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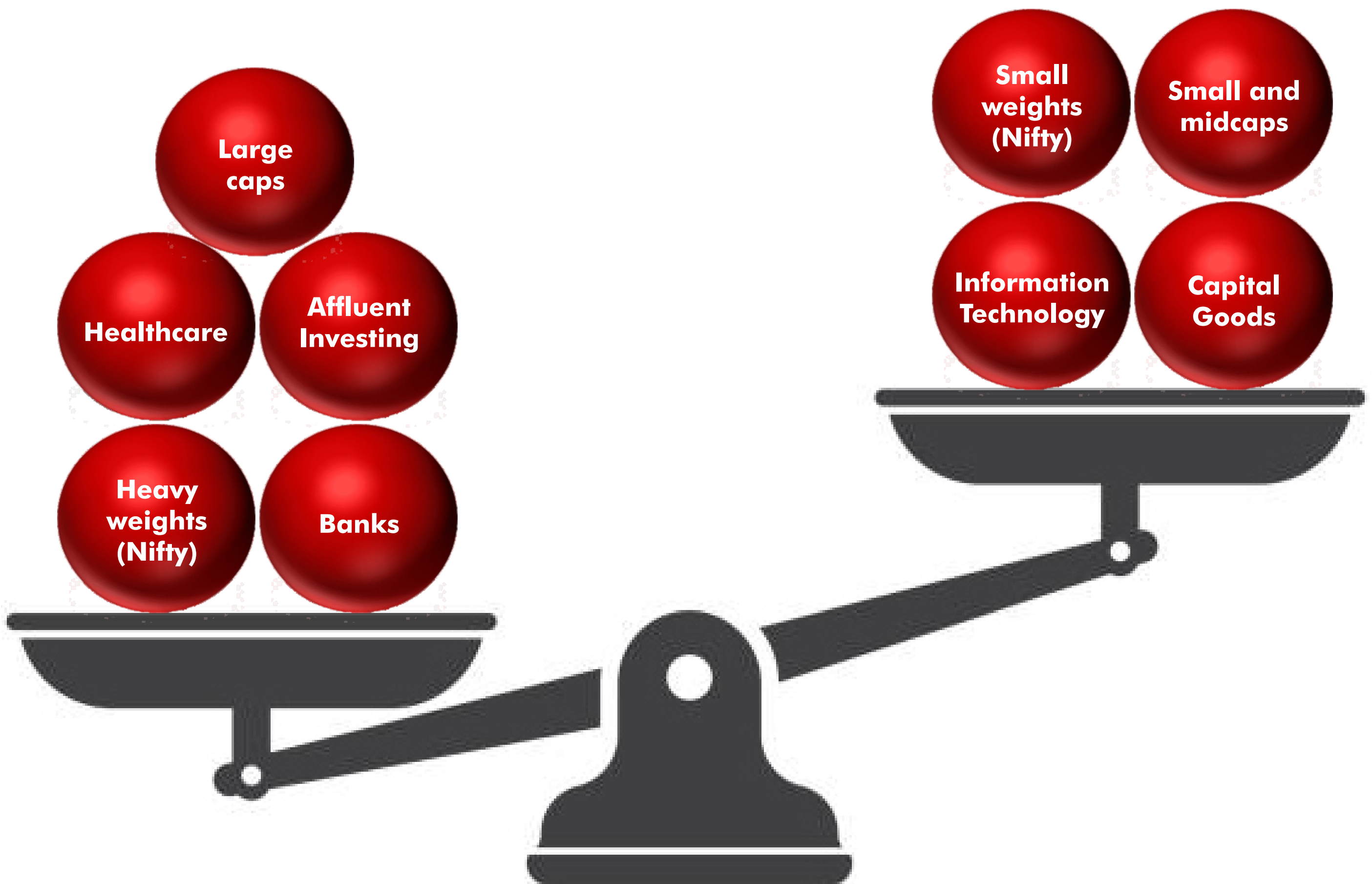

G&C 18.4: The wind is changing

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Strategy

THEMATIC | **March 06, 2024**

G&C 18.4: The wind is changing

The number of companies delivering positive earnings surprise in 3QFY24 was lowest since Mar-20; Nifty EPS estimate cut is 4.3% in FY24TD. This can worsen in FY25. PAT growth will decelerate as CPI-WPI spread compresses but market momentum can persist till elections as history suggests. In CY24, Nifty heavyweights led by Banks can outperform smaller companies, with FY25 earnings tilted in favour. IT outperformance is in divergence with strong earnings downgrade. Are we expecting stronger earnings reversion than FY21-22? Stance change-UW. Capital Goods valuation builds in unprecedented growth (16-18%) and FCF/sales (6-10%) over next 20 years. Expect SMID underperformance. We dispute supply/demand mismatch in SMID led by DMF flows alone and highlight FII ownership of large-caps is lowest since 2005. FII flows in SMID exceeded DMF. Expect EM to outperform DM led by India from a decadal perspective. Recommend 6 trades and make 4 changes to our portfolio.

This is India's decade but momentum can falter after elections

Over CY08-24, EMs' world Mcap contribution fell ~6%, GDP contribution rose ~10%. Divergence holds for EM ex-China too. This looks untenable as EM is expected to lead DM on medium-term GDP/earnings growth. Can India lead convergence? Yes, India's GDP growth is second only to Vietnam. Near term, market momentum will sustain till elections. Strong market breadth (%NSE500 stocks above 200dma>90%) has been associated with 6M fwd returns of ~12%; last such instance was in Jan-24. Our Nifty fair value (Dec-24) is 22.8k but wind is changing. Expensive valuation and worsening EPS estimate trajectory as margin lever recede, will weigh on market sooner or later.

Heavyweights to outperform; FII ownership of large-caps touches nadir

Outperformance cycle of Nifty EW over Nifty usually lasts for 3 years and is close to ending. With forward earnings tilted in favour of heavyweights, we expect Nifty to outperform Nifty EW led by banks. Expect SMID underperformance, a call which has not worked. Why has it happened? A mismatch in supply/demand. It's not just DMF flows. Availability factor defined as free-float/AUM contracted the least for mid-caps from a DMF perspective. Counterintuitive, isn't it? But incorporate FII flows in SMID, results change. FII ownership of large-caps is lowest since 2005.

Trades: What lies ahead? Focus on banks, Reduce IT/Capital Goods

Nifty FY24 EPS estimate trajectory is worsening, with 4.3% cut 11 months in FY24. We highlight 11 stocks (index weight ~33.2%) where our analysts' FY25 estimates are significantly lower than street and our analysts have been better in forecasting FY24 earnings for 7 of them. Over last few quarters, while sales growth was muted, PAT growth was exceptional driven by margin expansion as CPI-WPI gap was elevated, which is expected to contract. Companies posting positive EPS surprise was lowest since Mar-20. Focus on banks where impact of rate cuts appears a big overhang to street, but our analyst has narrowed it to 15-35bps. Maintain OW. IT's EPS growth reversion already seems priced in. In Capital Goods/Infra, sentiment can change after elections accompanied by slowdown in public capex. Expensive valuations don't provide comfort either.

G&C Portfolio Positioning – concentrated in large-caps (73%)

Since 23rd Oct, our G&C portfolio underperformed NSE500 marginally by ~40bps (~1% outperformance since inception) as SMIDs outperformed. Mid/small-cap allocation is 21%/6% & cash allocation is 4.6%. Becoming stock-specific, we prefer Banks over IT. Key OWs: Healthcare, Banks and Metals. Key UWs: Capital Goods and IT. We increase weight in Axis Bank marginally.

What's in: Shriram Finance, Sun Pharma, KVB and Triveni Turbine.

What's out: TCS, India mart, Bajaj Finance and GESCO.

Exhibit A: G&C 18.4 composition

Company	Mcap ($mn)
Large-Caps	
HDFC Bank	131,267
ICICI Bank	92,484
ITC	61,587
HCL Technologies	53,615
Sun Pharma	44,919
Tata Motors	43,623
Axis Bank	41,191
Nestle India	30,111
Tata Steel	23,054
SBI Life Insurance	18,335
BPCL	16,758
Tech Mahindra	15,078
InterGlobe Aviation	14,764
Hindalco Industries	14,229
TVS Motor	12,793
Dr Reddy's Laboratories	12,746
Shriram Finance	11,086
Mid-Caps	
Hero MotoCorp	11,121
Max Healthcare	8,762
Info Edge India	8,049
PB Fintech	6,019
Federal Bank	4,509
Embassy REIT	4,271
Narayana Hrudayalaya	3,223
Small-Caps	
Affle India	1,890
Triveni Turbine Ltd	1,888
Karur Vysya Bank	1,802
Kfin Technologies	1,388

Source: Bloomberg, Ambit Capital research

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Please refer to the Disclaimers and Disclosures at the end of this Report.

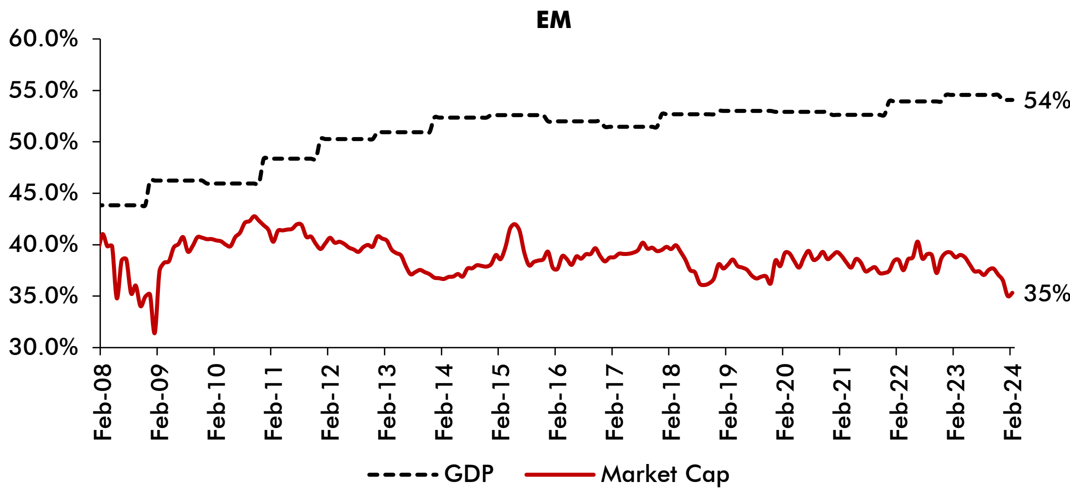
The Narrative in charts

Exhibit 1: Implied Nifty (Dec-24) for various yields and EPS. Base case – 7% yield, 980 EPS

10-year yield	Dec-24 EPS(INR)				
	960	**970**	**980**	**990**	**1000**
6.80%	23,415	23,659	23,901	24,146	24,390
6.90%	22,857	23,095	23,332	23,571	23,810
7.00%	22,326	22,558	**22,789**	23,023	23,256
7.10%	21,818	22,045	22,271	22,500	22,727
7.20%	21,333	21,556	21,776	22,000	22,222

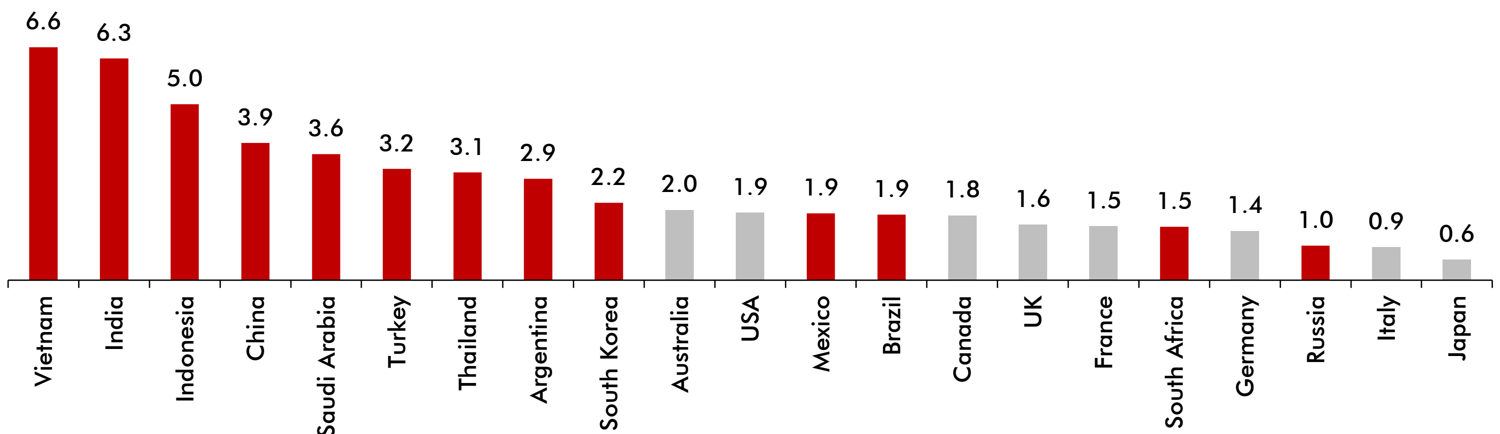
Source: Bloomberg, Ambit Capital research. Note: Implied Nifty levels have been calculated under the assumptions: Nifty trades at LTA (-2.7), EPS and yield by equation EYBY Gap= (Earnings)/(Nifty Level) - Bond Yield

Exhibit 2: EMs' world GDP share is rising but world Mcap share has declined



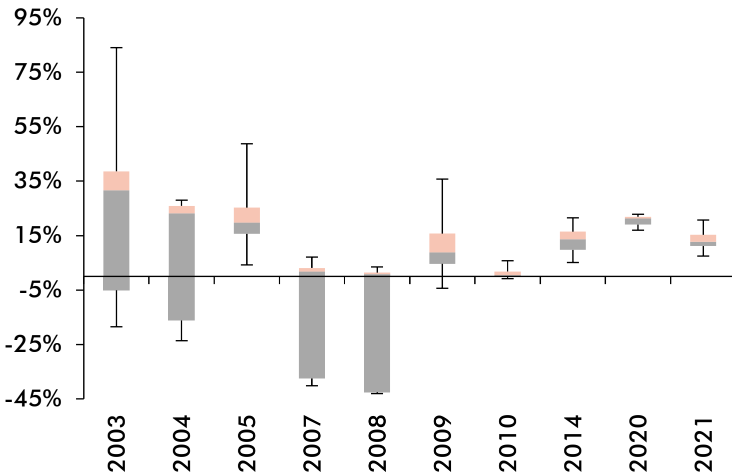
Source: Bloomberg, Ambit Capital research. Note: DMs constitute Australia, USA, Japan, Germany, UK, France, Italy and Canada. EM is World ex DM.

Exhibit 3: Can India lead the convergence? Yes, India is poised to be second-fastest growing economy over the next 5 years



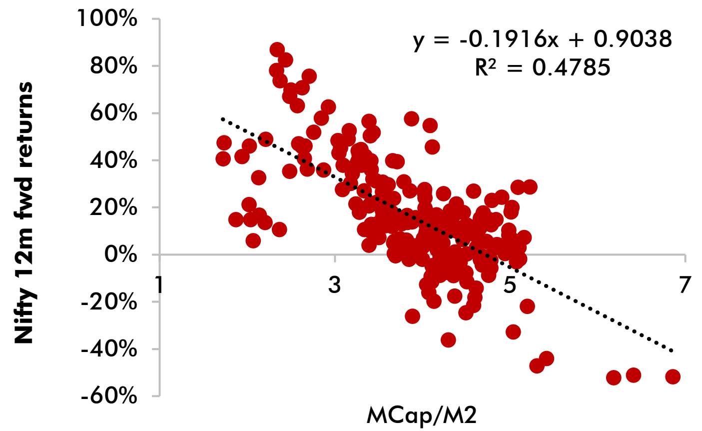
Source: Bloomberg, Ambit Capital research. Note: Countries marked in red indicate EMs and those marked in grey indicate DMs

Exhibit 4: While momentum can persist until the general elections…



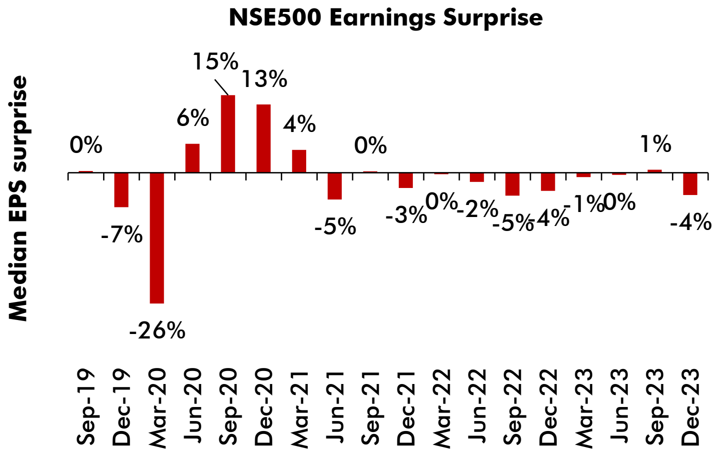
Source: Ace Equity, Ambit Capital research Note: No such instances in 2006, 2011-13 2015-19 and 2022.

Exhibit 5: …our Mcap/M2 indicator appears expensive



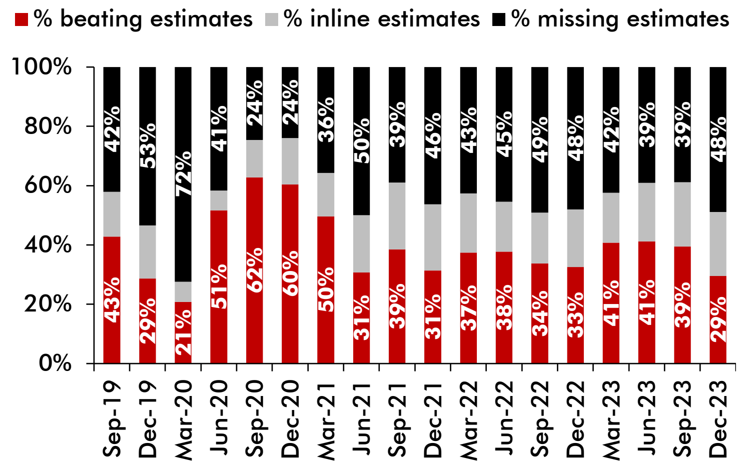
Source: Bloomberg, Ambit Capital research; Latest data as of 29 Feb 2024

Exhibit 6: Earnings surprise in 3QFY24 worst since 3QFY23



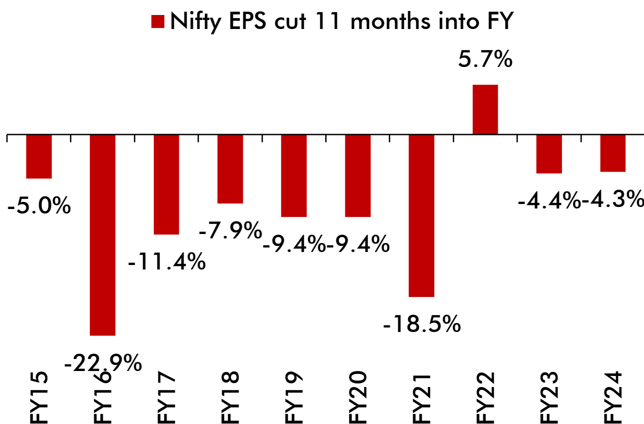
Source: Bloomberg, Ace Equity, Ambit Capital research.

Exhibit 7: The wind is changing



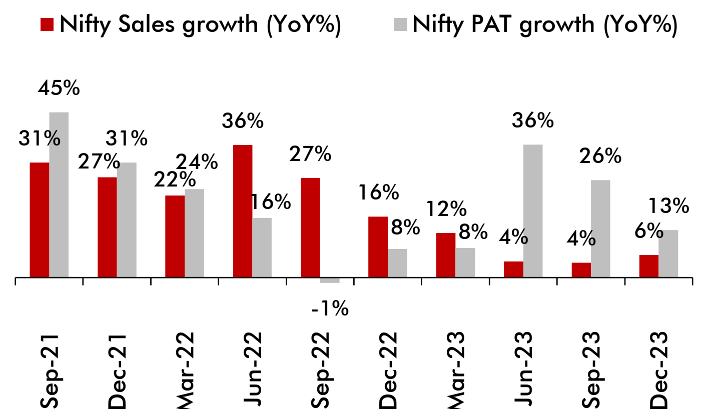
Source: Bloomberg, Ace Equity, Ambit Capital research. Note: Positive or Negative Earnings surprise is calculated as >5% or <-5% difference in the quarterly estimate at the end of the quarter v/s the actual reported numbers for the NSE500 constituents as of every quarter end.

Exhibit 8: EPS trajectory can worsen significantly in FY25



Source: Bloomberg, Ambit Capital research; Note: Latest data as of 1March'24

Exhibit 9: PAT growth is decelerating with 'margin contribution coming off'



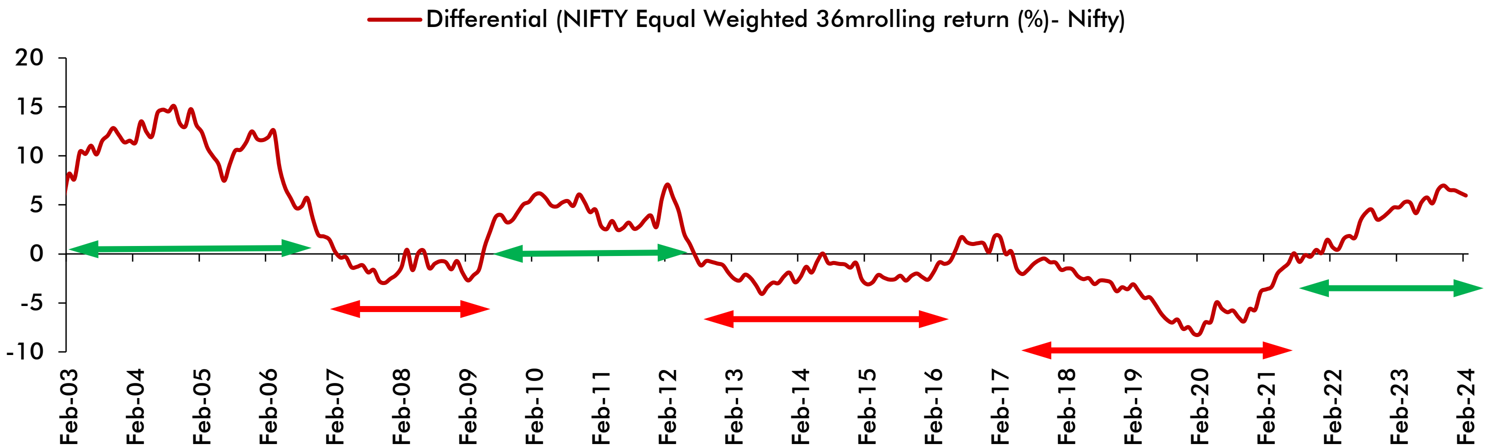
Source: Ace Equity, Bloomberg, Ambit Capital research as on 29 Feb'24

Exhibit 10: Which stocks can lead EPS downgrades? Our analysts have been quite accurate on 7 of them in FY24. Check this

Company Name	Ambit EPS estimate (₹)		Consensus EPS estimate (₹)		Ambit v/s Consensus		Weight in index
	FY24E	FY25E	FY24E	FY25E	FY24E	FY25E	(%)
L&T	91	101	96	123	-5.0%	-17.5%	4.3
Kotak Mahindra Bank	64	60	65	73	-1.6%	-17.5%	2.6
LTI Mindtree	157	167	160	187	-1.7%	-10.7%	0.5
Bajaj Finance	226	268	235	300	-3.7%	-10.5%	1.9
Divi's laboratories	58	72	59	78	-2.6%	-7.6%	0.5
TCS	127	131	127	141	0.3%	-7.5%	4.3
Wipro	20	22	21	23	-1.5%	-6.2%	0.8
RIL	108	116	106	124	2.2%	-6.0%	10.3
UltraTech	265	301	252	315	5.1%	-4.6%	1.2
BPCL	117	57	128	60	-8.7%	-4.5%	0.6
Infosys	59	64	59	67	-0.9%	-4.3%	6.2

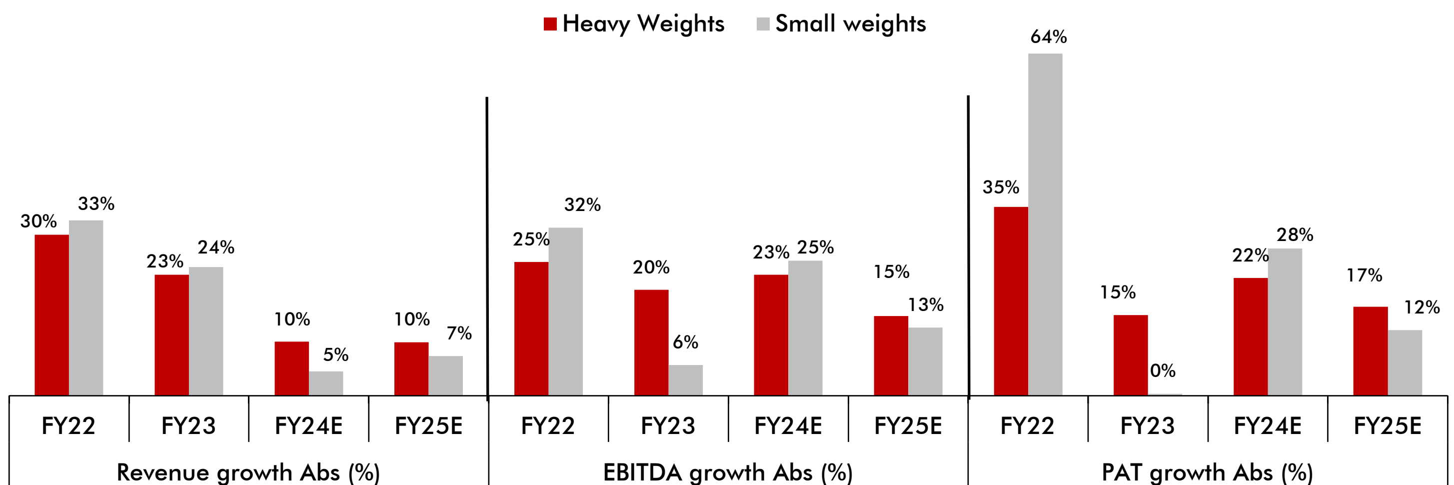
Source: Bloomberg, Ambit Capital research

Exhibit 11: What can outperform in 2024? Heavyweights. Outperformance of Nifty EW index over Nifty lasts about 3 years...



Source: Bloomberg, Ambit Capital research.

Exhibit 12: ...especially when FY25 earnings estimates are stacked in favour of heavyweights



Source: Bloomberg, Ace Equity, Ambit Capital research as on 01 March'24. Note: Heavyweights are Nifty index constituents with > 3% weight in the index.

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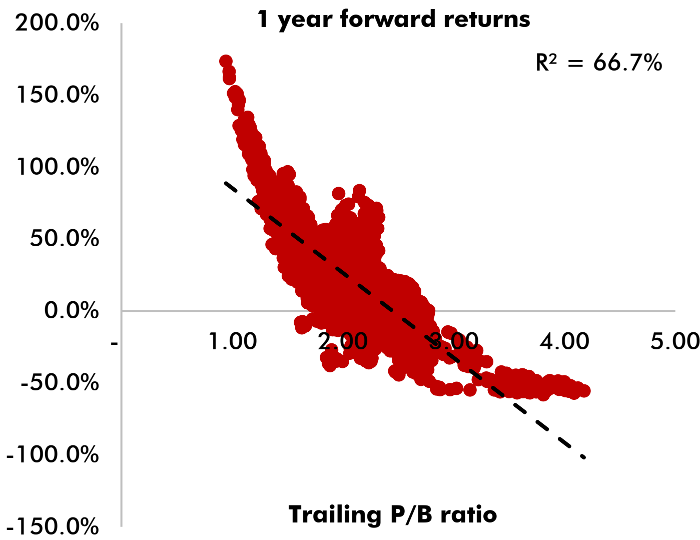
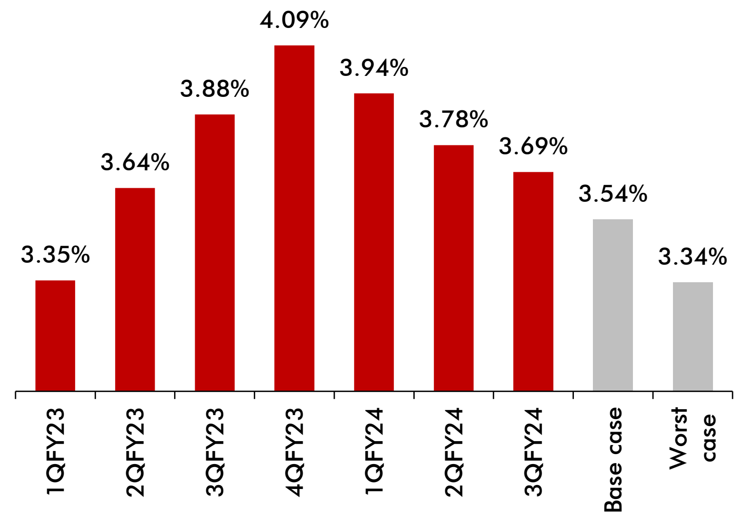
Exhibit 13: At current TTM P/B of ~2.22x, empirical relationship suggests 13.3% 12M fwd. returns for Bank Nifty. Since CY22, banks delivered ~18% median returns(12m) when TTM P/B<2.25x



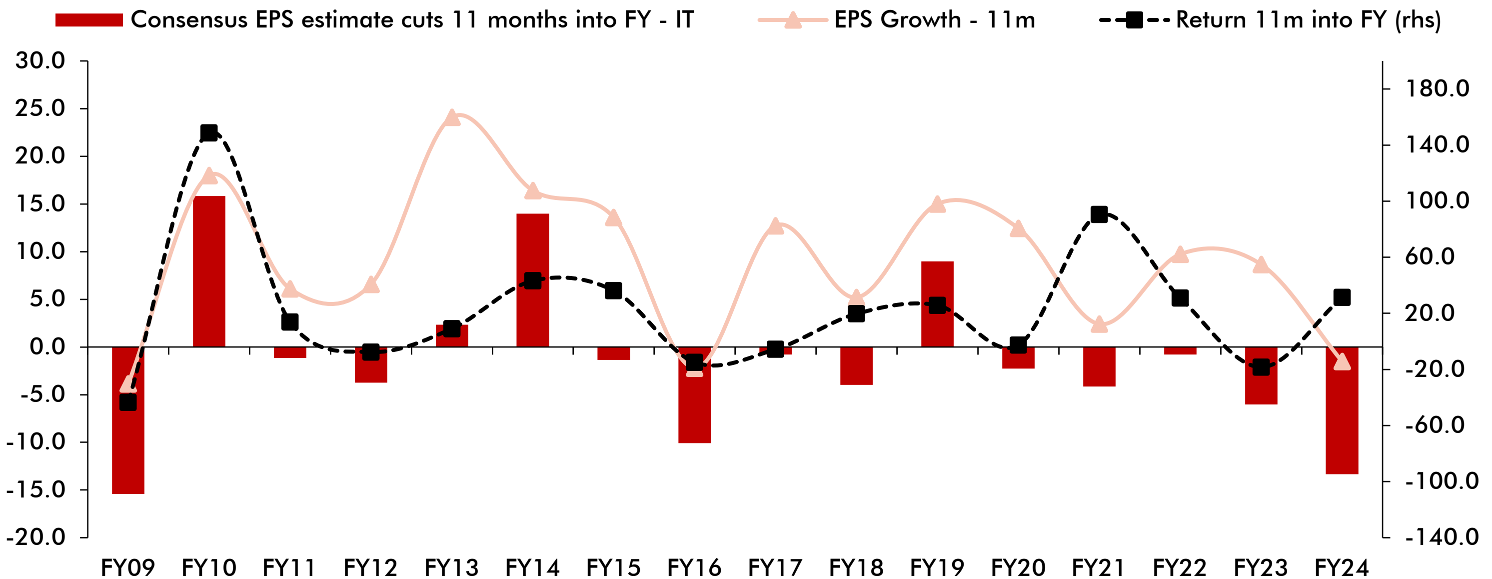
Source: Bloomberg, Ambit Capital

Exhibit 14: In worst case, NIMs can drop to 1QFY23 levels



*Source: Company, Ambit Capital research, *NIM is average of ICICI and SBI*

Exhibit 15: Nifty IT: Highest EPS cuts in a decade and earnings reversion will not be as strong as FY21-22; already priced in?



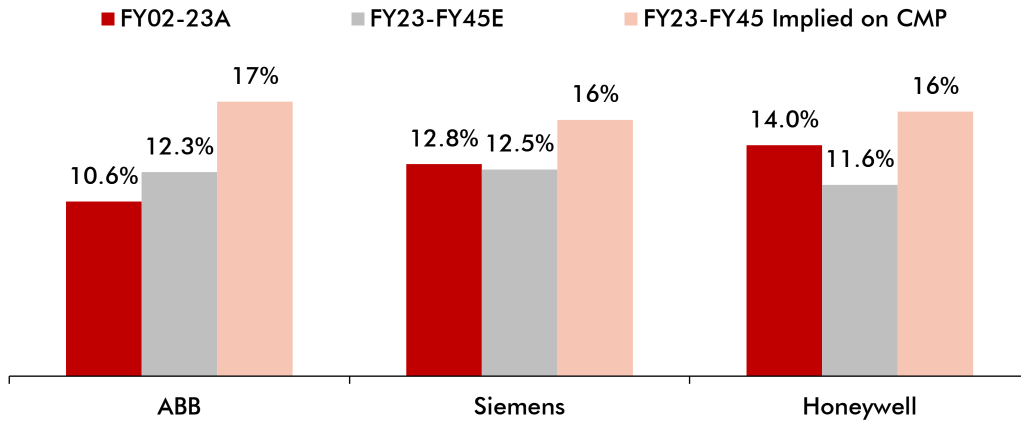
Source: Bloomberg, Ambit Capital research. Note: Latest data as of 01 March 2024

Exhibit 16: Pre-election surge in ordering activity typically leads to a hangover as evident in L&T's operating metrics from 2019

	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Order inflow	43%	94%	-18%	21%	-16%	-30%	-2%
Revenue	18%	36%	43%	13%	27%	13%	-4%
NWC/Sales	21%	20%	20%	18%	23%	23%	24%
OCF (₹ bn)	-13.4	24.1	18.6	61.8	-38.2	13.9	24.9

Source: Company, Ambit Capital research

Exhibit 17: Reverse DCF implies CMP builds in 16-17% revenue CAGR until FY45E vs 11-14% delivered over FY02-23



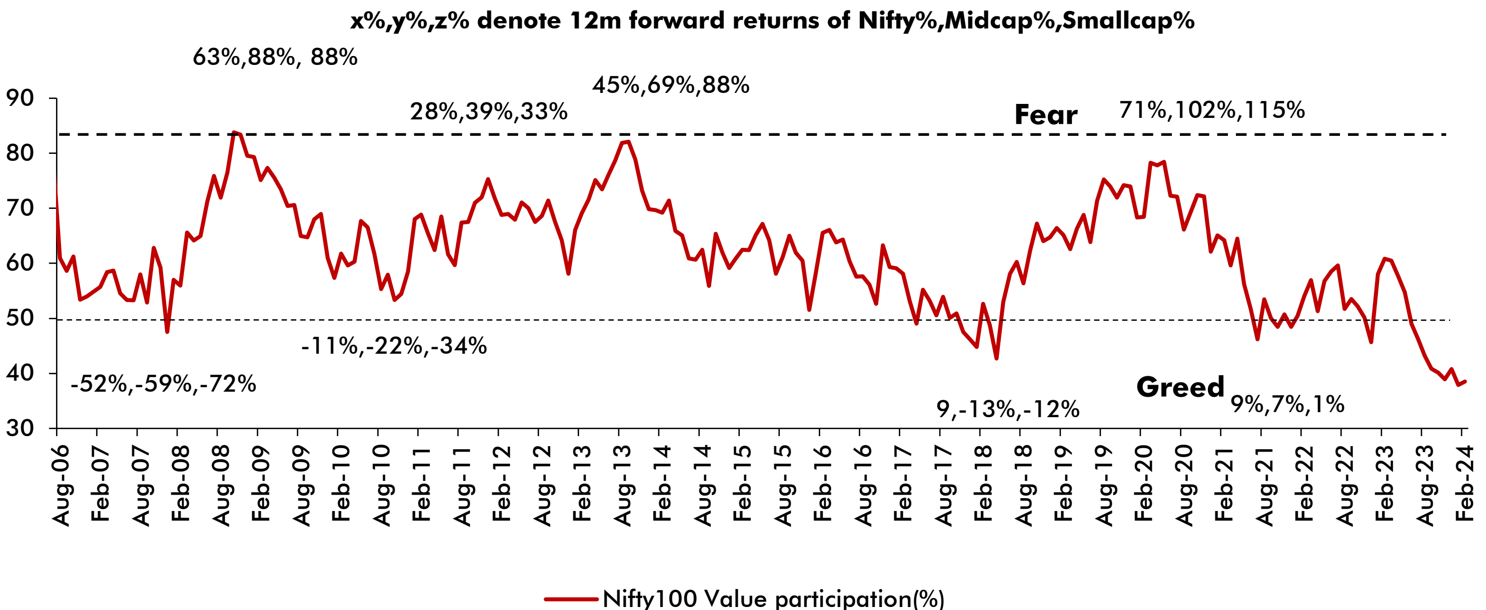
Source: Company, Ambit Capital research

Exhibit 18: How sectors look on our framework and our stance: Increased weight on Banks & Pharma. Reduce IT (UW)

Sectors	Recent Excess Returns	Relative Valuation to Nifty	Earnings estimate trajectory	Ownership w.r.t. NSE500 Sector weights	G&C Positioning	Comments
Auto	Very Unattractive	Very Unattractive	Robust	Significantly Overweight	OW	Driven by stock specific calls
Banks	Very attractive	Attractive	Robust	Neutral	OW	In line with framework
IT	Attractive	Very Unattractive	Worst since FY09*	Neutral	UW	In line with framework
Pharma	Unattractive	Attractive	Robust	Significantly Overweight	OW	In line with framework
FMCG	Neutral	Neutral	Robust	Significantly Underweight	UW*	In line with framework
Metals	Attractive	Unattractive	Neutral	Significantly Underweight	OW	In line with framework
O&G	Very Unattractive	Very attractive	Robust	Significantly Underweight	UW**	Disproportionate OW in OMC's
Capital Goods	Unattractive	Very Unattractive	Robust	Neutral	UW	In line with framework

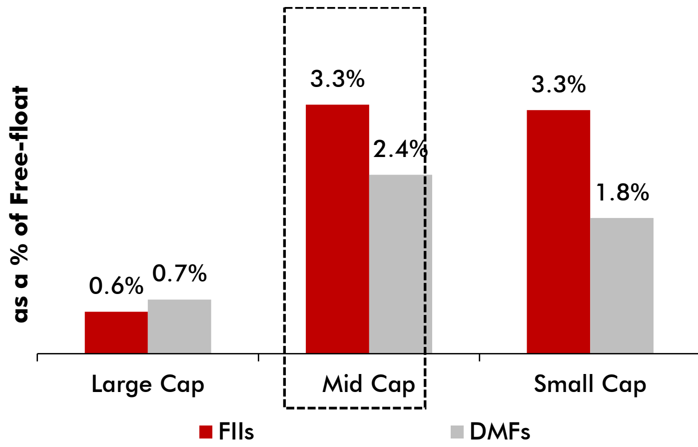
*Source: Ambit Capital research. Bloomberg Note: Scores are assigned for excess returns, relative valuation and classified into 5 quintiles, 0-0.20 scores as very unattractive, 0.20- 0.40 as unattractive, 0.40-0.60 as Neutral,0.60-0.80 as attractive, and 0.80 to 1 as Very attractive. Ownership is calculated as difference between Equity holdings of DMF's and NSE500 sector weights. +/- 5% are defined as neutral, 5-15% as underweight/overweight, >15% are classified as significant OW/UW. Earnings estimate sustenance has been calculated based on comparison of how earnings estimates evolution for current FY and next FY.**We have disproportionate OW in OMC's but don't own Reliance * marginal UW*

Exhibit 19: SMID to underperform: Greed & Fear Indicator is at the lowest value ever, signalling the highest greed. Though this did not work in CY23 for first time with FII and DMF demand for SMID outstripping supply



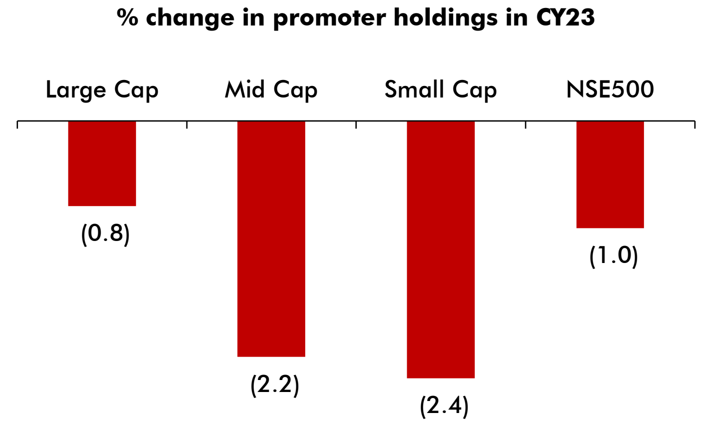
Source: NSE, Ace Equity, Ambit Capital research Note: Nifty 100 value participation is defined as the monthly turnover by value in NSE100 stocks as a part of total turnover on NSE.

Exhibit 20: Demand-FIIs flows> DMF flows in SMID in CY23



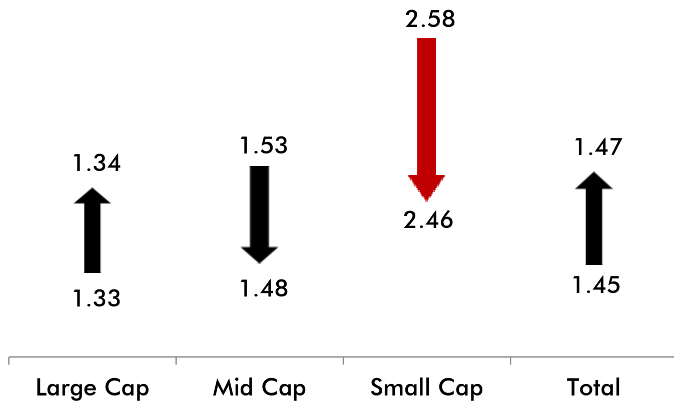
Source: Ace Equity, Bloomberg, Ambit Capital research

Exhibit 21: Supply - Decline in promoter holdings (%) in SMIDs is 3 times that in large-caps



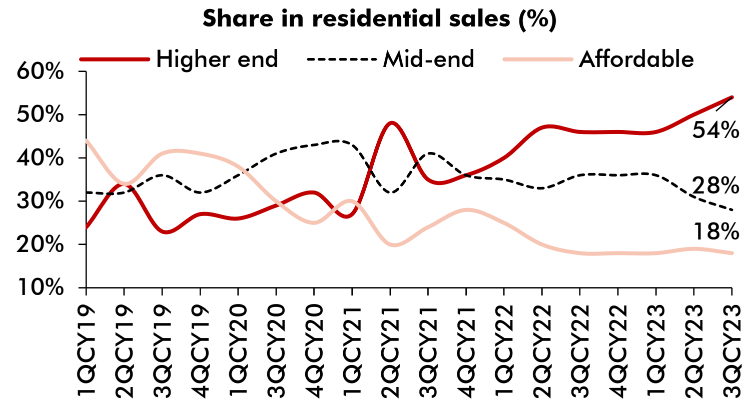
Source: Ace Equity, Bloomberg, Ambit Capital research

Exhibit 22: Result - Mid-caps' Modified Availability Factor (FFMcap/AUM of DII+FII) reduced by 3% in CY23



Source: Ace Equity, Bloomberg, Ambit Capital research.

Exhibit 23: A theme we recommend – 'Affluent Investing'; higher-end residential sales have surged in recent years

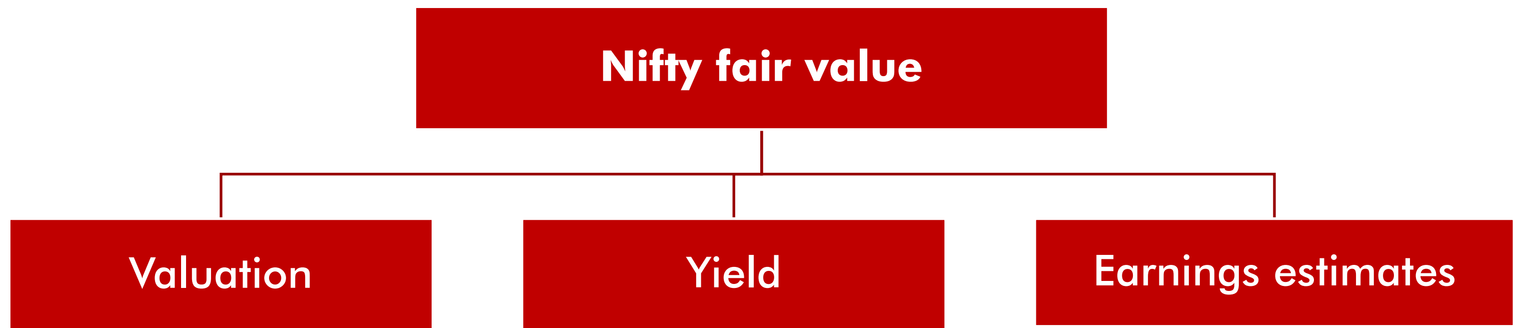


Source: Anarock, Ambit Capital research. Note – Higher end includes luxury and ultra-luxury

What is Nifty EYBY Gap implied 'fair value'?

Nifty fair value is a function of valuation, yield and EPS estimate. Since Oct-23, while valuation and earnings estimate trajectory seems to have turned worse, outlook on yield is more benign. We roll forward Nifty target to Dec-24. Nifty consensus Dec-24 EPS estimate stands at INR1055. Our analysis indicates that EPS estimates have, on average, been revised downwards by 8% from start to end of FY and our Dec-24 EPS estimate stands at INR980 (~7% cut). In the earnings section, we have highlighted the Nifty stocks that can lead downgrades over the next 12 months. We reduce our 10-year yield assumption by 20bps to 7%. We have been anti-consensus on yield since Sep-22 where we called that yields would not exceed 7.5%. For Dec-24, EYBY Gap implied Nifty fair value is 22.8k at 7% yield, Dec-24 EPS (INR980), and markets trading at LTA (-2.7).

Exhibit 24: Drivers of Nifty fair value



Source: Ambit Capital research

EYBY Framework: At 7% yield, INR980 Dec24 EPS

Revisiting the EYBY Gap Framework:

Mathematically, the earnings yield bond yield gap can be shown as:

EYBY Gap = (Earnings/Price) - Bond yield

To work out the EYBY Gap implied fair value, three inputs are required: EYBY Gap, yield, and earnings estimate (Dec-24).

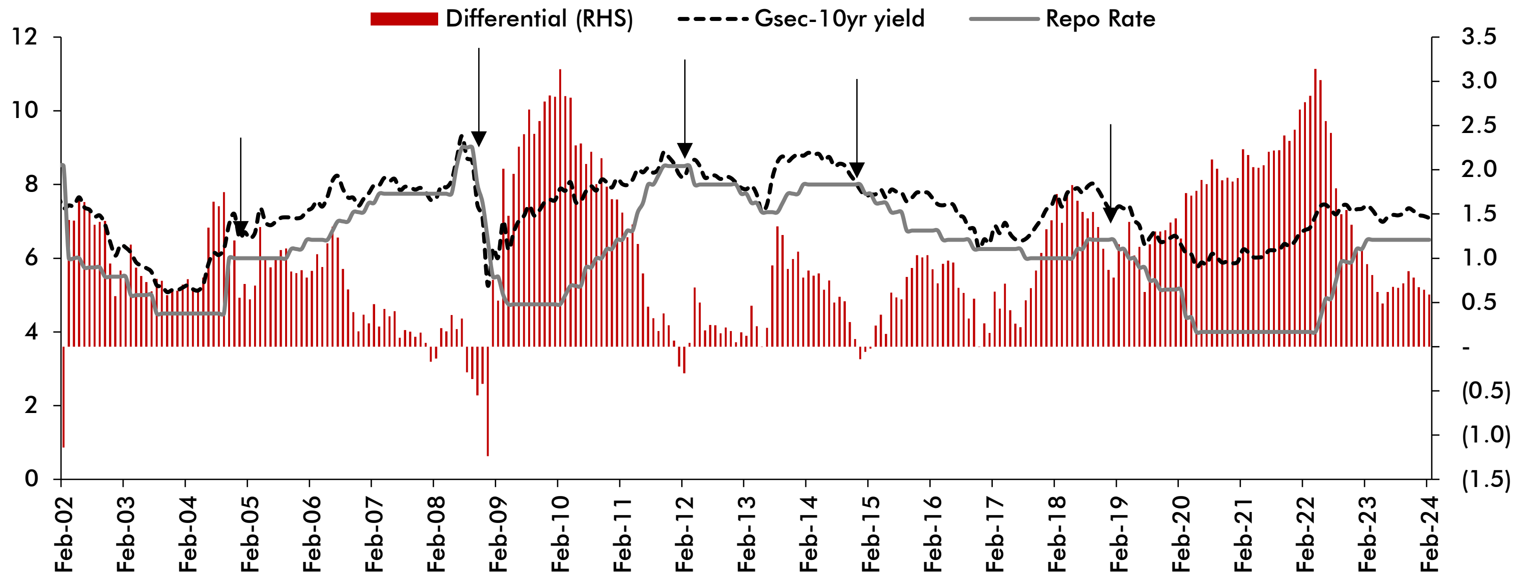
Assumptions: 7% yield, INR 980 EPS for December 24, and Nifty trades at LTA EYBY Gap (-2.7).

EYBY gap measures the attractiveness of equities w.r.t bonds by comparing earnings yield (1/PE) with bond yield. Higher the earnings yield as compared to the bond yield (higher gap), the better the subsequent returns and vice-versa.

How our assumptions fare. What is the change?

- **Dec'24 earnings estimate:** While EPS estimates in FY21-23 were resilient, 3QFY24 reporting season was the weakest in a while with the count of companies posting positive earnings surprises lowest since Mar-20 and number of companies posting negative earnings surprise increasing. This was in line with our view in May-23 that *"Earnings trajectory will likely change from FY24, with BFSI contribution to incremental EPS growth tapering to 43%"*. We see risks to Nifty's Dec'24 consensus EPS estimates (Dec'24 at ~INR1055) and have cut estimates by 7%, in line with history. Our earnings assumption for Dec-24 stands at INR980 as we roll forward one quarter.
- **Earnings yield bond gap**: Markets can trade at expensive valuations if earnings remain robust but selecting a long-term average (-2.7) looks like an appropriate assumption. We take LTA (-2.7) as the valuation at which markets would trade.
- **Yield:** We cut our yield estimate to 7% (7.2% earlier) over next 1 year. Why we have done that? Firstly, at the end of the rate hike cycle, the spread between the policy rate and the 10-year yield has been mostly lower than the 10-year average/median spread (99/111bps) in most instances. Most importantly, the government's decisions to reduce the borrowing will reduce pressure on G-sec as fear of oversupply of bonds have been allayed. The demand from insurance companies remains robust and inclusion in JP Morgan EM bond index remains a key positive.

Exhibit 25: Spread at the end of the rate hike cycle has been mostly lower or at most equal to 10-yr avg./median of 99/111bps



Source: Company, Ambit Capital research. Latest data as on 29th Feb'24.

Putting it together

With bond yield at 7%, Nifty Dec-24 EPS INR980 and EYBY Gap (-2.7), the Nifty implied sustainable price level is 22,789 (Dec-24).

Exhibit 26: Implied Nifty (Dec-24) for different EPS levels at 7% yield

Dec'24 EPS(INR)	Implied Nifty Level
960	22,326
970	22,558
980	**22,789**
990	23,023
1000	23,256

Source: Bloomberg, Ambit Capital research. Note: Implied Nifty levels have been calculated under the assumptions: Nifty trades at LTA (-2.7), EPS and yield by equation EYBY Gap= (Earnings)/(Nifty Level) - Bond Yield

In the above scenario, we have considered yield as 7% and varied Dec'24 earnings. Next, we do a scenario analysis for Nifty fair value under varying conditions of earnings estimates and yields. For instance, under conditions of Dec-24 EPS of INR990 and the 10-year yield at 7%, Nifty's fair valuation is ~23k.

Exhibit 27: Implied Nifty (Dec-24) for different yields and earnings levels

10-year yield	Dec-24 EPS(INR)				
	960	970	980	990	1000
6.80%	23,415	23,659	23,901	24,146	24,390
6.90%	22,857	23,095	23,332	23,571	23,810
7.00%	22,326	22,558	**22,789**	23,023	23,256
7.10%	21,818	22,045	22,271	22,500	22,727
7.20%	21,333	21,556	21,776	22,000	22,222

Source: Bloomberg, Ambit Capital research. Note: Implied Nifty levels have been calculated under the assumptions: Nifty trades at LTA (-2.7), EPS and yield by equation EYBY Gap= (Earnings)/(Nifty Level) - Bond Yield

Similarly, at EYBY Gap of -2.9% and Dec-24 EPS of 980, the implied Nifty level turns out to be 23,901.

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Exhibit 28: Implied Nifty (Dec-24) for different EYBY Gap levels and earnings at 7% yield

EYBY Gap	Sept-24 EPS(INR)				
	960	**970**	**980**	**990**	**1,000**
-2.50%	21,333	21,556	21,776	22,000	22,222
-2.60%	21,818	22,045	22,271	22,500	22,727
-2.70%	22,326	22,558	**22,789**	23,023	23,256
-2.80%	22,857	23,095	23,332	23,571	23,810
-2.90%	23,415	23,659	23,901	24,146	24,390

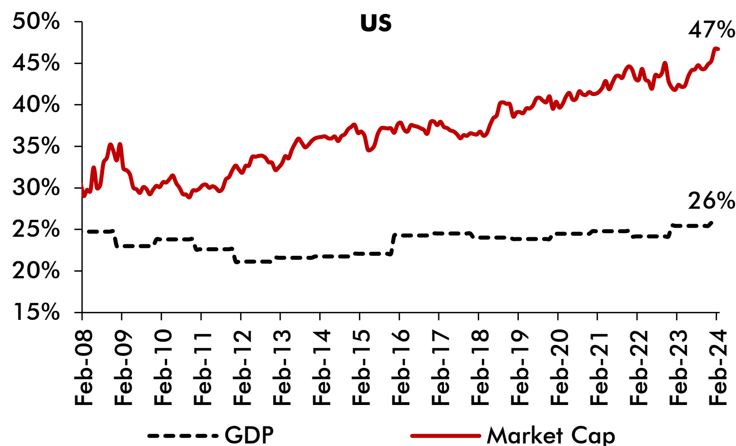
Source: Bloomberg, Ambit Capital research

EM likely to outperform DM over the next few years

While US share of world GDP has remained relatively stable (~24-26%) over CY08-24, DM contribution towards world GDP decreased by 10% since 2008. This is in sharp divergence with DM Mcap contribution which increased by 6% during this period. What has been DM's gain is EM's loss with Mcap contribution having fallen though GDP contribution increased by 10%. The analysis is equally true for EM ex-China, so do not attribute it to the underperformance of China, which has given 2% return in last decade. Can this trend change? How does medium-term growth outlook look like? A comparison of major G20 and EM indicates that a majority of EM countries are expected to grow much faster than DM. Even from earnings perspective, EM is expected to lead DM over next 3 years. Can India lead this EM rally? Yes. We notice that Nifty has rarely underperformed the EM index over a 3-year time horizon irrespective of its prior returns. Simply put, India's outperformance w.r.t EM has usually not been mean reverting. India's medium-term GDP growth (5 years) is second only to Vietnam and stands out across EM on the macro front.

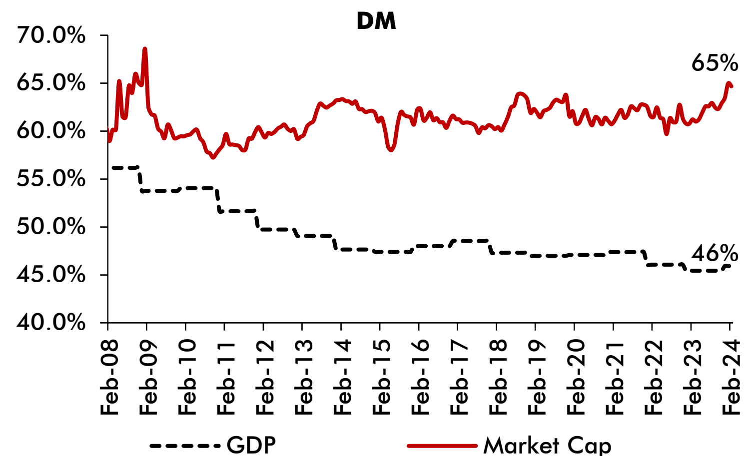
While the share of US in global market cap rose from 30% in CY08 to 47% in CY24, it has not been backed by a proportionate increase in GDP. US share in world GDP has been relatively constant at 24-26% for most of this period. Likewise, DM share in world market capitalization increased from 59% to 65% between CY08-24 but GDP contribution fell from 56% to 46% between CY08-24.

Exhibit 29: US share in global Mcap is at an ATH of 47%...



Source: Bloomberg, Ambit Capital research as on 29 Feb'24

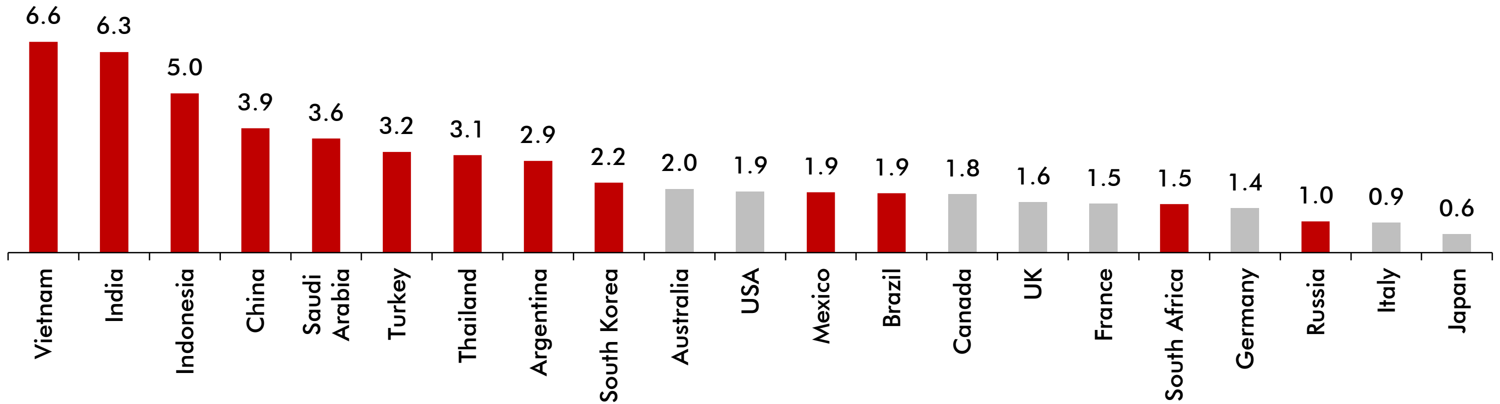
Exhibit 30: ...while share of DM in global GDP is coming off



Source: Bloomberg, Ambit Capital research as on 29 Feb'24. Note: DMs constitute Australia, USA, Japan, Germany, UK, France, Italy and Canada. EM is World ex DM

The odds are stacked in favour of relative outperformance of EM over DM over next few years, especially when global growth is expected to slow and EMs are expected to drive global growth. Also, there is positive divergence between EMs' GDP and Mcap contribution. Amongst major DM and EM countries, India is expected to be the second-fastest growing nation over the next 5 years with EMs dominating the top half of the list.

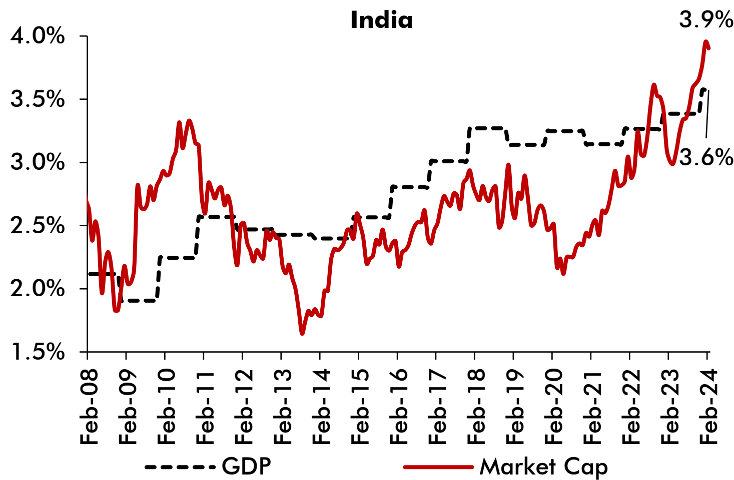
Exhibit 31: Can India lead the convergence? Yes, India is poised to be second-fastest growing economy over the next 5 years



Source: Bloomberg, Ambit Capital research. Note: Countries marked in red indicate EMs and those marked in grey indicate DMs

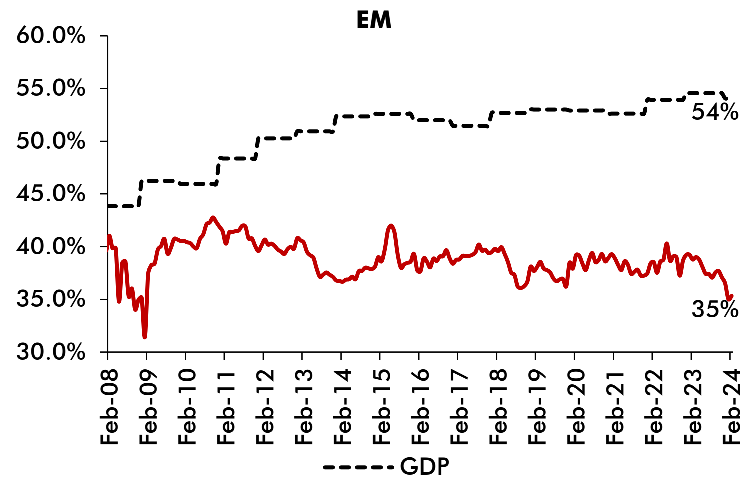
EMs contribution to GDP expanded ~10% over CY08-24 but its share in global market cap declined from 41% to ~35%. Divergence between Mcap and GDP contribution persist for EM ex-China Universe as well, so don't attribute this divergence to underperformance of China which has given 2% return over the last decade.

Exhibit 32: India's share of global Mcap has been steadily rising over last decade



Source: Bloomberg, Ambit Capital research as on 29 Feb'24

Exhibit 33: EM share of global Mcap has declined



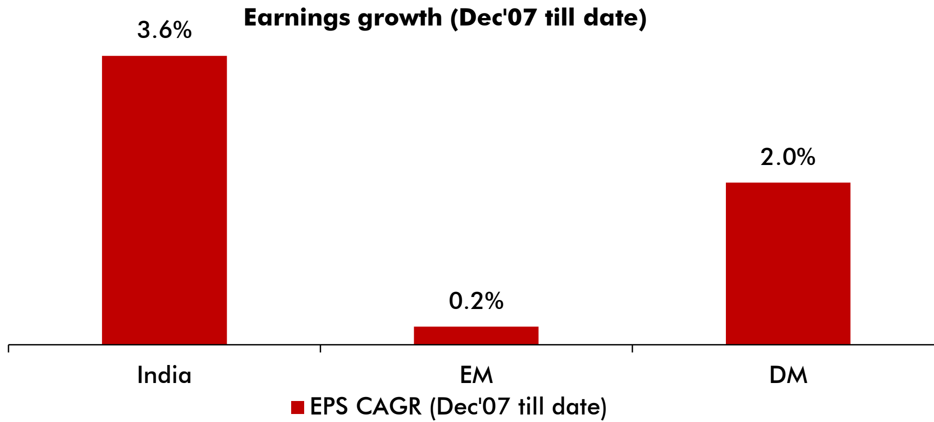
Source: Bloomberg, Ambit Capital research as on 29 Feb'24. Note: EM is World ex DM.

A Counter argument

GDP growth and corporate earnings growth can diverge, with unlisted segment also getting captured in GDP. This is especially true for EMs. Despite higher GDP growth since 2007, market capitalization of EMs has declined compared to DMs. Digging deeper, we find negligible EPS growth ~0.2% for EM since 2007, while DM earnings growth ~2% outpaced EMs. This can probably explain the divergence between Mcap and GDP of EMs.

During the same period, India stood out amongst its EM peers with earnings growth ~3.6%, second only to China ~3.9%.

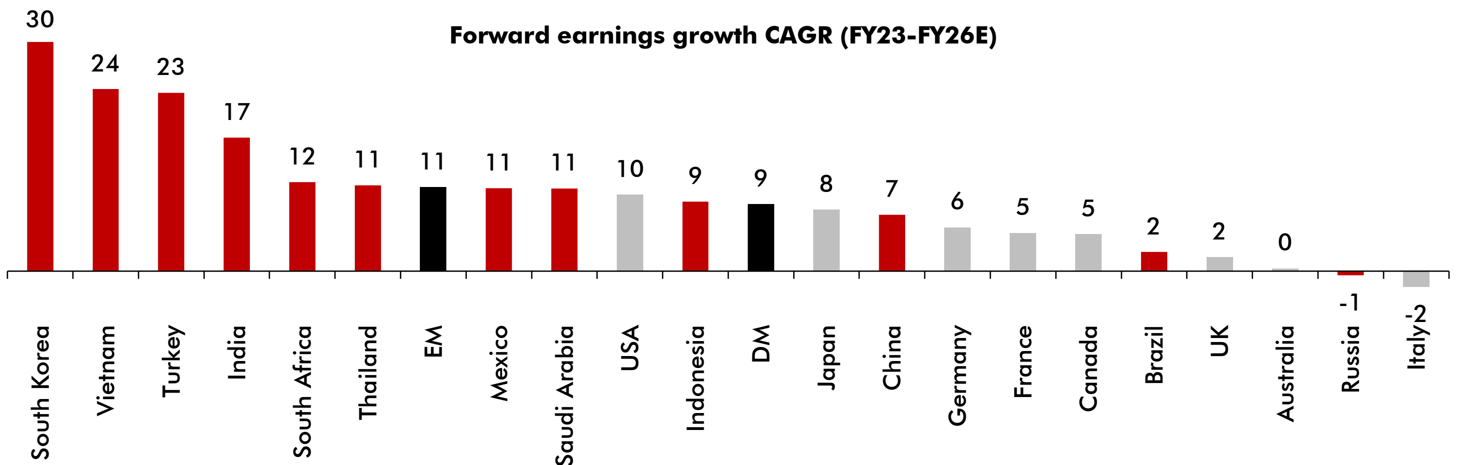
Exhibit 34: EM earnings growth far lower than DMs, causing a drag in Mcap growth



Source: Bloomberg, Ambit Capital research. Latest data as on 01 March'24.

But forward earnings growth (FY23-FY26) is also tilted in the favour of EMs with EMs dominating the top-half of the list, whereas most DM countries feature in bottom half.

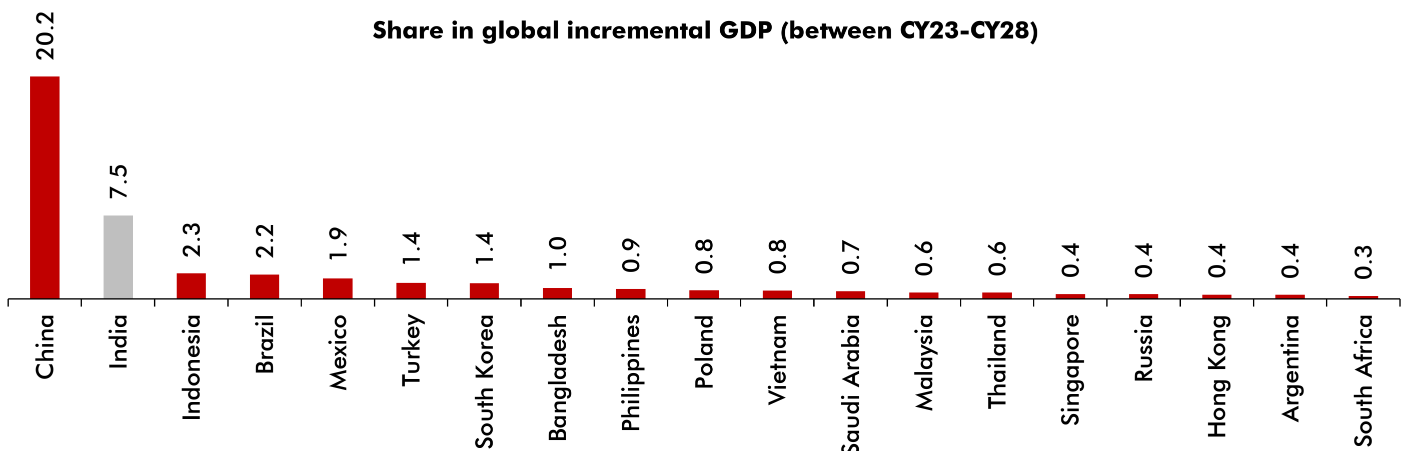
Exhibit 35: Earnings growth Monitor: Majority of EMs are expected to do better than DMs



Source: Bloomberg, Ambit Capital research. Latest data as on 01 March'24.

EMs are the growth engine. With EMs projected to contribute bulk of the incremental global GDP growth, among emerging market peers, India projected to be the second largest contributor to global GDP in the next 5 years.

Exhibit 36: Among EMs, India projected to be the second-largest contributor to global GDP in the next 5 years

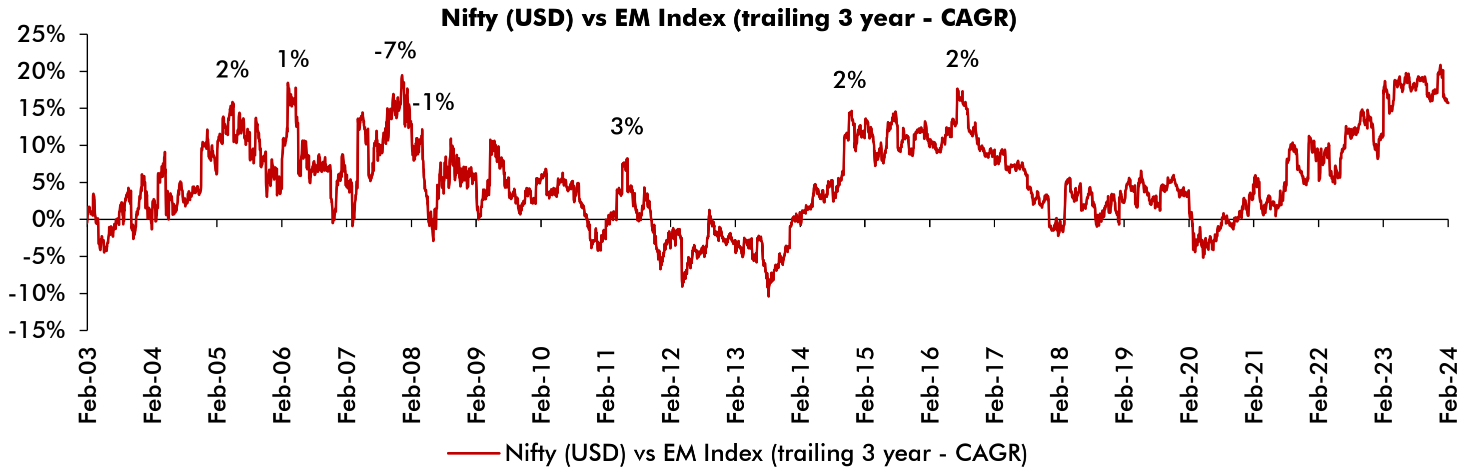


Source: IMF, Ambit Capital research. Note- Data only includes emerging economies. Latest data as on 29 Feb'24

The big question - Can India's outperformance continue in EM outperformance?

The stellar run of Nifty index in CY23 has driven outperformance of Nifty w.r.t emerging markets in the vicinity of 20% on a 3-year basis. Historical evidence suggests such periods of outperformance can continue over the subsequent 12 months. The momentum can persist. Moreover, periods of Nifty underperformance compared to the EM index are few and far between. Especially over the past decade, Nifty rarely lagged the EM index as outperformance continued over extended periods of time.

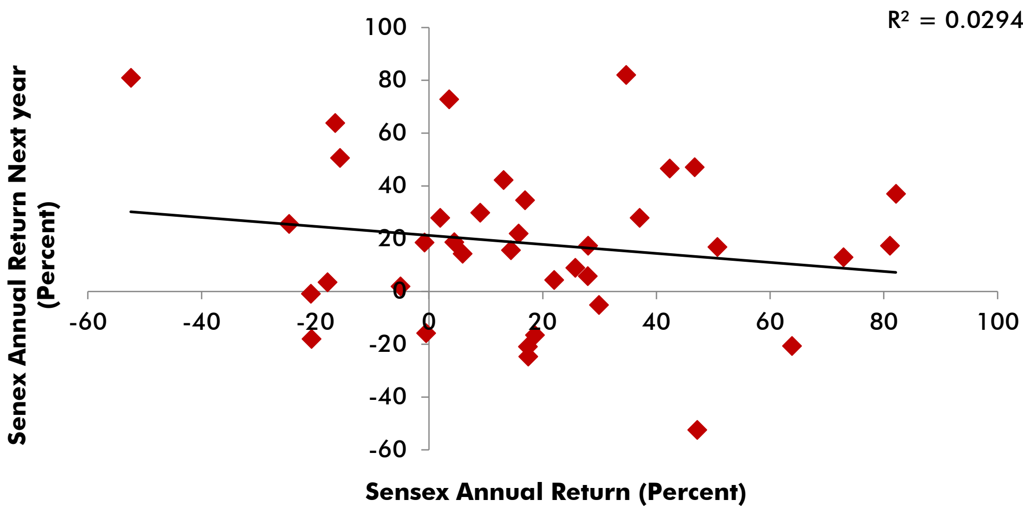
Exhibit 37: Nifty outperformance w.r.t EMs has often continued on a 3-year basis



Source: Bloomberg, Ambit Capital research. Note: Returns on peaks are 12m forward returns differentials between India and EM. Latest data as on 29 Feb'24

Also, an extraordinary year for Indian equities doesn't necessarily means a quiet year. So, India's outperformance can continue in this likely EM outperformance.

Exhibit 38: Exceptional CY23 for Indian equities doesn't necessarily mean a quiet CY24



Source: Ace Equity, Ambit Capital research

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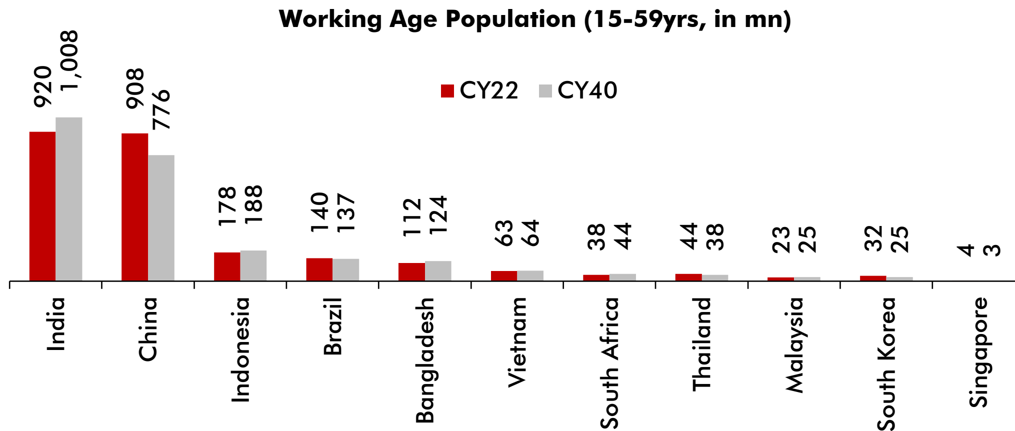
Why EM outperformance can be led by India

1. Population dividend

According to **media reports**, India overtook China to become the most populous country in CY23. India's population, at 1.4bn, is also much younger than China as median age in India is 28 vs 38 in China. Based on UN's population forecasts, India's working age population alone will cross a billion in the next 15 years, providing India with a significant population dividend.

Exhibit 39: Among major EMs, India will have the largest working age population

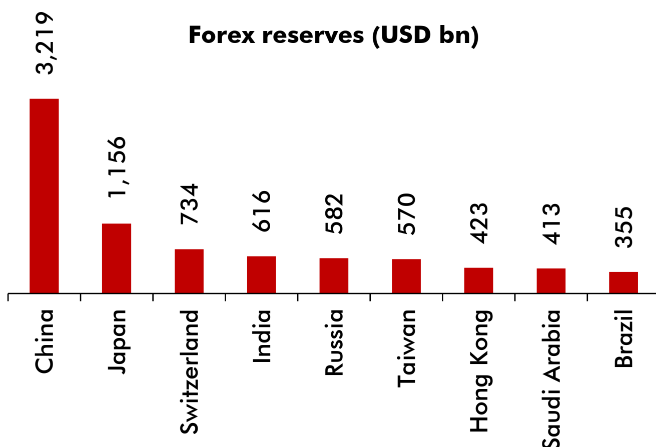


Source: UN Population Prospects, Ambit Capital research

2. Strong external position

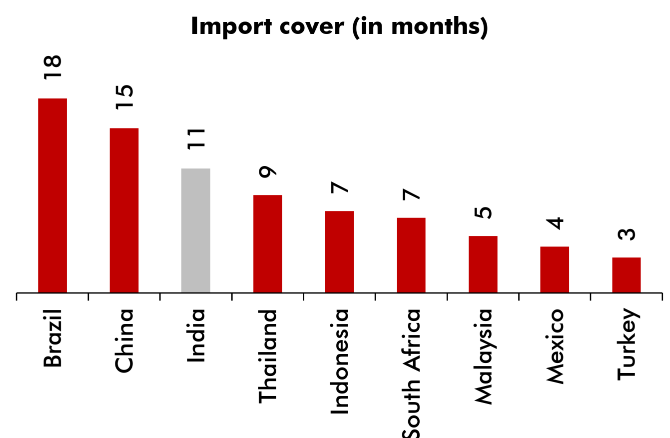
RBI has built huge forex reserves to protect the economy from external volatility, specifically hot EM flows and volatile dollar movements.

Exhibit 40: India has one of the largest forex reserves in the world…



Source: Bloomberg, Ambit Capital research. Note- Data as on end of Jan'24

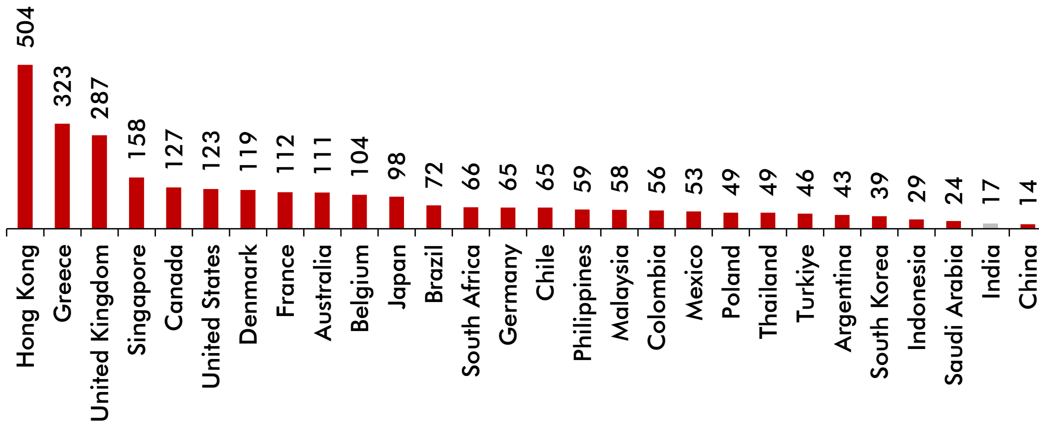
Exhibit 41: … as it is in a stronger position against external vulnerabilities



Source: Bloomberg, Ambit Capital research

The Indian government has been able to raise funds for its borrowing requirements domestically as there has historically been a discomfort related to foreign ownership of public debt. India's external general government debt is only ~5% of overall general government debt. By having a small proportion of external debt, the government is protected by currency bond risks.

Exhibit 42: India has one of the lowest external debts among EMs and DMs



Source: Media Articles, Ambit Capital research

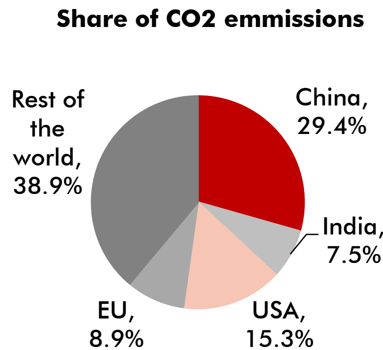
3. China +1 opportunity

After the Covid-induced supply chain crunch, many countries, especially among DMs, realized they need to diversify their manufacturing base and set up plants in other low-wage manufacturing countries. Among the countries that may benefit, India seems to be a major contender. Schemes such as PLI has already seen major manufacturing corporates such as Foxconn, Wistron, and Samsung increase their presence in India. China is the largest CO2 emitter and has been paying attention to its pollution problems in the last 5 years. It has taken several steps, including shutting down industries that don't comply with the environmental norms, to setting up carbon trading markets.

Exhibit 43: China's manufacturing wages are ~2x that of India

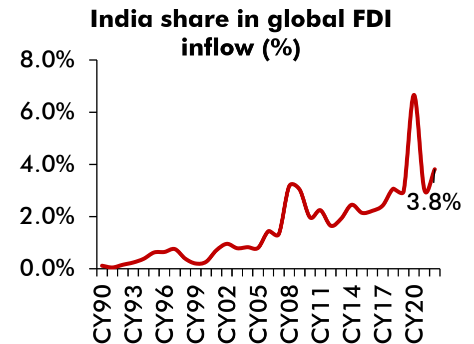
Source: Jetro Survey, Ambit Capital research

Exhibit 44: China is the largest emitter of carbon



Source: Carbon Project, Ambit Capital research

Exhibit 45: India has seen rising share in global FDI inflows

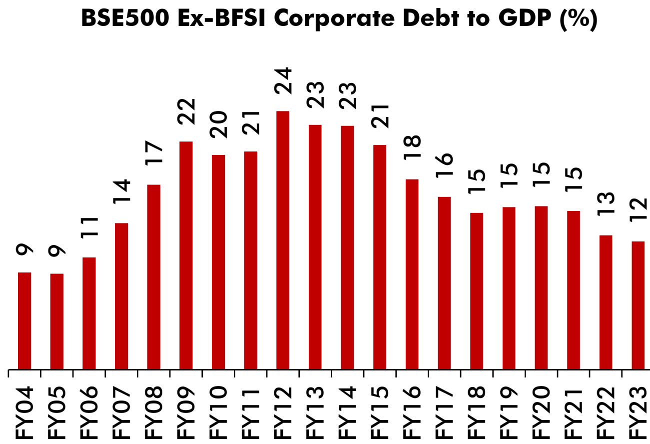


Source: World Investment Report, Ambit Capital research

4. Corporates in a position to undertake huge capex

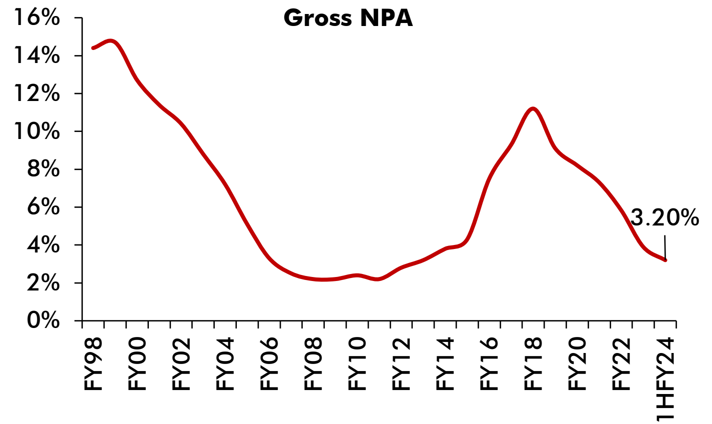
The question is not whether corporates can undertake capex; it is rather when they will undertake capex. As RBI reduced policy rates to a decadal low during Covid, corporates used it as an advantage to clear their debts and emerged out of the pandemic with stronger balance sheets. Similarly, during the IL&FS crisis in FY18, bank NPAs at 11.4% was the highest in almost 17 years. In the last few years, NPAs fell to record low levels.

Exhibit 46: Corporate debt is lowest since FY07



Source: ACE equity, Ambit Capital research

Exhibit 47: GNPA was recorded at a decadal low

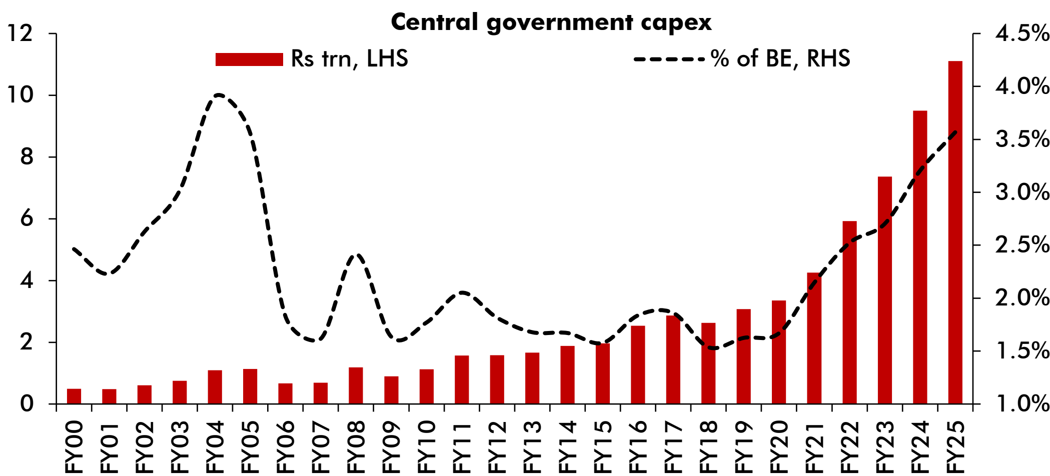


Source: RBI, Ambit Capital research

5. Central government capex: Focus on Infrastructure

Since FY21, government has significantly increased its capex. While road and railways have been the beneficiaries, ~8mn houses have been constructed under the Pradhan Mantri Awas Yojana. Government has doubled the capacity of ports and number of operational airports in last 9 years. Research suggests, capex has huge multiplier effect as 1₹ of capex brings in benefit worth ₹2.45 to the GDP in same year and ₹4.8 in next 7 years

Exhibit 48: Centre has increased its support to economy through higher capex allocation

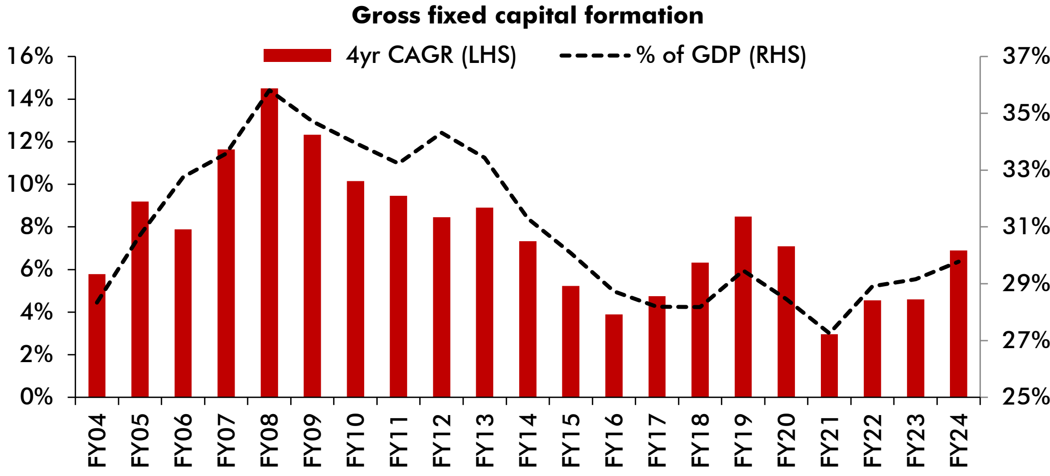


Source: Union Budget Documents, MoSPI, Ambit Capital research

6. Gross Fixed Capital Formation on the rise

Centre and states both have undertaken impressive capex in FY24YTD. Private capex too is seeing some green shoots. A major driver of gross fixed capital is the construction sector, driven not just by rail and roads but also real estate projects which are on the rise due to rising demand from major urban cities.

Exhibit 49: India is witnessing a rise in gross capital formation



Source: MoSPI, Ambit Capital research

Where are the markets heading?

Our analysis suggests that when (>=90%) of NSE500 index stocks trade above 200 DMA, market momentum continues in 83% of the instances and delivers ~12% returns over the next 6 months. After 2010, there has not been a single instance when forward 6-month returns were negative if the market breadth satisfied the above condition. Also, market returns are usually robust leading up to general elections with Banks and O&G leading the rally. Has it reached the zone of irrational exuberance? It is significant distance away. There is excess but no euphoria. While EYBY Gap stands at -2.86 in Feb'24 worse than 10-year median of -2.7, it is far away from threshold at which a sell signal can be called out (-3.5). At this level, the probability of market correction is very high. Though our Mcap/Money supply (M2) indicator appears more bearish. Historically, whenever the ratio exceeded 6x, Nifty posted negative 12M returns. Currently, it stands at 6.7x.

What happens when every laggard runs up?

A proxy for this can be "no. of index constituents" trading above 200 DMA. The idea is to look at market reaction after a significant portion of NSE500 index stocks (>90%) have moved above 200 DMA.

Currently, 75% of the NSE500 members trade over 200 DMA. Since 2002, there were 634 daily instances when the % of NSE500 index constituents trading above 200 DMA was >90%. We note that **83% of the times market delivers positive returns over the next 6 months with average/median returns of ~12%.**

The last time NSE500 members trading above 200DMA was > 90% was on January 15, 2024. Market momentum to continue until July? We highlighted this in Jan-24

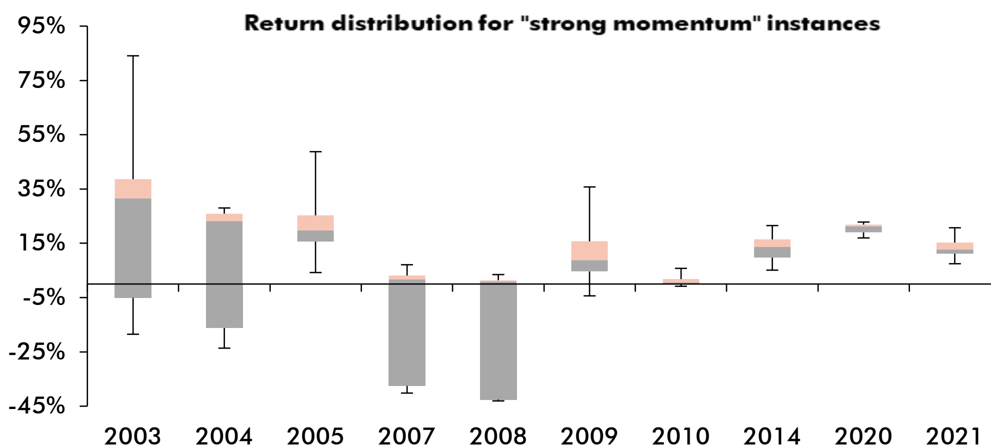
Exhibit 50: NSE500 performance when index constituents (%) trade above 200DMA >90%

	NSE500 performance over next...					
	1m	**2m**	**3m**	**4m**	**5m**	**6m**
Average	2.2%	4.4%	7.0%	9.2%	10.5%	12.1%
Median	2.6%	3.8%	7.1%	9.4%	11.0%	12.7%
No. of instances with positive returns	438	457	512	539	537	529
% of instances with positive returns	69%	72%	81%	85%	85%	83%

Source: Bloomberg, Ambit Capital research.

More importantly, after 2010 there has not been a single instance when next 6-month returns were negative. The last time that index constituents trading above 200DMA was >90% and 6M forward returns were negative was in Jan 2010. While valuations are expensive, they are sanguine as compared to 2007-08. There can be a small pullback over the next 2 months, but the trajectory remains strong. Also, market returns are usually robust leading up to general elections with banks, O&G and real estate dominating.

Exhibit 51: Since 2010, 6M fwd. returns have always been positive in these cases



Source: Ace Equity, Ambit Capital research Note: No such instances in 2006, 2011-13 2015-19 and 2022.

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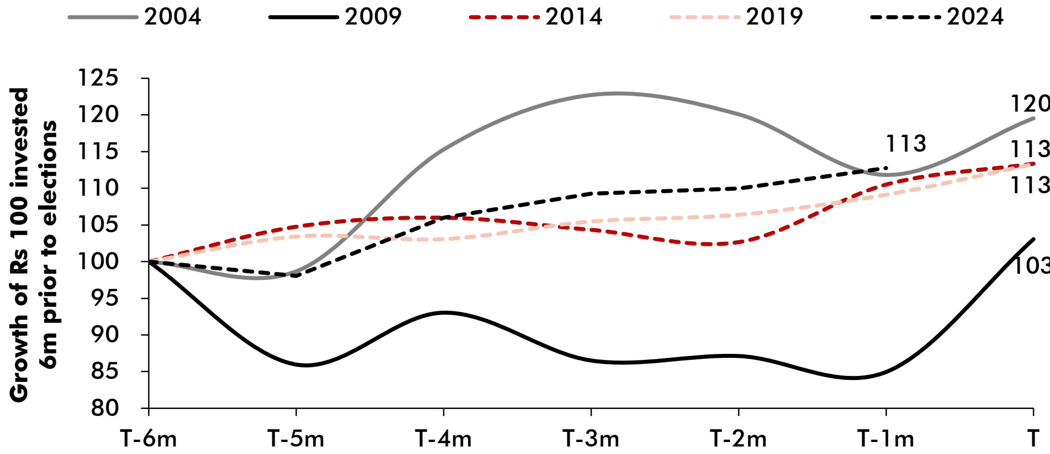
What happens prior to general elections?

The market remains strong and sentiment is often bullish. This makes sense as weak market performance can influence investor sentiment if portfolio performance worsens significantly. In 3 out of 4 prior instances, market trend was decisively upwards and even this time, nifty has delivered 13% over last 5 months.

Exhibit 52: Nifty performance 6 months prior to elections



Source: Bloomberg, Ambit Capital research. Note: For 2024, performance is as on 01 March'24

Exhibit 53: Pre-election: Banks, Realty & O&G lead the rally

Sector	2004-19		2004-19 (ex-09)	
	Average	Median	Average	Median
IT	9%	9%	12%	11%
Metal	7%	11%	5%	10%
Realty	11%	22%	29%	29%
Bank	17%	22%	26%	24%
Media	-2%	-5%	2%	2%
Auto	10%	10%	9%	9%
Finance	11%	20%	21%	21%
FMCG	4%	6%	3%	1%
O&G	20%	15%	22%	15%
Pharma	1%	1%	5%	4%

Source: Bloomberg, Ambit Capital research ; 6m returns leading up to elections

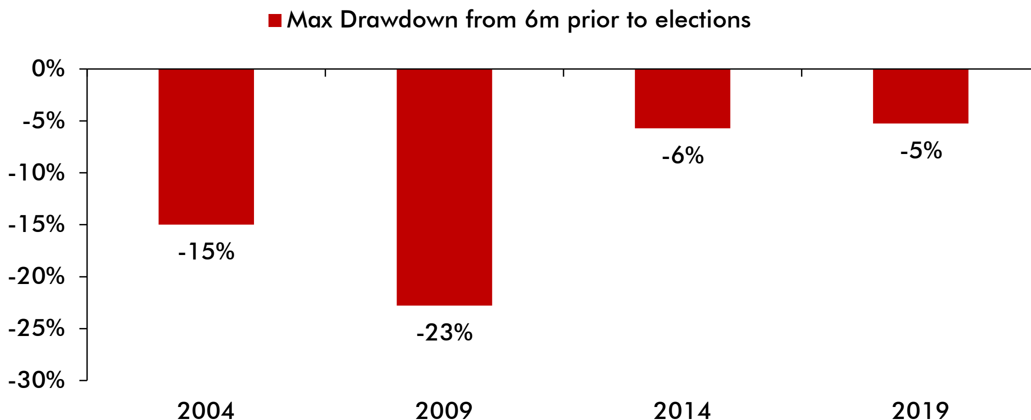
Exhibit 54: Post-election: IT has witnessed strongest return

Sector	2004-19		2004-19 (ex-09)	
	Average	Median	Average	Median
IT	30%	27%	17%	25%
Metal	27%	13%	3%	6%
Realty	36%	8%	3%	3%
Bank	14%	1%	-5%	-5%
Media	19%	12%	-5%	-5%
Auto	21%	9%	3%	-9%
Finance	16%	5%	-1%	1%
FMCG	11%	5%	3%	2%
O&G	5%	0%	-2%	0%
Pharma	14%	17%	7%	1%

Source: Bloomberg, Ambit Capital research; 6m returns leading up to elections

Barring the 2009 elections which coincided with GFC aftermath, usually the market stays very resilient. The drawdowns may provide opportunity but were limited in 2014/19

Exhibit 55: Drawdowns have been limited in the last 2 instances



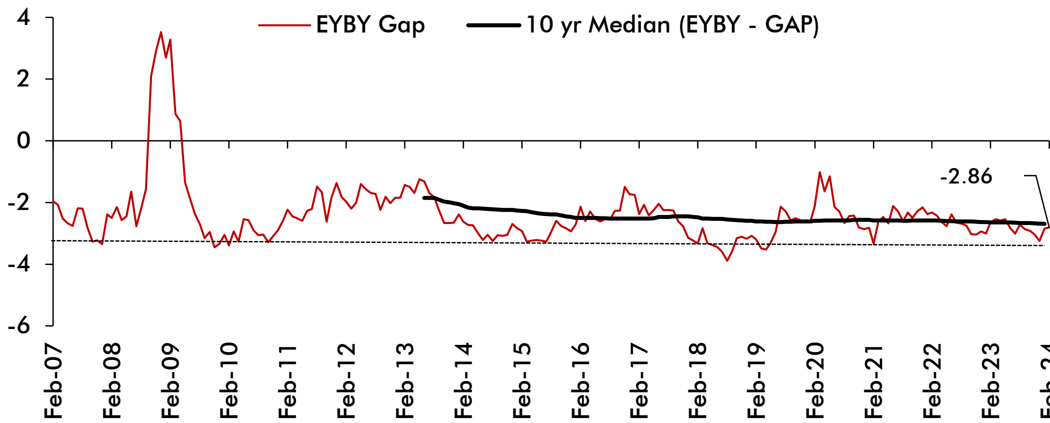
Source: Bloomberg, Ambit Capital research

What can happen after elections?

With Nifty rallying 20% in CY23, have we reached the zone of irrational exuberance? No, there is excess but no euphoria. While EYBY Gap stands at (-2.86) in Feb'24 worse than 10-year median of -2.7, it is a significant distance away from EYBY Gap threshold level (-3.5) when market correction become extremely probable. At current TTM EPS (INR934) and 7% yield, it translates to Nifty levels of 26700. Since Dec-23, EYBY Gap has improved from -3.25 as yields came off and TTM earnings expanded.

In our note "EYBY Gap- Addressing your pertinent queries", we highlighted that trailing EYBY gap above 0 or below -3.7 is extremely rare. Lower the number, equities are more unattractive (and vice-versa) as compared to bonds, which manifests in higher probability of a market correction.

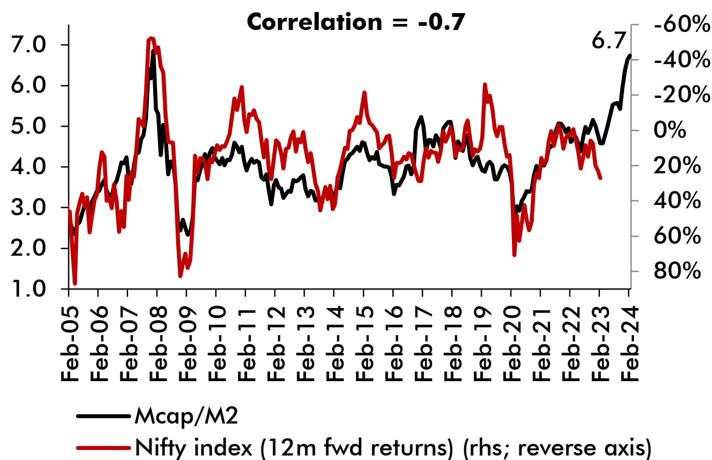
Exhibit 56: At EYBY Gap below -3.5, markets have corrected most number of times. Median 10-year EYBY Gap is -2.70



Source: Ace Equity, Bloomberg, Ambit Capital research

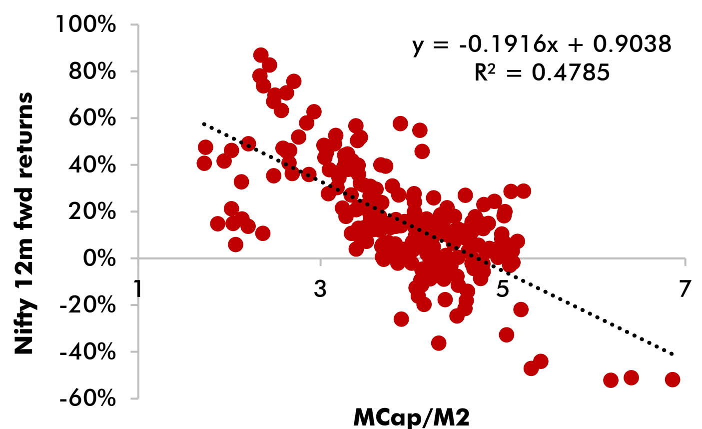
But our Mcap/M2 valuation indicator appear more bearish. As RBI has been firmly focused on taming inflation through synchronized monetary tightening, money supply (M2) has contracted over past 2 years, leading to expansion in broad money chasing market (MCap/M2) ratio, which currently stands at 6.7x, 2nd highest since 2003. Historically, there has been strong negative correlation (-0.7) between (MCap/M2) & Nifty 12M fwd. returns, suggesting that market returns would contract as money supply recedes. Only 3 times, it has exceeded 6x & each time Nifty posted negative returns (12m).

Exhibit 57: Mcap/M2 appears expensive at 6.7x



Source: Bloomberg, Ambit Capital research; Latest data as of 29th Feb-24

Exhibit 58: A correction appears likely



Source: Bloomberg, Ambit Capital research; Latest data as of 29th Feb-24

The wind is changing

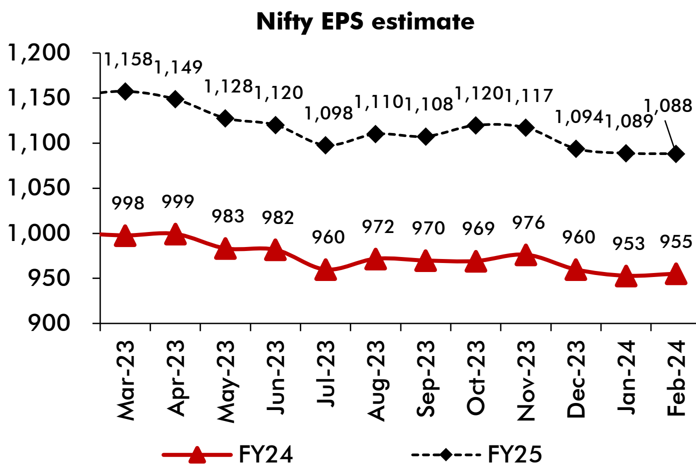
While top-line growth has been muted since 1QFY24, margin expansion driven by elevated CPI-WPI spread has flown into the bottom-line. The margin expansion lever may recede as CPI-WPI spread compresses with WPI rising and CPI moderating. In 3QFY24, the number of companies delivering positive earnings surprise was the lowest since Mar-20 and NSE500 EPS surprise (-4%) was worst in the last 4 quarters. Nifty earnings estimate trajectory can worsen significantly if these trends accelerate. We highlight stocks which can lead further downgrades in FY25 EPS estimates.

Evolution of earnings

While Nifty FY24 EPS/FY25 EPS estimate trajectory remains in line with history, it's not the same as FY21-22. Since FY12, Nifty earnings estimates have usually been revised downwards every year as we move into the year. Our analysis indicates that in any financial year, EPS estimates have, on average, been revised downwards by 16% over the last 2 years (t-24 to t) and by 8% on average over the last 1 year. Nifty FY24 estimate has been revised downwards by 4.3% since Mar-23.

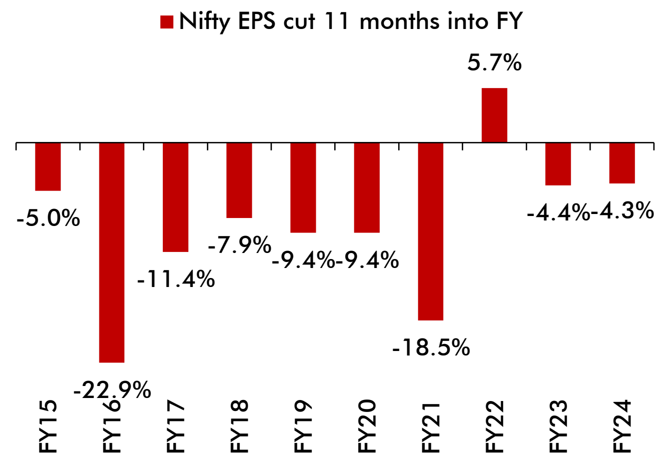
In May-23, IT, Metals and Reliance were expected to contribute ~20% of incremental EPS growth. Currently, their contribution is -7%.

Exhibit 59: Nifty FY24/25 earnings estimate has been cut by 1.5%/1.8% since September-end



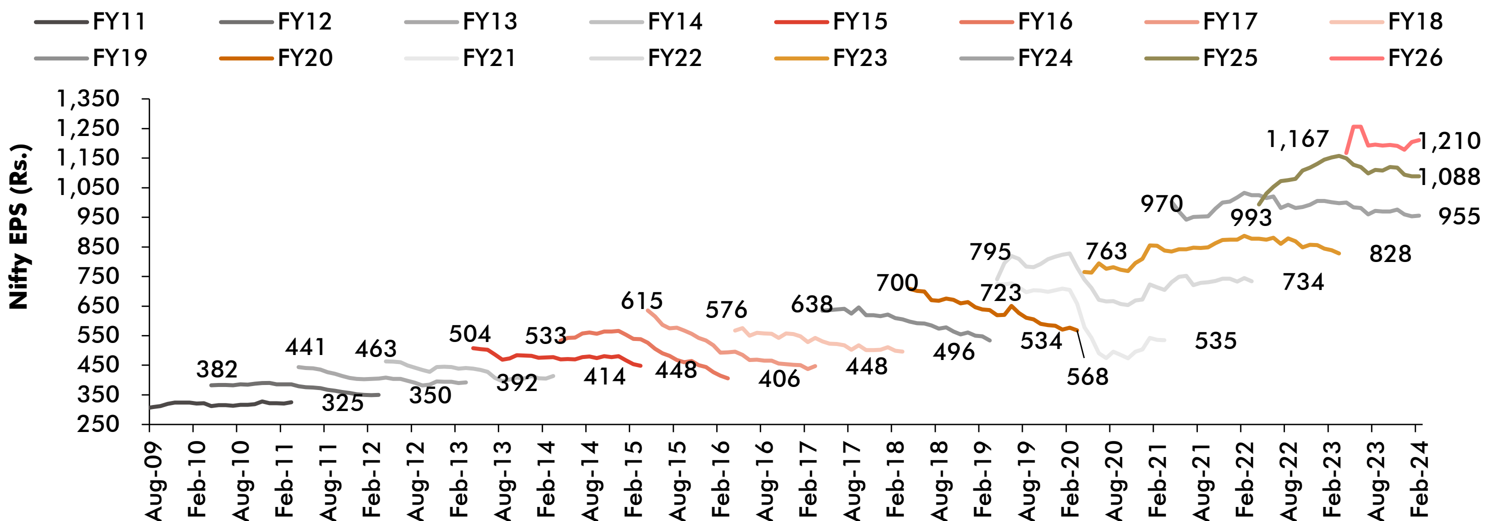
Source: Bloomberg, Ambit Capital research; Note: Latest data as of 01 Mar'24

Exhibit 60: EPS trajectory no longer same as in FY22-23



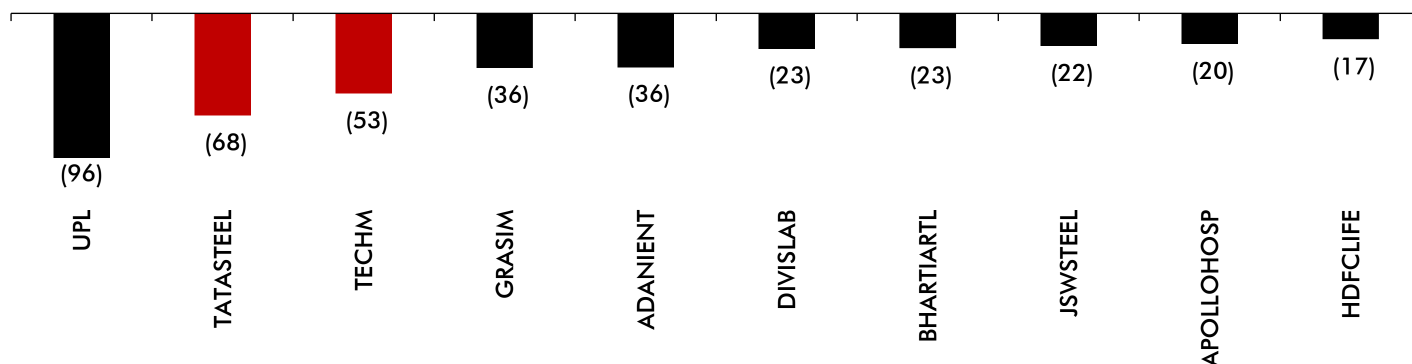
Source: Bloomberg, Ambit Capital research; Note: Latest data as of 01 Mar'24

Exhibit 61: Optimism in the market has begun to fade



Source: Bloomberg, Ambit Capital research

Exhibit 62: Biggest downgrades in FY24



Source: Bloomberg, Ambit Research. Note: Data as of 01 March'24. Stocks marked in red are a part of G&C.

"Growth Engine-BFSI" slowdown and earnings cuts in other sectors can drive

Nifty FY24 "earnings growth" contribution analysis comparison between May-23 and Jan-24 suggests that BFSI continues to hold fort along with O&G and Auto. The downgrades in IT, Consumer, Metals and Chemicals were the highest.

Exhibit 63: Earnings Growth Contribution Analysis - May'23: Since then, BFSI, Auto and O&G have held fort

Sector	Free float Weight	Contribution to Earnings Growth (%)		
		FY23	FY24E	FY25I
BFSI	38%	195%	42%	43%
IT	13%	20%	7%	10%
Oil and Gas	12%	-42%	14%	8%
Consumer	11%	0%	4%	5%
Auto / Auto Anc.	6%	58%	13%	8%
E&C / Infra / Cap. Goods	5%	14%	5%	6%
Metals and Mining	3%	-174%	5%	8%
Utilities	2%	-4%	2%	2%
Pharma	3%	22%	2%	3%
Cement	2%	-8%	1%	1%
Telecom	2%	12%	3%	5%
Retail	1%	4%	0%	1%
Healthcare	1%	-1%	0%	0%
Chemicals	0%	4%	1%	1%

Source: Bloomberg, Ambit Capital research

Exhibit 64: Earnings Growth Contribution Analysis - Feb'24: More cuts in Nifty FY24/25 expected

Sector	Free float Weight	Contribution to Nifty EPS growth		
		FY23E	FY24E	FY25E
BFSI	33%	190%	63%	41%
IT	14%	25%	-3%	11%
Oil & Gas	12%	-50%	16%	1%
Consumer	10%	3%	1%	4%
Auto / Auto Anc.	7%	72%	16%	6%
E&C / Infra / Cap. Goods	6%	7%	4%	7%
Metals & Mining	4%	-174%	0%	13%
Pharma	4%	22%	2%	2%
Telecom	3%	11%	2%	6%
Utilities	3%	-1%	1%	2%
Cement	2%	-8%	2%	2%
Retail	2%	3%	0%	1%
Healthcare	1%	-1%	0%	1%
Chemicals	0%	-1%	-3%	2%

Source: Bloomberg, Ambit Capital research; Note: FY23 numbers are different than the published May'23, owing to the completion of 4QFY23 earnings results, Latest data as of 29 Feb'24

Which stocks/sector can lead the downgrades?

These are those Nifty stocks where our earnings estimates have the largest divergence from the consensus and on majority of them, we have been more accurate that street for FY24 earnings estimates.

Exhibit 65: Earnings Estimate Divergence - Ambit vs Consensus: L&T, KMB and LTI Mindtree stand out

Company Name	Ambit EPS estimate (₹)		Consensus EPS estimate (₹)		Ambit v/s Consensus		Weight in index
	FY24E	FY25E	FY24E	FY25E	FY24E	FY25E	(%)
L&T	91	101	96	123	-5.0%	-17.5%	4.3
Kotak Mahindra Bank	64	60	65	73	-1.6%	-17.5%	2.6
LTI Mindtree	157	167	160	187	-1.7%	-10.7%	0.5
Bajaj Finance	226	268	235	300	-3.7%	-10.5%	1.9
Divi's laboratories	58	72	59	78	-2.6%	-7.6%	0.5
TCS	127	131	127	141	0.3%	-7.5%	4.3
Wipro	20	22	21	23	-1.5%	-6.2%	0.8
RIL	108	116	106	124	2.2%	-6.0%	10.3
UltraTech	265	301	252	315	5.1%	-4.6%	1.2
BPCL	117	57	128	60	-8.7%	-4.5%	0.6
Infosys	59	64	59	67	-0.9%	-4.3%	6.2

Source: Bloomberg, Ambit Capital research

Exhibit 66: How accurate were our analysts for these companies? Reasonably so...

Company	FY24 EPS estimate INR (1st Apr'23)			FY24 EPS estimate INR (current)			Cuts since 1st Apr'23	
	Ambit	Consensus	Deviation	Ambit	Consensus	Deviation	Ambit	Consensus
Kotak Mahindra Bank	50	59	-15%	64	65	-2%	28%	10%
L&T	**86**	**98**	**-12%**	**91**	**96**	**-5%**	**5%**	**-2%**
RIL	**111**	**124**	**-10%**	**108**	**106**	**2%**	**-3%**	**-15%**
Infosys	**65**	**68**	**-4%**	**59**	**59**	**-1%**	**-10%**	**-13%**
TCS	**126**	**132**	**-4%**	**127**	**127**	**0.3%**	**1%**	**-4%**
Bajaj Finance	218	227	-4%	226	235	-4%	3%	3%
LTI Mindtree	**170**	**175**	**-3%**	**157**	**160**	**-2%**	**-8%**	**-9%**
Wipro	**23**	**24**	**-2%**	**20**	**21**	**-1%**	**-12%**	**-13%**
Divi's laboratories	81	78	5%	58	59	-3%	-29%	-23%
BPCL	**48**	**41**	**15%**	**117**	**128**	**-9%**	**145%**	**208%**
UltraTech	321	263	22%	265	252	5%	-17%	-4%

Source: Bloomberg, Ambit Capital research. Note: Stocks marked in bold indicate the stocks in which our analysts have been more accurate on FY24 EPS estimates

We have highlighted these stocks in above exhibit where our analysts have been more accurate than street and highlight our reasoning behind the divergence with consensus for FY25 estimates.

L&T

Our analysts forecast lower EPS growth than consensus as we foresee a slowdown in domestic infra segment execution after the 2024 general elections. This is in line with historical trends where government capex slows down after elections leading to NWC inching up too. Even as the company surprised on order inflow from the Middle East hydrocarbon segment, execution will be slower than normal given that Saudi Aramco is pausing on its production capacity increase targets.

Kotak Mahindra Bank

Our analysts maintain significant discount (~17%) to consensus FY25E earnings. This is due to lower NIM (5% lower) and higher provisions (contribute to 10% lower earnings). We expect loan growth to come at a cost of margin decline due to evolving liability franchise and higher SA/TD rate (50bps higher than ICICI/AXSB). Sharp pick-up in unsecured loans will result in credit cost settling higher than long-term average at 85bps with limited buffer provisions.

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LTI Mindtree

LTIM disappointed on growth in the past 4 out of 5 quarters. Weak growth outlook for 4QFY24/1QFY25 drive lower-than-consensus growth. Pivot to large deals is unlikely to be costless, driving lower than consensus margins. The company will have to relax optimized offshoring, increase near historical low SG&A, has limited utilization scope and might have to go for carve-out/people takeover deal flow to drive improved growth. This drives lower earnings versus consensus.

Bajaj Finance

Consensus expectations on growth likely ignore the impact of BAF increasingly relying on more competitive segments for growth as well we regulatory headwinds to unsecured portfolio. Lower NIMs and higher credit cost drive lower-than-consensus EPS estimates. On NIM, the street is likely underestimating the impact of rising cost of borrowings, not fully factoring in increases in MCLR, impact of higher risk weight on loans to NBFCs and marginal NCD cost being higher than book cost. Increasing stress in unsecured products as well as others, partly due to upward normalization of stress ratios, will keep credit cost elevated.

Divi's Laboratories

We stand lower than consensus on EBITDA and EPS despite being inline on revenues. We expect margin recovery to pre-Covid levels in APIs to be a more gradual process given pricing pressure seen in this segment in the recent past.

TCS

We are lower than consensus on growth due to higher skew towards slowdown prone segments (BFSI/Retail/Hitech/Europe). LTM deal win growth of 12% in a rising duration scenario keeps us unconvinced of a sharper acceleration. We see risks of growth versus margin trade-off and after 4Q operating leverage could reduce with lower than pre-Covid levels of sub-con, limited utilization scope and dilutive deal flow.

Wipro

Weaker positioning and discretionary pullbacks could keep growth depressed. We are not convinced on a material growth rebound driving lower-than-consensus growth. Margin increases look difficult as the company needs to invest to reduce growth gap and operating levers are limited.

Reliance

In the case of RIL's FY25E EPS, we are about 5% lower vs consensus as we remain circumspect about the company's consumer businesses. We are building higher DD&A due to increasing amortization of the spectrum, amortization of capitalized project development expenditure in retail and higher upstream production. Also, our finance costs are higher due to expectations of elevated debt levels. The consensus numbers have been range-bound for the last 12 months, and we believe that there is limited scope for consensus upgrades now as we don't expect a repeat of FY23 in the O2C business.

UltraTech

India has had 3 years of robust demand growth, recovering from muted demand in FY20/21. But going into FY25, there are two headwinds: 1) post-election demand moderation and 2) lagged impact of below-normal monsoon on rural demand. In the past two decades, demand growth moderated in each post-election year barring FY10. There is also a threat to pricing power given likely 27MT/54MT clinker/cement addition in FY25. We believe there is downside risk to consensus estimates on profitability and volume growth.

Infosys

Caution on sectoral demand and high sequential growth ask rates given weak 4Q exit drives lower growth expectations versus street. We see margin declines versus margin increases in street as utilization scope will get used up by 4Q itself, hiring will have to re-start, pyramiding is not an incremental lever, historical low SGA might have to be raised in a less abundant demand situation and travel savings could reverse. In addition, large deals could be dilutive to margins.

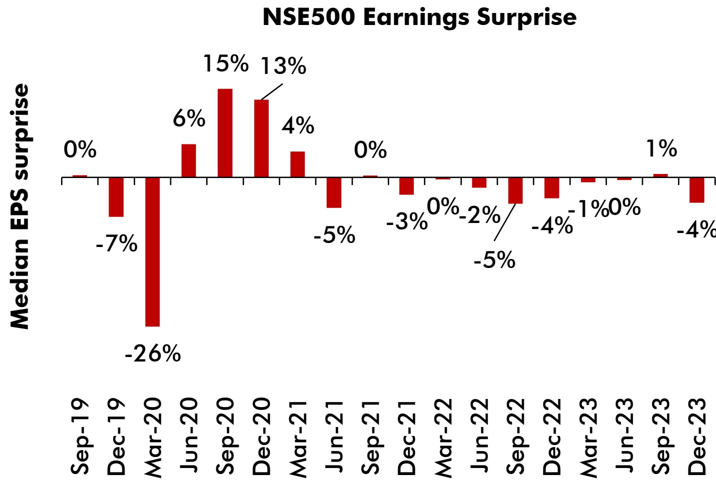
BPCL

We are below consensus for FY24-25E due to lower marketing margin assumptions. We are building gross marketing margin of ₹5.3/₹3.7 per litre; this is 13%/5% lower than consensus and could be because of higher Brent price estimates or/and higher price cuts.

Are earnings surprises slowing down?

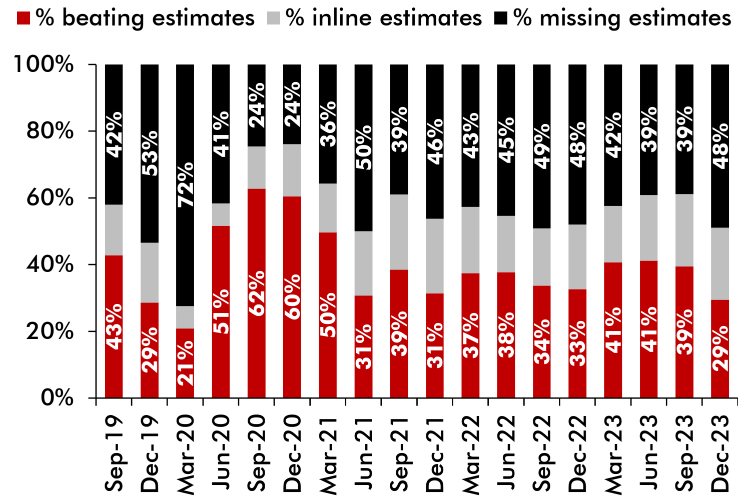
The 3QFY24 reporting season was weak, with the number of companies delivering negative earnings surprise significantly exceeding those delivering positive earnings surprise. The percentage of companies delivering earnings surprise was the lowest ever since Mar-20. This is significantly worse as compared to recent history. On an aggregate level, NSE500 earnings surprise stands at -4%, the worst in the last 4 quarters. This is expected going ahead as "margin expansion" lever would recede, a point which we have highlighted in detail.

Exhibit 67: Earnings surprise in 3QFY24 worst since 3QFY23



Source: Bloomberg, Ace Equity, Ambit Capital research.

Exhibit 68: The wind is changing

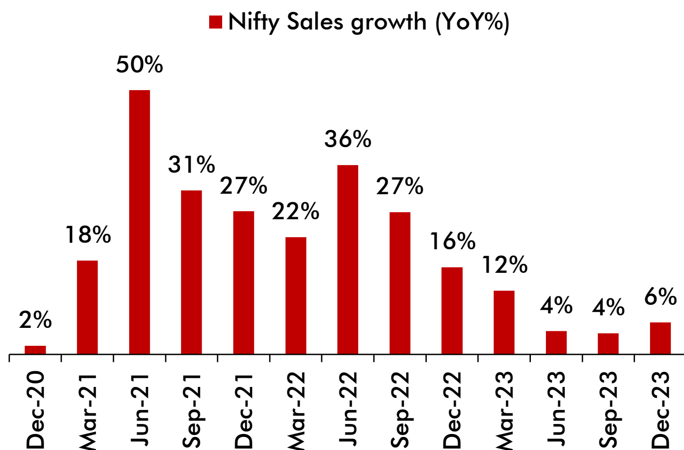


Source: Bloomberg, Ace Equity, Ambit Capital research. Note: Positive or Negative Earnings surprise is calculated as >5% or <-5% difference in the quarterly estimate at the end of the quarter v/s the actual reported numbers for the NSE500 constituents as of every quarter end.

What's causing this? Margin expansion lever receding?

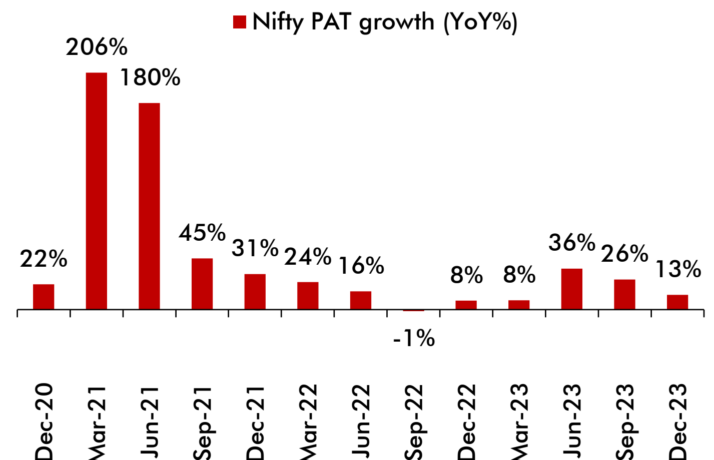
Net sales for Nifty is grew by 6% YoY in Q3FY24, in line with previous quarters. While topline growth has been muted over the last few quarters, the bottom-line growth has been driven by margin expansion. In FY23, PAT growth lagged despite high revenue growth weighed down by gross margin compression as WPI stay elevated. We are now witnessing the reversal. Revenue growth subdued in FY24, PAT growth was substantial in Q1 and Q2FY24 with moderation witnessed in Q3FY24. The margin expansion lever might no longer be available as the CPI-WPI spread begins to compress with WPI rising. But, it's not just the demand conditions which are plaguing the revenue growth, base effect is also at play.

Exhibit 69: While sales growth has slowed (~5%) in FY24....



Source: Ace Equity, Bloomberg, Ambit Capital research as on 29 Feb'24

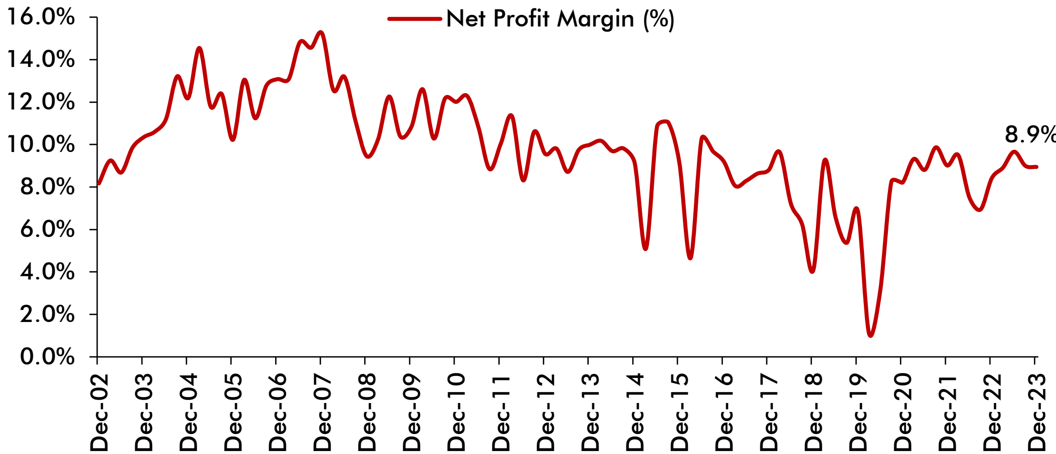
Exhibit 70: ...PAT growth was >10% for the last 3 quarters but is now decelerating



Source: Ace Equity, Bloomberg, Ambit Capital research as on 29 Feb'24

While demand conditions remain weak, PAT margin was close to 9.5% over the last 4 quarters. Average PAT margin over the past 8 years is ~7.8%.

Exhibit 71: PAT margin compressed by 80bps since 1QFY24

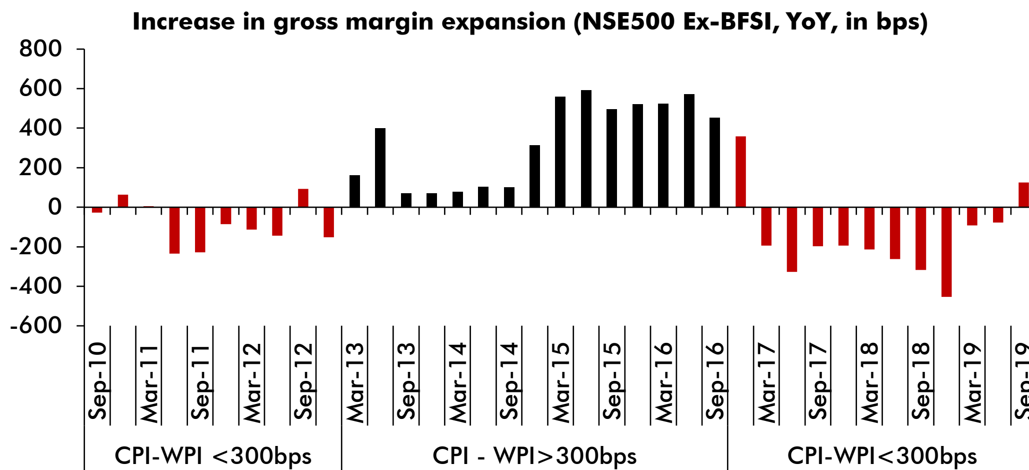


Source: Ace Equity, Ambit Capital research. Note: Universe is Nifty ex BFSI companies as of each quarter end;

Digging deeper: CPI-WPI spread is expected to compress

In a note written by our economy team in Apr'23, it was seen that the difference between WPI (producer price index) inflation and CPI inflation tends to positively affect gross margins of corporates. In India, periods when CPI led WPI by 300bps or above are accompanied by expanding margins of corporates. Between 4QFY13 and 3QFY17, CPI inflation led WPI by ~555bps but gross margins also witnessed a steep expansion of 333bps. In the 4 quarters before and after this period, when the gap between CPI and WPI was lower than 300bps, gross margins contracted by 170bps and 660bps respectively (see exhibit below).

Exhibit 72: High difference between CPI and WPI leads to increase in gross margins

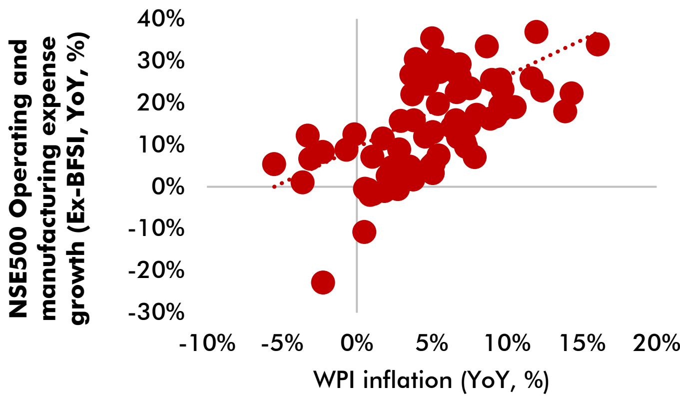


Source: ACE Equity, CEIC, MoSPI, Office of Economic Advisor, Ambit Capital research. Note- Data represents change in margin expansion on a YoY basis

WPI expansion in 2022 led to the declining profitability witnessed in FY23 despite the rise in revenue growth. However, as cost of raw materials contracted sharply annually and sequentially, profit margins expanded in the first two quarters of FY-24 despite slowdown in sales growth.

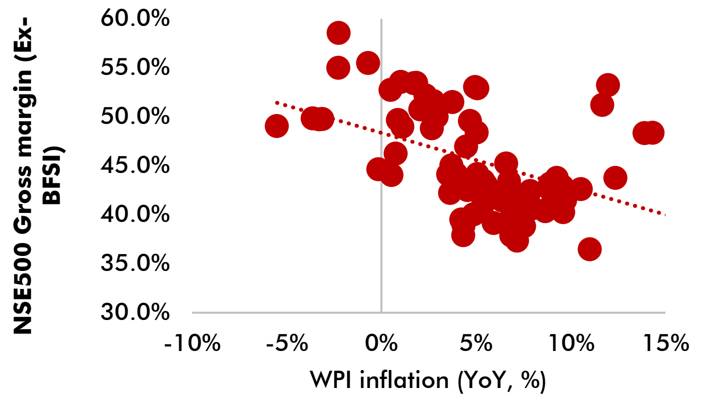
The rationale for this analysis is that lower WPI inflation means lower raw material prices for the companies, hence reducing the operating costs of the companies. Secondly, higher CPI means companies are not passing off the lower raw material prices to their consumers, hence enjoying the expansion in margin caused due to the difference in elevated selling price and lower costs (operating) for the companies.

Exhibit 73: Manufacturing and operating expenses tend to increase with rise in WPI…



Source: CEIC, Office of Economic Advisor, ACE Equity

Exhibit 74: …which leads to decline in gross margin of corporates

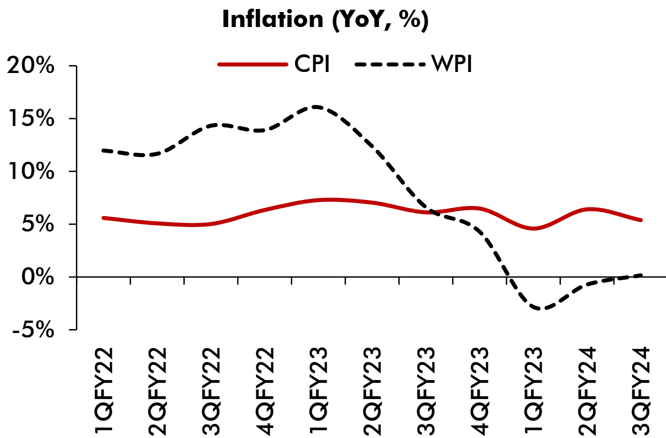


Source: CEIC, Office of Economic Advisor, ACE Equity

The fall in WPI-CPI gap in FY24

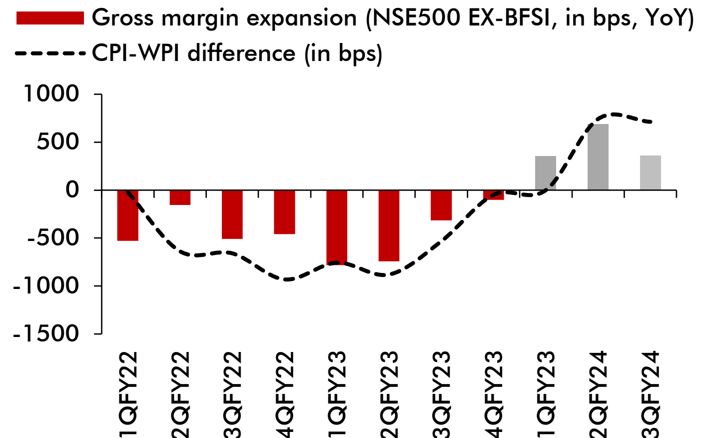
As mentioned in the note, we expected WPI to enter deflationary zone for most of FY24. In 9MFY24, WPI witnessed a deflation of 1.1% YoY as global commodity price deflation averaged 24% during the same period. On the other hand, CPI has remained elevated at 5.5% YoY. On average, gross margins expanded by 522bps in 1HFY24 (see exhibit below).

Exhibit 75: CPI-WPI differential has increased significantly in FY24YTD…



Source: CEIC, MoSPI, Office of Economic Advisor, Ambit Capital research

Exhibit 76: …which has led to expansion in gross margins



Source: CEIC, MoSPI, Office of Economic Advisor, ACE Equity, Ambit Capital research

WPI moved back into positive territory in Nov-23 and is currently 1%. Typically, WPI has a strong correlation with gross margins of corporates. This is possible due to the fact that higher commodity prices globally lead to increase in manufacturing costs, especially raw material costs of producers in India.

Where do we go from here?

We expect CPI inflation to moderate to 4.5-5% in FY25. Similarly, WPI has returned to inflationary zone in the last 2 months as the gap between CPI and WPI gap was at its lowest since Mar'23 (although the gap continues to remain >300bps). Further narrowing of this gap could lead to moderation in gross margins of corporates as well and we expect this to the flow towards the bottom-line. We expect to it compress hereon with FMCG, Consumer Durables, Cement and Building Materials margins to come under pressure.

Six trades for the year

Can the heavyweights catch up?

- The outperformance cycle of the EW index over Nifty usually lasts for 3 years & is close to end. There is a possibility of reversion especially with FY25E earnings in favour of heavyweights.

SMIDs to underperform

- Worst valuation and highest greed since 2005; highest FFMcap contribution at 33%; recent returns in excess of base-rates. Can FII & DMF flows in SMID continue at these valuations? A pause is warranted. Do you know FII flows in SMID exceed DMF flows in CY23!

Banks: Pessimism unjustified

- Real yield would stay robust/increase; divergence between Mcap and PAT contribution highest in decade; attractive entry multiple; robust earnings trajectory; benign credit cost; top-notch return ratios; NIM compression limited to 15-35 bps in worst case scenario. How many more reasons do you want? It's worth highlighting that since CY22, Bank Nifty delivered ~19% average returns over next 1 year when trading between 2.1x to 2.25x TTM P/B. Current multiple is 2.22x.

IT: A take on numbers & narrative

- In FY24, Nifty IT consensus EPS estimate cuts 11 months into the FY has been the worst since 2009 and stands at 13.3%. In 2009 & 2016, the other 2 instances of >10% EPS cut, Nifty IT delivered negative returns. Are we expecting a stronger earnings reversion than FY21-22? We don't think so and believe reversion is already priced in.

Can the Capital Goods rally continue?

- High expectations are built into their valuations. Valuations, however, build in never before seen growth (16-18%) and FCF/sales (6-10%) for the sector over next 20-25 years. With government funded capex expected to slow post-elections, mean reversion can manifest.

Affluent Investing: An emerging theme

- The perception of current conditions and future outlook of the high-income group (>50k per month) has been remarkably different from the rest. The K-shape recovery can continue. Invest in stocks which benefit from this trend.

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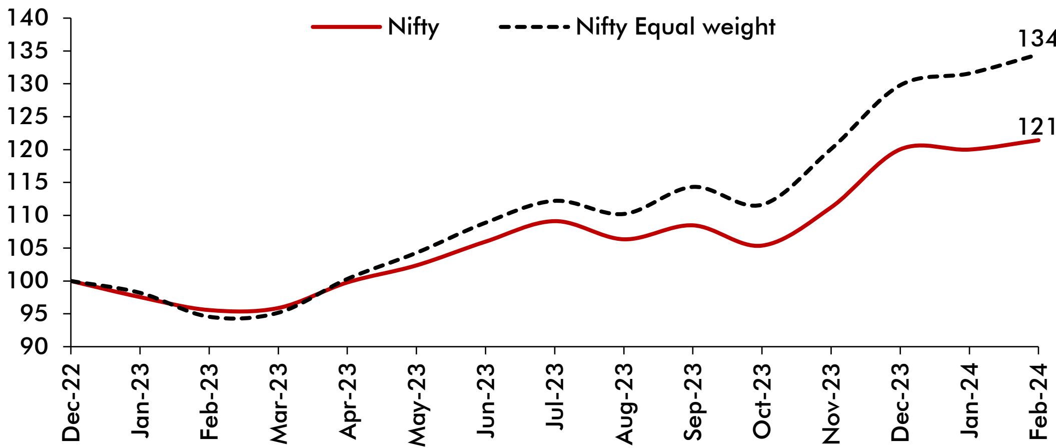
Can the heavyweights catch up?

Nifty rally in CY23 was broad-based with 12M return differential between Nifty EW index and Nifty at 10%, which expanded to 15% in Feb'24. A significant proportion of Nifty heavyweights features in the worst performing stocks of the index in 2023. Since the pandemic, their index weight fell by ~6% reflecting outperformance of smaller companies in the index. The outperformance cycle of the EW index over Nifty usually lasts about 3 years, with the current cycle beginning in Jul-21. Highest divergence between index weights is in Banks. With FY24 earnings growth tilted in favour of heavyweights and excess returns of EW index close to peak levels, mean reversion is anticipated. Over the next 12 months, we expect Nifty to outperform the EW index led by Banks.

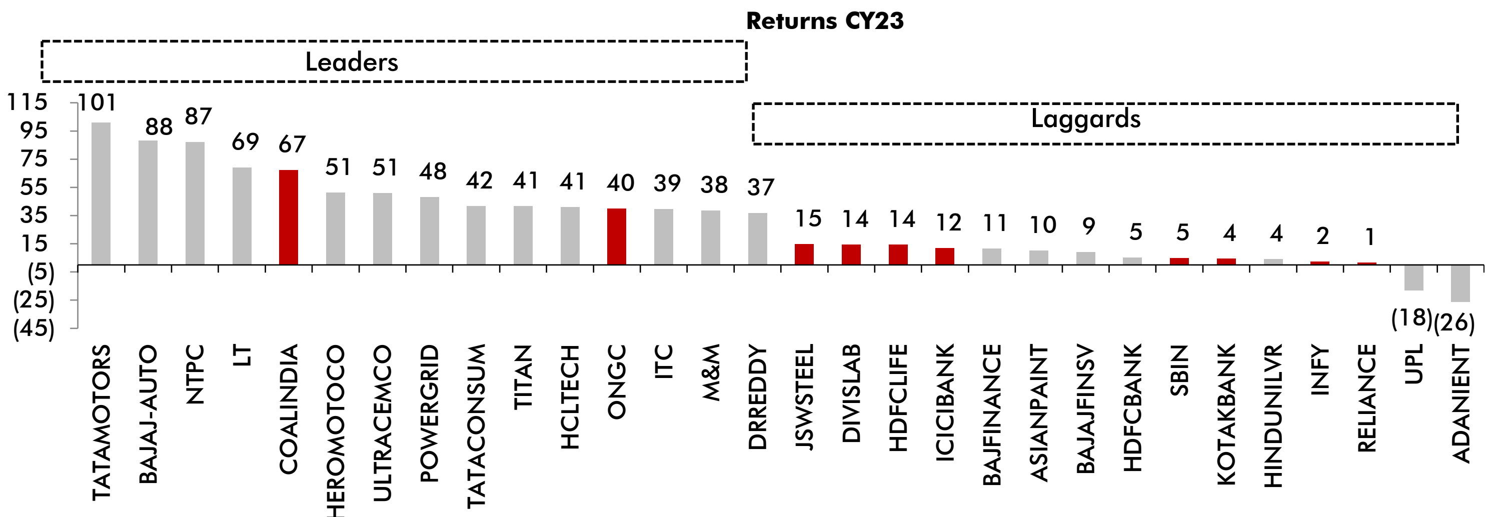
As Nifty propelled to a new ATH in CY23, the Nifty equal weight index outperformed Nifty by 10%. This highlights the breadth of the rally as well as the relative underperformance of heavyweights in the index. In CY23, only two of the top 10 index constituents by weight (heavyweights) feature in the 15 best-performing stocks and feature predominantly in the laggards; i.e. 7 out of 15 worst performing stocks in Nifty are heavyweights.

Exhibit 77: Heavyweights have underperformed small-weights in Nifty



Source: Bloomberg, Ambit Capital research

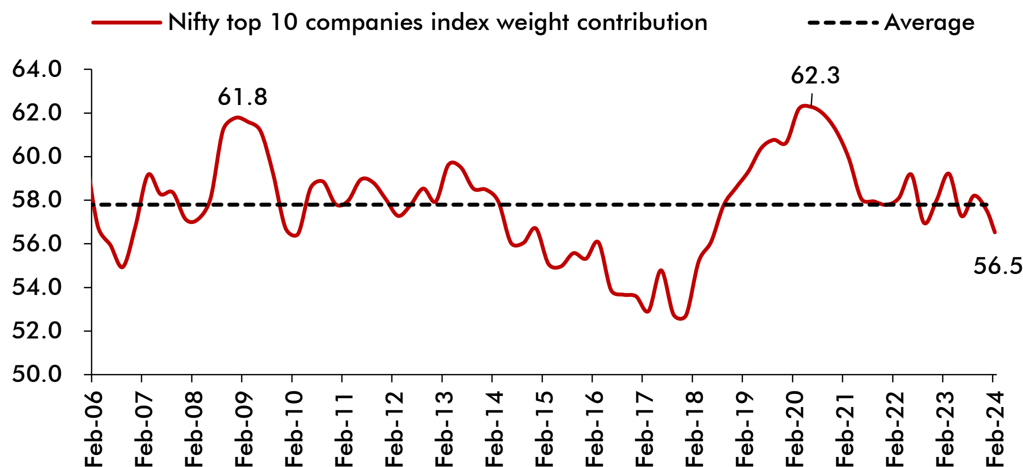
Exhibit 78: Price return of Nifty constituents in CY23



Source: Ace Equity, Ambit Capital research. Note: Stocks marked in red are Nifty heavyweights. Stocks with more than 3% index weight in Nifty have been categorised as heavyweights

As a result, Nifty heavyweight (top 10) stocks' weights fell from a peak of 62.3% in Mar-20 to 56.5% in Feb-24. In times of uncertainty, investors flock towards quality heavyweights and we can see that heavyweight index weight contribution hitting the peaks in the aftermath of the GFC and Covid-19 crisis. The same can be said for periods of exuberance when smaller companies in the index outperform heavyweights. In CY23, small-weights outperformed while heavyweights, led by Banks, significantly underperformed.

Exhibit 79: Weight contribution of heavyweights is low w.r.t recent past



Source: Bloomberg, Ambit Capital research

On excess returns framework, the outperformance of Nifty equal-weighted index over Nifty peaks in the vicinity of previous peaks of ~15% and there is a possibility of reversion with heavyweights likely to outperform the laggards.

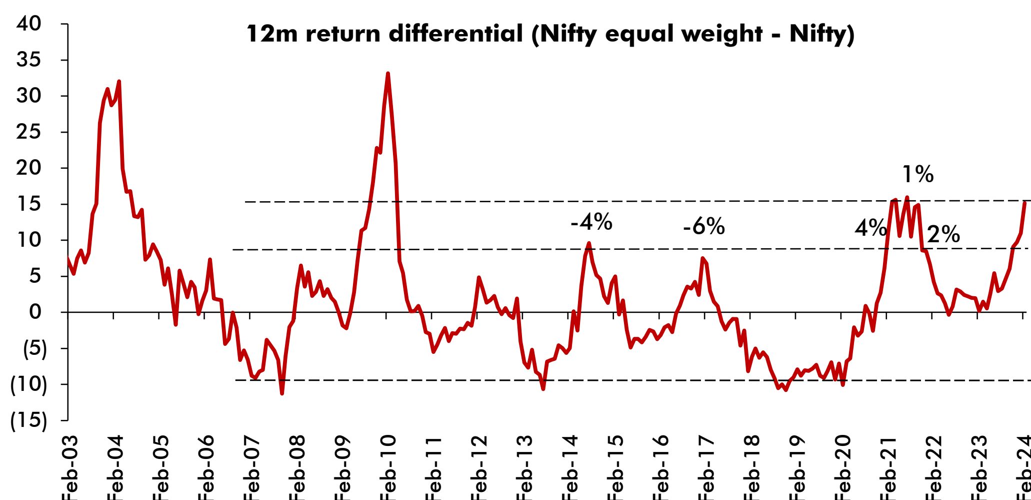
In the last decade (2014 and 2017), after peak outperformance of Nifty EW index, Nifty outperformed the EW index over the next 12 months driven by the performance of heavyweights. On the other hand, in 2021, EW index continued to outperform Nifty by a narrow margin. Adding earnings growth and cycle length to the analysis makes it more credible.

We define "Excess Returns" of the sector as the 12-month rolling return differential of a sector w.r.t the market. The excess returns of any sector w.r.t the index can be a lead indicator for predicting future returns of sector.

"Extreme outperformance can breed reversion to mean and so can extreme underperformance"

The idea behind tracking these excess returns is that there is an anchoring bias at play and investors look at how much the sector has outperformed/ underperformed Nifty over the last 1 year. For details, please check sectoral attractiveness framework

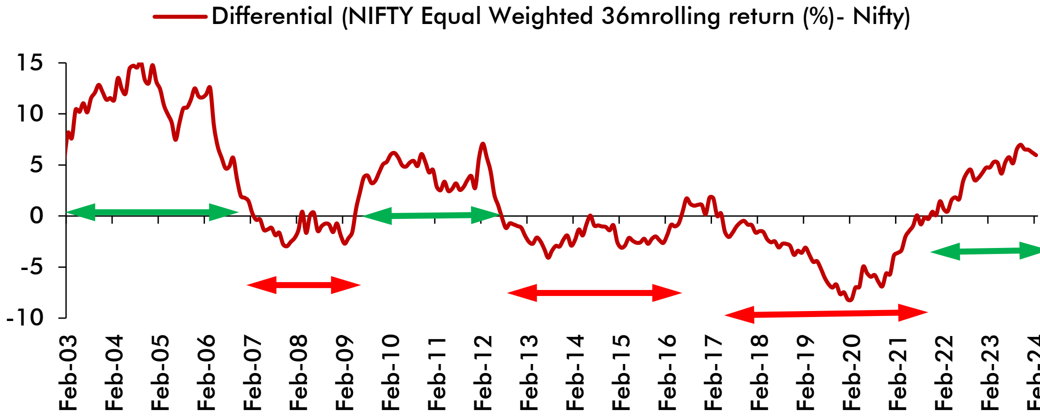
Exhibit 80: Possibility of reversal: Excess returns of Nifty EW index is close to peak



Source: Bloomberg, Ambit Capital research Note: Numbers marked on peak are 12m forward return differential between Nifty equal weight – Nifty index Note: Latest data as on 29 Feb'24

The outperformance cycle of the EW index over Nifty usually lasts about 3 years, with the current cycle beginning in July-21 (see below exhibit). While markets are expected to remain resilient leading up to the general elections, the outperformance cycle can possibly be on its last legs and heavyweights can outperform going ahead.

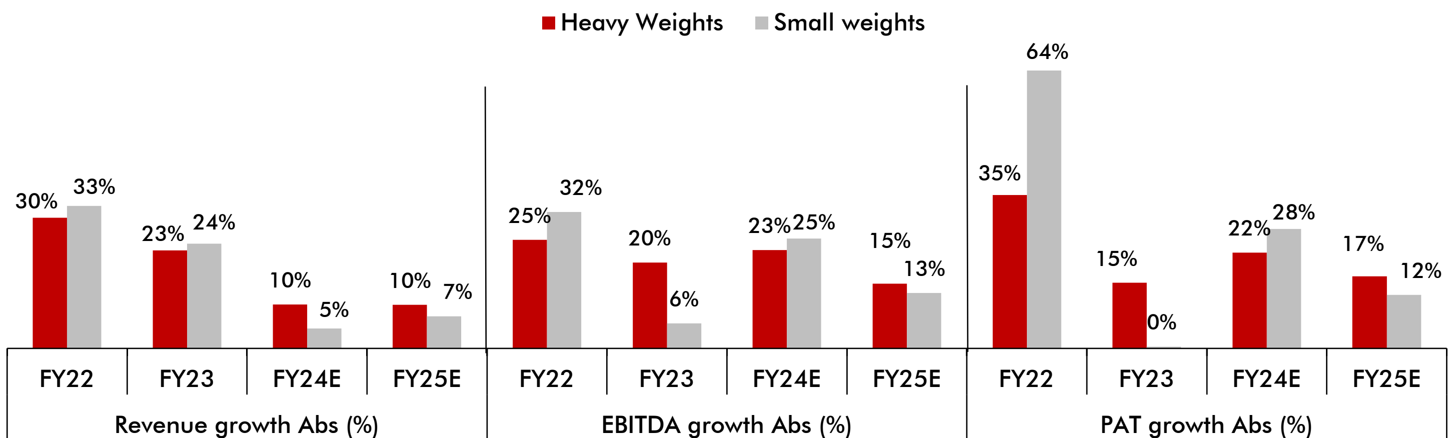
Exhibit 81: The outperformance of Nifty EW index over Nifty typically lasts about 3 years



Source: Bloomberg, Ambit Capital research. Note: Latest data as on 29 Feb'24

Also, heavyweights are expected to lead smaller companies in the index in FY25 over top-line and bottom-line, with similar EBITDA growth estimates. With forward earnings estimates growth tilted in favour of heavyweights, we expect the outperformance of Nifty over the EW index to manifest.

Exhibit 82: FY25 estimates are stacked in favour of heavyweights



Source: Bloomberg, Ace Equity, Ambit Capital research as on 29 Feb'24. Note: Heavyweights are Nifty index constituents with >3% weight in the index.

Digging deeper: Comparing sectoral weights between Nifty EW index and Nifty

Looking at sectoral weight distribution, we see that the biggest deviations between Nifty and EW index is in Banks, Auto, Oil & Gas and Metals. Our G&C portfolio is OW on Banks, and Autos. We recently published a note, Revisiting G&C 18.3 – Maintain OW on banks, highlighting that we see Banks offering reasonable value and quality in an otherwise overheated market. Banks earnings estimate trajectory is one of the best in a decade as well compared to other sectors.

Exhibit 83: Nifty EW Index is significantly UW on Banks and OW on Autos and Metals

Sector	Weight (%)		
	Nifty Index	Nifty EW Index	Deviation
Banks	28.3	12.0	16.3
Oil & Gas	12.0	6.0	6.0
IT	14.5	12.0	2.5
E&C and Infra	5.3	4.0	1.3
Telecom	3.0	2.0	1.0
NBFC	1.9	2.0	(0.1)
Retail	1.6	2.0	(0.4)
Building Materials	1.3	2.0	(0.7)
Cement	1.2	2.0	(0.8)
Utilities	3.0	4.0	(1.0)
Healthcare Services	0.6	2.0	(1.4)
FMCG	8.3	10.0	(1.7)
Agri Inputs	0.2	2.0	(1.8)
Conglomerate	1.7	4.0	(2.3)
Insurance	2.3	6.0	(3.7)
Pharma	3.9	8.0	(4.1)
Metals & Mining	3.8	8.0	(4.2)
Auto	7.2	12.0	(4.8)

Source: NSE, Ambit Capital research

Digging deeper, we find that Nifty EW index is underweight on the Banking sector and overweight on the Insurance sector as compared to Nifty. Outperformance by banking stocks going forward can drive Nifty 50 EW index underperformance.

Exhibit 84: Weights of Banking stocks in Nifty and Nifty EW Index

Company Name	Weight (%)	
	Nifty Index	Nifty EW Index
HDFC Bank	11.0	2
ICICI Bank	7.7	2
Kotak Mahindra Bank	2.6	2
Axis Bank	3.1	2
State Bank of India	3.0	2
IndusInd Bank	1.0	2
Total Bank exposure	**28.3**	**12.0**

Source: NSE, Ambit Capital research

Digging deeper into the SMID rally: UW

A treatise into fundamentals, sentiments and flows of what happened...

We continue our SMID underperformance stance citing worst EYBY gap since 2005, EPS estimate trajectory worse than large-caps and elevated greed. Further, SMID share in total FFMcap has increased to an ATH level of 33%. In previous instances of peak contributions in 2007 & 2017, both indices corrected in double digits over the next 12 months. Market sentiment measured by Nifty100 Value participation signals highest greed levels since 2006, indicating likelihood of SMID underperformance over the next 12 months. This call has not worked. What's the reasoning? A mismatch in supply/demand? A popular narrative is scarcity premium, driven by high DMF flows into SMIDs. It's not just DMF flows. Availability factor defined as free float/AUM contracted the least in CY23 for mid-caps from a DMF perspective. Counterintuitive, isn't it? FII ownership of large-caps is at a decadal low. Our analysis suggests 67% of FII inflows in CY-23 were in SMID, exceeding DMF flows. In CY23, promoters sold ~2.3% stake in SMID amidst frenzy but contraction in AF is not as high as we might think intuitively. Mean reversion is likely to manifest.

CY23 was exceptional for small and mid-caps, delivering 48% and 44% CAGR returns and outperforming Nifty by margin of 28% and 24% respectively. Over CY20-Feb24, small-caps and mid-caps outperformed Nifty by 21% and 15% CAGR respectively. In three out of the last four years, small-caps and mid-caps outperformed Nifty in double digits.

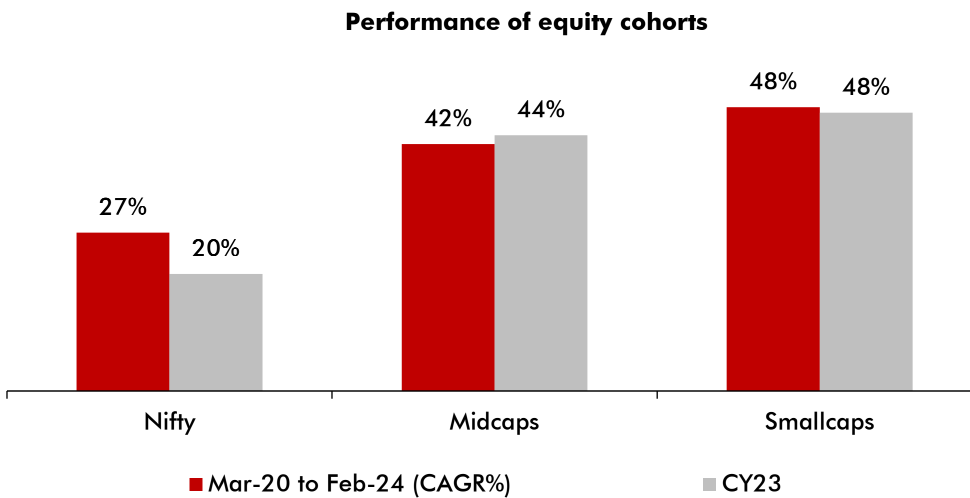
One of our key calls since Mar-22 has been the underperformance of SMID w.r.t large-caps. While in CY22 the equity markets took a breather with Nifty marginally outperforming mid-caps by 1% and small-caps by 6%. We explain our thesis in brief and provide some insights into demand/supply mismatch in SMID which has been at the forefront of this rally.

In our note G&C 18.3: Drivers are flashing risk we define base rates as the mean of "10-yr" returns (CAGR) delivered by Nifty measured over 2005-2023.

We note that a 2-sigma move delivering returns far above the "base rate" in the short term will weigh on future returns. (For reference, check page 29-31 of the note)

The base rate for mid-cap is around 15%, whereas for small-cap it stands at 11%. Alternatively, base rate of returns and earnings growth should be the same as earnings and price mirror each other in the long run. Expect SMID underperformance.

Exhibit 85: Outperformance of SMID w.r.t Nifty accelerated in CY23



Source: Ace Equity, Ambit Capital research, latest data up to 29 Feb'24

Size positioning: Prefer large-caps over SMID

We have been sellers on small and mid-caps. In a nutshell, these are the reasons

- SMID valuation measured by trailing earnings yield bond yield differential is at the worst levels since 2005. The last time it happened in 2017, SMID underperformed large-caps significantly over the next 12 months.
- Second, look at the free float contribution of SMID. The free-float market capitalization of SMID universe contribution as a % of total free float market-cap is at ATH of 33%. In previous instances of peak contributions in 2007 and 2017, both indices corrected in double digits over the next 12 months.
- Third, PAT growth distribution for SMIDs is nothing extraordinary to warrant such frothy valuations.

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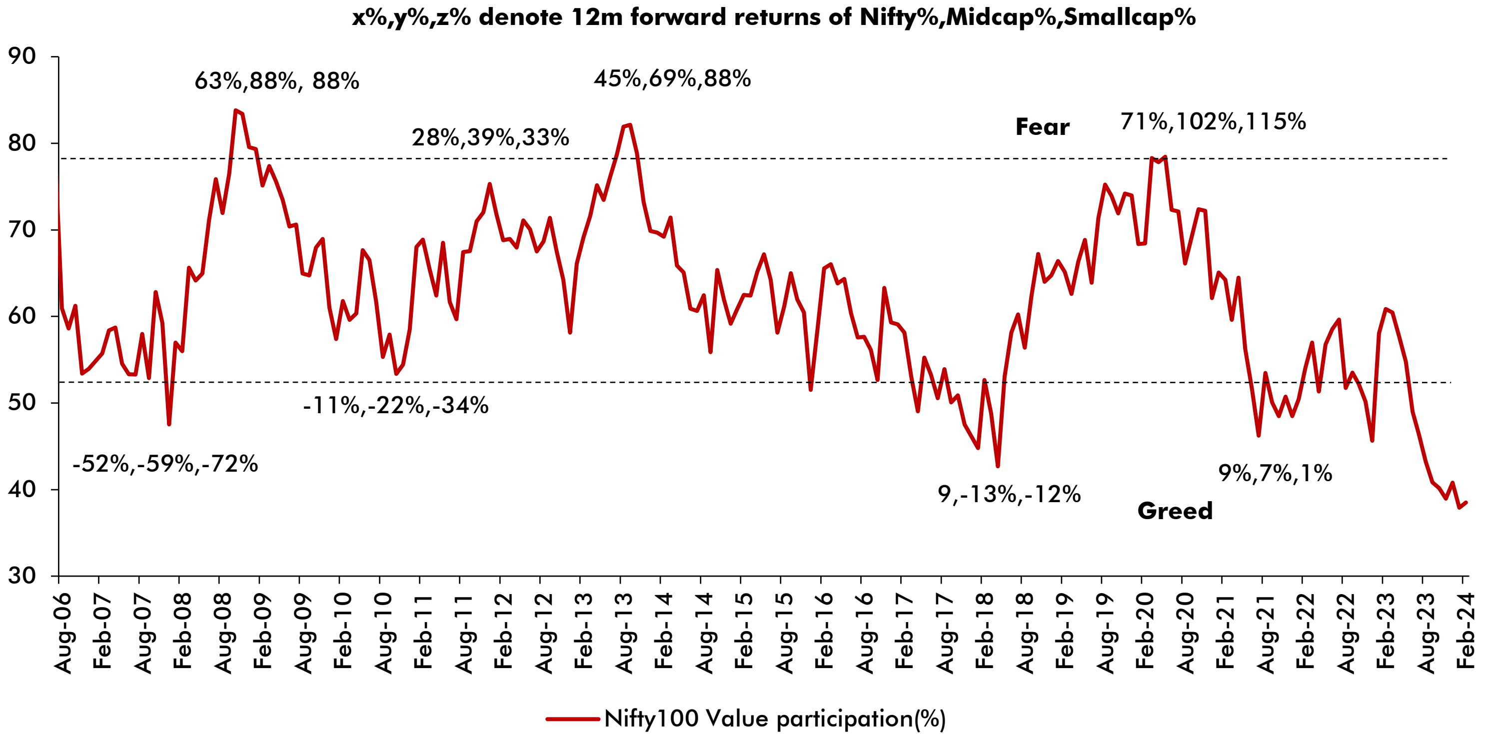
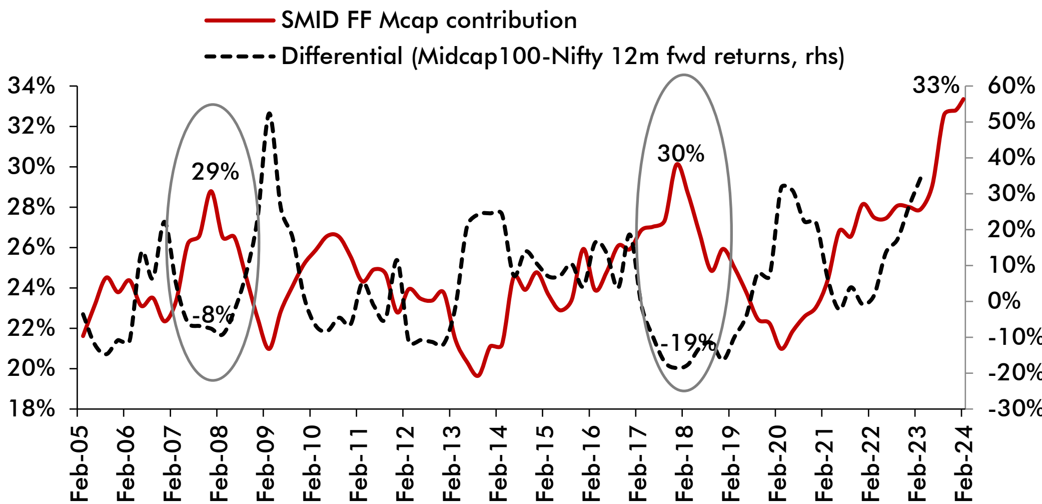
- Fourth, earnings estimates are more sustainable for large-caps vs SMID. Heavyweight sectors in SMID are witnessing an acceleration in FY24 EPS downgrades.
- Fifth, market sentiment measured by Nifty100 Value participation signals highest greed levels since 2006, indicating likelihood of SMID underperformance over the next 12 months. If investors are scared, bulk of NSE turnover would be in top 100 stocks and vice versa. For details, please refer our "G&C 18.3: Drivers are Flashing risk" dated Oct-23.

Exhibit 86: Greed & Fear Indicator is at the lowest value ever, signalling the highest greed



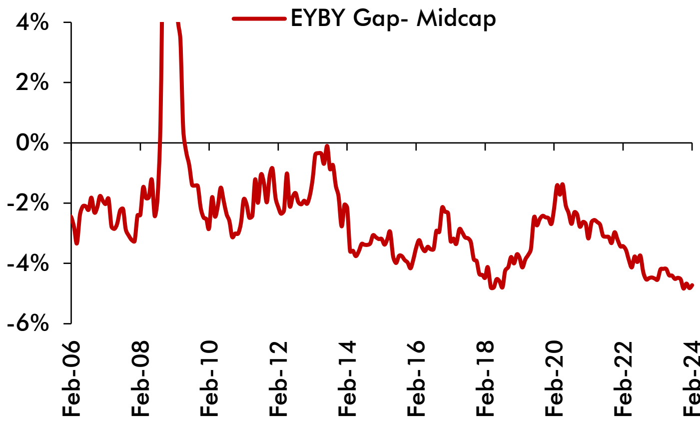
Source: NSE, Ace Equity, Ambit Capital research

Exhibit 87: SMIDs' share in total free float market-cap increased to 33%, ATH



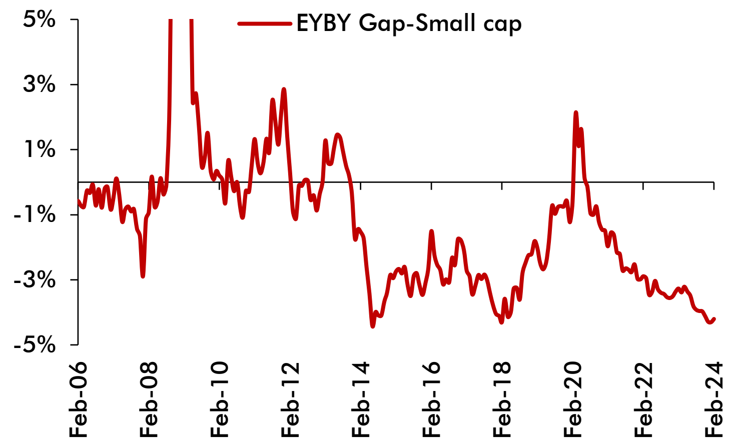
Source: Ambit Capital research, Bloomberg. Note: Above analysis is done quarterly for the entire listed universe, SMID includes companies ranked 101st onwards on market capitalization

Exhibit 88: Mid-cap EYBY Gap stands at (-4.7) close to all time worst levels. 10-year avg. stands at (-3.5)



Source: Ace Equity, Bloomberg, Ambit Capital research

Exhibit 89: Small-cap EYBY Gap stands at (-4.2) close to all time worst levels. 10-yr avg. stands at (-2.6)

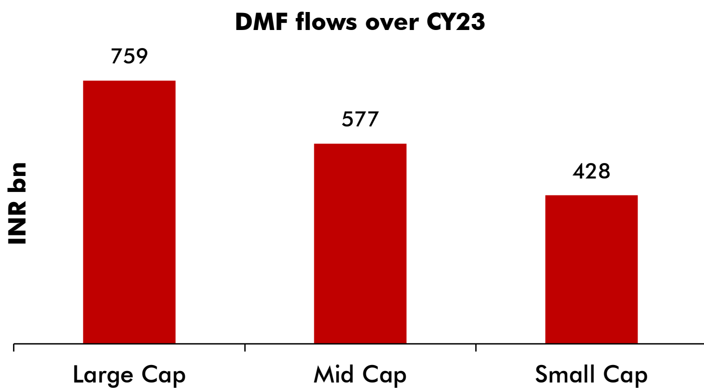


Source: Ace Equity, Bloomberg, Ambit Capital research

Analyzing demand and flows across equity cohorts

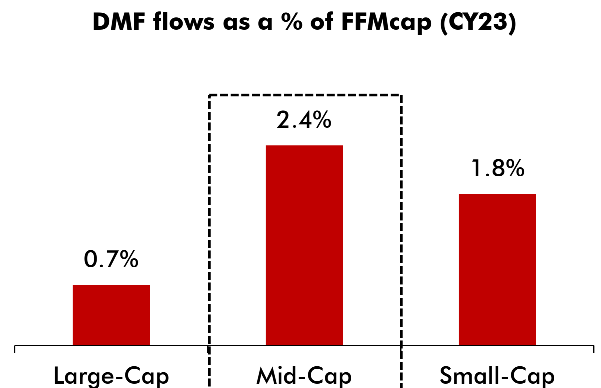
A popular narrative for SMIDs surge stems from the large DMF inflows driven by higher retail participation. In CY23, ~57% of total DMF flows were into small and mid-cap stocks. On an absolute basis, large-caps received highest flows ~INR759bn but as a % of free-float, mid-caps were the most bought equity cohort (~2.4%) followed by small-caps (~1.8%).

Exhibit 90: Large-caps received the highest absolute flows…



Source: Ace Equity, Ambit Capital research

Exhibit 91: …but SMIDs got highest flows on %FFMcap basis



Source: Ace Equity, Ambit Capital research

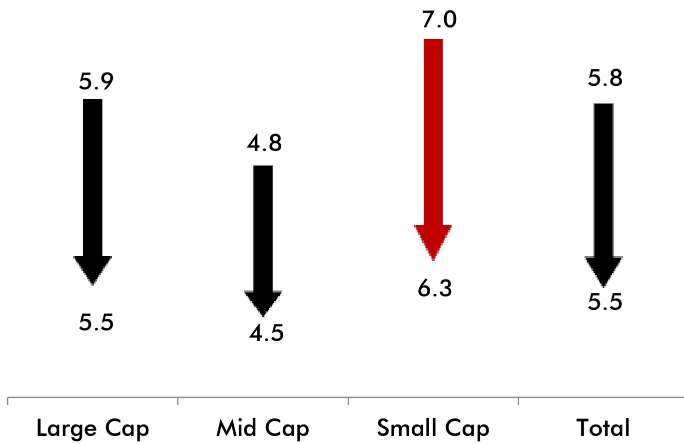
Availability Factor (AF) of 'mid-cap' should contract?

Since DMFs bought mid-caps the most, one would expect contraction in mid-cap [availability factor](#) (AF) to be the highest. However, this is not the case. Instead, mid-caps' AF has contracted the least across equity cohorts (~4%), with availability factor contracting from 4.8x to 4.5x. This is contrary to the popular narrative, implying scarcity premium driven by DMF flows is not the primary reason for mid-cap outperformance. For small-caps, it is possible as the contraction in AF is high (~-10%), but not in mid-caps.

We define AF for DMFs as the free float of Indian equities (the supply side) divided by assets under management of mutual funds (the demand side).

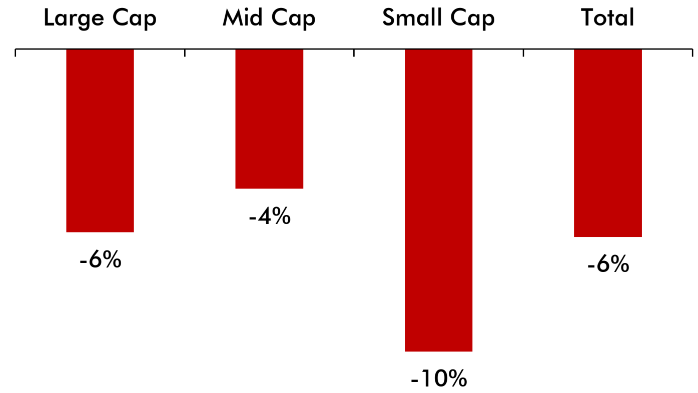
If ownership increases faster than free float, the AF would compress, indicating investor interest and vide-versa.

Exhibit 92: Mid-cap AF has contracted the least...



Source: Ace Equity, Ambit Capital research

Exhibit 93: ..whereas small-cap AF has contracted the most across equity cohorts in CY23

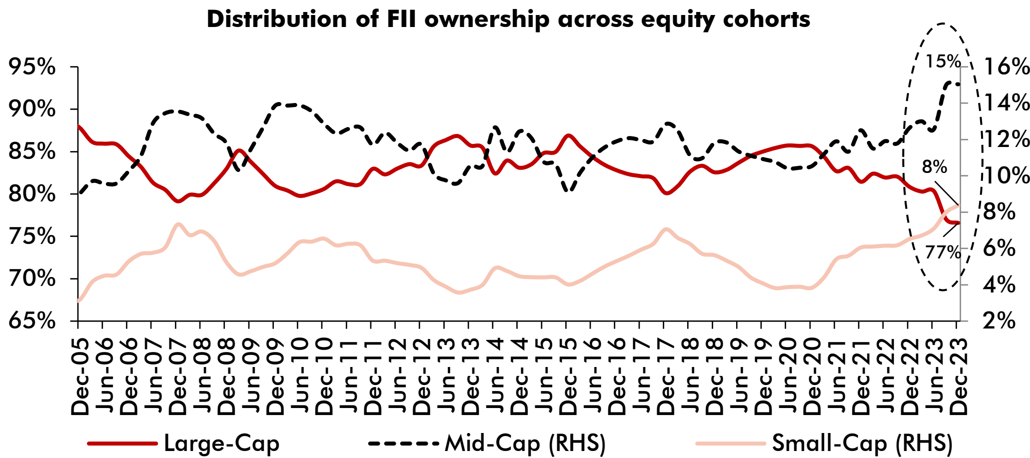


Source: Ace Equity, Ambit Capital research

Evaluating FIIs contribution to the SMID rally....

How has ownership changed? Mid-caps as a % of total FII investment in Indian equities are (as of Dec-23) at its highest level (~15%) since March-05. The same is true for small-caps (~8%). FII ownership of SMID has drastically increased over the past two quarters. On other hand, large-cap ownership has been declining since Mar-22. But ownership pattern is a function buying/selling and relative performance of SMID w.r.t large-caps.

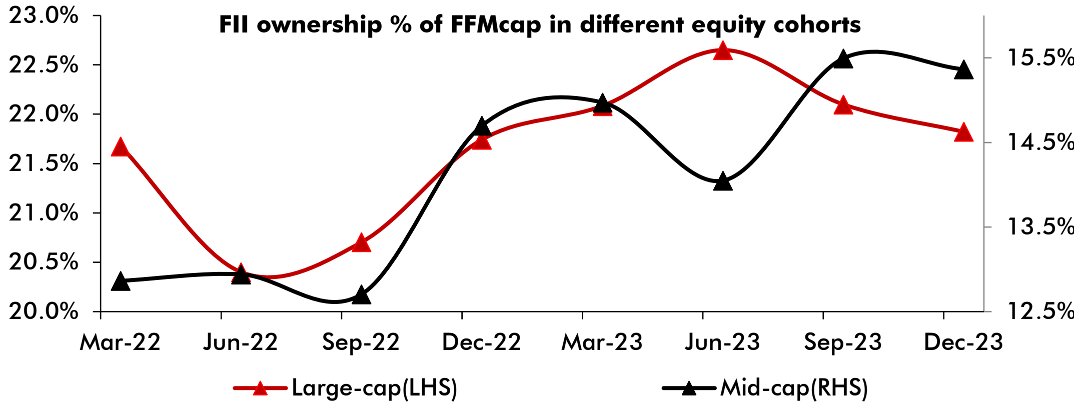
Exhibit 94: FII ownership of SMID is at its highest level since March-2005...



Source: Ace Equity, Bloomberg, Ambit Capital research

Has it actually been bought? FII ownership of mid-caps as a % of mid-cap FF increased significantly from ~12.5% in Mar-22 to ~15.5% in Dec-23, while ownership of large-caps has been materially unchanged since Mar-22. This highlights that ownership change highlighted in the above exhibit is not just a function of relative outperformance of SMID w.r.t. large-caps.

Exhibit 95: FI mid-cap ownership increased significantly since Mar-22

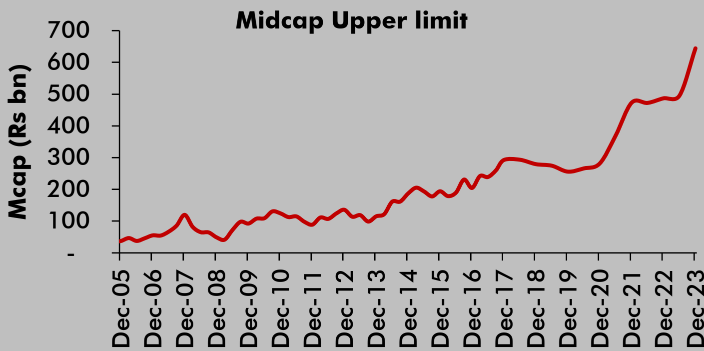


Source: Ace Equity, Bloomberg, Ambit Capital research

Some thoughts: Are SMIDs becoming more investible?

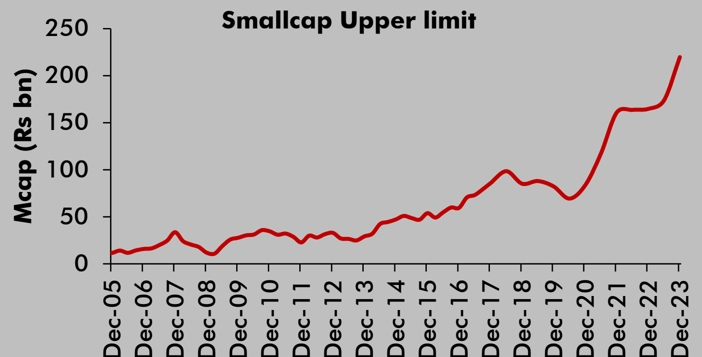
The rise of FII flows in SMIDs can possibly be the rise in Indian SMID universe market capitalization over the past decade, and becoming more investible for FIIs. The threshold for mid-caps has grown 16x and for small-caps 17x since 2005, with considerable growth witnessed since the pandemic.

Exhibit 96: Mcap of the 101st stock in the NSE500 universe



Source: Ace Equity, Ambit Capital research

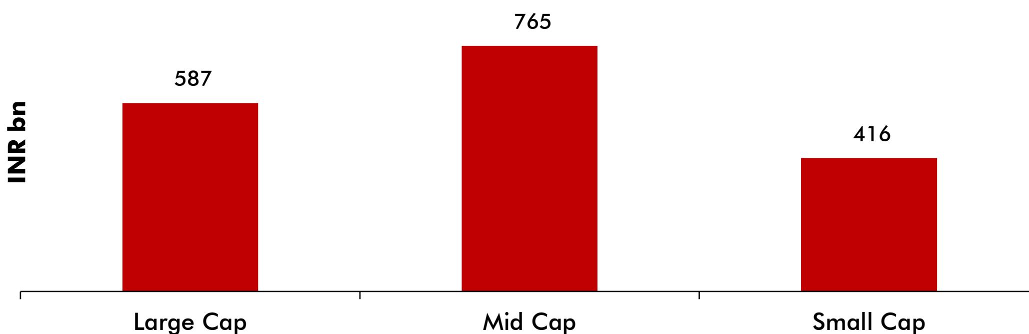
Exhibit 97: Mcap of the 251st stock in the NSE500 universe



Source: Ace Equity, Ambit Capital research

In CY23, mid-caps received highest inflows both on absolute basis (INR765bn, our estimate) and relative basis at ~3.3% of FF MCap.

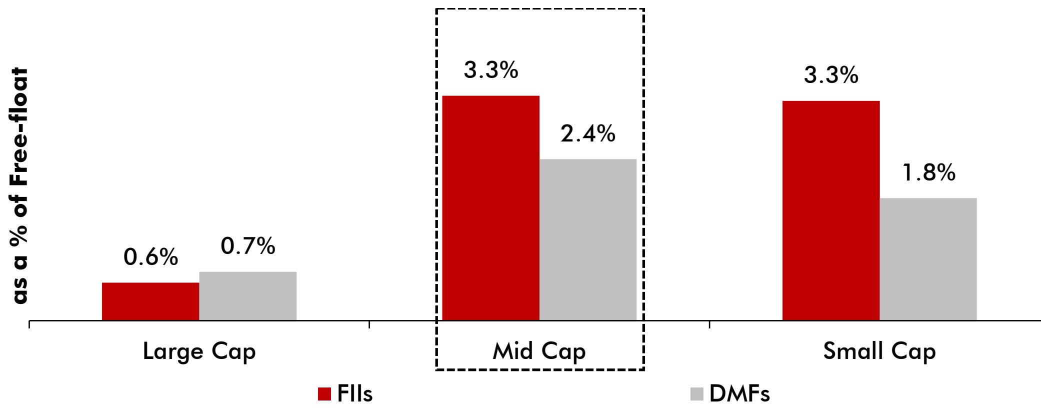
Exhibit 98: Mid-caps received highest FII flows



Source: Ace Equity, Bloomberg, Ambit Capital research.

Note: We have calculated the change in ownership in each stock & multiplied by the average price of the quarter and aggregated it as per AMFO classification. We have scaled these numbers to total FII flows in CY23

Exhibit 99: FII flows are higher than DMFs in SMID

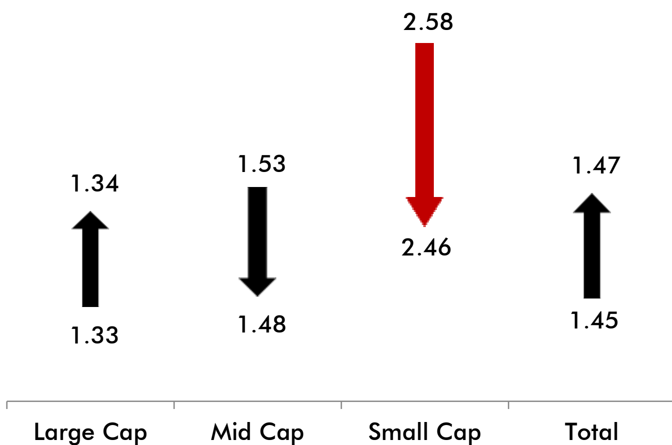


Source: Ace Equity, Bloomberg, Ambit Capital research

Putting it together

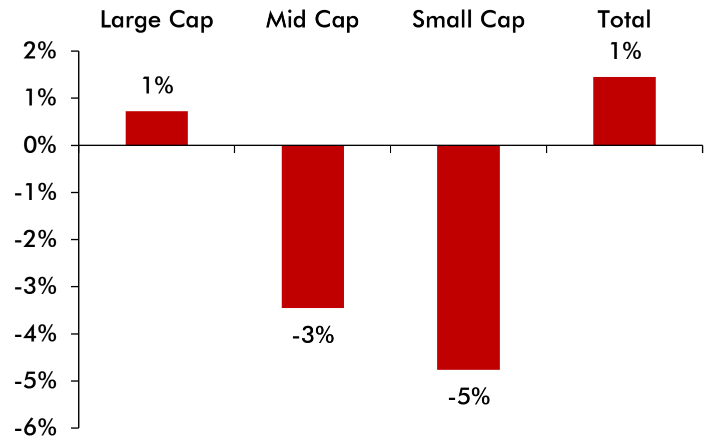
To compare the effects together, we look at the modified availability factor ("free float" of equities divided by "AUM" of DMFs and FIIs) to determine if the scarcity premium driven by DMF and FII flows is the reason for the resilience in mid-caps outperformance.

Exhibit 100: Mid-caps' MAF declined marginally



Source: Ace Equity, Bloomberg, Ambit Capital research

Exhibit 101: Highest contraction witnessed in small-caps



Source: Ace Equity, Bloomberg, Ambit Capital research

An (un) surprising revelation

While the Modified Availability Factor improved for large-caps and on an aggregate basis, it declined by ~3% for mid-caps and ~5% for small-caps. The decline in promoter holdings was witnessed across all equity cohorts, but decline in SMIDs was roughly three times that of large-caps. This implies that promoters/strategic investors of SMIDs sold a higher % of their stake driven by demand as compared to large-caps. On a 12-month rolling basis, decline in promoter holding in SMID was the second-highest for the quarter ending Dec-23 over CY19-23. Hence, though DMFs and FIIs increased their allocation to SMIDs in CY23, Modified Availability Factor didn't decline as much as we would have thought intuitively, thinking of narrative of supply/demand mismatch in SMID. Additionally, FII AUM grew at lower rate (26%) than free float market capitalization (31%) though FIIs invested ~US$21bn (INR1768bn), highlighting underperformance of FII portfolios in CY23.

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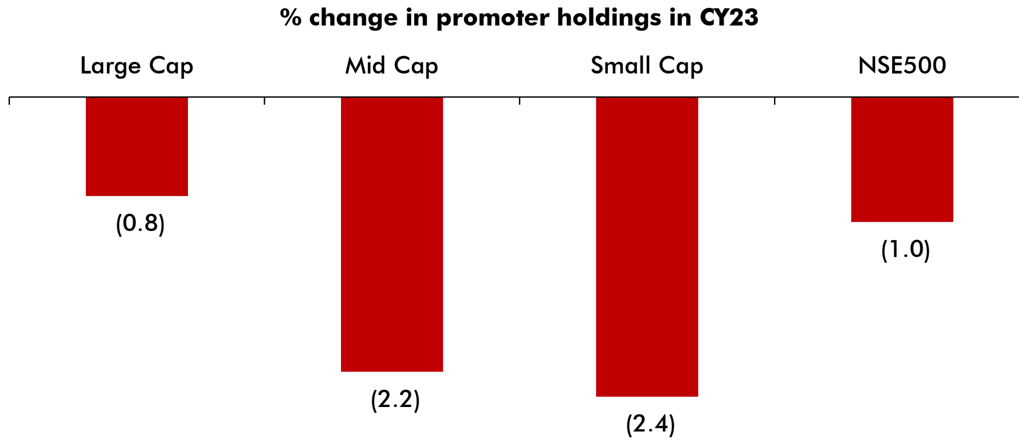
Exhibit 102: Decline in promoter holdings (%) in SMIDs is 3x that of large-caps



Source: Ace Equity, Bloomberg, Ambit Capital research

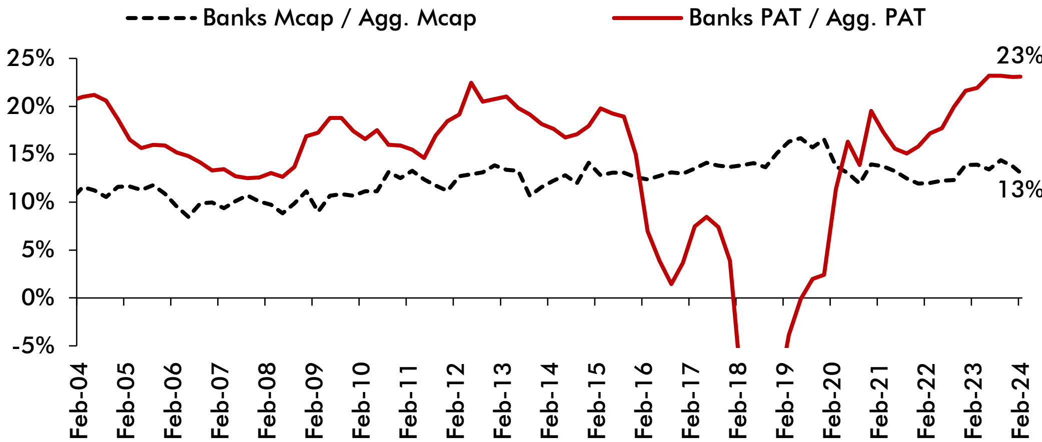
Banks to outperform

In our recent note Revisiting G&C 18.3 - Maintain OW on banks, we explained our thesis for banks:

- Banks' outperformance is tied to real yields, which would stay robust/increase.
- Our Banks team estimates 50bps repo-rate cut in H2FY25 will result in 15-35 bps lower NIMs.
- Divergence between Banks' Mcap and PAT contribution is one of the highest in the decade.
- Attractiveness on "excess returns" framework increased in recent months.
- Banks earnings estimate trajectory is one of the best in a decade and also compared to other sectors.

Banks stands out on divergence between market-cap/ PAT contribution to the NSE500 Universe market-cap and PAT pool. This is in contrast to other sectors where market-cap contribution to NSE 500 has risen much faster than PAT contribution. For Banks, it appears that the market is yet to factor in their profitability and it is likely to outperform over the slightly longer term.

Exhibit 103: Banks are positioned to outperform from a medium-term perspective



Source: Ace Equity, Ambit Capital research. Note: Latest PAT data as of Dec'23 (rolling 4-quarter sum); For not reported Dec'23 PAT is considered as of Sep'23; Market cap data as of 29 Feb'24

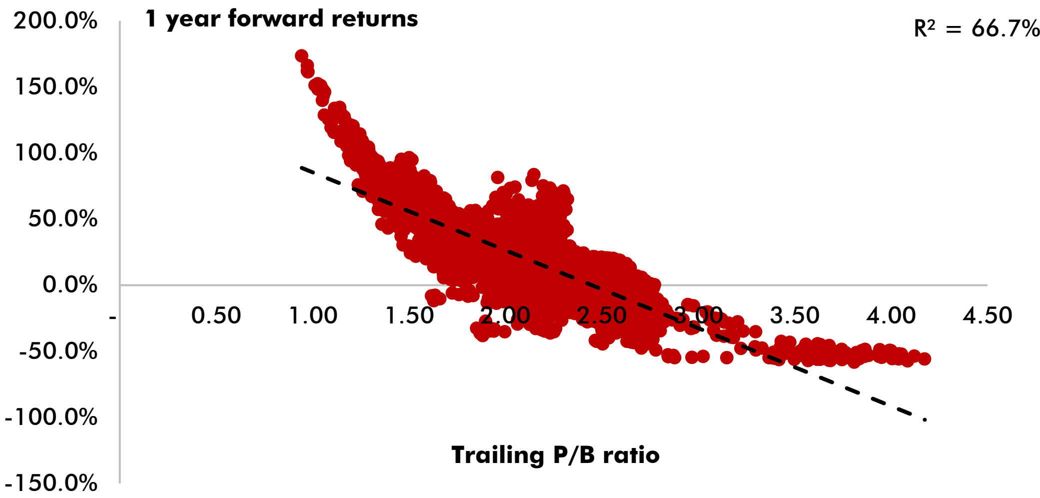
Lastly, from an entry multiple perspective, we look at the empirical relationship between valuation and 12-month forward returns of bank Nifty index. Banks TTM P/B multiple and forward returns are negatively correlated, as evident in the negative slope of the regression line. This is on expected lines of "lower is the entry multiple, higher is the expected returns".

Trailing price multiples (P/B) are a good predictor of 1-year forward returns. This reflects in higher explanatory power (R^2) of regression analysis between TTM PB and 12M fwd. returns.

Since CY22, Banks Nifty has rarely underperformed (2/71 instances) Nifty on a 1-year basis when trading in the range of 2.1x to 2.25x. The current multiple is 2.22x. While multiples are a function of growth etc., fundamentals don't appear to be a concern. In fact, since 2010, SCB's NPAs are close to an all-time low. Banks underperformance w.r.t Nifty in FY24 has brought the Bank Nifty to Nifty ratio close to monthly support levels.

Since CY22, banks delivered ~19% average returns over next 1 year when trading between 2.1x to 2.25x TTM P/B.

Exhibit 104: At current TTM P/B of~2.22x, empirical relationship suggests 13.3% returns for Bank Nifty over next 1 year.



Source: Bloomberg, Ambit Capital research

Exhibit 105: Bank Nifty to Nifty ratio is close to monthly support levels with banks underperforming market by 12% in FY24TD

Source: Bloomberg, Ambit Capital research

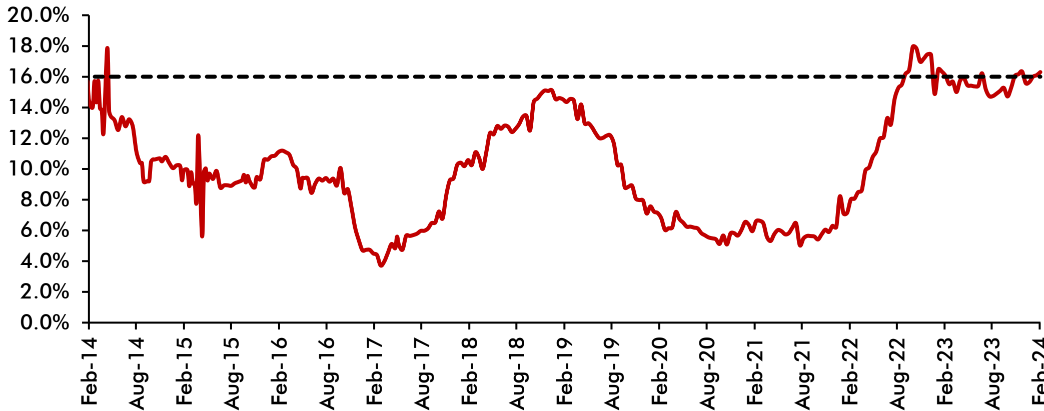
Our banking analyst Pankaj Agarwal highlights his investment thesis for banks in this section.

Beyond the din

Loan growth holding up

At the start of FY24, there was a fear that pick-up in loan growth in FY23 is transitory and loan growth will slow down in FY24. However, loan growth continues to hold at around 16%. From a longer-term perspective too, loan growth at present is the best in the past 10 years.

Exhibit 106: Loan growth continues to hold at around 16%

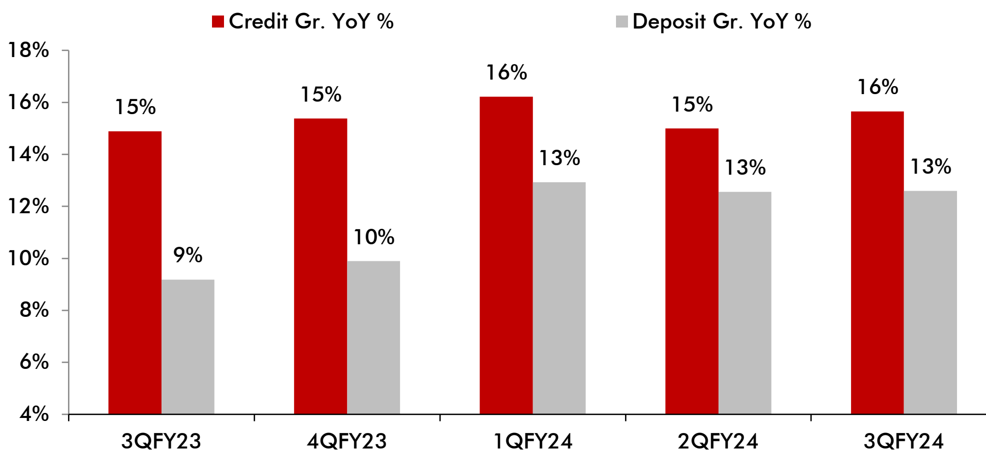


Source: RBI, Ambit Capital research

But slower deposit growth could bring moderation

Deposit growth improved to ~13% YoY by Dec'23 from 9-10% a year ago and narrowed gap with loan growth. However, deposit growth still lags loan growth, and we expect loan growth for the sector to moderate from 16% to ~14% in FY25/FY26.

Exhibit 107: Loan-deposit growth gap could bring down loan growth

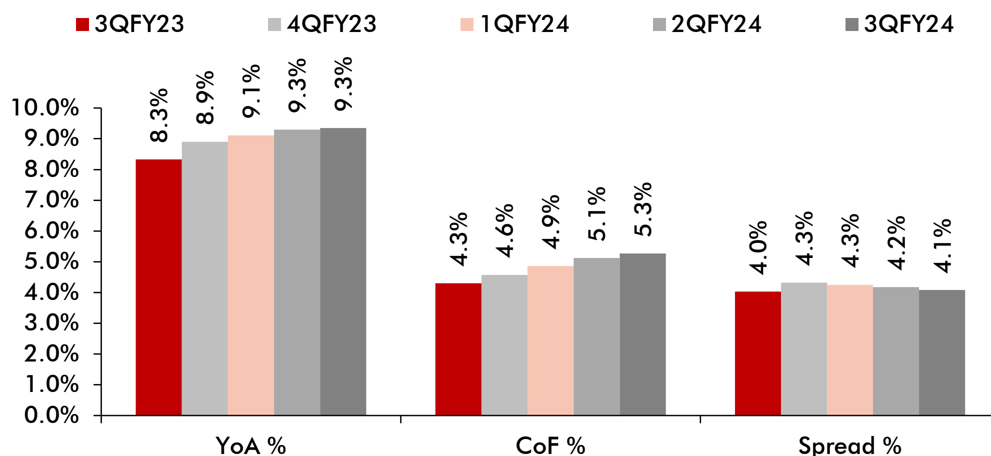


Source: RBI, Ambit Capital research

Expect 15bps moderation in NIMs with more downside risk

Given 50-90% of the loan book either linked to fixed rate or external benchmarks (mostly repo rate), loan yields are not increasing at the same pace.

Exhibit 108: Loan spreads continue to moderate due to increase in CoF whilst yield levers are limited and bank-specific



*Source: Company, RBI, Ambit Capital research, *YoA, CoF is weighted average of 24 banks, spread is calculated by subtracting CoF from YoA*

Going ahead, we expect CoF to increase by 20bps and NIM to decline ~15bps over the next quarter.

Exhibit 109: Cost of funds to catch up with rise in yields with 20bps upward repricing

	Mar'22	Dec'23	Change (bps)
Repo rate	4.00%	6.50%	250 bps
1 year G Sec yield	4.70%	7.09%	239bps
1 year MCLR	7.25%	8.75%	150bps
Yield on advances of banks*	7.57%	9.35%	178bps
1 year TD rates**	5.12%	6.75%	165bps
Cost of funds of banks*	**3.63%**	**4.89%**	**126bps**

*Source: Bloomberg, Company, Ambit Capital research, *Quarterly average of ICICIBC, AXSB, SBIN, **Average TD rates for ICICIBC, AXSB, SBIN for Mar'22 and Dec'23. Note: Not a material change between Dec'23 and Feb'24*

Besides 15bps NIM decline, there could be more downside for NIM in these scenarios:

- **Further increase in TD rates:** Historical data shows that delta between term deposit rates and Repo rate has been higher in high inflation environment. Hence if high inflation persist, there could be further increase in term deposit rates by ~30bps (despite no change in Repo rate) leading to further 15bps increase in cost of funds and hence compression in NIMs (see our report - "pessimism unjustified and how much more can COF rise for banks?" for details)

Exhibit 110: NIM compression could be higher by 10bps in case banks raise TD rate

	Base Case	Increase in TD rate
Fresh TD rates (1yr + 2yr)	6.90%	7.20%
Current Outstanding Cost of TDs	6.65%	6.65%
Current Outstanding CoF % (1)	5.05%	5.05%
Expected CoF % (2)	5.25%	5.40%
(2) - (1)	**20bps**	**35bps**
Expected rise in YoA %	5bps	10bps
NIM decline	**15bps**	**25bps**

Source: Company, Ambit Capital research, data is average of ICICI and SBI

- Central bank (RBI) lowering repo rate. Given RBI's inflation projection, experts expect repo rate to come down in 2HFY25. A 50bps reduction in repo rate could reduce NIM by 10-15bps for large-cap lenders.

Overall, NIM compression from 3QFY24 levels could be between 15-35bps depending on the trajectory of inflation and repo rate.

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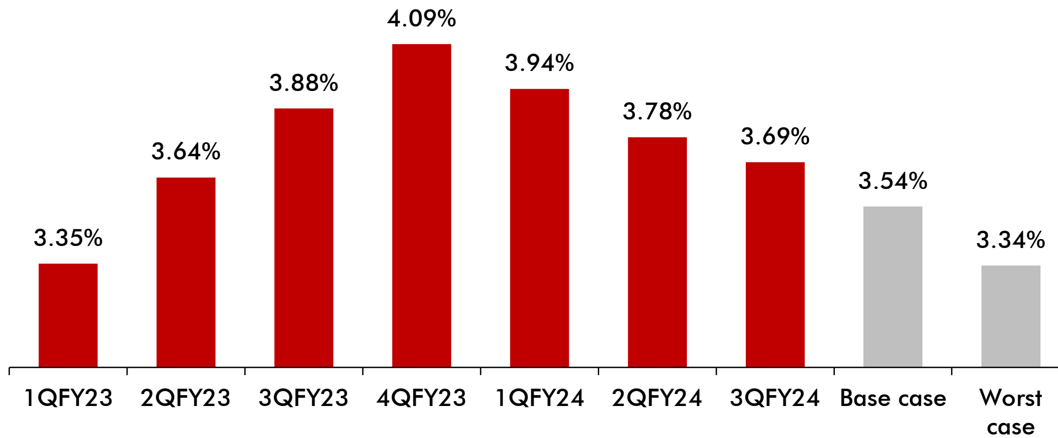
Exhibit 111: Cumulatively, NIMs can compress by 15-35bps from 3QFY24 levels

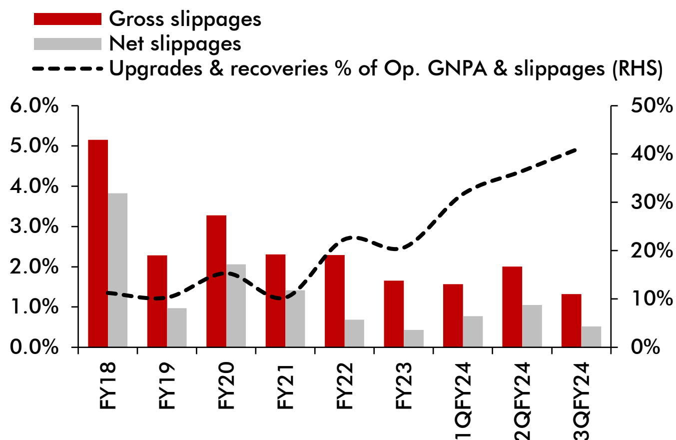


*Source: Company, Ambit Capital research, *NIM is average of ICICI and SBI*

Asset quality holding up, credit cost to undershoot in FY25 as well

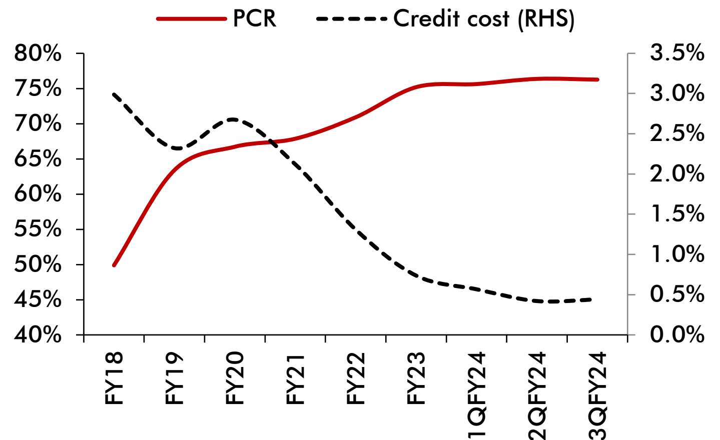
Asset quality has held up with net slippage trending much below long-term averages. Recoveries remain elevated and hence the marginal increase in gross slippages is not reflecting in net slippages. This has reflected in lower credit cost too.

Exhibit 112: Higher recoveries driving lower net slippages



Source: Company, Ambit Capital research, Note: GNPA/NNPA/recoveries and upgrades are weighted average of 18 banks

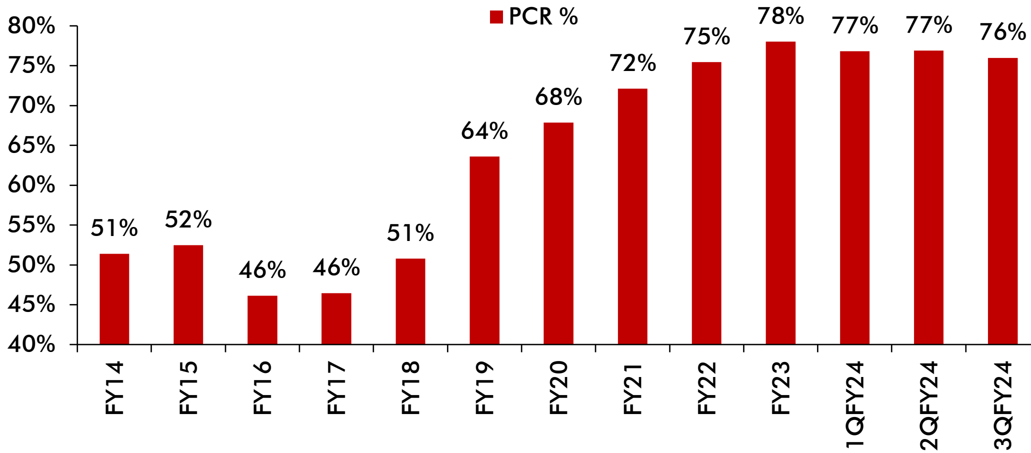
Exhibit 113: Credit cost stays benign



Source: Company, Ambit Capital research, Note: Credit cost and PCR is weighted average of 18 banks

Whilst we expect net slippages to rise in FY25/F26, we don't expect them to go beyond the long-term average of ~1% due to benign asset quality in corporate loans owing to low corporate leverage and high profitability. Moreover, provisioning cover of banks is higher compared to the past. Hence, credit cost should continue to undershoot long-term average in 4QFY24/FY25.

Exhibit 114: PCR at higher levels compared to the beginning of the last cycle

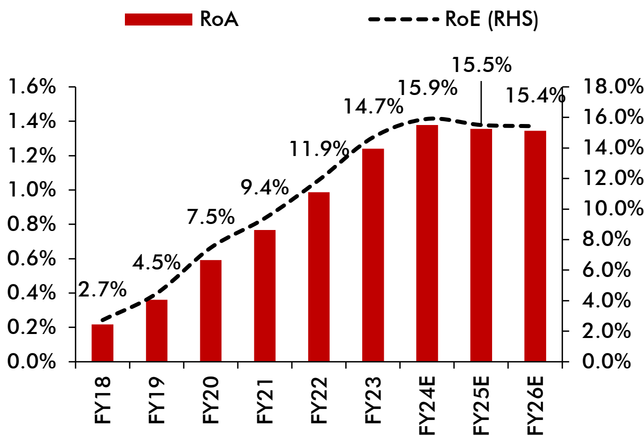


Source: Company, Ambit Capital research

Return ratios stay strong and will continue above historical average

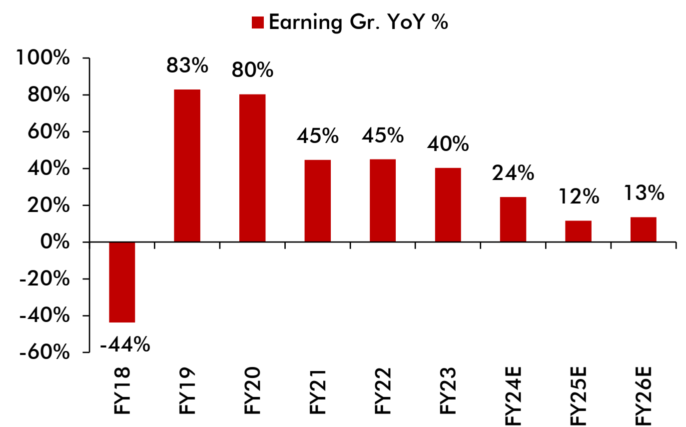
Although we expect moderation in ROA/ROE, for coverage banks (10), we expect RoA/RoE to settle at 1.3%/15% in FY26E vs. 1.4%/16% in FY24E.

Exhibit 115: Return ratios to stay top notch



Source: Company, Ambit Capital research

Exhibit 116: Earnings CAGR of 12% in FY24-26 on high base



Source: Company, Ambit Capital research

Remain positive on the sector

Whilst FY23 was one of the best years for the sector with decadal high loan growth of 16%, NIM/RoA/RoE expansion and benign credit cost, valuation multiple did not expand during this period. There was fear of loan growth being transitory, margin being cyclical and credit cost normalization being just around the corner. However, 9MFY24 defied slowdown in loan growth and asset quality is holding up. Despite building in 200bps moderation in credit growth to ~14%, 15bps NIM compression and net slippage of 2x/2.2x in FY25/FY26 vs FY24, we still expect ROE of >15% for our coverage universe.

IT to underperform: A take on numbers & narrative

What happens when there are sharp earnings cuts?

In FY24, Nifty IT consensus EPS estimate cuts 11 months into the FY were the worst since 2009 and stand at 13.3%. In 2009 and 2016, the other two instances of >10% EPS cuts, earnings growth and price return were negative. This year seems to be an exception. Historically, Nifty IT price returns have followed earnings growth and at worst with a lag of a year.

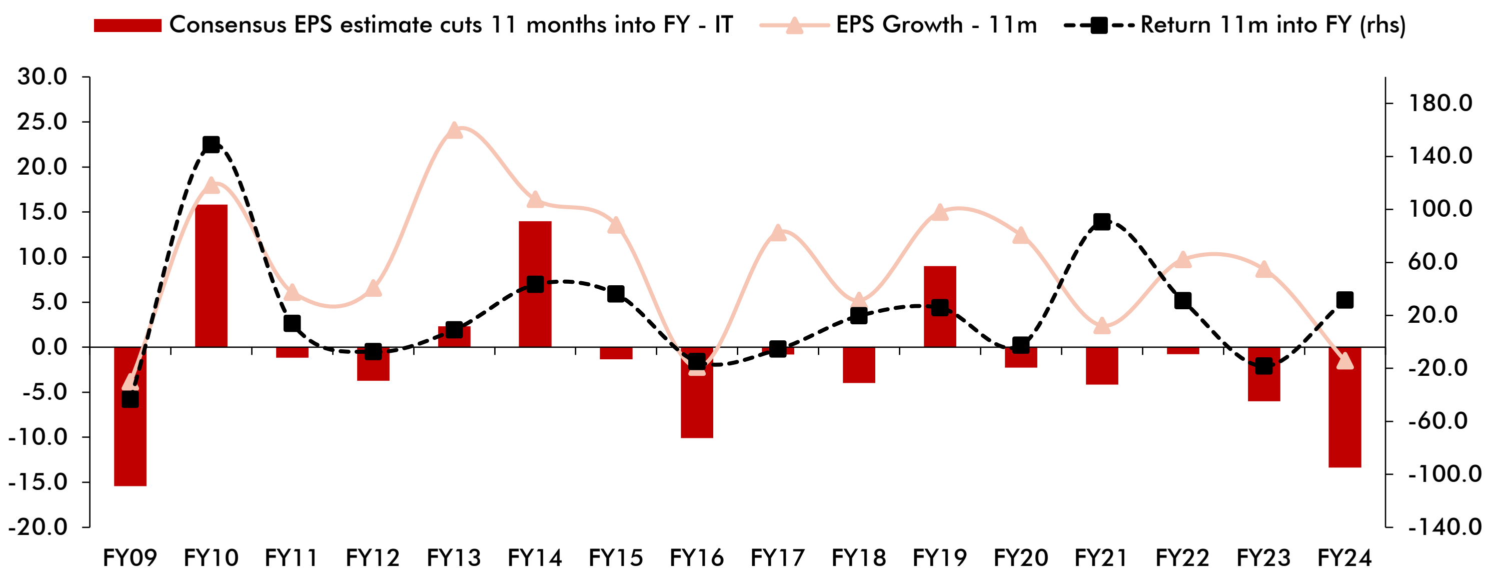
Can "earnings growth" reversion drive IT returns?

Despite significant EPS estimate cuts 11 months in FY21 and subdued earnings growth, Nifty IT returns were exceptional 11 months into FY (49.3%). The index soared despite EPS cuts and minimal earnings growth in anticipation of strong earnings growth reversion, AI mania and increased digitalization narrative.

The current episode of 'reversion'

The key difference is that the narrative is weaker and numbers don't support current valuations. Our IT analysts' FY25 EPS growth estimates of IT companies are higher than 10% only for Tech Mahindra, Coforge and Persistent Systems. So, if growth is reverting to a lesser extent compared to FY21 and valuations are expensive, we see anticipated EPS growth already been factored into current prices.

Exhibit 117: Nifty IT: Highest EPS cuts in a decade and earnings reversion will not be as strong as FY21-22; already priced in?

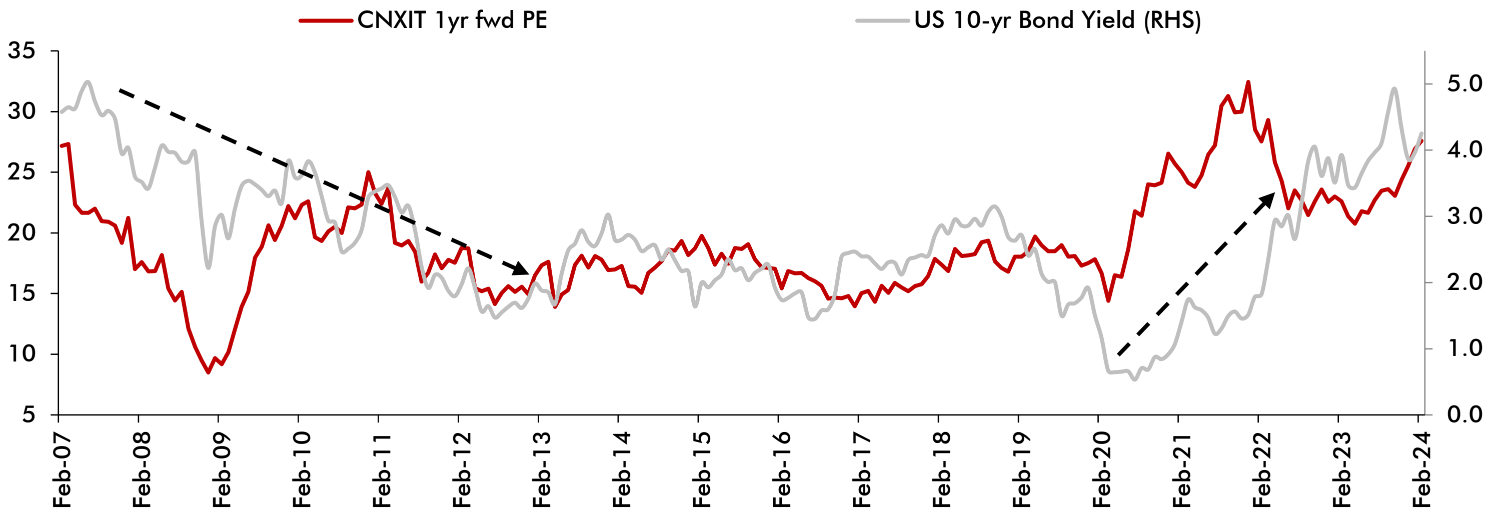


Source: Bloomberg, Ambit Capital research. Note: Latest data as of 01 March 2024

Historically, Indian IT growth and valuations have fallen when US yields fell

Over the past 17 years, CNXIT valuations/tier-1 IT US growth had a low correlation of 13%/47% with US 10-year yields. However, the correlation was higher in periods of turn in interest rates, when both CNXIT valuations and tier-1 IT US growth dipped when interest rates fell in US and vice versa. This evidence runs counter to the recent run-up of IT stocks on expectations of recovery in demand or valuation uptick given anticipated rate pivot by US Fed. The only exception was recently when growth slowed to -2% despite rates rising. US 10-year bond yield despite having fallen from a high of 4.9% in Oct-23 to 3.9% is at levels similar to 6 or 12 months ago. Tier-1/Tier-2 IT growth also slowed to 1.2%/4.4% YoY in 3QFY24.

Exhibit 118: While over a longer term there is low correlation (13%) between US 10-year bond yield and IT valuations, during turns in interest rates, IT valuations dipped when interest rates fell and vice versa



Source: Bloomberg, Ambit Capital research

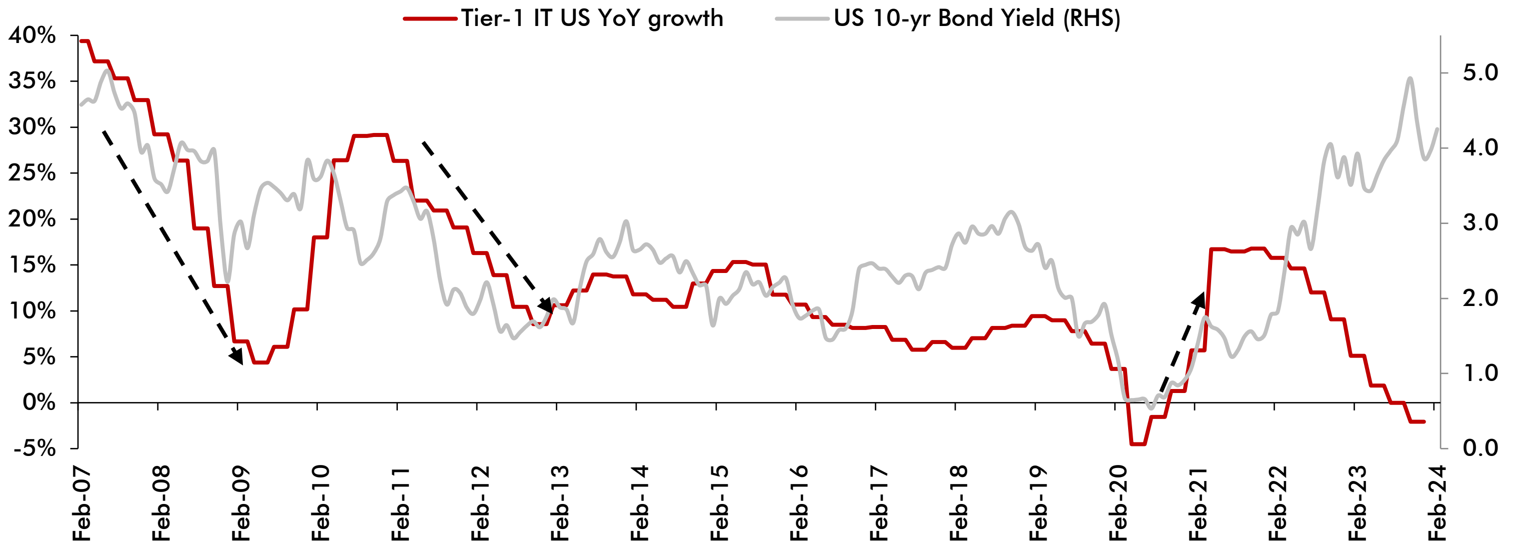
Ask rate even at 1-2% lower CoE build better than pre-Covid growth

A poll of next year interest rates of the officials at the Fed open market committee reveals median expectation of 80bps cut by end of CY24 (versus 5.25-5.5% currently). Given the fall in US 10-year yields from ~5% at peak to ~4.2% currently, these expectations seem to be more than adequately factored in. At our cost of equity (CoE) assumptions (11-12.5), tier-1/tier-2 IT is building 11.3-13.4%/15-26.2% USD revenue CAGR over FY24-33E with TCS/Infosys among tier-1 and Persistent/Coforge/LTIM building most optimism. Even if we assume 1-2% lower CoE, stocks build higher than pre-Covid growth rates for most companies and are steep for tier-2 IT.

Past US election years have seen negative IT returns and growth deceleration

2024 is a US election year, a risk keeping in mind which stock prices are ignoring. Typically, in an US election year, large deal announcements tend to slow as clients don't want to be caught in political crossfire. Indian IT export growth has slowed in all 4 past US election years compared to prior years. Even Infosys and TCS aggregate growth was similar or worse off in US election years than prior years. During last 3 of 4 US election years, CNXIT returns have also been negative. The only exception was 2020, when Indian IT saw a surge in demand after Covid. Currently, street expectations build material acceleration in FY25 while we see only a moderate improvement.

Exhibit 119: Tier-1 IT "US YoY growth" correlates better with US 10-yr bond yield (54%) compared to valuations; growth has in general decelerated when interest rates fell and vice versa, except recently when growth decelerated despite rate rise



Source: Bloomberg, Ambit Capital research

Macro demand indicators support at best a moderate growth improvement in FY25 with upgrades in CY23E US GDP not aiding growth and CY24E expectations build moderation; S&P500 revenue growth that has largely mirrored Tier-1 IT growth is suggesting only a moderate improvement from 4% to 5% for CY23 to CY24E (vs 11% in CY22).

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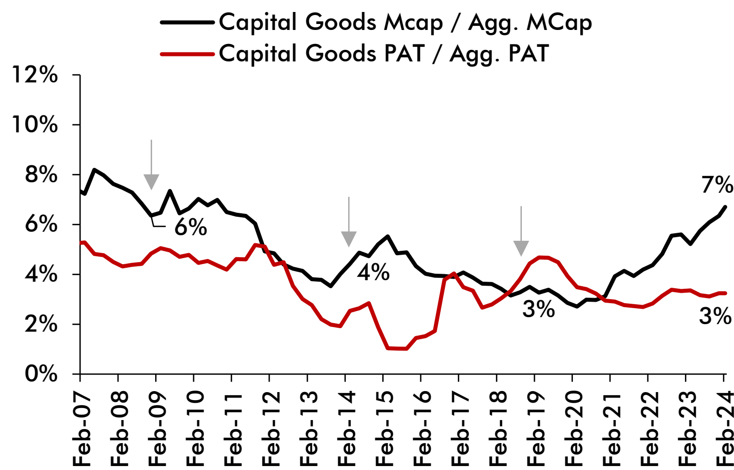
Can the Capital Goods/Infra rally continue?

Infra sector orders were strong in FY24 led by pre-election spending. However, such pre-election surge is followed by a long slowdown after elections as evident in 2019. Further, the interim budget for FY25 suggests infra capex growth of just 2-3% as fiscal consolidation is the new focus. L&T meanwhile has benefitted from mega hydrocarbon orders from the Middle East but much of the ordering related to Saudi Aramco's identified projects is now complete and it is no longer planning to increase production capacity further, suggesting a peak for hydrocarbon orders for L&T. For cap-goods companies, gross margins increased sharply since Dec-22 as commodity prices fell but will ultimately pass on to the consumers as demand-supply balance is restored. Valuations, however, build in never before seen growth (16-18%) and FCF/sales (6-10%) for the sector over the next 20-25 years. We have a SELL on the sector with a pecking order of KKPC> KKC>AIAE>LT>ABB>HWA>SIEM.

Since the past 3 years, Capital Goods outperformed Nifty by 23%. This has driven sector's Mcap contribution to 7%, the highest reading since 2008. But the sector's PAT contribution grew only marginally over the period. An important thing to note is that government-funded infra capex increases leading up to general elections, causing Cap Goods & Infra to perform well. In prior instances, we note that Capital Goods underperformance started after elections. The same phenomenon is visible for Infra. Excess returns over Nifty increased substantially over the past year and touched previous peaks.

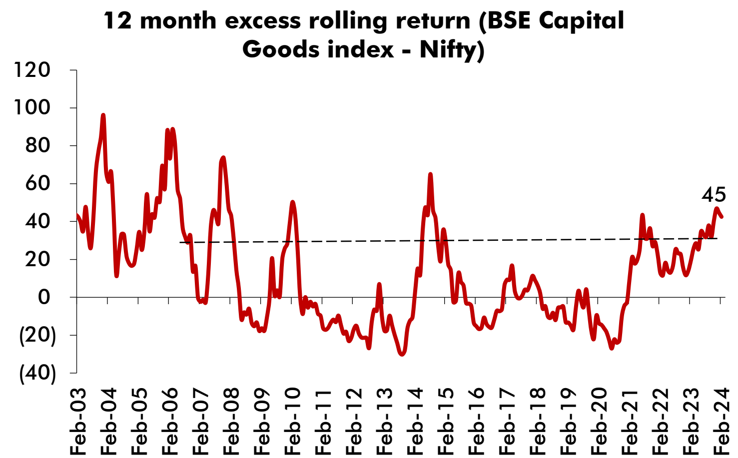
Note: PAT contribution has been calculated as sectoral PAT as a % of NSE500 PAT. Likewise for Mcap contribution.

Exhibit 120: Highest divergence in 8 years



Source: Ace Equity, Ambit Capital research. Note: Latest PAT data as of Dec'23 (rolling 4-quarter sum); For companies that have not reported Dec'23 results, PAT as of Sep'23 considered; Market cap data as of 29 Feb'24. Note: Arrows point to Mcap contribution of Cap Goods as on March during election years.

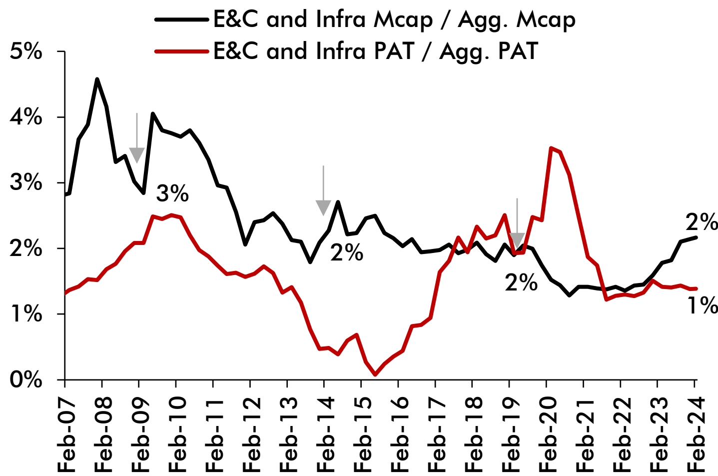
Exhibit 121: Excess return in the vicinity of historical peak



Source: Ambit Capital Research, Bloomberg; Note: Latest data as of 29 Feb'24

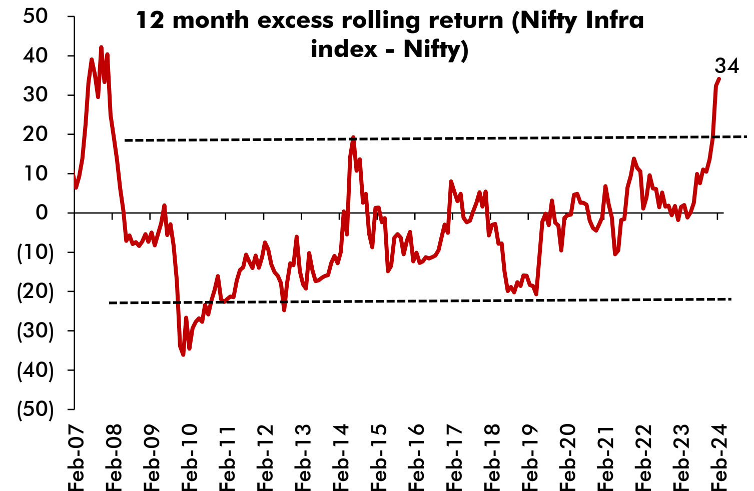
High expectations have been built in the valuations as Mcap increase has not been backed by PAT growth. With excess returns close to historical peaks, mean reversion can manifest especially after considering that after elections government capex usually slows down, weighing on the performance of these sectors.

Exhibit 122: Mcap rise not backed by PAT growth



Source: Ace Equity, Ambit Capital research. Note: Latest PAT data as of Dec'23 (rolling 4-quarter sum); For companies that have not reported Dec'23 results, PAT as of Sep'23 considered; Market cap data as of 29 Feb'24. Note: Arrows point to Mcap contribution of Cap Goods as on March during election years.

Exhibit 123: Excess return above historical peaks



Source: Ambit Capital Research, Bloomberg; Note: Latest data as of 29 Feb'24

Tender/award activity already slowing except for railways/power…

Breaking its strong momentum until 1QFY24, tendering activity is falling off and is now at the weakest level in the past 12 months. Power and railways are the only segments that continue to witness new projects that is reflective of continued activity in that space, while water and irrigation tenders declined from a favourable base last year. TTM awards activity (ex-mining), however, rose 67% YoY in Dec-24 led by across-the-board growth except irrigation. Power, railways and international hydrocarbon order wins by L&T were the key drivers of order activity during the quarter

…in the run-up to elections, but past trends suggest this does not end well

Pre-election trends from the past (May 2019) suggest that both Centre and State governments tend to complete project awards before the election code of conduct sets in. Revenue growth and working capital cycle also peak in the run-up to elections but collapses after that. While execution slowdown can set in with a gap of 2-3 quarters, ordering slowdown and NWC cycle worsening can be immediate and takes 2-3 years to normalize until a fresh election cycle resumes. With the private sector order inflow still below 15% of the total for L&T, dependence on government inflows remains high.

Margin benefit from falling commodity price is not sustainable

Gross margins for the cap-goods sector benefitted in 2HFY23 as commodity prices and freight rates fell from 2022 peaks. These companies are yet to pass on the relief to their customers. With most of the contracts with B2B clients, eventually the commodity price fall will be passed on, leading to margin normalization though L&T should see the benefit emerging in FY25.

Current valuations reflect consumer-like multiples building in growth that has never been delivered even on a low base…

Reverse DCF of listed Indian automation names like ABB, Siemens and Honeywell Automation suggests that ceteris paribus revenue growth needs to sustain at 16-18% p.a. for the next 20-25 years. This is even higher than 13-14% CAGR witnessed over the last 20 years when the base was extremely favourable for the Indian economy as well as these industrial companies. While there are tailwinds in the form of manufacturing capex pick-up and supply chain disruptions benefiting the Indian economy, we believe expectations of such high growth, that too for a longer timeframe, are misplaced. Moreover, this also comes along with the expectation of lower cost of funding reflecting as lower discount rate, which is fundamentally flawed – higher growth has to be accompanied by higher cost of funds to compensate higher inflationary effects as well as higher associated risks.

...and ignoring cyclicality for what is essentially a cyclical sector, leading to doubling of FCF as % of sales compared to historical levels

There are two other anomalies with current valuations as depicted by our reverse DCF: 1) even as capex cycle comes in a burst and fades away in a crash, current valuations reflect that peak margin levels estimated for FY25E will sustain forever and 2) because of the lack of cyclicality assumed, FCF/sales through the next 20-25 years appear very high at 6.5-10.5%, which is almost double that delivered over the past 20 years.

Exhibit 124: While ordering activity remains strong, tendering activity has been weak across sectors except Railways

₹ bn	Orders					Tenders				
	FY22	FY23	9MFY24	TTM	YoY Growth (TTM)	FY22	FY23	9MFY24	TTM	YoY Growth (TTM)
Roadways	1,646	1,330	796	1,568	17.9%	3,016	4,385	3,246	4,444	1.4%
Power	694	985	1,646	1,843	87.1%	216	1,381	677	1,352	-2.1%
Railways	572	838	593	964	15.0%	692	1,084	1,300	1,575	45.2%
Water	373	727	500	791	8.8%	1,408	2,974	1,964	2,425	-18.4%
Irrigation	169	159	180	216	35.8%	554	1,254	660	950	-24.2%
Others	1,006	2,319	1,744	2,552	10.0%	3,244	3,157	2,429	3,187	0.9%
Orders Ex-L&T	**4,458**	**6,358**	**5,459**	**7,934**	24.8%					
L&T Orders	1,371	1,600	1,241	1,716	7.3%					
Total	**5,829**	**7,958**	**6,700**	**9,650**	21.3%	**9,130**	**14,234**	**10,276**	**13,934**	**-2.1%**
Total Ex-Roads	**4,183**	**6,628**	**5,904**	**8,082**	21.9%	**6,114**	**9,850**	**7,030**	**9,490**	**-3.7%**

Source: Projects Today, Ambit Capital research

Exhibit 125: Interim budget for FY25 already bakes in a much weaker 4% growth in infra capex...

₹ mn	FY21	FY22	FY23	FY24RE	FY25BE
Direct Budgetary Capex allocation					
Roads	895,663	1,133,727	2,067,389	2,645,233	2,722,382
Railways	1,093,237	1,172,705	1,592,562	2,400,000	2,520,000
MRTS/Metro	85,726	232,620	202,509	229,878	247,859
Total Infra Capex	**2,074,626**	**2,539,053**	**3,862,460**	**5,275,112**	**5,490,242**
% YoY growth	35%	22%	52%	37%	4%
Defence Capex	1,343,049	1,379,870	1,429,400	1,572,282	1,720,000
Total Infra+Defence Capex	**3,417,675**	**3,918,922**	**5,291,860**	**6,847,394**	**7,210,242**
% YoY growth	29%	15%	35%	29%	5%
IEBR funded capex					
Roads	650,350	651,500	79,800	-	
Railways	1,252,553	733,881	447,269	200,000	130,000
MRTS/Metro	8,000	12,800	9,775	11,333	-
Total	**1,910,903**	**1,398,181**	**536,844**	**211,333**	**130,000**
Total Infra capex (incl IEBR)	**3,985,529**	**3,937,234**	**4,399,304**	**5,486,445**	**5,620,242**
% YoY growth	28%	-1%	12%	25%	2%
Total Infra+Defence Capex (incl IEBR)	5,328,578	5,317,104	5,828,704	7,058,727	7,340,242
% YoY growth	26%	0%	10%	21%	4%

Source: Budget documents, Ambit Capital research

Exhibit 126: ...even as headline capex numbers suggest 17% growth fuelled by telecom, state transfers and unclassified expenses

Reconciliation with Reported Capex	FY21	FY22	FY23	FY24RE	FY25BE
Infra+Defence Capex as above ex IEBR	3,417,675	3,918,922	5,291,860	6,847,394	7,210,242
Telecom	43,561	33,278	547,286	700,994	844,575
Dept of Financial services	126,500	366,340	19,860	5,186	619
Transfer to States	195,522	225,338	927,045	1,155,559	1,424,089
One-off Air India loss absorbed		668,654			
Capital support to OMCs + Strategic petroleum reserve	-	-	-	-	150,000
Others	479,916	716,208	614,200	793,330	1,481,586
Total Reported Central Capex	**4,263,174**	**5,928,740**	**7,400,252**	**9,502,463**	**11,111,111**

Source: Budget documents, Ambit Capital research

Exhibit 127: Pre-election surge in ordering activity typically leads to a hangover as evident in L&T's operating metrics from 2019

	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Order inflow	43%	94%	-18%	21%	-16%	-30%	-2%
Revenue	18%	36%	43%	13%	27%	13%	-4%
NWC/Sales	21%	20%	20%	18%	23%	23%	24%
OCF (₹ bn)	-13.4	24.1	18.6	61.8	-38.2	13.9	24.9

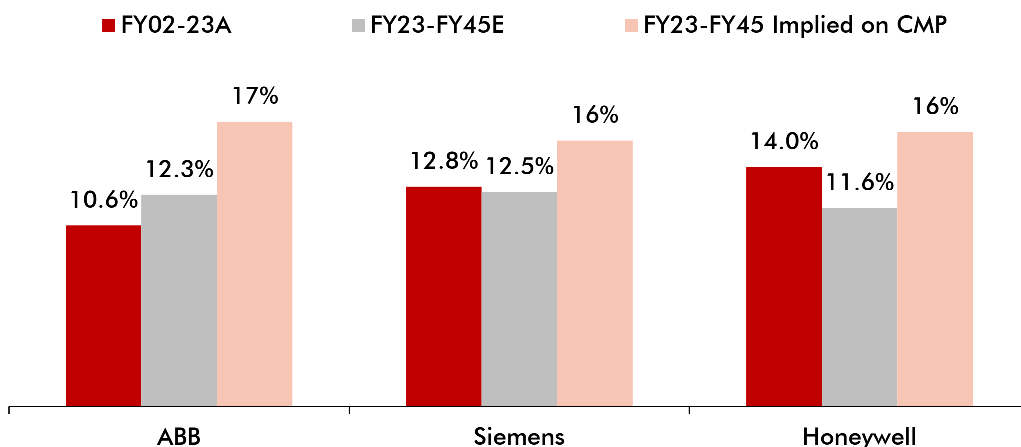
Source: Company, Ambit Capital research

Exhibit 128: Gross margins for the cap goods sector have been on a high in 2HFY23 as commodity prices fell

	Marr-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
ABB	34.0%	36.2%	34.8%	36.1%	36.3%	36.5%	36.7%	38%
SIEM	31.9%	31.6%	32.6%	32.9%	30.5%	31.8%	30.1%	32.0%
HWA	49.4%	48.8%	49.1%	40.6%	50.3%	47.8%	38.7%	42.0%
KKC	32.0%	31.1%	31.8%	33.8%	32.7%	32.5%	36.7%	37.0%
TRIV	44.5%	43.1%	46.7%	48.6%	52.0%	51.0%	49.0%	50.8%
CGPOWER	28.1%	28.6%	31.8%	31.6%	30.0%	30.0%	32.0%	31.0%
TMX	37.8%	41.3%	40.6%	44.1%	45.0%	44.0%	44.0%	45.0%
CU	65.9%	63.5%	64.5%	62.9%	61.9%	61.1%	64.7%	64.1%
GWN	58.0%	53.8%	53.5%	54.9%	55.0%	54.7%	55.2%	56.0%
AIAE	56.7%	56.5%	56.7%	63.8%	54.6%	56.3%	57.8%	58.9%

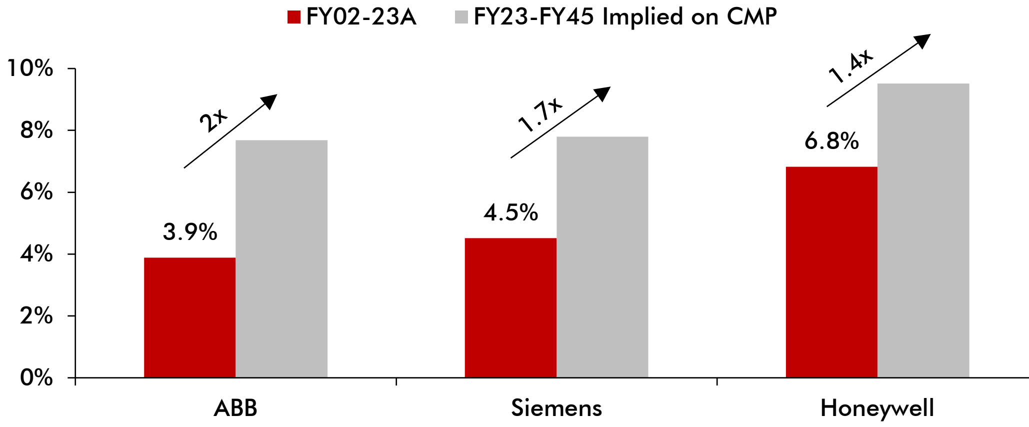
Source: Company, Ambit Capital research.

Exhibit 129: Reverse DCF implies CMP builds in 16-17% revenue CAGR until FY45E vs 11-14% delivered over FY02-23...



Source: Company, Ambit Capital research

Exhibit 130: ...and 7.7-9.5% FCF/sales vs 3.9-6.8% delivered in the past



Source: Company, Ambit Capital research

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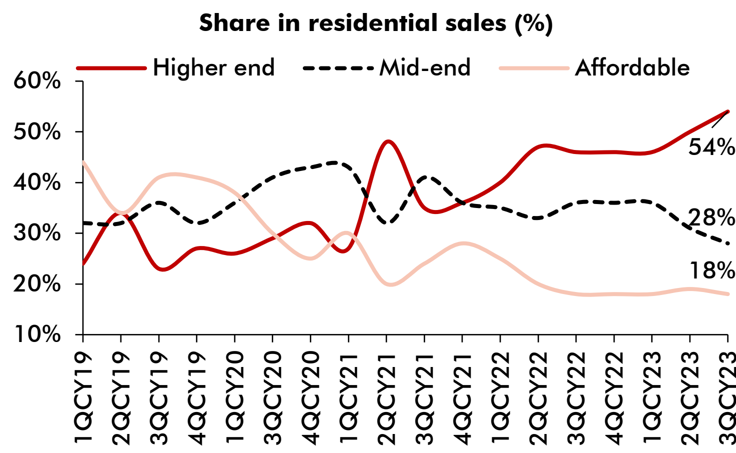
Affluent Investing – An opportunity

The affluent class in India was the first to recover from lockdowns imposed by the government as the economy rapidly formalized after the pandemic. In 3QCY23, the ultra-luxury segment of residential real estate accounted for 14% of sales. This share was less than 5% before the pandemic. Since the pandemic, higher-end segment of residential sales doubled from 27% to 54%.

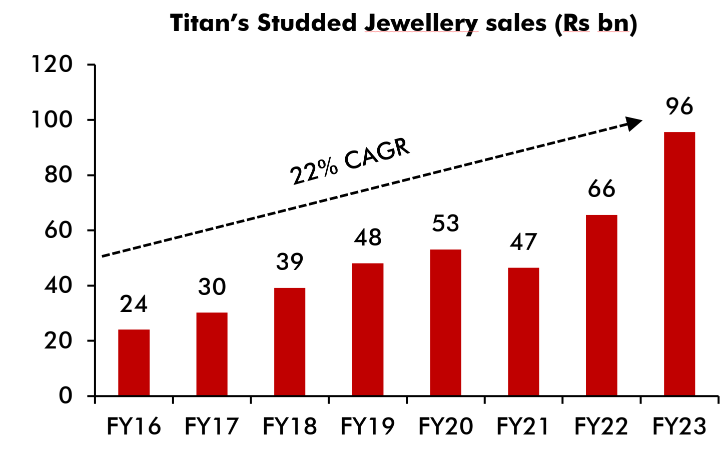
A K-shaped recovery highlights divergence between the affluent class and the rest. In a K-shaped recovery, some parts of the economy may experience strong growth while others may decline or remain stable. This can be used to describe uneven economic recovery.

Exhibit 131: Higher-end residential sales surged in recent years



Source: Anarock, Ambit Capital research. Note – Higher end includes luxury and ultra-luxury

Exhibit 132: Higher-end jewellery sales have increased significantly in recent years

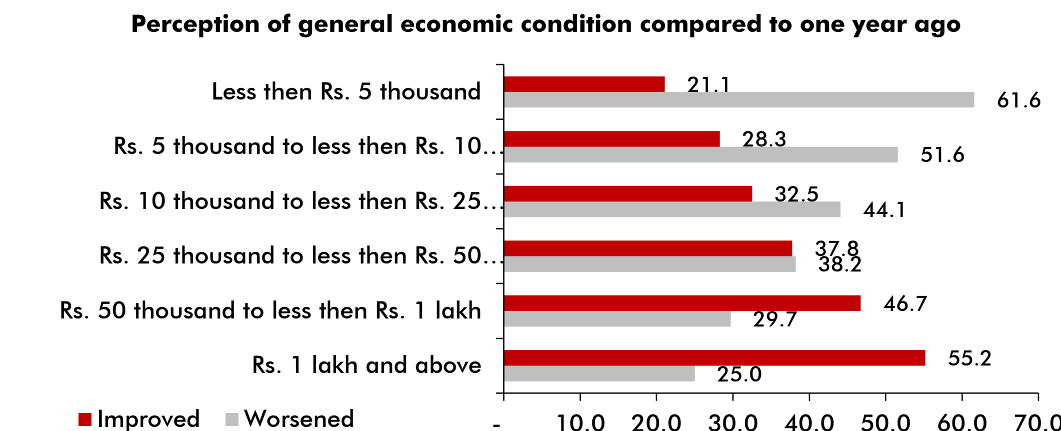


Source: Company, Ambit Capital research

Economic sentiment: The woes of the middle-class continue

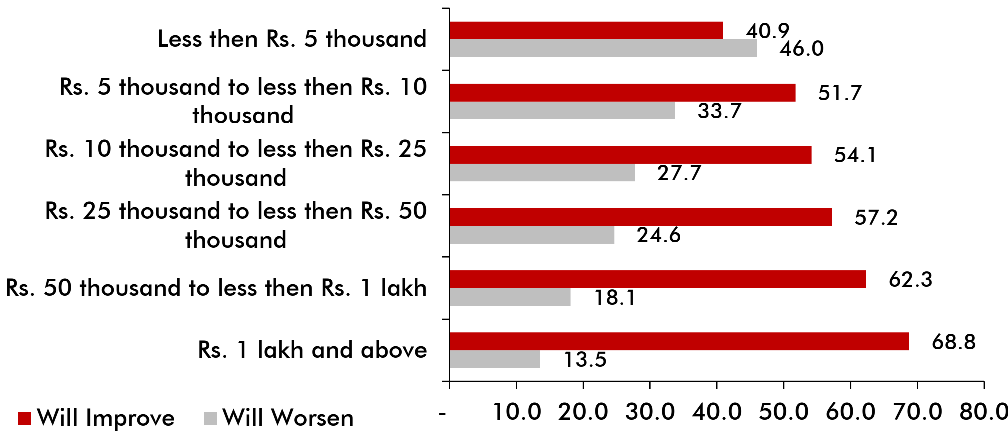
As per RBI's Consumer Confidence Survey, a majority of respondents having monthly income below ₹25k perceive economic conditions to have worsened over the past year. Surprisingly, even most respondents with monthly income of 25k-50k per month (well above the per-capita GDP of India) perceive economic conditions to have worsened over the past year. As we move towards the higher-income groups (above 50k monthly income), close to half of respondents perceive conditions to have improved since the past year, with more than 60% expecting conditions to improve in the coming year. In a nutshell, with negative sentiment sustenance among lower-income groups, there is a disparity in the perception of the current situation as well as outlook.

Exhibit 133: Respondents' perception of "current conditions" is a function of how much they earn



Source: Unit level data from CCS November survey, RBI, Ambit Capital research

Exhibit 134: Affluent class much more optimistic about economic conditions



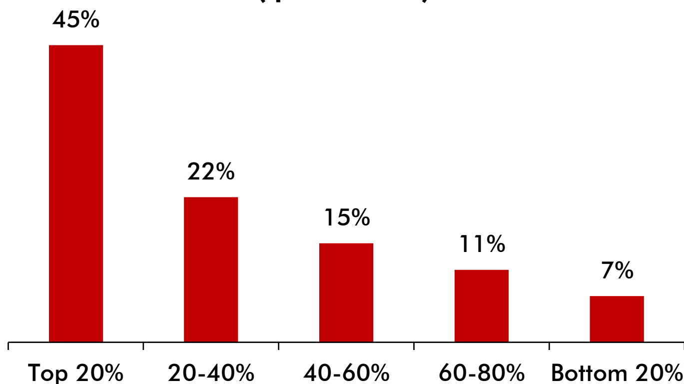
Source: Unit level data from CCS November survey, RBI, Ambit Capital research

Affluent consumption on the rise

According to Hurun India wealth survey, there are ~700,000 millionaires in India. This number is expected to grow by 75% over the next 5 years. While most of the affluent Indians live in Mumbai and Delhi, other cities such as Pune, Bengaluru, Surat, Ahmedabad and Nagpur are also seeing a steep rise in the 'super-rich' population.

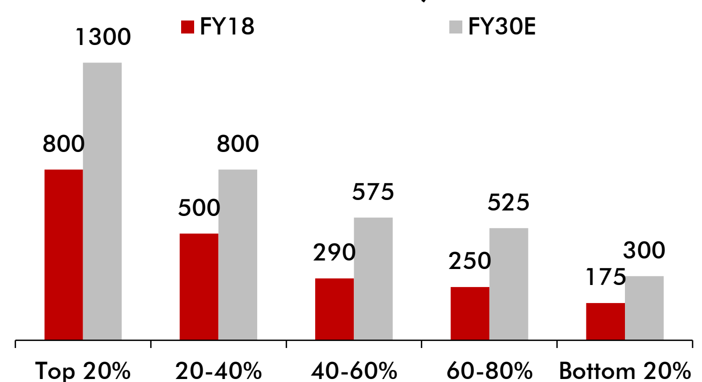
The top two quintiles of Indian consumers account for two-thirds of total income. The projected rise of this income group will create further demand for corresponding products. Screening out such companies can be a source of alpha from a medium-term perspective. Tourism and Hospitality stocks, Aviation stocks, Nestle, Metro Brands and Titan are some of the names which fall in this category.

Exhibit 135: Wealth is concentrated among the top 20% income earners



Source: ICE Survey (2021), Ambit Capital research.

Exhibit 136: The affluent consumer group is expected to see steep growth in its income over the next 12 years



Source: ICE Survey (2021), Ambit Capital research.

Evaluating sectoral attractiveness

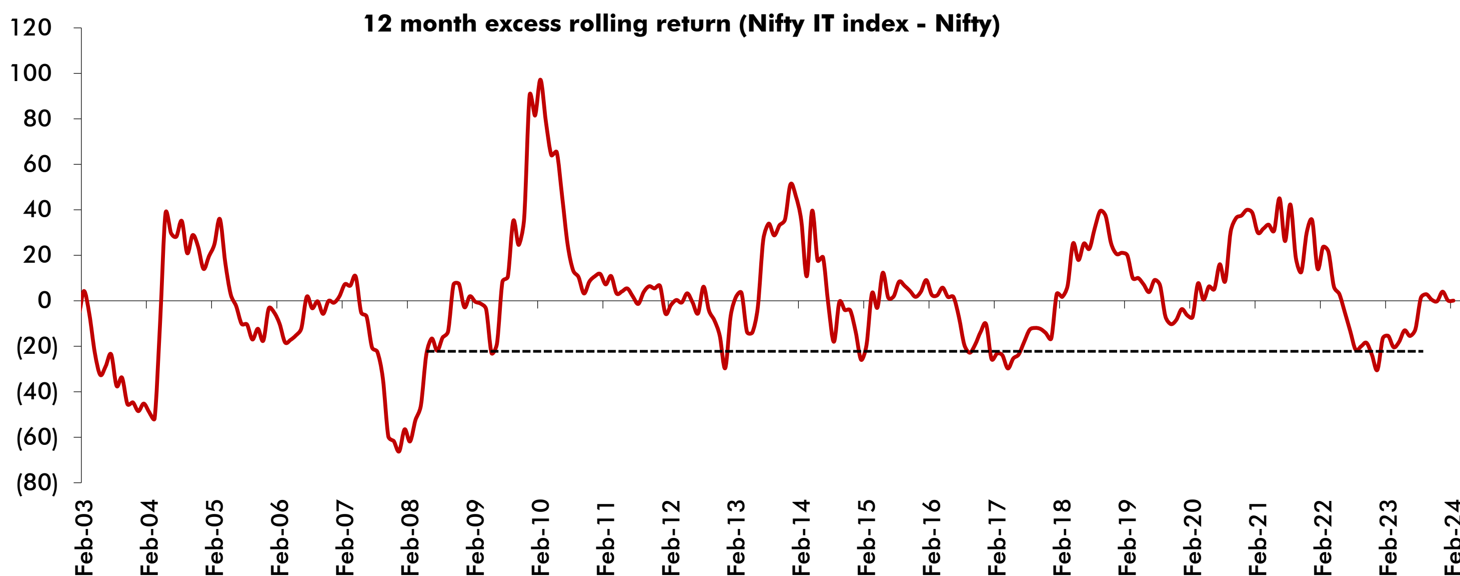
Our "sectoral attractiveness" framework comprises four parameters – 1. Excess returns, 2. Relative valuation, 3. Earnings estimate sustenance and 4. Ownership of the sector. In addition to this, we look at sector-specific intermarket relationships. We maintain our OW stance on Banks, Metals, Healthcare and OMCs but have cut weight in IT to UW (EW earlier). In G&C 18.3, we highlighted high expectations built in Capital Goods, Consumer Durables and Cement where market-cap increase is not backed by increase in profit pool and can correct if expectations are not met. The situation remains unchanged where financials continue to appear attractive.

"Sectoral attractiveness" determination is a key attribute for determining portfolio allocation. We evaluate sectoral attractiveness on four key parameters:

- **"Mean reversion" determined by excess returns**

We define excess returns of the sector as the 12-month rolling return differential of a sector w.r.t the market. The idea behind tracking these excess returns is that there is an anchoring bias in play and investors look at how much the sector has outperformed/underperformed Nifty over the last 1 year. "Extreme outperformance can breed reversion to mean and so does extreme underperformance". In May22 (see slides 30-33), we highlighted banks' underperformance w.r.t market is close to historical troughs and historically – this in itself serves as a great signalling tool. The key is to look at sectors at the turning points. The same was highlighted for IT in Nov-22.

Exhibit 137: Excess returns of the Nifty IT index reached a bottom in Dec-22 last year and IT rebounded thereafter

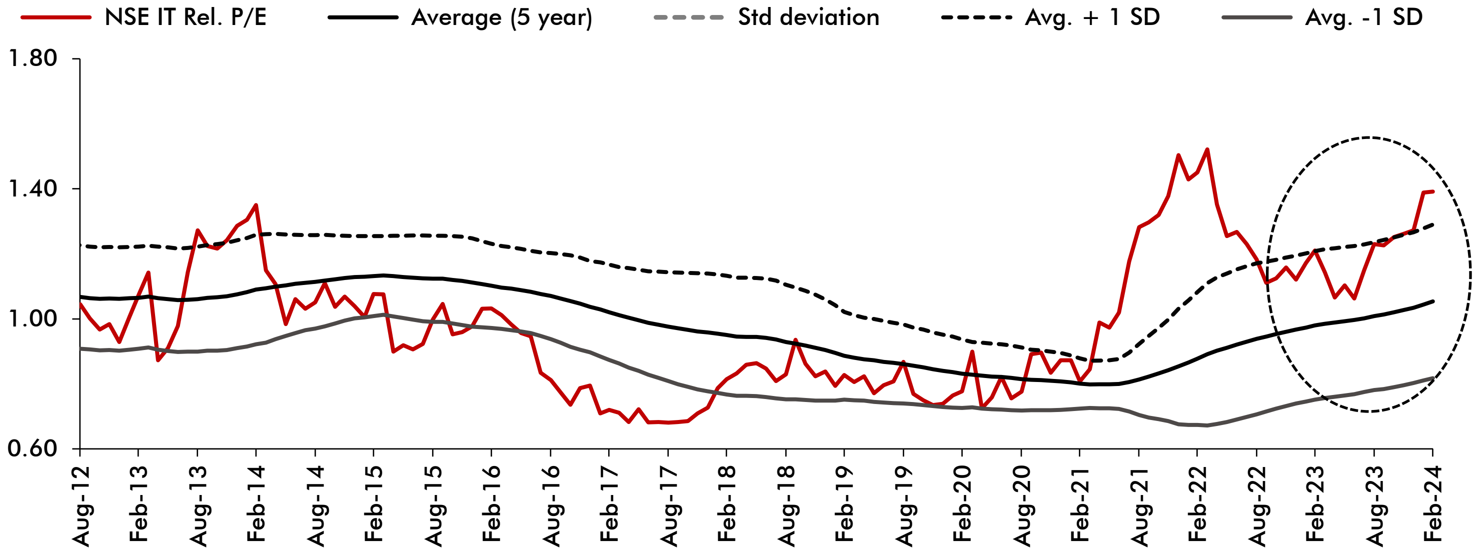


Source: Bloomberg, Ambit Capital research. Latest data as of 29 Feb'24

- **Relative valuations**

The relative valuation of the sector w.r.t market is the second variable for evaluating sector attractiveness. The crux is "Entry multiples matter." As highlighted in the Availability Factor (AF) note, AF of Indian equities is contracting as demand for Indian equities (26% CAGR since Dec-18) is outstripping supply of equities (20% CAGR since Dec-18), which has manifested in higher "trough multiples".

Exhibit 138: After the recent run, IT relative valuation Z-Score has touched +1.4



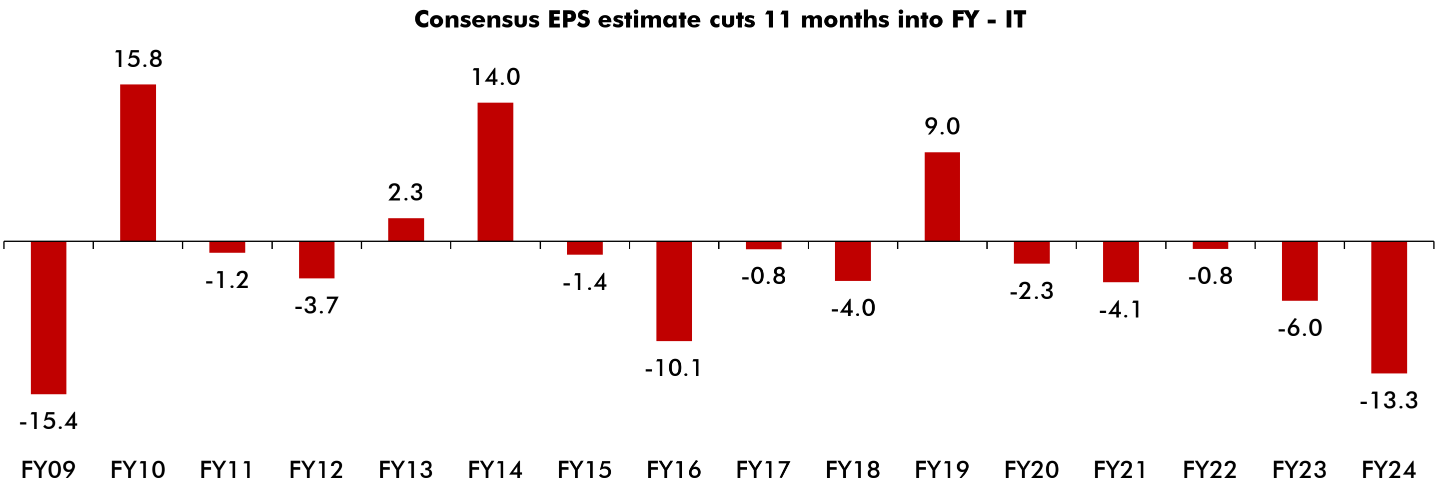
Source: Bloomberg, Ambit Capital research.

To account for this, it makes sense to look at relative valuations. Both the first and second variables are based on the principle of "mean reversion". The drawback with this analysis is that sometimes mean reversion can be slower, as seen in mid-caps in 2018-19.

- **Earnings estimate sustenance**

We look at earning estimate sustenance across sectors and compare it with the historical trends over the last decade. This gives us an idea of whether earnings cuts are reaching business cycle lows, estimates are robust, or already showing reversion. This is the third variable of our sectoral attractiveness framework.

Exhibit 139: Nifty IT earnings estimate trajectory is the worst since FY09



Source: Bloomberg, Ambit Capital research. Latest data as of 29 Feb'24

- **Ownership**

The ownership of the sector by DMF is the last variable of our sectoral evaluation. If the sector is under-owned and the mean reversion begins to manifest on price and valuation, this can add legs to the rally. We look at ownership of the sectors by comparing domestic MFs' allocation with index weights. The perfect way would be to compare the entire institutional investor ownership with the index weights, but since FII data comes with a lag, we have considered DMF as the representative.

This is how the sector looks like on our framework right now.

We want to highlight that our stock-specific calls have driven the OW in Auto. Our sectoral OW calls are on Banks, Healthcare, Metals and OMCs. We retain UW in Capital Goods and Cement.

Exhibit 140: How sectors look on our framework and our stance

Sectors	Recent Excess Returns	Relative Valuation to Nifty	Earnings estimate trajectory	Ownership w.r.t. NSE500 Sector weights	G&C Positioning	Comments
Auto	Very Unattractive	Very Unattractive	Robust	Significantly Overweight	OW	Driven by stock specific calls
Banks	Very attractive	Attractive	Robust	Neutral	OW	In line with framework
IT	Attractive	Very Unattractive	Worst since FY09*	Neutral	UW	In line with framework
Pharma	Unattractive	Attractive	Robust	Significantly Overweight	OW	In line with framework
FMCG	Neutral	Neutral	Robust	Significantly Underweight	UW*	In line with framework
Metals	Attractive	Unattractive	Neutral	Significantly Underweight	OW	In line with framework
O&G	Very Unattractive	Very attractive	Robust	Significantly Underweight	UW**	Disproportionate OW in OMCs
Capital Goods	Unattractive	Very Unattractive	Robust	Neutral	UW	In line with framework

*Source: Ambit Capital research. Bloomberg Note: Scores are assigned for excess returns, relative valuation and classified into 5 quintiles, 0-0.20 scores as very unattractive, 0.20- 0.40 as unattractive, 0.40-0.60 as Neutral,0.60-0.80 as attractive, and 0.80 to 1 as Very attractive. Ownership is calculated as difference between Equity holdings of DMF's and NSE500 sector weights. +/- 5% are defined as neutral, 5-15% as underweight/overweight, >15% are classified as significant OW/UW. Earnings estimate sustenance has been calculated based on comparison of how earnings estimates evolution for current FY and next FY. **We have disproportionate OW in OMC's but don't own Reliance * marginal UW*

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Reviewing our G&C 18.3 portfolio

We revisit our G&C 18.3 portfolio published in Oct'23. Our G&C 18.3 portfolio underperformed NSE500 index over the last 5 months marginally by 0.4% despite massive SMID outperformance, with our positioning being large-caps heavy. Overall outperformance since the beginning is ~100bps. Since Jan'24, Auto has been the biggest contributor to portfolio returns. Our OW "Financials" underperformed, which dragged overall performance. Our significant OW in Healthcare and Auto contributed to portfolio alpha. Prefer Banks over IT. We have made 4 changes. Add – Shriram Finance, Sun Pharma, Karur Vyasa Bank and Triveni Turbine; Remove – TCS, India mart, Bajaj Finance and GESCO; increase in weight – Axis Bank. Our preference order remains large-caps>mid-caps>small-caps. Mid/small-cap allocations are 21%/6% and cash 4.6%.

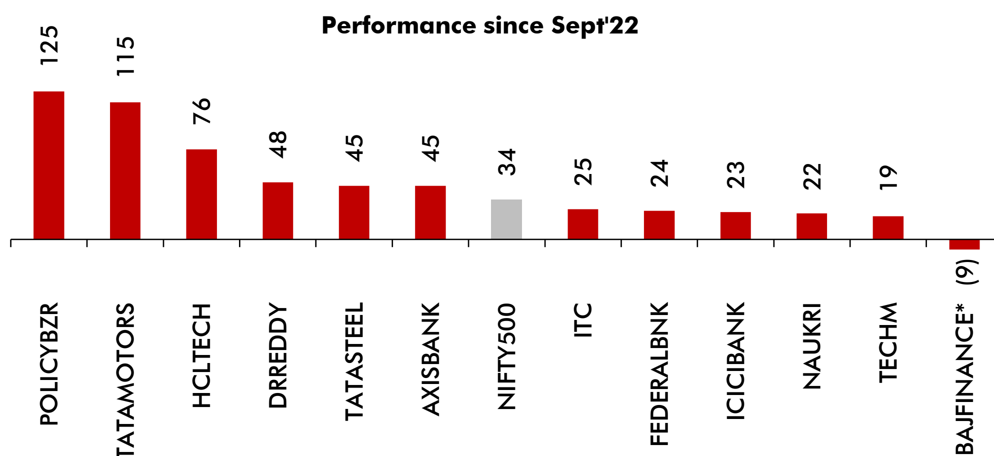
We added low-beta stocks displaying earnings momentum to the portfolio in Oct'23, which closed our UW position in Autos and FMCG. Becoming stock-specific.

How is our portfolio performance?

The portfolio performance is in line after lagging the benchmark in CY23. Our allocation towards small-caps and mid-caps has been significantly lower than benchmark since Sep-22 and has contributed to the underperformance. We increased some weight in the recent iterations, including bottom-up ideas from our house view. Our allocation to small and mid-caps in G&C 18.3 portfolio (Jan-24) is 23% compared to SMID weight in NSE500 benchmark which stands at 27%. Also, we don't hold any PSU Banks which was the stand-out performer in CY23 and delivered 135% return since 5th Sep-22.

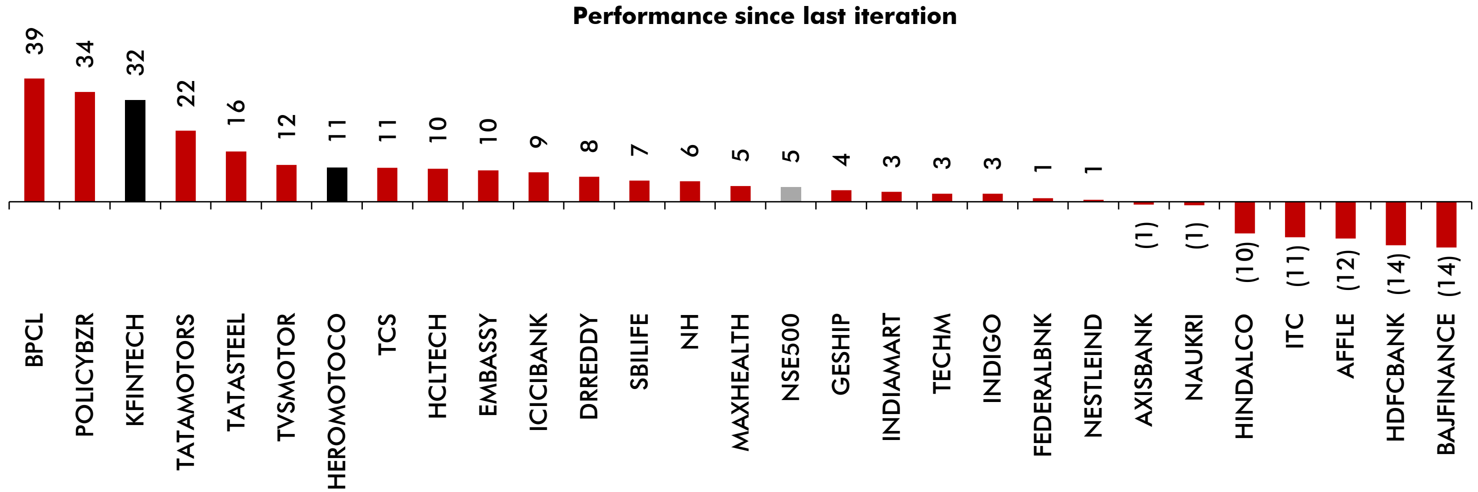
BPCL, PB Fintech and Auto OW helped bridge the gap over last month. Our stock selection has been better. While 50% of the stocks in the portfolio since G&C portfolio's inception outperformed the index, the extent of outperformance is significantly higher than the extent of underperformance. The biggest drag was Bajaj Finance, which underperformed the index significantly.

Exhibit 141: Out of 12 stocks that have been part of G&C portfolio since Sept'22, six have outperformed NSE500 with all six generating alpha of more than 10%



*Source: Ace Equity, Ambit Capital research; Note: * Bajaj Finance has exited the portfolio from this iteration*

Exhibit 142: Our latest additions (KFIN and Hero Motocorp) significantly outperformed the benchmark

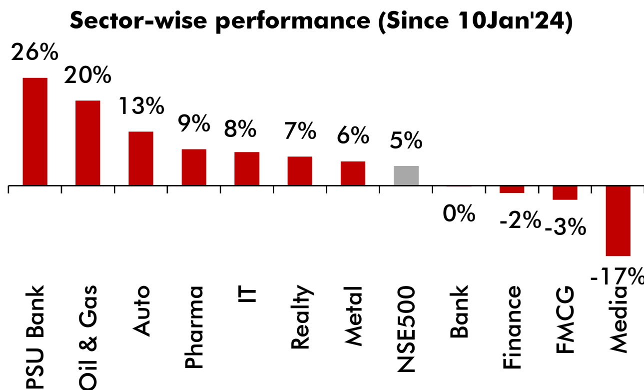


Source: Ace Equity, Ambit Capital research. Note: Stocks marked in black are additions to the portfolio in the last iteration.

Audit of our portfolio returns

- Since 10th Jan'24, PSU Banks was the biggest outperformer followed by Oil & Gas. Media and FMCG were the biggest laggards. Nifty 500 delivered 4.6% while the G&C portfolio (including cash) delivered 6.1%, outperforming the index by ~1.4%.
- We retain our OW stance on Banks. HDFC Bank, Axis Bank and Federal Bank underperformed. Reducing weight in Bajaj Finance in the previous iteration was positive from the portfolio perspective. While Financials (OW) underperformed the market by ~6% and dragged market performance, our latest addition, KFIN, outperformed by ~27%.
- Significant OW in Healthcare contributed to portfolio outperformance. Dr. Reddy, Max Healthcare and Narayana Hrudayalaya outperformed the market massively.
- In the last iteration, we increased weight in Auto, including Hero MotoCorp. Since then it has outperformed market by ~6%. Again, significant OW in Auto helped portfolio performance but these are more stock-specific calls rather than sector call.
- Oil & Gas (UW) outperformed the market by 16%. Our portfolio stock BPCL outperformed the market by ~34%.
- BPCL (39%), PB Fintech (34%) and KFin Technologies (32%) were the biggest outperformers whereas Bajaj Finance (-14%), HDFC Bank (-14%) and Affle India (-12%) were the key laggards.

Exhibit 143: PSU Bank and Oil & Gas outperformed most while Media & Finance were the biggest drags (NSE500)



Source: Ace Equity, Ambit Capital research. Notes: Returns have been calculated from 10th Jan'24 to 2nd Mar'24

Exhibit 144: G&C 18.3: Sector-wise performance and attribution since 10th Jan-24

Sector	Weight in G&C (%)	Contribution to return
Auto & Auto Anc.	13.7	2.2%
Oil & Gas	4.3	1.7%
New-age tech	3.8	1.3%
IT	10.6	0.9%
Healthcare	9.3	0.6%
Miscellaneous	7.8	0.3%
Metals & Mining	7.8	0.2%
Financials	27.6	0.1%
Media	6.9	-0.2%
FMCG	8.2	-0.5%

Source: Ace Equity, Ambit Capital research. Notes: Returns have been calculated from 10th Jan'24 to 2nd Mar'24

Exhibit 145: Performance of our G&C 18.3 portfolio since 10th Jan-24

Company Name	Caps	Sector	Absolute Price Performance	Contribution to G&C 18.3 performance
Bharat Petroleum Corp	Large-cap	Oil & Gas	39%	1.7%
PB Fintech	Mid-cap	New-age tech	34%	1.3%
Tata Motors	Large-cap	Auto & Auto Anc.	22%	1.3%
Tata Steel	Large-cap	Metals & Mining	16%	0.6%
TVS Motor Co	Large-cap	Auto & Auto Anc.	12%	0.5%
HCL Technologies	Large-cap	IT	10%	0.5%
ICICI Bank	Large-cap	Financials	9%	0.5%
Kfin Technologies	Small-cap	Financials	32%	0.4%
Tata Consultancy Services	Large-cap	IT	11%	0.4%
Hero MotoCorp	Large-cap	Auto & Auto Anc.	11%	0.4%
Dr Reddy's Laboratories	Large-cap	Healthcare	8%	0.3%
SBI Life Insurance Co	Large-cap	Financials	7%	0.2%
Max Healthcare Institute	Mid-cap	Healthcare	5%	0.2%
Embassy Office Parks REIT	Small-cap	Miscellaneous	10%	0.1%
InterGlobe Aviation	Large-cap	Miscellaneous	3%	0.1%
Narayana Hrudayalaya	Small-cap	Healthcare	6%	0.1%
Great Eastern Shipping Co/The	Small-cap	Miscellaneous	4%	0.1%
Tech Mahindra	Large-cap	IT	3%	0.1%
IndiaMart InterMesh	Small-cap	Media	3%	0.0%
Federal Bank	Mid-cap	Financials	1%	0.0%
Nestle India	Large-cap	FMCG	1%	0.0%
Info Edge India	Mid-cap	Media	-1%	0.0%
Axis Bank	Large-cap	Financials	-1%	-0.1%
Affle India	Small-cap	Media	-12%	-0.2%
Bajaj Finance	Large-cap	Financials	-14%	-0.3%
Hindalco Industries	Large-cap	Metals & Mining	-10%	-0.4%
ITC	Large-cap	FMCG	-11%	-0.5%
HDFC Bank	Large-cap	Financials	-14%	-0.7%
G&C 18.3 performance				**6.6%**
G&C 18.3 returns (incl. Cash)				**6.1%**
Alpha v/s NSE500				**1.4%**

Source: Ace Equity, Ambit Capital research

What goes out and what comes in?

What goes out? We exclude four stocks, TCS, IndiaMart InterMesh, Bajaj Finance and GESCO, from G&C 18.3 portfolio.

What comes in? There are **four additions** to our portfolio – Shriram Finance, Sun Pharma, Karur Vyasa Bank and Triveni Turbine. We increase weight in Axis Bank marginally. These along with 24 existing stocks from G&C 18.3 comprise our latest G&C 18.4 portfolio.

Size allocation: Concentrated towards large-caps (73%). Mid-cap/small-cap allocations stand at 21%/6%. Cash allocation stands at 4.6%.

Since mid-caps and small-caps are included in the portfolio, NSE500 is our benchmark.

Exhibit 146: G&C Portfolio vs NSE500: Implicit sector weights

Sector	Weights		Deviation
	G&C 18.4	NSE500	v/s NSE500
Auto & Auto Anc	14.3	7.3	7.0
Healthcare	12.6	5.7	6.9
Media	5.0	0.6	4.4
New-age tech	4.6	0.5	4.1
Metals & Mining	7.1	3.7	3.4
Financials	29.3	27.8	1.5
FMCG	7.0	7.5	(0.5)
Oil & Gas	5.4	8.9	(3.5)
IT	6.6	10.4	(3.8)
Capital Goods	1.3	8.5	(7.2)
Miscellaneous*	5.4	19.0	N/A

*Source: Ace Equity, NSE, Ambit Capital research. * Cannot be compared with NSE500*

Exhibit 147: Dissection of our G&C Portfolio – OW/UW w.r.t Nifty500

Sector	UW/OW	Portfolio Companies
Overweight		
Auto & Auto Anc	7.0	Tata Motors, TVS Motor Co, Hero Motocorp
Healthcare	6.9	Dr Reddy's Laboratories, Sun Pharma, Max Healthcare, Narayana Hrudayalaya
Media	4.4	Info Edge, Affle India
New-age tech	4.1	PB Fintech
Metals & Mining	3.4	Tata Steel, Hindalco Industries
Financials	1.5	Axis Bank, Shriram Finance, ICICI Bank, HDFC Bank, SBI Life Insurance, Federal Bank, KFin Technologies, Karur Vysya Bank
Underweight		
FMCG	-0.5	ITC, Nestle India
Oil & Gas	-3.5	BPCL
IT	-3.8	HCL Technologies, Tech Mahindra
Capital Goods	-7.2	Triveni Turbine
Miscellaneous	N/A	Interglobe Aviation, Embassy Office Parks

Source: Ace Equity, Ambit Capital research. Note: Auto OW and FMCG UW are not driven by sectoral calls but by stock-specific calls.

Why we have included these stocks in the portfolio?

Sun Pharma

Visibility on the next leg of growth for Sun's specialty business should improve in the next 12-18 months. Execution in specialty surpassed expectations with its share in revenues at ~18% led by focused R&D spend and effective business development initiatives. Pipeline building initiatives continue with ~52% specialty R&D CAGR over FY22-24E and deals to add Deuruxolitinib and Nidlegy to the pipeline. Commercialization is set to pick up again over FY25- 26 with multiple potential approvals lined up that would drive the next leg-up in revenues in the following years. Sun's consistent and successful efforts to move up the value chain would continue to support premium valuations vs peers. Rising salience of the specialty business in revenues and reducing dependence on US generics (now ~14% of revenues) support greater earnings resilience and higher valuation multiples.

Shriram Finance

AUM growth is expected to remain on a strong trajectory (FY23-26E: 16% CAGR) led by increasing dominant industry positioning in used vehicle finance and increasing penetration of eSCUF products in eSTFC branches. Expect NIMs to be stable given higher growth in higher margins products. Within vehicle finance, growth is higher in used PVs where yields are 100-200bps higher. On the liability side, marginal cost of NCDs is equal to or less than book cost, which bodes well. Credit cost is likely to remain stable given SFL has been prudent in the last few years on CV lending as reflected in lower net slippages as well as write-offs. Given AUM growth trajectory, stable NIMs and credit costs, we expect EPS CAGR of ~20% (FY23-26E).

Karur Vyasa Bank

Steps taken to overhaul the board in favour of independent directors, strengthening management by hiring external experts and improvements in loan origination & underwriting yielded results – loan growth and asset quality were better than peers in FY20-23. Enhanced loan monitoring should result in credit cost decreasing to average 80bps over FY24-26 vs 2% over FY20-23 and be a major driver of ROE improvement and earnings growth. Steps taken to diversify loan book and introduction of new channels/products should help maintain loan market share. LCR ratio of 258% and 47% MCLR-linked loan book put KVB on better footing vs peers in protecting NIMs in FY24-25. We expect ~20% EPS CAGR over FY23-26 with average ROE of 16%.

Triveni Turbine

Triveni Turbine (Not Rated) is global #2 in industrial steam turbines led by strong R&D and an aftermarket business that plays on cost arbitrage (25%+) even for other OEMs such as Siemens, GE and Toshiba while also helping bring in product sales opportunity. Even when domestic capex declined in the past decade, TTL's topline grew led by 25%/10% CAGR in higher-margin exports/aftermarkets businesses. Consensus estimates 25%/30% revenue/EPS CAGR over FY23-26, similar to our estimate of 22% CAGR in process capex. Despite superior growth vs peers, the stock trades at 44x 1-year forward P/E at the median of sector valuation.

Exhibit 148: G&C 18.4 composition and valuations

Company	Sector	Mcap	MDV-3m	Accounting Decile	Greatness Score	Ambit stance	P/E (x)		P/B (x)		ROCE/ ROA
		($mn)	($mn)				FY24E	FY25E	FY24E	FY25E	FY23*
Tata Motors	Auto	43,683	97	D8	17%	NR	19	16	5.7	4.2	5
TVS Motor Co	Auto	12,919	21	D10	42%	NR	51	40	13.9	10.9	21
Hero MotoCorp	Auto	11,055	34	D2	17%	NR	23	19	5.1	4.6	18
InterGlobe Aviation	Aviation	14,720	25	D1	42%	NR	17	16	229.8	16.2	5
Triveni Turbine	Capital Goods	1,973	2	D1	58%	NR	62	47	17.2	13.7	24
HDFC Bank	Financials	131,168	357	N/A	N/A	NR	17	15	2.5	2.2	2
ICICI Bank	Financials	91,889	180	N/A	N/A	BUY	19	18	3.4	2.9	2
Axis Bank	Financials	40,842	116	N/A	N/A	BUY	15	13	2.4	2.0	2
SBI Life Insurance	Financials	18,692	23	N/A	N/A	BUY	23	23	2.3	2.3	N/A
Shriram Finance	Financials	11,142	34	N/A	N/A	BUY	13	11	1.9	1.7	3
Federal Bank	Financials	4,506	25	N/A	N/A	BUY	10	9	1.3	1.1	1
Karur Vysya Bank	Financials	1,788	5	N/A	N/A	BUY	10	9	1.5	1.3	1
Kfin Technologies	Financials	1,413	4	N/A	N/A	BUY	51	45	N/A	N/A	N/A
ITC	FMCG	62,070	68	D2	33%	NR	25	23	7.4	7.1	29
Nestle India	FMCG	30,197	24	D3	50%	SELL	83	72	80.9	63.2	110
Sun Pharmaceutical Industries	Healthcare	44,901	34	D8	83%	BUY	40	33	5.9	5.2	18
Dr Reddy's Laboratories	Healthcare	12,560	24	D1	92%	BUY	19	17	3.8	3.2	18
Max Healthcare	Healthcare	9,036	17	D10	83%	BUY	55	45	8.0	6.8	30
Narayana Hrudayalaya	Healthcare	3,256	5	D1	75%	BUY	32	29	9.4	7.5	32
HCL Technologies	IT	53,921	49	D3	58%	SELL	28	26	6.7	6.5	27
Tech Mahindra	IT	14,999	32	D6	50%	BUY	44	23	4.8	4.8	18
Info Edge India	Media	8,095	16	D8	75%	BUY	81	70	5.7	5.4	5
Affle India	Media	1,903	3	D4	50%	NR	54	42	6.9	6.0	17
Tata Steel	Metals & Mining	23,393	61	D8	92%	BUY	N/A	14	2.0	1.9	12
Hindalco Industries	Metals & Mining	14,181	39	D5	92%	BUY	13	9	1.1	1.0	12
Embassy Office Parks REIT	Miscellaneous	4,293	4	N/A	N/A	BUY	51	35	1.5	1.6	3
PB Fintech	New-age tech	6,061	13	D5	33%	BUY	446	95	8.7	7.7	(13)
BPCL	Oil & Gas	16,369	62	D10	33%	BUY	5	11	1.8	1.6	5

Source: Bloomberg, Ambit Capital research. Note: N/A indicates data not available; NR indicates Not Rated; For SBI Life, P/E indicates Price to Value of New Business per share (P/VNB), P/B indicates Price to Embedded Value per share (P/EV); For not rated companies P/E, P/B, ROCE/ROA values are Bloomberg consensus; Latest data as of 02nd Mar'24

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Investment Rating	Expected return (over 12-month)
BUY	We expect this stock to deliver more than 10% returns over the next12 month
SELL	We expect this stock to deliver less than or equal to 10 % returns over the next 12 months
UNDER REVIEW	We have coverage on the stock but we have suspended our estimates, TP and recommendation for the time being NOT
NOT RATED	We do not have any forward-looking estimates, valuation, or recommendation for the stock.

Note: At certain times the Rating may not be in sync with the description above as the stock prices can be volatile and analysts can take time to react to development.

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