Q3FY23 REVIEW

20 February 2023

New quarter, old challenges

- **Q3FY23 was a middling quarter with investment themes outperforming consumption sectors; export-oriented sectors did well**
- **Capital goods/BFSI outperformed and staples/discretionary underperformed; tier-I IT players saw a resurgence**
- **We retain our stock-specific approach with a largely defensive stance; prefer retail-focused lenders and consumption themes**

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Some wins, some losses in Q3: Q3FY23 was a tepid quarter which saw Nifty 50 earnings rise 11% YoY led by the BFSI sector. Investment-led sectors such as capital goods and cement posted a healthy topline while consumption-driven sectors such as FMCG and durables found their pricing abilities put to the test. BFSI had a good quarter with margin expansion and improved asset quality. Exports were steady in both services and manufacturing sectors led by tier-I IT and electronics manufacturing services (EMS) players, though the pharma sector saw continued generics price erosion in the US.

Capital goods and cement spring topline surprises: We note clear outperformance among investment-driven sectors, such as capital goods which posted strong numbers and robust order inflows. The recent **capex-heavy budget** lends a further fillip to these sectors. Cement saw 18% YoY topline growth but muted margins and profits.

Consumption sector slows: Staples and durables players had a dull quarter as inflationary pressures weighed on demand. Rural consumption remained sluggish though commentary points to some respite in Q4, a view echoed by auto majors.

Exports shine: Tier-I IT companies posted 1-5% CC growth despite a seasonally weak quarter due to furloughs and also reversed their underperformance vis-à-vis tier-II players (seen over the past 4+ quarters). Further, Q3 saw robust TCV for the top tier (+10% YoY ex-TCS). In manufacturing, our EMS basket clocked strong topline growth YoY (ex-DIXON), while KKC also recorded robust exports.

Unrelenting macro challenges: Broader commentary across sectors highlights the same old challenges that have been plaguing India Inc for the past few quarters. While commodity prices have corrected from peaks, they remain elevated. Inflation is eating into demand and rural offtake remains modest. The chip shortage is another persistent problem, impacting sectors from auto to durables and capital goods.

Retain stock-specific approach: We retain our stock-specific approach with a largely defensive stance – our preference for retail-focused lenders and consumption themes continues.

Sector-wise analysis

Fig 1 – Q3FY23 review

Sector	Financial highlights	Conference call takeaways	Salient features
Auto	▪ Aggregate revenue/EBITDA/adj. PAT of coverage companies grew 25%/47%/59% YoY. ▪ On a sequential basis, revenue declined 1.7% QoQ whereas EBITDA/adj. PAT grew 6%/4%. ▪ Aggregate EBITDA margin of coverage companies grew 185bps YoY and 86bps QoQ ▪ The results were in line with consensus estimates.	▪ Exports continued to face headwinds amid difficult macroeconomic conditions. ▪ Demand in the domestic entry-level segment is reviving steadily. However, the rural recovery is slow. ▪ With raw material prices softening QoQ, auto players expect margin tailwinds ahead. ▪ Supply chain constraints have eased, though high-end models continue to face hurdles. ▪ Companies plan to focus on increasing their market share of premium models.	▪ MM reported ROE of 20.1% in 9MFY23, exceeding its 18% guidance. Management remains focused on reducing delivery times in the SUV segment. However, the slowdown in light commercial vehicles (LCV) segment is a concern. ▪ MSIL plans to focus on the high-end segment as revenue contribution of mini/compact cars continues to ebb. The company aims to achieve leadership in sports utility vehicles (SUV) by FY24. ▪ The entry-level segment across the product chain, including passenger vehicles, two-wheelers and tractors, continues to face a tough demand environment due to slow rural recovery. BAJAUT, HMCL, ESC and VSTT are bearing the brunt of the impact. ▪ Export markets remain a challenge across segments, with the exception of high-end product acceptability.
Banks	▪ HDFCB's net profit increased 19% YoY and 16% QoQ, while IIB's net profit grew 58% YoY and 9% QoQ. ▪ Both players beat consensus estimates.	▪ The interest rate cycle is likely to peak out at ~6.5%. ▪ Deposit rate realignment following the increase in lending rate can put pressure on margins. ▪ MSME and retail lending will drive overall credit growth in the system.	▪ HDFCB is likely to achieve its guided FY23 margin of ~4.2% along with stable asset quality, although we expect the cost-to-income ratio to remain elevated. ▪ Improvement in IIB's vehicle portfolio coupled with stability in the micro finance business is likely to aid margins. Further, stable asset quality may lead to higher profitability, given lower provisioning.
Capital Goods	▪ Despite supply chain challenges, capital goods players displayed impressive execution, with aggregate revenue growth of 18% YoY (21% ex-LT). ▪ Margins and pricing power were resilient. Ex-EPC players (engineering, procurement and construction), gross margin for our coverage stocks expanded by 280bps YoY and EBITDA margin swelled 450bps.	▪ Semiconductor and component shortages continued to impact the industry. ▪ In addition, the reopening of China can seriously hamper the already-distressed supply chain.	▪ LT is well on track to achieving its full-year guidance of revenue and order inflows. ▪ Product companies continued to do well, barring Hitachi Energy which was impacted by the chip shortage.
Cement	▪ Aggregate revenue of our coverage companies grew 18% YoY, whereas EBITDA/adj. PAT declined 2%/11%. ▪ On a QoQ basis, revenue grew 12% and EBITDA/adj. PAT surged 48%/94%. ▪ Aggregate EBITDA margin of coverage companies declined 283bps YoY and grew 347bps QoQ, while EBITDA/t was flat YoY and up 38% QoQ. The results were in line with consensus estimates.	▪ Cement players indicated that their capacity expansion projects would largely be commissioned within targeted timelines. ▪ UTCEM aims to complete 19.9mt phase I capacity addition by FY23-end and additional 22.6mt by FY25 (200mt by FY27-FY30), SRCM is looking to add 9mt by FY25 and expects to reach 80mt by 2030, while DALBHARA plans to raise capacity by 4mt in FY23 and another 9mt by FY24 (acquired JPA assets have 5.3mt of cement capacity).	▪ Cement companies' road-rail mix is skewed in favour of road transport. However, with restrictive fuel prices, we are observing a steady shift to transport by rail (wherever feasible/economical). ▪ TRCL's Q3 revenue rose 29% YoY to Rs 20bn aided by 19% volume growth which was contributed by capacity addition and a push in the eastern region (contributes ~25% of company volumes). ▪ Given the positive surprise by TRCL, we raised our FY23 EPS estimate for the

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		▪ Softening pet coke/imported coal prices have helped improve margins during Q3, and cement players anticipate further tailwinds. This is reflected in lower energy cost QoQ (by an average of ~2%) for coverage cement companies. ▪ In a positive step, players are focused on increasing the share of green energy by commissioning waste heat recovery systems and solar panels.	company by 38% post results but left FY24/FY25 forecasts largely unchanged.
Consumer Durables	▪ The topline for our coverage universe remained largely intact (modest 10% YoY/3% QoQ growth), while EBITDA and net profit were muted. ▪ Weak demand due to inflationary concerns saw most companies post a subpar performance vis-à-vis our/consensus estimates (ex-POLYCAB, SYRMA).	▪ High-cost inventory, the return of A&P expenses to pre-Covid levels, and higher employee cost weighed on margins. ▪ The summer season is expected to be a positive demand trigger for room air conditioner players. ▪ Upcoming energy rating transition in the fans segment resulted in higher sales of economy vs. premium products.	▪ Companies refrained from price hikes amidst weak demand, and topline growth was primarily driven by volumes. ▪ Operating margins deteriorated YoY but showed sequential expansion (barring VOLT and VGRD), laying the foundation for a revival in coming quarters.
FMCG	▪ The FMCG industry grew 7.6% YoY during the quarter, but aggregate volumes dipped 0.3%. Volumes in urban markets grew 1.6% YoY while rural markets continued to face challenges, marked by a 2.8% fall in volumes. ▪ Operating margins remained under pressure due to sustained inflation in key commodity prices. However, margins improved sequentially (15bps-480bps) as edible oil prices were benign in Q3.	▪ FMCG demand has improved gradually during the quarter, but near-term challenges persist and growth is expected to remain price-led. ▪ Rural demand remained weak due to higher inflation, but companies observed early signs of recovery in the latter half of December.	▪ We expect the Q4FY23 performance to be similar to that of Q3 with marginal recovery in volumes. Growth is likely to be price-led with urban markets outpacing rural demand. ▪ We see little scope for further margin expansion as prices of key commodities remain elevated. ▪ We believe BRIT and NEST will continue to grow their rural portfolios given an increased focus on improving rural reach.
Metals & Mining	▪ In the ferrous space, EBITDA of our coverage stocks recovered 52% QoQ from a bottom in Q2FY23 but was still 48% below the 8-quarter average over Q2FY22-Q1FY23 – a strong margin phase. Coverage stocks barring TATA were broadly in line or ahead of consensus expectations. ▪ Consolidated EBITDA for base metals stocks continued to weaken, declining further by 17% QoQ in Q3. Both majors, HNDL and VEDL, missed consensus expectations.	▪ The steel sector is set to benefit from domestic demand improvement driven by accelerated infrastructure spend by the government. Margin recovery will likely continue into Q4 albeit at a modest pace as a marginal recovery in prices would be partly offset by higher coking coal costs. ▪ Upstream aluminium margins bottomed out in Q2 and recovery is likely to continue into Q4. Aluminium prices have bottomed out with the end of destocking in the western world and a tighter market balance. Energy costs are likely to further reduce in Q4 with a pullback in international coal prices and better availability of linkage coal. ▪ The downstream aluminium business of HNDL subsidiary Novelis underperformed. Margins disappointed in Q3 and recovery is guided at a slower pace than previous market expectations, recovering to mid-cycle levels only towards end-FY24 with pressure from consumer/ channel destocking in packaging.	▪ We expect steel margins to stabilise to a mid-cycle level over FY24, albeit at a slower pace than our previous assumptions. Supportive government policies in China and the end of destocking outside China are key drivers underpinning margin recovery. While there is a risk that the pace of recovery in China could lag market expectations, we believe this would come through in FY24. ▪ We prefer TATA in the ferrous space. Post Q3, the stock has underperformed its ferrous peers due to weakness in the European business. We believe the correction is overdone, and earnings growth from fructification of capex over FY24-FY26 would be a key stock driver hereon. ▪ In the base metals space, we expect global aluminium margins to stabilise over FY24.

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Oil & Gas	▪ RIL delivered 13% QoQ growth in Q3 EBITDA on better margins in the cyclical business and 19% YoY growth driven by consumer businesses. The results were ahead of consensus. ▪ PSU upstream players under our coverage delivered strong results with EBITDA up 35% YoY and 12% QoQ, largely meeting consensus expectations. ▪ Oil marketing companies (OMC) recovered from H1FY23 losses at the EBITDA level, although this was still down 41% YoY. EBITDA for the sector was ahead of consensus, barring IOCL. ▪ In the city gas distribution (CGD) space, EBITDA for our coverage universe fell 11% QoQ with a decline in margins due to the inability to pass on higher natural gas prices. ▪ Gas infrastructure companies posted the weakest results this quarter, impacted mainly by higher spot LNG prices.	▪ RIL elaborated on 5G potential and improved disclosures for retail business. ▪ Upstream players are focused on completing their capex plans and enhancing exploration. ▪ CGD players expect growth to accelerate again as implementation of Parikh Committee recommendations will restore their competitiveness. Higher priority for CGDs in allocation of HPHT gas while bidding at ceiling price has the potential to bridge the gap in administered-price gas for the priority sector and thus lower cost volatility. ▪ For gas infrastructure companies, moderation in spot LNG prices could improve offtake in India. Gas transmission companies could benefit from new pipeline tariff guidelines and a potential increase in tariffs post regulatory review.	▪ We have upgraded RIL from HOLD to BUY post-results as the recent stock correction has opened up an entry opportunity. ▪ For upstream players, we see further dividend upside given higher profits driven by better oil and gas realisation. ONGC may finally see upside to volumes in FY24-FY25 as it commissions KG 98/2. Implementation of Parikh Committee recommendations is likely to lower profitability in FY24. ▪ With pullback in oil prices and continuation of retail prices, OMCs have turned into profit in Q3. Retail prices need to remain elevated for a couple more quarters for them to fully recoup losses. ▪ We prefer IGL in the CGD space as growth levers are intact (given policy support), despite the EV risk. Implementation of Parikh Committee recommendations will improve competitiveness of CNG against liquid fuels. With the easing of international gas prices and increase in propane prices, industrial demand is also set to rise. ▪ With softer spot LNG prices, volumes of gas infrastructure companies are likely to improve, aiding recovery.
Pharmaceuticals	▪ Pharma companies under our coverage reported aggregate Q3FY23 revenue growth of 11%/3% YoY/QoQ (+7%/+5% YoY/QoQ in Q2FY23). ▪ Aggregate EBITDA grew 11% YoY after a meagre rise of 2.7% in the previous quarter. Growth was led by DRRD (+71% YoY) and SUNP (+15% YoY) on account of specialty portfolio and gRevlimid contribution respectively. ▪ Companies continue to face pricing pressure in the pureplay generics US portfolio. This combined with elevated raw material prices and logistic costs (still higher than pre-Covid levels) resulted in sustained margin pressure. ▪ Aggregative EBITDA margin for our coverage universe remained flat YoY/QoQ with steep contraction reported by DIVI (-20ppt YoY) and AJP (-10ppt YoY), while DRRD reported the highest margin expansion of 780bps YoY. ▪ Aggregate net profit declined 7% YoY and 3% QoQ.	▪ Raw material prices/freight costs remain elevated but are moderating sequentially. ▪ US price erosion continued to impact US business for the non-specialty/non-complex portfolio. ▪ Limited competition in gRevlimid boosted sales of DRRD and CIPLA from our coverage universe. ▪ The absence of Covid-related products such as Molnupiravir and Paxlovid impacted LAURUS's contract manufacturing business. ▪ Active pharma ingredient (API) volumes across companies saw green shoots of growth after inventory destocking, though prices remained competitive.	▪ Approval of gRevlimid is likely to aid a continued uptick in SUNP's US business, in the near term in addition to sustained growth in the specialty portfolio, while the acquisition of Deuruxolitinib from Concert would spur long-term growth in the US. ▪ ERIS's expansion in insulin/insulin analogue and diversification into emerging therapies coupled with capex will support growth. ▪ One-India continues to drive growth for CIPLA. gAdvair approval remains key for the company. ▪ Drivers for LAURUS include global tenders for antiretrovirals and commissioning of new facilities. ▪ Ramp-up in new capacities is a positive for GLS though demand/utilisation remains a concern. ▪ Companies including ARBP, CIPLA and ALKEM continue to invest in R&D towards the biosimilar portfolio. ▪ Given its attractive valuation, ARBP will take a decision on a share buyback.

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Power	▪ Our coverage universe saw average topline growth of 20% YoY on the back of higher demand and tariffs. QoQ growth slipped 5% due to seasonal factors. Net profit grew 27% YoY. ▪ All the stocks we cover posted results in line with our/consensus estimates.	▪ Peak power demand is likely to rise to 230GW during Apr-Jul'23. Fuel availability would be crucial to cater to this demand. ▪ Renewable energy (RE) capacity addition is poised to accelerate as global module and commodity prices have started to taper off.	▪ We believe the power sector is on track to witness high demand growth of 6-7% annually going forward. ▪ RE is estimated to form 70-80% of the sector's planned capacity addition over the next five years.
Technology	▪ Despite the uncertain macro environment, Tier-I IT companies (ex-TECHM) posted healthy revenue growth in the range of 0.6% to 5% QoQ in constant currency terms in a seasonally weak quarter (due to furloughs and fewer working days). ▪ EBIT margins improved 0-160bps QoQ for Tier-I players, driven by (1) decent revenue growth, (2) easing of supply pressures, (3) subcontracting cost rationalisation, and (4) rupee depreciation.	▪ Persistent weak macro conditions along with an increase in travel & facility costs, pricing pressure in vendor consolidation deals, and a decrease in other discretionary expenses dragged down cloud business growth in the near term. ▪ Most companies are seeing traction in digital transformation, automation and cost takeout-led deals, leading to robust deal TCV (total contract value at 10%+ YoY, ex-TCS) and improved book-to-bill ratios. ▪ Managements remained cautiously optimistic on demand due to rising uncertainty over discretionary spending, including in the hi-tech, retail, mortgage, investment banking and communications verticals, which remain weak.	▪ We believe margin expansion would continue in FY24 on the back of levers such as (1) freshers' billability through quick onboarding, (2) moderating attrition, (3) operational efficiencies (utilisation, offshoring, automation, lower subcontracting), and (4) selective pricing improvement. ▪ At the beginning of the quarter, managements of tier-I players sounded cautious on Europe, but TCS, INFO and HCLT surpassed expectations. ▪ Commentary on demand remained positive, with traction seen in both growth and transformation/cost takeout-led deals.

Source: Company, BOBCAPS Research

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