A framework to look at the Indian equity market

Aniruddha Naha
Senior Fund Manager - Equity

Synopsis:

This note takes a close look at Sales, EBIDTA, PAT, Debt and ROE levels of corporate India, where we have taken the BSE 500 companies ex financials (financials being highly levered businesses) as a sample size to see the trends in them from 2001 to 2017. One can clearly conclude, corporate India's growth had bottomed out in 2015 and has been growing ever since, with expanding profitability and ROE and flattening debt levels. FY18, might not be a great year for sales and profitability growth, given the effects of demonetization and implementation of GST, but it will still see very manageable debt levels and Debt/Equity would trend even lower. Incremental resolutions of NCLT cases and these assets getting utilized to generate profits, will see higher utilization, better profitability, which should lead to lower debt levels and higher ROEs. Lower debt levels and higher ROEs is a fantastic combination, as it primes up corporate India for the next leg of capital expenditure.

Macro vs Micro:

With markets close to lifetime highs, there is a constant tug between the bulls and the bears with regards to where the market is heading. Over the last 6 to 9 months, there is a clear baton shift in the positives from the macros of the economy to the micros of the economy. The macros have clearly deteriorated, with crude moving from $40/ barrel to presently $68/ barrel and brent at $74/barrel. One third of India's import bill is crude and a big move will clearly hurt the country's economic prospects. Combined with CPI inflation inching up to 4.28% from a low of 1.50%, it has reflected in higher bond yields and a depreciating rupee. Clearly macros YTD are worse off.

Incidentally, the micros for the economy, reflected in earnings numbers have started picking up. To substantiate this, we have done an analysis of the annual numbers of the BSE 500 companies ex-financials (these are very high leveraged companies), to see what the long term trends are. The near term quarterly numbers have looked very good. Inspite of that, we have ignored them and tried to look at yearly numbers

- Sales & sales growth
- EBIDTA & EBIDTA growth
- PAT & PAT growth
- Debt & Debt Growth
- Debt/ Equity
- Interest Coverage ratio
- PAT & ROE
- A comparison of ROE to 10 year yields

Some very interesting facts:

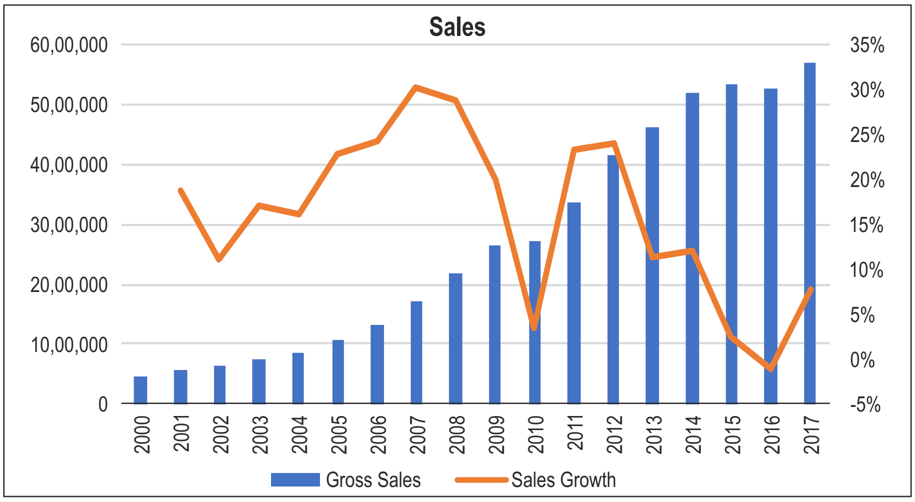
Over the period 2001 to 2017:

- Sales has grown 10X, EBIDTA has grown 12X and Debt 13X
- Sales growth rates have been as high as 30% in 2007 and as low as -1% in 2016
- Debt growth rates have been the highest in 2007 at 48%, but has slowed down dramatically from 2015 to lower single digits in 2017
- Debt to Equity, had peaked at 92% in 2014, which has now come off to 77% and trending lower. India is definitely deleveraging, which is good.
- Finally, the ROE profile has started to inch up. From 24% in 2008, it fell to 12% in 2015, stabilized here for another year and has inched up to 13% in 2017. All indications are that 2018 figures will be still better.

P.T.O.

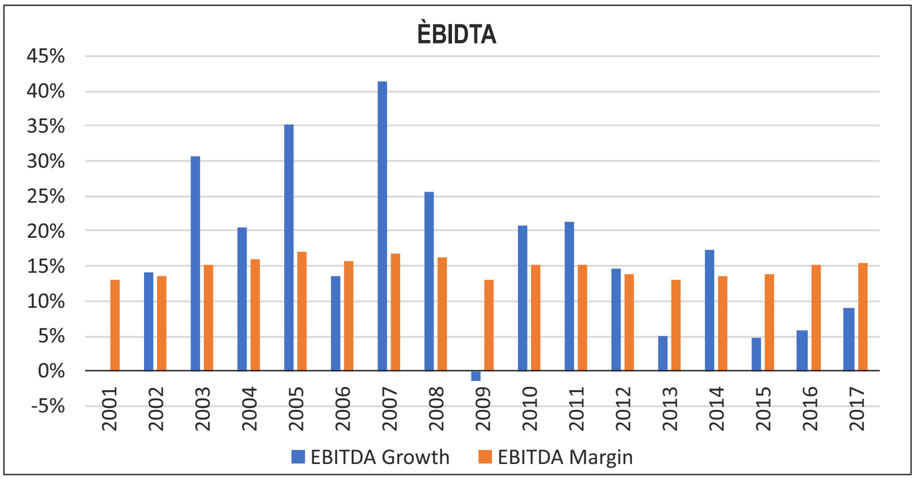
The story in charts

1. Sales for the BSE 500 companies have increased 10X in this century. More importantly, sales growth has started reviving, from -1% in 2016 to 8% in 2017.



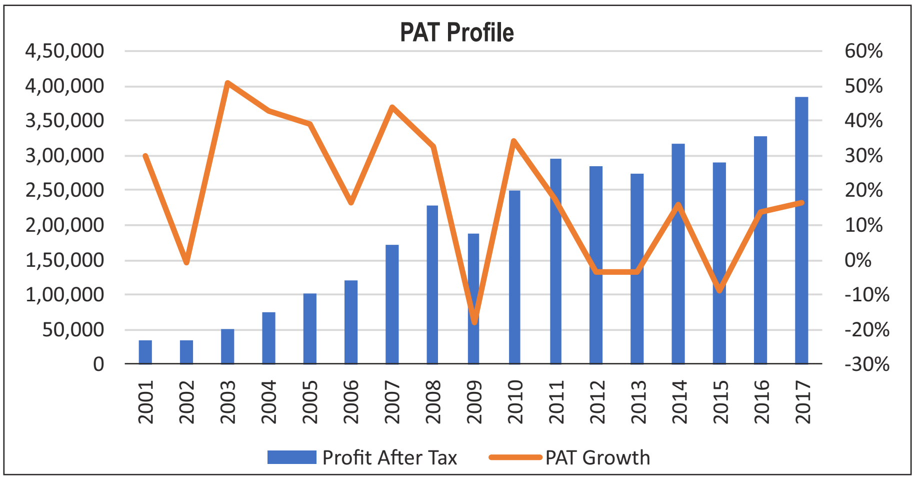
Souce: Ace Equity

2. EBIDTA growth has also started inching up, along with a stable EBIDTA margins. Margin stability will be tested as commodity prices have started inching up.



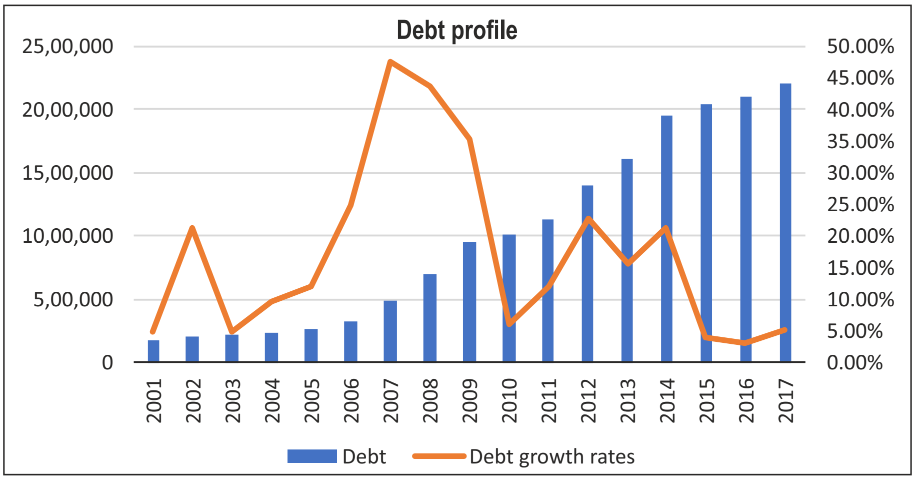
Source: Ace Equity

3. Profit after tax had seen a good growth in 2017 over 2016. Even FY16 had a good growth over the previous year, which is reflected in the uptrending line of PAT growth.



Source: Ace Equity

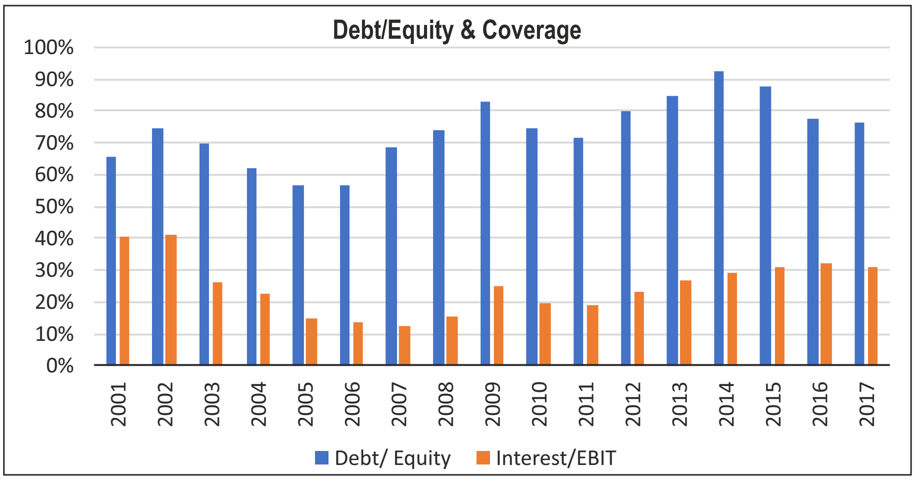
4. This is one of the most significant charts. While debt in an absolute term is still high, the growth rates have come off dramatically, clearly showing an aversion for debt. The growth rates of debt have been in the lower single digits over FY15 to FY17. This fall has happened, inspite of growth in sales and EBIDTA.



Source: Ace Equity

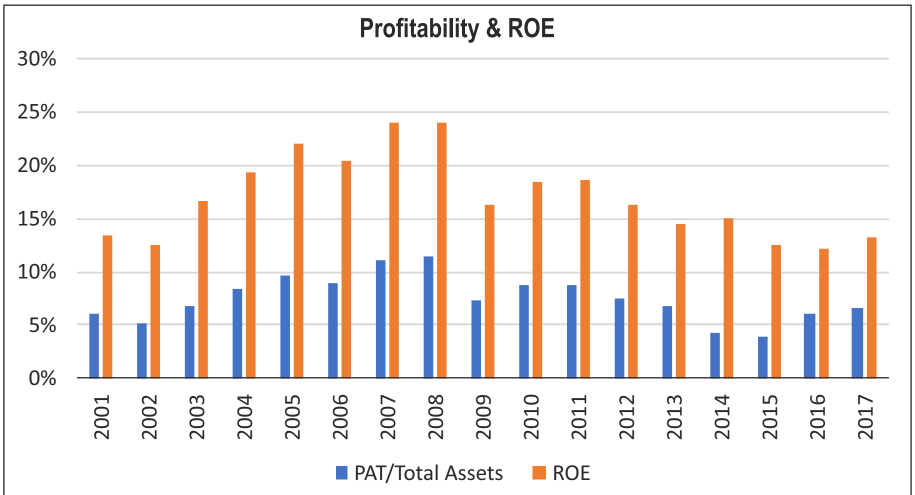
5. Corporate India is clearly deleveraging & Profitability is on the uptrend.

This is reflected in the lower Debt/Equity and Interest/EBIT. See below chart:



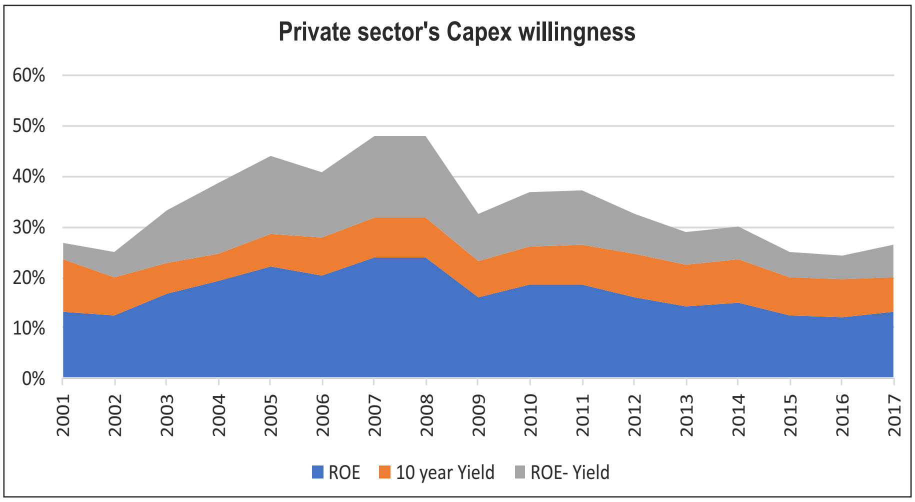
Source: Ace Equity

6. Profit after tax has increased on the asset base, a clear indication of better asset utilization. This is seen in the higher ROEs of the companies.



Source: Ace Equity

7. When the ROE profile is looked in light of the 10 year yield, the differential between ROE and the 10year yield has started increasing, which sends a message to the promoters that for taking business risk, they are getting compensated by higher profitability vis-à-vis the 10year. Historically, the total asset base went up 3X from 2002 to 2008, as the incremental ROE over the 10year yield moved from 5% to 16%. Incrementally, as utilisations leads to better profitability, one will see the difference increasing, unless global risks push up yields dramatically.



Source: Ace Equity

Valuations:

The earnings CAGR for the BSE 500 index from FY16 to 18 was 15%, which will trend to 28% in the period FY17 to fY19, as per Bloomberg estimates. The BSE 500 index trades at a multiple of 17.9X FY19, which is reasonable. The Nifty is trading at 17.3X FY19.

Conclusion:

The year 2015 onwards has been very positive for the Indian corporate sector as a whole. Sales and profitability has increased even as debt levels have remained stable and leverage, measured as Debt/Equity has come down. PAT/ Total Assets have also trended up since 2015, clearly indicating the setting in of operating leverage. Higher utilisations and profitability has led to higher ROEs and more importantly, as the ROE- 10yr yield differential increases, one will probably see the hunger for capital expenditure come back to the private sector, albeit over the next couple of years.

Lower Debt/equity, higher capacity utilisations and better cashflow generations is a potent combination for growth to come back. We expect earnings trajectory to remain strong into FY19 and FY20, as ROEs trend back towards the 20% and incremental ROEs over the 10 year spread to move back towards double digits.

Year	Gross Sales	Sales Growth	EBITDA	EBITDA Growth	EBITDA Margin	Profit After Tax	PAT Growth	Debt/Assets	Debt/ Equity	Interest/ EBIT	PAT/Total Assets	ROE	10 year Yield	ROE-Yield
2001	5,68,155	19%	67,811		13%	34,792	30%	30%	66%	40%	6%	13%	10.2%	3%
2002	6,31,750	11%	77,360	14%	14%	34,485	-1%	31%	75%	41%	5%	12%	7.4%	5%
2003	7,39,860	17%	1,01,124	31%	15%	52,030	51%	29%	70%	26%	7%	17%	6.2%	11%
2004	8,58,253	16%	1,21,929	21%	16%	74,239	43%	27%	62%	23%	8%	19%	5.2%	14%
2005	10,53,587	23%	1,64,910	35%	17%	1,03,092	39%	25%	57%	15%	10%	22%	6.7%	15%
2006	13,09,872	24%	1,87,334	14%	16%	1,19,828	16%	25%	56%	14%	9%	20%	7.6%	13%
2007	17,04,857	30%	2,64,685	41%	17%	1,72,291	44%	32%	69%	13%	11%	24%	8.0%	16%
2008	21,96,969	29%	3,32,151	25%	16%	2,28,193	32%	35%	74%	15%	11%	24%	8.0%	16%
2009	26,35,919	20%	3,27,640	-1%	13%	1,87,138	-18%	38%	83%	25%	7%	16%	7.0%	9%
2010	27,25,128	3%	3,96,158	21%	15%	2,50,632	34%	35%	75%	20%	9%	18%	7.8%	11%
2011	33,58,784	23%	4,80,296	21%	15%	2,94,072	17%	34%	72%	19%	9%	19%	8.0%	11%
2012	41,65,156	24%	5,50,504	15%	14%	2,83,992	-3%	37%	80%	23%	8%	16%	8.5%	8%
2013	46,32,688	11%	5,78,500	5%	13%	2,74,733	-3%	40%	85%	27%	7%	14%	8.0%	6%
2014	51,95,752	12%	6,77,831	17%	14%	3,17,731	16%	26%	92%	29%	4%	15%	8.8%	6%
2015	53,31,486	3%	7,09,533	5%	14%	2,88,998	-9%	28%	88%	31%	4%	12%	7.7%	5%
2016	52,76,296	-1%	7,50,090	6%	15%	3,28,836	14%	39%	78%	32%	6%	12%	7.5%	5%
2017	56,79,352	8%	8,17,105	9%	15%	3,83,159	17%	38%	77%	31%	7%	13%	6.7%	7%

Source: Ace Equity

*ROE- 10yr yield

Risk factors:

- Individual dynamics for each sector / company turning negative will be a risk
- An over-arching risk is rising interest rates. Incase interest rates move up dramatically, that will hurt the interest paying capability of leveraged companies and will hurt profitability overall.