QuestPMS Newsletter - June 2017

Rising tide lifting boats selectively

It is evident that we are in the midst of a bull run (please read our March 2017 newsletter). Nifty50 has run up by 16% in the last 6 months and midcap & small cap indices have given double digit CAGR return over the last 3 years. Yet, the top 5 stocks by market capitalization as of June 30th, 2014 have hardly given any return on a weighted average basis i.e. their cumulative market capitalization remains more or less the same over this 3 year period. Still, within the Nifty50 stocks of June 30, 2014, there are at least 5 stocks that have delivered CAGR return of over 25% in the last 3 years!

A few things are evident from the above analysis:

- Unlike the last bull phase, rising tide in India is not lifting all boats this time around
- Growth is evident in select pockets and market is handsomely rewarding those stories
- Sectors / companies facing headwinds continue to underperform and are being shunned by investors

The aforesaid also implies that while valuations in some cases have become rich, market is not in the bubble territory and bottom up stock picking continues to be the mantra in the current bull phase. The above analysis also begs the question as to why the current tide is benefiting only select sectors / businesses. Why are prospects of some sectors / businesses looking far superior to some of the other sectors / businesses?

The answer lies in understanding the back drop in which the NDA government inherited the Indian economy and the strategy it adopted to revive it. Apart from the fact that Indian economy was badly floundering during 2011-13, the world also simultaneously witnessed several challenges including global slowdown and the ‘PIGS’ crisis. Modi government, given this scenario, had 2 choices; either to kick the can and continue with the status quo policies of crony capitalism or to take the bitter pill and build a sustainable foundation for long term betterment of the economy through structural reforms. Modi government chose the latter option.

Push and pull of long term gains vs short term pain playing out

Structural reforms indeed is the better option from a medium / long term perspective but is not a panacea for immediate relief. In a normal scenario, benefits of structural changes become visible only in the medium term and therefore the interim period is painful for almost everybody. However, Modi government benefitted from one very significant stroke of luck i.e. crash in commodity prices, particularly crude oil. This development helped the government in quickly correcting the twin deficits (fiscal and current account) and reining in inflation, thereby facilitating lowering of interest rates. More importantly, it provided the government with fiscal flexibility to increase spending on infrastructure massively. This was crucial in the absence of private capex which in retrospect had to take much longer to revive given the over leveraged balance sheet of asset heavy businesses, under-utilized capacities and government’s refusal to unleash animal spirits through crony capitalism yet again.

Higher spending on roads, railways, transmission and distribution, urban infrastructure (metros, water), renewable energy – solar and wind, etc. over the last couple of years is now reflecting in traction in businesses / companies related to these sectors and much better visibility for the future through the build-up in their order book. Superior policy framework and more efficient execution due to focused and transparent approach of the concerned ministries too is helping as leakages have reduced hugely and the money spent is money well utilized in most cases now.

Further, lower inflation and Seventh Pay commission is leading to higher disposable income in the hands of consumers benefitting discretionary consumption sectors like automobiles and consumer durables. However, absence of private capex domestically and headwinds being faced by some sectors globally due to rise of 'protectionism' and other industry related issues has meant large scale divergence in corporate performance in the last couple of years.

Divergence in corporate performance to continue in future as well

The Indian government and the Reserve Bank have off late taken up the task of resolution of large corporate NPA accounts with renewed vigour. While the recognition of NPAs started in the right earnest towards the end of 2015 when AQR (Asset Quality Review) was carried out, resolution of these accounts in the absence of right policies was moving at a very slow pace. Recent ordinance in this regard suggests that government is showing the required urgency to take the issue head on. This will result in pain in the short term but augurs well for the overall economy. Also, good monsoon in 2016 and 2017 (as per the forecasts) should support rural demand. Further, global economy too has looked up in the last few months. Prospects for the Indian corporate sector therefore definitely looks rosier today and the same to an extent is being reflected in the stock market.

Going forward, over the next couple of years, while we expect some of the hitherto underperforming sectors / companies to benefit from the aforesaid developments, we expect divergence in corporate performance (among various sectors and even within the same sectors) to continue. This will imply that bottom up approach to stock picking will hold sway in future as well and the portfolios that are rightly positioned will continue to outperform the market.

QuestPMS Performance

Quest PMS has performed well during these interesting times as well as over the longer period as is evident from the table below.

(Returns above 1 year are CAGR)

	PORTFOLIO	SENSEX	NIFTY 50	BSE MID-CAP INDEX	NIFTY MIDCAP 50	BSE SMALL-CAP INDEX	NIFTY SMALL 100
3 Months	10.7	4.4	3.8	3.9	3.1	6.8	4.7
6 Months	26.1	16.1	16.3	21.7	23.4	27.9	26.5
1 Year	26.8	14.5	14.9	25.0	29.4	30.6	25.8
2 Years	23.5	5.5	6.7	17.1	18.6	18.0	17.2
3 Years	22.2	6.8	7.7	16.0	10.2	14.7	10.7
4 Years	33.5	12.4	13.0	25.2	24.3	28.5	25.9
5 Years	26.8	12.1	12.5	18.9	16.2	18.7	16.9

The Above returns are of a Model Client as on June 30, 2017. Returns shown above are post fees & expenses.
Returns of individual clients may differ depending on time of entry in the Strategy.
Past performance may or may not be sustained in future and should not be used as a basis for comparison with other investments.

Our bottom up approach with bias towards sectors with tail winds has been key to our performance. We believe that Quest PMS portfolio is very well positioned given the current political and business dynamics. We continue to monitor the portfolios very closely and make adjustments where necessary in line with business realities and valuation metrics.

We estimate Quest PMS portfolio weighted average EPS to grow at a CAGR of appropriately 24% over the next 3 years (FY17-20) while it is trading at a PE multiple of 20 on FY18 and 16 on FY19 basis giving us confidence in its ability to continue to outperform the market going forward as well.

Issues critical for building on the progress achieved till date

Modi government has till now done a remarkable job of communicating its economic agenda to the masses. For example, despite facing hardships, a large part of the society across the country supported demonetization. Perception of an honest government trying to do 'good' for the country has enabled the government to garner popular support even during difficult times. However, of late, BJP has had to compromise on its own economic principles, case in point being the farm loan waivers in Uttar Pradesh, Madhya Pradesh and Maharashtra. This has led to competing loans waivers by Congress run states like Karnataka and Punjab.

Undoubtedly, farmers have suffered due to 2 consecutive years of deficient monsoon (2014 and 2015), low single digit increase in MSP and overall low prices globally for agricultural produce. Hence, while a case can be made for farm loan waivers where farmers don't have the capital to participate in the current sowing season, politically motivated competing waivers can only have negative repercussions. Unfortunately, the situation has become messy now and there are no easy solutions, especially given the state elections lined up in the next 12 months. State governments at best can try and keep the amount of the loan waivers manageable and hope that GST and formalization of the economy will result in increase in their share of the tax revenue. It will be critical to control this malaise to ensure that government tax resources are efficiently and effectively utilized towards infrastructure development or for merit subsidies like health and education.

Demographic dividend has long been touted as one of the key positives of the Indian economy. However, if there is one area where one can fault this government, it is with respect to lack of ample employment generation opportunities created till date. Over a quarter of the people joining the world's workforce between now and 2025 will be Indians. Providing gainful employment to them will be one of the biggest challenges that Modi government will face in the coming years and if it can effectively tackle the same, Indian growth story can really blossom and India can be the fastest growing large economy well into the next decade.

Final thoughts

Stable macroeconomic situation, much improved policy framework, transparent governance and conducive commodity and oil prices have all come together to provide India with a multi decadal opportunity to move from a low income country to a middle income country. Significant administrative and policy reforms have been carried out over the last 3 years. While these reforms may have disturbed the equilibrium in the short term, they are very beneficial for the country from a medium term perspective. Similarly, GST, the mother of all reforms, will in all likelihood face several implementation related challenges but will have far reaching positive impact on the economy.

Businesses are already impacted due to GST and while the magnitude varies, the month of June (and even May) has witnessed lower primary sales (though secondary sales have done well) across industries due to clearing up of inventory. We expect businesses to be disrupted for another few months beyond which we see sustained growth well into the election year i.e. 2019. Lower primary sales and uncertainty with regard to GST related disruption has led to a small correction in the stock prices in recent days and this may as well provide a buying opportunity to investors. Hence, while the near term outlook is hazy, the medium and long term outlook for the Indian economy has never been more promising. With a bit of luck (good monsoon, continued low oil prices, etc.), India can truly be the foremost equity story globally for many years to come**.**

Bharat Sheth
June 30, 2017