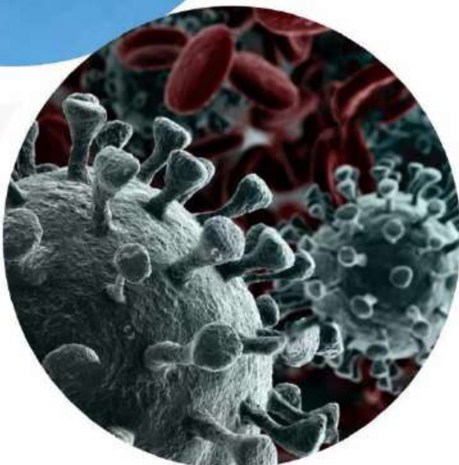
kotak Securities

Market outlook

March 2020



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MARKET OUTLOOK FOR MARCH 2020

Global markets sold off in February on escalating concerns related to the spread of the Covid-19 virus (Corona Virus) outside China and as far as Italy. Although, the World Health Organization has said the epidemic has peaked in China, but concern that its spread was accelerating in other countries has kept investors on edge. Nevertheless, the Indian equities have outperformed their global peers. Earlier in the month, the Sensex had recouped all its losses in the aftermath of the Union Budget 2021.

Fear of greater than anticipated economic impact due to the Covid-19 virus is leading to a fall in global bond yields. Even the IMF has recently cut its 2020 global economic growth forecast by 0.1%. Commodity prices have also corrected. The slowdown in economic growth and subdued commodity prices is expected to keep inflation under control leaving further room for any rate cuts (Fed) or liquidity injection (ECB and BoJ). This would be positive for emerging markets like India from a foreign fund flow point of view.

On the economy front, the CPI in January rose to 7.59%, the highest level in several years. IIP data remained in the negative zone. Auto sales numbers and Passenger Air traffic for the month of February also remained weak. On the positive side, the PMI data for the month of January was strong and may indicate that it could be early signs of bottoming out of the economic slowdown. However, one needs to be watchful of the economic impact of the Covid-19 virus on India. Indian Consumer Durables and Pharmaceuticals industry has a sizeable dependence on China for component/bulk drugs supplies. Corporates are already signaling towards rise in costs of procurement due to a combination of import duty hike and increase in ocean freight rates.

Market Outlook

As concluded by CII in its recent report the covid-19 virus outbreak is a serious pandemic of unforeseen proportions. No one knows how far the fear over Covid-19 virus will extend and to what extent stocks will fall further. Till the time the Covid-19 virus was contained in mainland China there was compliancy in global equity markets but now as more cases are getting reported in various countries the impact is sharper. Expect markets to remain weak till the time the number of cases reported globally either stabilises or goes down. Based on past precedencies the recovery in markets (post containment of such epidemics) is equal or higher than the fall. However, going by the speed at which the Covid-19 virus is spreading in most countries it will be a while before we hit the bottom.

Till date India has seen the least impact of Covid-19 virus which could work in its favour as far as flows are concerned. The immediate impact on FII flows would be negative as passive funds who tend to invest through ETFs would look to pull out money due to the sharp correction in global indices. With downside risk to global growth we can expect unconventional measures from governments and central banks across the globe. To address the near term headwinds due to Covid-19 virus and potential slowdown in FY21 GDP numbers we can expect some measures from the Indian government and RBI in coming times. If we see fresh rate cuts or infusion of liquidity by global central banks then FII flows could resume into select emerging markets as and when the covid-19 virus impact fades out. For India, SIP flows could act as a buffer in times when FIIs withdraw their investments.

Based on valuations we expect the Nifty-50 to take support anywhere between 10,500-11,000. Our one year Nifty-50 target ranges between 13,000-13,500. Basis of deriving at these figures is provided below in earnings & valuations part. We need to keep in mind that Nifty-50 has already corrected by 10% from its peak. On a conservative basis, downside of 10,500 and upside of 13,000 provides potential downside of 6% and potential upside of 16%. The risk-reward ratio of downside to upside at 1:3 has turned favourable. It is ideal to accumulate

stocks from current levels since risk-reward ratio is in favour of equities. The lower bond yields will support higher valuations for equities, which is big factor in favour of equities.

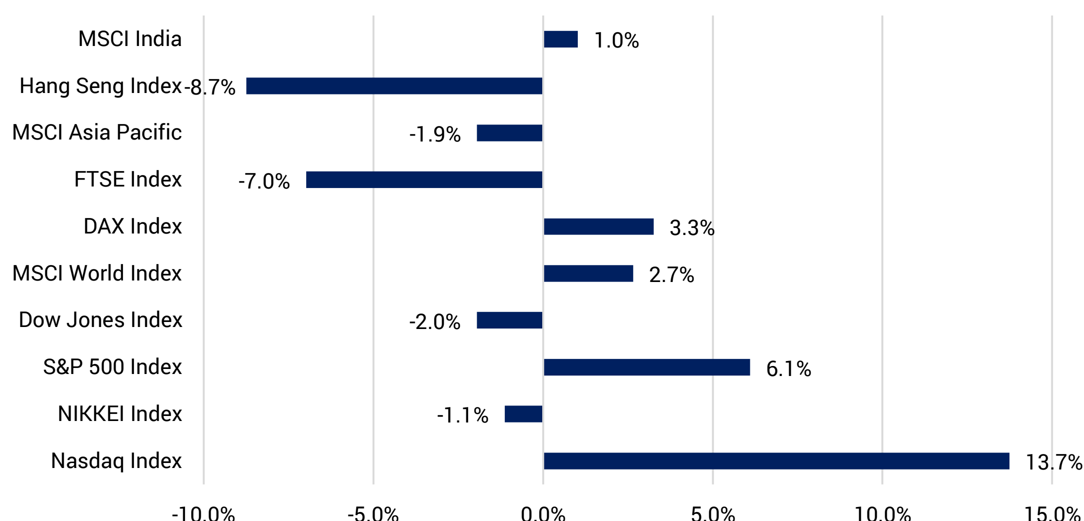
Interest in mid and small caps had revived before the budget but they too have corrected sharply in the recent correction. Mid & small caps may take a backseat for some time till clarity emerges on the broader Nifty-50 Index. In the course of CY20 we expect mean reversion to allow mid & small caps to catch up on their last two years underperformance vis-à-vis Nifty-50 Index. In the mid and small cap space we recommend investors to look for companies with good earnings growth prospect and available at beaten down prices with reasonable valuations.

Earnings & Valuation

We expect net profits of the Nifty-50 Index to grow 10% in FY20E despite the 10-15% uplift to profits from the corporate tax cut. We note that the strong growth in net profits of banks will be offset by sharp declines in net profits of the global commodity sectors, hurt by weak global prices in 4QFY20 due to the ongoing COVID-19 issue. Post Q3FY20 earnings season we expect net profits to bounce 26% in FY21 driven by higher profits of (1) banks due to lower loan-loss provisions, (2) metals companies due to normalization in prices and profitability and (3) telecom sector due to higher ARPUs, as companies align prices with costs after a period of aggressive price competition. However, considering the recent negative developments of Covid-19 virus and lower GDP growth estimates we could see earnings downgrades in the next few quarters. There is downside risk to many sectors either on the realization front or availability of raw materials or increase in raw material prices. These will get factored into earnings as we go into fiscal FY21.

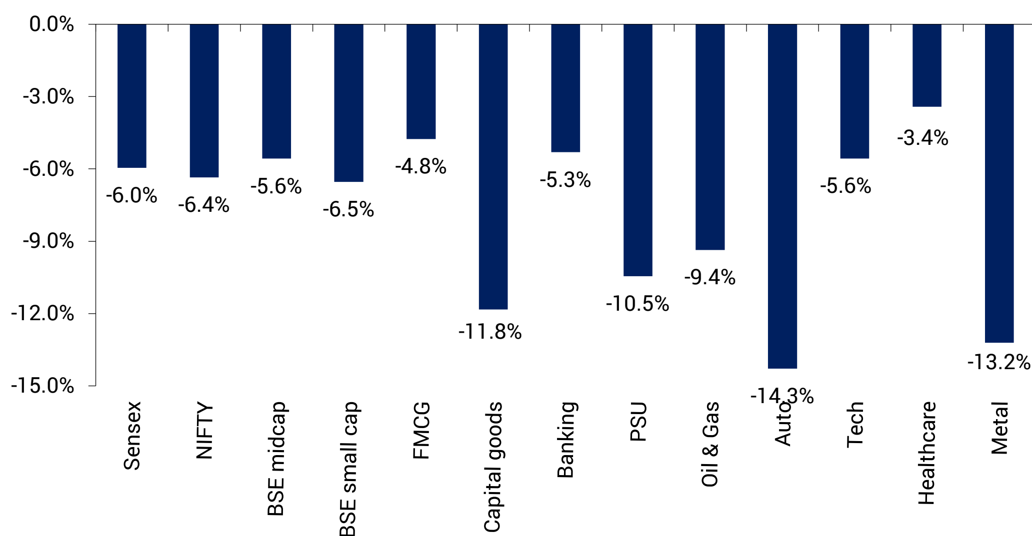
Valuations could provide some indications of major support levels based on past trends. In the last major correction seen in CY18 the Nifty-50 had gone down to 16x on forward estimates. At current levels of 11,202 the Nifty-50 trades at 16.6x FYY21E and 14.1x FY22E, respectively. These valuations are based on the last estimated EPS of KIE which builds in CAGR earnings of 22% between FY20-22E. If we build in CAGR of 18% for FY20-22E then Nifty-50 would be trading at 17.8x FY21E and 15.1x FY22E, respectively. Based on our benchmark of 17.5x the one year upside potential still remains in the range of 13,000-13,500 (even after considering potential earnings cut). Assuming Nifty-50 bottoms out at 16x in the immediate near future then near term downside in Nifty-50 works to anywhere between 10,500-11,000.

1-year performance of benchmark global indices (%)



Source: Bloomberg

Market performance – Sector wise (for the month of February 2019)



Source: Bloomberg

TOP INVESTMENT IDEAS

Valuation Summary

Company	CMP (Rs)	Target Price (Rs)	Potential Upside (%)	Mkt Cap (Rs mn)	EPS (RS)		EPS growth (%)		PE/PBV# (x)		RoE (%)	
					FY20E	FY21E	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
HDFC Ltd #, *	2176	2680	23.2	3,813	107	72	88	-33	4.4	4.1	22	13.7
ICICI Bank#, *	497	615	23.7	3,208	18.4	32	287	73	3.1	2.7	10.5	16.4
Bharti Airtel *	524	600	14.5	2,851	-5.5	6	NM	NM	NM	87.3	NM	4.1
Mahanagar Gas *	1005	1300	29.4	100	76.8	84	36.7	9.4	13.1	12.0	29	27
Quess Corp	514	690	34.2	78	18	26.1	3.4	45	28.6	19.7	9.1	11.7
Engineers India	70	123	75.7	45	6.9	8.6	16.9	24.6	10.1	8.1	18.9	21.9

Source: Kotak PCG and KIE (Kotak Institutional Equities); # HDFC Ltd and ICICI Bank is valued on PBV or Price/BV while rest of the stocks are valued on PE. Source: KIE India Daily dated March 02, 2020 and Stock Reco report of Kotak PCG dated Feb 28, 2020.*

INTERNATIONAL MARKETS

February was one of the worst months for the equity markets. Fresh cases of Covid-19 outside China triggered panic among global investors, which has led to decline in commodity prices and bond yields. Growth rates are also being revised in light of the economic impact on China and thereby on the global economy.

Global economic outlook vulnerable to spread of Covid-19 virus

In its January forecast, the IMF had pegged global growth estimate at 3.3% in 2020, up from 2.9% in 2019. However, following the continued spread of the Covid-19 Virus and the recent deaths reported in Italy and South Korea, the IMF has recently cut its 2020 global economic growth forecast by 0.1%. On China, it expects economic growth in 2020 to decline to 5.6% this year from earlier forecast of 6.0%. To contain the economic damage from Covid-19 virus, the People's Bank of China has cut the interest rate on 200 billion yuan worth of one-year medium-term lending facility (MLF) loans to financial institutions by 10 basis points (bps) to 3.15% from 3.25% previously. It also cut the one-year loan prime rate from 4.15% to 4.05%, and the five-year rate from 4.80% to 4.75%. Economic weakness is also showing in Japan, where its GDP "fell" an annualised 6.3% in the October-December period, compared with a revised 0.5% gain in July-September.

World Economic Growth Forecasts

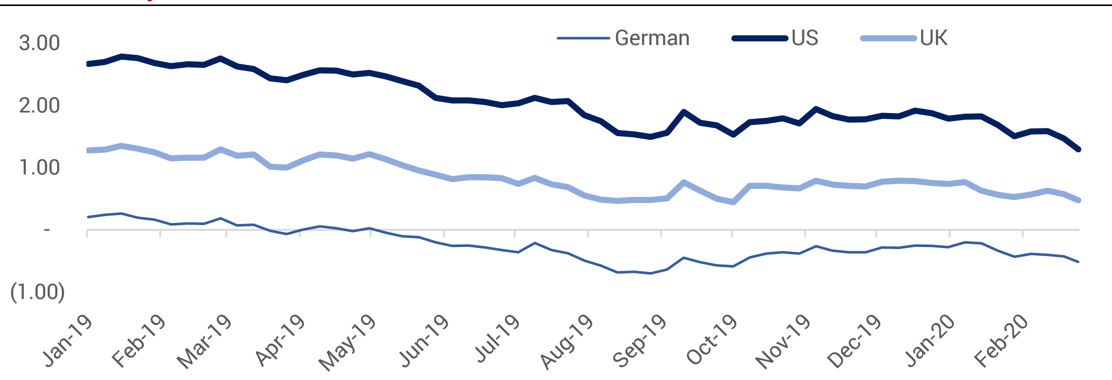
(%)	2018	2019	2020E	2021E
World	3.6	2.9	3.3	3.4
US	2.9	2.3	2	1.7
Euro Area	1.9	1.2	1.3	1.4
Germany	1.5	0.5	1.1	1.4
UK	1.3	1.3	1.4	1.5
China	6.6	6.1	6	5.8
India	6.8	4.8	5.8	6.5

Source: IMF

Bond yields dip on concerns of Covid-19 virus on global economy

Global treasury yields have eased in recent weeks, with the US 30-year bond hitting an all-time low, as a combination of Covid-19 virus fears and weak U.S. business activity data drove a flight into traditional safe haven assets. Both the 10-year and 30-year yields are down nearly 50 basis points so far this year. In UK and Germany, government bond yields touched their lowest level in several months, as investors shifted out of riskier assets following news of the new Covid-19 virus's spread in Italy. The yield on Germany's 10-year bond or Bund fell to -0.5%, its lowest in more than four months and below 0% for the first time since October.

10 Year bond yields



Source: Bloomberg

Fed remains cautiously optimistic on the US economy

The latest minutes of meeting of Fed policymakers showed that they remained cautiously optimistic on U.S. economy despite new risks even as they acknowledged new risks caused by the Covid-19 virus outbreak. Minutes also showed Fed officials were skeptical about any big rethink of the central bank's inflation target. Coming into this year the Fed had made clear that, after three interest rate cuts in 2019, it plans to hold interest rates steady, barring a significant change in the U.S. economic outlook.

Amid the escalated covid-19 virus fears, traders are now pricing in a 60% chance of an interest rate cut at the Fed's April meeting, according to the CME. The market also assigns a 40% chance of three cuts before the end of 2020.

Crude Oil prices cooled off.

Crude prices have continued to weaken in February as the fear of the Covid-19 growing into a full blown pandemic spreads across the world and affects economic activity. Global demand for crude oil is already weak and is now expected to see its first quarterly contraction in over a decade, according to the International Energy Agency (IEA). Demand is now expected to fall by 435,000 barrels a day (b/d) in the first quarter of 2020, down from the same period a year ago, and marking the first quarterly contraction in more than 10 years, (Source: IEA's monthly oil market report). The expected decline in demand prompted the agency to cut its 2020 growth forecast by 365,000 b/d to 825,000 barrels a day, the lowest since 2011. Concerned with the slide in oil prices, the OPEC will be meeting on 6th March to discuss further cuts in oil output. From an Indian standpoint, lower crude prices will be supportive in reducing inflation which has risen in recent months and also help in reducing the current account deficit & and fiscal deficit.

DOMESTIC MARKETS

The Indian markets sold off during the month on the back of global market selloff trigerred by concerns on the spread of Covid-19 virus. However, Indian equities outperformed the US, UK and Japanese markets. A positive fallout of the global market correction is the fall in crude oil prices, which will help in containing inflation. In this section, we look at macro-economic data, impact of Covid-19 on sectors and sector specific earnings outlook going into FY21.

Takeaways from the 3QFY20 earnings season

3QFY20 results and management commentary highlight ongoing economic slowdown. 3QFY20 results provided more evidence (if more evidence was required) of the ongoing slowdown in India. More importantly, management commentary did not sound very hopeful of an imminent revival in consumption demand. Net profits of universe of stocks covered by KIE (Kotak Institutional Equities) increased 6.6% y-o-y in 3QFY20 versus estimate of 21% growth. Most sectors disappointed on earnings with only the automobiles sector (among the major sectors) beating expectations. Similarly, adjusted net profits of Nifty-50 Index grew 11.5% y-o-y in 3QFY20, versus expectation of 21% growth.

Among Nifty-50 Index stocks that underperformed our estimates at the net income level were (1) Axis Bank (high provisions), (2) BPCL (lower-than-expected refining margins and lower other income), (3) IOCL (weak refining and petrochemical margins), (4) JSW Steel (lower realizations in standalone business and higher losses at international subsidiaries), (5) Maruti Suzuki (weaker product mix and higher discounting per vehicle), (6) Tata Steel (EBITDA loss at Europe and lower domestic realizations) and (7) UltraTech Cement (weaker-than-expected volume growth).

On the other hand, a few companies significantly outperformed our estimates: (1) Bajaj Auto (higher-than-expected gross margins and lower-than-expected other expenses), (2) Cipla (tight cost control on staff costs and lower R&D cost, (3) Hero MotoCorp (higher-than-expected gross margins due to aggressive cost reduction and lower tax rate), (4) HCL Technologies (treasury gains and lower-than-expected ETR), (5) Tata Motors (led by deferred tax credit) and (6) Tech Mahindra (led by forex gains).

Performance of major sectors during Q3FY20

Sector	Details
Banks	Banks reported weak loan growth, stable-to-declining NPLs and higher slippages in 3QFY20
NBFCs	Most NBFCs, under our coverage, had a decent quarter amid a challenging environment as they reported improvement in NIMs led by reduction in borrowing costs
FMCG	Most stocks under our coverage reported weak volume growth in general though gross margins improved
AUTOs	Automobile companies had a disappointing quarter across the board with most companies reporting double-digit decline in volumes on a yoy basis
Cement	Companies under our coverage reported decent growth in volumes though profitability weakened due to drop in realisations
Industrial	Companies under our coverage reported modest growth in revenue while order inflows declined 3% due to weakness in Power and Hydrocarbon segment
Pharmaceuticals	The five large pharmaceutical companies under our coverage with a large US presence reported 5% yoy and (-)0.6% qoq growth in overall revenues
IT	Weak spending in BFSI and retail verticals and higher furloughs led to moderation in revenue growth of Tier-I IT companies

Source: Kotak Institutional Equities

3QFY20 GDP growth at 4.7%.

Real GDP growth moderated to 4.7% in 3QFY20 as against an upward revised print of 5.1% in 2QFY20. On the other hand, nominal GDP growth rose to 7.7% from 6.4% in 2QFY19. While private consumption growth of 5.9% (5.6% in 2QFY20) was supported by festive-season demand, disappointment stemmed from a contraction in investment rate for the second consecutive quarter ((-)5.2% against (-)4.1% in 2QFY20). Meanwhile, government consumption expenditure remains the major pillar of growth, even though the pace of expansion moderated to 11.8% (13.2% in 2QFY20). Export growth remained muted at (-)5.5% owing to muted global demand. Indication of slackness was also visible in tepid import growth, which contracted at a sharper pace of (-)11.2%. The NSO continues to expect FY20E GDP growth at 5%, implying a GDP growth rate of 4.7% for 4QFY20. We retain our FY21E GDP growth estimate of 5.5%, supported by favorable base effects and accommodative financial conditions. The estimates however are subjected to downside risks depending on how the disruptions caused by Covid-19 play out

Real GDP growth slumped to 4.7% in 3QFY20

(%)	2014	2015	2016	2017	2018	2019	3QFY20
Real GDP	6.4	7.4	8	8.3	7	6.1	4.7
Private Consumption	7.3	6.4	7.9	8.1	7	7.2	5.9
Government Consumption	0.6	7.6	7.5	6.1	11.8	10.1	11.8
Gross Fixed Capital Formation	1.6	2.6	6.5	8.5	7.2	9.8	-5.2

Source: Kotak Institutional Equities

Economic recovery likely to be slow

Private consumption. We do not expect a quick recovery in private consumption as we believe the slowdown in private consumption reflects a broader slowdown in household income growth, which in turn reflects a more structural issue of inadequate investment and jobs. In our view, household consumption would require (1) a strong recovery in investment and related creation of new jobs, which can boost overall household income and/or (2) a large amount of fiscal benefits for households (higher government spending or personal income tax cuts), which could increase disposable income.

Government consumption. We expect a slowdown in government consumption spending given severe fiscal challenges. We would note that high growth in government consumption has supported overall GDP growth over the past few quarters when private consumption and investment have seen a sharp deceleration. We doubt the government can continue with its liberal fiscal approach given concerns around the government's tax revenues.

Investment. We do not expect a quick turnaround in investment given challenges with all the three components of investment—household investment, private sector investment and public sector investment. Households have reduced investment in real estate for the past several years and it is unlikely that they will step on investment in real estate given challenges with both household income and sentiment. The private sector will likely go slow on investment until the balance sheets of the companies in sectors such as metal & mining, oil & gas, power, roads and telecom become better through deleveraging and/or capital raise

Events to watch out in near term

Markets concerned with fresh Covid-19 cases in new geographies

Based on the latest update (Source: Channelnewsasia.com), there have been 88,297 confirmed cases of Covid-19 across the world and the death toll has been 3,043. There have been fresh cases of infections and deaths outside of China, which has worried global markets. In recent days, there have been 54 and 34 deaths in Iran and Italy, respectively. While this is concerning, a positive thing is that recoveries from virus far exceeds new confirmed cases. Meanwhile, China is confident the outbreak of novel covid-19 virus disease (COVID-19) will be brought under control by the end of April.

Daily number of new recovered cases exceeds new confirmed cases in China for 9 straight days

Source: CGTN

Need to be watchful of impact of COVID-19 on various sectors

COVID-19 has caused large-scale quarantines across China but we would note that the outbreak has predominantly been contained in Hubei province, which accounts for 1.3% of the total exports of China. Automobiles, F&B items and chemical raw materials are major output of Hubei. Also, recent reports suggest a declining trend in new cases. However, any surge in reported cases in key export hubs such as Guangdong, Jiangsu, Zhejiang can prolong the economic shutdown and may have cascading impact on global growth. Nonetheless, China has been proactive in limiting economic damage through a cocktail of fiscal and monetary measures historically, same is the case currently.

India is relatively immune to a slowdown in Chinese activity as China constitutes 14% of our imports and 5% of our exports. However, supply shocks emanating from shutdown in production across more provinces could result in specific impact on certain sectors and companies.

The impact of lower Chinese consumption of global commodities is likely to reflect in lower prices and profitability. We see material downside risks to our realization assumptions for metals, upstream oil companies and gas utilities in the case of a prolonged shutdown in China. At the same time, lower refining margins will impact profitability of downstream oil companies, while higher RM prices will impact profitability of pharmaceuticals (APIs) and textiles (VSF) sectors. A prolonged shutdown of manufacturing units in China will also limit the availability of key components for automobile OEMs as well as spare-parts in replacement markets, consumer durable companies (refrigerators, washing-machine, electrical appliances) and non-durables like adhesives, paints, etc. Low tourist arrivals may impact the aviation and hospitality sectors and IT services may see some impact arising from lack of travel affecting deal closures.

Table - product groups imported by India from China

	USD bn	(%)
Electrical machinery and equipment and Consumer Electronics	16	30
Reactors, boilers, machinery and mechanical appliances	9.9	19
Organic chemicals	6.6	12
Others	21.4	39
Total	**53.9**	**100**

Source: Kotak Institutional Equities

Impact on sectors

Metals

China's commodity consumption and export dominance have increased exponentially in the past two decades. In 2003, China accounted for just 20-22% of global commodity production (23% for steel, 23% for zinc, 20% for aluminum). However, over the past 17 years, China's share in world demand and production has increased to around 50% (53% for steel, 45% for zinc, 56% for aluminum). Due to the Covid-19 Virus crisis, we see demand for metals and mining products taking a hit which is already reflecting in softness in their prices. Nalco's earnings have the highest sensitivity to metal prices followed by Vedanta, Hindustan Zinc and Hindalco. China consumes 2/3rd of world iron ores and demand pullback has resulted in weak ore prices, which will impact merchant miners such as NMDC while cost deflation would benefit steel companies. Domestic steel prices in India are driven by import-parity pricing and should come under pressure with a lag of 30-45 days. Lower steel prices directly impact earnings of all steel producers.

Oil, gas and consumable fuels

Downstream companies (BPCL, HPCL, IOCL and RIL) will be impacted due to slowdown in demand for petrochemical and refined products. Lower LNG prices may boost margins for industrial segment of CGD entities. Lower oil and gas prices will lead to lower profits for the upstream oil & gas companies. Impact on companies: OIL, ONGC.

Pharmaceuticals

The Indian pharmaceuticals industry has deep linkages to China, given its reliance on China for critical elements of a drug's supply chain, starting from basic chemicals, key starting materials (KSM), intermediates and even APIs. Based on our channel checks, we understand that most companies have stocks lasting until the end of 1QFY21. Thus, most companies can manage supply disruptions from China until end of June.

Agrichemicals

The sector will be impacted due to disruption in supply chain of bulk chemicals and intermediates. Elevated RM costs may impact profits for less integrated players such as Dhanuka and Rallis.

Consumer durables

The consumer durables sector will be impacted due to shutdown of manufacturing units in China. Indian durables manufacturers have a large dependence on China for critical inputs such as compressors for air-conditioners and refrigerators. We note that almost all requirements of compressors as well as certain other components required for white goods are imported, with bulk of the same being imported from China. Companies that may get impacted are Havells (Lloyd), Voltas, Whirlpool. Electrical goods and appliances companies such as Crompton Greaves Consumer and Havells also import lighting and switchgear products from China and may be impacted.

Specialty chemicals

The sector will be impacted due to disruption in supply chain of commodity chemicals. Chemical players have gradually reduced dependence on China in recent years post environment-led supply disruptions.

CPI inflation – Any softening in inflation?

January CPI inflation rose to the highest level since June 2014 at 7.59% led by higher core inflation even as food inflation moderated marginally. While vegetable and fruits' prices have been moderating, food inflation has become more broad-based mirroring the trends in global food prices. Despite sluggish economic activity, core inflation rose further to 4.2%. The downward trajectory of industrial production and the upward surprise in inflation continues to pose a challenge for policymakers. While we expect inflation to have peaked in January amidst moderation in food inflation, the readings continue to remain alarmingly higher than the Monetary Policy Committee (MPC's) mandate of maintaining headline CPI in the 2-6% band. Despite weak growth, inflation is likely to remain elevated above 6% for most of 1HFY21 as food inflation becomes more generalized. High inflation will restrict any monetary easing through the policy rate cuts through 1HFY2. However, we continue to expect stealth easing through the liquidity channel to facilitate monetary transmission and support growth.

Consumption trends – Automobile and Air traffic are sluggish but Cement demand is improving

IIP in December grew (-)0.3%, primarily owing to an adverse base effect and weaker-than-expected manufacturing sector growth of (-)1.2%. Auto sector volumes continued to remain weak in January 2020 mostly led by inventory correction taken up by OEMs. The LCV segment showed some recovery owing to some pre-buy before BS-VI transition. Tractor demand continues to remain robust led by expectations of Rabi crop output and hike in MSPs, which will in turn boost farmer's income.

Macro-economic indicators

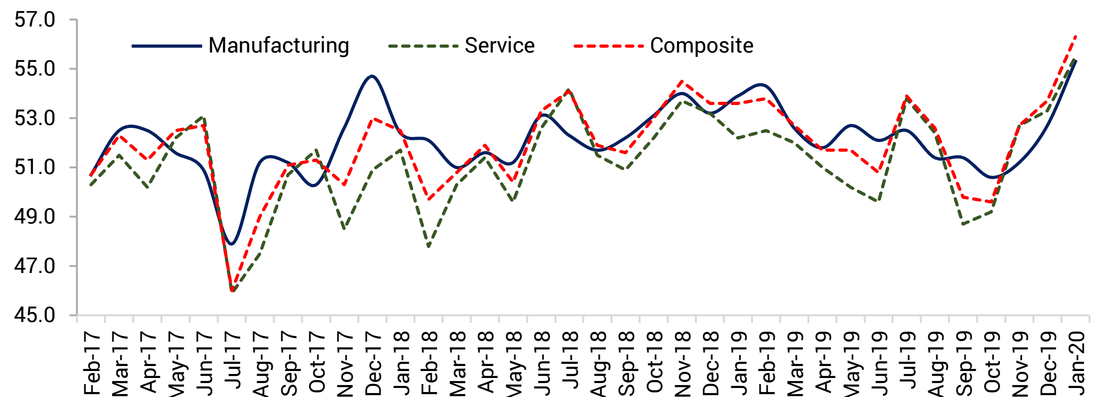
(%)	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Jan-20
Cement Production	7.7	-5.1	-2	-7.7	4.3	5.5	na
Commercial Vehicle sales	-25.7	-38.7	-39.1	-23.3	-15	-12.3	-14
Two wheeler sales	-16.8	-22.2	-22.1	-14.4	-14.3	-16.6	-16.1
Passenger vehicle sales	-31	-31.6	-23.7	0.3	0.8	-1.2	-6.2
Non-oil imports	-5.9	-15.1	-11	-9.3	-10.3	-11.5	-6.7
Airport Passenger Traffic	1.8	3.9	1.1	4	11.2	2.6	2.5

Source: Kotak Institutional Equities

But early signs of a nascent recovery are visible

The manufacturing Purchasing Managers' Index (PMI) for India shot up to 55.3 in January from 52.7 in December. A figure above 50 indicates expansion, anything lower signals contraction. The companies covered in the PMI survey recorded the strongest upturn in new business intakes for over five years, which they attributed to better underlying demand.

India Purchasing Manager's Index

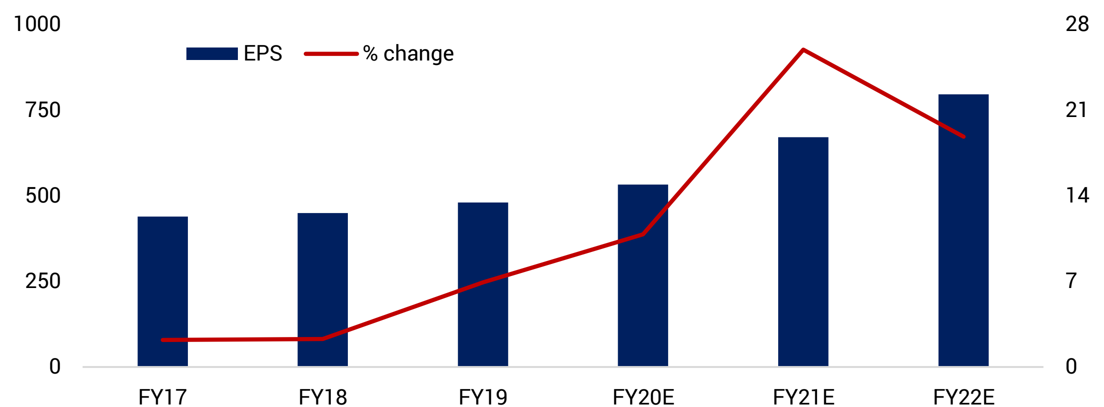


Source: Bloomberg

Earnings Outlook

We expect FY20E and FY21E net profits of the Nifty-50 Index to grow 9.6% and 25.7% from 11.3% and 25% at the beginning of the results season. The strong growth in net profits of Nifty-50 Index for FY20E and FY21E reflects a rebound in the earnings of financials, metals and mining and telecom sectors. The sharp recovery in net profits of (1) banks is on the back of expectation of normalization of bad debt provisions in the banking sector in FY20-21E, (2) the metals sector highlights our view of a moderate recovery in global metal prices from current depressed levels and (3) the telecom sector reflects our assumption of increase in ARPUs following the decision of telecom companies to align prices with costs after a period of cutthroat competition and steep declines in ARPUs.

Trend in Nifty EPS

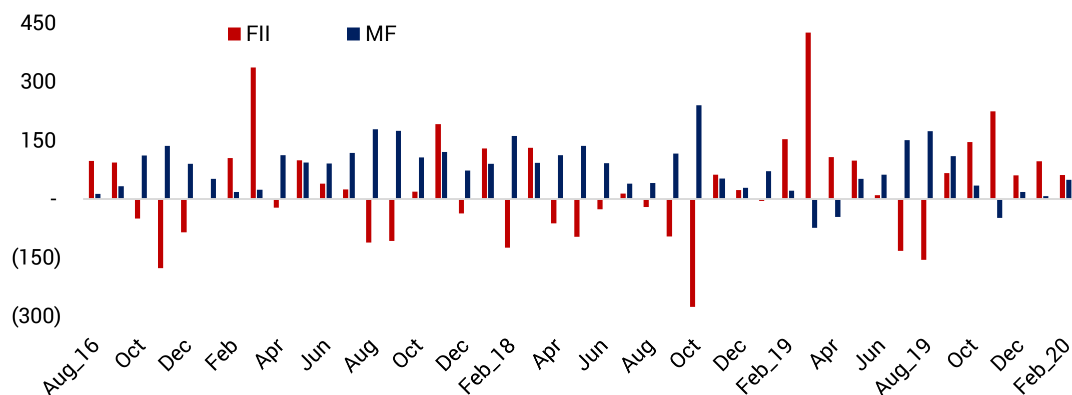


Source: Kotak Institutional Equities

FIIs flows gained momentum

Post the corporate tax cuts announced by the government in September 2019, FII flows have been gaining momentum, so much so, that by the end of December 2019, FII holdings in 409 firms of BSE 500 rose to 21.03%, one of the highest in recent quarters. Other factors that have led to steady FII flows include relaxation of additional surcharge on foreign portfolio investment and accommodative monetary policy stance by US Federal Reserve.

MF/FII flows (Rs bn)



Source: Bloomberg

Systematic Investment Plans (SIP) flows have emerged as a strong counter-weight against FII outflows. If the current monthly SIP run-rate at Rs 85 bn is maintained, the MF industry is expected to see SIP equity inflows of nearly Rs 1.0 trn in FY20, which can help provide support to the markets in times of FII selling.

Monthly SIP flows Rs bn

Rs bn	FY 2019-20	FY 2018-19	FY 2017-18	FY 2016-17
Total during FY	829.3	926.9	671.9	439.2
March	0.0	80.6	71.2	43.4
February	0.0	80.9	64.3	40.5
January	85.3	80.6	66.4	41.0
December	85.2	80.2	62.2	39.7
November	82.7	79.9	58.9	38.8
October	82.5	79.9	56.2	34.3
September	82.6	77.3	55.2	37.0
August	82.3	76.6	52.1	35.0
July	83.2	75.5	49.5	33.3
Jun	81.2	75.5	47.4	33.1
May	81.8	73.0	45.8	31.9
April	82.4	66.9	42.7	31.2

Source: AMFI

SECTOR EARNINGS OUTLOOK

We discuss our earnings projections by sectors and the key drivers of earnings through FY22E below.

Automobiles

We expect net profits of the automobiles sector to decline 6% in FY20 due to extremely weak domestic demand conditions. However, we expect a sharp bounce in net profits in FY21-22 on the back of (1) recovery in domestic volumes in the 2-W and 4-W segments in FY22E; FY21 volumes will still be weak and (2) profits at TTMT in FY21-22E versus a loss in FY20E (and FY2019).

Banks and diversified financials (NBFCs).

We expect a sharp surge in the profits of certain banks (Axis bank, SBI and ICICI Bank) due to a steep decline in loan-loss provisions driven by (1) peaking of NPLs and slippages in 4QFY19/1QFY20; NPLs have declined moderately in 9MFY20 and slippages fallen sharply over the same period, (2) high provision coverage ratio at end-FY2019, which would result in a decline in loan-loss provisions from FY20E and (3) possible recovery on loans already written off on successful resolution of a few large cases in the NCLT.

We see downside risks to our assumption of credit growth and potential upside risks to our credit cost assumptions in the retail loan book of banks and NBFCs in the event of a prolonged downturn in demand.

Construction materials

We assume higher profitability for cement stocks under our coverage for FY20-22E. We note that realizations and profitability have increased sharply over the past 12 months, despite weak demand conditions.

Consumer products

We expect the consumer product companies to deliver low-to-high single-digit revenue growth in FY20E. We note that demand conditions have worsened significantly over the past quarter. Also, the inflation in agriculture raw material prices in recent months has capped gross margins of certain consumer companies over the past few quarters.

IT services

We expect net profit growth of IT stocks in the Nifty-50 Index to taper down to 5% in FY20E from 16% in FY19 as we expect (1) a more gradual depreciation in the INR versus US Dollar in FY20E versus the steep depreciation seen in FY19 (2) decline in margins on higher costs (higher share of on-shoring given industry and visa issues) and limited tailwind from currency depreciation.

Metals & mining

We expect the net profits of the metal stocks in the Nifty-50 Index to decline 59% in FY20E after a 7% growth in FY2019. However, we expect the metal sector to show strong growth in net profits in FY21E led by recovery in realizations and profitability on (1) normalization of current weak global demand conditions (due to the COVID-19 issue) and (2) moderate improvement in domestic demand from a modest recovery in demand from the Indian automobile sector.

Oil, gas and consumable fuels

We expect the profits of the oil, gas and consumable fuels sector to decline sharply in FY20E on the back of weak refining margins for the downstream oil companies. In fact, the sector would be a major drag to the profits of the Nifty-50 Index despite higher profits of RIL. We expect net profits to grow 17% in FY21E led by higher profits of RIL's telecom business and higher refining margins for BPCL, IOCL and RIL.

Upstream oil & gas companies

We do not expect upstream oil companies to bear any subsidy burden in FY20-21 as was the case for the past few years.

Pharmaceuticals

We expect 15% and 24% growth in the net profits of the pharmaceuticals sector in FY20E and FY21E on the back of (1) pickup in new launches of generic products in the US from 2HFY19, which will drive US generic revenues and overall, revenues and profits, (2) steady growth in domestic pharmaceutical revenues.

Market Outlook

As concluded by CII in its recent report the Covid-19 virus outbreak is a serious pandemic of unforeseen proportions. No one knows how far the fear over covid-19 virus will extend and to what extent stocks will fall further. Till the time the covid-19 virus was contained in mainland China there was compliancy in global equity markets but now as more cases are getting reported in various countries the impact is sharper. Expect markets to remain weak till the time the number of cases reported globally either stabilises or goes down. Based on past precedencies the recovery in markets (post containment of such epidemics) is equal or higher than the fall. However, going by the speed at which the Covid-19 virus is spreading in most countries it will be a while before we hit the bottom.

Till date India has seen the least impact of Covid-19 virus which could work in its favour as far as flows are concerned. The immediate impact on FII flows would be negative as passive funds who tend to invest through ETFs would look to pull out money due to the sharp correction in global indices. With downside risk to global growth we can expect unconventional measures from governments and central banks across the globe. To address the near term headwinds due to covid-19 virus and potential slowdown in FY21 GDP numbers we can expect some measures from the Indian government and RBI in coming times. If we see fresh rate cuts or infusion of liquidity by global central banks then FII flows could resume into select emerging markets as and when the Covid-19 virus impact fades out. For India, SIP flows could act as a buffer in times when FIIs withdraw their investments.

Based on valuations we expect the Nifty-50 to take support anywhere between 10,500-11,000. Our one year Nifty-50 target ranges between 13,000-13,500. Basis of deriving at these figures is provided below in earnings & valuations part. We need to keep in mind that Nifty-50 has already corrected by 10% from its peak. On a conservative basis, downside of 10,500 and upside of 13,000 provides potential downside of 6% and potential upside of 16%. The risk-reward ratio of downside to upside at 1:3 has turned favourable. It is ideal to accumulate stocks from current levels since risk-reward ratio is in favour of equities. The lower bond yields will support higher valuations for equities, which is big factor in favour of equities.

Interest in mid and small caps had revived before the budget but they too have corrected sharply in the recent correction. Mid & small caps may take a backseat for some time till clarity emerges on the broader Nifty-50 Index. In the course of CY20 we expect mean reversion to allow mid & small caps to catch up on their last two years underperformance vis-à-vis Nifty-50 Index. In the mid and small cap space we recommend investors to look for companies with good earnings growth prospect and available at beaten down prices with reasonable valuations.

Key Variables

	Short term	Medium term	Remarks
Corporate Earnings	⇔	⇧	Near term growth is uncertain, but lower tax rate and improved performance of banking sector to drive earnings in medium term
Economy	⇔	⇧	Near term growth is weak but there are early signs of bottoming out
FII Flow	⇧	⇧	India stands out among global asset classes with prospects of strong long term growth given favorable demographics
Domestic Institutional Fund Flow	⇧	⇧	Long runaway of growth in financialization of savings
Supply of paper	⇩	⇩	Higher disinvestment target to create supply overhang especially in PSU stocks
Policy/Reform Initiative	⇧	⇧	With no major elections in the near-term, the Government to focus on reforms

Source: Kotak Securities – Private Client Research

Valuation

We expect net profits of the Nifty-50 Index to grow 10% in FY20E despite the 10-15% uplift to profits from the corporate tax cut. We note that the strong growth in net profits of banks will be offset by sharp declines in net profits of the global commodity sectors, hurt by weak global prices in 4QFY20 due to the ongoing COVID-19 issue. Post Q3FY20 earnings season we expect net profits to bounce 26% in FY21 driven by higher profits of (1) banks due to lower loan-loss provisions, (2) metals companies due to normalization in prices and profitability and (3) telecom sector due to higher ARPUs, as companies align prices with costs after a period of aggressive price competition. However, considering the recent negative developments of covid-19 virus and lower GDP growth estimates we could see earnings downgrades in the next few quarters. There is downside risk to many sectors either on the realization front or availability of raw materials or increase in raw material prices. These will get factored into earnings as we go into fiscal FY21.

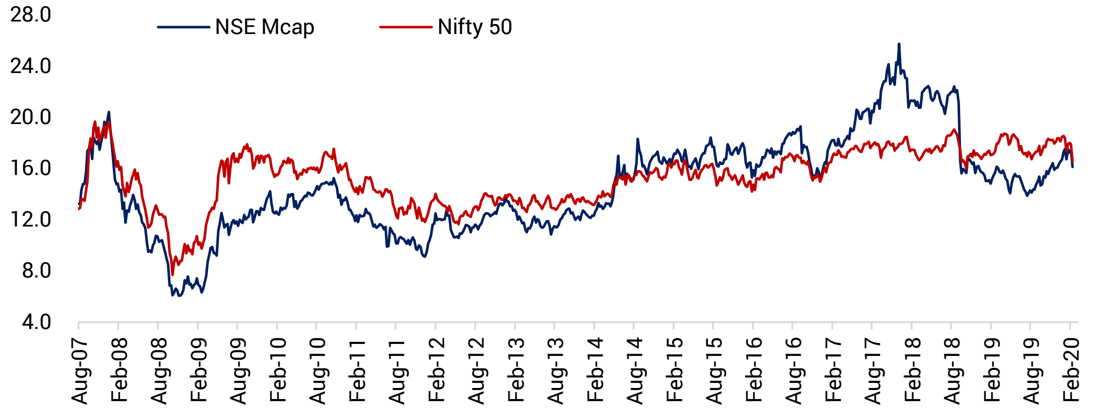
Valuations could provide some indications of major support levels based on past trends. In the last major correction seen in CY18 the Nifty-50 had gone down to 16x on forward estimates. At current levels of 11,202 the Nifty-50 trades at 16.6x FYY21E and 14.1x FY22E, respectively. These valuations are based on the last estimated EPS of KIE which builds in CAGR earnings of 22% between FY20-22E. If we build in CAGR of 18% for FY20-22E then Nifty-50 would be trading at 17.8x FY21E and 15.1x FY22E, respectively. Based on our benchmark of 17.5x the one year upside potential still remains in the range of 13,000-13,500 (even after considering potential earnings cut). Assuming Nifty-50 bottoms out at 16x in the immediate near future then near term downside in Nifty-50 works to anywhere between 10,500-11,000.

India's market cap to GDP ratio (%)

Source: Kotak AMC and Kotak Securities - Private Client Group

Based on Bloomberg consensus estimates the Nifty-50 is now trading at 16.5x Fw PE as compared to 16.1 Fw PE of the Mid Cap 100 Index. There is no major undervaluation in the Mid Cap Index as compared to Nifty-50.

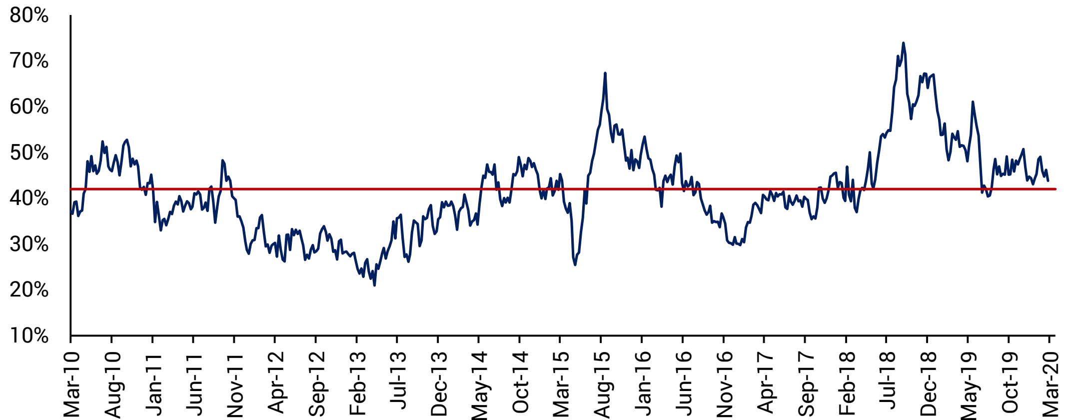
One Yr Fw PE chart: Nifty-50 Vs Mid Cap 100 Index



Source: Bloomberg

MSCI India trades at 44% premium over MSCI EM (based on Fw PE basis). India's premium over emerging markets is now very close to its 10 Yr avg. premium of 42%.

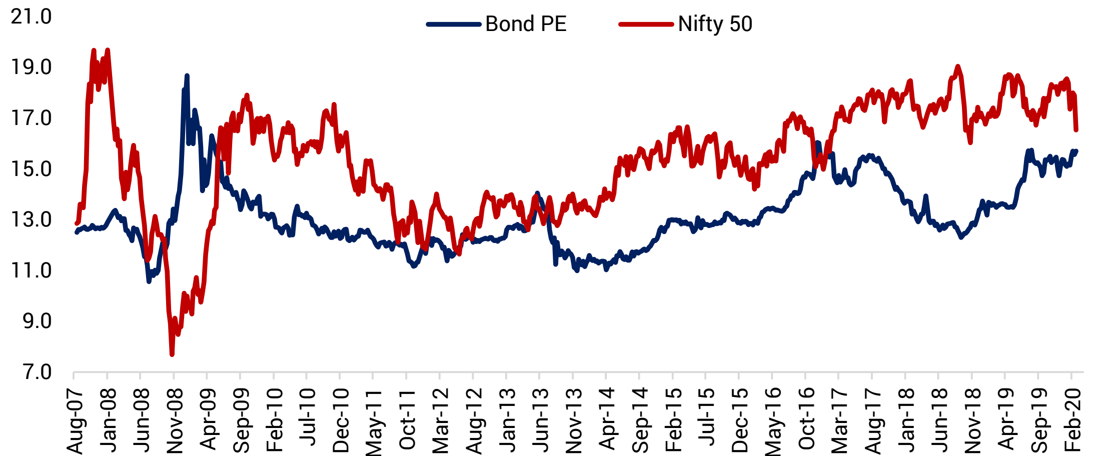
MSCI Emerging Market Vs MSCI India 1 Yr rolling FW PE



Source: Bloomberg

The 10 Yr G-Sec yield of 6.37% has increased the bond PE to 15.7%. The Nifty-50 Fw PE of 16.5x is now just 80 bps above the bond PE as compared to 10 Yr avg premium of 250 bps.

Bond PE Vs Fw Equity PE of Nifty-50



Source: Bloomberg

BHARTI AIRTEL: BUY

CMP: Rs.524 **Fair Value: Rs.600** **Market Cap: Rs. 2851 bn**

- 3QFY20 Consolidated performance - Overall revenues of Rs 219.5 bn (+4% qoq, +9% yoy) came in 0.7% ahead of KIE's estimate. EBITDA stood at Rs92.7 bn, (+4.6% qoq), broadly in line with KIE's estimate. PBT level loss stood at Rs6.05 bn, lower than 2Q's Rs9.4 bn, and broadly in line with KIE's estimated PBT loss of Rs6.35 bn.
- From an execution standpoint, there is ample evidence to suggest that the company is now operating in top gear. Consistent leadership positions in various third-party network tests, traffic (voice as well as data) growth prints and LTE net adds acceleration all bear ample testimony.
- Management said that they are hopeful of a constructive engagement with the judiciary and the government on the AGR case dues.
- Bharti remains committed to a partnership approach for its content offerings. They have tied up with global leaders to provide best in- class content on Airtel Xtreme.
- Management said that the current tariffs are at still unsustainably low levels (even post the December 2019 tariff hike). They highlighted that tariffs have also come down for the class of consumers who can afford to pay a much higher price for good quality service.
- KIE's revised FV stands at Rs600/share; it values the India wireless business at 9.5X FY22E EBITDA, Africa wireless and BHIN stakes at their respective CMPs and the DTH business at 7X EV/EBITDA.
- Sharp run up in the past year or so notwithstanding, Bharti remains a solid multi-year compounding play as long as the company and R-Jio resist the alpha-male tendencies in the forthcoming spectrum auctions.

Note: The above is brief note on the company, based on the KIE research report and update available (dated: 5th Feb 2020) on our website at:
https://www.kotaksecurities.com/research_report/recommendation/indiadaily.html

ENGINEERS INDIA LTD: BUY

CMP: Rs.70 **Fair Value: Rs.123** **Market Cap: Rs.44.9 bn**

- Engineers India Ltd (EIL) is a leading global engineering consultancy and EPC company. Established in 1965, EIL provides engineering consultancy and EPC services principally focused on the oil & gas and petrochemical industries.
- The Company has also diversified into sectors like infrastructure, water and waste management, solar & nuclear power and fertilizers to leverage its strong technical competencies and track record.
- The Company is optimistic that with planned capex expenditure of all the Oil & Gas majors in the hydrocarbon sector, the coming years would offer a number of opportunities across the value chain especially in the midstream and downstream segment with integrated refinery and petrochemical complexes as well as standalone petrochemical plants.
- Management has guided for revenue growth of c. 20% for FY20. Revenue from Barmer refinery will start contributing materially from FY21 onwards.
- The company is targeting to secure orders worth Rs 18 bn in FY20. It has already won orders worth Rs 14.6 bn in 9MFY20.
- We have revised EPS to Rs 6.9 (Rs 6.7 earlier) and Rs 8.6 (Rs 8.5 earlier) for FY20E and FY21E respectively.
- We value FY22 core earnings of Rs 5.1 per share (excluding other income adjusted for tax) at PER 14x and add back cash per share of Rs 50.4 per share in FY22. Thus arriving at a target price of Rs 123 (Rs 130 earlier).

Note: The above is brief note on the company, based on the research report and update available (dated: 6th Feb 2020) on our website at: https://www.kotaksecurities.com/research_report/recommendation/indiadaily.html

HDFC Ltd: BUY

CMP: Rs.2176 **Fair Value: Rs.2680** **Market Cap: Rs.3813 bn**

- HDFC's 3QFY20 loan growth remained moderate (16% growth in individual loans; 14% overall loan growth) reflecting sluggish momentum in the sector (stable ticket size; higher volumes driving growth). Calculated NIM expanded to 2.5%, up 10 bps yoy and 15 bps qoq. This was largely driven by declining funding cost likely due to falling incremental cost of funds and decline in MCLRs of banks.
- HDFC reported 14% yoy AUM growth in 3QFY20, marginally higher than 13% yoy growth in 1QFY20 and 2QFY20. HDFC has delivered core RoAs of 2.2-2.5% in FY08-14 (RoE of ~25%), which declined to 1.6- 2% in the past three years. KIE expects core RoA expansion to 2.1% in FY21E, which can potentially increase to 2.3-2.4%.
- Core RoE of 16% in the near term will potentially expand to 19-20% when the share of high-yielding developer loan increases and growth momentum picks up; this is challenging to model given the lack of clarity on the timing of the turnaround.
- Gross stage-3 loans were broadly stable qoq at 1.6% (up 15 bps yoy/2 bps qoq). GNPL ratio (as per IGAAP) increased 14 bps yoy/3 bps qoq to 1.36% in 3QFY20. ECL Overall coverage increased to 2.25% from 1.72% qoq. KIE forecasts gross stage-3 loans to remain stable around ~1.5% over FY21-22E (up from 1.4% in FY2019) with 49% coverage.
- KIE expects HDFC to deliver 17% core earnings CAGR in FY20-22E on the back of 11% yoy growth in FY20E & 17% AUM growth in FY21-22E post muted 13% yoy growth in FY20E, as developer loans bottom out. KIE also expects HDFC's core NIM to increase to 2.6% in FY22E from about 2.4% in FY20E.
- At fair value of Rs. 2,680, HDFC will trade at 2.6x core book December 2021E (Juxtaposed to medium-term RoE of 19-20%). KIE values HDFC Bank and HDFC Life at fair value, HDFC AMC at market price and HDFC ERGO at 22x FY20E PAT.

Note: The above is a brief note on the company, based on the KIE research report dated 27th Jan, 2020 and update available on our website at: https://www.kotaksecurities.com/research_report/recommendation/indiadaily.html

ICICI BANK LTD: BUY

CMP: Rs.497 **Fair Value: Rs.615** **Market Cap: Rs.3208 bn**

- In Q3FY20, ICICI Bank posted 2.5x yoy earnings growth on the back of 23% yoy growth in operating profits and ~ 50% yoy decline in provisions. NIM expanded 10bps qoq to 3.7% while loan growth was stable at 13% yoy (retail grew 19% yoy; non-retail grew 3% yoy).
- Consolidated net profits increased ~150% yoy to Rs46.7 bn in 3QFY20 led by strong earnings performance in the bank (up ~160% yoy) and subsidiaries (up ~100% yoy). ICICI Bank reported its best RoE of 14.7% this quarter after 52 quarters.
- Retail loans however continued to witness healthy growth at 19% yoy (moderating from ~22% in 2QFY20). The share of retail loans continues to inch upwards and is currently at 63% of overall portfolio (up 50 bps qoq and 360 bps yoy).
- Slippages were elevated in 3QFY20 from both retail and corporate loans. Slippages from the KCC portfolio were at Rs3.1 bn (compared to Rs1.9 bn in 3QFY19). The company has seen no major signs of stress in any other retail segment. Corporate slippages of Rs24.7 bn (~4.2% of corporate loans) were mainly from outside the 'BB and below' book (~70% of corporate slippages) and were largely driven by stock broking account (fully provided during the quarter) and a South India-based industrial account.
- KIE Forecast - Net NPL to reduce to ~1% by FY22E with slippages of ~1.7% in FY21-22E. Loan growth to improve to ~17% by FY21-22E. CASA CAGR of ~13% over FY19-22E and stable CASA ratio of ~46%. Calculated NIM of ~3.6% over FY20-22E.
- KIE believes ICICI bank's RoE is well positioned for ~15% + in medium term. KIE has a positive view and values the bank at Rs. 615 implying 2.4X book and 15X Dec FY21 EPS. In its SOTP valuation KIE has ascribed Rs.145/share towards valuation of its subsidiaries.

Note: The above is a brief note on the company, based on the KIE research report dated 27th Jan, 2020 and update available on our website at: https://www.kotaksecurities.com/research_report/recommendation/indiadaily.html

MAHANAGAR GAS LTD: BUY

CMP: Rs.1005 **Fair Value: Rs.1300** **Market Cap: Rs.99.9 bn**

- MGL's volumes grew 3% yoy to 3.05 mcm/d in Q3FY20, recovering from a weak print of 1.3% growth in Q2FY20, which was impacted by intermittent supply disruptions. Gross margins moderated 5% qoq to Rs13.9/scm in Q3FY20, as higher margins for CNG and domestic PNG segment post a decline in domestic gas price, were perhaps offset by lower margins on I&C PNG volumes amid qoq increase in long-term as well as spot LNG prices. Unit EBITDA margins declined 7% qoq to Rs9.2/scm, with operating costs remaining under control.
- MGL's EBITDA increased 8% yoy but declined 5% qoq to Rs2.59 bn, 2% below KIE estimate, in Q3FY20 reflecting (1) 3% yoy growth in volumes to 3.05 mcm/d, (2) 5% qoq moderation in gross margins to Rs13.9/scm, perhaps due to lower margins on industrial and commercial PNG volumes amid higher LNG prices. Net income jumped 25% yoy to Rs1.86 bn (EPS of Rs18.8), in line with KIE estimate, boosted by higher other income and lower tax rate at 23.9%.
- In 9MFY20, MGL delivered a robust 18-35% yoy jump in EBITDA and adjusted net income (EPS of Rs57.7) led by 15% yoy increase in unit margins to Rs9.8/scm amid favorable pricing changes and modest 2.5% growth in overall volumes to 3.01 mcm/d from a high base of pervious year.
- Slower volume growth and progressive changes in regulations to enable competition remain a cause of concern.
- KIE's EPS estimate is Rs76.8 in FY20, Rs84 in FY21 & Rs89.4 in FY22 and factoring in (1) higher unit EBITDA margins amid reset of PMT gas price, lower LNG prices and expected decline in domestic gas price. KIE DCF-based fair value is Rs.1,300 reflecting higher unit margins and roll-forward of DCF model. KIE retains ADD rating on the stock as it find valuations reasonable at in the context of (1) input cost tailwind, (2) high FCF/dividend yield and (3) healthy return ratios.

Note: The above is a brief note on the company, based on the KIE research report dated 10th Feb, 2020 and update available on our website at:
https://www.kotaksecurities.com/research_report/recommendation/indiadaily.html

QUESS CORP LTD: BUY

CMP: Rs.514 **Fair Value: Rs.690** **Market Cap: Rs.77.9 bn**

- In Q3FY20, Quess' PAT grew 15% sequentially and 11% yoy to Rs.713 mn, in-line with our estimate of Rs.729 mn. Revenue grew 11% qoq (all organic) and 36% yoy (31% organic) to Rs.29.5 bn, higher than our estimate of Rs.25.6 bn. Further, organic revenue growth yoy was supported by increase in general staffing (+37% yoy) and CLM (Conneqt +13% yoy). Notably, operating cash flow was up by 600 bps yoy to 51% led by better collections (DSO down to 59 days from 61 qoq).
- Workforce Management: Revenue grew by 52% yoy and 17% qoq to Rs.19.6 bn driven by headcount growth (General Staffing headcount stood ~244k associates). The company added 82 logos with a combined ACV of ~Rs.940 mn. However, margin was flat at 5.3% due to contraction in Indian IT staffing margins (down 280 bps to 3.4%).
- Operating Asset Management: Revenue grew by 4% both yoy and qoq to Rs.4.5 bn driven by Industrial Facility Management business (revenue increased by 11% yoy to Rs.3.47 bn). IFM maintained SLA vs headcount business ratio at 26:74. Industrial business continues to reduce operational losses. Margin was flat at 7.4%.
- Tech Services: Revenue grew by 19% yoy to Rs.5.4 bn driven by 13% increase in Conneqt and Allsec acquisition. The company added 44 new logos across businesses with ACV of Rs.430 mn.
- We expect Quess to report an EPS of Rs.26.1 in FY21E (Rs.19.2) and Rs. 34.5 in FY22E supported by organic growth and margin improvement. We maintain ADD rating on Quess with a target price of Rs.690/share, valuing the company at a P/E multiple of 20x FY22E.

Note: The above is a brief note on the company, based on the PCG research report dated 31st Jan, 2020 and update available on our website at:
https://www.kotaksecurities.com/research_report/recommendation/indiadaily.html

Rating Scale (Kotak Securities – Private Client Group) / Kotak Institutional Equities

Definitions of ratings

BUY	–	We expect the stock to deliver more than 15% returns over the next 12 months
ADD	–	We expect the stock to deliver 5% - 15% returns over the next 12 months
REDUCE	–	We expect the stock to deliver -5% - +5% returns over the next 12 months
SELL	–	We expect the stock to deliver < -5% returns over the next 12 months
NR	–	**Not Rated.** Kotak Securities is not assigning any rating or price target to the stock. The report has been prepared for information purposes only.
SUBSCRIBE	–	We advise investor to subscribe to the IPO.
RS	–	**Rating Suspended.** Kotak Securities has suspended the investment rating and price target for this stock, either because there is not a Sufficient fundamental basis for determining, or there are legal, regulatory or policy constraints around publishing, an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.
NA	–	**Not Available or Not Applicable.** The information is not available for display or is not applicable
NM	–	**Not Meaningful.** The information is not meaningful and is therefore excluded.
NOTE	–	Our target prices are with a 12-month perspective. Returns stated in the rating scale are our internal benchmark.

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