Greetings!

Irrefutable exuberance

In a recent media briefing, the Governor of Reserve Bank of India flagged off the disconnect between the real economy and equity markets. To be clear, he did not comment on specific market levels nor did he try to offer details other than to suggest that the markets will correct, eventually. He was more on the point that the effect of Covid on the real economy is for real and the impact is far from over. In the echo of his voice, we could hear the painful refrain about recessions being unpleasant affairs. Which affect lives and livelihoods; cause major resets; and also engender many losers and a few winners. And which, of course, should affect listed companies. Never mind some of the stocks find this to be party time.

The parallel to a certain comment by his illustrious counterpart from the US in December 1996 is irresistible. Alan Greenspan warned of irrational exuberance. The Dotcom bubble was but a new-born baby then. Nasdaq, which was around 1500, marched on beyond 5000 in the next three years, before crashing by over 75%. The bust was painful, though the warning may have come too soon. Equities can trade at what we might consider euphoric levels longer than most investors can keep their poise.

But, history need not repeat without a twist. Prior to March 2020, the world never saw a full-blown bear market, which took all of three weeks to play out. Timelines are shrinking in the brave new world chugging along at the speed of bytes. If there is something irrational about the surge in equities right through the spring& summer, one twist could be in the travel time to la la land and back. We may not have to wait three years to find out.

Irrational or not, the exuberance is irrefutable. The Nasdaq and the S&P 500 are both at new highs. India is trying hard to keep pace. India is having its maiden recession after 1980. In a recession year, profits plummet and it does not take a genius to know that. Game theory is busy at work here. If we can roll over earnings expectations to FY22 and even FY23, there is a lot of play out there. Market as a collective is willing to indulge the same. After all, sharp growth revival can be factored into Excel models on a two-year timeframe without being challenged anytime soon, as the trends in FY21 are supposedly one-off. The market is gaming this, as bulls outnumber the sceptics by a country mile. This is the context in which the RBI Governor made his point. In the world that is only a stone's throw away from the trading terminal, there is pain and suffering.

Recessions will produce winners and we have emphasised that more than once during the last few months. It has been our effort to find and hold on to some of those. That said, let us highlight a few headwinds that the Indian growth story is going to confront over the two-year timeframe the market wants to extend its horizon to.

The cost you cut is also the consumption you kill

There is a microcosm of corporate India that equity analysts/fund managers track to make a living. Those corporates have shown impressive efficiency in controlling costs during the pandemic. They have cut sales, administrative & general expenses. Work from home saves costs in the short run for those who can do so. For instance, operating expenses during Q1 of FY21 declined by an average of 5% on a YoY basis for our portfolio stocks. The best of Indian managements have responded well to the pandemic, despite not having much time to react.

There is a catch. Such cost items constitute the revenue line for many other businesses. Those of us who have sold the great Indian story to investors over the last three decades have always talked about the number of new jobs that one relatively well-paid IT job creates. The number is estimated at 4-5. That could be the job of the canteen worker, the restaurant staff, the worker in the mall, Uber driver, the travel agent guy, the seller of the bulb that conks off if the lights are on – and the list goes on. Those jobs are rendered no more for now. Not to speak of the migrant worker who is at the centre of the rather disconcerting reverse migration phenomenon. If there was a huge kicker to income when urbanisation soldiered on, there is no doubt a giveback if that unwinds. The reverse migration may well take many quarters to uncoil.

Unfortunately, this will end up creating a drag on consumer demand at the aggregate level and such drag can persist for many quarters. Given the pent-up demand we may be seeing from June, this drag due to the hit on disposable incomes may be getting masked temporarily. The importance of consumer demand for India and Indian market multiples is best brought out through some hard data

The Indian consumer was always the last man standing

We have seen many a crisis come and go. India had to pledge its family silver (gold) in 1991. We endured the Asian financial upheaval, international sanctions after Pokhran II, the Kargil war, the Dotcom debacle, the bad loan fiasco, having hardcore leftists in power, the global financial crisis, taper tantrums and demonetisation. The Indian consumer stood firm as a rock through thick and thin.

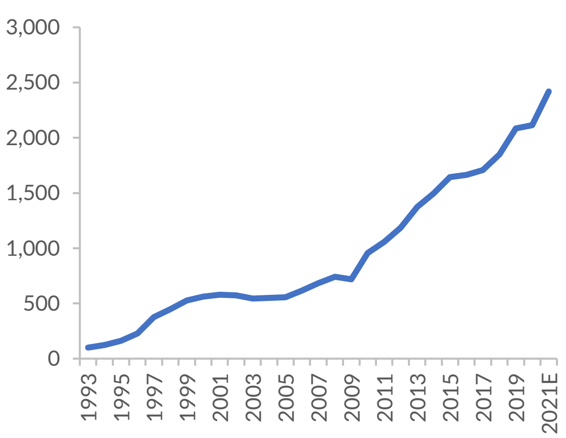
The revenue progression of consumer companies over the last three decades encapsulates the story of the Indian consumer. The revenues never had so much as a blip at any point.

SPARK FUND

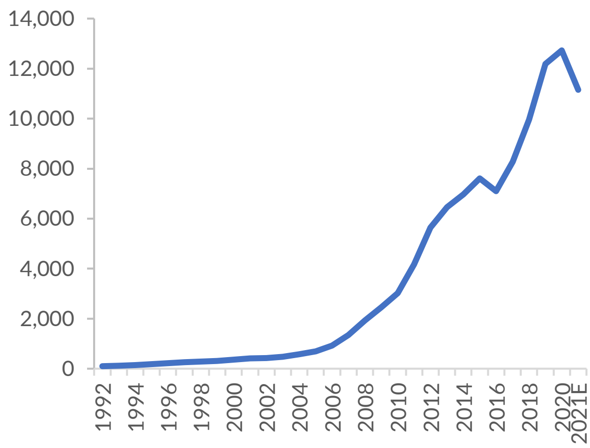
SALES OF CONSUMER COMPANIES OVER THE LAST THREE DECADES

(On a base of 100 in the first year of the respective data stream)

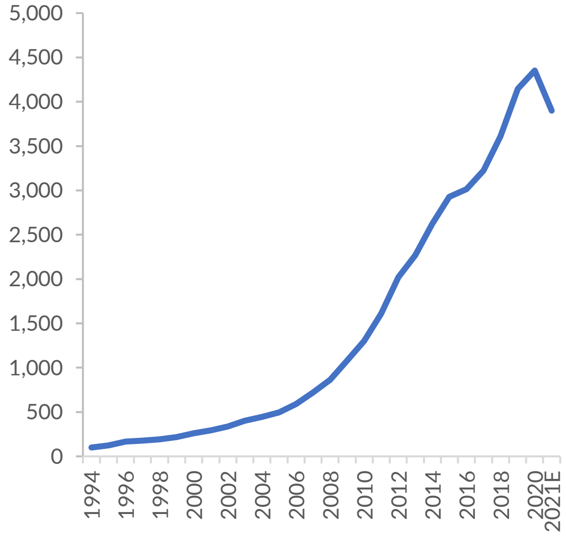
Hindustan Unilever



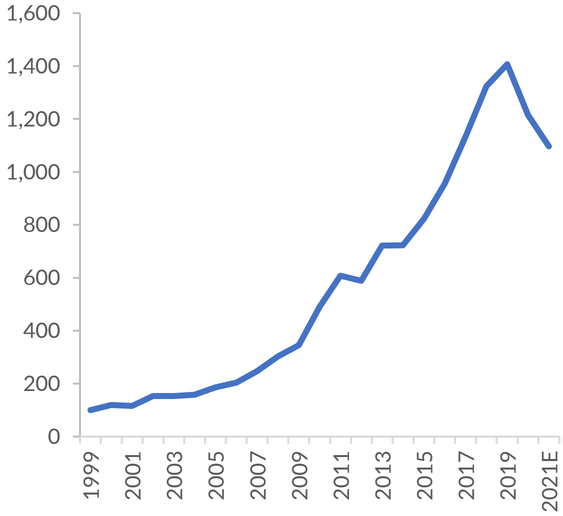
Titan



Asian Paints



Maruti Suzuki



Note: 1. Data pertains to March year end; *Source: Bloomberg*

2. Figures for Hindustan Unilever have been readjusted from Calendar year end data as appropriate;

3. 2021E refers to estimated revenue for FY21

Come FY21 and sales for Titan, Asian Paints and Maruti are all set to nosedive, even as Hindustan Unilever may save the blushes, though not by much. Of course, it is a recession year and this is par for the course. The world-beating valuation of Indian consumer stocks is underpinned at least in part on their apparent infallibility. Besides, it is fair to say that the disposable income of the middle-income Indian household never turned down during the last three decades. The consistent revenue growth of these wealth creators is but a reflection of the same. We are left wondering whether the hitherto resilient consumer may find the load too much to carry. Consumer fatigue may play out over time. The stress need not be apparent all at once. Income hits are too stark and too real for us to assume that this is business as usual. Elsewhere, the premium valuations that Indian private banks enjoyed over the last decade got their sustenance from their retail client who always paid her EMI on the dot. The aura around these banking names may be beginning to come off, as the pristine asset quality might take a bow.

The secondary impact of recession on livelihoods and the hit to consumer morale are yet to play out. When reality hits hard, valuations will experience a new force they have not been used to –gravity. There may still be pockets of consumption that will gain share and companies that win in the mayhem. The India growth story was always about the progress in the base of the pyramid and value migration. If the pyramid steepens and the resultant uneven bulge is occupied by a few winners, can they sustain already high valuations? Some recent analyst upgrades have blindly followed the recent price action and seem to have accorded even higher multiples to these winners. And some of us thought we were apprehensive the market may be hit with acrophobia along with Covid!!!

We refrain from being carried away. What you pay for growth matters, no matter how much the reality is dressed up to suit the occasion. A careful look at the tables below prove the point that the once-invincible banks eroded wealth only because valuations did not leave any room for error. In a sense, the market is so prescient that it may be already be getting ahead of the curve.

When did these companies touch their peak in valuations this year ?

Company	Highest P/E (x) this year on FY20 earnings	Date	Price (INR)	31-Aug-20 Price (INR)	% from high
Titan	80.1	19-Feb-20	1,330	1,101	-17.2%
Pidilite	77.3	11-Mar-20	1,700	1,403	-17.5%
Asian Paints	70.9	25-Aug-20	2,001	1,899	-5.1%
Whirlpool India	65.5	07-Feb-20	2,529	2,121	-16.1%
Havells India	56.4	25-Aug-20	663	616	-7.2%
Nestle	87.9	27-Apr-20	17,951	15,950	-11.1%
Hindustan Unilever	79.8	15-Apr-20	2,488	2,117	-14.9%
Godrej Consumer	52.1	15-Jan-20	762	651	-14.6%
Colgate	51.7	27-Apr-20	1,552	1,363	-12.2%

Source: Bloomberg

Several of these consumer names have fallen off from their peak valuations, which also have been historic highs(or close) for them. Note that for most of these names, the same was achieved before the pandemic or early on in the crisis. The current valuations are still well above the mean levels of the same names. It would be highly unusual for stocks to keep finding higher valuations in the face of decelerating earnings

Bank	Highest P/B (x) this year on FY20 book	Date	Price (INR)	31-Aug-20 Price (INR)	% from high
HDFC Bank	4.0	14-Jan-20	1,290	1,116	-13.5%
Kotak Bank	4.9	12-Feb-20	1,715	1,401	-18.3%
ICICI Bank	2.9	12-Feb-20	549	395	-28.2%
SBI	1.2	2-Jan-20	339	212	-37.5%
Axis Bank	2.5	2-Jan-20	757	497	-34.4%
Indusind Bank	3.1	13-Jan-20	1,540	630	-59.1%
Bajaj Finance	9.1	20-Feb-20	4,880	3,488	-28.5%

Source: Bloomberg

In the same Indian market, peak valuations for financials were achieved more than six months ago and even before the pandemic hit us. Early on in the crisis, the market was quick to discount the possible hit to asset quality, thereby acknowledging the cyclicality inherent in the business of lending.

When India gets back to growth, as it will for sure, we may see a different terrain in front of us to navigate. Welcome to the world of zero sum games and finding winners in the same.

Warm regards,

P Krishnan (CIO) and Team Spark Fund
