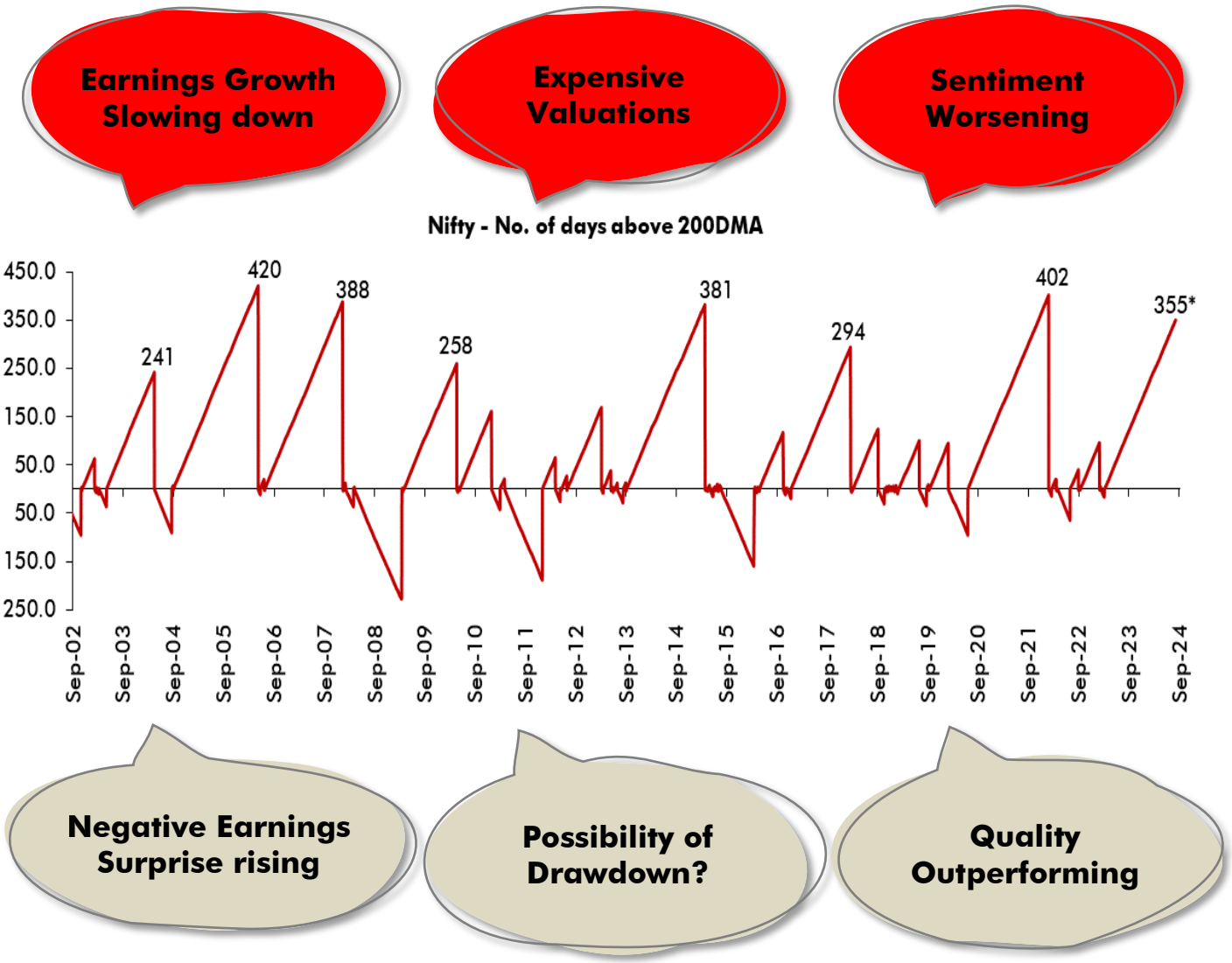
Strategy

September 2024



G&C 19.2 – Time for laggards to run

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G&C 19.2 – Time for laggards to run

Market momentum has slowed down and a drawdown could be near. Since 2000, the longest stretch for Nifty trading above 200DMA is 420 trading days and the current episode is 355 days so far. Can it halt? With earnings growth (7%) slowing down, negative revisions picking up (-4%), expensive valuations and worsening sentiment, it is a possibility. In such an environment, investing in stocks with best earnings revision is a winning strategy. It generates significant alpha: ~5%/~8% in large-caps/mid-caps respectively. Prefer Quality and Low Volatility Factors, which outperform when earnings growth slows down. Prefer Banks – the divergence between mcap and PAT contribution is close to ATH. Never in the last 2 decades, when Bank Nifty/Nifty ratio slipped to -2 Z-score, has Banks underperformed the following year. Also, Banks' FY25 PAT growth (11%) is expected to remain at par with Ex-Banks universe. Prefer Heavyweights in large-caps and large-caps over SMID. Our portfolio outperformed NSE500 by 6.1% since 27 May'24 and cumulative one-year alpha is 5%. Making 7 changes to the G&C portfolio.

State of the market – A drawdown is a possibility

We are hitting limits for absence of drawdowns. Since 2000, the longest stretch for Nifty trading above 200DMA is 420 trading days and the current episode is 355 days so far. Mean reversion would imply 10% drawdown. Divergence between index and median stock returns began widening in 2QFY25. It has become a stockpicker's market, with median correlation between stock returns and index returns at 2-year low. Price action and RSI show negative divergence in momentum indices.

Factors driving markets: earnings, interest rate, valuations and sentiment

Since 2021, earnings was the primary driver of returns, but over the past few quarters multiples expansion has become the key driver, especially in SMIDs. Not only is EPS growth slowing but estimate trajectory is also normalizing with downgrades in SMID. Expect this to accelerate as margin expansion lever (CPI-WPI spread) is no longer available. Valuations remain expensive on our P/B vs excess RoE framework even after accounting for a rate cut. A recent RBI paper suggests time varying trend in food inflation has increased and concerns on spillover to non-food components remain high. Our assessment: only one rate cut (25bps) likely in 3QFY25. Sentiment is deteriorating, as evident in surveys, while market sentiment remains in favour of greed.

Five trades for the year

Factor rotation to quality and low volatility is underway, which outperforms in a slowing EPS growth environment. Investing in companies with best EPS revisions has generated 5%/8% alpha in large-caps/mid-caps. We take a deep-dive and highlight key ideas. Empirical evidence for banks outperforming markets appears overwhelming, especially when their incremental EPS contribution remains strong. Expect Nifty heavyweights led by Banks & Quality to end underperformance of Nifty w.r.t Nifty EW Index which usually lasts 3-3.5 years. Remain sellers on SMID.

G&C portfolio positioning: Concentrated in large-caps (70%)

Since 27th May, our G&C portfolio outperformed NSE500 by ~600bps (~7% outperformance since inception). Mid/small-cap allocation is 23%/7% and cash allocation is 3.3%. Becoming stock-specific, we prefer Banks which has not worked out so far. Key OWs: FMCG, Healthcare and Financials. Key UWs: Capital Goods.
What's in: SBIN, GCPL, BHARTIHE, OINL, ERIS, KBL and CENT.
What's out: SHFL, TTMT, INFOE, EMBASSY, KVB, AFFLE and TRIV.

Exhibit A: G&C 19.2 composition

Company	Mcap ($mn)
Large-Caps	
HDFC Bank	148,641
ICICI Bank	101,364
Infosys	94,060
State Bank of India	83,182
HCL Technologies	56,763
Sun Pharmaceutical	52,143
Axis Bank	42,680
Mahindra & Mahindra	39,964
Nestle India	28,748
Tata Steel	22,486
InterGlobe Aviation	22,009
Tech Mahindra	18,914
Bharat Petroleum Corp	18,198
Hindalco Industries	17,856
Godrej Consumer Products	17,587
Hero MotoCorp	13,682
Dabur India	13,604
Mid-Caps	
ICICI Prudential Life Insurance	12,911
Oil India	12,147
Max Healthcare	10,402
PB Fintech	9,316
Bharti Hexacom	7,142
Federal Bank	5,353
Small-Caps	
Narayana Hrudayalaya	3,276
Century Textiles & Industries	3,204
Eris Lifesciences	2,348
Kfin Technologies	2,020
Karnataka Bank	987

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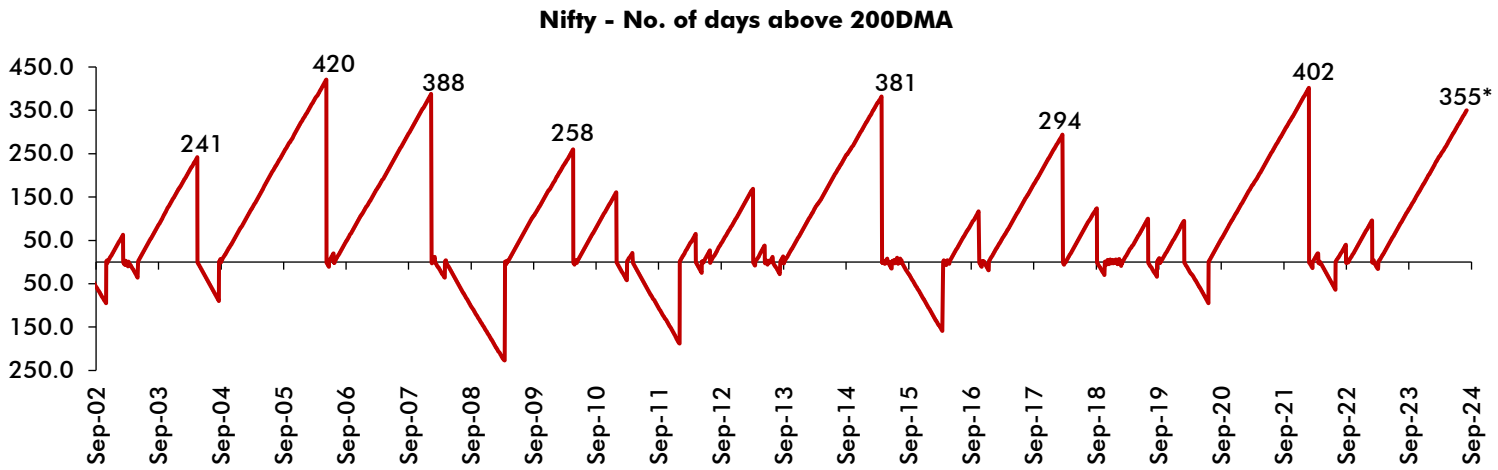
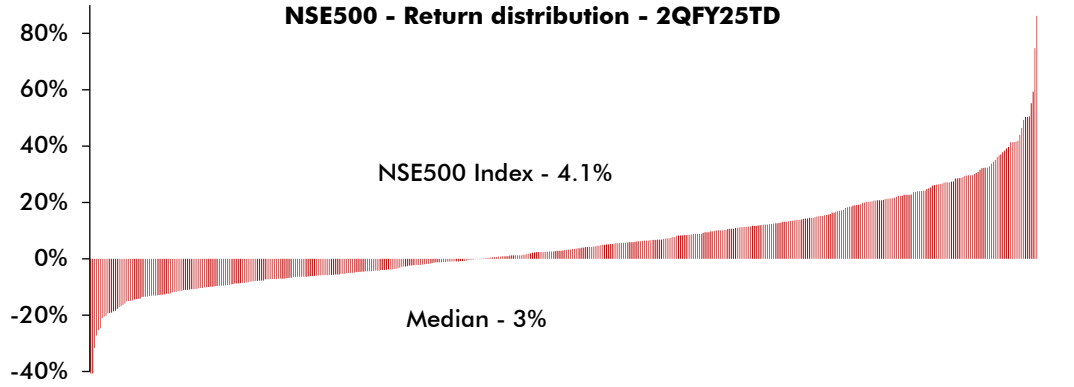
The Narrative in charts

Exhibit 1: Currently Nifty has been above 200DMA for 355 days*, which is the 2nd longest run that started in this decade



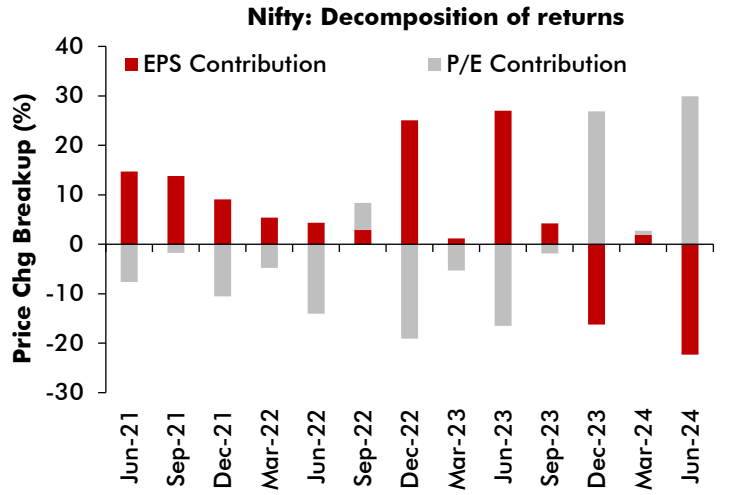
*Source: Bloomberg, Ambit Capital research. * 355 days and counting.*

Exhibit 2: The rally narrowed in 2QFY25 compared to the previous quarter



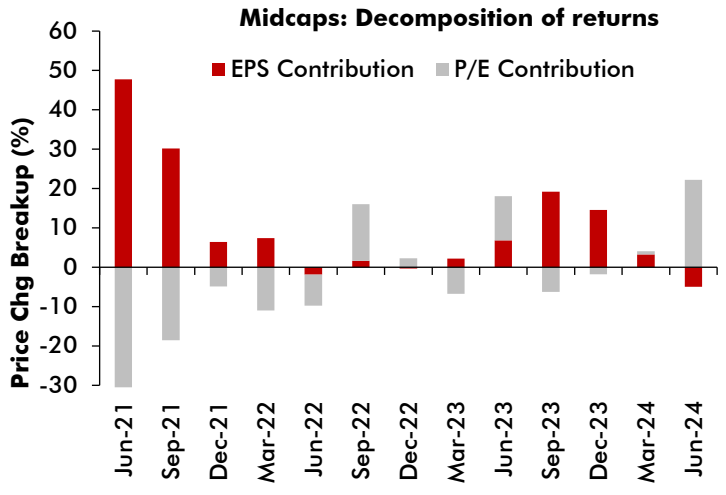
Source: Ace Equity, Ambit Capital research

Exhibit 3: Nifty returns decomposition: Earnings growth contribution declined in June-24



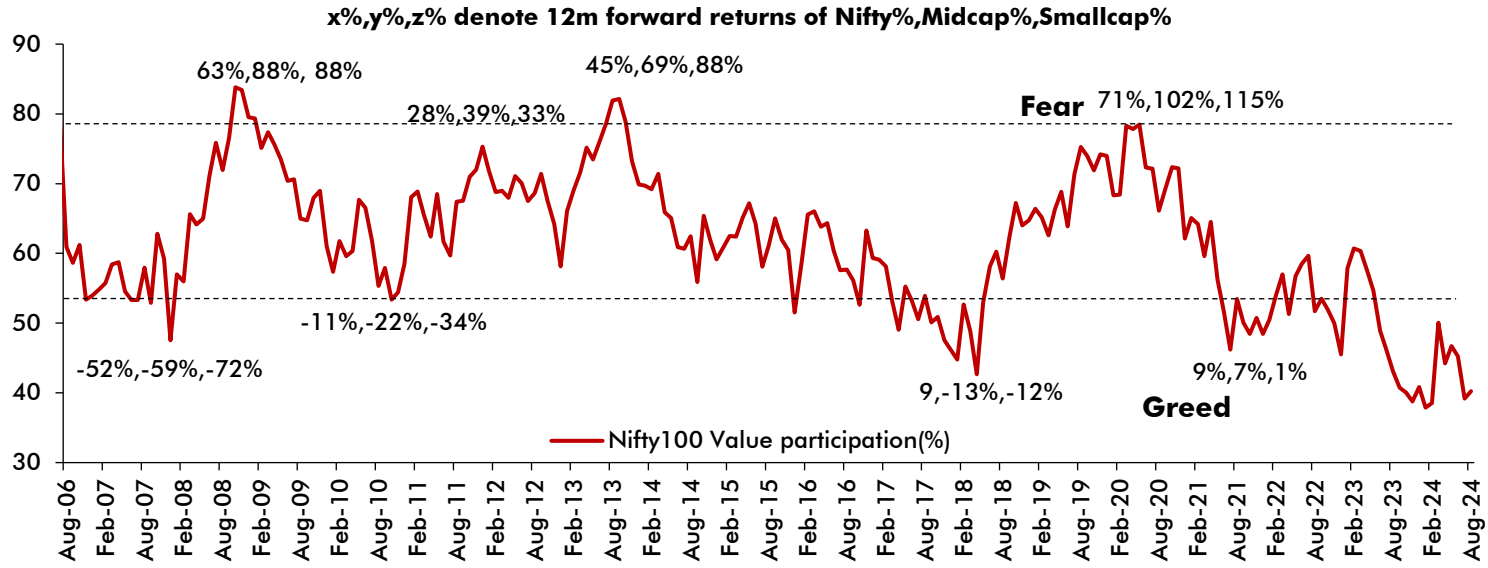
Source: Bloomberg, Ambit Capital research. Note: Data is taken on TTM basis as on March end each year, latest data is as of 03rd September'24

Exhibit 4: Multiple re-rating has been driving returns over the past quarter...



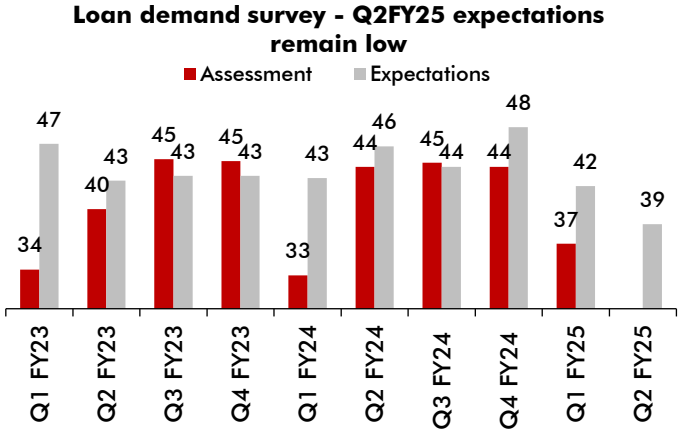
Source: Bloomberg, Ambit Capital research. Note: Data is taken on TTM basis as on March end each year, latest is as of 03rd September'24

Exhibit 5: Greed & Fear Indicator has been a great predictor of size positioning but has been less effective over last 1 year



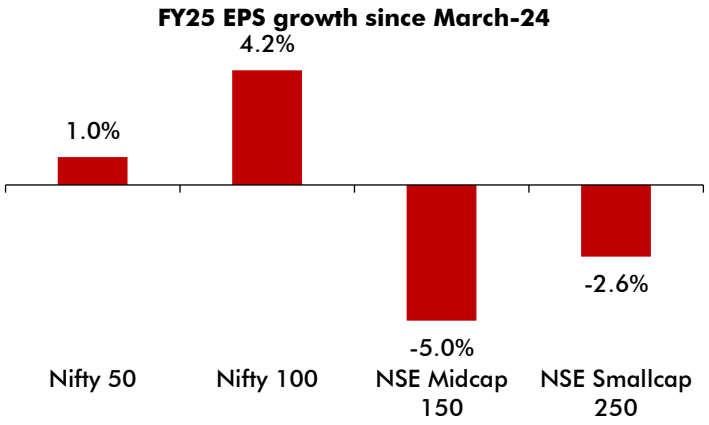
Source: NSE, Ace Equity, Ambit Capital research

Exhibit 6: RBI survey: Expect subdued loan demand in 2QFY25



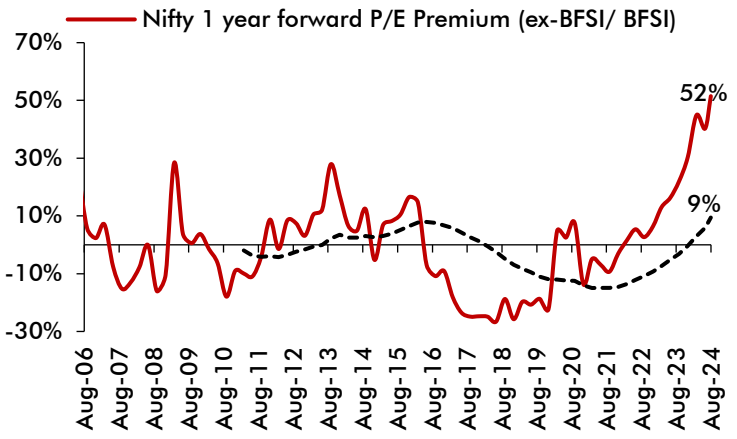
Source: RBI Survey, Ambit Capital research

Exhibit 7: Earnings estimate sustenance: Large-caps better than SMID



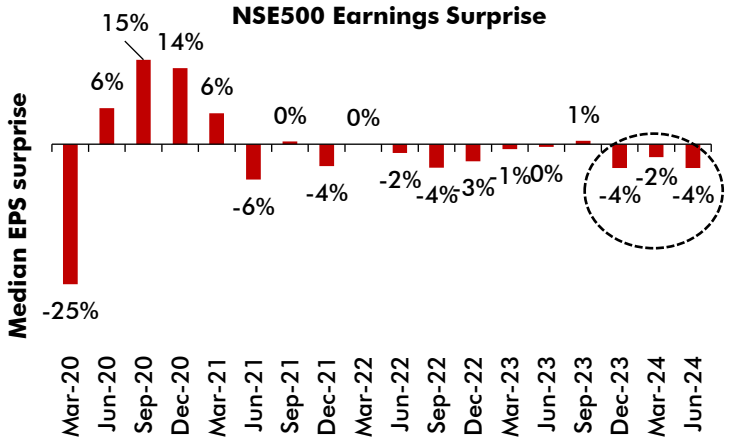
Source: Bloomberg, Ambit Capital research

Exhibit 8: Nifty Ex-BFSI universe trades at an ATH premium of 52% w.r.t BFSI on 12m fwd. P/E vs 5-year average of ~9%



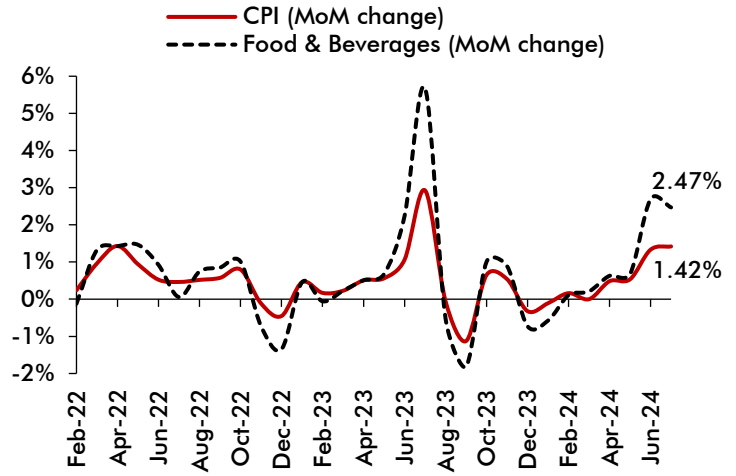
Source: Ace Equity, Ambit Capital research

Exhibit 9: Earnings surprises worsened in the current quarter



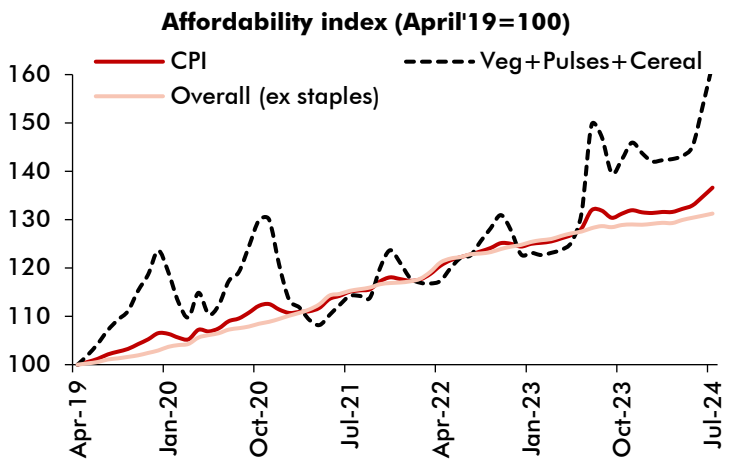
Source: Bloomberg, Ace Equity, Ambit Capital research Note: Roughly 270 stocks whose estimates are available, have been considered in the analysis. The conclusion remains the same for NSE200

Exhibit 10: Inflation witnessed 2nd highest MoM change since April-22



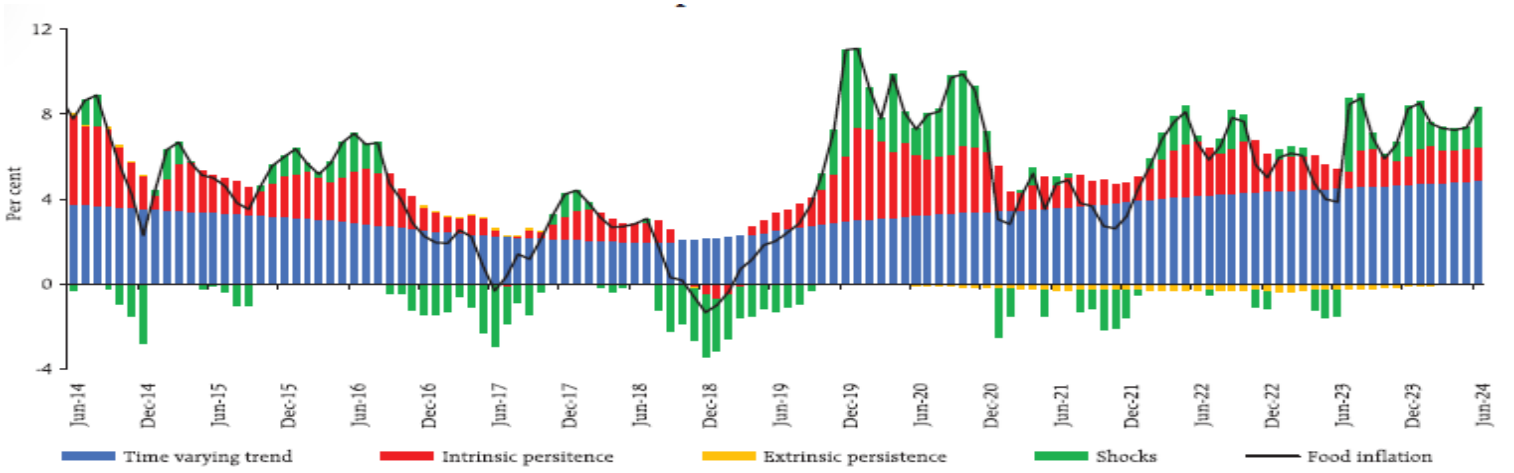
Source: Bloomberg, Ambit Capital research

Exhibit 11: Cost of staples outpaced average cost of living



Source: Bloomberg, Ambit Capital research

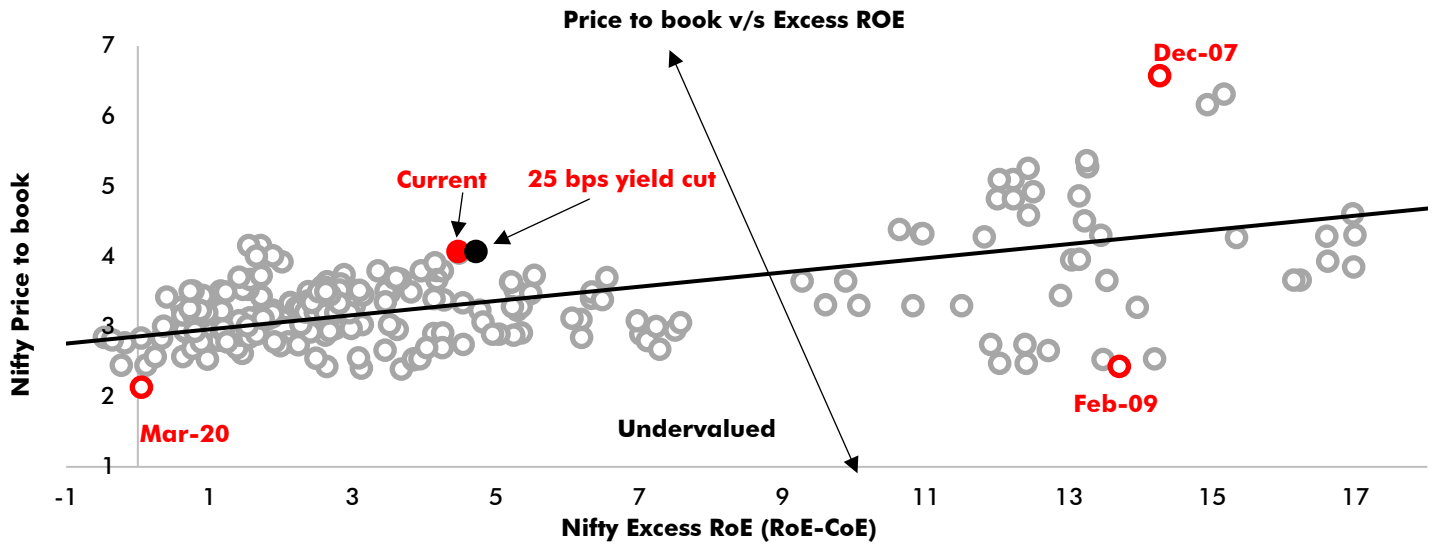
Exhibit 12: Decomposition of food inflation



Note: The contributions are converted to those in year-on-year inflation by taking 12-month moving averages.
Sources: NSO; and authors' estimates.

Source: NSO, RBI

Exhibit 13: Nifty remains overvalued even after assuming 25bps rate cut, trading above the line of fair valuation



Source: Bloomberg, Ambit Capital research. Note: Cost of Equity = 10-year Gsec-yield + Market risk premium (5%)

Exhibit 14: Implied Nifty (June-25) for different yields and earnings levels

10-year yield	June-25 EPS(INR)				
	1050	1060	1070	1080	1090
6.70%	26,261	26,511	26,761	27,011	27,261
6.80%	25,620	25,864	26,108	26,352	26,596
6.90%	25,010	25,248	**25,486**	25,724	25,962
7.00%	24,428	24,661	24,893	25,126	25,359
7.10%	23,873	24,100	24,328	24,555	24,782

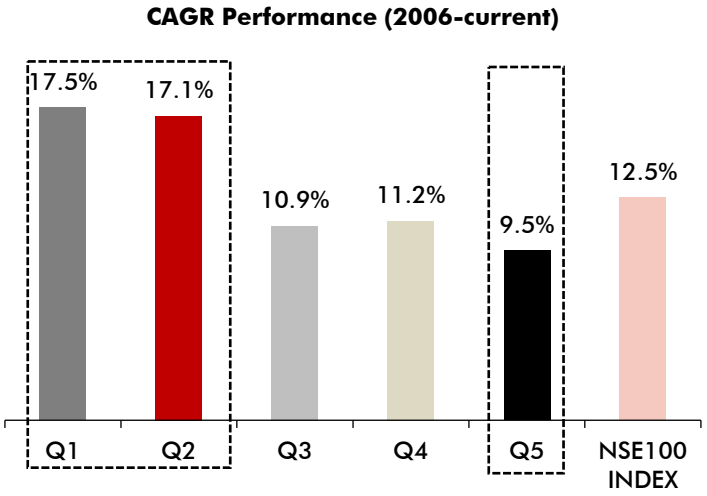
Source: Bloomberg, Ambit Capital research. Note: Implied Nifty levels have been calculated under the assumptions: Nifty trades at LTA (-2.7), EPS and yield by equation EYBY Gap= (Earnings)/(Nifty Level) - Bond Yield

Exhibit 15: Over the past 3 months, quality and low volatility turned a corner and began to catch up

Date	NIFTY200 Alpha 30	Nifty200 Momentum 30	NIFTY200 Quality 20	NIFTY200 Value 20	Nifty200 Low Volatility 20	Nifty High Beta 50	Nifty 200 Growth 20
Sep-23	6%	5%	3%	14%	1%	5%	0%
Oct-23	-5%	-4%	-2%	-2%	-2%	-4%	-1%
Nov-23	14%	12%	7%	10%	4%	8%	9%
Dec-23	10%	9%	7%	14%	8%	12%	8%
Jan-24	5%	6%	0%	10%	-4%	7%	1%
Feb-24	3%	3%	1%	9%	1%	1%	5%
Mar-24	2%	3%	0%	1%	-1%	0%	2%
Apr-24	6%	6%	1%	9%	-1%	10%	1%
May-24	5%	5%	4%	0%	-1%	0%	2%
Jun-24	6%	3%	6%	1%	6%	4%	7%
Jul-24	6%	5%	8%	10%	7%	4%	-1%
Aug-24	1%	0%	2%	-1%	3%	-4%	0%
Sep-24	-3%	-3%	0%	-4%	0%	-3%	-1%

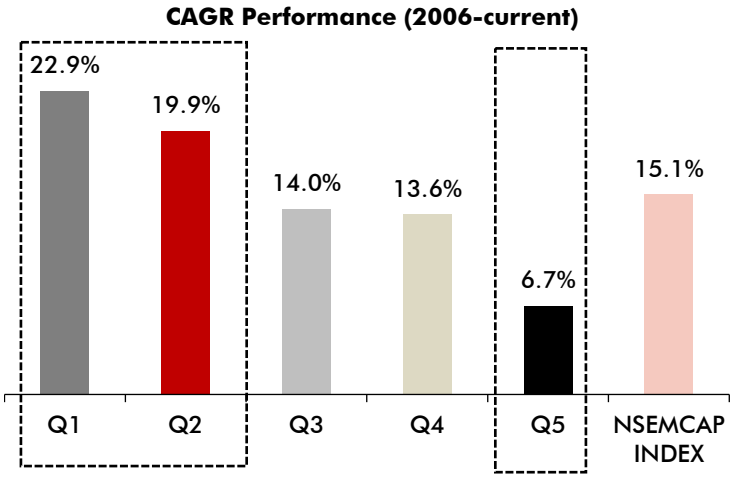
Source: Ace Equity, Ambit Capital research. Note: For comparability with other factor indices, we have created indices for Value, Low volatility and Growth factors based on NSE200 constituents, as factor indices for the same were not available.

Exhibit 16: Earnings revision strategy in large-caps: Q1/Q2 best quintiles) - Quintile to own; Q5 - Quintile to avoid...



Source: Bloomberg, Ambit Capital research

Exhibit 17: ...likewise for mid-caps



Source: Bloomberg, Ambit Capital research

Exhibit 18: Nifty Bank has outperformed Nifty by ~18% at Z-score of about -2

Date	Z-score (BNF/NF, 20-period)	(Nifty Bank – Nifty) Excess Return (%)			
		3m	6m	9m	12m
Apr-06	-2.2	1	18	16	9
Jun-08	-2.1	18	26	7	40
Nov-11	-2.1	10	8	8	20
Jul-13	-2.2	5	(4)	12	18
Feb-16*	-1.4	10	16	16	21
Sep-18	-2.2	9	15	16	11
Mar-20	-2.6	(8)	(19)	1	3
Aug-24	-1.9	N/A	N/A	N/A	N/A
Average		**6**	**9**	**11**	**17**
Median		**9**	**15**	**12**	**18**

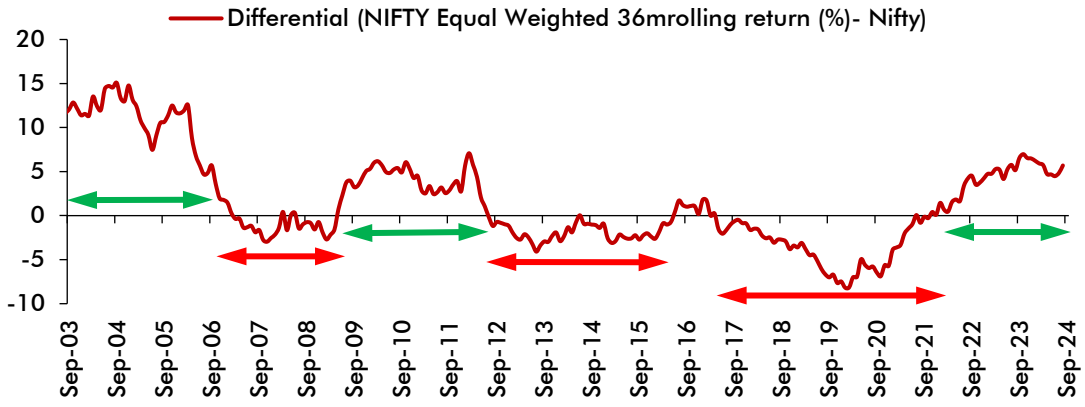
*Source: Bloomberg, Ambit Capital research Note: Z-Score has been calculated based on monthly observations of BNF/NF ratio and 20 observations have been used to calculate standard deviation and average. * In Feb-16, BNF/NF ratio touched -2 in the month but closed at -1.4. Note: Current z-score is -1.64*

Exhibit 19: Outperformance of Nifty Bank is backed by positive absolute returns on most instances

Date	Z-score (BNF/NF, 20-period)	Nifty Bank Return (%)			
		3m	6m	9m	12m
Apr-06	-2.2	(10)	23	31	24
Jun-08	-2.1	15	(1)	(18)	46
Nov-11	-2.1	22	10	17	42
Jul-13	-2.2	15	2	28	52
Feb-16*	-1.4	26	42	34	48
Sep-18	-2.2	8	21	24	16
Mar-20	-2.6	12	12	63	74
Aug-24	-1.9	N/A	N/A	N/A	N/A
Average		**12**	**16**	**26**	**43**
Median		**15**	**12**	**28**	**46**

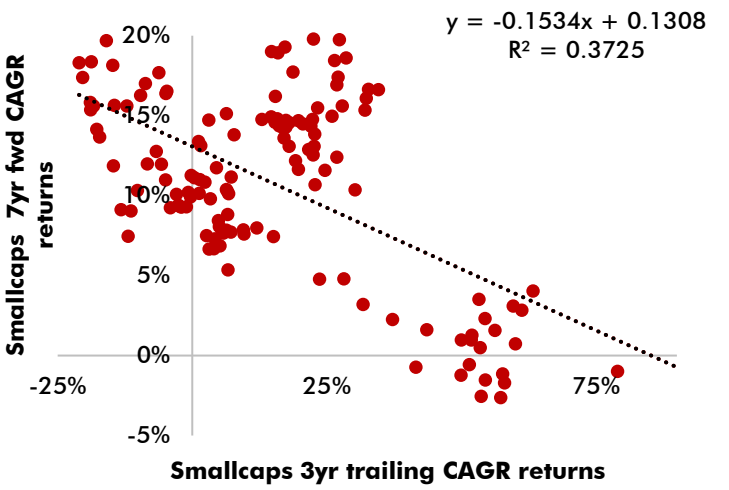
Source: Ace Equity, Ambit Capital research. Note: Current z-score is -1.64

Exhibit 20: The outperformance of Nifty EW index over Nifty typically lasts about 3 years



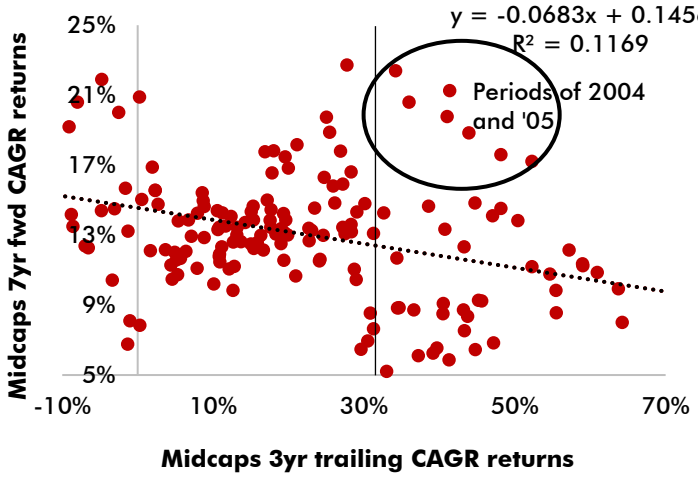
Source: Bloomberg, Ambit Capital research

Exhibit 21: Small-caps: strong returns over last 3 years (>26%) weighed on fwd. returns (<10% CAGR) over the following 7 years...



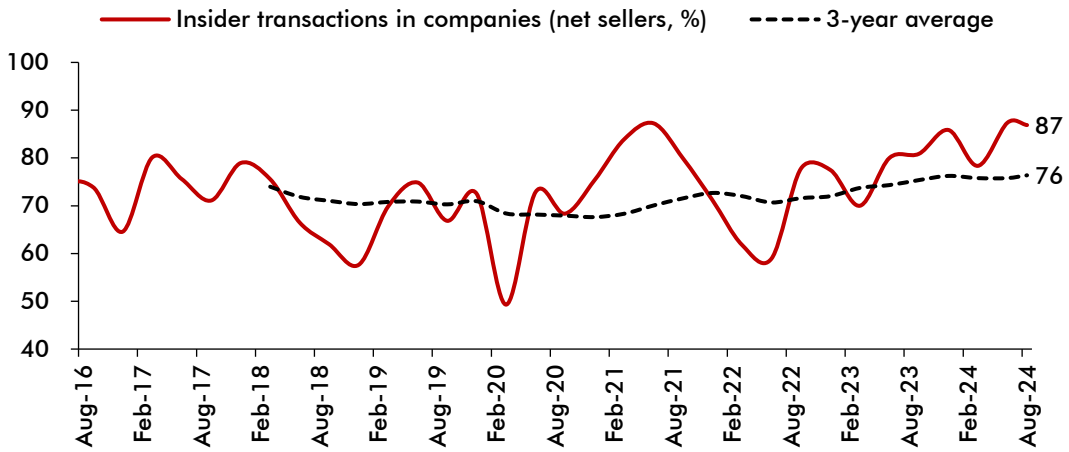
Source: Bloomberg, Ambit Capital research

Exhibit 22: ...while for mid-caps, the relation is mixed



Source: Bloomberg, Ambit Capital research

Exhibit 23: Percentage of insiders selling their stake is at an all-time high



Source: BSE, Ambit Capital research. Note: Universe is NSE500 index; No of Activity indicates number of companies with insider transactions in respective quarter; Latest data as of 31st Aug'24.

State of the market

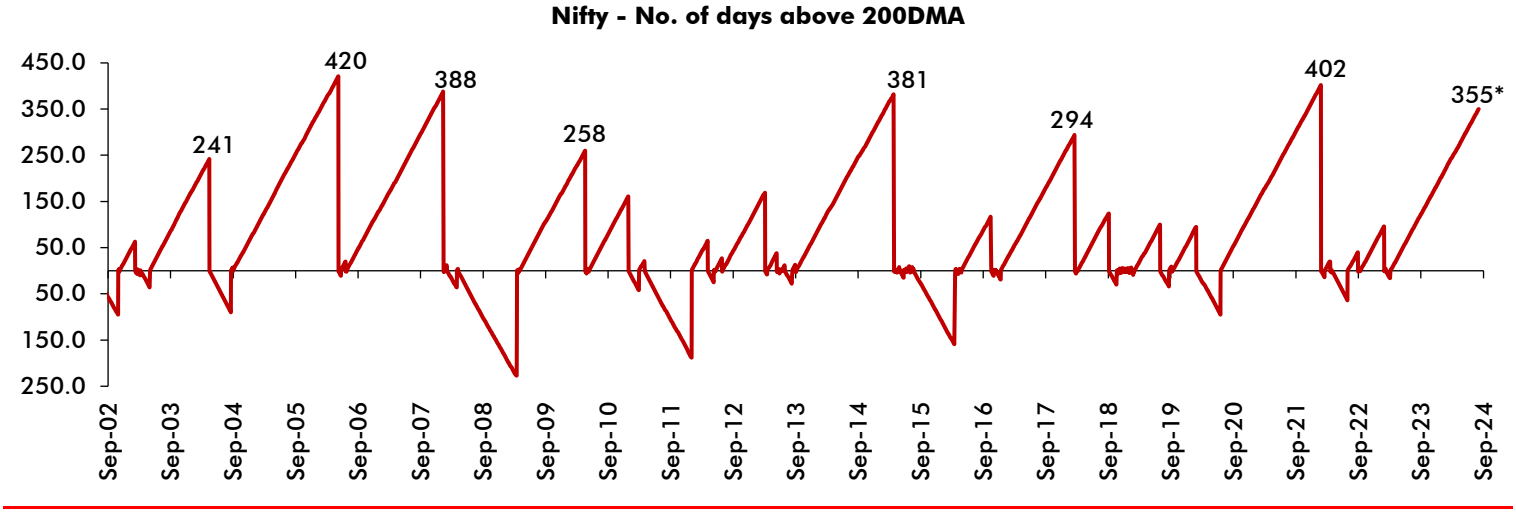
We are hitting limits for "absence of drawdowns". Since 2000, the longest stretch for Nifty trading above 200DMA is 420 trading days and the current episode is 355 days so far. Mean reversion would imply 10% drawdown. Divergence between index and median stock returns began widening in 2QFY25. It has become a stockpicker's market, with median correlation between stock returns and index returns at a 2-year low. Price action and RSI shows negative divergence in momentum indices.

Can the market momentum continue?

200DMA is a key psychological level for determining market trends and the market trading above 200DMA for a prolonged period indicates strength. Since 2000, there have only been five instances, including the current instance, when Nifty has traded above 200DMA for more than 300 days. The farthest Nifty has stayed above 200DMA is 420 days. Current duration is 355 days and counting. While multiples are expensive as compared to history on any framework, earnings growth is slowing and momentum seems to be weakening. As of today, Nifty is at a distance of 10% from 200DMA which is placed at 22,647. At the very least, 10% drawdown is in offing by historical trends.

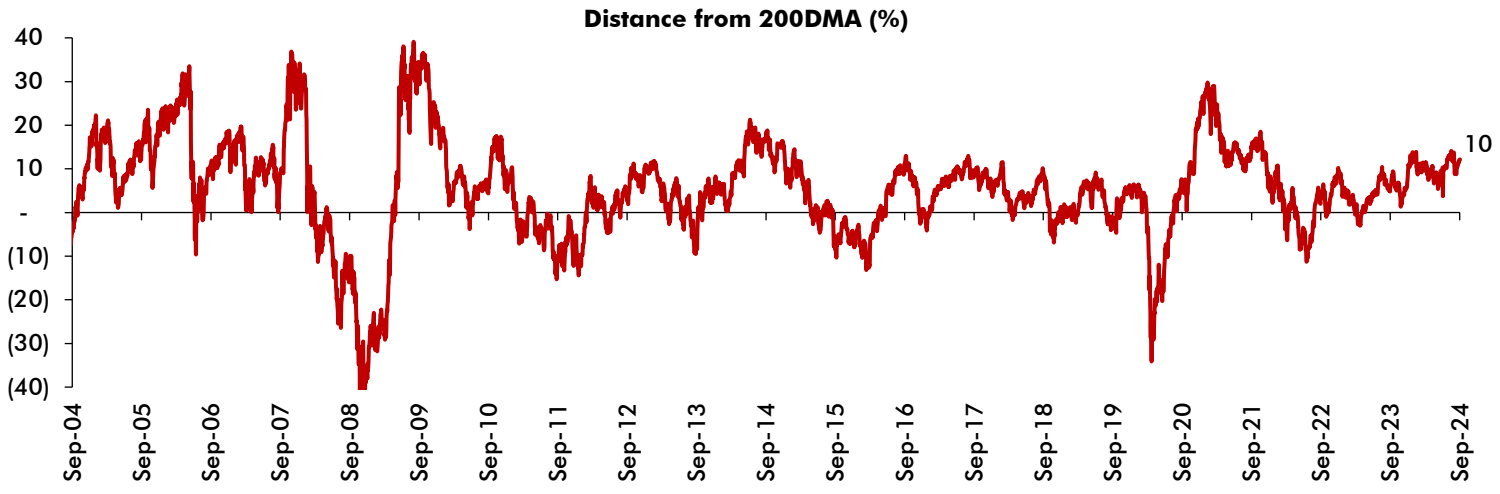
200DMA is an average of the stock price over the previous 200 trading days.

Exhibit 24: Currently Nifty has been above 200DMA for 355 days*, which is the 2nd longest run that started in this decade



*Source: Bloomberg, Ambit Capital research. *355 days and counting.*

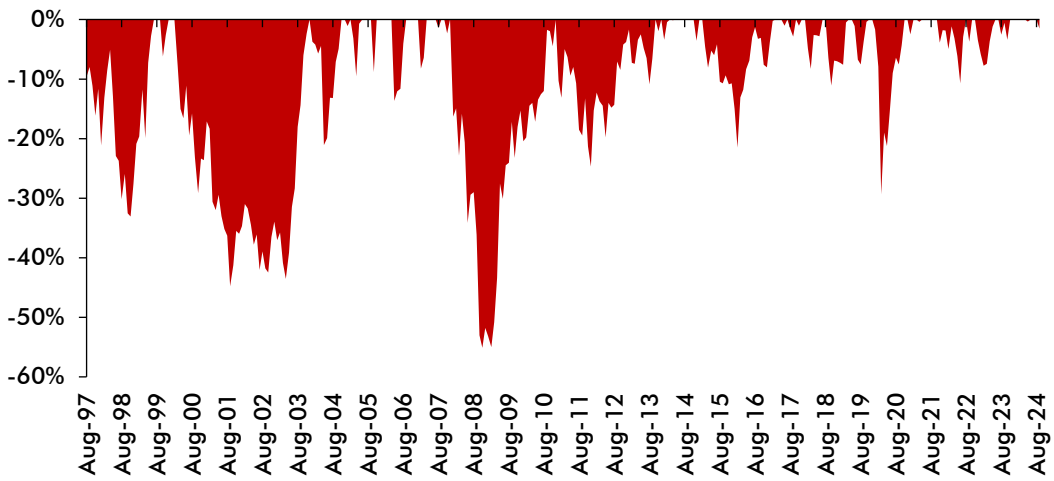
Exhibit 25: Nifty is currently 10% above 200DMA (22,647)



Source: Bloomberg, Ambit Capital research

Drawdowns are absent. Since CY97, the maximum drawdown for Nifty has been ~55%, while the same for each CY has been >10% in 20 out of the past 28 years. In CY23 and CY24YTD, the drawdowns were 7.8% and 1.5%. With earnings growth expected to normalize in FY25, drawdowns are likely to accelerate.

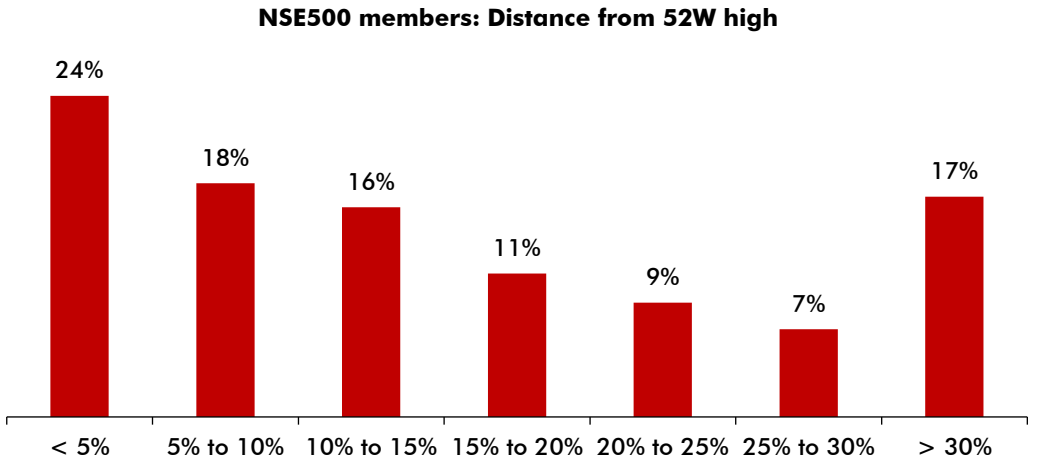
Exhibit 26: Calmness in the market - drawdowns have been limited since CY23



Source: Bloomberg, Ambit Capital research

With the absence of drawdowns, majority of NSE500 constituents are close to 52-week high. In fact, ~42% of the constituents are trading within 10% of the 52-week high. Can this change?

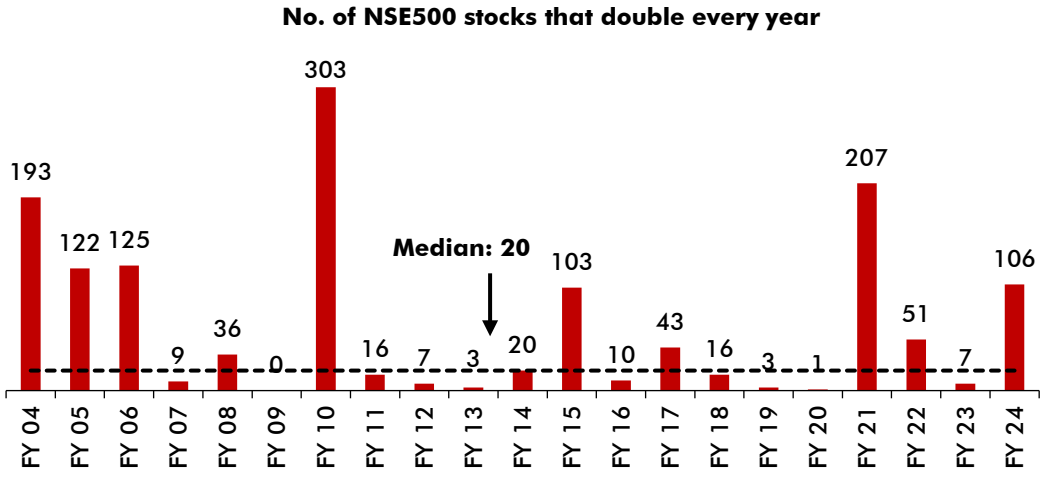
Exhibit 27: ~42% of NSE500 universe is within 10% of 52W high levels



Source: Ace Equity, Ambit Capital research

In FY24, the number of NSE500 stocks that doubled was highest since 2010 and more than 5 times the median, excluding FY21 abnormality when base prices were depressed.

Exhibit 28: Multi-baggers in FY24 were significantly higher compared to historical standards



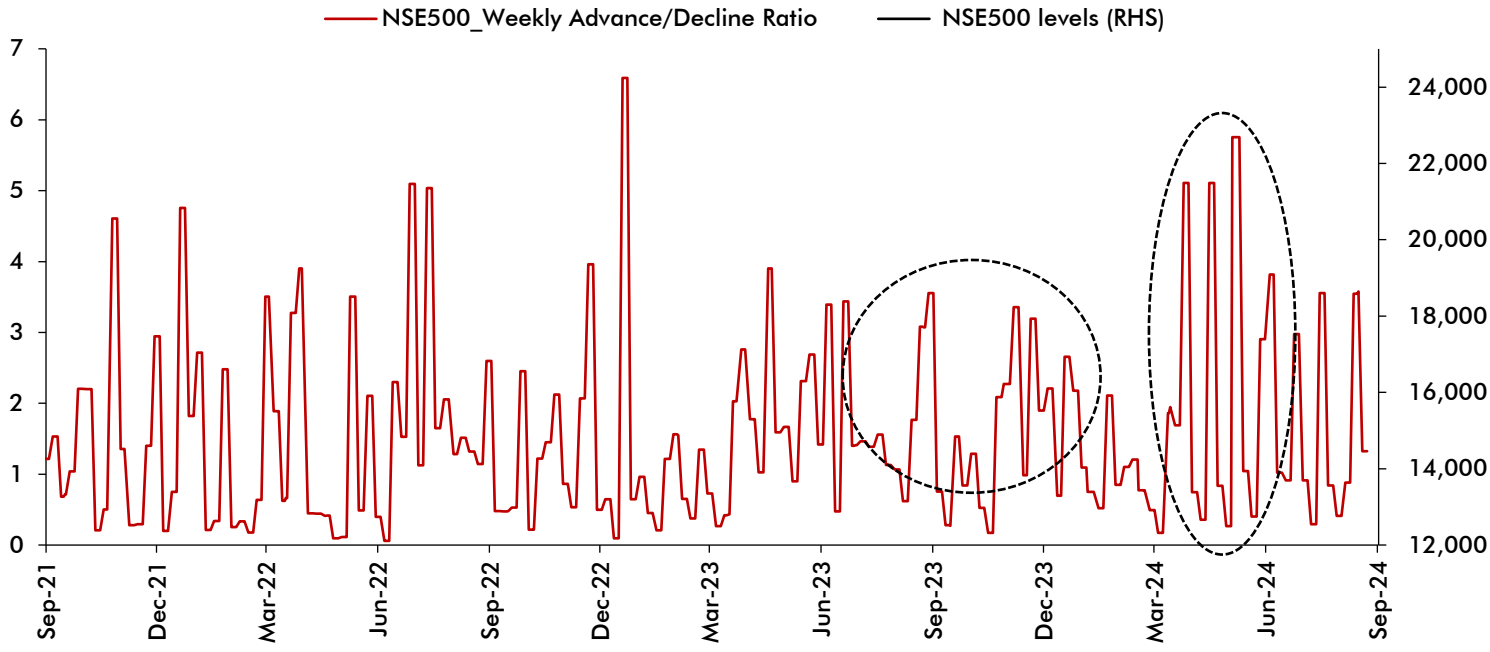
Source: Ace Equity, Ambit Capital research

Note: A/D Advance Decline ratio for an index is defined as no. of stocks advancing/no. of stocks closing lower over a reference time interval. For the weekly AD ratio, the reference period would be a week.

What lies ahead? Is market participation narrowing?

Market upward trajectory continued in CY24, with breadth of the rally better than that in 2HCY23, evident in advance/decline ratio trending upwards. While Advance/Decline ratio continues to be positive, indicating higher advances than declines, it is significantly lower than earlier.

Exhibit 29: Advances still lead declines, but the balance of power is shifting

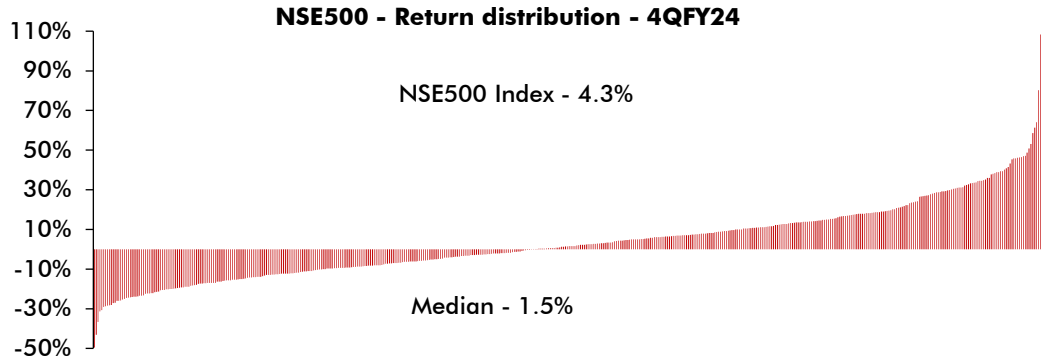


Source: Bloomberg, Ambit Capital research

This is evident in the divergence between index returns and median returns which has begun to accelerate. Let's look at the last 3 quarters for comparison –

- **4QFY24 –** Breadth of the rally was relatively narrow in 4QFY24 with almost equal number of stocks delivering positive and negative returns.

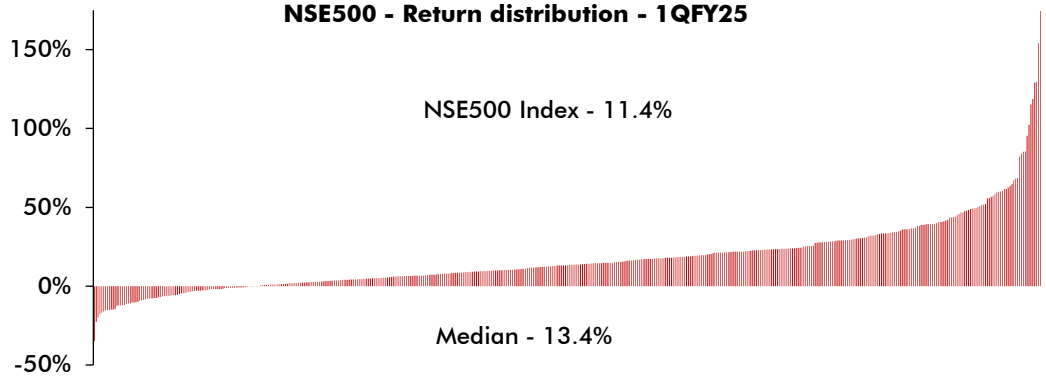
Exhibit 30: The rally in 4QFY24 was relatively narrow as compared to...



Source: Ace Equity, Ambit Capital research

- **1QFY25 –** Breadth significantly widened in 1QFY25, with median stock return ~200bps higher than that of NSE500 index. Additionally, the number of stocks delivering negative returns declined from ~46% in 4QFY24 to ~17% in 1QFY25.

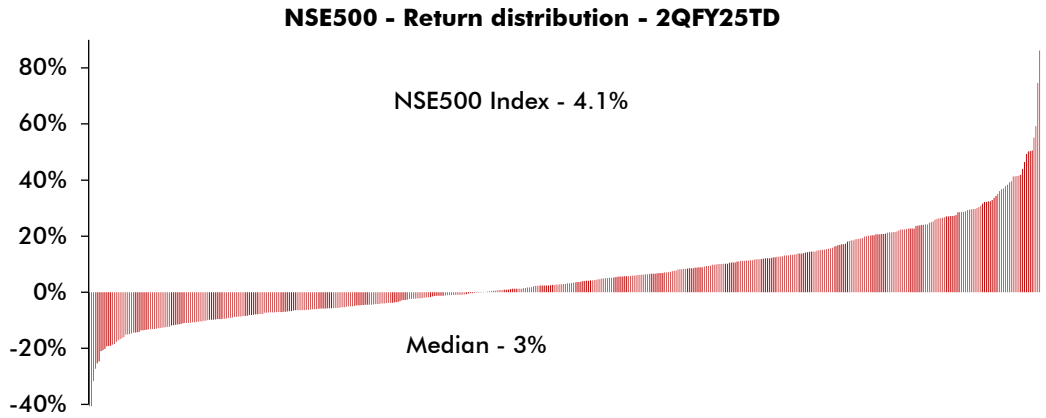
Exhibit 31: ...1QFY25 when the breadth of the rally was much stronger; however...



Source: Ace Equity, Ambit Capital research

- **2QFY25TD –** Strength of the rally is comparatively weak with median stock returns lagging NSE500 index by 1.1% and roughly 41% of stocks delivering negative returns.

Exhibit 32: ...it narrowed in 2QFY25 compared to the previous quarter



Source: Ace Equity, Ambit Capital research

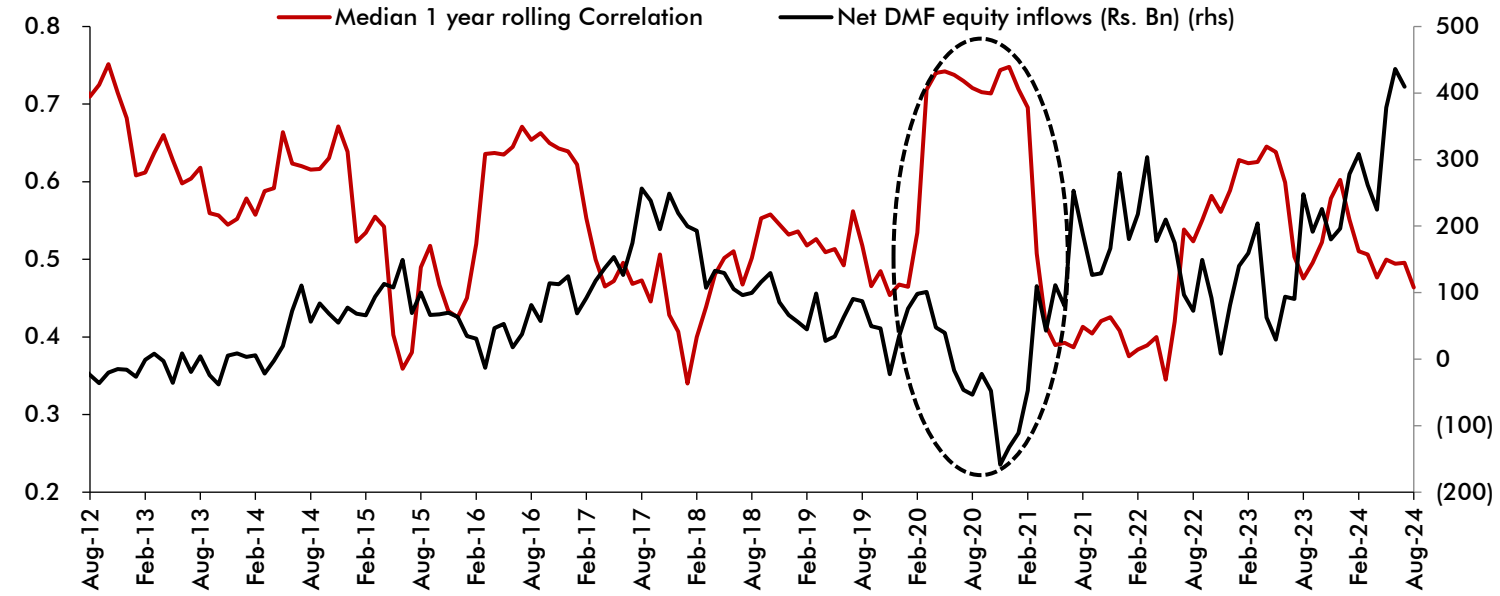
We expect this trend to accelerate and FY25 to be a stockpicker's market with a select few stocks driving the market amidst background of earnings growth normalization.

Stock selection will be key

In our recent flipbook, we had highlighted that FY25 can be a stockpicker's market, as the median correlation of NSE100 stock returns with the index is close to lowest levels since June'22. The declining correlation scenario suggests that, going forward, stock selection would be key for generating alpha. We expect polarization to return and the weekly advance-decline ratio also points in a similar direction.

High correlation does not necessarily imply that markets are rising, as evident in the correction during pandemic.

Exhibit 33: Median correlation with index is close to 2-year low; stock selection would be key for generating alpha



Source: Bloomberg, Ambit Capital research. Note: Universe here is NSE100. Latest data as on 2nd September 2024.

Lastly, what is the price action telling us? Third time, momentum index is approaching the peak with weakest strength amidst earnings growth slowdown. Momentum will likely take a backseat. We explore this in details in our trade ideas.

Exhibit 34: Momentum likely to falter, with valuations turning expensive

Source: Bloomberg, Ambit Capital research

Dissecting the source of market returns

What drives returns? Investing in companies with strong earnings growth and strong future prospects. Alternatively, ability to time markets or lower entry multiples/ relatively attractive valuations are likely to be a positive source of alpha for an investor. In short term, sentiments can play an important role as well. Additionally, flows, which influence demand-supply equilibrium of equities, are also an important variable. Lastly, interest rates is another key variable of interest. We examine each of the variables.

Market returns are influenced by –

$$\boldsymbol{Returns} = fx(eps\ growth, earnings\ revisions, valuations, sentiments, flows)$$

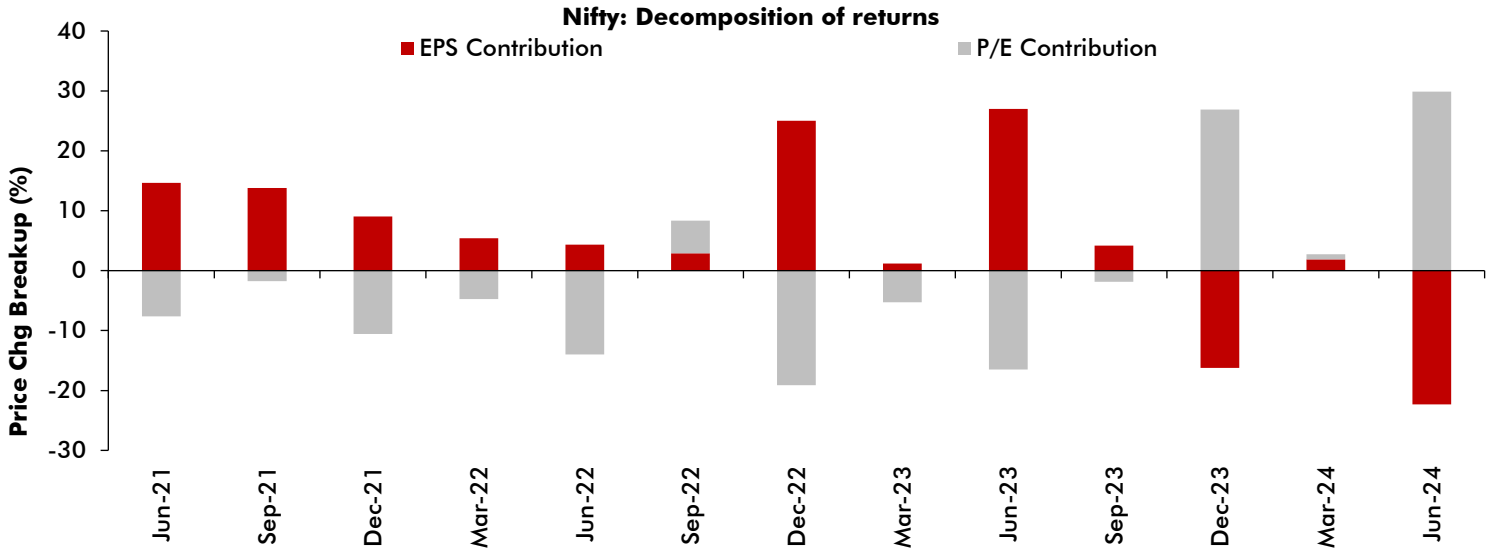
- **Earnings (past and what lies ahead?)** – Higher earnings growth for an equity cohort will translate to higher returns as price returns and earnings growth mirror each other over the long-term. However, it is important to monitor the gradient in forward earnings as well. We evaluate past and future.
- **Valuations** – Over a long-term horizon, valuations are a function of both internal (earnings growth) and external factors (macro-economic trends). Lower is the entry multiple, higher is the return. Valuations are indeed expensive and does not need a debate.
- **Interest rates**- Simply put, lower interest rates will increase the present value of future cash flows. But, are the benefits of lower interest already priced in? Does excess RoE spread (RoE - CoE) accounting for rate cut (lower CoE) justify current valuations?
- **Sentiment** – While earnings and valuation impact returns over the longer term, over the short term, sentiment also influences market returns. Moderation in consumer confidence, lower expectations of loan demand, declining industry optimism and greed in the market do not bode well for markets.

So, what drove returns since pandemic?

Digging deeper into the drivers of market return: Earnings or Multiple?

A dissection of Nifty quarterly returns into earnings and multiple contribution indicates that earnings growth was the primary driver of Nifty returns since June-21, as P/E multiple normalized. However, in 1QFY25, multiples re-rating was the key driver of Nifty returns.

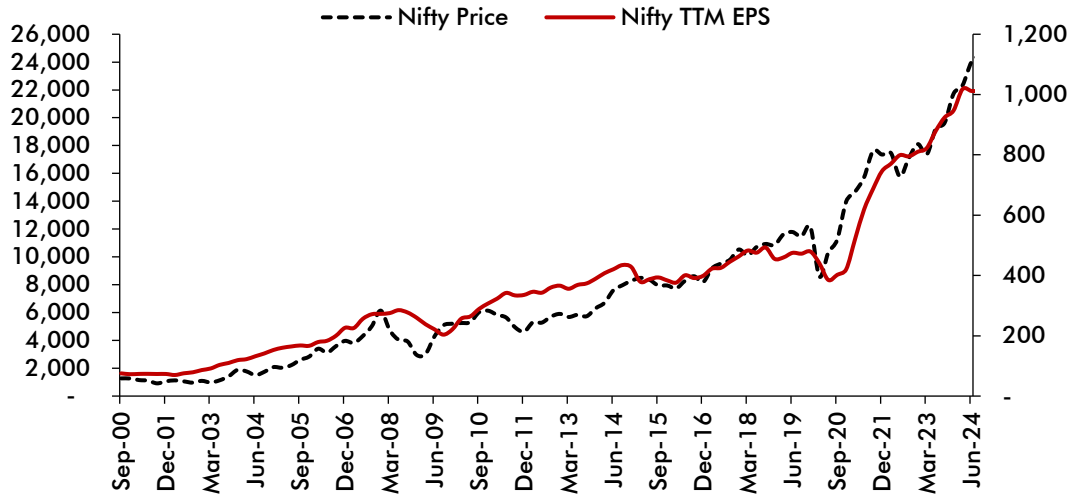
Exhibit 35: Nifty returns decomposition: Earnings growth contribution declined in June-24



Source: Bloomberg, Ambit Capital research. Note: Data is taken on TTM basis as on March end each year, latest data is as of 03rd September'24.

Clearly, returns are backed by superior earnings growth as compared to history. Since June-21, while Nifty delivered 15.1% CAGR returns, TTM earnings CAGR was ~20.2%. However, it is important to note that, Nifty TTM P/E was 27x as on June-21, at 40% premium to 10-year average. So, it's not under-reaction for strong earnings growth but normalization of multiple.

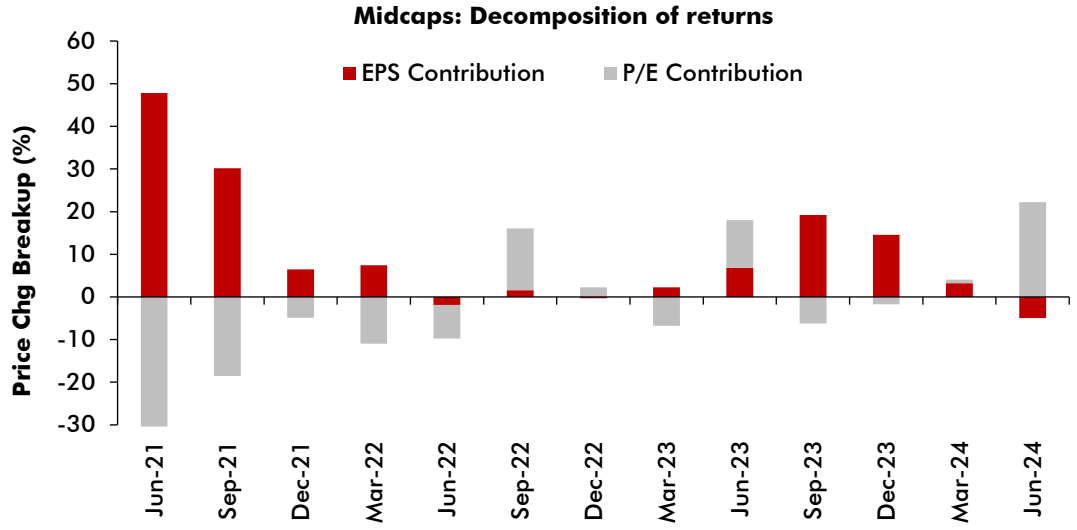
Exhibit 36: Nifty returns continue to trend upwards even as earnings growth slows down



Source: Bloomberg, Ambit Capital research

How are other equity cohorts placed? Small-caps appear more precariously placed as earnings contribution over the last few quarters has been negligible. For mid-caps, similar to Nifty, since June-21, earnings growth (31% CAGR) was the primary driver of returns (27% CAGR) as the P/E multiple marginally compressed. However, over the last few quarters, P/E multiple expansion was the major driver of market returns.

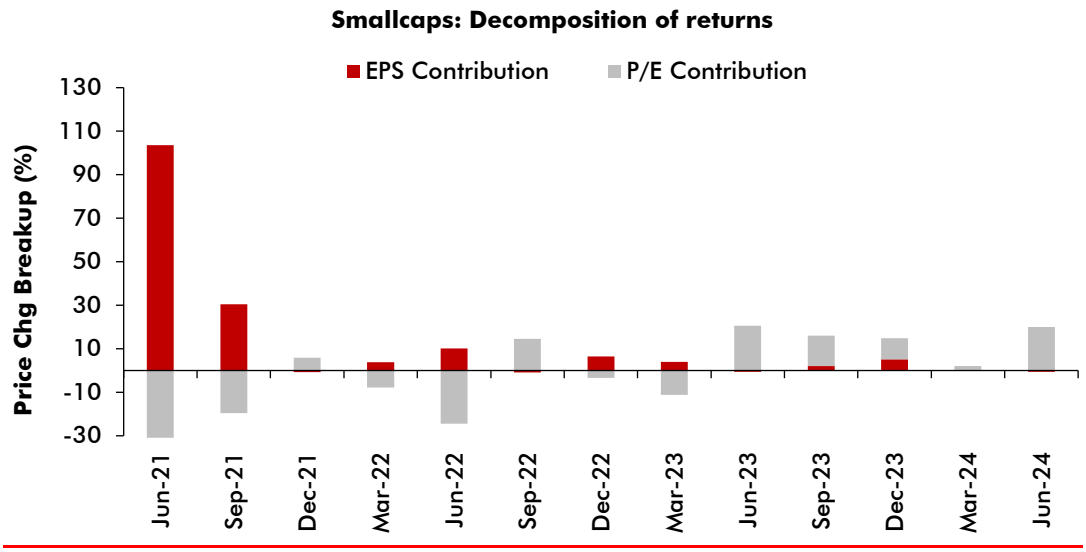
Exhibit 37: Multiple re-rating has been driving returns over the past quarter...



Source: Bloomberg, Ambit Capital research. Note: Data is taken on TTM basis as on March end each year, latest is as of 03rd September'24.

However, for small-caps, since June-21, earnings growth (21% CAGR) lagged returns (27% CAGR) as the P/E multiple expanded from ~29x to ~32x. Similar to Nifty and mid-caps, over 1QFY25, P/E multiple expansion was the major driver of market returns. What's the outcome of this?

Exhibit 38: ...and likewise for small-caps

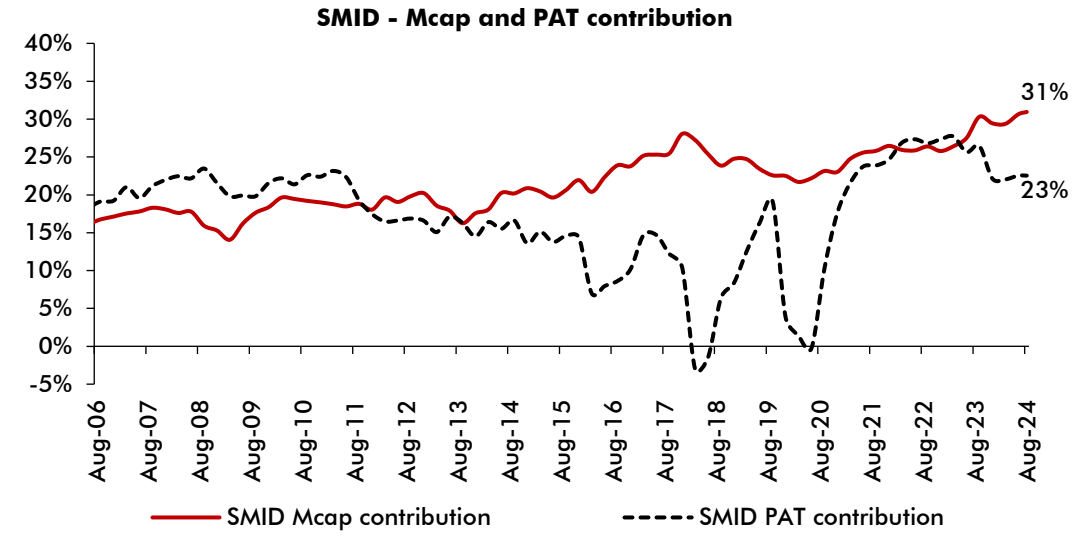


Source: Bloomberg, Ambit Capital research. Note: Data is taken on TTM basis as on March end each year, latest is as of 03rd September'24

Divergence between SMID Mcap and PAT contribution is expanding

With multiples expansion being the primary driver of market returns, the divergence between market-cap contribution and PAT contribution is widening. The exceptional run of small and mid-caps has taken mcap contribution (as % of NSE500) to its highest level of 31%. Historically, this has been a strong reversal signal. PAT contribution of SMID universe peaked out in March-23 at 28% and currently stands at 23% as of Aug'24. While PAT contribution is significantly higher than pre-Covid levels, divergence between PAT and mcap contribution is widening. EPS estimates trajectory appears better in large-caps vs SMID. As the market always looks ahead, the divergence appears unsustainable.

Exhibit 39: SMID: Divergence between mcap and PAT is expanding



Source: Ace Equity, Ambit Capital research. Note: Latest PAT data is as of Jun'24 quarter and Mcap data is as of 30th Aug'24

However, is Nifty fairly valued?

The 1QFY25 reporting season does not inspire confidence as earnings growth slowed down to 7%. Additionally, there is a high divergence between PAT growth (YoY) of BFSI (12%) and Ex-BFSI (4.6%) and. The gradient is too high, a trend which has got accentuated from last quarter. This is expected to continue and FY25 is expected to be a year of earnings normalization. **Can the momentum sustain**

despite slowdown in earnings? The current multiple is 3.8x and return delivery looks tough from a short-term perspective.

Exhibit 40: Nifty: Current multiple of 3.8x implies 3-year forward return of 5.7%

TTM P/B range	Median returns (CAGR)					
	1 Year	3 Year	5 Year	7 Year	10 Year	15 Year
< 2.2	38.1%	27.2%	31.7%	23.9%	17.9%	16.3%
2.2 - 2.5	29.2%	16.3%	14.6%	13.2%	13.7%	14.4%
2.5 - 2.7	17.7%	13.9%	12.4%	12.3%	12.8%	13.9%
2.7 - 2.8	11.6%	13.2%	13.2%	12.4%	12.3%	13.2%
2.8 - 2.9	10.9%	10.8%	12.3%	12.3%	14.3%	13.1%
2.9 - 3	9.2%	9.1%	11.7%	11.7%	14.1%	12.7%
3 - 3.2	6.6%	7.8%	11.1%	9.5%	10.2%	11.9%
3.2 - 3.4	11.7%	9.5%	10.1%	9.7%	10.0%	11.8%
3.4 - 3.7	5.4%	12.7%	8.2%	9.6%	10.5%	11.2%
>= 3.7	17.5%	5.7%	4.5%	7.7%	8.3%	10.0%

Source: Bloomberg, Ambit Capital research

Our next section delves into the prevailing sentiment.

Survey sentiment

Market sentiment can influence returns over the short term, and the prevailing optimism is beginning to fade. Moderation in consumer confidence, lower expectations of loan demand, declining industry optimism as rising input cost pressures weigh heavy on profit margins and high greed do not bode well for the markets.

- **Consumer confidence survey**

Both current situation and future expectations moderated in July-24

What is the survey about? It collects current perceptions (current situation index) and one year ahead expectations (future expectations index) of households on general economic situation, employment scenario, overall price situation, own income and spending across 19 major cities.

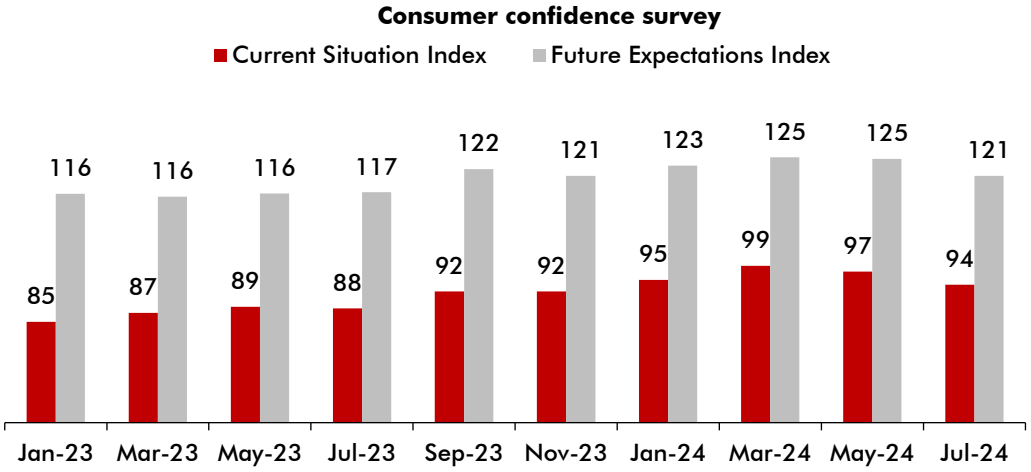
$$\text{CSI/FEI} = 100 + \text{Average of Net Responses}$$

How is it measured? 'Net response' of respective indicators is the difference between the percentage of respondents reporting optimism and those reporting pessimisms. It ranges between -100 and 100. Any value greater than zero indicates expansion/optimism and values less than zero indicate contraction/pessimism.

What is it telling us?

- **Current situation Index (CSI):** In July'24, it declined for the second consecutive month after a prolonged rising trend. Sentiment on major parameters, except spending, moderated and, as a result, the current situation index (CSI) declined to 94.
- **Future expectations Index (FEI):** Households' optimism on economic conditions for the year ahead remained in positive terrain, though it came down from the previous survey round. Lower optimism on general economic situation, employment and prices drove moderation.

Exhibit 41: CSI and FEI both tending lower, confidence seems to be dampening



Source: RBI Survey, Ambit Capital research

- **Industrial outlook survey:**

Current assessment and future expectations both moderated in July-24 as rising input cost pressures weigh heavy on profit margins.

What is the survey about? The Business Assessment Index (BAI)/Business Expectations Index (BEI) gives a snapshot of demand conditions in the manufacturing sector by combining nine parameters – (1) overall business situation, (2) production, (3) order books, (4) inventory of raw material, (5) inventory of finished goods, (6) profit margin, (7) employment, (8) exports and (9) capacity utilization.

A value above 100 indicates an expansion of the overall business activity and a value below 100 indicates contraction.

What is it telling us?

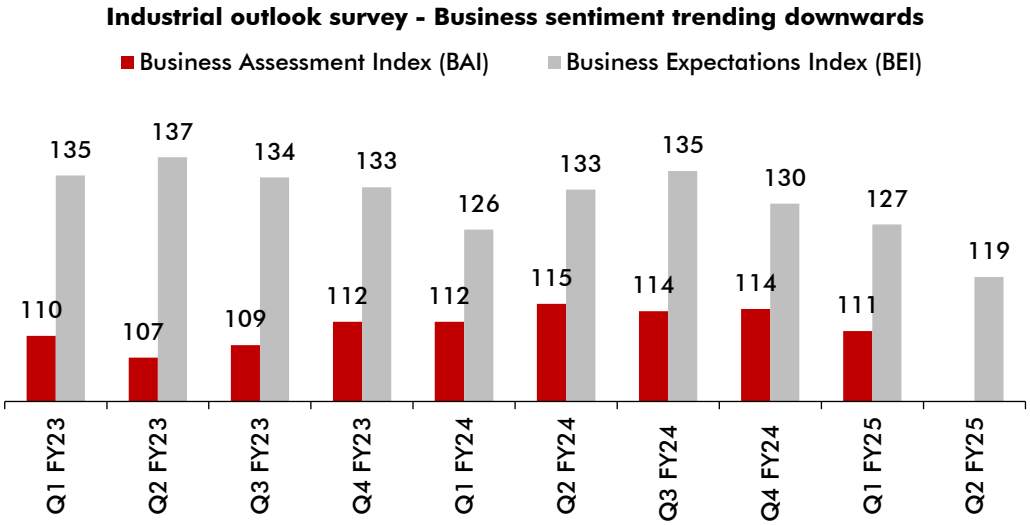
- **Assessment for 1QFY25**

Business sentiment in the Indian manufacturing sector moderated as the BAI moved downward to 111. This was led by moderation in demand conditions and increase in input prices affecting profit margins.

- **Expectations for 2QFY25**

Overall, the BEI moderated for the third consecutive quarter to 119. Manufacturers' optimism on demand conditions moderated further as input cost pressures are expected to persist. Additionally, they expect moderation in selling price growth and subdued profit margin vis-à-vis previous quarter.

Exhibit 42: RBI Survey: Industrial outlook has been trending downward over last 3 quarters



Source: RBI Survey, Ambit Capital research

- **Bank lending survey**

As 1Q is a seasonally weak quarter, loan demand was subdued in 1QFY25, similar to the same period last year. However, the key difference from last year is that the outlook for 2QFY25 has weakened too.

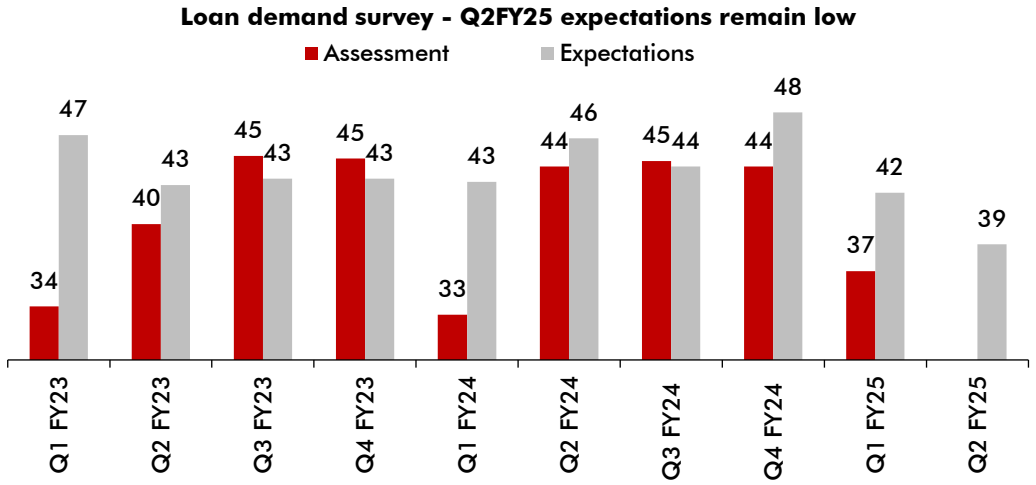
What is the survey about? The quarterly survey captures qualitative assessment and expectations of major scheduled commercial banks on credit parameters (viz., loan demand as well as terms and conditions of loans) for major economic sectors.

What is it telling us?

- **Assessment for 1QFY25:** Bankers' growth assessment of loan demand recorded a seasonal moderation.
- **Expectations for 2QFY25:** Bankers remained optimistic on loan demand across in Q2FY25, however, the outlook for 2QFY25 weakening. Usually, expectations pick up in the 2nd Quarter from a seasonally weak 1st quarter.

How is it measured? Net Response (NR) is computed as the difference of percentage of banks reporting increase/optimism and those reporting decrease/pessimism in respective parameter. NR ranges between -100 to 100. Values greater than zero indicate expansion/optimism and values less than zero indicate contraction/pessimism.

Exhibit 43: RBI Survey: Loan demand expected to remain subdued in 2QFY25



Source: RBI Survey, Ambit Capital research

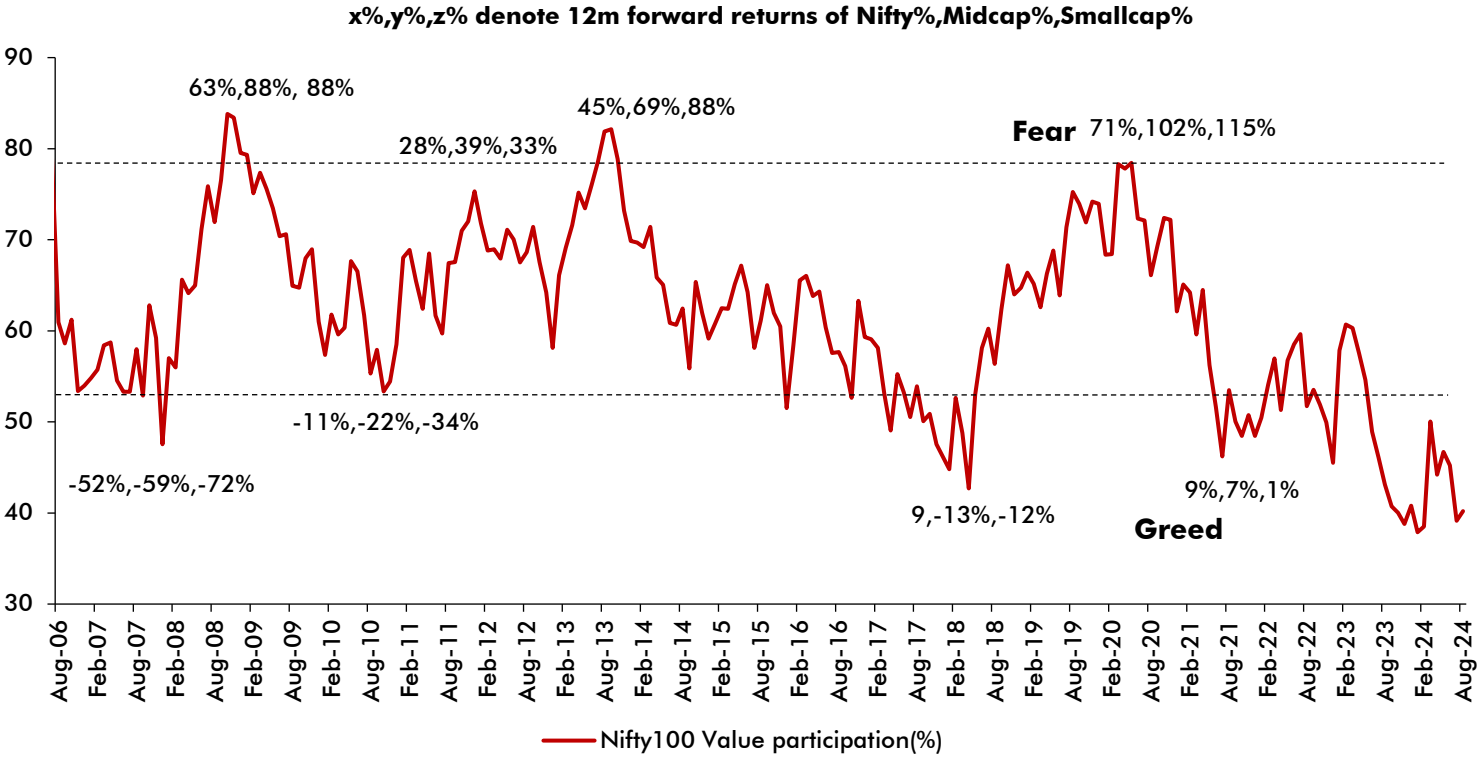
1QFY25 GDP growth came at 6.7% below RBI estimate of 7.1% and achieving 7.2% GDP growth (RBI estimate) in FY25 appears tad difficult with surveys also pointing towards moderation in demand conditions. Our economist expects 6.5-7%% FY25 GDP growth.

What is market sentiment telling us?

Market sentiment measured by Nifty100 value participation (our **Greed and Fear indicator)** continues to signal greed, while earnings growth seems to be slowing and all the surveys pointing in the same direction. It declined from 50% in March-24 and currently stands at 40%.

How to read this? If investors are scared, the bulk of NSE turnover would be in top 100 stocks and vice versa. Extreme fear indicates likelihood of SMID outperformance over the next 12 months and vice versa.

Exhibit 44: Greed & Fear Indicator has been a great predictor of size positioning



Source: NSE, Ace Equity, Ambit Capital research

Though it has failed in the recent past, we explore this in detail in our trades section.

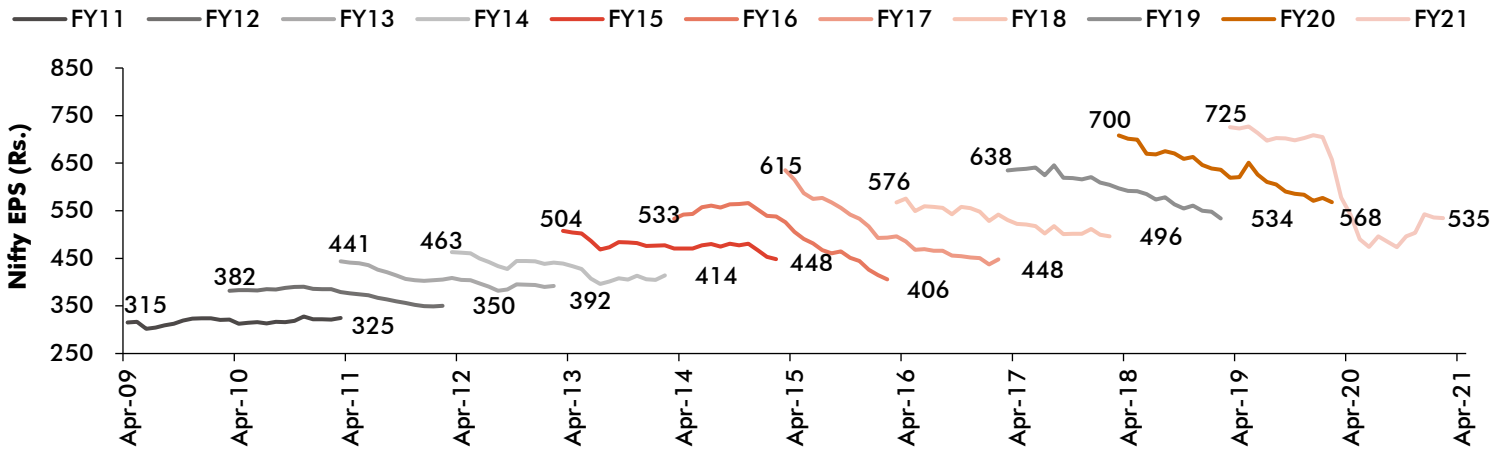
Earnings estimate trajectory to normalize

Not only is EPS growth slowing, the estimate trajectory is also normalizing with downgrades in SMIDs. Expect this to accelerate as the margin expansion lever (CPI-WPI spread) is no longer available. Do not expect a repeat of FY21-24, when estimates held up bucking the trend of the past decade. Negative earnings surprises are picking up with large-caps faring better than SMIDs. Aggregate negative earnings surprise for NSE500 was negative for the 3rd consecutive quarter and stood at -4% in 1QFY25, the highest in recent times. Focus on stocks where earnings estimates are sustaining amidst slowdown in earnings growth and acceleration in downgrades.

Over-optimism on earnings likely to fade

Since FY12, Nifty earnings estimates have usually 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 2 years (t-24 to t) and by 8% on average over 1 year (t-12 to t).

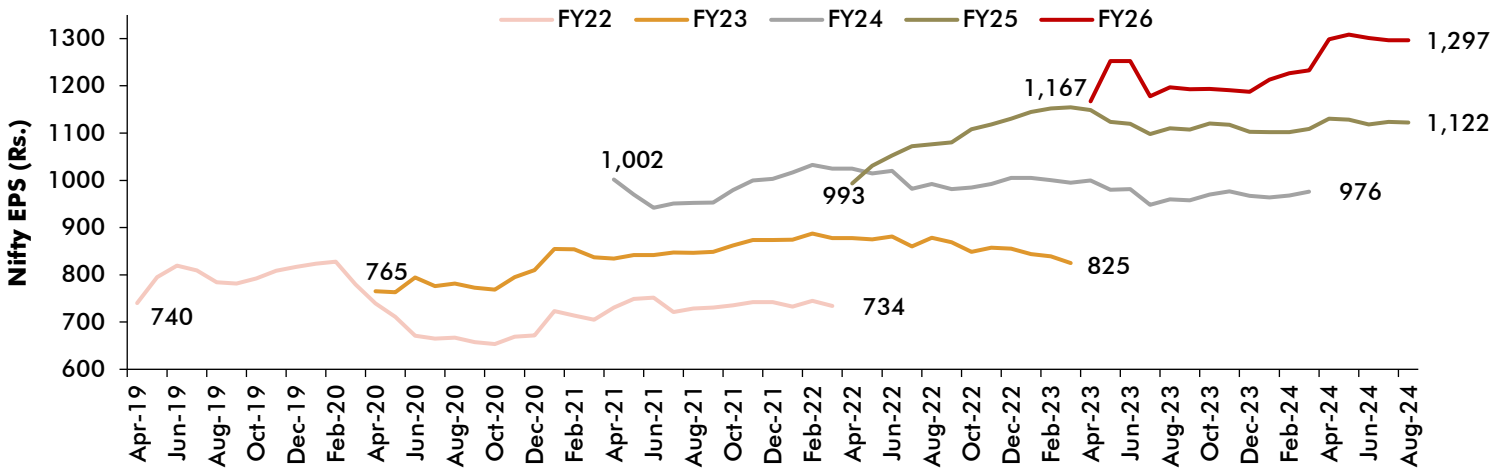
Exhibit 45: Historically, Nifty EPS estimates were cut 8% and 16% in 12 and 24 months respectively leading up to the FY



Source: Bloomberg, Ambit Capital research

However, earnings cuts were minimal in FY22 and FY24, and earnings were upgraded in FY23. Accordingly, FY25 and FY26 projected earnings saw a steep uptick. But we expect this to be a replica of FY12-20 rather than FY21-24. Why? With negative earnings surprises accelerating, the CPI-WPI spread expected to compress and margin lever receding, earnings are expected to normalize.

Exhibit 46: FY22-24 earnings trajectory was resilient and horizontal. FY25/26 can be different

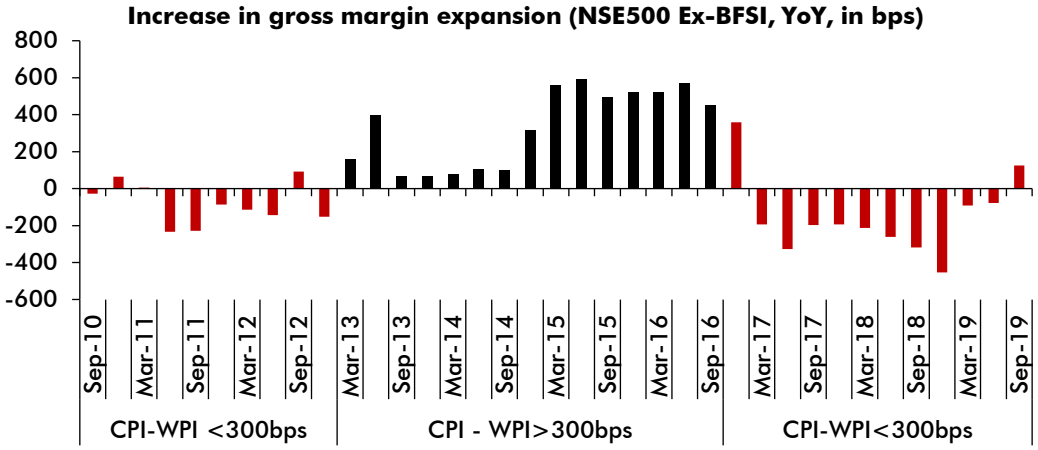


Source: Bloomberg, Ambit Capital research

- **Margin expansion lever no longer available.**

In Apr'23, we highlighted that the spread between WPI (producer price index) inflation and CPI inflation tends to positively affect gross margins of corporates. But now this lever is no longer supportive.

Exhibit 47: High CPI-WPI spread leads to increase in gross margins



Source: ACE Equity, CEIC, MoSPI, Office of Economic Advisor, Ambit Capital research. Note- Data represents change in margin expansion on a YoY basis

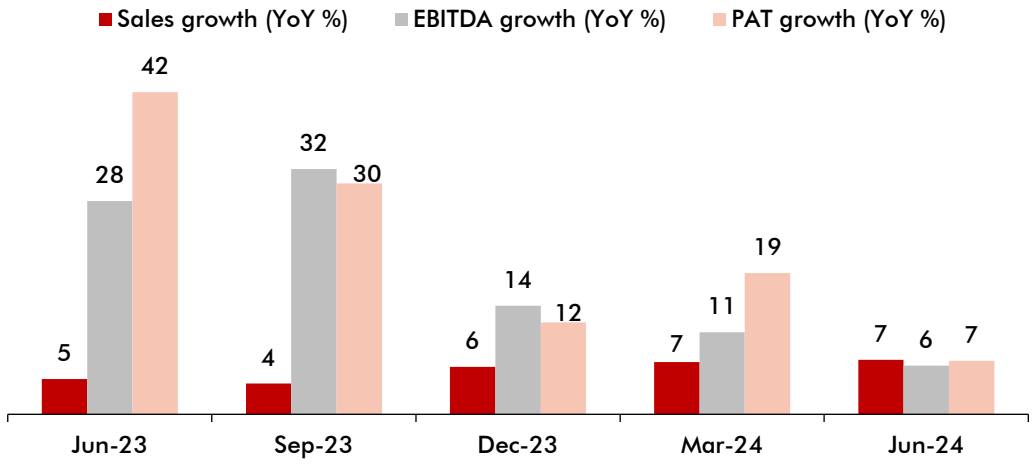
Why? We expect CPI inflation to moderate to 4.5-5% in FY25 whereas WPI has returned to inflationary zone in the last 9 months. CPI-WPI gap currently stands at 150bps and is at its lowest since Dec'22.

What is the outcome? This is likely to lead to moderation in gross margins of corporates and we expect this to the impact bottom-line. FMCG, Consumer Durables, Cement and Building Materials margins are expected to come under pressure. This can impact earnings estimate trajectory.

- **Earnings slowing and dragged by ex-BFSI**

In 1QFY25, while Nifty sales growth remained in line with the recent past, EBITDA and PAT growth slowed down. This was on expected lines as explained above.

Exhibit 48: Nifty: Sales growth remained in line; EBITDA and PAT growth are normalized

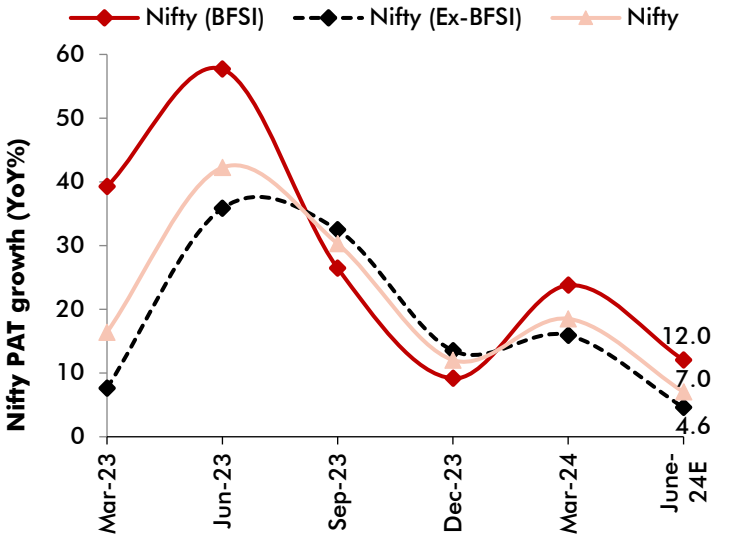


Source: Bloomberg, Ace Equity, Ambit Capital research. Note: Sales, EBITDA and PAT reflect reported numbers.

We observe the same trend in broader market index like NSE500 with high PAT growth divergence between BFSI (16.2%) and Ex-BFSI (3.4%), with aggregate PAT growth at 7.8%

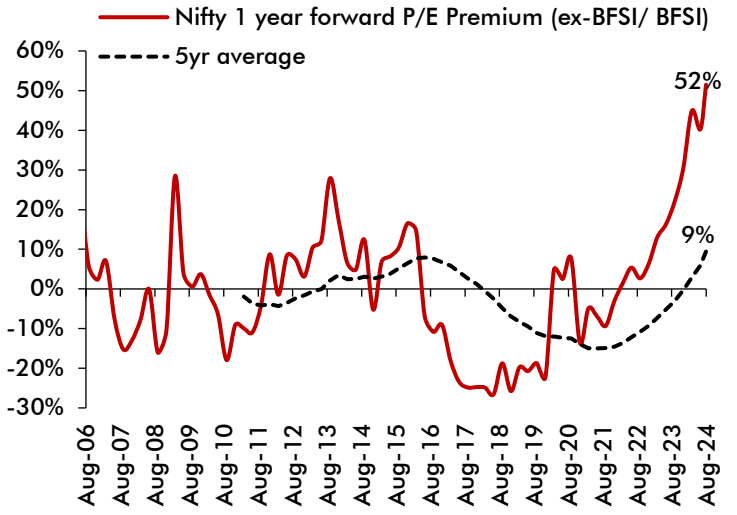
However, it is not just the headline number that is slowing. We observe high PAT growth (YoY) divergence between BFSI (12%) and Ex-BFSI (4.6%), with aggregate PAT growth at 7%. This viewed in conjunction with Nifty ex-BFSI trading at 52% premium on forward P/E basis seems alarming.

Exhibit 49: Nifty BFSI delivered PAT growth ~12% vs 4.6% for Nifty (ex-BFSI) in 1QFY25



Source: Bloomberg, Ambit Capital research. Note: Latest data is as of 16 August 2024. Note: For Banks, Revenue is Net interest income (NII), EBITDA is (PPOP). For Insurance, Revenue is APE (Annual Premium Equivalent), PAT is VNB (Value of New Business).

Exhibit 50: Nifty ex-BFSI universe trades at ATH premium of 52% w.r.t BFSI on 12m fwd. P/E vs 5-year average of ~9%

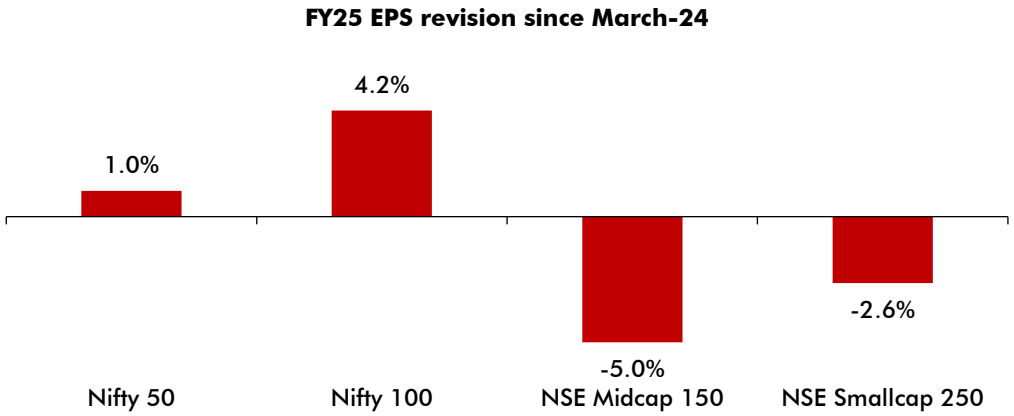


Source: Ace Equity, Ambit Capital research

- **A comparison of downgrades across equity cohorts**

In FY25, mid-caps led the earnings downgrades followed by small-caps, whereas large-caps witnessed earnings upgrades.

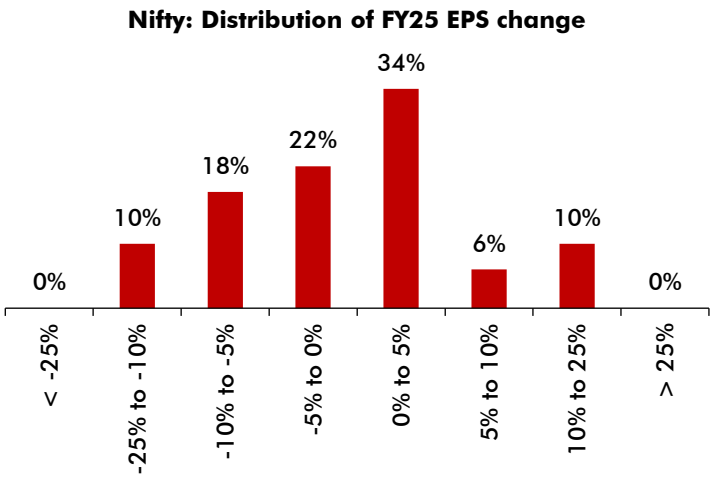
Exhibit 51: Earnings estimate sustenance: Large-caps higher than SMID



Source: Bloomberg, Ambit Capital research

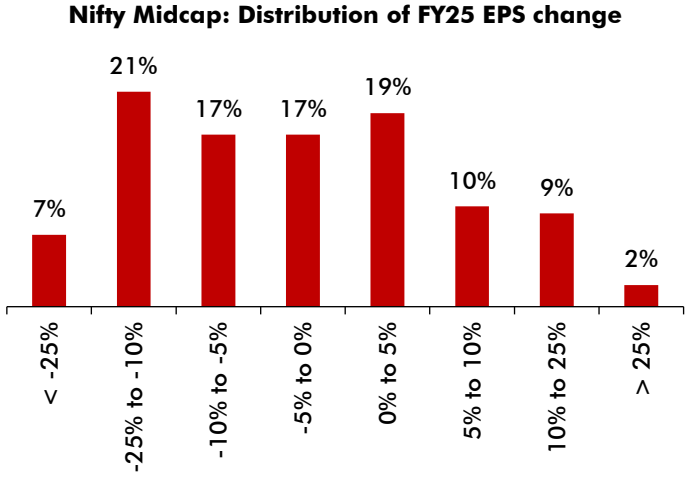
But, it's not just the headline numbers, the earnings downgrades are more widespread in mid-caps than Nifty. In mid-caps, 45% of the index constituents saw (>5%) EPS downgrade vs 28% in Nifty. Overall, 40% of the mid-cap stocks witness upgrades vs 50% in Nifty.

Exhibit 52: Nifty: 28% stocks witnessed >5% downgrade



Source: Bloomberg, Ambit Capital research

Exhibit 53: Mid-caps: 45% stocks witnessed >5% downgrade



Source: Bloomberg, Ambit Capital research. Note: mid-caps indicate NSE mid-cap 150 index stocks

The dissection of upgrades/downgrades at the sectoral level across equity cohorts suggests that in 1QFY25, FY25 earnings for Nifty and the broader large-cap universe remained relatively resilient with close to equal FY25 upgrades and downgrades on a sectoral basis. Moreover, higher downgrades were primarily witnessed in small-weight sectors such as Cement and Building Materials, Chemicals and Consumer discretionary.

Exhibit 54: Nifty: 6/12 sectors witnessed upgrades

Sector	Weight	FY25 PAT Upgrade / Downgrade
Healthcare	4%	1.9%
Telecom	4%	1.4%
Utilities	3%	0.7%
IT	14%	0.5%
Metals and Mining	4%	0.4%
BFSI	33%	0.2%
Auto and Auto Anc.	8%	-0.6%
Capital Goods	5%	-1.2%
FMCG	9%	-1.3%
Oil and Gas	11%	-4.0%
Consumer Discretionary	3%	-6.5%
Cement and Building Materials	2%	-8.9%

Source: Bloomberg, Ambit Capital research

Exhibit 55: Large-caps: 8/18 sectors witnessed upgrades

Sector	Weight	FY25 PAT Upgrade / Downgrade
New-age tech	1%	10.3%
Healthcare	4%	2.6%
Telecom	3%	1.4%
Consumer Durable	0%	0.6%
BFSI	30%	0.5%
IT	12%	0.5%
Utilities	3%	0.3%
Capital Goods	6%	0.3%
Miscellaneous	1%	-0.2%
Auto and Auto Anc.	8%	-0.4%
Metals and Mining	4%	-0.5%
Media	0%	-0.8%
FMCG	9%	-1.1%
Real Estate	0%	-1.1%
Consumer Discretionary	4%	-3.5%
Oil and Gas	10%	-3.6%
Chemicals	0%	-6.0%
Cement and Building Materials	3%	-11.6%

Source: Bloomberg, Ambit Capital research

On a sectoral basis, small-caps and mid-caps witnessed more downgrades than upgrades. Moreover, in large-caps the heavyweight sectors witnessed minor upgrades, whereas in SMIDs, heavyweight sectors witnessed minor downgrades.

Exhibit 56: Mid-caps: 13/18 sectors witnessed downgrades

Sector	Weight	FY25 PAT Upgrade / Downgrade
Telecom	3%	12.5%
Consumer Durable	3%	9.1%
Real Estate	5%	4.3%
Utilities	3%	2.9%
Miscellaneous	2%	2.8%
Auto and Auto Anc.	11%	-0.8%
Healthcare	11%	-0.9%
BFSI	16%	-1.0%
Capital Goods	13%	-1.1%
Consumer Discretionary	4%	-1.6%
IT	6%	-1.7%
Media	1%	-2.1%
Oil and Gas	4%	-3.1%
Chemicals	5%	-3.1%
FMCG	2%	-3.7%
Metals and Mining	3%	-6.9%
Cement and Building Materials	4%	-8.5%
New-age tech	3%	-9.8%

Source: Bloomberg, Ambit Capital research

Exhibit 57: Small-caps: 12/17 sectors witnessed downgrades

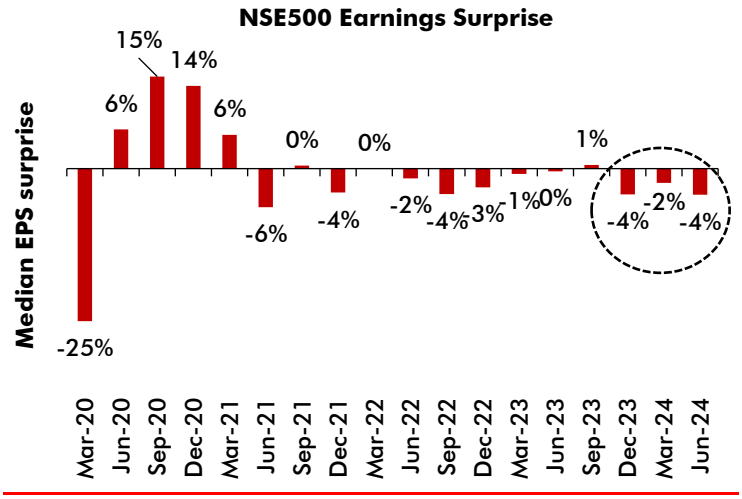
Sector	Weight	FY25 PAT Upgrade / Downgrade
Real Estate	2%	6.9%
Consumer Durable	7%	3.7%
Healthcare	14%	3.0%
Oil and Gas	2%	1.3%
Metals and Mining	3%	0.3%
FMCG	4%	-1.2%
BFSI	20%	-1.6%
Miscellaneous	7%	-1.7%
Capital Goods	13%	-1.9%
New-age tech	0%	-1.9%
Auto and Auto Anc.	6%	-2.1%
Media	3%	-2.2%
Consumer Discretionary	3%	-2.8%
Chemicals	5%	-3.9%
IT	8%	-4.0%
Utilities	1%	-6.1%
Cement and Building Materials	2%	-19.5%

Source: Bloomberg, Ambit Capital research

- **Negative earnings surprises accelerating**

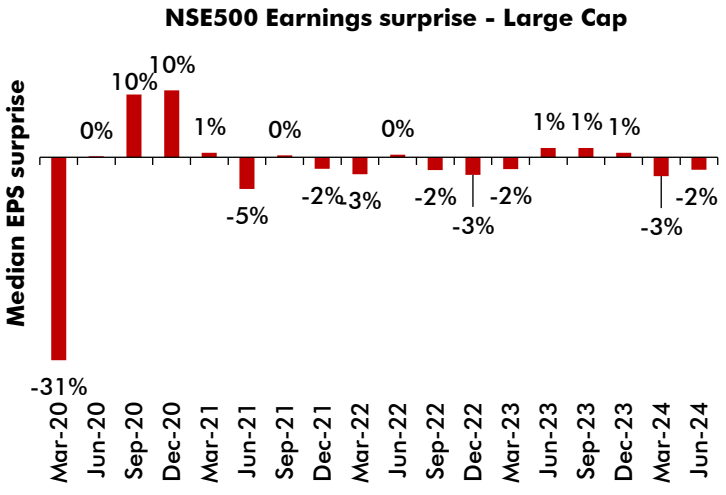
The 1QFY25 reporting season was weak, with aggregate NSE500 earnings surprises at -4%. On an aggregate basis, the % of companies beating estimates declined in the current quarter, while the number of companies missing estimates inched up marginally. Earnings surprises are the worst for small-caps at -6%, followed by mid-caps at -3% and large-caps at -2%.

Exhibit 58: Earnings surprises worsened in current quarter...



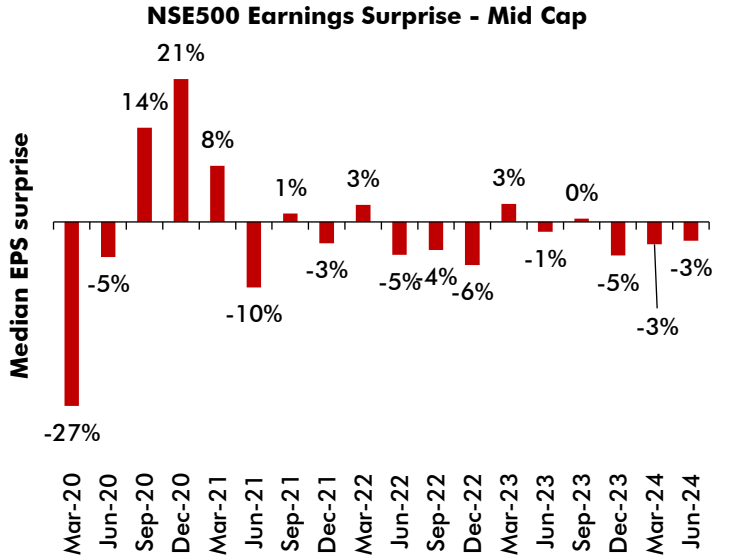
Source: Bloomberg, Ace Equity, Ambit Capital research

Exhibit 59: ...while large-caps remained relatively resilient



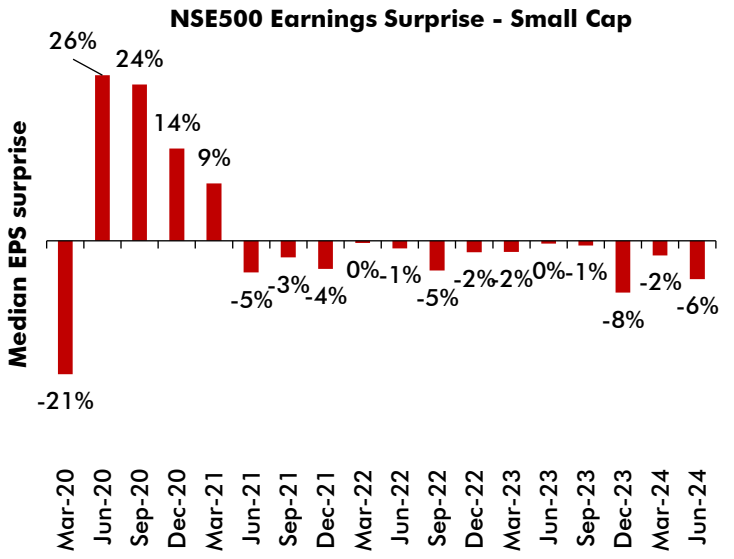
Source: Bloomberg, Ace Equity, Ambit Capital research

Exhibit 60: ...mid-cap surprises remained at -3%...



Source: Bloomberg, Ace Equity, Ambit Capital research

Exhibit 61: ...while negative surprise accelerated in small-caps at -6%

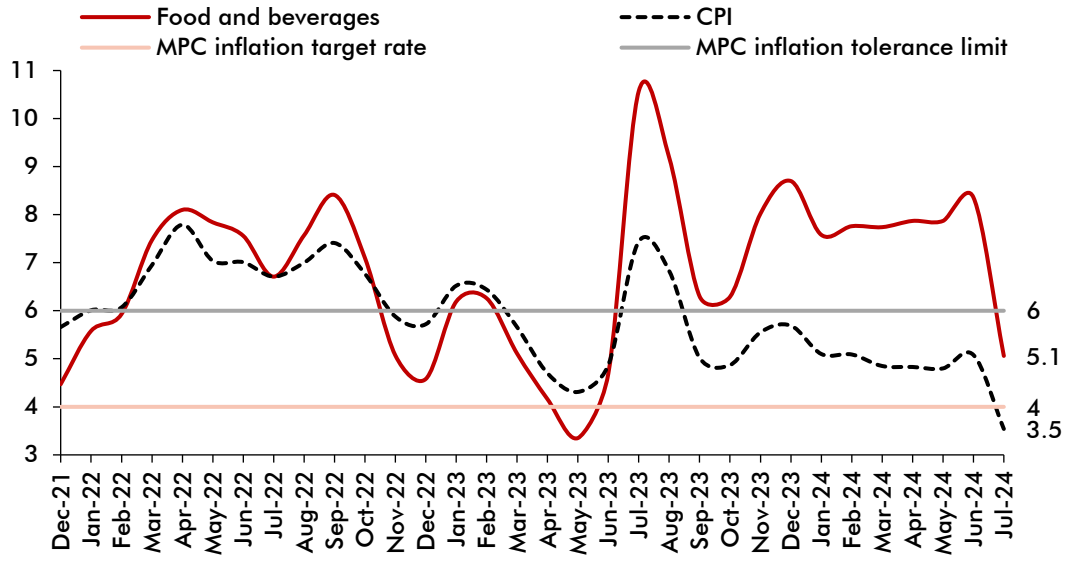


Source: Bloomberg, Ace Equity, Ambit Capital research

Interest rates: When is the rate cut and how much?

Since Dec-23, core inflation is within the MPC tolerance limit. But, headline inflation has stayed beyond tolerance limit barring last month and RBI has maintained policy rates. We expect this scenario to continue as food inflation remains elevated, driving headline inflation and we expect only one rate cut (25bps) in FY25. An important question is, has inflation slowed down? For the first time since Sep-19, headline inflation has fallen below inflation target. Moreover, for the first time since Jun-23, food inflation has come within tolerance limit.

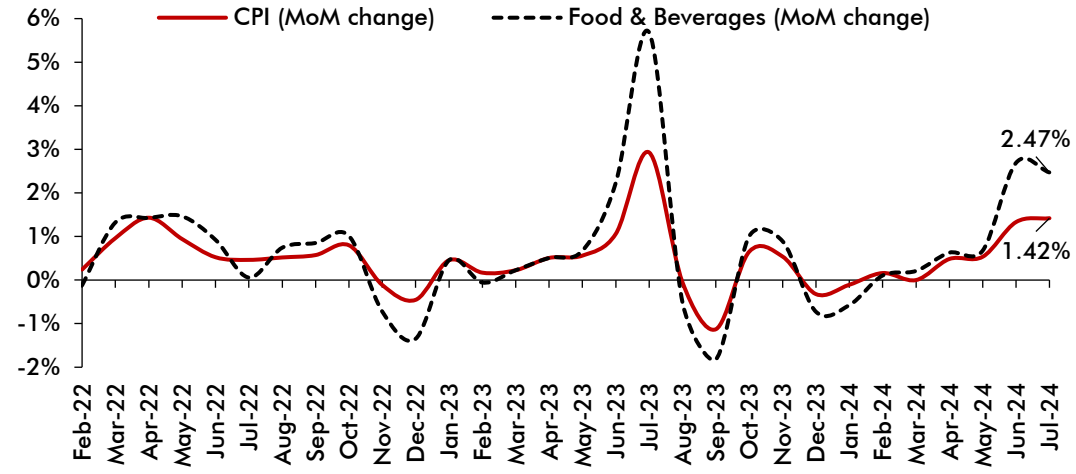
Exhibit 62: Food inflation remains elevated



Source: Bloomberg, Ambit Capital research

We see it as a statistical illusion. While the headline inflation at 3.54% in Jul-24 was the lowest in 5 years, it was driven by the base effect. Inflation momentum (mom %) at 1.42% was 2nd highest since April-22. Likewise, momentum in food inflation continues to remain elevated and was the 2nd highest since July-23.

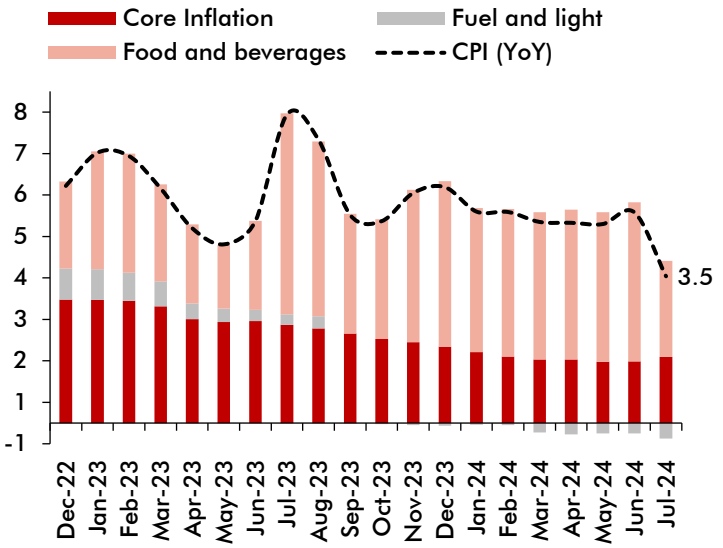
Exhibit 63: Inflation witnessed the 2nd highest monthly change since April-22



Source: Bloomberg, Ambit Capital research

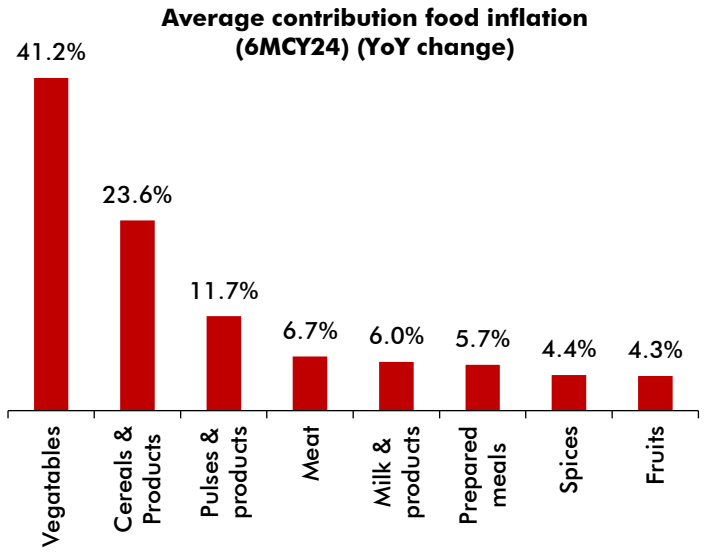
In the past 7 months, food inflation (averaging 7.5%) accounted for 72% of the incremental inflation and unless food inflation comes under control, rate cuts would be minimal. Within food inflation, cereal, pulses and vegetables contributed 77% of inflation. Supply disruption is set to keep food, especially cereal, pulses and vegetable prices elevated.

Exhibit 64: High food inflation has been the primary of elevated CPI



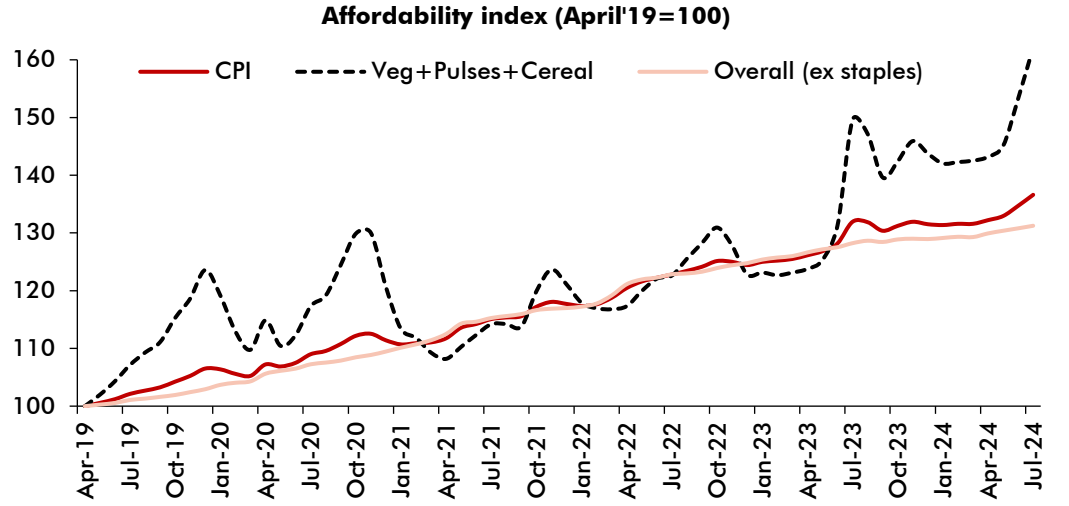
Source: Bloomberg, Ambit Capital research

Exhibit 65: Vegetables, cereals and pulses contribute ~77% of food inflation



Source: Bloomberg, Ambit Capital research

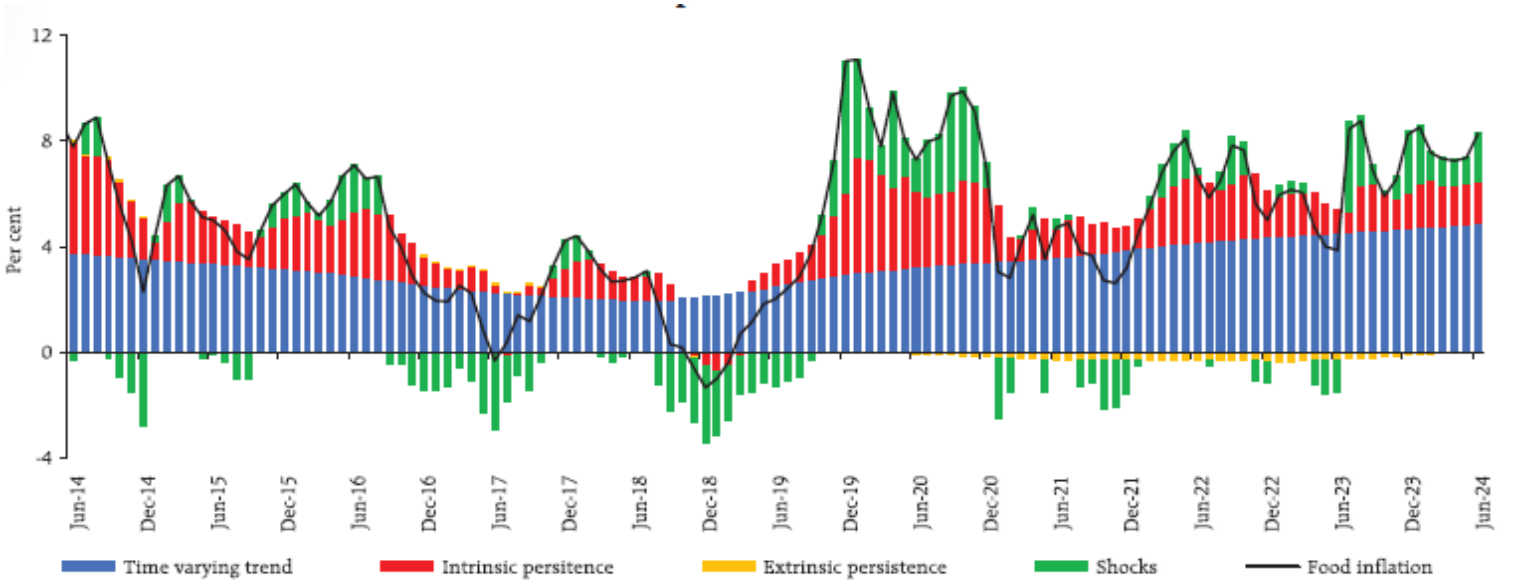
Exhibit 66: Cost of staples outpaced average cost of living



Source: Bloomberg, Ambit Capital research

In a recent RBI paper, "Are Food Prices Spilling Over?", the authors highlighted that persistence in food inflation has increased due to repeated climatic shocks of rising intensity. The increase in food inflation persistence is driven by secular upward drift in its time varying trend, signifying rising expectations of higher food prices due to overlapping supply shocks.

Exhibit 67: Composition of food inflation



Note: The contributions are converted to those in year-on-year inflation by taking 12-month moving averages.
Sources: NSO; and authors' estimates.

Source: NSO, RBI

The other key findings were:

- Intrinsic persistence was also found to contribute significantly to the food inflation process during this period – past food inflation developments, especially the high inflation episodes, have a bearing in shaping current food inflation movements.
- Extrinsic persistence or demand conditions contributed negatively to food inflation between 2020 to 1H2023.
- Most importantly, unfavourable supply shocks contributed significantly to elevated food inflation in 4 out of 5 years, i.e., since 2019-20, invalidating the perception of these events being transitory in nature (

Empirical evidence points to spill-overs to non-food components, which is being offset by disinflationary monetary policy. If high food inflation persists, however, a more cautious monetary policy approach is warranted to squelch the propagation of food inflation pressures into a more generalised inflation. Key findings from RBI paper:

- Spill-overs of food price shocks to costs, service charges and output prices are evident in their statistically significant positive correlations with inflation expectations.

Exhibit 68: Bivariate correlations

Indicators	Food inflation	Inflation expectation
Manufacturing input price ^	0.27**	0.60*
Manufacturing output price ^	0.30*	0.34*
Services input price ^	0.14	0.24**
Services price charged ^	0.26**	0.25**
Less-formal service charges#	0.38*	0.68*

*Source: NSO, RBI, Ambit Capital research Note: *: Significant at 5 per cent level; **: Significant at 10 per cent level.*
Note: The correlations are based on quarterly average data for the period from Q1CY2012 to Q2CY2024

- Positive correlation is also found between food inflation and input costs and output prices of manufacturing and services sectors embedded in purchasing mangers' indices (PMIs) and an index of less-formal service charges compiled from the CPI data.
- Goods inflation seems to be more sensitive to the spill-overs from food inflation shocks, as indicated by the significant and higher correlations of food inflation with manufacturing price expectations than with formal services sector's expectations.

- Less formal sector services charges have a much higher and statistically significant correlation with inflation expectations (0.68) and food inflation (0.38) than formal sectors, indicating their vulnerability to persistent food inflation shocks and spill-overs.

So, inflation expectations of households have to moderate for significant rate cuts, which is at elevated levels.

What is consensus thinking on rate cuts?

Survey of professional forecasters on macroeconomic indicators: The RBI conducts a survey of professional forecasters on macroeconomic indicators. Key highlights –

- Forecasters have assigned the highest probability to the headline CPI inflation lying in the range of 3.5-4.4% in 2Q and 4.5-4.9% during subsequent 3 quarters.
- The median estimate of in the survey is of a 25bps repo-rate cut in 3QFY25 and 1QFY26 each.

Exhibit 69: Forecasters expect 25bps rate cut in 3QFY25

Key Macroeconomic Indicators	Quarterly Forecasts											
	Q1: 2024-25				Q2: 2024-25				Q3: 2024-25			
	Mean	Median	Max	Min	Mean	Median	Max	Min	Mean	Median	Max	Min
Policy Repo Rate (end-period)	-	-	-	-	6.49	6.50	6.50	6.25	6.32	6.25	6.50	5.75

Source: RBI, Ambit Capital research

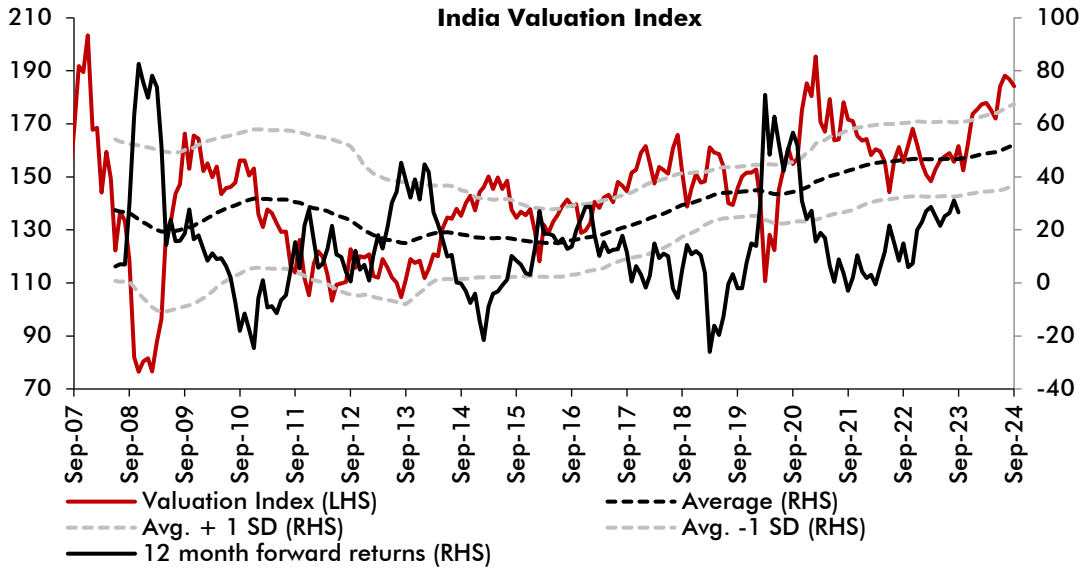
What is our call? India's inflation at 3.5% as on Jul-24(5.1% in Jun-24) was below MPC's target inflation rate of 4%. But it was a statistical illusion and momentum in both headline and food inflation remains high. In such a scenario, our economists do not expect RBI to cut policy rates by more than 25bps in FY25, which will keep real interest rate in the range of 1.25-1.5%. The median estimate of professional forecasters in the survey is of a 25-bps repo-rate cut in Q3FY25 and 1QFY26 each.

The next key question to address – is the market undervalued after accounting for rate cuts?

Where is the market heading? Is rate-cut priced in?

Nifty India Valuation index stands at one of the highest levels since 2020 at 184, 1.4 standard deviations above 5-year average (161). However, there is a stark divergence between ex-BFSI and BFSI valuations with ex-BFSI trading at ATH premium (67% on TTM basis). We have highlighted this in our trades section with banks as our key overweight.

Exhibit 70: India valuation index stands at 1.4 SD above 5-year average



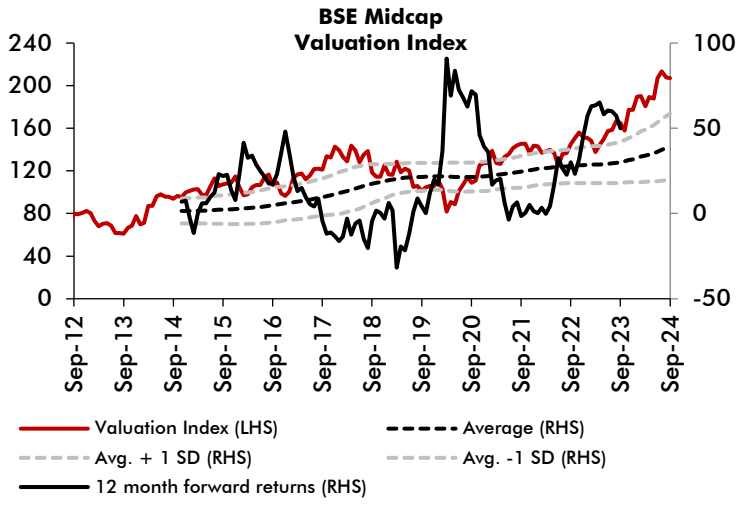
Source: Bloomberg, Ambit Capital research. Latest data as on 06th September 2024. Note: The forward returns and India Valuation Index are inversely correlated.

Note: India Valuation Index is constructed by taking an average of indexed TTM PE ratio, PB ratio, India Mcap-to-GDP ratio, and 10- year India govt. bond yield to Nifty trailing earnings yield ratio.

Note: SMID Valuation Index is constructed by taking an average of indexed TTM PE ratio, PB ratio, and 10- year India govt. bond yield to trailing earnings yield ratio.

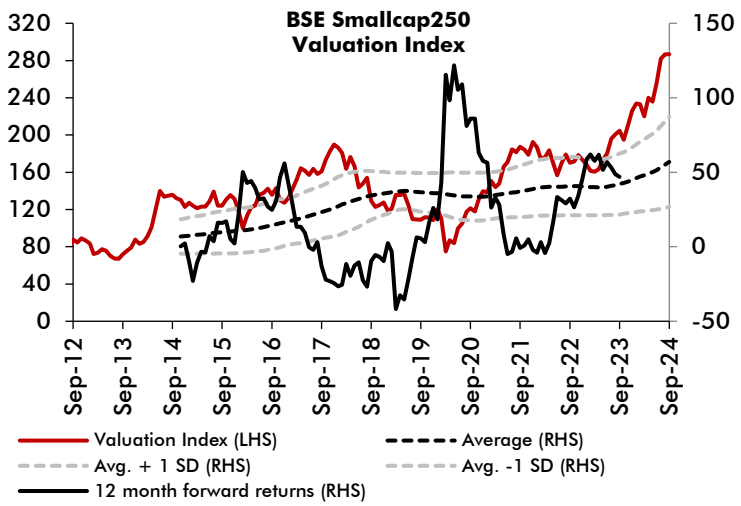
However, in the case of small and mid-caps, valuation index is the most expensive in history, much higher than 2021 peaks. Can rate cuts take valuation higher or are they already priced in? We evaluate this for large-caps, where the valuation is cheaper compared to other equity cohorts.

Exhibit 71: Mid-cap valuation index stands 2.1 SD above 5-year average



Source: Bloomberg, Ambit Capital research. Latest data as on 06th September 2024. Note: The forward returns and Valuation Index are inversely correlated.

Exhibit 72: Small-cap valuation index stands 2.4SD above 5-year average



Source Bloomberg, Ambit Capital research. Latest data as on 30th August 2024. Note: The forward returns and Valuation Index are inversely correlated.

Excess RoE framework: Nifty currently trading above fair value

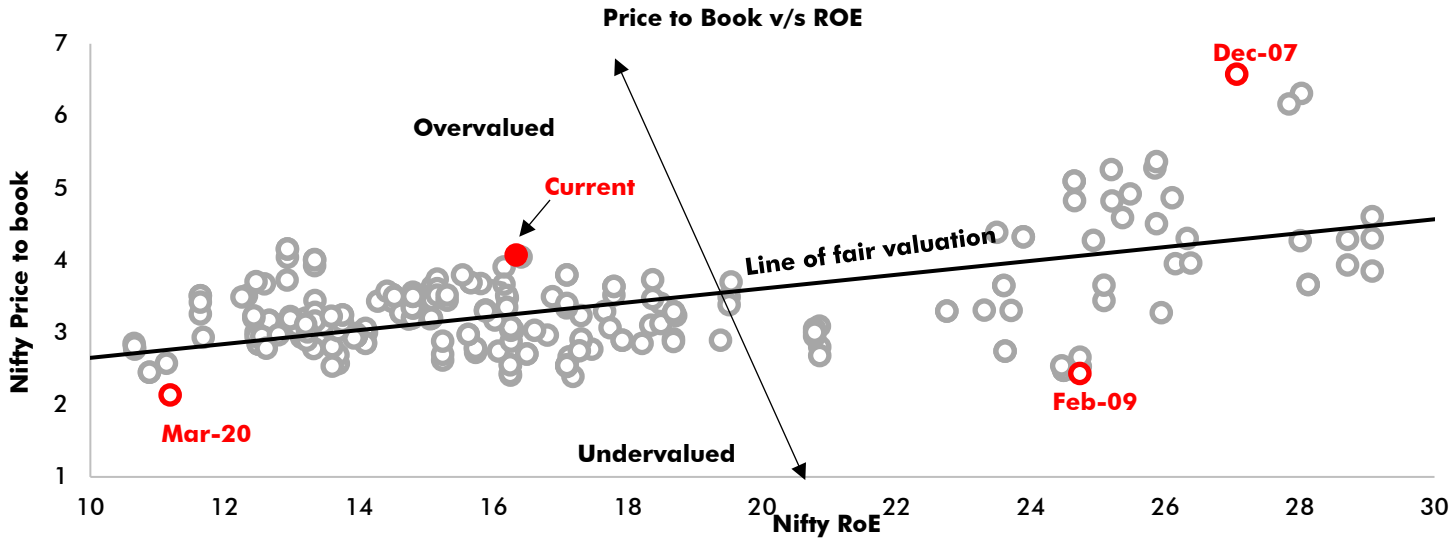
The P/E ratio is one of the most commonly used metrics to compare relative over/undervaluation of any security. The ratio essentially compared P/B (price to book) to RoE (return on equity).

$$\frac{\mathbf{P}}{\mathbf{E}} = \frac{\mathrm{P}}{BV} \times \frac{\mathrm{BV}}{\mathrm{E}}$$
$$= \frac{\mathrm{P}}{BV} \times \frac{1}{\mathrm{ROE}}$$
$$= \frac{\mathrm{P}}{BV} \div \mathrm{ROE}$$

We look at valuations in terms of P/B relative to RoE (Return on Equity).

Nifty appeared to be well above fair value in December 2007 and well below fair value in February 2009. Currently, Nifty appears to be expensive vis-à-vis past trends but not as much as Dec-07

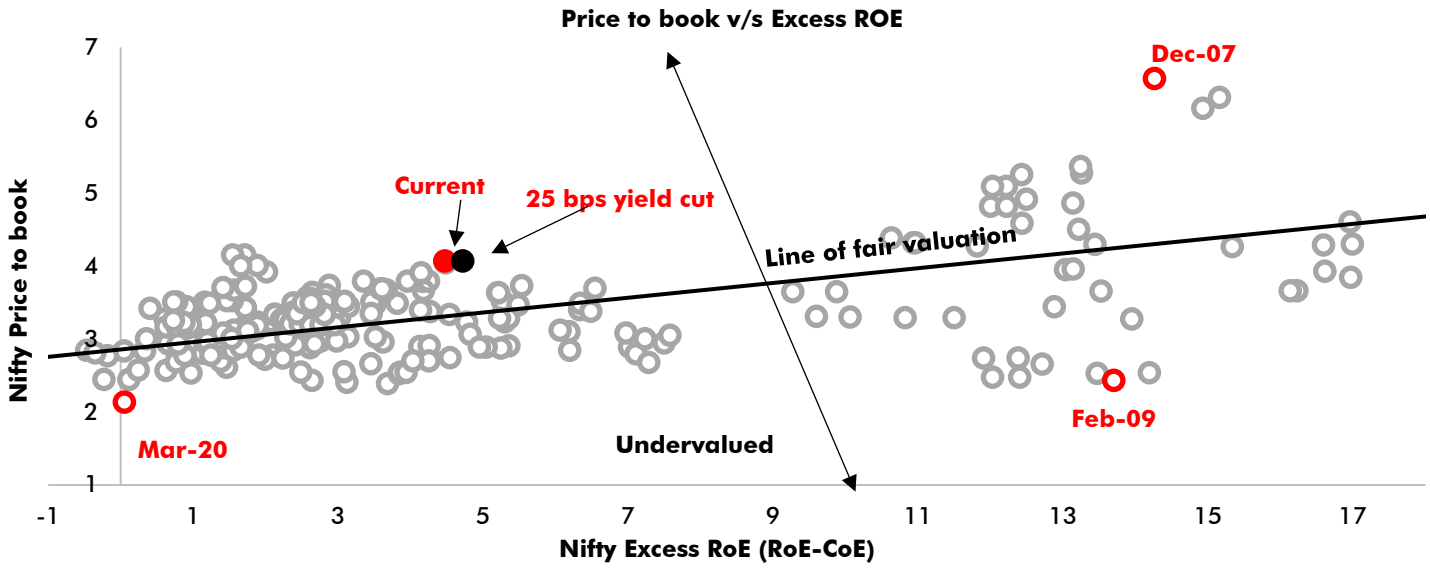
Exhibit 73: Nifty appears overvalued on P/B v/s RoE metric



Source: Bloomberg, Ambit Capital research. Note: Cost of Equity = 10-year Gsec-yield + Market risk premium (5%) Note: Besides the current observation (red circle), we have marked (red circles) December 2007 (before GFC crisis) and February 2009 (after GFC crisis started).

However, the ratio fails to account for CoE (cost of equity). A lower ROE might suffice if CoE is trending lower as well, which has been the case over the last few years. Analysing Nifty valuation without accounting for CoE might be futile. The market appears expensive even after accounting for lower COE, trading above line of fair valuation. Will it remain expensive after a rate cut of 25bps? The answer is yes.

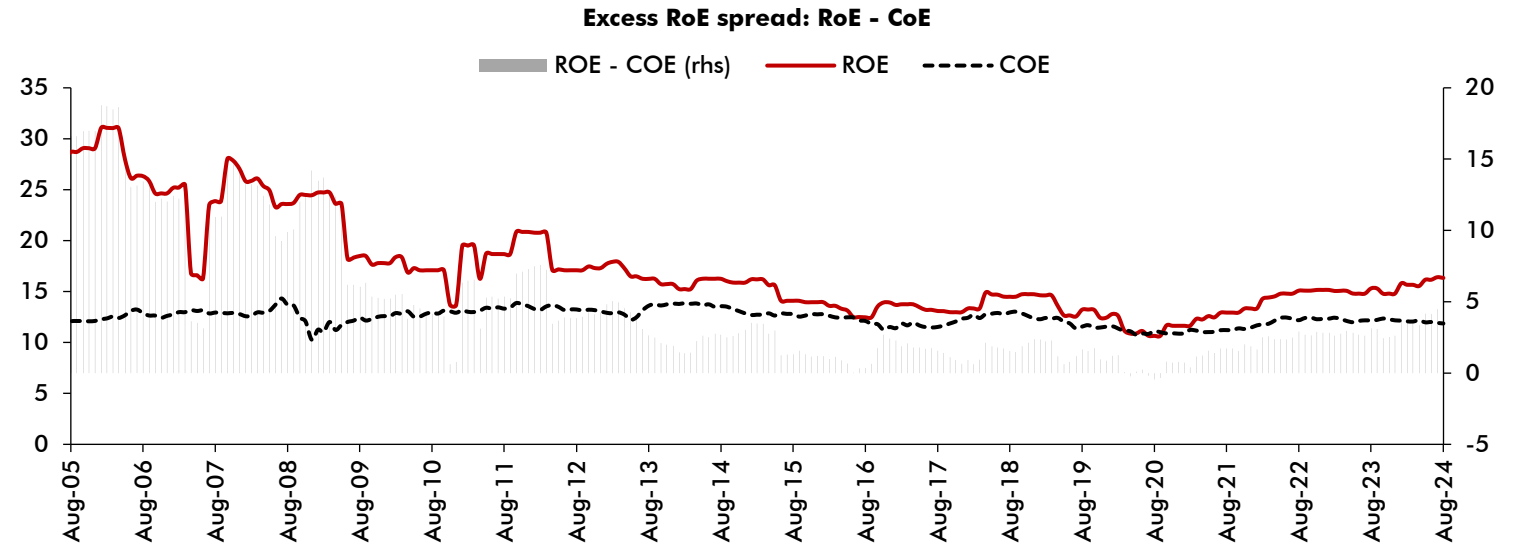
Exhibit 74: Nifty remains overvalued even after assuming 25bps rate cut, trading above the line of fair valuation



Source: Bloomberg, Ambit Capital research. Note: Cost of Equity = 10-year Gsec-yield + Market risk premium (5%)

However, it is worth highlighting that excess RoE improved significantly over the last 3 years and are at decadal high. Going ahead, we expect lower CoE to partially compensate for some normalization in RoE (40bps) expected over FY25.

Exhibit 75: Excess RoE is at a decadal high



Source: Bloomberg, Ambit Capital research

What is Nifty EYBY Gap implied 'fair value'?

Nifty fair value is a function of valuation, yield and EPS estimate. Since March-24, while valuation has expanded, earnings estimate trajectory seems to have worsened, with number of companies posting positive earnings surprises declining. We roll forward Nifty target to June-25. Nifty consensus June-25 EPS estimate stands at INR1164. Our analysis indicates that Nifty earnings estimates have on average, been revised downwards by 8% from start to end of FY. Accordingly, we take Nifty June-25 EPS estimate of INR1070 (~8% cut) and cut our 10-year yield assumption by 10 bps to 6.9%. For June-25, EYBY Gap implied Nifty fair value is 25.5k at 6.9% yield, June-25 EPS (INR1070), and markets trading at LTA (-2.7).

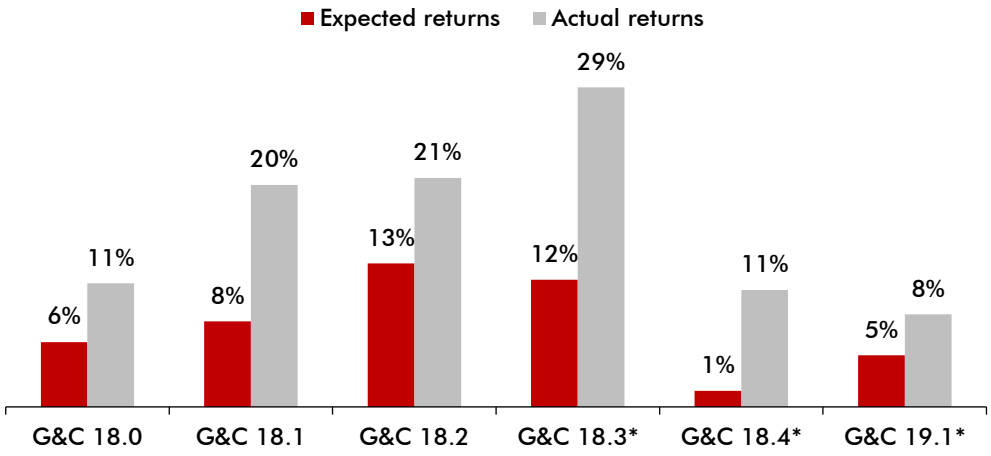
Exhibit 76: Implied Nifty (June-25) for different yields and earnings levels

10-year yield	June-25 EPS(INR)				
	1050	1060	1070	1080	1090
6.70%	26,261	26,511	26,761	27,011	27,261
6.80%	25,620	25,864	26,108	26,352	26,596
6.90%	25,010	25,248	**25,486**	25,724	25,962
7.00%	24,428	24,661	24,893	25,126	25,359
7.10%	23,873	24,100	24,328	24,555	24,782

Source: Bloomberg, Ambit Capital research. Note: Implied Nifty levels have been calculated under the assumptions: Nifty trades at LTA (-2.7), EPS and yield by equation EYBY Gap= (Earnings)/(Nifty Level) - Bond Yield

However, it is worth highlighting that actual returns have been significantly higher than expected returns of the EYBY model and if yields remain soft, then markets can go higher.

Exhibit 77: Actual returns have been higher than "EYBY gap" model implied returns



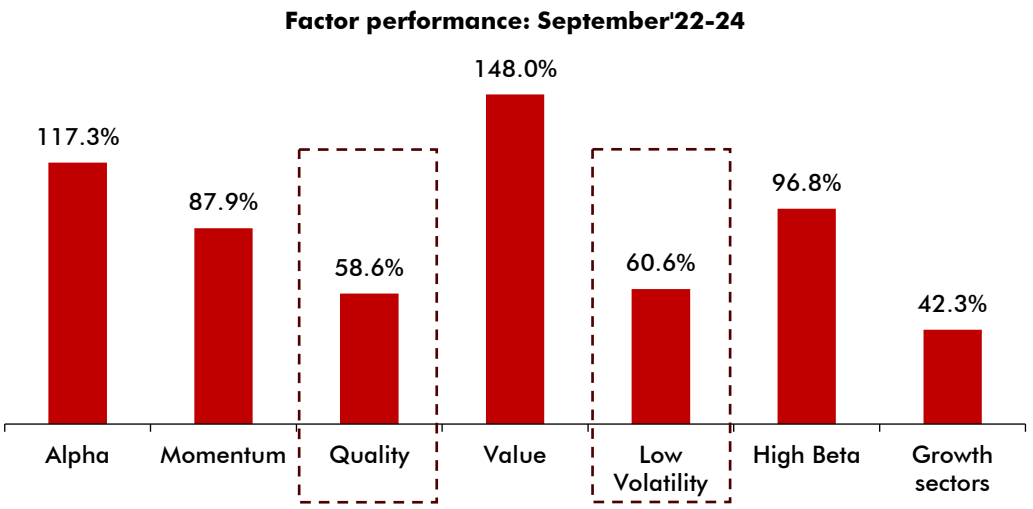
Source: Company, Ambit Capital research

5 Trade ideas

1. Quality and Low Volatility making a comeback

Over the last two years, factors like value, alpha, high beta and momentum outperformed, while quality and low volatility were significant underperformers.

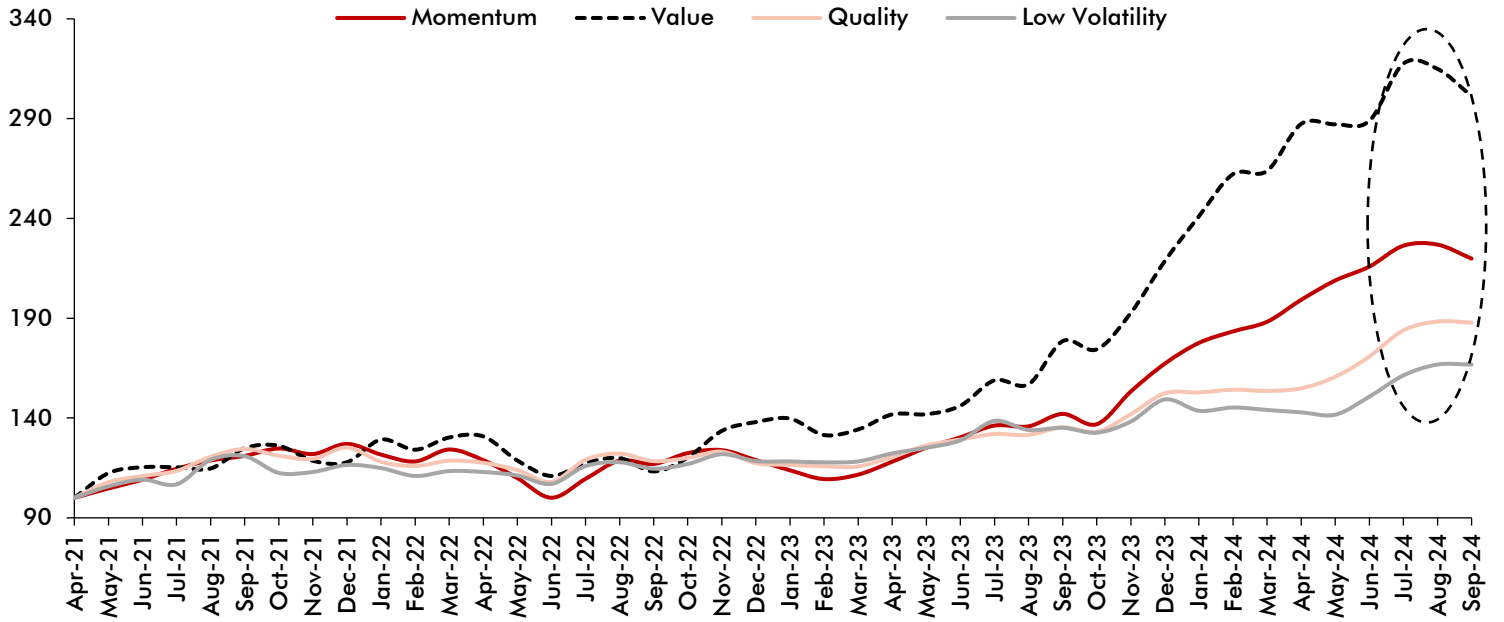
Exhibit 78: Value and Momentum tend to outperform in times of strong earnings growth



Source: Ace Equity, Ambit Capital research

Over FY21-24, strong EPS growth was the key catalyst as a broader universe of companies benefitted from the positive economic environment. In times of positive economic sentiment, value and momentum factors tend to outperform, while quality and low volatility underperform. However, the trend is changing.

Exhibit 79: Value and Momentum factors have decelerated, while Quality and Low volatility have remained resilient



Source: Ace Equity, Ambit Capital research

Over the past 3 months, quality and low volatility performed better compared to other factors. With EPS growth expected to normalize in FY25, we expect quality and low volatility factors to outperform, a trend which has just begun.

Exhibit 80: Over the past 3 months, quality and low volatility turned a corner and began to catch up

Date	NIFTY200 Alpha 30	Nifty200 Momentum 30	NIFTY200 Quality 20	NIFTY200 Value 20	Nifty200 Low Volatility 20	Nifty High Beta 50	Nifty 200 Growth 20
Sep-23	6%	5%	3%	14%	1%	5%	0%
Oct-23	-5%	-4%	-2%	-2%	-2%	-4%	-1%
Nov-23	14%	12%	7%	10%	4%	8%	9%
Dec-23	10%	9%	7%	14%	8%	12%	8%
Jan-24	5%	6%	0%	10%	-4%	7%	1%
Feb-24	3%	3%	1%	9%	1%	1%	5%
Mar-24	2%	3%	0%	1%	-1%	0%	2%
Apr-24	6%	6%	1%	9%	-1%	10%	1%
May-24	5%	5%	4%	0%	-1%	0%	2%
Jun-24	6%	3%	6%	1%	6%	4%	7%
Jul-24	6%	5%	8%	10%	7%	4%	-1%
Aug-24	1%	0%	2%	-1%	3%	-4%	0%
Sep-24	-3%	-3%	0%	-4%	0%	-3%	-1%

Source: Ace Equity, Ambit Capital research. Note: For comparability with other factor indices, we have created indices for Value, Low volatility and Growth factors based on NSE200 constituents, as factor indices for the same were not available.

Several studies from factor investing in the US have established periods of growth slowdown are associated with "quality" outperformance and can be used as the metric for timing exposure to quality factor.

2. Introducing Earnings Revision strategy

While our Good & Clean and Coffee Can portfolios are built for the longer term, our "Earnings Revision" portfolio is built from a quarter perspective. Stock prices tend to move in the same direction as their earnings revisions and outperformance of best earnings revision quintile (Q1) w.r.t NSE100 universe is ~5% since 2006. Since 2006, high earnings revision quintiles in the NSE100 index outperformed index ~80% times and worst earnings momentum quintile underperformed index ~2/3rd times on 3-year rolling basis. Information content is high with top two quintiles performing significantly better than the rest. The strategy works even better in mid-caps with alpha of (~8%). We have not applied this strategy to small-caps due to lack of earnings estimates of smaller companies. In large-caps and mid-caps, practical strategy is long Q1/Q2 and avoid Q3-Q5. In order to reduce portfolio churn, we also suggest a practical implementation of the strategy introducing the concept of safety net.

What does the strategy offer? Earnings revision is a strategy aimed at improving stock selection. Our analysis suggests that stock prices tend to move in the same direction as their earnings revisions. Since 2006, the highest earnings revision quintile (Q1) has delivered 17.5% CAGR returns while the lowest earnings revision (Q5) stocks delivered 9.5% CAGR returns. On the other hand, NSE100 index delivered 12.5 % CAGR returns over this period. The alpha is significant (~5%), so even with the inclusion of churn cost, the alpha would not disappear and still be significant.

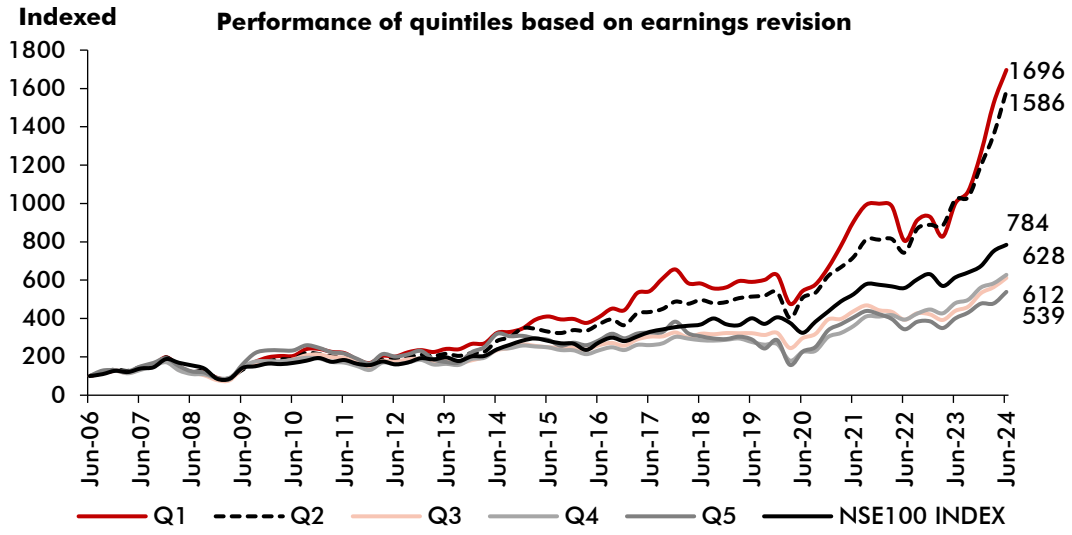
The framework of our earnings momentum strategy

Stocks with strong earnings revision witnessed their forward earnings estimates growing at rates better than the market. These companies might have turned around their operations, gaining market share, or may have simply been beneficiaries of sectoral tailwinds.

We define "earnings revision" as 6-month change in 1-year forward earnings of a company on a sequential basis.

- **Factor**: The aim is to invest in companies experiencing positive earnings revision. We define earnings revision as change in 1-year forward earnings over the last 6 months (1-year blended forward EPS semi-annual %).
- **Methodology**: Benchmark index is divided into 5 quintiles as per earnings revision with top20 stocks in Quintile 1 and lowest 20 stocks in Quintile 5. Quintiles are rebalanced quarterly at March-end, June-end, Sept-end and Dec-end.
- **Performance**: For NSE100, since Jun-06, the highest earnings revision quintile (Q1) has been the biggest outperformer, delivering 17.5% CAGR whereas the lowest earnings revision (Q5) stocks delivered 9.5% CAGR. NSE100 index delivered 12.5% CAGR over this period.
- **What stands out**? The performance of Q1 has been consistent, while Q5 has been extremely volatile. Companies with poor earnings revisions tended to have more volatile returns as market participants reacted negatively to companies with downward revisions in estimates. Markets historically rewarded stocks with strong earnings revisions and penalized those with poor earnings revision.

Exhibit 81: "Earnings Revision" is efficient in separating the chaff from the grain



Source: Bloomberg, Ambit Capital research

Exhibit 82: NSE100 quintiles for next quarter – 2QFY25

Q1	Q2	Q3	Q4	Q5
ADANIENS IN	BHE IN	TRP IN	AXSB IN	JSTL IN
TRENT IN	BJAUT IN	DLFU IN	TCS IN	DABUR IN
ZOMATO IN	CIFC IN	CIPLA IN	TTAN IN	INFO IN
VEDL IN	MM IN	MSIL IN	BRIT IN	ITC IN
ABB IN	APHS IN	BOB IN	BPCL IN	CBK IN
PNB IN	HMCL IN	IRCTC IN	TATACONS IN	HDFCB IN
INDIGO IN	ADSEZ IN	EIM IN	PIDI IN	SBICARD IN
ZYDUSLIF IN	JSP IN	NTPC IN	POWF IN	NEST IN
HNAL IN	TPWR IN	TATA IN	BAF IN	APNT IN
BHARTI IN	INFOE IN	DRRD IN	ONGC IN	HUVR IN
SIEM IN	TVSL IN	ICICIGI IN	PWGR IN	TECHM IN
TTMT IN	CLGT IN	SUNP IN	MRCO IN	LTIM IN
COAL IN	SBIN IN	KMB IN	UTCEM IN	IOCL IN
MOTHERSO IN	SRCM IN	HDFCLIFE IN	DIVI IN	BRGR IN
HNDL IN	ICICIBC IN	DMART IN	RELIANCE IN	IPRU IN
VBL IN	SHFL IN	HAVL IN	IIB IN	SRF IN
LICI IN	UNITDSPR IN	LT IN	WPRO IN	GRASIM IN
ACEM IN	RECL IN	GAIL IN	SBILIFE IN	ADE IN
BOS IN	BJFIN IN	GCPL IN	HCLT IN	

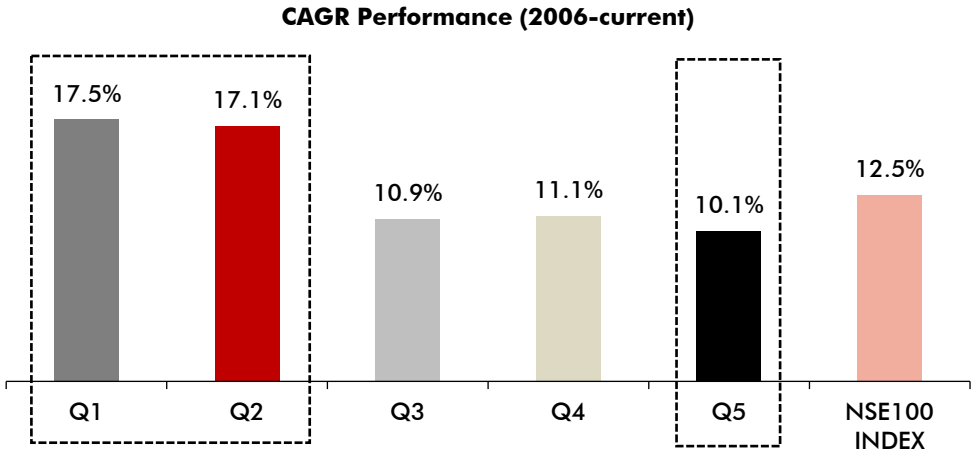
Source: Bloomberg, Ambit Capital research

Digging deeper into the "Earnings revision" strategy

Our Earnings Revision strategy in NSE100 shows consistency in the outperformance of Quintile 1 and 2, generating significant alpha even after including impact cost and churns. The starting point doesn't matter. On the other hand, Q5 has been a consistent underperformer. Additionally, information content was high with the top 2 quintiles performing significantly better than the bottom 3 quintiles. Across all timeframes, there is one clear message: "Buy Q1/Q2, Avoid Q3-Q5". The limitation of the earnings revision strategy is that the hit ratio is still 50%. 50% of the stocks outperform the mid-cap index, whereas 50% of the stocks underperform.

- **High Information Content:** The capability to "segregate" between "Stocks to own" and "Stocks to avoid". There is a stark divergence in the performance of stocks with high earnings revision (Q1-17.5% CAGR, Q2-17.1% CAGR) and stocks with poor earnings revision (Q3-10.9% CAGR, Q4-11.1% CAGR, Q5-10.1% CAGR). Across all timeframes, there is one clear message: "Buy Q1/Q2, Avoid Q3-Q5" as Q1/Q2 performs well across all timeframes, whereas Q3-Q5 perform poorly. We can restrict the investing universe to the top 2 quintiles and exclude the last 3 quintiles.

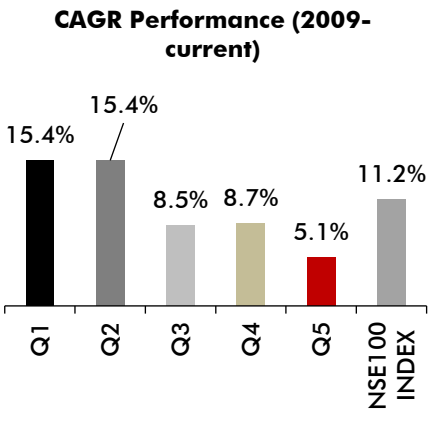
Exhibit 83: Q1- Quintile to own; Q5 - Quintile to avoid



Source: Bloomberg, Ambit Capital research

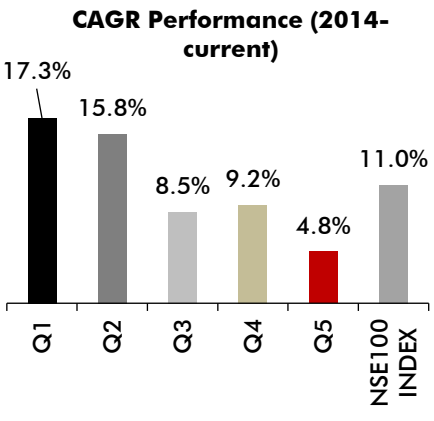
- **Starting point doesn't matter:** Our analysis suggests that the starting point does not matter; i.e. even if we back-test the strategy from 2009, 2011, 2014, or 2018, the low earnings momentum quintile (Q5) has significantly underperformed while Q1/Q2 has massively outperformed the markets.

Exhibit 84: The strategy has stood the test of time



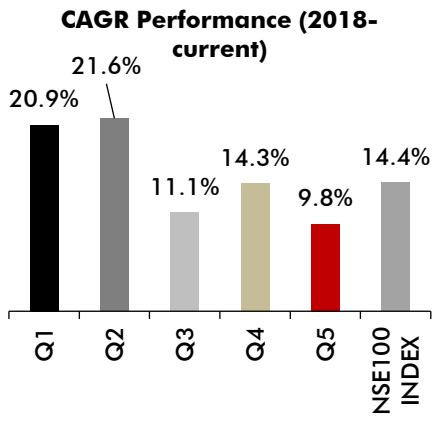
Source: Bloomberg, Ambit Capital research

Exhibit 85: The divergence between Q1 and Q5 remains high even if we shift the starting point to 2014...



Source: Bloomberg, Ambit Capital research

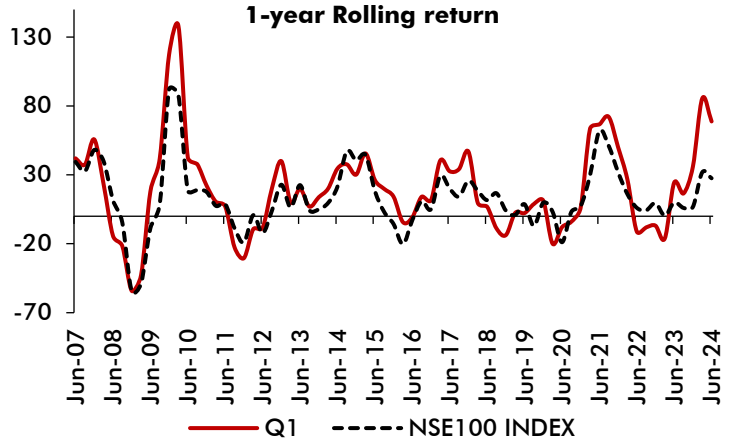
Exhibit 86: ...or to 2018, suggesting consistency in outperformance



Source: Bloomberg, Ambit Capital research

- **Consistency in performance:** On a 1-year rolling return basis, Q1 has outperformed the mid-cap index 47/69 times and 49/61 times on a 3-year rolling basis. An impressive feat. On the other hand, the bottom quintile has underperformed the mid-cap index on 50/69 (1-year rolling return) and 40/61 (3-year rolling return) instances respectively, consistent underperformer.

Exhibit 87: Q1 outperformance has been consistent...

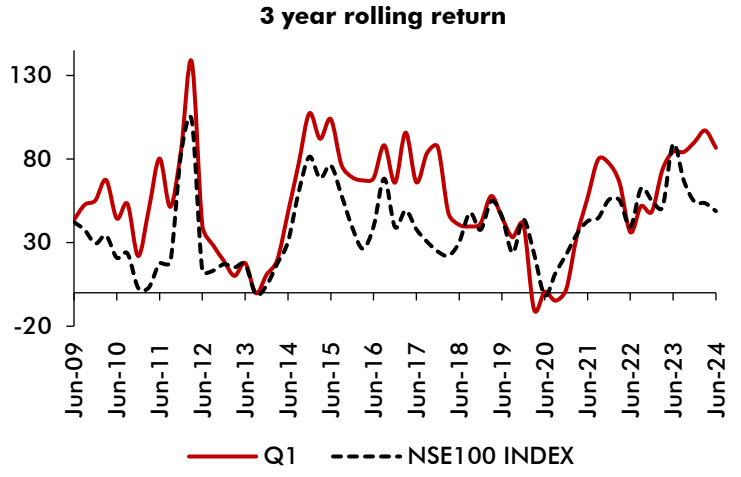


Source: Bloomberg, Ambit Capital research

Exhibit 88: ...whereas Q5 performance has been volatile

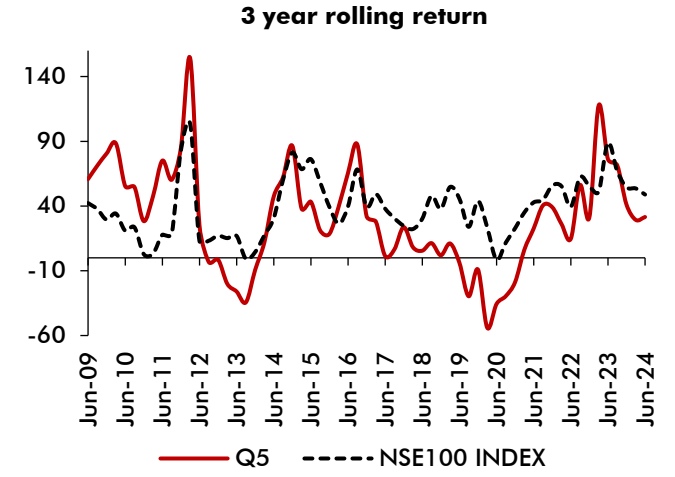
Source: Bloomberg, Ambit Capital research

Exhibit 89: Q1 has outperformed the index in 80% of the instances on a 3-year basis...



Source: Bloomberg, Ambit Capital research

Exhibit 90: ...whereas Q5 has underperformed the mid-cap index 66% of the times



Source: Bloomberg, Ambit Capital research

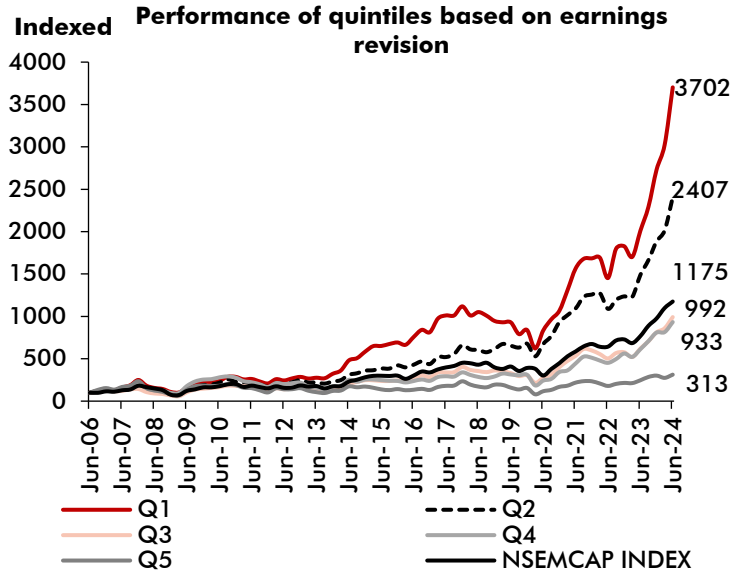
Limitation: The limitation of the earnings momentum strategy is that the hit ratio is still 50%. 50% of the stocks outperform the index, whereas 50% of the stocks underperform.

Earnings revision strategy generates higher alpha in mid-caps vs large-caps

Our earnings revision strategy in mid-caps shows consistency and persistence in the outperformance of Quintile 1 and 2 and significant alpha even after including impact cost and churns. The starting point doesn't matter with Q1's consistent outperformance across all timeframes. On the other hand, Q5 has been a perennial underperformer. Additionally, information content was high with the top 2 quintiles performing significantly better than the bottom 2 quintiles. Across all timeframes, there is one clear message: "Buy Q1/Q2, Avoid Q3-Q5". The limitation of the earnings momentum strategy is that the hit ratio is still 50%. 50% of the stocks outperform the mid-cap index, whereas 50% of the stocks underperform.

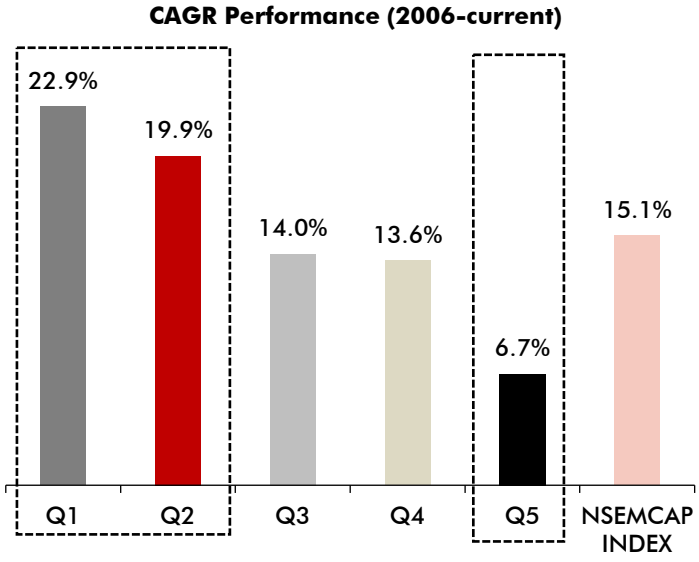
Performance: Since June-06, Q1 followed by 2nd highest earning revision mid-cap quintile (Q2) have been the biggest outperformers, delivering 22.9% and 19.9% CAGR respectively. The lowest earnings revision (Q5) stocks delivered (6.7%) CAGR returns. Mid-cap index delivered 15.1% CAGR over this period.

Exhibit 91: "Earnings Revision" is efficient in separating the chaff from the grain



Source: Bloomberg, Ambit Capital research

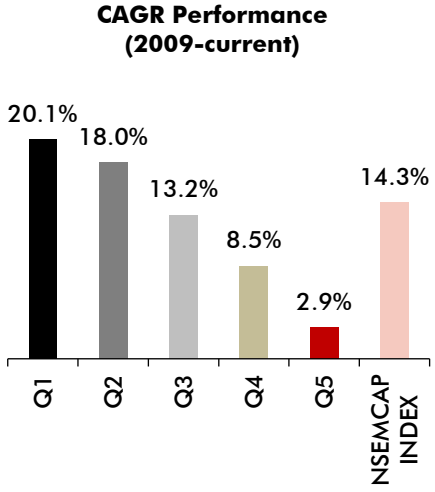
Exhibit 92: Q1 and Q2 - Quintiles to own; Q5 - Quintile to avoid



Source: Bloomberg, Ambit Capital research

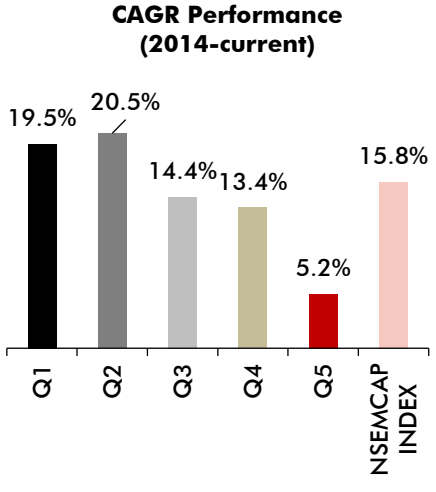
- **Starting point doesn't matter:** Our analysis suggests that the starting point does not matter; i.e. even if we back-test the strategy from 2009, 2011, 2014 or 2018, the low earnings momentum quintile (Q5) significantly underperformed while Q1/Q2 has massively outperformed the markets.

Exhibit 93: The strategy has stood the test of time



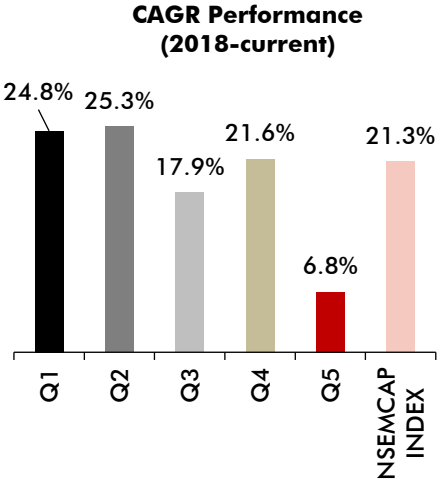
Source: Bloomberg, Ambit Capital research

Exhibit 94: The divergence between Q1 and Q5 remains high even if we shift the starting point to 2014...



Source: Bloomberg, Ambit Capital research

Exhibit 95: ...or to 2018, suggesting consistency in outperformance



Source: Bloomberg, Ambit Capital research

Mid-cap stocks to own/avoid for next quarter

We rank stocks based on earnings momentum and suggest Q1/Q2 as the quintile to own and Q5 as the quintile to avoid. The investible universe should be restricted to the first two quintiles.

Stocks to own: Q1 and Q2, **Stocks to avoid**: Q3-Q5

Exhibit 96: Mid-cap Quintiles for 2QFY25

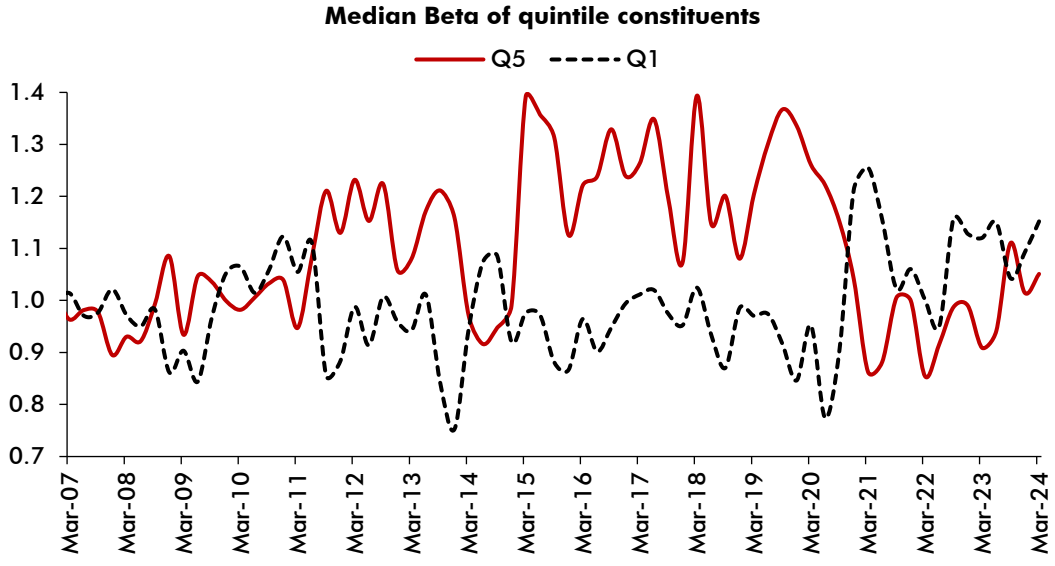
Q1	Q2	Q3	Q4	Q5
POLICYBZ IN	KPITTECH IN	CGPOWER IN	GLAND IN	APAT IN
MAZDOCKS IN	IH IN	PLNG IN	TATATECH IN	MRF IN
BDL IN	OINL IN	AL IN	ASTRA IN	PAG IN
LODHA IN	NYKAA IN	MMFS IN	BOI IN	TPW IN
DIXON IN	LTF IN	SONACOMS IN	SUNTV IN	SYNG IN
SUEL IN	LICHF IN	ABCAP IN	LTTS IN	DALBHARA IN
LPC IN	PEPL IN	BIL IN	ESCORTS IN	BANDHAN IN
KKC IN	CCRI IN	OBER IN	TCOM IN	JUBI IN
BHEL IN	POONAWAL IN	UNBK IN	IGL IN	Z IN
VOLT IN	MAXHEALT IN	IPCA IN	MPHL IN	PIEL IN
JSW IN	POLYCAB IN	PSYS IN	IDFCFB IN	LAURUS IN
PATANJAL IN	MANKIND IN	FB IN	TIINDIA IN	DELHIVER IN
NMDC IN	RVNL IN	GUJGA IN	COFORGE IN	TTCH IN
INDUSTOW IN	MAXF IN	APTY IN	PI IN	UPLL IN
HDFCAMC IN	BHFC IN	AUBANK IN	DN IN	IDEA IN
ALKEM IN	INBK IN	BIOS IN	TELX IN	GMRI IN
FORH IN	GPL IN	NHPC IN	HPCL IN	ABFRL IN
ARBP IN	DLPL IN	SAIL IN	YES IN	PAYTM IN
ACC IN				

Source: Bloomberg, Ambit Capital research

Mid-caps: Q5 scores even worse on risk-adjusted basis

An important observation from our analysis is that the bottom quintile portfolio tends to have more volatile returns than that of the mid-cap index. While beta of Q5 has historically been higher than that of Q1, it is important to note that it can remain elevated for extended periods. Between Mar15-Dec19, beta of Q5 portfolio ranged between 1-1.4, while Q5 returns trailed the index by ~6% CAGR over the same period.

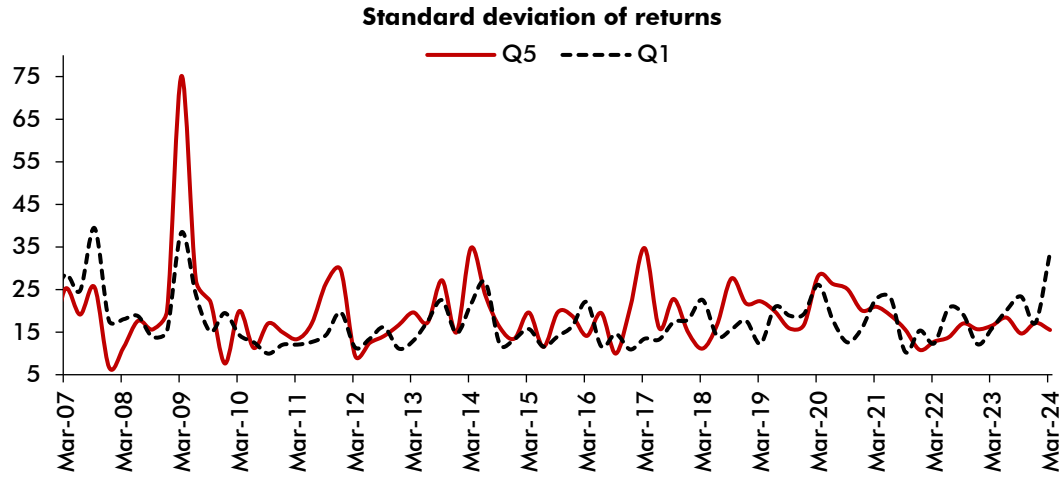
Exhibit 97: Beta of Q5 remained elevated for longer periods of time



Source: Ace Equity, Ambit Capital research

In this context, while the standard deviation of returns of Q1 increased over the past few quarters, the same for Q5 has been substantially higher over the past decade and a half. This can be attributed to the negative reaction of market participants towards companies with downward revision in estimates as those with poor earnings revisions tend to have more volatile returns. Similarly, a lower standard deviation in returns of Q1 indicates that market reaction to downgrades is significantly higher than that for upgrades.

Exhibit 98: Returns delivered by Q5 are much more volatile



Source: Ace Equity, Ambit Capital research

Limitation: Similar to price momentum strategies, the earnings revision strategy results in high turnover portfolios. We suggest a practical implementation of this strategy aimed at reducing turnover without compromising on alpha.

Safety net – Extend the investible universe to Q2

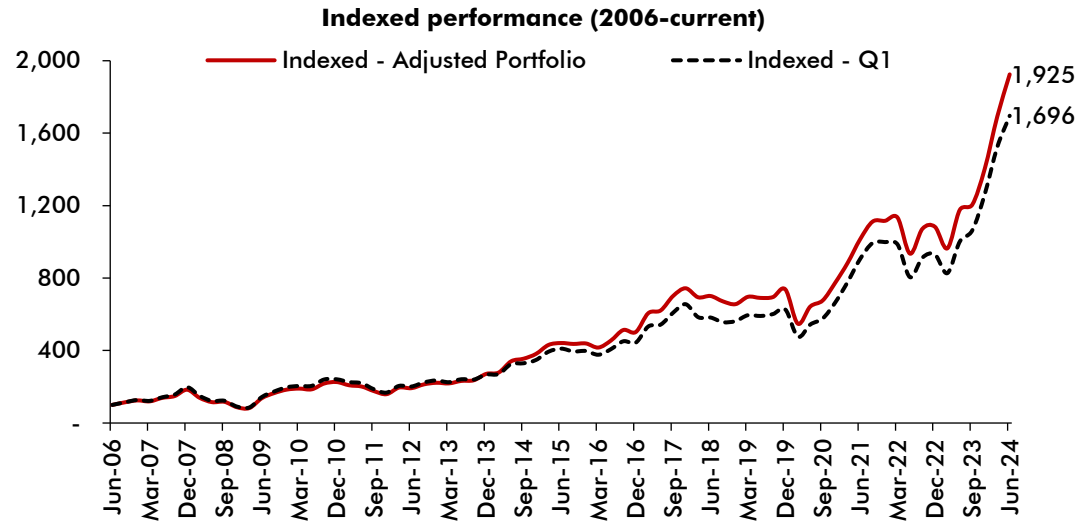
For both large-caps and mid-caps, Q1 is the best performing quintile followed by Q2 across different times. Since 2005, alpha generated by Q2 in large-caps is 4.6%, whereas in mid-caps it's 4.8%. Whereas all the other quintiles (Q3-Q5) fail to beat the benchmark. Accordingly, extending the investible universe to Q2 is likely to result in sustained performance along with lower portfolio churn, resulting in higher alpha of portfolio when accounting for transaction costs. The framework is as follows–

- **Methodology**: We create a portfolio (t) with the top 20 earnings revision stocks of Quintile 1. Quintiles are rebalanced quarterly at Mar-end, Jun-end, Sept-end and Dec-end. At rebalancing date (t+1), portfolio construction is as follows –
  - Stocks that continue to exist in Q1 as per earnings revision Q1 (t+1) remain in the portfolio.
  - However, even if the stock drops to Q2 (t+1), it continues to be a part of the portfolio. The idea is to capture true trend in earnings revisions, while reducing portfolio churn.
  - Only if the stock drops below Q2 (t+1), the portfolio is rebalanced. This is done by selecting stocks from Q1 (t+1) in order of highest ranking as per earnings revision i.e., 6-month change in 1-year forward earnings.

NSE100: Improved performance along with lower portfolio churn

- **Performance**: Since Jun-06, the adjusted portfolio marginally outperformed (17.8% CAGR) the highest earnings revision quintile (17% CAGR), while the NSE100 index delivered 12.5% CAGR over this period.

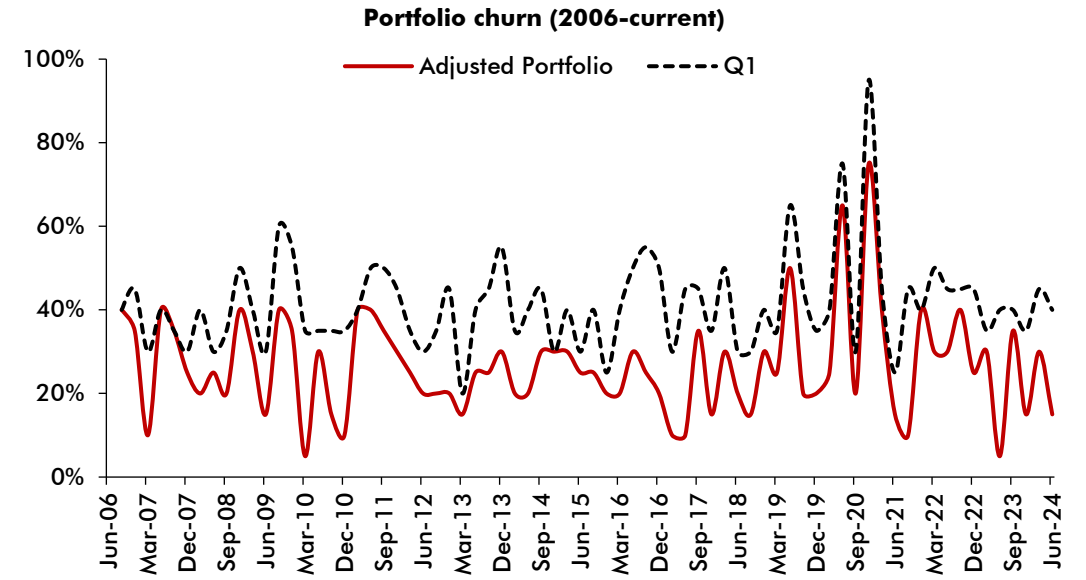
Exhibit 99: Performance of the adjusted portfolio is better than Q1...



Source: Bloomberg, Ambit Capital research

- **What stands out:** The adjusted portfolio generated slightly better performance, while exhibiting much lower portfolio churn at ~25% vs ~40% of Q1. The result of back-test remains the same even if starting point is changed to 2010 or 2015.

Exhibit 100: ...while adjusted portfolio exhibits much lower churn than Q1 portfolio

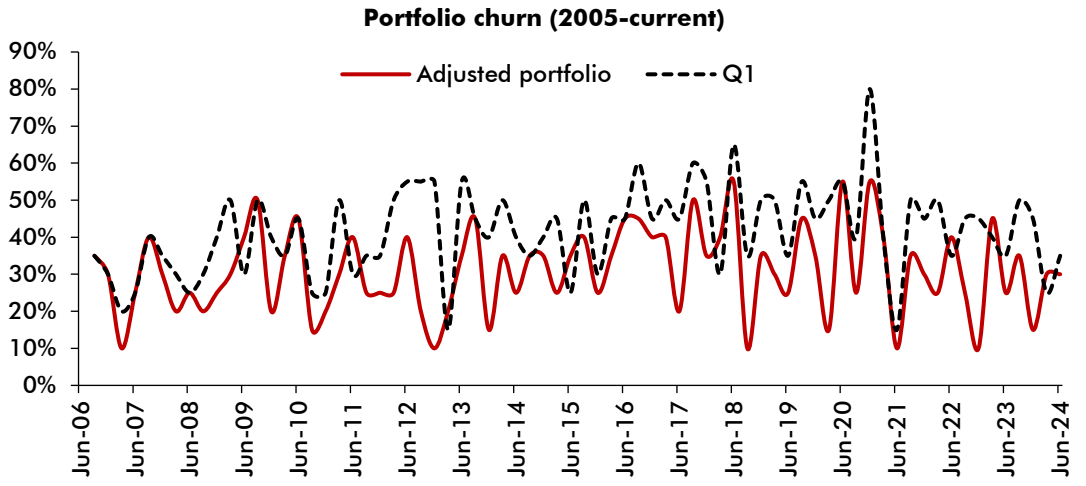


Source: Bloomberg, Ambit Capital research

Mid-caps: Lower churn at the expense of marginal decline in performance

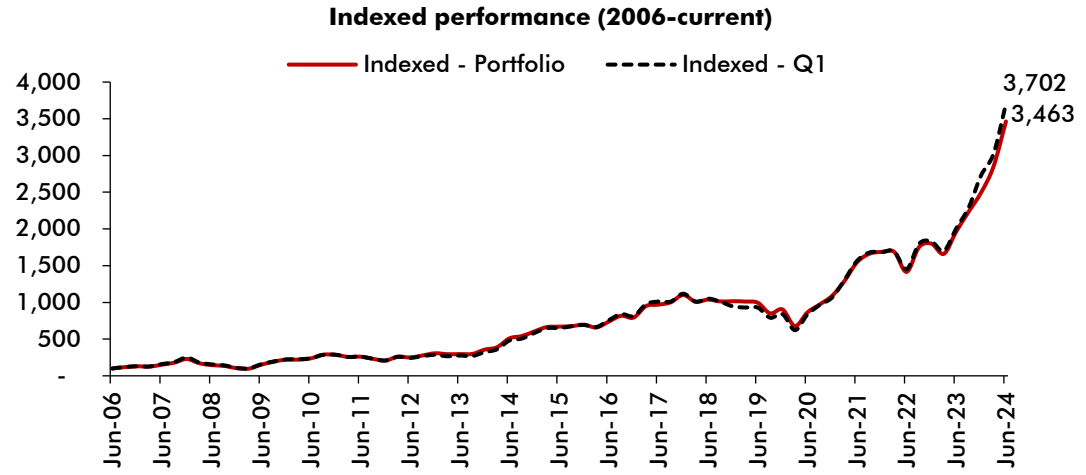
In mid-caps, while the adjusted portfolio does exhibit much lower churn at ~30% as compared to 43% for the Q1 portfolio, portfolio performance marginally deteriorates from 22.2% for Q1 portfolio to 21.7% for the adjusted portfolio.

Exhibit 101: Portfolio churn of adjusted portfolio is much lower than that of Q1



Source: Bloomberg, Ambit Capital research

Exhibit 102: Q1 marginally outperforms the adjusted portfolio



Source: Bloomberg, Ambit Capital research

In conclusion

- Markets have historically rewarded stocks with strong earnings revisions and penalized those with poor earnings revision. In large-caps, outperformance of Q1 w.r.t NSE100 index is ~5% since 2006, while the same for mid-caps is ~8%.
- A limitation of the earnings revision strategy is high churn in quintile portfolios, which is likely to impact alpha.
- In order to mitigate this, creating an adjusted portfolio by extending the investible universe to Q2 considerably reduces portfolio churn in both large-caps and mid-caps.
- This strategy does equally well in both large-caps and mid-caps. In both cohorts, churn ratio decreases. From a performance perspective, it even improves the returns in large-caps, while in mid-caps returns reduce marginally.

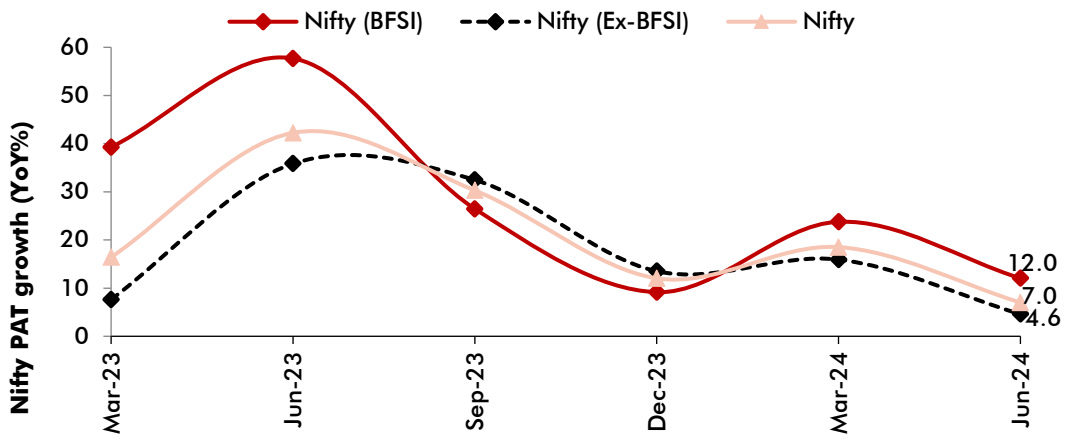
3. BFSI: Time for the laggards to run

The BFSI vs Ex-BFSI trade has come at a critical juncture. Our rationale for mean reversion is based on high divergence in earnings growth, unsustainable Ex-BFSI valuation premium and peak underperformance levels of Bank Nifty w.r.t Nifty.

- **Strong Gradient:** BFSI is driving Nifty PAT growth, ex-BFSI lagging sharply

We observe high PAT growth (YoY) divergence between BFSI (12%) and Ex-BFSI (4.6%) in 1QFY25, with aggregate Nifty PAT growth at 7%. The gradient is too high, a trend which has got accentuated from last quarter which makes the long BFSI trade for further inspection.

Exhibit 103: BFSI was the driver of Nifty PAT growth whereas Ex-BFSI drags

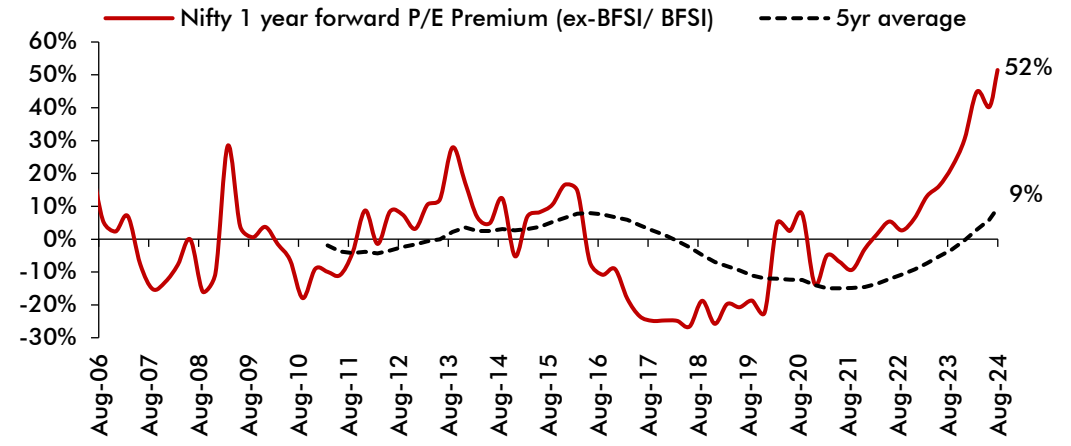


Source: Ace Equity, Bloomberg, Ambit Capital research

- **How does it corroborate with the valuation premium?**

Nifty ex-BFSI is trading at ATH premium of 52% over BFSI on 12M fwd. P/E basis. On TTM basis, the premium is close to 67%. With the earnings gradient worsening significantly, can the premium sustain?

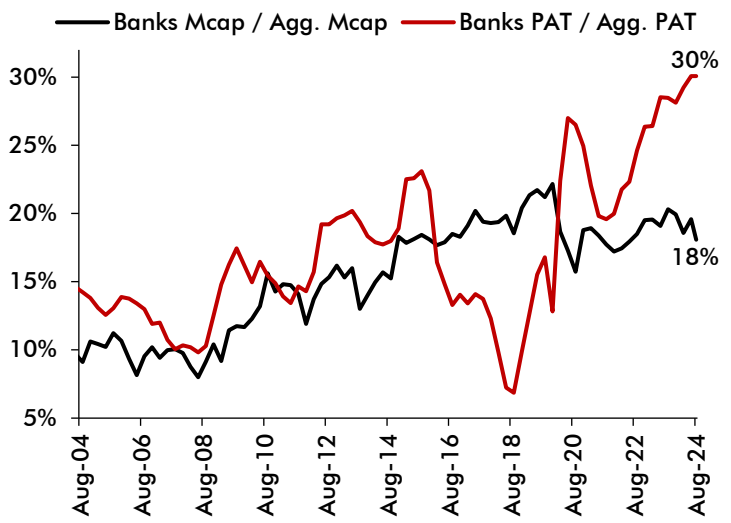
Exhibit 104: Nifty Ex-BFSI universe trades at an ATH premium of 52% w.r.t BFSI on 12M fwd. P/E vs 5-year average of ~9%



Source: Ace Equity, Ambit Capital research

On the other hand, BFSI continues to drive earnings but high earnings growth has not manifested in price returns. The spread between PAT contribution and mcap contribution is at the highest ever. Nifty FY25 earnings growth is projected at 11%, with both BFSI growth at 9% and Nifty (Ex-BFSI) at 11%. However, as mentioned above, high divergence in PAT growth was observed in 1QFY25 between BFSI (12%) and Ex-BFSI (4.6%). Accordingly, the ask rate for Nifty (Ex-Banks) to deliver 11% FY25 earnings growth would now be much higher. The spread will increase further unless mcap contribution begins to catch up, which can manifest only if banks begin to outperform the market. Our Banks' outperformance call has not worked so far but is now set for mean reversion.

Exhibit 105: Divergence between mcap and PAT contribution is close to higher-ever levels...



Source: Bloomberg, Ambit Capital research. Note: Latest data as on 30th August 2024

Exhibit 106: ...while Banks remains the primary driver of earnings growth

Sector	Contribution to EPS growth		
	FY25	FY26	FY27
Banks	29%	34%	46%
IT	9%	9%	10%
Oil and Gas	-3%	11%	9%
FMCG	4%	4%	3%
Auto and Auto Anc.	0%	8%	7%
Capital Goods	8%	6%	7%
Healthcare	4%	3%	1%
Metals and Mining	26%	10%	4%
Telecom	12%	6%	6%
NBFC	6%	5%	5%
Utilities	2%	2%	1%
Consumer Discretionary	0%	1%	1%
Cement and Bldg. Materials	2%	2%	1%
Insurance	1%	1%	1%
Nifty (BFSI)	**36%**	**39%**	**52%**
Nifty (ex-BFSI)	**64%**	**61%**	**48%**

Source: Bloomberg, Ambit Capital research

- **Can mean reversion manifest?** Yes, empirical evidence is in favour. Bank Nifty underperformance w.r.t Nifty is close to historical troughs (Z-score of BNF/NF monthly levels is -1.9).

Exhibit 107: Banks Nifty/Nifty touches a crucial level – Historically, 100% success rate

Source: Bloomberg, Ambit Capital research

Over 2005-24, in instances of extreme underperformance, whenever the Bank Nifty/Nifty ratio is in the vicinity of -2 standard deviations, Bank Nifty outperformed Nifty by ~18% over following year and delivered ~46% returns on absolute basis.

Exhibit 108: Nifty Bank has outperformed Nifty by ~18% at Z-score of about -2

Date	Z-score (BNF/NF, 20-period)	(Nifty Bank – Nifty) Excess Return (%)			
		3m	6m	9m	12m
Apr-06	-2.2	1	18	16	9
Jun-08	-2.1	18	26	7	40
Nov-11	-2.1	10	8	8	20
Jul-13	-2.2	5	(4)	12	18
Feb-16*	-1.4	10	16	16	21
Sep-18	-2.2	9	15	16	11
Mar-20	-2.6	(8)	(19)	1	3
Aug-24	-1.9	N/A	N/A	N/A	N/A
Average		**6**	**9**	**11**	**17**
Median		**9**	**15**	**12**	**18**

*Source: Bloomberg, Ambit Capital research Note: Z-Score has been calculated based on monthly observations of BNF/NF ratio and 20 observations have been used to calculate standard deviation and average. * In Feb-16, BNF/NF ratio touched -2 in the month but closed at -1.4. Note: Current z-score is -1.64*

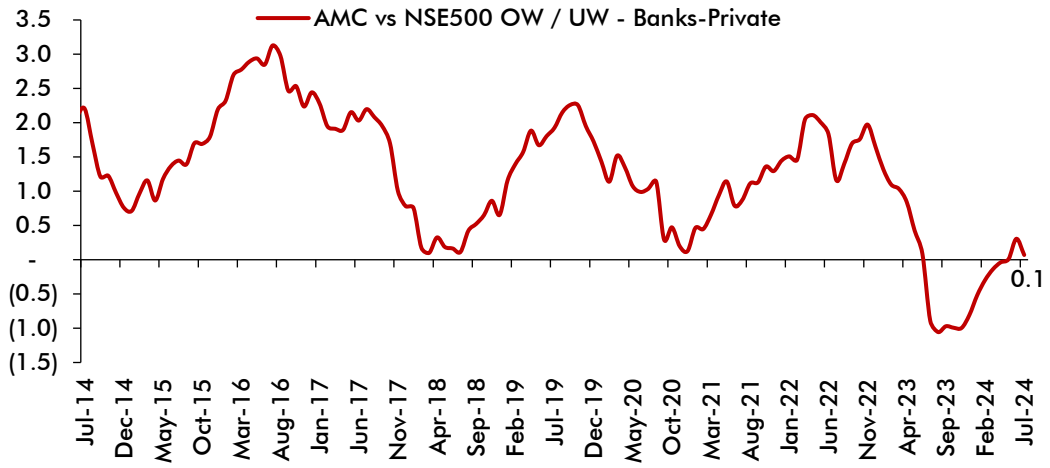
Exhibit 109: Outperformance of Nifty Bank is backed by positive absolute returns on most instances

Date	Z-score (BNF/NF, 20-period)	Nifty Bank Return (%)			
		3m	6m	9m	12m
Apr-06	-2.2	(10)	23	31	24
Jun-08	-2.1	15	(1)	(18)	46
Nov-11	-2.1	22	10	17	42
Jul-13	-2.2	15	2	28	52
Feb-16*	-1.4	26	42	34	48
Sep-18	-2.2	8	21	24	16
Mar-20	-2.6	12	12	63	74
Aug-24	-1.9	N/A	N/A	N/A	N/A
Average		**12**	**16**	**26**	**43**
Median		**15**	**12**	**28**	**46**

Source: Ace Equity, Ambit Capital research. Note: Current z-score is -1.64

The high probability of Banks to outperform Nifty over the next 12 months is likely to be the reason for DMFs to turn neutral on private banks after being UW for close to a year.

Exhibit 110: DMFs cut UW on Private Banks and are close to neutral



Source: Ace MF, Ambit Capital research

Is the current outlook of the banking sector better than that in Mar-20?

The answer is a definite yes. The analysis based on Z-score worked even during Covid. So, while there can be some negatives like credit growth slowing down, the outlook is significantly better. In fact, Banks are driving earnings growth and valuations are in favour. Accordingly, we remain OW on Banks. Prefer State Bank of India, Axis Bank and ICICI Bank. Rationale is as follows:

State Bank of India

- Asset quality should be better than large private banks.
- Better placed to manage loan growth and margin trade-off given low CD ratio, 40% MCLR book and loan growth expectations being lower than private banks.
- Best PSB franchise with sticky deposits, diversified loan book, ability to generate higher revenues per asset and continuously improving digital capabilities.
- Expect re-rating to be driven by narrowing of loan growth/RoE gap with large private banks.

Axis Bank

- Improving transaction market share (RTGS, POS, UPI) along with loan mix change towards better yielding products to further close the NIM gap with ICICI Bank.
- Credit cost should normalize slower than sector given 80bps of loans as buffer provisions over and above 78% PCR.
- Optionality of faster improvement in core profitability in case management is able to generate operational efficiency.
- 16% average RoE over FY24-27E and improving franchise strength on both sides of the balance sheet makes valuation attractive.

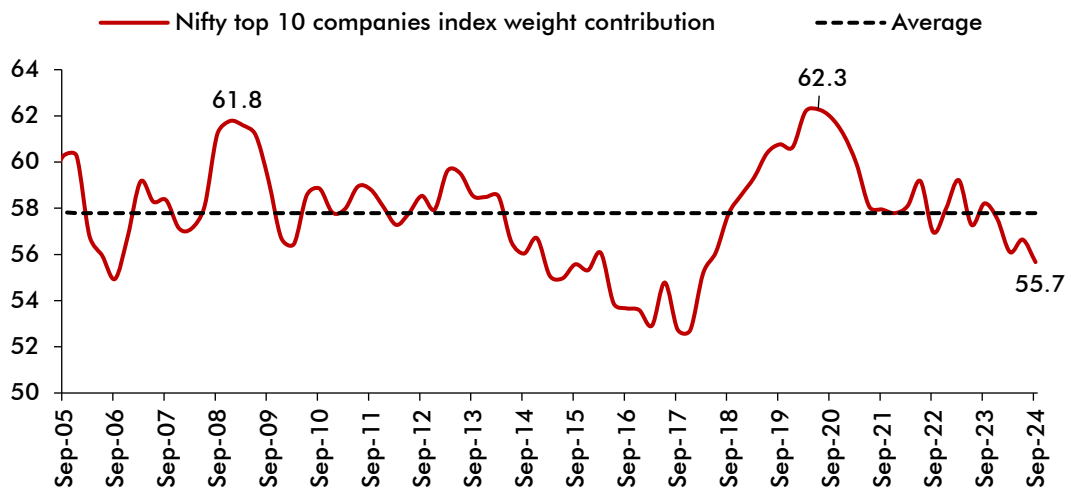
ICICI Bank

- Strong deposit franchise and wide distribution position the bank to continue market share gains with loan growth of 16%.
- Credit cost should normalize slower than sector given 1.5% buffer provisions over and above 80% PCR.
- Best-in-class RoE and leading loan growth amongst large banks makes valuations attractive.

4. Can the heavyweights catch up?

Nifty heavyweight (top 10) stocks' weights fell from a peak of 62.3% in Mar-20 to 55.7% in Sep-24. In times of uncertainty, investors flock towards quality heavyweights as evident in their weight contribution hitting the peaks in the aftermath of the GFC and Covid-19 crisis. Likewise, in periods of exuberance, smaller companies in the index outperform heavyweights. In CY23, small-weights outperformed while heavyweights, led by Banks, significantly underperformed.

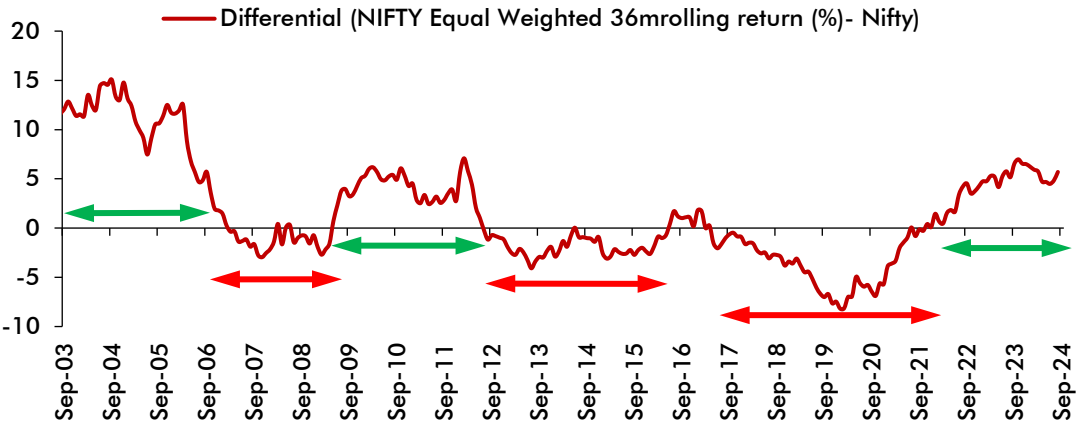
Exhibit 111: Weight contribution of heavyweights is lowest in 5 years



Source: Bloomberg, Ambit Capital research. Note: Latest data as on 06th September'24.

This resulted in the outperformance of Nifty EW index over Nifty which usually lasts about 3 years, with the current cycle having begun in July-21 (see below exhibit). While markets have remained resilient, the outperformance cycle can possibly be on its last legs and heavyweights can outperform going ahead.

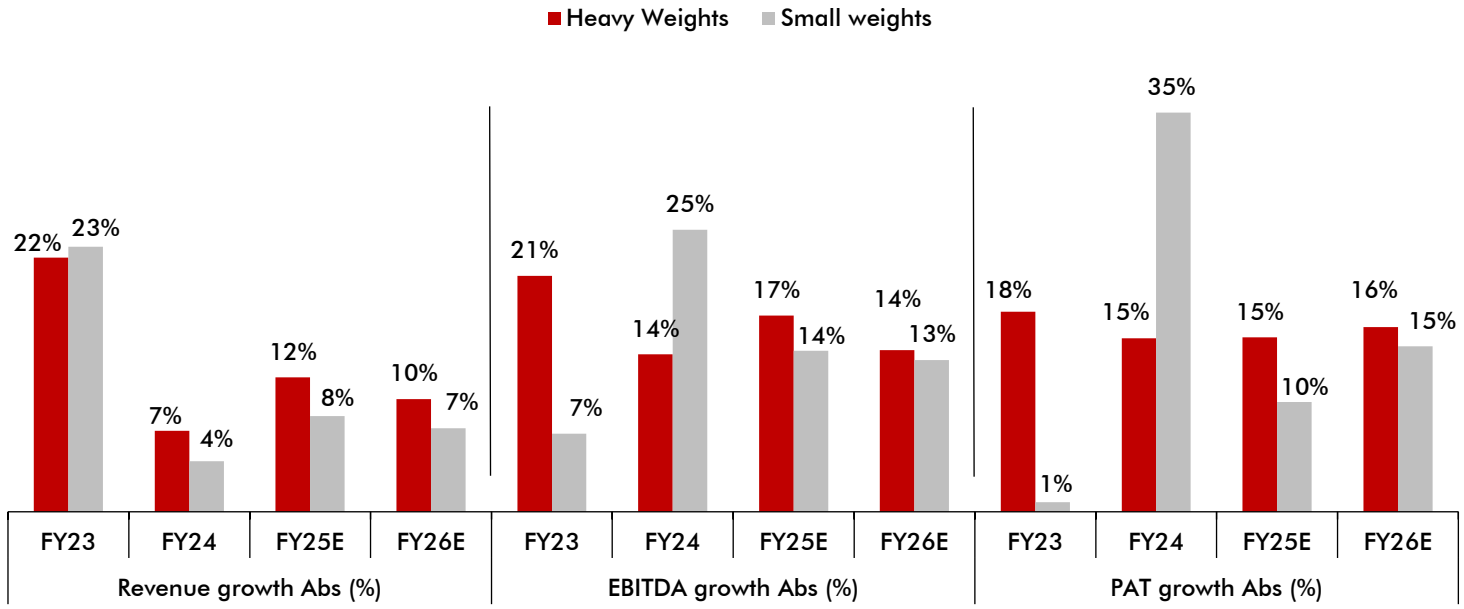
Exhibit 112: The outperformance of Nifty EW index over Nifty typically lasts about 3 years



Source: Bloomberg, Ambit Capital research. Note: Latest data as on 06th September'24.

Further, heavyweights are expected to lead smaller companies in the index in FY25/26 over top-line and bottom-line. With forward earnings estimates growth tilted in favour of heavyweights, we expect the outperformance of Nifty over the EW index to manifest.

Exhibit 113: FY25 and FY26 estimates are stacked in favour of heavyweights

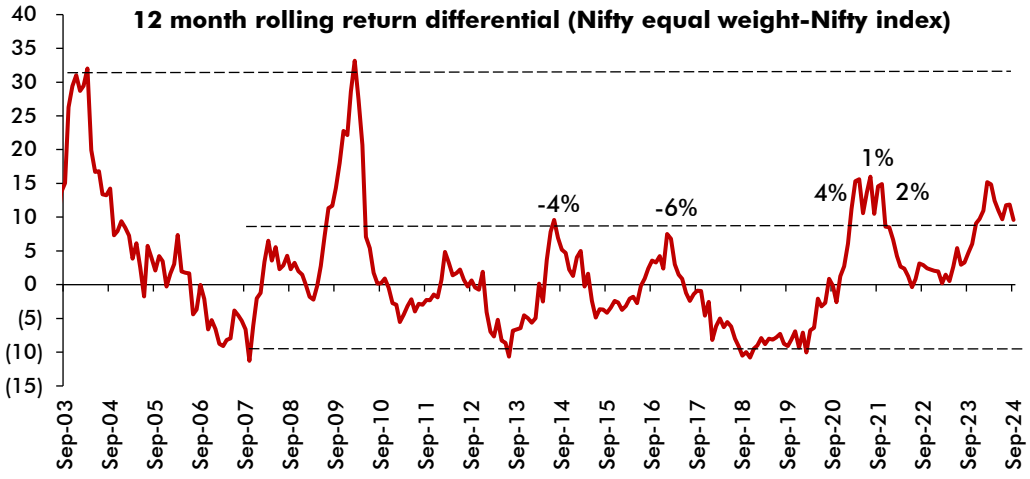


Source: Bloomberg, Ace Equity, Ambit Capital research as on 30 August'24. Note: Heavyweights are Nifty index constituents with >3% weight in the index. For BFSI companies EBITDA is operating income, revenue is net interest income for banks and NBFC and is net premium earned for insurance companies.

On the excess returns framework, the outperformance of Nifty equal-weighted index over Nifty has peaked out in the vicinity of previous peaks of ~15% and has been on a downward trajectory since then. There is a possibility of reversion with heavyweights likely to outperform the laggards.

In the last decade (2014 and 2017), after peak outperformance of Nifty EW index, Nifty outperformed the EW index over the next 12 months driven by the performance of heavyweights. On the other hand, in 2021, EW index continued to outperform Nifty by a narrow margin. Adding earnings growth and cycle length to the analysis makes it more credible.

Exhibit 114: Possibility of reversal: Excess returns of Nifty EW index is close to peak



Source: Bloomberg, Ambit Capital research Note: Numbers marked on peak are 12m forward return differential between Nifty equal weight – Nifty index Note: Latest data as on 06 Sept'24

We define "Excess Returns" of the sector as the 12-month rolling return differential of a sector w.r.t the market. The excess returns of any sector w.r.t the index can be a lead indicator for predicting future returns of sector.

"Extreme outperformance can breed reversion to mean and so can extreme underperformance"

The idea behind tracking these excess returns is that there is an anchoring bias at play and investors look at how much the sector has outperformed/ underperformed Nifty over the last 1 year. For details, please check sectoral attractiveness framework

5. SMIDs underperformance over next 12 months

We have been sellers on small and mid-caps. In our recent thematic G&C 19.1: Searching for Value dated 27th May'24, we reiterated our preference for large-caps over SMID noticing greed, frothy valuations akin to 2017-18, and better earnings estimate sustenance in large-caps.

Even from a price action perspective, this trade looks promising. We are noticing a negative divergence in relative ratio charts of Nifty Small-cap 250 to Nifty 100. The last time it happened at CY21-end, small-caps underperformed. The fundamentals are also changing in favour of large-caps.

Exhibit 115: Small-caps likely to underperform or go sideways over the next 1 year

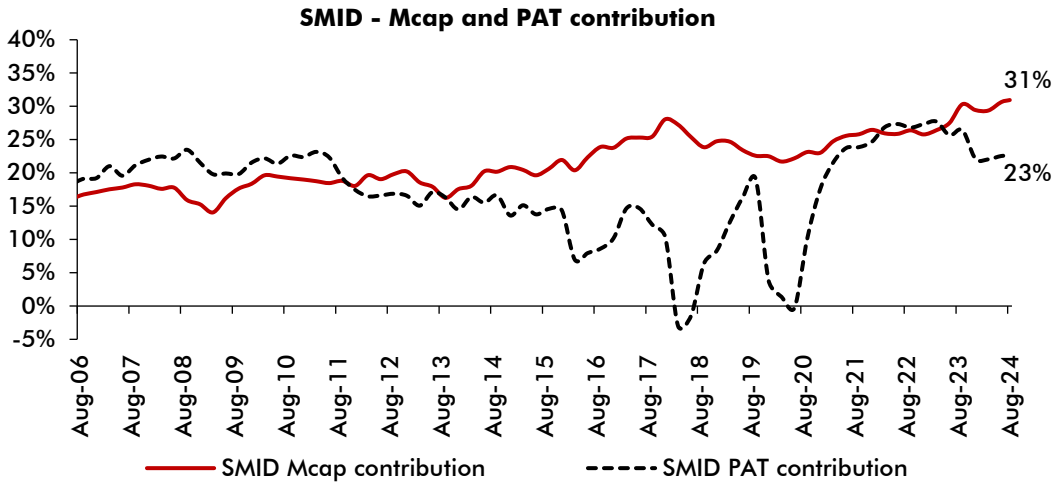
Source: Bloomberg, Ambit Capital research

Divergence between mcap contribution and PAT contribution is expanding

The mcap of SMID universe as a % of total mcap within NSE500 universe is at 31% (ATH). Historically, this has been a strong reversal signal. Is the rally driven by corresponding ATH PAT contribution? The answer is no.

PAT contribution of SMID universe peaked out in March-23 at 28% and currently stands at 23%. EPS estimates trajectory appears better in large-caps vs SMIDs. As the market always looks ahead, divergence appears unsustainable. It is worth highlighting that since Jan-24, the performance differential has begun to narrow with Nifty 100 (19%) catching up with Nifty Small-cap 250 Index (21%) and Nifty mid-cap 150 (23%).

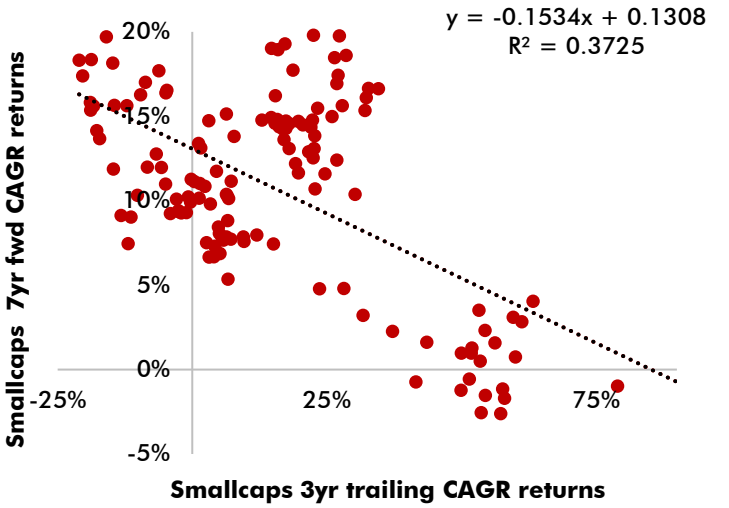
Exhibit 116: SMID "mcap contribution" and "PAT contribution" divergence is expanding



Source: Ace Equity, Ambit Capital research Note: Universe is NSE500 Index

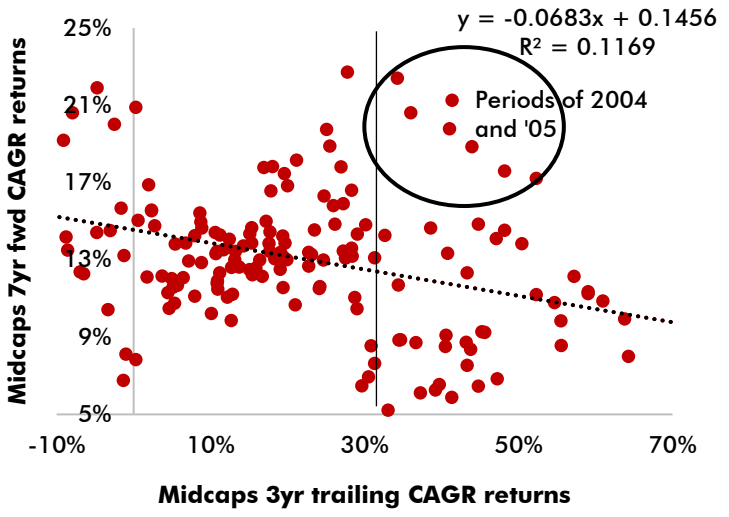
Additionally, our "Base returns" analysis establishes that a 2-sigma move over last 3 years weighs on forward returns (next 7 years), with small-caps appearing most vulnerable. We proxy base returns by earnings growth of equity cohorts over longer periods of time.

Exhibit 117: Small-caps: strong returns over the last 3 years (>26%) weighed on fwd. returns (<10% CAGR) over the next 7 years...



Source: Bloomberg, Ambit Capital research

Exhibit 118: ...while for mid-caps, the relation is mixed



Source: Bloomberg, Ambit Capital research

Size preference: large-caps over SMID

As highlighted in "G&C 19.1: Searching for Value", we prefer large-caps over SMID. Our rationale is as follows –

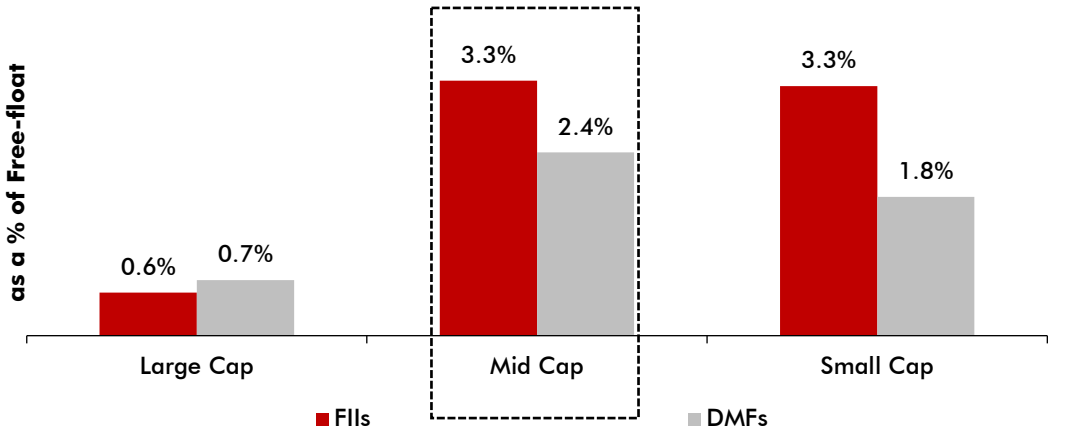
- **Valuation:** SMID valuation measured by trailing EYBY differential is close to the worst levels since 2005. The last time it happened in 2017, SMID underperformed large-caps significantly over the next 12 months.
- **Free-float Mcap contribution:** SMID universe FFMcap contribution is at an ATH of 35%. In previous instances of peak contributions in 2007 and 2017, both indices corrected at a double-digit rate over the next 12 months.
- **Earnings growth:** PAT growth distribution for SMIDs is nothing extraordinary to warrant such frothy valuations. With heavyweight sectors in SMID witnessing earnings downgrades, EPS estimates are more sustainable in large-caps.
- **Greed & Fear indicator:** Market sentiment measured by Nifty100 Value participation still signals extreme greed, 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 exhibits on these data p please refer appendix

We also highlight this call has not worked over the last 1 year. What is the reasoning? A mismatch in supply/demand? A popular narrative is scarcity premium, driven by high DMF flows into SMIDs. It is not just DMF flows. Availability factor defined as free float/AUM contracted the least in CY23 for midcaps from a DMF perspective. Counterintuitive, isn't it? FII ownership of large-caps is at a decadal low. Our analysis suggests 67% of FII inflows in CY-23 were in SMID, exceeding DMF flows. We have covered this in detail, in our previous thematic G&C 18.4: The Wind is changing.

While FII flows have slowed down in CY24 (US$ 6.2Bn), DMF flows continue to be robust (US$ 29.8bn). A bulk of the inflows (58%) has been in small-cap, mid-cap and thematic funds and that has continued the small and mid-cap rally.

Exhibit 119: In CY23, FII flows were higher than DMFs in SMID



Source: Ace Equity, Bloomberg, Ambit Capital research

Reviewing our G&C 19.1 portfolio

So, is all done and dusted? In our opinion, India remains a long-term structural buy but valuations have run ahead of fundamentals fuelled by domestic flows. The continued contraction of the Availability Factor will remain supportive of the market over the medium term, but valuations have become excessive which has prompted insiders to turn sellers. In such an environment, stock selection is key and our portfolio has outperformed the benchmark by ~6.1% since May-24 and ~5% outperformance in the last one year. Our portfolio is concentrated towards large-caps allocation (70%), Mid/small-cap allocation is 23%/7% and cash allocation is 3.3%. Becoming stock-specific, we prefer Banks over IT. Key OWs: FMCG, Healthcare, and Financials. Key UWs: Capital Goods.

What's in: SBIN, GCPL, BHARTIHE, OINL, ERIS, KBL & CENT.

What's out: SHFL, TTMT, INFOE, EMBASSY, KVB, AFFLE & TRIV.

Availability Factor of Indian Equities is contracting

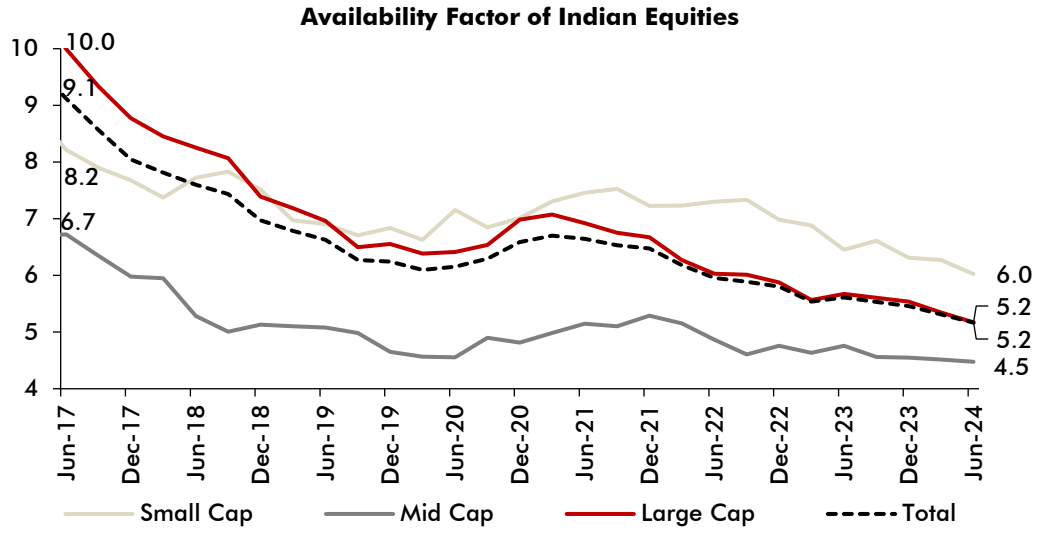
$$\text{Availability Factor} = \frac{\text{Free Float}}{\text{AUM of domestic Mutual Funds}}$$

Over 2017-24, we witnessed a shift in demand and supply curves as highlighted in our note "The Availability Factor – Demand and Supply at work". The demand curve has shifted upwards for domestic mutual funds with AUM increasing rapidly. The supply measured by the free float has also shifted upwards, but not at the same pace as demand. This has shifted the equilibrium point upward, which has manifested in a higher market multiple.

"AF" has reduced significantly over the last 7 years as ownership value (29% CAGR) outpaced supply (19% CAGR).

- AF has shrunk the most for large-caps (48%), where the growth differential between DMF ownership value and free float over June17-24 is the highest, followed by mid-caps (33%) and small-caps (27%).
- In large-caps, 7 years ago, 1 rupee of DMF AUM used to chase 10 rupees of free-float, but now this has come down to 5.2.

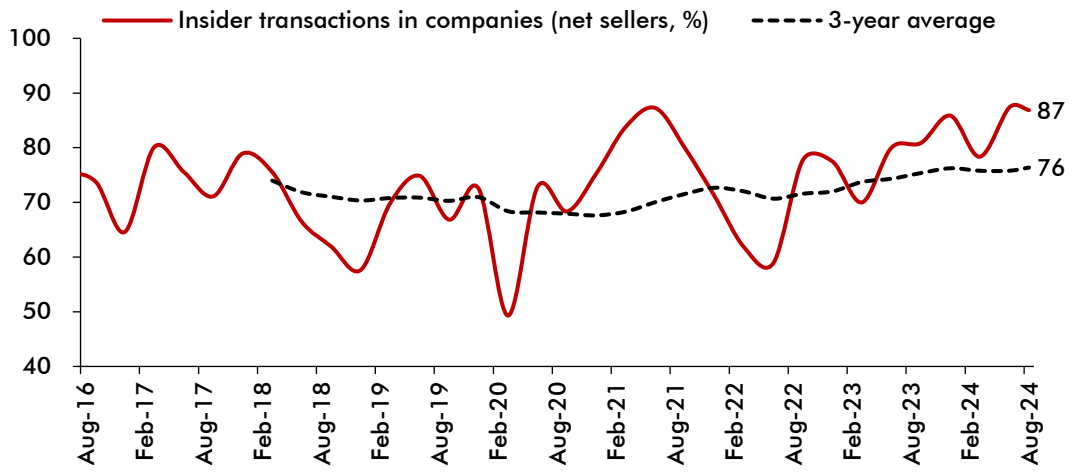
Exhibit 120: Availability Factor of Indian equities is contracting



Source: Bloomberg, Ambit Capital research. Note: Analysis includes Top 500 companies by market capitalization every quarter. This Availability Factor analysis is based on stock-level classification by AMFI

These exorbitant valuations have led to acceleration in insider transactions, which is at its highest level since June-15.

Exhibit 121: Percentage of insiders selling their stake is at ATH



Source: BSE, Ambit Capital research. Note: Universe is NSE500 index; No of Activity indicates number of companies with insider transactions in respective quarter; Latest data as of 31st Aug'24. Note:

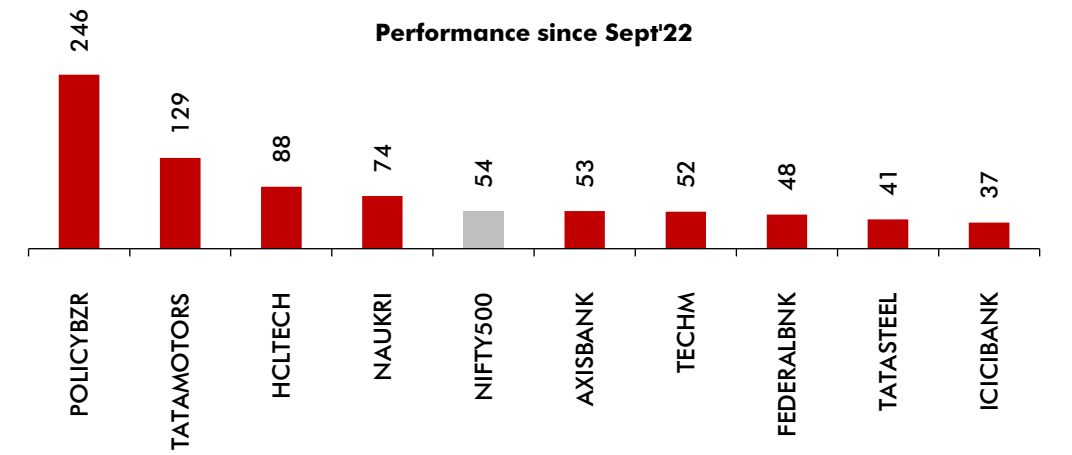
How is our portfolio's performance?

Our G&C 19.1 portfolio outperformed the benchmark by ~6.1% since our last iteration (27th May-24), 5% over last 1 year and our overall outperformance since inception is ~7% w.r.t the benchmark.

Performance of stocks held for the longest duration

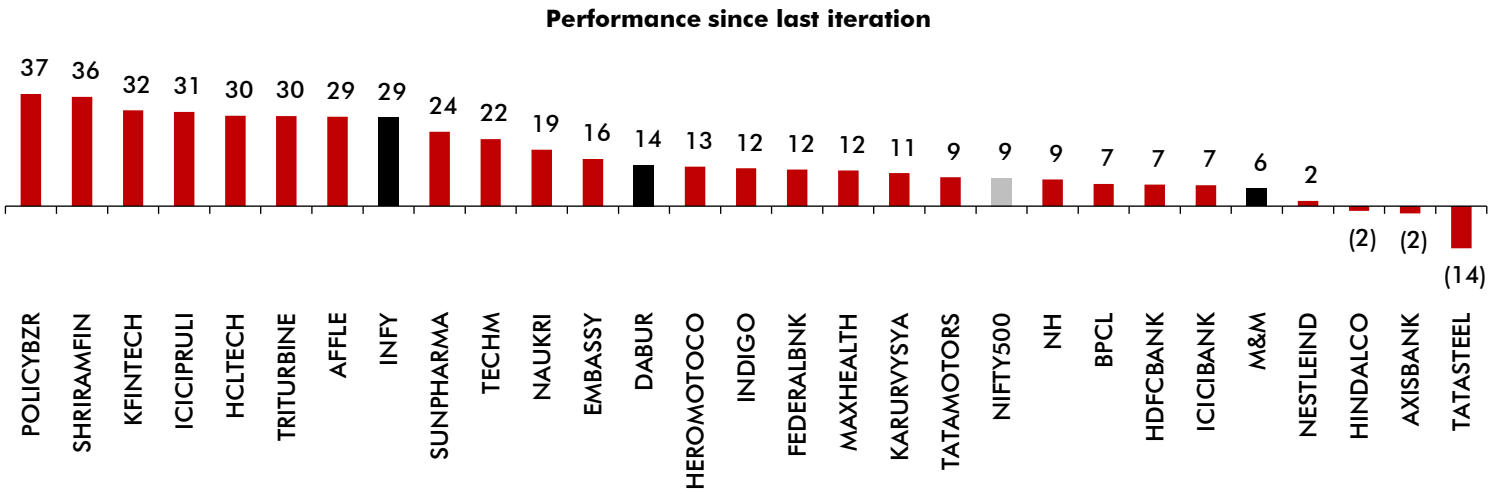
While 4/9 of the stocks in the portfolio since G&C portfolio's inception outperformed the index, the extent of outperformance is significantly higher than the extent of underperformance. Within two years since inception, PB Fintech and TATA Motors more than doubled while the biggest laggards were ICICI Bank and Tata Steel.

Exhibit 122: 4/9 stocks generated an alpha of >10% vs NSE500 since Sept'22



Source: Ace Equity, Ambit Capital research. Note: Performance of portfolio since inception.

Exhibit 123: 17/28 stocks outperformed the benchmark since May'24



Source: Ace Equity, Ambit Capital research. Note: Stocks marked in black are additions to the portfolio in the last iteration

Exhibit 124: Performance of our G&C 19.1 portfolio since 27th May 2024

Company Name	Equity Cohort	Sector	Absolute Price Performance	Contribution to G&C 19.1 performance
PB Fintech	Mid Cap	New-age tech	37%	2.8%
ICICI Prudential Life Insurance	Large Cap	Financials	31%	1.7%
Shriram Finance	Large Cap	Financials	36%	1.7%
Infosys Ltd	Large Cap	IT	29%	1.1%
HCL Technologies	Large Cap	IT	30%	1.0%
Info Edge India	Mid Cap	Media	19%	0.9%
InterGlobe Aviation	Large Cap	Miscellaneous	12%	0.8%
Sun Pharmaceutical	Large Cap	Healthcare	24%	0.8%
Tata Motors	Large Cap	Auto & Auto Anc.	9%	0.6%
Bharat Petroleum Corp	Large Cap	Oil & Gas	7%	0.5%
Dabur India Ltd	Large Cap	FMCG	14%	0.5%
Kfin Technologies	Small Cap	Financials	32%	0.5%
Hero MotoCorp	Mid Cap	Auto & Auto Anc.	13%	0.4%
Triveni Turbine	Small Cap	Capital Goods	30%	0.4%
Affle India	Small Cap	Media	29%	0.4%
Tech Mahindra	Large Cap	IT	22%	0.4%
Max Healthcare Institute	Mid Cap	Healthcare	12%	0.3%
ICICI Bank	Large Cap	Financials	7%	0.3%
Federal Bank	Mid Cap	Financials	12%	0.3%
Mahindra & Mahindra Ltd	Large Cap	Auto & Auto Anc.	6%	0.2%
HDFC Bank	Large Cap	Financials	7%	0.2%
Karur Vysya Bank	Small Cap	Banks	11%	0.1%
Embassy Office Parks REIT	Mid Cap	Miscellaneous	16%	0.1%
Narayana Hrudayalaya	Mid Cap	Healthcare	9%	0.1%
Nestle India	Large Cap	FMCG	2%	0.0%
Hindalco Industries	Large Cap	Metals & Mining	-2%	-0.1%
Axis Bank	Large Cap	Financials	-2%	-0.1%
Tata Steel	Large Cap	Metals & Mining	-14%	-0.5%
G&C 19.1 performance				**15.6%**
G&C 19.1 returns (incl. cash)				**15.4%**
Alpha v/s NSE500				**6.1%**

Source: Ace Equity, Ambit Capital research

What goes out and what comes in?

What goes out? We exclude seven stocks, Shriram Finance, Tata Motors, Info Edge, Embassy REIT, Karur Vyasa Bank, Affle and Triveni Turbine, from the G&C 19.1 portfolio.

What comes in? There are **seven additions** to our portfolio – SBI, Godrej Consumer Products, Bharti Hexacom, Oil India, Eris Lifesciences, Karnataka Bank and Century Textiles. These along with 21 existing stocks from G&C 19.1 comprise our latest G&C 19.2 portfolio.

Size allocation: Concentrated towards large-caps (70%). Mid-cap/small-cap allocations stand at 23%/7%. Cash allocation stands at 3.3%.

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

Exhibit 125: Dissection of our G&C Portfolio – OW/UW w.r.t Nifty500

Sector	UW/OW	Portfolio Companies
Overweight		
FMCG	4.5	Nestle India, GCPL, Dabur India
New-age tech	4.5	PB Fintech
Healthcare	3.3	Sun Pharma, Max Healthcare, Narayana Hrudayalaya, Eris Lifesciences
Financials	3.1	HDFC Bank, ICICI Bank, SBI, Axis Bank, ICICI Pru Life, Federal Bank, Karnataka Bank
Metals & Mining	2.7	Tata Steel, Hindalco Industries
IT	0.6	Infosys, HCL Technologies, Tech Mahindra
Underweight		
Oil & Gas	-0.2	BPCL, Oil India
Auto & Auto Anc.	-0.4	Mahindra & Mahindra, Hero MotoCorp
Miscellaneous	N/A	InterGlobe Aviation, KFIN Technologies, Century Textiles, Bharti Hexacom

Source: Ace Equity, Ambit Capital research. Note: IT OW has been driven by stocks outperformance w.r.t market

Why we have included these stocks in the portfolio?

State Bank of India

Banks is our key OW as highlighted in the trades section. Given deep distribution and trust, SBI continues to have lowest cost of funds in the system despite 20%+ market share. Loan book diversification with increased presence in retail has reduced concentration risk and renders better margin/fee opportunities along with 40% MCLR share (vs 20% for private banks). Additional liquidity should sustain loan growth ahead of deposit growth in a deposit-constrained environment. Restricting to government/top corporate employees for retail loans positions the bank better in less impactful retail NPL cycle vs private peers, and should drive superior 16% ROE. Optionality of corporate capex could further lift financials.

Godrej Consumer Products

Godrej Consumer Products Ltd (GCPL), since appointment of Sudhir Sitapati as MD & CEO, has plugged missing pieces of category development (e.g. fabric care, HI), innovation (HI molecule) and also recalibrated GTM strategy (Project Vistaar 2.0). On the back of these, GCPL has delivered industry leading volume growth. With the recent launch of a new molecule in HI (RNF) and aggressively priced launches in fabric care, we expect GCPL's growth dominance to sustain. Further, sale of low-margin (high working capital) East Africa business and focus on domestic operations assuage any capital allocation threats, an issue in the past and with earlier management.

Bharti Hexacom

With 97%/98% FY24 revenue/EBITDA from mobility, Bharti Hexacom (Hexacom) is levered to the mobile business akin to VI. It offers pure-play telco exposure with lower risks. Akin to Airtel, Hexacom would sustain growth leadership with 19% FY24-27E revenue CAGR. Operating leverage driven by tariff-led revenue growth drives our assumption of 525bps FY24-27E EBITDA margin expansion. Coupled with falling capex, we expect 7% FCF yield in FY27E from FY24's 2%. Hexacom offers a rare combination of cash flow yield and growth that will be distributed as

dividends. Premium valuations are for high predictability and gearing to a Jio IPO and tariff correction for VI's survival.

Oil India

OIL's operations were better than most U.S. shale companies since FY21, reflecting success of its exploration and Enhanced Oil Recovery (EOR) efforts. Continued production growth success and our expectation of global supply discipline enabling higher oil & gas realisation drives 14% standalone OCF CAGR and 15% pre-tax RoCE vs 9% in FY18-24. Utilization of midstream assets should remain ~90% as they largely support internal operations, with upside for downstream business too given higher refining margins and expansion of Numaligarh Refinery's (NRL) capacity by 200% to 9MMTpa by Dec-25.

Eris Lifesciences

Eris is predominantly a play on India formulations (92% of revenues), with 90%+ exposure to higher-growth chronic therapies. Multiple bolt-on acquisitions and new launches over the last few years have helped Eris address product concentration in its portfolio and diversify into higher-growth therapies such as dermatology, nephrology and oncology. This should boost organic growth in branded formulations to 13-15% vs 8-10% over FY18-22 and narrow the 15% discount to median FY26E EV/EBITDA for India-dominant companies.

Karnataka Bank

After strengthening its board and top management, the bank is on a modernization drive, adding multiple sourcing channels/products, centralized underwriting, separate collection verticals and fee income/liability initiatives. Strength of liability franchise and structural changes should drive loan growth of 17% in FY24-27E with 12% avg. ROE. Initiatives on loan sourcing/monitoring/collections and 91% secured loan book would drive credit cost decline from 1.6% in FY21-24 to 85bps in FY25-27. KBL deposit franchise and underwriting in core geographies is superior to new-age banks and SFBs.

Century Textiles

Century Textiles houses the real estate arm (Birla Estates) of the US$88bn Aditya Birla Group. Focus on '3S' – safety, sustainability and style – will help it stand out in the overcrowded premium/luxury real estate market. Despite ~9x growth in pre-sales FY20-24, GDV pipeline of ₹450bn with project addition of ₹200bn p.a. implies high growth in RE will continue next 3-5 years; execution remains key. Traditional cash cow (pulp/paper business) will continue supporting RE growth whilst textiles remains a laggard. Architecture of management team (RE senior team including CEO is ex-GPL), access to prime land parcels in MMR and sector tailwinds (mid/luxury) make Century a structural RE compounding play.

Exhibit 126: G&C 19.2: Composition and valuations

Company	Sector	Mcap	MDV-3m	Accounting Decile	Greatness Score	Ambit stance	P/E (x)		P/B (x)		ROCE/ ROA*
		($mn)	($mn)				FY25E	FY26E	FY25E	FY26E	FY24**
Mahindra & Mahindra	Auto	39,964	86	D8	50%	BUY	29.0	25.1	5.3	4.6	25.8
Hero MotoCorp	Auto	13,682	43	D2	17%	SELL	25.8	23.3	5.8	5.2	30.6
InterGlobe Aviation	Aviation	22,009	57	D1	42%	NR	22.2	22.7	19.0	10.6	24.1
HDFC Bank	Financials	148,641	374	N/A	N/A	BUY	16.5	14.0	1.7	1.9	2.0
ICICI Bank	Financials	101,364	199	N/A	N/A	BUY	15.2	13.9	1.9	2.3	2.4
State Bank of India	Financials	83,182	149	N/A	N/A	BUY	10.8	9.6	1.3	1.5	1.0
Axis Bank	Financials	42,680	120	N/A	N/A	BUY	12.8	10.8	1.4	1.6	1.8
ICICI Prudential Life Insurance	Financials	12,911	13	N/A	N/A	BUY	42.4	36.3	1.8	2.0	N/A
Federal Bank	Financials	5,353	25	N/A	N/A	BUY	10.7	9.0	1.0	1.1	1.3
Kfin Technologies	Financials	2,020	6	N/A	N/A	BUY	54.5	46.2	N/A	N/A	N/A
Karnataka Bank	Financials	987	5	N/A	N/A	BUY	6.3	5.6	0.6	0.6	1.2
Nestle India	FMCG	28,748	24	D3	50%	SELL	70.4	62.4	57.5	46.7	144.4
Godrej Consumer Products	FMCG	17,587	16	D1	25%	BUY	63.8	50.6	10.6	9.4	(9.4)
Dabur India	FMCG	13,604	18	D2	42%	UR	54.4	47.7	10.5	9.6	17.0
Sun Pharmaceutical Industries	Healthcare	52,143	37	D8	83%	BUY	36.7	33.1	6.0	5.4	18.4
Max Healthcare	Healthcare	10,402	15	D10	83%	BUY	56.0	44.8	8.0	6.8	27.0
Narayana Hrudayalaya	Healthcare	3,276	5	D1	75%	BUY	30.2	26.9	7.6	6.2	26.8
Eris Lifesciences	Healthcare	2,348	2	D10	33%	BUY	47.0	31.5	6.8	5.8	11.8
Infosys	IT	94,060	139	D1	67%	SELL	30.9	28.7	8.4	7.8	38.7
HCL Technologies	IT	56,763	57	D3	58%	SELL	27.5	26.9	7.0	6.7	27.8
Tech Mahindra	IT	18,914	35	D6	50%	BUY	34.3	24.7	5.4	5.3	9.4
Tata Steel	Metals & Mining	22,486	79	D8	92%	BUY	25.9	10.1	1.9	1.7	7.7
Hindalco Industries	Metals & Mining	17,856	52	D5	92%	BUY	10.0	9.4	1.3	1.1	11.6
Century Textiles & Industries	Real Estate	3,204	6	D6	42%	BUY	77.1	58.0	6.2	5.6	8.6
PB Fintech	New-age tech	9,316	18	D5	33%	BUY	177.6	83.2	11.7	10.1	(4.8)
Bharat Petroleum Corp	Oil & Gas	18,198	65	D10	33%	BUY	13.1	9.6	1.8	1.6	37.5
Oil India	Oil & Gas	12,147	53	D10	83%	BUY	13.8	11.6	5.9	5.4	17.2
Bharti Hexacom	Telecom	7,142	7	N/A	N/A	BUY	51.3	32.9	11.5	9.9	12.7

*Source: Ace Equity, Bloomberg, Ambit Capital research. Note: Latest data is as of 06th September'24. *considered ROA for Banks. **considered FY24 ROCE/ROA for companies that have reported results, for others considered FY23 ROCE/ROA. Estimates for NR companies are consensus estimates.*

Appendix

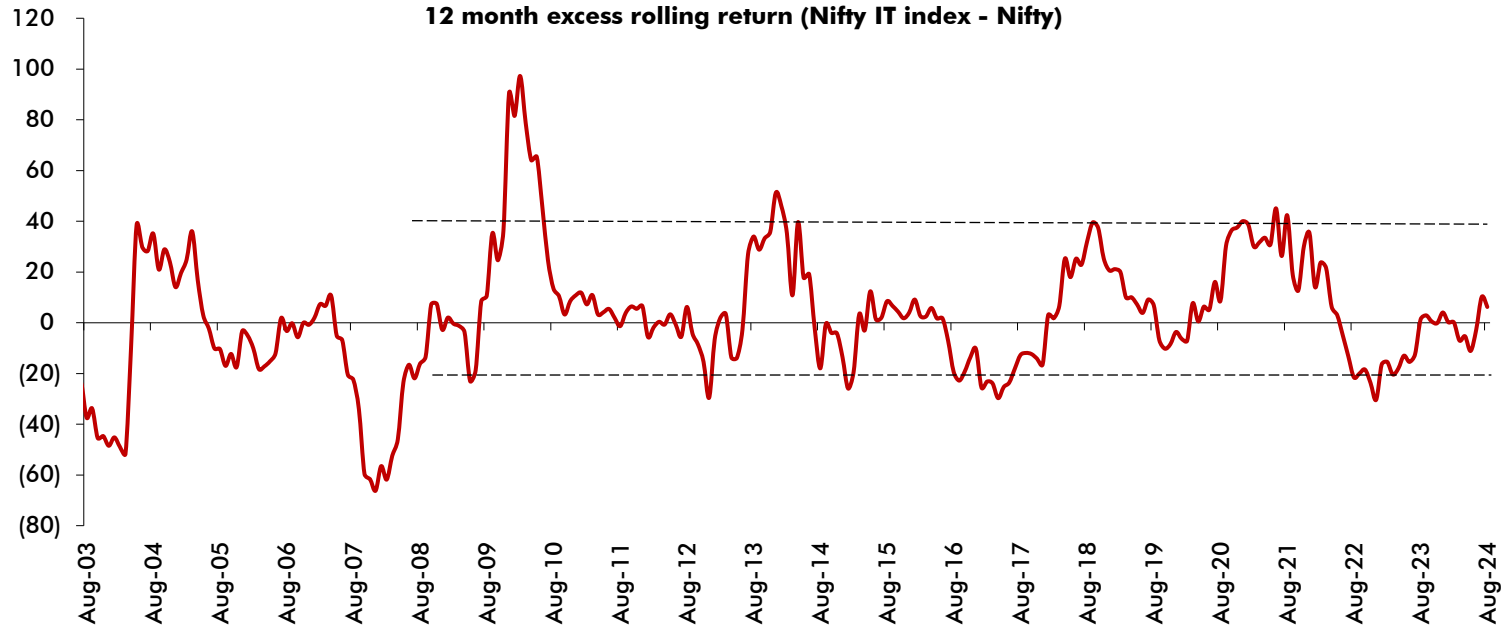
1. Sectoral Attractiveness Framework

"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), we highlighted banks' underperformance w.r.t market is close to historical troughs and historically – this in itself serves as a great signalling tool. The key is to look at sectors at the turning points. The same was highlighted for IT in Nov-22.

Exhibit 127: Excess returns of the Nifty IT index reached a bottom in Dec-22 last year and IT rebounded thereafter

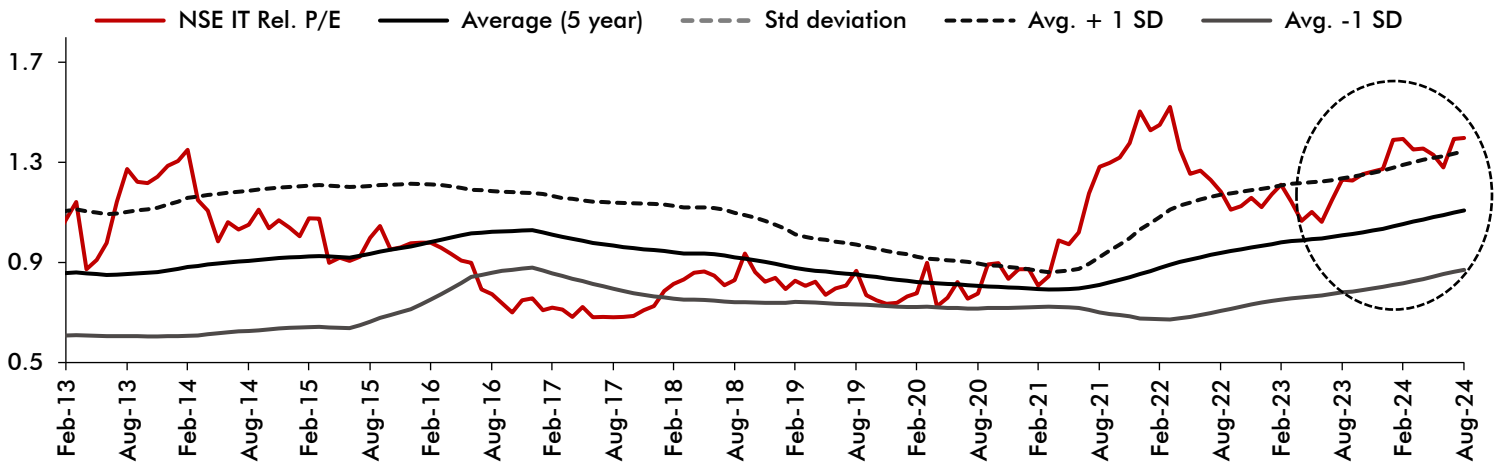


Source: Bloomberg, Ambit Capital research. Latest data as of 22 May'24

- **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 (29% CAGR since June-17) is outstripping supply of equities (19% CAGR since June-17), which has manifested in higher "trough multiples".

Exhibit 128: After the recent run, IT relative valuation Z-Score has touched +1.4



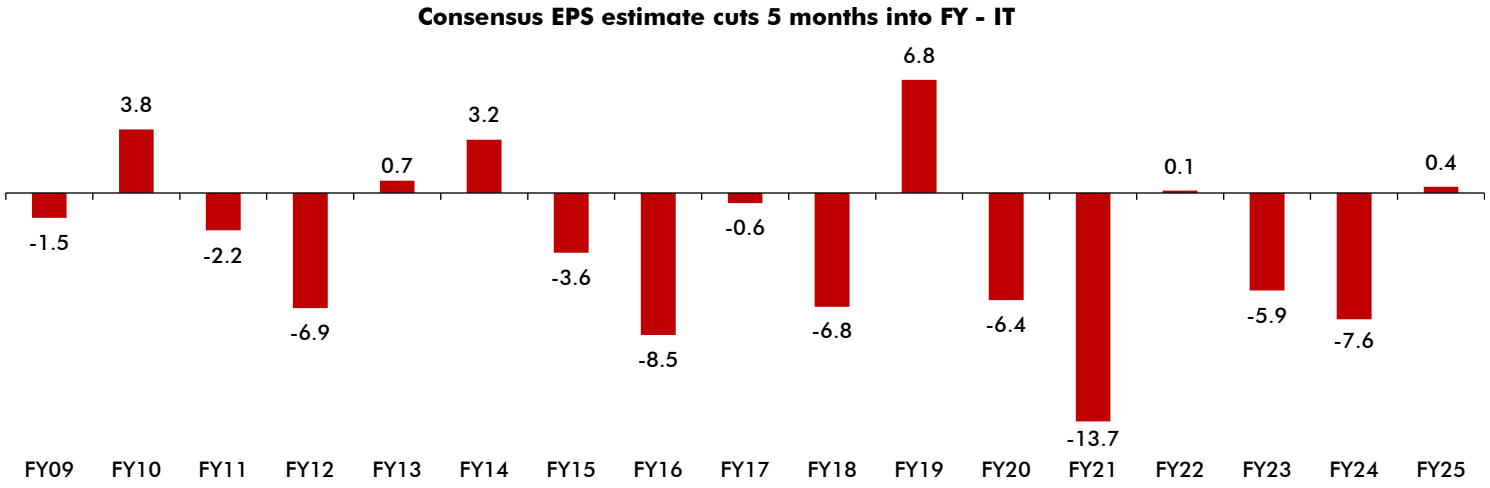
Source: Bloomberg, Ambit Capital research.

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 129: Nifty IT earnings estimate has been marginally upgraded in FY25 so far



Source: Bloomberg, Ambit Capital research. Latest data as of 30 August'24

- **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.

Sectoral attractiveness framework

Our "sectoral attractiveness" framework comprises of four parameters – 1. Excess returns, 2. Relative valuation, 3. Earnings estimate sustenance and 4. Ownership of the sector. In addition to this, we look at sector-specific intermarket relationships. Kindly refer to the appendix for further details on the framework.

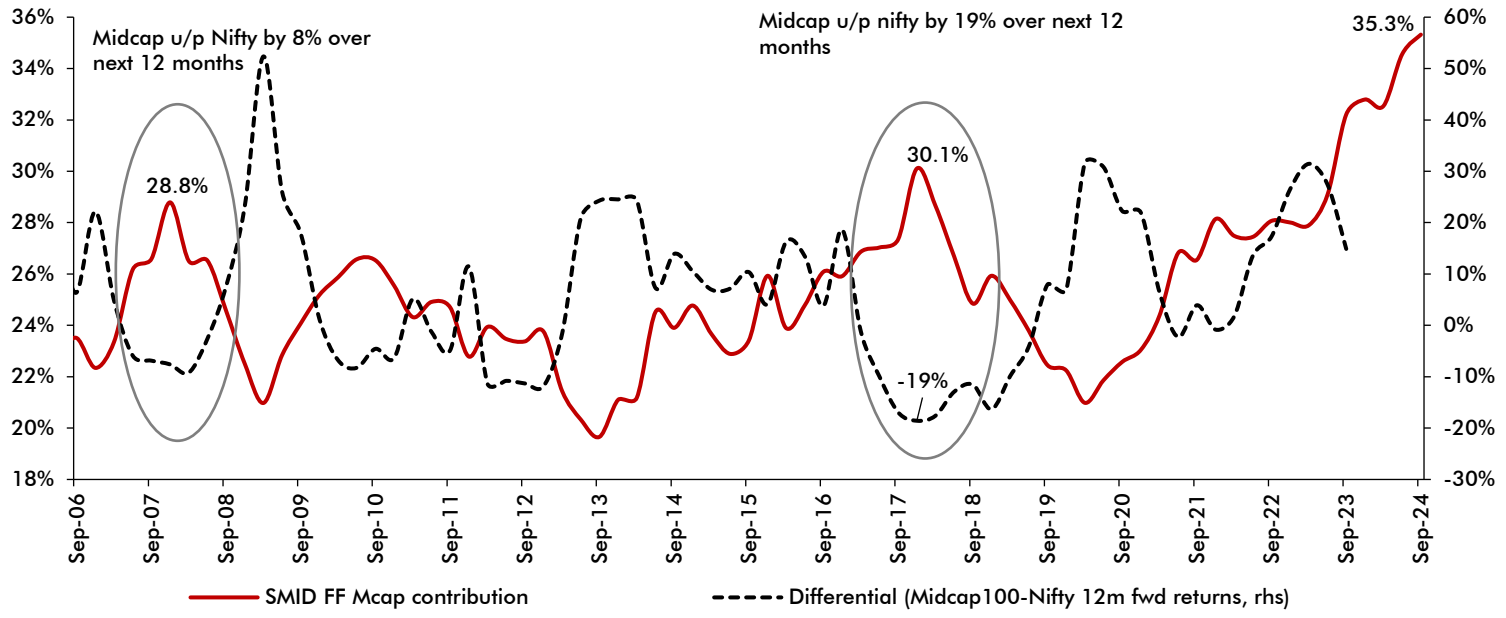
Exhibit 130: How sectors look on our framework and our stance

Sectors	Recent Excess Returns	Relative Valuation to Nifty	Earnings estimate trajectory	Ownership w.r.t NSE500 Sector weights	G&C Positioning	Comments
Auto	Very Unattractive	Unattractive	Robust	Significantly Overweight	UW**	In line with framework
Banks	Very attractive	Attractive	Robust	Neutral	OW	In line with framework
IT	Neutral	Very attractive	Robust	Neutral	Neutral	In line with framework
Pharma	Unattractive	Attractive	Robust	Significantly Overweight	OW	In line with framework
FMCG	Neutral	Unattractive	Robust	Significantly Underweight	OW	Exposure to Quality factor
Metals	Attractive	Unattractive	Robust	Significantly Underweight	OW	In line with framework
O&G	Very Unattractive	Very attractive	Robust	Significantly Underweight	UW***	Disproportionate OW in OMCs
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. *Marginal OW. **marginal UW. ***We have disproportionate OW in OMC's but don't own Reliance*

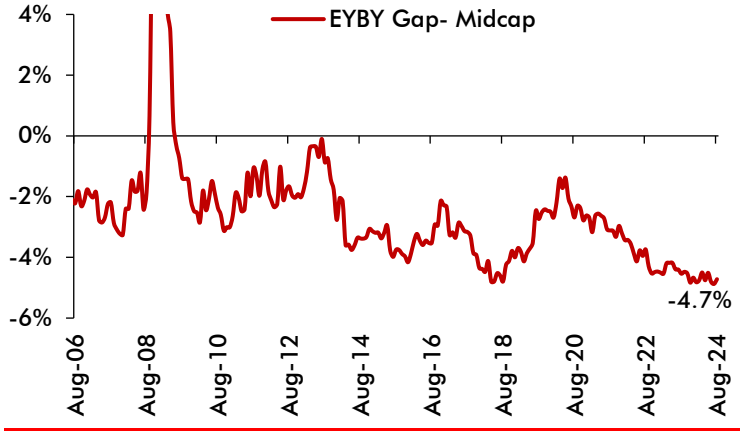
2. Why we don't like SMID

Exhibit 131: SMIDs' share in total free float market-cap is at an ATH level of 35%



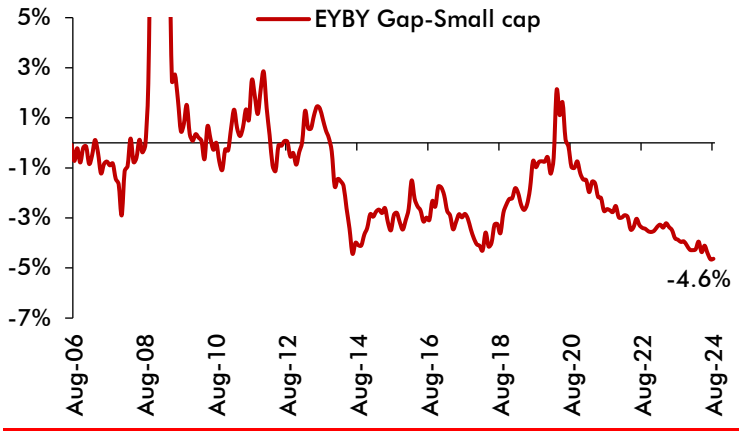
Source: Bloomberg, Ambit Capital research. Note: Above analysis is done quarterly for the entire listed universe, SMID includes companies ranked 101st onwards on market capitalization

Exhibit 132: Mid-cap EYBY gap stands at (-4.7) close to all-time worst levels. 10-year average stands at (-3.5)



Source: Ace Equity, Bloomberg, Ambit Capital research

Exhibit 133: Small-cap EYBY gap stands at (-4.6) close to all time worst levels. The 10-year average stands at (-2.7)

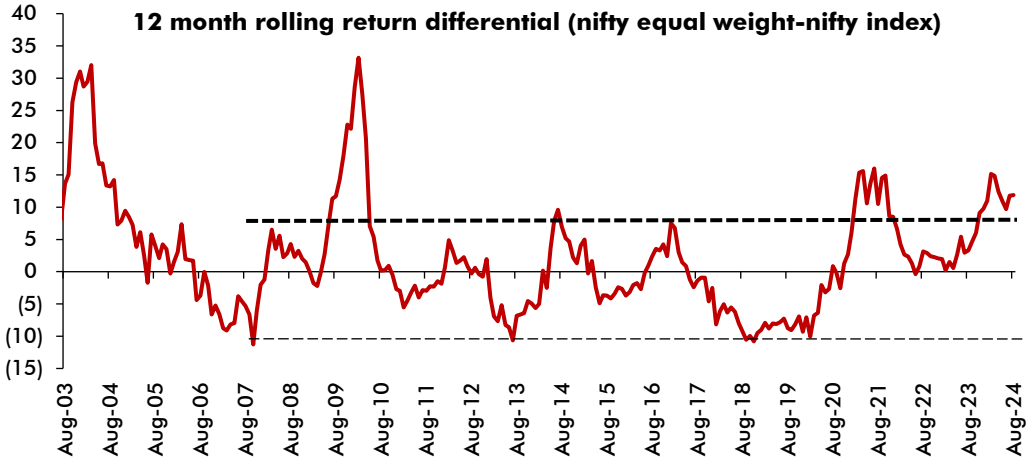


Source: Ace Equity, Bloomberg, Ambit Capital research

3. What are sectoral "Excess Returns" telling us?

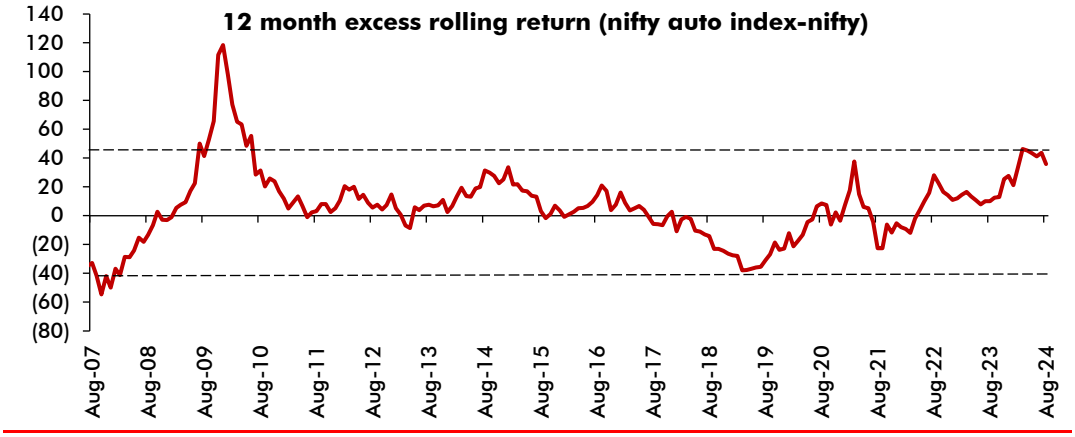
- **What is excess return?** The excess return of any sector index w.r.t market over a 12-month horizon can be a lead indicator for predicting future returns of the sector. The idea behind tracking these excess returns is that there is an anchoring bias at play and investors look at how much the sector has outperformed/underperformed Nifty over the last 1 year. "Extreme outperformance can breed reversion to mean and so can extreme underperformance".
- **Limitation**: Mean reversion will manifest but can take more time than anticipated. Additionally, excess returns have to be viewed in conjunction with relative valuation, earnings estimates sustenance and ownership of the sector. These form part of our sectoral attractiveness framework published in G&C 18.4: The wind is changing.
- **Where does it stand?** Nifty equal weight, Infra and Capital Goods excess returns are close to historical peaks while Banks also appear on excess returns. While Capital Goods and Infra have been big outperformers, mean reversion is a possibility especially after general elections when government capex usually slows down. In Nifty, heavyweights can outperform. Our recommendation as per our sectoral attractiveness framework: OW on Banks/Metals/OMCs, UW on Cap Goods. Prefer large-caps over SMIDs.

Exhibit 134: Nifty EW index



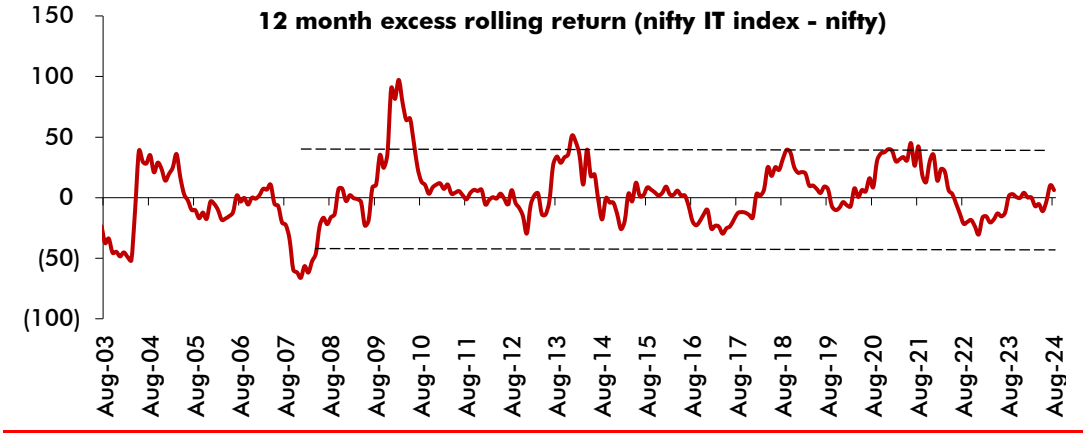
Source: Bloomberg, Ambit Capital research

Exhibit 135: Auto



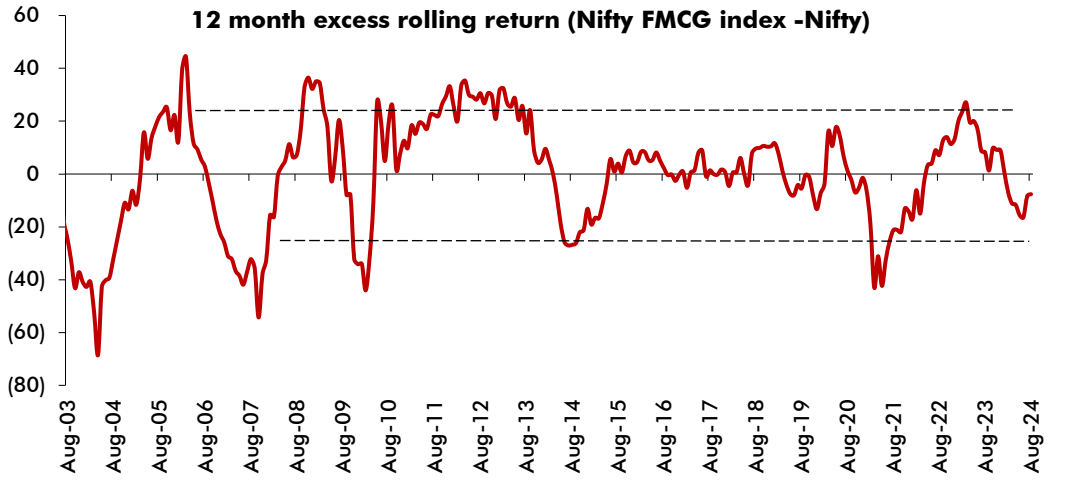
Source: Bloomberg, Ambit Capital research

Exhibit 136: IT



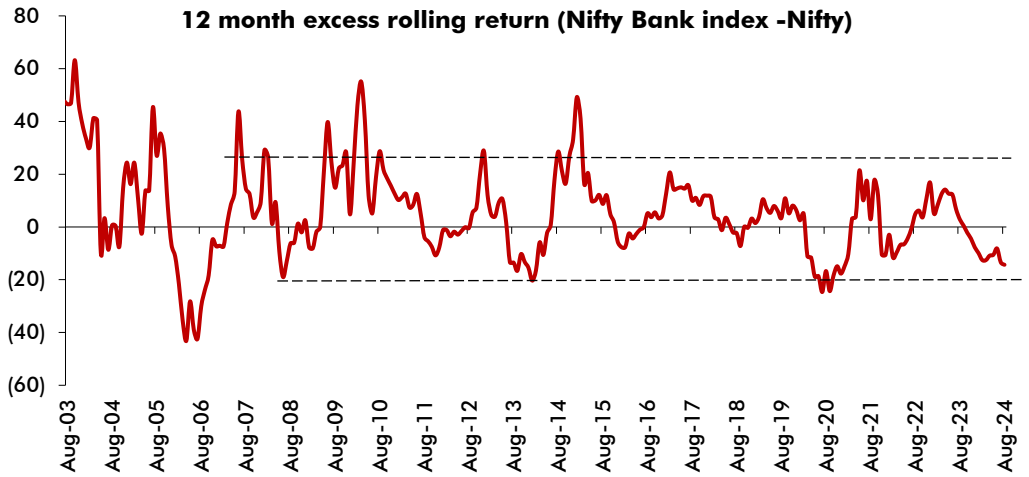
Source: Bloomberg, Ambit Capital research

Exhibit 137: FMCG



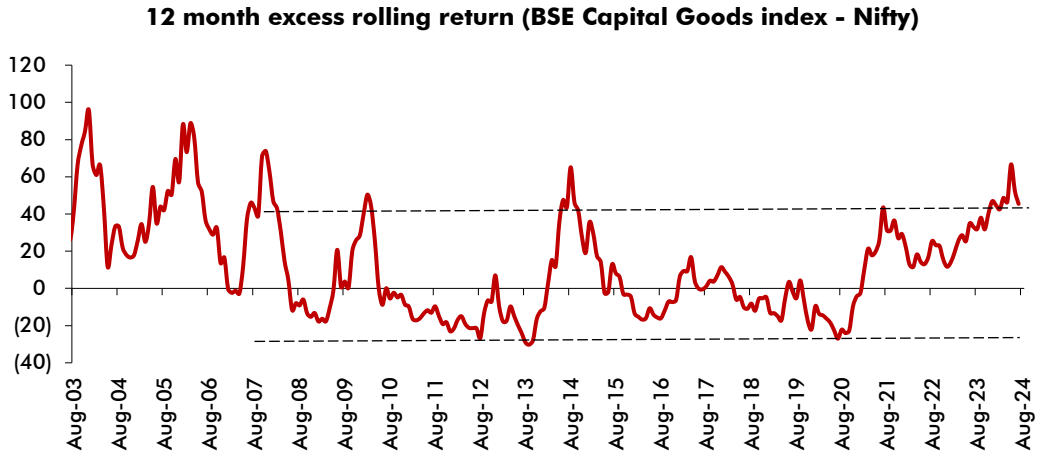
Source: Bloomberg, Ambit Capital research

Exhibit 138: Bank



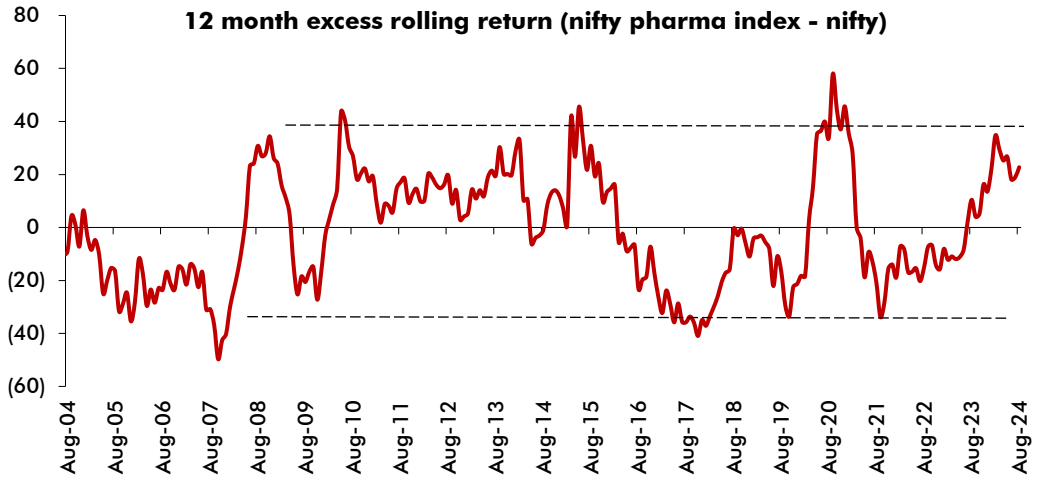
Source: Bloomberg, Ambit Capital research

Exhibit 139: Capital Goods



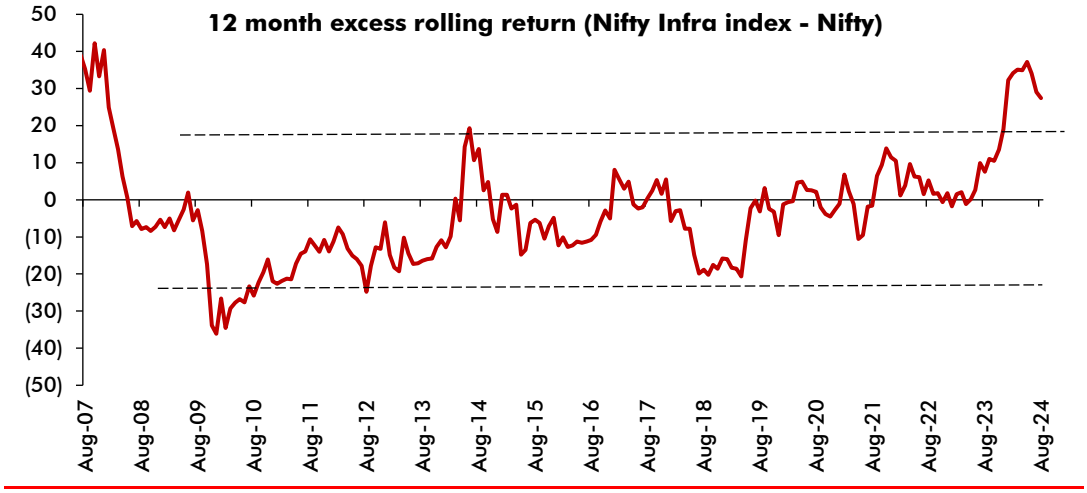
Source: Bloomberg, Ambit Capital research

Exhibit 140: Pharma



Source: Bloomberg, Ambit Capital research

Exhibit 141: Infra

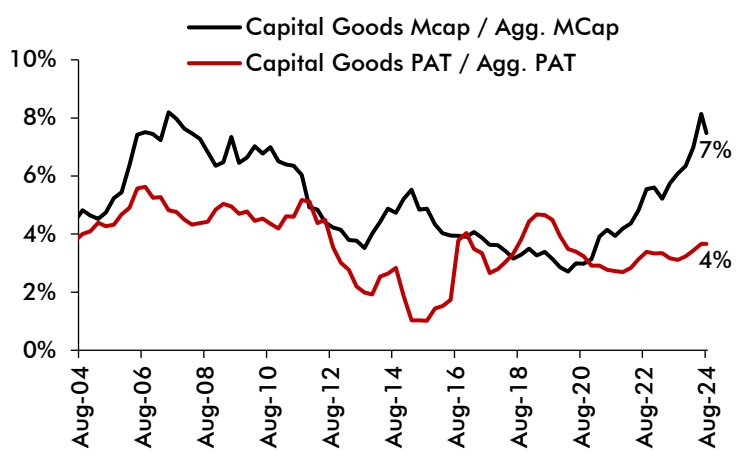


Source: Bloomberg, Ambit Capital research

4. Sectors: Contrasting Mcap and PAT contributions

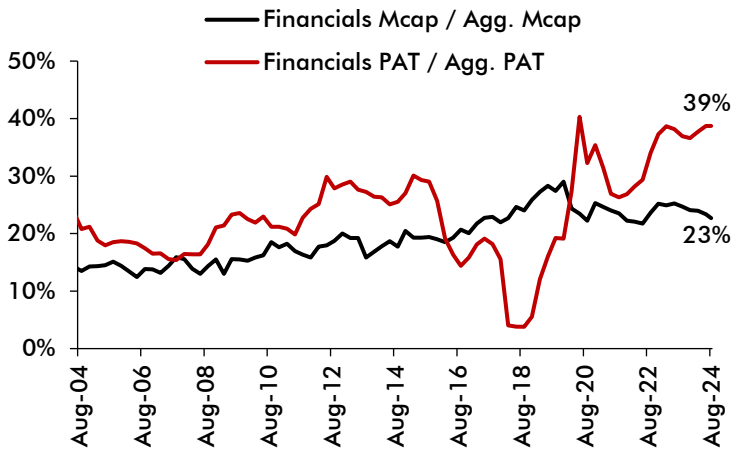
We look at sectors through the lens of PAT and market capitalization contribution towards a broader index, i.e. NSE500. While tracking Mcap contributions or sectoral weights can help screen excessive optimism/pessimism, contrasting it with PAT contribution can reveal interesting insights regarding expectation of earnings built in. For instance, in Banks, we note that PAT contribution is close to ATH whereas Mcap contribution has not risen. Are the earnings going to collapse or are banks going to outperform? We think the stage is set for the latter, as explained earlier. Likewise, for Capital Goods, PAT contribution is not that high but Mcap contribution is significantly higher. Significant earnings expectations are built in.

Exhibit 142: Capital Goods



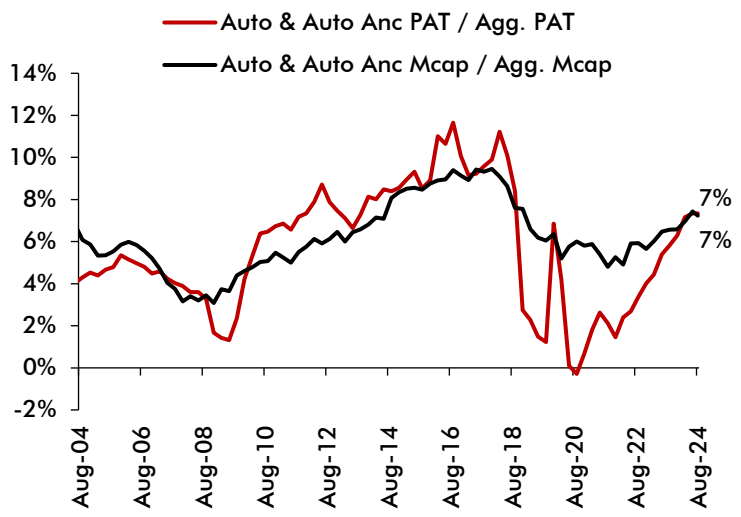
Source: Bloomberg, Ambit Capital research

Exhibit 143: Financials



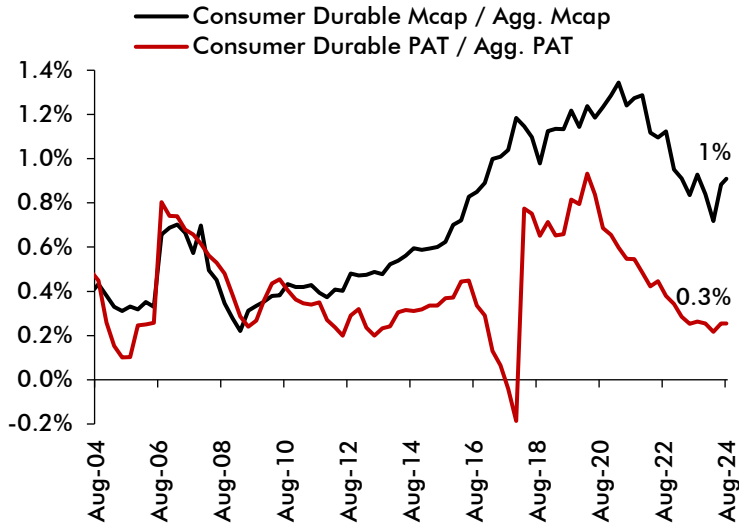
Source: Bloomberg, Ambit Capital research

Exhibit 144: Auto and Auto Anc.



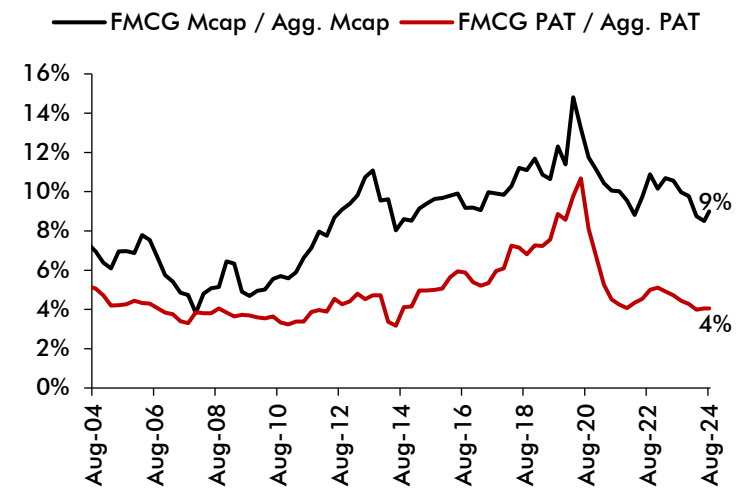
Source: Bloomberg, Ambit Capital research

Exhibit 145: Consumer Durable



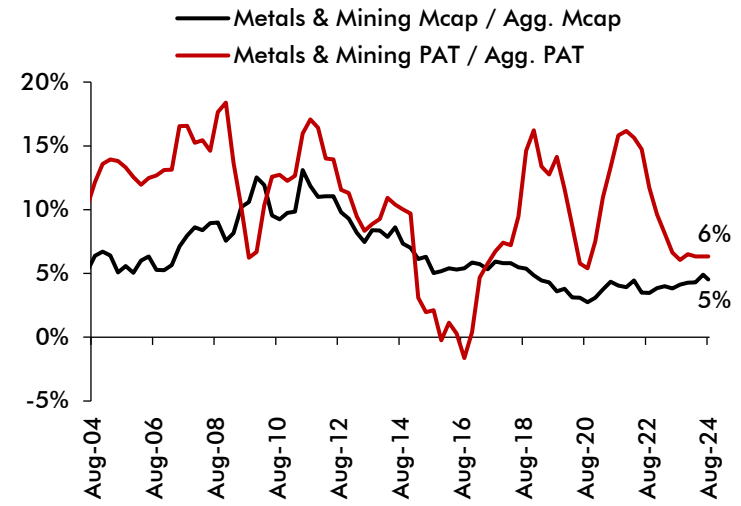
Source: Bloomberg, Ambit Capital research

Exhibit 146: FMCG



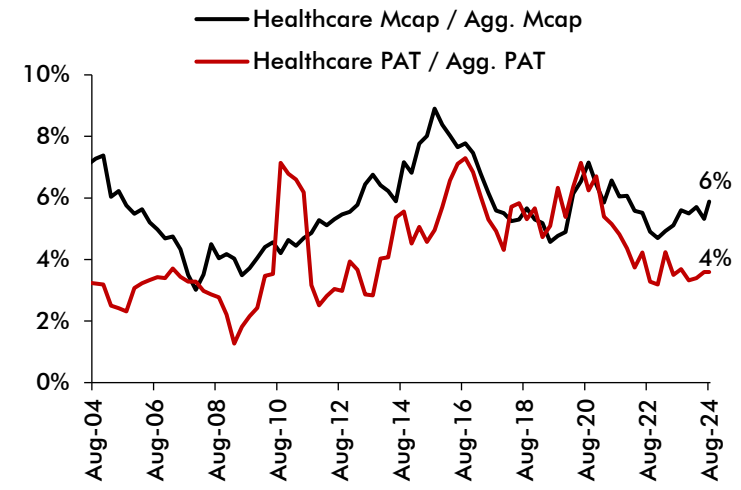
Source: Bloomberg, Ambit Capital research

Exhibit 147: Metals and Mining



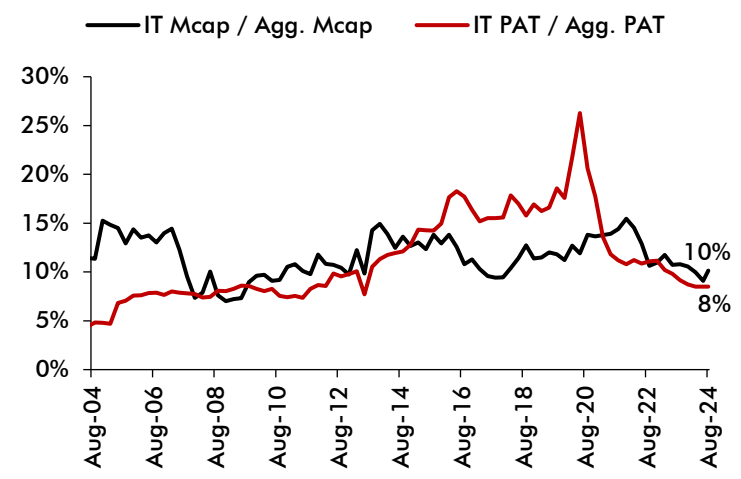
Source: Bloomberg, Ambit Capital research

Exhibit 148: Healthcare



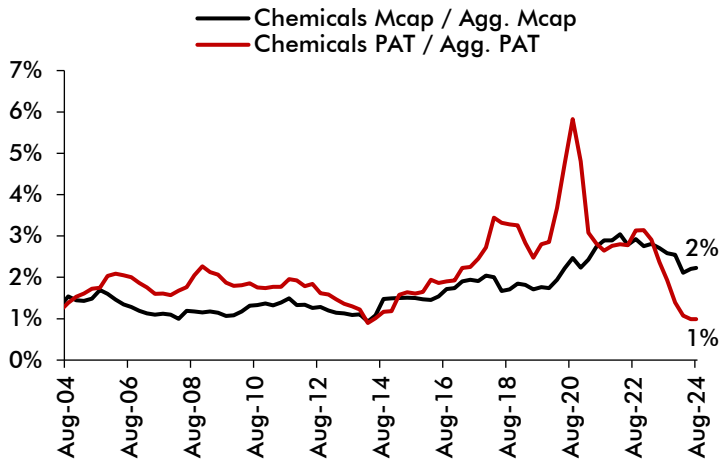
Source: Bloomberg, Ambit Capital research

Exhibit 149: IT



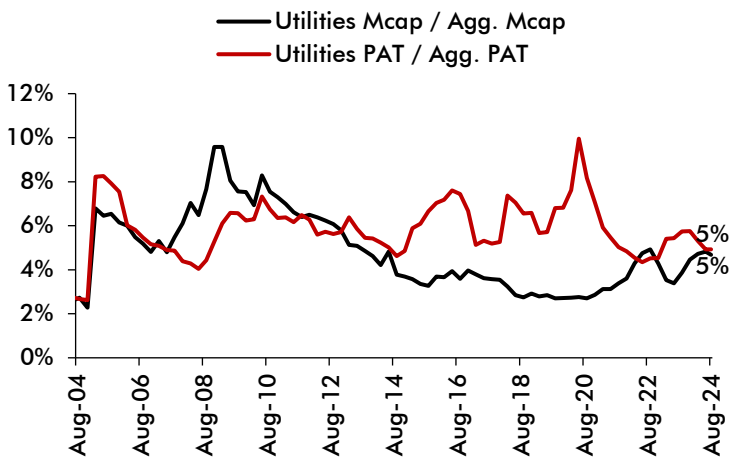
Source: Bloomberg, Ambit Capital research

Exhibit 150: Chemicals



Source: Bloomberg, Ambit Capital research

Exhibit 151: Utilities



Source: Bloomberg, Ambit Capital research

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