

Volatility is a symptom that people have no understanding of the underlying value – Jeremy Grantham

Dear Investors,

After a strong rally in CY23, would be prudent to reposition portfolios and be more agile with sector and company selection and profit booking from time to time

With all Indian equity indices roaring last year, its quite natural to have elevated expectations from the market in this year too. We have surely entered 2024 with some high hopes and cautious optimism about what lies ahead in the year. **Being more agile and on the front foot in current months could be rewarded as there is heightened chances of volatility in coming months.** Such volatilities would throw opportunities from time to time as along with momentum stocks, good quality companies also become victims of volatility and panic selling ensues. Last year Nifty-50 gave 20% return for the year, but the showstoppers were Midcaps which returned ~46% and Smallcaps being the clear winners returning ~55% returns during the year. When I look back at our investor letter written in Jan 2023, it seems the fact that consensus never plays out worked to the tee in 2023 and continues to do so now also. Below is a snapshot of our Jan 2023 letter:

WHAT TO LOOK OUT FOR IN 2023

We have entered 2023 with a lot of fear and hope as equity investors. Infact **after a long time we see investors having very low expectations from equity markets at the beginning of the year** unlike what was there when we entered 2022 a year back. The **consensus on the street is that 2023 would be as bad as 2022** or could get even worse when it comes to equity returns. However we know that when you least expect on something, that is when it delivers. Our view is that this year is likely to be less tumultuous for markets than last year. Inflation is already trending lower not just in India but in the rest of the world also. Central banks are expected to continue to tighten rates, but not to the extent seen in 2022. As a result, bonds will come under less pressure. Oil and natural gas prices are less likely to gyrate considering the supply chains have been re-organized globally. Lets look at some of the drivers for the market in 2023.

CY2023 performance was driven by expectations of the peaking of rate hike cycle, moderating inflation, improving liquidity, and consistently rising retail participation in equities, along with strong corporate earnings. The resounding victory of BJP in the three key state elections in Dec'23 added to the positive sentiments as it further strengthened the expectation of political continuity after the 2024 General Elections/May'24. **Indian equity markets recent performance should not be seen as short-term euphoria.** Even over the long term, India continues to be one of the top-performing markets with a 3-/5-/10-year return CAGR of 16%/ 15%/13% (in INR terms) and a CAGR of 11%/11%/10% (in USD terms). However, when such consensus builds up about our markets and economy from all sections on International platform, we believe its good to be doubly sure on the companies and sectors we are betting on and more importantly at what valuations we are entering.

WHAT TO LOOK OUT FOR IN CY2024

Predicting equity market returns in a politically active year is something bound to have lots of ifs and buts. But nevertheless, let us look at the drivers for the market beyond political outcomes.

Rate cuts hope are running high but could be delayed

The rally in the US and key global markets in the last several months was fueled by a rising belief, following Fed commentary, that central banks around the world will cut interest rates significantly in 2024 as the impact of the recent sharp tightening cycle on growth and employment will be manageable. However, in recent weeks the macro data from US suggests that rising interest rates have had little impact on job cuts and jobless data points to a strong economy. **Our view is that the market could be pricing in too many rate cuts and too soon.** Historically, a weaker US dollar has fueled EM inflows and, in this scenario, India will also see FII money percolating down from global EM funds. In addition to that India dedicated funds could see renewed inflows into Indian markets as China economy continues to slow down.

India's weight in MSCI index has gone up significantly but FII ownership is yet at decadal lows; room for large FII flows post elections

FII ownership is at decadal lows inspite of strong inflows in CY23; Domestic money would continue to lead

After the US\$17bn worth of FII selling in 2022, in 2023 we saw a complete reversal with FIIs pumping in US\$21bn into the Indian markets. Despite receiving the highest inflows among emerging markets, FII ownership of BSE-500 stocks remains near decadal low of 18.1%. Most interestingly, close to 75% of the FII inflows came from India-dedicated funds even as these make up only 7% of the FII AUM invested in Indian equities. **We believe this may be the start of a multi-year trend as global investors better appreciate the superior depth, breadth and liquidity of the Indian equity market.** At the same time the weak Chinese economy coupled with



regressive capital withdrawal policies implemented by the Chinese government deters FIIs to add any new fresh money there and on the contrary, we could see some serious rebalancing of Asia allocation from China into India. On the other hand, **domestic investors have emerged as a big support for Indian equity markets**, and this appears sustainable as even after the sharp increase in demat accounts and new folios, the percentage of the Indian household who invest in equities remains at 5-6% compared to high teens and higher in comparable economies. As per estimates the steady state domestic annual flows would be US\$30-35bn - 2/3rd of which is in the form of a stable inflows into domestic equity mutual funds through systematic investment plan (SIP) and the balance by way of pension funds (EPFO) and insurance (LIC and other players) flows. **We believe that the domestic flows are sustainable given only 5-6% of household assets in equities and Indian households save US \$750-800bn annually.**

Value and Momentum continues to find favour in the market but new leaders in growth part of the market are emerging

Value vs Growth vs Momentum conundrum

During the past seven years, growth has been the best performing style for the period from 2017 to 2020. However, in the past three years, value investing has taken the front seat in terms of outperformance. In the past two years, the value and momentum styles have outperformed the Nifty in six quarters while growth has outperformed in two. Since 2022, value was the best performing style in three of the last eight quarters. Momentum also outperformed in three quarters, while growth has performed well in two quarters. What we are observing over the last many quarters is that there has been a P/E and P/B multiple contraction and time correction in many well-known growth stocks which have failed to match up their own past earnings growth trajectory. At the same time, some new names in consumer discretionary, hospitality and new age companies have been surprising on the strong growth trajectory and hence have become the new flag bearers of growth part of the market. Hence, **we are sticking to a balanced approach between growth and value in our portfolio** construct and looking for the new leaders in these segments.

Capex cycle in both Govt and Private space will lead to all round growth effect in industrial, consumption, financial and real estate sectors

Sectors to look out for: India's multi-year capex cycle has started unfolding; will have 2nd level and 3rd level impact on multiple sectors and sub-sectors

India's capex (GFCF - Gross Fixed Capital Formation) to GDP ratio bottomed out in FY20 and has since risen by 270bps but is still 500-600bps lower than the previous peak seen around 2010. **All the three elements of the capex cycle (Housing, Corporate Capex & Govt Capex) are now largely picking up and hence the potential global slowdown (if any) should have limited impact on India.** A combination of a strong pent-up demand for housing, above average affordability and 12-year low unsold inventory should drive a multi-year virtuous housing cycle. Ditto for corporate capex with all-time low D/E ratio for Indian corporate, along with a decade high capacity utilisation level and well capitalised banking system should drive corporate capex. This is over and above the strong trend seen in Govt capex over the last 5 years. **The housing upcycle is in the 3rd year of upcycle and should still have 2-3 years to go if not more.** For the corporate segment, overall capacity utilisation is near 12-yr high with examples being cement & power. Even if govt. / infra capex spends cool off under budgetary pressure in 2024, we believe the large housing and corporate spending will drive the capex levels higher. We are strongly bullish on this segment of the economy and the same gets reflected in our portfolio positioning. Our view on various sectors is summarized in below table:

Sector	Our View
Auto and Auto Anc.	Capex cycle to drive demand for CV. We expect recovery in 2W & CV segment, Volume growth & Premiumization in PV segment, Raw Material tailwinds led improvement in EBITDA margins for all players
Banks & Financials	Positive Credit growth outlook along with low and stable NPLs, rising digitalization, attractive valuations make Banks attractive. However, concerns remains on CD ratio which could hamper credit growth and NIM compression
Cement	Continued momentum in both housing and infrastructure demand to keep cement demand strong; stable-to-declining trend in fuel costs to benefit margins.
Consumer Disc & Staples	Weak demand for staples on the back of weak rural demand. Consumer discretionary companies showing mixed trends. Market shifts from unorganised to organised visible. Premiumization is also happening. Urban consumption to do well
Industrials	Demand-supply gaps, improved pricing has led to increased confidence over sustenance of capex momentum. Tier 3/4 cities are new demand drivers for private sector capex. Govt capex is main driver for now. Significant large private capex yet to pick up.
Hospitality	Occupancy and ARR growth continues to remain elevated helped by strong leisure and business travel both in city hotels and holiday destinations. Though foreign travel yet to reach pre-covid levels but domestic tourists continue to rise.
IT & ITeS	Not in portfolio currently. While deal wins have been decent, companies are downbeat in their commentary due to uncertainty over client delaying discretionary spending & weak global sentiments
Real Estate and ancillaries	Demand supported by a macro tailwinds & favourable Industry Structure. Affordability continues to be good and wealth effect in metros continues to drive demand in real estate space.

Current Portfolio construct & Performance

In line with our outlook on the different sectors, we have concentrated our portfolio investments into the following sectoral allocations. The portfolio has an earnings CAGR of 24% over FY24-26 and trades at a ROE of 17.7%.

We continue to avoid IT sector as margins and growth yet to meet valuation comfort; we are overweight Urban Consumption and Industrials

Sectors/Themes	Weightage	Sectors/Themes	Weightage
Urban Consumption	38.5%	Financials	24.5%
Auto & Auto Anc.	8.4%	Banks	16.2%
Consumer Discretionary	15.6%	Housing Finance	3.6%
Hospitality	7.0%	Exchange & Other Services	4.7%
Real Estate & Ancillaries	7.5%		
		Others	5.2%
India Manufacturing & Industrials	28.9%	Diversified	-
Cement	6.1%	IT & ITeS	-
Chemicals	-	Logistics & Shipping	2.5%
Defence & Industrials	20.4%	Pharma & Healthcare	2.7%
Energy & Utilities	2.4%	Cash & Cash Equivalent	2.9%

We have consciously been under-weight in financials owing to the concerns of NIM compression which we see ahead. Also as mentioned earlier in our sectoral outlook, we continue to avoid IT & IT Services in our portfolio. We have approximately 14% exposure to PSUs spread across Energy, Utilities, Shipping and Housing & Infra Finance sectors where we see valuation comfort and significant scope of re-rating potential in quarters ahead. We remain biased towards midcaps and small-caps currently.

Month Ended	Large cap	Midcap	Small cap	Cash
31-Jan-24	46.4%	15.5%	35.1%	2.9%

Way ahead for our markets

While global growth is expected to slow down in CY24, all estimates of India's GDP growth peg it anywhere between 6.5-7.0% in FY24 and a further 6-6.5% in FY25. Similarly, we expect corporate earnings growth to be a strong ~15% in FY24 and FY25. For the domestic cyclical sectors, strong earnings growth should continue well into FY26 also. As against this, several large markets will likely witness earnings growth deceleration into CY24 and CY25. Nifty is now 20x 1-year forward - higher than the past 10-year average, but relative to EM (ex China) the premium at 67% is only somewhat higher than historical average of 59%. However, on PEG basis, India's valuation looks reasonable in the context of higher corporate earnings growth.

The current market context looks ideal with all factors viz. macro tailwinds, earnings growth, softening rates, cooling inflation and policy momentum looking picture perfect. Liquidity is something which remains volatile from time to time and would be supported by strong capital flows by both FII and DII. We remain firm believers in the medium to long term India story and expect these trends to strengthen with multiple themes at play (financialization of savings, private capex revival, rising discretionary consumption, strengthening of real estate cycle, and the massive creation of digital and physical infrastructure). That being said, we believe the journey will not be linear and will be interspersed with regular bouts of volatility as valuations are full, and any adverse change in the current benign liquidity backdrop or geopolitical situation can result in episodes of sharp corrections.

Happy Investing !!

Yours Sincerely

Aniruddha Sarkar

Chief Investment Officer & Portfolio Manager

Some of the recent portfolio additions

Over the last 3-4 months we would have added some diverse types of companies in the portfolio across sectors. Below we present a brief highlight about these companies and a summarized thesis on each of them as to why we like these companies.

Gas Authority of India Ltd (GAIL)

- ❑ GAIL is India's leading natural gas company with diversified interests across the natural gas value chain of trading, transmission, LPG production & transmission, LNG re-gasification, petrochemicals, city gas, E&P, etc.
- ❑ Rising domestic gas supplies (led by higher production by RIL, ONGC and ramp-up of new LNG terminals) coupled with tariff price increase to drive profitability of transmission business.
- ❑ Substantial improvement in petchem segment's profitability over H2 FY25 - FY26 as new petchem capacity will be operational and low inventories globally will drive re-stocking demand.
- ❑ Commencement of operations of 3,892km of gas transmission pipelines and 560ktpa of petchem capacity.
- ❑ GAIL already has >130MW of renewable energy capacity in place and is present (either directly or via subsidiaries/JVs) in ~67 CGD geographic areas (GAs), making it the largest CGD player in the country and a large-scale renewable energy player. These two segments are likely to grow materially over the next few years and may create a more diversified earnings profile for GAIL over the next 3-4 years.
- ❑ ROE improvement and healthy FGF generation to drive stock re-rating.

Home First Ltd

- ❑ The distinctive edge of Home First lies in its data-driven underwriting and approval processes, utilizing nontraditional metrics to identify creditworthy individuals. Driven by the substantial under-penetration in the affordable housing segment, with a projected gap of 97 million houses by FY30, Home First has a significant potential driven by macroeconomic factors such as an expanding middle class, nuclear families, and government support.
- ❑ To seize this opportunity, Home First plans an aggressive expansion, aiming to increase touchpoints from approximately 265 in FY23 to 400 within the next 2 years. The company strategically targets economically prosperous states for expansion, building on its already strong presence in the top four exporting states – Gujarat, Maharashtra, Tamil Nadu, and Karnataka, which collectively account for 77% of Assets Under Management (AUM) and around 66% of its branches as of FY23.
- ❑ With a robust presence in key states and a well-established plan for growth, the company is poised to leverage both the opportunity and its existing infrastructure and capital to achieve a substantial increase in AUM, targeting a growth rate exceeding 30% from FY23 to FY26. The Return on Equity (RoE) is expected to improve from 13.5% to 16.5% during the same period, indicating a promising trajectory for Home First.

QUEST PMS INVESTOR LETTER – JAN 2024



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