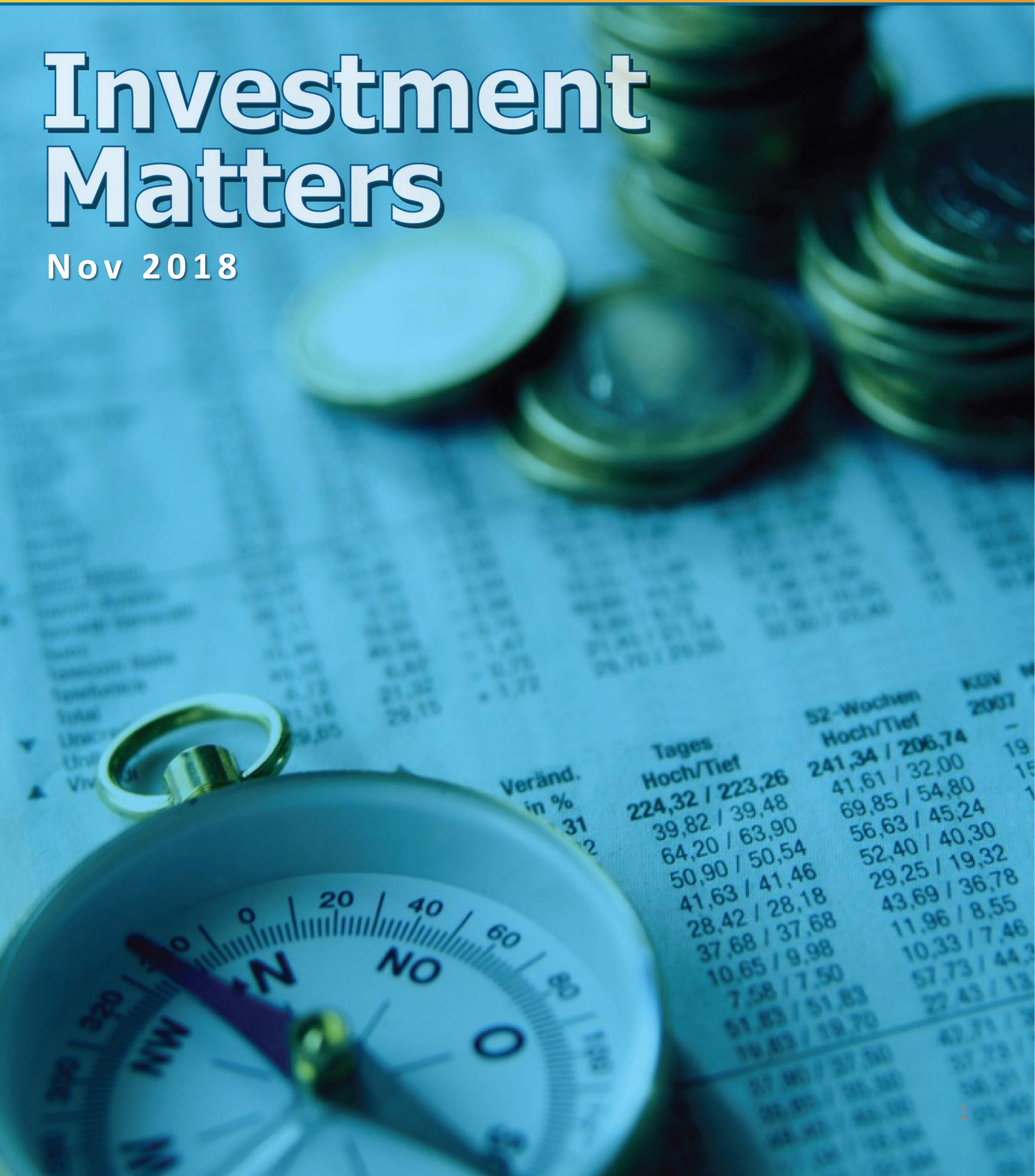
ALCHEMY CAPITAL MANAGEMENT

Investment Matters

Nov 2018



EQUITY OUTLOOK

Market Overview

Hope all of you had a very joyful and memorable Diwali with family and friends.

As I had mentioned in my August newsletter, at a personal/family level, festivals provide a natural way out of unpleasant situations and also bring along a fresh dose of happiness and hope. At the national level, festivals provide a boost to economic activity and I had wished at the time that this year, Diwali produces the much-needed thrust to accelerate the economic growth.

So far both, the feedback from our interaction with the business community and sales volume numbers shared by Corporate are mixed. Not many data points are available today to gauge how consumption is tracking this Diwali, apart from the auto sales number. In light of the NBFC liquidity crisis, Kerala floods, and a sharp correction in equity markets, these numbers are respectable. 2-wheelers have recorded double digit growth while passenger car industry has registered a decline. Commercial vehicles have grown at 20%+ while tractors volume growth has been relatively slow in single digits.

Recent media reports suggest that sales of consumer electronics and white goods have rebounded with 12-15% growth in October 2018. More importantly, there is a definite premiumization trend in play – Sony India sales grew 20% with larger 55+ inch screen television sets growing 3-20x of last year while LG India mentioned 50% growth in the premium 300+ litre refrigerators. These are welcome numbers compared to general gloomy talk which we hear around. The macro-economic variables of crude, depreciating INR, inflation and rising interest rates seems to have peaked out for the time being and should bode well for consumer demand going ahead.

Sustained demand is critical to abate the input inflation

46 of 50 Nifty companies have declared results so far. The aggregate sales have grown at 25.1% whereas operating profits have grown at 11.1% and net profit grown at 5.8%. Strong sales growth is heartening and is testimony of management commentary of strong micro. However operating profits have failed to keep pace with revenue growth. The culprit being sharp rise in input costs – crude, commodities, wage inflation etc. Companies have taken price hikes to cover the rising raw materials cost, however, there is always a lag effect. We hope Q3 reflects the full pass through of price hikes and thereby improvement in operating margins. However, sustained demand environment will be the key for companies to fully pass on the cost hikes.

Market to remain range bound in near term...in a wait and watch mode

A sharp reversal of macro variables in favour of Indian economy has led to a bounce back in Nifty50 from ~10000 levels to ~10600. However, there are multiple risk events lined up globally and locally which can spook the markets in the coming months. Markets therefore will remain in a wait and watch mode to take a clue from these events for a definite direction. We are no experts on global economy or economic policies. However, given the significance of these events, we thought it's prudent to highlight the same. Our deployment strategy would also depict a cautious wait and watch approach to see through the implications of these events.

EQUITY OUTLOOK

1. **Brexit Deal Agreement**

UK is set to leave European Union on 29th March 2019. As per the agreed timelines, October 18th 2018 was the deadline for finalising an agreement setting out terms of Brexit. However, that deadline has been missed and concerns are now mounting about a 'No Deal' Brexit which could have very serious implications for the UK economy. Many of the industrialists from automotive, aircrafts, pharmaceuticals and chemicals industries in UK have already warned of plant shutdowns and billions of dollars of losses, if right deal is not sought through. A 'No Deal' Brexit could lead to a run on the pound, lift USD and have disruptive consequences for European economy. Hence, it is widely believed that 'No Deal' Brexit is not an option. Post October deadline, now it is rumoured that an emergency meeting would be held sometime in late November. If that fails, agreement could be taken up for negotiations at EU Summit on 13-14th December 2018.

2. **Trump – Xi Jinping Meet to discuss tariff**

Trade war has threatened global economic outlook. So far, direct impact of tariffs levied by US and China on trade channels has been limited. However, indirect second order impact through damage to business confidence and higher financial costs could be sizeable and is already being indicated in the quarterly conference calls of US listed companies in the form of higher input costs. President Trump has agreed to meet Chinese President Xi Jinping in late November to discuss a cordial way forward. USA has applied USD50 bn tariffs on China till date, but come Dec'18, a much larger USD200 bn (already approved) tariffs will be put in place by USA. A further USD505 bn of tariffs is under discussion to be levied by Jan/Feb'19. These tariffs pose a serious challenge to Chinese Government in terms of risk of significant Renminbi depreciation and financial instability of the Chinese economic system which can subsequently roll over to the global system. Therefore, the Trump-Jinping meeting is an important event to watch and in case these discussions fall apart, it could entail sharp and violent reactions from market participants.

3. **Indian State Elections**

We are now entering an election heavy period which will culminate with the national elections in Mar-Apr 2019. In the next 2 months, there are 5 state elections out of which 3 are in the crucial northern/Hindi-belt states of Rajasthan, Madhya Pradesh, and Chhattisgarh and currently run by BJP. The outcome of these state elections can be indicative of political direction in the country and can also impact the pace and direction of economic reforms. Heavy losses for BJP in these elections could mean that populist policies will take precedence over the economic reform process. Media surveys and opinion polls suggest that BJP would most probably lose the state of Rajasthan and chances of losing another state - either MP or Chhattisgarh are also high. Our guess is that BJP losing 2 states is largely priced in by the markets. However one can never be sure of such things. Again, extent of damage to BJP in these elections and loss of one more state could lead to sharp negative reactions of market participants.

4. **Risk of near-term economic slowdown**

We believe that the current NBFC crisis has been largely averted. Our market intelligence suggests that most of the larger NBFCs have raised enough liquidity to tide through to Jan/Feb'19 even if debt market remains challenged over the next 2-3 months. However, there is a risk of near term economic slowdown if NBFCs follow a cautious approach and prefer to hoard the cash on the books rather than aggressively grow the balance sheet.

MSME and SME segments, key borrowers from NBFCs, are facing challenges as to availability of working capital funds. Production stoppages at SME/MSME level could lead to disruption of production schedules across industries. In fact, in many cases over the last 2 months, OEMs had to step in and ensure/make available working capital funds to their vendors so that they don't lose on Diwali sales due to lack of part availability from the vendors. However, we don't believe that OEMs can support the vendors beyond a point. OEMs will also not be very willing to support the vendors once the Diwali season is over. Since SMEs form a critical part of supply chain across the industries, their inability to raise enough working capital has the potential to slowdown/cripple the entire value chain. This is one of the key reasons why central government is putting pressure on RBI to provide liquidity to the economy and the SME sector in particular.

Strong Performance of Portfolio Companies

Our portfolio has delivered a strong 21% earnings growth compared to a tepid 6% earnings growth for Nifty. In fact, with a 21% sales growth and 20% operating growth, portfolio has also demonstrated superior resilience to rising input pressures.

Our top 10 positions have grown revenue at 27% and net profits at 17%. Even for top 10 non-financial positions average revenue growth is 31% and operating profit growth is 21%.

Some of the notable earnings performances (year-on-year net profit growth) during the quarter were Bajaj Electricals (79%), L&TFH (62%), LTTS (56%), Bajaj Finance (55%), United Spirits (54%), Bandhan Bank (47%), Tata Elxsi (47%), AIA Engineering (40%) and Mahindra CIE (39%). Bajaj Electricals is almost done with restructuring of distribution based upon TOC and now onwards should deliver strong business growth for consumer appliances. LTTS business outlook remains robust though management stake sale could act as an overhang on the stock. LTFH and Bajaj Finance both continued to experience a very strong growth momentum. In fact, Bajaj Finance management sees no dearth of capital and sees no reason to slowdown the growth.

Key disappointments during the quarter were Dishman Carbogen (-9%) & BASF India (-77%). We continue to closely monitor each of our underperforming positions and would not shy of taking a corrective action, if warranted.

A brief snapshot of quarterly financial performance of larger positions is provided in the table on the next page.

Rs Mn.	Sales			EBIDTA			Net Profit		
Name	Q2FY19	Q2FY18	% chg	Q2FY19	Q2FY18	% chg	Q2FY19	Q2FY18	% chg
AIA Engineering	7406	5591	32%	1478	1124	31%	1210	865	40%
Ashok Leyland	76080	60469	26%	8059	6118	32%	4709	3343	41%
Bajaj Auto	79868	65799	21%	13430	12984	3%	11525	11119	4%
Bajaj Electricals	15984	9356	71%	799	429	86%	341	190	79%
Bajaj Finance	26652	19170	39%	-	-	-	9203	5936	55%
Bajaj Finserv	96981	82661	17%	-	-	-	7040	6982	1%
Bandhan Bank	13079	9162	43%	-	-	-	4877	3311	47%
BASF India	16755	14551	15%	681	1144	-40%	93	412	-77%
Bosch	32011	28119	14%	5962	5080	17%	4200	3533	19%
Britannia Industries	28696	25453	13%	4544	3777	20%	3030	2611	16%
Concor	17223	14302	20%	4042	2696	50%	2643	2104	26%
Delta Corp	2014	1453	39%	762	655	16%	477	430	11%
Dishman Carbogen	4477	4438	1%	1286	1330	-3%	440	484	-9%
D-Mart	48725	35083	39%	3896	3179	23%	2257	1910	18%
Escorts	13984	12117	15%	1575	1409	12%	1026	776	32%
Federal Bank	13454	11861	13%	-	-	-	2660	2637	1%
Finolex Industries	5426	4753	14%	1249	496	152%	764	283	170%
Godrej Consumer	26592	25066	6%	5429	5318	2%	3580	3664	-2%
Greaves Cotton	4951	4524	9%	733	679	8%	494	429	15%
HDFC Bank	157790	133580	18%	-	-	-	50057	41510	21%
Hindustan Unilever	92340	83090	11%	20190	16820	20%	15250	12760	20%
Info Edge	2650	2252	18%	825	888	-7%	781	786	-1%
ITC	110689	103141	7%	42060	37615	12%	29547	26398	12%
Jubilant FoodWorks	8814	7266	21%	1474	1021	44%	777	485	60%
L&T Finance Holdings	16764	12960	29%	-	-	-	5591	3453	62%
L&T Tech Services	12661	9006	41%	2289	1374	67%	1919	1230	56%
Mahindra CIE	20235	16555	22%	2543	2052	24%	1308	940	39%
Maruti Suzuki	224332	217682	3%	34313	36775	-7%	22404	24843	-10%
OFSS	12133	11895	2%	4988	5136	-3%	3520	3419	3%
Quess Corp	20917	13953	50%	1120	789	42%	618	556	11%
Ramco Cements	11835	10664	11%	2472	2939	-16%	1145	1609	-29%
Sundram Fastners	10016	8137	23%	1890	1535	23%	1102	904	22%
Syngene International	4186	3352	25%	1267	1135	12%	783	769	2%
Tata Elxsi	4028	3422	18%	1067	827	29%	822	560	47%
TCNS Clothing	3205	2665	20%	570	421	35%	412	251	64%
Thomas Cook	15951	14020	14%	118	1	8977%	-112	-399	72%
Titan Co	44068	34876	26%	4671	4444	5%	3144	3061	3%
Ultratech Cement	77713	64264	21%	12076	12938	-7%	3908	4312	-9%
United Spirits	22281	19513	14%	4324	3177	36%	2587	1675	54%
Varun Beverages	11657	9634	21%	2112	1854	14%	423	329	29%

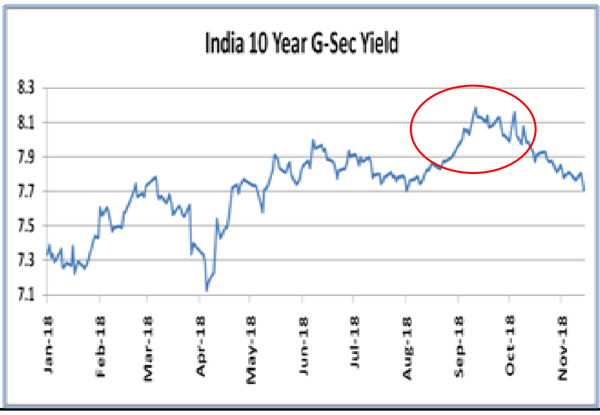
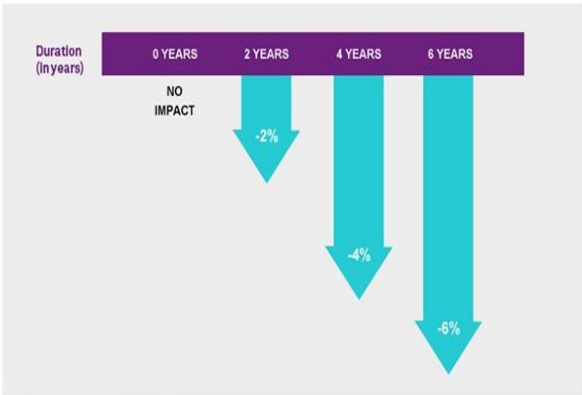
EQUITY OUTLOOK

When will this strong business performance get reflected in stock performance?

Frankly, we don't know when? But we know for sure that it will.

Most of the companies in our portfolio would easily qualify as the Holy Grail of long term investing. Either they have already built strong moats to fend off competition for long periods of times or already in the process of building one. There are no given things in the businesses but our research makes us believe that each of these companies have a long road ahead and can earn high return on capital for many years to come. Unfortunately, not many of these portfolio companies are hidden gems anymore and in a world polarised towards quality, they got aggressively bid up. We have paid the price for the same in the recent market crash, as even these high quality names fell in equal breath as any other stock – average fall being in mid-20s. However, we don't see any structural damage to any of the stories or any structural de-rating emanating from erosion of competitive advantage/business profitability/growth prospects.

In fact, our analysis suggest that sharper fall in these high P/E stocks can entirely be attributed to sharp rise in interest rates and expectations of further spike in interest rates. A high P/E quality stock is akin to high grade long duration bond. The impact of interest movement on a High P/E stock is therefore far severe just like higher impact or rising rates on a long duration bond.

Sharp move from 7.7% to 8.2% is cooled off	% Change in bond prices if rate spikes 1%
	

With the assurance of strong operational performance for the quarter, continued strong business outlook and most importantly, reversal of interest rates, we would not be surprised if these businesses gradually regain some of the higher multiple grounds. But that is not our base case. **Even without considering any pull back in valuation multiples, we expect stock prices should hereon broadly follow the earnings growth – which is a healthy 20-30% run rate for these quality names.**

The above arguments should take care of concerns related to a) negative returns or b) relative performance of the portfolio; we would also like to highlight how short term performance could sometimes be misleading of the reality.

Consider the following performance of the two strategies and the Benchmark –

Years ->	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Annnual Returns																				
Strategy 1	75%	-18%	-15%	20%	80%	18%	25%	35%	70%	-30%	70%	20%	-20%	38%	16%	25%	-5%	15%	35%	12%
Strategy 2	89%	-26%	-22%	15%	94%	16%	34%	40%	60%	-56%	88%	16%	-27%	31%	4%	35%	-1%	4%	33%	-3%
Benchmark	67%	-15%	-16%	3%	72%	11%	36%	40%	55%	-52%	76%	6%	-16%	28%	7%	31%	-4%	3%	29%	1%
Relative Performance of Strategy 1 vs Strategy 2																				
Strategy 1	-14%	8%	7%	5%	-14%	2%	-9%	-5%	10%	26%	-18%	4%	7%	7%	12%	-10%	-4%	11%	2%	15%
Relative Performance Vs Benchmark																				
Years ->	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Strategy 1	8%	-3%	1%	17%	8%	7%	-11%	-5%	15%	22%	-6%	14%	-4%	10%	9%	-6%	-1%	12%	6%	11%
Strategy 2	21%	-12%	-6%	12%	23%	5%	-3%	0%	6%	-5%	13%	10%	-11%	3%	-2%	4%	3%	1%	5%	-4%
2 Year CAGR																				
Strategy 1		20%	-17%	1%	47%	46%	21%	30%	51%	9%	9%	43%	-2%	5%	27%	20%	9%	5%	25%	23%
Strategy 2		109%	-24%	-5%	50%	50%	24%	37%	50%	-16%	-9%	48%	-8%	-2%	17%	19%	16%	1%	18%	13%
Benchmark		20%	-15%	-7%	33%	38%	23%	38%	47%	-14%	-8%	36%	-6%	4%	17%	18%	12%	-1%	15%	14%
3 year CAGR																				
Strategy 1			7%	-6%	22%	37%	38%	26%	42%	17%	26%	13%	18%	10%	9%	26%	11%	11%	14%	20%
Strategy 2			51%	-13%	21%	37%	44%	29%	44%	-1%	10%	-2%	17%	4%	0%	23%	12%	12%	11%	10%
Benchmark			6%	-10%	14%	25%	37%	28%	43%	1%	9%	-4%	16%	4%	5%	21%	10%	9%	8%	10%
Since Inception																				
Strategy 1	75.0%	19.8%	6.8%	10.0%	21.4%	20.8%	21.4%	23.0%	27.5%	20.1%	24.0%	23.6%	19.5%	20.8%	20.5%	20.7%	19.0%	18.8%	19.6%	19.2%
Strategy 2	88.7%	18.0%	2.8%	5.8%	19.5%	18.9%	20.9%	23.1%	26.8%	13.9%	19.3%	19.0%	14.6%	15.7%	14.9%	16.1%	15.0%	14.4%	15.3%	14.3%
Benchmark	67.4%	19.5%	6.2%	5.5%	16.3%	15.3%	18.1%	20.6%	24.0%	12.8%	17.5%	16.5%	13.6%	14.5%	14.0%	15.0%	13.8%	13.2%	13.9%	13.2%
Alpha Since Inception																				
Strategy 1																				6.0%
Strategy 2																				1.0%

Over the 20 year period, Strategy 1 has delivered 19.2% CAGR and a handsome 6% alpha over the benchmark. A 20 year period should count and put to rest any doubts or disbelief about the strategy. However, that's in a hindsight, which is always 20/20.

Was the journey really smooth? Were there no moments of distrust? There were plenty!

- Strategy 1 underperformed the benchmark 7 out of 20 years. Twice consecutively of 2 years.
- Strategy 1 also underperformed Strategy 2 on 7 occasions. And these are periods different than those periods when Strategy 1 was underperforming benchmark.
- Again, Strategy2 beat Strategy1 for two consecutive years, twice. These must be tough periods to convince anyone of superiority of Strategy1 in the long run
- Not only that 1 year performance could be misleading but even on 2 year and 3 year CAGR, there are multiple occasions when Strategy 1 underperformed both benchmark and Strategy2.
- Also note that the benchmark return itself has turned negative on 2 year basis on almost 6 occasions and twice on a 3 year CAGR basis. Despite this, benchmark has delivered 13% CAGR over 20 year period.

It's important therefore to understand that performance in short term is more random and therefore devoid of any judgement. In short terms markets movements are driven more by sentiments than by fundamentals. Hence price performance in short term could be vastly different from the reality. Unfortunately, we tend to derive reality based upon price movements.

Also, one must understand from the above example, that no strategy can be totally immune to the broader market and in line with the broader market/benchmark; it could easily experience 2/3 year CAGR turning negative. However that should not lead to loss of confidence in the strategy or loss of hope that meaningful alpha generation can take place. In fact, despite such periods of pain, a good strategy will always deliver reasonable alpha over the long run. ***Hence, the right way to assess the performance of any strategy or a portfolio manager is not on an intermittent time to time basis but based upon performance since inception and the longer the period since inception higher should be the degree of credibility of such strategy or portfolio manager.***

Patience is a virtue rarely associated with a fickle mind. A mind without knowledge and trust is rarely associated with virtue of patience. A journey started without a virtue of patience is rarely rewarded.

Amit Nadekar

Portfolio Manager
Alchemy Capital Management Pvt. Ltd

DISCLAIMER

General Risk factors

All investment products attract various kinds of risks. Please read the relevant Disclosure Document / Client Agreement carefully before investing.

General Disclaimers

The information and opinions contained in this report/ presentation have been obtained from sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate or complete.

Information and opinions contained in the report/ presentation are disseminated for the information of authorized recipients only, and are not to be relied upon as advisory or authoritative or taken in substitution for the exercise of due diligence and judgement by any recipient.

The information and opinions are not, and should not be construed as, an offer or solicitation to buy or sell any securities or make any investments.

Nothing contained herein, including past performance, shall constitute any representation or warranty as to future performance.

The client is solely responsible for consulting his/her/its own independent advisors as to the legal, tax, accounting and related matters concerning investments and nothing in this document or in any communication shall constitutes such advice.

The client is expected to understand the risk factors associated with investment & act on the information solely on his/her/its own risk. As a condition for providing this information, the client agrees that Alchemy Capital Management Pvt. Ltd., its Group or affiliates makes no representation and shall have no liability in any way arising to them or any other entity for any loss or damage, direct or indirect, arising from the use of this information.

This document and its contents are proprietary information of Alchemy Capital Management Pvt. Ltd and may not be reproduced or otherwise disseminated in whole or in part without the written consent.

Edited by: Sachin Pawar (Ph: +91-22-66171742)
Alchemy Capital Management Pvt. Ltd., B-4, Amerchand Mansion, 16 Madame Cama Road, Mumbai 400 001. Ph: +91-22-66171700
CIN- U67120MH1999PTC119811, Email ID: contactus@alchemycapital.com