Jan 2023

Nepean Long-Term Opportunities Fund II

"There ain't gonna be no recession."

So said, **Pierre Rinfret**, an economist and an advisor to the Nixon administration, in December 1969. His double negative comment backfired and the US economy began a downturn that very month that would last through November 1970.

Unlike what happened in 1970, we hope that the US and the world will have a shallow recession in 2023. Last year, global equities lost $14 trillion in value, *their second worst year on record*. Consensus estimates see **global GDP growth falling from 3% in CY2022 to 2.1% this year**.

Today, **the consensus 12-month recession probability for the US stands at 65%** and hence GDP growth is estimated to fall from 1.9% to 0.3%. The surge in interest rates by the Fed shaved off 20% from the S&P500 and took a whopping $3.6 Tn off US tech giants, now accounting for 17% of the S&P500 down from 22%. Consensus EPS growth for the S&P500 is a mere 3%, down from 6% in CY2022. While the Fed appears to be determined to bring inflation down to their stated target of 2%, the bigger question is whether or not a recession is necessary to tame inflation.

Meanwhile, MSCI Asia (ex-Japan) fell 20% in 2022, *its 4th largest decline in history*, led by Taiwan (-32%) and Korea (-31%). On the other hand, **India had its 7th successive year of positive returns**, up 5% in INR terms. Since 1985, this has happened only thrice. **India is now the 4th largest country by market cap (clubbing China and Hong Kong as one).** This is despite the fact that foreign investors (FPIs) net sold over $18 Bn in 2022; the selling continues into January with FPIs having already net sold $1.8 Bn this month.

In 2022 and in this year, India will be the fastest growing large economy in the world ! An EY report released this week states that by the time India turns 100 in 2047-48, its GDP will be $26 Tn (in market exchange rate terms) and its per capita income will be $15,000.

FUND FLOWS: We look at this in two buckets: the FPIs and local retail investors.
FPIs: With China re-opening, FPIs have ploughed back into China from Nov 2022 (the HSCEI is up 51% since). Not only are foreigners underweight the market but China trades at half of India's multiple (NIFTY50's at 19.4x CY2023 P/E vs. 8.4x for the HSCEI). We think FPIs will invest more in China this year at the expense of India.

Retail: The relentless selling by FPIs last year was absorbed by large scale buying from domestic investors (via mutual funds, AIFs, PMSs or direct), many of whom are new to the equity markets. Having said that, historically, when one year returns in equity markets are weak, retail investors tend to reduce exposure to equities and look for alternatives.

Hence it's no surprise that SIP (Systematic Investment Plans) cancellations hit a record high of 1.54 Mn in December 2022. As yields rise, there seems to finally be an alternative to equities, i.e. fixed income and to some extent, real estate. With the RBI hiking rates last year in step with the Fed, AAA rated bonds are now yielding 8.0-9.5% (pre-tax). The pictures below are illustrative of what wealth managers are increasingly recommending to their clients:

Net Flows: We have found that it doesn't take much to move the Indian equity markets. In CY2022 the math was as follows:

FPI flows	: -$18.5 Bn
Domestic Mutual Funds	: +$36.0 Bn
Retail direct	: +$8.0 Bn
Net flows into the equity market	**: +25.5 Bn**

Hence, the net flows required to move the NIFTY50 up 5% (in INR terms) were a mere $25.5 Bn for a country with a total market cap of $3.3 Tn or **a mere 0.7% of market cap**. That tells us that $5-10 Bn in inflows or outflows can have a large market impact.

INDIA: KEY DRIVERS IN 2023

India to become a global manufacturing hub: The Production Linked Incentive (PLI) scheme is the brainchild of the Modi government. The total commitment to investments is $58 Bn over the next five years ($34 Bn ex-Semiconductor PLI), with over 660 entities (both Indian and global) having received approvals for participation across 14 sectors. It aims to turn India into a global manufacturing hub taking advantage of the China +1 (and even Europe + 1) global diversification sought by foreign companies. The government estimates that the PLI program has the potential to create ~1.5 Mn direct and ~5 Mn indirect jobs.

Apart from the PLI scheme, foreign companies are setting up manufacturing capacities in India. For example, Vedanta has partnered with Foxconn and will invest $20 Bn in two semiconductor fabrication plants in the state of Gujarat. Moreover, Apple is now making the iPhone 14 in India and between April-December 2022, Foxconn and Wistron Corp. have each shipped more than $1 Bn worth of phones.

Morgan Stanley research estimates that manufacturing's share of India's GDP will rise from 15.6% to 21% by 2031. This implies that nominal output will jump from $447 Bn to $1.5 Tn.

Formalization of the Indian economy gathers pace: Monthly GST collections are now averaging Rs.1.4 lakh crores/$17 Bn. This is significantly helped by the rapid growth in digital transactions over the past 5 years. **UPI (Unified Payments Interface) clocked a record Rs.12.8 lakh crores/$158 Bn in the month of December**. On January 10, the National Payments Corp. of India (NPCI) allowed Non-Resident Indians (NRIs) to use UPI (once their domestic bank accounts are linked to their foreign mobile numbers). The 13.5 Mn person global NRI community will be able to use UPI to transfer funds to families in India and use it on e-commerce portals that allow such payments, further boosting digitization.

ONDC (Open Network for Digital Commerce): A Government of India initiative aims at promoting open networks for all aspects of exchange of goods and services over digital networks. It is based on an open-sourced methodology, using open specifications and open network protocols independent of any specific platform. For example, a farmer in Himachal Pradesh will be able to display his apples on the platform and sell them directly to a buyer anywhere in India. While ONDC is currently under beta testing in Bengaluru, we believe that it will significantly enhance intra-country commerce.

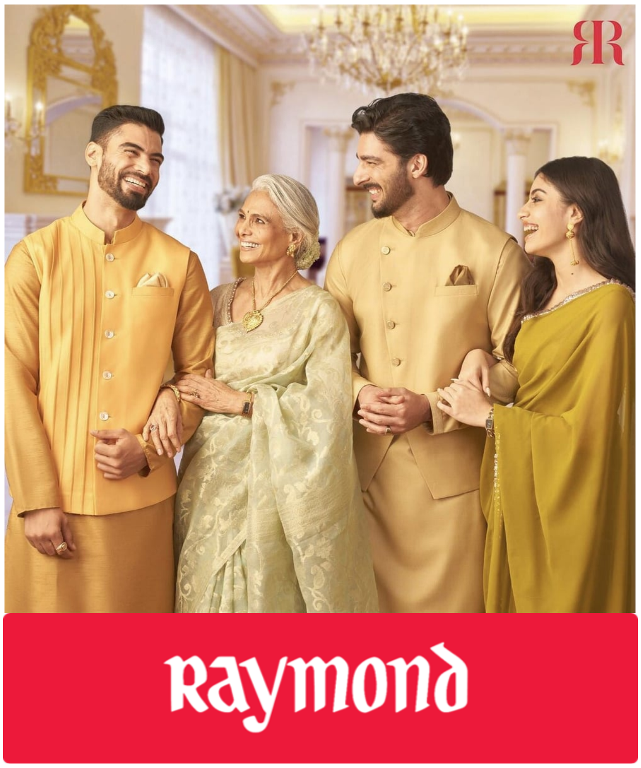
Penetration of the equity culture in India: The launch of an all 4G network by Reliance Jio in 2016 led to explosive growth not just in e-commerce by Indians, but also brought the equity markets into the palm of their hands. The rise in the number of equity investors was also fuelled by zero commission brokerages, work from home during COVID, eKYC (that now takes 15 minutes to complete vs. 2-3 days earlier) and the use of 750 Mn smartphones.

In the last 10 years, demat penetration has risen 4.5x to 7.7% of the population, but lags behind the US which is at 65%. As of December 2022, India had 108 Mn demat accounts vs. 587 Mn PAN cards. Hence in the long term, the runway for getting more Indians to invest in the equity markets is huge. Angel One (among India's largest discount brokers) reported in their 3QFY23 earnings that >95% of gross client additions came from Tier 3 & Tier 2 towns.

It's great to see states competing for investments: Yogi Adityanath, the Chief Minister of India's largest state, Uttar Pradesh, is on a roadshow nationwide this month to attract investments. His target is take his state's GDP to $1 Tn. Similarly, Maharashtra and Madhya

Pradesh (albeit all three BJP ruled) have announced ambitious targets of reaching US$1 Tn and $550 Bn in GDP, respectively.

The Big Fat Indian weddings are back !
The country's GDP got a boost in the months of November and December 2022, when Indians splurged Rs.3.75 lakh crores/$46 Bn across 3.2 Mn weddings. The biggest slice of that, or Rs.90,000 crores/$11 Bn (24%), went towards buying Jewellery. Another Rs.50,000 crores/$6.2 Bn (13%) was spent on Clothes. Around 400 Mn Indians are in the 'marriageable' ages of 20-34 years + another 500 Mn are under the age of 20 giving the wedding industry a huge runway.



CONCLUSION:

1. **We remain bullish on India; it's the only country left standing from the original BRICs economies. But we see near term headwinds caused by mostly external factors**. Since 1990, the S&P 500 index has corrected 10% or more 26 times and each

time Asian markets have corrected with it. **We believe that India historically has not and will not de-couple from global markets.**

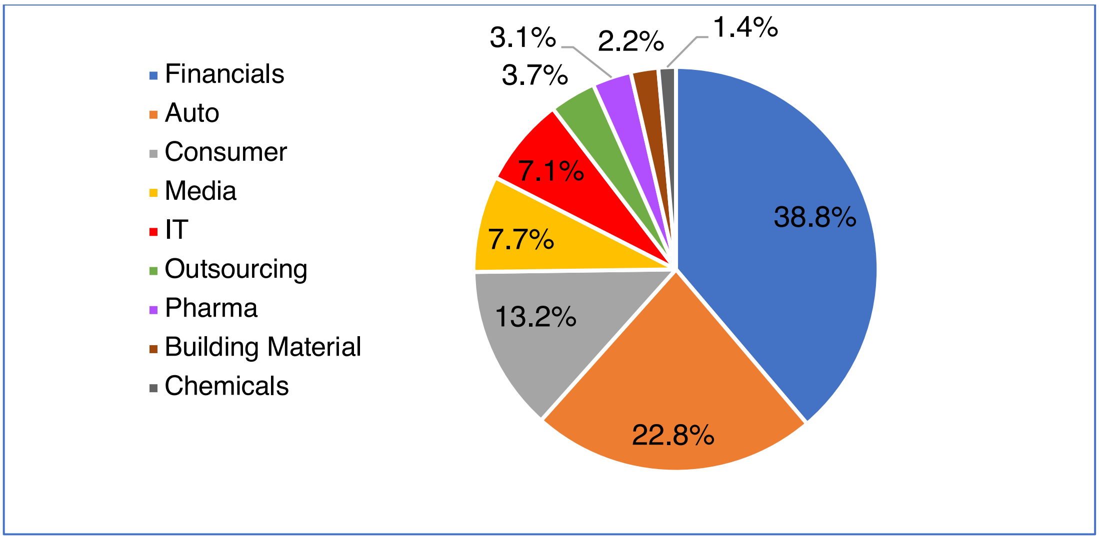
2. **It appears that the RBI** seems to be near the end of its rate hikes given that inflation is moderating. But some global economists have warned that China's re-opening will be inflationary as its factories ramp up production and domestic demand comes back.
3. We think that the Budget, in less than two weeks, will be **pro-growth** given that it's the one before next year's general elections (held once every 5 years) + 9 state elections this year.
4. Given the high valuations in India, we are looking at **stocks that have downside valuation protection**. For example, we chose **Sapphire Foods** over Devyani International (both franchisees for Pizza Hut and KFC) as the former trades at half the multiple. Similarly, we bought newly listed EMS player, **Syrma SGS**, as it trades at a 45% discount to market leader Dixon Technologies.
5. While we continue to look for stocks that have triggers, the high cash levels that we have maintained for the past several months give us the ability to pick stocks that will see corrections.
6. **The key risk to our thesis is a sudden end to the war in Ukraine.** This will help reduce commodity led global inflation, which we believe will prompt the Fed to scale back on rate hikes.

FUND PERFORMANCE (in INR, net of fees):
A1: Investors via Distributors; D1: Investors who are Direct

Performance since inception on Oct 13, 2021			
Category	**Fund**	**NIFTY 500**	**Outperformance**
A1	6.9%	-1.0%	7.9%
D1	7.7%	-1.0%	8.7%

Performance in CY2022			
Category	**Fund**	**NIFTY 500**	**Outperformance**
A1	8.5%	3.0%	5.5%
D1	9.2%	3.0%	6.2%

Sectoral Break-up of the Portfolio:



STOCKS ADDED IN THE PAST QTR:

Spandana Sphoorty Financial Limited (SPANDANA IN):

Spandana is **India's second largest NBFC-MFIs with an AUM of ~Rs.58 Bn/$70 Mn** as of September 2022. Coming out of COVID, the Micro Finance industry (MFI) is at the cusp of a turnaround with sectoral tailwinds on account of: a) harmonization of RBI regulations for MFIs; b) stress tested customer balance sheets; and c) strong capital adequacy to drive growth. It has a new management with Shalabh Saxena as the CEO and Ashish Damani as the CFO (both credited with building a strong franchise at Bharat Financial), a new organizational structure and a clean balance sheet. As a result, we believe the foundations are in place for Spandana to deliver an AUM CAGR of ~30-35% over the next 2-3 years and ROA/ROE of ~4.5%/~22% by FY25E. Given the sectoral tailwinds and the business turnaround, we believe **the stock is attractively priced at 1.2x FY23E P/B**.

Syrma SGS Technology Limited (SYRMA IN):

Syrma is a leading player in the Electronics Manufacturing Services (EMS) industry. It provides integrated solutions across a diverse range of industries from Automotive to Healthcare. It is well positioned to benefit from the outsourcing opportunity in India's growing electronics market, which is estimated to grow at 26% to $272 Bn by 2026. In addition, **Syrma has won two Production Linked Incentives (PLIs) projects in telecom and white goods** and is a beneficiary of the China +1 trend. Its high proportion of Original Design Manufacturing business (27% of sales) gives it greater wallet share and stickiness with its customers which in turn results in higher margins than its peers. We believe it is a very compelling growth story with multiple growth drivers trading at a **40-45% discount to its peers (P/E of 24x FY24).**

Landmark Cars Limited (LANDMARK IN):

Landmark is **India's largest auto dealership** (ex-Maruti) that listed in December. It operates across 8 states in 31 cities with 112 outlets, 53 of which are located in regions where the company has a monopoly. The founder is Sanjay Thakker, a first generation entrepreneur, who founded the company 25 years ago. **Landmark represents 7 OEMs**: #1 dealer in India for Mercedes-Benz, Honda Motors, VW, BYD and JEEP + Renault (#3). It also has an Ashok Leyland truck dealership in Gujarat. In FY22, revenues from operations were Rs.3,400 Crores/$460 Mn, EBITDA margin of 6.3% and ROCE of 19%. Landmark benefits from the trend in Indian passenger cars towards more premium and luxury cars. **The stock trades at around 13.5x at FY24 P/E.**

MEDIA:

CNBC India (English): https://www.youtube.com/watch?v=0Ce8QsH1-DU

CNBC Awaaz (Hindi): https://www.youtube.com/watch?v=nyM5K6WkGeg