Midcaps are a wealth generating space over 3-5 years: Kotak AMC

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With the market holding onto the ongoing rally in today's trading session, CNBC-TV18's Anuj Singhal caught up with Harish Krishnan and Pankal Tibrewal of Kotak AMC to have an insight on how various sectors will perform and to understand the company's market outlook in the coming days.

For the infrastructure space, the perception has always been clouded by asset owners, even though the economy has provided around USD 400-450 billion worth spending on infrastructure in dire situations as well, says Harish Krishnan.

There has been a significant increase in government infrastructure spending–raised by 40-50 percent–over the last two years, he said. Pankaj Tibrewal said that he believes that cyclical recovery in the economy is underway and sees the midcap space as an exciting and wealth generating one over the next 3-5 years.

On the cement sector, Harish Krishnan sees the industry to be at the cusp of a major multiplier trend and advises to pick company's, irrespective of them being large or midcap, that have invested and have cut costs in the downcycle.

Krishnan keeps a bullish stance on cement stocks from a 2-3 year perspective.

Below is the verbatim transcript of Harish Krishnan and Pankaj Tibrewal's interview to Anuj Singhal and Sonia Shenoy on CNBC-TV18.

Anuj: We will talk about Kotak 50 later but the Kotak Infra Fund is the one we want to talk about. Infrastructure has done well and in that you have both largecaps and midcaps and various aspects of infrastructure, you have Larsen and Toubro (L&T), you have cement stocks, you have some of the midcap stocks like FAG Bearings India. From here on, which part of infrastructure are you most bullish on?

Krishnan: Invariably the perception of infrastructure in most of our eyes has always been clouded by asset owners because those have been the huge wealth creating ones starting from 2005-2007 where in they went anywhere between 30X to 50X. However, if you look at the first stage of that recovery, 2002 to 2004, it is invariably the flow related.

So what is the flow related infrastructure stock? In our economy, even through good or bad times, we have got close to USD 400-450 billion of spending on infrastructure or what is known as the gross fixed capital formation and it comes from three sources. The first source is public spending which is the government spending which clearly as you all know that in the last two years has seen a significant fillip; it has gone up almost 40-50 percent on a base what it was. The second is private sector which I don't think has been doing anything much in the last two to three years.

I don't think given the corporate debt and the leverage positions that corporate India is facing in, I wouldn't think that private sector will go on. The real dark horse is I would say home building. That is a space which actually in the recession years of 2008 to 2014 was very resilient and then had seen kind of blip and we are expecting that.

So, these companies which are the flow related ones, so, like you mentioned, cement, it could be engine companies, it could be pump companies, it could be logistic companies rather than the asset owners is what we are more focused on because these are asset light and more importantly they have invested during the downturn, they are well geared for that coming economic revival and they are in the right places.

So, our entire focus is don't focus on the asset owners, focus on the flow across a range of businesses–engines, pumps, logistics, cement, home building and that is what is the infrastructure story to me.

Anuj: The temptation is to ask you on Kotak Emerging Equity Fund–two of the stocks that stand out for me V-Guard and Finolex Cables, of course these stocks have done well, what I want to understand from you is that is it just a bottom-up stock selection that you have done here, you stay invested in some of these stocks which have given you 4X-5X returns over the last few years, how do you go about selection of such stocks and even if you could tell us that whether you want to stay invested with some of these big names that have generated so much money for you?

Tibrewal: The core philosophy of the fund and the fund house has been to invest in businesses which run capital efficient business models and we have not deviated from that for so many years now. In many of the names which you said, clearly was a bottom up stock picking and which might have a criteria and normally over a period of time we like to run the businesses across their business cycles so there maybe periods where they may be consolidating in terms of price performance but we are not too perturbed about it. Quarterly results really don't bother us too much, it is good to keep an eye but not from a structural perspective.

So, I think that clearly helped us. The second part that we believe that the cyclical part of the recovery in the economy is underway and some of these franchises which are aspiring to be leaders or are in the great cost curve, for example, one of the names which you said, it is one of the best cost curves in the cables and wires space and clearly they have done phenomenally well. Picking these stocks at the right P/E is a crux to overall generation of wealth. Anuj: But this space is still going to do well?

Tibrewal: Looks like. Without going into stock specific, the space overall is a very exciting one and we believe that if you look at the overall midcap space, a lot of sectors are still at a market cap of Rs 18,000-20,000 as a sector as whole.

And we believe that over the next 3-5 years, they can generate a lot of wealth still and economy is underway. A lot of sectors are represented by the mid and small cap companies. And our job is to just look at from 101 company to the next 400 company and choose the next 40-50 compounding stories which can generate wealth for us over the next five years. Anuj: Let us talk about some more sectors.

Cement stocks for example. I see quite a bit of exposure to largecap cements, whether it is UltraTech Cement , Shree Cements . Valuation is it still fine for you or do you get tempted to now look at some of the midcap space where also prices have run up but maybe that is cheaper compared to the largecap ones. Krishnan: For us cement is at the cusp of three mega trends.

The first mega trend is from a multiplier perspective, what used to be ahead of the GDP curve went through a scenario of say 5-6 years where the multiplier itself has collapsed. And we think that as the economy slowly recovers, you are going to see that multiplier playing through. So, that is the theme that we are playing within the cement space. The second interesting thing that is happening is essentially, that cement is getting more and more consolidated.

We are clearly seeing pricing power emerging as consolidation comes through, and we are not talking about near-term, we are talking about 6-7 years business cycle, wherein we are clearly seeing that the more financially sound companies are tending to control more of that capacity. They have gone ahead of the cycle and invested in land and capacities and brands and that should hold them in good stead for the overall industry. And thirdly, cement is all about capturing energy at its various points.

So, be it from limestone or to freight and clearly we have seen energy costs come off quite materially over the last 2-3 years. Yes, one can argue that incrementally energy costs are stabilising or not, you are not going to get that.

But we still think that the first two aspects from a slightly longer-term perspective, still holds the cement space in very high stead. So be it into largecaps or into midcaps, our entire emphasis is identify companies which have invested in the downcycle, who have cut cost in the down cycle and then ride them for the cycle to play out regardless of whether it is largecaps or not.

So, we are not so perturbed by the purely the fact that they have gone up a bit too soon or a bit too far. Sure, like Pankaj said, they might consolidate a bit, but we still believe that they have an excellent franchises from a 2-3 year kind of perspective. Anuj: One more word on a couple of interesting stocks that you picked out. Persistent Systems, that is the only midcap IT stock that I can see in your list.

And also DB Corp. So, here again, was this just a stock specific story or are you getting a bit bullish on midcap IT or media stocks for example? Tibrewal: If you look at from an IT perspective, we are running underweight across our portfolios. Our view is that in the near-term or maybe in the next 1-1.5 years, the space is going to be a really challenging one for a lot of companies. And clearly, the application maintenance and development (ADM) business is going through its own challenges in various IT companies.

There we endeavoured that which are the companies which can move to the next league, apart from the largecap companies, the midcap companies and some of the picks are definitely there in the portfolio which we believe can sustain this downtrend and move to the next level, because they are into the right pockets and the right spaces which will do well in the next 5-10 years.

On the media we are extremely excited. If you look at over the last 10 years, clearly media as a sector has done extremely well, whether it be the print guys, whether it be the broadcasting side, whether it be the cable owners and so and so forth. So, this is an exciting and a sunrise sector and as the GDP per capita keeps on climbing, this sector can do extremely well.

Sonia: Anuj has been asking you about all the stocks that you have picked up and that have made you money. I wanted to ask you about one pocket that you have not looked at. I understand that you graduated from St Xavier's College in Kolkata, so Kolkata is pretty much your home turf. And there are so many companies that are Kolkata based that have done so well, names like Shree Cements, Berger Paints , Exide , many of them market leaders as well.

Have you not looked at any of those stories? Tibrewal: From an industry perspective when we pick up stocks, we are not too fixated upon a region or an industry per se. What we look is that businesses, can it generate capital efficient returns for us as a shareholder. That is the primary criteria which we search the businesses on. If it comes from Kolkata, Mumbai,` Ahmedabad, Delhi, it is just a matter of coincidence, but structurally, we look at business more from capital efficiency perspective and cash flow generation perspective rather than regions.

Sonia: It is good to know that you do not have a emotional connect to many of these companies where you are stock picking. Anuj was talking about a couple of themes and one other theme that you are quite bullish on is the white goods theme. Look at a stock like Whirlpool that has been in your portfolio. The stock is a three bagger in the last two years. Do you think that this consumer discretionary industry, the white goods industry is in a structural uptrend that has perhaps many more legs to go?

Tibrewal: Clearly we believe that. It is a classical second derivative play of power and we have seen in various occasions government coming and saying power for all by

2020 or 2022 and we have seen that in smaller towns and cities, people want to have a washing machine, people want to have a refrigerator, but the connectivity or the electricity is so poor that they do not really bring it in their homes. And if you look at the penetration levels, it is classically, much below level. So, it is a classic urban discretionary play as well as if you look at it from a demand perspective, we are extremely bullish that the next 5-10 years could be a very strong momentum for this white goods space especially. Sonia: I wanted your view on the earnings for the quarter as whole. We just get into it now in a couple of days with the IT sector.

What are you factoring in for the entire quarter and particularly for the IT sector and what is your prognosis? Krishnan: Q4 of last year which was the quarter that went by, which ended in March, we saw first signs wherein sales growth was reasonably good. We saw the first signs where barring corporate banks, earnings growth was actually in strong double digits. And we would think that Q1 is not going to be any more different. We are going to see signs of stress in certain pockets for example, corporate lenders will continue to see that stress because of the environment that they are in currently. IT, I would imagine that we are seeing certain managements possibly wanting to evaluate what the entire Brexit and its related contagion can be and therefore, while essentially Q1 and Q2 of the year tend to be very strong quarters for IT as a whole seasonality wise, possibly on the guidance part, we might actually see certain trickle down of the guidance by various managements. So, that is on the IT side. But essentially, if you look across the breadth of the companies, we are seeing actually earnings growth improving.

So, if there were say 10-15 percent of the overall economy which was doing reasonably well, in Q4 that has already moved on to maybe 30-35 percent. And we would expect that trend to continue to keep improving with a far smaller share of companies who are disappointing the street. While in the overall sense it is hard to pencil a number, especially given the huge provisioning that corporate banks will take onto, but I would imagine that overall we should be reasonably okay with earnings growth. The only caveat being with what is coming onto negotiated dealing system (NDS).

While it is still early days, there has been certain concessions by SEBI as far as accounting is concerned but, I would still think that it is pertinent to keep a watch on the impact of NDS purely from an accounting perspective. Anuj: Just couple of more points I want to discuss on your individual stock selection. You spoke about corporate banks, it is interesting in your last portfolio you have increased exposure to ICICI Bank while trimmed exposure to Axis Bank. A lot of us would believe that they are in same category so what would explain that call? Krishnan: Essentially, without getting into stock specific trades, our overall approach on corporate banking has been that we believe that is a space three years out from now where one can make significant money.

Unfortunately the next six months or the next nine months especially to the quarter leading to March 2017 is where you will have further related stress as far as the overall profits are concerned. So, you are right that both are very similar, in fact one of the names that you mentioned, we have a slightly higher overweight even though we may have trimmed down positions we continue to have a higher overweight. So, it has been to do with change in stance.

We definitely are reasonably positive on corporate banking. Within the corporate banks of course our preference is more to the private sector corporate banks because we believe that corporate banks are play on both cycles. You have got a cycle of the past where a lot of banks have made mistakes.

Yes, they are paying the price for it now but at some point the markets will move on to the next cycle and it is that next cycle that we believe that private sector corporate banks are possibly better geared to take on further market share gains from the state owned banks. So, essentially that has been our entire approach to overall corporate banking within our portfolios.