Ampersand Capital Investment Advisors LLP

Road less travelled - Aug 2017 Newsletter

Favourable flows continue to dominate headlines

Let us start with the summary of our market review - liquidity still remains supportive despite significant FII selling, fundamentals a bit slow to react yet investor mood is undaunted. We continue to hold on to our advise – resist going down the quality chain, use dips as buying opportunity and continuously evaluate seemingly overpriced stocks.

Corrective bouts likely, which is good for investing

After hitting an unexpectedly early peak in July, our markets have exhibited volatility and weakness over the past month. This was due to combination of regulatory action (SEBI's suspension of several listed names), rise in geopolitical noise (US-North Korea) and corporate imbroglio (Infosys). So this could just be an aberration, or more likely a corrective/consolidation phase which we have been calling and waiting for. If it indeed is the latter, we expect this to last through Sept/Oct (when large quality IPOs plan to raise around Rs 50-70k crore), and thereby give an opportunity to invest in high quality stocks, irrespective of market cap.

Fundamentals could take longer to play out

On the fundamental front, Q1 results were below par. While the disappointment was spread across sectors, it could partially be attributed to the GST disruption. Also, management commentary in the calls we attended seemed optimistic about the future, mostly based on early recovery trends witnessed in August. Economic indicators are mixed - monsoons have lagged forecasts a tad putting some risk to agricultural growth but inflation risk is subdued, which should drive consumption growth. In the overall analysis, earnings downgrade cycle could continue for another quarter. However, this doesn't change our predominantly bullish view especially considering market's indifference towards the continuing disconnect with the earnings. Therefore delayed earnings recovery will, at worst, constrain further valuation re-rating in the near term. Anecdotally too, mood continues to be bullish. We attended couple of broker conferences in August, where investors continued to display high level of interest.

We expect cyclical recovery in corporate capex (public capex is already strong) and rural wages to take hold gradually. Though we are again back to expecting an earnings recovery in 2HFY18, the cyclical factors appear strong enough for a U-shaped recovery which will carry forward into FY19. As such, we think valuations will re-rate gradually to this recovery, possibly culminating in a strong Q4FY18 for the markets.

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Miles to go

We revisit the sub-sector of road construction within one of our favoured themes of public capex. Stocks in the sector have done well over last year or more but we believe that the sector is poised for a second wind for the following reasons.

1. The Ministry of Road Transport and Highways has approved "In-Principle" declaration of about 51,300 km length of state roads as new National Highways subject to the outcome of their Detailed Project Reports (DPRs). The total length of NHs in the country as on 31st March, 2014 was about 91,287 km. This has been enhanced to about 1,15,435 km at present.

2. Ministry has also reduced threshold traffic for 4-laning of NHs from 15,000 Passenger Car Units (PCUs) per day to 10,000 PCUs/day for plain regions. NHAI will implement the same through additional market borrowings, etc., in a phased manner by leveraging available budgetary allocation. About 5,575 km of national highways have been identified accordingly.
3. In the first quarter FY18 earnings calls, company managements indicated road orders worth INR75,000-80,000 crs to be bid out in the remainder of FY18, with majority being in HAM route. The orders had slowed down recently as NHAI now considers only those projects for bidding which have >80% land requirement in place.

The new round of road capex is being led by the new generation of roadcos (KNR, Dilip, PNC) and the acceptance of Hybrid annuity model (HAM) among road construction companies and banks. Lessons have also been learnt from the past cycle with most companies operating at net working capital of 90-100 days (KNR being the best at 45). That coupled with steady EBITDA margins have led to respectable ROEs of ~20% and good cash conversion. We recommend investors to hold a combination of the following three stocks based on their investment horizon and risk appetite.

1. **KNR**: Clean balance sheet with efficient working capital management. Though order book to sales is on the lower side at 2x, order management was conservative in the first wave of HAM bidding which is set to change over the next 3-6 months. Trading at 15x FY19E.

2. **Dilip Buildcon**: An asset intensive business model with order book/sales of 3x. Though it has material equity commitment in HAM/BOT projects, recent deal to offload stake will help rotate the equity for new HAM bids. Trading at 12x FY19 (excluding BOT)

3. **PNC Infratech**: Clean balance sheet with order book/sales of 4.5x. High project concentration and project delays have plagued execution but likely to pick up in 2HFY18. Trading at 12x FY19E (ex-BOT).

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