SOHUM
ASSET MANAGERS

Sohum India Opportunities Fund: Investor Update Newsletter, September 2024

"Doubt is an uncomfortable condition, but certainty is a ridiculous one". This perhaps best describes the quarter gone by, particularly on the global front. At the start of the quarter, global financial markets were rocked by an episode of significant volatility as a surprise rate hike by the BoJ triggered the unwinding of the yen carry trade. The quarter also saw the start of the much-anticipated Fed easing cycle after more than 2 years. While the rate cut was expected, what surprised was the quantum – not many thought that the Fed would deliver an aggressive 50bps rate cut. The rationale for the larger cut and the key theme of the meeting was the shift in focus from inflation risks to employment risks in light of the recent softening in the labour market data. However, this has raised questions on whether the US economy is indeed heading for a soft-landing as widely believed.

Also, as soon as the Fed opened its doors, other central banks (particularly in emerging markets) have started to walk through with monetary easing without fearing for their currencies. For instance, central banks in the Philippines and Indonesia recently commenced easing cycles. However, the biggest surprise came from the PBOC which delivered a 20bp repo rate cut and a 50bp RRR cut (double the usual increments), a 50bp reduction to rates on outstanding mortgages, and most importantly, lending measures to support the equity market. This resulted in one of the most violent counter-trend rallies in China with the China CSI Index gaining 30% in a couple of weeks! While this is perhaps the first time that the Chinese central bank has provided such direct support to stock markets, the question remains whether these measures are enough to bring some stability to economic growth. In this regard, any fiscal stimulus package (which the policy makers have so far restrained from) will be keenly watched.

Finally, geopolitical tensions remained heightened during the quarter with the escalation of the Iran-Israel conflict. Going into the new quarter, we will have the US elections to contend with. Given how closely fought this election is likely to be, investors can continue to brace for higher global volatility.

In an uncertain global world, India continues to shine as the beacon of political and macro stability. Our macro stability stems from the pristine balance sheet of all stakeholders – consumers, corporate, government, banking and external. The corporate balance sheets are deleveraged to cyclical lows and can take on large capex programs ahead. Similarly, the central govt fiscal deficit has fallen from peak levels of 9.2% in FY21 to 5.6% in FY24. Banking sector gross non-performing assets stood at 2.8% as of Mar-24 which is the lowest in a decade while our current account deficit remains range-bound at 1%-1.5% despite oil at USD80/bbl. Perhaps the only balance sheet which has seen some increase in leverage is the consumer balance sheet (household debt to GDP has risen from pre-pandemic levels of ~35% to ~40% currently) but this is most likely to be offset by the post-pandemic increase in financial net worth of households.

Chart 1: Corporates continue to deleverage

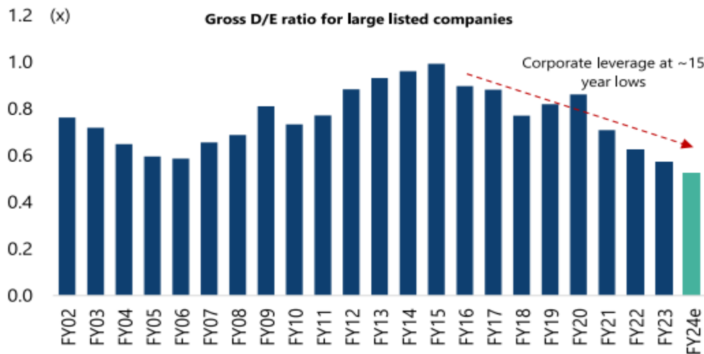
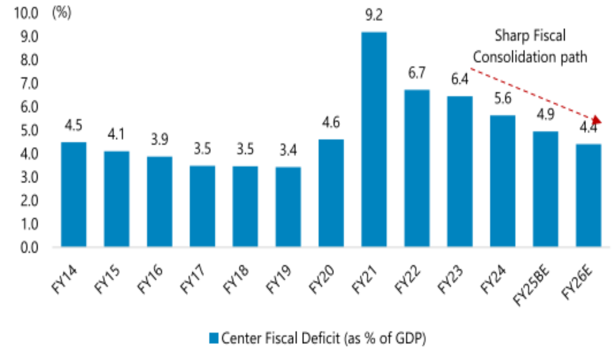


Chart 2: Sharp fiscal consolidation path



Source: Jefferies

Chart 3: CAD remains in check

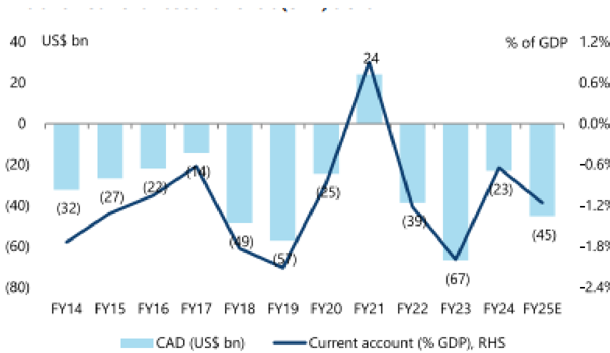
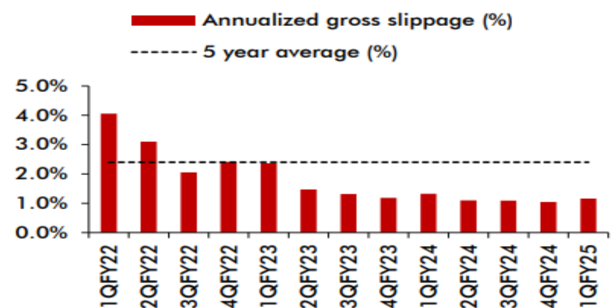


Chart 4: Banking Sector stress addition remains benign



Source: Jefferies, Ambit Capital

While India's medium to long-term story is attractive as ever, there are some near-term headwinds. These headwinds have been in the form of negative fiscal impulse as well as tight monetary policy, both of which are leading to some near-term growth slowdown. Post the election, government spending has been slow to pick-up with total govt. expenditure declining by 1.2% yoy in the first five months of FY25 led by significant decline in capital expenditure (-19.5% yoy). Similarly, tight monetary policy (with real policy rates upward of 2.5%) along with tight liquidity has now started to bite growth. This was evident from the 1QFY25 results with Nifty earnings growing by only 4% yoy. As we head into Q2 results, earnings are expected to slowdown further to 2% yoy (lowest in 17 quarters). As a result, we have now started to see some EPS downgrades. While 1HFY25 is likely to be a washout, we do believe that things should start to look up from H2 onwards as RBI's rate cut cycle begins and government spending also makes a comeback. Overall, we are now working with FY25 and FY26 EPS of 1060 (down from 1100) and 1230 (down from 1250) respectively. Despite the recent correction, Nifty (at 25,000) is currently trading at 20x FY26 which implies no major upside in the near-term. Broader market valuations are even more expensive (Nifty Midcap 100 is trading at an all-time high premium to Nifty-50). ***Thus, we continue to believe that large caps offer better margin of safety at this juncture and are positioned accordingly.***

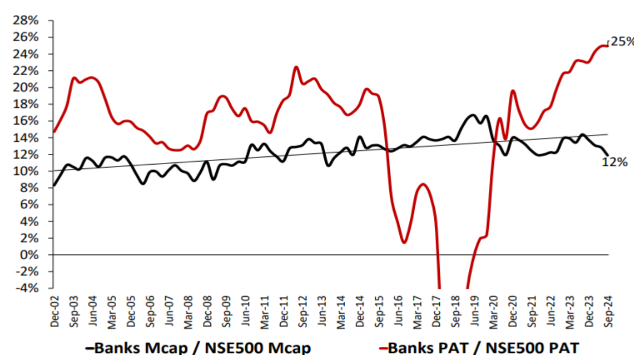
Portfolio Composition & Performance

Constructing a model portfolio against the backdrop of a stellar performance of the markets and the underlying expensive valuations presents a unique challenge of participating in the growth story without overpaying for it. Sustainability of businesses and valuations are the two cornerstones of our GARP investment philosophy. Our portfolio construction, as always, is driven by earnings growth

visibility, but also has enough built-in safety (in terms of reasonable valuations) to withstand any large, unexpected drawdowns in the market. We remain overweight – financials, telecom and capital goods, neutral – pharma, auto, metals and underweight – oil & gas, IT and consumer.

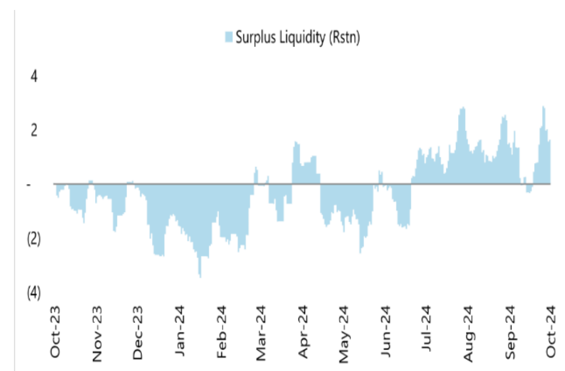
Banks now contribute 25% of the profits to the top 500 company universe. However, their market cap as a % of the NSE 500 universe is now at 12%, compared to the trend average of 14.1%, suggesting a relative reduction in the banking sector's share of market capitalization. Currently banking loan growth is growing just ahead of nominal GDP growth. Banks have reduced their unsecured credit's incremental growth. While there are some pockets of stress, overall credit costs for the banking sector remains stable with stead asset quality. This means that banks remain one of the few sectors in the market that isn't overheated from a price performance perspective and also offers a margin of safety at a time when the broader market is at a premium valuation. We would also like to note that the upcoming rate cut cycle, and potentially easier liquidity could help in addressing some of the concerns like high CD ratio for the sector. Interestingly, system liquidity has been in surplus mode for the last two months and the gap between banks' credit (13%) & deposit growth (12%) is at +2yr low, reflecting that majority of alignment may be largely done. With rate cuts on the anvil, this surplus liquidity will likely become more durable and help in lowering cost of funds for the banking sector.

Chart 5: Banking sector valuations offers margin of safety



Source: Ambit Capital

Chart 6: System liquidity in surplus mode



Source: Jefferies

Overall, as of 30th September 2024, our flagship Sohum India Opportunities Fund has in the last one year, gained 43.75% (pre-tax), net of applicable fees. In the same period, the Nifty Index has delivered 31.43% and Nifty TRI Index has returned 33.00%. Since our inception (20th May 2022), we have delivered 93.65% returns (an outperformance of 30.1% over Nifty TRI) with average large cap holding of 80% and consequently much lower risk. **Moreover, out of the total alpha created since inception, 72% 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 19% over FY23-26, with PE of 19.3x on FY25 and 16.5x on FY26 at 25,000 Nifty and ROE at 17.6%) and we anticipate the same to translate into benchmark outperformance in the near to medium term.***

We are truly thankful to all our investors who have stayed with us and backed us in our two-year journey. Our long-term focus, disciplined approach and complete alignment of interests provides resilience to this partnership. We believe this is just the start and we remain excited about the opportunities in the coming years with focus on delivering super value and performance to our unit holders.

Warm Regards,

Sanjay H Parekh