What should keep investors grounded?

Nifty is close to another milestone and this time it is 20,000. Many forecasters did not anticipate that this could be achieved in such a short span of time. When the index traded below the previous high of 18,477 reached in October 2021 and that too for a long time, there were many who expected a steep fall. Market has a mind of its own and chose to break out on the upside.

We believe the market rally is on a firm footing. Our April newsletter was titled "What worries the market? What can go right?". The title itself was meant to draw the attention of our investors to the possibility of a bullish move. We made our point on the improvement in banks and a possible positive surprise on the economy.

Nifty was at 18,065 on 30th April. Since then, the market has been viewing the glass as half full while discounting the positives.

1. Earnings downgrades have bottomed out with some caveats (IT, some parts of consumer sector – once again discussed last month in our piece titled "K-shaped recovery?")
2. Banks continue to improve
3. Concurrent indicators on the economy are showing that the recovery is solidifying
4. Inflation has shown a propensity to soften (food prices are a spoiler)
5. Capex is beginning to drive growth

While a 10% rally in less than three months should always raise some caution, the market is factoring in an improvement in core India. This may sound a bit strange for those used to the post-Global Financial Crisis market. Growth was not driven by capital-intensive sectors for a long time. When a broad-based growth is on the anvil, there is scepticism. How can PSU banks show low NPAs? How can any capital-intensive sector create value? Sceptics have been at it for a while now.

If you had very high ROCE/ROA, you were entitled to expand valuations without any ceiling. If your ROCE/ROA is below cost of capital because of an unhelpful macro-scenario or mistakes made (usually, it is a combination), then the drift was that such companies can never do well in India ever again. Down-cycles were thought to have ended forever for one set of companies and were deemed to be unending for others.

So here we are, knocking at 20,000. The milestone neither means a toppish market nor does it herald any new trend. This is the time to assess what the risk reward is looking like, particularly over 2-3 years from now. Overall, the economic growth seems to be a tailwind. However, there are a few points which should keep us on our toes.

1. IT Services

This is a bellwether sector. Some of the best governed companies and those who created a lot of shareholder value in the past are present here. We have been sensing for a while now (over 18 months and counting) that something is afoot which may not be great for the stocks therein. Let us look at how the sector weight has moved:

IT weight in Nifty 50 (%)

Period	Weights
Dec-19	12.8
Dec-20	16.3
Dec-21	19.1
Dec-22	14.0
Jun-23	12.6

Source: NSE Indices, Spark Fund Research

Well, we seem to have come a full circle. Stocks have fallen a great deal even as the market is at a new high. Everyone keeps saying that these are great companies and everything will be okay in the long run. While we have no great gift of clairvoyance to question all those out there, we deem it fit to look at the following

A. The goalpost for a possible recovery was FY23 when the stocks did poorly in the first half of 2022. When there were some red flags in April 2023, the goalpost shifted to the second half of FY24. Now, the same has been moved to FY25. Not much explanation as to why things should get better. It is just that one is entitled to a full revival.

B. Look at the EBIT margins in this sector

EBIT Margin (%)

Company	FY 18	FY 19	FY 20	FY21				FY22				FY23				FY24
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
TCS	24.8	25.6	24.6	23.6	**26.2**	**26.6**	26.8	25.5	25.6	25.0	25.0	23.1	24.0	24.5	24.5	**23.2**
Infosys	24.1	22.0	21.3	22.7	**25.3**	**25.4**	24.5	23.7	23.6	23.5	21.6	20.1	21.5	21.5	21.0	**20.8**
HCL	19.5	19.6	19.7	20.7	**21.7**	**23.0**	16.7	19.6	19.1	19.1	18.0	17.0	17.9	19.6	18.2	**16.9**
Wipro	15.2	16.5	16.8	17.3	**18.4**	**21.2**	20.5	18.5	17.3	16.9	16.3	14.3	14.0	15.6	15.8	**15.1**
Tech Mahindra	11.8	15.0	11.0	10.1	**14.2**	**15.9**	16.0	15.2	15.2	14.8	13.2	11.0	11.2	12.0	9.6	**6.8**
LTI Mindtree	14.1	18.4	16.1	17.4	**19.9**	**20.6**	19.4	16.4	17.2	18.5	18.1	17.4	16.1	13.9	16.4	**16.7**

Source: Ace Equity, Spark Fund Research

Even as the rupee depreciated from around 72-75 in Q2 of FY21 to over 82 in FY23 and even as there was a post Covid recovery in demand, the margins have been going south. Margins are now scraping the lower end of a five-year band even for the leaders Infosys and TCS even though the INR is at its weakest. Margins have cratered for a few of the weaker players. The drop in margins in the face of a weak rupee is to be viewed in the context of the fact that no country with a competitive currency competes with Indian IT.

Is the industry going to have to accept decidedly lower margins to keep getting even a low growth?

C. Valuation bands for Infosys & TCS

Period	Infosys		TCS	
	Average Trailing PE (x)	Average USD Revenue Growth (%)	Average Trailing PE* (x)	Average USD Revenue Growth (%)
FY2003-08	32	41	29	38
FY2010-18	19	11	22	15
FY2021-23	31	16	34	12

**Note: For TCS, average PE from 30th June 2005*
Source: Bloomberg, Company Reports, Spark Fund Research

The data is clear. If revenue growth slips or if margins tank, valuations may prove too heavy.

1. Does the Indian consumer have too much on her plate?

The demand trends are very divergent. Volume growth for Hindustan Unilever in Q1 was 3% YoY while domestic air traffic growth was 19% YoY. Hotel occupancy in Q1 for Indian Hotels was 65% while it was at 62% pre-Covid (Q1 FY20). These are admittedly random data points but offer food for thought. The Indian consumer is spending but has too big a shopping list when compared with income to keep everyone happy. Here is the problem now. The segments where there is a sluggishness in demand are those which have been over-owned for a long while now.

2. Rising share of more cyclical sectors in Nifty profits

Share of Nifty 50 profits (%)

Sectors	FY16	FY20	FY21	FY22	FY23	FY24e
Private Banks/Insurance/Financials	20	26	25	22	24	26
Public Sector Banks	2	5	6	6	9	8
IT Services	22	22	18	15	15	14
Consumer & Healthcare	11	11	9	7	10	9
Cyclical Commodities	8	18	26	29	16	18
Automobiles	12	2	1	2	5	7
Capital goods	2	3	1	2	2	2
Reliance	12	12	12	11	11	10
Others	12	-1	2	8	8	7

Source: Ace Equity, NSE Indices, Bloomberg, Spark Fund Research.

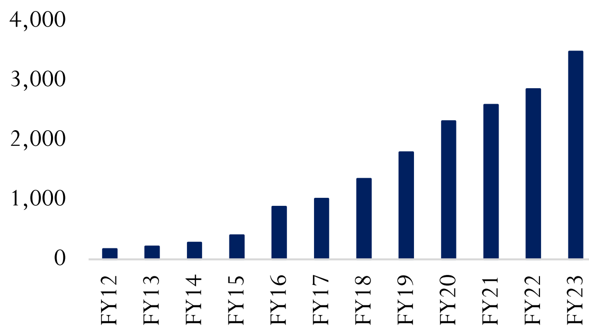
It is a fact that all sectors are displaying some cyclical characteristics in the new era that has dawned. However, there are sectors which we all know are prone to more cyclicality – financials (PSU banks being more cyclical than the private ones), metals, auto & capital goods. The share of profits for these sectors has been rising. At the same time, the valuations of those sectors whose profit share is going down are refusing to correct.

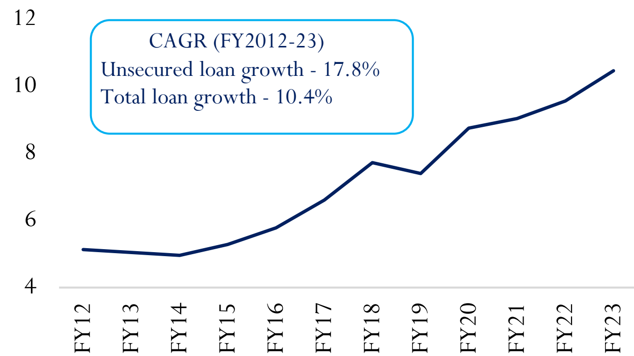
3. Global risks

This has not gone away. The rally in global markets may have given a false sense of relief. While a US recession may or may not be avoidable, the growth outlook for 2024 and beyond is looking very hazy. We need to watch out.

4. The rise in unsecured lending

Paytm has been acting as a broker for an ever-rising list of lenders. This may be exciting for many. Prior to 2008, banks which used agents to build their retail book paid a heavy price. If you move online, the risk does not disappear. Unsecured lending has risen for banks and more worryingly for non-banks and that too, for lending through digital channels.





**Note: MFI loan includes both from Banks & NBFCs; Unsecured loans from banks*

Source: MFIN India, RBI, Spark Fund Research

5. Politics

We want to keep it for the end. We are not in a position to predict how this will play out. Given the (possible) optimistic positioning of the market in the run-up to the elections, the risks will also keep building up and that is for sure. Elections in India may not matter 1-2 years after the event. It may still matter in the run-up and soon after the results come out.

How does this all stack up?

India could well have entered a period of solid and steady growth and a more balanced one at that. The market having breached a new high and scaled a milestone is therefore in the fitness of things. Unlike in the period 2002-2007, there are no global tailwinds to egg Indian growth along. To that extent, we need to moderate our optimism. Then there is the issue of this dichotomy. Where there are companies with low-risk business models, the growth is unexciting and valuations are astronomical. Where there is valuation comfort and growth, those businesses are in sectors which may be more cyclical. The challenge of the moment is to keep the right balance while remaining bullish on core India.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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