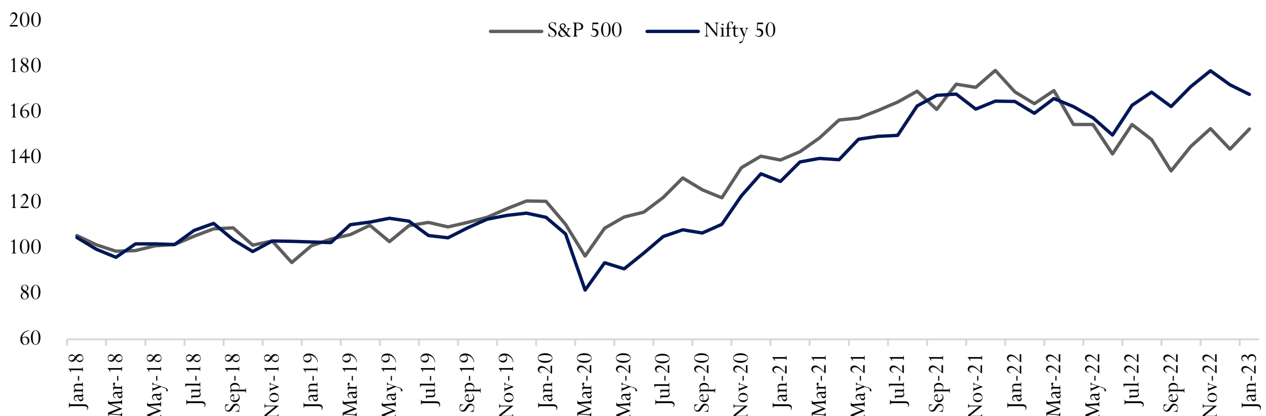
Acrophobia

The fear of heights is not a problem that Indian markets typically suffer from. This time around, the gravitational force appears heavy. It is almost as if the market has been looking for an excuse to sell off. The outperformance in 2022 was a surreal experience for India. Indian markets decoupled in effect even though no one was willing to use the term. On the other side, Indian economy displayed resilience amidst a gloomy global backdrop. Come 2023, the market set out to settle some scores. India went to the bottom of the table even as the US market celebrated the possible peaking of inflation. China had been rallying ever since the zero Covid policy was unceremoniously junked. Amidst all the cheer, India under-performed. Once again, India seems to have de-coupled. Only that the shoe is on the other foot now.

Interestingly, Nifty had a tight correlation with S&P 500 earlier on for many years. This broke in 2022 in India's favour and the trend seems to be continuing into 2023, this time to the detriment of the Indian market.

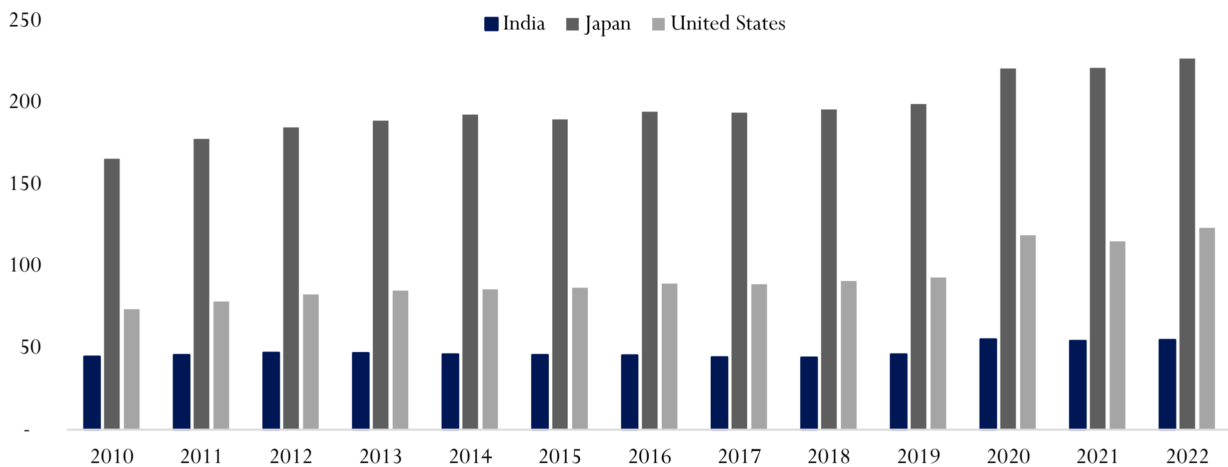
S&P 500 vs Nifty



Note: Index rebased to 100 from Jan 2018
Source: Bloomberg, Spark Fund Research

There is no logical reason for Nifty to have tracked S&P 500. However, there were good reasons for the out-performance in 2022. To begin with, India does not have a serious issue of indebtedness.

Central Government Debt to GDP (%)



Note: 2022 - Provisional numbers
Source: International Monetary Fund, CEIC, Spark Fund Research

Country	Private Debt to GDP (%)
India	85.6
United States	159.1
Japan	187.1
China	193.6

Note: Data represents 2021
Source: International Monetary Fund, Spark Fund Research

While debt levels and fiscal deficit have gone up for all countries, the strong growth in nominal GDP works in India's favour and it tilts the scale for India.

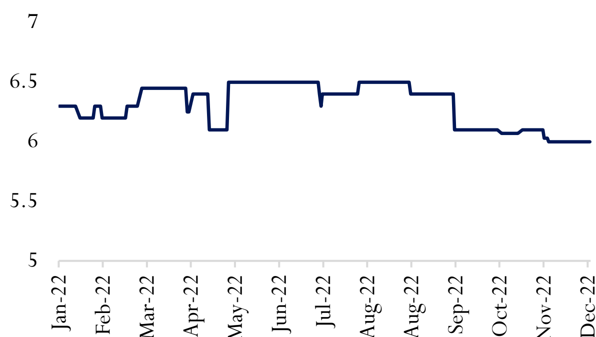
Secondly, Indian earnings have shown strong traction after the pandemic. The Nifty EPS is up from Rs 480 in FY19 to an estimated Rs 809 in FY23. The annual growth of about 14% in earnings is faster than in the previous ten years. The market has not gone up by the same extent during this period. India's earnings are expected to hold on to a reasonable growth in the coming year as well while the global earnings picture is very hazy. S&P 500 earnings have been getting revised downwards and the outlook does not look great either.

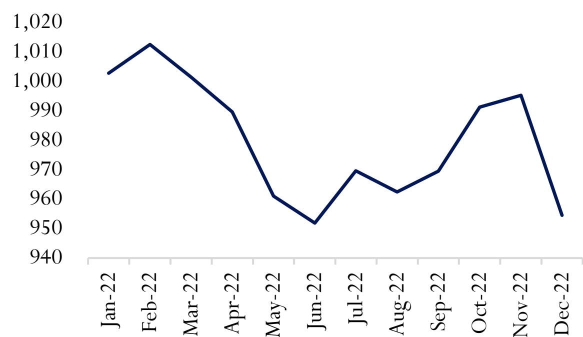
Thirdly, India's cyclical positioning is very different from that of the developed economies or for that matter China. Other than the drag from the global slowdown, Indian growth is on a solid footing. India has more growth drivers raring to go as against only a few that are causing a drag from a cyclical perspective. Global commodities, the overall level of inflation & interest rates, direction of fiscal deficit (if not the level) and state of the bank balance sheets are all positive factors.

All in all, it was logical that India had a relatively good year in 2022. 2023 has started off very differently.

What has changed?
1. The tendency for mean reversion.
Global capital tends to look for greener pastures on a rotational basis. China had become a cheap market on any reckoning even by its own dismal standards when it comes to valuations. The US tech stocks had fallen from grace precipitously. The simple explanation is that allocation to India got over-extended and some of the froth had to come off.

2. A pause in the growth outlook.
The following charts tell the story of growth downgrades, be it at the level of GDP or for earnings.





Source: Bloomberg, IIFL Securities, Spark Fund Research

It is clear that the market had gotten ahead of itself when it came to growth expectations. A reality check was in the works. However, the expected GDP growth at 6% plus is still amongst the best in the world. Earnings are still projected to compound in teens.

How about the news flow on Adani Group?
Yes – that was a proximate reason for the market breaking crucial support levels. While the last word on that saga is yet to be written, India is not new to this kind of event-based volatility. Hard data suggests that this episode has no system-wide impact, be it on the banking system or on earnings.

Yet the mood looks very pessimistic. How come?

Valuation is the elephant in the room

We believe the elephant in the room has been getting ignored consistently over the last few years. Which is valuation. The pockets in India where institutional ownership is high or overall hype is high are both the most over-valued zones. These include the high ROE/ROCE consumer stocks and the high ROA private banks/BFSI names. Not to speak of the Unicorns.

The chorus of opinion over the last few years has been that these are what make Indian markets attractive. While many of the consumer franchises and private banks are extremely well-run businesses, good companies need not always translate into good stock picks all the time.

First of all, the consumer franchises or the blue-blooded private banks are not innovators selling unique products or services. Secondly, the end markets they are in are not high growth anymore (they have reasonable growth no doubt). This applies to the IT services sector as well. These businesses have made a mark for themselves because they are efficiency machines. Therein lies a problem.

The impressive metrics of these companies work as golden handcuffs in a sense. These stocks are on a treadmill with very poor prognosis when it comes to beating ever increasing expectations even as their valuations point to such (non-existent) ability. Take the following examples. At the ROE/ROA band that HDFC Bank and Bajaj Finance operate in, there is little scope for positive surprises. Hindustan Lever has seen its margins go up steeply after the introduction of GST although the base level was already the highest in the Unilever group globally. At around 25%, the EBIT margin that a TCS commands is unparalleled. See the table below.

Company	ROE (%)	ROA (%)	EBITDA/EBIT Margin (%)
Bajaj Finance	22.0	6.5	-
HDFC Bank	16.9	2.0	-
Kotak Mahindra Bank	13.7	2.3	-
Asian Paints	26.9	-	17.3
Hindustan Unilever	20.8	-	24.2
Nestle	92.6	-	22.9
Infosys	32.8	-	21.2
Tata Consultancy Services	38.6	-	24.1

Note: TTM - latest available data; EBITDA for Asian Paints, Hindustan Unilever & Nestle, EBIT for Infosys & Tata Consultancy Services.

Source: AceEquity, Company reports, Spark Fund Research

As their peers suffered after the global financial crisis due to high leverage or other issues, these companies maxed out on all metrics. The quality premium was born during the worst period of scandals in the UPA-II regime. Over time, the quality premium morphed into an obsession. The falling interest rates added fuel to the fire. Somewhere along the road, analysts and pundits turned into blind cheerleaders of the quality juggernaut.

This had to end sometime. The seeds of destruction were sown in the Unicorn ecosystem. Some of those business models are disruptors. It is yet to be established whether they can be builders. Disguised as high quality, unprofitable companies were accorded valuations which do not add up whatever numerical gymnastics you may indulge in. In fact, some of the recent developments seem to suggest that the governance standards are lax in that ecosystem as well. These stocks were the first to crash in 2022. The established names in consumer, IT and BFSI space held out for longer. They are, after all, good businesses and are not the type of companies that need or raise fresh equity. Hence there was also a scarcity premium. All said and done, there is only so much you can do to push the envelope. The under-performance started sometime in 2022.

The reality is now sinking in that the expansion in valuations is a game well past its expiry date. Market re-rates improvements and the lack of legroom there may well work as a force de-multiplier. This is more relevant when the starting valuations are not reasonable by any normal yardstick. There are quarterly games that analysts play here but the law of diminishing marginal utility is seriously at work by now.

The net result of all of this is that large and well-owned segments of the market are feeling heavy for the last few quarters. Throw bad news at this cauldron and the outcome is what we are seeing – which is large scale destruction of wealth.

What next?

Once the hype has started to wear off, it is hard to stem the erosion. Mean reversion is a force that will keep gathering pace. It is not clear as to whether the same will take us back all the way to the first decade of this century. It is useful to note that Hindustan Lever used to trade at over 60 times its earnings in the 1990s before correcting to somewhere in the 20s in terms of P/E by 2007. That was devastating as it meant a lot of sideways movement. Will it be the same for a variety of stocks this time?

Hard to call this but here is some reason to hope for a better outcome. Interest rates may be higher compared to the depths to which they plumbed. Globally and in India, they are lesser than where they were in the decade before the financial crisis. Hence, we want to remain optimistic that valuations need not go down to where they were before the global financial crisis at an aggregate level. Besides, we have seen some good quality stocks correct in valuations over the last two years.

That said, watch out for stocks that trade at P/E ratios of 50, 60, 70 and above. There will be vibes suggesting that P/E is not a good measure. There will be references to valuing these companies on models propounded by the proponents that may zero in on names while ignoring the price (which is the easiest way to avoid further questions). Nothing will help. These valuations have to fall. This process is not an easy one by far. Not even for stocks and sectors which are on level ground already or were there for a while. After all, the same investors hold these stocks or have to buy them. Given the pain, that is not going to be easy. There is no option but to negotiate this phase of rethinking the price discovery process. Fundamentals will stay relevant. Good business models and managements will matter. But everything will need to be measured and calibrated. In our world view, the events making the headlines are important but matter only so much. Watch the elephant in the room closely.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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