PORTFOLIO MANAGEMENT SERVICES

Newsletter: May 2019

DHFL Pramerica Core Equity Portfolio Strategy

From the desk of the Portfolio Manager for DHFL Pramerica Core Equity Portfolio Strategy

Dear Investor,

In this newsletter we aim to share our thoughts on financial sector and the rational for our position in the financial sector.

The only way you get a bubble is when basically a very high percentage of the population buys into some originally sound premise and –- it's quite interesting how that develops –- originally sound premise that becomes distorted as time passes and people forget the original sound premise and start focusing solely on the price action. –- Testimony by Warren Buffett Financial Crisis Inquiry Commission

The privatisation of banks started with the notion that it will lead to better efficiency, less bureaucracy, increased financial penetration and more customer centricity. To a very large extent that has been playing out and we have seen the private sector grow at a very high growth rate and gain market share from PSUs for last several years. If we look at the market share of the top 5 private sector banks it was 26.34% in advances and in total disbursals it was 39% for FY2019.

In last 10 yrs the total bank credit has grown around 12.7% (Source of Data RBI). If we assume that the credit over the next decade will be roughly 13% compounded annual growth rate in line with the last 10 yrs and the block of these 5 banks keep on growing at 20%. In next 10 years the market share of these top 5 banks in incremental disbursals will be 70% of the incremental loans in the banking systems and 48% market share in the total outstanding advances. Clearly to sustain this growth for the banks is not going to be easy if the credit in the system grows at the last 10 yrs average. The last 10 years, was the period when we saw high growth in most high capex sectors like roads, steel, airports, cement, aluminium etc and a housing boom at least in the top tier one and two cities. So, the probability of growth being much higher than 13% over the next ten years of the banking system is not very high.

Table 1: Market share of top 5 Private banks in the total bank credit and disbursals

Figures in Rs Lakh Crore.	29-Mar-19	31-Mar-20	31-Mar-22	31-Mar-24	31-Mar-26	31-Mar-28	31-Mar-29
Total Bank Credit	86,74,900	98,02,637	1,25,16,987	1,59,82,941	2,04,08,617	2,60,59,763	2,94,47,533
Incremental system disbursals	9,44,600	11,27,737	14,40,007	18,38,745	23,47,894	29,98,026	33,87,769
Advances of top 5 Private sector banks	22,85,005	27,42,006	39,48,489	56,85,824	81,87,586	1,17,90,124	1,41,48,149
Incremental disbursals by the above five banks	3,65,807	4,57,001	6,58,081	9,47,637	13,64,598	19,65,021	23,58,025
Market share of the above five banks in incremental disbursals	39%	41%	46%	52%	58%	66%	70%
Total market share of five banks	26.34%	27.97%	31.55%	35.57%	40.12%	45.24%	48.05%

Source of data: RBI, bank results and internal research
Note: Figures for FY 2019 are actual numbers and after that the numbers are projection.

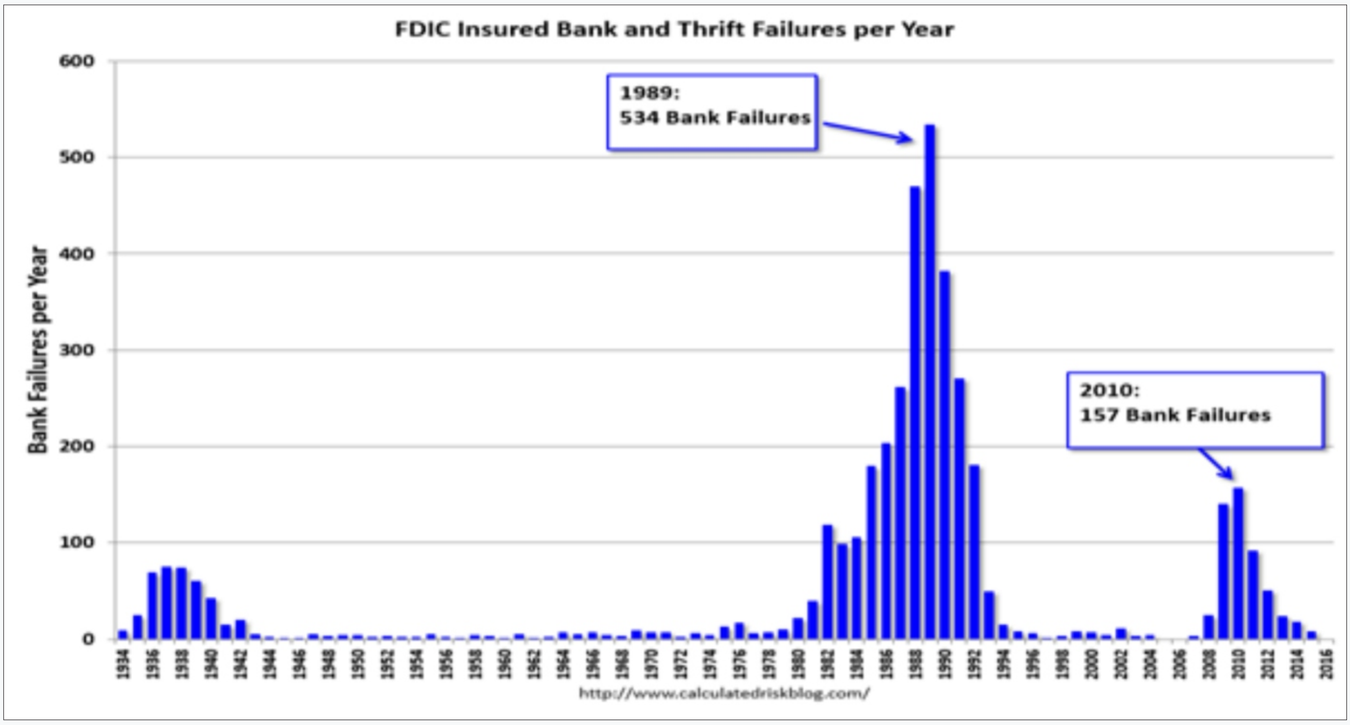
I do not think you can trust bankers to control themselves. They are like heroin addicts. -- Charlie Munger, Vice Chairman of Berkshire Hathaway

Growth is important for most financial institutions to justify the valuations which they are trading at and for management to get higher increments, bonuses and ESOP's. So, what does a financial institution do to grow profits at a high pace; increase leverage, take risk of ALM mis match, do riskier business, take off balance sheet risks (contingent liabilities), do higher risk/ capital guzzling business in subsidiaries and in our country may be in other countries also, miss sell (sorry cross sell) to generate high fee income and upfront book the interest income to show it as fee income.

With RBI having given banking licenses to a number of financial institutions over the last few years. We expect the intensity of competition will increase in the business of banking and have disastrous consequences. Historically in any business where the entry barrier is only capital and regulatory approval with large market size; the incremental competition has ensured that the return in business is lower than the cost of capital for most players and for few slightly better than the cost of the capital. We can take the example of telecom in our country which had only capital as an entry barrier and a large growing market; number of players from far off countries came in the business and after burning capital have moved out. Now with only three large players remaining in telecom business still making decent return on capital is difficult. Another example we can take is of the power sector, once it became deregulated, number of players entered with huge capex in power plants and the NPA's of the sector are still being cleaned.

The other point of our big disagreement versus the market, has been that the private sector will do much better credit underwriting and have better corporate governance standards. We will give three reasons for why we believe so. First, other than three or four private banks almost all banks have faltered big time in last 10 yrs on NPAs or Corporate Governance. Secondly if this were to be true we would not have had any NBFC crisis which we are seeing today in the system as most of the NBFC's are privately run financial institutions. Thirdly were this be true in case of USA where the financial institutions are privately run for more than 100 years; we would not have had so many banking failures at such frequent intervals in USA. Also, one of the reasons for the last global recession was greed and poor risk management and somewhat unethical practices at some of these large private Western financial institutions.

Table 2: US bank failure



Source:- 3.bp.blogspot

Table 3: 5 yr Rolling Bank Credit growth segment wise

		21-Mar-14	20-Mar-15	18-Mar-16	31-Mar-17	30-Mar-18	29-Mar-19
	5 yr rolling credit growth segmental						
III	Non-food Credit (1 to 4)	16.3%	14.6%	12.2%	10.6%	9.6%	9.3%
1	Agriculture & Allied Activities	14.5%	13.0%	12.8%	12.7%	11.8%	10.8%
2	Industry (Micro & Small, Medium and Large)	19.0%	15.2%	11.1%	6.7%	3.9%	2.8%
2.1	Micro & Small	15.6%	13.0%	11.9%	9.3%	5.6%	1.5%
2.2	Medium	0.5%	-0.9%	-0.4%	-3.4%	-3.6%	-3.2%
2.3	Large	21.8%	17.2%	11.8%	7.0%	4.1%	3.3%
3	Services	15.7%	14.2%	11.6%	12.0%	12.2%	12.6%
3.1	Transport Operators	18.6%	11.8%	7.3%	7.7%	8.8%	8.4%
3.2	Computer Software	13.9%	6.5%	6.5%	4.6%	1.9%	-0.1%
3.3	Tourism, Hotels & Restaurants	24.0%	13.8%	5.9%	3.0%	0.6%	-0.4%
3.4	Shipping	1.7%	1.9%	5.5%	1.1%	-5.2%	-5.4%
3.5	Professional Services	12.5%	14.2%	18.3%	23.5%	22.5%	16.6%
3.6	Trade	17.7%	17.3%	15.4%	13.7%	11.1%	10.1%
3.7	Commercial Real Estate	10.6%	12.6%	12.8%	10.5%	8.1%	5.7%
3.8	Non-Banking Financial Companies (NBFCs)	24.3%	22.4%	13.9%	10.9%	13.8%	16.9%
3.9	Other Services	10.8%	8.4%	6.8%	12.2%	14.0%	15.6%
4	Personal Loans	12.4%	14.8%	14.8%	15.7%	16.3%	17.1%
4.1	Consumer Durables	9.4%	13.0%	23.1%	23.9%	18.6%	-13.3%
4.2	Housing (Including Priority Sector Housing)	14.0%	15.9%	15.8%	16.7%	16.4%	16.6%
4.3	Advances against Fixed Deposits (Including FCNR (B), NRNR Deposits etc.)	5.5%	5.1%	6.1%	3.0%	3.5%	5.4%
4.4	Advances to Individuals against share, bonds, etc.	10.8%	13.7%	17.4%	9.6%	12.3%	10.4%
4.5	Credit Card Outstanding	-2.4%	8.6%	15.8%	20.6%	22.5%	28.8%
4.6	Education	16.0%	11.4%	9.7%	7.0%	4.9%	2.5%
4.7	Vehicle Loans	11.4%	14.3%	15.9%	13.9%	11.3%	13.7%
4.8	Other Personal Loans	13.6%	17.8%	14.9%	18.7%	23.4%	24.9%
5	Priority Sector	14.4%	13.0%	11.9%	11.4%	10.6%	8.4%

Source of data: RBI and internal research

Another reason which makes us cautious is the quality of credit growth which is happening in the system. In the last 5 yrs the highest growth in advances has happened in unsecured personnel loans and credit cards. At one place we are seeing auto sales doing poorly, growth slowing down in consumption related sectors, new housing sales moving slowly, poor agrochemicals sales, near decade low gross savings rate (Source: https://www.ceicdata.com/en/indicator/india/gross-savings-rate) and high pitch debates in media on high unemployment in the country. If there is so much pessimism and distress in the system then who are these bankers giving loans to. We have asked this question to many a people and there have been two responses: -

One is the credit is good; it is not showing any distress in the credit bureau data. But the problem with the first point is by the time it shows in credit bureau data it will be too late for the investors to run away and banks to unwind. An example we can take is of the infrastructure sector where a lot of poor-quality lending happened. Had an investor in banks which lent loans in infrastructure waited for credit rating agencies to declare those infrastructure assets as distress assets it would have been too late. Another near-term example is NBFC sector where the lending standards had been going down and they had been taking on aggressive risks for past few years and most investors kept on looking at growth and RoE. Eventually the debt market woke up to the reality of risks in NBFCs and froze. Some of the fast growing NBFC's are facing problem managing the day to day liquidity and credit rating agencies are now downgrading the ratings every few days. We turned cautious on the sector because of the way these NBFC's were growing and the risks they were taking on the balance sheet.

Second is, it is being cross sold to bank's existing customers so nothing to worry. We don't understand how it is that almost all banks have suddenly realised that they need to grow this business and have developed good internal processes to grow this business. Where in the last business cycle of late 2000 most financial institutions got burned very badly in unsecured consumer lending and credit card, as a category for the whole banking industry de-grew for several years.

Unburdened with the experience of the past, each generation of bankers believes it knows best, and each new generation produces some who have to learn the hard way. –- Irvine Sprague, former chairman of the Federal Deposit Insurance Corporation

Table 4: Broad Sectoral composition of Banking Credit

Share	27-Mar-09	26-Mar-10	25-Mar-11	23-Mar-12	22-Mar-13	21-Mar-14	20-Mar-15	18-Mar-16	31-Mar-17	31-Mar-17	30-Mar-18	29-Mar-19
Agriculture & Allied Activities	13.0	13.7	13.1	12.7	12.1	12.0	12.8	13.5	14.0	14.0	13.4	12.9
Industry (Micro & Small, Medium and Large)	40.5	43.1	43.8	45.2	45.8	45.5	44.3	41.7	37.8	37.8	35.1	33.4
Micro & Small	6.5	6.8	5.7	5.5	5.8	6.3	6.3	5.7	5.2	5.2	4.9	4.3
Medium	4.7	4.4	3.2	2.9	2.6	2.3	2.1	1.8	1.5	1.5	1.3	1.2
Large	29.3	32.0	34.8	36.7	37.4	36.9	35.8	34.3	31.1	31.1	28.9	27.8
Services	24.8	23.9	24.2	23.8	23.7	24.2	23.5	23.5	25.4	25.4	26.7	28.0
Personal Loans	21.6	19.3	19.0	18.2	18.4	18.3	19.4	21.3	22.8	22.8	24.8	25.7
Priority Sector	35.8	35.9	34.4	33.1	31.6	33.1	33.5	34.0	34.3	34.3	33.2	31.7

Source of data: RBI and internal research

We keep on meeting banks which don't stop praising their strategy and execution in implementing retail focused strategy. But if we look at the overall credit of banks the industry segment has fallen from nearly 46% in FY 13 to 33% in FY19 and personnel loans as a category has grown from 18% to nearly 26%. In last three years, of the incremental credit disbursed by the banks 42%, 49% and 33% was to personal loans as a category for FY17, FY 18 and FY 19 respectively (Source of data: Internal research and RBI Sectorial deployment of credit reports). If we look at the table 3 the fastest growing segment in last 5 yrs has been Personal loans and like lemmings jumping off the cliff most of the banks in their hunger to show growth are expanding their loan book at a very fast pace in this segment. How good has been the quality of underwriting will be known in next two or three years.

"The 'sound' banker, alas! is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him." -- John Maynard Keynes

How can we end a discussion on a sector without a talk on valuation?

In the initial heydays when private sector banks and NBFC started catching the investor's fancy most financial institutions traded at 1 to 2 Book values in line or slightly premium to other public sector banks because of better growth, perception that they are more efficient don't have corrupt business practises etc and will have lower NPA's. As private sector banks and NBFC's kept growing at a faster pace they kept on raising capital at higher Price to Book multiples and hence the book value grew at faster pace than the earnings growth. For example, a financial institution if it traded at 2 times book value and the total book value was 100 with 100 shares each having book value of 1. The stock price would Rs. 2 and market capitalization would be Rs. 200. If this financial institution raised Rs. 100 at a book multiple of 2. The total number of shares would be now 150 and total book value of the institution would be Rs. 200 and with book value per share now being Rs. 1.33 and with valuation multiple at two times book value; the stock is now worth Rs. 2.66. In the initial phase higher the growth, higher the Price to Book multiple would be for a financial institution. As time has progressed the sanity in the multiples (Price to Book) assigned lost all relationship to the fundamentals (RoE, GNPA, NNPA, risk in the business etc) and today the only correlation is with how fast the financial institution can grow and at what multiples can it raise capital. So, we find a number of financial institutions getting traded at 4,5, 6 and even 10-time Price to Book multiples. Higher the Price to Book multiple lower the equity dilution for the incremental capital raise and hence higher the increase in book value and finally stock price when capital gets raised. (Illustrated in table 5)

Table 5: Impact of capital raise on different book multiples

	A	B	C=A/B	D	E=C*D	F=E*B	G	H=G/E	I=(A+G)/(B+H)	J=D*I
	Initial Equity	total number of shares	Book Value per share	Book Multiple	Market Value of each share	M Cap before capital raise	New capital raised	New share issued	New Book Value per share	New Share Price
Case 1	1000	1000	1	2	2	2000	200	100	1.09	2.18
Case 2	1000	1000	1	4	4	4000	200	50	1.14	4.57
Case 3	1000	1000	1	5	5	5000	200	40	1.15	5.77
Case 4	1000	1000	1	8	8	8000	200	25	1.17	9.37

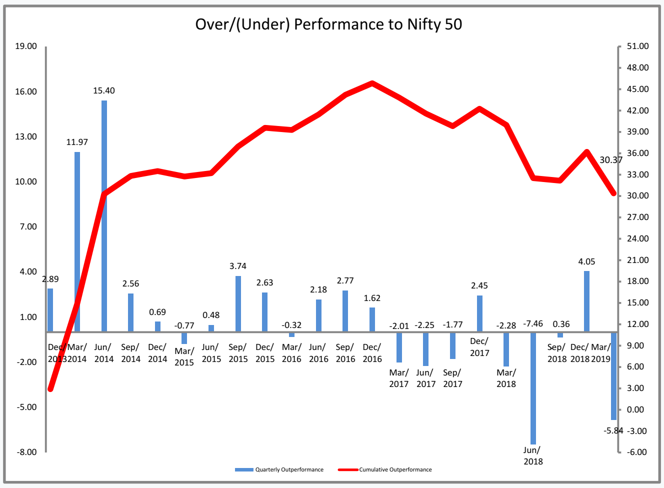
Source: Internal workings

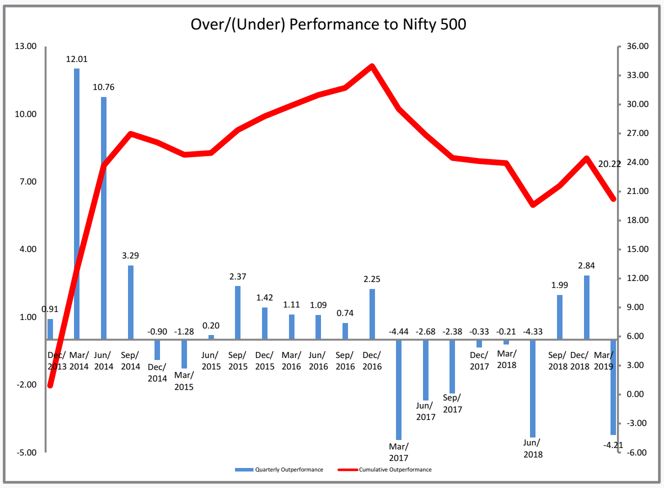
We have chosen after a lot of thought and internal discussion not to be part of this game as the risks are too high and to make money you need to have faith in a greater fool theory (which means the price of security is determined not by its intrinsic value, but rather by irrational beliefs and expectations of market participants). That is the reason for us currently not holding any large private sector banks or financial institutions.

Yours Sincerely,

(Himanshu Upadhyay)
Portfolio Manager

DHFL PRAMERICA CORE EQUITY PORTFOLIO STRATEGY
KEY PORTFOLIO PERFORMANCE INDICATORS





Performance depicted as at the above stated date is based on all the client portfolios under the Regular Portfolio of DHFL Pramerica Core Equity Portfolio Strategy existing as on such date, using Time Weighted Rate of Return (TWRR) of each client and then computing an arithmetic average for the overall strategy. Past performance may or may not be sustained in future.

Top 15 Holdings of DHFL Pramerica Core Equity Portfolio Strategy Discretionary Portfolio Regular Plan as on April 30th, 2019

Date of Purchase	Equity	Sector	%
Sep/2015	State Bank of India	Banking / Financial Services	6.37%
Jun/2015	ITC Ltd	FMCG	5.01%
Jul/2013	Indraprastha Gas Ltd	City Gas Distribution	4.95%
Feb/2018	Multi Commodity Exchange Of India Ltd	Other Financial Services	4.77%
Jul/2013	Container Corporation of India Ltd	Logistics	4.58%
Mar/2015	Castrol India Ltd	Lubricants / oils	4.23%
May/2018	Bharat Electronics Ltd	Industrial Electronics	4.20%
Aug/2013	Cummins India Ltd	Engineering	4.13%
Jan/2016	Oracle Financial Services Software Ltd	IT Services / Products	4.02%
Oct/2017	Power Grid Corporation Of India Ltd	Power- Transmission	3.82%
Jun/2018	Ge Power India Ltd	Power Equipment	3.30%
Aug/2013	Great Eastern Shipping Co Ltd	Shipping	3.29%
May/2014	Infosys Ltd	IT Services	2.95%
Jul/2013	Bosch Ltd	Auto Ancillaries	2.86%
Jul/2013	Engineers India Ltd	Consulting	2.81%
	Total		**61.29%**

Model Portfolio Details

Portfolio Details as on April 30th, 2019	
Weighted average RoCE	24.88%
Portfolio PE (1-year forward) (Based on FY 20)	17.05
Portfolio dividend yield	1.33%
Average age of companies	56 Years

Portfolio Composition as on April 30th, 2019	
Large Cap	41.50%
Mid Cap	23.75%
Small Cap	25.25%
Cash	9.50%

Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on April 30th, 2019

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 April 30th, 2019

Small Cap: Market cap lower than the 250th company in the nifty 500 (sorted by market cap in descending order) as on April 30th, 2019

The above holding represents top 15 holdings of DHFL Pramerica Core Equity Portfolio Strategy - Regular Portfolio based on all client portfolios existing as on the date stated above, excluding any temporary cash investments. The above holdings do not represent the model portfolio being offered to the clients (including prospective clients) and hence it is possible that these stocks may not be part of the portfolios constructed for new clients. The above holdings are for illustration purpose only and it should not be considered as investment recommendation or analysis or advice or opinion from the Portfolio Manager on the above mentioned stocks. The above portfolio holdings are provided on an "as is" basis, and the Portfolio Manager makes no express or implied warranties or representations with respect to the accuracy, completeness, reliability, or fitness of the above portfolio holdings or any financial results you may achieve from their use. In no event shall the Portfolio Manager, its directors or employees or its affiliates have any liability relating to the use of the portfolio holdings.

DHFL Pramerica Core Equity Portfolio Strategy Portfolio Performance as on April 30th, 2019

Period	Portfolio	NIFTY 50	NIFTY 500
1 Month	-0.91%	1.07 %	0.01 %
3 Months	1.36%	8.47 %	7.34 %
6 Months	2.78%	13.11 %	10.41 %
1 Year	-1.20%	9.39 %	1.77 %
2 Years	3.98%	12.38 %	8.47 %
3 Years	10.63%	14.40 %	13.63 %
5 Years	15.35%	11.83%	12.82%
Since inception date 08/07/2013	19.73%	12.69 %	13.90 %
Portfolio Turnover Ratio*	31.97%		

*Portfolio Turnover ratio for the period May 1st, 2018 to April 30th, 2019

Consolidated Portfolio CY Performance of DHFL Pramerica Core Equity Portfolio Strategy

CY	Portfolio Performance	NIFTY 50	NIFTY 500
08-07-2013 to 31-12-2013	13.79	7.43	8.36
CY 2014	77.24	31.39	37.82
CY 2015	2.48	-4.06	-0.72
CY 2016	8.90	3.01	3.84
CY 2017	24.56	28.65	35.91
CY 2018	-2.98	3.15	-3.38
CY 2019 till 30-04-2019	0.16	8.15	5.39
08-07-2013 to 30-04-2019	19.73	12.69	13.90

Important Disclosures regarding the consolidated portfolio performance: Performance depicted as at the above stated date is based on all the client portfolios under the Regular Portfolio of existing as on such date, using Time Weighted Rate of Return (TWRR) of each client and then computing an arithmetic average for the overall strategy. Past performance is no guarantee of future returns. The above portfolio performance is after charging of expenses (as depicted above). Return for period upto 1 year is absolute. Since inception date stated is considered to be the date on which the first client investment was made under the strategy. Please note that the actual performance for a client portfolio may vary due to factors such as expenses charged, timing of additional flows and redemption, individual client mandate, specific portfolio construction characteristics or other structural parameters. These factors may have impact on client portfolio performance and hence may vary significantly from the performance data depicted above. Neither the Portfolio Manager, nor its directors or employees shall in any way be liable for any variation noticed in the returns of individual client portfolios. The Portfolio Manager does not make any representation that any investor will or is likely to achieve profits or losses similar to those depicted above.

Investment objective of DHFL Pramerica Core Equity Portfolio Strategy: DHFL Pramerica Core Equity Portfolio Strategy seeks to generate returns by investing in a portfolio of value stocks which have the potential of wealth creation over long term.

This document is dated May 10, 2019. **C32/2019-20**