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**FROM THE FUND MANAGER DESK**

***ESOPs : Time to dilute?***

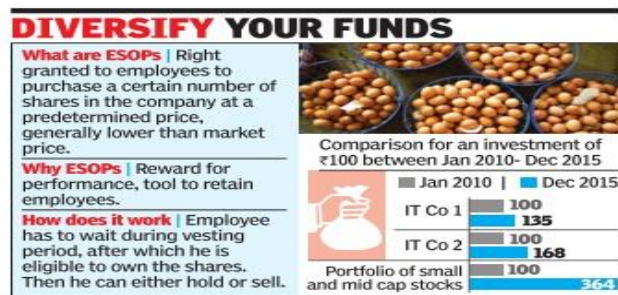
***Concentrated wealth in a slowing sector poses a serious portfolio risk for Senior Professionals in the IT services sector.***

Portfolio concentration is a tricky one. In times of high tides in the chosen sector, it delivers outsized returns. The same concentration can hurt deep during times when the sector goes through a soft patch. If the headwinds are structural, portfolio could be in for a serious risk of long-term under-performance.

Let us take the case of Employee Stock Options (ESOPs). In the early cycle of heady growth for the Industry/Sector, options work wonder as they create value by superior returns. Over time, the size of the options portfolio grows, both on account of performance as well as on accrual of annual new options. Consequently, it grows to form a significant part of the employee's overall wealth. So far, it is good. The challenge comes when the Industry transitions from the heady growth phase to a more mature phase as it happens in much of the sectors. That is when the concentrated options start hurting the overall returns.

The industry which advertised the virtues of India to the world is probably in one such a transition now. With prospects turning patchy for the IT services sector, ESOP stock performance could be in for a long-term under-performance. Concentration in such times could deeply upset the overall returns for senior professionals in this sector, given their large exposure to ESOPs.

It is time for dilution, esp for professionals in the traditional IT services sector. Below chart captures certain key data points in terms of how a well diversified high qualify small and mid cap portfolio has performed viz-a-viz tier-1 IT stocks over last five years.



Source: TOI

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As explained in detail in our campaign link <http://trustlineindia.com/esop-campaign/index.php>, the ESOP diversification strategy will help achieving following objectives:

- Risk diversification
- Mitigate sector risks
- Returns maximization

With real estate in bear market, options for such diversifications are not wide. Diversified equity schemes such as mutual funds and PMS ( portfolio management schemes) offer an attractive opportunity for ESOP dilution, given the robust long-term outlook for Indian equities.

Happy Value Investing!!!

ArunaGiri. N

Click below banner to know more on ESOP diversification:

The banner features a dark background with a golden golf ball on a tee and a stack of gold coins. Text on the right reads: 'WE DIVERSIFY SAVINGS INTO HIGH QUALITY PORTFOLIOS.' Below this is a 'KNOW MORE' button. The TrustLine logo is in the top right corner. Below the image, the text says 'Diversify your ESOP' and 'A smart plan for professionals to diversify their stock options.' At the bottom left is 'TRUSTLINEINDIA.COM' and at the bottom right is a 'Learn More' button.

## CORPORATE DEVELOPMENTS

- **Hinduja Group's** flagship company **Ashok Leyland**, the country's second-largest commercial vehicle manufacturer, has won orders worth Rs. 8 bn from the Indian armed forces.

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- **Tata Steel** Britain's largest steelmaker put its entire UK business up for sale to stem heavy losses, a move that would draw a line under its almost decade-long foray into Britain's declining steel industry.
- **Tata Motors**, the country's biggest vehicle manufacturer, has signed an agreement with Pune-based **Bharat Forge** and **General Dynamics Land Systems** (GDLS) of the US, for the ministry of defence's (MoD's) Future Infantry Combat Vehicle (FICV) program.
- **Wipro** has formed a strategic partnership with **Schneider Electric**, a global specialist in energy management and automated systems, to develop convergent solutions for India's Smart Cities.
- After several rounds of restructuring, battery maker **Eveready Industries India** Ltd is looking to spin off its packet tea business into a separate unit and scale it up by aligning its operations with that of the promoter group's plantation company, **McLeod Russel India** Ltd, said a media report.
- **ONGC** has unveiled a Rs 340 bn (\$5-bn) investment plan to develop its KG Basin fields delayed for years, which would help boost the company's oil and gas output by a fifth in about four years.
- **Bharti Airtel** announced that it had entered into a definitive agreement with Videocon to acquire the rights to use 1800 MHz spectrum in six circles for Rs 44.3 bn.
- **Avantha Group** company **Crompton Greaves** will sell its transmission and distribution (T&D) business outside India to First Reserve International, a US private equity (PE) fund, for an enterprise value of euro 115 million (about Rs 8.5 bn).
- **Tata Motors** has signed up a follow-on contract to supply additional 619 units of high- mobility (HMV) multi-axle trucks to the Indian Army. This is in conjunction, to an earlier order awarded to Tata Motors for 1,239 units of its 6X6 MMV, the company said in a statement.

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## MACRO NEWS

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- **The Centre** has issued fresh guidelines for **Foreign domestic investments** (FDI) in e-commerce allowing 100 per cent FDI in the marketplace-based model - an arrangement where e-commerce companies provide an online platform to other vendors to sell their products.
- According to provisional data from **National Securities Depository Limited** (NSDL) and Securities and Exchange Board of India (Sebi), **Foreign institutional investors** (FIIs) have put in Rs 204.8 bn thus far in the Indian market during the current month (till March 28, 2016).
- The country's **Current account deficit** (CAD) narrowed to \$7.1 bn (1.3% of GDP) in the quarter ended December 2015, from \$ 7.7 bn (1.5% of GDP) in the year-ago period.
- **The Government** slashed the interest rates on all small savings schemes, including Public Provident Fund, by 60 basis points, and Kisan Vikas Patra, by 90 basis points, to create conducive environment for the Reserve Bank of India to ease monetary policy rates further, and help banks transmit rate cuts to customers.
- **The Consumer Price Index** based inflation eased to a four-month low of 5.18 per cent in February from 5.69 per cent in January, which may prompt the Reserve Bank of India to cut its policy rate at its annual policy review next month to boost falling industrial production in volume term.
- **The Government** has announced big-bang policy measures to help explorers unlock hydrocarbon treasure worth \$36.6 billion (Rs 2.33 tn or more than 50% of the crude import bill estimated for 2015-16), retain and expand jobs amid low oil and gas prices as well as make it easier for them to do business.
- **CRISIL** has downgraded its ratings on the debt instruments of eight public sector banks, and revised its outlook on five others to 'Negative' from 'Stable'.

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- A high-powered panel of experts constituted by **The Government** to recommend a national uniform price for Bt cotton for the 2016 season is believed to have suggested a price of Rs 800 per 450 grammes of Bt cotton packet, which includes Rs 49 as trait fee or licence fee. The licence fee is 74 per cent less than the current one.
- **India's** goods exports declined for the fifteenth straight month in February 2016 falling 5.66% to \$20.73 bn from \$21.98 bn in the same month last year as global demand continued to be weak.

## FUNDS FLOW DATA

*Data as on 29<sup>th</sup> Mar 2016*

FUNDS FLOW DATA ( Rs in Cr)		
<i>Category</i>	<i>MTD</i>	<i>YTD</i>
FII	20687	1328
Mutual Funds	(5784)	6521
<b>Total</b>	<b>14903</b>	<b>7849</b>

## DEBT & FOREX MARKET

*Data as on 29<sup>th</sup> Mar 2016*

Debt / Forex Market			
<i>Category</i>	<i>Day</i>	<i>1 mnth</i>	<i>3 Mnths</i>
10 Yr Yield	7.5	7.6	7.8
Re / US \$	66.6	68.4	66.4

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MARKET VIEW\*

*Reversal of Role!*

In an interesting twist of tale, domestic funds seem to have swapped their place with FIIs. All thro' last year, domestic funds were in a buying binge while FIIs were busy selling. The roles have reversed now. Since early March, driven by risk-on trade, FIIs have been on a buying frenzy fueled by surging inflows into Emerging Markets funds. March has seen a new high for FII inflows. It is on a 34 month high with \$2.74+ Bn flows so far. Paradoxically, in the same month, mutual funds have logged their first outflows in 21 months (since May 2014). Reversal couldn't be more dramatic.

So is the reversal of divergence in the market. Shine is back on Sensex and on large caps whereas broader market is still bruised with local funds deserting them under redemption pressure. Divergence in the market has come a full circle. Unlike domestic money that dabbles with small and mid caps, FIIs fancy the larger cousins. With increased out-flows in mutual funds in March, no surprise that the sparkle is off from the broader small and mid caps.

While FII flows may support technically, fundamentals do not support a sustained rally in large caps. With punctured private capex cycle, it is difficult to build a case for sustained rally in heavyweights, unless there is a sharp reversal in commodity cycle for effective turn of an investment cycle. Given the low visibility of such recovery at this point of time, market will revert back to reward stock picking in the broader space when the technical disconnect between domestic and foreign flows diminishes over time.

But the good news is, the prolonged pause in the broader space is a brilliant window for accumulation for long-term investors. More so, if the early signs of green shoots in many segments of the economy are anything to go by. Broader markets seem to have gone into a boring pause mode punctuated by sharp downward drifts, precisely when the prospects have begun to brighten up with some of the Govt's policy actions beginning to work on the ground. That is precisely how irrational markets present opportunities for long-term investors. It is time for stock picking and portfolio construction without fretting about what the markets would do next.

We stay away from giving market outlook (except reporting the consensus view) as we believe that the short-term market movements are function of innumerable rational and irrational parameters and hence any attempt to predict the next market move would be a futile exercise. Hence, we would like to qualify the above consensus view on outlook with a clear caution that TrustLine does not have any specific view on the outlook and does not necessarily subscribe to that.

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## VALUE EXTRACTS

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- In this section of the newsletter, we attach an extract / write-up that we believe can add value to the readers from the “**VALUE INVESTMENT**” point of view or others that offer interesting perspective.
- Enclosed section carries an interesting article titled “**A Primer on PE Ratio**” by Sanjay Bakshi

*“Over long periods of time, strong business performance translates into strong investment performance”*

- **Bill Ruane**

### **A Primer on PE Ratios**

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The PE ratio is the most common tool used by investors and financial analysts to ascertain how expensive or how cheap a stock is. Unfortunately, it is also one of the most misunderstood tools in the investment business. A stock which may be having a PE of 5 may be thought to be cheap and yet it may turn out to be quite an expensive mistake. Similarly, a stock which may be having a PE of 100 may thought to be too expensive may actually turn out to be a bargain.

What are the determinants of a stock's PE ratio? There are eight. These are: (1) Stability; (2) Growth; (3) Dividends; (4) Return on invested capital; (5) Leverage; (6) The proportion of non-operating assets in a company's asset base; (7) Financial community's appraisal about the industry and the company, including its managers; and (8) Interest Rates.

#### **Stability**

Stable earning power is worth more than volatile earning power. The most stable and predictable the earnings, the higher will be the PE ratio, other things remaining unchanged.. Markets do not like unpleasant surprises. They love companies which can grow their earnings in a stable, predictable

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way. Such companies are rewarded by markets by making their stocks sell at relatively high PE multiples as compared to stocks of cyclical companies. Never expect a cyclical stock to sell at a very high PE multiple of normalised earning power.

### **Growth**

Growing earnings are worth more than non growing earnings. Assume that you were offered to pay a lump-sum of money in exchange of a promise to receive ten thousand rupees a year forever and ever. How much should you pay to buy this future stream of non-growing earnings? That will depend upon your opportunity cost of capital. Suppose that instead of investing your money in this future earning stream, you could lend money by incurring the same risk and earn a return of, say 10% a year.

There are growing fears of the world economy slipping into another recession. The International Monetary Fund (IMF) has again cut its growth estimates, highlighting continued vulnerabilities in EMs and most global investment banks are rushing to cut their growth numbers. Many market observers expect global central banks to eventually restart unconventional monetary policies to fend off deflation and recessionary pressures.

The figure of 10 times arrived at above can be likened to the PE ratio. Suppose, instead of the earning stream, you were offered a 100% stake in a firm which was expected to earn Rs 10,000 ever year, forever and ever. Also suppose that this firm would pay you all of its earnings to you as dividends. Then the maximum price that you would put on this business, given your cost of capital of 10% a year, would be Rs 1,00,000, implying a PE of 10.

Now assume that instead of receiving a non-growing earning stream, you were to receive an earning stream which grew at 5% p.a. Then the value of this growing perpetuity to you would double to Rs 2 lakhs i.e.  $10,000/[10\%-5\%]$  implying a PE multiple of 20. The non-growth earnings stream was valued at a PE multiple of 10. The 5% growth earnings stream was valued at a PE multiple of 20.

When investors' expectations about the growth prospects of after-tax earnings of a company are revised due to some developments, the PE multiple of its stock will change. This makes investing in growth stocks, which are already selling at high PE multiples quite risky. The market's expectation about future growth are already discounted by the high PE multiple. If earnings growth were to slow down, then the PE multiple could decline quite rapidly.

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### **Dividends**

Generally speaking markets tend to be wary of companies which retain much of their earnings instead of paying them out as dividends. If you were to rank stocks on the basis of dividend-payout ratios and PE ratios, you will find that there is a strong positive correlation between the two. Most MNCs in India pay out a large part of their earnings as dividends. This is one reason why their stocks tend to sell at higher PE multiples than Indian-promoted companies.

While it is true that sometimes, companies which do not pay any dividends (e.g. Infosys) sell at high PE multiples, but such companies are quite rare.

### **Return on Invested Capital**

Stocks of companies which earn high returns on their invested capital and are expected to do so in the future tend to command high PE ratios. The important point to note here is that the relationship between the return on invested capital and PE ratios is not linear. If a company earns 15% return on its invested capital and rationally sells at a PE of 15, this does not mean that a company which earns a 25% return on its invested capital should sell at a PE of 25. The reason for this is very simple. The second company is compounding its shareholders funds at a much faster pace than the first company. If you compound Rs 1,000 @ 15% a year for 20 years, your terminal wealth will be Rs 16,366.54. If, instead you were able to compound Rs 1,000 @ 25% a year for 20 years, then your terminal wealth will be Rs 86,736.17. This vast difference in terminal wealth would be the result of seemingly small difference in the two compounding rates. However, markets would tend to discount that differences in future terminal wealths of both companies today by according vastly different PE multiples to their stocks. The second company's stocks could easily sell at a PE multiple of 40.

### **Leverage**

Stocks of companies which have large amounts of debt, in relation to their total assets, sell at low PE multiples as compared to stocks of low-debt companies. Companies with high debt levels are correctly perceived to be far more risky by the market than companies with low, or no debt. That is why stocks of financial companies, which typically are highly leveraged, tend to sell at relatively low PE multiples.

### **Non Operating Assets**

A company may be in possession of a large quantity of assets which are not contributing anything significant to the company's bottomline. However,

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such assets could still be very valuable and would enter into the company's total valuation. However, since these assets are not contributing much to the reported earnings of the company, the denominator in such companies' PE ratio will be low, implying a high PE multiple.

### **Financial Community's Appraisal**

Markets are frequently irrational in valuing companies in the short-term. At any given point of time, there is usually a group of companies which are held in high esteem by the financial community. Such companies' stocks tend to sell at high PE multiples. If it was finance companies in 1992-94, it is software companies today. MNC stocks have always sold at relatively high PE multiples in India because the financial community views the economics of these companies' businesses as well as the quality of their managements in a favourable light.

### **Interest Rates**

The final factor affecting PE ratios is the factor of interest rates. When interest rates decline, two things happen: (1) the opportunity cost of capital declines, making the present value of perpetual income streams in equities go up; and (2) the savings of the public are diverted away from fixed income securities markets, which are no longer attractive, given lower interest rates, and is pumped into the stock market. These two factors, of a rise in intrinsic value of equities and the weight of money results in a rise in the general level of PE ratios. When interest rates rise, the reverse happens. Stocks, which are perpetuities, fall in intrinsic value and money is moved from the stock market to the bond market where the interest rates have become more attractive than before.

These, then, are the eight determinants of a stock's PE ratio. However, it must be emphasised that these factors are interrelated and sometimes work in the opposite direction. For example, a company which pays out a large proportion of its earnings as dividends may deserve a high PE multiple. However, by paying out large sums of money to shareholders, the company could end up with less cash to finance its growth, which implies a low PE multiple. Which of the two factors will have a more significant impact of this company's PE multiple is impossible to predict. Nevertheless, I find the above framework useful in trying to understand and interpret PE ratios.

**-Sanjay Bakshi**

Ist April' 2016

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**About TrustLine**

At TrustLine, we run a specialized PMS fund (Portfolio Management) for exclusive set of high net-worth clients (long only value based fund). We are a company with a single mission- to deliver superior long-term returns to our clients. We are managing over Rs.140+ crores of AUM for over 220+ highly satisfied clients. This makes us among the top 20 discretionary portfolio managers in India, with industry leading performance.

Over the years we, at TrustLine, have gained rich domain expertise by focusing and specializing in Portfolio Management Services (PMS). Unlike our competition, we are a unique firm focused only on PMS. This sets us apart and gives us a competitive advantage in the PMS space. At TrustLine we believe, the quality of "Research" is fundamental to delivering out-sized returns. When research is complemented by contrarian investment approach, the rewards can be dis-proportional. This forms the foundation of our investment choices and stock selection in our core PMS business. Our disciplined practice of this "Value Investment" principle has enabled us to deliver superior risk adjusted returns with significant out-performance over bench-mark indices.

With a client retention rate in excess of 99%+, we have grown as an organization through strong references, primarily driven by solid track record of building wealth across good and bad market cycles, through focused and disciplined approach to investing.

TrustLine products include:

- ***Intrinsic*** (Deep Value fund)
  - ***Intrinsic Floater*** (Arbitrage Fund)
  - ***Intrinsic FloaterPlus*** (Risk Arbitrage Fund)
- 

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