

Unifi Quarterly Review

2018

September

Macro | Its all about Crude & Currency

America's macros are getting stronger by the day with Services picking up, companies boosting hiring and GDP growth rate expected to touch a decadal high of 3%. Buoyed by strong economic growth and increasing inflation expectations, the Federal Reserve is continuing its tightening stance leading to a stronger dollar & increasing US interest rate. And this has pressurized all emerging market currencies. The Australian Dollar, Russian Rouble and South African Rand had lost 8%, 13% and 14% respectively. With the USD gaining strength, foreign flows into emerging markets have turned negative putting pressure on the local currencies. And strengthening crude prices have worsened the situation for net oil importers like India. The looming sanctions on Iran have provided succor to this strengthening trend and the trade war between USA and China isn't helping an already wary global sentiment.

Coming to India, a 23% run up in crude and 14% depreciation of the INR has rammed the economy hard. India's monthly GST collections have been a tad below the budgetary expectations, and has left little room for the Central government to deal with the twin shocks. With Brent crude crossing the \$85/barrel mark, the government was forced to break its policy on fuel price de-regulation, forcing the state-run oil marketing companies to absorb a part of the losses. This break in fiscal discipline led to a severe erosion of equity, actual and otherwise. At the microlevel, the meltdown in the infrastructure company, IL&FS which had consolidated debt of almost Rs. 1 Tn and RBI's NO to management continuity at a private bank did not help sentiment. India's debt mutual funds which held paper in IL&FS faced severe redemption pressure, leading to a fire sale of other holdings at higher yields. This sudden spurt in the yields led to a temporary loss of confidence in the debt markets leading to a short-term liquidity crunch for NBFCs. How long this loss of confidence sustains, only time will tell. As a result, NBFC valuations across the board tanked in proportions not seen in a while. In the first week of October, belying the expectations of most of the market participants, the RBI chose to maintain status quo on the policy rates while changing the stance from 'neutral' to 'calibrated tightening'. This move put further pressure on the currency as the Central bank prioritized inflation targeting over currency stability.

Unifi Strategy

In the context of the global and Indian macros, and the sharp correction in equities, it is natural for the confidence of many an investor to be shaken. The correction has given rise to a whole set of questions; Will oil prices continue to stay elevated? Will the Indian economy struggle if Oil were to moving towards \$100/barrel? Will the approaching elections spring further negative surprises? What should an investor do in such corrections?

Oil prices are difficult to predict given the nuances of geopolitical and supply-demand equations that drive them. However, India's ability to weather this volatility is the strongest it has been. For four years, between 2010-14 when materially crude was north of \$100/barrel, India's fiscal deficit was between 4.5%-6% whereas this time around it is at a relatively comfortable 3.3%. Importantly, India's retail inflation has been benign, with RBI revising its estimates downwards from 4.8% to 4.5% for Q1 FY20. This provides for significant headroom in combating macro-economic stress, especially on the back of improving fundamentals at the grass roots.

On the economic front, the first advance estimates of kharif crops have placed food grains production at 0.6% higher than last year and major water reservoirs' storage rose almost 17% higher than last year. Real GDP growth rate recorded at 8.2% in Q1 FY19 and RBI expects a full year growth rate of 7.4% for FY 19 which will be one of the highest growth rates in the world. Seasonally adjusted Capacity Utilisation (CU) increased by 1.8% to the longterm average of 74.9%. These factors point to a strong growth trajectory in the Agriculture, Manufacturing & Service segments of the economy, notwithstanding the headwinds from INR and Crude. While the current account deficit at 2.4% of GDP is a concern and is a function of oil prices & exports, stronger direct tax collections are expected to help the government maintain the fiscal deficit at 3.3% target. The GST collections during the upcoming festive season will be paying a critical role in the government getting its math right on the fiscal front.

Coming to the corporate sector, we expected that the earnings growth will recover by 20-25% in FY 19 due to bulk of the bank provisioning being completed last year. But the impact from IL&FS related provisioning & rise in crude oil prices is likely to temper the growth rate. Historically it has been established that while the share

prices tend to be volatile over the short & medium terms, they revert to tracking the earnings growth of the underlying companies over the long run. Beyond the noise, this is exactly what we at Unifi are focusing on. This correction in the market has been painful for portfolio values. Strategically, this is also an opportunity for us, to make some changes in order to position our portfolios better for the recovery

We would like to present the principles that guide us in such situations:

- Avoid knee jerk reactions. Focus on the fundamentals of the businesses we own, rather than react emotionally to the headlines from the media.
- Revisit our investment thesis on each business. Reach out to managements to clarify the realities they are facing at the moment. Revise our view of earnings estimates where warranted.
- Buy more stock in firms where our outlook is reaffirmed, but prices have declined significantly.
- Do not hesitate to reduce or exit fully from firms that will face significant long term challenges to their prospects.

It is in the very nature of businesses that powerful external events routinely impact their plans and performance in the short run. It takes some time (naturally, lesser time taken the better) to make adjustments that will restore the earnings power of these firms. In such situations, we rely on our assessment of the capabilities of the management team and the longstanding record of the firm's competitive DNA. When a portfolio correction is warranted, we reflect honestly and accept a loss early, rather than justify poor decision making and call it long term investing.

We will end this section by posing a few questions for you to ponder over during these volatile times. Is the Indian economy on a stronger platform or a weaker one post implementation of structural reforms like GST, Cleanup of banks, Direct transfer of subsidies, Higher tax compliance? Will the burgeoning Indian middle class which is splurging big in discretionary spending, stop buying its favorite brands because of higher prices at the petrol station? Did the country's economic progress stall in the past when governments changed at the Centre? With the country emerging as a the fastest growing one especially in the light of signs of overheating in China, will Indian equities remain unattractive for long? Attempting to answer some of these questions will throw a lot of light on some of the prevailing concerns of the market.

Fund Strategies

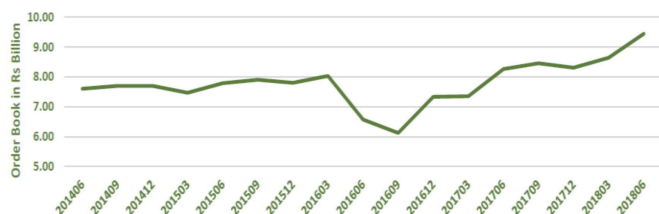
BC-AD - In line with the investment theme of migration of market share from unorganised players to the organised ones, we have invested in several firms across sectors like Footwear, Logistics, Retail, Luggage, FMCG & Branded Innerwear. The bulk of the portfolio consists of consumer facing companies with strong brand power in their respective sectors. In light of the ensuing correction, we have been raising our exposure to a leading player in the **Luggage** industry. In an industry worth c.Rs.10,000cr., the unorganized players command about 50% of the market share. Our investee company is the leader in the organised space and has nurtured inhouse brands spanning several sub-segments (hard/soft luggage, backpacks, polycarbonate uprights, premium suitcases). As the userbase of air travel increases and customer preference for branded luggage increases, incumbent leaders with industry leading distribution would be the key beneficiaries. Relatively newer segments like backpacks have higher margins & lower lifecycles leading to better margins with higher revenue throughput for the makers. We have recently added a small but promising **polymer packaging** company that is a proxy for the high growth consumption areas of Dairy, Beverages, QSR and Confectionary industries. We believe that the 'unorganised to organised' transition will happen gradually due to triggers like regulatory actions, taxation changes, increasing urbanization, demographic changes and evolving consumer habits. We still have meaningful levels of cash and are using the same in the current market opportunity to invest.

Green Fund - Green fund's underlying investment themes continue to see good tailwinds due to changing industry dynamics and/or regulatory actions. The shift to **Natural Gas** theme is playing according to our expectations with our investee companies bagging about 4 new licenses in the recently concluded city gas distribution auctions. This is a key step in making gas accessible to 29% of India's population from the current 19%. Another investee company providing **Industrial Steam Turbines** is seeing good traction in its order flows.

Demand for smaller sized steam turbines with power production capacity of less than 200 MW (called Industrial Turbines) depends on the private capex cycle. This in turn depends on industry capacity utilization trends which has improved to 73.1% in FY 18 from 72% the previous year. The company's order book movement has been robust as shown below.

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The theme of recycling continues to be an important part of the Green Fund portfolio. We continue to retain a significant exposure to a **refractory manufacturing** company which uses recycled refractories as a significant portion of its raw material mix. Refractories are materials having very high melting points which make them suitable to be used as heat-resisting barriers in industries like steel, cement, petrochemicals, glass etc. The industry has been growing at a fast pace on the back on increase in steel production. On the other hand, another recycling company we have which is into **lead recycling** has gone through significant price correction due to a delay in commissioning of a new plant. As a result, the earnings growth that we anticipated will only materialize in the next year. We are using the decline to increase our position. The long-term prospects of Recycling theme continue to remain attractive. Our investment in **coastal shipping** is facing near time margin pressure due to lag in passing on higher fuel prices. We expect margins to revert to normal over the course of this year.

APJ - The negative loop of strengthening crude, weakening INR and continued stress in the banking system, has severely impacted the macros surrounding India, and of course companies where crude is the integral feedstock. Barring one company in the transportation sector, we have gone back to our drawing boards in the APJ portfolio and see low risks to earnings growth for most of our portfolio companies in the context of the macros that have transpired so far. Moreover, a look at the liquidity over which most stock prices have fallen, do not raise alarm bells.

In our previous communication to you, we highlighted how the hardening of the crude cycle has marred our otherwise strong thesis on the **aviation sector**. While crude continues to impact the sector, we wish to emphasize that we will seek to play this out. The macros have hurt the entire peer group in the sector immensely, while the incumbent leader with its cost advantage, continues to strengthen its position in a market that continues to grow on the back of several tailwinds. (Just by way of illustration, in the context of the strong macros in India per se, the sensitivity of Indigo to a 2% improvement in yields is potentially Rs.1000cr.) As an oligopolistic market maker, it is clear that it is using this phase of complexity to increase its share in a growing market and when the cycle stabilizes, or industry economics change, the operating leverage will be strong. We continue to like India's largest manufacturers of **fluorination chemicals** and **coal tar pitch** and look forward to their strengthening business case over the coming years. The latter business has tailwinds in the form of expansion into two new high margin business segments that will materially change their profile, and future growth trajectory. Both these businesses continue to be available at valuations that are in sync with its growth profile, with the appropriate strengthening of their balance sheets. We have commenced adding an old favorite of ours, India's **largest manufacturers of ERW pipes**, given the developments expected in their businesses over the next year and beyond. In a nut shell, over the coming years, each of the businesses we hold have more than 1 significant tailwind that will strengthen their business case and position in the industry.

Spin Off – With 40% of the fund's deployment in **IT Products and Services**, the Spin Off fund has the least direct linkage to the ensuing macro volatility. On the contrary, the weakening INR is abetting short term tailwinds for the sector.

While the operations and revenues of these companies are not the least affected by macroeconomic conditions in India, the liquidity led sell off have affected them, highlighting the volatile line of thought of the street. Nevertheless, we continue to like both the IT product companies we hold in this fund. Revenue growth is the best determinant of growth in these companies, as value creation is back ended, and there is a reasonably strong visibility of both. We have taken this opportunity to add a demerger transaction in progress. We continue to be constructive on the **express logistics** space; the sector offers immense scope for consolidation and growth and we are playing this via the sector's most profitable player. The NBFCs have taken a hit given the sector contagion; we are cognizant of the issues at hand and are taking appropriate actions where needed. We continue to like the other key holdings in this space, across consumer goods and auto lubricants.

Rangoli/Blend – We continue to draw from the best of ideas across each of our thematic funds. To this end, we have taken exposure in a **generic API manufacturer** that has multiple growth drivers in the years to come. In several of its products, the company is one of the largest manufacturers of API in India and in some cases largest in the world. This company has been through major capex over last 3 years to increase its capacity and importantly to backward integrate. Further, Anti-Dumping Duty (ADD) has been levied on imports of one of its key revenue drivers. As the capex & dumping duty yield results, we expect their margins to improve over the next couple of years leading to a profit growth of 24% CAGR. We also own the **ERW company** (steel pipes) talked about in the previous section. The company has faced headwinds in the form of Kerala floods and strike by transporters, but having normalized them, they have a number of favorable tailwinds in the quarters to come. We have commenced taking exposure to an **IT services** company that is undergoing a demerger. This is a company that is demerging its pure services business from the its high growth and higher margin auto engineering services business. The automotive industry is witnessing heavy investments into embedded engineering as car makers enhance their adoption of electronics that cater to a cross section of improved features spanning safety to comfort. We believe this business could show industry leading growth rates with an improving margin profile.

Risk: Key risks to our portfolio would come from geo-political concerns globally, materially high foreign outflows, sharp currency movements, American and Fed policy announcements, steeper Chinese devaluation, spike in commodity prices and a prolonged delay in fiscal reforms. Global re-allocation of equity, which is not India centric will continue to happen and may result in turbulence from time to time. Indian markets as well as the INR will continue to remain vulnerable to global events, however unrelated to India. Interest rate hikes in the U.S may be a huge event risk and affect liquidity conditions domestically. NPA in the banking system and new IPO's may also hamper liquidity in the market.

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

Baidik Sarkar

Head - Research

This is neither an offer to sell nor a solicitation of any offer to buy any securities in any fund managed by us. Any offering is made only pursuant to the relevant information memorandum, together with the current financial statements of the relevant fund, if available, and the relevant subscription application, all of which must be read in their entirety. No offer to purchase securities will be made or accepted prior to receipt by the offeree of these documents and the completion of the appropriate documentation. Please refer to the Private placement memorandum before making a decision.

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