Piper Serica

Piper Serica Leader Portfolio Strategy™

Investor Letter Vol.52 | January 2025

- ## Portfolio Performance

The PMS return for the quarter was -2.4%. This brings our since-inception TWRR to 19.0%. This is higher than the return generated by Nifty at -8.4% and 13.6% respectively for the same period. The PMS return for the calendar year 2024 was 15.8% compared to 8.8% for Nifty. The PMS level cash holding is at appx. 11.8% (may vary for individual accounts).

- ## Market & Strategy Update

The Indian markets corrected in the last quarter despite strong domestic inflows. FPIs continued to sell leading to their decadal low holding in Indian stocks. With deteriorating macros and slowdown in domestic consumption there is nervousness around the premium valuation that Indian stocks trade at. If the earnings slow down further this premium valuation will be difficult to sustain. Nifty is trading at about 20x and 18x FY25 and FY26 EPS respectively. While this is not expensive by historical standards, it needs earnings to grow at the rate of 12-15% annually to sustain.

We continue to witness a slowdown in domestic consumption as consumers suffer from lower buying power. High inflation, high interest rates and high taxation have created a perfect storm that is hurting discretionary consumption. Stress on household income has led to a sharp deterioration in retail credit quality. In such a situation one would expect the government to do whatever is needed to boost consumption to kick start the virtuous cycle of consumption leading to private capex and higher economic growth. So far this support has been missing. On the contrary the taxation on consumption has become more complicated and has put greater burden on consumers. While we have not seen a drop in volume of consumption there is a clear evidence of down trading by consumers by switching to cheaper alternatives.

As we get into the earning season there seems to be a gradual realisation that earnings growth is slower than expected. Cyclical slowdown in earnings growth is not an extraordinary event coming after 4 years of strong growth. We expect this slowdown to continue for another 2 quarters. Markets need earnings growth to break out. Therefore we expect the nifty to trade in a narrow range for the next 6 months. Our estimate is that the broad market index would deliver absolute return of 10 to 15% in the year 2025 and most of this return would come in the second half of the year.

At the same time, we firmly believe that there are tremendous investment opportunities that will become available to us in a range bound market. Slow markets provide great investment opportunities to long term investors who ignore the short term volatility and focus on identifying long term multi baggers. In our most recent model portfolio rebalance we have removed certain slow growth large caps and have replaced them with small to mid-cap companies with a clear growth path ahead of them. These companies are part of large emerging sectors in which they have established leadership and have great management teams that are focused on innovation. They are getting support from the government as these companies replace imports. Many of these companies have listed only over the last couple of years thereby giving investors a unique opportunity to participate in their growth for the first time.

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- ## Emerging Sectors

We are seeing the emergence of large new sectors like EMS, fabless semiconductors, advance electronics, CDMO, life sciences, satellite communication, space tech, electric mobility and communications. These sectors will dwarf the growth of traditional sectors over the next 5 years as the Indian economy grows and matures. It is heartening to see that these young companies are focusing on innovation led business growth. These companies are finding a very receptive market across B2C, B2B and B2G customers. Many of these companies are replacing imports, especially from China and therefore are benefitting from government support. Leadership positions in these sectors are being established quickly. We are happy that the research that we have done in these sectors over the last year is helping us add some of these emerging leaders to our model portfolio at the right time. We are excited to add companies that we expect to grow at the rate of more than 25% over the next 5 years, with high margins, ROE and ROCE and that are funding their growth from internal cash flows. We believe that these companies will become multi-baggers and will help us continue to deliver alpha returns.

At the same time, it is pertinent to say that these companies will escape of the attention of investors who focus largely on cheap valuation as an investing metric since each one of these companies trades at higher than average PE multiple. However, once we build the growth into that equation these companies are actually cheaper than most of the slow growth large-cap value traps that seem cheap but fail to deliver returns.

- ## Model Portfolio Rebalancing

Following changes have been made to the model portfolio:

- **Underweight:** Banks and NBFCs, IT services, autos, FMCG and capital goods

We expect subpar quarterly earnings from banks and NBFCs. We expect an increase in cost to income ratio while asset quality will deteriorate further. Deposit growth and credit offtake continue to be a challenge. Collection efficiency for retail lenders will continue to struggle. The valuations have not sufficiently adjusted to reflect this. We believe that the recovery is still a couple of quarters away.

The model portfolio does not have any IT services company. We believe large cap IT services will continue to struggle for annual growth of more than 5% and will see margin pressure at the same time. The valuations ranging from 25-35 times earnings do not justify this low growth.

With deep discounting in the month of December the auto inventory levels have come down but we continue to see pressure on sales as customers switch to cheaper pre-owned vehicles. We expect auto manufacturers to take production cuts in the current quarter to reduce channel inventory.

- **Overweight:** Pharma, CDMO, EMS and insurance.

Our early bets on Dr. Reddys and Divis have done well as the investment thesis continues to play out. **Pharma** surprised everyone by becoming the best performing sector by annual returns in 2024. We believe that the US market will grow faster than currently estimated for Indian pharma companies. There is a virtuous cycle of generic shortage in the US, strong new product pipeline and subdued input prices that is playing in the favour or Indian pharma companies. With stricter manufacturing guidelines from the government and economies of scale the domestic CDMO industry that focuses on contract manufacturing for the domestic market has found wings. We believe this will be a high growth segment where leadership positions are already claimed. We have already added Akums and Windlas to the model portfolio and are looking for more opportunities.

We are very positive on the **EMS** space. India has severely underinvested in the electronics manufacturing space over the last 20 years. As a result we are highly dependent on imports for even the simplest electronics. With our prior focus on promoting small scale industry we never managed to become large scale competitive manufacturer. The government is fixing this by encouraging large scale production of electronics that replace imports through the PLI schemes. It is encouraging to see new companies benefit from these PLI schemes and the focus on domestic manufacturing to take leadership positions in this fast growing industry. Our experience with Dixon and Amber shows the power of catching a trend early and backing the leaders.

As the EMS companies mature they are now exploring new adjacencies that allow them to play to their strengths in manufacturing advanced electronics. We are seeing a strong move from them to get into high growth products like semiconductor design and OSAT manufacturing, avionics for drones and missiles, telematics for automobile industry, communication technology for spacetech, radars for defence forces, anti-drone systems, optical fibre based networks for telecom companies, cyber security etc. These companies are benefiting from the government focus on domestic manufacturing of these critical components. Large orders from government are allowing them to manufacture at scale for the first time and benefit from economies of scale. Over the next 5 years we see many of them becoming globally competent players. We believe many of these companies will become multi baggers over the next decade.

We have added 2 more EMS companies to the model portfolio. You will see these names getting added to your portfolio in January.

The **insurance** industry in India is still very nascent compared to its global peers. The data shows severe under-insurance across various categories like health, life, property and industry. The insurance industry has struggled with the regulator that has so far dragged its feet on innovation and a GST structure that makes insurance premium almost unaffordable for the lower and middle class. Early investors in the insurance companies have been disappointed with practically no returns over the last 5 years. There is little investor interest in the space. As a result we see an opportunity to back high growth companies at attractive valuations. We are seeing signs of the regulator

becoming more friendly towards innovation and also we are expecting the GST structure to become more affordable. We are overweight on the insurance space and believe that the sector will outperform the markets over the next couple of years.

The rebalanced model portfolio forecast return is 18.6% for 2025 based on our earnings estimates. The forecasted annualized return over next three years is 21.2%. We continue to maintain our portfolio risk management guardrails that we have discussed earlier.

- **Conclusion**

We see the current market correction as a great opportunity for long-term investors to add multi-baggers to their portfolio. These multi-baggers will always seem expensive from the lenses of traditional investing metrics. However, their rapid growth will drive portfolio returns that will beat all asset classes over the next 5-10 years. Our research team is very excited by the new investment opportunities that are presenting themselves through new IPOs. Our endeavour, as always, is to research these companies in great depth to understand their business model and build conviction about their high growth. Our portfolio management model will continue to diversify market risk. As active managers we would always want to stand apart from pseudo active managers, especially large funds, that find more comfort in hugging the index rather than doing the hard work of finding great investment opportunities for their investors.

Best wishes for a great 2025 from the team at Piper Serica!

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