ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

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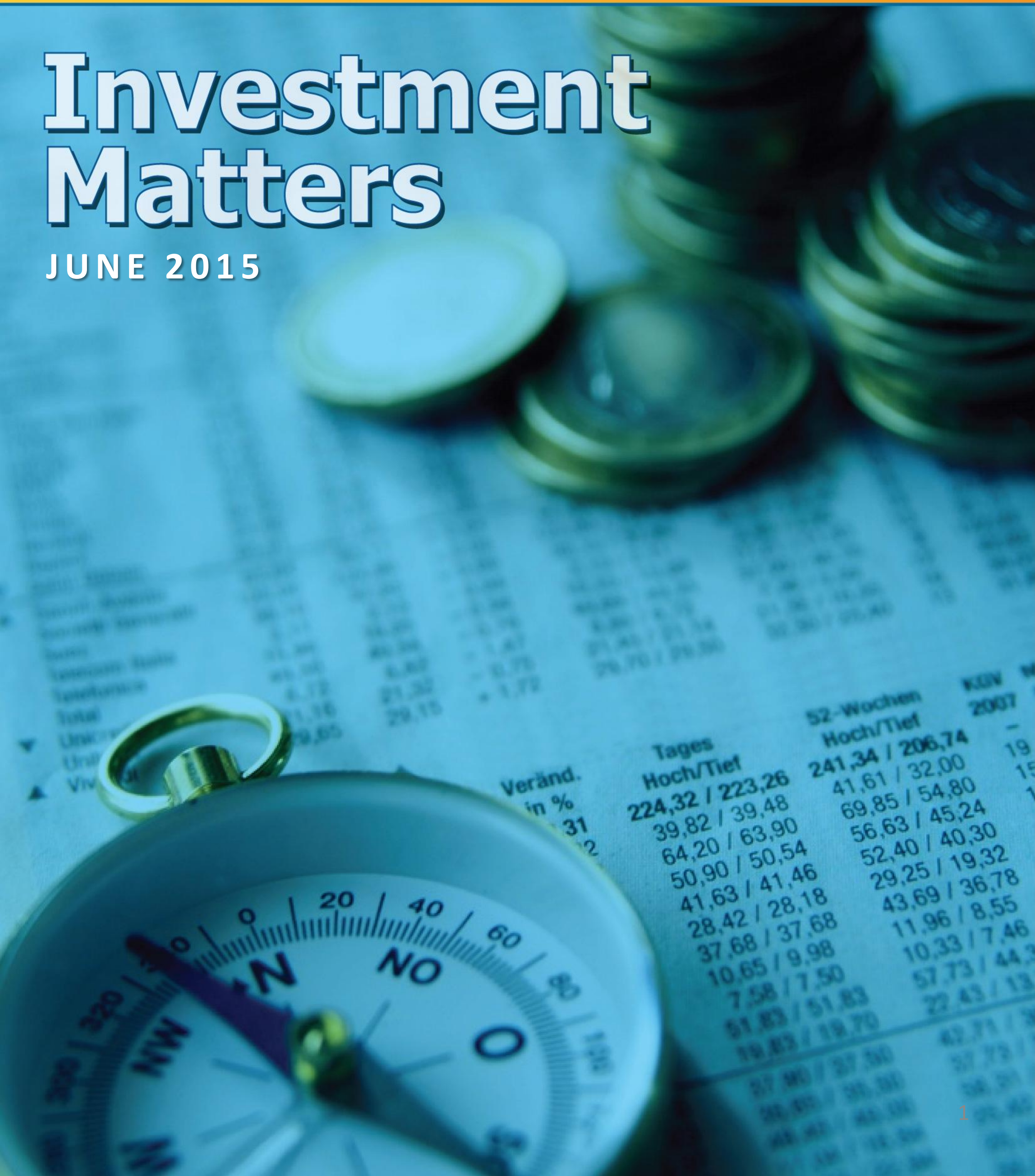


EQUITY OUTLOOK

The Indian markets continue to struggle since peaking in early Mar-15 as investors await visibility on earnings growth trajectory. While we have explained the factors responsible for the hazy outlook in our last month's newsletter, the table below quantifies the extent of cuts in earnings and the new consensus forecast for FY16 post the just concluded earnings season (4QFY15).

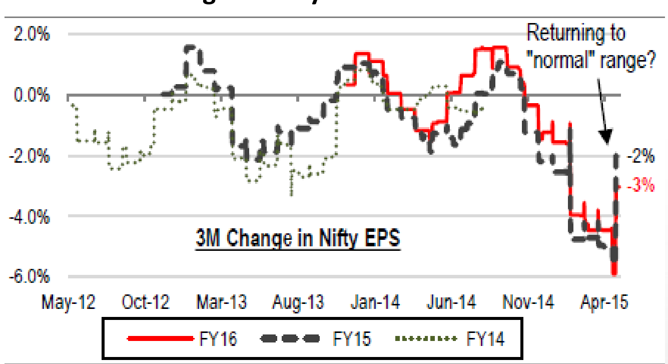
Table 1: BSE 100 Companies - Earnings Scorecard 4Q15

Sector	Consensus FY EPS Revisions				Consensus FY Sales Revisions				Consensus FY EBIDTA Revisions			
	FY15 Y/Y EPS Growth Forecasts %	FY15 Revisions vs. beginning of Q (bps)	FY16 Y/Y EPS Growth Forecasts %	FY16 Revisions vs. beginning of Q (bps)	FY15 Y/Y Sales Growth Forecasts %	FY15 Revisions vs. beginning of Q (bps)	FY16 Y/Y Sales Growth Forecasts %	FY16 Revisions vs. beginning of Q (bps)	FY15 Y/Y EBIDTA Growth Forecasts %	FY15 Revisions vs. beginning of Q (bps)	FY16 Y/Y EBIDTA Growth Forecasts %	FY16 Revisions vs. beginning of Q (bps)
Energy	-9	-8	8.2	-112	-9.1	-148	-9.7	-298	-11.5	-1355	28.1	-165
Materials	-16.3	-1608	34.5	-929	7.2	-135	9.2	-192	2.1	-984	17.9	-681
Industrials	0.2	-772	59.3	-997	5.4	-130	15.8	-90	13.3	-175	27.4	-18
Consumer Staples	11.8	-850	23.6	-215	7.4	-330	13.7	-186	14.6	-355	17.5	-247
Consumer Discretionary	5.4	-1019	29.7	-679	11.4	-133	14.5	-198	13.8	-464	20.5	-243
Health Care	-5.3	-1512	40.7	-189	28.5	1194	3	-132	9.5	-312	21.4	-171
Financials	9.5	-258	21	-287	12.7	41	15.2	63				
Information Technology	11.5	-226	10.5	-449	12.5	-58	12.8	-230	5.9	-382	14.2	-398
Telecommunication Services	57.6	320	9.4	-268	8.8	-134	10.3	-126	15	-56	12.1	56
Utilities	-3.4	-628	22.6	-403	3.3	-442	14.7	28	3	-343	17.8	-167
BSE 100	**2.9**	**-530**	**21.5**	**-417**	**1.4**	**-123**	**4.2**	**-183**	**2.9**	**-689**	**20.5**	**-266**

Source: Barclays

While commodity sectors like Energy and Materials have seen big cuts in earnings on the back of sharp fall in commodity prices, the resilient sectors like IT and Healthcare, which are export growth dependant too have disappointed. The positives have been that (i) Gross margins have generally improved across manufacturing companies and (ii) Capital goods companies have seen good growth in current order book after being relatively flat in FY13 & FY14. The above results also had a lot of one offs with banks provisioning increasing on them taking advantage of the last window to restructure loans and Euro depreciating against the INR. Investors should note that as shown in Chart 1 below, earnings cut are returning to normal levels after sharp cuts earlier in the year and markets expectations are getting more aligned to reality on the ground.

Chart 1: 3M change in Nifty EPS



Source: RAVE, IBES, Credit Suisse estimates

Table 2: India Quarterly GDP growth

	Mar-15	Dec-14	Sep-14	Jun-14	Mar-14	Dec-13	Sep-13	Jun-13	Mar-13
% Change YoY									
Gross Value Added	**6.1**	**6.8**	**8.4**	**7.4**	**5.3**	**6.6**	**7.5**	**7.2**	**4.1**
Agriculture	-1.4	-1.1	2.1	2.6	4.4	3.8	3.6	2.7	1.4
Industry	7.2	3.8	7.2	8.1	5.5	5.5	4.2	5.9	3.1
Services	8	11.1	10.2	8.4	5.6	8.3	9.7	8.9	5.4
Net Indirect Taxes	**18.9**	**3.7**	**8.6**	**-6.1**	**20**	**3.7**	**7.1**	**4.3**	**9.7**
Gross Domestic Production	**7.5**	**6.6**	**8.4**	**6.7**	**6.7**	**6.4**	**7.5**	**7**	**4.7**
Private Consumption	7.9	4.2	7.1	6.2	7	4.6	5.6	7.7	3.2
Government Consumption	-7.9	27.6	8.9	1.6	-7.2	11	5.3	27.3	-5.3
Fixed Investment	4.1	2.4	3.8	8.7	-1.4	5.3	6.3	2.3	6.5
Exports	-8.2	-0.3	-2	9.1	14.1	15.7	-1.6	2.6	-3.3
Imports	-8.7	2.8	1.1	-3.6	-7	-14.2	-8.4	-3.5	-0.2
Domestic Demand	5.6	5.8	6.3	6.6	1.1	3.2	3.7	5.9	2.9

EQUITY OUTLOOK

Top-Down, the fall in earnings is confusing investors in a backdrop of 7.5% GDP growth (new series) reported in 4QFY15. While we do not forecast GDP growth, we do look at its components for bottom-up trends. We believe in FY16 to kick start the investment cycle, it is imperative for government to spend in absence of private sector support and unlike previous years where they were constrained because of Fiscal deficit issues (see 4Qs of last 3 years in Table 2 above), the current year provides them fiscal space to spend given realistic assumptions in budget estimates.

As a part of fund strategy, we are gradually increasing our allocations to capital goods companies in areas which the government has prioritised to spend mainly; Defence, Railways, Renewables & Infrastructure. Over the past month, we have met about 70 companies spread across sectors to identify potential areas with improving growth visibility and are clearly seeing that companies in capital goods space with decent balance sheets are seeing improvement in order books. Managements are starting to feel confident of better days ahead and common refrain we hear is 10-15% revenue growth with improving margins is achievable in the current year. Some of our findings across verticals are highlighted below:-

Roads

National Highway Association of India (NHAI) is targeting to award 9000kms of road projects in FY16 compared with 1437kms in FY14 and 3067kms in FY15. The important point to highlight is that the government is prepared both in terms of land acquisition (90% land already acquired) and financially with extra cess on Petrol/Diesel to the tune of Rs 431bn (US$7bn) during FY16.

Order book for most Road EPC/BOT companies is providing visibility for growth for the next 2 years, however we observe that competition has still not abated in terms of aggression in bidding with a few deciding to exit the segment on account of low profitability.

BOT asset owners still have stressed balance sheets. The government on its part has relaxed norms for sale of equity into BOT projects prior/post completion so as to allow stressed owners to exit their projects.

The NHAI is taking over incomplete projects where the owner is unable to complete the same so as to kick start the cycle of execution once again.

Railways

The new Railways minister has announced his plans to invest Rs 1000bn (US$16bn) in FY16 (4-5X historical spending) and a total of Rs 8500bn (US$140bn) over the next 5 years. Life Insurance Corporation, Indian Rail Finance Corporation & Multilateral agencies will finance about US$ 40bn, Union Budget will provide grants of about US$30bn, Internal accruals of Indian Railways with the balance to be funded by Public Private Partnership (PPP) projects.

The new railway minister has delegated powers to division level officers to place orders instead of centralised decision making by the minister in the past which is in line with the move to empower bureaucrats by the BJP government. The change in process is delaying ordering as these officers cope with new powers which they never had earlier and hence ordering is likely delayed to 2HFY16.

Power - Transmission & Distribution (T&D)

The power ministry through Powergrid and PPP projects intends to spend as much as Rs 1000bn (US$16bn) on T&D in FY16 – this sum is 2.5-3X historical averages. 30% of the amount is already in various stages of tendering.

The T&D industry is running at very low utilisations and expects to see good improvement in margins over the next 24 months.

Defence

The government is very serious about defence procurement and the associated 'Make in India' policy that can be seen from the slew of defence purchase deals. It can be seen in the recent purchase of Rafael Jets from France where they did not wait for new Defence Procurement Policy which is likely to come out shortly but have asked policy makers to work backwards and include what they did as part of the policy.

The defence and finance secretaries are roping in bulge banks to look into long term financing arrangements for Defence Public Sector Units & related large private companies.

Medium & Heavy Commercial Vehicles (MHCVs)

MHCV volumes have grown at 16% in FY15 after two consecutive years of 20% decline. . The current pick up is on the back of a strong replacement cycle – over the past few years the average replacement cycle had got extended to beyond 10 years. Freight operators are seeing improvement in their utilizations along with better profitability.

Ashok Leyland, one of the large players in the industry has already started reducing discounts for new vehicles, which is another clear indicator of improving fundamentals.

One large listed equipment leasing company has started to spend on expansion of its equipment bank after a period of three years. They are planning to expand their gross block by 25% over the next two years.

To sum, while Indian markets have struggled over the past 3 months on sharp cut in earnings, lack of reform progress and investor attention moving to China, ground noises are pointing that government is starting to spend and positive changes are visible in companies with decent balance sheets.

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DEBT OUTLOOK

New Financial Year started with very high volatility. April and May 2015 witnessed high volatility in bond market across the global due to the global bonds sell off. By 3rd June 2015, German 10 year government bond had risen sharply by 80bps (from 7bps to 87bps) and US treasuries were up by 48bps (from1.89% to 2.37%) in a matter of two months. The selloff was primarily owing to concerns over Greece's ability to pay its dues to IMF in the first week of June, rebound in oil prices, expectations of US Fed Rate hikes. US Fed continues to debate on the timing of its first interest rate hike, with the next FOMC meeting scheduled on June 16 and 17. Indian bond yields too faced pressures rising to nearly 8%, in part due to the global sell off and further due to higher oil price, prognosis of weak monsoons and the corresponding fear of higher food prices. Also, some general impatience with respect to Indian assets seemed to have crept in with actual economic progress lagging expectations; especially given the strongly overweight positions that investors have been running in India. Amidst all this, the rupee too faced depreciating pressure touching level of 64 during the month. The month also saw the issuance of the new 10 year benchmark maturing on May 2025 at a coupon of 7.72%, much lower to the previous benchmark.

The Reserve Bank of India (RBI) reduced the repo rate by 25bps to 7.25% and kept CRR and SLR unchanged in line with the consensus expectations. The Central Bank raised its inflation forecast to 6% by January 2016 from 5.8%. The new projection is the same as the RBI's inflation target for January 2016. It mentioned that risks to the central trajectory of inflation are tilted to the upside due to the Indian Meteorological Department's projections of below normal monsoons and the impact of the increase in the service tax from 12.36% to 14%. The RBI also mentioned uncertainty on crude prices and volatility in the external environment as risks to inflation.

In the immediate term while the RBI is expected to be accommodative, keeping in mind that it needs to be supportive if the economy has to reach its optimal growth trajectory, its future rate actions will depend upon a host of variables, which would impact inflation and inflation expectations. With the central bank's primary mandate of keeping inflation contained to create macroeconomic conditions that are supportive of growth, it will continue to monitor how global energy prices behave; food stock management by the government - in the event of a sub-par monsoon to mitigate possible inflationary effects; the stance of the government on administered food prices (minimum support price); transmission of previous rate cuts by commercial banks and also the behavior of international crude oil prices.

Recent data shows the government has spent 8.7% of its budgetary allocation in the month of April compared with 6.7% in the previous year. Total spending in April was Rs 1.55 lakh crore, of which 17% was on the capital account compared with 10.3% of the total last year. The front loading of government capital spending is encouraging which if supplemented with an early award of fresh projects in various sectors with all clearances in place would help in investment recovery. Sustained revival of coal output also augurs well for electricity generation and mining. There is also some optimism on gas pricing and its availability. While all these augur well for the economy, in the medium term, in the absence of productivity improvements, our exports could be rendered incrementally uncompetitive due to the strong rupee and therefore the government would need to take measures to unclog stalled investment projects and encourage fresh capex by private firms.

DEBT OUTLOOK

RBI's concern over upside risks to inflation has tempered future rate expectations and dented market sentiments. Given a weaker visibility on continuation of the accommodation cycle, we expect the market to take cues from evolving liquidity and demand-supply dynamics. We believe the policy rates are close to neutral level. In the near term, the benchmark 10Y is likely to stay in range of 7.60% - 7.80%. As a fixed income investment strategy we suggest to invest part allocation in duration funds to generate capital gains and part in accrual strategy to get benefit of current high yield available in the market to generate consistent returns and take care of reinvestment risk.

Wealth Advisory Team

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