Economic Update

The Indian market continued to outperform the MSCI Emerging Markets Index during the last quarter, reaching a market cap of USD 4.3 trillion. Mid and Small Cap indices underperformed the large cap indices. Despite various initiatives taken by the Chinese government, India continued to outperform China. Declining China property prices and transaction volumes continue to impact both liquidity and sentiments. Weak domestic demand and sizable spare capacity have led factory-gate prices (PPI) to experience outright deflation for well over a year. Hence, Chinese exports continue with price deflation. Chinese credit growth is also weaker than consensus expectations.

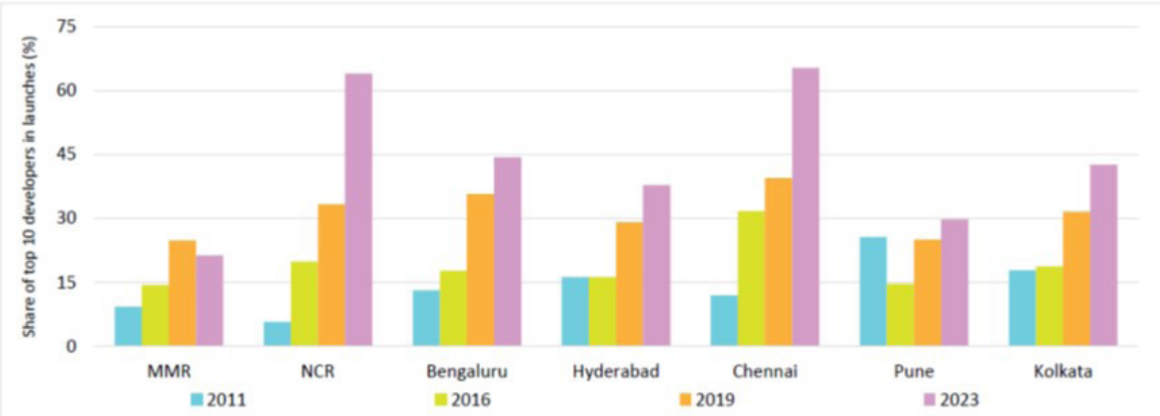
Though US CPI reported sticky prints sequentially at 3.2% in February compared to 3.1% the previous month, FOMC views cutting rates thrice this year. However, the median forecast for 2025 increased to 3.9% from 3.6%, and consensus now sees a shallower path of cuts in 2025 and 2026 compared to the last forecast in Dec '23. The market expects a June cut by the Fed. However, upside risks to either inflation or growth could disrupt the market's current dovish mood. At its last bi-monthly meeting on February 8th, the RBI decided to keep the benchmark interest rate (repo rate) unchanged at 6.5 percent for the sixth straight meeting, citing inflationary concerns. They agreed that while inflation is decelerating, food inflation volatility poses risks, even as the moderating trend in core inflation is comforting. Over the quarter, foreign institutional investors recorded strong net inflows of USD 1.07 billion, while domestic institutions recorded net inflows of USD 12.7 billion. The G-sec yield came down to 7.05% during the quarter. Driven by production cuts undertaken by OPEC+, the price of crude oil went up to around USD 87 per barrel. INR slightly weakened throughout the quarter and closed at 83.40 against USD.

For the quarter ending December 2023, India's GDP growth improved to 8.4% YoY from 8.1% in the quarter ending September 2023. This was meaningfully above consensus estimates (6.6%), mainly led by a sharp increase in net indirect taxes (GVA + Net Indirect Taxes = GDP, Net indirect taxes = Indirect tax Less Subsidy). The increase in net indirect taxes (as per the government's monthly accounts data) was driven by continued growth in tax collections and a decline in subsidy expenditure on a YoY basis. CPI inflation remained steady at 5.1% YoY in February, similar to January levels, while core inflation slowed to an all-time low on the current base of 3.4%. The current account deficit edged down to 1.2% of GDP, and the capital account surplus rose to 1.9% of GDP, leading to an overall BoP surplus of 0.7% of GDP in the Quarter ending Dec-23. In Dec-23, foreign tourist arrivals in India crossed the 1 million mark for the first time since Feb-20. The Election Commission of India (ECI) has announced the dates for the 2024 general elections (Lok Sabha or the lower house of parliament), polling to take place in 7 phases between April 19 and June 1, with the final results counted on June 4. The total electorate is currently estimated at 969 million, an increase of 73 million from the previous election in 2019, of which 18.4 million will be first-time voters (i.e., 18-19 years old).

Real Estate- The upcycle continues...

Housing prices, which started moving up from 2022 after remaining stagnant for almost a decade, continued an upward trend and appreciated by an average of 14 percent in 2023, encouraging investors to return to the primary residential market. India's housing market defied logic in CY23 to register all-time high sales as home buyers snapped up deals despite a jump in asking prices and the highest interest rates in six years. In CY23, housing demand in the top 7 cities was up 24% YoY. In addition, launches continue to trail demand, leading to unsold inventory levels falling to around 16 months at the end of CY23. The changing sentiments of homebuyers -- wherein not only are home-renters converting into buyers but also buying bigger homes -- have played a huge contributing hand to sectoral and economic growth.

For the top 14 listed Realty developers, the pre-sales growth was even stronger at 50% YoY for 9mFY24. The ouster of dubious developers from the real estate market thanks to greater regulatory oversight via RERA helped boost confidence among home buyers. The insolvency law too has played a role in the elimination of defaulting builders. This consolidation has led to: i) market share gains for organized developers; ii) constrained supply leading to low inventory levels, enabling a steady price increase; and iii) higher bargaining power for organized developers since they are able to sell most of the inventory at the launch stage itself (considering the lack of good quality supply in the market).



Source: PropEquity, Nuvama Research

Even better news is that in this upcycle, companies are generating strong Free Cash Flow, which was invisible in the previous upcycle. For example, during FY02–08, half of DLF's cash flows went towards working capital needs; on the other hand, over FY21–H1FY24, the company has operated at a negative working capital cycle, generating strong free cash flow. While DLF's pre-sales today are around 2 times the level of peak sales in the previous upcycle, the Development company today is net debt-free (versus INR 100 billion-plus housing debt then). Companies like Macrotech and Brigade Enterprises have also performed well on the Cash flow front.

Office space leasing surged to 18.1msf (up 68% YoY) in Q4CY23, broadly matching completions at 18.3msf (up 140% YoY), which pulled down vacancies by 30bp QoQ to 17.9%. CY23 demand at around 40msf was up 13% YoY while supply at 45.5msf declined 6% YoY. Space take-up by GCCs (40% share in CY23) and flex operators continued unabated even as demand from IT/ITeS companies remained weak. We believe the worst is over for office absorption. While large upcoming supply (~176msf by CY26) is an issue, an uptick in demand is likely to keep vacancies range-bound.

We believe housing demand would remain robust in the near term. We expect launches from listed developers to gather traction in CY24. Market share gains for organized developers shall sustain. RBI has already paused, and any rate cuts should stimulate further demand. We believe a potential fall in interest rates would enhance the valuation premium that realty stocks currently command. We also have direct exposure to Real Estate through Brigade Enterprises and Oberoi Realty while indirect exposure through Banks, Cement, and home improvement companies.

Nifty Q2 FY24 Earnings Review

Sales/EBITDA/PBT growth for Nifty constituents was in line with consensus estimates at +6%/+10%/+10% YoY in 3QFY24 while PAT growth at 17% was above consensus estimates. The banking sector posted a mixed performance in 3QFY24, marked by healthy business growth, controlled provisions, persistent NIM pressure, and high opex. Credit growth was mainly aided by continued momentum in retail growth. The corporate sector saw a gradual pickup, aided by MSME growth. Deposit growth was modest and continued to be led by term deposits, while some banks raised bulk deposits at higher rates, leading to a QoQ rise in the cost of funds (CoF) for the sector. Even on the NBFC front, the growth continues to be strong, and the asset quality is stable. The broking segment delivered a strong performance yet again in terms of demat account additions; however, operating margins were under pressure due to investments in customer acquisitions. APE growth for life insurance companies was higher than consensus estimates in 3QFY24. In Consumer Discretionary, the auto sector performed well, and its volume growth was led by 19% growth in two-wheelers. Gross Margins also improved led by improving efficiencies and operating leverage. QSR companies sustained sluggish performance as growth metrics (SSSG, ADS) remained weak on a high base. With the underlying growth remaining weak, companies experienced a significant impact on their unit economics. Local competition, delayed rural recovery, and price cuts continued to impact revenue performance of FMCG companies. On the Industrial front, The EMS sector reported another strong quarter with aggregate revenue growth of 57% YoY and also strong order book growth. Even on the capital goods front, traction is being witnessed across industries including power T&D, renewable energy, data centers, real estate, and defense. On the infrastructure front, awarding activity by NHAI has been muted so far, with just around 1,120kms of awarding in FY24YTD (Apr'23-Feb'24) vs. a target of around 5,000kms of awarding in FY24. While there is a huge tender pipeline, order inflows could kick in materially only post-general elections in FY25. Hospitals exhibited a strong performance driven by higher occupancies and improving margins. Oil & Gas companies exhibited a strong performance led by Oil Marketing companies. Real Estate companies delivered strong performance on launches and collections. Their balance sheet also improved. IT Services companies delivered very weak numbers, and Commentaries on demand recovery and discretionary spends were weak, although a few companies noted early green shoots in selective pockets.

Portfolio Review

Overall, we booked profit in some mid and small caps as they outperformed over the last few quarters, and the valuations were stretched in certain segments. Eventually, the mid and small caps did experience a correction which we were anticipating for the last few months. We continue to be cautious on global growth in the near future, but with the FED pivot, the expectations on the medium term have improved. The portfolio adjustments included adding exposure to Energy, Industrials, Healthcare, and Real Estate. The largest bank, State Bank of India, was fully exited, with the exposure allocated to private banks due to valuations comfort in that pocket. Aditya Birla Fashion, a poor performer in recent quarters, was fully exited and replaced with Brigade Enterprises, a small Real Estate company from Bangalore, exhibiting strong annual pre-sales growth and a sound balance sheet. Additional exposure was added to Reliance Industries, Sun Pharma, and Ipca Labs. To capitalize on the digitization of the Indian economy, a new addition to the portfolio was Emudhra, a company with a leadership position in the certifying authority business in India, boasting a ~35%+ market share, a large channel partner network, and the ability to sell directly to retail clients. Emudhra also has strong capabilities in the digital signature space, evident in Gartner rankings. We fully exited Jio Financials as the stock seems to be fully valued but added more Reliance Industries. PVRInox, a poor performer in recent quarters, was fully exited and replaced with Park Hotels, a small hotel company from Kolkata, which recently got listed. Park Hotels has a good pipeline of rooms to be added over the next three years and is available at comfortable valuations compared to peers. Additional exposure was added to ICICI Bank and NTPC. We also booked partial profit in Medanta & Varun Beverages due to full valuations from a 1-year perspective. We fully exited SRF due to concerns about continued dumping by China in its refrigerant gases business. We replaced SRF with Gujarat Fluorochemicals, which is building a strong capability in EV battery chemicals and Fluorochemicals. We fully exited HCL Technologies as the stock reached our target price and replaced it with LTIMindtree, which can return to high teens earnings.

As mentioned in the earlier section our view on Real Estate is cycle has been very positive. As a result, we invested in Brigade Enterprises, which is a Bangalore-based Real Estate Company and receives 70% of its revenues from Real Estate Sales and the rest from lease rentals and hospitality. The company has almost 22mn sqft of projects under development with their share being around 17mn sqft. Also, they have a land bank of 499 acres (57 mn sqft) out of which 42mn sqft is earmarked for residential purposes. With a big land bank and projects under development, the company has a prospective residential launch of around 10.8mn sqft over the next 12 months Vs launches of 7.2mn Sqft over the last 12 months. Occupancy for its annuity portfolio has also crept up and now stands at 93%. The residential market continues to exhibit healthy growth, both in terms of pricing as well as sales in the cities of Bangalore, Chennai, and Hyderabad.

Macro tailwinds like Rising Discretionary incomes and favorable demographics are helping in the strong growth of the Hospitality industry post COVID. The challenges faced during the pandemic made the industry more efficient and now able to deliver higher profitability per unit of sales. Over the next 5 years, the supply of branded hotel rooms is expected to grow at 5-6% while demand is expected to grow higher at 8-10% CAGR. This gap can result in stronger growth in Average Room Rents (ARRs) for the industry. While outbound tourists have reached 99% of Pre-COVID, the inbound are still 85% of Pre-COVID. On the above backdrop, we invested in Park Hotels in February upon its listing. This hotel chain is present across 20 cities with 2298 rooms across India. 44% of its revenues come from F&B which compliments the hotel business. The opportunity lies in the expansion of its own rooms from the current 1101 to 1931 over the next 3 years. Also, it operates a famous brand of confectionery shops Flurys and plans to expand it from the current 75 outlets to 250+ in 3 years. Overall, the company can compound its EBITDA at 22%-25% over the next three years.

Growing digitization globally has led to a big demand for cybersecurity. Hence we have invested in E Mudhra, which is a combination of Cybersecurity and paperless transformation solutions built on the foundation of digital trust using public key infrastructure technology. It's a big player in the paperless workflow with digital signatures. It has a bouquet of suites like emCA (PKI), emAS (Secure online access) on the enterprise business side and for the consumer side it provides digital signatures and certificates. Currently, Enterprise business contributes 77% of its revenues while the rest is from Trust Services. The company has a leadership position in the certifying authority business in India with a ~35%+ market share coupled with a large channel partner network and the ability to sell directly to retail clients. They are focusing on expanding the enterprise business in and outside India through a solution-oriented approach for specific sectors including Government, BFSI, etc. They have strong capabilities in the digital signature space as evident in Gartner rankings (leader in Identity and Access management) and System Integration partnerships with Infosys/TCS. They have a strong focus on expanding capabilities in the cybersecurity space. The company can grow its revenues at 25-30% CAGR over the next three years.

Outlook

We expect RBI to maintain the status quo on rates while allowing liquidity to be less tight in the coming months. We think RBI will engage in a shallow rate-cutting cycle beginning 3Q2024. An earlier rate cut could hinge on more aggressive action from the Fed or a durable decline in oil/food prices which pulls down headline inflation ahead of our forecasts. IMF forecasts India to remain a powerhouse and sustain a high growth rate average of 6.3% over the next five years. The most important catalyst in 1Q24 is both the market's view on the 2024 general election outcome in the coming weeks and then finally the actual results which are slated for June 4. The polls are suggesting both continuity and a strong government which we believe is also something equity markets are pricing in the near term but over the medium term, it's very attractive. The structural multi-year drivers of growth compounding in India are

- Favourable demographic dividend - 900 million working age population - one of the highest in EM
- Consumption tailwinds, such as urbanization and rising wealth, making it the 3rd largest market by 2027. India's GDP per capita crossed USD 2,600 in 2023 and has grown at 6.2% CAGR over the past 10 years. Many EM markets exhibited a significant increase in consumption spending post attaining a GDP per capita of USD2,000.
- Positive optionality from supply chain relocation (China+1 Strategy) looking to expand away from geopolitical fault lines. Government incentives such as PLI scheme, formalization of Indian industry catalysed by recent policy measures (GST, Bankruptcy Act) and increasing digitization have helped in increasing competitiveness vs global peers. Apple is a big example of this relocation.
- A robust structural reform agenda
- Strong infrastructure push, pro-industry policies and government spending.
- Import Substitution is a big theme especially in areas like electronics, defence, chemicals etc. The government recently announced USD 15bn of investments across three semiconductors projects.
- Strong expected mid teens earnings growth which is much higher than Emerging Markets

India's weight in MSCI EM has risen to an all-time high of 18%, and India continues to be UW market for EM fund managers hence the inflows can continue to be strong by FPIs. India will be included in the GBI-EM Global index suite starting June 28, 2024, which will result in USD 30-40bn inflows in bond markets. Domestic investors continue to be steady investors in the equity markets.

From a sectoral perspective, given the continued strong domestic growth, we are positive on domestic themes such as Banks, NBFCs, insurance, manufacturing, hospitals, power, and consumer discretionary. We expect banking sector earnings to remain resilient, led by healthy loan growth and controlled provisions. However, private banks will be impacted due to 1) higher cost pressures, 2) concerns over loan growth given stretched LDR, and 3) rising Cost of Funds (CoF) impacting margins. With the industry CD ratio at its peak, competition for deposits is heating up and we remain watchful on CoF. Banks with a higher CASA mix will continue to do better. With interest rates peaking out, Non-housing NBFCs like the vehicle financiers will be a big beneficiary in the near term. Sustained strong trajectories in F&O and cash volumes will continue to be translated into strong performances by the capital market-related players such as brokers and exchanges. Life insurance is expected to grow APE at the mid-teens level. In the Auto sector, we are positive on the outlook for the Passenger Vehicles and two-wheelers segment. PVs are expected to see steady volume growth led by strong growth in UVs, thereby driving margin expansion for incumbents. Two-wheelers' growth will be led by the positive cycle and growth in EV penetration. We expect QSR companies to sustain growth weakness in the near term, which will likely keep operating margins under pressure. Burger companies are expected to perform better than Pizza. Food delivery platforms are expected to deliver strong growth and improving profitability. On the Industrial front, the capital goods companies' managements remained positive on a robust order pipeline given the government's emphasis on capex led growth. On the infra front, the awarding activities by NHAI and execution have been muted and are expected to improve in FY25 after the general election. Companies with decent order backlogs, a solid financial position, and involvement in multiple segments are well positioned to benefit in the near to medium term. Real estate companies are expected to deliver strong double-digit per sales growth. In IT services, despite a few Tier-2 companies outpacing Tier-1 players over the last couple of quarters, we remain positive on Tier-1 names due to their wider range of offerings and disproportionate benefits in a cost-focused environment. Even valuations are favoring the Tier 1 companies.

Overall, the Indian market continues to be around an all-time high but on a broader level, the Nifty is trading at a 1-year forward P/E of 19.4x compared to the 10-year average of 20.3x, and at a P/B of 3.2x compared to the average over this period of 2.8x (Source: Motilal Oswal). The market-cap to GDP ratio for FY24e is at 132%, higher than its 10-year average of 80%. The earnings growth expectations continue to be attractive with FY24-26e earnings CAGR forecast around 17% (Source: Motilal Oswal). Strong USD, higher oil, and resilient inflation could challenge the outlook for domestic policy easing in India.