ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

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EQUITY OUTLOOK

Corporate performance during FY16 till date has been muted with Nifty companies growing at flat to low single digits on the back of weak demand scenario, sharp fall in commodity prices, slower than expected reduction in interest rates, high incremental NPA for the banking sector and higher tax rate. Q3FY16 performance till date (32 companies reported out of 50) continues to be on similar lines with profit growth flat at 0.3%. Sales growth remains on the negative side at -5% – impact of sharp correction in commodity prices and weak demand scenario, EBIDTA margins as a % of sales has increased by 120 bps, Interest cost has still not peaked with growth of 11% & tax moving up by 6%, thereby impacting profit growth at 0.3%.

Demand scenario in the near term is likely to be on the weaker side accentuated on account of two back to back poor monsoon impacting crop production and a global correction in commodity prices including agri products. Rural India is slower than urban markets which can potentially pick up on the back of a better monsoon in the current year. Government capex is picking up led by Roads, Railways, Defence, Irrigation, Urban Infra (Metro), this is likely to help certain select business benefiting in terms of visibility of growth going ahead. We expect Nifty companies to deliver better performance starting FY17 assuming stability of global commodity prices going ahead along with some pickup in demand.

Among the key best performing companies during the quarter (better than our expectations) were Bajaj Finance (profit growth of 58%), Grasim Ind (Profits up 103%), Praj Ind (Profits up 108%), Texmaco Rail (Profits up 138%), Ultratech Cement (profits up 39.6%). Most companies delivered inline performance (as per expectations) Sundram Fastners (Profits up 38%), HDFC Bank (Profits up by 20%), Bajaj Finserve (profits up 26%), Godrej properties (Profits up 53%), Cadila Healthcare (Profits up 40%), Everest Industries (Profits up 142%), Essel Propack (Profits up 43%) and BEL (Profits up 10%). Among the detractors where performance was weaker than expected were – Maruti Suzuki (Profits grew by 27% however we were expecting higher margins than reported, the company highlighted that FY17 profitability can improve from current levels), L&T (Profits grew by 19.4% however we were expecting better numbers. In this business quarterly numbers can vary depending on project execution. We expect FY17 to be a 25%+ profit growth year on the back of improvement in margins and execution), Concor (Profits degrew by -31.5% due to weak container traffic and a sharp haulage charge increase by Railways which the company has chosen not to pass to end customer. In the near term Concor will continue to report weak profit growth though better than current quarter. It is a very strong play on dedicated freight corridor and the investments that the company is making on private freight terminals and multimodal logistics parks), Tech Mahindra (Profits degrew by -6% on the back of slow pick up in margins. We expect FY17 to see improved performance. Stock is trading at attractive valuations).

Most of our portfolio companies have reported a very satisfactory performance given the backdrop of Nifty results during Q3FY16. On an average profits have grown in excess of 30% barring a few names, infact quite a few companies specially in the mid cap space have grown profits at >100% during the quarter, with most companies growing in the band of 30% to 60%. It is important to highlight that we remain optimistic of similar performance from these businesses going ahead and hence expect better portfolio performance during the current year.

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DEBT OUTLOOK

We are living in a turbulent time. Many things are defying the fundamentals. Take an e.g. US is increasing interest rates but US yields are falling, where as India is decreasing interest rates but Indian G-sec yields are moving up. Instead where world is struggling with low growth rate and zero/negative interest rate Indian sovereign bonds continue to be relatively attractive, as real interest rates in India remain positive and growth remains below the potential levels, given the weaker capacity utilization. Amongst its Emerging market peers, India remains the least vulnerable to any global upheaval driven by China hard landing or a US Fed rate hike or any geopolitical event since India's GDP (GVA) growth rate expected by RBI is 7.6% in the financial year 2016-17, one of the highest in Asia & EM. An improvement is India's bond positive macro's such as lower CPI, consolidation of Fiscal deficit, higher FX reserves and lower Current Account Deficit is much evident. The Union Budget due on 29th February this year will be keenly watched for structural reforms and fiscal consolidation intention of the Government.

RBI in its 6th Bi monthly policy review took following actions:

•Kept Repo rate under the liquidity adjustment facility (LAF) unchanged at 6.75 per cent
•Cash reserve ratio (CRR) of scheduled banks remains unchanged too at 4.0 per cent of net demand and time liability (NDTL)
•In future, the RBI will continue to provide liquidity under overnight repos at 0.25 per cent of bank-wise NDTL at the LAF repo rate and liquidity under 14-day term repos, as well as longer term repos of up to 0.75 per cent of NDTL of the banking system through auctions. RBI will continue with daily variable rate repos and reverse repos to smooth liquidity

The decision of the Central bank to keep policy rates unchanged comes from the history of slower global growth and falling commodity prices. Since the fifth bi-monthly monetary policy review statement released in December 2015; the growth in the emerging world economies has weakened in contrast to the small improvements witnessed in the advanced economies.

Back home, the economic growth is plagued by slower industrial activity and dipping agricultural output. On the other hand, the industrial growth is severely constrained by weaker investments and a lack of capacity utilisation. The Capital goods sector has reported deceleration and the lackluster construction activities show a very high number of projects stalled.

The monetary policy of the RBI is likely to remain accommodative. However, further rate cuts are contingent upon inflow of the inflation data. The RBI seems to be satisfied with the progress of banks in tackling the problem of Non-Performing Assets (NPAs). It believes that the Government's commitments on infusion of capital in Public Sector Banks (PSBs) will place the adequate capital in the right hands. More capital allows banks to absorb higher losses, if any. Additionally, the RBI is figuring out innovative ways to tackle the systemic problem of bad loans. Once the health of banking sector improves, credit disbursement may happen more effectively. Nonetheless, the effective transmission of rate cut benefits that have already been accorded remains the prerequisite for future rate cuts

DEBT OUTLOOK

The RBI expects the Indian economy to grow at 7.4% in the current financial year, but it remains worried about the possibility of downward revisions. However, it is more optimistic about the projected growth prospects for the next fiscal (i.e. 2016-17), as it expects India to grow at 7.6%. The RBI opines that the Indian economy is set to attain higher industrial and economic growth in FY 2016-17.

As for the question of inflation, the RBI appears to be satisfied with the way things have panned out; and giving itself the flexibility to make revisions in the inflation expectation, it has exuded confidence about achieving the target of 5.0% by the end of FY 2016-17. That being said, the Central Bank has warned against the immense inflationary pressure building up in segments such as, housing, transportation, education, and healthcare to name a few. It still hasn't factored in the impact of the 7th pay commission provisions in inflation projections. Contrary to expectations, if the monsoon turns out to be subdued this year, inflation is likely to become a bigger challenge.

Returns from long duration bonds were below expectation in last 12 to 18 months due to stagnant yields. Currently yields are hovering around 7.8% levels which make case for allocation in long duration bonds. We strongly suggest investors to hold on their current positions in Long duration funds. We believe returns are postponed due to complex global problems. Asset allocation is the only way to generate consistent returns. We suggests investors to have a diversified approach and invest in Short term funds, Long duration funds, Accrual strategy. We expect interest rates in long term would be at lower levels compared to current levels and hence 7.2% to 7.40% tax free yield is good rate to invest in. Also as interest rates falls these bonds may trade at premium resulting capital appreciation. For new fixed income investments we suggest to invest 30% in short term funds, 30% in duration funds to generate capital gains, 20% allocation in accrual strategy and remaining 20% in tax free bonds to get generate consistent and optimal returns.

Advisory Team

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