FINGINE Report

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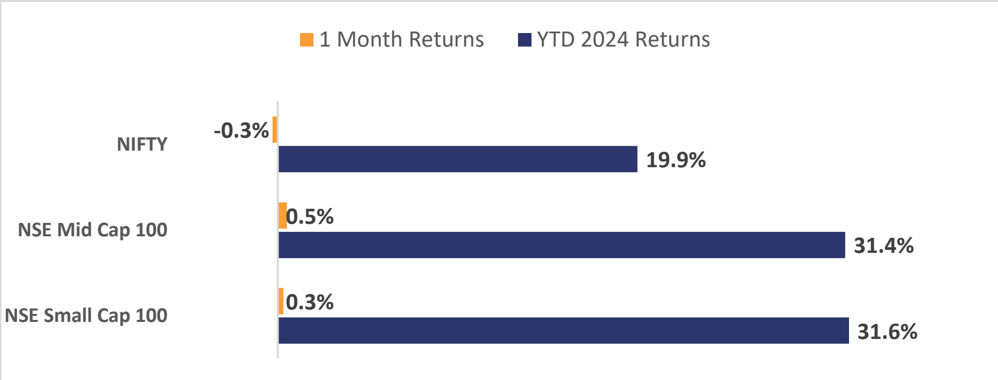
India's equity markets went through a sharp decline in the first half of November before valuations recovered to close almost unchanged at the end of the month. These movements correlated with net selling by foreign institutions early in November and a series of IPOs launched in the first half of the month, both of which put pressure on valuations, that subsequently eased off and led to a minor rebound.



News flow during the last month was marked by global uncertainty from the change in administration in the US as well as continuing escalations in the Middle East. At the same time, domestically, second quarter financial results were far below expectations bringing the earnings growth momentum of the last few years to a sudden halt. Postponement of the anticipated consumption demand expansion and asset quality issues for the financial sector impacted performance. Meanwhile, technology, telecom and infra sectors delivered positive outcomes during the reported quarter.

Currently, earnings growth projections are 6-7% lower than what they were at the beginning of the current financial year. Investors are now expecting that India Inc should resume its growth trajectory in the second half of the year supported by increased consumption spending, implementation of social security programs and overall higher government expenditure. Second quarter GDP growth of 5.4%, reported at the end of the last month, has been disappointing and the government is likely to accelerate its planned measures to regain the country's economic momentum. Accelerated growth, both in corporate profits and in the Indian economy, could be the catalysts for renewed investor participation going forward.

Currently, there is wide consensus that market valuations at 20 times one-year forward earnings are on the higher side of the historical range but certainly not in any bubble territory. One point that needs to be considered here is that the ongoing re-constitution of key indices continues to transition them from largely commodity-led companies to more new economy companies. This naturally leads to higher price-earnings multiples based on faster growth expectations built in by investors. Also, Indian companies on an aggregate currently have mid-teen returns on equity, low-leverage balance sheets, strong cash flows even when the economy has seen the current growth dip. This provides the framework to increase capacity and throughput without significant expansion in leverage. At the same time, companies will need to keep sharp control over working capital, and this is especially true for businesses relying on higher government expenditure, in taking forward their growth plans.

Indications of macroeconomic improvements should also be beneficial to profit growth in future. Availability of more capital flows, both domestic and foreign, may support growth objectives. However, the rising tide may not take all boats up from here on and allocators of capital will be looking at specific pockets that balance growth expectations with reasonable valuations.

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