7 July, 2014

Quarterly Update

(QE June 2014)

Dear Investor,

This is our 6th quarter together and we hope this finds you in good health and spirit.

The journey has just begun...

We are meeting on the other side of the biggest and most anticipated event, the Lok Sabha elections. Without labouring about the same, let us just say that Mr. Modi carries a phenomenal burden of expectations.

We believe, he has a vision for India and wants to leave behind a lasting legacy. In other words, go down in history as one of the architects of modern India!! This, we believe is a 10 year journey and Mr. Modi is likely to pace himself thus. This journey will be about doing sensible things in a calibrated manner and at times take politically hard decisions.

As was to be expected, the market greeted this watershed election event with a thumping applause with valuations doing a vertical somersault, discounting upfront, maybe a couple of years of expected reforms and pragmatic policy measures. Equity markets are always about anticipation and we believe that this optimism is not too misplaced though such sudden exuberance puts incremental onus on us to be more diligent and watchful. We continue to venture further, thinking laterally and digging deeper to look for robust new investment ideas, at reasonable valuations. We strongly believe that in our investment strategy 'not overpaying' was and will remain the most significant risk management mantra!

Global View

Terrorism has again raised its head in Syria, Iraq, Nigeria and Sudan and threatening to spread to Jordan. In the wake of the upheaval seen in Iraq the questions that begs answer are, 'is Afghanistan going to go the Iraq way and was the world better off with secular dictators in Syria, Egypt, Iraq than with the imposed versions of democracy?'

The unfolding of the Arab Spring is still playing out and the longer term impact of events currently playing out will significantly change the equations between current friends & foes, namely; US – Iran – Saudi. This can translate into fast changing geo-political situation and find economic manifestation in the form of higher oil price, demand for gold, higher inflation, etc. At this time we wish to submit that we can only be watchful of these events and not speculate of outcomes thereof on financial markets. Given this backdrop, we still continue to be biased towards companies with robust business model & low to moderate debt on their books so that they are well positioned to deal with any adverse turn of events.

Indian Economy

A lot can be written about our state of affairs and the way forward. But in short, it will take serious and deep rooted policy & management initiatives to clean the clogged lines of Indian economy. One area where we see clear and present opportunity for the new Govt to get going is the Implementation of GST.

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To quote CRISIL, '*By eliminating the cascading effect of multiple central and state taxes, GST will reduce the cost of doing business and increase profitability, and ultimately help GDP growth. Second, by simplifying the tax regime, GST can significantly improve tax compliance and increase tax revenues.*'

While CRISIL talks only of cascading tax effect and compliance cost, we would like to further highlight the significant longer term benefit for businesses by way of leaner logistics and inventory management.

The media and the investment community is abuzz with expectations of revival of the economy and business opportunities thereof for companies. However, a large number of companies, would be hard pressed to take full advantage of the same, weighted down as they are by the large dollops of debt on their books. Similarly, most PSU banks would need to significantly recap themselves to meet the Basel III norms, before they can aggressively start lending. Both these aspects are key considerations in our investment decision making process.

Value Perspective in Infra EPC business

We believe, for most of these debt laden EPC companies, either as priority or per force, the focus would be on deleveraging and resultantly they may not be able to capitalize on the growth opportunity in the infra space.

In this update, we wish to share our view on the infra EPC space that is currently hogging limelight. Post the installation of the NDA government and expectation regarding huge revival in infrastructure investments, EPC companies attracted a lot of investor interest. We also generally share this optimism and would like to have an exposure to this sector in due course. However, digging deeper and post our interaction with some of the EPC companies, we came away with slightly nuanced view. Most EPC / BOT companies have significant debt on their books (D:E ratio, 2-4x) and low interest coverage ratio attributable to stretched working capital cycle, aggressive investment in BOT projects and sub optimal operating margins. We believe, for most of these debt laden EPC companies, either as priority or per force, the focus would be on deleveraging and resultantly they may not be able to capitalize on the growth opportunity in the infra space. Thus, while the EPC segment is expected to see robust business growth, we believe that many of the of the older / traditionally EPC companies may have to make way for newer generation companies with better balance sheets and ability to undertake construction using modern technologies. It will be out endeavor to add a few such companies to our portfolio.

Looking ahead: We expect a lot of primary offerings to hit the market in the next few quarters either by way of QIPs or IPO. This will absorb part of the investible liquidity, hopefully dampen an otherwise exuberant market that seems to be racing ahead of fundamentals in the short term and also add quality companies to the investible universe.

We are looking at certain opportunities wherein change in management and outlook thereof has significantly changed the fortunes of the company for the better.

We believe, the low hanging investment opportunities are largely taken. Going forward, while the investing basics will remain the same, we will continue to think laterally and act conservatively. In the same vein, we are looking at certain opportunities wherein change in management and outlook thereof has significantly changed the fortunes of the company for the better but has not yet been priced in the equity value of the company.

Please feel free to call or write to me for any further information.

Warm regards,

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