QuestPMS Newsletter - March 2019

After swinging on both sides in 2018, pendulum reaching equilibrium in Q12019

The broader Indian market witnessed extreme exuberance in early 2018 followed by heightened pessimism in October 2018 and early 2019 before beginning its journey towards equilibrium in the second half of February 2019. Over the last few quarters, the market has absorbed number of negative news on the international and domestic front. Issues relating to protectionism and trade war, slowing global growth, extreme volatility in crude prices, tightening liquidity and rising interest rates in developed markets kept the global market nervous in the second half of 2018. Closer home, IL&FS / NBFC liquidity crisis, corporate governance issues across many companies leading to resignation of auditors, whistle blower complaints against leading companies, sale of pledged shares of eminent companies, worries with respect to government's populist measures running into lacs of crores and the lack of clarity with respect to prospects of a stable government post the general elections kept the domestic market on tenterhooks for the last few quarters.

These issues acted as perfect triggers forcing a correction when the valuations had become extremely rich. The corrections was quite widespread and in many cases very deep. In fact by February 2019 end, over 50% of the stocks in BSE 500 had corrected by more than 30% from their 52 week highs. However, over the last couple of months, some of the issues mentioned above have abated. For example, Federal Reserve has completely changed its position on interest rates and size of its Balance Sheet. European Central Bank too has indicated that it will keep it interest rates low for at least the rest of the year. There is renewed hope that United States and China will be able to resolve the trade issues. Closer home, Reserve Bank of India has reduced interest rates (with at least another rate cut in the offing), liquidity situation is slowly improving, populist measures announced by the Modi government in the interim budget have been within the realms of reasonableness and the prospects of a stable government post elections have improved. These positive developments too have acted as triggers when the valuations had become attractive in several pockets resulting in most indices rising in double digits from their recent lows in the last few weeks and months.

While the trailing PE multiples are high, we at Quest believe that markets are reasonably valued presently (except in a few segments where valuations remain high), especially in the context of earnings growth expected going forward. Over the last many years now, earnings growth have lagged nominal GDP growth of the country which implies that margins have remain compressed for a fairly long time. Revenue growth on the other hand bottomed out a few quarters back and last couple of quarters have seen healthy double digit topline growth across several sectors. While some sectors like automobiles are presently struggling, we believe that earnings too have bottomed out in most cases and we expect healthy EPS trajectory going forward, particularly in FY20. Future direction of markets will be driven by the earnings trajectories of the companies. We at Quest have seen reasonable improvement in our performance over the last few months and are positive that it will steadily improve in the coming months, quarters and years.

QuestPMS Performance

Most of the Quest's portfolio companies delivered on the earnings front in the last few quarters, but suffered due to market correction and because of the negative outlook that had formed, particularly with respect to the infrastructure sector. There were a few laggards as well in the portfolio and we have used the opportunity to strengthen the portfolio in the last couple of months.

Quest PMS portfolio has broadly performed in line with the market in the last quarter. Quest PMS performance across time periods and comparison with the six indices is listed 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	6.0	7.2	7.0	0.8	3.4	2.9	4.3
6 Months	8.0	6.8	6.3	4.9	9.8	4.1	8.5
1 Year	(8.1)	17.3	14.9	(3.0)	2.1	(11.6)	(14.4)
2 Years	4.7	14.5	12.8	5.4	7.8	2.9	(1.5)
3 Years	17.4	15.8	15.2	14.3	18.1	13.4	11.8
4 Years	13.4	8.9	8.6	10.6	11.3	9.5	5.4
5 Years	20.3	11.6	11.7	17.2	15.8	16.5	12.9

The Above returns are of a Model Client as on March 29, 2019. Returns shown above are post billed 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.

Till March 2018, we were outperforming all the indices in the short, medium and long term. However, we must admit that last few quarters have been tough for us requiring us to revisit certain aspects of our strategy and making changes to the portfolio wherever we thought the companies were not performing in line with our outlook. These changes have resulted in improved visibility in the overall earnings outlook of our portfolio. While we have largely completed the changes we had initiated a few months back, we continue to critically analyze various aspects of our strategy and monitor the portfolio very closely. If required, we will not hesitate from making further changes with the sole objective of strengthening the quality and earnings visibility of the portfolio and returning back to our track record of outperforming the above indices across time periods.

"India is less predictable….and it's good"

The above statement is the headline of a recent ETPrime.com article carrying the interview of Mr. Leif Johansson, chairman of AstraZeneca. Mr. Johansson argued that it is more important to know what the unpredictability is all about and if that is because of rapid changes going on in the country that is for good, than those changes need to be supported rather than complained about. He also stated that he is in India once or twice a year since 1983 and that 'it is difficult to find historically any more important time to be part of this country's growth".

Indeed, arguably, India has seen more changes in the last 5 years of Modi's regime than it has in any 5 year period in recent history. Apart from trying to bring about social changes through campaigns such as 'Swachh Bharat' and providing essential services like bank account, electricity and LPG connections to the deprived section of the society, the current regime has also brought about path breaking changes through implementation of DBT, GST, RERA and IBC. Structural changes are never smooth and there will be hiccups and unintended consequences on several aspects of the economy including growth; however, these changes are preconditions to India's evolution into the next phase of its economic cycle and sustainable growth.

We believe that while the country has mostly recovered from the pangs of 'Demonetization' and GST, growth impulses are still weak and many challenges remain. We are particularly worried about the fiscal situation on one hand and still tight liquidity situation in the wholesale NBFC / residential real estate sector on the other. However, India is in much better shape today than it was 5 years back and unless we commit self goals, we should see decent GDP growth, improving corporate earnings and healthy flow of funds from investors.

Final outlook

While the global markets have done well in Q12019, there is no denying clear signs of slowdown in global growth. The US Federal Reserve has lowered the growth forecast to 2.1% for CY19 and the yield curve in the United States inverted after more than a decade (3 month interest rates is higher than 10 year yield), indicating that the risk of recession sometime next year is real. The European Central Bank has twice cut the GDP growth forecast, first from 1.9% to 1.7% in December 2018 and then to 1.1% in early March, for the European Union. Today was the scheduled day for Brexit but unfortunately uncertainty about its fate continues as the British Parliament prepares to vote for the third time later today on Prime Minister Theresa May's Brexit deal. Unsurprisingly, Bank of England too has lowered the growth forecast for UK to 1.2% from 1.7%. More worryingly, China is perceptibly slowing down and it can have a significant impact on rest of the world economy given its size and linkages with rest of the world.

India is currently the world's fastest growing large economy though growth is lower than levels that would provide comfort to economists given the demographic challenges that the country faces as millions of job aspirations join the queue every year. However, several pieces of puzzles are falling in place that gives comfort that we are heading in the right direction. With capacity utilization inching up, private capital expenditure is slowly picking up and is set to gather pace over the next 6 to 12 months. Banks' and corporates' Balance Sheet have largely been cleaned (though there are challenges in sectors like Aviation and Telecom) and profitability of corporate India is likely to show significant jump in the next financial year. Brent crude oil and currency have been in comfortable zone and interest outlook too is benign. Most importantly, post the Balakot episode, prospects of a stable government at the centre has improved markedly.

The Indian markets are finely balanced in terms of valuation. Noise levels over the next couple of months will be high as the topics of global growth slowdown and trade issues, interest rates, China, Brexit, Brent Crude (exemptions relating to Iran sanctions ending in May 2019), general elections in India and monsoons will be intensely discussed and debated. We at Quest believe that if the earnings trajectory pans out as projected, market will find triggers to move to higher levels. However, if the current weak growth impulses accentuates resulting in deep cuts in earnings forecast yet again, the same triggers will work against the market. We are therefore completely focused on working towards improving the quality and earnings visibility of our portfolio as more than anything else, it is the earnings and cash flows of our portfolio companies that will ultimately determine the returns that we deliver to our investors in the medium and long term.

Ajay Sheth
March 29, 2019