CAPGROW CAPITAL

**07TH JULY, 2021**

**CapGrow Quarterly Investor Update Q1FY22**

Dear Investors,

Trust this letter finds you and your loved ones in good health and cheerful spirits.

The Covid Scenario has improved now with fewer active cases driven by widespread vaccination drives and better availability of healthcare facilities. The government has also woken up to the ground reality and acted swiftly on the gaps that existed. The vaccinations have gathered pace due to the increasing availability of vaccines and the higher number of vaccination centers/private hospitals that have started inoculating people. The risk of the third wave remains, and the governments are gearing up to ensure least damage and the spread among the community.

We will try to discuss our investment performance in this quarterly update and address some of the issues related to the macro environment and uncertainties that arise from the 2nd wave of Covid.

**How have the Markets and Economy Performed?**

The equity markets have been on an upswing since March 2020. The buyers, the traders, have been more enthusiastic than the sellers. Retail activity has overtaken institutional activity via digital platforms. Some of the local economic indicators have been lagging. Such periods like this reflecting disconnect with the real economy have existed in the past and are not unprecedented, but they don't last forever. The sustained rally has pushed valuations for mid and small caps to extreme levels, while large caps have not participated in the recent run-up. The volatility in equity markets is relatively high, and the threats and uncertainties exist due to Covid related issues that impact both the aggregate demand and supply side. A case in point is the recent profit warning by Tata Motors that reflects the supply-side issues. Impact due to supply chain disruptions across the globe because of the pandemic is a significant factor to consider while estimating future growth. It has not been easy to source and secure raw materials and components to keep the continuity in production, esp. for Automobiles and other manufacturing assembly lines.

**How CapGrow Portfolio performed?**

The portfolio performance of last quarter and last twelve months was a solid one for our Investors. Our Portfolios have done exceedingly well with returns exceeding the benchmark indices. The portfolio performance for both Growth and Special Situation Investment approaches is discussed below:

**Growth Investment Approach**:

The portfolio has outperformed the benchmark indices by a comfortable margin in the last quarter and last 12 months.

| CAPGROW GROWTH INVESTMENT APPROACH | | | | | | | |
|---|---|---|---|---|---|---|---|
| Performance (in CAGR) | 1 Month | 3 Month | 6 Month | 1 Year | 2 Year | 3 Year | SI |
| Growth Strategy | 5.8% | 16.2% | 26.5% | 72.1% | 17.1% | NA | 16.9% |
| Index (Nifty 500) | 1.9% | 9.4% | 17.0% | 59.0% | 18.1% | NA | 17.5% |

*As mandated by SEBI, returns are calculated on a time-weighted basis (TWRR) on aggregate portfolios. Returns are net of expenses and fees. SEBI does not verify performance-related information provided here. Returns of individual clients will differ from the above numbers based on the timing of their investments. The above returns are on the consolidated pool of capital.*

Our top holdings Piramal Enterprises and JB Chemicals, have done exceedingly well and are the main contributors to the outperformance. Our rationale for investment in Piramal is provided for investors to understand our approach to investing and the thought process that goes in our investment process:

*Piramal Enterprises Limited (PEL):* Piramal mainly engages in two businesses – Financial services and Pharma. PEL has recently acquired DHFL, while the Pharma business recently raised equity from the Carlyle PE fund. Piramal Pharma Ltd raised ~Rs.3500 crore from Carlyle group by diluting its 20% shareholding.

Financial Services business: PEL derives more than 50% of its revenues and profit from Financial services business carried out by its NBFC and HFC subsidiaries. The company is diversifying into retail and away from its past bulky exposures in Real Estate. Already substantial reduction in exposure to real estate segment in overall loan book has happened, and single group exposure of consolidated tangible net worth is reducing. Gross NPA's are below 0.5% in the financial services business. Going forward, the focus is on retail and a more granular loan book.

Pharma Business: It is a global player in this space, with 75% of the revenues coming from highly regulated markets – Japan, the USA, Europe. It offers a comprehensive range of services across the pharma lifecycle, from drug discovery services and development to commercial manufacturing of drug substances and products.

The Piramal group has demonstrated resource raising ability as PEL has raised close to Rs.14,500 crore of equity capital during FY20, including fresh equity capital of Rs.5,400 crore, have successfully sold its healthcare and analytics business for Rs 6,700 Crs, and ~Rs.2,300 crore by way of sale of investment in a Shriram group entity. This has led to a very solid balance sheet capable of funding the NBFC and the DHFL acquisition. We believe the market is underappreciating the upside possible from the DHFL acquisition, which is a steal and offers significant upside. The pharma business continues to be strong, and the big trigger would be the demerger of the two businesses. It will be a vertical split getting away with the holding company structure. The stock has done exceedingly well for our portfolio, and we continue to hold.

We continue to hold our positions in Financials, despite them underperforming in the last three months. Rather, we have added weights in HDFC, the largest mortgage lender, where the stock has underperformed by 20% in the previous 12 months' despite improving fundamentals. We have select large-cap stocks that have contributed negatively to the performance. Bharti Airtel stock is one such stock, and it continues to be flat while the fundamentals of the business continue to improve significantly. The market is awaiting an increase in ARPUs that should rerate the stock, and we believe we are not far from that trigger point. The data usage is rising, and the highly concentrated market of three players will bring the pricing back. The majority of the capital costs are front-ended and have already been incurred, while any incremental increase in revenues (volume and price combine) will flow to the EBITDA. We have gone through similar situations where the stocks have delivered an average performance while the fundamentals continue to improve before the stock rerates and covers up on the lost performance.

**Special Situation Investment Approach:**

| CAPGROW SPECIAL SITUATION INVESTMENT APPROACH | | | | | | | |
|---|---|---|---|---|---|---|---|
| Performance (in CAGR) | 1 Month | 3 Month | 6 Month | 1 Year | 2 Year | 3 Year | SI |
| Strategy | 9.5% | 22.3% | 37.8% | 102.8% | 28.3% | NA | 22.7% |
| Index(Nifty 500) | 1.9% | 9.4% | 17.0% | 59.0% | 18.1% | NA | 17.5% |

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The performance of SS portfolio continues to outperform the benchmark indices by a considerable margin. As we have repeatedly maintained in the past, this strategy is very niche and differentiated. It provides better returns with less risk as the corporate events announced by the companies are predefined, and only the timelines in getting the regulatory approvals are the risk. Our most significant position Fortis healthcare (FORTIS.NSE), has done exceedingly well for our portfolios, and now the market is recognizing the improving fundamentals. We were early in the stock and had huge overweight positions in our client portfolios.

Similarly, we have taken concentrated positions in India bulls Real Estate (IBREALEST.NSE) and Forbes limited (FORBES.BO), and where we believe the market is yet to appreciate the underlying changes. We continue to look for opportunistic bets that are less correlated to the movements of the markets, and that will give us significant absolute returns. We believe this is an absolute returns strategy and would continue to deliver superior performance over extended periods.

**Risks in the near term and Our Investment Approach**

We invest in discretionary strategies and are always trying to find innovative ways to develop our processes and use extensive data to shape our thinking and investment decisions. Overall, we believe the markets had a splendid run in the past 15 months since March 2020 and may not replicate the same in the coming months**.** The situation on the ground is not as splendid as reflected in the enthusiasm in the markets. The 2$^{nd}$ and 3$^{rd}$ tier cities have been badly affected in the recent Covid wave, unlike the last year when Covid was confined to the metro and major cities only. We see the following headwinds in the markets-

a) Euphoria in the midcap and small-cap space, especially the pace with which the prices have risen, is a cause of concern. We have seen enough irrational behaviors in the past, and the returns post such periods are subdued. The valuations are not cheap on an aggregate basis; we agree that earnings will increase in 2022 and 2023E, but we still believe that the market needs a price or time correction or both. Stocks of unknown companies and unprofitable companies seem to earn the largest gains in the recent run. “**Small-cap, momentum, and extraordinary gains” - is the new mantra, but we believe this is not sustainable.** We are still unsure that this market is at euphoric levels across all segments and will end with a bust. But even without a decline, the high valuations are a cause of concern, and there is enough precedence in the history that returns from here may be average.
b) The rise in commodity prices is causing inflationary pressure and may reduce margins for a lot of businesses. But inflation may not be a challenge in the short term as the prime reason for higher inflation is that last year, the prices were quite depressed. The possibility of an increase in interest rates remains on the horizon and may spoil the party.
c) Biden administration's recent fiscal stimulus will further cause an increase in money supply and unprecedented levels of global liquidity. The US balance sheet is stretched by any means, and the rush of liquidity and this expansion (US debt to GDP is +130%) has to end somewhere. This will affect economic growth.
d) The other developed International economies, like those in Western Europe and Japan, are still languishing. The slowing GDP growth rates, negative interest rates, and low consumer confidence don't support global growth.

However, despite such concerns, we see considerable opportunities in select sectors and specific stocks. In terms of sectoral approach, Banks, financials, telecom have not performed in the last six months, and while the outlook remains positive, primarily because we would witness a pent up in retail demand, and also the capex cycle may get kick-started in select industries as the utilization levels have soared. A significant part of Corporate India and the promoters have deleveraged in the current cycle. They would be the primary driver of the future capex cycle and the subsequent credit growth. The majority of the financials we own, including HDFC, SBI, and ICICI, have significant value in their subsidiaries that are doing remarkably well. We are only concerned about the short-term frenzy that can and may cause trouble in the markets in the short term. Sectors like Metals, Specialty Chemicals are pricing in the sustainability of growth for more extended periods while offering less margin of safety. We have trimmed our position in Vinati Organics and continue to monitor the fundamentals in that space closely. Overall, we remain very constructive in our approach in the current environment and look for opportunities that strictly fit our strategies.

To reassure our investors and partners, we remain very opportunistic and look for companies that have sound fundamentals and offer us a favorable risk reward. Among the hot IPOs and soaring small caps and midcaps, there are many opportunities for us to help protect capital and generate significant returns in the years to come. CapGrow rests on the inseparable principles of honesty, integrity, and transparency and each of these pillars reinforces our beliefs and systems to build and sustain a culture of excellence.

As always, we thank our esteemed investors for their contribution and reposing trust in us. We look forward to our engagement and continued relationship in this journey of wealth creation. We would be more than happy to provide you with any additional information regarding our portfolio stocks and investment performance. Please reach out to me at pms@capgrowcapital.com or + 91 98195 61662 if you have any queries.

Warm Regards,

Arun Malhotra

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Arun Malhotra
CIO

*Disclaimer:*

*We hereby confirm the following related to the Portfolio performance:*

i. *All cash holdings and investments in liquid funds are considered for the calculation of performance.*
ii. *Net of all fees and all expenses including taxes, are taken into consideration at the time of reporting the performance data.*
iii. *Any change in an investment approach that may impact the performance of the client portfolio is disclosed in all marketing material.*
iv. *Performance reported in all marketing material and websites is the same as that reported to SEBI.*
v. *The aggregate firm-level performance reported in all document is the same as the combined performance of all the portfolios managed.*
vi. *The performance-related information provided above is not verified by SEBI.*

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