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As India's Stock Surge Cools, It's Time for Investors to Work

By Joanna Slater

A sizzling six-month stretch, during which the benchmark index jumped more than 50%, has helped many investors make good money in Indian shares. So where will tomorrow's gains come from?

Fund managers recommend looking at companies on the Bombay Stock Exchange that fall into one of two categories: those catering to growing demand and those competitive enough to do well in the export race.

As investors hunt for new opportunities, there is good news about India's fundamentals. The economy is set to grow about 7% in the year ending March 31, interest rates are low and years of corporate restructuring seem to be paying off in increased competitiveness and higher earnings. Foreign institutional investors have plowed a record $4.6 billion into Indian markets since the start of 2003.

The not-so-good news is that investors will have to work harder for sizeable profits. "The easy money has been made, now we're moving into a different phase," said Jon Thorn managing director of India Capital Fund, a $43 million offshore fund focused on Indian markets. A year ago, he says, India offered "staggeringly cheap banks, cement companies and metal companies. Today they're just good value."

The bull run of the past six months helped make up for lost time, said Rajat Jain, chief investment officer of Principal Mutual Funds in Bombay. After a shock scandal and market crash during 2001, he says, "for a long time, the market did nothing—it ignored what was happening in the real economy. Now that's changing."

As a result, the market is less irrational, said Prashant Jain, head of equities at HDFC Asset Management, the mutual-fun arm of one of India's largest housing-finance firms. Prashant Jian, who isn't related to Rajat Jain, manages three stock funds valued at about $400 million.

Three years ago, Prashant Jian sold technology stocks before they plummeted and put money into neglected Old Economy Stocks. "These were sustainable, profitable businesses and to top it off, they were dirt cheap," he said. These days, there aren't any more cases—"discrepancies," he calls them—where stocks remain extremely undervalued.

Prashant Jain is bullish on a two- to three-year perspective and thinks there still is good value in Indian companies. People may laugh at the comparison, he said, but India this year will have faster gross-domestic-product growth than the US, interest rates in the two nations are almost identical and India has a current-account surplus. "So why should price/earnings multiples be only half of those in the US?" he asked.

Prashant Jian is particularly optimistic about the power of Indian consumers. With rising salaries and more consumer lending, people are buying more and at younger ages. Indian consumers used to have hardly any choice, but they are now flooded with it when looking to buy anything from clothing to cars.

One of his large holdings is Maruti Udyog, the big Indian auto maker, which has a dominant share of the economy-car market. Prashant Jain said that in Bombay, with a huge choice of cars and many wealthy residents, "you can sometimes start to think, who will buy a Maruti?" But in India's smaller cities, where huge numbers of consumers aspire to shift to a car from a motorcycle or scooter, a Maruti can be the only affordable option. Its basic model, the Maruti 800, costs less than $4,000, including taxes. Since its shares began trading during July, Maruti has more than doubled in price.

Another indirect way of tapping consumer appetite—especially for houses—could be cement companies, several fund managers said. When shackles on production were removed during the 1990s as part of India's liberalization process, a big number of new players entered the business, making capacity soar and prices crash. Prashant Jian said that with low interest rates, a housing boom and an ambitious state road-building program, cement demand will grow. "Most of the demand/supply mismatch is behind us," and going forward, "stocks that look expensive today will look cheap." The largest companies in the sector include Grasim Industries, Gujarat Ambuja Cements and Associated Cement.

At Principal Mutual Funds, Rajat Jain suggests rather than look at sectors, investors should search for good stocks that still are undervalued—of which there are plenty, he said. The fund manager is targeting mid-cap or large-cap companies that have become more competitive, have had good returns on capital and aren't trading much above 15 times this year's expected earnings.

Two of Rajat Jian's holdings have demonstrated ability to produce for the world market. One is Tata Motors, the truck-and-automotive arm of India's Tata conglomerate. The company has cut costs and boosted exports. It recently announced a deal with Britain's MG Rover Group to supply a version of its Indica car for the British market. Tata Motors has begun due diligence on a planned purchase of Daewoo Commercial Vehicle of South Korea, signaling its global ambitions. At home Rajat Jain expects Tata Motors to benefit from the government's road-building program.

Another stock in his portfolio is Ranbaxy Laboratories, the big Indian pharmaceuticals company, which is leading the charge in exporting generic drugs to the US and Europe. During the first nine months of this year, Ranbaxy's export sales rose 31% from a year earlier.