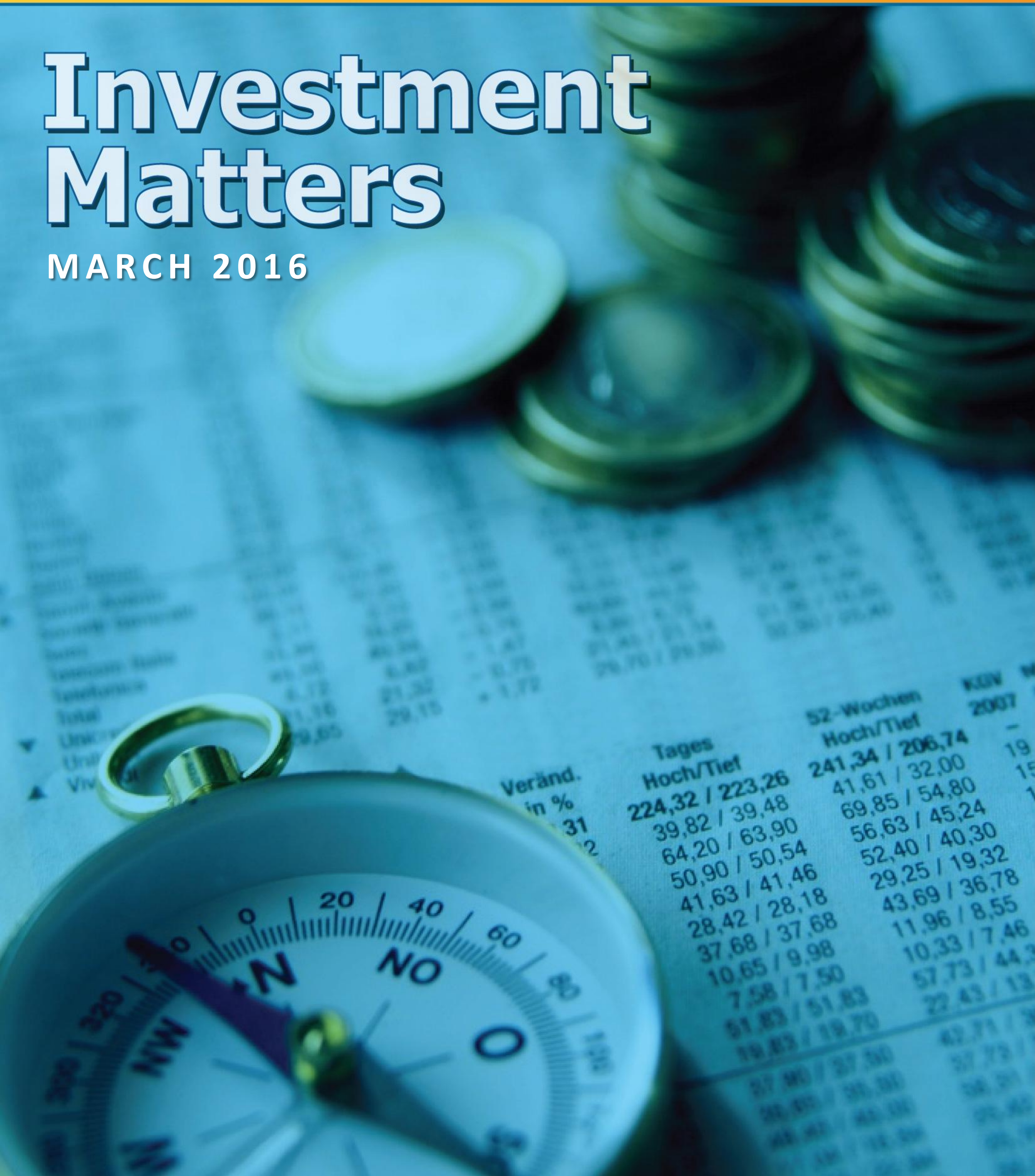
ALCHEMY CAPITAL MANAGEMENT

Investment Matters

MARCH 2016



EQUITY OUTLOOK

Equity markets have turned negative during the past few months and in fact has corrected sharply over 12 months from its peak of 9000 Nifty to current 7222 (March 1 2016) – a correction of almost 25%. We are highlighting our thoughts on some of the relevant questions that matter for the equity markets over the next few years as below -

➢Global environment is challenging what is Alchemy view on its outlook for markets going ahead?

✓Global environment continues to remain challenging in terms of growth, leverage, and low consumer demand. All of this gets ultimately reflected in currencies over time. Major developed market central banks are venturing into uncharted territories of negative interest rates hoping to prop up demand and consumption. It is futile to predict the implications of such policies on global markets and more specifically on India since timing such events is not practical. For now it suffices to say that India is relatively well placed given its better macro fundamentals like – low inflation and very manageable fiscal & current account deficits and decent growth. While this does not insulate our markets from global volatility it does put a floor. We believe that India's relative strengths was also its short term challenge as outflows from emerging markets led to outflows from Indian markets too as most funds have been overweight India. However, as global markets stabilise, FII inflows will resume again given India's long term structural strengths and good macro's.

➢Markets are deep in red with a 25% correction over the past 12 months, how much more correction is expected? Market rumours suggest a further correction is possible? Comments.

✓FII flows on account of global fears as explained above were negative with net selling of -$0.9bn during Feb 2016 and -$4.3bn over the past 12 months impacting market sentiment. Apart from negative flows, earnings growth for the corporate sector were on the weaker side on account of slow economic recovery, sharp correction in commodity prices specially crude impacting sales growth with inventory losses and large NPA's for the banking sector. We believe FY16 earnings scenario has bottomed and we are likely to see better earnings growth being delivered starting FY17 – a few key reasons are – Capex cycle picking up led by the government, incrementally commodity prices are expected to remain stable to higher, and a large part of banking sector NPA provisioning has happened in FY16 with substantially lower amounts remaining in future leading to better profit growth. As earnings recover markets will start pricing in a recovery in advance and hence we are optimistic that post this sharp correction markets are likely to recover lost ground.

➢What is your view of the Modi government. Do you think they are performing as per expectation and will India grow faster?

✓The government is completing 2 years in May 2016. This government inherited a high fiscal deficit, high current account deficit, high inflation, high interest rates, low FDI and low GDP growth from the previous government. Over the past 2 years, Indian macro indicators have turned for the better with fiscal deficit under control and targeted at 3.5% for FY17, low current account deficit at around 1 to 1.5% to GDP, Inflation well under control at around 5% (CPI), Interest rates have come down with 10 year bond yield hovering around 7.7%, FDI has improved significantly at $26.4 bn in CY14, and $18.9 bn 1HCY15 with higher GDP growth at 7 to 7.5% (on a low base with a change in definition). The biggest achievement of this government in our opinion is the fact that corruption at the central level has come down significantly and the government is working towards re-allocating resources from savings made in subsidies due to lower commodity prices and better administration and targeting of subsidies towards capital expenditure in infrastructure and rural areas. We believe that the government and the RBI are moving in co-ordination to solve some important problems like Bank NPA's, power sector problems and restarting stalled projects. Overall we believe the government is on the right track and we should see better growth in the economy led by government capex on Roads, Railways, Mining, Metro, Defence etc over the next 2-3 years. The fruits of a good macro should get translated into good micro from hereon.

EQUITY OUTLOOK

➢Rs/$ has depreciated sharply. Currencies globally specially emerging markets continue to depreciate. Fear of Yuan depreciating is impacting sentiment. Views.

✓Over the past 12 months, the Rupee has depreciated by 8.3% against the US$. Many emerging market currencies are faring worse than the Rs with sharp corrections. Concerns on the Chinese currency depreciating further over the next 12 months remains a risk and a point of discussion with most economists. We do not consider ourselves to be an expert on this subject however we are mindful of the risks that can emerge from such currency depreciation. In order to manage this risk we are focusing on businesses in our portfolios which do not get negatively impacted from the same – focus on business having high free cash flows with no/low leverage on the balance sheet, pricing power, a balance mix between domestic business and exports and which are amongst the leading players in their respective sectors with a certain competitive edge in terms of technology and/or scale. We are continuously monitoring all our investee companies to assess the impact of possible untoward global incidents.

➢Real Estate in India is not doing well. Most businesses are not showing growth. Leverage in some is very high. Indian Banking sector is seeing large NPA. How can equity markets do well in this scenario

✓The current business environment is challenging and has been so since the financial crises in CY08. Prior to the financial crises, most Indian corporate were aggressively investing either in large BOT infrastructure projects or working on large M&A targets overseas specially the EU region – Leverage being the common factor. Within India given that the real estate sector was doing extremely well, HNI/Retail was busy investing/trading surplus wealth along with leverage on real estate. Post the financial crises, high leverage for such corporate/HNI/Retail has started hurting and resulting in large NPA for the banking sector. Over the past few years specially FY16 we are seeing encouraging signs of asset sales happening from stressed old players to new entrants with strong balance sheets – of course this deleveraging is happening at a cost for the old players, however this process has started which is a very good sign. The Indian banks are being forced to recognise doubtful assets as NPA and provide for the same by the RBI and the Government by end of FY17, most banks have chosen to do an accelerated write-off by Q4FY16. Starting FY17 banks balance sheet will once again start on a clean slate with a lot of provisioning done by end of FY16. We believe we have reached the bottom of the cycle for the banking sector and the year ahead looks promising for the sector. Also, it is important to highlight that within this weak scenario mentioned above there were/are a lot of businesses which continued to perform very well example Consumer, Auto/Auto Ancillary/ Pharmaceuticals/IT etc. Stock selection plays an important role in a portfolio and we at Alchemy are focused on buying selectively towards businesses which can perform inspite of a weak macro on the earnings front.

➢Should I invest gradually or in one go? How would you invest my capital? What kind of businesses are you buying? Is valuation better now? Is it the right time to invest?

✓Given the sharp market correction over the past few months, valuations have once again become very attractive. Nifty Index currently trades at 14.5X FY17E PE with earnings expected to grow in double digits between 12-15%. We expect the markets to deliver better performance going ahead and would advice to allocate more to equity investments with a 3-5 year time horizon. We are focused on buying businesses delivering high profit growth in excess of 25% CAGR over the next 3-5 years with free cash positive, ROCE greater than cost of capital, low leverage, good quality management team and available at attractive valuations. Our portfolios currently are balanced 50:50 between large caps and mid caps and invested in varied businesses like Defence, Railways, Auto/Auto Ancillary, NBFC, Private banks, Consumer Discretionary etc.

It is our endeavour to consistently deliver better risk adjusted returns to client portfolios and become an asset manager of choice. We hope we have touched upon most of the relevant points of discussion through this note, in case there are further clarifications that are required feel free to approach our team and we will be happy to help you out.

Chandraprakash Padiyar

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DEBT OUTLOOK

Most awaited event of the fiscal year The Union Budget was presented on 29th Feb 2016. From fixed income market prospective the budget brought cheers as Government stayed on the path of fiscal moderation creating a substantial room for lower interest rates and will also leave more resources for the private sector. The budget continued to increase allocation towards infrastructure development with aim of improving investments in the economy. Many feared the expansion of fiscal deficit due to 7th pay commission payment coming up next fiscal year. During the month of February 2016 yield on the new 10-year benchmark (7.59% GoI 2026) ended the month at 7.62% down by 2bps over the previous month end. The yield on old 10-year benchmark Government bond (7.72% GoI 2025) ended at 7.79% up by 7bps for the month. The yield on 10-year AAA Corporate Bond ended the month at 8.62% as against 8.41% at the end of January 2016. Thus, corporate bond spreads during the month increased to 68 bps as against 48 bps in the previous month.

Globally, bond yields continued to soften across major markets. While UK and German 10 year bond yields softened by 22bps, the US and Japanese 10 year bond yields softened by 18bps and 17bps respectively. Investors' sentiments strengthened after the US Federal Reserve's January policy meeting minutes showed that the policy makers are inclined to pause the tightening process due to recent market turmoil. On the other hand, investors were disappointed by weaker-than-expected US jobs data, the US treasury prices rose as some weak domestic economic cues boosted the safe-haven appeal of bonds. In currencies space, US dollar lost in February, with the US dollar index closing down 1.4%. In India, long term bond yields traded at elevated levels during the month before substantially falling on the last day of the month, in the backdrop of the Finance Minister's announcement that the fiscal deficit target of 3.9% of GDP set for FY16 is achievable and target for FY17 is maintained at 3.5%. Foreign portfolio investors (FPIs) turned net sellers and aggregated to a net outflow of US$1.2bn during the month. Due to this Indian yields were trading at elevated levels.

Liquidity conditions continued to remain negative during the month of February 2016. As against ~Rs136234 crs of average liquidity net injected by RBI during the month of January through various sources (Liquidity Adjustment Facility, export refinance, marginal standing facility and term repos/reverse repos), ~Rs.161356 crs of liquidity was net injected by RBI during the month of February. The overnight rate ended at 7.05%, as against 7% at end January 2016.

In contrast to market expectations of a deceleration, headline CPI inflation accelerated to 5.7%YoY in January from 5.6%YoY in December marking the highest reading in 17 months. This was largely due to higher inflation in cereals within food and some non-food categories, such as housing. Food inflation accelerated to 6.8%YoY in January from 6.4%YoY in December led by increase in prices of cereals, milk, eggs, meat & fish. Core inflation (only ex food and fuel) was stable at 4.5%YoY in January, the same as December. Meanwhile, WPI inflation remained in deflation territory with -0.9%YoY in January vs -0.7%YoY in December, moreover the pace of contraction increased marginally due to lower-than-expected food and fuel prices.

DEBT OUTLOOK

Interest rates have fallen much less than inflation so far. With low commodity prices, low inflation and with the government having delivered yet again on fiscal front, the expectation of lower rates going forward is a very reasonable one. 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 suggest 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

Alchemy Capital Management Pvt. Ltd

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