



Waiting for Godot - October 2016

Markets in a satiated state

Markets weakened at the margin over the past month despite the domestic rate cut and reduced chances of an upset outcome in the US elections. US Fed rate hike remains a key event in this quarter, but may not surprise the markets when it happens. Besides, expectation of a domestic consumption recovery in H2 FY17 and steady progress on GST has neutralised some of the lurking risks in the global risk appetite. On the balance, we maintain our view that markets will undergo a corrective or consolidation phase which could last a few months, and thereby offer better investment opportunities.

Good news priced in?

In the September newsletter we had highlighted that the increased participation of small/micro caps with unproven track record and the premium valuations of midcap indices (vs. discount earlier) has resulted in a risk of growth expectations bordering on the unrealistic in several cases. This is evident in the Q2 results season so far – good results have failed to generate enough enthusiasm for the stock prices, especially in midcaps. On the other hand, earnings shortfalls continue to be punished. As a result, we have witnessed narrowing of the segments/stocks which are performing in the ongoing earning season. In some cases, disappointing results have been salvaged by a positive management commentary regarding H2FY17 recovery; a lot therefore seems to be riding on the demand data in the near term.

But expectations continue to be high given the trio of favourable macro tidings in H1 – good monsoons, lower rates and 7th pay commission implementation. Any delay in pick-up in demand data viz. consumer discretionary (autos, consumer durables, home improvement) and infrastructure spend (cement, steel and building material demand) will prolong the corrective phase in the markets. Besides, GST implementation in April-17 could pose challenges (albeit temporary) pertaining to inventory correction and/or demand postponement during mid-2017.

US election results seem to be a foregone conclusion and priced in; post the election results focus will quickly shift on US Fed, the future policy direction and the impact on USD. At the same time, a 25bps Fed rate hike later this year is unlikely to cause havoc in the markets as it is largely expected.

How to manage the risks

Given the satiated behaviour of the markets and the risks arising thereof, most prudent course of action would be partially book profits wherever valuations don't support fundamentals. While we continue to scout for new ideas (we focus on Bajaj auto in the next section), the new stock selection

criteria should become more stringent rather than less. The starting point in this environment should be to focus on stocks that have under-performed and which have the potential to surprise the consensus expectations. Meanwhile, we advise clients to consolidate existing position in our favoured sectors i.e. Cement, NBFCs, Speciality Chemicals. We recommend remaining fully invested in cement (Shree, Dalmia & JK Lakshmi are our preferences) as visibility of demand improvement in H2 and pricing power (esp. in Northern and Western markets) is one of the highest. Stay with Housing Finance companies in NBFCs (viz. LIC HF) and the large diversified specialty chemicals companies (viz. Aarti Industries).

Autos - A rewarding experience

In the consumer discretionary space, autos have stood out through sustained operational growth which has mirrored in exceptional stock performances over an extended period. At a time when tailwinds are favourable on likely rebound in rural economy and lower interest rates, we expect the sector to continue to do well in the coming year as well. A stock selective approach will continue to secure reasonable investment gains.

Bajaj Auto - Ride the premiumisation wave

Bajaj Auto is one auto stock has underperformed the sector, and more particularly the two wheeler space. The reasons are obvious and understandable - sluggish demand in key export destinations and absence in the domestic scooter market. Also, two wheeler industry is no longer a duopoly with new competitors establishing a niche for themselves. This is reflected in the company's modest sales performance over the past 5 years (~7% CAGR), which has lagged peers.

In our opinion, most of the uneventful phase is behind, and we expect the company's growth trajectory to be stronger compared to past trends. The key variable which is likely to drive this will be the domestic motorcycles business (around 60% of standalone sales), and the premium space in particular (over one-half of consolidated EPS as per our estimates, which includes 48% of profits in associate KTM). We re-emphasise that while motorcycle demand could lag other segments, the market is moving towards pricier models, thereby playing a significant part in driving in overall two wheeler growth. For Bajaj Auto, this structural trend presents the biggest opportunity.

We expect growth to be led by slew of new motorcycles in H2. The particularly meaningful models in our view would be (1) Kratos VS 400 positioned to compete with Royal Enfield's leisure motorcycles, (2) Pulsar 2017 range, which still remains India's leading sports motorcycle, and (3) variant of V, the newest brand in the commuter segment. Collectively, we expect these models to enhance the company's market share in motorcycles, thereby giving the best sales visibility relative to peers.

Based on consensus forecasts, stock trades at P/E of 17.8x FY18E and 15.9x FY19E. We expect EPS upgrades which should play out in the coming quarters. However, stock rerating could happen much faster. Any recovery in export markets especially given the recovery in commodity prices, could provide further tailwind to the pace of earning upgrades.