

Nepean Capital

2Q FY24/3Q CY23 Investor Newsletter

The Nepean Long Term Opportunities Fund II has given a return of 28.6% (net of fees) since the first close, having outperformed our benchmark the NIFTY500 by 1790 basis points.

Performance (in INR), Net of Fees			
Period	Fund	NIFTY 500	Outperformance (bps)
Since first close (October 13, 2021)	+28.6%	+10.6%	1790
Last 12 months	+21.1%	+16.6%	450
YTD	+17.6%	+11.9%	560
Last month	+3.0%	+2.2%	80

“I think it is a huge opportunity for India and America. I love the fact that we've been speaking more and embracing each other more. We will be your best natural ally for the next 100 years. It's pretty obvious to me.”

- **Jamie Dimon at the JP Morgan India Conference, September 25, 2023**

When the Chairman & CEO of the largest U.S. bank says this, the world listens. In fact, Jamie Dimon is certainly putting his money where his mouth is. Under his leadership, JP Morgan's commitment to India has gone from 6,000 employees in 2005 to over 50,000 today. Moreover, JP Morgan will be adding Indian government bonds to its widely tracked *Government Bond Index-Emerging Markets (GBI-EM) Index* and the index suite, benchmarked by about US\$236 billion in global funds. JP Morgan said 23 Indian Government Bonds (IGBs) with a combined notional value of \$330 billion, all of which fall under the fully accessible route for non-residents, are eligible.

I was in Hong Kong three weeks ago after some 4.5 years and caught up with former colleagues and friends alike from the financial industry. I found that there was a complete aversion to investing in China and that funds had interest in only two markets in Asia, Japan and India. I was flooded with questions about the state of the Indian economy, the fate of the monsoon, the probability of Prime Minister Modi getting a third term in next year's general elections (held every five years) and, of course, my top picks. What surprised me was that my Chinese tailor (whom I have known from the time I lived there 15 years ago) said, “*Mr. Trivedi, how are things in India ? I hear it is booming !*”

That was music to my ears. It's good to see that the India story is permeating beyond the global financial press and multinational corporations looking for supply chain alternatives. We believe India does seem to be at that lift-off stage where China was probably 15 years ago.

Much to the chagrin of the local media and investors, the rally this year has been part of a global equity markets rally and not unique to India. The S&P500 is up 12%, NASDAQ +27%, Nikkei +24%, DAX +9.3%, CAC +8.2%, Bovespa +9.5% and the NIFTY50 +8% (all in local currency). Hence the global correction that began 6 weeks ago has not spared India (-2.7% from the year's high of 20,192). Foreign portfolio outflows continued from Asia (ex-Japan) with -\$16 Bn in September, which followed -\$18 Bn in August. The outflows are no surprise given that the DXY is up 7.3% since mid-July to 107.12, and historically US dollar strength is accompanied by portfolio outflows.

After six straight months of net inflows from foreign portfolio investors (FPIs) into India, September witnessed net outflows of \$2 Bn. The \$15 Bn of net inflows YTD from FPIs (third highest in Asia after Japan and China) have been matched by net inflows into domestic mutual funds, thus confirming how important local investors have become to India's equity markets. The number of demat accounts of Indian retail investors hit a record 126 Mn, +11% from March this year. Even though INR bonds of

AAA rated Indian companies are yielding anywhere between 7.5-8.1% (pre-tax), inflows from domestic investors remain strong. Mid & Small-cap funds continue to see the largest inflows while Large-cap funds have seen modest outflows. What's interesting to note is that China Northbound flows are just marginally higher than India, even though its market cap is 3.5x larger.

S&P 500 Index

.SPX:INDEX

RT Quote | Exchange | USD

EXPORT ↓

WATCHLIST +

LIVE ●

LAST CALL

Last | 5:21 PM EDT

4,288.39 ▲ +0.34 (+0.01%)

52 week range

3,491.58 - 4,607.07

1D 5D 1M 3M 6M **YTD** 1Y 5Y ALL

+ Comparison **.GDAXI** **.NSEI** **.N225**



India's performance this year vs. the S&P500, Nikkei 225 & DAX

MSCI India trades at 20x CY24 P/E, making it the most expensive major stock market in the world (vs. the S&P500 at 18x). Having said that, the rally this year has been broad-based. Of the universe of the BSE500 stocks, a whopping 450 stocks are up +20% or more from their respective 52-week lows vs. the NIFTY50 +19%. Moreover, in April this year, as many as 300 of the BSE500 stocks were down 20% or more from their respective 52-week highs. Today that number is a mere 70. We believe that India is a bottoms-up market and there are still several event-based stocks to choose from.

Notwithstanding valuations, the mood on the ground remains fairly buoyant. The September manufacturing PMI clocked 57.5, albeit the slowest in the last 5 months but was the 27th straight month of the index being above the 50-mark. Last quarter, automobile manufacturers had their best sales ever with several car companies raising prices and cutting back on promotions. The festive season, which accounts for as much as 40% of full year sales for consumer goods, starts from October 15th and culminates with the Hindu festival of Diwali, this year on November 14th*. Similarly, electric two-wheelers saw an 18% jump YoY in sales for the month of September to 62,900 units.

The CEO of LG Electronics India, Hong Ju Jeon, said that this year India will be their fastest growing market in the world (in percentage growth terms). Penetration for white goods is quite low in the country: 13% for air conditioners (vs. 80% in China), 16% for washing machines and 30% for refrigerators. The demand will only intensify with the increase in electricity generation and the government's aggressive push to replace old analog electric meters with smart meters. The government plans to install 250 Mn smart meters across the country in a bid to reduce distribution losses. Of this, 200 Mn smart meters have been approved by the government for bidding, of which around 40 Mn have been awarded and another 60 Mn are in advanced stages of bidding.

**The Hindu calendar follows the lunar calendar and hence the exact dates of Hindu festivals change each year for the Gregorian calendar*

India's real estate sector is having one of its best years after a lull for the past eight. Mumbai saw 10,600 new property registrations last month, +23% YoY. Residential property, which accounted for 82% of sales, will help lift adjacent businesses too, like kitchen appliances, water & air purifiers, white goods, building materials, furniture, mattresses, cars, etc. For example, 1Q FY24 saw India's largest ceramic tiles manufacturer, Kajaria Ceramics, post 7.2% growth in volumes (vs. their 4-year CAGR of 6.2%). Similarly, CERA Sanitaryware reported sales growth of 8% and the company operated its plants at 100% of their capacity in case of sanitaryware and 126% in case of faucets.

Electronic manufacturing services (EMS) is a sunrise industry in India that's growing exponentially. In the last twelve months, we have seen a slew of IPOs from EMS companies. That takes the total listed to nine including the two poster boys, Dixon Technologies and Amber Enterprises. A new report by Morgan Stanley expects the Indian EMS industry to achieve a 21% revenue CAGR over the next 10 years and hit \$604 Bn by FY2032. We are playing this space with Syrma SGS (SYRMA IN), which makes printed circuit boards, RFIDs and electromagnetic & electromechanical parts. For the 1Q FY24 they reported stellar results: Sales +59%, EBITDA +64% and net profit +65%. We think the EMS space in India is at the same embryonic stage where the IT services industry was 25 years ago.

For example, Apple exported Rs.20,000 crores/\$2.4 Bn worth of iPhones from India in the 1Q FY24, +400% YoY. While the figure is tiny compared to the company's \$383 Bn of annual sales (TTM), it makes a great headline for Indian manufacturing as one of the alternatives to China. Apple's three key vendors, Foxconn Hon Hai, Wistron and Pegatron, have committed exports of around \$7.5 Bn this fiscal year in India's production linked incentive scheme (PLI). Separately, Google announced this week that they have partnered with HP to manufacture Chromebooks in India. The Ministry of Commerce & Industry stated last year, "*The PLI scheme for large scale Electronics manufacturing also focuses on building a vibrant and robust electronic component manufacturing ecosystem. This step will further strengthen product manufacturing in India for multiple sectors such as IT Hardware, LED Products, Automotive, Medical Devices, Solar Cells and Energy Storage.*"

What can impact the India story in the near term ?

Every year there are two major issues that can help or hurt the Indian economy, i.e. the price of oil (India imports almost 80% of its crude demand) and the monsoon. To be fair, they are both beyond the control of the government. Oil at \$93/bbl, +23% in the last 3 months, hurts India in many ways. Higher oil prices are like a tax on consumers that leads to less spending on discretionary goods, not to mention direct impact on several industries such as Aviation, Paints, Logistics, Chemicals, etc. It also impacts the current account deficit and as a result, the currency, making all imports expensive.

The most recent update on this year's monsoon is that it's been 6% below the long-term average. Parts of India such as Eastern Uttar Pradesh, Bihar, Jharkhand, Kerala & the North East have received deficient rainfall. While agriculture accounts for only 18% of GDP, it still employs nearly half the population. The government uses tools like lowering the price of LPG and limiting exports of key agri-commodities to contain inflation.

The medium/longer term issue that could impact capital flows into India's equity market would be the return of China. After all, China is the second largest economy in the world with consensus estimated earnings growth for A shares of 17% in 2024, 100 bps higher than India.

And last but not the least, the threat of a US recession is still looming. Financial pundits last year had predicted that the US and the world would go into a major economic downturn, but we are nine months into 2023 and it hasn't happened as yet. With the 10-year bond yielding 4.76%, the same pundits are now forecasting the recession will start early next year. The jury is still out on if and when it will happen, but we believe that its impact on India will be milder than on the West. The key assumption is that a recession in the West and China will be negative for commodities (including crude oil) but positive for India as it picks up the pace for urbanization and building out its infrastructure, both of which are mineral intensive. Frankly, given the high valuations in India, a correction would be welcome.

Portfolio Updates:

INOX Wind (INXW IN): A new addition to our portfolio last quarter, INOX Wind is one of India's largest integrated wind energy companies with three plants in India. It has the capacity to manufacture 1,900 MW of nacelle and hubs, 1,600 MW of blades and 600 MW of towers for 2 MW WTG. Starting this April, the Government of India has begun promoting wind energy to help grid stabilization and is auctioning upto 10 GW annually of wind projects as part of its target to reach 500 GW of non-fossil fuel capacity by 2030. This will help the company turnaround after seven painful years for the Indian wind energy industry.



Piramal Enterprises (PIEL IN): This is the second stock that we added to our portfolio. PIEL has restructured its business and is transforming itself from a wholesale lender to a dominant retail NBFC, post the DHFL acquisition. Its AUM mix has changed from 67:33, wholesale to retail, to now 50:50. With the stress recognition cycle behind, a new management in place (imbibing robust processes) and a strong capital adequacy of 31% (excluding the Shriram stake sale), we believe PIEL has set up a strong foundation to leapfrog into a diversified NBFC of scale. With an accelerated reduction in the stressed wholesale book, we think the wholesale book 2.0's build-up will be calibrated while capitalizing on the market gap (real estate loans) post HDFC Ltd.'s exit. We believe the stock is attractively valued at 0.8x FY25E P/B with multiple levers of expansion as the management continues to find ways to utilize the surplus capital and improve its ROE in the process.

Eureka Forbes (EUREKAFO IN): This is India's largest water purifier company that sells under the *Aquaguard* brand. It's also a leader in vacuum cleaners and has recently launched air purifiers. We met with the CEO Prateek Pota who was brought in by PE fund Advent International, which owns 74% of the company. Prateek joined last year from Jubilant Foodworks, where he built India's largest pizza (Domino's) franchise across 1,800 stores in 400 towns. The turnaround of the business is noticeably underway with EBITDA margins rising to 9.8% in the 1Q FY24 from 4.5% a year ago (but still shy of the 23% margins by unlisted competitor, Kent RO). The company has reduced its bloated headcount from 4,100 employees to 2,800 and launched a mass market water purifier priced at Rs.8,000/\$96. We believe that Eureka Forbes is a great way to play the piped water market which is growing rapidly thanks to increased urbanization and the ongoing electrification of India.

Spandana Sphoorty (SPANDANA IN): Last month, our investment analyst Parth Sanghvi conducted a site visit to three of Spandana's centers in Madhya Pradesh, the country's second largest state located in Central India. Spandana is a leading pan-India NBFC-MFI headquartered in Hyderabad with AUM of Rs.88.5 billion (\$1.1 billion) and a clientele of 2.4 million borrowers spread across 1,300 branches. Spandana has been undergoing a transformation which began after its founder and CEO resigned and was replaced by a professional team under the leadership of Shalabh Saxena in November 2021. In his previous role, Shalabh and his team at Bharat Financial Ltd. grew that company into India's largest microfinance player. This change in CEO was the key trigger for us to invest in the stock. Moreover we like PE backed companies. Here's the link to the report: https://nepeancapital.com/pdf_33



Landmark Cars (LANDMARK IN): India's largest and only listed premium & luxury car auto dealership added two more large OEMs, MG Motors (in Indore & Bhopal) and Mahindra & Mahindra (in Kolkata). Landmark is already the #1 dealer in India for several global auto brands, such as Mercedes-Benz, VW, Honda Motors, JEEP and BYD. The new OEMs will further add to its nationwide footprint and enhance its offering of EVs.



MEDIA:

CNBC India: <https://www.youtube.com/watch?v=wajtcF4cK8o&t=11s>

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