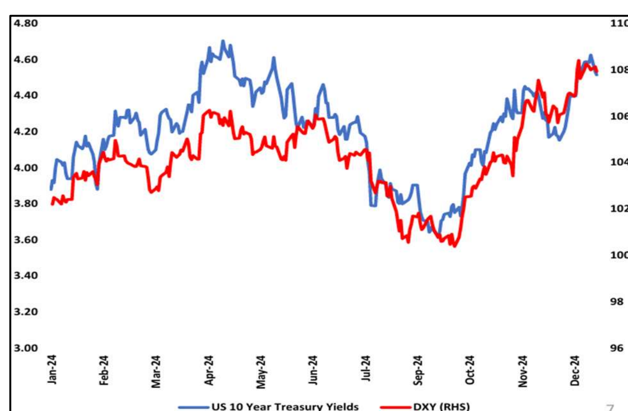
SOHUM
ASSET MANAGERS

Sohum India Opportunities Fund: Investor Update Newsletter, December 2024

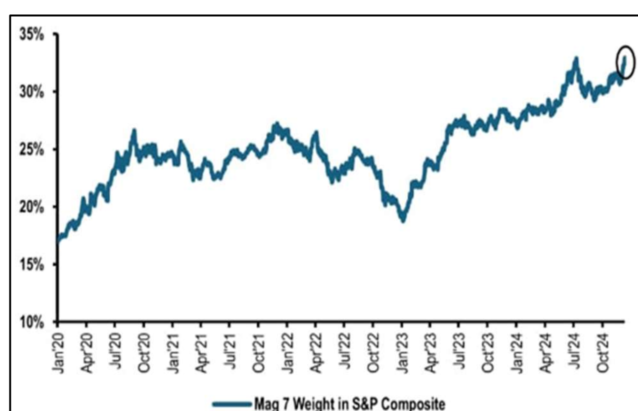
We are now approaching the midpoint of a decade that has brought rising equity markets, solid economic growth, and technological breakthroughs (artificial intelligence). All that in spite of unprecedented global lockdowns, the outlook of wars in Eastern Europe and Middle East, and the largest spike in interest rates and inflation in decades. The key question therefore is – will the good times (marked by high economic growth, strong market returns and improving productivity) continue into 2025 or whether US political change will contribute to heightened macroeconomic volatility/divergences. We saw glimpses of the latter in the second half of CY2024. After a smooth sailing for all asset classes in the first half of CY2024, we saw violent moves in US bond yields in the second half with the US 10-year gsec yield up 55bps for the full year despite 100bps of rate cut by the Fed. Similarly, despite rate cuts, the US dollar index appreciated sharply in 4QCY24 sending the Euro and other EM currencies into complete disarray. Also, while the S&P index delivered a solid 27% returns in CY2024, the breadth of the market continued to get narrower with the share of Magnificent 7 moving to record highs!

Exhibit 1: US Dollar yields rose despite rate cuts



Source: Bloomberg

Exhibit 2: Magnificent 7 at record concentration



Source: JPM Research. Note: "Mag 7" constituents – Apple, Microsoft, Amazon, NVIDIA, Alphabet, Meta, Tesla

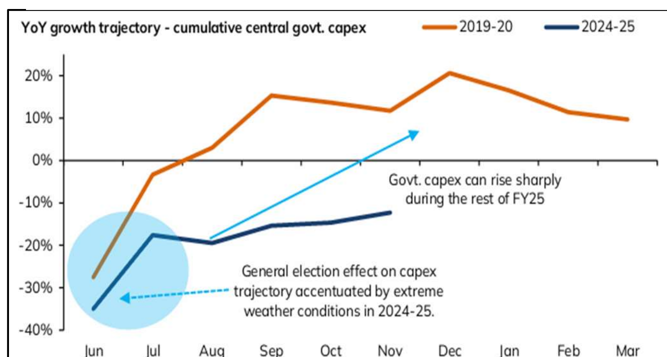
2024 was a tale of two halves for Indian markets as well – strong gains in the first half, followed by stagnation in the second. Slower earnings growth and sharp FII outflows tempered investor optimism in the second half. As we enter 2025, our stance is to "plan for growth, prepare for volatility". In our base case, we expect sustained economic growth in the US, supported by healthy consumption, loose fiscal policy, improving productivity and lower interest rates. Over the past two years, the US economy has defied expectations that higher interest rates would provoke a sharp slowdown. In 2024, nonfarm payroll growth averaged 170,000 per month and GDP growth estimates point to a 2.7% rate for the full year. We believe many of the key factors that have sustained US economic growth in recent years are likely to persist. Of course, the risk scenario is that "across the board" trade tariffs, excessive fiscal deficits and geopolitical strife will ultimately be more inflationary, more disruptive to global trading arrangements, more USD-positive and more "risk-off".

Coming to India, we believe it remains a structural growth story hit by a cyclical speed bump. In the last few years, Indian consumers levered up, taking advantage of easy financial conditions that prevailed post-pandemic, so much so, that even after tightening monetary policy by 250bp in the cycle, the RBI had to slam the brakes on unsecured consumer lending in late 2023. Separately, amidst sharp fiscal consolidation of 3.5pp of GDP by the central government post pandemic from FY21 to FY24, it judiciously re-allocated spending towards capex, thus giving a significant boost to infrastructure investment growth. The combined effect of policy support, and pent-up consumer demand boosted India's real GDP growth to an above-trend average of 8% during FY22-FY24.

However, over 2H CY24, weak government spending due to national elections, the effect of withdrawal of accommodative policies, and the macro-prudential tightening of consumer loans have started showing on growth. For instance, central government capex spending is down 12.3% YoY in FY25 YTD. Similarly, a significant driver of slowdown has been the sharp 5ppt slowdown in bank credit growth in past 6-months to 11.5% YoY as of mid-Dec which in turn has resulted in weak consumption numbers. We view this slowdown as cyclical and expect India's growth to revert to trend (6.5%-7%) in FY26 due to the following reasons:

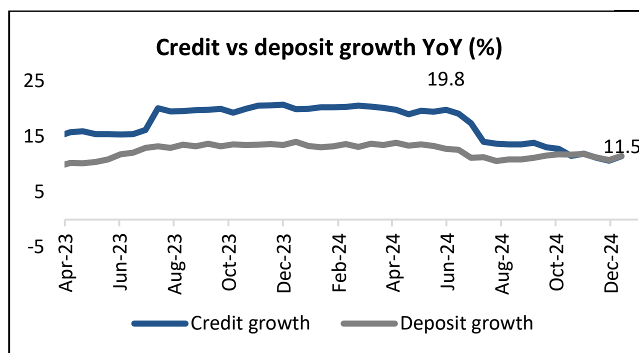
- In non-election years, central government capex has mostly been front loaded, resulting in higher average monthly run rate in Q1 of each fiscal year which faded through the rest of the year. However, during election years, capex spending has been observed to be back ended as it was observed in FY20 (general election year), and hence, is likely to repeat in FY25 as well. Thus, we expect a significant uptick in government capex in the remaining months of FY25. Overall, we believe that the upturn in India's capex cycle which started in late 2020, led by housing (30% of GFCF or capex) and a push from the central government towards infrastructure spending has more legs to go. The housing cycle is still strong, with inventories near 14-year lows. After rising by a CAGR of 30% in the last four years, while central government capex is unlikely to match its previous growth as incrementally populist spending is on the rise, it is still likely to be higher than nominal GDP growth. Moreover, private corporate capex is also rising, with strong corporate balance sheets and opportunities in power, electrification, PLI schemes, building materials, etc., driving the spend. Overall, we expect the capex uptick to support 6.5–7% GDP growth in FY26.
- The RBI had put pressure on banks to bring credit growth in line with deposits, which is now achieved with both growing at the same 11.5% rate - and as such unlikely to be a drag on growth going forward.

Exhibit 3: Govt. capex could rise strongly in rest of FY25, similar to FY20 which was affected by general elections



Source: ISEC Research

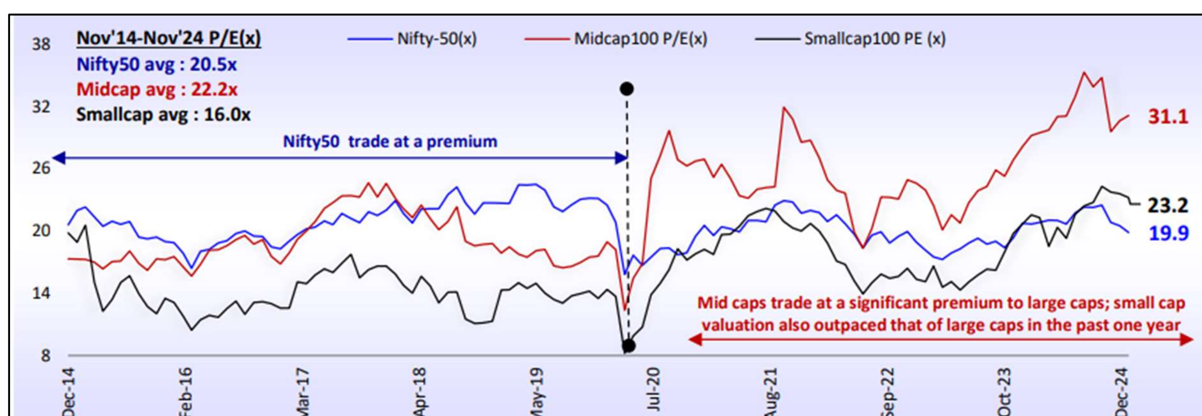
Exhibit 4: Credit & Deposit growth have converged and is unlikely to be a drag going forward



Source: Haitong Research

The 21% earnings CAGR over FY21–24 has moderated to <10% in FY25E. As discussed above, drag from aggressive fiscal consolidation and a 5ppt contraction in credit growth (regulatory driven) have led analysts to cut their estimates. With these drags in the base and both monetary and fiscal policy likely to be more accommodative going forward, we expect earnings growth to improve to 14% in FY26E. Overall, we are working with Nifty EPS of Rs.1050 for FY25, Rs.1200 for FY26 and Rs.1350 for FY27. At 20x multiple, we get Nifty target of 27,000, which implies a 14% return in the next 12-15 months for the index. Post the recent price as well as time correction, we think markets are offering a good entry point, particularly in large-caps. Post-COVID, mid and small-cap indices have consistently outperformed large-cap indices. Consequently, the 12-month forward P/E for mid-caps is trading at ~31x, at a 56% premium to the Nifty-50 and the 12-month forward P/E for small-caps is trading at 23.2x, at a 17% premium to the Nifty-50. We therefore believe that the margin of safety is much higher in large-caps and investors should look to allocate investments towards larger-cap indices.

Exhibit 5: 12-month forward P/E(x)



Source: MOSL Research

Portfolio Composition & Performance

Our portfolio construction continues to be tilted towards capex over consumption. We remain overweight – financials, telecom and capital goods, neutral – pharma, auto, metals and underweight – oil & gas, IT and consumer. Financials have been a laggard in 2024. At start of 2024, RBI was concerned about high growth in unsecured loans, banks' lending to NBFCs, wide gap in growth of loan (16%) & deposit (13%), high inflation and operational gaps at NBFCs & banks. At end of 2024, many of these issues seem to have been addressed with unsecured loan disbursements down c.15%, bank lending to NBFCs slowing to 6% and bank loan & deposit growth aligning. NBFCs & Banks are also trying to fix issues flagged by RBI. We expect pressure in unsecured retail loans to ease in FY26 as provisions on stress is taken upfront and disbursals have slowed. This can be tailwind to earnings trends for banks. Financials are trading at attractive valuations and as earnings growth gap is also narrowing between banks & market, we feel that risk-reward is favourable with triggers from easing asset quality pressures & regulations.

Overall, as of 31st December 2024, our flagship Sohum India Opportunities Fund has in the last one year, gained 20% (pre-tax), net of applicable fees. In the same period, the Nifty Index has delivered 8.80% and Nifty TRI Index has returned 10.1%. Since our inception (20th May 2022), we have delivered 78.43% returns (an outperformance of 28.36% over Nifty TRI) with average large cap holding of 79% and consequently much lower risk. **Moreover, out of the total alpha created since inception, 66% is attributable to large caps while the rest has been contributed equally by mid and small caps.** Our strong outperformance, thus, helps bust the myth that alpha generation is not possible in large caps.

Overall, ***our portfolio companies across all segments large, mid and small cap are well poised to deliver industry-leading earnings growth (Portfolio companies' earnings growth at 20% over FY24-26, with PE of 15.6x on FY26 at 23,645 Nifty and ROE at 16.9%) and we anticipate the same to translate into benchmark outperformance in the near to medium term.***

We wish our readers a very Happy New Year! We are truly thankful to all our investors who have stayed with us and backed us in our 2.5-year journey. Going into 2025, the balance between tailwinds (continued global economic expansion, easing monetary policy and falling interest rates, healthy earnings growth) and headwinds (elevated valuations, trade tariffs, strong dollar, increased macroeconomic volatility and ongoing geopolitical risks) suggest that portfolio returns are likely to revert to trend-like rates! India, however, stands out structurally as well as post recent correction, given the strength of corporate India's balance sheets and the prospects for robust and structural profitable growth. Against this backdrop, we remain optimistic for potential upside, though lower than the past two years.

Warm Regards,

Sanjay H Parekh