

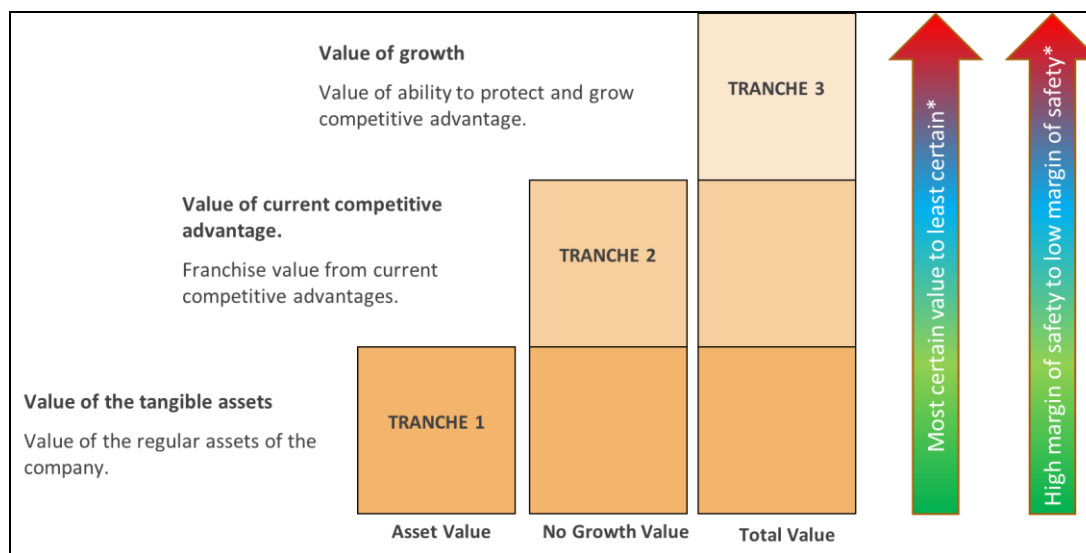


Nifty 3TV

Krusha Parekh, 23rd June 2021

In our earlier post, we have spoken about [Nifty's normalized P/E and its prospective returns](#). In this write up, we have tried to adapt the concept and break down Nifty50 Index into 3 tranches of valuation drivers.

3 Tranche valuation framework is based on Bruce Greenwald's work and tries to provide investors with finding a "Margin of Safety", appropriate to the company's business quality. By adapting this concept to Nifty50, we are trying to give the same message using different visuals. And in the process, present how an investor can seek a "margin of safety" while investing.

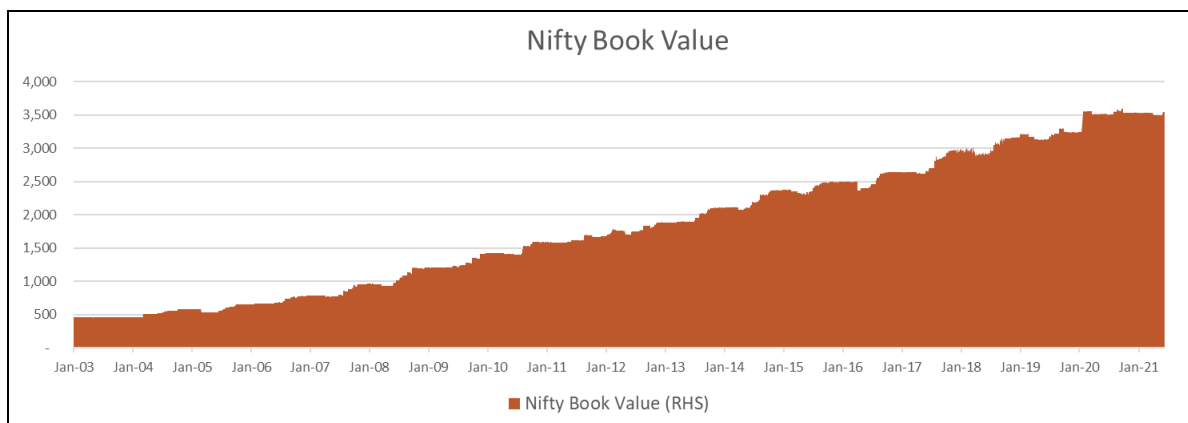


Constructing Tranche 1 – Value of Nifty's assets

Tranche 1 generally is value of hard assets of the company. Depending on business nature and quality, it can be book value of the business, tangible book value, replacement cost of assets, Net Asset Value or Adjusted Book Value.

We have used book value of Nifty as value of its Tranche 1.

It is assumed that any adjustments to book value that may be required for brand values, replacement cost of assets, bad assets of banks, etc. that we generally make, offset each other.



Constructing Tranche 2 – Converting normalized earnings to annuity

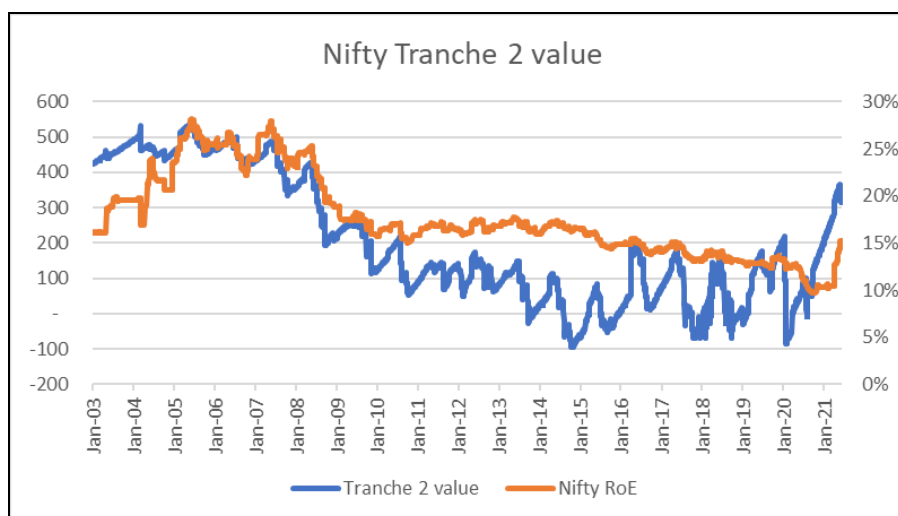
Tranche 2 represents value of current competitive advantage of the company. It values company's ability to earn returns higher than cost of capital.

Ideally, a company's core operating earnings are converted to perpetual annuity to value Tranche 2.

However, considering the same is not available for Nifty, normalized earnings of Nifty is converted to perpetual annuity as representative of "No Growth Value". Discount rate used is 14%.

Tranche 2 value = No Growth Value *minus* Tranche 1 Value.

With declining Nifty RoE, we can see that Tranche 2 value has not grown much.



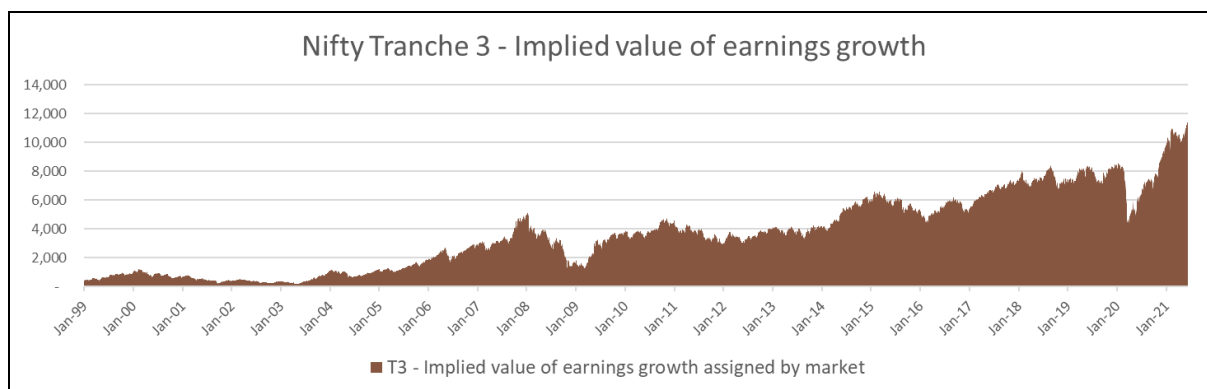
Constructing Nifty Tranche 3 – Value of growth assigned by market

Tranche 3 represents value of company's ability to deploy additional capital for growth, profitably. It is the value that measures the company's ability to earn higher than cost of capital (equity) returns on reinvestment of retained earnings (or equity raised).

Ideally, we would use a DCF method to arrive at value of Tranche 3 for companies.

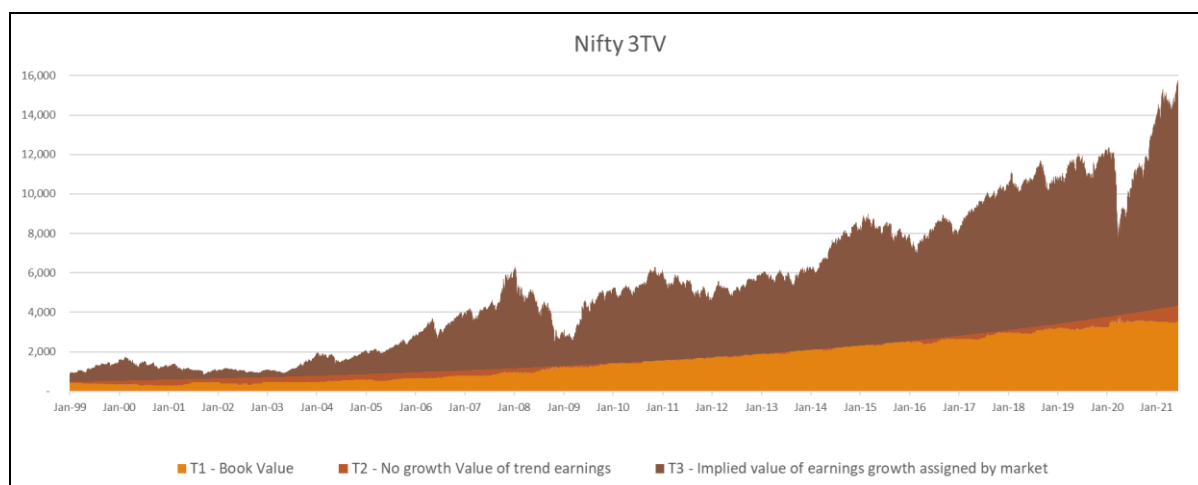
For Nifty, we have considered T3 as Nifty levels *minus* T2 *minus* T1.

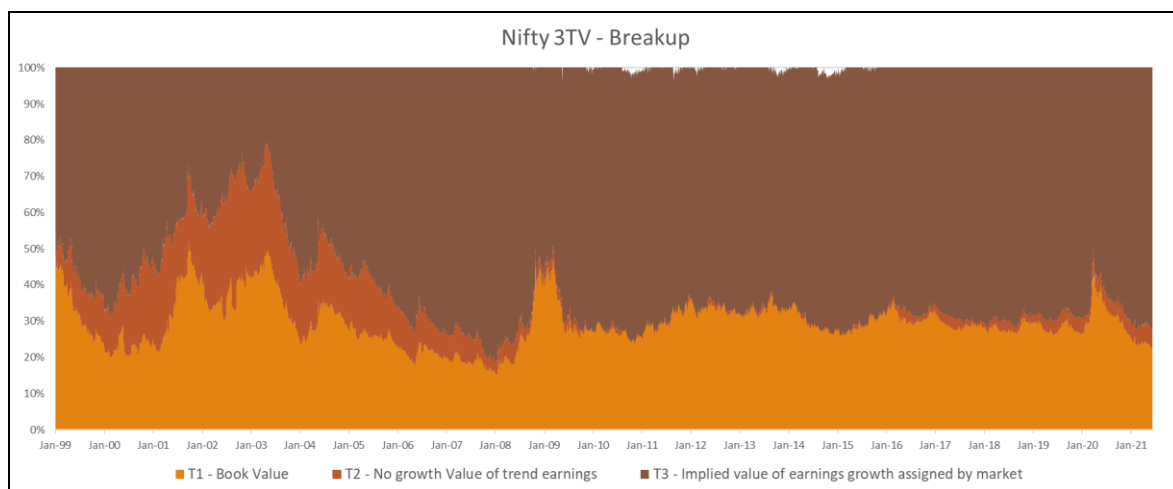
In another words, how much value is market assigning towards growth for Nifty.



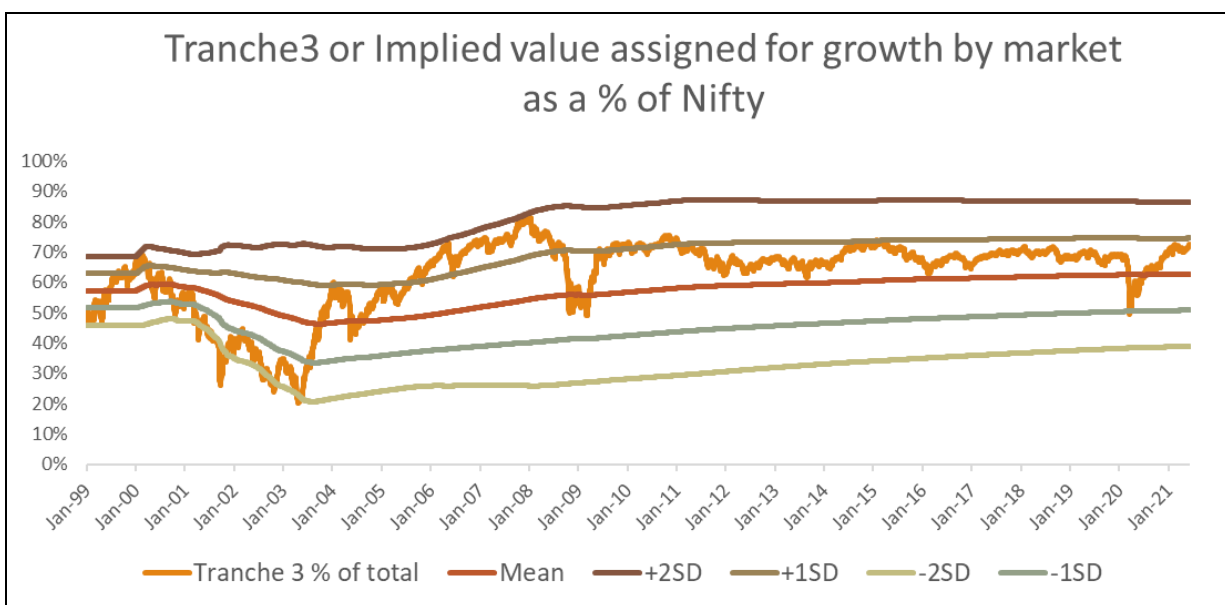
Nifty 3TV – Break-up

As we can see, traditionally market has attributed highest 3rd Tranche i.e., “earnings growth” component of Nifty's total valuation.





Nifty 3TV and Margin of Safety



Nifty's Book Value growth has been higher than trend EPS growth. Declining Nifty RoE has been a key contributor towards this. This has resulted in Tranche 2 or No Growth Value remaining low and contributing relatively less towards total Nifty value as seen in above slides.

The rise in overall Nifty value thus suggests that market participants has been assigning > 70% towards growth. A significant improvement in RoE is thus already priced in.

Current Tranche 3 levels are almost equal to value assigned towards growth during the 2007 peak when Nifty RoE stood >25%.

Conclusion remains the same to what we discussed in our [Nifty valuation and prospective returns](#). Prospective returns from current levels remain low when market is richly pricing Nifty's earnings growth.

This write-up additionally suggests ways in which an investor can gauge “Margin of Safety” at prevailing prices.

While India continues to be priced as a “growth” market by investors, one will be better off by paying less for the least certain component of total value i.e., future earnings growth and get better margin of safety.

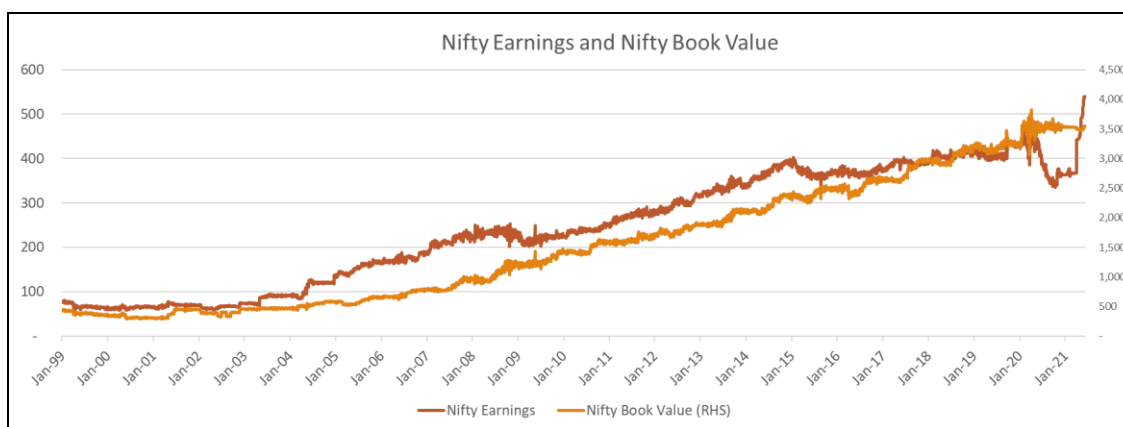
As they say, manage your risks and rewards take care of itself.

Annexure

1. Calculating Nifty Earnings and Book Value

Based on reported Nifty P/E and P/B, Nifty’s earnings and book value are as below.

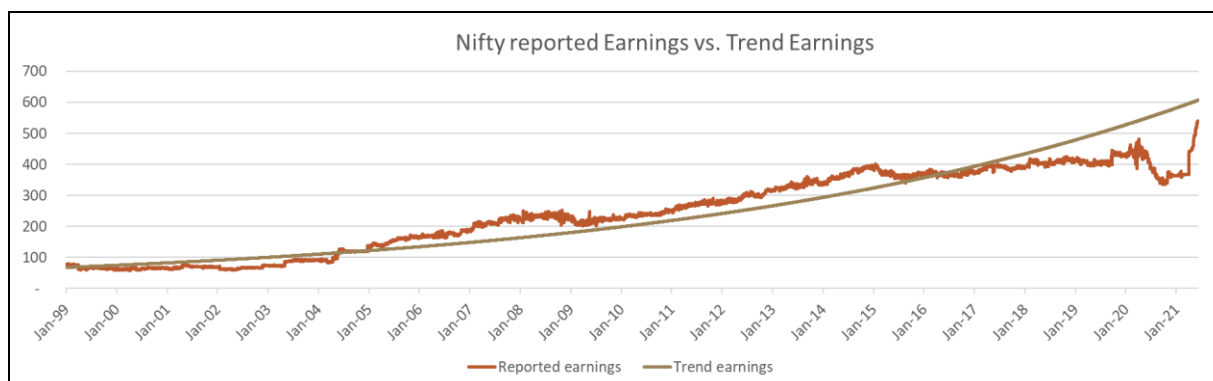
Point to point basis - Nifty’s earnings have grown by 9.0% and its book value has grown by 9.8% over last 22.5 years.



2. Calculating Nifty Trend or Normalised Earnings

Nifty Trend earnings growth rate is 10.3% p.a. since January-1999, earliest year for which data is available. Point to point earnings CAGR stands at 9.0%.

Note that NSE [started to use consolidated earnings](#) to calculate P/E since 31-March-2021 (Yes! they woke up suddenly after 20 years to do this. Consolidation kicked in during FY-2002). Hence sharp jump in earnings. While this makes history incomparable, we have gone ahead with the analysis of breaking Nifty levels into 3 tranches considering we are dealing with very long-term data series. It is also assumed that that current benefits will be offset later on.



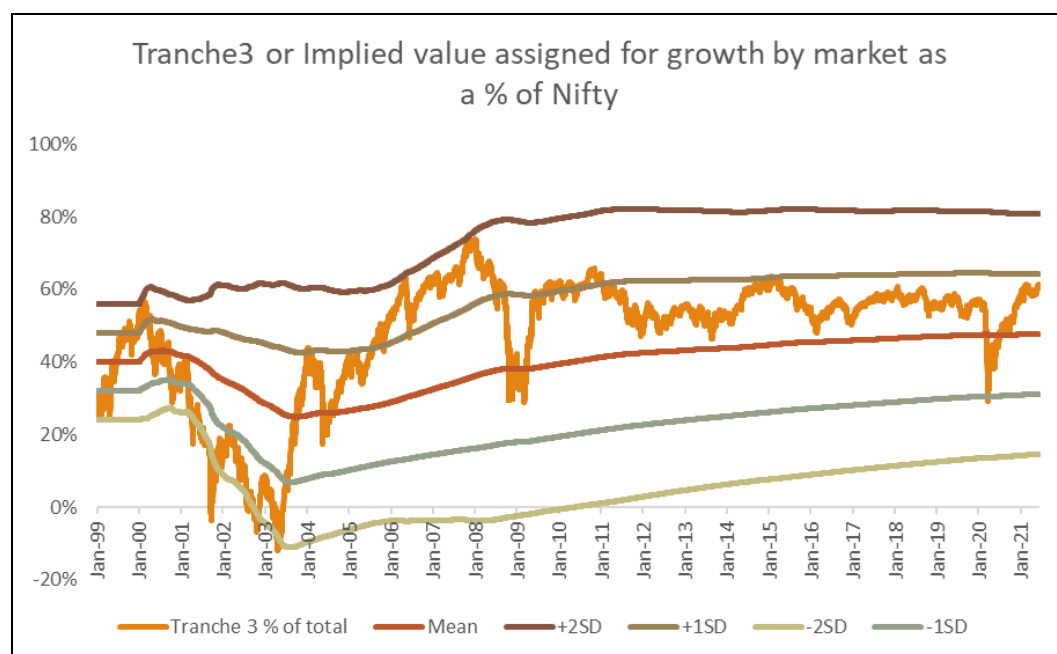
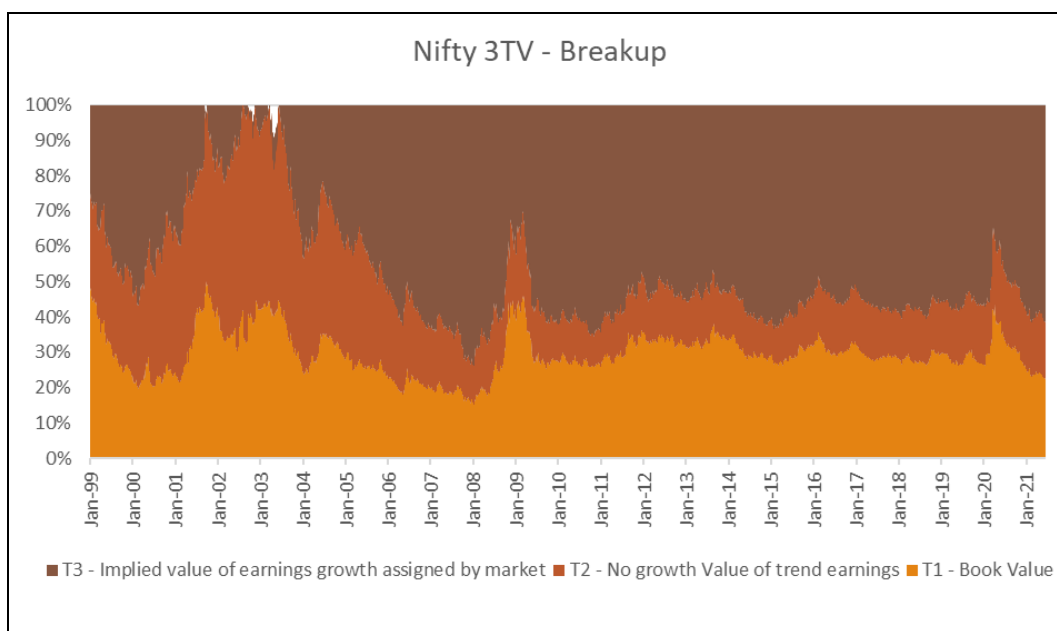
3. 3TV based on 10% cost of capital assumption.

While Multi-Act keeps Cost of Equity same across market cycle, market participants tend to adjust their cost of capital with prevailing interest rate regime.

Discount rates have a bearing on calculation of Tranche 2 i.e. No Growth Value in normalized earnings of Nifty.

To remove an element of doubt owing to discount rate being used, adjoining charts are based on discount rate of 10%.

They continue to suggest earnings growth being valued richly by the market.



Statutory Details:

Multi-Act Equity Consultancy Private Limited (SEBI Registered Portfolio Manager – Registration No. INP000002965)

Disclaimer and Disclosure:

The views expressed in this article are for educational and reading purpose only. Multi-Act Equity Consultancy Private Limited (MAECL) does not solicit any course of action based on these views and the reader is advised to exercise independent judgment and act upon the same based on its/his/her sole discretion, their own investigations and risk-reward preferences. This article and the information do not constitute a distribution, an endorsement, an investment advice, an offer to buy or sell or the solicitation of an offer to buy or sell any securities mentioned in this Document or an attempt to influence the opinion or behaviour of the Investors/Recipients. The article is prepared based on publicly available information, internally developed data and from sources believed to be reliable. Due care has been taken to ensure that the facts are accurate, and the views are fair.

MAECL, its associates or any of their respective directors, employees, affiliates or representatives do not assume any responsibility for, or warrant the accuracy, completeness, adequacy and reliability of such views and consequently are not liable for any direct, indirect, special, incidental, consequential, punitive or exemplary damages, including lost profits arising in any way for decisions taken based on the said article. It is stated that, as permitted by SEBI Regulations and the Company's Employee Dealing Policy, the associates, employees, affiliates of MAECL may have interests in securities referred to in the information. The contents herein – information or views – do not amount to distribution, guidelines, an offer or solicitation of any offer to buy or sell any securities or financial instruments, directly or indirectly, in the United States of America (US), in Canada, in jurisdictions where such distribution or offer is not authorized and in FATF non-compliant jurisdiction and are particularly not for US persons (being persons resident in the US, corporations, partnerships or other entities created or organized in or under the laws of the US or any person falling within the definition of the term "US person" under Regulation S promulgated under the US Securities Act of 1933, as amended) and persons of Canada.

General risk factors

- Securities investments are subject to market risks and there is no assurance or guarantee that the objective of the investments will be achieved.
- Past performance of the Portfolio Manager or its affiliates does not indicate its future performance.
- As with any investment in securities, the value of investments can go up or down depending on the factors and forces affecting the capital market. MAECL is not responsible / liable for any losses resulting from such factors.
- Securities investments are subject to external risks such as war, natural calamities, and policy changes of local / international markets which affect stock markets.
- MAECL has renewed its SEBI PMS registration effective December 04, 2020 and has commenced its portfolio management activities with effect from January 2011.