March 2019

Issue No: 2019-01

Equity: Preparation for 2020?

Are Indian Stocks still over-valued?

Is the stock market over-valued? Will 2019 witness a severe correction, or worse, a bear market ? Or are stocks now reasonably priced?

To answer these questions, here is our list of 10 pointers based on 2018 market trends

2018: Ten Pointers

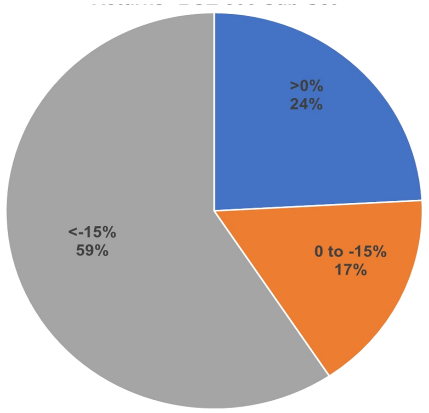

Chart-1: Returns over Jan '17-Jan '18

1. **76% of our BSE 500 sub-set** ("Universe-1": stocks left after excluding banks, oil PSUs and companies that had negative profits in calendar year (CY) 2017 or 2018 – please see last page for rationale), delivered negative returns between 31 Jan 2018 and 31 Jan 2019, with 59% of stocks falling more than 15%, and a further 17% dropping between 0% and 15%. Only 24% of the stocks showed positive returns.
2. **The decline in stocks** is therefore much deeper than the -1.8% loss shown by the Nifty Index for the same period. 2018 was a year where we could not infer stock (or equity mutual fund) performance, or indeed attractiveness in terms of valuations, by looking at the Sensex or the Nifty.

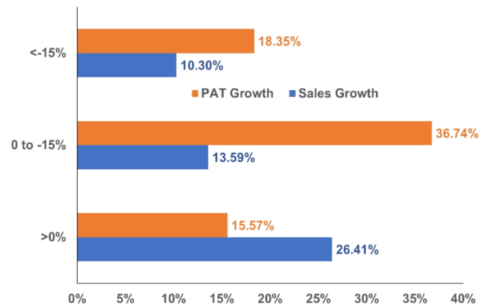

Chart-2: Sales and PAT Growth over CY 2018

3. **Sales growth** over the year (CY 2018/CY 2017) seems to have mirrored the return pattern, with stocks that delivered positive returns showing highest sales growth. We could interpret this as investors placing a premium on companies with robust demand growth.
4. **Profit Growth** over the same period does not show this linkage– maybe because markets were skeptical of growth obtained by cost control, which may not be sustainable.

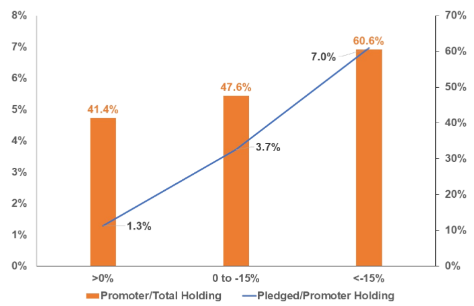

Chart-3: Promoter Holding and Pledges

5. **Promoter Holding** and returns showed some correlation, with investors seeming to prefer stocks with greater free float.
6. **Pledged Shares** were a definite negative for investors. Thus stocks that fell between 0% to 15% could not post positive returns in spite of a ~37% earnings growth in 2018 over 2017, as the proportion of pledged shares was almost three times that of the stock group showing positive returns.

Our recommendation in Jan 2018:

- **Reduce allocation to large and multi-cap funds by 25%**
- **Reduce allocation to mid and small-cap funds by 40%**

Our Recommendation Now:

- **Buy into the correction in a staggered manner through 2019**
- **Increase allocation to mid-cap funds**

Please see notes and disclaimer on the last page.

2018 Trends: Ten Pointers (continued)- Valuations

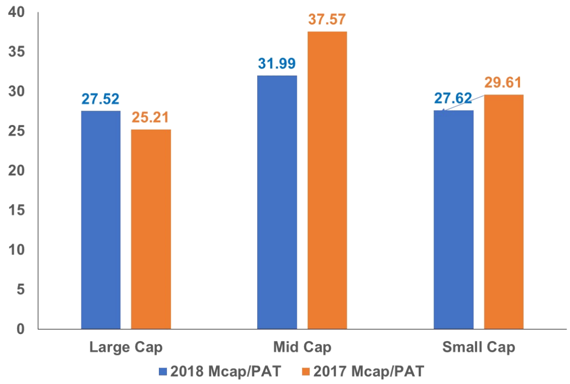

Chart-4: Valuations of stocks with positive returns

7. **<u>Advantage Large cap in returns</u>** Large cap stocks were the only ones that showed an increase in the aggregate MCap/PAT multiple (equivalent to the price-to-earnings or PE Multiple, used interchangeably from here) among stocks with positive returns between Jan 2018 and Jan 2019, as shown in Chart-4 alongside.
Mid cap stocks had a sharp decline in their PE, implying very high earnings growth (as returns were positive).
Small cap stocks had a moderate decline in their PE, implying a better matching of earnings growth with stock price movement.
Among all stocks, <u>only the large cap stocks which showed positive returns in 2018 managed to expand their valuations.</u>

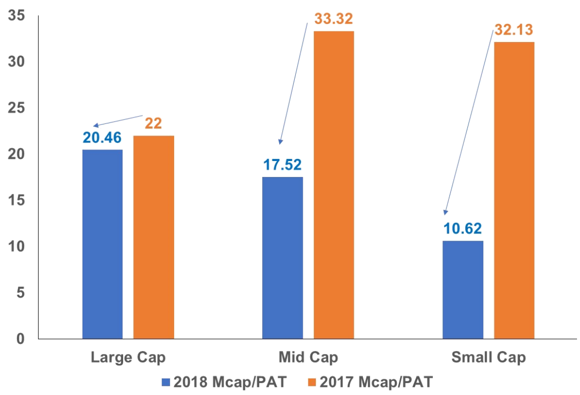

Chart-5: Valuations of stocks with returns up to –15%

8. **<u>Advantage Mid/small caps in valuations</u>** Mid and small cap stocks had a very steep decline in their PE, in spite of impressive earnings growth in the stock group that fell between 0-15% (Chart-5).
<u>The declines were not due to the numerator (Market Cap) declining as much as a big jump in the denominator (PAT). This is a story of valuations getting rationalized, with prices mildly declining in spite of strong earnings growth.</u>
Large cap stocks' aggregate PE fell moderately implying not much of a decline in this category.

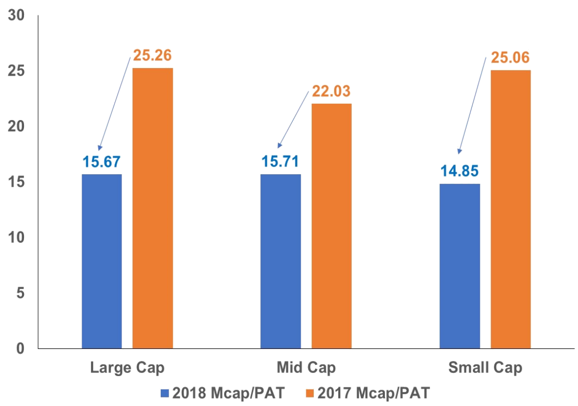

Chart-6: Valuations of stocks with returns <-15%

9. **<u>Fair, but not "bargain" valuations</u>** The stock group that fell more than 15%, unlike the previous group, has actually eroded serious wealth, with a 25% decline in market cap, which is <u>bear market territory</u>.
In spite of this fall, valuations are still in the 'teens' for these stocks in the aggregate.
Clearly, there is more scope for valuations to normalize in this segment, which is nearly 60% of our study universe, and points to <u>volatile times ahead.</u>

10. **<u>More of the same</u>** as happened in 2018 is indicated in 2019, as we believe valuations would need to moderate further, with prices rising less than earnings growth. Returns will come once valuations move towards the 'bargain' zone from the 'fair' zone. How much movement would be dictated by the prevalent mood and "sentiment" factors that influence short-term market movements.
<u>Buying in a staggered manner through this process of normalization, and emphasizing pockets where significant valuation corrections have happened (mid caps) seems the best course of action.</u>

Equity: Preparation for 2020?

Will earnings continue to grow in 2019?

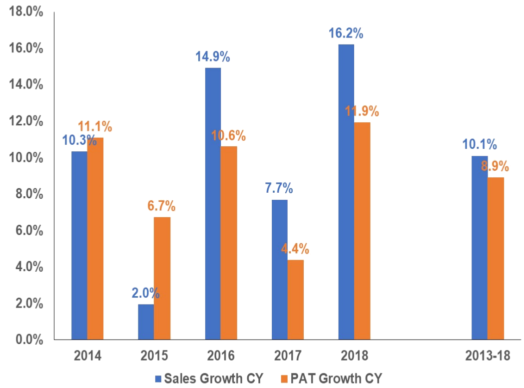

Chart-7:Trends in Sales, PAT Growth 2013-18

Charts 7 and 8 are based on the "Universe-2" dataset, where we have further filtered "Universe-1" for stocks that have shown positive profits in each of calendar years 2013 to 2018 (Refer last page for details.).

Chart-7 shows that we have had the highest growth in sales and PAT in the last 5 years in CY 2018. PAT growth has not kept pace with sales growth mainly because of reduction in the PAT Margin (PAT/Sales) from 8.2% to 7.8% between 2013 and 2018.

We have lived on optimism of a 15% plus sales and profit growth since 2013, and driven prices up on hope. 2018 marked a departure where sales and profits were encouraging, but the hope went missing.

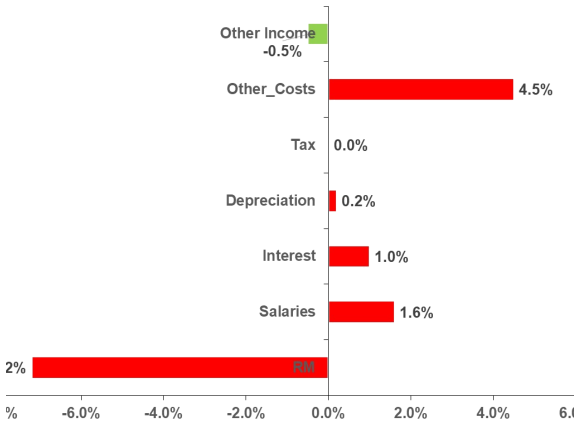

Chart-8: PAT Margin break-down 2013 over 2018

As Chart-8 shows, the 0.6% reduction in PAT Margin was mostly because of a fall in other income to sales by 0.5% between 2013 and 2018.

A large reduction in raw material unit costs through the period was offset by a jump in other costs (due to depressed sales growth), salaries and interest costs.

If global growth slows down as per consensus estimates in 2019, and the US dollar rally is stopped due to a dovish Fed and a high deficit, raw material costs should remain stable to declining.

With sales growth pick up, other costs as a percentage of sales would moderate. This should lead to better profit margins, and strong earnings growth if sales growth sustains.

If prices do not move up in tandem, we must see this as an opportunity to buy equities cheaper.

Preparing for good returns one year ahead

2019 has to be used as a time of preparation for good returns going forward, by buying systematically as valuations head southwards from the 'fair' zone.

As noted previously, this may not necessitate a steep slide in stock prices, if earnings growth sustains.

Our base case is for earnings momentum to improve over 2019.

We therefore advocate a staggered buying of equity funds, with emphasis on quality mid-cap funds over the year through a systematic transfer plan.

Key risks

- Input costs rising and reducing profit margins.
- Sales growth momentum not sustaining.
- External events– geo-political, oil price volatility, pressure on currency and rates.
- "Risk-on" sentiment re-emerging, leading to hope rallies that make stocks expensive quickly (we may have to reduce equity in this scenario).

2019: Bull or Bear?

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Data, Strategy and Customization for Growth

About the earnings study

- The study on sales, earnings, costs and valuations have been done using the ACE Equity Database on stocks selected from the BSE 500 Index. We have used quarterly results data and aggregated this data calendar year-wise for calculations.
- Universe-1 comprises 327 stocks from the index, after excluding banks and oil PSUs and companies where aggregate profits in either 2017 or 2018 are negative. Banks were excluded as NPA provisioning has dragged the PSU Banks into losses, which should be viewed as an aberration. Oil PSUs were excluded as government policy significantly influences their financials. Finally, we chose to compare profit growth only if there were profits in each year being compared, to remove distortions of companies moving from loss to profit and vice-versa.
- Universe-2 comprises 290 stocks from the index after excluding banks and oil PSUs and companies where aggregate profits in any of the calendar years from 2013 to 2018 are negative.

Disclaimer