Ist August' 2017

TrustLine
BizNotes

FOR PRIVATE CIRCULATION

M O N T H L Y V I E W

FROM THE FUND MANAGER DESK

Pockets of Pessimism

Indian Pharma: Fat pitch in sight, get ready for a hard swing!

It may seem odd to talk about a fat pitch when Nifty is at a striking distance from a five digit mark. It is no secret that Sensex has been soaring to stratospheric valuations on surging liquidity from both domestic and foreign investors. If anything, stocks are simmering at frothy levels for a while now. Yes, this is true for much of the sectors where it is a story of trumpets blaring amid ever-rising list of multi-baggers. But that hasn't stopped the markets to punish prices in certain select pockets to seductive levels on growing uncertainties in the short-to-medium term. If one looks around for sectors where drums are beating amid plunging stock prices, it is unlikely that one would return empty-handed.

No prizes, of course, for guessing the sectors that have been the laggards in this bull run. It is widely known that the top stocks that have spectacularly soured the sentiments are from the infamous group of three sectors, namely IT, Telecom and Pharma. While all of them are going thro' sectoral short-term setbacks, on measure of mispricing relative to long-term business fundamentals, Pharma seems to be more promising.

In a rare instance of unfortunate coincidence, confluence of factors have miraculously come together to conspire a deadly blow to the fortunes of pharma industry. The sector that helped India to build global prominence is suddenly facing huge set of headwinds on account of following developments:

- Increased regulatory scrutiny (Increasing cases of warning letters and import warnings from US FDA).
- Consolidation of distributors in US resulting in pricing pressures for generics.
- FDA's increased focus on fast-tracking drug clearances leading to more competition in generics and hence putting pressure on prices.
- NPPA (National Pharmaceutical Pricing Authority) bringing more drugs under price control in domestic market.

M O N T H L Y V I E W

- The risk of dictum from Indian govt. on generics prescription in the local market.
- To top it all, GST hiccups couldn't have come at a worse time i.e. destocking and delay in restocking in domestic formulations.

Very rarely, such a series of setbacks suddenly surround a particular sector and cause stock prices to get mis-appraised in a disproportional degree. Pharma is going thro' such a painful period. Are these setbacks structural or cyclical? If anything, FDA's vigorous vigil will play a vital role in streamlining the quality process which is positive in the long-term to achieve bigger business scale in generics. Similarly, accelerated drug clearances by FDA, while putting pricing pressures, will also help small and medium players to gain faster access to US generics. In our recent meeting, CEO of one of the promising mid-tier pharma companies echoed this long-term view. Moreover, much of the domestic challenges listed above should not dent the long-term prospects for the sector, except the dictum of generic prescription, which many industry insiders don't see it coming given the practical challenges in implementation. With govt. going slow on this, the noise around it has subsided significantly.

As someone wise said, great investment opportunities come around when excellent companies are surrounded by unusual circumstances that cause the stock to be mispriced manically. Pharma seems to be offering that classical value opportunities to those who have lots of patient capital. More so with small and mid-cap pharma (stock specific, of course) where relative undervaluation can give additional kicker.

Happy Value Investing!

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CORPORATE NEWS

- Private equity player **Premji Invest** buys a 2.2% stake in **Aditya Birla Capital** for Rs 704 crore, the holding company of the financial services businesses of Aditya Birla group. The proposed transaction values Aditya Birla Capital at Rs 32,000 crore.

- The government approved in-principle sale of **Hindustan Petroleum (HPCL)**, the country's third-largest refiner-retailer, to flagship explorer **ONGC** with the aim of creating an integrated Indian oil company with global size and heft. ONGC will not be required to make an open offer to minority shareholders of HPCL after buying out government's 51.11% stake as the deal won't trigger takeover norms, a senior government official said.

- **Indian Bank** has initiated cases at the National **Company Law Tribunal (NCLT)** against seven more accounts worth Rs 12 Bn. Indian Bank is the sole lender in all these accounts. Out of the 12 accounts earlier identified by the **Reserve Bank of India (RBI)** as large non-performing asset (NPA) accounts, Indian bank's exposure is to around eight of them, which are together worth Rs 26 Bn.

- **Wipro Ltd** said its board had approved an Rs 110 bn share buyback plan, the second in as many years by India's third largest IT services company which completed an Rs 25 bn share buyback last year.

- **Tata Motors Group** reported a decline of two per cent in its global wholesales, including **Jaguar Land Rover (JLR)**, during June 2017. Sales of Jaguar Land Rover were up 4.7 per cent to 49,422 units in June as compared to 47,197 units in the same month of 2016.

- **Reliance Industries** has announced the issue of bonus shares to its shareholders in the ratio of 1:1. The company has also announced the launch of **JioPhone**, which is a 4G phone and expected to hit the shelves starting the first week of September, and pre-orders begin August 24.

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MONTHLY VIEW

- **Reliance Capital** received Rs 3780 mn from Nippon Life Insurance, increasing Nippon Life's stake in **Reliance Nippon Life Asset Management** to 49%.

- **Shriram Group** and **IDFC** entered into an exclusivity arrangement for 90 days to jointly explore the possibility of merger to create Rs.650 bn giant.

MACRO NEWS

- **The International Monetary Fund (IMF)** has retained India's economic growth projections at 7.2 per cent in 2017-18, up slightly from 7.1 per cent in the previous year. However, the growth would accelerate to 7.7 per cent in 2018-19.

- **The Government** has approved a plan to build 34 **mega multi-modal logistics parks** at an investment of Rs 2 trillion. The projects, for which land is already available with state governments, will be taken up through public-private-partnerships.

- The south-west monsoon showed strong signs of revival across parts of the country with the week ending on July 19, recording 11 per cent excess rainfall. According to the latest weather update by the **India Meteorological Department (IMD),** India received 75.3 millimetres of rainfall from July 12 to July 19.

- In an out-of-turn meeting, the **Goods and Services Tax (GST)** Council raised the cess on cigarettes, in a bid to reduce profiteering by companies and harm to public health. The increase will give Rs 50 bn extra revenue to the Centre's exchequer; this will be used for compensating states.

- **The Reserve Bank of India (RBI)** is in the final process of designing a new Rs 200 note, which is expected to be in circulation latest by December. Officials said RBI would issue the new Rs 200 notes to tide over the shortage, in some parts of the country, of lower denomination currencies such as Rs 100.

M O N T H L Y V I E W

- Companies going for **Indian accounting standards (IndAS)** need not do second round of adjustment for mark-to- market losses on financial instruments in its book profits for the purpose of tax computation, the income tax department has clarified. This is so because these are already adjusted to book profits under **minimum alternate tax** (MAT), **the Central Board of Direct Taxes** (CBDT) said.

FUNDS FLOW DATA

Data as on 27th July 2017		
FUNDS FLOW DATA (Rs in Cr)		
Category	***MTD***	***YTD***
FII	1251	57160
Mutual Funds	6239	45694
Total	**7490**	**102854**

DEBT & FOREX MARKET

Data as on 27th July 2017			
Debt / Forex Market			
Category	***Day***	***1 Mnth***	***3 Mnths***
10 Yr Yield	6.4	6.5	6.9
Re/ US $	64.1	64.5	64.2

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MARKET VIEW*.

Seller's Strike...

With Nifty flirting around 10K milestone, it is busy time for business channels and financial portals. All of them compete with each other with screaming headlines on how so and so stock has multiplied so many times in such a short time. Number of such stocks that have skyrocketed keeps growing by leaps and bounds. It is no accident that much of these stellar stocks are from the infamous group of tiny or micro caps. The reasons are not difficult to fathom.

In many cases, the surge in prices is more to do with lack of sellers than to do with aggressive buying. Incessant rise in price has led to sellers going slow on fear of premature exit, leaving many counters with few buyers driving up the prices. As a result, stocks are soaring amid thin volumes. In such a scenario, even a small selling when it comes, could leave a deep crack in some of these celebrated multi-baggers.

Though this trend is more prevalent in tiny caps, the rub-off of this trend on wider small and midcaps is one of key reasons for elevated valuations in the broader markets. As anyone who had attempted to sell even marginal quantities would know, the prices are very unreal and portfolio value could see a big erosion even on small selling. Given such a fragile nature of valuation, one should be very careful not to take the sharp rise in portfolios at face value. Tide does turn and when it turns (no one knows when), it will be a turn for the buyers to strike. When that happens, the whole momentum game could play in reverse, esp. for tiny and micro caps. It is time for caution for the overall market, esp. when it is driven by surge in liquidity rather than by ever-elusive earnings upgrades.

We stay away from giving market outlook (except reporting the consensus view) as we believe that the short-term market movements are function of innumerable rational and irrational parameters and hence any attempt to predict the next market move would be a futile exercise. Hence, we would like to qualify the above consensus view on outlook with a clear caution that TrustLine does not have any specific view on the outlook and does not necessarily subscribe to that.

Ist August' 2017

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VALUE EXTRACTS

- In this section of the newsletter, we attach an extract/write-up that we believe can add value to the readers from the "***VALUE INVESTMENT***" point of view or others that offer interesting perspective.
- Enclosed section carries an interesting article titled ***"Good Companies Don't Always Make Good Stocks"*** from **contrarianedge.com**

"Beware of the investment activity that produces applause; the great moves are usually greeted by yawns"

- Warren Buffett in 2008 Annual Letter

Good Companies Don't Always Make Good Stocks

I was recently going through a new client's portfolio and found it full of the likes of Coca-Cola, Kimberly-Clark and Campbell Soup — what I call (pseudo) bond substitutes. Each one is a stable and mature company. Your mother-in-law would be proud if you worked for any one of them. They have had a fabulous past; they've grown revenues and earnings for decades. They were in their glory days when most baby boomers were coming of age. But the days of growth are in the rearview mirror for these companies — their markets are mature, and the market share of competitors is high. They can innovate all day long, but consumers will not be drinking more fizzy liquids, wearing more diapers or eating more canned soup.

If you were to look at these companies' financial statements, you'd be seriously under impressed. They paint a stereotypical picture of corporate old age. Their revenues haven't grown in years and in many cases have declined. Some of them were able to squeeze slightly higher earnings from stagnating revenue through cost-cutting, but that strategy has its limits —

you can only squeeze so much water out of rocks (unless someone like 3G Capital takes the company, sells its fleet of corporate jets and starts mercilessly slashing expenses like the private equity firm did at Budweiser and Heinz). These businesses will be around ten years from now, but their profitability probably won't be very different from its current level (not much higher, but probably not much lower either).

However, if you study the stock charts of these companies, you won't see any signs of arthritis; not at all — you'll have the impression that you're looking at veritable spring chickens, as these stocks have gone vertical over the past few years. So this is what investors see — old roosters pretending to be spring chickens.

Let's zoom in on Coke. Unlike the U.S. government, Coca-Cola doesn't have a license to print money (nor does it have nuclear weapons). But it is a strong global brand, so investors are unconcerned about Coke's financial viability and thus lend money to the company as though it were the U.S. government. (Coke pays a very small premium to Treasury bonds.) Investors ignore what they pay for Coke; they only focus on a singular, shiny object: its dividend yield, which at 3 percent looks like Gulliver in Lilliput (fixed-income) land.

And as investors do so, they are ignoring an inconvenient truth: They are paying a very pretty penny for this dividend. Coke is trading at 23 times earnings. This is not the first (nor will it be the last) time this has happened to Coke stock. Investors who bought Coke in 1998 were down 50 percent on their purchase ten years later and have not broken even for more than 15 years.

And this brings us to the problem with shiny objects: They don't shine forever. Investors are paying 23 times earnings for a very mature business. Consumption of Coca-Cola's iconic carbonated beverage is on the decline in health-conscious developed markets, and you can clearly see this in its income statement — sales and earnings have languished over the past decade.

Let's say Coke does what it has not done over the previous decade and grows earnings 3 percent a year, despite the shift in consumer preferences away from sugar-powered and chemically engineered (diet) drinks. If at the end of this journey its price–earnings ratio settles to its more or less rightful place of 13 to 15 times, then jubilant Coke investors will have lost a few percentage points a year on Coke's price decline. Thus the bulk of the dividend will have been wiped out by Coke's P/E erosion.

Coca-Cola to some degree epitomizes the U.S. stock market. If over the next ten years, despite all the headwinds it faces, Coke is able to grow earnings at a faster pace than 3 percent and interest rates remain at current levels (so that the company's P/E stays at the present "I want this 3 percent dividend at any cost" level), then its stock will provide a decent return. However, there is a lot of wishful thinking in this paragraph.

If interest rates rise and/or consumers' tastes continue to shift from high-margin sugary drinks to low-margin (commodity) water, then Coke will be hit from both sides — its earnings will stall, and investors will take their eyes off its shiny dividend. Suddenly, they will see Coke for what it is: a 124-year-old arthritic American icon whose growth days are sadly behind it.

I am using Coke just to demonstrate the importance of differentiating between a good company (which Coke is) and a good stock (which it is not), and the danger of having an exclusive focus on a shiny object — dividends — when you are analyzing stocks.

Article by Mr. Vitaliy N. Katsenelson for contrarianedge.com

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About TrustLine

At TrustLine, we run a specialized PMS fund (Portfolio Management) for exclusive set of high net-worth clients (long only value based fund). We are a company with a single mission- to deliver superior long-term returns to our clients. We are managing over Rs.250+ crores of AUM for over 350+ highly satisfied clients. This makes us among the top 20 discretionary portfolio managers in India, with industry leading performance.

Over the years we, at TrustLine, have gained rich domain expertise by focusing and specializing in Portfolio Management Services (PMS).Unlike our competition, we are a unique firm focused only on PMS. This sets us apart and gives us a competitive advantage in the PMS space. At TrustLine we believe, the quality of "Research" is fundamental to delivering out-sized returns. When research is complemented by contrarian investment approach, the rewards can be dis-proportional. This forms the foundation of our investment choices and stock selection in our core PMS business. Our disciplined practice of this "Value Investment" principle has enabled us to deliver superior risk adjusted returns with significant out-performance over bench-mark indices.

With a client retention rate in excess of 99%+, we have grown as an organization through strong references, primarily driven by solid track record of building wealth across good and bad market cycles, through focused and disciplined approach to investing.

TrustLine products include:

- ***Intrinsic*** (Deep Value fund)
- ***Intrinsic*** Floater (Arbitrage Fund)

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