Anived Portfolio Managers Pvt. Ltd.

CIN NO : U65923MH2015PTC260965

#thistimeitsdifferent……..

July 27, 2016

In this letter:

- Market valuation and outlook
- Consumer sector or fixed deposit – take your pick
- Portfolio action

"Bull-markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." – Sir John Templeton

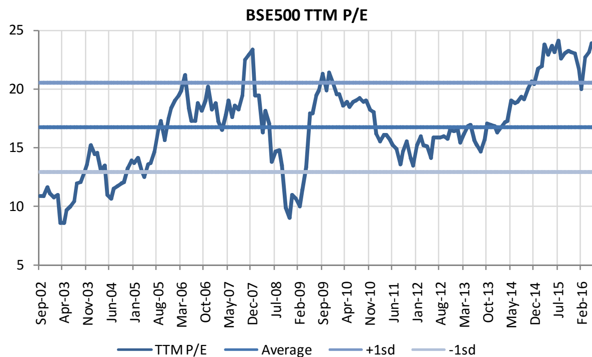
Dear Investors,

The above quote from the revered value investor, Sir John Templeton, very aptly describes the current market sentiment. His value-contrarian investing style of hunting for bargains in depression and selling when markets are at peak is what every investor aspires to do. However, that is precisely our predicament at current juncture – finding bargains at prevailing premium valuations. It is difficult for us to pinpoint what stage of bull-sentiment cycle we are on – optimism or euphoria – but we are definitely past pessimism and skepticism. Major events like China credit concerns and global commodity price crash at beginning of year and recent events like Brexit have been brushed aside pushing BSE500 up by ~8% for year-till-date. Even domestic events like exit of RBI governor Raghuram Rajan and stiffening of inflation have been ignored by the bond and equity markets. What makes us more uncomfortable is that this rally is despite any material improvement in the earnings outlook of the companies. Rather, earnings for the broader markets have seen downward revision in last six months with the hope for recovery in growth getting pushed forward to next year every quarter. What is fueling this optimism? We believe it is a mixture of hope of earnings recovery because of good monsoons and possible passage of GST bill coupled with overflowing global liquidity. The markets remains flushed with liquidity coming from a deviant global setting. Across the world central banks in developed economies are in a race of quantitative easing, pushing many sovereign bond markets in to negative yield trajectory. For the first time in history, an unprecedented $11.7tn of sovereign debt globally now offers negative yields. To put this figure in perspective, the total of sovereign debt issued by all the countries in the world is estimated to be $61tn. With global demand remaining sluggish, this liquidity is getting pushed to speculative assets like emerging market bonds and equities rather than being put to productive use. The week before 20 July saw a record $4.9bn rushing to emerging market bonds.

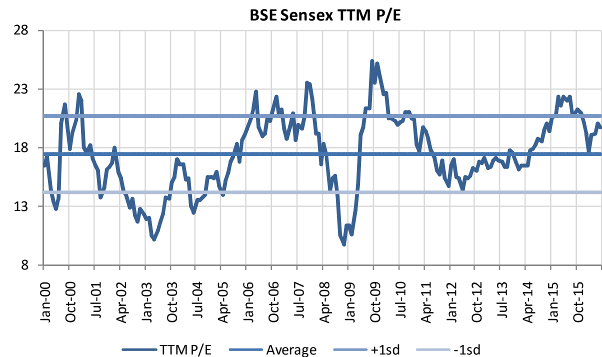
Regd. Office : Unit No. 708 and 709, Trade World, C Wing, Kamala City, Senapati Bapat Marg, Lower Parel, Mumbai – 400013.
Tel. : +91 - 22 - 4926 7900 • Fax : +91 - 22 - 4926 7910 • Email : info@anived.com

A normal monsoon after two successive years of drought is fueling hopes of rural demand recovery. Though the agriculture sector constitutes only ~15% of the GDP, its impact on India's consumption is high as still ~70% of population is in rural. A possible passage of the GST bill which will remove many roadblocks faced by the organized sector in India is further adding to the positive sentiment. As highlighted in our April 16 newsletterwe believe in the long-term India growth story because of structural changes that are happening. However, in our opinion, current valuations are running ahead of the fundamentals. The euphoria is clearly visible in the broader index with BSE500 currently trading at ~25x on TTM earnings. The last time it saw similar levels was in January 08 before the global financial crisis set in. This is despite earnings growth trajectory remaining weak for the companies. Midcaps in particular have moved into the overvalued zone are trading at substantial premium to the larger peers. Another data point that keeps us skeptical is the amount of money rushing into IPOs irrespective of the quality of the company.

BSE500 is trading at close to Jan08 levels…

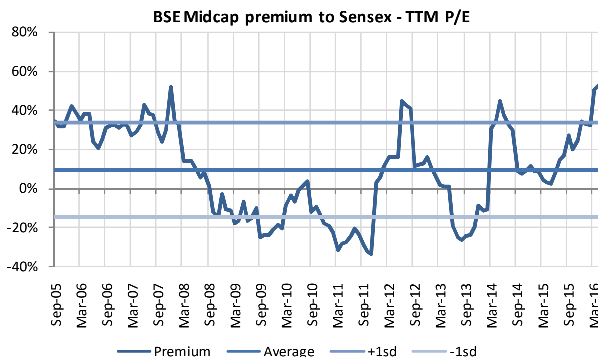


…with Sensex too trading above average

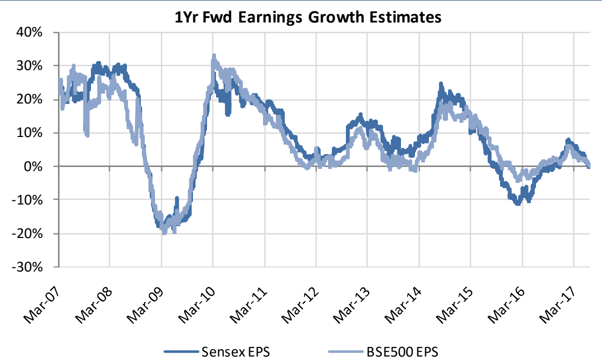


Source: Bloomberg

Midcaps trading at significant premium to largecaps…



…earnings accelaration remains elusive



Source: Bloomberg

Consumer sector or fixed deposits – take your pick

Another area where we believe that valuations are running ahead of fundamentals is the consumer sector. Our CAGR*BMQ framework (which we have elaborated in our January 2016 newsletter) is the cornerstone of our investment philosophy. Whenever we have applied this framework to listed Indian equities in the past, there are a few sectors which feature repeatedly and in some cases are well represented with a number of companies making the cut. Consumer sector, including some quasi-consumption themes like paints, regularly makes the cut driven by extremely strong fundamentals – secular demand/growth trends, long-runway for growth, tight working capital cycles (negative in some marquee names), superior return ratios and huge cash generation.

While it's difficult to argue the merits in not owning these businesses the challenge right now is with the valuations. Given the overall uncertainty in the global macro environment (US Fed interest rate hike, commodity slump, Brexit and contagion related to that) and tight domestic factors (Banks asset quality challenges, broad industrial slowdown, FDA issues with pharma, global slowdown fears in IT) consumer businesses have become a secure hiding place. Valuations on an average for our consumer universe has moved up by 25%, from ~28x one-year forward P/E on an average in May 2014 to ~35x in May 2016 (based on our FY17 earnings estimates). However there are some outliers here which we have highlighted in yellow below where either growth expectations are lower v/s past (ITC, Bajaj Corp) or have been impacted by one-off's (Nestle). Adjusted for these aberrations, P/E have expanded by 34% on an average. Considering the swift and sharp move in valuations we are now underweight on the sector with ~7% exposure.

Re-rating in consumer stocks – one-year forward P/E

Company	**May-14**	**May-16**
Britannia	25.1	47.2
Bajaj Corp	21.2	18.8
Dabur	30.4	33.2
Emami	21.5	38.8
Marico	26.3	36.9
ITC	28.1	25.4
VST Industries	18.4	16.3
Titan	33.7	32.7
Pidilite	27.9	40.8
Nestle	42.8	38.4
Asian Paints	32.7	44.2
Berger Paints	30.8	44.9
Kansai Nerolac	25.5	37.6
Colgate	33.3	36.0
Average	**28.4**	**35.1**

Source: Anived

If we were to look at a scenario where we assume mean reversion of longer term P/E (10 year averages) and build in the same earnings growth CAGR of an average 19% reported by our universe over FY06-FY16 for next 4 years, we would make an average 5.8% return. Hence the conundrum of owning FMCG stocks or just investing in secure bank FD's. In the same context we would also like to highlight that gross margins reported by most consumer companies are at life time highs (which aided earnings growth in FY16 despite anemic revenue growth in most cases) and are unsustainable over the mid to long term in our view. The tables below charts out the details.

FY16 growth metrics

Company	Revenue	EBITDA	Adjusted PAT	FY06-16 earnings CAGR
Britannia	10.7%	48.3%	51.0%	19%
Bajaj Corp	5.8%	14.8%	14.2%	20%
Dabur	8.1%	15.9%	17.5%	18%
Marico	7.0%	22.5%	25.9%	22%
Pidilite	10.8%	53.4%	46.6%	20%
Asian Paints	9.5%	28.5%	32.2%	23%
Berger Paints	7.6%	31.9%	39.7%	16%
Kansai Nerolac	8.1%	28.7%	31.0%	10%

Source: Company

Gross margin movement FY11-16

Company	FY11	FY12	FY13	FY14	FY15	FY16	Δ FY11-16
Britannia	34%	35%	37%	39%	40%	42%	+762bps
Bajaj Corp	56%	54%	58%	60%	62%	66%	+945bps
Dabur	53%	49%	51%	52%	52%	55%	+172bps
Marico	48%	46%	52%	49%	45%	50%	+179bps
Pidilite	47%	44%	45%	45%	44%	52%	+471bps
Asian Paints	42%	40%	41%	42%	44%	47%	+524bps
Berger Paints	37%	36%	38%	39%	41%	44%	+753bps
Kansai Nerolac	35%	33%	32%	32%	33%	39%	+416bps

Source: Company

Another area which, in our view deserves more investor focus is capital allocation. Most of our universe companies will end up generating significant free cash flows over next 5-10 years. With domestic adjacencies available at exorbitant valuations, some of these companies have chased international acquisitions which haven't been as value accretive as the standalone domestic business.

While markets and stock prices by their very nature can remain irrational for long period of times we as fundamental value investors believe that over longer term averages do hold true. In our interaction

with colleagues in the industry, the throwback has always been of secular long term growth prospects in a very volatile world which we are unwilling to challenge. However we believe that there is a price to be paid for that secular growth based on each investors hurdle IRR's and we do not find the risk-reward favorable as of now.

We would like to end our discussion with a quote from another legendary investor, Warren Buffet.

"Investors making purchases in an overheated market need to recognize that it may often take an extended period for the value of even an outstanding company to catch up with the price they paid."

In every bull market we hear "this time it is different". But for the last three centuries, since the South Sea bubble crashed, one thing is common – that it is never different when it comes to the greed-and-fear cycle. We would love to hear any contrarian views that you may have. Please send them to us at info@anived.com.

Portfolio actions

As mentioned earlier, we have found getting bargains difficult in the last three months. We have increased our holding in some of the existing portfolio companies in financials and technology sector where we believe the valuations remain attractive

We have also increased our holding in a mid-tier Indian IT services company which. The company has a strong track record of consistently growing faster than the industry, and we expect this trend to continue. It has 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 weak 1Q17 performance along with Brexit concerns can provide us with an opportunity to increase our position further at even better valuations.

In consumer sector, we have increased our holding in a value-based retailer whose valuations are still attractive and a good monsoon can have near-term positive impact. We have also initiated our position in a branded apparel retailer targeting India's large, and growing aspirational middle-class. The company has a wide footprint in most of the urban cities. Its portfolio includes India's top four men's apparel brand with each having revenues in excess of INR10bn. It has further expanded its reach by foraying to women's apparel through acquisitions. We believe there are multiple margin levers with the company to deliver above average earnings growth over next five years.

In healthcare sector, we have exited our position in a large cap pharma company. The company is undergoing organizational restructuring which will keep earnings suppressed for some time. The structural challenges that it is facing in its portfolio are material will take few years to correct. Further the ongoing management transition adds to the uncertainty.

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

Disclaimer:

This document is prepared by Anived Portfolio managers Pvt. Ltd. (APMPL) and is provided to you for information only. This document does not constitute a prospectus, offer, invitation, or solicitation, and is not intended to provide sole basis for any evaluation of the investment product or any other matters discussed in this document. Any view expressed in this document is generic and not personal recommendation and/or advice. The information contained in this document has been obtained from the sources that APMPL believes are reliable but APMPL do not represent or warrant its accuracy. Neither APMPL nor any of their respective officers, directors or employees accepts any liability whatsoever, for any direct or consequential loss arising due to relying/acting upon this document or its contents. Past performance is not necessarily an indicator of future performance. Actual results may vary from forward looking statements contained in this document due to various risks and uncertainties, including effects of economic and political conditions in India and outside India. New regulations and government policies may impact the business of APMPL. APMPL does not undertake to revise the forward looking statements from time to time. The product strategies mentioned in the document may change depending upon the market conditions and same may not be relevant in future. Before acting on any information contained herein, the readers should make their own assessment of the relevance, accuracy and adequacy of the information and seek appropriate professional advice and, shall be solely/fully responsible for the decisions taken by them. The sector(s)/stock(s) mentioned in this document do not constitute any recommendation of the same and APMPL or its Directors, officers or employees may or may not have any position in these sector(s)/stock(s).