SOHUM
ASSET MANAGERS

Sohum India Opportunities Fund: Investor Update Newsletter, June 2024

With two nail biting finishes, the quarter gone by was not for the faint-hearted. On 29th June, when all seemed lost, the men in blue managed to snatch victory from the jaws of defeat to lift an ICC world cup after an agonizing wait of 13 years. On the other hand, on 4th June, when victory seemed certain – with most exit polls predicting a landslide majority for the BJP government – the actual verdict turned out to be extremely underwhelming. After a decade of single party rule, we got a coalition government with the BJP falling short of the majority mark by 32 seats. Not surprisingly, the market collapsed under the weight of its own expectations with headline indices correcting 5-10% in a single day and individual stocks correcting up to 20%. It is on such days that the faith of investors on the "India story" gets tested and we being firm believers in this story took the opportunity to buy into our high conviction stocks where value had emerged. To us, the outcome itself was not so bad but the "very high expectation" bar that was set early on was the problem. The beauty of markets is that it is a self-correcting machine and hence the sharp correction that ensued took away some of the excessive froth in our view. Since then, the Nifty index is up 11% while the midcap and smallcap indices are up 14% and 19% respectively, in the last one month (4th June to 4th July).

The entire episode reminds us of an old speech by our late ex-PM, Sri Atal Bihari Vajpayee, wherein he had aptly said:

"Sarkaarein aayengi, Sarkaarein jaengi, par Desh chalte rehna chahiye"

(Government's will come and go but the country has to keep moving ahead)

There is a considerable amount of debate whether the election verdict will force the BJP government to walk on the path of populism and start doling out freebies at large. Our view is that NDA 3.0 is unlikely to be very different from Modi 2.0. It may not be possible for the BJP to deviate from its core ideology of capex-led nation-building, control on inflation and check on twin deficits. Hence, there is no reason to be overweight consumption, just based on the outcome of the polls. We do not believe that there will be significant slowdown in the ongoing nation-building programs. Thus, we do not see any major risk to the levels of infrastructure/defence/manufacturing capex. However, some rural focus, which was already part of BJP's manifesto, could benefit rural consumption in the third NDA term.

With the event now behind us, the attention once again will shift back to fundamentals. In this regard, India remains in a very good shape, almost enjoying a mini-Goldilocks moment with excellent macros (real GDP growth of 8.2% in FY24 following ~7% growth in FY23, inflation at ~5%, both current account and fiscal deficits well within the tolerance band, a stable currency, et al.), and healthy corporate earnings (Nifty ended FY24 with 20% earnings growth). Some of the breakout trends which the economy is currently witnessing are:

1) **Pick up in the investment cycle** with share of capex in GDP at an 11- year high along with improving ICOR (productivity of capital) while NPA cycle continues to drop to a cyclical low. As we have been highlighting, this pick-up in investment cycle has been possible due to healthy balance sheets of all stakeholders – households, government, corporate, banking and external. For instance, India's current account turned into a surplus in Q4FY24, marking the first surplus

since 2021. Similarly, the market capitalization of the entire PSU basket has doubled from Covid lows of 8% to 16% of overall BSE market cap, providing a significant war chest to the government. While the heavy lifting is currently done by households (turn in the housing cycle post a multi-year slowdown) and government (central govt capex to GDP has doubled since FY20 from 1.7% to 3.4%), private corporate spending uptick is also now visible in multiple data points (steel, clean energy transition, PLI schemes).

2) Improving ICOR is further validated by **RoE breaking out into value creation zone (>15%) after a decade and 'corporate profit/GDP' ratio rising above the mid-cycle level of ~4%.** In 2024, the corporate profit to GDP ratio for the Nifty-500 Universe swelled to 4.8%, scaling a 15-year high. If we chronicle the corporate profit to GDP ratio, we observe that during 2003-08, the corporate profit to GDP ratio almost doubled to 5.2% from 2.7%, with Nifty-500 profits surging 30%, which was twice the pace of underlying GDP growth (at 14.5% CAGR) over the same period. This was followed by a downturn (2008-20) with compression in the Nifty-500 profit to GDP ratio to 2.1% from 5.2%. However, in the current phase (2020-24), corporate profits have recovered sharply from the lows to hit a 15-year high of 4.8% (long term average of ~4%).
3) **Capacity utilisation levels reaching an inflection point** led by capital intensive sectors.
4) **Announcement of unprecedented new hi-tech projects** (semi-conductors, data centres, EMS components, EVs, defence, space etc.)
5) **Rising wealth effect for households** with booming property sector along with rising gold prices (>90% assets held in RE and gold) and strong returns from equities (especially in mid and small caps). In fact, the trend of increased retail participation in Indian equities in recent years have been nothing short of spectacular. SIP flows into mutual funds have crossed the milestone of Rs.200bn+ per month. In FY24, ~37mn new demat accounts were added taking total demat accounts for the industry to 155mn. Our analysis of Indian household asset holdings (including physical assets) shows equity as a proportion of total asset base at only 6%, and hence, the ongoing structural story of shift to equities remains strong.

These aforementioned break-out trends in the economy have clearly resulted in a break-out in our markets with a sharp rise in risk-tolerance. For instance, India's market-cap to GDP, at 147%, is close to its GFC peak. In fact, while our share in Global GDP (~3.6%) has been growing, but our share in Global Market cap (~4.2% vs. average of 2.7%) has been growing even faster. Similarly, the Nifty Midcap 100 has been the best-performing global index after Nasdaq during the decade. Overall, valuations while not in bubble zone are clearly stretched. The Nifty-50 index is currently trading at 21x 1-year forward P/E which is broadly inline with its 5-year average valuations of 20x while the Nifty Midcap 100 and Nifty Smallcap 100 are trading at near +1SD from its 5-year average. The gap between earnings yield (4.7%) and bond yields (7%) also remains very high at 230bps vs. historical average of 180bps. With Nifty FY26 EPS of 1250, our Mar-25 target price for Nifty stands at 25,000 (20x P/E multiple) which implies a mere 3% upside from current levels, against the long-term expected returns of ~12%-14%. Overall, our sense is while markets will continue to grow, the pace of returns is likely to slow down from hereon. However, we will continue to be aggressive dip buyers given the domestic goldilocks environment. We continue to believe that large-caps offer better risk-reward than many mid and small caps.

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 continue to remain bullish on domestic cyclicals, with our overweight stance on financials, capital goods, infra and construction and metals. Post the recent run-up in autos, we have cut our stance to neutral while we continue to remain underweight on IT and consumer. The overarching theme continues to be capex over consumption. An interesting table below, which we would like to highlight – despite delivering the highest profit CAGR between FY19-FY24, the BFSI index has underperformed. This gives us significant confidence that the sector is likely to outperform going ahead.

Table 1: Nifty Market-cap vs. Profit CAGR over FY19-FY24

NIFTY	Profits (INR b)		FY19-24	Market Cap (INR b)		FY19-24
Sectors	**FY19**	**FY24**	**CAGR**	**FY19**	**FY24**	**CAGR**
Automobiles	216	625	24%	5,312	14,623	22%
BFSI	553	2,540	36%	21,862	44,263	15%
Capital Goods	86	130	9%	1,941	5,188	22%
Cement	68	134	14%	1,663	4,343	21%
Consumer	240	438	13%	10,694	18,166	11%
Healthcare	84	220	21%	2,659	7,947	24%
Logistics	44	89	15%	783	2,898	30%
Metals	407	599	8%	3,220	7,912	20%
Oil & Gas	832	1,550	13%	11,507	24,816	17%
Retail	14	35	20%	1,010	3,378	27%
Technology	753	1,055	7%	14,818	29,652	15%
Telecom	-35	113	NA	1,331	7,273	40%
Utilities	235	369	9%	2,376	5,834	20%
Others	8	35	34%	162	3,641	86%
Nifty-50	**3,507**	**7,931**	**18%**	**79,336**	**1,79,934**	**18%**
Nifty-50 Ex Metals, O&G	**2,267**	**5,782**	21%	**64,609**	**1,47,206**	18%
Nifty- 50 Ex BFSI	**2,954**	**5,391**	**13%**	**57,474**	**1,35,671**	**19%**

Source: MOSL Research

Overall, as of 30th June 2024, our flagship Sohum India Opportunities Fund has in the last one year, gained 48.24% (pre-tax), net of applicable fees. In the same period, the Nifty Index has delivered 25.13% and Nifty TRI Index has returned 26.65%. Since our inception (20th May 2022), we have delivered 83.82% returns (an outperformance of 32.1% over Nifty TRI) with average large cap holding of 80% and consequently much lower risk. **Moreover, out of the total alpha created since inception, 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 19% over FY22-25, with PE of 18.9x on FY25 and 16.2x on FY26 and ROE at 16%) 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 genuinely believe that this decade belongs to India (Amrit Kaal) and investing in India presents a once-in-lifetime opportunity akin to the Japanese Economic Miracle of the 1980s and the Asian Tigers of 1990s. We are excited about the opportunities in the coming years and remain focused on delivering super value and performance to our unit holders.

Warm Regards,

Sanjay H Parekh