QUARTERLY UPDATE

- DECEMBER 2019 -

EQUITREE
SOWING SEEDS OF GROWTH

"History provides a crucial insight regarding market crises: they are inevitable, painful and ultimately surmountable "

– Shelby M.C. Davis

IS IT LIGHT AT THE END OF THE TUNNEL? OR SO IT SEEMS!

Beginning of 2020 has seen a sudden change of sentiments in the market with some buying finally coming about in the broader base, beyond the hitherto acute polarization in "safe haven stocks" that we have witnessed over the last 2 years!

The impact is visible in the indices returns – NSE Small Cap delivering ~ 8% as against -0.41% returns from Nifty (YTD as on Jan 27th 2020). **We are glad to report that our own portfolio has shown similar strength delivering ~ 12% return YTD – far exceeding the NSE Small Cap index return!!**

We believe this change of sentiment has largely come about from the amplified efforts of the government to put the economy back on track (elaborately discussed in our September 2019 update) and some belief that the economy has hit the rock bottom leaving very little room for further downslide.

Amongst other things the cornerstone of this change of sentiment we believe is the return of credit flow slowly coming back in the economy as the PSU banks and NBFCs open up their purses and go all out in disbursing money to corporates / consumers. While the official data is yet to endorse this, however, our scuttlebutt on the ground with bankers & corporates alike suggest that bankers are now chasing worthy corporates offering them all kinds of facilities – something that was completely soaked out during the last 12-15 months which eventually choked the businesses and economy at large.

Additionally some other soft factors are also indicating government's resolve to bring back the economy on track and pave the way for wealth creation from the market – which could also be stimulating hope in the market for better times coming ahead. Some anecdotes worth sharing in this regard include acts like:

- Prime Minister giving hope at a global platform that Indian tax regime (read capital gains) will be brought in line with the global markets to bring in more global investors and calling for wealth creators (read corporates and the market at large) to shrug off fears and get active.

- After having achieved 90% of the political agenda (as proclaimed by the Home Minister himself!), we suddenly and surprisingly find the Prime Minister himself inviting public comments and suggestions for the budget and conducting meetings with corporate chieftains and regulators alike.

- Market regulator softening stand on some critical issues like margin requirements for derivatives, broker funding for clients from "proprietary" funds etc. to bring back liquidity in the broader market

- Leading industrialists hinting that worst seems to be behind us at the recently concluded global economic forum

Of course, additionally the theories of "mean reversion" etc. are also playing out now citing the increasing valuation gap between the "safe havens" and the broader oversold market – something that we have been talking about for the last couple of quarters!

Nevertheless, while the market is hoping for a better FY 21 ahead, the sentiments will get tested shortly as the current hard macro data still churns out not so good-looking numbers and neither the corporate earnings for Q3 is likely to provide any signs of growth. We will need to wait and watch whether the sentiments continue to believe in seeing the light at the end of the tunnel or gives in again under the pressure of darkness of the immediate past!

BUDGET 2020 – WILL THE FM BITE THE BULLET?

The expectation from the government to offer tax sops and kick start the sagging economy by increased expenditure on infrastructure has never been so high from the budget as it is from budget 2020! To us, this will be nothing short of a fine trapeze performance, if achieved.

On one side the government's revenue from budgeted tax collections have taken a severe beating due to the slowing economy and on the other side the government has been continuing its resolve to keep the fiscal deficit in control leaving very little room for enhanced spending on infrastructure etc:

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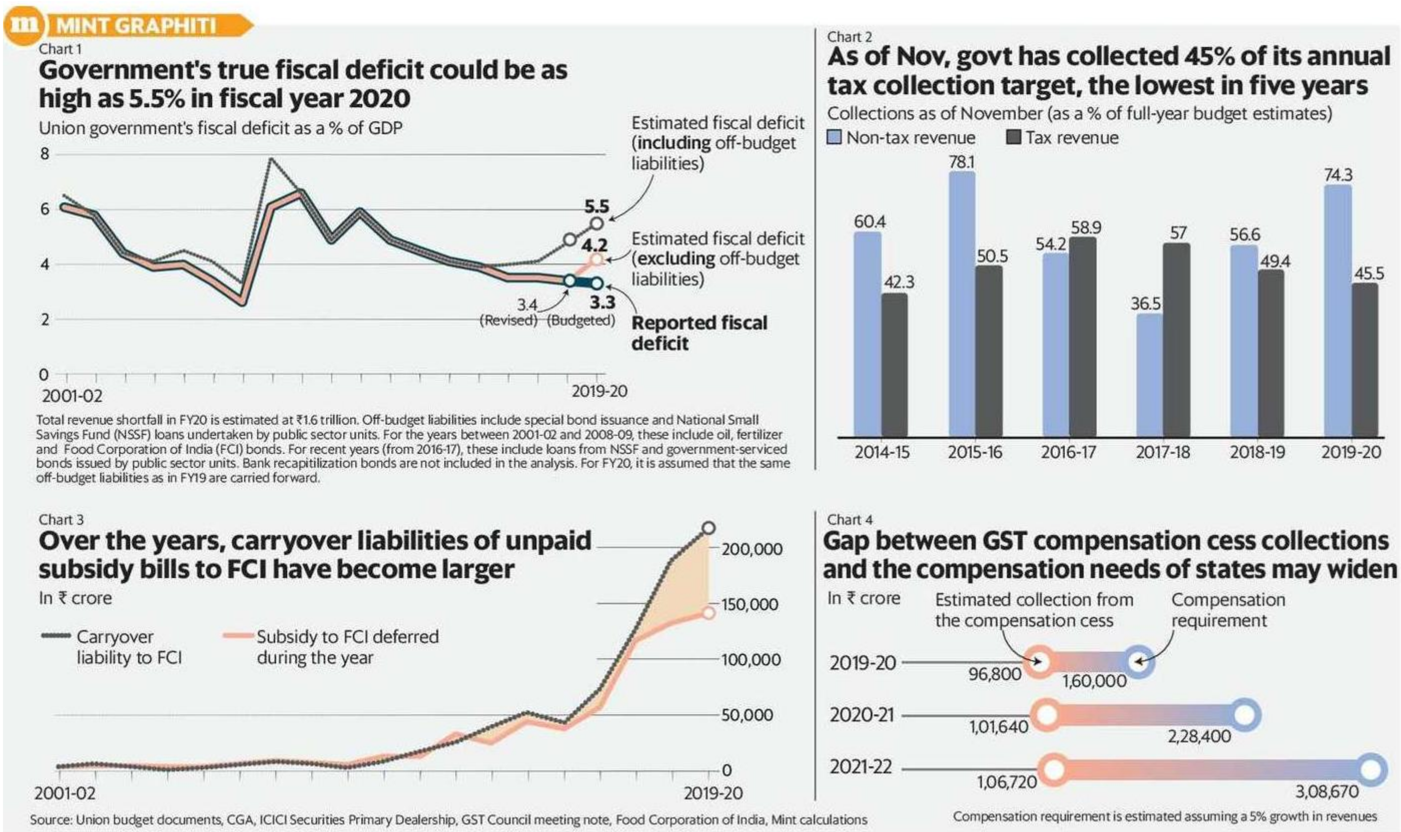

The recent run up in the broad base market seems to have factored in various incentives / sops to be rolled out in the budget taking a cue from various media reports. Most notable amongst these include:

- Lower personal income tax rates either by way of rationalizing slabs or raising exemption limits.
- Some relief with respect to Long Term Capital Gains.
- Sector specific import duty tweaks for promoting domestic manufacturing.
- Some policies to benefit the agriculture and infrastructure sectors.

It will be interesting to see how the market behaves once the BIG BUDGET event is out of the way.

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THE BEST TIME TO INVEST IS WHEN EVERYTHING APPEARS TO BE GLOOMY

Notwithstanding the budget expectation and what comes out of it on one hand and the gloomy macro data on the other, we thought it would be pertinent in the current context to share investment theory of one of the most prominent investors of all time Howard Marks.

In the book Mastering Market Cycles, veteran investor Howard Marks talks in depth about bull cycles, bear cycles and everything in between. In one section of this book, he gives a check-list which can aid investors in deciding when the best time to start investing is and when it makes sense to hold on to your wallets.

Howard Marks found over 50+ years of his investing career, that when most boxes tick off in the right-side column, it is an interesting time to start buying. We share his checklist hereunder:

Economy	Vibrant	**Sluggish**
Outlook	Positive	**Negative**
Lenders	Eager	**Reticent**
Capital Markets	Loose	**Tight**
Capital	Plentiful	**Scarce**
Terms	Easy	**Restrictive**
Interest Rates	**Low**	High
Yield Spreads	**Narrow**	Wide
Investors	Optimistic	**Pessimistic**
	Sanguine	**Distressed**
	Eager to buy	**Un-interested in buying**
Asset Owners	Happy to hold	**Running for exits**
Sellers	Few	**Many**
Markets	Crowded	**Starved for attention**

Funds	Hard to gain entry	**Open to everyone**
	New ones daily	**Only the best can raise money**
Recent performance	Strong	**Weak**
Asset prices	High	**Low**
Prospective Returns	Low	**High**
Popular Qualities	Aggressiveness	**Caution and discipline**

We reflect his checklist in the Indian context and find:

- GDP for FY20 is estimated to be at 5%, which is an 11-year low. IMF has estimated the GDP growth will be lower at 4.8%.
- Retail inflation touched a 5 year high of 7.35% (as of Dec 19) breaching RBI's upper limit of 6% and food inflation rising to 14.12% in December.
- India's unemployment rate rose to 7.5% during Sept-December 2019, according to data released by CMIE. This was the seventh wave to record an increase in unemployment since May-August 2017, when unemployment was at 3.8%.
- The broader market has been falling since January 2018 and investors remain cautious and fearful as can be seen in the lack of buying interest. Gold prices have been touching all-time highs, proving that investors are distressed and pessimistic, looking for risk-free investment options.
- IPOs in 2019 saw the lowest fundraising since, 2015 and credit & liquidity constraints plagued the markets for most of 2019.

Many of the macro data points visible in the current economic situation point towards the right column of this check-list and going by his theory on timing investments through various cycles, this indeed seem to be the best time to increase allocation to equity investing from a 3-4-year horizon!

ANECDOTAL EVIDENCES SUGGESTS THINGS PICKING UP ON GROUND

- **Increasing Fixed Deposits Making It Necessary for Credit Flow to Come Back**

As investors keep flocking to fixed deposits as part of their "safe haven" investments, there seems to be an asset liability mismatch at the banks as deposits with the banks continues to grow in absence of a matching onward lending. The incremental deposit accretion of the Indian banking system at INR 5.3 lakh crores remained higher than the credit growth as on Nov 19. ICRA expects y-o-y deposit growth to remain higher than credit growth at 8.4-9% for FY20. We believe, this mismatch will necessitate banks to open up their purses and start aggressive lending to catch up with the increased liabilities – which in turn should augur well bring back growth in economy.

- **Auto sector seeing better days ahead**

The festive season discounts offered by the dealers has helped in pushing up the sales and inventory correction. In the PV segment, inventory has returned to normal levels – some OEM players like Maruti and M&M reported a slight growth as well. The BS VI transition is also expected to see some buying coming about. Further the much awaited scrappage policy should also augur the demand as and when introduced. On an overall basis, the market leaders have started giving guidance that the worst seem to be over for the auto industry and we should start seeing better days ahead.

- **The intensity of short outperformance of small & mid-caps against large caps likely to bring back the investors**

Like we have been saying that the trend reversal in small & mid-caps will also be equally intense as we experienced it on the way down – the short out performance of the small cap index against the headline indices seems to be bringing back the attention of investors to small & mid-caps. The valuation mismatch that we have been talking about is now amplified with the most respected investors like S. Naren and Prashant Jain endorsing the same and making a case of small cap investing which has made the investors sit up and start exploring small & mid cap investing again.

- **Improving GST collections**

For the last couple of months (Nov and Dec'19), we have seen GST collection over Rs.1 lakh crore and the expectation for Jan'20 is pegged at Rs. 1.15 lakh crore! It may be mentioned here that since introduction of GST the highest collection ever witnessed was Rs. 1.13 lakh crore. This of course is partly due to the government's efforts to plug in the leakages; nevertheless, this would ease out fiscal pressure on the government finances a bit paving way for spending.

With all of these we strongly believe that the light at the end of the tunnel is indeed visible – while we still keep gauging the distance to the end of the tunnel! We are watchful for some of the key global & domestic events which will likely shape up the market direction over the coming months including our own Budget 2020, Coronavirus and its impact on global trade, actual impact of Brexit which is eventually slated for end of January, political tensions in Middle East (Iran etc.) and continue to look at building the portfolio.

Please feel free to revert in case you need any further information on any of our portfolio companies or would like to understand them in more details. You can write to us at pawan.b@equitreecapital.com / skabra@equitreecapital.com

Warm regards.

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