Greetings!

## The year that reinforced humility

2020 will easily go down as the year that most homo sapiens would like to put behind and erase from their memories. That is an easy one. The situation was nothing short of warlike and that would be an understatement. For markets, there was no year quite like 2020. It was more like a 20/20. The market made a dash to the abyss and then set a target for itself, which was a black swan event in reverse. Then, it vaulted over the wall of worries to overcome.

For us, 2020 was a year that injected another dose of humility. Forecasting is a profession fraught with perils in the best of times; 2020 was certainly not a plain-vanilla spreadsheet exercise. It was a complex interplay of economic sudden stops, shows of resilience and liquidity tsunamis.

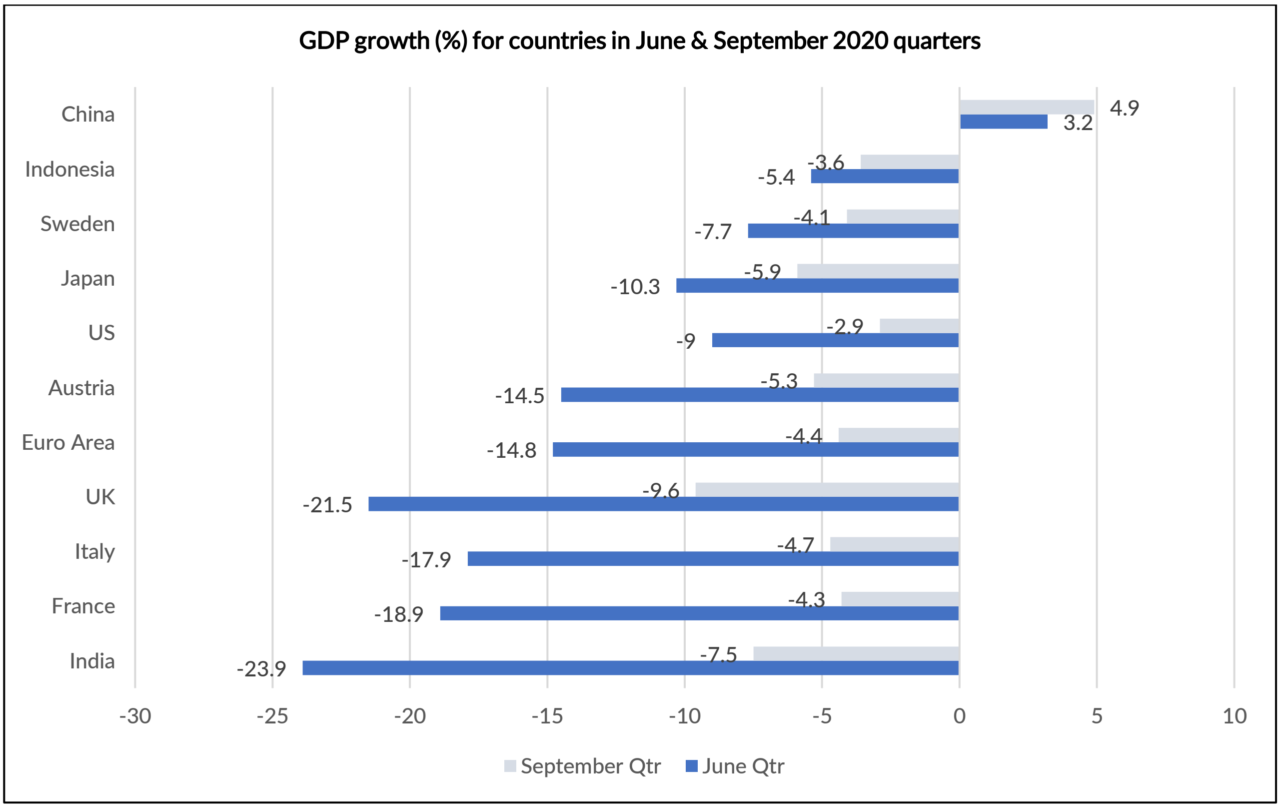
In India, what were the lessons about?

- The first ever Indian recession - Imported and deadly
- The corporate super show - Homemade and full of life
- The possibility of a phoenix-like move by the Indian economy

Did we understand all of this earlier on in the year? No. That is the lesson of humility that the market taught us. We sensed some of it, but the market possibly knew this and more. Let us try to understand the takeaways to prepare for the challenges in store for us in the coming year.

## India's maiden recession

India has seen the worst contraction for any G-20 nation. Some experts actually put the extent of contraction even higher.




*Source: Media Sources, Spark Fund Research*

We must bear in mind that GDP numbers, unlike most other numerical metrics in the world of finance, are estimates even after they are official. There is no mathematical reconciliation with any other reference point here, unlike in the case of, say, corporate financial reports or fiscal equations. It relies on hard data, surveys and estimates. The bone of contention that pegs the GDP numbers lower has to do with the decimation of the informal sector. The labour participation rate, which is estimated by CMIE, went down a precipice and remains low. Conversely, agricultural growth has been robust and the progress there has been linear. Consumption data has shown improvement for a wide range of categories, save the obvious laggards in travel, leisure and related areas. In particular, personal mobility and consumer durables recovered lost ground.

We must be cautious about the interpretation of this data, because:

1. Leaders have gained share and their performance has been taken as that of the economy
2. Most comparisons have a bias, as the reference point has tended to be anchored to the first quarter of the current fiscal, which makes it a mockery. A comparison with FY20 itself gives a muddled picture, as growth was weak that year (and even FY19)
3. It is premature to assess how much households have drawn down from savings to finance consumption. Household savings data has been on a slide, which has been a matter of concern anyway

A year-over-year comparison for the first nine months may provide a better picture for the consumer economy. Though the data for Q3 is unavailable, estimates show that the first nine months has seen a contraction. But not a collapse for the organised sector.

The difficulty continues to emanate from the informal economy. We will only know the impact from the loss of jobs due to reverse migration in the coming quarters. At this point, the overall demand data on the economy is holding up rather well.

The one aspect that has been less in focus is the state of the Indian economy before the pandemic. Though the stage was getting set for a cyclical recovery, the picture was far from good. Growth was anaemic in FY20 and even in the prior two years. The pandemic was, in economic terms, a climactic event that broke the back of an economy that was already out on a limb and a prayer. Which brings us to the point on the possibility of a phoenix-like rise from the ashes.

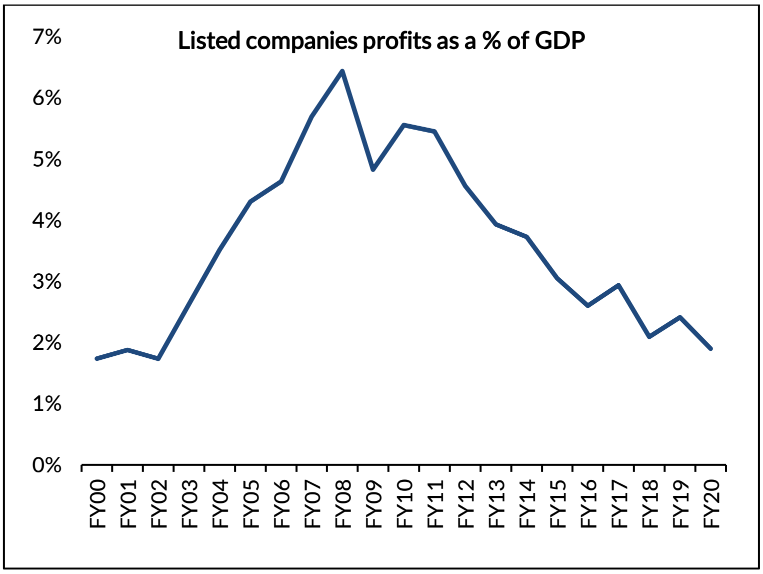
## The ultimate clean up act

For every year in the last decade or more, Indian analysts and strategists have started the forecast for the following year with an expectation of anywhere between 15-25% earnings growth. Save few occasions and a few exceptions, there has been a near-universal belief that growth will pick up in, say, two years. This expectation was there starting with the second term of UPA. This became a conviction trade when NDA came in with a never-before majority in 2014. Introduction of GST once again raised hopes. The return of BJP in 2019 with a higher majority raised expectations further.

As the data below shows, India has consistently underperformed these expectations

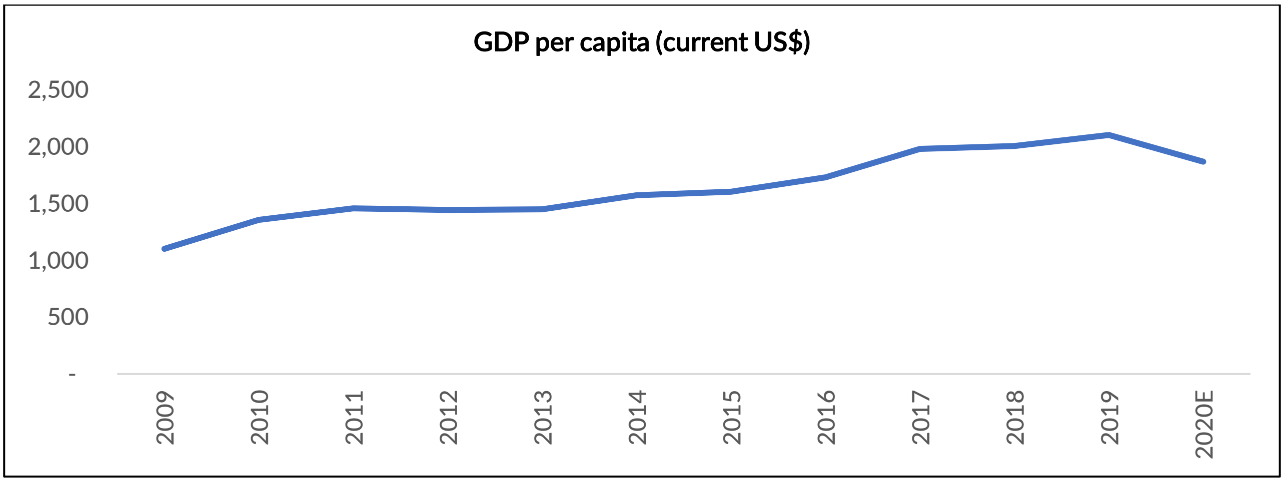
| Year | NIFTY EPS growth (%) | NIFTY RoE (%) |
|---|---|---|
| FY10 | 6.6 | 17.4 |
| FY11 | 25.2 | 18.5 |
| FY12 | 7.9 | 16.7 |
| FY13 | 2.4 | 15.7 |
| FY14 | 13.3 | 16.6 |
| FY15 | -3.7 | 13.7 |
| FY16 | -4.3 | 12.3 |
| FY17 | 11.5 | 13.3 |
| FY18 | 16.1 | 13.7 |
| FY19 | -5.5 | 11.7 |
| FY20 | -3.5 | 10.5 |

*Source: Bloomberg, Spark Fund Research*




*Source: I-Sec Research, Spark Fund Research*

As an economy, India has also underperformed China and other peers such as Vietnam (and even Bangladesh) during this period.




*Source: World Bank, Spark Fund Research*

We are not going into what went wrong. The bigger question for the market is what might turn this around. The pandemic shock and recession may have been what the doctor ordered for the economy. All recessions tend to be watershed events that squeeze out efficiencies. The 2020 contraction in India has been one of epic proportions. In this mayhem, data on corporate profits and recovery numbers suggest that the part of India, which is competitive, is showing resilience. This includes technology, well-managed banks, consumer companies, agriculture, select services and even many smaller firms.

On the other hand, there is a hit on the informal economy and on a wide section of small-and- medium enterprises. There is also an impact on corporates and other entities with leverage. Maybe, that is the part of the economy needing a drastic surgical intervention. The recession has managed to do what policy and other interventions could not fully achieve.

The lack of a big fiscal push has been viewed negatively. Most likely, the absence of a big bang stimulus has been because of compulsions, rather than conviction. Be that as it may, we are getting a recovery without steroids. Ironically, free-market economists always ask for that. We may have got it by sheer force of circumstances. In other words, the Indian economy was put through the ultimate acid test. Overall, it seemed to have come out in decent shape, though there are niggles and it is too early to call a victory.

Even if there are hiccups - and we believe there will be more than a few in 2021 - the Indian economy is setting the stage for a more durable recovery, in which:

1. Those who make the cut will drive growth
2. Earnings growth will revive for some, not necessarily for all
3. All activities will not and need not come back to life in the same way as before

In other words, it will be business as anything but usual.

The market may be discounting the above. It may have overreached itself in pockets, but this will be sorted out in the coming months. We need to get a handle on how corporate India will negotiate these waters. That is where investment returns will come from.

## Corporate super show

Look at the revenue and profit growth of the following sectors:

| | Revenue growth | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Sector | H1FY21 | FY20 | FY19 | FY18 | FY17 | FY16 | FY15 | FY14 | FY13 | FY12 | FY11 |
| Auto | -32% | -10% | 8% | 11% | 10% | 8% | 5% | 3% | 25% | 22% | 29% |
| Bank - Private | 3% | 14% | 19% | 6% | 8% | 14% | 12% | 13% | 21% | 36% | 18% |
| Cement & Construction Materials | -12% | -3% | 22% | 16% | -3% | 0% | 8% | -1% | 10% | 20% | 22% |
| Consumer Discretionary | -42% | 7% | 19% | 13% | 14% | 8% | 13% | 16% | 13% | 15% | 24% |
| FMCG | -3% | 2% | 7% | 8% | 6% | 4% | 11% | 13% | 19% | 18% | 19% |
| IT | 3% | 7% | 18% | 4% | 8% | 16% | 10% | 29% | 18% | 23% | 20% |
| Pharma | 10% | 6% | 13% | 3% | 1% | 12% | 15% | 17% | 15% | 17% | 11% |

| | PAT growth | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Sector | H1FY21 | FY20 | FY19 | FY18 | FY17 | FY16 | FY15 | FY14 | FY13 | FY12 | FY11 |
| Auto | -65% | -34% | 7% | 8% | 20% | 26% | 3% | 10% | 21% | -9% | 25% |
| Bank - Private | 112% | -26% | -7% | -11% | -4% | -4% | 14% | 10% | 21% | 29% | 38% |
| Cement & Construction Materials | 5% | 101% | -28% | NA | NA | -60% | -22% | -41% | -1% | 42% | -29% |
| Consumer Discretionary | -126% | 20% | 4% | 19% | 4% | 44% | 23% | 1% | 10% | 8% | 37% |
| FMCG | 3% | 22% | -4% | 14% | 14% | 2% | 11% | 15% | 24% | 20% | 13% |
| IT | -3% | 7% | 9% | 9% | 4% | 15% | 7% | 34% | 15% | 22% | 13% |
| Pharma | 10% | 38% | -2% | -3% | 1% | 36% | 32% | 2% | 7% | -59% | 198% |

*Source: Ace Equity, Spark Fund Research*

This is largely the result of a show of resilience from the best companies. This happened in an economy that contracted by ~15% in the first half of this year. Some of the numbers are the result of a low base. FY20 and even FY19 were not great years for many. However, good companies delivered on costs this year. All of the cost savings will not sustain. That said, companies that have stood up well also have the best balance sheets going into the recovery. The profit growth expectation for FY22 is driven by cyclicals staging a smart comeback. That is where the leverage lies. However, some of the more solid names are also likely to see continued traction. The coming year presents the best opportunity for earnings to fire that we have seen for India in years.

| Sector | Contribution towards FY22E growth |
|---|---|
| Financials | 41.6% |
| Energy | 28.2% |
| Consumer | 12.0% |
| Information Technology | 8.9% |
| Auto | 6.3% |
| Health Care | 2.0% |
| Others | 0.9% |

*Source: Bloomberg, Spark Fund Research*

In every crisis, there is opportunity. The market has a single-minded focus to discount that possibility. It has no time to look at the failures of the past. We may get a bout or two of volatility on the road ahead. It is clear that the market has set its coordinates for a destination that lies far ahead of those bumps in the road. As investors, our interests will be best served if we ingrain the learnings from 2020 and align our sights with the telescope that the market has mounted for itself.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

---