Strategy Communique

Q3

CY 2020

UNIFI INVESTMENT MANAGEMENT

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The year so far

In March this year when markets (and cities) emptied out, we made the decision to go against the then prevailing conventional line of thought, and aggressively added to our positions in select equities. We grounded that decision in a rigorous analysis of the variety of perceptions, and combined that with our core principle of seeking the most favorable balance of risk and reward in an investment.

[For those inclined, in the field of decision theory, there is such a thing as the Ellsberg Paradox. It suggests that most people hesitate to act in a circumstance where the odds of a situation have a guaranteed positive outcome, with the magnitude being unknown. They prefer taking risks in situations where the odds of the situation are known, but have lower outcomes. Investing in times of stress is a very similar proposition].

Never waste a good crisis

Corporate results from Q3-CY2021 have dispelled lingering concerns, if any, on the economic linkage between the core of the Indian economy and larger listed firms. As GDP for Q3- CY2021 shrank by -7.5%, the trend of consolidation sharply accentuated across sector leaders, and the portfolio companies. In a sense, survival instincts seem to have come to the fore as sector leaders seized the opportunity to consolidate market share [from weaker peers], and strengthened several aspects of their operating metrics, and in the process delivered significant corporate and shareholder value. Under normal circumstances, such endeavors and the resultant outcomes may have been difficult to practice, and execute.

While the universe of BSE-500 delivered EBIDTA growth of 12% [in the backdrop of a -7.5% decline in GDP], the core holdings of the portfolio delivered significantly ahead of their peers, as they capitalized on the crisis, and strengthened their proposition, as well as their operations.

Make no mistake, this does not mean the recovery is all pervasive. Frontline indices only cover the formal industry, with an overwhelming weight on those who are significant market leaders, while India's industries are overwhelmingly unorganized. What we are witnessing today is a strong phase of consolidation from the informal to the formal sector. While we anticipated this cycle of consolidation post the implementation of demonetization and GST, it has taken a social pandemic to enable this shift. While a significant part of this performance is attributable to the normalization of supply-chains, a deeper examination suggests signs of a new structural normal among the sector leaders, which will see them deliver materially ahead of the pre-Covid era.

Beneath the surface

As a parallel to this phase of consolidation among the leaders, there is a sharp improvement in the macro-environment underway.

- GST collections crossed the Rs.1 lakh crore mark in October & November, and is now marginally higher YoY, indicating a return activity across the breadth of the economy.
- India's power consumption [YoY] registered growth of 4%, 12% & 5% during September, October & November respectively, indicating a firm bounce back in the industrial activity while energy consumption [petrol & diesel] has registered growth of 5% & 7% for the month of October, indicating normalization of industrial activity.
- Total number of E-way bills generated in October at 64.1 mn., is the highest tally recorded since the system was introduced more than two years ago, indicating strong mercantile traction across the economy
- Manufacturing PMI rose to 58.9 on Oct-19 [the highest since 2008] implying strong expansion in manufacturing activity.

India's recovery is on a self-sustaining path

As the macroeconomic data indicate, India's industrial risk appetite has not only remained healthy, but has come back strongly. The point to note here is, while liquidity has significantly entered certain asset classes, and the markets, it is yet to fully permeate all parts of the economy [read brick and mortar, physical retail, leisure travel, F&B, and others that have a significant multiplier effect on the economy]. In the post-vaccine world [c.2-3 quarters from today], we expect these untouched parts of the economy to significantly increase their economic participation, and in the process, significantly strengthen the pace of economic recovery. As the markets discounted these developments, India recorded its highest ever monthly inflows of USD7bn [November-20], and in the process delivered a broad-based rally across the breadth of the markets. Given the stated objective of all global central banks to keep the system flush with liquidity, the intensity of flows is expected to sustain over the medium term. Given the resilient private sector where the leaders have emerged stronger, and a flourishing rural economy that will abet domestic consumption, we believe India Inc is set to deliver a positive earnings surprise for FY2021 and the forthcoming fiscal FY-2022.

We have navigated this period of an uncertain environment with success, by staying true to our core principles of seeking the right mix of risk and reward in each of our bottom-up investments. Our approach for the times ahead remains similar, and steadfast.

Thank you for your trust in us, and we look forward to touching base with you in the new year. Stay safe, and our best wishes for a healthy and prosperous 2021!

The Investment theme wise composition for the strategy is as below

Theme wise Allocation (3 rd Dec 20)

DVD	37.3%
BCAD	23.2%
Insider Shadow	15.5%
Spinoff	9.2%
APJ	7.0%
Holdco	3.6%
Cash	4.2%
Total	**100%**

Results summary

The third quarter ended 30th September for CY-2020 has been a good one, with most of the fund's investee companies delivering results above expected lines. The quarter saw revival of business activity post the decline witnessed during early part of the year. Financials constitute the largest segmental exposure (22%) in the strategy followed by Pharmaceuticals (19%), Information Technology (14%) and Chemicals/Fertilizer (13%). During the quarter, we advised taking 5% exposure each to Chambal fertilizer - which is India's largest private sector manufacturer of urea, CCL products - India's leading exporter of coffee and DCM Shriram – a diversified products company with presence in Chlor-alkali, sugar and agri related products.

During the quarter, we advised exiting Petronet, Aarti Drugs and Sanofi as their near term risk-reward turned unfavorable. We also recommended trimming exposure in Axis Bank, Tech Mahindra, Garware Technical Fiber, Suven Pharmaceuticals and JB Chemicals to fund new purchases.

We have reviewed the results of our key investments in the following section.

Company	Brief background and Investment rationale
ICICI Securities	ICICI Securities delivered a good quarter, with the broking segment growing by 82% YoY to Rs.392cr. ISec increased its market share in Equity trading volumes to 11.1% from 10.7% in Q1 FY21, adding about 113,000 clients in the quarter, taking the total count of clients to 4.96mn. The distribution revenue was almost flat on a YoY basis but recovered from the low Rs.80cr in Q1FY21. The focus for the times ahead would continue to be on rationalization of human resources and push to digital initiatives. On the back of robust revenue growth and measured operating expenses, PBT was up 102% YoY at Rs.372cr., and PAT was higher by 137% YoY at Rs.193cr. I-Sec is a leading tech-based securities player offering a range of financial services including brokerage, financial products distribution and investment banking, with a focus on both retail and institutional clients. As of Sep 2020, the proprietary electronic brokerage platform ICICI Direct had approx. 4.96 Mn operational accounts of whom about 1.2Mn had traded on NSE in last 12 months. I-Sec is also the second largest non-bank MF distributor with an AUM of Rs.352bn. We like the business due to its absolute technology leadership, continuing consolidation of user base, high RoE of more than 50%+ and access to ICICI Bank's franchise for customer acquisition. Key risks would arise from a prolonged downcycle in equity markets leading to lower turnover, and heightened competition leading to loss of market share.
Garware Tech	Garware delivered revenue, EBITDA and PBT growth of 15% YoY, 39% YoY and 32% YoY respectively. Gross margin expanded 5.1% YoY on the account of better product mix and new products launches. EBITDA grew by 39% on the back of operating leverage and gross margin expansion. PBT excluding other income grew nearly 46% while there was a 16% decline in the other income. Both the segments of Synthetic Cordage as well as the Fibre and Industrial products have recovered well and the core business segment [Synthetic cordage] has seen significant expansion in margins. The company was granted three patents in this quarter and this augurs well for topline growth and gross margin expansion in the times to come. The company has Rs. 530cr surplus cash on books as on 30th Sept'20 with core FY21E RoE of 26%. Key risks: Fall in the price of Salmon, sharp rise in Crude Oil and failure of newer innovative products to garner market share.
JB Chemicals	JB Chemicals reported flat revenue, EBITDA and PBT growth. Revenue growth would have been higher, but for the company deferred Rs.57cr of exports dispatches planned in Q2 FY21 to October due to constrained availability of ships/ containers. Adding Rs.57cr to the top line for the quarter, revenues would have been up 10% YoY to Rs. 501cr; and absolute EBITDA would have been up 35% and PBT (excluding other income) would have been up 40%. The export order book continues to be healthy, up 39% YoY in H1. As communicated earlier, the ownership of JB has changed in the prior quarter, and PE firm KKR now owns 54% of the company. We like the company due to the strength of its 4 key brands (Cilacar | Nicardia | Rantac | Metrogyl) and the potential for KKR to accelerate its growth momentum and add to their efficient operations. Key risks: prolonged economic weakness and supply chain disruptions that can impact the supply and demand for drugs and unexpected regulatory developments.
KEC International	KEC reported revenue growth of 16% YoY on the backdrop of strong execution. Company focused on improving employee productivity and also mechanized few of the processes to execute seamlessly. Despite 16% growth in revenue, the EBITDA remained flat on YoY basis due to change in the business mix. During the quarter, company executed more of railways and civil projects, where the margins are relatively lower. This will get corrected in the later part of the year as the execution of power T&D projects picks up. Lower interest expense resulted in a PAT growth of 4% YoY. Construction work has now resumed at almost all its sites and company is back to pre-Covid levels of execution across the board. KEC has an outstanding order book (plus L1) of more than Rs.24,000cr resulting in revenue visibility over the next 7-8 quarters. The company has not seen any delays in its payment cycles from key customers namely Power Grid and Indian Railways. KEC is a proxy play for rising infrastructure spends in India and we like the company for its ability to navigate the environment cautiously, but profitably. Key risks include higher receivable cycles and unforeseen project delays.
Suven Pharma	Suven reported decline in revenues of 13% YoY while EBIDTA and PAT declined by 25% and 20% YoY, respectively. The second quarter of last year had high margin campaign launches from its commercial CRAMS segment which we are aware is uneven. [Once a customer buys a batch of material, the next order comes after a lag of 12-18 months depending on how the new drug is received and accepted by the market]. Suven currently has six commercially launched intermediates and specialty chemicals and is looking to add two more in FY-2022. Suven's business model necessitates looking at the annual progress rather than quarter-wise developments. Despite a flattish H1, we are expecting revenue and PAT growth of 10% and 15% for the full year given the prospects in H2 especially due to the profit-share kicking in from formulation supplies to USA. Suven's revenues arise from contract research services, commercial scale intermediate and specialty chemicals and they have now diversified into formulations by building appropriate capacities and obtained USFDA approvals. The company has launched 2 ANDAs (formulation drugs) in H1, and is scheduled to launch one more in H2 and 3-4 ANDAs every year over the next 5 years. The company is planning a capex of Rs.600cr over the next 3 years towards refurbishment and expansion of its R&D as well as manufacturing capacities to be able to sustain their high margins and lay foundation for the next stage of growth.

Key risks - Management bandwidth (COO hiring underway) and slowdown in new research orders due to COVID are the key concerns.

Sonata Software

Sonata delivered Sales growth of 14% and earnings decline of 20%, on the back of YoY weakness in their top account from the travel vertical. Operations however improved significantly on a QoQ basis, on the back of a recovery in the stressed travel segment; earnings improved 14% sequentially from Q1FY21. Sonata is a key partner to Microsoft in their global product development initiatives, and has a strong domestic products re-selling business. With the worse of the pandemic induced stress in their travel business behind them, we expect the traction in earnings to return sequentially over the next few quarters. There is a trend of better off-shoring that is being witnessed on the back of industry wide workfrom-home initiatives, and this is likely to be margin accretive in the times to come.

Axis Bank is well placed to get back to normalcy from FY-2022 onwards. Given the low cost of deposits and access to capital, the bank is expected to deliver on all parameters from the forthcoming year, and eventually migrate to higher double-digit ROEs. Any announcement of a one-time restructuring from RBI will also allow lending institutions like Axis Bank to restructure eligible loans and help the customers move from the NPA buckets back to the standard bucket. That would help lower the stress and the associated provisions lower.

Risks: Slower than expected economic recovery in Europe and cuts in discretionary IT spends by enterprise clients

Axis Bank

Axis Bank reported NII growth of 20% YoY and 5% QoQ to Rs.7,326cr on the back of healthy expansion in NIMs. Advances grew by 11% YoY to Rs.5.76Tn with retail advances forming 53% of the same. The cost to income ratio continues to be in control at 38% in Q2 FY21. PPOP increased 48% YoY and 18% on QoQ basis to Rs.6,900cr. The provisions were flat on a sequential basis at around Rs 4,600cr. Overall, PAT was up by 51% QoQ at Rs.1,683cr. The asset quality improved, with GNPA & NNPA coming down to 4.18% and 0.98% respectively. The BB & below book is about 2.4% of the book and the bank estimates that about 1% of loans might come for restructuring by Dec-20. Overall, the incremental covid related stress pool is estimated at 3.5% of the book for which the bank already has made provisions of 2.2%.

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Key risks would include deterioration of asset quality leading to higher-than-expected credit costs and decline in NIMs due to falling yields

CCL Products

CCL delivered Sales, EBIDTA and PAT growth of 8% / 26% and 13% growth on YoY basis, and reported sharp improvement on margin parameters, led by prevalence of a better product mix. This was aided by rising utilization at their wholly-owned Vietnam subsidiary, while the India business saw a better mix of higher-margin products. In India, the new Free Dried plant at Chitoor did not see any production loss [Covid related] and is expected to continue performing at optimum levels. Their new capacities in Vietnam this is scheduled to come on stream over the next few quarters is expected to drive growth over the next few years.

Key risks to the investment could emanate from slowdown in global demand for Coffee, and poor incremental order wins.

Chaman Lal

Chamanlal Setia reported revenue, EBITDA and PBT YoY growth of 6%, 85% and 105%. Good monsoon during this year resulted in better harvest across most parts of the country. This led to lower paddy prices and aided in sharp gross margin expansion for the company. Higher gross margin coupled with flat employee expenses resulted in 85% YoY growth in the EBITDA for the company.

The low paddy prices are expected to continue for couple more quarters and this would result in strong growth for Chamanlal for FY21. The company continues to be cash-rich and currently has net cash of Rs. 93cr with RoE of 24%.

Risk: Sudden surge in paddy prices and deterioration of working capital cycle

Tech Mahindra

Tech M delivered revenues of $1,265.6mn for Q2 FY21, reporting a growth of 4.7% QoQ but 1.7% YoY decline. In INR terms, EBIDTA and PAT delivered growth of 31% and 10% respectively. The company witnessed steep increase in margins [by 390 bps] to 18.2%, driven by better off shore and lowering sub-contracting costs along with margin uptick in their portfolio companies. Segmentally, major growth was driven by the Technology, Media & BFSI which were up 20% YoY and represent 26% of their revenues, and looking ahead, incremental growth is expected to be driven by Telecom and Manufacturing segments (10% YoY decline and represent 55% of revenue). Demand induces by 5G technology expected to drive further enterprise growth in FY22. We continue to like Tech Mahindra on the back of their pursuit of margins, that is expected to accelerate from here on as well, and demand growth in telecom and other segments, accelerating in the forthcoming year.

Risks: Slower than expected economic recovery in USA and Europe and cuts in discretionary IT spends by enterprise clients.

DCM Shriram

The company reported revenue, EBITDA and PBT YoY growth of 17%, 5% and 5% respectively. The growth in this quarter was primarily contributed by Sugar business due to higher volumes of sugar and ethanol. DCM Shriram is predominantly present in Chlor-alkali and Sugar business along with agriculture products like Fertilizers, Bio seeds and other farm solutions. The demand for caustic soda is now coming back to pre-Covid levels and this is expected to result favorably on numbers in the times to come. Their net debt has reduced from Rs.1500cr in FY20 to Rs.40cr in Q2 FY21.

Key Risk: Unexpected regulatory developments in Sugar/Ethanol business and decline in caustic soda prices in the international market

ICICI Bank

ICICI Bank reported NII growth of 16% YoY and 1% QoQ at Rs.9,366cr, while their non-interest income dropped 10% YoY due to lower business volumes. Their cost to income ratio fell to 40% from 45% in FY20, on the back of lower operating expenses. Overall, operating profit was higher by 18% YoY at Rs.7,719cr. Advances were up 6.5% YoY & 3% QoQ at 6.5Tn with retail forming 66% of the same.

The bank continues to enjoy a strong consumer franchise with a CASA ratio of 41%, one of the highest within the banking industry. The stress in the corporate book has already been adequately provided by the management. The listed status of subsidiaries has provided good liquidity window to the bank enabling higher provisions. The management is confident of being able to manage the overdue and restructured book, given the good collections history of the underlying clients.

Key risks would include deterioration of asset quality, higher than expected credit costs and decline in NIMs due to falling yields.

Valuation Metrics

Weighted	FY 22E	FY 22E	FY 22E
Earnings Growth*	25.0%	16.0%	18.0%
Price to Earnings Ratio	29.5	18.7	16.0
ROE	26.2%	25.6%	24.3%
Price to Book Ratio	5.3	4.3	3.6
Weighted Avg Market cap (Crs)	38,383		

Top 10 Holdings

	Weights %
Position 1	9.99
Position 2	9.55
Position 3	9.30
Position 4	9.25
Position 5	9.19
Position 6	7.74
Position 7	7.65
Position 8	7.05
Position 9	6.30
Position 10	5.56
Total	**81.59**

Sector Exposure

Sector	%
Banking & Fin Serv	21.24%
Pharma	18.49%
IT	13.26%
Chemicals/ Fertilizer	12.16%
Agri Processing	11.86%
Materials	9.55%
Capital goods	9.25%
Cash	4.19%
Total	**100%**

Classification By Market Cap

Segment	Basis	%
Large Cap	> $2000mn	17.51%
Mid Cap	> $200mn < $2000mn	76.68%
Small Cap	> $50mn < $200mn	5.81%
Micro Cap	< $50mn	0.00%
Total		**100%**

Liquidity Analysis

Segment	% of portfolio
Less than 1 day	62.67%
Between 1 & 3 days	31.52%
Between 3 & 5 days	0.00%
Greater than 5 days	5.81%
Total	**100%**

Note: Portfolio metrics are as of 3 rd Dec, 20

UNIFI INVESTMENT MANAGEMENT

Risk Management

Risk	Mitigants
Consumption slowdown	All our investee companies have product and category leadership and the financial wherewithal to withstand temporary phases of demand slowdown.
Raw material inflation	The investee companies have strong pricing power, and a track record of taking price hikes to pass on the higher input prices to end customers given their brand recall, product and service efficiency.
Liquidity risk (in case of NBFCs)	Our investee companies have been able to tap diversified sources of liquidity thanks to their long-term history of comfortable asset quality and ALM.
Foreign Exchange risk	Bulk of the revenues of the investee companies are derived from domestic market. The revenue from exports would be minimal for each strategy as a whole and where relevant, are adequately hedged.
Leverage risk	Except for the financial companies, most of the operating companies in the strategies carry nil to moderate debt on their balance sheets with a track record of having managed leverage well in the past.
Technology Obsolescence	Technological changes can render the products/services of a company obsolete and thereby hurt its profitability and valuation. Such a risk is generally minimized by limiting the aggregate exposure of portfolio to such investments to less than 10% of value.
Governance Risk	We avoid investing in companies with a known history of corporate governance issues. Further, in case such issue arises in an existing investment, we stop additional purchases and start optimally exiting the investment.
Concentration Risk	High client concentration is a recurrent feature among small and mid-caps. At the portfolio level, such risks are minimized by limiting the aggregate exposure of portfolio to such investments to less than 10% of value.
Stock Illiquidity Risk	High Impact cost, due to thin trading at the time of buying or selling is endemic to small & mid-caps. We plan our investment decisions, size of the investment and trading strategies to minimize the costs due to illiquidity.
Key Man Risk	Small and mid-caps are frequently managed by a single person on whom the business is completely reliant and without whom the business would be materially inferior. We generally avoid such names and in cases where we make any exceptions, the aggregate exposure of portfolio to such investments is limited to less than 10% by value.
Slowdown in global consumption	The wallet-share of the investee companies in the global manufacturing value chain, does not pose a significant risk of loss of business to their vendors. New and high growth areas such as Lithium Ion batteries, EV vehicles are in relative infancy stage and have a strong growth curve ahead of them.