

End of a Prolonged Earning Recession

India has witnessed a prolonged earning recession over the last decade. The end of FY2018-19 marks 10 years since the recovery began from the aftermath of the global financial crisis. While the aggregate GDP growth on reported basis has been healthy over the last the 10 years at ~7% CAGR, the trend across Industrial growth, Corporate profitability and Earnings growth has been very disappointing. As a result, we have witnessed one of the weakest industrial growths in the last 10 years and from an aggregate corporate earnings perspective ***it's been a LOST DECADE.***

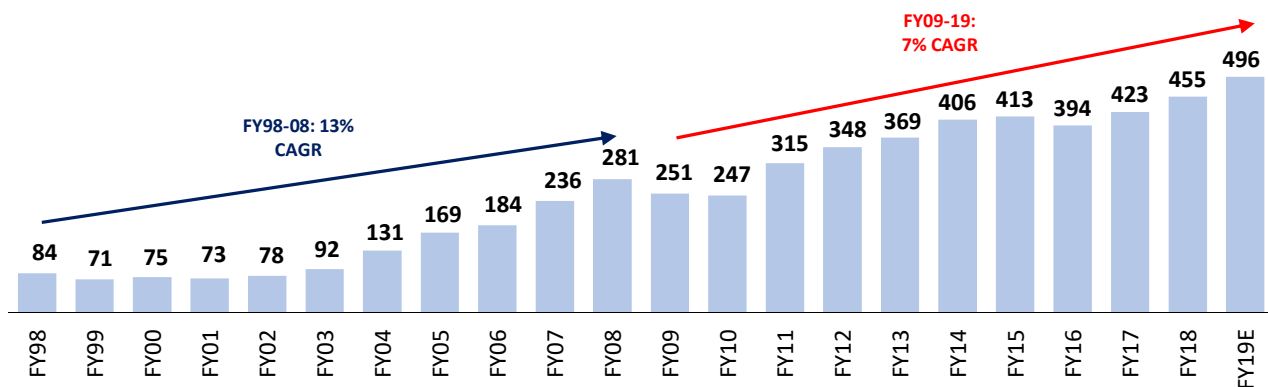
To put things in perspective, the prior decade 1998-2008, Nifty earnings had a CAGR growth of 13% and Corporate profit to GDP expanded from 2.3% to 7.8% at its peak. Thus, the Nifty EPS increased from 84 in FY98 to 281 in FY08 (Chart 1). As compared to this, during the last decade, i.e. from FY09 to 2019, we have witnessed weak industrial growth at 4.2%, significant compression in corporate profitability (Chart 2) and Nifty Earnings have at a CAGR of 7.0%. Due to the sharp compression in profit margins, the earnings growth for corporate India has significantly trailed nominal GDP growth over the course of the last decade. It has taken us 10 years to double the Nifty EPS from 247 in FY09 to 496 (E) in FY19.

There were multiple reasons for the below potential growth and sluggish earnings growth over the last decade including fiscal profligacy & high inflation for 5 years (2009-13), stalled projects, twin balance sheet issues, fiscal consolidation, etc.

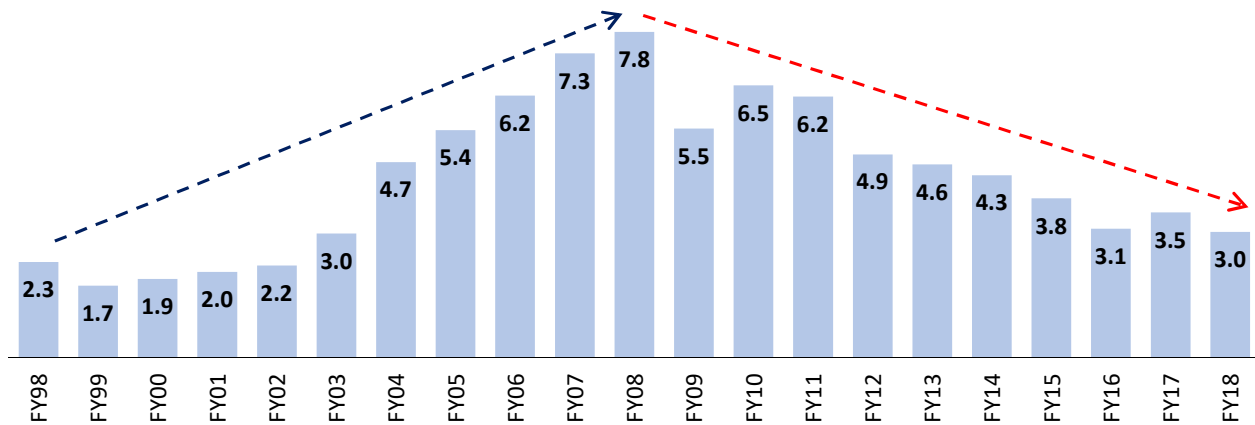
But there is light at the end of the tunnel. The good thing is we are likely to exit the earnings recession and the Nifty Earnings are expected to have sharp rebound of over 20%+ growth in FY20 after a gap of 9 years. The last time we had Nifty Earnings growing at 20%+ was in FY11 with a growth of 27%.

As the headwinds to growth recede, we believe that India will experience significant tailwinds from the structural reforms executed in the last few years and expect Nifty earnings growth of 15% CAGR over the next 5 years from FY19-FY24; which effectively would mean that nifty earnings can double over the next 5 years to ~ 1000 as opposed to 10 years taken to double Nifty earnings from 251 (2009) to 496 (2019).

Nifty EPS



Corporate Profit to GDP (%)



Thus, we believe, after a gap of 10 years, Indian economy is at an inflection point and we are poised for a sharp recovery in earnings. We continue to remain focused on investing into good quality businesses from sectors that will lead India's earnings growth.

One of our key investment hypotheses has been large corporate banks. The performance of leading corporate banks has been significantly impaired over the last few years due to high provisioning cost and sluggish growth. But, as is evident we are near the end of the provisioning cycle for corporate banks and as their provisioning normalizes in Fy20, we shall witness sharp rebound in their profits.

We remain sanguine on the prospects of recovery in Investment Cycle over the medium term. The resolution of stressed assets through the Insolvency & Bankruptcy Code and improvement in capacity utilization across industries will spur the next investment cycle in India.

Capacity Utilization has inched up to 75-80% levels for various industries, implying the need for further capex. RBI in its Mar-19 bulletin highlighted that there has been some recovery in the capex cycle in FY18-19 and the investment activity is likely to improve given the pipeline of projects lined up by private companies.

The Healthcare Sector in India has been in a downturn for over last 5 years. The profits of the top 4 companies in the sector have declined by 23% CAGR during the 3 year period between Fy15 to Fy18. This was driven by multiple factors including significant erosion in pricing in the US generic market, regulatory issues, amongst others. We believe, after such sharp decline, industry profits are near trough and the profits of top 4 companies have stabilized in Fy19 and would get back to growth trajectory from here on over the next 5 years.

We like companies in the sector which have used this downturn to make significant investments in their business and are likely to get back to healthy growth trajectory over the medium term. Thus, we like select companies in the sector and continue to remain positive on Contract Research and Management Services (CRAMS) segment.

India has always been a bottoms-up market for stock selection. Even in the midcap carnage of 2018, led by NBFC crisis and massive exodus of FII flows, there were several stocks which stood up and delivered handsome returns. Over the next few months, there will be noise around elections; we continue to remain focused on investing into good quality business that can deliver sustainable growth over the medium term to long term.

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