



October 01, 2016

Dear Investors,

Since India's union budget day (Feb 29, 2016), major indices such as Nifty 50 and BSE 500 have risen by more than 25% whereas the midcap index has risen upwards of 35%. Surely the risk appetite of investors towards equity in the current environment is very high given easy liquidity across the globe and consensus expectations of strong improvement in Indian fundamentals driven by factors such as good monsoon, clear path for GST (Goods and Services Tax bill) implementation and seventh pay commission. June ending quarter saw second consecutive quarter of sales and earnings growth after a long period of deterioration in earnings over multiple quarters. To track signs of a turnaround in growth, [graphs and tables presented as appendix of this letter provide details on trend over the last 10 quarters.](#)

The growth momentum we saw in Mar '16 quarter has slowed down in Jun '16 quarter and the growth is seen mainly because of the base effect of depressed earnings during corresponding quarter of last year. This is also evident from the fact that this quarter's earnings are below earnings seen two years ago in the corresponding quarter. Dec '16 quarter will be a pivotal quarter to provide much stronger evidence of whether we are in a sustainable and higher growth trend or not. That quarter will see a confluence of key demand drivers such as harvest, payout of significantly increased salaries under seventh pay commission and the festive season.

Market levels are factoring in significant growth momentum over the coming quarters as we are trading at trailing PE multiples of close to 24x for the Nifty 50. At an absolute level, these are lofty levels seldom seen in the past. Statistically we are 2 Standard Deviations away from the mean (17-18x) and we have traded less than 5% of time in history above this multiple. A single multiple sometimes can be very misleading and can force an investor to take incorrect actions. In the next month, **we plan to publish a comprehensive valuation study along with my evaluation** of the current valuation levels by sector, hence I don't want to present a half-baked view now.

Portfolio Performance*

Below is the gross (pre-fees and excluding dividends) performance of our core portfolio in **INR** terms for the last 7.5 years. For the first three years we managed proprietary funds and for the last 4.5 years we have been advising external clients. 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 resembles 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.**



7.5 Years Performance (April 2009 – Sept 2016)

Period (Apr 1 - Mar 31)	SCP	Nifty	BSE Midcap	BSE Smallcap	BSE 500	Validation/ Review
YTD (Apr 1 - Sept 30)	21.6%	11.3%	24.0%	21.2%	14.9%	Internal Estimate
FY 2016	-5.0%	-8.9%	0.2%	-3.2%	-7.8%	KPMG
FY 2015	116.2%	26.7%	49.5%	54.0%	33.2%	KPMG
FY 2014	72.2%	18.0%	15.3%	21.8%	17.1%	KPMG
FY 2013	29.1%	7.3%	-3.2%	-12.4%	4.8%	KPMG
FY 2012	14.3%	-9.2%	-7.7%	-18.9%	-9.1%	KPMG
FY 2011	34.7%	11.1%	1.0%	-3.8%	7.5%	KPMG
FY 2010	182.0%	73.8%	130.2%	161.7%	96.4%	KPMG
Annualized Returns	53.6%	15.2%	22.3%	20.3%	17.6%	
Cummulative Returns	2310.2%	185.0%	345.4%	293.7%	232.1%	

**Note: For detailed risk parameters and composition of the portfolio, please refer to the appendix at the end of this letter*

In the past year and a half, even though we have been able to outperform the major indices, we have underperformed the small/midcap indices. This has been a period of indiscriminate buying especially in the small/midcap segment irrespective of the earnings coming through. As we have said in the past, we look for businesses that would grow their earnings at an annualized pace of at least 20% over a 2-3 year period. Our portfolio companies have historically compounded their earnings at well above 30% (weighted average). Even during the last 18 months, when earnings for the BSE 500 companies as well as our universe have contracted, our portfolio has been able to show growth well above our targeted levels of 20%. This earnings outperformance gives us reasonable confidence that even our portfolio stock prices would be able to do the same over the long term especially when their valuations (presented in our last newsletter) are reasonable. Below are the comparable growth numbers for our portfolio and our universe (defined in the appendix).

Quarterly (Y-o-Y Jun '16) Performance for Portfolio Companies (16 stocks) and our Universe

	Weighted Average Growth		Median Growth	
	Portfolio	Universe	Portfolio	Universe
PAT Growth	59.2%	6.0%	26.4%	10.1%
EBIDTA Growth	18.5%	8.5%	17.5%	9.3%
Net Sales Growth	19.8%	8.2%	12.6%	4.2%

What's our view on the investment environment?

Risks: Too much consensus and geopolitics

Since the lows in March 2009, Indian markets (Nifty 50) have gone up 3.5x in INR terms and 2.7x in USD terms. This compares to earnings rising by only 1.75x in INR terms over the 7 year period. Of course valuations were depressed in March 2009 trading nearly 30% below long term average and that exaggerates the difference. This is nothing unique to India but common across most major equity markets. The well-published reason behind this has been liquidity induced by central banks and almost consensus view that in a near zero interest rate and unfavorable demand environment for commodities, equities is the only game in town.

When such environment continues for years, investors get complacent and assume such goldilocks environment continuing forever. Such consensus view and easy policies last until they can no longer be sustained with sudden rise in inflation sharply increasing the yields and compressing the equity valuations. One such jolt has the power to wipe equity gains of many previous years.

The intensity of terrorist activities in Kashmir have increased in recent months and although highly unlikely, the risk of this turning into a full blown war with Pakistan has certainly escalated.

Opportunities: Structural themes emerging in India

Manufacturing has been a key area of focus for the government. Passage of GST will create an integrated market for the first time in India and will reduce many major inefficiencies and barriers within the internal market. Imagine current environment wherein time and cost to transport a container from a northern state such as Punjab to a port is much higher than shipping it from that port to markets such as Dubai or Brazil. Over the last three years, Indian government has taken several policy and regulatory measures to ease doing business and improve infrastructure in India. This is reflected in India's rank improving from 71st to 39th over two years in the recently released World Economic Forum's competitiveness ranking.

Over past decades, with high interest rates, high power cost, poor infrastructure and regulatory framework, Indian manufacturers have operated in extremely tough environment relative to other major manufacturing nations. This has forced them to work extremely efficiently to survive. With above improvements, we are excited about the manufacturing opportunity in India and believe that over the coming years India can sharply increase their market share in supplying goods to Indian and global customers similar to how we did in textiles and pharma.

Another major transformation is around the financial connectivity with initiatives such as Jan Dhan Yojana (100 mn plus bank accounts enabled on mobile devices) and direct benefit transfers



which is an ability to transfer subsidies and other benefits directly to the bank accounts without leakages/corruption that has plagued this nation for decades. Leakages and corruption had created parallel economy (estimated to be as big as the official economy) within India with unaccounted cash that had no asset class to go into other than physical/unproductive assets such as gold and real estate. This will drastically change the asset classes in which people incrementally invest.

Interest rate and inflation cycle in India is moving in opposite direction to that in the developed markets. With inflation contained and trending downwards, India's central bank has plenty of room to reduce the benchmark policy rate. This should help the demand and in turn earnings growth going forward cushioning downside risk in case of major global meltdown. While we are conscious of the above risks, we are excited about some structural themes emerging in India.

Other major change is the government's plan for 100 smart cities and use of technology and digitization to enable growth in fields such as power, education and agriculture. Add to that the hyper pace at which internet is reaching rural India. We believe that this transformation will accelerate the pace of urbanization and discretionary consumption pattern of India's population and offer huge growth for many companies offering the right products and services.

Portfolio Positioning: To benefit from emerging themes in India

While we are extremely vigilant about the risks that we have listed above and others that may emerge, we believe that India is at an inflection point and we are very excited about the opportunities we are able to find. We have positioned our portfolio with businesses that would be major beneficiaries of the above big themes. Playing it through direct and obvious ways is often expensive and key is to find indirect and cheaper routes of achieving the same growth in earnings that is not obvious to other investors currently.

Warm Regards,

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Appendix - Detailed Performance Evaluation

- * We have consciously changed the composition of the core portfolio in terms of the average size of companies and the number of stocks in the portfolio after we started advising external clients in April 2012.
- * The weighted average size of stocks at the start in FY10 was below \$0.25 bn which has increased to near \$1.3 bn by the end of Aug '16. Also number of stocks have increased from 5 (+/- 2) in 2009 to 14 (+/- 2) during the past 4 years.
- * Reasonable diversification was done by design to improve liquidity and reduce volatility as a result of which annualized standard deviation has come down from 59% for the first 3 years to 19% during the last 4.4 years.

Latest 4.5 Years Performance (April 2012 – Sept 2016)

Period	SCP	Nifty	BSE Midcap	BSE Smallcap	BSE 500
Latest 4.5 Years (Annualized returns)	46.4%	11.4%	17.6%	15.7%	13.0%
Cummulative Returns	455.4%	62.6%	107.5%	92.8%	73.1%
% Positive Months	74.1%	57.4%	61.1%	63.0%	61.1%
Annualized Stdev	18.6%	14.4%	17.8%	20.6%	15.0%
Sharpe (RFR 7.5%)	2.09	0.27	0.57	0.40	0.36

First 3 Years Performance (April 2009 – March 2012)

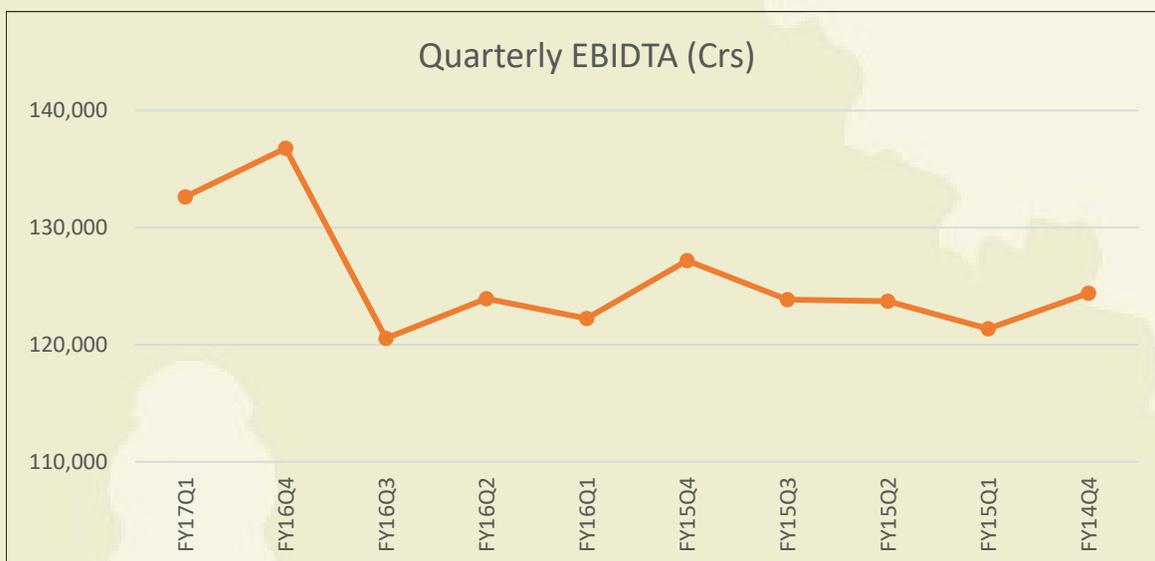
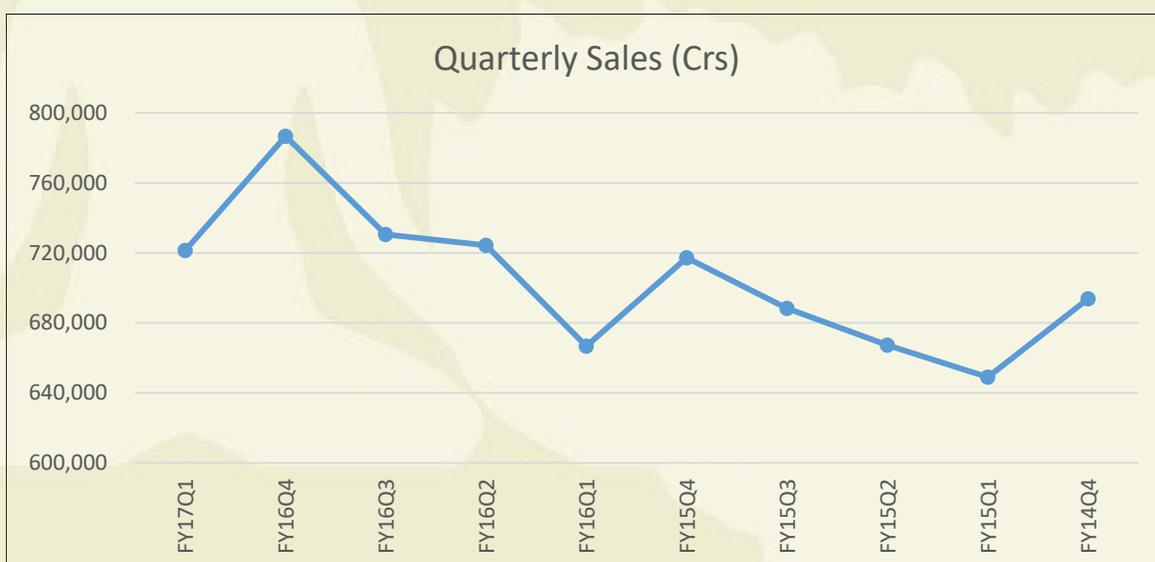
Period	SCP	Nifty	BSE Midcap	BSE Smallcap	BSE 500
First 3 Years FY10-12 (Annualized returns)	63.1%	20.6%	29.0%	26.9%	24.3%
Cummulative Returns	334.0%	75.3%	114.7%	104.2%	91.8%
% Positive Months	63.9%	55.6%	61.1%	55.6%	58.3%
Annualized Stdev	58.8%	26.4%	33.7%	40.3%	28.1%
Sharpe (RFR 7.5%)	0.95	0.50	0.64	0.48	0.60

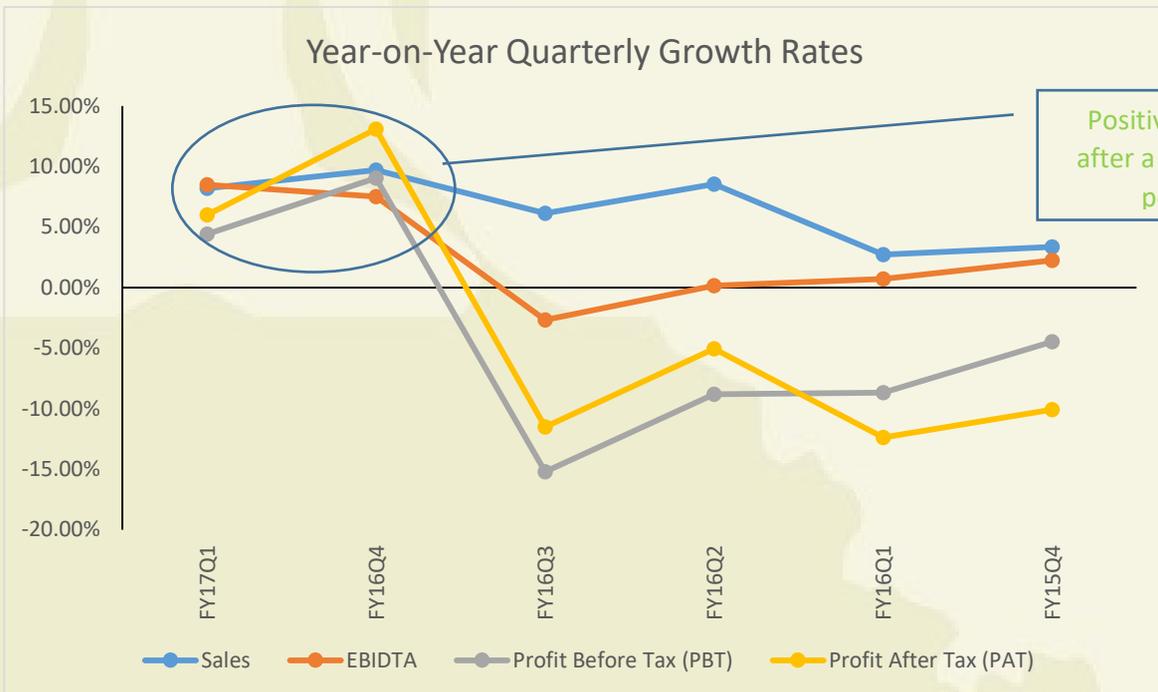
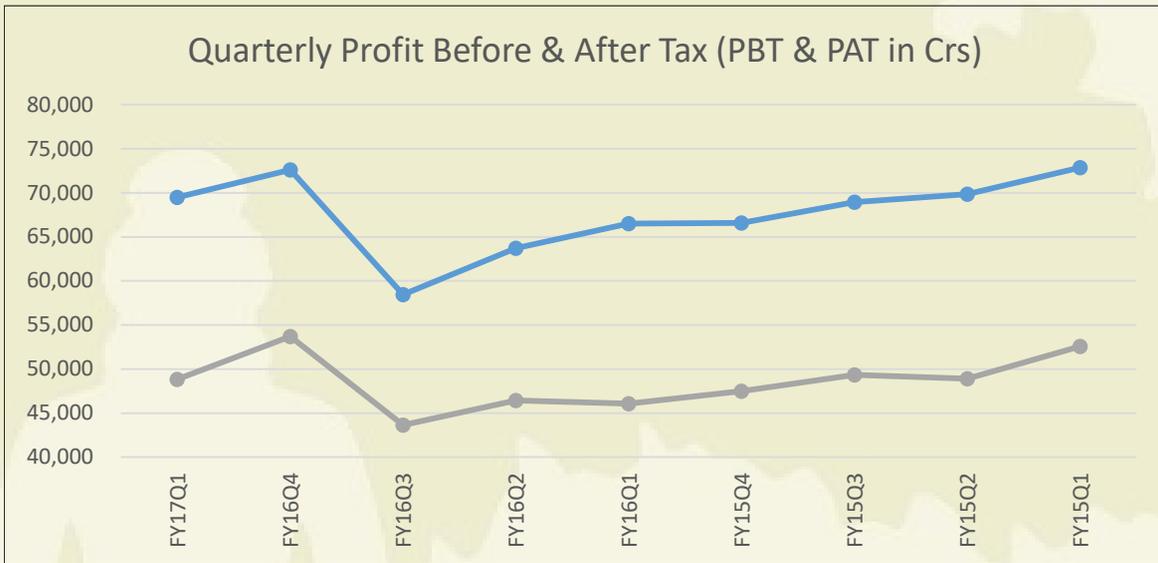
Universe used for the following analysis: The starting universe for the Valuation analysis comprised all the companies (872) in the BSE 500, BSE Midcap and BSE Small Cap indices. After excluding companies who do not have 14 years of listed history, we were left with 557 companies. This universe covered about 80% of the total listed market capitalization. In the current analysis, we have further excluded the following sectors/companies: Financial sector, Crude Oil sector and specific companies Tata Steel, Vedanta and Suzlon due to large exceptional items that would skew the overall results.

Source of all data: Ace Equity

Market Quarterly trend over the past 10 quarters

(Latest two quarters showing Y-o-Y growth in sales as well as earnings)







Consolidated P&L for the analyzed universe

(Shows trend of various line items across the 10 quarters)

	FY17Q1	FY16Q4	FY16Q3	FY16Q2	FY16Q1	FY15Q4	FY15Q3	FY15Q2	FY15Q1	FY14Q4
Sales	721,378	786,772	730,576	724,307	666,719	717,151	688,266	667,220	648,963	693,861
% Growth Y-o-Y	8.2%	9.7%	6.1%	8.6%	2.7%	3.4%				
OthOptInc	7,958	8,041	7,577	7,124	7,190	8,320	7,955	6,840	6,037	7,231
COGS	338,360	372,998	350,083	346,329	297,345	330,295	318,673	307,377	297,847	326,401
GM	390,976	421,815	388,069	385,102	376,564	395,176	377,547	366,684	357,153	374,691
% Sales	54.2%	53.6%	53.1%	53.2%	56.5%	55.1%	54.9%	55.0%	55.0%	54.0%
% Growth Y-o-Y	3.8%	6.7%	2.8%	5.0%	5.4%	5.5%				
OpEx	236,831	268,959	252,356	246,914	239,940	251,332	237,778	229,282	223,703	235,836
% Sales	32.8%	34.2%	34.5%	34.1%	36.0%	35.0%	34.5%	34.4%	34.5%	34.0%
% Growth Y-o-Y	-1.3%	7.0%	6.1%	7.7%	7.3%	6.6%				
OI, etc	21,517	16,081	15,153	14,248	14,381	16,640	15,909	13,680	12,075	14,463
EBIDTA	132,627	136,775	120,560	123,939	122,243	127,204	123,860	123,722	121,376	124,393
% Sales	18.4%	17.4%	16.5%	17.1%	18.3%	17.7%	18.0%	18.5%	18.7%	17.9%
% Growth Y-o-Y	8.5%	7.5%	-2.7%	0.2%	0.7%	2.3%				
Int	27,888	27,591	24,764	25,462	24,775	25,994	24,047	23,098	21,820	21,902
Exceptional/Fx/Other	131	(403)	3,148	2,129	(702)	2,962	(764)	297	(3,419)	3,712
Depr	35,127	36,961	34,199	32,646	31,640	31,649	31,638	30,482	30,117	29,074
PBT	69,481	72,627	58,448	63,702	66,531	66,599	68,938	69,845	72,857	69,705
% Sales	9.6%	9.2%	8.0%	8.8%	10.0%	9.3%	10.0%	10.5%	11.2%	10.0%
% Growth Y-o-Y	4.4%	9.1%	-15.2%	-8.8%	-8.7%	-4.5%				
Taxes	20,639	18,919	14,790	17,272	20,457	19,116	19,612	20,942	20,277	16,898
PAT	48,842	53,708	43,658	46,430	46,074	47,483	49,326	48,903	52,579	52,807
% Sales	6.8%	6.8%	6.0%	6.4%	6.9%	6.6%	7.2%	7.3%	8.1%	7.6%
% Growth Y-o-Y	6.0%	13.1%	-11.5%	-5.1%	-12.4%	-10.1%				

Common Size P&L (as a % of Sales)

	FY17Q1	FY16Q4	FY16Q3	FY16Q2	FY16Q1	FY15Q4	FY15Q3	FY15Q2	FY15Q1	FY14Q4
Sales	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Other Opt Inc	1.10%	1.02%	1.04%	0.98%	1.08%	1.16%	1.16%	1.03%	0.93%	1.04%
COGS	46.90%	47.41%	47.92%	47.82%	44.60%	46.06%	46.30%	46.07%	45.90%	47.04%
Gross Margins	54.20%	53.61%	53.12%	53.17%	56.48%	55.10%	54.85%	54.96%	55.03%	54.00%
Operating Expenses	32.83%	34.19%	34.54%	34.09%	35.99%	35.05%	34.55%	34.36%	34.47%	33.99%
Other Income, etc.	2.98%	2.04%	2.07%	1.97%	2.16%	2.32%	2.31%	2.05%	1.86%	2.08%
EBIDTA	18.39%	17.38%	16.50%	17.11%	18.34%	17.74%	18.00%	18.54%	18.70%	17.93%
Interest Expense	3.87%	3.51%	3.39%	3.52%	3.72%	3.62%	3.49%	3.46%	3.36%	3.16%
Exceptional/FX/Other	0.02%	-0.05%	0.43%	0.29%	-0.11%	0.41%	-0.11%	0.04%	-0.53%	0.53%
Depreciation	4.87%	4.70%	4.68%	4.51%	4.75%	4.41%	4.60%	4.57%	4.64%	4.19%
PBT	9.63%	9.23%	8.00%	8.79%	9.98%	9.29%	10.02%	10.47%	11.23%	10.05%
Taxes	2.86%	2.40%	2.02%	2.38%	3.07%	2.67%	2.85%	3.14%	3.12%	2.44%
PAT	6.77%	6.83%	5.98%	6.41%	6.91%	6.62%	7.17%	7.33%	8.10%	7.61%

Year-on-Year Quarter	FY17Q1	FY16Q4	FY16Q3	FY16Q2	FY16Q1	FY15Q4
Sales	8.20%	9.71%	6.15%	8.56%	2.74%	3.36%
EBIDTA	8.49%	7.52%	-2.66%	0.18%	0.71%	2.26%
Profit Before Tax (PBT)	4.43%	9.05%	-15.22%	-8.79%	-8.68%	-4.46%
Profit After Tax (PAT)	6.01%	13.11%	-11.49%	-5.06%	-12.37%	-10.08%

Y-o-Y Growth Trend



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