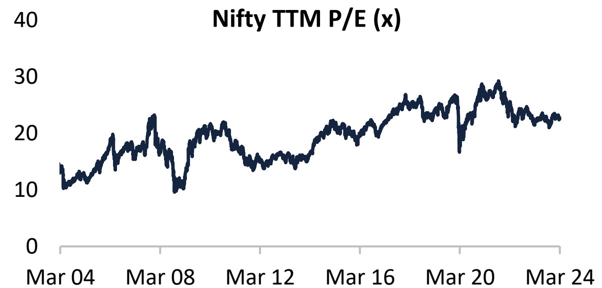
At the Crossroads

The last twelve months have been characterised by price discovery staying ahead of expectations in stocks which have seen a rerating. In fact, the post Covid recovery in the market has been marked by performance ahead of trend returns and broadly, ahead of earnings growth. At the same time, the Nifty valuations have moderated. The market has undergone a transformation in leadership. Let us look at some facts.

Period	Nifty Return CAGR (%)
FY04-24	13.5
FY09-24	14.3
FY14-24	12.8
FY19-24	13.9
Pre-Covid high to FY24	15.1

Note: Pre-covid high was on Jan 14, 2020
Source: Bloomberg, Spark Fund Research



Source: ACE Equity, IIFL Securities, Spark Fund Research

Nifty returns have been running above trend in recent years. However, Nifty valuations are not at an all-time high. How so?

1. Nifty earnings have broadened out. This follows the economic growth becoming broad-based.
2. Segments of the market which went through an extended lean patch (such as PSU & Corporate facing banks, Engineering & Capital goods) started to pitch in.
3. Investment spending has started to drive earnings.
4. Manufacturing has begun a comeback.

Let us look at earnings growth of companies in the Nifty.

Sectors	FY10-20 CAGR (%) Equal weighted	FY20-24E CAGR (%) Equal weighted
Private Banks	16.5	41.9
PSU Bank	4.7	39.8
Metals	4.6	27.6
Auto	11.4	24.4
FMCG & Consumer Discretionary	14.2	17.3
Reliance	4.9	16.3
IT	15.5	4.7
Others	16.3	22.8

Source: Bloomberg, Spark Fund Research

It is no surprise to us that the leadership in the market has shifted from asset-light, low (or zero) debt companies to segments which can benefit from well-rounded growth in the economy. Take PSU stocks. The debate over the out-performance of public sector companies in recent quarters is wrongly centred on whether the government as a promoter is a value creator or not. Most of the PSU companies cater to the core economy and many are sector/segment leaders in B2B businesses that stand to benefit from balanced economic growth driven by investment spending doing its bit and not just growth driven by consumer spending/tradeable services. Further, low or zero debt is not necessarily a force multiplier for stock performance all the time. Carrying lot of expensive equity in the balance sheet can be a drag, now more than in the past decade – when cost of capital has started to become relevant with the passing of the zero-interest era. Free cash flow generation is a sign of strength no doubt. In an economy where growth is the buzzword – and likely the only

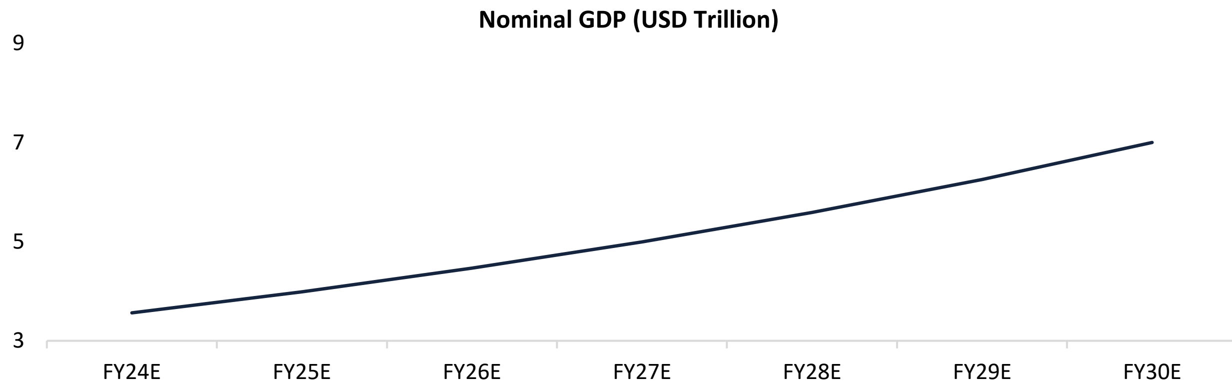
talk of the town for years to come – free cash flow may also signify unwillingness or inability to deploy capital fruitfully.

Data over the post-Covid period has laid bare some of these facts. While thumping the table on anything like this is fraught with risk in an uncertain world, it is time to take stock and see why and how the market can move up from the crossroads it is finding itself in. This is because:

1. The erstwhile laggards have now finished a good round of re-rating.
2. Small/Midcaps have had their long day in the sun and are perhaps looking over-extended.
3. The sustainability of PSU rally is being questioned by many serious observers, citing the inherently higher cyclicality in the underlying businesses and their chequered past. These are points to ponder without a doubt.

Whither now?

We do a scenario analysis if the economy is to get to USD 7 trillion by FY30. This requires a growth of 8.5% in real GDP.



Source: Reserve Bank of India, Spark Fund Research

Given that private consumption is not a very volatile element, we need fixed capital formation to do some serious heavy-lifting for the above to pan out. To be very clear, the ask rate of 8.5% real GDP growth is not easy. For the GDP to hit USD 7 trillion, we need a period of stable if not appreciating currency as well. We need Gross Fixed Capital formation to lead all the way till 2030 for reaching the target.

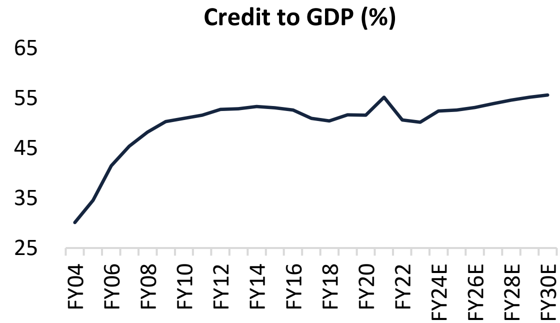
Particulars (%)	FY08	FY14	FY19	FY24 (SAE)
Private final consumption	57.2	57.5	56.6	55.6
Govt consumption	9.8	10.9	10.6	9.6
Gross Fixed Capital formation	31.6	30.7	31.9	34.1
Net Exports	-4.3	-1.8	-3.0	-2.5
Other sources	5.7	2.7	3.9	3.2

Note: SAE- Second Advanced Estimate
Source: Reserve Bank of India, Spark Fund Research

We need exports to do their bit if the currency is to remain stable. Given the rather bleak outlook for global demand, India must gain market share in global trade. Whichever way we slice and dice these numbers, there is a need for investment spending to remain high. Credit growth has to be robust to finance this.

Period	Bank Loan Growth CAGR (%)
FY04-10	25
FY10-20	12
FY20-24E	11
FY24-30E	14

Source: Reserve Bank of India, Spark Fund Research



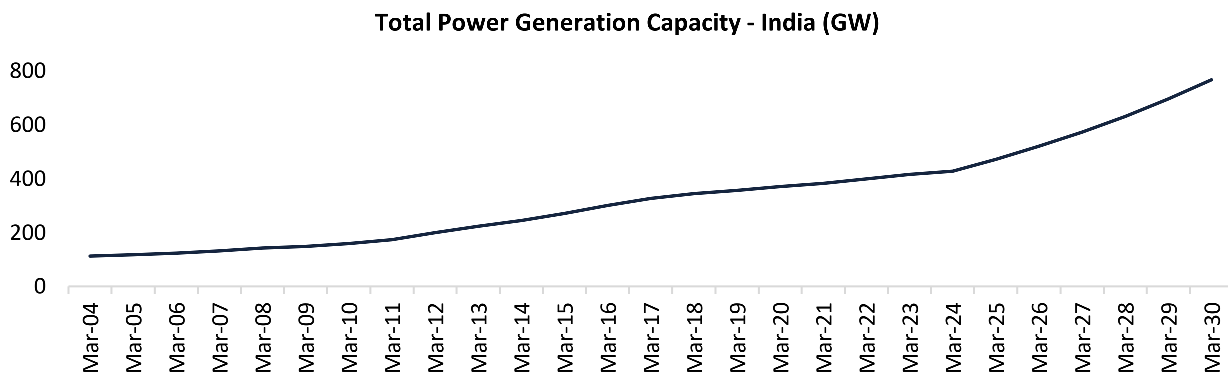
Source: Reserve Bank of India, Spark Fund Research

The credit multiplier to GDP growth has still been assumed to be lower than in 2004-10. Even with this, there is an opportunity for well-run banks to grow earnings over the rest of this decade. We do not see a risk of credit quality deterioration when growth is strong, and leverage is not excessive. The steady growth in earnings of financials could be a source of positive surprise.

Let us now look at a metric like power demand.

Country	Per Capita Power Consumption (MWh)	CY07-22 CAGR (%)
United States	12.9	-0.4
Japan	7.7	-0.7
Germany	6.4	-0.9
China	6.1	6.6
India	1.0	4.5

Source: World Bank, International Energy Agency, China State Council Information office, Spark Fund Research



Source: Ministry of Power, Spark Fund Research

If the above materialises, the per capita power consumption would settle at 2.0 MWh for India by 2030, which is still way below the other countries mentioned above. Even for this to pan out, we need a lot of capacity creation. This in-turn requires massive investment in power sector and great execution.

Let us look at the cement sector.

India	FY04-10	FY10-20	FY21-24E	FY24-30E
Cement Capacity Growth (%)	8.4	7.9	5.3	6.3
Cement Demand Growth (%)	9.3	5.3	6.0	**10.4**

Source: Avendus Spark, Spark Fund Research

Once again, what we see is that the demand growth should accelerate above the trend over the last few years for the economy to gallop towards USD 7 trillion.

The key takeaway from the above is that if the economy were to move towards USD 7 trillion, demand is likely to be strong in key core segments and earnings growth could be well-supported. The real risk for India continues to be that capacity shortages act as the spoiler. The current thrust in the economy seems to be to mitigate this risk. While the jury is still out on this, India stands a better chance now than anytime in the past.

The above scenario analysis throws up the following conclusions.

1. For the GDP to get to USD 7 trillion (or even USD 6.3 trillion, which is a 10% miss) by 2030, we need capital formation to remain the prime mover.
2. This will mean sustained credit growth, demand growth and capacity creation in core economy and a possible period of heavy capital flows. This is good for earnings for a wide basket of companies. However, we need more evidence that we will run this marathon.
3. The above could result in a steady INR (one more piece in the jigsaw puzzle of how we can get to USD 7 trillion).

Given the crossroads that we are now at, we will know the direction and momentum in a few months. The market rally, to our mind, is beginning to reflect a high level of optimism in the above panning out. If this comes true, there is a good possibility of sustained and steady (if not spectacular) earnings growth. If India flatters to deceive as it did once after the GFC, the market is anyway unlikely to be able to sustain on the asset light brigade. Like it or not, all eyes have to be on the core economy. While it has shown a great deal of resilience and has the potential to stay the course, we may have entered a period when the market will need to pause and take stock of what is probable and how much is too much.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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