

9th January, 2017

Aurum Small Cap Opportunities & Aurum Growth Portfolio

16th Quarterly Update – QE December 2016

Dear Investor,

At the outset, we wish you a very happy, healthy & prosperous new year. Last month, our small cap strategy completed four years of having delivered consistent out performance! Our mid cap strategy is now 42 months old and also continues to deliver robust out performance.

In the last four years we have witnessed monumental changes globally & at home. Globally we have witnessed Brexit, Trump, changing mix of energy basket & its consequences, emergence & gradual decimation of ISIS, Paris Accord (Climate change), etc. At home, we witnessed electoral successes of BJP & AAP, surgical strikes across the border & lastly, the monumental event called currency Demonetisation and the expected roll out of GST.

Going forward, implementation of GST was anyway expected to bring most of the economic activity within the ambit of the formal (reported / tax paying) economy. We believe, the recently concluded Demonetisation exercise is likely to turbo charge this transition process and will lead to radical transformation of the way business is conducted in India. As we had highlighted in our earlier communique, post DeMo, this should not be looked as a standalone step but one major step in a series of other steps taken or likely to be taken by the Government to curb black money and rein in the parallel economy.

Since the 'live' subject of discussion today in most financial corridors is the effect (or ill effect) of 'DeMo' on the economy, in this update, we have made an attempt to assess the same based on our analysis and on the ground feedback.



Demonetisation – A step amongst many

Black money or illegitimate wealth has various colours, starting from ‘tax not paid on legitimate income’ to ‘income from bribes & criminal activities’ and everything in between. As individuals or corporates, we all voluntarily or involuntarily participate in this process.

Simplistically put, higher the proportion of illegitimate wealth or black money, higher the propensity to spend on luxury discretionary consumption (*high end brands, jewellery, watch, 4W & 2W, overseas travel, etc.*) or invest in opaque assets like land, property or gold.

Black money generation and consumption patterns



Chart 3

Globally, this has assumed monstrous proportions and attacking it from outside via police action or tax audit is merely scratching the surface of the beast. The beast has to be tamed & terminated by starving it. We believe that Demonetisation is a significant step, amongst many others, towards that goal.

Other steps taken by the Government or likely to be taken, to curb the menace of corruption are as illustrated below:

Demonetisation – One in many steps to fight black money

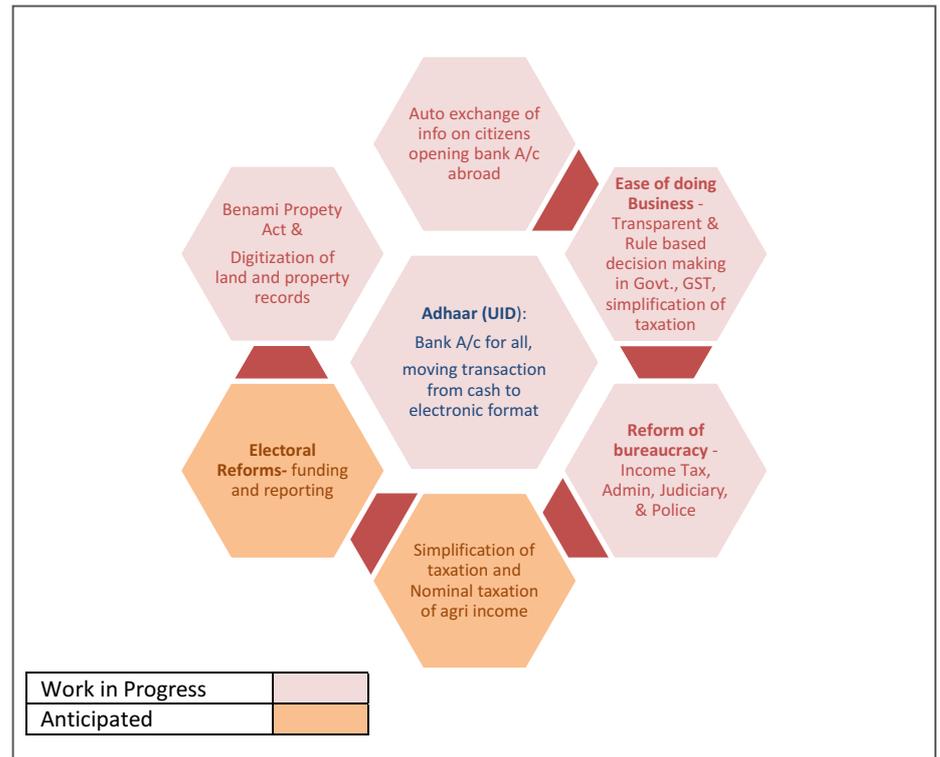


Chart 4

- **Ease of doing business - transparent, rule based decision making:** Reduce bureaucratic and ministerial discretion in decision making process. Higher the rule based transparency, lower the scope for discretion and corruption. Past govt. steps like auction of natural resources (coal, telecom) and our conversations with corporates indicate a robust movement in that direction. This, however, has yet to trickle down to middle and lower level of government bureaucracy and will be resisted tooth and nail.
- **Digitisation of property & land records:** Digitisation and seeding of property records with Aadhaar & PAN no. will help unearth properties funded from illegitimate income. This will also staunch the inflow of illegitimate income in real estate assets. Application of the recently passed Benami Properties Act should have a salutary effect on the system.
- **Administrative Reforms:** Overhaul of Income Tax, administrative bureaucracy, judiciary and police, including simplification of taxation law.
- **Quick detection and punitive action:** Making corruption socially & economically punitive via fast detection and punitive action will make corruption less attractive to the socially conscious population. This is part of the administrative reform mentioned above, including the judicial process.



Over the next few quarters, corporate results are going to reflect the underlying pain of demonetisation, leading to volatility in Indian equities

If properly followed through, illegal generation of money may reduce significantly in the coming years, though not cease to be.

Such radical steps can have extreme positive or negative outcomes over the long term. To begin with, it has certainly caused inconvenience to everybody. We believe:

- Government will not print as much money as was demonetised!!
- Gradually, significant transactions will become cashless, adaptability being moderate to high
- Over the next few quarters, corporate results are going to reflect the underlying pain, leading to volatility in Indian equities.

The long term impact of demonetised (along with other steps) will be felt as follows:

- ‘*Negative wealth effect*’, likely to reduce high-end discretionary consumption, with certain sectors feeling the impact over longer term
- Cost of owning a property and thus, cost of doing business likely to come down
- Lower inflation, followed by lower interest rate
- Accelerated adoption of electronic means of exchange & payment (salaries, vendors) with a trickle-down effect
- Expansion of tax base and consequent tax collection

From a sectoral perspective, we believe, Oil & Gas, Energy, Defense & Infra are likely to be least impacted. On the other hand, real estate & high end discretionary consumption like jewelry, luxury watch & writing instruments, designer wear, high end 2W & 4Ws are likely to feel the impact over medium to longer term horizon.

Sectoral Impact of demonetisation

NO IMPACT	SHORT - TERM IMPACT	LONG-TERM IMPACT
Will not be impacted by cash shortage / poor consumer sentiment	Will see temporary impact due to cash shortage & poor consumer sentiment	Will have long-term structural impact due to systemic crack down on black money
<ul style="list-style-type: none"> • Oil & gas • Energy (T&D) • Defense • Infrastructure (rural & urban) 	<ul style="list-style-type: none"> • Auto & Auto ancillaries • Banks • FMCG • Consumer Durables • Cement & Building materials 	<ul style="list-style-type: none"> • Real Estate • Jewellery • Luxury goods • MFI /NBFCs

Table 3

Goods and Services Tax (GST)

Soon, we are likely to see GST being rolled out in right earnest. When GST starts rolling, corporates at the top of the value chain will expect GST certificate from their suppliers & service providers. However application of GST is likely to impair the business model of many companies where 'tax evasion' was the business margin. Inability of such companies to respond to GST regime will crimp their businesses and eventually render it unviable, particularly in the SMES segment.

The twin rollers impact of Demonetisation & GST will be felt in the following ways:

- Consolidation and movement towards a formal economy
- Resultant transparency and a wider tax base
- Lower 'cost of doing business', to the extent of 2-3% of GDP and lower interest rate

Application of GST is likely to impair the business model of many companies where 'tax evasion' was the business margin

Twin impact of DeMo & GST

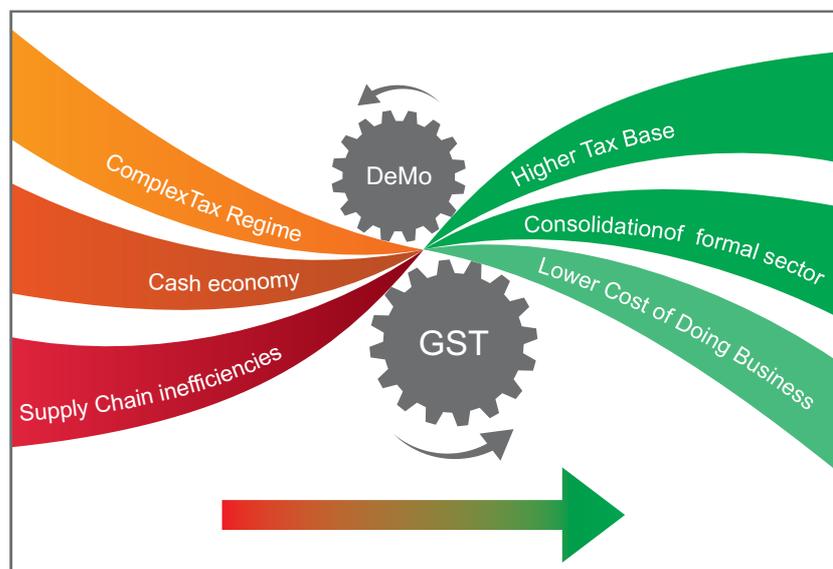


Chart 5

We are looking to invest in companies that are either not (or only marginally) impacted by demonetisation or are well placed to ride the consolidation wave that is likely to follow in the wake of implementation of GST

Conclusion

Whether by design or otherwise, government is working towards, first reducing and then making the cost of corruption high, both socially and economically. Towards that end, large scale digitization of property records and corresponding application of Benami Properties Act will significantly increase the cost of being corrupt. Well oiled implementation of GST will be another nail in the coffin. In conclusion, we do feel that DeMo has impacted the 'mass psyche' in a way that would propel most to get into the formal economy in future. This bodes very well for the country.

In the interim, over the next few quarters, as corporate performance trips on 'demonetisation', we think, stocks will react adversely as the reality of the same hits home. However, going forward, as and when GST is implemented, consolidation at the tail end of industry and low base effect will translate into robust growth, late FY18 onwards.

We, on our part, are looking to invest in companies that are either not (or marginally) impacted by demonetisation or are well placed to ride the consolidation wave that is likely to follow in the wake of implementation of GST. We remain upbeat about Indian economy (with a lag of 6-9 months) and will keep using such opportunities to invest in good quality companies at reasonable valuations. Having said that, Chinese yuan devaluation and flight of capital to US can temporarily upset the Indian appcrt as well. We continue to keep our eyes and ears open to these potential global events!

Please feel free to call or write to me for any further information.

Warm regards,

Sandeep Daga

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