

Growth Opportunities for India

In the past few weeks and especially the past few days, we have seen unprecedented volatility in our equity markets. Therefore, it is a good time to once again examine the broad trends which have driven this volatility and what will be the drivers of our markets in the future.

An era of global growth driven by leveraged expansion of greed is coming to an end. A lot of words have been written behind what has driven the credit crisis and the concomitant liquidity crunch on such a global scale. However, in course of time, lessons will be learnt out of this crisis.

People who will succeed in our equity markets will be the people who can look to the future and fathom the far reaching changes which will affect the global economic order of tomorrow. The global growth of the past two decades in the developed economies seems to have been driven by leveraged customers and leveraged financial markets. One of the important lessons that will be learnt out of the global crisis is that the period of global growth driven through leverage is coming to an end. However, the last 100 years of learning from global equity markets shows that the ever expanding global pool of savings will continue to search for opportunities to invest. The winners in equity markets worldwide will be the ones who can discern these growth opportunities in the years to come.

2007 and 2008 are landmark years in the global transfer of economic power. For the first time, emerging markets have now begun to contribute more to the global growth engine than developed markets. As developed markets slow down further,

emerging economies will now increasingly have the burden of carrying the global growth engine forward. It is inevitable that larger and larger global savings pool will hence get allocated to emerging markets. The changing world will also devise a new financial order.

In the next few months, the outlook for Indian equities will be dominated by four major drivers. The first driver will be the fundamental performance of companies. The second driver will be funds flow and newsflow from overseas. Thirdly, the market will focus on inflation trends and interest rate

trends in our economy. Last but not the least, as we move increasingly into the 'Election Period', political newsflow will become the dominating driver.

It is everybody's guess now that over the next few quarters we will see

some earnings slowdown in the aftermath of the liquidity crunch and the high interest rate era that our corporate environment has to contend with. Similarly, it is estimated that as economic growth in developed markets slows down, commodity prices and oil prices will come down leading to lower inflation and hopefully lower interest rates. This will be one of the important 'markers' that the market will look for. If our monetary policy is forward looking and if interest rates come down proactively, it will give a breath of fresh air to struggling corporate growth and hence cause a more optimistic outlook for stock markets in general. We are already witnessing political newsflow from various parts of the country which will cause increasing volatility as we move towards our 'General Election'. On balance, it is expected that in the next six months, given slowdown



in earnings growth, given likelihood of negative overseas newsflow etc. and given the political noise in the system, we will witness a market that will reflect these concerns. However, hidden within these concerns lie the seeds of long term positives for our market.

The Indian economy will build one of the world's leading infrastructures in the next 10 years. Lower commodity prices and lower interest rates will be a great help. Similarly, the great Indian consumption story will continue to play on after a pause and once again lower prices for goods and products and low interest rates will be a catalyst to growth. Lower inflation will greatly aid in reinforcing consumption and business sentiment in our economy. The Indian real economy is largely sheltered from disruptions in global economic growth. Our companies still largely sell in the domestic market. However, our financial



markets will not remain insulated from global happenings and will reflect in the near future the tight liquidity and concerns which are evident in other markets.

At some point of time, the global volatility will end.

Commodity prices and interest rates will come down. The Indian consumer will come back to the shopping malls with gusto. The great Indian infrastructure story will regain momentum. The clock will again start ticking for Indian equities and the global savings pool searching for growth will find long term stable trajectory of growth here. Young India will once again be looking towards its long term destiny with confidence. In the meanwhile, for those who still believe that India will be among the top 3 global economies by 2025, markets will present great buying opportunities.

We have analyzed each of the factors which are at the moment causing concern to the markets and how they are likely to play out in the future.

Let us examine the issues concerning investors with regard to India and the opportunities that lie therein:

1. INDIA'S BALANCE OF PAYMENT SITUATION

Issues: India's current account deficit increased to USD 10.7 bn in Q1FY09, compared to USD 6.3 bn in Q1FY08.

Opportunities / Solutions: The capital account flows were sufficient to finance the current account deficit in Q1FY09, resulting in a Balance of Payment surplus of USD 2.2 bn. So, even as FIIs sold in India in the current financial year due to the redemption pressures faced by them back home, India has continued to remain an important investment destination with FDI flows remaining strong at USD 14.6 bn (up 124% yoy) for Apr-Aug'08. Lower commodity prices would further ease trade deficit.

Even if the capital flows due to the global financial crisis get affected in the near term; by FY10, as the new hydro-carbon discoveries made in India start to come on stream, India is expected to have a very comfortable Balance of Payment surplus.

2. INDIAN CURRENCY

Issues: Indian Rupee has weakened substantially in the current fiscal year against the US Dollar (USD) because of rise in oil imports due to surge in oil prices, rising risk aversion globally and FII selling in India.

Opportunities / Solutions: India has very comfortable foreign exchange reserves of approx. USD 253 bn as on 31st Oct. 2008. In the short term, the Indian government and the Reserve Bank of India (RBI) have tools and measures at their disposals which could attract flows into India viz. liberalization of External Commercial borrowings, raising the FII debt limits, increasing the attractiveness of Non-Resident Indian (NRI) deposits etc.

Beyond one year, the trade deficit is likely to be manageable with lower crude and fertilizer prices and with the benefit of coming on stream of hydro-carbon

discoveries made in India, the Indian Rupee is likely to appreciate against the US Dollar, whose rally itself is in question given the extent of bail out of the financial sector being undertaken by the US Government.

3. LIQUIDITY ISSUES

Issues: With credit markets drying up globally, in India too the liquidity had become tight due to past multiple rounds of increase in Cash Reserve Ratio (CRR – the percentage of customer deposits that banks set aside as cash with RBI) by RBI, FII selling in India because of redemption pressures faced by them and general de-leveraging process seen amongst global financial institutions.

Opportunities / Solutions: RBI has now acted in an aggressive manner by cutting CRR, from 9% to 6.5%. The total liquidity injection via the CRR route amounts is Rs. 1000 bn (US\$21bn)

RBI has also instructed banks not to hold back sanctioned working capital and term loan limits to corporates and that loans to Small and Medium Enterprises (SMEs) could be restructured.

Some of the other steps taken by the policy makers include easing of External Commercial Borrowings by infrastructure companies and relaxing the LIBOR linked cost ceilings for loans above five years.

To meet liquidity requirements of the mutual fund industry the RBI has (a) extended the 14 day repo facility until the Rs. 200 bn limit is utilized and (b) permitted banks to avail of additional liquidity support upto 0.5% of their net demand and time liability (NDTL) which works out to ~Rs. 200 bn.

RBI has at its disposal the ability to make further cuts in CRR and Statutory Liquidity Ratio (SLR), as Indian Banks have one of highest reserve requirements amongst the major economies in the world.

According to media reports, the Government is considering utilising the balance under MSS bonds amounting to Rs. 1,71,000 crores for its revenue and

capital expenditure. Currently, Indian banks' G-Sec portfolios account for around 26% of total deposits as on 10th Oct. 2008. This gives RBI and the banking system additional room to support the economy in case of any situation of liquidity crunch.

The important thing to note is that even in an environment of liquidity crunch, the bank credit growth in the system in the first half of the current financial year FY09 has been strong at around 25%.

4. INDIA'S FISCAL SITUATION

Issues: The concern on India's fiscal deficit had arisen because of increase in subsidy bill.

Opportunities / Solutions: With crude oil prices coming off to around USD 65/barrel and fertilizer prices too showing signs of correction, the burgeoning subsidy bill problem would get addressed to some extent.

Also, the gross tax revenue collection in the current financial year continues to grow at a very healthy rate (direct tax collection growing at 33% as against budgeted estimates of 25%) and apart from that the government is expected to garner good amounts from the sale of 3G telecom licenses, and therefore despite the subsidy bill, the overall fiscal deficit, including the off budget subsidy is likely to be contained within 5% of GDP.



5. SLOWDOWN IN INDIAN GDP GROWTH

Issues: Indian GDP which grew at over 9% in the last few years is likely to slow down to around 7.5% in the current financial year in line with the slowdown being witnessed in economies across the world.

Opportunities / Solutions: The Indian GDP growth at around 7.5% would still make it amongst the fastest growing economies in the world.

The fact that Indian economy is less dependent on exports unlike other emerging economies and more led by investments and domestic consumption should hold it in better stead than many of the other emerging economies in the current global slowdown being witnessed.

Also, since India is seen more as a consumer of commodities than a commodities producer also helps Indian economic growth relative to countries which are primarily commodity producers in an environment of slowdown in commodities induced by global economic slowdown.

6. STRENGTH OF INDIAN BANKING SYSTEM

Issues: There has been a crisis amongst the leading financial entities in the global financial sphere which gives rise to rumors of such possibilities in the banking system of emerging market economies including India

Opportunities / Solutions: Indian banks are on a much sounder footing with strong balance sheets.

As mentioned earlier, Indian banks have one of the highest reserve requirements amongst the major economies in the world. NPAs of Indian banks have been consistently falling over the past five years.

Also, the fact that both retail consumers in India are extremely under-leveraged and that on an aggregate basis the Indian corporate balance sheets have a low leverage bodes well for the Indian banking system.

7. POLITICS

Issues: India is scheduled to go for elections for the central government in the first half of the next year 2009. Uncertainties related to who would form the new government always raise doubts in the minds of investors

Opportunities / Solutions: In the Indian context, it is reassuring that since the time of economic liberalization in early 1990s, every political party which has assumed power at the centre – irrespective of their public posturing for political reasons – have governed and taken the economic reform process forward. It is this reason that despite so many different governments assuming power at the centre since 1990s, the pace of economic growth which stood at around 5-6% then accelerated to 8-9% over the last few years in a time span of over 15 years.

8. INFLATION

Issues: Inflation had shot to well over 12% in the last few months and had been the most worrying factor for the Indian markets and investors

Opportunities / Solutions: The recent wholesale price inflation data suggests that inflation is getting reined in at around 11% and the worst appears to be over. The WPI in the week ended 18th Oct. 2008 is down to 10.68%.

Crude and commodity prices coming down are positive for India and it should start reflecting in lower headline inflation figures in early 2009. As inflation moderates, we would also expect interest rates in the economy to decline accordingly, which should be good for growth.

9. VALUATIONS

Opportunities / Solutions: At current valuations, the sensex is trading at less than 10 X FY 09 and 9 X FY 10 earnings, which are far below historical averages.

Once some calm comes to the global markets, it is expected that funds (FII) will flow back into India in view of structured Indian growth story now available once again at low valuations vis-à-vis the long term growth prospects.