Investor NEWSLETTER

Long-overdue relief for the Indian farmer

Dear Investor,

We wish you and your family a safe stay during this time of the lockdown.

What a year this has been so far! From a high of 42273 reached on 20th January 2020, the BSE Sensitive Index fell to 25638 just over two months later (on 24th March 2020), a fall of 39.3% from the peak. Two months later still (end of May 2020), it has risen to 32424, more than 26% from the bottom levels.

While we are happy that the fatality rate of Covid-19 is much lower in India compared to some other countries, we have to be aware that the problem likely to be caused by Covid-19 to the economy is very widespread. The GDP, Industrial production, and corporate profits would take a big hit in this financial year. However, as we had articulated in one of our earlier newsletters, not all companies are likely to be affected equally, and it is our endeavour to populate your portfolio with companies that have better balance sheet strength, and better resilience in terms of business model compared to the others.

We have all seen the economic stimulus package announced by the Government of India, as well as the monetary steps announced by the RBI. We have also seen the analysis of these steps in various media forums, both print, electronic media and the Internet.

It is quite disappointing that a bulk of the analysts covered the stimulus package in terms of what proportion of the GDP was covered by the fiscal package, rather than focus on some of the most far-reaching reforms in a vital sector of India – Agriculture. We see this as a sign of the times that focuses on what is immediately visible, and not on what is structural and long-term.

Why are the Agricultural reform measures important

Since 1991, India has seen some important economic reform measures, but almost all of them sidestepped the agricultural sector. As a result, the contribution of agriculture to overall GDP has steadily declined over the years.

Figure 1. Contribution of Agriculture to overall GDP

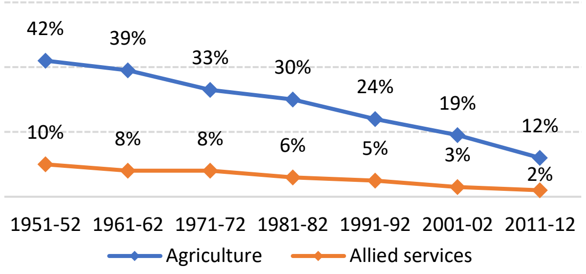
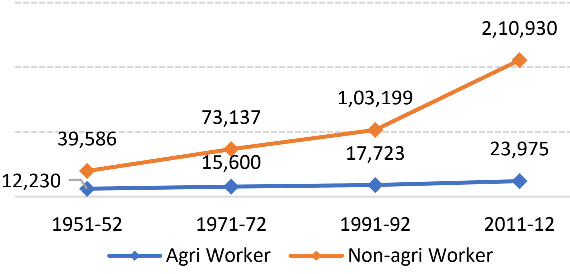


Figure 2. Per capita GDP of Agri and Non-Agri Workers

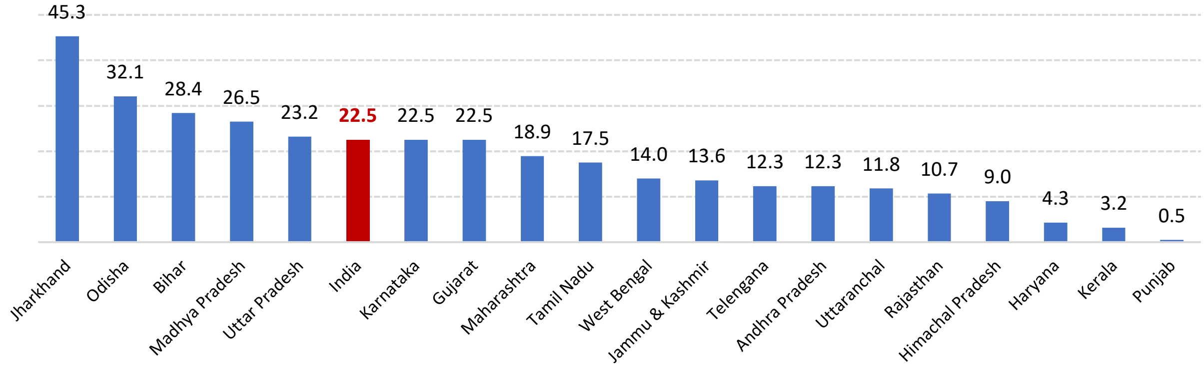


Source: Planning Commission / Unitus Ventures

Figures 1 and 2 make quite depressing reading. All these years, when we were crowing that India is getting transformed from an agri-oriented economy to a "service economy", about two thirds of our population was getting a raw deal.

The official figures about the number of farmers below the poverty line are also disturbing:

Figure 3. Official Estimates of Poverty Amongst Farmers



Source: Niti Aayog report – "Doubling farmers income" – 2017.

The recent steps announced by the Finance Minister, as part of the relief package for Covid relief, announced three important regulatory changes:

- Amendment of the policy for agricultural marketing, by making changes to the APMC Act
- Amendment to the Essential Commodities Act, and does away with the limits of storage that a private buyer of agricultural commodities can do.
- Encourage steps to promote contract farming.

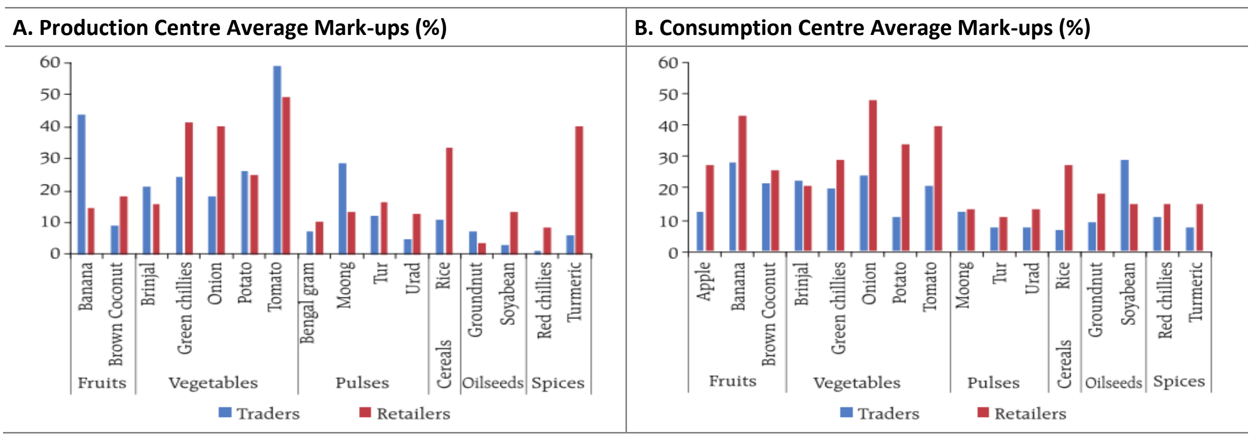
These steps have been hailed as "pathbreaking" and "long overdue" by eminent agricultural economists like Mr. Ashok Gulati. They may not yield immediate results, but there is no doubt that, if implemented in letter and spirit, they have the capacity of changing the fortunes of rural India, where nearly two-thirds of our population lives.

One of the main reasons why the farmer is at the receiving end is the regulatory framework that exists in this country.

- The farmer can sell his produce ONLY to the local APMC mandi (the designated market place stipulated by the Agricultural Produce Market Committee in their respective states)
- The farmer has NO say in determining the price of his produce. This is decided by the Committee member (or his/her representative) at the local APMC mandi.
- The farmer has to incur transport cost to transport his produce to the mandi, but he cannot unload the produce. The unloading has to be done by the APMC
- The arthia at the APMC gets a commission both from the farmer and the purchaser of the produce.
- If, for example, a farmer sold his rice to the local rice mill, the APMC has the power to impose a fine on the rice mill.
- The APMC Act was ironically formed for giving the farmer protection against exploitation. It instead had spawned a new breed of exploiters.

The RBI, in one of its papers, gives an indication of how much of the value added is taken away by the middlemen in the agri trade:

Figure 4. Average mark-ups for agricultural crops by middlemen



Source: RBI paper on "Supply chain dynamics and Food Inflation in India"

There are estimates that on an average, a farmer makes only between 25-28 paise out of every Rs.1 spent at retail level for agricultural products. And this varies widely. Sometimes, in perishable commodities like tomatoes and onions, the farmer sometimes as little as 9 paise per every rupee spent at retail level.

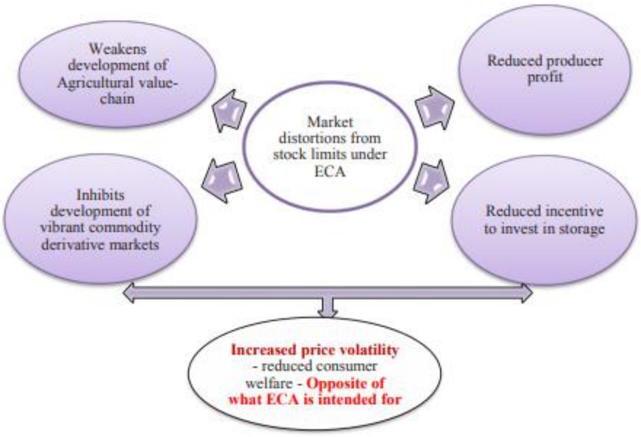
Another law that has outlived its utility is the Essential Commodities Act (ECA). Some indications of the ill-effects of this Act were given in the Economic Survey document of 2019-20. The following are excerpts from the document:

> First, frequent and unpredictable imposition of blanket stock limits on commodities under Essential Commodities Act (ECA) neither brings down prices nor reduces price volatility. However, such intervention does enable opportunities for rent-seeking and harassment. For instance, imposition of stock limits on dal in 2006-Q3, sugar in 2009- Q1 and onions in September 2019 spiked up the volatility of the wholesale and retail prices instead of smoothening them – in contrast to its objective of easing pressure on prices. Around 76000 raids under ECA were conducted during 2019. Assuming a minimum of 5 persons involved in a raid, considerable administrative effort goes into enforcement of ECA. As the conviction rate, however, is abysmally low and raids have no impact on prices, the ECA only seems to enable rent-seeking and harassment. The Act is anachronistic as it was passed in 1955 in an India worried about famines and shortages; it is irrelevant in today's India and must be jettisoned.

Source: The Economic Survey 2019-20.

The same economic survey highlighted the ill-effects of the Essential Commodities Act in preventing the development of storage infrastructure and in providing an effective price mechanism for the farmers:

Figure 5. Agricultural Market Distortions Due to ECA



Source: The Economic Survey 2019-20.

The Economic Survey itself stated that, far from reducing the price volatility in farm products (as was the original intent of the Act), the ECA actually increased price volatility. Besides, it reduced the incentive to invest in storage facilities and inhibited the development of vibrant commodity derivative markets. The Survey had categorically called for the scrapping of the ECA.

In one stroke, the government has amended both the ECA and the norms for agricultural produce marketing.

In addition, it has also announced a funding support of Rs.100000 crores for the creation of storage facilities at the farmgate.

Potential benefits that we see from these steps

1. The farmer is freed from the rules of selling ONLY to the local APMC mandi, and at prices which he cannot say no to. The new set of rules gives the farmer a choice to sell elsewhere, if the price is better.
2. Contract farming is encouraged, with food companies being the buyers, instead of the local middlemen. The setting up of Farmers Producers Organizations (FPOs) in several states would provide the farmers a platform to negotiate better prices, just as the milk co-operatives did in Gujarat to power the White Revolution.
3. The amendment of the Essential Commodities Act (ECA) and the fiscal support to set up storage facilities at the farmgate are likely to encourage investments in much needed storage facilities for agricultural produce. In a country where it is estimated that a fourth of the horticultural produce gets wasted because of a lack of adequate storage facilities, this is a welcome step.
4. The intended benefit of these changes is to transfer the balance of power from the middlemen to the farmer/consumer. It is our estimate that the farmer's net income would rise by about 25-30% as a result of these steps.
5. This would hopefully set the stage for a large-investment in food processing facilities in the country, thus creating employment in rural India for agri-related industries.

Of course there are pitfalls. There may be covenants introduced in the law that we are not aware of now. There may be a backlash from the middlemen lobby. The whole thing may take longer than envisaged. However, this is a big step in the right direction. Let us have a look at the potential implications:

Long-term Implications for an Investor

These are possibilities that we see emerging over the next several years.

a. Farm income takes a turn for the better. There is room to believe that over the next couple of years itself (if these proposals are implemented) the farmers' income on an average rises by about 30-35% from present levels. This is good news for a bulk of the farming community (and since this accounts for 60% of the population), this is good news for the economy as a whole.

b. Rural demand would revive, with continued benefit for FMCG, pharma, consumer discretionary spending, and increased investment in rural infrastructure.

c. Food-related companies get better leeway in streamlining their supply chains. Their cost of procurement can be streamlined as well. Contract farming is likely to become more widespread. It may also see emergence of new brands with Farmers Producers Organizations (FPOs) bringing out their own brands. Also, strong retail chains are likely to bring out brands of their own.

d. Food warehousing, including cold storages, will get a leg up over the next few years. We are likely to see expansion of facilities by existing players, as well as increase in the number of players in this field. Also, equipment suppliers to cold storages, and refrigerated trucks are likely to benefit from this move.

e. In the long run, if farming becomes more profitable, that may make labour costs more expensive for several industries, including real estate and construction, domestic help in urban centres .

Let us not forget that we still have a long way to go to come out of the problems created by the Covid-19. It would probably change the way several businesses operate. It would also alter the economics of many businesses, maybe permanently.

However, steps taken to alleviate the farming community of their most pressing problems are very welcome steps. We are hopeful that over the long run, these would prove to be very beneficial for our farmers, and therefore for our economy.

Warm regards

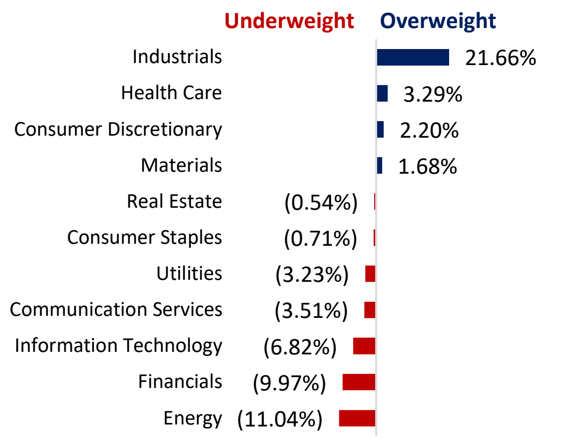
Yours sincerely,

(E A Sundaram)
Chief Investment Officer and Portfolio Manager

o3

Top 10 Holding of o3 Core Value Strategy - Regular Scheme Option as on 29th May 2020		
Name	**GICS Sector**	**Weight**
ITC	Consumer Staples	6.78%
Oracle Financial Services Software	Information Tech	5.69%
Colgate-Palmolive (India)	Consumer Staples	5.52%
HDFC Bank	Financials	4.89%
Container Corporation of India	Industrials	4.56%
Sanofi India	Health Care	4.33%
Indraprastha Gas	Utilities	4.26%
Castrol India	Materials	4.23%
Exide Industries	Consumer Discretionary	3.84%
Multi Commodity Exchange of India	Financials	3.84%
		47.94%

Overweight / Underweight of Regular Portfolio Compared to Nifty 500 as on 29th May 2020



Investment Objective: The investment objective is to achieve capital appreciation through investment in a diversified portfolio of strong businesses, purchased at reasonable valuation.

Model Portfolio Details as on 29th May 2020	
Weighted Average ROCE	30.61%
Portfolio PE (1 year forward PE, Based on FY22)	18.43
Portfolio Dividend Yield	1.90%
Average Age of companies	61 Years

Model Portfolio Composition as on 29th May 2020	
Large Cap	46.5%
Midcap	37.5%
Small Cap	9.0%
Cash	7.0%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on 29th May 2020
- Midcap: Market cap below 100th company to the market cap of the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 29th May 2020
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 29th May 2020

Model Portfolio Composition as on 29th May 2020	
Model Portfolio Over Lap with Nifty 500	14.11%
Model Portfolio Over Lap with Nifty 50	14.98%

Consolidated Portfolio Performance of Core Value Concentrated Strategy		
Period	**29th May 2020**	
	Portfolio	**Nifty 500**
1 Months	(0.30)	0.32
3 Months	(11.18)	(15.31)
6 Months	(18.41)	(20.29)
1 Year	(13.45)	(19.83)
Since Inception (15/04/2019)	(13.22)	(18.02)

Consolidated Portfolio Performance of Core Value Regular Strategy		
Period	**29th May 2020**	
	Portfolio	**Nifty 500**
1 Months	(0.32)	0.32
3 Months	(11.44)	(15.31)
6 Months	(17.18)	(20.29)
1 Year	(15.75)	(19.83)
Since Inception (14/05/2019)	(11.95)	(14.01)

- Since inception date stated is considered to be the date on which the first client investment was made under the strategy

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 strategy. Past performance is no guarantee of future returns. The above portfolio performance is after charging of expenses.