October – December 2019

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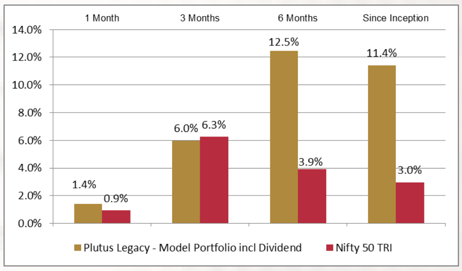
Equity Advisory Services

Absolute Performance: Model Portfolio: 31-Dec-19



Dear Investor,

Wish you a very happy and prosperous 2020. We would like to thank you for your patronage. Our Plutus Legacy strategy is doing well and has outpaced the Nifty by 8.4% since inception. Our **"Plutus Legacy"** strategy focuses on companies that clearly demonstrate leadership in their respective lines of business, are showing consistent growth in their top and bottom lines, generate a minimum return on equity and follow good governance practices.

2019 was a forgettable year in terms of the performance of the Indian economy. However, we look at the past year in terms of the key learnings and the opportunities that present themselves on a going forward basis. The launch of an integrated goods and services tax, a revamped insolvency and bankruptcy code, real estate regulations and a drive towards digitalization as well as financialisation of savings are all long term positive for the country as well as our economy. Businesses that embrace change will be successful and those businesses that continue to remain oblivious to the new realities will face existential questions. We are confident that our portfolio companies are at the forefront of embracing the new realities and investors are rewarding them with an increase in flows in what has become a rather polarised equity market in India.

For past two years, market had a very divergent performance, where in few quality companies are leading the main index up but broader market remained muted. The concentrated performance can also be seen in the Index weights with top 5 companies now accounting for 41.5% (Top 10 at ~61%) compared to 34.6% (top 10 at ~53%) two years back. Almost the entire performance of Nifty50 in CY 2019 can be attributed to gains emanating from the 5-6 large companies in the index. Similarly, Nifty50 performance of past three years can be attributed to just 10 companies. Financials now accounts for 42% of the Nifty50, even without including any insurance companies, all of which can be among top 100 by market cap. Our strategy "Plutus Legacy" is focused on such names and we believe that the bigger and stronger players will grow on a sustained basis in the years ahead.

We spoke earlier about key learnings from the past year. One sector that has grown rapidly in the past five years has been financial services. New Banking licenses have been given, payment and small finance banks have been launched and non-banking entities have continued to mushroom. Sometimes, we wondered, it was becoming too easy to raise capital and debt without having much background in credit as well as underwriting. Lending was done basis asset value and not looking at cash flows, companies borrowed short and lent long to create asset liability mismatches and loans were given with moratoriums that meant that loss recognition was not required till such time that the repayment was due ! So the can was nicely kicked down the road and the market kept rewarding this growth in balance sheet without concomitant growth in cash flows ! It took a large default for the system to recognize that many were swimming naked and the tide was about to turn. Time and again experience teaches us that we should only lever to the extent that the equity capital can support the leverage, the tenor of the borrowing and lending should largely be matched and loans should be underwritten basis cash flows of the borrower with asset(s) as secondary collateral. Each time we forget these lessons from the past and feel that this time it is different, we will face painful realities and then seek help from the government for problems that are largely self-created. The maximum wealth destruction in the past decade has happened in financial services as a result of frauds and loan losses. This should make us think that if that capital was productively deployed and not washed away, would growth not come back on track without the need to seek reliance on foreign capital?

We are pleased to report that the financial performance of our portfolio of high quality companies continues to reflect the market share gain in a tough environment accompanied by volume growth, operating leverage and hence margin expansion. 11 non financial companies in our portfolio have witnessed an average ~10% YoY revenue growth and average ~13% YoY operating profits growth for the second quarter of the financial year. Companies linked to discretionary spend like Asian Paints, Jubilant Foodworks continue to experience positive volume growth and have seen an expansion in their margin(s). We are pleased to share that we had discussed Biocon in our last newsletter. Our investment thesis has got validated with product launches in developed markets and a nice appreciation in the price of the stock

Despite the overall outperformance of the portfolio, one of our portfolio company Larson & Turbo Limited (L&T) has underperformed. L&T is the largest infrastructure company in India. L&T is a conglomerate with its businesses segmented into Infrastructure, Power, heavy engineering, defence engineering, Hydrocarbon, Development projects, electricals and automation, realty etc. It has also diversified into information technology and financial services housed under separately listed subsidiary companies. Company is a leader in majority of the businesses it operates in.

L&T's revenue and order book continue(s) to grow and has reached an all time high of Rs 145,000 Crore (TTM) and Rs 303,000 Crore respectively for the period ended in Q2-FY2020. Core infrastructure segment grew 9.1% yoy in Q2-FY2020 and ebidta margin expanded a bit. However the growth was driven by the public sector orders and overall ebitda margins remains lower compared to earlier peak.

The low liquidity situation for the infrastructure players, which started with the European crises of 2013 got elevated during the last year with the stress in financial system, bankruptcy of IL&FS and other large competitors. Given the working capital intensity and leveraged balance sheets, market is ignoring the infrastructure sector. New governments in Andhra Pradesh and Maharastra either announced cancellation of projects or signaled review, which added to the negative outlook for the company/sector. Cost overrun in some projects and losses in few own & operated by company (e.g. Hydrabad Metro) did not help margin, which reached the multiyear low in FY 2019.

However our analysis of the company show that L&T remained one of the least aggressive players among the peers in the last boom cycle and thus did not take oversized bets. It is now focused on deleveraging its balance sheet and planning to exit non-core businesses. Overall leverage in the balance sheet excluding financial services is reasonable for the company and with the sale of road projects to the pension fund as InVit and likely monetization of other non-core assets, they can strengthen the balance sheet further. On 31st December, government has announced the mega infrastructure plan for the next five years doubling the likely spend on infrastructure to Rs 102 Lakh Crore (~$ 150 Billion) compared to Rs 51 Lakh Crore spend in previous 6 years. L&T's current domestic order book is mainly driven by public sector spending and with the focus on Power and Roads in infrastructure plan of government; the company should be one of the biggest beneficiaries

Margin recognition in large projects for infrastructure companies is typically back ended as initially costs are incurred in mobilizing site and actual billing starts after a few quarters. Thus whenever company has continuous new projects under execution; the margin may be lower compared to the period when old orders execution reaches its peak. The company maintained its guidance for FY20 – revenue growth of 12-15%, order inflow growth of 10-12% and core E&C margin of 10.5%. We believe that with the old order executions, strong balance sheet and focus on core businesses, L&T may surprise the street with margin expansion and higher growth.

Internationally, the US Fed stopped cutting interest rates further in their last meeting as labour market condition remained strong and the threat of inflation is less muted than before. Clearly, a dovish Fed, lower interest rates and abundance of liquidity have helped increase price to earnings multiples leading to spectacular equity market returns in the US. Some of this dovishness has benefited emerging markets like India leading to the dichotomy between the performance of the large cap index and the state of the economy. We continue to believe that investors should remain invested across businesses that can produce return on capital that is sustainable and are hence focused on a list of about 110 companies versus the 6500 companies listed on the Indian exchanges.

The quarterly results start from mid-January and we will wait to see any lift in consumption patterns and the trends as far as manufacturing and industrial recovery is concerned. GST collection(s) remained above 1 Lakh crore for last 3 months. The Union Budget will be presented on 1st February and may provide some fiscal measure led relief.

Table 1: Performance of the portfolio companies

Company Name	1 Month	3 Months	6 Months	1 Year	3 Year*	5 Year*
Asian Paints Ltd.	4.6%	1.3%	31.4%	30.0%	26.1%	18.9%
Bajaj Finance Ltd.	3.9%	4.7%	15.0%	60.1%	71.3%	64.8%
Biocon Ltd.	4.3%	31.7%	17.2%	-6.6%	22.9%	32.9%
Colgate-Palmolive (India) Ltd.	-0.8%	-2.7%	29.7%	8.9%	17.4%	10.4%
Divis Laboratories Ltd.	3.3%	10.8%	15.6%	24.5%	33.0%	16.5%
HDFC Bank Ltd.	-0.2%	3.6%	4.1%	19.9%	28.2%	21.7%
Hindustan Unilever Ltd.	-5.5%	-3.0%	7.6%	5.7%	32.5%	20.4%
Housing Development Finance Corp Ltd.	5.0%	22.0%	10.1%	22.6%	24.1%	16.3%
ICICI Prudential Life Insurance Co Ltd.	-4.0%	4.1%	24.1%	48.7%	16.9%	-
Infosys Ltd.	5.0%	-9.2%	-0.1%	11.0%	13.1%	8.2%
Jubilant FoodWorks Ltd.	2.1%	21.5%	34.0%	32.0%	57.0%	19.1%
Kotak Mahindra Bank Ltd.	4.3%	2.4%	14.0%	34.1%	32.8%	21.7%
Larsen & Toubro Ltd.	-2.4%	-11.9%	-16.4%	-9.7%	13.0%	5.4%
Nestle India Ltd.	2.3%	6.4%	24.1%	33.4%	34.9%	18.3%
Reliance Industries Ltd.	-2.4%	13.6%	20.8%	35.0%	40.9%	27.7%
SBI Life Insurance Company Ltd.	0.2%	13.6%	32.9%	60.8%	-	-
Tata Consultancy Services Ltd.	5.3%	3.0%	-2.9%	14.2%	22.3%	11.1%
NIFTY 50	0.9%	6.0%	3.2%	12.0%	14.1%	8.0%
Model Portfolio	1.4%	5.8%	11.8%	-	-	-

Source: Ace Equity. Price appreciation excluding Dividends. *More than 1 Year data is CAGR.

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