QUEST INVESTMENT ADVISORS
SEBI Registered PMS & AIF managers

India's decade in the making; economic recovery will outlive the virus and short term events and noise

"Psychological influences are dominating factor governing investor behaviour. They matter as much as—and at times more than— underlying value in determining securities prices" - Seth Klarman

Dear Investor,

As we have entered into a new year with new hope and new plans for the year ahead, I hope all of you are safe and sound amidst the new wave of Omicron which so far has been relatively less fatal compared to the earlier variants and we hope it stays that way and leads Covid to become an endemic from being a pandemic. Our increased vaccination levels have definitely been something all Indians can be proud of inspite of our large population and geographical size. The velocity with which the new variants have spread and emerged in almost all countries within a month, really highlights how interconnected and inter-dependant all countries are in today's globalized world.

As we look forward into the future, it wouldn't be out of place to look back on our thoughts last year at this time in our Jan 2021 investors letter. Against the general pessimism in the market then, after a sharp run-up in the indices in 2020, we were of the strong view that year 2021 would be one of economic revival wherein investors should enter with optimism. With rising vaccination levels our view was that there would be increased movement towards normalcy in many areas of our economy and the same would also get reflected in corporate earnings revival. By all measures, **2021 indeed has little to complain about considering a strong rebound on earnings across sectors** and a strong policy support from government of India to herald India into a new decade of manufacturing boom. 2021 also marked an interesting milestone for Indian equity markets where we saw the **emergence of the strength of retail investors** both through direct equity and fund based investing. India was hence able to absorb the large FII outflows from secondary market in the last quarter of the year with a lot of ease as local investors were on the Buy seat.

Interestingly **2021 was also a year of Unicorns** in the startup world and Indian equity markets saw record number of 62 IPOs raising more than Rs 1.18 lakh crore from their listings attracting both global and local investors alike. The coming of age and listing of new age companies – Zomato, Paytm, Nykaa, Policybazaar was remarkable. As the digital penetration continues to rise, and the millennial population becomes an important target group – **the trend is going to continue** to reflect the changing tastes of the population as well. The **pipeline of strong issuances is likely to continue in 2022** as well, with the much awaited mother of all listings – Life Insurance Corporation of India Ltd (LIC) and tech start-ups like Mobikwik, Ola, Delhivery, Byjus which are expected to hit the bourses.

So what lies ahead in 2022 – an eventful beginning and a continuance of the bull run

2022 would not be a year to reduce equity exposure but rather stay invested and consolidate and cherry pick investments tracking their earnings

I see a lot of similarity between how we started last year at this time and how we are starting 2022. There are questions being raised about the valuations of market and the possibility of subsequent waves of covid hurting economic activity and growth. However to think of it, in the last 12 months, we have had the deadly 2nd wave of Delta variant and the lesser fatal 3rd wave of Omicron which have disrupted travel and business. Still we have seen Nifty-50 and NSE-500 generating 24% and 30% returns respectively and we are on track to close FY22 with a nearly 35% plus earnings growth on the headline index. However, here I would like to draw attention to our strong view that **the period of easy money making is behind us** and going ahead we need to be more focussed on what sectors we take exposure to and what companies we buy within those sectors as markets will track earnings and it wouldn't be a broad based secular run like the last 18 months.

We see year 2022 as the year of consolidation as we see few event risks in the first half of the year, namely **the crucial state elections in Uttar Pradesh and Punjab** being the highlight keeping investor sentiments on the edge. Outcome of these elections could be major drivers for the market sentiment in the near term over the next couple of months. At the same time we see the year seeing a lot of debate around US Fed rate hikes, reduction in global easy liquidity which was infused during pandemic, policy tightening back home by RBI, inflation normalizing to lower levels with commodity prices softening and at the same time improvements in supply chain disruptions which are mostly to be blamed for the inflation stickiness globally.

Earnings quality needs to improve

Earnings growth has been very strong during the pandemic. In fact, corporate profitability has been the best in a decade—attributable to a mix of costs, commodities, credit reversals and some marketplace consolidation. It is not demand-led, which better

reflects broader economic trends as well as quality and sustainability of earnings. After having a dream run and with their profits doubling, **momentum in commodities is likely to slow**. This is due to China's fading credit impulse, fading pent-up demand and transfers, and liquidity tightening by central banks—all of which is likely to weigh on industrial prices. However, **de-levered balance sheets of commodity players should cushion the impact to some extent**. At the same time **we see industrials and other cyclical sectors stepping in and reporting stronger earnings revival** compared to last year. On the earnings growth front for the broader market, **we see the lead being taken by the Banking sector**. Despite muted credit growth, banks have seen a very significant improvement in RoEs and PAT growth. This is owing to: a) improved margins (as liquidity was easy); b) fixed cost reduction by banks; and c) lower credit costs. While credit costs could continue to remain a tailwind, credit growth revival is now very important for their profitability to sustain. We see this credit growth picking up from the middle of the year as we are a strong believer of the major Capex cycle which India has entered into and will unfold in coming years.

Cyclicals will lead the next bull run as Indian capex cycle is in early stages

Stable and defensive sectors will play the second fiddle while cyclicals lead the charge in the next bull run

We have more reasons to be hopeful that the next 5 years will be a golden era for Indian economy and **India will once again emerge as the fastest growing large economy** in the world. Our high conviction of an economic upcycle similar to 2003-07 hinges upon the multiple macro tailwinds which India currently enjoys, which is actually much stronger than those existed during 2003. Multiple policy intervention (**like low tax rate, interest rate, surplus liquidity, PLI scheme, buoyant equity market** etc) has helped in faster investment recovery. **Various macro parameters** (like business confidence, tendering activity, central government capex, engineering goods export & import, IIP of capital goods) **are hinting towards a pick-up in capex cycle finally**. Going forward global capex cycle is likely to gain pace and could be higher than that seen post sub-prime crisis during 2009-12 albeit lower than that seen during 2002-07 period due to (a) Low base; (b) Record fiscal & monetary stimulus; and (c) Infrastructure building to address climate change issue and de-risking of global supply chain (China +1 global strategy). **The current uptick in global capex cycle over next few years are likely to be driven by US, India**, Brazil, Australia, Mexico among major countries.

Sectoral themes to look out for

The pre-covid slowdown and on top of that the blow inflicted by covid has made corporates risk-averse. Thus, unlike past downturns, **there are hardly any excesses as we enter into 2022**. Corporates have much leaner cost structures, very strong balance sheets (as cash flows have been used to repay debt and equity has been the main source of financing). Hence, their ability to bounce back once the dust settles can surprise all investors on the upside. To support the government's focus on growth, **the RBI is also more focused on nurturing growth rather than curbing inflation**. Hence, as a result, the RBI is continuing to keep the system in liquidity surplus, despite global liquidity tightening. This is keeping corporate borrowing rates and spreads low.

Govt policy framework supporting domestic manufacturing to see its ripple effect in economy both from manufacturing and subsequent rising income led domestic demand

Manufacturing is likely to be a key growth engine driving higher capex and economic growth over next 5 years on back of:

- India may be one of the key beneficiary of global strategy of de-risking global supply chain;
- Production linked incentive (PLI) may induce private capex of INR 7.7 trn over next 5 years. In addition, the recent approval to provide INR 760bn fiscal support to set-up semi-conductor and display manufacturing to help establish electronics manufacturing eco-system in India;
- Import substitution due to correction of inverted duty structure; and
- Supply side reform measures undertaken over past few years.

Auto & auto ancillaries – this has been one sector that has seen a slowdown due to an unprecedented semiconductor shortage, and as this issue gets resolved, the sector should see a bounce back, sooner rather than later as waiting periods are long enough and valuations are reasonably compelling. Global exports from India could also pick up significantly.

IT & IT Services – For the sector, the attrition peak is behind, and we expect attrition rates to edge down to pre-covid levels over the next two–three quarters. Demand around cloud migration, digitalization and system upgrades to reduce costs continues to be unbelievably strong and price hikes would start showing up in EBIT from FY23 if not earlier. Yes, valuations are not cheap anymore but with predictable visibility and a structural tailwind which could last for a few years, we remain optimistic.

Real Estate & home improvement – RERA-driven consolidation is throwing up growth opportunities for organized players in the Real Estate sector and covid-19 has only accelerated the process. With absorption remaining strong aided by improving affordability and low home loan rates and launches remaining contained due to liquidity constraints, large organized listed players should continue their dream run. We see large players reporting strong growth, cash flows and geographic expansion in coming year.

Banks provide good valuation comfort as well as earnings growth possibility after under-performing for most part of the pandemic

Banking & financial sector – The big elephant in the room are Banks & NBFCs. We feel that with the economic environment turning conducive and public capex picking up, the revival of private capex is not a question of if, but when. With the pick up of private capex, there would be a multiplier effect on the economy as well. Infact, with multiple State elections lined up we could see a further filip to public spending, which too would aid the larger economy.

New age companies – 2021 which has been the year of the Unicorn is going to alter the public markets framework too. Indian startup market has matured and is becoming a preferred market for public listings of predominantly India-focused/based consumer tech businesses and this has been proved seeing the investor interest and appreciation in all the recent listings. That the ball has been set rolling, suggests smaller, and more product companies, could well start making their way into the market. And importantly, the very modest representation of technology in the Indian indices (ex-IT services) is negligible relative to the US and China and in due course, this should start influencing market index weightings.

Portfolio performance and changes

Our views on the sectoral themes which we elaborated above is also reflected in our portfolio positioning currently with over-weight stance in IT& IT Services, Real estate and home improvement, Auto & auto ancillaries and chemicals. Banking & financials we have been adding our exposure and reducing our exposure to pharma players. We currently have around 6 – 7% cash levels in our portfolio which could rise higher in coming months seeing the volatility around elections as we would want to use any panic sell-off in the market to add to our high conviction bets for the medium to long term.

Our strategies have out-performed the benchmarks over the last 2 years and 2021 was no different

As on 31st Dec 2021	3 months	6 months	1 year	2 years	3 years	5 years	Since Inception
Quest Flagship PMS	-0.66%	9.43%	36.82%	29.96%	19.03%	16.14%	17.71%
NIFTY-50	-1.50%	10.38%	24.12%	19.39%	16.89%	16.21%	8.51%
NIFTY – 500	-0.38%	11.30%	30.19%	23.21%	17.80%	16.51%	8.91%
Quest Multi PMS	0.34%	10.64%	41.45%	34.51%	21.87%	17.82%	17.20%
NIFTY-50	-1.50%	10.38%	24.12%	19.39%	16.89%	16.21%	11.62%
NIFTY – 500	-0.38%	11.30%	30.19%	23.21%	17.80%	16.51%	12.71%
Quest Focus PMS	-4.16%	2.62%	32.96%	21.65%	12.82%	14.80%	14.96%
NIFTY-50	-1.50%	10.38%	24.12%	19.39%	16.89%	16.21%	15.46%
NIFTY – 500	-0.38%	11.30%	30.19%	23.21%	17.80%	16.51%	16.08%

Note: These are TWRR returns as on 31st Dec'21 of all clients taken together of the individual schemes and individual client performance can be higher or lower than this depending on their joining dates and corpus in dates. Returns over 1 year are annualized. Inception dates for different schemes are as follows: Quest Flagship – 12th Oct 2007; Quest Multi – 4th Aug 2014; Quest Focus – 24th May 2016

In recent times, valuations of many companies particularly that of large caps have moderated from their highs, although they remain above historical averages. In our view, large caps may offer valuation comfort in the near to medium term, relative to small-caps and mid-caps. However the valuation of Indian equity markets remains stretched relative to other EM peers. Therefore, FPI investors may not return in a big hurry till dust of state elections don't settle. However, valuations in India are also justified by the highest growth rate among peers. Low to negative real rates compared to peers also support valuations in India. We believe the cyclical recovery in earnings has some room to run in an environment of low interest rates, deleveraging by corporations, commodity up-cycle and rising input costs turning into an eventual tailwind for corporates.

Happy investing and wishing good health from all of us at Quest.

Yours Sincerely
Aniruddha Sarkar
Chief Investment Officer & Portfolio Manager

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