



STRATEGY COMMUNIQUE: Q3: CY 2024

November 2024

Earnings Review, Q2 2025

The Indian market has experienced a notable correction, with the Nifty-50, Nifty 500, and BSE 500 Index falling 7% from their recent peak. While not significant at an index level, the recalibration is an attempt to bridge the valuations of select firms closer to realistic levels. The previous several quarters have been driven by an almost systemic detachment between stock prices and the fair value of companies, indifferent to conventional models of valuations. While the business models of several firms with elevated valuations may be robust, investments made at high entry valuations constantly square off against the risk of multiple contractions, a critical risk in GARP [growth at a reasonable value] investing.

Corporate India experienced its weakest quarterly performance in years, indicating a broad-based earnings slowdown in Q2 FY 2025.

Q2 FY 2025 / (Q3 CY 2024)	Adj PAT Growth	
	YoY	QoQ
Automobiles	-1%	-15%
Banks - Private	10%	6%
Banks - PSU	32%	9%
Chemicals & Fertilizers	-5%	14%
Consumer	1%	-8%
Consumer Durables	26%	-20%
Healthcare	19%	0.3%
Infrastructure	23%	-21%
Technology	11%	3%
NSE 500	-0.9%	-5.8%

Two factors contributed to this downturn: (a) Extended Monsoons, disrupting agricultural output, and consumption, while (b) a significant slowdown in government capital expenditure [down approximately 15% YoY] resulted in pockets of slowdown in various aspects of infrastructure and allied areas. This trend was observed at both the central and state levels. As an extension, high inflation, particularly in food prices, and lower availability of less-than-prime credit affected household purchasing power.

However, as noticed in the Rangoli portfolio, firms with sustainable earnings continue to be recognized for their inherent strengths, standing out as reliable performers. This underscores the market's ability to reward long-term viability over near-term exuberance.

Investment Approach

Amid these uncertainties—often clearer in hindsight—it is imperative to embrace a balanced investment strategy that continually manages risks while seeking potential upsides. In this context, briefly touching upon Unifi's core investment advisory approach may be helpful.

The market provides different opportunity sets at varying times across traditional value, growth, compounders, and special situations, across market cycles. The opportunity is to be aware of which industry and market cycle we are in and apply traditional fundamental analysis to each of the opportunities, bottom-up, evaluating the best prospect of risk-adjusted return. As advisors enabled with a thematic and generalist approach, we advocated to pivot between different sectors based on the best opportunities the market offers at any given time. The duality of this approach is complementary. While a thematic view enables to be cognizant of broader trends and ho, generalist approach lends itself to flexibility and consistency over the long term. In between both lies a view that often comes down to our judgment on assessing risk/reward across opportunities based on our learning over cycles.

This is nuanced because, in a growth-driven market such as India, all growth is not equal. While the ideal growth company has an entrenched competitive advantage, expansionary market, pricing power, and a limited need for capital, in reality, most firms tick only a few of the characteristics, making triangulation of the essential variables key. A key area of judgment here is identifying business challenges, even if they are many years out. While these headwinds may not affect profitability and metrics in the near term, multiples will decelerate at a rapid pace with time. The risk of this playing out in a high-growth market like India cannot be overestimated.

In choosing the best investment options, we advise to prioritize sustainable earnings growth, resilient business models tested at high frequency for disruptions, and sustainable capital efficiency in making investment decisions.

Over the last two quarters, Unifi has closely monitored its investment advice across sectors and advised to repositioned where necessary.

India Macro's

A key reason Indian markets are showing resilience is the significant strengthening of its financial systems, low levels of debt that do not threaten solvency, and increasingly competitive businesses. The combined effect has resulted in Indian markets having the reserves to absorb external shocks. With near term GDP growth estimates of over 7%, a favorable Balance of Payments outlook, and a manageable fiscal deficit and inflation, the macroeconomic set for India from an investment point of view seems good. An analysis of several high-frequency indicators suggests directional momentum. Pockets of slowdown within categories may indicate consolidation and shifting of demand, based on innovation from suppliers.

% YOY	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-24	May-24	Jun-24	Jul-24	Aug-24	Sep-24	Oct-24
Water reservoir levels	-15.9	-20.4	-20.5	-18.5	-15.8	-15.4	-15.1	-16.8	-20.0	-24.2	6.5	27.3	20.8
PMI: Manufacturing	55.5	56.0	54.9	56.5	56.9	59.1	58.8	57.5	58.3	58.1	57.5	56.5	57.5
PMI: Services	58.4	56.9	59.0	61.8	60.6	61.2	60.8	60.2	60.5	60.3	60.9	57.7	58.5
E-way registrations	30.5	8.5	13.2	16.4	18.9	13.9	14.5	17.0	16.3	19.2	12.9	18.5	16.9
Toll collection (Units)	13.0	12.3	13.0	10.2	8.3	10.6	7.6	3.6	5.8	9.4	6.8	6.5	7.9
FX reserves	588.5	604.2	622.5	620.0	625.2	646.4	640.2	651.5	652.0	670.6	682.2	705.8	682.6
Currency in circulation	2.9	4.3	4.0	3.9	3.7	4.1	3.2	3.8	6.0	6.4	5.5	5.9	7.0
Vahaan registrations	-6.6	19.6	22.0	16.1	14.0	3.8	27.5	3.3	1.4	14.7	3.7	-8.7	32.4
PVs sales	19.4	5.5	1.6	15.3	15.1	14.4	3.6	0.5	3.7	-5.1	-3.5	0.1	0.8
CVs sales	13.4	216.8	-4.9	-1.6	-2.3	-6.6	14.2	2.4	-4.5	-6.6	-12.5	-12.9	3.0
Air cargo traffic	23.9	13.9	1.6	17.2	20.6	10.5	8.0	14.8	10.2	6.8	-6.6	-8.9	-8.1
Rail freight traffic	8.8	3.5	-0.9	3.7	15.1	-5.5	24.1	-4.3	13.3	9.4	2.3	2.9	
Power Generation	24.8	10.7	4.8	6.5	4.5	8.3	10.4	15.2	9.0	8.3	-4.7	0.4	0.8
SCB: Deposits	13.4	13.6	13.3	13.2	13.1	13.5	13.3	14.8	11.1	10.6	10.8	11.5	11.7
SCBs: Non-food credit	20.1	20.8	20.1	20.4	20.6	20.2	19.1	20.8	17.4	13.7	13.6	13.0	11.5
Fuel consumption	4.8	-2.2	3.7	7.3	8.2	1.7	7.8	1.9	2.3	10.7	-3.1	-1.5	2.9

Interest rates and Fiscal Deficit: It is widely anticipated that the RBI will begin reducing rates in the first half of FY26, driven easing domestic inflation to c. 4.5% by mid-2025—still above the RBI's target of 4% but significantly lower than the current policy rate of 6.5%. Notably, inflation in most developed and emerging markets has sharply declined from its peak and has shown signs of steady deceleration in recent months. The easing of geopolitical tensions will likely help stabilize commodity prices, supporting inflation. Additionally, India's fiscal deficit could potentially come in below the government's target of 4.9% (vs 5.6% YoY), driven by (1) stronger-than-anticipated growth in tax revenues, and (2) lower-than-expected capital expenditure.

However, there seem to be signs of a consumption slowdown in specific segments of the economy. While we will wait for more data over the coming months before drawing firm conclusions, the softer-than-expected performance of select FMCG

firms overall has been disappointing. This trend has prompted some earnings adjustments across specific sectors while opening up an opportunity to participate in the recovery from here on.

As active advisors, we closely monitor our portfolios to identify and suggest necessary adjustments. These include evolving macroeconomic conditions, shifts in firm-level dynamics, and emerging valuation opportunities. Our proactive approach ensures that we remain responsive to changes. Our rationale behind our key sectoral exposures is as follows.

Credit | Over the past few months, growth of the banking system has slowed from mid-teens to c.11% (as of 15th Nov'24). This slowdown can be attributed to challenges on the liability side, resulting in a slowdown in lending towards personal loans and NBFCs. This is a significant development, as it comes in the way of funding certain aspects of household consumption. Despite these headwinds, the banking system is well poised for strong double-digit growth over the medium term, including for the current financial year. Asset quality across the system continues to be favourable with some pockets of stress in credit cards and microfinance. Banks and NBFCs with higher exposure to these areas have seen weaker earnings, though corporate and retail customers with secured products continue to demonstrate strong credit discipline. Healthy corporate balance sheets and increasing awareness among retail customers about maintaining good credit histories will make credit losses manageable in the medium term. At Unifi, we suggest financial exposure predominantly to lenders offering secured retail products.

We have recommended to trim the overall exposure to the sector over the past few quarters, reflecting our approach to growth and to increase our exposure to the second-largest PSU bank, which has strong fundamentals, a clean balance sheet, and is reasonably valued. We also advised to hold a position in a mid-sized bank with reasonable exposure to credit cards and microfinance. While this bank has seen some stress, largely in line with broader industry trends, we believe the pressure is transitory, and the bank remains well-positioned to deliver healthy returns over the medium term.

Technology [Products, services, Hardware] | The current environment presents a case for IT services, as global IT spending is poised for a rebound, with inflation and interest rates expected to trend lower. As global macros improve, businesses worldwide are expected to resume productivity-driven IT investments. Our guidance reflects a diversified approach, with allocations to mid-sized IT firms that address niche, specialized market segments and a global product major, that will benefit from the spends of the BFSI sector, globally.

On the hardware side, enterprise demand for computing power is rising due to shorter product cycles and rapid innovation, driving both obsolescence and progress. Consumers are increasingly connected, with growth across retail, education, homes, and business solutions like cloud and SaaS. There's also greater acceptance of premium products and frequent upgrades. To capitalize on these trends, we've advised to invest in a top global and Indian IT distributor poised for growth.

Health Insurance | The recommendation to invest in India's largest private health insurance company has faced challenges, primarily due to an unexpected increase in the claims ratio, impacting performance. With measures in place to address these issues, we anticipate a period of consolidation over the next two quarters, positioning the company for stronger performance and sustainable growth in the future. The heightened awareness about medical insurance has driven strong growth across the board. As the country's most profitable health insurer, this company is well-positioned to match industry expansion while consistently improving its financial performance year after year. With the sector poised for sustained long-term growth, we suggested capitalizing on attractive, cyclically low valuations supported by robust financial fundamentals.

Healthcare | We are positive about the growth trajectory of India's healthcare infrastructure, particularly in the hospital sector. The sector is poised for robust expansion, driven by rising demand for quality medical services, a growing middle-class population, and higher insurance penetration. Our recommendation is one of India's largest hospital chains, a leader in operational efficiency, patient care, and geographic presence. Geographically the hospitals are spread deep across India's National capital Region, East India and Karnataka.

Diversified Consumption | We advise to maintain a diversified exposure to India's consumption basket, with investments spanning clothing, tourism, and house furnishing. Our strategy focuses on identifying pockets of growth within the consumption sector and areas where a strong reversal to growth is highly probable. These targeted positions enable us to capitalize on evolving consumer trends and demand patterns. While the current positions are small in a few of these segments, we are actively evaluating opportunities within the broader consumption space.

Background

The fund's holdings are well diversified and poised to benefit and consolidate their position and deliver industry-leading growth. We have advised to trim exposure in a few names that have performed significantly well and redeployed the cash generated in firms that offer a better risk/reward proposition.

Summary of results from the quarter Q1-FY 2025 (Generally Indian Cos follow Apr-Mar FY)

Company	Brief background and Investment rationale
Aarti Drugs	<p>Aarti Drugs reported 16% revenue degrowth in Q1 2025. This revenue decline was due to the continued price decline of the key raw materials YoY. The commodity API prices have faced significant pricing pressure in the past 12 months. The decline was led by export markets (down 17%) YoY compared to a decline of 14% for the domestic market for the API business. Formulation reported weak numbers with a 22% degrowth in revenue mainly led by a 33% decline in export revenue which domestic was up 2%. Gross margins improved by 280 bps YoY from 32.6% to 35.4% with expanding spreads for a few key molecules between product prices and RM. EBITDA fell 22% YoY due to the negative impact of operating leverage. However, with the new capacity commencing production and as the prices have stabilised post-Dec 2023, H2 FY 2025 should see significant growth with an expanded margin. Aarti Drugs is mainly into very bulk volume products, high-engineering products wherein, along with chemistry, one also requires very strong expertise in the engineering department, which is Aarti Drugs' key focus area. Aarti Drugs Ltd. is the largest producer of many APIs like Nimesulide, Ketoconazole, Metronidazole Benzoate, Tinidazole and Fluoroquinolones group and one of the leading producers of Metformin in the world.</p> <p>Key risk - Competition from China, Delayed scale-up of new projects.</p>
Bank of Baroda	<p>BoB reported PAT of Rs 4,458cr vs Rs 4,886cr in Q4FY24 and Rs 4,070cr in Q1FY24. Loan book declined by 1.7% sequentially and grew by 8.8% YoY. Moderation in loan growth was led by corporate book, which fell by 4.7% QoQ. It rose by 3.8% on a YoY basis. Management mentioned that moderation in corporate growth was a cautious call as it intends to reduce its dependence on bulk deposits, which funded these low-yielding corporate loans. Adjusting for the same, corporate loans grew by 10-12% YoY. The bank reiterated its guidance of 12-14% loan growth and ~10-12% deposit growth for FY25. Margins improved by ~4bps sequentially to 3.18%, excluding one-offs in Q4FY24. During Q4FY24, the bank had higher recoveries, leading to higher interest income and margins. Management reiterated its guidance of 3.15% (+/- 5bps) margins for FY25 vs 3.18% in FY24. Cost ratios were stable sequentially. Gross NPA improved by ~4bp QoQ to 2.88%, while Net NPA was stable sequentially at ~69bps. SBI has a Net NPA of ~64bps. Provision coverage was stable sequentially at ~77%. Gross slippages stood at 1.13% vs. 1.25% in Q4FY24. Due to higher Agri slippages in 1Q and 3Q, slippages are seasonally higher. Net slippages stood at 0.51% vs 0.46 in Q4FY24. Credit cost stood at 38bps vs 50bps in Q4FY24 led by lower net slippages. Management reiterated its guidance of ~1.2% gross slippages for FY25. Management is confident about the asset quality profile for all business segments and has lowered its credit cost guidance from below 1% to below 0.75%. Management mentioned that ECL (Expected Credit Loss) guidelines won't impact its credit cost guidance. Key risks would include lower-than-expected loan growth, asset quality deterioration leading to higher-than-expected credit costs and higher treasury losses.</p>