



Eat light and sleep tight - August 2016

Corrective phase to persist

In the July newsletter, we had opined that the corrective or consolidation phase will set in after the passage of the GST bill creates a near term peak. The correction may not be deep but could be spread over few months. This is playing out now. Additionally, news flow has been mildly negative (e.g. some slippage in monsoon, Q1 results, higher CPI). Still, correction hasn't been substantive or long enough in our view to attract our attention to new investible stock ideas. And this is one of the key reasons for delayed release of this newsletter.

Midcaps – favoured but not an automatic choice anymore

Major indices remained range bound over past month, although the Nifty Midcap indices again outperformed Nifty 50 by 400-500 bps. While this trend is in line with our thesis that India will remain a stock pickers market, valuations are becoming a concern. CNX Midcap 100 is now trading at a 6% premium to Nifty 50, near its all time high and in sharp contrast to the median 15-20% discount historically. The embedded growth expectations have reached unrealistic levels in certain instances.

Near term triggers missing

Following an uninspiring quarter of financial results, we enter a period where economic activity in India is usually at low ebb. The next phase of news flow will be in Q4, when the GST rate is decided by the GST council (pace of state approvals has been a positive surprise so far) and adopted in the new bill in the winter session of the parliament. It's a tight schedule especially given the conflicting demands on the determination of the standard GST rate, with high chances of it exceeding the original 18% recommendation by 100-200 bps that can dampen the excitement a bit.

Despite the endemic global slowdown, equity markets continue to latch on to an accommodative monetary policy. Recent sound bites from Fed has increased the probability of a rate hike though markets are still expecting only one this year. There is no reason to believe otherwise as of now but the resultant equity valuations are reaching a stage of complacency.

Create cash, consolidate

Although we will continually be scouting for ideas based on some structural themes we have identified and continue to favour - cement, speciality chemicals, NBFCs and building materials, we also think valuations have run ahead quicker than expected. So partial profit taking can be invoked wherever possible to create idle cash or shift to defensive names. We are advising the same in NBFCs and will be buyers at lower levels.

Cement remains our preferred sector despite recent rally and premium valuations. Our view that a strong Q1 was in the price has largely played out. There could be near term weakness with weak sales volumes data which should be an opportunity to add as a sustained medium term demand and earnings upcycle is still not priced in. We recommend consolidation of holdings in cement in this phase and stick to Shree Cement which has solid fundamentals despite premium valuations (EV/EBITDA of 13.5x FY18E, 2-year EBITDA CAGR of 36%).

At the same time, we have focused on just one new name within our favoured themes viz. Aarti Industries in Speciality chemical which did not participate as much as peers despite the expected earnings delivery acceleration in the remainder of FY17.

Agrochemical companies should do well

Normal monsoons have brought back interest in agrochemicals, with strong turnaround in fortunes compared to a year back. While stocks like PI industries and UPL are well researched and followed, we also like Dhanuka Agritech, a pure play domestic company. Not only will it deliver a very strong FY17 (and 2Q), it also has wide distribution reach and robust product pipeline that will help it ride through the bad years. In addition, given its strengths in product development, CRAMS could be a logical extension to its business over the long run.