Greetings!

The Covid surge

The fact is that India has been caught off guard and is having a tough time. From the point of view of the humanitarian, social or healthcare infrastructure, there are uncertainties and any scenario analysis is fraught with difficulties.

From an investor's view point, we would be well served in looking at this using an analytical framework and keep away from the media spotlight (which shows an abysmal picture). Here are some facts:

- India has administered 152 million doses covering an estimated 128 million people. While this is just 9.2% of the total population, the percentage comparisons with developed countries is completely out of place. India's demographic profile is different. The fact remains that vaccination is making progress and that is the only way out. Slowly but surely, this will push the virus back.
- Data from Mumbai shows that the mortality is down noticeably in the current wave, in particular amongst the senior citizens. Mumbai has inoculated an estimated 2.5 million people. Data is beginning to show that the vaccines are making a difference. Test positivity rate is slowly crawling down. Some other cities are yet to peak and the news might get worse before it gets better.
- We expect severe restrictions in several parts of the country. The inability of the health care infrastructure to cope with the surge in infections will be the decider. That said, experience from last year may help the administration in calibrating the curbs.
- The return to normalcy is not likely to be an event but a process and a gradual one at that. As we pen this down, the pandemic is overwhelming the healthcare systems in India. We are yet to see the worst in many states. While it is hard to predict timeframes, it is easier to conclude that a return to normalcy will take a few months, which is consistent with the experience in other countries who have gone through the second wave.

The fallout

The human cost is staggering. In itself, that could impact consumption which is a stark difference from 2020. There will be an economic impact from the second wave without a doubt. GDP estimates have been revised downwards by 0.5% - 1% for FY21. FY21 saw a steep contraction in GDP, and that too at an unprecedented level for India, and indeed the whole world. A downward revision of even 1-2% on the GDP numbers from a range of 11-12% growth expectation is not going to matter a whole lot.

What drives that growth down may matter more for earnings and therefore for stocks.

Let us look at how the Nifty earnings revisions have moved.

NIFTY EPS estimates range (INR)	As at Jan-20	As at Apr-20	As at Aug-20	As at Oct-20	As at Dec-20	As at Apr-21
FY20	530-550	480-500	460-480	450-460	450-460	457
FY21	670-690	510-530	410-440	400-430	470-490	500-520
FY22	**780-800**	**690-710**	**630-650**	**600-630**	**640-660**	**690-730**
FY23	-	-	-	-	-	800-840

Source: Bloomberg, Sales side, Spark Fund Research

Clearly, earnings have been revised upwards over the second half of FY21 as it became clear that the Indian consumer had displayed surprising resilience. The sharp year over year jump in EPS estimates in absolute terms was initially driven by the normalisation of credit costs for banks as well as the normal post-recession rebound from cyclicals. The subsequent acceleration in the EPS estimate has been driven by the somewhat automatic extrapolation of growth in consumer and IT. They did not show much of a drop in FY21 and therefore, expectations have been compounded over those good numbers. With imminent consumer fatigue and increase in raw material prices, consumer facing stocks are where the risk to earnings could build up fast. We estimate a cut in Nifty earnings to come about from the top end of the range where expectations were ratcheted up to.

However, our base case for a cyclical recovery remains in place for now. It could be delayed by a quarter or so. This would matter a bit less once the direction is clear and the momentum starts to build up. Post-recession recoveries can take time to gather steam, but they come off a clean base. The probability of a more durable cycle remains good.

The market

Last year, the market formed a bottom precisely when the uncertainty was at its highest. Going by the same logic, the market correction should resolve itself at some point during the second wave of the pandemic when many questions have no easy answers.

Market positioning on key sectors matters a lot in our view.

Look at the consumer sector. In 2020, expectations turned around quickly and have been rising. This happened in IT services as well. Look at the numbers below.

	HCL Tech		Maruti Suzuki	
Particulars	**FY20**	**FY21**	**FY20**	**FY21**
Revenue growth	17.0%	6.6%	-12.1%	-7.0%
EBITDA margin	23.6%	26.6%	14.1%	7.6%
EBIT margin	19.6%	21.3%	9.4%	3.3%
Adj EPS growth	10.9%	12.4%	-25.8%	-22.7%
Price as at 30-Apr-20 (INR)	405.8		4,011.5	
Price as at 30-Apr-21 (INR)		899.0		6,455.7
P/E (x)	9.95	19.62	21.34	44.43

Source: Bloomberg, Spark Fund Research

These numbers are representative of several other stocks in these sectors. Valuations have expanded over the last year from the panic lows amidst lockdown blues. However, for many consumer stocks, the valuations have actually expanded even as earnings growth is decelerating or reversing and margins are under stress. There is very little wiggle room left in such names. As the twin pressure points of input cost prices and consumer resistance manifest themselves, this sector may face headwinds.

Sector	Contribution towards FY22E EPS growth
Financials	29.4%
Auto	18.8%
Energy	10.4%
Information Technology	8.3%
Consumer	7.2%
Health Care	1.3%
Others	24.5%

Source: Bloomberg, Spark Fund Research

On the other hand, the financials present a different picture, particularly the well capitalised and the better run banks. The share in earnings growth estimate for financials is lower than the weight of financials itself. Forecasts for FY22 factor in improvement in asset quality but very limited growth. Valuations are still lower than in 2019 and indeed when measured against longer term averages. The recent pullback in prices can be attributed to the fact that when sentiment gets on to the back foot, selling happens first in the most liquid part of the market. For commodity cyclicals, a few factors are in favour. This is that segment of the market which has been out of sight and out of mind for long. Ownership is light. The earnings revisions here can be steep and that is the nature of the beast. There is also a possibility that the reflation trade in metals may have more legs to go, at least when it comes to the duration.

All in all, we remain buyers on market corrections. We note here that the risk in equity markets has gone up in the last month as the second wave of the pandemic proves rampant and intractable. The fall in market prices has started to discount this in an adequate manner. Balance of risks and rewards is slowly turning in favour of the latter. That may well be the opportunity presented by 2021.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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