



Pit Stop - June 2017 Newsletter

Markets looking for direction

We have been consistent in our view that markets could be in for a period of correction or more likely consolidation, as positive news flows seem to have ebbed for now. This phase is being played when indices moved in a narrow range with a downward bias. Recent loan waivers (and farmer agitations demanding more) and inconsistent progress of monsoons could further accentuate this phase. We therefore see a similar trend playing out in July as GST related disruption and June-quarter result jitters could weigh on the market.

Large caps seem better placed

Large caps continued to outperform midcaps, albeit marginally, over the last one month. Clearly, there is a shift towards safer options with a superior track record of managing growth versus the less proven mid cap names. Also, the valuation differential between large caps and mid caps had become too large to ignore. We continue to believe that this is not going to be a runaway year for mid caps (like it has been for the past couple of years) as the universe of investible ideas/themes is being restricted by expensive valuations.

So what should be the course of action?

Despite slower than anticipated economic recovery and issues mentioned above, India is still a buy on dips market in our view. However until new bottom up ideas emerge, we advise investors to hang on to whatever surplus cash one has created to deploy at an appropriate stage. The other option is to add to existing stock positions within our favoured themes of (i) infrastructure/construction and (ii) banking & financials sectors. There are however pockets of runaway valuation in financials, notably in the financial conglomerates (IIFL, Edelweiss) and home finance, where investors would do well to partially book profits.

Specialty chemicals – the second wind

Specialty chemicals sector has got re-rated significantly over the last 18 months. What started as a sector benefiting from the enforcement of stringent environmental norms in China, picked up pace with investors becoming aware of the companies with significant global scale in their line of chemicals – SRF, Aarti Industries, Vinati Organics and Navin Fluorine amongst the ones we have followed and liked. The second line of companies also benefited, partly on account of the spike in some of the commoditised chemicals esp. in dye intermediates. The sector has however been in

consolidation phase last 1-2 quarters as some of the product prices have cooled off and certain segments are still reeling from end-use slowdown esp. global agrochemicals and strong INR.

We think the sector is now set for a second leg of earnings recovery and re-rating. However, investors should be more discerning. The bigger companies will deliver moderate earnings growth in the near term (viz. Aarti) while some of the companies have either back-ended growth (Vinati) and/or unrelated diversification (Deepak Nitrite/Aksharchem). Also, valuations seem to have caught up with the near term financial performance.

Among the sample set, we like Shree Pushkar Fertilisers and Chemicals (Shree Pushkar) Company's integrated business model in dye intermediates and efficiency of operations (in terms of waste recovery and effluent control) can sustain ROEs around 20% despite price fluctuations in dye intermediates. Shree Pushkar's forward integration into dyes is getting good traction, and will deliver strong growth from 2QFY18 onwards, thanks to commissioning of new facilities. In addition, Shree Pushkar also has plans to enter textile auxiliary chemicals which can improve margins and return parameters over the medium to long term. We believe company can deliver a sector beating earnings growth of around 30% CAGR over the next two years.