16th April, 2019

Aurum Small Cap Opportunities & Aurum Growth

Dear Investor,

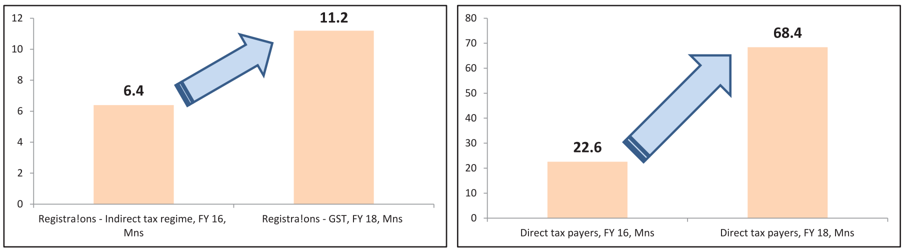
In the last 5 years, India has witnessed:

- Several disruptive reforms, namely, Demonetisation, GST, IBC (Insolvency Act) & RERA
- Severe forex volatility
- Oil price shock, with depreciating INR compounding it further
- Credit issues linked to companies like IL&FS and corporate distress in airlines and NBFCs

The good news however is that Indian economy was able to successfully weather all this turbulence and continued to plough on at a healthy pace.

- GDP grew at ~6 - 7% pa
- Indirect and direct tax filers increased at a healthy rate (Chart 1)

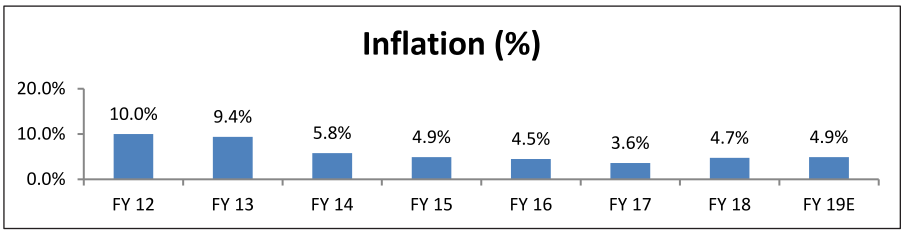
Chart 1: Expanded indirect & direct tax base



Source: Incometaxindia.gov.in

- Export grew @ 11% CAGR (FY 16 to FY 19)
- Fiscal Deficit declined from 4.5% (FY14) to 3.4% (FY19) of GDP
- Inflation was benign @ ~4-5% (Chart 2)

Chart 2: Benign inflation



Source: RBI

As we speak, reform pains are fading and gains are kicking in form of increased transparency & efficiency via DBT, larger tax base & accelerated formalisation of the economy. Further, in the last 5 years:

- **Healthier corporate balance sheet:** Large part of corporate India has emerged leaner & fitter, though it may have witnessed erratic earnings trajectory on account of disruptive reforms, oil & commodity price volatility and forex shocks
- **Rationalizing of competition:** Airlines industry is a recent example and we expect similar phenomenon in the NBFC space
- **Revival of private sector capex cycle:** Private sector capex has generally been rather weak over the last 6 -7 years. However, as per RBI OBICUS Survey, Oct-Dec 2018, capacity utilization in private sector is hovering near 75%. Going forward, we expect capex cycle revival to kick in shortly at around 80% capacity utilisation

We also are witnessing a global trade re-alignment which may work in India's favor because of the following reasons, namely;

- Brexit & US-China trade war is throwing up opportunities for India businesses as existing global supply chains are disrupted
- China is gradually losing its competitive advantage in certain sectors because of:
  - **Higher labor cost:** Labor cost in China have grown at CAGR of 9.6% , from ~USD 2.7 / hour in 2013 to USD 3.87 in 2017 (Source: China Statistical Yearbook 2018)
  - **Higher environmental compliance:** Higher environmental compliance in China has led to closure of many units, which are likely to come back at higher compliance level & cost
  - **Emerging current account deficit:** With Chinese exports flattening out over last few years, its balance of payments surplus has narrowed, resulting in limited room to engage in currency management

- Indian economy & businesses have weathered several headwinds and emerged stronger
- Competition is rationalizing, accelerated by better corporate credit discipline
- Brexit, trade wars & Chinese reforms throwing up new opportunities for Indian exporters

Table 1: Chinese exports and current account balance

Year	China: Goods Exports		China: Current A/c Balance	
	USD Bn	YoY	USD Bn	YoY
2014	2,244	4%	236	59%
2015	2,143	-5%	304	29%
2016	1,990	-7%	202	-34%
2017	2,216	11%	165	-18%
***9M** 2018*	*1,772*		*(7)*	

Source: IMF

Resultantly, Indian vendors finally have a much more level playing field vs Chinese competition

Domestic reforms to continue

We expect domestic reforms to continue at a steady pace regardless of the outcome of the ensuing general elections. We believe that structural reforms such as GST, IBC and crackdown on shell companies, amongst others, are irreversible. These have deeply impacted psyche of the business fraternity with the severe costs of non-compliance prompting them to turn compliant.

Going forward, some areas requiring particular attention are:

- **Administrative reforms -** While India has risen 23 ranks in the 2018 Word Bank's "Ease of Doing Business" to #77, there is still much headroom for higher digitization & simplification of government processes. Improving service delivery to citizens is another area where a lot of work remains to be done.

- **Judicial reforms -** This is a long neglected area requiring urgent attention. The misuse of PILs creates delays in execution of government policy & decision-making. Further, over burdening of courts results in interminable delays in resolving commercial disputes, resulting in poor enforceability of contracts.

- **Rural & Agri distress -** Rural & Agri economy is facing distress due to rapidly increasing farm production on one hand and lack of post-harvest storage & processing infrastructure on the other. Thus, agri related reforms will be a top agenda item of the next government, with an objective to make agriculture more sustainable and create seamless access to markets for agri producers. Some steps that need to be more aggressively worked on include:

  - Wider adoption of **crop insurance**

  - The Electronic National Agri Market (eNAM) launched in April 2016 today covers 585 APMCs across 18 States/UTs, with additional 400 targeted for FY20. Over 124 commodities are listed on eNAM. Inter-state sales commenced in small way in Jan 2019, moving closer to vision of a single, transparent national agri market on the same lines as GST enabled one nation, one market.

  - Investment & upgradation of agri commodity warehouses is a step that has to be rolled out in line with eNAM. Development of quality assayers and allied infrastructure is a necessary to reduce post-harvest loss (~ Rs. 92,000 crs p.a. / ~ 40% of agri-production), better realization for farmers and also to enable bank credit against agri commodities.

"eNAM & agri-warehousing reforms hold potential to create a game-changing transparent, pan-India market for agri-producers"

The other areas where rapid policy & structural reforms can be expected are:

- Electric vehicle related infrastructure & policy, renewable energy (solar in particular) and energy efficiency, progressive tightening norms of water and air pollution control norms, electricity distribution (unbundling of electrical utilities into generators, ("Content"), transmission ("Carriers") and distributors (last-mile / marketing) and further streamlining of IBC process and robust development of corporate bond market which will help to moderate NPA issues going forward and instill a sense fiscal discipline amongst entrepreneurs.

Streamlining of IBC process and robust development of corporate bond market is likely to moderate NPA issues going forward.

It's Always Darkest Before Dawn!

Having expressed optimism on the Indian economy, one should not forget the challenges that we face due to local and global factors. Two major factors that come to our mind are:

1. **Possible domestic credit squeeze**

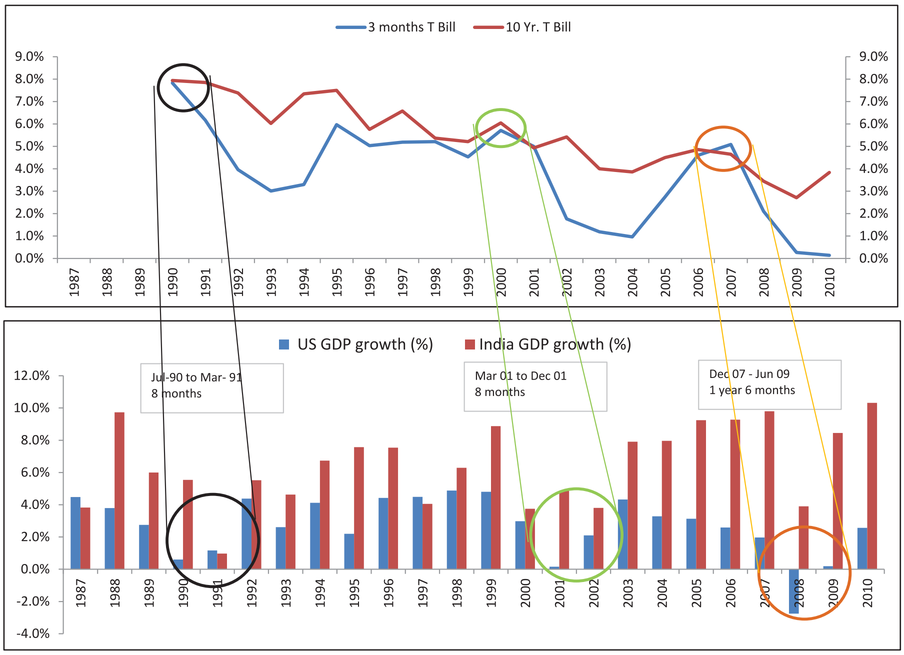
   ILFS debacle (Oct 2018) followed by a leading housing finance NBFC going into crisis has shaken the confidence of the debt markets, making investors nervous. This has created a liquidity crunch for the entire NBFC sector. With asset liability mismatch looming large for most NBFCs, one cannot rule out more pain to come in days to come, or even a shakeout amongst NBFCs. Along with NBFCs, businesses like auto and consumer durable, that are highly reliant on NBFCs for consumer credit and therefore growth are likely to be impacted as well. The auto segment is already feeling the impact of credit squeeze, with a slowdown in sales and inventory rising to 6-8 weeks as against normal inventory of 3-4 weeks.

Auto and Consumer Durables sales are significantly financed by NBFCs and are currently feeling the heat of credit slowdown

2. **Possibility of global recession**

   The US and EU have seen inversion of interest rates (Chart 3), often a lead indicator of economic slowdown and possible recession. Such a recession may also impact Indian GDP growth, primarily on account of reduced exports to these economies

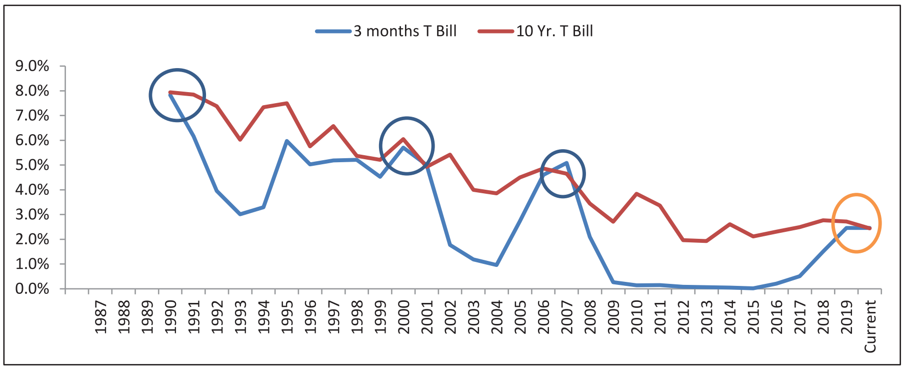
Chart 3: Inversion of US G Sec rates & impact on Indian GDP growth



Historically, these recessionary conditions in US have persisted for 6 to 18 months and have also impacted GDP growth in developing countries like India (Chart 3).

The US and EU may be on the cusp of a recession with implications for Indian exports. However, the Indian Economy remains significantly domestic consumption driven

Chart 4: Cusp of US recession?



As would be evident from Chart 4, the US economy may be at the cusp of another recession, with consequent risks to India's GDP growth.

However, we also see strong mitigating factors in favour of India. Exports make up less than 20% of India's nominal GDP, which is largely domestic consumption driven. Further, weak US growth is also likely to increase capital inflows to India.

We believe that the next 6-9 months would be a good period to build up a high quality small cap portfolio at reasonable valuations to reap the benefit of superlative returns over the next 3-5 years

Conclusion

As mentioned at the very beginning of this update, the Indian economy and businesses have weathered quite a few disruptive reforms over the last 5 years. Continuation of major structural reforms will enable India to move towards being a much more mature, transparent and rules-based economy. The World Bank projects India's real GDP growth to be 7.5% p.a. (2019-21), making it the world's fastest growing major economy, ahead of China.

We are optimistic that the economy, having grown strongly in face of several disruptive reforms, will deliver on these expectations and the next 6 – 9 months would be a good period to build up a high quality small cap portfolio at reasonable valuations to reap the benefits of superlative returns over next 3-5 years of the equity cycle!

Warm regards,

Sandeep Daga

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