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11 Jul 2016

A Rational Analysis of the Sensex for the Year ended December 2016 Interim Review:

In our January Sensex Rational Analysis report we had concluded by saying *"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)."*

Disappointing December quarter for corporate earnings and global commodity rout affected sentiment negatively and we saw SENSEX going down to ~23,000 by February. But as discussed in the January letter, even though we felt such a downside was probable, we were more focused on the reward vs risk at that point which was extremely favorable (i.e. more upside than downside).

SENSEX and the broader markets recovered sharply from the bottom that they had touched in February. This was mainly driven by positive news in the form of favorable monsoon outlook given by Indian Meteorological Department (IMD) and better than expected earnings for corporates in March Quarter.

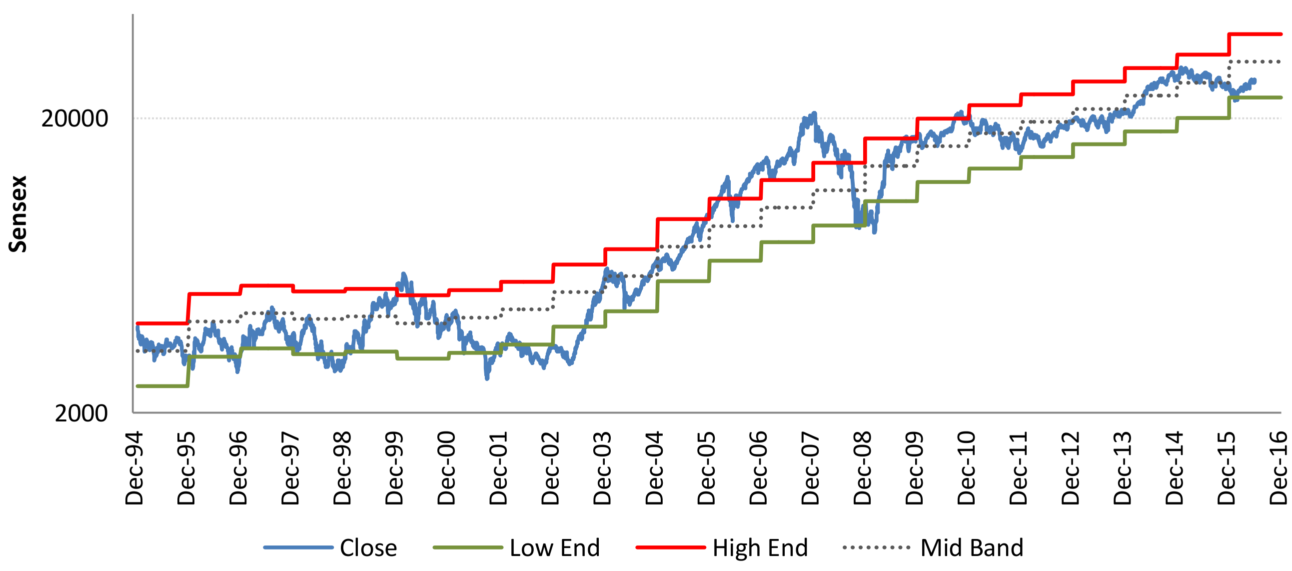
Fundamental Valuation:

Using our various valuation approaches we estimate the Fundamental Value of the Sensex on a top down basis for Calendar year 2016 as follows:

Sensex Valuation	**LOW**	**HIGH**
Historical	24,550	38,020
DCF	22,191	37,781
+1/-1 SD PE Band	23,601	39,898
Average	**23,447**	**38,566**

Sensex Valuation range for CY 2016: **23,500 – 38,500.**

Sensex and Valuation Range



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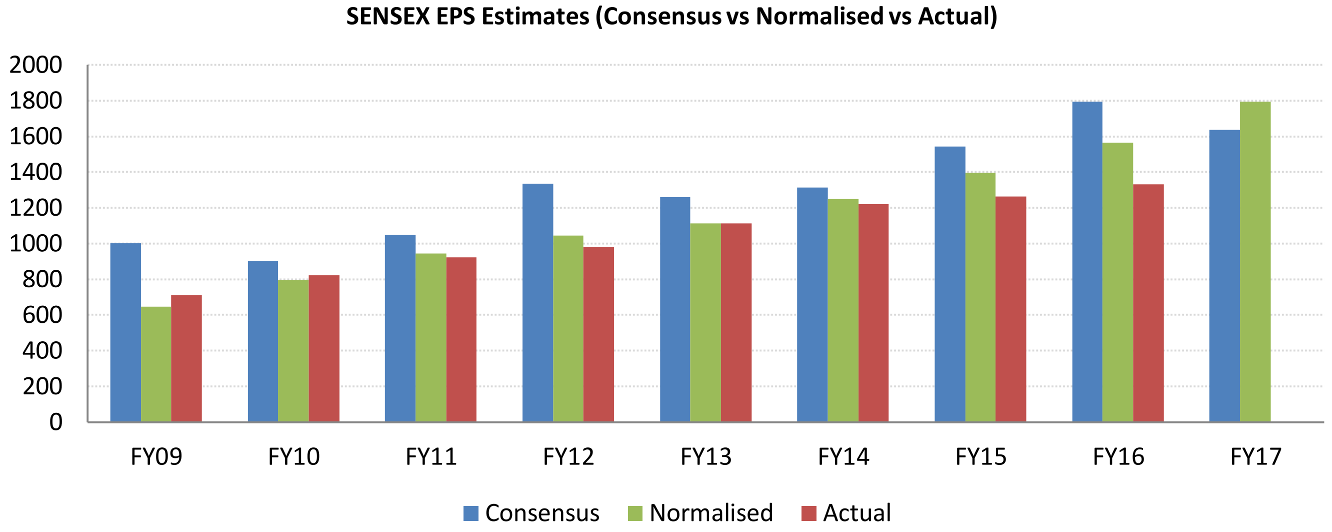
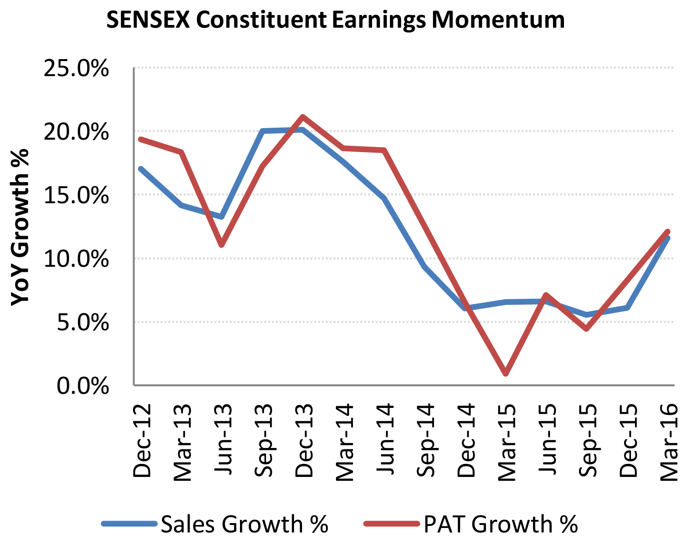
In the January report we had discussed about how we look at business valuation. We believe intrinsic value of a business does not fluctuate with business cycles. Thus we value a business from a normalized perspective (i.e. assuming business would revert to its mean).

We apply a similar valuation thought process for SENSEX as well. **Our estimate of normalized EPS is not a "forecast" of how much EPS would be achieved in a particular year. It is an estimate of what would be the EPS in a normal business environment.** As discussed in the last report current SENSEX EPS is below normalized (Mean) levels. Thus one could be undervaluing SENSEX looking at reported earnings or forecasted earnings rather than normalized earnings. An interesting point to highlight is that at the beginning of the year even the broker consensus SENSEX EPS estimates for FY17 were actually lower than our normalized EPS estimate (See chart below). Expectations for FY17 have been rationalized after serious negative divergence of consensus EPS estimate vs actual EPS in FY16 as companies continued to disappoint in FY16. This suggests that the street's expectations could be beaten on the upside if the mean reversion process on earnings picks up.



Earnings Momentum:
Earnings momentum has recovered in March. But this is partly on account of lower base. One needs to see if the earnings momentum picks up. There are some catalysts for earnings momentum in the form of improvement in the monsoon this year, which should benefit the Auto and FMCG companies. Commodities have recovered from the trough and thus they might have a lower negative impact. On the negative side PSU Banks are expected to show poor performance numbers as they continue to clean up their balance sheets.



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As the earnings momentum seems to have bottomed out, the possibility of SENSEX going down to the lower end of the valuation range remains low and only an event of severe negative sentiment would cause this to happen. Considering a neutral earnings growth and positive sentiment, there is a higher probability of the Sensex moving to our estimated Mid band valuation of 31,000. But for the Sensex to move beyond the Mid band we believe earnings momentum would need to pick up more strongly.

Technical Analysis:

When we wrote our last report, SENSEX was technically looking extremely weak. But since February when market touched the bottom, the SENSEX chart has turned and is now looking stronger. As the chart has turned stronger, the probability of SENSEX going back Technically to Low End of 23,500 again seems low. A retracement back to the 40 week moving average (red moving line in the chart) could happen as part of a normal retracement. Technical strength coupled with neutral earnings momentum, should also help SENSEX move to the Mid band of the valuation range i.e. 31,000.

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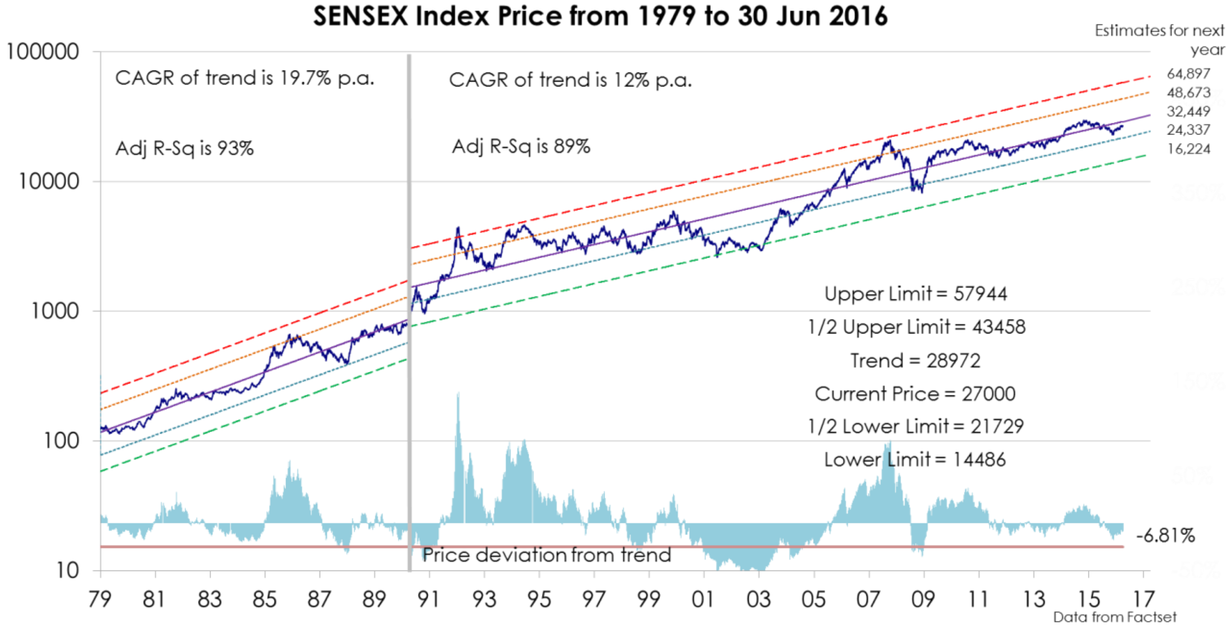
Quantitative Analysis:

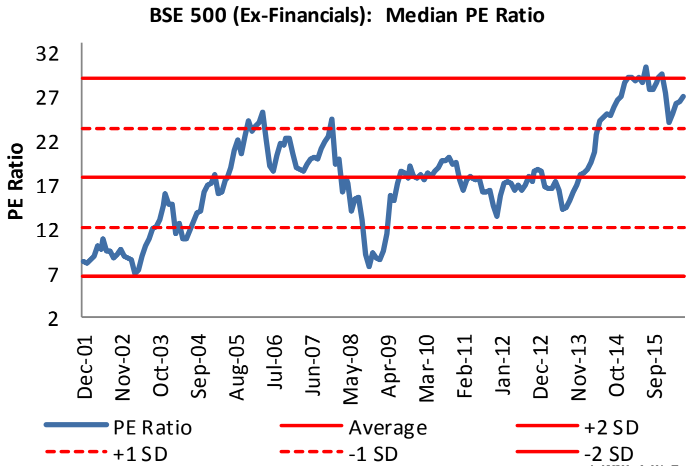


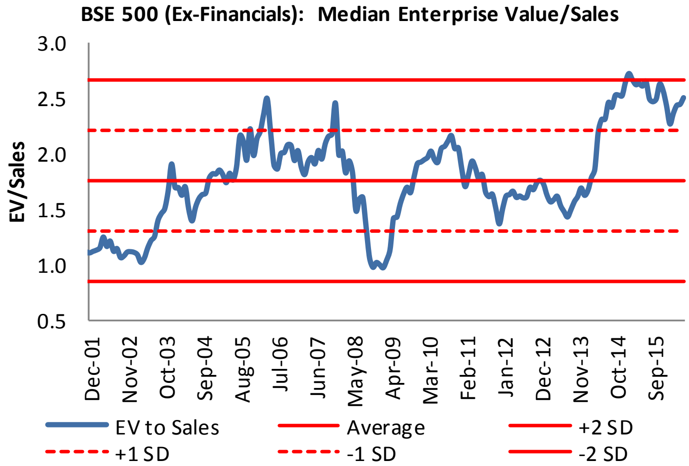
Currently, SENSEX is quoting below its historical trend line. In an environment where earnings momentum is neutral and technically SENSEX is strong, the index could move to the SENSEX Trend marked by the Purple line. The trend value as of the end of Dec 2016 is around 30,700 (refer our January report.

Behavioral Analysis:

The sentiment indicators that we track continues to be in the neutral zone; not indicating either excessive optimism or pessimism. But as noted in our January report, we felt the risk appetite was high at that point looking at interest in IPOs, Mutual Fund flows and valuations in the Mid and Small cap space.

Low valuation on the SENSEX is masking the exuberance that is there in the broader market. One can judge the same looking at the median valuation for BSE 500 companies (See chart below). Median valuation has been used to get a better feel of underlying valuation across companies, rather than being affected by Market Capitalisation statistics only. As can be seen from both EV/Sales and PE ratio, valuations are at historical extreme, suggesting risk appetite is very high.





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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 estimate the prospective return for the Sensex as well. Based on the prospective return of individual constituents, the best upside case for Sensex seems to be ~10.9% (or ~30100 from 8th July closing) while the worst case downside is estimated at -18.9% (or ~22000) with an average estimate of -9.8% (or 26,050).

Conclusion:

Since our January report, market internals have turned positive. Earnings momentum which was weak seems to have found a floor; technically the Market has turned strong. A favorable monsoon and high probability of GST being passed in the monsoon session of Parliament should support positive sentiment on the domestic side. **All our rational analysis tools (Fundamental, Technical, Quantitative and Behavioral) are suggesting a *higher probability* of the SENSEX moving up to 31,000.** We would assign a low probability of SENSEX moving beyond 31,000 at this point, given the neutral earnings momentum. On the downside, as earnings momentum seems to have bottomed out the probability of SENSEX revisiting the Low End of the valuation range (23,500) is low. From a Technical analysis perspective we feel SENSEX should most likely find buying support around the 40 week moving average which is currently around 25,600.

Regards

Rohan Samant
Portfolio Manager

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

Risk factors

General risk factors

a. Securities investments are subject to market risks and there is no assurance or guarantee that the objective of the investments will be achieved.

b. Past performance of the Portfolio Manager or its affiliates does not indicate its future performance.

c. Investors are not being offered any guaranteed or assured returns i.e., either of principal or appreciation on the Portfolio.

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.

e. External risks such as war, natural calamities, and policy changes of local / international markets may affect stock markets.

f. The Portfolio Manager has renewed SEBI PMS registration effective October 14, 2014 and has commenced its portfolio management activities with effect from January 2011. However the Portfolio Manager has more than 10 years of experience in managing its own funds invested in the domestic market.

g. The contents herein – information or views – do not amount to distribution, guidelines, an offer or solicitation of any offer to buy or sell any securities or financial instruments, directly or indirectly, in the United States of America (US), in Canada, in jurisdictions where such distribution or offer is not authorized and in FATF non-compliant jurisdiction and are particularly not for US persons (being persons resident in the US, corporations, partnerships or other entities created or organized in or under the laws of the US or any person falling within the definition of the term "US person" under Regulation S promulgated under the US Securities Act of 1933, as amended) and persons of Canada.