



Greetings!

Haves and the Have-nots

The kaleidoscope of the investment universe in India is now dotted by the above mix. Those companies who have return on capital that exceed cost of capital and those who haven't. Those who have weathered the storm better and those who haven't. Those who have a case for sustained profits and those who haven't. Those who have high debt on their balance sheet and those who haven't. Those who have high debt at the promoter level and those who haven't. Those who have the confidence of big money and those who haven't.

There is an overlap when you filter companies on the above broad criteria. The market has been very prescient when it comes to bestowing high P/E (or P/B) multiples on stocks. It is fair to say that the market has got it right in most of the stocks. At some point, the inevitable question comes – How high is too high?

A wise man once told me at the peak of the Nasdaq bubble that when you are riding a bubble, those inside barely feel it and those outside always wish they were inside it (even as they complain). The high valuations of select stocks in India possibly qualifies as a bubble. Call it a quality bubble or an institutional investor bubble. More like the latter. There are some have-nots who tick most of the boxes for the elite club membership but have not made the cut. Institutional investors have displayed a marked bias towards instant delivery.

These high valuations have now redefined the way company performance is analysed. Sample the below

- If the so-called consensus expectations are for mid-single-digit volume growth and the numbers in one quarter come in at a couple of notches higher, that is a beat and reason enough to celebrate with a higher P/E multiple.
- Analyst reports often state profit numbers that show “adjusted PAT”. With the adjustments, there comes another beat. Time to party once again!
- In some companies, the valuations are based on EV/EBITDA and, increasingly, the market is ascribing numbers closer to what was earlier an acceptable number for P/E ratio
- It has become standard practice to look at P/E on a two-year-forward basis. Even as the analysts (on the sell side, the buy side and the whole ecosystem) have got the one-year forward profit forecast for the Nifty companies wrong in most of the last ten years.

Top 15 Contributors to Nifty Performance Year to Date (From April 1 to Oct 31, 2019)

Company Name	P/E on TTM earnings
ICICI Bank Ltd	2.7*
Hindustan Unilever Ltd	77.0
Kotak Mahindra Bank Ltd	4.8*
Reliance Industries Ltd	21.7
HDFC Bank Ltd	4.4*
Bajaj Finance Ltd	12.1*
Tata Consultancy Services Ltd	25.5
Housing Development Finance Corp Ltd	4.0*
Bharti Airtel Ltd	2.1*
Nestle India Ltd	84.9
Asian Paints Ltd	79.2
Bharat Petroleum Corp Ltd	2.9*
Maruti Suzuki India Ltd	29.5
Larsen & Toubro Ltd	22.9
Titan Co Ltd	82.2

Source: Bloomberg, Spark Fund Managers internal research

*Denotes P/B ratio

Companies trading at or about their ten-year high on P/E or P/B

Companies trading just below their ten-year high on P/E or P/B

Companies trading at $\leq$ median of their ten-year P/E or P/B



At the least, we are in a mini bubble. There are many sound reasons to justify premium valuations for quality. Unlike in the past, the market has been discerning on the stocks that it has admitted to the elite list that command premium valuations. Almost in all cases, these companies are good businesses and have executed brilliantly in a tough environment. But that does not answer the question on how high is too high. It is good hygiene to reflect.

Etiology of this bubble

Quality has always commanded a premium in Indian market. India has never been an easy place to do business. In a country where cost of capital has always been high, the best in class were able to access capital at much better terms than the also-ran. The staccato liberalisation that India followed meant that incumbents were always at a competitive advantage. Factor markets such as land and labour have not seen reforms and incumbents are unintended beneficiaries. Quality premium naturally followed.

The scams of the UPA era brought in another dimension. Companies that were dependent on the government for business found the going tough. At another level, the income growth in the economy meant that markets opened up and companies that had good governance and managements stole a march over the rest. These included consumer sector names, private banks and select cyclicals. The great Indian flight to quality had started gaining momentum. Two other factors accentuated this trend. One was the phenomenon of real estate fading away from pole position in the asset allocation mix of the Indian HNI. The second was the fall from grace of a number of companies due to debt/accounting issues, which narrowed the investible universe. The first has led to surging flows to equity mutual funds. The second has led to an unprecedented risk aversion amongst institutional investors. Quality premium kept rising.

So far, so good. What we now have is a situation where analysts and fund managers are defending the ever-expanding valuations of good quality names. Metrics such as quarterly earnings beat, EV/tonne, EV/EBITDA and Price-to-Embedded Value (embedded value is used for insurance names and already factors the present value of future earnings; that does not seem to matter) rule the roost. The P/E ratio often seeks to discount the earnings of a future period (two-year forecast is always fraught with uncertainties) which is hard to estimate but never mind. We appear to have entered a brave new world of interpreting risk.

Whither valuations

This is hardly the first instance globally where valuations have moved away from the mean. Japan saw stratospheric valuations in the late eighties. When yours truly started a career in investments, Japan was used as a reference to justify high valuations in emerging markets, India included. Taiwan saw high valuations for a number of years, thanks to the influence of technology names. Then there came the Nasdaq and the tech bubble. There have been occasions where segments of the market traded high (as is the case in India right now). Chinese banks listed at some 6x Price/Book in 2007. Even the mighty S&P 500 valuations strayed far from the multi-decade range in the era of cheap money. Lower cost of capital (could be a reality in India if interest rates remain lower for longer) can justify higher equity valuations. That said, the notion that valuations keep on expanding regardless of the absolute level is one that failed the acid test beyond a certain point. In the case of Japan and Nasdaq, there was a painful reset. In Taiwan, a more sideways trend for a few years brought valuations to an even keel. The big tax cut in the US brought the S&P inside the long-term range, as the boost to earnings was not reflected instantly on index movement. In India, our base case is that a revival in the economy has the potential to broad base the fund flow to other segments of the market. Good quality stocks (outside the favoured segments) can then absorb investments and the institution-led quality bubble can moderate on its own. The risk is that the economy fails to fire. In such a scenario, the institutional investor-led quality bubble can inflate further with unpleasant consequences.

We believe that one should not underestimate the resolve of the government to persist with the reform push. This should kick start a new economic cycle within the next 2-3 quarters – maybe earlier. In the 2002-2008 period, the NDA government (under Vajpayee till 2004) was confronted with structural problems of a banking crisis (post Asian crisis, post Pokhran, post tech bust), high deficits and sagging growth. The reform push gained traction with privatisation, legislations such as Electricity Act and mega vision statements like the Golden quadrilateral project. Several key milestones were crossed first – Maruti listing and transfer of control to Suzuki, IBP sell off, IPCL sell off, measures that boosted sector level profitability such as revenue share model in telecom and award of road contracts on favourable terms to the private sector. The market scepticism was high initially but once confidence started to build up, the economy sensitive names started to participate. The trickle turned into a torrent.

It was only in the UPA government of 2004-2009 that the economy finally delivered on growth, though the seeds were sown earlier. The best-ever earnings growth period in Indian capital markets panned out. The more things have changed, more they remain the same. We have come a full circle and India is once again at the crossroads.



The current reform thrust is likely to gather pace and sustain because the political and economic cost of inaction is too steep. The government has a big mandate and it pays to take note.

Where are we in all this

To be clear, we own a certain number of stocks that are trading above their valuation history and where earnings growth is not able to account for all of that premium. These are companies and managements that are executing superbly and delivering high return ratios. They form part of the portfolio as secular bets on India's growth and lend some balance in the portfolio. As pointed out earlier in this note, there is a strong case for quality and that should sustain. With some moderation, in our view. That is the pricier part of our portfolio.

We have then gone on to allocate a fair bit of capital to companies with good quality managements, sound business models and healthy balance sheets, which are trading at valuations that are more reasonable. These are companies where all engines are not firing right now and, hence, these may not be market favourites for the moment. Possibly because the environment poses challenges (investment-demand related names). Or because companies are coming out of a difficult credit cycle (certain corporate banks). Or they are cyclicals where operating leverage can play out when the economy gets going once again. These include select mid & small caps, as well as some government-owned companies.

We have tried to keep single-stock risk to a reasonable level and placed a lot of emphasis on market liquidity of stocks in portfolio construction.

Estimated Valuation of Our Holdings

As is seen from the above (data is from a representative portfolio from Spark India@75 Flexicap Investment Strategy), the allocation to the reasonably valued part of the portfolio constitutes close to 60% of the client AUM in value and this part trades at a reasonable P/E of 18.2 on March 2020 estimates and at a P/E of 12.6 on March 2021 estimates.

Particulars	Stocks trading at <= 25 P/E (FY21) *			Stocks trading at > 25 P/E (FY21) *		
	FY20	FY21	FY22	FY20	FY21	FY22
Weighted average	18.2	12.6	10.6	38.4	30.7	26.0
Simple average	21.2	13.5	11.2	41.4	32.9	27.9
Median	14.2	12.3	10.5	37.5	31.5	28.4

**Internal estimates of Spark Fund Managers Pvt Ltd*

Our positioning may be summarised as follows

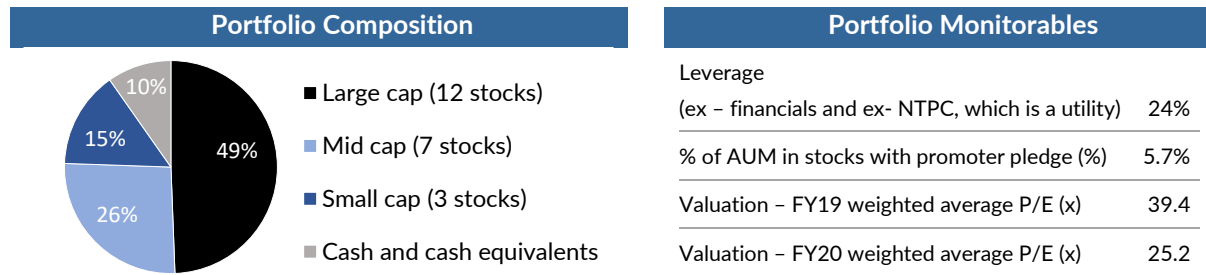
1. We agree with the quality trade.
2. Quality does not always presuppose high valuations. And vice versa.
3. We believe that good managements and balance sheets do make the difference.
4. Again, this does not mean that valuations have ceased to matter.
5. Economic cycles also matter, and they can and do turn.
6. When the political cycle aligns with the economy, reforms follow. And growth accelerates.
7. Businesses stand to gain from the resurgent economic cycle if they are well positioned.

Warm regards,

P Krishnan (CIO) and Team Spark Fund



Portfolio composition



Note: Represents portfolio of a typical investor onboarded in February 2019 when the strategy commenced; actual portfolios may vary depending on timing of entry into the strategy. Note: Market cap as per SEBI guidelines

1. Our investment in stocks continues to have bias towards large caps and larger midcaps. More than half of invested capital is in large caps and a good part of the midcap exposure is in larger midcaps.
2. The part of the AUM yet to be invested in stocks has been deployed in HDFC Overnight Fund which constitutes a predominant part of cash & cash equivalents. We switched from HDFC Liquid Fund to HDFC Overnight Fund in October after SEBI allowed liquid funds to levy an exit load. There is no exit load on Overnight Funds.

Disclaimer

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