SUNDARAM Emerging Leadership Fund

• Monthly Update •

Objective: To seek long-term capital appreciation with investments predominantly in mid and small cap companies.

Target Investors: Ideal for long-term investors seeking returns through investments predominantly in small and midcap stocks and are comfortable with short-term volatility.

Investment Horizon
Above 3 years

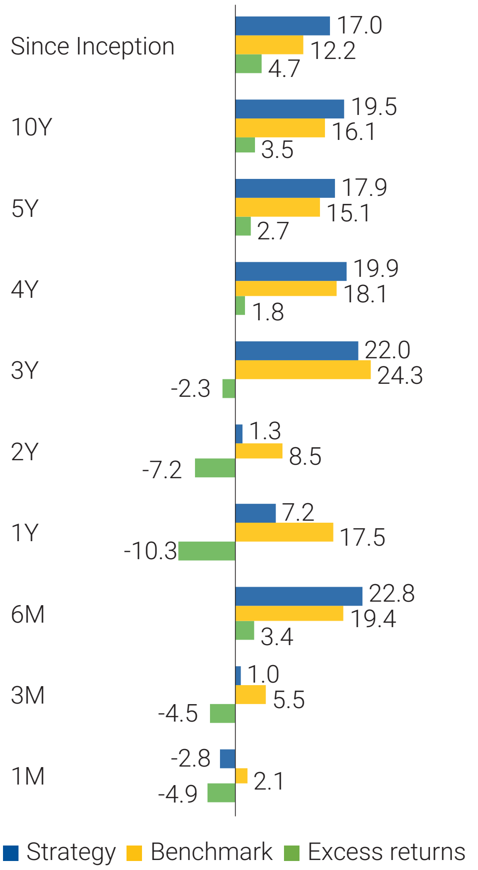
Benchmark
S&P BSE 500

Inception
June 2010

Fund Manager
Mr. Madanagopal Ramu

Assistant Fund Manager
Mr. Prashant N Kutty

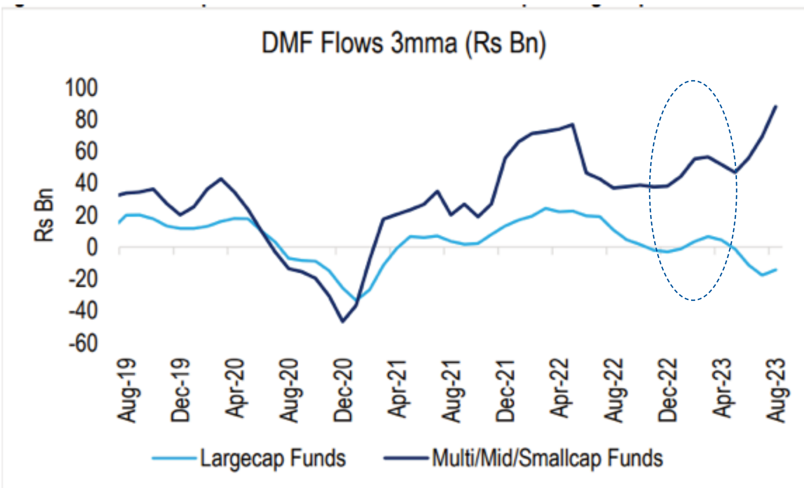
SELF vs S&P BSE 500 (%)



Pendulum swings to extreme. Risks being ignored

We saw huge surge in mid and small cap space during last 6 months. This very strong momentum in the space had a material contribution to the BSE 500 performance as well leading to a large deviation in returns between Nifty 50 (large cap index) and BSE 500 (multicap index) during this period. This impacted our portfolios recovery phase. In Q1 FY24 our portfolios created a meaningful alpha which go neutralised by the strong recovery in benchmark index contributed by midcap and small caps in Q2 FY24. We still manage to have an alpha in last 6 months vs Nifty 50. But important question is how long this mid cap rally continue?

Mid and Small cap space driven particularly by PSU sectors like PSU banks, Railway, Defense and Power stocks delivered almost 35% and 45% respectively during last 6 months. Market flows in our opinion are major contributors to this rally. Large flows in an illiquid space can create "Asset bubble" and we think a lot of mid and small cap stocks are in that zone. Signs of exuberance were visible in PSU sectors due to government led pre-election spending, we saw exuberance in many pockets of manufacturing as well given the noise around make in India leading to many of these stocks doubling in a short span of time, raising a key question for investment – is the risk reward still favourable in mid cap space. Risk seems to overweight reward in many pockets.



Source: Citi Research, AMFI

Some of the indicators for this are the valuation difference between companies in mid caps compared to similar companies in large caps. Sectors like IT, Industrials, Auto, etc. where the mid caps in the same space are trading at meaningfully higher multiple to their counterparts despite no major differentiation in the growth outlook. Higher valuations are being justified through arguments based on hope stories. We can argue that a lot of it has to do with the flows. IT sector mid caps benefitted during covid due to change in the nature of projects to meet the accelerated online shift in workspace and consumer service space. But historically, midcaps have struggled to grow in line with larger peers both in terms of revenue and profitability. So, it is now difficult to justify the premium valuations given similar outlooks.

Peer performance is available under the following link of Association of Portfolio Managers in India (APMI): https://www.apmiindia.org/apmi/welcomeiaperformance.htm?action=PMSmenu

Figure 17. 1Y Forward PE: Near +1SD Above 10Y Mean

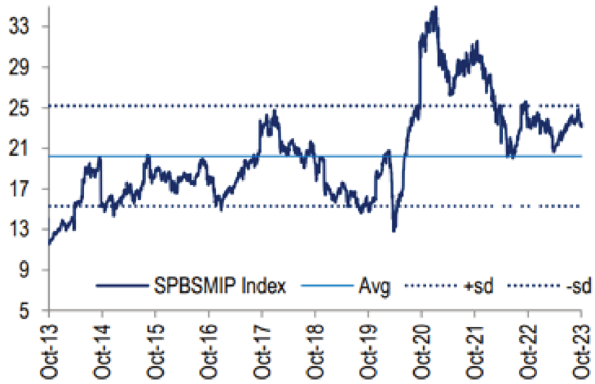
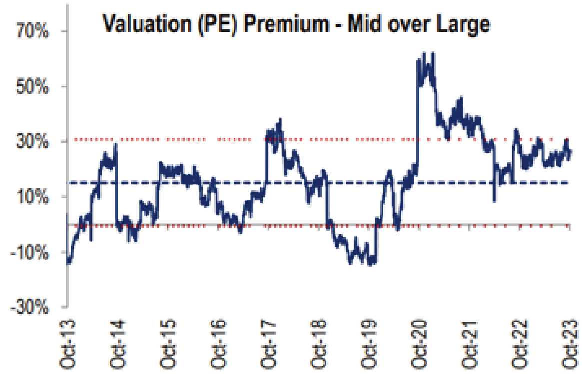
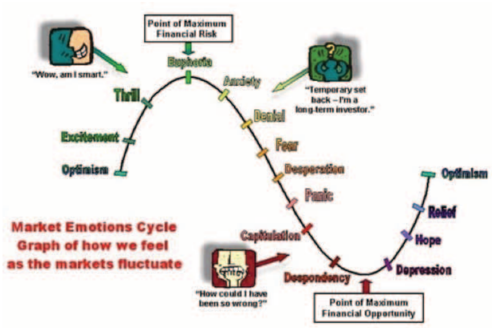


Figure 18. PE Valuation Premium: near highs barring brief post-covid period



Source: Citi Research, Bloomberg

Illiquid stocks also benefit during periods of flows on noise related to long term themes without paying attention to risk of high expectations and later disappointments. These are stocks part of India growth story. But the risk / concern here is valuations of majority of stocks are obnoxiously high and most of these companies have to see their earnings multiply several times over next 3 years to even justify their current valuation, forget about making returns. For example, EMS companies, all of them are trading at 100x FY23, even if anyone wants to make 50% return from these stocks in 3 years and with an exit multiple of say 30x (still a premium valuation to markets given growth can be higher for long time), the earnings of these stocks have to go up by 5x from current levels which translates to 3 years CAGR of 70%. The pendulum here has shifted from non-believers 4 years back to other extreme that India will be global hub of manufacturing. We want to believe that the spot is in between, so expect large disappointment in these lofty expectations. Capital goods companies too fall in this space – trading at hefty multiples on the hope of multiyear very high capex growth in India.



PSUs – in the mid cap segment PSUs have alone generated 33% of returns in last 1 year despite forming only 15% average weight. PSUs are benefitting from government's ability to spend on infrastructure, power, defense, railways, urban infra etc. As a country we still run large fiscal deficit and aggregate growth expectation of all these sub segment looks difficult to achieve. For example, Defense companies reacting to order flow and literally doubling in 2-3 months, but it takes 3-4 year to start and 10 years to complete these projects and importantly in case of some defense companies the existing project execution can peak in 2 years, so there is risk of fall in revenues 3 years down the line by the time new projects are announced and ordered. Pendulum her has swung to other extreme of reacting to order flows rather than earnings.

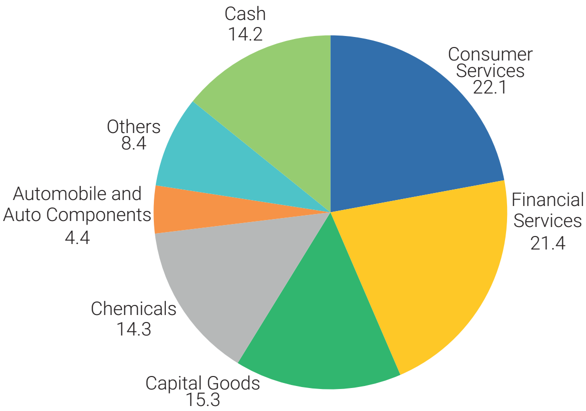
PSU banks are classic bucket of stocks which became mid cap because consistent underperformance in performance over a decade. But most of these companies re-rated in last 2 years due to lower NPA numbers and growth coming back. Pendulum here has swung to the point that investors are just looking to buy the cheapest PSU banks trading at lowest multiple without paying attention to sustainable profitability metrics, management capabilities, etc. But the key risk to PSUs is that they make very low ROA and they are already at peak profitability; 2 quarters down the line the profitability ratios will be under continuous pressure. Peak interest rate cycle and rate cut cycle subsequently can put pressure on margins. Low NPA cycle will reverse as recoveries normalise and lead to higher provisioning requirement. Private banks in this space will continue to gain market share from PSU banks in profitable segments, so weaker banks will continue to remain weak and fight for low profit wholesale loans, which will be repeat of last cycle. Today because of flows the discussions in banking space is all about which is the lowest P/BV stocks, and a lot of these <1.0x PBV stocks are there in mid cap space.

The four buckets mentioned above broadly cover majority of the mid cap segments. And we avoided most of these due to our poor experiences in previous cycles. In every cycle they show a lot of promise but deliver much less. While some things have changed, India will benefit in some of these segments like manufacturing, but current valuations are too high to justify the realistic growth possibilities.

We are therefore being very choosy in our mid cap and small cap stocks; we paid the price for that in last 1 year, but we expect the pendulum to swing back to neutral position once flows stop and a lot of the froth in valuations can get removed. We believe in investing in sustainable business cases in midcap space which benefit from long term themes but also available at right valuations with a 2-3 year view. However, markets are not in a mood to reward quality businesses available at slightly premium valuations. The flavour of the market is to buy the cheap stock with lot of buzz around it. Whether really the buzz turns true, no one cares because the stocks are doubling in 6 months' time. Money making is currently being viewed as easy, just invest based on news flows, high market flows supports such investors in short term. But when flows stop, the dance will stop.

Cycles keep repeating, and the saying people learn from history is not true. And the feeling that we are ready to pay high price because this time it is very different is what leads to bubble.

SECTOR ALLOCATION (%)

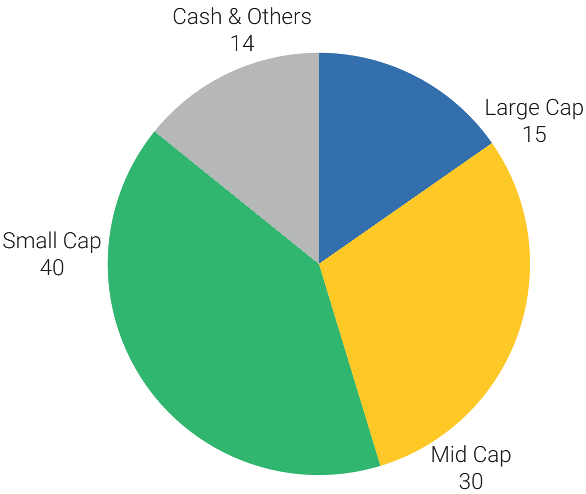


Note: Numbers may not add up due to rounding

WEIGHTED AVERAGE MARKET CAP

₹ 33,050 Cr

MARKET CAPITALIZATION (%)



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PERFORMANCE MEASURES – SINCE INCEPTION

Instruments	Strategy	Benchmark
Arithmetic Mean	16.8	12.9
Annualised Standard Deviation	14.9	16.3
Beta	0.8	-
Sharpe Ratio	0.6	0.4
Correlation	0.8	-
Alpha	5.3	-
Tracking Error	9.4	-
Up capture Ratio	102.1	-
Down capture Ratio	79.5	-

Performance Benchmarking

SEBI vide circular dated 16th December 2022 mentioned that Association of Portfolio Managers in India (APMI) shall prescribe a maximum of three benchmarks for each Strategy. Effective from 1st April 2023, the Portfolio Manager shall select one benchmark from those prescribed for that Strategy to enable the investor to evaluate relative performance of the Portfolio Managers. APMI vide communication dated 31st March 2023 prescribed the following benchmarks:

Strategy	Benchmark 1	Benchmark 2	Benchmark 3
Equity	Nifty 50	S&P BSE 500	MSEI SX 40

Among the options given, we had selected S&P BSE 500 which is a broad-based benchmark to our PMS strategies.

PORTFOLIO & STOCK PERFORMANCE

The portfolio has underperformed the benchmark by 4.9% during the month mainly attributed by Navin Fluorine which impacted the alpha by 1.5% (detailed explanation to the same attached below). Chemical names continue to be under pressure on the back of inventory de-stocking, and Chemplast was under pressure down 8%.as the PVC price fell further, which impacted the PVC VCM spreads. Berger Paints was down 5% on weak trends on demand in the upcoming season and constant pressure of heightened competitiveness from Grasim and rising crude oil prices. The e-com companies posted stellar returns in last month on the back of healthy growth trajectory in the last quarter, upcoming cricket world cup and festive season. Nykaa was up 15% while Zomato was up 7%. During the month, we have initiated position in REC Ltd. A big beneficiary of the rising trend toward renewable energy with over 50 GW per annum investments expected to be added from renewable energy and REC as an early cycle player would be the biggest beneficiary as source of funds. In addition, government efforts and initiatives to improve discoms balance sheet through schemes like LPS and RDSS has enabled REC to improve their sanctions and disbursement in last few quarters. Expect on the back of these 2 initiatives, the sanction book will grow at 20% for next 2 years and even disbursement will be strong. REC is also getting benefits of state led infra projects which is adding to the sanctions kitty. Has a healthy ROA structure of over 2% and leverage of 8-9x makes it a 19-20% ROE business. Still trades at less than 1 time book and has the potential to trade at a higher multiple with the growth in hand.

Navin Fluorine

Navin fluorine corrected sharply due to resignation of the MD of Navin fluorine and its one of our high conviction bets. The MD Mr. Radhesh was a key driver in the growth of the company over the last 5 years. The company hosted an investor conference call to address the top management attrition issues and to re-iterate the growth plans of the company.

Navin as a fluorine specialist and with its process engineering capability, is favoured by global players for outsourcing production of key ingredients in pharma, Agri and performance chemical space, and this capability is a process of many years of R&D. Company also benefits from the China plus 1 story, because fluorine chemistry is difficult and not many companies can offer at right cost. Capabilities stay with the company with focus on R&D, so company's ability to engage with large clients continues. Large capex program already announced will go on as per schedule, given there are CEOs for each of the segments. So, we see low risk to doubling of EBITDA call, by FY26 over FY23. Promoter along with Board are clear about bringing in a talent who continues with the growth aspirations of the company.

Navin is in a sweet spot with process engineering capabilities in fluorination space. Given the wide application of fluorine chemistry now and MNCs want a trusted partner for developing and manufacturing these ingredients, the opportunity size for growing ~20% CAGR over next 5 years, is quite possible. With a good balance sheet and capabilities, we think the transition should go on smoothly. We must stay invested and monitor the transition.

KEY FEATURES

- Bet on Sundaram's strength in the mid & small cap space; a **differentiated** yet **concentrated portfolio** positioned attractively along the cap curve.
- Multi-sector portfolio.
- Stocks with market cap less than Rs. 500 billion.
- "**EASE**" portfolio
  - i. **E**merging leaders – clean and high quality promoters / management.
  - ii. **A**sset light & High ROCE businesses are preferred.
  - iii. **S**calable companies: mid cap to large cap, small cap to mid cap transitioning companies.
  - iv. **E**xcellent cash conversion from operations.
- Identify stocks that are in early stages of their business cycle and could emerge as tomorrow's large caps.
- India 2025 - Themes
  - Financial inclusiveness
  - Phygital Bluechips
  - Consumption Czars
  - Export Voyagers

TOP HOLDINGS

Navin Fluorine International Ltd
Astral Limited
AU Small Finance Bank Ltd
Zomato Limited
Cummins India Ltd

KEY CONTRIBUTORS

Symbol Name	Unit Cost (₹)	Unit Price (₹)	Gain/Loss (%)
Westlife Development Ltd	428	935	118
AU Small Finance Bank Ltd	342	714	108
Berger Paints I Ltd	285	569	100

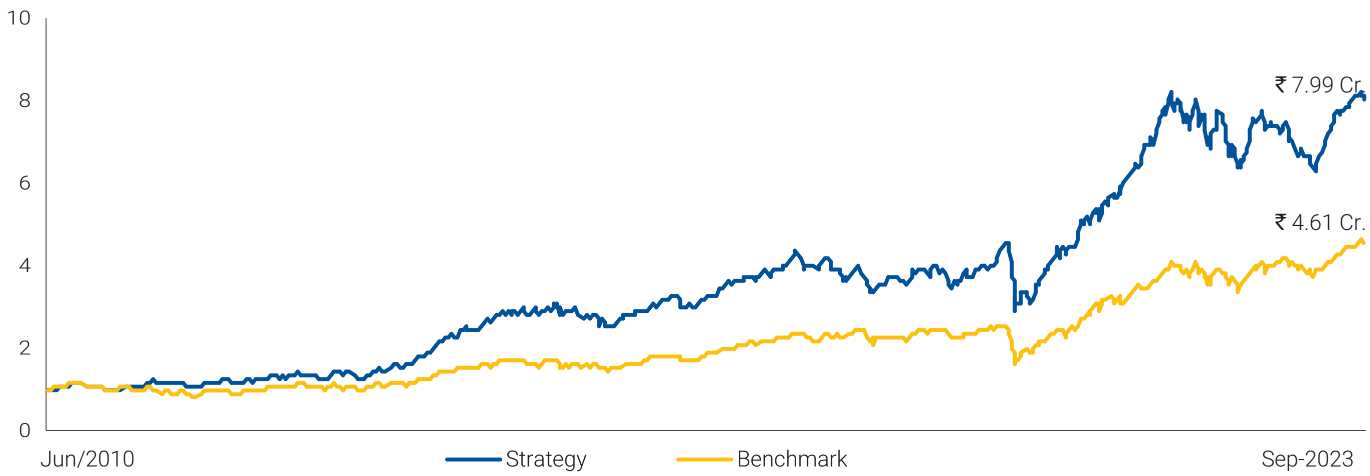
SECTOR BETS (%) – UNDERWEIGHT / OVERWEIGHT VS BENCHMARK

CALENDAR YEAR PERFORMANCE (%)

	Strategy	Benchmark	Excess return
2010	9.2	13.9	-4.7
2011	-2.9	-26.4	23.6
2012	28.7	33.4	-4.7
2013	18.3	4.9	13.4
2014	69.9	38.9	31.0
2015	3.4	0.4	3.0
2016	6.1	5.2	1.0
2017	41.8	37.6	4.2
2018	-11.6	-1.8	-9.8
2019	6.5	9.0	-2.4
2020	31.4	18.4	13.0
2021	46.3	31.6	14.7
2022	-6.8	4.8	-11.6
2023 YTD	10.8	12.6	-1.9

Source: Inhouse computation
Calendar Year Performance Since Inception June 2010

VALUE OF ₹ 1 CRORE INVESTED AT LAUNCH



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WHY SUNDARAM PMS

- Strong Track Record
- Low Churn
- Time Tested Stock Selection Process
- Reach Across Country
- Transparency
- Strict Adherence to Risk Guidelines
- Shared Research Capabilities

3Q QUALITY APPROACH TO STOCK SELECTION

- **Quality Business**
  Scalable, Growing, Reinvestment opportunities, Strong Moat
- **Quality Financials**
  High ROIC, Excellent Cash Flows, Low DE
- **Quality Management**
  Visionary, Problem solving

CUSTOMER SERVICES

Reporting Statements and Servicing: Monthly performance Statements Transactions, Holding & Corporate action reports, Annual CA certified Statement of the account & Online access

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DISCLAIMER

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