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Equity Strategy (Citi)
Asia Pacific | India

India Equity Strategy

Falling GDP, Rising Market – Here's Why

- Equities

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- **GDP growth is slumping - but the market is rising** — India's GDP growth has slumped ~250 bps in the last 1 year, expectations have crashed (consensus sub-6%) and India's 'structural growth' story is sounding more like a fable. But, even as GDP growth has been falling, the equity market has been rising (13%+ YTD, +7.5% relative to Asia-ex). Possible mispricing, but there's a plausible explanation too.
- **FY01-03 (last growth slump): the downsides of lower GDP growth** — India grew 4.6% during FY01-03 (down 200+bps); earnings growth moderated, sales momentum tripped, and market multiples dropped to lows. And the equity market fell 39% in FY01 (from dot-com highs) and traded sideways for the next two years. This suggests that equities should be doing poorly into the current slowdown, but that is not the case. So where is the disconnect?
- **But FY01-03: upsides in macro and corporate health**— The slowdown brought gains on the macro – inflation dropped to 3.4%, interest rates fell by 5% and the current account turned to surplus. Corporates gained too – ROEs rose to 22%, margins expanded and corporate gearing almost halved, and the FY03-04 bull market followed. Today we see some early signs of a similar macro easing (liquidity/rates), and a corporate sector refocus on returns/risk vs. growth.
- **Caught between FY01-03 bear years and the bull ones that followed** – We see growth downsides being offset by (further out) macro upsides. This should keep the market tussling, and range-bound. In our view, the growth revival will be slower and macro gains quicker than market expectations: this should lend an upward (and cyclical) bias to the market. We maintain 18,400 Dec 12 Sensex target (+6%).
- **Defensives do well going into a slowdown; cyclicals coming out of it** — Defensives do well going into a slowdown, cyclicals coming out of it and it is a little bit more balanced in between. In our opinion, India is probably in the middle of the economic down-cycle, and we see better risk-reward in cyclicals than defensives.

Figure 1. Key macro variables, FY00-FY03 vs. previous 5 year averages

	GDP growth (%)	WPI Inflation (ann. avg, %)	10-Yr Gov. Bond Yield (ann. avg, %)	USD/ INR (ann. avg)	Fiscal Deficit (as % of GDP)	CAD (% of GDP)
FY01	4.3%	7.1%	10.9%	45.69	-5.4%	-0.6%
FY02	5.5%	3.6%	8.8%	47.68	-6.0%	0.7%
FY03 - - a	4.0%	3.4%	6.9%	48.40	-5.7%	1.2%
Avg (FY96 - 00) - - b	6.8%	5.3%	11.8%	38.29	-4.6%	-1.2%
Change (a - b)	**-2.8%**	**-1.9%**	**-4.9%**	**10.11**	**-1.1%**	**2.4%**

Source: CSO, Bloomberg, RBI, Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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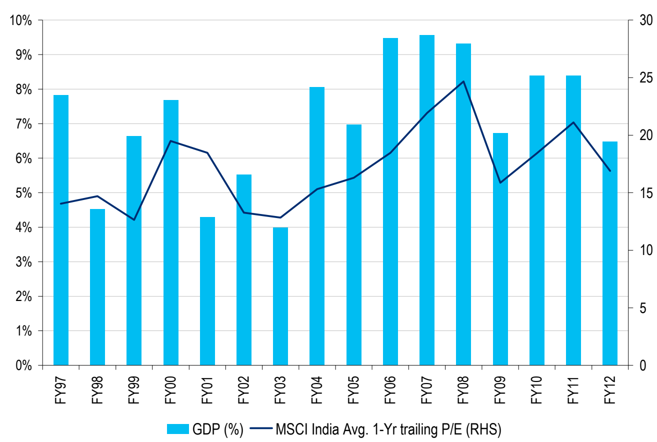
GDP Is Falling, the Market Is Not

India has seen growth drop off before

A GDP downswing similar to the current one has happened in this century….and some people do remember

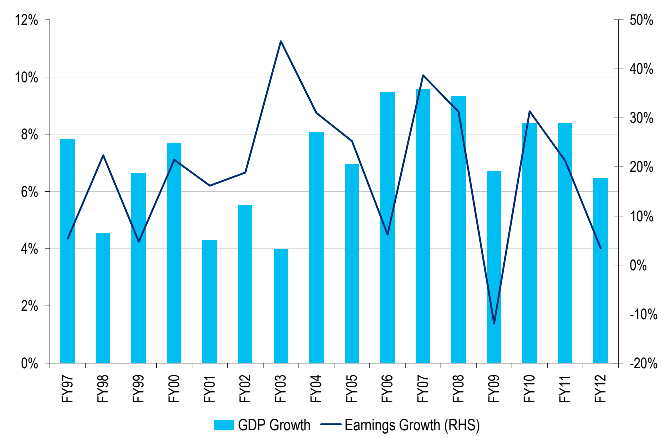
The current economic downswing (not thought of a few years ago) is not exactly new to India. It did happen, at what seems a long time ago, during FY01-FY03: but a number of India investors, and the authors, do remember the time. It was similarly depressing, and followed in the backwash of the Tech bubble (in which a lot of Indian companies/the market participated), and seemed to stretch for a long while. But then India was a smaller market, was followed by and invested in by fewer people, and fundamental / structural expectations were lower.

Figure 2. GDP growth and P/E valuation



Source: Citi Research

Figure 3. GDP growth and earnings growth



Source: Citi Research

But what exactly happened in that slowdown?

In FY01-03, it was the dotcom bust, a high interest rate and credit quality problem, and geopolitical challenges

The FY01-03 slowdown saw India's average GDP grow by about 4.6%: this was 2.2% lower than its 5-year average, and was a more substantial 3.4% drop over the previous year's growth. This slowdown came in the wake of the bursting of the dotcom bubble, followed by a high interest rate and credit quality problem, and was interspersed with significant political and quasi-military challenges in the neighborhood. These challenges were further compounded by the drought in 2002. Thus, it was a mix of several domestic woes, against a backdrop of a poor global environment, that caused the growth slump. And it is not dissimilar to the current problem, which has a greater global component but is also influenced by India's weakened investment and political environment.

So how did it hurt corporates and the market?

Earnings growth dropped below its long term average…but stayed comfortably positive

The drop in the GDP growth rate was meaningful and it took a toll on corporate earnings growth. Aggregate earnings growth moderated to 17.5% (vs. a long-term average of 20%) over the first two years, but posted a recovery in the 3rd year. Encouragingly, earnings growth – in each of these years – remained positive.

Multiples dropped to 14x trailing PE…below longer term average of 17x

Valuations were impacted – India traded at an average of about 14x trailing EPS, 8% lower than the previous 5-year average, and below its 17x longer term average for 1-Yr trailing multiples. That was about the lowest at which India has traded over a sustainable period, and the combination of lower earnings and multiples kept the market at substantial lows.

India is trading at 14.3x 1 Yr trailing (12.7x 1 Yr Fwd) – a little above its economic down-cycle average….set to fall?

So the slowdown in GDP growth led to earnings growth pressures and compression in multiples. In contrast, despite some significant GDP disappointments and downgrades YTD, Indian markets have posted a fairly strong relative and absolute performance. While India has corrected somewhat recently and trades at 12.7x fwd and 14.3x trailing – it is trading above its previous down-cycle levels; is it then set up to fall?

The market is worried ….but is it looking at the macro upside?

It is a risk – and the market is both cognizant, and chattering about it. But we believe there is an offset that eventually played through over 2001-03 – that is providing the market with some of its current tailwinds. And that is – the benefits of slower growth on the macro.

The Macro Improved

Going into the FY01-03 slowdown the macro was stretched…like it is now

India's macro was strained leading into the FY01-03 growth slowdown – in part because of relatively aggressive growth leading into the slowdown, and in part because of structural rigidities in capacities, infrastructure and the operating environment. Inflation and interest rates were high, liquidity was tight, the current account deficit was large, and the fiscal deficit was high too. The system was stretched. The drought in 2002 only added to this long list of challenges.

Figure 4. Key macro variables, FY00-FY03 vs. previous 5 year averages

	GDP growth (%)	WPI Inflation (ann. avg, %)	10-Yr Gov. Bond Yield (ann. avg, %)	USD/ INR (ann. avg)	Fiscal Deficit (as % of GDP)	CAD (% of GDP)
FY01	4.3%	7.1%	10.9%	45.69	-5.4%	-0.6%
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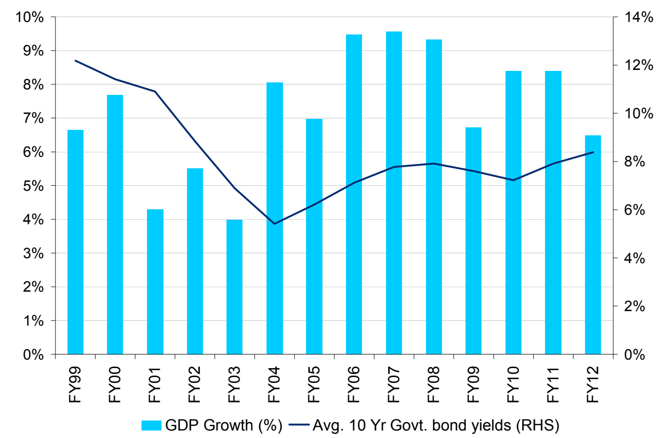
Source: CSO, Bloomberg, RBI, Citi Research

Towards the end of the slowdown, the macro had improved appreciably…other than the fiscal deficit

On the positive side, the growth slowdown helped to ease some of these macro pressures. As the table above highlights, over the three year period, when growth was low and below its previous averages, there was a reversal in most macro parameters. Inflation moderated materially, interest rates stepped down structurally as banks hoarded capital and moderated risk, banking sector liquidity rose substantially, and the current account turned into surplus. Fiscal deficit was the only exception, which expectedly went up as growth slowed. Effectively, easing growth released a lot of macro pressures. There likely were other contributors…but slowing growth was the primary driver of easing macro variables

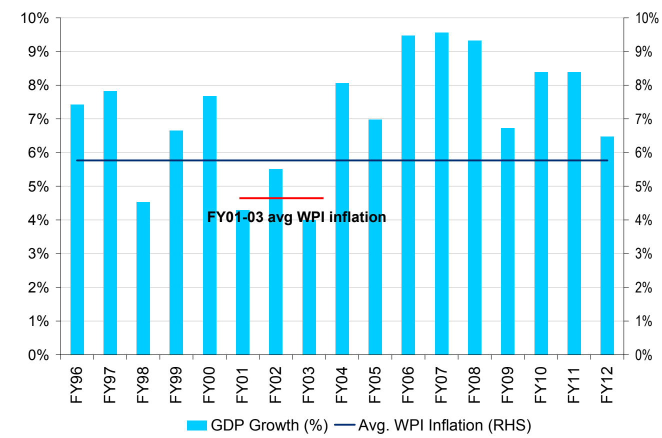
For sure there would have been other drivers – easier crude prices, the IT services and remittances boom and other fiscal and global and fiscal elements that would have influenced this switch. But we believe it was the step-down in growth that was probably the catalyst for this reversal.

Figure 5. GDP growth and interest rates



Source: CSO, Bloomberg and Citi Research

Figure 6. GDP growth and inflation



Source: CSO, Citi Research

The macro could ease in the same way this time…in fact, there are possible early signs in easing liquidity and falling market interest rates

We believe it could be similar this time; even as commentary, data and expectations on the macro continue to be very weak. To be sure, some of it is possibly already showing, albeit in very small measure. It is most apparent in banking sector liquidity – with the extreme shortage now gone, and the banks only marginally borrowing in the system. It is visible in market interest rate (not RBI's policy ones) – where top end corporate borrowers are beating down yields – by the order of 50-100bps. And it is spreading to retail assets too – where banks are beginning to price more aggressively. To be clear, our economist Rohini Malkani expects the RBI to cut its policy rates by 50bps only during the rest of the fiscal (on account of inflation considerations) – but we believe the slower/lower growth gets, the greater will be the downward pressure on interest rates (the yield curve is almost flat in any case).

Not all one way….headline inflation will be more rigid, the CAD will be more oil driven than by a likely slowdown in non – oil imports

It is probably less so with inflation where pent-up administered price increases will lend an upward bias to headline inflation. And non-food or core inflation continues to show an upward bias; however, we believe this will at some stage reflect the fairly apparent weakness in demand and slacken. The CAD impact on account of the slowdown is also more challenging to argue for given the vulnerability to oil prices. But we do believe the likely slowdown in capital goods imports (inconsistently visible in recent data), and the relative resilience of remittances and software exports (and the attractiveness of a substantially weakened currency), could also lend some tailwind. The fiscal deficit is a different story, though, with the slowdown likely to put further pressure on it, and is unlikely to improve until we see economic recovery. However, traditional strains on interest rates due to a high fiscal deficit should be moderate because of easy liquidity.

So we do not argue for a complete reversal in the macro on account of the slowdown but we believe it will improve, and ease what has been both a market valuation and growth overhang.

And corporates cleaned up

Corporate balance-sheets and returns in 2012 looked similar to those in 2000

The corporate sector going into 2000 was not too dissimilar from what it has been going into 2012. Balance-sheets were extended – leverage was high, margins had fallen and ROEs were modest. Sales growth was beginning to slacken, high interest costs were hurting, and asset risks for the broader banking system were high. Yes, very similar to the story of today's corporate India.

Figure 7. Key financial parameters for S&P Large Mid Cap Index

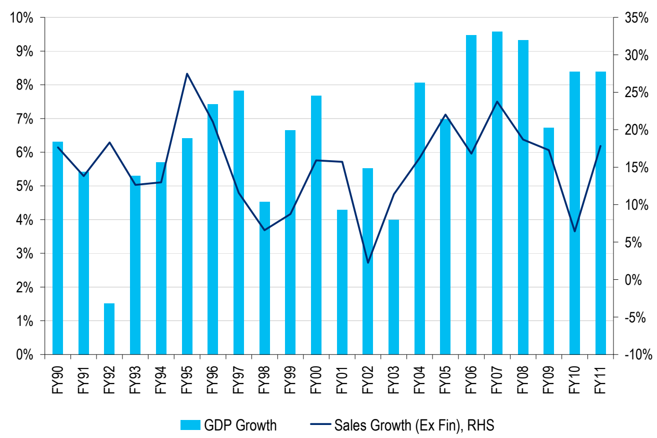
	Net Margin	Net debt/ Equity	RoE	Earnings Growth
FY00	7.9%	65.6%	15.9%	21.5%
FY01	7.7%	72.5%	17.1%	16.2%
FY02	8.0%	38.8%	18.6%	18.8%
FY03	9.3%	37.2%	22.2%	45.6%

Source: S&P, Worldscope and Citi Research

Growth slowed…returns rose….and gearing dropped

Corporates slowed down; but cleaned up. The table above reflects the significant and fairly broad based improvement in aggregates as businesses refocused on profitability (some on survival), eased off on growth, and brought back their houses in order. Everyone did not do as well or survive, but the corporate sector at large actually turned it around fairly impressively.

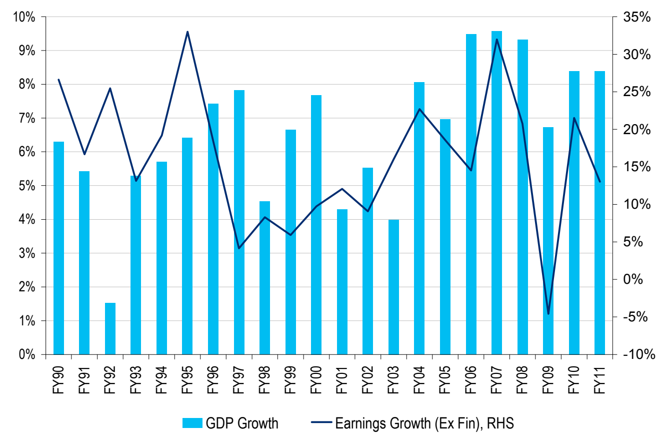
Figure 8. GDP and corporate sector sales growth



Source: CMIE, CSO and Citi Research

* Includes both listed and unlisted companies

Figure 9. GDP and corporate sector earnings growth



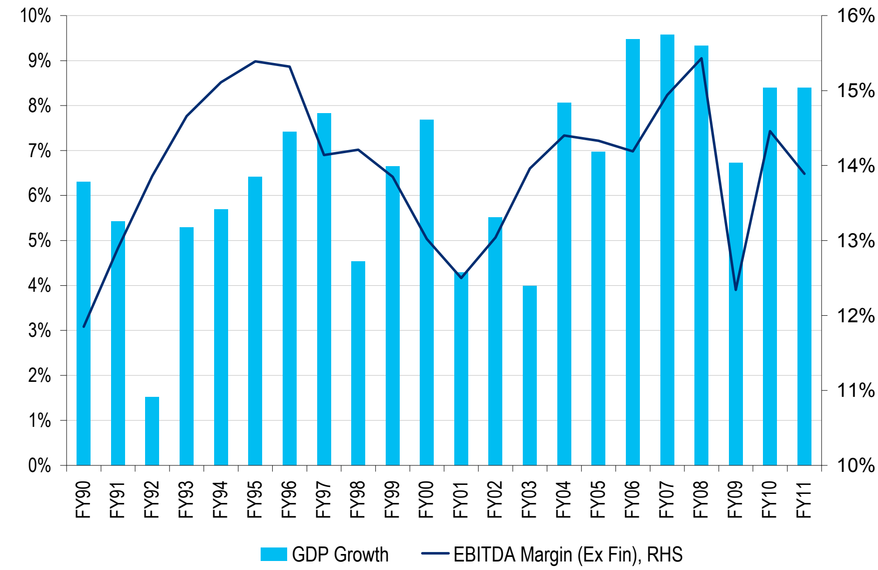
Source: CMIE, CSO and Citi Research

* Includes both listed and unlisted companies

Corporates appear to be focusing on balance-sheet and return repairs…partly reflected in recently quarterly results

We see a similar starting point and some suggestion that businesses are doing more or less the same thing i.e., focusing on returns, costs and less leverage. This is also in part reflected in recent quarterly results – where aggregates margins have now been up three quarters running (qoq), sales momentum is moderating, and new capex / investments announcements are moderating (there are of course other reasons for that also). It is still early days, but we do believe the corporate mood is clearly more profit and lower risk focused, and should result in better corporate fundamentals.

Figure 10. GDP and corporate margins



Source: CMIE, CSO and Citi Research

* Includes both listed and unlisted companies

A Growth Downside – Macro Upside Trade-off ?

If it is so similar to FY01 should India trade lower?

If the current slowdown, and macro and corporate positioning, is so similar to FY01-03: shouldn't the market trade at lower multiples, for 1-2 years, as it did in then?

No…..the market should and possibly is seeing the benefits of easing in some of the macro pressures...

While the current multiples (14.3x PE trailing) average 1-Yr trailing multiple of 14x over FY01-03, we do not see further downside in multiples. This is because we believe the market sees light at the end of the tunnel, and is seeing this earlier than in FY01-03 (given history). We would in fact argue that the market is effectively trading-off slower growth / lower multiples downsides; with the potential upsides of an improving macro and corporate sector.

We expect this trade-off to last a while …. and the market is unlikely to move sharply unless the economy swings

This is probably the reason behind the market's recent performance, and we expect this to be a recurring theme (until the slowdown or the recovery is more decisive). We do believe it is the timing and the pace of economic recovery that will largely determine when the market moves secularly, up or down.

We see less economic growth delta, and less market leverage, than in 2003

Our own view is that the economy will tend to be relatively stable from a growth perspective – averaging 5.8% growth over FY13/FY14 – and it will have neither the downsides of FY01-03 nor the upsides of the rebound that followed.

Market level, and how to play it?

Upward bias…Sensex target of 18,400 by Dec12 (+6%)

We expect this slowing economy vs. improving macro and corporate profitability trade-off to sustain for a while. And we see structurally lower valuations for the Indian market (14-15x 1-Yr fwd) vs. its longer term averages of 15-16x 1 Yr fwd. But we do not see the market staying at its slowdown-year multiples, 12-13x, for any sustainable length of time. Towards that end, we expect the market to show an upward bias, but a fairly modest one through to the rest of the year.

Sector show in FY01-03

Defensives did well in the early part of the slowdown…..cyclicals on the way out… you might need to time it, but cyclicals did better through the cycle the last time around

The FY01-03 sectoral data is influenced by the tech bubble and its burst in 2000, so it does tend to skew certain performances. In addition, the relatively smaller market representation will possibly distort some of the inferences. Our analysis however suggests that at aggregate, the early part of the slowdown was characterized by a relatively strong performance by the traditional defensives – Consumer staples, Healthcare, Energy and Utilities – while the exit leg of the slowdown saw the cyclicals – Banks, Industrials and Materials – leading returns. The results were more mixed through the slowdown cycle but the more levered and rate cyclical businesses tended to outperform at aggregate.

Figure 11. Performance of Indian equities and sectors

	FY00	FY01	FY02	FY03	FY04
MSCI India	77%	-39%	2%	-13%	74%
MSCI India rel. to GEMs	27%	-9%	-18%	11%	11%
Sectors (relative to MSCI India)					
Cons. Disc.	-95%	-14%	56%	-14%	97%
Cons. Staples	-83%	35%	-5%	-12%	-52%
Energy	-27%	50%	33%	1%	17%
Hlthcare	-57%	25%	27%	4%	-31%
Industrials	-77%	34%	-7%	22%	122%
IT	198%	-36%	-11%	1%	-47%
Materials	-16%	51%	-16%	-2%	44%
Telecom	-44%	-4%	12%	-36%	-8%
Utilities	-33%	32%	15%	11%	69%
Banks	-82%	43%	3%	32%	40%

Source: MSCI, Datastream and Citi Research

If more economic downside, then it should be defensives...if the worst is done, then it should be cyclicals…your call

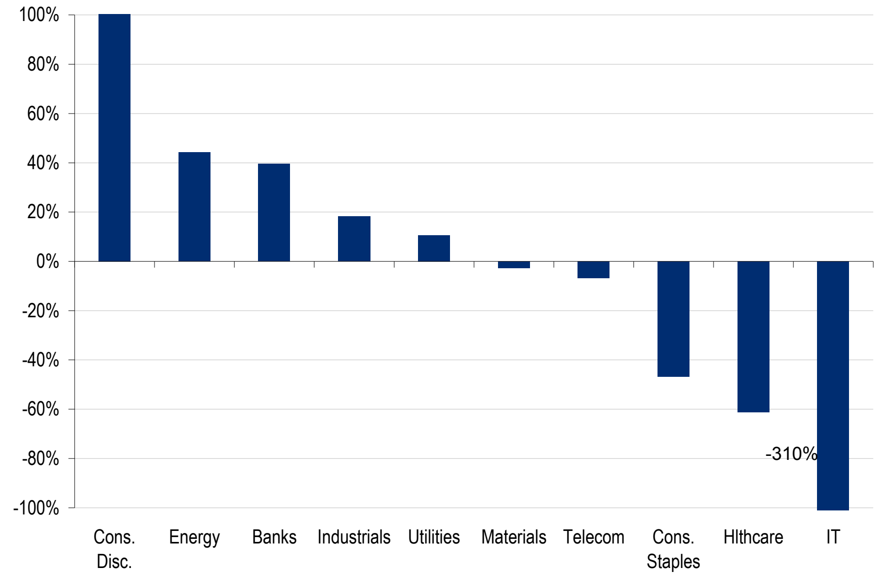
Will it be different this time, as one goes through the slowdown cycle? It tends to be different every time and it should be so this time, too. Our own sense is that cyclicals and the industrials will tend to be better positioned, particularly as and when (and if) expectations of an economic recovery or macro gains start showing up. While if the economy continues to slow or gets more mired in the political issues surrounding the economy, defensives should continue to do well.

Figure 12. GDP growth and valuations

1-Yr trailing P/E												
	GDP (%)	**MSCI India**	**Cons. Disc.**	**Cons. Staples**	**Energy**	**Hlthcare**	**Industrials**	**IT**	**Materials**	**Telecom**	**Utilities**	**Banks**
FY01	4.3%	16.9	14.7	33.9	5.2	37.8	11.4	83.7	12.4	6.2	7.7	5.0
FY02	5.5%	13.1	22.4	26.5	7.3	30.3	10.0	18.1	10.4	4.8	7.0	5.9
FY03	4.0%	12.6	23.6	19.4	9.5	20.5	10.8	23.3	8.9	3.7	7.1	8.7
Current		14.7	7.9	35.8	14.5	32.3	14.4	17.3	11.3	21.2	14.9	13.5
Sector premium/ (discount) relative to market												
			Cons. Disc.	**Cons. Staples**	**Energy**	**Hlthcare**	**Industrials**	**IT**	**Materials**	**Telecom**	**Utilities**	**Banks**
FY01			-13%	101%	-69%	124%	-32%	395%	-26%	-63%	-54%	-70%
FY02			71%	103%	-44%	132%	-23%	39%	-20%	-63%	-47%	-55%
FY03			87%	54%	-25%	62%	-14%	85%	-29%	-70%	-44%	-31%
Current			-46%	143%	-2%	119%	-2%	17%	-23%	44%	1%	-9%

Source: CSO, MSCI, Datastream

Figure 13. Change in sector premium/ (discount): FY03 – FY01



Source: MSCI, Datastream and Citi Research

2012-14 does not have the economic / corporate / market leverage of 2003….

We would however argue against the likelihood of a redux of 2003 – when there was a very sharp rebound as equity markets leveraged off the growth explosion that followed. Starting expectations are higher, the scale is bigger, the policy challenges are significantly greater, and investor exposure is that much higher. In addition, hopes of a cyclical rebound are somewhat already in the price – reflected in the market's performance, even as GDP growth is slowing and news flows remain far from supportive. This too would serve to limit the upside from here.

Nevertheless, we continue to position our model portfolio for up moves with a cyclical tilt to capture performance above the 5% upside we see to the market.

Appendix A-1

Analyst Certification

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Data current as of 30 Jun 2012	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
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% of companies in each rating category that are investment banking clients	44%	43%	40%	48%	43%	45%

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