



June 2016 - Concrete gains

Minor irritants now par for the course

Since our previous newsletter in May, some concerns have resurfaced as crude prices hit a 2016 high, domestic CPI crept up, IIP data slipped into negative territory and the Indian Rupee displayed vulnerability. However, this is not material enough to alter our overall constructive view on Indian equity markets for FY17. In fact, this emboldens our stand that India will continue to remain a bottom up stock pickers market, at least until one can call for a broad based economic revival.

Market correction is a buying opportunity

For the record, markets held up well in recent weeks despite these negative aspects, thanks to a decent finish to the results season e.g. Tata Motors, Hindalco, a rejoinder by the Indian Met department of above average monsoon forecast and favourable domestic flows. However, a correction seems to have finally set in from last week ahead of the FOMC meet and the Brexit vote, albeit slightly later than our expectations. As recommended in our previous newsletter, this corrective phase would be an opportunity to increase exposure to Indian equities. Our preferences continue to be in domestic centric and bottom-up sectors like NBFCs, Cement & Speciality Chemicals and themes such as structural spend on irrigation and roads.

Q1 results could be key determinant to market breadth

We will soon hit the 1QFY17 results season in July, which could well define the overall breadth and trajectory of our markets over the remainder of the year; we expect earnings to hold ground in FY17 thus breaking the downward revision cycle. Banking & Financials, Commodities and Infrastructure would be the key sectors to watch out for with respect to directional trends. Also, consumption driven sectors such as Autos, Durables and FMCG would highlight if there is any change in sentiment due to factors such as better rainfall prospects. Towards the latter half of the season, the RBI will meet once again as will the parliament for the monsoon session to discuss the possibilities of passing the contentious GST (more on these events in the next newsletter).

NBFCs - despite the run, we maintain positive stance

The strong performance in NBFC universe over the past few weeks almost makes us say 'we told you so'. But clearly, the positive trends were evident for a while, and it was just that the participation became more broad based to include NBFCs offering micro finance, gold loans etc. At this point, we dare say that there could be too much optimism built in too soon, but it is to be largely expected as the long term business prospects of this universe become evident to the investors. We would therefore hold to existing positions and even use a correction to increase allocation to this space.

Cement – Spring in their steps

Cement has traditionally been viewed as a relatively safer proxy to the impending revival in Infrastructure capex. This also explained the valuation premium sector has commanded in recent years despite marginal earnings support. With earnings recovery, the sector is now beginning to justify that premium. Consensus forecasts a 25%+ EBITDA CAGR for FY16-18E for the large cement companies and we think that all the ingredients are in place for earnings to deliver.

1. Although cement realisations remained subdued last fiscal, it was more than compensated by cost savings in power & fuel (e.g. shift to pet coke consumption), selective volume growth and lower finance costs.
2. Volume recovery likely to become broad based in FY17 after growing by just 3-4% in FY16. Since order books of E&C companies are at multi-year highs (mostly related to public expenditure), we expect execution to pick up in FY17/18, thus driving cement demand.
3. While regional industry dynamics will continue to play its part, better demand should ultimately result in higher and more stable pricing, always a key driver of earnings.

What stocks to invest in?

We judge stock attractiveness or otherwise by the use of traditional EV/EBITDA parameter rather than EV/tonne - the latter we feel distorts valuations of inherently under-utilised units either due to reasons of legacy or demand- supply mismatch. As such, these factors limit the potential to expand EBITDA/Tonne even after considering the fuel savings. While the space has plethora of investment worthy stocks, including companies of varying scale both pan India and/or specific geographies, our choices are limited to efficient and scalable players, namely -

- (i) Shree Cement (SHREECEM.BO, Mkt.Cap: USD 7.0bn) - earnings visibility driven by both volume and lower costs, with upside likely on realisations, which is likely to drive best-in-class growth thus sustaining premium valuations (16-17x FY17E EBITDA currently), and
- (ii) Dalmia Bharat (DALMIABHA.BO, Mkt.Cap: USD 1.3bn) - similar reasons along with the upside from financial deleveraging and attractive valuations at 8x FY17E EBITDA.

For the less faint hearted, there is India Cements (INDIACEM.BO, Mkt.Cap: USD 460mn) which has the potential to surprise on improving efficiency and also benefiting from financial leverage, but yet to deliver. And on the other extreme, we have the dominant Ultratech Cement (ULTRACEMCO.BO, Mkt.Cap: USD 13.9bn), but valuations seem stretched relative to growth, and the efficient but relatively smaller player Deccan Cements (DECCANCE.BO, Mkt.Cap: USD 86mn) available at 4-5x FY17E EBITDA).