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Diminishing returns

Investors should be wary of relying on a link between overall growth of the economy and returns on specific company stocks

Investors making the idle assumption that superior economic growth will produce superior stock market returns may still get away with it in India in 2010. This equation of rapid economic expansion with rapid creation of value by companies, however, is going to be tested more often as Indian entrepreneurs put larger amounts of capital to work.

India is certainly in line to become the top destination for international investors. With expected real GDP growth of 6-7 per cent or more in 2010, against 2 per cent for the US, Europe and Japan together, and an economy more balanced than China's between consumption, investment and exports, India is going to be recognised as the biggest sustainable growth story in the world.

Total corporate earnings will, of course, float up with the economy. Adding the IMF's forecasts for India's real GDP and consumer prices in the year ahead gives a nominal GDP rise of about 15 per cent. That is consistent with brokers' estimates of earnings growth for the stock market as a whole of around 20 per cent, since overall earnings (year-on-year) should be well ahead of the growth in the economy in 2010, as companies recover from the inventory depression of early 2009.

Even so, aggregate earnings can increase, while returns on equity capital decline. As Morgan Stanley pointed out in a report, India has, in the past, achieved higher returns on equity (RoE) than other emerging markets. In 2004-07, India Inc achieved an RoE of more than 20 per cent, over 6 percentage points ahead of the rest of Asia (ex-Japan). Reasons for this include the ability of Indian entrepreneurs to sweat their assets harder and keep them working longer. Morgan Stanley makes the point that India had temporarily lost some of its advantage of higher RoE in the downturn last year, but expects Indian business to regain this.

That Indian companies are efficient users of their assets, and of the capital that finances these assets, makes intuitive sense. Promoters are aligned with other shareholders' interests in minimising dilution as their enterprises grow. The obvious contrast is with the producer-driven, management-dominated enterprise systems of China and Japan, which have wasted huge amounts of capital on excess

capacity. A further possible source of higher RoE in India may be the supply-side constraints that, in some sectors, have inhibited the entry of new competitors. So, perhaps part of India's superior returns on capital could be residual economic rents as incumbents profit from entry barriers.

The fate of India's mobile phone industry shows how quickly competition can put the relationship between growth and profitability into reverse. This is admittedly an extreme case – no other major market has unleashed 14 operators so late in the market's development, or seen growth in revenues stall so completely, while new subscriptions were still racing ahead. There have been other cases in India: returns on road projects, for example, were bid down very quickly to low levels in 2005-06, before the NHAI's programme ground to a halt. There will be more to come. When the power generation industry begins to catch up with demand in 3-5 years' time, there is likely to be a sharp downward adjustment in valuations, as expectations of returns on the enormous pool of assets being created in this industry are reduced.

So, investors should be particularly wary of relying on a link between overall growth of the economy and returns on specific company stocks, when it comes to investing in infrastructure industries based on long-term ownership of substantial fixed assets. Successful economic development in India will, by definition, mean that the shortages that give exceptional rewards to early investors (for example, on merchant power) have to be competed away. Successful development will also mean the emergence of long-term investors like life insurance companies, that compete to own assets with returns much lower than the 20 per cent-plus RoE that Indian business has been able to generate.

Asset-intensive business models involve other risks during rapid economic change. Failed retail formats or unwanted TV channels can disappear overnight, leaving surviving competitors with an open field. Excess capacity in industries like shipbuilding lingers on for years, depressing returns for all competitors.

For investors who want to do more than simply buy the market, the macro-economic growth story is a cue for caution, not just celebration. ♦