

Why do Eagles fly in circles?



Growing up as a kid in an industrial township, one of my favourite pastimes (remember no phones, and only evening TV those days) was to watch eagles fly in circles in the sky for hours especially in the hot summer days. It was fascinating that these large birds could stay in that mode for so long without flapping their wings. The reason is that eagles try to stay inside a "Thermal" while trying to gain height. Thermals is a natural phenomenon – on hot days, certain areas of the earth get heated up more making the air above it lighter. The lighter warm air then rises and is called a thermal and it usually found over large buildings. If eagles fly in straight route, thermals will feel like speed bumps, but on finding a thermal, eagles start flying in circles to gain height with minimum effort.

Of course, it helps that despite their size, eagles have a body that is both lightweight and strong at the same time. There is no extra ounce of weight that they carry, and large wingspan helps. This also has a bearing on what we discussed in the August newsletter ([Six packs - Believe to Achieve](#)); corporates have to cut the extra flab to be able to take advantage of the thermals in a post-Covid world.

It is amazing how a natural phenomenon is used so effectively. We are seeing a parallel of this phenomenon through the changes in consumer behaviour and supply chain dynamics in a post-Covid world. Like the hot sun heats up earth unevenly, Covid has led to uneven and discontinuous changes in the business environment giving rise to what we term as "Business Thermals". In this newsletter, we list down these "Business Thermals" which have implications for investment decisions in months and years to come. Corporates who can demonstrate the ability to tweak their business models in order to "stay inside the thermal" can generate superior returns for shareholders.

Business Thermal no. 1: Import substitution from China

India imports US 2.5bn of pharma API and US\$19.0bn of electronics and components from China accounting for 40% of India's trade deficit with China of US\$49bn in FY19-20. There is already a worldwide trend to reduce the dependence on Chinese imports and recent geopolitical developments will add to it. India's production linked incentive (PLI) scheme is the first step in that direction. Companies that can stay inside this thermal can gain significantly from this shift over the next 5-10 years.

Business Thermal no. 2: Consumption habits

We see two clear trends already playing out – i) need for personal mobility and ii) packaged foods. More could follow in the sub-segments like electronics, apparel, health/wellness & hygiene. Companies that can explore adjacencies in their existing product portfolio and create strong presence in the now-important categories will have more legs for growth. We are already seeing evidence of that in some of the companies in our portfolio.

Business Thermal no. 3: Digital transformation

The sudden need to adapt to digitisation of various modes of economic activity is leading to surge in digital transformation spending. It has also led to faster adoption and according to various estimates, the period for consumer behaviour change towards digital has been reduced by 18-24 months. That is a significant jumpstart and the corporates who were slow earlier are scrambling to add digital capabilities. This will generate additional opportunities for Indian IT services as well as the ecommerce market places (listed as well as unlisted).

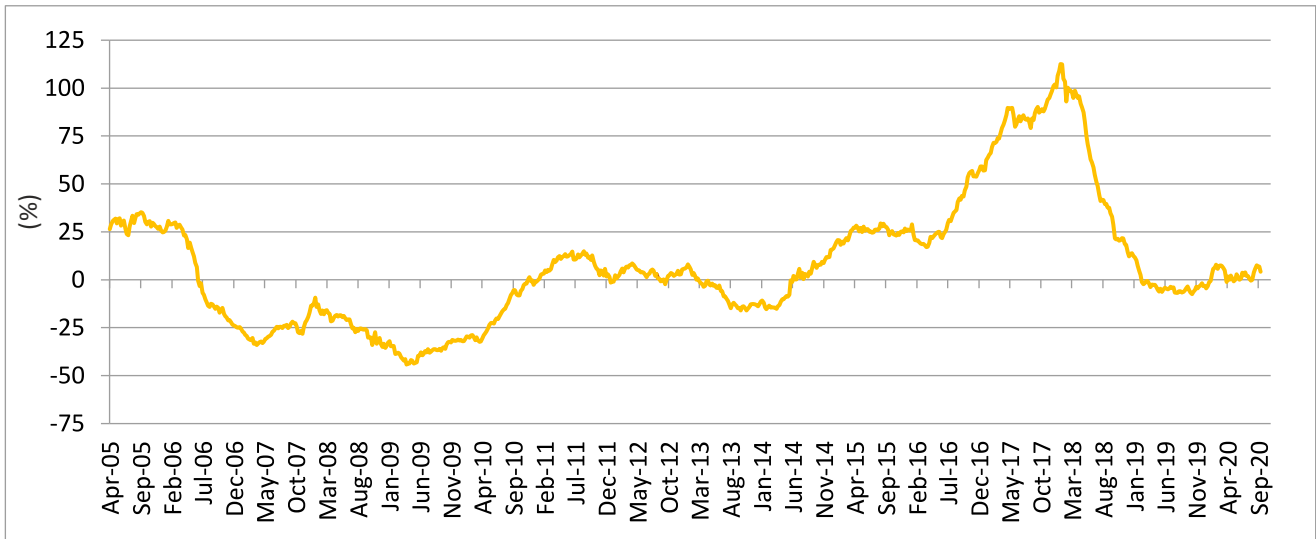
Business Thermal no. 4: Redefining Workplace

Work from home has obvious implications for demand for commercial real estate. But the indirect implications are on flattening the residential real estate markets in terms of the differential between various micro markets. Then there is a need to watch out for potential trend towards home improvement and better connectivity demand at home.

Large Cap vs. the Rest debate

Before we end, a quick comment on the debate on market capitalisation post the change in regulations for Multicap schemes. Reiterating the point, we had made in our last newsletter, the present valuation premium/(discount) of Nifty Midcap 100 vs. Nifty 50 is in a neutral zone and there are no obvious signals like the extreme we witnessed second half of 2017. Same is true for small caps with valuations being more reasonable in that segment. Hence we have been somewhat immune to this debate for some time and instead focused on bottom-up opportunities (irrespective of market capitalisation) in sectors/companies that are in a position to take advantage of the "business thermals".

Nifty Midcap 100 vs Nifty 50 P/E Premium/(Discount)



Source: Bloomberg

Given that the index valuation (Nifty 50 P/E at 17.5x FY22 and 20.5x 12 month forward) and relative valuation (Nifty 50 at 40-45% premium to MSCI EM Index) could lead to a consolidation phase in the markets, identifying these opportunities will be key.

Happy Investing!



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