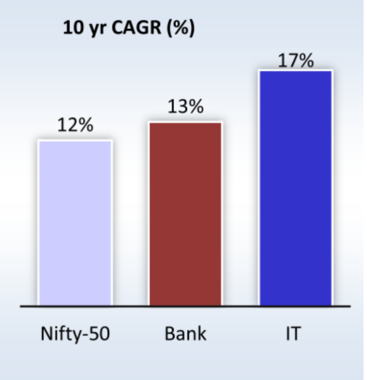
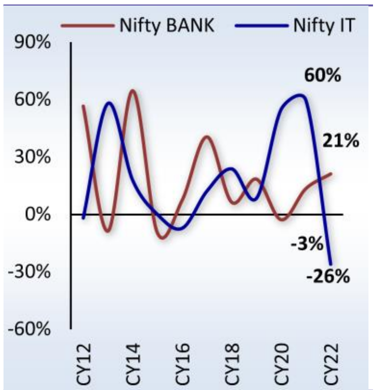
India Strategy

BSE Sensex: 57,654 **S&P CNX: 16,986**

Nifty Bank and IT – the top performing indices over the last decade (CY12-22)



Nifty Bank v/s Nifty IT: YoY change (%)



Bank v/s IT: Their roles in alpha creation!

Take your pick: Banks or IT?

- In an era of severe unrest and intensified volatility, alpha generation in equity investing has become ever more challenging! A capital allocator today has to form a perspective on multiple factors viz. macro (economy/central bank action/rates), geopolitics, technology disruption, sector allocation, stock selection, etc. before taking a concrete decision. Given this backdrop, we look at the roles of two big and critical domestic sectors in relative alpha generation over the last decade – Banks and Information Technology (IT). These sectors together constitute ~41% of Nifty-50 and ~31% of NSE-500 weights to date. In this note, we present several viewpoints around the same and highlight how relative divergence between these two sectors has played an important role in determining the relative out/underperformance of Indian markets.
- We analyzed the yearly performances of key sectoral indices over the last 10 years. Nifty-50 with other key indices posted a healthy double-digit growth during CY12-22. Nifty-50 reported 12% CAGR, while the other top performing indices, i.e., Nifty Bank and Nifty IT clocked 13% and 17% CAGR, respectively.
- During CY12-22, the weightage of Banks in Nifty-50 grew 820bp to ~38%; whereas, the weightage of IT rose 260bp to 14%.
- Further, the market cap contributions of Nifty Bank and Nifty IT constituents in Nifty-500 were higher by 40bp and 60bp to 12.0% and 10.3%, respectively, during CY12-22.

Nifty Bank v/s Nifty IT – Average 37% returns divergence over CY12-22

- Bank accounts for 26%/22%/24% while IT accounts for 16%/19%/18% of Nifty-50's profit pool/market cap/index weight. Hence, they have disproportionate influence on the underlying earnings and performance of Nifty-50.
- Over the past decade (CY12-22), while both Nifty Bank and Nifty IT outperformed Nifty-50, their performances remained highly volatile and divergent.
- On annual basis, Nifty-50 declined just once in the decade, whereas Nifty Bank and Nifty IT declined on three and four occasions, respectively, during CY12-22.
- The Bank and IT indices exhibited a stark divergence in yearly returns, with these two indices outperforming alternately over CY12-22. More importantly, the quantum of relative performance gap between the two sectors was >40% in 6 out of the 11 years and >10% in 10 out of 11 years.
- The gap has expanded sharply in years/episodes of macro disruption, which has become quite frequent of late (demonetization, GST, US-China trade-war, Covid-19, Russia-Ukraine war, Global Central Bank rate hike cycle, accidents in global banking, etc.). In fact, in the preceding three years, i.e. CY20, CY21 and CY22, the relative returns gap between Bank & IT stood at a staggering 58%, 46% and 47%, respectively, with IT outperforming in CY20 and CY21 while Bank outperforming in CY22. IT is so far (CY23YTD) outperforming Bank by 6%.
- Further, the average divergence between both indices stood at 37% over CY12-22, highlighting the obvious but critical role of sector selection in alpha creation.

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Exhibit 1: Key indices – YoY performance (%)

Year	Nifty-50	Nifty Bank	Nifty IT
CY12	28%	57%	-2%
CY13	7%	-9%	58%
CY14	31%	65%	18%
CY15	-4%	-10%	0%
CY16	3%	7%	-7%
CY17	29%	41%	12%
CY18	3%	6%	24%
CY19	12%	18%	8%
CY20	15%	-3%	55%
CY21	24%	13%	60%
CY22	4%	21%	-26%

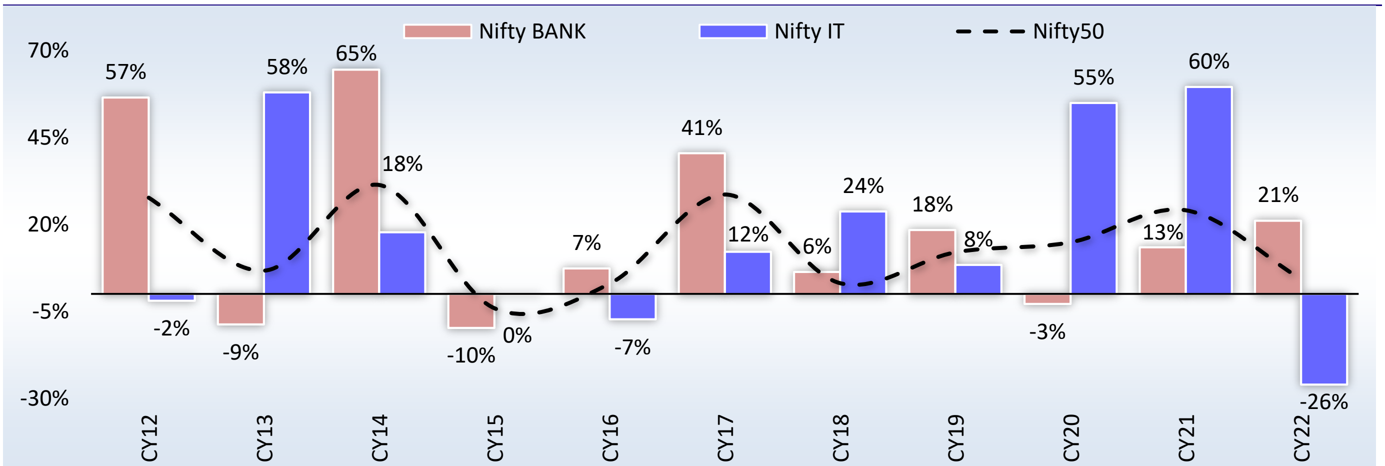
Green and red color represents the strong and weak performance among the two indices, during the year

Exhibit 2: Wide divergence between Nifty-50 and Bank/IT indices YoY (%)

Year	Nifty-50 v/s Nifty Bank	Nifty-50 v/s Nifty IT
CY12	-29%	30%
CY13	15%	-51%
CY14	-33%	14%
CY15	6%	-4%
CY16	-4%	10%
CY17	-12%	16%
CY18	-3%	-21%
CY19	-6%	4%
CY20	18%	-40%
CY21	11%	-35%
CY22	-17%	30%

Source: MOFSL, Bloomberg

Exhibit 3: Nifty-50 v/s Nifty Bank and Nifty IT – YoY performance (%)

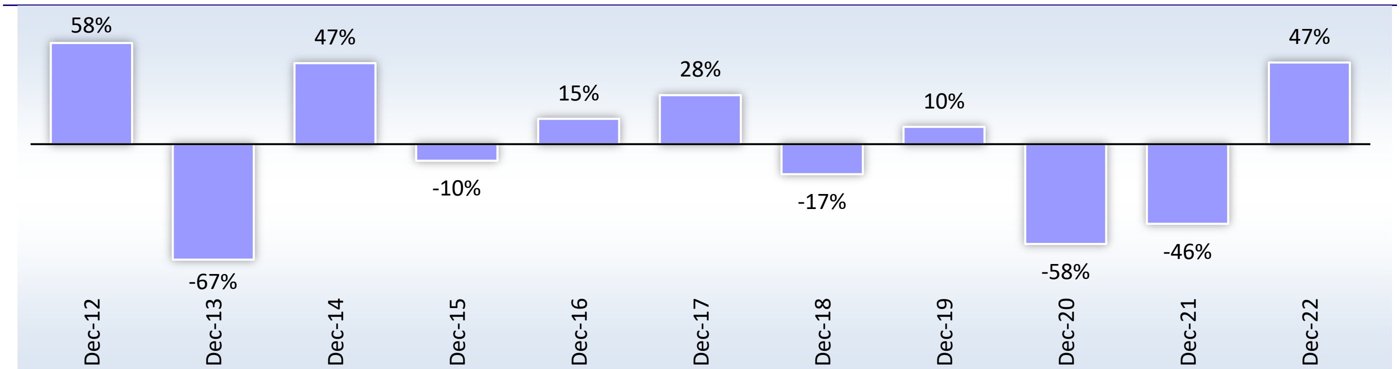


Source: Bloomberg, MOFSL

Wide divergence seen every year

- Despite the strong performances of both Nifty Bank and IT indices in the past decade, the combined annual returns have shown a huge divergence.
- The divergence ranged between ~10% and ~60% per year, highlighting the obvious but decisive role of getting this sector call right at the beginning of a CY.
- Both the sectors have very natural and pertinent macro linkages. Banking being a microcosm of broader economy cannot remain immune to the prevailing macro environment, both global as well as local. Technology meanwhile derives more than two-thirds of revenue from the US and Europe and has direct linkages with the trends prevailing in the global economy.
- For example, since the start of Covid-19, the IT sector has – both in 2020 and 2021 – benefitted from the tailwinds of rising technology spends globally as digitization assumed mission critical importance in an era of physical and social distancing. Meanwhile, the banking sector bore the brunt of weaker economic growth and concerns around deterioration in asset quality led by persistent lockdowns both in 2020 and 2021.

Exhibit 4: Divergence between Nifty Bank and Nifty IT's performance remained in high double digits

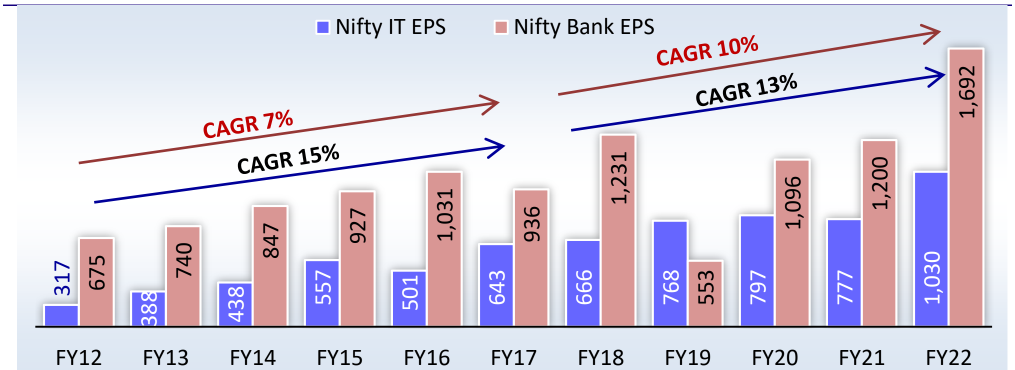


Source: Bloomberg, MOFSL

Earnings surge in double digits, with re-rating being a common phenomenon

- Earnings for Nifty Bank and Nifty IT reported a CAGR of 10% and 13% during CY12-22, while the indices compounded at 13% and 17%, respectively, over the same period.
- During CY12-22, though earnings grew at a decent pace, both the indices registered even faster growth leading to rerating.

Exhibit 5: Earnings for IT grew faster in the first half of the decade, while Bank saw faster growth in the second half

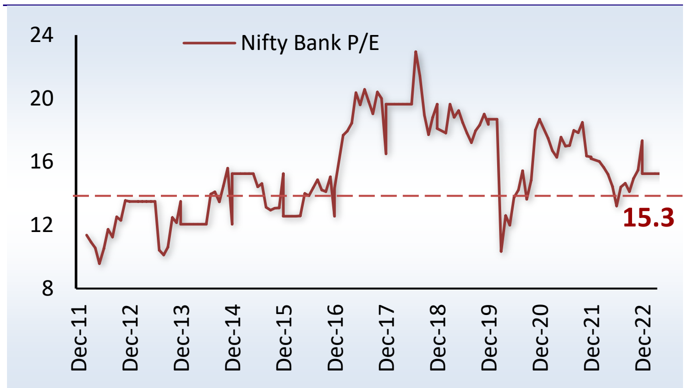


Source: Bloomberg, MOFSL

Valuations for Nifty IT richer than Nifty Bank

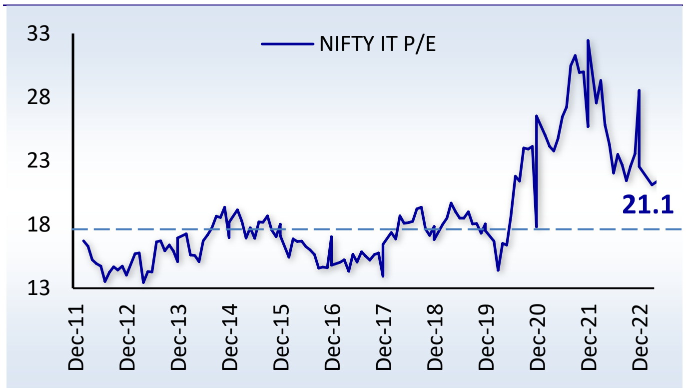
- **P/E ratio:** Nifty Bank's 12-month forward P/E is near its LPA, whereas that of Nifty IT is trading at a 13% premium to its LPA.
- **P/B ratio:** Nifty Bank's 12-month forward P/B is at 7% discount to its LPA, while that of Nifty IT is trading at 23% premium to its LPA.

Exhibit 6: Nifty Bank's 12-month forward P/E near its LPA



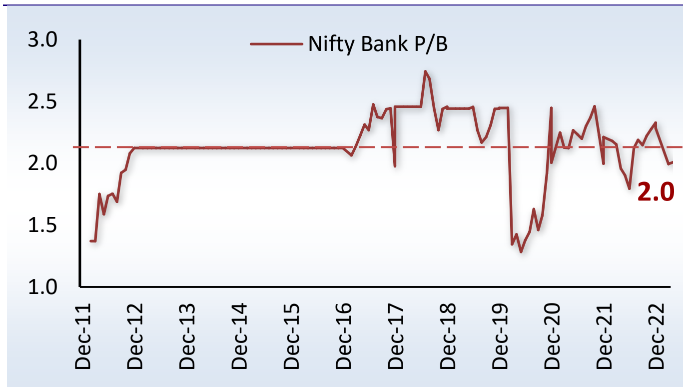
Source: MOFSL, Bloomberg

Exhibit 7: Nifty IT's 12-month forward P/E at 13% premium to its LPA



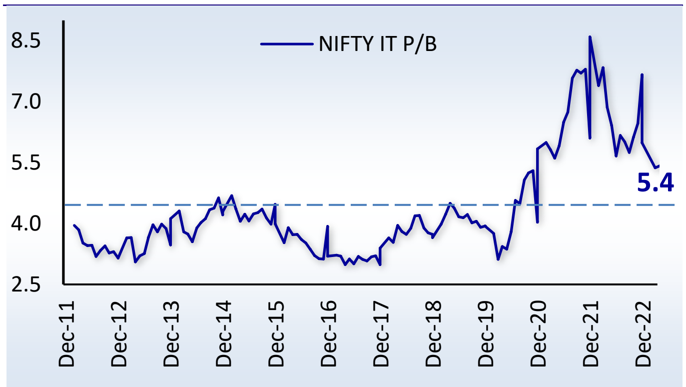
Source: MOFSL, Bloomberg

Exhibit 8: Nifty Bank's 12-month forward P/B at 7% discount to its LPA



Source: MOFSL, Bloomberg

Exhibit 9: Nifty IT's 12-month forward P/B at 23% premium to its LPA

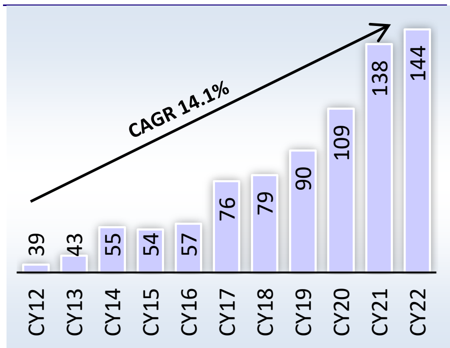


Source: MOFSL, Bloomberg

Market caps compounded at nearly the same pace for both indices over CY12-22

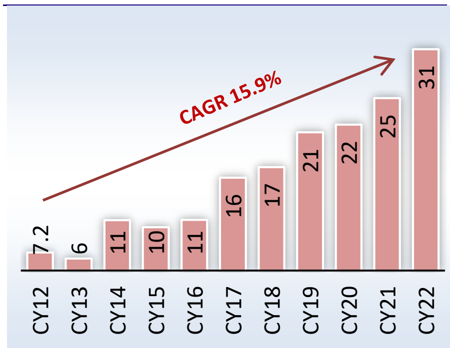
- During CY12-22, total market cap of Nifty Bank reported a 15.9% CAGR to INR31t; whereas, market cap of Nifty IT grew at 16.1% CAGR to INR27t.
- While the market caps for Nifty Bank and Nifty IT grew at a similar pace over the last five years, the pace of growth for Nifty IT was higher than Nifty Bank in the previous five years.
- Further, the market cap contributions of Nifty Bank and Nifty IT narrowed to a similar range of ~20% to that of Nifty-50 in CY23YTD. Besides, the trends of contribution were similar with respect to Nifty-500 as well. The market cap contributions of Nifty Bank and Nifty IT constituents stood at ~11% levels of Nifty-500 as of CY23YTD.

Exhibit 10: Market cap of Nifty-50 posted a 14.1% CAGR (INR t)



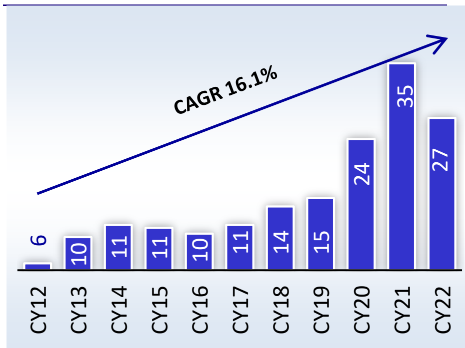
Source: MOFSL, Bloomberg

Exhibit 11: Market cap of Nifty Bank reported a 15.9% CAGR (INR t)



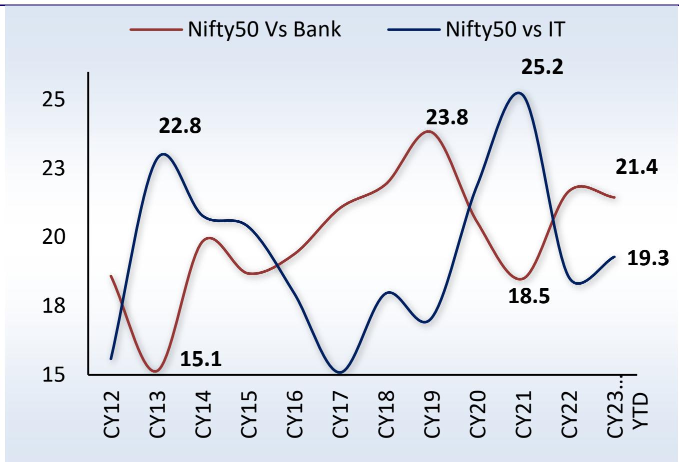
Source: MOFSL, Bloomberg

Exhibit 12: Market cap of Nifty IT clocked a 16.1% CAGR (INR t)

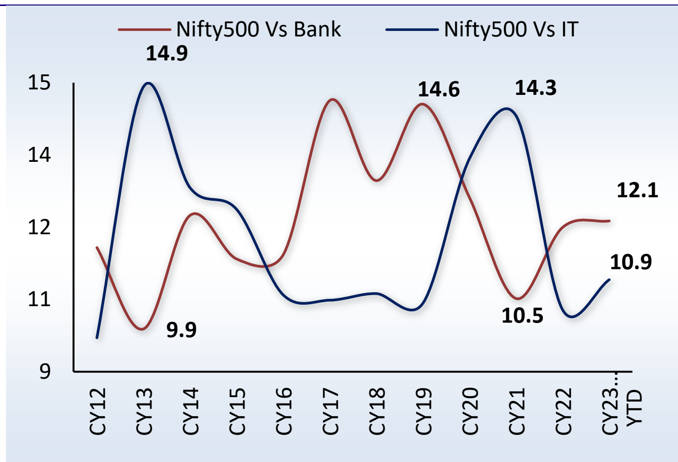


Source: MOFSL, Bloomberg

Exhibit 13: Market cap contributions of both indices were ~20% in Nifty-50, whereas contributions were ~11% in Nifty-500



Source: MOFSL, Bloomberg



Source: MOFSL, Bloomberg

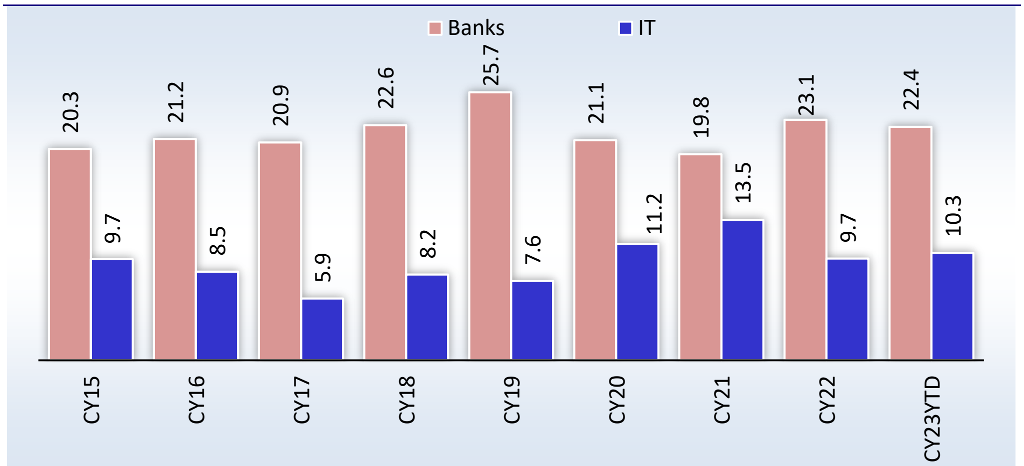
MF allocation in Bank remains high, IT allocation gains

- MF allocation in Bank remained strong with an average of ~22% in the last five years, down 330bp from the 2019 peak.
- Whereas, MF allocation in IT companies remained volatile with an average of ~10%, up 440bp from 2017 lows.
- Weightage of Bank in the benchmark remained at ~27% (down 355bp from 2019 highs); whereas for IT the weightage averaged ~15% (up 330bp from 2017 lows).

MF allocation in Private and Public Banks >2x of IT

In CY19, MF allocation was the highest in banks, while it was near the lowest level in IT. Meanwhile, in CY21, allocation in banks was the weakest, while it was the highest in IT.

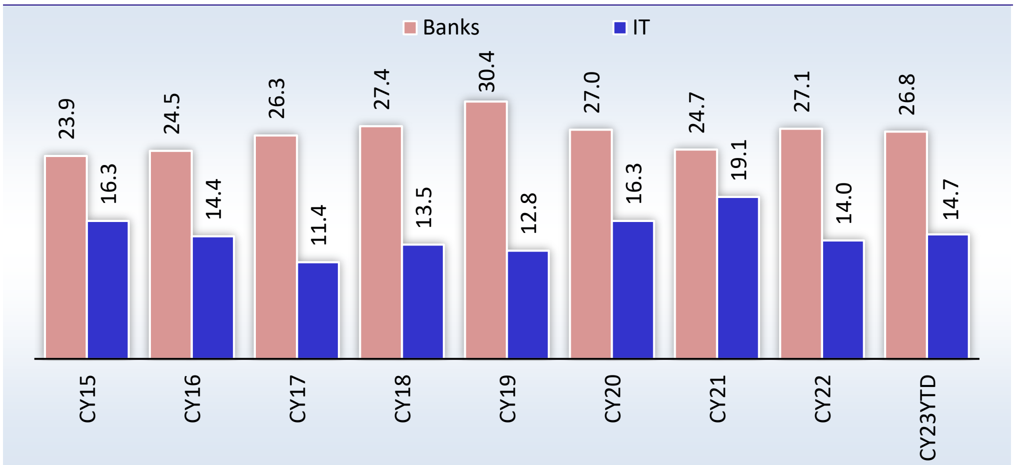
Exhibit 14: MF allocation in Banks and IT sector (%)



Source: MOFSL, Bloomberg

Banks' weight in Nifty50 peaked in CY19, whereas IT's weight peaked in CY21, in line MF allocation trend.

Exhibit 15: Banks and IT sector weights in Nifty50 (%)

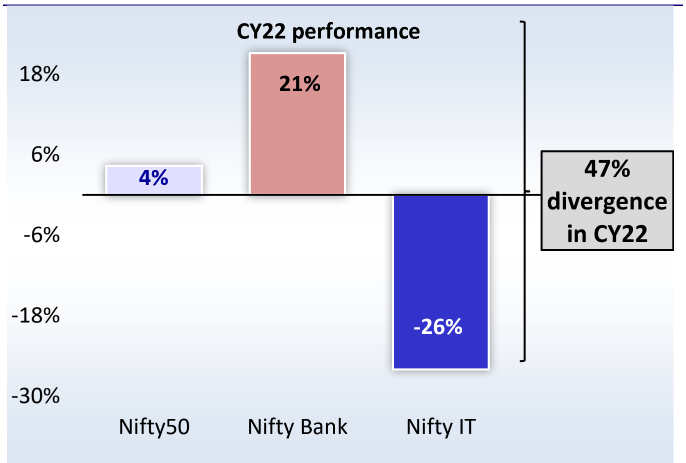


Source: MOFSL, Bloomberg

Can this divergence continue?

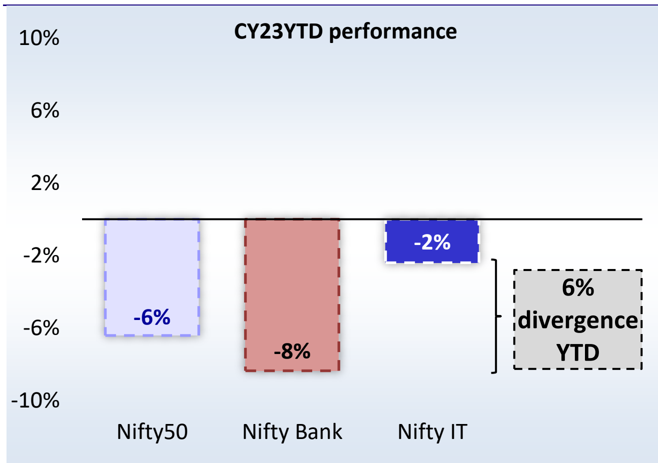
- Given the prevailing macro backdrop, we expect the divergence in the performance of these two sectors to continue. Both global and domestic economies are going through a challenging phase with moderate growth, rising rates and persistent inflation blurring the near-term outlook.
- While Bank's earnings growth over the last 3/5 years has been solid (Bank's profits in Nifty-50 up ~5.5x over FY18-23E to INR1.6t in FY23E from INR298b in FY18), the sector has seen a de-rating (commensurate market-cap up 1.9x over FY18-Mar'23), impacted adversely by several stock-specific factors as well as macro concerns around sustenance of current elevated margins, pick-up in deposit growth and persistent FII outflows from India.
- Meanwhile, after a very strong CY20 and CY21, the IT sector was the worst performer in the family of Nifty sectoral indices in CY22 with a 26% decline. Concerns around potential US recession, sharp rise in the US interest rates and elevated challenges in the US BFSI industry (key contributor to the Big-5 Indian IT firms) have put a cap on the IT sector's re-rating potential. To that extent, the forthcoming 4QFY23 earnings season and corporate commentary become very important to gauge the implications of deteriorating global macro situation on sector fundamentals.
- In CY23YTD, Nifty Bank is down ~8%; whereas, Nifty IT is also down ~2% (at the same time, Nifty-50 is down 6%).
- As we look ahead, we find the valuations of both these sectors quite reasonable. That said the relative divergence between the two can continue and will be a function of: 1) how the global macro shapes up amidst the current flux and 2) the relative earnings progression for these sectors.

Exhibit 16: In CY22, the divergence between Nifty Bank and IT indices was ~47%



Source: MOFSL, Bloomberg

Exhibit 17: However, in CY23YTD the divergence between both the indices has already played out to the extent of 6%



Source: MOFSL, Bloomberg

Exhibit 18: Nifty Bank and Nifty IT constituents – valuations

Company	Sector/ Index	Market Cap (USD b)	Price CAGR (%) as of Dec'22			Price chg.	EPS (INR)			P/E (x)			P/BV (x)			ROE (%)		
			1yr	5yr	10yr	CY23 YTD	2023E	2024E	2025E	2023E	2024E	2025E	2023E	2024E	2025E	2023E	2024E	2025E
HDFC Bank	Bank	106	10	12	17	-4	80	95	113	19.6	16.5	13.8	3.1	2.7	2.3	17.0	17.4	17.7
ICICI Bank	Bank	72	20	23	16	-4	47	53	62	18.2	16.1	13.8	3.0	2.5	2.2	17.8	17.1	17.0
SBI	Bank	56	33	15	10	-18	60	72	83	8.0	7.1	6.1	1.3	1.1	0.9	17.6	17.6	17.2
Kotak Mah. Bank	Bank	40	2	13	19	-7	74	85	100	22.9	19.8	16.9	3.0	2.6	2.3	13.6	13.6	13.7
Axis Bank	Bank	32	38	11	13	-10	33	83	95	25.4	10.2	8.8	2.1	1.7	1.4	8.5	18.4	17.6
Bank of Baroda	Bank	10	127	3	1	-14	27	31	36	6.0	5.1	4.4	0.9	0.8	0.7	14.9	15.2	15.3
IndusInd Bank	Bank	9	37	-6	11	-17	97	125	161	10.4	8.1	6.3	1.4	1.2	1.0	14.8	16.4	18.0
Punjab Natl Bank	Bank	6	51	-20	-11	-19	2	6	8	21.0	7.6	5.7	0.5	0.5	0.5	2.5	6.6	8.2
AU Small Finance	Bank	5	26	14	-	-14	22	27	33	25.2	21.1	16.9	3.4	2.9	2.5	15.6	14.9	16.0
Bandhan Bank	Bank	4	-7	-	-	-13	15	27	34	13.5	7.4	5.9	1.7	1.5	1.2	13.3	21.2	22.4
IDFC First Bank	Bank	4	22	2	-	-8	4	5	7	14.8	11.1	8.3	1.4	1.2	1.1	10.0	11.8	14.0
Federal Bank	Bank	3	68	5	10	-9	14	16	19	9.0	7.9	6.7	1.2	1.1	1.0	14.6	14.8	15.2
Nifty Bank	**Banks**	**348**	**21**	**11**	**13**	**-8**												
TCS	IT	142	-13	19	18	-4	116	136	156	26.8	22.9	20.0	12.8	12.7	12.7	47.6	55.6	63.7
Infosys	IT	76	-20	24	18	-9	59	68	77	23.4	20.3	17.9	8.0	7.8	7.7	33.5	38.7	43.3
HCL Technologies	IT	35	-21	19	21	1	55	63	72	19.3	16.6	14.6	4.6	4.7	4.8	24.0	28.3	32.7
Wipro	IT	25	-45	11	10	-8	21	24	27	17.3	15.1	13.4	2.9	2.9	2.8	17.2	19.2	21.1
LTI Mindtree	IT	17	-34	29	-	5	156	184	220	29.6	25.1	20.9	6.1	5.3	4.6	24.0	22.6	23.6
Tech Mahindra	IT	12	-43	15	16	8	58	68	80	18.9	16.1	13.8	3.4	3.2	3.0	18.8	20.8	22.9
MphasiS	IT	4	-42	22	18	-8	112	131	153	30.3	25.8	22.1	7.4	6.3	5.4	26.2	26.4	26.4
L&T Technology	IT	4	-41	31	-	-12	88	101	119	19.7	17.2	14.6	4.3	3.9	3.5	22.9	24.0	25.5
Persistent Sys	IT	4	-21	40	31	12	128	156	181	33.9	27.8	23.9	8.1	6.8	5.7	26.6	27.3	26.6
Coforge	IT	3	-34	43	32	-5	138	176	195	26.8	21.0	19.0	6.9	5.8	4.9	28.3	30.6	28.4
Nifty IT	**IT**	**322**	**-26**	**20**	**17**	**-2**												

*Note: To check divergence among constituents, we have highlighted 1, 5 and 10 year price CAGR as on 31st Dec'22 and have highlighted CY23YTD performance separately.

Source: MOFSL, Bloomberg

N O T E S

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