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The Smart Investor
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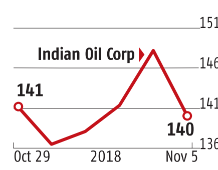
QUICK TAKE: WEAK Q2 DRAGS INDIAN OIL



Shares of Indian Oil (IOC) fell by 5.5 per cent on Monday. Analysts at JM Financial say that even after excluding exceptional items, IOC's September quarter (Q2) results were weak with operating profit 40 per cent below their estimates

TSI P2 FIVE FACTORS SET TO IMPACT MARKETS

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FPIs, MFs chasing fewer stocks

Their investments in the top 20 shares as percentage of the overall investment touched a multi-year high

ASHLEY COUTINHO
Mumbai, 5 November

Distorted valuations and regulatory changes have prompted institutional investors to go after fewer stocks in the last one year or so, indicating polarisation among equities.

Numbers for the September quarter show that the percentage of investments by foreign portfolio investors (FPIs) in the top 20 stocks vis-a-vis other stocks on the NSE stood at 55.15 per cent. This is the highest since September 2013, data from Prime Database shows.

Mutual funds (MFs) had invested 44.5 per cent of their corpus in the top NSE stocks. This is the highest since March 2014.

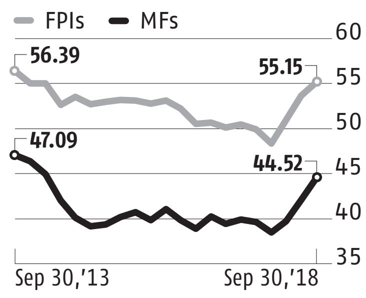
Companies such as HDFC, HDFC Bank, Axis Bank, Reliance Industries, TCS, Maruti Suzuki, ICICI Bank, Kotak Mahindra Bank and L&T have seen buying interest from both FPIs and mutual funds in the past five years.

"Traditionally, institutional investors, especially from outside India, have gravitated towards the top 10-20 stocks, keeping in mind the mandate for adhering to a certain market cap and the corporate issues faced by a lot of mid- and small-cap shares," said Pranav Haldea, managing director, Prime Database.

In the past few months, investors have been dumping mid- and small-cap stocks and taking refuge in large-caps. The Securities and Exchange Board of India's (Sebi's) mandate to categorise equity schemes according to market capitalisation has also restricted investments in these stocks by mutual funds. There is polarisation among sectors with IT and healthcare receiving the lion's share of FPI money in the past two quarters.

NUMBERS GAME

Percentage of investment in top 20 stocks vis-a-vis all NSE-listed firms



Source: PRIME Database

In the last one year, the BSE Midcap and Smallcap indices slipped 12 per cent and 19.5 per cent, respectively. In contrast, the BSE Sensex is up four per cent during the same period.

FPIs continued to dump stocks this year even as domestic institutions stepped up their purchases. FPIs have offloaded shares worth more than ₹400 billion this year. In comparison, domestic institutions have shopped for equities of more than ₹1 trillion.

In September, India saw $931 million of overseas outflows, driven by non-ETF outflows of $1 billion, according to a recent research note put out by Kotak Institutional Equities. This compares with the outflows of $832 million for Taiwan and $566 million for Russia. Allocation to India by Asia funds declined to 12 per cent in September from 13.2 per cent in August, while that by global emerging market funds declined to 9.7 per cent from 10.6 per cent. Shares of consumer discretionary and consumer staples witnessed the most selling in 2018, to the tune of $2.1 billion and $1.3 billion, respectively. IT and healthcare sectors saw the highest buying interest with inflows of $774 million and $194 million, respectively.

The surge in domestic equity inflows has insulated the Indian equity markets several times in the past few years. Flows in equity mutual funds through systematic investment plans continue to be robust (₹60-70 billion). While this is unlikely to get impacted significantly by the recent sell-off, lumpsum investments from retail and wealthy investors are beginning to taper off, say experts.

"We expect equities to grind lower in the coming months, given our expectation of further earnings downgrades led by higher interest rates, rising inflation, and its impact on the economy, coupled with weaker-than-expected monsoon so far," said Jitendra Gohil, head, India equity research, Credit Suisse Wealth Management, in a recent note put out by the brokerage.

Gohil said investors need to be cautious as valuations remained stretched compared to peers and historical averages. The country's equities were trading at a 12-month forward price to earnings multiples of 16.1 versus the 10-year average of 15. "While the domestic equity flows are slowing, this will remain high. We expect a sharp slowdown amid heightened risk aversion. We maintain our 'book profits' call on equities that started in early September," Gohil said.

ILLUSTRATION: AJAY MOHANTY

'FII flows into EMs may resume as valuations fall'

Valuations in other emerging markets (EMs) look better compared to India, says **MUKUL KOCHHAR**, head of institutional sales (India), Investec Capital. However, the country will also stand to gain as flows into EMs may resume as valuations have become cheaper after this year's correction, Kochhar tells **Samie Modak**. Edited excerpts:

PHOTO: KAMLESH PEDNEKAR

Why have the broader markets seen a sharp correction this year?

In the four years ending 2017, roughly one of five stocks in India quadrupled. So, we entered 2018 from a period where everything had worked. It had been difficult to distinguish skill from luck. This year, stocks have corrected, which was somewhat predicted. Since, the rise had been extreme, the correction, therefore has been severe.

How does the Indian market compare to other EMs?

India's valuations are at a premium compared to other EMs. There are reasons why some premium is justified — India offers one of the highest standards of minority protection in the world, deep and diverse markets, and good corporate governance standards. However, at present, other markets may look better, purely in terms of valuation. However, if the EM pack starts getting foreign flows because they have become cheap overall, India will also stand to benefit. If the flows improve, it will help stabilise the rupee and also provide temporary support to the market.

Given headwinds such as rising US dollar and bond yields, do you expect a turnaround in foreign flows?

We believe that both the factors are related and may be close to playing out. The Fed's rate guidance may already be baked into markets, with path being laid out for another four rate increases that will get us to 3.25 per cent by September 2019. This means that the Fed stands to overshoot its own neutral rate by sometime next year. By next year, if global weakness seeps into the US market, the path may be less steep, which will be less supportive of the dollar and yields. In addition, mid-term elections in the US may lead to a lame duck presidency as odds favour loss in the house of representatives by the Republican President.

Till valuations become cheap on an absolute basis and macro environment more stable, FII flows will remain volatile. However, foreign flows also depend on overall EM flows, which should get better from here.

Q&A

How do valuations look like after the correction? Do you see valuations under-shooting long-term averages?

Valuations remain higher than long-term averages by 10-15 per cent for the Nifty. Valuation premium is even higher when you move to mid-cap stocks. Such a premium is palatable if the macro environment becomes stable and there is visibility around the next government formation. Valuations can undershoot in the near term in case we get an unstable outcome in next year's election, or if the US-China trade war takes a turn for the worse. Investors should watch the meeting between Trump and Xi in December carefully as a China in crisis in the near term is not good for EM flows.

How big an event are the state and general elections from the market point of view?

State, not so much, since any outcome will get discounted. If results are not on expected lines, the argument will be that people vote differently in the central elections. From the market point of view, any stable government formation is a positive. As of now, the only stable possibility seems to be a government headed by the BJP. If another stable outcome emerges, that is also not too bad.

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Markets tumble after witnessing best week in 2 years

AMEYA KARVE
5 November

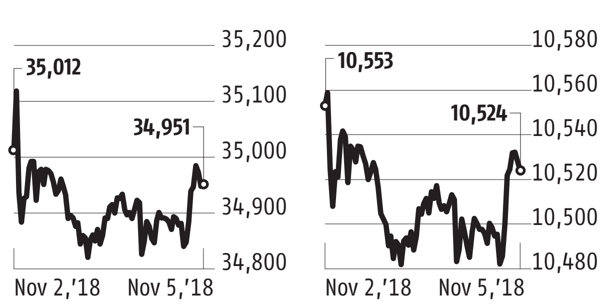
Stock indices fell, on weak global cues, after capping their best week in more than two years.

The benchmark S&P BSE Sensex dropped 0.2 per cent to 34,950.92 at the 3:30 pm close after swinging between gains and losses at least four times.

Thirteen of the 19 sector indexes retreated, led by a gauge of power-related companies, while some property stocks rose the most. The NSE Nifty 50 Index lost 0.3 per cent.

Drugmaker Cipla dropped the most among Nifty members, down 7.3 per cent, after its profit and revenue in July to September trailed analyst estimates. State Bank of India, the nation's top lender by assets, climbed 3.4 per cent after returning to profit.

MARKET MOVEMENT



Compiled by BS Research Bureau

The Sensex recovered last week amid company earnings reports and a fall in oil prices. Headwinds such as the trade tension between the US and China and a domestic cash crunch continue to weigh on investor sentiment. Upcoming local state and national elections are adding to uncertainty.

"Volatility and price fluctuations are here to stay for the next three to six months, mainly as investors bet on all the possible outcomes in the run-up to the state and national polls," said Arun Kejriwal, founder of Kejriwal Research & Investment Services Pvt.

Five Indian states are headed for polls this month and the next and the outcome is seen as an indicator of the voter sentiment on the Narendra Modi-led Bharatiya Janata Party national government, which in turn is expected to seek re-election around May 2019. The equity benchmarks are still down more than 10 percent from their all-time highest closes on Aug. 28. Yet, the stocks aren't attractive enough for some. Even as Nifty valuations decline, "it is not yet at levels which would suggest it is time to buy," Gautam Chhaochharia, analyst at UBS Securities India Pvt., wrote in a note to investors.

The NSE Volatility Index rose 6.9 percent, halting a three-day decline. Of the 42 NSE Nifty 50 Index companies that have announced results so far, 24 have either met or exceeded profit estimates. **BLOOMBERG**

THE COMPASS

SBI's strong Q2 rubs off positively on other PSBs

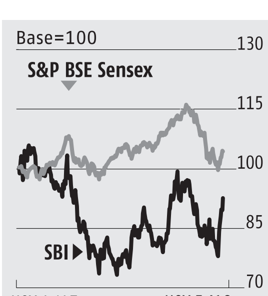
The ₹9.4-bn net profit was supported by exceptional income of ₹15 bn; advances grew 9.3%

SHREEPAD S AUTE

State Bank of India's (SBI's) July-September 2018 quarter (second quarter, or Q2) results were not only better than expected, but also suggest that major problems pertaining to asset quality or non-performing loans (NPAs) are behind. This also helped improve investors' confidence in other public sector banks, which have been facing asset quality and growth issues. With this, analysts believe the major pain is behind for SBI. This could lead to more gains for the stock.

Not surprising then, SBI and the Nifty PSU Bank index ended with 3.4 per cent and 2.9 per cent gains on Monday, against 0.27 per cent decline in Nifty50.

The key highlight in SBI's Q2 is the sequential improvement in asset quality, led by lower slippages (accounts turning bad), which declined 24 per cent. Importantly, 75 per cent of corporate slippages of ₹31.9 billion were from the watch list (known loan accounts with potential to default), indicating new bad loans were restricted.



Compiled by BS Research Bureau

With this, watch list, as a percentage of total advances, fell to 1 per cent, from 1.12 per cent a quarter ago. Gross NPA ratio improved to 9.95 per cent, from 10.7 per cent in first quarter (Q1) of 2018-19 (FY19). The management also sounded confident about controlling NPAs.

Yes, selling part stake in SBI General Insurance and transfer of merchant acquiring business (exceptional income of ₹15.6 billion) helped SBI post a net profit of ₹9.4 billion in Q2, but Q2 of last year also included a higher amount of ₹54.36 billion earned from stake sale in SBI Life allowing the bank to post a profit of ₹15.8 billion. Nonetheless, the net profit for latest quarter was ahead of the ₹6.3 billion estimated by analysts.

Even as higher expenses weighed on operating performance, a 12.5-per cent year-on-year (YoY) rise in net interest income to ₹209.1 billion, led by 9.3 per cent rise in advances to ₹20.7 trillion, are signs of recovery.

Interestingly, SBI's corporate loan book surged 14.3 per cent YoY. Net interest margin, too, improved 29 basis points YoY to 2.88 per cent, despite no large resolution under the National Company Law Tribunal as observed in Q1FY19.

"Good advances growth, improvement in asset quality (with lower slippages), and provision coverage ratio to a healthy 70.7 per cent are positives. Though provisions and slippages may remain elevated, but should be following a decreasing trend since major NPA recognition cycle has peaked," says Lalitabh Srivastava, AVP at Sharekhan, who believes the risk-reward is in favour of SBI.

Multiple ailments cloud outlook for Cipla

Company cautious on prospects given supply disruptions & commodity inflation, among others

RAM PRASAD SAHU

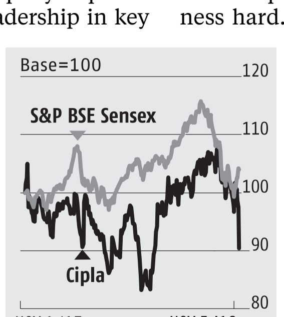
The Cipla stock shed as much as 7 per cent on weak September quarter results as well as a guarded outlook over the next couple of quarters.

The pharmaceuticals major said there was pressure on the tender business, supply disruptions, commodity inflation and business impact from countries hit by sanctions.

This hit Street sentiment. While some issues such as the disappointing India business performance are temporary, significant shrinkage in the global tender business is expected to recur.

Due to seasonal disruptions and delay in monsoon, the domestic acute therapy business was hit and India revenues, which account for 40 per cent of overall figures, were flat compared to the year-ago quarter. The base effect, given the restocking post-GST implementation, also impacted growth in the quarter. For the first half of the fiscal, adjusted growth at 13 per cent was better than the sector. The company hopes to outperform the sector given leadership in key therapies, market share gains and marketing push.

North America was the best performing market, growing at 12 per cent year-on-year. This was aided by new product launches while margins improved due to rationalisation of portfolio and product ramp up. The company indicated that its quarterly run rate should improve to about $125 million by Q4FY19 from the current $108 million. Growth is expected to come from both existing products as well as one limited competition product launch every quarter.



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Decline in the tender business, though not the most profitable, has hit its global access business hard. Given the weak funding by global donors, business revenues for the company in the segment has halved. The company indicated that pressure on the tender business is expected to continue.

While the company has a strong portfolio of over 70 abbreviated new drug applications awaiting approval and should benefit from new launches in the US, competitive pressures could limit the gains. While its inhaler portfolio holds promise in the global market, the benefits will largely come in FY20. The stock is expected to underperform given no new term trigger and the multiple worries highlighted by the company.