STRATEGY

Risk is reset down…some growth will be too

India Equity Research | Strategy

India's risk has reset down—on equity valuations, currency and liquidity, taking most of the froth out of it. But could this market froth fizzle result in an economic reset down too? We believe with new leverage constraints, capital access challenges and diminished risk appetite, India's cyclical recovery could be more normalised or relatively muted. This should bring India to its longer-term averages: on valuations (15–16x), earnings growth (15–16%) and portfolio biases (consumption, quality). We see the Indian market range-bound (9,800–10,500) over the next 12 months and volatile, particularly through the elections in May 2019, but also offering reasonable value across select higher-quality businesses.

Risk reset down

India's risk has reset down: across valuations (1x SD premium to EM at peak), the currency and, to a lesser extent, interest rates (static as US yields rose). While triggered by oil and US yield increases – and still sensitive to them, India's risk and macro levels are probably where they should be. So beyond extraneous market swings, India's risk has reset lower, but also possibly settled down.

Moderate economic reset too…

We would expect economic trends and earnings expectations to be also reset lower—albeit only modestly. This reset is likely to be primarily driven by constraints on leverage (corporate and consumer), potential slowdown on equity capital access, challenges on the fiscal and diminished risk appetite, given volatile markets and the upcoming elections. This shouldn't, however, alter the structure or direction of the economy – but may impact the expected pace of cyclical recovery.

Valuations to reset to averages – throwing up opportunities

We see India's valuation framework settling at its longer-term averages (15–16x): NIFTY target of 9,800–10,500 as the market navigates risk, economic and elections variances. We would position the portfolio towards a few standout stocks, a greater quality bias and a little more defensive than we have been. It should be a trading market until elections, but is offering stock opportunities.

Top picks

Company	Current market cap (USD Mn)	Current market Price (INR)	P/B (X) FY19E	P/B (X) FY20E	P/E (X) FY19E	P/E (X) FY20E	RoE (%) FY19E	RoE (%) FY20E	Dividend Yield (%) FY19E
Reliance Industries	97,858	1,140	1.8	1.6	16	12	13	13	0.3
Infosys Technologies	41,350	699	5.7	5.2	19	17	27	32	5.7
ICICI Bank	27,315	313	1.9	1.7	21	11	9	16	2.7
Larsen & Toubro	23,100	1,216	3.2	2.4	21	17	15	16	1.3
Mahindra & Mahindra	12,613	749	2.5	2.2	16	14	17	17	1.3
Dabur	9,483	396	10.6	9.2	41	36	28	27	1.0
Hindalco Industries	7,049	232	0.8	0.7	10	8	9	9	0.0
Zee Entertainment Enterprise	6,147	473	5.1	4.3	28	23	20	20	0.3
Dr Reddy Labs	5,771	2,567	3.0	2.5	20	15	15	18	0.8
Lupin	5,432	887	2.8	2.5	31	19	9	14	0.8

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India was sitting up as a vulnerable market

The risk reset: A complete surprise?

No. While the reset was likely triggered by the sharp rise in oil prices and the projected US rate hike (refer to our note ***Economy: Real of Rudimentary***), India was sitting up as a vulnerable market. India's relatively strong performance over 1HYCY18 was increasingly reflected across equities, FX and interest rates. We highlight below the extent of relative overvaluation across most comparable measures. Effectively India's markets – across asset classes – was overvalued, relative to its own history and its EM peers and was valued generously on an absolute basis.

Chart 1: India's absolute valuations remain high…

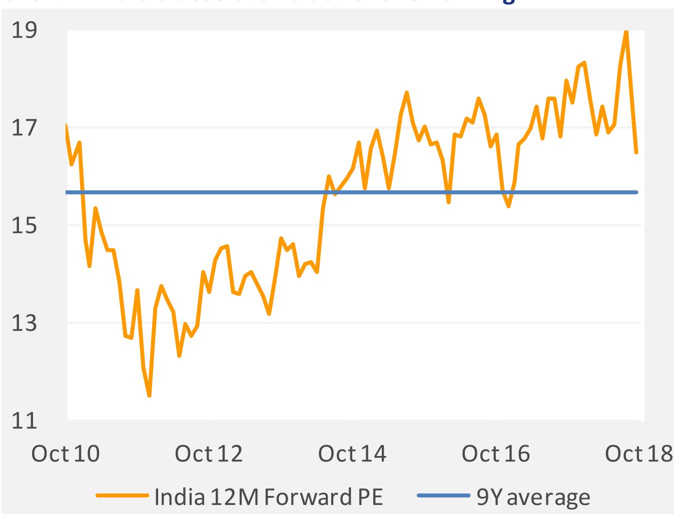


Chart 2: …have re-rated amid BoP shock

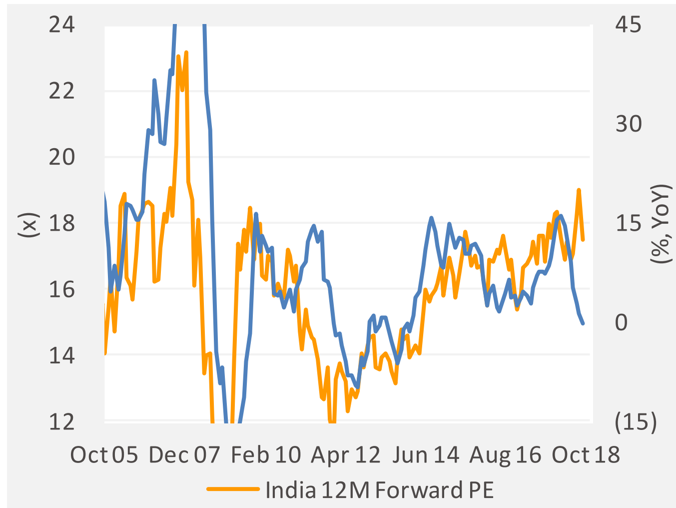


Chart 3: India has outperformed EM despite rising oil prices…

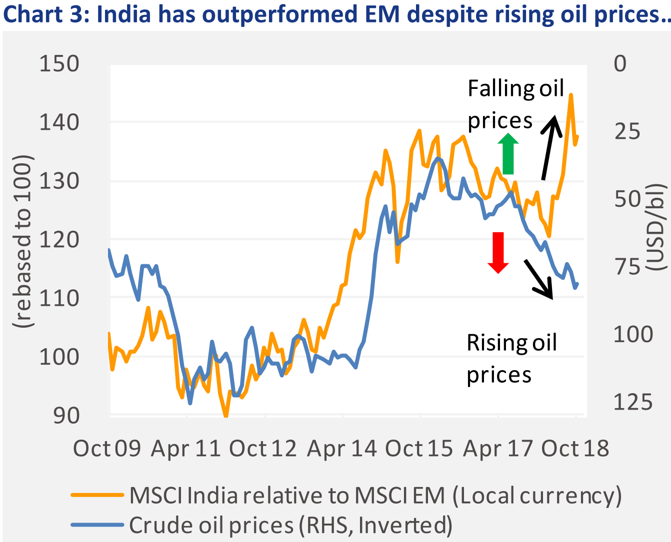
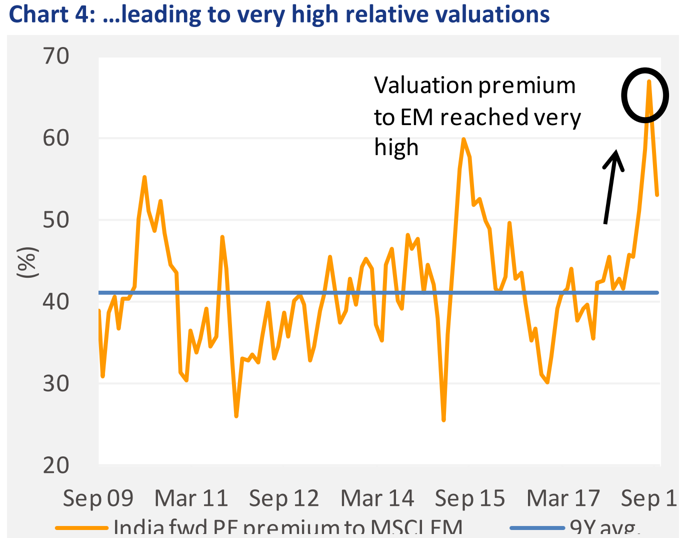


Chart 4: …leading to very high relative valuations



Source: Bloomberg, Edelweiss research

In addition, the performance of India's equity and currency markets relative to oil prices was also unusually strong vis-a-vis previous cycles – given India's fundamental (and almost unchanging) vulnerability to higher oil prices. The market took its time in picking it up— but there were enough indicators suggesting that India was frothy. Most of this froth is now likely out.

INR has probably overreacted —5% underperformance to EM peers over the past two months

But how is India placed across its macro parameters – given large moves and adjustments, high volatility, with risks more to the downside rather than the upside. We would believe equity market valuations — now hovering a little above their longer-term averages (still expensive) have seen the froth out. We also see interest rates more measured – an INR defence risk trading off with still slack inflation – and unlikely to move materially (risks skewed to moderate increases to the upside). And we would argue the INR has probably overreacted —5% underperformance to EM peers over the past two months, and while vulnerable to oil prices and foreign flows – could well be set for a slight reversal.

The bigger question: Will there be an economic reset?

We have in any case been relatively measured in our view on India's strong recent economic data

We believe more than the risk of a downward reset (which is more a market phenomenon), it is the possible impact of this process on the real economy that is of greater influence and needs more scrutiny. While we have in any case been relatively measured in our view on India's strong recent economic data (see our economy note ***Recovery: Real or Rudimentary***), could this be another spanner in the works in India's expected trajectory?

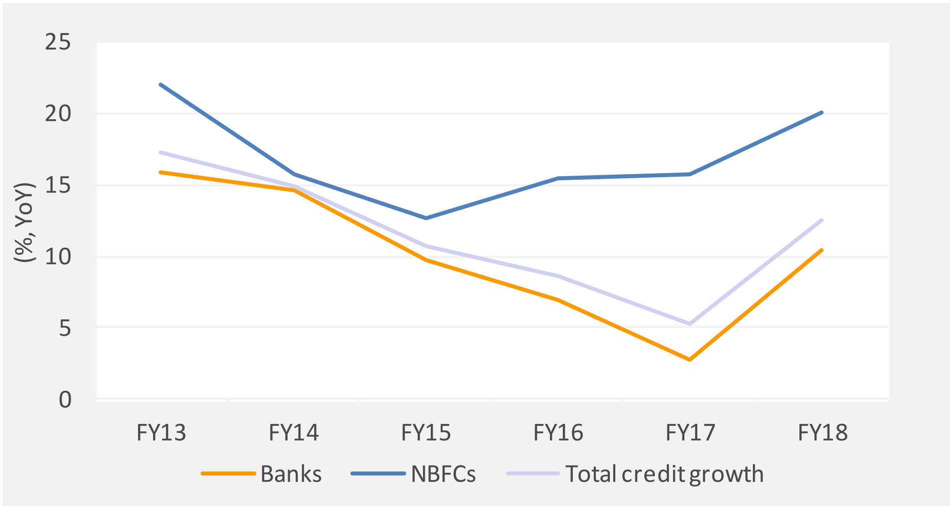
We take a closer look at the pillars of India's current and expected economic momentum, and the possible impact on them in the face of the recent market reset.

Leverage – Can new funding challenges dent economic momentum?

Incremental NBFC credit has become almost 65% of FY18 incremental lending

While India's banking sector credit has been growing relatively slowly on account of asset quality challenges as well as regulatory restraints for part of the government banking sector, credit to the system in general has been flowing more freely. This has in part been facilitated by the more vibrant and flush with funds NBFCs, disbursing credit across corporate and retail markets. That incremental NBFC credit was 35% of FY18 incremental lending in effect provided more leverage to the system than headline bank loan growth suggests. This oil for the economy is at risk.

Chart 5: NBFCs witness strong growth in past few years



Source: Bloomberg, CMIE, RBI, Edelweiss research

Access to credit is likely to slow down, even without the sector facing any discernible credit risk

We believe this access to credit – a necessity for some, but a distinct growth driver for others – is likely to slow down: even without the sector facing any discernible credit risk (long anticipated on account of their heady growth). This will be driven by greater challenges to funding: we see MFs and banks being more discerning on liquidity and credit judgements, the regulator likely to tighten ALM and liquidity requirements for the NBFCs and, most importantly, NBFCs themselves being circumscept about liquidity and growth expectations. That there has been regulator-induced leadership and ownership uncertainity pertaining to private sector banks (Yes, Bandhan) will only add to systemic funding constraints and may undermine potential growth.

Sharp INR depreciation risks denting the deepening offshore funding market

The INR's sharp 15% depreciation in 2018 also risks denting the deepening offshore funding market via contracted ECBs: as some un-hedged borrowers take losses, hedged costs rise and credit lines tend to clamp down in the face of currency volatility. There also tends to be risk aversion with FII debt (secondary market), albeit that is often more temporal, and could well swing with a changing market outlook.

That such aversions or reversals usually take time to reverse means the impact could last beyond the immediate term

We see this as the most vulnerable point in India's current cycle: the return of risk and liquidity constraints, which could challenge expected growth. That such aversions or reversals usually take time to reverse means the impact could last well beyond the immediate term. While the current squeeze will likely unwind soon (regulatory support, SBI bank purchases, etc) and there are already some signs of normalcy, leverage will build up slowly, than was the case before the market reset.

Credit will also become more expensive – for the system at large

While this could have more-specific implications for a few sectors that were materially driven by NBFC credit (real estate, affordable housing, higher yield, etc), it will have implications for corporate (SMEs, mid-corporates) and could be a pressure point for consumer credit too. And credit will also become more expensive – for the system at large.

Table 1: NBFCs' breakdown by segment

Segment	Sub Segments details	Est. Mkt Size 18 (INR tn)	Historical growth Overall	Market share summary Banks	NBFCs	Top 5 Players
Housing Finance		16.7	18	58	42	50
MSME (Incl. LAP)		~16.5	15	80	20	40
Commercial Vehicles		~3.0	13	45	55	60
Personal/Passenger Vehicles		~2.4				
	Cars - New	1.2	9	85	15	80
	Cars - Used	0.8	15			
	2W - New	0.4		40	60	75
Farm equipments	Tractors - New	0.5		55	45	50
Gold Loans		1.7	6	60	40	40
Microfinance		1.3	25	55	45	50
Loan Against Securities		1.1	20	80	20	
Corporate	Real Estate financing	3.8	15	55	45	

Source: Bloomberg, CMIE, RBI, Edelweiss research

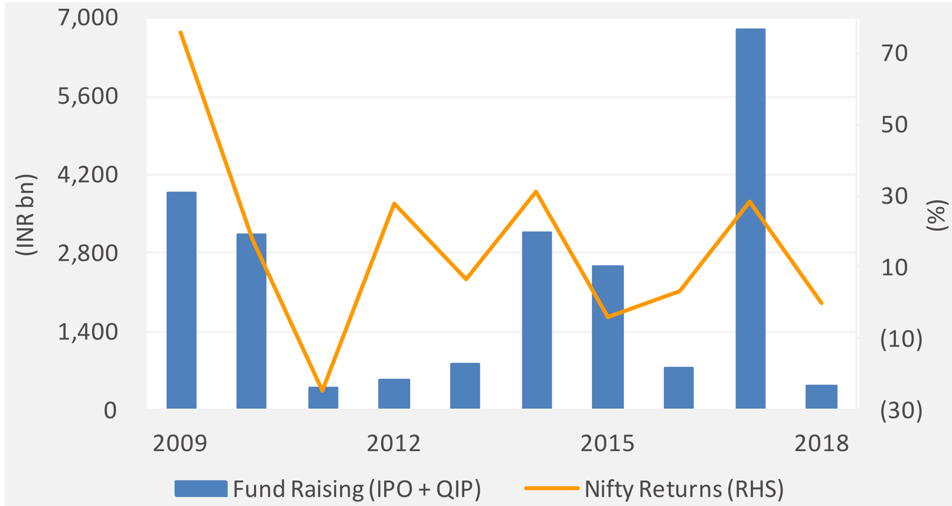
Capital access: Likely stalled, for now at least

A constrained debt market, and fairly flush equity valuations have meant relatively aggressive equity capital-raising over the past 18 months. While this has been for a mix of uses (growth, but also deleveraging and, in many cases, government divestment or PE exits), capital has been available for the economy, businesses and the government. A weaker and more volatile market will likely slow this down, at least for a while.

Weak and volatile markets limit capital-raising and restrict it to the top-end of the market; one should expect more of the same in the current cycle too

But for how long? A look at India's historical market cycles and capital-raising clearly suggests weak and volatile markets limit capital-raising and restrict it to the top-end of the market. One should expect more of the same in the current cycle too. But is this cyclical, or could it be more structural, especially in the wake of meaningful market dislocations?

Chart 6: India's capital-raising surges during phases of stellar equity performance



Source: Prime Database, CMIE, RBI, Edelweiss research

India's experience with FII flows has been positive. During the course of such market reversals, there have been only limited instances of drawdowns or negative flows over a full year. And over more medium-term intervals, flows have continued to be positive. India's trends with domestic flows will however be more interesting: has not really been tested since the current rush of flows that first started in 2014. And even in the face of more recent market underperformance (and negative performance for 12 months, for some), inflows continue at a decent pace. These flows have been a material balancing feature for the market in recent times, and will be a material and first-time influence on capital-raising.

Chart 7: FII flows into India turning negative

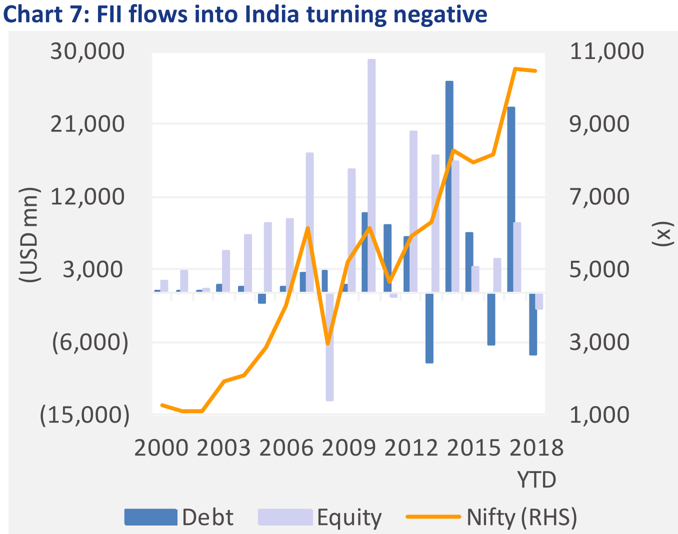
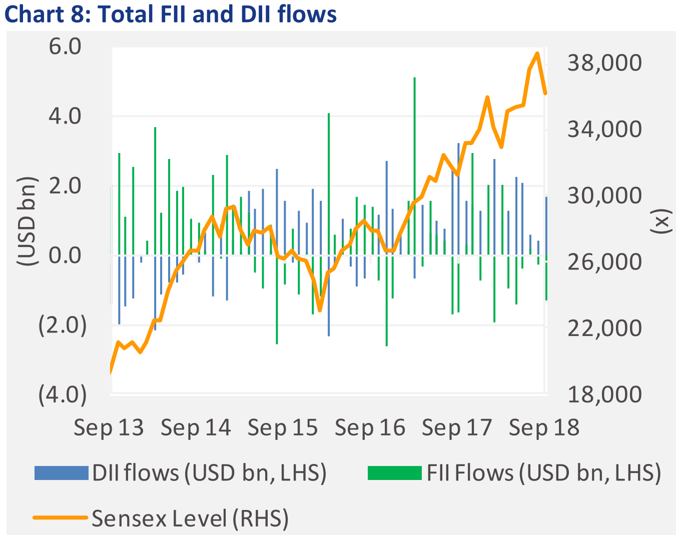


Chart 8: Total FII and DII flows



Source: CMIE, Bloomberg, Edelweiss research

We do however believe that capital-raising will be narrower – towards strong businesses and corporate, and more measured in its valuation generosity than over the recent past. This will, in the short term, constrain some of the economic and business activity that was flying high on tailwinds from the markets. This is, at the margin, a dampner.

The fiscal challenge…a little more usual

We expect challenges to fiscal, ex of the current market challenge

Is the current risk reset a challenge for the fiscal? And would it need a downward reset too? We do see challenges to the fiscal, ex of the current market challenge. This is reflected in the relatively slack GST collections, which continue to remain well short of targets. In addition, the government's move to absorb part of the fuel price increase (INR1.5 per litre through excise concession) will further put pressure on the fiscal, albeit only somewhat. Additionally, weak markets could pressure disinvestment proceeds, and if growth were to moderate, it would be an added pressure point.

Higher possibility of increased government spends in election year

While the government remains comfortable with its targeted 3.3% level, we see the risks of a breach reasonably high given some of the abovementioned challenges. In addition, that it is an election year, only raises the possibility of increased government spends (only a couple of months before spending checks kick in). Considering the government's track record on meeting its fiscal target is mixed, a breach is possible and therefore higher market borrowings are a reasonably reality. This fiscal push could well be a growth support over the nearer term, but its implicit and negative impact on rates, credit availability and, to some extent confidence (already in-play) may start becoming a drag on economic growth.

What does this do to the reform agenda?

The government's current/new reform thrust –towards the end of its term – may not make a material difference to growth

The government's ruling term is coming to the end, so to some extent its current/new reform thrust does not make a material difference to growth. The big reform over the tenure of the government, i.e. the GST rollout, is now largely done, and its impact (positive, we believe) will progressively play out. That does not change.

That said, recent governmental and regulatory actions, could well present challenges of their own, with medium-term implications. These include:

a) **Oil:** The near reversal of pricing decontrol for oil companies may impact investment in oil marketing – from both government and potential private sector players.

b) **Supreme Court restrictions on use of Aadhar as KYC** : While the regulations are still not clear, this change could impact a very-efficient KYC process that, we believe, has greatly speeded up telephone, bank account and other customer acquisition processes, which have added to economic momentum.

c) **Bank consolidation:** While structurally needed and positive, it creates uncertainity, and is likely to further impact the flow of credit during execution.

The government's aggressive divestment targets and relatively inconsistent approach to achieve them adds up to the challenge

We would also believe the government's aggressive divestment targets, and its relatively inconsistent approach to achieve them, could well be creating its own challenge. The different means of raising such proceeds – stake sale buyout, market divestments, buybacks, dividends – have been also inconsistent, and relatively hard to predict. We believe there have been distinct environmental hiccups: across the government, regulators and the courts , in very recent times. While these in-themselves might have only limited implications, but by and large they do add to growth risk, impact economics and undermine confidence.

Table 2: Sources of achieving divestment targets historically

Year	IPO/FPO/ OFS	Buyback	CPSE-ETF and SUUTI Stake Sale	Cross Holding by Oil CPSEs	Total Disinvestment Proceeds	As % of BE
2013-14	35	21	30	53	139	40
2014-15	261	-	-	-	261	60
2015-16	195	45	-	-	240	59
2016-17	80	190	193	-	462	128
2017-18	378	53	201	369	1,001	215

Source: Ministry of Finance,DIPAM,CMIE, Edelweiss research

What does this mean for India's equity market?

The run-up to the elections in May 2019 is likely to be marked by uncertainty and volatility

We believe there will be uncertainy and volatility in the run-up to the elections in May 2019—in the backdrop of the risk reset that has taken place and potential economic growth risks that are rising thereof. This will be a mix of the elections themselves (that will become more prominent towards December 2018, when a few key state elections will have happened), the macro (more global than domestic) and, to a lesser extent, India micro corporate performance.

India's equity market is expected to trade within its long-term average of 15–16x

All in all, we see this taking out froth – in valuations and expectations, and should consequently see the market trend towards more normalized, or its average, levels. This should: a) continue to keep the markets in a relatively moderate trading range; b) limit froth in valuations - and we expect India's equity market to largely trade within its longer-term averages of 15–16x or about 9,800–10,500 on the NIFTY (our earlier target range was 17–19x or 10,500–11,500); and c) put earnings at risk for the current year: with consensus earnings for FY19 at 23% while 1HYFY has generated about 7% growth. We would expect volatility to persist, but around its means – rather than the more elevated levels it erupted from. Any material moves beyond this relatively narrow band should push the market beyond its fair valuation (on either side).

This is how one should position for it...

We believe the following will be the themes that will dominate over the medium term as the market settles into a lower-risk environment, and sees some risks to growth. These are: **a)** Expansion of leverage will be slower. **b)** Liability gatherers and capital providers will be at a premium. **c)** Market share consolidation (precipitated by the recent risk reset) will likely consolidate. d) Rural dynamics will continue to improve. **e)** Growth could see some reset down, particularly capital- and leverage-sensitive. This should provide its own set of opportunities at a stock level too.

Bias model portfolio towards higher quality businesses at reasonable valuations

We see the stock profile also becoming more distinct – and bias itself towards greater quality, and relatively more defensive in its nature. We see dominant stock characteristics that would generate relatively high return (and keep a check on risks) in the following :

a) A higher quality, scale and market leadership bias

b) Staple consumption - away from discretionary

c) Reasonable valuations for higher quality businesses

d) A defensive bias in the business

At present, the Indian market is a very good stock-hunting ground

We are rejigging our model portfolio—raising consumer staples to OW and alterning our top pick recommendations. We believe high volatility in what should be a relatively narrow market trading band will throw up stock and portfolio opportunites that have not been available in India for a while. This could well make the Indian market a very good stock-hunting ground – as risks appear to have reset down, even as risk perceptions have gone up.

Table 3: Changes in model portfolio

Sector	Relative Weight in Current Portfolio	Relative Weight in Previous Portfolio	Changes in Weights	Stance
Sectors where relative weights have been increased				
Consumers	200	(300)	500	Upgraded from UW to OW
Utilities	(100)	(312)	212	No Change
Chemicals	47	(176)	144	Upgraded from UW to OW
Health Care	100	0	100	Upgraded from UW to OW
Information Technology	200	300	(100)	No Change
Sectors where relative weights have been decreased				
Autos	0	150	(150)	Downgraded from OW to UW
Metals & mining	(267)	(100)	(167)	No Change
Industrials	100	350	(250)	No Change
Energy	(250)	40	(290)	Downgraded from OW to UW

Table 4: Our large and midcap top picks

Company	Current market cap	Current market	P/B (X)		P/E (X)		RoE (%)		Dividend Yield (%)
	(USD Mn)	Price (INR)	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E	FY19E
Large caps									
Reliance Industries	97,858	1,140	1.8	1.6	16	12	13	13	0.3
Infosys Technologies	41,350	699	5.7	5.2	19	17	27	32	5.7
ICICI Bank	27,315	313	1.9	1.7	21	11	9	16	2.7
Larsen & Toubro	23,100	1,216	3.2	2.4	21	17	15	16	1.3
Mahindra & Mahindra	12,613	749	2.5	2.2	16	14	17	17	1.3
Dabur	9,483	396	10.6	9.2	41	36	28	27	1.0
Hindalco Industries	7,049	232	0.8	0.7	10	8	9	9	0.0
Zee Entertainment Enterprise	6,147	473	5.1	4.3	28	23	20	20	0.3
Dr Reddy Labs	5,771	2,567	3.0	2.5	20	15	15	18	0.8
Lupin	5,432	887	2.8	2.5	31	19	9	14	0.8
Mid caps									
L&T Infotech Ltd	4,225	1,803	7.1	5.9	22	19	35	34	1.8
Indraprastha Gas	2,287	241	4.0	3.4	20	17	22	22	0.0
L&T Technology Services Ltd	2,272	1,618	7.3	6.2	25	22	32	31	1.4
Sterlite Technologies	1,732	318	8.6	6.5	27	19	36	39	0.9
Aarti Industries	1,401	1,272	5.4	4.2	24	17	25	27	0.6
KEC International	968	278	2.9	2.3	13	11	24	22	0.4
Security and Intelligence Services Ind	921	928	5.7	4.8	35	25	18	21	0.5
JK Cement	667	704	2.2	1.9	16	11	15	19	1.1
TeamLease Services Ltd	558	2,411	7.6	6.1	41	30	20	23	0.0
KEI Industries	301	282	2.8	2.2	12	9	27	28	0.0

Source: Edelweiss research

Table 5: Model Portfolio

Stocks	Mkt Cap (USD bn)	Price (INR)	Portfolio (%)	Nifty wt (%)	Rel wt (bps)	P/E (x) FY19E	P/E (x) FY20E	P/B (x) FY19E	P/B (x) FY20E	RoE (%) FY19E	RoE (%) FY20E	Div Yld (%) FY19E
Information Technology			**16.8**	**14.8**	**200**							
HCL Tech	18.9	1,003	1.2	1.3	(13)	13.9	12.3	3.3	3.1	25.1	25.8	0.8
Infosys Technologies	41.4	699	8.0	5.4	263	19.0	17.0	5.7	5.2	27.0	32.0	11.4
L&T Technology Services Ltd	2.3	1,618	2.0	0.0	200	25.2	21.6	7.3	6.2	31.8	31.3	1.4
L&T Infotech	4.2	1,803	1.0	0.0	100	22.1	18.7	7.1	5.9	34.9	34.4	1.8
Teamlease	1.5	1,331	1.0	0.0	100	34.7	24.7	5.7	4.8	17.7	21.2	0.5
Tata Consultancy Services	99.1	1,950	3.6	3.6	0	23.4	20.4	11.0	10.0	40.8	50.8	3.8
Consumers			**13.0**	**11.0**	**200**							
Dabur	9	396	3.0	0.0	300	41.1	35.9	10.6	9.2	27.6	27.3	1.0
Nestle	13	9,656	2.0	0.0	202	58.6	44.2	24.8	22.2	44.3	53.1	1.1
Hindustan Unilever	44.8	1,526	4.0	2.4	161	53.2	43.2	39.8	34.6	79.5	85.6	1.3
Zee Entertainment Enterprise	6.1	473	4.0	0.8	321	28.1	22.8	5.1	4.3	19.6	20.5	0.3
BFSI			**37.8**	**36.3**	**150**							
Axis Bank	20.1	577	2.0	2.1	(18)	20.0	14.2	2.1	1.9	11.3	14.2	1.4
HDFC	39.9	1,733	7.0	7.6	(58)	29.9	25.7	4.4	4.1	15.3	16.5	1.3
HDFC Bank	73.9	2,008	11.0	9.7	127	24.8	19.8	3.7	3.2	17.3	17.4	0.8
ICICI Bank	27.3	313	8.0	4.3	370	20.6	11.2	1.9	1.7	9.5	16.2	2.7
IndusInd Bank	13.3	1,627	3.9	2.3	154	21.8	17.1	3.5	3.0	17.4	18.9	0.6
Kotak mahindra Bank	30.2	1,170	3.0	3.6	(65)	31.4	25.3	4.2	3.7	14.5	15.7	0.4
State Bank of India	31.8	263	3.0	2.3	69	19.2	10.0	1.2	1.1	6.3	11.1	1.5
Industrials			**5.3**	**4.3**	**100**							
Larsen & Toubro	23.1	1,216	5.3	4.1	125	21.0	17.2	3.2	2.4	14.6	15.7	1.3
Health Care			**4.1**	**3.1**	**100**							
Dr Reddy's Labs	5.8	2,567	3.1	0.6	245	20.5	15.4	3.0	2.5	15.4	17.9	0.8
Lupin	5.4	887	1.0	0.5	53	30.6	19.2	2.8	2.5	9.3	13.7	0.8
Autos			**7.2**	**7.2**	**0**							
Bajaj Auto	10.3	2,620	1.0	0.9	6	17.0	15.0	3.6	3.3	22.3	23.0	2.9
Mahindra & Mahindra	12.6	749	2.2	1.8	46	16.3	13.8	2.5	2.2	16.6	17.0	1.3
Maruti Suzuki India	29.4	7,182	4.0	3.0	103	22.1	19.5	4.5	3.9	21.7	21.3	1.2
Telecommunication Services			**1.5**	**1.5**	**0**							
Bharti Airtel	15.8	291	1.5	1.3	15	122.8	32.0	1.6	1.5	2.9	7.3	0.0
Chemicals			**1.0**	**0.5**	**47**							
Aarti Industries	1.4	1,272	1.0	0.0	101	23.9	17.0	5.4	4.2	24.5	27.4	0.6
Metals & mining			**1.0**	**3.7**	**(267)**							
Hindalco Industries	7.0	232	1.0	0.8	25	9.6	8.4	0.8	0.7	9.2	9.3	0.0
Energy			**10.2**	**12.7**	**(250)**							
Indraprastha Gas	2.3	241	1.2	0.0	118	19.5	16.6	4.0	3.4	21.9	21.9	0.0
Reliance Industries	97.9	1,140	9.0	7.7	131	15.5	12.4	1.8	1.6	12.8	13.4	0.6
Cement			**0.0**	**1.8**	**(179)**							
Utilities			**2.1**	**3.1**	**(100)**							
NTPC	18.4	165	2.1	1.3	74	11.9	10.3	1.3	1.2	10.9	11.9	3.4
Model Portfolio			**100.0**	**100.0**	**0**							
Nifty				**100.0**	**0**							

Chart 9: Model Portfolio's performance since inception

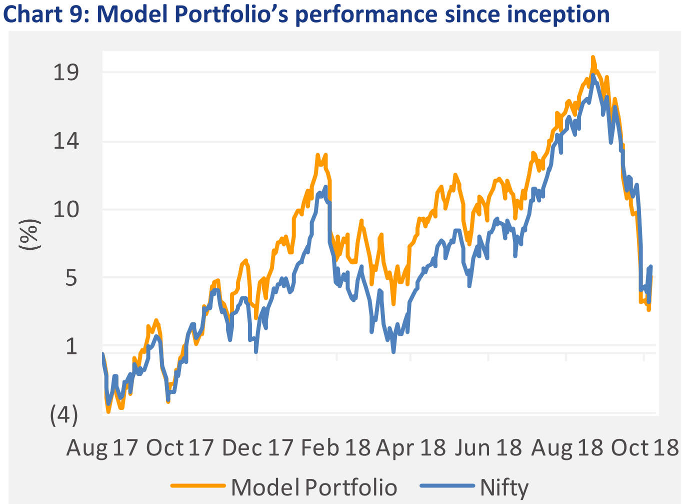
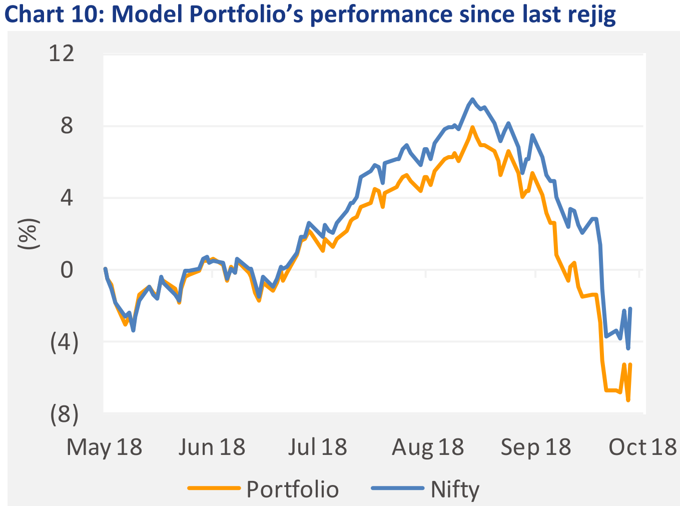


Chart 10: Model Portfolio's performance since last rejig



Source: Bloomberg, Edelweiss research

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Date	Company	Title
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