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Q1FY23 REVIEW

17 August 2022

Cost pressures behind us

- **Nifty 200 earnings were moderately below consensus, with only 40% of companies delivering a beat in Q1FY23**
- **India's market outlook is robust but could be swayed by global headwinds given heightened slowdown risks in China, EU and the US**
- **We maintain our conservative investment approach and remain positive on retail-focused lenders, staples and IT in the near term**

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Nifty 200 income still impacted by cost pressures: Nifty 200 companies were able to beat consensus revenue expectations by 4.2%, but their net income missed estimates by 3.1% in Q1FY23. In all, 42% of the companies reported revenue above consensus expectations (31% in Q4FY22). At the PAT level, 40% were ahead of consensus (38% in Q4) whereas 42% fell short (38% in Q4).

Robust growth in NSE universe revenue: Overall revenue for the NSE listed universe grew 39% YoY and 4% QoQ. Growth was led by the energy (74% YoY), utilities (60%) and consumer discretionary (43%) sectors, while healthcare (5%) and financials (12%) lagged. At the net profit level, real estate (152%) and consumer discretionary led (111%) outperformed. Cost pressures remained high with surging prices of raw materials, finished goods, power and fuel, but we believe input costs as a percentage of revenue likely peaked in Q1FY23. Wage expense appears to have stabilised and freight cost declined sharply.

Sector summary: The **life insurance** sector saw robust growth in premium with higher VNB (value of new business) margins. **Consumer durables** faced both demand and margin headwinds. High-cost inventory clouds the near-term outlook, but the festive season and good monsoons could provide a silver lining. Our **pharma** coverage reported muted growth on a high base. In **building materials,** demand varied across home decor segments, but margin pressure was visible across the board due to higher gas and timber costs. **Energy** and **commodity** companies had mixed results, while **banks** finally began focusing on growth as asset quality concerns abated. **FMCG** had a modest volume uptick and **IT** posted steady growth.

Investment view: We believe India is better placed than most peers amid the global volatility, though a meaningful capex cycle is still a few quarters away. Given that the Nifty 50 valuation has gradually inched back to +1SD from its 5Y mean, the upside from current levels looks limited. In our view, a conservative approach will serve investors better through CY22. We remain constructive on retail-focused lenders, consumption and IT sectors – the latter due to good earnings visibility and moderate valuations. We are cautious on energy and utilities, and largely neutral on other sectors.

Reporting season trends

India Q1FY23	QoQ (%)	YoY (%)
Net Sales	3.8	38.6
Raw materials	12.8	68.3
Salaries & wages	3.7	13.4
Interest expenses	4.7	7.5
Net profit	(14.6)	20.5
Q1FY23 Surprise	**Revenue (%)**	**Income (%)**
Weighted	4.2	(3.1)
Average	5.7	0.5

Source: Bloomberg, BOBCAPS Research

Q1FY23: Sector-wise review

Automobiles

The 1QFY23 earnings performance of the companies in the auto sector was steady though margins weakened YoY. However, this was factored owing to the shortage of chips and cost escalation. The volume growth was very strong given the lower base and was well supported by realisations effectively translating into better revenues. The cost escalation however kept the margins under check despite steady EBITDA gains. Despite the same the management commentary suggests the situation steadily normalizing and the companies are building up inventory to gear up for the festive season after 2 years (hit due to COVID-19). 2HFY23 is expected to be very healthy and may help the auto sector to recover and deliver YoY growth. Normal monsoon and steady health atmosphere are the key assumption for the same.

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Insurance

Q1FY23 saw private market leaders in the life insurance sector (**SBILIFE** and **HDFCLIFE**) as well as LIC clocking premium growth of 20% YoY. VNB margins expanded as the companies aimed to build a balanced and profitable product mix. Non-par businesses, especially the sale of annuity products, gathered momentum. However, many players struggled with retail protection as higher premiums and stricter underwriting standards exacted a toll on growth. The Covid-19 claims for most private players were low and should remain so assuming no further pandemic waves.

Opex ratios remained elevated owing to greater efforts to increase business. Persistency ratios across the 13th-month and 61st-month cohorts improved for major life insurers in Q1FY23 vs. Q1FY22. Although bancassurance remains significant in the overall distribution mix, Q1FY23 saw increased traction from the agency channel with major insurers stating that agents aren't averse to selling non-par products.

The IRDA's proposal to allow life insurers to sell health insurance policies has been welcomed by life insurers because they are well equipped to sell these types of products, as was undertaken historically till FY15.

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Cement

The earnings performance was expectedly weaker for the cement sector with EBITDA margins and EBTIDA/tn softening by an average of ~500bps/Rs400 YoY. The revenues grew steadily backed by realization gains (~3-5%) however volume growth was disproportionate largely due to pandemic hit weak base. The pressure further mounted on the cost structure (inflation of 15-20% on cost/tn YoY) from energy cost and logistic cost. Limited -pass through opportunities and inflated cost impacted earnings in 1QFY23. 2Q will be worst hit as prices have weaken (QoQ) and the cost escalation will continue at least for 1quarter. Moderation is expected from 3Q when the effect of cost inflation (energy cost) will taper following the softening of pet coke prices. JK Cement and Star cement were relatively better performers.

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Consumer Durables

Consumer durables companies witnessed animated demand in April followed by a gradual slowdown from mid-May. Management commentaries across the board cited June as the worst of both worlds, with inflation stifling demand and raw material costs soaring. Anticipating strong demand in Q1FY23, most companies had stocked inventory, as evidenced from their elongated working capital cycles. Hence, much of Q2 will be spent liquidating this high-cost inventory before relief on input costs begins to reflect on margins from Q3FY23.

Moving forward, with softening raw material costs eliminating the need for further price hikes, companies are looking to festive demand in August and September as a means to liquidate their high-cost inventories. We have maintained ratings on our durables coverage post Q1, with the exception of **VOLT** (moved from BUY to HOLD). Our top picks are **HAVL**, **CROMPTON**, **POLYCAB** and **DIXON**. For details, see our Q1FY23 Review: **A bumpy quarter**.

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Metals & Mining

Steel majors: Q1FY23 earnings beat consensus on below-anticipated margin declines. Players are guiding for a weaker Q2 due to margin compression but, more importantly, are looking at recovery over H2FY23. We have a constructive view on the sector as we expect margins to stabilise over H2 with recovery in Chinese demand. Looking to FY24-FY26, the Indian steel industry is poised to deliver volume-driven earnings growth as competitive brownfield expansion projects come onstream. We prefer **TATA** for its ability to capture higher margins through its integrated model. We also have a positive view on **JSP** given its higher exposure to the Indian infrastructure sector.

Base metal players: Q1 results reflected softer margins on the back of high energy cost inflation. Management guidance suggests a peaking out of costs in Q2 as companies consume higher cost raw material inventory. Alcoa's commentary suggests support for current aluminium prices with the global market likely remaining in deficit in CY22 and prices already dipping in the cost curve. The longer-term structural demand-supply gap remains intact with slow progress on new capacity (see our report: **Read-across from Alcoa results**).

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Oil & Gas

RIL – multiple catalysts ahead: While **RIL** missed consensus on Q1FY23 net income and will likely have its refining upside capped by ad hoc revisions from Q2, we see key upside triggers from its roadmap for the new energy business, upcoming digital/retail listing and planned 5G rollout.

OMCs – return to healthy profit needs pullback in crude price: Oil marketing companies (OMC) have once again underperformed consensus in Q1 as losses due to capped fuel prices outweighed the gains on refining. Near-term, the best-case scenario for OMCs will be to cover the high costs. Medium-term, we expect margins to return to the healthy zone as consumer acceptance of current elevated petrol/diesel prices should allow OMCs to remain profitable even at oil prices of ~US$ 90/bbl.

CGD – received policy support for structural volume growth: Q1 results reflected the ability of city gas distribution (CGD) companies to pass on the increase in natural gas prices. Further, to maintain competitiveness in the priority segment against the backdrop of higher spot LNG prices, the sector has received policy support in the form of larger allocation of cheaper administered price mechanism (APM) gas. Listed CGD players have also tied up some form of term contract to lower the impact of soaring gas purchase costs. Volume growth for the key compressed natural gas (CNG) segment so far remains supported by pickup in momentum in commercial segments, the launch of new CNG models by OEMs, and expanding CGD infrastructure in the country.

Upstream – earnings supported by high oil and gas prices: Q1 earnings were backed by the surge in oil and gas prices. While windfall taxes on crude limited the upside, companies are still likely to pocket healthy realisations of US$ 70-80/bbl while oil price remains elevated. Another domestic gas price hike is due on 1 Oct 2022, though the risk remains that the upside will be capped by the introduction of a floor-cap mechanism to limit the adverse impact on consumer industries.

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Pharmaceuticals

Our pharma coverage reported muted topline growth of 4.4% YoY (+3.6% QoQ) in Q1FY23 due to a high base of last year in the domestic business (contribution of Covid-led products) and price erosion in the US business. Companies such as **AJP** (+27% YoY), **LAURUS** (+20% YoY) and ERIS (+14% YoY) were outliers, posting strong growth during the quarter. For US-focused players, falling prices continued to depress US business performance as well as gross margins.

Aggregate US revenue declined 6.7% QoQ for our coverage, whereas domestic business grew 12.8% QoQ (flat YoY due to high Covid base) led by DRRD and ERIS. Elevated input and overhead costs due to sustained inflation in raw material, solvent, logistic and power & fuel prices resulted in aggregate EBITDA margin contraction of 540bps YoY, marked by significant slippages for LPC (-17ppt), ALPM (-16ppt) and **ALKEM** (14ppt). On the net profit front, our coverage universe posted a 14% YoY decline (+23% QoQ), wherein LPC and ALPM reported losses while ALKEM and CIPLA reported declines of 73% and 26% YoY respectively.

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Mid-caps

Q1 is generally a soft quarter for the building materials sector, but owing to the low base of last year due to Covid-19, all companies under our coverage reported solid results on a YoY basis. Demand varied across home decor segments, but margin pressure was visible across the board due to increased input costs for tiles (gas) and wood panels (timber). In the plastic pipes business, plunging PVC prices caused inventory losses.

In terms of product segments, wood panels continued to outperform, partly due to strong growth in the MDF (medium density fibreboard) segment. Although MDF margins did cool off QoQ, they were still far higher than the historical average. Cost inflation continued to weigh on producers as prices of key raw materials (mainly timber, nitrogenous chemicals) remained elevated. To offset this, plywood and particle board manufacturers announced price hikes in Jun'22. Smaller and unorganised players continue to face pressure from raw material cost inflation, logistics costs, demand volatility and working capital issues, which should aid sustained market share gains for larger players in the near term.

In the tiles business, unorganised players in Morbi (Gujarat) faced weak demand and subdued exports, forcing them to undertake shutdowns, thus vacating the domestic market for companies such as **KJC** and **SOMC**. Demand remained buoyant for branded tile players, resulting in better pricing given the favourable industry dynamics. High gas prices hit the unorganised segment hard, with organised players better able to mitigate the impact via appropriate pricing action.

In the sanitaryware segment, consistent price hikes (to mitigate cost inflation) aided by strong retail demand and a better product mix led branded sanitaryware companies to post a strong topline, sequential improvement in gross margin and market share gains during Q1.

In PVC pipes, demand from the real estate/plumbing segments continued to hold up, but margins in the agricultural pipe business were washed out by inflation. Further, though PVC availability has increased after removal of anti-dumping duty, the volatility in raw material prices and the ability to absorb both inventory losses and higher working capital needs gives large players an edge. The decline in PVC resin prices by 14% QoQ on an absolute basis and 4% QoQ on average has cramped gross margins during the quarter. Also, pipe companies had witnessed inventory gains in the corresponding quarter last year, the absence of which dented profitability YoY in Q1FY23.

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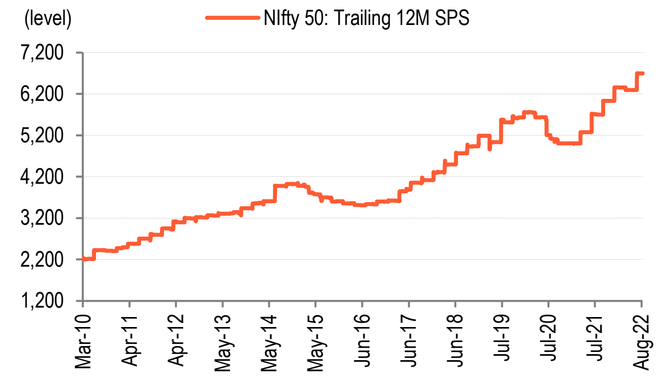
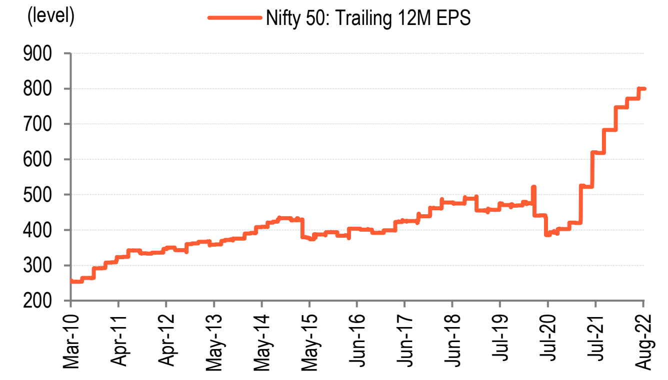
Fig 1 – Nifty 50: Sales per share



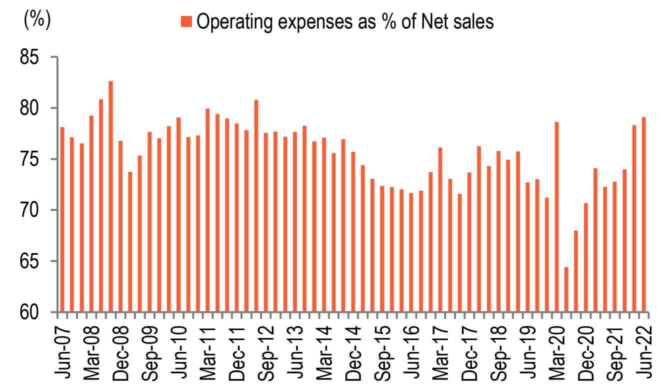
Source: Bloomberg, BOBCAPS Research

Fig 2 – Nifty 50: Earnings per share



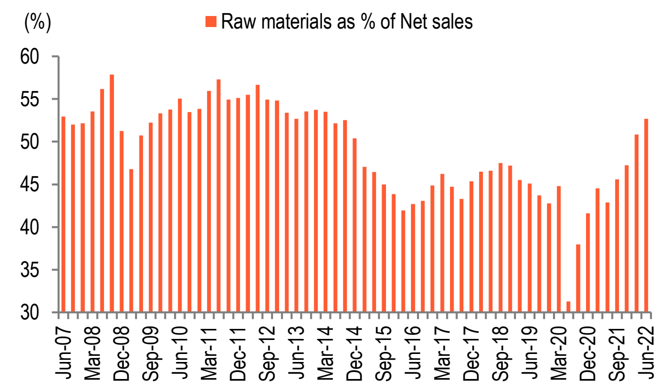
Source: Bloomberg, BOBCAPS Research

Fig 3 – Operating expenses continue to rise…



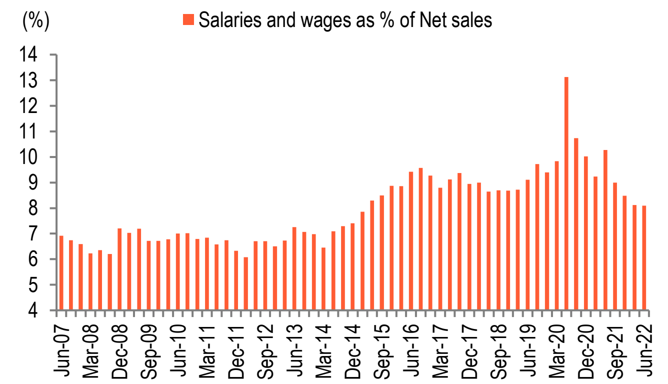
Source: CMIE, BOBCAPS Research | EN = Energy, UT= Utilities, MT=Materials

Fig 4 – …as raw material cost remains elevated



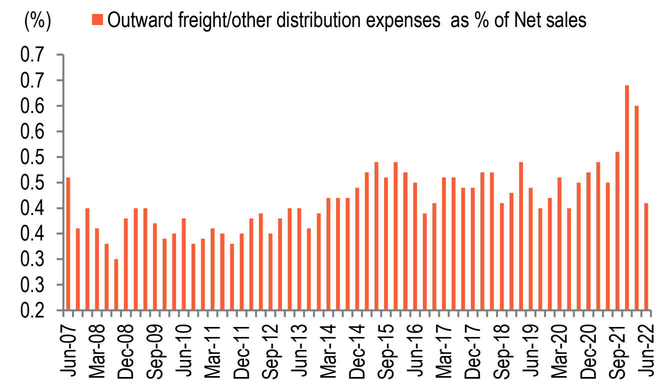
Source: CMIE, BOBCAPS Research | ID=Industrials, IT= Information Technology, RE= Real Estate

Fig 5 – Salary and wage cost appears to have stabilised



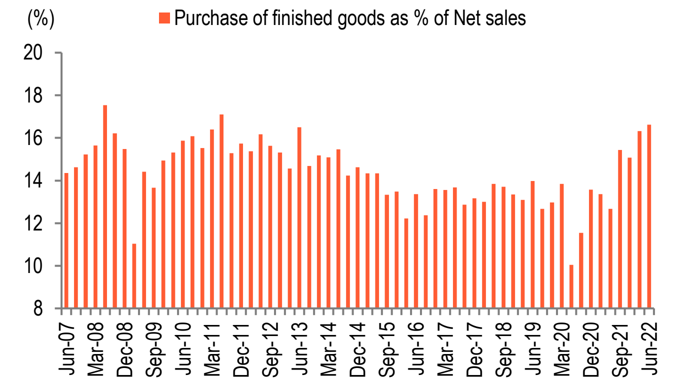
Source: BOBCAPS Research, CMIE

Fig 6 – Freight cost declined sharply



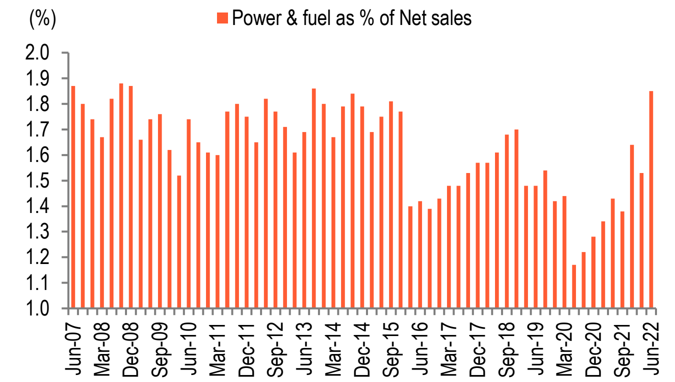
Source: BOBCAPS Research, Bloomberg

Fig 7 – Cost of finished goods remains high



Source: CMIE, BOBCAPS Research

Fig 8 – Power and fuel cost increased sharply



Source: CMIE, BOBCAPS Research

Fig 9 – Q1FY23: Beats and misses – NSE 200 by aggregates

Sector	# Cos	Mkt Cap (Rs bn)	Reported	% Mcap reported	Reported (Rs bn)		Consensus Estimate (Rs bn)		Weighted Q1 Beat (%)		Average Q1 Beat (%)	
					Revenue	Income	Revenue	Income	Revenue	Income	Revenue	Income
Financials	44	31,041	44	100	3,425	537	3,211	529	6.7	1.6	4.7	0.2
Information Technology	14	11,750	14	100	1,408	237	1,399	249	0.6	(4.8)	0.4	(0.3)
Energy	8	9,234	8	100	7,729	275	7,793	374	(0.8)	(26.5)	0.6	(30.7)
Materials	26	9,469	26	100	3,209	327	3,038	289	5.6	13.2	6.6	17.0
Consumer Discretionary	27	8,404	27	100	980	85	973	92	0.8	(8.1)	4.5	3.3
Consumer Staples	15	8,746	15	100	732	112	637	105	14.9	6.4	15.5	11.5
Industrials	21	6,213	21	100	1,275	64	1,092	66	16.7	(3.4)	6.0	(13.9)
Health Care	22	4,668	22	100	517	74	520	74	(0.6)	0.2	(1.6)	(16.4)
Communication Services	7	2,353	7	100	476	34	470	50	1.2	(32.4)	4.7	(12.2)
Utilities	12	5,173	12	100	1,242	139	1,012	115	22.7	21.3	21.5	29.3
Real Estate	4	526	4	100	45	11	43	13	5.1	(12.1)	(0.3)	(1.8)
Total	**200**	**97,577**	**200**	**100**	**21,039**	**1,895**	**20,190**	**1,956**	**4.2**	**(3.1)**	**5.7**	**0.5**

Source: Bloomberg, BOBCAPS Research | Note: We have excluded Vodaphone Idea and Tata Motors from income aggregates as the numbers were not meaningful

Fig 10 – Q1FY23: Beats and misses – NSE 200 by company count

Sector	Reported	Mcap reported (%)	Revenue				Income			
			Beat	Miss	In-line	No Data	Beat	Miss	In-line	No Data
Financials	44	100	16	14	9	5	18	18	2	5
Information Technology	14	100	1	1	11	1	4	6	4	1
Energy	8	100	3	2	3	0	1	6	1	0
Materials	26	100	17	1	7	1	18	6	2	1
Consumer Discretionary	27	100	14	2	7	4	9	12	4	4
Consumer Staples	15	100	5	3	5	2	5	7	2	2
Industrials	21	100	8	5	7	1	6	8	5	1
Health Care	22	100	5	5	8	4	7	12	1	4
Communication Services	7	100	2	1	3	1	3	3	0	1
Utilities	12	100	11	0	0	1	8	3	0	1
Real Estate	4	100	2	1	1	0	1	3	0	0
Total	**200**	**100**	**84**	**35**	**61**	**20**	**80**	**84**	**21**	**20**

Source: CMIE, BOBCAPS Research | Note: Inline is +/-3% vs. consensus

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Fig 11 – Earnings trends YoY (Q1FY22 – Q1FY23)

Sector	Net sales	Raw materials		Salaries and wages		Interest expenses		Net profit (after tax)	
	YoY (%)	YoY (%)	% of Net sales	YoY (%)	% of Net sales	YoY (%)	% of Net sales	YoY (%)	% of Net sales
NSE listed companies	**38.6**	**68.3**	**52.2**	**13.4**	**9.6**	**7.5**	**8.8**	**20.5**	**7.5**
Materials	38.1	45.6	48.3	9.8	5.2	2.0	1.7	10.4	10.4
Information Technology	19.9	39.0	0.3	20.3	54.9	46.9	0.5	1.5	14.5
Industrials	31.3	54.9	53.4	10.8	9.6	16.1	5.3	21.3	5.0
Financials	12.1	79.6	4.9	7.8	12.9	5.9	45.9	41.1	15.5
Communication Services	18.7	37.9	1.6	23.6	17.3	8.4	14.7	NM	(4.8)
Consumer Discretionary	42.6	43.5	70.4	11.8	6.4	18.4	2.4	111.2	4.6
Consumer Staples	31.7	36.6	63.7	12.7	5.5	6.6	0.9	27.3	10.3
Health Care	4.9	1.9	32.7	9.8	18.3	6.6	1.4	(7.9)	11.7
Real Estate	24.7	59.9	8.4	8.7	16.1	1.7	11.4	151.9	16.2
Energy	74.2	96.0	85.5	13.0	1.3	30.0	1.1	(30.4)	2.5
Utilities	60.0	100.5	67.6	3.6	3.3	(2.1)	4.5	10.4	11.6

Source: CMIE, BOBCAPS Research

Fig 12 – Earnings trends QoQ (Q4FY22 – Q1FY23)

Sector	Net sales	Raw materials		Salaries and wages		Interest expenses		Net profit (after tax)	
	QoQ (%)	QoQ (%)	% of Net sales	QoQ (%)	% of Net sales	QoQ (%)	% of Net sales	QoQ (%)	% of Net sales
NSE listed companies	**3.8**	**12.8**	**52.2**	**3.7**	**9.6**	**4.7**	**8.8**	**(14.6)**	**7.5**
Materials	2.3	4.0	48.5	2.7	5.2	(0.9)	1.7	(9.2)	10.4
Information Technology	5.0	25.4	0.3	6.5	54.8	(1.6)	0.5	(9.3)	14.5
Industrials	(11.8)	(0.1)	53.4	0.9	9.6	7.9	5.3	(37.0)	5.0
Financials	1.8	6.8	4.9	4.8	12.9	3.8	46.0	(7.4)	15.5
Communication Services	(0.1)	(33.6)	1.6	3.2	17.3	8.7	14.7	NM	(4.8)
Consumer Discretionary	(2.1)	(4.1)	70.4	5.5	6.4	11.1	2.4	(6.5)	4.6
Consumer Staples	10.4	0.3	63.7	7.4	5.5	10.9	0.9	13.0	10.3
Health Care	2.3	0.1	32.7	8.3	18.3	4.3	1.4	152.1	11.7
Real Estate	(8.6)	6.0	9.9	(3.5)	16.1	1.5	11.4	31.7	16.2
Energy	17.4	27.2	85.5	(4.1)	1.3	17.2	1.1	(52.4)	2.5
Utilities	24.3	41.3	67.6	(5.6)	3.3	0.8	4.5	4.0	11.6

Source: CMIE, BOBCAPS Research

Fig 13 – 3M change in consensus earnings estimates

(%)	1M	3M	6M
Nifty 50	(1.39)	(2.66)	15.09
Nifty 200	(3.54)	(5.28)	13.94
Nifty 500	(3.43)	(5.09)	14.75
NIFTY Midcap 100	(1.72)	(3.34)	62.71
NIFTY Smallcap 100	(5.45)	(9.57)	19.79
Nifty Bank	(0.84)	1.65	41.39
Nifty IT	(2.02)	(2.27)	9.65
Nifty Auto	(2.04)	0.97	93.93
Nifty Pharma	(3.73)	(9.48)	8.44
Nifty Metal	(10.99)	(24.83)	(36.78)
Nifty FMCG	(0.04)	(0.13)	10.46
Nifty PSU Bank	(2.84)	(5.07)	19.55
Nifty Realty	6.02	3.77	51.64
Nifty Financial Services	(0.99)	(0.47)	25.28
Nifty Infrastructure	(5.21)	(6.17)	14.71
Nifty Energy	(16.47)	(16.45)	(3.28)
Nifty CPSE	4.86	7.41	17.92
Nifty India Consumption	(0.82)	4.64	32.98
Nifty Media	(4.29)	(15.93)	82.96
Nifty PSE	(6.14)	(6.98)	(4.15)
Nifty Commodities	(12.37)	28.00	(5.30)

Source: Bloomberg, BOBCAPS Research

Disclaimer

Recommendation scale: Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

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