QuestPMS Newsletter - June 2019

Structural changes in rules of business beginning to reflect in market dynamics

We at Quest have for the last 3 to 4 years been writing about the changes being brought about by the incumbent government in the way business is done in India. A number of questionable (definitely grey and in some cases bordering on illegal) practices that were considered par for the course in the past are now being questioned and challenged like never before. The recent statement by Commerce and Industry Minister Piyush Goel urging the industry and intermediaries / consultants (lawyers and auditors) to not violate the spirt of law or find elements to circumvent the law is the clearest indication of the mindset of the incumbent government. This has disturbed the status quo and with little help coming from 'the authorities', governance issues that were earlier hidden under the carpet are now coming to the fore rattling the stock prices of companies where there are doubts about activities not being completely above board.

These structural changes in the 'rules of the game' have manifested into various forms and have resulted in sudden deratings, defaults, financial losses, resignation of auditors and directors, whistle blower complaints and investigations against companies, promoters, directors and auditors. While hiding behind 'quality' has been the norm in difficult times for the last many years, the premium on 'quality' or more importantly, the 'discount' for 'non-quality' has become stark in the recent months and is very clearly reflected in the stock prices. We believe that this evolution and indeed cleaning up of business practices is essential for India to do well in the long term and will be ultimately beneficial to the minority investors. As Mr. Uday Kotak mentioned in his recent shareholders communication "this is a new India where governance and transparency will be the pillars of progress". We can't agree with him more.

Slowing demand – What is ailing the economy?

Indian economy has clearly slowed down in recent quarters, particularly since the last festive season. The slowdown coincided with the IL&FS crisis leading to extreme tightening of liquidity in the system. Various theories have been pro-pounded by economists and industry experts to explain the slowdown. Some of the companies / managements have been honest enough to admit that they don't understand the reasons. Nor do we at Quest have any false misgivings of fully understanding the same. However, in hindsight, it is apparent that some of the froth in demand (generated by easy financing – lax underwriting, high loan to value ratio, etc.) has gone away impacting discretionary consumption, with funding becoming difficult for second and third tier NBFCs. Increase in capacity to carry load (change in axle norms), rise in cost (insurance, safety norms, etc.) and cyclical slowdown probably are some of the other reasons for the doldrum in which the automobile industry finds itself today. Very low food inflation (nominal GDP growth in agriculture was actually lower than real GDP growth in Q2 & Q3 FY19 implying disinflation) again partly explains why there is clear slowdown in rural demand for consumer goods.

We believe that the current quarter (April-June 2019) too would see low GDP growth and single digit revenue growth (in some cases degrowth) for most companies. Elections partly too can be blamed for the same. However, the good news is that elections have again given India a stable government and the chance of policy continuity, critical to bringing about transformation of the economy. Another piece of good news is that in the next 3 months, we will see anniversary of the IL&FS debacle and hence the base should become favourable from the 3rd quarter (October to December) onwards, giving a fillip to growth numbers.

Next couple of weeks are going to be important with the budget scheduled for July 5th and the monsoons progressing further into the country. The Finance Minister has the unenviable task of meeting funding demands of the social and the infrastructure sectors in the face of less than expected growth in taxes and still keeping the fiscal deficit number within the realms of reasonableness. The Jalan committee report, already delayed by a few months now, is critical in this respect as it can provide flexibility to the government to carry on with the necessary capitalization of the PSU Banks and support funding of the infrastructure sector while not disturbing the fiscal consolidation path in any significant manner. The funding support through excess (?) reserves of RBI can also reduce governments' dependence on small savings, thereby bringing down rates for the same and helping better transmission of the 75 basis points cut in the repo rates in the recent months. We are keeping our fingers crossed as the Finance Minister tries to balance the budget, Mr. Jalan submits his final report and monsoons try to cover the rest of the country and bridge the deficit witnessed in the month of June!

QuestPMS Performance

Virat Kohli, after the recent hard-fought victory against Afghanistan, commented that when things don't go your way, you need to show character. We at Quest faced a similar difficult situation about a year back when some of our investee companies didn't perform as per our expectations and we started underperforming the markets. The situation required us to question some of our beliefs, re-evaluate certain aspects of our investment strategy, accept our mistakes wherever we had gone wrong and most importantly take some hard decisions.

"Once an athlete decides to win in his mind, it is at that moment he truly wins..The act merely follows"... Jesse Owens

We truly believe that growth begins when we begin to acknowledge and accept our weaknesses. We are happy to share with you that we have almost fully completed the restructuring exercise that we started two to three quarters back and the resultant portfolio is very robust and in line with the changing dynamics of the Indian economy and markets. With Modi government coming back to power, we believe our overweight position on the EPC / Construction space will play out very well in the foreseeable future.

QuestPMS has done well in the current quarter. While our performance was slightly lower vis-à-vis Sensex and Nifty, we ended positive when compared to both BSE and NSE Midcap and Smallcap indices which ended negative. We believe, we are well set in our journey of 'Quality Performance' over the next few quarters and years. We expect weighted average sales and earnings of Quest's investee companies to grow at CAGR of ~13% and ~20% respectively over the next 3 years.

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	0.4	2.2	1.9	(3.4)	(3.0)	(4.6)	(6.8)
6 Months	5.2	9.2	8.6	(3.6)	(0.8)	(2.5)	(3.1)
1 Year	2.7	12.4	11.3	(2.4)	2.5	(9.5)	(11.6)
2 Years	2.3	13.1	11.5	1.0	4.4	(3.1)	(7.4)
3 Years	9.9	14.1	13.2	8.9	12.6	7.3	3.2
4 Years	11.6	9.1	8.9	8.5	10.7	6.4	3.7
5 Years	13.7	9.4	9.4	10.0	8.2	7.3	3.2

The Above returns are of a Model Client as on June 28, 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.

With trade disputes continuing to simmer, the 'Fed put' is back in play!

The world has changed perceptibly in the last few years. Rising income inequality and resultant discontent has changed political dynamics to such an extent that some of the policies of the right-wing governments are more 'leftist' than even that of 'left of the centre' parties. Also, rise of China as a super power threatening hegemony of the United States has provided the perfect backdrop to drum up support for 'inward looking' and 'protectionist' policies of Trump's United States. While trade tensions have ebbed and flowed in recent months, long-term solution is not in sight even after more than a year of beginning of the trade war. While there is half a chance that tomorrow's meeting between President Trump and President Xi may result in some breakthrough, it is anybody's guess as to how long will the truce last even if one is achieved in the first place.

With trade tensions threatening slowdown (global growth rates have already fallen by ~0.75% in the last one year) and perhaps recession in the next 4 to 6 quarters, monetary policy of central banks has miraculously taken a 'U' turn in the last few months making the recent monetary tightening phase one of the shortest ones in our living memory. Indeed the 'Fed put' is back in play supporting the markets amidst slowing growth across the world. The only issue is that the arsenal of central banks today is quite depleted and there is only so much they can do in terms of reducing rates or restarting quantitative easing.

India, while relatively insulated from the trade war, has seen its merchandise exports stagnate over the last 7 years. The compounded annual growth rate (in dollar terms) during this period (FY12-FY19) has been a meagre ~1% as compared to ~20% during the previous 7 years (FY05-FY12). While slowing growth in global trade is partly the reason, a large part of the blame should lie with our policies and inefficiencies. Trade war between United States and China provides India the perfect opportunity (assuming the world doesn't go into recession in which case everybody including India will be impacted) to strategically position itself to benefit from the current situation. We are hoping that the government is seized of the matter and that we will see major policy announcements to kick-start 'manufacturing' and 'export' growth in the next few months.

Final outlook

The broader markets in India have now underperformed for over a year. We have seen both price and time correction since the first quarter of CY18. High valuations, trade tensions, growth slowdown both globally and domestically, business models changing dramatically due to technological disruptions and governance issues coming to the fore among several sections of the Indian industry have all contributed to this underperformance. We believe that while global factors, particularly trade related issues and geopolitical tensions in the Middle East may continue to act as headwinds, India over the next couple of quarters should start to benefit from the good work that has been done by the NDA government on the policy front in the last few years. However, only companies whose business models were in any case attuned to the new way of doing business or have made changes to bring their business models in line with the same, are likely to outperform the markets going forward. We believe that the incumbent government will continue with the good work that it has done in the last few years. However, it will still need luck such that the world continues to chug along without going into a recession and the rain gods smile this time on India after being somewhat unhappy for the last couple of years!

Ajay Sheth
June 28, 2019