

Six Packs – Believe to Achieve

"Everyone has six packs, for most of us it's just covered up....one only needs to cut fat to make it visible"

This has been my stock response to one of the various random challenges that come your way in the numerous Whatsapp groups (not to mention the immediate family) during the various stages of lockdown. Its only later that I realised it is actually a well-accepted fact and not the lame excuse I had used as an escape route! All the abdomen/ core exercises are worthless if the layer of fat prevents someone from believing what they might already possess or can achieve.

As if on cue, corporate sector is now discovering its "invisible six packs". We specifically focus on two aspects from the ongoing results season – i) cost cuts and ii) strategy shifts, which is driving that effort. Companies that can blend a low-fat diet (cut costs) with an exercise regimen (new strategy and execution) will have visible six pack abs in no time.

I. Cost cuts – from temporary to structural

One of the common threads running through all the corporate results has been a strong margin defence as operating costs declined, in some cases more than the topline decline. While most of the initial cost decline was a result of lower economic activity, corporates are likely to re-evaluate the efficacy of their cost line items and a significant portion of cost reductions are likely to stick even when normalcy returns.

1. **Real estate:** Hybrid Work from Home (WFH) model can lead to permanent loss of space requirement and/or lower rentals
2. **Travel:** Video interactions (though not 100% substitute) can definitely cut into physical movement of people and costs
3. **Digital:** After the boost provided by demonetisation, Covid has moved consumer behaviour and transactions further online. Therefore, the need for more spend on IT systems and less on ensuring wasteful physical presence perhaps.

However, one company's cost is someone else's topline (think commercial real estate, hotels, airlines) so there is going to be a second order impact on incomes and consumption that will eventually hurt GDP growth. But that is a debate for another time.

II. Business strategy rebound

One of the less appreciated takeaways has been the ability of some companies to derive the much-needed clarity in their business strategy from the crisis. Companies which might have been too slow to acknowledge the wrongness of their present strategy or "writing-on-the-wall" situations have been jolted by the Covid crisis. Couple of instances below to illustrate the point.

1. One of the leading FMCG company which was so far focused on building its packaged foods business through new products in small/niche segments have signalled a shift towards fewer product launches but in larger categories.
2. The leading supermarket chain which had so far explored the online delivery/ecommerce route cautiously has indicated more openness to the idea.
3. In the telecom space, one of the pure long-distance bandwidth providers made progress towards becoming a solutions provider and help its clients in the digital enablement journey.

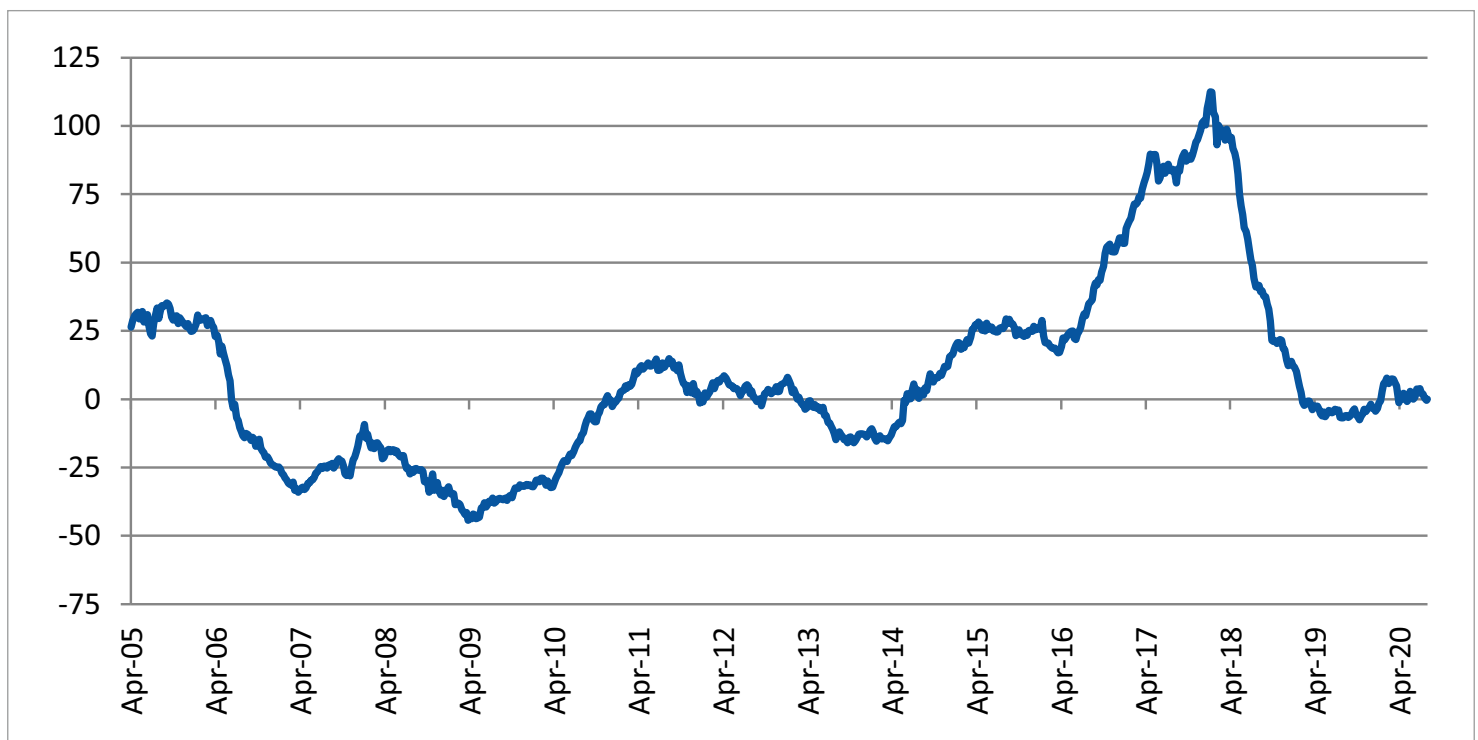
From an investment perspective, such important shifts in business strategy are an opportunity for generating superior growth and creating alpha.

The Large Cap vs. Midcap debate

Another related topic which becomes a point of debate is whether at the present juncture, one should be investing in Large caps or Midcaps. The present valuation premium/(discount) of Nifty Midcap 100 vs. Nifty 50 is in a neutral zone (see chart below) and there are no obvious signals at an aggregate level. Besides, any discussion on valuation at an aggregate level is of not much use except at the extremes i.e. when excesses are clearly visible (like in 2nd Half of 2017). Consider the following points.

- Midcaps can be fleet footed and thus equally capable (if not more) of developing six pack abs vs. large caps.
- Midcaps in a growing market with market leadership and low leverage can be equally attractive investment option as any large cap.
- In the sectors with post-Covid tailwinds viz. pharma, digitisation, ecommerce, electronic manufacturing, large caps and midcaps are adequately represented and, in some cases, even dominated by midcaps.
- Large caps have both growth as well as value stocks. Same is for midcaps

Nifty Midcap 100 vs Nifty PE Premium/(Discount) %



Source: Bloomberg

One should be somewhat immune to this debate and instead focused on bottom-up opportunities (irrespective of market capitalisation) in sectors/companies with tailwinds that can generate alpha through clarity of their strategy and execution. Given that the index valuation (Nifty 50 P/E Ratio at 20x 12 month forward earnings) and relative valuation (Nifty 50 at 35-40% premium to MSCI EM Index) could lead to a consolidation phase in the markets, identifying these opportunities will be key. Infact, companies or sectors which are embarking on an earnings upgrade cycle form one of the key pillars of our Growth at Reasonable Price (GARP) investment philosophy.

Happy Investing!



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