# Hope rises again, this time on wings

*Market participation may turn broad-based amid improving macros and headwinds for competing asset classes*

**2013— back to square one:** Two thousand and thirteen began with a lot of hope after the strong rally towards the end of 2012 triggered by all the right noises made by the new finance minister, P Chidambaram. Unfortunately, the rally faltered in 2013 as the government fell short of expectations, domestic macros deteriorated (with the Reserve Bank of India [RBI] turning hawkish in response to persistent inflationary trends and a changing global environment) and the global environment turned negative with the US Federal Reserve (Fed) starting to prepare the global financial markets for the tightening of its liquidity tap through a slower monthly bond-buying programme after numerous rounds of liquidity infusion. Hope turned into pessimism. Finally, market sentiment recovered significantly before the end of the year with the benchmark indices rising to all-time high levels.

**2014—hopeful again but backed by improving macros; general elections another catalyst:** Just like 2013, the market is high on hopes again. The hopes this time around are pinned on the economy bottoming out and corporate earnings improving in FY2014. The indication of a clear mandate to a new decisive government at the centre in the May general election is another sentiment booster for investors and is an important event for the sustenance of the rally in 2014. On the flip side, a hung parliament, uncertainty over the government's fiscal performance, inflation scare and the RBI's monetary tightening could downplay the otherwise positive sentiment in the market over the near term.

**Tapering fever eases, global liquidity to remain benign:** Financial markets globally (especially the emerging market ones) surpassed another hurdle with the recent announcement of tapering by the Fed (which has decided to taper its quantitative easing [QE] programme by $10 billion a month) and the US central bank's accommodative stance. From India's perspective, the net inflows from the foreign institutional investors (FIIs) remain strong while the local currency has stabilised at 62 levels against the dollar. We believe the recovery in the developed world will continue to be gradual and the easy monetary conditions from the Fed, Bank of Japan (BoJ) and the European Central Bank (ECB) may continue in 2014 also.

**Macros in revival mode, though the pace could be painfully slow:** The domestic macro variables suggest that the economy could have hit the trough (a 4.4% growth in the gross domestic product [GDP] in Q1FY2014), though a meaningful recovery may not be visible as yet. Therefore, over the next couple of quarters the economic growth could improve gradually driven by consumption and export-led sectors while the triggers for investment are still awaited. High interest rates have been a dampener and hopefully inflation would come under control by the end of the current fiscal.

**Corporate earnings—consensus estimates already factoring imminent concerns:** An expectation of a 6-8% earnings growth in FY2014 (vs the initial expectation of a 14% growth) largely factors in the head winds faced by the economy including the higher interest rates. The revenue growth and the earnings before interest, tax, depreciation and amortisation (EBITDA) margins have stabilised at lower levels and are likely to improve with a recovery in the economy and a pick-up in demand. Therefore, the earnings downgrade cycle seems to be on its last leg unless the RBI goes for aggressive tightening to contain inflation. Moving on to FY2015, the lower base effect and reasonable momentum in the economy will support a double-digit growth in the earnings.

**Significant re-rating unlikely; expect new sectoral leaders and a broad-based market participation:** After the recent rally, the benchmark indices are trading close to their long-term average multiple of 14.5-15.0x one-year forward earnings estimates and further re-rating would depend upon the extent of the revival in the macro-economic environment and the outcome of the general election. Moreover, volatility could persist in the stock market ahead of the general election in May and seasonal weakness in the April-June (Q1FY2015) quarter. The good part is that the market participation is expected to improve with broader participation due to investors' increasing interest in many sectors and mid-cap stocks (unlike the rally in limited stocks seen in large part of 2013). The three themes for the year 2014 are:

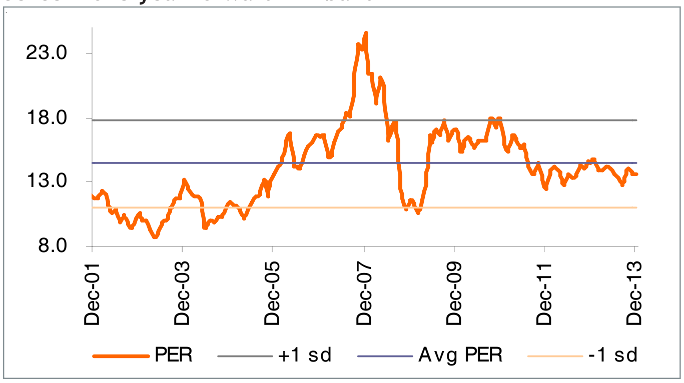
- businesses benefiting from a weaker rupee (both export and import substitution) and a global recovery,
- rural demand-driven consumer companies, and
- companies in cyclical sectors taking steps to repair their balance sheet through asset sale/equity infusion/debt restructuring.

**Picks for 2014**

Large-caps: ITC, Mahindra and Mahindra, ICICI Bank, HCL Technologies, Larsen and Toubro

Mid-caps: Cadila Healthcare, Jyothy Laboratories, Sun TV, CESC, Raymond, Selan Exploration Technology

**Sensex' one-year forward P/E band**

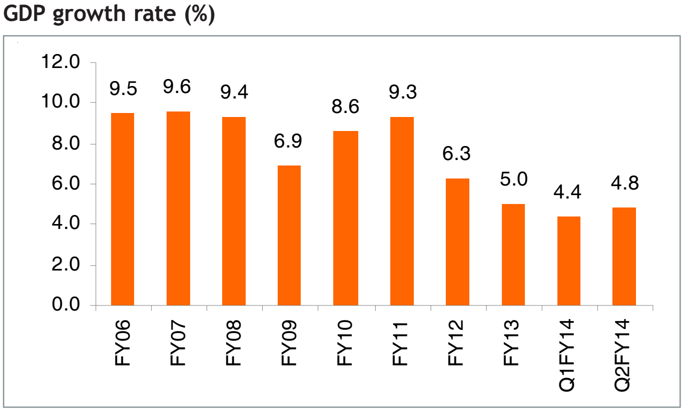



Source: Bloomberg, Sharekhan Research

### Growth hits trough...is that recovering?

With a GDP growth of around 4.4% in Q1FY2014 (also the lowest growth rate since March 2009) the economy seems to have hit the trough. The pick-up in agriculture and certain other sectors has supported growth so far even though the broader trend in the manufacturing sector remains weak. The gross fixed capital formation which indicates the level of investment activity remains significantly low while stalled projects as a percentage of projects under implementation remains at 10% (vs an average of 5%). Going ahead, the first half of CY2014 is likely to see a nominal recovery and relatively high inflation (in terms of both the Wholesale Price Index [WPI] and the Consumer Price Index [CPI]) which could peak out around the middle of 2014. Therefore, a recovery in the second half of CY2014 would hinge on probable rate cuts by the RBI and some pick-up in investments.

**GDP growth rate (%)**

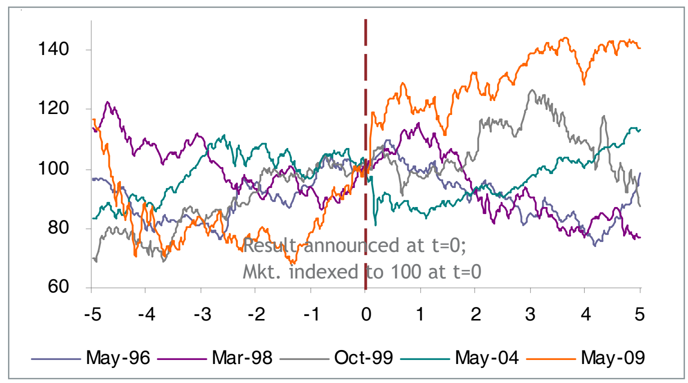



Source: Bloomberg, Sharekhan Research

### General election, a key point for the market/economy

Even though the market reacted positively to the results of the recent state elections, the general election in 2014 (Lok Sabha election) is likely to be the key point for the market for many reasons. The 2014 election's verdict could be decisive, as indicated by the voting pattern in the recent state elections, which could set the ball rolling in terms of reforms. This could shift the sentiment in a meaningful way, though the macro indicators could improve with a lag. Traditionally, the market moved 8-10% in six months before a general election. The same is expected to happen this time as well. However, the possibility of a hung parliament and sustained trend in inflation remain the key downside triggers.

**Market movement pre-and post-election periods**




Source: ECI, Bloomberg, Sharekhan Research

### Recovery underway in global economy, loose monetary policy to continue though

The beginning of the tapering of the Fed's quantitative easing programme has been an overhang for the financial markets globally, particularly the emerging markets. However, the US Fed's recent decision to implement taper in a phased manner and guidance for "near zero" interest rates have passed quietly. Despite signs of a gradual cyclical recovery across the globe, the easy liquidity stance taken by several leading central banks (BoJ, People's Bank of China, ECB etc) is likely to continue. From India's perspective, the outflows from the debt market have turned out to be lower than expected (even after a rise in US bond yields) while the inflows remain strong. In the meantime, the RBI has built a war chest to fight any volatility in the local currency which along with an improving current account deficit (CAD) could ease the pressure on the rupee. Going ahead, the inflows from the foreign investors are likely to remain strong in CY2014 due to benign liquidity and recovery in the Indian economy.

## Rupee-dollar outlook for 2014

**Rupee: Volatility to prevail; worst is possibly behind us**

Best possible case: Rs57/dollar

Worst possible case: Rs70/dollar

Expected range: Rs59-63/dollar

**Hammered in 2013**

The rupee fell by more than 11% against the dollar in 2013. The threat of US Fed's QE Taper exposed India's overdependence on hot money flow in order to finance its CAD.

**Bounce in the rupee**

The bounce in the rupee to 62 levels comes after the RBI and the Government of India jointly made efforts to contain the CAD at 1.2% of the GDP in Q2 of FY2014.

**2014—brings hope of stability in exchange rate on account of following reasons:**

1. ***A fall in CAD:*** a pick-up in exports and a slowdown in gold imports will push the CAD below $60 billion in the current fiscal. Both the government and the RBI are expecting the CAD to be below $56 billion in the current fiscal compared with the record high of $88.2 billion, or 4.8% of the GDP, in the last fiscal.
2. ***Brent oil:*** Brent crude prices are likely to fall to or below $100 per barrel on account of an increased supply from Iran and reduced geo-political concerns.
3. ***Recovering global economy:*** the GDP growth rate across the 34-member Organisation for Economic Co-operation and Development is projected to accelerate from this year's 1.2% to 2.3% in 2014 and 2.7% in 2015.
4. ***Forex reserves:*** the foreign exchange (forex) reserves with the RBI stand closer to $300 billion as of December 2013 as compared with $270 billion in August 2013.
5. ***A conducive political scenario:*** a change of guard at the centre in the upcoming general election.
6. ***Tapering start removes some uncertainties:*** the US Fed's decision to begin tapering removes uncertainty regarding the direction of the US monetary policy.

**Negative factors for the rupee**

1. ***The rise of the Aam Aadmi Party and its tendency to form a coalition with the Congress Party:*** the FII inflows may reverse.
2. ***Sticky inflation—less room to manoeuvre:*** a combination of high double-digit retail inflation and growth rate at a decade low renders the RBI's monetary policy ineffective.
3. ***Tapering impact yet to be discounted:*** the financial markets have yet to price in the Taper impact. The actual reduction in the Fed's monthly treasury purchases has started to push the 10-year yield in the USA above 3%.

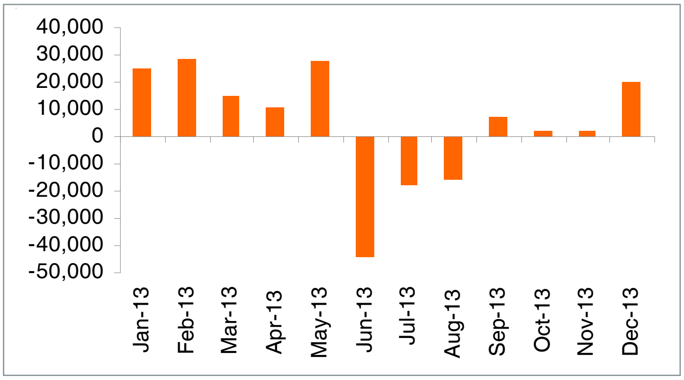
7\. ***Risk appetite at extreme currently:*** the yen shorts and US margin debt are at record high levels. The US Standard and Poor's Equity Index is at its farthest from the 200-day moving average in the last 25 years.

8\. ***Rising yield differential:*** the US benchmark yields are likely to rise to 4% tracking the US GDP growth rate and the Fed Tapering.

**Outlook**

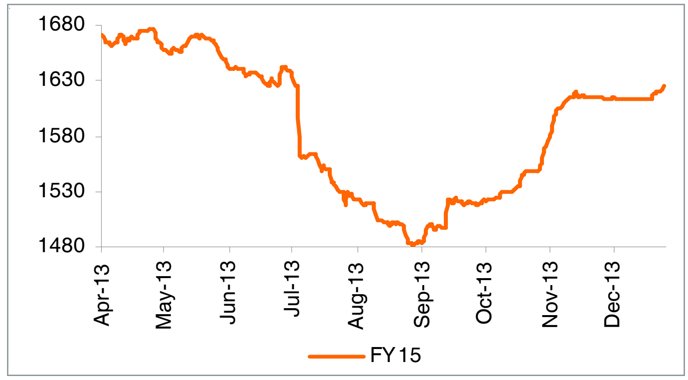
The rupee may appreciate to 57 levels against the dollar if the risk appetite continues in 2014; however, we believe the RBI would intervene by buying dollars. Moreover, a sharp appreciation in the rupee at the current juncture would be detrimental to the economy's growth.

**India's net foreign equity and debt investments (Rs cr)**




Source: Bloomberg, Sharekhan Research

**Sensex' consensus earnings estimates for FY2015**




Source: Bloomberg, Sharekhan Research

## Downgrades mostly factored, earnings trends to get broadbased

Since analysts' earnings expectations have been revised sharply in the past 12-18 months, we believe the bulk of the downgrades is done for FY2014. Going by the Q2FY2014 results, the margin pressure could ease and the stabilisation of the rupee could support the margins. Most of the imminent concerns are factored in the consensus earnings estimates, though monetary tightening by the RBI remains a risk to the earnings estimates in the near term. Realistically speaking, it is fair to expect a minimum double-digit growth in FY2015 compared with the expectations of a 6-8% growth in FY2014. In FY2014 the growth has been largely concentrated in a few sectors/ stocks, but it could broaden to the other sectors in FY2015.

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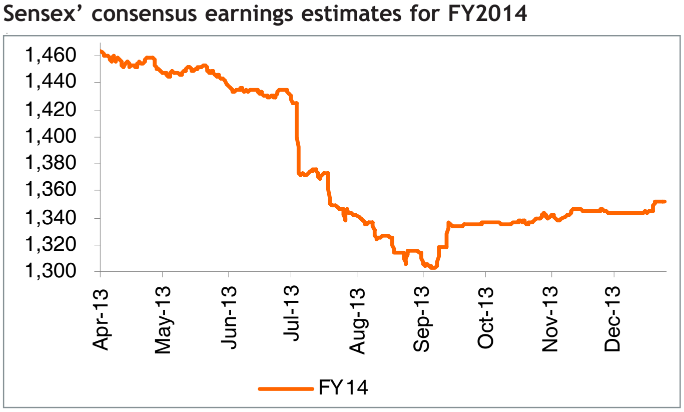
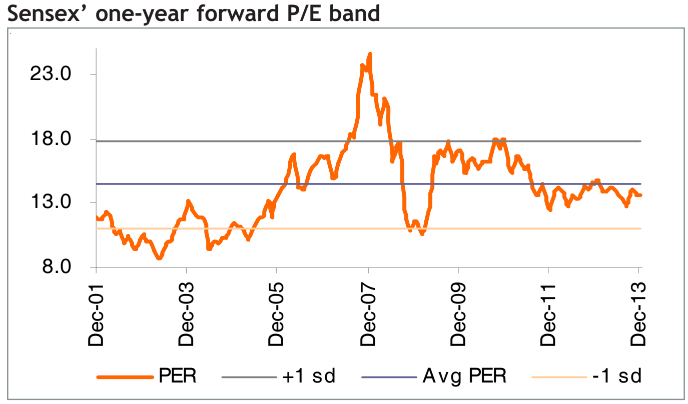



Source: Bloomberg, Sharekhan Research

## Re-rating contingent on macro revival and election outcome

Moving on to CY2014, volatility in the stock market may persist in H1FY2014 since expectations have started getting built in stock valuations which leaves scope for some surprises. As the equity market is already trading close to its long-term average (14.5-15.0x 12-month forward earnings), the rerating prospects hinge on a quick revival in the economy or a decisive government at the centre. The stablisation in the rupee, recovery in the economy and improvement in the demand environment also bode well for corporate earnings. As mentioned earlier, the earnings growth and expansion of multiples have been limited to a few sectors so far but the same may spread out in the coming year. The popular themes during the year will be external factor-driven sectors, rural consumption-driven companies and some bottom-up ideas.

**Sensex' one-year forward P/E band**




Source: Bloomberg, Sharekhan Research

**Picks for 2014**

| Company | CMP (Rs) | EPS (Rs) FY14 | EPS (Rs) FY15 | PER (x) FY14 | PER (x) FY15 | Investment arguments |
|---|---|---|---|---|---|---|
| ITC | 322 | 11.1 | 13.2 | 29.0 | 24.4 | • ITC's core cigarette business is least affected by the slowdown in consumer spending; the volume growth in the cigarette business would pick up (4-5%) in FY2015 on a lower base in FY2014 (dented by steep price hikes post-increase in excise rates)<br>• Unwarranted correction in the stock offers a good entry points for steady and healthy returns<br>**Key risk:** another round of a steep hike in excise duty |
| M&M | 966.0 | 60.3 | 64.0 | 16.0 | 15.1 | • The tractor segment contributing about 40% of the revenues is likely to maintain a double-digit growth on the back of a higher crop output and increased minimum support prices<br>• Automotive volumes are expected to recover in FY2015 on the back of a conducive macro-economic environment; new product launches would help regain market share in the utility vehicle (UV) space<br>• The outlook and performance of the key subsidiaries (Ssangyong Motor Company, Tech Mahindra and M&M Financial Services) have also improved which adds to the overall sum-of-the-parts valuation<br>**Key risk:** a delay in the recovery of the UV segment; also, increased competitive launches may further reduce the market share |
| ICICI Bank | 1103.7 | 77.9 | 91.9 | 14.2 | 12.0 | • With significant improvement in the liability profile, the bank is poised to expand its market share especially in the retail segment<br>• ICICI Bank is among the well capitalised banks and is better prepared to face asset quality challenges; the performance of its subsidiaries could improve further with a recovery in the economy<br>**Key risk:** continued slowdown in the economy would add to asset quality stress |
| L&T | 1067 | 52 | 57.6 | 20.5 | 18.5 | • Strong order inflow guidance indicates healthy revenue visibility; diversified presence, superior execution capability and healthy balance sheet remain its strengths<br>• The ongoing efforts to improve its returns ratios by monetising the long-term development assets are going to be a positive trigger for the stock<br>**Key risk:** a significant delay in the capital expenditure cycle reversal |
| HCL Technologies | 1246 | 83.5 | 94.7 | 14.9 | 14.3 | • It remains a prime beneficiary of the emerging re-bid/restructuring IT market, which still poses a $45-50 billion opportunity for the company<br>• The company has a proven track record of winning and executing large restructured deals in the past; it has a very robust order book of over $4 billion which provides robust revenue visibility.<br>• At a 28% discount to Tata Consultancy Services, there is still room for re-rating from the current levels<br>**Key risk:** a prolonged slowdown in the key markets (the USA and Europe) remains a key risk to our investment thesis |

**Picks for 2014**

| Company | CMP (Rs) | EPS (Rs) FY14 | EPS (Rs) FY15 | PER (x) FY14 | PER (x) FY15 | Investment arguments |
|---|---|---|---|---|---|---|
| Cadila Health | 792 | 36.1 | 51.2 | 21.9 | 15.5 | • New drug approvals (over 100 abbreviated new drug applications pending) and settlements launches (of Asacol HD in Q1FY2016) in the USA<br>• An improvement in profitability on a better product mix (better traction in the branded formulation business and the launch of niche products in the USA)<br>• The stock is currently available at a 25% discount to its three-year historical average (price/earnings multiple)<br>**Key risk:** a delay in obtaining product approvals in the USA |
| CESC | 456 | 51.4 | 52.6 | 9.0 | 8.7 | • Steady cash generation from the regulated utility business continues and significant improvement is visible in Spencer's and FirstSource Ltd (FSL); the business outlook for FSL has improved and with regular repayment of debt FSL will achieve a leaner balance sheet<br>• Spencer's is expected to break even at the operating level in the next four quarters and potential monetisation would be a trigger for the stock<br>**Key risk:** a delay in achieving a break-even in Spencer's and inability to sign a power purchase agreement for the Chandrapur plant (a new capacity) for a long time |
| Jyothy Laboratories | 192 | 7.8 | 11.7 | 25.0 | 16.0 | • It is expected to achieve a strong growth of above 20% in revenues and operating profit, driven by the integration of Henkel, the launch and relaunch of products and the rationalisation of the distribution network<br>• The recent repayment of debt through funds raised by preferential allotment to promoters and issuance of non-convertible debentures would result in interest cost savings of Rs45-50 crore at the consolidated level from FY2015; this along with a strong operating performance would result in an exponential growth in the bottom line<br>**Key risk:** an increase in competition in some of the key categories |
| Raymond | 290 | 14.8 | 23.2 | 19.6 | 12.5 | • Its restructuring exercise is largely done (in terms of supply chain revamp, cost rationalisation etc) and the benefits are likely to become visible in the results going ahead; thus we expect the branded apparel business to revive its profitability track record<br>• The management's enhanced focus on the monetisation of its lucrative 120-acre land bank (with its core team in place, the master plan for the real estate business is expected soon)<br>• The stock is ruling at an attractive valuation of enterprise value (EV)/EBITDA of less than 4x FY2015E and so we maintain our Buy rating on the stock with a revised price target of Rs387 (core business valued at 5x EV/ EBITDA+ land valued at 50% market price)<br>**Key risk:** slow discretionary spending and high gestation time for monetisation of the land bank |

## Picks for 2014

| Company | CMP (Rs) | EPS (Rs) FY14 | EPS (Rs) FY15 | PER (x) FY14 | PER (x) FY15 | Investment arguments |
|---|---|---|---|---|---|---|
| Selan Exploration | 302 | 28.0 | 41.0 | 10.8 | 7.4 | • Received approvals recently for developing eleven wells in its key oil fields; it has commenced drilling operations and the early signs from the four wells drilled recently are encouraging which would considerably boost production and earnings over the next couple of years<br>• It remains a debt-free company and its current cash/ share is around 25% of its market price<br>**Key risk:** a substantial delay in the commencement of production |
| Sun TV Network | 376 | 20.1 | 23.7 | 18.7 | 15.9 | • The implementation of the digital addressable system (DAS) across the country is expected to lead to a six-fold increase in the average revenue per user levels (from Rs4 to Rs15-20)<br>• Given the upside potential from the DAS regime and a gradual recovery in advertising, Sun TV's growth prospects look favourable going ahead<br>• The company enjoys an industry leading margin profile (73% EBITDA margin), has close to 53% dividend pay-out and a superior return on equity of 27%, and so it deserves a richer valuation<br>**Key risk:** any major delay in DAS implementation would negatively affect our investment thesis |