ECONOMY INSIGHT

October 07, 2016

After a weak 2QFY17, expect a mild pick-up in GDP growth

An analysis of 17 high frequency indicators (HFIs) and India's Keqiang Index (IKI) for India suggests that economic momentum in India decelerated further in 2QFY17, marking an 11-quarter low on the IKI front. The HFIs further suggest that 'consumption' as a theme continues to do well whilst 'investment' remains under pressure. In the short term, we expect higher agricultural sector growth in 2HFY17 and the award of the 7th Pay Commission to propel a mild U-shaped consumption-driven pick-up in GDP growth in 2HFY17. From a medium-term perspective, for FY18, we expect GDP growth to be recorded at 7.3% YoY (v/s 6.8% in FY17) as the "M+R+T resets" lend support to consumption growth (*click here* for the October 04, 2016 thematic).

Economic activity levels dropped further in 2QFY17

An analysis of 17 high frequency indicators suggests that 11 out of 17 indicators decelerated in 2QFY17 as compared to 8 indicators losing steam in 1QFY17 (see exhibit A in the right hand margin). Most notably, growth in the commercial vehicles sales component contracted by 6% YoY in 2QFY17 as compared to the growth of 15% YoY recorded in 1QFY17. India's Keqiang Index (IKI) also experienced a deceleration in 2QFY17 (see exhibit B in the right hand margin), thereby corroborating the message conveyed by the battery of 17 high frequency indicators that we track.

'Consumption' holding up relative to 'investment'

Data for 2QFY17 suggests that gauges related to consumption (such as two-wheeler sales and passenger vehicle sales) continue to do well. On the contrary, investment as a theme continues to stay under pressure as evinced by the persistent weakness in gauges like commercial vehicles sales, cement and coal production. Within consumption, early signs of rural consumption stabilizing are evident from the fact that rural wages are bottoming out and rose by 10bps whilst two-wheeler sales rose by 300bps in 2QFY17. Furthermore, WPI core inflation was recorded at an 8-quarter high while CPI core inflation also inched up, pointing to early signs of the return of pricing power.

Where do we go from here?

In the short term, we expect higher agricultural sector growth in 2HFY17 and the award of the 7th Pay Commission to propel a mild U-shaped consumption-driven pick-up in GDP growth. From a medium-term perspective, for FY18, we expect GDP growth to be recorded at 7.3% YoY (vs 6.8% in FY17) as the "M+R+T resets" lend support to consumption growth (*click here* for our October 04 thematic).

It is critical to note that 'investment growth' is likely to stay under pressure as: (1) the Government has budgeted extremely low capex growth for FY17 (4% vs 21% in FY16); and (2) there are no signs of a private sector capex revival.

Investment Implications

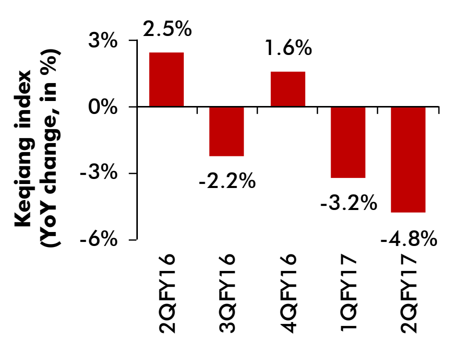
As highlighted above, both short-term and medium-term catalysts are likely to support consumption growth in India. In the short term, higher agricultural income in 2HFY17 fuelled by a good monsoon and the 7CPC payout being initiated in August 2016 should incrementally support consumption growth in 2HFY17. From a medium-term perspective, as cost of capital falls along the lines described in our note titled "M+R+T resets = A revolution in access", we are likely to see an upsurge in credit-funded consumption growth. Alongside that, as access to end-consumers improves for manufacturers, improved selling reach will also enhance consumption. Out top picks on the theme of enhanced consumption are **Asian Paints, Havells, TTK Prestige** and **Trent**.

Exhibit A: 11 out of 17 macro indicators lost steam in 2QFY17

No. of sectors that decelerated	4QFY16	1QFY17	2QFY17
8 Sectoral Indicators (A)	1	3	6
9 Macro Indicators (B)	3	5	5
Grand Total (A+B)	4	8	11

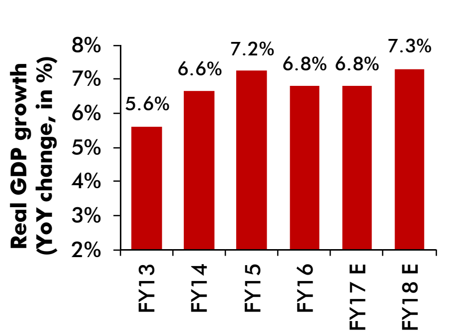
Source: CEIC, Ambit Capital research

Exhibit B: India's Keqiang Index was at an 11-quarter low in 2QFY17



Source: CEIC, Ambit Capital research

Exhibit C: India's Keqiang Index also decelerated in 2QFY17



Source: CEIC, Ambit Capital research

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Section 1: High frequency indicators suggest that the economy decelerated further in 2QFY17

Data for 2QFY17 suggests that 11 of 17 high frequency indicators lost steam in 2QFY17 compared to 1QFY17 (see exhibit below).

Exhibit 1: 11 out of 17 indicators decelerated in 2QFY17 vs 1QFY17

Indicator	Macro Indicator	YoY change in 1QFY17	YoY change in 2QFY17	Sequential Change
Passenger vehicle (PV) sales (units)	Consumption	8%	16%	8%
Two-wheeler sales (units)	Consumption	11%	14%	3%
Core WPI (Index values)	**Pricing**	**1%**	**2%**	1%
Retail credit (INR)	Consumption	18%	18%	0.2%
Rural wages (in INR)#	Consumption	5%	5%	0.1%
Non-oil bank credit (Rs.)	Investment	8%	8%	0.0%
Core CPI (Index)	**Pricing**	**5%**	**5%**	-0.1%
Bank Deposits (Rs.)	Savings	9%	9%	-0.2%
Non-oil exports (US$)	Exports	0%	-1%	-0.7%
Coal production* (Tonnes)	Investment	6%	5%	-1%
Petroleum Products Consumption (Tonnes)	Consumption	10%	8%	-2%
Cement production* (Tonnes)	Investment	6%	1%	-5%
Domestic tractor sales (Units)	Investment	15%	8%	-6%
Electricity generation (GWh)	Investment	9%	1%	-8%
Bitumen Production (Tonnes)	Investment	14%	-6%	-20%
Commercial vehicle (CV) sales (units)	Investment	15%	-6%	-21%
Revex less interest payments (Rs.)	Consumption	28%	-9%	-37%

*Source: CEIC, RBI, Ambit Capital research. Note:*Data for July and August has been averaged to arrive at the 2QFY17 number. #Data for the rural wages series is available only till May 2016.*

Furthermore, a historical analysis of these gauges suggests that the number of indicators slowing on a sequential basis hit a 6-quarter high in 2QFY17 (see exhibit below).

Exhibit 2: 11 out of 17 indicators decelerated in 2QFY17

Number of sectors which turned negative on a sequential basis	1QFY16	2QFY16	3QFY16	4QFY16	1QFY17	2QFY17
Sectoral Indicators (8 in total) (A)	3	3	2	1	3	6
Macro Indicators (9 in total) (B)	2	5	3	3	5	5
Grand Total (17 in total) (A+B)	5	8	5	4	**8**	**11**

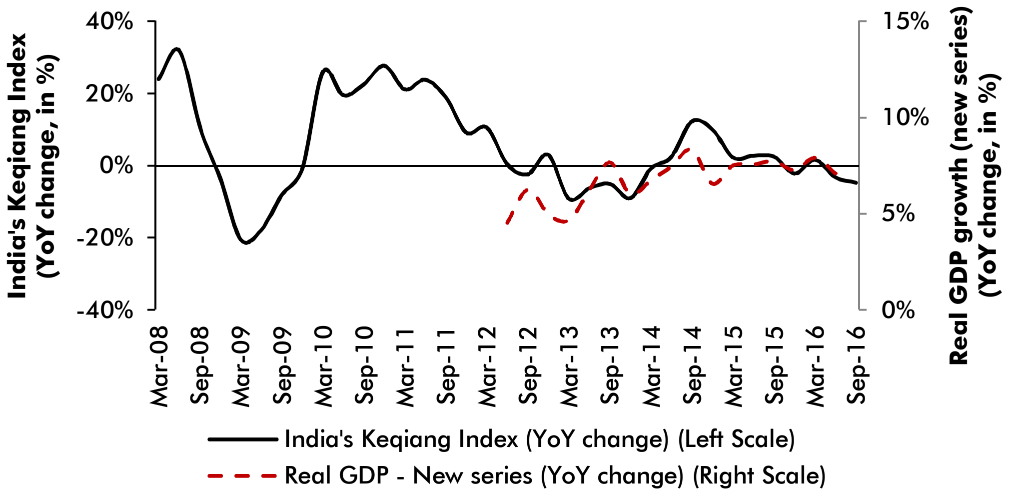
Source: CEIC, Ambit Capital research.

In specific,

- **Sectoral indicators**: 6 of 8 sectoral indicators lost momentum in 2QFY17. Sectoral indicators include passenger vehicles sales, commercial vehicle sales, two-wheeler sales, tractor sales, electricity generation, bitumen production, coal production and cement production
- **Macro indicators**: 5 of 9 macro indicators lost momentum in 2QFY17. Macro indicators include core CPI, core WPI, bank deposits, non-oil bank credit, retail credit, rural wages, petroleum products consumption, non-oil exports and revex less interest payment.

India s Keqiang Index (IKI) for 2QFY17 also suggests that the economy lost momentum in this quarter as compared to 1QFY17 (see exhibit below).

Exhibit 3: Data for 2QFY17 suggests that the IKI contracted by 4.8%, recording a 11th consecutive quarter of sequential deceleration



Source: CEIC, Ambit Capital research Note on methodology: The IKI comprises of 4 indicators namely Motor Vehicles sales, Capital goods imports, Power demand and Cargo handled at airports. These variables are identified using a regression model to maximize the adjusted R squared with the old GDP series. To arrive at the IKI, we build an equal weighted index using the four variables identified above. In the absence of capital goods' import related data beyond 4QFY14 we forecast the same by using quarterly non-oil imports data and the capital goods segment of IIP.

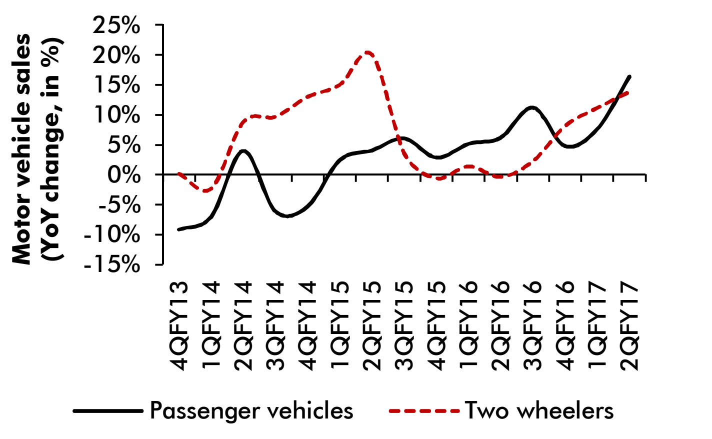
In specific, the IKI in 2QFY17 was recorded at -4.8% YoY (compared to -3.2% YoY in 1QFY17) (see exhibit above), marking an 11-quarter low in the reading of the IKI.

In terms of the thematic takeaways, three points are worth noting, namely:

Theme#1: 'Consumption' holding up relative to 'investment'

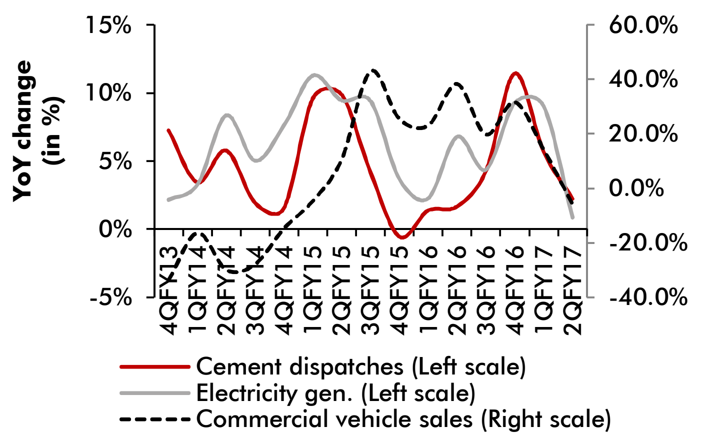
Data for 2QFY17 suggests that gauges related to consumption such as two-wheeler sales and passenger vehicle sales continue to do well (see exhibit below).

Exhibit 4: High frequency indicators relating to consumption recorded an acceleration in 2QFY17...



Source: CEIC, Ambit Capital research

Exhibit 5: ...even as investment related gauges decelerated in 2QFY17



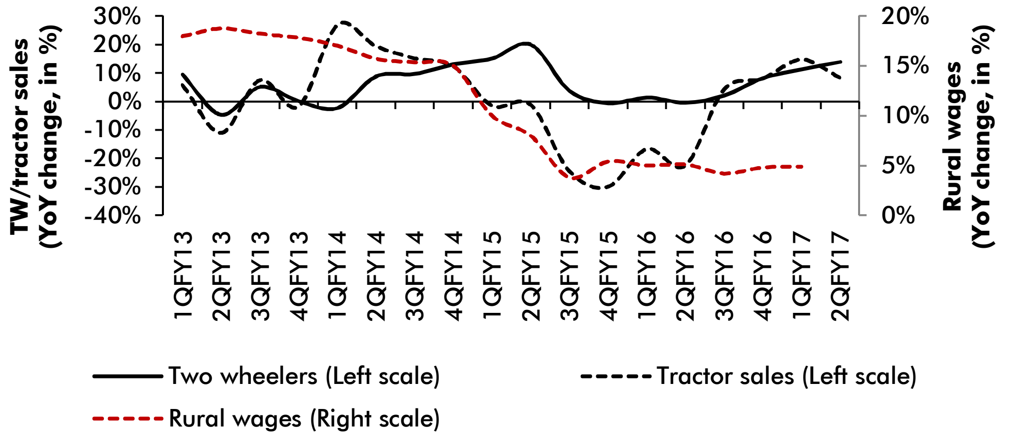
Source: CEIC, Ambit Capital research.

On the contrary, investment as a theme continued to stay under pressure as evinced by the persistent weakness in gauges like commercial vehicles sales, electricity generation and cement dispatches (see exhibit above).

Theme#2: Rural consumption shows signs of stabilizing

Within consumption, early signs of rural consumption stabilizing were evident from the fact that rural wages are bottoming out and rose by 10bps whilst two-wheeler sales rose by 300bps in 2QFY17 (see exhibit below).

Exhibit 6: Gauges related to rural consumption are showing signs of bottoming out

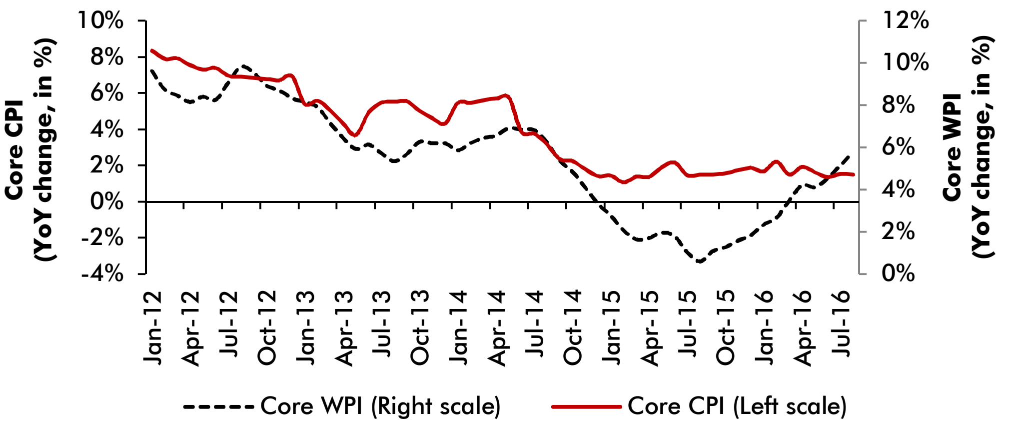


Source: TMA, Ambit Capital research.

Theme#3: Early signs of pricing power returning

Core WPI was recorded at an 8-quarter high while core CPI also inched up marginally in 2QFY17, pointing to early signs of pricing power improving in the economy (see exhibit below).

Exhibit 7: Core inflation has risen recently



Source: CEIC, Ambit Capital research

Section 2: Expect a U-shaped recovery, GDP growth likely to have bottomed-out in 2QFY17

In our note dated July 22 titled *'Economic Momentum decelerated decisively in 1QFY17'* we made the point that economic growth in FY17 will be flat compared to FY16. Specifically, we expect GDP growth in FY17 to be recorded at 6.8% YoY, i.e. unchanged from GDP growth recorded in FY16.

In our note dated October 4 titled *'M+R+T resets=Revolution in Access'*, we then made the point that, *"Whilst the M+R+T resets have been disruptive in the short run (resulting in a systematic compression in earnings growth), in this note we describe how the range of policy decisions triggered by Modi, Rajan and Technology has set off a silent revolution in 'access'"*. We further made the point that GDP growth is likely to undergo a consumption-driven improvement and we expect GDP growth in FY18 to be recorded at 7.3% YoY thereby marking a sequential acceleration of 50bps.

In the subsequent part of this section we highlight why we believe that in all probability GDP growth bottomed out in 2QFY17 and why a strictly consumption growth fuelled recovery is likely to materialize hereon even as investment growth remains under strain.

Section 2.1: Consumption growth is likely to pick-up hereon

The second half of FY17 is likely to experience stronger consumption growth than that seen thus far as:

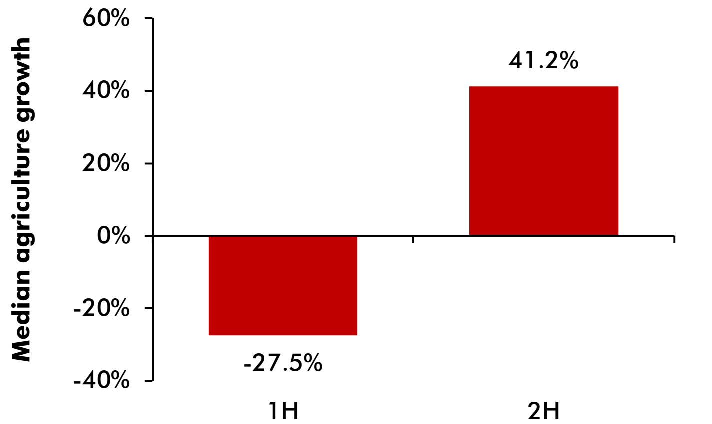
(1) Agriculture production is typically stronger in the second half of a fiscal year and there is a strong correlation between agricultural sector output and overall consumption demand. A normal monsoon after two consecutive droughts should result in higher agricultural output and should add to a mild pick-up in consumption in 2HFY17.

(2) The Seventh Central Pay Commission award will not lead to a significant increase in sale of durables such as passenger vehicles (PVs) to the extent that it did after the sixth pay commission award. However, a mild tailwind for small ticket consumption items is expected as ~16% hike in government workers salaries has been executed (excluding the effect of the allowances).

Reason#1: Agricultural sector growth is typically concentrated in 2H

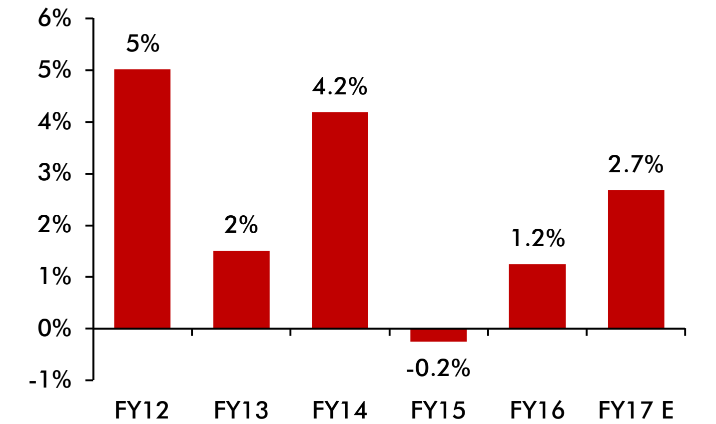
The data for agricultural sector output suggests that the agricultural production is always higher in the second half as compared to the first half since the kharif crop is harvested in 2H of a financial year (see exhibit below).

Exhibit 8: Agricultural GDP growth is typically concentrated in the second half of a financial year



Source: CEIC, Ambit Capital research. The median growth is for the period spanning FY05 to FY16.

Exhibit 9: FY17 is likely to see strong farm sector growth as it marked the first year of normal rains after two consecutive droughts

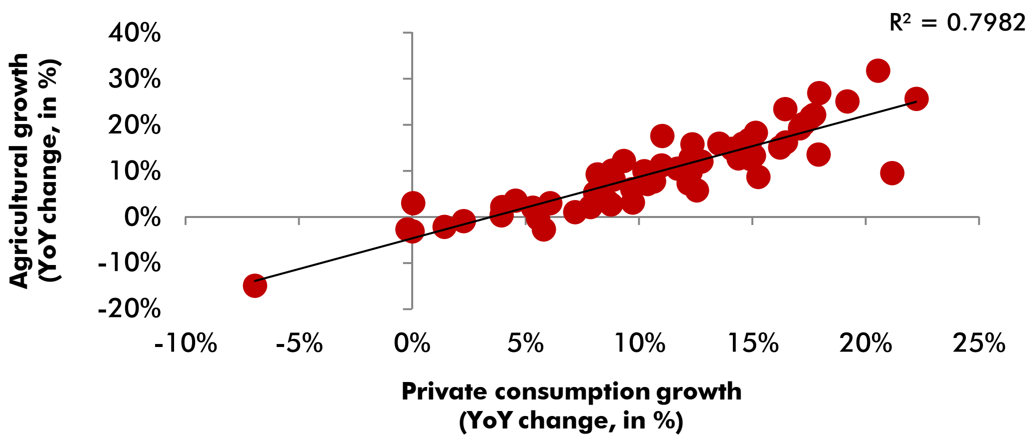


Source: CEIC, Ambit Capital research. Note: FY17 is Ambit's estimates

This dynamic is likely to be particularly material in 2HFY17 mainly because FY17 marks the first year of normal rains after two consecutive droughts.

Furthermore, agricultural production is strongly correlated to the overall consumption demand in the economy as a large proportion of the population is still dependent on agriculture for livelihood (see exhibit below).

Exhibit 10: There exists a very strong positive correlation between farm sector growth and consumption growth in India



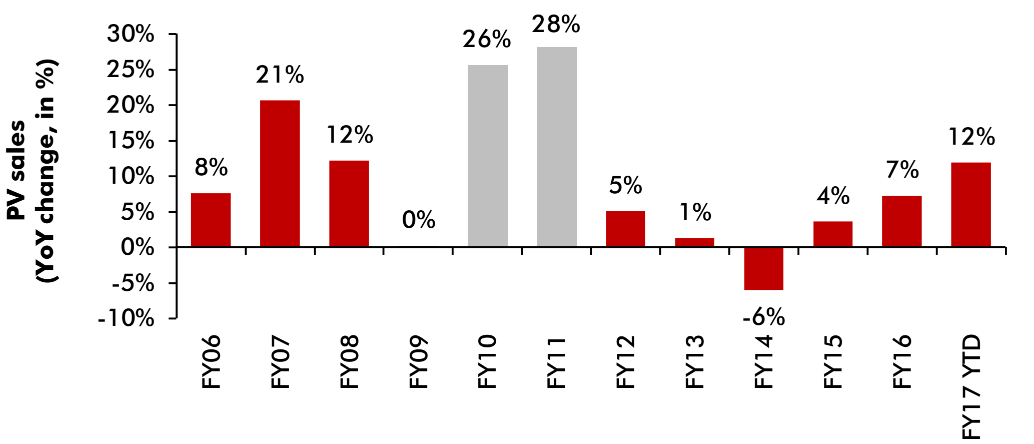
Source: CEIC, Ambit Capital research

Consequently, higher agricultural sector growth in 2HFY17 is likely to buoy consumption demand in the second half of FY17 as well.

Reason#2: Pay commission award disbursal from August 2016 will buoy consumption

As highlighted in our note dated November 20 (*click here* for the note) the sale of durables such as passenger vehicles (PVs) increased in the years that followed the implementation of the Sixth Pay Commission award in FY10 which saw the execution of a 35% pay hike for Central Government employees along with the payment of arrears for 30 months (see exhibit below).

Exhibit 11: Passenger vehicle sales increased as a result of implementation of Sixth Central Pay Commission (6CPC) award in FY09



Source: CEIC, Ambit Capital research

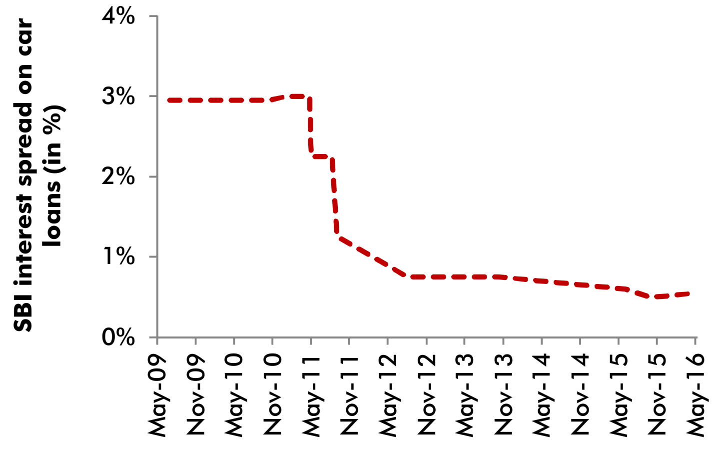
We also made the point that the implementation of the Seventh Central Pay Commission (7CPC) award is unlikely to result in such a profound impact for two sets of reasons namely:

- The hike recommended by the 7CPC amounts to an average of 23.55% compared 35% hike recommended by Sixth Pay Commission; and
- The arrears payment in FY17 will be minimal (7 months) compared to the arrear payments of 30 months paid out in FY10.

Whilst the 7CPC award is unlikely to boost consumption of durables and non-durables to the extent that it did after the 6CPC, the fact that ~16% hike in salaries has been executed (excluding the effect of the allowances) this is likely to prove to be a mild tailwind for consumption in 2HFY17.

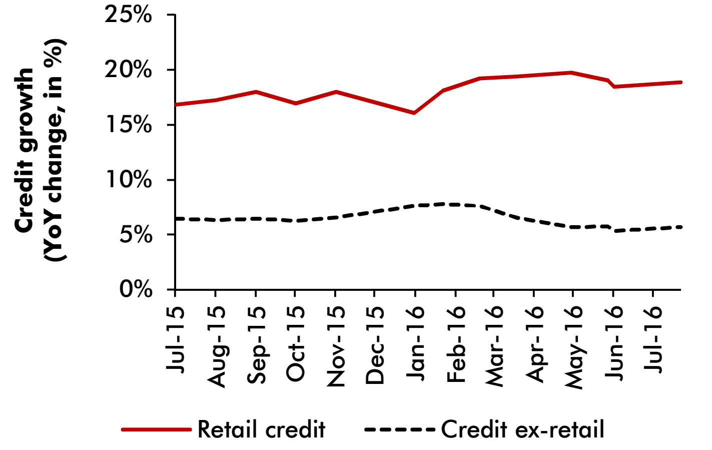
Besides these drivers of consumption growth, data with respect to the past few quarters already suggests that the cost of retail credit has been declining and retail credit growth has been rising steadily (see exhibits below).

Exhibit 12: The cost of retail credit such as that for car loans has been declining



Source: CEIC, Ambit Capital research, Note: The spread is calculated as the difference between the car loan rate offered to the consumer as against the cost of the funds for the banks.

Exhibit 13: Retail credit growth has been creeping upwards steadily since January 2016



Source: CEIC, RBI, Ambit Capital research.

From a medium-term perspective, as cost of capital falls along the lines described in our note titled M+R+T resets = A revolution in access , we are likely to see an upsurge in credit-funded consumption growth.

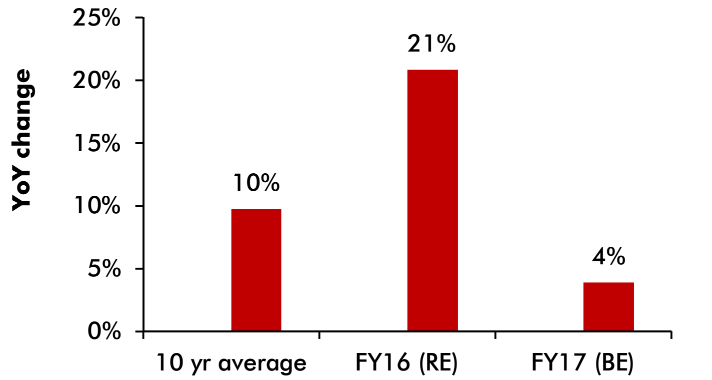
Section 2.2: Investment growth likely to stay under pressure in FY18

Even as we expect GDP growth to accelerate by 50bps in FY17, we continue to believe that the investment growth is likely to stay under pressure as (1) the Central Government has budgeted extremely low capex growth for FY17 and (2) there is no sign of a private sector investment revival.

Reason#1: Government set to go slow on capex growth in FY17 as well as in FY18

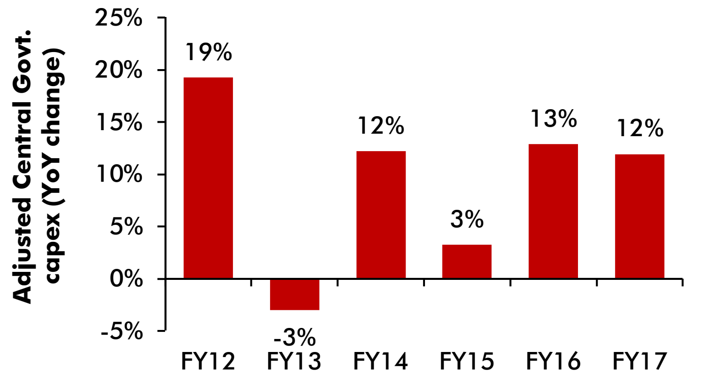
The Central Government has budgeted extremely low capex growth for FY17 as compared to FY16 (see exhibit below).

Exhibit 14: Government capex is set to decelerate significantly in FY17 from the highs seen in FY16



Source: Union Budget documents, Ambit Capital research

Exhibit 15: Even the Central Government's adjusted capex* is set to decelerate in FY17



*Source: CEIC, RBI, Ambit Capital research. *Note: 'Adjusted capex' adds the 'revenue grants given by the Centre to states which will be ultimately used for capex' back to 'Central Government capex'.*

Even after adding back revenue spends by the Government that may ultimately result in capital formation, overall capex growth is not set to accelerate but remain broadly flat (see exhibit above). Even after including the impact of off-balance-sheet capex of the Central Government (in the form of spending undertaken by the National Highways Authority of India, Indian Railways and Other PSUs), the Centre s gross capex in FY17 is set to increase by only 0.2% of GDP in FY17 compared to the 0.7% of GDP increase seen in FY16 (see exhibit below).

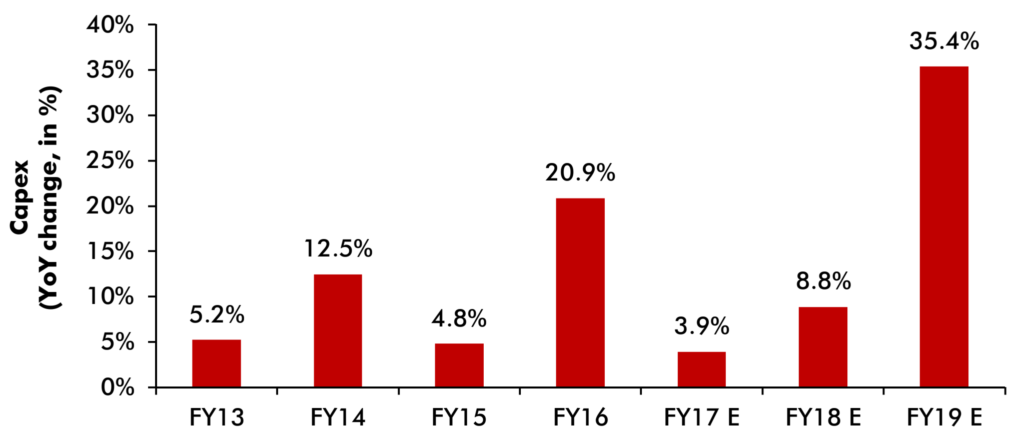
Exhibit 16: Centre's gross capex in FY17 is set to increase only by 0.2% of GDP in FY17

Aggregates as % of GDP	FY13	FY14	FY15	FY16	FY17
Adjusted Central Govt. Capex	2.8%	2.8%	2.6%	2.7%	2.7%
Highways and Railways	0.3%	0.3%	0.2%	0.6%	0.8%
Other PSU debt	2.7%	2.9%	2.4%	2.7%	2.7%
Gross central capex	5.8%	6.0%	5.2%	5.9%	6.2%
Change in gross central capex	**-0.5%**	**+0.2%**	**-0.8%**	**+0.7%**	**+0.2%**

Source: Union Budget, Ambit Capital research

According to the medium-term expenditure framework, Government capex is set to accelerate only from FY19 (see exhibit below).

Exhibit 17: Government Capital expenditure is set to increase from FY18

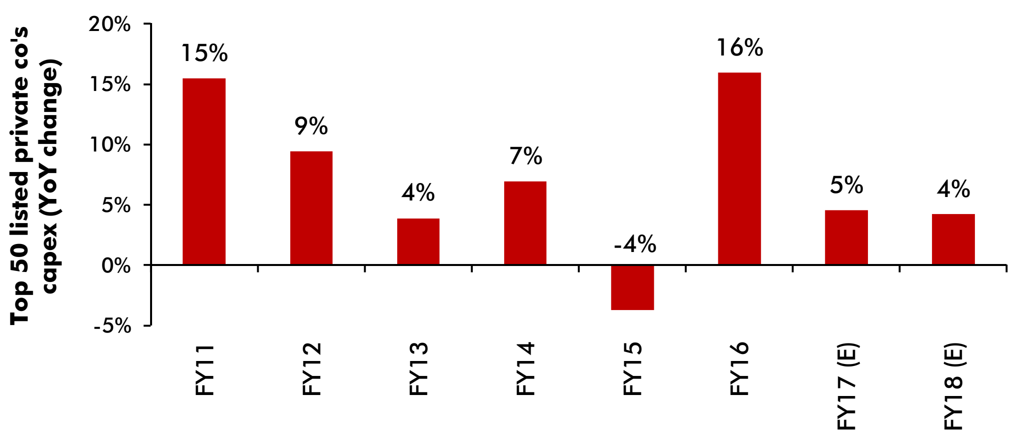


Source: Medium term expenditure framework, Ambit Capital research

Reason#2: Private sector investment likely to remain under pressure

An analysis of the consensus estimates of the top 50 listed private companies (by market-cap) suggests that the private sector will be cutting back on capex growth quite meaningfully in FY17 as well as FY18 (see exhibit below).

Exhibit 18: Private sector will be cutting down capex in FY17 and FY18

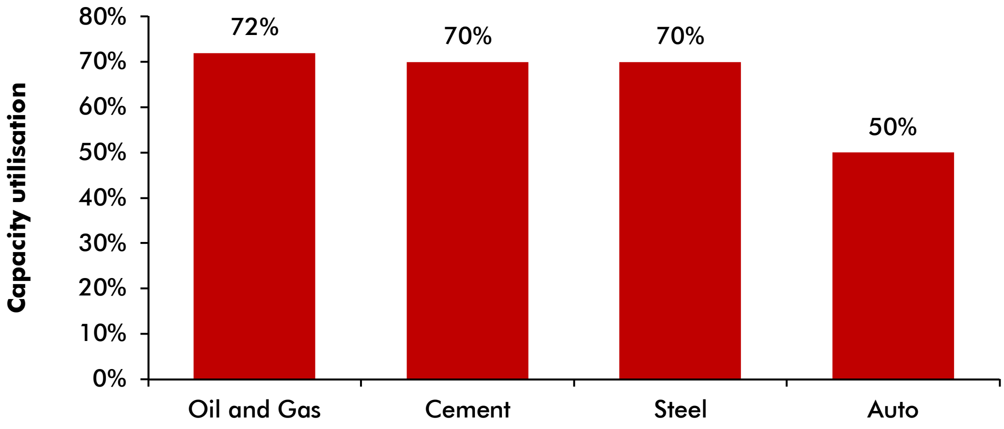


Source: Bloomberg, Ambit Capital research

Even as the sample set used here is limited, it does suggest that the private sector capex cycle is still to turn in India.

Furthermore, given that a range of sectors in India are suffering from severe overcapacity it appears unlikely that the capex cycle will turn in India anytime soon (see exhibit below).

Exhibit 15: Some of the largest sectors in India are suffering from overcapacity



Source: Source: Ambit Capital research, Note: These sectors together account for ~60% of India's industrial sector.

Section 3: Investment Implications

As highlighted above, both short-term and medium-term catalysts are likely to support consumption growth in India. In the short term, higher agricultural income in 2HFY17 fuelled by a good monsoon and the 7CPC payout being initiated in August 2016 should incrementally support consumption growth in 2HFY17. From a medium-term perspective, as cost of capital falls along the lines described in our thematic titled *"M+R+T resets= A revolution in access"*, we are likely to see an upsurge in credit-funded consumption growth. Alongside that, as access to end-consumers improves for manufacturers, improved selling reach will also enhance consumption. Out top picks on the theme of enhanced consumption are **Asian Paints, Havells, TTK Prestige** and **Trent**.

Asian Paints (APNT IN, BUY, mkt cap in $17,198bn, 6m ADV $15.8 mn, 3% upside): Asian Paints strong foundation has been built by focusing on: a) hiring top quality talent; b) using technology proactively to improve operating efficiencies; c) empowering professionals and Independent Directors on the Board in strategic decision making; and d) establishing deep-rooted relationships with dealers. Over the next two decades, labour cost would increase to 85-90% of paint project cost (from ~65% now), resulting in emergence of: (a) DIY segment for economy paints; (b) highly value-added labour involvement for premium paints; (c) upgrade formats of dealer stores. Asian Paints is successfully implementing new initiatives to lead these evolutionary trends. Asian Paints is currently trading ~10% premium to the sector median PE. We believe this premium is justified due to the firm s strong foundation and initiatives taken for the next phase of evolution in the industry. We expect the firm to deliver 18.4% revenue CAGR and 22.6% EPS CAGR over FY16-21 with ROCE improving from 33% to 36% over this period. Our DCF-based TP of Rs1,230 implies 42x FY18E P/E. For more details *(Click here)* for our 19th Aug, 2016 note.

Havells (HAVL IN, BUY, mkt cap in $4049mn, 6m ADV $10.3mn): Havells is India s largest light electricals company with 7% market share in overall light electricals category. It is the leader in the switchgear segment. It is also the third-largest player in cables & wires and fans and the fifth-largest in lighting. Given its premium brand and majority of revenues coming from premium products, Havells will benefit from upgrade in Indian consumers lifestyle. The company is also investing in next-generation, lifestyle products with automation in lighting and appliances. The company is strengthening its presence in premium consumer appliances by increasing SKUs, expanding distribution network and launching new products such as air purifiers and air coolers. Havells is trading at 31x FY18E P/E, at a meagre 4% premium to Crompton/V-Guard despite a diversified franchise, strong moats and pan-India franchise. Click here for our note dated 21 December 2015 for details.

TTK Prestige (TTKPT IN, BUY, mkt cap in $938 mn, 6m ADV $0.6 mn, 6% upside): TTK Prestige has cemented its leadership in the kitchenware industry by: (1) having a strong control on its distributor-based, pan-India channel expansion; (2) consistently investing in maintaining an aspirational brand recall; and (3) leveraging its dominance in pressure cookers to expand to cookware and appliances in the past 15 years. After the appointment of Sudeendra Koushik (from Phillips) as the head of product innovation two years ago, TTK delivered a strong pipeline of new products in its existing categories in FY16. The product innovation momentum is likely to continue over the next 5-10 years and is aimed at capitalising on: (a) lack of innovation in the pressure cooker and cookware segments in India; and (b) the potential to differentiate on product characteristics in appliances where most players import replicable products from China. With high operating leverage accorded by an increase in capacity utilisation at the Gujarat facility, we expect TTK Prestige to deliver 23% revenue CAGR and 40% EPS CAGR over FY16-19 with average ROCE of 23%. Our DCF-based TP of Rs5,660 implies 28x FY18E P/E.

Trent (TRENT IN, BUY, mkt cap in $1,114 mn, 6m ADV $0.7 mn, 0% upside): Trent will become one of India s largest women s wear and fast fashion companies (Rs20bn) in FY17E as it maximises its own brand portfolio and fast fashion brand under its JV with Inditex. Taking a cue from successful own brand global retailers which have predominantly been women-oriented, the company s strategy of building women-centric products is paying off as it realises that the size of the women s wardrobe is larger and diverse as it expands into underpenetrated regions. Also, supply chain built for design-to-product and balance sheet strength will help it penetrate deeper into the largely unorganised US$18bn women s wear market. Current multiple of 21x FY18E EBITDA is not expensive as it doesn t capture the long-term franchise (akin to what Madura built in men s wear over FY05-16) that Westside is building in the US$18bn largely unorganised but evolving women s wear market, turnaround of Star, and sustainability of the Zara JV. For more details *click here* for our note dated September 29, 2015.

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