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AMBIT 365

THE SINE CURVE: NARRATIVES VS NUMBERS

NEWSLETTER • MARCH '24

"NEVER LET THE TRUTH GET IN THE WAY OF A GOOD STORY" - MARK TWAIN.

However, narratives work only for some time in the markets, and eventually, the numbers do take over. Within the long cycle of India's growth, there are smaller counter-cycles. That is the essence of our Sine Curve framework, that nothing is linear. 3QFY24 GDP growth of 8.4% GDP, beat all estimates and made headlines. However, the GVA (gross value added) growth of 6.5% (the gap with the GDP number is large and unprecedented) was in line with estimates, and the nominal GDP growth for FY24 has been revised down for FY24 by 90bps to 9.1%, compared to the estimates released in January. The sharp difference in the GDP and the GVA growth was due to the lower release of subsidy payments (-59% y/y) and stronger indirect tax collection. This should normalize next quarter. The strong counter-cycle is weak consumption demand- at 3% for FY24, it is the weakest in 21 years (ex Covid year).

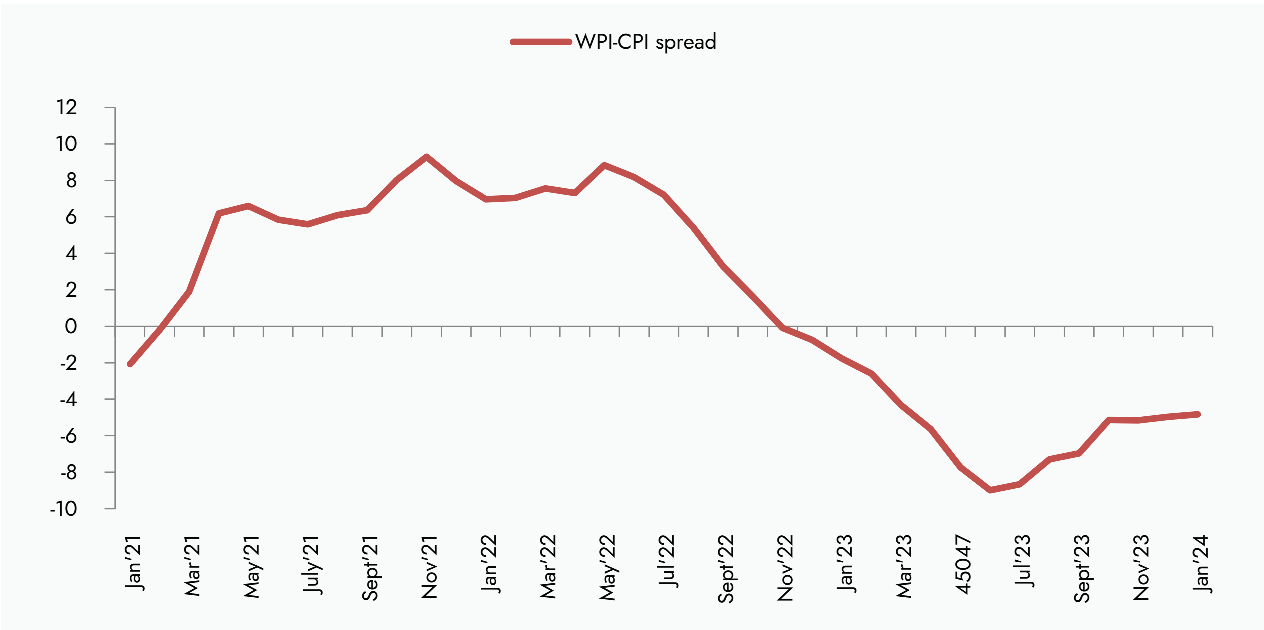
Curious case of revenue growth lower than nominal GDP growth: Despite an estimated 9% nominal GDP growth in FY24, Nifty revenue growth of 9mFY24 is a disappointing 5%. There are two possible explanations for the same. i) Unlisted players are taking market share away. Companies have talked about regional players becoming competitive again. D2C players are growing faster than their listed counterparts. ii) Companies have preferred to grow margins instead of volumes (partly the reason, which made smaller players competitive). Margin expansion has been helping the earnings growth - so far - despite poor revenue growth. Margin expansion has been driven by a sharp fall in input prices (WPI). The WPI-CPI spread fell from a peak of 9.3% in Nov '21 to a bottom of -9% by June 2023. Now, it is at -4.8%, the gap is moderating. This helped the gross margins of companies for 2-4 quarters, but that effect is fading away. For the December quarter, Nifty earnings rose at 14% YoY, much lower than the 25% YOY growth on average over the previous 3 quarters, and is likely to drift lower, if the sales growth does not pick up. Our sine curve framework says, that when growth decelerates, valuations can also contract, making it a double-whammy, and is a risk.

Growth dispersion = stock performance dispersion- The cycle and counter-cycle are a fabulous environment for Ambit365. Growth-deceleration stocks are falling, offering short opportunities and vice versa. For February, (pre-tax and pre-variable fees) NAV was up 2.1%- Return for five months since inception is now at 8.4%. Both long-stocks and short-stocks contributed to the gain; Nifty, we got whiplashed a bit this month. Our top short contributors are all companies seeing growth pressure- UPL, Bandhan Bank, Jubilant FoodWorks, Asian Paints, Page Industries, and Bajaj Finance (at the margin staring at a slower growth than earlier). Our top long contributors, on the other hand, are seeing earnings acceleration or a very favourable regulatory or macro environment. Our top 5 long book contributors were BPCL, Zydus Life, DLF, Coal India, and NMDC for February 2024.

Chart 1: Nifty Sales growth and earnings growth – Divergence to Convergence

Source: Bloomberg

Chart 2 – The WPI-CPI Spread gap is narrowing limiting the margin tailwinds



Source: CSO

BFSI: THE PERFECT SINE CURVE

The largest sector in India is the most diverse and complex and hence offers opportunities to play both growth cycles and counter-cycles. Last 3 months Ambit 365 has generated positive returns on longs and shorts in the sector. PNB has been one of our top contributors to the long book, and HDFC, BAF, Bandhan, and Chola have done well in the short book. We see 3 major trends in the sector a. Convergence in fundamental metrics (loan growth, NPLs, and ROE) across all the large private banks, b. Rising risk in the unsecured credit space, and c. the struggle to garner deposits to fund the growth - higher CD ratio (explained in the February Newsletter). This has resulted in valuation convergence too, and can narrow further. This valuation convergence still offers a long-short opportunity in the space. Also, as the risk in unsecured lending is rising coupled with consumption slowdown, select richly priced NBFCs can also witness valuation contraction.

We bring out the convergence in fundamental metrics of bank majors in the following charts.

Chart 3: Loan growth convergence

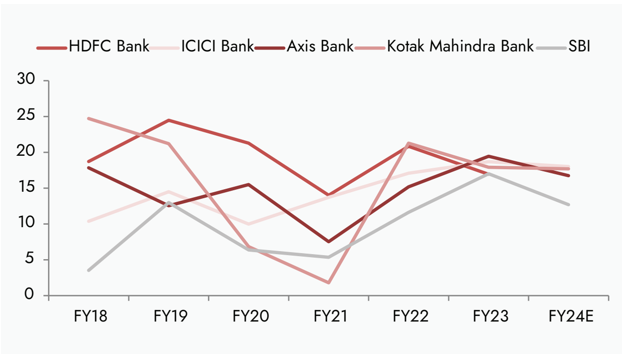


Chart 4: Asset quality (% GNPA) convergence

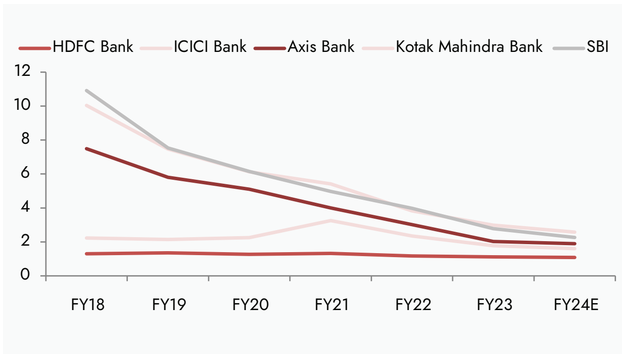


Chart 5: RoE divergence to convergence...

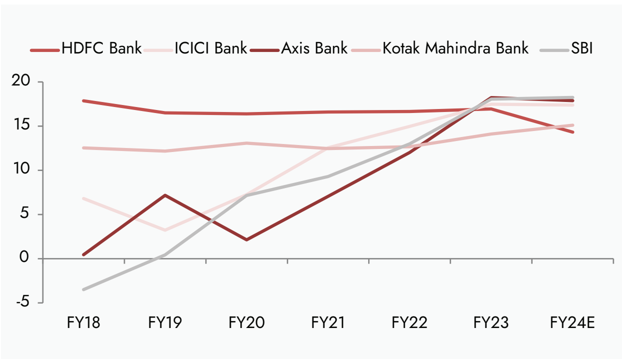
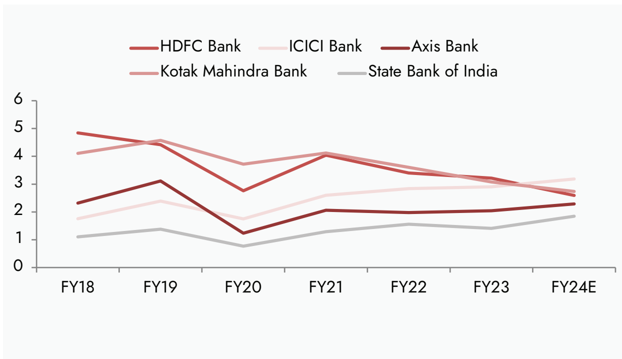


Chart 6: Valuation (P/BV) Convergence....



Source: Ambit Research, Bloomberg & Chart 3 (HDFCB due to merger no value for FY24E)

The great rotation: Over 2015-20, performance dispersion across banks was wide. Which also resulted in huge valuation gaps and stock return dispersion. Over 2015-19, HDFC and Kotak were up ~170%, SBI a meagre 7%. 2020-now (6 Feb 24) appears like a full rotation. SBI is up 135%, while Kotak and HDFC are up just 5-15%. Please see the ranked performance of NSE Bank Index components over these 2 periods below.

Chart 7: Performance over 2015-2019

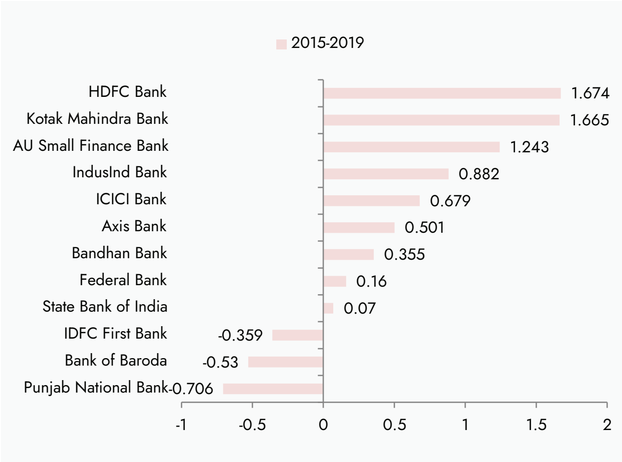
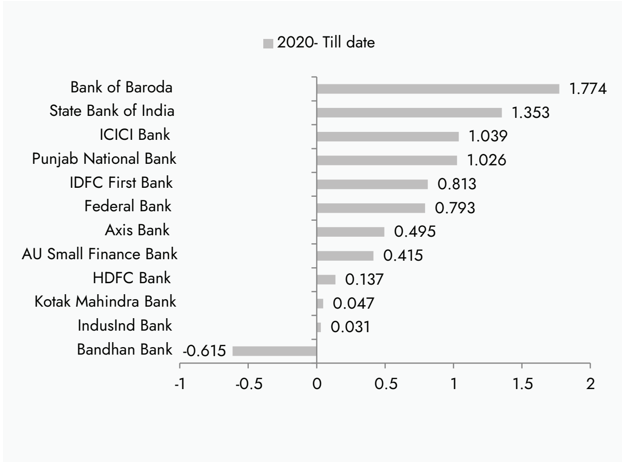


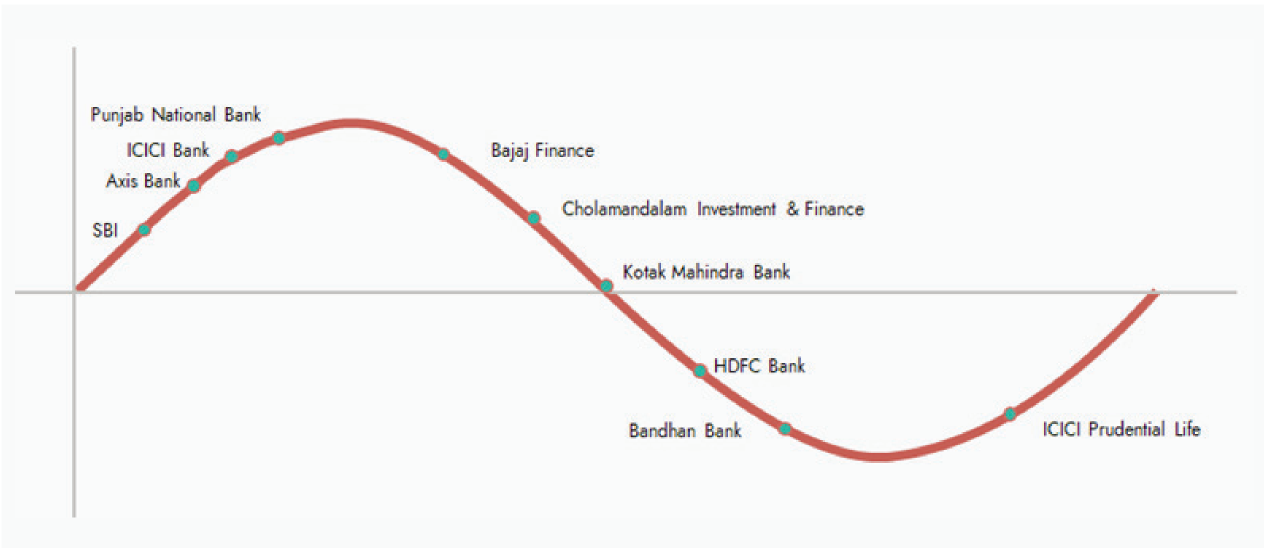
Chart 8: Performance over 2020 to 6Feb24



Source: Bloomberg

BFSI Sine Surve: The following chart represents Ambit 365's view on where we place the BFSI majors on the sine curve, accounting for convergence in fundamentals, risk, and valuations. Stocks on the ascending part of the curve form our long bucket and stocks on the descending part form our short bucket. We want to highlight PNB- which joined the convergence theme late but caught up rapidly. Just a year ago, we placed PNB near the horizontal line. The stock is up 150% in 12 months (compared to just 16% for the NSE Bank Index), and the valuations have caught up with BOB. Ambit365 has been in PNB since our inception in October, and we booked gains last month. Our current portfolio reflects our view shown in the chart below. We have long positions in SBI and ICICI. And we are short on BAF and Chola. We recently booked gains in HDFC short.

Chart 9: BFSI Sine-Curve



Source: Ambit365 research

NEW HIGH, BUT CRACKS APPEAR

When going into print the Nifty made a new high, buoyed by the GDP narrative. Normally, when the markets break into uncharted territory, it is difficult for shorts to perform, as we saw in December 2023. But shorts are doing well this year, and in March too. Of the nifty names - year to date 30 stocks are up and 20 down; the rally is becoming narrow. While this may not be conclusive evidence to call a correction at the headline index level (we just have to look at the US, where Magnificent 7 is driving the indices up), it does call for managing the net exposure in a narrow range- and use the Nifty to add some returns only very opportunistically and tactically. In last month's newsletter, we mentioned that encouraged by the strong US economic data, we were getting constructive on Indian IT services. But, after analysing the post-results commentary of Indian IT companies we have changed that view. We exited our long in TCS and are building shorts in Mphasis, LTI Mindtree, and Infosys. While we are maintaining our core position in SBI, we are adding ICICI - as after many months of sideways moves, we see the possibility of ICICI doing some catch-up. One sector that still confuses us is metals- as swings of hope and despair in China impact and move the sector, but not in any sustainable fashion. China's clarity is extremely crucial to take a conclusive call there. But after many months of sideways movement, the space must be getting ready to acquire direction.

The market continues to move in a non-linear fashion, as we discussed in last month's newsletter. While we did very well in February, a key learning to apply from there is to use Nifty more sparingly, since stocks are making large moves, but the Nifty is oscillating in a narrow range. Our current focus is on absolute return generation from stocks as of now, while keeping an eye on the Nifty for a clear directional move.

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