8 Oct, 2014

Quarterly Update

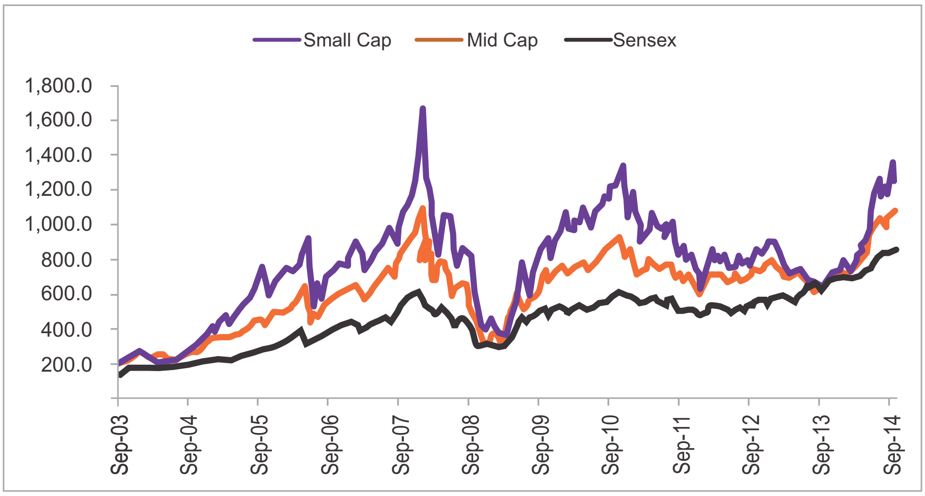
(QE September 2014)

Dear Investor,

This is our 7th quarter together and we hope we have been able to live up to your expectations.

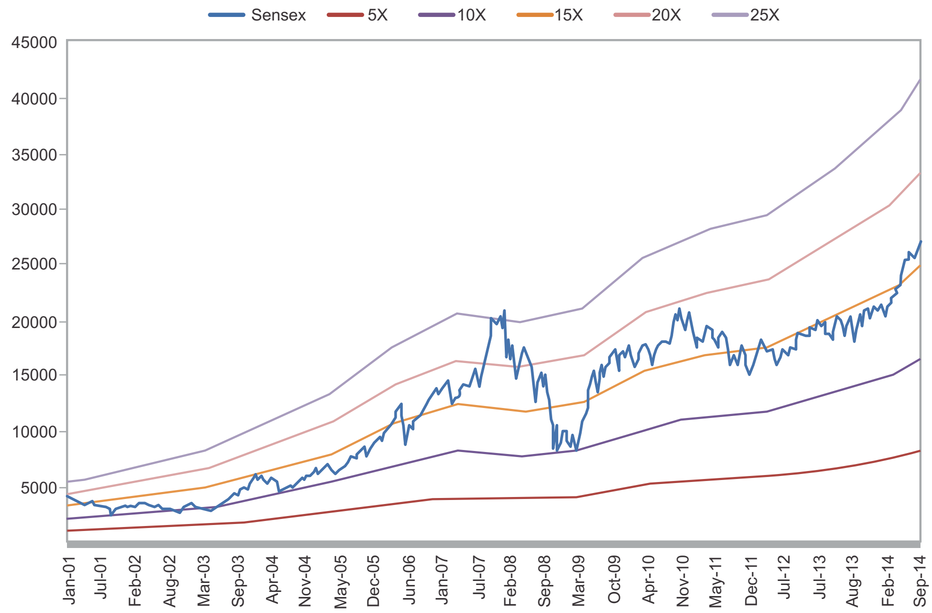
Still a long way to go..

If you recall, in our March 2014 update we had shared a comparative chart of large (Sensex), mid and small cap indices and had pointed out that we were at the '*cusp of a new growth cycle*' in respect of equities. Given hereunder is an updation of the same chart.



As would be evident, the new equity cycle has started with a big bang. Maybe that is the nature of all bull markets. The question that obviously begs answer is, '*Is it too much too soon*'? What next?

We have also pondered over this question and have tried to look for a well reasoned and logical direction. In this respect, we would urge you to take a look at the next chart. It is the Sensex PE band chart since 1996, comprising multiple cycles since then.



As seen in the chart, currently, the ***Sensex*** is in range of 15-16x, consensus earnings FY15. Going by historical precedence, we believe, we have a significant way to go in terms of the wider market valuation, provided we continue to see consistent movement towards reforms and sustained economic recovery.

We are still in the early phase of a new equity cycle with significant market gains expected in the next few years

Juxtaposing the two charts together, we conclude that though the Sensex has moved up sharply, it is still reasonably valued. This leads us to believe that we are still in the early phase of a new equity cycle with significant market gains expected in the next few years.

Having said all of the above, we once again want to emphasize that we are not in the business of predicting the market or taking investment decisions based on that. We build portfolio one company at a time, based on merit & valuation. Right now we are significantly in cash for our new clients and selectively divesting in our more mature portfolios dictated by our valuation guard rails.

Global Economy

We are not experts on commodities and do not track them on a regular basis. However, macro cues seems to indicate that the super cycle of commodities, as witnessed over the last 10-12 years, is coming to an end and we may be entering a more tempered commodity price cycle, as described in the book ***Super Cycles*** by Arun Motianey. The end of this super cycle will indeed throw up challenges for the global economy, including China, which has been primarily an export driven economy.

On the other hand, raising of interest rates by Fed is only about timing now. Many experts in the financial markets seem to believe that it is likely to happen sooner than later and resultantly the US dollar has rallied against all currencies in anticipation of such an event. The global equity markets seem to be sneezing as we speak and risk catching cold too. Given this backdrop, we believe that global economic uncertainties will continue to haunt us for some more time to come and so would the volatility of equity markets.

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Indian Economy

Some cynical pundits had expressed fear that after assuming office the new Government at the Centre would immediately bring about a change in the leadership at RBI and other such Institutions. Thankfully we are seeing that wherever good work was done by the previous regime is being carried forward without upsetting the apple cart. A case in point is the continued roll out of ***Aadhaar.***

Aadhaar registration, coupled with aggressive roll out of ***Jan Dhan Yojana*** bank account, can be a game changer in terms of subsidy management. Further, small measures such as doing away with notarisation (replaced with self attestation of documents), proposed scrapping of obsolete laws, and moderation of labour laws are early harbinger of things to come. The cobwebs & dust are being vacuumed & cleaned to make entrepreneurial activity more efficient and a strong revival of manufacturing business' seems likely. Further, we hope to see rollout of GST and other relatively more broad stroke reforms going forward.

Judicial pronouncement on coal block allocation was along the same lines as 2G telecom issue and sets the stage for a transparent and process driven methodology. In our investment process we have been consistently taking into consideration governance standards of companies and believe the old way of '*gaming or managing*' the system are no longer viable or sustainable ways of doing business.

If commodity prices in general were to indeed contract as aforesaid, India will generally benefit significantly from the same

Softening of gold & oil prices has given much needed elbow room to the regulators to manage macro economics. We believe if commodity prices in general were to indeed contract as aforesaid, India will generally benefit significantly from the same even though some sectors may feel the pinch. Unlike China, India is a large domestic consumption play with favourable demographics, now led by a strong leadership and a stable political dispensation. We think India is poised to move up a few notches as an investment destination for global investors.

Value Perspective in Organised Retail Business

Large organised retailers, who were already grappling with the profitability issues in India, on account of sub-par sales and a high cost structure, have been handed another blow by the rapid emergence of online retailing. Domestic online retailing has grown quickly to gather a critical mass and is estimated to be at ~Rs200 bn (~USD 3 b), growing exponentially at the rate of ~50%+ per annum.

Rapid growth of online retail has further impacted the deteriorating financials of many of the organised retailers. At an aggregate level, in the last 3 years, operating and net margins of companies such as Shoppers Stop, Pantaloon, and Trent have all shown a declining trend. Similarly, operating parameters such as same-store sales growth, conversion ratio and sales per square feet have declined (eg; same store sales for Shoppers Stop has declined from Rs 8,080 in FY11 to Rs 7,330 in FY14). This has brought the viability of organised retailing as a differentiated delivery model under cloud in the short to medium term.

To be fair, the surge in online retailing is not the only reason for the weak performance of traditional retailers. There are other factors such as economic slowdown and local competition. However, to stay in the game, traditional retailers will have to work on their internet strategy and find a balance. We would however, continue to err on the side of caution in the short to medium term.

On the flip side, logistics companies are expected to do well on the back of internet commerce boom, as was seen in the US (FEDEX).While we have assiduously avoided investing in organised retail, we are continuously on the lookout of business which well benefit from booming internet commerce in the country.

We believe, in the long term, strong brand franchise and distribution reach matter the most and we will continue to look for consumption led investment opportunities with such attributes.

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Currently, we are holding our horses and investing cautiously as and when we get investment opportunities within our valuation comfort zone. To that end, on a consolidated basis our portfolio is ~ 10% in cash. This may vary from client to client, depending on the maturity of individual portfolios.

Going forward, while the investing basics will remain the same, we will continue to think laterally and act conservatively. In the same vein, we are looking at opportunities wherein balance sheet restructuring of companies is happening / happened. Further we have come across interesting opportunities where there has been a change in management or empowerment of the younger generation from the family, leading to visible change in the outlook of the business for better.

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

Warm regards,

Sandeep Daga

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