

On Public Sector Shares

Dear Investor,

In the last 5-6 years or so in the Indian stock market, if there is one category of stocks that have been hated more than any other, it is the category of Public sector shares, or PSU shares. I have personally listened to comments ranging from mere irritation, to vitriolic hatred when it comes to discussing PSU shares.

Is this justified? Are there no PSU companies that are competitive and efficiently run? And is it right to paint the entire sector with the same brush when a few of them are run inefficiently?

First, let us look at the performance of PSU shares in the stock market.

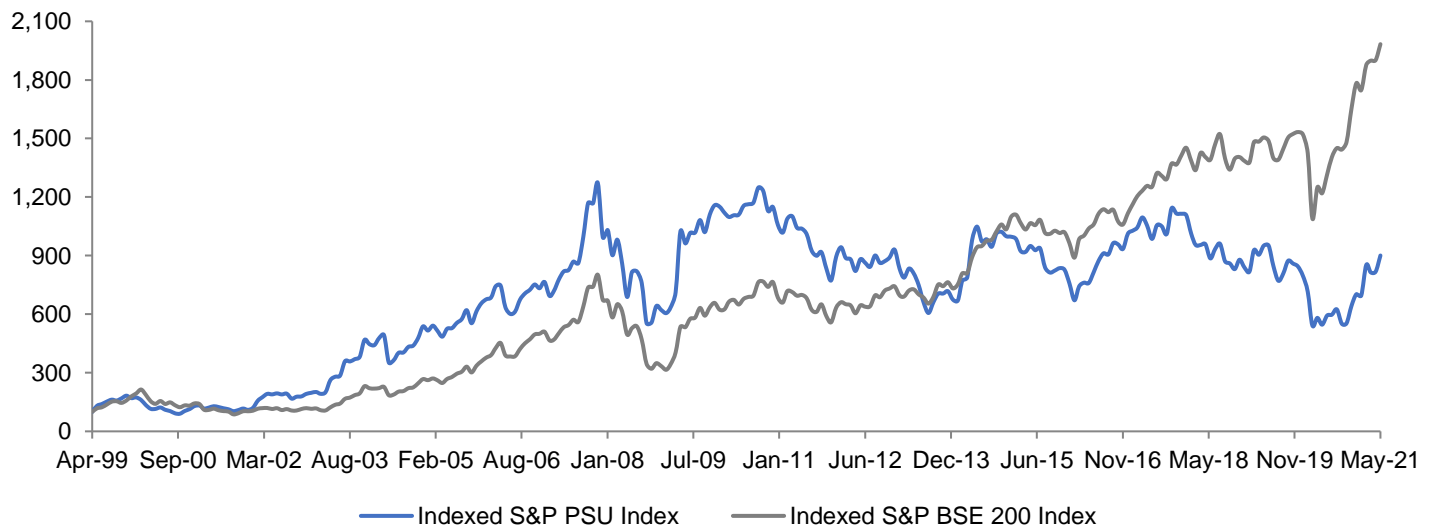
For this, we have chosen 4 time periods:

- (a) 1999-2021 (Long term performance)
- (b) 1999-2011 (Period when PSU shares did well)
- (c) 2011-2020 (Period when PSU shares did terribly)
- (d) 2020-2021 (Last year, when PSU shares are slowly regaining their acceptance levels)

For the purpose of study and comparison, we have chosen the universe of the S&P BSE PSU Index, and the S&P BSE 200 Index. The former consists of only PSU shares, while the latter is a standard benchmark large and mid-cap index. In our opinion, the comparison is valid because the PSU index is also a large-and mid cap index.

Stock market performance of the two indices between 1999 and 2021

Long-term chart - Comparative movement of the BSE PSU Index and the BSE 200 Index (1999-2021)



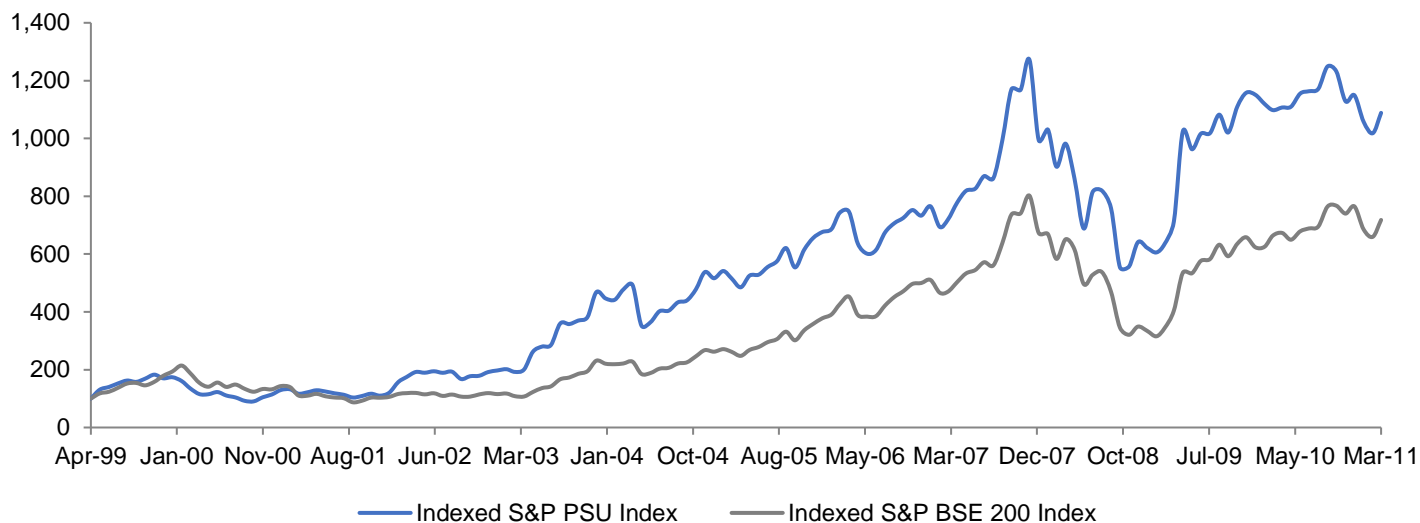
Data source: ACE Equity.

For the 22-year period from 1999-2021, the S&P BSE PSU Index has given a compounded annual growth rate (CAGR) of 10.42%, while the S&P BSE 200 Index has given a CAGR return of 14.43%. This is a significant underperformance for the PSU Index.

The data, however, gets very interesting when you see them in different time periods.

Performance between 1999-2011

The PSU Index did very well between 1999-2011



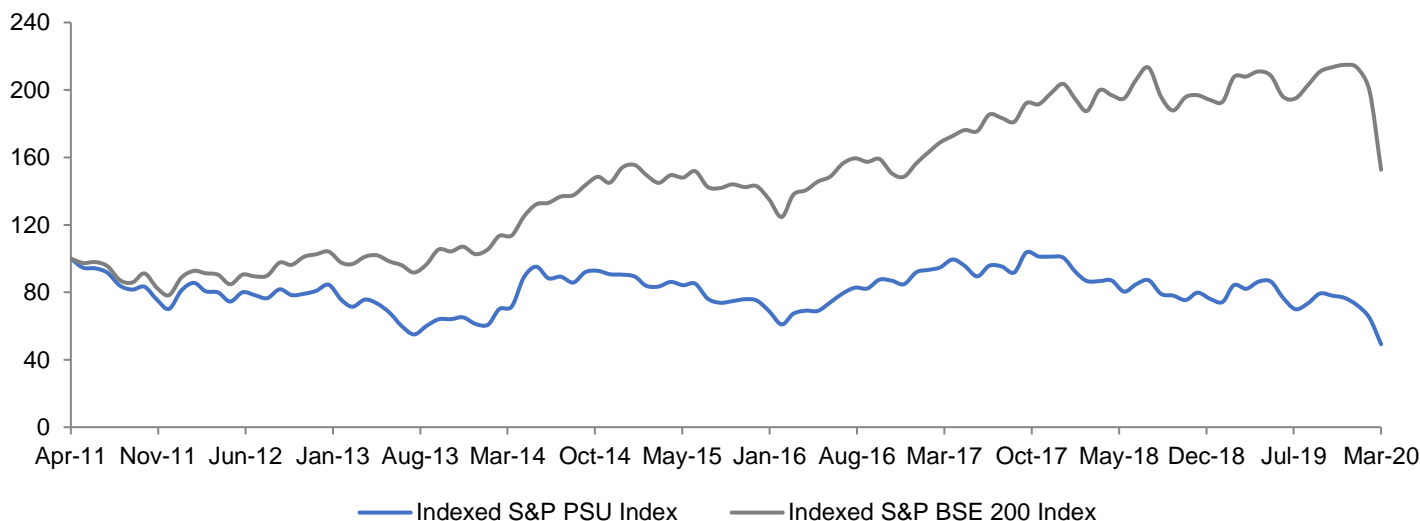
Data source: ACE Equity.

Please note that from 1999 and until 2011, the PSU Index did better than the BSE 200 Index. For the 12-year period April 1999 – March 2011, the S&P BSE PSU Index gave a compounded annual growth rate (CAGR) of 22.01%. During the same period, the S&P BSE 200 index gave a return of 17.85%.

The period after 2011 and until 2020 was probably the worst period for PSU stocks. Please take a look at the chart below (for the period April 2014 to May 2021).

The worst period for PSU stocks (2011-2020)

Between 2011-2020, the PSU Index performed terribly

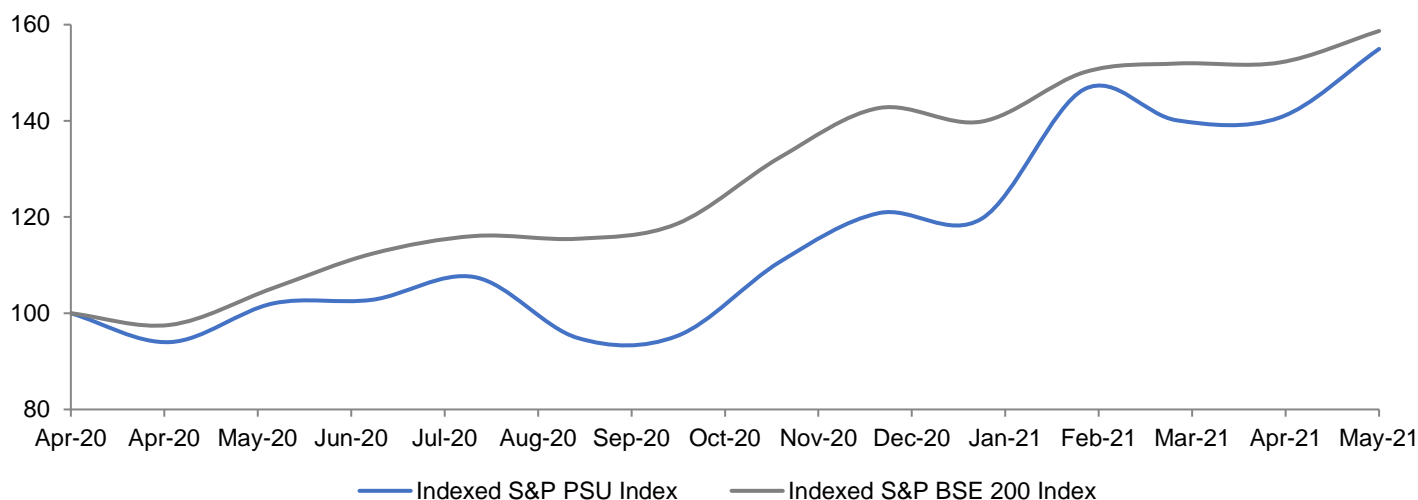


Data source: ACE Equity.

Between 2011 and 2020, the performance of PSU shares as a category has been terrible. They returned a CAGR of -7.58% for the 9-year period between 2011 and 2020. During the same period, the S&P BSE 200 index returned a CAGR of 4.82%.

However, the market is nothing if not a living proof of the principle of reversal to the mean. PSU shares as a category have done much better in the year 2020-21.

In the last one year, the PSU Index has done comparatively better



Data source: ACE Equity.

In the 14-month period between April 2020 to May 2021, the S&P BSE PSU Index has returned 54.95% and during the same period, the S&P BSE 200 Index has returned 58.68%. Still underperformed the main index, but it has shown signs of catching up.

The comparative financial performance of the PSU stocks does not justify the weak stock market performance of the last 7 years.

On this point there is no doubt. While there is no dispute that the financial performance of the BSE PSU Index components has lagged behind those of the BSE 200 Index in the last few years, it is nowhere as bad as is suggested by the stock market's reaction to it. We have chosen a comparatively longer term of 10 years, and a medium term performance of 3 years to compare the respective performances.

Comparative financial performance of the BSE 200 and BSE PSU companies.

	Last 10-years CAGR (*)		Last 3-years CAGR (*)	
	BSE 200 Companies	BSE PSU Companies	BSE 200 Companies	BSE PSU Companies
Revenues	11.2%	8.5%	9.9%	9.2%
PBIDT	9.8%	4.0%	9.3%	6.9%
Net profit	2.5%	(3.1%)	(6.8%)	(8.2%)
Debt/equity (average)	90.0%	80.0%	101.0%	106.0%
Tax payout (average)	29.0%	30.1%	30.8%	30.5%

(*) - For the period ending March 2020

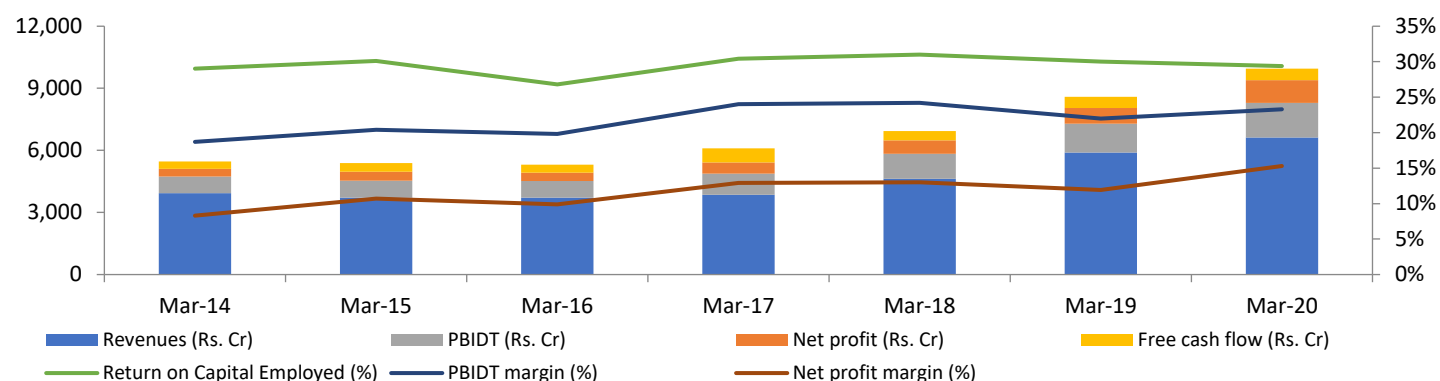
Date source: ACE Equity.

While there is no doubt that as a category, the PSU stocks have not done as well as the BSE 200 stocks in terms of profit growth or revenue growth, it is our contention that the performance is not as bad as is being suggested by the stock price movements. Also, public sector banks account for about 28% of the weight PSU banks have had a rough time during this period.

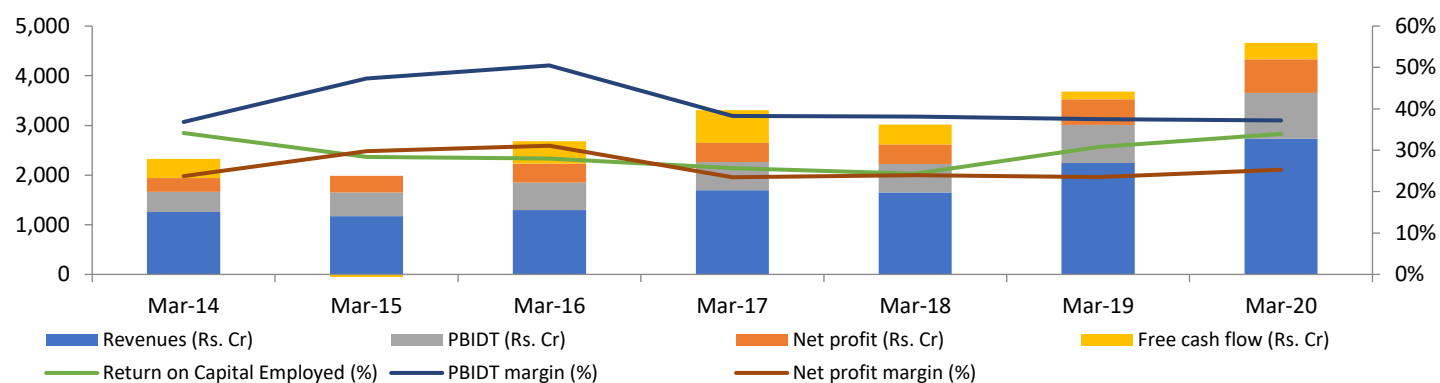
The underperformance of PSU shares in the period 2014-2020 can be viewed either as a justification for their poorer financial performance, or as an opportunity. We firmly believe that the best time (by extension, the best price) to buy any share is when the company behind it has been forgotten, or is neglected by the general investment community, provided of course that the company continues to be competitive and does well financially.

Let us look at some examples of public sector companies that have exhibited good competitiveness and financial performance. Let us give you a couple of examples from our own portfolio over the last two years.

Financial highlights of Indraprastha Gas Ltd (IGL)



Financial highlights of RITES Ltd



Data source: ACE Equity.

The two companies listed above are PSU companies. Does the financial track record of either of them seem remotely inefficient? IGL for instance, has compounded revenues at 9.1% and net profits at 20.4% over the period 2014-2020. It has also had an average Return on Capital of 29.5% and a debt/equity ratio of 0.04 during this period. Rites has compounded its net profits at 15.74%, has an average Return on Capital of 29.33%, and debt/equity ratio of 0.04.

The point, dear Investor, is to be wary of generalizations or stereotyping. Individual companies, irrespective of their ownership, public sector or otherwise, can be either highly competitive, or inefficiently run. Just as we cannot conclude that all private sector companies are epitomes of efficiency, we similarly cannot conclude that all public sector companies are laden with nothing but inefficiencies and corruption. Our job is to identify strong businesses, run by shareholder-friendly managements, and buy them at prices that are not exorbitant.

Yours sincerely,

(E A Sundaram)

Chief Investment Officer and Portfolio Manager

“By the time any view becomes a majority view, it is no longer the best view: Somebody will already have advanced beyond the point which the majority have reached”.

- Friedrich Hayek

Top 10 Holding of o3 Core Value Investment Approach - Regular Option as on 31 st May 2021			Overweight / Underweight of Regular Model Portfolio Compared to Nifty 500 as on 31 st May 2021	
Name	GICS Sector	Weight		
ITC	Consumer Staples	6.40%	Consumer Staples	10.39%
Oracle Financial Services Software	Information Tech	5.47%	Industrials	7.10%
Asian Paints Ltd	Materials	5.43%	Health Care	5.65%
Colgate-Palmolive (India)	Consumer Staples	4.82%	Consumer Discretionary	2.77%
Computer Age Management Services	Information Tech	4.57%	Real Estate	(0.63%)
Container Corporation of India	Industrials	4.40%	Communication Services	(2.52%)
HDFC Bank	Financials	3.89%	Materials	(2.87%)
Sanofi India	Health Care	3.86%	Utilities	(3.53%)
Bosch Ltd	Consumer Discre	3.67%	Information Technology	(7.13%)
Sun Pharmaceutical	Health Care	3.56%	Energy	(8.97%)
		46.07%	Financials	(13.27%)

Investment Objective: The investment objective is to achieve capital appreciation through investment in a diversified portfolio of strong businesses, purchased at reasonable valuation.

Regular Model Portfolio Details as on 31 st May 2021		Regular Model Portfolio Composition as on 31 st May 2021	
Weighted Average ROCE	26.21%	Large Cap	42.5%
Portfolio PE (1 year forward PE, Based on FY23)	23.59	Midcap	34.0%
Portfolio Dividend Yield	1.78%	Small Cap	10.5%
Average Age of companies	65 Years	Cash	13.0%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on 31st May 2021
- Midcap: Market cap below 100th company to the market cap of the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 31st May 2021
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 31st May 2021

Regular Model Portfolio Composition as on 31 st May 2021	
Model Portfolio Overlap with Nifty 500	13.25%
Model Portfolio Overlap with Nifty 50	15.74%

Consolidated Portfolio Performance of o3 Core Value Investment Approach Concentrated Option			Consolidated Portfolio Performance of o3 Core Value Investment Approach Regular Option		
Period	31 st May 2021		Period	31 st May 2021	
	Portfolio	Nifty 500		Portfolio	Nifty 500
1 Month	7.95	6.97	1 Month	7.60	6.97
3 Months	8.98	8.58	3 Months	9.87	8.58
6 Months	24.48	23.39	6 Months	22.32	23.39
1 Year	57.09	69.08	1 Year	53.57	69.08
2 Years	15.21	16.13	2 Years	13.07	16.13
Since Inception (15/04/2019)	15.31	15.21	Since Inception (14/05/2019)	14.90	19.62

- Benchmark is Nifty 500, the portfolio is spread across different market capitalization, hence Nifty 500 is chosen as benchmark
- Since inception date stated is considered to be the date on which the first client investment was made under the investment approach

Disclaimer: Performance depicted is based on all the client portfolios existing as on such date, using Time Weighted Rate of Return (TWRR) of each client and then computing arithmetic average for the overall strategy. Past performance is no guarantee of future returns. The above portfolio performance is after charging of expenses. *The performance related information provided here is not verified by SEBI nor has SEBI certified the accuracy or adequacy of the contents of this Document.*

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