Influence of the Economy

Companies are a part of the industrial and business sector, which in turn is a part of the overall economy. Thus the performance of a company depends on the performance of the economy in the first place. If the economy is in recession or stagnation, ceteris paribus, the performance of companies will be bed in general, with some exceptions however. On the other hand, if the economy is booming, incomes are rising and the demand is good, then the industries and the companies in general may be prosperous, with some exception however.

In the Indian economy, the matters to be considered in the first place are the behaviour of the monsoon and the performance of agriculture. As agriculture is the mainstay of the 70% of the population and contributes nearly 35% of the output of the economy, it is important for the assessment and forecast of industrial performance. If the monsoon is good and agricultural income rise, the demand for industrial products and services will be good and industry propers.

Secondly, India has a mixed economy, where the public sector plays a vital role. The government being the biggest investor and spender, the trends in public investment and expenditure would indicate the likely performance of the Indian economy. Concomitant with this, the government budget policy, tax levies and government borrowing programme along with the extent of deficit financing will have a major influence on the performance of the Indian economy, as these influence the demand and income of the people. The changes in excise and customs duties, corporate taxes, etc. are all relevant to assess the trends in the economy as they have an impact on the industry and the companies.

Thirdly, the monetary policy and trends in money supply which mainly depend on the government’s budget policy, its borrowing from the public and credit from the banks and the RBI, have a major impact on the industrial growth through the cost and availability of credit, the profit margins of the companies etc. The monetary situation along with the budgetary policy influences the movement in price level (inflation) and interest rates. The tight money position, increasing budget deficits and RBI creation of currency lead to an inflationary spiral. Although some interest rates in the organised financial system are now freed, the bazaar rates in the unorganised market do reflect the availability of funds in the free markets. So interest rates in the free markets and the degree of inflation do have a major influence on the economy and the performance of the industries. Although a mild inflation is good for business psychology, higher degrees of inflation, particularly in two digits, will defeat all business planning, lead to cost escalations and squeeze on profit margins. These will adversely affect the performance of industry and companies.

Fourthly, the general business conditions in the form of business cycles or the level of business activity to influence the demand for industrial products and the performance of the industry. In India, there are no business cycles but outputs do fluctuate depending upon the state of the economy, performance of agriculture, availability of power and other infrastructural outputs, imported inputs and a host of other factors. These factors do influence the costs and profit margins of companies from both demand and supply sides. The business earnings and profits are affected by such changes in business conditions.

Fifthly, the economic and political stability in the form of stable and long-term economic policies and a stable political system with no uncertainty would also be necessary for a good performance of the economy in general and of companies in particular. The government regulations being all-pervasive in India, the government policy has to be known in advance in all its aspects and there should be no uncertainty about the political system as economic and political factors are interlinked. Political uncertainties and adverse changes in government policy do adversely affect industrial growth. Government policy relating to projects, clearance for foreign collaboration and foreign investment, price and distribution controls, and listing requirements on stock exchanges and a host of other matters like import restrictions do affect the performance of companies. The foreign exchange position and the balance of payments situation at any time would also indicate the rigours of government policy with regard to imports, exports, foreign investment and related matters.

All the above factors of the economy influence the corporate performance and the industry in general. In any investment analysis, a broad picture of these factors and a forecast of the growth of the economy and of industry would be necessary to decide when to invest and what to invest in.

Economy vs. Industry and Company

At any stage in the economy, there are some industries which are growing while others are declining. The performance of companies will depend among other things upon the state of the industry as a whole and the economy. If the industry is prosperous, the companies within the industries may also be prosperous although a few may be in a bad shape. The performance of a company is thus a function not only of the industry and of the economy, but more importantly, on its own performance. The shape price of the company is empirically found to depend up to 50% on the performance of the industry and economy. The economic and political situation in the country has thus a bearing on the prospects of the company.

There are different phases in the economy such as boom, depression, recession, etc. The performance of the economy in India is not cyclical as in the case of developed countries exhibiting business cycles, as the Indian economy depends basically on the monsoon and the growth rate of agriculture. Besides, with a huge public sector in our mixed economy, the performance of the five-year plan, yearly public investment, government expenditure and a host of other factors influence the economy, industry and company. Thus one important factor...
is the fiscal policy which incorporates government expenditure and taxation, borrowing, deficit financing, etc. and which influence both the public and private sectors in the economy. The industrial growth in general and of infrastructural industries in particular influence the corporate performance.

As referred to earlier at any stage in the economy there are some industries growing fast while orders are declining. The performance of companies will depend among other things upon the state of the industry as a whole. If the industry is prosperous, the companies, within the industries may also be prosperous, if the economy is also doing well. The performance of a company is thus a function of the industry and of the economy in addition to its own performance.

As referred to earlier, the share price of the company is empirically found to depend to 50% on the performance of the industry and economy. The economic and political situation in the country has thus a bearing on the prospects of the company. The industries in different stages of growth are shown below :-

Even in industries of above average growth, there may be some companies of poor growth or no growth at all. The fundamentals of the company will explain this. The Market Price (MP) is a function of intrinsic factors to the extent of about ½ of it and the rest is accounted by the expectations, psychological and sentimental factors, as shown below.

In the above context, any particular industry can be studied with a view to assess the problems, prospects, etc. of the company in the industry. The industry data are to be examined from the point of view of the product-mix, raw materials, components, pricing cost of production, etc., profit margins and related data juxtaposed with those of the company. The capacity utilisation of the industry in general and of the company in question within the industry are to be compared. The demand and supply, the market conditions and the market share of the company in the market are to be studied before making a projection of its future growth, keeping the industry prospects in mind. The future profitability can be assessed from the half yearly and annual reports, press releases, AGM’s reports, market reports, management interviews and Industry and Commerce Association’s publications. The share of the company in which investment is sought is to be analyzed in terms of the fundamentals of the company in the background of the industry’s performance. The decision to buy has to be on the basis of whether the price of the share is proper and the future profitability is good based on a rational forecast for the future.

We have to consider the quantifiable factors and qualitative factors of the company. Among the quantifiable factors we have to consider the capital efficiency and the sales turnover and the profitability margins. The quantifiable data are based on financial statement analysis. The qualitative factors are:

a. Management efficiency,
b. Rating of promoters,
c. Rating of collaborators,
d. Uniqueness of the product,
e. Location of government policy and patronage, etc.

The industrial position not only depends upon the economic growth but on the nature of the industry itself. Within the industry the factors which have to be taken into account are the product-mix, the various outputs, nature of the products, inputs and raw materials, installed capacity of the industry - utilisation of capacity - the market nature of the inputs, their domestic availability and the problems of the industry in general. The pricing and Government controls on prices, distribution, etc., controls on imports and tax policy, excise and customs duties, etc. would influence the cost of production and the profit margins of the industry, as also the prospects of growth. In the area of market, the demand for the products produced and the prospects for exports, protection or tariff preferences, etc. influence the prospects of the industry. In many industries, the raw materials and other inputs and their availability domestically, particularly of electricity, have a major influence on the market from the point of view of supply. Labour conditions in the industry should also be looked into and have a bearing on growth prospects.

In the company analysis, the financial highlights of the companies, which are influenced by the industry and the economy are the capacity utilisation, demand, cost and profit margins. The state of the capital market and the capacity to raise capital from the market not only depend on the performance of the companies but of the economy and the industry as well. The fundamentals of the company are to be analysed in terms of its financial structure, leverage, liquidity and profitability, financial viability, etc. The information for this purpose is to be secured from the annual reports of the company, balance sheets, press reports, AGM’s reports management’s press releases and the publications of the Industry and Commerce Associations.

The most important variable influencing the company’s performance is management, namely, the quality, capability, popularity and integrity of the management. Generally, the rating of the promoters and management has to be looked into through their plans, financial management, growth orientation, expansion plans, tax planning, R & D, technology, etc. The popularity of the management is known from their track record, retention policy, distribution of dividends and bonus, etc. The honesty and integrity of the management can be seen from the shareholding pattern and the availability of floating stock and the liquidity of shares of the company. In the area of financial management, companies financial structure, retention policy, dividend record, bonus policy and liquidity ratios, etc. are to be looked into. The market capitalisation of a share is to be compared with the book value and the intrinsic worth of the company. The share has to be examined to know whether it is properly priced and reflects its true intrinsic value. The P/E ratio and earnings per share, book value, etc. are to be looked into in this context. Only shares which are under-priced are to be generally purchased, provided they have the potential for growth and capital appreciation.

In the above context, any particular industry can be studied with a view to assess the problems, prospects, etc. of the company in the industry. The industry data are to be examined from the point of view of the installed capacity and its utilisation, raw materials, components, pricing cost of production, etc., profit margins and related data juxtaposed with those of the company. The capacity utilisation of the industry in general and of the company in question within the industry are to be compared. The demand and supply, the market conditions and the share of the company in the market are to be studied before making a projection of its future growth, keeping the industry.
prospects in mind. The future profitability can be assessed from the half-yearly and annual reports, press releases, AGM’s reports, market reports, management interviews and Industry and Commerce Association’s publications. The stock of the company in which investment is sought is to be analysed in terms of the fundamentals of the company in the background of the industry’s performance. The decision to buy has to be on the basis of whether the price of the share is proper and the future profitability is good based on a rational forecast for the future.

To examine the financial highlights, we have to consider among other things, the capital efficiency and the sales turnover and the profitability margins. For this purpose, the following components may be taken into account:

\[
\frac{\text{GB}}{\text{Sales}} \times \frac{\text{GP}}{\text{Sales}} = \frac{\text{GP}}{\text{Equity}}
\]

(Capital turnover) (Sales turnover) (Profitability)

Normally, a company uses capital efficiently by having a high turnover of equity. Similarly, the use of capital is efficient if there is a high sales turnover to gross block. The company may have only a small profit margin but if the sales turnover is high, the profits will also be high. Gross profits-to-sales ratio measures the profit margins. In this context, the growth of gross block, sales, equity, and gross profits are to be analysed in respect of each company within the industry. On this basis, these ratios of companies within the industry are to be compared with the industry’s overall operating performance in respect of the variables referred to earlier. The gross profit (GP) is also to be examined in relation to the market capitalisation. The riskless return is 12% and a reasonable return is 15%. Depreciation, taxes, etc. may account for another 15%. A total return in the form of gross profit of not less than 30% is, therefore, to be expected from any company to start with. If a company in any industry is less profitable than that, it is not worth the purchase. Similarly, gross profit to gross block and the dividend policy, earning per share and bonus payouts are all to be examined from the point of view of the future prospects of the company in the background of industry performance and possible capital appreciation of the shares.

Industry Analysis

At any point to time, there may be industries which are on the upswing of the cycle called sunshine industries and those which are on the decline called sunset industries. In India, there are some growth industries like electronic and computer which are the key industries. The engineering, petro-chemicals and capital goods industries are in the core sector. A few industries like diamonds, engineering, etc. are in the export sector. June and cotton textiles are the decadent industries. At present, Tele Communications, Computer Software, energy etc. are some examples of Sunrise Industries.

As referred to earlier, performance of a company has been found to depend broadly up to 50% on the external factors of the economy and industry. These externalities depend on the availability of inputs, like proper labour, water, power and inter-relationships between the economy and industry and the company. It is, in this context, that a well-diversified company performs better than a single product company, because while the demand for some products may be declining, that for others may be increasing. Similarly, the input prices and cost factors would vary from product line to product line, leading to different margins and a diversified company is a better bet for investor.

The industry analysis should take into account the following factors among others as influencing the performance of the company, whose shares are to be analysed:

1. **Product Line**

   The position of the industry in the life cycle of its growth - initial stages, high growth stages and maturing stages are to be noted. It is also necessary to know the industries with a high growth potential like computers, electronics, chemicals, diamonds, etc. and whether the industry is in the priority sector or the key industry group or capital goods or consumer goods groups. The importance attached by the government in their policy and of the Planning Commission in their assessment of these industries is to be studied. Product may be new one or an import substitution product which has good future.

2. **Raw Material and Inputs**

   Under this head, we have to look into industries depending on imports of scarce raw materials, competition from other companies and industries, and the barriers to entry of a new company, protection from foreign competition, import and export restrictions, etc. An industry which has a limited supply of materials domestically and where imports are restricted, for example, will have dim growth prospects. Labour is also an input and industries with labour problems may have difficulties of growth.

3. **Capacity Installed and Utilised**

   The demand for industrial products in the economy is estimated by the Planning Commission and the government, and the units are given licensed capacity on the basis of these estimates. If the demand is rising as expected and the market is good for the products, the utilisation of capacity will be higher. If, however, the quality of the product is poor, competition is high and there are other constraints to the availability of inputs and there are labour problems, then the capacity utilisation will be low and profitability will be poor.

4. **Industry Characteristics**

   Whether the industry is cyclical, fluctuating or stable, has to be looked into first, as the prospects for growth will depend on this to an extent. If the demand is seasonal in the case of fertilisers, pesticides, etc., their problems may mar the growth prospects. If it is consumer product and the demand is all over India, freight charges are an important component of the cost of production. The scale of production and the width of the market would also determine the selling and advertisement costs. The nature of the industry would thus be an important factor for determining the scale of operations and profitability. The growth prospects would depend on raw materials, easy access to inputs, particularly power, transport and other infrastructural facilities.

5. **Demand and Market**

   The demand for the product should be expanding and its price should not be controlled by the government, if the industry is to have good prospects of profitability. If the demand is
income-elastic and price-elastic, the supplier should be able to sell the goods at a growing rate and the prospects of growth are good. It is also important that the prices of raw materials and other input costs like freight, electricity, etc. should not be controlled by the government. The demand should also be growing and there should be export demand for the product. If the nature of the product is such as drugs, fertilisers or other consumer goods, whose price and distribution are controlled by the government, the growth prospects would be less. Thus, decontrol of cement recently has helped the cement industry to grow and expand.

6. Government Policy with Regard to Industry
The government policy is announced in the Industrial Policy Resolutions and subsequent announcements from time to time by the government. The policy can also be seen from the strategy as laid down in the five-year plans and importance given to the industry by the Planning Commission and the expected demand in the economy. The Plan priorities for the industry, the physical and financial targets of investment and foreign collaboration in that industry are important variables affecting its fortunes. The government has powers of control over industry in terms of output, price and distribution of the product and a number of other aspects. The government policy with regard to granting of clearances, install capacity and reservation of the products for small industry, etc. are also factors to be considered for industrial analysis. The recent delicensing of the TV, VCR and consumer durables will boost the prospects of these industries.

7. Labour and other Industrial Problems
The industry, whether it is capital-intensive or labour-intensive, has to use labour of different categories and expertise. The productivity of labour as much as the capital efficiency would determine the progress of the industry. If there are problems of labour, strikes, lockouts and poor productivity, the industry should be unwelcome for the investors. The best example is banking, where presently labour productivity is poor.

There are some decaying industries, like jute and cotton textiles, whose shares are to be avoided by the investors unless such companies are diversified into other lines as in the case of Birla Jute. Certain industries with problems of marketing like high storage costs, high transport costs, dependence on foreign markets etc. as the in the case of fertilisers may have poor growth potential and investors have to be careful when investing in such companies.

8. Management
An industry with any problems may be well-managed, if the promoters and the management are efficient and capable of steering the company through difficult days. Such management like Tata’s, Birlas, Ambanis etc. who have a reputation, built up their companies on strong foundations. The management has to be assessed in terms of their capabilities, popularity, honesty and integrity. In the case of new industries and new management, there will be no track record and the investors have to carefully assess the project reports and the assessment of financial institutions in this regard. The capabilities of management will depend upon tax planning, innovation of technology, modernisation, expansion of R & D, etc. A management with a broad vision will plan for the expansion and diversification, make tax planning, increase the retained earnings with a consistent dividend policy so that the future expansion plans are put on a sound basis. A good management will also ensure that their shares are well distributed and liquidity of shares is assured and trading is fair and just in the market with no malpractices like cornering of shares or insider trading.

9. Future Prospects
Many of the factors of operation in industry are interlinked such as capacity utilisation, demand and markets, government policy, availability of inputs, infrastructure, etc. It is, therefore, necessary to have an overall picture of the industry and to study these problems and prospects. After a study of the past, the future prospects of the industry are to be assessed. For this purpose, the projected demand, input availabilities, unutilised capacities, the alternative growth strategies, methods of reducing of cost, economies of scale and the position of competitors in the market are to be probed into. A company has to be assessed in terms of its strategies to meet the challenges as they emerge and its future prospects should be assessed before an investment is made.

In fundamental analysis, intrinsic worth as reflected by BV or EPS or GPM, etc. is expected to indicate the market price. But in actual practice it is not so. Take the Tyres/ Tubes Industry for example. The table below shows how the market prices of similar companies in the same industry do not bear any perceptible relationship to BV, EPS, GPM.

<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Book Value (BV)</th>
<th>Market Price (MP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apollo</td>
<td>50.41</td>
<td>150</td>
</tr>
<tr>
<td>Govind Rubber</td>
<td>50.13</td>
<td>90</td>
</tr>
<tr>
<td>Modi Rubber</td>
<td>63.87</td>
<td>50</td>
</tr>
<tr>
<td>Dunlop Rubber</td>
<td>45.83</td>
<td>65</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>EPS</th>
<th>MP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ceat</td>
<td>10.17</td>
<td>78</td>
</tr>
<tr>
<td>JK Industry</td>
<td>10.24</td>
<td>128</td>
</tr>
<tr>
<td>Dewan Rubber</td>
<td>11.41</td>
<td>55</td>
</tr>
<tr>
<td>Apollo Tyres</td>
<td>11.84</td>
<td>150</td>
</tr>
<tr>
<td>Vikrant Tyres</td>
<td>11.86</td>
<td>40</td>
</tr>
<tr>
<td>Name of the Company</td>
<td>GPM</td>
<td>MP</td>
</tr>
<tr>
<td>Penier Tyres</td>
<td>7.8</td>
<td>300</td>
</tr>
<tr>
<td>Falcon Tyres</td>
<td>7.7</td>
<td>15</td>
</tr>
<tr>
<td>Dewan Rubber</td>
<td>7.9</td>
<td>55</td>
</tr>
<tr>
<td>Ceat</td>
<td>7.1</td>
<td>78</td>
</tr>
<tr>
<td>MRF Tyres</td>
<td>6.9</td>
<td>625</td>
</tr>
</tbody>
</table>

Example of An Industry Analysis

Petro-Chemicals
Product Nature: Petro-Chemicals are derived from petroleum and natural gas. The product groups are aromatics, plastics, surfactants, etc.

Raw Materials: Coal tar, intermediates, etc., calcium carbide, alcohol, etc.
Market (Users): Food processing, clothing, housing, health care, automobiles, etc.

Demand Scenario: The first enterprise in the public sector was Indian Petrochemicals Corpns. Ltd. (IPCL) set up in 1979. Demand was poor until 1983. After the pioneering work of IPCL to promote uses, the demand picket up. As per the demand projections of the government, demand and supply gap has persisted and necessitated imports costing more than Rs. 1,000 crores per annum.

Policy of Government: The government has placed petrochemical under the core sector as being vital to the national economy. The Planning Commission's study group headed by Abid Hussain has estimated the need for an investment of Rs. 22,000 crores to achieve self-sufficiency by 2000 A.D. The government has sanctioned a number of new projects which were in the pipeline such as those of Hindustan Lever, Nirma Chemicals, etc. Already RIL and TNP have set-up projects and there are others also on stream.

Problems of the Industry
1. Long delays in government clearances and project cost escalations;
2. Projects established were not of economic size in many cases;
3. High prices of main feed stock, namely, Naptha;
4. Need for R & D and introduction of new technologies which are most cost effective; and
5. High excise duties on Naptha.

Competition: What is the share of the company in question in the total market demand? Soon after IPCL, ABS Plastics began production whose capacity in current 2000 tonnes p.a. and is expected to be raised to 5000 t.p.a. The main competitors are Polchem with a 30% share in the market. There are others such as Indo-Nippon, Bansali Engineering, etc. The companies in this line with strong fundamentals are ABS Plastics, Gujarat Pertrosyl, PIL, NOCIL, Polchem, etc.

Cost Comparisons: The cost per tonne of the Bansali Engineering is three times that of ABS Plastics. ABS and Polchem are leaders in cost-effectiveness. The industry is asking for protection from foreign competition. The ban on exports of petrochemicals may help some units.

Process Comparisons: Mysore Petrochemical uses Oxelene Oxidation route; Tirumalai Chemicals adopts the benzene route; Rama Petrochemicals uses the alcohol as feed stock, while competitors are using propylene.

Company Analysis
In the case of company analysis, the balance sheet data should be first analysed for:
1. Efficient use of capital;
2. Leverage enjoyed in the use of capital;
3. Return on net worth; and
4. Return on equity.

The capital structure and the cost of different types of capital and the problems of servicing the borrowed funds are to be taken into account. For this purpose, the interest burden, tax and depreciation provision are to be examined. The cash profits and profit after depreciation should be considered in relation to equity and net worth.

The sales turnover is an important indicator of the activity of the company and an assessment of gross profits in relation to sales is to be made. Sales to equity would be high to indicate a good turnover of sales for equity (or NW) employed in the business. The profit margins, earnings per share and P/E ratios will indicate the earning potential of the company for the equity holders.

A fair return on capital employed can be assumed to be 10-15% as the government and public sector bonds give a return of around 13%. A provision for tax and depreciation has to be made at around 15%. These together would account for about 30% as gross profit for a company to be eligible for investment. The gross profits as well as net profits are to be related to the market capitalisation for each company. Besides, the performance of the companies analysed has to be compared with that of its competitors in the industry under the following heads:

1. Cost per unit;
2. Profit margins;
3. Earnings per share and P/E ratio;
4. Bonus payments;
5. Dividend distribution policy; etc.

The variables to be studied for each company and the relative ratios are set out below:

Size for the Company - The expansion and growth of the company has to be judged by the growth of sales, assets, gross block and net block. The growth of the company can also be judged by the rate of growth of any of the above variables while the size of the company has to be judged in terms of its sales, installed capacity utilisation with a view to see that the company is of an economic size.

The profitability of the company is to be judged by the net profits (PAT) or cash profits in relation to sales, equity or net worth, dividend distributed, etc.

The followin variables are also to be analysed for a company analysis:
1. Company’s share in industry-its capacity utilisation vis-a-vis the utilisation in the whole industry.
2. Modernisation and expansion plans - reflected in tax planning, retention policy, bonus policy, etc.
3. Earnings per share, cash earnings per share and P/E ratios.

Need for Forecast
The disadvantage of the above type of analysis is that it is based on the past performance and that it may not be an indicator of future performance. So a forecast is necessary for the coming six months or one year for making an investment. Such a forecast can be made on the basis of some assumptions of costs, prices and demand for its products. The earnings, gross and net profits, the EPS, etc. can be worked out and an assessment can be made whether the scrip is worthwhile purchasing judged by its prospects a year hence.

For making a forecast, some subjective weights may be given to management (50%), expansion and growth (25%), prospects of bonus (15%) and other subjective factors like Government patronage or changes in market conditions (10%). These give a
total weight of 100%. Companies in the same industry group can be studied by using the above weights to decide on which scrips to purchase depending on their rating. These weights and consequent judgement will be subjective and the result would depend on the ability and expertise of the analyst.

Guidelines for Investment
A company which has a high intrinsic worth is not necessarily the best stock to buy. It may have no growth prospect or it may be overpriced. Similarly, a company that performs well during any given year may not be the best to buy. On the contrary, a company which has been doing badly for some time might have turned the corner and it may be the best buy, as its shares may be underpriced and it has good prospects of growth. So an analyst should not be guided by one or a few indicators but has to consider the performance of the whole company, and over a period of time, say, 5 years. Besides a company is to be judged in the background of the industry’s performance, product nature, prospects of the industry, etc. A study of the industry factors constitutes the industry analysis. Next to economy’s performance, industry’s performance is vital for an assessment of a company’s prospects and growth.

Case Study : Asian Paint
Paint industry growth was at a rate of 12% during 1995-96. The industry as a whole will continue its growth at not less than 8-10% rate in the coming years. Asian Paints is the leader in decorative paints, controlling 45% of market segment of the total of Rs. 1,800 crore paints and varnishes industry. In industrial paints, it is the largest player with a market share of 14%.

With a low per capita consumption of paints in our country, it has good future prospects. The prospects for exports are good with an actual export of Rs. 16 crore in 1995-96. The users in industrial sector, namely, automobiles and its accessories, household appliances and consumer durables etc. are showing prospects of rapid growth. Thus, the potential for the industry both in the domestic and export sector is good.

Asian Paints which is a leader in this industry has an installed capacity of 1.08 lakh T.P.A. of Paints enamels and varnishes. Its gross block grew from Rs. 123 crores in 1993-94 to Rs. 187 crores in 1995-96, due to continuous expansion of capacity. The sales turnover recorded a compounded growth rate of 13.5% p.a. during the last five years, while its net profit grew faster by 27.5% during the same period.

This company has many plus factors:
1. Good Collaborator namely, Chemische Werke HHals A.G. Germany for manufacture of Vinyl Pyrdine Latex and PPG Industries Inc. USA, for electro deposition coating on automobiles.
2. Product differentiation and brand image is secured by Asian Paints by spending only 1.5% of revenue on advertisements to testing the quality, availability and dependability.
3. Plants well distributed geographically.
4. Six joint collaborations in foreign countries and good export growth.
5. Good stress on R & D for absorption of foreign technologies and their upgradation.

Asian Paints is one of the three winners of the ET - Harward Business School Association of India awards for its performance in 1994-95. The measures used by them are as follows:

Financial Ratios of the Company
- Gross Profits / Total assets 21.36%
- Retained Profits/ Net worth 18.24 %
- Net Profit / Net worth 25.96%
- Growth in Market Cap / Growth in Net worth (over 5 years) 1.60
- Cash flow to gross assets 20.64

Example of Company Analysis
It is necessary to analyse the financial data of the company in the background of the industry performance as shown below:

The data relates to 1996, but that may not matter as it is for illustration. Only selected companies are studied above. The debt-equity ratio representing leverage is good for NOCIL and Cochin Refineries. But PAT to NW is higher and the actual market price is covered by book value three times in the case of Cochin Refineries. Besides, examine the date of Gross Block, NW, Sales, Gross and Net Profits and their growth rates over a period of 5 years. Then assess whether the company's EPS and P/E ratios are better than the average industry performance and whether the scrip is underpriced or overpriced and buy only if it is undervalued with growth prospects or is fairly priced for its fundamentals. In the above example, Cochin Refineries is the best buy at its price.

How to Pick Up Growth Shares?
The growth companies are also called blue chip companies. The blue chips of yesteryears are not necessarily the blue chips of today. The investor has to review and assess the companies from time to time to locate the blue chips, based on fundamental analysis.

In order to enable one to identify these blue chips of tomorrow, one should know the nature and characteristics of these companies. A few guidelines in this regard are set out below.

Firstly, the management should be experienced and efficient; they should have the honesty, integrity and vision for expansion and growth. Such is the case with Ambanis, Tatas and Birlas. Secondly, the market share of the company should be substantial and at least more than one-third. The larger the share, the better the prospects of controlling the market and profit margins and expanding the operations. Bajaj Auto has a share of two-thirds in the two-wheeler and three-wheeler market. So is the case with Asian Paints, Laxmi Machine Works etc.

Thirdly, the company must be well-diversified into areas of growth potential. The growth potential changes from time to time. At present, industries with a growth potential are cement, paper, petrochemicals, etc. Thus a company with a good diversification into such growth areas would do well in sales, profits, and earnings. Some of the consumer product industries
producing soaps, cosmetics, toothpaste and powders etc. would generally record a consistent growth. A well diversified company like L & T, Hindustan Lever, or Century Textiles is a good buy at any reasonable price.

Fourthly, the company’s policy of expansion should be consistent and has a long-term perspective. Its asset growth should be reasonably good, reflecting its expansion goals. Growth helps the industry to stabilise its earnings from undue fluctuations and help the diversification process. The companies with a good asset growth are Reliance, L & T, GSF etc.

Fifthly, the company should have a consistent and stable distribution policy with good profit margins. The company should distribute a reasonable proportion of its profits as dividends, bonus etc. Such companies like Ponds, Colgate, Glaxo etc., would be in good demand, as investors prefer regular dividend-paying companies.

Sixthly, such a company services the investors well with bonus or rights issue or convertible debentures, from time to time in addition to increasing dividend payments. The financial structure and utilisation of capital are efficient. The profit margins are growing and the company is gaining in financial strength.

Lastly, the industry or industries in which the company is operating should have good growth prospects Pharmaceuticals, Biotech or multimedia. The products should be in continuous demand like food products, paper soaps, etc. or consumer non-durable goods. The future outlook of the company and prospects of the industry are interlinked, the prospects would depend also on the government policy and whether it is subject to price and distribution control or any restrictions or regulations. The prospects of the industry in which the company is operating should be assessed from all points of view.

Thus, in the choice of blue chips, the investor has to examine the fundamentals of the companies through balance sheet analysis for a period of at least five years before finally selecting the shares. The time of purchase should be decided on the basis of technical analysis referred to later. But for a layman, the purchase time should be in the bearish phase of the market, when an all-round decline in prices is recorded. At such times, the companies with strong fundamentals should be picked up at low prices for long-term investment if they can be classified as blue chips as per the above guidelines.

Pharma Industry
One of the Sunshine industries in India which has grown rapidly in the past and which has still potentiality to grow is the Pharma Industry. It has grown at a compound rate of 17% during the last decade. Still the per capita consumption of medicines in India at & 3 is one of the lowest in the world, despite a high rate of incidence of disease, compared with the world averages.

The pharmaceutical industry comprises of formulations and bulk drug with formulated sales at Rs. 9,125 crores and bulk drug sales of Rs. 1,822 crore in 1996-97. Although there are 77 therapeutic segments, according to disease profile the largest ten segments such as Antibiotics, Vitamins, Anti-T.B., Anti-parasitic, Anti-Rheumatic etc. comprise 61% of total formulations market. Further, the top largest four companies alone account for a significant market share of each of the therapeutic group. Thus, in Anti-Biotics, 24% share of the market is held by Ranbaxy, Cipla & Glaxo, while in the age of Anti-T.B. drugs, 65% of the market share if controlled by Lupin, H. Ciba and Cadilla.

Further, the top 25 pharma companies control over 52% of the entire retail formulations market. While these companies have a wide product range, most of their income is generated by only 2 or 3 segments contributing to more than 50% of total sales. The same is the case with the bulk drug segment. While there are over 23,000 units, producing bulk drugs the top ten drug manufacturers namely, Ranbaxy, Lupin, Kipron, IPCA Morepen, Natco, Dr. Reddys, Orchards, Chemimir and German Remedies account for about 84% of production and exports.

The health indicators point to a larger reliance on drugs in future. Those above the age of 65 will increase and birth rate will be higher and death rate be lower, which leads to greater demand for drugs. India accounts for 15% of world population but consume a mere one percent of the global pharma sales. The growing middle and upper classes in India, with rising disposable income higher literacy and increased medical awareness will increase the demand for drugs. Besides, poor sanitation, pollution, accidents and other health hazards will improve the usage of drugs.

The price control on as mush as 350 items have been brought down to 76 in 1985. The reduction of controls on the drug industry, the favourable inflow of R & D results in India and low cost and high margin scenario would be expectedly lead to a widening and deepening of the drug industry in India and the future of this industry is bright. Among the existing producers for foreign MNCs stand to gain more than the Indian MNCs, who in turn may reap better rewards than the all industry average or the average for many industry groups.

Future Outlook
The future outlook for this industry is bright. It is expected to grow at not less than 15% per annum in terms of sales, as against the growth rate of GDP of 6-7%, in the short run and its prospects are much brighter in the long run. This industry is undergoing many changes to strengthen itself and improve its profitability. The following are some of these trends:

1. FERA is diluted and foreign MNC can increase their stake upto 51% in the subsidiaries.
1. DPCO eliminated the need for compulsory bulk drug manufacture in India up to a minimum amount, thereby enabling them to close down some uneconomical units/divisions.

2. Corporate tax rate is brought down to 35%-48% and import duty on chemicals was cut from 110% to 30%.

3. The acceptance of GATT and WTO by India has paved the way for recognition of product patents.

4. Reorganisation and restructuring is going on among foreign MNCs and Indian MNCs to strengthen themselves by brand acquisitions, permitted take overs, and voluntary mergers.

5. Encouragement to product launches, particularly if export oriented.

6. Possible 100% investment by Foreign MNCs due to FDI liberalisation and freer Royalty out flow permitted by FERA liberalisation.

7. Growing global generic market changing mind set, more R & D investment and unlocking of unproductive assets, shedding off the excess fat by VRS for employees and selling off uneconomical capital wasting division. R & D is being encouraged through tax incentives.

Conclusions

The tabular presentation of fundamentals of four major pharma companies belonging to pharma MNC is for illustrative purposes. This is the starting point of further equity research. Many of these pharma companies are highly priced due to high market expectation, despite the fact that in mid-September 1998, the stock market was in a continued uncertain phase bordering on bearishness. BSE Sensitive Index was at an average of 3140 during mid-September 1998 as against 3945 during September 1997 and 3763 during March 1997 (averages).

An analysis of the four pharma companies for valuation and investment reveals that long-term prospects of these companies are good although in the short-run, some are overvalued. The equity research through fundamental analysis helps in the identification of any scrip, which, at current prevailing prices, may be under-valued and is worth buying. Of the companies in Pharma Group, Glaxo and E-March have good prospects to buy. Hoechst and Smithkline would be good in the long-run. Abott labs has to be avoided or sold off, due to the future uncertainty. Ranbaxy is growing fast.

Such an analysis is necessary for industry and company fundamentals followed by prior analysis of the economy is general and its expected performance in the near future.

The BSE Sensex reached an all time high of 6150 on Feb 14, 2000 from a three year low of 2741, reached on Oct 23, 1998 one year low of 3183, reached on April 28, 1999. During April-May 2000, the Index fluctuated around 4000 - 4800. The scrips tabulated show good prospects of appreciation on the present indications.

German Remedies has a market price in May, 2000 at around Rs. 600-650 and 52 week High and Low is Rs. 1,390 and Rs. 498. Its EPS is at Rs. 40 as at end March, 2000. The earnings have an annual growth rate of around 20%. Its past P/E multiple is around 16. At this multiple its EPS gives a fair market price of around Rs. 480 or Rs. 500. In view of prospects of growth of earnings and the recent high of past prices at Rs. 1,390, it has good prospects of growth.

Parke Davis has a market price in May 2000 at around Rs. 240-250, with a 52 week High and Low of Rs. 470 and Rs. 214 respectively. Its EPS is Rs. 14 and has grown by more than 100 per cent over the last one year. Its recent P/E multiple is 20. At this multiple, its EPS gives a fair market price of Rs. 280. Thus, the current market price of Rs. 240 appears to be undervalued.

FDC is at a current market price of Rs. 260, which is the lowest in the year. Its 52 week High and Low are Rs. 503 and Rs. 260 and P/E multiple is around 11. Its last EPS for the year ended March, 2000 is Rs. 27. All this level, its fair market price should be around Rs. 300/-. Its current market price is thus highly discounted at Rs 260.

Ranbaxy Ltd., has a current market price of Rs. 520/-, and P/E Multiple of around 30. At the EPSs, recorded for the past year at around Rs.18 its fair price should be Rs. 540. Its current market price is fair and even undervalued, if we take into account the growth prospects of the company.

The above analysis, which is illustrative, is relevant only for the year 2000 and the reader has to make similar studies for any point of tie, as the market sentiment and external and internal factors o the company change from time to time.

Notes