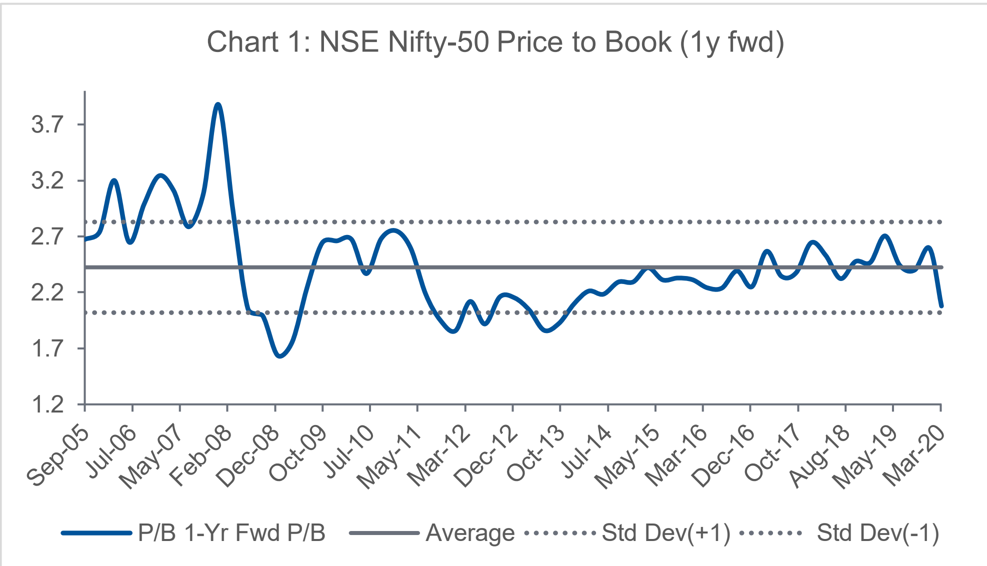
16 March 2020

# Ocean Dial Investment Update

As the global COVID-19 pandemic evolves, from an investment research perspective the key question in our mind is *what are stocks in India pricing in and to what extent*? This is because, in episodes of uncertainty and volatility, markets have historically been least efficient in pricing securities thereby enhancing our ability to potentially generate excess returns through our remit of investing in quality businesses at attractive valuations. The update is divided into four short sections. The first part provides some data points as context for the second part which is an outline of what expectations we believe are *baked into* the current prices, which will inform part three – what are we doing about it from a portfolio perspective. Finally there is an appendix which goes deeper into the methodology and assumptions we have made.

## Some context

- The Indian markets have corrected ~20% since the last week of February in line with global markets
- 81 of the BSE 200 constituents have fallen more than 20% over the same period
- India has **so far** been relatively un-infected with 107 cases of infection reported
- As per the Indian Council of Medical Research (ICMR), India is in Stage 2 of the virus transmission. Stage 1 is getting imported cases of infection, Stage 2 is local transmission, Stage 3 is community transmission and Stage 4 is when it turns into an epidemic
- ICMR thinks India has a 30-day window from now to halt the beginning of Stage 3 – community transmission
- Valuations are now at minus 1 standard deviation of the last 15 years average. (See Chart 1[1] - we have not used the P/E ratio as it is a little too early to gauge the impact on 'E'.)




[1] Source – Investec Securities India

## What is the market pricing in?

To attempt an answer to this we have used a Discounted Cash Flow (DCF) analysis that tries to measure the impact of disruption of business activity on the value of two hypothetical but representative Indian stocks: Stock A and Stock B. We have assumed two 'extreme' scenarios for each of these stocks: the complete loss of Free Cash Flow to Equity (FCFE) for (a) first 2 quarters of FY21 and (b) the entire FY21.

The appendix goes into greater depth but our scenario analysis shows that the current correction of ~20% in stock prices is already pricing in two to four quarters of disruption in the business and cash flows.

In short, we believe the markets whilst volatile are not behaving irrationally, but if we can be excused the use of a bold double underlining for a second time – **so far**. They are pricing in a worsening scenario of a rapid rise of infections in India and with it the disruption to business and economic activity – but not yet Armageddon.

Some positives to bear in mind:

- The sharp fall in crude oil prices will bring significant economic benefits. India's crude oil import bill was ~US$120bn in the last twelve months (~4% of GDP). The fall amounts to a ~US$20-30bn stimulus to the Indian economy leading to lower current account deficit, lower inflation, lower fiscal deficit, and thus higher GDP growth relatively. It can boost demand and profitability across sectors.
- The government has also cleared the reconstruction of Yes Bank with equity participation from State Bank of India (SBI) and six other private sector banks. The plan is credible, and prevents any contagion in the banking system from its collapse – a large overhang on sentiment of late.

Once the impact of the virus wanes, economic activity can bounce sharply depending on the extent and depth of damage due to disruption. India's experience during Demonetization may be a 'mini' example here (see the discussion on this also in the Appendix). On the other hand, while we believe disruption on business activity has been discounted, can markets fall further? This depends on whether there is a pandemic in India or if the global pandemic results in a global slowdown, business failures, and a contagious financial crisis. There are plenty of *unknowns* and our investment research and returns expectations cannot incorporate a view on the *unknowable* impact of such *unknowns*.

## Portfolio Strategy

- Do not speculate on matters where 'we don't know' such as:
  - Will there be a pandemic in India? Will there be a large-scale disruption in economic activity? Will the onset of summer help in keeping the virus away?
  - What will be the extent of the global spread of COVID-19 going forward and the disruption in economic activity it causes, both in terms of duration and level.
  - What are the risks of a prolonged global slowdown and potential risks of business failures/financial crisis?
  - Will a global co-ordinated fiscal and monetary stimulus help?

- Stick to our focus of bottom-up stock selection and identifying quality businesses with long term growth potential.
- Use the correction to churn the portfolio i.e. buying/raising exposure to stocks we always wanted, but could not do so earlier due to high valuations.
- Be fully invested but be vigilant to use cash/hedging as a strategy in case there is an extreme flare up of infections in India and globally.

This is a challenging environment with multiple overlapping factors from a domestic and global perspective. We are however long term-optimists in both the ingenuity of Indian entrepreneurs and consumers, and the Indian economy more broadly. In the near term our focus continues to be in having in depth knowledge of the companies in our Universe (the House of Ocean Dial discussed in our last note), so that we can act rationally and swiftly to capture mispriced opportunities that may present themselves. We look forward to keeping you updated on this as it unfolds.

# Appendix

## Case Study: What are stocks pricing in?

We have used the Discounted Cash Flow (DCF) analysis to measure the impact of disruption of business activity on the value of two generic Stocks: Stock A and Stock B.

We have made the following assumptions:

- Stock A: Normal growth of 15% p.a. in Free Cash Flow to Equity (FCFE) for 10 years.

| FY20 | FY21 | FY22 | FY23 | FY24 | FY25 | FY26 | FY27 | FY28 | FY29 |
|---|---|---|---|---|---|---|---|---|---|
| 100 | 115 | 132 | 152 | 175 | 201 | 231 | 266 | 306 | 352 |

- Stock B: Normal growth of 10% p.a. in FCFE for 10 years.

| FY20 | FY21 | FY22 | FY23 | FY24 | FY25 | FY26 | FY27 | FY28 | FY29 |
|---|---|---|---|---|---|---|---|---|---|
| 100 | 110 | 121 | 133 | 146 | 161 | 177 | 195 | 214 | 236 |

- Terminal growth rate: 5% p.a. for both the Stocks
- Two 'extreme' assumptions for loss of cash flow for both the stocks i.e. complete loss of Free Cash Flow to Equity (FCFE) for (a) first 2 quarters of FY21 and (b) the entire FY21.
- Three scenarios for bounce back of free cash flows, post disruption, have been assumed as follows:
  - **Scenario-1:** Cash flows bounce back to levels expected pre disruption (e.g. Rs 132 in FY22 for Stock A). *This is the most optimistic case.*
  - **Scenario-2:** Cash flows bounce back with normal growth over FY20 cash flows (e.g. Rs 115 in FY22 for Stock A). *This is a moderately optimistic case.*
  - **Scenario-3:** Cash flows bounce back to FY20 level (e.g. Rs100 in FY22 for Stock A). *This is the least optimistic case.*

- Given that normalised Nominal GDP growth of India will hover between 10-15%, most stocks in India will lie within the boundaries of growth assumption for Stock A and B.

The following table summarises the impact on the Share Value of the two stocks at various levels of cost of equity.

| Stock A: Growing at 15% | | | | | | |
|---|---|---|---|---|---|---|
| Time periods --> | No cashflow in FY21 | | | No cashflow in first 2 quarters of FY21 | | |
| Case --> | Scenario-1 | Scenario-2 | Scenario-3 | Scenario-1 | Scenario-2 | Scenario-3 |
| **Cost of equity** | | | | | | |
| **10.0%** | -2.1% | -14.9% | -26.0% | -1.1% | -7.7% | -14.0% |
| **11.0%** | -2.6% | -15.3% | -26.4% | -1.3% | -8.0% | -14.2% |
| **12.0%** | -3.1% | -15.7% | -26.7% | -1.6% | -8.2% | -14.4% |
| **13.0%** | -3.6% | -16.2% | -27.1% | -1.8% | -8.4% | -14.6% |
| **14.0%** | -4.1% | -16.6% | -27.5% | -2.1% | -8.7% | -14.8% |
| **15.0%** | -4.7% | -17.1% | -27.9% | -2.3% | -8.9% | -15.1% |
| | | | | | | |
| **Stock B: Growing at 10%** | | | | | | |
| Time periods --> | No cashflow in FY21 | | | No cashflow in first 2 quarters of FY21 | | |
| Case --> | Scenario-1 | Scenario-2 | Scenario-3 | Scenario-1 | Scenario-2 | Scenario-3 |
| **Cost of equity** | | | | | | |
| **10.0%** | -3.1% | -11.9% | -19.9% | -1.6% | -6.1% | -10.5% |
| **11.0%** | -3.8% | -12.5% | -20.5% | -1.9% | -6.5% | -10.8% |
| **12.0%** | -4.4% | -13.1% | -21.0% | -2.2% | -6.8% | -11.1% |
| **13.0%** | -5.1% | -13.7% | -21.6% | -2.5% | -7.1% | -11.4% |
| **14.0%** | -5.7% | -14.3% | -22.1% | -2.9% | -7.4% | -11.7% |
| **15.0%** | -6.4% | -14.9% | -22.6% | -3.2% | -7.7% | -12.0% |

Conclusion: The recent correction of ~20% in the Indian markets is already pricing in two to four quarters of disruption in the business and cash flows.

Notes:

1) Loss of business will lead to negative Cash Flow from Operations due to incurrence of fixed costs. This will need to be financed by borrowings, reduction of working capital and delay in capex. Thus, FCFE will not be negative.

2) The extent of disruption to a business and impact on stock prices will depend on the nature of the product/services provided by the business. Businesses with a 'longer utility' demand for e.g. consumer durables/auto, may see a postponement of demand with a sharp bounce back later. Businesses with a 'shorter utility' demand for e.g. restaurants/theatres may see a permanent loss of demand. Certain businesses may see a 'preponement' in demand due to hoarding, while banks may see higher demand for credit to fund business continuity and fixed costs.

3) This purpose of this exercise is to offer a broad guide as to when *Mr. Market*[2] might offer bargain prices for certain securities in the current environment of uncertainty and volatility. It has been carried out with a set of simple but sensible assumptions to provide a general picture that is generally accurate rather than precisely wrong.

# The Demonetisation Experience

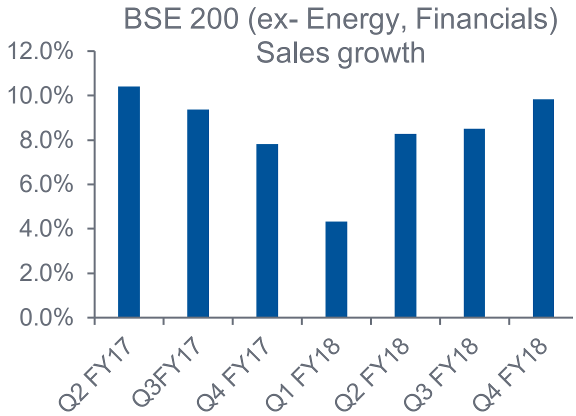
On 8 November 2016, the Government of India announced the demonetisation of all INR 500 and INR 1,000 banknotes to curtail the shadow economy and reduce the use of illicit and counterfeit cash. The announcement of demonetization resulted in prolonged cash shortages in the weeks that followed creating a significant disruption throughout the economy.

Chart 2 below shows the sharp decline in sales growth for BSE 200 companies (ex-energy and financials) and the subsequent recovery within two quarters. The BSE200 Index also fell 10%

[2] See Benjamin Graham's Intelligent Investor, Chapter 8.

by December 2016 and then sharply recovered all losses by February 2017. Chart 3 shows the BSE 200 Index performance.

Chart 2




*Source : Capitaline*

Chart 3


*Source : Bloomberg*

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