Ampersand Capital Investment Advisors LLP

Taking fresh guard - November 2016

We had expected a prolonged corrective phase...

We have been incessantly cautioning for a corrective phase in our stock markets mainly due to excessive valuations based of unrealistic growth expectations (Click previous newsletters since Aug - Eat light and sleep tight - Aug 16, Big money, small ideas – Sep 16, Waiting for Godot - Oct 16). Markets appeared satiated and good news in terms of monsoons, pay commission and lower interest rates had seemed priced in. We had also highlighted concerns over (i) increased participation of small/micro caps with unproven track record, and (ii) mid cap indices trading at premia which were historic highs relative to broader market.

..but reasons were not anticipated

Correction came and how - since the announcement to demonetise high currency notes earlier this month, our stock markets are down 7% even as global markets have surprisingly held up despite an upset outcome in the US presidential elections. As is usual in such instances, we believe this corrective phase could be exaggerated on the downside, and could be followed by a consolidation phase before eventual recovery in stock values. In the long run, there are emerging positives - higher liquidity in the banking system and improved fiscal standing (higher tax/GDP) - which can lead to a concerted fiscal stimulus in FY18E.

Uncertainty could persist for prolonged period

Currently, Nifty trades at PER at 14.5x FY18E, close to long-term mean but a demonetisation-led slowdown in next few months followed by the spill-over impact in FY18 raises the risk of earnings cut coupled with valuation de-rating. The equity portfolios therefore will need to be reconfigured to the new reality. The impact of demonetisation will be felt at two levels spread across the next few weeks and extending upto 6-12 months.

- First level impact is due to lack of physical currency notes which has led to sharp fall in footfalls, sales (esp. consumer discretionary) and construction activity (esp. cement, building materials). Besides, there has been disruption in the disbursement and the collection cycle of NBFCs/MFIs. It is assumed that the availability of notes will be reasonably restored in the next 3-4 months, say by March 2017. This however, will result in the depressing the overall demand at least until then, something which the market was looking forward to and factoring in post the favourable tidings i.e. good monsoons, pay commission inflows and lower interest rates.

- The more lasting impact on consumer demand over 6-12 months could be due to the negative wealth effect as some proportion of black money, either in the form of physical cash or real estate, sees erosion in value. Besides, combination of GST and monetisation will forcibly move some part of informal economy into “white” channel thus adding tax as an additional cost for these businesses/individuals.

Cash is king

In recent editions of our newsletters we had advised taking partial profits especially selling out of NBFCs, and then wait to invest in names where valuations seemed more reasonable. Still, even this calibrated approach could not have fully protected the portfolios from the disruption that has been caused by monetisation. Contrary to the old adage of buy on every correction, we would continue to create more cash as we believe that further downside remains a high probability in next 2-3 months not only due to the severe impact on domestic trade but also the impact of bond yield hardening in developed markets.

So what is the suggested course of action? While the gradual pace of recovery in the economic activity continues, the extent of lasting damage (to FY18 earnings) remains uncertain and evolving. Emerging positives in the long run (lower rates, better fiscal) would result in eventual recovery in the markets but the stocks that will benefit and hence lead the next leg of the rally will be different.

Investing: Back to basics

Over the past year, we have been consistent in our preferences - Cement, NBFCs and Speciality Chemicals as well as select names in the consumption space, including discretionary. Also, focus was on well managed Tier 2 names which had the potential generate greater alpha. Clearly, this needs to be re-jigged in the current scenario with reduced weights in some of these segments. While the initial stages of this process will create higher proportion of idle cash, investors can use any ensuing correction to add/increase exposure to following.

1. Quality names with strong balance sheet and proven execution capabilities, which have better potential to manage growth. These could also be in vulnerable segments like consumer discretionary or cement but undeniably the leaders in the segment e.g. Maruti Suzuki, Shree Cement. Interest rate cuts should help some of these segments. Sectors leaders where unorganised/informal % is significant will also benefit from demonetisation and GST in the long run e.g. Finolex Industries, APL Apollo.

2. Export oriented companies or names with only partial dependence on domestic economy, which are expected to benefit from tailwinds of depreciating INR. While IT and Pharma would have been ideal candidates for this theme, both are struggling with respect to macro headwinds on demand and pricing. Still, one could look to invest in select names like Tech Mahindra and Sun Pharma, again both backed by reputed promoter groups and execution capabilities.

3. Finally, banks would be near term beneficiaries due to improved liquidity and cost of funds. However, low conviction on NPAs and muted credit growth makes it only a short term investment.