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November 30, 2020

For the month ended November 27, 2020, Nifty 50 index was up 11.39% over previous month's close. Mid and small caps outperformed large caps. NSE Midcap 100 Index was up 15.52% and NSE small cap Index was up 12.96%. Within sectors, metals, banking, autos, public sector enterprises and realty outperformed Nifty 50 index whereas technology, media, pharma, infrastructure and energy underperformed. Foreign investors (FII or FPI) were net buyers again this month at USD8bn, whereas domestic funds remained net sellers again this month at USD6bn.

Fig: Flows

(USD mn)	Curr	MTD	CYTD
FII - Cash	(181)	7,915	14,462
DII - Cash	(461)	(5,843)	831
FII - Debt	(165)	(248)	(14,477)

Source: Bloomberg

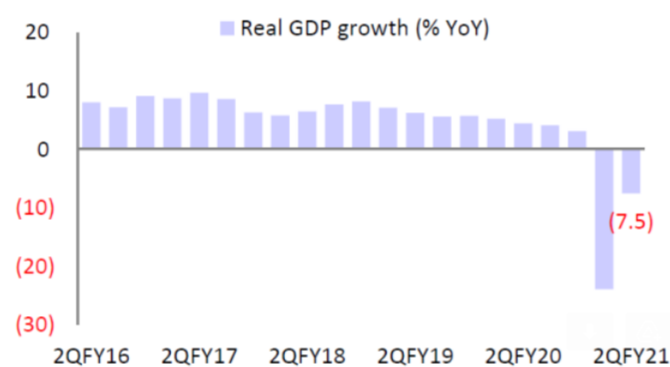
India has seen ~USD8bn of net buying by foreign investors in equities in the month of November making it the highest monthly buying ever seen in India. Foreign investors had pulled out close to ~USD 8.5 bn from Indian markets during March-April 2020 due to COVID-19 outbreak. That outflow has been recovered in a single month. Post that, foreign fund flows have been consistently positive, expect for September 2020, which saw outflows of ~USD800mn. Markets were cautious in the run up to US presidential elections; however, with the event now behind, there seems to be a relief rally. While domestic institutional holding in midcaps is at a decadal high, domestic fund inflows have been muted with net inflows of ~ USD160mn compared to ~ USD15bn buying by foreign funds in 2020CYTD. Bulk of the selling by domestic selling was witnessed in the month of November 2020.

For the quarter ended September 2020, foreign fund holding in Nifty stocks stood at 25.7% and mid-caps at 15.3%; thus, a blended 20.9% holding in BSE-500. Foreign fund portfolio is valued at USD ~411bn or ~42% of total free float. Domestic funds holding in Nifty increased by 30 bps and midcaps increased by ~70 bps from pre-COVID-19 levels. Domestic funds portfolio is valued at ~USD 290 bn, ~30% of total free float.

We believe that apart from the MSCI rebalancing, the global relief rally post US Presidential elections and likelihood of COVID-19 vaccine availability, there could be two India specific events which could have caused this renewed confidence, on the part of foreign investors, in India. On November 5, India's Prime Minister spoke with major foreign investors including sovereign wealth funds with a total asset under management in excess of about USD6trillion. The event provided an opportunity to leading global investors and Indian business leaders to engage and deliberate with senior policymakers on how to further accelerate the growth of international investments in India'. The meet was a success and foreign investments post that seems to be have been on an uptick.

Another India specific event or news flow is quarter two FY2021 growth surprising on the positive side. All high frequency indicators were highlighting that the Indian economy was recovering at a better-than-expected pace. Going by QoQ saar, the economy grew 49% in September Quarter after a -46% dip in June quarter. The economy basically came back at the same pace it went down. Almost "switch-off and switch-on" response. The growth numbers show that in the second quarter of FY2021 the real GDP contracted 7.5% YoY in Q2FY2021, sharply up from the 23.9% contraction recorded in the preceding quarter. The contraction in Q2FY2021 was much lower than consensus (street estimate: -8.9%, RBI: -10%, RBI nowcasting model: -8.6%). Nominal GDP in Q2FY2021 contracted by just 4%, indicating high inflation during the quarter.

Fig: India real GDP growth



Source: CSO

While consumption fell faster than investments and imports fell faster than exports however, better than expected performance by manufacturing, trade and construction sectors provided the biggest support to growth. Manufacturing activity is less contact-intensive compared to other sectors of the economy and hence it rebounded more quickly when lockdowns were lifted. PMI data corroborates this – manufacturing PMI rebounded much faster than services. The sequential improvement in construction growth possibly reflects resumption in construction activity following monsoon season and gradual return of migrant labour. On the other hand, sequential improvement in 'trade, hotels and transportation' could be due to pent-up demand entering the market and consumer spending ahead of the festive season.

This rebound in economy has been despite the government's continued belt-tightening to limit fiscal slippage. A separate data release showed that during April - October 2020 the central government spent 54.6% of its budget estimate for FY2021, down from 59.4% during April-October 2019. Public administration, which is the expenditure-side proxy for government spending, contracted 12.2% in Q2FY21 on the back of a 10.3% contraction in Q1FY21. It is estimated that lower government spending shaved off 160bps and 150bps from headline growth in Q2 and Q1FY21 respectively.

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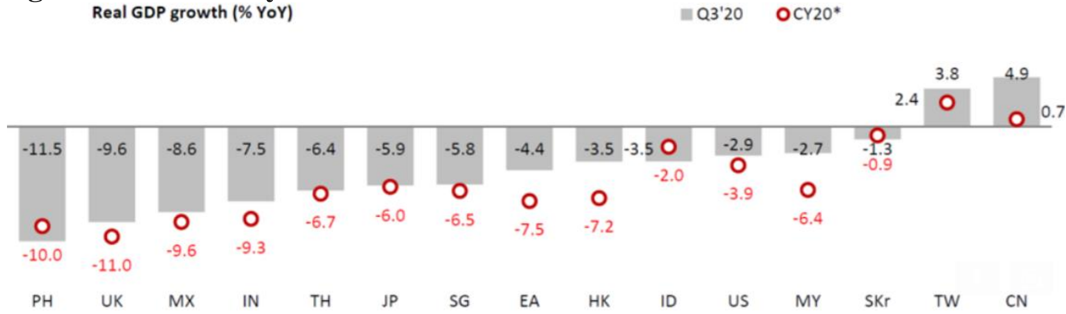
In Q1FY21, the contraction in capital formation was twice as sharp as contraction in headline growth, leading to a fall in investment rate to 22.3% of GDP. In Q2, the contraction in capital formation was in line with contraction in headline growth. Hence, investment rate increased to 29% of GDP which is broadly in line with its long-term trend.

Fig: Indian economy vs RoW



Source: CEIC, MoFSL (data for first 3 quarters of CY2020)

In the recently concluded 2QFY2021 results, Nifty companies reported broad-based earnings beat, leading to healthy 9-10% earnings upgrades in FY2021 estimates. One of the key and defining features of this performance was the better than expected focus on cost mitigation measures, apart from demand recovery and a healthy tailwind from gross margin expansion. Ex-Financials, Nifty reported 310bps YoY EBITDA margin expansion to 19.8. Raw material tailwind and demand recovery, coupled with better pricing power owing to supply constraints and lower discounts, resulted in sharp gross margin expansion. While Nifty sales declined 7% YoY (est. 5% decline), EBITDA/PBT/PAT reported growth of 8% / 14% / 17% YoY versus market estimates -0.3%/-6.8%/-5.2% YoY. 31 of 50 Nifty companies reported a beat on PAT estimates. Automobiles, Private Banks, Oil & Gas, and Technology led the incremental profit growth for Nifty companies. EBITDA for 26 Nifty-50 companies was above expectations. Only 8 companies reported EBITDA below expectations. 16 of the 50 Nifty-50 companies that reported 2QFY21 results, saw earnings upgrades of >5% for FY2022 EPS, while 3 companies saw downgrades of >5%.

Fig: Nifty PAT grows 17% versus estimates of 5% decline

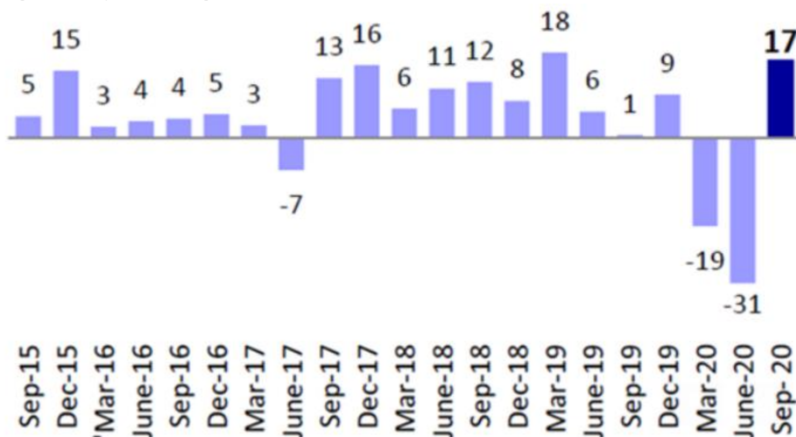


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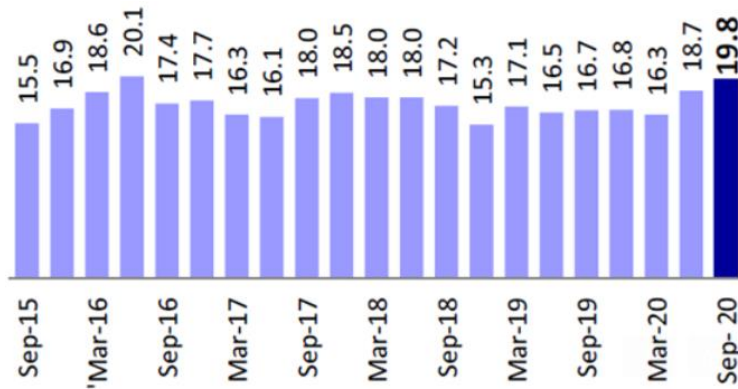
Fig: Nifty EBITDA margin (ex financials) expands 310bps to 19.8% YoY



The story for corporate earnings is quite encouraging during September quarter. A combination of faster business normalization and cost efficiencies have ensured revenue decline for Nifty companies is limited at ~7%. We find that the quality of earnings has improved with visible expansion of gross margins across India Inc in H1 coupled with better control over production costs to operating overheads have driven ~310 bps expansion in EBIDTA margins. With capex on tight leash and lower interest costs, PBT growth has been strong. While the entire cost efficiency gain is not permanent, overall costs should still be lower and operating margins are likely to better than the earlier cycle.

In addition, operating cash flows also show clear improvement due to improved terms of trade for most companies that have so far reported earnings. Ground checks also reveal similar trend playing out across smaller businesses with most getting more stringent with their policy on receivable days. Whenever growth sets in, the quality of earnings is expected to be better. Finally, gearing has improved as strong cash flows in first half FY2021 have been used to pare down debt.

Putting it all together, it appears that the supply side has scaled back operations and expectations and is managing to stay afloat on lower than usual demand. Meanwhile, some parts of the economy are seeing a bounty, particularly rural India, exporters and goods in general. There is a tailwind for consumption from unaffected sectors, especially rural India where price realization remains good. However, due to the pandemic we will likely see higher share of goods versus services. Investment trends look to be improving better than expected helped by tractor and cement sales etc. While private businesses remain cautious about leveraging up due to economic uncertainty, we could see some private sector capex push due to government incentives in select segments, rural reforms driving investments and consumption. However, a second wave of COVID-19 denting optimism cannot be ruled out. We are also aware that strong foreign fund inflows have been key driver of markets globally, particularly emerging markets and that India is not an exception. Any reversal of foreign fund inflows especially when domestic funds are relentless sellers, is also the reason why we would remain invested in large caps to ensure liquidity and thereby quality of the virtual portfolio.

We remained committed to our stated strategy and would further scale-up exposure to mid and small caps gradually and opportunistically. We are quite encouraged with the earnings season and overall recovery of economy which is also evidenced by the net addition of over

4.5mn Employees Provident Fund Organisation (EPFO) subscribers in the fiscal year so far, an indicator of new employment generation.

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