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Investment Matters

MARCH 2014

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EQUITY OUTLOOK FROM CIO'S DESK

India: Near a significant turning point

Global investors were attracted to India as it offered a high growth economic environment, improving demographics, a large domestic market powered by a growing middle class, world class companies in a diverse set of industries who compete effectively at home as well as abroad with an ability to translate this growth opportunity into market cap growth for investors. Long term investors have benefited from these long term structural factors that have driven returns in Indian markets. *MSCI India Index has returned 232% in $ terms compared to 66% for the S&P 500 over the last 10 years (2003-2013).* Needless to mention, good active managers have produced even better returns.

	1 Yr	3 Yr	5 yr	10 yr
MSCI India	6.90%	0.70%	121.30%	232.00%
S&P 500	29.60%	47.00%	104.60%	66.20%

However, over the last 3 years the experience has been very different and difficult. Global as well as local macro factors have taken precedence over the micro strengths that India possesses. While global macro issues post the Lehman crisis have been a common denominator for all EM's, it was India's self goals which restricted India from differentiating itself amongst the comity of EM's. The problems inflicting India are well known – high twin deficits - reliance on short term foreign inflows to finance the CAD and unsustainable fiscal deficit driven by socialistic and welfare driven economic policies, persistently high inflation driven by lack of any meaningful structural reforms and a lack of effective political leadership. However, an interesting opportunity presents itself to change the situation in 2014. The most anticipated event in India is the general elections due in May this year. This is a very crucial election as a stable government with a strong leadership can help India dramatically change its economic trajectory.

India goes into election and the major actors being the two national parties along with their alliance partners – the Congress leading the UPA alliance (the incumbent) and the challengers, the BJP leading the NDA alliance along with the recently stitched up Third front (a grouping of several regional parties).

The recent assembly elections in the 5 states coupled with the recent opinion polls conducted in mid January suggest that the BJP led NDA will emerge as the single largest party in the forthcoming elections. The emergence of AAP (an anti-corruption crusade turned political formation) which did spectacularly well in the recent Delhi state elections and the recently formed Third front – have infused some nervousness and scepticism amongst market participants – potentially denting the chances of the BJP to form the government. The recent move by AIADMK a strong regional party from the South to become a part of the Third front has further strengthened the scepticism.

Our considered opinion is similar to the market adage – "markets will climb the wall of worries" – that in the end the BJP led NDA has a high probability of forming the next government despite recent political events.

In India's *first past the post system,* it is incumbent upon the President to invite the single largest party/pre-poll alliance to form the government. This will give the NDA the edge to attract alliance partners post the elections to reach 272+ numbers.

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Our confidence in the high probability outcome stems from following considerations –

Anti incumbency against UPA – High inflation, corruption, slowing growth have all created a significant anti incumbency wave against the Congress. The BJP will be the biggest beneficiary of the same.

Modi has given BJP track record and tailwinds – The BJP is an attractive alternative at the national level as its is perceived as a pro-growth party with Narendra Modi having a good track record of governance and immense popularity. Recent polls place him at pole position for the post of the PM (34% v/s 3% for Rahul Gandhi). Other BJP ruled states in MP, Chhattisgarh and Goa have delivered high growth and good governance.

Young voters and UP/Bihar to be a big swing factor for BJP - a record 120 mn new young eligible voters are more likely to be attracted towards the pro-growth policies of the BJP and are less likely to prefer the rights based socialistic give-away policies of the Congress. Additionally, the BJP is likely to gain substantially in the two largest North based states of UP & Bihar which collectively constitute 120/543 seats. In 2009, the BJP won only 22 seats but is likely to win 60-70 seats this time as Modi has strategically focussed on these states where the incumbents SP and JDU could face anti-incumbency especially the former.

AAP, Third Front spoilers? No - AAP's meteoric rise in the Delhi elections had fuelled expectations of a 35-40 seat haul in the national elections. But AAP's predominant focus on just anti-corruption as a key plank and a lack of a larger multi-dimensional vision coupled with inexperience of governance could restrict its impact. Its ambition to fight 300-350 seats we believe is a tall order given that even the BJP after being in politics for over two decades still manages to fight on only ~400 seats. As far as the Third Front is concerned, it is an opportunistic congregation of regional parties. We believe this front is a non starter as – there is no clear common ideology binding them with leaders of each of these parties having ambitions to become the PM candidate.

<u>In short, this election is for the BJP to lose.</u>

Macro Stabilising

India's macro is incrementally on the mend. Its *monetary policy* is in place. Raghuram Rajan as RBI governor – who commands tremendous respect globally – has worked decisively against inflation by raising rates and has brought considerable stability to the currency markets. India has witnessed a substantial external adjustment in recent months such that its CAD is tracking well below half its level from last year, FX reserves have been re-built, and the RBI's fleet-footedness has successfully anchored Rupee expectations. No wonder then, that the Rupee bucked the recent EM stress. To be sure, India's external vulnerabilities have not disappeared but are substantially reduced from a year ago. This, in conjunction with the government's fiscal restraint, has made the economy much less vulnerable to external shocks. Mr. Chidambaram as FM has put a tight leash on expenditure. Asset sales through divestments and inflows from auction of telecom spectrum will to some extent compensate for lower tax revenues arising from lower growth. Also structurally, post the 2G telecom and the coal & iron ore scams – India's resource policies are moving towards a transparent system of auctioning resources – there is *significant unrealised revenue upside potential* for the fisc which is partly being realised currently (through telecom auctions) and will significantly happen so post elections. *To borrow the adage from Raghuram Rajan – "there is tremendous low hanging fruit" – for reforms in India which can change its fiscal health dramatically.*

EQUITY OUTLOOK FROM CIO'S DESK

Markets undervalued, to hit new highs in 2014

The Indian markets have largely consolidated in a broad Sensex range of 15000 to 21000 during the last 6 years and are currently trading at ~5% below their all time highs. From a valuation perspective the markets are undervalued – currently trading at 13.9X FY15E and at 2.4X P/B below its long term average of 15.4X P/E and 2.7X on P/B basis with ROE's having bottomed out at 16.5% v/s long term average of ~ 19%. India's market cap/GDP is at 62% v/s 108% in 2008. So the markets are not expensive, especially when one considers that corporate profitability is currently at cycle lows as corporate capacity utilisation is far below capacity. Depreciation of the currency is already driving earnings in export oriented sectors which when combined with a cyclical upturn in economic activity will provide substantial tailwinds for earnings growth. A positive political outcome – for which we prescribe a high probability - can safely take market multiples to 17-18X one year forward earnings implying market levels higher by 25-30%, while earnings play catch up later. What could also change is the positive flow of savings to equities – something that has not happened for the last two years of 2012 and 2013 when domestic institutions were net sellers to the extent of $24 bn even as FII's were net buyers of $45.5 bn. So a potential $30-40 bn ($25-30 bn by FII's + $ 5-10 bn by DII's) could create a large positive swing in the markets. The longer the market spends in a consolidation range, the larger is the subsequent breakout. *We are already seeing smart money amongst domestic investors positioning for this eventuality.*

So, where will the money be made?

The markets at a macro level have never been so bi-polar – disproportionately benefiting sectors/companies with clean balance sheets, high ROCE, profit growth and visibility while punishing those which were more cyclical, highly regulated, closely tied to the investment cycle & the infrastructure value chain, SOE's and those which were highly leveraged and had misallocated capital.

Our portfolio strategy and positioning is principally based on fundamental bottom up stock ideas which encompass long term structural themes at play. Our competitive edge lies in our capabilities to identify great investment opportunities with "on the ground presence" through intensive field visits, across the market cap value chain and construct a concentrated portfolio of high conviction names across these promising themes.

EQUITY OUTLOOK FROM CIO’S DESK

Globally competitive export oriented plays

An improving DM outlook and a competitive INR has created exciting tailwinds for global as well as export oriented companies. Over the last 20 years, Indian companies have created a globally competitive advantage and scale - both in services & manufacturing sectors. IT services where we have a bar bell approach – a large cap turnaround story and very niche hi-tech player. In manufacturing we have exposure to generic pharmaceuticals, agrochemicals, auto (2 & 4W) and auto component companies. Each of these names in the manufacturing space has the advantage of straddling both a large domestic as well as the global export markets. The depreciation of the rupee and our inherent skill based low cost manufacturing and design capabilities have created a significant profitable growth opportunities across the market cap range. Closer and growing geo-political relations between India and Japan and China’s rising wage costs and appreciating currency have created new opportunities for India to be a global sourcing/manufacturing base.

Deep value cyclical and turnaround plays

As the political landscape in India changes and a structural recovery takes hold, we believe that the investment universe will expand considerably. Companies with strong balance sheets but weak P&L’s running at below long term potential revenue generating capabilities and relatively attractive valuations will be an interesting play. As the State becomes stronger and policy environment improves – SOE’s and companies related to the infrastructure/investment cycle value chain will become interesting hunting grounds for new ideas. Our focus here is to invest in companies which have a strong balance sheet (or a rapidly improving one) but a poor P&L with a potential for a significant Δ change

Consumer – Discretionary & Non-Discretionary + Financials

This continues to be the most exciting area of secular growth opportunity in India. There are large pockets of consumer markets where penetration levels are low, demand is rising on a secular basis as incomes rise, there is significant scope for mix improvement led growth. Interestingly leaders in these segments are well entrenched players with large market shares and strong moats which are not easily replicable. Governance standards are high and companies have great balance sheets and free cash flows to finance growth. While valuations are high in relative terms and there could be near term underperformance but high returns on capital and long term visibility of sustained growth make these compelling core positions. We have exposure to companies in beverages – alcoholic & non alcoholic, cigarettes, speciality organised retailers, jewellery & fashion accessories, organised retailers, apparels, education and home improvement segments. In financials have exposure to players who have a very strong consumer and retail financing franchise.

Our on the ground presence with local knowledge and a long term track record of performance and experience places us well to be able to benefit from what we believe could be the – <u>“Next Structural multi-year Bull market in India”</u>

Hiren Ved

Chief Investment Officer
Alchemy Capital Management Pvt. Ltd

DEBT OUTLOOK

February 2014 was an unusual month for debt markets. Instead of better inflation number, lower current account deficit, Stable currency and low bond supply 10 year G-sec yield inched up to 8.9%. During the month Finance minister presented the interim budget on 13th Feb 2014. The revised estimates of fiscal deficit for FY 2014 was indicated at 4.6% as against 4.8% of GDP budgeted at the start of the year. He not only bettered the current year's estimate to 4.6% (versus 4.8% targeted), but also pegged the next year's target at 4.1% versus 4.2% that was expected of him as per the re-stated consolidation road-map. We believe it's challenging to achieve these numbers specifically; gross tax revenues are pegged to grow 19% versus an actual outturn of 12% for the current year. Similarly, non plan expenditure growth is estimated at8%versus 12% achieved in the current year.

Money market conditions tightened during the month as system requirements mounted and government spending towards the end of the previous month slowed down. Daily system deficit topped INR 1.5 trillion, which was met by banks accessing the MSF (Marginal Standing Facility) option. The money market curve witnessed flattening on the back of tightening system liquidity and rising fresh issuances. The money market-corporate bond curve is now flat-to-inverted as was expected in the previous month.

WPI for January fell to 5.05%, faster than consensus estimates on the back of further softening in vegetable and food prices in the month. CPI also printed lower at 8.79% Compared to the previous month print of 9.87%. The Indian economy grew at 4.7% in 3Q FY14, slightly below expectations. Industry continues to be the primary laggard, with third quarter output contracting by 0.7% compared to a year ago. Despite the drag from industry, services surprised on the upside boosted by higher government spending and robust export growth. Agriculture disappointed with growth slowing to 3.6% despite the lift from normal monsoons. According to the latest figures, fourth quarter GDP growth would have to grow over 5.5% for realising CSO's full year advance estimate of 4.9% for FY14. Agriculture can positively surprise in the fourth quarter on the back of good Rabi harvest but even with this, 4.9% GDP growth seems difficult.

India's current account deficit (CAD) came in $4.2 billion (0.9% of GDP) in Q3FY14. This is a sharp fall from $31.9 billion in Q3FY13 and is also lower than $5.2 billion in Q2FY14. More importantly, the trade deficit has steeply fallen to 6.9% of GDP from a peak of 11.4% in the first quarter. Despite slowing export growth, a dramatic fall in imports pulled the trade deficit down to $33.2 billion from $58.4 billion a year ago. Capital inflows at $23.8 billion – buffered by $21.4 billion of inflows under foreign currency non-resident (FCNR) deposits - were more than sufficient to finance the lower CAD in Q3FY14. The rupee therefore, appreciated against the US dollar, compared to the previous quarter

Going forward we expect yields to be stable at these levels with downward bias. As we head into March, liquidity will become the primary determinant. RBI has indicated that they would conduct term repos in March to ease out any abrupt changes in liquidity conditions. We expect shape of the yield curve to invert if liquidity worsens from here on. Money market yields may rise further as we expect government spending to remain weak. Outflows towards telecom spectrum auction (part allocation) and towards the last installment of advance tax could exert pressure on money market yields during the month. Short term funds would offer good opportunity to enter at higher yields due to seasonal tightness in liquidity, as we have seen in previous occasions that short term yields tends to fall in latter part of April. Conservative clients can also look at allocating some amount to Tax free bonds; current yields on tax free bonds are really very attractive.

Rupesh Nagda

Head – Investments & Products
Alchemy Capital Management Pvt. Ltd

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Edited by: Rupesh Nagda (Ph: +91-22-66171785), Sudeep Pai (Ph: +91-22-66171772)
Alchemy Capital Management Pvt. Ltd., B-4, Amerchand Mansion, 16 Madame Cama Road, Mumbai 400 001. Ph: +91-22-66171700