April 07, 2016

Dear Investors,

We wish all our current and prospective investors a Happy Fiscal 2017 and enumerate through the course of this newsletter why prospects for Indian Economy and on back of that Indian Equities look better than the concluded fiscal. While a lot of these positives seem small in their individual capacities, the confluence we believe could create a great foundation for a more secular growth and help India attain its optimum potential.

The first quarter of Calendar 2016 could be well summed up in one brief statement "Equity markets are subject to market risk" and this risk essentially takes form of volatility in asset prices. On the back of expected Fed tightening, hard landing in China and weak global growth outlook – in sync with global indices, India's Nifty 50 index fell 2.6% during the quarter. However this single headline number masks the intra-quarter sharp correction and the recovery that followed. In our Jan 2016 newsletter we had highlighted the earnings and valuation challenges that the market faced, particularly midcaps. Nifty 50 corrected 12% to reach its 52 week lows in Feb 2016. However, with budget installing fiscal and monetary confidence, the market has rallied ~11% from the lows.

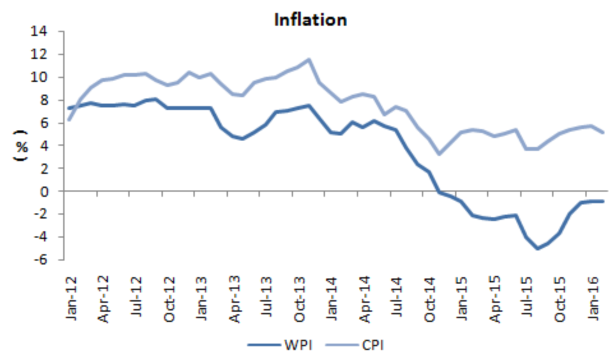
While the doomsayers will overplay the volatility, isn't that the inherent nature of equities. However for people like us who believe in longer term compounding such volatility provides an excellent opportunity to build positions in some really high quality businesses. We will briefly dabble with few such names later in the letter. These names fit very well into our investment philosophy that pivots around two central themes – compounding and preservation of capital.

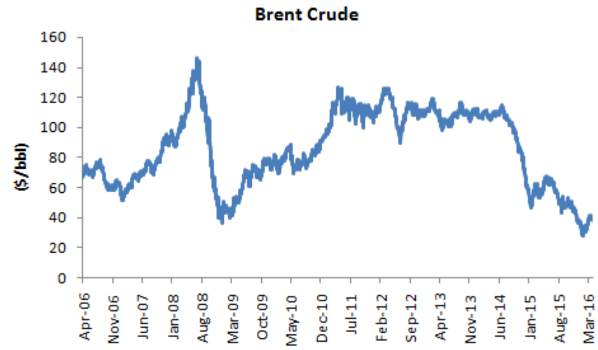
We would like to reiterate our view that the price and time correction witnessed in last 15 months along with multiple changes on economic front set a good base for positive equity returns over next 18-24 months. The old adage stays "Markets are driven by earnings over a long period of time". One of the primary reasons for lackluster returns by Nifty 50 in FY11-16 (Yes, even after the Modi rally, Nifty CAGR in last five years is only ~6%) is the poor earnings show by the companies. Nifty 50 earnings during this period has grown at a 4% p.a. This essentially means that a third of Nifty 50 returns in the five-year period came from P/E re-rating despite the lower than trend earnings growth, helped by abundant global liquidity. With US directionally moving towards rising interest rates, the market will now require higher earnings growth to maintain the positive returns trajectory. Help from valuations re-rating will be limited as Nifty 50 is currently trading near its long-term historical average on TTM earnings.

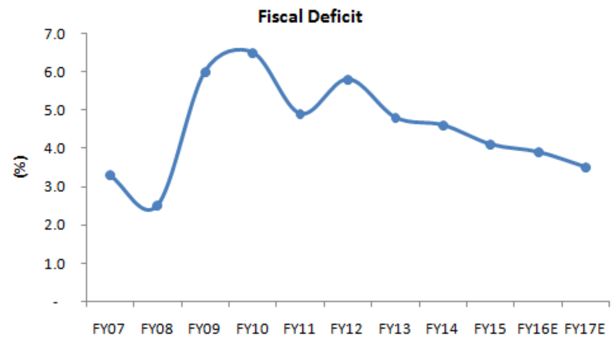
Our optimism on the earnings growth recovery is underpinned on macro as well as micro factors. While in a country of a billion plus diverse aspiration, it’s often easy to criticize the government of the day we believe some of positive developments often go unnoticed and are underappreciated. In last two years Prime Minister Narendra Modi’s government has taken multiple steps on policy front which we believe will go long way in changing the economic landscape of India. Some of these are transfer of subsidies through DBT, crack-down on black money, financial inclusion (through Jan Dhan scheme), rising government spending in infrastructure and bankruptcy code. Introduction of GST will be another transformational step. Accommodative monetary policy by RBI will be one more positive catalyst. These changes though individually small sized, when put together will have a large compounding effect. The best way to put this is through the epidemic phenomena explained in ‘Tipping Point’ by Malcolm Gladwell. As humans we have hard time understanding geometric progression arising out of interaction of small changes as the end result may seem far out of proportion to the cause. Some of important factors (not all inclusive) that we expect to have positive impact are:

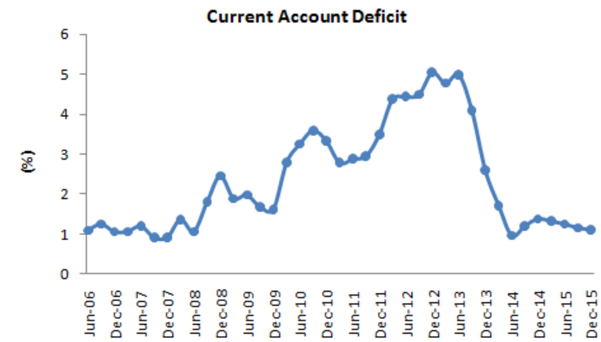
Fall in global commodity prices: India is heavily dependent on imports to meet its energy needs with 5-6% of the GDP as the net import bill. The reliance on import is even higher at 80% in petroleum, which constitutes one fourth of energy needs. The fall in global crude price will have significant impact on country’s finances. The expected savings could be as large as 3% of the GDP. Current account deficit which has worsened to as high as 5% of GDP in 2012 is now expected to be at much manageable rate of 1.1%. The petroleum fuel prices in India are now market linked, the government has taken a prudent step to increasing taxes on fuel. Apart from shoring up fiscal finances in near term, this will allow smoothening of end-consumer prices and hence inflation in future when global crude prices starts rising again. Boosted by growth, India is now expected to be third largest consumer of petroleum globally. The government has also started using its market position to bargain better pricing.

Lower inflation: India’s wholesale price inflation (WPI) has been in negative trend for last 16 months led by the deflationary trend in crude prices. Consumer price inflation (CPI) too has moderated sharply form ~10% levels in 2013 to a benign ~5% in February 2016. More importantly, food inflation which has been plaguing consumer spending heavily has also now moderated to less than 6%. This is despite successive two years of lower than average rainfall in the country.









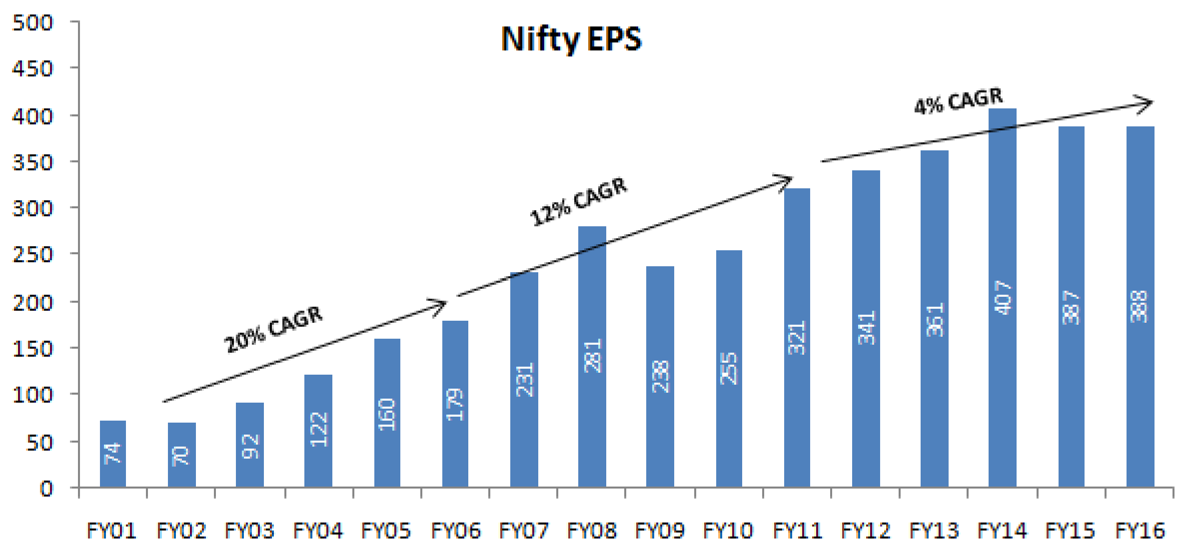
Source: Bloomberg

Crack-down on black economy: An important highlight of the current government is its initiatives to curb large scale corruption in government activities. One of the first steps after coming into power was to choose the auction process for allocating mines rather than the earlier arbitrary process which was susceptible to crony-capitalism. The process for appointing the chief of public sector banks, which are another major victims of institutionalized corruption, has also been improved. The government has also brought in new legislation which has punitive and criminal charges for hoarding black money. Demand for real estate and gold, which have been major beneficiaries of black money, is also getting impacted because of government's stringent steps.

Improving infrastructure quality and spending: The government has put forward ambitious plan to spend $130bn over next five years to improve railway infrastructure. A bulk of the spending will go into capital expenditure for capacity augmentation which had taken back seat earlier. Execution of many road and infrastructure projects that were earlier stuck are now back to implementation mode. Apart from this, the government has also unveiled its plans for smart cities with focus on improving quality of urban life as well as drive infrastructure spending.

Accountable subsidies: Another major change in fiscal spending is the subsidies payment. Enabled by Aadhar, subsidies are now directly paid into the beneficiary's banks accounts through DBT scheme. As per government estimates, 71% of LPG connections, 45% of ration cards and 60% of NREGA cards are now linked to Aadhar. In our opinion, this is a game changer initiative as DBT will reduce corruption in the system by eliminating the middle-men. By plugging the leakage and fraudulent claims, overall subsidy burden can be reduced and improve effectiveness per rupee spent.

At bottom-up level too we see multiple factors that could lead to earnings growth in FY17 and beyond. The deflationary trend in global commodity prices had a material impact on FY16 Nifty 50 earnings as energy and metals combined constitute ~15% of the index weight. The frontloading of NPAs by RBI further exasperated the situation as they constitute almost one third of index weight.



Source: NSE

Portfolio actions

As mentioned earlier, we have used the volatility in last quarter to start building positions in some four quality names. The companies are in our focus sectors of financials, consumer and technology. As mentioned in our earlier newsletter, our investment philosophy pivots around two central themes – compounding and preservation of capital. To achieve this we will focus on companies that offer superior growth opportunities, have high capital efficiency and are available at reasonable valuations.

The company in consumer sector is a household name with presence in food segment. We like the pricing power and consumer trust that the brand enjoys. The company has a long runaway in front of it to grow as current market penetration of its products is still low. As disposable incomes in India grow, we expect the company to benefit from it. The company is also a very efficient capital allocator with RoEs in excess of 50% on sustainable basis. The valuations had corrected sharply on concern in one of its largest product segment. We expect these issues to gradually resolve and product gain back its earlier strength in future.

We have also taken an initial position in a mid-tier Indian IT services company. It has had a strong track record of consistently growing faster than the industry, and we expect this trend to continue. It has had an impressive client list operating in consumer facing industries. As focus on digital grows, we expect this company to benefit in terms of higher technology spending from these clients. IT services is a business where scale benefits a player and we expect this company to reach $1bn in revenues over next few years. A profit warning for 4QFY16 and certain other technical factors allowed us to get our initial investment in the company.

In financial sector, we prefer private institutions or public sector banks. We believe latter have challenges on capital allocation front because of their social obligations and corruption. We have increased our holding in the largest private sector bank by market capitalization as we found the valuations in correction to be attractive. We believe this bank is a long-term compounding story because of its consistent growth, high return ratios and best-in-class asset quality. We have also taken an initial position in a mid-sized private sector bank. The valuations for the bank had corrected sharply because of investments that it is expected to make to sustain its growth. We believe the franchise still has significant amount of room for growth. Cheap valuations compared to history and peers made the position attractive to us.

Once again, we thank you for showing your interest in Anived PMS and look forward to your continued relationship with us. In case you have any queries, please feel free to contact us.

Warm Regards,

Prakash Kapadia	Hiral Desai
Principal Officer	Portfolio Manager

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