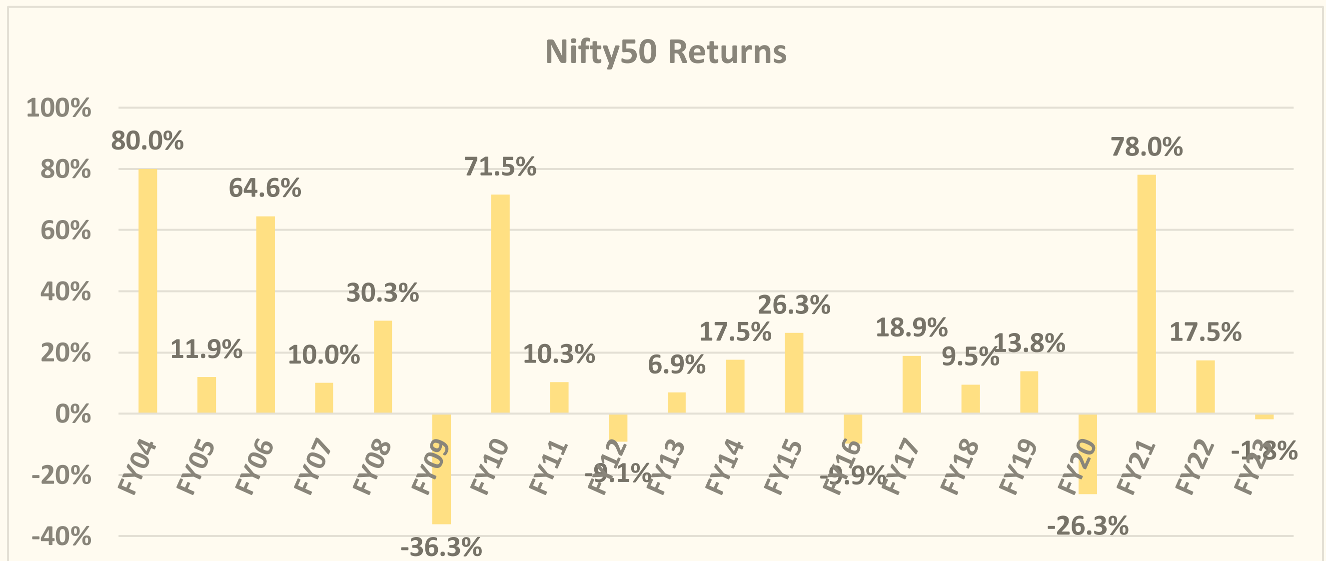
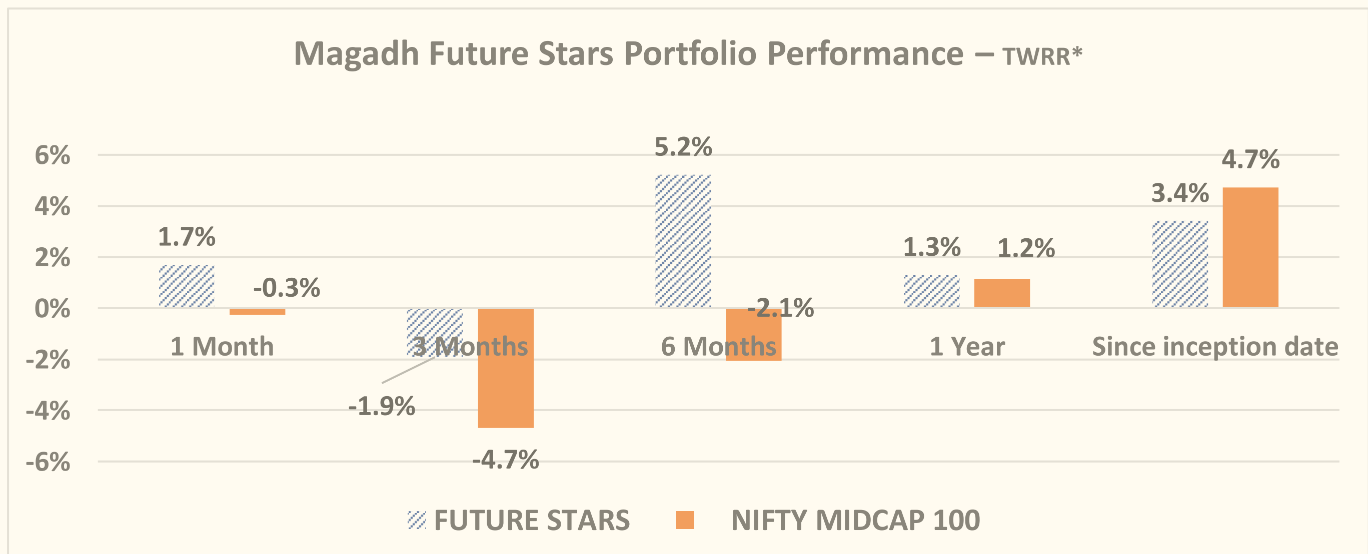
MAGADH CAPITAL

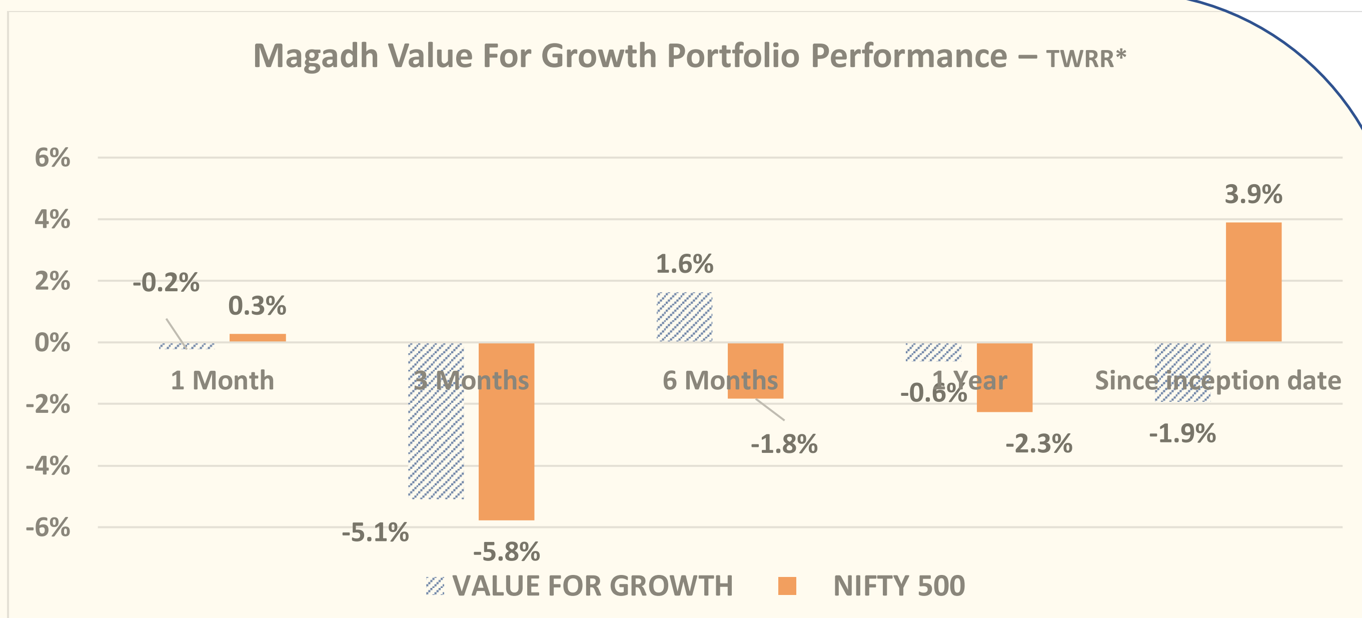
Risks Receding: Expect Equity Markets To Improve in 2HFY2024

In FY2023 Nifty 50 declined by 1.8%. This was only the 5th time in last 20 years that Nifty 50 delivered a negative performance. The year served a reminder that stock markets cannot be simply taken as a money making machine where everyone can make money easily. Instead, the year FY2023 will be remembered for reinforcing the importance of temperament, hard work and a long term approach for investing success.



We outperformed our benchmark, and Nifty 50, in both our investment approaches, Value for Growth as well as Future Stars in FY2023. In 1QFY2023 we had realized that FY2023 would be a lot about capital protection and we are reasonably satisfied with the outcome at the end of the year. The need to protect capital during periods of market uncertainty is an integral part of our investing philosophy.





Inception date was August 2021

*TWRR - Time Weighted Rate of Return

Macroeconomic backdrop

Hike in Fed funds rate in the USA – arguably at amongst the fastest pace ever – in last one year, persistent inflation, and intensifying pressure on banking system in the USA have not just kept policy makers on their toes but also unnerved investors across the globe. India's macroeconomic situation is amongst the best in the world but still some impact of global uncertainty has been felt here too.

We expect FY2024 to be better than FY2023 even though a recovery may be back-ended. Global macro economic conditions and sentiments around the same should bottom out sometime in mid FY2024. USA's Fed may stop hiking rates in next 3-4 months. In our base case outlook, a recovery – with favourable turns in inflation and policy rates- in some key macro parameters should start over next six months. There is some probability of the developed world slipping into a short and shallow recession though this is not in our base case scenario. In India we seem to have crossed the inflation hump and RBI policy rates may not rise much from here even in a bad case. In fact, RBI may see space to cut rates towards the second half of FY2024 with softening inflation, and if the US Fed starts cutting its policy rate by early CY2024. Over last 3 months the macroeconomic uncertainty has reduced notwithstanding the failure of some banks in the USA. Markets have in last one year got accustomed to the new normal of non-zero interest rates as ultra-loose moentary and fiscal policies followed in last 15 years in developed world seem a thing of the past now.

Indian macro

Nifty 50 valuations have softened and have come closer to historical averages on P/E multiples. However, higher interest rates – RBI has raised its reverse repo rate by 250 bps in last one year to 6.50%– may cause some further compression on P/E multiples. The impact of this rate tightening has been much softer on India than in the USA owing to much lesser extent of rate hike (USA saw an increase of 475 bps in Fed rate to 4.75%-5.00% in the same period !).

From a medium-to-long term perspective we are quite positive regarding prospects of Indian stock markets. Progress on reforms and their benefits, favourble demography, healthy balance sheets of government and banking system, and speedy infrastructure improvementcan continue to keep India as an oasis of growth globally. India's disciplined fiscal approach, healthy forex reserves, peppy growth, and fast rising disposable incomes are enhancing the country's relevance for large global investors. To us India is gradually reaching a stage in its development where France and Japan were in 1960s, and South Korea was in 1980's. These countries witnessed a rapid phase of GDP growth for a sustained period after crossing per capita GDP of around US$ 2,500 a level which we are now approaching.

Chart

Country	Starting year	Starting per capita GDP - US$	GDP Growth CAGR %	Over number of years
France	1967	2,364	13.2%	13
South Korea	1985	2,482	10.2%	22
Japan	1971	2,272	11.9%	24

This year has many state elections in India. By the end of this year, dates for 2024 general elections too are likely to be announced. Thus not much progress on reform should be expected in FY2024. Indeed higher expenditure on subsidy can be expected from here. However infrastructure development activity will be in full swing as generally happens in the year leading to general elections. Expect credit growth to maintain its strong trends in next 2-3 years.

Magadh Capital's focus on capital protection

To use equities as the way to wealth creation, Magadh Capital has a robust process in place based on fundamental research with bottom up analysis, and top down views to manage risks, and a heavy dose of behavioural finance.

Our portfolio is designed to mitigate extreme risks. We focus on delivering healthy returns over long term – 3-4 years and beyond. Towards this end we try to avoid big mistakes and strive to minimise risks of permanent loss of capital. If we see a high probability of market collapse of the 2000, 2008, or 2020 kind we do try to protect capital by withdrawing cash. Catching market moves is extremely difficult and hence we take such cash calls only if we see meaningfully high probability of impactful negative events ahead. As mentioned in our June , 2022 newsletter we had been quite active in May-June, 2022 - based on our view that markets had a reasonably high probability (we believed 70-80%) of declining by 25-30%. Eventually we were positively surprised by the resilience of markets. Due to high activity in 1QFY2023 our performance did get impacted at least slightly but as mentioned earlier we had chosen to act that way as a well thought-out part of our process. Accordingly, we took the impact on portfolio performance as a sort of insurance premium.

Make no mistake –outguessing deep bear markets even if partially is incredibly difficult. However many investors manage to do it. And if performed with even partial success, it boosts long term performance tremendously.

At Magadh Capital if we sense that markets are due for a crash by say, 25-30% with a probability of 70% or more then we proceed to position the portfolio accordingly - by raising cash levels significantly, and by enhancing portfolio proportion of defensive stocks and sectors.

However if we expect a 10-15% decline then generally we do not sell. Why ? Because if we assign a 70% probability to this decline of 10% then our expected decline is just 7%, ie 10% x 70%. In our view, to take a market call to protect 7% capital is not worth the effort. Yes – we would sell if we assigned a 90-95% probability for that event(of 10-15% decline in market) due to the almost certainty of the event. In that case it would be perfectly rational to sell and take out cash. However it is highly unlikely that we will be able to get this kind of foresight – that we can predict a 10% market decline, with 90% confidence. This 10% market correction is quite difficult to get right due to low margin of error directionally. On the other hand, if we are calling a 25% increase or decrease we have higher margin for error. So if we can do the latter with high conviction then it may be worth acting on that call.

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That's why we believe, not having divine powers we should not try to call 10-15% market decline. Remember 10-15% market decline can happen anytime, without any predictable reason. And we as equity investors should be able to stomach 10-15% decline – or else we should not be investing in equities.

However when it comes to protecting against 25-30% market falls we must be on our toes. Also, based on past data such declines happen quite rarely. That is why the call to sell out should also be extremely well thought-out and rare. Otherwise we can end up indulging in repeated short term market timing activities.

We believe that a crucial trait of any part of an investing process is that it should have consistency in its suggested course of action so that dependence on luck is curbed.

What worked for us in FY2023 …

Our bottom up holdings in sectors like capital goods and engineering, consumer durables, and consumer discretionary aided our performance. The themes of manufacturing in India, import replacement, rising disposable incomes, or gains from improving logistics and better power availability provided tailwinds to fundamentally strong stocks like Powermech, KEI Industries, PG Electroplast, and Varun Beverages. These companies have in last 3-4 years expanded their scale meaningfully in the process reaching healthy and improving RoE levels. With the big shift in cash flows they are implementing their next leg of capacity expansion and challenging the respective market leaders. With their graded expansion activities they have managed to respond to market demand well and at the same time have not stretched their balance sheets. In these sectors we believe there is a lot of room for ambitious and circumspect companies with vision to grow fast with solid return ratios.

Our constructive call on banks and defence sectors worked well during FY2023. It was not difficult to see in the beginning of the year that sizeable NIM(Net Interest Margin) expansion was on the cards amid rising interest rates, that credit growth would stay on its fast track, and that asset quality would continue to improve for large banks. In addition valuations too were reasonable. We have sizeable positions in both private as well as public sector banks mostly large ones. In our view stock prices of many of these banks are not fully reflecting the growth and asset quality improvement that these banks will likely witness further in next 2-3 years.

Defence is one sector where the ongoing reforms in India can help Indian companies transformatively. The Russia-Ukraine war and its geo-political and strategic implications have spurred the government to move faster towards Atmanirbharta in defence design, development and manufacturing. The pace at which Indian defence sector companies' order book is building

up now is unprecedented. One material change that the Indian defence manufacturing system is set to gain from is the change in approach of the armed forces. India's armed forces have traditionally been sceptical, often with good reasons, to Indian weapon platform suppliers' capabilities with respect to both, quality as well as time taken to deliver. After the Russia-Ukraine war their approach seems to be changing dramatically. As the forces start placing bigger orders on domestic companies the local ecosystem will expand not just in its ability to churn out quality weapon platforms but to research, design and development. With increased scale some of these companies' margins and return ratios should improve further too. While the private defence stocks seem stretched in valuations to us now, we see meaningful upside in PSUs. We expect some of these companies' orderbooks to grow further by upto 100% by end of FY2025 when the present value of cashflows from orderbook and cash on balance sheet will be enough to justify 50% or more of the market capitalization of some of these companies.

In FY2023 we also helped ourselves with the opportunity that the market provided in the shape of NMDC. That NMDC's steel business was going to be spilt off was a well publicized information. In addition, it was not too difficult to estimate the lower end of the range of value of the steel business. Still even as the split date was coming closer, NMDC stock continued to trade meaningfully below the summation of iron ore and steel businesses. Post splitting and delisting of NMDC Steel stocks, partial value unlocking took place immediately. Of course such opportunities do not appear too commonly. We could also wait patiently in this case since NMDC is itself a sturdy company with strong balance sheet, top quality and large iron ore reserves, sharp capacity ramp-up on the cards, and solid edge over peers in logistics.

On the other hand, relatively early in FY2023 we had grown cautious on IT sector and reduced our exposure sharply in April 2022. We took a call that the steep interest rate hike globally would take a toll on revenue growth of IT companies as businesses focused on sustainability and cash conservation - even if after some lag. We were also mindful of the fact that these stocks were trading at valuations meaningfully above their historical averages suggesting a dim picture ahead for these stocks. For a large part of the year we had no stake in the sector. Over next two quarters we believe that the market will give us opportunity to add IT sector stocks as the deficient sector outlook takes further toll on these companies' valuation multiples. The deterioration in near term business environment is not showing properly in these stocks' prices even after the correction post the insipid results from TCS and Infosys in April'23. In our view, long term fundamentals of the sector have not been derailed but we would like to get some comfort on valuations before we build positions here.

Despite tempations we stayed away from new era stocks like Zomato, Paytm, Policybazaar and Nykaa.We have not been able to convince ourselves to pay so heavily for businesses that are still struggling to

generate cash at best, or for companies that are still looking to pin down their business model at worst. No doubt, some of these companies are working in markets that can display high growth for a sustained phase but we would like to see further evidence of growth capabilities of these companies even when they start delivering profits - before we consider these stocks. Otherwise we will not be forced into these stocks just by market hype. We are mindful of greater fools theory where in an investor buys a stock only in the hope that some other investor will buy the stock at a higher price from him later.

….And what did not

Our stance on chemical stocks – we were overweight on the sector in the first half of FY2023 even as we had been reducing our exposure, went wrong. We were expecting margin compression and revenue growth to bottom out for these companies by 2HFY2023. However disruption in global supply chains continued to keep the raw materials prices elevated for longer, pressurizing the margins. Overcapacity in India and rest of the Asian region hindered revenue growth taking us by surprise. We had curbed our holding of chemical sector stocks drastically and brought it down to zero progressively during the rest of the year. Now, as a matter of investing process we take time to build a buying decision but if we decide to sell we typically do so fast. In this case our decision to exit, as against reducing weightage, took time to implement which in turn did not help the portfolio performance.

Some bottom-up calls like those on Borosil Renewables and Laurus Labs went against the portfolio last year. In case of Borosil Renewables the stock suffered since the company was disappointingly slow in execution of its expansion plan. Reduced prices of solar glass - with faster emergence of competition than what we had anticipated- on the other hand impinged on the company’s top line growth and margins. Here our patience did not get the expected reward as the company was not able to come up with means to beat back the base effect in its earnings even as valuations remained elevated. We do not hold the stock anymore but continue to track the company and are keen to figure out the reasons for delay in project execution. We would also watch the profitability and return ratio for the new project.

Laurus Labs saw a disruption of its business model as its ARV (anti-retrovirus, medicines for management of HIV) segment witnessed sharp erosion in prices and volumes. The company has not yet been able to figure out a way to expand in other segments to replace the loss of revenue and growth from its prime mover ARV segment. We still like the way the company is trying to transform itself by enhancing its focus on new businesses of Synthesis and Bio and would follow its progress there.

Then, we went wrong on some of our smaller holdings like Tata Steel and SAIL. We assumed that steel prices would move sideways in a narrow band

and in that scenario market would reward these companies's improving balance sheet and growing volume base would curb their structural costs thus boosting their return ratios sustainably.When steel prices declined faster and deeper than our expectations we realized the mistake and then were quick to sell these stocks thus limiting the damage.

One stock that did not work for us in FY2023 but which we continue to hold is Bajaj Finance. When buying the stock in 2HFY2022 we had known that the stock valuations (on P/BV multiple) were not in our favour. What we were expecting was that the company would continue to deliver on growth and asset quality even off an elevated base. The company has been reporting good numbers almost every quarter even as the stock price and hence valuation multiples have softened in last six quarters. Accordingly we continue to hold the stock largely with an eye on the growth that this company offers with robust risk management practices.

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PORTFOLIO DETAILS *

Magadh Future Stars

- **Total no. of stocks in the portfolio : 19**
- **Weightage of top 10 stock holdings : 75%**
- **Weightage of top 5 sectors holdings : 80%**
- **% of portfolio stocks with P/E ratio of more than 40X : 21%**

Future Stars: Weighted Average Parameters			
GROWTH			
% Change YOY FY2023**			
Revenue	81%	PAT	99%
VALUATION MULTIPLES* **			
P/E	29.7	P/BV	5.9
RISK			
BETA	1.06		
RETURN RATIOS			
ROE	18%		

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Magadh Value For Growth

- **Total no. of stocks in the portfolio : 26**
- **Weightage of top 10 stock holdings : 64%**
- **Weightage of top 5 sectors holdings : 80%**
- **% of portfolio stocks with P/E ratio of more than 40X : 12%**

Value For Growth: Weighted Average Parameters			
GROWTH			
% Change YOY FY2023**			
Revenue	28%	PAT	43%
VALUATION MULTIPLES* **			
P/E	22.4	P/BV	4.3
RISK			
BETA*	1.02		
RETURN RATIOS			
ROE	16%		

Stock Price Data is as on Mar 31, 2023

*As on Mar 31,2023

**Trailing 12month basis

*** Based on our FY23 revenue & PAT expectations

Date: April 18,2023

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Investment Approaches	Future Stars (Mid cap and Small Cap) Value For Growth (Multi Cap)
Investment Approach Launch	August 2021
Minimum Investment	Rs. 50,00,000/-

Investor may invest with us directly. To invest in any of our PMS investment approaches directly or for any additional details / clarification, please write to us at **investor.info@magadhcapital.com**