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The Growth Debate

November 27, 2007

The biggest area of concern has to be the deteriorating labour market situation in the US

As I have outlined before in many previous articles, I remain of the view that the US is heading for a severe growth slowdown and most probably a recession in 2008, and this will be negative for stock prices globally. As discussed before, in a recession-type of an environment, even a Fed determined to keep cutting rates cannot save the markets. All the bullishness surrounding Fed easing cycles are true provided the US were to not slip into a recession; otherwise all bets are off.

However, given the importance for investors of getting this call right, it is worth highlighting the contrarian view. There is a large body of opinion that the Fed can save the US economy and that a recession is an unlikely outcome. The bulls also feel that it is unlikely that inflationary tendencies will surface to slow the ability of the Fed to continue easing. This camp is understandably a lot more positive on the markets and sees any weakness as a huge buying opportunity. I have found the arguments in this connection by the folks at Gavekal to be the most cogent.

The more positive camp bases their view on the following:

1. They point out that housing slumps in the past seem to be very highly correlated with recessions only because historically, these slumps were caused by very high interest rates. The real cause of the economic slump was the high interest rates and not the housing market downturn. The bulls argue that the slump in housing was a byproduct of the high interest rates leading to a recession and not a cause of the recession. The bulls thus continue to argue that a housing slump not accompanied by high interest rates is not going to be as corrosive on the broad economy as is commonly believed. Today's environment is clearly one of low and still falling rates. This thesis to an extent has been borne out by the statistics on growth till date, which continue to show the other components of the US economy continuing to grow even as housing has caved in.

Of course the flip side to this argument is that even though rates have not spiked, the recent dislocations in credit have severely impacted its flow, which could potentially be as damaging as higher interest rates. One needs to track the extent of dislocations in credit flow to judge if the other sectors of the US economy can continue to decouple from housing.

2. The second argument of the bulls is that you have to break up the impact of the housing slump into two components — the direct impact of falling housing investment on the economy and employment and the indirect impact of falling house prices on consumption. The direct impact will be felt through weakness in all aspects of employment related to the housing sector, as well as a severe drop in the rate of housing investment as new homebuilding activity drops. At its peak in

2005, housing investment was over 6 per cent of GDP and has already fallen to below 4.5 per cent. Before it stabilises, this ratio could drop further to around 3 per cent. While this falloff in investment is significant and will be a drag on the economy, what concerns investors far more is the potentially damaging wealth effects of falling house prices on consumption. For a drop in the share of housing investment from 6 per cent to even 3 per cent by itself cannot push the US into a recession, that can only happen if consumption more broadly were to get hit. Strategists like Gavekal have argued that given that the top 20 per cent of US households consume more than the bottom 60 per cent, a housing downturn focused on the sub-prime borrower will not have as severe a fallout on economy-wide consumption as the bears fear. They have argued that as long as interest rates remain low and employment and income growth continues in the non-residential segments of the economy, the damage to consumption should be more muted and contained than the bearish view. The continued stability of growth ex the construction sector lends some credence to this view.

3. The third leg of the bull case is based on a research paper released by the Fed in 2005, laying out a relationship between housing and trade. The paper makes the case that the collapse in housing will be largely offset by an improvement in US trade figures. This conclusion seems to be backed by recent trade data, which show exports growing by 16 per cent and offsetting the -20 per cent drag from housing.

Basically the bulls make the argument that the weak dollar, falling yields and surge in liquidity will do enough to boost the economy and counteract economic woes induced by financial markets.

These arguments have validity, and at least we can see a construct in which a recession is not a foregone conclusion for the US. However, markets, while initially reacting with euphoria post the initial 50 basis point Fed cut, have pretty much retraced their entire move and are now hovering at mid-August lows once again. The markets once again seem to be pricing in a recession. The biggest area of concern has to be the rapidly deteriorating labour market situation in the US. The one indicator that investors must track from here on is the employment report — any further weakness and a recession will be pretty much baked in the cake. The other indicator on the real economy worth tracking is the ISM survey of purchasing managers, any break in this below 50 will also be a significant negative forward-looking indicator.

The question of course is that even if the US were to slip into a recession as I believe, then can the emerging market (EM) equity asset class continue to decouple, as many investors continue to believe? Certainly the price action seems to imply that this is what will happen, as most of the large EM markets are significantly above their mid-August lows. While the case for a decoupling of the real economy seems quite strong, I am not sure financial markets can decouple as seamlessly as everyone seems to expect. I do believe that the biggest beneficiaries of the expected surge of liquidity as

OECD central banks ease will be the more domestically-oriented and faster-growing large EM economies like India and China, but even these markets will have to face jitters as Wall Street gets more and more nervous on the outlook for the US. The longer-term trend towards these large emerging markets is clear but we will have a lot more choppiness than investors are currently anticipating to my mind.

Stay invested but be prepared for some air pockets ahead.

The Current Environment

November 14, 2007

The one total disaster scenario for global markets has always been if investors lose confidence in dollar-based assets.

The market environment post the US sub-prime meltdown in August has played out pretty much as one had expected. The dollar has come under intense pressure, the Fed has come to the rescue, and there has been a noticeable asset allocation shift towards emerging markets. The larger, more domestically-oriented markets like India have outperformed massively and investors continue to search for assets/markets with limited exposure to the developed world. The surprise of course has been in the speed of these moves. While one thought all this would happen with a time lag of at least three to six months, the market began reflecting these changes immediately.

The question of course is as to what one should do now.

I feel that one should now approach the markets with more caution. We have had a very good run from mid-August onwards and the time to temper risk, at least for the short term, may have arrived.

The US economy is clearly rapidly slowing and all the risks are to the downside. The chances of a recession in the US are at least 40 per cent and rising. Consumer confidence there has dropped alarmingly, oil prices at near \$100 per barrel have got to hurt and the housing meltdown shows no signs of stabilising. In addition to all the above, the credit market turmoil seems to be nowhere near the end, as on a daily basis one financial institution after another seems to be announcing larger losses than initially anticipated, with potentially larger markdowns still to come. There is also a growing feeling that the credit market dislocations will impact economic growth more and for longer than initially anticipated. Bernanke has clearly signalled at the last Fed meeting, that given a choice he is not keen on going down the road of continued and aggressive monetary policy easing and is aware of the long-term inflationary consequences of such a path. Independent of the weakness in financial sector earnings, some of the large bellwether US companies have reported weaker earnings than expected, denting the strong earnings and margin story of corporate America. While investors everywhere have bought into the global decoupling thesis, one should not be surprised to see conviction on this score being tested as the US really starts reporting poor economic growth. Investors are likely to get jittery, at least temporarily as to whether emerging markets can truly economically decouple from the OECD countries.

The total cratering of the dollar also has to have longer-term investment implications. While positive for international markets and fund flows into the EM asset class, at some stage can this not restrict the flexibility of the Fed in continuing to drop rates? The one total disaster scenario for global markets has always been if investors lose confidence in dollar-based assets. If that were to happen, then a forced debt unwinding would be imposed on the US and a reversal of the buildup in economic imbalances seen over the last decade. Such a loss of confidence will also reduce the flexibility the Fed has to lower

rates and generally push interest rates higher than they need to be to attract flows into dollar-based assets. A reduced funds flow into the US will force consumer retrenchment, as savings will have to rise and consumption drop. While we are not at such a juncture today, the one-way move of the dollar has to cause worry at some stage.

As any study on market behaviour post the commencement of a Fed easing cycle will indicate, markets do well provided the US does not go into a recession. If the US were to slip into a recession, then all bets are off and market performance will most likely be weak.

Flows into emerging markets have also been very strong and exaggerated. Take India as an example, wherein net flows have already far outstripped previous records and have come from all corners of the world and from all types of investors. Such huge inflows have to indicate that many investors are hiding in the EM asset class in search of performance, and will most probably bolt at the first signs of trouble or risk aversion.

China is also in the midst of a bubble that can only end badly, the timing of which is of course unknown. The Chinese authorities seem to be getting more and more desperate to rein in their bull market; at some stage they will succeed. What will be the impact on the EM asset class of a slowing down of the price momentum in Chinese asset markets?

The market in India is also troublesome, as it has been a very mega-cap, liquidity-driven rally, and very focused on certain domestically-oriented and infrastructure sectors. It has been a price momentum-driven market, and the extreme divergence in price performance has been feeding on itself. The relative return investor universe (still the bulk of the money in India) is getting squeezed into chasing the price momentum stocks and sectors, as they try to catch up to an index moving consistently higher on narrower and narrower breadth. The invention of new valuation methods to justify current prices is also worrying, the obsession with embedded value and the willingness to give huge valuations to what are in effect business plans are something which need to be watched.

The new rules on P-notes and FIIs will also restrict flows into India, albeit only temporarily. To the extent investors are reluctant to sell in order to hoard their existing P-note capacity, we are creating an artificial and shallow market environment. My own sense is that investors are less hedged and more fully invested than they would ideally like to be.

The one thing holding India up is the earnings trajectory of the companies, which has remained extremely strong. As long as this holds, India will continue to outperform at least on a relative basis.

While I am not questioning the longer-term thesis of emerging markets being the new darlings of this global liquidity cycle and being the biggest beneficiary of any liquidity injections, from a tactical perspective the markets may need to take a breather. Also the move of asset allocations away from the US towards the EM asset class is still very much under way and work in progress, and thus flows into markets like India will continue structurally for years to come. There is no real dent to the long-term thesis, but short-term one should be aware of the risks.

Liquidity will be badly hit

October 18, 2007

Since funds will find it difficult to hedge their underlying cash equity positions, many will have to reduce their overall exposure to Indian equities.

Faced with a relentless surge in capital inflows, regulators seem to have finally bitten the bullet on the participatory-notes (PN) issue, and have released a discussion paper to effectively phase out the instrument. Given the upward pressure on the rupee and the impact the exchange rate appreciation is having on the real economy, one can understand the pressure the authorities are under to stem inflows. However, the measures proposed may have a greater impact than is commonly understood.

- First of all, by restricting the issuance of PNs by any FII which already has more than 40 per cent of total assets in PNs, the authorities are effectively banning fresh issuance. Most FII brokers whom I have spoken to are already at or over this limit, and thus will have no further PN issuance capacity. Therefore, if the regulations go through as proposed, one can expect very little new capital coming into the equity markets from users of PNs, as they will not be able to get any broker to write a PN for them. The best most brokers will be able to offer, is that if you want to buy new stock through PNs, then you will have to sell an existing position to offset this. Without saying so explicitly, this is effectively a banning of PNs as we will see very little capacity in the system to issue fresh PNs.
- The proposed regulations also ban any fresh PN issuance from FII sub-accounts. Unfortunately, as of today, the writer of the PN in many cases is a sub-account of the FII broker, thus if you ban sub-accounts issuing PNs, then that also shuts down the instrument.
- The draft also talks about no new PNs being issued against derivative instruments, though a subsequent clarification allows roll-overs of existing positions for the next 18 months. This will seriously damage liquidity in the F&O markets as trading volumes come down, and also severely impinge the ability of long/short and macro-funds to hedge their underlying cash equity positions.

As these funds are unable to hedge, you will see many of them reducing their underlying equity positions as well. In the case of these funds if they are unable to hedge their exposure to Indian equities, they will have to reduce their overall Indian exposure as their mandates do not permit them to run long on only cash equity positions without some mechanism to reduce market risk.

One can understand what the authorities are doing, viz, trying to reduce flows into equity markets without a collapse in the underlying market itself. However, they should put in place a transition mechanism, so that all funds have the next six-nine months to apply to Sebi and get a direct FII licence. Once this period is over, Sebi should do whatever it wants with the PN instrument as it has given all legitimate funds enough time and notice to get direct FII status.

The problem with the draft is that you will create an interim period of six-nine months when effectively no current PN user will be able to increase its equity holdings in India. Funds will take at least six months to go through the process of applying to Sebi and getting approvals.

The authorities should create a mechanism so that these market participants are not shut out of the equity markets in this transition phase of moving from PNs to direct FII. Otherwise, the way the draft is written, many players can only sell for the next six months or till such time as they get their FII licence.

Sebi also needs to make sure it has the machinery and criteria in place to handle the expected flood of new applications for FII. The norms Sebi uses to decide on the new FII applications will be critical, as it will effectively determine how many of the current users of PNs will be able to continue participating in the Indian equity markets.

Whichever way you cut this, it can only, on the margin, be negative for equity markets. At least 50-60 per cent of incremental equity flows were coming through PNs. The authorities will have effectively stopped these flows till such time as market participants transition to a direct FII licence. How many of these market participants will come back to the equity markets and in how much time depends on Sebi and the time and criteria it puts in place to clear FII applications.

However, given current criteria, there is a significant portion of the current users of PNs like the macro and long/short guys, who will not clear Sebi's criteria for FII licence. These players and their money will exit the Indian equity markets permanently. The quantum of this lost capital and its pace of exit will determine the market's direction from here.

What Ails Tech

September 26, 2007

The tech sector is in turmoil, but are investors correct in assessing that the sector is now ex-growth.

IT services or the technology sector in India is going through considerable stress and a bout of dramatic stock underperformance. Investors of all types are now deserting the one-time darlings of the stock market. The large caps are down 20-25% in absolute terms, wherein the broad market is up more than 20%. This is huge underperformance and that too within nine months. The picture is even worse if you look at the smaller IT companies. Many are down 30-35% in absolute terms.

Such a divergence in performance is both unusual and painful (for those invested in tech), given the extent of negative price action now feeding on itself. In the sense that the price action of tech is forcing investors who cannot stomach the underperformance to liquidate their holdings in all IT companies, this liquidation causes further negative price action, which forces still more selling and the cycle gets repeated.

What the sector is undergoing currently is something which the folk at Bernstein in the US call growth purgatory. This is a process wherein the erstwhile high-growth stocks get gradually derated as their growth slows and sector leadership changes. Basically investors re-assess the growth outlook of the affected sector and typically find another group of stocks with stronger, more visible growth. Growth investors then move their investments to these new sectors (causing PE expansion) and out of the former growth stocks (causing PE compression). As the investor base changes, the former growth stocks keep getting de-rated till they become cheap enough to attract the value guys to invest. This process of transition in the company's investor base from growth investors to value investors is called growth purgatory and is a painful and prolonged period of underperformance for the company concerned. Basically the affected company has to go through a kind of no man's land where it is growing too slowly for growth investors and momentum investors to hold but its stock price is still not cheap enough for value investors to buy. Either the company becomes cheap enough to attract the value investor or fundamentals improve, growth re-accelerates and the growth and momentum guys re-enter.

This, to my mind, is what is happening to the tech sector in India, investors are questioning the growth status of Indian IT companies. It all began with the strengthening rupee and its impact on margins, and has now created fears of a possible US recession and its impact on the top line of IT giants. Basically investors have figured out that even the best tech companies will have an earnings compound annual growth rate (CAGR) of only about 15-20% over the coming three years (with taxes hitting earnings in 2010). Given the exuberance in India these days, 15-20% earnings growth seems quite pedestrian as people argue that today's new growth favourites, the capital goods and infra stocks, can deliver 30-40% growth for years to come and that too with very high visibility. If IT stocks can now only grow at 20%, why should they trade at a premium to

the market is the question asked by investors. Independent of the rupee, has not the law of large numbers caught up with the IT giants?

Now is the market right in assuming that the tech stocks have gone ex-growth? Or are we just seeing temporary difficulties, for if the stocks are truly ex-growth then we have more de-rating ahead; otherwise the stocks are probably near a buying point. I have just listed some factors to consider this issue.

- The 15-20% earnings trajectory over the coming three years may not be fair as a long-term proxy, as this year is unusual with an exaggerated movement of the rupee and 2010 is probably the year of maximum tax incidence (post-2010 the SEZ benefits start). It may not be inconceivable that in the post-2010 period growth actually re-accelerates.
- As IT companies have broadened their service offerings, they have multiplied their addressable market. Till six months ago, the Nasscom 2010 vision was on track. Today investors dismiss these same targets of 25-30% revenue growth, though any survey you read still indicates the huge growth runway available for offshoring.
- While everyone is assuming that the current rupee appreciation from 44 to 40 will kill the margins of techland, the rupee appreciated from 49 to 43 between 2002 and 2006, and the industry was able to handle this type of appreciation because it was more measured. The problem today, besides the level, is more the speed of appreciation, and lack of preparedness. As the rupee stabilises we may see some margin clawback as companies respond to the new exchange rate reality.
- If you believe, like some do, that the rupee will keep appreciating forever and at this pace, with 35 being the next logical stop, then I would argue that a lot many sectors beyond tech will have a problem. Most industries in India, even if they are totally domestic-focused, sell at import parity pricing. If the rupee continues to appreciate at this pace, will capital goods and commodity producers really have no margin stress as the market seems to be implying today?
- The IT majors are all cash machines, and will be sitting on \$1-2 billion of cash each. These cash mountains can be used for inorganic purposes, and share buybacks or dividends, and give companies great flexibility to boost returns. Investors today are only paying for growth, irrespective of capital efficiency and free cash. The IT business model is extraordinarily capital-efficient and generates free cash, and investors will recognise the value of this at some stage. Also while 20% earnings growth looks pedestrian today, it may not be so always.
- Investors are also giving the managements of IT giants little credit for being able to rejig their business model. As the reality of the rupee at 40 sinks in, one will see a response from IT players. They will push to accelerate price hikes, tighten utilisation, move to other geographies and innovate on their labour pool. Just the fact that we have seen a big margin compression in Q1 does not mean that IT companies have no means to counter this, if given time. Yes, margins will be lower than they used to be, but maybe not as low as the market is implicitly assuming.
- If investors are right and the IT industry is going to slow considerably over the coming years, an additional point to ponder is the impact this slowdown will have on India as a whole. For, as many analysts have pointed out, tech growth is driving large parts of our economy. Who will use all the commercial real estate? Will job growth and demand for

consumer non-durables get impacted? Can the tech sector get hammered by investors for slowing growth, and is it possible for this to have no impact on the growth of any other sector?

The tech sector is in turmoil, and has been hit by the perfect storm, but are investors correct in assessing that the sector is now ex-growth? With IT majors now trading at 15 times forward earnings, this is something worth thinking about, for if the growth purgatory were to play out fully, IT stocks will probably bottom out at 12-14 times earnings, implying further significant downside. If investors are wrong, then this may be a great entry point to get into world-class business' trading at reasonable multiples and going through temporary difficulties.

Each investor will have to choose which side he/she is on.

Fed rate cuts and Asia

September 12, 2007

The chief beneficiary of the cycle of interest rate cuts and liquidity injections will be emerging markets, specifically Asia.

Given the poor employment numbers released last week, wherein job creation actually turned negative for the first time in years, the probability of a Fed rate cut has only increased. The poor employment numbers have probably given Bernanke the cover he needs to claim that any cuts in rates are due to the weakening economy and not designed to bail out investors. The chances are now pretty high that we will see the beginning of an extended Fed easing cycle starting from September 18 itself.

Even though most commentators still feel that the US will escape once again with a soft landing, and growth will not drop below 2 per cent, the risks of a recession have clearly increased significantly. Given the extent of the US sub-prime mess, both in magnitude and duration, it does seem a bit of wishful thinking to assume that the worst that can happen is that economic growth will slow to only 2%, and that too for only a quarter or two. My own sense is that this slowdown will be more severe and more protracted than the consensus currently thinks as the headwinds facing the US consumer are multifold.

From oil prices to the old bugbear of near zero savings and consumption ratios at all-time highs, the US consumer is over-extended and the day of reckoning may have arrived. One just has to see the data on the quantum of mortgages still to be repriced, and recognise that credit flows to anything non-investment grade have been totally shut to become even more bearish. However, one has to be conscious of the fact that it has not paid to bet against the US consumer, as the bears have been calling for a sharp slowdown in consumption for years now, mostly to no avail. We will see what happens over the coming 12 months, but again the vulnerability of US consumption has never been higher. Also as various academic studies have shown, the economic consequences of a housing market bubble bursting are far more protracted and consequential than a bursting of a bubble in the financial markets. If this finding were to hold true this time as well, the problems are likely to be deeper and the workout longer than currently envisaged.

As I remain more bearish than the consensus on consumption in the US, I also feel that this Fed easing cycle will also be longer and deeper than most expect.

Now if you believe in a new Fed easing cycle, the obvious question is what this will mean for Asian markets and India.

Whenever the Fed has cut rates and dropped a chunk of liquidity into the markets, it is setting the stage for this liquidity to eventually move into some new asset class and drive up prices.

The asset class that is the beneficiary of this liquidity largesse is typically that segment of the market which has the best fundamentals. We have already seen this dynamic in play post-1998, when the liquidity pumped in by the Fed found its way into the tech sector,

which had great fundamentals at the time. A similar move happened in 2001, when post 9/11 the Fed cut and once again this liquidity eventually found its way into the housing sector (which again had good fundamentals at the time).

My own guess is that the chief beneficiary of this new cycle of interest rate cuts and liquidity injections will be emerging markets more generally and Asia specifically. The emerging markets have never had better fundamentals, and report after report is talking about decoupling and how we are transitioning towards an EM-led world. Investors never tire these days of pointing out how Asia runs a current account surplus, has fiscal flexibility and far lower leverage than the West. The earnings trajectory and capital efficiency of Asia is also now superior to the more developed markets of the US and Europe. Valuations in Asia, while not cheap, are still far below what they were the last time Asia was in fashion in 1993-94.

In this correction EMBI+ (Emerging Market Bond Index) spreads have widened far less than high yield bonds and the whole asset class has bounced back strong from initial jitters, indicating that investors are buying into the whole decoupling thesis. Contagion has not really spread from the developed credit markets into EM equities.

Commentators are making the point that just as a strong US economy bailed out the world post the Asian crisis and implosions across the EM world, robust growth in Asia will bail out the world this time. The asset class is acting far better than you would have guessed in an environment of global risk reduction and de-leveraging. The price action of the whole commodity complex also seems to indicate that markets believe that strong Asian growth can sustain the global economy despite the US slowdown.

As Asian corporate and economic performance holds up in this US led slowdown, you are likely to see more institutions hike their allocations towards Asia and EM, and the flow of money this will trigger can also be massive. In most surveys, you can clearly see that even the most sophisticated investors like endowments and family offices are below their intended long-term weights in Asia and the EM class as a whole. The contrasting fundamentals between Asia and the US over the coming 12 months will likely accelerate this structural asset allocation shift.

Post a Fed easing cycle, money has always flown into that asset class that has shown the best fundamentals and growth at that point in time. If you see current market behaviour, investor positioning and actual fundamentals, my own guess is that Asia can be the biggest beneficiary of the Fed's easing. Asia has now become the strongest link in the global economic and financial system, and will be priced as such.

As an India-specific aside, I cannot imagine now how the RBI's next move will not be to ease rates. Inflation has already come under control, we are about to enter an election cycle and every major central bank in the world has kept interest rates steady or cutting them. If, as it appears, the RBI will cut rates from here on, that is a huge positive for India. However, the concerns the RBI seems to have on capital inflows will only accentuate in the above environment; capital outflows from India will have to be

liberalised, and the RBI will soon have no choice on this. Another dilemma is the currency — let it appreciate? Or should we risk a sharp rise in domestic liquidity as the RBI keeps buying up dollars.

Again one cannot predict the next couple of months, and we could very easily go through another rocky patch for markets as investors start pricing in a more negative outcome for the US than the current consensus. However post that I still believe, the new Fed easing cycle will be a huge positive for Asia and the EM asset class. Asia and its companies have the best growth, returns and visibility, all of which become even more valuable in a choppy global economic environment.

What Now

August 22, 2007

The sub-prime crisis is unlikely to affect India much.

As was to be expected, as soon as investors had become complacent about risk, it came out of nowhere to bite us. Having gone through a couple of wrenching weeks, in which volatility was all-pervasive and all sorts of doomsday scenarios began to gain credence, the important issue to focus on now is how the investment scenario will change going forward. What will be the longer-term impact of this sub-prime crisis? Once this de-leveraging and re-pricing of the risk cycle gets completed, what investment assumptions will investors need to rejig as they look forward?

First, one clear message and outcome of this crisis is that US growth will be impacted and the US will grow slower than one would have thought even two weeks ago. Whether the US slips into a recession or not is still a moot point, and one will have to track that very closely, but a significant slowing of the US in the second half of this year is now baked into the cake, so to speak. One just has to read any research of the type of loans being originated, the large-scale prevalence of fraud, and the quantum of loans still to be re-priced, to understand the full magnitude of the impact this crisis will have on the US economy and its growth trajectory. The impact of this coming US slowdown will also, stress-test the global decoupling thesis. Can the global economy really continue to grow at nearly 5 per cent, even with the US clearly faltering badly? Can global markets also decouple from the US? This is after all, from an economic perspective, largely a US problem; no other geographical area has really participated in this sub-prime frenzy. Financial institutions in other countries may have to take a hit because of the sub-prime exposure and over-active treasuries, but their economies should not.

If, however, global growth does get impacted, what will be the implications for commodities and other more cyclical assets? This is an issue all investors will have to ponder on. Could this mark a turning point in the global growth cycle, and are we about to see sector rotation away from cyclical and commodities?

Secondly, interest rates in the US definitely and most probably globally will come down by more and faster than one would have budgeted for earlier. This will have its own impact in terms of increasing the attractiveness of equities and other growth assets, boosting liquidity and should eventually cushion any fall in these asset classes.

The third impact that comes to mind straight away is a further weakening of the dollar. With the US economy being hit the hardest, and seeing probably the greatest adjustment in interest rates, this will put pressure on the currency. On top of this, with so much damage being inflicted on the US debt markets, their liquidity and credibility, one should expect many investors to reduce their exposure and commitments to certain parts of these markets. Given the huge financing requirement of the US current account deficit, any reduction of capital inflows into the US can have a significant impact on the currency.

The fourth impact will be on the whole gamut of structured products, as investors were clearly buying assets of which they understood very little, and were blindly relying on credit rating agencies and the originating investment banks to guide them. The risk appetite of all these investors has taken a severe beating, and they are unlikely to touch more exotic instruments for some time. The inevitable outcome of this will be reduced access to capital for smaller less-established companies as the high-yield markets become more constrained.

Given the above context, I would argue that after the next couple of months, when all the forced selling and redemptions are done with and markets once again settle down, the above changes in the global investment environment may actually favour markets like India. Investors will be looking for strong growth stories that are independent of the US economy, and India fits the bill perfectly. We are in the midst of a huge domestic capex cycle, driven by infrastructure, and this is complemented by a strong domestic consumption story driven by demographics, income distribution and retail finance.

The visibility of 8 per cent plus GDP growth is very strong, and I do not expect any significant change in India's growth trajectory because of the problems in the US. Exports as a percentage of GDP are the lowest in India among all Asian countries and we as an economy are much less exposed to the US consumer than most in Asia. The larger Indian companies have very limited leverage on their balance sheets and we are not overly reliant on foreign capital for our growth. When investors look for growth visibility and sustainability, India should stack up very strongly.

Also, if the global interest rate cycle has turned, then one would also expect the RBI to be more cautious about tightening domestic monetary policy. The biggest concern on the domestic growth story has been the possibility of the RBI being too zealous in tightening, and slowing down the economy too much. Many of those concerns will recede if, as looks likely, the global growth and interest rate cycle has turned. A possible correction in commodities will also dampen inflation concerns.

India is also a more expensive but higher-quality growth story compared with most of the other markets in Asia. We are more expensive on PE multiples but have better return ratios in terms of RoE (return on equity) and free cash generation. Indian companies also tend to have much better-articulated growth strategies. In an environment where interest rates are dropping and sustainable, visible growth is hard to find, those few economies which can demonstrate a high visibility of earnings and economic growth should see a valuation expansion. There is a possibility this can happen in India as well.

The whole emerging markets asset class will have a few choppy months as the full extent of deleveraging and quest for liquidity plays out. India will be as badly affected as any of the other large emerging markets, in this indiscriminate bout of risk reduction. We also of course have the possibility of shooting ourselves in the foot by overlaying political risk on top of all the other global factors. However, at the end of this in the new market environment which will emerge, India should actually be a beneficiary.

It is already probably too late to sell now, instead focus on building positions in high quality companies trading at reasonable valuations. This bull market is not over.

When Experience is a Liability

July 25, 2007

Analysts and investors are optimistic on India, but it is difficult to be as bullish.

The strength of the Indian stock markets over the past month has been nothing short of breathtaking. Crossing the proverbial wall of worry, the market has shrugged off huge equity issuance and just kept on powering ahead. To be fair, this is a global phenomenon, with new highs being registered in both the US and the broad emerging markets indices as well. Despite the obvious distress in the US sub prime markets, and some spillover into debt spreads, the contagion from a possible \$50-100 billion loss to the financial system has been remarkably muted. Confidence seems to be all-pervasive and equity markets Teflon-coated.

The Indian markets have been able to shrug off the huge issuance of equity paper as new sources of capital have been tapped, which enabled issues to sail through with minimum disruption and diversion of capital. For the Sterlite fund raising, many of the orders were put in by specialist commodity funds, hitherto inactive in India. For ICICI Bank, a core group of shareholders were joined by a large PE fund putting in a billion-dollar cheque. DLF had huge participation from the Gulf. ICICI Holdings also attracted a bunch of atypical private equity and venture capital players.

Obviously, the India story continues to gain traction and suck in new investors. We have already crossed last year's total FII inflow number of \$8 billion by July itself, with July turning out to be the best month for FII inflow ever.

To complement the broadening of the global investor base, we are also seeing the growing influence of domestic insurance companies in the equity markets. Due to unit-linked schemes (with a very high weighting in equity) being the most popular type of insurance being sold, we find a new and sustained demand for equity developing under the radar of most market participants and daily SEBI reporting. Some insurance industry veterans estimate that this year over Rs 15,000 crore will be pumped into the equity markets from the private sector insurance industry alone, and if you include LIC the number jumps to Rs 30,000 crore. This is something like \$600 million a month and growing at 50 per cent per annum. This money also tends to be invested in large, well-established and more liquid equities, given the eligibility criteria laid down by the IRDA. This flow into the markets is secular and structural, and more than half of these flows are coming from non-metro centres. The insurance industry, with its huge distribution reach and focus, has spread the cult of equity far wider and deeper than what mutual funds have been able to. One unintended consequence of private sector entry into insurance may be that we have finally found our bulwark against the power of the FIIs!

Maybe this is part of the puzzle when one tries to understand who is buying in these heated markets, as most of the old India hands maintain that they are underweight in the market and unwilling to buy.

I have also been surprised by the enthusiasm of some very large global investors I have had the privilege of meeting recently. They continue to feel that India is much cheaper than China for similar earnings growth and that Indian companies are much better-run than most in Asia and will continue to blow away analysts' and investors' earnings expectations. They feel that the strong inflow into India will continue and see no reason why markets should come down. India without currency gains has actually lagged the region, and with most investors feeling that the RBI is done with the tightening, the only obvious headwind to India catching up with the rest of the region has lifted, to their mind. Earnings and economic growth will accelerate again 12 months down the road—this is their feeling.

They were actually arguing that one should expect to see country rotation driving money into India over the coming months. While they acknowledge that valuation is not cheap, they say that no market with the type of long-term visibility of earnings offered by India is cheap anywhere on the globe. They feel paying 17-18 times earnings is not out of line for 20 per cent long-term earnings growth.

While I can see their point of view and they may also be right I still find it difficult to be as bullish. It is true that the RBI is probably done and the next move in interest rates is south. Also most of the so-called smart money is cautious, and mutual funds have raised Rs 6,000-7,000 crore in the past month or two, of which very little has been deployed, and if the experts are right we are in for another year of 9 per cent plus economic growth. The market is also acting very well indeed, shrugging off short-term worries on the rupee, corporate profitability and politics. Price action indicates great underlying strength in the markets, and any correction is unlikely to be driven by local factors.

Yet it all seems too easy.

In my experience whenever making money becomes deceptively easy, one should be on high alert, for it is in the best of times that the worst mistakes are made. In an environment like today one can easily get carried away and forget about risk.

Experience has become a handicap today, as people with long memories tend to lose out to the young Turks in identifying and backing the hot new entrepreneurs and companies of the day (many of whom have a long and chequered past). The new kids on the block seem prepared to pay for embedded value and the sum of the parts in just about any company and have little concept of execution risk or business cycles. The older more experienced lot tends to be more cynical and, having bought into ten-year visions in the past only to see it all crash and burn, cannot pay up now. They know markets cannot go up forever, and having seen tough times before are finding it difficult to compete with a set of investors who have only seen a rising market. In today's market the more questions you ask before buying, the lower the returns you are likely to deliver.

Confidence is overpowering caution and anything seems possible. Markets are actually rewarding equity issuance and focused only on top line growth, ignoring profitability and capital efficiency. Investors are scared to sell and are being pressured to buy without adequate preparation and analysis. For any deal there are multiple suitors, and money appears to be the ultimate commodity. Times like these do not last forever, they cannot, but as always it is impossible to predict when a nasty shock is just around the corner.

I still believe in the long-term India story, and believe one can make superior returns on a 3-5 year basis, but we need to tone down our exuberance; as soon as we forget about risk, that's exactly when it will magically reappear.

Return of Emerging Markets

July 11, 2007

We need to deliver strong 8 per cent plus GDP growth and near 20 per cent earnings to justify and fulfill expectations.

Last week marked the 10th anniversary of the Thai baht devaluation, the event in hindsight that saw the beginning of the Asian crisis. Given the severity of the crisis and how deeply it affected most Asian economies, one saw numerous research reports marking this anniversary and providing perspective on what actually happened. It is also amazing to see and reflect on just how strongly the whole emerging market (EM) asset class has come back into fashion from the dark days of the end of 1997-98.

At the bottom of the Asian crisis, the whole EM asset class was called into question, and there were many people even calling for the death of the asset class. At the bottom, even on a 10-year basis investors had only lost money (in dollars) in most emerging markets, and at a time when the US and European markets were forming new highs. Given all the economic issues these markets faced in the 1990s, the volatility of returns in the emerging markets was also much higher than in the US and Europe. Savvy investors were justified in asking as to why they should invest in an asset class that had higher volatility and delivered to them lower returns than simply buying the S&P 500. Why should they take the risk and make the effort of buying companies in far-flung geographies (with the corporate governance headache), yet still get lower returns than buying GE?

Of course all that was then and such talk marked the bottom of sentiment towards emerging markets. Over the last few years, the emerging markets asset class has come roaring back.

At its bottom in August-September 1998, the whole EM universe traded below book value and at a 70 per cent discount to the price/book multiple of the MSCI World index. The return on equity (RoE) for the entire EM universe went below 5 per cent and even on such low profitability, PE multiples were at a discount to the MSCI World index.

Since the beginning of 1999, the MSCI EM index has outperformed the MSCI World index by a compound 12 per cent per annum in dollar terms (source: Morgan Stanley) and we have seen convergence in all valuation multiples (price earnings, price/book multiples and dividend yields are all either at or very close to parity between the MSCI EM and MSCI World). Forget a discount which had been the norm, many of the EM bulls are now making a case as to why the EM universe should trade at a premium, given its higher growth rates and higher ROEs.

Given the sustained out-performance, we have seen more and more institutions and individuals raise their weightings towards the emerging markets with many taking a secular long-term view of where the future engines of economic growth reside. This

process of reallocation of capital from the US and Europe towards Asia, Latin America and the BRIC countries is still ongoing. To the extent this is a secular shift in capital allocation, you have a natural bid towards the EM asset class as most institutions are nowhere near their long-term desired weightings, and the quantum of capital which can shift is large enough to impact the asset class.

Having had such a huge run, many market observers are now beginning to get nervous on the EM asset class. Obviously emerging markets cannot continue to outperform the developed markets indefinitely. Since the valuation gap between the emerging markets and developed markets has closed, for the EM asset class to continue to outperform either valuations will have to go to a premium or the EM universe has to sustain higher earnings growth. The other longer-term secular driver of returns is the continued likelihood of currency appreciation for most of the larger emerging markets. The bulls make the case as to how earnings in the EM universe will continue to outpace their more developed brethren, and lay out the economic rationale for this in terms of demographics, outsourcing, domestic consumption, etc.

Be that as it may, the fact is that it will be much harder from here on for the EM universe to sustain continued relative out-performance vis-à-vis the MSCI World Index. Even if out-performance does sustain it cannot be at double-digit levels.

Given the above backdrop for the EM universe we should not get carried away in India. The country has had a huge run since 2003, and been one of the better-performing markets in the EM universe, but this has also been an extraordinary time for the whole asset class. If sentiment towards the asset class weakens, India will go down irrespective of what is happening on the ground.

It is true that India has now been truly discovered, and, being a trillion-dollar economy and with greater than a trillion-dollar market cap (just crossed Korea), it can no longer be ignored. However, having become part of the EM mainstream, we are much more hostage to global EM sentiment and flows than the case historically.

The issue for investors in India is whether at 8-9 per cent GDP growth, the country can experience its own version of the goldilocks scenario. Has our growth potential expanded enough so that 8 per cent GDP growth is slow enough to not cause overheating and a surge in inflation, but still fast enough to sustain strong near 20 per cent corporate earnings growth?

Can we improve our productivity performance so that even at 8 per cent growth, inflation behaves and the RBI is not compelled to intervene and spoil the party? If we can sustain this growth dynamic, then it is incredibly powerful and one can then argue for sustained high earnings growth and therefore PE multiples. This dynamic can trigger and sustain a virtuous circle like what we have experienced over the last 3-4 years. Strong economic growth leads to strong earnings, which lead to strong markets, and strong markets allow companies to access capital to invest and sustain the economic and profits growth.

India now has the burden of expectations. Investors and, for that matter, voters will no longer accept even 7 per cent growth. We need to deliver strong 8 per cent plus GDP growth and near 20 per cent earnings to justify and fulfill expectations.

Are we, as a country, doing enough to improve our long-term growth potential through sustained productivity improvements? The corporate sector in India is clearly doing its part; it is the government that worries me. We still have far too many rigidities in the system that remain unaddressed. These have to be addressed and the so-called second generation of reforms have to be more than an esoteric concept or buzzword.

A Stealth Correction

May 23, 2007

If you talk to most investors, you will find them a disgruntled and frustrated lot, which is surprising given that Indian financial markets are having the time of their lives, or so it is commonly perceived. If you were to read the general press, you would also think that we are in the midst of a huge bull market, and for most new investors their biggest worry about India is a feeling of the markets being much overextended. They feel they have missed the run.

While it is true that the markets have had a dream run since 2003, rising by 370%, the performance of the last 12 months has been very different from the three years prior. Rising from a level of deep undervaluation and investor skepticism, the first three years of the bull run was a time of broad market participation and a rising tide lifts all boats type of a market. The last 12 months has been quite different.

The BSE SENSEX is up only about 11% in rupee terms over the last 12 months, with the MSCI-India index up about 23% in dollars and 13% in rupees. So global investors have benefited from rupee appreciation, and got much higher returns than the locals. While the headline performance numbers mentioned above are decent and competitive they hide the extremely weak breadth of returns.

As a recent strategy report published by Morgan Stanley in India (dated 15th May 2007) highlights, while the Sensex may have given us returns of about 10-11% over the past 12 months, this entire return is due to only 5 stocks. Reliance, Bharti, Infosys, Reliance Communications and ICICI Bank have accounted for approximately 130% of the sensex return of the past 12 months, implying that if you did not own these 5 stocks but everything else in the Sensex, then you would have had a negative return. It was not always like this, markets have not always been so narrow, as between 2003-2006, the top 5 performing stocks in the Sensex accounted for about 50% of the index performance.(source: Morgan Stanley).

This phenomena is not restricted to the Sensex only, but actually gets even worse as you look at a broader basket of stocks. Morgan Stanley have highlighted in their report that the median return of the market over the last 12 months is actually -17%. They have looked at a basket of 2389 stocks that actually traded over the past 12 months, and pointed out that 67% of these stocks actually delivered a negative return, and while the median return of this entire universe is -17%, the median return of the 67% of stocks which declined was -30%. Now this hardly seems like a raging bull market does it? Two out of every three stocks which traded over the past year are actually down, and that too quite significantly.

The above statistics highlight just how difficult it has been to make money over the past 12 months and also why most funds have found the going so treacherous. It is understandable why the majority of funds have found it so difficult to beat the market. Either you were in the 5 stocks highlighted above, or most likely you have underperformed and not made money.

Now what are the implications of such a narrow market? The positive spin to this is that we are undergoing a natural corrective process, and that the market, reacting to the interest rate hikes is gradually de-rating in terms of PE multiples. While the markets may have been over exuberant last May (when mid and small caps were in full bloom), this is now getting naturally ironed out and prices taking a breather while earnings catch up. A decline in trading volumes also indicates that retail participation today is far less than 12 months ago.

Taken in this light, the last 12 months is a very healthy pause that will refresh. It also questions the view of the bears who are constantly worried about market excesses. If the majority of traded stocks are down, how can the market be over exuberant? As to how long this consolidation phase goes on is unclear, but at some stage the de-rating process will stop.

The negative view is that we are seeing the last stage of the market rally, where-in the breadth has narrowed dramatically and soon even the narrow indices and top 4-5 stocks will cave-in and follow the broader market down. This camp points to the narrow breadth as a sign of weakness and not a reason to be less concerned on the market.

While I don't think this narrow breadth is a precursor to markets collapsing, I think this corrective phase will continue for some more time as investors need to figure out the impact on both earnings and growth of a tighter monetary environment. The longer term impact of the rupee is another variable investors need to deal with.

The huge pipeline of capital raisings is also a concern in my mind. We should expect to see atleast rupees 50,000 crores of equity fund raising in the next 6-9 months, yet no one seems to be worried. The average investor has not made money in the past 12 months, most funds have underperformed and FII flows into the country are weak and significantly lower on a year on year basis,yet everyone is sure all issues will be subscribed. While it is true that the quality of paper coming to market is good and should get subscribed, where will the money come from? Will this quantum of fund raising not put pressure on markets?

The Indian markets are not as overextended as commonly perceived, and except for a small group of mega caps, are already in correction mode. My own sense is that this corrective phase will extend and broaden aided in part by the largest equity issuance pipeline I have ever seen. The attempt over the last week is to try and broaden the market rally and get even the mid caps to participate, aided no doubt by investors of all hues recognizing the narrow breadth of the rise. Many investors are using strong global markets to try and force local investors to commit. While this may continue for some time it is unlikely to last

A further period of consolidation awaits.

Here come the Sovereigns

May 9, 2007

The government needs to shed its risk aversion and be willing to trade higher risk for higher long-term returns.

In recent times countries increasingly are beginning to appreciate the need to manage their large foreign exchange holdings in a more strategic manner. Be it Korea, Russia, China and now maybe even Japan, countries with very large foreign exchange reserves are realizing the opportunity costs of keeping these reserves invested only in G-3 government debt or, worse still, bank deposits. They are beginning to carve out a portion of these reserves and setting up specialist investment organizations to manage these long-term pools of capital. These dedicated investment organizations are following one of two models. Either they can be modeled on the GIC (Government of Singapore Investment Corporation) and invest in all types of financial assets globally, and become effectively multi-asset fund managers, or they can be more like private equity, focused on buying strategic stakes in select companies—like Singapore's Temasek Holdings.

Whichever model is followed, the end objective is clear—the organization has a clear mandate to focus on returns, broaden the asset allocation and accept higher risk.

These changes are being driven by the huge surge in global foreign exchange reserves, which, at \$5 trillion, have increased by almost a trillion dollars in the last 12 months alone. This spike in reserves, which shows no signs of abating, has been accompanied by a realization that most countries are already holding reserves way in excess of what they need for liquidity purposes. An additional factor driving this trend is the acceptance by many countries that oil stabilization/windfall funds initially set up to smoothen out the impact of fluctuating oil prices may be more permanent in nature than thought previously. Being more permanent in nature, these oil funds can also be managed as long-term pools of capital like the FX reserves.

Setting up these sovereign long-term pools of capital is a new development that investors and policy makers need to understand and track.

As Stephen Jen of Morgan Stanley has pointed out in numerous articles on the subject, the size of these so-called sovereign wealth funds is already nearly \$2.5 trillion. These long-term pools of capital, which, over time will look more and more like multi-asset mutual funds, are distinct from and already almost half the size of the total quantum of foreign exchange reserves (approximately \$5 trillion). Mr Jen also makes the prediction, using realistic assumptions that these sovereign funds will increase to over \$12 trillion in size by 2015, surpassing the total size of the world's FX reserves. In fact he predicts that by 2011 itself, the sovereign funds, will equal and then surpass global FX reserves at \$6.5 trillion.

While currently the three largest sovereign pools of capital are ADIA (Abu Dhabi Investment Authority, with a rumored size of \$800 billion), GIC (Government of

Singapore Investment Corporation) and Norway's global fund (to handle windfall oil profits), China's SFIC (State Foreign Exchange Investment Corporation) will soon join this club and eventually become among the largest pools of capital in the world.

Such a large and growing long-term pool of capital, which is moving away from government bonds into riskier equity—corporate bonds and real estate assets—has investment implications for all asset classes and markets.

First of all, it creates a large and sustained incremental demand for risky assets like emerging market debt and equity and equities more broadly. Even if one assumes that only 40 per cent of these funds are invested in equities, as these funds increase in size to over \$6 trillion over the coming five years, that creates an incremental demand for \$1.6-2 trillion of equities, not a trivial amount. This is a new and more structural demand for risky assets. Given the nature of the countries running these surpluses (mostly Asian, including West Asian), one can expect them to be comfortable holding emerging market assets, and thus the impact of this new long-term and structural demand will be even more significant for the emerging markets.

Secondly, to the extent that some of these reserve pools adopt a more private equity approach and attempt to buy real assets, we run the risk of financial protectionism rearing its ugly head. The experience of Dubai ports in dealing with the US authorities is a case in point. Issues of this type will recur as economic nationalism prevails on both sides.

A movement of funds of this quantum away from risk-free government securities into riskier equities and corporate bonds also has the potential to impact bond yields and even currencies.

All of the above once again leads one to ask as to why India has still not thought about or implemented a plan to better manage our own burgeoning reserves. We are already at \$200 billion and counting, and surely the RBI cannot think we need this entire corpus for liquidity purposes. Even if we want to be conservative and assume that \$150 billion is needed for liquidity and only \$50 billion can be carved out into an investment pool, an additional return of 4 per cent per annum on this pool will generate an incremental \$2 billion of national wealth per annum.

This investment pool can also be used strategically to acquire real assets globally, in case the government retains an allergy towards higher-risk financial assets. It can be turned into an energy security fund, for example, and used to supplement the efforts of ONGC Videsh in acquiring energy assets globally. If we as a country aspire for global leadership in certain sectors or technologies, can this investment pool not be used strategically to fulfill this ambition in partnership with corporate India?

To the extent, that management of this investment fund is farmed out to global investment advisors (till adequate skills are developed in-house), it can also be an effective tool to develop Mumbai into a global financial centre. Mandates can be strategically handed out to only those organizations that set up full-fledged offices and operations in Mumbai. As global fund management mandates begin to be run out of

Mumbai, this will create its own eco-system of service providers and put us on the global map as a source of capital.

The government needs to shed its risk aversion and be willing to trade higher risk for higher long-term returns. We are now the only economic power in Asia still unwilling to go down this road. Given that Korea, China, Taiwan and now most probably even Japan have seen wisdom, what is holding us back?

An Uncertain Time

April 25, 2007

The inevitable consequence of an uncertain economic or stock market outlook is a market de-rating.

The current environment for global equity markets is full of uncertainties and dilemmas. This picture holds true in even greater measure for Indian equity markets. Though one would not be able to guess judging from the way markets globally have rebounded since end February, uncertainties about the future outlook are higher today than almost at any time in the last few years.

First of all, if we look at global markets, the big issue remains the US economy. Will the economy in the US go into a recession? Can the US consumer once again dodge a bullet and overcome the housing slowdown? How will the impact of the sub-prime meltdown affect financials (nearly 30 per cent of US earnings) and the broader economy? Can the global economy truly de-link from a US slowdown as markets and commodity prices seem to indicate? Can the huge improvement in US corporate profitability be sustained? Are we headed towards stagflation in the US as productivity slows in sync with a slowing economy? Will the Fed really be in a position to cut rates by the middle of this year and bail out markets, as many people implicitly assume?

Many questions to which the answers are not intuitively obvious. While the markets have broken out to the upside, I still feel that the environment will not be easy as people think. Investors seem to be willing to ignore risk and implicitly assume that things will eventually work out just because they have in the past few years. The bears have been harping about these issues for years now, but always been wrong. There seems to be a lot of complacency among investors and an unwillingness to look at negative data points.

Even in China, the environment is clearly worsening. You have a situation wherein the government clearly wants to slow down the economy and curb investment growth. While they may not succeed in the short term, the direction of government policy and intention is clear. This cannot be good for financial markets, and, as we discovered in February, China does matter.

As for India, the environment has also clearly worsened. The big issue is the extent of the oncoming slowdown, for a slowdown itself is now inevitable. Will the economy drop from 9.2% GDP growth to 8% or will we drop still further? We as a country have now got used to GDP growth in the range of 8-9%, even 6%, the long-term trend till 2003 will now seem like a recession. If the RBI has overshot and we do drop below 8% economic growth, then the markets will have a problem as corporate performance will clearly disappoint. We will very quickly build excess capacity across sectors in such a scenario.

The other concern I think investors have is the uncertainty around government policy. The actions taken by various ministries designed to control and direct industry-level prices and profitability do not inspire confidence. Investors are now wondering which industry is next, and what the government will do this time. What prevents the government from deciding that some other industry is making too much money and going after it? A certain predictability towards government economic policy making has been lost. If someone had told you a month ago that the GOI will discriminate against Indian cement manufacturers, in favor of cement imported from

Pakistan, he/she would have been laughed me out of the room, but that is exactly what is happening.

India is ultimately a growth market, and the value of a growth company depends on its future expected profitability. The higher the predictability and absolute level of future profitability, the higher will be valuations, to the extent you cannot predict future profitability or it gets clouded because of extraneous government actions, the value of a company or market will reduce. Till three months ago, the cement industry had probably the best visibility among sectors in terms of demand/supply balance and expected profitability, but all that changed with a stroke of the government's pen. Actions such as this will bring into question why investors should be willing to give a high valuation to any company or sector in whose economics the government can interfere.

Investors are currently willing to ignore these actions on the part of the government as being driven by short-term political considerations; if, however, this continues or broadens, it may cause serious damage to the market and multiples.

Even the actions of the RBI appear to be more aggressive than required. They seem to feel they have fallen behind the curve and are now scrambling to get in front of inflation expectations. Everyone is convinced that over the next couple of months, the inflation numbers will come down on their own through crop arrivals and the base effect; yet the RBI deems it fit to tighten the monetary environment in between monetary policy meetings. What does the RBI see that we investors do not? What is the endgame of the RBI? If we have a poor monsoon in June-September, does that mean that the RBI will keep tightening monetary policy to counteract the price impact of poor harvests independent of economic growth?

All this uncertainty is negative for markets and has to have an impact eventually. The one thing investors hate above all else is uncertainty; it is corrosive for markets and especially valuation multiples. The inevitable consequence of an uncertain economic or stock market outlook is a market de-rating, as investors reduce risk appetite and market commitments.

Rising interest rates are another factor that will serve to pull down valuation multiples, as the required rates of return on equity investments rise.

The market multiples in India have risen from about 10 times one year forward in 2003 to something in the region of 16 times currently. This PE expansion has been a big driver of the market rise along with strong earnings. This PE expansion story is now more or less done, and we should expect if anything some de-rating of multiples from here. The market has only the earnings growth plank left, and one should keep a hawk eye on earnings trends; any damage here and the market is in trouble.

The Impact of IT

27 March, 2007

The Information Technology (IT) and BPO (Business Process Outsourcing) industry is a fascinating success story which all Indians are justifiably proud of. The IT/BPO industry has put India on the global map and demonstrated that there is no reason why Indian companies cannot aspire for leadership and excellence. While everyone is aware of how well this industry has done and its growth trajectory, I have till now never seen any study from the financial community quantifying the impact of this sustained growth on the broad economy.

This gap has now been plugged by the release of a new report by CLSA entitled Chain Reaction,(written by Bhavtosh Vajpayee and Anshu Govil). The report tries to lay out the implications of strong IT sector growth across the economy and some of its conclusions are fascinating.

The report points out that while IT/BPO exports have been on a tear over the last two decades reaching about \$30 billion in Financial year 2007, over the next 3 years the industry will double (\$60 billion export target in 2010) and thus its incremental impact over the coming three years will be similar to what it has achieved over the last 20.

The industry is expected to create over 1.7 million new jobs directly and using a conservative multiplier of 1.4 (every IT job is expected to create 1.4 new jobs in other sectors), about 2.3 million indirect jobs over the coming 3-4 years. This level of job creation implies that the IT industry will absorb 80-85% of all the employable engineers and about 60% of all quality graduates. While this is great for youngsters entering the job market it highlights the difficulty the rest of corporate India will face trying to hire young professionals. If the IT industry alone is going to hire 80% of all engineers then who will join manufacturing and industry? Where will we for example get engineers to put up the 100 million tones of cement capacity coming up over the next 4-5 years? This highlights again the need to dramatically boost the capacity and quality of our education system, and the imperative for every large Indian company to put in place adequate internal training and hiring infrastructure. The quality of this infrastructure will be a competitive advantage.

From a broad economy perspective, this job creation is good news as the report points out that every year about 4 million people enter the job market in urban India, and thus over the coming 3-4 years the IT industry (both directly and indirectly) will absorb nearly 35% of this emerging urban workforce. If you take both urban and rural India, about 13-14 million people enter the working age population annually, the IT industry has the potential to employ 10% of these people.

The impact of IT on real estate is also significant. Using a Cushman & Wakefield projection of 850 million square feet of residential demand till 2010, the report points out that about 70-75% of this incremental residential demand will cater only to the IT sector(for both rental-cum owned housing). Even for commercial space, the demand projection is for 155 million square feet of commercial space in India till 2010, The IT sector alone will account for about 65% of this, even after assuming that the sector builds about 50% of its own space and leases only 50%. Going by the above, the real estate story in India may have less hype on demand than many investors currently think. There is no doubt that the IT sector will not be allowed to gobble up 65% of incremental commercial space.

The growth of the IT sector will also play a huge role in creating a vibrant middle class in India. Between 2002 and 2010, India will add 4.4 million households to the upper middle class of which about 20% will be accounted for by IT. Between 2002-2010, the report points out, that 21 million households will be lifted out of the deprived category (less than 100,000 income) and the IT industry through indirect job creation will account for at least 20% of this upliftment.

Even on the tax front the impact is tangible, over the next 3-4 years 13-14% of all income tax collections will come from IT employees.

The report predicts that 20-25% of India's nominal GDP expansion over the next three years will come from the direct and indirect impact of the IT sector, which is a huge number for one sector to deliver.

While one may differ on certain assumptions made in the report and some of the findings, it is clear that over the coming 3-4 years IT will be a critical driver of the India growth story. If this is the impact IT will have, it will be interesting to try and forecast what will be the impact of the emergence of retail and financial services on the Indian economy. These are two new sectors which have the potential to employ millions and really broad base growth across regions and skill sets. If the IT sector can have this quantum of impact by directly employing 3.5 million people over 20 years, what will be the impact of organized retail and insurance which will employ at least 5 million in 5-7 years? These may be lower paying jobs but their impact will be magnified by the compression in scale up time.

Also the investment in retail (with Reliance alone investing 25,000 crores) seems to be many multiples of the money invested in IT.

For all the panning by the left of MNC's, the fact is that if you trace the history of the Indian IT industry, its birth and growth can really be traced to the willingness of GE, Nortel and one or two other global companies to outsource work to India. If they had not come to India this industry would never have taken off. It once again highlights the importance of opening up and integrating our economy with the world.

The impact of IT is also significant as a role model to which companies and individuals can aspire to. It set the precedent of how to build wealth through market cap. and good corporate governance and changed the goalpost of investor expectation.

The industry also delivered despite all the infrastructural and procedural headaches and stopped corporate India from hiding behind those excuses. It demonstrated that if freed of governmental interference and outdated legislation, Indian companies can be world class.

The impact of gaining global scale in just one industry is there for all to see and are there any other sectors where India can aspire for global relevance? Is the generic pharma story big enough? Can auto components/auto drive manufacturing? Will textiles finally achieve its potential for job creation?

We need at least one more sector to breakout and deliver global scale. Given the current confidence of corporate India, I am sure it will happen.

Keep The Faith

16th March, 2007

The Indian markets have just gone through another wrenching correction, where-in the markets have dropped by about 15%. If you exclude 3-4 large cap stocks like Reliance, Bharti and maybe ICICI, then most stocks are down more than 20%. India is also till date the worst performing emerging market (among markets of relevance), and has experienced greater volatility than most. In what is now becoming a pattern, at the first signs of international turmoil, India corrects and corrects hard.

This correction traces its roots to both international developments as well as the underwhelming performance on the budget by Mr. Chidambaram and co.

On the international front, as has been widely discussed, the sharp appreciation in the yen leading to fears of an unwinding of the carry trade spooked investors globally, as also weaker than expected economic data out of the U.S. All markets corrected, across geographies and the risk spectrum.

Though frankly I think all this is just an excuse for risk reduction, as risk appetite had got out of hand, with spreads for all types of risky assets compressing to silly levels, and complacency widespread. While things seem to be now slowly settling down, prior periods of risk reduction have stretched for at least 3-4 weeks, and it may be unrealistic to assume that everything is fine again in just about a week. We should expect some more turbulence and volatility before we can give the all clear to global markets.

On the budget presented by the Finance Minister on Feb. 28th, the market has clearly given it the thumbs down, and the disappointment felt by the market only served to further hammer sentiment. Without getting into micro details on the budget, I think the market's disappointment stems from 2-3 specific macro issues.

First of all, to me this budget highlights how little room for maneuver this government has on reforms. If this is the best that Mr. Chidambaram can deliver, with still 2 years to go for national elections, then we should not delude ourselves into thinking that this government is reform oriented. We should accept that nothing will happen over the coming 2 years on a whole host of pending issues, be it financial sector and pension reform, FDI caps or subsidy rationalization. Nothing even remotely contentious or difficult will be attempted. It is sad that Dr. Singh has let the reform agenda get sidetracked in this manner, but whether the left is at fault or higher ups in his own party, only insiders know the truth.

Secondly, the manner in which the Finance Minister has been conservative in budgeting for revenues bothers me. This FM has always been aggressive in assuming high tax revenues, and then pushing the government machinery to deliver on the revenue targets. He has always bet on growth, and normally delivered. By assuming only 15-16% growth in tax revenues for the coming year despite achieving near 30% growth in 06-07, what is the FM signaling? Is he trying to lowball the revenue numbers so that he is not forced to accede to more requests for handouts and can keep some semblance of fiscal order in expenditure composition?

Or is the FM accepting that an economic slowdown is around the corner? He cannot say publicly that he expects the economy to slow, but his revenue numbers indicate limited buoyancy. If the economy is to continue growing at 9%, I cannot believe that he truly expects such a limited

performance for tax revenues. Even more worryingly, he expects corporate tax revenues to rise by only 15%, after they grew 40% in 06-07. What does the FM know or see that we don't?

I only hope that he has been conservative on revenues to keep the big spenders in check, but let us see how the year pans out.

The third worrying signal is the re-emergence of the tendency on the part of the government to play god, and fiddle with industry specific economics. Why target the cement industry? Is it really that crucial to bringing down inflation? Why is the government deciding what is excess profit? Who will the government target next, car companies, builders or maybe FMCG companies? Are we slowly lurching back to price control and forgetting that we are supposed to be a market economy? I hope not and believe that the FM is too smart to let this happen, but it again highlights the politicization of economic policy making.

The issue now becomes what does one do at this stage of the market?

If we go back to first principles, then let's remember why we were bullish on Indian equities in the first place. The core reasons were as follows:

1. The Indian economy can grow constantly at 8% for at least the coming decade.
2. This 8% growth will drive earnings growth of 17-20% for the listed corporate sector.
3. India has a strong tradition of entrepreneurship and vastly improved corporate governance if there are 50 world class Indian companies today there will be hundreds more after 5-7 years and they will be 4-5 times their current size.
4. Indian companies understand cost of capital and are thus focused on shareholder value creation and returns on capital.

Is there any reason for us to doubt any of the above, because of this budget and the international turmoil we are currently witnessing? The answer is that nothing has really changed as far as the long term growth trajectory of the country and its corporate sector is concerned. Yes we are downbeat on the government and its ability to perform, but their actions (government) have still not been able to damage corporate sentiment. None of the industry captains I have spoken to are any less confident of their growth path or strategy. This is a powerful testament to just how irrelevant the government is slowly becoming (thankfully) and how low expectations have become. As of today I see no reason to change one's long term outlook on the economy and/or markets. The big caveat to this is of course if the government continues to interfere at a micro industry level. Another 2-3 episodes similar to what they have done to sugar, petroleum or to cement can damage sentiment and harm investment plans. If the government was to move ahead, on job reservations, that would be another big dampener.

However barring the above, one should stay invested. We have had a very good run of 4 years of strong market performance, and it may be time for the markets to consolidate and catch their breath. It will be far more difficult to make money in 2007 as compared to the last 4 years, but that is only to be expected and not reason enough to bail. Large returns still lie ahead if you have the willingness to be patient and develop a quality portfolio..

An Execution Premium

27th February, 2007

One trend which I have noticed recently is the way that valuation multiples have converged within sectors across the stock market. In most sectors while a valuation gap has remained between large capitalisation stocks, and the small caps, within the universe of large and small caps, valuation gaps have narrowed dramatically. Take for instance, the FMCG space, all the major players are trading between 21-23 times 08 earnings. In the IT space all the major players are at multiples of 23-25 times 08 earnings, in construction and engineering the ratios are 18-20 times, and even in cement on an EV/ton basis the gap is not dramatic. The same holds true for the metal majors, TISCO, Hindalco and Sail all of which are trading at 6-7 times 08 earnings. A similar observation can be made for generic and MNC pharma as well as many other sectors. The same trend is also visible within the mid cap company universe, the absolute valuations are lower, but quite similar across companies. This narrowing of valuation differences is a relatively recent phenomenon, and things were quite different, prior to this bull run. Prior to 2003, you had huge divergences in valuation as the leaders were rewarded with a huge premium.

This narrowing of multiples is an obvious consequence of the huge bull run we have had over the past 4 years, which has tended to lift all boats. As valuations for particular companies within a sector have got stretched, investors in search of laggards have bid up the prices of other companies in the same sector, trying to catch up.

This also reflects the fact, that as the economy has accelerated, most companies have delivered good earnings as the sheer breadth of the economic advance and capacity shortages have caused almost all companies to deliver strong earnings. Corporate profit growth has been very broad based, and growth trajectories across companies(in the same sector) have not been hugely different, as everyone has joined the party.

The fact that certain sectors have been discovered for the first time by investors and thus got re-rated as a whole has also contributed to this phenomenon. The question is of course whether this will continue, or will sharper differences emerge once again in relative valuation multiples.

By clustering valuation multiples so closely together, the market is basically implying that the long term economic prospects for most companies are quite similar, and that their governance and growth trajectories will be closely aligned. Being obsessed with growth, the market has also stopped noticing and valuing capital efficiency.

While most companies have grown very strongly over the past 4 years, I would argue that the time to be more discerning in your stock selection is now, for over the coming 4-5 years we will see very wide divergences in corporate performance. A case can be made that valuation multiples across companies and sectors will diverge over the coming years and micro stock selection will come back in vogue. The growth and profit trajectory of major companies in the same sector will be all over the place over the coming years and the market will eventually recognize this.

The reason I say this is that it is now in the best of times when the worst of mistakes are made. Right now when corporate India feels it can do no wrong, one needs to be very focused on the companies you have in your portfolio, and the quality of their management teams. While the growth opportunity for India is clear, does your company have the management team to scale up and capture these opportunities in a profitable and capital efficient manner? Do your holdings have the depth in management to globalize and attract top talent and manage attrition? Can the

companies you own avoid the temptations of easy availability of capital and not get caught up in hubris and ego to over stretch ? A badly timed capacity expansion or costly acquisition can damage a company's prospects and returns for many years. Do your companies have the systems and processes in place to handle business volumes 4-5 times their current size ?

I also feel that corporate performance will deviate significantly over the coming years as competition ratchets up across sectors. India has now entered the mainstream consciousness of board rooms across the globe, the inevitable consequence is rapid entry of new players and excess capacity across sectors. The easy profit growth of the past few years , as the economy accelerated and all capacity was used up, will inevitably give way to much greater competition, and divergence in profitability metrics. The game is about to change and cozy industry structures and relative market shares disrupted across the economy. The concept of efficiency and scale will also undergo a redefinition.

Because corporate India has been on a dream run over the past 4 years, the market as is its wont is extrapolating and merrily assuming that this will continue. Just because all companies have performed well in this bull run does not mean that all will continue to do so. As the market begins to realize that companies will have significantly different growth trajectories over the coming 5 years, valuation multiples should diverge and start reflecting the quality, scalability and relative competitive positioning of each company.

India has always been a stock pickers market, and has always attracted fundamentalists because of this. The last 4 years have seen too much money being made too easily, this will change and once again stock selection will become critical. Already signs of this are apparent as the market advance over the last 3 months has gotten progressively narrower.

Let buyers beware. Know what you are buying and why. Every company in a sector is not made the same., nor has the same growth prospects.

What can go wrong?

13th February 2007

As I now travel the world trying to raise money from some of the smartest and most long term oriented investors on this planet, their issues and concerns are quite similar. Almost all buy into the long term case for India, and feel that they have to be exposed to this country from a long term perspective. They understand the quality of entrepreneurship in the country, and are excited by our strong long term growth prospects. They are universal in stating that almost no other country has the visibility on economic and profit growth that they see in India.

Their concern, besides the market having run up too much too soon, is really around what can go wrong. What is the catch they should be thinking about?

Reflecting on this, I could come up with a couple of issues, one for the short term, and some others which are more structural and longer term in nature.

Obviously, the easiest thing which can go wrong is some type of external shock, which hits all markets, reducing risk appetite globally and across all asset classes. We could also have some type of an economic event hitting a particular emerging economy and causing contagion across all emerging markets.

While either of the above scenarios will be painful, the pain will be felt across many markets. What investors are looking for are local factors which can torpedo the India growth story independent of global issues.

From a short term perspective, the issue I worry about the most is inflation.

India is an extremely inflation sensitive nation, and rising inflation has significant and immediate political consequences. Only natural, when one considers how poor the country really is and the disposable income of the average citizen. What is also undeniable is that inflation is rising, and beginning to cause heartburn across all government agencies. The WPI(wholesale price index) has already crossed 6.5%, and shows no near term sign of stopping. If we decompose the WPI, we find that the real culprit is primary products(22% weightage) which is rising at over 9% per annum, followed by manufactures(64% weight) rising at 5.6%. The only saving grace is the deceleration in FPL(fuel, power and lubricants) inflation as oil prices have come off. If oil prices had remained at 75 dollars, we would have seen the WPI number cross 7%. If you look at these numbers on a trend basis, then the worrying conclusion is that for both primary products and manufactures the trend is still accelerating.

Now obviously the RBI is worried, and has hiked the repo rate three times(25 basis points each time) since April 2006. The central bank has also raised the cash reserve ratio by 50 basis points (to 5.5%). The RBI is convinced that money supply growth at over 20% is excessive and the demand side too robust. Unless the inflation numbers start coming off soon, one can expect the RBI to continue tinkering with provisioning, capital adequacy and reserve ratios to slow down credit growth and raise borrowing costs across the system.

Given the structural excess demand developing for government securities, we may not see much impact of the RBI measures in terms of rising G-Sec yields, but that does not mean the RBI is having no impact. Investors will be well advised to track rising interest rates across retail and corporate loan products, instead of government bond yields to judge the impact of the RBI.

The worry I have with this is that it is always difficult for any central bank to fine tune its tightening so that you dampen excesses but don't damage the economy. There does exist the risk that the RBI will overdo it, and slow the economy by more than warranted.

This risk is accentuated by the fact that our inflation worries may be more of a supply side issue(especially rising food prices linked to poor harvests), in which case the RBI may have limited ability to control inflation in the short term. We may get into a scenario, where being unable to slow down the relentless march of an accelerating headline WPI number the RBI is forced to overshoot.

Tightening liquidity and rising rates can hurt growth, as access to affordable credit has been a major growth driver for our economy. Corporate India has embarked on a major debt funded capex drive, and for the first time we have significant interest rate exposure at the retail level, both of which will be impacted by excessive tightening.

I don't think we are at risk of a sharp slowdown yet, but if rates were to rise by another 250-300 basis points across loan products, we could be in trouble. Even if the above scenario were to pan out, I think it would be at most a temporary setback, painful, but not damaging or putting to question the long term structural growth outlook for India.

Two long term and more structural issues that could put to doubt the whole secular thesis on India, are education and employment.

On education, only about 65% of males across the country are literate, 10% have passed the 10th grade and about 5% have a graduate degree, the figures are even lower for women(2001 census/CERG Advisory). By 2010 we will have 460 million people between the ages of 5 to 24(source:CERG Advisory), who will need to be educated and trained. How will the government handle this challenge, when it has failed miserably till date. Unless we see reform in the government response to the education challenge and much greater private sector participation and innovation, we will have a crisis. The beginnings of change and private sector participation are visible, but a lot more needs to be done.

The second issue is employment, by 2010, we will have more than 105 million young adults in the age group of 20-24 looking for work.(source: CERG Advisory) For our economy to generate employment of that magnitude, we need to improve our growth mix and ensure that people can move off farms and into light manufacturing and basic services. We cannot afford to have another decade of no organized sector job growth. We need to deliver on the required reforms in labour, agriculture and infrastructure. Again, initial signs are positive, but more needs to be done.

I do believe that India can tackle the above structural issues, given the innovation and drive visible in the private sector, but action is urgently needed if we wish to have a multi-decade growth spurt.

How Expensive Is The Market ?

24 January 2007

Everyone is worried about valuations for the Indian stock market. Any new investor I speak with is concerned about potentially coming in right at the top, and even the smart money locally is by and large cautious. Most of the old time and experienced India hands have been underweight or at best neutral our markets for quite some time now. Our esteemed Prime Minister, Dr. Manmohan Singh has also talked of “irrational exuberance”, words made famous by Alan Greenspan. Some people have started wondering whether we are in the midst of some type of bubble in the equity markets, which is bound to burst and end in tears for all.

It is of course quite obvious and understandable why everyone is so concerned, for the markets have been on a real tear over the past 4 years. The sensx ended 2006 up about 46%, and this is the fifth calendar year in a row of positive return. The market is up more than 4 times since the rally really began in 2003. The sensx has delivered a compounded return of over 33% since 31/12/2001, way above the 19% compounded return delivered since its inception in April 1979. Given the above numbers , you can be forgiven for automatically assuming that the markets have to be very expensive, and valuations in nose bleed territory.

Lets look at the facts, to test this assumption.

First of all if we look at the earnings to bond yield(earnings yield/g-sec yield)), it is currently at about .7, after hitting a low of .14 in 1992(markets very expensive) and a high of 1.8 in 2003(markets very cheap). The current reading is just about at the 15 year average(post liberalization period)of .7. Thus while on this indicator markets are not cheap, they are not insanely expensive either, especially when compared to India’s own long term history. The markets(using this metric) have been more expensive then today, and were so all the way from 1991 till 2000. The markets look expensive when compared to the reading of 1.8 in 2003, but that was a period of extreme undervaluation, and probably as ridiculous and irrelevant as a point for comparison as the reading of .14 in 1991.

Secondly if we look at PE multiples, we can come to a similar conclusion. While the market multiple has swung around quite violently, from a high of 60 plus (91-92) to a low of sub 10 times in 2003, the current multiple of 18 times is at the 15 year median of 18.2. Once again not cheap, but this is not the top of a dotcom bubble either. Also if you believe that with trend GDP growth at 8%, corporate earnings can grow at 20% and that the listed sector can keep ROE’s at or near 20%, even on an absolute basis, multiples do not look outlandish. One should look at PE multiples in the context of long term earnings growth, sustainable ROE(return on equity) and risk free rates.

A country delivering visible 20% earnings, and sustaining ROE’s of 20% plus(as India is today) will get a high valuation, the issue is rates. To the extent interest rates keep rising in India , they have the potential to drag down both growth and multiples. This is something we all need to keep an eye on.

As an aside the PE mentioned above is for the sensx, as we broaden the universe, PE multiples fall significantly to about 15-16.

When we compare India across emerging markets, the oft quoted statistic is that India screens as among the most expensive on PE multiples. While this is true, it is also linked to the fact that India has consistently delivered among the highest ROE’s , and also has a much better record of

delivering earnings growth, then most of its emerging market peers. It is also simplistic to compare multiples across countries, without adjusting for sectoral composition of the respective markets.

Many of the larger emerging markets have large sectoral weightages in banking, property, low value add manufacturing and commodities, often these sectors make up the bulk of the earnings. These are fundamentally lower PE sectors and drive their market averages down. India has higher sectoral weights in sectors like IT services, higher value-add manufacturing, FMCG and pharma, sectors which I think command fundamentally higher multiples. This different sectoral composition is reflected in the higher ROE India delivers (especially adjusted for the commodity cycle) and also drives a higher structural rating than most other emerging markets. Thus there seems to be some basis to why India trades at higher multiples than many other emerging markets.

Another interesting statistic, highlighted by a friend is that from Dec. 1991 (post liberalization) till 31/12/2006, the sensex has delivered a compounded return of 14%, despite the 33% compounded return since 2001. He points out that in this period (from 1991), M1 (which has been a good proxy for nominal GDP growth and earnings) has compounded at 14.8%. Thus the markets since liberalization have pretty much moved in line with nominal growth, and the huge gains of the past few years may be just a catch up from an environment of deep under valuation.

Be that what it may, the fact is that while the markets are no longer cheap, this is not Nasdaq of March 2000 either. We may have certain pockets of bubble like behaviour (property and embedded property stocks come to mind), but it is by no means across all sectors or of a big enough magnitude to bring the whole market down.

India is like a mid cap stock which has transitioned to large cap status. It has gone from being unloved, ignored and cheap to being on most people's radar and much more visible. The easy money, in terms of a multiple re-rating has already been made, but as long as growth is strong and visible, the market does not have to go into a deep bear phase or collapse. Growth expectations are embedded into the market and we cannot afford to disappoint, and hopefully our policy makers understand this.

The market obviously will not keep delivering 33% type returns, and we have to be realistic on our return expectations (even assuming some multiple compression, long term mid double digits looks realistic) and we will obviously have some negative return years as well.

As always, buyer beware, but the market does not seem so overdone on valuation, that we need to worry about years of negative return being the most likely outcome for someone entering today.

The Curious Case of Corporate Earnings

10 January 2007

We are about to enter the earnings season for the third quarter of FY 2007. As per my and everyone else's expectations this should be a very strong quarter once again for earnings, with numbers as high as 40-45% year on year earnings growth being predicted.

If, as everyone expects these forecasts do come to pass, then it will mark the 15th quarter in a row where-in earnings have been higher than or matched expectations. The financial year 2007, should be the fourth year in a row where earnings growth has been higher than 20-25%.

The inevitable question is as to how long can this continue? For haven't we all been taught that over the long term earnings cannot grow faster than nominal GDP (otherwise they will eventually become an impossibly large share of GDP). Haven't we all been warned that you should never extrapolate strong earnings growth into the future as the nominal GDP constraint is unavoidable.

This is one of the basic tenets of understanding long term market performance and behaviour. Thus how can the market bulls expect earnings to keep compounding at 20% for the foreseeable future?

How is it that with nominal GDP growing at best around 13%, earnings have been able to compound at 25% and that too for years on end? I think there are three or four explanations for this phenomenon.

Firstly, prior to this earnings surge, corporate India was coming off a period of lackluster earnings performance in the mid 90's till 2003, as the economy had weakened and companies were engaged in cost cutting and rationalization. Thus prior to this earnings surge the profit share of GDP was probably below its long term average. We could simply be seeing a mean reversion as corporate earnings regain their rightful share of GDP.

Secondly I think that as capital expenditure has accelerated among Indian companies, this has also been a boost to earnings. Whenever you have a strong capex cycle, it inevitably boosts earnings. For the company selling the capital equipment or recording the sale, books the profit upfront on the sale, whereas the company buying the equipment capitalizes the cost and amortizes it over multiple years through depreciation. Thus a strong capex cycle inevitably frontloads profits, and to the extent the capex cycle in India is still accelerating and investment share to GDP rising, this will be a powerful boost to profits over the coming years.

Thirdly, I think what we are seeing also is the fact that while nominal GDP is growing at 13%, ex-agriculture it is actually growing at 15-16%, and within this the private listed corporate sector is growing still faster. With the economy also being gradually liberalized, the role of the private sector is expanding across sectors. For example insurance, aviation, banking and telecom are huge sectors that come to mind straight away, where-in the private sector has entered, gained share from the government and will eventually make huge profits.

There are other huge sectors where for the first time, major players are getting listed. Real estate comes to mind straight away, where everyone is now getting listed and thus boosting earnings growth of the listed sector, though not of the economy. To the extent that the listed private sector gains share across the economy, one can argue that its profit share of GDP should also be in a secular uptrend. Either the profit share of GDP of the whole economy will rise as we become more capitalistic or the private sector's share will rise at the cost of the public and unlisted sector.

Take the case of aviation where till recently the private sector made money at the expense of Indian Airlines.

As the listed private sector becomes a larger part of the economy, which is to my mind an inexorable trend, it can grow at a multiple of nominal GDP to account for its share gain.

The fourth point would be that Indian companies are clearly going global and increasing the international share of their business. The share of international trade to GDP is on a structural rise for the economy. To the extent that Indian companies are able to open up markets and address global customers, there is no reason that their profit growth should be constrained by domestic factors alone. As they gain share globally it opens up a new profit stream for them and they can break-out of the profit constraints of only being dependent on the local economy. In India we also have entire sectors like software which are totally focused on global markets and have very little to do with the Indian economy. In the more advanced and mature countries of the west, the share of international trade to GDP tends to be quite stable and thus the above dynamic does not really play out the way it is in India.

We are also experiencing very strong productivity growth in India, and this normally is very beneficial to corporate profits as labour's share of profits tends to structurally decline in such an environment.

The final explanation can be that in fact we growing much faster then the government statistics show, or that as we reform and improve tax compliance, the underground economy is shrinking and this is not fully captured in government statistics., but shows up in profit numbers.

Corporate earnings have had a dream run over the last 4 years, and all signs seem to indicate that this will continue. Sceptics point to deteriorating earnings quality and the lack of free cash flows, but I think that is noise which cannot detract from the very strong corporate performance. They also point to the strong commodity cycle as an explanation, but again there is more to the strong earnings performance then simply commodity prices. A worrying trend is the inevitable increase in competition as all the capex plans of companies fructify, and global players gain entry, but hopefully strong growth will absorb this.

As to how long this performance can continue, is difficult to say, but if you believe that the Indian economy is on an 8% long term trend growth rate, 20% may be the trend for corporate earnings, atleast for the foreseeable future. This ultimately is the attraction of India , for in no other market can you reasonably expect the listed corporate sector to compound earnings at 20%, with a reasonable level of transparency and capital efficiency.