Sohum India Opportunities Fund: Investor Update Newsletter, June 2023

After a roller-coaster ride of 21 months, Nifty-50 finally surpassed its all-time high and touched 19K mark in Jun'23. This was no mean feat! Nifty's journey from 18K to 19K took 425 trading days (from Oct'21-Jun'23) vs. only 30 days when it covered the journey from 17K to 18K. In our last investor letter (March 23), we had highlighted our positive stance on markets (Nifty@17,350) on the back of strong macro and earnings outlook coupled with reasonable valuations. This seemed to have played out well. So where do we stand now?

Macro: With global interest rates nearing its peak, the Indian economy continues to move from strength to strength. With consumer sentiment clocking record highs as per RBI survey, it is hard to find signals of marked slowdown in India's high frequency indicators. Credit growth, GST collections, manufacturing and services PMI, auto sales, etc all continue to flash green. Headline inflation fell to a 25-month low of 4.3% in May-23, well within the RBI comfort band of 2%-6%. After a weak start, the monsoon season has also gathered space with cumulative rainfall deficiency down to only 10% of long-term average, which bodes well for the rural economy. Higher than expected budgeted RBI surplus transfer (Rs.874bn transferred vs Rs.303bn budgeted) is likely to keep fiscal deficit in check. India's external position continues to improve with CAD shrinking to 0.2% of GDP in Q4FY23 (vs. 2% in Q3FY23) and BoP turning positive once again. As a result, forex reserves have regained a fair bit of the lost ground, up by US$65bn since the low of US$525bn in Sep-22 while domestic liquidity is back in surplus mode.

Earnings: Post-strong recovery in corporate earnings in FY22, FY23 earnings was hit by a multitude of headwinds ranging from spike in commodity costs to multi-year highs (adversely impacting corporate margins), supply chain disruptions (Covid-19 restrictions in China), global slowdown led by sharp rate hikes by global central banks and normalization of pent-up domestic consumption. For FY23, Nifty delivered an EPS growth of 11% yoy, on the back of a high base of 34% in FY22. Street is now building in mid-teens earning CAGR over FY23-25E, which looks achievable in our view.

Valuations: After reporting cumulative outflows between Oct-21 and Feb-23, FII flows have bounced back strongly in the last four months, with cumulative inflows of USD14bn over Mar-Jun'23. This in turn have propelled markets to new highs. Consequently, valuations have also moved up. With FY24 EPS of Rs.950 and FY25 EPS of Rs.1070, Nifty is currently trading at 19.5x one-year forward P/E vs. long-term average of 18.0x and last 5-year average of 21.5x. On our preferred yield-gap parameter (10-yr bond yields less 1/Nifty PE), the gap at 200bps is ~50bps above average, though rates now have downward bias. On a relative basis, India's valuation premium to MSCI Asia ex-Japan stands at 63% vs. 10-year average of 40%. ***Thus, Indian equities are not inexpensive, and we cannot rule out a 5%-7% correction in headline indices with slightly bigger correction in broader markets. However, if such a correction were to come, we would be aggressive buyers given our structurally positive view on the Indian economy.***

We also note that after almost 2 years of relentless selling, FIIs have just turned buyers. There is now a growing acknowledgement among foreign investors that with a number of structural reforms having taken place and its pain absorbed upfront, India can now repeat a China. As India moves from US$2500 GDP/capita to US$5000 GDP/capita over the coming years, many foreign investors have seen this journey take place in China. China was at US$2500 in 2007. This increase in per capita income has

tremendous consequences for both infrastructure and consumption and companies positioned for this trend can be structural beneficiaries. With this acknowledgement and with flows into China now capped, India can be a disproportionate beneficiary of foreign money among EMs in the years to come. Large foreign flows along with the fact that as India grows, both absolute domestic savings and the percentage coming into financial assets (equities in particular) will rise, could be one reason why multiples may not correct beyond a point.

Portfolio Composition & Performance

We continue to be overweight banks and underweight IT in our portfolio. The financials & IT sectors together account for c. 50% of Nifty & are key for any India portfolio. Past 14-year data shows that both move in the opposite direction 70%+ of the time. We believe that there's still a lot of room in the OWT banks / UWT IT call, given the fundamental trends & relative valuation.

The banking sector has seen strong performance in FY23 as system wide loan growth at 16% was at a multi-year high. Moreover, asset quality is benign and fast transmission of rate hikes has helped to widen NIMs. While FY24 is likely to see some NIM compression, system credit growth is expected to be strong at 12%-14% (higher for pvt sector at 18-20%), as India starts seeing a new private capex cycle (both housing and private corporate capex in upturn). We expect the banking sector to report 15% + kind of earning growth in FY24, on the back of a strong FY23 base. On the other hand, IT outsourcing demand has weakened substantially in 2023 with several tech majors reporting flat to declining revenues in 4QFY23. The outlook is weak as well with mid-single digit growth guidance and no increase in employee headcounts planned in FY24. The march quarter was the first quarter with some disappointments for IT majors. We believe that more disappointments are likely, especially in the mid-cap space. Moreover, despite weak outlook, IT companies' valuations are still above the historical averages while nifty bank is trading almost at long term average level (despite decadal high RoEs).

In addition to financials, our other key OWTS are autos, capital goods and telecom. Both Centre and State government budgets show that India is heading into a construction overdrive led by unprecedented infrastructure spend and a thrust on domestic manufacturing. While the Central govt.'s capex has been on an upcycle, the State governments capex has also picked up in recent times and the private sector is not holding back either, with corporate capex announcements reaching an all-time high in FY23. We are playing this theme through the capital goods sector. Our constructive stance on the auto sector is underpinned by a pickup in auto volumes in the two years after a significant lull period, government thrust on electric mobility and continued trend of premiumization across the industry.

Overall, as of 30th June 2023, our flagship Sohum India Opportunities Fund has since its inception (20th May 2022), gained 24% (pre-tax), net of applicable fees. In the same period, the NSE 50 Index has delivered 17.97% and NSE 50TRI Index has returned 19.78%. While the last three months have been quite upbeat with a broad-based market rally, we are cognizant of not getting carried away. Our approach remains the same – buying fundamentally strong companies which are available at reasonable valuations relative to their growth (GARP). Also selectively, we have increased our exposure to mid/small cap in last quarter, but our threshold of returns is much higher than large cap to qualify an entry in our portfolio (As of 30th June – 73.3% is large cap, 23.2% in mid/small cap & 3.5% cash). Also, last but not the least, for us managing risk - through our stock selection process and portfolio construction - is as important as creating alpha over longer term.

Warm Regards,

Sanjay H Parekh