Special Situations Value Portfolio

kotak® Asset Management

Portfolio Management

To us the 2 most important investment rules are:

1. Strive to never lose money
2. Never forget Rule 1!

This adage, made famous by Warren Buffet is our guiding light and we strive to ensure Capital preservation.

We believe that if we contain the downside, superior returns will be taken care of by a multitude of options i.e. business/ strategic developments, appreciation of earning power of companies, investor psychology, etc.

Thoughts on the Economy

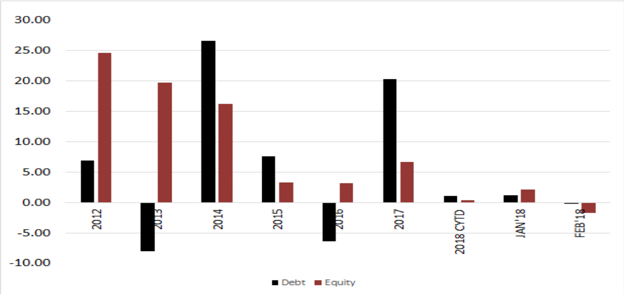
Indices Performance (USD returns)			
	1M	3M	1YR
Nifty	-7.02%	1.65%	20.92%
Sensex	-7.12%	2.16%	21.69%
NSE Midcap 100	-7.55%	-2.08%	22.10%
MSCI EM Asia	-5.42%	4.77%	30.46%
MSCI EM	-4.73%	6.64%	27.64%
MSCI World	-4.30%	1.96%	15.19%

Levels (Local currency)	28-02-2018	52wk High	52wk Low
Nifty	10,493	11,172	8,860
Sensex	34,184	36,444	28,716
NSE Midcap 100	19,665	21,841	16,243
MSCI EM Asia	599	646	454
MSCI EM	1,195	1,279	921
MSCI World	2,118	2,250	1,831

Sector Performance (USD returns)			
Top 3	1M	3M	1YR
BSE IT Index	-2.68%	15.45%	23.33%
BSE TECK Index	-3.56%	9.85%	19.67%
Nifty Metal Index	-4.00%	7.58%	30.70%
Bottom 3	1M	3M	1YR
Nifty PSU Bank Index	-18.28%	-20.91%	-4.13%
BSE Bankex Index	-10.71%	-2.03%	23.38%
BSE PSU Index	-10.65%	-10.07%	0.77%

Note: Past performance is not an indicator of expected future performance.

Net FII inflows into debt and equity (USDBn)



Source: Bloomberg, Kotak Institutional Equities

Key highlights:

- Improvement at the corporate level visible even while some macro challenges (higher current account deficit and inflation risks) emerge: Nifty Q3FY18 earnings growth at 13%YoY; likely to see a step-up in growth in FY19E.
- Bankruptcy resolution under the Indian Bankruptcy Code (IBC) gaining momentum; News flow on balance sheet stress on Indian banks remains challenging; Need for banks to focus on building robust systems and risk management processes
- Real GDP growth in India: Exhibiting signs of recovery; expect improvement in FY19E to ~7.1% (Real Gross Value Added growth)
- GST Collections: Trends remain stable; improvement keenly watched for; crucial for meeting the projected FY19 budgeted net tax collections.
- Minutes of the MPC (Monetary Policy Committee) meeting: Reflects worries on inflation; Policy rates likely to stay on hold in the near term.

The month of February 2018 has been a challenging month for Indian equity markets. The large cap Nifty index fell 7% while the NSE Midcap 100 Index was down 7.5% both in USD terms. The volatility seen in Indian markets has been an outcome of the fear of higher than expected rate hikes by the US Federal Reserve, somewhat challenging macro outlook in India, worries on the health of bank balance sheets post the unearthing of a fraud at a state owned bank as well as the impact of sentiments post the imposition of long term capital gains tax on equity in the Union Budget.

Indian markets appear to be at crossroads leading us to believe that navigating equity markets in FY19 would be tougher than it was in FY18. On one hand, India's micro is in better shape than what it was a year ago, while on the other the macro environment now appears to be challenging given the (1) increase in inflation, (2) possibility of fiscal slippage, and (3) increase in oil prices in the past few months. Economic growth however does appear to be picking up as evidenced by the latest GDP release as well as the high frequency indicators. There is visible recovery at the ground level. As per data, auto numbers continued to record good growth (partly aided by the weak base of demonetization) especially in commercial vehicles and two wheelers. Other improving indicators include growth in domestic airline passengers (20%), petrol consumption growth (16%), and Services PMI (51.7, a seven-month high).

Volumes (USDmn)		Feb-18	% Chg 1M
India BSE & NSE		5,976	0.76
Delivery Vol (%)	**Feb-18**	**Jan-18**	**Dec-17**
	36.32	38.31	32.87
Bond Markets (%)	**Feb-18**	**Jan-18**	**Dec-17**
10yr Gov Bond	7.73	7.43	7.33
Interbank call	6.05	5.95	6.10
Inflation (CPI)	N/A	5.07	5.21
Net flows (USDmn)	**Feb-18**	**Jan-18**	**Dec-17**
FII (Equity)	(1,666)	2,075	(1,025)
FII (Debt)	(153)	1,191	408
DII (Equity)	2,755	(140)	1,268
Currencies	**Feb-18**	**Jan-18**	**% Chg 1M**
USD/INR	65.10	63.69	-2.17%
USD/JPY	106.68	109.19	2.35%
USD/EUR	0.82	0.81	-1.77%
Commodities	**Feb-18**	**Jan-18**	**Dec-17**
Gold (USD/oz)	1,318	1,345	1,303
Brent Crude (USD/bbl)	65	69	66

The improvement in the earnings momentum continued for Q3FY18 with the large cap Nifty recording a growth of 13%YoY for Q3FY18, taking 9MFY18 earnings growth to 6%YoY. A key point to note is that consensus Nifty earnings also did not see any downgrades during the quarter, highlighting that there is confidence in a likely step-up in growth in 4QFY18 and FY19E. Among the larger sectors, private sector banks continued to report healthy trends both in terms of loan growth and earnings growth even while the weakness in profitability for corporate banks and state owned banks continues. The NPA (Non-Performing Assets) problems did not abate, as earlier anticipated, with several PSU (Public Sector Undertakings) banks reporting large losses, as they made higher NPA provisions.

Bankruptcy resolution under the Bankruptcy Code gaining momentum; News flow on balance sheet stress on Indian banks remains challenging; Need to focus on building robust systems and risk management processes

The Indian banking system was shaken up by a fraud case at a state owned bank to the tune of INR127Bn (USD1.95Bn). Currently the case is under investigation and the Reserve Bank of India is also reviewing the working of SWIFT, a global system which is used to transmit payment instructions, and scrutinizing the issuance of LoUs (Letters of Undertakings) to check for any gaps. The secretary of the Department of Financial Services has directed CEOs of state banks to check all NPLs above INR500mn (USD7.68mn) for possible fraud.

However, amid all this negative news, a glimmer of hope comes from the bankruptcy resolution process. News flow surrounding the resolution of the cases referred to the bankruptcy courts has been high here, as a few large steel sector NPAs (Non-performing assets) are reportedly seeing good interest, with some receiving bids above market expectations.

While we will clearly have to wait for the final outcome of the process, time bound resolutions of NPLs under the Indian Bankruptcy Code (IBC) bodes well for the sector.

RBI tightens norms on restructured assets: Regulatory environment for corporate lenders to get tougher

In view of the enactment of the Insolvency and Bankruptcy Code, 2016 (IBC), RBI has decided to substitute the existing guidelines for restructured assets with a harmonized and simplified generic framework for resolution of stressed assets. RBI's new norms for stressed loans does away with the forbearances that banks enjoyed on restructuring and refinancing of loans. These new norms will be applicable to fresh stressed loans (from March 2018) and will require banks to downgrade a loan to an NPL before it is restructured, follow tighter norms for upgrades and refer stressed loans to insolvency courts in case resolution fails. The new norms will take banks closer to IndAS (new Indian Accounting Standard), although its timeline is still unclear. The likely impact of guidelines is as under:

- It is possible that many more cases will have to be referred under the IBC. To start with, RBI has asked banks to work on exposures of INR20bn (~USD0.30bn) and above. For exposures below INR20bn, RBI will likely come up with separate time frames and reference dates.
- By September-end most of these loans (which are in default under the existing restructuring packages) will have to be referred under the IBC if not resolved. Whether resolved or referred under the IBC, banks will have to recognize these as NPLs first which will lead to higher NPLs and higher credit cost for FY19E.

Reporting of SMA (Special Mention Accounts) data by banks

RBI has also directed banks to report credit information, including classification of an account as SMA (default of even 1 day) to the Central Repository of Information on Large Credits (CRILC) on all borrower entities having aggregate exposure of INR50mn (USD0.77mn) and above with them. The CRILC-Main Report will now be required to be submitted on a monthly basis effective April 1, 2018.

Real GDP growth in India: exhibiting signs of recovery; expect improvement in FY19E

India's real GDP growth for Q3FY18 was at a five-quarter high of 7.2% YoY. The spurt followed a weak demonetization-driven base and was led by a revival in gross fixed capital formation (CFCF) where growth increased to a six-quarter high of 12.0%. The CSO (Central Statistical Organization) has raised its GDP estimate for FY18E to 6.6% from 6.5%. Real GVA (Gross Value added) growth is expected at 6.4%in FY18E. Real GVA growth was 6.7% YoY in Q4FY17 versus 6.2% in Q3FY17.

On the demand side, private consumption growth continued to slow down and stood at 5.6% in Q3FY18, reflected partly in the subdued real rural wages. Government consumption growth firmed up to 6.1%. Expectedly, net exports remained a drag on growth given the surge in import growth overshadowing the export growth. On the brighter side, gross fixed capital formation (GFCF) grew for the third consecutive quarter, surging by 12% from 6.9% in Q2FY18.We believe that the economy has started to show signs of improvement both cyclically and structurally. Monthly high frequency data seems to support this view. Given this backdrop, we expect the Indian economy to recover gradually to ~7.1% in FY19E.

GST (Goods and Services Tax) related disruptions are likely to smoothen out in FY19 and we expect to see improvement in consumption amid stable wages and expected payouts from states' implementation of 7CPC (Central Pay Commission). Improvement in global growth outlook would be supportive and this along with a mildly depreciating INR/ USD (which is our base case view for FY19) could lend support to exports which is currently exhibiting extremely weak trends.

Table 1: Real GVA growth in India (%)

Real GVA (% Growth)	FY15	FY16	FY17	FY18AE	FY19E
Agriculture & Allied	-0.2	0.6	6.3	3.0	2.9
Industry	7.0	9.8	6.8	4.8	6.7
Services	9.8	9.6	7.5	8.3	8.4
Real GVA	**7.2**	**8.1**	**7.1**	**6.4**	**7.1**

Source: CSO; Kotak estimates ; AE- Advanced estimates of the CSO

GST Collections: Trends remain stable; improvement keenly watched for; crucial for meeting the projected FY19 budget net tax collections

Goods and services tax (GST) collections for January 2018 stood at INR863bn (USD13.26bn), largely flat on a MoM basis. Cess collection of INR83bn (USD1.27bn) was 10% higher than the monthly rate seen in the prior months. The trends in terms of the improvement in GST collections are important in order to track the fiscal deficit of the centre for FY18 (Budgeted at 3.3% of GDP for FY19). The Union budget 2018 has estimated a rise of 12% in GST tax collections on an adjusted basis (14% excluding compensation cess). The implementation of the e-way bill is an important milestone in the improvement in GST collections and compliance.

Minutes of the MPC (Monetary Policy Committee) reflects increasing worries on inflation; Policy rates likely to stay on hold in the near term

The minutes of the Monetary Policy Committee meeting released highlight a gradual change in tone towards inflation risks. While the committee voted to keep rates unchanged (5:1), most of the Committee members highlighted upside risks to inflation. Upside risks to inflation include: (1) crude prices, (2) MSP (Minimum Support prices) increases for crops as proposed in the budget, (3) fiscal slippage and (4) staggered impact of states' implementation of the recommendations of 7CPC (Central Pay Commission) HRA (house Rent Allowance) hike. Further, amid increased inflation uncertainty, the possible narrowing of the output gap with improved growth also appears to worry a few members.

From here on, we expect the RBI to leave rates on hold in the near term as growth improves and as the central bank gets more clarity on monsoons, sustainability of high crude oil prices post the winter squeeze, and global financial conditions. RBI would clearly be data dependent in terms of a change in stance from neutral currently even while the policy tone is likely to remain hawkish.

The strong up-move in G-Sec yields in the recent past factors in many of the risks that have been enumerated by RBI and hence may stay range bound in the near term. The ability of the Government to maintain their fiscal deficit target in FY19 and stick to the budgeted borrowing program along with the CPI inflation trajectory would be key determinants of domestic yields

Investment Strategy

The main objective of our strategy is to generate capital appreciation through investments in equities with a medium to long-term perspective. This strategy invests in all listed equity and equity related instruments with emphasis on capturing Value and Special Situation opportunities. Key investment strategy parameters

A. Large market opportunity

1. Market Size at least 2 times of current company sales, and/ or
2. Growing at 1.5x of India's GDP

B. Robust competitive strength or economic moat

1. Intangible assets like brands, patents or regulatory licenses
2. High switching costs for customers thus giving pricing power
3. Companies having network economics
4. Robust cost advantages
5. Innovative products or services which consistently serve unique client needs

C. Strong financials and earnings growth

1. Portfolio Debt to Equity under 1x
2. Compounded earning growth at least in line with industry growth
3. Healthy margins, having the ability to withstand business volatility

D. Management dynamism and corporate governance

1. Passion to become a larger player in field of business
2. No unrelated diversifications
3. Capital allocation which optimises business performance
4. Asset turns and working capital turns at industry levels or trending there
5. High promoter shareholding

E. Fair valuations

1. Companies having negligible implied growth in Discounted Cash Flow valuations
2. Relative valuations are at reasonable levels vs growth and return ratios

Investment Philosophy

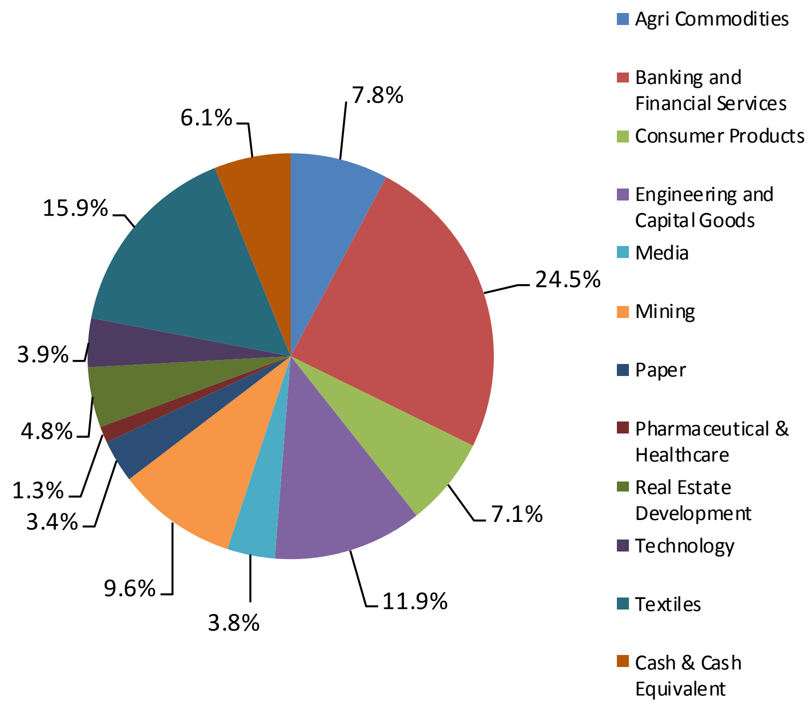
The portfolio shall be a mix of **Value Opportunities** and **Special Situations.**

1. **Value Opportunities -**are ones, where in the opinion of the fund manager, the company's Intrinsic Value is 'X', while the stock is trading at a discount to X. The discount should be such that it offers reasonable 'Margin of Safety' for an investment in the stock. This discount to Intrinsic Value is a result of multiple reasons i.e. temporary miss in performance, risk aversion at broad market level, regulation uncertainty, etc. As uncertainty regarding these aspects abates, the Intrinsic Value is expected to be realized.
2. **Special Situations-** These shall be investment opportunities dependent on the probability of occurrence of one or more corporate events, rather than market events. These situations can largely be classified as:
   a. **Price related situations:** In **Price related situations,** stocks shall be bought at a discount to the price, which is/ maybe guaranteed by any institution. These situations can arise in the form of buybacks, de-listings, etc.
   b. **Merger related situations:** In **Merger related situations,** shares of a company can be created at a discount to the current market price.
   c. **Corporate Restructurings:** In **Corporate restructurings,** consequence of specific corporate action in the form of spin offs, asset sales, management change, etc. could lead to either value unlocking or cash pay-outs to investors.

Model Portfolio Details

Top 10 Holdings as of 28th February 2018	
Security Name	**% Wt**
Siyaram Silk Mills Ltd	11
Coal India Ltd	10
KRBL	8
Finolex Cables Ltd	7
WELCORP	5
ICICI Bank Ltd	5
Ashiana Housing Ltd	5
Repco Home Finance Limited	4
Karur Vysya Bank Ltd	4
Power Finance Corporation Limited	4

Sectoral Exposure as of 28th February 2018

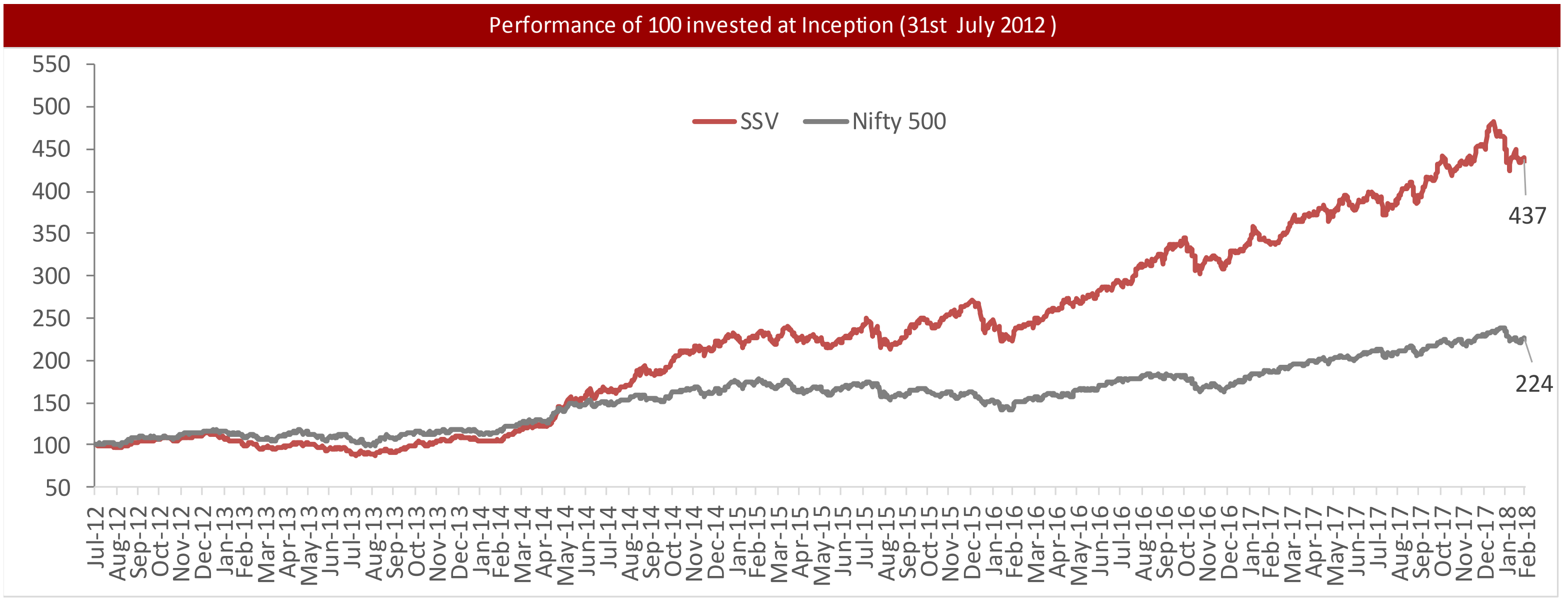


Risk ratios	Portfolio	Nifty 500
Date of activation	31-Jul-12	
Volatility	14%	12%
Sharpe ratio	1.66	0.69
Treynor ratio	26%	8%
Beta	0.89	1
Annual Tracking Error	0.09	
Information ratio	1.64	
R2	76%	
Jensen's Alpha	16%	

Fee Structure	
Fee Structure	Fixed Fee 2.5% per annum for the tenor, No performance Fee
Exit Load	3% (1st Year), 2%(2nd Year), 1% (3rd Year)
Brokerage	0.10%
Custodial Charges	As levied by the custodian.
Frequency of MIS	Disclosure of portfolio through printed MIS on a quarterly basis.
*Indicative Fee Structure	

Strategy Details	
Portfolio Strategy	Special Situations Value Portfolio
No. of Stocks	10-20 stocks
Benchmark	Nifty 500 Index
Min Initial Investment	Rs 25 lakhs

Model Portfolio Details



Date of Inception 31-Jul-12

INR (%)	3 Months	6 Months	9 months	1 Year	2 Year	3 Year	4 year	5 year	Since Incp.
KMAMC Special Situations	0.6	11.9	16.9	28.0	39.8	24.2	42.6	34.3	30.2
Nifty 500	1.2	6.5	10.9	20.1	26.0	8.6	17.5	15.6	15.6

* Returns are of Model Portfolio (net of management fee)
** Returns are annualised for periods greater than 1 year