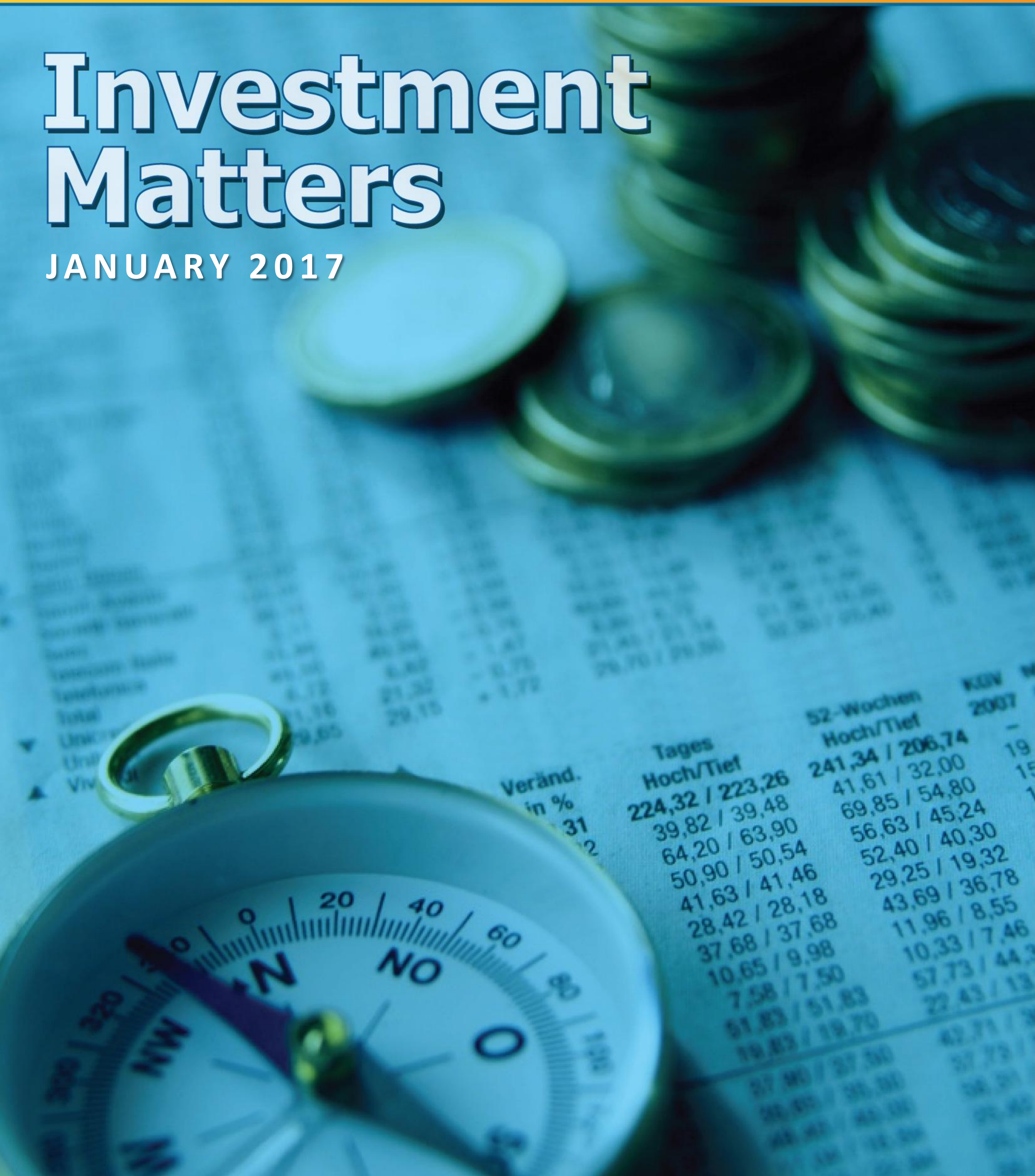
ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

JANUARY 2017



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EQUITY OUTLOOK

I take this opportunity to wish a Happy, Healthy and a Profitable New Year !

The last quarter of 2016 was indeed quite eventful. The "Trump" win and Modi "Demonetisation" both came as a shock. One was against popular consensus and the other totally unexpected. A lot has been spoken and debated about the two events. While we shall pass commenting about a Trump win because frankly we have no real competitive advantage or deep knowledge of US politics to do so, but would like to mention only one thing – risks inherent in taking event calls - and how the press, the media and the pollsters all got it all wrong and that people many a times may not really reveal their true political allegiances or minds publicly. That the anti establishment populist sentiment trend is taking hold across the political spectrum (Modi, Brexit,Trump et al) is now intelligentsia folk fore.

Back home PM Modi announced demonetisation, an unprecedented reform that should have far reaching consequences and implications for the economy and its various stakeholders. To begin with we think of it as a ***big bold*** move, largely unexpected ***out of the box thinking*** and ***big risk taking*** by the PM. We wanted to convey this upfront without diluting our thoughts with the benefit of hind sight of the events that have followed through post the decision.

We do see demonetisation will cause short term pain and we could see some moderation in economic growth, disruption of trade and business supply chains especially in the informal sector. There have been many attempts to quantify the impact of demonetisation on economic growth, revenues and corporate profitability. We do not subscribe to these estimates though we agree with their broad direction as firstly a lot of these estimates are merely those estimates. There has been a lot of anecdotal evidence gathering and then there is the real complexity of regional variations, urban/rural divide and varying supply chains across sectors between the producers and consumers. But more importantly, we see it as a short term and at best a medium term agent of disruption. One to three quarters of disruption does not impact the long term value of a business though it may have a bearing on near term valuations. Our take, and this is also based on anecdotal evidence, is that things are returning back to normal and in some cases faster than initially anticipated. The pace of recovery would also in part depend on how much of the new currency is put back into circulation and curbs on withdrawals are relaxed. We believe that by and large the organised sector and especially well run companies (as always) have coped well with the disruption and are well positioned to take market share away from the unorganised sector over time.

The fight against corruption will extend beyond demonetisation. The government will have to and is expected to usher in more policy changes to curb black money and formalise the economy. Unless the ability and confidence of the black money economy participants to continue business as usual is severely dented, the cynics are likely to judge demonetisation as merely a path to achieve political gains (though it could well be one). Implementation of GST will undoubtedly accelerate the process of formalisation of the economy and give a clear edge to the process of market share gains for the organised and the efficient at the cost of the unorganised and inefficient.

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Increasing formalisation of the economy apart, there are other macro benefits which should accrue. Contraction in money supply would help the already benign inflation outlook. We see a strong possibility of further rate cuts over the next 12 months. Government finances could benefit from higher tax collections as compliance improves. We think there are several legal impediments to Reserve Bank paying out the “windfall gains”, if any, though the probability of that seems very low for now - from exit or black cash from the system. It is almost imperative that the government uses any gains to expand its spending to boost the economy through increased capex, though its institutional capacity to rapidly spend needs to watched. The easier and more effective way to bring back growth would be to consider some form of transfers to consumers, either through tax slab changes or direct transfers in some form to the poor. If that happens, we think consumption will bounce back fast. However, as we mentioned earlier we should expect further steps by the government to curb black money. Hopefully the government will use the lessons from demonetisation to devise ways to curb black money using tax or other incentives rather than causing economic shocks or disruptions which do impact both consumer as well as investment sentiment.

Investors will look forward to the forthcoming budget keenly to decipher government action to get growth back. We hope the government uses the opportunity to cut taxes and not play Robinhood by being populist by increasing taxes on the rich excessively. Because that will hurt sentiment and the investment climate.

Aggregate earnings growth has been flattish since the Modi government came to power, something that we have witnessed every time there has been a need to set the macro right. However, market multiples have been supported by the much anticipated earnings growth and an almost 200bps cut in interest rates over the last two years. If there are no major disruptions and the budget manages to get the feel good factor back we see a resumption to the earnings growth story which was almost starting to take shape in Q2FY2017. Then a durable rally in 2017 could be a distinct reality. In the meanwhile the budget, followed by UP elections will keep us well entertained and on our toes!

We would encourage all investors to read the brilliant interview of PM Modi where he articulates his views on Demonetisation:-

http://indiatoday.intoday.in/story/narendra-modi-black-money-demonetisation-opposition/1/845224.html

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