

October 20, 2021

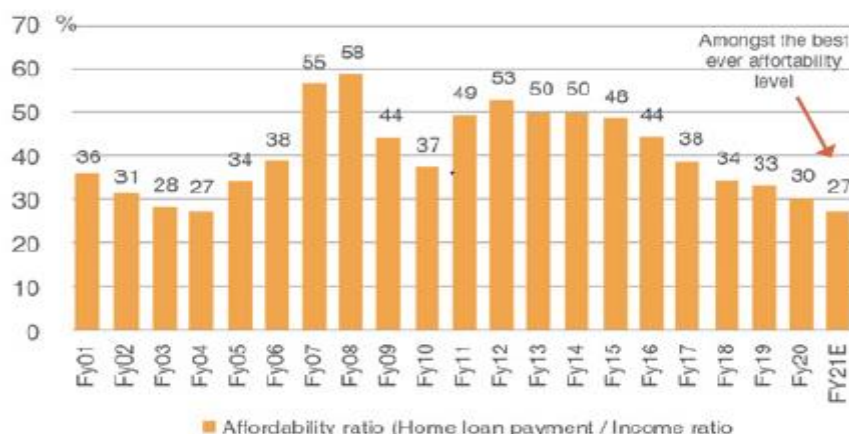
Portfolio Commentary

Building Materials – An Alpha Play

Most of us would recall the heady days of real estate that dominated the first decade of this century. At the time, almost anybody with a large enough piece of land turned into a ‘developer’ as the business was extremely lucrative. A massive demand surge was followed by prices skyrocketing year after year, arguably to unsustainable levels. After that what followed was several years of subdued activity and a long, painful time correction led by an increase in interest rates, demonetisation, introduction of RERA and a funding crunch, that drove several developers out of business. Indian real estate sector underwent its worst down cycle.

The sector finally seems to be turning a new page with drivers in place for a multi-year demand cycle owing to low mortgage rates coupled with stagnant property prices, low unsold inventory, government support, spread between mortgage rates & rental yields at multi-year lows and improving economic outlook.

Affordability (home-loan payment to income ratio) Ratio Trend

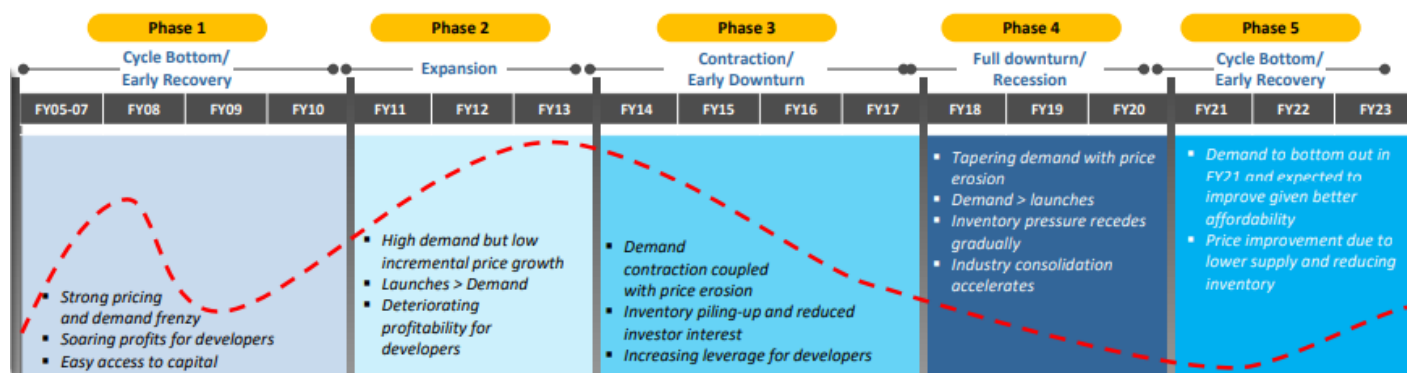


Supporting supply dynamics to play a key role in revival:

- New launches in the last couple years were down by ~40% in Tier 1 & 2 towns compared to the previous 5 years.
- The number of developers has declined by ~60% since slowdown hit in 2012
- Completion cycle improving as projects consolidate in the hand of few developers with balance sheet strength.

The housing sector has a significant multiplier effect on the economy. It is estimated that around 30-35% capex in India is led by household sector of which 65-70% (~20% of all capex) is in housing. An uptick here would certainly help kick start an upcycle in the overall economy.

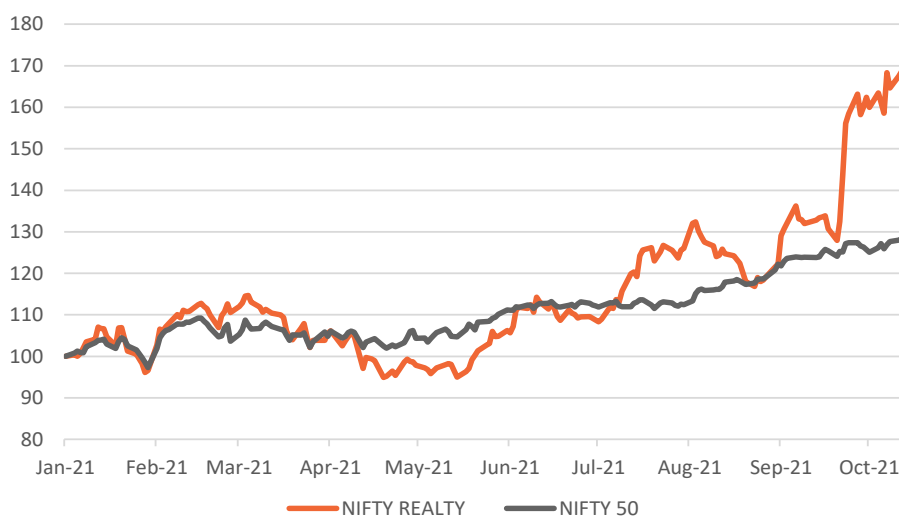
Indian Real Estate Cycle in Nutshell



Source: Spark Capital, Sanctum Wealth

We saw the early signs of housing demand revival and turned positive on this sector ([investment outlook 2021](#)) in the beginning of the year. Our conviction has been well rewarded with most of the listed real estate players and allied businesses outperforming since beginning of the year.

NSE Realty Index price performance vs. Nifty 50 (indexed to 100)



We are at the start of an upcycle in the sector but post this stupendous rally, we wanted to do a sense check on various companies in the sector and further upside potential over the medium term. We concluded that most direct plays like developers are region specific and have leverage on their books. In contrast ancillary real estate businesses are more geographically diversified, have strong balance sheets and healthy return ratios. It's therefore not hard to guess that we will largely own the latter in our portfolios.

“When Everybody Is Digging for Gold, it’s Good To Be in the Pick and Shovel Business” - Mark Twain

Organised players in different sub-segments of building materials continue gaining market share on account of differentiated product offerings, superior distribution, and higher aspirational value attached to brands. This explains sustained positive revenue growth in the organised, internal home building materials segment even though real estate sector decelerated in the last 5-7 years. Increasing income, affordability and growing aspirations combined with growth of new urban centres in tier-II/III cities ensures that these segments continue to grow despite sluggish real estate sales with an option to report faster growth in case of pick up in real estate sales. Its akin to “heads I win, tails I do not lose much”.

The table below highlights the growth of the various sub-segments of internal home building materials, and for this analysis, we aggregate the revenue of the top manufacturers (accounting for majority of the organized market share) and compare each segment’s growth to the nominal GDP growth.

	Sector CAGR			Sector/nominal GDP growth (%)		
	FY16-21	FY11-16	FY06-11	FY16-21	FY11-16	FY06-11
Light Electricals	9.9%	12.9%	25.1%	1.33	1.11	1.56
Pipes	9.8%	11.4%	22.0%	1.32	0.97	1.37
Paints	5.8%	15.2%	16.1%	0.78	1.30	1.00
Adhesives	5.0%	15.3%	21.5%	0.68	1.31	1.34
Wood Panel and Laminates	4.6%	15.1%	29.5%	0.61	1.29	1.84
Ceramics	0.3%	19.8%	26.2%	0.03	1.70	1.63
TOTAL	6.7%	15.2%	20.4%	0.90	1.30	1.27

Source: Industry, Sanctum Wealth

Each of these segments in the organized market are seemingly oligopolistic with only 2-5 players. However, it is the unorganised market that has a large market share (30-65%). Hence, there is enough room for the organised players to continue their growth momentum for the next few years. As pointed earlier, increasing disposable incomes and brand consciousness amongst consumers is already helping the organized players gain market share. Further, the unorganized players continue to lose market share with the formalisation of economy and low scale as well as hit by disruptions during the pandemic and helped organized players gain further market share.

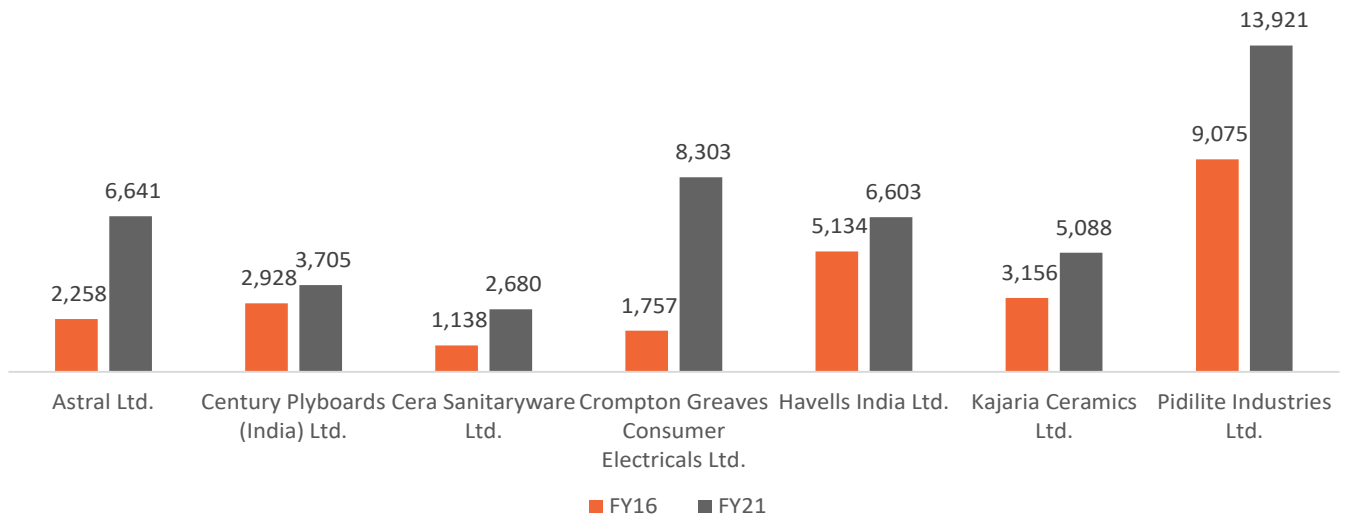
	Paints	Pipes	Light Electricals*	Ceramics	Adhesives	Wood Panel & Laminates
Market Size (INR bn)	470	302	900	280	130	290
Organised	70-75%	50%	60-65%	50%	60-65%	35%
Unorganised	25-30%	50%	35-40%	50%	35-40%	65%
Competitive Intensity	4	4	NA	5	2	5
Expected growth	12-15%	12-14%	12-15%	10-12%	15%	10-12%
Key players	Asian Paints, Berger, Kansai Nerolac	Astral, Finolex, Supreme, Prince	Havells, Polycab, KEI Inds, Crompton Vguard Bajaj Electricals	Kajaria, Cera, Somany	Pidilite, Astral	Centuryply, Greenply, Greenpanel, Greenlam, Stylam

*Light Electricals includes Cables and Wires, Lighting, Fans, Switches and Other Consumer Durables

Source: Industry, Sanctum Wealth

We expect the “Big getting bigger” trend to accelerate during the next upturn owing to sheer scale of Advertising & Promotion budget (A&P), increasing distribution network/penetration and strong balance sheet for organized players. Majority of the unorganised players have been struggling with leveraged balance sheet, liquidity crunch and supply chain disruptions since the beginning of the pandemic. Organised players grabbed this opportunity to improve their cash flows. Most of the building material players witnessed a steady rise in operating cash flows till FY20 and a steep acceleration in FY21.

Healthy growth in operating cash flows over last five years (INR mn)

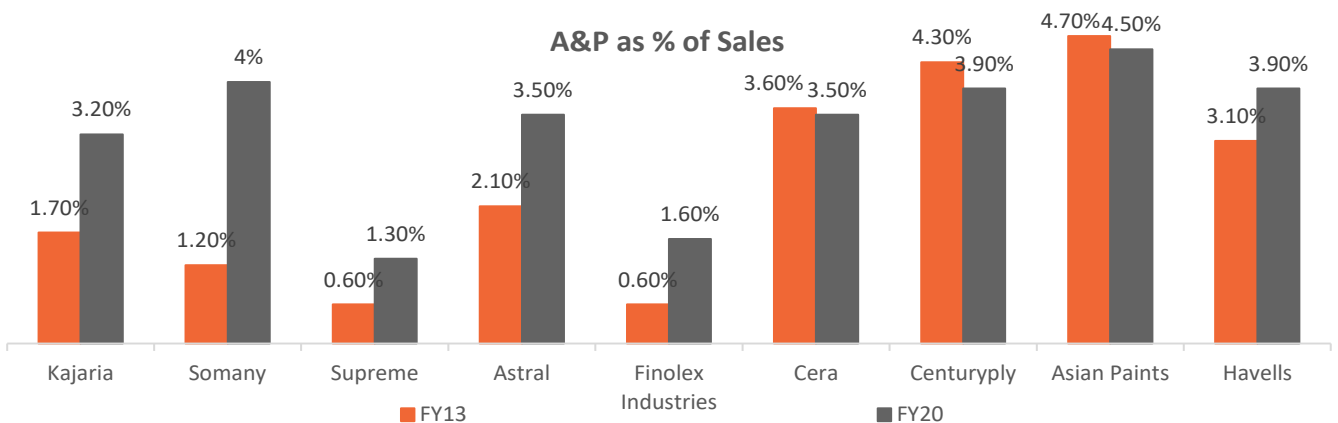


Source: Ace Equity, Sanctum Wealth

Largely, everywhere in the world paints and adhesive have been considered industrial products. But in India, Asian Paints and Pidilite (Fevicol) built strong brands and ranked up in consumer preference that has helped them achieve category dominance over the last two decades. Following that lead, several other category leaders are also now creating brands in otherwise commoditised business.

For instance, Astral took a leaf from Pidilite's marketing strategy book and started educating the plumbers on use of plumbing pipes which increased brand recall in the minds of decision makers. Further, many players are entering the adjacent categories thus increasing the opportunity size for themselves. Case in point being Astral and Prince Pipes entering the water tanks segment, Centuryply expanding and ramping up the MDF business in addition to traditional plywood business, Cera Sanitaryware entered the tiles segment few years back in addition to sanitaryware etc.

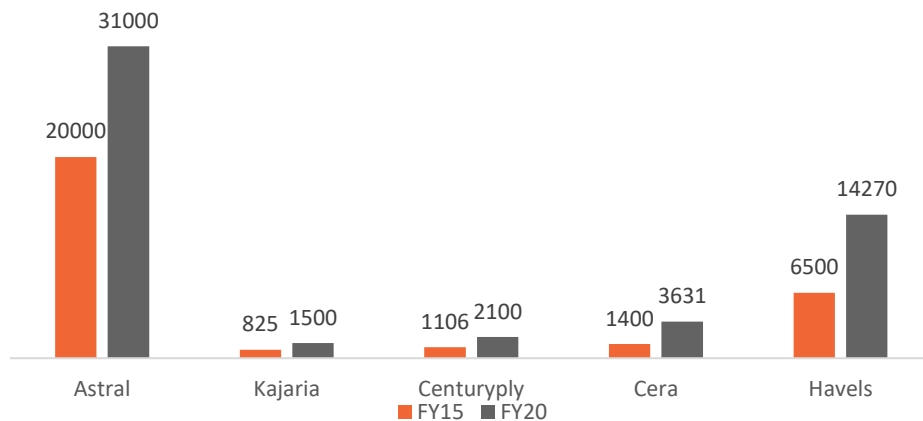
On the back on brand recall, building material players have successfully transitioned from a model based on volume push through dealers to demand pull through branding. For this, they have ramped up their Advertising and Promotion (A&P) expense in last five years. On an average, players are spending almost 3-4% on A&P (as a % of sales) as compared to 1-2% few years ago.



Source: Companies, Sanctum Wealth

Brand recall needs to be supported with strong distribution to aid success. Hence these players continue to up their distribution network to penetrate further in semi-urban and rural areas. These areas have been dominated by regional players many of whom are facing liquidity and supply disruption challenges. Large, organized players have better financial heft and supply networks. Consequently they are well placed to grab market share from local players and post higher than industry growth in coming years.

Growth in number of dealers over last five years



Source: Companies, Sanctum Wealth

We have been believers in the value creation opportunity offered by building material companies for a long time. We have been opportunistic and have caught the trend early to include these businesses in our portfolios. Apart from bell weather companies like Asian Paints and Pidilite we have been holding companies such as Astral Poly for over 4 years in our discretionary portfolios. Astral has been expanding its presence in the PVC & CPVC segments along with venturing into adjacencies like Adhesives, Storage tanks and ramping up these categories while growing ahead of industry averages along with superior return ratios and healthy balance sheet.

Astral Share Price vs. NSE 200 Index (indexed to 100)



Source: Ace Equity, Sanctum Wealth

Further, we also own companies such as like KEI Industries, Polycab and Bajaj Electricals that have drivers supporting continued growth momentum over the next few years.

In-House Strategies – outperforming the best performing markets

During the 6 months period ending September 2021, Nifty 50 has been one of the best performing indices relative to global peers. During this period, our flagship Multicap strategy Sanctum Indian Titans, has fared even better outperforming the Nifty 50 by nearly 915 basis points.

	6 months	1 Year	3 Year
Sanctum Indian Titans	29.1%	61.5%	23.4%
NSE Nifty 50 Index	19.9%	56.6%	17.2%
NSE200 Index	21.5%	59.3%	17.6%
NASDAQ Composite Index	9.1%	29.4%	21.5%
S&P 500 INDEX	8.4%	28.1%	13.9%
MSCI Global Index	5.4%	25.5%	10.6%
MSCI AC Asia Pacific Index	-3.1%	16.0%	6.1%
MSCI Emerging Markets Index	-4.8%	15.8%	6.1%

Source: Bloomberg, Sanctum Wealth

Overall, our portfolios remain centred around the themes of housing, manufacturing, and exports opportunities. We are incrementally raising weights in lending financials we expect cyclical demand recovery to pick up and NPA provisioning to trend lower resulting in better operating performance for the sector going forward.

Earlier this year, as the economic rebound seemed to percolate to mid-sized companies, we added midcap exposure to Sanctum Indian Titans. Our underlying companies delivered strong growth and market momentum rewarded it richly thereby helping us outperform. But now the valuations are getting into the stretched territory and we have started trimming our weights.

As we write this note, the quarterly result season is underway with expectation of another strong quarter from the earnings perspective. In our view, several sectors need to be watched out for margin related pressure despite strong topline growth. While stocks / sectors will experience some volatility depending upon how they deliver vis-a-vis the heightened expectations, we will track management commentary cues and business prospects from longevity perspective and would select stocks based on those parameters within themes mentioned above.

Annexure: Performance of In-house PMS Strategies

Performance as on September 30, 2021	1 Month	3 Month	6 Month	1 Year	CAGR		
					2 Year	3 Year	Since Inc.*
Sanctum Indian Titans	3.5%	15.6%	29.1%	61.5%	29.5%	23.4%	18.2%
NSE200 Index	3.3%	11.9%	21.5%	59.3%	25.5%	17.6%	17.2%

* Since Inception Returns are from 18-Nov-16

Performance as on September 30, 2021	1 Month	3 Month	6 Month	1 Year	CAGR		
					2 Year	3 Year	Since Inc.*
Sanctum Indian Olympians	1.0%	10.6%	20.3%	47.0%	20.4%	18.9%	14.5%
NSE100 Index	2.7%	11.8%	20.5%	56.7%	23.9%	17.1%	14.7%

* Since Inception Returns are from 16-Sep-16

Performance as on September 30, 2021	1 Month	3 Month	6 Month	1 Year	CAGR		
					2 Year	3 Year	Since Inc.*
Sanctum Smart Solutions	2.3%	14.7%	25.0%	52.6%	29.3%	16.7%	13.4%
NSE200 Index	3.3%	11.9%	21.5%	59.3%	25.5%	17.6%	15.5%

* Since Inception Returns are from 03-Nov-16

Performance is calculated using Time Weighted Returns, net of fees and expenses. Returns over 1 year are compounded annually, Returns for less than 1 year period are absolute. Please note that the performance information provided above is not verified by SEBI. Please note that past performance is not a guarantee of future performance.

Sanctum Wealth

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