

When S&P 500 had lost more than a tenth of its value in the first week of February, Wall Street analysts dismissed it as a minor blip in an otherwise ‘entitled’ eternal rally that’ll supposedly make us all uber-rich. The fact is that at the end of the first week of Feb, little over half of S&P 500 constituents had reported 4Q17 earnings, with S&P 500 earnings (‘as reported’) suggesting just under 11% growth, making 4Q the fourth straight quarter of earnings deceleration, with 3-4% earnings growth in the quarter attributable to stock buybacks alone. On ‘as reported’ earnings basis, the index began Feb at already stretched ~21x C2018E earnings, predicated upon +33% earnings growth! With 4Q17 operating margins in US at the highest levels we have seen in well over a decade, and USD unlikely to be a tailwind, it is remarkable that street could somehow project 30%+ earnings growth for C2018E. Add in the fact that we have seen a largely uninterrupted rally over the past few years and to call a selloff at those valuations as a ‘minor blip’ was laughable. As we write this, 1Q18 earnings for S&P 500 constituents are rolling out, with earnings averaging 6-7% outside Financials and Tech. Similarly, Nifty 50 would hardly show any material earnings growth outside Commodities for C1Q18. Given that earnings have been largely lackluster for 4+ years now, our performance is a reflection of our ability to pick solid clean businesses at valuations that aren’t predicated on unrealistic acceleration in earnings growth. Be it the case of a media holding reporting solid growth as new stations (launched a few quarters ago) get profitable, or the case of an amusement park comping high precipitation levels from last year, or several similar stories, near-term earnings upsides within our book are largely decoupled from the broader economy as material idiosyncratic tailwinds drive growth. This is particularly critical today when key risks to global markets come from elevated valuations and estimates for heady earnings growth on already elevated margins across most sectors, with growth increasingly concentrated within fewer pockets. Much doesn’t need to go wrong in such situations for investors to lose. It increasingly feels like investors are so busy looking at the relatively clear road ahead, that they may not be mindful of the fact that they may have already used most of the gas in the tank.

In 1Q18, India Under-served was down **-5.0%** (net of charges and mgmt. fees), vs. **-5.8%**, **-4.0%**, **-10.2%**, and **-11.6%** declines in BSE 500, Nifty, BSE Midcap, and BSE Smallcap respectively. Since inception in April 2011, India Under-served has delivered annualized return of **+18.1%**, vs. **+10.3%**, **+9.0%**, **+12.9%**, and **+11.0%** gains for BSE 500, Nifty, BSE Midcap, and BSE Smallcap respectively. Over this period, India Under-served’s annualized volatility was **1.43%**, **0.93%**, **4.38%**, and **7.34%** below BSE 500, Nifty, BSE Midcap, and BSE Smallcap respectively.

Tale of two markets. Currently in India, we have *Nifty 50* on one side and everything else on the other end of the ‘froth’ spectrum. While we view *Nifty*’s valuations as a bit stretched, small and midcap valuations (as a universe) are unequivocally rich. It seems like institutional participants are finally jumping on the earnings growth bandwagon and stories are being created around a bullish narrative that has already catapulted a large part of this market into orbit. From where we stand, while mid/high-teen earnings growth can support *Nifty*’s valuations, one would need to see an extended run of clean 20%+ broad-based growth to support current valuations in the small and midcap universe. With profitability across most industries at or near their peaks, and material costs beginning to weigh on most names, it is hard to see how *Nifty 50* (ex-financials) can clock 20%+ earnings consensus growth in FY19E (Mar). While small and midcap earnings are likely to be a bit better, most stocks are already pricing in unrealistic growth expectations. Over the course of the next couple of quarters, we expect *Nifty*’s FY19E (Mar) expectations (ex-financials) to likely get cut towards at least mid-teens from 20%+. A glance at F3Q (Dec) numbers should have corroborated what increasingly appears to be a market creating a ‘top’ - In F3Q, *Nifty 50* (ex-financials) posted ~9.5% earnings growth when comping a weak demonetization-hit quarter from last year. Even this headline performance was replete with drivers that aren’t reflective of any broad-based turnaround - In names such as *Asian Paints*, almost entire earnings growth was attributed to spending cutbacks and process changes even as volume growth was mediocre. Excluding the windfall from the IUC fee cut, *Reliance Industries*’ F3Q earnings growth would have been 15% (vs. the headline 25% growth). Overall, 70% of *Nifty 50* constituents (ex-financials) missed their estimates and that’s when we count names like *Infosys* among the ones that beat consensus, where the beat would

have been a miss if it hadn't been for reversal of prior tax provisions. In a quarter that was supposed to deliver clean and solid earnings growth off of a low base, *Nifty's* numbers were unequivocally poor. Given that FY19E wouldn't have as much of a poor comparison to benefit from, given that weakness in the informal economy is real, given that materials costs are a clear headwind almost across the board, and given that (excluding Commodities and select Industrials) most industries are already at or close to record high margins, it is puzzling to identify the next leg of growth to reconcile with street's FY19E 20%+ earnings growth at the beginning of the year. Anything other than a very solid revival on the topline and continued expansion in margins cannot support such expectations. F3Q (Dec) earnings for *Nifty Midcap 50* (ex-financials) meanwhile grew at a healthier ~23.5% in F3Q (Dec), but headline was skewed by a handful of names (half of that growth was attributable to 3 of the top 8 components).

We had been stressing upon risks of earnings cuts within mass consumption categories such as two-wheelers and telecom services. Consider last quarter results of *Nifty's* two 2W components, *Bajaj Auto* and *Hero Motocorp*, both of which were fairly hit in the post-demonetization period. While the street was rightly not baking incremental margin expansion in these names for FY19E (Mar), margin contraction risks were largely ignored. As the year began, FY19E (Mar) consensus revenue growth for these names was in the low-teens, a bit higher than what these names averaged in Dec quarter when comping the low base from last year. Meanwhile, their FY19E earnings were being forecasted to grow in the 10%-15% range, a sharp acceleration from the 4% average growth in the past quarter, even as materials costs are clear headwinds going forward. Similarly, *Bharti Airtel's* FY19E (at the beginning of the year) was built on high single-digit growth in revenues amid continued ARPU pressures. In F4Q (Mar) earnings last week, *Airtel* posted another 6% sequential decline in ARPU. All said, based on recent earnings, ~2/3rd of *Nifty's* components (ex-financials) need to show material acceleration in earnings growth to come in line with street's FY19E expectations.

We gained further conviction within specific catalysts in core positions that are likely to drive near-term earnings growth and/or keep a lid on margins as inputs costs rise.

In December, Supreme Court reaffirmed that diagnostic lab reports can only be signed off by individuals who have an MD in Pathology. Subsequently, we have noticed that organized players have extensively lobbied to enforce this requirement. We note that this requirement has certainly forced several players to engage pathology doctors to sign off on reports. Depending on the location, we estimate that this requirement costs labs an incremental INR 10-20K/month. For a typical stand-alone lab that processes 40 samples/day, we estimate that this could potentially wipe out half of that lab's EBITDA, potentially accelerating the ongoing shift towards organized scale players.

Another recent key event with implications for our diagnostics lab holding was a proposal from the Delhi government to put price caps on diagnostics services at hospitals/clinics. In doing so, the government wants to ensure that hospitals/clinics don't price their diagnostic services at more than 15% premium over what is charged by national diagnostics services labs in the region. Our checks within Delhi suggest that diagnostic tests at hospitals with 100+ beds are, on average, priced at 75%+ premium over national diagnostics lab operators, suggesting significant compression in their margins if they choose to continue to conduct tests in-house. To put that in perspective, at several large hospitals in Delhi¹ that do limited outsourcing of diagnostics, EBITDA contribution from diagnostics makes majority of their EBITDA. We estimate that about a third of the total volume of tests at hospitals with 50-100 beds are outsourced to specialized diagnostic labs within Delhi. Hospitals with 100+ beds meanwhile currently outsource, on average, a much lower 15-20% of their test volume. Given that hospitals with 100+ beds account for about half of all private hospital beds in Delhi, we

¹ Delhi accounts for more than a third of revenues for our healthcare diagnostics holding

would expect increased outsourcing to diagnostics specialists (if the above proposal goes through), particularly those that can process samples within the region.

Cost pressures likely to remain muted for our paper holding. In recent years, hardwood pricing in the state, where our holding's flagship plant is located, has been driven by sourcing by 4 players, including our holding. With one of them shutting last year and another player already delinquent on sourcing (as per our discussions with the associated agri-cooperative), our holding remains one of only two players that could dictate pricing. With imported BCTMP pulp pricing also likely to remain moderate, we are convinced that 20%+ EBITDA margins in this position will be held going forward. With ahead of schedule debt paydown, we also expect another 2 years of 20%+ earnings growth, with little assistance from overall demand acceleration or inorganic expansion.

Mall supply is unlikely to be a bottleneck for our movie exhibition holding. One of the perceived challenges to growth for a certain movie exhibition holding of ours remains mall supply. Our conservative forecast for mall openings in India suggest that multiplex properties would at least double over the next decade. Even disregarding footfall shift from continued closure of single-screens, it's hard to work with a base case worse than at least tripling of industry revenues over this period.

Our April performance will be firmed within 7-10 days. Please let us know if you have any questions.

Thanks,

Piyush Sharma

Meet your investment manager

Piyush Sharma, born and raised in India, is investment manager of Right Horizons Minerva Funds. Having spent time with Citigroup and Bombay Stock Exchange in India, he moved to United States in 2002, where he covered stocks within Business Services, Autos, Consumer Products and Financials with Sanford Bernstein, Longbow Research, and Avondale Partners, working in teams that received accolades from leading institutional research arbiters, including Institutional Investor (II) and Greenwich Associates. Piyush received an MBA from University of North Carolina at Chapel Hill, MS from MNNIT, and BS in Accounting from University of Allahabad.

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