

INVESTMENT MATTERS

January 17, 2007

2007: Crystal Ball Gazing

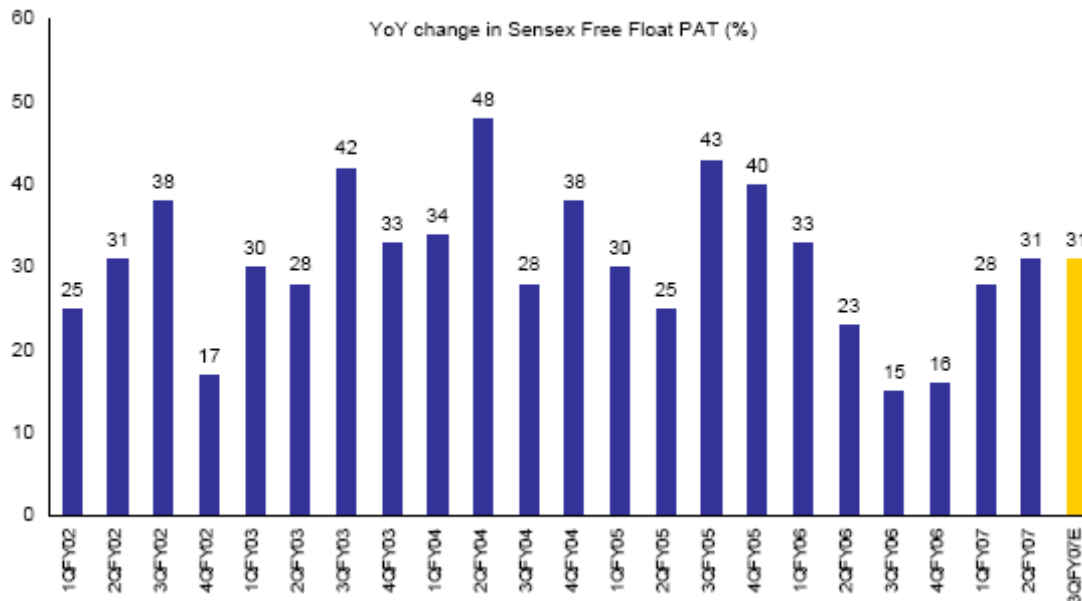
Hiren Ved

hiren@alchemycapital.com

2006 was a year of surprises for India. Both the economy and the corporate sector surprised the investor on the upside. A mid-year 25%+ correction in the middle of a raging bull market also came as a surprise. Not because of its occurrence but because of its sheer swiftness and depth. However, strong fundamental underpinnings of the economy, robust corporate earnings growth coupled with a rebound in sentiment towards emerging markets as an asset class helped the Sensex deliver a 47% return in 2006, its fourth consecutive year of positive returns.

Needless to emphasize, that such a snap back can only occur in a structural bull market. So what's in store for 2007?

In 2006 India's economic growth performance target was comprehensively beaten. A 9.1% GDP growth for H1FY07 (April – September, 2006) is the strongest growth in any six months since FY04. We believe that the drivers are in place for the economy to not only deliver on expectations (8-9% DP growth), but raise the bar even further in 2007. This we believe would be made possible by acceleration in corporate and infrastructure spends coupled with a steady increase in consumer spending, helping India to further lift its trend growth rate. India Inc has posted strong top and bottom-line growth for last four years on back of improved efficiencies and better operating leverage. The Sensex companies have posted PAT growth in excess of 35% in 1st half FY06 and the ROE of Sensex companies has jumped to 23.6% in 2006 (its highest ever) as compared to its 15 year average of 17.3%. High ROE (in conjunction with high growth rates), as we have always argued in the past, is the reason why Indian markets trade at a premium to other emerging markets. There continues, as in the past few years, a healthy skepticism based on an overwhelming consensus regarding the sustainability of high earnings growth and ROE's, given the higher base effect, higher CAPEX and margin pressures.

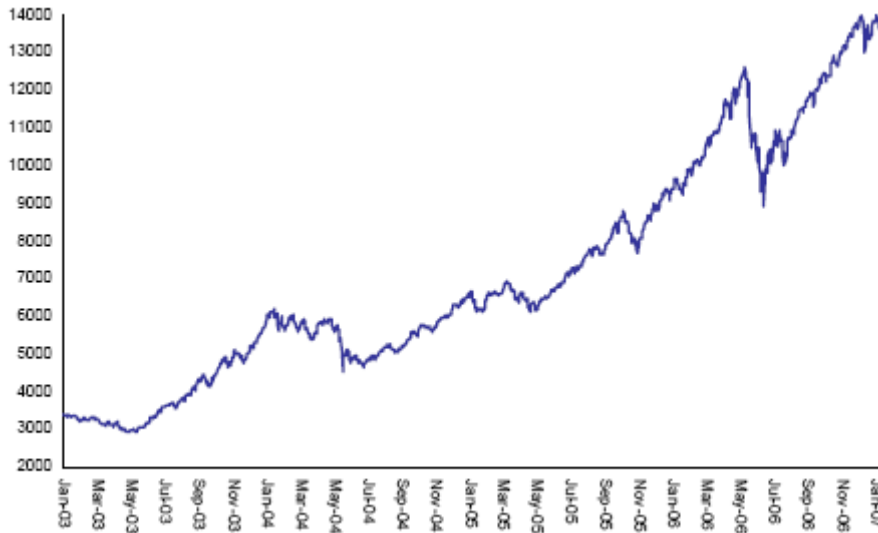


While this is, mathematically, hard to dispute, I believe the strong culture of using capital, efficiently and productively, is now well engrained in corporate India's ethos. So, while we could see some tapering off of ROE as the new capex cycle begins to play out, I believe that, structurally, we have graduated to higher growth and efficiency plane. The Q3 FY07 earnings season has started on a very strong note and I expect the earnings growth momentum to continue as the year progresses. I expect earnings to grow in the range of between 20-22% for FY08 as against a monotonous consensus of 15% put out by street analysts each year.

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That brings us to the billion-dollar question – how do we see the markets faring in 2007?

While it would be too brave to expect another 40%+ return year in 2007, after two consecutive years' of 40%+ returns, it should not be impossible to eke out a 15% return on a broad market basis. This should take the markets in the 15500 to 16000 range for the year (FY08 EPS of 850 and P/E of 18-19x) with the support on the downside being in the 12600-700 levels (being the previous top in May 2006). A relatively moderate return year should prove to be a good year for stock pickers (though India has always been a stock pickers market). I also expect a relatively higher level of participation by domestic investors (through higher MF flows and IPO) if the markets manage to sustain above 14000 levels alongside the traditionally strong flows from FII's.



The potential party poopers on the domestic front could be high inflation and hence higher interest rates. While the recent softness in commodities, especially oil, augurs well for sobering inflation, we could see one more tightening cycle of approx 25-50 bps. Global risks would be to watch out for a dramatic fall in the dollar and the resulting ripple effect it could have on global liquidity flows.

In sum, despite the attendant risks the long trade on Indian equities should be a good one. I wish you all a healthy and prosperous 2007.