ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

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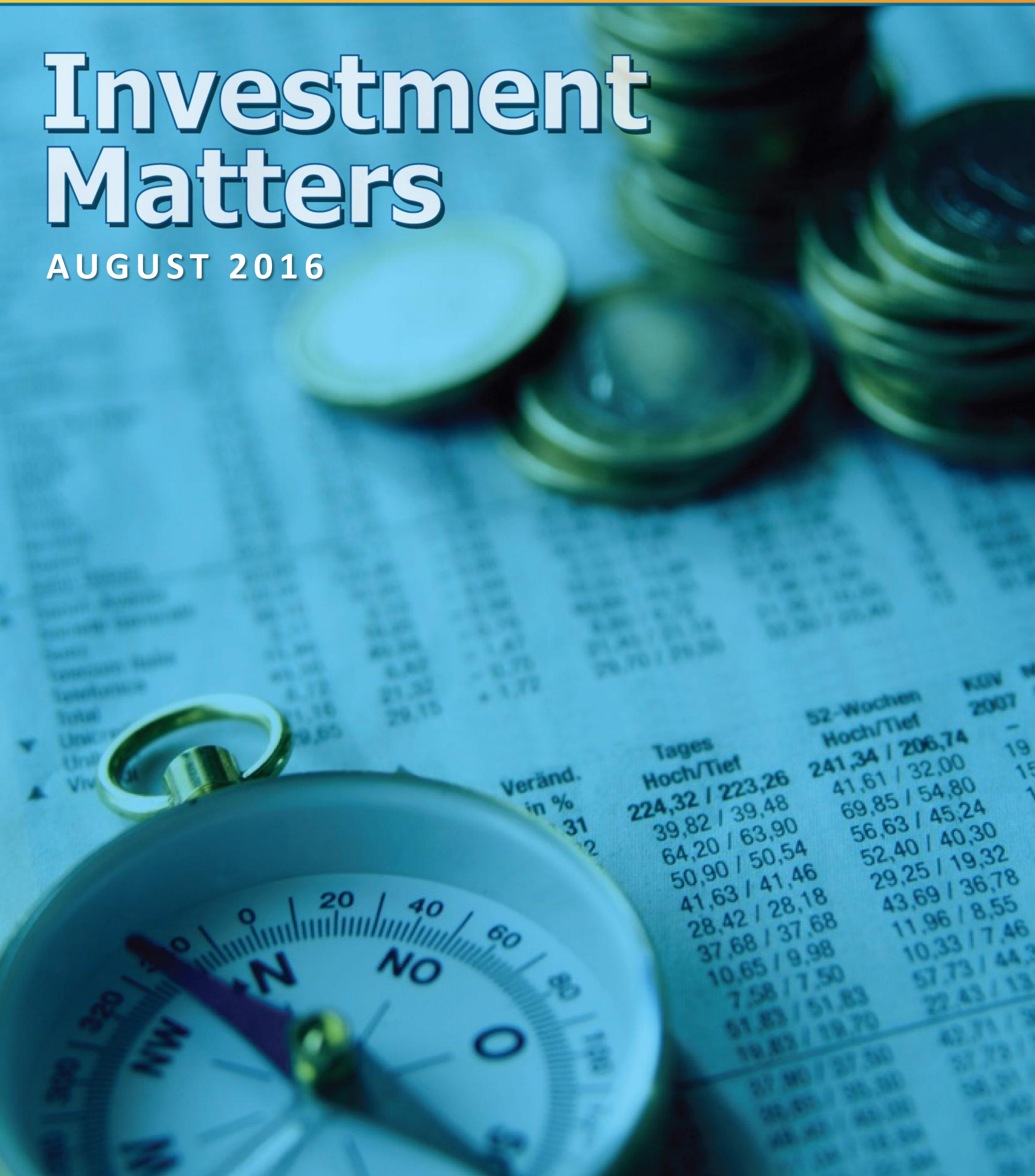

EQUITY OUTLOOK

Indian corporates, over the past few years, have faced multiple headwinds in their efforts to grow profits – sharp correction in commodity prices led by crude, poor monsoons impacting rural demand, sub optimal capacity utilisations impacting private corporate capex, weak exports on account of slow global markets and higher than normal debt to equity in aggregate corporate balance sheets (BSE 500). The resultant impact has been that Nifty profits over the past 3-4 years have remained flat with nominal change. With this backdrop, it is important to reflect where we are today and what the prospects of the same are, going forward.

Below are a list of headwinds and tailwinds that are likely to impact earnings going forward and hence, the market trajectory :-

Tailwinds	**Headwinds**
Strong Monsoon	Global demand environment is weak – impacting exports
Stable commodity prices	Capacity utilisations remain low – weak private corporate capex
Sharp improvement in government infrastructure capex	Leverage remains higher – though incrementally improving
GST implementation from FY18 onwards	
Lower interest rate scenario	
Gradual improvement in domestic demand scenario	

As can be seen from the table above, over the past few months, some of the past headwinds have now turned into tailwinds and a few new reasons to be optimistic have got added to the list. A combination of all the positives have the potential to outweigh the negatives, that are more global in nature, going ahead. Importantly, consensus today expects Nifty profits to grow at a 15%+ CAGR over the next 2 years, after a long gap. Among the many tailwinds mentioned above, GST implementation is the key game changer in the long term. This tax reform is a big ticket reform measure that can improve government finances substantially and hence the quality of government balance sheets can change meaningfully. This, in turn, can lead to structurally lower interest rates and higher equity prices/valuations.

Goods & Services Tax (GST) is a single tax applicable across goods and services and can truly make India a single nation in terms of taxation. Till now, India has had varied taxation rates on different goods/services across states and hence, MRP of the same product could be different across the country. Also, various states. in order to encourage manufacturing, were giving tax incentives to set up factories at backward locations – all this is likely to change with the GST, where most tax incentives will go away and will get replaced by a lower indirect tax rate i.e. GST. The resultant impact would be that government tax revenues are likely to go up sharply on account of leakages being plugged. This will certainly go a long way in assisting the government in meeting its fiscal deficit target of 3% of GDP in the next few years, thereby improving prospects of lower interest rates on a structural basis in the long term and leading to higher equity valuations.

EQUITY OUTLOOK

Monsoon is turning out to be strong, with most states getting above normal rains at the end of 1st week of August, 2016. The Met department is predicting an above normal monsoon in August and September 2016 as well. July is the most important month and since, till date, monsoon has turned out to be strong, prospects of a higher agri output are very bright, thereby having a potential to improve the rural demand environment over the medium term. The consensus is already building in demand improvement in its projections and hence, it was important that we do not see a disappointment in earnings on this count.

Government capex is also showing healthy signs of growth across segments ie Roads, Railways, Defence, Irrigation, Affordable Housing, Urban Infra (Metro). This is likely to drive momentum going forward.

Global demand environment, on the other hand, remains very weak and is reflecting in lower growth in many businesses we track, that are dependent on exports (both goods and services). This is likely to result in varying corporate performances going forward and hence, stock selection is likely to be an important driver of returns. We at Alchemy are focused on domestic oriented businesses and expect earnings growth of our investee companies to be at 20%+ CAGR over the next few years.

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