QUARTERLY UPDATE

- JUNE 2020 -

"There are two times when people forget their principles: at the top of the market and at the bottom "

– Phillip A. Lowe

Dear Investors,

Hope everyone is safe, healthy and taking all precautions to stay fit through the ongoing pandemic.

You will recall that in our last quarterly update we had mentioned that any incremental positive news flow coupled with liquidity could ignite a disproportionate buying response and voila this is exactly what we have seen happening during the last quarter – in fact the pullback has been beyond our own expectation! We share our thoughts in this newsletter against this backdrop.

A STRANGE DICHOTOMY – MARKETS CELEBRATE LIQUIDITY, AS THE WORLD CONTINUES TO BATTLE A PANDEMIC!

After a brutal selling and massive drawdowns seen in the March quarter, the June quarter saw a proverbial "V" shaped recovery with the Nifty delivering ~ 20% return – almost closing in to 11,000 mark again! **Our portfolio has been in line with the indices, registering 26% return during the quarter** (*kindly note that individual performance can be different*).

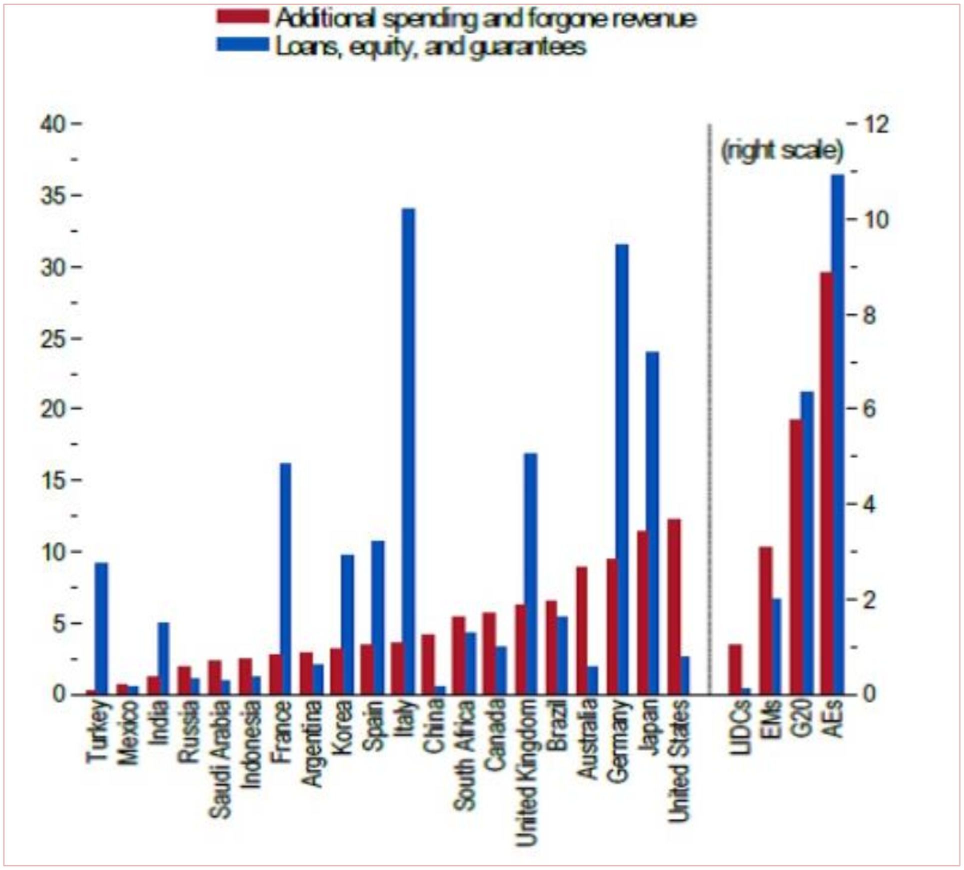
While this recovery has brought the "*safe zone frontline stocks*" at almost near pre-covid levels with quite a few of them making even newer highs, the last quarter also saw a renewed buying interest in a lot of small and mid-cap stocks with a lot of them recovering 50-100% from their lows. Some of our own portfolio companies have also seen 50-70% recovery during the last quarter from the lows made in March.

On the other side, the world continues to reel under the pressure of increasing number of Covid cases (**more than 15.7 million cases worldwide**) and is resorting back to micro lockdowns to contain the numbers while work on developing a vaccine goes on unabated.

We reflect on some factors that have driven this momentum:

- **Liquidity support from central banks around the world and strong FII flows:**

Central banks around the world have injected a massive financial stimulus by providing sizeable fiscal support not only through budgetary but also off-budget liquidity measures as shown hereunder:



Source: Kotak

The size of the financial stimulus supported by the Big-4 central banks increased to US$20tn versus US$15.3tn at CY19 end and US$11.2tn at CY15 end.

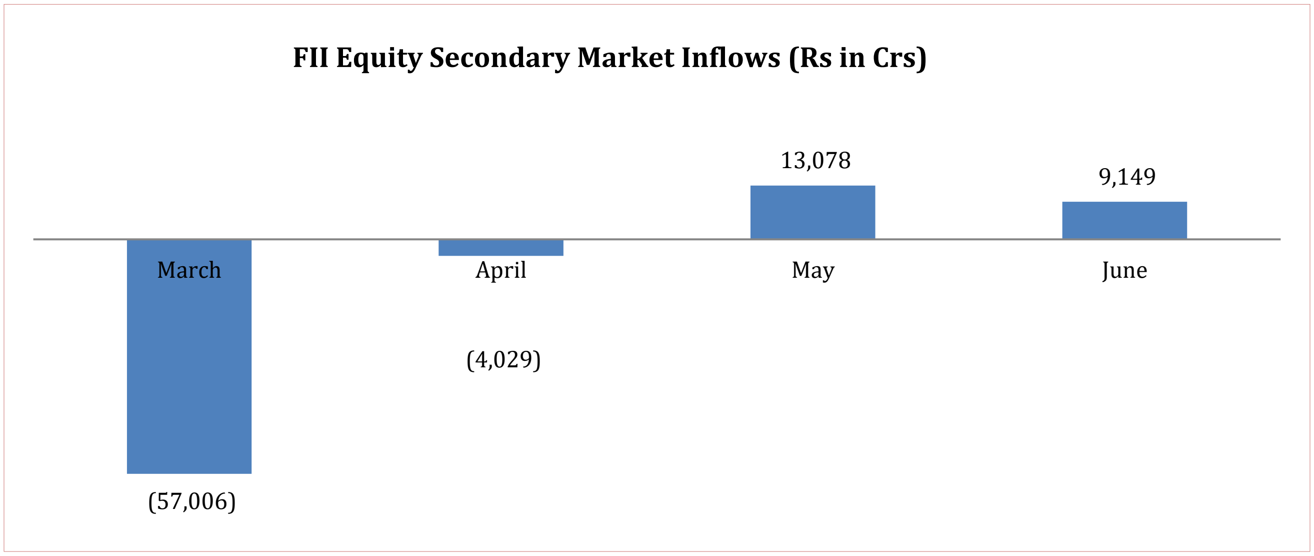
India has also provided liquidity support through loans and guarantees at ~4.5% of GDP.

This unprecedented infusion of liquidity in global markets has done two things:

- **Averted the looming financial crisis (at least for now) –** with the lockdowns being announced globally, the world was staring at financial melt-down as leveraged corporates increased the risks of bankruptcies and massive job losses due to the complete economic halt.

- **Pushed the debt yields down to near zero –** The flush of liquidity has pushed the debt yields abysmally low with the 10-year US treasury now yielding a meagre ~ 0.5%! Generally, bond yields and equity valuations have an inverse relationship – so a lower bond yield typically results in pump up of equity valuations. This is what has driven the equity markets globally.

India, has also seen its share of positive FII inflows in the month of May and June after the sharp selloff in Mar'20 leading to spectacular recovery in the index during the June quarter.

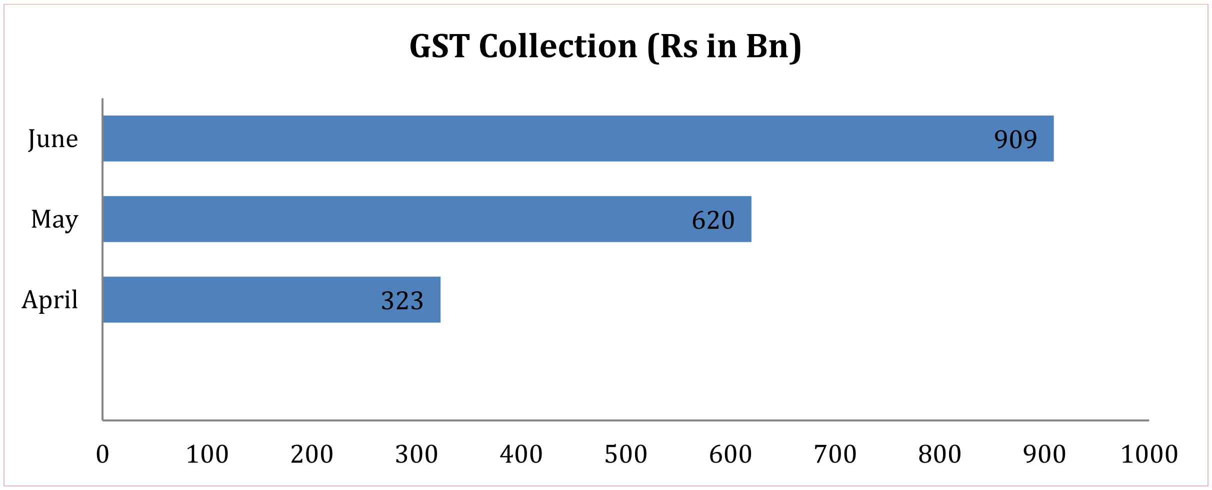


Source: StockEdge

- **Some early green shoots visible in macro-economic indicators**

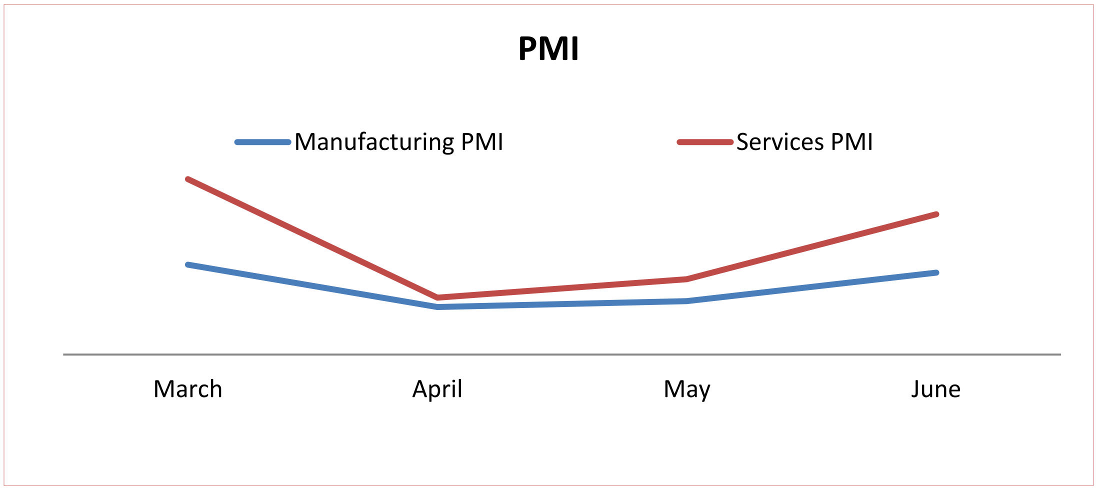
  - **GST collections showing signs of early recovery**

June months GST collection saw a surprise smart come back – almost around 90% of average collections. However, we suggest that one should take this with a pinch of salt as filings for the months of February, Mar & April were extended and allowed till June. Given that, June numbers would have some bulk up of previous months as well, hence this should not be read as a normalization of GST revenue trend.



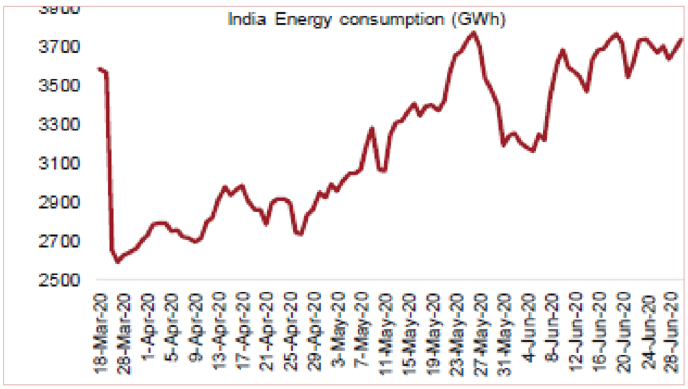
- **Improvement in June PMI**

India's Manufacturing PMI improved to 47.2 in June 2020 which had fallen to an all-time low in April. A print below 50 still indicates contraction in business activity.



Source: Company Research

Pickup in energy consumption and marginal recovery in auto sales



Wholesale sales (Units)

Company	Apr-20	May-20	Jun-20
Maruti	632	18,539	55,902
M&M	5,505	33,901	55,902
Hero	0	112,682	450,744
TVS	9,640	58,906	198,387
Escorts (Domestic)	613	6,454	10,623
Ashok Leyland	0	1,420	2,394
Eicher- RE	91	19,113	38,065
Bajaj Auto	37,878	127,128	278,097

Source: IDFC First, MOSL

- **Surge in retail participation (Small Traders)**

Following the sharp fall in markets, India has seen about 1.8 million new accounts opened since March. The month-on-month average F&O and cash volumes surged by 28% and 18% respectively in June 2020. The cash volumes were led by non-institutional participation which stood at the highest level since Aug 2009 at 68%. (Source –MOSL).

In addition to the FII inflows, it has been this unprecedented retail participation which has brought buoyancy in the broader market. Classical of retail investors who look to make a quick buck in battered down stocks, the quarter has seen a surge in stock prices of quite a few '*penny stocks'* – going up 2-3x as well from their lows!

This retail surge has also been on the back of the lockdown which has forced people to remain indoors and has made the small businessmen / traders turn to the stock market as a medium of secondary source of income.

- **Robust rural demand – Leading the recovery**

Rural India has been less impacted by the Covid pandemic and has seen good liquidity as well due to a very good crop season as well as various government welfare schemes including – direct benefit transfers, government guaranteed loans, MNREGA, etc. This has led to a faster demand recovery in the rural markets fueling the hope for an extended recovery happening sooner than later.

LIQUIDITY NOTWITHSTANDING, WE SUGGEST CAUTION AHEAD

Despite an initial pick up in the key indicators from the absolute lows of April 2020, we remain cautious for the rest of 2020 given the following concerns:

- **Rising number of Covid cases in India leading to sporadic lockdowns**

India has recorded more than 14 lakh cases till date and is adding ~50,000 cases every day. This is forcing some states to implement the lockdown again. While manufacturing activities have been largely allowed in this second round of lockdowns, however, restricted mobility of people have impacted availability of labor on one hand and demand recovery on the other. Such intermittent lockdowns also bring in extreme volatility in businesses in general making it very difficult to gauge the business impact in the short run.

Furthermore, the second wave of covid cases are also extending to rural areas and states which were hitherto un-impacted by the pandemic putting the demand recovery in rural areas also under question. We will need to wait and watch how and when does normalcy return back in businesses – until then earnings volatility is likely to continue thereby impacting the stock prices as well

- **Discretionary spending of urban poor / middleclass likely to be impacted**

Top 10 metro cities have been worst impacted due to the Covid pandemic and has seen extended period of lockdowns forcing a wide range of businesses to lay off staff and resort to salary cuts amongst other efforts to minimize fixed costs. While the government has doled out enough stimulus packages for the farmer and rural poor, there has been nothing substantial for the urban poor / middleclass to spur demand. This in our view will keep the economic activities little suppressed on a broad level.

- **Subdued bank credit growth**

Bank credit growth plummeted to 6.2% in June 20 vs 11.3% in June 19 despite government efforts to revive the economy. From various discussions with bankers and businesses on ground, we understand that the disbursement even under the Atmanirbhar Bharat scheme (Rs. 3 lakh crore to be disbursed to MSMEs) have been rather slow with just about Rs. 86000 crore being disbursed till date. Private Banks have anyways been wary of extending credit due to concerns on potential slippages and poor credit ratings of borrowers. We believe that delays in extension of this credit will further put stress on the MSME which is an essential link in the supply chain even for the bigger companies and in turn impact adversely on the expected recovery

- **Overarching fear of increasing NPAs**

RBI has in its recent report suggested that the banking NPA may swell to ~ 12.5% from 8% currently due to the poor economic conditions. Banks in general have been raising funds to shore up their buffer to accommodate any shocks that may come up once the moratorium is lifted. There are increasing representations being made to RBI to allow a one-time restructuring to take care of such stressed accounts however we still need to wait and watch RBI's next step on this issue. We believe in absence of a restructuring being allowed balance sheets of Banks / NBFCs could be under pressure as the NPA may increase post moratorium is lifted. This in turn could also put pressure on the stock prices.

- **More speculation and less of long-term investments:**

In June 2020, less than 33% of the total traded quantity was converted into delivery as compared to 40% in March 2020; indicating that investors have been speculating more in the markets than buy and take delivery to hold for long term. This is also in sync with the increasing retail participation.

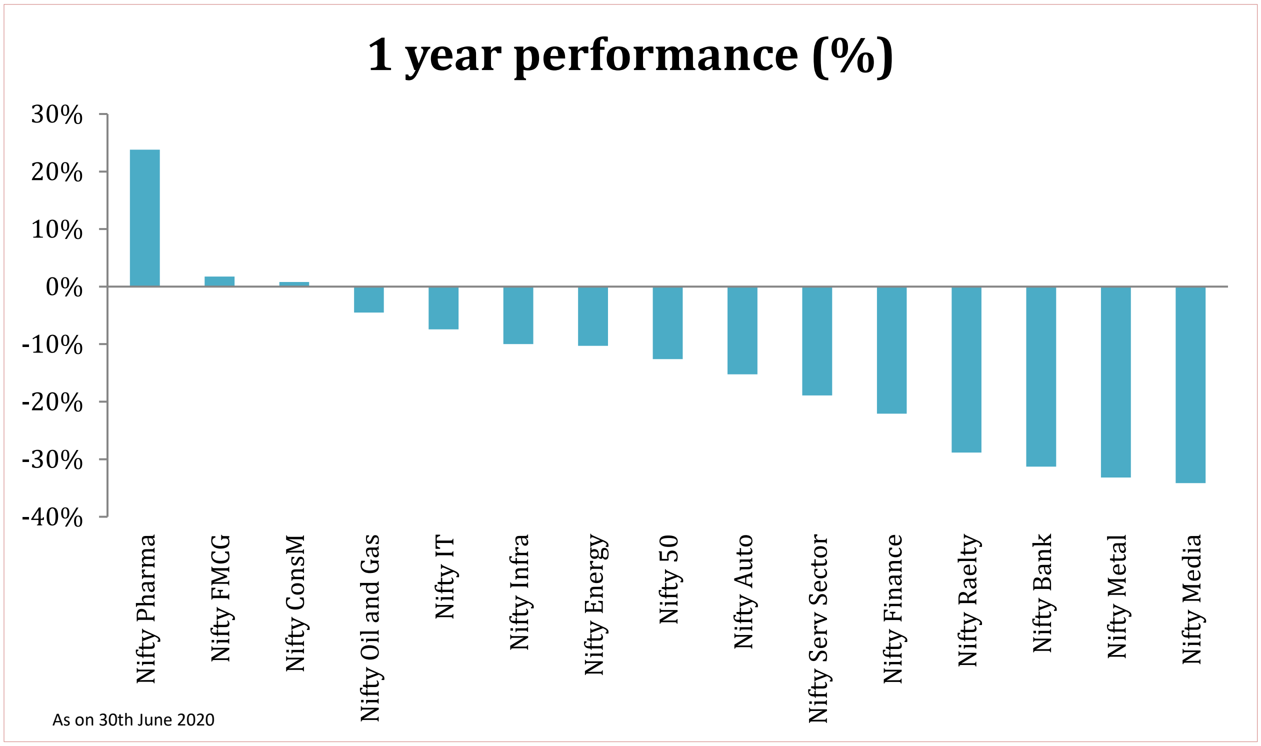
- **Sustainability of the liquidity**

Availability of easy liquidity in the global markets and increased participation from the retail investors have been the cornerstone of the current rally in the market. In absence of need of funding their own businesses, a lot of retail investors have been channelizing their savings in to the market to make a quick buck. However, as the businesses come back on track, we believe this excess liquidity will be pulled out again and find its way back in to their respective businesses. Further any retracement of fiscal stimulus provided by global central bank could also push the debt yields higher sucking out the easy liquidity available in equity markets.

- **Benchmark nifty valuation trading again at all time high**

Nifty 50 is currently trading at a TTM PE of ~27x vs its long-term average of ~19x. The liquidity driven rally coupled with earnings downgrades has led to expensive valuation of benchmark index. Typically, markets have corrected every time the benchmark nifty valuation has swelled to 27-28x – we wonder whether this time will be any different?

However, one needs to be mindful of the fact that the index run up has actually been on back of only a few select stocks, making it look expensive in general. Barring pharma, FMCG and consumer sector, most other sectors are much below their previous highs:



OUR PORTFOLIO UPDATE

In our last update we had discussed in detail about the stress test that we took on our portfolio companies on various parameters to assess their longevity through this pandemic. We are happy to report that despite the challenges and stressed economic conditions most of our portfolio companies have been able to stand in good stead and have quickly geared up to the changing environment:

- **Utilization levels back to 60-70%**

After a complete wash out in April and an average May, most of our portfolio companies are back to ~ 60-70% capacity utilization in June. Despite the ramp up in capacity utilization in June, given the damp beginning of the quarter, we expect some of our portfolio companies to report operating losses for 1Q. However given the strength of the balance sheets and the businesses that our companies are in to, we expect a much better 2H and return to growth trajectory in FY 22 for most of our companies.

- **De-leveraging visible in most of our companies**

Quite a few of our portfolio companies have de-leveraged during the March quarter – interestingly this deleveraging is not only for repaying of term loans but reducing the working capital limits as well. This has helped in making the balance sheets leaner and more agile. Majority of companies have deferred their cap-ex plans as well, and are looking to maintain an adequate amount of liquidity. We strongly believe that better cash and working capital management, combined with better cash flows from operations will help the companies sail through the difficult times that lie ahead.

- **Conservatively reduced our projections for FY 21, while expecting a much better FY 22**

Given the damp 1Q result expected due to the lockdown and further uncertainty with respect to resumption of normal economic activities, we have conservatively reduced our profit projections by 25-35% for most of our companies in FY 21 and expect a handsome recovery in FY 22. We continue to keep a close watch on our businesses and will review our projections from time to time. ***We are happy to inform that we have been positively surprised by 1Q results of a couple of our companies which have announced their results till now making us revise our projections on the upside!*** We are certain that as pandemic subsides and economic activity resumes, most of our companies will bounce back with a bang.

OUR STRATEGY GOING FORWARD

We have a cautious approach from the benchmark index perspective at this point in time for the reasons discussed earlier in this newsletter. Having said that we are seeing a lot of deep value in our own portfolio companies which we continue to add selectively and are also seeing a lot of value opportunities in the broader market within our scope of expertise.

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- JUNE 2020 -

In line with our communication in the last newsletter for initiating our multi cap strategy, we are happy to report that we have added 2 new stocks in our portfolio during the last quarter – a Rs. 2000cr market cap FMCG company trading at 9x and a large commodity company with market cap of Rs. 26000cr trading at 7x. Both the companies are debt free and enjoy leadership status in their respective businesses and have large amounts of free cash available on their balance sheets.

We continue to believe in the value investing strategy as historically also, 'Value' theme has recovered better than 'Growth' theme, post market corrections.

Year	Returns post Corrections	
	MSCI India Value Index	MSCI India Growth Index
2008 to 2009 (Lehman Crisis)	116%	110%
2013 to 2014 (Taper Tantrum)	41%	35%
Feb-16 to Nov-16* (China Crisis)	15%	11%
2018 to 2019 (NBFC Crisis)	10%	7%

Source: Edelweiss Research. Past performance may or may not sustain in future. * All returns mentioned are 1Y returns except for Feb-16 to Nov-16. For 2008 to 2009, Period considered is 20-Nov-08 to 20-Nov-09, For 2013 to 2014, Period considered is 31-Aug-13 to 31-Aug-14. For 2018 to 2019, Period considered is 30-Nov-18 to 31-Dec-19. Returns mentioned are in absolute terms. Past performance may or may not sustain in future

Source: MOSL

As always, we remain committed and aligned with our investors interest and will be happy to take your questions if you need any specific information on any of our portfolio companies and / or any other queries. Please feel free to reach out to us at pawan.b@equitreecapital.com / skabra@equitreecapital.com.

Please take care, stay at home and stay safe.

Warm regards.

TEAM EQUITREE
www.equitreecapital.com