S
SOHUM
ASSET MANAGERS

Letter to Investors: The Year That Was!

What a year 2022 has been! Who would have thought that in a year where the S&P was down 19.4%, MSCI EM was down 22.4% and brent crude remained above US$100/bbl for six consecutive months, the Nifty would have delivered such a staggering outperformance with positive returns for the 7th consecutive year. Or that the Nifty PSU bank index would be the best-performing sectoral index in 2022 or the top Nifty gainers would be the much-hated anti-ESG stocks like ITC and Coal India.

The biggest lesson one can draw from these events is that investment strategies cannot be strait-jacketed - *I will buy only quality companies at any prices, never buy PSU stocks, never buy commodity stocks, etc.* Strategies that may have done well in the past may not necessarily be the best strategies for the future. Thus, as investors, we should not fall for narratives, but rather focus on sectors/stocks with high earnings visibility for the next 2-3 years and the price that we are paying for those earnings. This remains our core philosophy and with this backdrop, our **flagship Sohum India Opportunities Fund has since its inception (23rd May 2022), gained 15.08% (pre-tax), net of applicable fees. In the same period, the NSE 50 Index has returned 12.38%, including reinvested dividends.**

As we enter CY2023, once again, the three factors that are likely to determine market direction and returns are a) macro environment, b) earnings trajectory and c) valuations.

Macro environment: While there remains downside risks to global growth, India's growth is likely to be relatively resilient, with inflation having peaked and interest rates close to peaking. We remain confident on domestic growth as three key balance sheets – Household, Corporate & Banking Balance sheets remain the strongest it has been in a decade. In addition, government balance sheet has seen a swift pace of consolidation post Covid thanks to buoyant tax collections. The only area of concern remains the external balance sheet since we are currently running a current account deficit of approx. US$100-120bn and financing such a large deficit amid a tight global liquidity environment could be a challenge. This in turn has implications for INR and domestic liquidity and remains a key monitorable.

Earnings trajectory: The trend of upgrades seen during 2021, gave way to downgrades with earnings for FY23 cut ~5% since the start of the fiscal year (Apr'22). For FY24, Nifty earnings growth are projected by consensus to increase by 15%, improving from a downgrade hit ~13% earnings growth in FY23. A 15% growth, if it transpires, is very healthy, given where the rest of the world finds itself. Moreover, with continued cyclical improvement in domestic economy and an improved margin confidence on easing cost pressures, we believe earnings downgrades are unlikely for FY24 (Nifty EPS – FY23-25 at 830-950-1070).

Valuations: Nifty trades (18105) at 19x one-year forward earnings, which is 1-standard deviation above its long-term mean, while India premium over MSCI EM has risen to a whopping 75% from its historical average of 40%. Additionally, with the 10-year Gsec yield at 7.3% compared to Nifty earnings yield of 5.3%, the yield gap is currently ~100bps above its 1ppt long-term average. Thus, the market is definitely not cheap by historical standards. ***However, given our positive view on India's household and corporate balance sheet, we believe a longer-term foundation for higher economic and earnings growth is being laid. As such, we would be buyers in next 3-5% fall, particularly for the domestic economy focussed companies.***

Portfolio Composition

Our portfolio continues to be oriented towards domestic facing cyclical stocks with our key OWTs being financials, real estate and construction material. A strong performance by banking stocks in 2022 begets the question as to how much further upside can be expected in 2023. For 2022, a combination of factors – strong loan growth, NIM expansion and low credit costs – led to consistent earnings

upgrades which helped drive stock valuations higher. For 2023, we expect loan growth to remain strong and credit costs to be benign. NIMs could be a tale of two halves – stable to improving in H1CY23 but funding costs driving them down in H2CY23. On net basis, we still expect consensus earnings upgrades, as credit costs are likely to remain low. While stocks have moved higher, in many cases valuations are still at or below mean which provide room for further upside.

We also remain overweight on plays related to domestic manufacturing and construction. We believe that India is heading into a construction overdrive led by uptick in housing and unprecedented infrastructure spend (particularly with General elections around the corner). We are confident of a multi-year housing cycle - i) rural housing uptick led by PMAY Grameen allocation, and ii) urban housing, which has decadal low inventory and improved affordability. This is likely to be strongly supported by an increase in infrastructure investments (highways, metro projects, freight corridors, airports and railways) backed by government capex. We are playing this theme through exposure to real estate, construction material and capital goods.

Incrementally, we have increased our exposure to metals as China has started to ease its Covid policy and support its ailing property sector. We believe worst-margin quarter for Indian steel companies, and the big chunk of earnings cuts are now behind. Moreover, balance sheets are in a far better shape due to continued deleveraging.

As we highlighted above, investment strategies cannot be straight-jacketed, and investors should be willing to learn and adapt. While 2021 was the year of euphoria for new-age internet companies, 2022 turned out to be a year of extreme despondency for these stocks. These stocks continue to attract peak pessimism and herein lies the opportunity in our view. We have recently added two internet stocks to our portfolio which have dominant market share in their respective businesses, where path to profitability is near and clearly established and where the valuation froth has disappeared.

Our largest UWT position continues to be IT as we see potential for negative surprises across the board on revenues led by higher furloughs and pressure on the existing book of business. This should lead to further contraction in P/E multiples which still remain above historical averages for the sector as a whole. We also are UW on Oil & Gas sector.

To conclude, we remain optimistic about the India growth story (read – LONG India) but at the same time are cognizant of the fact that the global economy will continue to be turbulent and could have potential spill-over impacts on the Indian economy. *Thus, we recommend buying the dips.*

We would once again like to thank all our early investors for supporting Sohum in its journey so far. Our primary goal continues to be to **preservation of capital, deliver superior investment results with risk under control, not to overpay for growth; avoid errors to extent possible**. While we currently have a large cap bias (*83% in large cap, 14% in mid-small cap, 3% cash levels*), we continue to closely review ideas in the mid/small cap space, wherein a necessary condition is attractive price value gap in addition to good business character & comfort with management.

Our mission at Sohum is to conduct ourselves with integrity, be compliant and being fair & transparent with our unit holders. We wish you a very Happy New Year and hope for your continued and lasting partnership in the coming times.

Warm Regards,

Sanjay H Parekh