PhillipCapital

India Strategy

It's all about earnings now

14 March 2018

INDIA | STRATEGY

Stock returns over the medium to long-term are dictated by corporate earnings. Nominal GDP growth is another good proxy for long-term equity returns. For India, both factors are showing a very robust upward trend. While corporate earnings have surprised negatively in five out of the last six years, the scope for a negative surprise in FY19 is rather slim, as a favourable base and revival in economic activity provide strong tailwinds. While negative surprises cannot be completely ruled out, we find that even in a stressed-case scenario, corporate earnings will grow by 16% yoy in FY19.

With a backdrop of robust corporate earnings, the market debate shifts towards valuation. Our Equity Risk Premium (ERP) model indicates that for India, the ERP has been stable in a tight range of 6.5%-7.5% over the last four rather turbulent years. We don't expect ERP to breach this range; in fact, we see it hovering largely mid-range. Based on the ERP model, our one-year forward bear case, base case, and bull case Nifty targets are 9,200, 11,500 and 14,000. Our bear-case target implies a downside of 10% from current levels, but considering healthy earnings growth, we find this probability to be rather slim. In fact, we believe that earnings visibility will pull markets higher and that there is a higher probability of the bull-case scenario with almost 35% upside.

Our key arguments:

Robust corporate earnings growth in FY19 is highly likely: Consensus expects NIFTY index earnings to grow by 22% in FY19 (in line with our projections). We believe that risks to this earnings growth are quite low – even in our stressed-case scenario, earnings should grow by 16-18%. For our stressed-case scenario, we cut earnings estimates for companies that are expecting recovery, including SBIN, Tata Motors, Bharti Airtel, Axis Bank, Ultratech Cement and Sun Pharma. In 9MFY18, the Nifty's earnings growth was 17% yoy, which should sustain in Q4FY18. A low base will help, but management commentary has generally been upbeat and earnings growth could accelerate. Structural changes in the economy (increasing formalisation, a pick up in GFCF, and improving capacity utilisation) should fructify in FY19.

Equity risk premium (ERP) for the Indian market is sustainable at current levels: Over the last one year (after demonetisation), the implied ERP has reduced because of increased domestic inflows. At 6.7%, ERP is currently at a seven-year low. However, over the last four years it has been quite stable in a tight band of 6.5% to 7.5%. We believe that the ERP is quite sustainable at current levels over the medium to long term, because allocation to the equity asset class is part of the long-term structural theme of a larger formal economy. While short-term noise could dent valuations, improvement in earnings growth would help correct any short-term aberrations in ERP.

Our ERP model provides a bull case to bear case range of 14,000 to 9,200: Our bull case valuation (at the lower end of the ERP, 6.5%), which will be fuelled by a recovery in key sectors including banking, IT, telecom, and pharmaceuticals as dictated by consensus earnings, should result in equity assets seeing consistent inflows, resulting in ERP declining further to ~6%. We believe the bull case has a higher chance of materialising than our bear case, because even in our bear case, it does not look like earnings growth will be subdued. Higher ERP of 7.2% which will translate to bear case target of 9,200 is more likely to be driven by external factors.

Asset allocation in times of volatility: We continue to hold our overarching theme of value for FY19, notwithstanding higher volatility. We have upgraded the IT sector to buy (increase our weight for the sector in our model portfolio) while we have reduced our significant overweight stance in metals and mining. We are maintaining our weights for other value picks like infrastructure, cement, and telecom.

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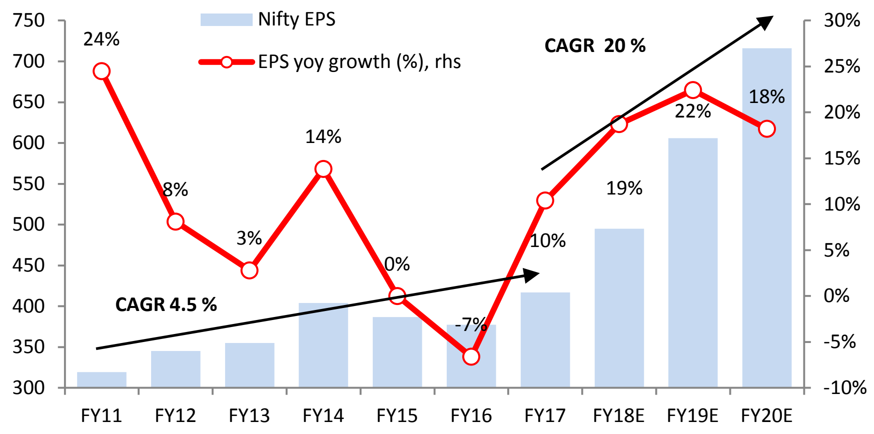
Earnings unlikely to surprise negatively in FY19

Even in a stressed-case scenario, earnings growth will be robust.

In FY11-17, Nifty's EPS grew by just 4.5% and earnings saw significant downgrades through the years. However, for FY19, consensus expects a high growth at 22%, and a more reasonable 15% for FY18. In fact, at 20% CAGR, consensus expectations about NIFTY's FY17-20 earnings growth trajectory is very robust. This number looks very high and experience suggests that chances of downgrades are quite high. However, we believe that sluggish earnings growth over FY11-17 has resulted in a favourable base and therefore chances of downgrades are not very significant; in fact, earnings growth is more likely to be robust. Our analysts are reasonably confident about the corporate earnings trend staying strong.

NIFTY earnings growth



Source: Bloomberg, PhillipCapital India Research

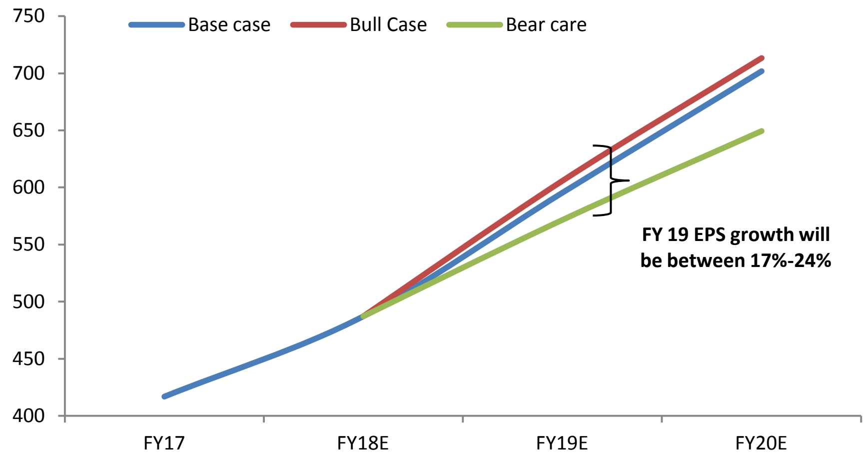
Earnings scenarios: Base, bull, and bear cases – all are in a rather tight band

The bear-bull case earnings growth is in a tight band of 17-24%.

We build bull, bear, and base case scenarios for Nifty earnings for FY19 and FY20. We take consensus expectations as a base case (consensus is building a strong earnings growth of 22% for FY19). For bull- and bear-case scenarios, we use PhillipCapital analysts' expectations of key operating parameters. By tempering expectations in companies or sectors that are expected to recover we arrive at our bear case. Significantly lowering the expectations of recovery, results in the bear case for earnings. Building for earnings upgrade in beaten-down sectors, we arrive at our bull case (while keeping other parameters constant).

In the backdrop of these scenarios, we find that NIFTY earnings growth is unlikely to see a huge negative surprise. Even in a bear case scenario, earnings should grow by about 17% while in the bull case, they should grow 24%; From the last three years, the base has been quite favourable and earnings growth is only regressing towards the mean.

NIFTY earnings are in a tight band



Source: PhillipCapital India Research Estimates, Bloomberg

EPS growth scenarios

EPS growth (%)	FY19E	FY20E
Bear Case	17%	14%
Base Case	22%	18%
Bull Case	24%	18%

Source: PhillipCapital India Research Estimates, Bloomberg

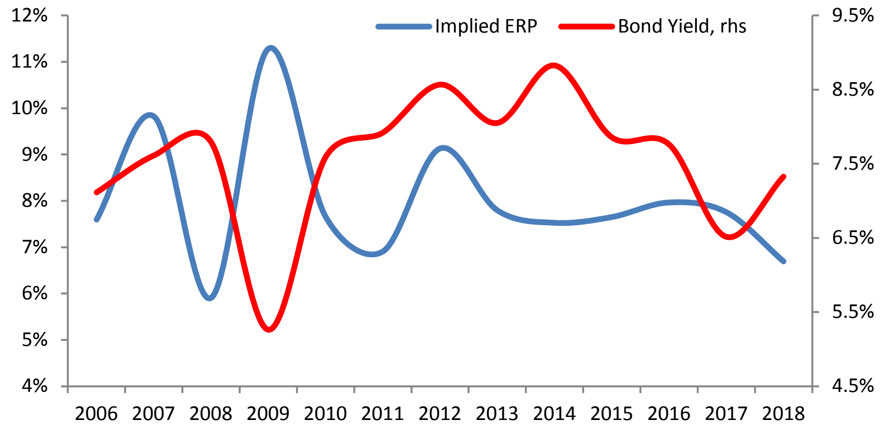
Bull Case: We build the bull case thesis by upgrading earnings estimates for IT by 8%, metals by 5%, ITC by 5%, and M&M by 5%. In the Nifty, the IT sector (with its large weight) can surprise positively and add meaningful value. We recently upgraded this sector to overweight from underweight. Click here for a detailed report.

Bear Case: We build the bear case by reducing our estimates for companies that are recovering including some key names in financials (SBI: -50%, ICICI and Axis Bank: -20%) and telecom (Bharti Airtel: -50%, Bharti Infratel: -10%), pharma (Sun Pharma and Dr Reddy's: -20%), Asian Paints and Ultratech Cement: -10%, and the metals sector: -5%.

Implied equity risk premium (ERP) has been stable

The ERP indicates the risks that investors perceive for equity assets. The current implied risk premium for Nifty is 6.7% (a seven-year low) which suggest that investors do not perceive the Indian equity assets to be very risky. The ERP declined to less than 6% in the peak of the 2008 market, which can be considered the 'irrational exuberance zone'.

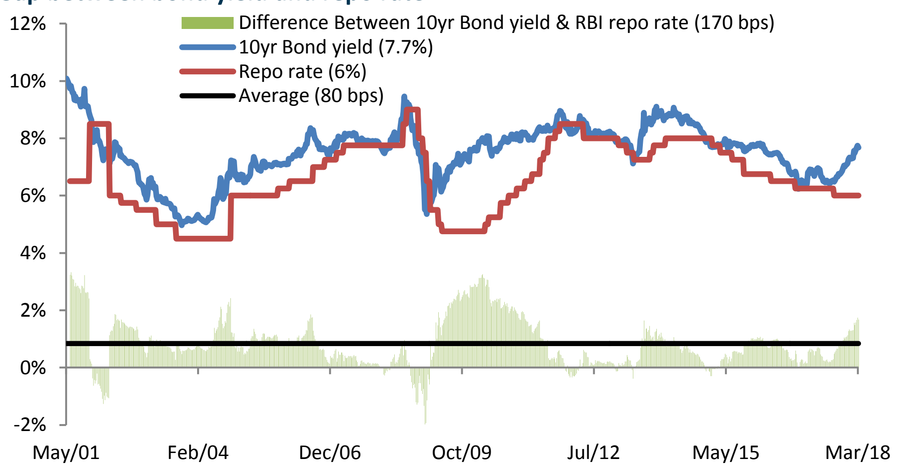
Past movement in ERP



Source: PhillipCapital India Research, Bloomberg

Besides ERP, market valuations are also dictated by cost of funds, indicated by government bond yields. The recent surge in Indian bond yields is mainly due to rising global bond yields and election-year spending (also some domestic technical factors). Thus, to some extent, the lower ERP is illusory. Current bond yields are 170bps above the repo rate vs. their long-term historical average of +80bps, indicating significant rate hikes ahead. We do not expect any major rate hikes for the year, but bond yields could remain high because of global factors.

Gap between bond yield and repo rate



Source: PhillipCapital India Research, Bloomberg

If bond yields were to normalise to their historical trend (+80bps vs. repo) then the equity risk premium would rise to 7.7%, indicating that the market is factoring in volatility that is similar to the demonetisation period or before the China debt scare in early 2016. Both instances showed the relative inexpensiveness of the market. While interest rates could rise with rising global bond yields, most of the challenges are already factored into the current yields.

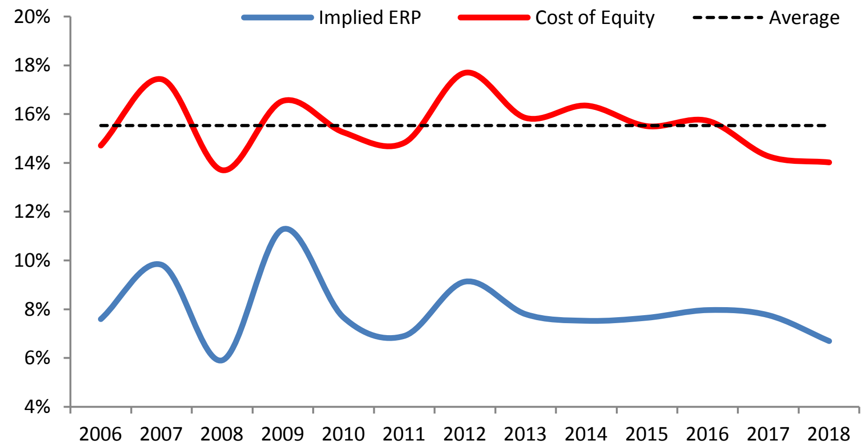
According to our Economist, Anjali Verma, bond yields for FY19 will be 7.5-8.0%, which translates into a cost of equity of 14.5% for FY19. This expectation (of market returns) is not at all low in absolute terms. On the other hand, expectations from other asset classes are quite low, and are unlikely to improve in the near term. Allocation to equity will continue to be a dominant strategy over the next 12 months.

India cost of equity: Expectations are reasonably high

We do not expect major downside for the market based on the 'cost-of-equity' model.

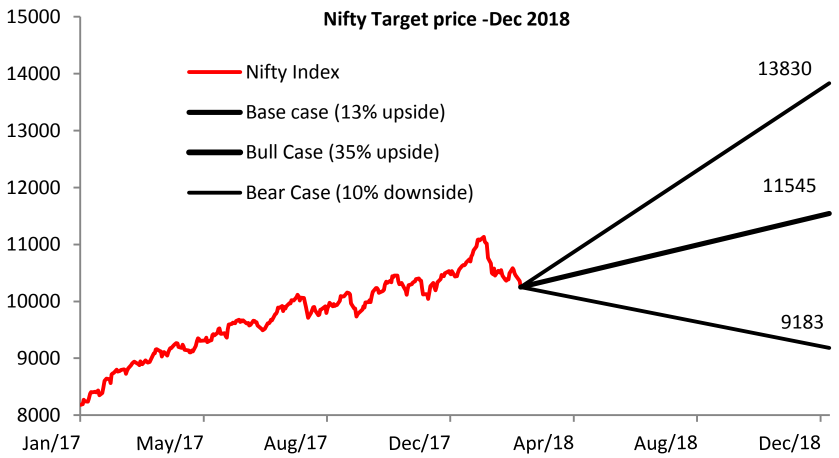
Cost of equity is a very important measure for investors (it is a basic rate of return that investors expect from the market before looking at other investment options). Current cost of equity for India is 14.5% vs. past average of 15.5%. The decline in cost of equity is somewhat illusory, as the market has seen a rather long period of subdued earnings growth, which has resulted in expansion of PE multiples, even as the market P/B is closer to the long-term average. Also, in absolute terms, the cost of equity for India is reasonably high, which provides valuation comfort.

ERP and cost-of-equity



Source: Bloomberg, PhillipCapital India Research   Note: Cost of equity & Implied ERP is as of 1st January 2018

Nifty targets: The good, the bad, and the pragmatic



Source: PhillipCapital India Research, Bloomberg

Base Case: In the ERP model, we build the NIFTY base case with constant ERP at 6.7% and three-year earnings CAGR of 17%. Based on this, our December 2018 Nifty target works out to 11,500.

Bull Case: We build this with our bull-case earnings growth expectations. Higher earnings would mean recovery in key sectors such as banking, pharmaceuticals, IT, and telecom, which would not only improve the immediate growth visibility, but also improve long-term visibility. With this, the ERP would decline. Baking in 6% ERP would translate to a NIFTY target of 14,000 for December 2018, an upside of 35%

from current levels. We believe there is a reasonable chance of this materialising as we expect an overall pick up in the economy, without major inflationary headwinds.

Bear Case: In this case, we assume that the ERP would rise by 100bps to 7.7% because of an increase in market volatility and no recovery in stressed sectors. With bear-case NIFTY earnings assumptions, we arrive at the NIFTY target of 9,200 for December 2018, which implies a 10% downside from current levels. We note that the downside is limited and that by December 2018, markets would start factoring in FY20 earnings. The NIFTY at 9,200, implies a P/E of 13x FY20 earnings – and considering improving GDP, we find the probability of this target materialising remote.

Near-term earnings momentum to remain strong

The base for Q4FY18 earnings is quite low, and we expect Q3FY18 momentum in earnings to gain traction in Q4.

Consensus expectations of EPS at Rs 495 for FY18 will translate into 27% earnings growth for Q4FY18. While there could be some negative surprises in banking, which would pull down earnings growth, we believe it is still likely to be about 20% in Q4, which is reasonably strong. Even after Q4, the base for Q1/Q2/Q3 FY19 (considering Q3FY17 base was very low) is quite benign. Considering this soft base, improving nominal GDP growth, and possible recovery in key sectors, we believe earnings momentum will remain strong, even sequentially.

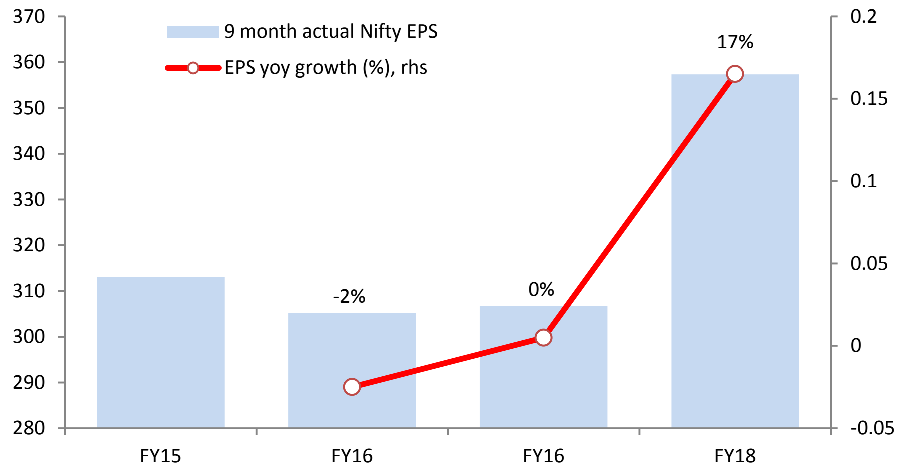
Q3 total earnings for NIFTY (not adjusted for weights) grew by a robust 15% while NIFTY EPS grew by 26% yoy translating to YTD earnings growth of 17%.

Nifty EPS trend (yoy %)

	EPS growth trend (yoy %)			
	Q1	Q2	Q3	Q4
FY14	15%	8%	17%	16%
FY15	17%	6%	-3%	-33%
FY16	2%	0%	-10%	-2%
FY17	-4%	-5%	12%	52%
FY18	7%	15%	26%	?

Source: Bloomberg, PhillipCapital India Research

Nifty actual 9M EPS trend

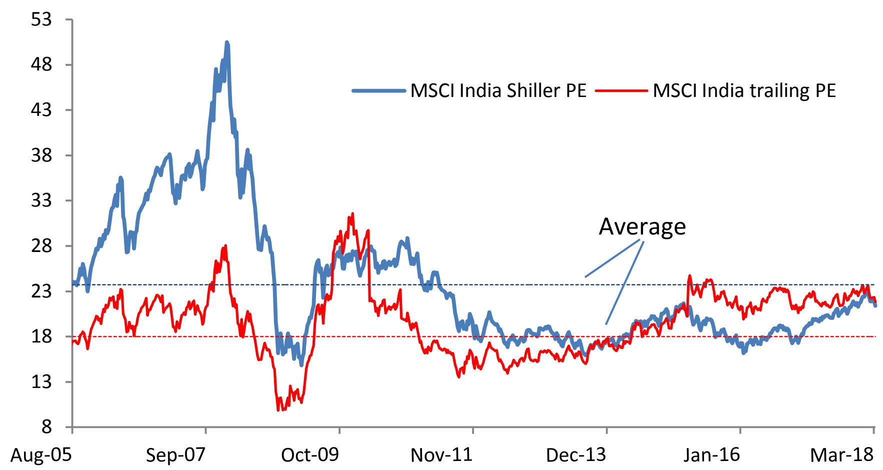


Source: PhillipCapital India Research, Bloomberg

Valuation in a volatile market

MSCI India Cyclically Adjusted Price Earnings (CAPE) ratio, popularly known as Shiller PE, is at 21.4x, at a 9% discount to its long-term average of 23.7x. This parameter gauges long-term market valuation. Since corporate earnings have been subdued for a very long time, Shiller PE normalises earnings over the long-term, shedding light on latent potential or exuberance. The current valuation dictated by Shiller PE indicates latent potential in the Indian market – earnings are more likely to regress to the long-term mean from here.

MSCI Shiller PE is at 21.4x vs. average of 23.7x

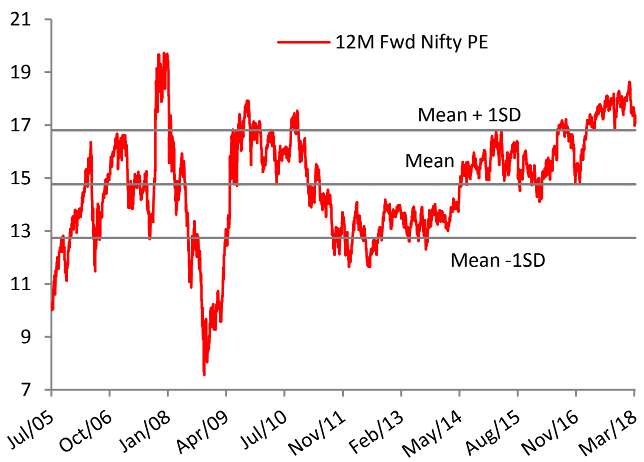


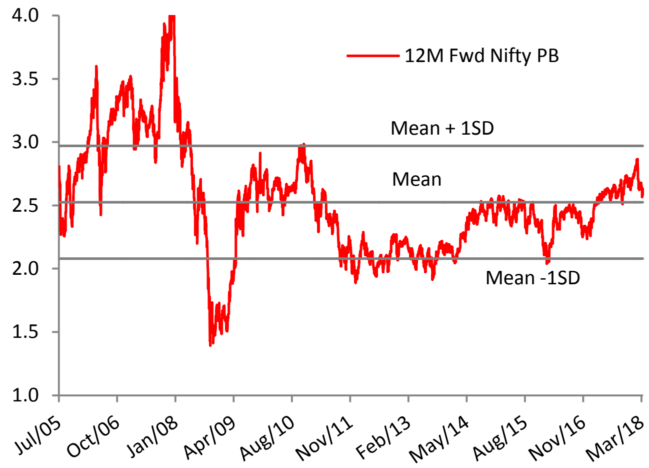
On P/B, the Indian market is reasonably valued, and on P/E it is only cyclically higher, as earnings are closer to the bottom of the cycle.

Source: Bloomberg, PhillipCapital India Research

While Shiller dictates long-term valuations, medium-term challenges could be very different. A look at the NIFTY one-year forward multiple indicates that it is trading slightly above one standard deviation, but the P/B is trading closer to the mean. This indicates the price paid to the invested capital.

Nifty Valuations

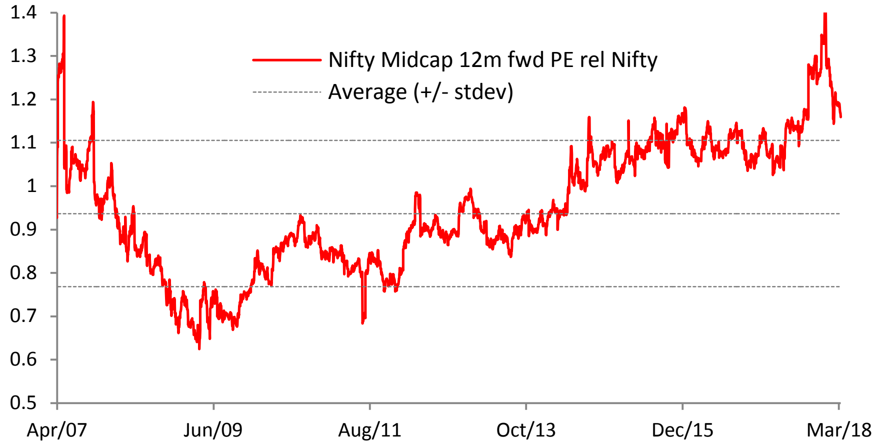




Source: Bloomberg, PhillipCapital India Research

Valuation of mid-caps remains stretched (these are now in a new zone) at 1.83 standard deviation above average on 12-month PE relative to large-caps. On 12-month forward absolute PE, mid-caps have lost ground by almost 20% in 2018 (from 25.3x to 20.1x in 2018)

Nifty: Mid-cap vs. large-cap



Source: Bloomberg, PhillipCapital India Research

Election year: Mostly positive rub-off on the markets

What we analysed

- How the Sensex fared since 1979 (10 union/central elections) till date.
- How did the Sensex fare, if bought six months before elections and held till 6 months later (basically, one-year returns).

Key findings

- **Returns over one year**: 70% of the time, markets have delivered positive returns (ranging from 10% to almost 80%). Twice, markets delivered negative returns (First in 1996 – UF government; Second in 1998 - BJP formed the government with AIDMK support, which it withdrew a few months later).
- **Returns pre-elections**: 80% of the time, markets delivered positive returns (1% to 29%).
- **Returns after elections**: 70% of the time, markets delivered positive returns (ranging from 4% to 69%).

Sensex returns (%) six-months before and six-months after Union elections

	6m bef	Elec Date	6m latter	6m bef	Elec Date	6m latter	6m bef	Elec Date	6m latter
Dates	03-07-1979	03-01-1980	03-07-1980	22-06-1984	22-12-1984	22-06-1985	22-05-1989	22-11-1989	22-05-1990
Sensex	125	118	123	246	272	459	706	712	778
Sensex Retn(%)	-5.25		3.81	10.31		68.96	0.84		9.31
Govt Formed					Congress			National Front	
Total Return in 1 yr			**-1.44**			**79.26**			**10.15**

	6m bef	Elec Date	6m latter	6m bef	Elec Date	6m latter	6m bef	Elec Date	6m latter
Dates	20-11-1990	20-05-1991	20-11-1991	26-10-1995	26-04-1996	26-10-1996	14-08-1997	16-02-1998	14-08-1998
Sensex	1265	1284	1911	3409	3765	3251	4321	**3450**	2969
Sensex Retn(%)	1.51		48.77	10.46		-13.66	-20.16		-13.94
Govt Formed		Cong + left			United Front			NDA	
					UF formed govt, No big party formed govt. 3 PM in 2 yrs BJP failed to form govt Devi Gowda and then Gujral became PM			BJP form govt ,AIDMK withdrew support latter	
Total Return in 1 yr			**50.28**			**-3.21**			**-34.11**

	6m bef	Elec Date	6m latter	6m bef	Elec Date	6m latter	6m bef	Elec Date	6m latter
Dates	05-03-1999	05-09-1999	06-03-2000	20-10-2003	20-04-2004	20-10-2004	16-10-2008	16-04-2009	16-10-2009
Sensex	3649	**4710**	**5521**	4852	**5805**	**5673**	10581	10947	17323
Sensex Retn(%)	29.07		17.21	19.65		-2.27	3.46		58.24
Govt Formed	NDA			UPA				UPA	
Total Return in 1 yr			**46.29**			**17.38**			**61.69**

	6m bef	Elec Date	6m latter
Dates	15-11-2013	15-05-2014	15-11-2014
Sensex	20399	23905	28177
Sensex Retn(%)	17.19		17.87
Govt Formed		NDA	
Total Return in 1 yr			**35.06**

Sectors/stocks that have given positive returns (%) six months before elections

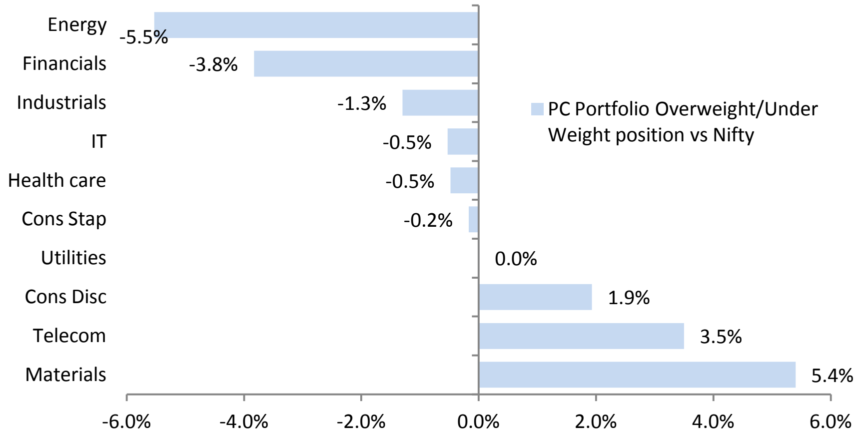
Sectors	Pre Budget return in % (6 m before Election)	2014	2009	2004	1999
AUTO	Ashok Leyland Ltd	69	0	22	236
	Motherson Sumi Systems Ltd	55	21	33	89
	Mahindra & Mahindra Ltd	19	0	50	58
	Hero MotoCorp Ltd	19	28	48	68
Banks	ICICI Bank Ltd	33	3	41	1
FMCG	ITC Ltd	17	19	23	2
	Dabur India Ltd	14	22	28	44
Cement	Shree Cement Ltd	41	70	80	193
	ACC Ltd	32	18	28	122
	Ambuja Cements Ltd	24	31	40	74
CAP Goods	Bharat Heavy Electricals Ltd	61	24	39	33
	Siemens Ltd	48	1	112	68
	Larsen & Toubro Ltd	47	1	43	65
	Bharat Electronics Ltd	24	31	11	66
Metals	Vedanta Ltd	1	31	51	39
O&G	Hindustan Petroleum Corp Ltd	79	16	54	27
	Indian Oil Corp Ltd	56	9	57	51
	Bharat Petroleum Corp Ltd	50	9	55	40
	Oil & Natural Gas Corp Ltd	40	6	38	77
	Reliance Industries Ltd	24	25	15	21
Pharma	Aurobindo Pharma Ltd	118	24	13	40
Power	Tata Power Co Ltd	15	9	78	16
Logistics	Container Corp Of India Ltd	46	7	52	82

Model portfolio changes

- We upgraded the IT sector and added HCL Tech (3.5%) and TCS (2.8%) to our portfolio.
- Added 30bps to ITC, considering valuation comfort.
- Sold PNB (0.9%) – left with no choice on this. Sold Hindalco Industries (2.1%), as a strategy to reduce weight in the metals portfolio.
- Reduced the weight of Bajaj Electricals to 1.5% from 2.5%, as the stock has seen a strong price rally.
- Reduced positions in metals: JSW steel (to 2% from 2.6%), Tata Steel (to 2.5% from 3.7%), and Vedanta (to 1.5% from 2.1%).
- Cut Bharti Airtel's position marginally by 30bps.

We're currently overweight on materials, telecom, and consumer discretionary and equal-weight on IT, healthcare, and consumer staples (we upgraded the IT sector).

PC portfolio overweight/underweight position vs. Nifty



Source: Bloomberg

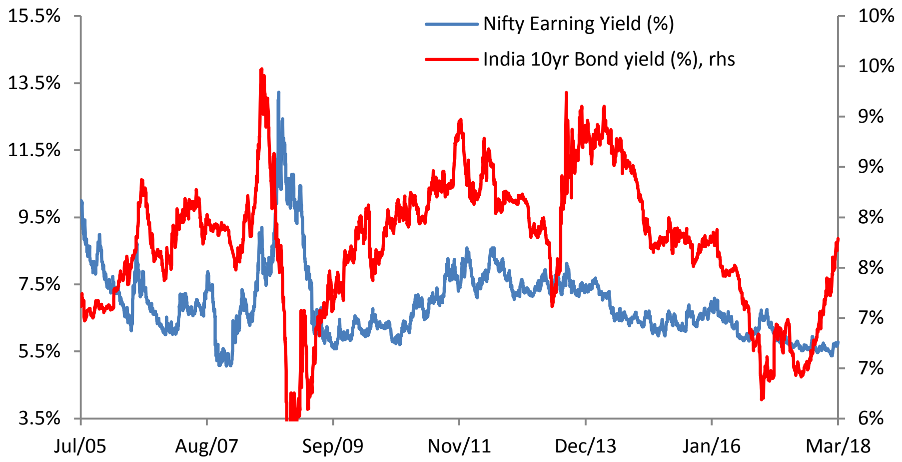
Model portfolio

Company	Weight	EPS (Rs) FY17	FY18E	FY19E	EPS Growth (%) FY17	FY18E	FY19E	P/E (x) FY17	FY18E	FY19E
FMCG	**9.4%**									
HUL	2.5%	20	22	29	3%	9%	34%	66	61	45
Bajaj Electricals	1.5%	11	15	22	-2%	41%	46%	54.3	38.4	26
ITC	5.4%	9	9	10	10%	7%	11%	31.0	29.1	26
Automobile	**8.1%**									
Maruti	4.2%	243	263	325	61%	8%	23%	36.3	33.5	27
Tata motors	1.6%	19	29	52	-46%	56%	78%	19.0	12.2	7
Bajaj Auto	2.3%	132	147	180	5%	11%	23%	22.4	20.2	16
IT	**12.5%**									
Infy	6.2%	63	75	72	7%	19%	-3%	18.8	15.9	16
TCS	2.8%	133	134	149	9%	1%	11%	23	23	21
HCL	3.5%	60	63	67	55%	5%	7%	16	15	14
Pharmaceuticals	**3.5%**									
Sun Pharma	2.5%	28	13	20	16%	-53%	55%	18.5	39.5	25
Aurobindo	1.0%	39	44	50	13%	10%	15%	14.8	13.4	12
Cement	**3.7%**									
Ultratech	2.6%	99	98	137	19%	-1%	40%	42.2	42.7	31
Dalmia Bharat	1.1%	39	63	88	80%	62%	41%	73.3	45.3	32
Metals & Mining	**9.0%**									
Tata Steel	2.5%	41	74	84	334%	78%	15%	15.1	8.5	7
JSW Steel	2.0%	14	20	29	150%	40%	43%	21	15	10
NTPC	3.0%	13	14	16	5%	6%	19%	13.2	12.4	10
Vedanta	1.5%	15	23	36	43%	52%	59%	21.0	13.8	9
Industrial	**4.7%**									
L&T	2.3%	42	53	61	43%	24%	16%	31.0	24.9	21
NCC	2.4%	5	6	7	2%	26%	26%	26.3	20.9	17
Finance	**31.2%**									
Axis bank	3.3%	35	15	25	11%	-55%	61%	15.0	33.8	21
indusInd bank	3.5%	48	60	74	25%	25%	23%	36.2	29.0	24
SBI	3.4%	(2)	4	19	-115%	-286%	361%	(115.5)	62.3	13
Cholamadalam Fin	2.9%	36	46	57	20%	26%	24%	39.7	31.4	25
HDFC Ltd	5.7%	47	68	67	4%	46%	-2%	39.7	27.2	28
HDFC bank	6.7%	57	65	81	17%	15%	24%	32.9	28.5	23
ICICI Bank	5.7%	17	11	13	1%	-34%	18%	17.9	27.2	23
Oil & Gas	**7.3%**									
Reliance Industries	7.3%	101	50	53	18%	-51%	6%	9.2	18.7	18
Telecom	**7.9%**									
Bharti Infratel	1.0%	15	17	19	18%	13%	12%	22.9	20.3	18
Bharti Airtel	3.0%	13	2	16	37%	-85%	679%	31.5	209.3	27
Idea	1.5%	(1)	(12)	(13)	-115%	974%	-91%	(70.7)	(6.6)	(6)
Zee Entertainment	2.4%	13	14	17	32%	9%	23%	45.4	41.5	34
Others	**2.7%**									
Aarti Ind	2.7%	38	41	55	23%	5%	35%	30.1	28.5	21

Source: Bloomberg

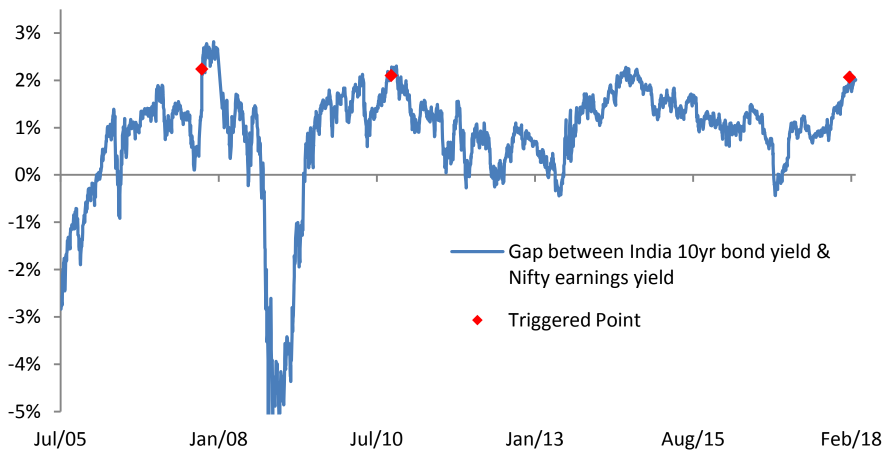
Appendix

Bond yield vs. earning yield



Source: Bloomberg, PhillipCapital India Research

Gap between the bond yield and earning yield has widened



Source: Bloomberg, PhillipCapital India Research

Nifty performance in a volatile market

	Nifty performance after gap between bond yield and earnings yield at current level			
Date	**1 month**	**3 month**	**6 month**	**12 Months**
05-10-2007	12.8%	21.0%	-10.4%	-25.8%
09-04-2010	-3.1%	-0.2%	13.8%	10.2%
11-10-2010	1.0%	-6.1%	-5.7%	-20.3%
15-05-2014	5.9%	9.4%	17.3%	16.9%
Average	**4.1%**	**6.0%**	**3.8%**	**-4.8%**
% of Rise	**75%**	**50%**	**50%**	**50%**

	Bond yield performance after threshold date			
Date	**1 month**	**3 month**	**6 month**	**12 Months**
05-10-2007	-0.06%	-0.18%	0.03%	0.71%
09-04-2010	-0.2%	-0.24%	0.09%	0.09%
11-10-2010	0.1%	0.25%	0.00%	0.57%
15-05-2014	-0.2%	-0.27%	-0.56%	-0.90%
Average	**-0.1%**	**-0.1%**	**-0.1%**	**0.1%**
% Fall	**75%**	**75%**	**25%**	**25%**

	Oil price performance after threshold dates			
Date	**1 month**	**3 month**	**6 month**	**12 Months**
05-10-2007	14.69%	22.67%	32.95%	19.11%
09-04-2010	-7.7%	-11.09%	-0.94%	42.71%
11-10-2010	6.1%	14.31%	48.09%	26.29%
15-05-2014	2.7%	-7.63%	-29.45%	-41.23%
Average	**3.9%**	**4.6%**	**12.7%**	**11.7%**

	Earning yield after threshold dates			
Date	**1 month**	**3 month**	**6 month**	**12 Months**
05-10-2007	-0.5%	-0.6%	1.4%	3.3%
09-04-2010	0.2%	0.3%	-0.1%	0.5%
11-10-2010	0.0%	0.6%	0.7%	2.4%
15-05-2014	-0.3%	-0.3%	-0.5%	-0.2%
Average	**-0.1%**	**0.0%**	**0.4%**	**1.5%**

Source: Bloomberg, PhillipCapital India Research

Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	>= +15	Target price is equal to or more than 15 of current market price
NEUTRAL	-15 > to < +15	Target price is less than +15 but more than -15
SELL	<= -15	Target price is less than or equal to -15.

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