We Follow A Rigorous & Disciplined Approach For Investments: Ajay Bodke, Prabhudas Lilladher

In an interview with BW Businessworld, Ajay Bodke, CEO & Chief Portfolio Manager - PMS, Prabhudas Lilladher, talk about Market Capitalization, mid and small cap stocks and more

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Mid and small cap stocks have corrected heavily since the start of 2018. Do you think the worst is behind us now, or is more pain in the offing?
The performance across Mid-small cap stocks for 2-3 years prior to the correction that started in January 2018 was stunning, primarily on account of improvement in earnings and expansion of P/E Multiples. This was led by lower finance costs, better growth prospects and ample liquidity. Benign raw material (RM) prices due to soft commodities had led to margin expansion for most businesses. However, since the start of 2018 we have observed significant correction due to: 1. Rise in Crude Oil Prices, 2. Rise in interest rates and 3. Trade wars triggered due to protectionist policies. Also, SEBI mandate on Mutual Funds (MF) that they have to be true to schemes' stated objective in so far as investment in stocks across various market capitalizations in concerned led to some selling from MFs in mid/small cap companies. Auditor's resignations, Nirav Modi scam and Additional Surveillance measures (ASM) imposed by exchanges further dampened sentiments resulting in negative breadth for the broader markets.

The funnel of performing stocks has got narrower over the past 2-3 months resulting in severe erosion in most portfolios. However, as the asset class has delivered almost 18-20% CAGR for the past few years, a drawdown was due and that is what is happening currently. Needless to say, Midcap/Small-caps had risen significantly over the past 2 years without offering even a 15-20% correction which is the usual trend in equities every year barring CY2017. This had resulted in mid/small cap valuations rising to an almost 28% premium Vs large-caps. Some course correction was due which is happening currently and making markets healthy from a long-term perspective.

Historically, Market Capitalization has an inverse relationship with both risk and return. Companies with larger Market Caps tend to grow more slowly, on average, than mid/small-cap stocks. However, large caps tend to be less volatile during rough markets as investors fly to quality and become more risk-averse. This is precisely the opportunity for buying into mid/small-cap space as a result of attractive valuations Vs their long term historical valuation multiples. The primary advantage of investing in mid/small-cap stocks is significant upside growth potential that is unmatched by mature companies. This potential growth motivates investors to buy mid/small-cap stocks despite their higher risk profile for long-term investing.

Also, we would like to point out that at this point in time one-year forward multiple for Midcap100 index has corrected from 23x to 19.9x in the current fall and is now trading at a mere 5-8% premium to large caps Vs 28% Premium at the start of the year. Considering the opportunity for growth coming back due to progressive reforms and low-earnings base, the delta swing in earnings may be higher in Midcaps over the next 12-24 months, making them reasonably priced Vs large caps if you have a 2-3-year Investment horizon.

With mounting US and UK debt, doomsday predictions with respect to global markets have been surfacing of late. Do you see a large global correction in the offing? If it were to occur, do you think domestic equities are sufficiently decoupled from global markets to not face collateral damage
Emerging markets including India will need to brace for higher oil prices in case US were to impose punitive measures against oil importers from Iran. Global oil prices were rising steadily after President Trump withdrew from the Iran nuclear agreement & decided to impose economic sanctions with a threat to punish countries and companies that continue to trade with Iran. Furthermore, Trump's sanctions on Venezuela have accelerated the sharp decline in its oil production amid a severe economic, financial, and humanitarian crisis. These sanctions only heightened fears about decreasing availability of oil for global market. However, after scaling record highs, oil prices have since cooled after US secretary of state Mike Pompeo said oil sanctions waivers may be granted to countries seeking relief from tough White House measures against Iran that are set to start in November 2018.

With imports accounting for nearly 85% of its annual consumption, India is particularly vulnerable to a macro shock due to sustained rise in global oil prices. It feeds into a vicious circle of widening trade & current account deficit, fiscal pressures, rise in imported inflation, outflow of foreign funds leading to weakening currency, rise in bond yields & pressure on equities. This forces RBI to hike interest rates to ensure macro-economic stability by attempting to stem FII outflows & tamp down inflationary pressures.

After introduction of e-way bill, GST collections have started showing a steady up move. April-May 2018 fiscal deficit has reached 55% of the overall budget which is still lower than the 63% reached last year. However, considering higher crude prices, weak rupee, impending MSP hikes and likely populist measures in a pre-election year, there are fears of some slippage in achievement of the budgeted fiscal deficit.

An escalating US-China trade war is bound to have repercussions on global growth. The tit-for-tat tariffs announced by China, the EU, Canada, Mexico, India etc in retaliation of the tariffs announced by the US administrations risks causing serious disruption to global trade & severe slowdown in global economic growth. Any sustained turbulence in financial markets & asset prices can further undermine global growth. EM currencies are struggling with Indian rupee being no exception. It has weakened to all-time lows despite talks of RBI intervention but if one considers the long-term Rupee movement over the last 5 years (since the previous lows in August 2013 in the wake of taper tantrums) it has been remarkably steady vis-à-vis other EM currencies that have fallen sharply.

It appears that local markets are stuck in a narrow band, awaiting firm cues in terms of earnings growth. Would you concur? Do you see earnings growth picking up anytime soon… and if yes, based on what inferences?
We are seeing improvement in micros with India's factory activity (PMI) in June 2018 expanding at its fastest pace in seven months with favourable demand leading to greater output. In addition, automobile sales have grown at a fast clip, FMCG companies are looking at double digit volume growth and more importantly corporate earnings are showing signs of strong rebound. On the other hand, Macros are getting vulnerable with higher Oil prices, higher interest rates and weak rupee. This is accompanied by turbulence in global equity markets as a result of impact on global economic growth due to trade wars & rising interest rates in the US leading to outflows from emerging markets including India.

This has dampened Foreigner Institutional Investor (FII) sentiment which normally focuses on macros and allocates money based on the relative attractiveness of an economy. Despite huge outflows from FIIs, the only silver lining is Domestic Institutional Investors (DIIs) continuously receiving inflows through Systematic Investment Plans (SIP) of approximately Rs 70 billion (bn) per month lending strong support to the indices and cushioning any deeper corrections at the index level.

However, due to the risk-off sentiment globally and realignment of portfolios of mutual funds schemes as per SEBI direction to ensure that the investments across market capitalizations are broadly in consonance with the stated investment objective of the schemes; most broader market names have seen corrections in the range of 15-50% from their 52-week highs, resulting in severe erosion of wealth in small/mid caps.

What sectors are you bullish on at this stage?

We have continued with our stance to stay over-weight in Retail focused lenders which are the key beneficiaries of growing demand for credit in an economy that will see a significant change in financing landscape away from a capital-starved, NPA-heavy PSU banking system that is struggling to stay afloat. Automobiles, Retail and FMCG continue to be significant part of our allocation as we see them as key beneficiaries of discretionary spending and spurt in rural spending by the government ahead of busy election season as well as strengthening of already-visible aggregate demand post-harvest on the back of favourable monsoon.

Do you see Pharma as a deep value sector at this point, or do you think that the risks still outweigh potential returns?

We believe that the pharma sector is close to bottoming out. However, there are as yet no visible upside triggers. The pressure on margins on sale of generics in US continues to weigh on overall profitability, regulatory overhang on plants affected by import alerts is receding, overhang of Indian government pushing for generics in the domestic market will continue to weigh on local margins & upsides from specialty offerings are still some way off. The sector warrants a vigilant monitoring for signs for these headwinds to abate.

What stocks are you bullish on within the BFSI space?

We continue to like retail-focussed banks & NBFCs due to consistent growth in Net Interest Income (NII) and net profits, strong & steady NIMs, ROAs & ROEs; pristine asset quality with very low NPAs & high provision coverage ratios, strong balance sheets with high capital adequacy ratios and adherence to strong risk mitigation measures.

Do you think the worst is behind us when it comes to PSU banks, or do you foresee more negative surprises in the times to come?

PSBs and some large private corporate focused banks are highly under-owned in Institutional portfolios for the last few years as their profits were under severe pressure due to accelerated provisioning for NPAs & stressed assets.

Government had infused massive capital in PSBs to take care of their provisioning requirements. However, many PSBs have utilized this capital to provide for the sharp spike in stressed assets necessitating further infusion of capital by the government to take care of further provisioning requirements, growth needs and adherence to Basel III norms. However, this needs to be quickly followed by many structural reforms like increased autonomy in hiring talent both directly & laterally, strengthening credit appraisal skills by enhancing domain expertise, bringing about an attitudinal change in employees like their private sector counterparts by focusing on sales & marketing rather than relying for business from customers walking into the branches and above all by expediting a rapid consolidation in the fragmented PSB space. Emergence of 3 to 5 large sized PSBs post-consolidation alone will ensure that they compete fiercely with private sector players and aggressively defend their market share over the medium-term.

Unless the government unveils a time-bound roadmap for such structural reforms, PSBs can never form part of one's core portfolio though one can look at them from a short-term trading perspective due to low valuations & under-ownership. Any shift towards corporate-focused banks can be better played through some of the private sector counterparts.

In conclusion, please tell us a bit about the investment management processes you follow at Prabhudas Lilladher.

At PL-PMS we follow a rigorous & disciplined approach for investments embedded in constant evaluation of topical macro themes for generation of ideas which are then subjected to a three-layered evaluation matrix of assessment of business fundamentals, comparative valuations & market interest factors. Macro themes at various points straddle a broad range of drivers of aggregate demand in the economy like stage of investment cycle revival, direction of monetary policy, global commodity cycle calculus, opportunities accorded for movements in consumption curve, harnessing of external trade winds etc.

Once an appropriate macro theme is chosen, beneficiary sectors are identified and ideas within those sectors filtered first through business fundamental bucket where qualitative and quantitative aspects are analyzed. Corporate governance practices of the promoters/management and their long-term track record in stakeholder value creation being the foremost qualitative aspect considered. Addressable market opportunity, sustainable competitive advantages of the franchise either in terms of its product/service offerings, distribution outreach, cost efficiencies, nimble-footedness in competitive response etc. are studied. Various financial ratios analyzed to focus on margin profile, capital efficiency & risk to arrive at estimates of medium-term growth in revenues, earnings and most importantly free cash flows.

If a company successfully clears this hurdle, it is put through the second bucket of appropriate valuation comparison. Valuation tools employed differ with the characteristics of each sector & comprise of P/E, P/B, EV/EBITDA, DCF v/s Enterprise Value etc

If the business is found to be valued at lower than its fair value then various market interest factors like free float, institutional holdings, research coverage etc are look into to assess potential price performance.

Franchises that successfully clear the three hurdles find a place in portfolios. Our portfolio construct employs various risk mitigation strategies to avoid excessive sectoral & stock concentration, achieve optimal diversification, minimize liquidity risk etc.

We generally avoid taking aggressive cash calls as our investors have given us a mandate to invest in equities as an asset class with a minimum two to three-year perspective.

We employ a combination of growth & value philosophies in an attempt to achieve an optimal balance in portfolio construct though the emphasis on each style varies depending on the broad position where the market conditions & valuations are perched. In an environment of ample liquidity, benign interest rate outlook and robust demand the accent is more on growth style to leverage fast-paced earnings trajectory in market with higher valuation multiples. Conversely, a tighter liquidity & interest rate scenario, anaemic growth trends and heightened risk outlook on economic or geo-political front would warrant a broader shift to value style. However, each market scenario mentioned above presents opportunities for some investments employing the contrarian style.

Market's wild oscillations in terms of thematic & sectoral preferences present opportunities to buy out-of-favour, contrarian ideas at low valuations, with ample margin-of-safety on the downside & large medium-term upside potential. As the negativity surrounding that theme/sector ebbs, market eventually realizes undervaluation & re-rating follows.