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Q&A-"Earnings fatigue across sectors": Aditya Suresh, Macquarie



Aditya Suresh, managing editor and head of India research at Macquarie Capital, joined the Trading India forum on Friday, October 25, 2024, to share his views on Indian equity markets, quarterly earnings and recent IPOs.

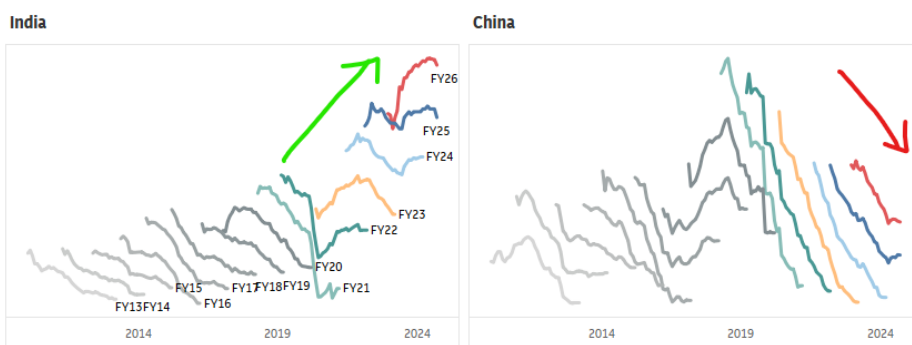
Below are edited excerpts from the conversation:

Q: With India witnessing record foreign institutional investment (FII) outflows, is there more to this selloff story than just rotation to Chinese stocks?

A: The broader backdrop is that India trades on 22 times rolling two-year forward price-to earnings (PE) versus China at under 10 times (even with the recent rally), with consensus forecasting 15% 2-year earnings-per-share growth (EPSg) of China at 11%, and 16% return on equity (ROE) for China at 12%. That said...on EPSg, India's 400 basis points (bps) 2Y forward earnings growth premium against China is in line with levels since 2010.

On ROE, India's 400 bps (basis points) premium versus China is similar to record levels seen in 2016; while India may potentially offer better quality growth, even here we see downside to the operating leverage driven by margin expansion baked in consensus -- consumer discretionary, industrials. If we zoom out, then we'd highlight earnings fatigue across sectors and downside to consensus in India. In contrast, we note low expectations in China.

Earnings Expectations (consensus)



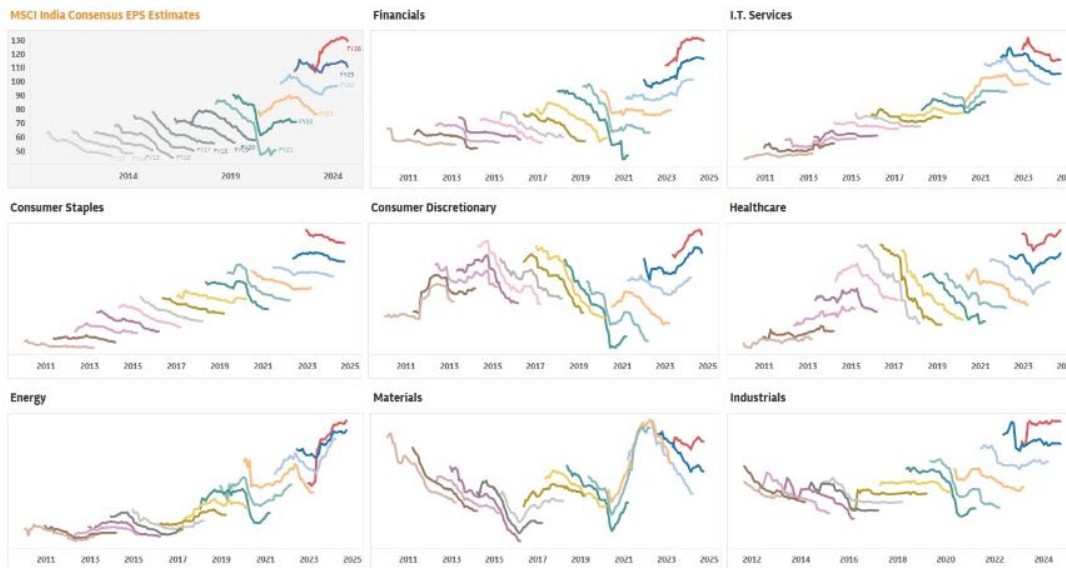
Q: Despite FII outflows, domestic institutional investors have stayed buyers, supporting the market. How do you see the interplay of FII-DII flows, and the rising prominence and domestic ownership of stocks?

A: Going back to India's rich multiple, what explains India's elevated multiple is an ongoing compression of equity risk premiums. Was this being driven by China/Emerging Markets (EM) rotation? Only mildly, as India has not seen any significant foreign fund inflows over the past three years. The main driver has been a deluge of domestic liquidity, driven by the financialisation of savings -- direct and indirect participation -- and formalisation -- pension fund allocations. Underscoring the growing equity culture in India, net flows in 2024 (annualized) by domestic investors (institutional + retail) is c.US\$75 billion. In contrast, cumulative FII net flow over past three years is -\$5

billion and as such foreign ownership is now below domestic institutional and retail combined.

Q: Do you see further correction in equities from the current levels, or a bounce-back now expected?

A: Local liquidity is a sponge to absorb drawdowns. As a market are we overstretched - absolutely.



This chart helps frame the earnings backdrop and what is already baked in consensus estimates. The problem is that at an aggregate level, consensus sees no earnings fatigue and continues to forecast a 15% two-year EPS compounded annual growth rate (CAGR) for MSCI India. These need to be revised lower.

Q: Is this moderation in earnings likely to continue, given that India does not have the advantage of a low base effect? How do you see the earnings growth, especially in IT, banks and non-banking finance companies (NBFCs) and consumer companies?

A: For financials, best of credit costs already in estimates & credit growth momentum is slowing. For consumer discretionary, look at data on auto inventory, RBI's credit card spending, commentary from HUVR etc. - clear evidence of moderation in momentum and consensus needs to cut revenue and margin assumptions -- positive operating leverage is assumed in estimates, which we don't see.

IT sector is interesting. Revenue estimates had already been trimmed. Against that we are now seeing a bottoming out of expectations and some upside to margin estimates. This sector alongside pharma have been our preferred sectors for the past few quarters.

Q: If the earnings do not justify the rich valuations in at least some parts of the small- and mid-cap segments, do you expect a reversal of fortunes, even as concerns over frothy valuations persist?

A: I think it's important to look at what is already in expectations, and it appears fundamentals don't support say the two-times premium for mid-caps over large-caps. It's important to acknowledge that these valuations are a function of local liquidity. If this holds, then sure multiples will remain elevated and India a rich bazaar.

Q: We have seen a flurry of IPO activity, but do you think the valuations are fair for investors?

A: Tapping into this - domestic demand for equity and in response to high market pricing, on the supply side, we have seen promoters, multinational corporates (MNCs) and private market investors cash in. About two-thirds of these funds raised are in the Offer for Sale (OFS) category, and effectively only 5% is explicitly earmarked for growth capital expenditure. I would only say that have a process and stick with it. India has been a great market for compounding investments over 30 years.

Q: How much of the current rates outlook do you see weighing on equities in the near-term? What are your expectations from the central bank on rates?

A: Our view is similar to current consensus; one cut of 25 bps by RBI in second half of FY25.

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