INSTITUTIONAL EQUITY RESEARCH

INDIA | STRATEGY | Quarterly Update

Portfolio Manager Style Guide

Style Strategies: Value vs. value traps; focus on large caps

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Return of optimism; trap lines closing in

The New Year has begun on an optimistic note for the equity markets marked by better earnings growth expectations, perceived limited impact of demonetization, and optimism in the global markets. This optimism frequently translates into buying cheap stocks, perceived to be 'value'. However, more often than not, cheap is expensive and expensive is cheap in the Indian context.

Is value investing really back in flavor?

The value investing strategy seems to be making a comeback of sorts because: (a) commodities have started recovering, and (b) regulatory challenges have emerged in classic growth sectors (technology, pharmaceuticals). Even though growth strategies have outperformed value in most periods (5-, 3-, 1-year), in the last three months (even after demonetization), value has seen gains. These gains can be attributed to the poor performance of growth stocks in the pharmaceuticals sector and outperformance in the commodities sector. This shift poses a greater challenge in identifying the style of investing, as risks are both systematic (commodity plays) and unsystematic (pharma and IT). As unsystematic risks can be mitigated in a diversified portfolio while systematic cannot, we believe that the value strategy has still not come into a secular fold. However, there are clear markers – rising global inflation, a likely regime of higher interest rates, and likelihood of future higher wages – which support the value-investing style. Apart from classic macro indicators, the valuation gap between value and growth is higher than its long-term average, making value valuations attractive. Thus, it is critical to have a sizeable allocation towards value in the portfolio.

Value, backed by quality, delivers lasting outperformance

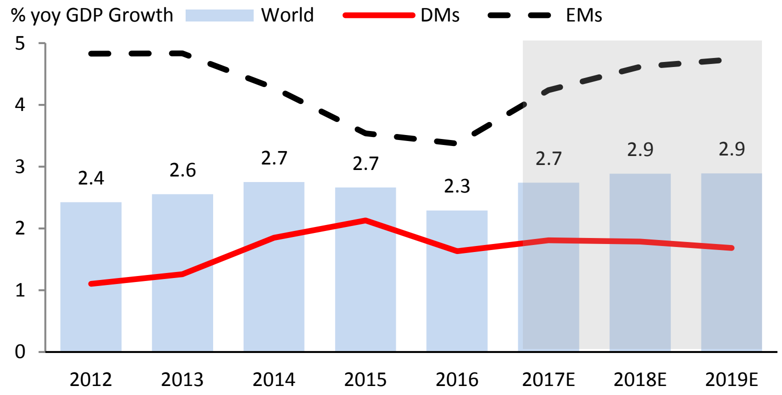
Buying high-quality assets without paying a premium is as much value investing as buying average quality assets at a discount. The latter is easier to implement, because a pure-value strategy based on cheap valuations is well defined, but markers for quality are debatable. However, based on certain well-established frameworks (Novy-Marx, Graham, Grantham, and Piotroski's F score matrix) that gauge value and quality as two sides of the same coin, we present a list of possible winners from our coverage universe.

The following are our key ideas based on the quality-value frameworks:

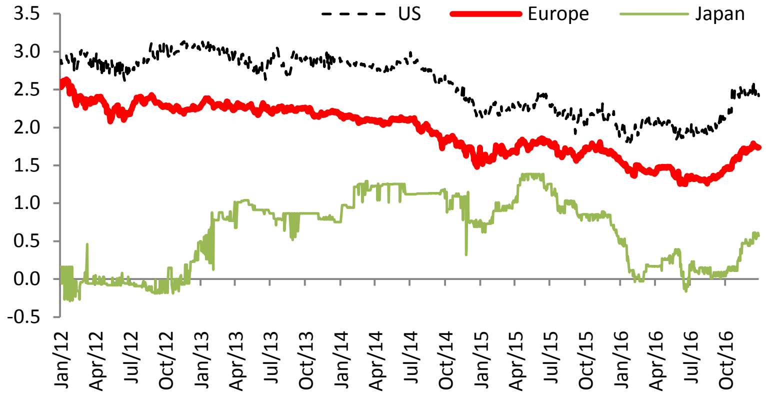
- We leverage Novy-Marx' framework that emphasizes consistency of gross profits to assets as measure of quality and apply traditional value screeners (P/B): We use EBIDTA in lieu of gross profits for better data consistency across sectors. Stocks that screen well using these criteria include **Tata Steel**, **IRB Infrastructure**, **Reliance Industries**, and **Sintex**.
- Piotroski's F-score matrix defines financial strength as a measure of quality in order to avoid value traps: This screen identified **VA Tech Wabag, Ashoka Buildcon, Hindalco, and KEC International** as inexpensive "good" companies.
- EV/DACF is another reasonably good cashflow measure to ascertain value: We add an ROE filter to this framework to identify quality + value names that include **Tata Motors, Sun Pharma, Apollo Tyres, and HCL Tech.**

Charts in Focus – Global growth rebound?

Global growth expectations have turned positive...

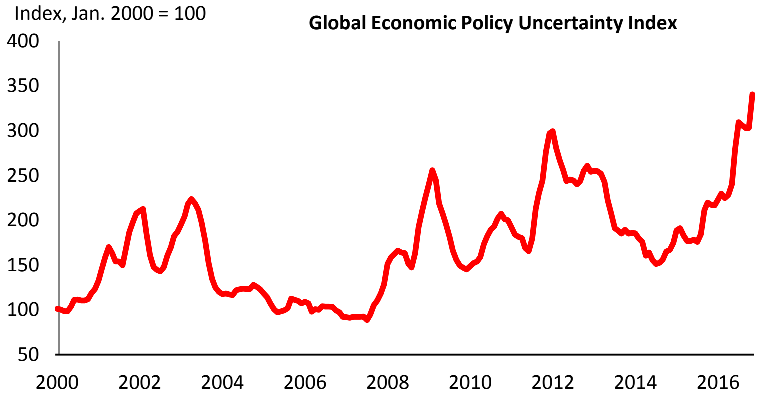


...in line with rising long-term inflation expectations across the developed world

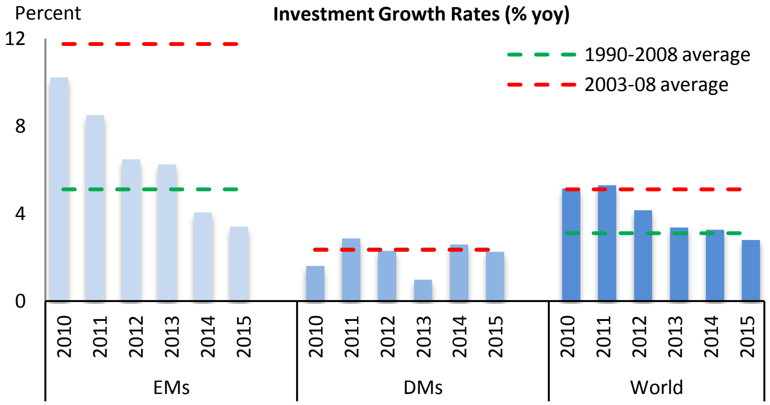


Note: Long-term inflation expectations are derived from 5-year forward 5-year inflation swap rates.

However, headwinds such as rising global policy uncertainty...



...and slowing investment growth will be watched carefully



Source: Bloomberg, World Bank, Global Economic Prospects, Jan 2017

Value strategy has seen some traction but not enough

"It's far better to buy a wonderful business at a fair price than to buy a fair business at a wonderful price"
- Warren Buffet

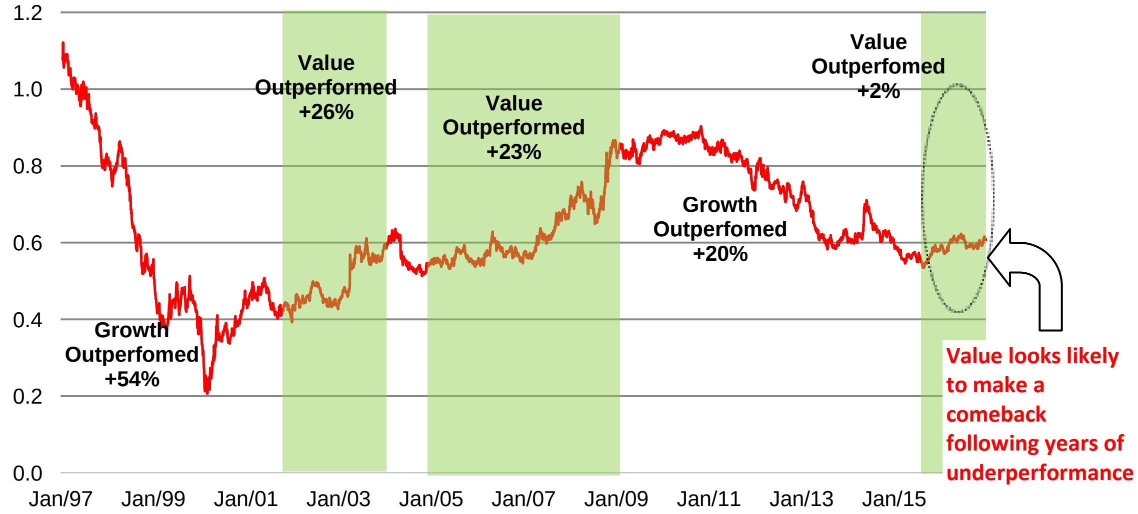
Value strategies have shown to deliver substantial returns, but many times in short bursts. On aggregate, India has seen value performing in line with growth over the last 15 years; global factors have exerted a significant influence on value outperformance in India too. 2003-2009 saw meaningful value outperformance in India, but this was also seen globally. Value has underperformed growth in the last five years by a noteworthy margin, but the underperformance is reducing over the last three years.
The last three months have seen some outperformance, but a closer look indicates that growth performance has been hit by company-specific factors in the healthcare sector or an overreaction to demonetization in the consumer discretionary sector. While some value sectors have underperformed, the commodity sector (higher weight in value) has done reasonably well due to global factors. Thus, at present, the short-term outperformance of value versus growth is a mix of company-specific factors in the growth index, with some outperformance in a key value sector. However, when compared to other non-style-diversified indices such as Sensex or Nifty, there are almost no gains (actually some underperformance vs. the Sensex).

CAGR	20y	15y	10y	5y
Value	9.2%	16.0%	6.5%	7.7%
Growth	12.8%	13.3%	5.9%	15.5%

While it seems that value investing as a strategy is still to come into a secular fold, returns from value stocks frequently tend to be bunched up. In the last 15 years, value, on an aggregate basis, outperformed growth by a significant margin. However, the number of years value has outperformed growth is just 9 out of 19. Also in the last 20 years, the period of value outperforming growth is much shorter than the other way around. This means value has very short bursts of very high returns, also because value stocks have much higher beta. This makes allocation to a value strategy a critical component for portfolio construction, as timing these short bursts of high returns is quite difficult.

Bottom Line: Current conditions are indicative of value investing strategy coming back in flavor

Value vs. growth historical trends

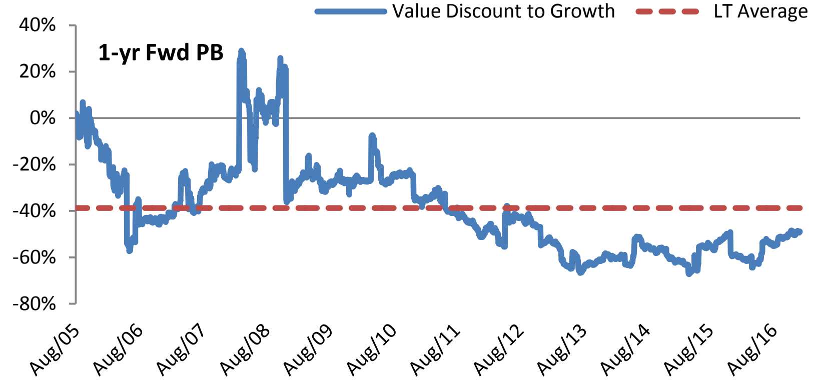


Source: Bloomberg

Is the value strategy poised for a comeback? We think so..

Value has been trading at a substantial discount to growth since the Great Financial crisis of 2008. However, narrowing growth premiums due to industry-specific headwinds in IT and pharma should see some reversal in this trend. We are already seeing early signs of value recovery with the P/B differential between MSCI India Value and Growth reducing and moving closer to its long-term average (came in line with its three-month outperformance). While most of this outperformance could be attributed to unsystematic factors, ***we reckon that the foundation is in place for a 'value rally'.***

Value vs. growth P/B differential has seen some rerating...



...in line with its three-month outperformance

	Growth	Value	Value vs. Growth
3m	-7.9%	-5.0%	2.9%
6m	-1.9%	-2.7%	-0.8%
1y	-2.4%	1.7%	4.2%
3y	23%	18.80%	-4.2%
5y	66%	45%	-21.8%

Growth performance has been challenged due to sector-specific headwinds in healthcare and consumer discretionary

MSCI Value Sectors	Wts (%)	3m Return	Wtd Return
IT	21.8%	-3.8%	-0.82%
Financials	21.8%	-4.5%	-0.98%
Energy	20.8%	0.1%	0.03%
Consumer Discretionary	11.4%	-6.8%	-0.77%
Materials	6.1%	0.5%	0.03%
Telecom	5.2%	-1.8%	-0.09%
Industrials	4.9%	-1.8%	-0.09%
Utilities	4.3%	8.3%	0.36%
Consumer Staples	3.6%	-1.4%	-0.05%

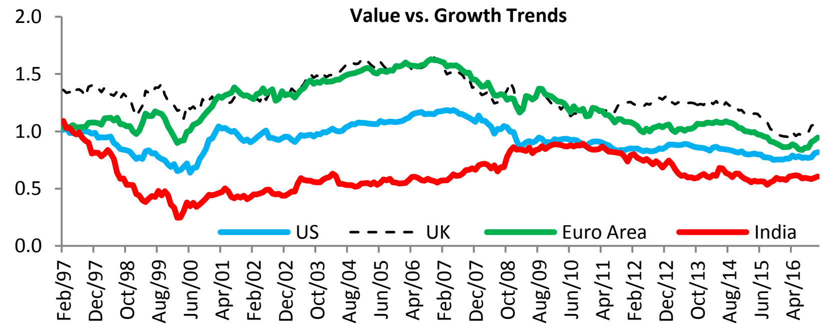
MSCI Growth Sectors	Wts (%)	3m Return	Wtd Return
Financials	19.9%	-4.5%	-0.9%
Health Care	19.6%	-7.6%	-1.5%
Consumer Discretionary	15.6%	-6.8%	-1.1%
Consumer Staples	15.3%	-1.4%	-0.2%
IT	12.5%	-3.8%	-0.5%
Materials	9.5%	0.5%	0.0%
Industrials	6.8%	-1.8%	-0.1%
Energy	0.8%	0.1%	0.0%

Source: MSCI, Bloomberg, BSE

Building the global case for value outperformance

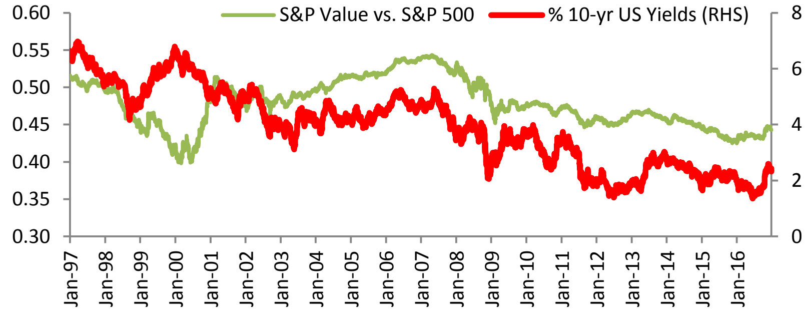
While the MSCI India Value Index has not substantially outperformed a well-diversified non-style index, we find that globally, value has started outperforming. A closer look at US, China, UK, and Euro zone value indices indicates major outperformance. The S&P 500 Value Index (SVX) is highly correlated to the performance of other value markets and has seen considerable outperformance recently. US Value performance in turn is highly correlated to the interest rate environment which has started tightening. Rise in core inflation will benefit value plays significantly, as it will spur the investment cycle; but core inflation in still sluggish in many regions of the world like Europe. China saw some improvement in producer price inflation, albeit from a low base. All these factors indicate that ***the time for value investing is round the corner***.

Globally, value is gaining momentum, largely driven by a run-up in commodities and a rate-tightening environment



Value vs. Growth returns	US	China	UK	Euro Area
3m	6.6%	6.6%	10.0%	10.7%
6m	4.7%	-1.3%	11.6%	12.8%
12m	9.2%	0.9%	13.5%	7.4%
3yr	-5.0%	-4.9%	-12.9%	-12.7%
5yr	-5.8%	-24.2%	-17.9%	-19.3%

Value Returns performance tends to be highly correlated globally, and dominated by US interest rates



Value 1-m returns correlation	India	China	US	UK	Euro Area
India	1	0.47	0.44	0.35	0.4
China		1	0.49	0.4	0.37
US			1	0.79	0.81
UK				1	0.88
Euro Area					1

Source: MSCI, Bloomberg, BSE

How to implement value strategies: Focus on the quality aspect of value

#Framework 1: Profitability and Value - Novy-Marx's profitability framework for identifying quality names at inexpensive valuations

"Buying high-quality assets without paying premium prices is just as much value investing as buying average quality assets at discount prices."- Prof. Robert E Novy Marx, University of Rochester, Simon School of Business

In his paper, "The Other Side of Value: The Gross Profitability Premium" (June 2012), Novy-Marx showed that profitability (measured by gross profits-to-assets) has roughly as much predictive power in identifying value winners as traditional value metrics like book-to-market. We borrow this academic concept and try to fit in the Indian context to identify stocks that offer both quality and value.

Our screen below builds on this concept of quality investing to highlight stocks within our coverage that have delivered:

1. Consistently positive profitability – At least a 10-year history of positive EBITDA/total assets
2. Cheap valuations based on one-year forward PC estimates – FY17E P/B< 1.5x; FY17E P/E <15x
3. Buy or Neutral rated
4. Market Cap > Rs 20bn

Companies with at least 10-years of positive EBITDA-to-assets history that look cheap on P/B (<1.5x) and P/E (<15x)

						EBITDA/total assets										P/B	P/E
	Sector	RECO	Target	(%) Upside	MCap (Rs. mn)	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17E	FY18E	FY17E	FY17E
Apollo Tyres	Automobiles	BUY	239	28	95,009	13.4%	21.9%	13.2%	13.9%	17.1%	20.8%	22.4%	17.7%	15.5%	16.1%	1.3x	8.6x
Tata Steel	Metals	BUY	500	7	451,809	15.0%	7.3%	12.4%	8.5%	8.4%	9.6%	7.9%	4.6%	9.1%	10.7%	1.5x	12.9x
IRB Infrastructure	Infrastructure	BUY	280	27	77,776	10.1%	14.4%	13.7%	12.6%	12.4%	11.2%	5.6%	6.3%	6.9%	7.8%	1.3x	12.1x
Shriram Transport	Financials	BUY	1,350	43	213,678	1.3%	1.4%	1.4%	1.9%	1.7%	2.2%	2.2%	2.8%	2.0%	1.9%	0.0x	12.4x
Reliance Industries	Oil & Gas	BUY	1,190	14	3,381,121	9.5%	11.9%	12.4%	10.5%	9.1%	8.1%	7.4%	7.3%	6.1%	8.7%	1.2x	14.0x
Sintex Industries	Midcap	BUY	120	34	46,877	8.8%	9.0%	12.5%	10.0%	9.1%	10.4%	10.4%	9.2%	10.0%	11.3%	0.7x	7.3x

Source: PhillipCapital India Research. As of January 20, 2017
Note: For Financials, we use pre-provision profit as a proxy for EBITDA

The Novy Marx framework is market-cap agnostic and presents a balance of both mid cap and large cap stocks. **Tata Steel and Reliance Industries are our large-cap picks** while **Sintex, IRB Infra, Shriram Transport Finance and Apollo Tyres** are our mid-cap picks.

How to implement value strategies: Focus on the quality aspect of value

#Framework 2: Financial Strength and Value – Piotroski's F-Scores for value investing while avoiding value traps

Joseph D. Piotroski, Professor of Accounting at Stanford University Graduate School of Business, in his paper "Value Investing: The Use of Historical Financial Statement Information to Separate Winners from Losers" (2000) introduced an accounting-based measure of firm quality called Piotroski's F-score that separated "good" companies from "bad". This F-score is constructed by summing nine binary variables where four focus on profitability, three capture liquidity, and two evaluate operational efficiency. Empirical evidence suggests that an F-score based investment strategy, when applied in order to buy expected winners and short expected losers, generated a 23% annual return between 1976 and 1996. We apply this framework to our coverage to identify "good" companies (score of 8 or 9) that look cheap on a coverage relative P/B basis (fall in coverage relative quartile 1 or 2). We also maintain our filters of Buy and Neutral-rated stocks with market capitalization greater than Rs 20bn.

The Piotroski Scorecard allocates 1pt each for a company with

1. Positive return on assets
2. Positive operating cashflow
3. Higher return on assets
4. CFO/assets > ROA

Profitability

5. Lower debt/assets
6. Higher current ratio
7. No share count increase

Liquidity

8. Higher EBITDA margin
9. Higher asset turnover

Operational efficiency

Note: Changes are measured on a yoy basis (FY17E vs FY16)

Good quality companies (F-Score of 8 or 9) that offer value (P/B cheap on a coverage relative basis)

Company Name	Sector	RECO	Target	(%) Upside	M Cap (Rs mn)	ROA FY16	ROA FY17E	CFO FY16	CFO FY17E	CFO/Assets FY16	CFO/Assets FY17E	Gross Debt/T.Assets FY16	Gross Debt/T.Assets FY17E	Current Ratio FY16	Current Ratio FY17E	Share Count FY16	Share Count FY17E	EBITDA Margin FY16	EBITDA Margin FY17E	Asset Turnover FY16	Asset Turnover FY17E	Piotroski F-score	P/B 2017E	Covg. Rel. P/B Quartile
KEC Intl.	Cap Goods	BUY	160	8.3	38.0	2.9%	3.1%	-3,093	4,525	-4.0%	5.6%	32.8%	30.3%	1.6	1.8	257	257	8.1%	8.6%	1.10	1.12	9	2.2x	2
VA Tech Wabag	Cap Goods	BUY	575	17.0	26.8	3.0%	4.2%	-1,635	1,229	-5.4%	3.7%	12.9%	9.6%	2.1	2.2	55	55	8.7%	8.8%	0.85	0.96	8	2.5x	2
Heidelberg	Cement	BUY	150	30.0	26.2	1.5%	3.6%	1,816	2,689	6.9%	9.5%	26.0%	21.9%	1.0	0.8	227	227	12.9%	15.5%	0.61	0.66	8	2.6x	2
Ashoka Buildcon	Infra	BUY	205	22.2	31.4	0.6%	0.7%	-1,252	2,031	-0.8%	1.3%	26.9%	26.7%	0.2	0.2	187	187	29.5%	29.7%	0.17	0.19	9	1.6x	1
Hindalco Inds	Metals	BUY	210	19.8	362.2	0.6%	2.1%	67,802	65,184	4.9%	4.6%	48.7%	47.7%	1.4	1.3	2,065	2,065	8.8%	12.7%	0.72	0.73	8	0.9x	1
GSPL	Oil & Gas	BUY	175	10.8	89.0	7.6%	7.9%	6,032	6,696	10.3%	10.7%	18.1%	16.8%	3.8	4.1	563	563	87.2%	87.0%	0.17	0.17	8	2.1x	2

Source: PhillipCapital India Research. As of January 20, 2017

Piotroski's F score tends to be biased towards small- to mid-cap stocks, as their high book-to-market (low P/B) often do not reflect the benefit of quality financial strength (also: limited coverage and less transparency). **We find KEC International, VA Tec Wabag, and Ashoka Buildcon screen** well in this framework. For further details, please see: https://www.chicagobooth.edu/~/media/FE874EE65F624AAEBD0166B1974FD74D.pdf

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How to implement value strategies: Focus on the quality aspect of value

#Framework 3: Cashflow-based multiples – Companies that are cheap on EV/DACF and have a track record of consistent ROE

Given the obvious limitation of valuation metrics (capital structure, working capital) such as P/E and EV/EBITDA, we look for cashflow-based multiples that provide a better measure of a company's earnings ability. While price-to-cashflow is the most widely used cashflow metric, it tends to look better for companies that are highly leveraged. Hence, to look at companies from a capital structure and working capital agnostic basis, we use the Debt Adjusted Cashflow measure (most commonly used for oil & gas companies).

We measure this as: Debt-adjusted cashflow = cashflow from operations – (increase)/decrease in working capital + *after-tax net interest expense.

We highlight companies in our coverage that look cheap on EV/DACF on a coverage-relative basis with at least three years of positive ROE. We only include Buy and Neutral rated stocks whose market caps are more than Rs 20bn.

Companies that look cheap on a coverage-relative EV/DACF basis with consistently positive FY15-17E ROE

Company Name	Sector	Target	(%) Upside	RECO	Market Cap	EV/DACF FY15	EV/DACF FY16	EV/DACF FY17E	Quartile	ROE (%) FY15	ROE (%) FY16	ROE (%) FY17E	P/E FY17E
Apollo Tyres	Automobiles	239	28.0	BUY	95,009	1.5x	1.3x	1.2x	1	21.0	16.9	15.4	8.6x
Tata Motors	Automobiles	570	6.8	BUY	1,713,623	0.9x	0.8x	0.9x	1	25.0	13.7	16.5	11.0x
Infosys	IT Services	1,130	18.6	BUY	2,188,184	2.6x	2.2x	2.0x	2	22.5	21.8	21.1	15.1x
HCL Technologies	IT Services	860	2.1	NEU	1,189,146	3.1x	2.4x	2.1x	2	19.5	25.2	25.2	13.4x
Allcargo	Logistics	215	20.8	BUY	44,873	2.1x	1.8x	1.7x	2	10.4	12.6	16.3	15.2x
Sun Pharma	Pharma	825	27.1	BUY	1,557,807	4.2x	3.5x	2.3x	2	18.7	17.2	19.1	21.8x

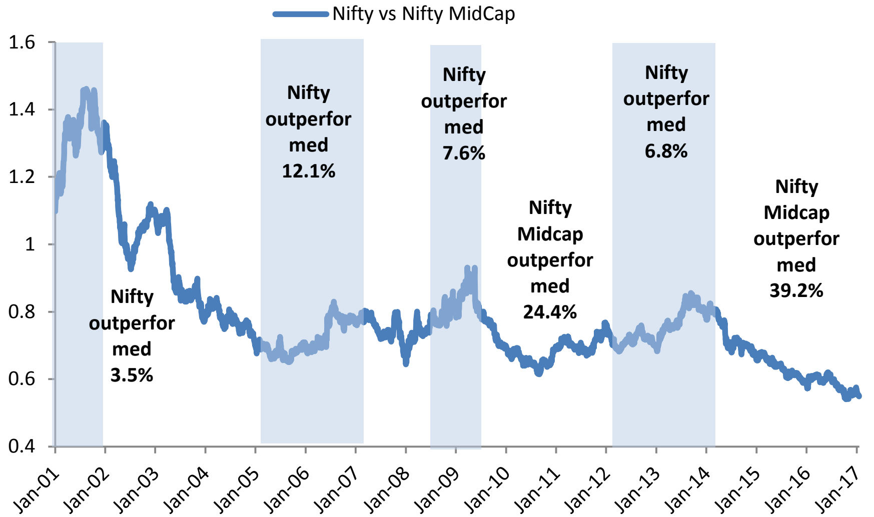
*Tax rate assumed at 30%, Source: PhillipCapital India Research. As of January 20, 2017

Our EV/DACF screen tends to be biased towards large-cap stocks, given their higher visibility of cashflow measures and history of consistent returns. We highlight **Apollo Tyres, Tata Motors, HCL Tech**, and **Sun Pharma** as our top picks.

Large-cap vs. mid-cap?

Mid-caps have outperformed large-cap stocks over the last five years and the mid-cap vs. large-cap performance is quite similar to growth vs. value. Mid-caps are typically growth stocks, and in an environment when growth is rerated, mid-cap stocks will tend to outperform. However, like the value outperformance of the last three years, large-cap stocks have started outperforming. In terms of valuation versus growth prospects, large-caps are better placed over the next 12 months, as they offer discounted valuations with a similar growth rate as mid-caps.

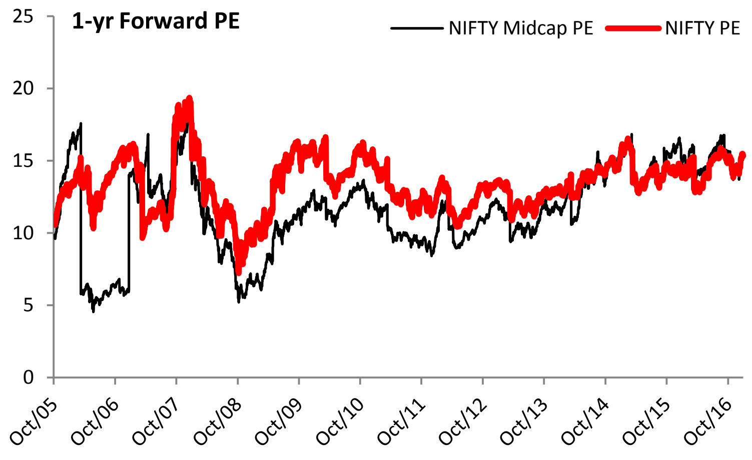
Price performance: Nifty vs. Nifty Midcap 100

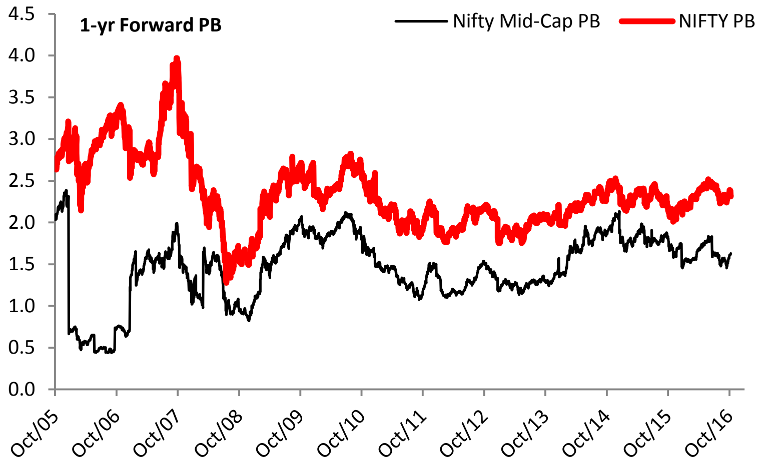


Price returns	Nifty	Nifty MidCap	Nifty vs. Nifty MidCap
3m	-4.9%	-6.9%	1.9%
6m	-1.2%	3.9%	-5.1%
1y	3.0%	7.1%	-4.1%
3y	30.3%	69.5%	-39.2%
5y	64.8%	103.6%	-38.8%

Source: Bloomberg, PhillipCapital India Research

One-year forward PE and PB trends: Nifty vs. Nifty Midcap 100





EPS growth: Nifty vs. Nifty Midcap 100

	Nifty EPS	YoY Growth (%)	Nifty Mid Cap EPS	YoY Growth (%)
FY2009	264.48		431.85	
FY2010	247.41	-6.5%	485.03	12.3%
FY2011	325.00	31.4%	503.90	3.9%
FY2012	350.32	7.8%	527.53	4.7%
FY2013	391.98	11.9%	474.62	-10.0%
FY2014	413.89	5.6%	583.61	23.0%
FY2015	457.13	10.4%	628.46	7.7%
FY2016	421.75	-7.7%	629.73	0.2%
FY2017E	440.09	4.3%	835.37	32.7%
FY2018E	534	21.3%	1008.66	20.7%

Source: Bloomberg, PhillipCapital India Research Estimates

Model Portfolio

		EPS (Rs)			EPS Growth (%)			P/E (x)		
Company	**Weight**	**FY16**	**FY17E**	**FY18E**	**FY16**	**FY17E**	**FY18E**	**FY16**	**FY17E**	**FY18E**
FMCG	10.0%									
HUL	2.0%	18.9	19.4	22.1	4%	2%	14%	45	44	38
Colgate Palmolive India Ltd	2.0%	22.3	21.7	24.7	9%	-3%	14%	40.4	41.5	36.5
ITC	6.0%	7.8	8.7	9.2	2%	11%	6%	33.1	29.8	28.0
Automobile	**8.5%**									
Maruti	3.0%	151.3	240.0	279.7	23%	59%	17%	37.8	23.8	20.5
Tata motors	3.0%	34.3	48.7	71.6	-21%	42%	47%	15.7	11.1	7.6
Bajaj Auto	2.5%	126.2	150.0	177.6	16%	19%	18%	21.7	18.2	15.4
IT	**6.0%**									
Infy	6.0%	59.0	62.9	72.0	9%	7%	14%	16.0	15.0	13.1
Pharmaceuticals	**8.5%**									
Sun Pharma	5.0%	24.1	29.7	34.3	12%	24%	15%	26.7	21.6	18.7
Aurobindo	3.5%	35.0	42.5	50.6	24%	21%	19%	20.0	16.5	13.9
Cement	**4.0%**									
Ultratech	3.0%	83.3	104.5	108.3	9%	25%	4%	43.1	34.4	33.2
Dalmia Bharat	1.0%	21.5	58.6	63.1	25%	173%	8%	16.9	6.2	5.8
Metals & Mining	**8.3%**									
Tata Steel	3.0%	9.5	36.2	66.6	-	279%	84%	48.3	12.7	6.9
Hindalco	2.0%	3.8	14.6	16.2	-72%	285%	12%	48.6	12.6	11.3
NTPC	3.3%	12.4	12.1	13.6	21%	-2%	12%	14.0	14.3	12.8
Industrial	**4.0%**									
L&T	2.0%	44.9	66.8	74.7	-5%	49%	12%	31.5	21.2	18.9
NCC	2.0%	4.3	5.0	6.7	112%	17%	33%	18.8	16.0	12.0
Finance	**33.3%**									
Axis bank	4.0%	34.5	12.7	18.9	11%	-63%	49%	13.0	35.3	23.7
indusInd bank	3.0%	38.4	49.7	64.0	13%	29%	29%	32.6	25.2	19.6
SBI	4.5%	14.9	9.6	15.4	-35%	-36%	60%	17.2	26.7	16.6

Cholamadalam Fin	2.5%	36.4	47.9	63.9	20%	32%	33%	27.9	21.2	15.9
HDFC Ltd	5.0%	44.9	46.6	51.3	16%	4%	10%	28.4	27.4	24.8
LIC Housing Finance	2.0%	32.9	38.9	46.4	20%	18%	19%	16.0	13.5	11.3
HDFC bank	6.0%	48.6	58.0	69.5	19%	19%	20%	25.7	21.6	18.0
ICICI Bank	6.3%	16.7	14.6	12.2	-13%	-13%	-16%	15.4	17.6	21.0
Oil & Gas	**5.0%**									
Reliance Industries	5.0%	92.3	74.4	78.3	15%	-19%	5%	11.1	13.7	13.1
Telecom	**9.5%**									
Bharti Infratel	2.0%	12.6	14.3	15.4	19%	13%	8%	27.7	24.4	22.5
Bharti Airtel	3.0%	9.8	11.5	19.3	-35%	18%	68%	32.4	27.5	16.4
Dish TV	2.0%	6.6	3.2	5.0	-	-52%	56%	13.0	26.8	17.2
Zee Entertainment	2.5%	9.5	10.7	15.7	10%	13%	47%	51.0	45.3	30.9
Others	**3.0%**									
Tata Comm	1.5%	7.6	4.9	13.6	103%	-36%	178%	92.7	143.8	51.8
Praj Industries	1.5%	3.9	4.5	7.6	50%	17%	69%	21.0	18.0	10.6

Source: PhillipCapital India Research Estimates

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