EQUITY:IN

A HITCHHIKER'S GUIDE TO INVESTING IN INDIAN EQUITY MARKETS

ANSHUMAN KHANNA

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CONTENTS

Preface ..... *xi*

CHAPTER 1 INTRODUCTION 1

CHAPTER 2 SELECTING A STOCK TO INVEST IN – WHAT'S RELEVANT AND WHAT'S NOT 15

CHAPTER 3 MAIN CRITERION ONE: PROMOTER GROUP PROFILE 35

CHAPTER 4 MAIN CRITERION TWO: BUSINESS PROSPECTS 63

CHAPTER 5 MAIN CRITERION THREE: VALUATION 87

CHAPTER 6 SECONDARY FACTORS 151

CHAPTER 7 TIMING YOUR ENTRY AND EXIT 171

CHAPTER 8 PORTFOLIO ALLOCATION 181

CHAPTER 9 REGULATORY FRAMEWORK 191

CHAPTER 10 INFORMATION BASED INVESTING 201

CHAPTER 11 TECHNICAL CHARTING AND TRADING IDEAS 215

CHAPTER 12 CLOSING SUMMARY 239

Acknowledgements *255*

CHAPTER 1

INTRODUCTION

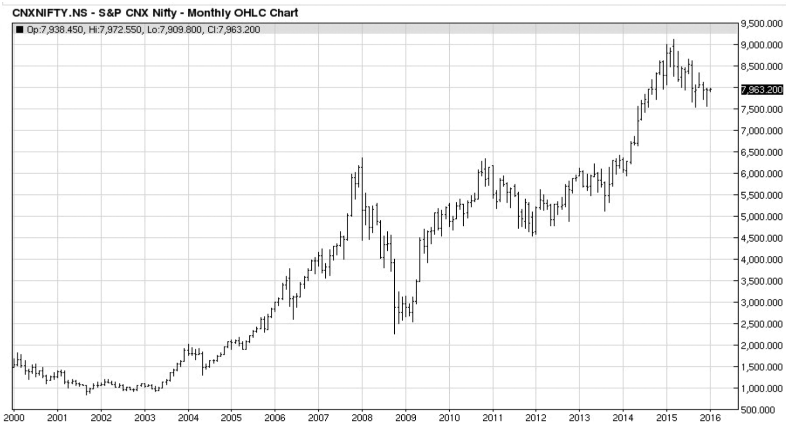
Indian equity markets and India as a country, are unique in certain ways, which mandates a tailor-made approach to investing in Indian equities.

The Indian stock markets present an attractive destination for varying category of traders and investors, ranging from foreign and domestic institutions, to hedge funds and retail investors.

India as an emerging market has always been a big draw for the foreign investors, given it's growth potential of unparalleled proportions owing to the population base and trailing economic indicators such as per capita income. Indian companies have been seen as the proxy play for the India growth story and investors have made a bee line for stocks seeking to find and benefit from multi-baggers over the years.

As such, the Indian equity indices have seen a commendable performance in the 21st century with the Indian benchmark index, Nifty rising from 1482 in 2000 to 7946 in 2015.

Below is the chart showing Nifty's rise from 2000 to 2015.



With the liberalization of the foreign exchange norms on the back of the introduction of Foreign Exchange Management Act in 1999, the flows by foreign investors in India have augmented the liquidity flow. It has not only aided the returns being generated by the Indian equities but has also taken the entire market into a whole new tangent in terms of corporate governance, financial reporting and investor activism.

Over the last five years, the interest in India has developed even more, with the country emerging as one of the fastest growing economies in the world and the demand and infrastructure deficit driven story unfolding before our eyes.

In their efforts to successfully operate in the Indian markets, investors and traders alike, tend to adopt well known techniques for investing or trading as have been used globally for a long period of time. The techniques adopted range from value-based investing to technical charting and hedging based strategies.

It has been seen that there are certain peculiarities in the Indian market which do not allow for a cookie-cutter prescription, as available in US-centric authored books, to be applied to the Indian markets. While for the large part an approach to investing as provided in the 'Intelligent Investor' may hold true for Indian markets, it cannot be applied without adaptation. Similarly, books on technical charting do not necessarily hold good for the large part of Indian market movements for reasons discussed subsequently.

It would be evident to any investor or trader participating in the Indian markets that in fact India is a unique country with equally unique stock markets and business environment which exhibit certain features which distinguish it from the markets of developed economies. It is important to recognize these differences in order to be able to tailor your approach to Indian stocks and companies and not be caught at the wrong end of the proverbial rifle at the risk of losing your capital.

So what is it that makes Indian markets unique or different? Some of the factors are discussed in this chapter.

1. MARKET DEPTH – OR THE LACK THEREOF

Indian markets do not boast of the level of depth that is present in US markets or any other mature market. While volumes in the Indian stock markets have grown over the years, especially with the opening of the Indian economy to foreign direct investment (FDI) and foreign institutional investors (FII) in the 1990s, the volumes and market capitalization of Indian markets still lags behind those of developed markets such as USA and Europe.

This lack of depth is even more pronounced at the individual stock level with various mid cap and small cap stocks in India seeing volumes and turnover levels which are so low that any mid-size investor may be able to influence the price movements in the stock by virtue of his concerted buying or selling orders, a practice that is patently illegal under Indian laws as it is in developed markets. Moreover such low volumes negate big positions being built or liquidated at a given market price and thus throw off analyst findings based on a quoted price of the stocks.

The inevitable consequence of the lack of depth and maturity in the Indian market is that at any point of time large and erratic price movements in the equity prices or even at index level may be precipitated by the action of few large investors. The corollary of this phenomena is that the market, being at the mercy of few numbers, would not always act in a perfectly rational manner and may be subjected to the whims or manipulation by select players. Thus many theories, especially those of technical chartists, which may work perfectly in mature markets such as US and Europe, may not work in Indian equity markets.

As a consequence, a stock which may make a compelling investment target owing to its apparent undervaluation may still suffer adverse price movements and not see its market price reflecting its intrinsic value. This is so purely on account of the lack of depth and the price movement being influenced by few large players. Thus such stocks may seem to belie the fundamental approach to investing in the short to medium term.

Similarly, stocks which may appear undervalued may not in reality be undervalued as the quoted price of the stocks would not be supported by substantial volumes. As such transacting in such stocks at the ‘quoted’ price with a view to build a reasonable size of a position would not be feasible and when the investor would start building a position he would end up paying a price per share which may be the perceived intrinsic worth of the share in the first place, thereby negating any attempt to reap gains on the stock.

The volume and depth at the stock as well as market level thus has to be kept in mind by the investor when considering India specific investment strategies.

2. REGULATORY SENSITIVITIES

Indian markets tend to react very erratically to any regulatory action, especially any perceived negative moves.

Whether it be the action of the tax administration to go after any foreign multinational group company or the infamous Vodafone centric retrospective amendments in tax law or even levying of a tax on the foreign institutional investors. It may be an adverse judicial pronouncement affecting the business prospects of a company, or an action of the regulators taking steps to penalize or even ban products or services of companies.

At any given point of time, for any particular sector, the investor is a sitting duck where the regulatory action or even the smell of any such action may lead to wild movements in the stocks of the companies that are in such sector. While this may hold partly true for mature capital markets as well, the level of impact that such regulatory moves and rumours tend to have on Indian equity markets is far more emphatic.

Add to this the level of regulatory complexity prevalent in India. From the plethora of legislation at the Centre and State level, the regulatory framework imbibes delegated legislation in the form of rules, regulations and notifications. There is a multitude of authorities and approvals that any company needs to interface and liaise with. Moreover, at any given point of time there are a large number of regulatory considerations which could end up furthering or adversely affecting the business prospects of a company. The differing political ideologies of the many political parties, regional as well as national, also affect the business activities of the companies in different and unexpected ways.

For any investor to navigate the expanse of the Indian stock markets, it would be inevitable that they gain insights into the unique regulatory landscape present in the Indian economy and particularly familiarize themselves with the sector specific regulations that govern the investee company's business.

Apart from affecting the price of stocks, regulatory events and actions can have the effect of decimating the entire business model of companies and for this reason also the understanding and tracking of the regulatory framework as a part of the investor's activities is required in India.

For example in 2005, post the demerger of Reliance Industries into various entities, the Ambani brothers had formed a company by the name of Reliance Natural Resources Limited (RNRL) with the objective of purchasing gas from Reliance Industries from its KG Basin block and selling the said gas to Reliance Power for use as feedstock for its proposed power plant in Dadri. At the time, RNRL was considered as a hot favourite in the Reliance stable of stocks, as it was viewed to be having a fairly certain and stable business model with the margins on purchase and sale of gas locked in with long term purchase and sale contracts. The stock was lapped up by the investors.

However, regulatory action intervened, in the form of steps taken by the ministry as well as the courts striking down the proposed arrangement as being unlawful and contrary to the terms of the public policy and production sharing contract governing Reliance's KG Basin block. There was thus a total decimation of the business model of RNRL and the company ended up remaining a shell company which was ultimately merged into Reliance power.

Such regulatory actions and developments, though not unique to India, are nevertheless pronounced in their effect when it comes to Indian equity markets and specific company stocks. The regulatory actions and changes are moreover frequent, complicated and cascading in nature and the complexity of the regulatory framework in India coupled with the foregoing, sets the Indian market apart.

3. POLITICAL STRUCTURE

Not only is India the world's largest democracy, it is also unique insofar as the federal structure of the political setup under the Indian constitution. This when combined with the fact that there is no restriction on the number of political parties which may contest in an election, it results in the inevitable fallout that we see different political parties governing in the different states as well as the Centre thereby creating a methodical chaos.

Consequently, there is a divergence of political ideologies and policies prevailing from state to state. Any company transacting business in India in multiple states not only has to deal with the respective state governments but also the particular party in power in the Centre.

Understanding the political ideologies of the different (and changing) political parties and tweaking the business prospects of companies based on the same is thus peculiar to the process of investing in the Indian equity markets. Diverse political ideologies range from the conservative and pro-labour policies of the Communist parties in States such as West Bengal and Kerala, to the pro-business liberal policies in states such as Gujarat and Maharashtra.

Not only do these ideologies and policies influence the working at the level of the State Governments but also at the Centre especially where the ruling government is comprised of a coalition of parties, which is the often the result of the imperfect working of the world's biggest democracy. In fact, for an investor to have a real sense of the leanings of the Government and the expected business environment, it becomes necessary to have a sense of the relative strength of the different political parties in the coalition set up. As has often been seen, a relatively strong conservative coalition partner ends up stalling the reform agenda of a progressive coalition lead party.

It would thus be seen that the diversity of the political ideologies and how these come into play in the unique democratic setup of India to affect the business prospects of companies, is yet another distinguishing feature of the Indian equity markets.

4. STAGE OF MATURITY

The Indian markets are also unique in terms of their stage of maturity.

Unlike the markets in US or Europe which have been operating for decades and have evolved sophisticated systems and regulations to govern their operations, the Indian markets only started to find their feet post 1990's liberalization measures announced by the Narasimha Rao – Manmohan Singh government.

Even in the 1990's the Indian markets were susceptible and fell prey to major stock market scams amidst manipulations by the likes of Harshad Mehta and Ketan Parekh. Accordingly, dematerialization of securities was brought in during the 1990's and the Securities and Exchange Board of India (SEBI) was constituted as the market regulator to bring in the new century in place of the draconian Capital Controller of Issues.

With the advent of the liberalized foreign exchange regime under FEMA 1999, the markets were opened up to foreign investors albeit under a regulated and monitored route of FDI and FIIs. This, in turn yielded newer problems for the Indian markets in the form of controversies behind participatory notes (P-notes) and the suspected round tripping of black money by resident Indians using the P-note mechanism. Amendments were made on a repeated basis to check the menace and even today the regulators keep a close eye on the FII route for investment. To the extent that every time there is even a whiff of the regulators banning issuance of P-notes by the FIIs or otherwise restricting them, the market goes into a tizzy of a downward spiral.

In parallel, the SEBI regulations for disclosure and investor protection have been refined and spruced up, bringing greater transparency and disclosure to the investors, affirming minority rights and tightening corporate governance.

SEBI insider trading regulations have been implemented and amended from time to time to restrain inside information based trading and other malpractices. SEBI has also actively developed the Takeover regulations and delisting regulations to address the need for a systematic framework for corporate takeovers and delisting exercises at par with international markets.

The corporate law and foreign investment regulations have also been continuously upgraded by the Central Government of India with a view to align these to policy objectives such as minority protection and greater participation of foreign companies in various sectors such as insurance, retail and manufacturing. The approval systems have been eased over a period of time with increasing number of inclusions under the category of automatic approval to aid ease of investing in India by the foreign business houses.

The tax treaties of India with various countries have been put in place to provide the framework and tax benefits for foreign nationals and corporates investing or doing business in India.

While many steps have been taken towards the development of the Indian markets, there have also been many regressive elements or unaddressed issues which still continue to dog the markets and the participants. This includes retrospective taxation of profits on sale of shares, tax litigation on equity transfer such as Vodafone case, and uncertainty around approvals for foreign investment and takeovers.

As such the Indian markets still have a long way to go to achieve a matured framework for the investors and promoters alike, yet the initiatives taken have been directionally affirmative.

The aforesaid plethora of developments and uncertainties add to the uniqueness of the markets in India.

5. STAGE OF ECONOMIC DEVELOPMENT

The Indian economy and the markets are also unique insofar as these present a one of a kind amalgam of size and potential for growth.

While there exist large economies such as that of the USA with high GDP and per capita income levels, these economies do not exhibit a growth curve which may excite an investor looking for multi-baggers. This is primarily due to the fact that these economies are matured and demand saturated.

Again there are economies such as China which have a large population base, yet these also do not exhibit potential for sustained growth in their GDP levels owing to the fact that there has been rapid pace of economic development and infrastructure planning by the Government. There is equitable level of income distribution and the potential for demand based growth remains limited.

As opposed to these, India is a unique proposition of a country, with a large population base, infrastructure deficit, low per capital income and huge demand based growth spurts in various sectors of the economy. Any product or service which is yet to penetrate the rural population of India yields exponential growth prospects for the companies.

The liberalised and pro-business environment with the transparent procedures and systems, aided with the governmental initiatives puts India in a unique position, perhaps incomparable to any other country, when it comes to the business prospects and potential for returns.

6. SENSITIVITY TO GLOBAL DEVELOPMENTS

It is a fact that in today's age all the international markets are inter connected and exposed to each other when it comes to price movements, especially in the case of currency markets, commodity markets and equities.

Similarly with the opening up of economies to global trade and investment, there is greater susceptibility of markets to the flow of liquidity.

However the vulnerability of certain markets to international events, price movements and liquidity flows tends to be more than the others. This is especially the case with the Indian equity markets.

The Indian equity markets are characterized by a high degree of sensitivity to various external events and global developments. This is so for a number of reasons. The primary reason is the fact that Indian markets still depend, to a large extent, on foreign liquidity flows and consequently, the buying or selling activities of foreign institutional investors tends to impact the markets significantly. This impact is two-fold, first the foreign inflows and outflows affect the Indian currency which in turn affects the financials of the companies which are having forex exposure, and secondly the foreign inflows and outflows in the form of buying and selling of stocks affects the price levels of the stocks as well as the broader market.

Thus, in a situation where the sentiment of the foreign institutions changes from a long to short based on international developments and they pull out funds from the Indian market, we see the Indian markets react strongly to such an eventuality.

Similarly the Indian markets tend to react strongly to developments in other countries such as recession in the USA for instance. Being exposed to other countries in terms of export and import trade, the Indian economy is affected by changes in the international economic scenario.

Thus in 2008, when the sub-prime crisis hit the USA, the Indian market took a massive tumble with the benchmark Nifty index falling 50% from 6000 levels of January 2008 to 3000 levels in second half of 2008.

Furthermore, changes in the monetary policies of the central banks of other countries also affect the exchange rate of the Indian rupee vis-à-vis the major foreign currencies and has a strong reaction from Indian markets in terms of the stocks of companies exposed to foreign currencies, as well as from bonds.

Again the movement in global commodity prices such as coal and crude oil also evinces strong reaction in the Indian markets given our high dependence on import thereof.

The high beta of the Indian markets to global macro-economic events is yet another unique feature of the Indian capital markets which requires an investor to tailor the investment methodology to countenance such aspects.

7. PROMOTER GROUPS

The Indian corporate diaspora is comprised of a unique confluence of promoter groups. Prominent amongst the Indian promoter groups are the government owned public sector companies such as Indian Oil Corporation, Oil & Natural Gas Corporation, Steel Authority of India and Shipping Corporation of India. The Indian Government, both Centre as well as State have taken it upon themselves to participate in private business and even list such businesses in the Indian equity markets.

Then there are the family owned companies, with a major business presence in diverse areas, such as Birlas, Tatas and Ambanis and plethora of other household names that are put on a pedestal and idolized for their business acumen and empires. Many of these family groups have spawned multiple generations and have seen the businesses being split and multiple groups being formed with differing or even overlapping business interests. For instance, the Ambanis saw a split in the first decade of the 21st century and the erstwhile Reliance empire got sub-divided into two Reliance Groups. Similarly the Jindals as a family also find themselves running different business groups with the Sajjan Jindal Group, Naveen Jindal Group and others. The family owned promoter group is a dominant category in the Indian equity landscape with a large number of companies falling under the same.

The third category of promoter groups found in India are the multinational corporates, comprising of companies owned by MNC groups such as Nestle, Holcim, Gilette, and Unilever.

Lastly there are companies which are ‘promoter less’ such as HDFC Bank, ITC and L&T.

The diversity of the promoter groups is augmented by the fact that the promoter families as well as MNCs themselves prevail from different geographical and cultural backgrounds and operate businesses with totally different mind-sets from one another.

The diversity and implications of the promoter groups on the investee companies are discussed in depth in a subsequent chapter of this book.

8. RAMPANT TIPS AND SPECULATION

Tipsters are everywhere and information 'tips' are there for the asking in any country. But unlike the mature western markets, in India, so called 'tips' which are posed to imbue inside information and promised as a sure shot road to money making, are rampant. So much so that one would almost forget that such information sharing and access is patently illegal and bound to land someone even in jail – at least in theory in India, but for real in other countries a la Rajat Gupta in the USA.

In such a situation the uninitiated lay investor has to skilfully navigate the waters of Indian equity markets keeping in mind the pitfalls of such information based investing and filtering the extent and nature of the information to be relied upon. Even where the information provided is genuine and not falling within the ambit of inside information, the investor needs to be aware of how to, and to what extent, make use of such information for purposes of his investment activity.

Information comes in many forms and areas and need to be dealt with based on multiple factors. This unique aspect of the Indian market is also discussed in depth in subsequent parts of this book.

Keeping the above peculiarities of the Indian capital markets in mind, this book endeavours to share with you some insights on the approach of investing in the Indian equity markets, by adapting the various well known principles of investing and trading to the India centric circumstances.

This book deals with the approach to be adopted by an investor in building a portfolio with a medium to long term perspective in the Indian capital markets. It does not provide short term trading or intra-day strategies though these have also been discussed briefly at the appropriate places.

This book considers the various factors that may come up before an investor for his consideration during the course of the above exercise. It also tries to filter out the factors that are relevant from those that are not relevant for consideration and the weightage that may be ascribed to each of the relevant factors.

The main approach to picking stocks for investment has been reduced to three main factors or criteria that a stock must fulfill for it to be considered worthy of investment. These three criteria are discussed in detail along with examples of companies from the Indian markets.

Thereafter we discuss secondary factors which though not the mainstay for picking or rejecting stocks, still have a bearing on the stock selection such that, a stock which may fulfil the three main criteria may still be rejected on account of certain secondary factors.

Once the stocks fulfilling the three basic criteria and also satisfying secondary factors have been selected by the investor (answering the question 'which stock to invest in?'), we go on to discuss the aspects relating to the allocation of capital amongst these stocks i.e. portfolio allocation as well as the timing of purchases and sales of the portfolio stocks by the investor i.e. 'how much to buy and when?.'

We then go on to discuss some of the other relevant aspects of the Indian stock markets i.e. the regulatory framework and how the investor should understand the relevant regulatory aspects affecting his investee companies as well as how he should keep a track of changes therein. We also discuss the so-called 'tips' in the Indian markets, the different types of information floating around and how these should be dealt with by an investor if and when he stumbles upon information which may be pertinent to his investee companies.

We have also discussed aspects relating to technical charting and trading strategies in a separate chapter. While these are not core to the practice of building a fundamentals based portfolio, these have nevertheless been discussed by way of ideas particular to the Indian markets which may be adopted by an investor to supplement his long term portfolio.

The discussion on the various aspects as above has been illustrated with real life Indian companies' examples including the price charts and financials wherever pertinent.

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