InCred PMS

MULTICAP Portfolio

Newsletter

The last two years have undoubtedly been very rewarding for Indian investors as Indian markets have been one of the best performing emerging markets.

The most common thought in the minds of investors today- are valuations running ahead of fundamentals?

The answer is Yes and No.

We notice a tendency in markets to indiscriminately back companies/ sectors based on an underlying theme (Cloud / D2C (direct to customer) / Electric Vehicle (EV) / Green Energy) while shunning certain pockets still in recovery. A quick calculation suggests that technology stocks represent c.33% of the US-listed universe today (with c.10% from the FANG and c.9% from other internet/ecommerce companies). China, adjusting for recent softness, was around 13%, led by Tencent, Alibaba and a host of e-commerce companies. India, by comparison would be close to 15%, but largely represented by IT services companies (source:Bloomberg). The market is eager to push up this number (case in point Zomato) with many multi-billion-dollar D2C listings lined up.

We do not disagree with the general drift of the market in favour of emerging sectors, not least given the global precedents, but chose to be more selective and opportunistic. We haven't made significant changes to our portfolio since March, which we believe is fairly forward looking and well-backed at that, and we also believe that we are well positioned subject to benefit from the transfer of value in favour of certain recovering pockets (Autos, Pharma and Financials).

Current Market Dynamics

The Indian equities markets continue to benefit from the monetary policy of central banks and strong domestic cyclical recovery. We believe that the equities are in mid cycle with market multiples not being inexpensive and earnings growth rebound would support valuations.

Several factors may favour for continued strong earnings growth in Indian equities, namely start of the capex upcycle led by higher state outlays for infrastructure projects, PLI incentives for manufacturing, deleveraged balance sheets and decadal low cost of capital; strong recovery in consumption rising disposable incomes in services sector and real estate demand fueled by pent up demand and increasing supply of credit.

While these factors support the larger universe, the bigger opportunity for alpha lies in sectors and companies that have underperformed markets and peers either due to transitory externalities (NPAs / chip shortages / covid recovery), execution delays or due to sheer lack of investor interest, despite offering a healthy earnings growth outlook.

Divergent sectoral trends

To encapsulate, margin pressures and commodity prices emerged as the central themes in Q2, playing out differently for varied sectors, ensuing hits and misses. This apart, strength in financials was another clear trend. We summarize sectoral trends below:

Consumption-oriented sectors have borne the biggest brunt from recent commodity price hikes, which led to earnings miss on weaker margins across segments – Autos, Staples and Consumer Discretionary companies.

- While raw material prices have marred margins, pricing power across sectors remained mixed (though expected to recover in the next few months).

- Additionally, the Auto sector saw volume constraints emerging on account of chip shortage and supply-chain situation is gradually improving. Auto industry volumes PVs (personal vehicles), LCVs (light commercial vehicles) and domestic premium motorcycle segments) got negatively impacted due to chip shortage in October 2021; however, it saw a recovery from September 2021 levels. Domestic PV segment demand trends continued to remain strong and we expect a swift recovery once the chip shortage situation is resolved. Export 2 Wheeler segment volumes continued its strong momentum whereas domestic segment continued to remain under pressure.

Margins across segments have contracted YoY and QoQ owing to raw material price rise. Compared with pre-COVID quarter (Q2FY20), consumption margins have starkly contracted owing to weak pricing power, volume impact (specific to Autos) and raw material price shocks.

Even as India's overall credit growth remains tepid at ~7% YoY, private banks continue to gain market share and post strong results led by:

(1) lower provisions seen for most of the top tier private banks

(2) focus would return to loan growth for the lenders going ahead

(3) Peaking of credit cost for other lenders

The IT sector's Q2 results were broadly in-line, with strong demand outlook led by digitization drive, deal wins and cloud migration. Most companies handled margins well despite attrition pressure and wage hikes. Overall, we remain bullish on the space given the ongoing digital transformation and growth potential.

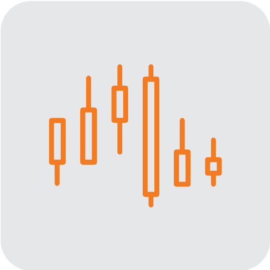
Led by strong India and rest of the world (ex-US) performances, all Pharma companies have shown strong quarterly results. The Sectoral pipeline in the US is expected to be better in FY23.

In the July-September quarter three factors contributed to the miss in earnings high raw material prices impacting gross margins, elevated freight cost and high energy prices impacting EBITDA margins. Freight cost has already started to moderate with a 50 percent decline in the Baltic Dry Index from a high of 5650 made on October 7, New Castle Coal prices have also corrected by more than 40% from a high of USD 269.5 per tonnes. Over the next 2-3 quarters we expect the increase in raw material prices to moderate hence the stocks which have reacted negatively on miss in estimates to bounce back strongly.

The way forward

The Multicap portfolio has a superior Return on Capital Invested (ROIC) of 25%, Earnings growth profile of 32% annualized over FY21-23 compared to benchmark and also the portfolio is net cash ex-financials.

We would continue to be disciplined in deployment of capital for utilizing the volatility in the markets and look for opportunities in the market on a bottom-up basis which is more relevant for a strategy like ours.



Avoid making mistakes by not being in crowded trades like chemicals (average price / sales of 10x), midcaps IT companies (valuations above 2 standard deviation above mean), sugar (narrative change ethanol), steel (prices at 2 standard deviation of mean) and many more.

Deploy incremental cash on sharp downticks as we believe that the bull market corrections are sharp and swift. There has been a 40 percent plus price correction in companies like Neuland Labs and Sequent Scientific on account of transitory factors leading to derating and we expect them to bounce back on account of structural tailwinds.

Size quality companies especially which have underperformed examples Bosch, United Spirits and Godrej Consumer Products.

Identify price & value gaps to position in stock wherein earnings compound and multiples expansion optionality is there.

About the fund manager

Aditya Sood

Fund Manager, InCred PMS

Overall investment experience of 17 years in equity markets out of which 15 years in fund management.

Global experience of managing emerging market equities in the United Kingdom.

Founder of Vishuddha Capital Management, a boutique alternate management firm (now part of InCred AMC)

Formerly headed the investment function of ICICI Prudential PMS managing assets of over INR 4,000 crores.

He combines a philosophy of focusing on 'Return of Capital" along with "Return on Capital" and picked ahigh point in the market to close his PMS at ICICI Prudential and return capital to investors with a handsome profit.