26 September 2019

India Strategy

BSE Sensex: 38,990 | **S&P CNX: 11,571**

Revisiting the tale of divergence

Divergence within and outside Nifty continues; presenting top Mid-cap bets

The Indian government's big-bang measure of reducing the corporate tax rate has lifted market sentiment and resulted in a sharp rally subsequently. Nonetheless, from an index perspective, large-caps continue outperforming mid-caps. In fact, the concentration of the market performance in select Nifty stocks and the big divergence in the benchmark's performance within as well as versus mid-cap and small-cap indices were the trends we discussed in detail in [Mar'19](). In this note, we revisit those trends, observing that the divergence has expanded even further over the last six months. We also present our top mid-cap bets.

Divergence within Nifty at new high: BIG continue to get BIGGER

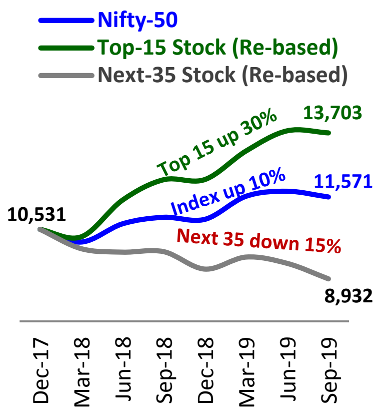
- The government last week announced slashing of the corporate tax rate from 30% to 22% along with other measures to boost manufacturing. The reduction in tax rates will likely improve corporate profitability and augur well for the private capex investment cycle over next few years. The tax cut benefits will accrue across the board. Effective tax rates for Nifty-Midcap 100 for FY17/18/19 stood at 30.6%/33.1%/36.7%. Higher rate for FY19 is owing to the significant losses in several PSU Banks in the Mid-cap 100 index.
- The fiscal stimulus has driven a sharp upswing in the market and lifted sentiment. Nonetheless, we note that the trend of large-caps outperforming mid-caps has continued post the tax rate cut announcement.
- The concentration of the market performance in select Nifty stocks and the big divergence in the benchmark's performance within as well as versus mid-cap and small-cap indices is a trend we highlighted in Mar'19. We revisit those trends again in this note.
- The Nifty has delivered 10% returns since Dec'17. However, this performance is largely driven by a group of top 15 Nifty stocks (66% of Nifty market cap), which are up by 30% over this period. The other 35 stocks are down by 15%. *The divergence between these two groups is at 45%, up sharply from 33% in Mar'19.*
- The Nifty Mid-cap 100 index is down by 22% since Dec'17. Here too it is the top-30 stocks (48% of CNX Mid-cap 100 market cap; -2% returns over the period) that are largely in favor. The other 70 constituents are down by a massive 29%.

Mid-caps versus large-caps: The divergence is expanding

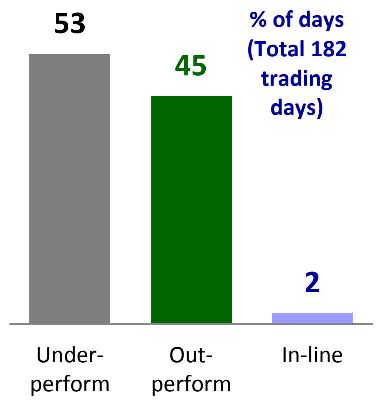
a) **Contribution of top 15 to top 100 market cap near its peak**: Contribution of the top-15 stocks to the top 100 market cap has been climbing up after hitting a 15-year-low of 44.5% in Dec'17. At 51.4% in Sep'19, this contribution is near its decadal high.

b) **Mid-cap index market cap still 31% off Dec'17 peak:** At INR15t, the Midcap 100 absolute market cap is down by 31% from the Jan'18 peak of INR22t and also below the Dec'14 level of INR16.7t. For the Nifty, the market cap at INR84.5t has increased modestly by 8.5% since Dec'17.

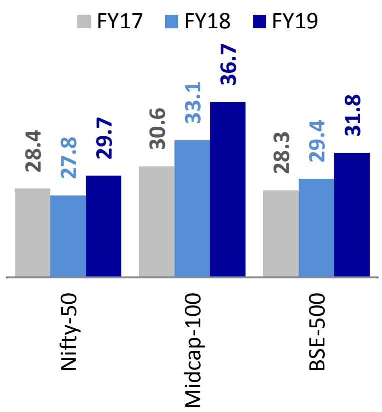
Nifty returns were driven by top 15 stocks



Midcap Vs Nifty (%) perf since Jan'19



India Inc – Tax rate (%)



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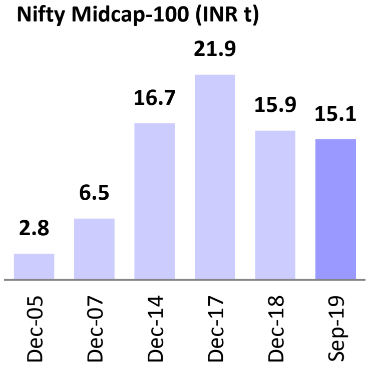
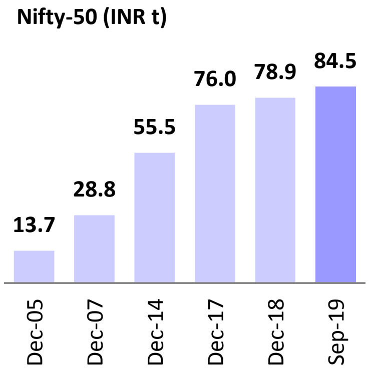
Midcap m-cap down 31% from peak…



…while Nifty m-cap has seen 11% rise



c) **Large-cap versus mid-cap rolling differential returns:** Typically, the spread between large-cap and mid-cap returns has peaked out at 15-20%. Post hitting this peak range, the performance has typically reversed in the past. Currently, this spread is at 14%.

d) **Historical peak-to-bottom correction trends; difference between Nifty and mid-cap correction highest since 2006:** The average difference in the peak-to-bottom correction between the Midcap 100 and the Nifty has been 14%. In the current episode, this difference is at 31% **– the highest since 2006**.

Mid-cap valuations correct; five-year return CAGR now same for Nifty and Nifty-Midcap 100

- After reaching a peak of 42% in Mar'18, the relative valuation premium of mid-caps v/s the Nifty has corrected sharply owing to the sharp underperformance of the Nifty-Midcap 100 v/s the Nifty. The premium has turned into a discount and the Nifty-Midcap 100 now trades at a 9% discount v/s the Nifty.
- On a P/B basis, the Nifty Midcap 100 index (2x) trades at a 25% discount to the Nifty (2.6x). From the relative valuation perspective, the mid-cap index has corrected from a peak of 3x P/B in Aug'18 to 1.9x currently, in line with the LTA. On the other hand, the Nifty trades at 2.6x, also in line with the LTA of 2.6x.
- The trailing five-year return CAGR of the Nifty Mid-cap 100 dominated the Nifty returns by a healthy margin until 2017. Subsequently, given the continued underperformance of mid-caps, the gap has shrunk consistently and now virtually been bridged. The five-year return CAGR of the Nifty and Mid-cap now stands at 7.8% and 7.6%, respectively.

Sentiment improves post corporate tax reduction; can Mid-caps correct its under-performance?

- Market sentiment has turned better post the announcement of the corporate tax rate reduction. This has resulted in a sharp rally, with Financials, Consumption and Automobiles leading from the front. This is a massive long-term positive move for corporate profitability in India as it boosts cash flows in perpetuity. Notwithstanding the near-term concerns around earnings, the weak demand trends and the stress in Real Estate/NBFC sectors, this move by government has the potential to re-rate the markets. Benign monetary policy and surplus monsoon are the other key positives. Valuations at 19x FY20 – although not cheap – can overshoot over the near term, in our view. FIIs have been big sellers in this quarter with net outflows of USD4.7b, while domestic funds have remained buyers during this period. We expect FII flows to respond positively to these measures and grow as economic activity gets better. We expect the sharp under-performance of Mid-caps to correct going forward and present our top ten bets.

- **TOP IDEAS: LARGE-CAPS**: ICICI BANK, SBI, L&T, ULTRATECH, TITAN, EICHER MOTORS, ICICI PRU LIFE, BHARTI AIRTEL
- **MID-CAPS:** Indian Hotels, Federal Bank, MMFS, Ashok Leyland, PI Industries, ABFRL, JK Cement, Oberoi Realty, Colgate, Alkem Labs. ***(Refer Page 7 for detailed views on mid-cap bets***).

Exhibit data is sourced from Bloomberg, Capitaline and MOFSL database. Prices as of 26th September 2019

Looking at the market divergence through key exhibits

Exhibit 1: Divergence between two baskets of Nifty stocks has expanded relentlessly

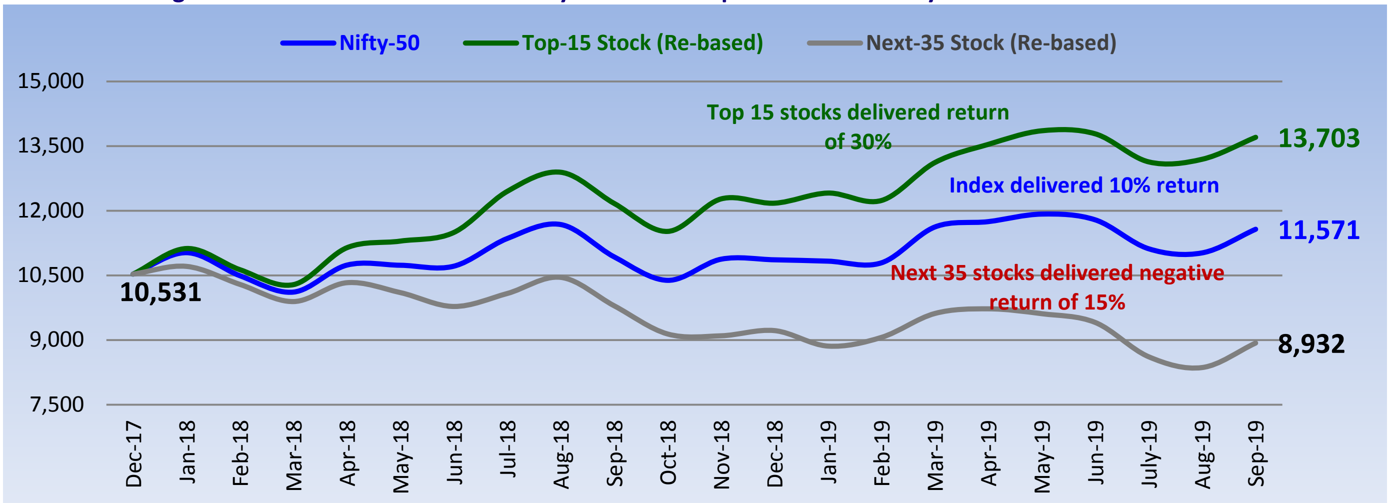


Exhibit 2: Nifty index significantly outperforms Nifty equal weighted index owing to the superior performance of a select few stocks over the last 21 months

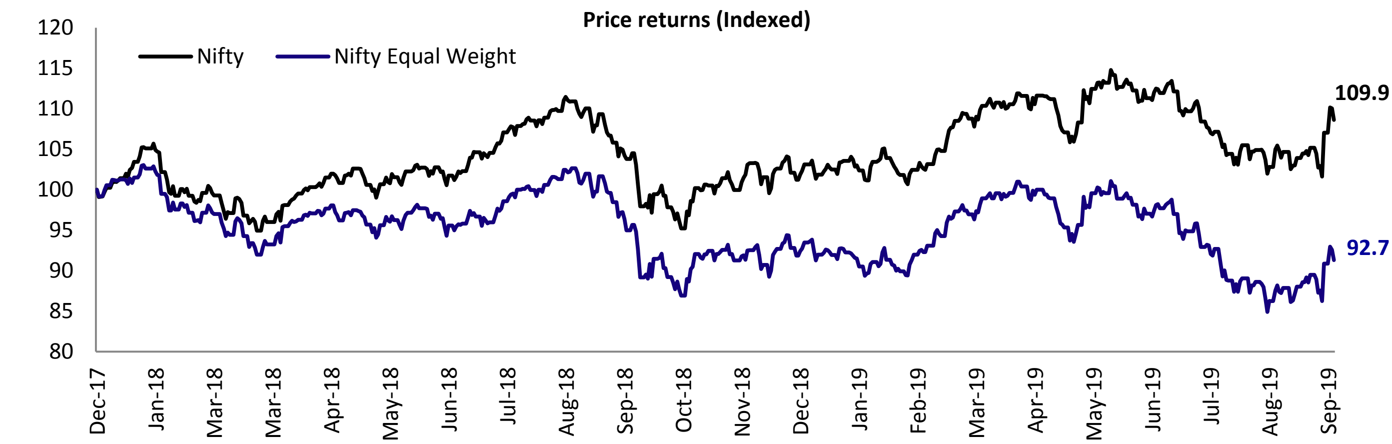


Exhibit 3: Nifty has outperformed Midcap/Small-cap indices by 32%/47% since Dec'17

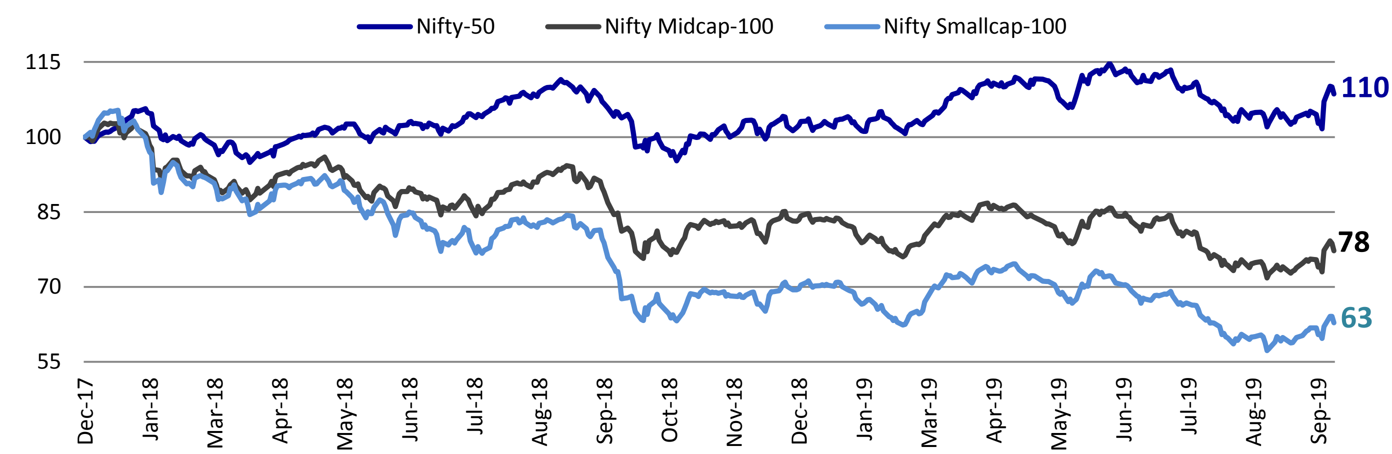


Exhibit 4: Nifty returns were driven by a group of 15 stocks, whereas the other 35 stocks dragged the index performance

	No of companies	
Return range	**Midcap-100**	**Nifty-50**
25%+	14	13
0-25%	13	9
-25-0%	21	10
<-25%	52	18
Total	**100**	**50**

Exhibit 5: In Aug'19, the contribution of top-15 to top-100 market-cap was at its highest level since Dec'08

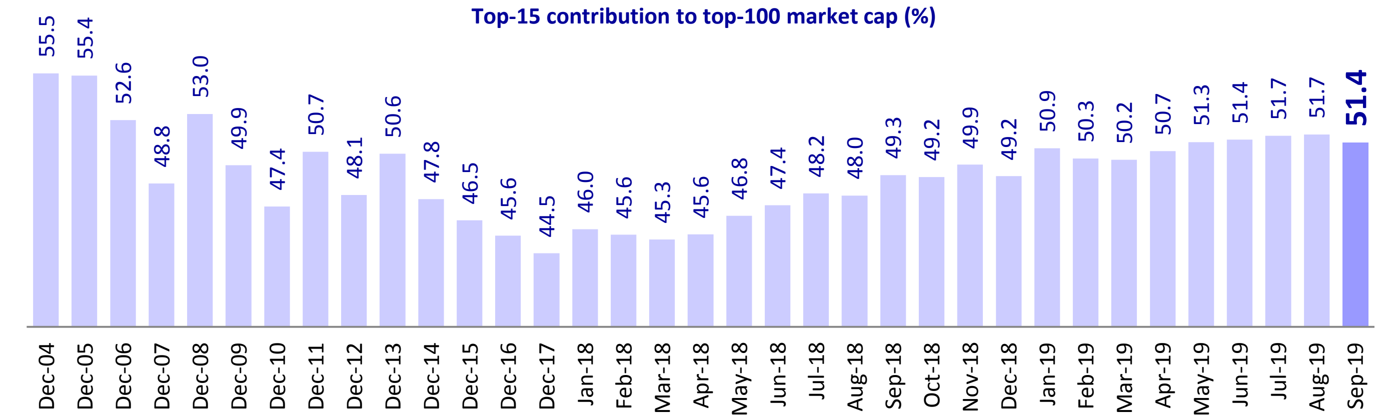


Exhibit 6: Nifty Midcap100 total market cap still below the Dec'14 levels

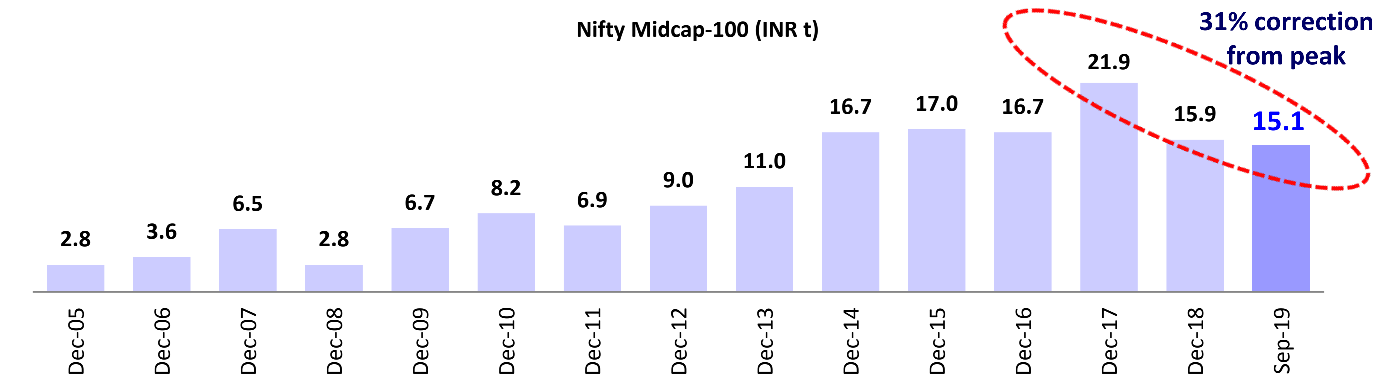


Exhibit 7: …whereas Nifty market cap has increased modestly post Dec'17

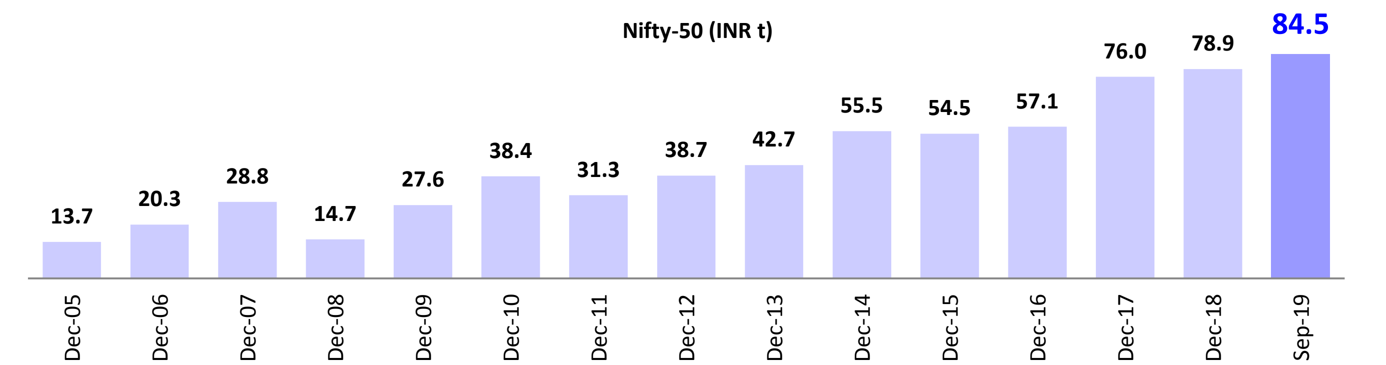


Exhibit 8: Rolling return differential between Nifty and Mid-cap almost near its peak

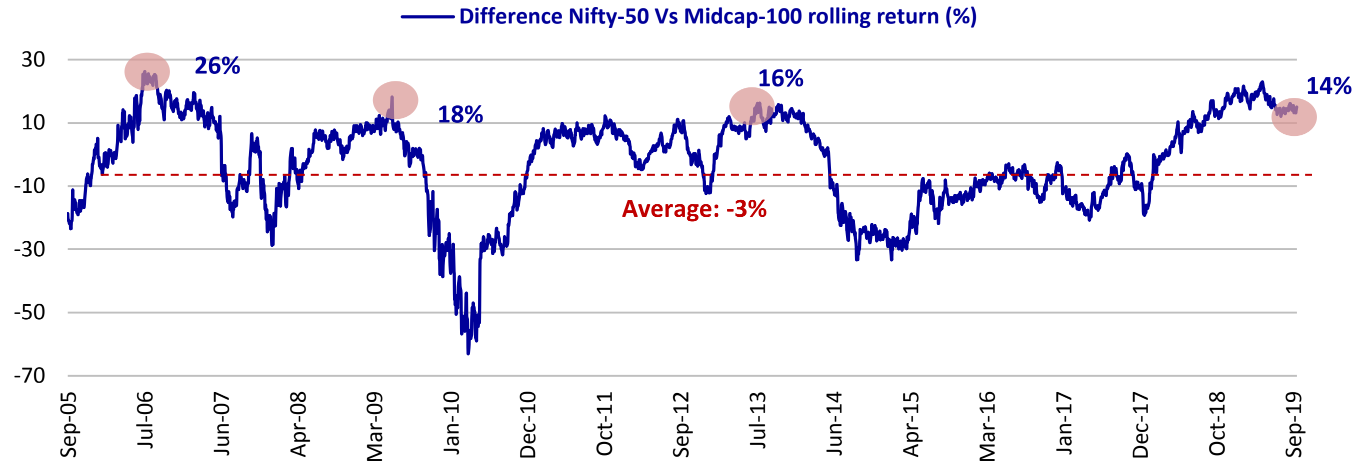


Exhibit 9: Differential in mid and large-cap correction from peak to bottom is highest since 2006

Month Year		Peak Index Value		Bottom Index Value		% Change	
Peak	Bottom	Nifty-50	Nifty Midcap-100	Nifty-50	Nifty Midcap-100	Nifty-50	Nifty Midcap-100
Apr-06	Jul-06	3,558	5,141	3,143	3,878	-12	-25
Dec-07	Feb-09	6,139	9,200	2,764	3,176	-55	-65
Oct-10	Dec-11	6,018	9,361	4,624	6,112	-23	-35
Dec-12	Aug-13	5,905	8,505	5,472	6,590	-7	-23
Jul-15	Feb-16	8,533	13,729	6,987	11,559	-18	-16
Dec-17	**Aug-19**	**10,531**	**21,134**	**11,023**	**15,652**	**5**	**-26**
					Average Correction	**-18**	**-32**

Exhibit 10: Mid-caps' premium to Nifty has turned into a discount

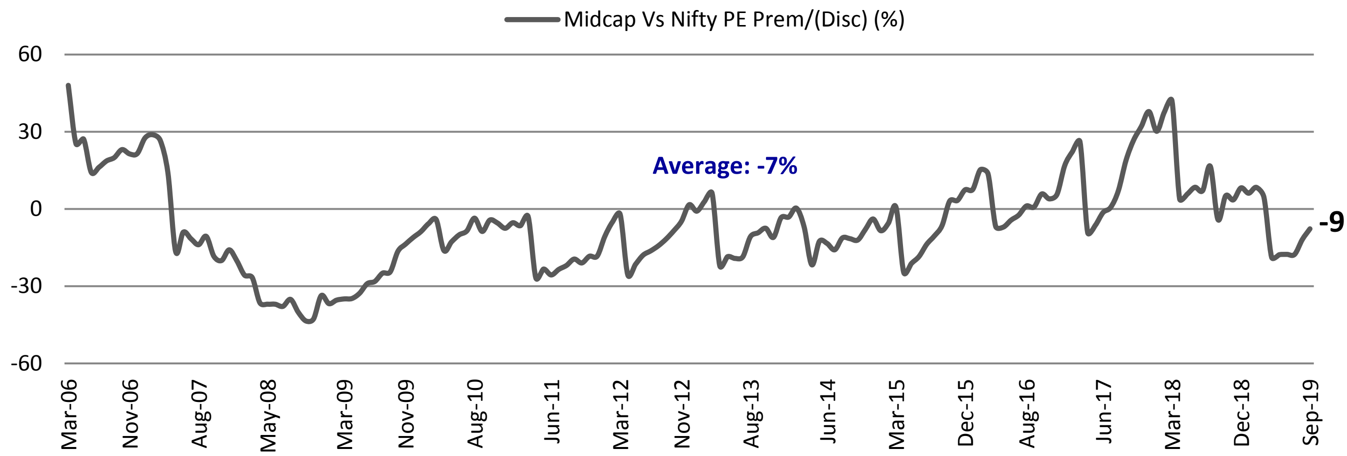


Exhibit 11: Midcap P/E index has corrected from 25.6x in Aug'18 to 15.9x currently

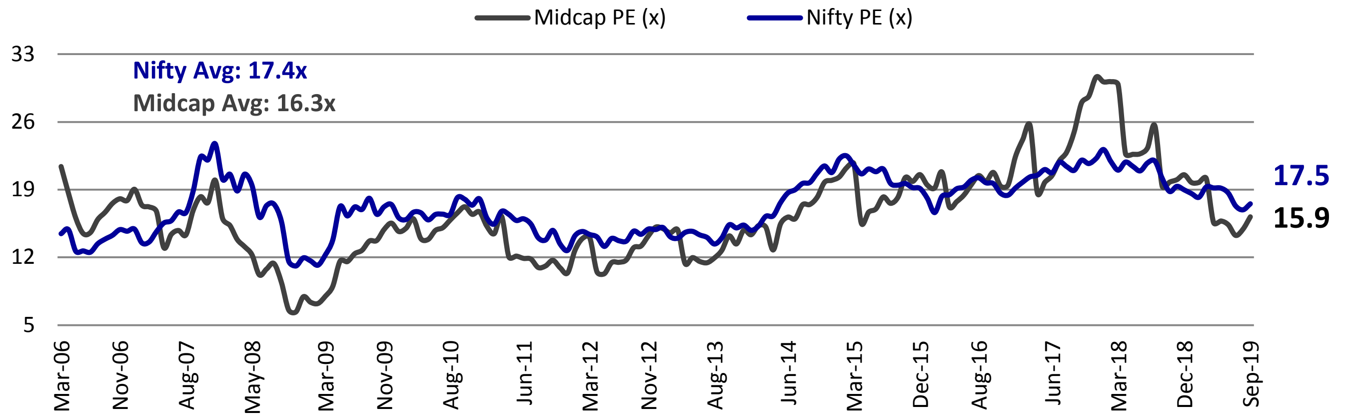
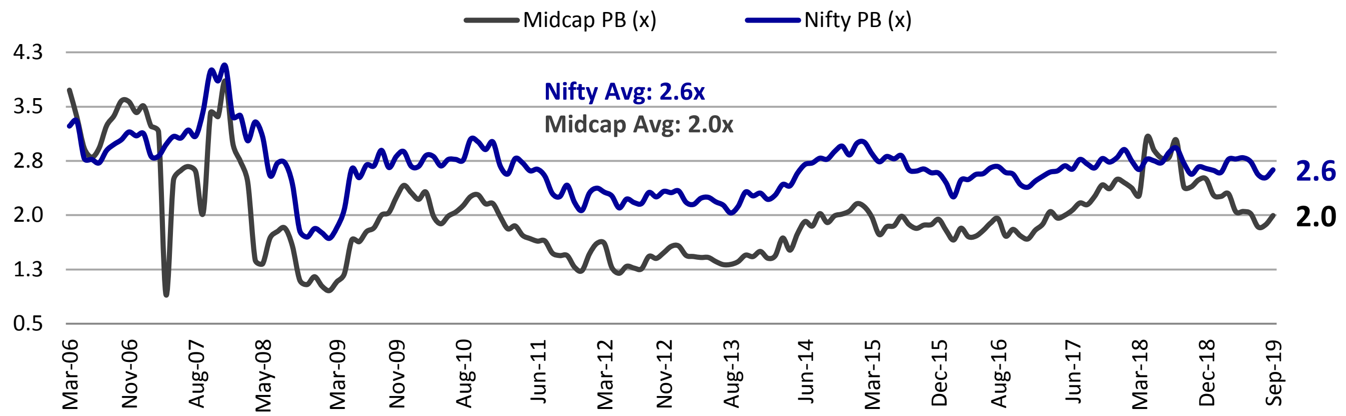


Exhibit 12: Midcap P/B has corrected from 3x in Aug'18 to 2x now



In Mar'18, the five-year CAGR returns were 20% for Nifty Mid-cap and 12% for Nifty (i.e. returns over Mar'13-Mar'18). However, due to the underperformance of Nifty Mid-cap v/s Nifty, both indices now have almost same five-year CAGR returns.

Exhibit 13: Large-cap v/s mid-cap five-year trailing returns - gap is now bridged

Month	5 Year trailing returns (%)		GAP
Year	Nifty-50	Nifty Midcap-100	Large Vs Mid
Jan-18	12.8	20.0	7.2
Feb-18	13.0	21.1	8.1
Mar-18	**12.2**	**20.4**	8.2
Apr-18	12.6	21.0	8.4
May-18	12.4	19.3	6.9
Jun-18	12.9	19.9	7.0
Jul-18	14.6	22.4	7.8
Aug-18	16.4	24.8	8.4
Sep-18	13.8	19.6	5.9
Oct-18	10.5	17.9	7.4
Nov-18	12.0	17.9	5.9
Dec-18	11.5	17.2	5.7
Jan-19	12.2	17.5	5.3
Feb-19	11.4	16.5	5.0
Mar-19	11.6	16.2	4.6
Apr-19	11.9	14.9	3.0
May-19	10.5	12.1	1.6
Jun-19	9.1	9.7	0.6
Jul-19	7.6	8.0	0.4
Aug-19	6.7	7.1	0.3
Sep-19	**7.8**	**7.6**	**-0.2**

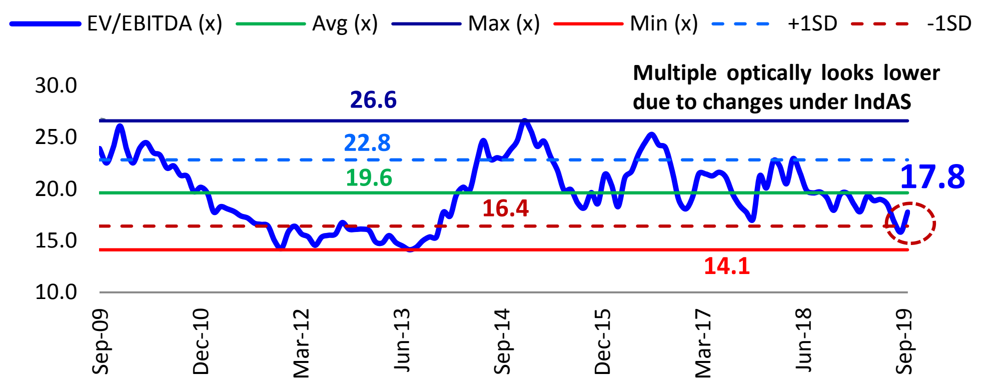
TOP PICKS

Ten preferred Mid-Cap ideas

1. INDIAN HOTELS

- The Indian hospitality industry appears set to enter an upcycle led by favorable demand-supply dynamics. Currently, industry occupancy (67%) is near optimum levels, which, in turn, should provide strong pricing power to hotel players.
- With the GST rate on room tariffs above INR7,500 now slashed to 18% from earlier 28%, demand in the upper upscale/luxury segments is likely to increase, benefiting IHIN as well.
- As part of its 'Aspiration 2022' strategy, IHIN aims to reduce costs by 3-5pp and take the EBITDA margin to 27-28%. Additionally, IHIN plans to change its owned and managed room mix to 50:50 from 30:70 now, which will reduce its capex requirement.
- The stock trades at EV/EBITDA of 24.8x/18.3x FY20/21E. We value the stock at 18x FY21 EV/EBITDA and arrive at an SOTP (consol. and JV & associate) based TP of INR178. Maintain **Buy**.

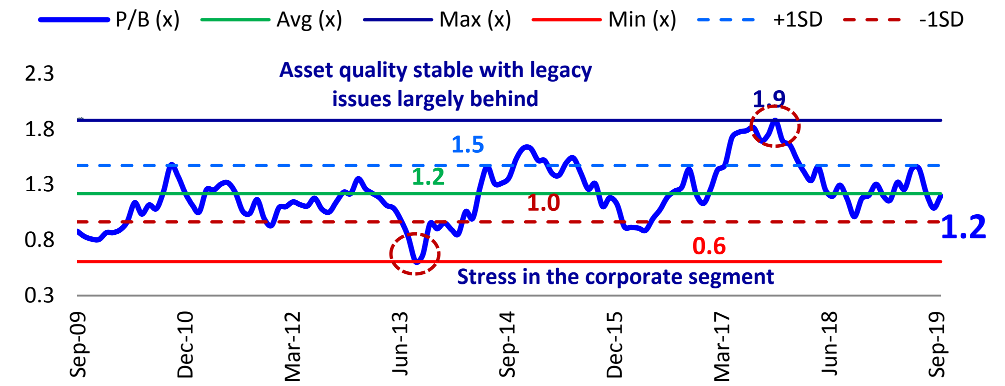
Currently @ 9% disc to its 10-year avg. multiple owing to Ind-AS 116 adjustment



2. FEDERAL BANK

- Total net stress loans (NNPA+ standard restructured+ net SRs) have declined to 2.3% of loans from 5.4% of loans in FY16. It has limited exposure to new standard stressed exposures, while maintaining a healthy coverage ratio at 67.4% (including TWO) will likely facilitate controlled credit costs.
- CASA + retail term deposits constitute ~93% of total deposits. It has lower cost of funds compared to other mid-size banks. Thus, it will have lower impact on margins driven by the move to link all floating rate retail and MSME loans to the external benchmark.
- We believe the recent corporate tax rate cut will improve the bank's earnings for FY20/21 by ~17%/15% as it falls in the higher tax bracket (~34%) and carries lower DTA reversal. The stock trades at 1.3x FY21E ABV, and thus, we maintain our Buy rating with a target price of INR125 (1.6x FY21E ABV).

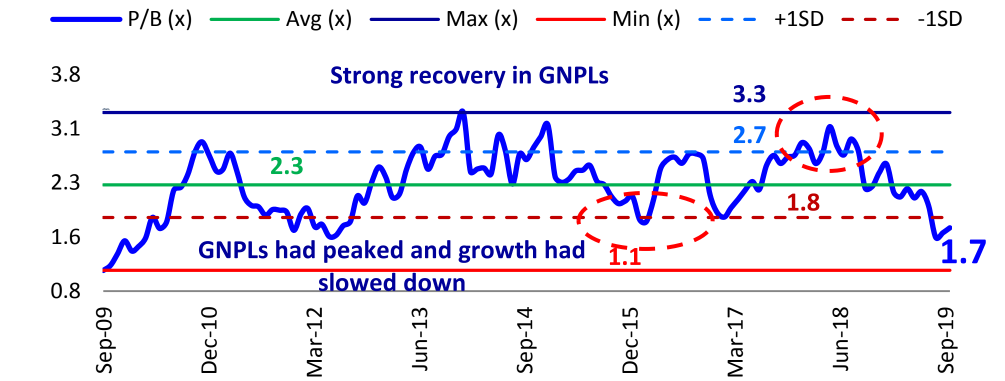
The stock is trading at its historical average of 1.2x BV



3. MAHINDRA & MAHINDRA FINANCIAL SERVICES

- AUM growth is expected to be ~15% YoY in FY20, despite moderation in OEM sales, as market share gains in key OEMs and expansion in new geographies/product categories continue.
- While credit costs in 1Q were high, it was technical; asset quality remains largely stable. Not only did the GNPL ratio decline from 10% to 6% in FY19, stage 2 loans were also down from 10% to 9%.
- Adjusted for subsidiaries, the stock trades at 1.3x FY21E BVPS, which is 25% lower than its 10-year average.

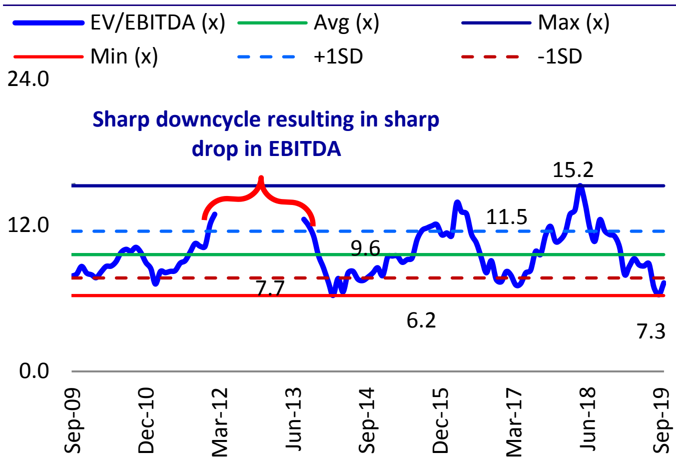
The stock trades at its historical average of 1.2x BV

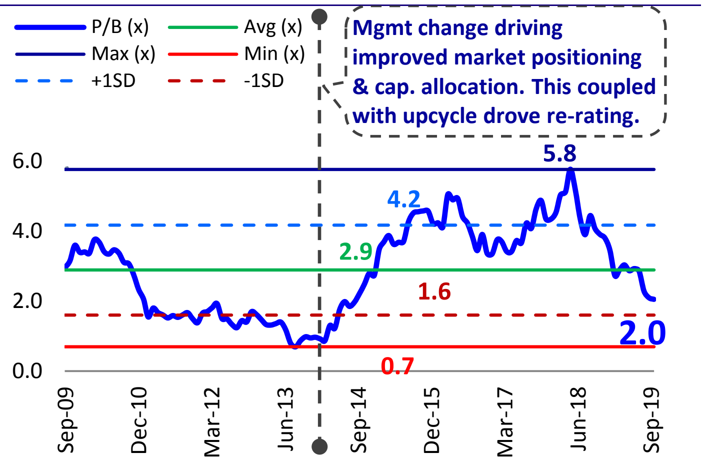


4. ASHOK LEYLAND

- AL is on a very strong footing (lean cost structure and net cash balance sheet); it is focused on adding new revenue/profit pools (in the form of LCVs, exports, defense & spares) with an objective to reduce domestic M&HCV revenue contribution from ~70% to 50%.
- Mandatory scrapping of trucks (policy under works) should benefit CV demand in FY21 and beyond.
- EV/EBITDA multiple has corrected substantially from the recent peak and is trading at the bottom end of the range on FY21 downcycle earnings – at ~25% discount to LPA despite a marked improvement in business positioning and capital allocation.

Valuations near 1 SD below mean | Near pre-management change levels

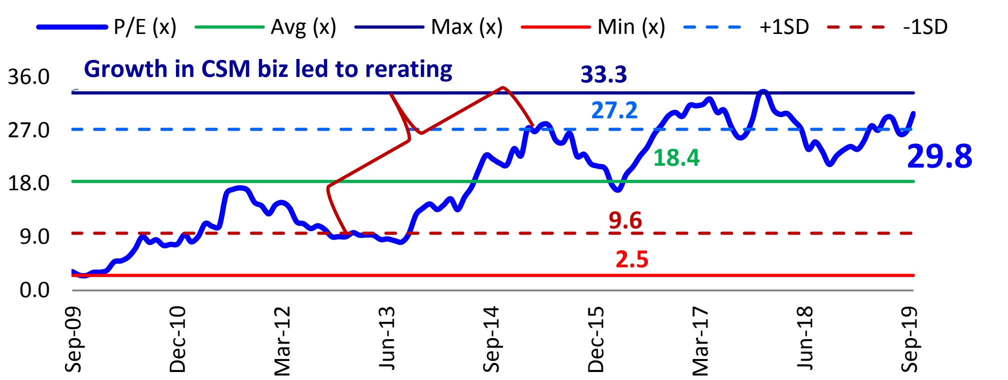




5. PI INDUSTRIES

- Custom Synthesis Management (CSM) business is set to capitalize on growing exports momentum due to firm requirements from innovators and environmental issues in China (reflected in the size of order book – USD1.35b as of FY19, up 23% YoY). PI launched three molecules in FY19 and plans to launch another 3-4 this year, which will likely drive segmental revenue CAGR of 26% over FY19-21.
- Domestic agro-chemical business is expected to deliver an 11% CAGR over FY19-21, backed by 2-3 product launches in FY20 and scaling up of two products that were launched in FY19.
- On a one-year forward P/E basis, PI has historically traded at a three-year average multiple of 28x. However, we value PI at 30x FY21 PE (~7% premium to its 3-year avg. multiple), factoring in strong growth potential in its CSM biz and arrive at a TP of INR1,510. Maintain **Buy**.

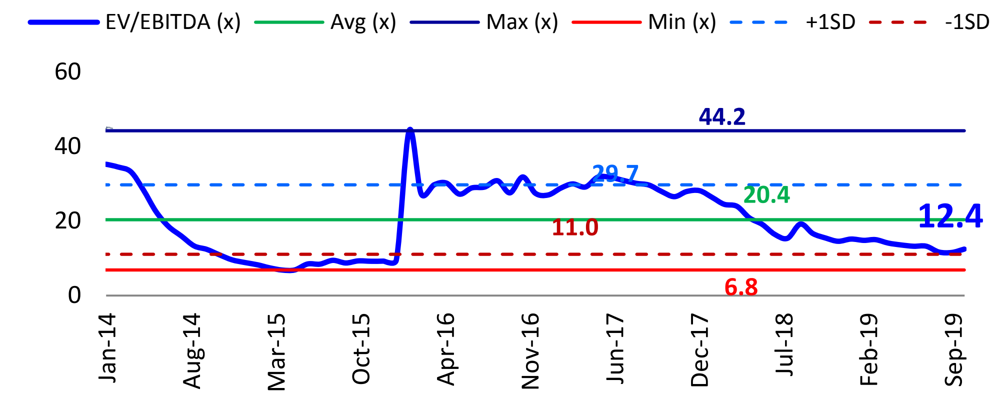
Trading at a premium to its three-year avg. multiple backed by strong growth prospects



6. ADITYA BIRLA FASHION

- Pantaloons is expected to improve store productivity and margins with a higher focus on private labels and a higher mix (above 80%) of margin-accretive fashion products. We expect Pantaloons to add 55/65 stores in FY20/21, with the EBITDA margin expanding by 130bp to 8.5% over FY19-21.
- Lifestyle business is aiming to expand in the women's inner wear segment (with already significant presence in men's inner wear – growing at 50-60% annually). This, coupled with cost efficiency drives in the brands business, is expected to improve the EBITDA margin by 110bp over FY19-21.
- We maintain our Buy rating on ABFRL with a target price of INR250, valuing it on an SOTP basis, ascribing 22x EV/EBITDA to Pantaloons and 18x EV/EBITDA to Lifestyle business.

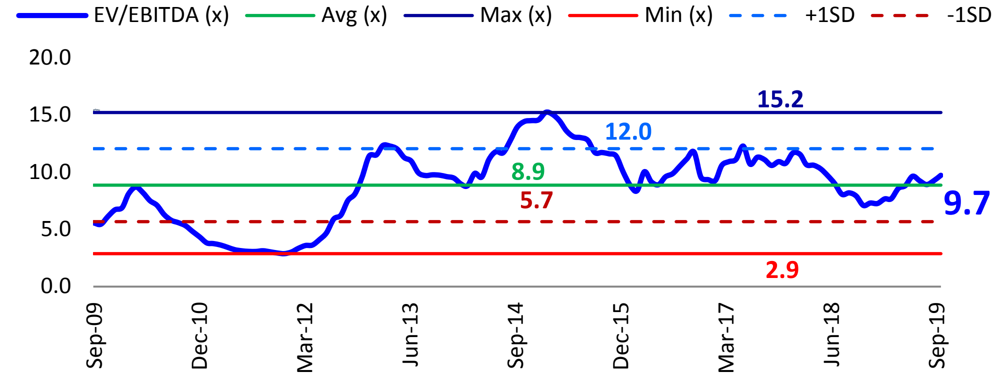
Multiple seems lower on account of Ind-AS 116 effect on EBITDA



7. JK CEMENT

- We like JK Cement's (JKCE) positioning in the key markets of north and central India – it derives ~70% of volumes from these regions. In our view, north and central will have >85% utilization levels over the next two years, supporting pricing and margins there. Moreover, JKCE is further increasing its exposure to these regions (expansion of 4.2mt or ~40% to 14.7mt).
- The expansion would also help JKCE move down the cost curve (with ~80% of post expansion grey cement capacity being cost efficient) by reducing its power & fuel costs, thereby improving its competitiveness.
- The company is also expanding and upgrading its old kiln at Nimbahera, which should drive power savings of 10-12 units per ton and fuel savings of 40-50 kcal, resulting in annual cost savings of INR600-700m (6% of EBITDA) from FY22.
- We expect JKCE to deliver EBITDA CAGR of 24% over FY19-21 and RoE improvement from 11% to 14%. We arrive at a target price of INR1270/share (implied grey cement EV/t of USD 70/t on FY21 capacity), valuing white cement at 10x FY21E EV/EBITDA and grey cement at 9x FY21E EV/EBITDA.

JK Cements trading near its average multiple



8.OBEROI REALTY

- Commencement of operations at Borivali (Oct'20), Worli (Oct'21) malls, and Commerz III (Mar'21) is likely to drive good traction in the annuity portfolio. We expect annuity portfolio CAGR of 47% to INR14.4b over FY19-23.
- Foray into affordable housing (AFH) via closure of the Thane land deal and the planned launch of Exquisite III (Goregaon) by Oct'19 are likely to boost residential sales volumes by 2x to 1.6msf in FY20 (v/s 0.8msf in FY19).
- Strong balance sheet position (net debt to equity of 0.1x in FY19) provides cushion for scalability amidst market consolidation.
- We remain positive on OBER due to its (a) strong balance sheet, (b) strong brand equity, which helps command premium pricing, (c) execution track record, (d) robust line-up of launches both in residential and annuity portfolio, (e) benefits from the ongoing consolidation in the industry and (f) foray into AFH with the land deal in Thane, where demand is strong in the segment for branded players. Maintain Buy with an SOTP-based TP of INR650/share.

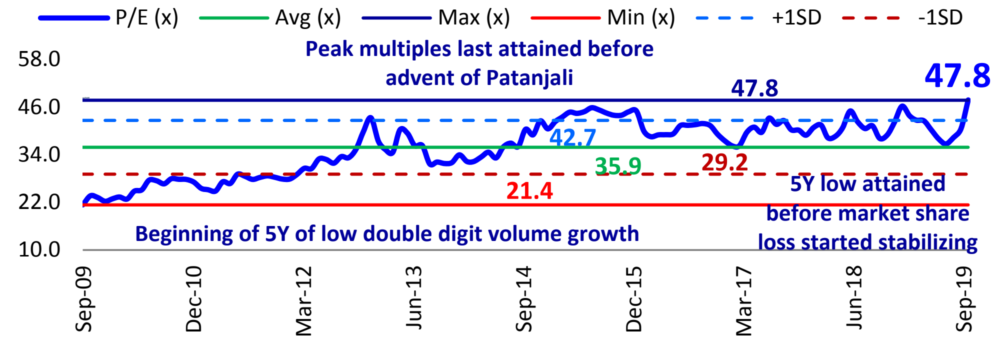
Valuation summary

NAV Calculation	INR m	per share (INR)	%
Residential	1,13,131	311	47
Leasing - Offices and Malls	1,03,845	286	43
Hospitality	13,278	37	6
Value of Other assets	12,309	28	4
Gross Asset Value	**2,42,564**	**661**	**100**
Less: Net Debt	4,500	12	2
Net Asset Value	**2,38,064**	**649**	**98**
CMP		**514**	
Up/down		**26%**	

9. COLGATE

- Colgate is also a clear beneficiary of corporate tax cuts (unlike peers like Dabur and Patanjali) and we believe that it will utilize the gains in an effort to boost growth. Market share has stabilized over the past three quarters at 50-51% but is well below the peak of 56-57% achieved four years ago.
- The new MD, MR. Ram Raghavan (joined in August'19) has already shown aggressive intent on share gain and volumes.
- If the company is able to claw back a good amount of the market share lost in recent years, medium-term earnings growth because of significant underutilization of capacity created (don't need material capex investment until FY22) can be healthy and RoEs can move significantly above the current impressive levels. Valuations are at a discount to peers at 39x FY21E (post tax cut impact).

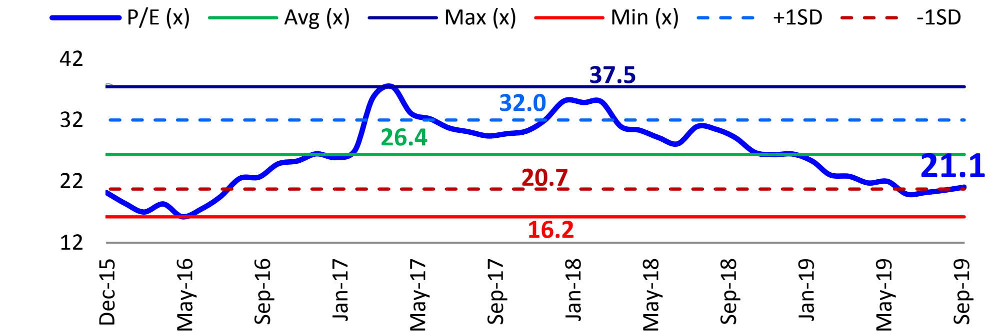
Further rerating prospects on targeted market share gain



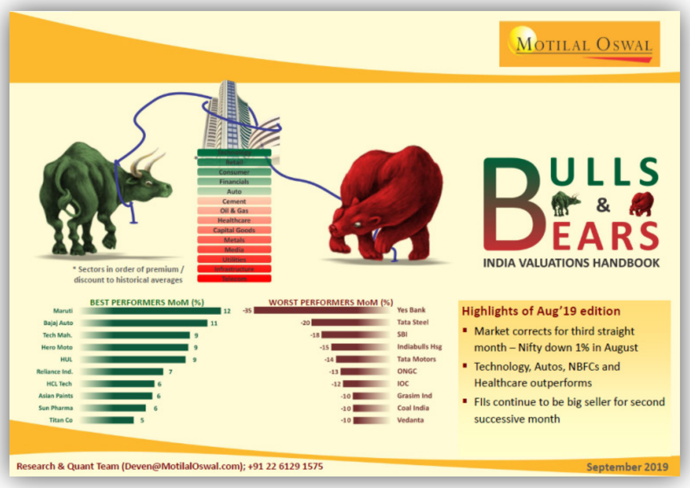
10. ALKEM LAB

- Alkem is best fit to the theme of higher exposure to domestic formulation (67% of sales), limited price erosion in the US business due to a low base (USD270m), sound compliance record, and attractive valuation.
- Compared to high-single-digit growth of the industry, Alkem is well placed to deliver a 14% CAGR over the next 2-3 years in domestic formulation, led by 7-8% CAGR in volumes and 2-3% CAGR in price and new launches. Recent wide fluctuations in climate would also support superior growth for Alkem.
- With the US business marginally EBITDA positive and the strong ANDA pipeline (58 pending for approval); the new launches could to lead to a 17% CAGR in US sales. Better operating leverage would improve overall profitability.
- Accordingly, we expect 28% earnings CAGR over FY19-21 and RoE to improve from 15% in FY19 to 19% by FY21.

Alkem's valuations have corrected sharply in the last two years and is now trading at a 20% discount to average



India Strategy, Thematics and Quant Research Gallery



Explanation of Investment Rating	
Investment Rating	**Expected return (over 12-month)**
BUY	>=15%
SELL	< - 10%
NEUTRAL	> - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

*In case the recommendation given by the Research Analyst is inconsistent with the investment rating legend for a continuous period of 30 days, the Research Analyst shall within following 30 days take appropriate measures to make the recommendation consistent with the investment rating legend.

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