



2Point2 Capital Investor Update Q2 FY19

Dear Investors,

This is the ninth quarterly letter to our Investors. Our letters to you will provide an update on our investment performance and present our views on relevant topics.

PERFORMANCE

2Point2 Long Term Value Fund

The 2Point2 Long Term Value Fund (launched in July 2016) is our only strategy under the PMS license granted to us by SEBI. This strategy focuses on generating long term returns by holding a concentrated portfolio of investments (maximum 15 stocks).

Returns Summary

	FY17* (8 months)	FY18	YTD FY19*	Since inception*	Out-performance
2Point2 Long Term Value Fund	26.8%	16.6%	-3.1%	43.2%	
NIFTY 50 Total Return Index#	8.3%	11.8%	9.0%	31.9%	+11.3%
MIDCAP 100 Total Return Index#	22.2%	10.3%	-8.0%	24.0%	+19.2%

*Since inception returns are for a 27-month period from 20th July 2016 to 30th September 2018. FY17 returns are for an 8-month period. YTD FY19 returns are from 1st April 2018 to 30th September 2018. As mandated by SEBI, Returns are calculated on a weighted average basis. Returns are net of expenses and fees.

#Total Return Index includes returns from dividends received

As of 30th September 2018, 87.0% of the total capital was deployed in equities with the rest lying in interest earning assets. **Note:** Returns of individual clients will differ from the above numbers based on the timing of their investments. The above returns are on the consolidated pool of capital.

2Point2 Long Short Value Fund

The 2Point2 Long Short Value Fund (launched in August 2016) is our long/short equity strategy using **ONLY** proprietary capital. The “long” part of this strategy is similar to our 2Point2 Long Term Value Fund portfolio. In addition to the long portfolio, this strategy also uses futures to “short” stocks on which we have a fundamental negative view.

	CAGR Returns since inception*
2Point2 Long Short Value Fund	21.4%

*Period of 26 months beginning 4th August 2016 to 30th September 2018. Returns are calculated on a weighted average basis on only the invested corpus (gross long + gross short). Returns are net of all expenses.

COMMENTARY

Q2 FY19 saw significant volatility in the markets specially in the mid-cap and small-cap space. While the large cap indices have yielded positive CY returns at 5.1%, the mid and small-cap indices had returns of -18.1% and -31.1% respectively. Our portfolio too fell with the broader markets with CY returns at -8.03%. The anomaly of the last three years where the small caps / mid-caps were trading at a significantly higher valuation than large caps (we talked about this [here](#)) seems to have somewhat corrected this year.

We now have an 87.0% exposure to equities in the PMS on a consolidated basis (new portfolios would have lower exposure) and are gradually increasing our exposure to equities as value has started to emerge in several areas.

We have tried to avoid investing in businesses that are overvalued and/or have poor corporate governance standards. Panic periods such as these lead to a non-linear derating in stocks which exhibit either of these characteristics. Having said that, our portfolio (financials heavy) still has seen a decline in line with the broader markets. The good news is that the underlying portfolio companies continue to perform as per our expectations. They have grown earnings/cash flows at a pace higher than the rest of the market and are strengthening their overall market position. As the YoY earnings growth of the portfolio has outpaced the underlying value of the portfolio, there has been a considerable decline in valuation of the consolidated portfolio. The below table summarizes important characteristics of our portfolio as on 8th October 2018:

Median Market-Cap (Crores)	2,900
Median ROE	18.2%
Median Valuations (TTM P/E)	18.9
Median Earnings Growth (Q1 FY19)	19.6%

A large part of the drop in the portfolio can be attributed to the crash in the NBFC / Financials space triggered by the IL&FS defaults in September and the worsening macro environment (rising yields and depreciating currency). In the next section, we take stock of the current NBFC crisis and also go back in time to revisit similar/different crisis to see how bad the crisis is this time. We follow it up with the characteristics we look for in a potential NBFC investment.

HOW BAD IS THIS NBFC LIQUIDITY CRISIS?

With the recent default on Commercial Papers (CPs) by IL&FS, all NBFC stocks have fallen. NBFC has suddenly become a swear word. While there are concerns on liquidity management of specific NBFCs, there are no solvency concerns as yet. However, this has again given rise to extreme debates such as whether there is even a need/place for NBFCs when so many banks exist. The perceived risk that investors associate with investing in NBFCs has suddenly shot up. And this has happened before too – many times. Let us go back in time to see how things panned out then.

1. Liquidity Crunch due to the 2008 Global Financial Crisis (GFC)

The GFC led to a sudden liquidity crunch in both commercial debt market and banking channels due to a crisis of confidence in the financial markets. While banks became reluctant to lend to NBFCs, mutual funds as a source of funds also dried up with huge redemptions in debt funds by investors.

In a report released by CRISIL in November 2008, the rating agency mentioned that disbursements by NBFCs dropped sharply as they were busy repaying their short-term obligations to mutual funds (MFs). An analysis of 33 rated NBFCs accounting for almost 30% of the sector, indicated that most of these NBFCs slowed down disbursements due to a lack of funds. Average monthly disbursements during September and October 2008 were estimated to be half of the disbursements in August. MFs were no longer lending to the NBFC sector, and were withdrawing their existing exposures as they matured.

The RBI took several steps, including reducing risk weightage and provisioning norms for loans given to NBFCs, to help them navigate the liquidity crisis. The RBI approved a scheme for providing liquidity support to select NBFCs through a Special Purpose Vehicle (SPV) for meeting the temporary liquidity mismatches in the operations for an amount of 25,000 crores.

The retail NBFCs quickly recovered from the GFC blues over the next one year as liquidity came back to the sector. As per CRISIL, the growth in AUM which had dropped to ~8% in FY09 increased to 19% in FY10.

2. Liquidity Crunch due to the 2013 Currency Crisis

When the US Federal Reserve announced in 2013 that it will gradually reduce the amount of money it was feeding into the US economy, FIIs pulled out large amounts of capital from both the Indian debt and equity markets. The value of Indian Rupee went from 55 to a US dollar in May 2013 to 68 in August 2013. Select NBFCs crashed between 20-40%.

In order to stem the Rupee slide, the RBI significantly tightened the short-term liquidity resulting in an overnight increase in short term rates. The CP rates shot up by ~150 bps and the G-Sec yields touched an all-time high of 9.5% in July 2013.

The impact of the rate reset on NBFCs was short-lived. According to ICRA, the credit growth registered by retail focussed NBFCs was a mere 8% in FY14 but quickly recovered to 20% in FY15 despite continued elevated rates. The NBFC stocks quickly recovered from the drawdowns in less than a year.

3. The Andhra Microfinance Crisis

In October 2010, based on anecdotal accounts of coercive recovery, high interest rates, multiple lending and suicides by borrowers, the AP government passed the AP MFI Ordinance 2010 which was converted to an act in January 2011. The Act made it illegal for MFIs to collect outstanding loans in the field in the manner in which they and their client base had become accustomed to. Many MFIs (with significant presence in AP) like BASIX saw a solvency crisis due to mass defaults from customers. Few others like SKS Microfinance (now known as Bharat Financial Inclusion) were able to survive due to the capital raised in the IPO. There was a complete dry up of funding from banks leading to a crisis on both the Asset and Liability side.

The RBI responded to the crisis by appointing the Malegam Committee to study the issue and make recommendations. The committee came out with a report in 2011. It legitimized MFIs and the private sector's involvement in microfinance and called for continued priority sector lending support to MFIs. The clear message from RBI was that MFIs are to be excluded from state jurisdiction, paving ground for the 2012 microfinance bill in the parliament.

Since then, the MFIs have resumed their high growth trajectory and the industry has grown from ~ 17,000 cr in 2011 to ~ 75,000 crores today. The risk management of the industry has considerably

improved with cap on borrower overleveraging, robust KYC, superior credit appraisal due to presence of credit bureaus, geographical diversification of MFIs etc. Many of the MFIs were eventually given the license by RBI to convert into Small Finance Banks and a few have been acquired by other banks at fairly rich valuations.

4. The Gold NBFC crisis

The gold NBFCs (led by Muthoot and Manappuram) were growing at a pace of 100%+ until FY11, led by an increase in physical penetration and a continuous increase in gold prices until 2012. The focus was on disbursements with little focus on collections. They were lending at 90%+ LTVs and were generating 30%+ ROEs.

This changed with a slew of adverse regulations by RBI, coinciding with a crash in gold prices. First, in February 2011, the RBI removed priority sector status for bank loans to gold NBFCs, which led to a higher cost of borrowing for these companies. Thereafter, in March 2012 the RBI put a cap on the Loan to Value (LTV) ratio at 60 percent for loans given against the collateral of gold jewellery. This put them at a disadvantage to banks and unorganized lenders who were lending at much higher LTVs. Immediately thereafter, the gold prices crashed more than 25% between July 2012 to July 2013 leading to defaults by borrowers.

The fallout of the crisis was:

- The growth of the industry tapered down with AUMs of Muthoot and Manappuram declining from FY2012 onwards and finally reached the same level in FY2016.
- There was a shakeout in the industry with a large number of NBFCs and Banks vacating the space leading to an oligopolistic industry structure with Muthoot and Manappuram as the market leaders. NBFCs such as Magma Fincorp, Shriram City Union, Capital First, Cholamandalam etc. exited the gold finance business.
- The risk management was improved with lower LTVs, monthly interest collection from borrowers and disbursal of shorter tenure loans. The RBI finally increased the LTVs back to 75% in 2014.
- The growth recovered to low double-digit growth in the core gold loan business with ROEs of 20-25%. The major players have also diversified into new businesses such as Microfinance, Housing Finance, Vehicle Finance where the growth is much higher.

5. Demonetisation

Demonetisation was a black-swan event for NBFCs in India. With the scrapping of high value notes in November 2016, both collections and disbursements took a huge hit for NBFCs dealing in cash. In addition, the cash economy suffered because of the absence of cash, further impacting the ability of borrowers to repay. The impact was severe on NBFCs focused on lending to the rural economy or the bottom of the pyramid.

For microfinance companies, the PAR-30 (Portfolio at Risk >30 days) as on 31st March 2017 increased from less than 1% in March 2016 to more than 20% in large states such as Uttar Pradesh and Maharashtra. Large MFIs such as Janalakshmi and Satin Creditcare had to raise several rounds of equity to weather the liquidity crisis which was slowly turning into a solvency crisis.

Eventual credit losses were between 2-15% for different MFIs. The disbursements quickly recovered to pre-demonetisation levels in just two quarters and the industry was back on a high growth trajectory. Companies pursuing reckless growth slowed down considerably.

Learnings from Earlier Crisis

The current crisis is of the Liability side just like the crisis in 2008 and 2013 mentioned above. The crisis on the Asset side like the Andhra MFI crisis, the Gold Finance crisis or Demonetisation have inflicted far more damage to companies' balance sheet and led to more casualties as compared to the crisis on the liability side. Liquidity issues have resolved themselves over a short period of time both in 2008 and 2013 without any blow-ups.

Also, this crisis is nowhere as bad as the liquidity crisis of 2008 or perhaps even 2013. In an interview to Economic Times, Ajay Piramal said, "In 2008 there was no liquidity in the market. Today there is no liquidity crisis. It is more a crisis of confidence. That is different from not having money to lend. There is so much fear in public and private sector banks that they would rather sit on cash than lend. It is not a question of liquidity."

The ILFS debt, although large, is fragmented. It is held by a large number of entities including several PSU banks, many mutual funds and insurance companies. While there is hope of large recoveries, even if there is not – the pain will be borne by a large fragmented set of players.

However, the confidence of investors in the debt market has been shaken and this has led to large scale redemptions of debt funds. This may lead to a temporary freeze in the commercial credit markets and an increase in short term rates. This should at worst affect the short-term growth and profitability of NBFCs (in some cases) just like it did in 2008 and 2013.

The risk that exists is the collapse of another of the larger NBFC names (in addition to IL&FS) due to either a liquidity crunch or a fraud. This will lead to a much-protracted systemic liquidity crisis due to a trust deficit in the debt financial markets. However, even then it is unlikely that well managed NBFCs will see a dearth of capital raising options in the longer term. We are in no position to predict when things will revert back to normal. However, we are confident that there are certain categories of NBFCs that are indispensable because they serve an important role of financial inclusion in specific spaces. We are happy to continue to own these and even increase our allocation to them. After the recent fall, few well managed NBFCs are available at <1.5x P/BV or single digit P/E multiples despite ROE characteristics of 20%+ and double-digit growth.

Characteristics of a good NBFC investment

We describe below some characteristics that we like to see in an NBFC investment:

- **Untapped by banks:** The NBFC should be solving a genuine financing need for the borrower that the incumbent banks are unable to fulfil. It may not be possible for an NBFC to effectively compete in a segment where the banks are a direct competition. Some segments where the banks are not active or competitive:

Segment	Reason
Microfinance	Loans are unsecured; A bank's high cost structure cannot match the frugal operations of an MFI
Gold Finance	Turnaround time is slower; Economies of scale not there as bank provides many products
Home Loan – Self employed	Bank's credit appraisal process involves only declared income
SME / MSME	Bank's credit appraisal process involves only declared income

In competitive segments like home loans for the salaried segment, the NBFCs work with thin ROAs because of a higher cost of fund as compared to a bank.

- **Headroom for growth:** There are certain spaces where the demand and headroom for growth is so large that a large number of players can co-exist for a long period of time without compromising each other's profitability. Microfinance is one such example. There does not seem to be any apparent competitive advantages that one NBFC-MFI has over the other. However, NBFC-MFIs – large and small, still continue to earn a 20%+ ROE. The thing to look out for is a robust risk management culture – robust credit appraisal process and collection process, and a geographical diversification of AUM. Housing finance was one space where NBFCs captured a lot of value as long as there was under-penetration. With a real-estate slowdown and an increase in number of competitors (number of HFCs went up from around 50 in 2013 to nearly 100 now) the headroom for growth may not be there for home loans (especially for competitive segments such as loans for the salaried).
- **Price insensitive borrowers:** We like segments where the loan is non-discretionary. These are loans where higher cost of funds can be easily passed on without adverse consequences on demand of the loan itself. Eg. Gold loans, Microfinance loans, MSME loans etc. A consumer may postpone a home loan because of a higher cost but is unlikely to postpone emergency loans like gold loans or microfinance loans due to an increase in price.
- **Economies of scale / brand:** We like NBFC spaces where a larger scale means a lower cost of operations and a lower cost of funding. This enables incumbents to capture a disproportionate share of the market resulting in an oligopolistic market structure. There are certain NBFC spaces where the economies of scale cease to exist beyond a certain size (MFIs), while there are some others like Gold Finance where there is a lot of operating leverage. This prevents new players from entering the market or forces existing ones to vacate the market. In addition to scale, there are certain NBFCs like gold finance where brand also becomes important – brand signifies trust for the borrower who is entrusting the NBFC with family jewellery.
- **Skin in the game:** In the financials space, dilution for growth is inevitable as capital is the raw material for growth. We like NBFCs where the Promoters are frugal with dilutions and hold large stakes despite many years of operations. Eg. Muthoot Finance, MAS Financial, HDFC, Mahindra Finance etc.
- **High sustainable ROEs with low leverage:** NBFCs that have strong underlying ROEs even without significant leverage can withstand a liquidity crisis much better. For instance, NBFCs in microfinance / gold finance generate higher ROEs without significant leverage; Housing Finance NBFCs cannot because they work on thin ROAs. Even a slight fall in demand leads to a hyper-competitive scenario leading to uneconomical ROEs for them.

In short, NBFCs have been through worse and have come out alive. The NBFC sector in India is an important participant in the financial inclusion agenda. Well managed NBFCs will continue to do well in the long term despite minor hiccups like these. Strong will become stronger as the weak ones are weeded out. We believe this is a good time to dispassionately evaluate the sector and invest in the right companies at what currently look like more than reasonable valuations.

If you have any queries (about your portfolio, 2Point2 Capital or investing in general), do reach out to us at the below coordinates. We would love to talk.

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Thanks and Regards,

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