ALCHEMY CAPITAL MANAGEMENT

Investment Matters

August 2020

EQUITY OUTLOOK

Near-term risks abating

RBI's restructuring guidelines of 6 August 2020 protect the largest and most volatile sector from near-term shocks. This is an important positive for the market and reduces the short-term downside risks. However, macro challenges persist, and we expected a slow recovery as the effects of the pandemic gradually reduce. We are moving to reduce cash in our portfolios, but our stock-picking approach remains unchanged. We continue to focus on quality stocks, market leaders with strong cash flows and balance sheets, reducing sector concentration and remain selective about our banking sector exposures.

RBI steps in, again

The RBI's announcement of liberal restructuring norms for banks is a strong short-term positive for sector. The relief was needed as the pandemic-induced lockdown has disrupted cash flows for many borrowers and tagging NPLs on a 90-day basis would do more harm than good. The critical difference is that the restructuring is at the lender's discretion, while the moratorium is a borrower's entitlement. The banks now have greater control of the process and can take steps to maximise the recoverability of the loans.

We have two areas of concern. First, the 10% provision is not enough and the schedule of reversing these provisions is too quick. The provisioning requirement should have been the same as NPAs – 20% upfront with a one-year performance requirement before reversal. This would encourage banks to restructure with greater responsibility, focusing only on recoverability. Second, the RBI mandates disclosures of the restructured book only from Mar-21. This means that the true picture of bank balance sheets will not be visible for another 8-9 months. It is critical, therefore, to judge banks by their past track records of credit behaviour, corporate governance and disclosure standards as investors, to a large extent, will be "playing blind".

This restructuring scheme does not protect banks from facing large NPAs and loan losses over the next 4-6 quarters. It gives them greater control of the outcomes, helps them minimise losses and spread the impact over time rather than take a concentrated hit. This is a vital positive that helps them protect their franchises and minimise the risks to financial stability.

Real estate is a major beneficiary. The industry and its lenders have been clamouring for this dispensation. It allows companies to access incremental funds and complete many of the stranded projects. This has many positive externalities for the broader economy – ranging from blue-collar employment to demand for products like steel and cement.

Macro challenges persist

The short-term risks may have been addressed, but we still see significant challenges for the economy over the medium term.

- **Credit capacity is still constrained**. The RBI measure will reduce risk-aversion, especially among PSU banks. However, they remain capital-constrained and the government will find it difficult to pump in the required equity, given the acute fiscal strain in FY21. Smaller private banks and NBFCs, on the other hand, continue to struggle with weak balance sheets. Only a handful of 4-5 private banks have the capital and deposit base to grow their book, and that is not enough to aid macro growth.

- **The capex cycle has multiple headwinds**, which could take a long time to solve. Project finance from the private sector will remain constrained for a long time, given the poor experience of the last decade. Government capacity to fund projects is limited, and has got worse after the pandemic crisis. Some innovative attempts are being made to create alternate funding sources by recycling operating assets, but that will take some time to have an impact. A sustained growth revival is not possible without a strong capex recovery.

- **The consumption shock will linger well into FY22**. The direct impact on incomes is compounded by a weakening of consumer confidence, which will feed into lower demand for discretionary goods. We do not expect normalised demand to come back very soon, beyond the immediate spike that is expected when the lockdown is lifted. Return to 85-90% normalcy could be quick, but the last 5-10% will be a harder struggle.

- **Braced for a slow recovery**. The good news is that an immediate crisis has been averted – the RBI's actions over the last six months have ensured that. The worry is that the economy will take 1-2 years before a full recovery, and we are braced for that. Quality companies with resilient business models will cope better than others, and we are not expecting a rising tide to lift all boats in the medium term.

Our approach

Our broader approach to the markets remains unchanged, but we are making a few adjustments as the environment changes.

- Near-term downside risks to the market are mitigated. We will continue to steadily deploy and reduce our cash levels. Deployment to new portfolios are also being stepped up and we will focus on accelerating that process, too. Our overall philosophy of investing new inflows over a period of time remains unchanged.

- We are reinforcing our quality bias. We will remain with market leaders, strong balance sheets, high/improving return ratios and resilient businesses. We do not think that this is the time to bottom-fish in stressed names, despite the relief granted by the RBI.

- We continue to diversify our exposures and avoid concentration risks in any sector. In that context, we believe that the winners of the last decade may not be the winners in the future, and are looking to newer sectors like pharma, chemicals and telecom for the next wave of winners.

- We will remain selective in our approach to bank stocks. The relative winners will be the 4-5 private banks with strong balance sheets, but we worry that the returns from the last 4-5 years are unlikely to be replicated. We do not believe that we can depend on these stocks for outperformance, as we have been used to.

Seshadri Sen
Head of Research
Alchemy Capital Management Pvt. Ltd

Source :
Alchemy Research
Bloomberg

MARKET INSIGHTS

Alchemy view on Market trends, analysis, and way forward; with additional inputs from industry experts about the different aspects to superlative asset management.

1. Blogs – July 2020

- Investment Approach For A Growth-Challenged Economy
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  Mr. Hiren Ved to CNBC TV18

3. Market Views – July 2020*
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Q1FY21 Performance of Portfolio Companies

The following table summarizes the performance of portfolio companies**, which have declared results so far of Q1FY21 :

Stock	Sales (Rs Mn)			EBITDA (Rs Mn)			PAT (Rs Mn)		
	Q1FY21	Q1FY20	% chg	Q1FY21	Q1FY20	% chg	Q1FY21	Q1FY20	% chg
Reliance Industries Ltd	912,380	1,623,530	-44%	168,750	213,150	-21%	132,480	101,410	31%
Hindustan Unilever Ltd	104,060	99,840	4%	26,440	26,470	-0.1%	18,730	16,909	11%
United Spirits Ltd	10,302	22,184	-54%	-776	3,951	NA	-1,403	1,974	NA
Bharti Airtel Ltd	239,387	207,379	15%	106,392	84,926	25%	-5,460	-13,136	NA
Avenue Supermarts Ltd	38,332	57,805	-34%	1,089	5,959	-82%	496	3,353	-85%
HDFC Bank Ltd #	197,407	182,646	8%				66,586	55,682	20%
Dr Reddy'S Laboratories Ltd	44,175	38,435	15%	11,129	7,267	53%	5,793	6,628	-13%
Bajaj Finance Ltd	41,521	36,949	12%				9,623	11,953	-19%
Tata Consumer Products Ltd	27,139	23,924	13%	4,827	3,509	38%	3,276	1,737	89%
ICICI Bank Ltd #	154,224	111,628	38%				31,487	19,080	65%
Varun Beverages Ltd *	16,402	28,105	-42%	3,777	7,879	-52%	1,408	4,069	-65%
L&T Technology Services Ltd	12,947	13,475	-4%	2,059	2,727	-24%	1,172	2,039	-43%
Tata Elxsi Ltd	4,139	3,738	11%	1,061	819	30%	689	488	41%
Coromandel International Ltd	32,132	21,307	51%	4,125	1,953	111%	2,506	626	300%
Syngene International Ltd	4,216	4,209	0%	1,245	1,211	3%	580	720	-19%
Multi Commodity Exchange Of India Ltd	1,227	1,108	11%	763	591	29%	564	437	29%
Bajaj Auto Ltd	29,485	75,650	-61%	4,085	11,982	-66%	5,280	11,257	-53%
Nestle India Ltd *	30,215	29,828	1%	7,494	6,892	9%	4,975	4,478	11%
ICICI Prudential Life Insurance Ltd@	8,230	14,700	-44%				2,010	3,090	-35%
Bajaj Finserv Ltd	117,968	102,187	15%	42,499	30,071	41%	12,152	8,453	44%
Bayer Cropscience Ltd	12,278	9,504	29%	3,253	2,018	61%	2,517	1,353	86%
ICICI Lombard General Insurance Ltd $	22,191	23,850	-7%				3,981	3,098	29%
HDFC Asset Management Company Ltd	4,115	5,044	-18%	3,143	3,934	-20%	3,024	2,918	4%
Kotak Mahindra Bank Ltd #	44,974	44,777	0.4%				12,449	13,602	-8%
Pidilite Industries Ltd	8,778	20,168	-56%	664	4,437	-85%	268	2,929	-91%

* indicates CY end - So Q1FY20 = Q2CY20
\# indicates Net Interest Income + Other income and PAT for banks
@ Indicates Annual Premium Equivalent (APE) and Value of New Business (VNB) for life insurance companies
$ Indicates Net Written Premium and PAT for general insurance companies
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Alchemy Capital Management Pvt. Ltd., B-4, Amerchand Mansion, 16 Madame Cama Road, Mumbai 400 001.
Ph: +91-22-66171700, Website : www.alchemycapital.com
CIN- U67120MH1999PTC119811, Email ID: contactus@alchemycapital.com