4 Jan 2018

Dear Partners,

After a sobering new year last year where markets were reeling from the effects of demonetization, this year seems to have given investors a lot to celebrate about. The NIFTY has been up ~29% in the last calendar year.

So what's the outlook and how are we positioning portfolios?

Summary

- The India growth story is picking up momentum; lower economic classes are participating in the growth story as well.
- As a country, we have many challenges to overcome. However, problems should not be confused with lack of progress.
- The attractiveness of India's growth story will not translate into strong equity returns if entry multiples or time horizons are ignored. Stock price movements are driven both by the attractiveness of the story –"the narrative" and reported results – "numbers". At present, for the market in aggregate, the story is running ahead of numbers – valuation multiples are very high.
- When markets are doing well, risk tolerance tends to increases only for it to rapidly decline when markets correct. Guard against "recency effect" - stay true to your Asset Allocation
- For incremental capital allocation, one needs to have muted expectations of short term returns and have longer investment time durations so earnings growth can beat the impact of valuation multiple decline

We remain very optimistic about India's long term growth story. Some anecdotal evidence

- Economic prosperity is adding new consumers to "discretionary categories" - my neighbour's driver returned by air from his village - an affordable ticket won over a 48 hour train journey.
- A friend supporting sustainable grass roots initiatives shared that their pilots have resulted in a 16X increase in farm incomes
- China is cracking down to control pollution with a heavy hand – this is creating opportunities in many industries for India as global players find not only cost differences narrowing, but reliance on a predominant China supply chain risky.
- GSTs impact is already having its desired impact with non-compliant players losing market share to compliant ones across multiple industries.

The chink in India's growth story has always been crony capitalism and poor infrastructure. However, consider this.

a) The bankruptcy code is resulting in a change in promoter behaviour. Newspapers report that many companies are seeking clarity on over-due interest so they can bid for their assets.
b) India's tax to GDP ratio at ~ 16% vs 23% for Brazil, and 20% for China. GST and technology will plug tax leakage and give the Govt. the ammunition to spend on Infrastructure

Yes, there are things as citizens we should worry about. This week's agitations in Maharashtra are a manifestation of inequality – a huge challenge for Govt.'s globally not just in India. However, we should not confuse problems with lack of progress. If one observes closely, one realizes that the biggest critics of GST are the ones who were not paying taxes. For sure, we could do a better job on execution for e.g. of the GST roll out – but one should be a bit reflective of challenges of getting things done in our democracy.

As an illustration,

- My IIM A batch with 100 interested attendees (including me) could not agree to a venue for our re-union this year, eventually leading to a split event.
- A friend who is on the board of an NGO comprising IIM luminaries laments that the 10 board members, many CEOs amongst them, have not achieved consensus on a woman director for over a year

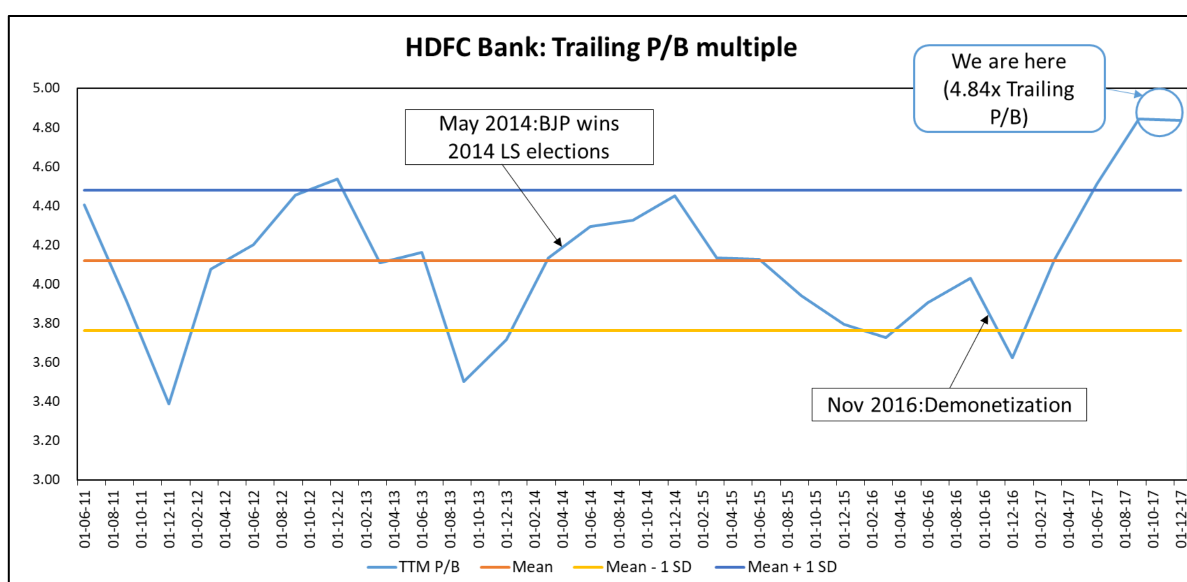
If the cream of management talent in the country, (who knows each other and has a common agenda) cannot have alignment on simple issues, surely the Govt. which is trying to create alignment within diverse and often adversarial interests deserves some leeway in rolling out an immensely complex tax reform. As Daniel Kahneman noted, "we are quick to recognize fault in others, but don't seem to see them in ourselves"

In summary, Indian Equities is a very compelling Asset class for the patient long term investor. Companies that have large addressable markets, are benefitting from structural tail winds of growth and are run by management teams with prudence and discipline can therefore compound earnings for long periods of time.

<u>However stock price performance is determined by two other factors other than earnings growth, "change" in PE valuation multiples and time horizons</u>

PE multiples are prices investors are prepared to pay for a company. What is a fair PE multiple is not precise mathematics, but can be ascertained within a band. However, prices frequently depart from the fair value band - getting exuberant at times; and depressed at others driven by greed and fear. These emotions influence the intensity with which money wants to get in or get out and hence can move prices sharply higher or lower from fair value.

Herein lies the short term challenge – amidst the euphoria of current market performance, one should not lose sight of the reality that the "narrative" is running well ahead of "numbers". It's not just India, almost all global equity markets are near an all-time high. As an example consider the valuation of HDFC Bank, perhaps the most secular execution story in India with fairly predictable earnings. As one can see from the chart below, the market is willing to pay "4.8x" trailing Book value/share for HDFC Bank today, well above the higher end of last eight years historical trading bands.



Source: Ace Equity, Solidarity Analysis

We believe PE multiples for the vast majority of companies are well above fair value and there is a case for multiples to normalize and revert to mean.

a) PE multiples always tend to mean revert. One can also see this trend for very well run companies like HDFC Bank (refer chart above)
b) Most of the stock price growth over the last 3 years has come from PE multiple growth rather than earnings growth. For sure for select companies, higher PE multiples reflect an enhancement in the quality of the business (higher margins, free cash conversion etc.) or higher growth expectations. However, for the vast majority, the elevated multiples are not the reflecting the Indian investors new found faith in the India story, but rather the higher liquidity flows to Equity markets due to Real Estate and Gold not being attractive Asset classes at present and poor post tax returns on Fixed Deposits.

01 Jan 2014 to 29 Dec 2017 (4 yrs)	Absolute Index Expansion	Absolute Earnings Growth	Absolute PE Expansion
Nifty 50	67.0%	16.0%	44.0%
Nifty 100	76.5%	13.5%	55.4%
Nifty 200	84.0%	9.5%	68.1%
Nifty 500	93.1%	12.7%	71.4%

Source: NSE, Solidarity Analysis

c) We are not very far away from the national election. At Solidarity, we focus on earnings growth and hence believe that the India story is largely structural and not dependent on whether the Congress or BJP is in power at the centre as they both have a slightly left of centre capitalist agenda. However, the broader market believes that a BJP Govt. will be better for stock prices. The Congress strong showing in Gujarat seems to suggest that 2019 will not be a cake walk for the BJP which seemed to be a given a year ago. This uncertainty does not seem to reflect in market multiples at present.
d) Moreover, some head winds to PE multiples are visible - many companies have had an increase in Gross margins in the past few years which were aided by drop in commodity prices - which have now started rising again. Interest rates came off over 200 bps in the last 2 years but have risen ~100 bps in the last 4 months.

Hence, two opposing forces will play out in the short to medium term and their relative impact will determine overall market returns

a) The tail winds of earnings growth from a global and domestic economy picking up speed, and market share gains for dominant players post GST
b) The head wind of PE multiple decline from current levels towards longer term mean

We are long term investors. We don't attempt to predict what the market will do in the short term. Nor do we have a view on whether a correction is imminent and when multiples may correct. In fact as over short horizons what matters is price momentum and not valuations, sentiment could drive markets even higher from here. Why then should the short term valuations warrant so much commentary? We are all influenced by recent events. When markets are doing well and everyone is enjoying the capital appreciation, risk is often forgotten – good times make us feel light headed and we start believing our risk tolerance is much higher than it actually is.

We counsel

a) Maintain Asset Allocation discipline. Don't invest capital into Equities that you may need over the next 24 months. Park that surplus in Liquid funds that invest in AAA paper
b) As the starting point is a high valuation multiple, one should have realistic IRR expectations over the next 3 years (for a well-diversified portfolio). This is simple mathematics (illustrated below)

IRRs under different scenarios

Compounded EPS growth			15%
Change in PE multiple	Time (yrs) 1	3	5
-5%	9.2%	13.1%	13.8%
-10%	3.5%	11.0%	12.6%
-15%	-2.3%	8.9%	11.3%

Compounded EPS growth			20%
Change in PE multiple	Time (yrs) 1	3	5
-5%	14.0%	18.0%	18.8%
-10%	8.0%	15.9%	17.5%
-15%	2.0%	13.7%	16.2%

Source: Solidarity Analysis

c) Stay invested by focusing on the longer term prize provided by compounding of earnings growth – if the markets are broadly flat for about a year and earnings grow, a lot of the valuation froth gets eliminated.
d) Deploy incremental capital gradually in a Systematic way rather than through large chunks or be prepared to let your Managers hold cash for long periods of time.

Our approach to portfolio positioning at present

Even as the aggregate market seems well above fair value, "aggregates" can be misleading – there are pockets of extremes alongside pockets of deep value. For example in financials, we believe "Private Corporate Banks" offer very compelling value even as we believe valuations in Housing Finance, many NBFCs, small banks and retail oriented banks are "out of comfort zone".

Broad approach we are following:

- While we love strong "narratives", we will not pay absurd valuations to participate. We are buyers at a "fair" price and not at "any price" – hence, we will be patient and hold cash if necessary rather than always be fully invested.
- We will continue to remain overweight on companies within sectors with structural tail winds for growth and where valuations are in favour.
- We will let our winners' compound where the run way for future growth is strong even if we believe they are above fair value and may correct. We will trim when we believe base case IRRs over 3 years are falling below 12% and better IRR opportunities are available
- Due to paucity of ideas at acceptable valuations, we will be prepared to take more concentration risk than in the past where risk/reward trade-off is strongly in favour

As most "Quality and Growth" themes are very expensive, it is imperative we continue to experiment with other approaches while not diluting our core

- We will continue to participate in companies that could be strong franchises but are "temporarily" out of favour – for e.g. a stretched balance sheets due to a wrong business decision. The non-negotiable conditions will be strong Operating cash flow, manageable debt burdens, and a visible path to debt reduction. As these companies reduce debt, valuation re rating with earnings growth should provide strong returns if the thesis works out right and stupendous returns if Capital Allocation errors of the past are not repeated. Naturally, these will be low weight positions where position sizing will be increased with evidence of execution
- We will be open to being tactical and opportunistic and "rent" businesses for short durations when we see >30% IRR opportunities - companies that are not structurally high ROE

businesses but where valuations are in favour and/or the industry is in favour on a cyclical rebound. I want to be clear that this is not our preferred approach. However, it is better than holding cash at 6% IRR. Moreover, it is imperative we be open minded with other approaches rather than be a one trick pony in a very expensive market.

You will observe a reflection of the above in your portfolio statements. As always, I will be delighted to have a personal conversation

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2017 has been a strong year for us as it has been for almost all Investment Managers we know. Even as we have enjoyed our success, we continue to introspect on our mistakes and learnings - details of which we will share in our next letter

I hope the holiday season provided the opportunity to spend time with family and friends. We wish that 2018 is your best year ever till date. We close with the commitment that we will be as prudent with managing your Investments as we are with ours, and with all our interests always completely aligned.

Sincerely,

Manish Gupta
Chief Investment Officer