

'Select mid-cap IT stocks offer growth prospects'

Fair valuation of stocks has prevented a rally despite higher FII inflow

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Markets could begin to perform better over the second half of the fiscal as earnings show signs of being back-ended, improving in the later half feels, Mr Soumendra Lahiri, Head Equities, Canara Robeco Asset Management.

Impact of inflation on corporate margins could continue for a couple of quarters though, says Mr Lahiri, in an interview with *Business Line*.

Excerpts from the interview:

How do you see the earnings season panning out?

The first quarter of FY11 was expected to be tough in terms of earnings growth. Revenue growth continues to remain robust even while the impact of higher costs in the form of raw material, wages, and so on is visible from the lower margins. Also, higher interest rates will have an impact on the operating costs of corporates. Even though topline growth for companies is expected to be in the range of 18-20 per cent, bottomline will continue to remain under pressure and is expected to grow at levels close to 12-14 per cent.

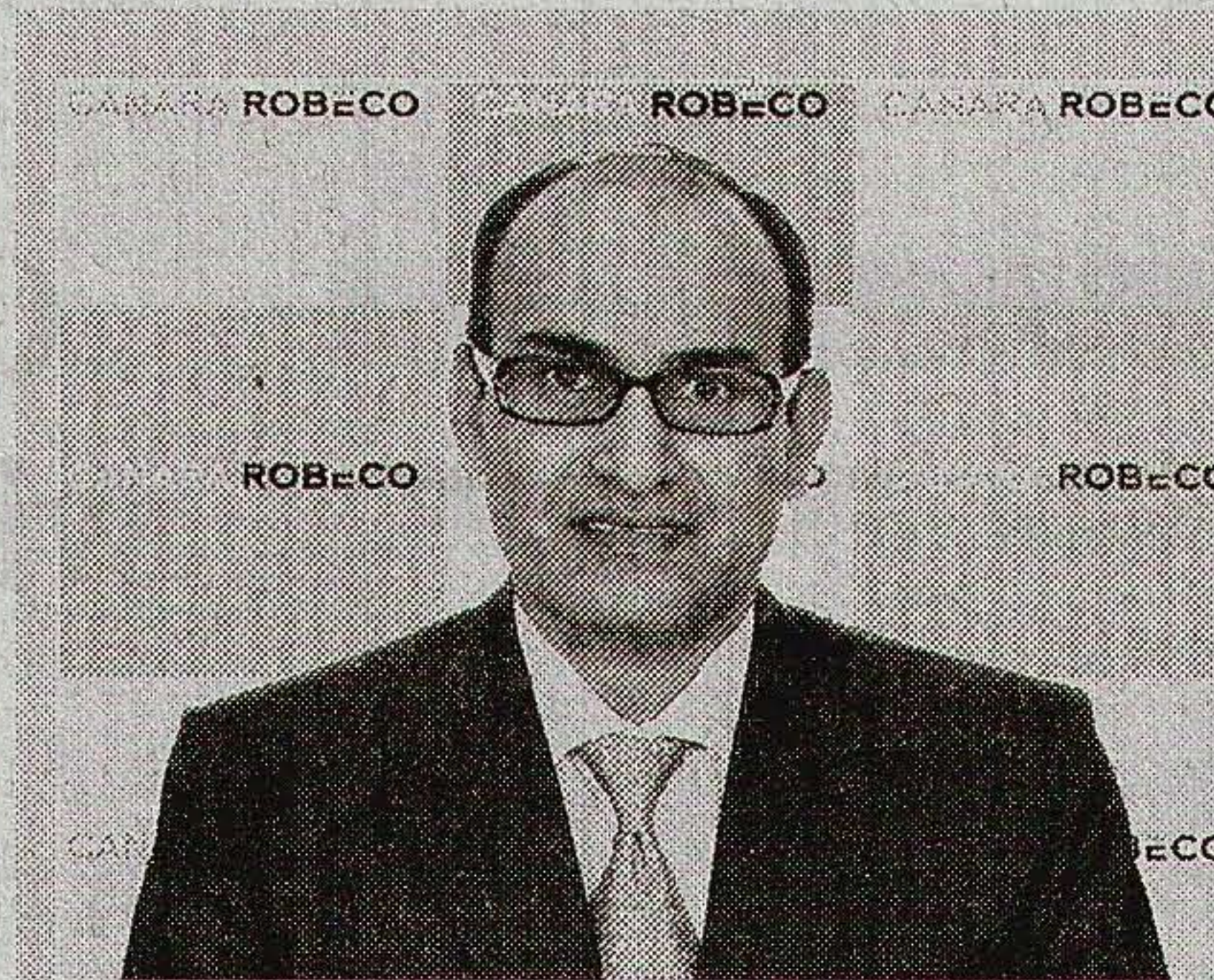
Would tightening liquidity and expectations of commodities gaining

ground once again begin to hit earnings of corporates?

The impact of these on corporate margins is already seen over the last 12 months. Amongst others, the manufacturing sector has been hit the most which is reflected in the IIP numbers (5.8 per cent year-on-year growth for May). We are likely to see further erosion in profit margins going forward. However, we expect this impact to last for a couple of quarters before we see signs of inflation peaking out and interest rates cooling off.

FII money has returned but there does not appear to be any positive signal for a re-rating in the markets, given the slowdown suggested by most economic indicators. What is your sense of where the markets could move?

The FII flows through the year have been very lumpy and mostly concentrated around the end of the quarters. We have seen flows coming in at the end of March and then again towards the quarter-ending June when markets spiked. FII inflow in CY 2011 totalled Rs 10,240 crore (till August 1), which is better than other emerging markets. One reason why markets haven't really taken off despite these flows is that valuations are



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— Mr Soumendra Lahiri

for their defensive attributes causing a polarisation in valuations. Can they live up to the high valuations demanded?

We have seen a period of global economic uncertainty in the last two years. The problems in the US, Euro region and concerns in China have impacted global growth. In such a market environment, consumer stocks tend to do well due to strong cash flows, high return on equity and good dividend pay-outs. However, valuations seem to be a bit on the higher side. With such high valuations, this space is priced for perfection and one needs to be very careful while investing

fair at the current levels. Markets seem to be fairly priced at 16 times FY 12 earnings, trading near their long-term average. In this current scenario, the main driver for the markets would be the earnings growth. Thus, an earnings upgrade would be essential for markets to move up from the current levels. Also, a large part of the earnings growth this year seems to be back ended, which means you would see better earnings towards the second half of the year. So, one could expect markets to perform better in the second half of the year.

Consumer stocks have been traded up

at current levels.

Which sectors would be termed as 'value' opportunities at this point in time?

Broadly, we are more stock specific in our approach rather than picking up a sector as a whole. However, there are opportunities showing up in sectors like cement and IT. In cement, capacity additions have been taking place over the last year or so whereas the demand has been lacklustre. However, things are expected to change over the next two to three quarters which should result in improved demand for companies. Within the IT space, we believe that certain mid-cap companies are offering reasonable valuations with good growth prospects in the medium to long term.

Recent annual reports suggest an increase in the cash and equivalents held by corporate India (in March'11) over a year ago. Do you think there are indications of reluctance to deploy money?

While the overall balance sheet size of most corporates has grown, two elements – Working Capital and Cash & Cash equivalents have shown higher growth. The surge in working capital can be attributed to the rising cost of raw

materials which has increased the overall input costs for corporates. The slowdown in policy decisions and subsequent reforms growth have resulted in corporate preferring to adopt a wait and watch attitude towards investments and hence have gone slow on capital expenditure. In the interim, the cash and cash equivalent allocation has gone up. Thus, high interest rates combined with lack of demand growth have led to companies increasing cash levels and postponing investments till the market environment improves.

Mid-cap funds have been struggling to put up a decent three-year track record. Are the risk adjusted returns turning out to be unattractive?

The current environment with high inflation, higher interest rates and slowdown in demand make it difficult for smaller companies to perform. However, at this point in time, valuations in this space are reasonable. Given the current market environment, one needs to be more stock specific in the mid-cap segment with focus on companies having strong operating cash flows and demonstrating improving operating parameters like revenue growth and return on capital.