The Case for P/E De-rating of Indian Markets

Expert Take

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India is the most expensive equity market globally. Indian markets trade at 19 times FY20 expected earnings, which is at a significant premium to global emerging markets (EMs).

The traditional valuation premium that India has enjoyed over its peers has been driven by combination of high earnings growth, superior quality of growth and expectations around sustainability of high growth.

The euphoric reaction of stock markets to the decisive mandate to the incumbent government was on account of expectations that a single party government will be unconstrained and will take decisive pro-growth policy initiatives to drive sustainable high growth in India.

Some of these expectations about future growth need to be recalibrated, now that the first policy document of the new government — the budget — is out and there are no stimuli or quick fixes in it to revive India's growth.

Economic growth has moderated significantly with the GDP growth in Q4 of FY19 having touched a low of 5.8%. Even the RBI has reduced its growth expectations for the ensuing year to 7%, acknowledging the slowdown in the economy and growth head winds going forward.

The Indian economy has been persistently growing below its potential for over five years now and what was perceived as cyclical slowdown is becoming the new normal for growth. Prolonged periods of below potential growth tend to inherently lower the future potential growth of the economy.

We have had this optical illusion about India being the fastest growing economy in the world. But that is a half-truth. India being the fastest growing economy, ahead of China, has to been seen in the context that Chinese growth had moderated from a peak of 14% in 2007 to 6.5% in 2018. Chinese growth drivers like the demography, investments, working age population, etc. have peaked and China is in the process of engineering a soft landing for their economy.

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India's current growth at 6.5% is far below the peak growth of 10% achieved in 2007 despite the fact that unlike China, our growth drivers are nascent and will keep ascending for the next decade. So here is the dichotomy — while our growth drivers are ascending, the economic growth is moderating.

China grew at 10% for over 25 years which catapulted it into the second largest economy in the world. Even today, at 6% real growth on a $13 trillion base, China is still adding $780 billion of output per annum to its GDP as compared to India's modest $180billion.

Due to growth moderation, we have had a lost decade as far as corporate earnings are concerned. The ratio of corporate profits to GDP has declined from 8% in 2007 to 3% in 2018, which reflects significant margin erosion for corporate India. Due to the sharp compression in profit margins, the earnings growth for corporate India has significantly trailed nominal GDP growth over the course of the last decade. Nifty earnings have grown at a mere 7% CAGR over the last 10 years from FY2009 to FY2019.

Finally, there has been deterioration in quality of earnings in India. Nifty returns on equity (ROE) has declined from 22% in 2007 to 13% in 2018 and now is in line with other EMs like Brazil, Russia, China and Indonesia. The current ROE of Nifty is barely above the cost of capital. The cost of capital is high in India not only due to higher risk-free rates but also due to poor corporate governance and higher misallocation of capital.

India' growth has converged with its EM peers and the quality of growth has deteriorated. India no longer warrants the valuation premium over its peers that it has enjoyed over the last 20 years. The government does not intend to provide stimulus to revive animal spirits in the economy. Now, it's left to each of the constituents of the economy to rekindle their own spirits to drive India to high growth trajectory.

Until then, there is a case for P/E de-rating for Indian equity markets.

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