SUNDARAM ALTERNATES
UNEARTHING OPPORTUNITIES

4×4 Wealth Multiplier Themes

"Over every mountain there is a path, although it may not be seen from the valley"

Theodore Roethke
1954 Pulitzer Prize winner

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As we venture into 2022, we continue to remain positive on Indian equities for investors with a 3–4-year view despite challenges like the lingering coronavirus infections, stock valuations, global interest rate cycles, global growth, inflation, etc. Although the picture of where the markets are heading in the next 3-6 months is unclear, we can say with confidence that it offers enough number of opportunities to make a decent return if one invests today and remains invested over the next 3-4 years. This confidence arises from both the bottom-up analysis to pick stocks that meet our growth and return criteria and the impressive India macro story from a medium-term perspective. India's macro picture looks solid to face uncertainties and grow at a reasonable rate over next 3 years.

India appears more attractive in comparison to majority of the other emerging economies on various macro parameters like inflation, foreign exchange, GDP growth and fiscal spends, tax collection, government spending on investments and urban consumption. It is probably the only economy that is expected to do better in terms of growth when compared to its pre-Covid-19 levels. This is largely driven by the meaningful growth in both Indian IT services and manufacturing sector vs the pre-Covid-19 levels. While Russia faces inflation and Covid-19 challenges, Brazil is up against fiscal and inflation challenges. Likewise, Turkey is facing inflation, forex and growth challenges. Growth remains a hurdle in Mexico due to weak consumer and investment sentiment. GDP growth expectations for majority of emerging economies and some of the developed markets like UK, Japan, South Korea are all below 2% as of FY23E. However, India's GDP growth expectations are ~7% in FY23 which is above par in comparison to emerging economies. India likely to continue to be lucrative market for global investors. The two largest economies, US (~4%) and China (~5%) in the world will also see better growth expectations, this should help the India growth story.

When it comes to investment, we are predominantly bottom-up research focused. We believe in building research based concentrated portfolios and the focus is always on investing in businesses with higher growth potential, exhibiting quality financial metrics, run by a top-class management and available at a fair price.

In the long term, equity market returns do track earnings. But in short periods, it can be non- correlated. Since March 2020, with the onset of Covid-19 threat, a variety of factors have played positive and negative catalysts for the earnings trajectory of companies. These factors have been either short term or long term, positive or negative, factored or ignored in valuations. This has led to some underpriced value creating opportunities (like BFSI) as well as led to inflated valuations in some businesses (fintechs). Firstly, some momentary positive factors are being extrapolated to infinity resulting in an asset bubble in few businesses, for example, online companies. Secondly, some short-lived negative factors are extrapolated as doomsday scenarios for some industries, like retail, cinemas, and travel. Lastly, some positive factors triggered by Covid-19 which are structural in nature continue to be underappreciated by the market, like global digital investments and supply chain realignment.

In our opinion, the ability to differentiate between these and accordingly build strategy positions, offers the possibility to create significant alpha over the next 4 years (2022-25). If one can identify some temporarily disrupted but well-run businesses, buy and stay invested with them over the next 3-4 years, we believe the markets will provide ample opportunities for value generation.

Our idea is to identify 4-5 ideas in each of these themes, stay invested in them over next 4 years to generate meaningful alpha to our investors. These themes are likely to be our guiding post for our research-based stock picking.

1. Capex "Maestros"

Finding opportunities to regularly invest back in business

This theme covers companies that have a clear road map of multi-year capex through internal accruals/low debt while maintaining a healthy ROIC and grow multi-fold in the next 5 years. We concentrate on growth focused and healthy return generating manufacturing businesses or consumer centric businesses and not traditional high capital-intensive industries like utilities or commodities with poor return metrics. These companies are likely to have a much higher 5-year capex spend compared to their historical levels and grow profitably over the next 5 years. Some of them are doubling or tripling their capex spent as they find attractive growth opportunities in post covid world. On one hand, we have structural beneficiaries of Covid-19 like export inclined segments essentially chemical/commodities companies, which are primary beneficiaries of climate control and supply chain realignment policies. On the other hand, well-run domestic consumer facing companies that saw temporary disruptions during Covid-19 are now investing to expand capacity aggressively, given the capital constraints faced by smaller competition that is drawing them out of the market.

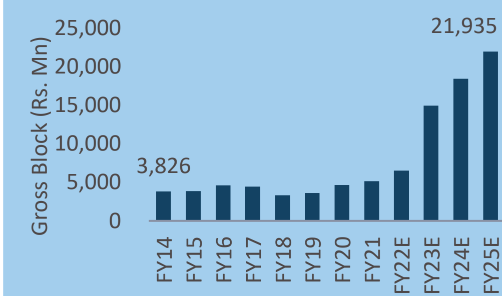
We prefer companies that have been able to identify profitable opportunities to grow, backed by multiyear capex plans and have historically exhibited the ability to execute timely projects at a high RoIC. Passionate promoter driven companies like Astral, PI Industries and SRF have been testimonial to this story as they have executed their growth plans exceedingly well over the last 5 years without compromising on profitability at the cost of higher capex. Some of these capex stories, like PI Industries, Astral Poly, D-Mart and SRF have played well in our portfolios. Furthermore, names like Navin Flourine, Minda Industries and V-Mart offer an equally interesting outlook. For example, Navin Flourine is envisioning to invest 2-3x higher capex over the next 4-5 years compared to the preceding 4-years into new products/ verticals, which promise long runway for growth and higher profitability. Similarly, Minda Industries through its technology tie ups and aggressive investments in new age/contemporary ancillaries like EV, sensors, premium switches, alloy wheels, which will result in increasing the overall content/vehicle across vehicle categories.

Our risk to this call is the potential cyclical slowdown in the end user industry or global slowdown post monetary tightening. With China's plans to focus on growth in 2022 and US' mega infrastructure plans, liquidity is still higher despite tightening and risk of a slowdown looks slim at this juncture.

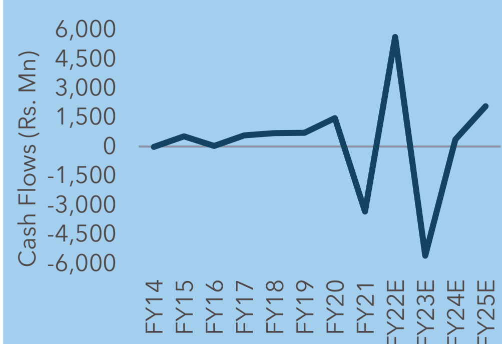
Illustration

Navin Flourine

Accelerated capex mode as it could spend Rs. 20bn in 3-4 years.



At zero debt and is funded by internal accruals



Source: In-house Analysis

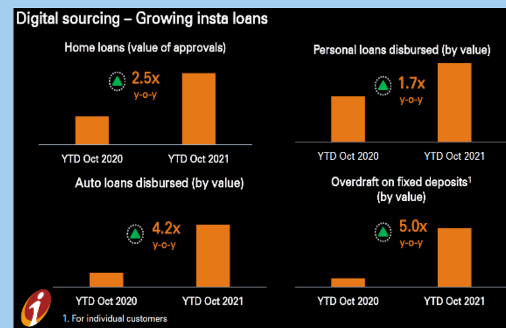
2. Phygital "Bluechips"

Technology adapters for a stronger business unit

These are traditional bellwether companies that have adopted technology intrinsically across their business verticals in their journey to gain market share and emerge as stronger businesses. Technology has aided these companies in being more cost competitive, agility in process and improve productivity. In few instances, we expect some of these businesses to challenge the new age technology companies in their respective industries. BFSI is one such sector, where technology has been a disruptor as well as a game changer in the last 2 years.

Lending is a commodity business, but underwriting is not. Payments is a commodity business, while CASA is not. We prefer companies with an excellent underwriting ability and quality liability franchisee within the BFSI space. Current disruptions of Covid19 and higher NPAs has led to banking and financials being temporarily out-of-favour. But we believe names like ICICI Bank, HDFC Bank and Bajaj Finance are in a much better spot to gain market share and grow over the next 5 years. In our opinion, the fear of fintech companies eating into their market share is unwarranted and is likely to fall short of current market expectations. All these companies have a strong backing of the following: **1.** Low cost of funds led by focus on CASA, **2.** Profitable lending business enabling spending on digital initiatives and **3.** This digital spending enabling them to gain substantial market share and save costs over next 5 years.

Excerpts from ICICI Bank 2021 analyst day presentation



Digital contribution[2]	Y-o-Y volume[3]
• Savings account: 28%	• 1.8x ▲ in new accounts • 3.6x ▲ in video KYC
• FD volume: 52% • FD value: 25%	• 1.1x ▲ in FD volume • 1.2x ▲ in FD value
• Total approvals: 23% • Disbursement: 16% • Cards sourced: 45%[4]	• 2.0x ▲ in loans approved • 2.2x ▲ in loans disbursed • 1.3x ▲ in credit cards sourced

• Faster growth through digital platforms
• Driving increase in risk calibrated core operating profit

Source: ICICI Bank

On the contrary, if one observes ICICI Bank, Bajaj Finance and HDFC Bank's customer base, these high potential customers in liability, to whom cross selling unsecured high-yield loan and other financial products may be far easier and profitable than the fintech approach. With Covid-19's threat on NPA behind us and gradual return of growth especially with investments picking momentum in India, the phygital BFSI space provides a huge value opportunity. Low credit growth has been a reason for the underperformance in the banking sector. With this turning around, our picks like AU Small Finance Bank and Bajaj Finance are looking at 25%+ YoY growth in Q3FY22, as new customer addition and disbursements gain momentum. As per the latest commentary, there is no negative surprise expected in NPA numbers.

Similarly, we see few retail companies embarking on digital initiatives to improve throughput and become cost competitive. For example, Titan has embarked on digital initiatives over the last 5 years in the areas of inventory management, store productivity, customer engagement programmes and development of omnichannel presence. These initiatives will help reduce cost, optimize inventory management at store level, improve store throughput and become more competitive than ever before. These factors are being underappreciated by the market and there is a high concentration of interest in online companies. Although some of the recently listed online e-commerce companies are good businesses models, the current punchy valuations leave very little margin of safety for investors.

Titan excerpts from Annual Report 2021

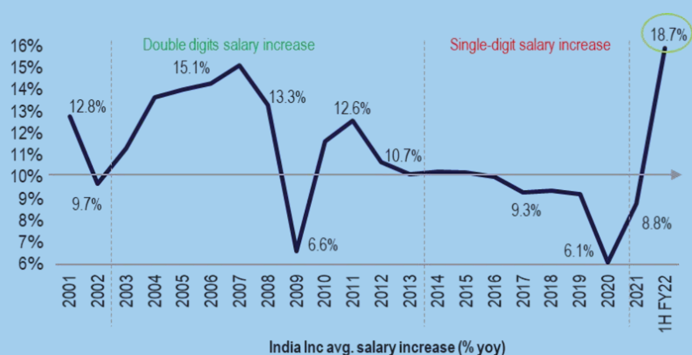
"The combined effect [digital initiatives] of these was an explosive growth in sales through new ways: video calling, try-at-home, appointment shopping, omni channel, chatbots, endless aisle, etc. Apart from these, multiple Company processes have seen the effect of various Digital interventions that have ended up reducing costs, improving speed, and increasing accuracy: Artificial Intelligence in Design, Industrial Internet of Things in gold plating, Robotic Process Automation in invoice processing, Persuasive Technology in sales force management and many more".

3. Consumption "Czars"

Positive wealth effect, household savings rate & rising PCI, all Point to robust consumption growth ahead

Discretionary consumption in the past has offered structurally attractive investment opportunities. The pandemic struck a blow to the business model and earnings in the short term, which got construed as a structurally negative blow to their business existence, making it underpriced, especially in mid and small cap space. Low interest rates, hot job markets reflected in high attrition rates in IT Sector, e-commerce and BFSI space is likely to trigger a surprise growth in discretionary spending over the next 3 years. There could be some minor setbacks due to precautionary measures taken by government on the Omicron variant.

18.7% salary hike in India Inc; highest in 15 years



85% of QSR outlets still from top 8 cities; long growth runway

Particulars	FY17 (Rs. Bn)			FY20 (Rs. Bn)		
	Unorg+ Stdl	QSR chains	% chain	Unorg+ Stdl	QSR chains	% chain
Delhi, NCR & Mumbai	609	119	47%	734	168	42%
Next 6 cities	549	106	45%	678	177	45%
Next 21 cities	341	13	6%	414	33	8%
Rest of India	1550	7	3%	1895	18	5%
Total	3046	236	100%	3721	395	100%

Source: Spark Capital

Consumer durable companies, particularly air conditioning segment, organized retail, passenger vehicles, home sales will see a higher-than-expected demand in the medium to long term. If India can pull through a meaningful job creation in manufacturing as well, which looks possible, then it's a decadal opportunity. Over the past 4 years, some of these stories, like Titan, D-Mart and Trent have helped us make meaningful returns in our portfolios. In addition, we expect V-Mart, Westlife and PVR to do well as the pandemic becomes an endemic over the next 1-2 years. These stocks have been negatively impacted due to Covid-19, but footfalls will return to organized retail in shopping, theatres, and restaurants formats. Recent box office success of few Hollywood and Bollywood movies is evidence of such consumption patterns especially when the infection threat is low. OTT will be an additional source of entertainment, but theatres will continue to remain first choice for the majority. Also, the QSR segment reported complete recovery to pre-covid levels in Q3FY21 not just in India, but across the world as the threat of infection receded.

4. Export "Voyagers"

Exports in robust growth mode with IT services, chemicals, pharma drugs & electronics at the forefront

India is on the path to clock more than $400bn worth of goods exports in FY22 as it clocked $103bn in Oct-Dec 2021, the highest so far and well above pre-Covid-19 levels. Services exports will be another >$230bn in FY22, according to Government of India. After a long period, we find opportunities for both services export and goods exports firing simultaneously. This bodes well for job creation & economic growth. Within services, IT services is expected to contribute a chunk to the growth and manufacturing exports, will be led by chemicals, pharma drugs, textiles, electronic/

engineering goods, plastics, etc. In fact, globally, IT services is the only sector which has grown uninterruptedly during Covid-19 compared to struggling manufacturing and is one of the primary reasons for a better macro picture for India vs the pure manufacturing or commodity-based export countries.

We see structural trends in IT services; globally CIO priorities are cloud computing, digital transformation, security software, AI/ML/PA, and DW/BI/Analytics. Indian IT services companies are seeing the revenue growth trajectory shift from mid-single digit to high teens. We believe that this momentum is likely to continue for some more period as the benefits of digitizing in reducing cost of operations and improving throughput, are visible for global MNCs. What began with large transition deal wins for Indian IT companies in 2020, will now move to the next leg of digital application adoption in each segment. Therefore, growth will be driven more by shorter deals. Digital adoption will spread across customer facing applications, inventory management systems, service/product delivery platform etc. It is suitable to play the story through digital companies than traditional players. Companies embarking on acquisition led strategy to bridge capability gaps are also ideal plays. Mindtree and Tata Elxsi derive majority of their volume from such applications and are also strategically positioned to get a share of small size digital orders.

India's Manufacturing/ exports of manufactured products was decelerating in the pre-Covid-19 period due to loss of market share to other emerging ASEAN economies in key export products like textiles, auto parts etc. However, in the post-Covid-19 world there are 5 factors working in favor of Indian manufacturing to regain momentum and grow.

1. **Supply chain constraints** emerging in China is leading to high inflation in variety of products. Global majors in pharma, agro-chemical, textiles, etc. are therefore looking to outsource from an alternative source, India is one of their best options. We have discussed on India's cost competitiveness briefly below

2. **ESG**: Climate control initiatives taken by China are enabling profitable growth opportunities for manufactured products not just in India but globally as well. China has been restricting/ outright banning industries in specific sectors which have continued to use outdated and highly polluting technology to remain cost competitive and gain export market access. We find niche opportunities in light of China's challenges in spaces like pharma APIs, agro chemical, fluorine, PVC, fluropolymers, metals, etc. This opportunity may not necessarily be short-term rather structural. One macro theme which is running through commodity manufacturing is China's phenomenal capacity creation in last decade that has led to deflationary prices for a prolonged period reducing RoCE for nearly all commodity manufacturers. Now with China slowing down on capacity creation, the RoCE of many commodity projects are looking better. Globally, manufacturing has become more profitable than before. This is inflationary but it will avoid stress on financial system, setting stage for next credit cycle driven growth

3. **Trade war**: Since Covid-19, the anti-dumping duties and ban due to political and climate control related trade sanctions have risen, providing an opportunity for Indian manufacturers to gain export market share. Example refrigerants, tiles, textiles as key beneficiaries

4. **Government of India's PLI** initiative that targets to localize manufacturing in consumer electronics, auto parts, chemicals, etc. Foxconn and Dixon's India investment plans are all indicative of the opportunities that can be harnessed in manufacturing. To begin with, most of the capex will be focus on assembling and then transform to product manufacturing. We are seeing some capital goods players interesting in this context

5. **Capital goods and global auto companies** are expanding their Indian operations to outsource more with or without PLI benefits purely based on merit from their Indian plants. Schaeffler will be investing Rs.1200 Cr over the next 3 years compared to Rs.250 Cr spent in the last 3 years to add capacity to meet existing client's requirement. ZF plans to make Indian operations $3 bn by 2030 which is currently around $0.5 bn with plans to invest continuously. These are certain examples and proof for India becoming more cost competitive globally for MNCs

According to a KPMG study "Cost of manufacturing Operations Around the Globe – 2020", India ranks among top destinations in terms of primary cost of manufacturing. India ranks 16th in overall competitiveness index but ranks among top 5 destinations in primary cost index. Corporate tax rates and interest rates pull down the cost competitiveness. But with current low interest scenario and cut in corporate tax rates in 2019, we believe the attractiveness of India should improve further to top 3 destinations. On the secondary cost index India ranks lower and primary reason is poor transportation infrastructure. In our opinion, benefits of government efforts like DFC, port capacity additions, road infra construction, and GST, will help improve India's attractiveness as a global manufacturing destination over next 5 years. India provides a large domestic market due to its size compared to many of these smaller nations.

India ranks decent on primary cost for doing business – 1 being best, 2020

Countries & Jurisdictions	Hourly compensation costs	Real estate costs	Utility costs	Corporate tax rates	Interest rates
Malaysia	2	1	3	2	4
China	2	2	1	3	4
Mexico	1	1	1	4	5
Vietnam	1	4	1	2	5
India	**1**	**1**	**2**	**4**	**5**
Taiwan	3	4	2	2	3
US	5	3	3	3	3

Source: KPMG

We believe as we scan the opportunities in India, majority of our ideas rise from the above-mentioned themes. The key is to remain disciplined, not panic during volatility and focus on a bottom-up and research driven stock picking instead of the market sentiment. Again, our strategy is to invest into 4-5 ideas under each of the 4 wealth multiplier themes to create a concentrated, well researched and high conviction portfolio for investors with a >3-year view.

Key risks to the themes

1. **Global growth slowdown** - risk is low as high liquidity will still remain through 2022-23, only flow will decelerate
2. **Inflation** – H2FY22 will start seeing moderation in inflation numbers as supply bottleneck eases
3. **Interest rate cycle** hardening – we expect it to be gradual without impacting phase of recovery or growth in US/China.
4. **New mutations** and wider spread of infections leading to more restrictions. This risk is best not judged, but must be addressed depending on severity, longevity, and geographical coverage of lockdown restrictions.

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