



Big money, small ideas - September 2016

Markets resilient but we remain firm

Markets initially did weaken as per our expectations. However, the trend seems to have temporarily reversed over the past week, aided by benign data on domestic inflation and more importantly, the decision of both US Fed and BoJ to hold back rate hikes. We however maintain our view that markets will undergo a corrective or consolidation phase which could last a few months, and thereby offer better investment opportunities.

Micro caps participation is a concern

In what has been a range bound market, the element which stood out in recent times is increased participation of small/micro caps with relatively unknown names or proven track record. This has to be a concern and could be lead indicator of market volatility and imminent correction. Irrational surge even within our preferred universe of mid caps is making us slightly uncomfortable. Even as foreign inflows through ETFs chased the large caps, domestic flows have led to a surge in midcap valuations. Just for the record - CNX Midcap 100 is now trading at a 6% premium to Nifty 50, near all time high in sharp contrast to the median 15-20% discount. While the trend is understandable in what is essentially a stock pickers market, growth expectations in several names are bordering on the unrealistic now.

Key events to watch out for

We enter the Q2 results season in the coming weeks, and that again would be tepid and unexciting, in our view. However, management will likely sound more optimistic for the remainder of the year, mainly in consumption related sectors as well as cement and NBFCs. The more significant event would be maiden RBI policy from the newly appointed governor, and data points suggest that 25-50bps cut in lending rate will be highly anticipated by markets. As such, a steep correction is unlikely in the near term.

So what is the suggested course of action

Since our overriding statement in this newsletter suggests that markets will correct, the most prudent course of action would be partially book profits wherever valuations don't support fundamentals. We had also highlighted in the previous newsletter that we would continually scout for new ideas (more on that in the following section) as well as consolidate existing position in stocks/sectors we strongly believe can generate absolute returns i.e. Cement, NBFCs, Speciality Chemicals. Though pockets of NBFCs are now fully valued, lower interest rates can provide a "second wind" to large and high credit-rated NBFCs/HFCs through lower cost of funding.

Public capex – breaking the shackles

In the E&C space, order book / sales ratio of companies are at multi-year highs, mostly related to public expenditure. However, one of the issues constraining the construction sector has been stretched balance sheet and liquidity. The recent Government notification to (i) release 75% of funds after the arbitration has been awarded (even if contested) against department/PSU and (ii) all arbitration to be moved under the new Arbitration Act, could be a shot in the arm. This will lead to pick up in execution in 2HFY17/FY18, driving demand for not only Cement but other building materials and construction equipment. Some of the key sectors driving public capex are:

1. Roads – While the achievability of The NHAI's target of 15,000 km of EPC/Hybrid annuity awards is debatable (6,600 km identified on the NHAI website), there is clearly a renewed sense of urgency. Besides, some of the larger road companies are sitting on order books of 3-5x revenues already. We expect the actual construction to pick up post monsoons, partly visible in the pick-up in bitumen consumption growth in August.
2. Water supply and irrigation – Besides roads, there is state-specific thrust on water supply and irrigation projects more notably in Telengana, AP and Maharashtra
3. Railways – Though slow to take-off in terms of actual awards and more difficult to isolate the beneficiaries (in terms of stocks), railways upgradation and capacity augmentation programme is significant and could last years. Railways spend as a % of FY17 budget allocation however was only at 15% till July'16 vs. 50% in roads.
4. Real estate – While residential recovery is still to take shape, commercial real estate demand has picked up as evident in new construction as well as rental escalations.

More importantly, while we have so far focused only on Cement sector and Pipes (both steel and PVC) as the beneficiaries from the rising capex activity, we turn our attention now to the diverse construction equipment sector which is more diverse but highly leveraged to project activity.

Construction equipment – rising with the tide

According to Indian Construction Equipment Manufacturers Association (ICEMA), there has been a 49% growth in sales of earth-moving equipment between Jan-July of 2016, brightening prospects for the industry to post its best ever sales in a year. The numbers indicate a pick-up in road and irrigation projects construction this year. This is fastest in the last five years, following three years of decline between 2012 and 2014.

One of the companies which has started to benefit from the pick-up in construction and commercial real estate activity is Cummins India (CUMMINSIND.BO, USD3.7bn), even as the market continues to have a negative view. Investors are unduly concerned about adverse impact of excess thermal power supply on diesel generators manufacturers like Cummins and Kirloskar Oil. Meanwhile, market is missing the sustained recovery in demand from construction of data centres, hospitals, roads and agri equipment sector.

Cummins and Kirloskar Oil Engines (KOEL) are leveraged to this recovery. Earnings in 2016 so far have benefited already and we see these companies sustaining 15-20% growth from 2HFY17. We like Cummins and KOEL (KIRLOSENG.BO, USD746mn) owing to strong track record of profitability, expansion of product range and target markets. Cummins will see sharp decline in capex soon and hence may boost dividend etc. Company has increased localisation and is well equipped to face competition. Stock at 30x FY17 PE could give good returns led by 1) earnings upgrade and 2) higher dividends payout that will boost PE as well.

We in fact see host of tailwinds in favour of capital goods companies including Ingersoll Rand, Elgi Equipments, Carborundum Universal and Timken India. These include 1) domestic recovery 2) increased exports competitiveness driven by increased R&D as well as tax benefits of GST and 3) global recovery that is also pushing stock price of global leaders like Caterpillars to new highs.