12th Oct 2021

Aurum Small Cap Opportunities Quarterly Portfolio Update – Q2, FY 22

Dear Investor,

India's economic engine is chugging along well and picking up pace rapidly

Just a few days back M&M started accepting bookings for its most premium SUV to date, XUV 700 and it garnered 50,000 bookings within three hours! Take a moment to sample this – in value terms this represents Rs. 9500 crores. If this is not a reflection of the bullish economic sentiment prevailing on the ground, then what else is! Another anecdotal data point worth mentioning here is the news of chaos due to overcrowding of flyers at Mumbai airport some days ago conveying the same message.

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India is on the verge of accomplishing what just few months back was being thought of as impossible by critics – record vaccination coverage of its massive population. On an average over 70 lac vaccines are being adminstered daily and we already have ~70% of adult population covered with atleast one dose and over 25% with both doses. Such high levels of vaccination have allowed the federal and state governments to take faster 'unlock' decisions and reviving economic activity.

The pace of reforms has also commensurately picked up across the board - be it agriculture, power sector, defence or divestment of non strategic PSUs – the latest being disbandment of Ordinance Factory Board and clearance of Air India divestment to Tata's. With a normal monsoon, we also expect the rural economy to continue its robust growth. PSU Banks are clearly coming out of the shadows of NPA mess of the last decade and a few of them are likely candidates for divestment too. Further, they are coming back with force into the lending system albeit with better credit appraisal capabilities and post funding monitoring frameworks. Global high demand for digital transformation, cyber security, cloud migration and AI/ML programming has meant burgeoning

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order books for Indian IT companies and record rise in salaries of IT professionals, creating a natural cascading positive effect on sectors such as real estate, amongst others. Aatmanirbhar focus coupled with China +1 possibilities is finally catalysing the manufacturing sectors and leading to a clear revival of the private sector capex cycle. All of this and more bodes well for the Indian economy and we anticipate companies with robust business models and strong balance sheets to be disproportionate beneficiaries of this anticipated economic growth.

The Global scene isn't as rosy…

Just as the world had started to breath more easily post the pandemic lockdowns, EverGrande, possibly the Chinese Lehman moment crept up on us. EverGrande is the largest real estate development company in the world and has USD 350 bn of debt to boot. It is fast sliding towards insolvency. Other Chinese real estate companies are likely to follow in its wake. EverGrande is just one amongst the series of events happening in China including the crackdown on tech companies, declaring EdTech as 'not for profit' business, quasi take over of Hong Kong, sabre rattling over Taiwan. In the context of EverGrande, we would request you to refer to our Q2FY16 quarterly (Is China Going the Japan Way?), where we had discussed the Chinese debt fueled growth (https://nineriverscapital.com/NRC-Quarterly-Update-QE-Oct-2015-China-Going-the-Japan-way.pdf). The recent push by China to purposely curtail manufacturing activity in the name of cleaning up the environment doesn't add up to a logical reasoning. We believe, the mess is far too bigger and beyond our comprehension but clearly points to more global pain on that account. Seemingly to divert attention from its internal economic and political issues, China is once again displaying aggressive military posturing against Taiwan in particular and in South China Sea in general.

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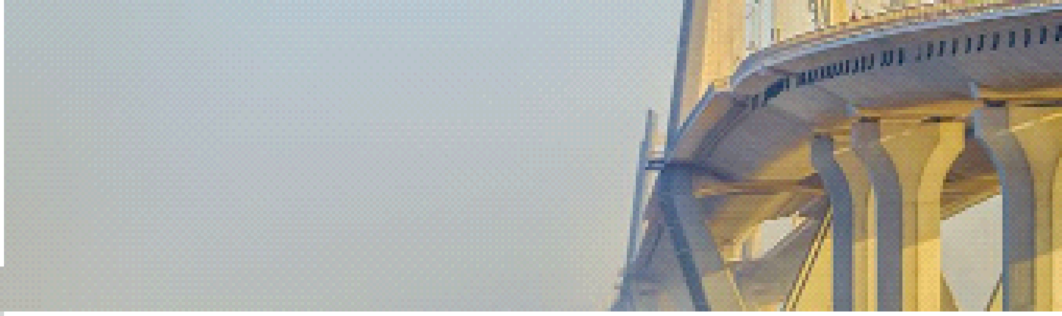
The supply chain disruptions continue to impact global trade as continued port congestion has led to astronomical increase in shipping freight costs further accentuated by labor shortages in US, UK and other European countries with large no. of people getting free money from the Government are refusing to come back to work. The planned bond buying by US Fed can also create a 'Taper Tantrum' effect on the financial markets. Oil prices have again hardened to level that would surely be worrying policy makers in India.



Given the resilience of India as a strong domestic economy and information technology powerhouse, we expect our economy to remain broadly on course. The stock markets however may react sentimentally in the short term and one should be ready to endure heightened volatility.

Private Sector Capex Cycle revival in clear sight

For a few quarters now, we have been getting clear indications from 'on the ground' channel checks that the 'ever elusive' revival of private sector capex is actually happening now. We also managed to collate some more data to buttress that argument.

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Table 1 is the order book of Praj Industries over the years. The order book in FY18 was INR 6.8 bn (INR 680 cr) and the stock price was 87 when we first bought the stock. The order book moved up to ~ INR 10 bn in FY19/FY20 and then at a rapid trot doubled to INR 20 bn in Q1FY22. Resultantly, the stock price also responded to this rapid order book accretion and moved upto INR 360 by June FY22. That is ~4x for us and the big numbers are yet to pan out!

Table 1: Order book & Stock Price of Praj Industries

	FY 18	FY 19	FY 20	FY 21				FY22
				Q1	Q2	Q3	Q4	Q1
Order Book (INR bn)	6.8	9.3	10.8	12.6	14.1	16.7	17.5	20.2
Stock Price (INR)	87	149	55	63	72	114	194	360

The rapid order book accretion of Praj was driven by the progressive & enabling ethanol blending policy rolled out by the federal government. It addressed woes of the sugar industry on one hand, while achieving the objective of reducing vehicular emissions and also reducing oil imports on the other. Similarly, we are witnessing a strong alignment of a clutch of macro factors and enabling government policies in various other sectors and resultantly revival of private sector capex cycle on the ground. Some such initiatives and other observations that point to a strong private sector capex revival are:

- **Investment & development of indigenous defence systems:** Over the last few years the domestic defence industry has seen an accelerated pace of development and procurement by the defence forces, as seen in **(Table 2)**.

These include howitzers, fighter & transport planes, helicopters, radars & electronic warfare systems, ongoing ship & submarine projects and recently a spurt of ordering for drones. All these put together, along with the stated policy of 'self-sufficiency', we expect the defence ecosystem to continue to see robust growth and investment by private sector in capacities to cater to the OEMs like BEL, HAL, Shipyards, etc

Table 2

Order Book (INR bn)	FY17	FY18	FY19	FY20	FY21
Bharat Electronics	402	401	518	519	534
Hindustan Aeronautics	NA	611	585	529	806

- **China+1 policy:** Even before Covid-19 struck, countries & companies had been considering ways and means to reduce their dependence on China for critical products and to ensure protection of intellectual property. Post the pandemic, this trend has accelerated with visible on the ground signs of manufacturing gradually moving away from China to other geographies. The priority for developed countries has shifted from pure cost savings to near shoring, control over important production base and rebuilding country's own manufacturing base wherever practical. The QUAD, which India is part of, is also working to enhance global supply chain resilience ex China. Japan on its part, has offered financial support to Japanese companies that invest in countries other than China. Multinational corporations are looking at countries with stable governments and progressive policies such India, Vietnam, Indonesia, Malaysia, Thailand, Philippines, Bangladesh and Mexico in addition to boosting home manufacturing with high levels of automation. In our opinion, this is a decadal movement which is likely to open many vistas for India to be a big supply base for many global companies.

- **Production Linked Incentive (PLI) scheme:** In India, service, manufacturing and agri sector are ~ 54%, 19% and 14% of GDP, respectively. With the aim to enhance the contribution of the manufacturing sector to at least 25% of

It is expected that over the next 2-3 years' time frame, PLI is likely to generate capex in excess of INR 1.4 trillion (~ USD 20 bn) in pharmaceuticals, mobile & hardware, white goods, telecom, specialised steel & alloys, food processing & technical textiles, etc.

GDP, generate employment and develop a robust & advanced manufacturing economy, GoI announced the PLI scheme in April 2020. It is applicable to companies investing in 13 specific sectors. It involves a cumulative incentive of INR 1.9 lac cr (~USD 2.5 bn), on incremental revenue from new investment over the next 5-6 years. PLI will be a big booster for the Indian manufacturing sector and allow Indian companies to build scale competitively. It is expected that over the next 2-3 years' time frame, PLI is likely to generate capex in excess of INR 1.4 trillion (~ USD 20 bn) in pharmaceuticals, mobile & hardware, white goods, telecom, specialised steel & alloys, food processing & technical textiles, etc. with a revenue potential of 10x of the investment over next 5 years. As the PLI juggernaut rolls ahead, the final commitments under this scheme is expected to be much larger.

- **Robust Corporate health:** Over the last 10 years Indian manufacturing companies have taken lot of efforts to reduce manufacturing costs, improve quality, sweat assets and improve productivity. Since 2003, India companies have won 401 JIPM TPM awards, highest for any country outside Japan. Indian companies have won 38 Deming Prizes – the highest global recognition for TQM implementation. India has the most US FDA approved pharma plants outside US. As the top tier corporates undertake such productivity & value accretive journey, the entire ecosystem including their work force, vendors & suppliers, competitors move up the quality & productivity graph. Moreover, post the implementation of **IBC** (bankruptcy act) corporate houses and companies have consciously cleaned up their balance sheet and have become more fiscally disciplined by reducing debt. The buoyant equity markets have also allowed companies to raise equity capital for future growth setting the ball rolling for incremental capex.

- **Gradual Order Book accretion of some EPC companies:** Over the last 10 years bulk of the capex in infrastructure or plant & machinery has been by the government and government owned companies. On a consolidated basis, while govt. spending is expected to continue, order book accretion **(Table 3)** of engineering & EPC companies may be indicative of incremental order flow from private sector as well. We have seen announcement of new investment in refining & petro chemicals, cement, logistics, data centres and renewable energy segments. While still nascent, we may be seeing initial signs of private sector capex cycle in the form of higher order book accretion of some large & niche EPC companies in India. Our conversation with engineering product suppliers to large EPC contractors also indicate an upbeat mood and growing confidence. We are also getting similar vibes from large corporate banks.

Table 3: Order Book accretion

Order Book (INR B)	FY17	FY18	FY19	FY20	FY21	Q1, FY22
Thermax	40	57	54	52	52	61
L&T	2,613	2,601	2,908	3,039	3,274	3,237
Triveni Turbine	7.1	8.3	8.5	7.9	6.4	7.3
ITD	66	75	100	117	117	120
Bharat Electronics	402	401	518	520	534	545
Hindustan Aeronautics	NA	611	585	529	806	NA
BHEL	1,052	1,181	1,087	1,084	1,021	NA

In conclusion, we are seeing an alignment of a number of macro & policy initiatives at global & national levels to re-industrialise domestic economy and firing up of the private sector capex cycle.

Our approach to playing the private sector capex theme

We plan to adopt a 'Pick & Shovel' strategy to identify and invest in the private sector capex revival theme.

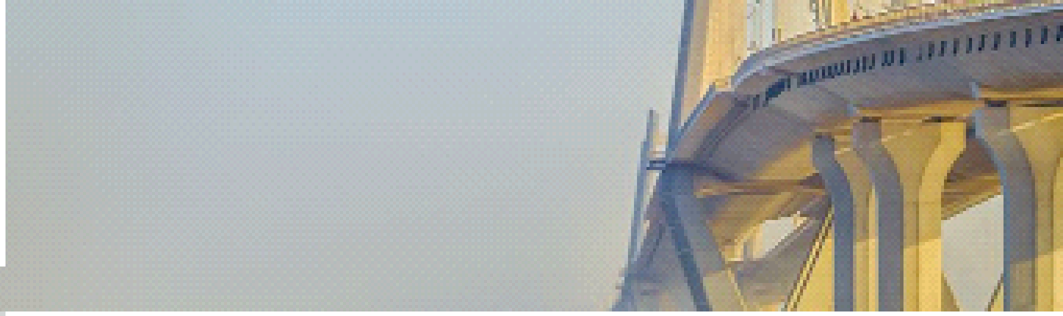
We plan to adopt a 'Pick & Shovel' strategy to identify and invest in the private sector capex revival theme. Our focus would be to invest in industrial companies that are likely 2nd degree beneficiaries of an uptick in the private sector capex cycle. These would be the companies supplying consumable or engineering products that are part of the larger capital projects or will see higher demand in line with higher levels of production. Thus, we would be looking at companies supplying *welding solutions, transformers &*

switchgears, compressors, industrial motive belts, pipes & tubes, abrasives, reactors & pressure vessels, bearing, pumps & motors, refractories & grinding media, etc. Moreover, these companies need to have strong management team and balance sheets to be able to weather any short term hiccups.

Looking forward to your continued support and encouragement.

Warm regards,

Sandeep Daga



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