

# A TIME FOR CHERRY PICKING

The stock market has already discounted a strong earnings growth in 2010. Valuations look rich. The investor must look for opportunities in islands of excellence



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**HIS CALL:** No room for P/E expansion. Midcaps will deliver outsized performance.

**HIS BIG INVESTMENT IDEA:** Watch for tax and policy changes from the government in 2010; they will spout investment opportunities.

**T**he year 2010 will be a very interesting and important one for the Indian equities markets. We are coming off an incredible 2009, when the markets rose by more than 80 percent, there were huge inflows from foreign institutional investors and the economy proved resilient.

This will be a very important year for economic reforms in the country, with goods and services tax (GST), direct tax code, a new education bill, insurance policy, petroleum pricing and other issues all on the agenda. The government must demonstrate its commitment to these measures, or risk serious investor disappointment. Investors also want to see a clear roadmap for getting the fiscal deficit under control. These will be critical to sustain interest among investors, both locally and internationally, in an environment where valuations are not cheap.

Certain drivers of returns look clear.

1. Interest rates are going to rise, probably from January itself, as the central bank will be forced to react to double digit consumer price inflation numbers.
2. Excise duties and other taxes are going up as the government will have to begin a normalisation process and take back some of the fiscal stimuli announced in 2009.
3. The rupee will likely continue to strengthen in 2010 (against the dollar); maybe not dramatically but another 4-5 percent is very possible.
4. Economic growth will accelerate by at least 100 basis points from about 7 percent to near 8 percent, as we get a more normal monsoon (hopefully), and exports start growing again.

With price-to-earnings multiples already at 16-17 times forward earnings, it is critical that earnings come through for markets to progress from here. It is by no means certain that we can deliver the 20-25 percent earnings growth most market participants expect.

Investors should invest in high quality businesses that do not need to raise equity to grow. With a deluge of equity raising, firms that are self-financing will get a premium, as non-diluting growth will attract higher multiples. I think capital efficiency will once again come into vogue, and investors will need to focus on the underlying return on equity (ROE) or return on invested capital (ROIC) of a business and not just on earnings growth. This obsession with earnings growth, irrespective of its quality, was a feature of the markets in 2007, and many of these companies/sectors, having got hammered in 2008, bounced back strongly in 2009.

However, in the more normalised environment that I expect in 2010, the quality of growth and capital efficiency will regain prominence. Prior to 2007, there was a very clear correlation both among sectors and companies within a sector of P/E multiples and ROIC; this broke down in the growth-obsessed markets of 2007 and panic of 2008-09. This will now get re-established.

Investors should also look out for certain high-quality niche IPOs. There is a good chance that high quality smaller IPOs may get neglected and drowned out by all the hype surrounding the mega issues. But they will present a good opportunity. Certain unlisted PSUs like RITES

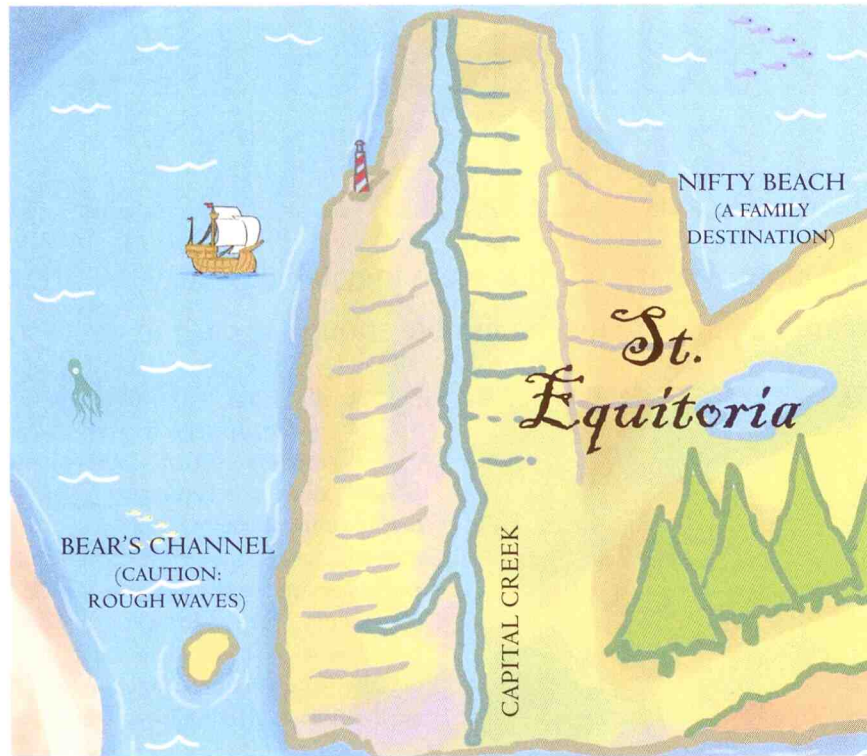
may be very interesting, if they are globally competitive and the government has no control in determining their profitability.

Given the likely implementation of the GST, one should look for companies or industries, where the unorganised sector is a major competitor, as GST will level the playing field dramatically, and lead to large market share gains for the organised listed sector. Retailers like **Shopper's Stop** have talked of a 100-basis-point improvement in margins just due to GST alone.

One clear implication of the new direct tax code, in whichever form it gets implemented, is a narrowing of the tax differential for companies in India. Anyone paying tax at or near the peak rate will benefit hugely, while anyone paying MAT, or relying on area-based benefits, will lose out. Investors should bear this in mind. The desire to make capital investment a basis for taxation in the new direct tax code (through a proposed tax on gross block) should further sharpen investor focus on the underlying ROIC of a business, as low-return businesses will have to pay a disproportionate share of profits as tax.

While everyone is aware of the huge investments required in infrastructure, I would play this spend through providers of inputs for the projects, rather than the project developers themselves. Infrastructure projects are very capital-intensive and cannot have a supernormal returns profile. The capital intensity and returns profile improves dramatically for the suppliers of inputs, both services and equipment. The return on capital and growth outlook of **Crompton Greaves** or **Engineers India** are, for example, far superior to an infrastructure developer, but valuation multiples are quite similar today.

Delisting is another theme, as SEBI implements the minimum free-float criteria. It could be a low-risk strategy to generate reasonable returns in a year when capital appreciation will be tough to come by. Many MNCs will not meet the 75 percent threshold and would prefer to delist than float additional equity locally. Stocks like



## Investors should be prepared for more subdued returns in 2010. P/E multiples cannot expand much from here

**Oracle Financial Services and Monsanto India** are plays on this theme.

Investors should be prepared for more subdued returns in 2010. I do not think P/E multiples can expand much from here, given the huge equity issuance pipeline and the limited attempts at deep fundamental reform from the government. There does exist a chance that a real bubble will develop in emerging market equities, as the OECD economies delay normalising monetary policy, but one cannot have this as the base case. If we expect no P/E expansion, then earnings growth become the primary driver of returns in 2010. But a strong earnings trajectory has already been discounted. So, stock specific analysis will become critical. Companies that exceed expectations will be rewarded and

those who disappoint will get the opposite reaction from the investors.

India is a growth story, with hopefully a decade of 8 percent GDP growth ahead. With the growth runway huge, both locally and internationally for India Inc., investors must focus more on the quality of management and business model. *Which management teams can fully capitalise on the growth opportunity and with a capital-efficient business model?* That is the question investors need to ask. This is why India will always be a stock picker's market, and why I expect select midcaps to deliver outsized performance. Midcaps are where sell-side research inefficiency is greater and entrepreneurship and business model innovation at their peak. Companies like **Zenith Infotech** and **Bayer Crop Science** are examples of such business model innovation.

*(Disclaimer: We at Amansa Capital own or have owned in the past 12 months, Zenith infotech, Crompton Greaves, Engineers India, Oracle Financial Svcs. and Bayer Crop Science) ■*