QUARTERLY UPDATE

EQUITREE
SOWING SEEDS OF GROWTH

- OCTOBER 2019 -

"A stock market decline is as routine as a January blizzard in Colorado. If you're prepared, it can't hurt you. A decline is a great opportunity to pick up the bargains left behind by investors who are fleeing the storm in panic."

– Peter Lynch

THE WAIT GETS LITTLE LONGER

Over the last couple of quarters, we have shared various statistics on the markets, economy et al and how they all collectively indicate towards a conducive set up for renewed vigour in small and mid-cap investing – with a caveat of faster resolution of the NBFC liquidity issues and visibility of the earnings coming back. Despite occasional small bouts of action *(eventually turning out to be false alarms!)*, a sustained buying interest in the broader markets still remains elusive – primarily getting plagued by the same issue – lack of trust on the health of financial institutions on one hand and a much slower than expected visibility of earnings growth. In hindsight it appears that while we were conscious of the liquidity related issues and the impact that it could have on the broader economy, we undermined the scale of the issue and were over optimistic in our assumption of a faster redressal and broader interest coming back in Indian equities sooner than later.

Enumerating hereunder some of the macro factors which has continued to dampen the investors' interest in the broader markets:

- GST collection for September 2019 dipped to 19 Months low of INR 91,916Cr. Business slowdown is visible which has resulted in lower indirect tax collections.

- Commercial Sector Flow of Credit: Slowing credit growth is indirectly hampering the consumption across the country. Banks and NBFC's have now become very cautious while lending whether it's to the corporates or retailers.

(% Growth YOY)	AUG 2019	AUG 2018
Gross Bank Credit	9.9%	12.2%
Non Food Credit	10.1%	13.5%

Source: RBI

- De-growth of 12.25% in production of vehicles (including PV's, CV's, two and Three Wheeler) from April-Aug 2019
- Overall domestic sales of vehicles continued its de growth for ~10 Months. Festival season saw some pick up in retail sales but wholesale on the other end continued to decline.
- Manufacturing PMI was at 51.4 in September 2019 unchanged from August 2019 and is at a lowest level since May 2018.
- Q1FY20 GDP growth rate falls to 5%.
- Fresh warning alarms from stress in financial sector – the PMC Bank / HDIL fraud, instability at Yes Bank (despite doing one round of QIP from marquee investors), Indiabulls Finance PIL being admitted

GOVERNMENT AWAKENS WITH REPONSES – *ALBIET A BIT SLOWER*

The government has (finally!!!) bit the reality on ground and has acceded to the fact that Indian economy is indeed going through a slowdown and needs major reforms / actions to bring it back on track. After all the time lost pre and post general election and learning curves of the new Finance Minister, government is now open to listening to problems across sectors and address the same as soon as possible in order to bring consumption & economy back on its feet. Since the presentation of the long term vision plan (Budget 2019) and a very adamant posturing around it, we have now seen the Finance Minister doling out something or the other on a weekly basis (including reversals of some not so market friendly decisions taken by them in FY19) and trying hard to bring the economy back on track. Some of the measures taken by the government which addresses the problems across different sectors:

- **Addressing the liquidity issue:** Finance Minister announced slew of measures recently which were aimed at infusing the much-needed liquidity in the system. Some of these measures include:

    - Additional Liquidity Support wherein the NHB (National Housing Bank) can extend up to INR 30Kcr credit lines to the HFC's (Housing finance companies) as compared to INR 20Kcr previously.

    - Partial Credit Guarantee Scheme for purchase of pooled assets of NBFC up to INR 1 lakh crore.

    - An additional capital of Rs 70,000 crore has been sanctioned for banks, which will enable loans worth Rs 5 lakh crore.

    - Banks to organize loan Melas for NBFC's and customers in 400 districts in order to boost liquidity in the system. Government recently announced disbursal of over INR 81,700cr of loans in their first such initiative over a 9-day loan Mela

This sector has been the core reason for overall credit crunch in the economy and its contagion effect affecting consumption across the country. Government has taken these steps to bring back liquidity in the economy which should indirectly address the demand issues faced across other sectors as well.

- **Roll Back of FII Surcharge:** The surprise surcharge levied on capital gains for FIIs / High Net worth Investors in the budget 2019 which triggered indiscriminate selling by FIIs and HNIs alike was finally rolled back by the FM. The roll back indeed helped in soothing the nerves and put a check on the continuous selling in the markets.

- **Relief package for the Auto Sector:** Auto sector being the worst hit in this economic slowdown found some relief when the Finance Minister announced a stimulus package in August 2019. Government removed their own ban on purchase of new vehicles, postponed the revision of registration fees to 2020, additional depreciation levied of 15% on inventory and confirmed that they will soon announce a scrappage policy. Road Minister, Mr. Nitin Gadkari diluted his earlier aggressive stand and went on to clarify that they don't intend to stop selling diesel & petrol cars in the near future. These measures helped in offering some solace to an otherwise very anxious auto industry.

- **Export Incentive:** Finance Minister announced a new scheme of remission of duties or taxes on export product – incentivize exporters at an estimated cost of INR 50kcr. Rodtep (Remission of duties or taxes on export product) scheme will replace existing schemes and benefit the exports further. This will boost the overall exports of the country which has been facing issues post demonetization and GST.

- **Corporate Rate Cut:** This was one of the biggest and most unexpected announcements made by the government to provide an impetus to the slowing economy and has brought India in line with major economies across the world in terms of corporate rate. Slashing the corporate tax rate from 30% to 22% (before cess) will add additional cash flow generation in the hands of these companies and flow into either capex, dividends, acquisitions or other plans which will directly or indirectly benefit the company profits & shareholders wealth. Government also slashed the MAT rate from 18.5% to 15% and lower tax option of 15% for new manufacturing companies (Set up after 1st October). ***This announcement led to short term sentiment boost which led to jump in the index Sensex by ~3,000Points in 2 days. Majority of our portfolio company's pay taxes in the range of 30%-35% and are going to benefit substantially post this rate cut*.**

- **RBI surplus reserve to the government:** RBI approved the transfer of record INR 1.76Lakh Crore dividends and surplus reserve to the government. This will help the government boost the economy without having to stretch the fiscal deficit.

- **Fast track payment of outstanding government dues:** Finance minister recently met 32 CPSE's (Centre and Public-Sector Enterprises) to discuss the outstanding payment issues and capex situation. Post this government confirmed that all outstanding dues to vendors and dealers shall by paid before October 15th. This is also a big positive for companies having exposure to government payments and these payments will improve the overall working capital of these companies.

- **Repo Rate Cuts:** RBI has been consistently reducing the Repo rates and has reduced the same ~1.35% over the past 1 year to spur growth. However, not much of this has percolated down by the commercial banks as yet. RBI has been consistently chasing the commercial banks to reduce their lending rates and only recently, SBI and a few others have started reducing their interest rates. We believe as the reduced interest rates percolate down to borrowers this could lead to a revival of private capex and consumption to some extent.

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We believe that the series of fiscal and monetary measures taken by the government now reflects their serious intent in addressing the slowing economy and getting the growth back on track. Nevertheless there is likely to be some lead time before impact of these measures start getting visible as most of these measure have been announced in late August – September’ 2019. We expect the economy and likewise corporate earnings to start showing signs of improvement from quarter ending Dec’19-Mar’20.

NOT ALL IS LOST THOUGH – SOME EARLY GREENSHOOTS ON THE HORIZON

Despite an overall sluggishness mood, there have been some pockets of exuberance as well.

- Amazon recorded INR 750Cr worth of Mobile Phone Sales in 36 hours during the big billion day offers.
- Amazon & Flipkart together sold merchandise of ~ Rs. 19000cr over 4 days (during big billion-day sales) across areas like electronics, beauty, baby care, furniture, private labels and so on.
- Interestingly despite the current auto slowdown in the auto industry we saw massive bookings for new car launches like MG Hector & Kia Seltos. So much so that both the companies have already announced expansion of their capacities to meet the demand
- Uniqlo, a Japanese retailer clocked sales of INR 2.2Cr in first two days at its maiden store in India.
- Mercedes sold 200 cars in a single day on Dussehra in India.
- April –June 2019 FDI inflows increased by ~33% as compared to the similar period of previous year.
- Consumer Finance companies like Bajaj Finance and one of the largest retailers Dmart reported 63% and 48% growth in Q2 profit!

This kind of purchasing power makes one think whether there is indeed paucity of discretionary incomes or is it just sombre market sentiments deferring the demand – which got tapped in by offering discounts and / or introducing better product! We hear from companies on the ground that despite a slow start to the festive season, demand seems to be coming back. We believe that as the government's efforts start yielding in with better macros, there is enough latent demand waiting to be unleashed, which in turn should lead to better corporate performance and overall market returns as well.

PORTFOLIO OVERVIEW

Q1 FY20 has seen one of the slowest GDP growths in the recent times @ 5%. This overall slowdown has had an all-encompassing effect on corporate earnings as well. In line with this slow down coupled with the push back of business due to the general election has impacted performance of our portfolio companies as well during the Q1 leading to de-growth in profits for most of our companies having exposure across different sectors. Given the slow pick-up in the economy, we are expecting some more headwinds for Q2 and have accordingly scaled down our projection for most of the portfolio companies for FY20.

The de-growth in profits along with a very negative sentiments in the markets have dragged the valuations of the companies to a multi-year low – with most of them trading way below their 10-year average P/E multiples.

We have been very closely reviewing each of our businesses and strongly believe that most of our portfolio companies have the tenacity and agility to cope with these cyclical headwinds – we would like to draw your attention that most of our portfolio companies have been in existence for over a few decades and have experienced these kind of cyclical turns and have always emerged stronger! We reiterate that none of our portfolio companies have been dragged down for want of any "poor corporate governance" and / or any wilful defaults et al. Having said that, we have taken corrective actions wherever we realized that the business environment has become irrevocable and will continue to monitor the situation closely and keep taking corrective measures wherever required, if any.

Based on discussions with various stake holders on the ground, we believe that one could start seeing some positive trends by end of Q3/Q4 of FY 20 and are looking for a much stronger come back in FY 21 – both in absolute terms as well relative term on the back of a modest FY20.

In our opinion as the growth for most of these companies come back, their valuation would also start getting closer to the 10-year averages – which in turn suggests that most of them are likely to see a 2-3x (or more in some cases) return over the next 18-24 months.

As we manoeuvre through these volatile times, we continue to cautiously add some of our portfolio companies as they trade at valuations last seen in 2008 and are also looking to add some new names in the portfolio where the business is looking robust and the valuations are in our favour.

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.

Lastly, we take this opportunity to wish all our investors a very Happy Diwali – ***May this festival of lights bring in new freshness and gleam in your lives and look forward to more prosperous Samvat 2076!!***

Warm regards.

TEAM EQUITREE
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