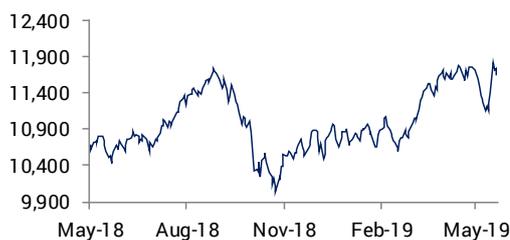


MAY 24, 2019

	23-May	% Chg			
		1 Day	1 Mth	3 Mths	
<b>Indian Indices</b>					
SENSEX Index	38,811	(0.8)	0.6	8.2	
NIFTY Index	11,657	(0.7)	0.7	8.0	
NSEBANK Index	30,409	(0.4)	3.2	13.2	
NIFTY 500 Index	9,553	(0.5)	(0.4)	7.1	
CNXMcap Index	17,318	(0.2)	(2.6)	4.7	
BSESMCAP Index	14,353	(0.1)	(2.9)	6.2	
<b>World Indices</b>					
Dow Jones	25,490	(1.1)	(4.2)	(2.1)	
Nasdaq	7,628	(1.6)	(5.8)	1.3	
FTSE	7,231	(1.4)	(3.2)	0.7	
NIKKEI	21,151	(0.6)	(5.4)	(2.0)	
Hangseng	27,267	(1.6)	(8.3)	(5.1)	
Shanghai	2,853	(1.4)	(10.8)	1.9	
<b>Value traded (Rs cr)</b>					
	23-May	% Chg Day			
Cash BSE	3,746	50.0			
Cash NSE	52,323	50.4			
Derivatives	2,581,258	389.0			
<b>Net inflows (Rs cr)</b>					
	22-May	MTD	YTD		
FII	(741)	(2,576)	65,646		
Mutual Fund	66	6,569	3,907		
<b>Nifty Gainers &amp; Losers</b>					
	Price	Chg	Vol		
23-May	(Rs)	(%)	(mn)		
<b>Gainers</b>					
Adani Ports	408	5.6	23.0		
Zee Entertainment	360	5.3	15.9		
Indusind Bank	1,599	5.3	12.4		
<b>Losers</b>					
Vedanta Ltd	157	(5.4)	14.3		
Eicher Motors	20,321	(4.3)	0.1		
ITC Ltd	288	(3.9)	31.4		
<b>Advances / Declines (BSE)</b>					
23-May	A	B	T	Total	% total
Advances	202	452	58	712	100
Declines	252	518	58	828	116
Unchanged	7	33	15	55	8
<b>Commodity</b>					
	23-May	% Chg			
		1 Day	1 Mth	3 Mths	
Crude (US\$/BBL)	68.5	1.1	(8.2)	2.0	
Gold (US\$/OZ)	1,283.5	0.8	0.7	(3.3)	
Silver (US\$/OZ)	14.6	1.0	(2.5)	(8.5)	
<b>Debt / Forex Market</b>					
	23-May	1 Day	1 Mth	3 Mths	
10 yr G-Sec yield %	7.2	7.3	7.5	7.4	
Re/US\$	70.0	69.7	69.6	71.0	

## Nifty



Source: Bloomberg

## News Highlights

- ▶ Moody's Investors Service said that India's credit rating will depend on the policies of the new government and expressed the hope that the country will continue with its fiscal consolidation plan. (BS)
- ▶ **Cipla** signed an agreement to acquire 26 percent stake on a fully diluted basis in AMPSolar Power Systems Private Limited. (Moneycontrol)
- ▶ **Hindustan Copper's** board meeting on May 28 to consider and recommend increase in borrowing limits and creation of security/charge for seeking approval of shareholders of the company (Moneycontrol)
- ▶ **Infosys** completes formation of strategic partnership with ABN AMRO in the Netherlands (BSE)
- ▶ **Reliance Capital** Offer for sale up to 3,21,10,091 equity shares (5.25%) of Reliance Nippon Life Asset Management opens today. Floor Price of the sale shall be Rs 218 per equity share. (BL)
- ▶ **Zensar** enables Sanlam to deliver company-wide Digital Transformation (Moneycontrol)
- ▶ Infrastructure major **Larsen and Toubro (L&T)** on Thursday acquired over 4.5 lakh shares of Mindtree from open market, taking its shareholding in the IT services firm to 26.93 per cent, according to a regulatory filing. (BS)
- ▶ CARE reaffirmed **Future Lifestyle's** Commercial Papers ratings as A1+(BSE)
- ▶ **MOIL** inks MoU with ministry of steel for FY2019-20 (Moneycontrol)
- ▶ **Adani Ports and Special Economic Zone** will set up its first container terminal outside India in Myanmar at an estimated cost of \$290 million (over Rs 20 bn). (BS)
- ▶ **Steel Strips Wheels** has bagged repeat firm exports orders for 400,000 wheels for trailer market. This would be a significant increase of about 30 per cent from the same period of previous year. (BS)
- ▶ CPCB vide its order dated 17.05.2019 has revoked its closure directions dated 18.02.2019 on **Radico Khaitan**. There has been no loss of production during the period due to earlier closure directions. CPCB has directed the Company to restrict its capacity of molasses plant for country liquor from 200 KLD to 77 KLD until 30.06.2019 while the Company complies with the additional requirements for its Zero Liquid Discharge (ZLD) system. (BSE)

## What's Inside

- ▶ **Result Update:** Qess Corp Ltd
- ▶ **Market Outlook - Election 2019** ('Phir Ek Baar Modi Sarkar')

Source: ET = Economic Times, BS = Business Standard, FE = Financial Express, IE = Indian Express, BL = Business Line, BQ = BloombergQuint, ToI = Times of India, BSE = Bombay Stock Exchange, MC = Moneycontrol

## Result Update

## QUESS CORP LTD (QUESS)

### Stock Details

Market cap (Rs mn)	:	96029
52-wk Hi/Lo (Rs)	:	1303 / 579
Face Value (Rs)	:	10
3M Avg. daily vol (Nos)	:	119,517
Shares o/s (mn)	:	146

Source: Bloomberg

### Financial Summary

Y/E Mar (Rs mn)	FY19	FY20E	FY21E
Revenue	85,270	105,196	122,937
Growth (%)	38.3%	23.4%	16.9%
EBITDA	4,646	5,878	7,202
EBITDA margin (%)	5.4%	5.6%	5.9%
PAT	2,656	3,935	5,226
EPS	17.6	26.3	35.2
EPS Growth (%)	-15%	50%	34%
BV (Rs/share)	187	213	249
ROE (%)	9.9	13.2	15.2
ROCE (%)	12.2	13.4	15.2
P/E (x)	37.3	24.9	18.6
EV/EBITDA (x)	20.9	16.2	12.7
P/BV (x)	3.5	3.1	2.6

Source: Company, Kotak Securities - PCG

### Shareholding Pattern (%)

(%)	Mar 19	Dec-18	Sep-18
Promoters	71.4	71.4	71.7
FII	14.1	14.1	7.3
DII	5.6	5.5	4.1
Others	8.9	9.1	16.9

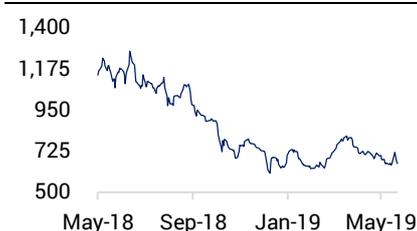
Source: Bloomberg

### Price Performance (%)

(%)	1M	3M	6M
Quess Corp Ltd	(3.7)	(3.8)	(11.9)
Nifty	0.7	8.0	10.7

Source: Bloomberg

### Price chart (Rs)



Source: Bloomberg

**PRICE Rs.656**

**TARGET Rs.704**

**ADD**

Quess's Q4FY19 reported PAT increased 19% qoq to Rs.761 mn (vs our estimate of Rs.791 mn) led by better operating margin and significantly higher other income. Quess has been consistent in improving its cash flow conversion rates. Beginning FY19, Quess was at Operating Cash Flow (OCF) OCF/EBITDA conversion rate of 31% and exited at 59%. The management's focus is to improve OCF/EBITDA conversion by at least 4-5% to 60%+ and is ready to compromise on operating margin. Quess is focusing on turnaround of Monster and expects the same in the coming quarters.

### Key Highlights

- ❑ Quess reported net revenue at Rs. 22.95 bn (v/s our estimate of Rs.23.1 bn), higher 6% qoq and 21% yoy amid higher employee strength and increased revenue realization per employee per month. In FY19, revenue increased by 38% to Rs.85.3 bn amid organic revenue growth of 24% yoy in FY19.
- ❑ Operating margin increased marginally by 29 bps qoq to 5.74% (flat yoy), though lower than our expectation of 5.8%. On a yoy basis, margin drop is due to operating losses at Monster. We expect margin improvement, going forward due to better revenue mix, turn around of monster and efficiency improvement.
- ❑ In Q4FY19, total employee headcount increased by 22% yoy (net addition 25,128 during the quarter) to 318,000 employees. Similarly, net addition in employee headcount stood at 56,300 in FY19. General Staffing headcount crossed 192,000 as on March 31, 2019 led by a strong addition of 24 new logos in Q4FY19 and over 200 new logos in FY19.
- ❑ In security services business (Terrier), Quess added over 2,400 new headcount in Q4FY19 taking the total closing headcount to over 19,100 guards across 180 cities in India. Terrier achieved a strong revenue growth of 30% yoy in FY19.
- ❑ Consolidated tax rate is expected to be in the range of 8%-11% due to benefits available under section 80JJA.
- ❑ Cash flow from Operations (OCF) stood at Rs.780 mn for Q4FY19 as against Rs.530 mn in Q3FY19 and Rs.2.02 bn in FY19 compared to Rs.1.09 bn in FY18 resulting in a 59% OCF/EBITDA conversion during Q4FY19 and 43% in FY19 vs. 31% in FY18.

### Valuation & outlook

We are introducing FY21E earnings and roll-forward our valuation to FY21E. We now expect Quess to report an EPS of Rs.26.3 in FY20E (earlier Rs.30.6, lowered margin assumption) and an EPS of Rs. 35.2 in FY21E supported by both recent acquisitions done by the company and organic growth. We recommend ADD rating on Quess with a revised target price of Rs.704/share (earlier Rs. 1072/share), valuing the company at a P/E multiple (20x FY21E). In India, every month ~1 million people are entering the workforce, generating sustainable employment becomes an imperative which opens huge growth opportunities for Quess.

### Sumit Pokharna

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### Quarterly performance table

Particulars (Rs Mn)	Q4FY19	Q3FY18	Q4FY18	YoY (%)	QoQ (%)
<b>Income from ops</b>	<b>22,948</b>	<b>21,722</b>	<b>18,908</b>	<b>21</b>	<b>6</b>
Total Expenditure	21,630	20,538	17,814	21	5
<b>EBIDTA</b>	<b>1,318</b>	<b>1,183</b>	<b>1,093</b>	<b>21</b>	<b>11</b>
Depreciation	325	317	285	14	3
<b>EBIT</b>	<b>992</b>	<b>867</b>	<b>809</b>	<b>23</b>	<b>15</b>
Other income	290	123	240	21	135
Interest-net	321	280	252	28	14
<b>PBT</b>	<b>962</b>	<b>710</b>	<b>797</b>	<b>21</b>	<b>36</b>
Extra ordinary Exp/(Inc)			8		
Tax	121	11	31	289	1,025
<b>PAT</b>	<b>841</b>	<b>699</b>	<b>758</b>	<b>11</b>	<b>20</b>
Less: Minority Interest	(6)	10	-		
Share of p/(l) of equity accounted investees (net of income tax)	(86)	(49)			
PAT after MI	761	640	758	0	19
Basic EPS	5.21	4.4	5.21	0	19

Source: Company.

### Quarterly result analysis – Q4FY19

- **Net revenue growth** – In Q4FY19, Quess reported net revenue at Rs. 22.95 bn (v/s our estimate of Rs.23.1 bn), higher 6% qoq and 21% yoy supported by higher employee strength and increased revenue realization per employee per month.
- **Cost of material and stores and spare parts consumed:** In Q4FY19, raw material cost decreased 39% qoq to Rs. 431 bn due to base effect (+4% yoy).
- **Staff Cost:** Employee cost increased by 7% qoq to Rs.18 bn (20% yoy) due to increase in headcount. However, employee cost to total revenue ratio also increased to 79.3% from 78.4% in Q3FY19.
- **Employee headcount:** In Q4FY19, total employee headcount increased by 22% yoy (net addition 25,128 during the quarter) to 318,000 employees. Similarly, net addition in employee headcount stood at 56,300 in FY19.
- **Other expenditure:** In Q4FY19, Other expenditure increased 7% qoq to Rs.2.99 bn (+32% yoy).

### Margin Ratio (%)

	Q4FY19	Q3FY18	Q4FY18	YoY (bbps)	QoQ (bbps)
EBITDA Margin	5.7	5.45	5.8	(4)	0
EBIT Margin	4.3	4.0	4.3	5	(26)
Adj PAT Margin	3.3	2.9	4.0	(69)	(55)
Other Income/PBT	30.2	17.4	30.1	7	1,152
Tax/PBT	12.6	1.5	3.9	867	159

Source: Company

### Expenses (Rs. Mn)

	Q4FY19	Q3FY18	Q4FY18	YoY (%)	QoQ (%)
Raw Material consumption	431	706	414	4	(39)
Staff costs	18,206	17,028	15,141	20	7
Other Expenditure	2,993	2,804	2,260	32	7
Total	21,630	20,538	17,814	21	5

Source: Company

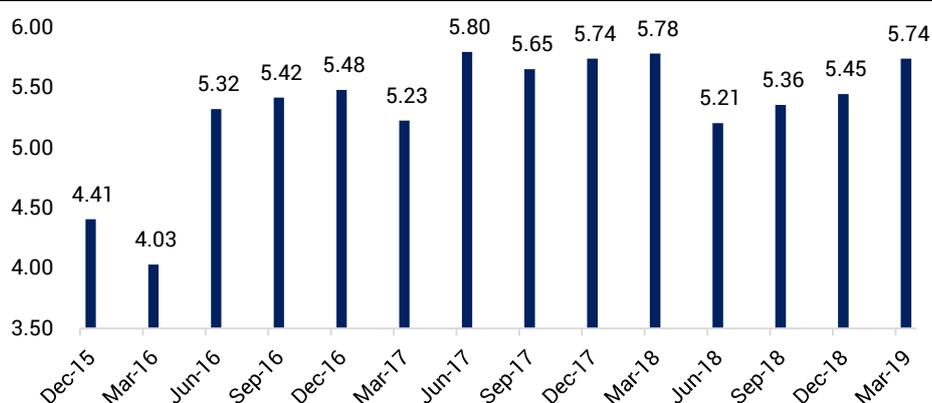
### Expenses Ratio (%)

	Q4FY19	Q3FY18	Q4FY18	YoY (bbps)	QoQ (bbps)
RM to Sales	2	3	2	(31)	(137)
Staff to Sales	79	78.4	80	(74)	95
Other expenses to Sales	13	13	12	109	13

Source: Company

- **Operating margin (%):** In Q4FY19, operating margin increased by 29 bps qoq to 5.74% (-40 bps yoy), marginally lower than our expectation of 5.8%. In FY19, the drop in margin is primarily on account of operating losses at Monster. We expect margin to improve going forward due to better revenue mix and efficiency improvement.

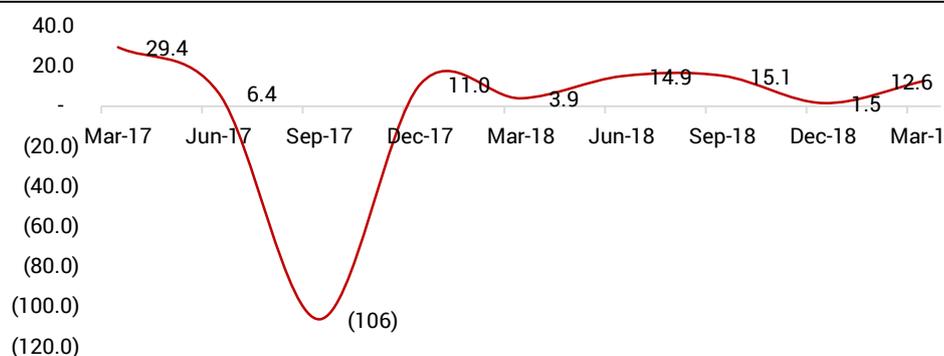
### Quarterly operating margin (%) trend



Source: Company

- **Operating profit (Rs. Mn):** Qess reported EBIDTA of Rs.1.32 bn (11% qoq and 21% yoy) in Q4FY19 on account of higher revenue and proportionate lower cost. Reported operating profit is marginally lower than our estimate due to lower than estimated revenue and margin.
- **Other income:** In Q4FY19, Qess's other income increased significantly by 135% qoq to Rs.290 mn due to higher interest income (+21% yoy).
- **Income Tax:** In Q4FY19, the company paid tax at a higher rate of 12.6% of PBT v/s 1.5% in Q3FY19. Consolidated tax rate is expected to be in the range of 8%-11% due to benefits available under section 80JJA.

### Volatile tax rate – Tax benefit under Section 80JJAA



Source: Company

- As per the amendment in the finance Act 2016, deduction under Section 80JJAA of Income tax Act, 1961 was extended across all sectors subject to

fulfillment of conditions as stipulated in the said section. The amendment was first applicable for the FY17.

- **PAT:** Qess's Q4FY19 reported PAT increased 19% qoq to Rs.761 mn (-1% yoy).

### Other Key developments

Average revenue realization per employee per month increased by 3% qoq.

### People Services:

- General Staffing headcount crossed 192,000 as on March 31, 2019 led by a strong addition of 24 new logos in Q4FY19 and over 200 new logos in FY19.
- General Staffing business achieved a Core to Associate ratio of 1:330 in Q4 FY19 compared to 1:260 in Q4FY18.
- Collect & Pay contracts share improved to 65% in FY19 from 58% in FY18 but it is a margin dilutive business.
- Training & Skill development arm, Excelus trained over 38,000 candidates in FY19 and retained its Champion Employer status securing additional contracts under DDUGKY, PMKK & RMSA schemes.

### Facility Management:

- Facility Management business continued its strong organic growth momentum in FY19 led by healthy addition of 120 new logos across sectors such as Technology, FMCG, Manufacturing & Industrial, E Commerce & Logistics, Healthcare, Education, BFSI, Real estate & Residential etc.
- **Security services business - Terrier:** Terrier added over 2,400 headcount in Q4FY19 taking the total closing headcount to over 19,100 guards across 180 cities in India.
- New contracts in security services included CCTV Installation & Monitoring contracts from a large E-commerce player and a large NBFC in India. Terrier achieved a strong revenue growth of 30% yoy in FY19.

### Customer Lifecycle Management:

- **Conneqt:** Conneqt witnessed sustainable growth by addition of 04 new clients and 09 new lines of businesses from existing clients in Q4FY19.
- Conneqt closed one of the largest deal with a Private Sector Bank and has entered into new verticals such as Healthcare, New age startups and services like PR to PO (Purchase requisition to Purchase Order).
- The company generated revenues of Rs.8540 mn and EBITDA of Rs.740 mn in FY19 translating to a margin of 8.7%.
- **DigiCare:** The Company currently operates over 250 service centers and has increased its geographic footprint from 55 to 150 towns post acquisition while expanding its service portfolio from "in - store heavy services" to "in - home services" like troubleshooting, repairs and installations.

### Internet Business:

- **Monster:** The Company launched a revamped Monster.com portal across India, SEA and Gulf in Q4FY19.
- The core services of the platform are now enhanced and made simpler, powered by Semantic Search 2.0, with refreshed Job posting interface along with some new employer branding solutions.

- This was accompanied by a set of better together recruitment modules - the automated interview solution called Quinton, Pre- hire Assessments, curated profiles and better profile ratio solution called Q Hire along with Monster Social Jobs, Virtual Career Fair and Hackathon.
- The new launch was followed by a new Monster brand campaign “Work Life balance” which was received very well by the job seekers garnering about 600 mn impressions, more than 7 mn clicks and more than 4 mn visits during the campaign period.
- The platform witnessed the highest ever monthly traffic during the campaign period in March 2019.

### **Recommend ADD**

We are introducing FY21E earnings and roll-forward our valuation to FY21E. We now expect Qess to report an EPS of Rs.26.3 in FY20E (earlier Rs.30.6) and an EPS of Rs. 35.2 in FY21E supported by both recent acquisitions done by the company and organic growth. We recommend ADD rating on Qess with a revised target price of Rs.704/share (earlier Rs. 1072/share), valuing the company at a P/E multiple. In India, every month ~1 million people are entering the workforce, generating sustainable employment becomes an imperative which opens huge growth opportunities for Qess.

### **Key Risk and Concerns:**

- Weak cash conversion cycle
- Acquisition risk
- losing clients
- Slowdown in IT sector
- Employee is the key to success – Inability to recruit, train and retain qualified associates

### **Company Background**

Qess Corp Ltd. (erstwhile IKYA Human Capital Solutions) is one of India’s leading integrated business services providers. The company offers comprehensive solutions including recruitment, temporary staffing, technology staffing, IT products and solutions, skill development, payroll, compliance management, integrated facility management and industrial asset management services.

Incorporated in 2007 and headquartered in Bengaluru, the Company has strong presence in India, North America, the Middle East and South-East Asia. Qess Corp is promoted by Fairfax Financial Holdings through its Indian subsidiary, Thomas Cook India Ltd (TCIL) and Mr. Ajit Isaac (Chairman and CEO). The Company got listed on exchanges in 2016.

## Financials: Consolidated

### Profit and Loss Statement (Rs mn)

(Year-end Mar)	FY18	FY19	FY20E	FY21E
<b>Revenues</b>	<b>61,673</b>	<b>85,270</b>	<b>105,196</b>	<b>122,937</b>
% change YoY	42.9	38.3	23.4	16.9
<b>EBITDA</b>	<b>3,485</b>	<b>4,646</b>	<b>5,878</b>	<b>7,202</b>
% change YoY	46.5	33.3	26.5	22.5
Other Income	628	712	755	802
Depreciation	747	1,232	1,314	1,533
<b>EBIT</b>	<b>3,365</b>	<b>4,127</b>	<b>5,319</b>	<b>6,471</b>
% change YoY	52.9	22.6	28.9	21.7
Net interest	755	1,144	900	600
<b>Profit before tax</b>	<b>2,611</b>	<b>2,983</b>	<b>4,419</b>	<b>5,871</b>
% change YoY	51.6	14.3	48.1	32.9
Tax	(483)	329	486	646
as % of PBT	(18)	11.0	11.0	11.0
<b>Profit after tax</b>	<b>3,093</b>	<b>2,654</b>	<b>3,933</b>	<b>5,225</b>
Minority interest	(4)	(2)	(2)	(2)
Share of profit of associates	0	0	0	1
Net income	3,097	2,656	3,935	5,226
% change YoY	154	(14)	48	33
Shares outstanding (m)	145	146	146	146
<b>EPS (reported) (Rs)</b>	<b>20.8</b>	<b>17.6</b>	<b>26.3</b>	<b>35.2</b>
CEPS (Rs)	26.3	26.6	35.9	46.3

Source: Company, Kotak Securities – Private Client Research

### Cash flow Statement (Rs mn)

(Year-end Mar)	FY18	FY19	FY20E	FY21E
EBIT	3,365	4,127	5,319	6,471
Depreciation	747	1,232	1,314	1,533
Change in working capital	(1,137)	(11,195)	(1,631)	(976)
Chgs in other net current assets				
Operating cash flow	2,976	(5,837)	5,002	7,028
Interest	(755)	(1,144)	(900)	(600)
Tax	483	(329)	(486)	(646)
<b>Cash flow from operations</b>	<b>2,704</b>	<b>(7,310)</b>	<b>3,616</b>	<b>5,783</b>
Capex	(5,294)	(1,602)	(1,814)	(1,683)
(Inc)/dec in investments	(2,085)	1,577	-	-
<b>Cash flow from investments</b>	<b>(7,380)</b>	<b>(25)</b>	<b>(1,814)</b>	<b>(1,683)</b>
Others	8,473	9	(31)	-
Increase/(decrease) in debt	(58)	4,816	(1,407)	(3,072)
Proceeds from share premium	-	-	-	-
Dividends	-	-	-	-
<b>Cash flow from financing</b>	<b>8,415</b>	<b>4,825</b>	<b>(1,438)</b>	<b>(3,072)</b>
Opening cash	4,626	8,365	5,855	6,218
<b>Closing cash</b>	<b>8,365</b>	<b>5,855</b>	<b>6,218</b>	<b>7,246</b>

Source: Company, Kotak Securities – Private Client Research

### Balance sheet (Rs mn)

(Year-end Mar)	FY18	FY19	FY20E	FY21E
Cash and cash equivalents	8,365	5,855	6,218	7,246
Accounts receivable	13,936	16,164	19,454	22,230
Inventories	85	221	272	318
Loans and Adv & Others	5,844	4,836	5,966	6,972
Current assets	28,229	27,075	31,910	36,766
Misc exp.	0	0	0	0
LT investments	2,862	1,285	1,285	1,285
Net fixed assets+CWIP	16,340	16,711	17,211	17,361
<b>Total assets</b>	<b>47,431</b>	<b>45,071</b>	<b>50,405</b>	<b>55,411</b>
Payables	1,481	1,729	2,031	2,177
Others	19,043	12,265	14,514	16,961
Current liabilities	20,524	13,994	16,544	19,138
Provisions	1,150	1,334	1,625	1,885
LT debt	2,686	7,502	6,095	3,023
Min. int & def tax liab/(Asset)	(1,538)	(5,014)	(5,047)	(5,049)
Equity	1,455	1,461	1,461	1,461
Reserves	23,153	25,795	29,728	34,953
<b>Total liabilities</b>	<b>47,431</b>	<b>45,071</b>	<b>50,405</b>	<b>55,411</b>
BVPS (Rs)	169	187	213	249

Source: Company, Kotak Securities – Private Client Research

### Ratio Analysis

(Year-end Mar)	FY18	FY19	FY20E	FY21E
EBITDA margin (%)	5.7	5.4	5.6	5.9
EBIT margin (%)	5.5	4.8	5.1	5.3
Net profit margin (%)	5.0	3.1	3.7	4.3
Receivables (days)	82.5	69.2	67.5	66.0
Inventory (days)	0.5	0.9	0.9	0.9
Sales/gross assets(x)	2.9	2.7	2.9	3.2
Interest coverage (x)	3.6	3.0	5.1	9.4
Debt/equity ratio(x)	0.1	0.3	0.2	0.1
ROE (%)	16.1	9.9	13.2	15.2
ROCE (%)	17.9	12.2	13.4	15.2
EV/ Sales	1.5	1.1	0.9	0.7
EV/EBITDA	25.8	20.9	16.2	12.7
Price to earnings (P/E)	31.5	37.3	24.9	18.6
Price to book value (P/B)	3.9	3.5	3.1	2.6

Source: Company, Kotak Securities – Private Client Research

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## ELECTION OUTCOME – MAY 2019

### Election Verdict: 'Phir Ek Baar Modi Sarkar'

Based on actual results and leads the BJP led coalition is again coming back to power with around 350 seats and BJP itself getting around 300 seats. We have scanned the BJP's pre poll manifesto and the interim budget presented in February 2019 to capture the key focus areas in future. We have mapped these focus areas with the segments/sectors that will likely benefit in the coming years. Based on our reading we feel following sectors could benefit the most in the next one year: capital goods, construction, building materials, corporate banks, power equipment, housing finance companies and rural focused companies. Consumption stocks could take a back seat because of the slowdown in demand and rich valuations.

In terms of market cap orientation we see more value in Mid & Small Caps rather than Large Caps at this stage. Based on Bloomberg estimates the Mid Cap Index is now at trading at 14.8x Fw PE Vs 18.3x Fw PE of Nifty-50. The Mid Cap Fw PE now trades at 19% discount to Nifty Fw PE. From the peak of Jan'18 the Nifty is up ~5% as of 23rd May'19 whereas the NSE Mid Cap 100 Index and BSE Small Cap Index are still down by 20% and 28%, respectively. Time wise 18 months has gone since the Mid and Small caps have seen correction. Local flows, which are the main force driving mid & small cap has seen a sharp slowdown in the last six months. With NDA coming back into power we can expect local investors to take comfort in the mid & small cap space with a longer 2-3 year horizon and inflows could resume in them.

Based on the latest KIE estimates, the Free Float EPS of Nifty-50 for FY20E & FY21E works to 618 & 731, respectively. On these estimates the Nifty-50 trades at 18.9x FY20E and 15.9x FY21E, respectively. The one year Bloomberg Consensus target of Nifty-50 works to ~12,800, implying target PE multiple of ~17x (slightly above the 10 Yr avg Fw PE of Nifty placed at ~16.5x). In a Bull case the Nifty can go between 13,200-13,800 in CY19/FY20 based on higher target multiple of 18-19x on Fw basis (averaging 13,500). If we remove the predicted earnings of BFSI sector then FY20E earnings growth of Nifty-50 comes down to ~12-13%. Hence, It will not be desirable to expect Nifty to trade at 19-20x on Fw multiples for a longer period given the slowdown in many sectors, firm crude prices and global risk of escalation of trade war between the US and China.

In our view priority of the government will be to revive economic growth and investment although the macro-economic situation is quite challenging. There is a need of strong fiscal stimulus but scope of doing so seems limited given high crude prices leading to higher current account deficit and higher fiscal deficit. However, there is scope for monetary stimulus in the form of rate cuts, higher FPI limits for government bonds and infusion of liquidity in the banking system. Government would need to implement further reforms to attract more FDI in various sectors of the economy. Revival of capex cycle and investment of private sector in infrastructure building will be crucial to achieve the desired GDP growth and job creation.

After few days/weeks markets would again go back to basics and factors that will come to the front will be 1) global events like Trade War 2) behavior of crude prices in the midst of Iran tension 3) earnings & valuations 4) RBI policy and 5) Built up to the Union Budget. There are handful of large caps that also look attractive at this juncture. We have highlighted few large cap names (in the below table) from the universe of Kotak Institutional Equities that look attractive at this level.

Post Pulwama attack lot of smart money from FIIs has already come into the market and higher proportion of that has come in the form of passive investment (i.e. ETFs). Hence, we cannot rule out profit booking from these smart investors in the very near future. However, long only money which has been waiting on the side lines by both active FIIs and local investors can come into the market (as there is visibility in terms of government stability for another five years and possibility of bolder reforms).

## Attractive stocks across market cap

Favourable Sectors	Large caps	Mid/Small caps
Corporate Banks	ICICI Bank & SBI	Federal Bank
Capital Goods	L&T	
Power & Power Equipment	Power Grid	KEC Int'l & Kalpataru Power
Construction		PNC Infra & NCC
Select NBFCs	HDFC Ltd & M&M Financial	
Rural focus	M&M Ltd.	Escorts
Other select stocks based on Earnings growth, RoE & valuation	Zee Entertainment	Welspun Corp, Aegies logistics, Himatsingka Seide, Surya Roshni and Apollo Tyres

Source: Kotak Institutional Equities / Kotak Securities – Private Client Research; Note: For detailed reports kindly visit Kotak Securities - Private Client Group - Path: Login to [www.kotaksecurities.com](http://www.kotaksecurities.com) > Research > Equity Reports > Stock Recommendation Snapshot. For KIE reports kindly go to the following link: [https://www.kotaksecurities.com/research\\_report/recommendation/equityrecommendation.html?wlsrc=0&scriptname=/resources/trading/js/profile/default.js](https://www.kotaksecurities.com/research_report/recommendation/equityrecommendation.html?wlsrc=0&scriptname=/resources/trading/js/profile/default.js)

## Why Mid & Small Caps?

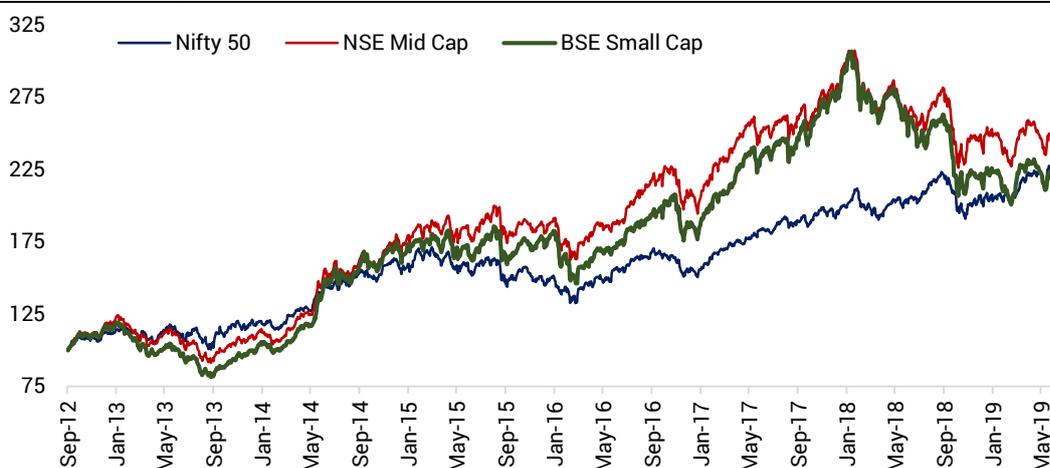
After the NDA government came into power in 2014 the Fw PE of Mid Cap Index started to trade at premium over the Nifty-50 Fw PE. This continued for around four years in a row. At the peak of January 2018, the Fw PE of Mid Cap Index had gone into a bubble zone of ~25x when Nifty-50 was trading at ~19x (i.e. >40% premium over the Nifty-50 Fw PE). The 10 year average discount of Mid Cap Fw PE to that of Nifty-50 Fw PE works to 8%. We feel the Mid Cap Fw PE which at present is at 19% discount to the Nifty Fw PE can revert to the 10 year average discount range of ~5-10% in the coming months. Even though the Mid Cap Index is trading at 14.8x Fw PE there are dozens of companies trading below 15x on Fw PE and having more than 15% RoE profile.

## Indices performance

Indices	Nifty	NSE Mid Cap	BSE Small Cap
Peak - Jan'18	11130	21732	20047
Low -post Jan'18	9998	16004	13119
Fall-%	-10%	-26%	-35%
Current (23 May 2019)	11657	17318	14353
% rise (current over previous low)	17%	8%	9%
% rise/fall from peak (i.e. Jan'18)	5%	-20%	-28%
Underperformance-to Nifty		-25%	-33%

Source: Bloomberg

## Performance: Nifty Vs Mid Cap Vs BSE Small Cap

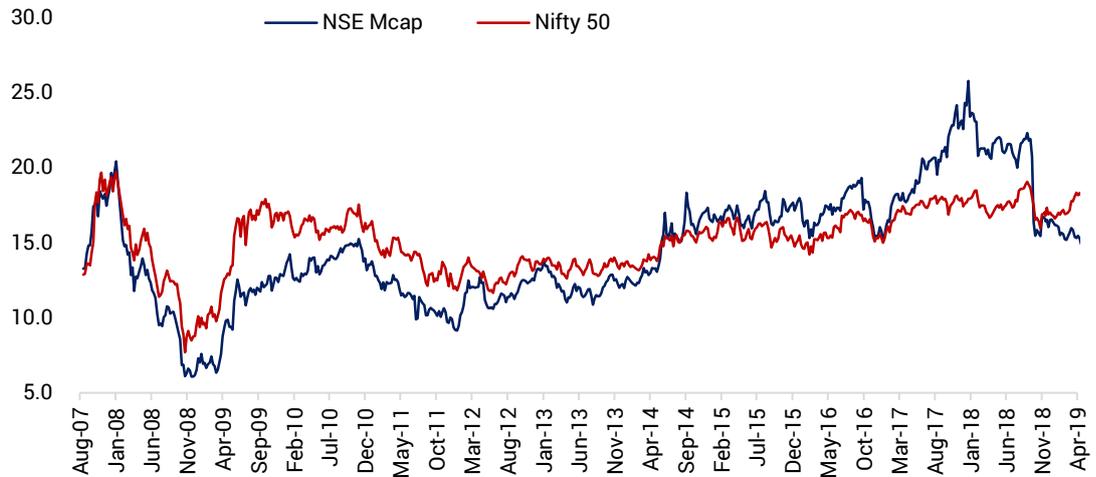


Source: Bloomberg

The BSE Small Cap Index has given up all the outperformance generated in the 4 year period of 2014 to 2018.

Post the sharp underperformance, Mid Cap 100 Index Fw PE has come down to 14.8x Vs 18.3x for Nifty-50 Fw PE.

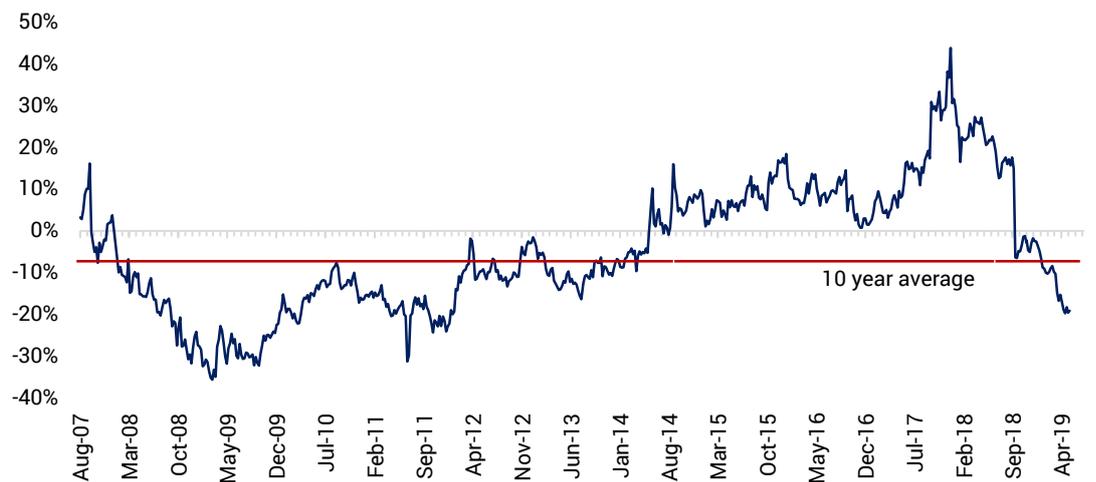
**One Yr Fw PE Chart: Nifty-50 Vs Mid Cap 100 Index**



Source: Bloomberg

On valuations, The Mid Cap Index Fw PE now trades at 19% discount to the Nifty Fw PE.

**Mid Cap Fw PE – Discount to Nifty-50 Fw PE**



Source: Bloomberg

As a cross check we ran through the Bloomberg consensus estimates. The average upside of top 100 companies having market cap of more than Rs.250 bn is just ~10%. On the other hand the average upside of stocks below Rs.250 bn market works to ~18%. Below Rs.250 bn market cap the maximum upside works in stocks with less than Rs.50 bn market cap where the average upside is ~30%.

**Bloomberg Consensus upside:**

Market Cap range	Average Potential upside
>Rs.250 bn	10%
Below Rs.250 bn	18%
Below Rs.50 bn	30%

Source: Bloomberg

**Few areas which need urgent attention from the government:**

Infusion of liquidity into the system (though the onus will remain on the RBI) to reduce the stress of NBFCs. Though the RBI has cut rates by 50 bps in 2019, the funding cost of most NBFCs has gone up by 100-200 bps. Most NBFCs are constrained to lend due to the tight liquidity situation and some of them are even forced to sell down assets to meet debt maturities.

The government needs to come out with measures that will improve employment levels. Private sector capex needs to revive to improve the job creation in the economy. Capacity utilisation of corporate sector has risen to ~76% but the recent slowdown in certain key sectors and assets available under IBC & NCLT could delay fresh capex by corporates.

The risk emanating from pledged shares of promoters could reduce their risk appetite of investing in new ventures (especially in the infrastructure space). Hence the government will have to take the lead and drive investments.

Consumption slowdown is more prominent in the rural side as farm income levels have remained subdued mainly due to suppressed realisations. Growth numbers of leading food chains, lifestyle and apparel companies predominantly catering to urban areas has been decent. FMCG companies having a mix of rural & urban areas are facing some kind of slowdown. To a certain extent the NBFC liquidity issue could also be one of the reason for slowdown in automobile sales. Overall, we feel consumption stocks which are very richly valued could take a back seat and investors could look for investment opportunities in other spaces.

**TOP MID & SMALL CAP IDEAS****Recommended Stocks**

Company	CMP* (Rs)	Target Price (Rs)	Potential Upside (%)	52 Week H/L (Rs)	Market Cap (Rs mn)
Aegis Logistics	210	250	19.0%	283 / 170	70,173
Apollo Tyres	184	270	47.1%	300 / 174	105,028
Cyient Ltd	556	684	23.1%	821 / 530	61,746
Himatsingka Seide	188	290	54.5%	377 / 161	18,485
KEC International	290	340	17.3%	384 / 230	74,517
M&M Financial	401	500	24.5%	527 / 343	248,002
NCC Ltd	109	135	24.0%	126 / 63	65,380
PNC Infratech	171	192	12.3%	185 / 122	43,843
Surya Roshni	241	330	37.0%	388 / 185	13,102
Welspun Corp	139	171	22.8%	187 / 87	36,919

Source: Kotak Institutional Equities; Kotak Securities – Private Client Research; \* CMP as on 23 May 2019

## ANNEXURE -1

### Key measures proposed in the BJP Manifesto that could have impact on Equities

- Commit to make India a USD 5 Trillion economy by 2025.
- By 2024, make capital investment of Rs.100 Trillion in the infrastructure sector (build gas grids, i-ways, regional airports, metros etc.).
- Making India a global manufacturing hub (Take country's ranking in Ease of Doing business Index into the Top50; Strengthening Companies Act; New Industrial Policy and creating clusters/networks for growth).
- Aim to provide credit of Rs.1 Trillion by 2024 to the MSME under 'The Credit Guarantee Scheme of the Government'.
- Recognise the need of cheaper cost of capital.
- Plan to build 60,000 km of National Highways, connect 100% of villages with rural roads, operationalize 100 new airports, modernize 400 railway stations, and cover 50 cities with metro networks.
- In the next five years, create a National Warehousing Grid.
- Doubling farmer's income by 2022. Plan to spend Rs.25 Trillion in Agri-rural sector to improve the productivity of the farm sector.
- To ensure 'pucca' house to every family who are living in 'kuccha' house by 2022.
- To launch 'Jal Jivan Mission' under which a special program, 'Nal se Jal' to ensure piped water connection to every household by 2024.
- To connect every Gram Panchayat through a high speed optical fibre network by 2022.
- To ensure 100% disposal of liquid waste water and reuse of waste water.
- Build an efficient storage of transport mechanism for agriculture products.
- Complete work on the remaining 68 irrigation projects under Pradhan Mantri Krishi Sinchai Yojana by December 2019.
- Digitalization of land records on a mission mode.

## ANNEXURE -2

### Key measures announced in the Interim Budget that could have impact on Equities.

- Increasing income levels of small and marginal farmers. Increasing net income of a section of individual tax payers. These two measures would cost the government ~Rs.1 Trillion.
- 'Pradhan Mantri Gram Sadak Yojana' allocation is proposed to be increased to Rs.190 bn in FY20BE as against Rs.155 bn in FY19RE.
- Government has proposed an outlay of Rs.750 bn for 'PM-KISAN' for the FY20BE as compared to Rs. 200 bn in FY19RE.
- Proposed Defence Budget will be crossing Rs.3 Trillion in FY20BE
- Capital support from the budget for railways is proposed at Rs.646 bn in FY20BE. The Railways' overall capital expenditure programme is proposed at Rs.1.59 Trillion in FY20BE.
- Allocation for the North Eastern Areas is being proposed to be increased by 21% to Rs.582 bn in FY20BE over FY19BE.

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<b>ADD</b>	–	We expect the stock to deliver 5% - 15% returns over the next 12 months
<b>REDUCE</b>	–	We expect the stock to deliver -5% - +5% returns over the next 12 months
<b>SELL</b>	–	We expect the stock to deliver < -5% returns over the next 12 months
<b>NR</b>	–	<b>Not Rated.</b> Kotak Securities is not assigning any rating or price target to the stock. The report has been prepared for information purposes only.
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<b>NM</b>	–	<b>Not Meaningful.</b> The information is not meaningful and is therefore excluded.
<b>NOTE</b>	–	Our target prices are with a 12-month perspective. Returns stated in the rating scale are our internal benchmark.

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