M+R+T resets to the fore

The demonetisation-driven cash crunch that is playing out in India will paralyse economic activity in the short term. Hence, we expect GDP growth to decelerate from 6.4% in 1HFY17 (as per Ambit est.) to 0.5% YoY in 2HFY17 with a distinct possibility of GDP growth contracting in 3QFY17. However, from 3QFY17 until 4QFY19, we expect a strong 'formalisation effect' to play out as nearly half of the non-tax paying businesses in the informal sector (40% share in GDP) become unviable and cede market share to their organised sector counterparts. We expect this dynamic to crimp GDP growth in India in FY18 as well and hence we cut our FY18 GDP growth estimate to 5.8% YoY (from 7.3%). We also scrap our March 2017 Sensex target of 29,500 and unveil our March 2018 Sensex target of 29,000.

The 'three effects' that will be triggered by the demonetisation move

The demonetisation affected by the Government on November 8, 2016 will trigger three sets of effects. Effect #1 will be the transactional hit created by a hard cash deficit as banks are unable to replace the demonetised cash expeditiously. This effect will be temporary and will kill business activity mainly over 2HFY17. Effect #2 will entail an adverse structural hit: (1) to non-tax paying businesses in the informal sector that become unviable; and (2) to the real estate sector where 30-40% of the value of purchases is funded using black money. Finally, effect #3 is likely to be a structural boost to tax-paying businesses in the formal sector which are able to capture the market share vacated by the informal sector.

We cut our GDP growth est. for FY17 by 330bps, FY18 by 150bps

Owing to effect #1 (i.e. the transactional impact created by the cash deficit) we expect real GDP growth in 2HFY17 to come under meaningful pressure. In specific, we expect GDP growth to decelerate from the 6.4% YoY growth recorded in 1HFY17 as per Ambit estimates (vs Government estimate of 7.1% YoY in 1QFY17) to 0.5% YoY in 2HFY17. Furthermore, we highlight the distinct probability of GDP growth contracting in 3QFY17. As regards FY18 we cut our GDP growth estimate to 5.8% YoY from 7.3% YoY. We build in far stronger growth in FY18 as compared to 2HFY17 mainly as we expect effect #3 (i.e. the structural market-share booster received by tax-paying businesses in the formal sector) to propel GDP growth higher in FY18.

As a response to the slowing GDP growth, we expect the RBI to consider rate cuts of 25-50bps over 2HFY17 itself. Furthermore, we highlight the distinct risk of fiscal slippage materializing in FY17 (to a lesser extent) and FY18 (to a greater extent) as against the stated target of 3.5% and 3% of GDP as the Government is expected to provide support to the lowest economic strata in the form of fiscal transfers.

Investment Implications

In the light of negative effects of the recent steps taken by the NDA Government and with just 4 months to go before FY17 comes to a close, we scrap our current Mar'17 Sensex target of 29,500 and unveil our Mar'18 Sensex target of 29,000.

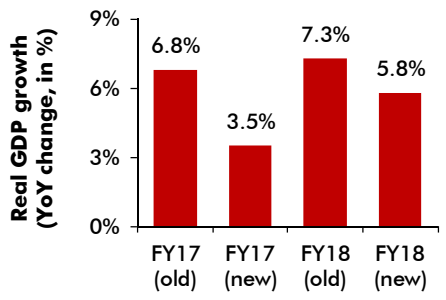
As highlighted in our *November 10, 2016* note the Government's latest move to squeeze the economy will disrupt economic activity in the short term, especially those segments where cash-based transactions are the norm like real estate, unsecured lending, real estate construction services and building materials. Whilst in the near term we expect these businesses to suffer, over the next couple of years the strongest players in these sectors will gain market share as competition from unscrupulous/unorganised players reduces. Irrespective of our BUY/SELL stance today, we believe investors should consider purchasing these stocks over next couple of quarters at better entry points. The famous five are Asian Paints, Titan, Havells, Motilal Oswal and Century Ply.

Exhibit A: 87%of all transactions in India took place in cash-form in FY12

Payment Type	FY10	FY11	FY12
Card Payment Transactions (Excluding Commercial)	3%	4%	4%
Electronic Direct / ACH Transactions	5%	6%	7%
Cash Transactions	**90%**	**88%**	**87%**
Other Paper Transactions (Checks, Demand Drafts)	3%	3%	3%

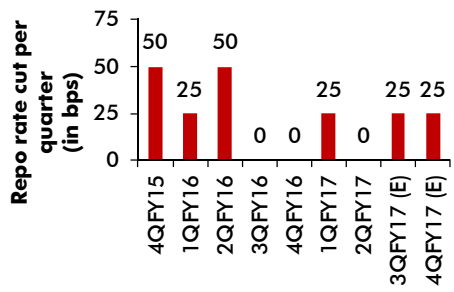
Source: Euromonitor, Ambit Capital research.

Exhibit B: We cut our GDP forecast for FY17 and FY18



Source: CEIC, Ambit Capital research

Exhibit C: We expect the RBI to cut rates by 25-50bps in 2HFY17



Source: CEIC, Ambit Capital research

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Section 1: The 'three effects' that will be triggered by the demonetisation move

Summary: The demonetisation move by the Central Government on November 8, 2016 will trigger three sets of effects. Effect #1 will be the transactional hit created by a hard cash deficit as banks are unable to replace the demonetised cash expeditiously. This effect will be temporary and will kill business activity mainly over 2HFY17. Effect #2 will entail an adverse structural hit: (1) to non-tax paying businesses in the informal sector that become unviable; and (2) to the real estate sector where 30-40% of the value of purchases is funded using black money. Finally, effect #3 is likely to be a structural boost to the tax-paying businesses in the formal sector which are able to capture the market share vacated by the informal sector.

Effect #1: The transactional hit created by a hard cash deficit

Nature of effect: The decision to demonetise the 500- and 1,000-rupee notes has created an immediate impact in terms of creating a shortage of hard currency.

Quantification of the effect: Data suggests that 87% of all transactions in India in FY12 were executed in cash form (see exhibit below).

Exhibit 1: 87% of all transactions in India took place in cash form in FY12

Payment Type	FY07	FY08	FY09	FY10	FY11	FY12
Card Payment Transactions (Excluding Commercial)	2.8%	3.1%	2.9%	2.8%	3.5%	4.1%
Electronic Direct / ACH Transactions	2.6%	3.0%	3.8%	4.5%	5.6%	6.8%
Cash Transactions	**90.6%**	**90.0%**	**89.7%**	**89.5%**	**87.9%**	**86.6%**
Other Paper Transactions (Checks, Demand Drafts)	4.1%	3.9%	3.6%	3.2%	2.9%	2.5%

Source: Euromonitor, Ambit Capital research

Assuming that the historical run-rate of the pace of decline in cash transactions of 0.8% per annum continues, 82.6% of transactions in India are likely to have materialised in cash form in FY17.

To complicate matters, our calculations suggest that a cash deficit of Rs8.5tn is likely to materialise in 3QFY17 (see exhibit below for details) as the pace of cash disbursals does not keep pace with the overnight destruction in value of Rs.14tn.

Exhibit 2: A cash deficit of Rs8.5tn is likely to materialise in 3QFY17

Head	Value (Rs trillion)
Value of old Rs500 and Rs1,000 notes in circulation (Source: RBI)	14
Total deposits received by the banking system till date (Source: https://goo.gl/OCAHDE)	4
Total deposit expected by December 30, 2016 (Source: https://goo.gl/OCAHDE)	10
Total withdrawals expected (Since Rs0.92tn of withdrawals have been recorded till date, we expect 5.5tn i.e. 0.9tn x 6 of withdrawals to be recorded over 6 weeks)	5.5
Net reduction in currency circulation (i.e. Rs14tn less Rs5.5tn)	8.5

Source: SBI, RBI, Media reports, Ambit Capital research

The reasons for the slower cash disbursals are three-fold namely: (1) the quantitative limit of Rs24,000 per week on currency withdrawals; (2) the need to re-configure ATM cassettes to be able to vend the new 2,000-rupee note (which is larger than any of the notes that are currently in circulation in India) means that the existing ATMs cannot be used to seamlessly replace the cash value that has been demonitised; and (3) physical constraints on printing cash (source: https://goo.gl/G7eO0W).

Thus, in a cash-based economy where ~83% of transitions materialise in the form of cash, a cash deficit to the tune of Rs8.5tn or 5.7% of GDP is expected to materialise in 3QFY17 and continue into 4QFY17 (albeit to a lesser extent). This then, is bound to have a paralysing effect at the economic activity levels in the short term.

Duration of effect: Even as the impact of effect #1 will be lethal, we expect this impact to be transient and its intensity to abate by 4QFY17 as the Government is able to gradually reconfigure ATMs, print more notes and simultaneously increase cash withdrawal limits.

Effect #2: The structural hit (1) to non-tax paying businesses that become unviable and (2) to the real estate sector

Nature of effect: The decision to demonetise the 500- and 1,000-rupee note is part of the Modi-led Government's broader agenda to boost tax compliance in a country characterised by large-scale tax evasion. Furthermore, a series of tax-related raids are expected to be functionalised by the Government (see exhibit below) in a bid to create a credible threat of penalties for tax evaders.

Exhibit 3: The Government is expected to launch tax raids in the coming months

Title	Description
Deposits above Rs2,50,000 to face tax, penalty on mismatch (https://goo.gl/PCvHt8)	Further dangling the stick, government has warned that cash deposits above Rs2,50,000 threshold under the 50-day window could attract tax plus a 200% penalty in case of income mismatch.
Black money: 300% rise in raids, seizures by Income Tax Department (https://goo.gl/BThozn)	In a mammoth jump of over three times in the searches, raids and seizure action in the first seven months of this year as compared to the corresponding period of 2015, the department seized over Rs330 crore of alleged tainted cash, jewellery and other movable and immovable assets.
Income tax dept conducts raids across India as illegal financial institutions crop up; shops call it a day (https://goo.gl/CEfc9X).	The income tax department conducted multiple raids in Delhi, Mumbai and other cities on November 10 in the wake of reports of alleged profiteering and subsequent tax evasion by converting demonetised currency notes in an illegal manner.

Source: Media reports, Ambit Capital research

Besides GST implementation, the transition of the economy towards an economy that is less cash-driven (and one that creates a paper trail) is likely to result in a range of non-tax paying businesses becoming unviable as their limited margins are crimped by tax payment.

Separately, activity in the real estate sector will be subject to a structural hit as a range of research suggests that 30-40% of the value of purchases in this sector are funded using black money (see exhibit below).

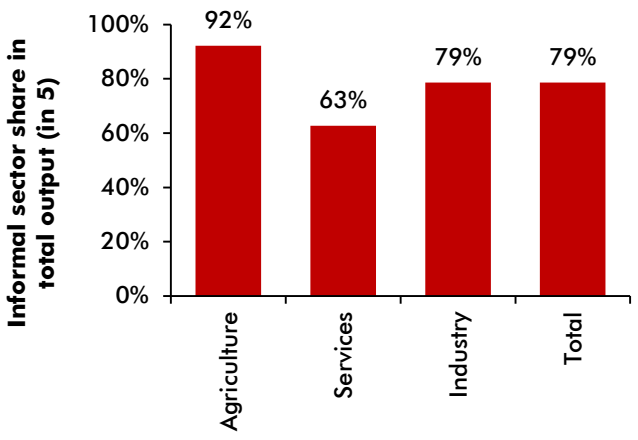
Exhibit 4: Research suggests that more than 30% of India's real estate sector is funded by black money

Title	Key relevant finding	Source	Year
Weeding out black money from real estate: What Government should do to make housing affordable	Even though no official figures are available, it is safe to assume that anywhere between 30% and 40% of real estate transactions, be it the purchase of land or an apartment in a metro, involve black money.	Pankaj Kapoor, MD, Liases Foras, a real estate research company	November 2014
India's parallel economy	Another big source of generating black money is the real estate sector, which has witnessed an unprecedented boom in the past 10 years or so. In Delhi, the ratio of unaccounted value of real estate transactions to the total value is as high as 78%. The same ratio is 50% in Kolkata and Bengaluru. In smaller towns and semi-urban centres, nearly 100% of property transactions are conducted in cash.	National Institute of Public Finance and Policy	July 2014
White paper on black money	While the source of generation of black money may lie in any sphere of economic activity, there are certain sectors of the economy or activities, which are more vulnerable to this menace. These include real estate, the bullion and jewellery market, financial markets, public procurement, non-profit organisations, external trade, international transactions involving tax havens and the informal service sector.	Ministry of Finance	May 2012

Source: Various research studies, Ambit Capital research

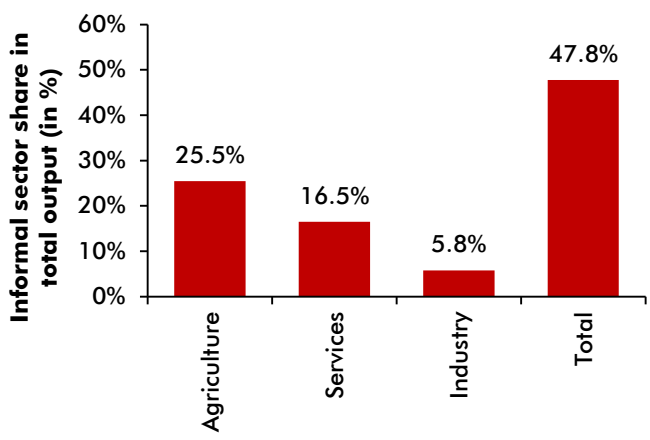
Quantification of the effect: The informal sector accounts for more than 40% of India's GDP and provides employment to close to 80% of the labour force (see exhibit below).

Exhibit 5: The informal sector provides employment to 80% of India's labour force



Source: NSSO, Ambit Capital research. Note: The data pertains to FY12.

Exhibit 6: The informal sector accounted for 48% of India's total output in FY12

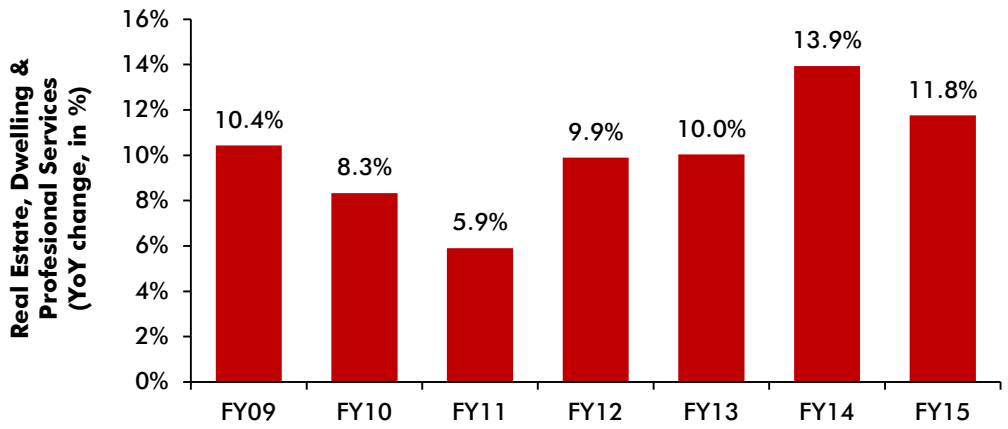


Source: NIPFP, Ambit Capital research. Note: The data pertains to FY12.

Whilst it is difficult to capture details regarding the profit margins of businesses in the informal sector, we assume that from 3QFY17 to 4QFY19 the share of the informal economy in India shrinks from 40% to 20%.

The real estate sector accounts for 11% of India's GDP (source: 'White Paper on black money' – Ministry of Finance). It will be fair to assume that this sector (proxied by the national accounts header called 'Real Estate, Dwelling & Professional Services') which has been growing at an average pace of 11% in real terms over the past five years will now grow at a structurally lower pace (see exhibit below).

Exhibit 7: In the national accounts, real estate sector has grown at a rapid pace since FY12



Source: CEIC, ambit Capital research

Duration of effect: We expect this impact to persist for the next few quarters and continue until FY19 as implementation of the GST by 2HFY18 reinforces the formalisation effect.

Effect #3: The structural boost to tax-paying businesses in the formal sector

Nature of effect: As the informal sector shrinks on the back of a crackdown in the black economy and on the back of GST implementation, the formal organised sector is likely to gain market share as a 'formalisation effect' comes into play.

Quantification of the effect: The formal sector accounts for 60% of India's GDP today. We assume that from 3QFY17 to 4QFY19 the share of the formal economy in India expands from 60% to 80%.

Besides the advances in market share that the formal sector will benefit from, incumbents are also likely to benefit from the reduction in cost of debt capital that materialises as the quantum of white savings grows.

As highlighted in our note *'M+R+T= Revolution in access'*, dated October 04, our analysis suggests that the cost of debt capital in India (proxied by the SBI lending rate) is likely to fall by ~360bps by FY20 as savings move away from physical assets to the formal financial system (see below for the details of the analysis).

Exhibit 8: The quantum of white savings in India is set to rise as Government cracks down on black money

Metric	FY13	FY14	FY15	FY16	FY17E	FY18E	FY19E	FY20E
Investment ratio (as a % of GDP)	38.3%	34.7%	34.1%	33.3%	32.8%	32.8%	33.2%	33.6%
White savings ratio (as a % of GDP)	26.9%	26.3%	26.2%	27.4%	28.1%	28.8%	29.5%	30.1%
Black savings ratio (as a % of GDP)	6.9%	6.8%	6.8%	6.2%	5.6%	4.9%	4.2%	3.5%
Nominal GDP growth rate (YoY change, in %)	14%	13%	11%	9%	11%	11%	11%	11%
Nominal GDP (in INR tn)	100	113	125	136	151	167	186	206
White savings (in INR tn)	26.8	29.6	32.7	37.2	42.4	48.1	54.7	62.1
Black savings (in INR tn)	6.2	6.9	7.6	8.4	8.5	8.4	8.2	7.8
Investments (in INR tn)	43	44	46	50	55	61	68	75
Savings and Investment gap (in INR tn)	9	6	5	4	4	5	6	6

Source: CEIC, Ambit Capital research. Nominal GDP is assumed to grow at 11% from FY17 onwards.

A linear regression analysis suggests that every 100bps increase in the white savings ratio is likely to reduce the lending rate by 90bps (see exhibit below for the details of the regression results).

Exhibit 9: As savings increase, lending rates fall

	Coefficients	t Stat
Intercept	0.2	11.4
Investment (as % of GDP)	0.8	3.7
Savings (as % of GDP)	-0.9	-3.8

Source: Ambit Capital research. Note: The independent variable used is the SBI advance rate. The adjusted R squared for the model is 26%. The total number of observations used is 45.

Duration of effect: We expect this effect to begin playing out by 2HFY18 as the run up to GST implementation is likely to be marked by record exits of businesses operating in the informal space.

Section 2: We cut our FY17 GDP growth estimate by 330bps, FY18 estimate by 150bps

Summary: Owing to effect #1 (i.e. the transactional impact created by the cash deficit) we expect real GDP growth in 2HFY17 to come under severe pressure. In specific, we expect the GDP growth to decelerate from the 6.4% YoY growth recorded in 1HFY17 as per Ambit estimates (vs Government estimate of 7.1% YoY in 1QFY17) to 0.5% YoY in 2HFY17. In specific, we highlight the high probability of GDP growth being recorded in negative territory in 3QFY17. As regards FY18 we cut our GDP growth estimate to 5.8% YoY from 7.3% YoY. We build in far stronger growth in FY18 as compared to 2HFY17 mainly as we expect effect #3 (i.e. the structural market-share booster received by tax-paying businesses in the formal sector) to propel GDP growth higher in FY18.

We suspend our current GDP model; transition to the 'quantity theory of money'

In the light of the disruption caused by the demonetisation decision triggered by the Central Government on November 8, 2016 we suspend our current supply-side GDP model.

Our GDP model comprises four related sub-models focused on agricultural sector growth (which is defined as a function of a rainfall adjustment factor and MSP hikes), investment growth (which is defined as a function of policy rates, bank credit growth and Sensex returns), industrial sector growth (which is defined as a function of level of investment in the economy) and services sector growth (which is defined as a function of industrial sector growth and growth in the developed world). This model by definition is not capable of building in the impact of demonetisation and associated impacts.

To quantify the impact of the demonetisation on GDP growth we rely on the 'quantity theory of money' (QTM). This theory posits that the nominal GDP of an economy is the product of the base money and velocity of money circulation (see exhibit below).

Exhibit 10: The quantity theory of money (QTM) posits that nominal GDP growth is directly affected by money supply growth

Head	Description
The equation	The quantity theory of money is defined as M x V = P x Y or where, M stands for currency in circulation V stands for velocity of money i.e. the rate at which the money is exchanging hands P denotes the price level, Y denotes the real GDP and hence, PxY denotes nominal GDP.
Theory propounded by	The QTM was propounded by Simon Newcomb, Alfred de Foville, Irving Fisher and Ludwig von Mises in the late 19th and early 20th century. Subsequently, by the 1920s economists like JM Keynes accepted the theory in general.
Criticisms	The theory has been criticised as it fails to work during a liquidity trap. In such a situation even doubling the money supply does not have any effect on prices.

Source: Ambit Capital research

We cut our GDP growth estimates for FY17 by 330bps, FY18 by 150bps

Having identified the model, we assume that the velocity of money supply in India dips from the historical median of 2.3x to 2.2x in 2HFY17 mainly to reflect the shock that the economy has to deal with as a result of effect #1, i.e. the transactional impact created by the cash deficit. Furthermore, we assume that base money is eroded by an average of 5% QoQ in 2HFY17 (over and above the seasonal growth rates) owing to the demonetisation which restrains growth in currency in circulation.

The combination of these two assumptions suggests that India's nominal GDP growth is likely to decelerate in 2HFY17 as a result of the demonetisation. In real terms this means that GDP growth is likely to decelerate from the 6.4% YoY growth recorded in 1HFY17 as per Ambit estimates (vs Government estimate of 7.1% YoY in 1QFY17) to 0.5% in 2HFY17. In specific, we highlight the high probability of GDP growth being recorded in the negative territory in 3QFY17.

As regards FY18 we cut our GDP growth estimate to 5.8% YoY from 7.3% YoY as we build in a full recovery in the velocity of the money supply to 2.2x even as we maintain a drag of 1% on base money growth (see exhibit below).

Exhibit 11: We cut our FY17 GDP growth estimate to 3.5% (from 6.8%) and FY18 growth estimate to 5.8% (from 7.3%)

	Old GDP est. (YoY change, in %)	New GDP est. (YoY change, in %)	Velocity of M0 (in times)	Fade factor on M0 (over and above the seasonal growth)	Year-end CPI inflation (YoY change, in %)
FY16	6.8%	6.8%	2.2x	0%	5.1%
FY17 (E)	6.8%	3.5%	2.1x	-3%	3.8%
FY18 (E)	7.3%	5.8%	2.2x	-1%	5.0%

Source: CEIC, Ambit Capital research, Note: Forecasts of the QoQ change in currency in circulation indicate the changes assumed over and above the seasonal movement.

According to data provided by the National Institute of Public Finance and Policy (NIPFP), at the pan-India level the informal sector accounts for 40% of India's GDP. Amongst the supply-side constituents, the share of the informal economy in the agricultural sector, industrial sector and services sector stands at 53%, 12% and 35% respectively. Given this we expect the slowdown in FY17 and FY18 to be mainly driven by slower growth in the services sector (see exhibit below).

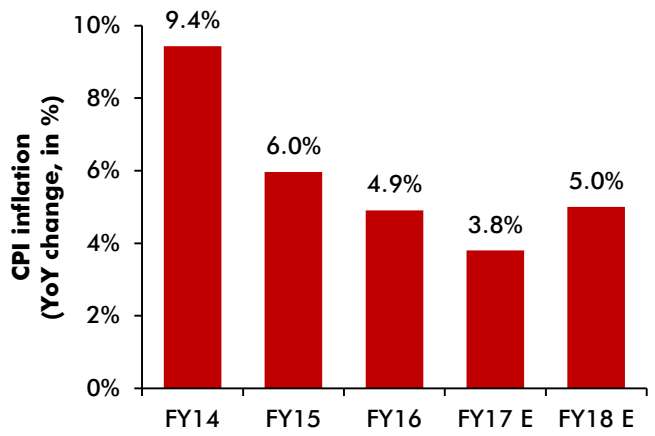
Exhibit 12: We expect GDP growth in FY17 to be recorded at 3.5% YoY, FY18 at 5.8% YoY

Growth (YoY change, in %)	FY15	FY16	FY17 (Old Estimates)	FY17 (New Estimates)	FY18 (Old Estimates)	FY18 (New Estimates)	Change FY18 (new) vs FY17 (new)
Agriculture	-0.2%	1.2%	2.8%	0.8%	1.8%	1.5%	+120bps
Industry	5.9%	5.8%	5.5%	4.0%	6.1%	5.0%	+100bps
Services	10.3%	8.9%	8.9%	4.0%	9.9%	7.3%	+330bps
GVA at basic prices	7.1%	6.7%	6.9%	3.6%	7.5%	5.9%	+130bps
Memo Item: Investment	4.9%	3.9%	3.9%	2.5%	4.6%	3.5%	+100bps
GDP at MP	**7.2%**	**6.8%**	**6.8%**	**3.5%**	**7.3%**	**5.8%**	**+230bps**

Source: CEIC, Ambit Capital research, GDP at FC refers to supply-side GDP i.e. GDP at Factor Cost. GDP at MP refers to demand-side GDP i.e. GDP at Market Prices

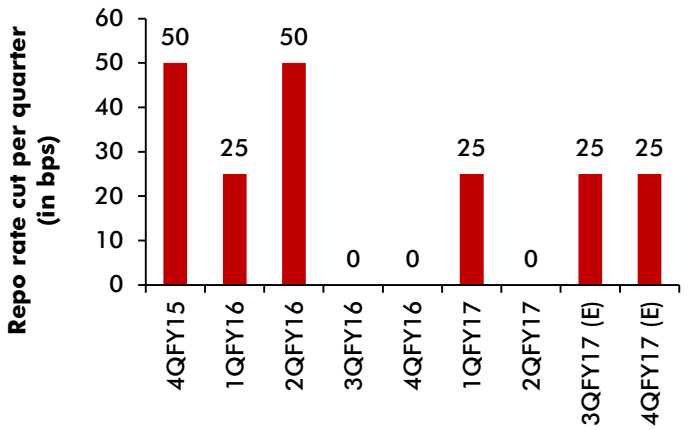
As regards CPI inflation, we cut our FY17-end inflation forecast to 3.8% YoY as we build in lower GDP growth in 2HFY17 (see exhibit below).

Exhibit 13: We expect CPI inflation to fall further in 2HFY17



Source: CEIC, Ambit Capital research

Exhibit 14: Rate cuts to the tune of 25-50bps could be administered over 2HFY17



Source: CEIC, Ambit Capital research

This in turn leads us to increase our expectation of repo rate cuts in FY17 from 0bps to 25-50bps from hereon (see exhibit above).

As regards fiscal policy, in view of the significant inconvenience caused to those employed in the informal sector in India by the demonetisation move, we expect the Government to focus on increasing transfer payments to the lowest economic strata and re-iterate our view that there remains a high risk of fiscal slippage materializing from the Government's stated target of 3.5% in FY17 (to a lesser extent) and 3.0% in FY18 (to a greater extent) appears highly likely.

It is critical to note that whilst the declaration of previously undeclared income in likely to provide additional tax revenue to the tune of +1% of GDP in FY17 itself, this could well be offset by slower economic activity in general in 2HFY17. As regards FY18, the extent of fiscal slippage is likely to be a function of whether the Central Government is able to book revaluation profits with the RBI as a result of the demonitisation – an accounting treatment that our policy expert sources highlight is *'technically incorrect but could be engineered by this Government'*.

How can negative real GDP growth in FY17 be understood intuitively?

Two intuitive approaches can be used to understand the rationale for our expectation of negative real GDP growth in 3QFY17.

Firstly, if we assume that the economic activity completely freezes for only 8 days in 3QFY17 (a quarter which comprises of 92 days) then the implied GDP growth rate for 3QFY17 after deducting the GDP lost owing to the shutdown of economic activity for 8 days amounts to approximately -2% YoY.

Exhibit 15: The freezing of economic activity for 8 days implies a negative GDP growth for 3QFY17

Head	Values
India's GDP growth in 3QFY17 assuming that the demonetization event had not taken place	Rs.38tn
Nominal GDP growth assumed for 3QFY17 with no demonetization having taken place	11.5% YoY
Implied per day GDP in 3QFY17 which has 92 days assuming that the demonetization event had not taken place	Rs.0.4tn
India's GDP growth in 3QFY17 with demonetization in play which we assume results in a total shutdown of economic activity for 8 days	Rs.35tn
Nominal GDP growth implied for 3QFY17 with demonetization in play	1.8% YoY
Real GDP growth implied for 3QFY17 with demonetization in play assuming a deflator of ~4%	-2.2% YoY

Source: CEIC, Ambit Capital research

Secondly, if we assume that the informal sector GDP was to contract by 5% YoY in nominal terms even as the formal sector GDP was to expand by 6% YoY in nominal terms then nominal GDP growth in India in 3QFY17 amounts to ~2% which in real terms amounts to approximately -2% (see exhibit below).

Exhibit 16: Even if the informal sector GDP was to contract by 5% YoY in nominal terms, headline real GDP growth will contract in 3QFY17

Head	Values
India's GDP in 3QFY16	Rs.34.8tn
Formal component of India's GDP in 3QFY16 (60% share)	Rs21tn
Informal component of India's GDP in 3QFY16 (40% share)	Rs14tn
Formal component of India's GDP in 3QFY17 assuming a nominal growth of 6% YoY	Rs22tn
Formal component of India's GDP in 3QFY17 assuming a nominal growth of -5% YoY	Rs13tn
India's GDP in 4QFY16	Rs.35.3tn
Nominal GDP growth implied for 3QFY17 with demonetization in play	1.6% YoY
Real GDP growth implied for 3QFY17 with demonetization in play assuming a deflator of ~4%	-2.4% YoY

Source: CEIC, Ambit Capital research

Section 3: Investment Implications

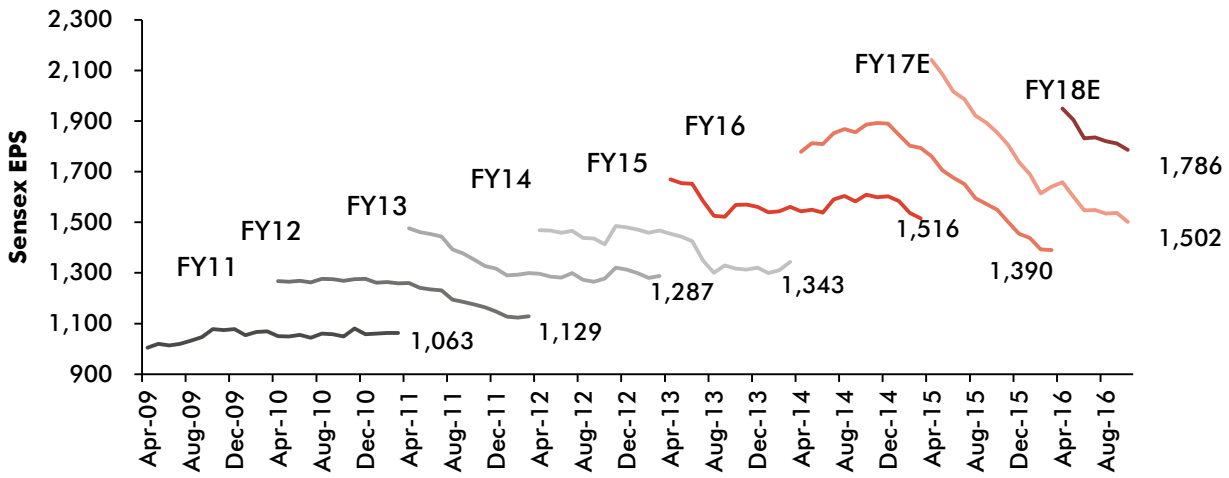
Our Sensex target

In the light of negative short-term effects of the recent steps taken by the NDA Government and with just four months to go before FY17 comes to a close, we scrap our current Mar'17 Sensex target of 29,500 (first published on June 10 *click here* for the note). In the sub-sections below, we revisit our current FY17 and FY18 earnings estimates for Sensex and unveil our Mar'18 Sensex target of 29,000.

Sensex earnings estimates face sharp revision downwards

In our Dec'15 thematic "*M+R+T = Earnings recession in India*", we had highlighted how under the influence of economic resets deployed by PM Modi, Governor Rajan and Technology, earnings growth is likely to remain weak for market-leading Indian corporates who had earlier enjoyed high earnings growth thanks to crony capitalism and artificial suppression of competition. The exhibit below highlights this phenomenon as Sensex EPS has remained largely flat since FY14 (in spite of the sell side's never-ending optimism that it will rise). Further, it is interesting to note that while some moderation in overoptimistic analysts' Sensex EPS estimates has happened in the past, such a revision in estimates has been extremely sharp in recent years (FY16 and FY17).

Exhibit 17: Consensus Sensex EPS estimates have declined sharply in recent years



Source: Bloomberg, Ambit Capital Research. The chart above has been made using Bloomberg consensus estimates for Sensex EPS for a given financial year over the course of past two years. For e.g. FY16 Sensex EPS estimate has been charted over the course of Apri'14 to Mar'16

The current Ambit FY17 Sensex EPS estimate stands at Rs1,496 (implying 7.4% earnings growth over FY16) while the consensus FY17 Sensex EPS estimate stands at Rs1,466 (implying 5.6% earnings growth in FY16). However, in light of our expectation of weak GDP growth expected over the next two quarters, it is highly unlikely that FY17 Sensex EPS would be able to reach the kind of levels being estimated by our analysts currently. In light of this, our March 2017 Sensex target of 29,500 (first published in June 2016) is rendered meaningless.

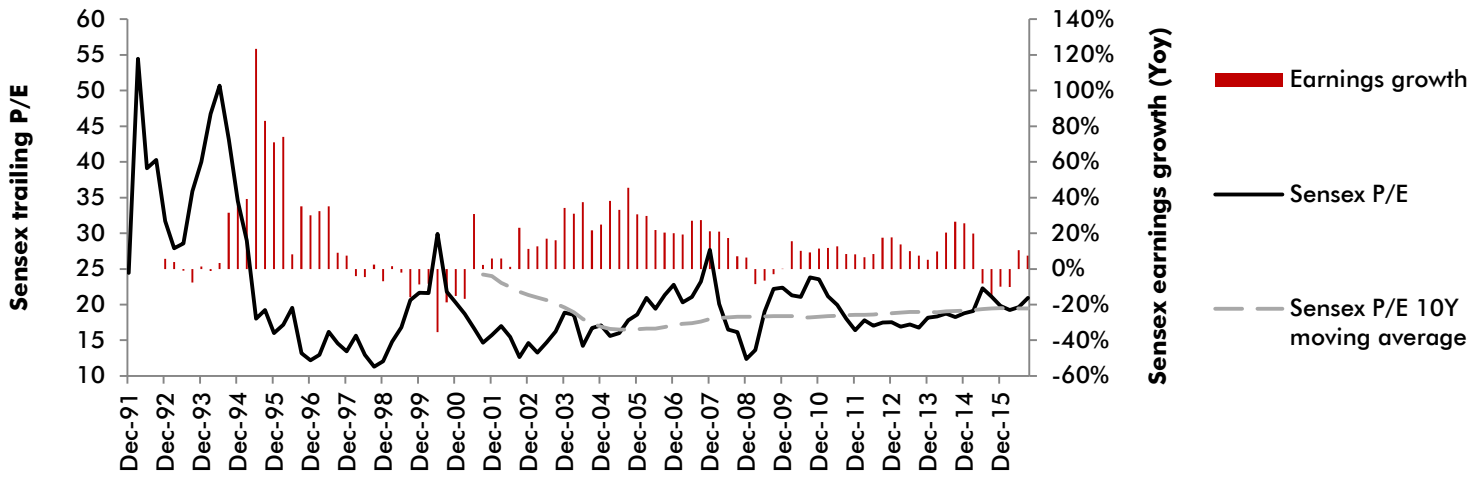
We highlight our March 2018 target of 29,000

With FY17 Sensex EPS likely to be revised downwards, the current Ambit FY18 Sensex EPS estimate of Rs1,782 (implying 19% earnings growth over FY17) and consensus estimate of Rs1,801 (implying 23% earnings growth over FY17) are also at risk. We expect both these numbers – Ambit's and consensus - to be revised downwards over the course of next year.

To arrive at our Mar'18 Sensex target:

- We build in a flat Sensex FY17 EPS growth over FY16 in order to reflect the weak GDP growth expected over the next two quarters. This in turn implies a Sensex FY17 EPS level of Rs1,390.
- We apply a conservative growth of 10% to the FY17 Sensex EPS of Rs1,390 arriving at FY18 Sensex EPS estimate of Rs1,530.
- Finally, we apply trailing Sensex P/E multiple of 19x (which is also the 10-year moving average P/E for the Sensex) to the FY18 Sensex EPS estimate to arrive at Mar'18 target of 29,000 (implying 10% returns from the current level of the Sensex).

Exhibit 18: Sensex currently trades close to its long-term P/E multiple of 19x



Source: Ace Equity. Ambit Capital Research; Note: The Sensex trailing 12m EPS has been back calculated using Sensex P/E ratio and Sensex Index level at each quarter

Stock-specific investment implications

As highlighted in our note dated November 10, 2016 the Government's latest move to squeeze the economy will disrupt economic activity in the short term especially in those segments where cash-based transactions are the norm like real estate, unsecured lending, real estate construction services and building materials. Whilst in the near term we expect these businesses to suffer from slowing demand, reduced investment and working capital issues, over the next couple of years the strongest players in these sectors will gain market share as competition from unscrupulous/unorganised players reduces. Irrespective of our BUY/SELL stance today, we believe investors should consider purchasing these stocks over next couple of quarters at better entry points. The famous five are Asian Paints, Titan, Havells, Motilal Oswal and Century Ply.

Asian Paints (APNT IN, BUY, mcap US$13bn)

We expect Asian Paints to face near-term demand headwinds due to slowdown in real estate transactions post black money clampdown. However, in the medium to long term (1-2 years), we expect Asian Paints to emerge stronger with market share gains due to: 1) lower disruption to supply chain as it is least driven by cash vs peers; 2) lower impact of slowdown in real estate as repainting by existing flat owners is the key\demand driver; and 3) shrinking of unorganised segment. There's risk to our FY17-18 estimates (sales growth of 20%, EBITDA growth of 26% and EPS growth of 28%) but we believe long-term growth might accelerate. Any weakness in stock price on near-term earnings miss should provide better entry point vs current valuation of 35x FY18E P/E.

Titan (TTAN IN, SELL, mcap US$4.1bn)

Demonetisation will result in jewellery industry shrinking by up to 30% where unorganised players (80% of the market) stand to lose. Their competitive advantages of low compliance cost and low transparency will erode and result in higher making charges but without a brand proposition. While Titan's Tanishq is also likely to suffer over the next 3-4 quarters, it will stand to gain market share (currently 4%) the most given its wide presence in over 115 towns, de-risked balance sheet (inventory is hedged) and strong brand positioning built over 22 years. Tanishq's proposition is built on design and experience, thus charges a premium to peers. Consequently, the customer base is predominantly white collared with ticket size of Rs70,000 (at best 1/3rd of peers). While the company will emerge stronger in the market, the near-term turmoil will likely de-rate punchy valuations of 31x FY18E EPS.

Havells (HAVL IN, BUY, mcap US$3.0bn)

In the electrical industry, organised players will gain market share from unorganised (currently share at ~35%). Historically, unorganised players benefitted from tax evasion through black transactions. Within organised players, Havells would emerge as the major beneficiary given: (a) its pan-India distribution network with strong channel connect; and (b) high exposure to cables & wires (revenue share at 41%) where the share of unorganised market is higher, at ~40%. Even if we cut our FY17/FY18E EPS by ~6/12% given the likely deceleration in the real-estate-led demand (accounts for ~48% of Havells' revenue), the stock trades at 35x FY18 P/E (~70% premium to five-year average). Any weakness in stock price is an opportunity to BUY as we expect Havells to maintain its leadership given it is strengthening its competitive moats and is unlikely to be hit by EESL disruption as it focuses more on the premium price points.

Motilal Oswal (MOFS IN, UNDER REVIEW, mcap US$1bn)

As pressure on black money drives migration of savings from physical to financial assets, participation in the equity market is gaining momentum amongst the Indian public. MOFS will be a straight-forward beneficiary of this trend due to its strong positioning across the value chain of the investment management industry – its strong positioning in stock broking is exemplified by a high revenue market share (4-5% across cycles) and its improving asset management franchise is validated by market share expansion (from 30bps in FY15 to 90bps in FY16). Together, both these businesses account for 55% of MOFS' PAT. Moreover, after investing heavily in technology, branding and improved distribution channel in these businesses since FY14, MOFS also stands to benefit from operating leverage playing out now.

Century Ply (CPBI IN, BUY, mcap US$0.6mn)

Amongst all the building material categories, the wood substrate market, i.e., plywood/board, would be the most affected by the adoption of cashless economy. Given materially higher share of unorganised market and small-scale units (~70%), the channel has had a penchant for operating on cash in order to improve RoI through pushing tax-evading high-margin unorganised products. The clampdown on cash transaction will impose severe liquidity constraints on the channel as well as on the operations of the unorganised players. Add to this the impending GST adoption, we are ready to see a major dislocation in the industry structure; inevitable exits of smaller players and potential acquisition/partnership possibilities will help strong brands like Century and Greenply. Over the next 12-18 months, we expect the industry size to shrink given delay in high-ticket house refurbishment spending, downtrading and disruption from new-age cheaper products like MDF (imports). Whilst our near-term estimates are at risk, we expect high possibility of non-linear growth in FY19 as Century starts MDF plant in early FY18 and channel's affinity for organised players increases. The stock trades at 20x FY18E EPS.

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