Metis Opportunity Fund

Job losses in the informal economy threaten sanguine F2019 earnings expectations

January 2018 Newsletter

Jan 28, 2018

We finished C2017 at similar elevated level of caution on the current risk-return tradeoff in general markets (from a 1-2 year holding period point of view) as at the beginning of the year, while keeping a constant eagle eye on the underlying economics of our businesses/watch-list names to limit temporary external affects in near-term and significantly outperform over our holding period (3+years). As things stand, global emerging risks to Indian listed equities stem more from a combination of stretched valuations and unrealistic earnings rebound expectations vs. anything tipping over the growth applecart. With external balances in control, political stability well established, and government policies continuing to remain market driven, India is among the few major countries which have a good chance to actually meet these higher expectations. Furthermore, there is an increasingly large opportunity set of liquid bottom-up situations in Indian markets. In our case, our book is currently stacked with names whose earnings lagged broader markets in the current fiscal, be it because of recently expanded facilities, new launches, elevated temporary provisioning, or gradual exits from unprofitable businesses. That now forms a solid base of easier comparisons for us in F2019E (Mar) vs. a broader market dependence on unrealistic growth expectations. Thus, in any global market downturn scenario, our holdings not only have a solid chance to limit drawdown but we are also better positioned to likely post a quicker rebound in the subsequent upturn.

Amid continued earnings and price disconnects within small and midcaps, *Metis Opportunity* was up **+9.51%** (in USD; net of all fees) in 4Q17, vs **+6.51%**, **+9.37%**, **+15.04%**, **+20.62%**, and **+8.94%** gains in *Nifty TR*[1], *BSE 500 TR, BSE Midcap TR*, *BSE Smallcap TR*, and *Eurekahedge India* respectively. All but 3 of our positions rose in 4Q. Largely on account of gains during the quarter, our current cash position of 13% is lower than the 14% cash as at the end of the prior quarter. We added no new position in 4Q and engaged in some immaterial pruning during the quarter.

In 2017, *Metis Opportunity* was up **+30.4%** (in USD; net of all fees). That compares with **+38.5%**, **+46.3%**, **+70.9%**, **+59.3%**, and **+32.0%** increases in *Nifty TR, BSE 500 TR, BSE Smallcap TR*, *BSE Midcap TR* and *Eurekahedge India* respectively. Over this period, our volatility was **448 bps**, **395 bps**, and **179 bps** below that of *BSE Smallcap TR, BSE Midcap TR,* and *BSE 500 TR* respectively, and **426 bps** ahead of *Eurekahedge India*.

Over the past 3 years, *Metis Opportunity* is up **+39.5%** (in USD; net of all fees) vs. **+30.7%**, **+44.0%**, **+76.4%**, **+76.2%**, and **+40.5%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respectively.

Since inception in April 2011, *Metis Opportunity* is up **+117.6%** (in USD; net of all fees) vs. **+54.2%**, **+72.6%**, **+112.2%**, **+87.4%**, and **+50.5%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respectively.

Labor rigidities threaten jobs in post-GST India – Connotations for FY19E (Mar) Nifty earnings. Our restrictive labor policies have ensured that employment (manufacturing in particular) remains concentrated within the least productive unorganized employers, with other factor inputs driving growth among the largest more productive companies. Labor reforms remain the third rail of Indian political economics and no one apparently has the grit to address this head-on. No matter which survey you pick, it's evident that India has hardly created net jobs in manufacturing in years. Amendments to *Industrial Disputes Act* in handful of states meanwhile have only been restricted to smaller employers, whose demand for labor in any case was not driven by factors other than underlying demand. Predictably then, most of our labor force had always slipped into the informal economy - Majority of non-agri rural employment and material portion of urban employment is informal/unorganized. With GST rolling out last year, the situation surely gets murkier with major disruptions across the informal economy.

[1] 'Total Return' indices are used for comparison

Our recent pan-India checks overwhelmingly suggest ongoing attrition in the informal economy and accordingly confirm that about a fifth of contract labor agents have seen an increase in labor supply. However, contract labor placements remain flattish, with pharmaceutical sector hiring being the notable exception (off of a low base). That isn't surprising because labor productivity differentials mean that organized players cannot fully absorb displaced labor from the informal sector. While the switch would reflect positively in productivity numbers, it's hard to not see this shift away from the informal economy adversely impacting aggregate consumer spending, particularly within the mass-consumption discretionary categories. Disturbingly, in the near-term, recaptured hiring from the low 'post-demonetization' base or IIP spikes from infra builds (cement, steel etc.) can easily give a false sense of a jobs rebound even as the aggregate jobs situation has clearly worsened.

Mass discretionary spending and trade-down in staples are notable risks. As things stand, street is yet again expecting about +24% earnings growth (+21% ex-financials) for *Nifty 50* for FY19E (Mar), on +13% broad-based revenue growth (excl. financials and commodities). Street estimates now almost seem like a broken clock that are bound to be right at some point, except that FY19E estimates just aren't there yet. At current levels, we clearly see more room for downward revisions than upside surprises. Particularly, we see risks within mass discretionary spending - If job losses in the informal economy continue, one could expect to see deceleration in smartphone penetration and data usage, and further cuts in tariffs. At current cellular penetration rates and an aggressive pricing environment, we don't see Telecom tariffs driving material revenue growth. While underlying leverage at *Airtel* and further traction in African business could certainly drive optically high earnings growth once ARPUs stabilize, it seems to us that analysts are baking in tariff stabilization a bit too soon (high-single digit revenue growth consensus for FY19E), likely out of fear of being behind the curve than based on ground realities.

Expectations of 2W sales remain at risk too, particularly within the 2 large *Nifty* components where FY19E (Mar) revenues are currently expected to grow in the low-mid teens. Ironically, Indian Autos and Telecom are also two of the top-3 industries (Financials being the third) in terms of valuation premiums vs. emerging market peers. Collectively, Telecom and 2W OEMs account for just under a fifth of *Nifty*'s FY19E (ex-financials) current earnings growth expectations, with revenue acceleration and margin expansion driving earnings at a time when pricing power and materials costs will be material headwinds. Meanwhile, we are unable to see room for upward revisions elsewhere - Optimism off of low bases is already factored in earnings estimates of names such as *Dr. Reddy's* (FY19E +58%; coming off of US FDA warning letters for multiple sites, and FX drag) or *Tata Motors* (FY19E +56%; coming off of depressed utilization levels at Indian facilities, and expected benefits from new launches and upgrades at *JLR*) or the entire Banks pack (FY19E avg. +37%; coming off of initial wave of provisioning large accounts referred to *NCLT*). Therefore, ignoring outliers, we don't see *Nifty*'s FY19E earnings growth surpassing mid-teens and expect cuts to street's current FY19E estimates.

While aggregate capacity utilization might be low, that observation isn't reflective of Nifty's benchmark constituents. It's well documented that aggregate private capex remains very weak as capacity utilization (based on *OBICUS* survey) remains in low 70s. However, interpreting that number to suggest that there is a reservoir of 'operating leverage' potential energy within *Nifty 50* constituents is over simplifying the situation. Firstly, there is an issue of different weightages vs. *Nifty* – Since *OBICUS* uses GVA as weights (and *Nifty* uses floated market cap), Basic Metals, which has significant idle capacity, has a far larger weighting within *OBICUS* survey than in *Nifty* (13-14% in *OBICUS* vs. barely 3-4% in *Nifty 50*). Secondly, Industrial names within *Nifty 50* aren't necessarily representative of the broader industrial malaise - While it's evident that utilization levels in sectors such as Power (low PLFs across power plants) and Materials remain poor, most headline Industrials names are operating at very high utilization levels. There are of course names such as *Tata Motors* that are saddled with excess capacity or select benchmark Industrials names that are ramping up utilization levels after recent expansion, notably a major 2W/CV OEM that launched its third facility in Tamil

Nadu last year. However, across most Industrial benchmark components, utilization at legacy facilities remains at or near-peak and there is limited room for margin expansion. India's leading passenger car OEM is utilizing almost its entire capacity. Leading 2W OEMs are also running at near full capacity, including the biggest player that is planning a new facility in Andhra Pradesh. One of India's largest auto parts makers, which gets 2/3rd of its revenues from outside the country, is running at full capacity and actively looking at distressed assets in *NCLT* proceedings to add capacity. Elsewhere, benchmark names such as *Asian Paints* have added capacity across locations to address bottlenecks.

In contrast with benchmark constituents, earnings expectations for our book aren't dependent on a broad-based economic turnaround to outpace broader markets in F2019E (Mar), with company/industry idiosyncrasies coming forth to drive above-market earnings growth. Some of these stories are listed below:

Increasing engine capacities in scooters continue to drive the shift in the 2W market. Higher engine capacities and improved efficiency are driving the most recent leg of growth within scooters, benefiting a parts position of ours that is closely aligned with India's largest scooter manufacturer. With long product development cycles, this business operates on 'cost-plus' contracts and exhibits one of the most stable profitability profiles within the auto parts space. Further, stepping back from the government tenders in the LED Luminaires business alone drove a -15% drag on F1H18 (Sept) earnings. With no incremental drag from the LED Luminaires business in F2019E, we expect continued traction in the core parts business to again shine through in the coming fiscal.

Our radio holding would be comping a very weak media cycle in F2019E. Television advertising revenues were largely flattish in 2017, something the industry hasn't seen in a long time, closing its third successive year of continued sharp deceleration in TV media spends. Cuts were seen across print and radio platforms (excluding impact of Phase III launches) too. Our checks suggest that, structurally, digital disruption was concentrated particularly within Print and Television while OOH and Radio maintained/expanded their share.

F3Q (Dec) and F4Q (Mar) account for about 55% of radio industry revenues and industry hardly registered any growth in the second half of F2017 (Mar), and even that benefited from the launch of Phase III stations. Our C4Q17 checks across legacy stations suggested that volume has now registered high single-digit growth even as pricing remained flattish.

When it comes to our radio holding, we note that the 2 key industries that have always featured within their top-5 industry advertisers (Telecom and CPG) cut their ad spends sharply in 2017 - Over the past year, ad spends for Telecom and CPG were cut by ~15%, and ~5% respectively. That said, about half of all advertisers in these industries grew their spends in C3Q17 and our checks suggest that spends went up marginally again in C4Q17. Furthermore, a lot of the slack at core advertisers has been picked by e-tailers (*Amazon* is now the second largest advertiser in the country). By our estimate, about 10% of radio ad volume in December in Delhi, India's biggest radio market, came from the Big-3 of Indian e-tailing (*Flipkart*, *Paytm*, and *Amazon*). Given that a vast majority of this volume was in 'peak hour' spots, we estimate that 12-14% of radio ad revenues in these major markets could have been attributed to the top-3 e-tailers. This comes on the back of what was a very robust year for unlisted capital raising, with funds raised more than tripling to $9+ bil, with established names attracting more capital even as angels and early-stage VCs cut back sharply. Going forward, our checks suggest that e-tailers' ad budgets would expand sharply in 2018 as *Amazon* expands its grocery footprint. Even though our checks suggest that telecom ad spends will ramp up in 2018, ARPUs remain under pressure and we therefore don't anticipate a ramp-up in telecom just yet.

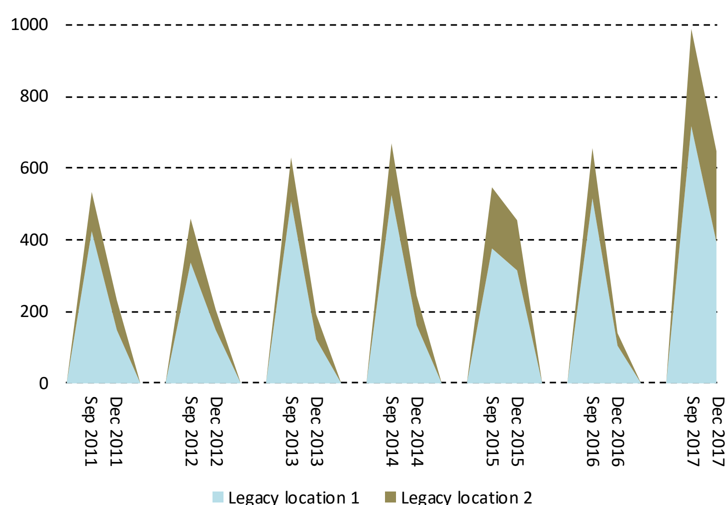
We note that government exposure at our radio holding has recently been pared from 15% of revenues in F2017 (Mar) to 7-9% now, which is more in line with historical averages, further reducing probability of occurrence of another 'concentration' shock.

Structural cut back in imports and limited industry capacity helping establish a new '20%+ normal' EBITDA margin for our paper holding. With industry-wide W&P paper utilizations running at around 90% and Chinese imports dropping, we see little challenge in this player passing through any potential escalation in inputs. Meanwhile, continued cuts in coal requirements have positioned this manufacturer very strongly to absorb coal price increases - Renewables now make 60% of its total energy consumption. While CIL has announced a high-single digit increase on non-coking coal, we note that 75% of the much-reduced coal requirement at this player was being fulfilled through the open market and that they are now planning to rejig the mix towards increased cheaper sourcing from CIL. Similarly, the company is well positioned to withstand pulp price fluctuations - 60% of wood procurement at the flagship plant in Eastern India is being procured locally, with most of it from within a 200-km radius.

On current repayment schedule, this company would repay 7-8% of its F2018E (Mar) outstanding term loans in F2019E. At current free cash run-rate however, it clearly has the bandwidth to pay off even 4-5x that schedule in F2019E and continues to be in pre-payment talks with lenders. If these discussions work out, faster repayment by itself could contribute 10%+ to F2019E earnings growth and ensure that this holding's earnings growth continues to outpace broader markets.

Weather and prior excess provisioning combine to set up easier comparisons for an Outdoor Entertainment holding in F2019E. In F2Q18 (Sept), the two legacy locations of this holding of ours collectively reported a -10% decline in footfalls, which was partially offset by a +7% increase in avg revenue per visitor, as Southern India recorded record rainfall. While F3Q18 (Dec) earnings haven't been released yet, we note that precipitation levels remained elevated in F3Q too (see **Exhibit 1**).

Exhibit 1 – Average daily precipitation in Sep and Dec quarters



Source: World Weather Online

Earlier, in F1Q (Jun), EBITDA would have been +24% higher if other expenses weren't saddled by INR 105 mil of excess provisioning related to disputed tax liabilities in pre-GST regime. While these ensure that this position of ours would be coming against easier comparisons in F2019E (Mar), continued ramp-up at a new location (+20% and +24% yoy increases in footfalls and revenues in F2Q (Sept) at the new park) ensures further margin expansion following drag-back after the fresh launch in the prior fiscal.

Immediate cash-flows and optically high headline multiple conceals tremendous long-term upside at an 'Internet' position. One of our better performing positions last year (+55%) continues to trade at a valuation, which while being optically high, completely disregards optionality in investee companies. Principally, this value situation gathers its basis from collective cash burn at investee companies and reluctance on the part of investors to ascribe any material value to currently cash bleeding businesses, even as there are clear signs of competitive intensity declining in some of these landscapes. In sum, the situation is such that if one were to ascribe any material multiple to a non-doomsday earnings run-rate of just a couple of select investee companies, the upside is substantial, in our view.

Green shoots in software services?. If *Accenture* earnings are any indication, there are signs that software services might see a pick-up within a couple of quarters. That bodes well for a small software holding exposure of ours, which incidentally has a much higher contribution from digital deals, that isn't pricing any material turnaround at current levels.

We think of each investor that joins us as our lifelong partner and in a rewarding journey that is truly almost limitless. It is a solemn responsibility of ours to earn and keep their trust every day. We are motivated by the continuing support of our existing investors and new discussions with potential partners (onshore and offshore) who wish to join our disciplined, sustainable approach to wealth creation.

Performance and Attribution summary

All but 3 of our positions gained in 4Q. Our two best performing positions in the quarter were an Auto Parts name (up **+56%**), and a Leather name (**+42%**). Our two worst performing positions during the quarter were a Media name (down **-7%**), and a Business Services name (down **-2%**). For our historical position-wise benchmarking vs. peers and *BSE 500*, please see **Exhibit 2d**.

Since inception in April 2011, *Metis Opportunity* is up **+117.6%** (in USD; net of all fees) vs. **+54.2%**, **+72.6%**, **+112.2%**, **+87.4%**, and **+50.5%** increases in *Nifty TR*, *BSE 500 TR*, *BSE Midcap TR, BSE Smallcap TR*, and *Eurekahedge India* respectively (see **Exhibit 2a** and **2c**). Over trailing 12 months, *Metis Opportunity* was up **+30.4%** (in USD; net of all fees). That compares with **+38.5%**, **+46.3%**, **+70.9%**, **+59.3%**, and **+32.0%** increases in *Nifty TR, BSE 500 TR, BSE Smallcap TR*, *BSE Midcap TR* and *Eurekahedge India* respectively. Over this period, our volatility was **448 bps**, **395 bps**, and **179 bps** below that of *BSE Smallcap TR, BSE Midcap TR,* and *BSE 500 TR* respectively, and **426 bps** ahead of *Eurekahedge India* (see **Exhibit 2b**).

Exhibit 2a – Perf. since inception

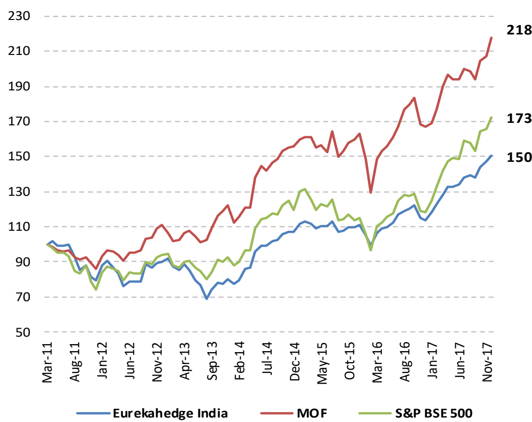


Exhibit 2b – TTM volatility

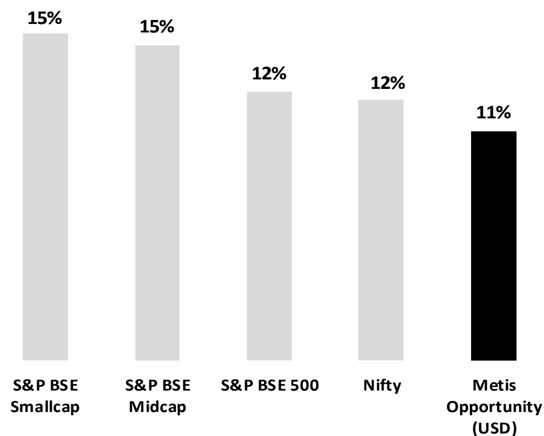


Exhibit 2c – Calendar year benchmarking

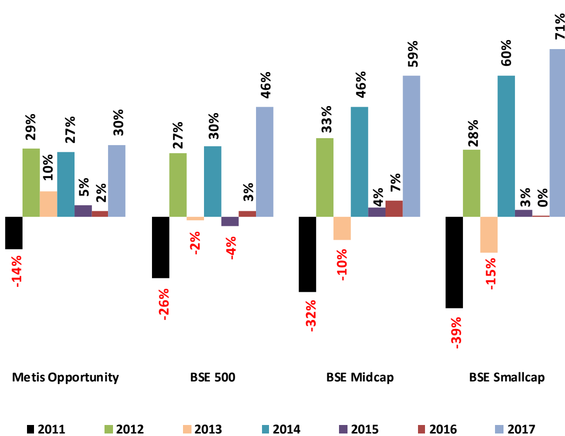
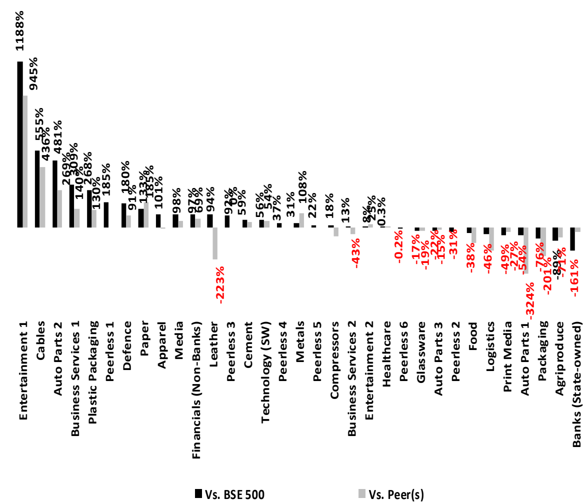


Exhibit 2d – Industry-wise benchmarking for positions



Note: Metis Opportunity went live on Mar 11th 2014; Industry-wise benchmarking compares position-wise performance (relative to BSE 500 and Industry-peers) from initial cost basis (NOT average cost basis) to present/exit.
Source: Internal Sources; NSE, BSE, Eurekahedge

Exhibit 3a – Relative rolling 12-mth returns

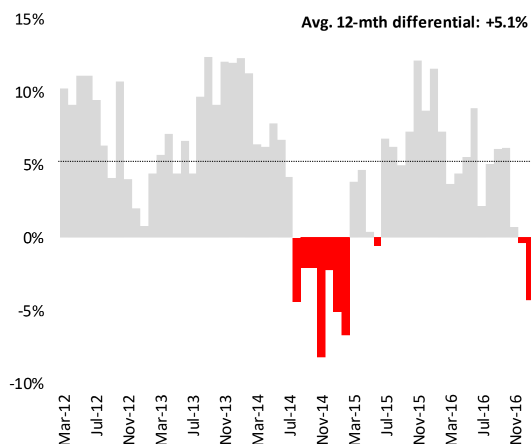
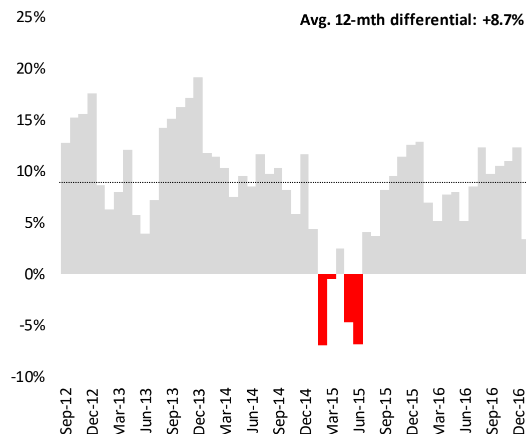


Exhibit 3b – Relative rolling 18-mth returns



Note: Relative return differentials are calculated vs. S&P BSE 500 Total Return index returns
Source: Internal Sources

Exhibit 4 – Time window analysis for our sub-strategies

	India Underserved		*India Undervalued*	
	3 Month	*12 Month*	*3 Month*	*12 Month*
Number of periods	79	70	84	75
Average period return	**5%**	**22%**	**4%**	**20%**
Number of profitable periods	55	67	55	66
% profitable periods	**70%**	**96%**	**65%**	**88%**
Best period	24%	55%	26%	66%
Gain Standard Deviation	6.0%	13.2%	6.4%	17.1%
Sharpe Ratio @10% RFR	0.29	0.84	0.23	0.53
Sharpe Ratio @5% RFR	0.45	1.20	0.36	0.79
Sharpe Ratio @0% RFR	0.61	1.56	0.50	1.05
Loss Standard Deviation	2.4%	0.8%	4.4%	5.8%
Downside Deviation @10% MAR	3.6%	3.2%	4.9%	7.1%
Downside Deviation @5% MAR	2.9%	1.4%	4.3%	5.1%
Downside Deviation @0% MAR	2.3%	0.2%	3.8%	3.5%
Sortino Ratio @10%	0.61	3.68	0.41	1.45
Sortino Ratio @5%	1.14	11.55	0.74	3.00
Sortino Ratio @0%	1.95	88.29	1.18	5.80
Average Gain/Loss	2.3	23.4	2.0	2.9
Profit/Loss Ratio	5.3	522.2	3.7	20.9

Note: Metis Opportunity is a blend the above onshore sub-strategies
Source: HedgeAlytix

Exhibit 5 – Long-book snapshot

Top position as % of book	12%
Smallest position as % of book	1%
Top 5 positions as % of book	42%
Avg. weighted market cap of book (mil)	$1,011
Avg. weighted free float of book	47%
Net exposure	94%
# of positions	22

Source: Internal Sources

Exhibit 6 – Historical Quarterly Performance

	Metis Opportunity (USD)	*Nifty TR*	*S&P BSE 500 TR*	*S&P BSE Midcap TR*	*S&P BSE Smallcap TR*	*Eurekahedge India*	*India-focused CE Funds**
2Q11	-4.4%	-4.2%	-4.5%	-5.8%	-8.2%	-1.1%	-6.1%
3Q11	-4.4%	-13.5%	-13.0%	-11.9%	-16.0%	-13.5%	-21.9%
4Q11	-5.8%	-7.8%	-10.8%	-17.5%	-20.5%	-7.5%	-16.4%
1Q12	11.6%	13.1%	15.6%	22.1%	17.9%	9.6%	20.0%
2Q12	-1.1%	-0.9%	-1.8%	-4.0%	-2.3%	-9.3%	-8.0%
3Q12	8.4%	7.1%	7.1%	6.9%	7.0%	12.4%	14.1%
4Q12	7.6%	2.4%	4.1%	6.5%	4.0%	1.9%	-0.8%
1Q13	-7.3%	-4.9%	-7.6%	-14.7%	-22.4%	-4.9%	-2.6%
2Q13	1.5%	1.7%	0.1%	-4.1%	-4.2%	-7.1%	-9.5%
3Q13	4.4%	-3.1%	-3.1%	-6.7%	-3.6%	-7.1%	-4.5%
4Q13	12.5%	8.3%	9.9%	17.9%	18.2%	8.0%	11.0%
1Q14	-1.2%	4.8%	4.5%	4.3%	6.3%	7.5%	13.0%
2Q14	19.6%	14.1%	18.7%	32.8%	44.6%	15.9%	15.5%
3Q14	2.9%	2.4%	1.9%	-0.2%	2.8%	3.1%	7.8%
4Q14	4.9%	1.3%	2.6%	5.9%	1.1%	4.4%	3.2%
1Q15	3.5%	3.9%	4.5%	3.4%	-0.5%	4.5%	7.7%
2Q15	-5.3%	-2.8%	-2.7%	-0.8%	0.0%	-1.4%	-3.5%
3Q15	0.1%	-7.6%	-6.1%	-1.2%	-3.0%	-2.2%	-5.6%
4Q15	6.6%	-0.8%	0.6%	2.4%	6.5%	3.1%	-3.8%
1Q16	-9.0%	-2.4%	-3.8%	-4.3%	-10.6%	-4.1%	-2.0%
2Q16	8.7%	5.7%	6.6%	8.4%	9.9%	5.6%	7.3%
3Q16	11.4%	5.8%	8.0%	14.5%	10.3%	6.8%	5.3%
4Q16	-7.2%	-6.6%	-7.4%	-10.2%	-7.5%	-5.2%	-11.0%
1Q17	14.1%	17.8%	20.3%	23.3%	25.7%	12.4%	19.6%
2Q17	2.0%	4.4%	4.9%	4.3%	7.0%	4.8%	4.8%
3Q17	0.1%	2.3%	2.7%	4.9%	4.1%	2.9%	2.2%
4Q17	12.0%	10.1%	12.8%	18.1%	22.1%	8.9%	8.8%
Trailing 1 year	30%	38%	46%	59%	71%	32%	39%
Trailing 2 years	33%	41%	50%	70%	71%	35%	37%
Trailing 3 years	40%	31%	44%	76%	76%	41%	29%
Trailing 5 years	96%	64%	84%	133%	138%	67%	75%
Since inception	**118%**	**54%**	**73%**	**112%**	**87%**	**50%**	**34%**
2017	30%	38%	46%	59%	71%	32%	39%
2016	2%	2%	3%	7%	0%	3%	-1%
2015	5%	-7%	-4%	4%	3%	4%	-6%
2014	27%	24%	30%	46%	60%	34%	45%
2013	10%	1%	-2%	-10%	-15%	-11%	-7%
2012	29%	23%	27%	33%	28%	14%	25%
2011	-14%	-24%	-26%	-32%	-39%	-21%	-39%
Sharpe Ratio	0.63	0.28	0.37	0.50	0.39	0.28	0.17
Calmar Ratio (3-yr/3%)	0.42	0.22	0.37	0.93	0.73	0.72	0.23

*Note: Fund went live on March 11, 2014; *Close-ended funds in US*
Source: Internal Sources; NSE; BSE; Bloomberg; Eurekahedge

Investment Managers

Piyush Sharma, is the co-investment manager of Metis Opportunity Fund. 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 by 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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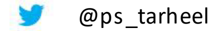
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Gaurav Aggarwal, CFA, CPA, CIPM is the co-investment manager of Metis Opportunity Fund. He was a senior analyst with portfolio management duties over $50 million in fund of fund assets at a leading regional investment bank (Global Investment House) in the Middle East. Prior to this, he was with Bay Harbour Management, a $1.2 billion distressed debt and equity hedge fund in New York City. He has also served as an analyst with Polen Capital Management, a $2 billion long-only value money manager in Florida. He received an M.S. in Accounting (specializing in Finance) and B.S. in Business Administration from the University of North Carolina at Chapel Hill. He is a Chartered Financial Analyst and a Certified Public Accountant.

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