



Not a bed of roses - May 2017 Newsletter

Positive triggers may be wanting

Our markets continued to sustain positive momentum this fiscal, hitting highs as we pen this newsletter. The optimism this time around was triggered by lower probability of El Nino impacting monsoons. Nevertheless, we seem to have peaked in terms of news flows for now, especially with the much anticipated GST rates and prospect of an early onset of monsoons failing to enthuse. Although we retain positive stance on equities from a 12-month perspective, driven by domestic economic recovery and steady migration of domestic savings, we see distinct possibility of a corrective phase which could last a quarter or more. Recent political developments in the US too could be an excuse for a much needed correction to stock markets.

Large caps can narrow valuation gap vs. midcaps

While we have continuously advocated bottom up stock picking as the better way to play our stock markets, it is also our belief that mid caps may not do significantly better than large caps over the coming year. It is too early to call it a trend but mid caps (Nifty Midcap 100) so far this fiscal have given similar returns (3.5%) compared to large caps (Nifty 50). We expect this trend to show up more in the coming quarter or two, as mid caps are more vulnerable to price correction. It may be prudent to focus on some of these companies with sound fundamentals and superior track record and not get carried away by some of the overvalued mid caps.

Results below par, retain preference for domestic themes

Corporate results so far have disappointed a tad which suggests a slower economic recovery. However, management commentary on business outlook for FY18 has been largely positive. This especially holds good for consumer non-durables, construction, cement and even realty despite the impending GST transition. The banking and financial sector too is showing signs of mend, albeit slower than general expectations. It is this universe of domestic centric sectors that we prefer over the exporters and overseas dependent sectors. We focus in the next section on one of such domestic growth sector –aviation.

Aviation – Taking flight

Historically, the Aviation sector had had to contend with the baggage of value destruction, but has come off age globally. In India, the investment case is even more pronounced given the sustained ~20% traffic growth for several months now. After a tough FY17 when yields plunged even as crude

prices spiked from its lows, we think the dynamics have changed for the better providing for a reversal in earnings trajectory in FY18 followed by sustainable growth tracking traffic trends thereafter.

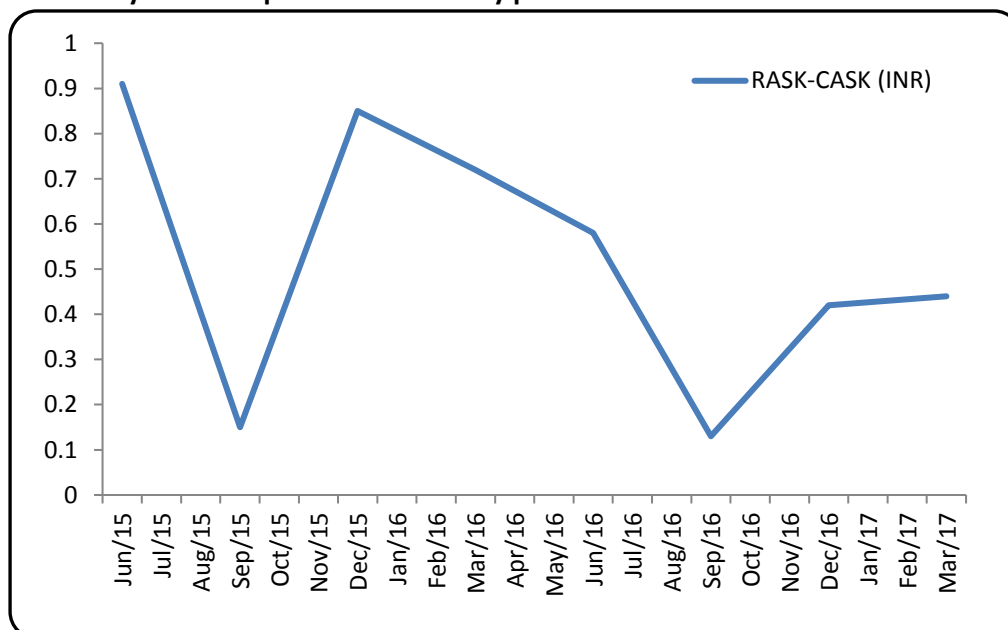
1. After a year of supply led compression in yields in FY17, the demand-supply appears much more balanced from now on. This has already started leading to gradual improvement in the yields-cost spread in the last few months. But we believe there is significant headroom for further improvement (see chart) as the year progresses, seasonality notwithstanding.
2. Costs and the associated base effects are contained as crude remains range bound (only >60/bbl poses a problem). Strong INR adds further to cost cushion (fuel accounts for 60% of the USD-linked costs)
3. Commentary from leading airlines suggest calibrated supply additions making the yields-cost spread more sustainable beyond FY18, barring any demand shock.

Amongst the 3 listed entities in the Airlines space, Interglobe Aviation has been a preferred choice of institutional investors even as Jet Airways has fallen out of favour. We however prefer Spice over Indigo for the following reasons

- Consistently superior operating metrics i.e. seat factors
- Gradual cost optimisation, and last but not the least,
- Attractive valuations (FY18E P/E of 11x vs. 16x for Interglobe).

We believe that the investor perception of Spicejet is changing as a result of the consistent performance which will gradually lead to narrowing of valuation gap as well vs. Indigo. Spicejet could also benefit from the new UDAN scheme for smaller airport connectivity which can provide the next leg of traffic growth.

Revenue yield-cost spread on a recovery path



Source: Indigo; RASK – Revenue per available seat km, CASK – Cost per available seat km