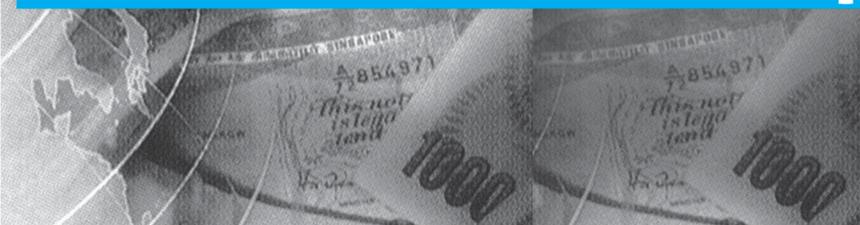




FII View

On Prospects



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The Year 2004 has been the most remarkable year in the history of Indian capital markets with the BSE Sensitive Index closing at another record high and FII flows at over \$8.6 billion, a 13.7 per cent growth over previous record year. It is particularly interesting to note that India attracted 30 per cent of the foreign flows that washed the shores of the Asia Pacific region during 2004 at a time when India witnessed a major election reversal and a lean monsoon season (see table below).

This is a testament to the resilience of the Indian economy and its well managed corporate sector which continues to show a high earnings growth compared to the peers in the Asia Pacific region.

In addition the following factors contributed significantly to the FII flows to India :

- **Regulation and Trading Efficiencies:** Indian stock markets have been well regulated by the stock exchanges, SEBI and RBI leading to high levels of efficiency in trading, settlements and transparent dealings enhancing the confidence level of FIIs in increasing allocations to India.
- **F and O Segment:** The highly successful derivatives market in India has provided additional depth to the markets with high traded volumes and multiple instruments by which investors can participate in the Indian equity markets. In fact the Single Stock Futures (SSF) market in India is one of the most successful SSF market in Asia after Korea.
- **New Issuance:** We have witnessed extremely high quality issuance during the year from companies such

	Korea	Taiwan	India	Indonesia	Philippines	Thailand	Total
Foreign Flows \$	10,494	7,472	8,610	2,090	270	(288)	28,647
Foreign Flows % of Total in the region	37%	26%	30%	7%	1%	-1%	
PE 2005 E	7.78	11.75	13.21	9.87	11.61	9.99	
EPS Growth 2005 E (%)	-3.78	-2.41	13.02	14.40	13.10	7.18	
Local Index Dec 31,2004	895.92	6139.69	6602.69	1,000.20	1822.83	668.1	
YTD Perf (local currency)	8.09%	2.04%	9.05%	0.41%	25.43%	-13.28%	
YTD Perf (in USD)	21.81%	7.15%	13.42%	0.28%	23.82%	-12.28%	
1 Year Volatility	25.40	25.00	26.80	24.60	17.90	25.80	
Information Ratio	2.30	(1.40)	1.50	4.70	2.60	(4.00)	

E : Consensus estimates. 1 Year Volatility is calculated as annualised standard deviation from that of country index
Information Ratio is calculated as average daily excess return over the past 12 months divided by its standard deviation

as NTPC, ONGC and TCS leading to strong FII participation with successful new issuance of over \$ nine billion, yet another record for the year.

Outlook for 2005

Attractive Markets: Indian equity markets continue to be attractive to foreign investors with expected earnings growth of over 13 per cent compared with negative growth expected among competing countries in the region such as Taiwan and Korea. Indian blue chips are seen to have high quality of balance sheets with net debt to equity of the top 30 companies being negative, with net cash on the balance sheets. However earnings growth is expected to be lower than last year and upside in stock prices will be subject to sentiments in the global markets and foreign flows to emerging markets. However high quality new issuance from PSUs and other large corporates will continue to see good demand from FIIs. However domestic mutual funds have been net sellers of equities during 2004 with risk aversion still prevalent among local investors after seeing several short periods of high volatility. With the booming stock markets presently catching the headlines in local press, this trend will hopefully reverse during 2005.

Outsourcing: The rhetoric over outsourcing of jobs to India has died down after the US elections and demand will soar for Indian BPO and software services companies. However Indian software companies will need to enhance margins by going up the value chain to high level consulting and scaling up the project sizes. Significant outsourcing opportunities will also open up in textiles and drugs with dismantling of quotas for textiles and introduction of product patent regime for pharmaceuticals.

Infrastructure: Woefully inadequate infrastructure is the biggest bottleneck for the growth and profitability of Indian corporations. The administration needs to move much faster in privatisation of projects in the areas of power, transportation, ports, airports and other urban infrastructure to enhance competitiveness. This is particularly relevant due to the fact that competing countries in Asia Pacific and China have moved at a much faster pace during the last five years and have in place a first world infrastructure.

Capex Cycle: With strong balance sheets, high liquidity in the banking system, supportive capital markets and growing demand for goods and services we expect to see a strong wave of capital expenditure cycle during the year leading to tremendous opportunities for Indian equities.

Dollar Weakness: Analysts continue to look for a weak US dollar with the US twin deficits (budget and trade deficits) unlikely to be resolved anytime soon. Studies have shown that flows into emerging markets rise significantly during times of dollar weakness and India will continue to be a beneficiary of this trend. Indian Rupee is expected to strengthen further during 2005 which will be particularly favourable for domestic demand oriented businesses such as banks and automobiles.

Rising Commodity Prices: Demand supply dynamics in both crude and metals call for higher prices during 2005 with increasing Chinese demand and economic recovery in Japan. This has inflationary implications for India going forward, though it will be a boon for commodity counters.

Consolidation: FII activity has been focused on large cap companies due to liquidity reasons, and hence several high quality mid cap companies trade at a valuation discount due to lack of investor demand. We expect to see significant merger activity among mid caps which will enable them to gain better valuations under the institutional radar screen, in addition to consolidation efficiencies. While China attracts significantly higher FDI, India with its highly developed capital markets will be a beneficiary of FII flows at increasing pace each year. To summarise, Indian markets have successfully absorbed the gains seen during 2003 and consolidated well during 2004 with a modest gain and look set to outperform the global financial markets during 2005.

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