

Economic Update

The Indian market underperformed the MSCI Emerging Markets Index during the last quarter, primarily driven by corrections in the domestic market. Mid-cap and small-cap indices outperformed large-cap indices. The weakness in India was attributed to continued FPI selling, subdued capital expenditure due to elections, and heavy monsoon rains. Following Trump's victory in the US elections, the trade war rhetoric between China and the USA has intensified, likely impacting China's exports and markets.

From a political perspective, the BJP recently won state elections in Haryana and Maharashtra, contrary to consensus expectations of losing both. This strengthens the resolve of the Modi-led government at the center to pursue its capex and reformist agenda. During the quarter, the FOMC cut interest rates by 50 basis points. However, the December rate cut was considered hawkish, with the FOMC emphasizing that the "extent and timing" of further cuts would depend on data. Powell also stated during the post-meeting press conference that the FOMC could "be more cautious" about additional easing, having already reduced rates by 100 basis points. The dot plot was revised significantly higher, forecasting only two cuts in 2025, half of what was expected in September, with 2026 also likely to see just two cuts (down from four previously anticipated).

In December, the Monetary Policy Committee (MPC) of the RBI kept the repo rate steady at 6.5% with a 4:2 vote and unanimously maintained a neutral stance. However, the Cash Reserve Ratio (CRR) was cut by 50 basis points to 4% of Net Demand and Time Liabilities (NDTL) in two equal tranches on December 14 and December 28. This marked the first CRR cut since May 2022, providing additional interbank liquidity of INR 1.16 trillion.

During the quarter, foreign institutional investors recorded significant outflows of USD 11.6bn, while domestic institutions registered net inflows of USD 16.5 billion. The G-sec yield was volatile but ended the quarter nearly flat at around 6.76%. Crude oil prices corrected to approximately USD 75 per barrel due to economic weakness in the West and China. The INR depreciated by 2.1% during the quarter, closing at 85.61 against the USD, driven by a stronger USD due to the Fed's hawkish stance. India's forex reserves declined to USD 650 billion from an all-time high of USD 700 billion.

GDP growth moderated to 5.4% YoY in the quarter ending September 2024, its lowest level since March 2023, down from 6.7% in the June quarter and below consensus expectations of 6.5%. The slowdown was evident in both capital expenditure and private consumption. The RBI MPC revised its FY2025 GDP growth projection downward to 6.6% YoY (from 7.2% earlier), factoring in the weak GDP print for the September quarter. However, the MPC remains optimistic about growth rebounding in the second half of FY2025.

Headline CPI softened to 5.5% YoY in November from 6.2% in October, aligning with expectations. Core CPI (excluding food and fuel) remained steady at 3.7% YoY for the second consecutive month.

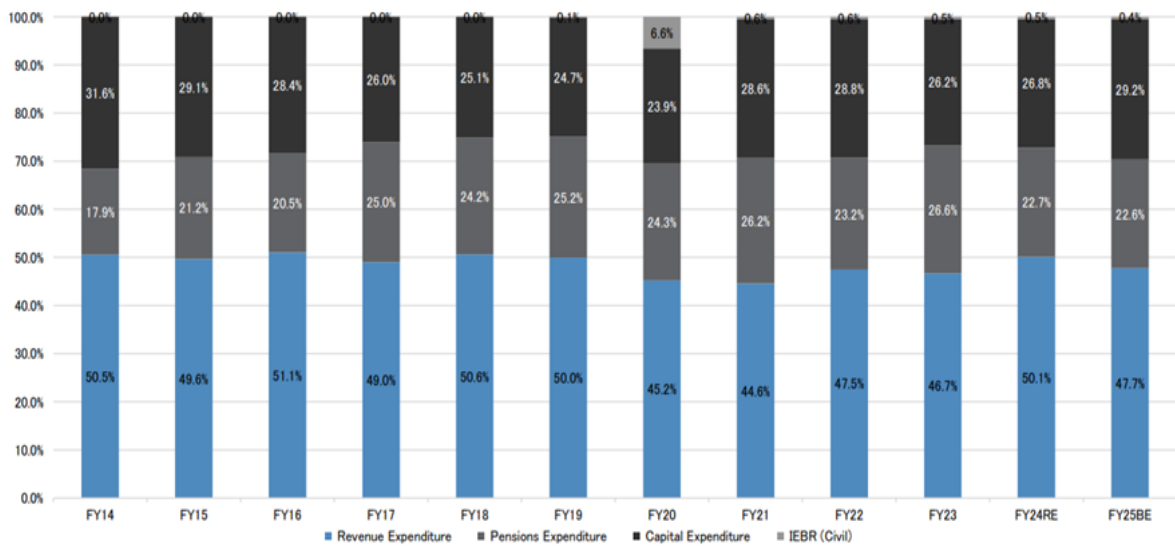
India's defence opportunity

India is the 4th largest military spender in the world. The country's defense sector presents a long runway for structural and value-accretive growth due to increasing capital expenditure (estimated at USD 150 billion over the next five years compared to ~USD 85 billion over the previous five years), rapidly rising exports (~46% CAGR over the past seven years), a strong focus on domestic manufacturing, high RoCEs, and robust cash flows.

Over the past decade, the government has achieved a paradigm shift in policy, procedures, and, most importantly, mindset to propel the growth of domestic defense manufacturing. Geopolitical factors and lagging past spending are prompting increased defense capex. Historically, defense capex grew at a slower pace due to competing demands on government finances. While India has traditionally been a large importer of defense equipment, it is now focusing on domestic production to enhance self-reliance, reduce costs, and generate employment. The government has established a comprehensive policy framework to make imports a last resort.

We believe the growth in defense capex and increasing indigenization represent a long-term structural trend that will drive ~12-15% revenue growth for leading defense companies over the next decade.

Revenue and pension expenditure continues to form a major part of India's total defence expenditure, but the share of capex has been picking up and is expected to be nearly 30% in FY2025.



Source- JP Morgan Report

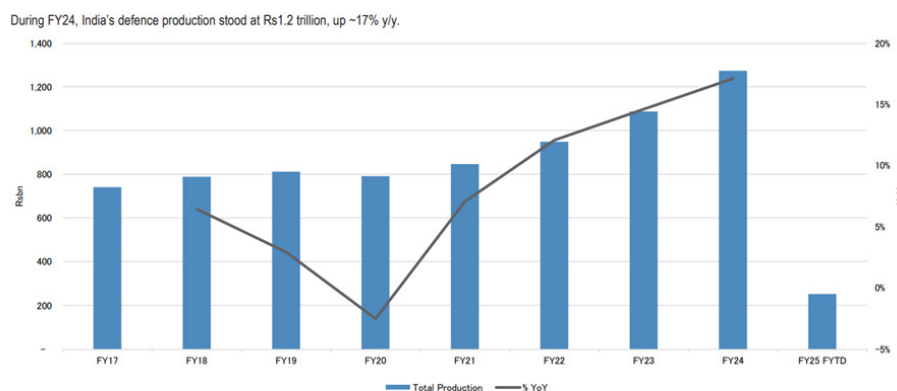
The **Defence Acquisition Procedure 2020 (DAP-2020)** is guided by the principles of defense reforms announced under the **Aatmanirbhar Bharat Abhiyan** (Self-Reliant India Movement). It promotes the indigenous design, development, and manufacturing of defense equipment, platforms, systems, and subsystems. Indigenous content (IC) requirements have been enhanced across all procurement categories, and the IC verification methodology has been simplified. A new acquisition category, Buy (Global – Manufacture in India), has been introduced to encourage foreign OEMs to establish manufacturing or maintenance entities in India under the revised FDI policy.

Various categories under DAP 2020

Ref.	Category	Indigenous Content
(a)	Buy (Indian-IDDM)	Indigenous design, development and manufacture \geq 50%
(b)	Buy (Indian)	In case of indigenous design \geq 50% otherwise \geq 60%
(c)	Buy and Make (Indian)	\geq 50% of the 'Make' portion
(d)	Buy (Global - Manufacture in India)	\geq 50%
(e)	Buy (Global)	Foreign Vendor - Nil Indian Vendor \geq 30%

Source- JP Morgan Report

India's defense exports are already growing rapidly from a small base. Defense exports stood at INR 15 billion in FY17 and have grown at a CAGR of 46% to reach INR 210 billion in FY24. The government's long-term target is to establish India as a manufacturing hub for defense exports. This growth is driven by various policy initiatives, as reflected in the steady expansion of total defense production in India.



Source- JP Morgan Report

Government-owned companies like **Bharat Electronics** and **Hindustan Aeronautics Limited (HAL)** are excellent proxies for the defense opportunity in India. As the primary domestic manufacturer of fighter aircraft, helicopters, engines, and associated equipment, HAL faces no domestic competition. It has a structural growth opportunity over the next decade, as the domestic procurement of fighter aircraft remains a priority. HAL has strong prospects, with ~INR 1.7 trillion in new orders expected over the next 24 months.

The opportunity size should continue to grow as the Indian Air Force replaces older-generation fighter aircraft with Light Combat Aircraft (LCA) and its more technologically advanced variants. HAL's robust order book (~3x book-to-bill ratio) provides high visibility for medium-term growth. Over decades, HAL has developed expertise in manufacturing aircraft under license (e.g., MIG-21, Jaguar, SU-30MKI), developing indigenous aircraft (e.g., Dornier, ALH), and upgrading existing aircraft (e.g., MIG-21, Jaguar). This expertise is unlikely to be replicated in India anytime soon, ensuring HAL's position as the primary supplier of domestically produced aircraft for the Indian Armed Forces.

With its diversified revenue and order inflow streams, which cover a full spectrum of defense equipment and platforms across land, air, and naval domains—as well as emerging areas such as electronic warfare—**Bharat Electronics** is well-positioned to benefit from increasing defense spending in India. The company has a strong book-to-bill ratio of ~3x. It allocates 6% of its revenues to R&D, focusing on developing new products.

We believe 2H FY25 is expected to provide a boost to defense companies due to announcements of large orders such as QRSAM, LCA, and Pinaka. Recent corrections in stock prices in this sector make them even more attractive.

Nifty Q2 FY25 Earnings Review

Sales, EBITDA, PBT, and PAT growth for Nifty constituents were in line at +4%/+5%/+4%/+4% YoY in 2QFY25. Earnings were pulled down by weak performance in commodities, including metals and oil & gas. Weak government spending (due to elections) and excess rainfall also impacted demand.

The banking sector reported a soft quarter, with margin moderation and higher provisioning expenses, particularly for private banks. Net Interest Margins (NIM) contracted for several banks due to cost pressures from intense competition for liabilities and continued stress on CASA mix. Public Sector Banks (PSBs), however, delivered a solid beat, driven by lower-than-expected provision costs.

Among NBFCs, most—including MFIs, especially in unsecured product segments—reported a deterioration in asset quality, attributed to customer overleveraging, sluggish consumption, and floods/extended monsoons. Power financiers and select affordable housing finance companies were exceptions.

In the auto sector, rural demand showed signs of recovery after several quarters, supported by a healthy monsoon, the festive season, and the upcoming marriage season, benefiting two-wheelers (2Ws) and tractors.

In consumer staples and discretionary segments, the demand environment remained challenging due to adverse weather (floods and heavy rains) and persistent inflation, which impacted urban demand. Volume

growth across most companies was discouraging after a slight pickup in 1QFY25.

IT services companies reported healthy performance, though their commentary remained cautious. Hospitals delivered better-than-expected results, driven by higher occupancy.

The capital goods sector exceeded expectations in both ordering and execution. Cement demand in 2QFY25 was impacted by heavy monsoons and lower government spending. The EMS sector had another robust quarter, with aggregate revenue doubling YoY. Telecom companies performed strongly, benefiting from the flow-through of tariff hikes.

Portfolio Review

The overall portfolio exposure remained stable, with Mid & Small caps maintaining similar weights. Adjustments included increasing exposure to Information Technology, Consumer Discretionary, Healthcare, Real Estate, and Industrials, while reducing exposure to Energy, Consumer Staples, and Materials.

Portfolio Changes:

1. Exits

- **PNC Infrastructure:** Exited due to weak growth in the road sector, despite the potential opportunity, and fines for corruption levied by the Ministry of Roads.
- **United Breweries:** Exited upon reaching the target price.

2. New Additions

- **Kalpataru Projects:** Added for its revenues from specialized EPC projects, particularly in sustainable infrastructure and energy.
- **Acme Solar:** Entered during its IPO. As a renewable energy company, it provides exposure to the growing green energy sector in India.
- **Max Estates:** A small but rapidly growing real estate company in the NCR region, focusing on premium and luxury segments.

3. Increased Holdings

- **Large Caps:** Added Zomato, M&M, Mankind (post-BSV acquisition), and REC after corrections.
- **Mid Caps:** Increased exposure to Gujarat Fluoro (driven by battery chemical business), Medanta, Apollo (due to strong Q2 results), and Mankind (post-BSV acquisition).
- **Coforge:** Increased allocation, as it is expected to grow fastest among mid-cap IT companies over the next two years.
- **SBI Life:** Despite near-term growth concerns, its long-term opportunity remains strong.

4. Reductions

- **Reliance:** Reduced exposure due to weak results and no visible near-term triggers.

Company Insights

- **Kalpataru Projects:** A leading EPC player with operations in 75 countries and 250+ projects under execution. Its diversified portfolio includes Power T&D, Railways, Buildings & Factories, Water & Irrigation, and Urban Infrastructure. The company's order book stands at USD 7.2 billion (45% international), with a book-to-bill ratio of 3.5x. Focus areas include margin improvement, working capital management, and non-core asset divestments. Profits are expected to grow at a 25-30% CAGR over the next two years.
- **Acme Solar:** One of India's largest renewable energy IPPs, with a portfolio of 6,720 MW (2,540 MW operational and 4,180 MW under construction, expected to be completed by early 2027).

The company generates revenue through electricity sales and is poised for significant growth as new assets become operational.

- **Max Estates:** Focused on premium real estate in NCR, the company has executed Grade A commercial properties with rentals ~30% higher than peers. Its residential projects, starting with a GDV of INR 18 billion in FY24, are driving growth. With total leased area of 1 million sq. ft. and 2.7 million sq. ft. under development, the company is positioned for substantial growth in FY25-26, supported by a recent capital raise of INR 8 billion.

Outlook

We believe that an improvement in headline CPI and a sequential moderation in food prices will provide the RBI with the confidence to ease rates during the February policy meeting, given the context of a slowdown in trailing growth. We expect growth to pick up in H2 FY25, supported by increased government spending and agricultural growth. In terms of high-frequency indicators, power demand rose to a seven-month high of 9.9% in December 2024 (MTD). Additionally, the government cash balance, a lead indicator for government spending (inversely related), dropped into the negative zone at INR 458 billion in the first week of December from a positive INR 282 billion in November. Notably, the government cash balance peaked in September 2024 and has been declining since.

A declining primary deficit and the potential for a primary balance are likely to attract private investments more than what may currently be priced in. A private investment cycle could extend India's earnings cycle, making current valuations more attractive than they appear. The outcome of the Maharashtra elections should alleviate concerns some market participants may have had about the Central government's ability to undertake reforms or complete its five-year term.

Over the next few quarters, we foresee infrastructure spending continuing to lower logistics costs, with railways being a key beneficiary. Additionally, investments in sectors such as defense, electronics, aerospace, food processing, renewables, and mass housing are expected to rise. On the supply side, we anticipate reforms in direct taxation, the implementation of more free trade agreements, scaling of INR trade, and a focus on energy transition, including expanding the sources of energy supply to include nuclear.

Factors like the election cycle and heavy rains in August drove down government spending in the first half of the fiscal year. However, these influences are now giving way to a significant uptick in government expenditure, an expanded wedding season, and a robust summer crop.

We also observe a structural rise in equity holdings on household balance sheets, supplemented by increased global allocations to India as the country's index weight rises. Furthermore, India's reliance on crude oil is incrementally decreasing, which is positive news for the current account deficit.

Sectoral Perspective

From a sectoral perspective, given the continued strong domestic growth, we remain positive on themes such as banks, NBFCs, insurance, manufacturing, hospitals, power, and consumer discretionary.

In banking, we remain cautious about margins and the delinquency cycle in unsecured loans while factoring in a marginal increase in credit costs for private banks. Robust balance sheets, strong contingency buffers, and reasonable sector valuations keep us optimistic. However, following Q2 results, most banks have seen a downward revision in earnings expectations for FY25. While there is no consensus on the timing or quantum of a repo rate cut in India, it would be incrementally positive for the NBFC sector, particularly for fixed-rate lending like vehicle finance and MSME.

The microfinance sector may face a challenging patch in the next few quarters due to widespread customer overleveraging across states. Capital market participants are benefiting from rising volumes, strong demat additions, and positive market sentiments. We believe impending F&O regulations could affect the short-term profitability of players like Angel One and BSE, but they are expected to exhibit strong growth over the longer term.

The IRDAI has announced new regulations regarding surrender values, effective from October 1, 2024. This

could lead to volatility in premium growth for the rest of FY25. However, structurally, the life insurance sector can sustain a 15% growth rate for several years.

In the automobile sector, two-wheelers (2Ws) are likely to post high single-digit growth in FY25, alongside a revival in exports from a weak base. Tractor OEMs have already raised FY25 volume growth guidance to 6–7% (from low single digits previously). For passenger vehicles (PVs), volume growth may remain muted due to weak entry-level demand and limited SUV growth from last year's high base. Rural demand has consistently shown an improving trend, supported by favorable monsoons. However, urban demand weakness and higher inventory in general trade impacted urban revenues in Q2. Companies are refocusing on traditional strategies—such as expanding distribution reach, launching new products, and offering consumer incentives—to regain growth momentum.

Most capital goods companies remain optimistic about a robust order pipeline, which is expected to materialize in 2H FY25, alongside a healthy uptick in domestic orders. EMS companies will likely continue to see strong growth driven by swelling order books.

Consolidation in the cement industry is intensifying, which should prove beneficial in the long term. Post-festive demand, a resurgence in construction activities and infrastructure projects is expected to drive demand recovery. Cement prices have been marginally up and steady (as of October 2024) compared to Q2 FY25 averages.

Real estate, particularly smaller companies, is set to deliver strong pre-sales driven by the ongoing upcycle and sectoral momentum. In IT, the outlook for discretionary spending has improved. Indian IT companies have a positive correlation with the US economy, which is expected to perform better under the anticipated Trump administration. We also maintain a positive outlook on telecom, as all incumbents prioritize profitability.

Market Observations

Overall, the Indian market has corrected by 10% from its peak, and the Nifty index is trading at a 1-year forward P/E of 19.9x, compared to the 10-year average of 20.5x. Its P/B ratio is at 3.2x, compared to the long-term average of 2.8x (Source: Motilal Oswal). The market-cap-to-GDP ratio for FY25 is at 146%, significantly higher than its 10-year average of 84%.

Earnings growth expectations remain attractive, with FY24–26 CAGR forecasted at 14–15% (Source: Motilal Oswal). It is crucial to closely monitor the US rate cycle and RBI actions to address the slowdown in the Indian economy. Additionally, the global trade impact of policy changes in the US, especially regarding China, must be watched closely. Tracking government cash balances with the RBI, government spending on revenue and capital expenditures, and winter sowing will help assess food prices and rural demand strength.