

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.

The 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**

