

Annual Letter 2018-19

Dear Partner,

2018-19 will be remembered as the year of de-rating in the broader markets. While headline index is making new highs on the back of select stocks, broader markets continue to drift lower. It's a two-tiered market where only a set of stocks have continued to do well while rest of the lot has just not gone anywhere but south. Our performance for the year was no different.

We had a difficult year. We lost around 20.5% at a portfolio level which affected our 2 year & 3 year rolling returns as well. Since its inception, the model portfolio has returned 29% CAGR.

Model Portfolio Performance

CAGR since Inception (Nov 2009)	29%
Rolling CAGR in last 3 Years (FY 2017, FY 2018 & FY 2019)	10.6%
Rolling CAGR in last 2 Years (FY 2018 & FY 2019)	1.7%
Returns During FY 2019	-20.5%

It continues to be a challenging environment for our investment style with growth stocks performing much better than value stocks. We are not averse to investing in growth companies. However, we are not comfortable in chasing growth at valuations that are out of our comfort zone. At this point in time, we have a far higher comfort in value + growth bucket. As long as our stocks are trading at a big discount to their fair values, we are not worried.

FY 19 was worse than our last bad year in 2011 when we were down by -6%. Our strategy has not worked well over the last 24 months. We have seen such phases of prolonged underperformance earlier as well. Our long-standing partners & clients have seen us navigating successfully through downcycles & we are grateful for their continuous support, increased commitment.

Investment styles too go through cycles. Sometime stocks you own are just out of favour & no matter what you do, it just doesn't work. Markets keep telling you that you are wrong. We are going through one such phase at this point of time. Yet – we believe we have a clear understanding of what we own & why we own it. Looking forward – we are very excited about the current composition of the portfolio & we expect above average outcome.

Periods of underperformance are not pleasant, but we are determined to continue with our deep dive approach & look for opportunities, as we always have.

We continue to look for opportunities in underlying theme of leaders with temporary headwinds + large undervaluation + entry barriers. We believe this is great time to invest in companies where balance sheet correction is due i.e. domestically focussed companies where capacities have been created & utilisation is moving up at a steady state rate. As cash flows improve, these companies can reduce their balance sheets & equity values can improve along with overall enterprise value.

Portfolio Changes

During FY 19 - We exited 2 stocks & there were 5 new additions to the portfolio. As FY 20 began, we added 3 more stocks & exited 1 stock during May 2019. So overall, 8 additions & 3 exits over the last 14 months.

At this point our portfolio is spread across consumption, agri, media, corporate banks & core sectors.

Exits

KRBL

When we first got into KRBL around 2010-11, it was trading at 600-700 cr market cap. Company was largely under the radar & was being perceived as a commodity business despite 90% + business coming from B2C sales, mainly due to its high working capital issues. KRBL must keep huge inventory of basmati rice & age it for 12 to 18 months & that's where the large part of value addition happens. With time things changed, operational efficiency improved as well, and the perception of the business changed. The stock has been re-rated. What used to trade at 0.4x sales, traded at 3.7x sales last year. We felt there was a good amount of optimism about stability of company's future earnings which is being reflected in the valuations leaving no room for error. We exited the stock around 500-550 range, at around 11000 cr to 12000 cr market cap during May 2018.

CESC Limited – Special Situation

We entered the stock around April 2018. We took a call on the sum of parts valuation which was turning out to be 40-50% higher. Given the impressive return profile of power distribution business, the de-merger of CESC looked like a very attractive special situation with a reasonably good margin of safety. However, the regulatory authorities did not allow the proposed de-merger of power generation &

distribution business. Instead of 4-way de-merger, it panned out to be a 3-way de-merger. We took a -15% hit & exited the positions in October 2018.

Pennar Industries

Pennar industries is a diversified engineering company which caters to railways, solar, automobile, consumer appliances, water treatment & few other industries. While their solar division was doing well, the other divisions struggled. Now their railways, tubes & other divisions are doing well, and solar outlook doesn't appear too good. After holding the stock for almost 3-3.5 years, we exited the stock in May 2019 & booked a loss of around 20%.

Product focused companies with applications across various industries is okay, but when you have an umbrella of various diversified businesses under one structure, having all engines firing at one go is a bit difficult. Some or the other division can always throw up a surprise. We failed to assess these risks while entering the stock. Betting on standalone businesses seems to be a much better idea, unless there is a special situation & value creation via corporate actions is guided for.

New Additions

During last 12 months, we have added 7 new stock ideas in the model portfolio. 5 out of these 7 stocks are from the old economy / core sectors. While the other 2 are from consumption & agri space.

Revival In The Core Sectors

As discussed in our earlier posts this year, we remain very positive on the revival of capex cycle & growth in the core sectors. Excess capacities which were built during the hey days of 2008-2011 came back to haunt us for almost a decade. Lot of projects were undertaken just because funding was easily available. As a result, the capacity utilisations suffered, balance sheets went for a toss which affected the banking sector as well.

Now capacities are getting filled up & base demand is growing with every passing year. Despite the pessimism all around & talks of slowdown, the fact is that our steel demand continues to grow at 6-7%. Per capital consumption of Maharashtra is north of 80 KG, while Uttar Pradesh is at less than 15 KG. Such gaps across regions will narrow down over the next decade. India's steel production base has moved from 60 MT to 105 MT over the last decade. With installed capacity of 140 MT, it is very likely that we may start facing shortage of steel in another 2 years from here on. Utilisation of existing capacities & new capex is inevitable. We believe that cost of structure of Indian steel companies is much

better & they can compete with global peers. Government will continue to be in high protection mode for steel since Chinese players are selling well below their cost of production.

India's peak power demand has risen from 120 GW to 180 GW over the last decade. Last mile connectivity of electricity is all set to play out as we move forward. If we extrapolate the current consumption trend, India will absorb its entire excess thermal capacity over the next 5 years. It takes 5 years to build a thermal plant & there is no alternative to support the base load other than thermal. Capex has to begin sooner than later. As power generation picks up, India will mobilize 200 MT + incremental coal & the entire value chain around it should pick up.

At the same time, we are somewhere at the tail end of the NPA mess. Over the last 5 years, almost 10 lakh cr worth of bad loans have been provided for. Since 2015, we have had a sub-par credit growth on the corporate side. The chances of very high slippages is low. Old mess is being cleaned out. Insolvency & Bankruptcy code is a major reform and has permanently changed the game. Now the pendulum is evenly balanced & lenders have better resolution mechanism in case the asset turns bad. And this is just the beginning of IBC. As we move forward, the code will witness further evolution & will keep on getting better. The stage is set for strong credit growth as banks witness writebacks & provisions taper off. PSU banks with large corporate exposure + retail franchise should do well in the times to come.

Modi government believes in incremental approach. It will continue to cruise on the reform momentum. Piped drinking water to every home & 1 trillion \$ spending on infrastructure is going to be the top agenda during Modi 2.0. Infrastructure spending will continue to inch up on a higher base & implications are huge. 41% of value addition in the manufacturing sectors comes via SME sectors. As the investment cycle picks up, a well spread out job recovery & consumption should not surprise us. Investments fuel consumption & not vice versa. Every unit spent on infrastructure will eventually lead to increase in consumption appetite.

Aversion Towards PSU's

'There is no incentive for PSU managers & employees to perform better. Hence it does not merit an investment case.'

It's a widely held view & true to a large extent. In our view, PSU's don't do well because of their managers but despite them. Most of the PSU's are linked to activity in the old economy. They have natural resources, excess land for brownfield expansion & access to capital, and in many cases, they do have strong balance sheets. Their performance is largely dependent on the government spending cycles & external environment. Betting on PSU's is akin to betting on external environment including the

political establishment. These are not buy & hold forever kind of investments. One must be conscious about exiting them as well.

External environment is improving & PSU valuations are still hovering at historical lows. We are invested in a couple of PSU stocks & continue to look for opportunities within this space.

It's a highly two-tiered market we have seen in a long time. Only handful of stocks are doing well while broader markets continue to be in pain. Almost 60% of mutual fund & FII AUM is invested in top 10 NIFTY weights. This is the best time to re-balance portfolios. Scale up the high conviction ideas while markets are giving opportunity & scale down or trim the ones with low conviction. Investment returns are lumpy, they occur in spurts. It is important to stick your neck out & stay with the approach if the underlying thesis is intact.

We really struggled to find investment ideas during 2017-18 and were not able to deploy. But now we have quite a few ideas on the table. Our buy's are businesses that are doing well & are priced at really low valuations. Bombed out valuations + peak pessimism + improving fundamentals is a great combination to be in.

"In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes." – Howard Marks

Chetan Phalke

CIO - Alpha Invesco Research, June 2019