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Acumen at work

The decadal drop in India's RoE

Even as India is marked out as a 'bright spot' in the global economy, India's RoE has actually been declining since FY07. After attaining a peak of 24 per cent in FY07, the Sensex's RoE declined rapidly to 17 per cent in FY10. Post FY10, the Sensex's RoE briefly improved to 19 per cent in FY12 after which the slide continued to its current level of 14 per cent. RoE for a broader measure of the market, i.e. the BSE100, has also been trending downwards after attaining a peak of 23 per cent in FY07.

Optimists argue that this RoE decline is cyclical in nature. To test the veracity of this argument, we stripped out cyclical sectors (i.e. industrials, materials, energy, consumer discretionary, utilities, and financial services) from the standard BSE100 RoE as well as the corrected BSE100 RoE. This adjustment yielded limited relief to India's consistently declining RoE. The BSE100 ex-cyclicals corrected for the survivorship bias, in fact, has been trending downwards for nearly two decades!

After attaining a peak of 27 per cent in FY1999, the corrected BSE100 ex-cyclicals' RoE trended downwards and was recorded at 15 per cent in FY16. In fact, amongst non-commodity based EMs, the compression in India's RoE has been amongst the highest.

What drove compression?

Decomposing India's RoE into its three constituents (namely net profit margins, asset turnover and financial leverage) shows that the slide in RoE in India has been mainly driven by declining profit margins (and to a lesser extent by declining asset turnover). Even as profit margins for the corrected BSE100 declined from the peak of 10 per cent in FY07 to 6 per cent in FY16, financial leverage increased from 2.3x to 2.7x and the asset turnover ratio declined from 0.9x to 0.6x.

A cross-sector analysis suggests that an increase in competitive intensity, in all probability, drove the profit margin compression in India. We use the coefficient of variation (CoV) in the RoE of a particular sector as a measure of the degree of competitive intensity whereby a high CoV indicates the sector's RoE being dispersed and, hence, the existence of high competitive intensity in that sector and vice versa.

Unsurprisingly, this analysis suggests that there exists an inverse correlation between the 'extent of drop in RoE' in a sector over FY07-16 and the 'increase in the CoV of RoE' over FY07-16.

India richly valued

While the BSE100's RoE has fallen since FY07, its trailing 12-month P/E currently trades at a 22 per cent premium to its long-term average and is currently trading at a 52 per cent premium to the MSCI EM P/E. Optimists argue that India's trailing P/E of BSE100 is 'optically inflated' as the earnings cycle is supposedly at its bottom.

However, there appears to be limited fundamental basis to this argument.

The RoE of the defensive sectors (namely IT, consumer staples, healthcare and telecommunication services) currently stands at a six-year high of 20 per cent.

These sectors have not experienced any RoE compression. Hence, the ‘optically inflated P/E argument’ clearly does not apply to these sectors.

Metals and Mining (M&M) stocks (i.e. energy, metals and mining, steel, aluminium, metals, glass containers, copper and commodity chemicals) on the other hand have seen their RoE come under profound pressure as the commodity super-cycle came to an end in 2011. The RoE of this sector then nose-dived from 26 per cent in FY07 to a mere 9 per cent in FY16. Given that this sector’s RoE is closely linked to the global commodity cycle and given that the global commodity cycle is unlikely to turn soon (unless China recovers suddenly), it appears highly unlikely that this sector will be able to drive an RoE improvement at the market level.

Valuation-returns link

If you buy the Indian market when it’s trading well above its long-term average trailing P/E, it will be difficult for you to generate healthy returns over the next 12 months.

A time-series analysis of market data suggests that there exists no significant correlation between starting period valuations and share price returns for horizons longer than a year. In other words, valuations do not have any significant bearing on returns for periods longer than one year.

Hence, for investors looking to generate market out-performance over a holding period exceeding one year, it makes a great deal of sense to focus on quality franchises with strong underlying fundamentals rather than basing their investment decisions on current valuations.

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