Greetings!

Storm before the calm?

India has seen unprecedented human tragedy in the last two months which we have never witnessed in our living memory. When it comes to forecasting, the dictum of discretion acting as the better part of valour is a given. It is a good idea to take a break and reassemble the thoughts once the country has managed to pick itself up from the embers and start moving again.

Nevertheless, a couple of points that work as sanity check in reverse are in order. The extreme pessimism and negativity point towards at least two errors of forecasting. Error of extrapolation and error of exaggeration.

In 2020, when the GDP plummeted by some 25% in that horrendous quarter, GDP was projected as contracting by as much as 15% for the full year. The eventual number ended up at about half as much, a significant error in the world of forecasting. This time around, the projections are getting trimmed down to under 9% from 12% and above. Mind you, this is a year of rebound. Base effect is bound to be helpful. But such has been the negativity that there appears to be a competition for who will downgrade first and the most. There is a lot of water waiting to flow under the bridge still. While the first half of the current fiscal may only have the base effect as a tailwind, the second half can see a lot of positive traction.

The second is the error of exaggeration. Be it the vaccine policy or oxygen bottlenecks, all we hear in the media is that the government at the centre and the country have all got it wrong. India has inoculated more people than any other country other than the USA and China. But the media focus has been on those who are left out. While it is unfortunate that many are left without any defence, the fact remains that the denominator in India is too huge for that to be used as relevant number to measure the outcome of any such programme. There is criticism over why all potential manufacturers are not allowed to produce the vaccines. At the best of times, and that too for easier drugs in injection form, the norms for approval tend to be very stringent and the lead times are longer. Here, a complex biological process is involved. But who cares? The misery brought about by a diabolical pathogen has been multiplied manifold by an echo chamber of negative emotions. India may not really need to inoculate everyone to reach herd immunity. As the more mobile parts of the population get a degree of protection either through vaccination or infection or both, the virus will likely go into a faster retreat. Beware of the error of exaggeration that is built into any forecast that takes shape during these times.

We expect the pace of vaccination to pick up substantially in the coming weeks. As more of the itinerant and high-risk target groups are covered, the situation can start to improve in a significant manner on a sequential basis. The market tends to be forward looking and we have seen that in play. The government can step up spending through borrowings to boost the economy which is par for the course for all countries in this crisis. Global markets have never shown this kind of forbearance to sovereign debt.

It is not our position that things are hunky dory. Nor are we making a case that the market which seems to have looked right through this din and despair has got it all right. It pays to hold our horses and let the nation heal a bit. In our investment strategy, we have pretty much done nothing to deal with the impact from the second wave of the pandemic. The economic impact is an unknown right now and it is better to deal with the same when more layers are peeled.

When the recovery comes

We have said this more than once that post-recession recoveries are cut from a different mould. Those who survive will make Darwin proud. When it comes to the banking system, the recession has actually taken it to the extreme. The banks had already done a clean up act by FY20 after a bruising battle with bad loans that kept the economy limping for over a decade. The Covid recession exacerbated the effect. Some banks managed to fortify their balance sheets with capital buffers. The drubbing that bank stocks took and the slower recovery in stock prices have left a lot of bank stocks at valuations which represent a discount to the long-term mean. You cannot say that for much of the market.

When the economic engines start to hum again, banks will need to lubricate them. As it happens, the best managed banks are in a unique vantage point.

Let us look at how the market share of banks has panned out since the last big credit cycle in India between 2002-2008.

Bank	FY02 (Credit in INR cr)	FY02 Market share	FY07 Market share	FY21 Market share	FY21 (Credit in INR cr)
State Bank of India	120,806	20%	17%	22%	2,449,498
HDFC Bank Ltd.	6,814	1%	2%	10%	1,132,837
ICICI Bank Ltd.	47,035	8%	10%	7%	733,729
Bank of Baroda	33,663	6%	4%	6%	698,652
Punjab National Bank	34,369	6%	5%	6%	660,486
Axis Bank	5,352	1%	2%	6%	623,720
Kotak Mahindra Bank	1,004	0%	1%	2%	223,689
Industry	**589,723**	**100%**	**100%**	**100%**	**10,950,000**

Source: Ace Equity, RBI, Spark Fund Research

The seminal shift in banking has been that the private banks have now garnered a meaningful share. They go into the post-recession recovery with a fully fortified balance sheet. It is a fairly straightforward argument in favour of well-capitalised banks as and when the recovery gathers pace. We reiterate that the credit growth revival is nowhere in the price expectations of bank stocks right now. The loan growth trends over the last two decades is a powerful indicator of the potential recovery once the cycle turns.

Period	Loan growth (CAGR)
FY03-08	26%
FY08-13	17%
FY13-18	10%
FY18-21	8%

Source: RBI, Spark Fund Research

Apart from banks, it is also useful to understand how the economy sensitives behave when the economic cycle has a decisive uptrend. It was in the 2002-08 period that the economy last grew with both the investment and the consumption engines firing. The returns from stocks were broad based and backed by earnings. The table below illustrates this.

Company	FY02-08 EPS CAGR	FY02-08 Stock price CAGR	FY08-21 EPS CAGR	FY08-21 Stock price CAGR
Reliance Industries Ltd	32%	57%	7%	10%
Larsen & Toubro Ltd	54%	66%	8%	6%
Tata Steel Ltd	95%	51%	-7%	2%
Bharat Petroleum Corporation	7%	4%	20%	15%
Bharat Heavy Electricals Ltd	35%	70%	-192%	-12%
Maruti Suzuki India Ltd	57%	41%*	7%	18%
Tata Motors Ltd	41%**	32%**	-211%	7%
HDFC bank	27%	33%	22%	20%
HDFC Ltd	25%	38%	14%	14%
State Bank of India	16%	41%	6%	7%
Bank of Baroda	13%	35%	-6%	2%
Asian Paints Ltd	25%	33%	17%	26%
Titan Company Ltd	58%	66%	16%	30%
Hindustan Unilever Ltd	2%	0%	12%	20%
Nestle India Ltd	15%	20%	13%	21%
Colgate-Palmolive (India)	24%	18%	12%	18%
Dr. Reddy's Laboratories	-2%	1%	12%	17%
Infosys Ltd	32%	21%	13%	17%
Bharti Airtel Ltd	502%	67%	-204%	2%

**From 9-Jul-03 **5-year CAGR*
Source: Ace Equity, Bloomberg, Spark Fund Research

The long and interminable wait for the next cycle may have erased all such memories. That does not detract from the merits of the case for cyclicals as the consolidation in some of these sectors has resulted in improved balance sheet ratios and better capital allocations. All the building blocks of superior returns are slowly falling into place.

It is our case that a recovery will eventually come about, in part aided by highly pro-cyclical policies all around and in part by the free market equivalent of natural selection. There is a strong case in favour of some sectors which have remained dormant for the last many years. It is time for the investment engine of the economy to fire. The market is in the process of a decadal shift in its priorities. It pays to listen to what the market is telling us.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

Disclaimer: The contents of this document are for general consumption only and are not to be construed as either a Research Report or a recommendation of any manner by Spark Capital Advisors (India) Private Limited or its affiliates ("Spark Group"). Spark Group shall not be responsible for any investment decisions made by the readers and recipients of this report.