

8th October, 2015

## **Aurum Small Cap Opportunities & Aurum Growth Portfolio 11th Quarterly Update – QE September 2015**

Dear Investor,

This is our 11th quarter together. During this journey we have seen general market expectations run ahead of ground reality and also fall behind in fear and uncertainty, as is the case today. On our part, consistent with our investment philosophy, we have tried to stay disciplined & conservative and not get swayed by short term market sentiments.

A year ago, in our September 2014 Quarterly Update we had highlighted our belief that the commodity cycle has run its course and we are likely to see years of benign commodity prices. Our assumption was overcapacity and gradual moderation in demand. In retrospect, we have to admit, we were overly optimistic in our assessment. As it turns out, there is significant contraction in demand primarily due to the withdrawal symptoms that the Chinese economy has displayed in recent times. We have made an attempt to understand the **China factor** and that is the centre piece of this Quarterly Update.

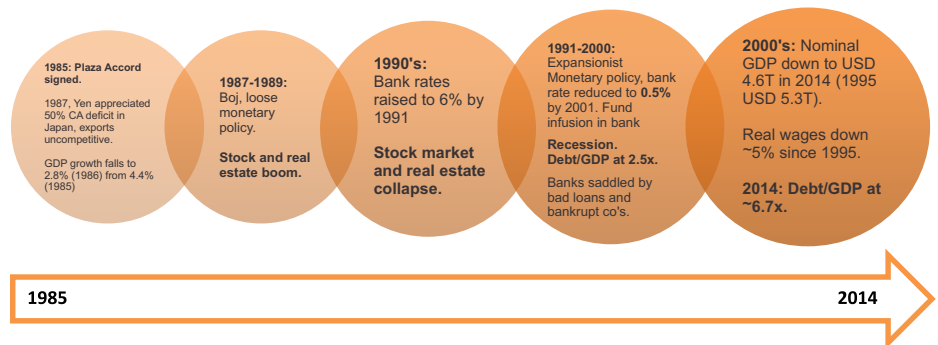


## The Lost Decades of Japan

Before we move to China, it is worth spending a few moments to understand what happened in Japan and if the event there can be extrapolated to better understand the development in China today. One of the triggers of Japan's economic derailment in the last 2 decades finds its roots in the **Plaza Accord** signed in **1985** and Japan's economic policy in its aftermath. The accord signed by the then G-5 nations (*US, West Germany, France, UK, and Japan*) agreed to devalue the USD by 50%. The decision was precipitated by grave economic situation, with US grappling with a slowing economy, an overvalued currency that rendered its exports uncompetitive globally and a high current account deficit. On the other hand European nations and Japan were experiencing enormous current account surpluses as well as low to negative GDP growth.

So, the major world economies, in an unprecedented cooperation agreed to revalue the exchange rate system over a two-year period via synchronized currency market interventions by central banks. Target rates were set and resultantly, the USD depreciated by 50% by 1987, while West Germany, France, the U.K. and Japan saw ~50% appreciations in their currencies. What followed, however, could not have been anticipated by any of the participants!

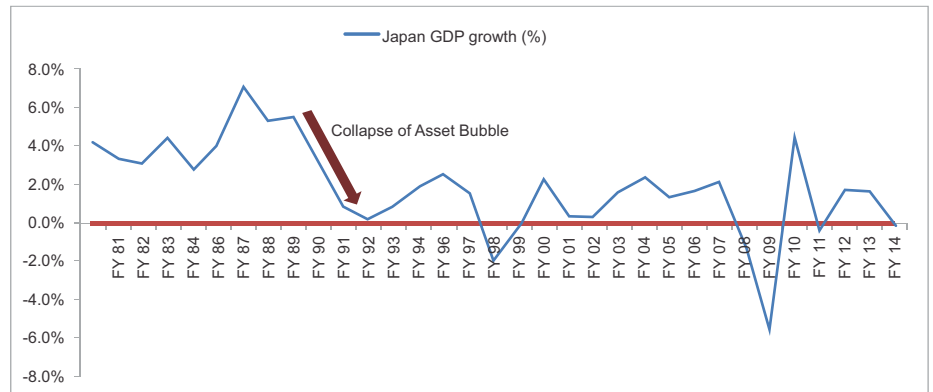
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As the Japanese Yen appreciated, post the Plaza Accord, its exports became uncompetitive and growth slowed down. Bank of Japan (BoJ) responded with loose monetary policy which led to a stock market & real estate bubble (1987-1989) of unprecedented magnitude, which in turn was followed by tightening monetary policy by BoJ and a subsequent collapse of the asset bubble.



### Japan: Anemic GDP Growth



Source: World Bank

As would be evident from the graphical representation above, since the collapse of the asset bubble, in the early 1990's, the Japanese economy has witnessed anemic and erratic growth.

The primary reason for the economic morass that plagues Japan today is the Government's reluctance to take hard & prudent policy decisions to clean up the debris of the asset bubble. Instead, it continued to support zombie banks and bankrupt firms with capital infusion and investment in public projects. As things got from bad to worse, the government kept on doing the same of the old thing, i.e; follow a loose monetary policy. Resultantly, as of 2014, Japanese debt to GDP ratio has spiraled to 6.7x, leaving the Japanese policy makers painted in the corner. The macro figures convey a similar gloomy picture. From \$5.33 t in 1995 Japanese GDP contracted to \$4.36 t in 2014 and real wage has declined ~5%. GDP growth has also been an anaemic ~0.8% & 0.9% over the last 10 & 20 years, respectively. These are the lost decades of Japan, a country once destined to conquer the world economically!

Given China's debt fueled journey since 2007, the question that looms large now is whether China is on the verge of something similar?

### China – At a Cross Road

The Shanghai Composite Index had risen ~2.4x from ~2300 in August 2014 to ~5150 in June 2015, in less than a year. Since then it has been gradually declining till manic Monday (21st August) happened, when the Index lost about 9% in a single day. Overall, it has lost about ~75% of the gain.

While exact data is not available, real estate sector has also apparently acquired bubble proportions with significant debt in the economy either directly or indirectly invested in the same. Question then being, 'is China going to replay Japan and its lost decade/s'?

While there are no straight answers, it would be interesting to compare the two countries in different time frames.

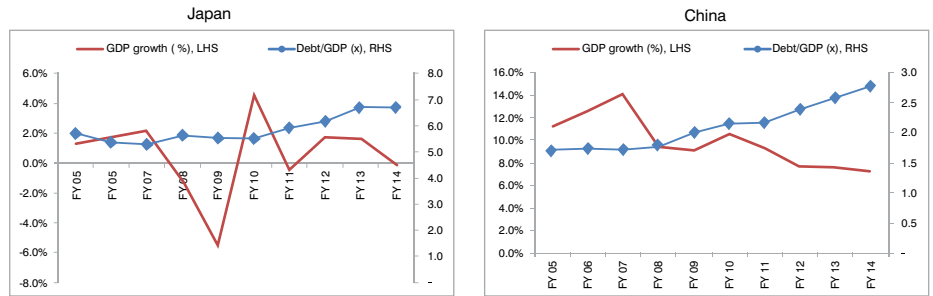
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Japanese debt to GDP ratio has continued to deteriorate from ~0.8x (1995) to 5.3x (2000) and ~ 6.7x (2014)!

## Debt/GDP – From bad to worse



Source: NRC Research

Since the collapse of the bubble in early 1990's, Japanese debt to GDP ratio has continued to deteriorate from ~0.8x (1995) to 5.3x (2000) and ~ 6.7x (2014)! The phenomenal debt pile has now left Japanese policy makers with little wiggle room.

Like Japan two decades ago, post Lehman (2008), China pump primed the economy to forestall an economic slowdown, largely fuelled by debt and invested heavily in building infrastructure & real estate, without commensurate visibility of economic activity. From Chinese debt to GDP ratio of 1.6x (2007, USD 7 t debt) has gone up disproportionately to 2.8x (2014, USD 28 t debt). During the same period the GDP went up from USD 4.5 t (2007) to USD 10 t (2014). Given the opaqueness of the Chinese GDP data, the actual number may well be higher!

## Japan & China – A Qualitative Comparison

That apart, there are a few qualitative aspects that deem comparison. Since Chinese data is not transparent and often not reliable, what we have here is a broad qualitative assessment drawn from various sources and our own interpretation of the same.

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Head	Japan, 1990's	China, 2014
<b>Government System</b>	Democracy	Totalitarian
<b>Demography</b>	Closed & aging	Relatively young
<b>Institutional Integrity (Judiciary, Civil Service, Legislature, Central Bank)</b>	High	Low
<b>Political Risk</b>	Low, though seen series of short lived government	High
<b>Economic Growth Led by</b>	Consumption & Export	Infra Investment & Export
<b>Domestic Consumption</b>	High	Moderate
<b>National Debt/GDP</b>	~2.5x (currently ~6x)	2.8x
<b>Bank NPA</b>	High	High (estimated)

Source: NRC Research



**We believe, this confluence of high debt to GDP, slowing growth and sub optimal investments in State owned Enterprises (PSU) & infrastructure will limit the economic policy manoeuvrability of China like Japan**

**There are a few things going China's way, namely; a growing consumer economy, a relatively young population and significant pool of government owned assets that can be consolidated & privatized**

We believe, this confluence of high debt to GDP, slowing growth and sub optimal investments in State owned Enterprises (PSU) & infrastructure will limit the economic policy manoeuvrability of China like Japan. Here, it would be worth noting that an estimated ~50% of the debt in China is tied to real estate investment. Most local bodies have limited revenue generation capacity and have been dependent on buoyant land prices to fund themselves and their projects. To compound matters, the political system is authoritarian with little proven institutional integrity. Not a very happy picture, right?

To avoid going the Japanese way, Chinese leadership will have to show political maturity and economic sagacity to take tough economic decisions well in time and also manage the socio political upheaval likely in its wake. If rightly managed, economic issues can be addressed & reined in over the next few years (and not quarters, mind you). Alternatively, the Chinese leadership can take the easy way out with another bout of loose monetary policy!

### China - The way forward

However, unlike Japan, there are a few things going China's way, namely; a growing consumer economy, a relatively young population and significant pool of government owned assets that can be consolidated & privatized. These are the factors that the Chinese leadership can capitalize on.

Anecdotally, we are less certain of things. Recently, addressing the business elite of US on 22nd September President Xi Jinping stated *"China's economy will stay on a steady course with fairly fast growth. It's still operating in a proper range with a growth rate of 7%. Our economy is under pressure but that is part of the path on the way toward growth"*.

Going by this statement it would imply that the Chinese economy is going to continue to grow at a robust 7% in spite of anecdotal evidence of contraction and correction. A business-as-usual scenario! If this were indeed to come about we would become very uncertain of the path being followed by China!



**In these times, a stable & decisive political dispensation at the Centre and an astute Central Banker driving pragmatic monetary policy may well prove to be a great combination to steer India relatively smoothly through these times**

## India – On the runway

When China is at a crossroad and EU is losing its mojo, can India remain unaffected? In the short term the answer is NO. However, as long term investors, we believe India can very well emerge stronger in the midst of economic mess that the world is currently in. Fortunately, in these times, a stable & decisive political dispensation at the Centre and an astute Central Banker driving pragmatic monetary policy may well prove to be a great combination to steer India relatively smoothly through these times. Low inflation, benign interest rates, weak commodity prices (especially crude) provide significant elbow room to the policy makers to spur growth, especially in the core sectors. Further, the recent measures undertaken by Govt in respect of curbing of black money, gold deposit scheme and affectively linking of Aadhaar card identity to subsidy payout, amongst others, shall lead to better utilization of resources. This aspect is overlooked by many an analysts in the short term, although the multiplier effect of this is likely to be significant over longer time frame.

Some of the key reforms likely to be rolled out over the next couple of years and having long term ramifications are;

- **Administrative & labour reform:** Bureaucracy to be made more accountable, ease of doing business and simplified labour law along with extensive skill development, Right to Service Act
- **Financial inclusion:** Bank accounts for all, followed by accessible life & accident insurance & contributory pension scheme. These are likely to have a far reaching impact on life of the rural and economically weaker section of population
- **Subsidy reform:** Early success seen in LPG subsidy reforms process with savings to the tune of INR 12000 cr (~USD 2 b). PDS and fertilizer segment likely to be addressed next. Fertilizer segment reform might well be a prelude to reform & reduce the participation of large and well off farmers in the subsidy pie and finally to exclude them.
- **Agriculture Product & Marketing Commission reform (APMC):** APMC reforms will include dismantling of APMC wholesale markets, creation of wide spread warehousing infrastructure & receipt based verification process. Likely to directly benefit farmers and have a deflationary impact on food items.

The above mentioned reforms are indicative in nature and there might well be more in the pipeline. With most other large economies beset with their own challenges, we believe India would be a 'go to' destination for global investors once there are signs of stability in global markets. Till then business/sector specific investments will continue to pour in, albeit in a guarded fashion. On the flip side, as reforms gain traction, we expect the political discourse to get more shrill, given the Opposition's go-for-bust strategy. That is our single biggest concern.

We are also witnessing a sea change in the way business is done. Business dynamics are rapidly changing with the advent of technology as is evident in many areas including retail, cab aggregation, food delivery, healthcare management, amongst many others. Given the fact that India is at the forefront of this new tech wave, we may also see significant foreign investments being channelized in these businesses and that bodes well for India both in the short and the long term.

Also, given the vibrant start up ecosystem we are witnessing in India, we will continue to see creative destruction of business models. This is going to be throw up multitude of fundamentally sound ideas from time to time. It is for us to be on the lookout for such ideas early on for investing and then patiently wait to see them play out.

## Sector View - IT in transition

Of late we have been hearing of IT automation as an emerging threat to the traditional IT service model. In this communication we try to demystify the same in common man's language and our position on the same.

*Automation in IT refers to rule based execution of business or IT system functions, conventionally performed through manual intervention to either manage, implement or upgrade IT related assets.* In other words, it is rule based, self-regulating, runs largely unattended and is particularly suitable for adoption in repetitive business processes.

Infrastructure Management Services (IMS), testing and lastly software development & maintenance are the low hanging fruits where IT automation process can be widely applied.

At the heart of this trend has been the growing realization that a linear model of hiring people to manage IT systems is not sustainable. Automation, in contrast, can be a highly scalable model at a fraction of the cost of the traditional labor arbitrage IT model. Industry estimates suggest that virtually 70% of IMS process can be automated.

Till about a couple of years ago most IMS, testing and AMD projects were bid for and priced on a largely transparent and linear cost structure basis,

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Revenue may well see muted growth and margins may come under pressure as new IMS and testing projects are competitively bid for by companies with different cost structures. This will be most evident in companies with significant exposure to IMS revenue, eg; HCL Technologies

wherein the cost elements were well known & common to most bidders and clients. However, going forward, different solutions providers have incorporated different levels of automation in their service offering and have different cost variables. Thus, going forward, bidding for these IT projects will now entail competing with other solutions providers with different levels of automation and cost structures.

It, thus, follows that traditional IT IMS and IT testing business models are most at risk and may prove to be challenging for many companies who may not have anticipated these developments. Similarly, IT automation product companies like NetIQ, Geek, Blue Prism, and IPSoft have emerged whose automation tools can be incorporated in the service offerings of traditional IT / IMS companies.

We believe, the business model of IMS & testing driven companies are in transition and inability to respond to this disruptive development will lead to significant revenue pressure for many large and mid-tier companies. Also, going forward, large, multi-year IMS projects may well be laddered than linear.

The good news is that several large and mid-tier Indian IT companies have responded to these changes either by developing their own automation software tools or incorporating 3rd party solutions in their service offerings. Apparently, TCS is working on ~15 platforms to automate different aspects of its work, while Wipro is building its FixOmatic framework which will enable automation of up to 40% of all level 1 and level 2 support tasks. Similar would be the case for Infosys, HCL Tech, Hexaware, amongst others. However, we believe, while most would be able to transition to the right side of the IT automation highway, the transition will not be without perils. Revenue may well see muted growth and margins may come under pressure as new IMS and testing projects are competitively bid for by companies with different cost structures. This will be most evident in companies with significant exposure to IMS revenue, eg; HCL Technologies.

We on our part have avoided investing in IT companies with generic service business model, having anticipated the long term threat to the same. Instead we are inclined to invest in product & IP driven companies.

While we are at it, one needs to make distinction between **automation** and **artificial intelligence (AI)**. As stated earlier, automation is a rule based implementation and response mechanism. It is a closed system and cannot





**AI is the process by which a system on a continuous basis gathers & analyses information from the eco system to recognize patterns autonomously and ultimately respond to external stimulus without or with minimal human intervention**

replace human perception or experience led response. On the other hand, *'AI is the process by which a system on a continuous basis gathers & analyses information from the eco system to recognize patterns autonomously and ultimately respond to external stimulus without or with minimal human intervention'*. This process is progressive and incremental in nature. This is applicable not just to IT systems but to any dynamic systems where a large amount of data is being generated. A prime example of such an AI system is the driverless **Google Car**. Some such other AI platforms for the IT space are Amelia (IPSoft), Ignio (TCS), Holmes (Wipro). While we have named only a few, there are many such AI platforms under development and going forward will have tectonic impact on our lives in general and the IT space in particular.

In the short run, the economy continues to be lethargic, especially the secondary sectors (manufacturing & construction). However, going forward, we expect the same to see uptick in sentiments on the back of government initiative to roll out infrastructure assets in areas like transport, T&D and defense. We believe, impact of the same would be visible, albeit with a delay of few quarters and we remain continually focused to unearth value in this area.

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

Warm regards,

**Sandeep Daga**

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