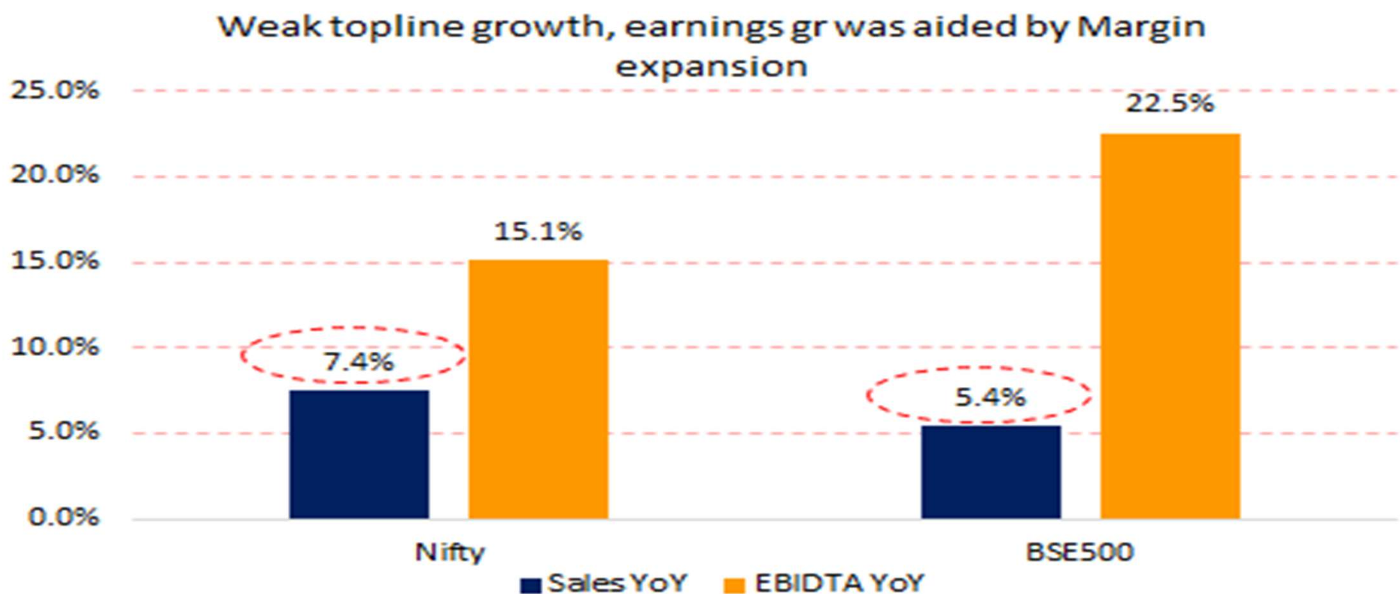
March 2024

Overcast condition – Time to shift to quality.

India Inc - 2023 earnings would have been muted if not for commodity price fall helping margin expansion in an otherwise muted volume growth year. We disagree with market on suggestion to move from small/midcap to large cap, which also lacks earnings trigger. Earnings growth is going to be selective in stocks across cap curve.

Lack of any such catalyst for 2024 could hurt FY25 earnings expectation.

We discussed in our previous note about how the 2023 earnings performance of corporate India was strong but was mostly supported by margins rather than revenues. Weak volume growth was more than compensated for by gross margin expansion, leading to stronger earnings growth of around high teens. Gross Margin expansion was a function of sharp fall in commodities, which spiked the year before due to Ukraine Russia war. Metals, materials, basic chemicals all of them corrected sharply as supply chain issues surrounding war got normalized and dumping of commodities from China, due to domestic slowdown. Generally, we can't argue for valuation rerating in a stock if there is surprise only due to margin, particularly if the volume growth is weak, because it's not a sustainable growth, but this factor rerated many of these stocks particularly in mid and small cap space.



Source: Bloomberg, ACE Equity, Sundaram Alternates. Note: TTM Growth as of Dec-2023.

We are not able to match the overall strong GDP growth with volume growth in many sectors in listed space. It could be because of the reversal of unorganized to organized story which played out during Covid-19. Investments driving growth should have translated to consumption growth as well, which is lagging significantly. We are not seeing broad based volume growth in FMCG, consumer discretionary, auto companies except in some pockets. Few consumption segments even lag real GDP growth.

In 2024 the volume / revenue growth is likely to be muted and like 2023, across most of the sectors and on aggregate basis may be in high single digits, but scope for margin expansion looks limited. Rather with crude at $90 and China recovery story, we might see risk to the commodity prices and therefore margins. This risk is still a little away but cannot be ruled out. But the visible risk is that with margin expansion story behind us and topline growth seems to be muted, we see risk to India Inc earnings growth (Nifty50). Consensus earnings growth expectation as per Bloomberg is 14% for FY25, our estimates suggest closer to 10%. Sectors like Auto, Pharma, Materials even FMCG had low volume growth but got support from margin expansion to deliver high earning growth. In FY25 these sectors are likely to deliver subdued single digit earnings growth. In the case of Financials, one offs like recovery from written off accounts contributed to earnings surprise, these factors will fade away completely in 2-3 quarters. Overall, we believe the earnings expectation for FY25 is high and needs to be cut. Nifty therefore is trading at 21-22x FY25e, which translates to 4.7% earnings yield. With 7.1% India G-Sec yield the spread of India equities over bond yield is unattractive at negative (-)2.5%. This is decadal low and therefore we cannot argue for large return in nifty50 from current levels unless earnings surprise. Spread between corporate earnings and bond yield are at decadal low even globally.

Lack of earnings trigger and high valuations can lead to underperformance of passives in 2024.

With muted earnings growth, wider participation to rally and index performance will become difficult. Therefore, active fund managers, particularly focused concentrated, should do well in FY25. While our stock selection alpha was positive in 2023, our portfolio alpha turned negative due to long tail of benchmark stocks outperforming the indices. In 2024 this will start to change, and tail will start hurting passives and diversified portfolios. We need to ensure our stock selection remains positive during the year to generate alpha. Please remember even in 2023 we managed a positive stock selection alpha.

With earnings surprise becoming scarce, Quality to make a comeback.

Key argument here is; when factors like large swings in commodity prices play out, majority of corporates benefit, and reverse will happen when no such large factor is playing out. With India growth at 6.5% in FY25, the number of companies delivering more than 15% earnings growth will come down substantially and with valuations being high the earnings surprise will become scarce and will become the domain of quality (moat companies) high growth companies which are growing their topline with market share improvements and growing earnings by expanding or holding on to higher margins with the help of their bargaining power. Historically, most of these companies trade at premium multiples, but now see their premium narrowing down due to market witnessing mean reversion in last 2 years. Mean reversion in the market was a function of both flows and earnings being broader based. We see the valuations of quality companies with sustainable moat has narrowed down too much and over next 2 years will regain their valuations as the earnings growth largely remain restricted to a limited universe of high growth stocks trading at reasonable price.

Our Portfolios are well positioned to benefit from this high growth universe.

Out PMS portfolios earnings growth is above 20% for FY25 & FY26, and are driven by stocks selections in **NBFC, consumer discretionary, ecommerce and industrial space.** We are betting on NBFC, which should beat banks meaningfully over the next 2 years with the help of better credit growth and stable or expanding margins. Stocks like Bajaj Finance, Chola, Fivestar, Home first and Au will benefit from fixed rate books and higher credit growth compared to peers in the banking space. Banks on the other hand will see margins and returns compressed due to normalizing provisioning costs and lagging impact of cost of funds. When a rate cut happens the pressure on profitability will be higher, while it can help NBFCs. NBFCs seem to be in a win-win situation. BFSI form 30% of benchmark index. If this works, this call alone can help us generate reasonable alpha over next 2 years.

	NIM FY24e	Loan CAGR FY24-21	Loan CAGR FY26-24	ROA FY24e	EPS CAGR FY24-26	FY26 P/BV
HDFC Bank	3.7%	31.0%	16.2%	1.9%	16.1%	2.3
ICICI Bank	4.5%	18.0%	18.0%	2.3%	6.7%	2.6
Axis Bank	3.8%	17.2%	17.0%	1.8%	11.6%	1.8
Average	**4.0%**	**22.0%**	**17.1%**	**2.0%**	**11.5%**	
SBI	3.0%	14.5%	13.6%	1.0%	12.8%	1.5
BOB	3.0%	14.7%	13.6%	1.1%	6.7%	1.0
Canara Bank	2.8%	12,5%	11.0%	1.0%	8.9%	1.1
Average	**2.9%**	**14.6%**	**12.7%**	**1.0%**	**9.5%**	
BAF	9.5%	30.4%	31.4%	4.6%	31.0%	4.4
Five Star	16.6%	31.3%	40.0%	8.2%	34.4%	3.3
Home First	7.0%	34.6%	32.0%	3.8%	30.3%	3.2
Chola	6.4%	28.8%	24.9%	2.4%	37.8%	3.9
AU SFB	5.3%	28.3%	25.0%	1.6%	35.0%	2.5
Average	**9.0%**	**30.7%**	**30.6%**	**4.1%**	**33.7%**	

Source: Bloomberg, Internal estimates

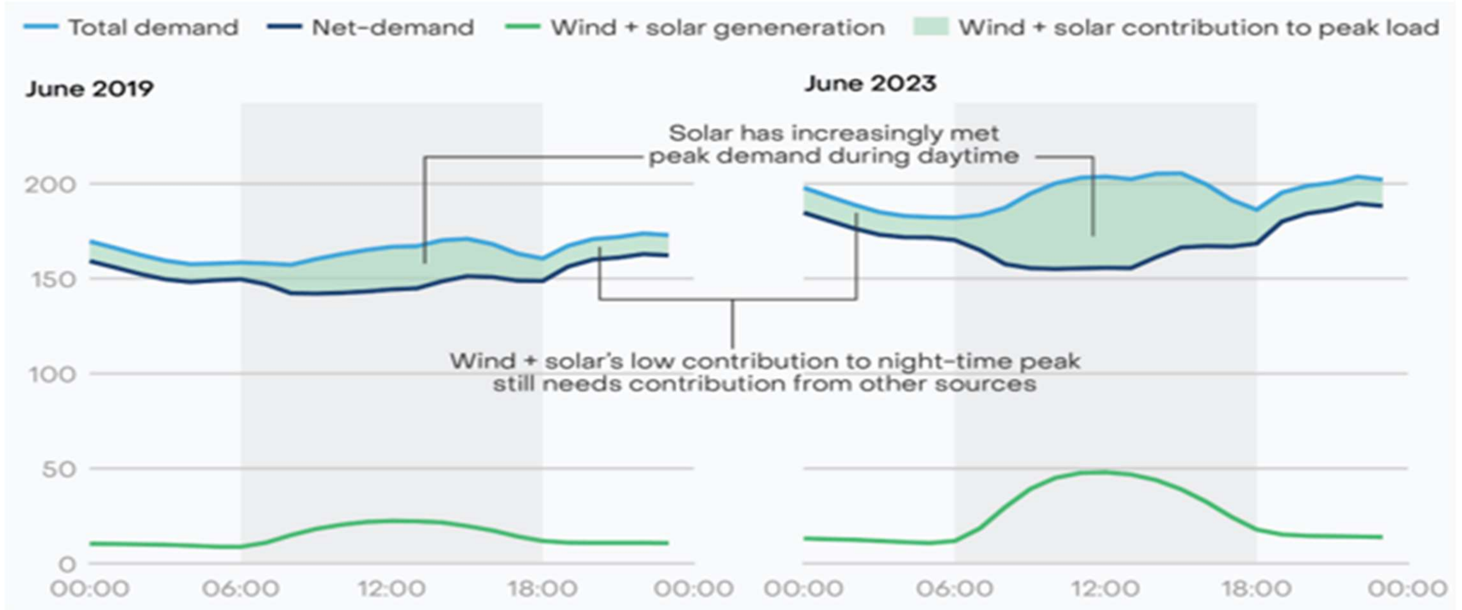
Our consumer discretionary stock selection like **Trent, Zomato and Titan** stood out in 2023, despite consumption sector underperforming. These stocks will continue their leadership in 2024 as well with the help of superior execution. They will see much superior earnings growth compared to FMCG companies which form 10% of benchmark again. We expect returns from these stocks will be in line with earnings at around 20%. 2023 was a great year for all these stocks. Our calls like Sapphire might take over that role in 2024-25. Wait for turnaround in QSR space, which is still underpenetrated in India, valuations are compelling, disproportionate returns possible.

Company	EV/EBIDTA FY26E	EV/Sales FY26E	Revenue CAGR (FY 24-26E)	Revenue CAGR (FY 19-24E)
FMCG Staples				
HUVR	29.0	7.1	9%	10%
Nestle	42.6	10.5	11%	11%
Dabur	28.4	5.9	10%	8%
Marico	26.3	5.6	10%	6%
ITC	16.1	6.0	10%	8%
Discretionary & Retail				
Titan	41.6	5.2	17%	20%
Sapphire Foods	14.2	2.8	19%	17%
Trent	42.6	6.4	31%	36%
Zomato	57.1	7.3	32%	56%
Nykaa	53.2	4.8	26%	45%

Source: Bloomberg

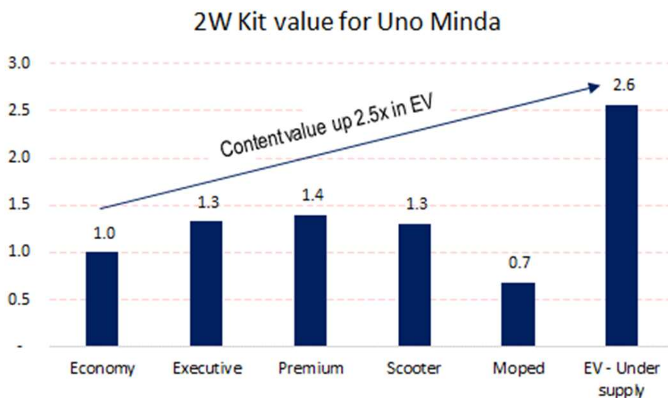
In manufacturing we have higher allocation to the **power sector and chemicals sector.** Both these sectors will benefit from a favorable cycle in 2024. The power sector will benefit from peak deficit widening over next 5 years, order inflow likely to be strong. Power T&D space will also see revival in capex with large renewable capacity addition burdening the grid over next 5 years. Chemicals will see outlook becoming better in the second half in agro chemical space and valuations are non-demanding here. Any small improvement in outlook can lead to substantial performance in this space.

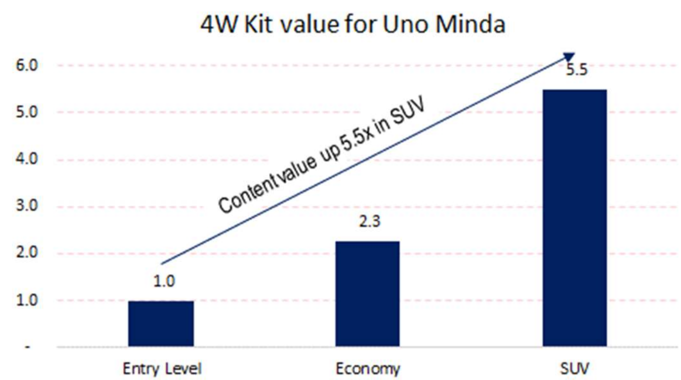
Average Daily peak and net demand in GW for June-2019 and June-2023



Source: Ember's Analysis of Merit India data

Our **Auto exposures are play on emerging trends like premiumization, connected cars, electric vehicles, digital and LED light features etc.** Auto ancillary companies like Uno Minda and Motherson Sumi will outgrow auto space by 1.5 to 2.0x with the help of content per vehicle increase on the back of trends highlighted above.





Source: Uno Minda investor presentation, Sundaram Alternates

Source: In-house

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