January 15, 2021

Nifty PE shifting orbits …

Current Nifty PE of 32.8x (based on FY20 EPS) and Trailing Twelve Months (TTM) PE of ~38.5x has been off late a central point of argument among investors with relation to whether the broader markets are highly euphoric and run ahead of fundamentals.

In our view, comparing PE multiples in isolation will not spell out the correct direction or assessment as to whether Nifty multiples are stretched or undervalued. For instance, looking at just TTM PE of 38.5x will definitely make one say about overvaluations but on the contrary this number does not give the correct picture as the TTM EPS so applied includes performance of Q1FY21 and Q2FY21 wherein earnings of corporate India were completely washed out thereby deflating the true earnings. Secondly, markets are forward looking which tries to discount the future earnings potential of companies.

We try to dissect why TTM PE and forward PE of Nifty will shift to higher orbits based on the following:

- Nifty constituents have undergone major change in past decade and hence current and forward PE multiples have shifted to higher orbit. The weights of capital efficient sectors such as FMCG, Financials (private banks), IT and Pharma have increased from 29% in March 2009 to 70% in December 2020.
- Earnings visibility and consistency is preferred by markets and hence capital efficient sectors like FMCG, Financials, IT and Pharma, which command higher PE multiples, have been gaining higher weightages in the Nifty.
- Better performing business segments within existing companies is not captured by current PE multiples. Business models like L&T, SBI etc. have multiple business lines and hence SoTP (Sum of the parts) based valuations of these companies are not captured by the PE ratio alone.
- Bottom up P/E construct on expected performances signals shift in forward PE multiples of Nifty

Hence, in order to arrive at a fair value on the bottom up basis, we take a 10-15% discount to our weighted average PE of 26.2x in order to account for future earnings downgrades and any other unforeseen macro risks which might risk earnings to come at a target PE range of 22x-23.6x. Consequently, we arrive at a fair value of 16300 on Nifty over a 12-18 month period (22x FY23E EPS).

Exhibit 1: Nifty Target

Revised Sensex & Nifty Target						
Earnings Estimates	FY18	FY19	FY20	FY21E	FY22E	FY23E
Nifty EPS (₹/share)	455	470	440	480	625	740
Growth (%)		3.2%	-6.2%	9.2%	30.0%	18.5%
Earnings CAGR over FY20-23E						18.7%
Earnings CAGR over FY21E-23E						24.2%
Target Multiple						22.0x
Nifty Target (at 22x FY23E EPS)						16,300
Corresponding Sensex Target						54,600
Potential Upside (@Nifty 14,434)						13%

Source: Bloomberg, ICICI Direct Research

Index Outlook

ICICI Securities – Retail Equity Research

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A) Nifty constituents have undergone major change in past decade

Over the past decade (from March 2009 – December 2020), the Nifty composition has undergone a major change (refer Exhibit 2) in terms of sectoral weightages. During March 2009- December 20 period, the weightages of sectors such as Oil & Gas, Construction, Metals and Telecom (high capex intensive, high sensitivity to regulations, volatile profitability and ROCE's) have come down from ~60% in 2009 to ~20% in the overall index. On other hand, weightages of sectors like Financials, FMCG, IT, Pharma (low capex intensity, High cash flows, Consistent profits and ROCE) improved from ~30% in March 2009 to 70% in December 2020 in the index.

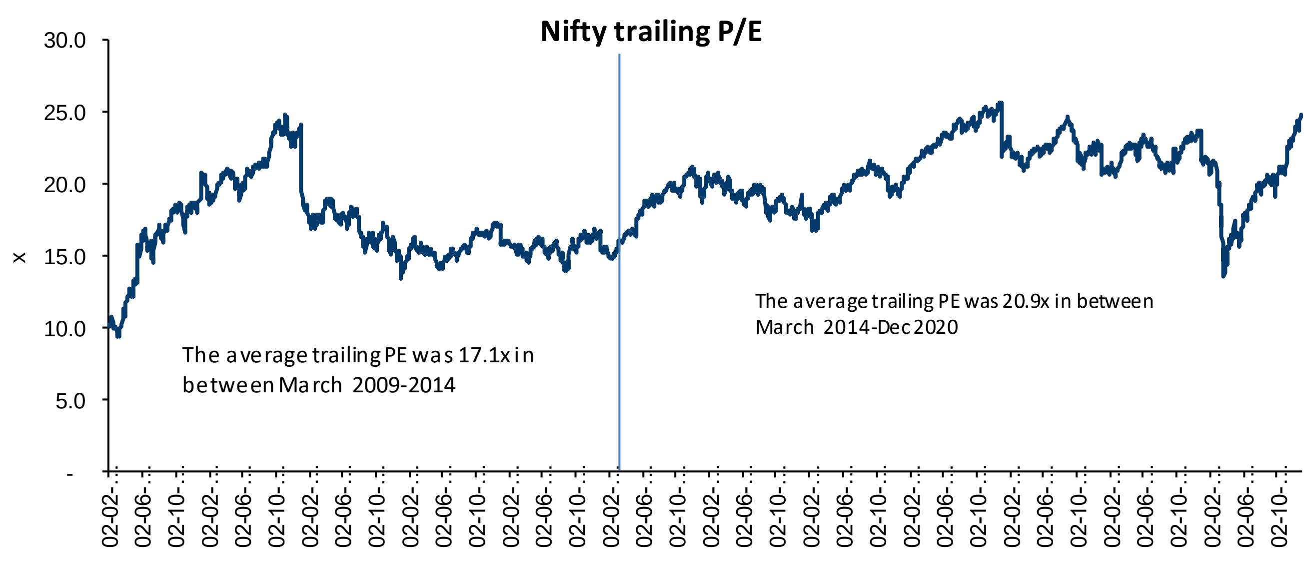
Exhibit 2: Trend in sectoral weightages in Nifty

Sectors/Year	Mar-09	Mar-14	Mar-19	Dec-20
Financial Services	11.8	27.5	38.9	38.8
IT	9.1	16.3	13.7	16.3
Oil & Gas	40.7	14.3	15.3	12.5
FMCG	6.4	12.6	11.3	11.5
Automobile	3.3	8.8	6.1	5.4
Pharmaceuticals	2.5	5.2	2.4	3.6
Construction	3.9	5.0	3.7	2.6
Metals	5.4	4.8	3.7	2.5
Telecom	9.8	1.7	1.5	2.0
Others	7.1	3.8	3.5	4.8

Source: NSE, Bloomberg, ICICI Direct Research

The change in contours in the Nifty composition logically shifts the PE orbit as well. This is well corroborated by the fact that trailing PE of Nifty in 2009-2014 (where major weight transition happened) averaged between 17.1x. The average current PE multiples further expanded to 20.9x as the share of capital efficient sectors such as FMCG, Financials, IT and Pharma have performed well.

Exhibit 3: Nifty trailing P/E



Source: Bloomberg, ICICI Direct Research

B) Earnings visibility and consistency is preferred by markets and hence capital efficient sectors have been gaining higher weightages in the Nifty which has trigger further shift in PE multiples

Sectors with high weights like Financials, FMCG, IT and Pharma have already witnessed strong earnings growth in H1FY21 and ensuing recovery will also be strong and consistent going into FY22-FY23E, which would then help sustain premium valuations multiples and hence the higher orbit of Nifty PE. On other hand, cyclical sectors such as Auto, Oil & Gas, Metals will also see a cyclical upturn and will exhibit strong growth rates in FY22-FY23E profits albeit a low base.

Exhibit 4: Current sector weights & EPS CAGR FY21E-23E

Sectors/Year	Sector Weight (%)	EPS CAGR % FY21E-23E	Comments
Financial Services	39	26	The earnings trajectory of the capital efficient sectors have been robust and consistent in H1FY21 and will remain strong going into FY22-FY23
IT	16	16	
FMCG	12	11	
Pharmaceuticals	4	11	The cyclical sectors has seen a good amount of disruptions in their earnings during the pandemic period. Hence, the recovery in their earnings is more a fucntion of low base and gradual recovery in business environment.
Automobile	5	52	
Oil & Gas	12	24	
Construction	3	34	
Metals	3	30	
Telecom	2	LP	
Others	5	28	
Nifty		24	

Source: NSE, Bloomberg, ICICI Direct Research

C) Better performing business segments within existing companies is not captured by current PE multiples

There are 9 companies in the Nifty, contributing 32% weight, wherein valuations are based on Sum of the Parts (SoTP) methodology. All these companies have various subsidiaries having exposure to different sectors and hence all the business are valued on different methodology. So in such a canvass looking at a standalone Nifty PE and arriving at a judgment might not be effective. For instance, Kotak Mahindra (4.6% weight) has a well-diversified spread across financial services space spanning from banking, life insurance, AMC and securities business and all of these individual businesses are valued on parameters like P/BV, Price to Embedded value, PE basis. Same is the case with companies like Larsen & Toubro (2.6%) which has diversified business across engineering, infrastructure, IT and NBFC wherein the segments like IT are growing much faster than the core business and hence attract higher PE multiples. So on a consolidated basis, the PE of the overall business will be higher than PE ascribed to core infra and engineering business. There are more examples of companies like Bajaj Finserv, ITC, SBI etc. with diversified business models and higher implicit PE's.

D) Bottom up P/E construct signals an orbit shift in Nifty PE based on future earnings performance expectations.

We have also used a bottom up approach of weighted average PE of all individual constituents of Nifty based on the expected earnings performance and individual target prices assigned for each stock. The respective target PE of the stocks are then multiplied with the respective weights. On that basis, we arrive at a forward PE of 26.2x on FY23E basis.

Exhibit 5: Target PE of few individual constituents based on FY23 EPS

Nifty Stocks	Target PE (x)	Nifty Stocks	Target PE (x)
Adani Ports	16.0	SBI Life	45.3
Asian Paints Ltd	58.2	Titan Company Ltd	58.0
Bajaj Auto Ltd	18.9	Tata Steel Ltd	9.2
Bajaj Finance Ltd	46.5	Sun Pharma	21.9
Bharti Airtel Ltd	32.3	NTPC Ltd	5.4
Dr Reddy's	26.0	Maruti	28.0
Nestle India Ltd	63.3	Indusind	37.2
Infosys Ltd	25.4	Britannia	44.5
ITC Ltd	17.0	Grasim Industries Ltd	34.7
HDFC Bank Ltd	19.3	Divis Lab	40.0
Reliance Industries Ltd	17.7	Axis Bank Ltd	17.5
TCS	29.4	Shree Cement	39.8
Overall Nifty PE	26.2		

Source: Bloomberg, ICICI Direct Research

Hence, in order to arrive at a fair value on the bottom up basis, we take a 10-15% discount to our weighted average PE of 26.2x in order to account for future earnings downgrades and any other unforeseen macro risks which might risk earnings to come at a target PE range of 22x-23.6x. Consequently, we arrive at a fair value of 16300 on Nifty over a 12-18 month period (22x FY23E EPS).

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