4 January 2016

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India Banks

SDR: A band-aid for a bullet wound

Our analysis of 10 out of 15 strategic debt restructuring (SDR) cases suggests that this scheme is in no way a cure-all for Indian banks' deteriorating asset health – instead it exacerbates the risk by deferring an estimated Rs 1.5trn (US$ 23bn) of NPA formation (30-40 accounts or 2.2% of total credit) from FY16/FY17 to later years. Grim tidings from the FSR report on stress in the system from large borrowers and weak sectors would prod the RBI to tighten provisioning norms. We raise credit cost estimates across our coverage, pare target prices, and downgrade the sector to underweight.

- **Toxic delay: SDR defers Rs 1.5trn NPA recognition:** Our detailed interactions with companies under SDR, lenders, lawyers and industry experts suggest that banks may end up refinancing 30-40 ailing accounts under the scheme in the next one year, thus postponing NPA recognition of Rs 1.5trn (2.2% of credit). We think banks have little scope to fully recover loans via the sale of assets given several pitfalls to SDR.

- **Massive write-offs inevitable:** SDR invocation is not treated as restructuring for asset classification/provisioning, and thus most cases have standard restructured assets with low provisions of 5%. Our analysis of 10 SDR cases invoked so far reveals that interest accruals and loss funding will push up debt by 70% from first restructuring via corporate debt restructuring (CDR) until conclusion of SDR. Banks will thus have to write-off 35-95% of interest (debt + equity) in FY17/FY18 if stressed assets find no takers. The lenient 5:25 scheme may also see slippages from cyclical sectors.

  The haircut in case of a takeover will also be high, resulting in huge provisions for banks even if the SDR is successful. Our fair EV for six cases (three EPC, three metal players) representing 67% of total SDR debt is 65-85% lower than the current EV.

- **Grim tidings from RBI's financial stability report (FSR):** The report highlights that levered companies' debt as a proportion to total debt in the system has gone up by 200bps in the last one year. RBI's two stress tests on (1) credit concentration (group borrowers) and (2) weak sectors (infrastructure, iron & steel, MSME & textile) reveal a severe impact on bank NPAs and net worth in case of defaults.

- **The emperor (RBI) will strike back:** Banks currently retain the existing classification on assets that have been stressed for 1.5-2 years and also book income on the same. To ensure lenders do not take undue advantage of SDR/5:25 schemes (most cases are concentrated in stressed sectors and/or with large group borrowers) to postpone NPAs, the RBI may require them to start building provisions for these accounts and/or defer income recognition. This apart, the RBI's recent list of 150 truant borrowers that may be classified as bad by FY17 would put further pressure on banks.

- **FY16 a painful year for corporate lenders:** We cut target P/B multiples across our coverage to reflect the stress on bank books and adjust our TPs for the restructuring hit (at ~50% from 20-25% estimated earlier due to surging debt in SDR cases and the likelihood of onerous write-offs). We downgrade SBIN, AXSB and ICICIBC from BUY to SELL and BOB, CBK and PNB from HOLD to SELL. We maintain BUY on YES/IIB but cut our TP from Rs 1,075/Rs 1,200 to Rs 870/Rs 1,125.

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Impact on banks on SDR failure

Companies	Year of SDR failure	NPA bucket	Provision/ MTM hit (%)
Ankit Metal and Power	FY18	D3	92.9
Coastal Projects	FY17	D3	95.0
Electrosteel Steels	FY17	D3	89.5
Gammon India	FY18	D3	93.5
IVRCL	FY18	D3	88.9
Jyoti Structures	FY17	D2	37.4
Monnet Ispat	FY17	D2	35.1
Rohit Ferro-Tech	FY17	D3	93.6
Shiv-Vani Oil & Gas	FY17	D3	90.8
Visa Steel	FY17	D3	91.7

Source: Company, RCML Research | D is doubtful

SDR success

Sector	Buyout probability (%)	Likely haircut (%)
EPC and capital goods companies	10-15	75-85
Oil exploration companies	10-15	70-80
Metal companies with high debt with quality issues	20-35	65-80
Metal companies with high debt with linkage issues	35-50	50-65
Power companies with high debt and fixed PPA issues	50-65	35-50
Power companies with linkage issues	65-80	20-35
Real estate companies	75-85	15-25

Source: RCML Research

Click here for the full report.

1 January 2016

MarketFresh: FMCG Tracker

RM cost index edges down in November

The RM cost index continued on its deflationary path for most consumer companies in Nov'15, albeit at a slower pace. While the recovery in urban demand continue to be slow and gradual, the rural market continue to face slowdown blues on back of second consecutive year of deficit monsoon. However, we expect a gradual volume-led recovery with improving margins in H2FY16/ FY17. BUY HUVR, APNT, DABUR, CLGT, BRIT and MRCO.

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- **RM cost index moves down in Nov'15:** The RM cost index for Nov'15 was down 0.8% MoM (-2.8% YoY) for commodities under our coverage. Prices of key RM inputs for HPC companies such as LLP/LAB/HDPE corrected 4.3%/4.1%/3.5% MoM while those of palm oil/copra also declined 4.1%/3.9% MoM. In contrast, agricultural commodities such as barley/mentha oil/tea saw price inflation of ~3% MoM each and safflower oil/sugar/wheat ~1-2% MoM.

- **RM cost index eases for HPC players:** With LLP and copra witnessing deflationary trends, hair oil players MRCO/BJCOR/DABUR/Emami saw a 2-3% MoM drop in their RM index. Detergent & soap makers HUVR/ GCPL too witnessed deflation of 2-3% MoM as prices of LAB and LLP corrected in Nov'15.

  Food companies however saw flat-to-inflationary trends due to rising prices of most agricultural commodities post a deficit monsoon. The RM index for BRIT increased by 0.7% MoM led by higher sugar and wheat prices, while that for NEST was largely flat in Nov'15. APNT saw a 2.8% MoM decline in its RM index led by a 2.3%/8.3% MoM correction in TiO2/phthalic anhydride prices.

- **Promotional activities continue to push consumer spending:** Sluggish demand has forced consumer companies to continue investing heavily in promotions to spur consumer spending and protect market share. In the hair oil segment, MRCO cut prices of *Parachute Coconut Oil* (100ml) by ~3% MoM in December. HUVR was the most active in terms of pricing action in December, hiking prices of *Surf Excel Quickwash* (1kg pack) by 3.8% MoM and other personal care products such as *Pepsodent Expert Protection Toothpaste – Complete* (80 gm) by 3.3% MoM and *Pond's Cold Cream* by 7.1% MoM.

  In the foods segment, Agro Tech upped prices of *Sundrop* by 3-4% MoM, while in the tea segment, HUVR/Tata Global cut prices of *Red Label*/*Tata Tea Gold* (500 gm pack) by 7.3%/2.9% MoM. Amul hiked prices of *Amul Butter* (100gm pack) by 5.3% MoM.

Recommendation snapshot

Company	CMP	TP	Rating
Asian Paints (APNT)	879	935	Buy
Bajaj Corp (BJCOR)	428	500	Hold
Britannia Industries (BRIT)	2,986	3,600	Buy
Colgate Palmolive (India) (CLGT)	977	1,100	Buy
Dabur India (DABUR)	276	310	Buy
Emami (HMN)	989	1,150	Hold
Godrej Consumer Products (GCPL)	1,342	1,350	Hold
Hindustan Unilever (HUVR)	857	950	Buy
ITC (ITC)	328	320	Hold
Marico (MRCO)	227	250	Buy
Nestle India (NEST)	5,785	5,500	Sell

Stock price performance

Company (%)	1m	3m	6m	1yr
Asian Paints	4.0	4.7	15.5	17.3
Bajaj Corp	(2.1)	(5.0)	(2.3)	15.2
Britannia Industries	0.5	(4.4)	9.3	63.1
Colgate Palmolive (India)	0.1	1.6	(4.9)	8.2
Dabur India	(0.8)	(0.8)	(2.2)	18.9
Emami	4.5	(15.6)	(16.5)	24.7
Godrej Consumer Products	7.0	9.2	11.3	38.9
Hindustan Unilever	2.8	4.9	(6.7)	12.9
ITC	(5.4)	(0.4)	4.4	(10.8)
Marico	7.0	13.6	1.5	40.3
Nestle India	(1.6)	(9.9)	(5.8)	(8.4)
BSE FMCG	(1.5)	1.4	1.5	2.4
Sensex	(0.0)	(0.2)	(6.6)	(4.9)

Click here for the full report.

3 January 2016

India IT Services

Q3 Preview: Growth to remain tepid; outlook key

We expect muted growth for our IT coverage universe in Q3FY16. Large-caps are likely to report tepid US$ revenue growth of 0.3-1.1% QoQ with Chennai floods exacerbating the seasonal weakness in Q3, particularly for TCS and Wipro. Margins are likely to remain range-bound with the seasonal slowdown offset to an extent by INR depreciation. We like high FCF yield and differentiated business models among mid-caps (FSOL, REDI, OFSS and Infoedge) and maintain preference for INFO in large-caps.

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- **Momentum to slow down in Q3:** We expect muted US$ revenue growth of 0.6%/ 0.7%/0.3%/0.8%/1.1% QoQ for large-caps INFO/TCS/WPRO/HCLT/TECHM in Q3FY16 due to seasonality (more holidays, furloughs) and cross currency headwinds of 40-50bps. We thus build in EPS growth of 0.8%/5.4%/(2.7%)/4.1%/(7.8)% QoQ for INFO/TCS/ WPRO/HCLT/TECHM on expectations of slower revenue growth and flattish margins. Among mid-caps, we expect FSOL/REDI/OFSS to book strong QoQ revenue growth of 5.3%/5.9%/9.5% in INR terms.

- **Chennai floods exacerbate seasonal weakness:** TCS and Wipro, with employee strength of 65,000+ and 22,000+ respectively in Chennai, would be impacted by recent floods in the city and have already issued revenue warnings. We expect the impact to spill over to the broader sector as well.

- **INFO to maintain guidance:** We expect INFO to maintain its FY16 revenue growth guidance of 10-12% YoY in CC terms. While WPRO's Q3 revenue growth guidance was disappointing, we expect its Q4 guidance to be better at 1.5-3.5%, given a lower base and positive seasonality.

- **Mixed performance from mid-caps:** We expect mid-caps under our coverage to deliver mixed US$ revenue growth, in the range of -1 to 5.1% QoQ, with FSOL (5.1% QoQ) leading the pack. Margins should remain range-bound as seasonality is offset to some extent by INR tailwinds. We continue to like FSOL for its cheap valuations (8.3x FY17E) and strong cash flow generation.

- **View:** Large-cap IT stocks have underperformed the broader index by 5.1% in Q3 given a weak growth outlook for the quarter. We think revenue-led earnings beat is the key for outperformance and upgrades remain a challenge for the sector. We prefer high-yield FCF and differentiated business models in mid-caps, with FSOL, REDI, OFSS and Infoedge as our top picks. INFO remains our preferred large-cap stock.

Fig 1 - Q3FY16: IT preview

(Rs mn)	Results date	Sales	QoQ (%)	YoY (%)	EBIT	QoQ (%)	Margins (%)	PAT	QoQ (%)	YoY (%)	EPS (Rs)
TCS	12-Jan-16	275,745	1.5	12.5	73,312	(0.3)	26.6	59,844	(1.2)	9.9	30.2
Infosys	14-Jan-16	158,589	1.4	15.0	41,035	2.9	25.9	34,186	0.8	5.4	14.9
Wipro	18-Jan-16	128,824	2.9	7.4	24,515	0.9	19.0	21,757	(2.7)	(0.8)	8.8
HCL Tech. (HCLT)	4th week of Jan	103,356	2.0	10.6	20,603	5.0	19.9	17,942	3.7	(7.1)	12.7
Tech Mahindra (TECHM)	1st week of Feb	67,325	1.8	17.1	9,578	6.0	14.2	7,244	(7.8)	(10.1)	8.6

Source: Company, RCML Research

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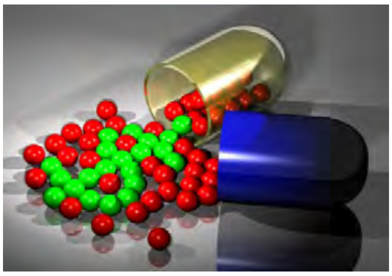

India Pharmaceuticals

Q3 Preview: Favourable base to buoy growth

The pharma sector is likely to report optically strong revenue/EBITDA/PAT growth of 10%/12%/37% YoY in Q3FY16 off a low base. QoQ however, earnings could decline 5% due to regulatory issues (SUNP, DRRD), lack of key approvals (LPC), and competition in key products (CIPLA, TRP). While domestic growth should pick up post a tepid Q2FY15 (low base, inventory re-stocking), sharp EM currency devaluation could hurt growth. ARBP (mid-cap pick) is set to post its best-ever quarterly profits.

- **ARBP, DIVI to outperform**: ARBP (PAT: +47% YoY) and DIVI (PAT: +28% YoY) are likely to emerge as outperformers in Q3FY16, and LPC (PAT: -27% YoY) DRRD (PAT: +7% YoY) as laggards. SUNP was hit by Ranbaxy integration costs and Halol issues in Q3FY15, and hence should see strong PAT growth (+178% YoY) due to the favourable base. TRP (-46% QoQ) is likely to report the sharpest drop in PAT sequentially, with increased competition in *gAbilify*. STR's earnings (PAT: +46% YoY) will be buoyed by Shasun and Arrow acquisitions whereas Natco (adj. PAT: +29% YoY) should benefit from strong traction in *Sofosbuvir*.

- **Approvals weak:** Barring ARBP (16 approvals, four tentative) and LPC (10 approvals, one tentative but not meaningful), the approval cycle remains weak for most other players. This along with price erosion in the base business and incremental competition in key products should lead to weak US growth for the sector.

- **Weaker INR a positive, EM currency devaluation to hurt:** A 6% YoY depreciation in INR-USD is positive for the sector (40-50% exposure) with DIVI, ARBP, LPC and SUNP the biggest beneficiaries. However, this will be negated by a sharp 15-30% YoY devaluation in EM currencies (15-20% exposure) with firms exposed to Russia, Venezeula and Brazil (GNP, DRRD, TRP) to be the most vulnerable. We factor in an 80bps QoQ margin contraction for our coverage universe in Q3FY16.

- **Key monitorables:**

(a) **SUNP:** Progress on RBXY merger; further update on warning letter
(b) **Cipla:** *gNexium*/*gPulmicort* contribution; *Seretide* UK launch update
(c) **LPC:** Update on Gavis integration; key product approvals
(d) **DRRD:** Outlook on Russia/Venezeula; update on warning letter
(e) **TRP:** Market share ramp-up in g*Nexium*, contribution from g*Abilify*; Brazil outlook
(f) **NTCPH:** Update on key products; traction in *Sofosbuvir*
(g) **STR:** Shasun and Arrow integration, update on Mylan notice
(h)**GNP:** Price hike impact (*Mupirocin* cream); Russia/Venezuela outlook
(i) **DIVI:** Update on new Kakinada plant
(j) **ARBP:** Traction in recent launches; turnaround of acquired EU biz

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RCML coverage

Company	Ticker	CMP (Rs)	TP (Rs)	REC
Aurobindo	ARBP IN	876	935	BUY
Cipla	CIPLA IN	650	755	HOLD
Divi's Labs	DIVI IN	1,155	1,305	BUY
Glenmark	GNP IN	922	1,370	BUY
Lupin	LPC IN	1,837	1,720	HOLD
Natco	NTCPH IN	579	600	BUY
Strides	STR IN	1,289	1,570	BUY
Torrent Pharma	TRP IN	1,452	1,445	HOLD

Source: RCML Research

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