



Greetings!

Article 370 moment for the economy

Suffice to say that the decision to cut corporate tax to 25% was a momentous and decisive moment. It is perhaps the most radical reform step that the Modi government has undertaken (we exclude demonetisation, which was more of a misadventure; and GST, which was a reform that was in the works for years). It was indeed the Article 370 moment for the economy. Thus far, the Modi government has been unsure in its steps on the economy while showing a great deal of determination and finesse while dealing with other contentious issues such as Kashmir, corruption in high places, social agenda and foreign relations.

This raises the following questions

1. Why now?
2. Why this?
3. Will it work?

Let us start with the choice of timing – Why now?

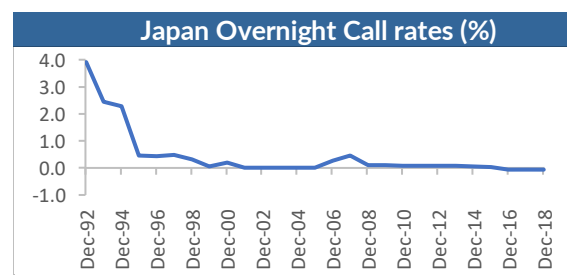
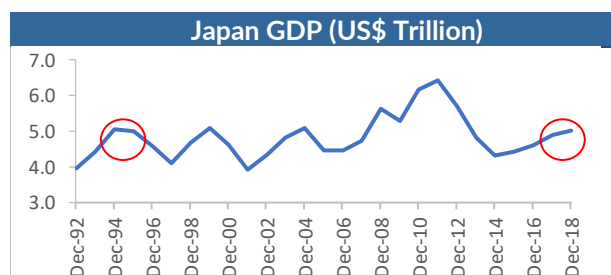
Confidence began to crater

The timing appears to have been driven by the seemingly unending data stream on the economy and the financial system. India is faced with a new problem – lack of demand. The spectre of unemployment looms large. Sagging tax revenues limit the options for the government. Stock prices started to plummet and so did the currency. After being in denial for a few weeks, the government found its mojo. At long last, the latent political instinct that has made Modi the winner he is, got activated. The government appears to have understood that blaming the market (which is only a messenger) does not help. Demand slowdown in a country with above-par demographics and sub-par productivity is worse than recession in an economy that is on full employment. The latter is a matter for cycles and the former can often be a symptom of a much deeper malaise.

Which brings us to the question - Why this?

Japanification of Europe (The West ???)

Europe has recently waded into the zone of negative interest rates yet again. The attempts at inflating the Eurozone out of stagnation in 2018 have come unstuck. The US, while some distance away and seemingly in better shape, is also seeing deflationary pressures. The tax booster from Trump looks to have dissolved into the cauldron. Comparisons with the Japanese experience from the mid-eighties till date are everywhere. Japan did a fiscal stimulus first and subsequently resorted to a marathon monetary stimulus, amongst other things, introducing the concept of negative rates and QE to the world. Its economy shrank from USD 5.0 trillion in 1995 to USD 4.7 trillion in 2007. It struggles at around the USD 5.0 trillion mark even now. Of course, the optimists have a point in that Japan had structural rigidities (a moribund financial system, arcane local laws, et al) and a demographic pyramid whose base has been melting away. At least in the Eurozone, the comparisons are ringing alarm bells with no easy escape route in sight.





Lessons for India

Why this comparison now? We are not near deflation, zero interest rates or a GDP that is shrinking. Nor do we have an ageing population. Quite the contrary. There is no case for being alarmist.

But then we have some symptoms of the basic affliction of structural rigidity that can make our situation challenging. For ten years, producers in India are on capex strike and for five years, the financiers are on lending strike. For the last year or so, we have seen an incipient consumer strike and, lately, we have an investor strike. When demand contracts (for India, tepid growth in demand is bad enough – we are on a treadmill) in the face of falling interest rates, that spells trouble. You realise that the lack of demand is not restricted to goods alone but also to credit. You now realise that supply of credit through NBFCs may have created demand for the same earlier. All of this brings our problem to lack of productivity and under employment.

The demographic dividend can now look like a demographic toll.

This is the spot where the government found itself in (we are not far from the spot). With tax collections sagging and coercive methods running out of steam, India needs growth and growth on steroids is not an answer. The government appears to have understood one part of this very well – GST cuts on consumer goods is a temporary sop and that does not create incomes. You need real income generation for demand to come back and sustain.

Hence the corporate tax cut. A huge risk from the government, as revenues have been ceded instantly from the most compliant part of the economy – the (so-called) fat cats. It is also a complete rollback of sorts from tax increases effected only ten weeks ago. Much more than a rollback. What was taken away from wealthy individuals plus some more bucks – has been given to the wealthy producers (though Indian enterprise is burning the midnight oil by now to arbitrage some of that, but that is the sideshow). The move in July was certainly ill-timed if not a policy error outright. The willingness of the dispensation to reverse that shows policy flexibility, the kind of which India has seldom seen. We can do with more of this.

The government seems to have two main objectives. One is to halt the sentiment slide and shore it up. The other is to revive investment demand (and through that, jobs, income growth and taxes).

That brings us to the third question of the efficacy of this move – Will it work?

The simple answer to the question of whether it will work is – it depends.

It depends on whether the government pushes ahead with more reforms – be in privatisation, labour reforms, land reforms or reforms in tax administration (several tax officials being eased out is a clear recognition of the issue).

Some simple arithmetic on the tax rate of 25.1% suggests that there could be a sharp revenue decline year-over-year in the December instalment of corporate tax collections. There will be a revenue loss for the full year as well. Growth is not about to pick up from this month. But pick up it must – over the next few months. That is what the government has to be betting on. The comments from the Prime Minister in New York should be seen in this context (as the audience was not the voter base in India, this was no political speech). It is fair to assume that the government has the numbers worked out and ipso facto, there has to be a follow up to the big-bang announcement on tax cuts. There is a high enough probability of the government coming out with some real reforms. Not optics like transferring stake in one government entity to the other, which runs the risk of dissipating the goodwill generated. Rating agencies and financial markets will give no credit for such book entries and the reform push can boomerang with grave consequences. The confident stance of the government on the fiscal glide path appears to suggest that the equation will be balanced with some bold moves. The will to go the whole hog, which was missing, seems to be in place now.

In short, brace for more positive surprises. We are possibly at the cusp of a 1991 moment once again.

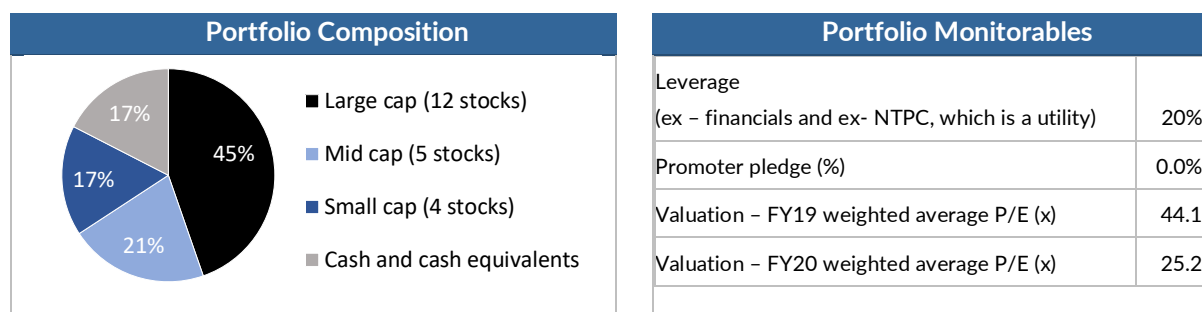


Takeaways for us as investors

1. We look out for growth coming back at a gradient. As repeated time and again in our communication over the last seven months, it is the investment engine that we should keep our eyes on.
2. Consumption is not over the hill. In India, we have miles to traverse before we get there. But that is not the game changer in this phase of India's growth journey.
3. We are selectively optimistic on the reform theme. We have already been invested in good companies from the PSU stable – initially for reasons of compelling risk-return trade-off and for a revival in investment demand. Some of them could be morphing into reform plays. Quick takeaway – It is not all about the private sector and there are good businesses in PSUs with value-unlocking potential. As an example, we illustrate on the following page how two of our key PSU holdings – RITES and Rail Vikas Nigam Limited (RVNL) – stack up vis-à-vis their private-sector counterparts.
4. Stick to quality. No change in stance over there. Quality in management (competencies as well as alignment to minority shareholders) is key. For some PSUs, it is alignment that may now be improving.
5. The quality premium is here to stay. This is more relevant in the case of the richly valued private-sector banks and consumer stocks. This could well lead to an asset bubble at some point, which is a risk. In the meantime, quality will be at a premium when it comes to the theme of investment demand pick up as well.
6. A relapse into the bad old ways (can the recent government move be a one off?) is always a risk. That probability is never at zero. We should be cognizant of that. If we have a relapse, sticking to quality helps.
7. We think it is early days to turn more bullish on small caps as an asset class. Selective stock picking can work there. The only question is – why pay high valuations for small caps? (quality small and midcaps have not corrected in valuations as earnings have also fallen with prices).
8. Finally, earnings upgrades can happen once the investment engine roars into life. Which is a few quarters away and something that will be work in progress. Given relatively higher starting valuations all over, expect more moderate market returns in this cycle. This is going to be a bull on a diet.



Portfolio composition



Note: Represents portfolio of a typical investor onboarded in February 2019 when the strategy commenced; actual portfolios may vary depending on timing of entry into the scheme. Note: Market cap as per SEBI guidelines

1. Our investment in stocks largely reflect the views expressed earlier in this piece. More than half of invested capital is in large caps and a good part of the midcap exposure is in larger midcaps.
2. We are broadly underweight financials, mainly because leading indices such as Nifty have as much as 40% in financials. Our investments in the sector are in well-managed private banks, which, we believe, are well positioned to grow when the economy recovers. Their capital position is comfortable and they have stable or falling credit costs.
3. Our investments broadly fall into the theme of a reviving Indian economy with a focus on beneficiaries from the same over a one-to-two-year timeframe.

In the first half of this fiscal, the above strategy has outperformed BSE 100 (and Nifty) despite the huge bouts of volatility we witnessed.

Comparing RITES and RVNL with their peers

Company	RITES	RVNL	KNR Constructio ns	Capacite Infra	L&T	Dilip Buildcon	Sadbhav Engineering	Ashoka Buildcon
CMP (30/9.2019)	266	24	231	198	1,474	416	142	97
P/E(x) - FY19	13.8	7.2	12.0	14.0	23.6	10.4	116.9	(81.7)
P/E(x) - FY 20E	11.9	6.0	14.1	10.1	20.4	8.2	88.5	20.1
P/B(x) - FY19	2.4	1.1	2.5	1.6	2.4	2.0	3.0	9.5
RoE (%)	20.3	17.9	22.2	12.2	13.2	21.4	-6.3	-13.0
RoCE (%)	20.2	9.2	19.5	18.9	6.3	16.6	12.3	19.6
Net (D/E) (x)	-1.4	0.5	0.6	0.1	1.8	2.5	13.2	20.3
Book-to-Bill ratio (x)	3.1	7.7	3.0	4.0	2.1	2.3	3.2	2.5
Current Ratio	1.7	2.3	1.3	1.4	1.2	1.2	1.0	0.8
Turnover /Receivable (x)	3.8	11.0	12.5	3.8	4.0	8.1	4.2	5.7
Promoter shareholding (%)	87.4	87.8	55.2	43.8	0.0	75.6	46.6	54.3
Promoter pledge (%)	0.0	0.0	0.0	0.0	0.0	27.6	35.9	0.0
Experience in business (No of years)	45	17	24	7	81	13	31	26
Areas of work	Railways	Railways	Roads	Buildings	All Infra projects	Roads	Roads	Roads
		Roads		Factories			Bridges	
							Mining	



Both RITES and RVNL cater to large addressable markets and operate with limited competition. They get orders from Indian Railways on nomination basis, courtesy their long-standing and proven track record in implementing large projects for them. The award of contracts on nomination basis is something not uncommon in infrastructure space due to domain competencies being somewhat limited, which is the case for Railways. RITES has a certain part of its orders coming from exports to neighbouring countries and also from transportation consultancy. RVNL has a sizeable order backlog as is seen from the book-to-bill ratio, giving it visibility of growth. They have good return ratios and low gearing. The comparison with private players in the infrastructure space shows that valuations are attractive. Given their clean balance sheet and no promoter risk, we see them as clear beneficiaries when the process of modernising rail infrastructure gathers pace.

Risk assessment

Liquidity Risk

The portfolio, at the broader level, is highly liquid. Most of the holdings can be liquidated across the strategy (or Scheme) within a single trading day, based on our assessment of average trading volumes over the preceding one month

Concentration Risk

This remains well addressed with no single stock exceeding 7% of the portfolio, well under the strategy objective and parameters laid out

Market Risk

As we are invested in stocks, a good number of which are not either in the BSE 100 or where the portfolio weight is at a significant variance from the stock's weight in the index, the portfolio can exhibit volatility if the market were to have a drawdown. We have sought to limit this risk by diversifying the holdings across sectors and through holding a reasonably high level of cash.

Warm regards,
P Krishnan (CIO) and Team Spark PMS