



### Raining Cats and Dogs - July 2016 Newsletter

#### An opportunity it was indeed

In our June newsletter, we had highlighted that uncertainty over Brexit vote and FOMC meet would induce stock market volatility, and the ensuing correction should be used as opportunity to increase exposure to Indian equities - and indeed it did. Post events (including RBI Governor Rajan's surprise exit announcement), stock markets globally and here in India have more than recouped losses (Nifty up 5.5% post Brexit)

#### GST bill - high on expectations

In India, the market rally also seems to be supported by improved chances of passage of the GST bill (again something we had indicated would be a positive trigger and sentiment booster). As we pen this newsletter, the monsoon session of parliament has commenced and negotiations seem to be underway to arrive at a political consensus. This could take a few weeks before the bill is put to vote which means markets could hold up with a positive bias until then. We will discuss some beneficiaries later in this newsletter.

#### Result season begins on sombre note

Initial results for Q1 have been mixed with key disappointments being Infosys and its lowered guidance and HUL's lacklustre performance. In any case, we are not enthused by the Indian IT space, especially post-Brexit. Unlike the past, we believe corporate results announced in the latter half of the earnings season (namely Banks, Commodities and Infrastructure related sectors) would determine the outlook of our stock markets for the remainder of the year. Amongst our favoured segments, we look forward to financial results in Cement, NBFCs, select discretionary and consumer names.

#### Brace for a mild corrective phase

Following the nearly 23% rally from the pre-budget lows, the NIFTY currently trades at 1-year forward P/E of 17.5x, which is at a 20% premium to historic averages. In addition, market is again awash with ideas across market capitalisations, led by strong domestic flows. We therefore opine it is poised for a corrective or consolidation phase, with near term peak values potentially coinciding with the passage of the GST bill. The correction may not be deep but could be spread over few months. Once again, this could throw up more opportunities to invest in stocks at more reasonable valuations.

## Looking back at the quarter

Since initiating the Ampersand newsletter in April, wherein we highlight our sector/theme preferences and follow up with investible stock ideas, we have decided to take stock at the end of every quarter. Here's a quick recap and review of our three preferred sectors – Specialty chemicals, NBFCs and Cement – which were in focus in the first three editions of the Ampersand newsletter.

- Cement remains our preferred sector despite recent rally and premium valuations. We believe that while the widely expected strong Q1 performance may be priced in, a sustained medium term demand and earnings upcycle is not. We therefore expect premium valuations to sustain, and would play it through Shree Cement (EV/EBITDA of 13.5x FY18E, 2-year EBITDA CAGR of 36%) and Dalmia Cement (7x EV/EBITDA FY18E, 2-year EBITDA CAGR of 17%).
- NBFCs rank as the best performing universe so far this year, and justifiably so given the growth in loan books/AUMs as well as benefit of lower funding costs, leading to ROE expansion. However, given the surge in stock values in a short span, we would wait for a correction to increase allocation to this space. We still like (i) gold loan NBFCs (viz. Muthoot, Manappuram), also given the reduced provisioning risks due to rise in yellow metal prices, and (ii) embedded value plays (viz. ABNL) vis-a-vis the (i) cyclical recovery & monsoon beneficiaries (viz. M&M Financial, Shriram Transport) and (ii) the newly-listed small banks (Equitas, Ujjivan).
- Speciality Chemicals for us started with identifying well established companies with decent track record viz. SRF, Navin Fluorine. Our preference has been towards Navin Fluorine due to its (i) asset-light CRAMs model and (ii) greater exposure to pharmaceuticals end-use. This has played out; SRF has under-performed and is now trading at 30% valuation discount (12x FY18E). Subsequently, the flow of ideas in chemicals universe broadened rapidly, including a plethora of companies with lesser credentials and higher earnings risk. Given the wide range in “chemicals” and the associated complexity in tracking each of them, we prefer to focus on larger and diversified companies like Aarti Industries; its backward integration and customer penetration lends stability to earnings growth.

## Building materials – Neutralising commodity business with scale

Extending the logic for our positive stance on cement (rising public expenditure, rising E&C order books, gradual return of pricing power), there are a few building material segments (Pipes, cables) which will stand to benefit too. In this newsletter, we focus on pipes (both steel and PVC), the specific demand drivers for which are as follows.

- **PVC pipes:** Government spend on irrigation and water supply projects are expected to increase over next 5 years – i) increased thrust on Pradhan Mantri Krishi Sanchai Yojana (PMKSY) for improving irrigation in non rain-fed areas, ii) Fast track implementation of 89 irrigation projects, 23 by March 2017, iii) State level water management programmes for improving water supply esp. in Maharashtra and Telengana.

- **Steel pipes and tubes:** Increased use of hollow section steel tubes in fulfilling structural requirements in buildings and urban infrastructure projects. This “Structural” segment is now 55% of total steel tube demand in addition to the traditional demand sources from auto, oil & gas, water supply and sewage.

In both Steel and PVC pipes, the capacities are extremely fragmented. The organised sector is growing faster than the market (@8-10%), taking share from the unorganised sector which is still at 30-40% of the overall market. We expect this shift to continue, and will get further boost in the event of GST implementation.

Besides macro demand drivers being in favour, these segments are also a case study on some of the companies acquiring margin stability and superiority by building scale through superior execution viz. APL Apollo Tubes ([APLAPOLLO.BO](http://APLAPOLLO.BO), USD 330mn) and Finolex Industries ([FINOLEXIND.BO](http://FINOLEXIND.BO), USD 845mn).

Going back 4-5 years, these businesses were perceived as commodity businesses and/or pure conversion businesses. However, a few companies took the initiative to build market-leading capacities over a period of time, which provided scale economies in addition to advantages in RM sourcing. This has accorded the unit margins (INR per tonne) the much needed stability, partly insulating it from the underlying raw material price movements viz. HR coils in the case of steel tubes. Geographically distributed capacities/warehouses, deep distribution network and tight control on working capital have been the other hallmarks of these successful companies.

Valuations for the segment leaders are on the higher side at 18-20x FY17E. However, advantages of scale as well as direct benefits from identifiable public spend themes (like urban infra/irrigation/water supply) will likely sustain multiples as earnings should register 20-25% CAGR over the next few years.