

India Strategy

Clouds loom on rural resurgence

INDIA | Strategy

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Poor monsoons have a wide ranging impact on the Indian economy. While shocks to rural GDP are becoming less pronounced with diversification of agri revenue streams (significant revenues from dairy and horticulture), their impact on inflation could be major. With Skymet predicting below-normal monsoon for 2017 (95% of Long Period Average) largely due to a potential return of El Nino (to emerge in the second half of the season), the risks of weak rural GDP growth and higher food prices stoking inflationary pressures cannot be ignored.

Despite favourable rural focus in the FY18 budget, risk of another drought (15% probability assigned by Skymet) weighs heavily on the rural resurgence theme. Following the recent rally, we turn cautious on rural discretionary plays (Hero Motorcorp, Escorts), and rural-focussed NBFCs (MMFS, Bharat Financial Inclusion), given unfavourable risk-reward. While a sluggish rural economy will impact consumption, we see limited impact on consumer staples, as their fortunes are driven more by pricing, which generally has a positive correlation with inflation.

Skymet's prediction: It has forecasted a precipitation of 95% of LPA for the monsoon season, with an error margin of (+/-5%). It has attributed 50% probability to a normal monsoon. The weather forecaster expects rainfall to weaken after July as El Nino evolves – it predicts precipitation for June at 102% LPA, for July at 94%, August at 93%, and September at 96%. It expects rainfall to worsen as the season progresses, in tandem with the effects of El Nino developing – it sees June at 20% above normal, while July and August are only at 10% above normal. In terms of spatial distribution, it anticipates below-normal rainfall over peninsular India, Maharashtra, Gujarat, parts of Madhya Pradesh, and Haryana. Eastern regions of Odisha, Jharkhand, and West Bengal could see better rainfall.

Note on accuracy: Skymet has been directionally correct in four out of the five predictions that it has made (exhibit 4). However, in temporal distribution, there has been a sharp variance in its forecasted vs. actual precipitation (especially for June) despite it getting the direction of overall precipitation correct (exhibit 5).

What to expect from a below-normal monsoon? We look at the period from 1951-2015 and find that India has experienced below-normal monsoon (95% LPA) for 21 of 65 years with an average agri GDP fall of 1.1%. For the same time period (1951-2015), the long period average of agri-GDP growth is around 2.8%. However, the picture looks more encouraging if we look at more recent history (2000-2015), indicating perhaps improving ability to handle monsoon shocks. From 2000 to 2015, India experienced below normal monsoon in eight out of 16 years, but average agri GDP growth was 0.4% (vs 2.9% average agri GDP), while CPI was 5.8%.

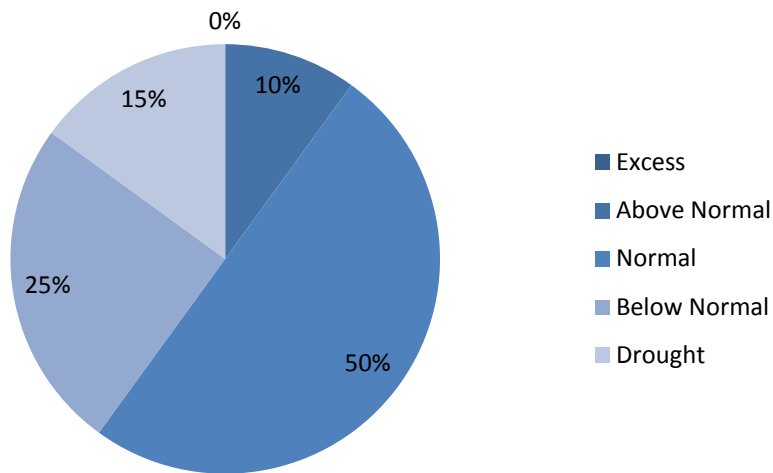
Key themes and stocks to play to ride out another weak monsoon:

1. **Cautious on rural discretionary and NBFCs.** Escorts, Hero Motocorp, Finolex cables, Mahindra & Mahindra Financial Services, Bharat Financial Inclusion, DB Corp, and HMVL
2. **Increase exposure to consumer durables on what looks like an extended summer.** Voltas will benefit from a dry and hot season.
3. **Expect further upside on consumer staples as well as dairy companies.** Traditional inflation beneficiaries like Colgate, HUL, ITC, Marico will be in focus if higher inflation scenario pans out. Dairy sector benefits in weak monsoon years as it becomes the primary source of income for many farmers. This provides better price stabilisation and helps private dairy players. Top pick: Parag Milk Foods

Aashima Mutneja, CFA
 (+91 22 66679974)
 amutneja@phillipcapital.in

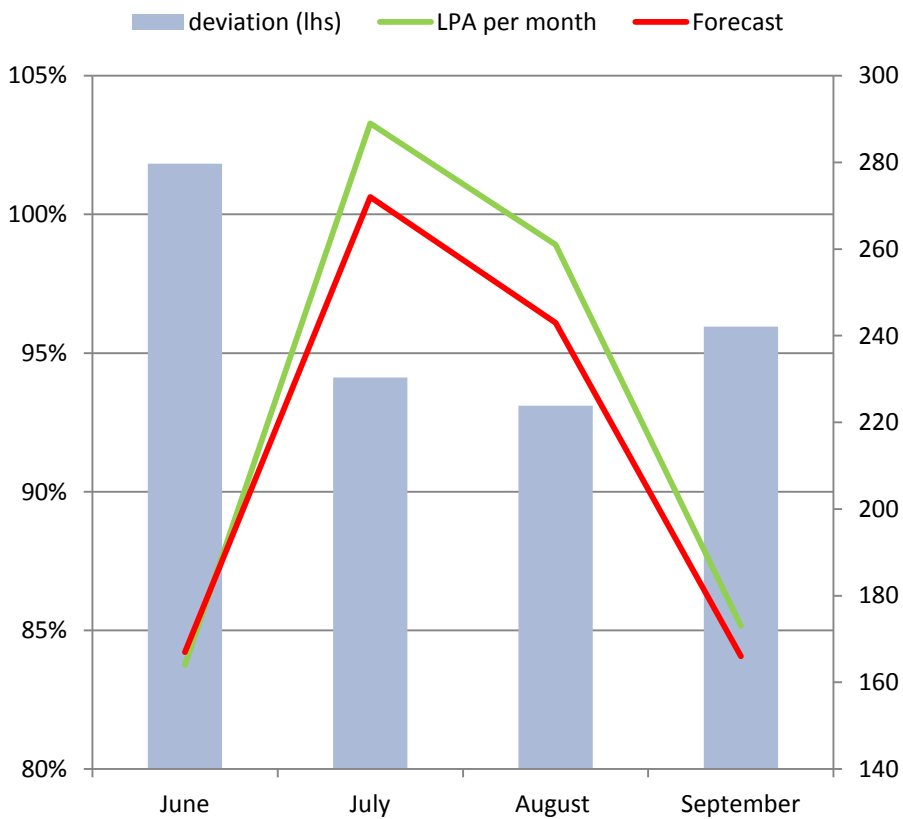
Naveen Kulkarni, CFA, FRM
 (+91 22 66679947)
 nkulkarni@phillipcapital.in

Exhibit 1: Skymet – probability distribution of scenarios for 2017 monsoon



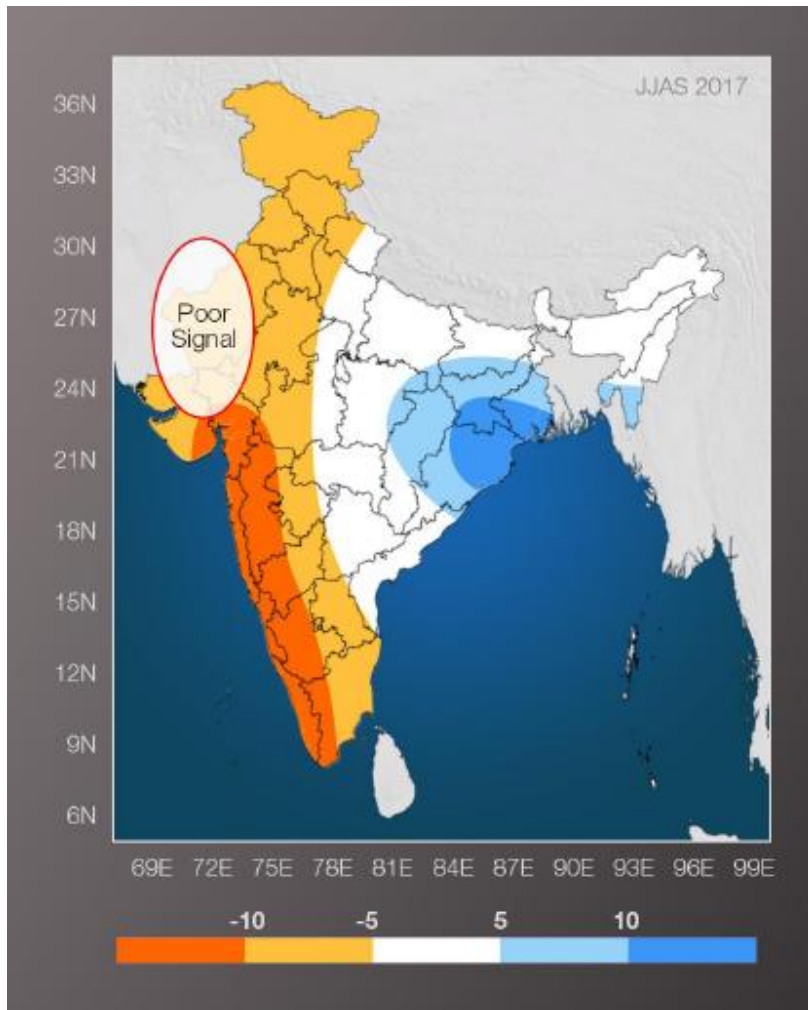
Source: Skymet, PhillipCapital Research India

Exhibit 2: Skymet – temporal distribution of 2017 monsoon



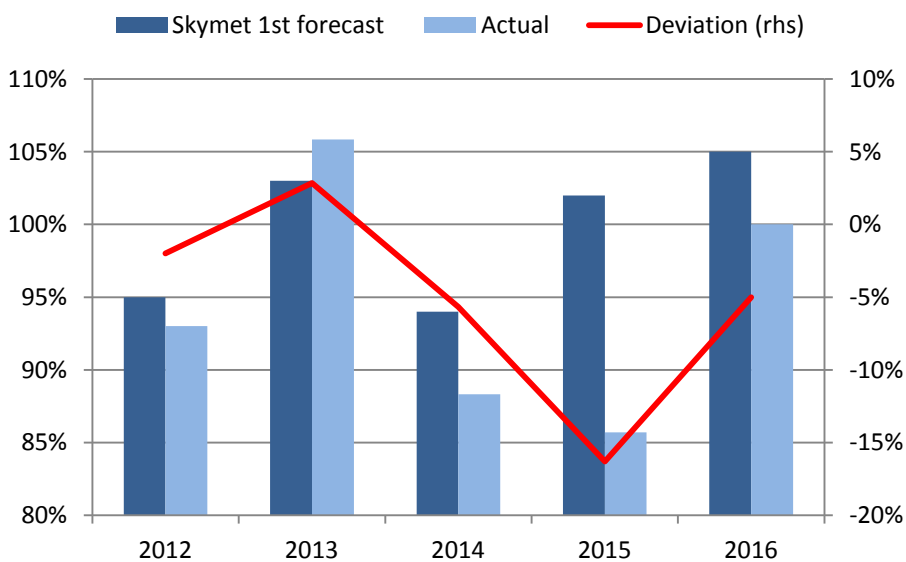
Source: Skymet, PhillipCapital Research India

Exhibit 3: Skymet – spatial distribution of 2017 monsoon

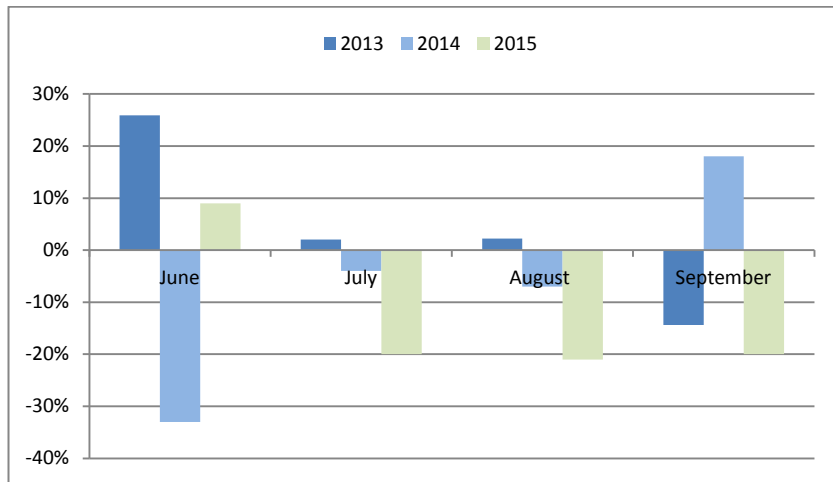


Source: Skymet, PhillipCapital Research India

Exhibit 4: Skymet – historical accuracy



Source: Skymet, PhillipCapital Research India

Exhibit 5: Skymet – historical accuracy for temporal distribution


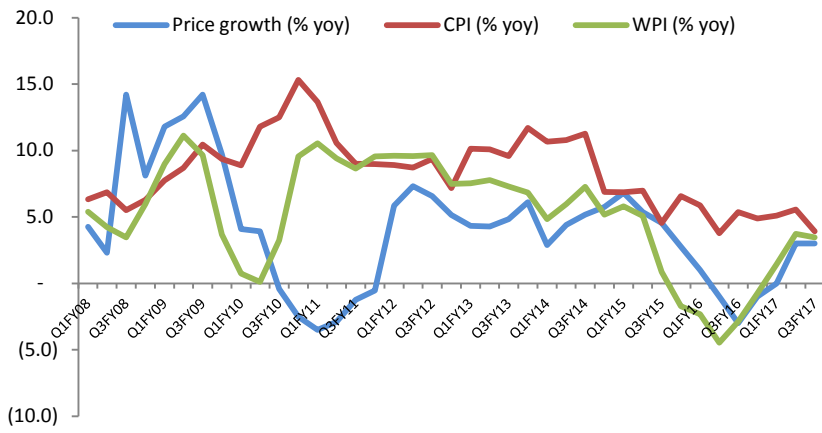
Source: Skymet, PhillipCapital Research India

Exhibit 6: Agri-GDP growth in years of below-normal monsoon

Year	India monsoon deviation (%)	Agri-GDP growth (%)
1951	-13.8	1.5
1952	-6.4	3.2
1965	-20.0	-11.0
1966	-11.0	-1.4
1968	-9.4	-0.2
1972	-23.8	-5.0
1974	-11.5	-1.5
1979	-17.8	-12.8
1982	-13.0	-0.3
1985	-6.5	0.3
1986	-9.3	-0.4
1987	-15.1	-1.6
1999	-6.5	2.7
2000	-9.9	0.0
2001	-7.1	6.0
2002	-16.4	-6.6
2004	-12.6	0.2
2009	-21.1	0.8
2012	-7.0	1.4
2014	-11.7	0.2
2015	-14.3	1.1
Mean		-1.1
Avg Agri-GDP Growth % (1951-2015)		2.8

Source: data.gov.in, RBI, PhillipCapital Research India

Exhibit 7: HUL Price hike vs. CPI/WPI (% yoy)



Source: Company, Bloomberg, PhillipCapital Research India

Model Portfolio

Model portfolio

Company	Weight	EPS (Rs)			EPS Growth (%)			P/E (x)		
		FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E
FMCG	10.0%									
HUL	2.0%	18.9	19.4	22.1	4%	2%	14%	49	47	42
Colgate Palmolive India Ltd	2.0%	22.3	22.1	25.5	9%	-1%	15%	44.5	45.0	39.0
ITC	6.0%	7.8	8.6	9.6	2%	10%	11%	36.4	33.2	29.8
Automobile	8.5%									
Maruti	3.0%	151.3	243.2	273.1	23%	61%	12%	39.6	24.6	21.9
Tata motors	3.0%	34.3	24.9	42.3	-21%	-28%	70%	13.6	18.8	11.0
Bajaj Auto	2.5%	126.2	137.3	159.3	16%	9%	16%	22.5	20.7	17.8
IT	6.0%									
Infy	6.0%	59.0	63.2	71.9	9%	7%	14%	17.5	16.3	14.4
Pharmaceuticals	6.0%									
Sun Pharma	4.0%	24.1	29.0	32.2	12%	20%	11%	28.7	23.8	21.5
Aurobindo	2.0%	35.0	40.8	50.3	24%	16%	23%	19.1	16.4	13.3
Cement	4.0%									
Ultratech	3.0%	83.3	104.5	108.3	9%	25%	4%	48.0	38.3	36.9
Dalmia Bharat	1.0%	21.5	59.1	65.8	25%	175%	11%	17.3	6.3	5.7
Metals & Mining	12.3%									
Tata Steel	3.0%	9.5	25.8	62.3	-	170%	142%	50.9	18.8	7.8
JSW Steel	2.0%	6	15	18	-25%	160%	24%	32	12	10
Hindalco	2.0%	3.8	13.8	16.6	-72%	265%	21%	51.1	14.0	11.6
NTPC	3.3%	12.4	12.1	13.6	21%	-2%	12%	13.3	13.6	12.1
Vedanta	2.0%	10.6	21.2	27.9	4%	101%	31%	25.9	12.9	9.8
Industrial	4.0%									
L&T	2.0%	44.9	62.1	72.1	-5%	38%	16%	34.9	25.2	21.7
NCC	2.0%	4.3	4.4	6.2	112%	2%	43%	19.1	18.7	13.1
Finance	33.3%									
Axis bank	4.0%	34.5	12.7	18.9	11%	-63%	49%	14.5	39.5	26.5
indusInd bank	3.0%	38.4	49.7	64.3	13%	29%	29%	36.8	28.4	22.0
SBI	4.5%	14.9	5.0	11.8	-35%	-66%	136%	19.7	58.6	24.8
Cholamadamam Fin	2.5%	36.4	47.9	60.3	20%	32%	26%	26.8	20.3	16.2
HDFC Ltd	5.0%	44.9	46.6	51.3	16%	4%	10%	33.8	32.6	29.6
LIC Housing Finance	2.0%	32.9	38.1	41.2	20%	16%	8%	18.9	16.3	15.1
HDFC bank	6.0%	48.6	57.9	69.9	19%	19%	21%	29.4	24.7	20.5
ICICI Bank	6.3%	16.7	14.6	12.2	-13%	-13%	-16%	16.9	19.3	23.1
Oil & Gas	5.0%									
Reliance Industries	5.0%	92.3	96.3	78.3	15%	4%	-19%	13.7	13.1	16.1
Telecom	9.5%									
Bharti Infratel	2.0%	12.6	14.3	15.4	19%	13%	8%	26.5	23.4	21.6
Bharti Airtel	3.0%	9.8	9.4	14.4	-35%	-4%	54%	35.2	36.7	23.9
Dish TV	2.0%	6.6	2.6	3.6	-	-61%	41%	16.1	41.5	29.5
Zee Entertainment	2.5%	9.5	11.2	15.9	10%	18%	42%	56.1	47.5	33.5
Others	1.5%									
Tata Comm	1.5%	8	5	14	105%	-36%	177%	94.5	146.9	53.0

Source: PhillipCapital India Research Estimates

Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	>= +15	Target price is equal to or more than 15 of current market price
NEUTRAL	-15 > to < +15	Target price is less than +15 but more than -15
SELL	<= -15	Target price is less than or equal to -15.

Management

Vineet Bhatnagar (Managing Director)	(91 22) 2483 1919
Kinshuk Bharti Tiwari (Head – Institutional Equity)	(91 22) 6246 4101
Jignesh Shah (Head – Equity Derivatives)	(91 22) 6667 9735

Research

Automobiles	IT Services	Pharma & Specialty Chem
Dhawal Doshi (9122) 6246 4128	Vibhor Singhal (9122) 6246 4109	Surya Patra (9122) 6246 4121
Nitesh Sharma, CFA (9122) 6246 4126	Shyamal Dhruve (9122) 6246 4126	Mehul Sheth (9122) 6246 4123
Banking, NBFCs	Infrastructure	Strategy
Manish Agarwalla (9122) 6246 4125	Vibhor Singhal (9122) 6246 4109	Naveen Kulkarni, CFA, FRM (9122) 6246 4122
Pradeep Agrawal (9122) 6246 4113		Aashima Mutneja, CFA (9122) 6667 9764
Paresh Jain (9122) 6246 4114		Telecom
Consumer & Retail	Logistics, Transportation & Midcap	Naveen Kulkarni, CFA, FRM (9122) 6246 4122
Naveen Kulkarni, CFA, FRM (9122) 6246 4122	Vikram Suryavanshi (9122) 6246 4111	Manoj Behera (9122) 6246 4118
Jubil Jain (9122) 6246 4117	Media	Technicals
Preeyam Tolia (9122) 6246 4129	Manoj Behera (9122) 6246 4118	Subodh Gupta, CMT (9122) 6246 4136
Cement	Metals	Production Manager
Vaibhav Agarwal (9122) 6246 4124	Dhawal Doshi (9122) 6246 4128	Ganesh Deorukhkar (9122) 6667 9966
Economics	Yash Doshi (9122) 6246 4127	Editor
Anjali Verma (9122) 6246 4115	Mid-Caps & Database Manager	Roshan Sony 98199 72726
Shruti Bajpai (9122) 6246 4135	Deepak Agarwal (9122) 6246 4112	Sr. Manager – Equities Support
Engineering, Capital Goods	Oil & Gas	Rosie Ferns (9122) 6667 9971
Jonas Bhutta (9122) 6246 4119	Sabri Hazarika (9122) 6667 9756	
Vikram Rawat (9122) 6246 4120	Sales & Distribution	
Sales & Distribution	Ashvin Patil (9122) 6246 4105	Corporate Communications
Shubhangi Agrawal (9122) 6246 4103	Shubhangi Agrawal (9122) 6246 4103	Zarine Damania (9122) 6667 9976
Kishor Binwal (9122) 6246 4106	Kishor Binwal (9122) 6246 4106	
Bhavin Shah (9122) 6246 4102	Bhavin Shah (9122) 6246 4102	
Ashka Mehta Gulati (9122) 6246 4108	Ashka Mehta Gulati (9122) 6246 4108	
Archan Vyas (9122) 6246 4107	Archan Vyas (9122) 6246 4107	
	Execution	
	Mayur Shah (9122) 6667 9945	

Contact Information (Regional Member Companies)

SINGAPORE: Phillip Securities Pte Ltd
250 North Bridge Road, #06-00 Raffles City Tower,
Singapore 179101
Tel : (65) 6533 6001 Fax: (65) 6535 3834
www.phillip.com.sg

JAPAN: Phillip Securities Japan, Ltd
4-2 Nihonbashi Kabutocho, Chuo-ku
Tokyo 103-0026
Tel: (81) 3 3666 2101 Fax: (81) 3 3664 0141
www.phillip.co.jp

THAILAND: Phillip Securities (Thailand) Public Co. Ltd.
15th Floor, Vorawat Building, 849 Silom Road,
Silom, Bangrak, Bangkok 10500 Thailand
Tel (66) 2 2268 0999 Fax: (66) 2 2268 0921
www.phillip.co.th

UNITED STATES: Phillip Futures Inc.
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel (1) 312 356 9000 Fax: (1) 312 356 9005

MALAYSIA: Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3, Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450 Kuala Lumpur
Tel (60) 3 2162 8841 Fax (60) 3 2166 5099
www.poems.com.my

INDONESIA: PT Phillip Securities Indonesia
ANZ Tower Level 23B, Jl Jend Sudirman Kav 33A,
Jakarta 10220, Indonesia
Tel (62) 21 5790 0800 Fax: (62) 21 5790 0809
www.phillip.co.id

FRANCE: King & Shaxson Capital Ltd.
3rd Floor, 35 Rue de la Bienfaisance
75008 Paris France
Tel (33) 1 4563 3100 Fax : (33) 1 4563 6017
www.kingandshaxson.com

AUSTRALIA: PhillipCapital Australia
Level 37, 530 Collins Street
Melbourne, Victoria 3000, Australia
Tel: (61) 3 9629 8380 Fax: (61) 3 9614 8309
www.phillipcapital.com.au

INDIA: PhillipCapital (India) Private Limited

No. 1, 18th Floor, Urmi Estate, 95 Ganpatrao Kadam Marg, Lower Parel West, Mumbai 400013
Tel: (9122) 2300 2999 Fax: (9122) 6667 9955 www.phillipcapital.in

HONG KONG: Phillip Securities (HK) Ltd
11/F United Centre 95 Queensway Hong Kong
Tel (852) 2277 6600 Fax: (852) 2868 5307
www.phillip.com.hk

CHINA: Phillip Financial Advisory (Shanghai) Co. Ltd.
No 550 Yan An East Road, Ocean Tower Unit 2318
Shanghai 200 001
Tel (86) 21 5169 9200 Fax: (86) 21 6351 2940
www.phillip.com.cn

UNITED KINGDOM: King & Shaxson Ltd.
6th Floor, Candlewick House, 120 Cannon Street
London, EC4N 6AS
Tel (44) 20 7929 5300 Fax: (44) 20 7283 6835
www.kingandshaxson.com

SRI LANKA: Asha Phillip Securities Limited
Level 4, Millennium House, 46/58 Navam Mawatha,
Colombo 2, Sri Lanka
Tel: (94) 11 2429 100 Fax: (94) 11 2429 199
www.ashaphillip.net/home.htm

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Registered office: No. 1, 18th Floor, Urmi Estate, 95 Ganpatrao Kadam Marg, Lower Parel West, Mumbai 400013