PREMIUMISATION OF THE INDIAN MARKET

India's premium status in Asia and Emerging Markets has been a matter of much discussion and some consternation. We refer to the valuation premium that India enjoys.

Indices	P/E (x) – Current Year
Nikkei 225 (Japan)	23.9
NIFTY 50 (India)	20.9
S&P 500 (US)	20.6
TAIEX (Taiwan)	18.6
KOSPI (South Korea)	15.2
Emerging Markets	Around 13-14
Shanghai Composite (China)	11.3

Note: Earnings Data is as per CY23E for all markets except India (FY24E), prices as of 30th Nov 2023.
Source: Bloomberg, IIFL Securities, Spark Fund Research

This premium that India enjoys has expanded in recent years. Asset allocators/Strategists who have expressed concern on India as a stock market have almost invariably raised a red flag on this. They have not taken a view that India is a bad story. Nor have they stated that the growth outlook elsewhere is better. Most of them have even agreed that some premium is in order – but then, how much is too much? That is where the rubber does not meet the road for many.

A brief peek into premium markets from yesteryears

Japan – The premium emerged when Japan evolved into a developed economy and an export powerhouse in the 1970s and 1980s. Finally, the Nikkei ended at an all-time high of 38,957 in 1989. Valuations had hit a century (P/E). The market crashed and the 1989 high is yet to be taken out after nearly 35 years. Of course, the economy has been in recession during a good part of this time and Nikkei may not have captured the Japanese success stories well enough. However, this premium did not end well at all.

Taiwan – Traded at a big premium during the 1990s. The tech heavy TWSE had heavyweights like TSMC, chip design companies and outsourcing giants who traded up big time, particularly during the Nasdaq boom in the late 1990s. The rub-off effect was felt even in petrochemical companies (Formosa Group) – which traded at high valuations even though Taiwan neither had crude nor a market for finished products (other than access to China). This premium has moderated somewhat over time.

Southeast Asia – Traded high in the 1990s, collapsed during the 1997 Asian crisis and these markets have never been the same again.

The perpetual laggards

Korea and China take the pole position, with Brazil and Russia not far behind. Will not elaborate on Russia – everyone had concerns for ages and those have been proved right. Brazil was always commodity heavy and LATAM has been infamous for currency crises.

Korea is a curious case. It has successfully become a developed economy and a success story with a per capita income of USD 33,150 (Taiwan – USD 32,340). It always traded at a discount and for Korea, this broadly came to be known as a governance discount which was always held as a country risk.

The conglomerates that control a lot of corporate activity in Korea never satisfied the foreign investors and Korea has been accused of rampant private sector corruption as well.

Then there is China. Perhaps it is the most successful of the post WW-II economies. It has not rewarded stock market investors in the long run. Shanghai Composite has moved by 36.44% in the last 10 years (3.15% CAGR). Absence of respect for balance sheet returns (hard to get Chinese companies talk about ROE/ROCE – the game has always been about market share, gross margins, and growth) has been one main reason. Too much government presence & control in banking & financial services, telecom and other key sectors has been another drag.

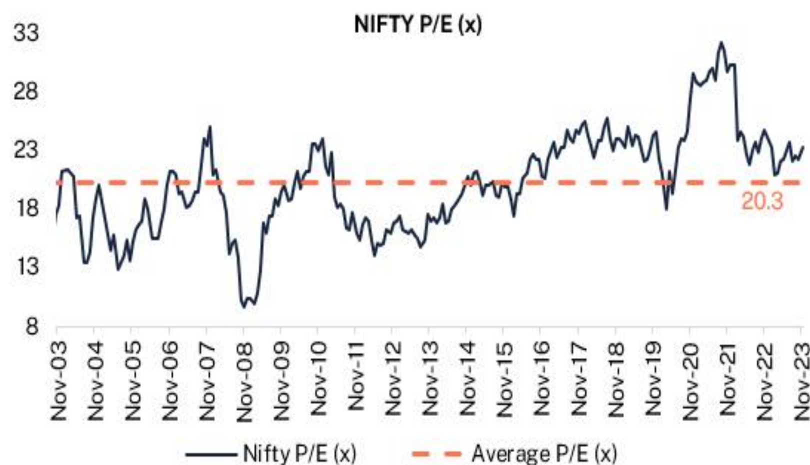
In a nutshell,

Those markets who bubbled up have come crashing down.

Those who were laggards became chronic stretcher cases.

But here is an important point to note. In any measure calculating an average, there are data points on either side. In the game of emerging market valuations, the laggards and leaders have never switched positions. India and Taiwan have been premium markets and have remained so. Therefore, the fretting and fuming over India's premium needs to be contextualised with due merit accorded to the risks brought about by an expanding premium.

Indian rope trick - A market that deifies gravity



Source: Bloomberg, Spark Fund Research

India has not been such a big economic success story yet when compared with China, Taiwan, or Korea. Yet it always enjoyed this premium status. What led to it? Can it sustain?

Leadership stickiness – Advantage Strong Incumbents

One, India always had high cost of capital and markets disciplined the bad boys and rewarded those who behaved. This proved a competitive advantage to those who got capital at the most attractive terms (e.g. – Private banks like HDFC bank).

Two, regulation has been good in India over time. SEBI has done well over time. RBI has been a highly under-rated and extremely effective regulator by global standards – not just in EMs. If banks have done well and bank shareholders (including the legions of employee beneficiaries) have amassed shareholder value even from large absolute base levels, they have RBI to thank for. RBI has kept the system safe for well-reasoned risk-taking.

Three, the slow pace of reforms from the government has benefitted incumbent businesses in a big way. Staccato reforms prevented competition to come in. An unintended result is persistently high ROCE for the leaders. Similarly,

the painfully slow pace of reforms in the financial sector have ensured that the private banks (and insurance companies) kept gaining share from their public sector counterparts.

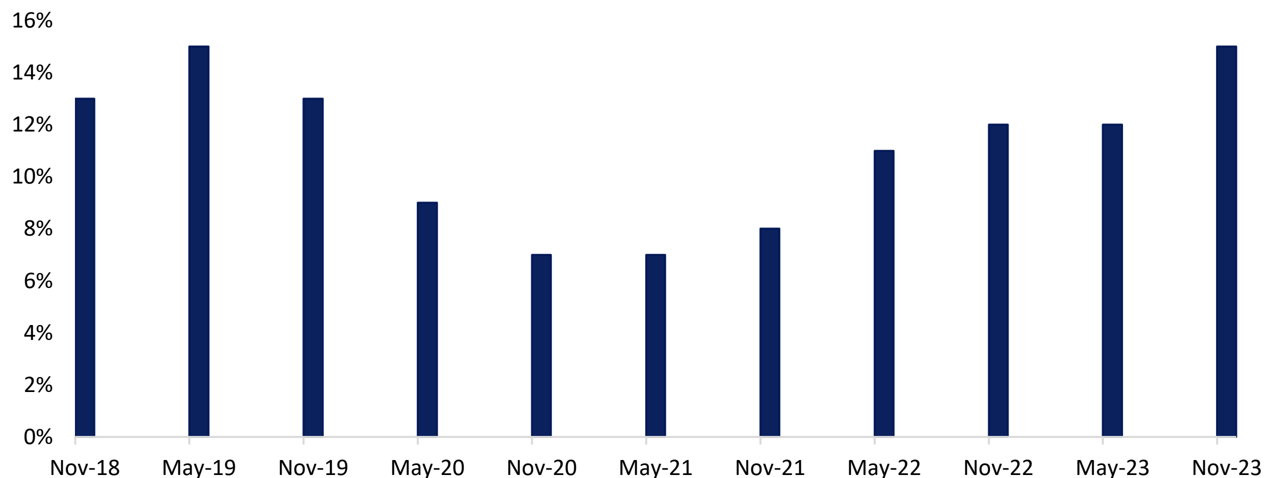
Good governance

While it was horrible in the 1990s and there have been various instances of disasters, good examples have outnumbered the horror stories. Companies like Infosys, Hindustan Lever and HDFC Bank have set high standards. Even the mighty Tata group has seen its market cap leapfrog after some governance gaps were plugged. Good role models have spawned a slew of companies who have learnt to respect and take advantage of good governance, transparency, and fair practices. A virtuous cycle of sorts has been the result. This is hardly the situation in other emerging markets.

Role of government

It has been a long-held principle in free market governance systems that governments should stay away from business. In emerging markets (and many developed countries as well), they don't stay away. This has been a problem. India has been no exception but the developments over the last decade or so have been incrementally positive.

Where independent regulators have evolved (RBI, IRDAI, SEBI – to some extent the authorities in the power sector), we have seen progress. On the other hand, Indian government has perpetually been pressed for resources. Public Private Partnership has not been a matter of conviction. It has been more of a compulsion. Further, the scams of the UPA era ended up strengthening processes. While privatisation has still not happened, India may be moving towards that. The political realization that intervention in social sector gives greater benefits to parties in power than tinkering with businesses is sinking in as well. There is a reason to be cautiously optimistic.



Note: The above percentage was calculated based on market cap of PSUs at the end of each period.
Source: ACE Equity, Spark Fund Research

There are large companies in the PSU space with leadership in B2B businesses that will benefit big time when the economy shifts gears led by a more balanced growth than just consumption-led growth. This may be happening now and this will give variety in the choice of companies that investors have in front of them. This can support valuations at an overall level as the PSU stocks do not trade at astronomical valuations yet.

How concerned we should be about India's premium

While an unbridled expansion in premia for market multiples have usually not ended in a good place, India's premium is at present not in that zone. Behavioural factors are always important here. Here is why we believe the concerns on India's premium multiples may be a bit premature

1. India's market multiples are an uncomfortable average of sorts between very expensive stocks (consumer names, select private financials and IT services for most part) and more reasonable valuations elsewhere. The economy sensitives can have earnings upgrades when there is growth, and this will get priced in progressively.
2. India as an economy does not have a leverage issue which is at alarming levels. There are concerns and in part, these were addressed by RBI recently. Proactive regulatory moves have been very much in evidence for much of the last 10-15 years in many instances. This inevitably helps equity investors after short periods of pain.
3. India's market leaders seem to have the ability to generate superior return ratios. Some of this is due to good management. Some of it is due to the slow pace of reforms which helps incumbents. Be that as it may, the availability of several companies with high quality metrics – financial and business – is supportive of premium valuations.
4. There has been a virtuous cycle we have witnessed where good governance has resulted in shareholder returns which in turn has ensured good governance. Of course, there are some very bad stories – unlisted space is a key concern and private equity investors do not seem to practice what they preach. However, much of the listed space is in better hands. At least as of now.
5. The government, even though much-maligned – is getting better with its own effort at maximising value and efficiency. Increasing role of independent regulators and better processes are leading to more value creation. While we don't want to go overboard on this, the story is one of improvement and not otherwise.

Is there hype?

Of course, there is.

Is there greed?

Of course, there is.

That said, we believe we are NOT at a point where the premium will shrink easily. India is a good story even from a geopolitical angle with a lot of capital looking to come in. In the current juncture, we are better off worrying about the internals of the market and pockets of excesses rather than the premium that India enjoys.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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