THE SCANNER

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Sectoral review: What has been and what can be!

Once again, it's that time of the year when we ruminate over the year gone by and plan for the year that is upon us. In the investment management landscape, it presents us with a good opportunity to evaluate how the year has developed and strategise for the year ahead. With this in mind, we present a sectoral wrap up for the Indian markets.

Exhibit: Sectoral periodic table

Annual Returns of Indian Equity Sectors till 12 Dec 2024 (January to December returns)

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
IT 59.73%	Finance 59.13%	Healthcare 15.21%	Commodities 30.86%	Commodities 52.53%	IT 25.62%	Energy 22.24%	Healthcare 61.03%	Industrials 64.54%	Utilities 20.92%	Industrials 68.01%	Healthcare 39.45%
Healthcare 22.04%	Industrials 54.44%	Consumer Discretionary 7.71%	Energy 15.27%	Consumer Discretionary 52.30%	FMCG 10.92%	Finance 16.95%	IT 55.74%	Utilities 64.20%	Industrials 18.21%	Consumer Discretionary 39.02%	Industrials 36.05%
Telecom 16.77%	Consumer Discretionary 52.94%	IT 4.41%	Utilities 9.37%	Telecom 47.61%	Finance 2.64%	Telecom 11.29%	Commodities 25.85%	Commodities 60.45%	FMCG 16.40%	Healthcare 37.34%	Telecom 29.64%
FMCG 10.45%	Healthcare 46.65%	FMCG 1.63%	Finance 6.48%	Finance 44.29%	Energy 0.83%	IT 9.42%	Consumer Discretionary 20.62%	IT 54.65%	Energy 16.12%	Utilities 32.62%	Consumer Discretionary 27.24%
Energy 1.53%	Commodities 27.78%	Energy 1.06%	Consumer Discretionary 4.46%	Energy 39.42%	Healthcare -5.99%	Consumer Discretionary -1.45%	Industrials 17.19%	Telecom 41.01%	Finance 8.47%	Telecom 29.07%	IT 25.62%
Consumer Discretionary -4.15%	Utilities 19.89%	Telecom -0.07%	FMCG 3.25%	Industrials 35.91%	Consumer Discretionary -15.54%	FMCG -3.32%	Energy 16.96%	Consumer Discretionary 29.04%	Commodities -0.50%	FMCG 27.24%	Utilities 20.92%
Industrials -4.88%	FMCG 18.09%	Utilities -3.85%	Industrials -0.52%	FMCG 31.46%	Utilities -15.54%	Healthcare -3.81%	Telecom 13.99%	Energy 23.82%	Consumer Discretionary -2.34%	IT 25.06%	Commodities 15.53%
Finance -11.34%	IT 17.31%	Finance -6.30%	IT -7.69%	Utilities 29.43%	Commodities -18.81%	Commodities -4.33%	FMCG 10.00%	Healthcare 19.91%	Telecom -5.51%	Finance 16.38%	Finance 14.05%
Commodities -11.75%	Energy 12.87%	Industrials -6.63%	Healthcare -13.08%	IT 11.19%	Industrials -18.96%	Utilities -7.62%	Finance 0.76%	Finance 14.05%	Healthcare -11.92%	Commodities 16.09%	Energy 12.17%
Utilities -14.23%	Telecom 6.35%	Commodities -14.38%	Telecom -21.58%	Healthcare -0.08%	Telecom -40.64%	Industrials -8.07%	Utilities -1.78%	FMCG 8.57%	IT -24.93%	Energy 13.93%	FMCG 0.37%

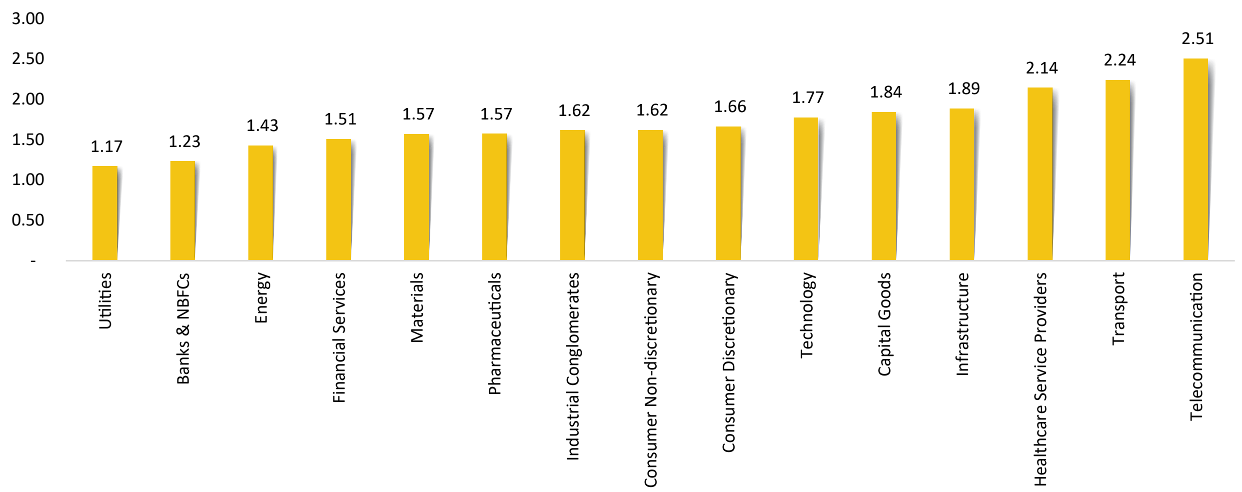
Sector which looks attractive

In our last year's sector update, we had communicated that the banking sector was looking attractive. We believe that the sector continues to look attractive. One of the primary factors contributing to our positive outlook if the trend of reducing Non-Performing Assets (NPAs). Over the past few years, the banking sector has made a concerted efforts to either reduce NPAs or to provide for the legacy NPAs. These efforts have now come to fruition as a result of which the sector now has a stronger balance sheet, comfortable capitalisation levels, and adequately provided NPA. At the same time, it is important to note that several banks have witnessed short-term challenges due to pressure on net interest margins and slower deposit growth, along with the challenge of maintaining loan growth with a higher credit-deposit ratio.

Valuation perspective

The banking sector is currently trading at reasonable valuations compared to the overall market and other sectors.

Exhibit: Sector valuation overview



Private banks and PSU banks exhibit a notable difference in valuations, evident when analysing their historical multiples within the banking sector.

Exhibit: Nifty private vs PSU bank valuation

Source: NSE

Currently, the Nifty Private Bank Index is trading near -1SD levels, whereas the Nifty PSU Bank Index is close to +2SD levels. This indicates that select private banks with compelling fundamentals are trading at attractive valuations compared to PSU banks.

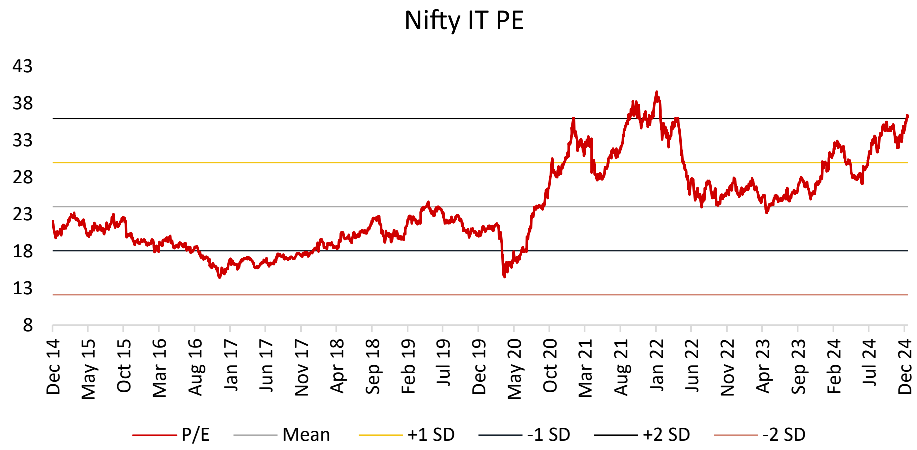
Sectors which look expensive from a valuation perspective

Several sectors in India currently appear expensive from a valuation perspective, primarily due to high investor optimism, robust earnings expectations, and strong liquidity flows.

Information Technology (IT)

The sector enjoyed strong growth during the pandemic and experienced good investor interest. However, in the prevailing environment - global slowdown, weak discretionary IT spending, and margin pressures – the sector can witness some headwinds. Despite this, valuations remain elevated due to optimism about digital transformation and Artificial Intelligence (AI) adoption. Large-cap IT stocks trade at rich forward P/E multiples despite uncertain near-term growth.

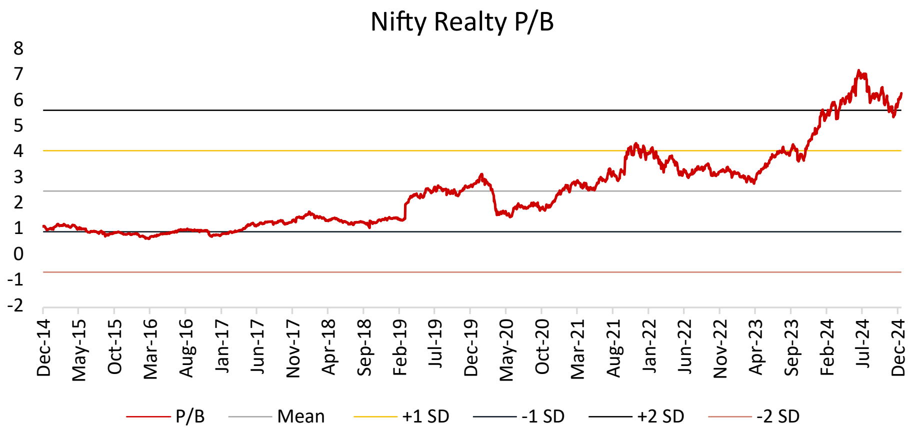
Exhibit: Nifty IT PE



Real Estate

In the aftermath of the pandemic, the Indian real estate sector has witnessed a strong demand recovery in residential housing and commercial spaces. Factors like rising incomes, increased affordability, and lower interest rates (in earlier periods) have fuelled the growth in sales. The demand for premium and luxury housing projects, where margins are higher, has encouraged developers to focus on this space. Inevitably, a revival in housing demand and commercial real estate has led significant re-rating. However, valuations look expensive relative to historical levels. The sustainability of this growth remains uncertain amid rising interest rates.

Exhibit: Nifty Realty PB



Q&A

Sarvajeet Bodas, CFA

Advisor, Client Servicing

Multi-Act

Is there a fundamental argument for private banks over public banks?

From a business perspective, private sector banks are often preferred over public sector banks due to their:

- Higher operational efficiency
- Stronger financial performance
- Better asset quality

They benefit from prudent lending practices, faster decision-making, and greater autonomy, as they face minimal government interference. Additionally, private banks are more agile in adopting new technologies and focusing on retail lending, which ensures higher margins and lower default risks. Their superior credit monitoring and risk management systems further result in lower NPAs compared to public sector banks.

Due to this, private banks also exhibit stronger growth potential and higher valuation multiples, driven by consistent profitability, better capital access, and market share gains. They are known for their innovative, customer-centric approach, offering seamless digital services and personalized products. While public sector banks struggle with legacy issues, government mandates, and slower operational reforms. Thus, from both a valuation and a fundamental perspective, private banks look more compelling than public sector banks.

Apart from real estate and IT, are there any other sectors which you believe are currently overvalued?

Yes, there are select sectors that are showing signs of overvaluation in the current market. These include:

- **Pharmaceuticals:** The pharmaceutical sector remains attractive due to its defensive appeal, export opportunities, innovation in specialty drugs, and rising domestic healthcare demand. However, near-term challenges like pricing pressures in the US generics market, regulatory risks, and inconsistent earnings growth make the sector's current valuations look stretched.

- **Capital goods and industrials:** Optimism around India's infrastructure focus, capex cycle revival, and manufacturing growth has driven up stock prices in these sectors. And, even though order inflows are strong, valuations reflect overly optimistic growth assumptions.

- **Renewable energy and green sectors:** Strong government focus on clean energy and investor enthusiasm around sustainability themes have pushed up valuations. However, in the current environment, profitability remains a challenge due to high execution costs and lower margins. Stocks trade at aggressive forward multiples despite nascent growth.

Currently, utilities are trading a relatively cheaper valuations. Is the sector attractive?

When a sector or a stock is trading at relatively cheaper multiples, it is important to assess the reasons for the compelling valuations. In the case of utilities, the recent correction in City Gas Distribution (CGD) companies has significantly impacted sector valuations. The recent correction in CGD stocks has been primarily driven by rising input costs and reduced allocation of low-cost domestic gas, resulting in valuation derating. Additionally, the emergence of Electric Vehicles (EVs) as a viable alternative poses a long-term risk to CNG demand growth. Current estimates reflect muted EPS growth for players like IGL and MGL due to their compressed margin profiles. However, if CGD companies successfully pass on significant cost increases to consumers, thereby narrowing the price advantage of CNG over petrol/diesel, earnings estimates could see upward revisions, improving the risk-reward profile in the short term. At the same time, it is important to underscore that the long-term impact of EV adoption on CNG volumes introduces uncertainty into the growth outlook.

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Regd. Office: Ground Floor, ICC Chambers I, Saki Vihar Road, Powai, Mumbai – 400 072, Maharashtra. 022-61408989

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