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Why Dalal Street's one-time darlings are struggling to keep the romance going

Abhishek Mukherjee | 9 min read | 18 Mar 2024, 06:18 PM IST


Without innovation, market leaders are vulnerable to the onslaught from agile challengers. (istockphoto)

SUMMARY

- *HDFC Bank, HUL and Asian Paints have for long been the undisputed leaders of their industries. But the stocks' recent spell of underperformance has starkly demonstrated the market's most pervasive disclaimer—past performance is no guarantee of future results. And yes, size does matter.*

New Delhi: On the night of 2 October 1980, in a makeshift boxing ring set up in the parking lot of the glitzy Caesars Palace hotel in Las Vegas, Muhammad Ali walked out to rapturous applause. Ali, arguably the greatest heavyweight boxer of all time, had come out of his short-lived retirement to fight Larry Holmes, his one-time sparring partner.

At 38-years old and nursing multiple ailments, Ali was considered way past his prime. But he had lost none of his trademark swagger. "I'm gonna whup...Holmes," the legend thundered before the match.

When the fight began, however, it was starkly evident that the wheels of history had decisively turned. Holmes dominated Ali from the first round itself, punching and jabbing his opponent at will. Ali's sluggish movements and slow reflexes made him a sitting duck. After some time, the 'match' deteriorated to a full-on thrashing as the 25,000-strong crowd watched in horror.

After the 10th round, Ali's trainer stepped into the ring and pleaded with the referee to stop the fight. It was the only time in Muhammad Ali's glorious career that he lost a match due to a technical knockout.

From 'floating like a butterfly and stinging like a bee' in the early part of his career to being rendered almost immobile by size and the weight of expectations, Ali had come a long way.

Perhaps the champion never came to terms with a fundamental fact—the sprightliness of youth cannot be replicated during the mellow years of maturity.

Four decades later, millions of investors are learning this lesson the hard way.

Fickle Fortunes

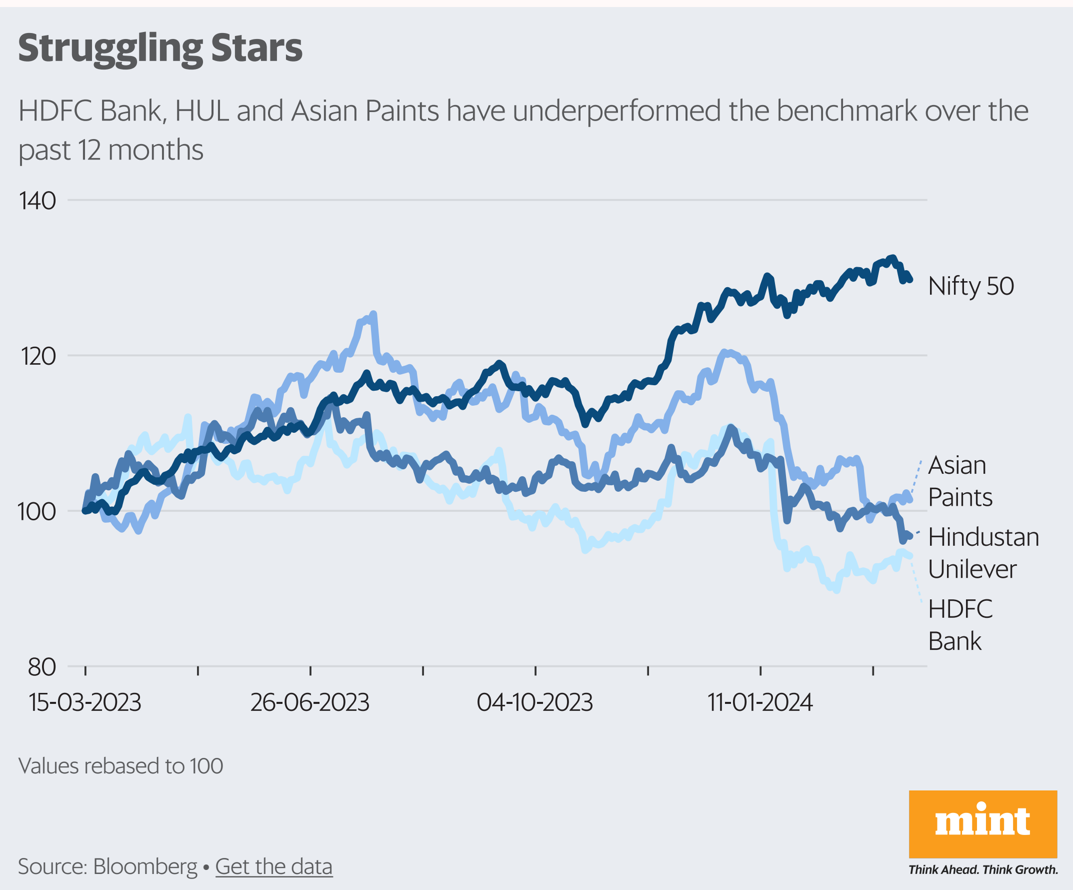
HDFC Bank, Hindustan Unilever and Asian Paints handsomely rewarded investors' faith year after year. (PIxabay)

For years, HDFC Bank, Hindustan Unilever (HUL) and Asian Paints were synonymous with equity market investing. Of course, there were periods when the stocks remained comatose, but the consensus view was that one can never go too wrong by investing in India's biggest private sector bank, the largest fast-moving consumer goods (FMCG) firm and the biggest paints company.

The three companies handsomely rewarded investors' faith year after year, consistently expanding their market share, stamping their dominance over rivals and delivering healthy growth in earnings and stock price appreciation.

But as they say, all good things have a sell-by date.

2023 was the first year when stocks of HDFC Bank, HUL and Asian Paints simultaneously underperformed the Nifty50. Against the benchmark's 20% jump, Asian Paints rose 10%, HDFC Bank 5% and HUL just 4%.

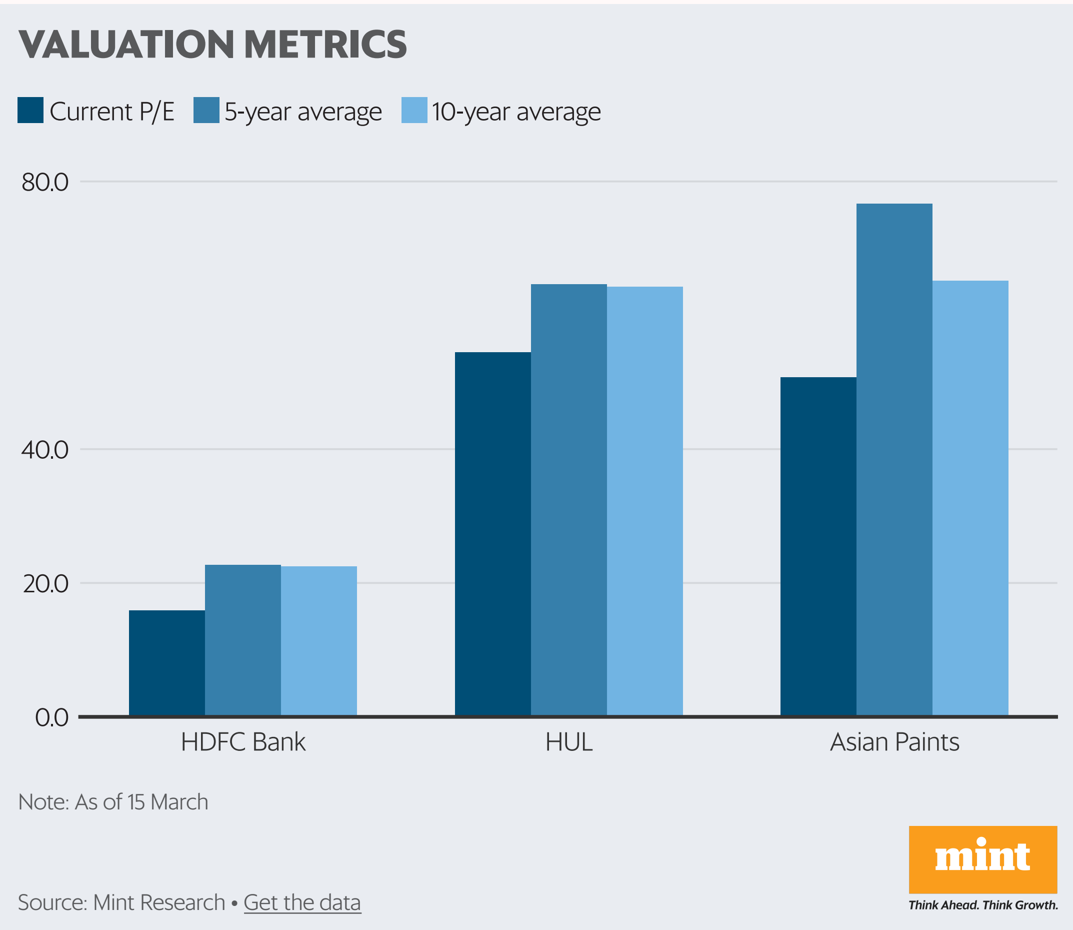


Analysts say apart from common financial ratios like price-to-earnings (PE), price-to-book (PB) and return on equity (RoE), investors should also pay attention to the biggest number out there—the company's size.

"One thing for sure is that when a company is a dominant player in an industry, it is very difficult for it to grow faster than the sector itself. This was a situation that Bajaj Auto found itself in scooters decades back or Maruti in cars," Devina Mehra, the founder, chairperson, and managing director of First Global, an investment firm, told *Mint*.

"Newcomers or smaller players tend to take away market share from them. There is also a danger of disruptive technology which can completely unseat leaders, like what happened with Kodak, Blackberry etc.," she added.

Mehra said there is also the phenomenon of overpaying for a company, no matter how attractive the underlying business is.



"It is a myth that you can never go wrong buying consumer brands with substantial cash flows. It all depends on the price that you are paying for them. Not even Warren Buffett has made returns in these types of stocks for the last many decades," she pointed out.

Banking on Pedigree

HDFC Bank is currently the 11th largest bank in the world. (Reuters)

Some of us might be captivated by the big, fat Ambani wedding but an even more power-packed union transpired last year.

When HDFC Bank, the biggest private sector lender, announced a merger with parent HDFC, the country's largest housing finance company, the group wrested for itself a seat at the global high table.

HDFC Bank is currently the 11th largest bank in the world with a market capitalization of $140 billion, ahead of marquee names such as Goldman Sachs and Citigroup.

The global bragging rights, however, have not rubbed off on its stock. The reverse, if anything.

HDFC Bank's share is down around 15% from its level in July 2023, when the merger came into effect.

BANKING LEADERBOARD

Company	Mcap (₹ cr)	6-month returns (in %)
HDFC Bank	1,109,114	-11
ICICI Bank	760,792	10
SBI	667,155	24
Kotak Mahindra Bank	343,816	-3
Axis Bank	333,601	5

Note: As of 15 March

Source: Mint Research • Get the data

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After absorbing HDFC, HDFC Bank widened its lead over its private sector peers. Its advances of over ₹25 trillion (as of December 2023) are double that of ICICI Bank, though below SBI's ₹36 trillion. HDFC Bank accounts for over 10% of overall deposits and nearly 16% of net advances.

However, the merger has also crimped its net interest margin (NIM), which measures the money that a bank earns in interest (from loans and investments) compared to what it pays on deposits.

NIM is one of the most crucial profitability metrics of a lender, and for over two decades, HDFC Bank outshone its competitors by delivering NIMs of 4%.

But swallowing up HDFC's loan book has pushed HDFC Bank's NIMs to 3.4% (Q3 FY24) as home loans have lower margins compared to other products.

With its total advances outpacing deposits by around ₹3 trillion, and deposit growth via the low-cost current accounts and savings accounts (CASA) route being lacklustre, HDFC Bank had to meet the shortfall through high-cost borrowings.

> ***Growing both deposits and advances on such a big base is akin to an elephant matching step with lively hares.***

"We believe deposit mobilization will remain an uphill task given tight liquidity and stiff competition. While margin pressures will persist, improvement in NIMs will be largely driven by shifting portfolio mix towards retail lending," Axis Securities said in a post-earnings report.

This is where size becomes an impediment for the lender, as growing both deposits and advances on such a big base is akin to an elephant matching step with lively hares.

Slow Moving

A wisecrack in the policy circles is that if you truly want to get the pulse of the economy, ignore what the statistics ministry is publishing and comb through the results of HUL.

Very few domestic companies can match the corporate lineage, governance standards and market dominance of HUL, considered a proxy for India's consumption story.

But Mr Market, like Indian parents, can still remain unimpressed.

The halo around HUL has dimmed in the past few quarters after the FMCG major's growth plateaued.

FMCG SHOWDOWN

Company	Mcap (₹ cr)	6-month returns
HUL	543,366	–7
Nestle India	249,036	15
Varun Beverages	181,121	53
Godrej Consumer	122,379	19
Britannia	117,002	7

Note: As of 15 March

Source: Mint Research • Get the data

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The stock had its worst two-session fall in more than a year this January after it posted a lacklustre set of numbers for Q3 FY24.

Its standalone net profit increased just 0.55% on-year to ₹2,519 crore, while revenue dipped 0.38% to ₹14,928 crore. Both the figures were down sequentially—a rare event for HUL.

Underlying volume growth—a crucial metric for FMCG firms, which measures their increase in turnover excluding the impact of price hikes—came in at 2%, as against 5% for the year-ago quarter.

Urban volume growth stood at 3%, while the rural segment disappointed with a measly 1% expansion. While the management tried hard to exude confidence in the post-earnings conference call, the mood shift was palpable.

With a rural recovery driver nowhere in sight, JM Financial expects HUL's stock to remain under pressure for the near-term.

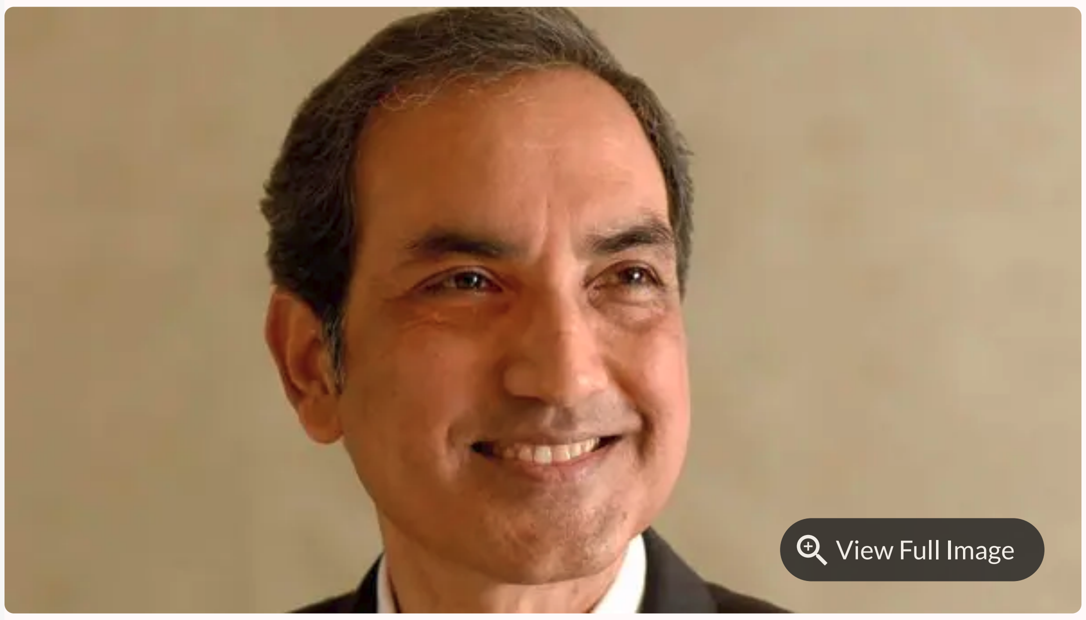
“We see two issues with HUL’s December-quarter earnings report and commentaries—management sees a mere 4% two-year volume CAGR as ‘strong’, and the view on margin seems to now be to maintain the current 23-24% level vs earlier stance that getting back to 25%-mark would not be a challenge at all," analysts at JM Financial, an investment banking firm, wrote in a note.

CAGR is compound annual growth rate or the annualized average rate of revenue growth over a given period.

“Interestingly, management also expects the number of categories where it would win shares to be lower in the coming couple of quarters—this is due to regional and smaller players getting more aggressive in the marketplace," they added.

With a rural recovery driver nowhere in sight, the domestic brokerage firm expects HUL’s stock to remain under pressure for the near-term.

At the company’s earnings call, HUL managing director Rohit Jawa alluded to the distress building up in some pockets of rural India.



Rohit Jawa, CEO and MD, HUL.

“Due to lower agriculture yields and uncertainty of future crop outputs, rural consumer sentiment remains subdued. Consequently, the anticipated buoyancy from the festive season did not materialize," he said.

But analysts maintain HUL’s volume woes have more to do with resurgent local brands rather than macroeconomic trends. Most regional brands had retreated after the covid-19 pandemic disrupted supply chains and led to a surge in input prices, leaving their operations unviable.

However, with raw material prices cooling off, these local brands have made a strong comeback, nibbling away market share from organized sector players.

Weak spending sentiment on the ground also means consumers are easily swayed by price discounts, where the local players often score over listed companies.

Painting the Town Red

The entire paints sector is gearing up for an epic showdown. (iStockphoto)

HUL is not the only corporate giant feeling the heat from rising competition. In fact, an entire sector is gearing up for an epic showdown.

Grasim Industries, the flagship firm of the Aditya Birla Group, has forayed into the paints business under the Birla Opus brand with an investment commitment of ₹10,000 crore. Group chairman Kumar Mangalam Birla said the company is targeting ₹10,000 crore revenue and profitability within three years of full operations.

Grasim has commissioned three plants and plans to operationalize three others in the next 12-15 months. At full capacity, all the six plants of Birla Opus will have a total commercial capacity of 1,332 million litres per annum (MLPA), the second highest in the sector after Asian Paints.

It is not often that a challenger makes such an audacious entry, that too in a staid sector like paints. It is not without reason that shares of all the top-five paints companies by market capitalization are down on a six-month basis.

PAINT SECTOR'S PAIN

Company	Mcap (₹ cr)	6-month returns (in %)
Asian Paints	274,402	-11.0
Berger Paints	64,898	-8.0
Kansai Nerolac	20,897	-21.0
Akzo Nobel	10,432	-6.5
Indigo Paints	6,233	-12.0

Note: As of 15 March

Source: Mint Research • Get the data

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The most worried of the lot naturally is Asian Paints, which has a job on its hands to protect its 50-plus percent market share in the organized decorative segment.

While it posted a healthy 12% year-on-year volume growth in Q3, supported by festive demand, analysts expect the road to be far from rosy in the medium term.

Reimagining Big

Is size always a bane? Not necessarily. For example, the current rally on Wall Street is being powered by the 'Magnificent Seven' mega-caps—

Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla.

Back home, sectoral leaders like L&T, Tata Motors and NTPC too are in a relatively comfortable position. While India's largest IT services firm TCS is facing sectoral headwinds, analysts say tech is one sector where scale clearly confers distinct advantages of resources and network effect, which companies can harness to tap into emerging technologies like AI.

The current rally on Wall Street is being powered by the 'Magnificent Seven' mega-caps. (Reuters)

But overall, without innovation or venturing into newer segments, the market leader in any sector is vulnerable to the onslaughts of smaller, more agile challengers.

"Leaders often face diminishing returns on growth after reaching a certain scale. Their sheer size makes significant leaps more challenging. We see this with established companies like HUL, HDFC Bank, and Asian Paints. These giants are entering a mature phase, where explosive growth becomes less likely," said Sunil Nyati, managing director, Swastika Investmart, a brokerage. However, these companies still possess the potential for steady, albeit slower, expansion, he added.

Investors, then, would do well to note the altered landscape.

"As I often repeat: No theme runs forever. No geography, no asset class, no sector. The trick is to stick to data and shift when things change rather than build stories in your head," First Global's Mehra added.

Building stories in one's head may be therapeutic, but reality finds a way to ambush our little notions. Muhammad Ali would have perhaps concurred.