CAPGROW CAPITAL

Quarterly Newsletter – September 2020

It gives me great sense of hope and faith in writing this Sept quarter Investor's letter. The pain of pandemic is still around, and even though we see lots of people on the streets as we step outside, the threat and risk of infecting COVID are still high. Currently the issue is not of safety alone but 'lives vs livelihood' as people are now saving their livelihood. The recovery rate is the saving grace but now our near and dear ones are getting impacted reflecting the widespread of the virus.

When will it end? When will we be restored to normal? Where do we go now from here? This is anybody's guess, and we are not medical practitioners, but we are hopeful of a vaccine by 1st quarter of CY21 and then another 6 months for bringing those vials to the public. We have faith in the medical efforts that are undergoing across the world to bring an end to this pandemic.

How is the Indian Economy faring up?

We want to reiterate that Indian economy is very resilient, especially the agriculture component of the mix which has shown good growth prospects. The rebound in stock markets is an expectation of that. On the economic front, we keep getting month-on-month improvements with the big daddy of banking coming forward recently and reassuring markets that their business levels in Sept 2020 have reached the pre-COVID levels. We, at CapGrow, are not too encouraged by those numbers, as these are more of a pent-up demand and an inevitable bounce after a straight fall was expected. Rather the GDP growth numbers are being revised downwards by various agencies. The productivity figures are suggesting some positive growth; however, the aggregate of all will still lack the normal growth and earnings.

The mixed results indicate that the economy may be having trouble gathering momentum, and the low interest rate or the moratoriums are not helping much. We feel that the opening of lockdown has eased the 'supply problem', but the damage across various sectors has impacted the income levels and the demand in the economy.

The government, the savior so far in stimulating demand, is also on a weaker wicket. The tax collections, GST have lagged behind and the disinvestment target seems far-fetched at this point. We are of the view that the ground reality is quite bad, especially few pockets in the economy like small households and MSMEs and their negative fallout would be felt on the balance sheet of the financial intermediaries – the NBFCs, the banks. Additionally, low demand will impact the core sector of the economy – Cement, Capital goods, Power, Steel, and Banking. The reality of a damaging ground situation would sink into the market as the 2nd Quarter results start flowing in. Overall, these uncertainties will add to the volatility and provide us the opportunity to own good companies.

What is happening in Equity Markets?

The markets have been getting narrower and most investors are of the view that they are now more erratic and less on fundamentals. The investing principle that stock prices should mirror earnings and the economic fundamentals is no longer happening. The scarcity premium in few stocks and herd mentality in lapping upon few selected names is best playing out in the markets. The retail participation is at an all-time high with equities being the only sector that seems to be doing well and where public can sit at home and theoretically can earn bounties. The Institutional money is now

more and more routed through the ETFs that lead to further narrowing the breadth of the market. Another theme which we see across sectors playing out is- “big is getting bigger” and we have seen enough of this evidence in banking, telecom, Infra, Cement, Auto etc. On top of this is the increase in buybacks and delisting that have happened when the stock valuations were lower due to the pandemic crash. The cash rich companies are doing buy backs and delisting that provides support to the stock prices. The big divergence between “Performers and Non-Performers” is wide and even stocks like HDFC, HDFC Bank, Kotak Bank, L&T, Cummins, are down 15-25% from pre-COVID levels. Pharma, Chemicals and IT have led the market rally aided by the super daddy Reliance. Investors are generally greatly influenced by recent happenings and hence the impetus and higher valuations for the pharma sector as the perception of higher usage of pharma ingredients and less aggressive USFDA may help companies to post earnings growth. We feel the sector was due for a rebound after four years of downfall and this is a typical case where the analysts may be right for the wrong reasons.
Overall, we are positive on financial names, especially where the fund raising have happened and the balance sheets have become stronger. There is no doubt that NPAs will rise, but higher capital availability will ensure adequate provisioning and availability of capital for growth once the market normalizes. The markets will get excited with any development on the vaccines front while the earnings will take some time to recover.

CapGrow Portfolio Performance:

The performance of both of our portfolios is provided below:

	1 Month	**3 Months**	**YTD (FY)**	**1 Year**
CapGrow- Growth Strategy	**-4.1%**	**6.7%**	**29.0%**	**-8.5%**
NIFTY 500	*-0.3%*	*10.2%*	*33.5%*	*0.0%*
CapGrow-Special Situations	**3.1%**	**20.0%**	**47.3%**	**17.7%**

All figures are latest as on 30th September 2020

CapGrow Growth Strategy:

Over the quarter, our Growth strategy portfolio was up 6.7% QoQ v/s the Nifty 500 up 10.2%. This underperformance is attributable to having a large weightage in telecom name Bharti Telecom (~7% v/s 1.5% in the index) and being overweight on the BFSI space (36% in our portfolio v/s 29% in the Index). Over the quarter, the strategy was able to book handsome gains in some of the tactical opportunities. The portfolio made a whopping 30-35% return in ~4 months in one of the delisting play in the IT space. Also, we were able to book good profits (30% returns in less than one month) in one of the prominent disinvestment name. The strategy also benefited from having a meaningful exposure to the leading IT companies. We understand that the fund overweight on financials is hurting performance in the short term, however these are challenging times and we are very confident of the quality of names we hold in our portfolio. The Infra names (both L&T and Kalpataru) have underperformed in the past six months even though they are quality names to own in that space. The recent release (post 30th Sep) by HDFC Ltd and HDFC Bank (both are large weight calls for us) about their operational performance and the stock price reaction is a testimony of the good times to come.

CapGrow Special Situation Strategy:

The special situation strategy continues to outperform the benchmark. Our Portfolio was up 20% QoQ v/s the Nifty 500 up 10.2%. We were able to outperform the benchmark substantially by identifying opportunities that had potential of huge gains either by value unlocking or it being available at distressed valuations or an event such as management change. As we always quote, “Management change is the biggest positive event to look at” and the same has been proven by us as our strategy made a 40% return in one of its Snacks Foods Business company. We are sure the same would be seen in the recent pharma diagnostics/clinical chain industry bet we have taken. Also, we were able to generate a good 55% return in one of the financial holding companies by tracing an event which was long due and which was impacting its valuations. Huge value unlocking was seen as a precursor to this event. Going ahead we are sure that strategy will keep outperforming the index, even though the returns may be little lumpy because of the timing of the events that are dependent upon regulatory approvals. Not to mention that we were also mentioned as one of the top performing PMS for this strategy in the month of August 2020, 3rd time topping the monthly charts in a span of 24 months. We are here to keep achieving similar milestones going forward.

What are the Risks ahead?

We identify five risks that could come back and haunt the recovery.

- The global scenario is weak, and the US balance sheet reflects an ugly picture compounded by the recent elections in the near term. U.S has spent 13% of its GDP in stimulus as compared to 6.5% of GDP in 2008 GFC.
- The GDP degrowth is worst in history, and the impact on few select sectors will be disastrous. There is no precedent to gauge the impact and the fallout of this on the banking sector is uncertain.
- The Indian government coffers are constrained due to low tax collections and monthly GST figures, while the unemployment is high hurting the demand. India doesn’t have the luxury of a reserve currency to print more while the fiscal deficit is already running north of 11%.
- The healthcare infrastructure in India is quite weak in comparison to the population size and the requirements of beds and medicines; physicians arising out of pandemic are falling short by a huge margin. The COVID is spreading to Tier-2 and Tier-3 cities now which were holding up the demand so far. The crisis could deepen further hurting the domestic demand and also divert the government’s attention away from Infrastructure spending (savior so far) and education spending. Some of the impacts may be visible only in the medium and long term.
- Narrowness of the market rebound reflects lack of confidence: The recovery in the markets is led by Reliance and tech sector. The core sectors of the economy, the likes of L&T, Capital Goods, Power, Oil and Gas, Airlines, Real Estate still are down 25-30% from the pre COVID levels. Such a huge concentration poses risks to the overall market recovery.

Roadmap Ahead

We do not expect a quick and powerful turnaround in corporate earnings. Instead, opportunities in the current environment will come from:

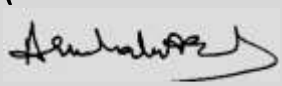
- Negative sentiment, especially in COVID-affected sectors
- Companies (especially financials) that have raised equity and strengthened their balance sheets. Private banks with higher capital Adequacy ratio along with higher provisioned balance sheets will ensure growth and dominance mitigating the stress arising once the moratoriums are lifted.

- Manufacturing and structural shifts that happen from China towards India.

The current environment in which we are presently set up is neither overwhelmingly bullish nor bearish, but opportunistic. A challenging economic environment will hurt the demand for all companies except the most strongly positioned companies. For stealth of exceptional companies, the current environment presents an opportunity to strengthen their market position. And that's why we believe that this is not a time to compromise on our premise of investing in quality companies, strong domestic franchises and companies with strong moats around them. We have scrutinized all stocks in our portfolio to various sensitivities and rigorous tests, and also have taken advantage of downturns to capture strong companies available at reasonable valuations. Our Growth Portfolio reflects our Defensive stance to mitigate the heightened risks in the current environment, while the Special Situation consists of companies that have significant events that are expected to create value in the next twelve months. We have tremendous confidence and faith in what we are doing with our portfolio, and we have faith in equities as an asset class to provide best returns for our investors. As always, we are always available to answer any queries you may have. I am myself available at +91-98195 61662 or you can send us an email at arun@capgrowcapital.com to schedule an online zoom meeting with us.

Stay Safe and Blessed with family. We will emerge stronger from this pandemic.

Best Regards,
Arun Malhotra
(Co-Founder & Chief Investment officer)



CapGrow Capital Advisors LLP