

APRIL 17, 2017

UPDATE

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Small need not be beautiful. The sharp rally in stock prices, especially of mid-cap. and small-cap. names without any significant changes in underlying fundamentals, makes us uncomfortable about the nature of the rally. It is perhaps easier to believe the narratives around 'undiscovered' stocks rather than well-researched large-cap. names. We make a few changes to our recommended Model Portfolio as some of our 'wildcard' recommendations have performed rather well over the past 3-4 months.

A joyride can turn into a crash rather quickly

The sharp rally in stock prices, especially of companies with weak fundamentals and limited visible changes to financials and/or operations, makes us quite uncomfortable about the nature of the current rally. It seems we are getting into a zone of irrational exuberance. In particular, we are unable to fathom the bullishness of the market with respect to the mid-cap. and small-cap. names, which are seeing rapid increases in market capitalization without any real changes in their fundamentals. It is not as if the stocks were inexpensive to start with.

Size matters; the smaller the better is the new mantra

We note that the performance of stocks and sectors has been quite varied over the past few months (see Exhibit 1). In particular, mid-cap. and small-cap. stocks have done much better than their large-cap. counterparts. It is possible that the market may have discovered certain virtues in the smaller stocks that were unknown until recently. However, it is also possible that limited knowledge about the 'undiscovered' names may have made it easier for a section of the market to believe narratives about the names. Large-cap. stocks are generally well-researched and it is hard to find new virtues in familiar stories. 'Familiarity breeds contempt' perhaps applies equally to human beings and stocks. It is interesting to see the performance (see Exhibit 2) and valuations (see Exhibit 3) of various buckets of stocks in our coverage universe.

Index valuations look reasonable but may not mean much

As discussed in our April 10, 2017 note titled *The curious case of the Indian market*, the valuations of the broad market indices (see Exhibits 4-5) are quite misleading given (1) the wide range of valuations across sectors and (2) the large contribution of 'low' P/E stocks and sectors to the overall net profits of the indices (see Exhibit 6). Even more interestingly, several mid-cap. and small-cap. stocks in the semi-branded businesses are trading at rather rich valuations (see Exhibit 7), which makes us nervous about the potential erosion in market capitalization of the names as and when the market becomes more rational in its expectations about the earnings and returns of such businesses.

Here's a mystery on 'liquidity'

One of the common explanations that we hear about the rich valuations of the market and investors' helplessness to do much about the same is the 'liquidity' argument of large inflows into domestic equity mutual funds (see Exhibit 8). However, it seems that the 'net' investment by DII's (including insurance companies) in the market is quite low (see Exhibit 9) compared to the inflows into the MFs. Insurance companies have been net sellers in the market and cash levels with MFs have perhaps gone up over this period.

QUICK NUMBERS

- **BSE Smallcap Index up 24%, BSE Midcap Index up 20% and BSE-30 Index up 10.5% CYTD**
- **Nifty-50 Index trades at 18X FY2018E 'EPS'**
- **US\$3 bn of inflows into domestic equity MFs, US\$0.2 bn of inflows by DIIs in 1QCY17**

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Changes to large-cap. Model Portfolio

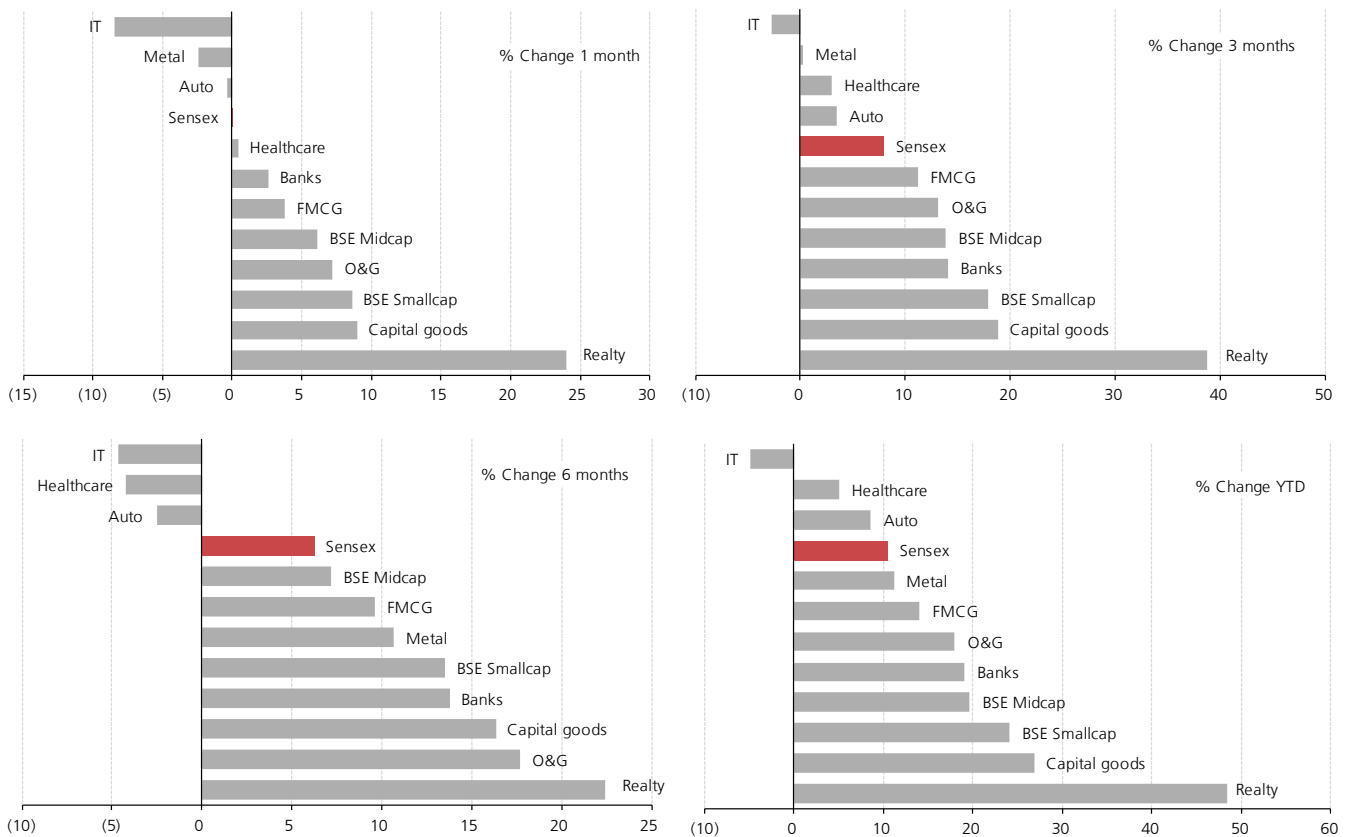
We remove DLF (200 bps earlier) from our Model Portfolio (see Exhibit 10, our revised Model Portfolio) noting its strong performance over the past four months, roughly the period the stock has been in our Model Portfolio. The stock is up 55% in the past four months. We were 'playing' for (1) value 'unlocking' in the commercial portfolio of DLF (within its 60% subsidiary DCCDL) and (2) a recovery in the residential real estate market by 3QFY18 on the back of sharp increase in affordability (flat residential real estate prices in most metros and 200 bps decline in interest rates over the past 3-4 years).

We include Vedanta with a weight of 200 bps on reasonable reward-risk balance. The stock offers about 20%+ upside to our current fair valuation of ₹290 and even some reduction to our fair valuation on INR-USD changes (stronger INR is negative for EBITDA and valuation) should still result in meaningful potential upside to our revised target price. Also, we are increasingly more positive on the global supply-demand balance for aluminum noting the potential restructuring of aluminum capacities in China. The ex-China world market is already in a deficit situation and any removal of Chinese capacity on environmental grounds by Chinese authorities could result in tightening of the market.

We also remove 100 bps from Infosys (900 bps now) and add it to ITC (400 bps now). We are already quite underweight the Indian IT services sector with no 'positions' in other Tier-1 IT stocks.

Exhibit 1: Mid-cap. and small-cap. indices have risen sharply in the past few months

Performance of sectoral indices over various periods



Source: Bloomberg, Kotak Institutional Equities

Exhibit 2: Smaller companies have outperformed bigger companies

Aggregate performance of companies in KIE coverage universe in various market capitalization buckets (%)

Market cap. (US\$ bn)	Companies		Performance (%)				
	(#)		1m	3m	6m	1y	YTD
>US\$20 bn	18		(0.4)	7.7	7.7	16.6	9.6
US\$10-20 bn	18		0.4	9.0	8.7	27.9	15.3
US\$5-10 bn	35		2.4	8.9	8.9	22.9	14.7
US\$2.5-5 bn	34		2.4	14.1	6.6	19.2	19.5
US\$1-2.5 bn	54		3.1	14.8	10.0	27.2	20.1
<US\$1 bn	34		5.0	19.7	10.5	24.0	25.6
KIE universe	193		0.8	9.3	8.2	20.7	13.3

Source: Bloomberg, Kotak Institutional Equities

Exhibit 3: The market has a lot of faith in earnings recovery in the smaller companies

Aggregate valuation of companies in KIE coverage universe in various market cap buckets (%)

Market cap. (US\$ bn)	Companies		P/E (X)			P/B (X)		
	(#)		2017E	2018E	2019E	2017E	2018E	2019E
>US\$20 bn	18		18.8	16.2	14.1	2.7	2.5	2.2
US\$10-20 bn	18		19.0	16.2	14.3	3.2	2.8	2.5
US\$5-10 bn	35		21.3	17.7	15.2	2.6	2.4	2.1
US\$2.5-5 bn	34		31.3	27.8	22.0	3.0	2.8	2.6
US\$1-2.5 bn	54		26.1	17.1	13.5	1.9	1.8	1.6
<US\$1 bn	34		41.8	20.9	15.8	2.7	2.4	2.2
KIE universe	193		20.6	17.2	14.8	2.7	2.5	2.2

Source: Bloomberg, Kotak Institutional Equities estimates

Exhibit 4: We expect earnings of the Nifty-50 Index to grow 18% in FY2018 and 15.4% in FY2019

Valuation summary of Nifty-50 sectors (full-float basis), March fiscal year-ends, 2017E-19E

	Mcap. (US\$ bn)	Adj. mcap. (US\$ bn)	Earnings growth (%)			PER (X)			EV/EBITDA (X)			Price/BV (X)			Div. yield (%)			RoE (%)		
			2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E
Automobiles	107.9	57.4	(9.9)	39.1	20.6	25.5	18.3	15.2	11.6	9.0	7.5	3.8	3.3	2.8	0.9	1.1	1.2	15.1	18.1	18.7
Banking	237.1	179.0	15.7	35.4	23.9	25.1	18.6	15.0	—	—	—	2.6	2.3	2.1	0.9	1.1	1.4	10.3	12.6	13.9
Cement	36.8	16.6	23.6	26.5	27.6	30.2	23.9	18.7	14.6	11.4	8.8	3.0	2.7	2.4	0.6	0.6	0.6	9.8	11.2	12.8
Consumers	99.1	54.4	6.2	13.4	14.1	39.3	34.7	30.4	26.2	23.0	20.0	13.2	12.3	11.6	1.7	2.0	2.3	33.6	35.6	38.3
Energy	158.8	57.0	31.8	5.1	7.5	12.1	11.6	10.8	8.0	7.1	6.0	1.7	1.5	1.4	2.5	2.4	2.6	13.8	13.3	13.0
Industrials	24.3	21.4	11.4	37.5	24.2	29.7	21.6	17.4	22.7	18.2	15.2	3.9	3.6	3.2	1.4	1.8	2.3	13.1	16.5	18.5
Infrastructure	10.3	4.0	31.0	(24.6)	3.0	17.6	23.4	22.7	15.5	14.8	14.2	4.0	3.5	3.1	0.5	0.7	0.8	22.6	15.0	13.8
Media	7.8	4.4	32.9	24.2	21.2	41.7	33.6	27.7	23.6	20.4	17.0	5.3	4.9	4.4	0.5	0.7	0.8	12.7	14.5	15.9
Metals & Mining	40.8	14.5	16.4	64.3	12.6	17.9	10.9	9.7	8.8	7.0	6.3	2.7	2.4	2.2	5.1	4.6	5.1	14.9	22.2	22.6
Pharmaceuticals	55.1	29.2	17.0	12.1	18.3	22.8	20.3	17.2	13.8	11.9	9.6	4.1	3.5	3.0	0.7	0.8	0.9	18.0	17.2	17.4
Technology	146.4	63.8	9.4	4.7	8.7	15.6	14.9	13.7	10.8	9.9	8.8	3.7	3.4	3.0	2.4	2.5	2.8	23.7	23.0	22.0
Telecom	31.0	9.8	(5.9)	(24.1)	56.7	33.8	44.5	28.4	7.5	7.8	6.7	2.4	2.3	2.3	1.4	1.3	1.9	7.0	5.3	8.1
Utilities	40.3	15.4	14.3	14.7	12.2	13.4	11.7	10.4	10.5	9.1	7.9	1.6	1.5	1.3	1.9	2.2	2.4	12.1	12.7	12.9
Nifty-50 Index	996	527	14.7	17.9	15.4	19.9	16.9	14.6	11.0	9.5	8.2	2.8	2.6	2.3	1.7	1.8	2.0	14.3	15.3	15.8
Nifty-50 Index (ex-energy)	837	470	9.7	22.4	17.8	22.6	18.5	15.7	12.2	10.6	9.1	3.3	3.0	2.6	1.5	1.7	1.9	14.4	16.0	16.8

Notes:

(a) We have used consensus numbers for Bosch, Indiabulls Housing Finance and Kotak Mahindra Bank.

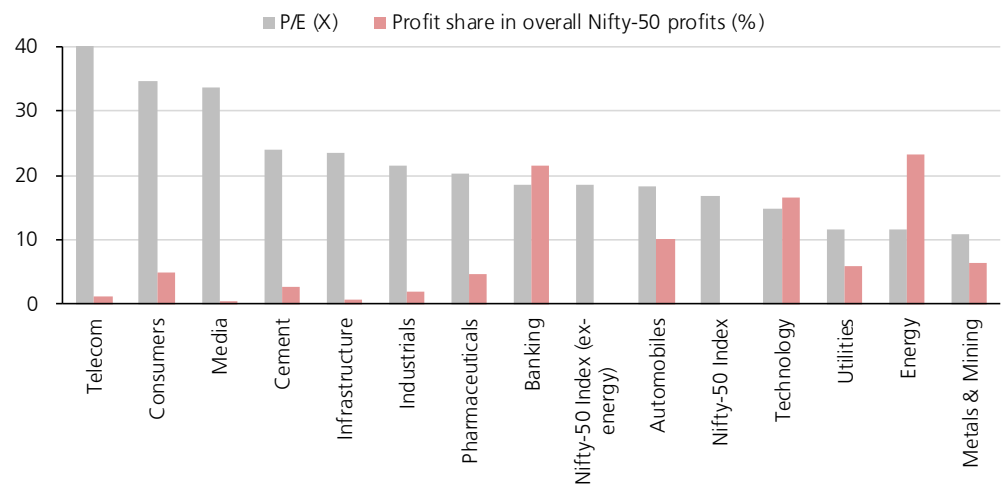
Source: Kotak Institutional Equities estimates

Exhibit 5: The Nifty-50 Index trades at 18X FY2018E 'EPS' and 15.2X FY2019E 'EPS' (free-float basis)
Valuation summary of Nifty-50 sectors (free-float basis), March fiscal year-ends, 2017E-19E

	Mcap. (Rs bn)	Adj. mcap. (Rs bn)	Adjusted net profits (Rs bn)			Adjusted P/E (X)		
			2017E	2018E	2019E	2017E	2018E	2019E
Automobiles	6,953	3,698	150	213	260	24.7	17.3	14.2
Banking	15,277	11,535	459	588	726	25.1	19.6	15.9
Cement	2,371	1,071	41	50	63	26.3	21.3	17.0
Consumers	6,385	3,504	94	106	121	37.3	32.9	29.0
Energy	10,234	3,676	291	308	331	12.6	11.9	11.1
Industrials	1,568	1,380	46	64	79	29.7	21.6	17.4
Infrastructure	663	258	15	11	11	17.6	23.4	22.7
Media	501	285	7	8	10	41.7	33.6	27.7
Metals & Mining	2,630	935	45	88	100	20.6	10.6	9.4
Pharmaceuticals	3,551	1,884	80	91	109	23.5	20.7	17.2
Technology	9,437	4,111	270	278	303	15.2	14.8	13.6
Telecom	2,001	628	18	13	22	34.6	47.0	29.1
Utilities	2,599	991	74	82	94	13.3	12.1	10.6
Nifty Index	64,169	33,956	1,591	1,902	2,230	21.3	17.9	15.2
Nifty-50 Index (ex-energy)	53,935	30,280	1,300	1,594	1,898	23.3	19.0	16.0

Source: Kotak Institutional Equities estimates

Exhibit 6: 'High' P/E sectors account for a relatively low share of profits of the Nifty-50 Index
Sector-wise P/E and profit share in overall profits for the Nifty-50 Index, FY2018 basis (sorted on high PE basis)



Source: Kotak Institutional Equities estimates

Exhibit 7: Market expects high RoE for a long time for certain semi-commodity sectors given their high P/B
EPS growth, P/E, P/B and RoE of certain stocks, March fiscal year-ends, 2017E-19E

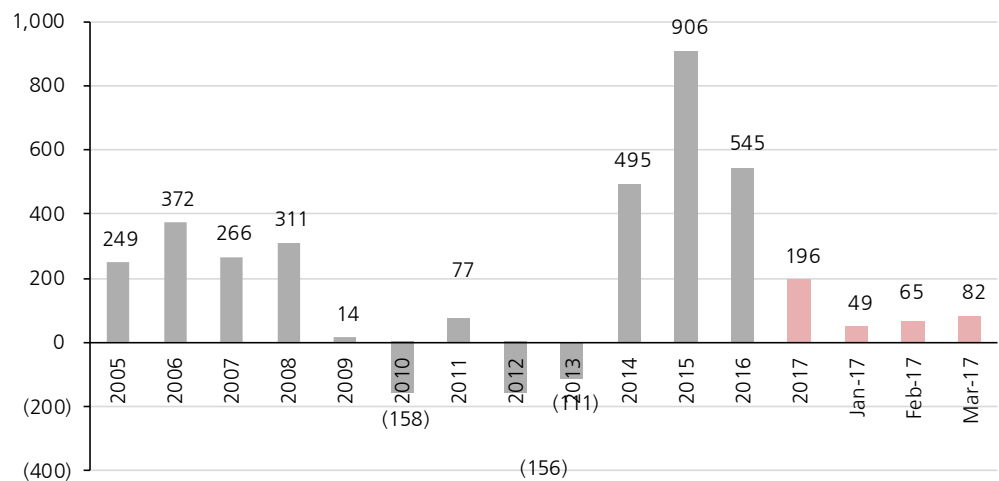
Company	Sector	EPS growth (%)			P/E (X)			P/B (X)			RoE (%)		
		2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E
Amara Raja Batteries	Automobiles	2.6	18.1	13.5	29.1	24.6	21.7	5.9	5.0	4.2	21.9	21.9	21.1
Apollo Tyres	Automobiles	8.5	1.9	23.4	10.5	10.3	8.3	1.6	1.4	1.2	16.7	14.8	15.9
Exide Industries	Automobiles	12.1	8.5	8.5	28.1	25.9	23.9	4.0	3.7	3.4	15.0	14.8	14.7
ACC	Cement	(13.3)	37.3	50.0	43.8	31.9	21.3	3.3	3.1	2.8	7.5	9.9	13.8
Ambuja Cements	Cement	4.2	42.3	43.2	42.6	29.9	20.9	2.5	2.4	2.3	7.6	8.2	11.2
Dalmia Bharat	Cement	35.0	189.4	44.8	72.0	24.9	17.2	4.5	3.9	3.2	6.5	16.7	20.2
Shree Cement	Cement	237.5	35.7	35.1	45.4	33.5	24.8	8.6	6.9	5.5	20.4	23.0	24.7
UltraTech Cement	Cement	21.5	31.2	26.0	41.6	31.7	25.1	4.8	4.2	3.6	12.1	14.1	15.5
Asian Paints	Consumer Products	5.8	12.5	18.5	53.5	47.6	40.1	15.6	13.5	11.7	31.3	30.4	31.3
Pidilite Industries	Consumer Products	13.2	14.6	16.1	42.7	37.3	32.1	11.0	9.3	7.8	28.0	26.9	26.5
Crompton Greaves Consumer	Industrials	17.4	16.0	24.3	46.7	40.2	32.4	28.8	18.2	12.4	82.5	55.4	45.6
Havells India	Industrials	20.8	19.0	16.1	52.0	43.7	37.6	9.6	8.6	7.8	19.4	20.8	21.8
Voltas	Industrials	27.1	11.3	15.2	30.7	27.6	24.0	5.0	4.4	3.9	17.2	17.0	17.3
Astral Poly Technik	Others	21.0	28.2	23.2	55.4	43.2	35.1	8.1	6.9	5.8	15.0	17.1	17.9
Cera Sanitaryware	Others	15.6	20.0	17.3	38.3	31.9	27.2	7.2	6.0	4.9	20.7	20.5	19.8
Century Plyboards	Others	2.9	28.5	22.4	33.6	26.1	21.3	8.7	6.9	5.8	28.7	29.4	29.5
Greenply Industries	Others	1.6	8.8	15.8	27.0	24.8	21.4	4.1	3.5	3.0	19.1	16.9	16.8
HSIL	Others	20.6	16.2	16.5	22.7	19.6	16.8	1.7	1.6	1.5	7.6	8.3	9.1
Whirlpool	Others	28.8	22.6	22.8	48.1	39.2	31.9	10.4	8.6	7.1	24.2	24.0	24.5

Notes:

(a) We have used consensus numbers for Century Plyboards and Greenply Industries.

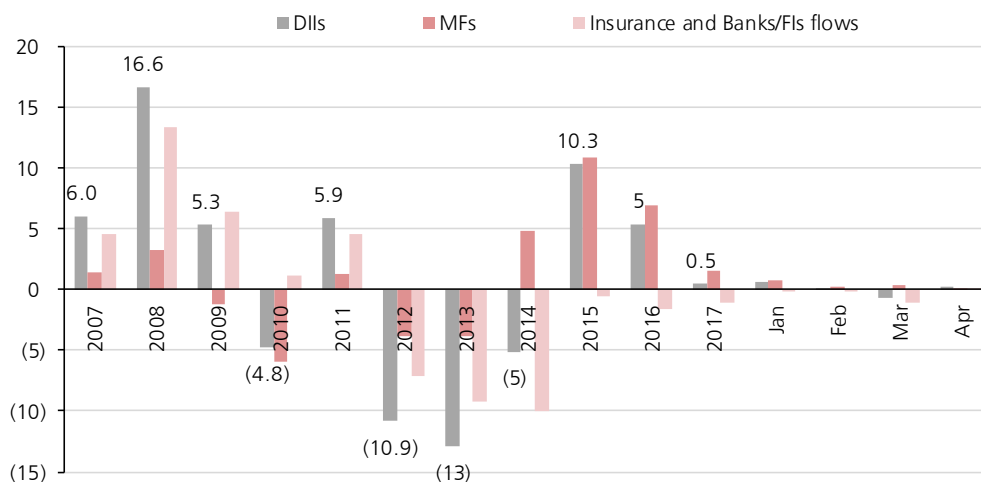
Source: Bloomberg, Companies, Kotak Institutional Equities estimates

Exhibit 8: Domestic equity MFs have seen US\$3 bn of net flows as per AMFI data in 1QCY17
Net MF flows, calendar year-ends, 2005-17 (Rs bn)



Source: AMFI, Kotak Institutional Equities

Exhibit 9: DIIs invested US\$182 mn and MFs US\$1.4 bn in 1QCY17
Equity flows by domestic institutions (MFs + insurance companies) (US\$ bn)



Source: Bloomberg, Kotak Institutional Equities

Exhibit 10: A few bottom-up ideas
KIE large-cap. Model Portfolio

Company	Price (Rs) 17-Apr-17	Rating	KIE weight (%)
Automobiles			
Maruti Suzuki	6,116	ADD	3.0
Tata Motors	449	BUY	5.0
			8.0
PSU Banking			
State Bank of India	290	BUY	8.0
			8.0
Pvt. Banking/Financing			
Axis Bank	502	ADD	2.0
HDFC	1,480	ADD	7.0
HDFC Bank	1,436	REDUCE	8.0
ICICI Bank	282	BUY	10.0
LIC Housing Finance	637	BUY	2.0
			29.0
Consumers			
Colgate-Palmolive (India)	1,003	BUY	2.0
ITC	279	ADD	4.0
			6.0
Energy			
GAIL (India)	395	ADD	3.0
IOCL	425	BUY	4.0
Petronet LNG	440	ADD	2.0
Reliance Industries	1,392	ADD	7.0
			16.0

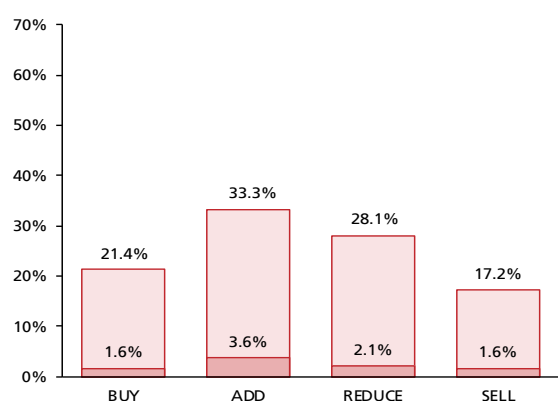
Company	Price (Rs) 17-Apr-17	Rating	KIE weight (%)
Metals & Mining			
JSW Steel	194	ADD	2.0
Vedanta	236	ADD	2.0
Tata Steel	462	ADD	2.0
			6.0
Others			
InterGlobe Aviation	1,092	ADD	2.0
			2.0
Pharmaceuticals			
Aurobindo Pharma	653	ADD	2.0
Cipla	576	BUY	4.0
			6.0
Technology			
Infosys	925	ADD	9.0
Tech Mahindra	422	BUY	2.0
			11.0
Utilities			
NTPC	159	BUY	2.0
Power Grid	202	BUY	4.0
Tata Power	84	REDUCE	2.0
			8.0
			100.0

Source: Bloomberg, Companies, Kotak Institutional Equities estimates

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Source: Kotak Institutional Equities

As of March 31, 2017

Ratings and other definitions/identifiers

Definitions of rating

BUY. We expect this stock to deliver more than 15% returns over the next 12 months.

ADD. We expect this stock to deliver 5-15% returns over the next 12 months.

REDUCE. We expect this stock to deliver -5-+5% returns over the next 12 months.

SELL. We expect this stock to deliver <-5% returns over the next 12 months.

Our target prices are also on a 12-month horizon basis.

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