Impact Consultancy Private Limited

Pause Mode

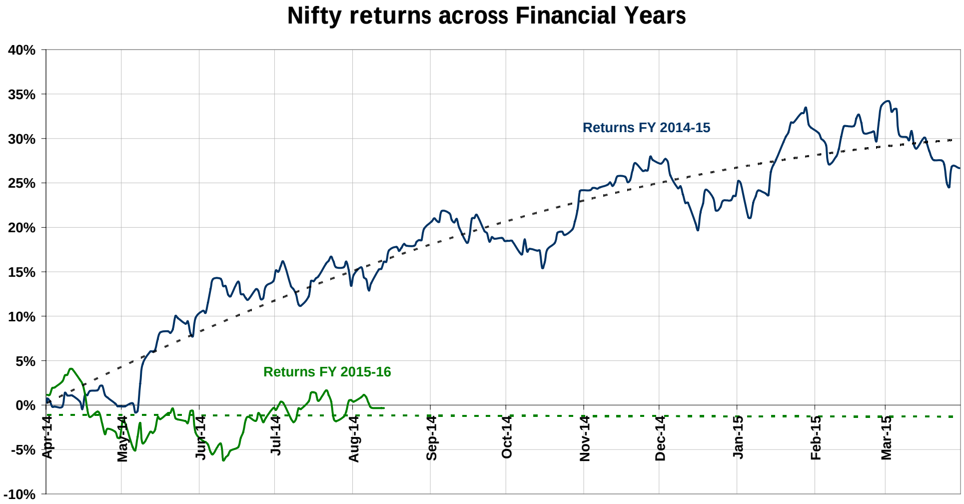
The Big Picture

11th August 2015

Overview

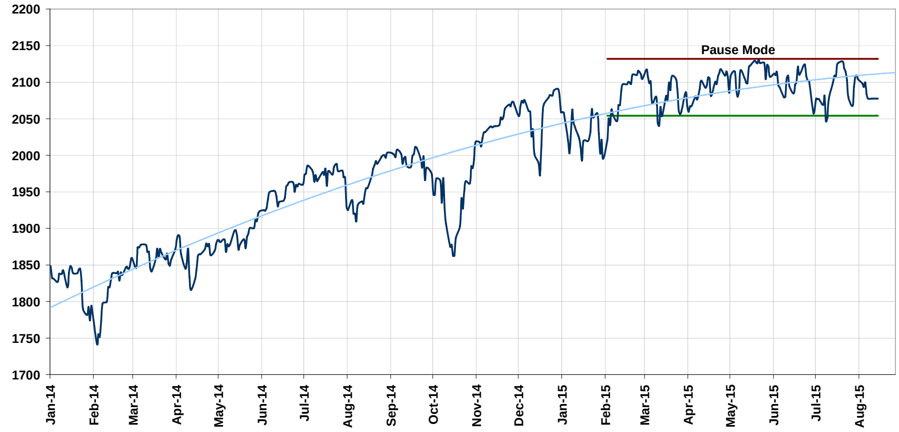
The Indian equity markets continue to trade in a very narrow range of about +/-5% since the start of this financial year and are still 6% lower from the high of March-2015. Cumulative returns so far in FY 2015-16 have been absolutely flat around 0% compared to around 18% at this time last year. The absence of any major triggers such as reforms or better corporate earnings has put a cap on upsides and incremental domestic liquidity has sufficiently propped the market at current levels. This dearth of any significant volatility consequently also restricts the available trading opportunities.

A majority of the corporate earnings for the first quarter of FY 2015-16 have been announced and expectedly have been disappointing. The y-o-y earnings growth for the Impact-100 companies stands as -6.7% and for Nifty-50 is -5.1%. That pushes the Nifty-50 Price/Earnings ratio is 23.50 against a 10-year average of 19.78.



It is a similar situation in the US – the S&P-500 has been moving in an astonishingly narrow 80 point range (+/-2%) for more than 6 months! The US Treasury bond yields are also flat from the beginning of 2015. The only place where there have been any movements has been commodities, which have fallen by 10% in 2015 on the back of a 20% fall in 2014.

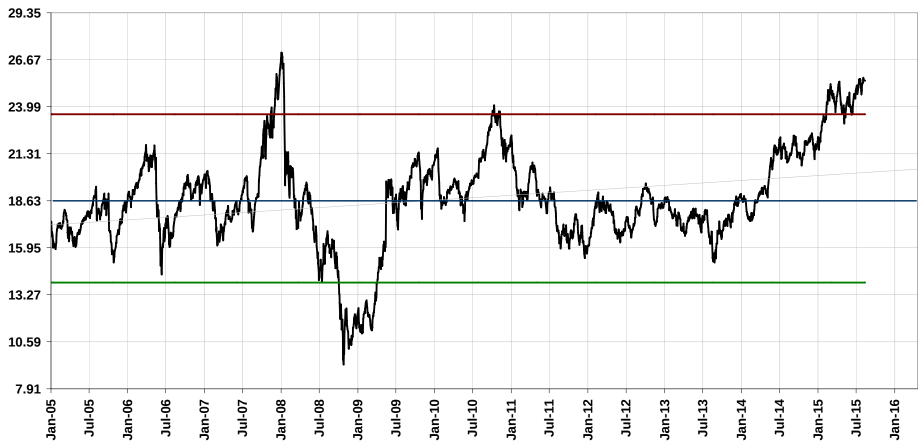
S&P-500 since 2014



Corporate Earnings & Valuation

The worse than expected growth in earnings has pushed the Nifty-50 P/e ratio to unsustainable levels. This is even worse with the broader Nifty-500 index which is significantly overvalued and is at the highest levels since 2008 (when it crashed 64% through that year). The earnings visibility for mid-cap and small-cap companies just doesn't seem to be there and are therefore particularly vulnerable to deep corrections.

Price/Earnings ratio of Nifty-500 Index



That Debt problem

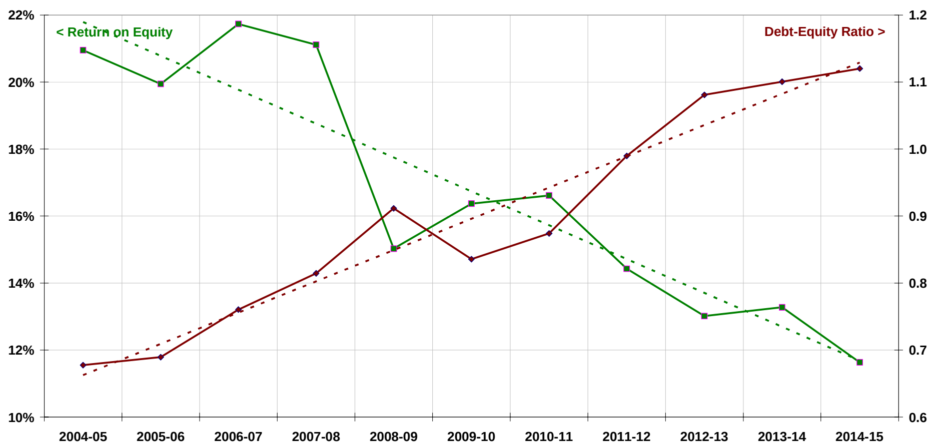
The Reserve Bank of India in its monetary policy review earlier this month left interest rates unchanged. This has disappointed many people who mistakenly believe that lower interest rates can make things better and spur growth. It is true that the corporate sector is grappling with high interest costs which are eating into their profitability – but the reason is not because of high rates but because of too much debt.

For the corporate sector in the last 10 years, while sales have grown by 19.8% per annum, total debt has grown by 26.2% per annum and consequently profits have grown by only 13.7%. Therefore, the addition to corporate debt has actually been disproportionate to the actual growth potential of the sector.

Underlying that is actually the more critical problem – during this 10 year period, Net-Profit-Margins have almost halved from 10.5% to 5.9% and Return-on-Equity has fallen from 21% to 11.6%. This points to a chronic systemic problem that just lower interest rates can't fix - the Indian corporate sector is unable to make sufficient money and as a result cannot service the increasing levels of debt.

So, over the last 10 years while Return-on-Equity has halved, Debt/Equity ratio has almost doubled. Although it is still very far from getting into a "debt-trap" it is certainly not a healthy economy, and worryingly only getting worse. We have always argued that the problem with the investment cycle is not the high cost of capital (interest rates have moved up only 2% in this period) but the rapidly declining return on capital.

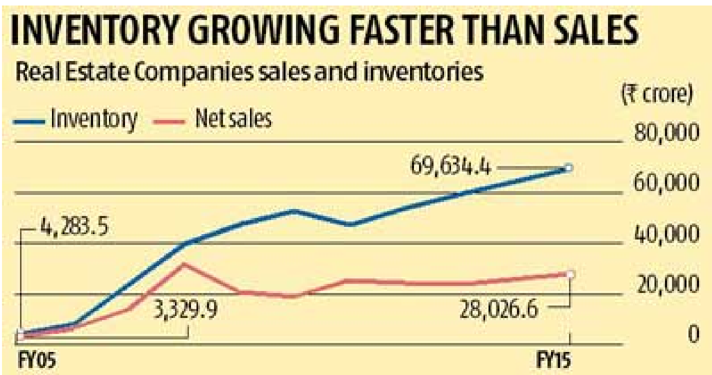
Debt/Equity and Return-on-Equity for Indian Corporate sector



The prescription for this remains the same – growth and increase in productivity. And what could trigger it still remains the same – reforms, which are getting increasingly hard to come by. Unless the central government is able to push through meaningful reforms such as tax reforms (GST in particular), rationalization of government spending (specifically subsidies) towards capital expenditure and improving ease of doing business, the corporate sector will find it increasingly difficult to improve the return-on-capital while being bogged down by too much debt.

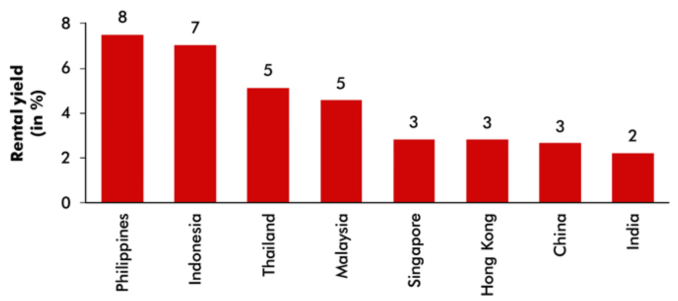
The other black hole

The Indian real estate market's dynamics can be perplexing for most conventional economic analysts. Recent data published by Knight-Frank and Ambit-Research point to huge debt-funded build up in real estate inventory. Over the last 8 years, while sales growth has been flat, inventory has been increasing by 7-8% per annum – most of it funded by bank credit. As a result, most metros have unsold inventory of 2-5 years of sales and the Indian banking systems' exposure to the sector is estimated to be over Rs 500,000 crores.



But interestingly, real estate prices have largely been stable over the past couple of years. Although Knight-Frank estimates that prices have actually increased by 6.3%, some property websites have estimated that prices have actually fallen by 7-18% - overall, once could say that they have been “flattish”. On the other hand, rent yields (annual rent/ capital value of property) have drifted down over the years and are now as low as 2% (against an average of 3-4%). So, one of the two parameters – rent or price – is out of sync. Since rents are usually a more direct reflection of economic activity, it appears that property capital values are actually overvalued.

Rental yields in India are extremely low relative to peers



Source: Global property guide, Ambit Capital research.

Although the Indian real estate market follows a different dynamic to financial asset markets, especially due to the existence of “black money” and the cultural propensity towards property ownership, it does appear that a combination of flat demand, rising inventories, huge debt, extremely low rent yields and very high property rates vis-à-vis per-capita-income, seems unsustainable. All these factors put together should, by conventional logic, result in a deep correction – but at the moment, it does not seem apparent. But if a correction does happen, apart from sinking the highly-leveraged real estate companies, it could really hit the banks and housing finance companies hard.

Outlook

The Indian equity markets have been in a narrow range for a while now, what is technically called a “consolidation phase”. This phase is usually a precursor to a big move, either on the upside or downside. Given that any upside moves will be capped by valuation barriers and that the market is nowhere close to its high, our sense is that the next significant move will be on the downside. Fundamentally, Nifty-50’s fair value is around 7200, about 15% lower from here.

Happy Investing.

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