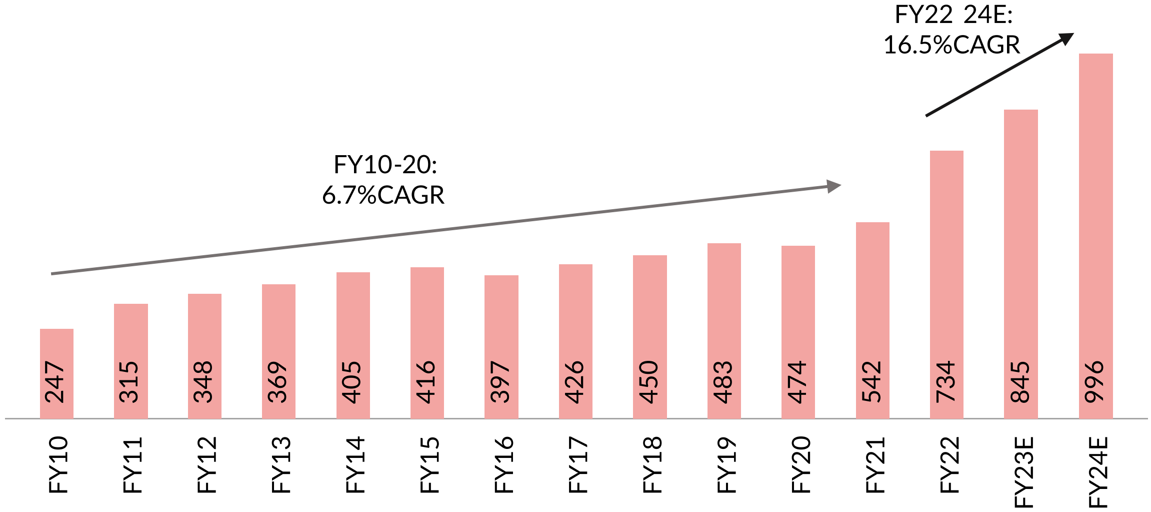
New Credit Expansion Cycle

New Investment Cycle

Accelerated Household Incomes

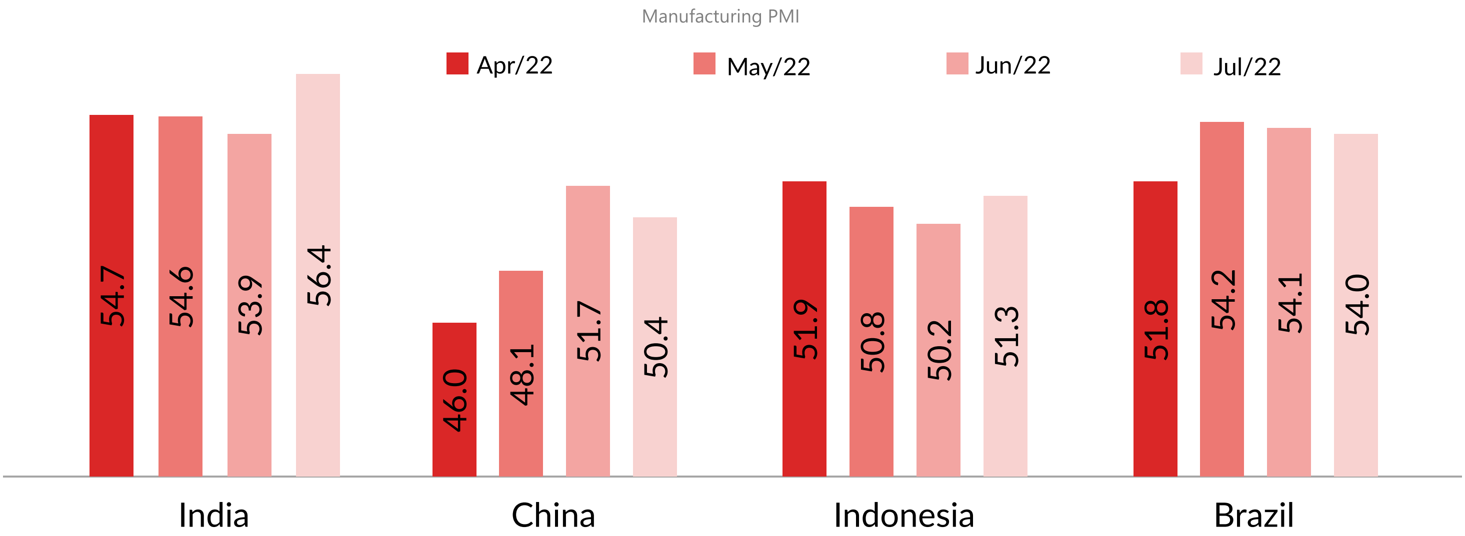
The Sheer Magnitude of Earnings Growth

Between FY2010-2020, India's earnings compounded at 6.7% CAGR, and the markets returned 8.5% in CAGR [Nifty]. In FY 2021, earnings were up 14%, followed by another 36% in FY 2022, marking a growth of 55% in 2 years, followed by expectations of 15% in FY 2023. Market returns have broadly followed this trajectory, despite the challenges of Covid, inflation, crude, Ukraine, and supply chain dislocations. Adjusted for exigencies, markets have respected what they always have - underlying corporate earnings. This growth phase has coincided with several other initiatives that will pivot India to the next stage of an economic breakout, furthering the visibility of earnings growth.



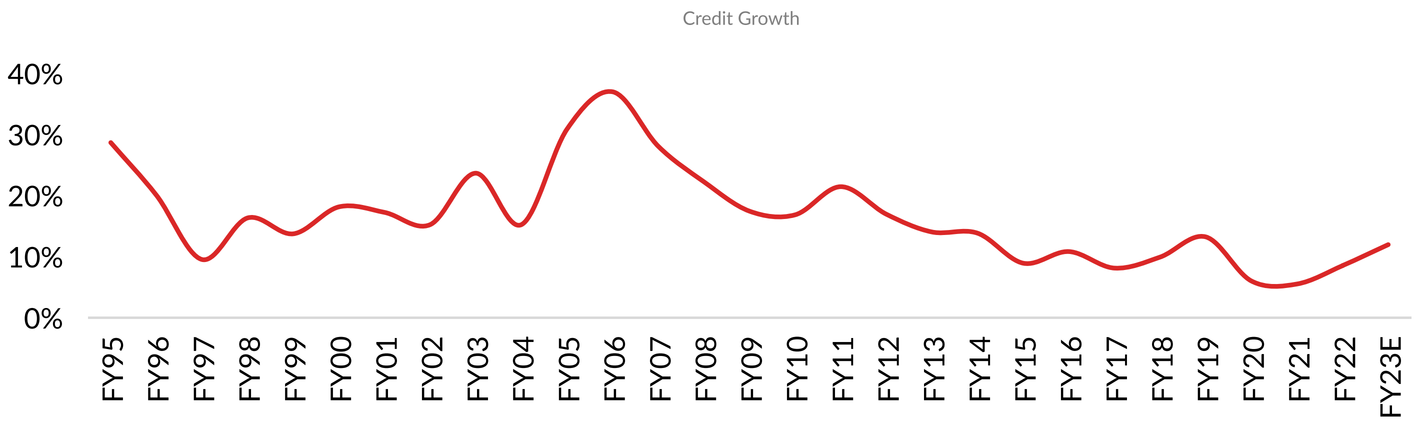
A New Investment Cycle

In the past, we have spoken about how India's significant reforms across GST, RERA, UPI, Minimum Support Prices (MSP), and many others are accelerating the formalization of the economy and creating a new cycle of supply and demand. An area that has traditionally been under-discussed is the looming opportunity in manufacturing. India has today emerged as the second-most sought after manufacturing destination globally, reflecting the scale possible in India. The numbers are a testament. India's manufacturing exports (non-petroleum products) for FY21–22 reached $353bn, vs. $266bn in the previous year, growing 33%. This reflects a surge compared to the pandemic-hit FY20–21 and the pre-pandemic number of $272 billion in FY19–20. The pandemic has disrupted global supply chains with an added dimension of Europe+1 in addition to China+1, kickstarting a cycle of manufacturing across multiple industries and birthing a new investment cycle. And this is not anecdotal; about 80% of all the manufacturing-oriented companies in Unifi's portfolios are either in the midst of a large capex or in the process of monetizing their concluded projects. And almost in all cases, this has followed a long period of demand accumulation and relative surety in pricing power.



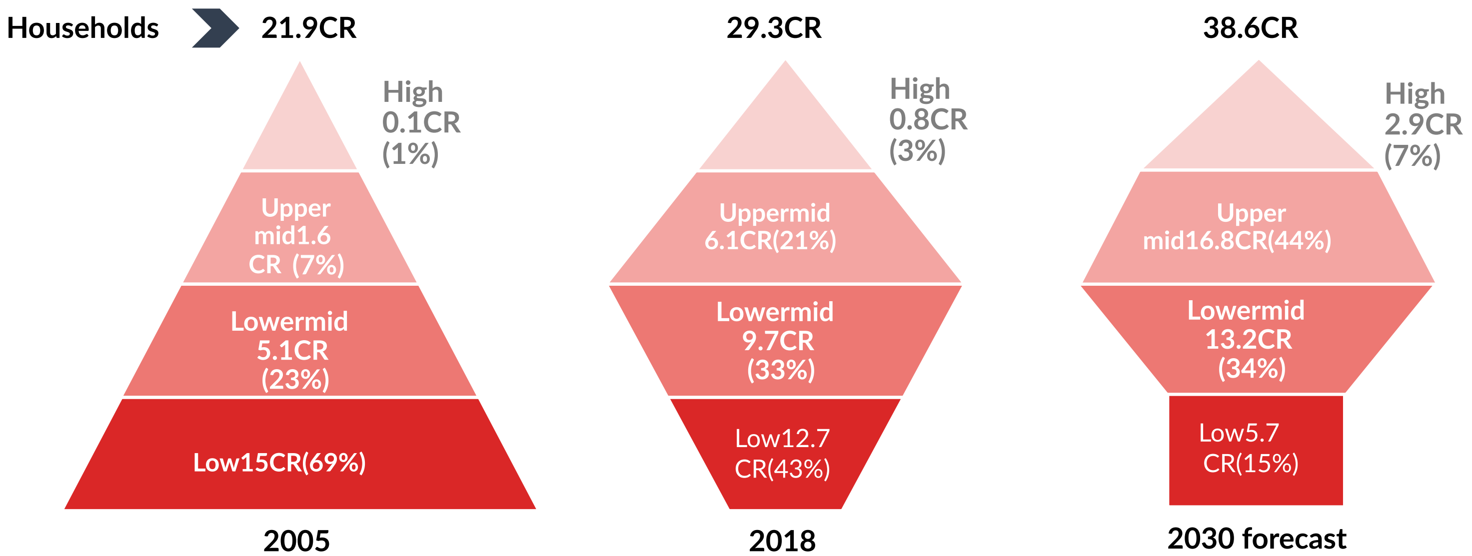
A New Credit Cycle

Since 2014, India has gone through one of the most prolonged periods of deleveraging. The debt to EBITDA of India's top 500 corporates [BSE 500] has fallen from 3.3x to less than 1.3x in this period. Consequently, we do not see a meaningful impact of higher interest rates on the current business environment. On the other hand, as current growth rates consume India's capacities and birth a new investment cycle where the cost of capital is generally high, the outcomes are expected to be stronger than that of the previous cycle. An increase in the cost of capital in an under-leveraged system is generally beneficial for equity investors in good businesses, unlike the previous cycles, which had a combination of an over-leveraged system as well as overcapacity. Against this backdrop, India's systemic credit growth touched a multi-year high of ~15.5% in Aug '22. This will likely accelerate in the next few years.



Acceleration in Household Incomes

A cursory look at the data on household incomes in India reflects the underlying opportunity across consumerism in India. Presently 1 in 4 households have incomes exceeding Rs.5.5 lakh. Over the next few years, this is expected to rise to 1 in 2 households. These numbers have a significant impact on household consumption and the way they seed India's economic multiplier. The path to increased consumption and premiumization is not just paying for rational product attributes or functional benefits but also for social and psychological reasons for which a customer consumes and pays a premium. This excess household income is available for spending and will drive the demand for discretionary consumption. This is largely responsible for an increase in the visibility of the terminal value of most firms in India that cater to discretionary consumption, which will be a large structural shift.



Note: Low :<INR 2.5 lacs,Lower mid;INR 2.5 - 5.5 lacs,Upper mid:INR 5.5 - 27.5 lacs, High: >INR 27.5 lacs
Projections with annual GDP growth assumed at 7.5%
Source: PRICE projections based on ICE 360 Surveys (2014,2016,2018)

Portfolio Construction

As each of these events culminates, and India grows at 7%+ for the years to come, the sector leaders will break out into a bigger scale, while at the other end of the spectrum, it will lift huge numbers of households out of their current base of sustenance consumption. And this is a key component of our mental model as we advise equity portfolios for the current cycle.

Credit is a significant part of our portfolio today. India has witnessed a sharp recovery in the economy during the post-COVID phase, which is also reflected in strong credit demand. India's systemic credit growth touched a multi-year high of ~15.5% in Aug'22, led by strong consumption demand. With a new investment cycle, this number is expected to improve. Further, a rising interest rate environment coupled with coupled benign credit costs will help banks report a stronger quality of earnings over the next few years.

Better real estate consumption is visible given the low levels of inventory in Tier-1 cities. This has a large flywheel effect on several players in the building value chain from cables & wires, electrical durables, sanitary ware, and other building materials. The sector is generally witnessing an improved demand and pricing scenario, with financial outcomes that are likely to be better than the previous cycle. This is reflected in our recommendation for players in this sector.

Ageing population, burgeoning lifestyle diseases, and rising affordability are contributing to the Indian healthcare industry, with healthcare delivery growing at 12-14% CAGR over the last 6 years. Low public spending and limited penetration of health insurance has led to 'out-of-pocket' expenditure accounting for ~63% of total healthcare compared to global average of 22%. As the insurance penetration increases in India, the 'out-of-pocket' expenditure is expected to come down and this would drive the footfalls to private sector. We have recommended one of the largest hospital chains in India that would benefit from the domestic patients and also medical tourism.

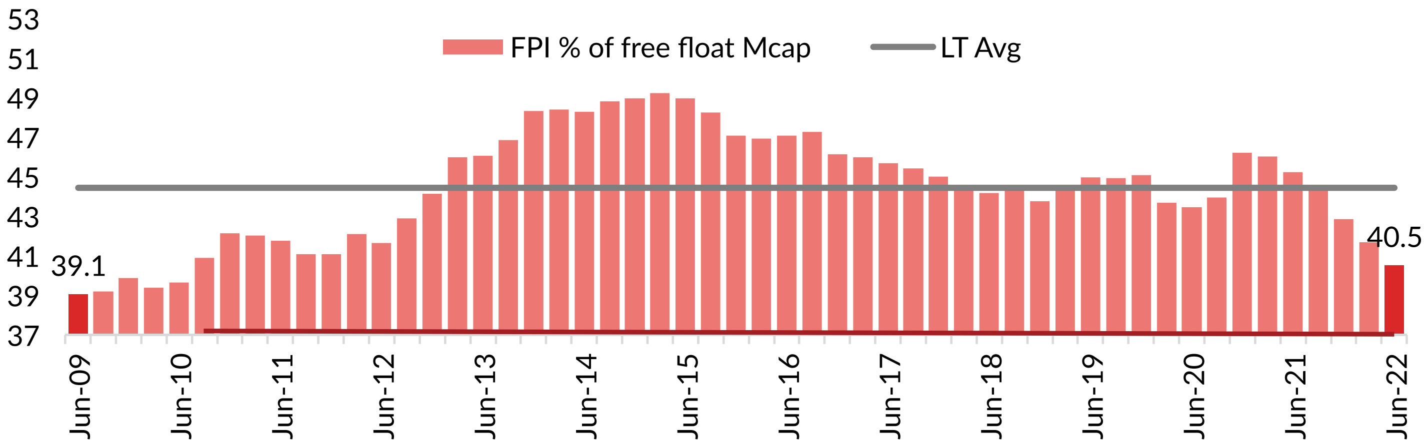
Over the years, the nature of India's household savings has witnessed a paradigm shift from physical assets to financial assets. This is validated in several ways: systematic investment plans into capital markets by investors at ~Rs.12,000crs per month and the number of demat accounts that have grown 3x over the past 3 years. Trends of financial literacy and access to financial products are significantly higher than in the previous generation and are likely to continue to grow. As the demand and supply sides here mature, the small base of exposure to financial products will accelerate with the rise of incomes. Keeping this in perspective, we have advised exposure to leaders in this industry.

The unprecedented increase in energy prices across many European nations has forced several chemical companies to pair their operations as it becomes unviable to operate at these high costs. This, coupled with China proving to be an unreliable partner, will benefit select Indian Chemical companies that are highly backward integrated and focused on exports. We have predominantly advised taking exposure to Chemical companies that are category leaders with high backward integration and moving higher up in the value chain. The current global environment would help these companies in the long run.

In Closing

This fundamental breakout in India today is an outcome of piecemeal reforms over many years – impacting the millions in rural hinterlands to urban manufacturing clusters. In between,there is a wave of indigenous technology effort underway in India that is constantly lowering the cost of technology and accelerating the pace of welfare transmission and consumption. India's statesponsored technology stack is the most sophisticated network of systems worldwide that is at once solving for identity, formalization, payments, and tax systems. And the rapid adoption of these platforms is forcing a vast, inefficient, informal cash economy into a new age and creating productivity at a scale unseen before. Alongside, it is safe to say that there is no other supply-side mechanism providing the world an option for new manufacturing capital and technology transformation.

This has led domestic investors to reimagine how they view India's equities. The entire performance of Indian equities over the last many years has been driven primarily by domestic investors and is a breakout moment for India. This is even more important as Indian equities are not dependent on the recalibration of funds out of India and will likely follow the direction of a new investment and consumption cycle currently underway.



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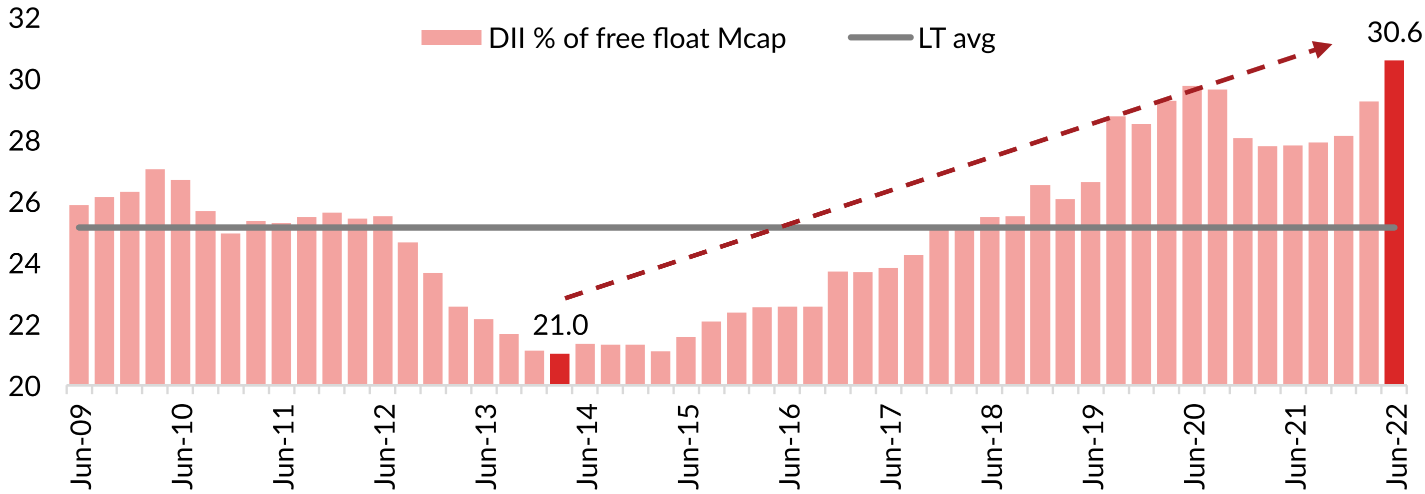

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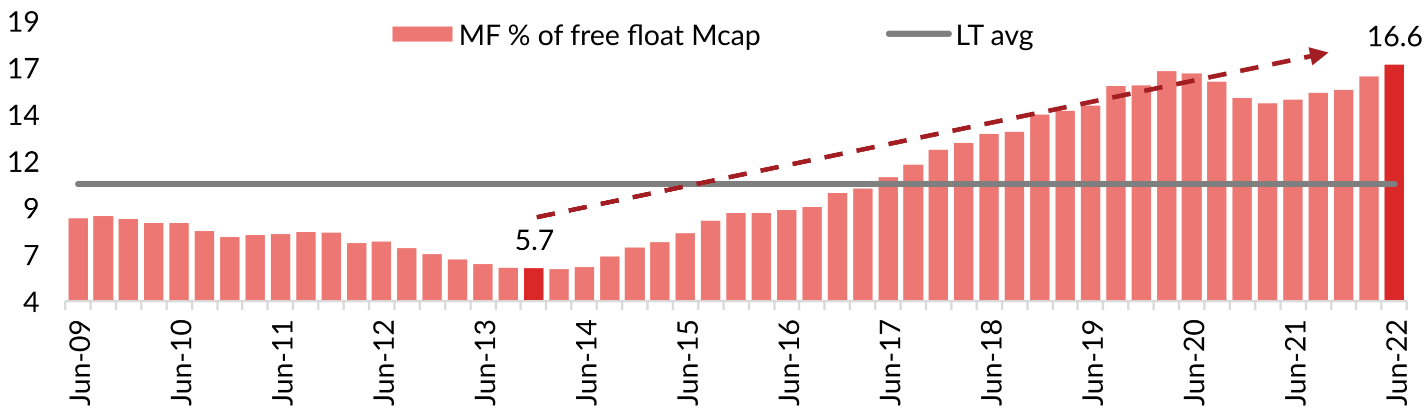

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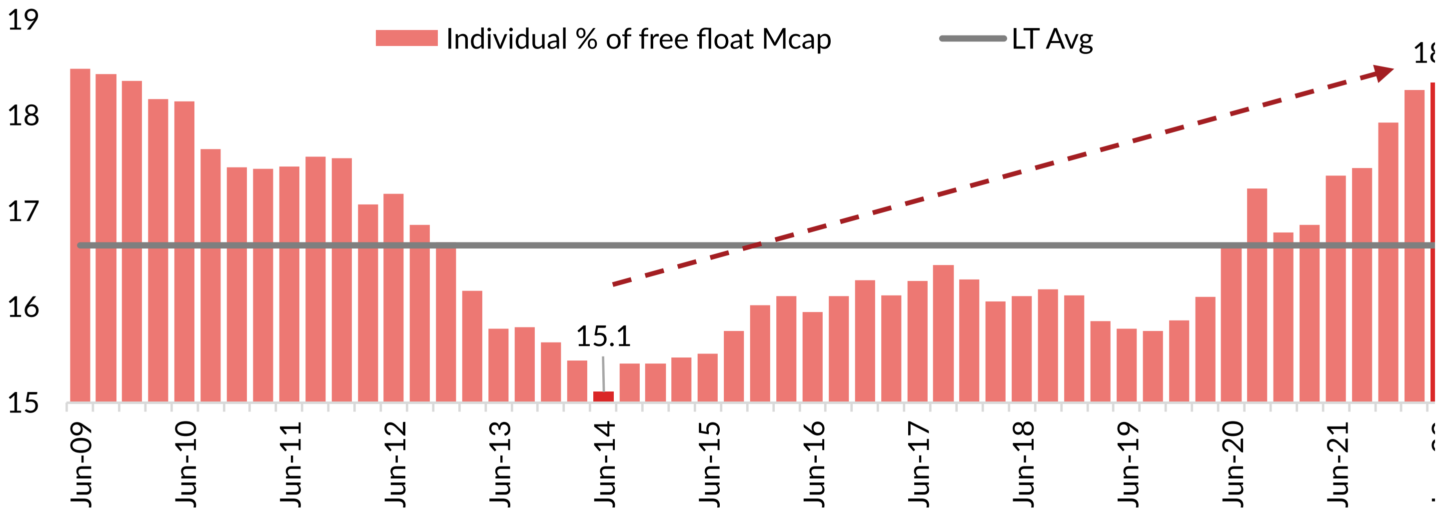
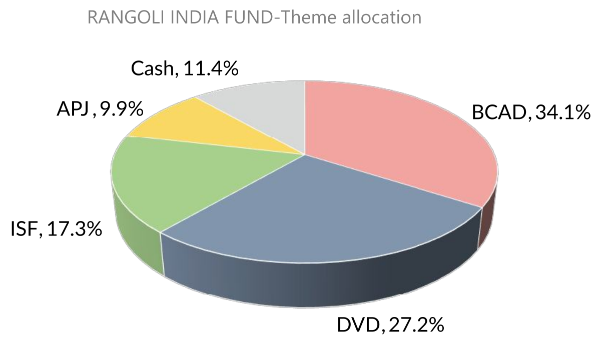
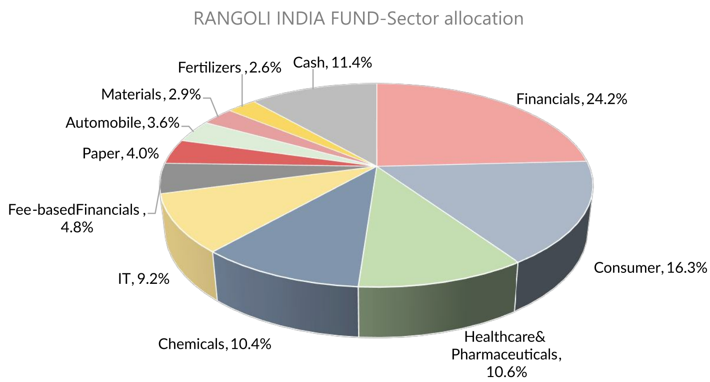
UNIFI INVESTMENT MANAGEMENT



The strategy wise composition of the Rangoli India Fund is as below:



The sector wise composition of the Rangoli India Fund is as below:



RangoliIndia fund– SeriesA

Key Portfolio Metrics

It is important to note that each investment in the fund has been advised based on its own merit and the portfolio characteristics are merely a by-product of the process. In sync with Unifi's philosophy, the aggregate portfolio has low leverage, demonstrates potential for strong earning's growth, and has reasonable valuations.

ValuationParameters* (As on 29th Sept 2022)	**FY2022**	**FY2023E**
P/ERatio	24.0x	19.5x
Earnings Growth	43.1%	24.6%
Debt Equity Ratio	0.1	0.1
ROE %	24.1%	23.6%
PE/ GrowthRatio	0.71x	

*Adjusted for one-offto make figures representative

We are continually monitoring the environment for any opportunities that have potential to materially improve the portfolio composition. We will be writing to you again post the 2nd quarter's results.

In closing, we encourage you to write to us, or your relationship manager for a detailed review of the portfolio and understanding of our proposition in greater granularity

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. How long it takes for sentiment to return in consumption remains to be seen. 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	Geopolitical tensions globally 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 (Corona Virus, and 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 ofthe 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 spanning Brexit, US-China trade war, OPEC related developments, and other geo-political issues. 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. Further, in case 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 ccombination of their recent deal wins, and current bid pipelines bode well for their future.

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