Built by investors for investors

PMS NEWSLETTER | DEC - 2021

Moats & Special Situations Portfolio

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Date: 6 Jan 2022

Dear Investors,

Below is the performance of the Moats & Special Situations Portfolio (M&SSP) as of 31 Dec 2021.

Portfolio Performance [1]	Equity Allocation	Total Portfolio Returns	Benchmark Returns
Since Inception (annualised)		14.9%	13.1%
Dec 2021 Quarter	71%	-2.7%	-0.6%
Apr-Dec 2021		8.6%	23.6%

During the quarter Indian equity market witnessed a small correction. This was despite US Markets making new highs. But even post the recent correction broader market valuation remains elevated. Foreign Institutional Investors (FIIs) have been aggressive sellers during the quarter with around 1 Lakh crore selling in equities, which is higher than what we saw during Feb-April 2020 Covid-19 panic. The US Federal Reserve has taken the first step to reduce the post Covid-19 easy money policy by tapering the bond buying program. They have also hinted at bringing forward the interest rate hike cycle than what was expected earlier. This in response to persistent inflationary pressures witnessed over the last one year. Another cause of concern for the market has been the Omicron variant which is more transmissible but relatively milder than earlier variants hitherto. These two factors may have been the trigger for the recent correction, but we believe elevated valuations are breeding grounds for such triggers.

Our portfolio performance during the recent correction has been disappointing. While it's natural for a quality and value conscious strategy like MSSP to underperform in a frothy market, the underperformance is generally compensated, we believe, by outperformance when the excesses in the market correct. The outperformance comes through far lower correction vs the market. But our portfolios performance in the recent correction has not showcased this pattern. During the quarter our portfolio witnessed a drawdown (Peak to intermediate trough) of -9% vs the Benchmark drawdown of -11% and NIFTY -10%. Despite having a relatively better estimated price to fair value portfolio, at least in this phase of the decline that factor did not assist much in restricting our drawdown. It would be too early to say whether we have witnessed the full correction, as valuations in our estimate continue to remain substantially elevated. More importantly, valuations have not corrected within stocks/sectors that were witnessing valuation excesses. On the contrary, pockets of value have corrected further leading to a wider gap between overvalued vs undervalued segments of the market.

One such segment of the market is "Financials" where we have the largest exposure and are relatively overweight within the invested portion (i.e. excluding cash). This exposure has dragged our overall performance recently, but we feel this is one segment of the market where good quality businesses within the sector are available at attractive valuations. It is rare to find good quality businesses at attractive valuation in a relatively frothy market and is most likely due to certain concerns of the market with regards to outlook for the sector.

[1] Benchmark is an average of the BSE 500 and BSE Mid Cap index. Benchmark Performance is calculated using Total Return Indices. Equity allocation mentioned above is for older accounts. The above returns are consolidated for all clients, time weighted and post management and performance expenses. The actual returns of clients may differ from client to client due to different portfolio and timing of investment. Past performance is no guarantee for future performance. Inception Date is 27th January 2011.

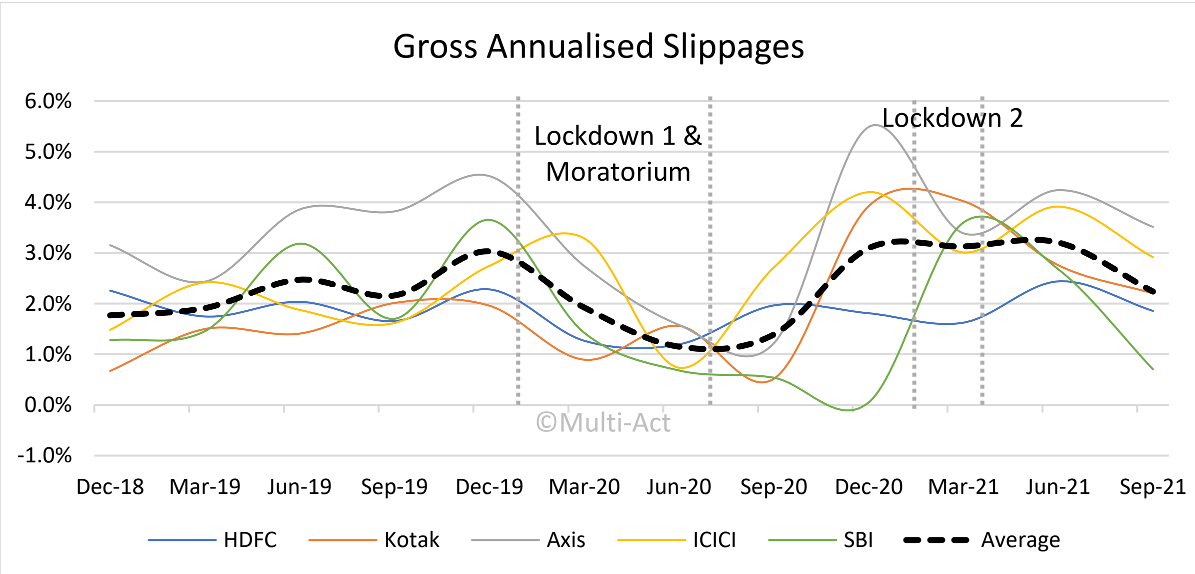
As can be seen from the adjoining table, Bank Nifty has witnessed major underperformance vs the market. The sector has been specifically out of favour post the Covid pandemic. In the following paragraphs, we will try to take you through the various concerns of the market regarding financials and why we continue to believe that they offer reasonable value currently.

	Bank NIFTY	NIFTY
3 Month	-5.2%	-1.5%
6 Month	2.0%	10.4%
1 Year	13.5%	24.1%
3 Year	9.3%	16.9%

1. <u>Asset Quality</u>

Our economy has gone through two major Covid-19 waves which not only had impact on human lives, but also had an impact on livelihood and economic activity. Investors have been worried about the impact of this once in a century crisis on asset quality (i.e. Non-Performing Assets) of Banks and NBFCs.

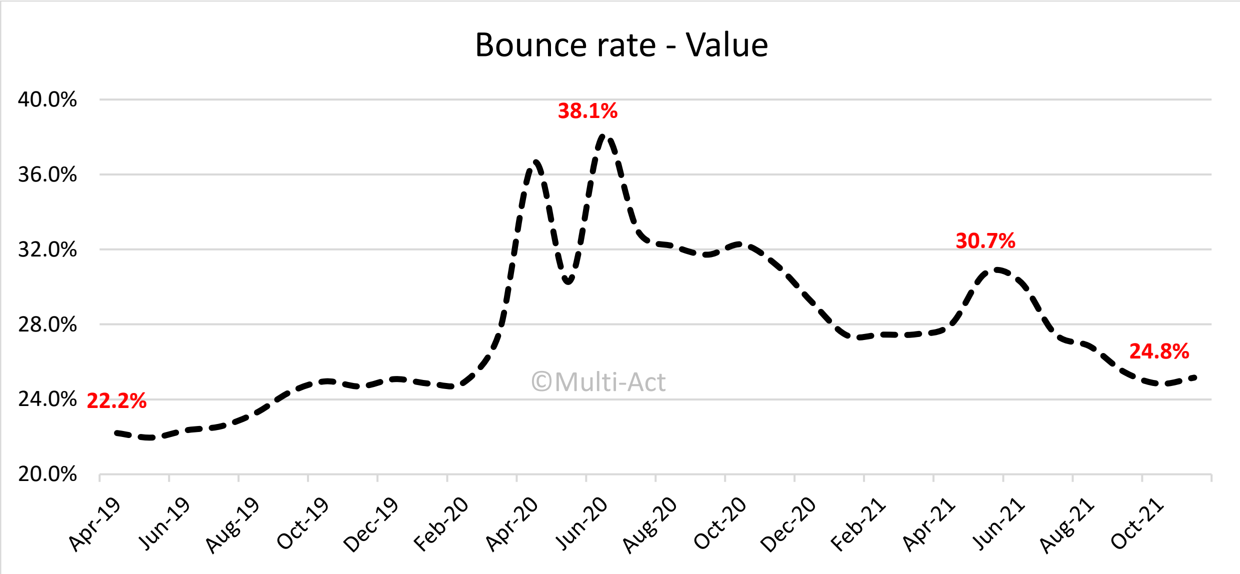
While banks did see slightly higher credit costs due to higher provisioning and slippages, most of the banks displayed resilience in their collection efforts and curtailing slippages closer to reasonable levels in context of the disruption.



Slippage represents the % of Assets that turned into NPAs during the quarter. Slippages give a better picture of flow of NPAs. There was dip in slippages during Jun & Sep 2020 Quarters due to Moratorium. But the bunched-up slippages were reflected in the December 2020 Quarter.

As can be seen from the chart, despite facing two back-to-back years of lockdowns and Covid-19 waves, the banks have been able to maintain their asset quality. Annualised slippage number for most banks as of September 2021 was not materially different than the pre-covid period. The resilience of the banking system can be attributed to 1. Most of the corporate stress had already been recognized by the banking sector in the preceding years, thus there wasn't any incremental stress that came out of the corporate book and 2. Salaried customer base was relatively resilient and less impacted by the lockdowns. The self-employed and MSME customers were provided liquidity relief through moratorium and ECLGS scheme to help them sustain through the first lockdown. During second lockdown, the only relief available was in Restructuring 2.0. Restructured assets have increased post second wave (average ~1% of total advances); but is mainly in retail accounts as opposed to the chunky corporate restructuring in the past.

Another data that suggests normalization of asset quality is bounce rate. The bounce rate data is also back to pre-Covid levels suggesting improvement in credit behavior.

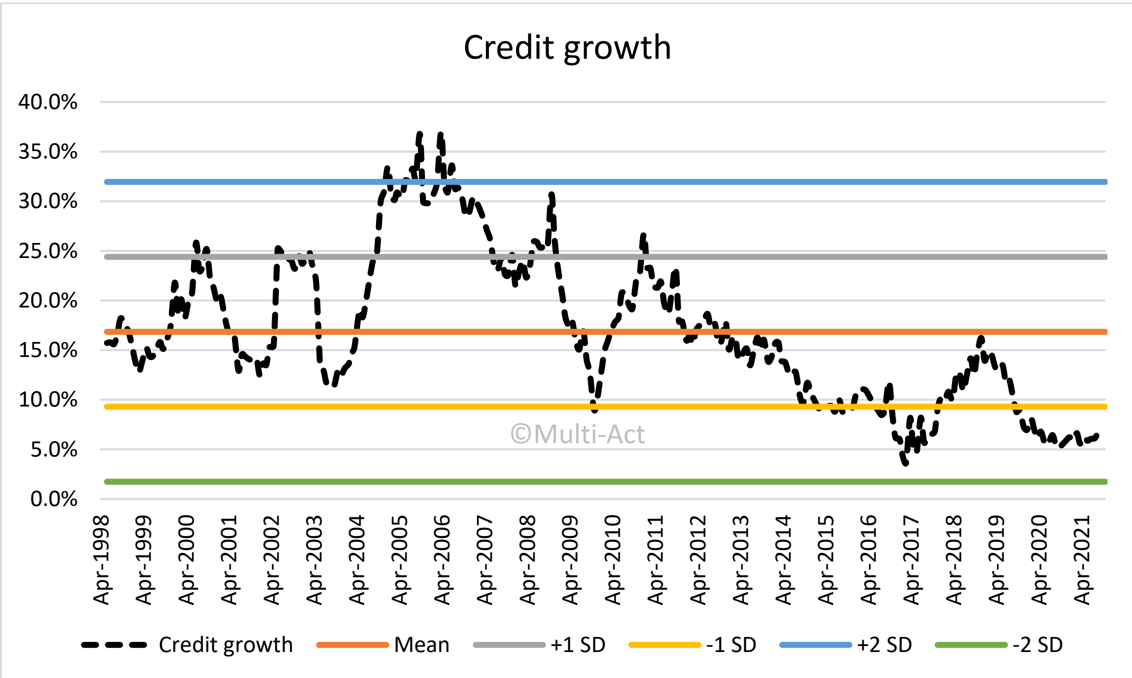


Bounce rate is a ratio of debit ECS mandates that were returned(unsuccessful) out of debit ECS mandates that were presented for payment across banking system.

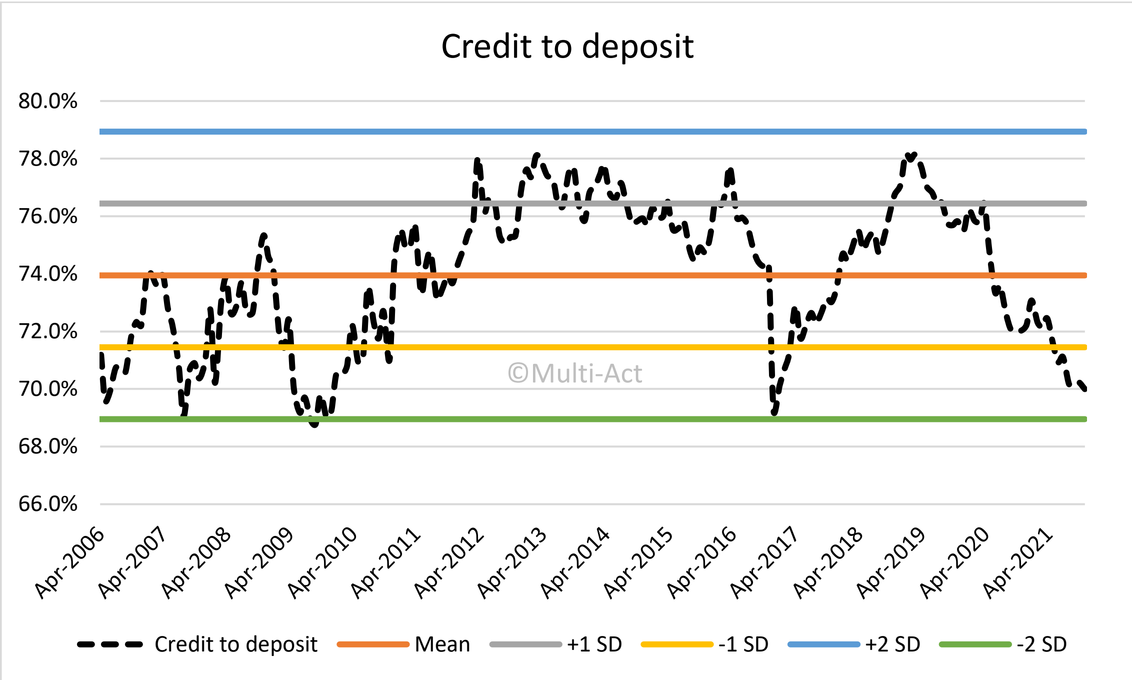
Healthy asset quality performance during period of stress and improving bounce rates and collection efficiency gives us comfort that the worst for the sector in terms of Asset Quality could be behind.

2. <u>Growth</u>

Another concern of investors has been tapering of growth for the sector. Let us first have a look at two long term charts: i. Long term credit growth and ii. Long term credit to deposit ratio.



Long term average credit growth in India has been ~16.8%. Current credit growth (6.9%) is below -1 Standard Deviation levels of 9.3%. After bottoming out in April-17, credit growth had started to pick up and touched mean credit growth levels by Nov 2018. However, credit growth was hit post IL&FS crisis and due to Covid-19 for last two years. Credit growth is also very closely associated with growth in GDP, and we have had virtually two years of flat GDP growth. Another factor has been Balance Sheet deleveraging by large corporates. Repayments by large corporates has further masked the reported credit growth. As economic activity picks up, we believe credit growth should pick up and start inching towards longer term average growth rate.



Credit to deposit ratio in India generally oscillates between ~70% to 78%. Since covid struck in March 20, deposits in banking system have grown by 16.9% while credit growth has been merely 7.1%. Currently credit to deposit ratio is at 70% (between -2SD & -1SD). The capital adequacy ratio of most banks is at comfortable level. Comfortable capital adequacy and credit to deposit ratio indicates enough room to accelerate the credit growth.

The ability to grow is also being complemented by intention of managements to grow:

<u>HDFC Bank's Srinivasan Vaidyanathan</u>- The bank is operating and is poised to capture significant growth opportunities. Key enablers are very well lined up for execution of our strategy. The growth momentum that has already started, which is put in motion shows great early results.
<u>Kotak Bank's Uday Kotak</u>- We have seen our growth engine August, September and into the festive season, begin to show significant traction, more than we have seen probably in the last couple of years. We are coming into this with the confidence of a very solid, high-quality low credit cost and a relatively low restructured book, combined with a very strong liability franchise, which we are now nearly close to 61% on current and savings account. Therefore, we come into this with greater capacity with a significant ability to grow off a relatively small base of our bank. And we also come on the back of a significantly higher confidence in the quality of our existing book, whether restructured or not.

With the long term as well as short term indicators hinting towards bottoming out of credit cycle and possible credit growth, we believe banks with adequate capital adequacy and low cost of funds advantage should be in a better position to capitalize on this growth.

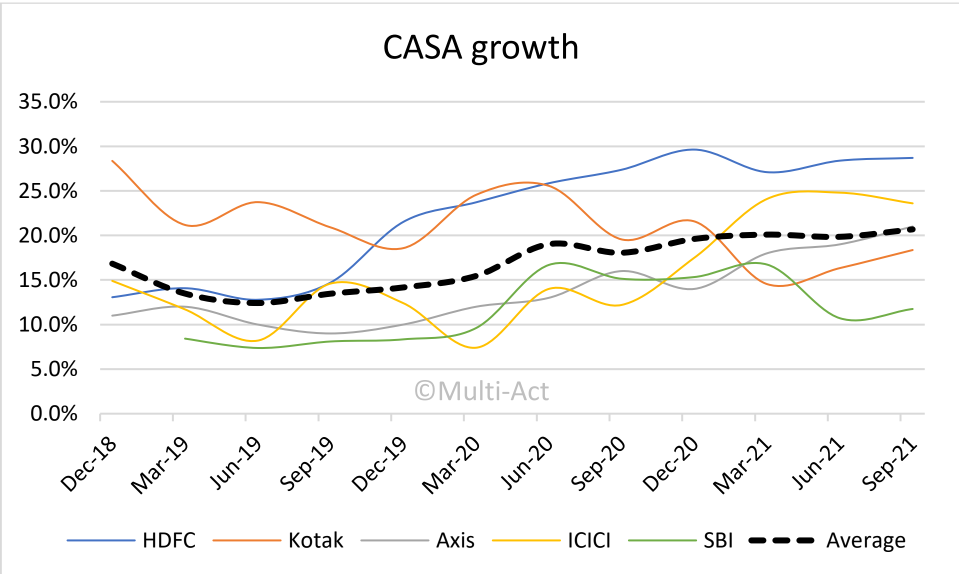
3. Disruption from Fintechs / BNPL

The third concern, which is slightly longer term in nature is with regards to potential disruption of traditional Banking by Fintechs and other Buy now pay later (BNPL) firms. We have tried to understand the business models of these fintech firms in terms of target market, cost advantage, lending prowess, cost of customer acquisition, right to win, etc. Their business models could be summarized in two broad heads: -

i. Some of these companies are being complementary to traditional financial institutions. These companies are merely providers of user-friendly interface to customers, they source business for the banks and the ultimate lending is done by banks i.e. loans sit on bank's balance sheet.
ii. Where these companies are lending from their own balance sheet- we have observed that majority of the customer base is below prime (i.e. poor credit profile). This we believe is the case as Fintechs do not have a right to win (low cost of funds advantage) in prime segment lending that the banks already serve and hence to meet their cost of capital (which is high as it is mainly equity funded) they must lend down the quality curve.

While these were concerns, which in our view are temporary in nature and already turning better, the market seems to be ignoring some of the positives

1. The IL&FS Crisis had a dual impact of reducing competitive pressure from NBFCs and also improving deposit traction for Banks. Most banks witnessed good flow into deposits including in Low cost Savings and Current account deposits



2. The general perception post tax rate reduction in September 2019 from 34% to 25% was that the benefits would be passed on to customers. If the banks would have passed on the benefit to customers, it would have led to a drop in pre-provisioning operating profits. In the below table for example, we present data

for of HDFC Bank with 8 quarters average ROA pre tax rate change against 8 quarters average ROA post tax rate change. **We have used HDFC Bank as an example as the bank has not raised any capital during covid period (capital raise inflates NIMs due to lower leverage and assets being financed by equity).*

Particulars	**Pre-tax rate change**	**Post tax rate change**
Effective average tax rate	33.9%	25.2%
As a % of total assets (annualized)		
Pre-provisioning Operating Profit	3.4%	3.5%
Provisions and Contingencies	0.7%	1.0%
PBT	2.8%	2.5%
Tax	0.9%	0.6%
Profit After Tax (ROA)	1.8%	1.9%

As can be seen from the table above, there has been no contraction in pre-provisioning operating profit as a % of total assets, indicating that bank has not passed on the advantage of tax rate reduction to customers. Also, HDFC Bank's ROAs have expanded despite pre-tax profits being under pressure due to higher credit cost during Covid impacted quarters. Had the credit cost being around historical average of 0.6%, expansion in ROA would have been even greater.

So, while there are concerns surrounding asset quality, growth, and disruption; banks have also had their share of positives in terms of CASA growth, tax rate reduction, etc. the benefits of which are still not fully reflected in the numbers due to covid-related disruption over last 2 years. The sector has clearly underperformed and has also hurt our relative performance. But most stocks in the sector are available at attractive valuation and offer good prospective returns from a 2-3 years perspective. Our portfolio is positioned to capitalize on this opportunity should the market factor these positives.

Asset Allocation

Our overall equity weight stands at around 71% for older accounts (Excluding arbitrage position). For new accounts our initial weight has gone up meaningfully from ~25% by end of September to ~55% as some of our existing ideas came back to reasonable valuation to add/increase weight in new accounts.

Portfolio Activity

Business Model Allocation	Mar-21	Jun-21	Sep-21	Dec-21
Moat	19%	22%	25%	24%
Limited Moat	49%	44%	42%	43%
Moat + Limited Moats	***68%***	***66%***	***67%***	***67%***
Special Situations	28%	30%	28%	29%
Regulated Utility	4%	4%	5%	4%
Grand Total	**100%**	**100%**	**100%**	**100%**

Sector Allocation	Mar-21	Jun-21	Sep-21	Dec-21
Financials	28%	29%	29%	29%
FMCG	21%	22%	20%	19%
Financial Services	9%	9%	10%	11%
Information Technology	7%	10%	8%	9%
Real Estate & Infrastructure	3%	7%	7%	8%
Auto & Auto Ancillaries	6%	7%	6%	8%
Capital Goods	2%	2%	6%	6%
Utility	7%	5%	5%	4%
Pharma	7%	5%	5%	4%
Materials	10%	4%	4%	3%
Grand Total	**100%**	**100%**	**100%**	**100%**

Portfolio Activity during the Quarter

We added a NBFC engaged in the Credit Card business. We like the segment since the category is underpenetrated which provides long term growth tailwind to this segment. The Parent of the company has a large untapped captive customer base which ensures long term visibility without compromising on quality of customers. Recently the stock had corrected due to RBI announcement regarding a discussion paper to evaluate charges within the payments ecosystem including Credit Cards. The concern of the market is regarding a potential reduction in Merchant Discount Rate (MDR, which is charged by Credit Card issuing company to the merchant where the Card is used). RBI has not intervened on MDR charges for Credit Cards in the past, since there is an element of Credit risk that the card issuer is taking which is also factored in the MDR charges. Thus, it’s not a pure payment related charge. Even if there is any cap that is introduced on MDR charges, it would likely be marginal and there are levers within the P&L (reduction in reward points) to absorb such changes.

Regards,

Rohan Samant	Rohan Advant	Akshat Hariya
CIO	**Sr. PM & Associate Director**	**Research Analyst**

Statutory Details: Portfolio Manager – Multi-Act Equity Consultancy Private Limited (Registration No. INP000002965)

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Note:
1. All cash holdings and investments in liquid funds, is considered for calculating the performance.
2. All performance data are reported net of all fees and all expenses (including taxes).
3. The above performance numbers are not verified by the SEBI

Disclosure as per Global Investment Performance Standards (GIPS®) –

Multi-Act Equity Consultancy Pvt. Ltd. claims compliance with the Global Investment Performance Standards (GIPS®). You can refer to the GIPS Compliant performance presentation here. Multi-Act Equity Consultancy Pvt. Ltd. has been independently verified by M/s. M. P. Chitale & Co., Chartered Accountants for the periods April 1, 2011 through March 31, 2019. The verification is available upon request. MAECL has claimed GIPS compliance for the Financial Year 2021 and such performance numbers shall be made available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

The Composite representing the Moats and Special Situations portfolio was created on 27th January 2011. Performance has been compared with Total Return of the Index. For Moats & Special Situations Composite, blended benchmark of BSE 500 (50% weight) and BSE Mid Cap Index (50% weight) has been used. The Gross Return is before all expenses (except Brokerage). Net Return is after all actual expenses. A complete list of composite descriptions, policies for valuing portfolios and calculating performance fees are available on request.

Multi-Act Equity Consultancy Pvt. Ltd. is an independent SEBI registered Portfolio Manager. The firm maintains a complete list and description of composites, which is available upon request. This MSSP Composite includes all discretionary fee paying portfolios that are being managed with the objective of generating capital appreciation by investing in companies that in the opinion of the Portfolio Manager are of high quality Moat or Limited Moat businesses at fair value or discount to fair value OR in Non Moat businesses at deep discount to fair value as special situations. The portfolio manager has also the discretion of not being fully invested if he is not able to find ideas that meet the above criteria along with valuation criteria, thus, indirectly taking an asset allocation call between Equity and Cash (& Cash Equivalents).

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General risk factors

a. Securities investments are subject to market risks and there is no assurance or guarantee that the objective of the investments will be achieved.
b. Past performance of the Portfolio Manager or its affiliates does not indicate its future performance.
c. Investors are not being offered any guaranteed or assured returns i.e. either of principal or appreciation on the Portfolio.
d. As with any investment in securities, value of the Client's Portfolio can go up or down depending on the factors and forces affecting the capital market.
e. The Portfolio Manager is neither responsible nor liable for any losses resulting from the operations of the Portfolios.
f. The investments made are subject to external risks such as war, natural calamities, and policy changes of local / international markets which affect stock markets.
g. The Portfolio Manager has renewed SEBI PMS registration effective December 04, 2020 and has commenced its portfolio management activities with effect from January 2011. However, the Portfolio Manager has more than 10 years of experience in managing its own funds invested in the domestic market.

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