THE BIG CALL - BUBBLE IN QUALITY?

Abakkus
Believe in the Basics

Summary

30th Oct, 2019

Indian equity markets have never witnessed as high a valuation in a few stocks for such a prolonged period as we see today. Most of these stocks are usually associated with perception of high & increasing growth and improving capital efficiency. While these characteristics are true for a few stocks, a closer look tells us a completely different story for the majority. Our study of 27 high P/E prominent companies in India show that a majority have not delivered performance that justifies current valuations, and there can be little return expectation from these investments.

(a) Majority have grown even below nominal GDP since 2010 (b) Majority will need to trade at 50x-75x P/E in FY28 for mere 12% annual return in next 9 years (c) Global peers have grown faster and have better capital efficiency, but trade at 1/3rd valuations (d) Reverse DCF shows 30-40 years of consistent growth is required to merely affirm current peak valuations.

We attempt to unearth and understand the valuation bubble in perceived quality stocks in India. In conclusion, investors would do well to diversify allocations out of such stocks to a broader market.

Select quality stocks are in a bubble zone and could give zero or negative returns over the next few years

Introduction

Equity markets and investing have always been challenging and all participants are always in a perennial learning mode. We don't know of a single person who would admit to be know-it-all. Of course, we have grown up reading, listening and experiencing the greats of investing; right from value investors like Benjamin Graham, Warren Buffet, Peter Lynch and the likes of passive investment greats like John Bogle or enterprising hedge fund greats like Bill Gross, George Soros, Carl Icahn and others.

There are various methodologies followed for valuation of stocks and most fundamental based investors would follow one of the same or a mix of them. These would vary from a simple P/E (Price to Earnings), P/B (Price to Book), PEG (Price Earnings to Growth) kind of ratios to the more extensive Discounted Cash Flows (DCF) using the Capital Asset Pricing Model (CAPM). The basics of investing though remain the same: investing in a company's stock is like becoming a partner in the company and the price paid for that share should justify value for the business of the company that one is buying into.

Of course, there are always times when new innovative valuation methods come into play; like market capitalization per pair of eyeballs during the 'dot-com' era, Enterprise Value (EV) per MegaWatt (MW) during the Indian power sector boom in 2007-08, Price-to-book for NBFCs based on likely future capital raise in India, Market Value to Gross Merchandise Value (GMV) for e-commerce, footfalls for retail, and various newer methods of valuing companies in the current era of disruption.

The future cash flows have to justify the price an investor pays for a stock today

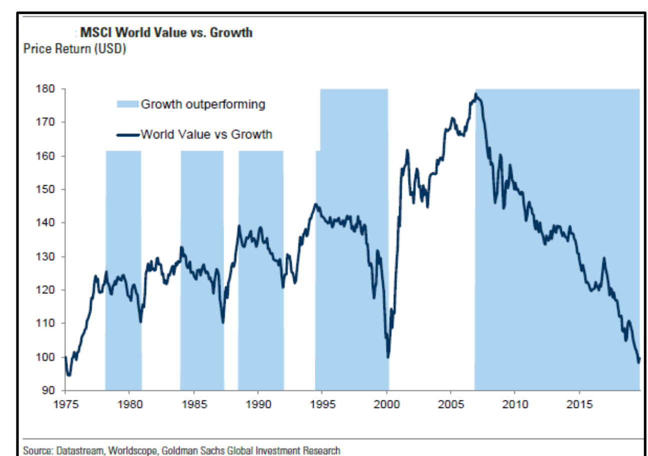
Current Scenario

Over the last couple of years, global economy and equity markets have seen enhanced volatility. A combination of global factors, protectionism, political uncertainty, record low bond yields, disruptions and new business models, massive Private Equity funding and the likes have led to a polarised market behaviour. In India, another phenomenon experienced is the cleaning up of crony capitalism, liquidity related issues, corporate governance questions, increased banking non-performing assets, etc. The independence of auditors and rating agencies, apart from other fiduciaries have also been questioned, leading investors to become extra cautious.

All the above has led to a unique phenomenon: A bipolar market where the concepts of consistency, quality, stable earnings, low volatility and perceived safety have done disproportionately well while the other side of the markets languish due to investor apathy. A recent report by Goldman Sachs also highlights that an index of "stable earnings" US companies is now trading at all-time high 65% premium to "volatile growth" companies (Exhibit 1). Similarly, globally, outperformance of Growth vs Value Stocks has had the strongest and longest run in the last 10 years or so since 1970 (MSCI World) (Exhibit 2).

Exhibit 1: Relative P/E Valuation of Stable Growth vs Volatile Growth stocks of S&P500 since 1985

Exhibit 2: Outperformance of Growth vs Value Stocks since 1970 (MSCI World)



*Source: Goldman Sachs, Factset, I/B E/S, Global Strategy Views, Rotation and Duration

Being an intrigued investor and always willing to learn, the current performance of some of the "quality" stocks had us thinking. Based on all traditional metrics, these stocks seem to be extra-ordinarily expensive and therefore logically, not in our investment shortlists nor in our portfolios. We, at Abakkus, were not convinced about their valuation a few months back too and with their recent up moves, they have become more expensive. We got together to introspect what we were missing that other smarter investors understood and we did not. And that is where a very detailed study, analysing most of these stocks started.

We made a list of the current high P/E stocks as a start. A very detailed analysis and number crunching followed. Yes, it is said that stock investing is an art. It can never be only numbers and financials and there must be some qualitative & future growth perspective to it. But ultimately every valuation methodology has one underlying principle: the value paid today should justify future earnings potential of the company.

Valuation Premium of Stable growth vs volatile growth stocks in the US has gone well above its long-term median of 11% and well into bubble territory

Our analysis:

We made a list of a few prominent perceived-high-quality expensive listed Indian companies.

The Revenue, EBITDA and Net profit growth of each of the companies was tabulated from FY10-19. We also analysed the same growth over 3 & 5 years to clear the notion that near-term growth for such companies has been higher and therefore the high valuations.

We analysed the nominal GDP growth for India during this period, as logically superior companies should grow at a much higher rate than nominal GDP. Also analysed was the CPI inflation during the last 9 years. Most of the companies selected are consumer facing companies and sales growth for each one of them is a combination of inflation and volume growth.

Exhibit 3A: Annual Growth rate of Revenue, EBITDA, Net Profit from FY10-19

					Revenue CAGR			EBITDA CAGR			PAT CAGR		
No.	Company	Sector	Trailing PE (x)	Latest Mcap (Rs. Cr)	Last 9 Years	Last 5 Years	Last 3 Year	Last 9 Years	Last 5 Years	Last 3 Year	Last 9 Years	Last 5 Years	Last 3 Year
1	Hindustan Unilever Ltd.	FMCG	70x	4,60,585	9%	6%	7%	14%	12%	14%	12%	9%	13%
2	Maruti Suzuki India Ltd.	Other	31x	2,19,135	13%	15%	11%	13%	27%	13%	13%	21%	12%
3	Asian Paints Ltd.	Building Material	67x	1,70,718	13%	9%	11%	12%	12%	8%	11%	11%	7%
4	Nestle India Ltd.	FMCG	86x	1,45,001	9%	4%	11%	12%	7%	19%	10%	8%	42%
5	Titan Company Ltd.	Consumer Discretionary	85x	1,18,031	17%	13%	21%	20%	13%	29%	21%	14%	27%
6	Dabur India Ltd.	FMCG	65x	83,467	11%	4%	3%	13%	10%	5%	13%	10%	5%
7	Pidilite Industries Ltd.	Building Material	69x	68,575	14%	11%	10%	15%	16%	7%	15%	16%	5%
8	Siemens Ltd.	Other	58x	59,556	4%	2%	7%	4%	28%	12%	3%	36%	-8%
9	Berger Paints India Ltd.	Building Material	98x	46,571	14%	9%	13%	17%	15%	11%	17%	15%	11%
10	Colgate-Palmolive (India) Ltd.	FMCG	55x	41,739	10%	5%	5%	10%	12%	9%	7%	8%	10%
11	Procter & Gamble Hygiene & Health Care Ltd.	FMCG	92x	38,706	14%	8%	2%	11%	15%	5%	9%	13%	3%
12	ABB India Ltd.	Other	82x	32,635	6%	7%	10%	6%	16%	12%	4%	24%	19%
13	Kansai Nerolac Paints Ltd.	Building Material	60x	28,347	14%	11%	13%	12%	17%	10%	12%	16%	-21%
14	Whirlpool Of India Ltd.	Home Appliance	64x	27,774	10%	14%	16%	13%	26%	19%	12%	27%	19%
15	Gillette India Ltd.	FMCG	100x	25,369	11%	3%	-5%	9%	18%	11%	8%	21%	13%
16	Honeywell Automation India Ltd.	Home Appliance	66x	25,011	12%	13%	13%	13%	33%	33%	12%	33%	36%
17	3M India Ltd.	Other	80x	24,535	12%	12%	12%	16%	36%	20%	16%	53%	23%
18	Voltas Ltd.	Home Appliance	47x	22,935	5%	6%	8%	4%	17%	12%	4%	18%	14%
19	Bata India Ltd.	Consumer Discretionary	65x	22,713	12%	7%	7%	17%	9%	21%	20%	11%	15%
20	Apollo Hospitals Enterprise Ltd.	Other	66x	21,127	19%	17%	16%	14%	10%	14%	5%	-8%	-1%
21	Astral Poly Technik Ltd.	Building Material	110x	17,193	27%	18%	14%	27%	21%	24%	25%	20%	23%
22	Emami Ltd.	FMCG	44x	15,286	11%	8%	5%	8%	9%	1%	7%	-5%	-6%
23	Symphony Ltd.	Home Appliance	72x	8,757	18%	10%	24%	13%	4%	3%	11%	-3%	-8%
24	TTK Prestige Ltd.	Home Appliance	45x	8,590	17%	10%	12%	17%	13%	18%	16%	11%	18%
25	Blue Star Ltd.	Home Appliance	76x	8,353	9%	12%	11%	2%	17%	15%	0%	23%	26%
26	VIP Industries Ltd.	Consumer Discretionary	63x	6,672	12%	13%	14%	10%	23%	28%	13%	20%	30%
27	Blue Dart Express Ltd.	Other	78x	5,462	15%	10%	7%	12%	8%	-12%	4%	-6%	-23%
Average					**12%**	**10%**	**10%**	**12%**	**16%**	**13%**	**11%**	**15%**	**11%**

* Source: Ace Equity, Abakkus
** Market Cap is as of Oct 22, 2019
*** Revenue, EBITDA, PAT CAGR from FY10-19
****Average Nominal GDP growth rate of India has been ~13% since 2010, average inflation over the same period has been ~7%

Natural deduction follows that given the much lower inflation now in India, nominal GDP growth for the next 9 years should average much lower than the last 9 years, even presuming a similar real GDP growth rate of 7%+. It is also natural to believe that the penetration levels today of most of these products is much higher than what it was 9-10 years back and hence the growth for the next few years should be lower than what it was over the last few years. Nonetheless we are presuming that all the companies in our universe of study will grow at the same pace over the next 9 years as they have over the last 9 years.

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Extrapolating it further, we have built scenario analysis of return expectations from these stocks.

E.g. HUL has grown its revenues at 9% CAGR and net profit at 12% CAGR in the last 9 years (Exhibit 3A). This also has to be seen in the light of a nominal GDP growth of 13% during the same period, implying a growth for Hindustan Lever of less than the GDP growth. Inflation during this period has been 7%, thus revenue growth net of inflation is only 2%.

Even if HUL's profits continue to grow at 12% CAGR till FY28, its P/E in FY28 will have to be 55x for mere 10% annual share price return and 82x for 15% annual share price return. Similar projections were done for all the other companies under the sudy. (Exhibit 3B)

Exhibit 3B: Projected Revenue, EBITDA, Profit in FY28 and required P/E for 10%,12% & 15% returns

		FY19			FY28 (Assuming last 9 years PAT/PBT growth rate)			FY28 Market Cap & Implied P/E for Required Annual Return					
								10% CAGR		12% CAGR		15% CAGR	
No.	Company	Revenue (Rs. Cr)	EBITDA (Rs. Cr)	PAT (Rs. Cr)	Revenue (Rs. Cr)	EBITDA (Rs. Cr)	PAT (Rs. Cr)	Mcap (Rs. Cr)	PE (x)	Mcap (Rs. Cr)	PE (x)	Mcap (Rs. Cr)	PE (x)
1	Hindustan Unilever Ltd.	39,311	9,430	6,060	86,992	30,455	17,444	10,86,036	55x	12,77,240	65x	16,20,283	82x
2	Maruti Suzuki India Ltd.	86,069	13,565	7,495	2,50,335	40,479	22,072	5,16,709	23x	6,07,678	28x	7,70,890	35x
3	Asian Paints Ltd.	19,350	3,757	2,171	56,042	10,256	5,333	4,02,544	71x	4,73,415	84x	6,00,565	106x
4	Nestle India Ltd.	11,292	2,877	1,607	24,860	8,036	3,942	3,41,904	80x	4,02,098	94x	5,10,094	120x
5	Titan Company Ltd.	19,779	2,174	1,391	83,638	11,569	7,697	2,78,311	33x	3,27,310	39x	4,15,219	49x
6	Dabur India Ltd.	8,515	2,036	1,445	21,385	6,172	4,174	1,96,811	45x	2,31,461	53x	2,93,628	68x
7	Pidilite Industries Ltd.	7,079	1,515	925	22,838	5,517	3,164	1,61,696	40x	1,90,163	47x	2,41,237	60x
8	Siemens Ltd.	12,795	1,635	901	17,512	2,365	1,173	1,40,429	120x	1,65,153	141x	2,09,510	179x
9	Berger Paints India Ltd.	6,062	942	498	19,429	3,940	2,063	1,09,811	49x	1,29,144	58x	1,63,829	73x
10	Colgate-Palmolive (India) Ltd.	4,462	1,274	776	10,147	3,046	1,381	98,418	55x	1,15,745	65x	1,46,832	83x
11	Procter & Gamble Hygiene & Health Care Ltd.	2,455	639	375	7,787	1,662	785	91,266	97x	1,07,333	114x	1,36,161	145x
12	ABB India Ltd.	10,862	1,023	511	18,916	1,687	736	76,952	100x	90,499	118x	1,14,806	149x
13	Kansai Nerolac Paints Ltd.	5,424	813	448	17,243	2,327	1,211	66,841	33x	78,609	39x	99,722	50x
14	Whirlpool Of India Ltd.	5,398	747	407	13,154	2,186	1,143	65,488	53x	77,018	63x	97,704	79x
15	Gillette India Ltd.	1,677	394	229	4,251	825	464	59,818	129x	70,349	152x	89,244	192x
16	Honeywell Automation India Ltd.	3,175	577	359	8,592	1,714	970	58,975	54x	69,358	63x	87,987	80x
17	3M India Ltd.	3,025	605	366	8,417	2,311	1,444	57,853	40x	68,038	47x	86,312	59x
18	Voltas Ltd.	7,124	798	566	10,668	1,183	832	54,080	65x	63,601	76x	80,683	97x
19	Bata India Ltd.	2,931	556	329	7,865	2,311	1,730	53,557	31x	62,986	36x	79,903	46x
20	Apollo Hospitals Enterprise Ltd.	9,617	1,095	199	45,644	3,603	305	49,816	133x	58,586	156x	74,322	198x
21	Astral Poly Technik Ltd.	2,507	400	201	21,650	3,415	1,456	40,540	23x	47,677	28x	60,482	35x
22	Emami Ltd.	2,693	762	305	7,098	1,492	547	36,044	62x	42,390	73x	53,775	92x
23	Symphony Ltd.	844	172	92	3,741	519	227	20,647	81x	24,283	95x	30,804	120x
24	TTK Prestige Ltd.	2,107	321	192	8,739	1,315	706	20,255	27x	23,821	31x	30,218	40x
25	Blue Star Ltd.	5,235	371	209	10,968	451	207	19,696	95x	23,163	112x	29,384	142x
26	VIP Industries Ltd.	1,785	235	145	4,947	566	436	15,733	35x	18,503	41x	23,472	52x
27	Blue Dart Express Ltd.	3,174	305	90	11,103	829	132	12,880	98x	15,148	115x	19,216	146x

*Source: Ace Equity, Abakkus
** Consolidated numbers wherever applicable
*** Net Profit is as of FY19, but Latest Market Cap is as of 22 Oct'19

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Startling Insights

1. Out of 27 companies in the study, in the last 9 years
   - Average annual Profit, EBITDA and Revenue Growth has been 11%, 12% and 12% respectively
   - 6 companies have grown profits at less than 5% CAGR
   - 7 companies have grown revenue at less than 10% CAGR
2. 18 of the 27 companies need to trade at P/E more than 50x in FY28 for 12% annual return
3. 7 companies out of these need to trade at P/E of higher than 100x in FY28 for 12% annual return

The reason attributed by analysts and investors in favour of these high P/E companies has largely centred around stability of earnings and much superior growth. A few market participants whom we spoke to, justified the high PEs as they believed that these companies were growing at rates of 20-25% every year.

However, surprisingly most of the companies have grown in line or around the pace of nominal GDP growth. In fact, a few companies have not even kept pace with the nominal GDP growth. Colgate India for e.g., has grown revenues at a CAGR of 10% and Profit at a CAGR of 7% over FY10-19. One important reason presented for the high P/E ratios for these companies is stable and higher growth. This data of growth is not too different than nominal GDP growth, thus making the argument of 50x-75x P/E multiples based on higher growth untenable.

If we look at Exhibit 3B, we can see the implied P/E ratios which these companies should trade at in FY28 to generate 10%, 12% and 15% CAGR returns over the next 9 years. Thus, for Asian Paints to yield the investors a return of 10% CAGR over the next 9 years, it will have to trade at a P/E of 71x FY28 earnings and for a 15% CAGR return, the P/E will have to be only 106x FY28. Similar data is extrapolated for all the companies under study. We don't think anywhere in the world at any point of time, companies have traded at P/Es of 50-100 for 10-15 years at a stretch (refer Exhibit 8)

Contrary to the perception of high growth in expensive companies, majority of companies in our study have grown below nominal GDP growth rate since FY10

For a mere 12% annual growth in next 9 years, most of the companies in our study will have to trade at P/E more 50x to 75x in FY28

Global Comparison:

We also analysed, global companies that are comparable to respective Indian companies. Again, the general belief is that Indian consumer companies are expensive compared to their global peers because of superior revenue and profit growth. Let's take a look at Exhibit 4.

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Exhibit 4: Asian Paints vs Sherwin Williams - Revenue & Profit Growth, ROE, PE, Market Cap/Revenue

	Revenue (Mn USD)		Growth CAGR %	PAT (Mn USD)		Growth CAGR %	ROE%		Latest Market Cap (Mn USD)	Mcap / FY19 PAT (x)	Mcap / FY19 Revenue (x)
	FY10	FY19		FY10	FY19		FY10	FY19			
Asian Paints	954	2,764	13%	126	310	11%	61%	24%	24,286	78x	9x
Sherwin Williams	7,094	17,534	11%	475	1,750	16%	27%	30%	51,000	29x	3x

*Reporting period of Sherwin Williams is December end and that of Asian Paints is March end
**Extraordinary item has been adjusted
***Source: Bloomberg, Company Annual Report
****1 USD = INR 70
***** Mcap as of 24 Oct, 2019

Sherwin Williams and Asian Paints are the largest and most valuable paint companies in the world and India respectively. A quick look at their fundamentals show that Asian Paints has reported a revenue growth of 13% CAGR over the last nine years, same as nominal GDP growth of India and just 2% higher than that of Sherwin Williams. However, profit growth of Asian Paints over this period is only 11% compared to a healthier 16% for that of Sherwin Williams. Even ROE of Sherwin Williams for the last reported annual numbers are higher than that of Asian Paints. But, let's take a look at the valuations. Asian Paints trades at a P/E of 78x FY19 compared to Sherwin William's 29x based on CY18 numbers. Even on market/sales the premium is startling. Asian Paints trades at Mkt Cap/Sales of 9x vs Sherwin William's of 3x.

Belying the perception of high growth justifying high PE, Asian Paints profit has grown much slower than Sherwin Williams since FY10, but still trades at 300% premium

Implication of Reverse DCF of Fair Value

Another logical reason given for the high multiples of these companies has been their stable earnings, great Balance Sheets and low volatility. There is a thought that given their low Beta, a DCF valuation matrix is more ideal. We undertake even that analysis on two prominent FMCG companies : HUL & Nestle India:

Exhibit 5A: Last 9 & 5 year FCFE growth of HUL and Nestle India

FCFE CAGR	Period	HUL	Nestle India
9 Year CAGR	FY10-19	12%	13%
5 Year CAGR	FY14-19	11%	9%

*Source: Ace Equity, Abakkus

While the average cost of equity for Indian markets is cited close to 13%, we have given much lower cost of equity of 9% to both HUL and Nestle, by taking very conservative Beta assumption in CAPM model. Understandably, 9% cost of equity is very generous given risk-free rate of India is around 7%.

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Exhibit 5B: Reverse DCF Assumption & Result - Required Growth & duration to justify current valuation

DCF	Cost of Equity	Growth	# of Years	Long-term GDP	Fair Value (Rs. Cr)	Current Market Cap (Rs. Cr)
HUL	9%	10%	35	5%	4,21,410	4,60,585
	9%	12%	25	5%	5,06,716	
Nestle India	9%	10%	35	5%	1,54,231	1,45,000
	9%	12%	25	5%	1,74,389	

*Assumption & Valuation: Abakkus, Current Market Cap as of 22 Oct'19

To justify current market cap of Hindustan Unilever, the company will have to grow at 10% CAGR for the next 35 years and thereafter 5% in perpetuity, or 12% CAGR for the next 25 years and 5% in perpetuity (Exhibit 5B). Just to put things in perspective, Hindustan Unilever revenue and profits will have to be Rs. 11 lakh cr ($160bn) and Rs. 1.7 lakh cr ($24bn) after 35 years, if it were to achieve these growth rates.

Similar analysis for Nestle India is also presented in Exhibit 5B.

Intrinsic Valuation of Indian FMCG companies like HUL, Nestle shows they will have to grow at 10% for a staggering 35 years or at 12% for 25 years to merely justify current valuations

Comparison with a few crucial and large Indian sectors

We also attempted to compare the valuations of these high multiple companies with some core sectors of economy, that are very large but with more volatile earnings.

As can be seen from Exhibit 6, the total market cap of Hindustan Unilever and Nestle India is more than the market cap of all listed Indian companies in the following sectors: Iron & Steel, Construction Materials (includes cement), Non-Ferrous Metals and Ferrous Metals (classification as per Ace Equity). The peak profits in last 9 years that these companies made is around Rs 73,000 cr, almost 10x that of Hindustan Lever and Nestle India put together.

These are startling numbers and again question the all-time-high and near bubble valuations that these consumption facing companies in India are trading at. (Refer to exhibit 6)

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Exhibit 6: All Listed Companies over 1000 cr market cap in Iron & Steel, Cement, Metals vs HUL + Nestle

Company Name	Sector	Latest Market Cap (Rs. Cr)	FY19 Revenue (Rs. Cr)	FY19 PAT (Rs. Cr)	Peak Revenue (Rs. Cr)	Peak PAT (Rs. Cr)
Ultratech Cement Ltd.	Construction Materials	1,23,974	37,379	2,431	37,379	2,713
Shree Cement Ltd.	Construction Materials	65,010	12,555	1,015	12,555	1,384
Vedanta Ltd.	Non - Ferrous Metals	55,795	92,048	9,698	92,048	13,692
JSW Steel Ltd.	Iron & Steel	53,940	84,757	7,554	84,757	7,554
Tata Steel Ltd.	Iron & Steel	43,336	1,67,302	8,876	1,67,302	17,547
Hindalco Industries Ltd.	Non - Ferrous Metals	42,090	1,30,542	5,495	1,30,542	6,208
Ambuja Cements Ltd.	Construction Materials	41,232	26,041	2,960	26,041	2,960
ACC Ltd.	Construction Materials	29,165	14,802	1,510	14,802	1,561
The Ramco Cements Ltd.	Construction Materials	17,772	5,162	507	5,162	654
Dalmia Bharat Ltd.	Construction Materials	15,735	9,484	349	9,484	349
Steel Authority Of India Ltd.	Iron & Steel	14,953	66,974	2,126	66,974	6,851
Jindal Steel & Power Ltd.	Iron & Steel	10,980	39,372	-2,412	39,372	4,002
Others Above 1000 cr Mkt Cap		**87,271**	**1,05,323**	**6,071**	**1,06,259**	**8,340**
Total		**6,01,254**	**7,91,741**	**46,181**	**7,92,676**	**73,816**
HUL	FMCG	4,63,270	39,311	6,060	39,311	6,060
Nestle India Ltd	FMCG	1,44,061	11,292	1,606	11,292	1,606
HUL + Nestle India		**6,07,331**	**50,603**	**7,666**	**50,603**	**7,666**

* Source: Ace Equity, Abakkus
**Sector classification as per Ace Equity
*** Peak Profit = Highest Profit during FY10-19
**** Market Capitalisation as of 24 Oct, 2019

HUL and Nestle together have higher market capitalisation than combined market capitalisation of top 40 core sector companies, even though their peak profits is less than 1/10th by comparison

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Why have these companies traded at such expensive multiples and what is the reason for their continuing near-term outperformance?

The reason for continued overvaluation of these companies is skewed investment inflow to these large cap companies over the past 4-5 years. As can be seen in Exhibit 7, incremental domestic flows that were invested into the top 100 listed companies used to be only 31% of total flows in 2013-14 that have now risen to a whopping 84% in the top 100 companies and 96% in the top 200 companies. On the Foreign Portfolio Investors (FPIs) front, till June 2014, 48% of their investments were in top 100 companies and 77% were in top 200 companies. This has now risen to 88% in the top 100 companies and 96% in the top 200 companies.

Exhibit 7: Money Inflow in Large Caps in India

INR mn; BSE500 analysis	One year before 2014 elections Jun13-Jun14	Three years before now Jun16-Jun17	Last one year Jun18-Jun19
Mutual Fund, Insurance and FI investments	**5,526,932**	**11,962,284**	**18,451,251**
Incremental investment during the year	**1,390,945**	**2,202,188**	**1,778,169**
Fresh investment directed towards:			
Top 50 companies	16%	36%	77%
51st - 100th companies	15%	14%	7%
101st- 200th compnies	32%	21%	12%
201st - 300th company	13%	13%	3%
301st - 400th company	8%	6%	1%
401st - 500th company	16%	9%	-1%
FII + FPI investments	**11,196,351**	**20,604,892**	**28,466,113**
Top 50 companies	25%	35%	63%
51st - 100th companies	23%	13%	25%
101st- 200th compnies	29%	30%	8%
201st - 300th company	7%	9%	3%
301st - 400th company	5%	4%	2%
401st - 500th company	11%	9%	-1%

Source: ACE Equity

Methodology:

a) Total holding value is arrived at by multiplying shares held in each company with share price as of end of period

b) Gains during the quarter stripped off by multiplying the change in share price with quantity held at start of period

c) Increase in value of holding after stripping of price changes is assumed as fresh inflow

*Source: Ace Equity, ET

(Continued Overleaf)

The trends of institutional investments, both domestic and foreign, clearly indicate that investors have focussed only on the larger companies irrespective of valuations, while ignoring the broader markets even though there is a big valuation gap. Few of the reasons for the same might be:

1. Flight to Safety: In an environment of volatility, fear and uncertainty, these companies have presented some growth and no negative news flow. Thus, investors have been comfortable adding these stocks to their portfolio as allocation bets.

2. Inclusion in Index and Passive Funds: The outperformance of these stocks in absolute basis and significantly on relative basis has led to a surge in their market capitalisation. The increase in market cap has led these stocks to be included in multiple indices, both in India as well as global indices like FTSE EM and MSCI. In an era of passive investing gaining ground, more inflows in passive funds has led to more buying in these stocks irrespective of valuations.

3. Regulatory Classification: In India, the reclassification of funds initiated by regulator, SEBI, has led to most of the mutual fund inflows moving to the top 100 companies.

4. Self-fulfilling cycle of pyramiding: Since these stocks have done relatively very well, funds that own them have done well over the last 2-3 years. Near term performance attracts more money and then the funds buy the same stocks again. Thus, it's a self-fulfilling cycle of buying, performance, flows and more buying in the same stocks

Incremental investment inflow from institutional investors have been almost fully into top 100 companies in recent years

Why we believe that these companies will give no, low or negative returns over the next 5-10 years?

All-time high valuations. To make even 10% CAGR returns, the companies will have to trade at P/E ratios of 50-75x in FY28.

There have hardly been companies in the global markets which have traded at multiples of 50-75x for periods of 10-15 years. In fact, we found that very few companies in US have traded at P/E over 50x for even 5 years cumulatively since 1990 even though this period included 'dot-com bubble' and 'subprime crisis' (Exhibit 8).

Exhibit 8: US stocks that have traded at high valuation (>50x PE) for more than 5 Years

Period	Number of Companies	Name of Companies
Since 1990 to Present	Only 8 companies have traded over 50x P/E for more than 5 years CUMULATIVELY (not even continuously)	Amazon, Comcast corp, Salesforce, Adobe, Netflix, Starbucks, Qualcomm, Celgene
Since 2005 to Present	Only 3 companies have traded over 50x P/E for more than 5 years CUMULATIVELY (not even continuously)	Amazon, Salesforce, Netflix

* Source: Bloomberg, Abakkus
** REITs have been excluded from this study
*** Based on monthly P/E data

Modern trade and e-commerce are making competition in a lot of these segments much easier and funded by risk taking Private Equity funds.

Our view is very clear: unless the growth expectations of these companies over the next few years goes up significantly, there is absolutely no fundamental justification for these valuations to sustain.

There have been many instances in India itself, where the same companies or similar companies have seen no or negative returns over long stretches of time e.g. HUL between 2000 to 2010 or recently even companies like ITC, Castrol and Page Industries.

While it is difficult to foresee what will cause these companies to underperform, history has shown that something happens that pricks the bubble balloon

We believe that most of these companies might not be able to sustain their bubble-like valuations. In fact, the basket other than these is becoming more attractive and as the economy normalises, reverting to its 7% growth trajectory, a much higher return can be expected from the other basket

What can cause our conclusion to go wrong

- In the near term, risk aversion may lead to more flows being invested in the "clean, safe, quality" basket.
- A company or few of them may surprise on growth being much higher than that over the last few years.

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