October19, 2016

In this letter:

- IT – structural or cyclical headwinds
- Portfolio action

"Be fearful when others are greedy and greedy when others are fearful." – Warren Buffett

Dear Investors,

The above quote, though easy to comprehend and sounds rational,however the real test of a value investor's steadfastness lies in implementing it. In our last newsletter of July 16 we had put forward our views on why we believe that the risk-reward offered by broader market is unfavorable for a long-term investor. There has not been much change in either market valuations or our view in the last three months. Fueled by global liquidity, good monsoons, passage of GST bill and recent RBI rate cut, the markets have continued to remain in above average valuation zone. Sectors like NBFCs, discretionary as well as staple consumption and mid-caps continue to remain in what we believe is euphoric zone.

At a time when most of the sectors are in the 'greed' zone, there is only one sector that is in the 'fear' zone viz. technology sector. The sector has sharply underperformed the broader market YTD; especially after the Brexit event BSE IT index has corrected by ~10% compared to ~5% increase in BSE Sensex. There is an ongoing debate on whether the current headwinds faced by the sector are structural or cyclical in nature. We believe that revenue slowdown witnessed in the last two quarters has element of both. We are overweight on the sector in our portfolio construct. And hence, we thought it is best suited topic for this newsletter.

The Indian IT sector has enjoyed a reverential status in the last two decades because of its wealth creation. The emergence of an $110bn export industry from scratch in the last two decades has been the poster child of India's economic liberalization. However, with growing scale, the law of large numbers has also caught up with the industry. Revenue growth rates, particularly coming out of the global recession of 2008-09, have slowed down as the sector has entered the consolidation phase of the industry life-cycle.

Apart from the base-effect, the emergence of new age digital technologies based on cloud and mobility is also threatening the traditional IT services The Indian IT companies pioneered the global delivery model for IT services. This allowed them to garner a market share of 60% in offshored IT services and

15% of the total world-wide IT services spending. As client spending shifts from traditional IT services to new-age technologies, it is natural to have impact on revenue prospects on Indian IT companies. The key question that needs to be answered is: whether Indian IT is losing market share? In 2016, we expect the US$ revenues of the top-5 Indian IT companies (including Cognizant) to grow ~7% compared to low-single digit growth expected in world-wide IT service spend. The subdued growth for Indian companies has an element of cyclical pressure (which we will discuss later) as well as cross-currency impact of GBP depreciation (UK is ~17% of the Indian IT exports and GBP has depreciated by more than 20% in YTD). Hence, Indian IT continues to gain market share, albeit at a slower pace.

Exhibit 1: Indian IT market share

		2011	2012	2013	2014	2015	CAGR
$ mn	Offshore IT services	116,500	127,300	136,450	146,882	163,039	8.8%
%	Offshore as % of total	13.5%	14.4%	15.1%	15.8%	18.1%	
$ mn	India Top-5	32,400	36,318	41,411	46,684	51,245	12.1%
$ mn	India Top-5 as % of offshore	27.8%	28.5%	30.3%	31.8%	31.4%	
$ mn	IT Services spending	609,841	630,269	645,564	664,991	683,806	2.9%
%	India Top-5 market share	5.3%	5.8%	6.4%	7.0%	7.5%	

		2011	2012	2013	2014	2015	CAGR
$ mn	Tata Consultancy Services	9,767	11,177	12,980	15,057	16,237	13.6%
$ mn	Infosys	6,825	7,231	8,095	8,644	9,214	7.8%
$ mn	Cognizant Technology Solutions	6,121	7,346	8,843	10,263	12,416	19.3%
$ mn	Wipro	5,786	6,168	6,483	7,027	7,239	5.8%
$ mn	HCL Technologies	3,902	4,396	5,010	5,693	6,140	12.0%

		2015	2020	CAGR	
$ mn	IT Services spending	683,806	792,718	3.0%	
$ mn	India Top-5	51,245	81,021	9.6%	
%	India Top-5 market share*	7.5%	10.2%		*Assuming same as historical trend

Source: Anived, Nasscom, IDC

Acknowledging the shift in IT spending, Indian companies too have stepped up their investments in digital technologies. The increase in onsite effort in the last two years for all the companies is a clear reflection of this. Though the contribution from these services is still low, their impact on growth will get reflected in next couple of years. In traditional IT services too, automation and artificial intelligence have become focus areas in order to defend/expand market share in legacy business. The shift from old to new, as with every transformation, can increase volatility and reduce near-term predictability of the business.

There is also an element of cyclical headwinds for revenue softness in the last six months because of confluence of events like Brexit, US Presidential elections and negative interest rates globally. The ramifications of Brexit for businesses having links with UK are still not fully understood. Companies have resorted to slower decision making or complete cancellation (eg. RBS Infosys contract) of their plans till the time further clarity emerges on roadmap for Brexit. Simultaneously in the US,the rise of protectionist voices in the run up to presidential elections is also inducing uncertainty in the minds of corporate. As these events culminate in near future, decision making should improve and benefit Indian IT companies.

As in any industry consolidation phase, there will be few players that will emerge stronger and survive whereas others will go into the decline phase of slow and gradual death. We believe the outcome for Indian IT industry will be similar. The journey of Indian IT in the last 20 years can be segregated into two phases: 1) the low-risk phase of low hanging fruits from cost arbitrage and 2) the high-risk phase of outcome-based pricing. In each phase the growth leaders have been different. In the next phase where innovation and productivity will be the key differentiators also some players will emerge stronger than others.

Exhibit 2: Growth leadership in Indian IT – revenue CAGR in last two decades

	FY97-01	FY01-05	FY05-09	FY09-13	FY13-16	FY16-20
Differentiation	**Cost Arbitrage**			**Risk Taking**		**Innovation/ Prodctivty**
Risk Factor	**Low Risk**			**High Risk**		
Services	**Custom Application / Pkg Impl**			**ITO / IMS / Cloud**		**SMAC/Automtn**
Infosys	79.8%	40.0%	30.8%	12.2%	8.7%	?
TCS		34.3%	28.9%	17.8%	12.7%	?
Wipro	51.2%	37.2%	33.7%	9.5%	5.7%	?
HCL Tech	42.1%	26.5%	30.0%	21.0%	10.9%	?
Total	**55.8%**	**35.2%**	**30.7%**	**14.8%**	**10.0%**	**9-10%**

Source: Anived

The valuations for the sector remain attractive. At current valuations, the expected earnings CAGR over next ten years for Infosys are 8-9%. This in our view is not unrealistic and is conservative. With dividends payout increased in last few years, the large caps in the sector have dividend yield of 2-2.5%. At such low valuations there could be many things which can go in favor for the sector. An emergence of global macro concern can lead to outflow of money invested by foreign investors in India and thus leading to rupee depreciation. Almost all Indian IT companies are cash rich; this cash can be used for acquisitions. Alternatively, it could be returned to shareholders which will have positive impact on RoEs and valuations of the stocks. In our opinion, such positive triggers are not factored in current valuations of the sector.

We would like to end the discussion on Indian IT by providing a comparison of fundamentals and valuations between two companies. As evident from the table below, company 'A' scores over 'B' is almost all fundamental and valuation related parameters. The only point that 'B' scores over 'A' is on forward earnings growth. The caveat here is that 'B' has had a notorious history of not meeting the forward earnings expectations. The sanguine earnings estimates at the beginning of the year invariably get downgraded as the year progresses.

Exhibit 3: Which company will you buy?

	Company A	Company B
Market capitalization	Large Cap	Large Cap
Revenue CAGR		
↳ Last 5 Years	17.8%	6.8%
↳ Forward 3 Years	10.4%	10.2%
Earnings CAGR		
↳ Last 5 Years	14.6%	5.4%
↳ Forward 3 Years	8.6%	16.6%
TTM P/E	17.8x	19.5x
FTM P/E - current	15.9x	16.9x
↳ Last 5 Years - average	16.4x	16.6x
↳ Last 5 Years - '+1sd'	18.3x	18.9x
↳ Last 5 Years - '-1sd'	14.5x	14.2x
Net debt / equity	(0.5x)	0.9x
Average RoE - 5 Years	24.9%	16.8%
Dividend Yield - TTM	2.4%	1.5%
FCFF Yield - TTM	3.5%	2.0%

Source: Anived, Bloomberg

Not keeping any suspense any further, 'A' is Infosys and 'B' is Sensex. Clearly one is in the 'fear' zone and other in the 'greed' zone. Investors can choose between two scenarios: 1) wait of earnings to recover, which though difficult to predict would mean missing out on valuation re-rating or 2) take a long-term view and buy selective stocks in the sector that may emerge out stronger from the headwinds. We would love to hear any 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 current market situation. We have taken initial positions in couple of companies in consumer discretionary and healthcare sectors where we believe there are prospects of high earnings growth over next few years.

In consumer discretionary sector, we have taken initial position in retailer focused on targeting men's' smart casuals. The brand has grown at a rapid pace in last five years and pan-India expansion should provide further growth opportunities. Working capital improvement is expected to provide further fillip earnings growth.

In healthcare, we have initiated position in small cap that is working on two key themes: 1) reducing focus on un-remunerative API products and 2) working on becoming a preferred in-sourcing partner for global pharmaceutical companies for research based unique products which. This will help the company to deliver high growth in revenues and profitability over the next couple of years

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
Principal Officer

Hiral Desai
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).

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