neo next

~ April, 2023

INDEX

Link to our previous newsletters:

Neo Next Newsletter_Jan 2023.pdf

Neo Next Newsletter_Nov-22.pdf

Neo Next Newsletter_Oct 2022.pdf

Neo Next Newsletter_Sept 2022.pdf

Executive Summary

Greetings from Neo team!

As we had highlighted earlier, CY23 would be a transition year where the impact of central banks taming inflation, rates peaking and growth slowing down, plays out. As the concerns have clearly shifted from inflation to growth, pivot of timing and pace of rate cuts will be keenly watched out for this year. However, while global growth moderates as the full impact of monetary tightening and the banking crisis unfolds, the multiplier effect on India will be lower. In the second half, peaking rates, lowering of macro-vulnerability and improved balance sheets will provide the tailwinds.

One of the most aggressive monetary tightening campaigns ever (475bps over last 1.3 years) has effectively come to an end in the US. Consensus expects 70% probability of a final 25 bps rate hike in the May policy, post which a rate cut cycle is likely in July/ September policy onwards. Further sign of easing labor tightness in US with declining payroll data in March should take even more pressure off the Fed. Empirical analysis suggest that a rate cut cycle resumes with a six-month lag from peak rates. Due to easing inflationary pressures and risk of financial stability, FOMC estimates Fed rate of 5.1% by the end of the year, implying 20 bps cut in 2HCY23. Thereby the key would be the timing and the extent of rate cuts.

In India, Monetary Policy Committee (MPC) unanimously decided to keep policy repo rate unchanged at 6.5% in order to assess impact of the cumulative 250 bps hike so far. This implies we are at the end of the rate hike cycle, as MPC has revised down its FY24 inflation forecast to 5.2% from the earlier 5.3%. The improvement in India's External Accounts reduces probabilities for further local monetary tightening.

The key to CY23 outlook will be balancing the demand slowdown as a lag impact of increased interest rates and the pace and timing of interest rates cuts with peaking inflation. While CY23 will be volatile with growth tapering, but the uncertainties seem lower than 2022. While one must be realistic in short term return expectations, Inflation and Interest rates peaking out will be positive for the markets for both bonds and stocks over medium term. Further supportive are the Equity valuation multiples in India which have corrected below long-term averages with the strain of growth from a recession in the devel oped world. Also with fears of global recession rising, inflation dropping and tightening ending, bonds will appeal given the yield pick-up.

On balance, as the US Fed pivots and ECB follows suit, and in India, RBI responds too, we could see sentiment improve.

Warm Regards,
Neo Multi Family Office

Shradha Sheth
Head of Equities, Neo Group
Email Id: shradha.sheth@neofamilyoffice.in

Nikhil Gite
Head of Fixed Income, Neo Group
Email Id: nikhil.gite@neo-group.in

India Equity Outlook: Demand Resiliency & Pivot

Key Monitorables

As we had highlighted earlier, CY23 would be a transition year where the impact of central banks taming inflation, rates peaking and growth slowing down, plays out. The key to 2023 outlook will be balancing the demand slowdown as a lag impact of increased interest rates and the pace and timing of interest rates cuts with peaking inflation.

Growth slowdown:

CY23 will be volatile with growth tapering. US sequential CPI inflation has been near zero for five months. US composite PMI has been below 50 for seven out of the last eight months, retail spending having been flat in real terms for two years. Thereby monitoring the slowdown in US will be the key. Further global money supply is weak (flat), hence an easing is warranted. With distinct weaknesses in the US economy, we will monitor for earnings downgrades globally and in India. If the pivot is due to a major slowdown, it will hurt India growth but relatively lesser.

Market expects lower year end Fed rate

Consensus expects 70% probability of a final 25 bps rate hike in the May policy, post which a rate cut cycle is likely in July/ September policy onwards. Empirical analysis suggest that a rate cut cycle resumes with a six month lag from peak rates. Due to easing inflationary pressures and risk of financial stability, FOMC estimate Fed rate of 5.1%, implying 20 bps cut in 2HCY23.

Sign of easing labor tightness in US

Post the better than expected PCE data reading last week, there are signs of easing labor market tightness in the US, which is a key factor for elevated services inflation ex. housing. There was a 24% fall in US non-farm payrolls to 236k in March as compared to previous month reading of 311k.

Rate cycle

In India, Monetary Policy Committee (MPC) unanimously decided to keep policy repo rate unchanged at 6.5% in order to assess impact of the cumulative 250 bps hike so far. This implies we are at the end of the rate hike cycle, as MPC has revised down its 4QFY24 inflation forecast to 5.2% from the earlier 5.3%.

Falling trade deficit

On the positives, there has been a reduction in external vulnerability in terms of FX reserves/external debt, external debt/GDP, current account, money supply growth for India. Further worst of the rate hikes and capital flights may be over. India has registered strong improvement and better fortified against capital outflows. India's trade deficit has improved dramatically. The country is likely to report close to zero Current Account Deficits in the March quarter (from a deficit of 4.4% in Sept-22). The improvement in India's External Accounts reduces probabilities for further local monetary tightening.

FPI Index net shorts at 5 year high:

FII Index futures position in February showed extreme bearishness, which is a contrarian indicator. FPIs net bearish bets on Indian equities have reached the highest level in more than five years in a sign of growing dissonance between the US central bank and the market participants about the trajectory of economic growth in America. However, on the cash side, in Mar'23, FIIs turned net buyers after 3 months (US$1.5bn); DII flows remained strong (US$3.4bn). Total institutional flows were highest in March since August 22. The next 6 months can be challenging from a FPI flow perspective, looking at risk aversion in the face of impending US recession or a material slowdown. However, Flows will chase relative growth outperformance in FY24, and we believe India will hold up well. While local flows have been holding up well, FPIs could come back in a material way towards the second half of FY24 as the pivot by central banks begins.

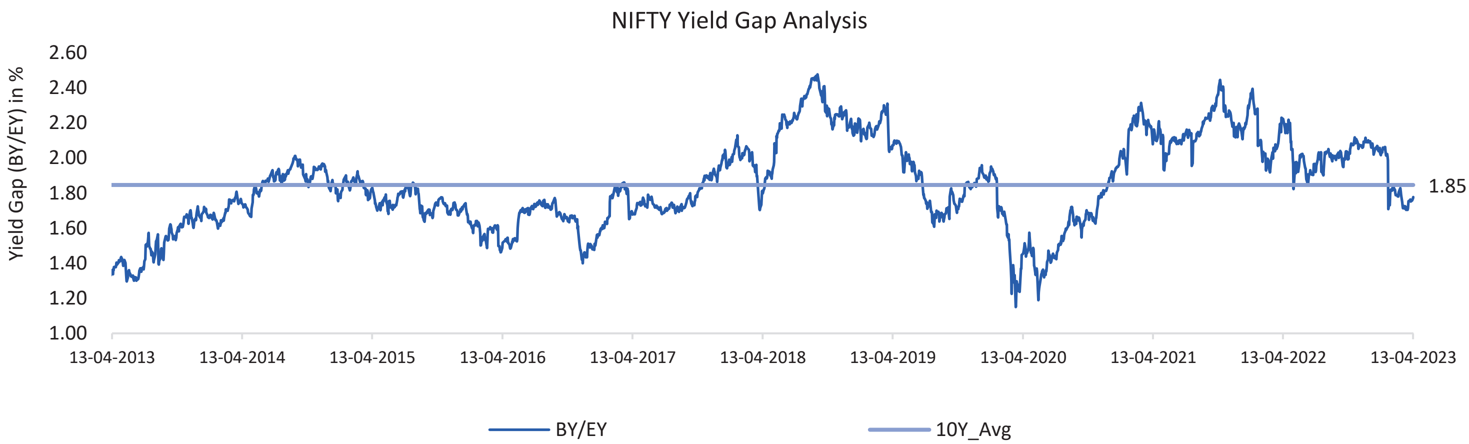
Cash pile at mutual funds is at two years high

The average cash holding of top 20 mutual fund houses by Asset Under Management (AUM) was 5.9% at the end of January 2023. This is the highest cash proportion in the past two years which could provide the support.

Valuations moderate below 10-year average

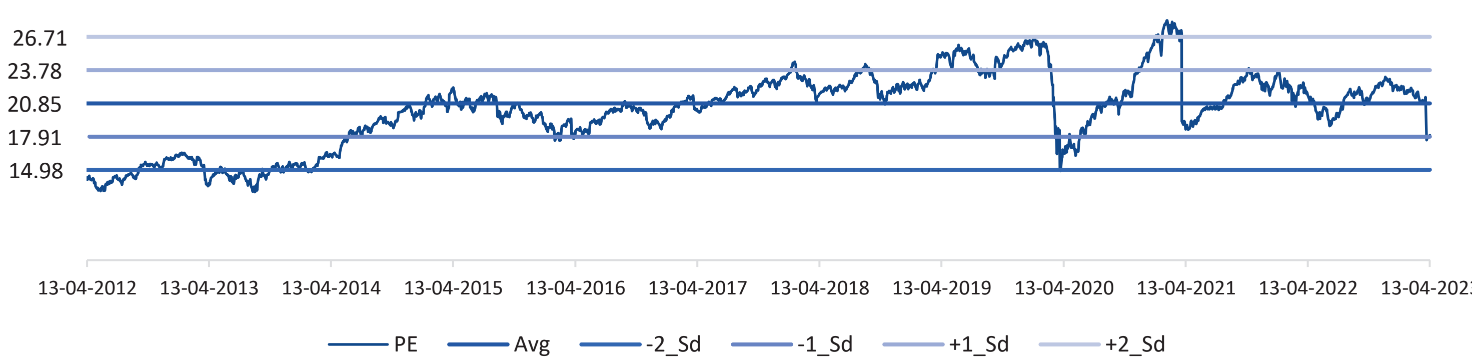
While one must be realistic in short term return expectations, however equity valuation multiples in India have corrected below long-term averages with the strain of growth from a recession in the developed world. Given the ongoing correction and consolidation phase, Indian equities is trading at sub long term average valuation (price to earnings and bond equity earnings yield basis). Also relative to other emerging markets, India is now trading at average premium levels. There have been very few longer-bear phases in India. Nifty PER is down by 20% in 17 months. While next 6 months can be challenging from a FPI flow perspective, looking at risk aversion in the face of impending US recession or a material slowdown. However, as the US Fed pivots and ECB follows suit, and in India, RBI responds too, we could see sentiment improve. Global M1 softening could suggest a moderation in Nifty earnings. Hence, we will monitor any earnings downgrades versus 18-20% earnings growth expectation for FY24 for Nifty. On balance, we would advise portfolio construction with companies having reasonable pricing power, relatively higher earnings visibility, and comfort on valuations.

Nifty 12-month forward P/E of 18x, is below average. Even bond equity earnings yield valuation is below long-term average, providing comfort on valuations.



Source: Bloomberg

Chart 2: Nifty 50 forward P/E; Below 10Y average



India's earnings momentum has held up better than emerging peers. Further with earnings having a resilient growth trajectory ahead, at 16.7% CAGR over FY23-25E, India's absolute performance may sustain. Continued strength in earnings will provide downside protection in a slowing global demand environment.

Equity Investment Process and Framework

While in the short term there are market related news which may impact the stock returns. Over the long term, stock prices are slaves to earnings. Our endeavour is to deliver healthy absolute long-term returns driven by our framework through which we pick companies. **We through our approach aim to pick Profitable companies at a reasonable price with incremental growth and capital efficiency.** Further we give emphasis on the Quality of industry and company. We follow a holistic framework that helps identify the healthy performing companies covering all the significant areas affecting the investment like business trends, financial strength, capital efficiency and valuation frameworks.

Our portfolio picks are companies with:

High Financial and Valuation strength

We evaluate companies based on their historic and forward business trends, financial strength and capital efficiency. We give high weightage to forward financial strength driven by higher future earnings with capital efficiency and strengthened by valuation bands for entry points.

Earnings visibility: The medium-term earnings growth trajectory >15% on an average.

Management teams are not compromising on discipline to boost short term earnings – focus, prudent capital allocation, balance sheet discipline, granularity of thought process is visible

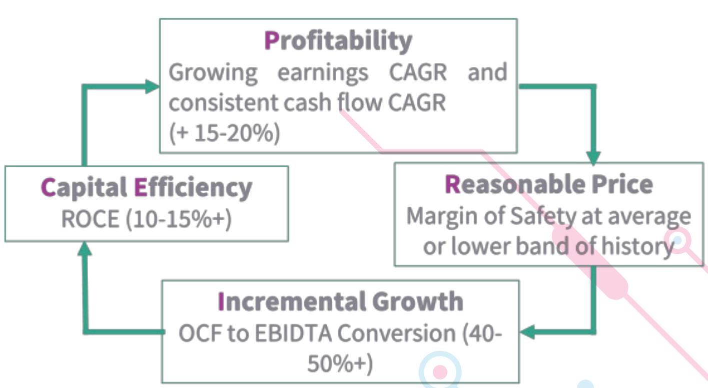
Capital efficiency: ROE of companies is >15%+.

Margin of safety: We buy companies at fair valuation with an objective of capital protection and consistent returns over a long period. We focus on our entry points, with the objective of margin of safety while investing. We give strong weightage to historic valuation bands for generating higher returns and avoiding to overpay on entry price. The earnings growth of our port folio companies and their moats remain strong.

The decline in valuation multiples may happen due to normalization of monetary policy, perceived short term growth challenges, event-based outcomes. We will watch for such variables and buy companies with adequate margin of safety to factor in such factors. HDFC Bank is one such example where the stock's valuation came off in the run up to the merger led by RBI dispensations. However, this provides adequate margin of safety with the valuation at historic lower band. Further there are cross synergy benefits which are yet not factored in.

Focus on Quality: We evaluate a firm's industry and management quality, to gauge the future growth and development of the company. We pick companies with sustainable competitive advantage over long term with innovation focus. We give weightage to company's competitive advantage in terms of entry barriers, leadership depth, company's skin in the game. We usually prefer companies with enough skin in the game with promoters holding is greater than 40% and are also increasing stakes over time. Further within large caps we follow a contrarian approach with declining FII holdings. This helps us in identi fying companies ahead of the curve in large-caps space to make absolute compounded returns.

Chart 3: Investment Process



Forward Financial Strength:
~ Growth rate of 10-15%+

- EBITDA 2Y Forward CAGR
- PAT CAGR 2Y Forward CAGR
- OCF CAGR 2Y Forward CAGR
- OCF to EBITDA Conversion = 40-50%+
- ROE, ROCE > 15%

Valuation Strength:

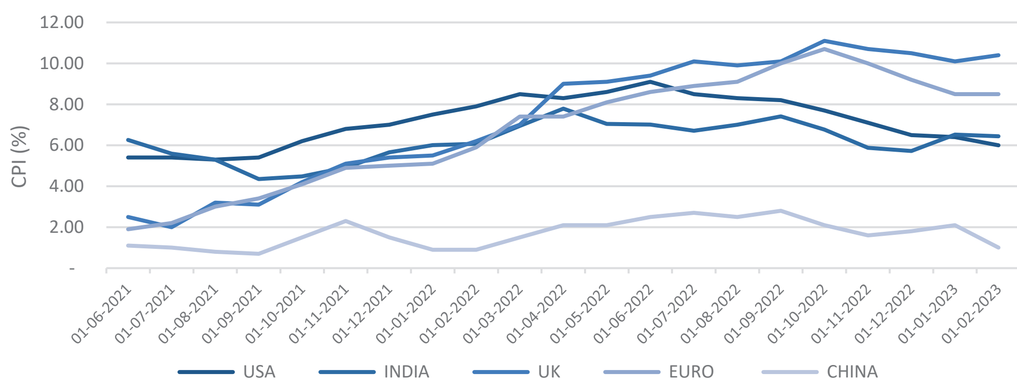
- Margin of Safety at average or lower band of history

Fixed Income Outlook

MPC committee's unanimous decision to keep the policy repo rate unchanged at 6.50% is in line with our expectations as mentioned in our earlier released Policy notes as well as newsletters. The Governor clearly stated in his statement that **"the decision to pause on the repo rate is for this meeting only, also to remain focused on withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth."**

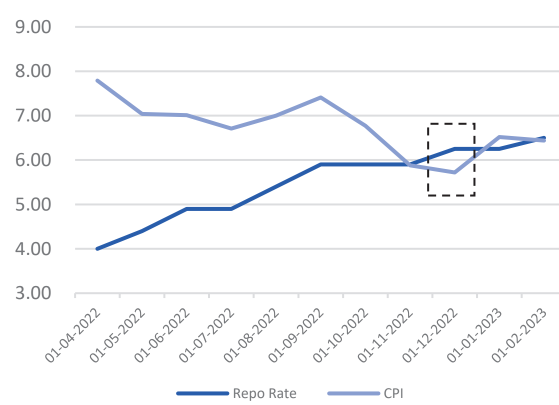
Since the start of hike cycle in India there has been a 250-bps rise in policy rate. India's real interest rate was negative by more than 3% when the first hike was delivered by RBI. Currently, the real interest rate stands marginally positive and is expected to remain in this zone for coming months as RBI's inflation projection indicates softening in next few quarters. In such case, there can be a **prolonged pause** followed by a change in stance.

Chart 4: Global CPI Inflation



Source: Bloomberg

Chart 5: Indian Inflation – India Repo Rate

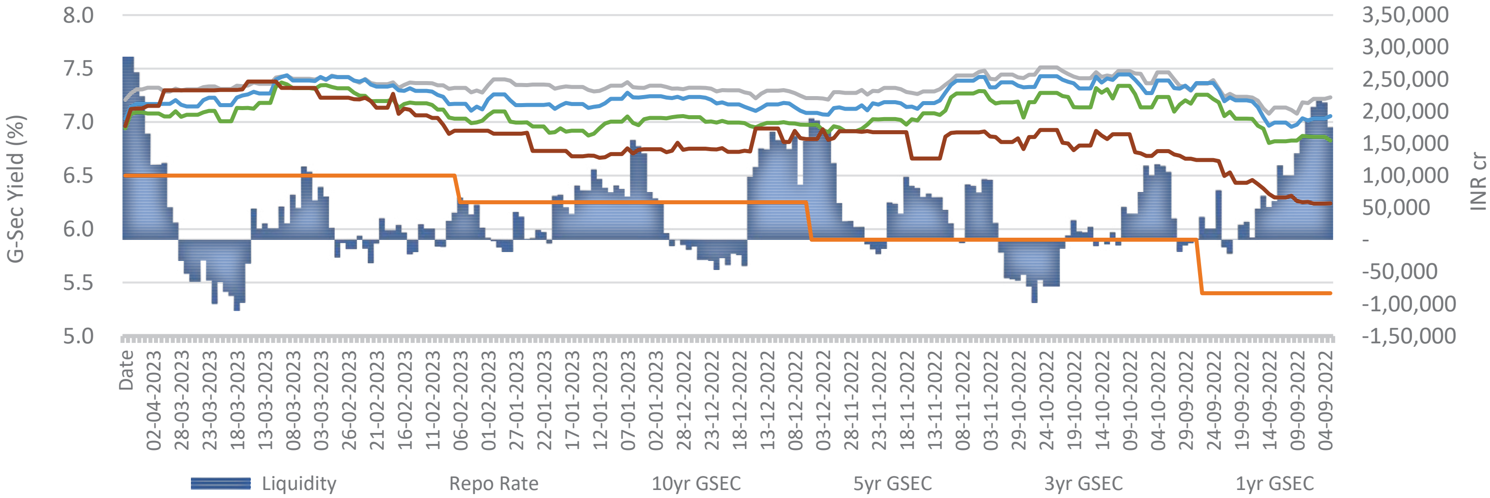


Source: Bloomberg

Further, CPI in India seem to have peaked out and is hovering closer to RBI's upper target range of 6.00%. RBI revised its projection for FY 2023-24 to 5.20% from 5.30% and for Q4 FY 2023-24, the projection is lowered from 5.60% to 5.40%. The growth projection at 6.50% for FY23-24 seems a strong number. However, there is downside risk to this number mainly due to global instability. The reserve bank so far has chosen its own path and have been more domestic data dependent than the global but the spill over effect of these instabilities may force RBI to act accordingly.

The central bank will continue to support economy by maintaining sufficient liquidity with their neutral to positive liquidity maintenance approach in the economy. As the graph suggests, there has been a steepening in yield curve where short term rates have fallen more as compared to longer.Considering the neutral liquidity in system and total 250 to 300 bps rise in G-sec and bond yields in last 9 months, we continue with our stance that 3-to7-year maturity is still attractive and offers good carry. There would be some pressure on long term yield in the short term as almost 72% of the supply in this year's G-sec borrowing is distributed between 10 years and above. Overall, the central bank has indicated that they would be watchful and act accord ing to situations keeping focus both on inflation and growth.

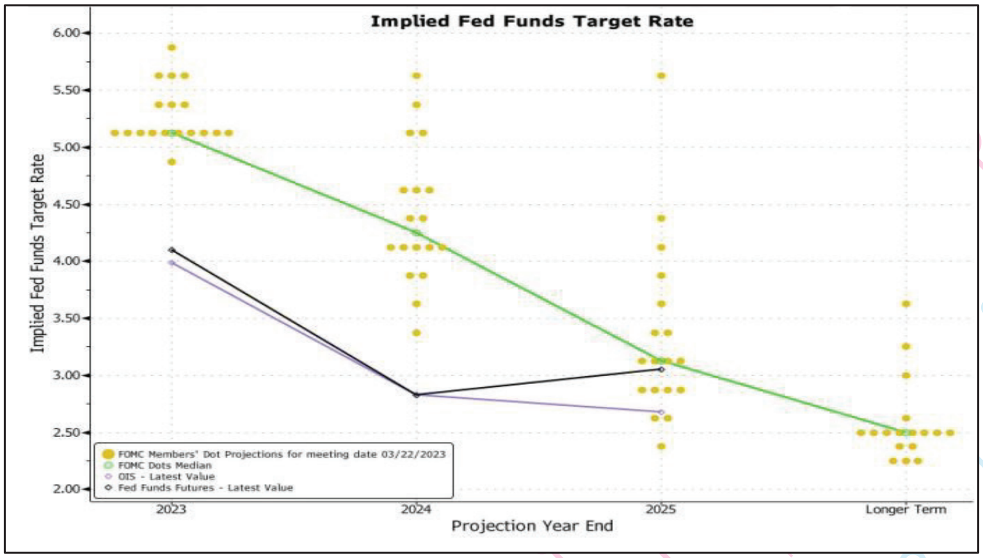
Chart 6: Liquidity V/S Yield



Source: Bloomberg

Fed View: The Federal Reserve raised interest rates by a quarter percentage its ninth increase in about a year. Chairman Jerome Powell addressed the turmoil in the U.S. banking sector, saying the issues were limited to a few banks and emphasized the broader financial system was "sound and resilient." However, both Powell and Treasury Secretary Janet Yellen, stated **they'd do whatever it takes to save all depositors.** Those comments roiled markets. The central bank suggested an end to rate hikes is near by removing a line from its statement about "ongoing increases." The median forecast among members of the Federal Open Market Committee is for one more increase this year. Officials also see slower economic growth in 2023 than they did a year ago, according to the so-called dot plot.

Chart 7: Implied Fed Funds Target Rate



Source: Bloomberg

Key Portfolio Update: Equities

Our portfolio companies with reasonable pricing power and earnings growth should be resilient in a challenging environment and provide the compounding overtime. We remain positive on manufacturing and capex-oriented companies in industrials and infra, BFSI space with a bias toward banking and sub segments like AMC, rating agencies, automotives and some consumption plays for the next 18-24 months. Our focus currently is to make sure our companies across our portfolio have limited downside in regard to valuations & have reasonably good earnings visibility. We favour strong idiosyncratic earnings growth at reasonable prices on their historic valuation bands.

Table 1: Top 5 Model Portfolio Holdings

Top Holdings
HDFC Bank
Vesuvius India
ITC Limited
HDFC Limited
VIP Industries

Industrials and Infrastructure: The capex budget is expected to rise by a whopping 37% y-o-y to a record INR10tr. Including the transfers to states for capex under centrally sponsored schemes, the rise is 30%, to a record INR13.7tr. And including PSE capex to this, the rise is 28%, to INR18.6 tn. Increased allocation in Road/Railway/Water & Metro segments in the FY24 Union budget by 25-50% over FY23 Budget. Focus on capex in Union Budget will drive strong domestic demand. Withdrawal of export duties on steel will improve profit margins of Steel Companies and in turn the pricing for their key consumables.

Huge capital expenditure in infrastructure will create a great multiplier effect for the economy. Further moderating raw material prices to aid profitability ahead. The glide path of fiscal deficit provides more growth for capex. We like industrial consumables with pricing power like Vesuvius India and infra companies with relatively better balance sheets and strong order book providing healthy earnings visibility like Power mech projects.

Banks: Banks are seeing good credit growth in non-industrial segments, including Agri. Their balance sheets are cleaned up, growth could be non-dilutive for some time, and valuations are supportive. We like HDFC bank twins as the merger is getting discounted with attractive valuation, closer to lower end of their valuation. On 17th March 23, National Company Law Tribunal (NCLT) approved the merger of HDFC and HDFC Bank. HDFC Ltd has already received approvals from Reserve Bank of India, SEBI, PFRDA and Competition Commission of India (CCI) as well as from India's stock exchanges - BSE and NSE. While HDFC bank has challenges around meeting regulatory requirements and raising low-cost deposits which have potential to adversely impact loan growth and ROE in short term. The proposed merger is to create a large balance sheet and net worth that would allow a greater flow of credit into the economy. It will also enable the underwriting of larger ticket loans, including infrastructure loans, an urgent need of the country. There are strong cross selling and operating cost synergies which are yet not accounted for.

Auto: Chip shortage issues hare gradually easing as Semiconductor manufacturers have increased their production. PV players are reporting healthy UV volumes. CVs also are reporting strong sequential recovery. We also expect to see lower discounts (seasonal in PV; pricing discipline in trucks). This should result in strong margin performance by PV/CV OEMs. We like MSIL as it is gaining share in the UV space and further looking at strong gains ahead. Further we like certain ancillaries which do not face the disruption risk from the EV era and infact are beneficiaries of the same like Fiem Industries

Consumer: Led by continuing uptick seen in air travel and pent-up demand along with recovering international business, we believe players like VIP Industries continue to see strong earnings visibility. Further we continue liking defensives like ITC which saw modest tax increase in budget paving way for balanced revenue growth (volume + pricing) and further share gains from illicit trade with continuing reasonable valuations.

Key Portfolio Update: Fixed Income

Financial Summary of the Model Portfolio

Table 2: Model Portfolio Key Highlights

(Amount in Crs.)	Data as of Sep-22					
Company Name	**Rating**	**AUM**	**Net worth**	**Debt/Equity**	**GNPA**	**CRAR**
Bajaj Finance	AAA	1,57,292	45,837	2.96	1.49%	25.13%
Housing Development Finance & Corporation	AAA	6,90,284	1,23,440	4.28	1.90%	22.50%
L&T Finance	AAA	85,237	20,150	4.24	4.02%	22.65%
NABARD	AAA	6,95,804	62,013	9.48	0.33%	18.60%
Shriram Transport Finance Ltd	AA+	1,24,128	27,994	4.48	6.31%	23.20%
Cholamandalam Investment & Finance Limited	AA+	91,841	12,900	6.17	5.80%	18.40%
Muthoot Finance	AA+	58,303	19,183	2.43	1.67%	31.96%
Piramal Capital & Housing	AA	63,780	27,472	2.00	3.70%	23.00%
Hinduja Leyland Finance Ltd	AA	18,638	2,834	6.04	6.31%	17.61%
IIFL Finance Limited	AA	34,968	8,171	3.75	2.42%	21.70%
TVS Credit Solutions	AA	17,670	2,210	7.38	2.78%	17.64%
TMFL	AA-	27,432	5,180	5.53	10.39%	22.56%
Arka Fincap Limited	AA-	2,171	1,017	2.24	0.00%	33.43%
Incred Financial Service Ltd	A+	4,730	2,300	2.07	2.40%	32.78%
SK Finance	A+	5,718	1,698	3.36	3.06%	26.97%
Veritas Finance Limited	A	2,729	1,489	1.20	3.56%	55.33%
Navi Finserv Pvt Ltd	A	5,650	1,990	2.55	0.66%	26.69%

Disclosures:

(a) Neo Wealth Management Private Limited and it's Research Analysts engaged in the preparation of this document or their respective associates or relatives may hold positions in shares/ securities of the Companies referred to in this document;

(b) Neo Wealth Management Private Limited or it's Research Analysts engaged in the preparation of this document or their respective associates or relatives, may have actual/beneficial ownership of one per cent. or more securities of the companies referred to in this document, at the end of the month immediately preceding the date of publication of the research report;

(c) To the best of knowledge of Neo Wealth Management Private Limited or it's the Research Analysts engaged in the preparation of this document, Neo Wealth Management Private Limited or it's Research Analysts or their respective associates or relatives, do not have any material conflict of interest at the time of publication of the research report;

(d) To the best of our knowledge, Neo Wealth Management Pvt.Ltd. or it's Research Analysts or their respective associates have not received any compensation from the subject company in the past twelve months;

(e) Neo Wealth Management Private Limited or its associates have neither managed nor co-managed public offering of securi ties for any companies referred to in this document in the past twelve months;

(f) Neo Wealth Management Private Limited or its associates have not received any compensation for investment banking or merchant banking or brokerage services from any companies referred to in this document in the past twelve months;

(g) Neo Wealth Management Private Limited or its associates have not received any compensation for products or services other than investment banking or merchant banking or brokerage services from any companies referred to in this document in the past twelve months;

(h) Neo Wealth Management Private Limited or its associates have not received any compensation or other benefits from any companies referred to in this document or third party in connection with the research report.

(i) Research Analysts engaged in the preparation of this document have not served as an officer, director or employee of any companies referred to in this document;

(j) Research Analysts engaged in the preparation of this document or Neo Wealth Management Private Limited has not been engaged in market making activity for the companies referred to in this document.

Disclosures:

Investment in securities market are subject to market risks. Read all the related documents carefully before investing. There is no assurance or guarantee that the objectives of the investments /investment products / clients will be achieved. The users of this document are advised to consult their legal, tax and financial advisers to determine possible legal, tax and financial or any other consequences before making an investment decision. Past performance of the stocks/securities are not indicative of future returns. The securities quoted are for illustration only and are not recommendatory. Nothing contained in this document is verified or approved by Securities and Exchange Board of India (SEBI). The stock(s)/sector(s) mentioned in this material do not constitute any advice or recommendation of the same and Neo Wealth Management Private Limited or it's associates, affiliates may or may not have any present / future positions in these stock(s)/sector(s). In preparation of this document, we have relied upon data/inputs from some external parties. The accuracy or adequacy of such data/ information is not assured. Nothing contained in this document shall be construed as an investment advice or research recommendation or research report and Neo Wealth Management Private Limited or it's promoters, Directors, Employees, Associates and Affiliates shall not be responsible or liable for any loss or damage or liabilities arising from the use of this document by anybody in any manner. Registration granted by SEBI, membership of BASL and certification from NISM in no way guarantee performance of the intermediary or provide any assurance of returns to investors.

This document is provided as part of the Research Analyst services offered by Neo Wealth Management Private Limited. Any complaint / dispute pertaining to the same would not have access to Exchange investor redressal or Arbitration mechanism.

Neo Wealth Management Private Limited

SEBI Registration No.: INZ000306537 (Stock Broking) |NSE Trading Member Code: 90296 | BSE Clearing Member: 6792 | IN-DP-725-2022 (CDSL) | CDSL DP ID: 12096600 | Investment Adviser: INA000017286 | CIN-U74140MH2021PTC367572 | AMFI Registration Number: 258756

Compliance Officer: Mr. A. Jayadevan. Ph: +91 22 66423600, Email: Compliance@neo-wealth.com.

Registered Address: 903, B-Wing, 9th Floor, Marathon Futurex, Mafatlal Mills Compound, N.M. Joshi Marg, Lower Parel Mumbai, 400013. Tel +91 22 66423600.