QUARTERLY UPDATE

EQUITREE
SOWING SEEDS OF GROWTH

- JUNE 2019 -

"If you wait for problems to disappear before investing in stocks, you will never commit, or earn a penny"
– Ralph Wanger

IS THIS THE DARKEST HOUR BEFORE THE DAWN?

Over the last couple of quarters we have shared various statistics indicating increasing attractiveness of the small & mid cap companies – primarily on account of decent earnings growth in select small & mid-caps and increasing valuation gap between the large caps and small & mid-caps (refer our quarterly newsletter of March 2019). Most of these indicators directed us to believe that these small & mid-caps are now in an oversold territory and should see meaningful bounce back!

Our belief was also endorsed / seconded by various learned participants in the market on different platforms including launch of different kinds of new small and mid-cap funds. Some prominent announcements on these lines include:

1. Ex Reliance CIO Sunil Singhania has launched a fund to exclusively invest in to companies with market cap of less than Rs. 5000cr
2. Kotak Securities coming up with a detailed report on why small & mid-caps look attractive
3. Mirae Asset Management has launched a NFO for mid-cap investing
4. DSP Blackrock has reopened its small & mid cap fund for new contribution

Despite the market wide belief that the time is ripe for the small and mid-caps to start performing or at least stop further draw down, the support for small & mid cap investing still eludes the broader market!

We did see a bit of relief rally in the month of March when the portfolios recovered around 10% in a month; however the sell off since then has more than negated all the gains.

With large part of market believing that it's about time for small & mid-caps to find some support, we wonder if this is the darkest hour before the dawn.

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ARE SMALL & MID CAPS OVERSOLD OR MORE DOWNSIDE IN THE WAITING? – WE BELIEVE IT IS THE FORMER

Through our past quarterly updates we have discussed various factors leading to this kind of sell off in the small & mid-caps. We believe most of these factors have now played out and one should see rebuilding of positions from here on sooner than later. Our belief emanates from the following factors.

- **Time correction seem to be getting over:** Post every bull run it is not out of context for the small & mid cap to see a significant correction (2008 saw ~ 79% correction; 2013 saw 54% correction). While each cycle has its own trajectory, however, going by the historical trends over the last 15 years the longest that the market has seen a persistent bear phase has been of about 21 months (S&P BSE Small cap index falling from 11,148 in Sept 2010 and bottoming out at 5,101 in June 2013). We are already about 18 months in the current bear phase with the NSE Small Cap index correcting ~ 40% from its peak in Jan'18. Given the long broad based decimation that we have experienced in the market where average company below the top 250 stocks is down ~ 47% over the last 18 months, we believe this time correction should be at its fag end now and should see recovery happening over the next quarter or so at best.

- **Down rating of stocks already factors in muted 1st– 2nd qtr (FY 20) earnings**: After a dismal 3rd – 4th quarter (FY 19) most brokerages have reduced projected earnings for companies across sectors for FY 20. The "growth" premium assigned in the valuations have since completely tapered off for e.g. S&P BSE AUTO index has already corrected by ~15.8% in the past 6 months from Jan 10 (20,132) to July 10 (16,948). Having said that if one were to do a ground up analysis of businesses, there are islands of opportunities and growth for companies across diverse sectors and such tapered off valuations should attract investors in these companies as the comfort around the earnings growth come about.

- **Political uncertainty is out of window for the next 5 years:** The nervousness and anxiety with respect to national elections and having a stable government at the centre has been completely addressed with the thumping majority gained by the BJP / NDA. We believe that after all the major clean up action done by NDA version 1.0 (Demonetization, GST, IBC, NCLT etc.), NDA version 2.0 should now use this super majority to vehemently push through the growth agenda and build up on the foundation created during the last 5 years. A stable government should also provide a lot of comfort for attracting foreign capital – which otherwise is very critical for our capital hungry nation at this point in time.

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- **Large part of corporate governance issues and NPA clean up done with:** We believe that large part of the PSU NPA provisioning has been done with. This was also prominent from the significant turnaround seen in Q4 numbers of PSU Bank Index which reported 187% PAT growth y-o-y (85% PAT growth for FY 19). Private Banks like ICICI, Axis, IndusInd which went through their own motions of NPA / corporate governance issues have now stabilized and are looking good. Further, banks have been recapitalized with ~INR 140k Cr in the past one year. This has further helped in improving the capital adequacy ratios of the banks and brings them back in business. On the other hand the drubbing in the market prices has also brought out a lot of skeletons from the cupboards (with respect to corporate governance) of a range of listed companies – irrespective of the market cap! We believe that ~ 47% correction witnessed in the stock prices on the broader market has now factored in a lot of these issues. We believe that corporate governance is an ongoing issue and needs to be watched on continuous basis and cannot be settled at a press of a button permanently, however, in the same breadth that does not make the whole market uninvestible!! Our sense is that while the market continues to be instilled with fear on corporate governance issues, however buying should come about in some of the better managed companies sooner than later.

- **Lingering gloom because of global macros/trade war does not impact India as much:** As mentioned in some of our previous updates that though trade war has been a major concern for global markets and a reason for correction in equity markets across the world, it does not have a major impact on Indian businesses as India is NOT a predominantly export oriented economy. On the contrary, the US-China feud presents an opportunity for Indian companies to gain some market share in the global trade. Federation of India Export Organization has spelled out that US is looking to increase sourcing of things like toys, footwear, apparel, and engineering goods more specifically from India. Further, US Fed has also indicated a soft stand on the interest rate and is expected to reduce the rate in the coming quarters. We believe that cheap funds sloshing around in global markets would look for avenues to invest in to emerging markets for returns and Indian markets should stand to benefit significantly from this such.

- **NBFC liquidity issues likely to see some relief:** Since the ILFS & DHFL default issue there has been a general tightness in the liquidity for NBFCs which has led to a dramatic fall in the lending done by NBFCs:

NBFC Loans in Urban and Rural Areas (₹ cr)

Areas	FY 2017-2018 Q1	FY 2017-2018 Q2	FY 2017-2018 Q2	FY 2017-2018 Q4	FY 2018-2019 Q1	FY 2018-2019 Q2	FY 2018-2019 Q3	FY 2018-2019 Q4	GRAND TOTAL
Rural	32,872.66	36,769.64	45,232.80	49,213.08	44,273.10	46,756.47	46,131.28	42,758.27	**344,007.29**
Semi-Urban	15,689.99	16,412.88	19,750.78	21,963.14	20,210.35	21,573.35	20,204.96	19,044.45	**154,849.91**
Urban	167,566.74	162,013.57	179,137.95	211,437.87	179,174.58	189,009.18	138,921.83	134,012.56	**1,361,274.28**
Other regions	694.74	1,872.01	3,630.93	1,256.10	1,062.06	1,657.27	1,159.47	639.39	**11,971.96**
Grand Total	**216,824.12**	**217,068.10**	**247,752.47**	**283,870.18**	**244,720.09**	**258,996.28**	**206,417.53**	**196,454.66**	**1,872,103.44**

Source: *FIDC*

This has had a cascading effect in the economy at large including a variety of market participants who generally rely on such NBFCs for their funding. The primary reason for the NBFCs holding back their lending has been a temporary mismatch in their assets and liabilities – where on the asset side (lending done to corporates by NBFC) the recoveries have been slower and increased repayment pressure on the liability side (funding raised by NBFCs from sources like Banks, Mutual Funds etc) as rollovers are not happening as planned. Having said that it is not like there is absolute dearth of liquidity – well managed NBFCs have been able to raise funds from multiple sources – both equity and debt for e.g. Magma Fincorp has raised INR 6000cr over the last 1 year! Furthermore, a couple of banks have announced tie-ups with NBFCs – ICICI Bank & Indostar, Bank of Baroda & SREI Finance more specifically – giving visibility and comfort around NBFC liquidity.

Recent budget has further announced a slew of measures to enhance NBFC liquidity – right from allowing FPIs to invest in to bonds of NBFCs, creating a war chest of INR 134,000 crore with the banks to specifically invest in to NBFCs, providing sovereign guarantee of up to 10% for a period of 6 months for well securitised loans acquired by banks from NBFCs. We believe these slew of measures should help in addressing the liquidity issue faced by NBFCs and rekindle flow of credit

Part of the funding gap created by the NBFCs has been filled in by the normal banking channels. Contrary to the popular belief that liquidity has been stretched in the economy, it is interesting to note that the overall bank credit as of May 24, 2019 was up ~ 11% on a y-o-y basis! This being the case, we strongly believe that the results of these should be visible over a quarter or so.

	25th May 18 to 24th May 19	30th Mar 18 to 29th Mar 19
Gross Bank Credit	+11.5%	+12.2%
Food Credit	+24.2%	-0.9%
Non-Food Credit	+11.4%	+12.29%

- **Budget lays out vision document to drive growth – hopefully:** The government has laid out its vision document as part of the budget speech vying for creating a $5 trillion economy by 2025. The vision document provided for substantial capital outlays for infrastructure development including Railways, Roads, and Water Supply amongst others over the next 5 years. While the intent seems to be in the right place, one needs to see how and when does the funding start coming in for swift execution – and that remains the biggest caveat to thump up the economy at this point in time. The government has announced an aggressive privatization plan to generate resources including expressing intent to go down up to 40% in the PSUs, if need be. Additionally, for a first time government has announced plans to raise sovereign bonds from global markets to fund its capital expenditure. While the efficacy of such open market borrowing will be tested in due course of time, in the interim such measures will surely help in bridging the gap for much needed capital investments, which will have its own cascading effect on the economy on the positive side.

PORTFOLIO PERFORMANCE

	FY19 PAT Growth	TTM PE
Equitree Emerging Opportunities	5.02%	8.33x
NSE Small Cap 100*	7.03%	15.57x

**Excluding loss making and recently turned profitable companies.*

We started FY 19 on a very positive note with our portfolio companies reporting ~ 14% growth in profits till 9M of FY 19. However, the slowdown in the economy during the 4th quarter – more particularly in segments like Autos, Building Materials and Retail has impacted performance of over portfolio companies as well ending the year with a modest 5% growth in profits on an aggregate basis. Overall the revenue growth in our portfolio companies was ~9.42% for FY19 which is quite decent given the pain in the economy.

We expect the impact of the slowdown to continue a bit in the 1st quarter of current year and start tapering off from 2nd quarter onwards. While we expect the 1st quarter to be slightly lower or flattish on a y-o-y basis, we expect execution to pick up in most of our businesses from the 3rd quarter and believe that on a full year basis, our portfolio should see a double digit growth.

An interesting point that we would want to highlight is that despite the price corrections that we have seen in some of our portfolio companies, the latest shareholding pattern of most of our companies indicate that neither the promoter nor any of the big investors / institutions (especially FII's) have liquidated their holdings. This suggests that the selling has been more from the weak hands in the retail market primarily driven by fear. We are supremely confident that as the earnings start coming about and the overall fear recedes, we should see the price re-adjusting accordingly.

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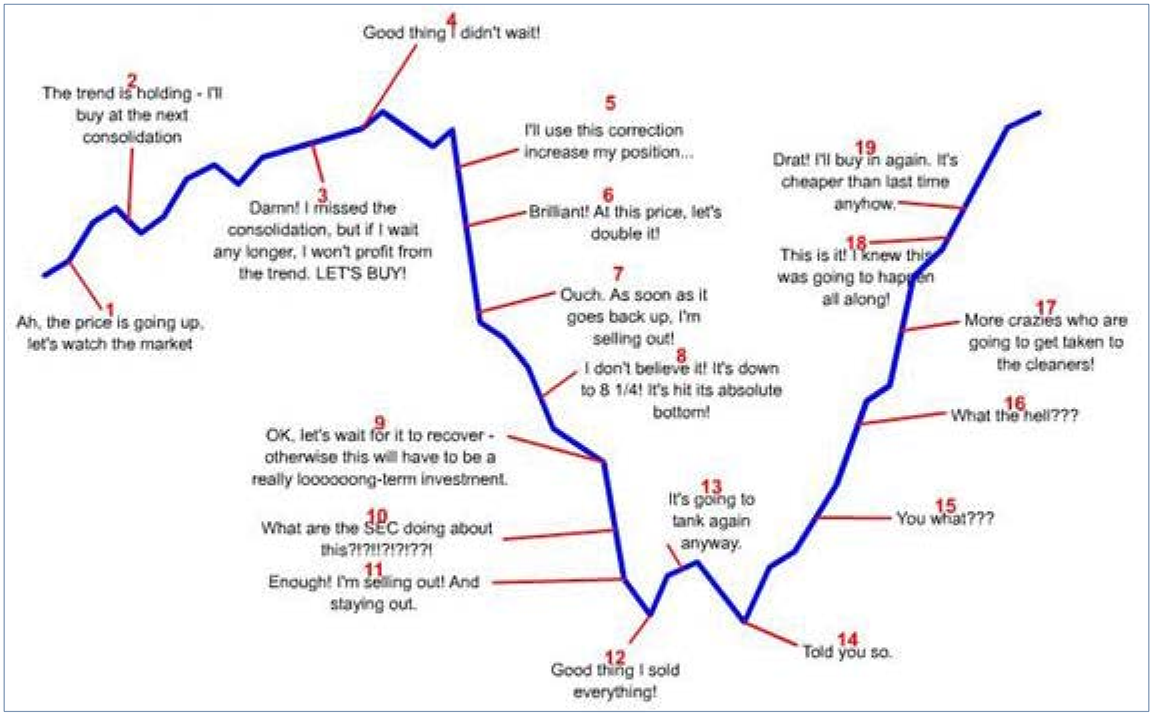
DONT LET EMOTIONS DRIVE YOUR DECISIONS!

The biggest mistake investors make is that they keep investing in a bull market (Euphoria) and they book losses in a bear market (Fear). Businesses don’t stop functioning in a bear market nor do they report best numbers in a bull market. Business cycles and Stock Market Cycles have to be seen separately in order to understand the true value of the company. Currently Indian Stock Market is going through a bear market which is driven more by macro factors as compared to micro. When fear kicks in everything looks bad (specially the smaller companies) and this is why the buying interest in stocks is at its utmost lows.

As Bill Ackman puts it "It is crucially important not to let psychological factors interfere with economic rationality in investment decision making" This becomes even more relevant for wealth creation from long term investing!

We would like to share an interesting chart hereunder depicting how typical investor sentiments go through bulls and bear phase – am sure a lot of readers will relate to their sentiments which is akin to the bear market sentiment shown hereunder!



As always, we remain committed to ensure that we create wealth for our investors in the long run and will be happy to hear from you in case you need any further information / clarification from our side.

Warm regards.

TEAM EQUITREE
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