Honesty and Integrity Investment (HNI Investment)

Email for June 2018

Dear Friends,

Here are the details of performance of HNI investment based on the share prices as on 30th June 2018

Annualised Returns (IRR) (1) (2) (3) (4)	HNI Portfolio	Nifty	Sensex
FY13	-10.6%	-5.3%	-3.7%
FY14	112.2%	21.1%	21.3%
FY15	21.6%	25.0%	23.0%
FY16	86.0%	-7.0%	-7.7%
FY17	168.3%	21.9%	20.1%
FY18	***66.4%***	***17.0%***	***18.8%***
Q1FY19	***-45.4%***	***11.4%***	***19.6%***
From Inception till 31st March 2018	**84.0%**	**12.8%**	**12.1%**
From Inception till 30th June 2018	***81.8%***	***12.8%***	***12.5%***

(1) For all HNI clients and promoters (2) Inception was in August 2012 (3) Gross IRRs excluding the impact of HNI investment fees (4) Return during the quarter is reported only when it's adverse i.e. negative or lower than Sensex/Nifty. Quarterly IRRs looks overblown due to compounding effects of short periods

Portfolio value for the stocks we had at start of the quarter is down by 13% while the stock that we bought in June is down by 1.3% from our average purchase price. But as I have always indicated to you, what actually matters is long term performance and its sustainability.

Fortunately, we were able to find a new investment opportunity during the quarter and we have put some money to use. I really do not know what actual returns we will make on this stock but there is more than reasonable probability of protecting our capital over 5 years. In the interim anything can happen. We cannot control it. What's more encouraging is that after a long period, valuations in the couple of stocks which are in our watch list are slowly coming closer to warrant more actions. We might add more stocks to our portfolio soon but nothing can be said for sure as of now. Let's see how it goes. But the probability has improved for sure.

Who moved my book value?

I will now take out one more weapon from my arsenal to oppose the analysts who believe that markets are undervalued or fairly valued. These days people have at least stopped using an argument of price to earning (PE) ratio to prove their point, simply because they cannot. LTM PE of Nifty 50 is around 26x and it's hard to justify with earnings growth when we are seeing a rise in local and global interest rates.

So analysts have now diverted their attention to another metric, price to book (PB) Ratio. Nifty PB currently is around 3.5x which is only slightly more than its historical 10-15 years average. So they argue, markets are undervalued or fairly valued. We can argue a lot regarding relevance of this metric but let that be for some other day. Today I will just focus on anomalies in numbers largely ignored by market participants.

I would like you to focus just on changes happened during a short period of mid July 2016 to mid November 2016. Here you go.

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	July 2016	Nov 2016	Growth
Nifty Values	8200	9200	12.2%
PB Multiples	3.5	3.0	-13.3%
Implied Book Value per share	2370	3067	29.5%

Please note that during this short period of 3-4 months, markets have risen by 12.2% but PB multiples have contracted by 13.3%, implying a marvellous growth in book value per share by around 30%.

Now book value per share can grow only by three means. First by capital raised net of buybacks. However capital raised net of buybacks were not substantial during this period to have such a large impact. Secondly book value can also grow due to profits. However 30% rise in book value in a quarter due to profits will mean an annualized rate of profit (ROE) of 186% while actually nifty firms make an ROE of around 14%-17%. So even this do not fully explain a 30% rise in book value per share during the period. Third it can also grow by changes in the composition of index. The impact of this change cannot be properly estimated. But again it cannot be that substantial. However for sure a part of this 30% rise will be explained by these three factors put together. I am not sure how much but it's unlikely to be more than 10% given the window of only one quarter.

What then explains the substantial portion of this rise in book values resulting in depressed PB multiples? ***Answer is an accounting change.*** The balance sheets of Indian companies shifted to IND-AS accounting system from April 2016. This was reported in quarterly results starting from June 2016 quarter. This shift resulted in many changes in the way various assets and liabilities are accounted in books. The net effect of most of the positives and negative changes (like investments, income tax and dividend etc) had a very low impact on the book value. However one change, moved the book value like never before.

At the time of this switch over, an option was given to corporates to revalue their assets at fair market value. All assets on a net basis were revalued upwards sharply by corporate India. We all know how easily one can procure a valuation certificate from an "independent valuer" whose fee is paid by the company whose assets are being revalued. This changed it all in one stroke and gave fillip to book value per share.

But it was not enough for corporate India. You might be thinking that if assets are revalued upwards, the higher depreciation on revalued amount should depress the future reported earnings. So why would a corporate do that? Yep, you are right but here is the secret. *Out of land, building and machinery, no depreciation is provided on land, it being a perpetual asset*. *This land was valued upwards sharply. While plant and machinery on which depreciation has to be provided was valued downwards*. However upwards land revaluation far exceeds downward revaluation of plant and machinery resulting in higher book value. Moreover the downward revaluation of plant and machinery led to lower depreciation charge in subsequent quarters giving a boost to reported profits.

Hence corporate India has used this accounting shift to its advantage massively. *Now you have financial statements which have higher book value, higher profits and lower leverage (debt/equity ratio) than would have been otherwise*. It's a noisy world out there.

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You might be thinking ohh my god how I am supposed to know all this before investing in equities. Well.. that’s why you need intelligent advisors like me. Call me on +91 8130431222 ☺ Just joking.

That’s it from my side. Happy to answer any questions that you might have on the investment performance.