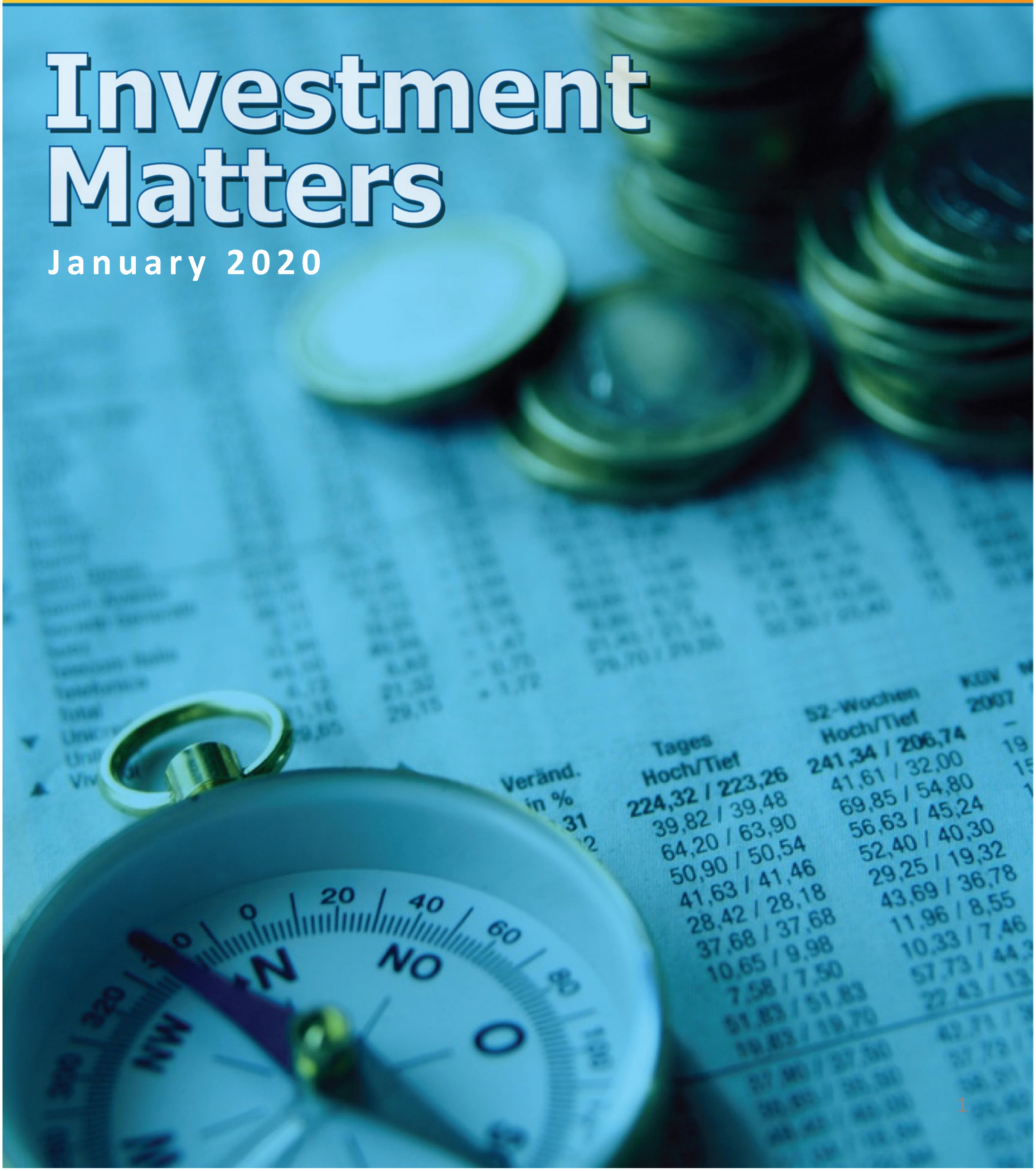
ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

January 2020



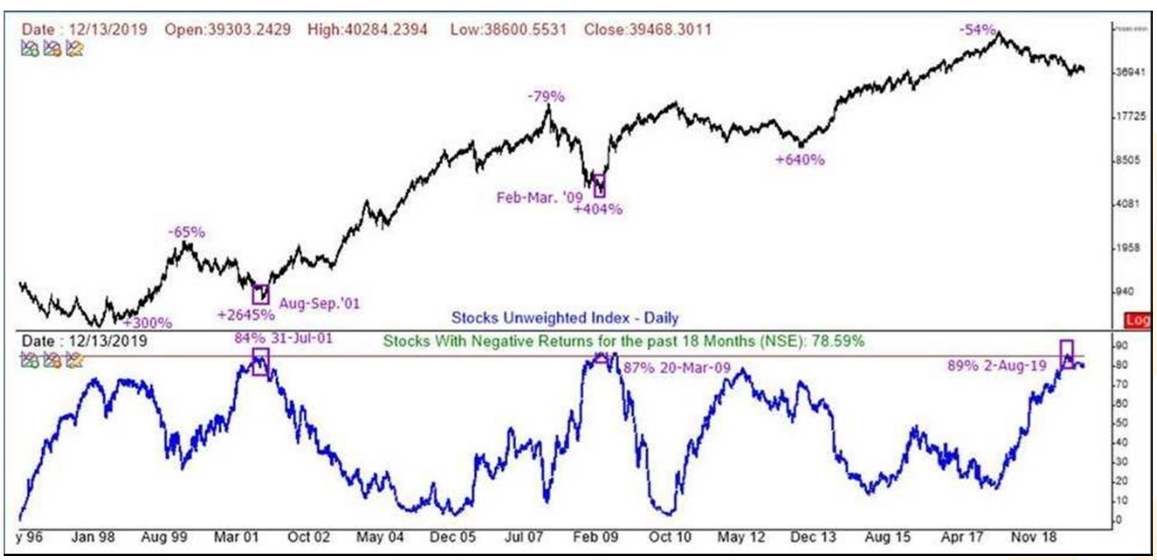
EQUITY OUTLOOK

2020 – Past peak polarization and seeds of recovery

At the outset I wish all of you and your families a very Happy New Year and a very healthy and successful 2020.

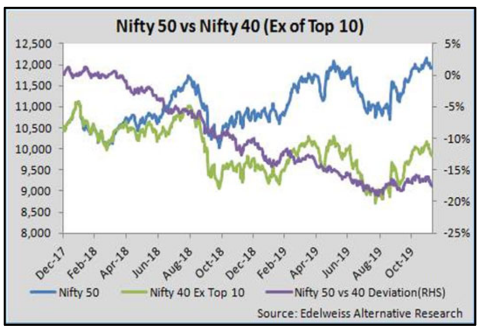
The year gone by…
2019 was a unique year for Indian markets. The aftermath of the IL&FS crisis left an indelible mark on the economy and the credit markets, considerably slowing down the economy from a growth of 7.0% in Q3CY18 to 4.5% in Q3CY19. In addition, the economy was also impacted due to disruptive structural reforms like demonetization, GST and RERA (real estate regulation act), all of which are positive in the long term but growth dilutive in the short term.

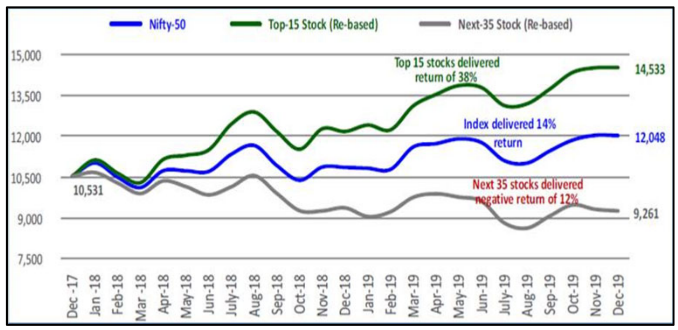
The narrow indices (NSE Nifty and BSE Sensex) delivered 12% and 14.4% returns respectively. However, this positive return completely masked the very poor breadth of returns in the broader markets. The Nifty Midcap index & BSE Small cap index delivered -4.3% & -6.8% returns respectively during the same period. The extent of polarization seen in CY2019 was at 20 year extremes and was matched by similar levels of polarization seen only during two other occasions: in July 2001, in the aftermath of the technology bust and in March 2009, post-Global Financial Crisis (GFC). The chart below illustrates that nearly 90% of the stocks listed on NSE showed negative 18-month returns till Dec 2019.



EQUITY OUTLOOK

Even within the Nifty 50 stocks, the returns were skewed towards select 10-15 stocks, which delivered returns of 30-40% while the remaining stocks actually delivered negative returns.

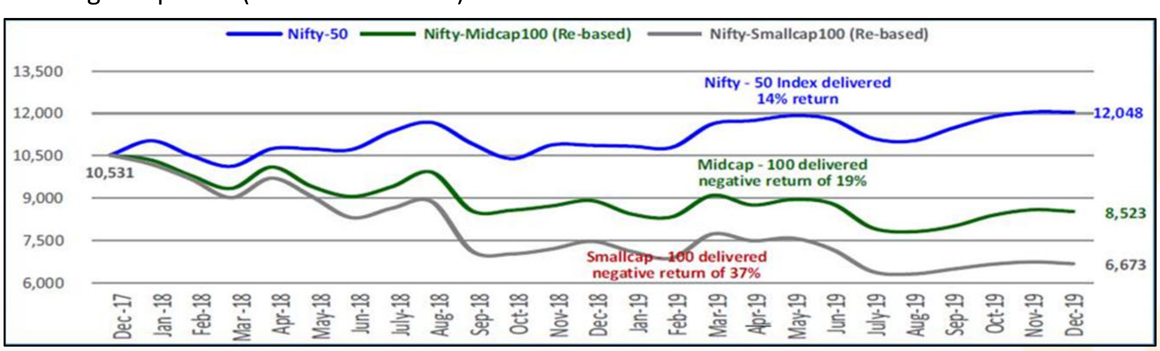




We believe that a large number of businesses found it relatively difficult to navigate and withstand continuous regulatory disruptions mentioned above. This brought in an extreme phase of risk aversion and flight to safety which caused the Indian equity market to become extremely polarized in last 1-1.5 years.

Most incremental inflows in the Indian markets went to this select group of stocks due to their relative liquidity, safety, visibility of growth in some cases, and high quality nature of their business without any consideration for the current valuation. In addition, certain regulatory reasons caused significant outflows from small and midcaps which also contributed to their underperformance.

The stark difference between large caps and the broader markets (small and midcaps) is reflected in the negative returns of small-caps and mid-caps at -37% and -19% respectively during this period (Dec-17 to Dec-19)



Why we think this will change for the better…

1. Fiscal policy actions

After winning a landslide victory in May 2019, a sense of complacency crept in the government and focus shifted to fulfilling its social agenda such as scrapping Article 370, National Registry of Citizens/Citizenship Amendment Act, etc. However, the economic slowdown and its adverse impact on employment and incomes are starting to manifest in the loss of critical state elections previously ruled by the BJP/NDA post May 2019 (such as Maharashtra and Jharkhand). As a result, the government and its top functionaries have become aware of the negative impact of a continued economic slowdown on their ability to fulfil its economic and social agenda in future.

Since Sep 2019, the central government has sprung into action through various policy initiatives:

a. Tax rate cuts. There is a precedent of lower corporate taxes translating to higher investments in later years and a wealth effect trickling down in the economy. Considering the slow investment growth rate in India, government decided to cut corporate tax rates to 25.2% from 35% earlier and for new manufacturing units to 17% to bring it in line with the most competitive economies in Asia.

b. Support to the real estate sector. Real estate and construction contribute in a large way to creating employment and increasing the investment rate in the economy. The credit crisis and resultant slowdown has hurt this sector the most in past few years. As a result, government has taken several steps to improve the outlook for these sectors such as a dedicated Alternative Investment Fund (AIF) for incomplete projects, tax and interest rates incentives for affordable housing, etc.

c. Large strategic divestments/privatisation. Given the limited fiscal space and the inability to raise new tax revenues in the midst of a slowdown, government has been forced to embark on a privatisation drive to divest strategic stakes in certain large profitable PSUs such as Bharat Petroleum Corporation, Container Corporation of India, Shipping Corporation of India, etc.

d. Asset monetisation. The government is looking to sell completed projects in roads, power, communication, and gas pipeline infrastructure sectors to large infrastructure funds, sovereign wealth funds, and institutional investors.

e. Insolvency & Bankruptcy Code (IBC) amendments to ensure faster resolution. IBC was one of the landmark reforms of the current government in its first term. However, due to its limited history, there were several grey areas which required regular intervention of the judiciary and executive branches of the government from time to time, leading to delays in resolution. Finally, one of the first and large case of Essar Steel was resolved satisfactorily and that has set the groundwork for future resolutions as well. This reform is already helping the beleaguered banking sector to recover a lot from past NPAs and incrementally improving the banking system liquidity.

2. Monetary policy actions

In the past 1 year, India's central bank, RBI, has been active led by the new governor, Mr. Shaktikanta Das by responding to the shocks and economic slowdown through several actions – reducing policy rates, resorting to sector specific liquidity requirements, and out-of- turn liquidity enhancing actions. After reducing rates and improving liquidity, focus is now on improving the transmission of these actions to the real economy.

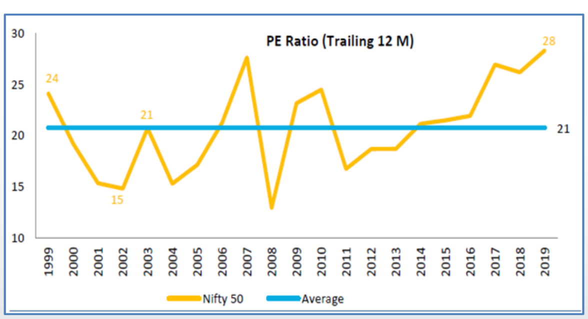
3. Monsoon recovery and rural demand

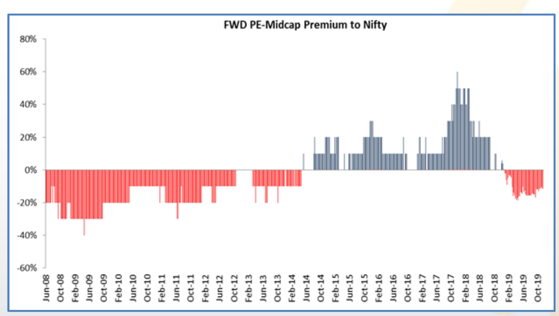
The monsoons made a strong recovery in 2019 with overall rainfall exceeding 100% of the normal. The full benefit was not seen in the summer crop because of localised flooding and spatial differentials, but the sowing for the winter crop has been very strong. This, coupled with some food price reflation, should benefit the rural sector and help revive sentiment and demand. Many consumer companies (Hindustan Unilever is a prime example) had pointed out that the weakness in rural demand far exceeded that in urban areas, so a revival in agriculture could potentially cause a big swing in consumption growth.

4. Mean reversion in valuation & Corporate profitability

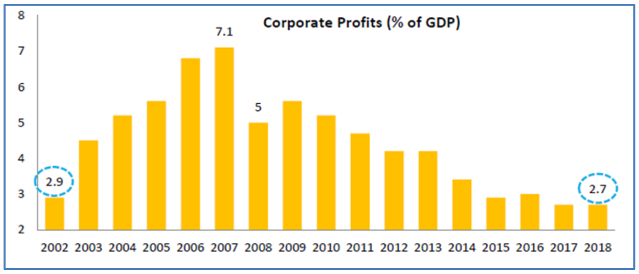
The divergence between small/midcaps and large caps has reached levels last seen in 2013, just before the next bull phase started and it is now too wide to sustain much longer. Clearly, this is not sustainable and we do expect a mean reversion. I truly believe that we are at an inflexion point in the cycle where this phenomenon should reverse over the next 2-3 quarters.

The valuation differential between large cap and midcap has increased in the past year.





At the same time, corporate profitability is also at a multi-decade low as seen below.



Both of these are unsustainable and will revert to their respective means. Hence, we expect valuation discount of midcaps to reduce going forward and corporate profits as % of GDP to improve on the back of a recovery in the economy.

Risks

Geopolitical events since the last week of Dec 2019 have reinforced the fragility of the current world equity market set up to unexpected shocks relating to higher crude oil prices. India is particularly vulnerable as it imports more than 80% of its requirements. Higher crude prices, if they sustain above USD 80 per barrel for some quarters, could pose a serious challenge to the fiscal and current account situation of the country resulting in a weakened INR and resultant impact on capital inflows.

In summary

The current macro environment is reminiscent of past periods when the Indian economy slowed down significantly for several reasons. Such poor macro periods are reflected by slowing GDP growth rates, high fiscal and current account deficit as % of GDP. The challenging macro forces the government's hand to initiate structural fiscal reforms (in this case, privatisation and corporate tax cuts amongst others) and loosen monetary policy to stimulate growth to revive the economy. The equity markets have in the past responded by delivering strong returns in years immediately following a tough macro environment.

Year	GDP Growth Rate %	As % of GDP		10 Y G-Sec Yield % Come Off Subsequently	Equity Market Return In CY	Equity Market Return From The Lows in Subsequent 1-2 Years
		Fiscal Deficit	CAD			
1991	1.43	7.61	3.14	NA	91%	347%
2001-02	3.88	5.98	0.97	5.07	-18%	72%
2008	6.72	5.99	2.46	5.3	-52%	106%
2012-13	4.47	5.84	5.04	8.55	30%	40%
2019	5.2	4.00	2.45	6.5	14%	?

EQUITY OUTLOOK

We believe we are well positioned to benefit from a cyclical long term recovery in the economy, earnings and consequently improving breadth in the markets. Our portfolios have a good mix of steady high quality compounders and exposure to emerging growth companies and companies that would benefit from an economic recovery.

Hiren Ved
Chief Investment Officer
Alchemy Capital Management Pvt. Ltd

Source :
Alchemy Research
Bloomberg

Balancing opportunities and risks

We approach 2020 with a cautious mindset, in the back of continued macro uncertainty. A muted consumption recovery is likely, but the investment cycle remains challenged and some risks to financial sector stability still persist. We remain focused on quality growth stocks for our portfolios, with a heightened awareness of risks. The extreme narrowness of the market could partially reverse in CY20, but we will remain quality-conscious in our stock-picking.

Muted consumption recovery

We see the scope for a muted consumption recovery in 2020. Some key enablers are in place and they should play out over the next 1-2 quarters:

- There is still scope for interest rate transmission, even if policy rates stabilize for the next few quarters due to rising inflation. Banks are in a position to cut deposit and lending rates, with systemic liquidity significantly positive and credit growth muted at < 8%, as per the latest RBI data.

- The strong monsoon has positively impacted the sowing for the rabi season, and this should flow through to rural sentiment and consumption. The slowdown was particularly severe in rural areas, which have taken multiple hits over the last few years. A turnaround in this segment could swing the overall numbers significantly.

- We enter a period of a positive base effect. The slowdown had started to intensify in 2HFY19 and we enter that period now, especially in sectors like autos where the optical growth numbers should start to look better.

There are however, significant risks to the recovery. First, the fiscal deficit is a worry with revenue growth sluggish – this was compounded by the corporate tax rate cut. The government has reportedly cut back spending in 4Q to be able to meet the fiscal deficit target: this could have a negative impact on growth. Secondly, many sectors are still vulnerable and large defaults, especially from real estate/NBFCs, could hurt financial sector stability and negatively impact growth.

Global factors represent the third risk – mainly, the recent spike in oil prices. If this does sustain, it narrows the government's policy options as it puts pressure on the external account, inflation and, possibly, the fiscal deficit. In that scenario, the growth recovery is likely to get delayed by a few quarters.

Investment cycle still challenged

We see the investment cycle still remaining muted. The enablers for private sector infra spending could take some time to fix: funding, contract stability and lowering of execution risk. On the other hand, the government's continued fiscal challenges make it very difficult for a major uptick in private spending. Without a significant pickup in infra spending, a broad-based recovery in the investment cycle is unlikely.

Earnings growth

Earnings growth should remain healthy for 2HFY20, on the back of two factors. First, the full impact of the corporate tax would be visible over the next two quarters; there was some dilution because of the DTA losses in 2Q. Secondly, the recovery of the Essar NPA will go straight to the bank bottom lines, optically helping PAT growth. Adjusted for these one-offs, however, underlying PBT growth is likely to remain in single-digits. In such an environment, the companies that do deliver strong EPS growth will likely to get disproportionately rewarded on valuations.

Investing in 2020

Our approach to investing in 2020 remains underpinned on three factors:
We continue to hunt for growth. Even in a challenged macro, there will be winners in each sector and those are where the opportunities lie. Companies that consolidate market share in a downturn tend to be big winners in the medium term.

Valuations of the high-quality growth companies are a worry, but elevated multiples are not a worry until growth starts to falter. The key is to find companies that are able to sustain growth while keeping cash flow and balance sheet metrics intact.

The sharp 2-year correction in mid-caps has taken the froth out of valuations. We now remain market-cap-agnostic and are looking at stocks across both large- and mid-caps.

Seshadri Sen
Head of Research
Alchemy Capital Management Pvt. Ltd

Source :
Alchemy Research
Bloomberg

1. Vision 2020 – Analyzing 2019 with hindsight bias

"Any single approach to investing – e.g. investing in any asset class (equity/debt, large cap/midcap, gold/oil) or investing via any investment style (such as value, growth, distressed) or investing in anything – will experience a time when it performs so terribly bad that people will question its validity"

CY2019 has been challenging for most of the active fund managers (active meaning bottom up stock picker who have little regard to index constituents) as we feel that the slowing economy has led to simultaneous phenomenon of **extreme** "risk aversion" and "flight to safety".

Why extreme? Both these phenomenon have led to **disproportionate** reaction to an actual or perceived underlying event, both positive and negative.

Risk Aversion - For instance, the demand slowdown in auto sector coupled with uncertainty about BS VI transition and Electric Vehicle (EV) fears led to sharp de-rating of the sector. Similarly, uncertainty and fear regarding liquidity crisis and real-estate developer book meltdown has led to sharp de-rating of NBFCs across the board.

On the other hand is the phenomenon of "**Flight to Safety**". The businesses which have delivered on growth during these times have been disproportionately rewarded with hitherto unseen valuations. Since, there is a small number of businesses which have been able to dodge the bullet of slowing economy, both these phenomenon have led to current state of **highly polarized market**.

There were signs of this polarization breaking up when government announced the reform of "Corporate Tax Rate Cut", but it lasted only for a month. Since Oct'19 end, broader market bounce back has withered away, leading to even higher market polarization.

Portfolios Managers which are overweight with the stocks from these polarized bucket have done wonderfully well over the last 12-18 months. These portfolios have not only beaten respective benchmarks but also delivered healthy positive returns.

However, almost all of these businesses are today trading at all-time high valuations which probably are not fully in sync with long term sustainable growth rates of these businesses and hence run a risk of underperformance or even absolute decline in value if things mean revert.

PORTFOLIO MANAGER'S COMMENTRY

Over the last 12 months (CY2019), Alchemy High Growth Portfolio has seen a decline of -0.7% versus BSE 500 which is up 7.8% during the same time. The portfolio struggled to keep pace with the polarized market and suffered from some of the contrarian bets in auto, media and infra space. Troubles don't come alone. Portfolio was also hit by rumors and actions/events questioning Corporate Governance/Capital Allocation (CG/CA) policies for some of the holdings in the portfolio. Needless to mention, CG/CA allegations have led to significant value destructions in these names. Lastly, the sharp fall during Jul-Sep'19, particularly in mid-cap space led to many of our holdings going under-water simultaneously.

At Alchemy we have always practiced disciplined risk management of not letting multiple detractors in the portfolio at the same time. So as a matter of prudent risk management practice, we exited some of these names during the last few months, by a taking relative call on these investments.

Alchemy High Growth Portfolio Movement July'18 to Dec'19

<table>
<tr>
<td rowspan="2">Jul-Dec'18</td>
<td>Transitional changes post change of hands
a) Alignment with product strategy of owning quality high growth franchises
b) Profit-booking in overvalued mid-caps
c) Risk management given worsening macro</td>
<td>Exits: BEML, TV18, PFS, GSFC, Natco Pharma, SBI, ACC, Grasim, IEX, CARE, Kalpataru Power, Jubilant Lifesciences, Gujarat Gas
Add: Avenue Supermarts, Bandhan Bank, Info Edge, Titan, GCPL, Bajaj Finserv, LTTS, L&TFH, TCNS, M&M, Bosch, Delta, Asian Paints</td>
</tr>
<tr>
<td colspan="2">1. This phase led to heavy churn in the portfolio due to simultaneous Buys & Sells. But it's more of a aberration. Our long term churn remains low at ~0.4.
2. Though concerned about economic slowdown from IL&FS fallout, didn't expect it to last beyond 2 quarters as government swung fast into action appointing Mr. Uday Kotak as chairman.
3. Cash Level declined from 13.1% to 6.7%</td>
</tr>
<tr>
<td>Jan-Mar'19</td>
<td colspan="2">No churn or major exits from the portfolio.
1. Market started rallying mid-Feb'19 in anticipation of continuity of leadership and reforms as post-Pulwama probability of second term for Mr. Modi increased substantially.
2. However, this widening disconnect between fundamentals and valuations led to risk/rewards in our investible universe deteriorating significantly.
3. As a result, deployment levels for new clients dropped to 40-50%.</td>
</tr>
</table>

PORTFOLIO MANAGER’S COMMENTRY

<table>
<tr><td rowspan="2">Apr-Jul’19</td><td>Exit from Cyclical and Turnaround names as economy continued to weaken at unexpected pace</td><td>Exits: Escorts, Ashok Leyland, Maruti, L&T FH, Federal Bank, Bosch

Add: Zee (distressed value)</td></tr>
<tr><td colspan="2">1. Used the rally from General Election and then up to Budget to exit some of the cyclical names and turnaround businesses in the portfolio
2. Budget showcased lack of grip of Government over the economy and in absence of any meaningful measures to kick start the economy, the chances of prolonged slowdown were real
3. Our quantitatively backed, probabilistic approach helps us identify with a reasonable degree of confidence right price to buy and right risk/reward to enter. The deterioration in these two variables led to deployment falling to as low as 20% for the new money and cash in the portfolio rising to 15% level
4. Our initial assessment through this quantitative and probabilistic approach was that it would be by December/March quarter that risk would be fully compressed and asymmetric opportunities would emerge.</td></tr>
<tr><td rowspan="2">Aug-Dec’19</td><td>Sharp fall in multiple mid-caps positions in the portfolio triggered risk management which doesn’t allow multiple detractors in the portfolio.</td><td>Exits: Finolex Industries, BASF, DCAL, Zensar Technologies, MCIE, Greaves Cotton
Add: Sterling & Wilson Solar Axis Bank, Bajaj Finance, HUL, MCX, Varun Beverages, Concor, GCPL</td></tr>
<tr><td colspan="2">1. Surprise move by Government of cutting corporate tax rate cut restored the investor confidence and market showed the willingness to again provide a longer rope to Modi Govt.
2. Recognizing the same, we increased the deployment but only to the names who could a) retain the windfall gain b) redeploy to boost the sales
3. Exit deployment rates stood at 40%. Aggregate Cash Levels stand at 12.5%.</td></tr>
</table>

2. VISION 2020 – Predicting Alchemy High Growth's 2020 Portfolio Performance with Quantitative Measures

If there is any job where probability of going wrong is stacked highly against you then it is forecasting. Hence I will not venture into predicting the future but I will provide you with credible data to assess how the current portfolio shall aim to deliver absolute and relative returns in 2020.

The following table captures the qualitative shift in the portfolio over the last 2 years. The Portfolio now has 65% weight of large caps, but it has been achieved without sacrificing business growth rate or growth potential. More importantly, both earnings profile and returns profile (RoE) has been significantly improved albeit at a cost of higher P/E.

Trailing 12 Month data	Jan-18	Jun-18	Jan-19	Jun-19	Dec-19
Sales Growth (%)	22.0	20.3	23.4	17.1	21.6
EPS Growth (%)	13.7	15.5	21.1	15.1	18.3
RoE (%)	14.7	15.9	17.4	17.6	20.7
PE (x)	26.0	28.9	30.7	33.9	34.1
LargeCap Weight	36%	31%	52%	46%	65%

Further, we expect the portfolio to outperform the benchmark and broader market. The following table captures the superiority of portfolio on key financial metrics vis-à-vis benchmark providing strong visibility of both absolute and relative performance ahead.

	AHG Portfolio Metrics				BSE 500 Index		
	FY 2020	FY 2021	FY 2022		FY 2020	FY 2021	FY 2022
Sales Growth	17.6%	17.3%	13.4%		11.5%	10.9%	7.4%
EPS Growth	24.2%	30.0%	22.9%		23.0%	18.4%	17.4%
PE	30.5	23.9	19.3		21.9	17.3	14.7
PB	8.2	6.4	5.2		2.7	2.4	2.2
RoE	20.3	21.0	21.5		10.9	12.3	14.5
RoA	8.9	9.3	8.4		2.5	2.6	2.8

Today, we believe, Alchemy High Growth portfolio has a right mix of growth/value/turnaround as well as right mix of large & mid-caps to navigate the current challenging macro; not get overtly caught into reversal of quality trade and benefit from a broader market recovery.
Wishing you all a very happy and prosperous New Year!

Amit Nadekar
Portfolio Manager
Alchemy Capital Management Pvt. Ltd

Source :
Alchemy Research
Bloomberg

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