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4 Jan 2019

## A Rational Analysis of the Sensex for the Year 2019

We had concluded our SENSEX Rational Analysis Interim review on 4th July 2018 by saying "**We believe that with the current set of information, SENSEX should at worst trade around the Mid-band of the valuation range (32,500) by December 2018 while any upside should be capped at ~38,300 which is the historical trend line. Any weakness below 32,500 which is driven purely by sentiment without any deterioration in fundamental momentum should be used constructively."** As of 31st Dec, SENSEX stood at 36,068, which is 6% below our suggested cap. Post our interim review the years high was touched in August which was 2% above our suggested cap and SENSEX made a low of 33,291 in October, which was still higher than yearly low of 32,596 touched in March.

| | Suggested | Actual | Gap |
|---|---|---|---|
| **Upper bound** | 38,300 | 38,989 | 1.8% |
| **Lower bound** | 32,500 | 33,291 | 2.4% |

**SENSEX movement in 2018:**

| | |
|---|---|
| **High** | 38,989 |
| **Low** | 32,596 |
| **Close** | 36,068 |

2018 had started on a positive note, but things turned negative at the macro level with US Administration taking a tough stance in the trade dispute with China and Indian currency getting impacted due to global weakness in emerging market currencies. The Currency weakness was also due to sharp jump in Oil Prices which peaked out in October before reversing sharply thereafter. Indian Markets recovered post the sharp correction in Oil prices in the last couple of months of the year. While we had started seeing improvement on the ground in terms of earnings visibility, the overall macro environment turned negative.

## Fundamental Valuation:

### A. Top Down Valuation

Using our various valuation approaches we estimate the Fundamental Value of the Sensex on a top down basis for Calendar year 2019 as follows:

| Sensex Valuation | LOW | HIGH |
|---|---|---|
| Historical | 31,826 | 47,871 |
| DCF | 26,203 | 44,691 |
| +1/-1 SD PE Band | 29,003 | 48,486 |
| **Average** | **29,011** | **46,992** |

Sensex Valuation range on a Top Down basis for CY 2019: **29,000 – 47000** with Midband around 38000.





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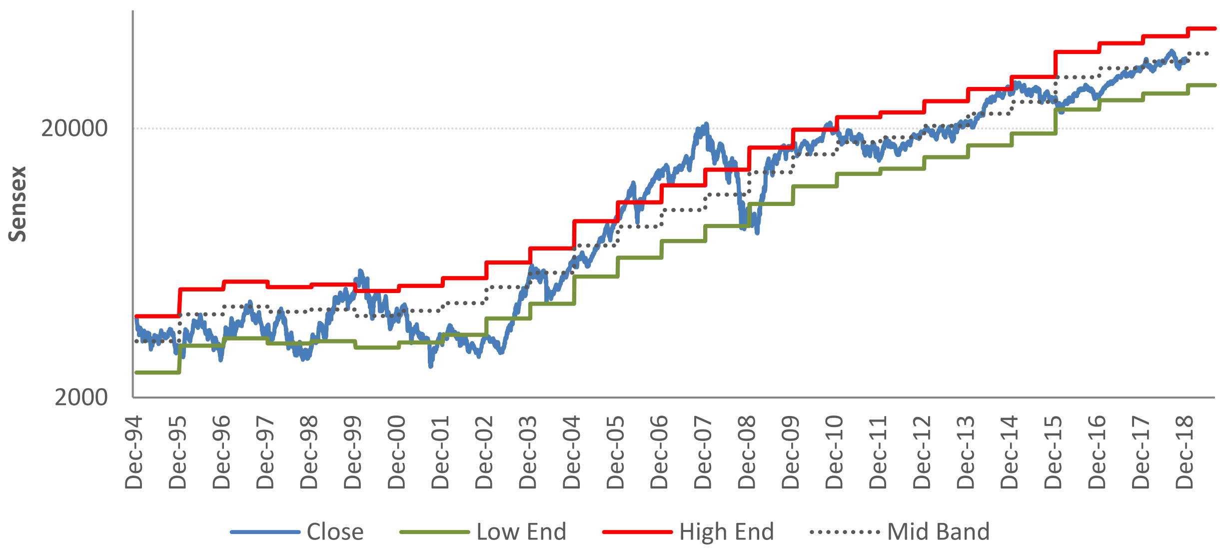
Our top down valuation approach assumes normalised earnings i.e. using long term historical average of Return on Equity and the Book value. Thus we are making an implicit assumption that there would be a mean reversion (from current level of below -1 Standard Deviation) of Return on Equity and thus earnings.



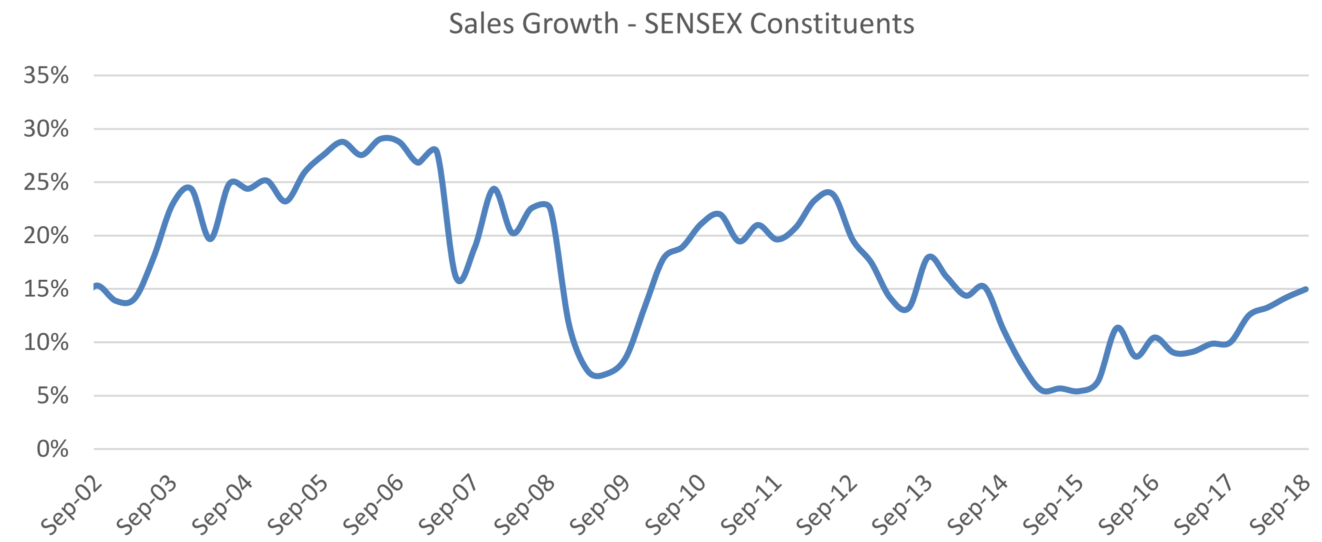

**B. Bottom up Valuation:**

As we have discussed in the past (please refer bottom up valuation section in this [link]), due to meaningful change in the composition of SENSEX historically, the Top down valuation might not be the most reliable method. Thus we had also introduced the bottom-up valuation method. As we have valuation bands for each of the SENSEX Index constituents, we are using the weights of these individual stocks and their respective valuation bands to arrive at the SENSEX Valuation from a bottom up perspective. **Thus based on the bottom up approach the valuation band for SENSEX for CY19 comes to around 24,500 – 42,000.**


**If we combine both the top down approach and bottom up approach, the valuation band for SENSEX for CY19 comes to around 26,750 – 44,500. The Mid-band would thus be ~35,600.**

**Earnings Momentum:**

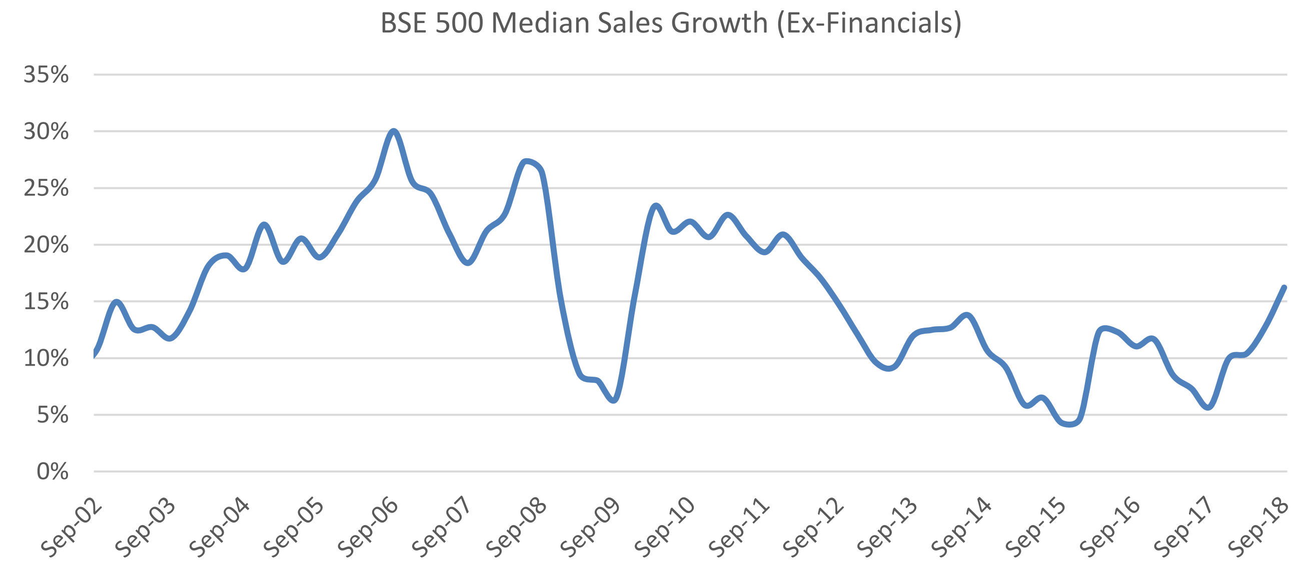
While Macro environment had turned negative in 2018, the earnings momentum for listed companies improved meaningfully.




*Source: ACE Equity*

*Above Chart shows the Sales growth of current index constituents. NII growth has been used for Banks and NBFCs. Any aberrations in terms of Inorganic sales growth, divestures etc have been ignored wherever the same have been significant.*

The momentum is not restricted to only SENSEX companies but is visible even at broader market level.




*Source: ACE Equity*

IT Sector showed meaningful improvement in earnings momentum as well as outlook after almost 1.5-2 years of subdued growth. The sector was also supported to some extent by INR depreciation. Post the GST driven slowdown in 2017, FMCG companies reported improvement in business in 2018. As per management commentary of these companies, the momentum is expected to sustain as they are seeing improvement in demand in rural areas as well. Banks have shown initial signs of topping out of the NPA

Cycle and initial NCLT resolutions during the year has also improved visibility of recovery from some of the large accounts.

While NBFCs reported strong business growth in 2018, the effect of IL&FS crisis is yet to be seen and would be a headwind in 2019 as the cost of funds for the NBFCs would go up. Capital goods companies and Cement companies have both shown improvement in order book and offtake. Though demand is largely driven by Government Infra push and very limited improvement from private sector capex. Auto sector had started 2018 on a positive note, but by the end of the year we have started to see higher inventory levels at dealers and the momentum going into 2019 does not seem as strong.

Barring some of the negative sectoral issues, the green shoots that we had discussed in last year's review has materialized. We feel the earnings momentum has been picking up and barring a severe deterioration in Macro, 2019 could be stronger as compared to 2018 from business and earnings momentum perspective.

**Technical Analysis:**

While broader markets have continued to remain weak in 2018, SENSEX has remained relatively stable. **The chart currently is neutral** and not clearly giving a direction at this point.

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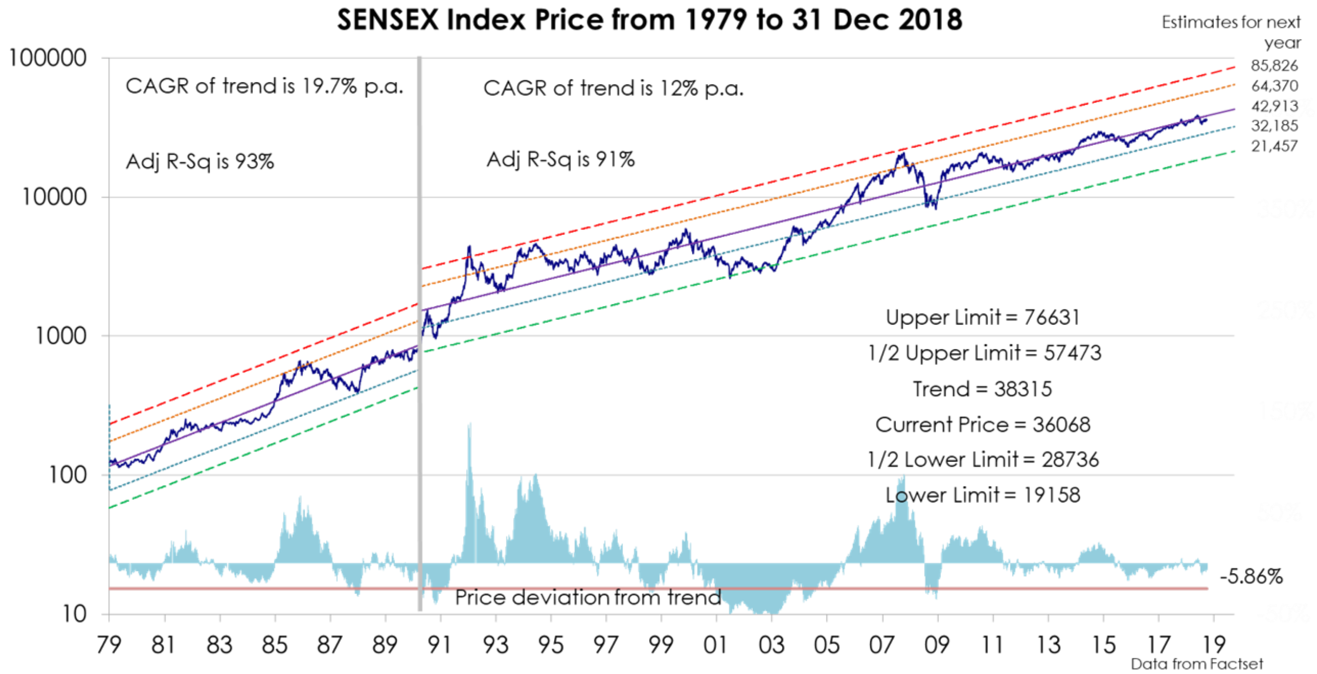
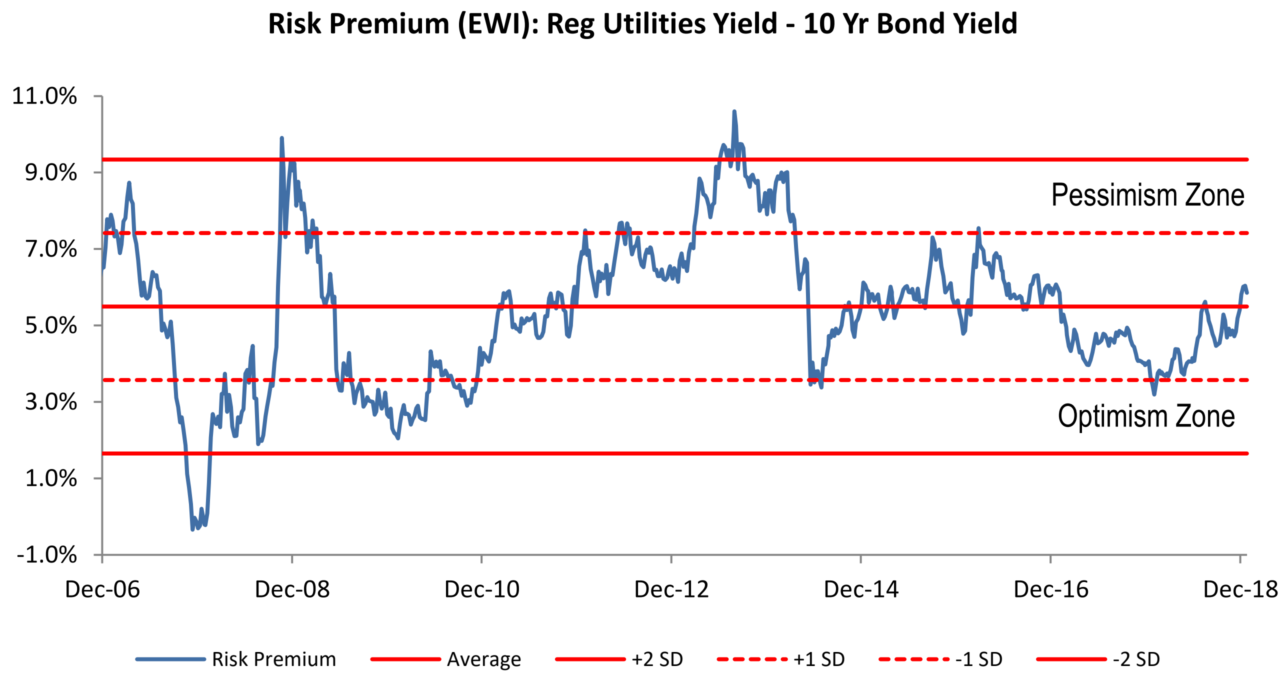
## Quantitative Analysis:




Currently, SENSEX is quoting slightly below historical trend line. We have historically observed that strong technical and earnings momentum would ideally take the market to ½ upper limit (orange line) of the historical SENSEX trend. Currently technical momentum is neutral, but earnings momentum is improving gradually and thus movement to the ½ upper limit may not happen in the near future and thus we can assume it could move along the trend. The trend value for the SENSEX as of December 2019 is around 42,900.

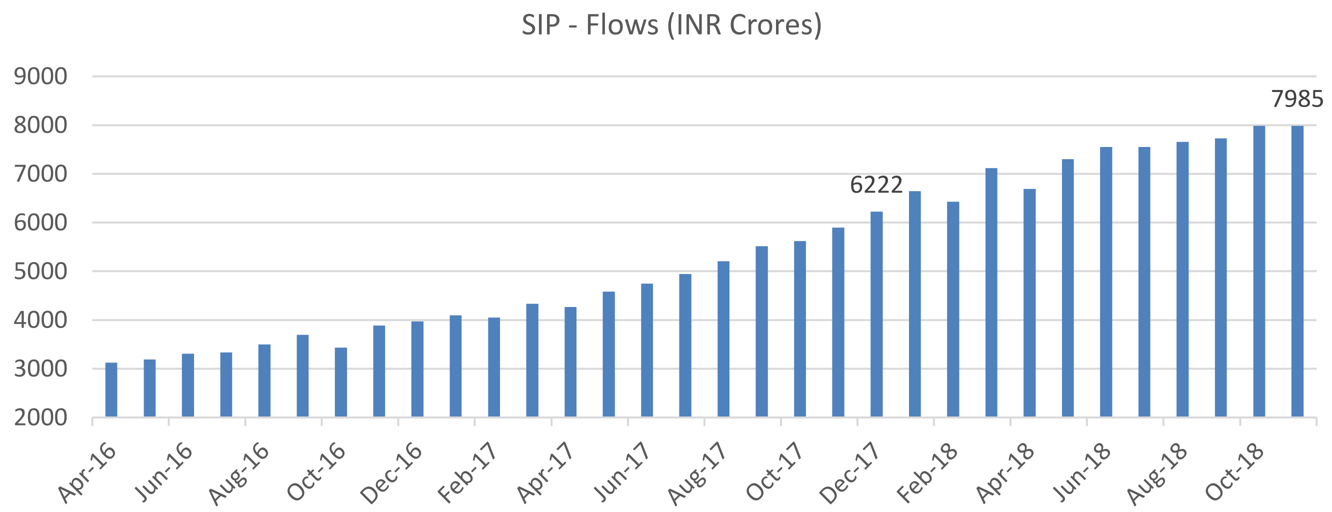
**Behavioral Analysis:**

The year 2018 had started with strong investor sentiment. But deterioration in macro and overall risk aversion in the global market trickled down to the domestic market to some extent. But the risk aversion has not touched the extreme where it could be termed as pessimism, as can be seen from the chart below. Risk premium of utilities over Sovereign 10 year bonds has corrected back to mean from optimism zone. But it is nowhere near the pessimism zone.



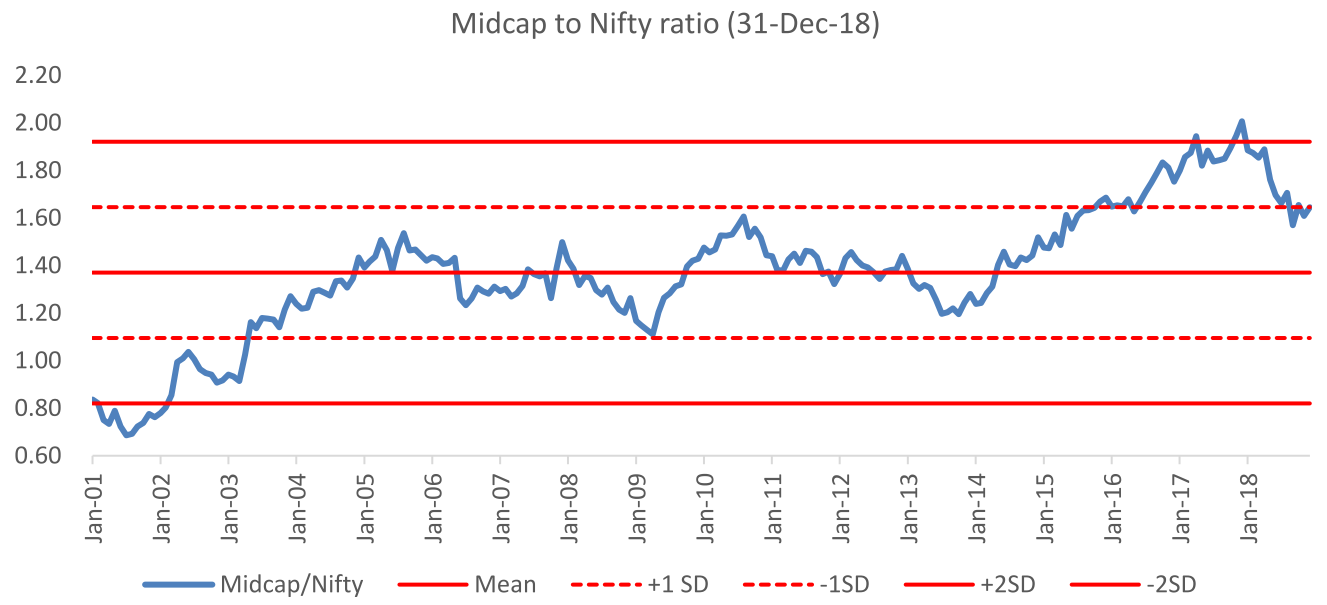

*Regulated Utilities Risk premium Index captures the risk premium for Equity of Regulated Utilities over the GoI 10 year bond yield.*

This can also be corroborated by the fact that domestic investor sentiment has not been dented by sharp fall in the markets (especially mid and smallcaps) as the SIP inflows continue to be strong and in fact have increased throughout the year.




*Source: AMFI*

The Midcap/NIFTY ratio is also a good ratio to assess risk appetite in the market. A higher ratio indicates that market participants are relatively willing to take more risk. This ratio has also corrected from extreme it had touched at the end of last year. Thus broadly sentiment seems to be gradually normalizing, though not indicating pessimism.




*Source: NSE*

**<u>Prospective Return of Constituents:</u>**

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 more immediate estimate of projected prices of individual constituents in the next 6 to 9 months. This is again 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 4.5% (or ~37,700) while the worst case downside is estimated at -19.5% (or ~29,000) with an average estimate of -7.5% (or ~33,400). Be aware though that this changes every day as new information on valuation, earnings momentum and technical momentum comes in and though can only be used a near term guide.

**<u>Conclusion:</u>**

There are two factors which are in favour of the market – Improving business momentum and supportive positive domestic investor sentiment. The factors that working against the above positives – Global macro risks and relatively negative technical momentum. We believe that SENSEX should be able to hold around the midband of the valuation range ~35,600 as business momentum has been improving. If we start seeing improvement on any of the other factors that are currently negative, we could see further upside. The 2019 General election is a wildcard and it could change sentiment factor. A status-quo might not affect sentiment in a big way. But a negative surprise could severely impact sentiment and thus could change the direction of the market. But given the information that we have as on date, we should see SENSEX holding 35,600 for December 2019 with an upward bias.

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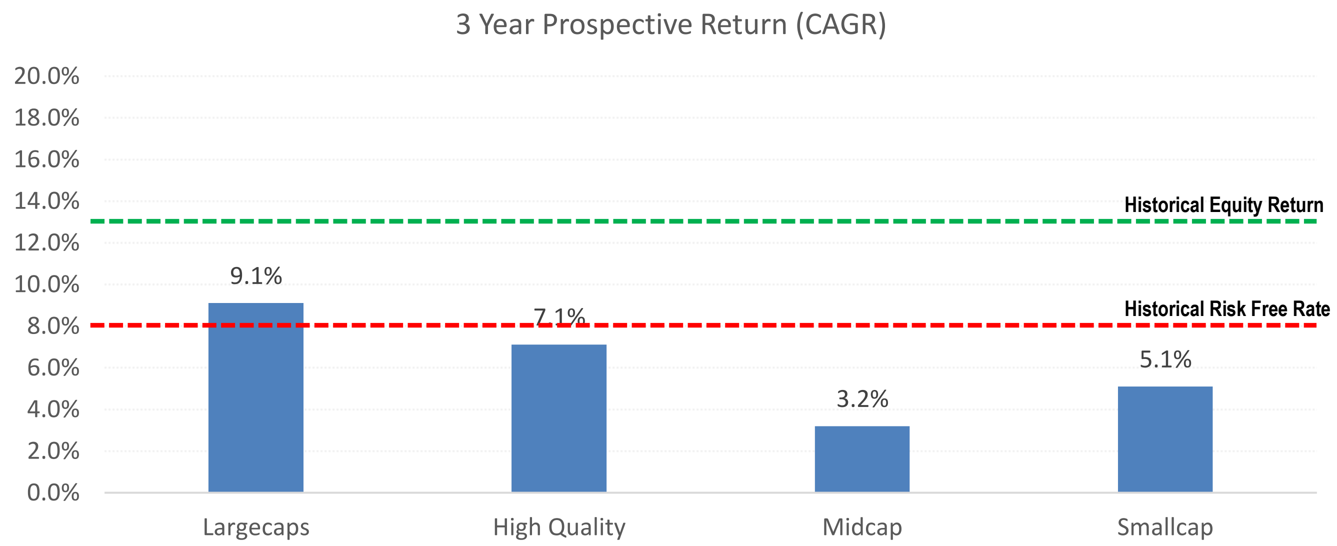
**3 Year prospective return:**

The SENSEX analysis report is restricted only to the 30 stock index and from a one year perspective. But to understand how the broader markets are placed from a medium-term perspective, we would like to introduce 3 year prospective return of different segments of the market. Below chart shows 3 year prospective return for Large Caps, Midcaps and Small caps and also High Quality stocks. Please note that prospective returns have been calculated assuming mean reversion of valuation multiples and trend growth. Thus if valuation multiples at the end of 3 years remain elevated, the returns could be higher and on the other hand if the valuation multiples at the end of 3 years go below historical averages, the returns could be lower.




*We have taken the index constituents of BSE100 (Largecaps), BSE Midcap, BSE Smallcap and Multi-Act High Quality universe. We have then calculated median PE and median EPS growth historically. Median has been used to remove outliers. For the purpose of calculating 3 year prospective return we have assumed that earnings growth would grow at historical average rate and valuation multiples would revert back to mean from where they are currently prevailing.*

Post the market correction this year, the numbers have improved in a big way in the current year as compared to last year (as of 31 Dec 2017: Largecaps 0.9%, High Quality 2.5%, Midcaps -7.1%, Smallcaps -12.5%). But 3 year prospective returns still aren't very attractive as they are hovering around risk free rate.

Regards
Rohan Samant
Portfolio Manager

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

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## General risk factors

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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.

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