DSP MUTUAL FUND

JULY 2020

We often say, “Hindsight is 20 /20”. The not-so-obvious is always obvious in hindsight! This is especially true for investing. For most investors, it becomes crystal clear retrospectively, that a great time to invest would have been during large market corrections as in 1999 / 2008 / 2013, etc. However, looking into the future and predicting market outcomes, especially in the midst of a pandemic, is challenging to say the least.

20/20 in medical parlance actually refers to visual acuity (the sharpness of vision) and means the following:

- The first 20 is what the person being tested sees 20 feet away from him/her.
- The second 20 is what a person with normal vision should be able to see from 20 feet away.

In the current scenario, where visibility into the future of businesses is hazy at best, we utilize a similar assessment concept “Vision 20/20”. We assign the first number to ourselves, as analysts and fund managers and our level of visibility when assessing our portfolio companies. The second number goes to the ‘perfect’ market participant, but only in retrospect (of course!).

We employ 3 lenses when evaluating the future of our investee or potential investee businesses (and by extension, our funds):

1. **Vision 15/20** – high visibility on business model, industry landscape and customer trends
2. **Vision 10/20** – medium visibility on business model, industry landscape and customer trends
3. **Vision 5/20** – low visibility on business model, industry landscape and customer trend

Note that we do not have a Vision 20/20 lens as we believe we are in uncharted territory and unable to have 100% clarity regarding future trends.

The above lenses don't necessarily indicate better or worse investments from a stock investment point of view. Certain ideas in the high visibility bucket may be fully priced in, while the low visibility bucket may have opportunities that trade at discounts offering good upside once things normalize. Nevertheless, this categorization does offer interesting insights into the future of our investing landscape.

Vision 15/20 - High visibility	Vision 10/20 - Medium visibility	Vision 5/20 - Low visibility
• Personal Mobility • Shift to Online Buying • Healthcare & Hygiene • Insurance - medical, termlife • Affordable Housing • Data boom - Work from Home • Agriculture	• Protective gear (masks etc.) • Value Conscious Buying - i.e. some downtrading • Packed food consumption eg: biscuits, good quality cooking oil • Facility Management Services • Staples • Limited Use Hygiene Products	• Holidaying vs staycation • Shopping • Eating out • Business Process Outsourcing (BPO) • Outdoor recreation • Medical services - hospitals • Commercial real-estate • Luxury housing

Let's explore trends in each of these buckets:

- **Personal Mobility:** It is possible that people in mid-high income brackets would prefer to buy cars/2W instead of using Uber/Ola. The demand for second hand vehicles has picked up with a focus on low-budget, mass market vehicles. CarDekho and Carwale have reported improved customer traffic on their websites at about 99% and 90% of pre-Covid-19 levels, respectively. Spinny, a used car platform indicates that 60% of customers are 1st time Buyers. Zoomcar and Ford Smart Mobility, have seen their subscription business increase 4-5x from pre-Covid levels.

- **Shift to Online Buying:** Many shoppers experienced online buying for the first time during this pandemic. Big Basket reported ~1mn app downloads during the month of April. Even half of those convert there is a healthy rate of acceleration. PharmEasy saw a huge spike in demand for online healthcare and medicines. Jio has begun collaborating with local kirana shops to deliver goods pioneering the offline to online model.
- **Healthcare & Hygiene:** Export driven pharma companies are well positioned to leverage the 'Self Reliant India' theme - Divi's Lab, Syngene International, Biocon, Dr Reddy etc. Hand Hygiene products (Hand sanitizer/ hand wash) have seen ~10x jump in penetration levels High penetration categories (Soaps & detergents (>99%)) are likely to witness increased per capita consumption - Hindustan Unilever, Godrej Consumer Products Limited, ITC and Reckitt Benckiser are some names that are present in these segments.
- **Insurance - Medical and Term-Life:** Unavailability of social security, the high cost of healthcare and low penetration of protection policies in India may drive the demand for both medical and term-life insurance.
  - **Term life:** India has the highest protection gap (difference between the amount of insurance that is economically beneficial and the amount of coverage actually purchased) in the region at 92% and it has increased 4x in last 15 years[i].
  - **Medical:** Policy bazaar has seen the demand for health insurance increase by 40% during Covid times - An increase in both the number of policies and in the amount insured[ii].
- **Affordable Housing:** With Covid cases clustered in and around slums, the government is likely to focus on providing better living conditions to poor people. Affordable housing has been on the government's radar and the associated benefits such as tax deductions have been extended till March 2021 under the February 2020 budget. If the affordable housing sector picks up, then related sectors such building materials including cement and paints may also benefit.

- **Data Boom - Work from Home:** Now that both employees and employers have figured out how to make work from home productive, it is likely to continue in some way, shape or form. The rent seeking stories (REITs, Commercial Real Estate) could see disruptions. Would some people buy bigger homes, and farther away from city centres, to make space for their home-offices? The new work model also suggests an internet boom benefitting telecom players. It could also translate into increased consumption of ready to eat packaged foods categories (<5% penetration currently).
- **Agriculture's Big Moment?** As per the Centre of Monitoring Indian Economy (CMIE), over 122 million people lost jobs in April 2020. During the same time, the number of farmers increased during this period by ~5m[iii]. With lack of employment opportunities and changes in APMC laws (enabling farmers to sell produce at better prices), will migrant labourers prefer to stay back in their villages? There are political compulsions for skill mapping and providing livelihood –Gareeb Kalyan Rozgar Abhiyaan is working in pilot mode in six states

2) Vision 10/20 - Medium visibility bucket

- **Protective Gear:** While some apparel companies have started manufacturing masks including Aditya Birla Fashion & Retail, Wildcraft etc. we are uncertain whether this trend is sustainable or whether is it likely to fade away in a post Covid-world.
- **Value Conscious Buying:** During these difficult times of pay cuts and job losses, we expect mass brands to outperform premium brands. Signs of down-trading are already emerging. During 4th week of March to 1st week of June: detergent bars (premium down 16%, mass up 22%), hair wash (premium down 12%, mass grew 18%) and wheat flour (premium down 20%, while mass grew 4%)
- **Packaged Food Consumption (i.e. biscuits):** Parle-G recently reported their best month in eight decades[iv] - however, we would not want to extrapolate this growth into perpetuity.
- **Facility Management Services:** Offices/hospitals require more regular sanitization (cleaning of workstations, doorknobs, and washrooms, etc. more frequently) – we expect this to normalize in a post-Covid period.

- **Staples:** Though this category witnessed heavy buying due to initial hoarding, the long term growth path seems unchanged.
- **Limited-use Hygiene Products:** Given their limited use in daily life and premium positioning, other hygiene category (toothpaste, facewash, shampoo) trajectories do not show acceleration.

3) Vision 5/20 - Low visibility bucket

- **Holidaying vs Staycation:** Regular passenger flights may take a while to normalize due to the enclosed spaces and close proximity of passengers in an aircraft. This also affects fuel demand. Some part of the dip in business travel could be long lasting – which in turn affects hotels (that are typically built on high fixed cost models).
- **Shopping & Eating out:** People have stopped eating out, online deliveries were severely impacted and cloud kitchens have closed. The retail segment has also suffered. Both categories will take some time to get back on track. Regaining and winning customer trust by demonstrating that "new post Covid-19 norms" (social distancing /masks/hygiene) are being implemented prudently is crucial.
- **BPO Industry:** Customer data is sensitive and not every work from home setup is ready with VPN / secure line access – this is expected to normalize faster as the government has allowed offices to function with lesser staff.
- **Disruption of Multiplex Models):** One of the reasons that multiplex and movies have taken off in a big way in India is due to the lack of outdoor recreational opportunities. We have tested uncharted territory here - movies are getting released on OTT Platforms and PVR/Inox have expressed their displeasure. This reduces their bargaining power not just with film producers but also with shopping mall operators. (10-15% of mall footfalls come from multiplexes.)[v] Will mall footfalls also get affected due to this shift? Time will tell.
- **Medical Services (Hospital and Private Healthcare):** With State capping rates for both Covid and non-Covid beds,[vi] it could deter private investment in hospitals. While the government has announced expenditure rationalization, those relating to health, welfare, rural

development and agriculture are largely unaffected. State investment in health is a positive for the long run.

- **Defaults in Banking Space:** Banks are learning to deal with moratoriums and there are talks of restructuring assets - Previous restructuring experiences have not been good (RBI allowed banks to restructure assets post the Global Financial Crisis until 2015/2016), however, this resulted in a whole suite of non-performing assets. The responsibility of who (government / banks / shareholders / taxpayers) bears the brunt of defaults is still unclear.

Data sources: CLSA Research, Internal, as of July 2020

Summary and Investment Approach

How do we incorporate the above insights into our portfolios? Below is a snapshot of our funds, along with the proportion of their portfolios that feature in the various visibility buckets.

Visibility -->	High	Medium	Low	
Fund	**Vision 15/20**	**Vision 10/20**	**Vision 5/20**	**Cash**
DSP Equity Fund	44%	9%	44%	3%
DSP Equity Opportunities Fund	33%	18%	44%	5%
DSP Focus Fund	47%	12%	37%	4%
DSP Mid Cap Fund	45%	9%	37%	9%
DSP Small Cap Fund	36%	5%	50%	8%
DSP Tax Saver Fund	33%	20%	40%	7%
DSP Top 100 Fund	46%	14%	34%	6%

Source: Internal, Bloomberg, as of July 2020, kindly note that due to rounding off, numbers may not sum to 100

A significant portion of our portfolio weights are distributed between the High and Low Visibility buckets. This is not necessarily by design, as we are more focused on fundamental stock calls. To be fair, the down-move and subsequent up-move in the market have been so swift, that it hardly provided sufficient time for big changes. However, we are comfortable with the way our portfolios have a good balance, a barbell approach. About half the portfolio is comprised of businesses that are well positioned to take advantage of an eventually normalizing scenario, buttressed by companies with much better visibility today.

We believe that over a long-term investment horizon, and assuming a going concern, one or two years of a company's profits being impacted may not significantly adversely affect the discounted cash flow valuation. However, the investment horizon will be stretched as our investee companies weather the storm. We need to be patient. Here below is a snapshot of how our funds fare on two key metrics – leverage and return on equity:

Fund	Net Debt / EBITDA	Return on Equity
DSP Equity Fund	0.2x	23%
DSP Equity Opportunities Fund	1.1x	15%
DSP Focus Fund	1.5x	16%
DSP Mid Cap Fund	0.2x	18%
DSP Small Cap Fund	0.3x	19%
DSP Tax Saver Fund	0.9x	17%
DSP Top 100 Fund	2.1x	13%

Source: Internal, Bloomberg, on 21 July 2020, based on weight average portfolio holdings. Net debt / EBITDA computed after excluding financials companies as specified under GICS classification.

In line with the table above, we maintain:

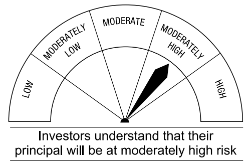
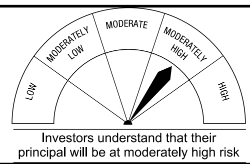
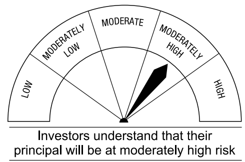
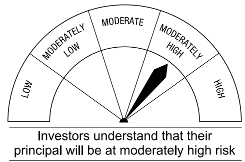
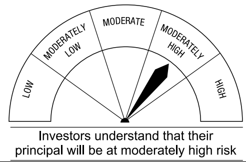
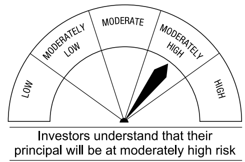
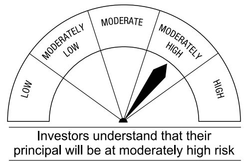
1. A preference for low leverage: Most of our portfolios are well placed in terms of leverage ratios (i.e. proportion of debt in their balance sheet relative to EBITDA or Equity). We believe low debt with high cash flow generation works well over the long-term and becomes all the more important in times of crisis as we are witnessing today. Companies overburdened with high debt or poor cash flow generation may find it

difficult to compete effectively in the current environment and may be forced to give away market share to competitors. Across our funds, as evident in the table above, we have been careful about this aspect and are quite comfortably placed in terms of debt and cash flows for our investee companies. In a few funds we have been moving out of the more leveraged companies into those with stronger balance sheets.

2. A preference for capital efficient businesses: We believe an important driver of wealth creation is the ability of a company to invest capital efficiently. This is well captured in the return on equity metric – and is at a comfortable level for our funds as seen in the table above.
3. Price / Value mismatch: As long term investors and fund managers we believe situations like the current one tend to create good opportunities in terms of price and value mismatch. As mentioned earlier, one or two years of profit erosion would not affect the long-term value of businesses, but only push the investment horizon a few years into the future. We are always on the lookout for such anomalies where short term disruptions lead to disproportionate price reaction creating attractive long term opportunities.
4. An eye on emerging trends: We are closely watching various trends as they emerge and acknowledge that the environment is uncertain and quite fluid. While businesses like retail and multiplexes seem to have lost favour today, a decisive cure for Covid might see these segments revive quickly. Hence viewing our portfolios from emerging trends and the aforementioned visibility buckets perspective are useful inputs.

The world is changing rapidly and radically. Most sectors will recover – some sooner and others later. While previous changes were more extraneous (technology, infrastructure etc.), this time around, the changes are shifting the very behaviour of consumers itself. We are excited yet watchful.

Product labeling:

DSP Equity Fund Multi Cap Fund- An open ended equity scheme investing across large cap, mid cap, small cap stocks	This Open Ended Scheme is suitable for investors who are seeking* • Long-term capital growth • Investment in equity and equity-related securities to form a diversified portfolio	
DSP Focus Fund An open ended equity scheme investing in maximum 30 stocks. The Scheme shall focus on multi cap stocks.	This Open Ended Equity Scheme is suitable for investors who are seeking* • Long-term capital growth with exposure limited to a maximum of 30 stocks from a multi cap investment universe • Investment in equity and equity-related securities to form a concentrated portfolio	
DSP Top 100 Equity Fund Large Cap Fund- An open ended equity scheme predominantly investing in large cap stocks	This Open Ended Scheme is suitable for investors who are seeking* • Long-term capital growth • Investment in equity and equity-related securities predominantly of large cap companies	
DSP Mid Cap Fund Mid Cap Fund- An open ended equity scheme predominantly investing in mid cap stocks	This Open Ended Equity Scheme is suitable for investors who are seeking* • Long-term capital growth • Investment in equity and equity-related securities predominantly of midcap companies	
DSP Small Cap Fund Small Cap Fund- An open ended equity scheme predominantly investing in small cap stocks	This Open Ended Equity Scheme is suitable for investors who are seeking* • Long-term capital growth • Investment in equity and equity-related securities predominantly of small cap companies (beyond top 250 companies by market capitalization)	
DSP Equity Opportunities Fund Large & Mid Cap Fund- An open ended equity scheme investing in both large cap and mid cap stocks	This Open Ended Scheme is suitable for investors who are seeking* • Long-term capital growth • Investment in equity and equity-related securities predominantly of large and midcap companies	
DSP Tax Saver Fund An open ended equity linked saving scheme with a statutory lock in of 3 years and tax benefit	This Open Ended Equity Linked Saving Scheme is suitable for investors who are seeking* • Long-term capital growth with a three-year lock-in • Investment in equity and equity-related securities to form a diversified portfolio	

***Investors should consult their financial/tax advisors if in doubt about whether the product is suitable for them.**

[i] https://brandsite-static.hdfclife.com/media/documents/apps/HDFC%20Life%20Presentation%20-%2012M%20FY20%20(Final).pdf

[ii] https://www.livemint.com/money/personal-finance/covid-19-health-and-term-insurance-covers-gain-traction-11590922374124.html

[iii] https://www.thehindu.com/data/data-over-12-crore-indians-lost-their-jobs-during-the-coronavirus-lockdown-in-april/article31520715.ece

[iv] https://zeenews.india.com/companies/parle-g-records-its-best-ever-sales-in-its-8-decades-during-covid-19-lockdown-2289041.html

[v] https://economictimes.indiatimes.com/industry/services/retail/covid-19-impact-at-malls-the-last-to-recover-will-be-cinemas-and-eateries-post-lockdown/articleshow/75276266.cms?from=mdr

[vi] https://thewire.in/health/delhi-govt-to-subsidise-beds-procure-oxygen-tanks-for-covid-19-patients-in-private-hospitals