The Bottom Line... PLUTUS LEGACY

TRUSTPLUTUS
Wealth Management with a Conscience

Mid-March 2020

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Dear Investors,

Greetings.

As we write our note, the Indian markets are capitulating for a variety of reason(s). We all learnt last evening that Yes Bank has gone under moratorium based on a decisive action by the Reserve Bank of India. We feel that this is a much needed step and look forward to an orderly resolution that will hopefully protect the interest of deposit holders and other investors. As much as we hope to see entrepreneurship flourish in India, consolidation is an inevitable phase in the life of a business. Nowhere is this consolidation more evident than in financial services where the bigger and better players are not only driving economies of scale but also developing sustainable barriers to entry given their vast distribution and access to capital. When we had created our Legacy portfolio, our thinking was to invest in such companies that are leading beneficiaries of this consolidation that will help them grow their earnings and generate adequate return on invested capital. We are pleased to share that our strategy has played out well and the portfolio has handily beaten the Nifty over one, three, six and nine months.

As far as banking is concerned, only two banks are standing tall when it comes to growth without any significant blip in terms of credit cost. HDFC Bank has distribution across urban and rural India, have a proposition that addresses need across segments starting with priority sector all the way to large corporates and are also becoming digitally competitive to effectively compete with the new age banks and fintech firms. They have consistently grown their top and bottom line, are well capitalised and continue to drive efficiency improvement demonstrated through a declining cost to income ratio. The only criticism that they might face going forward is the high share of unsecured loans in their retail book that can potentially lead to higher credit costs in the future. The stock has corrected in the past few months but this has more to do with an overhang around the leadership change than to do with any issue in the portfolio. Kotak Mahindra, while not a leader in terms of business volumes has also demonstrated the ability to grow keeping the highest governance standards in mind and with prudent underwriting in terms of credit risk. Kotak Bank may become a beneficiary in terms of the consolidation/amalgamation that may engulf Indian banking.

Many non-bank finance companies grew primarily through regulatory arbitrage by giving loans against collateral that was not accepted in banks, offering friendly repayment terms including moratorium on principal repayment and bullet payment of interest and also indulging in asset liability mismatches by borrowing short and lending long tenors. As long as the music played, all players danced till the event happened in 2018. Since then, several questions have been raised around the business model of many of these NBFC's, their going concern status is being questioned and many of the smaller players are either seeking consolidation or are becoming even smaller in terms of their business profile. Bajaj Finance stands out as a firm that has been able to achieve scale, is practically able to offer all products that a bank offers other than current and savings accounts and has managed this scale and growth without compromising either on their governance standards nor in terms of credit underwriting. However, given the rampant increase in its share price and also early portfolio indicators that show some potential stress building, we intend to watch our position carefully.

Life Insurance distribution and manufacturing was privatised in the year 2000. Insurance in India was traditionally purchased only as a tax shield and very little of protection was sold to customers. While private sector insurance companies also started out with unit linked insurance plans and endowment policies, the real need in this country is for protection (pure life cover). In the past few years, the share of protection as a share of premium is increasing and inching towards double digit/early teens. Protection is a margin accretive business for the life insurance companies and a higher share helps to drive the embedded value of insurance companies. Since the market is valuing life insurance companies on a multiple of embedded value and not price to earnings(s), as premium income grows and share of protection increases, the companies become more valuable. We have two good companies in our portfolio – ICICI Life with a strong agency cum bancassurance business and SBI Life with an equally strong branch distribution plus agency model. Our basic premise is that as awareness levels increase, an increasing number of customers will seek protection and with an increasing number of covered customers buying pure risk policies, the embedded value of these companies should grow at a healthy clipping.

In a country of a billion people, at some point in time, somewhere someone is buying one of their products. The stability of their proposition, strong brand recall, high return on capital and high percentage of profit that converts into free cash flows endears some of the fast moving consumer good companies to investors. They have also been beneficiaries of the tax cuts announced last year and have been growing their top line (albeit slowly) even in difficult market conditions. Our portfolio has the best consumer companies in India – Asian Paints, Hindustan Lever, Colgate and Nestle. The only thing that we do not like about these companies is that with each passing day they become more and more expensive. We are not believers of the consistent compounding theory at any price – we believe that these companies should keep growing as long as the economy grows but are clear that one cannot own these companies at any price.

All companies across the world are keen on pursuing transformation using technology – many are also wanting to leverage digital as a competitive advantage. Over the years, the Indian IT MNC space has become less crowded and the only two stand out companies with size and high quality of governance are TCS and Infosys. Infosys seems to be enjoying fresh impetus under new leadership though both companies produce high return on equity and convert a large percentage of their profit into free cash and declare dividend(s). We think that these two companies will produce consistent returns in the low teens including dividend and are a core part of our portfolio.

We are invested in Biocon as we think the company is well-positioned in the emerging biosimilar markets supported by its R&D capabilities, deep pipeline and strong management team. Over the last few years, the company has seen success in its biologic development with a spate of approvals in the US/EU and focus has shifted to the earnings potential from its pipeline investment. Key catalysts for the stock that we are tracking is the momentum in recent launches and new filings/approvals in the US.

Reliance Industries now offers a unique exposure to a set of businesses that include industrial, consumer and digital. Completion of the Aramco deal, further consolidation in the telecom business plus upward repricing in tariffs and a potential strategic sale in Reliance Jio are positive catalysts that we are tracking that can potentially rerate the company.

Our Plutus Legacy strategy continues to deliver on its promise of low volatility in the past 9 months with 14.1% alpha by model portfolio over benchmark index NSE Nifty50 TRI. We remain committed to investing into quality companies but with one caveat; the price and valuation needs to justify the future growth that we can expect from each company. As we write this letter, NSE Nifty50 is down by ~5.5% taking the total fall to ~7.3% for this month. Against this our model portfolio is down ~4.5% for the month.

Thank you for your patronage and we will connect once again at the end of the quarter.

Connect with us