TWO SECTORS HOLD THE KEY

The relative resilience of the Indian market over the last two years has been a subject matter of much discussion. Compared to the emerging markets or even to the huge mother markets in the US, India has been resilient even as returns have been low.

Indices	2Yr CAGR Returns (%)
Nifty 50 (India)	3.9
Nikkei 225 (Japan)	3.3
TAIEX (Taiwan)	-2.9
S&P 500 (US)	-4.6
Shanghai Composite (China)	-7.7
Nasdaq (US)	-8.9
KOSPI (Korea)	-12.4

Note: Data as of 31st Oct 23.
Source: Bloomberg, Spark Fund Research

The weightage of India within emerging market indices has gone up to mid-teens, which is an all-time high. At an aggregate level, valuations of Nifty are lower than where we were in October 2021, which was a major post-Covid peak. October 2021 is being identified as a moment of reckoning as Nifty peaked out then and that was taken out only in 2023. Inflation fears came to the fore after 2021 and the cost of capital, as represented by global interest rates, has been on a relentless rise since then. US Mortgage rate touched 8%, levels not seen in living memory.

The relative macros for India have seldom been better.

1. Indian inflation, at around 5-6% is in a band which is not too far from the US inflation.
2. The Indian G-sec rate, at about 7-7.5%, is higher than the US but then it is somewhere in the lower end of its own long-term range, which has been between 5-15%. For the US, the 10-year bond touched a post GFC high recently.
3. Indian GDP growth is well above that of the global numbers and also that of China.
4. Government deficits are not looking good anywhere. India is no exception.
5. Indian growth outlook is way more robust. That is the opportunity that the market has tried to price in. The market is still at it and invariably, there will be overshoots.
6. The growth of core India is what stands out. Core India goes beyond consumption. It is about prudent investments going into capital expenditure. It is about balance sheets using appropriate gearing and not just about living with the wishful thinking that the cost of capital (particularly equity) is low and going lower.

However, there will be times in this journey when the market has to pause and catch its breath. Reality check is bound to kick in. Now is one such time. From the point of view of how the market is poised, the lens has to zoom in on two sectors – BFSI and IT services.

IT Services – Opportunity may be in disruption

IT services is possibly at the cusp of a very big change. Generative AI is in the news everywhere. It increasingly appears that such attention is justified. This is a game changer. Here is a sense of the opportunity and the conundrum that it brings to the Indian IT services sector.

Gen AI is all about a massive leap in productivity. There is a lot of debate on which pockets of the IT services spectrum will feel the impact for now. The most important implication for Indian IT is that Gen AI will seek to get the same work done by fewer human resources. We know the immediate response is that this is not a zero-sum game and that Indian IT companies have a big opportunity. That is true.

However, the mainstay of the current model in Indian IT services is on billing on time & material as the basis.

FY05-24E CAGR (%)	Inflation Adjusted Revenue	Headcount

TCS	12.5	16.2
Infosys	11.7	14.1

Note: 1. Inflation adjustment is a blended number across India (2/3rd weight) and US (1/3rd weight).
Source: Ace Equity, Bloomberg, Spark Fund Research

1. The growth in Indian IT revenues over the years has been dependent on people addition. The larger companies may no doubt, develop Gen AI capabilities and soon enough. However, it is hard to conceive how they can transform such a large base to adapt to the new order without disruption and some level of cannibalisation. What will they do with the large teams they have created? How easy is the transition path? There are no easy answers.

2. On margins, it is clear that they are defending margins in recent quarters more than they are able to defend revenues. The margins are seen defended at the lower end of a longer-term band for the best in class. For others, the margins have dropped below their own band and are broadly at 12-18% levels at the level of EBIT margin. Mid-tier names are already there.

   IT companies have benefitted (or should have benefitted) from the 8.5% depreciation in the Indian rupee over the last 18 months. Bear in mind that this might have been a straight increase in top-line if other things ARE EQUAL. Other things will never be equal. Customers will want to take this benefit to their account and have done so.

   We are therefore at a situation where growth in revenues is getting challenged by economic uncertainties in the short run and by disruption soon thereafter. Margins may get defended but there might be a cost. Is that the top-line?

3. The other point is on deal wins. In IT services, the deals announced are statements of intent. The actual flow into revenues will depend on a lot of factors along the way. Market is right in not getting overly excited over this metric. It does not bestow visibility of revenues per se. It delivers the possibility of such visibility.

Given the above, the debate will always move around valuations and margin of safety and that remains low. While the disruptive change unravels before us, the market will be guarded in going overboard on IT services names, unless a bubble is conjured up.

BFSI – Cyclical at the end of the day

We have a very positive view on the outlook for Indian lending institutions. The rationale is straightforward.

1. The Indian banking (lenders) system came out of what was arguably the worst bad loan cycle in its history. It was an over-extended super cycle on the wrong side. The end game was a comprehensive capitulation and clean-up. What has emerged is a much stronger banking system
2. India witnessed its only recession in the post liberalization era, thanks to Covid. Recessions are market clearing events and act as productivity boosters. The stress on the banking system was well-contained and banks were proactive in provisioning and action on the ground. This has set up the base very well for a period of sustained growth.
3. With investment as % of GDP reversing the downtrend and with capex/investments set to be the major driver of GDP growth, credit intensity of such growth is set to improve. While credit demand may not match the highs witnessed in 2004-07, chances of the same sustaining a steady clip for a longer number of years (maybe 4-6 years) are on the rise.
4. Amidst all this, regulation has been proactive and of high quality. We saw how RBI dealt with an incipient problem in one of the smaller banks. Now, they have raised some red flags on unsecured lending.

Overall, for an NPA cycle to take root, we need excessive gearing or a collapse in demand. At the moment, we seem well clear of that moment or phase.

Valuations are reasonable for most banks. Valuations have cooled off even for the erstwhile expensive banks such as HDFC Bank. PSU banks are trading at attractive valuations even as visibility is good for the business to grow and for relevant metrics to sustain.

What is the problem then?

One, over-ownership. Everyone has turned bullish from being very sceptical and that backdrop is never great for stocks to perform. Two, we need to recognize that banking (lending) is a cyclical business after all. Eventually, bad loans will go up – and now that the accretion of fresh bad loans is at a very low level, this metric cannot really improve from here. It can worsen in time. We believe this is quite some time away but the market is going through a rain check.

Where does this leave us?

We have entered a period of consolidation. In other words, momentum is going to be elusive. Returns will tend to be laboured and have to be eked out step by step through investing in the right stocks. We repeat yet again that the cost of capital has gone up and valuations, by whatever measure expressed or analysed, have to reflect this reality. From a period of relatively high return for stocks, we may have entered a period where expectations must be pegged down to realistic levels.

Annualized Return (%)	3Yr	5Yr	10Yr	20Yr
NIFTY Total Return Index	19.3	14.3	13.1	14.8

Note: Data as of 31st Oct 23.
Source: Bloomberg, Spark Fund Research

Some degree of mean reversion looks inevitable. We may also have to prepare the ground for valuation and return dispersions to narrow – across sectors and across market caps. While mid/small caps may be seen as having better growth visibility, the risk element has been given a go-by in the quest for chasing the momentum. Do not chase the rainbow following the momentum. The path to sustainable returns in stocks may yet be paved with thorns hidden in flowers.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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