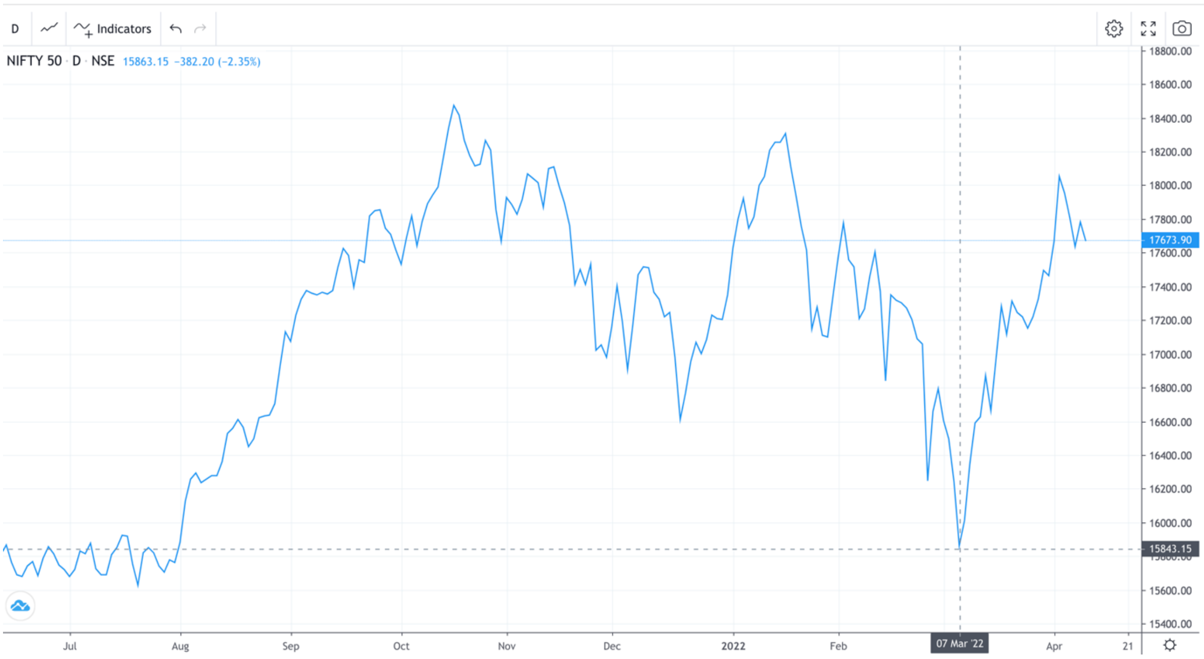
April 2022

Nepean Long-Term Opportunities Fund II

VIEW ON THE INDIAN EQUITY MARKET:
The Indian Equity market (NIFTY 50) rose 144% from the trough (Mar 20, 2020) to the peak (Oct 18, 2021). Since then it has been in correction mode with over $30 Bn of FPI (foreign portfolio investor) selling, double that of the $15 Bn sold during the global financial crisis of 2008. **However, we believe that the correction isn't over yet.** While the headline index fell 15% (and has largely recovered since), individual stocks have fallen significantly more. An analysis of the **BSE500 universe** reveals that:

- 72 stocks have corrected 40% or more from their respective 52 week highs
- **304 stocks have corrected 20% or more from their respective 52 week highs**
- **Hence 60% of the BSE500 stocks are in a Bear market**



The NIFTY 50 over the past 12 months

Global inflation, caused by supply chain bottlenecks and further accentuated by the Russia-Ukraine war, has come to haunt corporate India. Currently commodities are in super backwardation, and as a result we see at least two quarters of earnings pain and margin compression in sectors such as: Consumer Goods, Autos, Chemicals, Fertilizers, Cement, Real Estate and Textiles among others. Thankfully, Brent Crude which had spiked to $128/bbl in early March has corrected 21% to $101/bbl. However, if oil sustains at these levels, India's current account deficit will widen to around 3.5% of GDP vs. 2.5% @ $75/bbl.

We believe that as 4Q FY22 results begin this week, the street will start to cut earnings for FY23. In fact, we think 1Q FY23 results will be far worse than 4Q FY22.

FUND FLOWS:
Foreigners have net sold $74 Bn in Emerging Asia (ex-China) from the late Jan 2021 peak. **In India, the FPI selling has been mostly focused on Large caps, namely IT, Financials and Industrials.** The selling in Asia has continued well into 2022, with YTD net outflows of $20.3 Bn in Taiwan, $8 Bn in South Korea. $13 Bn in India and $4.2 Bn in China. The only surprise exception has been the ASEAN region, that has witnessed $7.6 Bn on net inflows.

The large FPI selling since October last year in India has been absorbed by huge inflows into **domestic mutual funds**, which continue unabated **ending the fiscal year with a record net Rs.1.64 lakh crores/$21.8 Bn**. In fact, the month of March witnessed record equity flows of Rs.28,463 crores, +44% MoM. SIP (systematic investment plans) inflows also hit an all-time high of Rs.12,328 crores; March was the 13th consecutive month of inflows.

In addition, April-Feb FY22, i.e. **the first 11 months of FY22, net Retail investments (ex-Mutual Funds) were Rs.1.58 lakh Crores, +157% YoY.**

We believe that the strong domestic flows into equity mutual funds and directly into the equity markets will continue because:

1. There is still no real alternative to the equity markets for most Indians to park their incremental savings. **Today, State Bank of India's Fixed Deposits (>3 years and <5 years), yield 5.2% pre-tax or a mere 3.5% post-tax** (assuming you are in the 33% income-tax bracket). The RBI needs to hike rates meaningfully (125-150 basis points) before investors start finding fixed income an attractive investment option.
2. **700 million Smartphone users** (and growing) at 4G broadband speeds, eKYC (that takes all of 15 minutes to complete) and zero commission brokerages have brought the stock market into the palm of Indians. These factors have also driven the penetration of equity ownership across the country. India now has 81 million demat accounts; this number has doubled in the past 3 years. **ICICI Securities reported that over the past 3 years, millennials and Gen Z constituted 70% of their active customers.**
3. **Angle One** (one of India's largest online brokers) shared some interesting trends in its 3Q FY22 results:
    - **75% of their clients placed orders through their Mobile app**
    - **99% of their clients executed orders online**
    - Gross Client Additions ↑ 9.5x in the past 2 years
    - >94% of Gross Client Additions came from Tier 2 & 3 towns

The two Billion-dollar questions are:

1. How much will inflation in India eat into the average's investors disposable income which will slow down the inflows into the market ?
2. Will FPI selling accelerate with further US rate hikes ?

We think FPIs will take a while to return to EMs/India due to:

1. The five more estimated rate hikes by the US Federal Reserve (totalling 175 bps this year + another 3-4 hikes in 2023) will end the 'carry trade.'
2. **We suspect that FPIs will invariably find China more attractive since its valuations are at a 48% discount to India, with MSCI China CY23 P/E of 9.9x (a 6 year low) vs. 19x for MSCI India (same as the S&P 500)**. Also, FII ownership of Chinese stocks remains low at 15% (only 4.5% for A shares) vs. 18% for India.

3. **YTD Performance of various Asset classes** validates the underperformance of Emerging Markets:

Crude Oil	+35%
Gold	+6%
S&P 500	-5%
Bitcoin	-6%
MSCI Developed Markets	-6%
MSCI Emerging Markets	-8%

KEY ISSUES:

1. 3Q FY22 GDP growth of 5.4% (vs. 8.5% in the 2Q) was below market expectations and demonstrated slowing growth momentum. **Gross Fixed Capital formation, which accounts for 36% of GDP, grew a mere 2% vs. 14.6% in the 2Q**. Given that private sector capex has still not picked up, the burden falls squarely on the Government of India. We hope that the GOI picks up the pace of privatizations and Asset Monetizations to fund this much needed capex.
2. The good news is that in FY22, **the Tax to GDP ratio hit its highest ever level at 11.7%,** (6.1% for direct taxes and 5.6% for indirect taxes) **confirming the path to the 'formalization' of the economy.** Gross Tax revenues exceeded the GOI's target of Rs.22.17 lakh crores by as much as Rs.5 lakh crores. Gross Corporate tax collection was up 56% YoY to Rs.8.6 lakh crores. Gross Personal Income tax collection too was up 43% to Rs.7.48 lakh crores.
3. **The IPO market** this year also remains log jammed with 55 companies in queue (including LIC), while another 37 companies have filed DRHPs and are awaiting SEBI approval. The LIC IPO will suck out anywhere from $8-10 Bn from the financial markets thereby impacting secondary market flows.
4. **Indian equity markets are experiencing the listing of New Tech companies for the first time, where valuations metrics are driven by another country, i.e. the US.** Even as recently listed New Tech companies crashed anywhere from 40-70%, Private equity and VC funds invested a record $77 Bn in CY2021, +62% YoY. In contrast, **China Tech has lost $1.9 Trillion in value** since its high in Feb last year.
5. **We remain cautious on the markets given high inflation, global credit tightening and upcoming earnings cuts. Having said that, we continue to look for stocks that have triggers that are not priced and will play out over the next 3-4 years.**

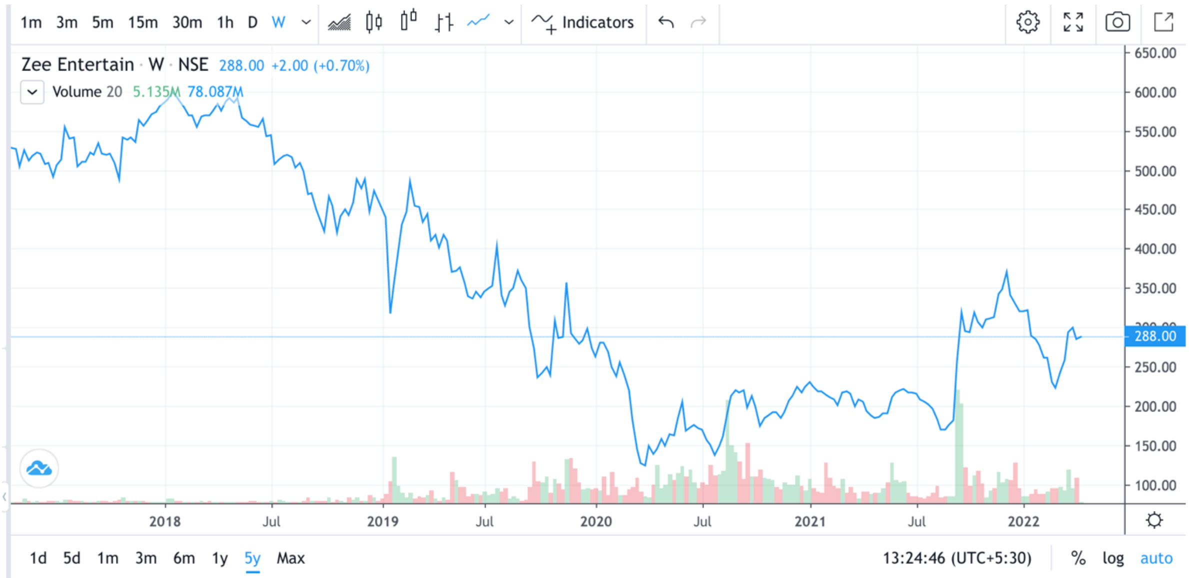
FUND PERFORMANCE:

Performance between 14/10/21 and 31/3/22			
Category	**Fund**	**Nifty 500**	**Outperformance**
A	0.0%	-5.5%	5.6%
D (Direct)	0.4%	-5.5%	6.0%

Performance between 31/12/21 and 31/3/22			
Category	**Fund**	**Nifty 500**	**Outperformance**
A	0.4%	-0.7%	1.1%
D (Direct)	0.6%	-0.7%	1.3%

6 STOCKS ADDED IN THE PAST QTR:

Zee Entertainment (Z IN): Zee is India's largest television network. We invested in it as we believe its merger with Sony Pictures will create an even more dominant player in the Indian broadcast and online media space, with a vast network of media assets consisting of 75 TV channels, two video streaming services (ZEE5 and Sony LIV), two film studios (Zee Studios and Sony Pictures Films India), a digital content studio (Studio NXT), and programming libraries. **Zee is a great example of a stock that was yesterday's Large Cap and is today a Mid Cap.** It has corrected from Rs.600 in Jan 2018 to Rs.288 today.



Varun Beverages (VBL IN): Varun is PepsiCo's largest bottler in India with an 85% market share. In addition to Pepsi's range of carbonated drinks, it also bottles and distributes Tropicana juices, Aquafina water and Gatorade. Last month Varun became a co-packer for Pepsico's Kurkure Puffcorn. The summer months are its largest revenue generators and it lost out on them in the past 2 years due to COVID. We invested in Varun as it will be a clear beneficiary from the decline in COVID and the normalization of economic and social activity in the country. Moreover, it's a great way to play the rapid electrification of India taken up by the Modi government over the past 8 years in Tier 2-5 towns. As a result, drinks can now be refrigerated and drunk cold.

Bajaj Auto (BJAUT IN): Our investment in Bajaj is a contrarian bet on the auto cycle. Two-wheeler stocks are trading at cycle low multiples of 15x FY24 P/E. With economic activity picking up and consumers coming back to the market, we believe it is only a matter of time before the cycle turns in favor of Bajaj. The other points we like about Bajaj are that 50% of its business comes from exports and therefore it's a beneficiary of rupee depreciation. Also, they are expanding the presence in the EV space, and we feel this can be a trigger for the long-term re-rating of the stock.

Hindustan Foods (HFD IN): Hindustan Foods is India's largest and most diversified contract manufacturer in the FMCG space. Its product range covers Personal Care, Home Care and Food and Beverages. It has 13 plants across the country, 20+ years of experience and an enviable list of clients from HUL to Reckitt Benckiser to Tata Consumer Products. It is a high growth company led by a dynamic promoter which we believe will be a steady compounder in the future.

Apcotex Industries (APCO IN): Apcotex is one of the leading producers of Synthetic Rubber (NBR & HSR) and Synthetic Latex (Nitrile, VP latex, XSB & Acrylic latex) in India. The company has one of the broadest range of Emulsion Polymers available in the market today. It is the only producer of its products in India which are used across a range of industries from tyres to footwear. Founded by the former Managing Director of Asian Paints, Apcotex possesses leadership in a niche segment and is trading at a compelling valuation.

Axis Bank (AXSB IN): It has been undergoing a fundamental transformation under the new leadership towards a culture of conservativeness, prudency and risk calibrated growth. Capitalising on the pandemic induced slowdown, Axis has strengthened its capital position, built a solid and sticky CASA franchise and created a strong provision buffer. Axis has been investing aggressively in technology and with its improving digi-banking capabilities, we expect it to become a solid presence in the tech-based banking and payments ecosystem. We believe the reasonably priced acquisition of Citi's India retail business should strengthen Axis's competitive positioning in the affluent segment and offer a strong fillip to the Burgundy business. Trading at ~1.5x FY24E P/B, Axis's discount to its peers is at a decadal high offering a very favourable risk-reward ratio.

MEDIA:

CNBC India (English): https://youtu.be/CR6cHFvw8Pc
CNBC Awaaz (Hindi): https://youtu.be/NDSoWAIotqU