



Tigers on home turf - Feb 2017 Newsletter

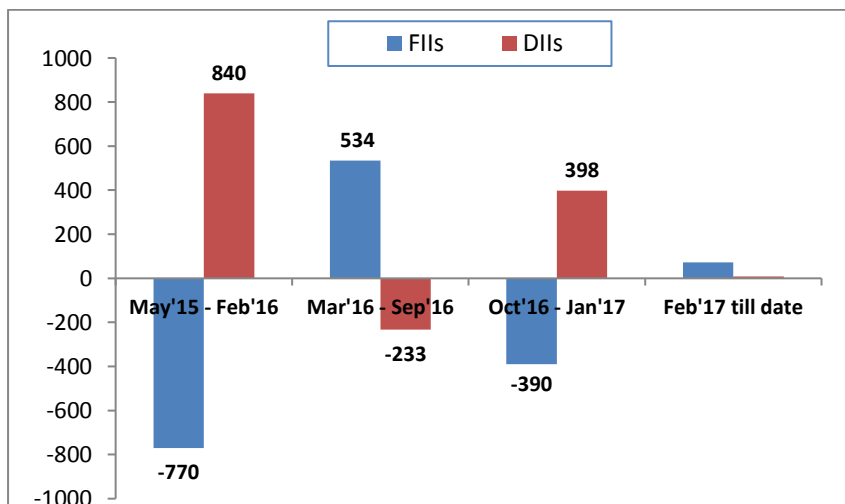
Hits and misses

With every passing financial year, the bar for the Union Budget seems to be getting lower. So despite the 2017 budget turning out to be an average one (barring the thrust on real estate and meeting the fiscal deficit expectations), it was well received by stock markets. Of course, the fact that there was nothing overtly populist in the budget (in our previous newsletter we had laid down our expectations of a popular, not a populist budget) and taxation on equity asset class was left undisturbed, helped too. Even the RBI credit policy in the subsequent week was a clear miss from equities perspective as consensus had tilted towards a routine cut. But after a few inconsistencies, RBI is now taking the inflation targets seriously and wants to watch core inflation and not be swayed by headlines. The shift of monetary policy to Neutral stance would not immediately affect the applicable rates for the corporate and retail borrowers, but it does constrain the runaway euphoria.

Making hay in favourable conditions

Talking of euphoria, investing in Indian equities does feel like Indian cricket team performing on domestic pitches. Some of the movements and stock appreciation especially in micro and small caps is typically driven by domestic flows (and not FIIs), and reminds us of batsmen with average technique scoring big runs even as the accomplished ones (read quality midcaps) score even bigger (read get more expensive). This is not to say that the quality midcaps have not weathered demonetisation better (akin to an odd session or two with overcast conditions). But by and large, sun has been shining, pitch is favourable and crowd support (read domestic flows) partisan.

Can this continue? We think the odds favour it. Australian team is touring and the subsequent IPL season will extend this run on the domestic turf. Something similar is happening in equities this cricket season. Since November, DIIs have helped absorb selling by foreigners and are now driving the markets. Infact, DIIs have played a perfect foil to the FII activity over last 18-24 months (chart below – figs in INR bn).



We might see the tussle between FIIs and DIIs resulting in sideways or consolidation phase, especially as corporate earnings have still not fully digested demonetisation (impact likely to sustain in Q4FY17). However, anecdotally we see a lot more allocation of domestic savings to equities as investors cut back on real estate investments and/or debt instruments. We thus see strong support to this rally over 6-12 months and any correction will not be very deep.

Results hold the key

This quarter will be period of results in more ways than one. While Q3 financial results beat lowered expectations, the dynamics of the demonetisation mean there could be second and third level impact (especially on the cash-based informal segment) on earnings in Q4 and may be beyond. NBFCs have by and large surprised operationally, so have some of the consumer discretionary names but they were helped enormously by an excellent festival season early in Q3. The full impact will come in Q4 despite the overall easing of cash situation, as the flow through could still take some time to play out in rural areas, which was hit the most. The general corporate commentary has been of a pick-up in January and February compared to Q3.

The other result which probably holds equal significance but the impact could be momentary is of the ongoing Assembly elections, to be announced before mid-March. A favourable result in favour of BJP will be viewed as a positive voter response to governance in general but Demo in particular. This could act as a double edged sword as well. On the other hand, an unfavourable result would attract negative market sentiment but only for the near term.

New kids on the block

Staying with the NBFC theme, we focus on the diversified conglomerates like IIFL and Edelweiss. Both the companies have come a long way from being predominantly capital market focused, and now boast of a wide bouquet of businesses – NBFC and wealth management being the primary drivers of value. While NBFC businesses have been relatively well understood with the underlying book values providing base for the valuation, wealth management seems to be at an inflexion point.

Most of the shops are witnessing sharp increase in Assets under Advice with healthy fee income growth; this will be aided significantly by the tailwind of rising share of financial assets in domestic savings over next 2-3 years. More importantly, wealth management business is capital efficient and has significant operating leverage making it ideal for premium valuations based on Price-to-earnings rather than Price-to-book. While IIFL is well ahead in wealth management, built and led by a strong top team, Edelweiss (and for that matter smaller names like JM) can create disproportionate delta from this business as the cost-to-income ratio declines rapidly once assets crosses threshold. Investors can buy Edelweiss for (i) the profitability inflexion in wealth management and (ii) exposure to the lucrative asset reconstruction business while IIFL offers (i) a well-capitalised NBFC play and (ii) well-oiled and already hugely profitable wealth management setup.