QuestPMS

QuestPMS Newsletter - September 2017

Is 'short term' actually short and how long is 'long term'?

Readers of our last newsletter may recall us talking of the push and pull of short term pain vs long term gains playing out in the Indian economy. It has been 40 months since the Modi government came to power and ushered in a new era of structural reforms. Indeed a lot has been achieved during this period in terms of policy reforms, yet, the economy is stuttering at a slow pace and there is little visibility of 8%+ GDP growth rates. While the stock market continues its uptrend amidst some volatility off late, slowdown in the real economy begets the question, how long will this short term pain continue and when will the broader economy witness the benefits of structural changes. Also, from an investor's perspective, whether stock markets will, supported by ample domestic inflows, continue to be patient with tepid earnings growth or will it at some point in time start losing patience?

While one can blame disruptions caused by demonetization and Goods and Services Tax (GST) as the prime reasons for the slowdown in the last few quarters, in hindsight, most of us have been guilty of underestimating the time it takes to transform an economy of India's size and diversity. Experience shows that nursing a company back to health by bringing about major changes in senior management, capital structure and work culture easily takes 2-3 years. It was therefore, in retrospect, impractical to believe that the pain of restructuring the Indian economy will last only a few quarters and tangible benefits will start to surface immediately thereafter. Changing the way business is done and work culture is obviously a herculean task. While a company can hire and fire people, a country has to painstakingly change the attitude of its bureaucracy as well as its citizens which takes time.

Indian stocks have done well in the last few years despite low earnings growth as they factor in longer term benefits of a restructured and transformed Indian economy. Commodity prices and FDI inflows have been supportive and have kept the macro picture buoyant while the micro economy faces upheavals of a major transformation during this transition period. Monsoon too has been favourable since 2016 though a bit uneven off late. Formalization of savings and consequent domestic inflow as well as buoyancy in global markets continue to support Indian stock prices. With macro picture getting slightly blurred now and earnings taking time to revive, support from domestic liquidity and continued optimism in global stock markets will be important for Indian stock prices in the next few quarters.

Indirect tax collections through GST will be important, going forward!

The initial set of returns are still being filed and it is early days to call out the impact of GST on tax collections. While some figures have been published for July and August 2017, data on transitional credit claims has complicated the picture. We are in unchartered territory here and clarity will emerge only over the next few weeks and months. It will be important for tax collections to be at least equal to the pre GST era as government expenditure on infrastructure has been instrumental over the last couple of years in supporting the economy in the near absence of private capital expenditure.

Indeed, one of the key objectives of implementing GST is to improve the tax to GDP ratio through better compliance as the same helps in improving fiscal situation while maintaining and increasing investment in infrastructure and social sectors. With general elections only 18-20 months away, NDA government will need to provide a thrust to the slowing economy and increase expenditure on the social sectors. There are already murmurs of a stimulus package and in this backdrop, shortfall in indirect tax collections can throw the fiscal math out of gear, impacting the macro picture adversely and extending the transition period by another few quarters.

Earnings growth in the last 3 years has been in low single digits and the July to September quarter is unlikely to be very different. While nobody doubts long term benefits of GST and the benefits it will bring to the organized players, jury is still out on the transitional issues (even for the organized players / formal economy) and the ability of informal economy to make the transition to the formal economy. Pain in the informal economy may manifest itself in many ways including through lower demand as well. In this milieu, sufficient indirect tax collections will be critical to keep the government expenditure going and provide the much needed support and momentum to the Indian economy.

Persistence will be key to achieving long term objectives

As India continues in its transitional journey towards a more stable, transparent and merit based economy, shrewd political management to keep the hopes going and generous dose of luck (low crude prices, good monsoon, global growth and geo political stability) will be critical over the next 12 to 18 months. Benefit of government's focus on the infrastructure sector is becoming visible through the order book of some of the EPC / construction companies. However, the benefits of policy reforms will manifest into higher overall growth and broader earnings improvement only over a period of time. In the interim, share prices of cleaner and more robust businesses with some signs of improvement in numbers are doing extremely well while businesses which have earlier benefited due to political patronage or those which continue to suffer due to global factors or internal issues have shown little traction even in this bullish phase.

We at Quest believe that policy reforms are an ongoing process and continued focus on the same will be critical for a full-fledged transformation of the Indian economy. While indirect collections under GST and speedy resolution of NPA issues under NCLT will be vital over the next few quarters, carrying out labour and land reforms will be absolutely essential from a longer term perspective. Ability of the central government to achieve the fine balancing act of keeping people's hope going over extended period of time in the midst of transitional pain is not an easy task. Modi government has successfully managed the same in the past. Its ability to continue to do so will be more important than ever before as we head into the next general elections in 18 months from now.

QuestPMS Performance

Quest PMS' philosophy of investing in under researched / ignored / turnaround companies with sound underlying businesses and competent management has worked out well over the years. While this strategy sometimes requires us to invest in companies early, it provides us with better risk adjusted returns over a period of time, 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	1.6	1.4	3.0	6.1	4.2	5.2	3.9
6 Months	7.1	5.9	7.1	10.8	7.3	13.5	10.3
1 Year	23.2	12.4	13.9	19.5	21.5	28.8	26.5
2 Years	25.1	10.2	11.7	20.6	21.9	21.6	21.1
3 Years	20.2	5.6	7.1	17.5	14.3	14.7	15.3
4 Years	35.1	12.2	13.8	28.7	25.2	30.8	28.6
5 Years	24.3	10.8	11.4	18.5	15.8	18.1	17.1

The Above returns are of a Model Client as on September 29, 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 to stock picking is more relevant than ever before. We believe that our ability to focus on earnings rather than stock prices will be key in generating decent returns in good times and significantly outperforming the market in bad times. 'Disruption' is the buzzword today – whether it relates to policy matters or to technological advancements. In this scenario, close monitoring of the portfolio assumes even more importance and we continue to 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 25% over the next 3 years (FY17-20) while it is trading at a PE multiple of 22 on FY18 and 17 on FY19 basis. This giving us confidence in its ability to continue to do well going forward as well and achieve the targeted returns over the investment horizon.

Key risks as we see it

As we are now experiencing, benefits of structural reforms take time to manifest itself in the form of faster economic growth and improved earnings. Keeping the support for reforms going in the interim period requires clever management of people's psyche and probably occasional doses of government's largesse (farm loan waivers?). Also, over a period of time, some real benefits of reforms should start to trickle in to keep the hopes alive. We at Quest believe that while some segments of the society have already started to benefit from policies like Jan Dhan Yojana and Direct Benefit Transfer (DBT), it remains to be seen whether these benefits are large enough to meet expectations and keep the support going for the reform measures of this government. In this backdrop, generating sufficient employment opportunities over the next 12 to 18 months will also be one of the biggest challenges for the Modi government.

A couple of important state elections are due in the next few months. While victory of the NDA government will give push to the reform measures, adverse results carry the risk of government leaning towards 'left of centre' policies to achieve some kind of balance in the mind of the electorates. Macro picture has started to look hazy off late; metal prices have increased by ~10-15% in the last 3 months, brent crude is approaching $ 60 per barrel, current account deficit has seen an uptick, government's ability to meet the fiscal target of 3.2% is under question mark and inflation seems to have bottomed out. Significant increase in social expenditure in this backdrop can be counter-productive and undo a lot of good work that has been done in the last 40 months.

Geo-political risks (particularly those emanating out of North Korea) and impact on liquidity of central banks' shrinking their balance sheets are some of the other key variables from the market perspective.

Final thoughts

India has covered tremendous ground in terms of policy reforms in the last 3 years. Insolvency and Bankruptcy Code (IBC), GST, Real Estate Regulation Act (RERA), DBT, transparent auction of natural resources and FDI Liberalization in defence, aviation and construction sectors are all path breaking reforms. It is possible that some of these reform measures such as RERA and IBC may take longer than expected to deliver results but nevertheless they are very important legislations that will change (for the better) the real estate industry and debt recovery mechanism respectively in times to come. Similarly, GST implementation has its own share of challenges but unarguably, it is the biggest tax reform that India has ever seen. The government seems to be working with a sense of purpose and has shown flexibility and receptiveness to genuine issues faced by businesses. We believe that while it may take slightly longer for growth and earnings to meet market expectations (though lower base of last fiscal Q3 and Q4 should help), the Indian economy is moving in the right direction.

Bharat Sheth
September 30, 2017