Sohum India Opportunities Fund: Investor Update Newsletter, March 2023

"There are decades where nothing happens; and there are weeks where decades happen" – Lenin. The start of 2023 has been an eventful one. We have seen a flight of deposits from the US banking system and consequently the failure of two US banks, even as the Fed has continued to tighten monetary policy. In Europe too, we have seen the bailout of one large bank by another. Similarly, India has quickly moved from being one of the best performing equity markets last year to one of the worst performing markets so far this year with the Nifty index down[1] 8% from its Dec-22 peak.

We believe that the recent correction in Indian equities provides an excellent opportunity for long-term investors to play the India growth story. As we have been repeatedly highlighting, the Indian economy is at inflection point with all balance sheets – household, corporate, banks, government and external, being the strongest it has been in a decade. For instance, households in India are not over-leveraged like their counterparts in other EM and DM economies. Similarly, corporate profits to GDP after slumping to less than 2% in FY20 from its peak of 7% in FY08, has once again started to inch up (FY22 at 4.5%). PSU banks have seen their GNPA ratio decline from a peak of 14.6% in Mar-18 to 5.5% in Dec-22. Buoyant tax collections have helped in swift post-pandemic fiscal consolidation while services exports surplus is now handsomely exceeding the oil deficit, making a favourable case for India's external position.

A cyclically strong balance sheet of all stakeholders combined with structural positives like demographics, able political leadership, digitization and formalization of the economy, food security, energy security, etc means that the Indian economy looks set to grow strongly in this decade. With nominal GDP growth of 10%-12%, earnings growth can easily compound at 12%-15% for the index. In fact, if we look at the last 20 years, Indian markets have generated superior returns than all major markets (Table 1) and we expect the trend to continue into the foreseeable future.

Table 1: Outperformance of India over other global markets

	20 year Total Returns	CAGR Returns
Nifty Index	12.6x	13.9%
S&P 500 Index	5.9x	10.1%
MSCI Emerging Markets Index	5.0x	9.4%
FTSE 100 Index	2.3x	6.2%
Nikkei Index	3.4x	7.7%
MSCI China Index	6.9x	10.9%

Source: Bloomberg. Note: All returns in USD terms.

With visibility on earnings growth, the only chink in the armour for Indian equities has been valuations, which now stands corrected. Nifty is -8% from Dec-22 peak and flattish over the past 19 months. The valuation (1-yr fwd. consensus PE) has declined 30% from Oct21 peak, almost matching the 35% PE

[1] All prices as of 31st March, 2023

contraction during the 2011 tightening cycle when repo rates went up by 375bps (vs. 250bps this cycle). Consequently, valuations are now broadly in line with the long-term average of 18.0x and below 5-year average of 21.5x. On our preferred yield-gap parameter (10-yr bond yields less 1/Nifty PE), the gap at 180bps is still ~30bps above average, though rates now have downward bias. Relative valuations are also better now. With India being the worst performing market in the Asia region and across key markets globally in 1Q23, India's valuation premium to MSCI Asia ex-Japan has halved from a record peak of 96% to 45% and is now only slightly above its 10-year average of 40%. Given the above, we feel risk-return is now quite favourable with bulk of the price correction over. At the most, we may have some more time correction. We are quite positive on markets and believe that with FY24 EPS of 950 and FY25 EPS of 1070, the market has the potential to climb to 19,500-20,000 in the next 12 months, generating mid-teen returns.

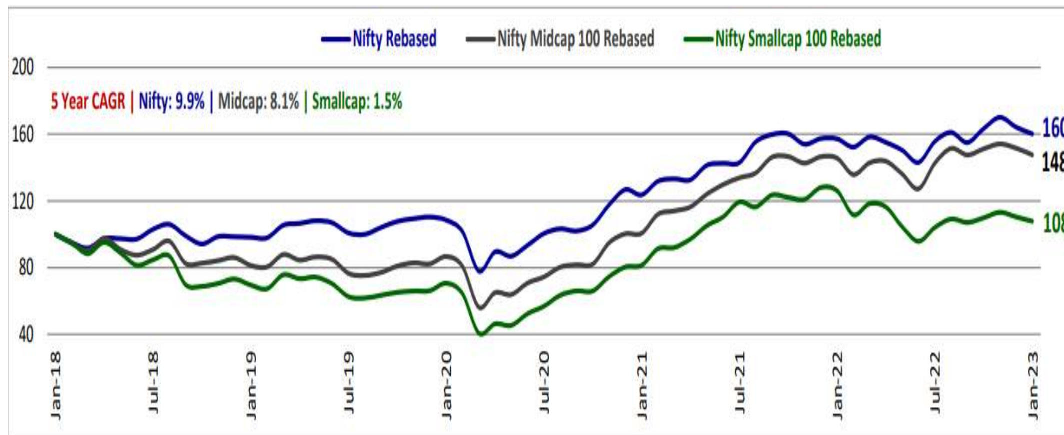
Portfolio Composition & Performance

In the period prior to Covid, when the Indian economy was slowing down (i.e between FY13-FY20) we saw that private consumption was the main driver of domestic growth while capex growth was extremely weak. However, in the last two years post covid, we have seen growth in gross fixed capital formation (GFCF) exceeding private consumption. In fact, in Q3FY23, private consumption growth slowed down to 2% yoy while GFCF registered a healthy growth of 8% yoy. We believe that India's domestic capex cycle and credit cycle are at a nascent stage of recovery coinciding with the decadal bottom of the NPA cycle and PAT/GDP at a decadal high of 4.5%. The real estate upcycle is likely to be one of the key contributors to the overall capex cycle. Moreover, manufacturing activity has flourished during capex upcycle in the past and is likely to be augmented by the policy initiatives of the government in the form of PLI schemes for various sectors. We have accordingly positioned ourselves to play these themes with overweight positions across domestic cyclicals - banks, capital goods, real estate and construction materials and underweight positions across IT and consumer staples/discretionary.

In the last couple of months, Indian financials have borne the rub-off effect of global dislocations. However, we believe that they are far better placed than their global counterparts given strong levels of capital adequacy, granular deposit franchise (higher share of retail deposits), limited ALM gap and MTM, limited dependence on AT-1 bonds and lower exposure to riskier segments like promoter/acquisition finance. We have therefore used the recent correction in stock prices to add to our existing positions in banks as their fundamentals continue to remain strong (credit growth, NIMs and credit costs are all in sync) and valuations have become further attractive. At the same time, we have cut our exposure to the insurance sector post the recent adverse regulatory developments announced in the Union Budget.

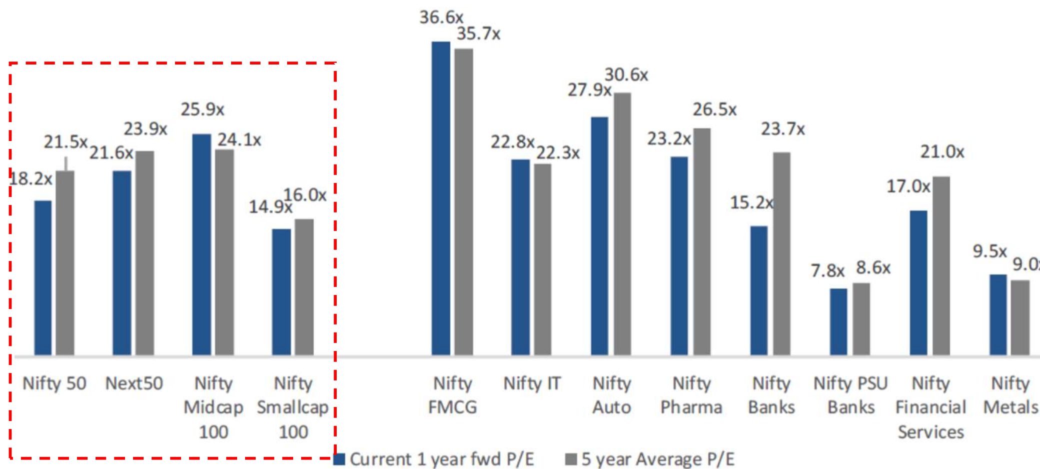
Additionally, we continue to follow a predominantly large cap strategy at this juncture with 80% of our portfolio invested in largecaps, 10% in midcaps and 7% in smallcaps. Since covid, we have seen significant outperformance of small-caps/mid-caps over large-caps led by low cost of capital, abundant liquidity and sharp increase in direct retail participation. However, if we take a slightly longer timeframe, such as 5 years, then we observe that large caps have generated better returns (Chart 1). Moreover, given the current macro environment - tight global and domestic liquidity conditions, elevated cost of capital and still expensive valuations (Chart 2), we believe it is prudent to be selective in the small and midcap space and we would always seek higher threshold of returns than large caps for the higher risk in mid & small cap stocks.

Chart 1: Large caps have outperformed midcaps and small caps over the last 5 years



Source: MOSL Research

Chart 2: Midcap valuations are still frothy compared to large caps



Source: HTI Research

Overall, as of 31st March 2023, our flagship Sohum India Opportunities Fund has since its inception (23rd May 2022), gained 8.1% (pre-tax), net of applicable fees. In the same period, the NSE 50 Index has delivered 6.72% and NSE 50TRI Index has returned 7.85%. While the last few months have been tough for our markets, we remain fairly confident about our strategy to focus on companies with strong fundamentals which are reasonably valued relative to their growth and avoiding large concentrated bets. This should help us generate superior returns over our benchmark in the medium-term, whilst staying in lower risk territory.

As a wise investor says:

"The biggest risk in investing is not market volatility, but our own behaviour. We have to be disciplined and stick to our long-term plan, even when things get tough".

Warm Regards,

Sanjay H Parekh