



MARKET INSIGHTS

INDIA INC. DRIVES DOWN RECOVERY ROAD

NOVEMBER 2016

“India, the new myth — a collective fiction in which anything was possible...” *Salman Rushdie, “Midnight’s Children”**

DID MR. RUSHDIE MISS THE MARK? IT CERTAINLY LOOKS LIKE IT. INDIA’S NARRATIVE IS HARDLY A MYTH.

On the contrary, it is a bright spot in today’s global economy.

Shifting gears in its drive down the Economic Development Road, India possesses one of the greatest (if not the greatest) growth potential. Driven by an emerging middle class, improved macroeconomic fundamentals and multiple economic reforms, India has overtaken China as the world’s fastest-growing major economy, a lead it is forecast to retain over the coming decade.**

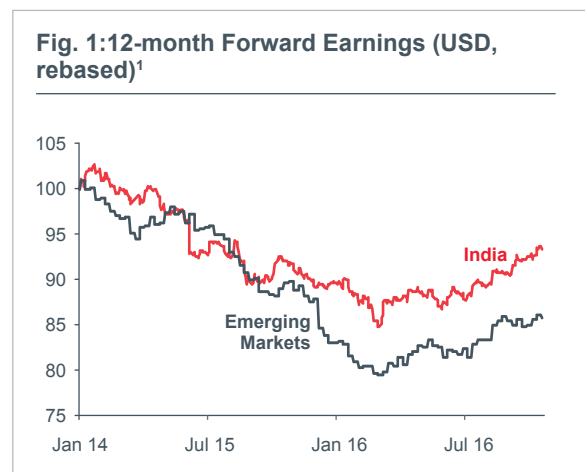
The recent passage of big-bang legislations (such as the goods and services tax and bankruptcy bills) not only paves the way for this growth but also boosts the Modi administration’s credentials as a reformist administration. As expected, these reforms grabbed the headlines.

But there are less-appreciated executive reforms that also deserve credit; some were bold measures. These include implementing unique identification and direct benefits transfer to minimise pilferage, foster financial inclusion, and promote financial revival schemes for state electricity boards and banks.

The road ahead looks smoother. There is little denying that the recent stretch had a few potholes. The encouraging news is that this stretch may be passing, although companies will have to drive a few more miles to confirm this.

IT’S EARLY DAYS, BUT INDIA’S PROFIT OUTLOOK IS IMPROVING

Falling sales (reflecting poor demand and idle capacity) dragged down profits over the last few years (Fig. 1).



*Salman Rushdie is a British-Indian novelist. “Midnight’s Children”, written in 1981, was his second novel.

**According to Consensus Economics as at 10 October 2016, India’s GDP growth between 2016 and 2026 inclusive is forecast to average 7.0% per annum. This far outstrips China’s growth forecast of 5.8%.



But this phase seems to be passing; there are good reasons to argue that the worst has passed and that the profit outlook is improving.

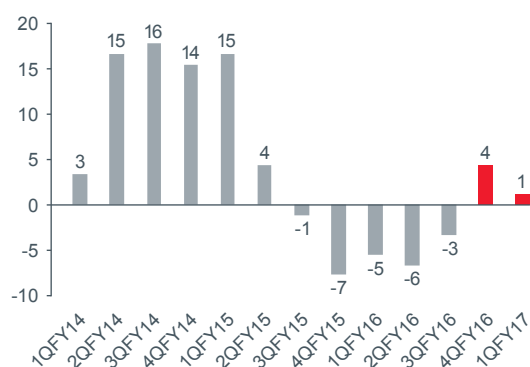
A deeper dive into 2015's earnings, for example, suggests that slower profit growth was exaggerated by two one-off factors:

- ▶ The Reserve Bank of India's directive to banks to make provisions for possible defaults on selected companies.
- ▶ Commodity-linked sectors experienced earnings collapses as commodity prices declined.

The overall impact of these two factors was to set a low base for 2015 earnings, making them less comparable with their history. MSCI earnings, for example, rose only 5.3% per annum (p.a.) over the past three years, versus 16.0% p.a. between 2000 and 2010.

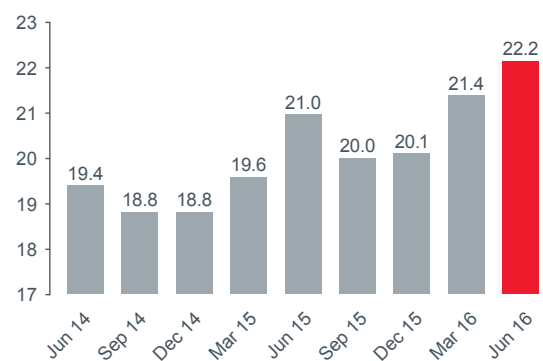
Encouragingly, India Inc's sales trend has turned positive (Fig. 2) after falling for almost five consecutive quarters, pressured by persistently negative wholesale inflation. Wholesale inflation has now stabilised and is firmly in positive territory. Sales growth will likely mean revert to its long-term average rate of 16%* as things normalise over the medium term.

Fig. 2: Indian Corporates Maintain Positive Sales Growth Trend (% Year-on-Year)²



Regardless, the deflationary period allowed Indian companies to expand operating margins amid input cost deflation. Operating margins for Indian companies hit a two-year high** in the most recently concluded quarterly earnings season (Fig. 3).

Fig. 3: Indian Corporates' Operating Margins (ex-financials and oil marketing companies) (%)³



In addition, companies look set to enjoy operational leverage as demand recovers and spare capacity gets used up. Indeed, companies are slowly ramping up production, with capacity utilisation rising from 71.2% in 2QFY16 to 72.9% in 1QFY17***—nearing the 75% level, which research suggests could prove an inflection point for the return of a missing link in the Indian economy's growth engine: Private capital expenditure.

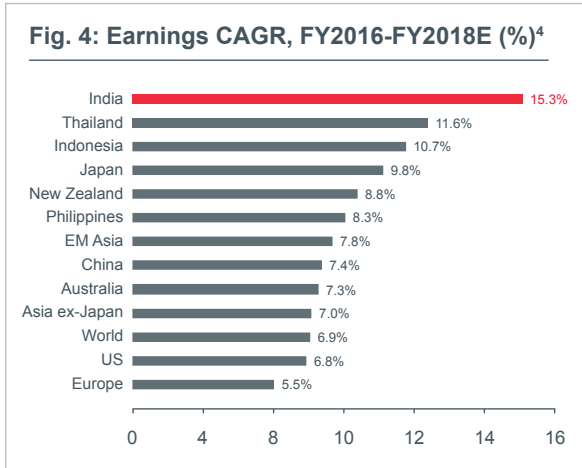
INDIA'S PROFIT GROWTH FORECASTS OUTSTRIP ITS PEERS

India's profit growth forecasts are leading its peers, thanks to the surge in the operating margins and the removal of the sales volume drag.

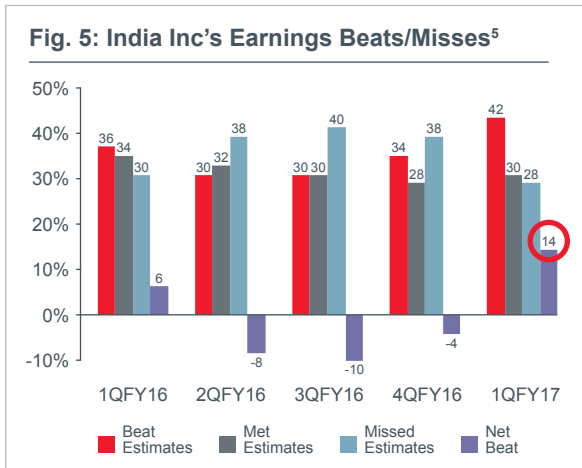
*Motilal Oswal Group, September 2016. ** Based on Nifty universe. ***Reserve Bank of India, 4 October 2016.



Earnings growth is forecast to average around 15% per annum (Fig. 4) over the coming two years.



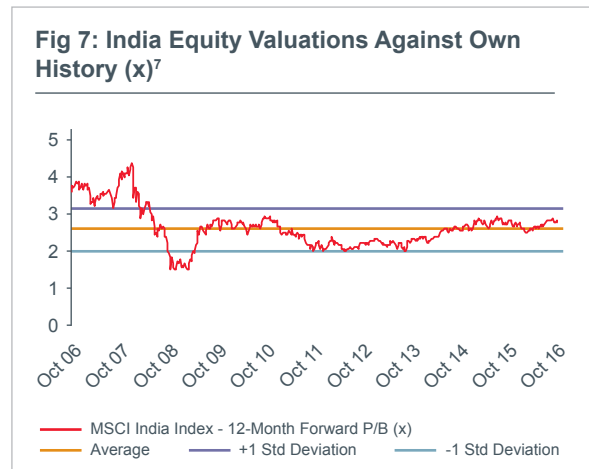
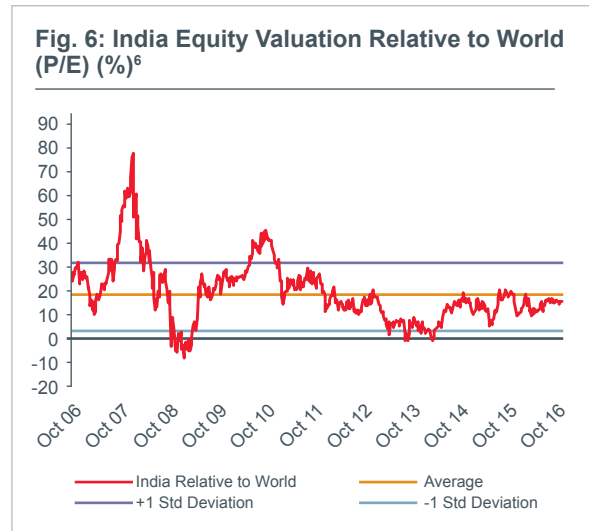
Encouragingly, not only have more companies been enjoying earnings upgrades in recent quarters, more companies beat their estimates than missed them during the last reporting season (Fig. 5). With the changes outlined above swinging into play, it would be surprising if this trend does not continue in the immediate future.



EQUITY VALUATIONS SEEM FAIR

On a one-year forward basis, India's valuation multiples remain within fair value range and close to historical averages (Figs. 6 & 7).

On a three-year investment horizon, that relative valuation gap in India's favour only increases owing to India's stronger profit growth forecasts.



The picture seems to be that while investors recognise India's story, lingering concerns are keeping relative valuations on the conservative side of fair value. That suggests there is more in store if events develop as forecast.

Mr. Rushdie may have yet further cause to rue his rash words!



Sources

¹IBES, MSCI, Datastream, 13 October 2016. Based on MSCI indices. Rebased on 31 December 2014.

²Motilal Oswal, September 2016.

³Motilal Oswal, September 2016.

⁴IBES, MSCI, Datastream, Eastspring Investments, 20 October 2016. Based on MSCI indices. CAGR: Compound annual growth rate.

⁵UBS Research, September 2016.

⁶Datastream, 20 October 2016. P/E: 12-month forward price-to-earnings ratio. Based on MSCI indices.

⁷Datastream, 20 October 2016. P/B: 12-month forward price-to-book ratio. Based on MSCI India Index.



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