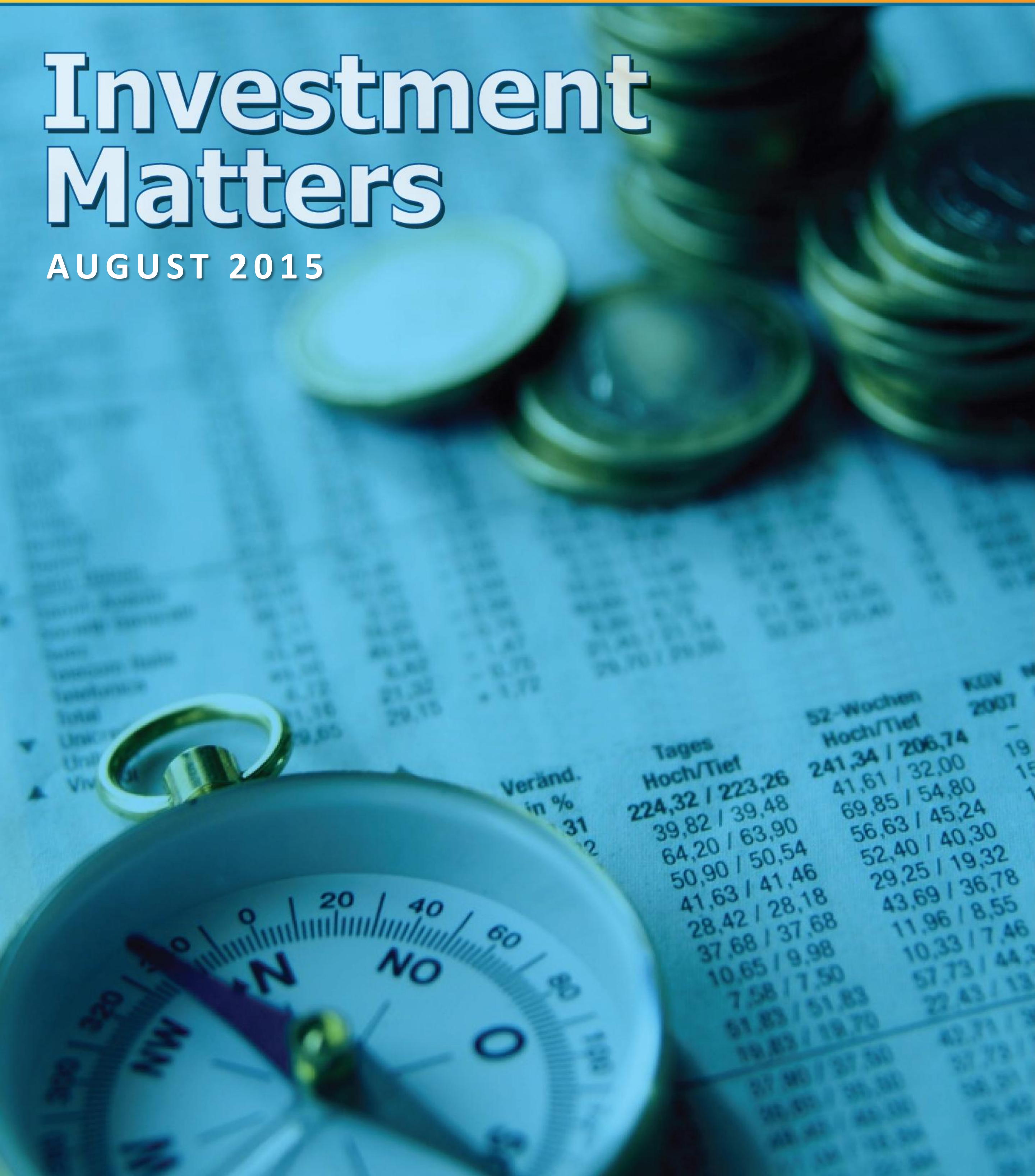
ALCHEMY

CAPITAL MANAGEMENT

# Investment Matters

**AUGUST 2015**



# EQUITY OUTLOOK

As the earnings season nears a close a read through from some of our portfolio companies as well as from key companies in various important sectors makes for interesting observations.

Broadly topline growth is still very tepid. Partly a result of soft demand trends and significantly due to fall in commodity prices making price growth difficult in such a deflationary environment. Though some pick up in urban demand is visible (in 4 wheelers), rural demand still remains a challenge given the slightly deficient rainfall and largely due to significantly lower crop prices. Capital goods companies with an exception of a few (those who export and those leveraged to higher Coal India production) have seen no significant order accretion even though government capex in the first few months is running higher than last year indicating a potential recovery with a lag.

A further fall in commodity prices post this quarter ending could extend the the growth challenge well into the first half of the current year till inventory accumulation ahead of the forthcoming festive season delivers growth. However another challenge to traditional retailers could be the continued aggression we see from e-tailers who start the early discounting season from mid August coinciding with our Independence Day celebrations. Notable amongst them is Amazon who has pre-empted other retailers ahead of the festive season to capture wallet share. So while several categories are facing increased competitive pressures from e tailers, others like biscuits, liquor and personal products are witnessing positive tail winds from premiumisation.

The second trend is companies who are net users of commodities are seeing increasing gross margins which is helping earnings despite a tepid top line growth. That trend is likely to continue well into the next couple of quarters as oil and commodity prices continue to tumble. Competitive dynamics of each sector and category would determine how much companies are able to retain this extra margins and how much they would need to pass on to consumers/clients to retain growth.

Transmission of lower rates into interest costs has been poor as banks are reluctant to pass on lower rates to borrowers thereby implicitly increasing the risk premium they charge to clients especially in sectors like power, infrastructure and metals. Though AAA corporate are benefiting significantly as they are disintermediating from the banking sector by borrowing from the money markets at far lower rates. Also high quality whole sale borrowers and select NBFC's are better able to take advantage of the 75bps RBI rate cuts than most others.

We highlight some specific sector read through and trends below –

Financials: Net Interest Margins (NIM) for the private sector banks was largely in-line; PSU banks witnessed moderate margin expansion qoq. Slippage trends in-line with expectations, with PSU banks seeing incremental stressed asset formation in the form of 5/25 restructuring with roads and iron & steel remaining the top two sectors. Growth was challenging during the quarter, with PSU banks seeing a qoq de-growth in their loan books. Most banks shifted their SLR securities from HTM to AFS. Our portfolios are largely weighted towards NBFCs and private banks which continue to perform significantly better.

Pharma: Most of the Pharma companies have reported disappointing numbers primarily due to lower growth in exports to the US. The growth in US market has impacted due to lack of product approvals while growth in emerging market affected due to currency headwinds. As we are seeing marginal improvement in ANDA approval pace, we expect US business to recover from 2HFY16 onwards. Again here our portfolio companies fared relatively better.

Information Technology: This earnings season was generally in line though we believe that specialist companies focussed on faster growing verticles/segments are likely to fare better. The recent weakening of the rupee should help earnings in the near future.

Auto: Most companies reported lower than estimated revenues, primarily on the back of weaker volume growth. However, softening commodity costs and favourable currency movement has resulted in gross margin expansion for majority of the companies. Especially companies like Maruti have stood out.

Cement and Building Materials: Cement demand continues to remain muted, led by weak offtake from urban real estate and rural slowdown. Cost pressure has cooled down for the industry led by coal/petcoke price declines. South based companies have reported strong margins led by realisation gains. Revenue growth trajectory continues to slow down in 1QFY16 (10-15% vs. 20%+ in the previous quarters) for tiles/sanitaryware players due to sluggish demand. Importantly, the companies saw stress building up in their working capital cycle.

Consumption: Lack of inflationary trend has impacted pricing/mix growth across most of the players. We note that with the increasing prominence of volume growth in the lack of pricing/mix growth has led to several players investing the accrued gross margin benefits into volume revival triggers in terms of price cuts and promotions. Despite tepid offtakes, earnings across companies were above estimates on account of higher than anticipated gross profits.

Cap Goods, Engineering and Consumer Durables: Housing-led electrical/consumer recovery is yet to pick up. Growth across major sub-segments has remained <5% yoy. Domestic market traction for capital goods projects/products is in the process of bottoming out. Order inflow, revenue and margin have witnessed moderate recovery from a low base.

Indian markets have held up well as compared to the carnage in most other emerging markets and despite the government's inability to pass the much awaited GST bill during the monsoon session of the parliament due to political wrangling. Given that India is a net beneficiary of lower commodity prices and the recent low CPI print of 3.8% has upped the chances of interest rate cuts by the RBI and investors continue to remain positive on our markets and strong domestic flows, which we alluded to last month, continue to support our markets well.

**Hiren Ved**

**Chief Investment Officer**
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# DEBT OUTLOOK

In its bi-monthly policy review, the RBI has kept the repo rate unchanged at 7.25%, CRR at 4% and SLR at 21.5%. The rationale for the pause was higher than expected inflation in past couple of months, especially core CPI which moved up by around 50bps since last policy. It is noteworthy that around 30bps out of 50bps is contributed by fuel inflation, which is likely to reverse in coming months, given the correction in crude oil prices. The RBI also noted that near-term inflation expectations have moved up. On the guidance front, it sounded moderately dovish stating that there are several mitigating forces – decline in crude prices, the government's proactive food supply management, higher sowing of pulses, oilseeds, etc. Hence, the risks to the Jan'16, 6% inflation target are now balanced (versus upside risks cited in the last policy).

We continue to expect CPI to undershoot the RBI's target of 6% in Jan 2016, leaving room for another 25bps easing during rest of FY16. However, from next policy review's perspective (on Sept 29, 2015), Fed's action on Sept 17 and its impact on global markets will be quite critical. To that extent, the September policy outcome is uncertain as of now.

The RBI mentioned 4 key factors that needs to be monitored for further policy action - fuller transmission by banks, developments in food prices, de-bottlenecking of supply-side issues such as power, land, etc., and normalisation of US monetary policy. Going forward, given the liquidity scenario and government's capital infusion plans, there should be further transmission by banks. Also, food prices should be in check even if monsoon is sub-par here on, given the government's pro-active food supply management and benign international food prices (down 15% YoY). The key source of uncertainty remains normalisation of US monetary policy.

World is facing low growth across the globe and as a result we see accommodative policies from large economies. Currently, our nominal policy rates are actually higher than other countries with similar macro-dynamics and thus fixed income flows into the country have been substantial over the last year. This has resulted in rupee appreciating against virtually every other major currency in the year so far. In the absence of accompanying productivity improvements, this renders our exports incrementally uncompetitive. If major trading peers ease their monetary policy further and we don't, then on the margin this pressure via the currency channel becomes even more accentuated.

Given the prevailing disinflationary forces, we expect CPI to undershoot RBI's target of 6% in Jan'16 and thus expect another 25bps easing in FY16. However, policy action on Sept 29 remains uncertain, given that US Fed is expected to normalise monetary policy in its Sept 17 meeting. Its impact on global markets would be critical for RBI's policy action. We are bullish on bond prices and except interest rates to eventually fall in next 12 months. As a fixed income investment strategy we suggest to invest part allocation in duration funds to generate capital gains and part in accrual strategy to get benefit of current high yield available in the market to generate consistent returns.

**Advisory Team**

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