Oct 2022

Nepean Long-Term Opportunities Fund II

"I said they're storm clouds," Dimon warned. "They're big storm clouds here. It's a hurricane [and] that hurricane is right out there down the road coming our way. We just don't know if it's a minor one or Superstorm Sandy."

- Jamie Dimon, Chairman & CEO, JP Morgan Chase, June 2022

We used Jamie Dimon's quote in our previous newsletter and have repeated it here as it seems that his prophecy is coming true. We do see a hurricane coming over the next few months and making landfall on the global capital markets. The final quarter of 2022 starts with a heady mix of:

1. **Fed's war on inflation** that's resulting in interest rates rising globally and the strengthening of the US dollar. Emerging Markets (EMs) like India are collateral damage as it's causing imported inflation with the INR depreciating 11% YTD, even after the RBI sold US$100 Bn to arrest the fall. The dollar is also hurting US corporations that have large overseas businesses. 29% of aggregate S&P 500 revenues are derived from outside of the US. For example: Microsoft warned that the rising dollar will shave 5 percentage points off its revenue next quarter.
2. **Commodity inflation remaining elevated**. Although oil (Brent) has corrected 27% from a year high to $94/bbl, it remains expensive for most EMs. OPEC's decision to cut oil production by 2 Mn barrels a day will only add fuel to the fire (no pun intended). A roundtrip air ticket in Economy class for my younger son from Durham (RDU, North Carolina) to Mumbai this December has cost (me) a whopping Rs.3.24 lakhs or US$4,000! To put things in perspective, pre-COVID in 2019 I paid 30% less for a Business class ticket Mumbai-LAX roundtrip.
3. The war in Ukraine entering its 9th month and showing no signs of abating, thereby continuing its impact on point #2 above.
4. It has dawned upon global corporations that there is no quick fix for the supply chain bottlenecks. China +1 will take several years to implement and mature. As a result, **in the medium term inflation is here to stay**.

INDIA: TO DE-COUPLE OR NOT TO DE-COUPLE, THAT IS THE QUESTION

While the YTD performance of various Asset classes is mostly negative, India's benchmark index, the NIFTY 50, has performed relatively better than the US markets.

Crude Oil	+25%
Gold	-10%
NIFTY 50 (in US$)	**-14%**
10 year US Treasury	-16%
S&P 500	-23%
MSCI Developed Markets	-24%
MSCI Emerging Markets	-27%
NASDAQ 100	-31%
Bitcoin	-58%

The S&P 500 and the NIFTY 50 this year (in local currency)

POST-COVID DOMESTIC DEMAND IN INDIA HAS SURGED:

- Last month's **Auto Sales** have rebounded when compared with Sep 2019. Passenger cars +44.5%, Trucks +17% and Tractors +37%. The only sector that is lagging is Two-wheelers, down 14%.
- **Hospitality** has seen explosive growth with all sub-sectors gaining, from hotels to airlines to dining out. An online travel portal that we spoke to last week, said flight bookings are up (value wise) over 100% from pre-COVID levels.
- **Real Estate** sales too have grown in spite of rising interest rates. For example, property sales in Mumbai rose 11% YoY last month, making it the best September in 10 years. **Lease volumes in the commercial real estate sector were up 29% YoY** in the 3Q to 16.1 Mn square feet, a 7 quarter high.
- **Non-food credit growth** has inched up with September **clocking +16.7% YoY**. This has been aided by the massive clean-up of the NPL problem at Indian banks.
- **GST collections** have been registering over Rs.1.3 lakh crores/$17 Bn a month for the past 12 months, signalling that the Government of India (GOI)'s steps in formalizing the economy are gaining traction.
- **Manufacturing sector's** share in the Indian economy reached the pre-COVID level of ~18% of GVA in FY22 and is poised to hit an all-time high this fiscal as the GOI rolls out more incentives to attract FDI. India is benefiting from China +1 as major global corporations look at it as *one* of the destinations. **Apple now manufacturing the iPhone 14 in India is a great headline!** Apparently Apple has also asked its suppliers to start making Airpods and Beats headphones in India starting next year.
- **ONDC (Open Network for Digital Commerce)** is a GOI initiative aiming 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 can potentially boost intra-country commerce.

FUND FLOWS:

- **While FPIs** have sold $21.8 Bn YTD in India (2nd highest in Asia ex-Japan, Taiwan is #1 with $44.4 Bn of outflows), they have pulled $111 billion from Asian markets (ex-China), surpassing the US$93 billion sold during the 2008 crisis. Foreigners remained net buyers of Chinese onshore equities with $8 Bn this year.
- **Domestic Mutual Funds** have net invested $32 Bn YTD. Flows into systematic investment plans (SIPs) have grown every month with September clocking a new high of Rs.12,700 crores/$1.6 Bn. Separately, YTD retail investors have net ploughed Rs.85,700 crores/ $11 Bn directly into the market.
- **Until now there were no real investment alternatives to Equities**. However, with rates rising and demand for real estate reviving (ironically partly fuelled by gains made in the equity markets), investors now have other options to invest.

VALUATIONS:

Among 18 EMs, India has been the 6th best performing market (in local currency terms), -1.9% YTD vs. an average of -22.7%. However, India has been and remains the most expensive market in Asia trading at 20.3x CY2023 P/E, **more than double that of China** (9.3x) and vs. 11.2x for Asia (ex-Japan) and 16.2x for the S&P 500.

CONCLUSION:

1. **We remain bullish on India; it's the only one left standing from the original BRICs economies. But we see near term headwinds caused by 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. **The RBI is stuck between a rock and a hard place**. If they raise rates too much then they risk derailing the post-COVID recovery, but if they don't, they risk the INR falling even more and importing in more inflation.
3. 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 have seen major corrections.
4. **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.
5. **We sincerely hope that the *storm clouds* result in a minor hurricane and not *Superstorm Sandy or Ian!***

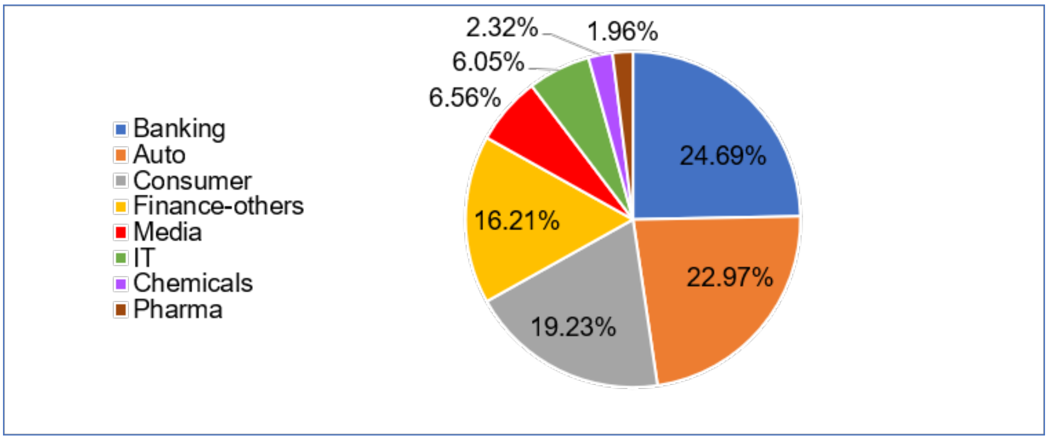
FUND PERFORMANCE (in INR, net of fees and taxes):

A1: Investors via Distributors; D1: Investors who are Direct

Performance since inception on Oct 13, 2021			
Category	**Fund**	**NIFTY 500**	**Outperformance**
A1	+3.6%	-5.1%	+8.7%
D1	+4.5%	-5.1%	+9.6%

Performance YTD			
Category	**Fund**	**NIFTY 500**	**Outperformance**
A1	+4.0%	-1.1%	+5.1%
D1	+4.6%	-1.1%	+5.7%

Sectoral Break-up of the Portfolio:



STOCKS ADDED IN THE PAST QTR:

Greenpanel (GREENP IN)

This is India's #1 manufacturer and exporter of MDF (medium density fibreboard) which accounts for 85% of its revenue. The growth in MDF continues to be driven by increase in demand for readymade furniture. The annual market is currently at a mere Rs.3,200 crores/$400 Mn but is expected to grow at a CAGR of 15% over the next 4 years. Annual consumption of MDF in India (1.75 Mn cubic meters/CBM) lags China (annual 50 Mn CBM) by a wide margin. The company is net debt free, has a healthy RoE of 30% and 30% EBITDA margins. 1Q FY23 MDF realizations were up 39% to Rs.31,345 per cubic meter. At 14.5x FY24 P/E the stock is attractively priced.

Sapphire Foods (SAPPHIRE IN):

Sapphire is one of the two franchisees of Yum! Brands (Yum) in India and promoted by PE firms led by Samara Capital. The company operates 281 KFC and 235 Pizza Hut outlets in India; 93 Pizza Hut and 5 Taco Bell outlets in Sri Lanka (largest QSR chain in Sri Lanka) as of June'22. Sapphire's new scalable restaurant economic model, its omnichannel strategy and reduction in store sizes has led to a big shift in Sapphire's unit economics. Over the last 2-3 years, Sapphire has managed to narrow the margin gap with its peer Devyani International through cost efficiency and operating leverage. We believe the growth runway for Pizza Hut is very high given the large gap between the number of stores by the market leader (Domino's) and the combined number of Pizza Hut stores between Sapphire and Devyani. With respect to KFC, we expect Sapphire to continue with its impeccable execution and add stores at a CAGR of ~20% till FY25E. Sapphire is attractively valued at 24x FY24E EV/EBITDA and the valuation gap between Devyani and Sapphire (~40%) should bridge over time as Sapphire's execution excellence comes to the fore.

MEDIA:

CNBC India (English): https://youtu.be/Bk61lp5sS6o
CNBC Awaaz (Hindi): https://www.youtube.com/watch?v=nyM5K6WkGeg