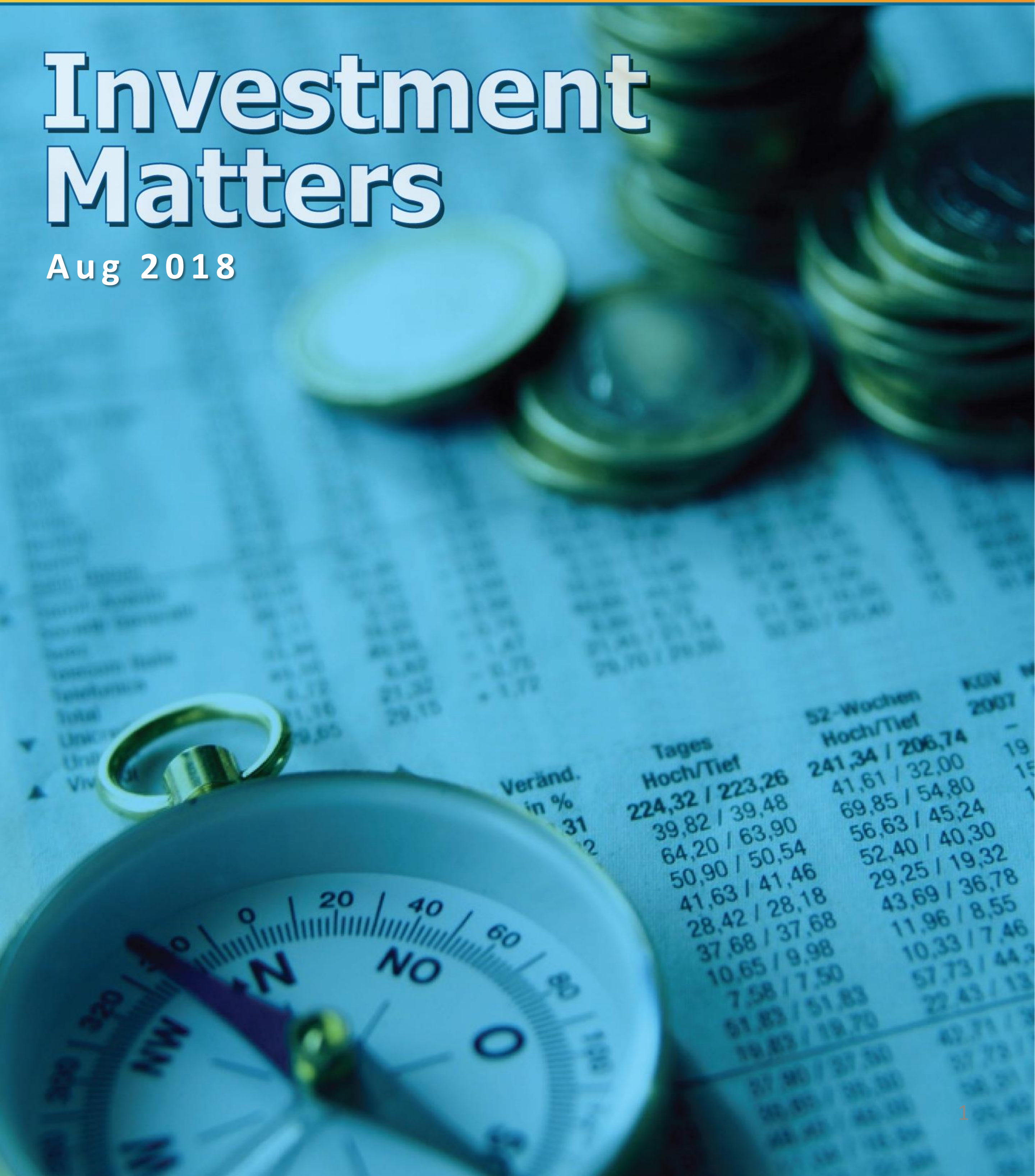
ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

Aug 2018

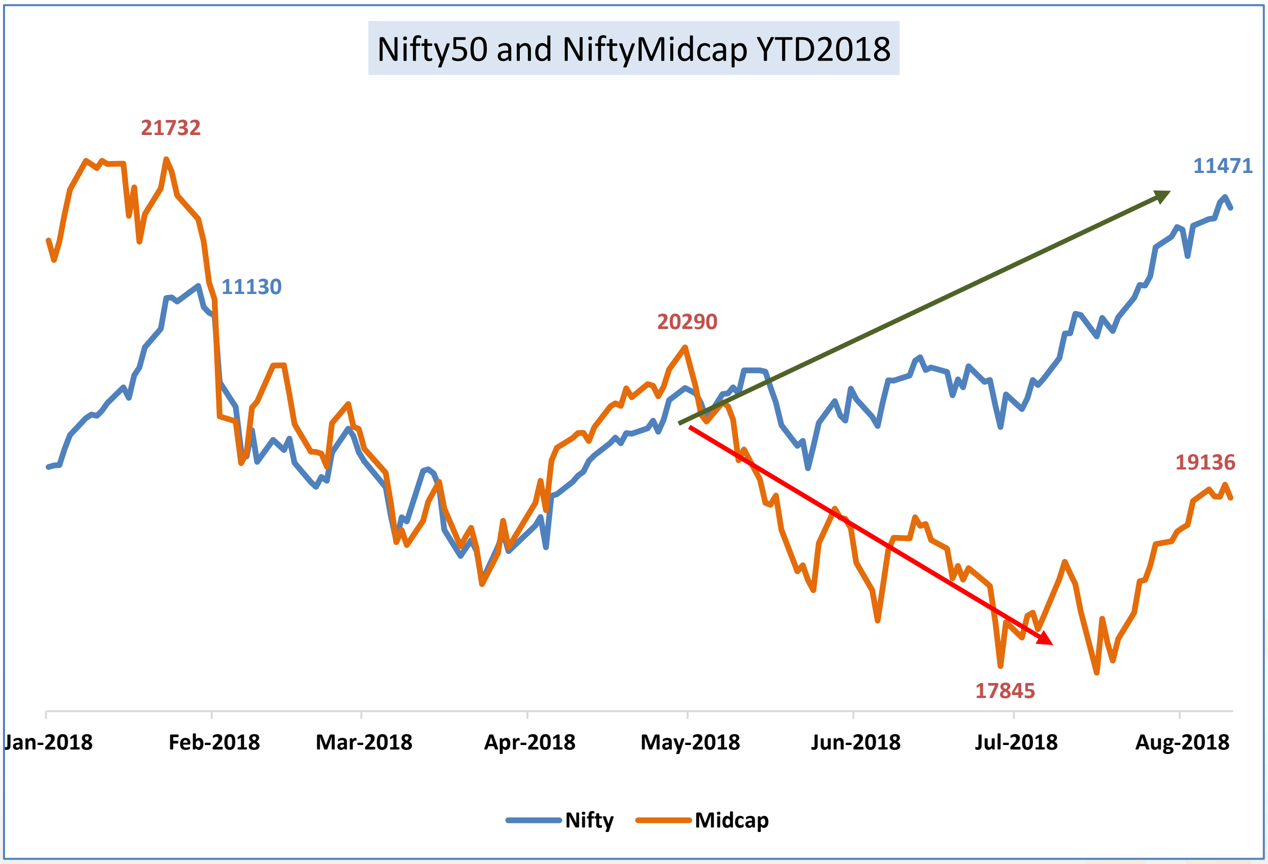


Market at New Highs…

July turned out to be a good month for the equities. As we had mentioned in our June2018 Newsletter, a strong earnings season has propelled the main indices upwards and this has also helped the Midcap and Smallcap indices recover. In fact, Nifty50 scaled to new highs rising by 6% to close at 11356, breaching the previous high of 11130 recorded on 29th January 2018. Midcap index also posted smart gains recovering 3.8% from yearly low of 17845 to close at 18877. As we write this newsletter, Nifty50 remains steady at 11429 whereas Midcap continue to build upon its recovery inching further to 19136.

…but Investors are not happy (Tale of Two Indices)

Though Nifty50 has moved to new all-time highs, we see no celebrations around this time. The prime reason being that the market has become extremely narrow with only few stocks participating in the up-move while the broader market continues to recover. In fact, Midcap index at 19136 is still 12% lower than the year high of 21732 recorded on 23rd January 2018.



Main indices to inch upwards but remain volatile and broad recovery patchy

We expect Nifty50 to remain strong with an upward bias, particularly post the strong earnings performance for Q1FY19. However, the broader market will continue to remain volatile and recovery patchy given an equal number of worries – high crude, depreciating currency, rising inflation, northwards interest rates, trade war uncertainty, fed tightening, currency wars, emerging markets outflows and last but not the least fears during an election year as to populist measures to please the vote bank and possibility of a fractured mandate at the centre.

But as mentioned in our June2018 newsletter, market will start differentiating between good, bad and ugly. Though all the midcaps declined together during market correction over May to mid-July (as seen in the chart above, the businesses beating earnings expectations for Q1FY19 with an equally strong future outlook will see a sharp recovery in stock prices.

Portfolio Performance – Price vs Value

Price

Our portfolio performance during the month of July and also YTD2018 has not really been encouraging and we are cognizant of the fact. There are three key reasons for this underperformance –

a) Cash Drag - As we don't follow a model portfolio and build positions gradually over few weeks to months, the sudden spurt in the market - like 8% in April and 6% in July – leads to underperformance in the portfolio. Though our overall cash levels at ~10% are not very high, in the recent portfolios cash levels could be as high as 40-60% leading to strong underperformance in these portfolios compared to benchmark. We often face such a challenge in the short-term, particularly, during run-away markets, however, our experience suggests that over the long run our strategy of maintaining the price discipline, not following a model portfolio and deploying the money judiciously has always paid off in the long run generating significant alpha for the clients. We see no reason, for this time it to be any different. In fact, (as we will elaborate later) we are confident that over the coming two quarters, our portfolios will start delivering definite outperformance to the benchmark indices.

b) Flakes – some of our investee companies though failed to deliver on the expected lines, we decided to lend more time to affirmatively negate our original hypothesis (BASF, Jubilant, ACC, MCIE, Thomas Cook). It's important to understand that business plans don't necessarily work out as planed and sometimes it might take longer than envisaged. And therefore, sometimes it could lead to performance drag in short term. Eventually we might decide that indeed it was a mistake and hence exit the position at a loss, but it's almost must to be patient before reaching a conclusion as rewards could be spectacular. Case in point is our investment in Bajaj Finance. We were one of the early institutional investors in Bajaj Finance buying the stock at less than a book in 2010. As the stock market went through correction during 2011, we were deeply worried about our investment in Bajaj Finance as asset book was not seasoned and any slippages there would have led to significant value destruction. But there were no signs of cracks or any visible evidence to prove that asset quality is deteriorating; we held our nerves well and yes, rewards were spectacular. In any case, we are reviewing each of the flakes hard and we will take corrective actions wherever necessary. The last but most important in the current context.

c) **Midcap meltdown** – Many of our stocks have tumbled along with the market, particularly those which were either run ahead of fundamentals in terms of valuations due to strong performance (Quess, L&TFH, Titan, Ashok Leyland) or those which have a vulnerable profile in terms of management or business profile (Kalpataru, Federal Bank, DCAL). We had mentioned at the start of the year, 2017 had been a spectacular year in terms of returns and volatility had been unusually low as also midcap valuations are unsustainable and hence 2018 could see both rise in volatility and unpleasant correction in midcaps. Though we could see the writing on the wall, one must understand that one can neither the volatility and correction in the market nor is it advisable to avoid the market by exiting the market. One must learn to stomach such volatility in prices and in fact, capitalise on such corrective phases to build a solid portfolio for the future. And that's exactly what we have done and will be doing over the next few quarters during which period markets would remain volatile and midcap recovery patchy, as mentioned earlier.

The secret to navigate the turbulent phases in the market with right mindset and correct actions is to ignore the price performance and focus on value accretion.

<u>Value</u>

The sharp correction in the broader market during May-July 2018 has led to significant deterioration in portfolio price performance, even on a one-year basis (as performance is a point-to-point indicator) we remain confident that this is only a temporary phenomenon. The confidence stems from the fact that the underlying businesses continue to track well accruing significant intrinsic value and it's just a matter of time that ticker price catches up with the intrinsic value. Of 38 investee companies having so far declared the June2018 quarter results, 22 companies beat the expectations, 10 delivered in-line of expectations whereas 6 companies have delivered below expectations.

In absolute terms, 17 companies have delivered 20%+ topline growth, 20 companies have delivered 30%+ operating profit growth and 16 companies have delivered 35%+ earnings growth. Just as a reference and reminder for intrinsic value accretion, at 26% compounding profits double every 3 year.

We urge investors to focus on value accretion in the underlying portfolio businesses instead of stock prices, which at an aggregate level has grown the operating profit at 31.1% for the quarter.

EQUITY OUTLOOK

	Sales			EBIDTA			PAT			EPS		
Rs Crs.	Q1FY19	Q1FY18	YoY Growth	Q1FY19	Q1FY18	YoY Growth	Q1FY19	Q1FY18	YoY Growth	Q1FY19	Q1FY18	YoY Growth
A C C LTD	3848	3959	-2.8%	625	637	-1.9%	329	326	0.8%	17.5	17.3	0.8%
AIA ENGINEERING LTD	735	610	20.6%	156	130	19.8%	105	89	18.2%	11.1	9.4	18.8%
ASHOK LEYLAND LTD	6250	4534	37.8%	630	306	105.7%	370	111	232.8%	1.2	0.4	223.7%
AVENUE SUPERMARTS LTD	4559	3598	26.7%	423	303	39.4%	251	167	50.0%	4.0	2.8	43.5%
BAJAJ AUTO LTD	7419	5328	39.2%	1281	938	36.6%	1115	924	20.7%	38.5	31.9	20.7%
BAJAJ ELECTRICALS LTD	1140	1020	11.7%	80	45	77.1%	41	7	454.4%	4.0	0.7	464.3%
BAJAJ FINANCE LTD	3941	2834	39.1%	-	-	-	836	461	81.4%	14.4	8.3	72.8%
BAJAJ FINSERV LTD	8771	7536	16.4%	-	-	-	826	585	41.3%	51.9	36.7	41.4%
BANDHAN BANK LTD	1767	1275	38.5%	-	-	-	482	327	47.5%	4.0	3.0	35.2%
BASF INDIA LTD	1627	1510	7.7%	97	70	37.4%	24	1	3495.6%	5.6	0.2	2700.0%
BRITANNIA INDUSTRIES LTD	2544	2375	7.1%	389	329	18.5%	258	216	19.4%	21.5	18.0	19.4%
CONTAINER CORPORATION OF INDIA LTD	1568	1467	6.9%	390	338	15.6%	252	247	2.4%	5.2	5.1	2.4%
DISHMAN CARBOGEN AMCIS LTD	482	340	42.0%	121	70	72.5%	40	13	202.6%	2.5	0.8	203.7%
FEDERAL BANK LTD	2938	2653	10.7%	-	-	-	263	210	25.0%	1.3	1.2	10.9%
FINOLEX INDUSTRIES LTD	828	731	13.2%	194	131	48.4%	103	80	29.1%	8.3	6.4	29.4%
GUJARAT GAS LTD	1765	1478	19.4%	249	270	-7.9%	121	104	16.3%	8.8	7.6	16.4%
HDFC BANK LTD	26367	22185	18.9%	-	-	-	4601	3894	18.2%	17.5	15.0	16.7%
INDIAN ENERGY EXCHANGE LTD	74	62	19.8%	62	49	24.7%	42	31	33.5%	13.9	10.4	33.2%
INFO EDGE (INDIA) LTD	260	222	16.7%	84	70	19.8%	63	64	-1.9%	5.1	5.2	-1.9%
ITC LTD	10707	9955	7.6%	4202	3746	12.2%	2819	2561	10.1%	2.3	2.1	9.6%
JUBILANT LIFE SCIENCES LTD	2079	1596	30.2%	438	338	29.6%	200	144	39.4%	13.0	9.4	37.7%
KALPATARU POWER TRANSMISSION LTD	1325	1207	9.8%	157	137	14.5%	81	70	15.0%	5.3	4.6	15.0%
L&T FINANCE HOLDINGS LTD	3041	2301	32.2%	-	-	-	540	337	60.3%	2.7	1.7	54.0%
L&T TECHNOLOGY SERVICES LTD	1152	823	40.1%	196	126	56.0%	198	98	102.1%	18.7	9.4	100.1%
MAHINDRA & MAHINDRA LTD	13358	10878	22.8%	2110	1434	47.1%	1257	752	67.2%	10.6	6.3	66.9%
MAHINDRA CIE AUTOMOTIVE LTD	1973	1525	29.4%	291	206	41.4%	134	86	55.7%	3.6	2.3	54.7%
MARUTI SUZUKI INDIA LTD	22459	17546	28.0%	3351	2331	43.8%	1975	1556	26.9%	65.4	51.5	26.9%
QUESS CORP LTD	1968	1297	51.7%	102	75	36.3%	54	46	19.2%	3.7	3.4	11.0%
RAMCO CEMENTS LTD	1220	1029	18.6%	250	290	-13.8%	125	156	-19.9%	5.3	6.6	-19.8%
STATE BANK OF INDIA	65493	62911	4.1%	-	-	-	-4876	2006	-343.1%	-5.5	2.4	-323.8%
SUNDARAM FASTENERS LTD	971	846	14.7%	177	148	19.6%	106	90	17.8%	5.1	4.3	17.7%
SYNGENE INTERNATIONAL LTD	406	291	39.5%	99	66	49.6%	66	62	6.5%	3.3	3.1	6.1%
TATA ELXSI LTD	382	323	18.2%	107	73	45.0%	70	50	41.7%	11.3	8.0	41.7%
THOMAS COOK (I) LTD	887	788	12.5%	58	55	5.6%	38	26	46.4%	1.0	0.7	46.4%
TITAN COMPANY LTD	4451	4067	9.4%	483	365	32.3%	328	238	37.9%	3.7	2.7	36.1%
ULTRATECH CEMENT LTD	9021	7035	28.2%	1690	1632	3.6%	631	898	-29.7%	23.0	32.7	-29.5%
UNITED SPIRITS LTD	2012	1782	12.9%	192	157	22.3%	81	63	28.6%	1.1	0.9	28.7%
VARUN BEVERAGES LTD	2097	1934	8.4%	576	481	19.8%	307	246	24.9%	16.6	13.5	23.5%

Turn the Adversity into Opportunity

Uncertainty can drive one nuts! The market is volatile. Corrections are steep. Global powers are at loggerheads. Domestic reform process is challenged and the central government stability is unsure. And investors are, well, human.

However, the only way to succeed is to bring the stability despite all this shifting sand. And let me tell you how it works – Keep the eye on the goal; Focus on the long term. So, turn the current adversity into opportunity and systematically use every dip in the market to deploy money to achieve long term financial goals.

In fact, as we embrace all the bad news, let me point out some green shoots which are not only real but also significant. First, after a lull of one and half year, consumer is back with a bang – FMCG volumes are growing at double digits, modern retailers are growing double digit despite onslaught of E-tailers, 2w/4w sales are growing double digit, consumer durables sales are growing double digit. India is 2/3rd consumption economy and hence the return of consumer is a significant thing.

Monsoon is turning out to be good and could lead to strong rural recovery. Infrastructure is holding well, cement volumes are growing at double digit for the last 8 months and steel volumes are growing at high single digit. The only missing piece in the puzzle is Investments. However, as we speak to corporates we see uptick in capex, particularly engineering companies which design and build the plants/factories or supply critical equipment/machineries for new plants/factories, are running full order books signalling definite pick up in investments. Even capacity utilisation at 73% suggest that with a 10% growth we could see capex cycle reviving over the next 1.5 to 2 years, which means a full-blown recovery isn't far away.

Finally, let me take this opportunity to greet you all as I write my first newsletter and also thank each one of you for the unwavering support over all these years. After all, a fund manager is only as good as his investor are. Unless you support me through the testing times and the periods of underperformance, with the full confidence in the firm's investment philosophy, portfolio manager's capability and the underlying portfolio, I will not be able to bring to the fruition the journey we have embarked upon.

Amit Nadekar

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