Unifi Quarterly Review

2019

November

UNIFI INVESTMENT MANAGEMENT

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Global | It is a slowdown

2019 has seen the slowest pace of economic expansion in a decade; global growth is poised to be around 3.0% in 2019, down from 3.6% in 2018. The slowdown is primarily driven by weakening industrial production and consumer demand. The Fed cut rates for the third time in 2019 as the US economy continued to slow down, and may do so again, if inflation does not spike up or the economy slows down faster than estimates. While Central banks are easing rates to combat slowing economies, there are fears whether such a policy response will yield similar results as in the post 2008 crisis. In the midst of this softness, the one global positive, especially for India, is the low price of crude oil and other commodities.

India | Government in the act

India is grappling with its own economic puzzle. For the year as a whole, the new indicative rate of growth is closer to 5.9%. Lower automobile sales, flattening of core sector growth and declining investment in construction & infrastructure sectors continue to indicate the sluggishness in the economy. Given the prevailing economic conditions on the ground RBI in October cut rates for the fifth time this calendar year, bringing repo rate to 5.15%, now down by an aggregate of 135 bps from February 2019. The expectation is for another 25-bps cut in the December review. The core inflation is still low at 3.3% making a case for further easing of rates

The Central government's intent in structurally pepping up the economic growth of the country is evident. While the market has discounted the effect of the 10% reduction in corporate tax rates, we believe the multiplier effects of these will be visible over the next few years as domestic corporates and international entities revisit their capex plans. The net impact of this measure on earnings is likely to be pronounced in the years to come, and patience capital is key to participating in the same.

In other initiatives, (A) the government has setup a Rs.25,000cr. fund to restart stalled building projects in the construction sector; (B) the cabinet has raised DA for central government employees by 5% which shall translate into additional spending power; and (C) while GST collections have been lower than expectations, the government is committed to disinvestment (BPCL, SCI, CONCOR & Air India by March 20). The transfer of dividend and surplus reserves from RBI will also help matters.

These policy measures will take a few quarters to show an impact on the economy, and in the interim, much will depend on the rural economy's fortunes in the post-harvest season. While rainfall has been bountiful, it needs to translate into a bumper harvest for the rural economy to bring back consumption. Corporate defaults might be reaching the final stages, helping banks to bring back focus on disbursements which should aid growth. NCLT related recoveries might also finally see traction with the Supreme court and the government clarifying on some of the uncertainties surrounding the process, helping banks recover monies against provisions and in the process support systemic liquidity.

Consolidation

While the macros take their time in translating to robust earnings, we continue to take a bottom up approach in our investments, increasing exposure to companies which will be beneficiaries of growth from their own doing. While Indian markets are exposed to the effects of global slowdown, the majority of the economy is driven by domestic consumption, which has been sluggish over the past few quarters. Firms that are doing well are the ones that are consolidating and growing their market share, and our alignment is with such firms, across sectors. With a revival of rural consumption on the cards and the government's focus on bringing back growth, we expect FY21 to be a far better fiscal in terms of topline and bottom line. We will continue to align with firms that exhibit a high quality of earnings growth, capital efficiency and governance.

Review of Strategies

We have captured an outline of each of our investment strategies in the following sections. Please click on the links provided under the relevant strategies for a detailed summary of how the fundamentals of the invested companies have played out in Q2 FY20. The earnings review for the quarter have been presented at a PBT level so as to give a true measure of their growth in profitability, given the material impact of the one-time tax cuts. Kindly note that individual portfolios will vary in holdings and proportion based on the timing of your investment with Unifi. For a detailed review of your portfolios, please do not hesitate to contact your relationship manager.

BC AD | The fund continues to invest in sectors that are currently witnessing a shift in market share from the unorganized to organized players. With regulatory compliance like GST & RERA getting stringent by the day, it will be incrementally tougher for the unorganized and marginal players to continue benefitting from tax and/or regulatory arbitrage. Shifting consumer spending patterns towards branded goods are also helping the respective sector leaders increase their market share and deliver growth that is higher than that of their industry.

As **on Nov 15,2019**	
WT. Avg PE	32.7x
WT. Avg PB	8.6x
WT. Avg ROE	27%
WT. Avg Market Cap	Rs 14,345 Cr

We are pleased with how our investments in the consumption sector's leaders have performed in this quarter. Notwithstanding the soft demand environment, the execution of our holding companies has been directionally positive, and they are well positioned to grow ahead of the industry in the times to come

DVD / Blend | The DVD / Blend fund strategy continues to cherry pick ideas from across the seven distinct themes managed by Unifi, thereby investing in "the best of our best" and participating in opportunities across the breadth of the market. The ideas represent a mix of emergent themes, corporate actions and fundamentally attractive bottom up opportunities. We continue to focus on delivering superior risk adjusted returns from an absolute perspective.

As **on Nov 15,2019**	
WT. Avg PE	17.3x
WT. Avg PB	3.5x
WT. Avg ROE	20%
WT. Avg Market Cap	Rs 10,514 Cr

For the quarter by, all of the fund's investments across pharmaceuticals, consumption, NBFCs, have performed well, and are directionally poised to deliver on expected lines for the year to come. Two select names, one in IT Products and the other in specialty chemicals space have had a soft quarter, led by longer decision-making times at the clients end and domestic macroeconomic headwinds, but continue to be directionally positive. We have taken exposure to new names across pharmaceuticals, textiles, and capital goods that are exhibiting strong fundamental tailwinds.

Spin Off | The spin off fund seeks to generate superior risk adjusted returns relative to market indices by investing in stocks of companies that are undergoing a corporate demerger. Typically, in a transaction such as this, the sum of the parts of valuation of the different companies that are undergoing a separation is higher than the market cap of the de-merged entity. The fund's proposition is to gain from the fundamental asymmetry linked value-price mismatch, by closely tracking the entire Spin-Off process and investing in such companies, subject to a comfort from bottom up fundamentals.

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As **on Nov 15,2019**	
WT. Avg PE	17.6x
WT. Avg PB	3.6x
WT. Avg ROE	18%
WT. Avg Market Cap	Rs 4,428 Cr

All key positions in this strategy have continued to execute well in Q2 of FY-20, and are directionally poised well for the future. A select IT product company has had a soft quarter, led by delayed decision-making timelines and this is a normal occurrence in the course of their business. The fundamental outlook and attractiveness of all the businesses we hold remains strong.

APJ | The fund seeks to deliver absolute returns over a five-year horizon through investments in sectors that will benefit from the next stage of India's growth on the back of improvement in India's economic and policy climate. The fund continues to consolidate its exposure among its top holdings that are expected to have significant fundamental and operating tailwinds in the times to come across sectors such as chemicals, packaging, logistics and manufacturing.

As **on Nov 15,2019**	
WT. Avg PE	13.6x
WT. Avg PB	2.0x
WT. Avg ROE	15%
WT. Avg Market Cap	Rs 5,140 Cr

All the investments continue to deliver numbers that are directionally positive. Two select names, one in IT Products and the other in specialty chemicals space have had a soft quarter, led by longer decision-making times at the clients end and domestic macroeconomic headwinds, but continue to be well poised to deliver in the times to come. The key investments of the fund across express logistics, fluro chemicals, specialty packaging and others continue to perform well, and are evolving well to deliver in the future.

Green | The fund continues to invest in sectors that would benefit from India's evolution towards a more "sustainable economy". The investment universe would comprise of well managed businesses offering best in class solutions to address challenges in the areas of Energy, Emissions, Waste and Water.

As **on Nov 15,2019**	
WT. Avg PE	16x
WT. Avg PB	3x
WT. Avg ROE	18%
WT. Avg Market Cap	Rs 3,300 Cr

Risk

Risk	Mitigants
Consumption slowdown	The Indian economy has witnessed a general softness of demand across all non-discretionary categories of consumption. Reversal of the same will depend on the recovery in economy, better disposable incomes and the willingness of consumers to increase their non-discretionary spends. Our investee companies have product and category leadership and the financial wherewithal to withstand temporary phases of demand slowdown, and lead consolidation of demand.
Raw material inflation	Indian 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. Our investee companies generally have good pricing power, and a track record of maintaining their price across a cycle of raw material volatility. Their brand recall, product and service efficiency are key mitigants in passing on higher costs to consumers.
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).
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.

Leverage risk	Except for the 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	High client concentration is a recurrent feature among small and mid-caps. 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 single 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.

Please do let us know if you'd like any clarifications regarding your portfolio account with us. Thank you for placing your trust in Unifi.

Yours truly

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