QUEST INVESTMENT ADVISORS
SEBI Registered PMS & AIF managers

Finding opportunities in midst of an eventful period ahead

Dear Investors,

After an eventful CY2022, the current year 2023 would have easily passed off as any other regular non-eventful year if not for the recent geopolitical conflict which has started between Israel and Palestine in the first week of Oct'23. Unlike in CY2022, **the recent rally in the markets was much broad based with mid- and small-caps continuing to outperform large-caps by a wide margin**. The Midcap100 and Smallcap100 indices have risen 29% and 31%, respectively, whereas Nifty has been up by only 8% in CY23YTD as of Sep'23 ending. The Indian markets touched all-time highs in Sep'23 amid **a plethora of challenges in the global and domestic markets including high inflation, multi-year high interest rates, rising bond yields, recessionary fears, and lower than normal monsoons**.

Midcaps and Smallcaps continue to outperform the Largecaps in 2023 so far

The factors that propelled the Indian markets to new highs were a favorable mix of sound macro and microeconomic conditions, moderating inflation, declining commodity prices, expectations of peaking global interest rates, six straight months of FII inflows (Mar-Aug'23), healthy SIP flows, and notable retail participation. With new highs in the market come new fears and hopes. We believe **there are fours factors that would be driving the market** over the near term and they for ease of remembering I would acronym them as **YEEG – Yields Earnings Elections Geopolitics**.

Yields – Will rising US Bond Yields dent the attractiveness for equity?

If we go by theory, the answer is yes with rising bond yields the equity risk premium rises. However, if we look at the US markets then history teaches us that **Equities and Corporate Bonds typically do well in the 6 months after the final Fed hike, especially if a recession is avoided.** On our expectations of a recession in US, though we are no experts, but we are in the camp which holds the view that **a soft landing is the most likely scenario**, and we find this narrative is increasingly finding ground there. The US economy has been relatively resilient so far, but there are signs of a slowing real estate market and softer consumer sentiment in the latest readings. The recent spike in Treasury yields on the back of supply concerns should not alter that conclusion, and looks exaggerated, as the end of Fed rate hikes should help anchor bond yields.

With Interest rates peaking out in most markets and especially in US, we see a case of Yield curve reversion without a rate cut in the near to medium term

It is becoming increasingly evident that **the US Federal Reserve will continue to sustain the 'higher for longer' interest rate environment**. Consequently, this is progressively ushering borrowing costs higher for mortgages and corporate loans across developed markets and **raising the equity risk premium for emerging markets to become attractive**. This **could put pressure on FII flows into India** and other emerging markets but then **India's relative strength is making its share of the wallet bigger**. Even as interest rates remain elevated, the outlook for global growth remains vulnerable to the Euro area and China. Some stimulus from China is in the making and that could flip the slowdown concerns in the Chinese economy which could again revive the global growth trajectory.

Earnings – What to expect in Q2 and H2. Where are the pockets of growth?

Usually, the 2nd quarter is considered to be a weak quarter, but it gives a good mid-year perspective of what lies in H2. A lot of base effect would start coming into play in this quarter. In general, weakness in commodities and improvement in supply chain in the last 12 months is expected to drive better YoY growth along with around 200-250 bps EBITDA margin improvement (ex-financials) for the headline index Nifty-50. As for sectoral trends we could see the following:

Margin improvement across board coupled with mid teens earnings growth could be seen across sectors

- **Banks & Financials** – NIM contraction coupled with Asset quality improvement would be seen. Margin pressures visible during Q1FY24 are expected to continue in Q2 led by higher cost of deposits and higher liquidity in the system. System credit growth would remain strong at 15% YoY led by retail and Services sector as indicated from various banks provisional figures reported so far. We would look out for guidance on cost of funds which is expected to inch higher.
- **Consumer Discretionary** – The next two quarters would be driven by big events like ICC Cricket World Cup and Indian festive season, and these can serve as positive catalysts in the short term for consumer demand. Also, we see a lot of resilience in Urban consumption with rising household disposal income coupled with a willingness to spend. Within consumer discretionary

we could continue to see strong topline and bottom-line growth in QSR, Hotels, Retail and Autos.

Consumer discretionary is seeing resilience demand and so is Real Estate in-spite of rising interest rates

- **Real Estate & Cement** – In Real Estate we expect strong sales growth across top tier cities and among the major listed players. Price hikes coupled with raw material cost declines would augur well for their margin improvements. We would watch out for the inventory levels in the system which would indicate the future price trajectory and demand cycle. For cement players industry level EBITDA is expected to show strong YoY increase supported by strong volume growth and reduction of power and fuel costs. Avg. cement prices have marginally increased QoQ for Q2FY24, region wise maximum hike is seen in West and Central.
- **Industrials and Infra** – Our bullishness on the capex cycle of India which we elaborated in our last investor letter continues to see increased order book and execution leading to all time high order books for some of the leading players. We would continue to monitor trends in indigenization, order inflows, import substitution and technology tie-ups with global players in the sector. In infrastructure we are seeing some slowdown on road capex owing to the monsoon season but that is likely to pick up in the remaining six months of this FY going into the elections.
- **Autos & auto ancillaries** – Auto OEM would continue to see margin improvement owing to lower raw material prices and strong free cash flows aided by strong order backlogs and price hikes taken in recent past. Favorable forex and operating leverage would also be a positive for the sector. We would look out for the outlook in the festive season. For Auto ancillaries, export demand would be key monitorable for us as domestic demand remains robust.

IT sector valuation look compelling, and we would be keen to see bottoming out of their concerns on margins and deal pipelines

- **IT & IT Services** – Q2 is seasonally strong quarter; however, current macro conditions are expected to impact revenue growth of IT companies. Although IT companies are witnessing strong deal wins led by cost take out deals, ACV is still lower (despite high TCV) due to longer tenured deals, pricing & transition effect.
- **Pharma & specialty chemicals** – We expect subdued performance from the pharma & specialty chemicals sector in 2QFY24. Weakness in the agrochemical value chain and strong intensity of Chinese dumping is expected to impact performance. Aggressive Chinese dumping and predatory pricing are imparting further pressure on prices amidst a weak demand scenario.

Elections – some Key state elections will set the mood of the nation for 2024

Elections in the five state elections would be keenly watched to understand the mood of the nation

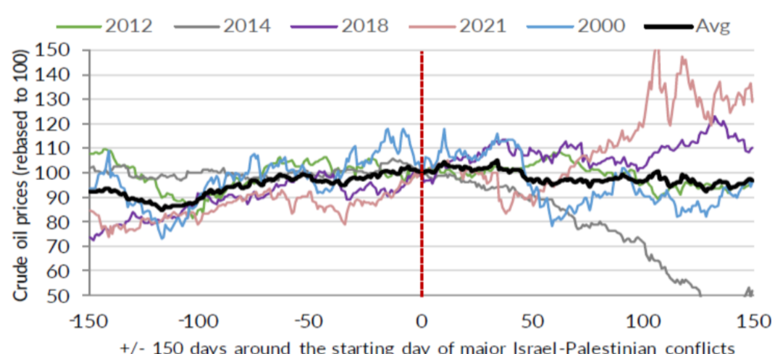
We have always maintained that elections happen every 5 years and governments come and go but economy keeps moving ahead. The busy election calendar will kick off in Nov-Dec'23 with five state elections, which will then set the stage for the General Elections of 2024. While the various pre-poll surveys so far indicated that the current regime would continue for an unprecedented third consecutive Lok Sabha term, we believe predicting an election outcome in India is always fraught with risk. Hence, **markets are likely to remain volatile heading into the elections**. That being said, **history however is in favor of a pre-election rally**. Since the last five consecutive Lok Sabha elections (i.e. from 1999 to 2019), Nifty has rallied 10-35% for six months until the announcement of election results.

Geo-politics – Will the current Israel Palestine hurt Indian economy majorly

One big concern of the rising geopolitical concern in the middle east is the impact on crude oil prices which hurts Indian economy. Apart from rising crude oil prices, there isn't much of a direct impact to Indian economy from the conflict in the middle east. Let's look back at history and see how the impact has been. As can be seen in the two charts below, **Israel Palestine conflict has had limited impact on crude oil prices**.

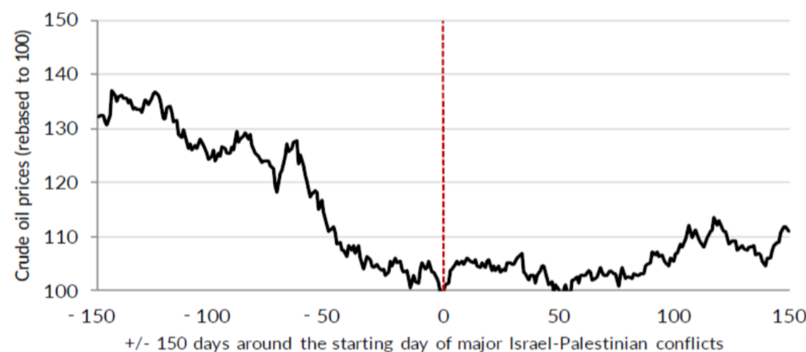
Historically Israel Palestine conflict has had limited impact on crude oil prices

Exhibit 1: Israel-Palestinian conflicts have had a limited impact on crude oil prices



Source: Bloomberg, Axis Capital; Note - Includes conflicts of 2000, 2012, 2014, 2018, 2021 (excluding 2008 conflict)

Exhibit 2: Crude oil price movement during major Israel-Palestinian conflicts



Source: Bloomberg, Axis Capital; Note - Includes conflicts of 2000, 2008, 2012, 2014, 2018, 2021

CONTACT: QUEST INVESTMENT ADVISORS PVT LTD, 188/3 GURUKRUPA BUILDING, FIRST FLOOR, JAIN SOCIETY, SION(WEST), MUMBAI – 400022
EMAIL: pms@questinvest.com PHONE: 022-24066700 Visit us at: www.questinvest.com

The other aspect of the Israel conflict is the bilateral trade between India and Israel and if that would be impacted. Israel happens to be one of the largest defense supplier to India and there are many ongoing projects between the two nations. Some of these could get delayed however India has alternate suppliers too from Russia but at a higher cost. We could also see more push for localization in the matter with an urgency. Nevertheless, **its too early to gauge the exact size and scale of impact to Indian economy currently** because like we saw during the Ukraine-Russia war, trade with Russia increased on the contrary after the war started including India getting discounted Oil from Russia.

Market outlook and way ahead

Domestic macros remain robust in an otherwise global uncertain environment

On the domestic macro front, there doesn't seem to be any bad news yet and as they say, "absence of any bad news is good news", seems to be playing out. **GST collections are up 10% YoY** at INR 1.63trn for Sep'23, while **net direct tax collections grew 24%** till mid Sep'23 in the current financial year, helping the fiscal deficit position. Sep'23 PMI: Manufacturing reading at 57.5 was robust, while PMI-Services was even stronger at 61. Auto retail sales were robust (PVs 17.6% YoY and 2Ws 22% YoY), along with a pickup in auto wholesale volumes. **Real estate sales continue to pick up and Govt. capex growth till Aug'23 in FY24 is up 46% YoY** with states beginning to contribute strongly. **Monsoon season ends with 'near-normal' rains** (94.4% of LTA), which, along with the government policy measures including export curbs on essential food produce, should alleviate risks to food inflation. Water reservoir levels remain low at 73%, which against the 10-year average of 92% is a key concern for Rabi crops. **Weak global demand is impacting export demand**, **although the decline in exports growth is reducing** (-6.9% YoY for Aug'23).

We would continue to bet on domestic consumption, financials and industrials and stay shy from export dominated businesses largely

We believe that **in the midst of volatility over next couple of quarters, sector rotation could be an important driver than the general market uptrend.** For example, in CY23YTD, PSU Banks have outperformed Private Banks while Healthcare has outperformed the IT sector, and in Consumption – Auto and Discretionary sectors have outperformed Consumer Staples. We believe valuations will become an important driver for stock picking to drive outperformance given the divergence seen so far in CY23YTD. **Domestic economy is witnessing a clear demarcation with premium and luxury goods witnessing strong demand while basic demand being hit due to high inflation**. We believe all eyes rest on festive demand in coming couple of months for the market to sustain momentum.

FII flows remained positive during Mar'23-Aug'23 with cumulative inflows of USD21.3b; moreover, FII inflows stand at USD14.8b as of CY23YTD. However, FII flows turned negative in Sep'23 as they sold equities worth USD2.3b. In our opinion, **India's solid macroeconomic fundamentals in the context of weak global growth as well as prospects of another year of healthy corporate earnings should keep the flows resilient**, especially given China's persistent downturn. Valuation wise Indian equity markets are close to their historical long-term average and are trading at ~19x 1 year forward P/E multiples and a P/B of 3.0x which makes our market not so expensive compared to its history but yes when compared to other EMs it does look expensive. But then we have discussed in our past letters too about why India's growth premium deserves the higher multiple.

Portfolio performance and highlights

Over the last 2 years, our portfolio would have gone through some periods of under-performance which had nothing to do with our selection of poor companies but was more an outcome of flows driven market rally in selective companies and sectors. We however continued to focus on the longer term and constructed a portfolio which reflected our investment philosophy of looking at earnings growth at reasonable valuations. As can be seen below over FY23-25 the aggregate portfolio is seeing a margin expansion wherein EBITDA growth is faster than the revenue growth. Current Portfolio trades at around 22.4x on FY25 earnings.

Quest Multi PMS	
Revenue CAGR (2023-25E)	16.3%
EBITDA CAGR (2023-25E)	24.1%
FY2025 ROE	13.9%

As can be seen in the table below we have majorly focused on three broad sectoral themes in the portfolio, namely;

1. **Consumption** (Autos, Consumer Disc. And Real estate) – This makes up around 30% of the portfolio.
2. **Banks & Financials** (PSU banks, Pvt Banks, NBFC, AMC & New Age Fintech) – This makes up again 30% of the portfolio.
3. **Industrials** (Cement, Capital goods, Industrials and Utilities) – around 24% of the portfolio.

Sector	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23
Auto and Auto Anc.	3.6%	6.2%	8.9%	10.6%	9.2%	10.0%
Consumer Disc & Staples	6.5%	12.0%	8.1%	9.8%	10.8%	12.3%
Real Estate and ancillaries	5.7%	5.8%	8.5%	3.0%	6.2%	7.8%
Pharma and Healthcare	10.1%	6.7%	6.6%	7.1%	4.0%	3.0%
Chemicals	5.7%	5.0%	2.5%	4.0%	3.3%	
Cement		6.2%	6.2%		5.4%	8.5%
Defence & Industrials	3.8%	10.3%	14.5%	18.3%	7.9%	15.9%
Energy & Utilities	15.2%	12.6%	10.7%	8.4%	6.3%	
Banks & Financials	25.2%	21.6%	23.0%	23.4%	30.1%	30.2%
IT & IT Services	12.3%	5.9%	4.0%	7.9%		
Others	2.1%			3.0%	5.4%	6.2%
Cash & Cash Equivalent	9.8%	7.7%	7.0%	4.5%	11.5%	6.1%

Particulars	3 months	6 months	1 year	3 years	5 years	Since Inception
Quest Multi PMS	3.28%	21.96%	14.84%	21.95%	15.08%	14.79%
BSE 500 TRI	5.49%	19.39%	17.48%	24.26%	15.11%	13.42%

We have remained underweight in IT & IT Services for a long time now and that stance has to some extent also added to the underperformance in last one year. However, we maintain our cautious view on IT because the headwinds of slowdown in developed economies remain and would continue to keep pressure on deal wins and project deliveries for some quarters.

Some of the portfolio companies which has done well for us and where our thesis is already playing out would be Zomato, IDFC First Bank, Paytm, Kolte Patil and Trent. Each of these have added significant contribution to our overall portfolio returns and we continue to hold them as we believe each of these have a long runway for growth in earnings and beating benchmark growth.

Would also like to share our brief investment thesis on some of the portfolio companies where we would taken exposure in the last six to nine months and which are yet to play.

1. ***CIE Automotive India*** - We expect its India business to outperform the industry growth by ~5-10% driven by 2W industry revival, new PV launches by key OEMs, EV portfolio expansion and execution of newly-won orders from Bosch, Royale Enfield, Stellantis, Tata Motors etc. and potential wallet share gain by strong existing customers (M&M, Tata, and Bajaj). On profitability front, we expect a sustained improvement in margins in both India and Europe businesses led by raw material prices normalization, improvement in Metalcastello business from CY24, efficiency led improvement in India business resulting in consolidated EBITDA margin improving by 200 bps over next 2-3 yrs resulting in EPS CAGR of 20%+ and net cash on Balance Sheet.

2. ***Indian Hotels –*** Strong macro enablers like improving Infrastructure, new airports, improved road & rail connectivity, opening of new/big convention centers, continued rise in discretionary spend & changing travel habits are all driving the current growth and will continue to be medium/long-term growth drivers for the Hospitality Industry. International traveler arrivals are still much lower than pre-covid levels, so there is another likely area of growth here. With Industry-leading Hotel signups/pipeline & strong existing portfolio, Indian hotel will benefit from expansion in market share and rate premium and growth in management fees income as it grows its portfolio of owned and management contracts. FY23 room rates were higher vs FY19 rates and occupancy is at similar levels. Further, cost rationalization done during Covid is still yielding fruit.

3. ***SBI Cards -*** We are positive on the outlook for credit card and expect SBI Cards to report strong growth in card issued and spending by leveraging its parent SBI's large customer base, strong open market channel, and co-branded card tie-ups. Margins should largely bottom out in 1HFY24 and improve over FY24-26E as revolver mix stabilizes and rates peak & credit costs normalize post portfolio actions incl. curtailing credit limits, closing accounts, accelerated write-offs taken by company in last 2 quarters. We expect profit growth of more than 30% CAGR over FY24-26 & RoE expansion from 1HFY24 trough of 24%.

4. ***Ultratech Cement*** - Ultratech reported 9.0% CAGR in volume (5.3% CAGR for industry) over past decade, which has driven market share gains across regions. At the same time, it has moved down the cost curve to take sector leadership in margin profile as well. Ultratech is currently in midst of its second phase expansion, which should lift its capacity to 160 MTPA in next two years. Company has been the Industry leader in capacity addition / acquisitions in last decade or so & we expect the trend to continue. Company is targeting cost savings through greater efficiency via logistics restructuring/green energy over the medium term. In near term, we believe recent price hikes shall support profitability despite higher fuel costs. We expect double-digit growth in volumes in FY24E led robust demand in infrastructure and the uptick in the housing cycle and Ultratech clocking better-than-industry growth & expect profits to double between FY23 & FY26

We would continue to look for companies with favorable risk reward in the current market. We believe the current portfolio is well poised to outperform the benchmark in the medium to long run as lot of drivers in our portfolio companies start kicking in. We maintain around 6% cash levels in our portfolios currently and would take a higher cash call if we see any major headwinds in the market which warrants us to reduce equity exposure drastically which isn't the case currently.

We have added one new company in our portfolios during the last quarter namely Timken India Ltd. We are sharing herewith a detailed writeup on our investment thesis for the same which hope throws more light on our thinking process on the companies.

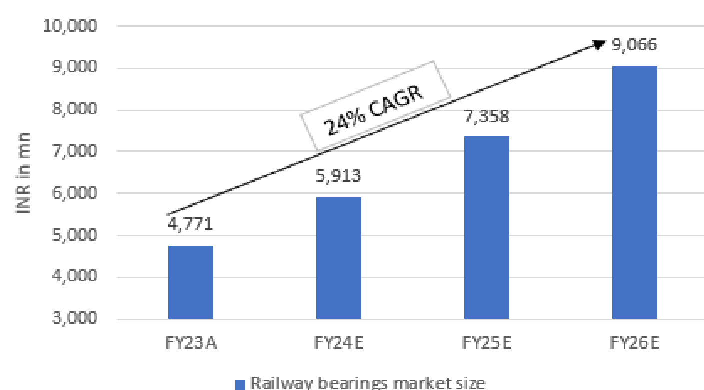
TIMKEN INDIA LTD

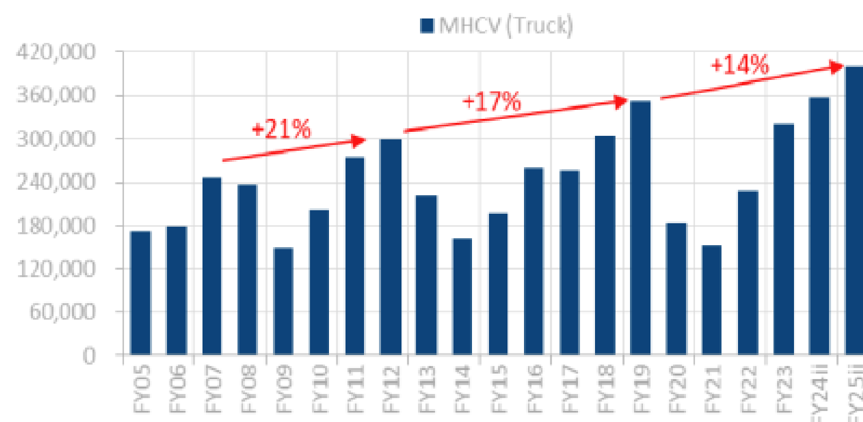
Why are we positive on India Manufacturing & India Capex as an investment opportunity?

- In our opinion, India is progressing on the road to rapid Industrialization led by several initiatives taken by government to boost growth in the industrial sector. Among notable ones are PLI (Production linked incentive), PM Gati Shakti (Multimodal connectivity infrastructure), Bharatmala (Northeast India connectivity), Startup India, Make in India 2.0, Atmanirbhar Bharat Campaign, National Manufacturing Policy aimed at increasing the share of manufacturing in GDP to 25 percent by 2025 and MSME innovative schemes.
- Additionally, there are measures that have commenced to strengthen the railway infrastructure. Railways are a major part of the National Infrastructure Pipeline (NIP) project pipeline with an allocation of 13% of the total allocated funds. Indian Railways have prepared an NRP (National Rail Plan) which is directed at formulating certain strategies based on both functioning capacities and business-oriented policy initiatives to increase the modal allotment of the Railways in freight to 45%.
- There are over 1 lakh kms of railway routes in India where both passenger trains and wagon trains run simultaneously. The long-term goal of the government is to create a parallel route to the existing line exclusively for freight trains. With DFC (east and west corridor), the government is setting up over 2500+ kms of the rail route. Over the long term, all the ~3 lakh wagons will need to be upgraded to 25T-axle load wagons. We believe railways will periodically upgrade to new wagons over the next 20 years resulting in an overall opportunity of ~INR59bn (3L wagons x 8 bearings x 24,500 per Class K bearing).
- Commercial vehicle sales are a proxy barometer of economic activities all over the world. In India, commercial vehicle sales touched an all-time high of 1.01mn units in FY19. Since, there was a sharp reversal and sales volume fell to a 10-year low of 0.57mn units in FY21 due to new regulatory norms, the slowdown in the economy and chip shortage arising due to covid lockdown. CV sales have recovered since then led by a recovery in Indian economic activity, rise in replacement demand primarily due to vehicle scrappage policy and multiple muted years.

Why Bearing industries could be a play on both India Capex as well as India Manufacturing & Why are we Buying Timken India?

- Bearings are part of every kind of equipment or machinery ranging from automobile parts, farm equipment, and household appliances to segments comprising defense and aerospace equipment.
- Timken caters to an entire spectrum of bearings including Tapered Roller Bearings (TRB), Spherical Roller Bearings (SRB), Plain Bearings, Cylindrical Roller Bearings (CRB), Needle Bearings, and Slewing Rings etc. along with supported ancillaries with a focus on localized manufacturing having facilities in Jamshedpur and Bharuch. Bharuch facility is also currently expanding its manufacturing capacity by adding spherical and cylindrical roller bearings. The Company would be investing approx. Rs 600 crore towards this expansion and commercial operation is expected to start in January 2025.
- In our view, railway bearing segment is set to grow at a 2X+ growth rate more than the whole Indian bearing industry led by railway expansion, a shift to higher load bearing (1.8x more realization than standard bearing), multiple metro projects, niche train projects (high-speed trains, semi-fast trains, etc.) and the railway bearing replenishment market. Timken India will be the largest beneficiary of this uptick in railways and metro expansion as it commands over ~50% market share in freight wagon bearings (60% of the railway bearings market) and a high market share in metro projects sustainable growth projection for Timken India in our view.
- The domestic CV segment is expected to have steady growth over the next two years as highlighted earlier & Timken India would benefit as it primarily caters to the Heavy CV segment. Timken is also poised to capitalize on the structural opportunity arising out of India becoming a major manufacturing hub for global OEMs.





- Timken is one the largest player in the renewable energy space (particularly wind) globally (largest individual end-market sector generating 12% of sales, compared to only 5% in 2018). With shift towards renewable energy a key theme over the next decade the demand from renewable energy the Indian entity would also witness growth, as India also moves towards its renewable energy targets.

- Growth from industrial motion business & also from recent acquisitions done by Timken globally should result in increasing product basket in our view.

- Timken India exports taper roller bearings to cater to the Timken entities' international customers in diverse industries like railways, automotive and off-highway equipment. While the near-term opportunity may remain weak due to the weak macro environment in developed markets especially the US. We believe exports will pick up pace in the medium term led by expanding capacities at the Bharuch plant and further qualification of products along with normalization of demand in end markets.

- Overall, we expect revenues to grow at a 18% CAGR between FY23 & FY28E, led by a 25% CAGR in railway revenues, led by a shift to higher capacity bearings in railways due to commissioning of DFC and addition of 90,000 freight wagons & Vande Bharat Coaches, high double-digit growth in in the process industries segment, export opportunity & revival in CV demand.

Key Risks to our investment thesis in Timken

- Persistent weakness in Exports – While we expect a weak macro environment in developed markets, especially the US, to impact export revenue in the near term. We believe exports will pick up pace in the medium term. However, if the export demand remains soft for longer periods it would impact on both revenue as well as profit growth.
- Delay in Railway orders – While the Railway demand is linked with the need and govt. focus on modernization of Railway infrastructure, if there is delay in ordering due to budgetary constraints or change in government priorities or supply chain issues, it would impact Timken India negatively.

Happy Investing!

Quest Investment Advisors

QUEST INVESTMENT ADVISORS

SEBI Registered PMS & AIF managers

Disclaimer:

The purpose of this Letter is to provide general information of the market and the house view of Quest Investment Advisors Pvt Ltd. to existing and prospective investors in a manner to assist them in understanding the market and equity products. The Letter is purely for information purposes and should not be construed to be investment recommendation/advice or an offer or solicitation of an offer to buy/sell any securities. This letter is for the personal information of the authorized recipient(s) and is not for public distribution and should not be reproduced or redistributed to any other person or in any form without prior permission of Quest Investment Advisors Pvt Ltd. While reasonable endeavors have been made to present reliable data in the communication, but Quest PMS does not guarantee the accuracy or completeness of the data in the same. Quest Investment Advisors Pvt Ltd or any of its connected persons including its subsidiaries or associates or partners or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained, views and opinions expressed in this Presentation. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information, opinions and estimates contained in this Presentation reflect a judgment of its original date of publication by Quest Investment Advisors Pvt Ltd and are subject to change without notice.

The performance comparison shown with peer strategies is just for illustration purpose and data has been taken from www.pmsbazaar.com and www.pms-aif.com which are available in public domain. The objective of showing the performance is merely for the benefit of the investors to provide them transparent information of strategy performances and where does Quest strategies stand vis-à-vis industry peers.

This Letter is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to local law, regulation or which would subject Quest Investment Advisors Pvt Ltd and its affiliates to any registration or licensing requirement within such jurisdiction. The product described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this Report/Presentation may come are required to inform themselves of and to observe such restrictions.

This letter is qualified in its entirety by the Terms of Agreement and other related documents, copies of which will be provided to prospective investors. All investors must read the detailed Terms of Agreement including the Risk Factors and consult their tax advisors, before making any investment decision/contribution to be managed under the Portfolio Management Services offered by Quest Investment Advisory Pvt Ltd.