Sohum India Opportunities Fund: Investor Update Newsletter, March 2024

What a superlative year FY24 has been for the Indian economy as well as Indian equities. The combination of strong growth and moderate inflation made for a goldilocks macro-economic scenario for India in a fragile global economic landscape. This got well reflected in our markets with the headline Nifty index delivering 29% returns during the financial year to become the second-best performing market after Japan's Nikkei. The broader indices posted far more stellar gains with the Nifty mid-cap 100 returning 60% while the Nifty small-cap 100 index was up 70%. As we have been highlighting for some time, the current domestic economic growth cycle is being driven by capex rather than consumption. Post covid, gross fixed capital formation growth has exceeded private consumption growth in each of the three years with the wedge between the two widening the most in FY24. It therefore comes as no surprise that the best performing indices in FY24 have all been capex linked – realty, capital goods and power – while one of the biggest laggards has been the Nifty FMCG index.

Going into FY25, the domestic growth outlook continues to remain strong. Post the above expected GDP growth in the December quarter, consensus forecasts for FY25 have been revised upwards. In our view, investments will continue to remain the biggest driver of growth for the foreseeable future, although the wedge with consumption could narrow to some extent. We remain confident about this due to the following:

1. Gross fixed capital formation (as a % of GDP) bottomed out in FY21 and has been rising since then. The last capex cycle between 2000-2008 lasted for 8 years with GFCF as a % of GDP reaching a peak of 36%. We are still 500-600bps below the peak suggesting a long runway.
2. After a stellar 28% growth in FY24, central govt capex is budgeted to rise by 17% yoy in FY25 as against non-capex (excl interest payments) spending budgeted to decline by 1% yoy. This is a clear indication of government's intention to boost the investment cycle. Normalization of covid subsidies and robust tax collections has created space for increased central government capex. Both central and state governments have stepped up focus on infrastructure creation. Government infrastructure capex is focused on improving logistics (railways, roads and highways), which will help crowd in private investment.
3. According to the RBI OBICUS survey, capacity utilization stands at a robust 74%. However, anecdotal evidence of large listed players indicates higher capacity utilization levels than that suggested by the system. For example, Ultratech is at 77% vs system utilisation number of 68% and NTPC is at 76% vs system utilisation number of 68%. Similarly, top 3 steel makers have capacity utilisation of >90% against system utilisation of ~80%. Afore mentioned implied capacity utilisation trends are positive for private capex cycle when coupled with rising animal spirits, upward GDP revisions, strong corporate profitability and clean balance sheets (low levels of leverage). Strong corporate profitability is reflected in the fact that pat for BSE500 companies have increased from Rs.4 trn in FY20 to Rs.10 trn in FY23.

Along with a strong growth outlook, the broader India macro conditions remain resilient as well with declining inflation, manageable current account deficit (helped by robust services trade surplus), focus on fiscal consolidation, stable INR and expectations of RBI rate cut cycle. The only negative perhaps is the current tightness in banking system liquidity. However, with the CAD hovering only at 1% despite crude oil at USD85/bbl, there is possibility of a large BoP surplus in FY25 on account of India's inclusion into the global bond indices. As per most reports, India's fixed income markets could see inflows upwards of US$40bn in FY25. Such large inflows in turn can help to significantly ease domestic liquidity as the RBI will look to shore up its forex reserves.

Robust economic growth has translated into strong earnings growth with Nifty EPS set to expand by a solid 20% yoy in FY24. Thereafter, we expect a decent 13% earnings CAGR for FY25/FY26. With earnings outlook positive, the only constraint for our markets is valuations. With Nifty EPS estimates of 975 for FY24, 1100 for FY25 and 1250 for FY26, the headline index is currently trading at 20x one-year forward earnings which is in line with the last five-year average but higher than long-term average of 18x. The broader markets are even more expensive with the Nifty Midcap index trading at a significant premium to Nifty and the Nifty smallcap index trading at only a small discount to Nifty, compared to history (Exhibit 1 and 2). We believe that while valuations are likely to remain "rich" given the strong earnings delivery, stable macros, a committed government and increasing household ownership of equities, there exists pockets of froth in the market which should be clearly avoided. Thus, we continue to believe that large caps offer better margin of safety at this juncture and are positioned accordingly. ***At FY26 EPS of 1250 and 20x multiple, we believe that the Nifty can head to 25,000 over the next 12 months which would generate a return of 12% from current levels.***

<u>Portfolio Composition & Performance</u>

Given the backdrop of demanding valuations, our endeavour remains to cherry-pick a portfolio that does not compromise on growth momentum, but also has enough built-in safety to withstand any adverse global event, financial or otherwise, that may shock the markets. We are overweight on financials and large pharma as these offer growth as well as safety. We also remain invested in real estate, cement/infra, power and select auto plays for continued growth momentum. We are underweight IT and consumer, wherein neither growth momentum nor valuation comfort is offered. While financials have been a big laggard in the last one year, we expect the underperformance to start reversing once domestic liquidity conditions become more benign in line with our BOP surplus thesis.

Overall, as of 31st March 2024, our flagship Sohum India Opportunities Fund has in the last one year, gained 46.6% (pre-tax), net of applicable fees. In the same period, the Nifty Index has delivered 28.6% and Nifty TRI Index has returned 30.0%. Our strong outperformance helps bust the myth that alpha generation is not possible in large caps. In fact, each year we see significant divergence in returns within large cap stocks which leaves ample room for alpha creation. For instance, in FY24, the top ten stocks in the Nifty index in terms of performance delivered 100% return on an average while the bottom ten stocks gave only 3% return on an average (Exhibit 1). The key is therefore to buy fundamentally strong companies which are available at reasonable valuations relative to their growth (GARP strategy). Portfolio composition between large, mid and small is simply an outcome of the above process. ***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 21% over FY22-25, with PE of 16.4x on FY25 and ROE at 16%) and we anticipate the same to translate into benchmark outperformance in the near to medium term.***

Exhibit 1: Large divergences in performance within the Nifty Index

Particulars	% Returns - Annualised		
	1Y	3Y	5Y
Nifty Index	28.6	15.0	13.9
Avg of top 10	99.4	42.0	31.8
Avg of bottom 10	3.0	0.8	6.4

Source: Bloomberg, data as of 31st March 2024

As we end FY24 on a high, I would like to take this opportunity to thank all our investors for their kind, relentless and unwavering support to Sohum Asset Managers. We will continue to collaborate in FY25 and ensure that we act as enablers and partners in each other's progress and growth.

Warm Regards,

Sanjay H Parekh