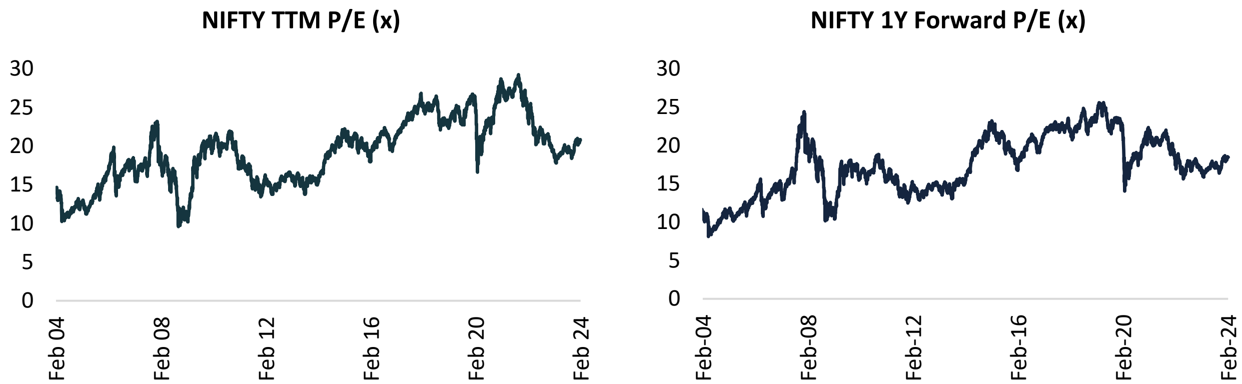
THE CHEMISTRY OF OVER-VALUATION IN INDIA

The mathematics of valuations is somewhat easier to understand. The simplest measure is the PE ratio and how this has moved for the Nifty tells us the story of how prices have moved against earnings growth.



Source: ACE Equity, IIFL Securities, Spark Fund Research

From the above data, it appears that the market is well below its peak valuations. However, this conceals the dispersion in valuations across sectors. The fact of the matter is that there has been earnings growth in sectors which were punching below their weight and this has held valuations somewhat in check even as prices have moved up significantly. Besides, the forward earnings multiple is only an estimate and the truth about valuations will depend on actual delivery. In the decade or so before Covid, every year started with earnings expectations in the high teens and more. Almost every one of those years saw earnings settle lower. With the market climbing higher and higher after 2013, valuations expanded. Particularly for certain pockets such as private banks, consumer staples (FMCG) and consumer durables.

Further, India has always been a pricey market with a valuation premium over other emerging markets.

Index Average Trailing P/E (x)	FY13	FY23
MOEX (Russia)	3.5	2.4
Shanghai Composite (China)	12.4	13.5
KOSPI (South Korea)	15.3	11.5
NIFTY 50 (India)	15.9	23.1
Ibovespa (Brazil)	18.7	6.0
TAIEX (Taiwan)	22.3	11.3

Source: Bloomberg, Spark Fund Research

The valuation premium has expanded over the last ten years. The above picture summarises the math behind valuations in India. Why did the valuation expand after the GFC? And what aggravated the dispersion in valuations? For that we need to delve into the Chemistry of overvaluation.

Cheaper money, Pricey Assets

Rates kept heading down after the GFC and the climactic event was Covid when they cratered. There was a chorus of opinion which suggested that rates would remain near zero for long. That premise was proven wrong by events that transpired since then. Earlier on when the cost of capital was drifting down, the inverse relationship between rates and equity valuations was used by investors to inflate asset prices. The table below gives an idea on how this played out for select Indian equities.

Company Name	Annualized Stock Returns (%) (FY09-21)	Attributed to EPS/BVPS growth (%)	Attributed to valuation rerating (%)
Nestle	18.6	55.3	44.7
HUL	21.4	44.6	55.4
Asian Paints	33.6	56.3	43.7
HDFC Bank	25.6	85.6	14.4
Kotak Bank	30.7	73.7	26.3
Titan	36.0	45.0	55.0
TCS	30.1	56.2	43.8
Avenue Supermarts	44.9	48.8	51.2

*Note: *Avenue Supermarts listed on March 21, 2017, BVPS for Banks, CY data for Nestle.*

Source: ACE Equity, Spark Fund Research

Disclaimer: The information and opinion expressed hereinabove does not constitute as an investment view on the stocks mentioned.

In short, Indian equities benefitted from lower rates through the transmission mechanism in the financial markets rather than through lower cost of capital benefitting company balance sheets. When rates turned up after 2021, many expensive stocks found themselves on shaky ground.

Valuation expansion was selective

Not everything became pricey in India. For instance, PSU banks, capital goods names and several companies in manufacturing sector saw no valuation re-rating during the period. In general, asset light companies saw valuations zoom up and companies with debt were cold-shouldered. There were several reasons for this.

One, the growth in that era was led by growth in consumption and tradeable services. Investment spending as a % of GDP fell between 2008 and 2021. Two, several capital-intensive sectors such as power and real estate ended up with stressed balance sheets and debt itself became a bad word. Thirdly, the Indian banking system went through its worst bad loan cycle which lasted over a decade. PSU banks and some private banks (ICICI Bank, Axis Bank notably) bore the brunt of the problem. Finally, the GST reform led to disruptions for SMEs which further aggravated the problems for banks.

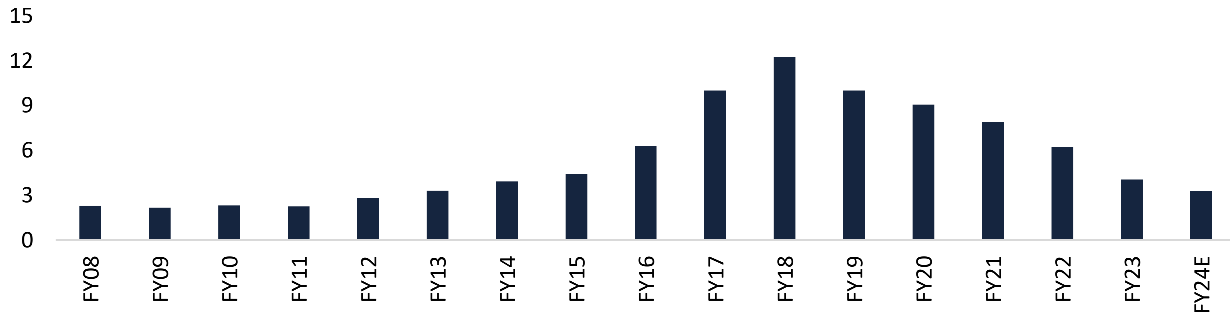
The above had the weird effect of bloating valuations of companies with relatively defensive businesses (for that era), good managements and healthy balance sheet ratios.

Such was the effect of the Chemistry that the combination of the above resulted in a reaction which made richly valued stocks/sectors even more expensive. Many experts declared that astronomical valuations have further upside in a world of zero rates. All that seemed to matter was whether a stock/sector had so-called moats which give competitive sustainability and whether investors at large have approved the entry of such names into a club of expensive stocks. Such was the Chemistry of over-valuation that these stocks were acknowledged as fair value in a new world order (or so it seemed).

Something changed in 2021-22

The helicopter money that was showered into the developed world during Covid brought back inflation. Further, years of under-investment in commodities resulted in prices going up. An unexpected war in Europe finally led to the perfect storm for inflation and rates. Global rates went back up even as pundits nodded their heads in disbelief. The US Fed made it known that they will respect their mandate – which was to guard against inflation and defend employment. Their support to equity markets cannot now be taken for granted.

For India, the writing started to slowly appear on the wall. Stocks which were expensive for years were finally recognized for what they were. A few changes started to take shape in the Indian economy. The Covid recession extracted efficiencies from that part of the corporate world that coped with Covid well enough, and the group was not just restricted to the asset light brigade. The bad debt resolution programme had finally taken out the last man standing in the line of defaulters. Look at the progression of bad debts.



Source: Reserve Bank of India, Spark Fund Research

The PSU banks were amongst the banks that improved their metrics. The return of investment spending meant that B2B firms saw earnings growth improve. The over-ownership in the erstwhile superstars saw vulnerability creep in slowly. All the above signified the shifting sands in the spectrum of over-valuation. Sectors that were down in the dumps have re-rated since then on the back of improving earnings, possibility of demand visibility sustaining and the recognition that asset heavy industries can also grow when balanced growth sustains.

What Next

The over-valued sectors of the pre-Covid decade have not seen mean reversion in valuations. Not yet. They are still expensive. Some of these stocks are seeing challenges to earnings growth but investors are unwilling to let go of valuations. In the meantime, questions are already being raised on the "over-valuation" in the PSUs, capital goods and PSU Banks. To be fair and to be clear, valuations have re-rated for these names. There is no merit in taking a position that valuations can keep expanding in this space. If we do so, we will make the same mistake that was made while believing that the high PE stocks in the asset-light brigade can keep expanding their valuations no matter what. Some of these businesses, which are B2B, are inherently more cyclical. PSU Banks (and private banks too) will see the NPA cycle make a comeback. Therefore, caution is always warranted when prices move out of sync with earnings growth.

That said, are we at the stage of exuberance yet? The answer to that depends on the stage of the economic cycle. It is quite likely that the Indian economy has more legs in this growth cycle. In asset intensive sectors, there is no evidence of unsustainable gearing. If growth does not abate, earnings support can keep valuations of the sectors currently in play well-supported. In fact, look at the below. While some of the valuations are now higher, they are not out of whack. Furthermore, various metrics are in a better shape for these banks when this cycle is still on the ascendant.

Price to Book Ratio (x)

PSU Banks	FY08	FY24E
Bank of Baroda	0.9	1.3
Bank of India	1.5	0.9
Bank of Maharashtra	1.2	2.4
Canara Bank	1.1	1.3
Indian Bank	1.5	1.3
Punjab National Bank	1.5	1.3
State Bank of India	2.1	1.9
Union Bank of India	1.3	1.2

Source: ACE Equity, Bloomberg, Spark Fund Research

Debt to Equity Ratio (x)

Company	FY	D/E	Company	FY24E
DLF	2007	10.4	DLF	0.1
Suzlon	2013	48.6	JSW Energy	1.8
Tata Power	2017	3.8	Adani Ports	0.9
Adani Enterprises	2009	4.0	JSW Infra	0.5
Lanco Infratech	2014	25.5		
GMR Airports	2016	7.9		

Price to Earnings Ratio (x)

Expensive Stocks	FY24E	15-Year Mean
Nestle	70.0	62.0
Astral	75.2	52.1
Relaxo Footwear	73.9	52.5
Titan	73.1	63.1

Source: ACE Equity, Bloomberg, Spark Fund Research

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Corporate balance sheets have not yet loaded up on debt. PSU Banks and many of the private banks (not just HDFC and Kotak) are in much better shape now, be it terms of their balance sheet or in other areas such as technology adoption. The Chemistry of valuations works in a way that a rerating process seldom loses steam midway on the way up. It is prudent to be always cautious in the market. However, the notion that only asset light industries and select businesses have a right to become over-valued has already been questioned. We may not have seen the last word on this saga. More so if the economy continues to fire on all its engines – be it investment spending, consumption, or government push.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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