Built by investors for investors

PMS NEWSLETTER – June 2020

Moats & Special Situations Portfolio

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Dear Investors,

Below is the performance of the Moats & Special Situations Portfolio (M&SSP) as of 30th June 2020.

Portfolio Performance	Equity Allocation as on 30-06-20	Total Portfolio Returns	Benchmark Returns
Since Inception (annualised)		12.8%	7.9%
June 2020 Quarter	81.0%	20.7%	22.5%

- 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.

Sentiment has quickly moved from despair to hope in the last 3 months. There has been a sharp recovery in the market assuming that the worst in terms of the lockdown and its impact is behind us. And since most global economies are opening up and economic activity getting back to some extent, there has been a broader improvement in sentiment from global funds flow perspective.

Are we out of the woods?

Healthcare situation: Europe certainly seems to have passed the peak in terms of Covid-19 cases. US also seemed to have peaked a while back but is witnessing a second wave. Though mortality rate in US has gone down. New cases in India do not seem to have peaked out. And all timelines indicated in the past (of peak cases) have been exceeded so far. Vaccine, which is the long-term solution to this crisis, seems some time away. Drugs like Remdesivir and Dexamethasone have shown initial promise in terms of recovery time and reduced mortality, but the overall efficacy is still uncertain. Most countries including India are easing lock downs irrespective of whether the number of cases is under control or not. As the economic damage of an extended lockdown would be far severe than the crisis at hand, this has increased the risk of a second wave.

The Economy: The estimates regarding damage on the global economy have just started to come out. But the true picture would be clear only over the next few quarters. We looked at the World Bank GDP estimates as of January for Calendar Year 2020 and 2021 and the revised estimates as of June. Since CY 2020 would be a washout, it is better to look at compounded growth for CY20+CY21 to assess the real damage. Below chart shows the extent of estimated economic damage over the next two years.

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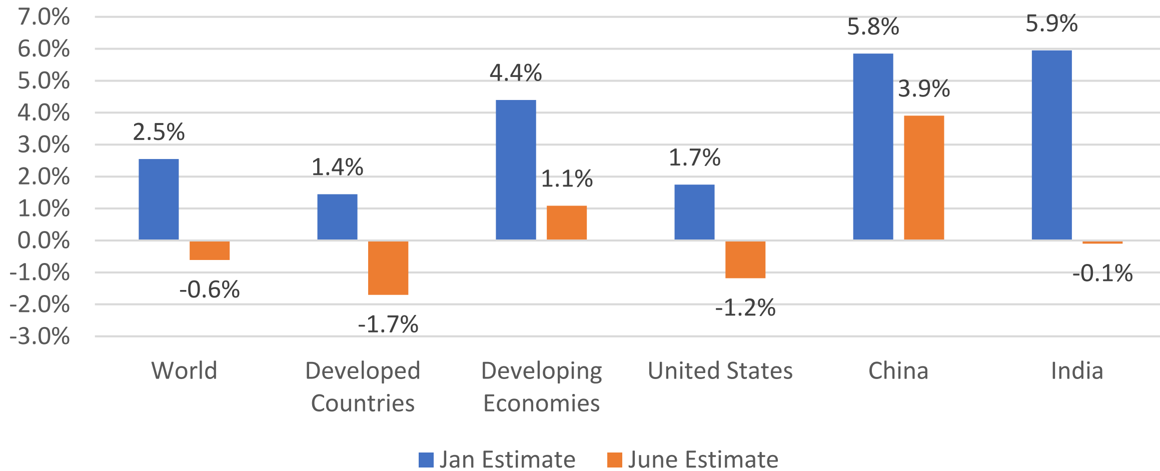
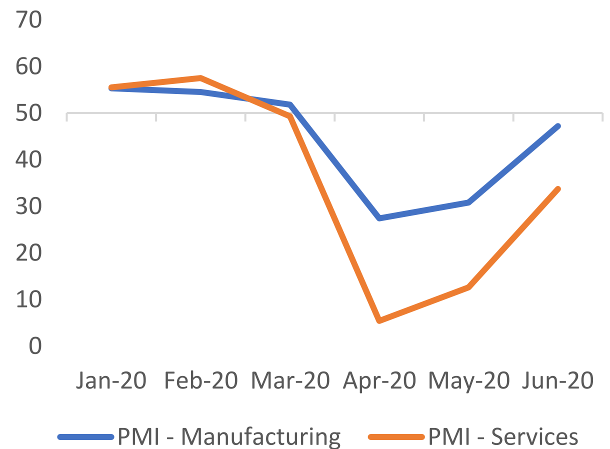


With 2 years of growth lost, the extent of the estimated damage on the Indian Economy seems to be far severe than other economies in terms of revised estimates. The reason being, lockdown in India has been far stricter than most countries. While the success of the prolonged lockdown in terms of restricting the total cases is unknowable, the economic damage has been real. With easing of restrictions, economic activity has bounced back to some extent. Manufacturing and Services PMI have bounced back from the April lows but still away from the index point of 50, which demarcates expansion (above 50) vs contraction (below 50).



Commentary of corporate India has been encouraging and most managements seem to have been positively surprised by the recovery they have seen in June. But one needs to be careful as pent-up demand which could be behind the initial spurt in demand and the true trajectory of underlying demand can only be estimated several months from now. Secondly, the impact on the financial sector from asset quality perspective is still not clear as there is a 6-month moratorium that some of the borrowers have availed under the RBI guidelines. Once we are out of the moratorium period, would we understand the true extent of damage for the financial sector.

Prepared for Restricted Circulation

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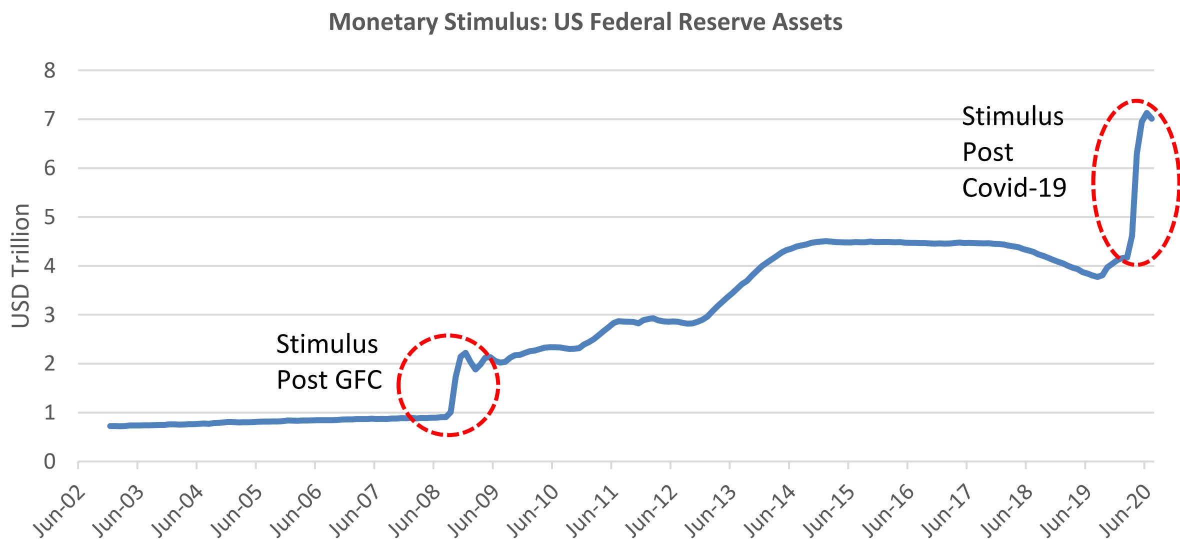
The Equity Market: An oft used adage in the market is that the market hates uncertainty. In March, when we entered our first Lockdown, we were at the peak of uncertainty. Uncertainty with respect to extent & effectiveness of the lockdown and the economic impact. With the easing of restrictions in India, despite increasing number of cases, the market has correctly guessed the unwillingness of the government to extend the lockdown any further. Thus, the worst in terms of lockdown could be behind us. But uncertainty with respect to economic impact still remains. The second aspect which is relevant for the equity market is liquidity. The equity market has also been supported by FII flows in the last 2 months. We have witnessed massive monetary stimulus by global Central Banks, of a greater size than seen even post Global Financial Crisis. This has supported global asset prices. While equity markets can be supported by liquidity in the near term, we believe fundamentals will determine the medium to longer term direction. Thus, we need to wait and watch how equity market reacts once clarity emerges on the economic front.



There has been progress as compared to where we were in April. But we are still not out of the woods either from health crisis perspective or assessing the economic impact perspective. While the equity market has rallied from troughs of pessimism in March, for the rally to sustain and move forward we would require supportive information from the economy.

How we plan to wade through this?

As discussed in our last newsletter, we used the sharp correction in March as an opportunity to buy businesses that had corrected due to negative sentiment and which we expected to be least impacted by the crisis. We also added stocks in financial sector, which we believe would have a near term impact due to current crisis but would emerge stronger from this crisis as they have liability franchises.

The sharp rally in the current quarter has reduced the opportunity set for us. We have turned cautious again, as we might not be adequately compensated for the risk we would be taking, especially in the current economic context. We would now wait for evidence of improvement on the ground to take incremental risk. If the market continues its current rally without any confirmatory evidence, we would be willing to sit on the side-lines.

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Asset Allocation:

Our overall equity weights stand at around 81% for older accounts. For new accounts our initial weight is around 40%.

Portfolio Activity:

Business Model and Sector Allocation:

Moat/Limited Moat	Sep-19	Dec-19	Mar-20	Jun-20
Moat	33%	30%	33%	31%
Limited Moat	38%	44%	39%	42%
Moat + Limited Moats	***71%***	***74%***	***72%***	***73%***
Special Situations	26%	22%	24%	23%
Regulated Utility	3%	4%	4%	4%
Grand Total	**100%**	**100%**	**100%**	**100%**

Sectors	Sep-19	Dec-19	Mar-20	Jun-20
Financials	18%	16%	22%	26%
FMCG	10%	8%	14%	14%
Auto & Auto Ancillaries	16%	17%	12%	13%
Pharma	16%	15%	10%	11%
Materials	10%	10%	8%	8%
Utility	4%	4%	7%	8%
Information Technology	12%	16%	11%	8%
Financial Services	-	4%	9%	8%
Capital Goods	8%	8%	6%	5%
Media	3%	3%	2%	-
Logistics & Transport	4%	-	-	-
Grand Total	**100%**	**100%**	**100%**	**100%**

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Portfolio Activity during the quarter:

After a long list of additions at the troughs of the market in the last quarter, we have added only one new stock to the portfolio and had four exits (two due to high valuations and two due to re-evaluation of the business prospects).

We added SBI Cards & Payment Services to the portfolio. SBI Cards is the second largest Credit Card business in the country. The company has historically grown its customer base through direct distribution. They have been targeting SBIs customer base meaningfully only in the last few years, which provides a lot of headroom for growth. Credit cards as a business has high credit costs. And certainly, the current environment would lead to a further increase in credit costs in the near term. We believe there is enough room to absorb elevated credit cost in the P&L, without affecting the Balance Sheet.

We exited Sanofi after holding it for more than 5 years. We continue to like the business for its high exposure to chronic therapy portfolio like Diabetes and Cardio. But current valuations do not factor a few risks. The discontinuation of Diabetes R&D by the Parent company recently, will affect long term visibility with respect to new product launches from the parent's portfolio. The sale of its Ankleshwar plant and the impact on the export business would affect near term earnings. Considering the valuations were not factoring these risks, we decided to exit.

We exited DB Corp. We have faced a major drawdown in this Investment. Our original thesis was that Newspapers in India, especially Hindi/Vernacular are not close to obsolescence as perceived by the market. While readership surveys supported our thesis, declining Ad revenue in second half of CY20 tested our thesis. But as decline in Ad Revenue was relatively lower as compared to Television or Radio, we believed the nature of the decline to be cyclical. But as we entered the Covid Crisis, the Newspaper Industry saw a collapse in circulation due to lockdown. As lockdown eased in Non-Metros (that DB Corp caters to) circulation did bounce back, but not to the full extent. There also seems to have been apprehension with respect to newspapers as carriers of the virus, as the company had to run Ads in its own papers to suggest that newspapers are safe. Ad revenues which drives the profitability of the business collapsed along with circulation. While most businesses have witnessed a similar collapse in revenue during the lockdown, the trajectory of the recovery is doubtful. Advertisers are going to take time to assess the impact of the lockdown on readership of newspapers in terms of changed habits if any, before coming back to the same medium at the pre-crisis level. The recovery could be long drawn. Thus, the wait for evidence for our original thesis could be longer. If our original thesis was wrong there would be more pain in holding the stock. If our original thesis was correct, the wait to be proven right would be longer. In face of this dilemma, we felt it best to assume that we are wrong, exit the stock and wait on the sidelines for evidence supporting our original thesis to come back to reevaluate the stock.

We exited Persistent Systems. Our original thesis for Persistent Systems was that the company was the first to identify trend of IT services business shifting away from traditional services to Digital (Social, Mobility, Analytics and Cloud). And since the company had a product development DNA as it catered to global Software product companies, we believed they would be better placed from a capability perspective to capitalize on the opportunity. But as digital opportunity scaled up for the industry, the traditional IT Services companies were able to scale up their digital offerings and retain their client relationships. Not having strong client relationships with enterprises other than Software product companies proved to be the Achilles heel for Persistent as they were not able to win larger engagements as digital deal sizes scaled up. While our thesis did not play out, the only reason we continued to hold on to the stock was valuation. As we entered the crisis, the commentary from most IT services companies suggested that in addition to possible budget and pricing cuts, clients are also focusing on vendor consolidation i.e. reducing the number of vendors. Thus, while valuation of Persistent is not expensive, we decided to exit considering a possible disproportionate impact on Persistent as compared to other IT Services companies.

We exited Crisil from a valuation perspective. While the business has done exceptionally well in the domestic ratings business by gaining market share, we are not very clear how the current crisis is going to impact their research business. At the current valuation we believe there is limited room for negative surprises and thus decided to exit.

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Regards,

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Sr. Portfolio Manager

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

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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.

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Risk factors
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 November 24, 2017 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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