Greetings!

Do valuations matter?

This rhetorical question assumes significance in the light of markets being at new highs. That too when the economy is nowhere near a high. Good old Benjamin Graham would say valuation matters a lot. Lots of liquidity has flown through Wall Street since he left the scene. More pertinently, we have to ask what measure of valuation would have been most relevant for Graham, the original Guru.

If you are to answer that in a simple way, that would be based on cash flows.

If you now ask Prof Ashwath Damodaran, one of the experts on valuation living amidst us, he would say all valuations are relative. That is a signal change. He is not saying cash flows don't matter. He is implying something else has started to matter much more.

So what works best for us in India and on a bread-and-butter basis?

That is what matters to us and to you. The view, which supports relative valuations, may qualify as a more pragmatic measure in today's world.

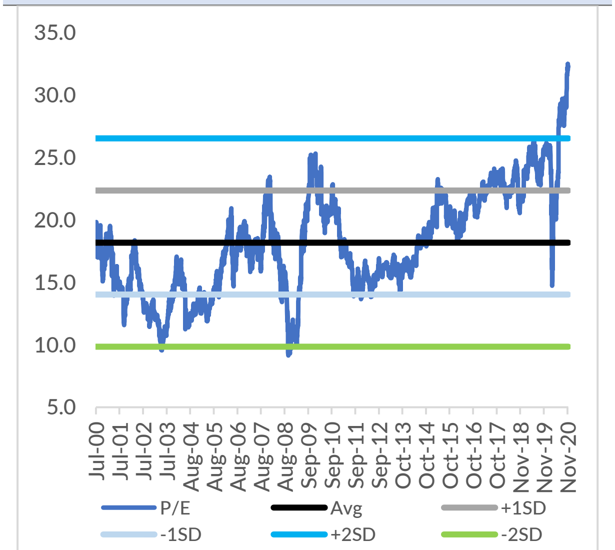
To address the rhetorical question in the header, valuations will always matter. The scale we use to measure valuations will need to be relevant for the times we live in. For instance, high P/E stocks keep going up and we wonder how that sustains. Relative valuations give us a probable answer. P/E relative to global peers, relative to the cost of money and relative to earnings resilience. That said, some caveats are still in order.

- Do not get carried away with the ever-intensifying chorus of a new normal. A world where no price is too high for what is regarded as quality. Everything ends. And not necessarily all that well.
- Do not get carried away with this notion that says equity markets are at a new high because it knows all about the bright future that lies ahead. And, hence, 12 to 18 months on, India will start to report high economic growth and, even more pointedly, higher earnings growth. There is not enough data on hand to support that, yet.
- Do not fall into the value trap all the same. Indians, as consumers, have been value conscious. As investors, we have behaved somewhat differently. We have been chasing growth (success) and price (results). A bit of generalisation there but not far from some hard facts.

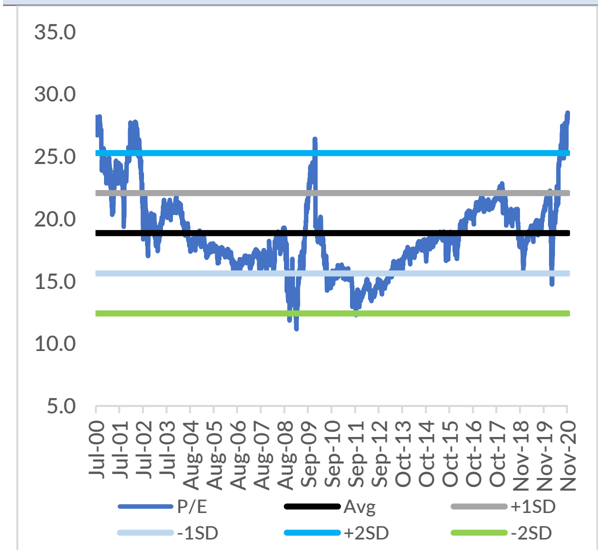
In short, don't get carried away with any of these cliched calls on the market.

On P/E and P/B the following charts show the story of Indian and US markets.

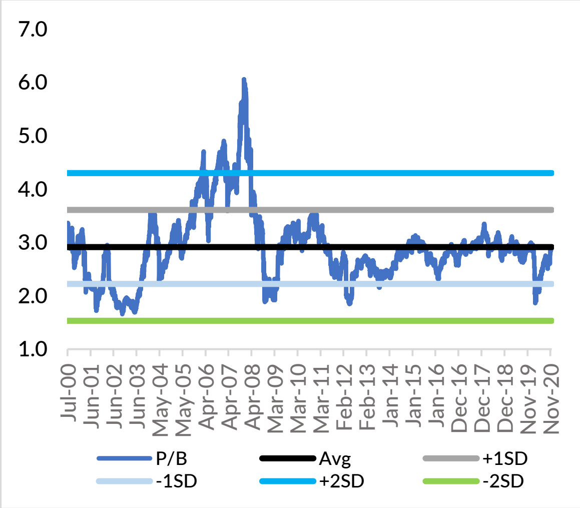
NIFTY P/E (12 M TRAILING)



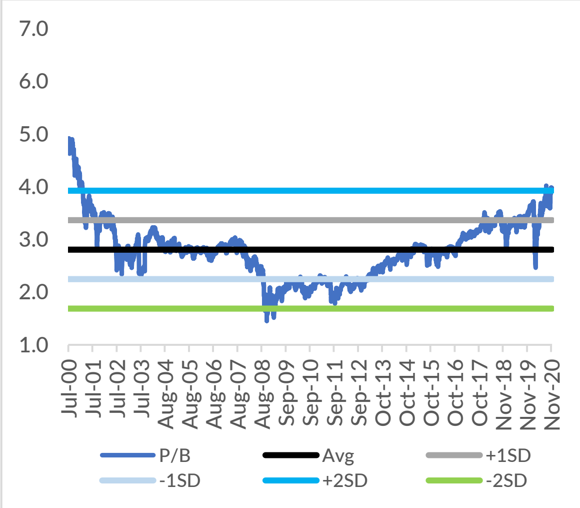
S&P 500 P/E (12 M TRAILING)



NIFTY P/B (12 M TRAILING)



S&P 500 P/B (12 M TRAILING)



Source: Bloomberg

The photo is half done and we need a crystal ball. But, here goes:

1. Valuations, as measured by the above metrics, have moved up and until we get decisive evidence to the contrary, are likely to remain higher for longer. Liquidity, not earnings, is the key driver. This is global in nature. Don't fight that trend.
2. The winner-take-all nature of the economy and earnings has been prominently visible if you break up the valuation beyond headline numbers. In India, the leading half of Nifty trades at 34.3 times on median P/E and the lagging half of Nifty trades at 18.4 times median P/E. (See table below)
3. Do not miss the trees for the wood. When you go through details, across all market caps, performers have formed an elite subset and price has been the biggest measure of what performance has been all about. Relative strength in prices has been a great forward indicator, most of the time. However, in crucial reversals, as it happened during the pandemic, it did not work for all stocks.

Leading half of Nifty

			Trailing 12M	
Rank	Company	1-year stock performance*	P/E (x)	P/B (x)
1	Divi's Laboratories Ltd	101.8%	69.9	13.2
2	Dr Reddy's Laboratories Ltd	65.7%	41.1	5.2
3	Cipla Ltd/India	59.8%	39.4	3.9
4	Infosys Ltd	58.0%	26.7	6.7
5	Wipro Ltd	47.5%	20.6	3.3
6	HCL Technologies Ltd	45.8%	20.1	4.3
7	Mahindra & Mahindra Ltd	36.1%	627.7	2.0
8	Tata Steel Ltd	35.1%	24.5	1.0
9	JSW Steel Ltd	33.9%	21.2	2.3
10	Tata Consultancy Services Ltd	30.5%	33.1	10.4
11	Asian Paints Ltd	29.8%	78.8	21.1
12	Hero MotoCorp Ltd	27.7%	17.1	4.3
13	Reliance Industries Ltd	25.6%	30.8	2.8
14	Nestle India Ltd	23.8%	85.2	86.9
15	Bajaj Finance Ltd	20.5%	54.3	9.1
16	Britannia Industries Ltd	19.0%	61.9	19.7
17	Kotak Mahindra Bank Ltd	18.1%	40.2	4.7

Leading half of Nifty *(continued)*

Rank	Company	1-year stock performance *	Trailing 12M P/E (x)	Trailing 12M P/B (x)
18	Titan Co Ltd	17.4%	79.2	17.8
19	Shree Cement Ltd	15.8%	56.8	6.8
20	Tech Mahindra Ltd	15.2%	19.3	3.6
21	Sun Pharmaceutical Industries Ltd	13.7%	34.3	2.9
22	HDFC Life Insurance Co Ltd	13.2%	99.8	19.0
23	Hindalco Industries Ltd	13.1%	13.2	0.9
24	HDFC Bank Ltd	13.0%	28.8	4.5
25	UltraTech Cement Ltd	12.7%	24.2	3.6

Lagging half of Nifty

Rank	Company	1-year stock performance*	Trailing 12M P/E (x)	Trailing 12M P/B (x)
26	Tata Motors Ltd	11.7%	NA	1.0
27	Grasim Industries Ltd	11.3%	13.4	1.1
28	Eicher Motors Ltd	10.8%	38.3	7.0
29	Adani Ports & Special Economic Zone Ltd	7.7%	22.9	3.4
30	Hindustan Unilever Ltd	5.1%	68.6	56.2
31	Bharti Airtel Ltd	4.7%	NA	3.4
32	Bajaj Auto Ltd	-0.1%	17.8	4.3
33	Power Grid Corp of India Ltd	-0.5%	10.9	1.6
34	Housing Development Finance Corp Ltd	-1.8%	18.4	3.1
35	Maruti Suzuki India Ltd	-2.9%	37.6	4.3
36	Bajaj Finserv Ltd	-3.9%	41.3	4.4
37	ICICI Bank Ltd	-7.7%	32.4	2.5
38	SBI Life Insurance Co Ltd	-11.9%	59.9	9.7
39	Larsen & Toubro Ltd	-15.6%	17.6	2.3
40	GAIL India Ltd	-18.6%	5.3	1.0
41	Axis Bank Ltd	-18.6%	88.2	2.0
42	NTPC Ltd	-18.6%	8.0	0.8
43	ITC Ltd	-21.4%	15.6	3.7
44	Bharat Petroleum Corp Ltd	-27.1%	24.5	2.3
45	UPL Ltd	-27.1%	18.5	1.7
46	State Bank of India	-28.6%	9.4	0.8
47	Indian Oil Corp Ltd	-35.6%	NA	0.8
48	Coal India Ltd	-38.8%	5.1	2.4
49	Oil & Natural Gas Corp Ltd	-40.4%	9.4	0.5
50	IndusInd Bank Ltd	-45.3%	13.6	1.7

Source: NSE, Bloomberg **As on 27th November 2020*

All of the above leaves us with only one conclusion. Flexibility on incoming data and an updated interpretation of the trends ahead are essential to defend and grow capital. In the context of our investment process, this has some impact on churn being higher than what we may have liked it to be. But we do believe this is the consequence of a willingness to respect the heightened uncertainty, rather than lack of conviction.

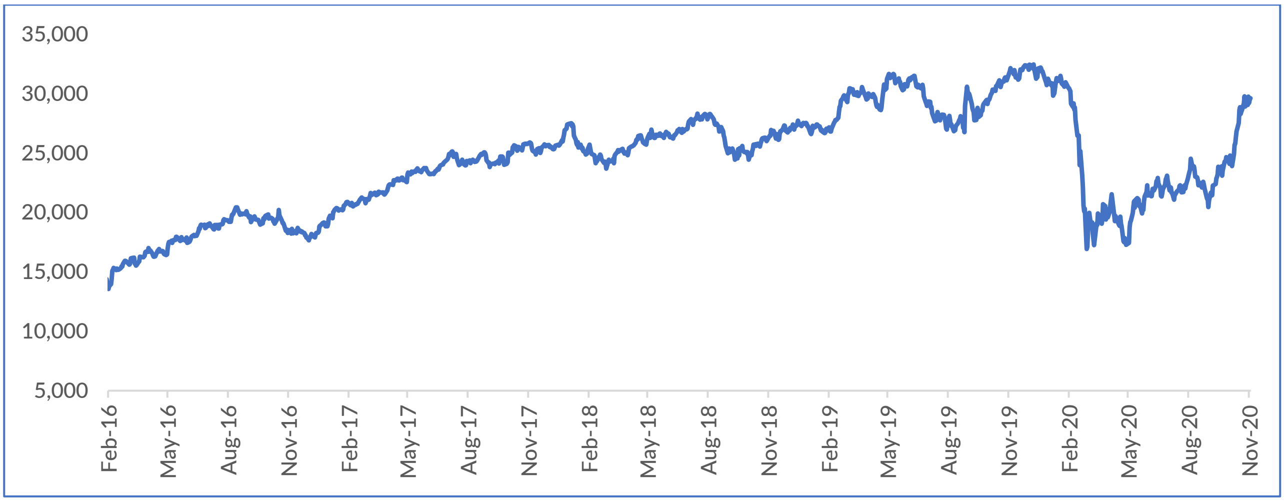
It is time therefore to discuss Banks, which are on the comeback trail.

Why are Banks buoyant?

Monthly weight of Banks in the Nifty

Months	Dec-19	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20
Weights (%)	30.4	29.6	30.1	26.2	25.9	24.2	24.9	23.0	24.9	22.8	24.7	27.3

Bank Nifty



Source: NSE, Bloomberg

The following background information on Indian banks is good to summarise for understanding banks

1. Indian Banks have been fairly tightly regulated. RBI has been one of the Indian institutions that has a good record of doing its job in a political milieu that has been all over the place. The role of RBI in creating shareholder value in Banks is often underestimated though the focus of RBI has been on protecting depositors and in ensuring financial stability.
2. Indian Banks have domestic liabilities and for most part domestic assets. They are, to a large extent, insulated from global contagion (though there is a feedback loop that sets in through currencies, inflation and interest rates).
3. The cap on shareholding and voting rights has ensured that free float has been great (MSCI and FPI positive).
4. Though unintentional, the ownership cap has prevented unscrupulous promoters getting entry into banks and spoiling the show. Since the promoter class has been reined in, shareholders have ended up benefitting.
5. The alignment between minority shareholders and operating managements has been excellent. ESOP-related wealth creation has been humungous, and managements have responded positively to market discipline. Markets have rewarded good managements with ever increasing price-to-book multiples and this has created glaring gaps in cost of capital across banks.
6. Finally, the unending delay in PSU Bank reforms (selling them off in brief) has been of particular benefit to well-run private banks. In every which way possible. Even the Global Financial Crisis of 2008 has played into the hands of private banks. In a way, that has killed the prospects of foreign banks getting access to Indian banking and foreign banks would have given a run to private banks, particularly in retail banking.

So much for the past. Now what has the pandemic done to Indian Banks?

Role of technology

This has increased multifold. Many would argue that banking is now a tech play. There is some substance to it, though we would not want to oversimplify this. Advantage private banks.

Access to Capital and Liabilities

This has been easier for better-run banks with a relatively healthy NPL position and adaptability. Advantage private banks.

We are at the cusp of an accelerating consolidation of market share in Indian banking. The public sector banks are possibly caught in a Catch-22. Abysmal price-to-book ensures that if and when they raise capital, book value per share (the quick and dirty measure of basis for valuing banks) goes down. Access to capital is constrained. That prevents them from doing some good lending (they are crippled here anyways due to other competitive disadvantages). Their spreads are weak and they cannot cover cost of capital. This will further depress their value drivers.

On the other hand, the weak economy that is likely emerging out of the Covid times will ensure that only the most nimble will make the bucks. Once again, private banks are better positioned due to their capital position, technology, stable managements, alignment of incentive with shareholder interests and, importantly, a regulatory regime that indirectly protects shareholder interests.

In our framework, valuations that have been depressed as a result of the pandemic-induced sell off, offer good risk-return trade off. See below the comparison of P/B ratios.

Peak P/B of banks

Banks	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	Average	Feb-20	FY21E
HDFC Bank	4.2	4.5	4.1	4.1	4.1	4.3	3.8	4.1	4.7	4.1	4.0	3.7	3.7	4.0
Kotak Mahindra Bank	3.9	3.5	3.3	3.3	3.2	4.9	4.1	4.2	4.2	4.7	5.0	3.4	4.7	4.9
State Bank of India	1.9	2.7	1.9	1.9	1.2	1.5	1.3	1.3	1.5	1.4	1.5	1.3	1.2	0.9
ICICI Bank	2.1	2.7	2.1	2.1	1.9	2.6	2.1	1.7	2.2	2.3	3.0	1.8	2.7	2.3
Axis Bank	3.0	3.5	2.6	2.6	1.9	3.4	2.7	2.7	2.5	3.0	2.7	2.2	2.3	1.8
IndusInd Bank	3.4	3.7	3.4	3.4	3.2	4.9	3.4	4.2	4.6	4.6	3.7	3.1	2.3	1.6
RBL Bank	NA	NA	NA	NA	NA	NA	NA	4.3	3.7	3.9	3.4	2.9	1.4	1.1
Federal Bank	1.0	1.7	1.4	1.4	1.2	1.7	1.7	1.8	2.0	1.5	1.5	1.3	1.2	0.8
City Union Bank	1.5	2.1	1.6	1.6	1.6	2.2	2.0	2.8	2.9	3.1	3.4	1.9	3.0	2.4
Punjab National Bank	1.9	2.1	1.5	1.5	0.8	1.0	0.9	0.9	1.6	1.1	1.1	1.0	0.5	0.4
Bank of Baroda	1.5	1.9	1.4	1.4	0.9	1.2	1.3	1.0	1.1	0.8	0.9	0.9	0.5	0.3
Bandhan Bank	NA	NA	NA	NA	NA	NA	NA	NA	6.1	7.8	6.6	5.5	4.1	3.3

Note: *Source: Ace Equity, Bloomberg*

1. Peak P/B calculated as highest stock price of the year divided by the book value per share of the respective year
2. Average P/B calculated as average P/B of each year
3. Feb-20 P/B calculated as closing stock price as on 28th Feb 2020 divided by BPS of FY20
4. FY21E P/B calculated as the closing stock price as on 27th Nov 2020 divided by BPS estimate of FY21

We believe we are in a Goldilocks era for Indian private banks. The balance of risks and rewards is good. One of the biggest risks is the usual one for India. Too much money chasing the same assets and a price discovery process that quickly degenerates into a bidding war. At this point, we have some ground to cover before we worry about that with the Bank Nifty trading at about 9% lower than its peak. We remain buyers of private banks, albeit on correction, with a flexible mind to deal with the risks if and when they come about.

Warm regards,

P Krishnan (CIO) and Team Spark Fund
