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Dear Investors,

Q4FY17 happened to be sandwiched in midst of 2 'once in a lifetime' events – Demonetisation and clarity on implementation of GST (due 1st July 2017). We are amongst the lucky few who have witnessed such momentous events happening within such a short span of time.

On ***Demonetisation***, our interactions with most companies indicate that the recovery post demonetisation was swift and most businesses saw the demand coming back to 65-70% of pre-demonetisation levels within couple of months. However, most companies also indicated that the revenue growth which has remained elusive now for about 4-6 quarters across our universe continues to be more hope-based.

With respect to ***GST***, given the enormous nature of reset that the businesses will have to go through, there are likely to be shorter term disruptions. Most businesses will see channel de-stocking as the trade is unlikely to take the "rate risk" on their books and this could have near term earnings impact for the companies.

By this very construct Q4FY17 should have been a period of wait and watch 1) to assess the real impact/after effects of demonetisation and 2) gather more clarity in terms of news flow on Implementation of GST. However, contrary to this BSE 500 gained 14.4% in the Jan-Mar 2017 quarter on back of 1) possibility demonetization impact being lower versus earlier envisaged and 2) inflow of strong liquidity from both FII and DII. Clearly, the swiftness of the up move has taken us by surprise.

BSE500, which in our opinion, was expensive as mentioned in our July 2016 newsletter at ~25x it's TTM earnings has further moved upwards on valuations. BSE 500 has appreciated by ~10% since our July 2016 newsletter compared to ~5% increase in Sensex. This rally again comes with the expectations of the earnings recovery which so far has remained elusive. **Given our value conscious approach to investing and lack of any meaningful visibility on business recovery, we have increased our cash levels to 18% at end of Q4FY17 compared to 3% a year back.**

BSE 500 – benchmarking the benchmark – a look back at eventful CY14 - CY16

BSE500's out-performance to Sensex is a three year phenomena – it has risen by 41% between Dec-13 and Dec-16 compared to 26% returns given by Sensex in the same period. **The core of our philosophy is the belief that 'stock returns would mirror earnings growth' over a reasonable long period of time.** And earnings growth is something that BSE500 as well as Sensex have failed to deliver in last three years on aggregate basis. Considering, BSE500 is our benchmark for evaluation we were intrigued to dig deeper in search of drivers of such performance.

Our analysis is for period CY13 to CY16 and focuses on 466 stocks that have financial and price history for this period. The 34 stocks not part of analysis comprise ~3% of total market capitalization of BSE500 and have got listed in last three years. The analysis throws up some interesting results. We do not deny that there have been pockets in BSE500 which have seen strong fundamental performance over the last three years. However, most of the names where earnings performance and hence stock returns have been strongest in the last three years have benefited from cyclical tailwinds rather than revenue/demand-based recovery.

Further, earnings for many companies were depressed in FY13/FY14 because of the high inflation and sharp rupee depreciation in the period. The base of trough earnings further benefited from the correction in commodity prices, stable fiscal/current account situation and most importantly declining interest rates. Roughly 65% of the stocks are trading at higher valuation in Dec 2016 compared to Dec 2013 if we use the stock returns vs earnings growth as the evaluation criteria. Following are few interesting points from our analysis. Please refer the table on page no. 4 more details on analysis.

Key points from analysis of BSE500 between CY13-16:

- **High revenue and earnings growth:** Only 99 companies of the 466 i.e ~21% have delivered revenue and net income CAGR of more than 10% over the period CY13-16. On aggregate basis, the revenue and net income of these companies have grown at CAGR of 16% and 20% over this period whereas aggregate market capitalization has grown at 23% CAGR. **The median P/E at the end of CY16 stands at 24.8x and has seen re-rating of 26% over last three years. Median mcap/revenues is up 94% at 3.2x.**

- **<u>If we exclude the Sensex companies from the above 99 companies, then the median P/E has expanded by 39% to 26.2x from 18.8x at the end of CY13.</u>**
- These 99 companies have contributed to more than 40% to the incremental market capitalization of BSE500 over CY13-16. **<u>i.e. ~20% of companies have contributed to 40% of market capitalization growth.</u>**
- **<u>Negative earnings CAGR:</u>** There were 103 companies that reported negative net income CAGR over CY13-16. Though their aggregate market capitalization has grown by only at 6% CAGR, the median P/E has expanded by 133% to ~32x at the end of CY16 compared to 13.9x in CY13.
- **<u>From profits to losses:</u>** 36 companies that reported positive net income in CY13 had recorded losses in CY16. On aggregate level, their net income moved from INR308bn to losses of INR475bn. These companies had the most impact on aggregate earnings of BSE500. **<u>Excluding these companies, aggregate income of BSE500 companies would have grown by 10% CAGR over CY13-16.</u>** Despite losses the aggregate market capitalization of these companies grew by 4% CAGR over this period.
- On aggregate level, revenues and net income of the 466 BSE500 companies grew 1% and 3% respectively over CY13-16. Median P/E has expanded by 47% to ~22x from 15x at the end of CY13.

As highlighted earlier we feel that valuations are running ahead of fundamentals at this juncture with limited visibility of a demand led earnings recovery on the horizon. Like in the past, most estimates are factoring a ~20% earnings growth in the Sensex earnings which in our view are more hope based rather than backed by solid visibility. We believe it will be difficult to achieve such expectations in absence of a broad-based demand/revenue recovery as cyclical benefits of commodity prices and low interest rates recede. The earnings growth is also contingent on two important themes 1) NPA-led recovery in banks and 2) domestic and global cyclical continuing to do well. We believe that the former is dependent on latter which could see some pressure because of global volatility and recent rupee appreciation.

We continue to build our research pipeline and look at better valuation opportunities to deploy meaningful amount of money. We have been successful in identifying few names that fit our philosophy and are in reasonable valuation zone. We have taken initial positions in these names. However, considering sharp run-up in some of our invested name in Jan-Mar quarter, which we believe is more euphoria driven than fundamental based, we have trimmed our position in these names. Therefore, we have been net sellers in the quarter.

BSE 500 Analysis

Fundamentals	No. of companies	Agg. Mkt Cap. (INR mn)			Agg. Net Income (INR mn)			Agg. Revenues (INR mn)			Median P/E (x)			Median Mcap/revenues (x)		
		Dec-16	Dec-13	CAGR	Dec-16	Dec-13	CAGR	Dec-16	Dec-13	CAGR	Dec-16	Dec-13	Change	Dec-16	Dec-13	Change
Including Sensex companies																
Revenue & NI CAGR >10%	99	28,487,661	15,472,669	23%	1,324,072	772,120	20%	7,591,142	4,802,017	16%	24.8	19.6	26%	3.2	1.7	94%
Revenue CAGR 0-10% & NI >10%	85	14,988,997	7,962,538	23%	623,790	350,290	21%	4,526,574	3,884,636	5%	18.6	20.4	-9%	2.6	1.5	74%
Revenue CAGR >10% & NI CAGR <10%	26	3,007,306	1,843,777	18%	183,275	147,059	8%	1,081,458	725,162	14%	27.3	16.6	64%	4.0	3.2	23%
Revenue & NI CAGR betwn 0-10%	36	12,870,852	10,314,501	8%	557,425	484,687	5%	3,740,356	3,112,052	6%	25.5	19.9	28%	3.7	2.6	44%
Negative NI CAGR	103	21,095,451	17,838,082	6%	1,025,482	1,387,950	-10%	10,863,113	9,494,230	5%	32.3	13.9	133%	2.5	2.3	11%
Negative revenue CAGR	32	8,490,147	4,930,927	20%	748,829	505,805	14%	10,301,082	14,417,913	-11%	18.8	14.4	30%	2.0	0.9	136%
NI - Loss to Profit	30	1,817,635	1,028,206	21%	135,837	-109,371	LTP	2,166,110	2,563,332	-5%	24.0	NM	NM	0.9	0.5	67%
NI - Profit to Loss	36	5,684,414	4,992,703	4%	-474,950	308,386	PTL	5,314,041	4,920,139	3%	NM	12.8	NM	0.5	0.8	-38%
NI - Loss to Loss	19	820,001	772,684	2%	-92,438	-106,676	LTL	873,574	858,097	1%	NM	NM	NM	0.9	1.2	-28%
Total	466	97,262,464	65,156,086	14%	4,031,321	3,740,250	3%	46,457,450	44,777,577	1%	21.9	15.0	47%	2.6	1.7	58%
Excluding Sensex companies																
Revenue & NI CAGR >10%	91	11,905,430	4,192,909	42%	520,232	269,742	24%	3,565,171	2,183,094	18%	26.2	18.8	39%	2.9	1.5	95%
Revenue CAGR 0-10% & NI >10%	83	12,562,288	6,089,956	27%	488,132	256,024	24%	3,706,693	3,191,333	5%	18.6	20.4	-9%	2.6	1.4	83%
Revenue CAGR >10% & NI CAGR <10%	26	3,007,306	1,843,777	18%	183,275	147,059	8%	1,081,458	725,162	14%	27.3	16.6	64%	4.0	3.2	23%
Revenue & NI CAGR betwn 0-10%	29	3,234,634	2,157,346	14%	116,691	99,243	6%	1,127,855	947,657	6%	27.5	19.7	40%	3.8	2.3	63%
Negative NI CAGR	94	9,675,870	7,691,899	8%	338,508	542,328	-15%	5,471,729	5,133,709	2%	33.4	14.5	131%	2.6	2.1	21%
Negative revenue CAGR	30	3,400,431	1,518,591	31%	276,675	164,964	19%	4,669,215	5,978,939	-8%	20.5	15.6	31%	2.2	0.9	141%
NI - Loss to Profit	30	1,817,635	1,028,206	21%	135,837	-109,371	LTP	2,166,110	2,563,332	-5%	24.0	NM	NM	0.9	0.5	67%
NI - Profit to Loss	34	2,569,958	2,605,807	0%	-462,412	298,027	PTL	4,812,480	4,529,678	2%	NM	10.3	NM	0.5	0.7	-30%
NI - Loss to Loss	19	820,001	772,684	2%	-92,438	-106,676	LTL	873,574	858,097	1%	NM	NM	NM	0.9	1.2	-28%
Total	436	48,993,553	27,901,173	21%	1,504,500	1,561,341	-1%	27,474,285	26,111,002	2%	22.1	14.7	50%	2.6	1.6	64%

Portfolio actions

This quarter witnessed a lot of action on the portfolio front – we had more sells than buys, courtesy to buoyant markets.

We partially exited one of our bigger positions in the consumer retail space focused on tier-2 and tier-3 cities. We believe the valuations have run ahead of earnings expectations.

We bought initial position in a small auto ancillary company which recently came out with their initial public offering. At the time of the IPO the expectations of earnings were pretty high and they failed to materialize resulting correction in the stock. We think the valuations are now attractive and any uptick in visibility of revenues will lead to better performance.

We have bought one of the leading hair oil brands in the country. The company has seen muted volume growth in recent times which was further exacerbated by demonetization. However, hair oil sales can bounce back faster than expected. Also the company has significantly ramped up its management bandwidth which should yield better results in the future.

We bought position in one of the well-known media company which may continue to benefit from the digitization trend. They are content owners with reputed history of operating in the space. Online media can propel the business to new heights and it is available at a reasonable valuation.

We partially exited our position in the biggest housing finance company with concerns on the valuation front.

We also reduced our position in a private bank where stock price rallied sharply on technical reasons rather than fundamental.

We exited our position in a dairy company because of sharp change in expected earnings trajectory. The rise in raw milk prices and inability to pass on price hikes in its products can put stress on company's financials.

Warm Regards,

Prakash Kapadia	Hiral Desai
Principal Officer	Portfolio Manager

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