

Investors' Guide to Fundamental Analysis

An Exercise with Five

Indian Industries

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This is the second part of the two-part article on the relevance of fundamental analysis in stock selection – the first part appeared in the January issue of the Portfolio Organizer. Covering five industries – automobile, pharma, IT/ITES, cement and banking, the article attempts to help the reader to analyze a company's fundamental strength based on its financial statements.

Automobile Industry

Indian automobile industry is growing at a great speed. It is expected that it will have a cumulative growth of 9.5% till 2010. National and international industry giants are all geared up to reap the benefit of this growth. The growth has surprisingly not been tampered by the rising fuel price and several inflation-related factors in its spare parts segment. The Economic Survey has pointed out 15% steady annual growth rate for the sector making it a joyous sector to invest. The vehicle sales in India went up by 20% in 2006. It is believed that the auto-industry is a major force in driving the Indian economy.

Facts from the Industry

The auto industry registered a growth of 20% in 2006 as against 13% in 2005. The total vehicle production, including tractors went upto 9,735, 216 during the period. The passenger vehicles surpassed a growth of 8% whereas the medium and heavy commercial vehicles registered a growth of 4.5%. The light commercial vehicles had a growth of 19% and the two-wheeler segment grew by 17%. This painted a very happy picture for the industry.

Thrust on Export

The growth-oriented domestic automobile industry is bound to attract a massive investment. This is believed to be to the tune of \$18 bn. However, its export potential still remains untapped despite having global recognition, as per the Economic Survey.

Automobile in exports by 28% in year 2005-06 as compared to 2004-05 the commercial vehicle exports grew by 36%, the passenger vehicle exports grew by around 6% and the two-wheelers by over 40% during the

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period. The passenger car exports grew by about 28% in the quarter ending April-June '06 and the motorcycle exports grew by 45.3%.

Future of the Industry

The growth drivers of the auto industry in India will include higher GDP growth, India's huge geographic spread entailing mass transport system, increasing road development as part of the infrastructure development, large and increasing disposable income with the service sector, cheaper and easier finance availability, shifting to four-wheelers from the two-wheelers and procurement of used cars.

A conservative estimate puts the growth rate of Indian economy at 7-8%, with the booming Indian automobile sector being considered a key contributor. India's auto market has immense growth potential. It is to witness substantial mergers and acquisitions. Since many private equity firms in the industry are facing a lot of risk, a lot of hedge funds are emerging in the auto industry. This will ensure the strengthening of the M&A activities.

Pharma Industry

The Indian pharma industry is set to grow at 11% per annum. With a size of \$10 bn, it is one of the largest industries of the world. The industry is visualized to be making a huge profit out of the fact that about \$65 bn worth of drug would go off-shelf as generic drug in the UK and the US. India is supposed to be making huge profit from the low cost R&D and operation which will make the pharma industry travel a long distance as against its competitors. This will make the Indian pharma industry to go global and become one of the major export-earners of the country.

The Indian pharma industry is already known for producing quality drugs at low price and to be a major international player in some segments. Despite the fact that the Indian pharmaceutical sector is highly fragmented with more than 20,000 registered units, it has expanded drastically in the last few decades.

About 70% of the market is held by the by 250 leading companies and 7% being held by the market leaders. The pharmaceutical industry meets around 70% of the country's domestic demand for bulk drugs, drug intermediates, pharmaceutical formulations, chemicals, tablets, capsules, orals and injectibles whereas the rest is imported either from Europe or the US.

As per a study, the Indian pharma industry can capture \$65 bn business globally next year. With the generic business remaining as one of the most important aspects of the Indian pharma industry, India will remain ideally positioned to sweep the much-talked-about \$22 bn generic market the world over in this century.

The Indian pharma companies are hard hit by price regulations. These regulations have reduced their pricing ability. The NPPA (National Pharma Pricing Authority), which is the authority to decide the various pricing parameters, sets the prices of different drugs, which leads to lower profitability for the companies. Despite being one of the most cost-effective industries it is thus unable to make much progress.

The Indian pharma sector has been marked by lack of product patent, which prevents global pharma companies from introducing new drugs in the country and discourages innovation and drug discovery. The Prime Minister's Office (PMO) is working on a policy for the sector in an attempt to develop it into a world-class industry.

The new drug policy is an all-encompassing policy framework that is being drafted by an expert committee to provide guidelines to the pharma industry. The main objectives of this policy are:

- To ensure availability of essential pharma products at reasonable prices;
- To strengthen the indigenous capability to produce cost-effective and quality products and export pharmaceuticals by reducing barriers to trade in the sector;
- To strengthen the system of quality control over production and distribution; to encourage R&D in the sector; and
- To create an incentive framework for the industry in order to rope in new investments.

Chiefs of all major MNC drug-makers are alarmed by the government move to include more drugs under cost-based control. Pfizer MD Keval Handa, GlaxoSmithKline MD Kalyana Sundaram and Novartis Vice-Chairman and Managing Director Ranjit Sahani recently met senior health ministry officials and proposed that the government should move out of price control to a regime of greater monitoring. They felt that such a step would meet the objectives of the new drug policy and the common minimum program of the UPA government.

The performance of the Indian pharmaceutical industry in terms of growth in sales and profits has gone into double digit in the current year so far. The industry has bettered the global market growth by 3% during 2006. The country's pharma sector showed a growth of 10% compared with 7% for the global industry. The financial results of the 50 large companies during the last three quarters of the current year indicate that their net sales had gone up by over 23% and profits by 38% over the same period of the previous year.

The Economic Survey indicated that the pharmaceutical industry recorded domestic sales of \$4.5 bn and over \$3.8 bn in exports. It looks like investing in pharma sector in India in the long run will fetch a scoop of wealth for the investors.

It is a matter of great pride that the US biopharmaceutical companies prefer India to China for their immediate expansion plans through outsourcing to get a foothold in the market. Since they lack knowledge of the Indian market and the Indian regulatory systems, the US companies are striking alliances with Indian companies. With an urge to expand their business in India in the next two years, the US firms are gearing up to garner profit through local partners. The domestic pharmaceutical sector has the potential to double its existing market size by 2010 and thereby become the second major manufacturing base in the world next to China provided it is supported by the right regulatory framework.

Also the challenge is to transform the market into a large players market from the small and the medium-size players. There are a lot of good things going for India now. Over the next few decades, India will have the largest population in the age group of 15 to 60 years. This will mean that India will have the potential to become one of the fastest-growing markets in Asia along with China.

The economic activity will shift to Asia provided the necessary regulatory environment is created. India has the potential to become a major centre for global corporations, particularly in the areas of information technology and pharmaceuticals.

Key Findings

The key findings from the above discussion are:

- India holds \$6 bn of the \$550 bn global pharmaceutical industry. It has an annual 7% growth and is trying to increase its share by 10% each year.
- Domestic pharmaceutical companies will increasingly be looking for consolidation across the value chain by forming partnerships or mergers with companies of complementary strengths.
- The biopharmaceutical market is observing a consistent growth trend since 2004.

IT/ITES Industry

The last decade has seen the greatest surge in the Information Technology (IT) and Information Technology Enabled Services (IT/ITES), which, incidentally have turned out to be the most important contributor, to the industrial growth in India. Of the total exports this sector accounts for 96%. With this knowledge base and unique English language ability of the skilled workers of this sector India has become a world destination for this industry.

In this sector India has developed some world class delivery models (onsite, near site and offshore) entering into long-term contracts with the customers expanding their portfolio of operations.

With a highly competitive price, a good delivery model and tailor-made risk management process, the Indian IT/ITES industry has a success story worth boasting of.

The main reasons for the increase in the demand of this sector globally were initially for the price competitiveness coupled with quality.

Tiding over the initial cost model, the customers have started to look beyond this and have been able to use the Indian model successfully by using non-traditional benefits as given below in the figure.

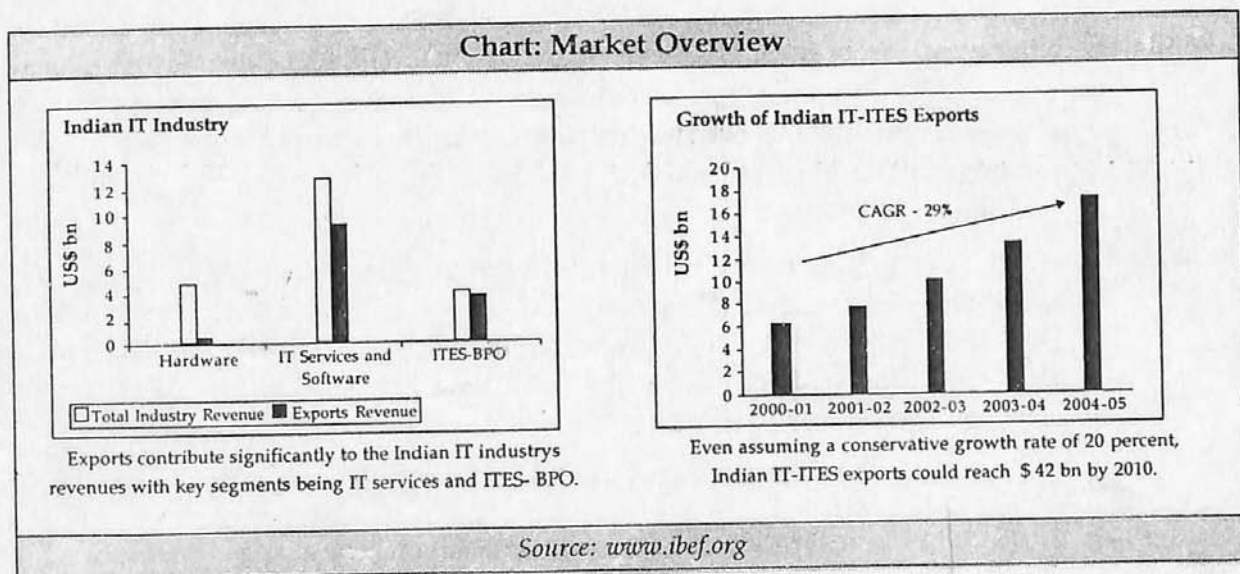


Figure: Cost Advantage	
Peak work-load management	India resources used to process peak period transactions
Offshoring existing outsourcing work	Work that is currently outsourced has sometimes offshored first given relatively fewer change management issues
Cost-effective expansion	Using India for team expansion purposes without reducing existing team
Capacity release	Work transferred to India to enable existing overseas team to focus on higher value activities
Understanding hitherto uneconomical activities	Given lower cost thresholds, certain labor activities become economically viable in an India based delivery model. For insurance, reconciliations
Cost reduction	Replacing overseas team with Indian resources
Skills availability	Using India as a delivery base to fill resource availability/quality gaps in other regions
One-off projects	One-off projects such as reconciliations, report preparation, delivered out of India
<i>Source: www.neevtech.com</i>	

The range of services provided by this industry was wide, starting from mere task to complex business models which were developed and delivered for the customers tailor-made or customized.

Sourcing Models

A wide range of sourcing models has evolved for sourcing IT and ITES services from India based on the required capabilities as well as risk profiles.

There is an increasing trend towards a global delivery model (higher proportion of offshore in the onsite – near shore – offshore mix) as well as a preference for captives and co-sourcing arrangements, though mature captives are gradually tending towards becoming third party service-providers.

Cost Advantage

The cost impact of sourcing from the Indian IT and ITES industry can be significant due to the lower wages and lower cost of living. While the increasing demand for resources is gradually adding pressure on labor costs, companies within the industry are attempting to sustain cost competitiveness through appropriate location choices and revamped human resource management practices.

Cement Industry

The cement industry is a key infrastructure industry and has gained much prominence after its price was decontrolled in 1989 and subsequently delicensed in 1991. With its price

and performance being monitored by the Government of India on a regular basis, this industry has responded very well to the decontrolled process.

Capacity and Production

The industry comprises 125 large cement plants with an installed capacity of 148.28 million tons and more than 300 mini cement plants with an estimated capacity of 11.10 million tons a year. The key players are both in the government and private sector.

Exports

The export of cement during 2002 to 2004 was 5.14 million tons and 6.92 million tons respectively. Export during April-May, 2003 was 1.35 million tons. The major exporters were Gujarat Ambuja Cements Ltd. and L&T Ltd.

Recommendations

A 'working group on cement industry' was constituted by the Planning Commission for the formulation of 10th Five-year Plan for the industry. The group projected a growth rate of 10% for the cement industry during the Plan period. Besides, it projected creation of additional capacity of 40-62 million tons mainly through expansion of existing plants.

The working group also identified following demand-related thrust areas for the cement industry:

- Giving further push to housing development programs;
- Promotion and creation of concrete highways and roads; and
- Promotion of the use of ready-mix concrete in large infrastructure projects.

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Technological Change

The technology in the cement industry has undergone change tremendously. From the old wet and semi-wet technology, the industry has shifted to a dry technology to the extent of 93% making inroads into eco-friendly cement-making process. The cement industry in India produces different varieties of cement like that of Ordinary Portland Cement, Portland Pozzolana Cement, Portland Blast Furnace Slag Cement, Oil Well Cement, Rapid Hardening Portland Cement, Sulphate Resisting Portland Cement, White Cement, etc. Some cement plants have set up dedicated jetties for promoting bulk transportation and export of such cements which are produced according to the BIS specifications.

Prices Strong

Cement registered a significant 27.5% YoY growth in July 2006 fuelled by higher capacity utilization levels and continued robust demand despite the advent of monsoons. Price growth was seen across southern and western regions, registering a high growth of 33%, followed by northern and central regions registering 27% growth respectively. However, relatively lower growth in eastern region (18%) was mainly due to higher supply and weaker demand. Given the high utilization and operating levels, cement prices are

expected to remain stable at the current levels despite an occasional regional demand slowdown due to severe rain and floods.

With operating rates reaching 90% since August 2005 and still growing, the higher cement price levels will sustain in the near future. India average prices were expected to be up around 25% for FY07 as "most of the large capacity factories" are likely to be commissioned only in the fourth quarter of FY08.

Banking Industry

The Indians inherited a very weak banking system from the British legacy at the time of independence. The nationalization program (1969) helped this sector achieve remarkable success in many respects such as stability among depositors, penetration into rural India and the consequent reduction in poverty and diversification out of agriculture. The key performance of the various kinds of banks in India is given below.

With predominance of the bank-based nature of financial system, the banking industry in India has gained the reputation of being one of the most protected in the country. In the 1990s, a chain of events such as introduction of modern technologies, competition from new players in the liberalized market place, and enhanced emphasis on governance to protect shareholder interest changed the way banks conducted their business in India.

The Government of India set up the Narasimham Committee in order to preserve the soundness of the financial system, especially the banking segment

The Indian banking sector with its diversity like the State Bank of India and its associates and other nationalized banks, private domestic banks (the new generation of banks) and foreign banks also faced a similar set of challenges. Though the public sector banks acquired a dominant position thanks to the regulatory environment, several of them performed poorly in the late 1980s. The Government of India set up the Narasimham Committee in order to preserve the soundness of the financial system, especially the banking segment. The committee (in 1991) made far-reaching recommendations that formed the basis of banking reforms. Some of the comprehensive reform measures suggested included:

- Stricter income recognition and asset classification,
- Higher Capital Adequacy Ratio (CAR),
- Phased deregulation of interest rate,
- Lowering Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR),
- Entry deregulation and branch delicensing.

These measures mainly aimed to improve the efficiency and profitability of the banking industry.

Post-Narasimham Committee report and the Basel II agreement, the Indian banking industry has shown the following results:

- The ROA, treated as a proxy for risk-adjusted return, increased from (-) 0.28% in the pre-liberalization period to 0.79% (against more than 1% in other emerging markets


such as Singapore, Malaysia and Korea) post-liberalization, indicating a significant rise in the ability of banks to convert their assets into net earnings.

- Despite a marginal fall in the net interest margin from 2.84 to 2.73, the banking industry has managed to improve its operating profit ratio by increasing its non-interest fee-based income and reducing its operating costs/staff expenses.
- The evidence indicates that after the reform initiation period, the banks have increasingly been providing off-balance sheet items such as derivatives, which generate major part of non-interest income.
- The proportion of operating costs/staff expenses has declined mainly due to computerization and the voluntary retirement scheme.
- Despite a fall in Operating Profit Ratio (OPR) and Net Interest Margin (NIM) between 1992-95 and 2000-03, the private banks successfully managed to reduce their operating expenditures, particularly the staff expenditures, thereby successfully maintaining their status.
- Among the private banks, the foreign banks seem to be superior in terms of three out of five criteria used.
- In the public domain, the state banks tend to be superior with respect to ROA, Operating Cost Ratio (OCR) and Staff Expenditure Ratio (SER), while the nationalized banks seem to show better performance in terms of OPR and NIM.

Thus, although there is a significant improvement in the overall performance of banks as one moves from the post-reform period to the late-reform period, one finds certain anomalies such as a fall in the NIM (except in the case of the nationalized banks), a fall in the ROA of private domestic banks, a reduction in the OPR of private domestic and foreign banks and a rise in the OCR/SER of foreign banks.

It is indicative that the Indian banking industry has grown at a steady 30 + % in the retail business, especially in the private sector new generation banks. The overall growth in the stock price of the banking sector has been also impressive and the market has responded well to the growth of the industry in a good way. The way Indian banking sector is growing, the investors can surely have a good piece of the cake.

Conclusion

The idea behind this exercise is to understand how fundamental analysis can be done and the due diligence for an investor before doing a fundamental analysis. In order to elaborate, five Indian industries namely, automobile, pharma IT and ITES, cement and banking industry have been taken up to create a deep understanding of the facts and figures of these industries. The exercise is an illustrative one and is not exhaustive in nature. It is advisable for both the students of investment and investors to consider as many angles as possible for taking up a fundamental analysis and not to depend on the market indicators and technical parameters too much. 

The overall growth in the stock price of the banking sector has also been impressive and the market has responded well to the growth

Reference # 6M-2008-02-09-01