

# Indian market has traditionally traded at premium due to its entrepreneurial talent

## WEEKLY INTERVIEW

There are segments of the Indian market where stocks have been touching their yearly highs, says **Bhupinder Sethi**, Tata Mutual Fund's co-head of equity. In an interview with **Kumar Shankar Roy**, Sethi says we are not in a bear market, but investors are cautious because of near-term macro-economic challenges. Excerpts:

■ **Have investors fully priced in risks from high crude and raw material prices, a renewed sovereign debt crisis and uncertainty over the strength of consumption demand from developed economies in Indian stock prices?**

I think the Indian stock market has been fairly resilient so far to the macro-economic worries that are there on the horizon. The fact that valuations are not too high since we are at around the long-term average valuations of around 15 times one-year forward earnings and that investors seem to be taking a longer-term view, seems to have held up the market at these levels. In my view, investors are sanguine that by the end of the year, inflation would start showing signs of moderating and the sovereign debt crisis would not precipitate into something bigger. Any disappointment on either of these two counts would continue to bog down the market.

■ **Consensus earnings for FY12 have seen downward revision by 2 per cent but are still projecting 17.5 per cent growth. Since a lot of cost increases are being reflected from 1Q FY12, will more earnings downgrade happen?**

You are right that some of the cost increases and higher interest rates would start hitting the companies, more so from 1QFY12 onwards. From where we are today, in our stress analysis of the BSE Sensex earnings, we think the earnings growth for FY12 could slow down to 15 per cent should the cost pressures remain elevated and if growth slows down.

■ **Indian markets are now trading close to the long-term average of 14-15 times price-earnings ratio, but the premium to emerging markets still remains at 35 per cent, against the 10-year average of 25-26 per cent. Will this premium reduce?**

I think the Indian market has traditionally traded at a premium because of the entrepreneurial talent that exists in India. There are several good-quality Indian companies in the index that are in sectors that have sustainable, secular growth prospects and superior return on equity (RoE), such as software, consumer discretionary spending and private sector banks, among others. India's massive growth potential and economic liberalisation, among others, have all given further impetus



**Bhupinder Sethi**  
Co-head equity, Tata Mutual Fund

to the valuations Indian equity markets trade at. As a nation, we have to be aware and cautious of the fact that international investors have a choice of countries to invest in, and, therefore, governance deficit and slowdown in infrastructure rollout that can hurt our long-term growth potential can reduce premium accorded to Indian equities.

■ **Which are the sectors that will take a further hit over the next two-three quarters? Also, is there any sector where you see good value emerging now?**

Sectors that will be under some stress in the near term because of the present macro-economic challenges and individual sector's own dynamics would be the public sector banks, automobiles, cement and metals. We do see value emerging in select tier-II public sector banks, the smaller cement companies and some of the automobile companies.

■ **The infrastructure theme hasn't worked that well for investors. What is the problem?**

The backdrop is that investors did make good returns in the infrastructure theme until the end of 2007. Since then, the infrastructure theme has had the handicap of high valuations and slowing down of the investment cycle. Also, several companies in

**"GOVERNANCE deficit and slowdown in infrastructure rollout that can hurt our long-term growth potential can reduce premium accorded to Indian equities"**

the infrastructure space have been continually in the capital-raising mode, thus affecting their capital efficiency return ratios. Poor governance perception and rising interest rates have also affected the sector. However, given the underperformance of the infrastructure sector, there are select opportunities available again in the space at attractive valuations with favourable reward-risk ratio.

■ **People are saying that foreign funds are re-allocating Indian allocations with cash portion going up. What is your sense?**

Well, the data doesn't show that. So, while it is true that in this year, so far, foreign funds haven't allocated too much money to India, but net sales figure of \$150 million in cash equities in the present calendar year-to-date doesn't add up to much if we are talking about too much cash being raised out of India.

■ **Firms have faced severe margin pressure over the past year. As an investor, are there any better any sectors where you see good value emerging now? Your views...**

Not all producer companies in India fully benefit from rising commodity prices. Public sector oil exploration companies share the subsidy burden of under-recoveries, a compa-

ny like Coal India doesn't benefit fully from rising coal prices. So, in terms of producer stocks, investors will fully benefit, if the companies are positioned to completely leverage rising commodity prices. In consumer stocks, companies that have strong brands and the ability to pass on or absorb cost inflation, can protect their margins and do well, even in a rising commodity price environment.

■ **Are we in a bear market? What factors would drive us out of this range-bound movement?**

A bear market is generally characterised by broad-based falling of stock prices, and widespread pessimism, which causes negative sentiment to be self-sustaining. At present, there are segments of the Indian market where stocks have been touching their yearly highs, although, admittedly these companies are more on the consumption side of the economy. So, I wouldn't say that we are in a bear market, but yes, investors are cautious given the near term macro-economic challenges facing us. In my view, signs of inflation cooling off and pick up in investment cycle would trigger the broad market to rally in a secular manner.

■ **Since you mention that positive news flow on investment pickup and visibility on inflation peaking out are triggers for the market, when do you see these things taking shape?**

This is the last year of the present five-year plan, and so, as the year progresses, there should be some hastening of projects to meet targets. In addition, if the government over the next six months can push through some important reform-related bills in parliament and facilitate an environment for investment pickup, that should be positive triggers for the market. As QE2 ends on June 30, and the Chinese government tries to slow down its economy as it too grapples with inflation, we believe that both from the liquidity perspective and from the demand side, there should be some cooling off of commodity prices. We have already seen metal prices starting to fall, and with the prospects of a good monsoon, which augurs well for food inflation, by the end of the present calendar year, chances are that inflation could show signs of moderating at least cyclically. ■