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A bubble in quality?

Companies with safe balance sheets and clean governance have benefited disproportionately from elevated stock specific risks

Akash Prakash | New Delhi November 05, 2019 Last Updated at 01:14 IST

Sunil Singhania of Abakkus Asset Manager has written an interesting piece on a bubble in quality stocks in India. Mr Singhania is a smart investor, has a good track record and is a veteran of the markets, having seen both bull and bear phases. All serious investors and students of stock market should read his piece.

Mr Singhania basically makes the point that quality stocks in India trade at very high multiples. These multiples cannot be justified if we look at the financial performance of these companies, or compare them with global peers. Given the high starting valuations, these companies will deliver very low to negative returns over the coming 10 years. He, therefore, argues that investors must move out of these companies and broaden their portfolio.

To support his arguments, he has studied these high quality, high P/E stocks and done a deep dive into their financial performance since 2010. He has compiled an illustrative list of 27 quality stocks that includes HUL, Asian Paints, Nestle India, ABB, Berger Paints and Pidilite. This basket was trading at a trailing P/E multiple of over 65 times. Studying the financials of these companies, Mr Singhania realised that over the last nine years they have delivered on an average a top line and EBIDTA growth of only 12 per cent, and net profit growth of 11 per cent. These numbers, while better than the broad market are still below nominal GDP growth of 13 per cent (over the same period). He asks why investors should pay elevated multiples if these companies only deliver nominal GDP-type growth rates at best. In fact, in the list, the only large cap company with a profit growth greater than 20 per cent is Titan, showing just how rare it is for a company to deliver 20 per cent profit growth for an extended period.

The paper then looks at the valuations from a more fundamental perspective, doing a reverse DCF (discounted cash flow) to understand the growth expectations already embedded into current prices. The team at Abakkus found that in the case of HUL, for example, even after modelling an artificially low cost of equity, the company would have to deliver 25 years of 12 per cent growth in free cash flow and then a terminal growth rate of 5 per cent just to justify current valuations. Not impossible, but hardly trivial.

The paper compares Asian Paints and Sherwin Williams, making the point that Sherwin William delivered higher earnings growth and return on equity than Asian Paints over the last nine years, but trades at one-third the multiple. Similarly, Facebook and Alphabet have even better free cash flow metrics and growth than most of the Indian quality stocks, but trade at less than 30-times earnings.

The paper also compares sectors and makes the point that the market cap of HUL and Nestle India alone is equal to the entire market cap of the cement, steel and metals sector in India. This despite the core sector stocks having 16 times the sales and almost 10 times the profits (at peak).

The core of Mr Singhania's argument is that if one were to assume the same growth rates over the coming nine years as these companies have delivered in the last nine, the vast majority of these companies would have to trade at P/E multiples of between 55 and 75 times FY 28 earnings to even deliver a 12 per cent CAGR in share price appreciation.

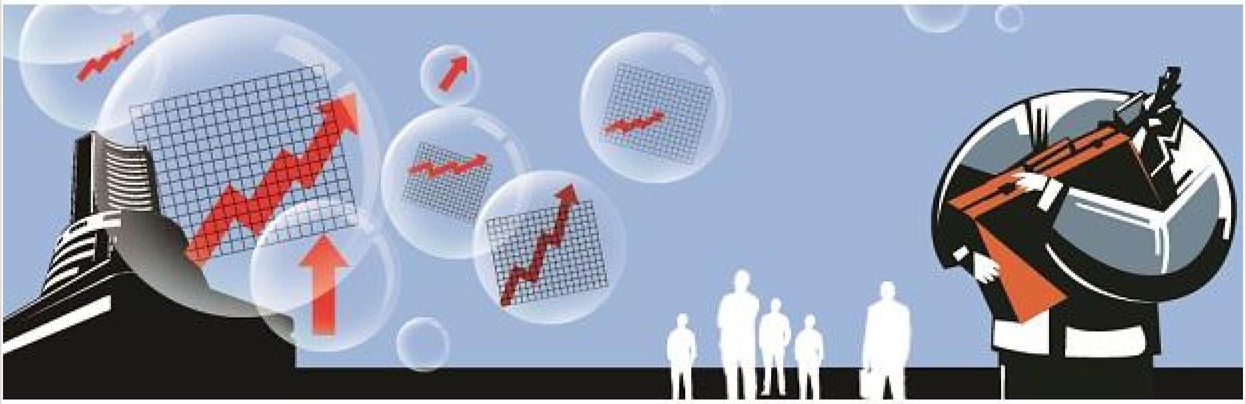

Illustration: Ajay Mohanty

He makes a valid point — that with inflation in structural decline, nominal GDP will not compound at 13 per cent over the coming nine years and with a higher base for all these companies, even to repeat the growth rates of the last nine years is not easy. In almost no market in the world have large cap stocks traded at these types of multiples for a decade at a stretch. If high-quality companies in India are able to trade at 60 or 70 times earnings even in FY28 needed to deliver a 12 per cent share price CAGR), it would be a rare occurrence indeed.

I have great sympathy for the arguments presented in the paper. I believe the valuation gap has gone to an extreme. There is no doubt that the companies Abakkus highlights are outstanding businesses with phenomenal returns on capital and free cash flow, everyone would want to own them at a price. They are simply trading too expensive.

In India over the last six to seven years, the quality valuation premium has expanded. This is due to weak profitability across corporate India. In 2009, corporate profit share-to-GDP for India and the US was similar at near 8 per cent; today the same ratio for the US is over 10 per cent, while for India it is below 3.5 per cent. The earnings per share (EPS) growth for Indian equity markets has been less than 5 per cent over the last six years. With such weak profitability, any company delivering stable double-digit earnings has been bid up disproportionately.

We have also had a series of corporate governance blow-ups, and a clean-up is under way in corporate India. With elevated stock specific risk, companies with safe balance sheets and clean governance have benefited disproportionately.

Due to a series of regulatory and judicial interventions, combined with risk aversion and tight liquidity in the financial system, capital intensive business models have been challenged. Investors have favoured businesses with limited investment needs.

A combination of all of the above created a positive backdrop for high-quality, consumer-facing, capital-light business models. As these companies have outperformed massively, it has now become fashionable for investors in India to say that their investment approach is to buy good companies and never sell. There are a handful of companies with superior businesses and great management for which never-selling may be the right approach. However, these businesses are incredibly rare, not even 1 per cent of companies can fit this description. Are you smart enough to build a portfolio full of these outliers? Most investors are not.

The vast majority of today’s 75 P/E stocks will only flatter to deceive. They will not deliver the sustained, long duration growth rates and capital efficiency built into their valuations. They will deliver sub-optimal share price returns from here.
A small minority of companies will deliver on their growth expectations, but even here, given today’s starting valuations, the days of super normal share price performance are over.

With improved economic growth, better corporate profitability and governance, markets will broaden, as EPS growth gets back into double digits. This is critical for India’s long-term growth story. Capital intensive companies in India today have a high cost of equity capital and almost no access to equity markets. This has to change if we are going to build out infrastructure and restart the private sector investment cycle. A reduction in the quality premium is required for longer-term macro-economic stability.

As fear subsides, liquidity conditions normalise and governance blow-ups come to an end, investors’ risk appetite will also stabilise. The quality premium will regress to the mean. Today, you are being well paid to make this bet.

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