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EQUITY STRATEGY ASIA

India Equity Strategy
Off the Rural Horse

Key Takeaway

About the most consensus positive call in the market is rural demand. Excessive focus on the sector's growth that "has been" has led to the market underpricing early signs of cyclical weakness. We downgrade rural beneficiaries from consumer sectors to Neutral and recommend shifting weights to beaten-down, cash-rich industrials (raised to Neutral from UW).

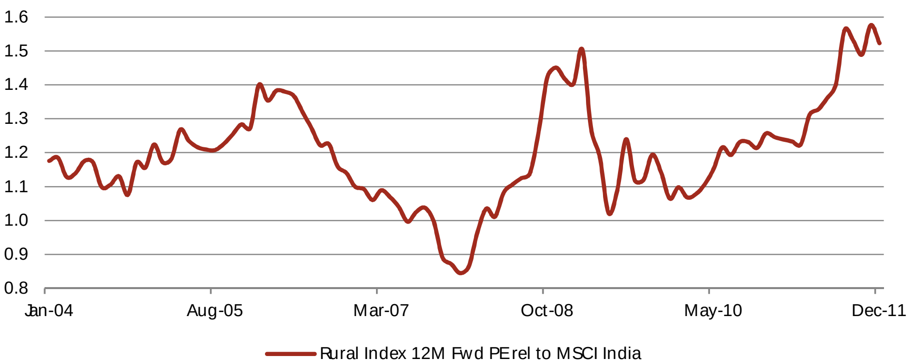
Consumption is slowing, is it all urban? Recent GDP data show that private consumption growth is now below 6% one of the few such incidences in the past six years. In addition, production of many discretionary and non-discretionary items like two-wheelers, cars, refrigerators, TVs, shampoos etc are now witnessing sharp deceleration, if not outright de-growth.

Red flags emerging in Rural indicators. Overall consumption patterns are perhaps dominated by sharp weakness in urban centres. However, many rural indicators too are pointing to a change for worse. Agriculture credit is now at decade lows while more worryingly agricultural NPAs have risen sharply. The latest tractor sales number is also somewhat concerning. Available data on FMCG companies' rural sales shows clear deceleration with the latest rural growth numbers below those of urban growth.

Drivers of rural growth muted. The two main drivers of rural growth have been: a) positive income effect due to government schemes and MSP rises and b) land price driven wealth effect. NREGA and MSP increases have been muted this year compared to last few years. Anecdotally, drivers of rapid land price increase have also weakened.

Stock market expectations high. Rural has been the most preferred investment theme in the market with our basket of stocks that are linked to this theme outperforming the index by 30% in past six months. Most interestingly, while the current year has seen some revision in earnings due to disappointments, there is almost no revision for next year earnings in the rural basket.

Chart 1: Valuation premium of rural linked stocks at multi-year highs



Source: Datastream, I/B/E/S estimates, Bloomberg, Jefferies

Reducing weight on rural, increasing on industrials. A recovery in the economy will most likely be led by recovery in corporate investments. If that does not happen, any continued macro weakness could cause to more disappointments in the rural beneficiaries against lofty expectations. We would then recommend investors to reduce position in companies like HUL and M&M and shift weight to cash-rich underperforming industrials like L&T and Cummins.

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Rural growth - increasingly a mixed bag

Risks to rural growth linked investments more from the near uniform views

India's stellar rural growth is about the most consensus, verging on nearly unanimous, theme for investors in financial markets. Risks emanate precisely from this fact that rural growth is perceived as almost completely unaffected by the sharp slowdown in the rest of the economy. Early indicators and logical analysis of its drivers imply at least some caution in investments in the stock market.

Rural analysis – "mural" analysis

Plurality of rural India helps develop legends that make any report on the subject a captivating read right from the start. There are anywhere between 600,000 and 1 million villages in India with a combined population of over 700-million people. For anyone who starts by categorizing this continent-sized population as a single group, the first touch with the life in villages proves breath-taking, amid other things in its sheer diversity.

Less data, more pictures and anecdotes

Few real-time data on economic life in rural India

It's in the same unfathomable variety of rural India, the seeds of highly subjective and touchy-feely analysis are born. The reality is that there are extremely few real-time, objective data points on the economic life of rural Indians. All survey-based information on important parameters like land transactions, employment, wages or even expenditures on key consumables are generally available only sparsely and that too after long delays.

Because of lack of data, analysts often turn photographers while talking about the rural economy

As a result, rural economy analysis has taken a highly pictorial form in the equity market industry in the last few years. A top-down discussion of the logical drivers of the rural economy are almost universally supplemented by the photos of well-paved roads, nicely-bannered village shops or hard-working farmers with their gadgets or vehicles to prove the progress in the sector.

Any analysis on incremental growth trends would have to move back to available data and logic

To be clear, photos replace charts in India's rural economic discussions not just to make the reading more impressionable but mostly out of necessity of not having real-time data. The downside of the approach is obvious: a photo-based analysis is unlikely to show whether this diverse segment is growing at twice the speed in the previous period or a half. The long-term trends of better current state of affairs over the state many moons ago dominate the stories with little possible work on most recent trends and whether they are already in expectations or not.

As this report is not to introduce the sector or talk about its long-term trends or potential, but on marginal analysis – ie, whether growth in the periods ahead is likely to be lower or not – we will have to return to the traditional methods of available quantitative evidences and logical arguments.

Consumption is slowing – is it all urban?

Some slowdown visible in consumption series

It is true that India's ongoing slowdown is led by the plunge in corporate investment cycle. That said, the associated impact from lack-of-supply caused inflation, high interest rates and reduced optimism have also begun to impact consumption. At around 6%, consumption growth is persisting close to the lowest levels seen in years. As the break-up of GDP growth also shows, all non-service related sectors (linked more to the rural economy) are decelerating sharply in recent quarters.

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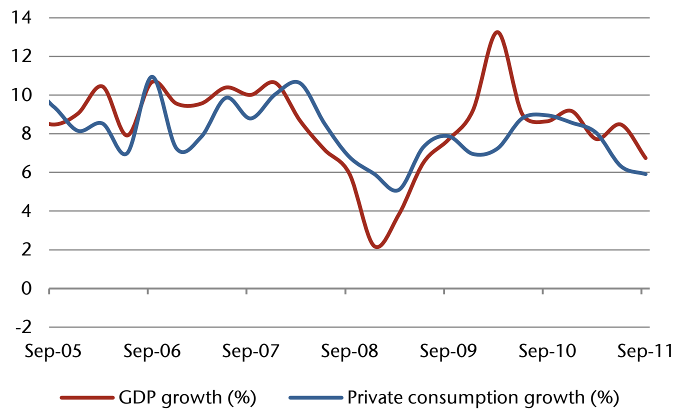
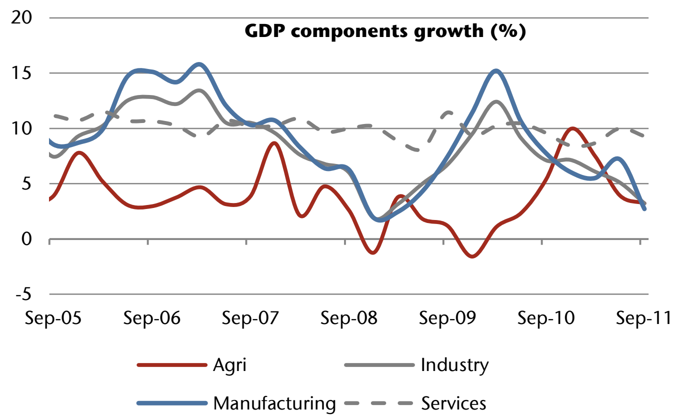
Exhibit 1: Private consumption is close to its lows



Source: CMIE, MOSPI, GoI, Jefferies

Exhibit 2: All components ex services now growing below 5%

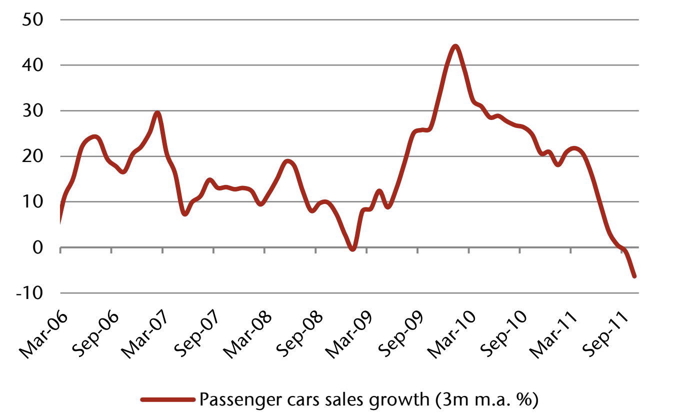


Source: CMIE, MOSPI, GoI, Jefferies

Strong deceleration and de-growth signals in the production of many consumer discretionary and non-discretionary items

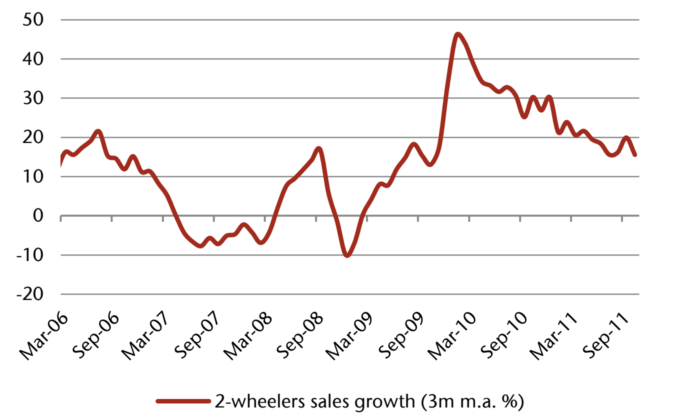
High frequency data shows a material slowdown in many consumer product segments – starting from cars to discretionary items like refrigerators and black and white TVs. The deceleration is not just in discretionary segments. Partly due to the high base effect and partly due to the slowing consumption expenditure, there is material deceleration in the growth rates of items like shampoos and oral care products as well.

Exhibit 3: Passenger car sales is now showing de-growth in annual growth terms



Source: CMIE, Jefferies

Exhibit 4: 2-wheeler growth is stronger by comparison, but this too has shown material deceleration



Source: CMIE, Jefferies

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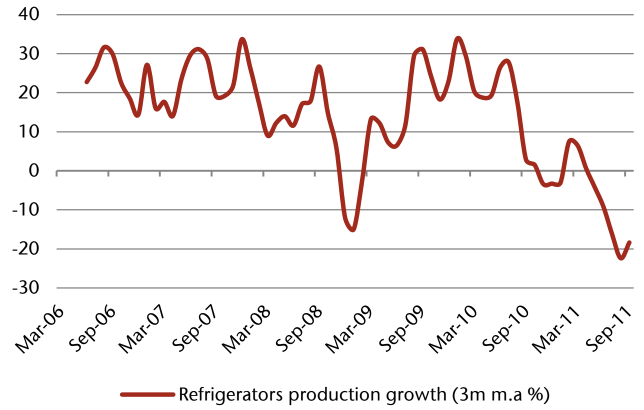
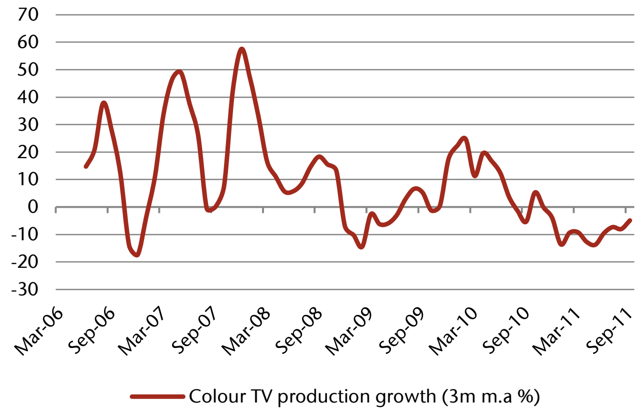
Exhibit 5: Refrigerators production growth is now falling



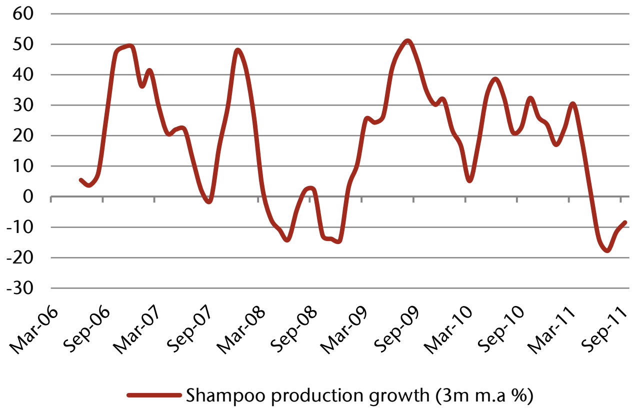
Source: CMIE, Jefferies

Exhibit 6: Colour TV growth too is at lacklustre levels



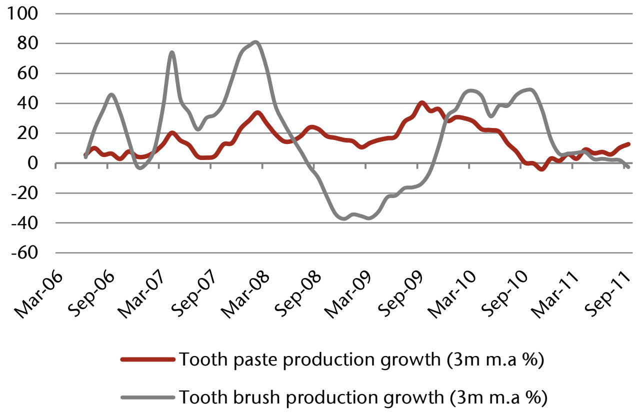
Source: CMIE, Jefferies

Exhibit 7: FMCG goods growth like shampoo off their highs



Source: CMIE, Jefferies

Exhibit 8: … so are oral care products



Source: CMIE, Jefferies

Rural-only signals: some warning flags

Could all slowdown in above charts be due to urban consumption alone?

All the above charts are for consumption across India and not just in rural provinces. The market is well aware of slowdown in the urban region which is likely the primary driver of most above series. The key question, of course, is whether there is any meaningful rural economic deceleration.

Worrying declines in agricultural credit

As we discussed above, there are extremely few real-time signals covering the vast rural economy. The two most encompassing, useful indicators are agricultural credit related data and tractor sales. Out of this, the former is definitely worrying. At below 8% YoY for the last two months, agricultural credit is growing at the lowest rates in over 15 years. More worryingly, there is a sharp increase in the sector's non-performing assets with the largest State Bank of India.

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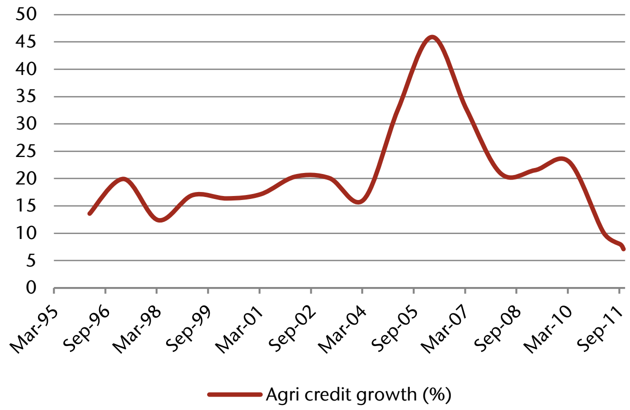
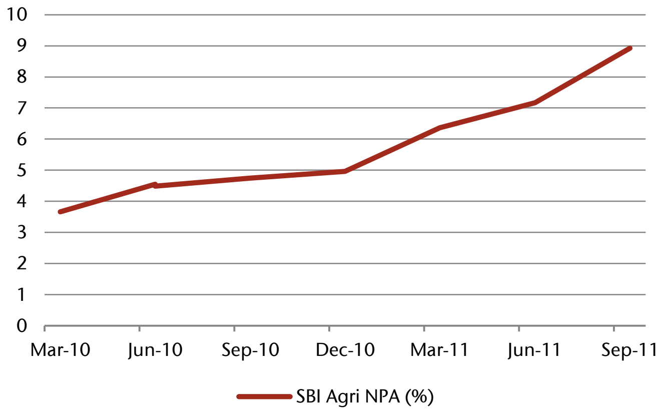
Exhibit 9: Agriculture credit growth is at 15-year low…



Note: Monthly numbers and Annual numbers are from different series but are almost identical; Source: RBI, CMIE, Jefferies

Exhibit 10: …while agriculture NPAs have risen sharply

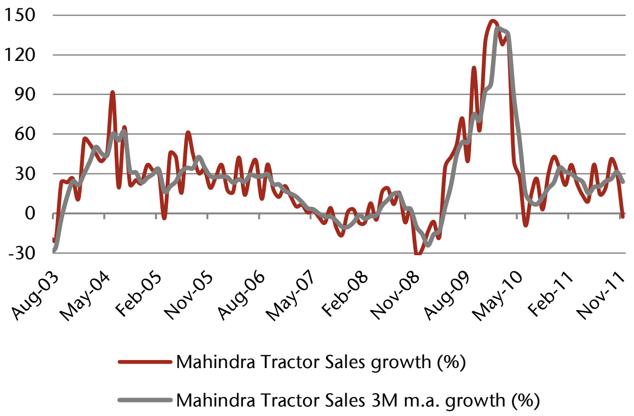


Source: Company Data, Jefferies

Tentative signs of some slowdown in tractor sales and FMCG companies' rural sales

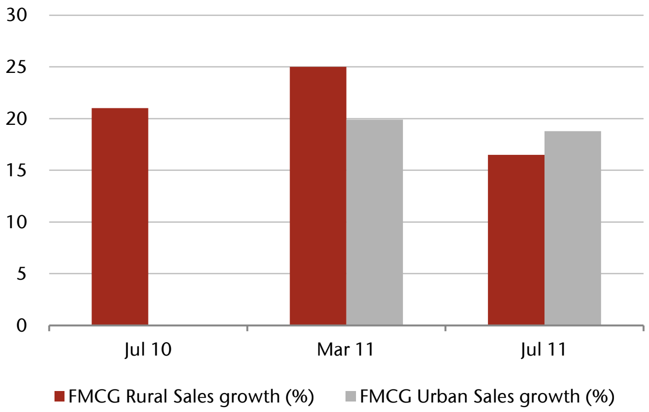
Tractor sales data from Mahindra & Mahindra are relatively sanguine although the most latest data point is somewhat disconcerting. There are patchy data available on fast moving consumer good companies' rural sales growth and there too there are some signs of deceleration in the most recent quarterly revenues. Rural FMCG volume sales growth in April-Sep of the current financial year has been only 10% compared to the 15% growth rate witnessed in the past three years (Source: *Business Standard*).

Exhibit 11: Tractor sales have recently fallen off sharply



Source: Company Data, Jefferies

Exhibit 12: FMCG Sales growth has slowed sharply in rural



Source: AC Nielsen, Jefferies

Not as much growth in MSP rises or NREGA expenditure

It must be noted that the above charts do not provide any clear evidence of slowdown. Logically, the two primary drivers of rural economic growth were employment and salary boosts provided by the government's rural employment guarantee scheme (NREGA) and wealth effect created by land prices. Additionally, there was also significant income boost provided by the steep increases in the support prices (MSPs) of key crops like wheat and rice. As the charts below show, neither MSP prices nor NREGA outlay growth are as strong as before.

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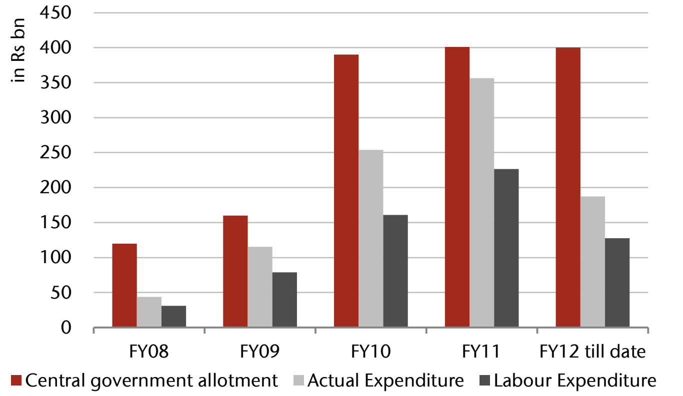
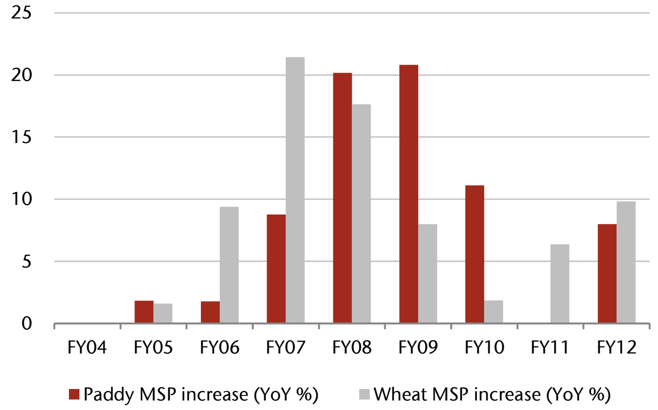
Exhibit 13: NREGA spend in current fiscal till date less than 60% of FY11



Note: FY12 expenditure is till 5th Dec as reported on NREGA website; Government allotment is Central government budgeted outlay; Source: NREGA, GoI, Jefferies

Exhibit 14: Minimum Support Price rises has been moderate



Source: Ministry of Agriculture, GoI, Jefferies

Many major drivers of land price rise are on the wane

The least data-friendly subject, and perhaps the most important driver of rural demand, is wealth effect created by steeply rising land prices. Anecdotally, land prices in India climbed multi-fold in many rural regions starting from 2004. Some of the drivers behind the boom were well-funded urban property developers acquiring land for various types of development, road construction/infrastructure development raising the value of nearby land, high agricultural income yield and low interest rates. As is anecdotally clear, all these drivers are substantially less effective now compared to before, even if not working in the reverse.

Main issue: investor expectations

To repeat: rural slowdown cannot be proven based on information available at present

Allow us to repeat one more time: for the vast and diverse rural India, the above evidences are scant and far from categorical in their conclusions. Painting a 700-million+ people segment with one boom or slowdown brush is simplistic in extreme even with best possible information. One can easily tell the rural tale even today with the same arguments that have been made repeatedly in the last five years to show that all is well. After all, there has been a great monsoon. Crop prices are still rising. Rural wages continue to benefit from government policies. And there are productivity increases. And even the most pessimists cannot claim that rural land prices, unlike urban property, are coming down.

Clearer view possible on rural stock investment due to relative performance and valuations

The stock market conclusion is less ambivalent than the actual and potential rural growth trajectory because of the role played by lofty and unanimous expectations. We have created a basket of 15 stocks from the largest listed non-financial stocks that are generally considered a proxy on rural demand. As the following charts show, the basket has not only outperformed the benchmark handsomely in the last 18 months, the valuation premium too has expanded to the highest level in at least eight years.

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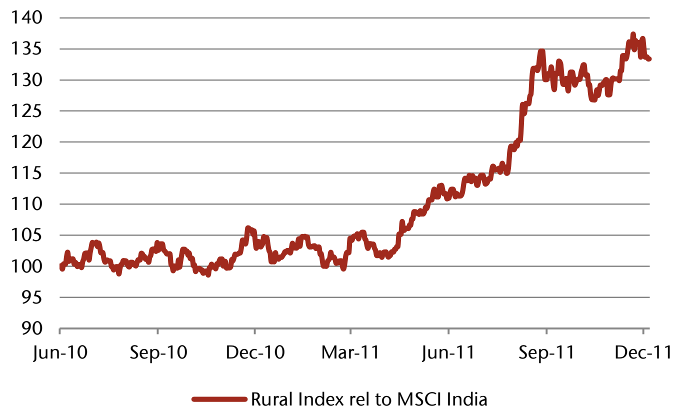
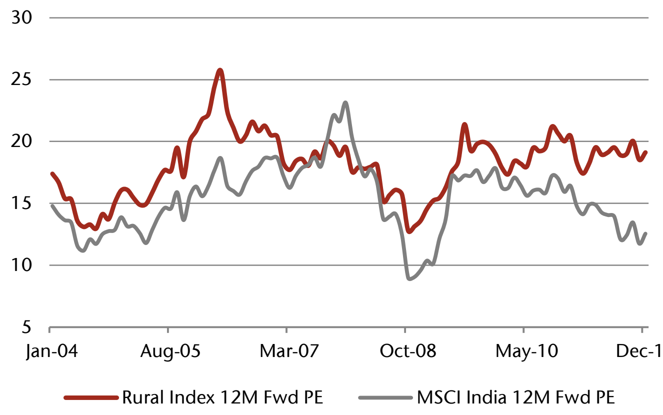
Exhibit 15: Rural Index has outperformed the benchmark by 30% in past 6 months...



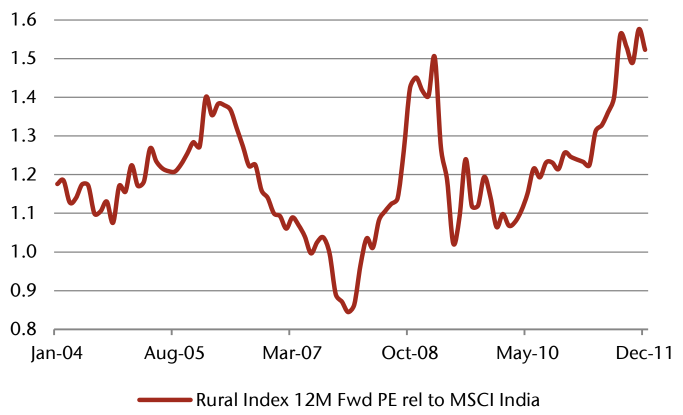
Source: Bloomberg, Jefferies

Exhibit 16: ...as valuations of Rural stocks have remained strong...



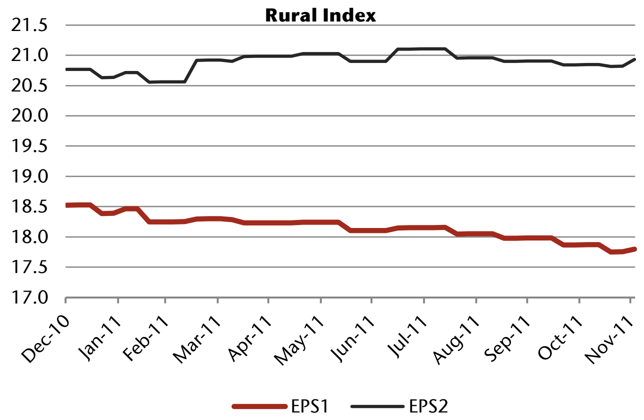
Source: Datastream, I/B/E/S estimates, Bloomberg, Jefferies

Chart 1: ...leading to a sharp rise in valuation premium



Source: Datastream, I/B/E/S estimates, Bloomberg, Jefferies

Exhibit 17: EPS revisions have been relatively mild especially for FY13



Source: Datastream, I/B/E/S estimates, Bloomberg, Jefferies

Surprisingly little changes in earnings expectations for the following year despite the disappointment in the current year

The most interesting above is the chart on forecast earnings. There is clearly some disappointment for analysts in profit expectations for the current year. It is definitely less than what it has been for the market in general as shown by the table below. Yet, there is almost no revision for earnings for the following year. And therein lies the biggest risk.

Exhibit 18: EPS revisions have been muted for rural stocks

	EPS1		EPS2	
Earnings Revision	**Rural Index**	**MSCI India**	**Rural Index**	**MSCI India**
1M	-0.4	-0.7	0.4	-0.9
3M	-1.4	-0.3	-0.1	-1.8
YTD	-3.9	-7.9	0.8	-10.0

Source: Datastream, I/B/E/S estimates, Bloomberg, Jefferies

Upgrade cash-rich industrials to Neutral from Underweight and downgrade rural-demand linked consumer companies from Overweight to Neutral

We have been extremely positive on this group of relatively defensive companies in the last few quarters. We would now recommend investors to reduce the position on consumer companies like Hindustan Unilever and Mahindra & Mahindra that are linked to this theme – more because of lofty expectations and relative valuations. We would recommend investors to shift the released weights to cash-rich, underperforming industrials like L&T and Cummins. Positively, any recovery in the economy will be most likely led by the recovery in corporate investments. Negatively, if the economy continues

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to weaken, there is a likelihood of accumulating disappointments against lofty expectations for rural demand companies.

As is clear in our recommendations, we are not talking about completely underweighting the rural demand theme or overweighting the industrial recovery beneficiaries. This is because the economic signs on the former are only tentative while on the latter are mostly non-existent. The call, once again, is due to where expectations and valuations reside.

Appendix – Rural Index

The Rural Index is created using a basket of 15 stocks. The index is market capitalization weighted index. The stocks included in the Rural Index are listed below in Exhibit19.

Exhibit 19: Rural Index basket

BB Code	Name	Sector	Price (INR)	Rating	Target Price (INR)
BJAUT IN Equity	Bajaj Auto Ltd	Consumer Discretionary	1,700	Buy	1894
CHMB IN Equity	Chambal Fertilizers & Chemicals Ltd	Materials	93	Not Covered	n/a
CLGT IN Equity	Colgate-Palmolive India Ltd	Consumer Staples	1,001	Not Covered	n/a
DABUR IN Equity	Dabur India Ltd	Consumer Staples	96	Not Covered	n/a
HMCL IN Equity	Hero Motocorp Ltd	Consumer Discretionary	2,062	Buy	2509
HUVR IN Equity	Hindustan Unilever Ltd	Consumer Staples	395	Hold	365
ITC IN Equity	ITC Ltd	Consumer Staples	204	Buy	235
JI IN Equity	Jain Irrigation Systems Ltd	Industrials	120	Underperform	104
MM IN Equity	Mahindra & Mahindra Ltd	Consumer Discretionary	749	Underperform	640
MSIL IN Equity	Maruti Suzuki India Ltd	Consumer Discretionary	1,000	Hold	1154
MCLR IN Equity	McLeod Russel India Ltd	Consumer Staples	228	Not Covered	n/a
NEST IN Equity	Nestle India Ltd	Consumer Staples	4,214	Not Covered	n/a
SUNTV IN Equity	Sun TV Network Ltd	Consumer Discretionary	293	Not Covered	n/a
TGBL IN Equity	Tata Global Beverages Ltd	Consumer Staples	91	Not Covered	n/a
Z IN Equity	Zee Entertainment Enterprises Ltd	Consumer Discretionary	127	Not Covered	n/a

Source: Bloomberg, Jefferies

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Other Companies Mentioned in This Report

- Bajaj Auto Limited (BJAUT IN: INR1,700.30, BUY)
- Cummins India Limited (KKC IN: INR352.35, BUY)
- Hero MotoCorp (HMCL IN: INR2,061.85, BUY)
- Hindustan Unilever (HUVR IN: INR395.00, HOLD)
- ITC Limited (ITC IN: INR204.15, BUY)
- Jain Irrigation Systems Limited (JI IN: INR120.35, UNDERPERFORM)

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- Larsen & Toubro (LT IN: INR1,315.65, BUY)
- Mahindra & Mahindra Limited (MM IN: INR748.90, UNDERPERFORM)
- Maruti Suzuki India Limited (MSIL IN: INR999.55, HOLD)

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			IB Serv./Past 12 Mos.	
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HOLD	599	40.90%	61	10.18%
UNDERPERFORM	93	6.40%	2	2.15%

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