The Silver Lining

Over the course of last year, we have been highlighting about India's own Nifty Fifty bubble and the froth in NBFC's (including Housing Finance Companies). While we have been saying this for a while and have been proven wrong by markets now for some time, we refrained from changing our views. The last piece on India's Nifty Fifty bubble was published in The Economic Times (https://economictimes.indiatimes.com/markets/stocks/news/view-expansion-in-valuation-cant-go-on-forever/articleshow/58622038.cms) quite some time back. During the period from January 2018 to August 2018, while the Nifty Index rallied by 10.9%, 83% of these gains were driven by just 7 stocks, depicting the sharp polarization in markets and the narrow participation.

The last month has seen significant volatility and correction in markets due to news flows and events around NBFC and Banks. Before we comment on the same, let us make some additional perspective on the "Nifty-Fifty" Bubble.

In the past decade, from FY08-18, sectors such as FMCG, Retail banks, NBFC which have been at the forefront of the Nifty-Fifty Bubble have seen sharp re-rating in their earnings multiples. As a result, stock price returns of companies across these sectors have been far in excess of the underlying earnings growth. Something similar had happened a decade prior in the FMCG sector and the sector de-rated significantly, especially the stocks with higher PE. A point to note is that earnings growth was healthy during that period (FY 1998-08) but still stock returns lagged earnings growth.

Stocks (Bloomberg ID)	EPS CAGR	Stock CAGR	Starting PE	Ending PE	EPS CAGR	Stock CAGR	Starting PE	Ending PE
	FY98-08	**FY98-08**	**FY98**	**FY08**	**FY08-18**	**FY08-18**	**FY08**	**FY18**
HUL	8%	4%	32	23	11%	22%	23	55
ITC	20%	16%	24	21	8%	16%	21	32
GCPL	19%	23%	10	19	20%	36%	19	50
APNT	22%	25%	17	23	17%	28%	23	48
MRCO	19%	22%	12	21	16%	28%	21	46
DABUR	20%	24%	14	24	15%	26%	24	46
NEST	19%	15%	40	24	11%	21%	24	56
CLGT	11%	8%	45	22	11%	18%	22	39
BRIT	22%	12%	32	21	19%	37%	21	55
GSK	11%	3%	38	16	15%	26%	16	30
Average	**17%**	**15%**	**26.4**	**21.3**	**14%**	**26%**	**21.3**	**45.7**

Source: Jeffries Research, Company Data.

We have reached a point in cycle where either growth in these sectors has been moderating or marginal growth has not been profitable (Housing Finance Companies) yet due to strong liquidity flows there valuations multiples kept expanding. Thus, there is high probability of de-rating in these sectors. Though it is difficult to predict the exact end of the super cycle, probability of longer term de-rating is higher now given starting point of high valuations, which will lead to lower returns over the following decade.

The volatility last month has been accentuated with the default by IL&FS on it's debt obligations and the risk off in the NBFC sector. The prevailing easy liquidity, growth prospects and high valuations accorded to NBFC's by the markets had led to strong loan growth in the sector and mushrooming of new NBFC's at a rapid pace. We have always believed that lending is a commoditized business and the key lies in recoveries and not in lending. Thus, it's a business of risk management and the aggressive growth of existing players and mushrooming of the new players with weak underwriting standards kept us away from the sector. We continue to remain vary of the NBFC's and have thus far avoided them.

Despite all these near term challenges, we believe India's real economy is recovering and our investment cycle is making a gradual comeback. Public investments are accelerating at both the central and state government levels and we are seeing healthy recovery in industrial capex**.** The order book for leading companies in capital goods industry has been growing at teens for last four quarters indicating revival in industrial capex.

The resolution of stress assets over the next year should provide fillip to brownfield investments. Capacity utilization is increasing and should reach the threshold of 85% in next few years; so it's a matter of time before corporates firm up fresh Greenfield investment plans. We are the peak of the NPA cycle in the banking system and going forward lower provisioning should create fresh lending capacity in the system. Business and Consumer confidence is on an upswing.

India has executed significant Structural Reforms in the last few years. Some of these reforms are game changers. The insolvency bill should ensure that we do not see pileup of such massive NPA in the next cycle. Logically, the GST should increase compliance and over medium term significantly enhance tax collections. This should improve India's tax to GDP ratio and provide the necessary funds to the government for developmental spending. Inflation targeting by RBI and prudent fiscal management should reduce macro-economic volatility and ensure India is cushioned from global shocks.

India's macro-economic fundamentals are stable and inspire confidence. There are some headwinds like global trade conflicts, rising oil price, election cycle etc, but India is in a much better shape to deal with them. The path of India's economic policies has been very consistent since 1991 irrespective of the election outcomes.

Our investment strategy continues to focus on companies that are sectors leaders, have made significant investments in their business over the last few years and have healthy balance sheets. Some of these companies are operating at sub optimal capacity utilization and should witness significant operating leverage and superior FCF (free cash flows) as growth accelerates. These companies should be able to deliver superior growth over the medium term as India's real growth accelerates.

Date: 01st October'2018

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