AJCON GLOBAL

YOUR FRIENDLY FINANCIAL ADVISOR

Top picks and view on Indian equities during NBFC crisis.. **Nov. 20, 2018**

Non-banking financial companies (NBFCs) and housing finance companies (HFCs) were under pressure during the last week on the concerns over credit growth due to the liquidity crisis. Also, the stocks were down because of fears that mutual funds and other large subscribers to commercial papers issued by NBFCs and HFCs would choose to not rollover the securities when they mature. In the past one month, DHFL, Indiabulls Ventures, Indiabulls Housing, PNB Housing, Repco Home Finance and Edelweiss Financial have tanked 35% to 65% as the crisis at Infrastructure Leasing & Financial Services (IL&FS) created panic and triggered a sell-off in these stocks.

On October 19, the Reserve Bank of India (RBI) announced measures to pump in funds into NBFCs with market borrowings getting costlier and banks reluctant to lend to the sector. To help stem liquidity crisis, the RBI on Friday increased lenders' single borrower exposure limit for non-banking financial companies (NBFCs) which do not finance infrastructure, to 15 per cent of capital funds. The limit has been raised from 10 per cent and is effective up till December 31, the Reserve Bank of India said in a notification. Government securities held by them up to an amount equal to their incremental outstanding credit to NBFCs and HFCs, over and above the amount of credit to NBFCs and HFCs outstanding on their books as on October 19, 2018, as Level 1 HQLA (high quality liquid assets) under FALLCR within the mandatory SLR requirement," RBI said. This will be in addition to the existing FALLCR of 13 per cent of net demand and time liability (NDTL), and limited to 0.5 per cent of the bank's NDTL, the central bank said. The move by RBI shows that it doesn't want NBFCs to suffer due to liquidity crisis.

On the economy front, September CPI inflation was flat at 3.77 percent against 3.69 percent, MoM, while WPI inflation rose to 5.13 percent in September from 4.53 percent in August. August IIP was at 4.3 percent versus 6.5 percent in July.
Foreign investors were net sellers last week, while domestic institutions remained buyers.

The country’s foreign exchange reserves fell US$5.1 billion in the week ended October 12. This is the highest dip in seven years, according to data released by the Reserve Bank of India (RBI). Total forex reserves declined from US$399.6 billion in the previous week to $394.46 billion on October 12. This is also the lowest foreign exchange level since over a year, caused mainly because of a fall in foreign currency assets. According to the RBI’s latest monthly bulletin, the central bank sold US$1.28 trillion worth of US dollars from end March to August. Total foreign reserves have fallen by over US$30 billion since March 2018 with foreign currency assets sliding by US$29.4 billion during the same period, the RBI’s data showed.
The rupee has been facing intense selling pressure for more than a month now. It depreciated by over 12 per cent this year owing to several factors like rising bond yields on government securities, rising crude oil prices which increases the trade deficit, and concerns surrounding widening fiscal expenditure given the run up to the general elections slated for next year. On Friday the exchange rate closed at Rs 73.32 against the dollar.

Ajcon’s view and top picks
Going ahead, we believe rupee movement against the dollar, cues from ongoing global trade war especially between US and China, volatility in oil prices, movement of bond yields, F&O expiry, festive sales, Q2FY19 earnings season, outcome from (both exit polls and actual result) of upcoming assembly elections in five states will determine the market trend. At current juncture, investors can have a stock specific approach in great Companies as no one knows the bottom. The current panic provides investors sitting on cash a wonderful opportunity to accumulate great companies backed by strong management at cheap valuation. The current pessimistic environment offers an opportunity to accumulate great Companies. Investors can gradually start building their long term portfolio in some of the top rung stocks of which many have come down 30-40 percent in the recent fall. We do believe that the market seems to be in oversold zone. However, do not rule

out further correction and expect volatility to continue ahead of state elections. All said and done, we still believe that equity is a great asset class and always remember panic time is the best friend of a true investor. It is this time when one should put money in the market from medium to long term perspective.

Top picks

Varroc Engineering

CMP: Rs. 768, Target: Rs.998, Upside: 30%, Horizon: 12 months

We like this Company in the auto ancillary space and is a robust play on exterior auto lighting systems. The stock has witnessed significant correction in the current mayhem from a high of Rs. 1040 after the IPO to Rs. 768 currently. (IPO price was Rs. 967). The Rs 1,955-crore initial public offer consisted of an offer for sale of 2,02,21,730 equity shares by promoter Tarang Jain (17,52,560 shares), and investors Omega TC Holdings (1,69,17,130 shares) and Tata Capital Financial Services (15,52,040 shares) which was fully subscribed and got a good response from institutional investors.

Incorporated in 1988 at Aurangabad by Jain Family, Varroc Engineering, is a Tier I automotive component group which is engaged in designing, manufacturing and supplying exterior lighting systems, plastic and polymer components, electrical and electronic components, and precision metallic components to passenger cars, commercial vehicles, two-wheelers, three-wheelers, and off highway vehicle manufacturers. Varroc acquired the lighting system division of US-based Visteon in 2012 for $92 million, becoming the sixth-largest automotive lighting system manufacturer in the world, After the acquisition, Visteon's business grew by an annual 17-18 percent, as against the world average of 4 percent, over the last 5 years. The division it acquired of Visteon was at number six globally. The Company aspires to be in top three but it is not easy to do. The peers it has in the lighting business are quite big. The management is banking on business from two of the world's largest car manufacturers -- Volkswagen and Renault-Nissan -- to take its own operation to new highs.

We recommend a “Buy” on the Company due to the following factors: a) 6th largest fastest growing among top six global exterior auto lighting suppliers, b) strong competitive position in attractive growing markets, c) focus on high growth markets for its global lighting business, d) long standing relationships with marquee clients like Ford, Jaguar Land Rover, Volkswagen, RenaultNissan-Mitsubishi, American electric car manufacturer - Tesla, Harley Davidson, Suzuki, Honda, Bajaj Auto, Yamaha, Hero, Piaggio, Eicher Motors (Royal Enfield) etc, e) comprehensive product portfolio, f) low cost, strategically located manufacturing and design footprint of 36 manufacturing facilities spread across seven countries, with six facilities for global lighting business, 25 for India business and five for other businesses, g) robust in house technology, innovation and in house R&D capabilities in India, Czech Republic, China, USA, Mexico, Germany, Italy, Romania with 1,414 R&D engineers – 185 patents granted globally, h) strong balance sheet with Net Debt: Equity at 0.31x, positive operating cashflow with decent RoE of 15.94%.

Mahanagar Gas Ltd. (MGL)

CMP: Rs. 828, Target: Rs. 1,076, Upside: 30%, Horizon: 12 months

We like Mahanagar Gas Ltd. as it is a structurally strong city gas distribution story. Initiative to substitute crude oil with natural gas to reduce India’s import bill also has the potential to give a boost for extensive gas usage. In this backdrop, we are of the view that the anticipated increase in gas demand would come mainly from retail segment or from the city gas distribution sector. Besides World Health Organization report of May 2018 also mentions that majority of the most polluted cities in the world are from India. If this situation is to be reversed and getting a cleaner and healthy environment for our citizen becomes a basic priority and if India is to fulfill its COP21 commitment to reduce the emission intensity of its GDP then there has to be larger penetration of natural gas in Indian energy basket.

Mahanagar Gas Ltd. was incorporated on 8th May 1995 with the objective of supplying natural gas as compressed naturalgas (CNG) and piped natural gas (PNG) in Mumbai and the adjoining areas. MGL is a joint venture between GAIL (India) Ltd. and BG Group, UK. Royal Dutch Shell acquired BG group plc resulting in Royal Dutch Shell becoming the ultimate holding company of all the BG Group companies, including that of BG Asia Pacific Holdings Pte. Limited (BGAPH). The Company is the Sole authorized distributor of CNG and PNG in Mumbai, its adjoining Areas and Raigad with more than 22 years track record in Mumbai.

The long-term CGD business outlook looks very positive in view of the following factors: Favorable regulatory environment addressing previous bidding round impediments with forward looking and investor friendly reforms. Likely surge in the natural gas demand due to increased awareness about pollution and commitment of the Government of India at COP21. Rising population and rapid urbanisation, strong policy framework and guidelines in terms of CGD footprint expansion, mission PNG, smart cities, green corridors, etc., and the developments of CGD network in over 326 cities by 2022 and the ninth round of CGD bidding round called by PNGRB offering 86 new geographical areas in 174 districts, which will cover almost 29% of India's population. Our conviction on the Company stems from the fact that CNG is most preferred fuel by auto consumers as it is priced ~60% discount to petrol and 45% discount to diesel. We like the Company considering its Monopoly status in CNG space – Mumbai and adjoining areas, extensive supply network built over 20 years, infrastructure exclusivity Mumbai – upto 2020, adjoining areas – upto 2030, Raigad – upto – 2040 underpenetrated market with significant potential for expansion, robust infrastructure in place to support future growth, favourable regulatory environment, focused growth strategy in place, significant entry barriers for competitors to enter into its area of operation such as infrastructure exclusivity, requirement of large investments to establish a natural gas distribution network, lead time in allocation of domestic natural gas and obtaining the required regulatory approvals.. Natural gas penetration in Maharashtra is around 30 percent implying huge growth potential. Given the rising awareness of CNG and PNG's benefits over alternative fuels, we believe MGL's volume outlook remains optimistic. During FY18, MGL was able to add an additional 20 CNG stations and upgraded 14 stations, the capacity of which went up. With this, MGL added almost 3.44 lakhs kgs per day of compression capacities and its cumulative compression capacity stands at 30.80 lakhs kg/day. At present, MGL operates 223 CNG stations, supplying CNG to more than 609000 vehicles with a steel pipeline network of 5,042 kms as of now. To tap the big opportunity presented in this sector, the Company is aggressively looking to increase its CNG stations by 20 in FY19E.

In the Piped Natural Gas (PNG) space, the Company added ~1.6 lakh domestic consumers in FY18 taking the tally to ~10.3 lakh customers. The Company has added over 440 industrial and commercial consumers and has over 3,600 industrial and commercial consumers as of now. Going forward, MGL plans to only add to its current rate of household additions per year under its domestic PNG segment. The Government of India recently came out with auctions for 86 new geographical areas under the PNGRB bidding for which MGL has been one of the key bidders targeting ~20 cities. We expect the Company to post strong volume growth going ahead led by increase in CNG consumption both in auto and PNG space. Geographical expansion to Raigad & Karjat and Government's push for PNG's domestic connections will support volume growth. The Company has also recently hiked CNG prices which would help its operating margins to improve and which would be evident in FY19.

Post correction witnessed in this current mayhem owing to concerns like stake sale by BG Asia Pacific Holding Private Limited ultimately owned by Royal Dutch Shell, higher raw material cost and rupee depreciation, the Company at CMP of Rs. 828 (Face Value: Rs. 10), is attractively valued at 17x at reported FY18 EPS of Rs. 48.38. The Company witnessed strong Q1FY19 and posted decent numbers. The Company enjoys strong return ratios (ROE: 22.8 % and ROCE of 31.9%) with equity capital of Rs. 98.8 crores. We expect an upside of 30 percent for investors with a horizon of 12 months with a target of Rs. 1076 (18x at estimated FY20 EPS).

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