S&P BSE 200 Index
The Mystery of the Disappearing Earnings
Demystifying Earnings Growth

- Since 2002, S&P BSE 200 earnings growth has been 13%
- From 2002-2008, the earnings growth was 28% but from 2010-2015, this growth fell to 5%
- The S&P BSE 200 Index can be classified into 2 categories – sectors with ‘Stable’ earnings cycle and sectors with a ‘Cyclical’ earnings pattern.
- Cyclical sectors typically are those that display troughs and peaks in earnings. This may be impacted either by global or local factors, depending on the peculiarity of the sector.

- **Stable Sectors:** Auto, Retail Banks, NBFC, Consumer Staples, Consumer Discretionary, IT Services, Healthcare / Pharma
  - 99 companies with combined market cap of Rs. 54,897bn account for 56% of BSE 200
- **Cyclical Sectors:** Cement/Building Material, Corp Banks, Industrials (including CVs), Utilities, Telecom, Commodities (Metals/Oil & Gas etc)
  - 101 companies with combined market cap of Rs. 51,971bn account for 44% of BSE 200

*Source: Bloomberg*
The weight of Cyclical sector peaked in 2007-08, while Stable sector weight peaked in 2016.

Source: Bloomberg Consensus Estimate
Weight of Cyclicals in the Index has reduced with reducing proportion of their earnings.

Source: Bloomberg
Cyclical sectors have borne the brunt of the slow down growing at -1.2% CAGR since the peak of 2008.
For stable sectors, earnings growth has been consistent, growing at a 15.7% CAGR even from the peak of 2008.

Since 2011, in each year earnings growth of stable sectors has been higher than the cyclical sectors. As a result, index earnings have growth at 4.2% CAGR since 2008, dragged down by the higher weight of cycicals in the base year.
From 2003-08, cyclical sector earnings grew at a much faster pace as compared to stable sectors.

As a result, cycicals in general witnessed a rerating from 2003 (PE: 5.9x) to 2008 (PE: 23.0x) and hit peak valuations in Dec-07.
For FY 10-15, cyclical companies had flat earnings whereas stable companies continued to grow at 16.5% CAGR.

As a result, most ‘stable’ sectors witnessed a sharp rerating with the PE moving from 22.2x to 26.7x

This led to preference for ‘High Quality, High Growth’ investing

Source: Bloomberg
2015-2017: Cyclical Rerating on hopes of recovery

Elevated PE of stable segment leaves little room for rerating despite steady Earnings Growth

Cyclical segment has been impacted by a peculiar factor each year – Oil Price Crash, Metal price softening, Higher Provisioning in Corporate Banks and Competitive intensity in Telecom

Source: Bloomberg
Factors which impacted growth between 2014-2017:

- Higher provisioning across Corporate Banks – PSU as well as Private Sector, on an average provisioning is up 4x from FY 12 levels.
- Soft Global Commodity prices including Metals and Crude Oil, reflected an uncertain Global economic environment.
- Domestic capex cycle failed to take-off as was expected.
2014-17 story: One sector has underperformed each year

<table>
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<tr>
<th>BSE200</th>
<th>FY 14</th>
<th>13-14 Growth</th>
<th>Abs Gr</th>
<th>Contri to Gr</th>
<th>FY 15</th>
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<th>Abs Gr</th>
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<th>FY 16</th>
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<td>2,171</td>
<td>3.7%</td>
<td>78</td>
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</table>

13-14: PSU Banks
14-15: Energy
15-16: Private Sector Corporate Banks
16-17: Commodities – Metals especially Steel
The Story so far... Correlating earnings with Macro parameters

**2002-2008:**
- Domestic Economic Growth: Robust
- Domestic macro-economic factors: Stable to Positive
- World Economic Growth: Robust
- Cyclical Earning Growth: 29%
- Stable Earning Growth: 21%
- BSE 200 Earning Growth: 28%

**2010-15:**
- Domestic Economic Growth: Weakening
- Domestic macro-economic factors: Negative
- World Economic Growth: Weak
- Cyclical Earning Growth: 1%
- Stable Earning Growth: 17%
- BSE 200 Earning Growth: 5%

**2015-Onwards:**
- Domestic Economic Growth: Improving
- Domestic macro-economic factors: Stable
- World Economic Growth: Stable

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Source: Bloomberg
Demystifying the 20% hope: FY 17-20 Earnings Growth

- Earnings growth for the Index is expected to be driven by cyclicals which are expected to grow 24% CAGR over FY 17-20E led by Corporate Banks and Commodities.

- While earnings growth appears to be driven by cyclicals, this may be back-ended i.e. from 2H FY 19 onwards.

- Earnings for ‘Stable’ companies is expected to be 14.7% CAGR over FY 17-20E which appears reasonable given growth of 15.7% CAGR over 2008-17.

- 24% of the earnings growth is expected to be driven by Corporate Banks. 17% of Profit growth is expected to be driven by Commodities mainly Metals.

Source: Bloomberg Consensus Estimate
The ‘Cyclical’ sector has seen declining earnings contribution, from a peak of around 80% in FY 2008 to around 44% currently.

Earnings growth of ‘Stable’ companies has been consistent even in this period clocking double digit in each year.

Going forward, with improving Nominal GDP Growth and moderate inflation, overall earnings growth recovery is expected.

The earnings recovery in Cyclicals may not be uniform across sectors

- Corporate Bank Earnings Growth may be back ended, could start from Q2 FY19
- Commodity earnings may be front-ended given the current higher prices. Also, the supply cuts in China may not necessarily last

Though overall FY 17-20 E earnings growth of 20% CAGR for S&P BSE 200 looks aggressive - analysing the drivers of earnings growth, bulk of the growth is expected to be driven by cyclical sectors which tend to have a high earnings Beta.

Source: Bloomberg Consensus Estimate
Key Takeaways

Cyclicals
PSU Banks
• After the recent government announcement, the question on the survival of most of these banks has been removed.
• After the recent spike in prices, a few of these are trading close to their book values and hence further upside from here may be limited.
• We expect most PSU & Corporate focused banks to be burdened by higher provisioning for the next 2-3 quarters. Our investment strategy for this segment will be more short term and trading oriented rather than a buy-and-hold.

Metals/Commodities/Energy
• Overweight Cement across most portfolios
• Building equal weight or marginal overweight position in metals
• Neutral to positive on Oil & Gas

Stable
• Will use any price opportunity within these segments to increase our weights
• Looking at companies where earnings growth can be higher than consensus
• Concern on those segments where valuations are ahead of earnings growth (eg Staples)

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