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Dear Investors,

Happy 2017. Last year in Jan 2016 when we set-off on penning down our first newsletter we deliberated on ~ 15-20 various subjects and themes which would kick-off our quarterly interaction journey with our investors. Finally we opined that its best to set the objectives and expectations correct to begin with and we spoke about our investment philosophy. This time around when we sat down to pen down our 5th newsletter the topic chose itself "CY2016 – a lost opportunity or a stepping stone".

CY2016 – a lost opportunity or a stepping stone

We were extremely sanguine at the start of 2016, alike a lot of investor fraternity friends hinging on demand recovery (on a low base), 18 months in the office of the new government (first year is usually putting the house back in order), commodities had started cooling off and monsoon was likely to be normal. However the leading benchmark indices returned a paltry 1.9% for Sensex and 3% for Nifty in 2016. The initial promise got derailed by 1) sharp fall in commodity prices (on premise of slowing growth in China and the developed world), 2) leading to huge asset quality issues in the Indian Banking Sector (AQ outcomes were far worse than market expectations), 3) Two global political developments – Brexit and Donald Trump's victory, which increased the volatility across global markets and 4) the government move to render old Rs.500 and Rs.1000 notes invalid tender.

Banking and financial sector

The year started with extreme uncertainty for the sector on the back of Central Bank driven Asset Quality Review (AQR). While most market participants knew that asset quality amongst corporate lending banks (both private and public) were under stress due to muted economic environment over 2014-2015 and global commodity correction, it's the magnitude that caught investors by surprise. While the AQR was not comprehensive it exposed skeletons in Bank's BS. As the year progressed - 2nd

derivative impacts, inability to resolve stress cases through measures like S4A, SDR, 5/25 and little improvement in macros led to significant downgrades in earnings estimates for most corporate heavy banks.

Technology sector

With concerns on the global and domestic front, the year of 2016 started for IT on relatively positive note. The sector was a place to hide as rupee was depreciating, revenue outlook for the tier-1 companies remained stable and valuations were reasonable compared to historical averages. Though technology shifts in customer IT spends had created flux in revenues and profitability of Indian IT, FY17 was expected to be a recovery year as evidenced by Infosys' growth guidance at the beginning of the year. However, things took a sharp turn for worse in middle of the year. Brexit and ensuing uncertainty in spending by EU clients put the first spoke in the revenue recovery wheel. The sharp depreciation of British Pound and Euro vis-as-vis US Dollar and Indian Rupee further exacerbated the situation leading to cut-back in revenue outlook for all the companies. Though the impact on earnings was limited to less than 5% for the tier-1 companies, valuations took a severe beating with stock prices correcting 20-25%. The election of Trump in US and following newsflow on H1B has kept the investor sentiment negative as we move into 2017.

Consumer sector

Weak volume growth, rural slowdown and aggressive scale-up by Patanjali was the backdrop at the start of CY2016 for Consumer companies. As we progressed through the year volume and revenue momentum remained elusive for most companies in our consumer universe barring Paints, which continued to see double digit volume growth (however bulk of the growth was driven by low end paints leading to slower revenue growth). The only bright spot for consumer companies was significant decline in RM prices leading to life high Gross Margins for most companies in our universe. Normal monsoon and pay commission hikes which were supposed to propel demand but did little and by the end of the year Demonetisation put the entire wholesale distribution in a dizzy. Given that the wholesale distribution was severely impacted due to cash crunch and more severe impact of demonetization on rural India we believe normalcy will return only in Q2CY2017.

Automobiles

Q1CY16 set the tone for what looked like a great year for Automobiles with 2W, CV and PV all seeing decent growth momentum on low base of the previous year. Aided by softer commodity prices most companies saw their Gross Margins expand. However this momentum waned off towards mid of the year primarily for CV's (June-September) on weak economic activity, uncertainty over implementation of

GST. Demonetization towards year-end undid some positive momentum which got built around the festive season.

CY2017 – When the going gets tough the tough get going

There is no hiding from the fact that CY2016 ended up being below par vs our initial expectations. As we step into CY2017 we are faced with a new term to describe the global economic landscape VUCA (Volatile, Uncertainty, Complexity and Ambiguity). The challenges are plenty both local and global – local (economic impact of demonetization is still uncertain, macro growth indicators remain muted, bank credit growth are at multi-year lows), Global (Trump's way ahead for US, Fed's take on interest rate cycle, China's growth uncertainty, rising commodity prices), however there are rays of sunshine along the way. Some of the key positives which could play out in CY2017 1) Banks AQ problems are by and large recognized with earnings at multi-year low which could rebound sharply on improvement in economic activity (commodity prices have started going up), 2) Bond book gains sitting in BS of Banks as yields have come-off, 3) Prior year's low base should aid decent revenue growth trajectory within consumer and automobiles space, 4) Governments balances are far stronger vs where they were a year back, 5) The biggest reform post India's independence in GST is likely to be implemented in July 2017.

Banking and financial sector

Last 12-18 months have been the most challenging time that Indian financial sector has witnessed in a really long time both from a growth and asset quality perspective. However we believe that we are at fag end of bad asset quality recognition cycle with most corporate exposed banks reporting GNPA's much higher than their historical averages. There are quite a few positives likely for Indian financial sector in CY2017 1)Earnings are at multi-year lows due to AQ related provisioning 2)10 year Gsec yields have come off by ~150bps over last 12-15months which will prop up treasury gains 3) global commodity prices have recovered quite a bit in last 12 months providing relief in some of Metals related exposures 4) Demonetization has led to a bounty of CASA deposits coming in which can be used to lower lending rates and drive credit growth 5) Demonetization and subsequent implementation of GST will ensure a lot of smaller businesses which were hereto catered by unorganized form of financing will enter the formal financial channel.

Technology sector

As we begin 2017, we believe there are challenges as well as opportunities in for the Indian IT. The obvious challenge is navigating the possible regulatory changes in the H1B visa in US. In our opinion, the tier-1 companies are much better placed than mid-cap peers in navigating this challenge. Most of the companies have ramped up their local recruitment significantly in last two years in preparation of this

change. Though we do not rule out any margin disruption in short-term because of the regulatory changes, we expect such impact of to be small and transitory in nature. Let us not forget that Indian IT companies are integral part of technology infrastructure of American corporate. They have played an important role in deflationary trend of IT services and thus reducing costs for their clients.

On the positive side, if the fiscal and tax incentive plans of new political administration in US were to fructify then this will lead to stronger economic leading to higher technology spends. The outlook of rising interest rates in US is also positive for the BFSI sector in US which remains the highest spender on technology services. Coincidentally, BFSI in US has been the best performing sector in terms of stock price after the Trump election. The recent commentary on BFSI IT spend recovering in US further confirms the sentiments.

In our newsletter of October 2016 we had discussed our views on the Indian IT sector. Though we expect the new-age technologies to have a near-term impact on the sector's revenues, we believe that the Indian companies will continue to gain market share. However growth expectations have to be much moderate compared to the history as grown in scale in last twenty years and law of large numbers has caught up.

With valuations trading closer to one standard deviation below last-five year averages, we believe the risk-reward is in favor of investment in the sector. High free cash flow and dividend yield along with possibility of rupee depreciation should provide downside protection to the valuations.

Consumer sector

With the advantage of demographic profile and rising aspirations, we believe that the investors will start focusing on the longer term growth potential of the consumer companies – given earnings compounding potential, however given the lofty valuations which the sector has seen over the last few years we would love to own the business , but are slightly underweight given the price (Ref our new letter Oct 16) where we had highlighted how the stocks have rerated sharply but the price to pay for the expected growth was not giving us comfort.

Hopefully with increased volume growth and higher earnings trajectory we could re-asses our view or investors chasing high beta could lead to some correction in multiples in the sector which could make us believe that we should increase weightage in the sector.

Automobiles

The situation on the ground has started showing signs of recovery and sales are picking up gradually for the sector. It is very difficult to point out the exact timing of the recovery for the automobile sector but we remain positive in the medium term and expect recovery to commence soon.

With economic activity limping back to normalcy we could expect some more pain in the near term for the sector in some sub segments and also rising commodity prices could keep margins under check for the sector in near term, the key trend to monitor is sales growth, with rising per capita and aspirations we believe growth could soon bounce for the sector. Passenger vehicles sales could be lesser affected as majority of sales are through financing (trending lower interest rates) , could be partly offset by the recent rise in fuel prices by the government due to global increase in crude prices and rupee depreciation . For 2 wheelers the flip could come from some positive announcements or benefits for rural India in the upcoming budget. Lastly the CV recovery is purely a function of increased economic activity in the country, with GST now soon to become a reality we believe that this segment would also add to the segment in the coming quarters. We continue to believe that this sector holds promise in India over the medium term.

There are challenges galore as we step into next 12 months, however as they say "When the going gets tough the tough get going". Sensex earnings growth has been abysmally low at ~5% CAGR over last 6-7 years (rolling averages) which has led to sub-par returns on the index. While it's very difficult to predict the turnaround of an economic cycle especially in such a dynamic global environment, we believe there are enough things which can go right for India over next 12-24 months which we have highlighted earlier.

In that backdrop, with hope and hard-work, we believe India will come-out with flying colors in CY2017 rewarding our investors.

Portfolio Actions

During the quarter we added a mid-sized housing finance company both pre and post Demonetisation on AQ issues primarily in their LAP exposures (Management has indicated capping LAP exposure).

During the quarter we also added one of the largest mortgage player in India on concerns of slowing growth and margin pressures in a falling interest rate environment

During the quarter we added initial weight in our portfolio to 2 recently listed dairy names with focus on value added product segment driving growth and profitability

During the quarter we added a leading hair oil company after the valuations became attractive on concerns of slowing growth and near term demand uncertainty post-demonetization.

During the quarter we completely exited our position in one pharma company as the stock is expected to show tepid growth in near term due to high base of one offs.

Warm Regards,

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Hiral Desai
Portfolio Manager

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