Resilience and relevance in a challenging world

It is the nature of business that in even the best-run companies unexpected difficulties, profit squeezes, and unfavourable shifts in demand for their products will at times occur.

-Philip Fisher

The pandemic is continuing to rage across the globe and occupy significant investor mindshare. Apart from being a healthcare emergency, it has led to a global economic distress with sharp rise in bankruptcies and unemployment pressures. While we would like to believe that the world is gaining better understanding of the pandemic, the fact remains that it is still evolving. Hence, predicting the economic effects of the lockdown remains near impossible, also because there is no paradigm for the same. Importantly, economic outcomes are always non-linear and emergent which essentially means they are unpredictable even if the same inputs are applied.

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We read a lot of economists predicting various shapes of recovery (V-shaped, U-shaped or L-shaped) with each of these strongly argued for as well as against. Determining which one will eventually pan is becoming increasing difficult. While consumer sentiment, businesses and eventually the society, will sooner or later adjust, adopt, and evolve along with new normal, understanding of the “new normal” is important. We cannot build an investment stance based on just one version of the hypothesis. Hence, we look for more…

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We refrain from talking about the worldwide stats of Covid-19, progress on medical solutions (cure or a vaccine), cautious and gradual opening up of a few countries, for two simple reasons – 1) this is secondary knowledge; and 2) need for stronger insights and basis to act on our portfolio which these do not provide. Consequently, we prefer deep diving into the domestic context.

Macro remains a dominant theme, more effective in understanding the risk. While portfolio construction typically should be bottoms-up and business specific, it is important to carve out factors that will never lose importance while investing. Companies following a disciplined and focused approach in their businesses tend to tide through crisis in a much better manner.

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These are unprecedented times and the degree of uncertainty is high. We may not have answers to a lot of questions, however, as stated above, adjustments, adoption and evolution will be the new normal. Path dependency of the progress is important as there could be either permanent changes in business models, or new dimensions getting added to existing ones or in some cases becoming totally irrelevant. This transition phase will test the endurance and flexibility of almost each individual entity.

While currently it is difficult to think that things are any good, as money managers, a part of us remain optimistic and expect the cessation of bad news while embracing better news in the distant future.

Clearly the world of future will be a different one from the world we knew, therefore the question to be asked is - is there a playbook to remain relevant in future? is there a way to be future agnostic?

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We cannot predict the depth and duration of stock market volatility, hence instead of focusing on the short-term impact/events, two aspects will remain important:

1. Which businesses will be able to survive this crisis? Will they remain relevant and adopt to the new normal in the medium-long-term; Can they come out stronger and take advantage of the situation?
2. Which are the businesses which can further strengthen their competitive positioning and hence lead the consolidation of market share?

Narrowing of the investment landscape will continue and winners can emerge from unexpected corners. The disruptors / survivors will clearly get separated from the disrupted.

Source: Bloomberg, Sector returns based on Bloomberg industry classification Feb 12 – May 25, 2020. On Feb 12, 2020 NSE 100 TRI closed at an all-time high.

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Risk management is a key metric while taking investment decisions, and hence essentially avoid companies which

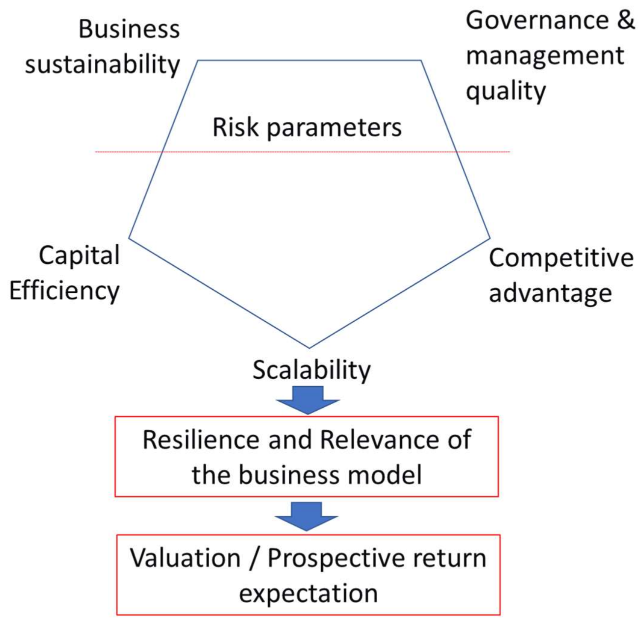
a) lack the flexibility in their business model to adopt to changes; or

b) are distinctly at the receiving end of this change, or

c) lack the resilience to withstand the period of pain

and consequently, could result into permanent loss of capital. This, in our opinion is a vital step

Framework with resilience and relevance



Source: LIC Mutual Fund

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Covid-19 will undoubtedly change many aspects of businesses; thus, resilience and relevance of the business have gained further importance. While we remain fairly convinced about our investment framework, it becomes pertinent to question which business models, managers, strategies will hold on and which ones will be negatively impacted. There are 'segment and category specific' questions which need to be considered. The result would be a mix of opportunities as well as risks to the fore.

We look at the broader segments impacting decisions, before moving to end consumer specific areas:

Investments and policy measures: With the Government's focus towards providing stimulus and support for Covid-19, public infrastructure spending may remain under pressure for the near to medium term, given the strain on government financials. Having said this, India has laid out ambitious monetary measures and reforms to deal with the pandemic as well as to be a self-reliant country. The reforms, coupled with corporate tax cuts in Sep-19 would aid the competitiveness of Indian businesses globally and could prove to be a step in the right direction which partly

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addresses some of the issues (land, labour, regulatory approvals, resources, etc) plaguing investments in India.

Global cyclicals: The plummeting crude oil prices and commodity crunch will lead to consolidation in the industry. Highly leveraged businesses will be severely impacted. Furthermore, demand deterioration will result in deterioration in capital efficiency

End consumer specific:

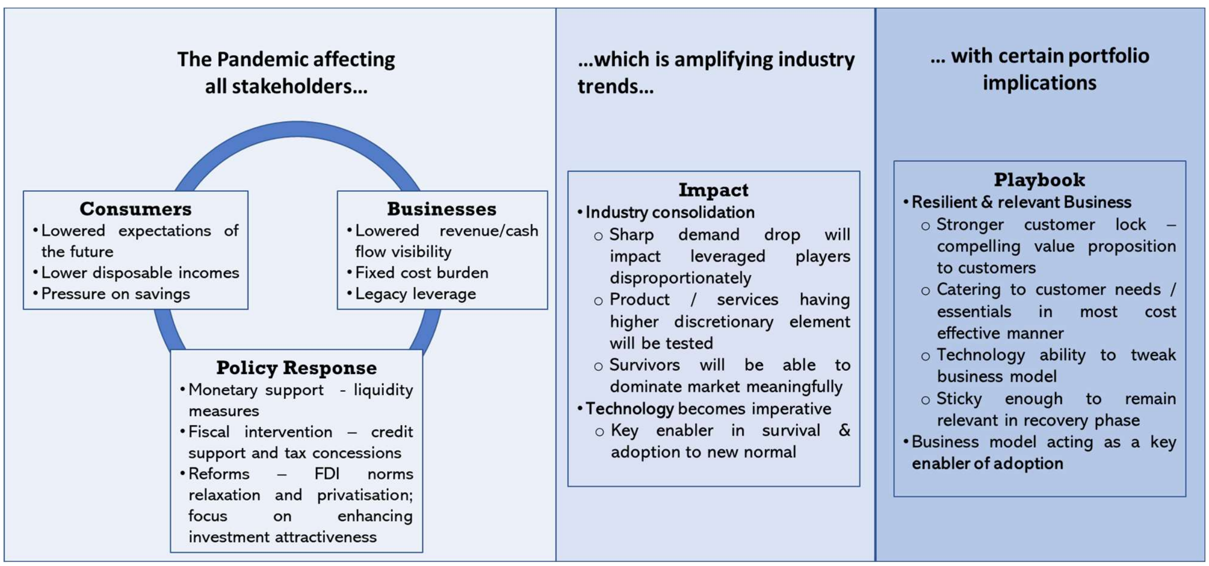
- **High end discretionary demand:** While the upper end of the economic class will be somewhat less impacted, but they are not immune from the slowdown. Will aspirational categories (ACs/white goods/personal accessories) face bigger challenges while higher ticket discretionary (Passenger Vehicles / Jewellery etc) could see gradual recovery post easing of the lockdown?
- **Needs will overshadow wants.** Impulse buying could take a hit. Demand for defensive businesses focused on essentials will likely remain, however, they will have to reconfigure their business models/products to accommodate lower ticket sizes. More interesting debate is about some of the aspirational categories becoming essentials.
- **Faster adoption of online and increasing traction of artificial intelligence** to drive sharp and focused brand positioning; managing the supply chain efficiently becomes imperative.
- **New product launches** in existing/niche categories **might take a backseat**, however the same in health, hygiene and nutrition will be increasingly focused as health awareness picks up.
- **Re-organisation of supply chains**, manufacturing processes, office infrastructure, etc could change in a few industries.

These are just some of the many changes that could emerge in the "new normal" and the list can go longer as

Industry consolidation and technology adoption are the trends which clearly get amplified.

each of the product / service is taken up. Nevertheless, there remains a risk that something which has gained a lot importance in the short period might not be relevant once the recovery starts happening, which typically means - the risk of extrapolating current to the distant future.

Having thought through this, two trends get amplified: (a) industry consolidation; and (b) technology adoption. Businesses winning in both these trends should be the ones to look out for. Within industries, we place our bet on the defensiveness of the business model rather than the discretionary nature of demand. **We prefer to focus on existing leaders who are likely to disrupt / innovate in their businesses to ensure that their leadership/competitive advantage remain strong.**



Source: LIC Mutual Fund

It is prudent to be conservative about future expectations, which leads to sharper portfolio positioning. We believe this helps us in building a portfolio with resilient and flexible businesses. If on the flip side, we get proven to be exceedingly conservative, we should be happy as these companies which did well in a conservative scenario will do better than expected in an optimistic scenario.

It’s best to test resilience and relevance of the business models along with adaptability of the same in a “new normal”.

Macro trends are going to be very important as well as highly unpredictable. Hence, we treat macro aspects as risk factors while building a portfolio. Against this backdrop, it’s best to test resilience and relevance of the business models along with adaptability of the same in a “new normal”.

Final and the most important takeaway - **Value creation imperatives in investments viz high standards of governance, high capital efficiency strong moats, and sustainable growth are unlikely to change.**

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