Investment Matters

May 2020

Markets rally, but risks remain

The market rallied in April after a weak 1QCY20 – the Nifty was up 14.7% last month (as on 30th April, 2020) after a 23.2% correction in March 2020. We, however, believe that significant risks still remain and continue to be cautious in our stock-picking. We see no immediate case for “turnaround” companies until the FY21 earnings dislocation is fully assessed. The market may, ultimately, look through this temporary earnings compression but it is too early to play that theme. We are, therefore, focusing on market leaders with quality businesses, strong balance sheet and low earnings risks and are happy to pay premium valuations for these companies in the current context.

The extension of the lockdown into early May was accompanied by some easing of restrictions. We expect a slow and elongated return to normality, with multiple obstacles for businesses persisting post-lockdown. Some of them are a) continued social distancing norms b) limited mobility in large towns c) labour shortages due to the large-scale reverse migration d) changing demand patterns as consumer confidence takes a beating. Macro growth risks, therefore, will continue on with demand and supply pressures feeding on each other.

It is, therefore, too early to assess the damage to FY21 earnings at this stage. Companies will face multiple challenges on resumption of operations – availability of labour, smooth functioning of the supply chain and, most importantly, no visibility on demand. Moreover, larger companies will be compelled to financially support their supply chains and distribution to help preserve their franchises. The damage to cash flows is, therefore, likely to be deeper than to earnings – this may translate to short-term damage to earnings multiples.

The contours of the FY22 earnings recovery are still uncertain. We do not have a handle of a) areas where the demand destruction could be long-lasting and b) the ability of companies to withstand the FY21 stresses and emerge with their balance sheets and business structures intact. Companies will have to contend with disruptions to their supply chains and distribution infrastructure and not all of them will have the resilience to restore the ecosystem quickly. The leaders are likely to recovery faster and gain market share when demand starts to normalise. The FY22 earnings recovery is likely to be asymmetrical in favour of stronger players.

EQUITY OUTLOOK

Policy interventions, while inevitable and desirable are unlikely to drive a V-shaped recovery. The fiscal capacity of the government is limited – the revenue shock of the Union government itself is likely to exceed 2% of GDP. The stress on state government finances is even more acute. There are also execution challenges, ranging from identifying genuine recipients for income support to ensuring transmission of credit to SMEs through the rigidities of the banking system. The economic damage is too acute to be quickly rescued by a fiscal package.

In this context, we are focusing on multiple areas to build our portfolio. First, we are focusing on leaders across industries as we believe that they will gain disproportionately from the recovery. We are also looking for companies with strong balance sheets (cash balances, high profitability) which can survive the challenges of FY21. We are also increasing our diversification across sectors to capture the possibility that the next 2-3 years could see a fresh set of sectors emerge as the key market drivers. We may also be willing to sit on cash a while longer and not necessarily try to pick bottoms, if we believe visibility is poor even in these companies. The current environment is dynamic. Risks not foreseen may emerge given the current challenges which may prompt us to either trim or exit some positions in favour of cash and or alternative companies that have better relative prospects.

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