



July 28, 2015

Dear Investors,

Indian markets may seem weak to someone just looking at the popular indices such as the Nifty, Sensex or Bank Nifty, but the indices representing the non-large cap companies such as Nifty Junior and BSE Midcap have hit all-time highs during July. During the last 14 months (up to June end), domestic equity mutual funds received net inflow of around \$15 bn of which 50% has come into mid and small-cap funds. Total flow (including Foreign and domestic investors) in the small-midcap stocks is estimated to be \$20 bn during this period. For the total small-midcap stock float, which is around \$40 bn, many seem to get illiquidity premium in anticipation of future high growth. Lot of future growth is already discounted in the current price for many. Before we look into more detail, let's look at the performance of our core portfolio.

Portfolio Performance*

Below is the performance of our core portfolio for the last 6.25 years. Since clients have joined at various stages, individual performance may differ slightly based on the timing of purchases. For uniformity and ease we measure our performance using a "representative" portfolio (that resemble advice given to clients) and we call it SageOne Core Portfolio (SCP). SageOne core portfolio is not a dummy portfolio but the CIO's actual total equity portfolio.

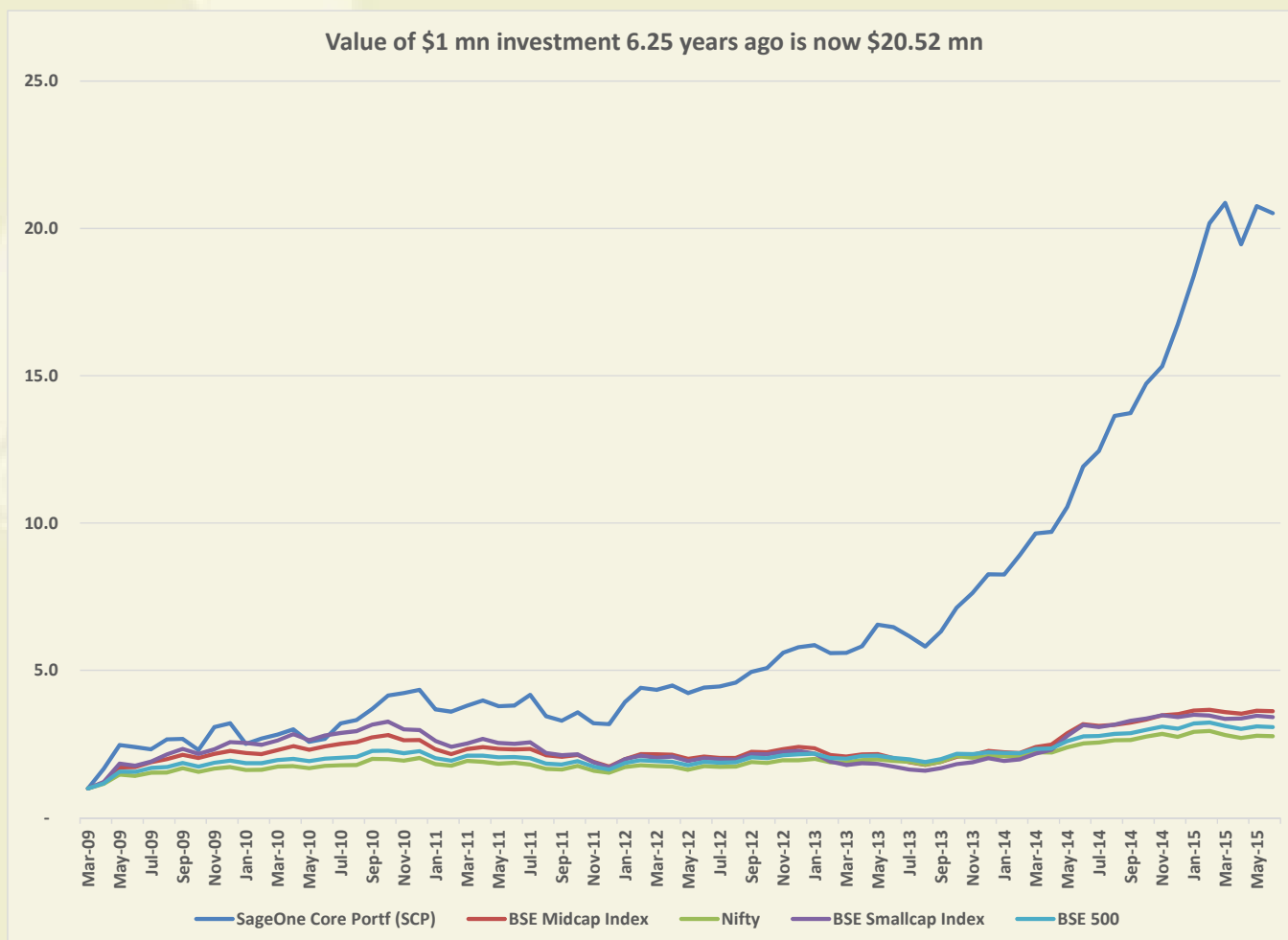
Period (Apr 1 - Mar 31)	SCP	Nifty	BSE Midcap	BSE Smallcap	BSE 500	Validation/ Review
FY 2016 (Apr 1 - Jun 30)	-1.66%	-1.44%	0.83%	1.70%	-1.31%	Internal Estimates
FY 2015	116.21%	26.66%	49.55%	53.99%	33.19%	KPMG
FY 2014	72.21%	17.98%	15.32%	21.83%	17.08%	KPMG
FY 2013	29.14%	7.31%	-3.22%	-12.44%	4.81%	KPMG
FY 2012	14.26%	-9.23%	-7.67%	-18.92%	-9.11%	KPMG
FY 2011	34.67%	11.14%	0.99%	-3.78%	7.48%	KPMG
FY 2010	182.04%	73.76%	130.23%	161.73%	96.38%	KPMG
Annualized Returns	62.16%	17.71%	22.82%	21.69%	19.81%	
Cummulative Returns	1951.97%	177.02%	261.27%	241.13%	209.46%	

% Positive Months	72.00%	56.00%	58.67%	56.00%	60.00%	
Annualized Stdev	43.24%	20.94%	26.90%	31.86%	22.27%	
Sharpe (RFR 8.5%)	1.24	0.44	0.53	0.41	0.51	

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* For more granular details on the portfolio annual performance, please visit our website www.SageOneInvestments.com. We have consciously changed the composition of the core portfolio over time in terms of average size, number of stocks and quality of businesses. The weighted average size of stocks at the start in FY10 was below \$0.25 bn which has increased to near \$1.6 bn by the end of FY15. Also number of stocks have increased from 5-6 in 2009 to 14 (+/- 2) during the past 3 years. This was done by design to reduce volatility especially on the downside in the portfolio as annualized standard deviation has come down from average of 54% during the first 3 years to 17% during the last 3 years.

Following is a chart comparing cumulative performance of SCP with various indices over the past 6.25 years.



Operating Performance

During FY15, if you look at the top 500 companies as represented by BSE 500 index, the total sales (sum for all 500 companies) grew by just 2% and the net profit fell by 9%. For the BSE Midcap companies, sales grew by 7% and the net profit fell by 5%. There was a huge discrepancy in performance across sectors. While Oil (-23% net profit drop), Iron & Steel (-ve net profit) and Infrastructure (-ve net profit) were the top contributors towards de-growth, Healthcare (30% net profit growth) and Chemicals (59% net profit growth) were the top contributors towards growth.

For our core portfolio, the sales grew by 19.4% and net profit grew by 26.1%. We are happy to see our portfolio companies growing their topline with expanding net margins during such tough environment where the net margins have fallen to 6.4% (for BSE 500 companies) compared to highs of 12%+ reached during 2008. Current net margins are the lowest level seen over at least the past two decades if not the lowest ever.

In the previous two newsletters (April 2015 and October 2014), I have provided my views on the valuation and returns expected from the equities over the next business cycle. In this letter, let me provide two angles from which we can look at the current situation.

Relative View of India

This is more macro, short-term and technical perspective of the equities market domestically and internationally. Here we have absolutely no advantage over other investors and probably we are at a disadvantage compared to global investors. From our perspective, this is “good to know” or “to be aware of” and we don’t make portfolio investment decisions based on this view. Those decisions are made based on the second angle that we will present later in this letter.

India is a net importer of commodities and lower prices benefit India not only in terms of government’s balance sheet but also in terms of lower raw material prices for many industries. In the current world economic environment, where there is deflationary scare and dearth of growth opportunities, India stands out resulting in over allocation by many foreign institutional investors (FIIs) and global brokerage houses.

Domestically, the biggest competition to equities has been from real estate, gold and fixed deposits (FD). Real estate (RE) has been flat for the past couple of years and with the fear of crackdown on black money (main source for investment in RE and gold) by the government, the excitement has shifted away from this asset class. Gold and interest rates on FDs have been in a downtrend and both aren’t considered as attractive asset classes by domestic investors in the short-term. In this scenario, equity investment stands out especially from post-tax returns perspective.

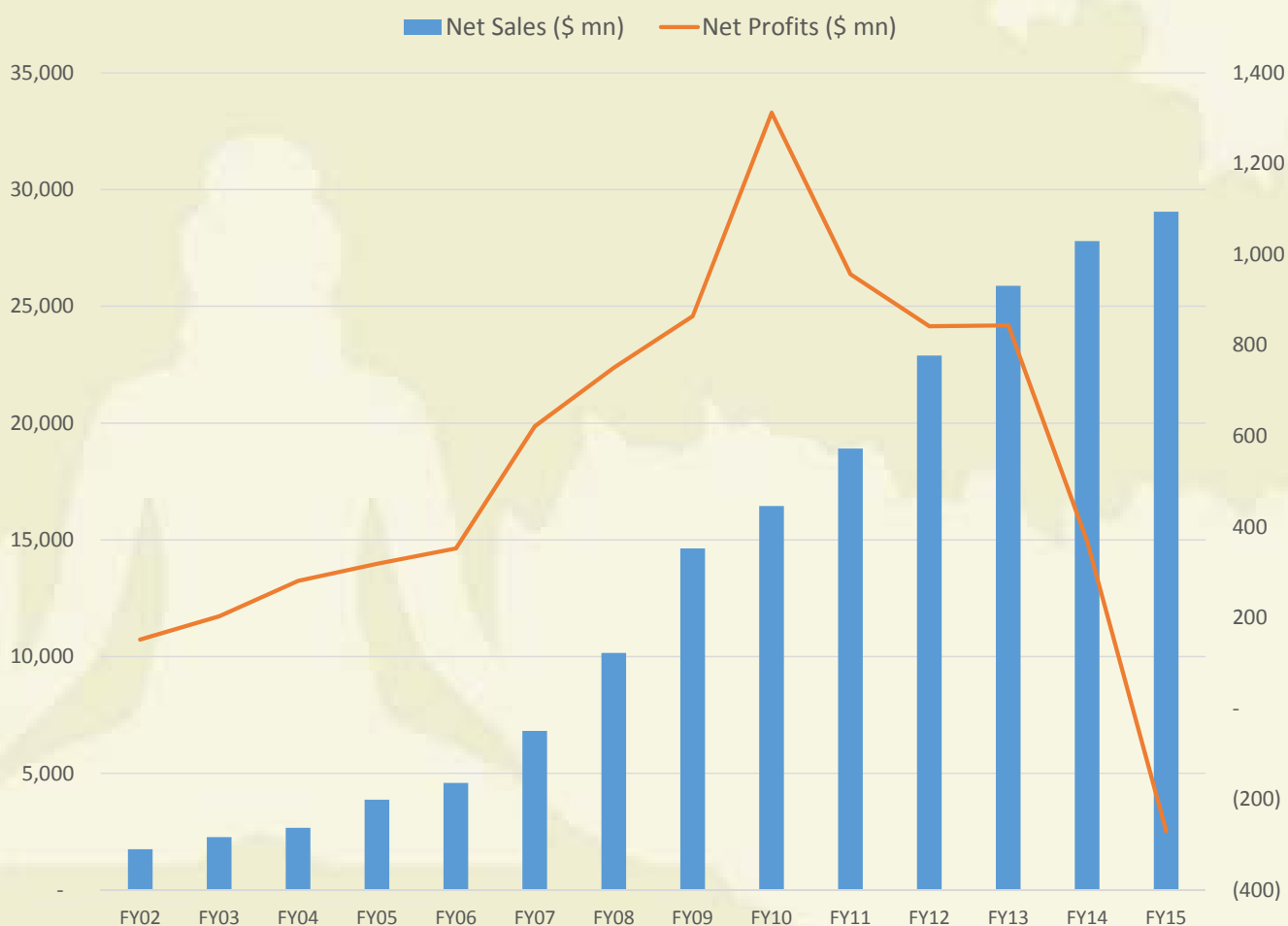
Add to the above, high expectations from India’s new management (Modi government) emanating from significantly improved fiscal position and more importantly the intent, and we have a strong cocktail for equity investments. The only problem is that this is a broad consensus as manifested by various indices moving up by 25 – 55% during FY15 when earnings have fallen.

Absolute View of India

This is more fundamental and long-term view of India's business environment and the opportunity ahead as a bottoms up investor. India's banking sector (especially public sector banks - PSBs) is laden with unsustainable levels of non-performing, re-structured and refinanced assets. PSBs are known for their politically influenced lending and to large/risky projects in cyclical and troubled sectors. Due to their stressed situation currently, they are not in a position to lend large capital until government capitalizes them. At the same time India's corporate balance sheet is highly leveraged and stressed and not many have the appetite to borrow. This situation leaves the onus of capital spend with the government. Fortunately they have expressed their intention to and are in a situation to do so.

On the spending side, government expects savings from reduced subsidies primarily due to (low) oil prices. On the revenue side, higher buoyancy on indirect taxes is expected to give the extra spending room. The centre collected \$ 24.4 bn in indirect taxes in April-June this year, up 37 per cent over the \$17.8 bn collected in the year-ago period. Contributing measures include increase in excise duty on petroleum products, withdrawal of excise duty exemption on auto and other consumer durables and increase in service tax from 12.36% to 14% effective June. Government is looking at a spending cushion of about \$16 bn for FY16 from the above which is likely to be used for infrastructure spending and social-sector schemes. Total central budget for Capital expenditure (non-revenue expenditure) for FY16 is \$38.3 bn. The infrastructure and energy ministries have been told to spend most of their capital expenditure in the first six months of the year, with a promise they will be provided more under the supplementary demand for grants in the winter session of Parliament, if need be.

Our own research talking to infrastructure companies show significant pickup in their order book over the past 2 months. There is no question that the money will flow in this sector, but is this a good investment opportunity. For long-term investors like us, the graph below provides many insights. This graph shows total revenue and net profit of all infrastructure companies in BSE 500 from FY02 to FY15. While revenue has jumped 17x from \$1.75 bn to \$29 bn, profit initially jumped 8.6x (FY10) from \$0.15 bn to \$1.3 bn, but it's in negative territory now.



The problem has been aggressive bidding by companies to capture topline resulting in destroyed bottom-line. One would have thought that a tough lesson has been learnt, but appears that it isn't the case based on our interaction with companies bidding for government tenders. As Howard Mark has written in his memos multiple times, a good investor needs to employ secondary thinking to find good investment opportunities. Seemingly straight forward investment opportunities in direct beneficiaries in sectors that can't sustain profitable growth can be disastrous for long-term investors. Our strategy is to look for indirect plays in sectors that can provide growth with sustainable profits.

Goods and Services Tax (GST) regulation (April'16) is expected to be another big secular change that will simplify India's tax structure, broaden the tax base, and create a common market across states. This will lead to increased compliance and increase India's tax-to-GDP ratio.

Indian businesses can be put into three broad buckets 1) State owned 2) Organized and 3) and Unorganized. As India privatized many sectors such as telecom, car manufacturing, banks etc. we have seen the kind of value that has been created for investors. Unorganized bucket is also a large bucket in some industries making up as high as 80% of market share. Unorganized



businesses are small mom and pop shops that typically avoid taxes and hence offer products at significant discounts compared to the bigger organized players who comply to all laws. With GST these unorganized players would be brought under tax base and that would make it a level playing field with more efficient and larger organized players. Over the years, market share has been slowly moving from unorganized to organized players. With GST this movement would be accelerated.

We believe that even within the organized players, the most efficient player having the right positioning and strategy would take away majority of this market share. We look for businesses which are most efficient, with proactive managements running it with right positioning and strategy and in industries where the unorganized bucket is large. This provides the private players big opportunity to grow at much higher rate compared to the overall industry. One such example is in a manufacturing sub-industry. 6 years ago this industry had an unorganized market share of more than 60%. Over the past 5 years, the overall industry growth has been around 15-17% and unorganized market share has dropped to below 40%. Only one company has been able to outperform significantly with annualized growth of more than 30% as it was able to capture majority of market share transfer. In terms of stock returns, this company has provided a 9x return vs not much to show for others. Just finding the right sector isn't even half the job done, but finding the right company to bet on is what would create value for the investors.

Surely in the Relative view of India, there is too much consensus that is causing discomfort in terms of valuation, but the Absolute view offers a lot of promise for a good stock picker.

Warm Regards,

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