SPARK FUND

"It is the economy, stupid"

That was the rallying cry from Bill Clinton to galvanise the energy of his campaign team on his way to the Presidency. Amidst all the din that we see around us and the surfeit of data, we want to start 2022 with this one-liner. We want to remain focussed on what will drive the Indian economy. The economy is possibly the only factor that can drive the market forward.

The Omicron scare inevitably brings the dreaded memories from earlier this year. At India's darkest hour, our view was that the economic recovery would be delayed but not denied and the market would discount the positives. This broadly played out. The market went on to factor this and rose by more than 25% before pulling back over the last month.

This time around, we have to bring in more nuance. The outlook for global interest rates is vastly different now. We are looking at rising rates. If valuations expanded over the last many years when the rates kept going down, the converse has to be true now. If there was a lot of scepticism over the ability of the economy to recover from Covid in April 2021, there is some degree of complacency right now. In short, the market is not positioned for being positively surprised by some easily achievable outcomes in the short run.

What is in the price now?

Price is god for the markets. There are times when god has other plans. Nothing exemplified this better than the shortest bear market in living memory upon the dawn of the Covid times. The market crashed in quick time but foresaw and gradually discounted much better times in the making.

Here is our take on some key expectations and metrics that the Indian market may have factored in going into 2022.

1. The market has now priced in the fact that the economy has exited the Covid recession
2. The market has priced in a fair chunk of the earnings revival
3. The market seems to believe that the best-in-class companies, particularly in the consumer space, have the magic touch to beat all odds and produce earnings on demand.
4. The market is yet to wake up from the dream world where the central banks apparently owed it to the equity markets to offer backstops as and when called for.
5. The market seems to believe that the Unicorns, almost without exception, can tread water. Linear growth in revenues is a given and the path to profitability is a divine right.

In short, all that can keep a debate on valuations at bay are probably in the price. On the flip side, the market may not have adequately priced in a few possibilities;

1. Omicron causing a serious disruption. Hard to attach a probability but we need to keep an open mind
2. Global liquidity working in reverse on rising rates
3. Continued margin pressure resulting from inflation

We may therefore have a shake-up call on top of the wake-up call which could usher in some level of mean reversion. The risk we are constrained to highlight is this:

Any sort of mean reversion of valuations at individual stock levels, even to a higher mean adjusting for lower cost of capital, will still mean a significant correction in prices from current levels. See the tables below

What if valuations tend to revert towards the mean – to a higher point than the current mean

Name	CMP (31st Dec' 2021) INR	10yr mean PE (x) on 2 year forward	% downside/upside to a correction to above 15% of the mean
Hindustan Unilever Ltd.	2,360	31.5	-18.2
Asian Paints Ltd.	3,383	34.5	-36.3
Avenue Supermarts Ltd.	4,671	65.6	-16.2
Titan Company Ltd.	2,522	39.2	-32.1
Nestle India Ltd.	19,706	49.5	-7.6
Havells India Ltd.	1,397	25.8	-64.9
Tata Consumer Products Ltd.	743	27.5	-27.3
Jubilant FoodWorks Ltd.	3,591	64.8	32.6
Tata Consultancy Services Ltd.	3,738	16.9	-30.9
Infosys Ltd.	1,888	18.0	-23.8

Name	CMP (31st Dec' 2021) INR	10yr mean PE (x) on 2 year forward	% downside/upside to a correction to above 15% of the mean
Wipro Ltd.	715	15.1	-30.9
Larsen & Toubro Infotech Ltd.	7,332	12.9	-62.9
Reliance Industries Ltd.	2,368	11.8	-26.6
Maruti Suzuki India Ltd.	7,426	22.1	13.5
Ultratech Cement Ltd.	7,591	24.8	30.6
Shree Cement Ltd.	26,987	28.1	28.7
Bajaj Finance Ltd.	6,977	2.2	-61.7

Note: P/B (x) for Financials; Source: Aceequity, Spark Fund Research

How much of the returns of 2014-2021 came from expanding valuations ?

Name	Price CAGR (FY14-21) %	EPS CAGR (FY14-21) %	Share of returns from P/E (x) re-rating as against earnings growth
Hindustan Unilever Ltd.	22.0	9.3	57.7%
Asian Paints Ltd.	24.5	14.5	41.0%
Avenue Supermarts Ltd.	45.4	22.0	51.7%
Titan Company Ltd.	29.0	4.0	86.0%
Nestle India Ltd.	17.5	10.4	40.6%
Havells India Ltd.	28.1	12.9	54.1%
Tata Consumer Products Ltd.	23.0	-1.0	104.5%
Jubilant FoodWorks Ltd.	27.4	10.0	63.7%
Tata Consultancy Services Ltd.	22.1	13.8	37.6%
Infosys Ltd.	20.9	12.0	42.7%
Wipro Ltd.	10.7	7.2	32.4%
Larsen & Toubro Infotech Ltd.	54.5	18.2	66.7%
Reliance Industries Ltd.	23.4	10.5	55.1%
Maruti Suzuki India Ltd.	19.5	6.3	67.4%
Ultratech Cement Ltd.	17.4	13.0	25.4%
Shree Cement Ltd.	22.2	15.9	28.5%
Bajaj Finance Ltd.	61.6	33.6	45.5%

Note: P/B (x) for Financials; Source: Aceequity, Spark Fund Research

The data above clearly highlights the risk to many leading performers of the last many years if valuations were to move towards mean. The risk is live and here even if valuations settle higher than the current mean which is defendable with the lower cost of capital. However, if cost of capital (interest rates are a good proxy for the same) rises from the lows, the markets cannot be in perpetual denial. The data also illustrates that a large chunk of the returns from the last 7 years came from expansion in valuations.

We acknowledge that this discussion on valuations has been done almost every year over the last several years. Valuations kept defying gravity. We want to stress that 2022 may not be the same. It is likely to be that year when the markets may decide to factor in the directional change in rates. It is excess liquidity that spawned new models for valuing stocks and nothing else. Simple earnings or cash-flow based valuations will stand the test of time.

This brings us to this crucial question: What is not in the price on the positive side **for India**.

We can think of only one answer – **It is the economy**.

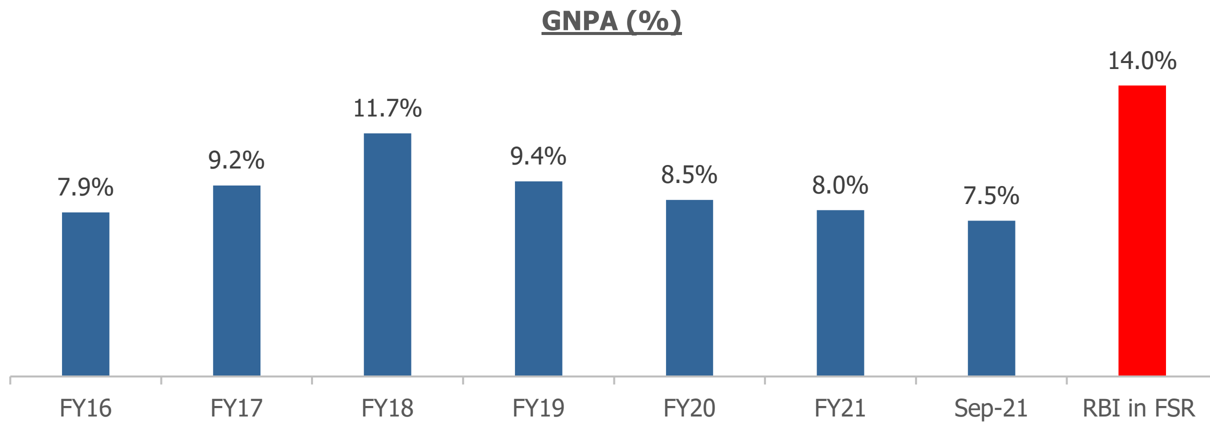
The economic upcycle may have many legs

For most of the period when the global interest rates were on the way down, Indian economy struggled to get its mojo. There was the issue of high inflation and negative real rates between 2009 and 2014. Then there was the pile-up of bad loans, delay in recognising the same and the eventual implosion. IL&FS may have been a climactic point there. There was demonetisation and the disruption it caused.

The introduction of GST and the chaos emanating from the same may have caused the down cycle in the economy to extend further. All through the last decade-and-a-half, the capex cycle remained a no show.

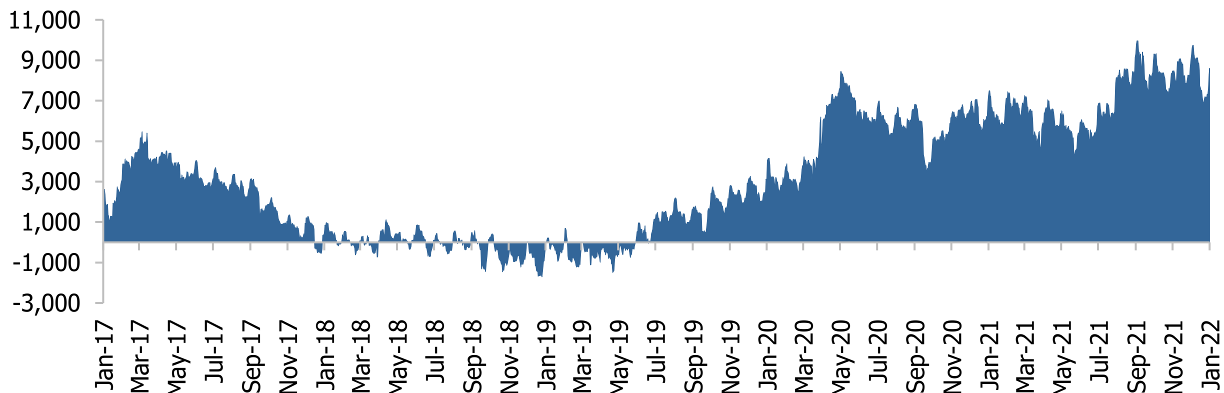
The pandemic was the proverbial final nail in the coffin. The recession of last year may have marked a watershed low point for the cycle. We are in the first year of the recovery and such a recovery is unlikely to stop abruptly and reverse its course. It is quite possible that there may be hiccups, as there was one during the second covid wave. There are several tailwinds at work now

1. Banking system has low bad loans and high liquidity – As against an assessment from RBI in early 2021 that the bad loans would peak at as high a level as 13-15% in September 2021 post-Covid, the actual bad loans stood at 7.5%.



Source: Aceequity, Spark Fund Research; RBI Financial Stability Report (FSR) -22nd issue on January 11, 2021

The graph below depicts a measure of the excess liquidity in the banking system. This captures the liquidity that banks wish to park with the RBI and we can see the bulge after the onset of Covid. Banks would rather lend these funds to commercial borrowers if there was enough demand.



Source: Bloomberg, Spark Fund Research

2. Tax collections show a robust trend

Particulars (INR Bn)	Apr-Oct 2021	Apr-Oct 2019	Change(%)	FY17	FY18	FY19
Gross Tax Revenues	13,641	10,518	30%	17,158	19,190	20,805
Direct Taxes	6,591	5,255	25%	8,344	9,911	11,366
Indirect Taxes	7,050	5,263	34%	8,815	9,279	9,439
Key Highlights						
Corporate Income tax	3,309	2,728	21%	4,849	5,712	6,636

Particulars (INR Bn)	Apr-Oct 2021	Apr-Oct 2019	Change(%)	FY17	FY18	FY19
Personal Income tax	3,113	2,444	27%	3,494	4,199	4,730
Customs	1,123	645	74%	2,254	1,290	1,178
Union Excise Duty	2,041	1,140	79%	3,818	2,588	2,310

Source: Spark Capital Research, Spark Fund Research

The direct tax collections this year are well above the **pre-pandemic year** and this is significant. This no doubt represents the strong recovery in the formal economy but formalisation itself is a powerful force and has multi-year positive implications. Formalisation blends itself into the coming of age of the GST reforms. GST reforms have been a growth driver in other economies after the initial flux. India seems poised to witness that.

The tax buoyancy will support the capex drive from the government. While governments have seldom been the catalysts for the equity market in India, there has been a fair degree of consistency in policy after the demonetisation fiasco. The consistency in letting oil companies adjust prices is a case in point. We expect the government to stay the course on capex spending in FY23 as well.

3. Private Capex to revive

There are two reasons for the above. Private capex has been a no-show over the last 15 years because of excess capacities in India and globally. The other reason is the absence of visibility of a positive profit cycle. The second has turned for the better post-pandemic. Big ticket capex is driven by sectors such as metals and industrial commodities. These sectors are now throwing up healthy cash flows. This will drive capex spending.

Cash flow from Operations (INR Bn)	FY19	FY20	FY21	FY22	FY23
Hindalco Industries Ltd.	119.8	127.5	172.3	225.0	224.0
JSW Steel Ltd.	146.3	127.9	187.9	250.5	239.7
Shree Cement Ltd.	20.8	39.7	42.5	30.7	37.8
Steel Authority of India Ltd.	72.2	-6.2	234.3	238.3	203.3
Tata Steel Ltd.	253.4	201.7	443.3	349.9	388.0
Ultratech Cement Ltd.	60.1	89.7	125.0	89.4	111.4

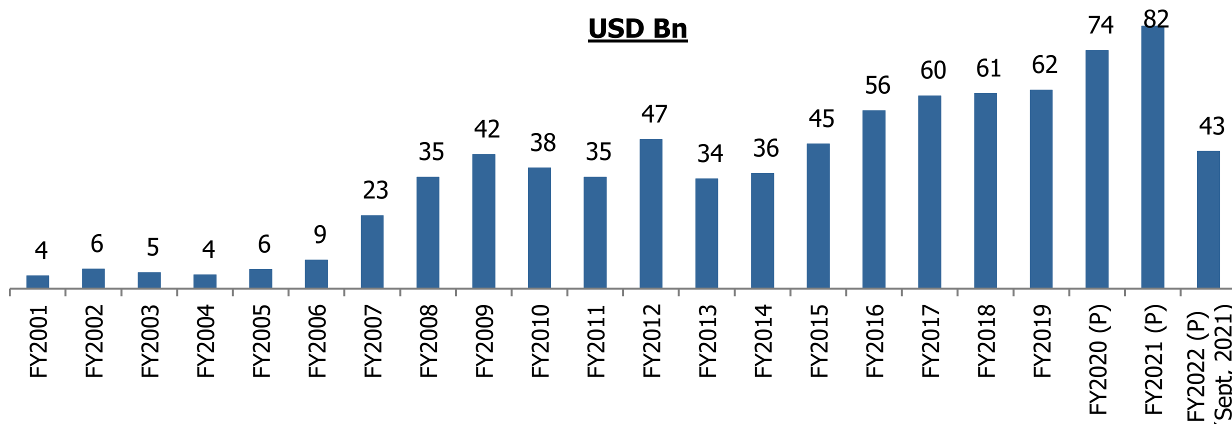
Source: Company, Spark Fund Research

The cash flow from operations point to a remarkable increase. This is one of the best lead indicators for an impending uptick in capex spending.

4. The economy has new drivers

Digitisation is increasingly the invisible capex driver. It may not drive creation of mammoth industrial clusters. The impact on employment and on sustaining and driving real estate (primarily housing) and utility/urban infrastructure is significant. India has seen robust FDI flows, and a good part has gone into the new economy so to speak.

India Foreign Direct Investment



Source: GoI, Spark Fund Research

The physical asset creation from this is not comparable to the FDI boom that powered China and much of Asia in an earlier era. However, the cascading positive benefits on incomes is not to be underestimated. It is possible that India's capex cycle and physical infrastructure creation is being driven by demand for these from rising incomes as against a build-out in all of this driving incomes. India's growth, much like its high share of services which for long has confounded conventional emerging market growth dynamics, need not follow the typical path. That said, the new economy is driving positive productivity changes, and this is reflected in the employment generated in segments which never existed a decade back. The food delivery platforms alone may be employing close to an estimated 1 million people now. This is an entirely new employment avenue.

The labour participation rate in India has come down over the last five years. While the data raises eyebrows and fuels a lingering pessimism on the sustainability of any recovery, the nature of employment could be seeing a big change. The impact of the GIG economy may not be getting captured in an appropriate manner in the conventional measures of quantifying labour statistics. While the pain in the bottom of the pyramid is for real and we don't want to trivialise that, the economy may well be undergoing a transformation of sorts.

2022 will provide the answers

We will know better about the forces at work in the coming year. We believe that the economic recovery will sustain into FY23 and that is the only positive surprise for the Indian equity markets. Most growth projections place the GDP growth in the range of 8.5%-9.5% for FY22. This is already up from the 8%-9% range that was predicted when the second wave hit the economy.

For FY23, there is a section which believes that the economy will falter. We believe that is unlikely. A combination of cyclical factors and the trends outlined above can result in the economy registering a growth that is not far from the nearly 10% growth in FY22. The FY22 growth itself is off a very low base. Even for FY23, the first quarter will have tailwinds from the low base of the second Covid wave. The RBI for instance believes that the real GDP growth in Q1 of FY23 will touch 17%. Currently, this possibility is not being priced in by the market.

We believe the traction in the economy will be the market driver after a period of market consolidation and market correction. This has implications for stock selection and in the choice of sectors to choose. Earnings surprises are more likely in sectors that are economy-sensitive. Growth investing may assume different hues going into another year in the post-pandemic world. It pays to be prepared for the makeover in the making.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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