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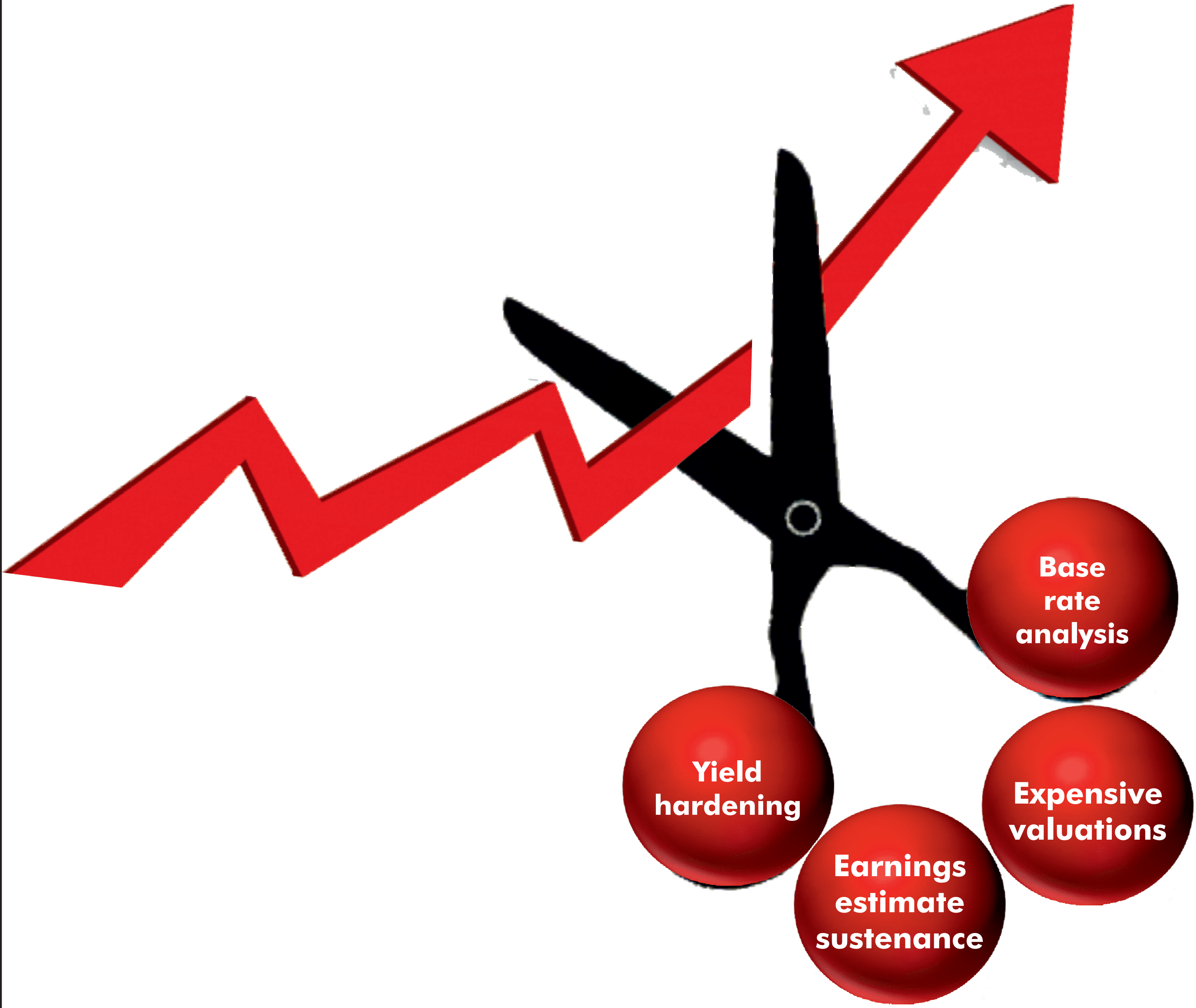

G&C 18.3: Drivers are flashing risk

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G&C 18.3: Drivers are flashing risk

Sep-24 EYBY-based Nifty fair value rises to 21,500 using 7.2% G-sec yield and Sep-24 EPS of ₹970 (vs consensus' ₹1,041). All three drivers – valuation, yield and earnings estimates – have turned worse since May-23. We raise our 10-year yield assumption by 10bps as fiscal slippage, elevated inflation, lower liquidity surplus and contracting global liquidity will weigh on yields. Yield being the primary driver of valuations (R-square~86%), there is risk of multiple derating. Divergence between Nifty BFSI and ex-BFSI valuation is 34%; EPS estimates are sustainable only in BFSI and Auto. EPS estimate trajectory is not same as FY21-23, with Nifty FY24 EPS cut by 4% since Mar-23. Expect more cuts led by IT, Metals and Reliance. Preference remains in favour of large-caps over SMID. Adding low beta + earnings momentum stocks closes our UW position in Autos (OW) and FMCG (EW). Prefer Banks over IT (EW). Highlight OW in Financials/Metals/OMCs and UW in Cap Goods.

We estimate a Nifty fair value of 21500 by Sep-24

Assuming -2.7 EYBY Gap (10-year average), the implied Nifty sustainable level is 21,500. Nifty fair value is a function of valuation, yield and earnings estimates, each of which has turned worse since May-23! Multiples are at risk as yield is the primary driver of Nifty valuations since 2021 (R-square~86% between EY and yield) is hardening. Divergence between BFSI and ex-BFSI valuation stands at 34% in Nifty, whereas in NSE500 it is 90%! With EPS estimate trajectory significantly better in BFSI than ex-BFSI, this is worrisome!

Yields and Earnings Estimate Trajectory changing for worse

Yields can stay elevated as fiscal slippage, persistence of elevated inflation and lower liquidity surplus/OMO sales weigh! Falling global liquidity with Fed BS contraction (10% cut, 1% every month since May-23) is a key negative. While yields stay benign prior to elections and (yield-repo) spread at the end of the rate cycle is usually benign, we increase yield assumption to 7.2 %(+10bps) factoring these risks. Earnings estimate sustenance is seen only in BFSI and Auto. Current PAT growth distribution doesn't justify frothy valuations!

Where to hide?

Prefer large-caps over SMID noticing greed, frothy valuations akin to 2017-18, and earnings estimate sustenance better in large-caps. "Base returns" establishes that a 2-sigma move over last 3 years weighs on forward returns (next 7 years), with small-caps appearing most vulnerable. With divergence widening between index and "median stock" returns, we turn to 2008/18 episodes of SMID correction to determine portfolio tilt. Factor analysis suggests that high quality, low leverage, EPS momentum and EPS revision did well in both instances.

G&C Portfolio Positioning - concentrated in large-caps (78%)

Over the last 5 months, our G&C Portfolio has underperformed by ~2% as SMID outperformed. This reduces G&C portfolio outperformance to ~1% since Sep'22. Mid/small-cap allocations are 13%/9% and cash allocation 7.5%. We maintain significant OW in Financials and Metals. We add low beta stocks with earnings momentum to the portfolio, which closes our UW position in Auto and FMCG. Becoming stock specific. Prefer Banks over IT. Key OW: BFSI, Metals, Pharma and OMCs. Key UW: Capital Goods, Cement. We make 4 changes.

What's in: NESTLE, TVS MOTORS, EMBASSY and CDSL

What's out: SRF, BHARTI AIRTEL and AMBER ENTERPRISE

Exhibit A: G&C 18.3 composition

Company	Mcap ($mn)
Large-Caps	
TCS	153,859
HDFC Bank	138,924
ICICI Bank	78,613
ITC	65,771
Bajaj Finance	56,644
HCL Tech.	41,097
Axis Bank	36,356
Tata Motors	29,206
Nestle India	28,168
Tata Steel	18,104
SBI Life Insurance	16,414
Tech Mahindra	13,742
Hindalco	12,756
InterGlobe Aviation	11,322
Dr Reddy's	11,176
TVS Motor	9,126
BPCL	9,042
SBI Cards	8,953
Mid-Caps	
Max Healthcare	6,828
Info Edge India	6,533
Federal Bank	4,126
PB Fintech	3,919
Embassy REIT	3,524
Small-Caps	
Narayana Hrudayalaya	2,591
IndiaMart InterMesh	2,006
CDSL	1,689
Affle India	1,719
Great Eastern Shipping	1,476

Source: Bloomberg, Ambit Capital research

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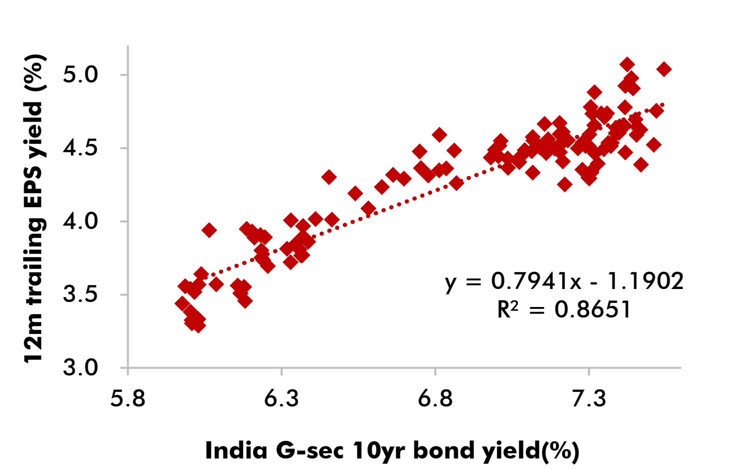
The Narrative in Charts

Exhibit 1: Nifty levels(Sep-24) for different yields & EPS: Base Case-7.2% yield, 970 EPS

10-year yield	Sept-24 EPS(INR)				
	950	960	970	980	990
7.0%	21,991	22,222	22,454	22,685	22,917
7.1%	21,493	21,719	21,946	22,172	22,398
7.2%	21,018	21,239	**21,460**	21,681	21,903
7.3%	20,563	20,779	20,996	21,212	21,429
7.4%	20,127	20,339	20,551	20,763	20,975

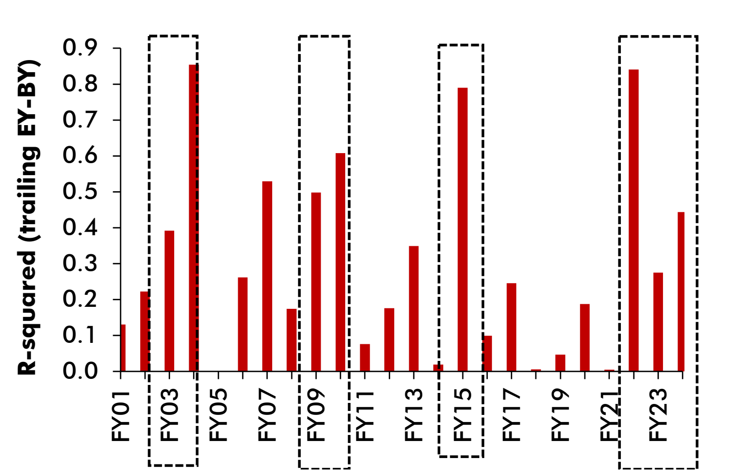
Source: Bloomberg, Ambit Capital research. Note: Implied Nifty levels have been calculated under the assumptions: Nifty trades at LTA(-2.68), eps & yield by equation EYBY Gap=(Nifty Level)/(Earnings)- Bond Yield;

Exhibit 2: An extremely close relationship between Nifty trailing EY vs India G-sec 10-yr (Since Apr'21), which is not always the case



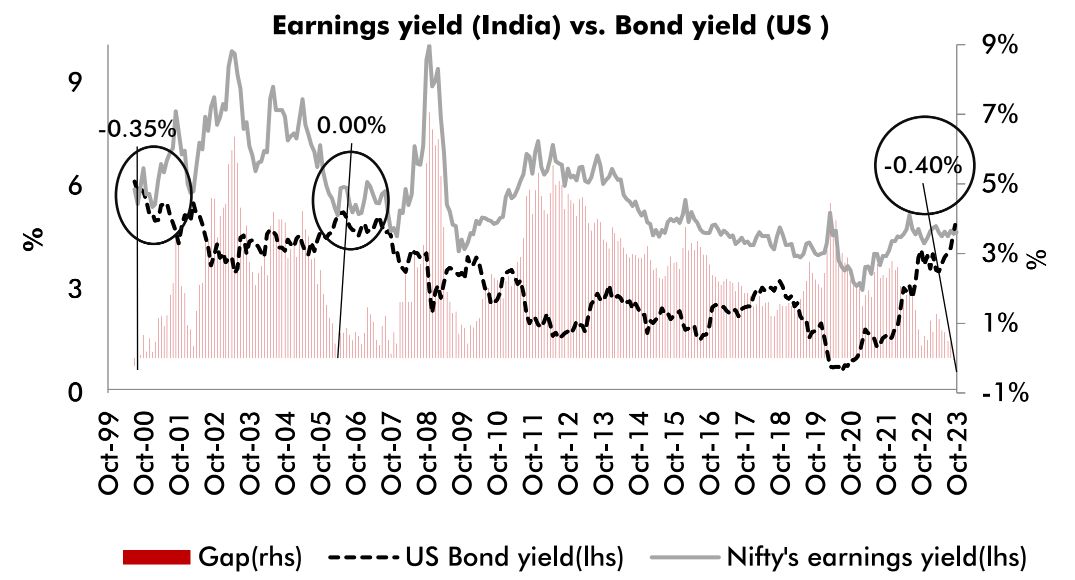
Source: Bloomberg, Ambit Capital research

Exhibit 3: R-square in line with historical precedents of dotcom boom, GFC and taper tantrum when central bank policy was the dominating factor



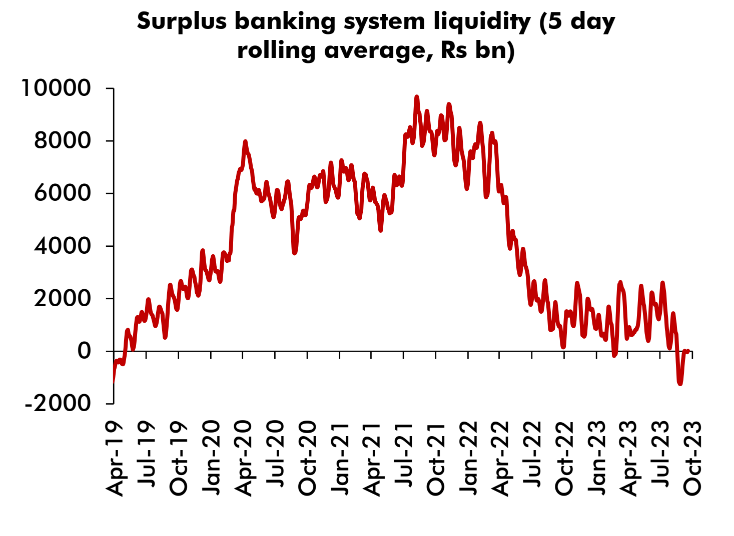
Source: Bloomberg, Ambit Capital research

Exhibit 4: Spread between India's Earnings yield and US bond yield has turned negative for the third time in the last 2 decades!



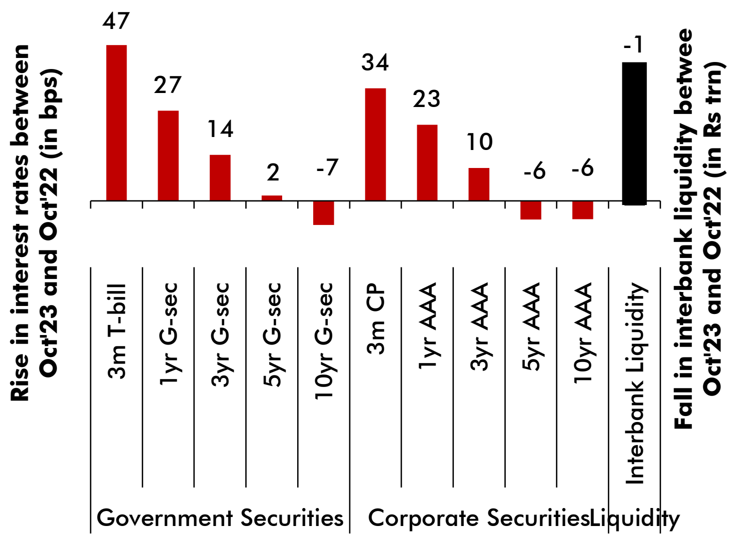
Source: Bloomberg, Ambit Capital research

Exhibit 5: RBI has been draining surplus liquidity from the system



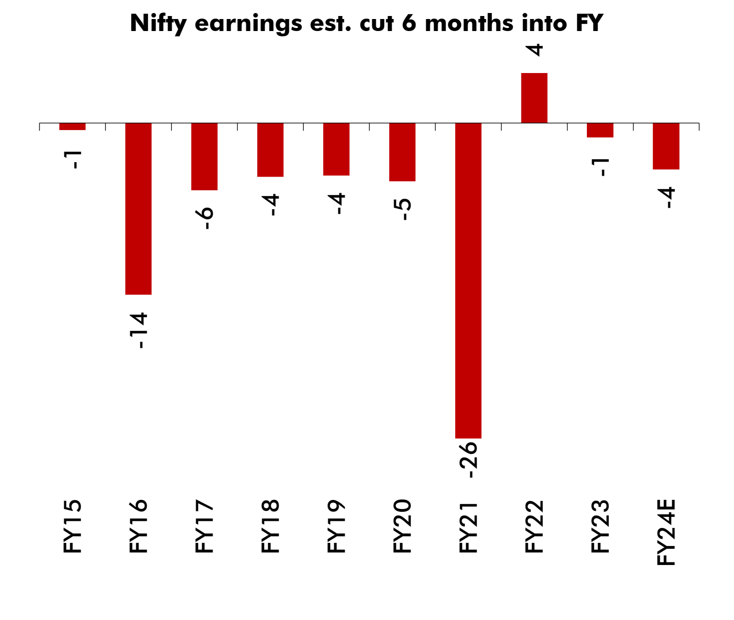
Source: Bloomberg, Ambit Capital research. Negative represents surplus, Note: Latest data up to 18th Oct'23

Exhibit 6: Shorter end yields have significantly increased in the past 1 year



Source: Bloomberg, Ambit Capital research. Note – Data as of 18th Oct'23

Exhibit 7: EPS trajectory no longer same as FY22-23



Source: Bloomberg, Ambit Capital research

Exhibit 8: Earnings Growth Contribution Analysis Oct'23: More cuts in Nifty FY24/25 expected; Estimate sustenance seen only in BFSI & Auto

Sector	Free float Weight	Contribution to Nifty EPS growth FY23	FY24E	FY25E
BFSI	36%	190%	61%	45%
IT	14%	25%	-1%	11%
Oil and Gas	10%	-50%	12%	5%
Consumer	11%	3%	2%	5%
Auto / Auto Anc	6%	72%	14%	5%
E&C / Infra / Cap. Goods	6%	7%	3%	6%
Metals and Mining	4%	-174%	3%	9%
Utilities	2%	-1%	1%	2%
Pharma	3%	22%	1%	2%
Cement	2%	-8%	2%	2%
Telecom	3%	11%	3%	5%
Retail	2%	3%	0%	1%
Healthcare	1%	-1%	0%	1%
Chemicals	0%	-1%	0%	1%

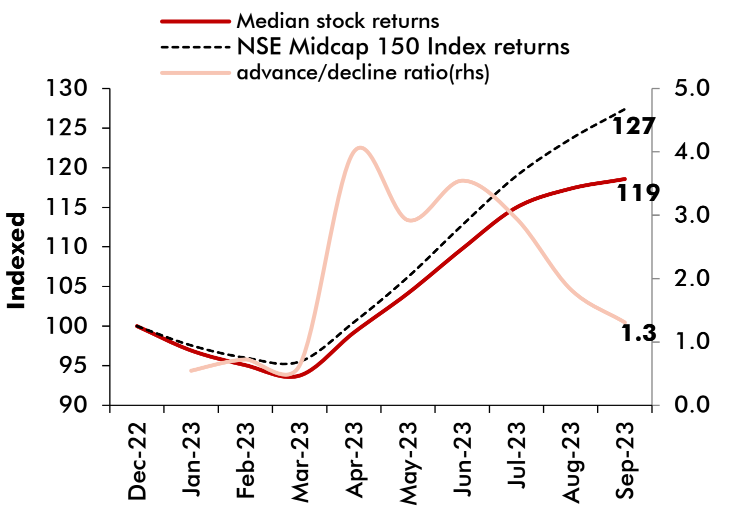
Source: Bloomberg, Ambit Capital research. FY23 numbers are different than the published May'23 owing to the completion of 4QFY23 earnings results

Exhibit 9: Heavyweight sectors in mid-caps see accelerated downgrades (FY24) compared to large-caps and small-caps

Sector Name	FY24 EPS- Change since Jun			Weights		
	Large-cap	Mid-cap	Small-cap	Large-cap	Mid-cap	Small-cap
BFSI	1%	2%	5%	33.3%	22.7%	18.5%
Capital Goods	2%	1%	-2%	6.4%	8.8%	18.0%
Healthcare	4%	-3%	0%	3.7%	10.1%	10.7%
Chemicals	-17%	-10%	-8%	0.9%	5.9%	6.0%
Auto and Auto Anc	4%	0%	1%	6.6%	9.7%	3.7%
FMCG	-2%	-9%	-1%	12.2%	4.7%	5.5%
Miscellaneous	-2%	-1%	-2%	0.7%	4.6%	12.3%
IT	-5%	-3%	1%	11.8%	6.3%	6.9%
Metals and Mining	-8%	3%	5%	3.7%	2.0%	3.8%
Oil and Gas	0%	0%	13%	9.7%	2.9%	1.3%
Consumer Durable	-6%	-9%	-2%	0.3%	2.7%	2.4%
Real Estate	0%	-2%	-3%	0.3%	3.4%	1.7%
Utilities	0%	5%	-6%	3.3%	1.8%	1.3%
Cement	-4%	-5%	-10%	1.6%	2.5%	0.9%
Building Materials	4%	0%	1%	1.9%	3.0%	1.0%
Media	N/A	-3%	10%	0.0%	2.7%	3.3%
Textiles	N/A	-1%	-10%	0.0%	1.6%	1.7%
New-age tech	-42%	-27%	7%	0.7%	2.7%	0.5%
Telecom	-11%	4%	N/A	2.4%	1.8%	0.6%
Aviation	50%	N/A	N/A	0.3%	0.0%	0.0%

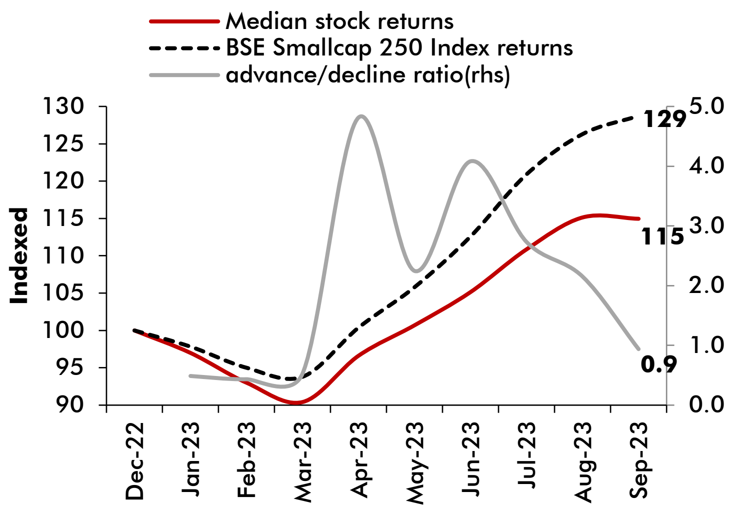
Source: Bloomberg, Ambit Capital research

Exhibit 10: Rally has become narrow in mid-caps...



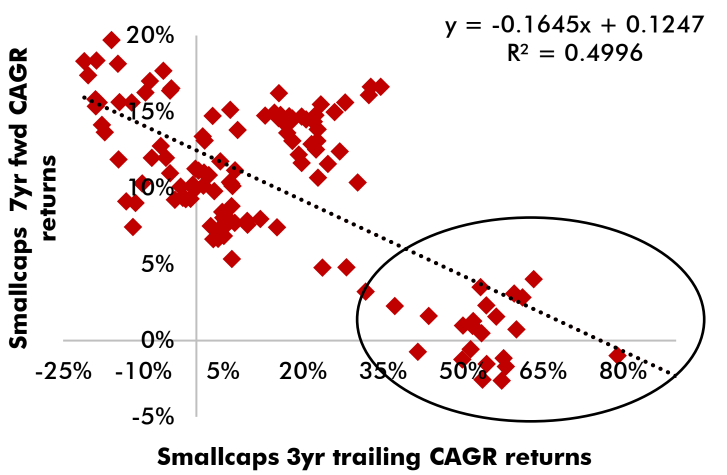
Source: Ace Equity, Ambit Capital research

Exhibit 11: ...and median stock return has turned negative in small-caps



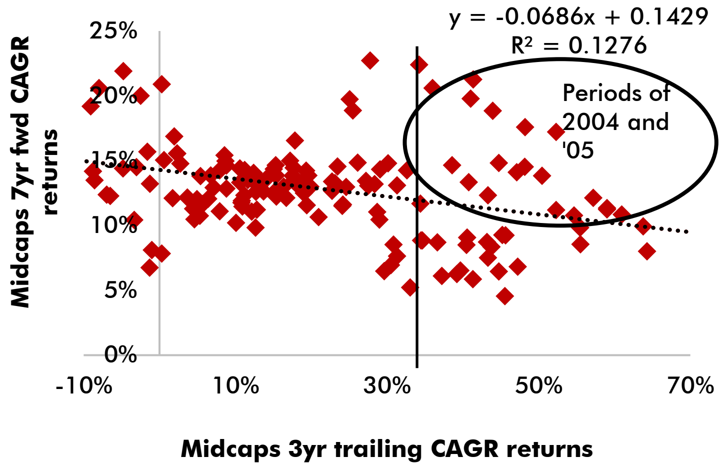
Source: Ace Equity, Ambit Capital research

Exhibit 12: Small-cap: Strong returns in last 3 years (>35%) weighed on fwd. returns (<5% CAGR) over next 7 years…



Source: Ace Equity, Ambit Capital research. BSE Smallcap 250 index under consideration; Returns are calculated on a rolling basis

Exhibit 13: …while for mid-caps, the relation is mixed



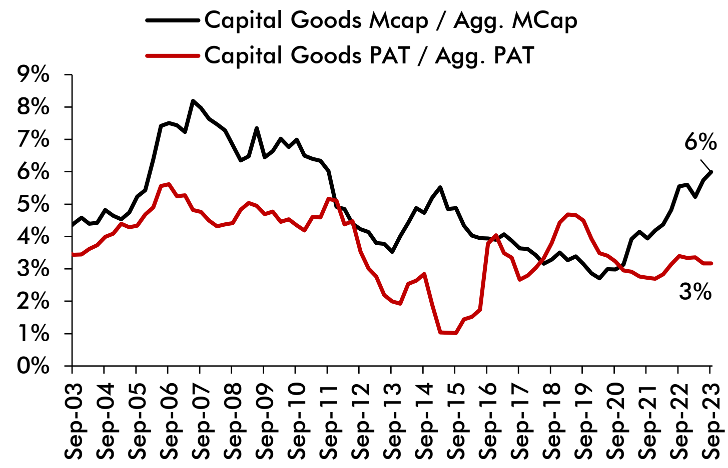
Source: Ace Equity, Ambit Capital research. Nifty Midcap100 index under consideration; Returns are calculated on a rolling basis

Exhibit 14: How sectors look on "Sectoral Attractiveness" framework and our stance

Sectors	Recent Excess Returns	Relative Valuation to Nifty	Earnings estimate trajectory	Ownership w.r.t NSE500 Sector weights	G&C Positioning	Comments
Auto	Unattractive	Unattractive	Robust	Significantly Overweight	OW	Driven by stock specific call, adding low beta stock
Banks	Attractive	Neutral	Robust	Neutral	OW	In line with framework
IT	Neutral	Unattractive	One of worst	Neutral	EW	In line with framework
Pharma	Neutral	Attractive	Reasonable	Significantly Overweight	OW	In line with framework
FMCG	Neutral	Unattractive	Robust	Underweight	EW	Driven by stock specific call, adding low beta stock
Metals	Attractive	Unattractive	Reasonable	Significantly Underweight	OW	In line with framework
O&G	Attractive	Very attractive	Robust	Significantly Underweight	UW**	Disproportionate OW in OMC's
Capital Goods	Unattractive	Very Unattractive	Robust	Neutral	UW	In line with framework

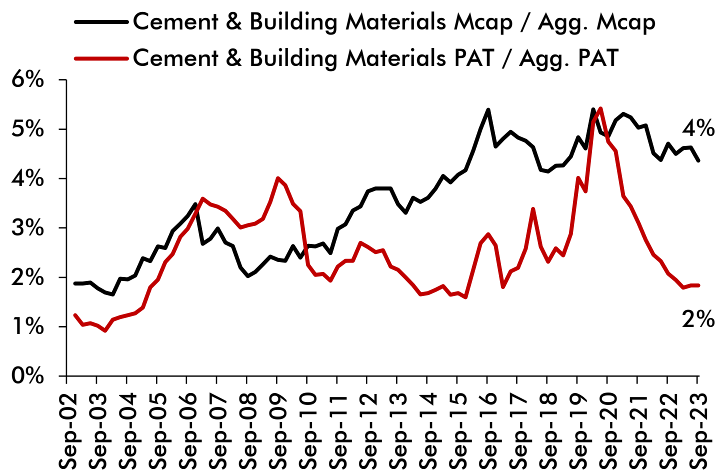
*Source: Ambit Capital research, Bloomberg. Note: Scores are assigned for excess returns, relative valuation and classified into 5 quintiles, 0-0.20 scores as very unattractive, 0.20- 0.40 as unattractive, 0.40-0.60 as Neutral,0.60-0.80 as attractive, and 0.80 to 1 as Very attractive. Ownership is calculated as difference between Equity holdings of DMF's and NSE500 sector weights. +/- 5% are defined as neutral, 5-15% as underweight/overweight, >15% are classified as significant OW/UW. Earnings estimate sustenance has been calculated based on comparison of how earnings estimates evolution for current FY and next FY.**We have disproportionate OW in OMC's but don't own Reliance*

Exhibit 15: Capital goods: Highest divergence in 7 years between mcap contribution & PAT contribution to NSE500



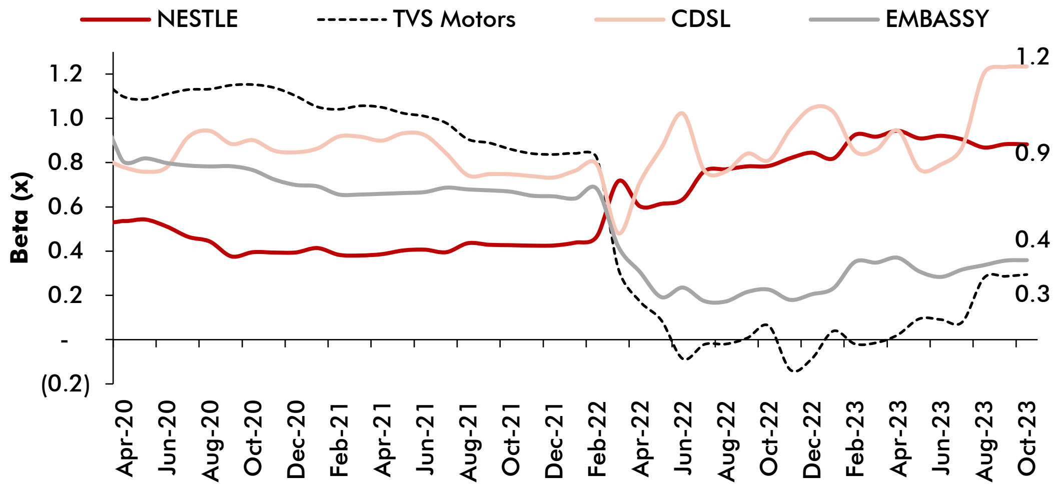
Source: Ace Equity, Ambit Capital research. Note: NSE 500 index has been considered for analysis. Latest PAT data as of 30th June '23 (rolling 4-quarter sum), and market cap data as of 30th Sept'23

Exhibit 16: Cement: Rising input cost led to significant PAT decline over last 2-3 years while mcap contrib. remains high



Source: Ace Equity, Ambit Capital research. Note: NSE 500 index has been considered for analysis. Latest PAT data as of 30th June 23(rolling 4-quarter sum), and market cap data as of 30th Sept'23

Exhibit 17: Except CDSL, our new inclusions exhibit low beta

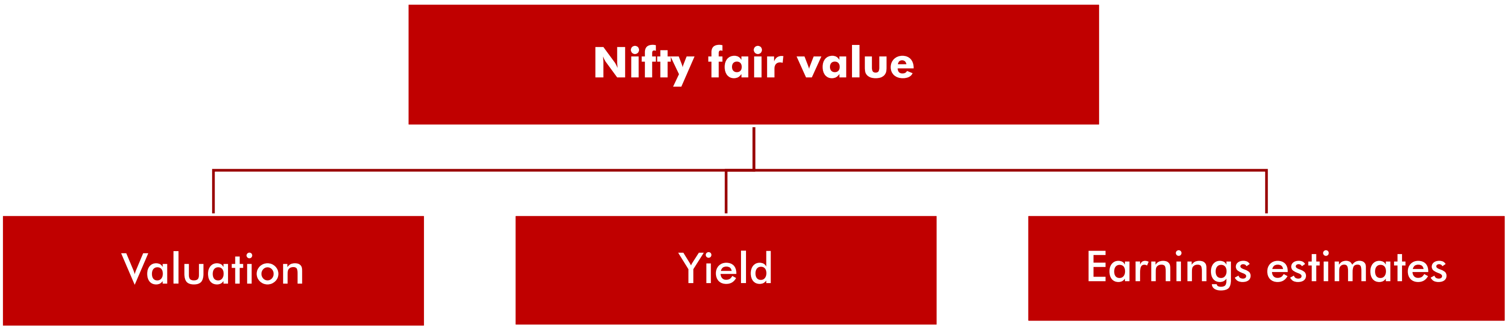


Source: Bloomberg, Ambit Capital research. Latest data as of 18th Oct'23

What is Nifty EYBY Gap implied "fair value"?

Nifty fair value is a function of valuation, yield and EPS estimate, each of which seems to have turned worse since May-23. We roll forward Nifty target to Sep-24. Nifty consensus Sep-24 EPS estimate stands at INR1041; we assume a ~7% cut and our estimate stands at INR970. Six months into the financial year, Nifty FY24 estimates have already been cut by 3.9%, higher than FY22-23 and, hence, a slightly higher cut to consensus in our estimation. This is on expected lines as EPS downgrades occurred in IT, Metals and O&G (Reliance) in line with our house view. We marginally increase (+10bps) our 10-year yield assumption with the emergence of new risks. EYBY Gap implied Nifty fair value is 21.5k (Sep-24) at 7.2% yield, Sep-24 EPS (INR970), and markets trading at LTA (-2.7).

Exhibit 18: Drivers of Nifty fair value



Source: Ambit Capital research

EYBY Framework: At 7.2% yield, INR970 Sept'24 EPS

Revisiting the EYBY Gap Framework: In May'23, we highlighted that, unlike in FY23, Banks' contribution to FY24 earnings growth is coming off and earnings estimate sustenance is seen only in Banks and Auto. Our Nifty fair value stood at 20900 (Mar-24), which was trimmed to 20700 (Mar-24) as we cut Nifty FY24 EPS to INR930 (INR940 earlier). We re-visit our view and roll forward our targets to Sept-24.

EYBY gap measures the attractiveness of equities w.r.t bonds by comparing earnings yield (1/PE) with bond yield. Higher the earnings yield as compared to the bond yield (higher gap), the better the subsequent returns and vice-versa.

Mathematically, the earnings yield bond yield gap can be shown as:

EYBY Gap = (Earnings/Price) - Bond yield

To work out the EYBY Gap implied fair value, three inputs are required: EYBY Gap, yield, and earnings estimate (Sept-24).

Assumptions: 7.2% yield, INR 970 EPS for September 24, and Nifty trades at LTA EYBY Gap (-2.7).

How our assumptions fare? What's the change?

- **Sept'24 earnings estimate:** While the EPS estimates in FY21-23 were resilient, 1QFY24 reporting season was weak compared to last quarter. This was in line with our view that *"Earnings trajectory will likely change from FY24, with BFSI contribution to incremental EPS growth tapering to 43%"*. We see risks to Nifty's Sept'24 consensus EPS growth and have cut our estimates by 7%, in line with the decadal average cut of 8%. We roll forward our Nifty target to Sept-24, assuming cuts to the consensus earnings estimate (Sept'24) of INR1041. Our earnings assumption stands at INR970 as we roll forward one quarter from Jun-24 to Sept-24.
- **Earnings yield bond gap**: Markets can trade at expensive valuations if earnings remain robust but selecting a long-term average (-2.68) looks like an appropriate assumption. We take LTA (-2.68) as the valuation at which markets would trade.
- **Yield:** We expect yields to stay at 7.2% over next 1-year. Some risks have emerged that could put upward pressure on yields: fiscal slippage, elevated Inflation, RBI draining liquidity/OMO Sales, and reduction in global liquidity. For details, refer to Section: A culmination of favourable and unfavourable!

Putting it together

With bond yield at 7.2%, Sept-24 EPS INR970, and EYBY Gap (-2.68), the Nifty implied sustainable price level is 21460 (Sept-24).

Exhibit 19: Implied Nifty (Sept-24) for different EPS levels at 7.2% yield

Sept'24 EPS(INR)	Implied Nifty Level
950	21,018
960	21,239
970	21,460
980	21,681
990	21,903

Source: Bloomberg, Ambit Capital research

In the above scenario, we have considered yield as 7.2% and varied Sept'24 earnings. Next, we do a scenario analysis for Nifty fair value under varying conditions of earnings and yields. For instance, under conditions of Sept-24 EPS of INR980 and the 10-year yield at 7.2%, Nifty's fair valuation is ~21.7k.

Exhibit 20: Implied Nifty (Sept-24) for different yields and earnings levels

10-year yield	Sept-24 EPS(INR)				
	950	960	970	980	990
7.0%	21,991	22,222	22,454	22,685	22,917
7.1%	21,493	21,719	21,946	22,172	22,398
7.2%	21,018	21,239	21,460	21,681	21,903
7.3%	20,563	20,779	20,996	21,212	21,429
7.4%	20,127	20,339	20,551	20,763	20,975

Source: Bloomberg, Ambit Capital research. Note: Implied Nifty levels have been calculated under the assumptions: Nifty trades at LTA(-2.68), EPS and yield by equation EYBY Gap=(Nifty Level)/(Earnings)- Bond Yield

At EYBY Gap of -2.88% and Sept-24 EPS of 970, the implied Nifty level turns out to be 22,454.

Exhibit 21: Implied Nifty (Sept-24) for different EYBY Gap levels and earnings at 7.2% yield

EYBY Gap	Sept-24 EPS(INR)				
	950	960	970	980	990
-2.48%	20,127	20,339	20,551	20,763	20,975
-2.58%	20,563	20,779	20,996	21,212	21,429
-2.68%	21,018	21,239	21,460	21,681	21,903
-2.78%	21,493	21,719	21,946	22,172	22,398
-2.88%	21,991	22,222	22,454	22,685	22,917

Source: Bloomberg, Ambit Capital research

All the drivers of Nifty fair value turned worse since May 23 and we analyze each variable in detail. We also touch upon broader index valuations.

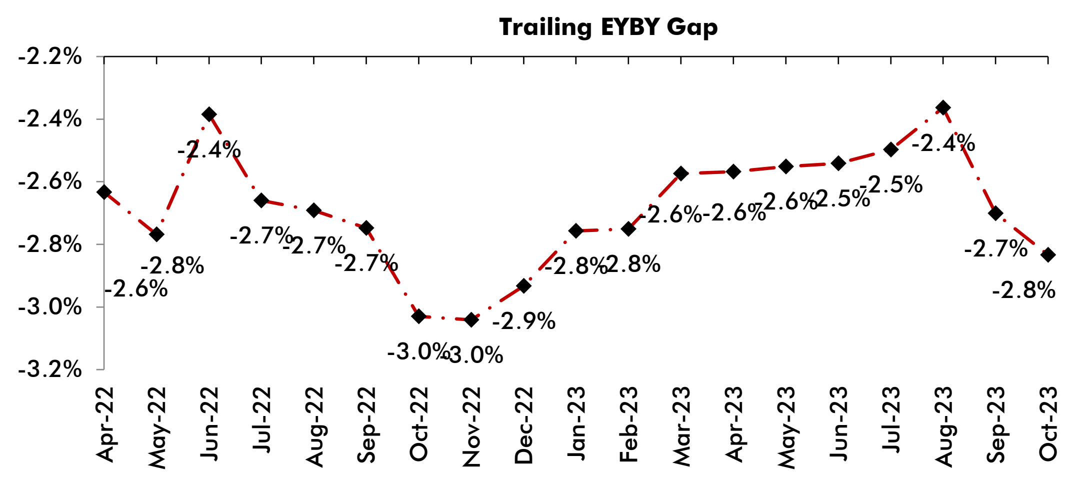
Are Indian Equities expensive?

While current Nifty valuations may give the illusion of not being expensive, the ex-BFSI universe trades at ATH valuations (ex-Covid) where earnings estimate sustainability is absent barring Auto. Nifty ex-BFSI trades at ~34% premium to BFSI. The relationship between Nifty's trailing earnings yield and India's 10-yr bond yield has been extremely tight-knit since 2021, with R-square of 86%. This is not always the case, with such correlations over the last two decades being observed in only three instances – right after the dotcom boom, GFC and taper tantrum. Thus, as yields hardened, market multiples de-rate. BSE500 P/S Valuation distribution is reminiscent of pre-GFC peaks and the divergence is much higher in broader index with NSE500 ex-BFSI trading at ~93% premium to BFSI! Downgrades to their earnings estimates worry us! The opportunity cost of investing in Indian Equities is now same as giving up investment in US treasury. In such instances, markets corrected in 2000 but stayed resilient in 2006.

At first glance, Nifty doesn't appear expensive, with EYBY Gap at (-2.83%) only slightly worse than the 10-yr average (-2.68%). Ambit India Valuation Index trades marginally above the 5-year average and doesn't appear expensive either. But, are large-caps really not expensive?

Ambit India Valuation Index is a composite of TTM PE ratio, PB ratio, India Mcap to GDP ratio and 10-year bond yield to Nifty trailing earnings yield ratio.

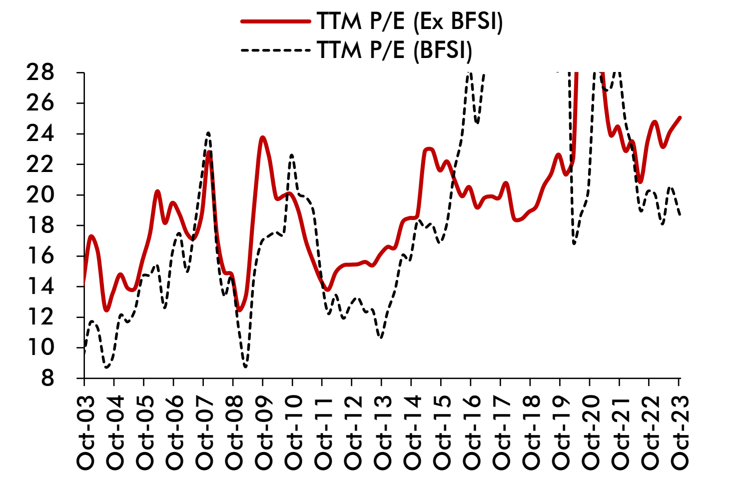
Exhibit 22: EYBY Gap is slightly worse than the long-term average



Source: Bloomberg, Ambit Capital research. Note: Latest available data as of 19th Oct'23

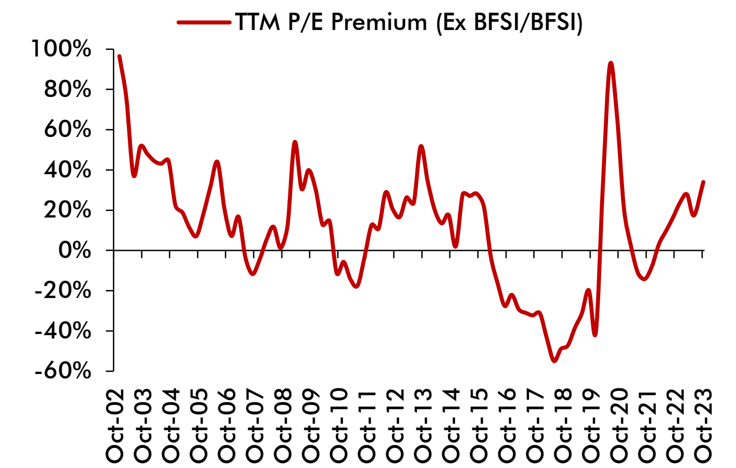
But, Nifty decomposition into BFSI and Ex-BFSI reveals that the reasonable broader index valuation is masked by subdued BFSI valuations. There is a stark divergence in Nifty BFSI and Nifty Ex-BFSI universe valuations, with Nifty ex-BFSI trading at ~34% premium to BFSI on TTM PE basis. Ex-BFSI Universe is trading at the highest valuation ever (ex-Covid period). BFSI universe is better positioned on earnings estimate sustenance compared to others, especially in a year when the earnings estimate trajectory normalization is expected and ex-BFSI valuations are close to peaks(ex-Covid period).

Exhibit 23: Dissection of Nifty in BFSI and ex-BFSI Universe



Source: Ace Equity, Ambit Capital research. Latest data as of 18th Oct'23

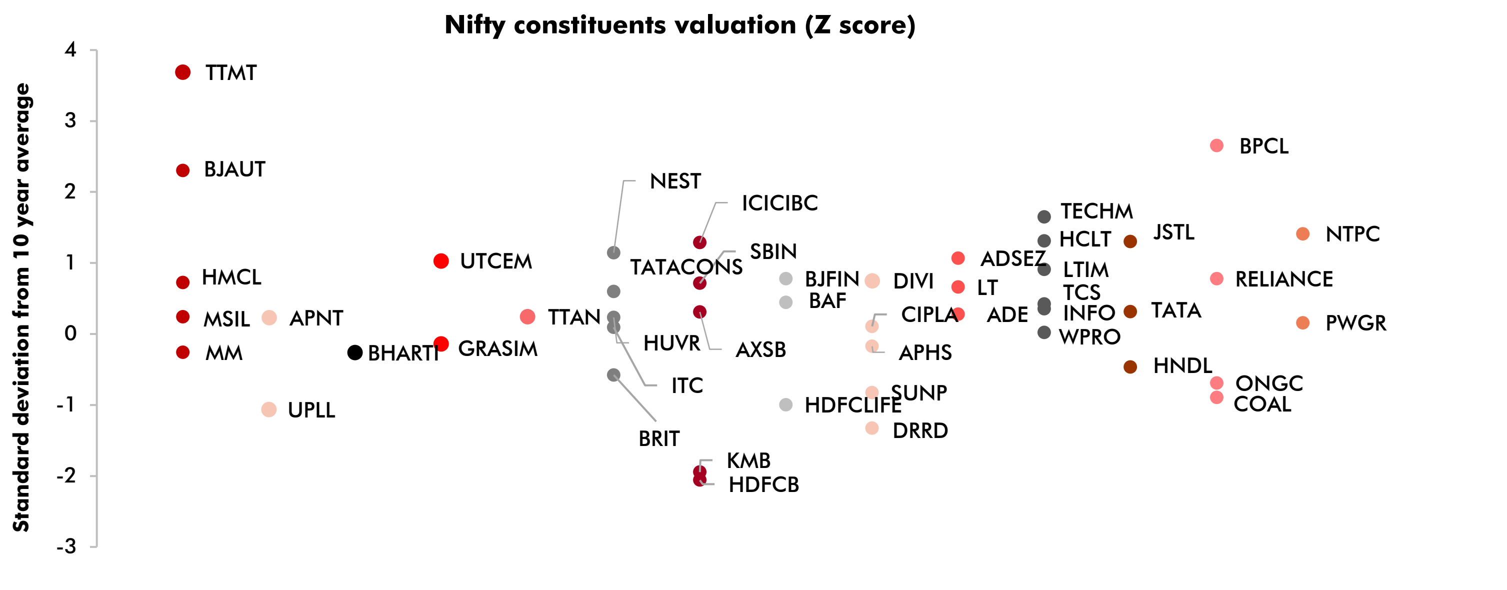
Exhibit 24: Ex-BFSI Nifty Universe most expensive than BFSI since 2015



Source: Ace Equity, Ambit Capital research. Latest data as of 18th Oct'23

The same is apparent from valuation of Nifty stocks. Banks, healthcare and PSUs dominate the Nifty universe trading below their 10-year average.

Exhibit 25: How far do Nifty constituents currently trade from 10-year average?

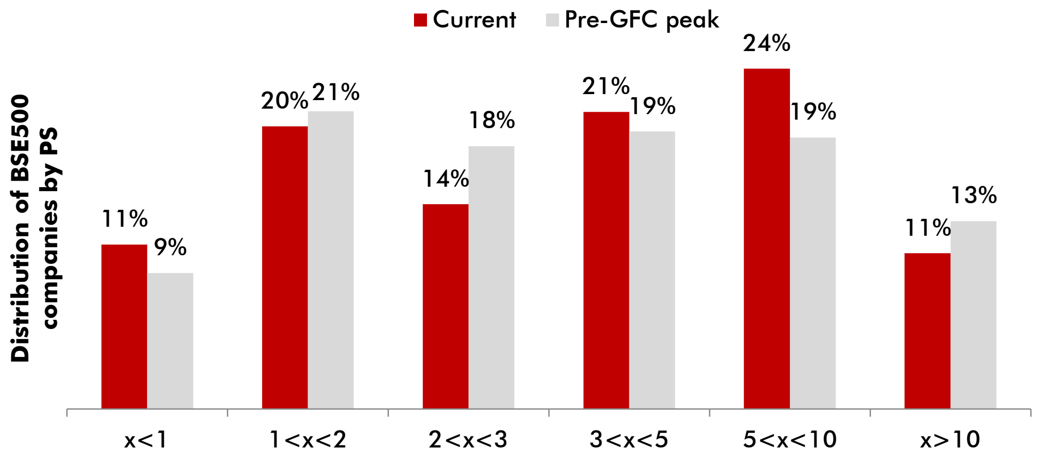


Source: Bloomberg, Ambit Capital research. Z-scores have been computed for Nifty constituents, measured as current valuation dispersion from 10-year average. TTM PE/PB/EV-EBITDA in terms of standard deviation. Latest data as of 19th Oct

For the broader BSE 500 Universe, a comparison of TTM P/S Distribution indicates that markets are quite expensive. Yes, the number of companies trading at P/S >10 is lower than the pre-GFC peak but the proportion of stocks trading in the 5<P/S<10 band is significantly higher. SMID stocks are trading at trailing EYBY Gap closer to 2017 levels.

Earnings yield bond yield gap is one of the better predictors of market returns, with ability to explain 62% of the 3-year fwd. returns

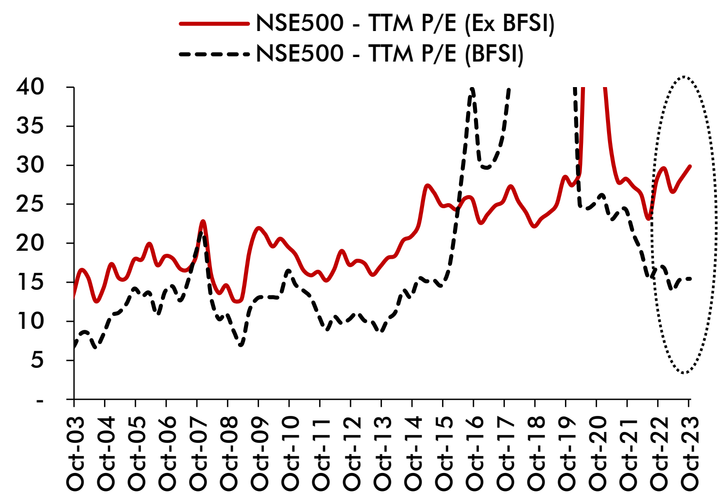
Exhibit 26: BSE500 valuation distribution is quite similar to pre-GFC peak



Source: Bloomberg, Ace Equity, Ambit Capital research. TTM sales figures have been used. Universe is BSE500. BFSI stocks have been included in this analysis. Latest data as of 20th Oct'23.

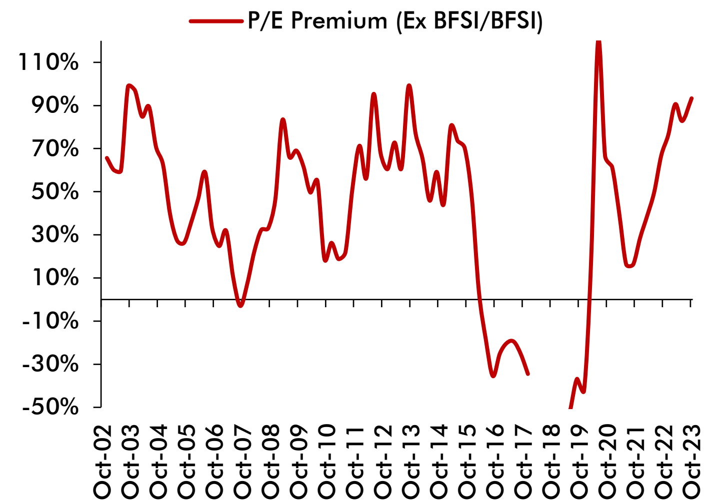
NSE500 decomposition into the BFSI and ex-BFSI universe highlights even higher divergence than Nifty. Ex-BFSI trading at ~93% premium to BFSI on TTM PE basis. Ex-BFSI Universe is trading at its highest valuation ever (ex-Covid period). Despite the BFSI universe being better positioned on the earnings estimate sustenance, the ex-BFSI universe is trading at frothy valuations with not-so-exceptional earnings growth and is witnessing downgrades in its earnings estimates. This worries us! An important question is what has been the driver of valuations and how it is getting changed.

Exhibit 27: Stark divergence in BFSI and Ex-BFSI valuations



Source: Ace Equity, Ambit Capital research. Latest data as of 18th Oct'23

Exhibit 28: Ex-BFSI valuations trading at ~93% premium to BFSI valuations



Source: Ace Equity, Ambit Capital research. Latest data as of 18th Oct'23

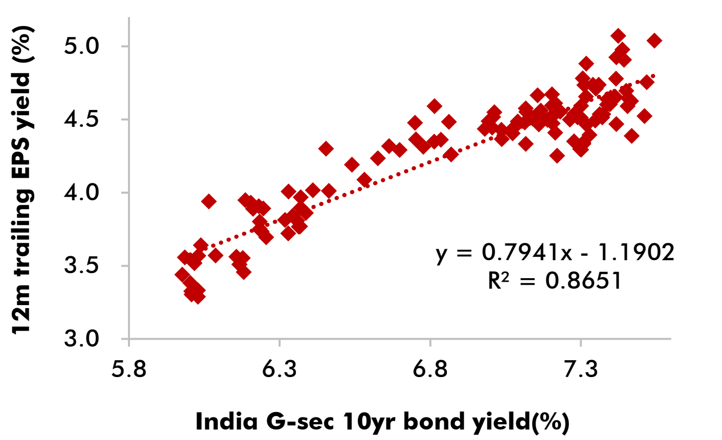
What's driving valuations? It's the yield!

While earnings growth in FY21-23 was excellent (36% CAGR for Nifty), and market returns mirror earnings growth in the long run, we notice that yields have been the driver of valuations over the last 3 years. Market valuations are a function of three variables: risk-free rate (often the same as country's 10-year yield), risk premium and implied growth.

R-square is how much percentage of variance in Y (dependent variable- EY) can be explained by X (the independent variable-BY).

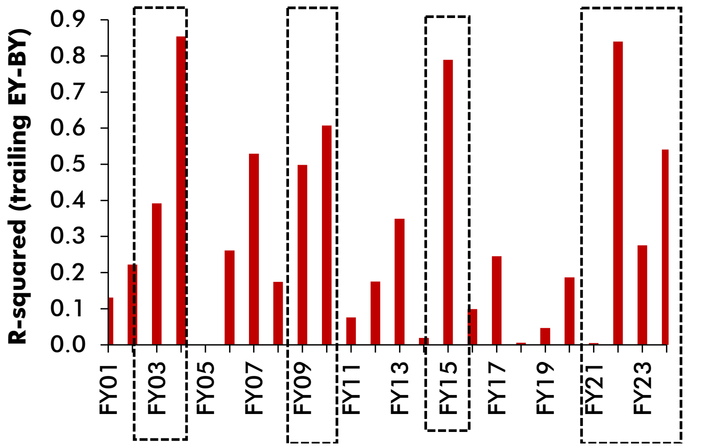
Our analysis reveals that the relationship between Nifty's trailing Earnings yield and India's 10-year bond yield has been extremely tight-knit since 2021, with an R-square of 86%. This is not always the case for valuations! Since 2000, such correlations were observed in only three instances – right after the dot-com boom, GFC and taper tantrum, when central bank policy changes have been the most dominating factor for the market. And, as such deciphering yield trajectory is key for gauging market direction!

Exhibit 29: An extremely close relationship between Nifty trailing EY vs India G-sec 10-yr (Since Apr'21)



Source: Bloomberg, Ambit Capital research

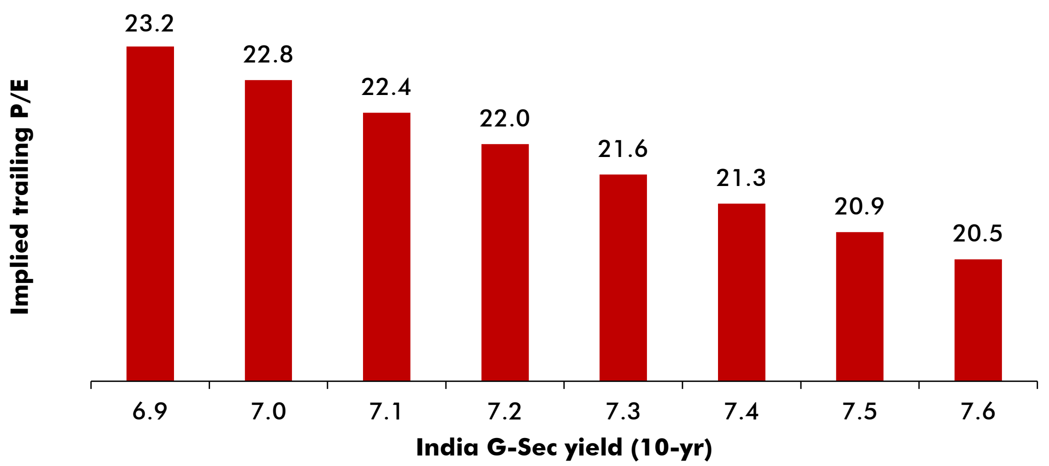
Exhibit 30: R-square in line with historical precedents of dot-com boom, GFC and taper tantrum when central bank policy was the dominating factor



Source: Bloomberg, Ambit Capital research

Given the high correlation between equity valuation and bond yield, we can use bond yields to arrive at market valuations. By applying the slope and intercept of the linear relationship between EY and BY, the implied Nifty TTM P/E would be 21.4x for current yield at 7.37%, which is 6% lower than current Nifty TTM P/E (22.8x). The relationship clearly shows that Nifty index movements have been based on changes in bond yield. As seen below, as yields hardened, market multiples de-rate. And, we do see risks to yield. A hardening of ~10bps yield in the short term can de-rate market multiples by ~2%. The sensitivity analysis put things into perspective.

Exhibit 31: Implied P/E using the above equation, is 6% lower than current P/E !

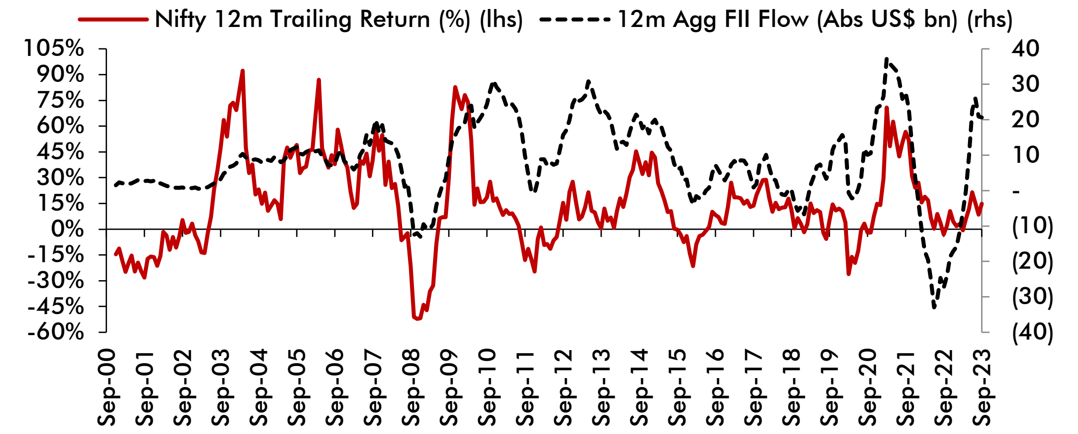


Source: Ambit Capital research

Do elevated US yields impact Indian equities?

With US yields at a 15-year high, their attractiveness w.r.t. Indian equities is also at the highest level in one and a half decades. Indian equities' earnings yield has slipped below US 10-year bond yield. This can negatively impact FII flows as investors can shift their allocation away from EM equities to US bonds. A shift of money out of Indian equities towards US bonds can cause a market correction as FIIs continue to be the driver of market returns.

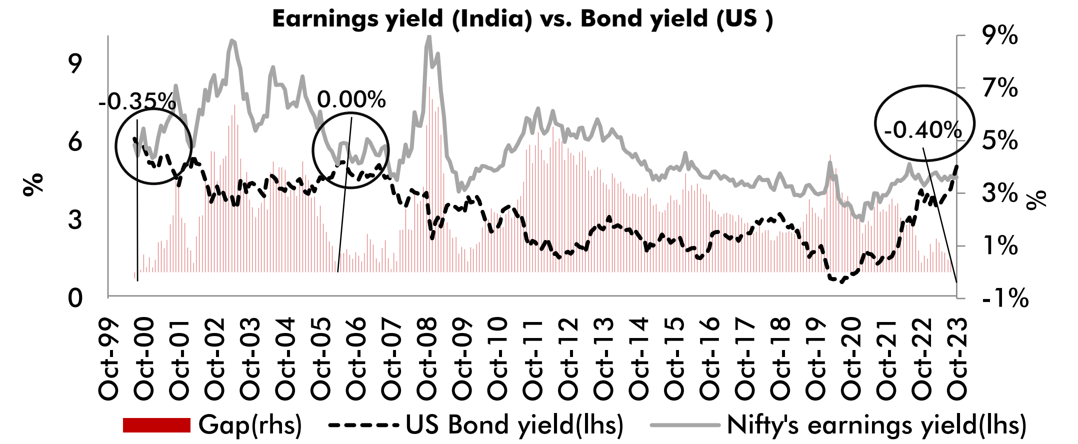
Exhibit 32: FII flows and market returns are correlated



Source: Bloomberg, Ambit Capital research

Historically, the spread between India's earnings yield and US bond yield has remained positive, except for two instances 2000 and 2023. For the third time, the spread between Nifty's earnings yield and US 10-year yield has become negative at -0.40%, an extreme event! We investigate the information content in these extreme events.

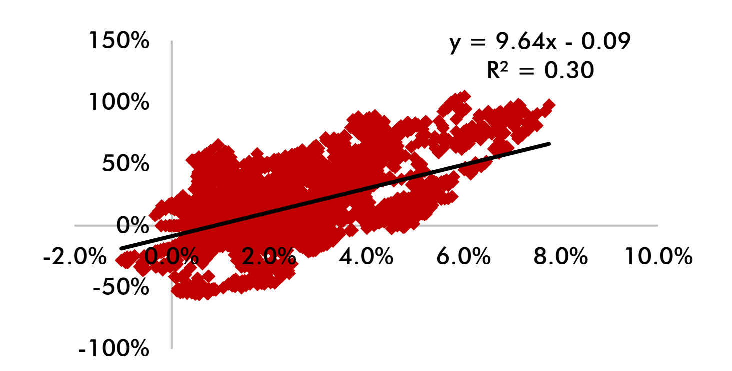
Exhibit 33: Spread between India's earnings yield and US bond yield has turned negative for the third time in last 2 decades!



Source: Bloomberg, Ambit Capital research

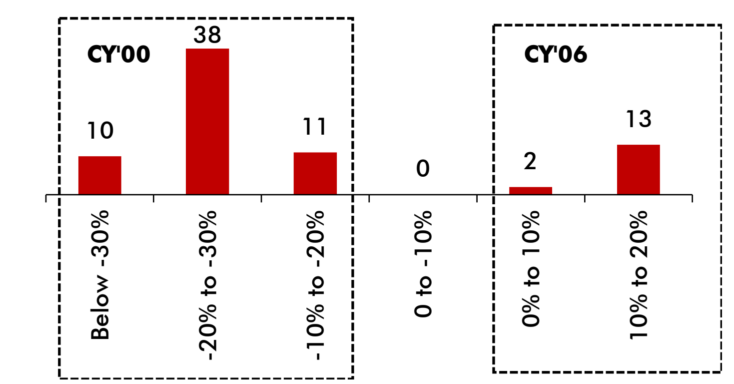
We notice that this EYBY spread has some predictive power for forecasting 1-year returns. In 2000, when the spread turned negative the market corrected while in 2006 it didn't. If yields strengthen further, the expensive Indian equities can de-rate.

Exhibit 34: Correlating Indian earnings yield and US bond yield spread with Nifty 1-yr forward returns



Source: Bloomberg, Ambit Capital research

Exhibit 35: "1-year fwd. return" distribution of instances when spread turned negative



Source: Bloomberg, Ambit Capital research

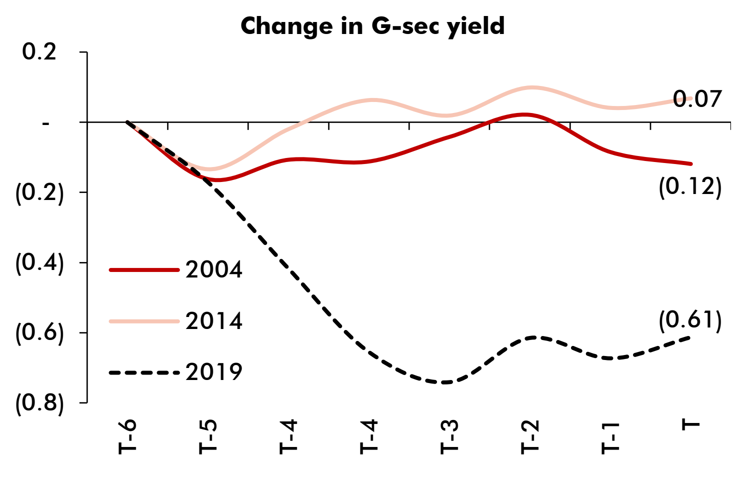
Yields: A culmination of favourable and unfavourable!

We see risks of yield hardening and increase our assumption to 7.2% (+10bps, Sept'24). While we understand that yields stay benign before elections, yield-repo spread at "rate hike" cycle end is 50-60bps, demand from insurance companies remains robust and inclusion of India in the JP Morgan bond index is a positive, risks have emerged! Fiscal slippage, "elevated inflation" lessening hopes of rate cuts, lower liquidity surplus, and contracting global liquidity led by FED balance sheet contraction are expected to put upward pressure on yields, which in turn can drive multiple derating.

What's favourable?

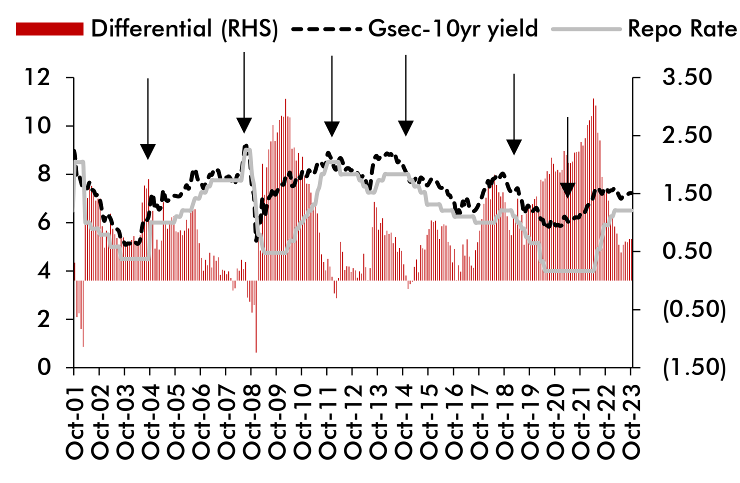
We observe that in the 6 months leading to general elections (2004-19), G-sec softened in 3 out of 4 instances. Why can this year be different? Real rates have turned positive and look adequate even if inflation remains sticky. Additionally, at the end of the rate hike cycle, the spread between the policy rate and the 10-year yield has been mostly lower than the 10-year average/median spread (99/111bps) in most instances.

Exhibit 36: Evolution of 10-yr yield before general elections



Source: Bloomberg, Ambit Capital research. Note: T pertains to April of the election year, 2009 witnessed massive cuts in the repo and G-secs post-GFC crisis and hence it was excluded from the above charts.

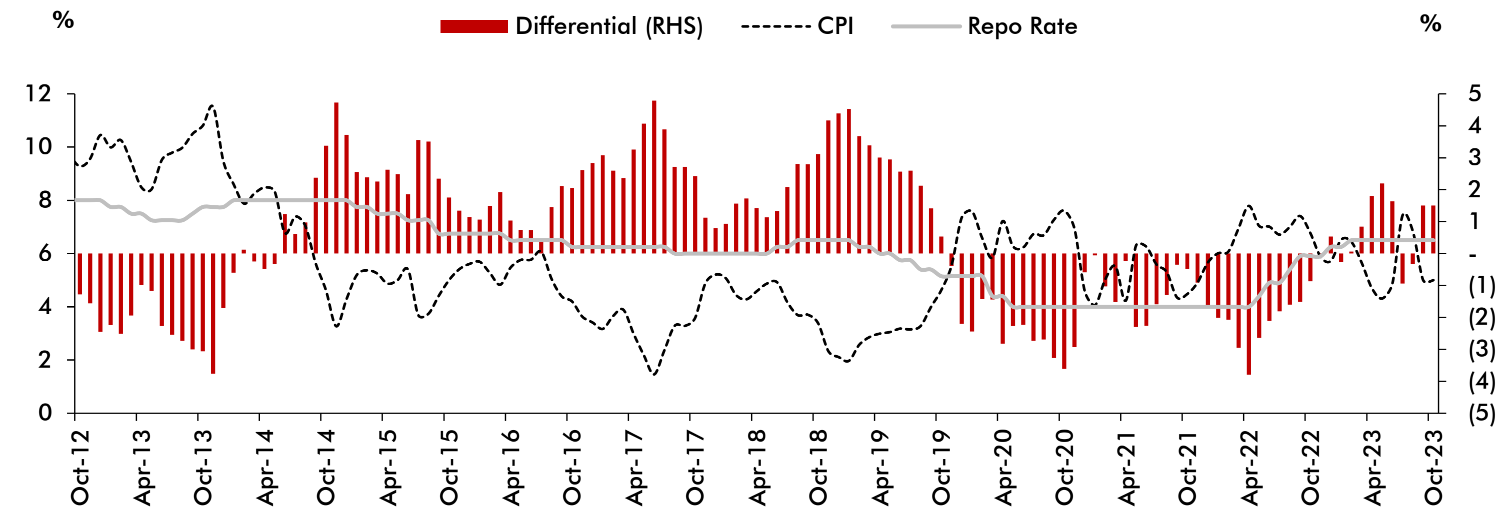
Exhibit 37: Spread at the end of the rate hike cycle has been lower or at most equal to 10-yr avg/median of 99/111bps



Source: Bloomberg, Ambit Capital research

Secondly, CPI eased to 5% YoY in Sept'23 as vegetable prices moderated and the real rate returned to positive territory (1.5%). Our economist believes that elevated cereal and pulses prices remain a concern and inflation would average 5.5-5.7% in FY24. This is 10-30bps higher than MPC's estimates and 150-180bps higher than MPC's target rate of 4%. Thus a 6.5% terminal repo rate would yield a (80-100bps) real positive policy rate, which looks adequate. This suggests that even if inflation remains sticky, RBI need not keep raising policy rates.

Exhibit 38: Real interest rates should yield ~100bps even if higher end of CPI FY24 estimates are factored in



Source: Bloomberg, Ambit Capital research

Thirdly, demand from life insurance companies remains robust. Statutory requirements require financial institutions such as banks and insurance companies to hold government securities. While SLR for banks is ~18% of the NTDL, insurance companies have to invest at least 25% of their funds in the central government securities.

Exhibit 39: Insurance companies have statutory requirements to hold G-secs

Percentage of funds as per IRDAI regulations	Life Insurance Companies	Pension and annuity funds	General Insurance Companies
Central Government Securities	Not less than 25%	Not less than 20%	Not less than 20%
Central Government Securities, state government, and other approved government securities	Not less than 50% (including above)	Not less than 40% (including above)	Not less than 30% (including above)
Housing and Infrastructure	Not less than 15%		Not less than 15%
Other Approved Investments	Not exceed 50%	Not exceed 60%	Not exceed 70%

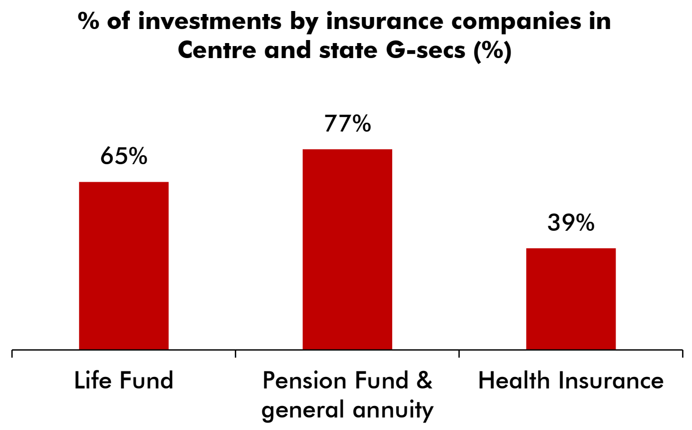
Source: Bloomberg, Ambit Capital research

Over CY16-22, insurance penetration increased from 3.4% to 4.2% and the share of central government G-secs held by insurance companies increased by 389bps during the period. The increase in demand for G-Secs in the last 3 years has been a function of the emergence of non-participating products as a category. This is unlike CY00-18 when private life insurance was dominated by ULIP. Non-par products also enjoyed tax benefits such as exemption on both, premium payments and returns, but the latter's exemption has been removed in the latest budget.

Non-par products are fixed benefit products that result in life insurance purchasing G-secs. ULIPs have a higher equity mix, unlike non-par products which are purely backed by G-secs/ fixed benefit products

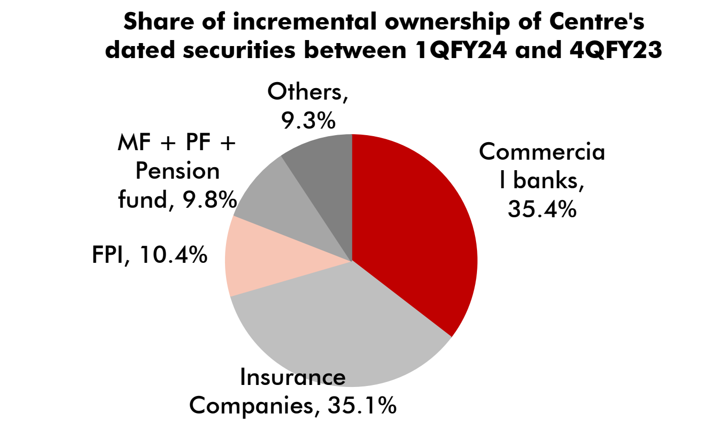
The tax changes announced in the 2023 budget had a limited impact on life insurers' ability to grow premiums, with all private players seeing strong new business premium growth over 5MFY24. Further, HDFC Life indicated on its 1QFY24 conference call that the drop in high ticket size policies due to tax changes was only 1-2% in the first quarter. Our channel checks suggest premiums being divided across different members of the family and policies being sold to people between 45-50 years of age, who will retire within the policy period, is keeping demand for non-par products elevated.

Exhibit 40: Insurance companies invest a significant % of their AUMs in G-sec



Source: IRDAI, Ambit Capital research. Note – Data as of the end of FY22.

Exhibit 41: Insurance companies continued subscribing to dated securities in 1QFY24



Source: Bloomberg, Ambit Capital research

Inclusion of India in the JP Morgan bond index is a positive

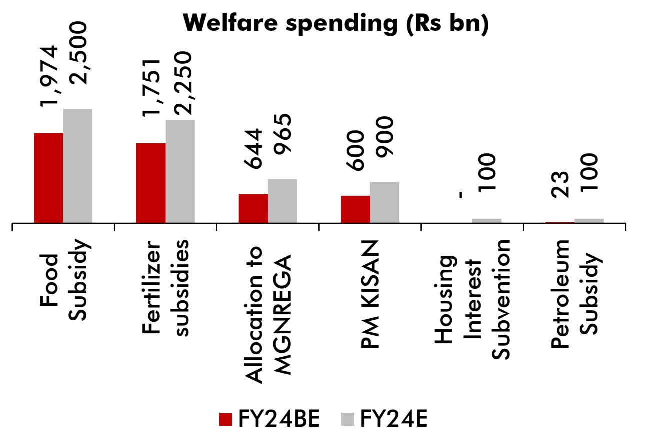
JP Morgan has communicated that it will include Indian government bonds in its widely tracked USD236bn Govt. Bond Index-Emerging Markets (GBI-EM) index from June'24. India will have a maximum weightage of 10% in the index as nearly 23 Indian G-secs worth USD330bn are eligible for the index. As a result, passive inflows of foreign capital to the tune of ~USD26bn are expected in FY25! The optimism surrounding this decision had already led to foreign holdings of the 23 eligible bonds increasing from USD7.4bn at the end of CY22 to ~US12bn in CY23YTD. Inclusion in the index is set to increase demand for G-secs, which could keep the rate range-bound! Rising inflows should help the rupee appreciate although this would be limited due to the rise in dollar index and elevated crude oil prices.

What's unfavourable?

Risks have emerged that could put upward pressure on yields: fiscal slippage, elevated inflation, RBI draining liquidity/OMO Sales, and reduction in global liquidity.

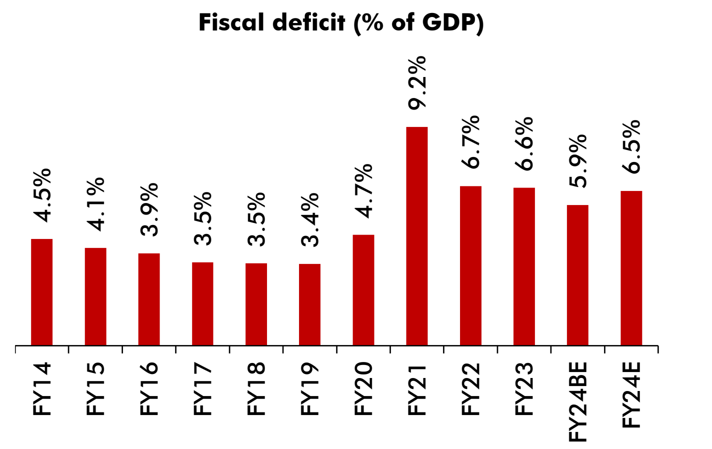
Risk of fiscal slippage: With election less than 6 months away, the government could overshoot its welfare spending targets. Incremental food and fertilizer subsidies alone could cost ₹1trn. Welfare schemes such as MGNREGA, PM-KISAN, and Housing Interest Subvention scheme (about to be announced) would also see their allocation rise significantly over the budgeted amount. Even if the government can achieve its revenue and capex targets, it would still miss its fiscal deficit target by 60bps as additional borrowing of ₹1.8trn would be required.

Exhibit 42: Welfare spending is set to increase significantly in FY24...



Source: Union Budget Documents, Media Articles, Ambit Capital research

Exhibit 43: ...which would put pressure on the fiscal borrowings of the government

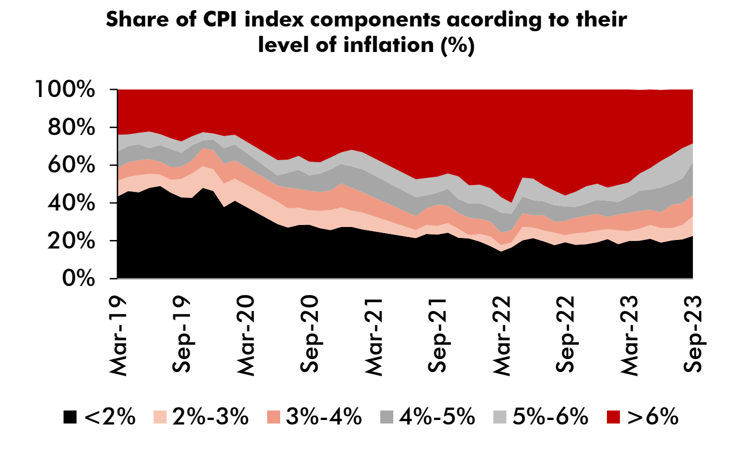


Source: Union Budget Documents, Ambit Capital research

Secondly, elevated inflation would keep policy rates high for a longer duration

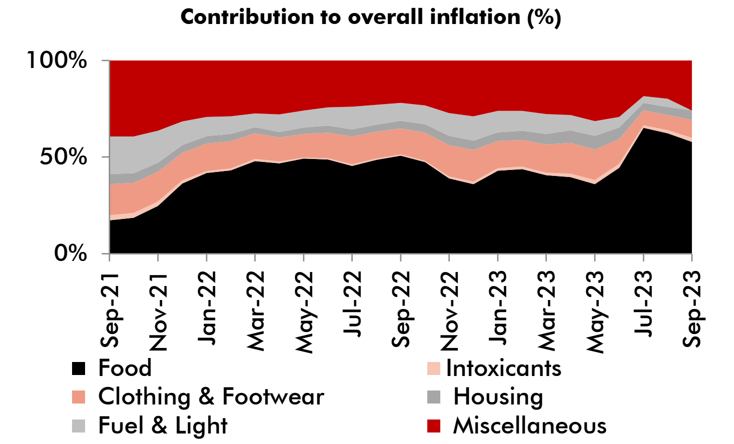
Inflation in FY23 averaged 6.7% and it was broad-based as more than half of sub-components averaged inflation above 6%. In FY24, moderation in core inflation brought down inflation to 5.5% YoY in FY24YTD. But inflation remains elevated and is being driven by food items. While major vegetables like tomato, onion, garlic etc. are expected to have normal supply by the start of 3QFY24 start, prices would remain moderate. It is the prices of cereals and pulses (staple food items) that require utmost attention and response as cereal inflation for this segment has been averaging 13% and 10% respectively (see exhibits below).

Exhibit 44: Most components continue to see inflation above RBI's target range of 4%



Source: MoSPI, Ambit Capital research. Note – Data simply represents the inflation levels faced by components in the CPI index. In Jan'19, ~40% of the components had inflation below 2% YoY

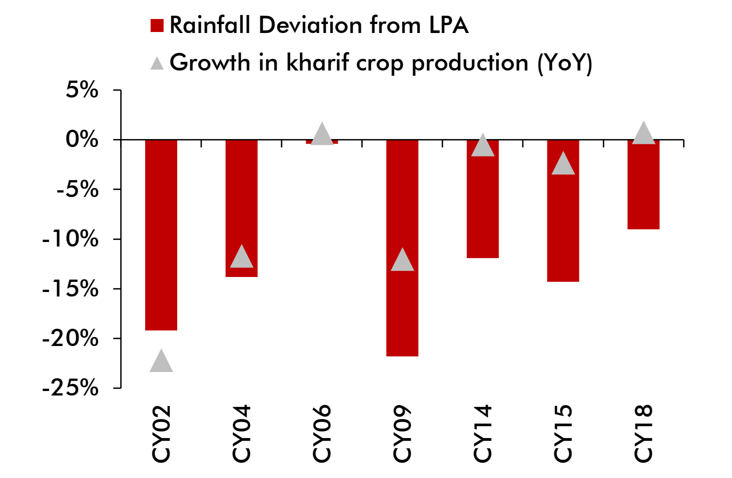
Exhibit 45: Food (45.9% share in CPI basket) is driving inflation currently



Source: CEIC, MoSPI, Ambit Capital research

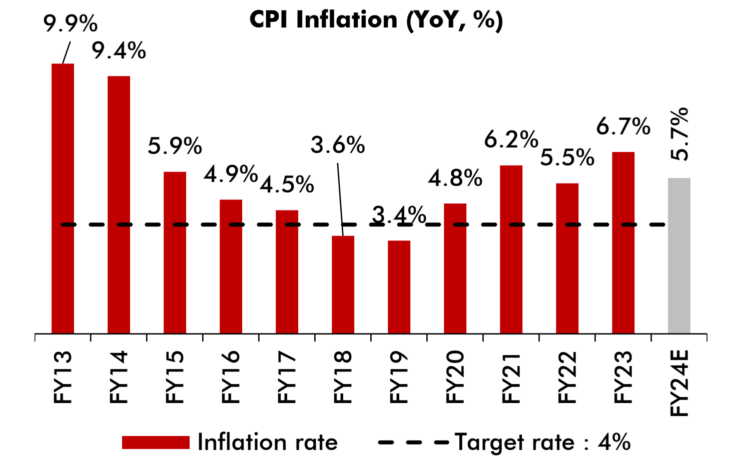
FY24 was officially an El NiNo year and its impact on rainfall was visible. SW monsoon season ended 6% lower than the long-period average. Historically observed, this does not bode well for Kharif crops. We believe cereal inflation could push CPI inflation further than MPC's estimate of 5.4% YoY.

Exhibit 46: El Nino years tend to see a fall in crop yield



Source: MoSPI, IMD, Ambit Capital research

Exhibit 47: This would bring keep the inflation elevated at 5.7% YoY (FY24E)

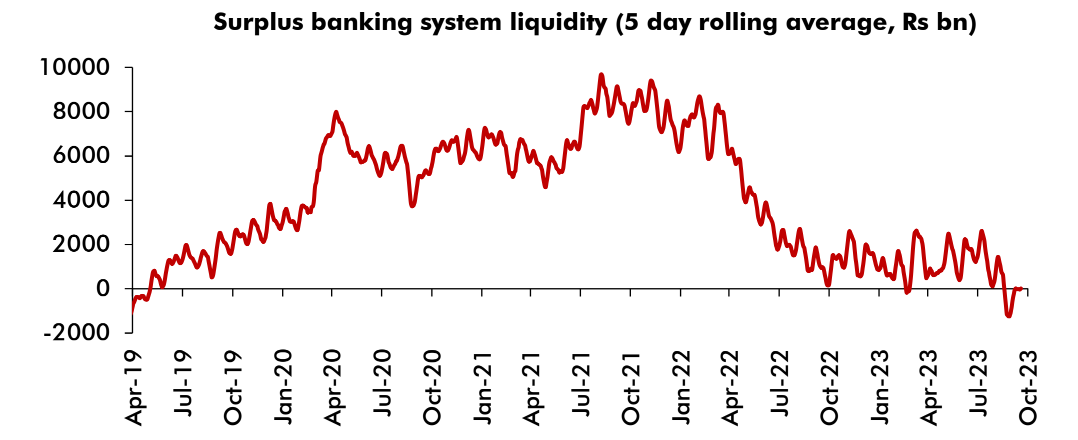


Source: CEIC, MoSPI, Ambit Capital research

Thirdly, lower liquidity surplus puts pressure on short-term yields

RBI has been using a 2 pronged approach to reduce excess liquidity – firstly, increasing the policy rates and, second, using other policy tools such as VRRR, MSF, and SDF. The calibrated approach helped RBI drain out excess liquidity (₹8-9trn) in the last 2 years.

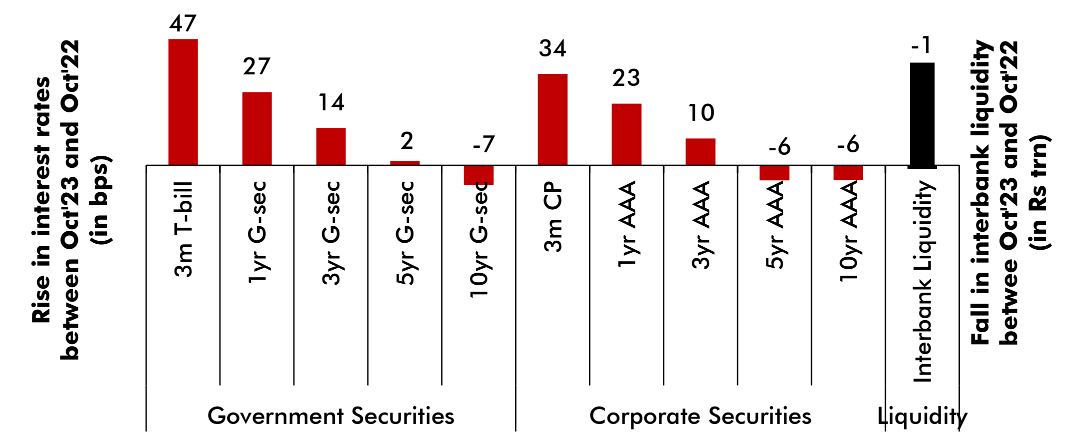
Exhibit 48: RBI has been draining surplus liquidity from the system



Source: Bloomberg, Ambit Capital research. Negative represents surplus. Note: Latest data up to 18th Oct'23

MPC's measures have led to a rise in borrowing costs, especially at the short end of the yield curve. MPC, in its recent policy meets, does not seem comfortable with the current levels of liquidity too, hence liquidity tightening measures would be exercised further.

Exhibit 49: Shorter-end yields significantly increased in the past 1 year

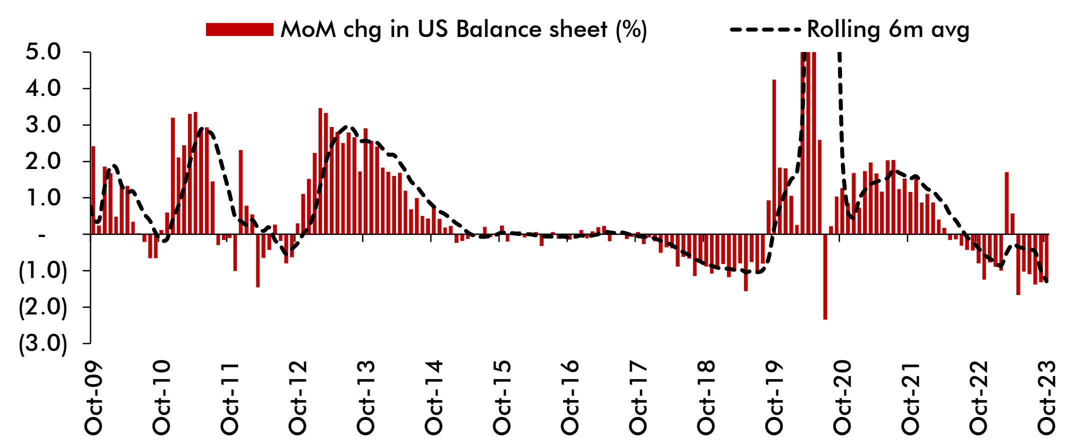


Source: Bloomberg, Ambit Capital research. Note – Data as of 18th Oct'23

...and lastly, global liquidity is contracting

Global liquidity is reducing with the Fed contracting the balance sheet which has fallen below US$8trn for the first time since June-21. For the last 6 months, the contraction has been more than 1% every month!

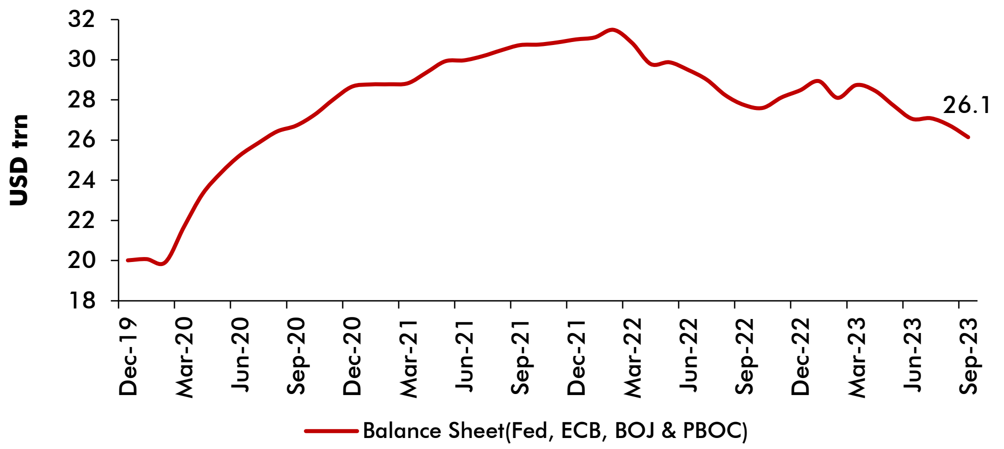
Exhibit 50: The Fed has been downsizing balance sheet



Source: Bloomberg, Ambit Capital research

In G&C 18.2: Riders on the storm, we highlighted that while the aggregate BS (in USD terms) may give an illusion of contraction, it was driven by the depreciation of Euro, Yen, and Yuan vs USD and not actual balance sheet contraction with the exception of ECB. But, this seems to have changed since May 23 with only PBOC continuing with expansion. This can impact FII flows which are a driver of market returns.

Exhibit 51: Total assets of major CBs are down 17% from ATH of USD31.5trn in Feb'22 vs 7% in May'23



Source: Bloomberg, Ambit Capital research

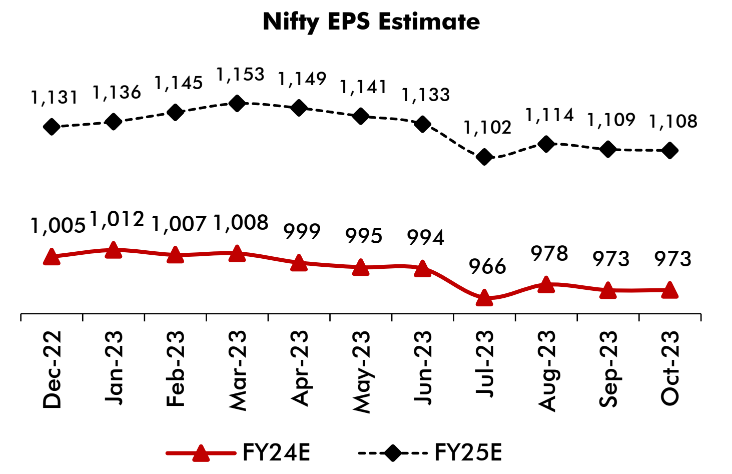
Earnings estimate trajectory holds the key

While headline Nifty EPS estimates in FY21-23 have stayed resilient, continuation in FY24 has been difficult. Nifty EPS cut 6 months into the financial year has been one of the highest in recent times. Earnings estimate cut since May-23 has been in line with our house view with IT, Metal and Reliance leading the downgrades. And, we expect this trend to continue. In "G&C 18.2: Riders on the Storm", we highlighted that growth engine "BFSI" is slowing down and its contribution to overall growth is tapering. Don't get fooled by the higher contribution of BFSI in Oct-23 vs May-23 towards Nifty FY24 EPS growth, it has been driven by sustenance while others have tapered! We see Nifty FY24 EPS at 920 (930 earlier) as compared to consensus ~INR973. While profit distribution is good, it's not great to warrant such frothy valuations! We also notice earnings estimates are more sustainable in large-caps as compared to mid-caps!

Evolution of earnings

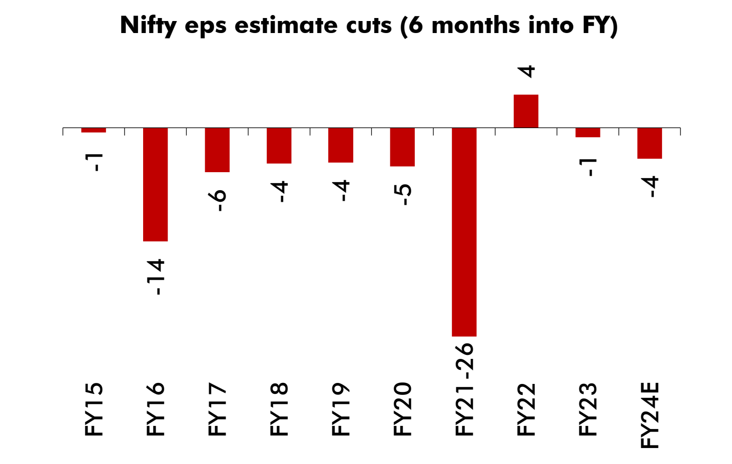
Since Jun-end, Nifty FY24 EPS/FY25 EPS estimates have been cut by ~2.2%! In May-23, IT, Metals and Reliance were expected to contribute ~20% of incremental EPS growth. Currently, their contribution is 0%! In the 1QFY24 reporting season, IT and Metals led downgrades and we expect this trend to continue.

Exhibit 52: Nifty FY24/25 earnings estimate has been cut by 2.2% since Jun-end



Source: Bloomberg, Ambit Capital research

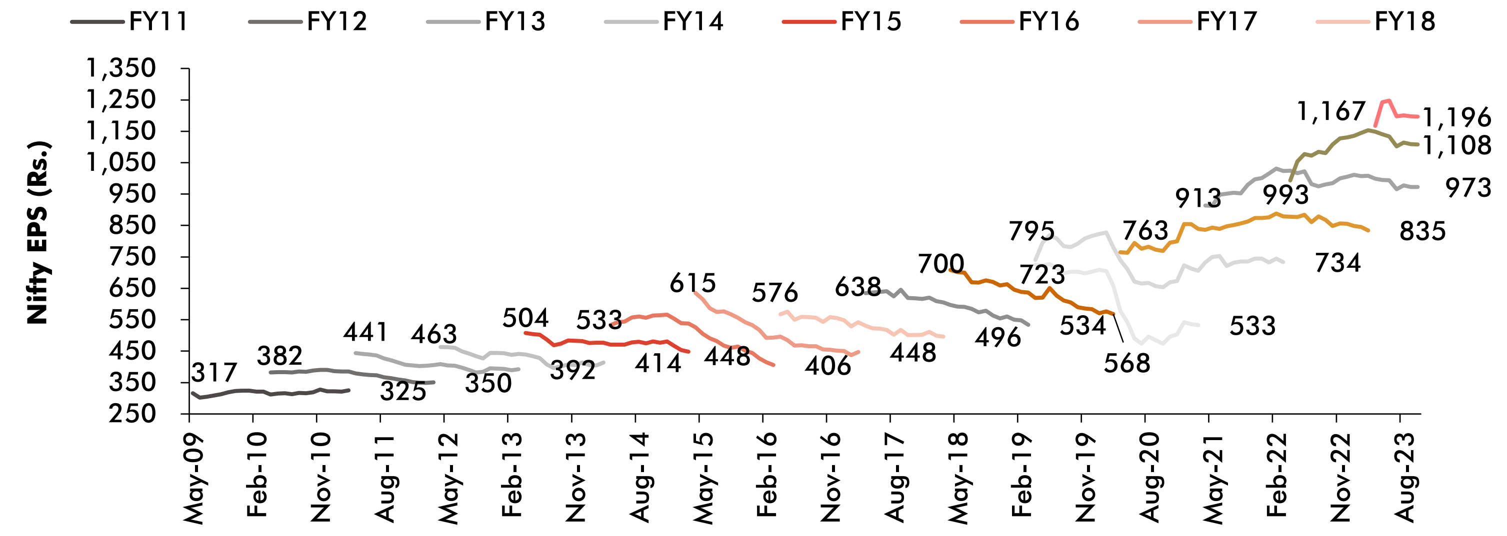
Exhibit 53: EPS trajectory no longer same as FY22-23



Source: Bloomberg, Ambit Capital research

How have EPS trajectories evolved? Since FY12, Nifty earnings estimates have been revised downwards every year as we move into the year. Our analysis indicates that in any financial year, EPS estimates have, on average, been revised downwards by 16% over the last 2 years (t-24 to t) and by 8% on average over the last 1 year. FY24/25 trajectory which was earlier trending upwards, has begun to fade!

Exhibit 54: Optimism in the market has begun to fade



Source: Bloomberg, Ambit Capital research

Additionally, earnings delivery breadth has been poor, even if Nifty aggregate earnings are delivered. For instance: In FY22, Nifty headline earnings estimate sustained, but the breadth of earnings delivery remained poor. Over the last decade, only ~23 % (median over FY12-22) of the Nifty constituents have been able to deliver earnings estimates at the start of the financial year (t-12), suggesting that earnings estimates sustenance is a rarity. Additionally, only ~4% of Nifty constituents (median over FY12-22) have beaten earnings estimates at the start of the fiscal by 25%.

Exhibit 55: Breadth of Earnings delivery remain poor

Deviation	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23
Below -50%	16%	12%	12%	20%	29%	19%	18%	14%	24%	10%	6%	10%
-25% to -50%	10%	14%	20%	24%	19%	17%	10%	14%	16%	18%	10%	22%
0 to -25%	43%	34%	34%	37%	44%	40%	42%	47%	41%	37%	40%	36%
0% to 10%	24%	24%	16%	14%	2%	8%	12%	14%	10%	12%	20%	20%
10% to 25%	4%	12%	10%	2%	4%	4%	4%	10%	2%	12%	6%	8%
25% to 50%	2%	2%	4%	0%	2%	8%	12%	0%	2%	0%	8%	2%
50% and above	0%	2%	4%	2%	0%	4%	2%	0%	4%	10%	10%	2%

Source: Bloomberg, Ambit Capital research

"Growth Engine-BFSI" slowdown and earnings cuts in other sectors can drive normalization of earnings trajectory!

- Nifty FY24 "earnings growth" contribution analysis comparison between May-23 and Oct-23 suggests that only BFSI continues to hold the fort.
- Amongst Nifty, Banks earnings will grow at 18% in FY24 compared to 37% in FY23. While BFSI drove the bulk of FY23 earnings growth (+190%), they will contribute only 61% of FY24 earnings growth (42% in previous G&C); other contributors are Auto (14%), and O&G (12%).
- Risks to "Tech earnings" remain with the expectation of revenue growth normalization to the pre-Covid period and developed economies' GDP growth estimates tapering. In O&G, Reliance earnings are geared to petchem margins and are at risk, hingeing on China's recovery. Likewise, for Metals. We expect limited growth surprises and some softening of FY24 growth expectations in IT.
- Thus, Nifty FY24 EPS growth would be lower than 18% (current estimate), especially when earnings estimate sustenance is seen only in Banks and Auto.

Exhibit 56: Earnings Growth Contribution Analysis - May'23: Since then, only BFSI has held fort

Sector	Free float Weight	Contribution to Earnings Growth (%) FY23	FY24E	FY25E
BFSI	38%	195%	42%	43%
IT	13%	20%	7%	10%
Oil and Gas	12%	-42%	14%	8%
Consumer	11%	0%	4%	5%
Auto / Auto Anc	6%	58%	13%	8%
E&C / Infra / Cap. Goods	5%	14%	5%	6%
Metals and Mining	3%	-174%	5%	8%
Utilities	2%	-4%	2%	2%
Pharma	3%	22%	2%	3%
Cement	2%	-8%	1%	1%
Telecom	2%	12%	3%	5%
Retail	1%	4%	0%	1%
Healthcare	1%	-1%	0%	0%
Chemicals	0%	4%	1%	1%

Source: Bloomberg, Ambit Capital research

Exhibit 57: Earnings Growth Contribution Analysis - Oct'23: More cuts in Nifty FY24/25 expected

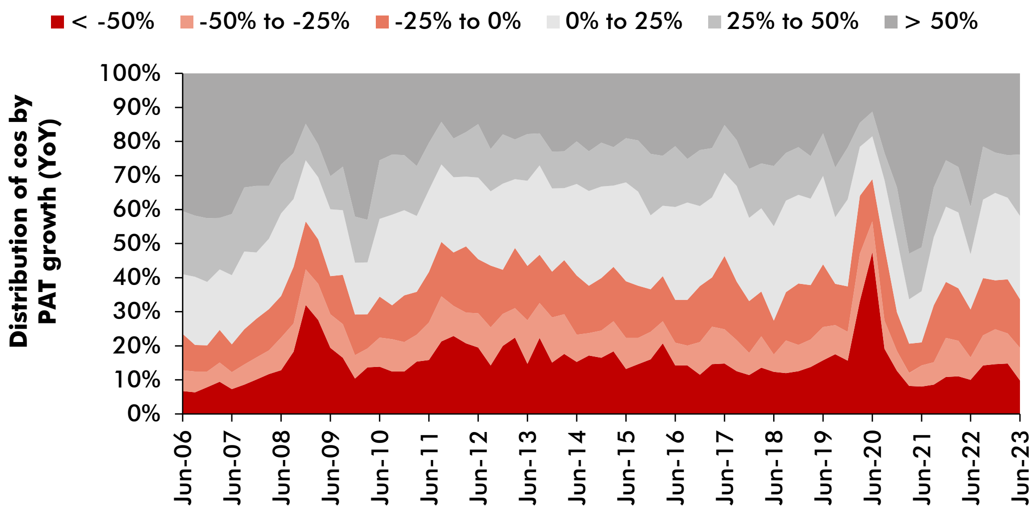
Sector	Free float Weight	Contribution to Nifty EPS growth FY23	FY24E	FY25E
BFSI	36%	190%	61%	45%
IT	14%	25%	-1%	11%
Oil and Gas	10%	-50%	12%	5%
Consumer	11%	3%	2%	5%
Auto / Auto Anc	6%	72%	14%	5%
E&C / Infra / Cap. Goods	6%	7%	3%	6%
Metals and Mining	4%	-174%	3%	9%
Utilities	2%	-1%	1%	2%
Pharma	3%	22%	1%	2%
Cement	2%	-8%	2%	2%
Telecom	3%	11%	3%	5%
Retail	2%	3%	0%	1%
Healthcare	1%	-1%	0%	1%
Chemicals	0%	-1%	0%	1%

Source: Bloomberg, Ambit Capital research. FY23 numbers are different then the published May'23, owing to the completion of 4QFY23 earnings results

Is earnings momentum dying?

In our note "[Too much, Too Fast",]() we highlighted that the PAT growth distribution for mid-cap and small-cap indices is nothing extraordinary that warrants such frothy valuations. We assert the same for the broader index BSE 500: "Good but not Great" Profit distribution.

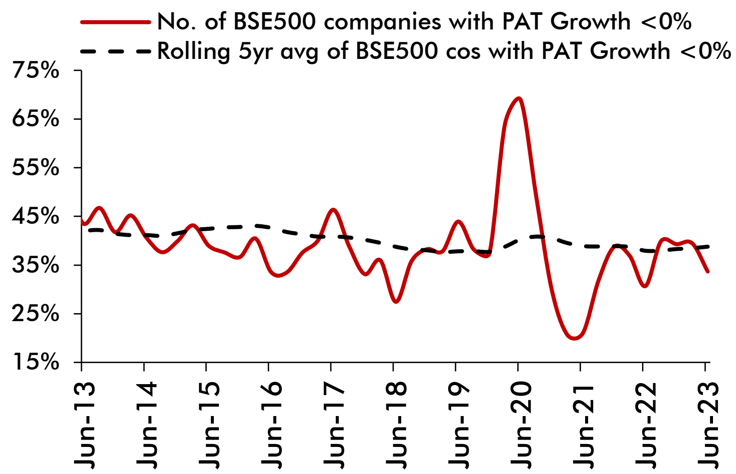
Exhibit 58: "Good but not Great" profit distribution



Source: Ace Equity, Ambit Capital research Note: BSE500 Index under consideration

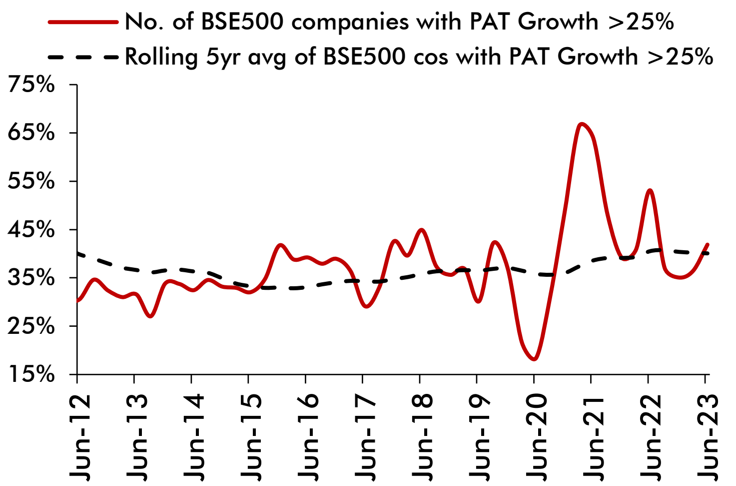
The PAT growth distribution is "Good but not great". The percentage of companies posting extraordinary PAT growth (>25%) in BSE500 is only marginally higher than history whereas number of companies posting losses is only slightly lower as compared to history.

Exhibit 59: Proportion of companies reporting PAT decline is lesser than LTA...



Source: Ace Equity, Ambit Capital research

Exhibit 60: ...and companies delivering exceptional PAT growth are marginally above LTA



Source: Ace Equity, Ambit Capital research

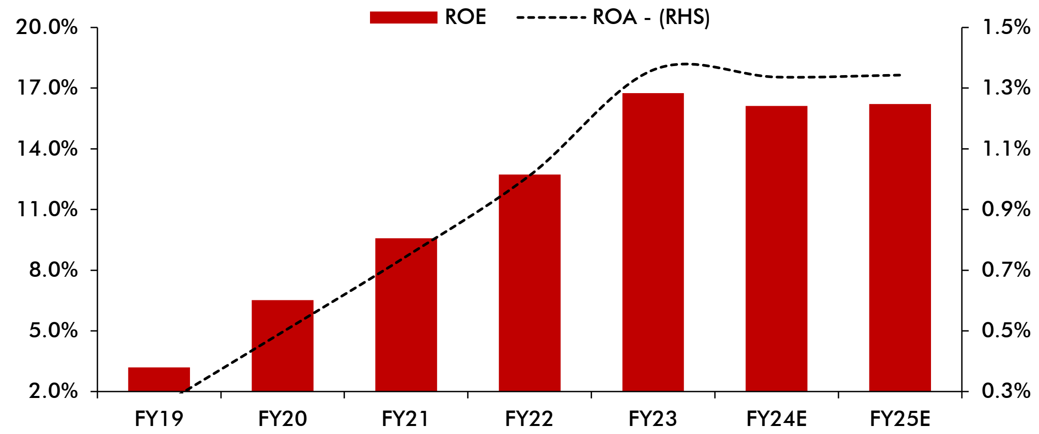
Exhibit 61: Heavyweight sectors in mid-caps witness accelerated downgrades (FY24) compared to large-caps & small-caps

Sector Name	FY24 EPS- Change since Jun			Weights		
	Large-cap	Mid-cap	Small-cap	Large-cap	Mid-cap	Small-cap
BFSI	1%	2%	5%	33.3%	22.7%	18.5%
Capital Goods	2%	1%	-2%	6.4%	8.8%	18.0%
Healthcare	4%	-3%	0%	3.7%	10.1%	10.7%
Chemicals	-17%	-10%	-8%	0.9%	5.9%	6.0%
Auto and Auto Anc	4%	0%	1%	6.6%	9.7%	3.7%
FMCG	-2%	-9%	-1%	12.2%	4.7%	5.5%
Miscellaneous	-2%	-1%	-2%	0.7%	4.6%	12.3%
IT	-5%	-3%	1%	11.8%	6.3%	6.9%
Metals and Mining	-8%	3%	5%	3.7%	2.0%	3.8%
Oil and Gas	0%	0%	13%	9.7%	2.9%	1.3%
Consumer Durable	-6%	-9%	-2%	0.3%	2.7%	2.4%
Real Estate	0%	-2%	-3%	0.3%	3.4%	1.7%
Utilities	0%	5%	-6%	3.3%	1.8%	1.3%
Cement	-4%	-5%	-10%	1.6%	2.5%	0.9%
Building Materials	4%	0%	1%	1.9%	3.0%	1.0%
Media	N/A	-3%	10%	0.0%	2.7%	3.3%
Textiles	N/A	-1%	-10%	0.0%	1.6%	1.7%
New-age tech	-42%	-27%	7%	0.7%	2.7%	0.5%
Telecom	-11%	4%	N/A	2.4%	1.8%	0.6%
Aviation	50%	N/A	N/A	0.3%	0.0%	0.0%

Source: Bloomberg, Ambit Capital research

What are "drivers" of earnings telling us?

Exhibit 62: Strong fundamentals do not reflect in valuations for banks



Source: Company, Ambit Capital research. Note: We have considered the weighted average growth of large banks (ICICIBC, AXSB, KMB, SBI)

Exhibit 63: FMCG volume growth to remain weak due to macro headwinds and sub 2-3% real wage growth

	2QFY22	3QFY22	4QFY22	1QFY23	2QFY23	3QFY23	4QFY23	1QFY24	2QFY24E
BRIT	6%	13%	13%	9%	21%	17%	13%	8%	4%
DABUR	12%	8%	8%	8%	6%	3%	6%	11%	9%
HUVR	11%	10%	11%	20%	16%	16%	11%	6%	4%
GCPL	9%	8%	7%	8%	7%	9%	10%	10%	6%
MRCO	22%	13%	7%	1%	3%	3%	4%	-3%	-1%
NEST	10%	9%	10%	16%	18%	14%	21%	15%	13%
TATACONS*	13%	0%	-1%	3%	-2%	-5%	8%	10%	11%
TATACONS**	23%	16%	19%	19%	29%	29%	26%	24%	16%

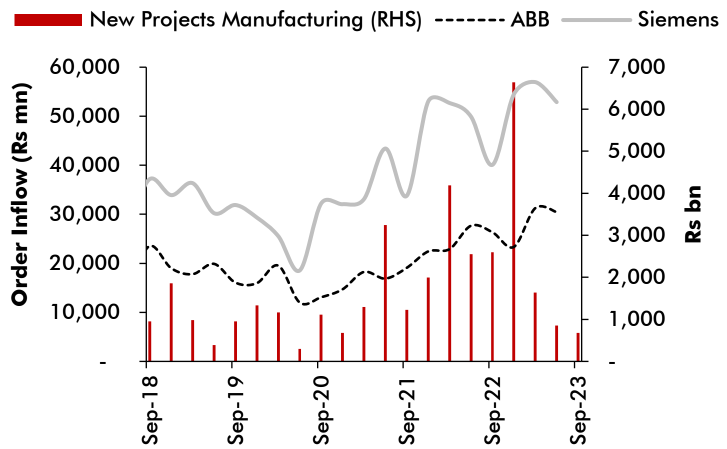
*Source: Company, Ambit Capital research. * Denotes India Beverage and ** denotes India Foods*

Exhibit 64: Sensitivity analysis of RIL's EPS at different Petchem assumptions; our base case is US$440/T

Sensitivity analysis of RIL's EPS		
Petchem Margins (FY24E) (US$/T)	**Consolidated EPS (FY24E) (INR)**	**% Change YoY (FY24E vs FY23)**
300	94	-5%
350	101	2%
400	108	9%
440	**113**	**14%**
500	121	22%
550	128	29%
600	134	35%

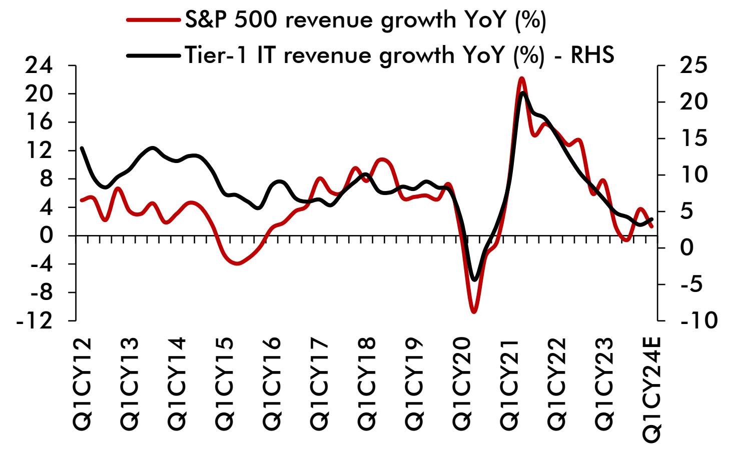
Source: Company, Ambit Capital research

Exhibit 65: High correlation of ABB/Siemens India order inflows with new project announcements data; new projects slowdown in 1HFY24 will impact orders for the sector



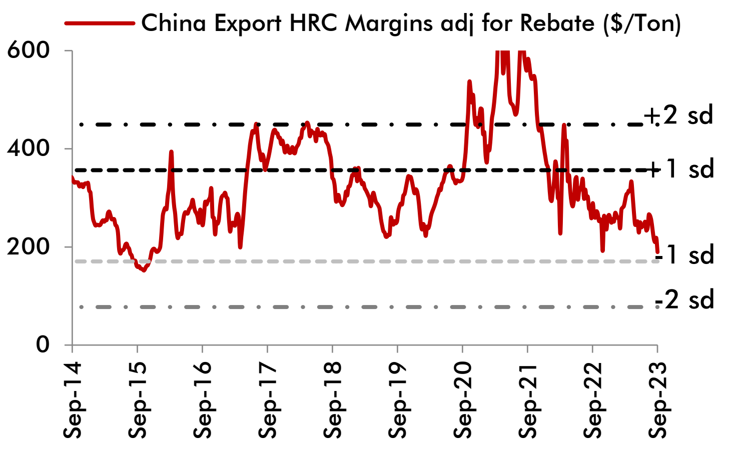
Source: Company, Ambit Capital research

Exhibit 66: Tier-1 IT revenue growth in line with S&P 500 revenue growth, which could moderate to ~4% in CY23E



Source: Company, Ambit Capital research

Exhibit 67: Margin recovery would need supply-side responses and easing of US financial conditions



Source: Company, Ambit Capital research

Banks: Returns ratios to stay strong

Loan growth momentum is sustaining at 14-15% and we expect sector growth to sustain given the broad-based nature of growth and low corporate leverage. However, NIM compression should continue for banks for the rest of FY24 with a minimum another ~30bps compression from 1QFY24 levels. Moreover, the best in asset quality is behind the sector and we expect slippages to inch up. Despite compression in NIMs and higher slippages, we expect ROE for large banks to be in the range of 16% due to provisioning buffers (60-100bps of loans) banks are carrying and margins being higher than historical average despite compression. Despite loan growth of 15%, high capital levels/provisioning buffers, and multi-year high ROE/ROA, banks' valuations are still below pre-Covid levels and long-term average for many banks.

FMCG: Volume growth trajectory to remain weak

FMCG companies' median revenue growth is expected to moderate from 11-14% seen over the last 4-6 quarters to 3-6% led by price cuts and lack of uptick in volume growth. We expect volume growth trajectory to remain weak due to macro headwinds, sub 2-3% real wage growth increase, and limited capex investment. FMCG companies have also sought to improve margins, leading to under-investment delay in pricing action across some categories. For FMCG companies to clock 10-12% revenue growth, it will be prudent to look at scalable adjacent portfolio while sacrificing near-term operating margins – we see largely only GCPL and TATACONS walking that path. Earnings growth for FMCG companies will thus be led by margin expansion (on low base) and cost-saving measures. Retail preference for GCPL>BRIT amongst BUYs and NEST>TATACONS amongst SELLs.

Oil & Gas: Past 'Peak Uncertainty', selectively optimistic

The Oil & Gas market has been dominated by high price volatility since Mar'22 due to geopolitical concerns in Eastern Europe. By now, however, some of those uncertainties are clearing up and this process will continue. This would lead to margin normalization/upgradation for Indian companies. Also, we expect oil/gas consumption to rise by 5%/9% YoY in FY24E due to improved economic outlook and an increase in domestic natural gas production. Thus, we expect FY24 earnings to be led by both volumes and margin recovery. However, RIL's earnings are highly dependent on petchem's margin rebound which puts it at high risk. OMCs' profitability would revive due to positive marketing margins and above-average refining cracks. CGDs would see twin recovery in volumes and margins. RIL's consumer businesses are bearing the brunt of a consumer slowdown, and 60% of FY23-24E EPS is driven by standalone business. We remain selective and our pecking order is OMCs (prefer IOCL over BPCL/HPCL)>ONGC>IGL. We are SELLers on RIL, GAIL, PLNG, GGas, and MGL.

Industrials: Project announcements hit record low amid capex buzz

In 2QFY24, new project announcements by the manufacturing sector declined 74% YoY to ₹677bn in 2QFY24, which is the lowest since 2007. Historically, we notice a strong correlation between new project announcement data and capital goods sector order inflows. While the past 2 years' orders have been strong, we expect the slowdown in new project announcements to reflect on order inflows of companies like ABB India and Siemens Ltd now. The strong order inflows had also led to a favourable demand-supply environment for the industrial companies, which should now normalize, leading to moderation in margins. At the same time, continued strength in government-funded infra capex until elections (especially from the States) as well as mega order wins by L&T in the Middle East hydrocarbon market are likely to keep order inflow and execution strong for L&T. Our pecking order is L&T>ABB>HWA>SIEM within our all SELL large-cap industrial coverage, while we prefer KKPC>AIAE>KKC among the mid/small-cap names.

IT: Rebound hopes to temper

Past 4 quarters have witnessed 1) growth moderation, 2) Europe/Retail join in the pain of BFSI/CMT/US, 3) stronger deal flow unlikely to drive better growth on higher leakage, short cycle deal pullback, higher deal duration, and longer deal translation to revenue, and 4) cost of growth is visible in margins as also cash flows. With growth, margins and cash generation below pre-Covid levels, we see risks to valuations of tier-1/tier-2 IT sustaining at 35%/86% premium to pre-Covid levels. We believe it is still not time to turn constructive as 1) macro demand indicators suggest growth moderation in FY24E and only a modest recovery in FY25E, 2) street margin estimates are still aggressive and we build in increases in both FY24E/FY25E, 3) cash generation weaker than pre-Covid averages across companies, and 4) implied growth rates over FY23-33E still materially ahead of pre-Covid ranges. Prefer Tier 1 over Tier 2 with HCLT/TechM our only BUYs and Mphasis preference in Tier 2.

Metals: Elongated recovery

The Metals cycle plunged from a peak in Sep'21 to near trough levels driven by the lagged impact of the global credit tightening cycle. Chinese credit impulse bottomed in Oct'21 but is now likely to stay flattish through CY23. Therefore, metals margins recovery would need support of 1) some supply response and 2) easing of US financial conditions. We do expect these to provide some support to margins though a significant rebound appears unlikely. We expect TSE to outperform given 1) relatively attractive valuations, 2) recovery in TSE margins in 2HFY24 post roll-off of energy hedges and completion of Netherlands blast furnace relining, and 3) re-rating potential from any positive trigger at TSUK. HNDL should benefit from the end of cansheet de-stocking. Metals valuations bottomed in July'22 this cycle at 0.8-0.9 P/B. The cycle should ultimately revert from trough to peak, with P/B to >1.5, though the recovery path might be slightly elongated.

What base rates are telling us?

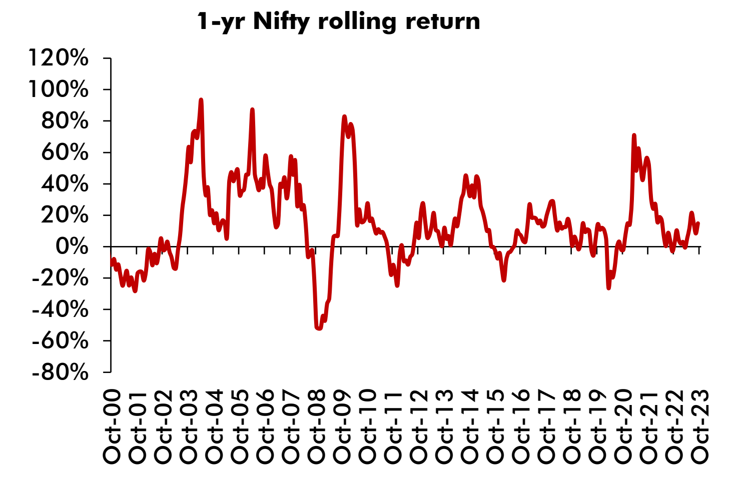
We define base rates as the mean of "10-yr" returns (CAGR) delivered by Nifty measured over 2005-2023! The other proxy for "base rates" of Nifty annual returns can be earnings CAGR as earnings and price mirror each other in the long run! Both are in sync at around 10%. We note that a 2-sigma move over the 3 years can weigh on forward returns (next 7 years)! This seems to be the case in SMID which delivered 35% CAGR over the last 3 years, far above the base rate! Small-caps appear most vulnerable with historical evidence suggesting abysmal forward returns (next 7 years). For mid-caps, results are mixed: an exceptional 3-year return backed by exceptional earnings growth has been followed by strong returns over next 7 years in some instances. But the current frothy mid-cap valuations are backed by not an extraordinary PAT growth distribution and hence mid-caps forward returns appear muted. We remain sellers on SMIDs and our preference order remains large-caps>mid-caps>small-caps.

"Base rate" indicates subdued SMID returns ahead!

Investing requires a clear sense of what's priced in today and possible future results. Instead of focusing on "the inside view", i.e. *fundamental research* to create a forecast, we focus on the "outside view" specific forecast in the context of a larger reference class. The base rate usually represents the probability of an event based solely on historical data without considering specific conditions/supplementary factors. It forms the foundation of probabilistic reasoning.

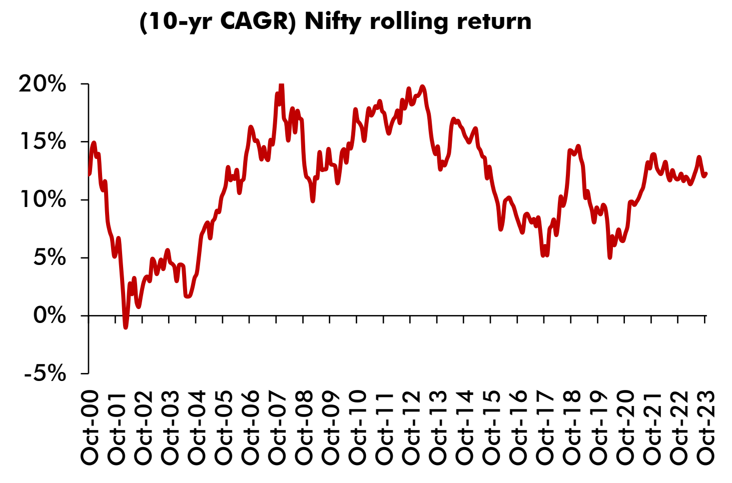
Our assumption for using a 10-year CAGR as the "base rate" of delivered returns is based on the premise that returns can be volatile in the short term. But over a longer time horizon, volatility reduces, and stable returns are witnessed as the "entry multiple" effect becomes less prominent. We define base rates as the mean of 10-yr CAGR delivered by Nifty measured over 2005-2023. The other proxy for "base rates" of Nifty annual returns can be Nifty earnings CAGR as earnings and price mirror each other in the long run. Nifty EPS CAGR has been 9.6% since Apr-06, whereas the "Nifty 10-year returns" average from Apr-06 till date has been 10%.

Exhibit 68: Short-term returns can exhibit strong volatility



Source: Ace Equity, Ambit Capital research

Exhibit 69: But over longer term, returns are tightly grouped



Source: Ace Equity, Ambit Capital research

Application to Nifty

It is pertinent to note that as markets mature, the base returns tend to drift lower, which we notice in India too. Structurally, base returns have come down with Nifty 10-yr returns over 2010-20 lower than in 2000-10. This also implies that a 2-sigma move with the index delivering returns far above the "base rate" in the short term will weigh on future returns! The base rate of Nifty returns (10-year CAGR) of the index is a combination of returns over the short term (3-year CAGR) and the medium term (7 years). For instance, historically, if an index has delivered ~10% CAGR (10 years), referred to here as ***"base rate"***, and the index delivers ~40% CAGR over 3 years, then implied returns for the remaining 7 years are a paltry ~(-1%) CAGR.

Putting things in perspective through the below equation:

$$(1+x)^{10} = (1+y)^{3} * (1+z)^{7}$$

Where,

x is "base rate return" *(10yr CAGR rolling returns over Sep't13-Sept'23)*

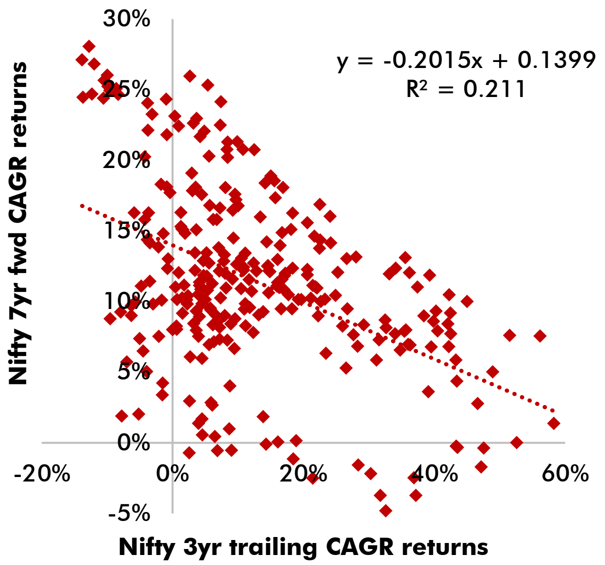
y is "current 3yr returns" (3yr CAGR trailing return over Sept'20-Sept'23)

z is "implied 7yr forward returns"*(7 year forward returns over Sept'23-Sept'30)*

We are assuming that base returns are constant for example. Base returns seem to decline over time and hence, derived 7-year returns might be overstated. Other things are assumed constant.

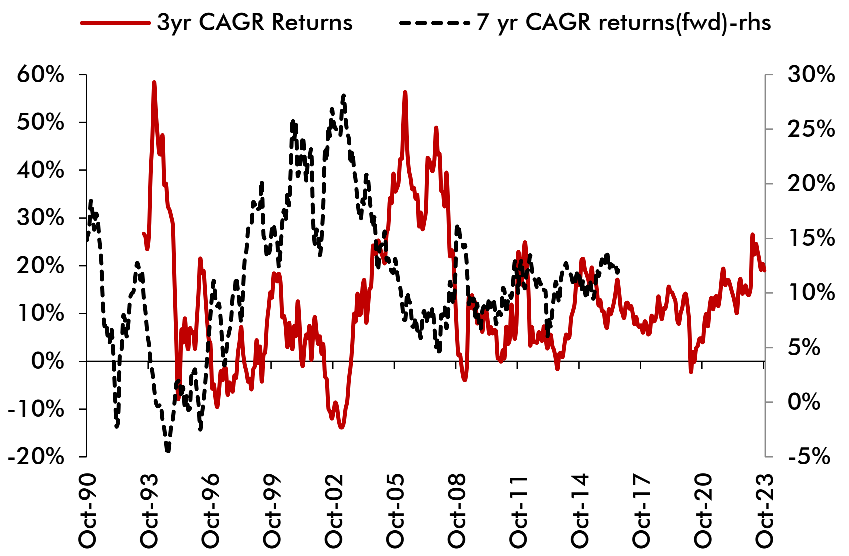
An analysis of Nifty 3-year returns and corresponding 7-year forward returns over the last 20 years confirm that which is reflected in the negative slope of the regression line. The peaks of 3-year returns are associated with abysmal 7-year forward returns and vice-versa. Perfectly logical. Nifty delivered 20% CAGR over the last 3 years and doesn't look precariously placed.

Exhibit 70: A strong move over the last 3 years can weigh on the next 7 year's returns



Source: Ace Equity, Ambit Capital research

Exhibit 71: Periods of irrationality are followed by quieter periods



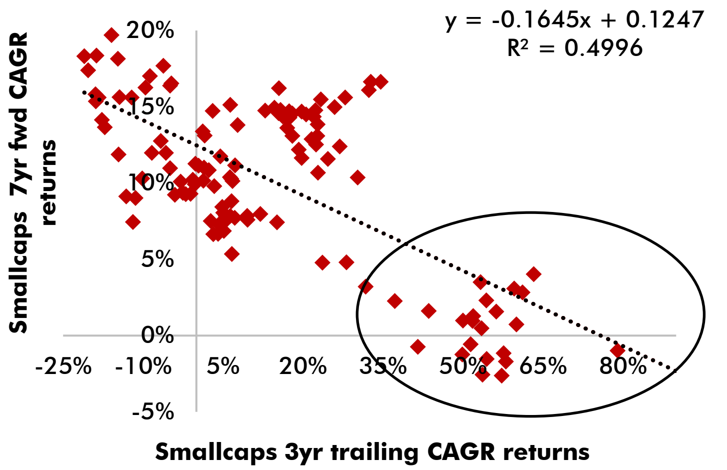
Source: Ace Equity, Ambit Capital research

Application to small-cap and mid-cap indices

Historically, when small-caps have delivered returns far above base rates (>35%) over 3 years, the next 7-yr fwd. returns have been abysmal (<5% CAGR). For mid-caps, it appears mixed with a period of sustained outperformance and muted returns. The 7-yr fwd. return CAGR exceeding 15% for mid-caps even after a 2-sigma move are associated with isolated periods of 2004-05 when EPS growth was exceptional. Current 3-year trailing returns (CAGR) for small and mid-caps stands at 35% CAGR approximately, small-cap 7-year forward returns have always been subdued after such a sharp move.

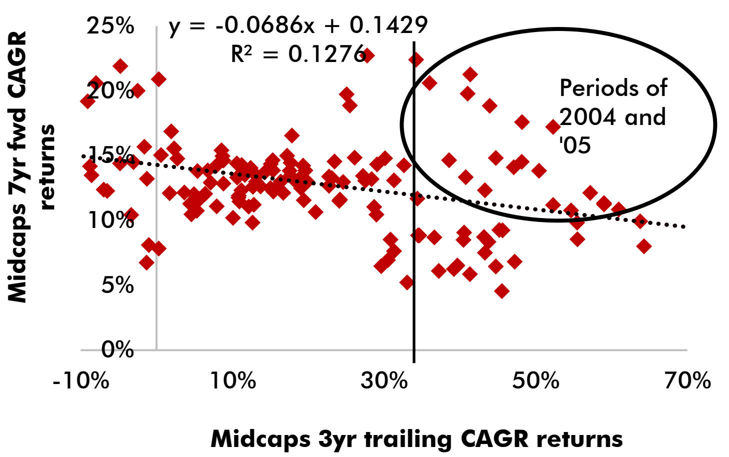
The base rate for mid-cap is around 15%, whereas for small-cap it stands at 11%! Some divergence between the two measures of base returns especially in small-caps.

Exhibit 72: Small-cap: strong returns over last 3 years (>35%) weighed on fwd. returns (<5% CAGR) over next 7 years…



Source: Ace Equity, Ambit Capital research. BSE Smallcap index under consideration; Returns are calculated on a rolling basis

Exhibit 73: …while for mid-caps, the relation is mixed



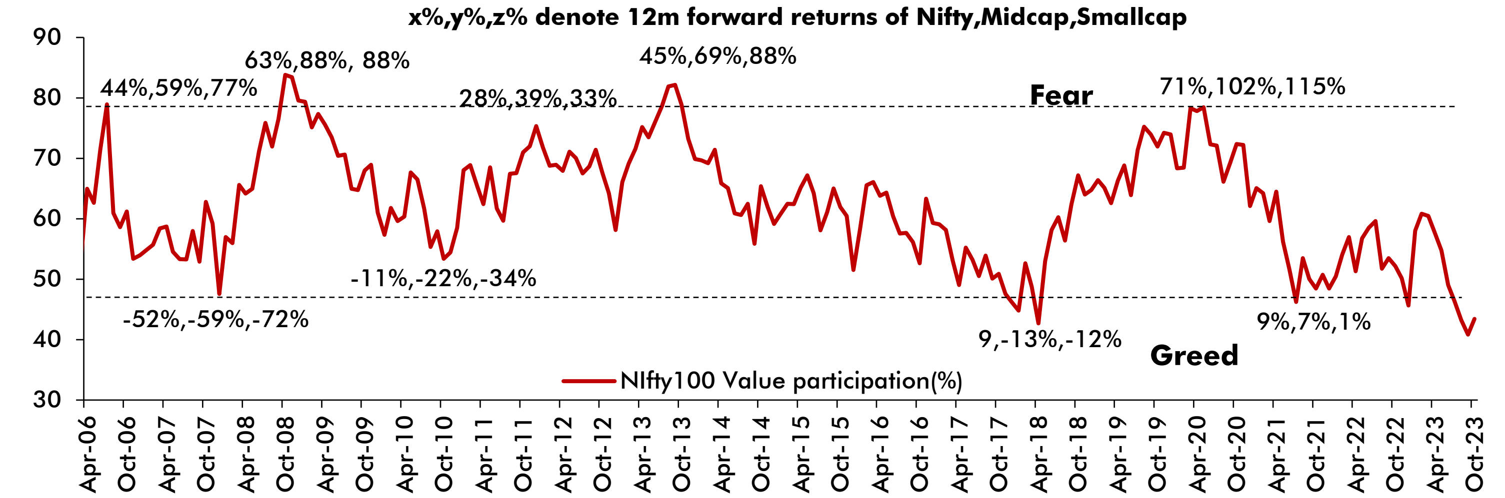
Source: Ace Equity, Ambit Capital research. Nifty Midcap100 index under consideration; Returns are calculated on a rolling basis

Size positioning: Prefer large-caps over SMID

We have been sellers on small and mid-caps. In a nutshell, these are the reasons

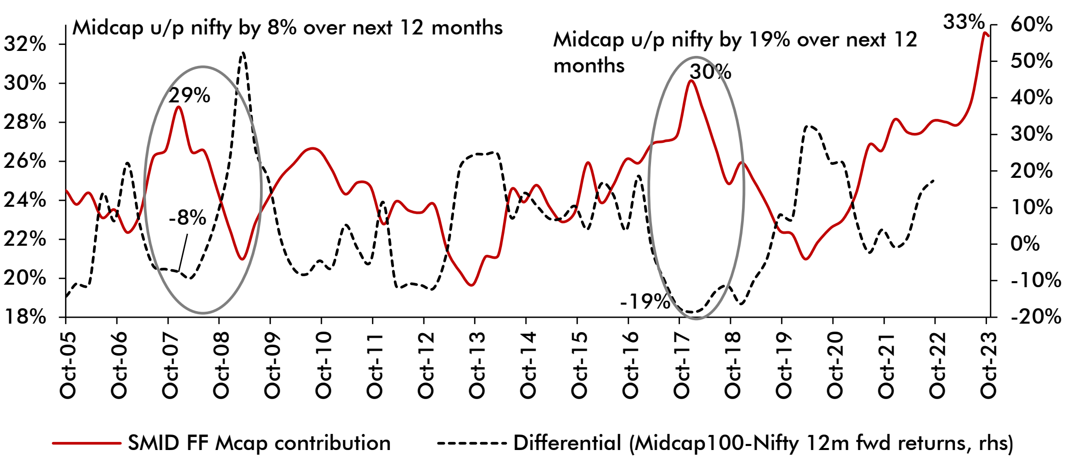
- The SMID valuation measured by trailing earnings yield bond yield differential is close to the worst levels since 2005. The last time it happened in 2017, SMID underperformed large-caps significantly over the next 12 months.
- Second, look at the free float contribution of SMID: The free-float market capitalization of SMID universe contribution as a % of total free float market-cap is at ATH of 33%. In previous instances of peak contributions in 2007 and 2017, both indices corrected in double digits over the next 12 months.
- Third, PAT growth distribution for SMIDs is nothing extraordinary warranting such frothy valuations. We have discussed this in the "earnings momentum" section.
- Fourth, earnings estimates are more sustainable for large-caps vs SMID. Heavyweight sectors in SMID witnessing an acceleration in FY24 EPS downgrades.
- Fifth, market sentiment measured by Nifty100 Value participation signals highest greed levels since 2006, indicating likelihood of SMID underperformance over the next 12 months. If investors are scared, bulk of NSE turnover would be in top 100 stocks and vice versa. For details, please refer "Too much, Too fast" dated 17th August.

Exhibit 74: Greed & Fear Indicator is at the lowest value ever, signalling the highest greed



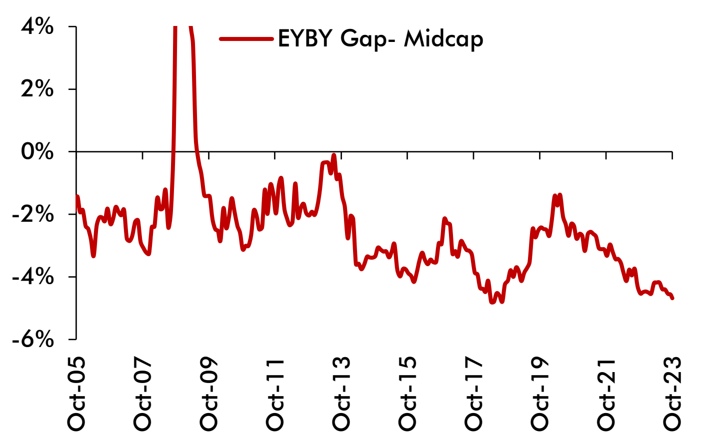
Source: NSE, Ace Equity, Ambit Capital research.

Exhibit 75: SMIDs' share in total free float market-cap increased to 33%, ATH



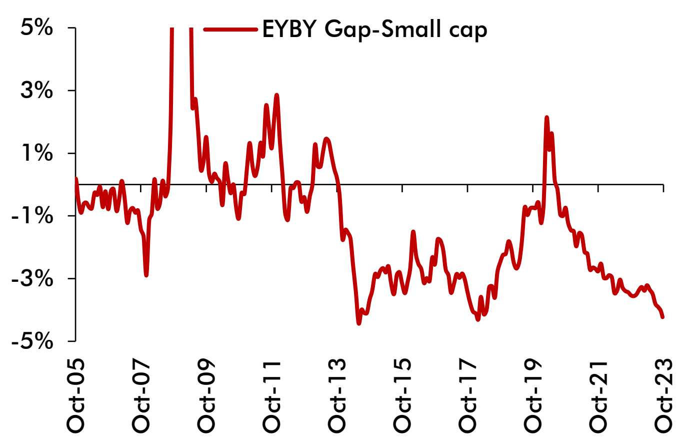
Source: Ambit Capital research, Bloomberg. Note: Above analysis is done quarterly for the entire listed universe, SMID includes companies ranked 101st onwards on market capitalization

Exhibit 76: Mid-cap EYBY Gap stands at (-4.7) close to the worst level of (-4.8) in Apr-18. 10-year avg. stands at (-3.3)



Source: Ace Equity, Bloomberg, Ambit Capital research

Exhibit 77: Small-cap EYBY Gap stands at (-4.7) at all time worst levels. 10-yr avg. stands at (-2.5)



Source: Ace Equity, Bloomberg, Ambit Capital research

Where to hide! Lessons from 2007 and 2017

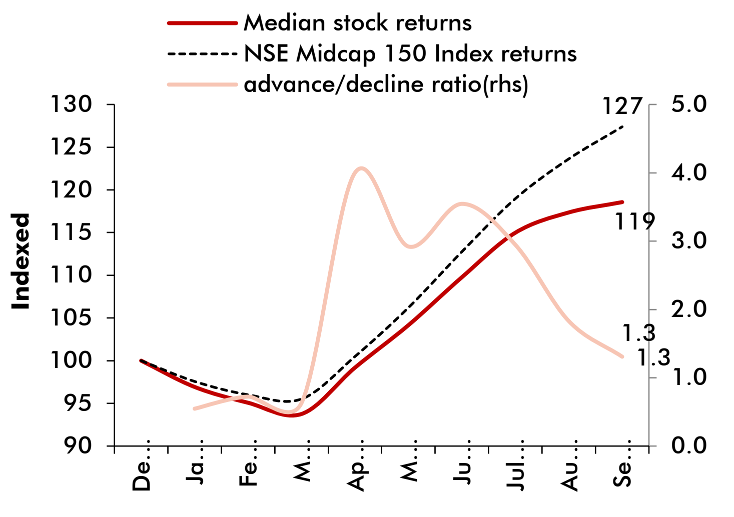
With SMID trading at peak valuations akin to 2017-18 and divergence between headline index and median stock returns increasing, SMID underperformance going ahead can't be ruled out. We turn to 2007-08 and 2017-18 episodes of SMID underperformance to seek lessons for SMID investing in tumultuous times. Factor analysis indicates outperformance by high quality, low leverage, earnings momentum, and EPS revision factors in mid-caps in both 2008 and 2018. These factors should serve as anchors for portfolio construction in current times as the risks to all the drivers - earnings, valuation, and yields - appear elevated.

Divergence between "median stock" and index returns highest in CY23!

In our recent flipbook, we highlighted that cracks in the SMID rally have begun to appear. Since Jul-23, divergence between mid-cap and small-cap "median stock" returns with headline index returns increased significantly. For mid-caps, the divergence between the two measures was 2% in September, with median stock return delivering 1% while the index delivered 3%. In small-caps, the "median stock" return turned negative after March 23 (-0.2%) while the index delivered +1.9%. Sep-23 "divergence" readings for SMID are the highest in CY23TD.

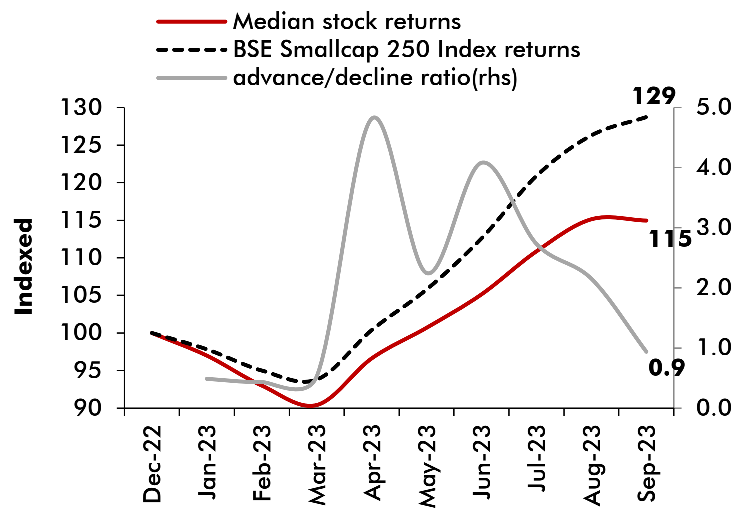
The monthly advance/decline ratio also points in a similar direction, with the ratio significantly worsening in Sept'23. This implies that the rally has become narrow and we should exercise caution considering expensive valuations. Time to be selective.

Exhibit 78: Rally has become narrow in mid-caps...



Source: Ace Equity, Ambit Capital research

Exhibit 79: ...and median stock return has turned negative in small-caps



Source: Ace Equity, Ambit Capital research

Key findings from 2007-08 and 2017-18 episode:

We turn to 2007-08 and 2017-18 episodes of SMID underperformance to seek lessons for SMID investing in tumultuous times analyzing the Nifty mid-cap 150 index. Factor analysis indicates outperformance by high quality, low leverage, earnings momentum, and EPS revision factors in mid-caps in both 2008 and 2018! The performance of other factors was not consistent!

▪ Value (TTM PE)

Exhibit 80: Value outperformed growth in 6/10 months…

CY2008	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overal
Q1	-20%	-2%	-18%	11%	-7%	-23%	12%	1%	-18%	-34%	-68%
Q2	-20%	-1%	-16%	8%	-9%	-17%	4%	2%	-10%	-34%	-65%
Q3	-19%	0%	-12%	10%	-5%	-18%	9%	3%	-15%	-26%	-57%
Q4	-19%	0%	-14%	11%	-3%	-19%	3%	2%	-15%	-34%	-65%
Q5	-17%	-1%	-18%	13%	-7%	-23%	4%	7%	-11%	-27%	-61%
Q1 - Q5	-3%	-2%	0%	-2%	0%	1%	8%	-6%	-6%	-7%	-7%

Source: Ace Equity, Bloomberg, Ambit Capital research. Q1 represent high P/E and Q5 represents low P/E

Value factor outperformance persisted through the 2007-08 episode but didn't do well in the 2017-18 episode.

Exhibit 81: …whereas growth outperformed in 7/10 months in 2018

CY2018	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overal
Q1	0%	-2%	-3%	6%	-3%	-4%	3%	10%	-12%	-4%	-11%
Q2	-4%	-6%	-1%	5%	-4%	-5%	2%	3%	-9%	-4%	-21%
Q3	-2%	-1%	-3%	4%	-5%	-4%	5%	4%	-11%	-1%	-14%
Q4	-2%	-1%	-3%	5%	-5%	-5%	6%	2%	-13%	0%	-17%
Q5	-1%	-4%	-8%	8%	-8%	0%	0%	4%	-18%	3%	-24%
Q1 - Q5	1%	2%	5%	-2%	4%	-4%	3%	6%	5%	-7%	13%

Source: Ace Equity, Bloomberg, Ambit Capital research. Q1 represent high P/E and Q5 represents low P/E

▪ Quality (RoCE/ROE*)

Exhibit 82: Quality outperformance continued through majority of 2008…

CY2008	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	-22%	-1%	-14%	11%	-7%	-17%	4%	3%	-14%	-28%	-62%
Q2	-19%	0%	-13%	8%	-8%	-19%	4%	7%	-12%	-29%	-61%
Q3	-20%	0%	-16%	8%	-7%	-21%	5%	3%	-14%	-34%	-67%
Q4	-14%	0%	-18%	14%	-3%	-21%	11%	2%	-18%	-38%	-65%
Q5	-29%	0%	-21%	14%	-5%	-24%	5%	-3%	-14%	-31%	-72%
Q1 - Q5	7%	-2%	7%	-3%	-2%	7%	0%	6%	1%	2%	10%

Source: Ace Equity, Bloomberg, Ambit Capital research. Q1 represent High ROCE/ROE and Q5 represents Low ROCE/ROE, ROE considered for financials*

Quality companies (Q1) outperformance w.r.t Junk (Q5) was persistent in both episodes.

Exhibit 83: …as well as in 2018

CY2018	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	-2%	-4%	-1%	3%	-7%	0%	4%	3%	-10%	-3%	-16%
Q2	-3%	-2%	-4%	3%	-3%	-5%	5%	2%	-14%	-1%	-20%
Q3	-1%	-1%	-3%	7%	-4%	-6%	6%	8%	-12%	-3%	-9%
Q4	-3%	-3%	-5%	9%	-6%	-4%	1%	5%	-14%	-1%	-21%
Q5	-1%	-6%	-8%	5%	-7%	-7%	4%	7%	-19%	6%	-25%
Q1 - Q5	-1%	2%	7%	-2%	0%	8%	0%	-4%	9%	-9%	9%

Source: Ace Equity, Bloomberg, Ambit Capital research. Q1 represent High ROCE/ROE and Q5 represents Low ROCE/ROE, ROE considered for financials*

Turnaround (change in RoCE/ROE*)

Exhibit 84: Factor outperformed but lacked consistency on a monthly basis in 2008…

CY2008	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overal
Q1	-22%	-2%	-15%	6%	-8%	-18%	5%	4%	-15%	-31%	-52%
Q2	-20%	-4%	-13%	11%	-4%	-19%	4%	3%	-13%	-32%	-46%
Q3	-20%	-1%	-18%	11%	-5%	-23%	8%	3%	-13%	-28%	-49%
Q4	-19%	3%	-16%	14%	-4%	-19%	5%	2%	-16%	-32%	-44%
Q5	-23%	2%	-19%	12%	-8%	-22%	6%	-2%	-16%	-34%	-55%
Q1 - Q5	2%	-4%	4%	-7%	0%	3%	-1%	5%	1%	3%	2%

*Source: Ace Equity, Bloomberg, Ambit Capital research. Q1 represent High delta in ROCE/ROE and Q5 represents Low delta in ROCE/ROE, * ROE considered for financials*

Exhibit 85: …and in 2018 but picked up in the second half

CY2018	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	-7%	-7%	-5%	5%	-8%	-2%	6%	7%	-13%	3%	-23%
Q2	1%	-3%	-6%	9%	-6%	-8%	2%	3%	-15%	-2%	-23%
Q3	-2%	-1%	-2%	6%	-3%	-3%	4%	5%	-13%	0%	-11%
Q4	0%	-2%	-3%	2%	-4%	-3%	3%	5%	-9%	-3%	-11%
Q5	-2%	-2%	-5%	6%	-6%	-5%	4%	5%	-18%	1%	-23%
Q1 - Q5	-5%	-5%	0%	-1%	-2%	3%	2%	2%	6%	2%	0%

*Source: Ace Equity, Bloomberg, Ambit Capital research. Q1 represent High delta in ROCE/ROE and Q5 represents Low delta in ROCE/ROE, * ROE considered for financials*

Factor outperformed in both instances but performance was not consistent on a monthly basis

Price momentum (last 6 months' returns)

Exhibit 86: Momentum underperformance steep in 2008 before bounce-back in Oct'08…

CY2008	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	-24%	2%	-23%	6%	-4%	-13%	4%	1%	-13%	-27%	-65%
Q2	-22%	0%	-18%	10%	-4%	-19%	4%	1%	-16%	-30%	-66%
Q3	-19%	0%	-13%	13%	-6%	-20%	6%	5%	-15%	-27%	-59%
Q4	-20%	2%	-13%	9%	-8%	-24%	7%	3%	-15%	-35%	-67%
Q5	-16%	0%	-15%	17%	-8%	-24%	9%	4%	-18%	-41%	-68%
Q1 - Q5	-7%	2%	-8%	-12%	4%	11%	-5%	-4%	5%	14%	4%

Source: Ace Equity, Ambit Capital research. Q1 represent High momentum and Q5 represents Low momentum in prices

Momentum did well in 2017-18 but underperformed for majority of the time in 2007-08 Episode.

Exhibit 87: …though it performed well in 2018

CY2018	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	-2%	-5%	-5%	9%	-5%	-3%	3%	8%	-12%	-4%	-16%
Q2	-3%	0%	-5%	5%	-5%	-4%	3%	4%	-15%	3%	-17%
Q3	0%	-4%	-5%	7%	-4%	-5%	5%	2%	-12%	-3%	-19%
Q4	-2%	-2%	-3%	4%	-5%	-5%	4%	8%	-14%	4%	-13%
Q5	-3%	-4%	-3%	3%	-8%	-3%	4%	2%	-15%	-1%	-26%
Q1 - Q5	1%	0%	-2%	6%	4%	0%	-2%	6%	3%	-3%	10%

Source: Ace Equity, Bloomberg, Ace Equity, Ambit Capital research. Q1 represent High momentum and Q5 represents Low momentum in prices

Volatility (standard deviation of daily returns over last 1 year)

Exhibit 88: "High Volatility" underperformed significantly in the last stages of correction

CY2008	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	-22%	0%	-20%	9%	-5%	-20%	9%	2%	-20%	-37%	-70%
Q2	-21%	-1%	-18%	12%	-7%	-20%	4%	4%	-15%	-34%	-68%
Q3	-19%	1%	-15%	12%	-5%	-21%	7%	-1%	-15%	-31%	-63%
Q4	-18%	3%	-12%	10%	-6%	-17%	5%	5%	-10%	-25%	-52%
Q5	-22%	-4%	-18%	11%	-7%	-24%	4%	2%	-13%	-31%	-70%
Q1 - Q5	1%	5%	-2%	-2%	3%	4%	5%	0%	-7%	-6%	-1%

Source: Bloomberg, Ace Equity, Ambit Capital research. Q1 represents High volatility and Q5 represents Low volatility

High Volatility underperformance was steep in the 2017-18 episode but not so much in 2007-08. Factor underperformance was highest in late stages of correction.

Exhibit 89: 2018 was similar to 2007 but overall underperformance was much higher

CY2018	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	1%	-6%	-5%	6%	-6%	-3%	2%	4%	-18%	-2%	-25%
Q2	-5%	-5%	-3%	7%	-8%	-5%	7%	6%	-15%	5%	-17%
Q3	-1%	0%	-5%	5%	-3%	-7%	3%	5%	-14%	0%	-18%
Q4	-4%	-2%	-6%	7%	-3%	-4%	4%	6%	-9%	-1%	-12%
Q5	-1%	-2%	-3%	3%	-7%	-3%	3%	5%	-13%	-3%	-19%
Q1 - Q5	1%	-4%	-2%	3%	1%	0%	-1%	-1%	-5%	1%	-6%

Source: Bloomberg, Ace Equity, Ambit Capital research. Q1 represents High volatility and Q5 represents Low volatility

- **Leverage (debt/equity ratio)**

Exhibit 90: Leverage factor underperformed consistently in 2008…

CY2008	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	-22%	2%	-17%	10%	-5%	-24%	5%	-4%	-14%	-32%	-69%
Q2	-20%	1%	-13%	9%	-7%	-18%	4%	4%	-16%	-35%	-65%
Q3	-21%	-1%	-17%	11%	-6%	-25%	7%	0%	-18%	-32%	-70%
Q4	-21%	2%	-15%	14%	-7%	-15%	6%	3%	-17%	-37%	-64%
Q5	-27%	1%	-15%	13%	-3%	-17%	7%	3%	-12%	-28%	-60%
Q1 - Q5	5%	1%	-2%	-3%	-2%	-7%	-3%	-6%	-2%	-4%	-9%

Source: Bloomberg, Ace Equity, Ambit Capital research. Q1 represents High leverage and Q5 represents Low leverage

High Leverage underperformed in both instances.

Exhibit 91: …and in 2018 too

CY2018	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	0%	-6%	-8%	6%	-5%	-9%	6%	8%	-18%	4%	-21%
Q2	-4%	-1%	-6%	5%	-5%	-5%	2%	6%	-12%	0%	-18%
Q3	-3%	-1%	-4%	4%	-3%	-4%	0%	4%	-10%	-1%	-17%
Q4	0%	-3%	0%	5%	-9%	1%	4%	4%	-9%	-1%	-8%
Q5	0%	-1%	-2%	3%	-6%	-2%	5%	3%	-10%	-4%	-13%
Q1 - Q5	0%	-4%	-6%	2%	1%	-7%	1%	5%	-7%	8%	-7%

Source: Bloomberg, Ace Equity, Ambit Capital research. Q1 represents High leverage and Q5 represents Low leverage

- **Earnings momentum (TTM earnings growth, QoQ)**

Exhibit 92: Earnings momentum worked well in 2007 both in terms of spread and consistency…

CY2008	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	-21%	-2%	-15%	15%	-3%	-20%	9%	1%	-18%	-18%	-46%
Q2	-18%	4%	-14%	6%	-5%	-21%	6%	3%	-14%	-15%	-45%
Q3	-18%	1%	-17%	9%	-5%	-19%	5%	7%	-13%	-11%	-44%
Q4	-20%	-3%	-17%	15%	-5%	-19%	3%	2%	-14%	-15%	-49%
Q5	-26%	2%	-17%	11%	-9%	-23%	8%	-1%	-13%	-15%	-55%
Q1 - Q5	5%	-3%	2%	4%	6%	3%	1%	2%	-4%	-3%	8%

Source: Ace Equity, Bloomberg, Ace Equity, Ambit Capital research. Q1 represents High momentum and Q5 represents Low momentum in earnings

Companies exhibiting strong earnings momentum outperformed in both instances. Refer to our latest note on earnings momentum for deep dive.

Exhibit 93: ...and in 2018

CY2018	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	-3%	-4%	-1%	4%	-9%	-3%	2%	6%	-14%	-15%	-21%
Q2	-1%	0%	-4%	4%	-3%	0%	3%	7%	-11%	-11%	-8%
Q3	-1%	-4%	-6%	8%	-3%	-4%	4%	3%	-11%	-11%	-14%
Q4	0%	-2%	-3%	6%	-6%	-6%	5%	5%	-15%	-14%	-17%
Q5	-4%	-5%	-7%	6%	-6%	-9%	6%	3%	-17%	-18%	-30%
Q1 - Q5	1%	1%	6%	-2%	-3%	6%	-4%	2%	3%	2%	8%

Source: Ace Equity, Bloomberg, Ace Equity, Ambit Capital research. Q1 represents high momentum and Q5 represents low momentum in earnings

- **Earnings revision (change in 1-year forward EPS)**

Exhibit 94: Earnings revision (Q1) delivered 2% outperformance in 2008...

CY2008	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	-16%	-1%	-19%	8%	-8%	-23%	7%	0%	-20%	-34%	-71%
Q2	-18%	-4%	-16%	8%	-7%	-19%	6%	6%	-12%	-38%	-67%
Q3	-17%	4%	-12%	6%	-3%	-19%	0%	5%	-9%	-26%	-56%
Q4	-18%	2%	-13%	10%	-7%	-21%	6%	4%	-10%	-28%	-58%
Q5	-27%	0%	-16%	9%	-11%	-19%	5%	3%	-18%	-35%	-73%
Q1 - Q5	11%	-1%	-3%	-1%	3%	-4%	2%	-3%	-1%	2%	2%

Source: Bloomberg, Ambit Capital research. Q1 represents highest revision and Q5 represents lowest revision in 1-yr fwd. earnings

The factor *outperformed* in both instances, but performance was more consistent in 2017 as compared to 2008.

Exhibit 95: ...whereas it delivered 3% outperformance in 2017

CY2018	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Overall
Q1	-1%	-7%	-3%	5%	-7%	-4%	5%	8%	-16%	4%	-19%
Q2	-1%	-1%	-5%	6%	-3%	-2%	7%	6%	-12%	-4%	-11%
Q3	1%	-3%	-5%	5%	-6%	-4%	2%	6%	-10%	-2%	-17%
Q4	-4%	-1%	-1%	6%	-9%	-5%	7%	4%	-13%	1%	-16%
Q5	-4%	-4%	-6%	7%	-3%	-8%	3%	3%	-13%	1%	-22%
Q1 - Q5	3%	-4%	3%	-3%	-3%	4%	2%	5%	-4%	2%	3%

Source: Bloomberg, Ambit Capital research. Q1 represents highest revision and Q5 represents lowest revision in 1-yr fwd. earnings

State of market: What factors are outperforming?

With NSE Midcap150 index as reference, we evaluate factors performance. Starting Dec'22, Nifty Midcap150 index constituents are ranked on each parameter and quintiles are formed, with Q1 referring to stocks which score high on parameters: High PE, High RoCE etc. We notice outperformance by value, volume, earnings momentum and earnings revision whereas quality and turnaround (Delta RoCE) are underperforming.

- **Value (TTM PE)**

Exhibit 96: Low P/E stocks (Q5) outperformance w.r.t high P/E has begun to accelerate! Divergence was highest in Sep-23

CY23	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Overall
Q1	-6%	-3%	-1%	3%	8%	6%	5%	4%	3%	20%
Q2	-2%	1%	-1%	5%	6%	4%	3%	2%	-2%	17%
Q3	-2%	-1%	-2%	3%	6%	6%	4%	6%	3%	24%
Q4	-1%	-1%	-2%	8%	2%	6%	6%	4%	3%	26%
Q5	0%	-4%	1%	8%	3%	7%	10%	3%	9%	42%
Q1 - Q5	-6%	1%	-2%	-5%	6%	-1%	-5%	1%	-6%	-22%

Source: Ace Equity, Bloomberg, Ambit Capital research. Q1 represents high P/E and Q5 represents low P/E

Value outperformance has shot up since June, with best performance in July and Sep. Cumulative outperformance stands at 22%.

▪ Quality (RoCE/ROE*)

Exhibit 97: Quality companies (high RoCE) continue to underperform, while junk (low RoCE) continues to do well

CY23	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Overall
Q1	-3%	-1%	-3%	5%	5%	6%	2%	4%	3%	19%
Q2	-2%	-1%	-3%	4%	6%	6%	5%	5%	0%	21%
Q3	-2%	-1%	2%	6%	4%	6%	7%	4%	3%	30%
Q4	-4%	-3%	1%	3%	6%	6%	7%	4%	4%	28%
Q5	-2%	-3%	-2%	10%	4%	8%	6%	4%	6%	33%
Q1 - Q5	-1%	2%	-1%	-5%	1%	-2%	-4%	0%	-3%	-15%

Source: Ace Equity, Bloomberg, Ambit Capital research. Q1 represents High ROCE/ROE and Q5 represents Low ROCE/ROE, ROE considered for financials*

Quality companies (Q1) underperformance w.r.t Junk (Q5) has accelerated since Jun-end. Cumulative underperformance stands at 15%.

▪ Turnaround (change in RoCE/ROE*)

Exhibit 98: Stocks exhibiting the biggest improvement in RoCE have not shown any massive return differential with Q5

CY23	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Overall
Q1	-4%	-1%	-3%	6%	4%	4%	5%	5%	2%	19%
Q2	-3%	-1%	-1%	5%	4%	6%	6%	1%	4%	23%
Q3	-1%	-3%	-1%	6%	2%	5%	6%	5%	5%	27%
Q4	-1%	-2%	-1%	6%	5%	9%	5%	6%	3%	36%
Q5	-4%	-2%	-1%	5%	8%	6%	5%	4%	3%	26%
Q1 - Q5	0%	0%	-1%	1%	-5%	-2%	0%	1%	0%	-7%

*Source: Ace Equity, Bloomberg, Ambit Capital research. Q1 represents High delta in ROCE/ROE and Q5 represents Low delta in ROCE/ROE, * ROE considered for financials*

Factor performance has improved in last 3 months but remains underperformer. Cumulative underperformance stands at 7%.

▪ Price momentum (last 6 months' returns)

Exhibit 99: Momentum made a big comeback last month, delivering best performance this year

CY23	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Overall
Q1	-4%	-4%	-1%	7%	3%	7%	5%	4%	7%	27%
Q2	-2%	-1%	0%	5%	5%	5%	6%	3%	2%	28%
Q3	-2%	-3%	-2%	6%	7%	6%	5%	4%	2%	26%
Q4	-4%	1%	-3%	4%	6%	5%	5%	3%	3%	21%
Q5	-2%	-2%	-1%	7%	3%	6%	6%	7%	1%	30%
Q1 - Q5	-2%	-3%	0%	0%	0%	1%	-1%	-3%	6%	-3%

Source: Ace Equity, Ambit Capital research. Q1 represents High momentum and Q5 represents Low momentum in prices

Momentum has underperformed this year (3%) but has made a strong comeback

▪ Volatility (standard deviation of daily returns over last 1 year)

Exhibit 100: High volatility outperformance continues in Sep-23

CY23	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Overall
Q1	1%	-3%	-2%	8%	5%	6%	8%	5%	9%	42%
Q2	-5%	-1%	-2%	7%	3%	7%	5%	6%	3%	23%
Q3	-2%	-1%	1%	4%	6%	7%	6%	3%	3%	30%
Q4	-2%	-2%	-1%	3%	6%	5%	5%	2%	-1%	17%
Q5	-2%	-1%	-1%	6%	4%	5%	4%	5%	2%	23%
Q1 - Q5	3%	-2%	0%	2%	2%	1%	4%	0%	7%	20%

Source: Bloomberg, Ace Equity, Ambit Capital research. Q1 represents High volatility and Q5 represents Low volatility

High Volatility delivered best performance in Sep-23 and has turned very profitable since Jun-end. Cumulative outperformance stands at 20%.

▪ Leverage (debt/equity ratio)

Exhibit 101: Low Leverage has made a comeback in Aug-23 but not so significant outperformance!

CY23	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Overall
Q1	-5%	-2%	0%	6%	6%	8%	5%	2%	4%	**26%**
Q2	-3%	0%	0%	5%	5%	7%	5%	5%	2%	**28%**
Q3	1%	-1%	-2%	3%	6%	4%	4%	3%	0%	**18%**
Q4	-2%	-4%	-1%	5%	4%	3%	6%	4%	1%	**18%**
Q5	-3%	2%	-1%	5%	3%	6%	5%	7%	2%	**27%**
Q1 - Q5	-2%	-4%	1%	2%	3%	2%	0%	-4%	2%	-2%

Source: Bloomberg, Ace Equity, Ambit Capital research. Q1 represents High leverage and Q5 represents Low leverage

No significant difference in performance between high leverage and low leverage.

▪ Earnings momentum (TTM earnings growth, QoQ %)

Exhibit 102: Stocks exhibiting highest earnings momentum (TTM EPS QoQ%) did exceptionally well till Jul-23 but have slacked off recently

CY23	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Overall
Q1	-3%	1%	2%	5%	5%	7%	7%	1%	3%	31%
Q2	-1%	-2%	-2%	7%	4%	5%	5%	6%	4%	28%
Q3	-4%	-3%	-2%	6%	8%	6%	4%	3%	4%	24%
Q4	-2%	-2%	-2%	6%	3%	7%	6%	3%	4%	23%
Q5	-3%	-3%	-2%	4%	5%	6%	5%	7%	2%	25%
Q1 - Q5	0%	4%	3%	1%	-1%	1%	2%	-6%	1%	6%

Source: Ace Equity, Bloomberg, Ace Equity, Ambit Capital research. Q1 represents high momentum and Q5 represents low momentum in earnings

Factor performance has slacked off in last 3 months but has done well in CY23. Cumulative outperformance stands at 6%.

▪ Earnings revision (change in 1-year forward EPS)

Exhibit 103: Companies witnessing biggest revision in 12m fwd. earnings (Q1) are outperforming significantly. Trend accelerated over the last 2 months

CY23	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Overall
Q1	-3%	-5%	1%	6%	5%	9%	6%	7%	4%	33%
Q2	-3%	-1%	-2%	7%	5%	5%	3%	2%	2%	17%
Q3	-1%	2%	-1%	3%	5%	5%	3%	2%	2%	22%
Q4	-2%	-1%	-2%	7%	6%	6%	8%	2%	6%	32%
Q5	-2%	-2%	-1%	5%	3%	6%	8%	4%	1%	22%
Q1 - Q5	0%	-3%	2%	1%	1%	3%	-1%	4%	3%	11%

Source: Source: Bloomberg, Ambit Capital research. Q1 represents highest revision and Q5 represents lowest revision in 1-yr fwd earnings

Factor performance has accelerated over last 3 months. Cumulative outperformance stands at 11%.

Exhibit 104: Top 20 mid-cap stocks: A combination of high P/E, high volatility, high price and earnings momentum factors

Company Name	Returns (Dec'22-Sept'23)	Quintiles							
		PE	ROCE/ ROE*	ROCE/ OE* Delta	Momentum	Volatility	Leverage	Highest earning momentum (TTM EPS QoQ)	Revision in 12m fwd earnings
REC	147%	Q5	Q3	Q3	Q1	Q1	N/A	Q3	Q4
Indian Railway Finance Corporation	135%	Q5	Q4	Q4	Q1	Q1	N/A	Q4	N/A
Power Finance Corporation	123%	Q5	Q2	Q4	Q1	Q1	N/A	Q2	Q4
Aurobindo Pharma	109%	Q4	Q5	Q4	Q1	Q1	Q2	Q3	Q4
Polycab India	108%	Q2	Q2	Q1	Q1	Q1	Q4	Q2	Q3
ZF Commercial Vehicle	74%	Q1	Q3	Q1	Q1	Q3	Q5	Q1	Q1
Linde India	73%	Q1	Q3	Q5	Q1	Q2	Q5	Q5	N/A
PB Fintech	71%	N/A	Q5	Q1	Q4	Q1	Q5	Q1	Q1
Supreme Industries	68%	Q2	Q2	Q5	Q1	Q1	Q5	Q4	Q4
Bharat Heavy Electricals	65%	Q1	Q5	Q3	Q1	Q1	Q2	Q5	Q1
CG Power and Industrial Solutions	64%	Q1	Q1	Q2	Q2	Q2	Q5	Q2	Q4
IDFC First Bank	62%	Q4	Q4	Q1	Q1	Q1	N/A	Q2	Q2
Lupin	60%	Q2	Q5	Q1	Q1	Q1	Q2	Q1	Q2
Thermax	58%	Q1	Q3	Q2	Q2	Q3	Q2	Q4	Q3
Natco Pharma	55%	Q4	Q3	Q1	Q1	Q2	Q3	Q1	Q4
Trent	54%	Q1	Q1	Q1	Q1	Q3	Q2	Q2	Q2
ABB India	53%	Q1	Q2	Q1	Q4	Q3	Q5	Q1	Q3
L&T Finance Holdings	53%	N/A	Q5	Q5	Q1	Q1	N/A	Q1	Q3
JSW Energy	52%	Q2	Q5	Q4	Q1	Q2	Q1	Q5	Q1
Tata Communications	52%	Q4	Q2	Q2	Q1	Q1	Q1	Q5	Q4

*Source: Ace Equity, Bloomberg, Ambit Capital research. * ROE considered for financials*

Exhibit 105: Screening the "Midcap Universe" by factors which outperformed in the 2007-08 and 2017-18 corrections

High Quality	Low Leverage	Highest earning momentum(TTM EPS QoQ)		Revision in 12m fwd earnings
Q1	**Q5**	**Q1**	**Q2**	**Q1**
3M India	3M India	360 One Wam	3M India	Aarti Industries
Abbott India	Abbott India	ACC	AIA Engineering	Aditya Birla Fashion and Retail
Bata India	ACC	Ashok Leyland	Ajanta Pharma	Bharat Forge
Bayer CropScience	Bata India	Alkem Laboratories	APL Apollo Tubes	Bharat Heavy Electricals
Blue Dart Express	Bayer CropScience	Bank Of India	Astral	Dalmia Bharat
CG Power	CG Power	Central Bank Of India	AU Small Finance Bank	Delhivery
Coforge	CRISIL	Delhivery	Bharat Forge	Devyani International
Coromandel International	Escorts Kubota	Escorts Kubota	Abbott India	Dixon Technologies (India)
CRISIL	Glaxosmithkline Pharma	GMR Airports Infrastructure	Colgate-Palmolive (India)	Dr. Lal Pathlabs
Devyani International	GMR Airports Infrastructure	Godrej Properties	Dixon Technologies (India)	FSN E-Commerce Ventures
Glaxosmithkline Pharma	Gujarat Gas	HPCL	Dr. Lal Pathlabs	GMR Airports Infrastructure
Gujarat Gas	Indraprastha Gas	Hatsun Agro Product	Endurance Technologies	Ipca Laboratories
Hindustan Zinc	L&T Technology Services	Cummins India	The Federal Bank	Jindal Stainless
ICICI Securities	Linde India	Kansai Nerolac Paints	Emami	JSW Energy
Jubilant FoodWorks	Mazagon Dock Shipbuilders	KPIT Technologies	Vodafone Idea	KPIT Technologies
KPIT Technologies	Oracle Financial Services	LIC Housing Finance	IDFC First Bank	Laurus Labs
L&T Technology Services	PB Fintech	Lupin	Indian Bank	Oberoi Realty
Mazagon Dock Shipbuilders	Relaxo Footwears	L&T Finance Holdings	Max Financial Services	One97 Communications
Metro Brands	Schaeffler India	Samvardhana Motherson	Max Healthcare Institute	Patanjali Foods
Motherson Sumi Wiring India	SKF India	MRF	Prestige Estates Projects	PB Fintech
NMDC	Sumitomo Chemical India	Nippon Life India Asset	Pfizer	Solar Industries India
Oracle Financial Services	Sun TV Network	The New India Assurance	PI Industries	Sona BLW Precision
Page Industries	Supreme Industries	One97 Communications	Power Finance Corporation	The Indian Hotels Company
Petronet LNG	Tata Elxsi	PB Fintech	Relaxo Footwears	Trident
SKF India	United Breweries	Polycab India	Sona BLW Precision	Union Bank Of India
Solar Industries India	Vedant Fashions	Poonawalla Fincorp	Trent	United Breweries
Tata Elxsi	Vodafone Idea	Union Bank Of India	TVS Motor Company	UNO Minda
The Fertilisers and Chemicals Travancore	Whirlpool Of India	Voltas	UCO Bank	Yes Bank
Tube Investments of India	ZF Commercial Vehicle	Zydus Lifesciences	ZF Commercial Vehicle	ZF Commercial Vehicle
Vedant Fashions				

Source: Bloomberg, Ambit Capital research. Note: NSE Midcap 150 index under consideration

Exhibit 106: Screening the "Small-cap Universe" by factors which outperformed in the 2007-08 and 2017-18 corrections

High Quality	Low Leverage	Highest earning momentum(TTM EPS QoQ)		Revision in 12m fwd earnings
Q1	**Q5**	**Q1**	**Q2**	**Q1**
Shoppers Stop	Finolex Cables	Aditya Birla Sun Life AMC	Aavas Financiers	Epigral
Mahindra Holidays	Clean Science and Tech	Alembic Pharmaceuticals	Akzo Nobel India	BEML
Suzlon Energy	GNFC	Apollo Tyres	Amara Raja Energy and Mobility	V-Mart Retail
Fine Organic Industries	Just Dial	Aarti Drugs	Anupam Rasayan India	The India Cements
Castrol India	NBCC	Astrazeneca Pharma India	Apar Industries	Raymond
Triveni Engg. and Industries	Zensar Technologies	Avanti Feeds	Birlasoft	Restaurant Brands Asia
CAMS	Mahanagar Gas	Bombay Burmah Trading	Cholamandalam Financial	Welspun Corp
Indian Energy Exchange	Engineers India	Bank Of Maharashtra	Cera Sanitaryware	Data Patterns
Apar Industries	Jyothy Labs	Balrampur Chini Mills	Carborundum Universal	Piramal Pharma
Easy Trip Planners	BLS International Services	Ceat	Cyient	Mahindra Lifespace Dev.
Sanofi India	Avanti Feeds	Chalet Hotels	EPL	Cochin Shipyard
Angel One	Triveni Turbine	CreditAccess Grameen	Finolex Industries	PVR Inox
Archean Chemical Industries	Ingersoll-Rand	EIH	Firstsource Solutions	BSE
Clean Science and Tech	Vijaya Diagnostic Centre	Engineers India	GMM Pfaudler	MCX
Ingersoll-Rand	Intellect Design Arena	Equitas Small Finance Bank	Godrej Agrovet	Jubilant Pharmova
Tata Teleservices	Indigo Paints	Esab India	Garware Technical Fibres	Kaynes Technology India
Safari Industries	KSB	Eureka Forbes	HFCL	Varroc Engineering
E.I.D. - Parry	Tanla Platforms	Godfrey Phillips India	Home First Finance Company	National Aluminium Company
Sonata Software	Praj Industries	Hikal	IDFC	Graphite India
eClerx Services	Indiamart Intermesh	Indiamart Intermesh	IIFL Finance	Hitachi Energy India
Cholamandalam Financial	Glenmark Life Sciences	Just Dial	Intellect Design Arena	Chemplast Sanmar
Rainbow Children's Medicare	Birlasoft	Jyothy Labs	Indigo Paints	PCBL
Tanla Platforms	Lakshmi Machine Works	Lemon Tree Hotels	Ircon International	Balaji Amines
Balaji Amines	Delta Corp	Lloyds Metals and Energy	JB Chemicals and Pharma	Prism Johnson
Blue Star	CAMS	Mahanagar Gas	Jamna Auto Industries	KEC International
Gujarat State Petronet	Gujarat Pipavav Port	Manappuram Finance	Kalyan Jewellers India	Nuvoco Vistas Corporation
Narayana Hrudayalaya	Castrol India	Motilal Oswal Financial Services	KEC International	Triveni Engineering
Ujjivan Small Finance Bank	Indian Energy Exchange	Narayana Hrudayalaya	Krishna Institute of Medical Sciences	Granules India
Westlife Foodworld Ltd	Go Fashion	NBCC (India)	KNR Constructions	Suzlon Energy
Elgi Equipments	Infibeam Avenues	Natco Pharma	Kalpataru Projects International	DCM Shriram
Praj Industries	Rainbow Children's Medicare	Poly Medicure	KSB	Sapphire Foods India
BLS International Services	Medplus Health Services	Praj Industries	Lakshmi Machine Works	Syrma SGS Technology
Epigral	Saregama India	Raymond	La Opala RG	Gillette India
Triveni Turbine	Sanofi India	Sheela Foam	CE Info Systems	Welspun Living
Happiest Minds	Rites	Sterlite Technologies	MAS Financial Services	TeamLease Services
Rites	Gujarat State Petronet	Swan Energy	NCC	IRB Infrastructure Developers
NBCC	GSFC	Sterling and Wilson Ren. Energy	Nesco	Lemon Tree Hotels
VIP Industries	Tejas Networks	Tata Investment Corporation	Prism Johnson	Chalet Hotels
Glenmark Life Sciences	Tata Teleservices	Triveni Turbine	RBL Bank	Birla Corporation
Go Fashion	Alok Industries	TV18 Broadcast	Ratnamani Metals and Tubes	Amber Enterprises India
JK Paper	Shree Renuka Sugars	UTI Asset Management Co	Route Mobile	Sobha
Chemplast Sanmar	Sterling and Wilson R.E.	Varroc Engineering	Star Cement	Allcargo Logistics
CE Info Systems		Vardhman Textiles	Tanla Platforms	
Jamna Auto Industries		Welspun Corp	TVS Holdings	
Krishna Institute of Medical Sciences		Welspun Living	Vaibhav Global	
Campus Activewear		Zensar Technologies	V-Guard Industries	
Ratnamani Metals and Tubes				
Godawari Power And Ispat				
Godfrey Phillips India				

Source: Bloomberg, Ambit Capital research. Note: NSE Smallcap 250 index under consideration

Evaluating sectoral attractiveness

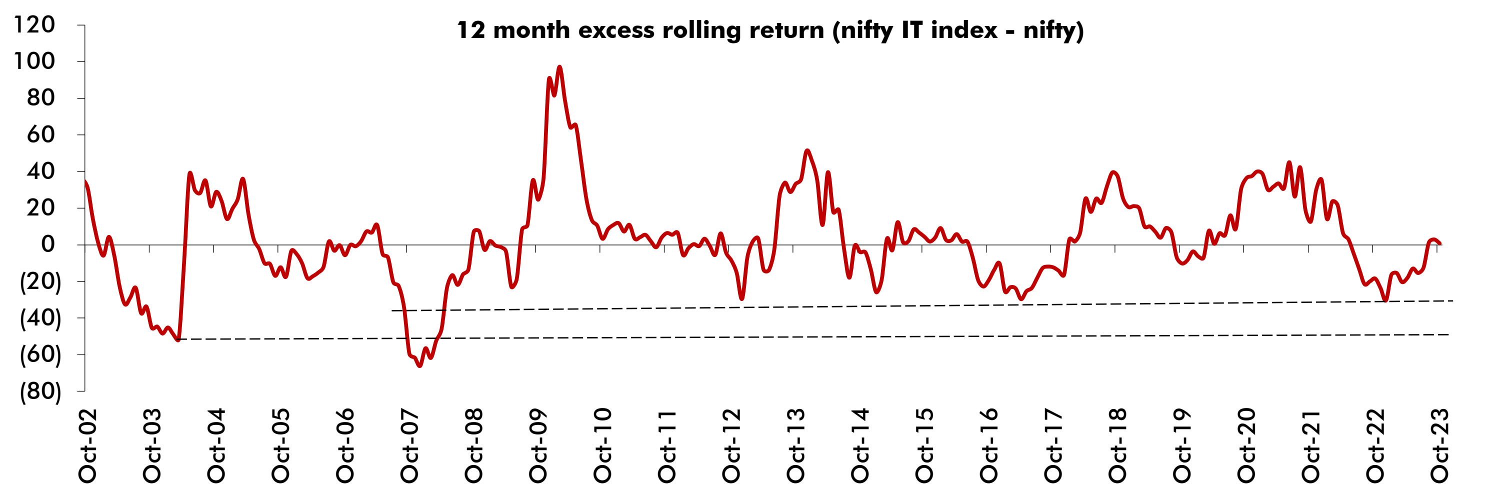
Our "sectoral attractiveness" framework comprises four parameters – 1. Excess returns, 2. Relative valuation, 3. Earnings estimate sustenance and 4. Ownership of the sector. In addition to this, we also look at sector-specific intermarket relationships. We become selective in FMCG and Auto by adding low-beta stocks exhibiting EPS momentum. We maintain our OW stance on Banks, Metals, Healthcare, and OMCs; keep EW on IT. We notice high expectations built in the Capital Goods, Consumer Durables and Cement sectors where market-cap increase is not backed by increase in profit pool and can correct if expectations are not met. On the other hand, markets have not yet factored in profits of financials and appear attractively positioned.

"Sectoral attractiveness" determination is a key attribute for determining portfolio allocation. We evaluate sectoral attractiveness on four key parameters:

- **"Mean reversion" determined by excess returns**

We define excess returns of the sector as the 12-month rolling return differential of a sector w.r.t. the market. The idea behind tracking these excess returns is that there is an anchoring bias in play and investors look at how much the sector has outperformed/underperformed Nifty over the last 1 year. "Extreme outperformance can breed reversion to mean and so does extreme underperformance". In May22 (see slides 30-33 of the PPT), we highlighted banks' underperformance w.r.t market is close to historical troughs and historically – this in itself serves as a great signaling tool. The key is to look at sectors at the turning points. The same was highlighted for IT in Nov-22.

Exhibit 107: Excess returns of the Nifty IT index reached a bottom in Oct-22 last year and IT rebounded thereafter

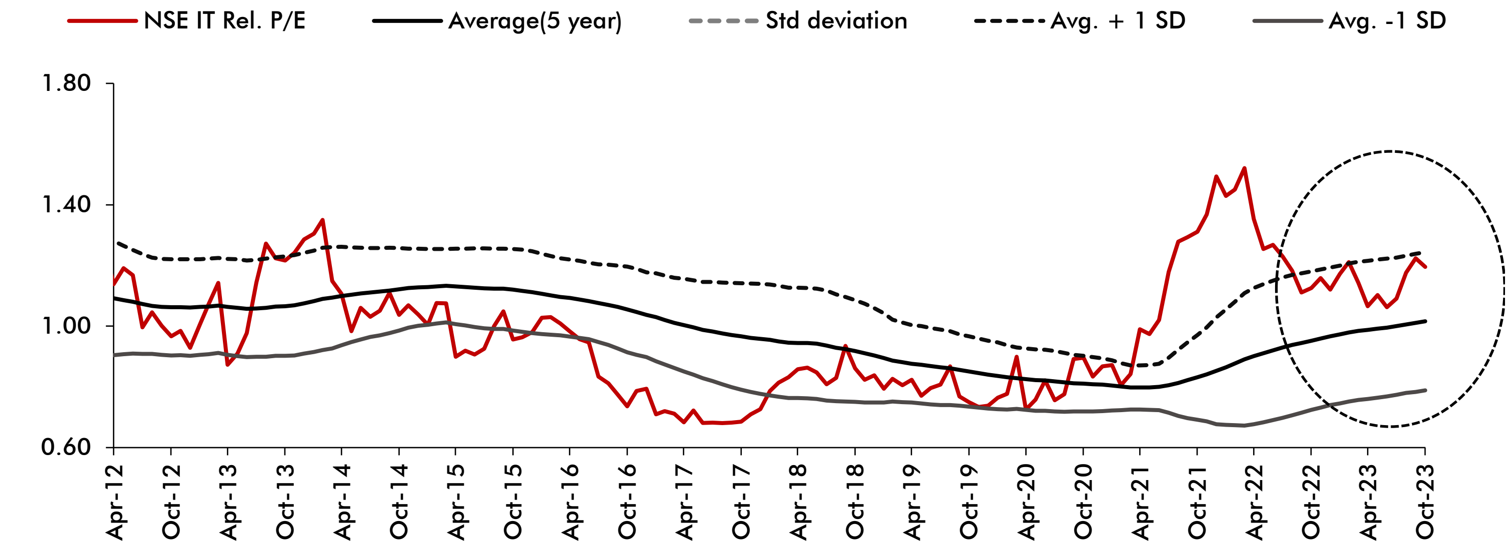


Source: Bloomberg, Ambit Capital research. Latest data as of 19th Oct'23

Relative valuations

The relative valuation of the sector w.r.t. market is the second variable for evaluating sector attractiveness. The crux is "Entry multiples matter!" As highlighted in the Availability Factor (AF) note, AF of Indian equities is contracting as demand for Indian equities (25% CAGR since Jun-17) is outstripping supply of equities (15% CAGR since Jun-17), which has manifested in higher "trough multiples".

Exhibit 108: After the recent run, IT relative valuation Z-Score has touched +2



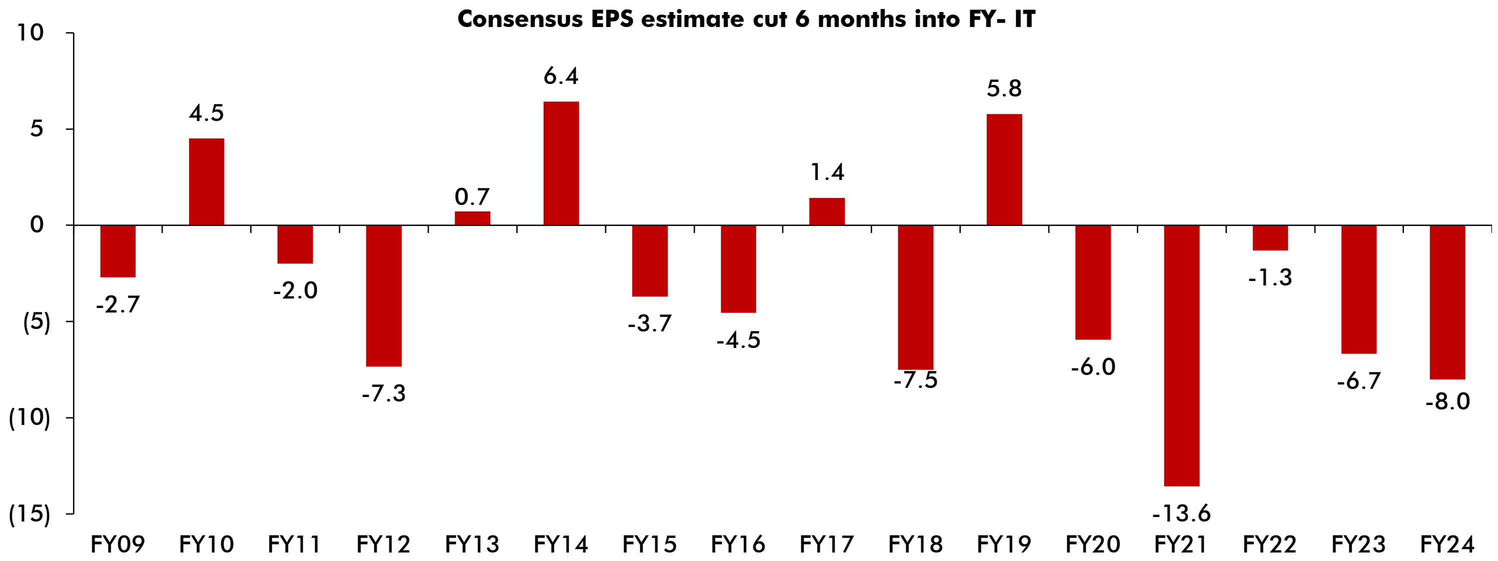
Source: Bloomberg, Ambit Capital research. Latest data as of 21st Oct'23

To account for this, it makes sense to look at relative valuations. Both the first and second variables are based on the principle of "mean reversion". The drawback with this analysis is that sometimes mean reversion can be slower, as seen in mid-caps in 2018-19!

Earnings estimate sustenance

We look at earning estimate sustenance across sectors and compare it with the historical trends over the last decade. This gives us an idea of whether earnings cuts are reaching business cycle lows, estimates are robust, or already showing reversion. This is the third variable of our sectoral attractiveness framework.

Exhibit 109: Nifty IT earnings estimate trajectory is the 2nd worst since FY09



Source: Bloomberg, Ambit Capital research. Latest data as of 30th Sept'23

Ownership

The ownership of the sector by DMF is the last variable of our sectoral evaluation. If the sector is under-owned and the mean reversion begins to manifest on price and valuation, this can add legs to the rally! We look at ownership of the sectors by comparing domestic MFs' allocation with index weights. The perfect way would be to compare the entire institutional investor ownership with the index weights, but since FII data comes with a lag, we have considered DMF as the representative.

This is how the sector looks like on our framework right now.

We want to highlight that our stock-specific calls have driven the OW in Auto (UW earlier) and EW in FMCG (UW earlier). Our sectoral OW calls are on Banks, Pharma, Metals and OMCs. We retain UW in Capital Goods and Cement (explained in the next section).

Exhibit 110: How sectors look on our framework and our stance

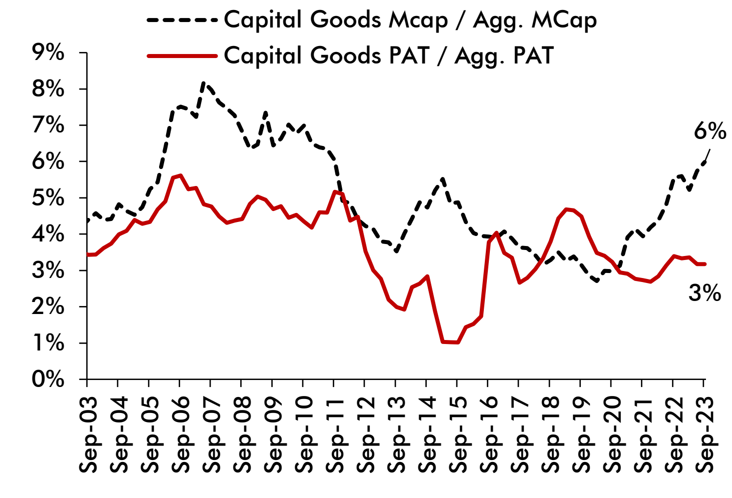
Sectors	Recent Excess Returns	Relative Valuation to Nifty	Earnings estimate trajectory	Ownership w.r.t. NSE500 Sector weights	G&C Positioning	Comments
Auto	Unattractive	Unattractive	Robust	Significantly Overweight	OW	Driven by stock specific call, adding low beta+EPS momentun
Banks	Attractive	Neutral	Robust	Neutral	OW	In line with framework
IT	Neutral	Unattractive	One of worst	Neutral	EW	In line with framework
Pharma	Neutral	Attractive	Reasonable	Significantly Overweight	OW	In line with framework
FMCG	Neutral	Unattractive	Robust	Underweight	EW	Driven by stock specific call, adding low beta+EPS momentun
Metals	Attractive	Unattractive	Reasonable	Significantly Underweight	OW	In line with framework
O&G	Attractive	Very attractive	Robust	Significantly Underweight	UW**	Disproportionate OW in OMC's
Capital Goods	Unattractive	Very Unattractive	Robust	Neutral	UW	In line with framework

*Source: Ambit Capital research. Bloomberg Note: Scores are assigned for excess returns, relative valuation and classified into 5 quintiles, 0-0.20 scores as very unattractive, 0.20- 0.40 as unattractive, 0.40-0.60 as Neutral,0.60-0.80 as attractive, and 0.80 to 1 as Very attractive. Ownership is calculated as difference between Equity holdings of DMF's and NSE500 sector weights. +/- 5% are defined as neutral, 5-15% as underweight/overweight, >15% are classified as significant OW/UW. Earnings estimate sustenance has been calculated based on comparison of how earnings estimates evolution for current FY and next FY.**We have disproportionate OW in OMC's but don't own Reliance*

Sectors to watch out for divergence!

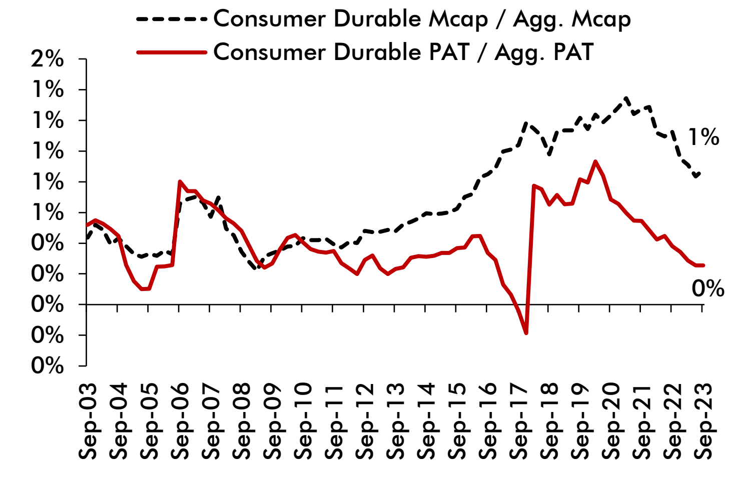
We screen for sectors where market capitalization added is not backed by profit pool contribution. We highlight sectors where we observe a huge divergence in market-cap and PAT contribution to the overall NSE500 market-cap and PAT pool. Essentially, a lot of expectations have been built up! We notice that Capital Goods, Consumer Durables and Cement show huge divergence in profit and market-cap contribution, where market-cap contribution (of NSE 500) has risen much faster than PAT contribution. For Financials, it appears that the market is yet to factor in their profitability and are likely to outperform over the slightly longer term.

Exhibit 111: Capital goods: Highest divergence in 7 years! Significant expectations built in!



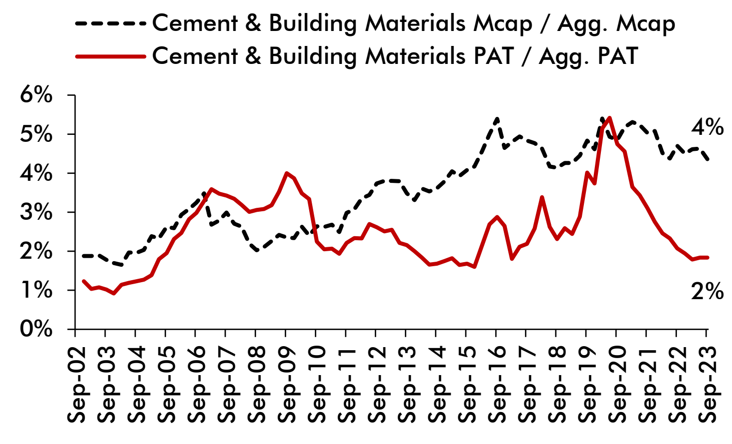
Source: Ace Equity, Ambit Capital research. Latest PAT data as of 30th June '23 (rolling 4-quarter sum), and market cap data as of 30th Sept'23

Exhibit 112: Consumer Durables' contribution to profit pool one of the lowest* in the decade on weak demand while mcap contribution remains relatively high



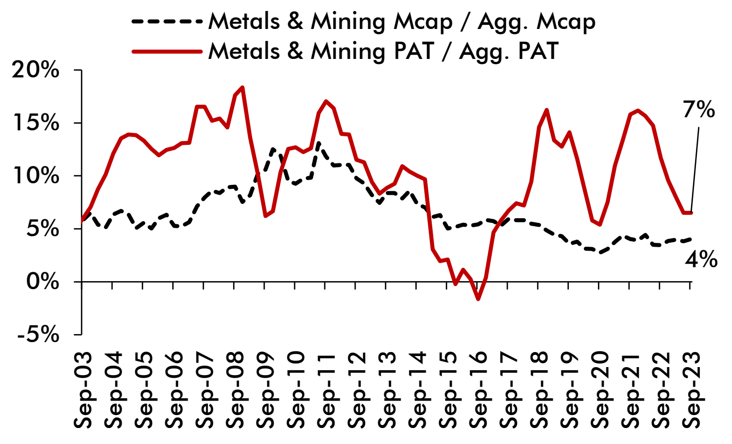
*Source: Ace Equity, Ambit Capital research. Latest PAT data as of 30th June 23(rolling 4-quarter sum) and market cap data as of 30th Sept'23, *except Dec'17 profit impacted by Videocon one-offs*

Exhibit 113: Cement: Rising input cost led to a significant PAT decline over the last 2-3 years while mcap contribution remains high



Source: Ace Equity, Ambit Capital research. Latest PAT data as of 30th Jun'23 (rolling 4-quarter sum), and market cap data as of 30th Sept'23

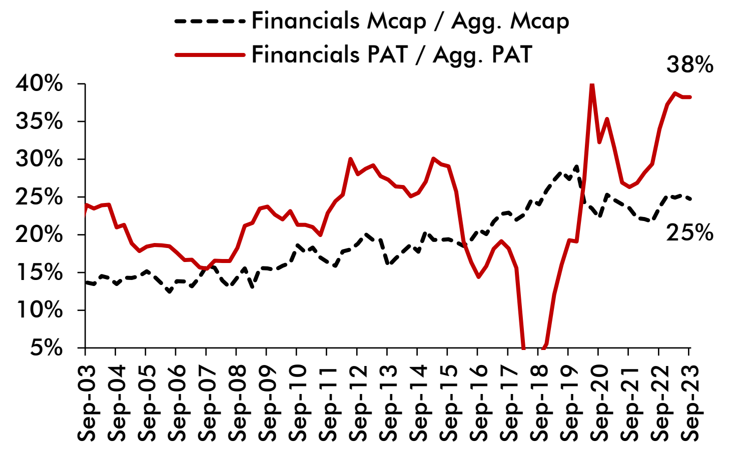
Exhibit 114: Divergence in Metals mcap and PAT contribution has contracted!



Source: Ace Equity, Ambit Capital research. Latest PAT data as of 30th Jun'23 (rolling 4-quarter sum) and market cap data as of 30th Sept'23

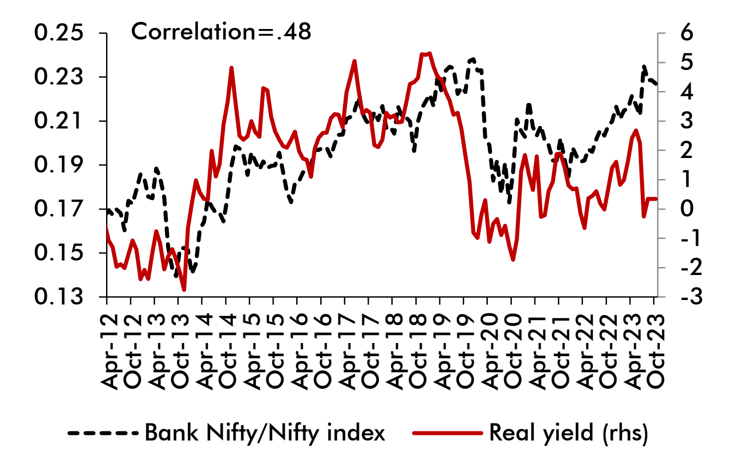
The divergence in profit and market-cap contribution of Financials remains significantly high, especially when earnings estimate sustenance is seen only in Banks and Auto. Additionally, banks outperform markets with expansion in real yields, which we expect. Some convergence is likely in the medium term, which can drive "Financials" outperformance. This is our key OW.

Exhibit 115: Divergence in mcap and PAT contribution of Financials remains high despite sustenance of earnings trajectory/surprises; convergence likely?



Source: Ace Equity, Ambit Capital research. Latest PAT data as of 30th Jun'23 (rolling 4-quarter sum), and market cap data as of 30th Sept'23

Exhibit 116: An expansion in real yield can drive banks' outperformance over Nifty



Source: Company, Ambit Capital research. Latest data as of 20th Oct'23

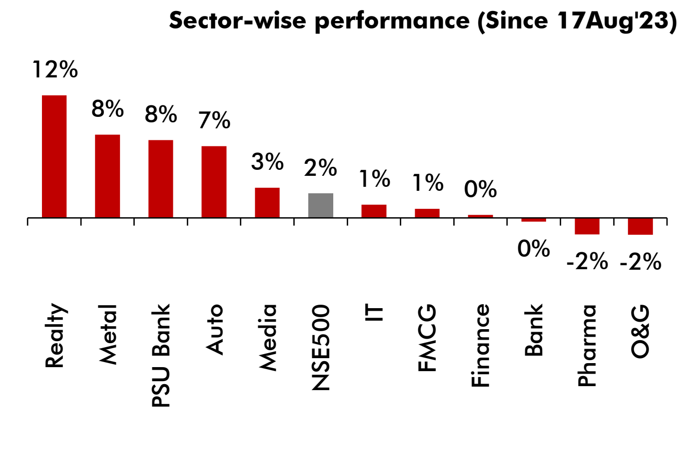
Reviewing our G&C 18.2 portfolio

We revisit our G&C 18.2 portfolio launched in May'23. We did a minor tweak to our portfolio on 18th Aug'23. Our G&C 18.2 portfolio has underperformed NSE500 index over the last 5 months by around 2.5% as SMID outperformed massively, and our positioning is "large-caps" heavy. Overall outperformance over the last 1 year has fallen to <100bps. Financials remained the biggest contributor while our OW "Media" underperformed which dragged overall performance. We maintain significant OW in Financials and Metals. We add low-beta stocks displaying earnings momentum to the portfolio, which closes our UW position in Autos and FMCG. Becoming stock-specific! Prefer Banks over IT. We made 4 changes. ADD-Nestle, TVS Motors, CDSL, Embassy; Remove- SRF, BHARTI, AMBER. Our preference order remains large-caps>mid-caps>small-caps. Mid/small-cap allocations are 13%/9% and cash allocation 7.5%.

Audit of our portfolio returns

- Since 17th Aug'23, Realty was the biggest outperformer followed by Metals. O&G and Pharma were the biggest laggards. Nifty 500 delivered 2.4%, while the G&C portfolio (including cash) delivered (2%), marginally underperforming the index.
- In G&C 18.2 dated 17th May'23, we retained our OW stance on Financials. ICICI Bank, HDFC Bank and SBI Cards underperformed. However, this underperformance was cushioned by Bajaj Finance, Axis Bank, SBI Life and Federal Bank. Financials remained the biggest contributor to returns!
- We reduced weight in IT and O&G in the 17th Aug iteration, and it reduced drag on portfolio performance since these were key laggards. On the other hand, our OW "Media" underperformed which dragged overall performance.
- While Pharma (OW stance) underperformed the market by ~4%, our latest additions Narayana Hrudayalaya and Max healthcare outperformed the market by more than 4%. Dr. Reddy's was the key laggard in our portfolio.
- Metals (OW stance) outperformed the market by 5% and our portfolio stocks Tata Steel and Hindalco outperformed the market by more than 3%.
- Bajaj Finance (12.2%), GE Shipping (11.4%) and Bharti Airtel (10.3%) were the biggest outperformers whereas IndiaMart (-13%), SBI Cards (-7.5%) and Dr. Reddy's (-5.3%) were the key laggards.

Exhibit 117: Realty and Metals were biggest outperformers while O&G and Pharma were the biggest drags (NSE500)



Source: Ace Equity, Ambit Capital research. Notes: Returns have been calculated from 17th Aug'23 to 20th Oct'23

Exhibit 118: G&C 18.2: Sector-wise performance and attribution since 17th Aug-23

Sector	Weight in G&C	Contribution to return
Financials	34.1	0.5%
Telecom	4.1	0.4%
Metals & Mining	7.1	0.4%
Auto & Auto Anc	4.9	0.4%
IT	10.5	0.2%
Miscellaneous	5.7	0.2%
Consumer Durable	1.5	0.1%
New-age tech	3.6	0.1%
Healthcare	9.3	0.0%
FMCG	5.0	0.0%
Chemicals	3.3	-0.1%
Oil & Gas	3.9	-0.1%
Media	6.8	-0.3%

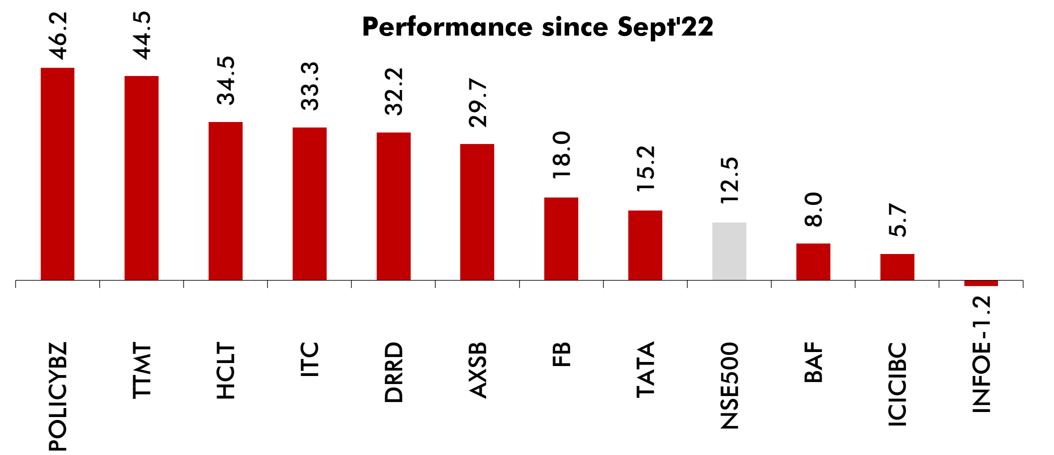
Source: Ace Equity, Ambit Capital research. Notes: Returns have been calculated from 17th Aug'23 to 20th Oct'23

Exhibit 119: Performance of our G&C 18.2 portfolio since 17th Aug-23

Company Name	Caps	Sector	Absolute Price Performance	Contribution to G&C 18.2 performance
Bajaj Finance	Large Cap	Financials	12.2%	0.5%
Great Eastern Shipping Co	Small Cap	Miscellaneous	11.4%	0.2%
Bharti Airtel	Large Cap	Telecom	10.3%	0.4%
Federal Bank	Mid Cap	Financials	8.4%	0.2%
Tata Motors	Large Cap	Auto & Auto Anc	8.1%	0.4%
Max Healthcare	Mid Cap	Healthcare	7.8%	0.2%
Amber Enterprises	Small Cap	Consumer Durable	7.0%	0.1%
HCL Technologies	Large Cap	IT	7.0%	0.3%
Narayana Hrudayalaya Ltd	Small Cap	Healthcare	6.3%	0.1%
SBI Life Insurance	Large Cap	Financials	6.1%	0.2%
Tata Steel	Large Cap	Metals & Mining	6.1%	0.2%
Hindalco Industries	Large Cap	Metals & Mining	5.4%	0.2%
Axis Bank	Large Cap	Financials	4.7%	0.3%
PB Fintech	Mid Cap	New-age tech	2.0%	0.1%
Tata Consultancy Services	Large Cap	IT	1.7%	0.1%
ITC	Large Cap	FMCG	-0.6%	0.0%
Affle India	Small Cap	Media	-0.7%	0.0%
InterGlobe Aviation	Large Cap	Miscellaneous	-0.8%	0.0%
ICICI Bank	Large Cap	Financials	-2.0%	-0.1%
Info Edge India	Mid Cap	Media	-2.2%	-0.1%
SRF	Large Cap	Chemicals	-2.7%	-0.1%
Bharat Petroleum Corp	Large Cap	Oil & Gas	-3.0%	-0.1%
HDFC Bank	Large Cap	Financials	-4.7%	-0.3%
Tech Mahindra	Large Cap	IT	-5.0%	-0.1%
Dr Reddy's Laboratories	Large Cap	Healthcare	-5.3%	-0.3%
SBI Cards & Payment Services	Large Cap	Financials	-7.5%	-0.4%
IndiaMart InterMesh	Small Cap	Media	-13.0%	-0.2%
G&C 18.2 performance				1.9%
G&C 18.2 returns(incl. Cash)				2.0%
Alpha v/s NSE500				-0.4%

Source: Ace Equity, Ambit Capital research

Exhibit 120: Out of 11 stocks that have been part of G&C portfolio since Sept'22, 6/11 have outperformed NSE500 massively, generating an alpha of more than 10%



Source: Ace Equity, Ambit Capital research

What goes out and what comes in?

What goes out? We exclude three stocks – Amber Enterprises, SRF and Bharti Airtel from our G&C 18.2 portfolio.

What comes in? There are **four new additions** to our portfolio – Nestle, TVS Motors, CDSL and Embassy REIT. These along with 24 existing stocks from G&C 18.2 comprise our latest G&C18.3 portfolio.

Size allocation: Concentrated towards large-caps (78%). Mid-cap/small-cap allocations stand at 13%/9%. Cash allocation stands at 7.5%.

Since mid-caps and small-caps are included in the portfolio, NSE500 is our benchmark.

Exhibit 121: G&C Portfolio vs NSE500: Implicit sector weights

Sector	Weights		Deviation
	G&C 18.2	NSE500	vs NSE500
Media	6.3	0.8	5.5
Financials	35.0	30.1	4.9
Metals and Mining	7.3	3.4	3.9
Healthcare	9.1	5.5	3.7
New-age tech	3.5	0.5	3.0
Auto and Auto Anc	8.9	6.8	2.1
FMCG	8.6	8.5	0.1
IT	10.4	10.4	0.0
Oil and Gas	3.7	7.7	(4.1)
Miscellaneous*	7.2	26.3	N/A

*Source: Ace Equity, NSE, Ambit Capital research. * Cannot be compared with NSE500*

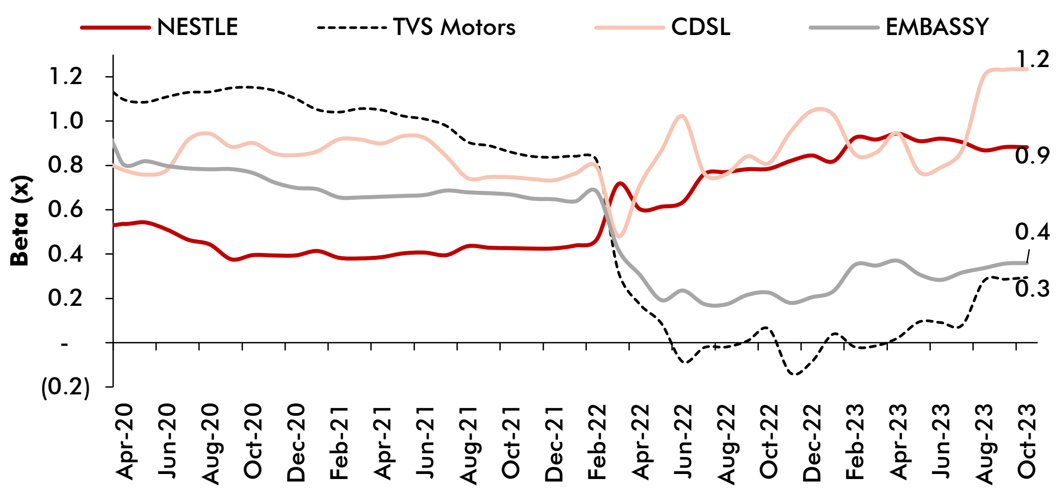
Exhibit 122: Dissection of our G&C Portfolio – OW/UW w.r.t. Nifty500

Sector	UW/OW	Portfolio Companies
Overweight		
Media	5.5	Affle India, IndiaMart InterMesh, Info Edge
Financials	4.9	Axis Bank, Bajaj Finance, CDSL, Federal Bank, HDFC Bank, ICICI Bank, SBI Cards, SBI Life Insurance
Metals and Mining	3.9	Hindalco Industries, Tata Steel
Healthcare	3.7	Dr Reddy's Labs, Max Healthcare, Narayana Hrudayalaya
New-age tech	3.0	PB Fintech
Auto and Auto Anc*	2.1	Tata Motors, TVS Motors
Equal weight		
FMCG*	0.1	ITC, Nestle
IT	0	HCL Tech, TCS, Tech Mahindra
Underweight		
Oil and Gas	(4.1)	BPCL
Miscellaneous	N/A	GE Shipping, Indigo, Embassy

Source: Ace Equity, Ambit Capital research. Note: Auto OW and FMCG EW are not driven by sectoral calls but by stock-specific calls!

Why we have included these stocks in the portfolio? We intend to reduce the beta of the portfolio and include stocks which exhibit earnings momentum! All these stocks are part of our preferred earnings momentum quintiles.

Exhibit 123: Except CDSL, our new inclusions exhibit low beta



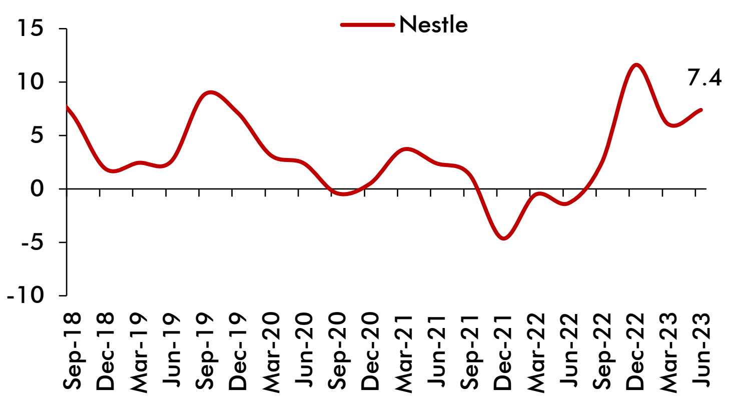
Source: Bloomberg, Ambit Capital research. Latest data as of 14th Oct'23

Nestle: Portfolio strength (leadership across most of the categories), penetration levels (<30%), and distribution expansion journey (shifting from wholesale to distributor model and increasing rural footprint) are the cornerstones for NEST's best-in-class revenue growth (10-12%) over the last 5 years. This is getting further reinforced with an investment of ₹50bn towards capex and enhancement of digital capabilities. NEST also offers the potential to foray into newer categories/cross-pollinate newer brands (case in point – recent launch of Gerber baby foods and Pet care business to Nestle India) from its global portfolio. All this gives us confidence in NEST's 11-13% revenue CAGR over the next 3-5 years, amongst the highest in the FMCG space. CY22 EBITDAM of 22.1% was lower YoY by 230bps owing to RM inflation headwinds. As RM prices moderate, we also expect EBITDAM improvement of 210bps despite introducing value packs and expanding deeper into rural geographies. This should help NEST clock 16%/17% EBITDA/PAT CAGR over CY22-25E. While the stock trades at 58x CY25 PE, we intend to lower the beta of the portfolio. Considering financial and operating performance to be better than peers, we expect NEST's stock price to largely mirror its earnings growth expectations.

CDSL: CDSL benefited from increase in retail participation and IPOs in the last 3 years given strong broker relationships. CDSL's demat market share increased to 73% from 50% in Dec'19. We expect medium-term revenue/EBITDA growth to be higher (11%/12%) than pre-Covid (8%/6%) levels on: i) households increasing allocation in equities, ii) growing popularity of mobile investing and iii) equitization with more companies listing. Despite the stock trading at 39x, we think CDSL is well-placed to benefit from regulatory initiatives being considered to increase retail participation in equities including fractional shares/faster settlement. Further, scale-up of the insurance repository business could represent a 7-8% upside risk to our valuation.

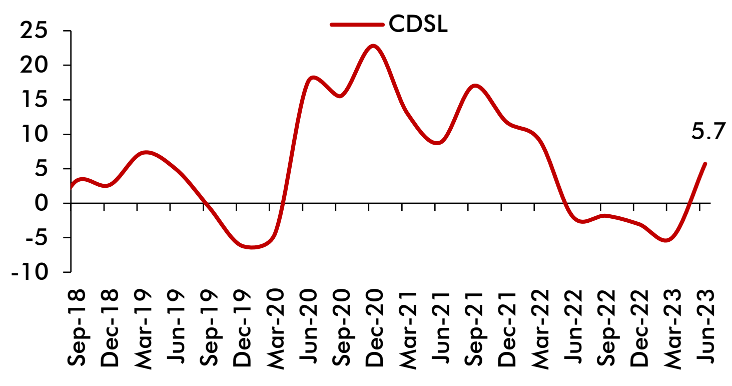
Embassy Office Parks REIT: Co-sponsored by Blackstone/Embassy, Embassy REIT is India's first and Asia's largest REIT in sqft (~45mn sqft under management). Quality tenants (47%/81% rental obligations from Fortune-500/MNCs) with 6.6 years' WALE provide earnings stability. Portfolio occupancy stood at 85% with SEZ de-notification strategy activated. GCCs continue to drive leasing demand even whilst demand from traditional IT, ITeS remains sluggish. Whilst in the near term leasing will only see moderate pick-up, we believe FY24 is the worst of 5-year downcycle for CRE. Clarity on SEZ de-notification remains a key monitorable. Remain BUYers; SOTP-based TP of ₹389 is based on 15%/16% revenue/EBITDA CAGR over FY23-26E with FY24E NDCF of ₹22.3/unit. Acquisition headroom given low leverage (29% net debt to GAV) and higher MTM (15%) provides upside risk.

Exhibit 124: High earnings momentum in Nestle



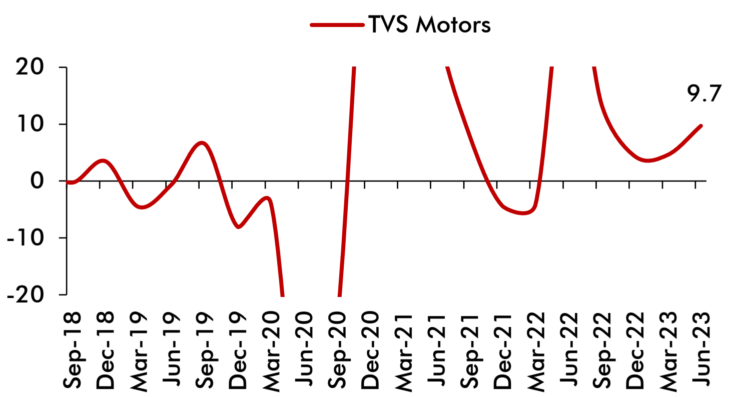
Source: Bloomberg, Ambit Capital research

Exhibit 125: Likewise in CDSL (TTM EPS, QoQ)



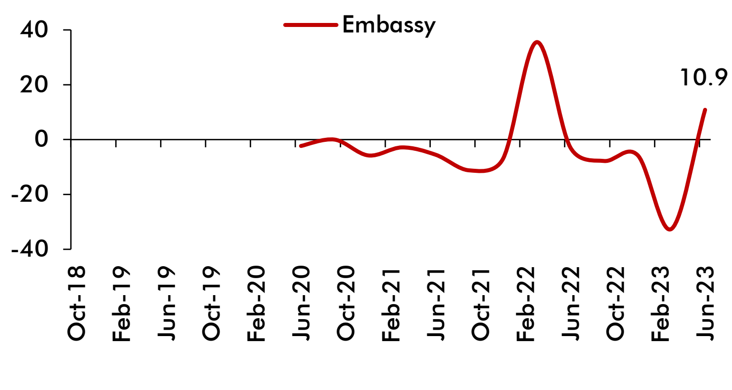
Source: Bloomberg, Ambit Capital research

Exhibit 126: TVS EPS momentum has been exceptional…



Source: Bloomberg, Ambit Capital research

Exhibit 127: …whereas it has come back in EMBASSY



Source: Bloomberg, Ambit Capital research

Exhibit 128: G&C 18.3 composition and valuation

Company	Sector	Mcap ($mn)	MDV-3m ($mn)	Accounting Decile	Greatness Score	Ambit stance	P/E FY24E	P/E FY25E	P/B FY24E	P/B FY25E	ROCE/ ROA* FY23
Tata Motors	Auto	29,206	76	D9	0%	NR	14	12	4.0	3.0	5
TVS Motor	Auto	9,126	16	D9	42%	NR	39	31	10.0	8.0	21
InterGlobe Aviation	Aviation	11,322	22	D4	42%	NR	16	14	N/A	13.9	5
HDFC Bank	Financials	138,924	354	N/A	N/A	NR	18	15	2.6	2.3	2
ICICI Bank	Financials	78,613	174	N/A	N/A	BUY	17	15	2.9	2.5	2
Bajaj Finance	Financials	56,644	72	N/A	N/A	SELL	36	30	6.5	5.5	5
Axis Bank	Financials	36,356	103	N/A	N/A	BUY	13	11	2.2	1.8	2
SBI Life Insurance	Financials	16,414	15	N/A	N/A	BUY	23	20	N/A	N/A	N/A
SBI Cards	Financials	8,953	11	N/A	N/A	BUY	29	22	6.4	5.2	6
Federal Bank	Financials	4,126	25	N/A	N/A	BUY	10	8	1.1	1.0	1
CDSL	Financials	1,689	10	N/A	N/A	BUY	43	40	N/A	N/A	N/A
ITC	FMCG	65,771	55	D3	42%	NR	26	24	7.8	7.4	29
Nestle India	FMCG	28,168	14	D5	92%	SELL	76	65	69.9	55.1	110
Dr Reddy's Laboratories	Healthcare	11,176	31	D1	75%	BUY	19	17	3.4	2.9	18
Max Healthcare	Healthcare	6,828	12	D10	67%	BUY	46	38	6.0	5.2	30
Narayana Hrudayalaya	Healthcare	2,591	3	D1	75%	BUY	34	29	8.8	7.5	32
TCS	IT	153,859	77	D4	50%	SELL	28	27	14.7	12.0	53
HCL Technologies	IT	41,097	34	D3	33%	BUY	22	21	5.3	5.2	27
Tech Mahindra	IT	13,742	36	D7	58%	BUY	28	20	3.9	3.8	18
Info Edge India	Media	6,533	13	D5	58%	BUY	68	56	4.5	4.3	5
IndiaMart InterMesh	Media	2,006	6	D1	75%	BUY	43	36	7.0	6.0	13
Affle India	Media	1,719	3	D4	58%	BUY	47	35	7.8	7.2	15
Tata Steel	Metals and Mining	18,104	49	D5	75%	BUY	18	10	1.4	1.3	12
Hindalco Industries	Metals and Mining	12,756	30	D5	83%	BUY	11	8	1.0	0.9	12
Embassy Office Parks REIT	REITs	3,524	1	N/A	N/A	BUY	50	33	1.3	1.4	3
PB Fintech	New-age tech	3,919	9	D5	33%	BUY	177	62	5.7	5.0	(13)
Bharat Petroleum Corp	Oil and Gas	9,042	16	D9	17%	BUY	4	6	1.0	1.0	5
GE Shipping	Shipping	1,476	3	D2	67%	BUY	7	10	1.3	1.1	22

Source: Bloomberg, Ambit Capital research. Note: N/A indicates data not available; NR indicates not rated; For SBI Life, P/E indicates Price to Value of New Business per share (P/VNB), P/B indicates Price to Embedded Value per share (P/EV); For not rated companies P/E, P/B, ROCE/ROA values are Bloomberg consensus; Latest data as of 20th Oct'23

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