Greetings!

Does the macro matter?

I raise this rhetorical question with three decades of professional investing experience in India. Professional training has taught me to believe that one should not pay too much attention to Indian macro. The dictum has been to focus instead on identifying, investing in and holding on to good companies that have the hallmark of greatness written all over them. Yet, the importance of this question cannot be overstated at this juncture.

The Indian macro has never flashed an all-clear signal and has been iffy at the best of times. The successful company always found its way through the labyrinth that India is. Such stocks climbed the wall of worries, scaled ever-increasing highs on valuations and created shareholder value. Ironically, the unflattering macro has been manna from heaven for the smart Indian management.

In a country where the cost of capital has always been high, managements who knew how to navigate the waters while fortifying their balance sheets came up trumps. Staccato reforms have protected incumbent leaders. This gave them the opportunity to improve their market position, margins and return ratios.

Two clear examples are Maruti and Hindustan Unilever.

Maruti controls about half the car market in India thirty years into liberalisation. In contrast, China has several car makers, multinational and home bred, that fiercely compete for a slice of a much bigger pie. The market leader there has a share, which is struggling to get to teens. Maruti reported an EBITDA margin of 13.5% in FY2019. No mass-market car maker in China, the US or Europe has been able to clock such margins. Does Maruti make better cars that have some unique technological capability? Far from it. Suzuki, the parent of Maruti, does not have leadership status in any other market. Maruti is a formidable player who has a deep connect with the Indian consumer and a lock on distribution. It has been an execution machine.

Take Hindustan Unilever. The EBITDA margin for the company expanded from 19.3% in FY17 to 24.8% in FY20. Post GST, the company has strengthened its advantage as an incumbent. No other Unilever group company across the world enjoys such margins. Does Hindustan Unilever sell products that are superior, hard to make or technologically complex? Far from it. Hindustan Unilever reaches more homes than others can figure out on a map. It has been another execution machine par excellence.

Both these companies seem to have benefited from the following trends in India:

1. High cost of capital in India, which is inherently beneficial to dominant incumbents. It calls for major investments to create distribution channels and the Catch-22 situation for any challenger has proved too much to overcome.
2. The stop-start nature of reforms in India – be it pertaining to land, labour or tax administration – has meant that challengers are presented with roadblocks at every step of the way.
3. India has grown despite all the drawbacks and roadblocks. Indian incomes have grown over the last three decades. The middle-class Indian has seen her income go up, slow at times and a bit faster on occasions. But it has always grown.

We would, therefore, make this case that the peculiar nature of the Indian macro story has played a crucial part in the fabled story of wealth creators amongst Indian stocks. This does not seek to take the credit away from entrepreneurs and managers behind these. We argue that they had some strange macro tailwinds behind them. Strange, because the slow pace of reforms has unwittingly played into the hands of strong incumbents. The market expansion has fuelled their growth. This expansion may now be facing some strong headwinds.

For the first time, we see job and income losses in urban India on a large scale. This has to take a toll. What is important is to understand the interface of macro with micro. The linkage between the two is often hard to model. But try we must, if we are to make a difference to our investment process.

The coming storm for the Indian consumer

The income growth of the average Indian consumer is at risk. This is not the typical slower growth phase that we have seen on a few occasions in the past. Now, we have a drop in income. India adds about 11 million young people into its labour force every year. This has been the story of the Indian demographic dividend. This dividend has been partially encashed by investors in the bull run from 2010 to 2018. The higher economic growth between 2000 and 2010 resulted in income and job creation. The swelling work force reaped the benefits of higher growth. Even with all this, earnings growth of companies in the Indian consumer space has hardly set a scorching pace.

Company	EPS CAGR FY10-20	TTM P/E (x) 30th Sep, 2020
Hindustan Unilever	12.5%	66.9
Nestle India	11.6%	73.9
Colgate	6.8%	47.6
Britannia	29.7%	64.6
Titan	19.6%	70.4
Asian Paints	12.5%	71.1
Havells India	26.1%	57.0
V-Guard Industries	21.6%	38.7
Jubilant Foodworks	23.2%	111.2
Pidilite Industries	15.1%	65.6

Source: Bloomberg, Ace Equity, Spark Fund Research

Real GDP growth (%) per annum	
FY2000-2010	6.5%*
FY2010-2017	7.1%*
FY18	7.0%
FY19	6.1%
FY20	4.2%

*Source: MOSPI, *Simple average for the period*

Income generation has been slowing, even as the addition to labour force continues unabated. This was before the pandemic. The pandemic has now dealt a body blow to the economy. Consumer demand is sure to be hit, though the impact may not be uniform across all categories.

Pandemic and the average Indian

A recession is an event that destroys income. Such diminution of income is non-uniform. Evidence around the world shows that people who are least prepared to deal with the pandemic are the worst affected. India is no exception.

The data from Centre for Monitoring Indian Economy shows that nearly 21 million salary earners have lost their jobs from April to August. This has never happened in India. These jobs will come back over time. But it will not be business as usual for a couple of years. Maybe, even longer. Though different categories and players will see varying impact, the Indian growth dream is built on rising general prosperity. Investors have bet on the average Joe turning upwardly mobile. We should be naïve to believe that the average Indian will spring back to where she was in early 2020 without a hiccup. The slowdown and resultant earnings impact cannot be a blip that is limited to FY21. Household balance sheets need to heal and, in the interim, consumption demand may surprise on the downside. It is hard to model this.

Which is why investors normally demand a margin of safety. For good quality stocks that form part of the narrow set of investible stocks in India, such margin of safety is conspicuous by its absence. This is why we have been wary of the richly valued consumer stocks at present. Some of them are great companies but are priced for perfection.

We are far from a perfect situation. We may well be heading into a perfect storm.

Do valuations matter?

We believe they do

Here are some hard facts and the first point is fresh in memory:

1. Indian private lenders traded at expensive valuations for a long time. All the way from around 2014 to early 2020. When the show was on, nothing mattered. As concerns over retail asset quality dawned on the market, the weight of lofty valuations and over-ownership by funds have been too much to bear. Over the last six months, there has been serious wealth erosion here. The timing of such fall from grace has been impossible to predict. The warnings signs were always there, though.
2. Take a look at Taiwan. It enjoyed high P/E multiples for what seemed like eons. Then, the multiples started to crater. So much so that Taiwan has become a value investor's destination in the last few years. But, some investors had to pay a price when the music stopped.

Taiwan Stock Exchange Weighted Index (TWSE)			
Time Period	GDP growth (%)	Average P/E (x)	Dividend Yield (%)
1980s	11.1	>50	<1%
1990s	8.7	~30-40	<1%
2000s	2.7	24	3%
2010s	3.6	16.4	3.80%

Taiwan Semiconductor Manufacturing	
Year	Dividend Yield (%)
2004	1.0
2009	4.6
2014	2.1
2019	2.7

Source: Bloomberg, Spark Fund Research

For India, the red flags on growth have been there, particularly since 2016. The pandemic made matters a lot worse. Even in the optimistic scenario of growth coming back quickly, such a recovery will lack punch for several quarters. The valuations of consumer names in India have been rising against falling growth. We are willing to buy the argument that strong players will

get stronger. But you cannot run on empty. An anaemic pie cannot produce compounding of earnings. It is time to smell the coffee.

Our read of the macro is this:

1. Indian consumer incomes have taken a major hit
2. Banks are not the lone losers in this, but bank stocks have corrected a fair bit
3. Consumer names have seen valuations skyrocket on the TINA factor
4. Unlike in politics, investors have a choice to vote with their feet
5. The trend growth in India may have slipped down to 5-6%. That is the expert view
6. Serious reforms (and execution on the ground) are required for trend growth to pick up
7. Reforms, if they happen, have costs. A price has to be paid no matter what

Where are we invested

The market rally may prove deceptive in the sense that there is a lot that has risen with the tide. We prefer to be invested where earnings are at a lesser risk and valuations have legs to stand on. Over the last six months, we have positioned ourselves largely into these pockets:

IT Services

1. Valuations, while at a multi-year high, are still well below sector peaks
2. Valuations are lower than other sectors, even as earnings growth visibility is better
3. IT gets its India advantage on supply, not demand
4. IT is driven by global demand but powered by local human resources. Good place to be in
5. In a post-pandemic world, demand for IT services is likely to be robust for years to come
6. The only source of strength for the INR is a weak USD. The inevitable weakness in INR is a sector +ve
7. Strong managements, balance sheets and healthy return ratios underpin our positivity

Healthcare

1. Demand resilience is obvious. This is the archetypical defensive in this environment
2. We cannot say valuations are supportive anymore. We remain watchful

Rural-Facing Companies

1. Demand has held up relatively better, as rural incomes have stayed resilient
2. The pandemic has not spread too much into the hinterland but this is at risk
3. We are concerned as we go into the next leg of the scourge. Some caution is in order

Select Financials

1. Financials have been quick to give up their perch
2. To some extent, valuations have become defendable
3. Market-share gains will continue for the best of breed
4. Pockets of resilience such as insurance exist
5. Digital enablement is another aspect we like here

Our portfolio construction has been aimed at a prudent mix of all of the above and a few other good businesses we think are worth holding. We would love to get some exposure to domestic-demand stories but at more appropriate levels. We are in a market where we like to keep our options open.

Fence is often a great place to sit in during such times. Our motto is to sit there and carefully watch the data. That, for now, is a better plan than wading into slippery ground and trying to fly kites.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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