The Bottom Line... Plutus Opportunities

TRUSTPLUTUS
Wealth Management with a Conscience

April 2020

Pramod Dangi, CA, CFA
Equity Advisory Services

Dear Investors,

We write our note against the backdrop of one of the fastest and deepest sell offs ever seen in the Indian equity markets. FII have sold over fifteen billion dollars across debt and equities in a single month driven more by fear than by rationality. Financials have taken one of the biggest knocks with quality names down between thirty and fifty percent. Discretionary and luxury product manufacturers are bracing for a period of time before demand makes a comeback and sectors like real estate and infrastructure that were already slowing down now need a fresh dose of thinking in terms of business models and the way forward.

Commentators are writing obituaries on business models, companies and industries. While it is understandable that the system is going through a shock, history does reveal that memories are short and economies world over are likely to make a comeback sooner than later. What does happen when such a shock hits the system is that the weaker players tend to either exit or consolidate with stronger partners and this is a way of life. It is too early to predict the extent and eventual outcome of the Covid-19 crises. Much depends on the period of lockdown and the need for restrictions thereafter, further spread of the contagion, changing weather impact, build-up of healthcare infrastructure and progress on finding a long term effective cure. However, the current emerging scenario of slower growth or de-growth in majority of economies and monetary as well as fiscal loosening will continue for a while. We may witness a supply and demand shock in the medium term and while the central banks may continue to provide the liquidity, the availability of incremental capital may be limited to just a few strong companies. While the benchmark cost of capital will certainly come down, the credit spread may widen, thereby increasing the ***eventual*** cost of capital for majority of the companies. Companies with leveraged balance sheet, capital intensive business model(s) or inflexible cost structure(s) may face challenges and be forced to exit.

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. As far as financial services are concerned, only few companies are standing tall when it comes to growth without any significant blip in terms of credit cost over past few years.

Financials Services

We clearly see a consolidation in the industry within a handful of names as stronger banks continue to enjoy the lower cost of deposits and thus should enjoy higher net interest margin. The banking companies with strong balance sheets and conservative underwriting practices will attract more capital and will gain market share. Unsecured micro finance sector and subprime lending may face challenges. The immediate focus will be on the strength of the balance sheet & liquidity and not on growth.

Kotak Mahindra Bank (KMB), while not a leader in terms of business volumes has demonstrated the ability to grow keeping the highest governance standards in mind and with prudent underwriting in terms of credit risk. KMB may become a beneficiary in the event of any consolidation/amalgamation that may engulf Indian banking in coming time. While they have gone slow on lending, they continue to attract deposits and have a CASA ratio of 52 percent - an industry high. With the promoter shareholding issue no longer an overhang and as multiple businesses outside of banking get the scale, the stock should benefit from the sum of the parts.

The oldest private sector bank **City Union Bank (CUB)** continues to grow at a steady pace and has had a much lower credit loss than peers due to its unique personal relationship driven banking. The focus of the bank remains on old age banking model to garner fixed deposits on one side and then lend to SME and trader community on the other side. Almost the entire book of CUB is secured lending and thus despite carrying higher provision(s), over a cycle, the bank has maintained a lower cost of credit through demonstrated restructuring and recoveries. Started as a community lead bank in Thanjavur, Tamilnadu in 1904, CUB continues to be run conservatively unlike the new age banks that tend to grow too fast and come down even faster.

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.

Muthoot Finance is the largest gold loan company in India with distribution primarily across southern states and is expanding to new regions. They have a strong proposition that entails lending to customers who are in urgent need of money in the quickest period of time. Their branch distribution, strong appraisal and underwriting processes and quick turnaround ensure that they are able to protect their NIM and yet have a 100% secured lending portfolio. The company also tends to do well with the increase in gold prices since repayments and recoveries tend to be much better in an environment when the price of underlying collateral is rising. Muthoot Finance is well capitalised and continues to drive efficiency improvement demonstrated through a declining cost to income ratio. The company has kept the credit cost in check and is carrying excess provisions despite the secured nature of their book. The diversification undertaken by the company in areas other than gold loan seems a bit unwarranted though the share of such business is currently quite low.

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 the largest private sector insurance company in the portfolio– **HDFC Life,** a strong agency cum bancassurance business. 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 life insurance companies should grow at a healthy clipping.

Energy

In the short term, the drop in oil and energy commodities' price(s) should help the consumer industries and intermediaries. While there may be short term disruption in demand, the energy sector is changing structurally with the focus on natural gas and renewables against coal. India aims to move towards a gas-based economy by increasing the share of natural gas to 15% from the current 6.2% in the energy mix of the country by 2030. Demand for natural gas in India will be driven by city gas distribution (CGD) including auto CNG/LNG, fertilizer, refinery and other industries along GAIL's gas grid. Petroleum and Natural Gas Regulatory Board (PNGRB) has authorized 228 regions over the years for CGD, including 136 in the most recent 9th and 10th rounds in FY18-FY19. After successful completion of 9 and 10 CGD Bidding Rounds, 71% of Country's population will have access to the CGD network(s).

Majority of the demand shall be met through imports and that requires LNG import terminals. **Petronet LNG** imports and stores LNG and then distributes through a gas pipeline. We like the annuity nature of the business with a fixed regasification charge per unit of gas (MMBtu) with full pass through of any escalation in gas prices. Petronet LNG is the largest importer of LNG for its customers and has a 5% escalation in regasification charges per year. **Gujarat Gas** is the oldest and largest CGD company with a higher mix of industrial customers followed by domestic LPG and CNG. While the CGD companies get preference in the domestic gas supply at cheaper rate for household piped gas supply, the key profits are generated by higher margins on CNG and industrial supply. Adoption of gas use by industrial customers is getting a leg up with bodies like National Green Tribunal (NGT) ordering the shutdown of units running on coal-gasifiers in Morbi, an industrial hub for ceramic. The company is able to pass on the cost of gas to customers over a period and enjoys a stable net distribution margin for different segments. The key risk(s) in these businesses comes from two sources: firstly, any regulatory intervention on the regasification charges or distribution margin can impact the financial performance and secondly lack of supply or unreasonable escalation in the price can create headwinds in short term.

Healthcare

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 are the momentum in recent launches and new filings/approvals in the US and other developed markets. Company has very low reliance on China for raw material and in fact should benefit from the further push for cheaper alternate(s) to existing drugs.

Domestic pharmaceutical market is expected to growth at ~10% over next 10 years and medicines for lifestyle led chronic ailment is expected to grow at ~12% to become 45% of the market. Unlike large Indian generic players, MNC companies are a pure play on domestic pharmaceutical industry and have a unique positioning. Most of the products of the MNC companies are market leader(s) in a competitive marketplace and are generally offered at premium pricing. Better quality control and large medical representative (MR) network with higher productivity and knowledge base help these companies to capture a higher share from prominent doctors in respective therapeutic segment(s). Our portfolio companies in MNC Pharma space, **Abbott India** and **Sanofi India** have greater revenue dependence on chronic diseases as compared to acute therapies and hence have a stable revenue base. Further these two companies have limited products under drug price control. Restructuring of products in terms of power brands with continuous new product launches and FMCG like high returns and free cash flow generation are the key characteristics of these companies. However the risk emerges from the regulatory price control under the new National List of Essential Medicines (NLEM) expected in 2020 and we are keeping a close eye on any disruption from that standpoint.

Consumables

Our portfolio has some of the best consumable companies in India catering to industries as well as consumption demand – **3M India, Pidilite, United Spirits** and **United Breweries**. While growth may be constrained in the short term, given that most of these companies don't have a high leveraged balance sheet and have strong brand recall, we believe that these companies will bounce back and will grow in line with growth in economy. However, we are also cognisant of the fact that one cannot own these companies at any price, and hence we went in with lower initial weights in these companies in the portfolio and will use the current volatile period to build the position over a period of time.

In a normal economic condition, in a country of a billion people with millions of small businesses, at some point in time, somewhere someone is buying one of the products from our portfolio companies. 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 and industrial good companies to investors. They have also been beneficiaries of the tax cuts announced last year and have non leveraged balance sheet. As the unorganised sectors will face challenges, these companies will emerge much stronger over the period of time to capture even higher market share

Our **Plutus Opportunities** strategy is focused on a portfolio of stocks that we think are best positioned in the long term to capture the opportunities that India presents from a growth perspective and includes companies that clearly demonstrate a sustainable business model, are showing consistent growth in their top and bottom lines, generate a minimum return on equity, are not leveraged and are adequately capitalised. These companies are best poised for the eventual growth that will make a comeback once things settle down.

Thank you for your patronage and we will connect once again once we have the last quarter's results in the bag.

Connect with us