Portfolio performance

The since-inception (June 2019) TWRR for the PMS is 16.04% (post fees and expenses). This compares favorably with our benchmark Nifty that returned 14.4% over the same period. Our standard deviation is almost at the same level and CAPM beta is well below that of the benchmark and our Sharpe ratio is well above.

Market update

Markets across the globe continued to rally. Nifty hit a new all-time high. With moderation of inflation in the US and sharp fall in commodity prices there is an expectation that interest rates will rise lesser than anticipated. Investors sitting on the side-lines have started to plough capital back into the equity and other risk assets. India saw another month of solid FPI flows. Combined with robust flows into the mutual funds from domestic funds this saw the benchmark hit a new high.

However, this rally in Nifty and Sensex has been the narrowest rally ever. Barely 5% of the listed stocks are at all-time highs. To compare, when the indices made a new high last year as many as 18% of the listed stocks made a new high. Almost 40% of the BSE AllCap constituents are 20-50% away from their high. Only 14% of the large-caps, 6% of mid-caps and 4% of small-caps are at an all time high. This is the reason that investors see a marked difference between their portfolio returns and Nifty and Sensex performance. But this is also a good opportunity for long-term investors because the valuation of good quality mid and small-cap companies will catch up with their large-cap peers over a period.

We have seen that markets regularly create these optical illusions. Therefore, it is important that investors stick to their investment plans for at least 3-5 years. Any knee jerk reaction to changing allocations based on very recent performance creates recency bias and destroys long term returns of the portfolio. Recent research has shown that investors who look at their portfolio once a year see a gain 91% of the time while investors who look at their portfolio every day see gains only 51.5% of the time. The reason is that longer-term horizon dramatically reduces the volatility in the portfolio while allowing the returns to compound. Therefore, investors are well advised to look at their equity portfolios as long-term compounding machines rather than short-term beauty contests.

Portfolio update

We are seeing very interesting investment opportunities in small and mid-cap space. There are some excellent companies that have created a very solid presence in high growth sectors. However, the markets have been so focused on large cap names that they have neglected these companies. As a result, these companies, with 15-25% annualized growth rate over the next 5 years are now trading at very attractive valuation multiples. At the same time, investing in small and mid-caps is a tricky business and requires in-depth research. It also requires the investor to have the ability to stand away from the crowd and patiently wait for markets to catch up with the real value of the company.

Based on our research we have added two small cap companies to the model portfolio – South Indian Bank and Greenpanel. You will find a summary of our investment thesis in the following section.

At the same time, we have reduced our allocation to Laurus Labs. While we believe that Laurus Labs is an excellent bet in the medium to long term for its robust custom synthesis business, we underestimated the price damage in its ARV business. The company has struggled to manage the ARV business while focusing on the growth of the custom synthesis business. As a result, the management commentary about near term growth has significantly weakened. We are watching the company closely and will wait for more management updates.

We have significantly expanded our research into the small and mid-cap space as we believe that the large cap rally is overdone and sooner than later the investors will start looking for undervalued fast growth small and mid-cap companies. We are at an advanced stage of completion of our research in two more companies and will add them to the model portfolio at an appropriate time. To make room for them we will exit at least one ultra large-cap company in the current model portfolio.

Addition: South Indian Bank

The business model of a bank is quite simple. It should be able to raise deposits at the cheapest rate possible and then deploy the same into high quality assets at a higher rate. The difference that is left is the Net Interest Margin. This is the core income of the bank that is buttressed by fee income. The net profit left after paying for the corporate expenses is the return for the shareholders and reflects as the Return on Equity. But banks often get into trouble while executing this model leading to misery for shareholders. Most of the mistakes are made while lending that leads to high Non-Performing Assets (NPAs) that eat away the profits and the equity capital. At the same time, resolution of old issues under a new leadership creates a unique opportunity for investors.

South Indian Bank is such an opportunity. With its lineage it always had a good liability franchise. However, two years ago that franchise had started withering and CASA deposits had fallen to 27%. Problems with the loan book were even bigger. NIM fell to 2.7%. Return on Assets was 0.3%, NPA was 3.5% and increasing, provision coverage ratio was a lowly 50% and the bank was staring at a mess. Fast forward to now when the Bank is looking at the CASA of 35%, NIM of 3.5%, RoA of 1%, NPA of about 2% (0.02% in the new loan book) and PCR of 72%. In other words, there is a remarkable improvement in all key metrics across the board. The bank has now laid out its plan for FY24 with even better metrics and is well on its way to achieve it.

The turnaround of the Bank can be attributed to a change in culture and structure led by its new CMD Murali Ramakrishnan who took charge in 2020. He is a seasoned banker with leadership position at ICICI Bank prior to his current stint. The hard work done by the bank is now starting to bear fruit. We believe that the investors are slow in realizing this change. The valuation of the bank is at 0.6x its book value compared to 1-1.5x for its peers. We believe that this valuation gap will close over the next couple of quarters as the Bank delivers results in line with its guidance.

We have added the Bank to our model portfolio because we believe that the stock price will benefit from an increase in valuation multiple as well as earnings growth. The risks to our thesis are any unforeseen deterioration in the asset quality or any changes in the key management. We will watch out for these risks.

Addition: Greenpanel Ind Ltd

Greenpanel is India's largest Medium-density Fiberboard (MDF) manufacturer with a 29% market share. The company is also a leading exporter of MDF. It was earlier a part of Greenply, a listed plywood company. The two entities demerged with Greenply becoming a plywood company and Greenpanel becoming an MDF company. Both are run by separate management teams. MDF is the fastest growing category in the decorative wood industry. This is reflected in Greenpanels 31% revenue CAGR over the last 3 years. MDF as a category is expected to grow at a rate of 15%-18% CAGR over the next 5 years. MDF is a cheaper substitute to plywood and is used by most readymade furniture manufacturers as well as real estate developers. Greenpanel, being the category leader is favorably placed to take advantage of the growth opportunity led by its strong distribution network, product level innovation, and a steady balance sheet.

We expect Greenpanel to continue to deliver a healthy 18%-20% annual earnings growth over the next 3-5 years. The company has a strong net cash balance sheet, healthy profit margins (EBITDA margin ~27%) and steady return ratios. It trades at a 12.5X FY24 P/E multiple, down from 25X multiple 6 months ago. The stock has corrected mainly due to fear of recession in global markets along with capacity expansion by other MDF players over the next 3 years. However, additional capacities will get absorbed over time since the category still is under-penetrated. Cheaper substitute to plywood, lower penetration, rising acceptability, strong revival in demand for housing units and readymade furniture are the key drivers that will help the company deliver on the growth.

Once the near-term concerns subside, we believe a leading brand like Greenpanel will go back to commanding a higher valuation multiple based on its earnings growth. A combination of earnings growth and valuation expansion with a margin of safety at current valuation makes it a very attractive addition to our model portfolio.

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