GREEN
LANTERN
CAPITAL
LLP

“The most interesting year of my life… is it over or has it just begun!!”

Dear Investors,

Year 2020, has been a very tumultuous year and while we are glad that it’s over, at the same time a significant amount of wealth has been created over the period. We've also got a glimpse of how resourceful humanity can be when it is restricted. It usually is **“New Year, New Me,”** but this year, it turned out to be **“Tough Year and an even Tougher Me.”** We believe that 2021, with COVID vaccines just around the corner and significant amount of liquidity sloshing around, to be an even bigger year for investors. Looking at the developments of the last quarters of 2020, we are reasonably sure and can confidently wish you all a very happy and prosperous new year 2021.

This is that time of the year, when we look back at the year gone by, what we had done and how we fared, as well as look forward to understand how the evolving economic conditions are and make a prognosis as to how the coming year would pan out.

Looking back at the year gone by, it has been among the most volatile periods in the history of global financial markets with Indian equity markets falling vertically by more than 35% on average, in a short span of time. Economies the world over, moved from tepid growth to complete lockdown to gradual and cautious getting back to business. Excessive pessimism and very low affinity for risk led to market valuations correcting significantly to decadal lows. Many large, big, well known and high-quality companies and businesses were available at prices last seen more than 10 years back. The valuations and volatility Index (VIX) showed that most of the negatives had got more than discounted.

This was followed by gradual opening up of the economy and economic activity since has gradually started picking up. Various indicators of economic activity like fuel demand, auto sales, railway freight, e-way bills, GST collection, manufacturing PMIs indicated that economic activity gradually revived. This led to swift bounce-back in the equity markets recovering 50% from the bottom and scale back to the pre-covid levels and eventually surpassing those as well.

We had been communicating with all of you through our newsletters and presentations about a “once in a decade” opportunity for serious wealth creation. However, with the sharp bounce back in equities, valuations in frontline stocks and companies now appear rich and are factoring in a much sharper and swifter economic recovery and growth going forward!!

Fund positioning and performance in CY2020

To start with we want to share with all of you, the investment approach and the excellent performance of your funds in these challenging times. Over this period of heightened volatility and uncertainty, your funds were actively allocated across market cap and sectors depending on the value offered and favourable risk-reward equation.

- The portfolio in the initial phase was skewed more towards large cap and quality mid-cap stocks, making eminent sense from risk-reward perspective. We found deep value in large companies which were trading at attractive valuations and the valuation gap between large caps and mid-caps had narrowed down significantly. Also, large companies have strong balance sheets, good management quality, time tested systems and processes and well established and strong brands. These businesses tend to do well in uncertain business and economic environment.

- Sector exposure was also actively allocated towards defensive IT companies initially followed by allocation towards BFSI and metals based on the outlook and value available. The same has benefitted your funds immensely. We have now increased cash levels in the funds slightly, as well as maintaining exposure in BFSI and sectors and stocks that continue to offer value.

- As the risk perception went down and valuation of large caps became rich, portfolio composition was gradually re-oriented and value was sought in largish mid cap and small cap segment which had underperformed large caps substantially since Dec’17, and continued to offer lot of value. We continue to maintain exposure in bottom up mid and small cap companies that continue to offer value and good growth visibility.

We are extremely happy and proud to report that the above mentioned investment approach of focus on high quality companies with high margin of safety, even during the peak drawdown of the market your funds in Green Lantern Capital Alpha Fund outperformed the market by a wide margin.

It was very heartening to see that during market recovery also, your funds moved up sharply and more than recovered the worst drawdown, substantially outperformed the benchmarks and delivered outstanding returns to our investors over the period.

CY2021: A multiyear economic growth cycle in the making!!

Looking forward at the economic conditions, we believe 2021 to be better and a multiyear economic growth cycle to start taking shape during the year.

Global economy went through a massive shock last year, GDP shrank and massive fiscal and monetary stimulus was infused. The economies technically went into recession and have been gradually reviving since then. The big question facing us all now is whether **“It's a Recovery or Normalisation?”**

Kapil Gupta of Edelweiss Securities in his recent note "2021: A two track recovery" aptly addresses this conundrum. Achieving pre-covid output levels is normalisation while regaining the pre-covid output path would mean full recovery. We believe that, the current economic bounce is more of a normalisation driven by supply chains normalising, restocking, shift from unorganised to organised (which is just mkt share shift) and govt. spending which will all fade away. Any economic recovery in a cycle always takes time and is uneven and patchy. We believe that while economic cycle to unfold will take some time, there are pockets of opportunity in the near term that look interesting.

One of the important means to understand global economic dynamics is to understand global leverage cycles which determine economic outcomes.

- **2000-2010s:** The period saw increased leverage driving reflation in the Developed Markets (DM) leading to strong DM demand and higher trade deficits, which in turn led to external demand driven Emerging Market (EM) surpluses and growth. Strong performance in EM assets like currencies, Bonds and Equities followed.
- **2010-2020s:** period was marred by DM deleveraging post the Great Financial Crisis (GFC), leading to weak demand and narrowing trade deficits which meant weak external demand and shrinking trade surpluses for EMs and hence lower growth. The EM assets sharply underperformed, currencies depreciated, Bonds fell and equities did poorly. Essentially leading to a lost decade.
- **2020 - :** period is again witnessing significant leverage and spending in the developed markets post-covid. This should again lead to increased demand in the DMs, rising trade deficits leading to export driven growth and trade surpluses in the emerging markets. The outcome of this would again be outperformance of EM assets.

This has multifold implications for the global and Indian economy: 1) Increased demand for export of goods leading to export driven growth for the Indian economy (in 2005-2008 period exports grew 25% CAGR leading to sustained GDP and corporate earnings growth). 2) Increased global demand and surplus liquidity also leads to significant increase in commodity prices, which again is good for corporate earnings and capital expenditure. 3) Increased capital flows into the country, which keeps currency also stable to appreciating. This environment is extremely favourable for sustained period of significant wealth creation in equity markets.

At the same time in the domestic economy a virtuous cycle of its own is unfolding, which should also contribute to domestic demand revival in pockets and contribute to faster GDP growth. As per spark capital:

1. $100 bn of forex reserve accretion over the last 3 qrtrs, has led to high liquidity in the system, all time low interest rates which boosts demand with a lag and should mean good 2021.
2. High soft commodity prices, increased rural spends by govt., higher gold prices leading to wealth effect in rural India mean that rural demand should continue to remain strong in the near future.
3. Consolidation in the industry from unorganised to organised and massive cost cutting by corporates during the pandemic period set the stage for significant operating leverage and much faster earnings growth for listed companies.
4. Higher global commodity prices is also very good for Indian banking system due to higher credit growth, better credit behaviour, NPA recoveries and also higher investments by companies, with a lag.
5. Real estate adjustment maybe at the fag end of the cycle, with weak prices over the last 7-10 yrs, steady growth in disposable income and all time low gap between home loan rates and rental yields. Affordability has gone up quite substantially.
6. Last but not the least, Production Linked Incentive (PLI) scheme announced by the govt. for different sectors with time bound implementation schedule, would further help in capitalising on emerging global trends (China + strategy, increased DM demand) and lead to investment and growth in the economy.

In conclusion, the Indian corporate profits to GDP has fallen to the lowest in 20 years from a high of 7.8% in FY08 to 1.8% in FY20. We believe that a confluence of both emerging global as well as domestic factors should drive a virtuous cycle of economic growth in the Indian economy, drive sustainable earnings growth for companies and in turn very good stock market returns for investors over the next few years.

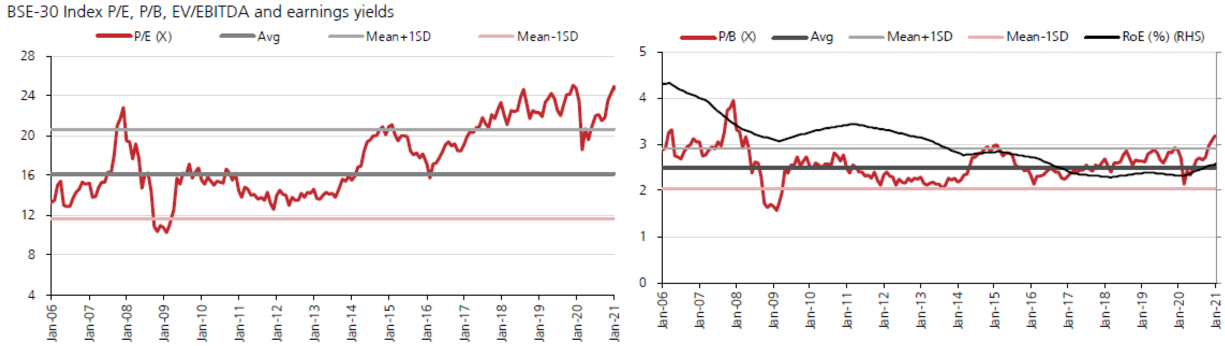
Risks and Challenges:

A very sharp rise in global inflation leading to sharp rise in global real rates would be a risk which we would be monitoring very closely. From domestic perspective, a very sharp rise in crude prices, significantly above $75/bl would again be a risk to be watched out for.

Outlook and recommendation:

Markets having moved up sharply, many of the frontline companies and stocks appear rich in valuation. Many of the sectors that were offering value few quarters back are now fair to richly valued. Mkt cap to GDP has also moved back from a low of 56% to 98% now, which is near its peak levels.

BSE-30 Index P/E, P/B, EV/EBITDA and earnings yields



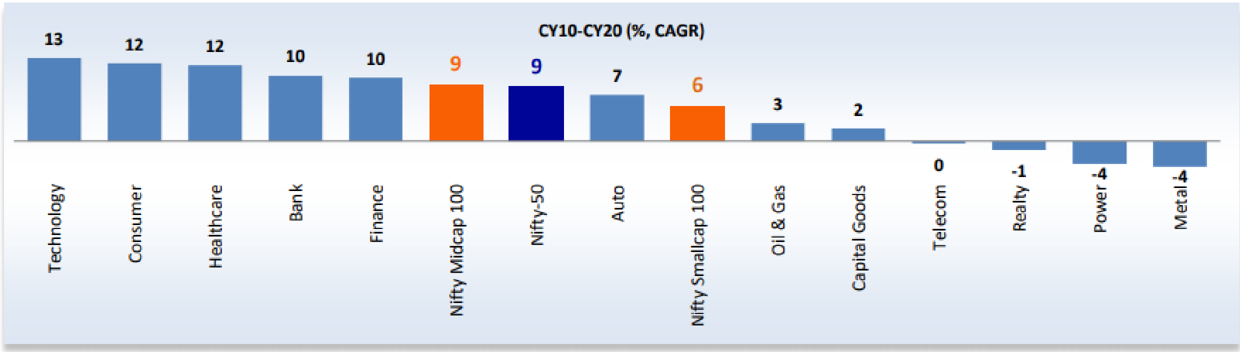
Source: Kotak Institutional Equities

However, any economic revival is typically preceded by expansion in valuation (PE) followed by earning growth catching up over time. Since, a corporate profit growth cycle is upon us, any market correction should be used as an opportunity to increase allocation in equities. We believe that, despite recent upmove, domestic and global cyclical companies offer the most attractive investment opportunity as the recovery unfolds. Bottom up stock picking in mid and small cap segment also presents interesting value hunting opportunities.

1. BFSI: A cyclical economic recovery benefits banks the most, faster credit growth, margin expansion, fee incomes, lower credit cost and recoveries from NPAs drive faster earning growth and stock price performance. Over the last decade banks have delivered meagre returns and with sharp growth expansion present good investment opportunities in corporate banking space on any declines.

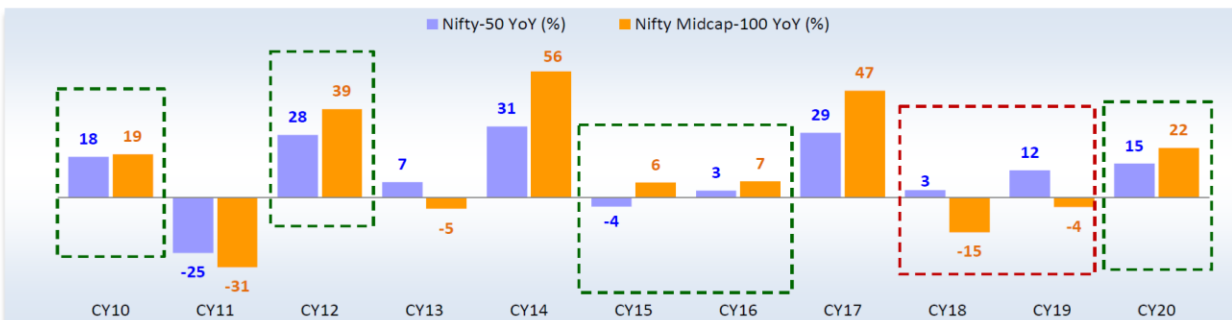
2. Commodities: Huge amount of liquidity sloshing around the world, coupled with DM leverage cycle driving global cyclical recovery continues to present interesting opportunity in the commodity space. Despite the recent sharp upmove, commodities, have significantly underperformed over the past decade and present huge opportunity.

Sectoral performance over the decade (%, CAGR)



3. Mid/small cap space: A cyclical recovery drives faster earning growth in the mid and small cap space and despite the recent upmove, we believe that valuations remain reasonable in the space, and there are quite a few good quality companies to be picked up and create value.

After underperforming in the last two years, mid-caps bounced back in CY20



Source: Motilal Oswal Research

In the end to conclude, while equity markets appear rich in the short term, we are at the cusp of a sustained corporate profit growth revival driven by both global and domestic factors. Even fear of Covid-19 is also now behind us with the arrival of vaccines, thus any market correction driven by volatility presents a great buying opportunity.