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A Rational Analysis of the SENSEX for 2016

Highlights of 2015:

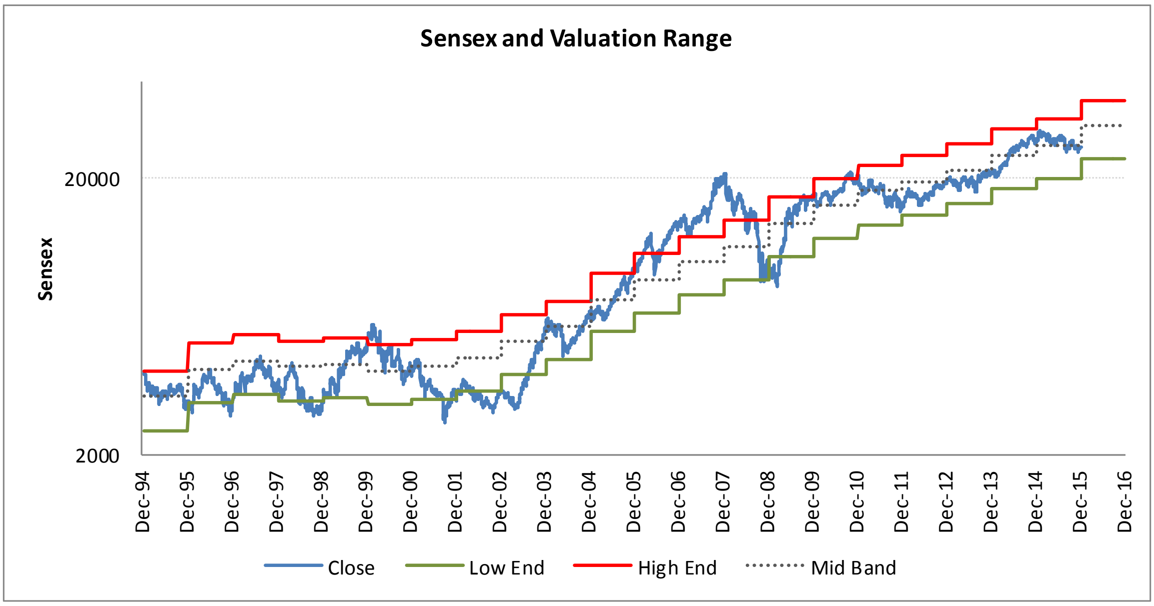
The year 2015 had started on a very optimistic note with market participants expecting a strong recovery in earnings growth. SENSEX touched 30,000 in March. The optimism was built on the basis of a pro-business government that had been elected to the parliament with a strong majority. But as the year passed by, expectations had to be rationalized, as not much improvement was seen on the ground in terms of earnings growth.

Based on our rational analysis of the Sensex for December 2015 and the interim review that we did in July 2015, we had pointed out the mismatch in the ground reality and expectations that had been built in the valuation of the Sensex. We held the view that based on a rational analysis; the SENSEX should consolidate around no higher than its fair value (Mid band) of the Index which was around 27,500. This could have been branded as pessimistic at the start of 2015. But as of 31st Dec 2015, the index closed the year around 26,100 slightly lower than our already lower expectations.

Fundamental Valuation for 2016:

Valuation using	**Lower end**	**Higher end**
Historical data	24,550	38,020
Discounted Cash Flow	22,191	37,781
Standard deviation around Price to Earnings band	23,601	39,898
Average of the above	**23,447**	**38,566**

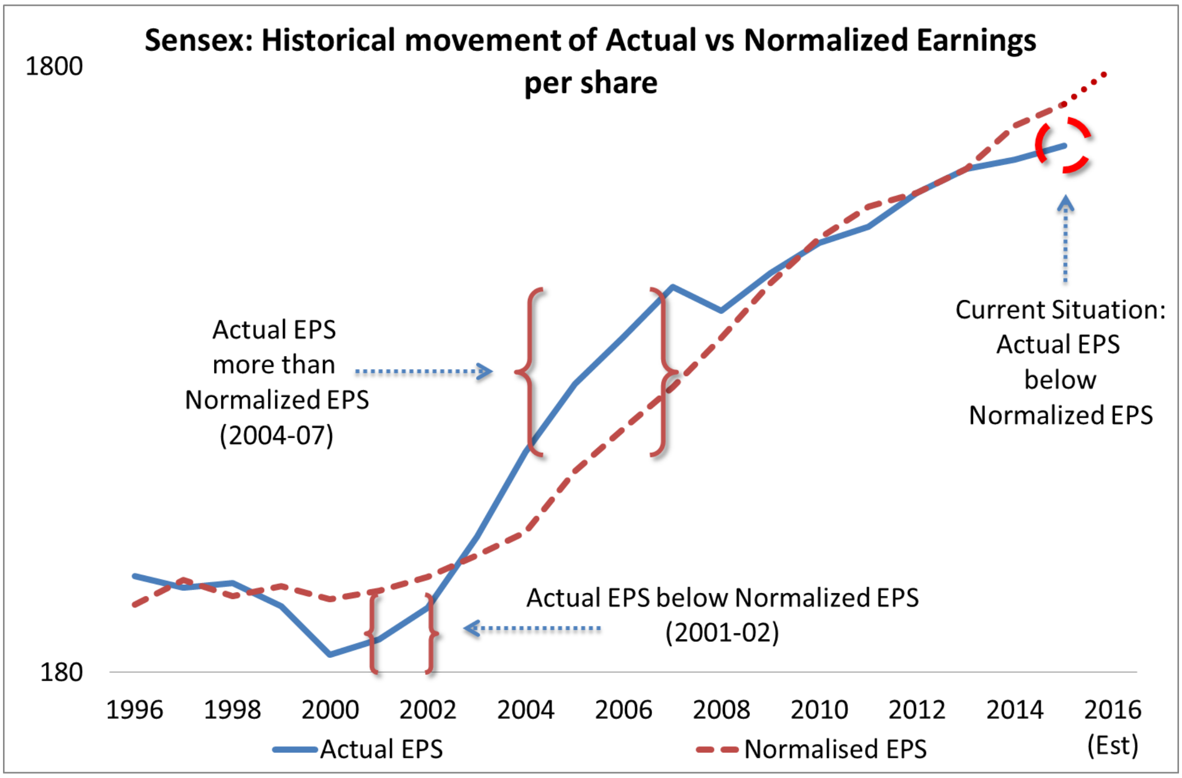
SENSEX Valuation range for the year 2016: **23,500 – 38,500.**



Normalized Earnings per Share

We are believers in mean reversion. Businesses in general go through ups and downs. But the intrinsic value of a business is not affected by business cycles. There is an underlying margin and an underlying earnings growth that a business would achieve in a normal period over a full cycle. We believe it is the role of analysts to value the business over a full cycle. We value businesses therefore based on such a normal environment, and we believe this helps us to avoid undervaluing businesses in a bad period and overvaluing them in good one by not falling prey to a common behavioral error of extrapolation.

A similar thought process is applied to our SENSEX valuation, wherein we don't value the SENSEX based on current earnings or market estimates (which can be affected by sentiment), but based on normalized earnings (EPS).



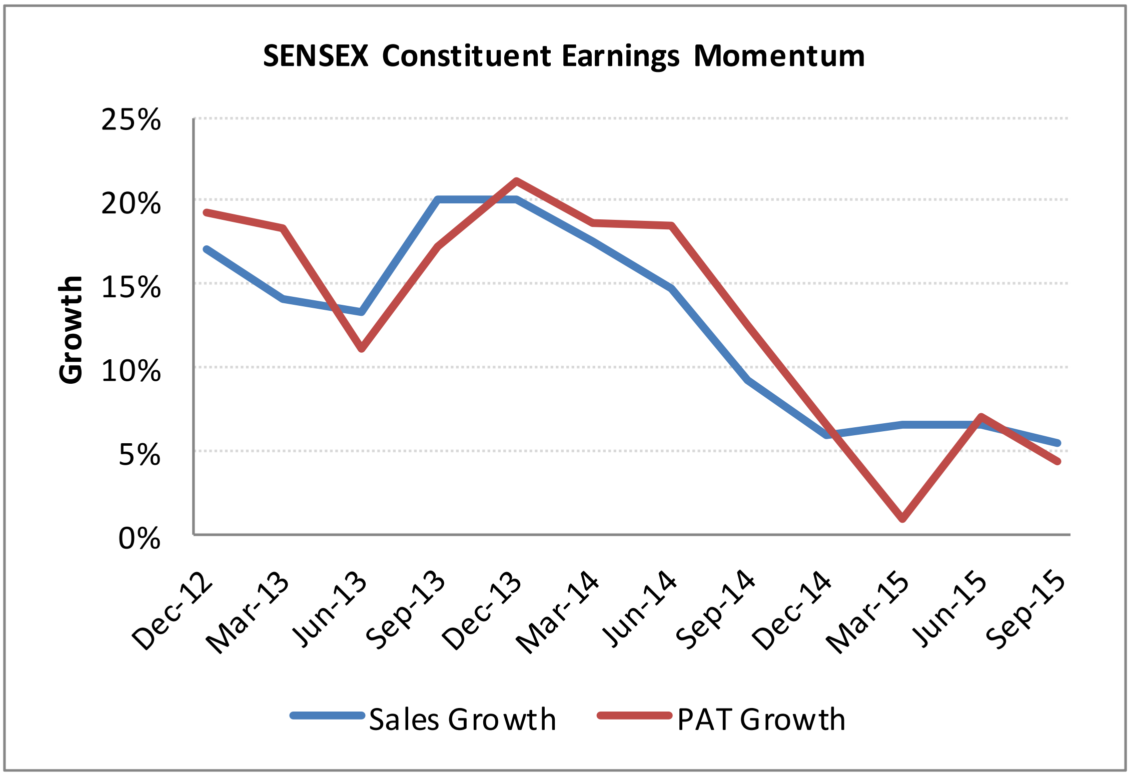
As can be seen from the chart, actual EPS was below normalized EPS in 2001-2002 period while it was above the normalized EPS during 2004-2007 period. Using normalized EPS, valuation is not affected by cycles and gives a better tool to a long term investor.

Currently, the actual EPS is lower than normalized EPS which indicates that one needs to see a sharp recovery in earnings to catch up with the normalized EPS.

Thus our valuation band based on the normalized estimates for Dec 2016 is 23,500 to 38,500.

Earnings Momentum:

As we have discussed in our past Sensex Rational Analysis reports (Refer July 2015 Interim Report), our valuation bands incorporate barometers of expectations and sentiment. SENSEX would move towards the higher end of the range, when both earnings momentum is strong and is also supported by positive sentiment. Conversely a low/negative earnings momentum coupled with poor sentiment increases the risk of the Sensex moving towards the lower end of valuation range.



India Inc is going through a rough patch currently with low earnings momentum as can be seen from the adjoining chart. Capacity utilization levels across industries remain low and thus there is no requirement of significant capital expenditure at this juncture which has affected private sector investments. There is significant stress in the Banking system on account of stretched corporate balance sheets and poor health of State Electricity boards. Rural economy which had held up consumption growth so far has slowed down on account of poor monsoon. These factors along with a general slowdown in the global economy have affected corporate earnings growth.

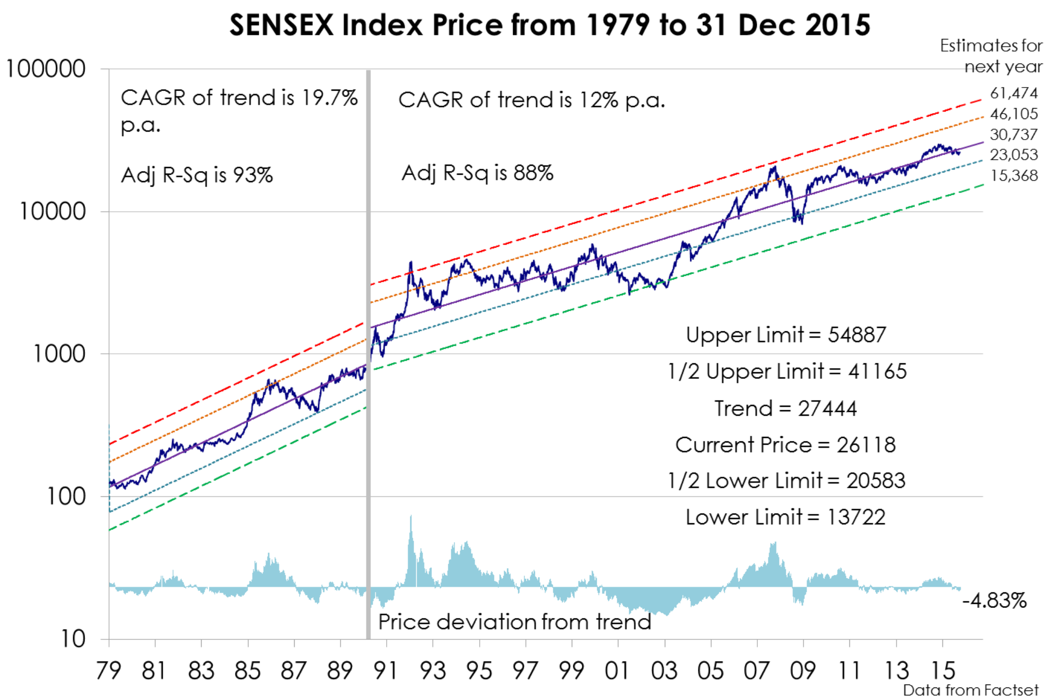
Thus considering the poor earnings growth, one cannot expect the SENSEX to go beyond the mid-band of the valuation range of ~31,000 even if sentiment is strong. On the other hand a change in market sentiment to negative, could risk the Sensex moving down to the lower end of the valuation range of around 23,500.

Technical Analysis:

Verdict: Weak chart

Technical weakness coupled with poor earnings momentum therefore increases the risk of SENSEX going to the lower end of the valuation range of **23,500**.

Quantitative Analysis:



Currently, SENSEX is quoting below its historical trend line. In an environment where earnings momentum is poor and technically SENSEX is weak, the index could move to the half lower limit of 23,053 (its projected value at the end of 2016).

Prepared for Restricted Circulation

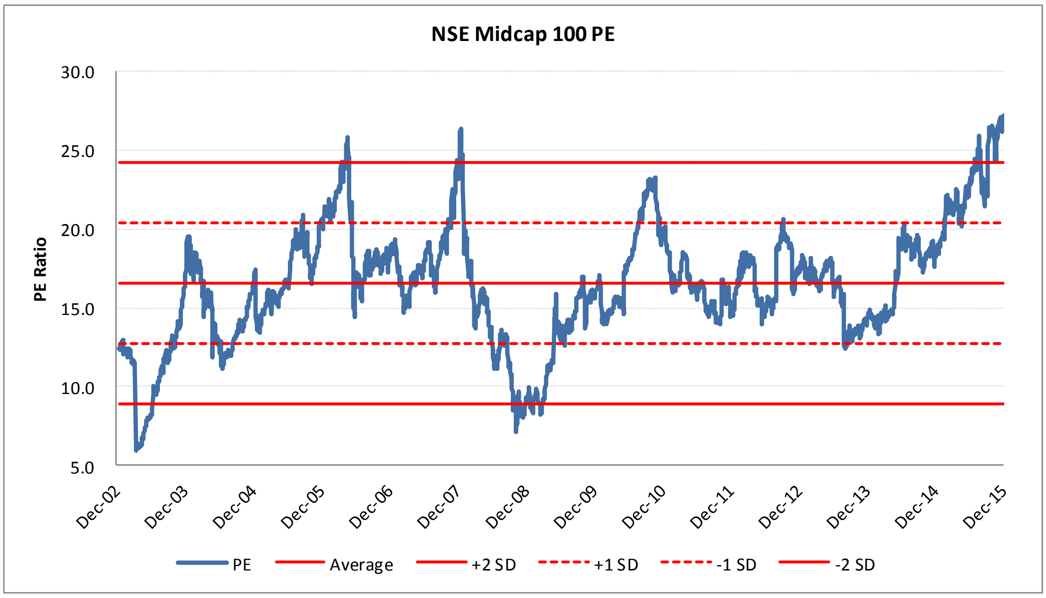
Behavioral Analysis:

The sentiment indicators that we track are in the neutral zone; not indicating either excessive optimism or pessimism. But if one sees retail inflows into Mutual Funds, IPO over subscriptions (See table below) and overvaluation in the Mid and Small cap space, there seems to be ample risk appetite in the market.

Recent IPOs saw healthy subscriptions:

IPO Date	Security Name	xTimes Oversubscribed
21-Dec-15	NARAYANA HRUDAYALAYA	8.7 x
10-Dec-15	ALKEM LABORATORIES	44.3 x
10-Dec-15	DR LAL PATHLABS	33.4 x
30-Oct-15	S H KELKAR AND COMPANY	27.1 x
29-Oct-15	INTERGLOBE AVIATION	6.2 x
16-Oct-15	COFFEE DAY ENTERPRISES	1.8 x

Mid Cap Valuation:



We have seen further run up in the valuations of Mid and Small caps. This seems to be mainly driven through retail money that is flowing in to Mutual Funds.

NSE Midcap valuation is at an all-time high level (above +2 SD).

Source: NSE

But while the domestic risk appetite seems to be healthy, the global gloom and first hike of US Federal Reserve seems to have made FIIs risk averse, and they have sold close to Rs 30,000 Crore (net) of equities since May 2015. This negative sentiment seems to have affected the Large caps in particular who have heavy FII holdings. This partly explains why we have SENSEX below the mid band of valuation range while Mid caps and Small Caps continue to remain expensive and at record high PE ratios.

Thus to summarize, the broader market has enough risk appetite but that is not reflected in the SENSEX valuation as FIIs have been risk averse, particularly on Emerging Markets.

Prospective Return of Constituents:

Based on our rational analysis framework (fundamental, technical, quantitative & behavioral) we arrive at a best case and worst case prospective return estimate for individual stocks. This is a bottom up approach. Using the Sensex constituent and their weights we can arrive at the prospective return for the Sensex as well.

Based on the prospective return of individual constituents, these are the estimates for SENSEX for 2016.

	SENSEX Returns	SENSEX value
Best case	5.7%	27,600
Worst case	-15.5%	22,000
Average	**-9.8%**	**24,800**

However this is a static approach given current earnings momentum and sentiment. This prospective return is recalibrated every day.

Conclusion

As we have discussed above, considering the poor earnings momentum, technical status etc. there is a risk of the SENSEX trading down to the lower end of the valuation range of 23,500. But a rational investor should always evaluate both the reward vs the risk at any point in time. Currently the risk of the downside from current levels is ~ 8% vs the reward of SENSEX going to at least the mid band (~31,000) should the economy improve and earnings momentum pick-up. This is a 20% upside potential, without even considering the potential return to the high end (which at this stage we confess we would assign extremely low probability). Thus, even if all the bad news continues, one is risking an 8% mark-to market hit on the SENSEX. Instead if some of the positive factors like – good monsoons in 2016, passing of key policy reforms like Bankruptcy Code, GST etc and financial restructuring of State Electricity Boards (SEBs) come through, there is significant upside for SENSEX.

Thus based on how we are placed today, the downside risk of 23,500 is quite plausible for the SENSEX But rather than anchoring on that number, we would focus on the reward vs risk of just under 3:1 (21 %/ 8%) and be more sensitive to hints of any number of positive developments that could move the SENSEX towards the Mid band of the valuation range (31,000).

We will of course review the outcome in our next interim report – 1st July 2016. You can read our past analyses on http://multi-act.com/knowledge-centre/

Regards

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Statutory Details: Portfolio Manager – Multi-Act Equity Consultancy Private Limited

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d. As with any investment in securities, value of the Client's Portfolio can go up or down depending on the factors and forces affecting the capital market.
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