

Still no takers?

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Much has been written about what has transpired on Wall Street and its impact on economies and financial markets in the rest of the world, for us to recount the same here. Instead, it would be worth going back to the basics of why India remains among the best places to invest in over the long term and if there are pitfalls in the short term, then how we must deal with them. The collateral damage wrought to the Indian stock market could prove on hindsight to have been the trough that long-term investors ought to capitalise on quickly.

While there is no shortage of gloom and doom all around us, it would be illustrative at this point to recount some of the structural, sustainable advantages India boasts relative to other countries and therefore, the strong investment case it makes for itself.

- 👑 About 70% of the Indian economy is dependant on domestic consumption, unlike others in the region, which are export dependant.
- 👑 Half the economic growth is services led; the other half is broadly divided between industry and agriculture. Such diversity is invaluable in times like these and offers the kind of resilience worthy of others' envy. It is worth noting that India has never 'de-grown' in the 61 years post its independence in 1947.
- 👑 India's capital efficiency and productivity has improved dramatically over the past decade, taking the return on equity of listed Indian corporates well above 20% at its peak. Even now, average RoEs are likely to trough in the range of 18-20% in 2009-2010, which is nearly twice that of several emerging markets.
- 👑 India's demographics are famously strong and they are likely to get better on a relative basis over the next couple of decades.
- 👑 The banking sector has demonstrated that inspite of an over-heating economy, it remains solid and robust and insolvency is a term least associated with any Indian bank in the last six months. While non-performing loans may be on the uptick and could rise further in the months ahead, they are nowhere near levels that could threaten the banks' survival themselves or affect the banking system remotely. Yet several Indian banks continue to trade at below book values today.
- 👑 India's GDP growth is likely to trough in the 6.0-6.5% range over the next 12-18 months, a level that will look starkly solid in contrast to its peers in the region. The savings rate remains a healthy 35% of GDP and domestic consumption demand is cyclically down currently, chiefly engineered by the Reserve Bank of India (RBI) tightening the screws on credit growth over the last two years.

Let us also look at some of the tactical gains India can derive over the next 12-18 months: some events which have turned positive for it only recently, and some which are likely to work in its favour in the short term.

- ☙ Crude oil has fallen below \$100/bbl and represents annual savings of roughly \$40bn, i.e. 3.5-4% of GDP. Other commodities such as steel, coal, chemicals, fertilisers and soft commodities like major food grains, have all receded sharply from their highs in 2007 and 2008. This will take the pressure off inflation, ease fiscal strain, cut the subsidy bill and lead to a more accommodative fiscal policy by the RBI and the Government later in 2009.
- ☙ Recent major oil & gas finds by companies like Reliance Cairn and GSPL will alter India's long-term balance of payments equation post 2010, when both Reliance and Cairn begin to pump out oil & gas. Gas from just a single field of Reliance and oil from a single field of Cairn will have a significant positive impact. For example, RIL's KG-D6 gas supply at 80mcm/d (which could peak to 120mcm/d) may result in potential savings of US\$9bn for the economy, with gas displacing other liquid fuels in areas like fertilisers, refining and industrial heating in addition to its use in power generation. The knock-on benefits arising from this conversion on costs and value-add by industry would be huge, in addition to the above.
- ☙ Inflation is expected to peak off by the end of 2008 and begin declining from early 2009 into single digits. Even if this figure doesn't go back to the halcyon days of below 4% soon, a significant decline from the peak levels of 13% will certainly be enough to mark a shift in RBI policy on interest rates before long.
- ☙ Lower interest rates conceivably coupled with lower commodity prices could be critical factors in turning around demand and lowering input costs sharply in 2010 and 2011, an event not factored into today's earnings estimates.

While many of India's advantages remain intact, investors often tend to lose sight of them in times like these. To be sure, we do not disagree that just as there are positives, there are other lingering question marks and weaknesses that persist, some which are transient and others that are more deeply entrenched.

- ☙ The biggest challenge right now is the degree of weakness of the Indian rupee, which has come in a short span of the last quarter (9% for the Sept quarter alone) and ~7% to the end of November 2008. While conventional logic ought to suggest that this weakness could be short-lived, the painful fact is that it must be endured.
- ☙ Inflation has finally reversed and is now seen to be declining on a weekly basis, which is good news. A petrol price cut looks imminent, which will further accelerate the rapid decline in inflation in the months ahead.
- ☙ The RBI has reversed its monetary stance of the last two years and has embarked on a rapid monetary easing cycle. This will accelerate in the weeks and months ahead as inflation drops away rapidly.
- ☙ High interest rates have begun to hurt demand for consumer durables; housing, autos and other discretionary spending. Infrastructure projects in some areas are now being pushed back chiefly on account of delays in funding by banks and increases in interest rates. This is likely to result in growth being pushed further back into FY10 or FY11. Normalcy in credit markets accompanied with sharp decline in lending rates in the months ahead, can rekindle a recovery in capital and consumer spending midway into next year.

- ☪ India is a net importer of capital and has been dependant on funding its growth through the capital market route, more than through Foreign Direct Investment (FDI), because of the tardy pace of unshackling controls over sectors like banking, insurance, retailing, real estate etc. Now that Foreign Institutional Investors (FIIs) have pulled money out of the country during 2008, this has begun to hurt companies/projects that were looking to the capital market to raise equity. With cost of debt rising sharply, such projects remain stillborn or delayed.
- ☪ Finally, there is the wild card that remains turned down and which will open only sometime in May-June next year, which will bear the name of the next Government at the Centre. The colour of that Government will perhaps prove to be the next big catalyst to a sustained recovery of the economy.

Therefore, while the long-term assessment is under less doubt and subject to greater consensus, it is the short-term picture that remains clouded by uncertainty. Some of this is sentiment driven, while the rest is proven by actual fact at the ground level. We reckon that there is enough that the Government and the RBI can do to make a big difference to sentiment. However, such action must be well orchestrated, timed and executed in the right dose. This could take some doing and time before the RBI can claim success and economic variables revert to some sort of equanimity, maybe a quarter, two or more. We don't know. But we can sense that some key variables like the currency and inflation have moved to a sufficient extreme for us to believe that with a bit of impetus from global events, the RBI can be in a position to reverse its policies targeting inflation and go back to supporting growth in the economy.

Funnily, the challenges of today may well provide the opportunities of tomorrow and the majority of investors will go back to doing what they do best; being wise only on hindsight. Currently the assumptions of corporate earnings growth for FY09 appear reasonable, but subject to further downgrades. However, it is the FY10 estimates that appear optimistic and will see downward revisions in the months ahead.

The forced selling of distressed investors, including hedge funds, has rendered valuations irrelevant for several leading and very profitable strong businesses in the mid-caps space. The universe of stocks beyond the Sensex or MSCI India indices, companies whose revenues are in excess of \$500mn with RoEs matching or superior to the market, has scores of stocks which trade at PEs in mid-single digits for growth which may slow down relative to its last three years. Their competitive position and the sound premise on which their business is built, suggest that these companies will recover quickly once conditions turn favourable. We have no prescience of what the market will do in the short term. However, we feel reasonably confident that India could be among the ones which will recover earlier than others in the region.

Different canards have been raised through the last 10 months to explain India's stock market decline. Starting with valuations, followed by inflation, rising crude oil prices, its rising current account deficit, a fast slowing economy, weakening currency, adverse balance of payments in 2009 and now earnings downgrades. All of these have contributed in rendering India's stock market to valuations that many only a year ago would have yearned to own, but didn't because valuations got in the way. Now that valuations have turned in their favour and a lot of water has flowed under the bridge, most investors are still reluctant to take a pragmatic long term view of the market.

In their defence, we must accept that two critical outcomes remain unknown. The possible shape of the new Government in June 2009 and when growth will revive. The outcome of the elections will remain a wild card until we have a new Government by June 2009, but if growth were to make a comeback around the same time, then equity markets at the same time next year will wear a very different look. The price of certainty is indeed very high. Less than a year ago, the statistics read somewhat like this; GDP in excess of 9%, RoEs of 22-23%, forecasted EPS growth > 15%, P/B > 5x and PEs > 20x. India now trades at a PE of 9-10x, P/B < 2x, forward earnings (FY10E) and possible trough RoEs of 16-18% and GDP growth which too could base out somewhere near 6.0-6.5%. Still no takers?