QuestPMS Newsletter - September 2019

The Big Reset – Fiscal Consolidation to Fiscal Expansion!

The NDA government through most of its tenor since 2014 has been steadfast in its resolve to work within the constraints imposed by fiscal discipline. To a significant extent, it was helped by the falling Brent Crude prices in 2014 and 2015. However, even as the benefit of the fall in crude prices started to wear off and the country faced 3 structural upheavals over the next 3 years – Demonetization in 2016, GST in 2017 and the IL&FS crisis in 2018 – this resolve didn't slacken much till late 2018. While the government extensively used extra budgetary resources to keep the government expenditure going in the face of subdued private capital expenditure, it made sure that headline figure of fiscal deficit remained on the glide path providing comfort to the economists and the rating agencies!

The first deviation from this fiscal glide path was made in the 'vote on account' budget of 2019 where the NDA government went ahead and announced sops for the farming community (INR 6,000 per farmer) and the middle class (effective tax rate reduced to zero on income up to INR 500,000). However, this was necessitated due to political exigency as BJP was smarting from electoral defeat in Rajasthan, Madhya Pradesh and Chhattisgarh and its prospects for the general elections were not looking too bright at that time. However, the steep cut in corporate tax rate (resulting in a fiscal stimulus of INR 1.45 lac crores) in response to the slowing economy means that the NDA government now realizes that structural clean-up, specially in the face of slowing global economy, needs to be supported with benign monetary as well as fiscal policy.

We believe that steep cut in corporate tax rate to 25.2% is the right recipe to turn around the economy for multiple reasons. Firstly, it enables the NDA government to deliver on its long-held promise on corporate tax rate, restoring trust and faith of the industry. Secondly, having provided stimulus to rural India and the middle class through the budget and higher MSP, it was time to give a big push to the private capex cycle which had been the 'Achilles Heel' of the Indian economy for a few years now. While one can argue that pick up in demand is a pre-requisite for capex cycle, one should also bear in mind that overall capacity utilization is at ~76% and any capex project will have a minimum of 12 to 24 months gestation period. Thirdly, an even lower tax rate of 17% for new manufacturing units has the potential of attracting huge FDI as it makes India a highly competitive destination when global supply chains are being redrawn and global companies are looking for an alternate to China. Indeed, cut in corporate tax rate couldn't have come at a better time!

No matter what it takes….

This is probably the first time in decades, if not ever in India's history, that the Finance Minister has held 4 press conferences in a period of less than 30 days to address the concerns of the Indian corporate sector. Through these 4 press conferences, the Finance Minister has announced measures on multiple fronts to address the various issues faced by businesses and investors. These include releasing liquidity in the system through timely GST refunds and releasing pending payments due from the government, merging and recapitalizing banks and pushing public sector banks to lend to the SME sector, addressing investors' issue on surcharge on capital gains and of course the steep cut in the corporate tax rate.

Recent actions clearly establish the intent of this government – that it will do 'whatever it takes' to revive the economy and work towards the target of a USD 5 trillion economy. However, through its various steps and the steps it desisted to take, it has made it amply clear that it will steer clear of 'moral hazard' issues and will not bail out 'companies' or 'businesses' who are in trouble because of their past misdeeds even if their collapse may have an impact on rest of the economy. Even the biggest step ever on the Direct Tax Front of reducing the Corporate Tax rate to 25.2% will benefit those the maximum who pay maximum taxes! This approach therefore clearly puts 'quality' at a premium as is, more than ever before, reflected in the movement in stock prices.

QuestPMS Performance

We at Quest have always been conscious of the management pedigree and the quality of the business that we invest in. With the approach of the NDA government towards the corporate sector becoming crystal clear, we have made our quality parameters even more stringent over the last few quarters. The resultant restructuring and impact of the same is evident in your portfolio construct. We believe that the net outcome is that we are now sitting on a very resilient portfolio that will be much less volatile than the market and over a period of time give good returns to our investors.

After a difficult FY19 (particularly the last 3 quarters), QuestPMS relative performance has improved in the last 6 months. While there has been some short-term impact of the portfolio restructuring that has been carried out and we still underperform the large cap indices, we believe we are now well set to outperform the various indices as we had been doing till a few quarters back. We expect weighted average sales & earnings of Quest's investee companies to grow at CAGR of ~13% and ~22% respectively between FY19 to FY22.

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	(7.9)	(1.8)	(2.6)	(4.8)	(9.8)	(7.5)	(9.9)
6 Months	(8.4)	0.0	(1.3)	(8.9)	(13.4)	(12.4)	(16.2)
1 Year	(1.0)	6.7	5.0	(4.5)	(4.9)	(8.7)	(9.1)
2 Years	(3.1)	11.2	8.3	(4.4)	(3.2)	(9.6)	(14.2)
3 Years	4.0	11.5	10.1	2.3	3.5	1.0	(3.1)
4 Years	9.6	10.3	9.6	6.9	8.2	4.6	1.7
5 Years	10.2	7.7	7.6	8.2	7.0	4.3	2.5

The Above returns are of a Model Client as on September 30, 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 back to the wall, India responds and how!

Some of the biggest reforms in India have been carried out when the country had its back to the wall – economic liberalization in 1991 when India had to pledge its gold reserves with the IMF, 'dream budget' of 1997-98 amidst the severe slowdown and Asian crisis and the more recent structural reforms of the NDA government post the policy paralysis and widespread gloom witnessed in 2012-13. The current slowdown in India's growth has been evident for over a year now. GDP growth peaked at 8% in Q1FY19 and since then it has been steadily coming down. It was evident that structural reforms like GST will entail a transition period and most of us accepted the same as the necessary evil for the long term good of the country. However, the IL&FS crisis and the resultant credit squeeze put the brakes pretty hard on the Indian economy. Slowing global GDP and trade flows and the resultant impact on exports too didn't help. As a result, our GDP growth rate plummeted to 5% in Q1FY20, possibly resulting in a rethink on the fiscal policy front at the highest level.

It was pretty evident that a slowing economy and falling markets would mean lower than budgeted tax revenues and disinvestment proceeds making targeted deficit numbers unrealistic in any case. The need of the hour was to break this vicious cycle of lower growth resulting in lower tax revenues and therefore higher deficit even with controlled expenditure. While we are no economists, we believe that the sharp reduction in corporate tax rate, apart from changing the market and corporate mood and making India competitive with other investment destinations, has the potential to start a virtuous cycle of higher growth, higher tax revenue and disinvestment proceeds and therefore fiscal consolidation in the medium term.

Final outlook

It is never as good as it appears nor is it at bad as it is made out to be. It is the sentiment which exaggerates the good feeling as well as heightens the sense of despondency when it sets in. Yes, the slowdown is real but perhaps the extent of it is exaggerated. One needs to look at the difference in wholesale (sale to dealers) and retails sales data of automobiles and the sentiment prevailing currently (partly due to media) to understand the same. While vehicle registration (retail sales) between April and August 2019 is down by 5.5%, SIAM sales data (wholesale) reflects a dip of 15.9% which clearly indicates that inventory built up last year is slowly getting cleared. So yes, there is a slowdown as is reflected through the vehicle registration data but the same is exaggerated whereby sentiment makes one focus more on the wholesale data.

Various measures announced by the Finance Minister in the last few weeks not only lifts the sentiment of the market and the corporate sector, it also reinforces the confidence of the global business community in India which had started to become a bit shaky off late. More importantly, it reestablishes the pro-growth and pro-business credentials of the Modi government beyond any doubt. It is now clear that the government will try its utmost, without compromising its stand on crony capitalism and corruption, to reverse the slowdown that India has been witnessing for over a year now. This is a huge comforting factor as it not only drives positive sentiment, it also boosts confidence of the business community which can now plan with a sense of optimism.

However, one also needs to note that this positive change in sentiment will take time to translate into jump in consumption demand and the government will need to be at its toes and continue to work on the long pending labour and land reforms to ensure that the gains of the last few weeks are not withered away. Also, not all policy measures will result in desired outcomes, specially within the time period one envisages, and hence one will need to be patient. For example, pick up in corporate tax collection (post the fall in FY20) may take longer than anticipated as the benefits of current measures may take more time than we think to manifest. Further, there are variables like global slowdown, trade war, geo political risks, etc. which are not under anybody’s control; however, the outcome of the same has a bearing on India and markets.

On balance, it seems India has turned the corner. Growth has either bottomed out or should be bottoming out now. For a change, rains have been plenty this year. Despite the attack on Saudi Aramco, Brent Crude is trading in a reasonable band. Commodity prices are down. Interest rates globally continue to head lower and the EU is restarting quantitative easing. This however doesn’t mean that everything is fine. We do definitely need a bit of luck on our side. But as they say, luck favours the brave and those who work hard and this government has definitely shown some gumption and has been burning the midnight oil off late!

Ajay Sheth
September 30, 2019