Market Communication – September 2018

ASK
INVESTMENT MANAGERS

Dear Investors,

The last 4-6 weeks have been quite volatile for the Indian markets. It started with a sharp devaluation of the Indian Rupee (INR) and has subsequently morphed into a bond scare, the results of which have seen a hit to the Indian Equities market. Let us examine what has happened and what we, at ASK expect going forward.
The INR depreciation started with the prospects of a trade war between the USA and China, a sharp rise in the price of crude oil which was accompanied with a worsening of India's current account deficit. As we write, the currency has dropped by more than 13.5% year to date against the USD and is yet to find a stable level. Following a strong performance against the USD in CY2017, it is currently one of Asia's and Emerging Markets (EM) worst performing currencies for CY2018. The fall in INR is in line with the weakening of other EM currencies against the USD, witnessed this year. The USD has strengthened against most global currencies as the Federal Reserve increases interest rates and prospects of an improved balance of trade figures as a result of the trade war with China amongst other factors. Overnight the US Fed has one again raised interest rates which will act as continued support to the strong USD.

Initially the INR was relatively stable. However upon the market sensing that the RBI was not aggressive in defending the currency, along with policy makers' comfort with the INR depreciation, the negative momentum built to the point we now see the INR trading in the 72-75 band to the USD. However, It is important to note that over the mid to long term INR depreciation has actually been a conservative 2.2% per annum and 3.0% per annum (3 years and 15 years) respectively. Historically the INR has been prone to such rapid depreciations after being stable for a few years as the currency catches up with its real value. This year's decline should be viewed in the context of the fact that the currency was essentially flat between the years of 2015 to 2017 (63.1 - 63.9).

On somewhat of an upside, the currency slide on the margin has a slight positive bias on the earnings of some of the Index constituent companies. Export-oriented businesses such as IT services, pharmaceuticals, auto manufacturers (primarily, two wheelers) would benefit as export earnings in INR are enhanced. Additionally, we believe that global commodities like steel and aluminum would also benefit as the products are priced at import parity prices. Corporate lenders will be the beneficiaries of improved profitability of metal companies which have traditionally been large borrowers, though as we will discuss later, other areas of stress unfold for such entities in the economy.

Ultimately though, the Indian equity market is negatively impacted due to India being a net importing nation with the twin deficit issue of fiscal and current account deficit that is seeing expansion year to date. Initially, markets were not concerned and indices were up in the month of August (in INR terms) despite FIIs withdrawing money to avoid currency losses. Domestic Indian investors continued to have faith in the markets with inflows outstripping any foreign outflows and thus indices responded to the improved profitability as explained above. The fact that inflation remained benign and monsoon rains were widespread helped sentiment during August. Most of the market upside was concentrated on a small group of stocks, however the broader market remained under pressure. September, has subsequently seen widespread pressure across the market including the prior outpeformers such as financials that have now seen solid correction month to date.
The drop in INR raised expectations of policy response to control the slide and accordingly, expected policy response has been one or more of the following:
• Sharp tightening of liquidity and an increase in interest rates to reduce speculation and attract net inflows of money into the country.
• Reduce taxation on offshore inflows into the country. This increases the post tax returns and helps increase a country's attractiveness. Whilst Government revenues take a small hit, the underlying businesses do not get impacted.
• Increase in trade barriers. This step may have been less attractive in the past, but given the current environment of trade wars between China and the US, this may be more palatable and thus greater chance of likelihood. Subsequently there have been reports that India may increase duties on several import items.

Interest rates in India were increasing regardless in response to domestic growth indicators and to the increase in US yields. As noted above, the currency depreciation fuelled expectations of further rate increase and bankers have noted expectations of about 50bps increase in interest rates in the near term.

While the INR depreciation was getting addressed and there were signs that globally currencies are finding their new levels, Infrastructure & Leasing Finance Services Ltd (IL&FS), an Indian infrastructure development and finance company, defaulted on its debt. This was not something that was expected from such a prominent name. Indian Mutual Funds held IL&FS commercial paper and had to incur losses from such a substantial default. There is a fear of contagion also given that IL&FS was a significant entity and this was shown in the subsequent market fallout in the following days.
The IL&FS issue and the prospects of a further increase in yields has made Mutual Funds very choosy about the corporate paper (ie. short term debt with tenor < 1 year) they are holding. Recently there was a case of DSP Mutual Fund selling debt paper of Dewan Housing Finance at sharply higher yields causing panic in the markets. It is a fact that the Mutual Funds were not keen to absorb such corporate paper and NBFCs were having issues refinancing debt (short term debt) and borrowing extra to fund growth in a scenario of increasing and volatile interest rates. Mutual Funds and bankers have been looking to see stability in interest rates before lending incrementally to the NBFCs.

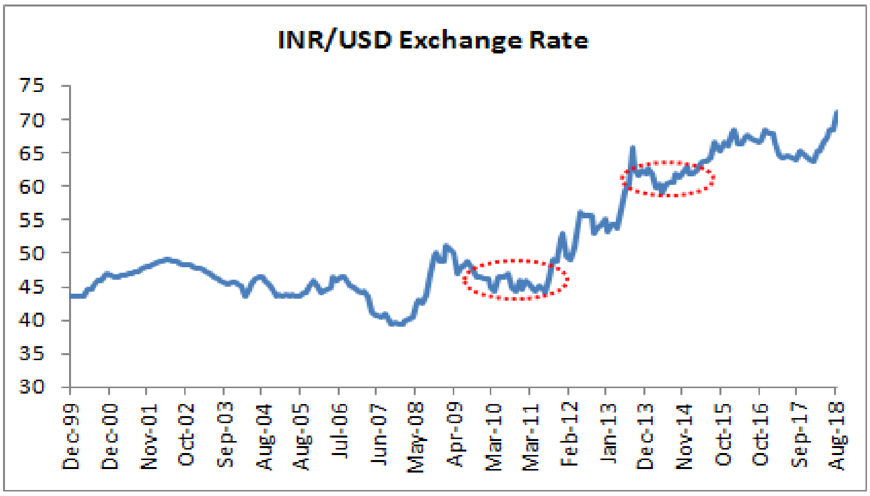
This is creating two issues:

• Increase in borrowing costs that can be passed on to borrowers only by those NBFCs which have pricing power; and
• Prospects of lower growth on reduced availability of funds.

NBFCs over the years in a scenario of reducing interest rates had grown very well, had delivered higher net interest margins and had seen cost to income ratios decline. There is a threat that this cycle is coming to an end and hence the NBFCs have come under substantial pressure in the market, especially smaller/weaker NBFCs with smaller presence and pricing power. The above noted challenges shall, we believe, add further pressure to NBFC short to midterm performance, especially the less prominent players.

How are ASK portfolios positioned?
In line with the investment philosophy at ASK, we are invested into high quality companies which demonstrate consistent free cash flow generation, have grown strongly in the past and have prospects of continued growth into the future. In the past month, our portfolios suffered somewhat on low exposure to exporters and corporate banks that have seen short-term recent outperformance. We continue to believe that corporate banks would see increased competition going forward from Mutual Funds. Regulations have also started to favour such circumstances as corporates have been asked to source a part of their borrowing requirements from the bond markets. The proposal is that companies with more than INR 1bn of borrowings above one-year tenure (excluding external commercial borrowings or inter-corporate borrowing) that have a rating of AA and above will ultimately have to borrow 25% of incremental debt requirement from the domestic bond market.

Whilst the export-oriented businesses will gain in the current period, we believe that the earnings gains would be a one-time thing and not compound over a period of time. In the past, the INR has been stable after a sharp depreciation given the fundamental strength of the Indian economy (refer to chart below).

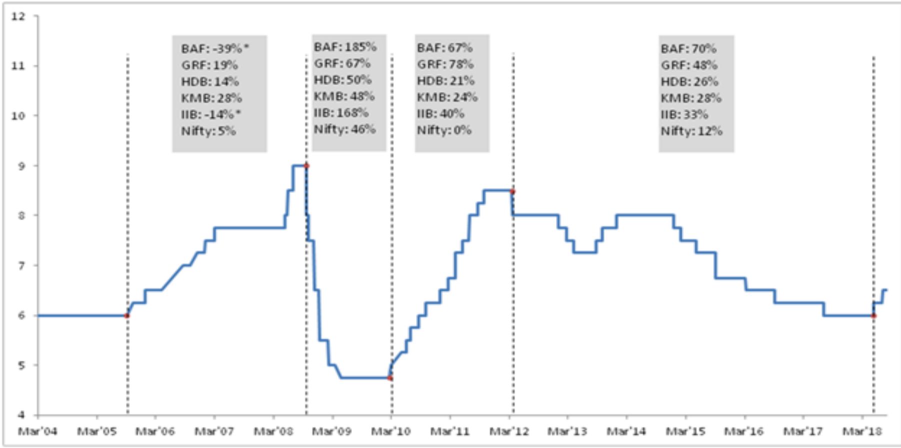


Source: Bloomberg

ASK portfolios are invested into NBFCs but only of the highest quality. While we have seen some extra correction in this part of the portfolio, our view is that this should be seen as an opportunity to buy into this space. In the past, the set of NBFCs that we have owned have managed to deliver strong returns in periods of increasing interest rates just as they have delivered in periods of reducing interest rates. We are continuing to keep a close eye on market events in this space in particular.

The chart on the next page shows how the stock prices of select NBFCs have performed in periods of increasing and decreasing interest rate cycles.

Select group of Indian listed NBFC's Stock Price Performance during past interest rate cycles



* Before change in management and business strategy

Note:

- Returns (in grey box) are CAGR returns for the relevant period.
- Abbreviations: BAF=Bajaj Finance; GRF= Gruh Finance; HDB= HDFC Bank; KMB= Kotak Mahindra Bank; IIB=IndusInd Bank.

We believe the ASK portfolios are well positioned to weather the current market uncertainty. However, there is internal recognition that India is in an uncertain phase in the market cycle which will most certainly lead to short term volatility, including as has been the case this month. The current uncertainty would be followed by Q2 company earnings results which are expected to be softer vs Q1 results on the back of Kerala floods and a higher earnings base effect post GST implementation last year. Furthermore, the market will be closely watching the upcoming state elections which could further add to market volatility.

While the markets are expected to remain volatile and earnings would seem (visually) to be a tad soft, there is no denying the stable structure and strength of the Indian economy. At ASK, our investment philosophy remains targeted towards capital preservation and appreciation over the long term. We believe in sustainable quality and performance of the companies that we are investing in. Hence, in our view, investors should look at this period as an interesting time for potential investment via a gradual manner with a focus on the long term outcomes as opposed to near-term.

Prateek Agrawal
Business Head & CIO ASKIM

Market Communication – September 2018

In INR terms, Nifty50 corrected by 6.4% in September while BSE Mid Cap and BSE Small Cap indices corrected by around 12.5% and 16.1% respectively in the month. As has been the trend during most months of CY18, the correction in mid and small caps has been higher than the main market.

There have been enough reasons for volatility in the markets – domestic and global. Admittedly for investors with a long-term view this could be viewed judiciously as an opportunity as long as they are braced for more volatility. Globally, recent developments on the trade front could create more trouble than what the markets are assuming. In September US tariffs on an additional USD 200bn of Chinese imports became effective. This was countered by retaliatory Chinese tariffs on USD 60bn of US imports. Importantly the US is looking to increase the tariff rates as well as the coverage of imports from China. If all this proceeds in a slightly deleterious manner, there will be repercussions to the expected Chinese and global GDP growth. All these developments have already started slowing down the Chinese growth rate. Recent Chinese economic growth has been very debt funded and things could get nasty. Having said that, the US is trying to stitch up trade deals with other countries but the outcome remains to be seen.

Similarly recent US Fed rate increases and the change in language have been taken in stride but the future magnitude / timing of rate tightening could surprise the market. After all, the US economy is running at low unemployment rates and crude prices have been strengthening. Recent crude price strengthening is also causing discomfort to countries like India. The nature of the recent rise - comprising healthy demand and supply side issues from Venezuela, the impending curb on Iran, OPEC not increasing supply, etc could move either way. If the Iran/OPEC issue is resolved favourably then there could be some cooling off. Alternatively if any additional supply was to get disrupted in the interim, then prices could surge from here as well.

In India, issues pertaining to IL&FS have rattled the market. Some progress has been made recently on the IL&FS issue with the principal shareholders agreeing to infuse INR 4500 crs into a right issue. To allay concerns on system liquidity the central bank has been infusing liquidity through Open Market Operations. Clearly the action of the policy makers and government will be very critical to ensure that the problem is contained. Rather unfortunately from a timing point of view, but correctly from a regulators view, the Central bank has got assertive on the implementation of private bank ownership directives and requirements. On that front various private banks have been falling short and have seen strong price corrections.

The markets could see more volatility despite the recent correction as they do trade at slightly higher than average forward valuations. Strong earnings growth assumptions are built in and have to be delivered, a phenomenon which has not happened for quite a while in the past few years. But this is in aggregate and the outlook will be very different when stocks are looked at individually and present the best opportunity for investors. Fortunately Indian macros and outlook remain good and have lead to more movement towards equity as an asset class. September saw net FII outflows of USD 1 b and FIIs are now net sellers of USD 3.9b for the FY19YTD. FIIs have been net sellers in each of the preceding 6 months except July when they were marginal buyers. Despite this FII selling, Nifty50 has risen by ~ 8% in this period. Admittedly the quantum of selling has been small but it has been the domestic Mutual Fund inflows of USD 7.3bn in the last 6 months, of which September saw an inflow of USD 1.1bn, which give support to the market. The trend in domestic MF buying through SIPs should be persistent in the times ahead. We expect Indian equities to continue to deliver better relative returns.

Gaurav Misra, Senior Portfolio Manager

IEP Portfolio Update – September 2018

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What began as a company specific trouble at IL&FS group has snowballed into a panic situation in equity markets with Nifty down 6%, BSE Finance down 13% and benchmark BSE 500 down 9% during Sep'18 in INR terms. The catalyst to the correction was sale of short term papers issued by DHFL (Dewan Housing Finance Limited) by DSP Mutual Fund at a significant discount. This led investors' outlook on DHFL's stock and NBFCs in general to weaken on concerns that they will face challenges in raising money which will inturn slow lending growth and also have impact on Net Interest Margins (NIMs). All this is in addition to depreciating rupee, rising crude prices and firming up of interest rates domestically.

Led by the chain of events, the cost of incremental borrowings could increase for NBFCs in general in the near term until the issue subsides. However the degree of impact would be varied depending on the stature of each NBFC. We believe that quality NBFCs would be relatively less impacted given

• ability to pass on higher cost of funds to customers
• better ALM (asset liability management) position and
• relatively better ability to raise money at fine rates owing to higher credibility. In fact, the cost of borrowing of different corporate with similar rating has also changed.

Our analysis reveals that ALM profile for Bajaj Finance and Cholamandalam Finance are well matched and hence the current scenario is unlikely to have a significant negative impact on NIMs. Both these names have corrected by 20-25% during the month. Other finance names like Kotak Mahindra Bank, Bajaj Finserv and IndusInd Bank have corrected between 10% and 12%.
Other part which has corrected sharply during the month include consumption/auto pack. Names like Eicher, MRF, Astral Poly, Motherson Sumi, Britannia, Havells, Minda Inds etc have corrected more than 10% during the month.

Eicher: The stock has been impacted due to lower than expected sales worsened by the floods in Kerala, dip in product waiting period, change in insurance norms mandating increase in upfront payment and start of production cuts at Oragdam (plant) due to labor issues. However, we continue to believe Eicher is the largest beneficiary of India's two wheeler premiumisation story. Also, while two wheeler continues to grow at rapid pace, stronger growth in commercial vehicle (CV) business should complement rapid profit growth.

MRF: The stock has corrected in response to the sharp increase in raw material prices leading to perceived pressure on margins. We believe the company has the capability to pass on the increase in raw material prices, albeit with a lag. Over period, company has increased it's per unit profitability along with improvement in capital efficiency. The brand and the distribution built by the company acts as entry barrier for the others. Also, industry is concentrated with top 5 players commanding ~90% market share.

Britannia: after a strong performance in last few month, the stock corrected sharply by 14% during the month. Britannia continues to remain one of the strong bet in FMCG area with significant growth levers; including expanding distribution, new product/category launches, premiumisation and cost efficiency. The company has ability to transform from a biscuit company to a broader F&B play, leading to a high durable long period growth for the company.

Minda: While Minda has corrected by 18% during the month, in line with correction in midcap index and the perceived slowdown expected in auto space, we continue to remain positive on the name. Over the years, Minda has consistently branched out into new product segments through tie-ups/JVs with major global players. Minda, with its strong presence in core segments and deliberated transition into newer product segments is well placed to capitalise on the growth opportunities in the industry led by a mix of regulatory changes as well as premiumisation. Company is rightly placed to capitalise on the regulatory and the evolving technological landscape in automotive industry. We expect profit CAGR of 25% over next 2 years with superior ROCE of 30%+.

Astral Poly: the stock by 11% during the month, in line with correction in midcap index. The company continues to grow strongly in pipes and adhesives business and has recently entered into double wall corrugated pipes – expanding its size of opportunity. Raw material price inflation coupled with currency depreciation can lead to short term pricing pressure, which eventually should be recouped.

Overall, we are invested into very high quality companies. While we have seen correction in this part of the market, we continue to maintain faith in the portfolio companies. Also, the underlying economic trends of rising disposable income, younger population, higher aspiration level translating into higher consumption and savings are unlikely to be impacted over the medium term due to adverse incidents in the short term. On the contrary the positive effect of the reforms (GST, Insolvency and Bankruptcy code, RERA, direct benefit transfers and others) undertaken by the government are yet to show significant positive effect.
We believe we are well positioned for the market uncertainty. The current uncertainty would be followed by Q2 results which will be partly impacted by Kerala floods and input inflation. With the correction in stock prices even in quality businesses now, we believe investor should look at this as a period to invest into the markets.

ASK Indian Entrepreneur Portfolio – Sep 2018

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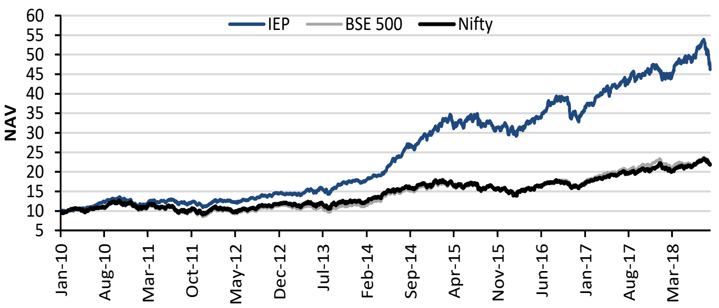
Investment Objective: ASK Indian Entrepreneur Portfolio (IEP) invests in entrepreneurially driven and/or family owned businesses; listed on the Indian stock markets, for compounding gains over the medium to long term.

Top 10 Holdings (%)	
Page Industries Ltd	8.1
Bajaj Finserv Ltd	7.5
Britannia Industries Ltd	7.0
Bajaj Finance Ltd	6.6
IndusInd Bank Ltd	6.4
Havells India Ltd	6.4
Asian Paints Ltd	5.5
Cholamandalam Investment and F	5.3
Astral Polytechnik Ltd	5.3
Eicher Motors Ltd	4.9

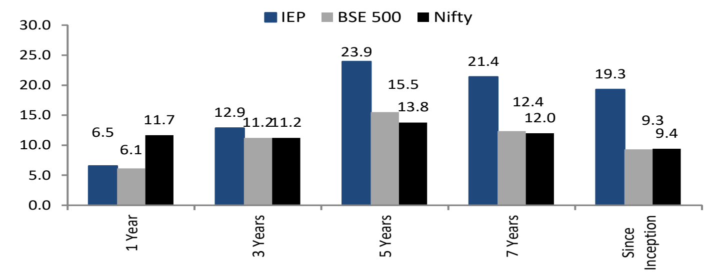
ASK IEP Movement Since Inception



Rs. 1 Cr invested in IEP in Jan 2010 is now worth Rs. 4.62 Cr v/s Rs. 2.16 Cr in BSE 500

Top Sector Weights (%)	
NBFC	11.9
Banks	10.9
Building Products	9.6
Retail	8.1
Auto anc	7.8
Insurance	7.5
FMCG	7.0
Cement	6.6

CAGR Performance



Portfolio Metrics	
Total Assets under Management & Advisory in Rs. Crs.	6,304
Weighted Average Market Cap in Rs. Crs.	63,712
Median Market Cap in Rs. Crs.	53,124
Beta (since inception)	0.74

Portfolio Manager
Sumit Jain

Inception Date of ASK IEP is 25-Jan-2010. Information as on 28-Sep-2018

Note: Performance figures are net of all fees and expenses. The above returns are composite returns of all Integrated Clients . Returns for individual client may differ depending on time of entry in the Strategy. Past performance may or may not be sustained in future and should not be used as basis for comparison with other investments. Retu rns for 1 year or less time period are absolute returns, while more than 1 year are CAGR