

### *The case for industrials/capital goods now*

Dear Investor,

In the last few months, you would have noticed that the Core Value portfolio has been having an overweight position on Industrials/Capital Goods stocks. This has been quite in contrast to the Index weights, and to several other mainstream equity portfolios. In this edition of the newsletter, we give our reasons why, and discuss our new additions in this sector.

We have articulated several times in the past about our preferences to buy strong companies when they are not very favoured by the rest of the market. This is our way of aligning ourselves with the ways of the capital market. If we agree that the capital market ultimately rewards efficiency (and punishes inefficiency) in the use of capital, then we think the appropriate way for an investor to do it is to

- Stick to companies that are competitive and have displayed efficiency in use of their capital, and
- Use the client's capital more efficiently and buy the stocks when their stock prices are not much higher than what we believe is warranted.

Let's have a look at how the sector "Capital Goods" has been perceived over the years by the stock market:

#### Sector weights in the Nifty 50 Index over the years

Sector	Dec-02	Dec-07	Dec-12	Dec-17	Dec-20	Dec-21	June-22
Auto	5.6%	3.4%	8.8%	10.6%	5.4%	5.0%	6.0%
<b>Capital Goods</b>	<b>3.1%</b>	<b>10.5%</b>	<b>5.9%</b>	<b>3.8%</b>	<b>2.6%</b>	<b>3.0%</b>	<b>2.7%</b>
Cement and Cement Products	2.4%	2.1%	4.2%	1.6%	2.2%	2.4%	2.0%
Consumer	17.9%	3.6%	12.3%	9.2%	11.5%	10.8%	11.4%
Financial Services	11.7%	12.0%	29.5%	35.0%	38.8%	35.6%	35.1%
Health Care	8.3%	2.2%	5.0%	4.0%	3.6%	3.4%	4.0%
Media & Entertainment	1.2%	0.4%	0.0%	0.8%	0.0%	0.0%	0.0%
Metals & Mining	2.9%	9.0%	3.8%	4.5%	2.5%	3.3%	3.1%
Oil & Gas	17.6%	25.4%	12.3%	12.7%	12.5%	12.3%	14.2%
Others	0.9%	2.3%	0.3%	1.5%	1.0%	1.3%	1.2%
Technology	24.2%	9.5%	11.4%	11.4%	16.3%	19.1%	15.9%
Telecommunication	2.6%	11.4%	2.0%	2.4%	2.0%	2.1%	2.4%
Utilities	1.6%	8.2%	4.5%	2.4%	1.6%	1.7%	2.0%

Source: National Stock Exchange.

Please look at the table above. When the last big surge in capital expenditure happened in India (in the years prior to 2007), the weight of capital goods in the Nifty rose from 3.1% to 10.5%. After that it had fallen to 2.6% in Dec 2020, and in June 2022, stands at 2.7%. It is close to its 20-year low.

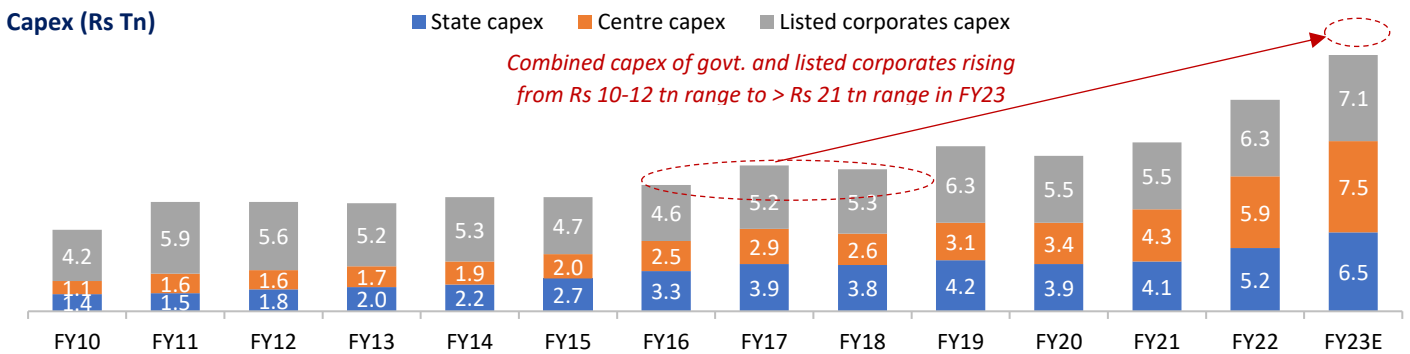
At the same time, let us look at the outlook for the capital goods sector:

- There is a stated intention for massive thrust in capital expenditure, driven by the government. The National Infrastructure pipeline gives details of the plans of a very big thrust in the sectors of power, railways, roadways, and urban infrastructure.

- The PLI schemes announced in various industries attempts to increase the thrust on manufacturing.
- Capacity utilization levels in India’s manufacturing sector have reached nearly 75%, which is usually the time when another round of capacity additions happen.
- The stated intention is to increase domestic offtake of defence capital expenditure.
- At nearly \$77 billion, exports of Engineering goods from India are the highest amongst all commodities exported out of the country. Also, Exports out of India rose by 47% in the period April 2021-February 2022 compared to the corresponding period of last year. This was higher than exports out of Canada (31%), USA (28%) and China (24%).

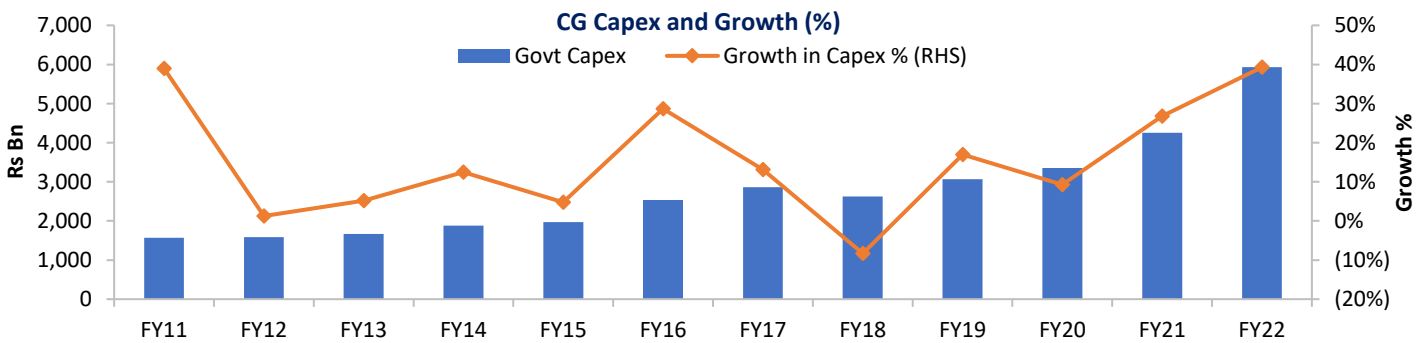
Recently, ICICI Securities released a report giving the details of such tailwinds in India’s capital goods sector. We are reproducing some of those charts here:

**Capital expenditure plans of listed corporates and government over the next couple of years**



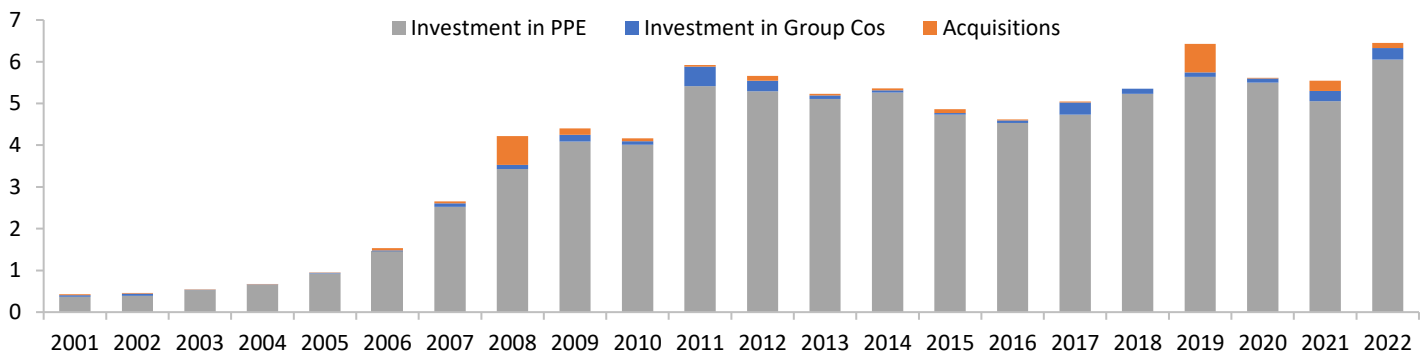
Source: ICICI Securities

**Trend of government capital expenditures**



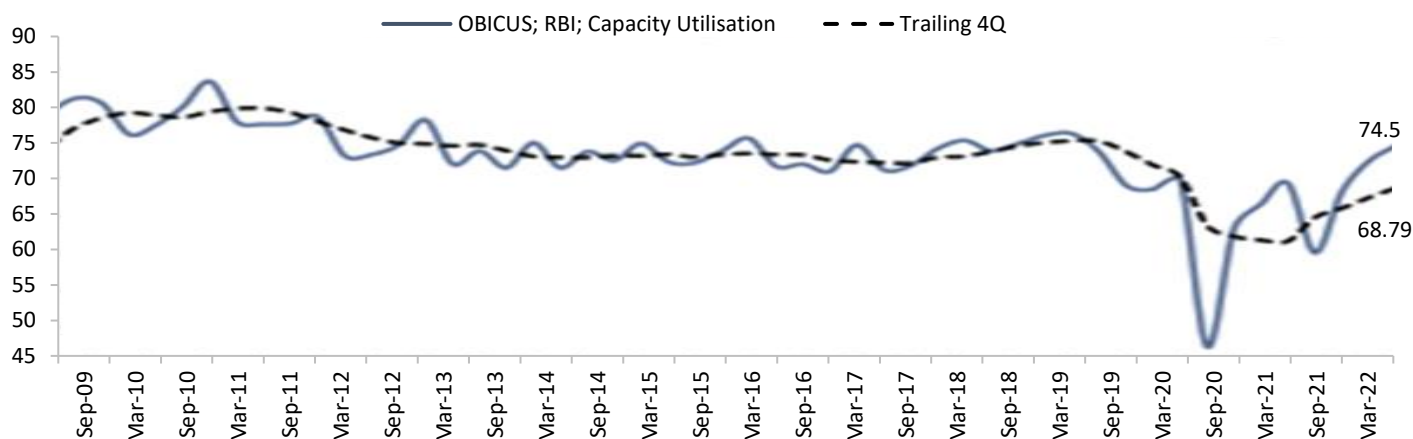
Source: ICICI Securities

**Trend of capital expenditures for listed companies in India (Rs tn)**



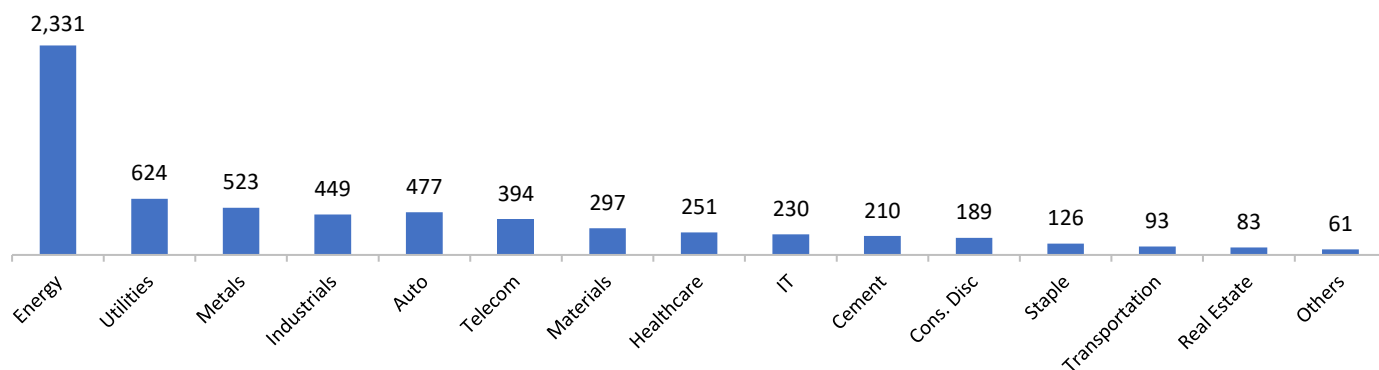
Source: ICICI Securities

### Capacity utilization levels rise



Source: ICICI Securities

### Sectors where maximum capital expenditure is expected (Rs bn)



Source: ICICI Securities

The takeaways for an investor from these data are clear:

- There is a revival seen for capital expenditures, driven primarily by the government, and to a lesser extent by the private sector
- Manufacturing, defence, energy, transportation and urban infrastructure will receive the maximum share of the capital expenditure.

These two points, the favourable tailwinds for the capital goods sector, and the fact that the popularity of this sector is still quite low (as evidenced by the low weight of this sector in the index) have been the reasons for our overweight position in this sector.

Your portfolio already has held Larsen & Toubro, Bharat Dynamics, Cummins India Ltd, Rites and Thermax, for a few months now. The most recent addition has been that of Honeywell Automation India Ltd (HAIL). Apart from Bharat Dynamics, and to some extent, Rites, the others are catering to multiple industries with a wide variety of customers. In addition, we have been holding Container Corporation, Bosch, ZF Commercial Vehicle Control Systems and Blue Dart for a while now. Although these are not strictly capital goods companies, the revival of capital expenditures and manufacturing would certainly benefit these companies too.

HAIL had recently fallen in price to below Rs.31000 in May 2022 compared to Rs 46000 it was quoting in February 2022. If we believe that India's manufacturing footprint would be higher in the coming years, then HAIL would certainly proportionately benefit from the investments in industrial automation, building automation, control systems in energy

industries and data centres. The company also scores more than satisfactorily on our parameters of high return on capital and consistency of free cash flows, strength of the balance sheet and low leverage levels. In the last decade, the company has generated greater than 20% Return on Capital on eight occasions and has generated free cash flow in eight out of the previous 10 years. HAIL also has negligible debt and has seen a steady improvement in its EBIT margin from 7% in 2012 to more than 15% in 2022.

One of the ways we seek to judge whether a stock is at an acceptable price is to see its valuation in comparison to its 10-year average. Therefore, when HAIL came to below its 10-year average valuation in May-June 2022, we started to accumulate for our investors.

We are confident that over the next few years, this positive bet on Capital goods and Industrials would benefit the portfolio.

Warm regards

Yours sincerely,

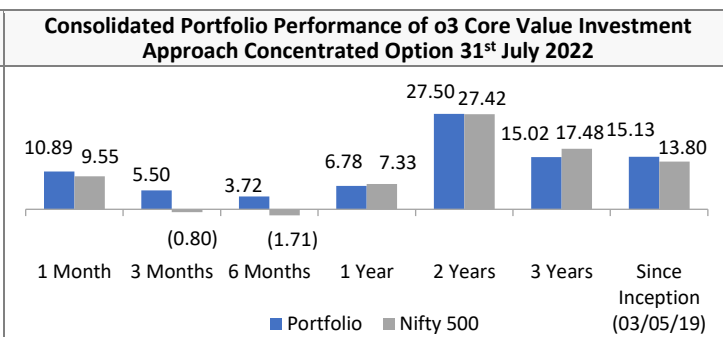
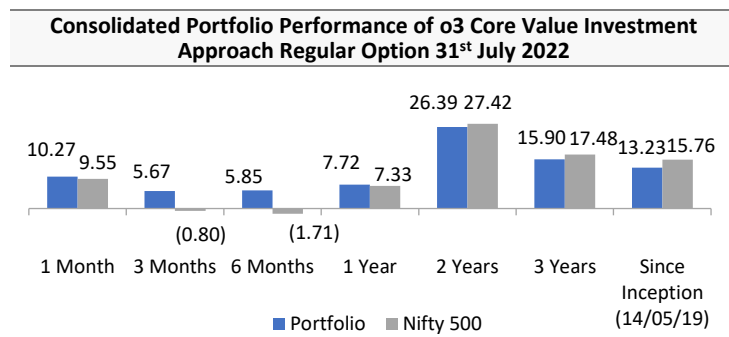
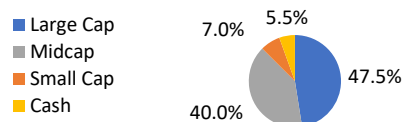
**E A Sundaram**

Chief Investment Officer and Portfolio Manager.

**Investment Objective:** The investment objective is to achieve capital appreciation through investment in a diversified portfolio of high quality companies, purchased at reasonable valuation.

o3 Core Value Investment Approach			Regular Model Portfolio Data	
Name	GICS Sector	Weight	Underweight	Overweight
ITC	Consumer Staples	6.83%		13.29%
HDFC Ltd	Financials	5.07%		5.84%
Bosch Ltd	Consumer Discretionary	4.98%		4.11%
Cummins India	Industrials	4.89%		1.98%
Asian Paints Ltd	Materials	4.65%		0.37%
Blue Dart Express Ltd	Industrials	4.36%	(0.59%)	
Titan Company Ltd	Consumer Discretionary	3.94%	(0.85%)	
Indraprastha Gas Ltd	Utilities	3.81%	(2.74%)	
Larsen & Toubro Ltd	Industrials	3.76%	(5.92%)	
Sanofi India	Health Care	3.62%	(9.42%)	
		<b>45.91%</b>	(11.57%)	

Performance Description	Regular	Concentrated	Nifty 500	Regular Model Portfolio Composition	
Largest Monthly Gain	12.51	11.41	14.52	Weighted Average ROCE	20.16%
Largest Monthly Loss	(20.53)	(19.19)	(24.25)	Portfolio PE (1 year forward PE, based on FY24)	26.26
Beta of Portfolio	0.76	0.74		Portfolio Dividend Yield	1.84%
Standard Deviation (Annualised)	17.41	16.90		Average Age of companies	61 Years
Correlation	0.93	0.92		Overlap with Nifty 500	25.53%
				Total Debt/Equity	0.35
				Debt/Equity (Excluding Financial Stocks)	0.10
				Sales Growth	8.14%
				EPS Growth (FY24 over FY22)	20.53%



- Benchmark is Nifty 500, the portfolio is spread across different market capitalization, hence Nifty 500 is chosen as benchmark
- Since inception date stated is considered to be the date on which the first active client investment was made under the investment approach
- Industry Classification as recommended by AMFI, all the above data are as of 31<sup>st</sup> July 2022

**Disclaimer:** Performance depicted is based on all the client portfolios existing as on such date, using Time Weighted Rate of Return (TWRR) of each client and then computing arithmetic average for the overall investment approach. Past performance is no guarantee of future returns. The above portfolio performance is after charging of expenses. The performance related information provided here is not verified by SEBI nor has SEBI certified the accuracy or adequacy of the contents of this Document. Beta, Standard Deviation & Correlation are from Since Inception period.

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