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BEGINNING OF A DOWNSWING?

The early numbers indicate that while topline growth continues to be robust, growth in profitability is likely to slow down on account of higher commodity prices, wages and interest rates. Treat any talk of an early turnaround in corporate performance with scepticism



DIPEN SHAH
Kotak Securities

Margins have fallen because companies have not been able to pass on all the cost increases to customers due to competition



SHRIRAM IYER
Edelweiss Securities

The margin compression that we are seeing is along expected lines and has already been factored into stock prices

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Sanjay Kr Singh

THE Q1 FY08 (quarter one of financial year 2008-09) earnings season has begun. Till Thursday, July 24, results of 221 companies had come in. While this is too small a sample for drawing definitive conclusions (there are about 4,000 companies listed on the Bombay Stock Exchange), what the early numbers do point to is that costs are up, and the above 20 per cent growth in corporate profitability, which was the norm in 2007, may be a thing of the past.

Before proceeding, do look closely at the table (Early numbers indicate a slowdown). Then you are likely to savour the story behind the numbers better.

INCOME. Year-on-year (y-o-y) growth in income continues to be robust. That's not entirely because consumer sentiment, and hence demand, remains robust. "Some of the growth in revenue would have happened because companies would have tried to pass on rising costs to their customers," says Uma Shashikant, managing director, Centre for Investment Education and Learning. —*ee*

PB-DT. While revenue has grown, the y-o-y growth in PB-DT (profit before depreciation, interest and tax) has shrunk. The primary reason for this is the increase in costs of raw materials, and salaries all of which have gone up. According to Dipen Shah, vice president, private client group research, Kotak Securities, "Growth in PB-DT would also have shrunk because while corporates would have passed on some of their cost increases, they would probably not have been able to pass on all the cost increase, due to factors such as competitive pressure and demand reduction."

NET PROFIT. For the companies that have declared their results so far, the growth in net profit has declined from 35.2 per cent (June 2007) to 16.1 per cent (June 2008). Though less than half the figure for June 2007, it isn't too bad. In March 2008 it was even lower at 10.6 per cent. Besides high commodity and wage costs, higher interest cost has also contributed to slower growth in net profits. What remains to be seen is how much further this number declines as more companies declare their results.

OTHER INCOME. Here the swing in the year-on-year growth numbers is quite dramatic — from 79.4 per cent for the previous year (June 2007 over June 2006) it has declined to -4.4 per cent this year (June 2008 over June 2007).

Companies earn 'other income' from three sources primarily: forex gains, market related investments, and from the sale of non-productive assets (cars, real estate). And they have probably made losses in at least the first two categories.

MARKET RELATED INVESTMENTS. Equities have not done well in recent times with the Sensex down about 30 per cent since the beginning of this year. Debt, too, has not done well. But the steep decline in 'other income' raises a question. Says Shashikant: "Have corporate treasurers taken on too much risk? Most corporates invest predominantly in liquid funds and FMPs (fixed maturity



Early numbers point to a slowdown

Y-O-Y COMPARISON

DECLINING BOTTOMLINE GROWTH

	Jun 07	Jun 08
Income	22.7	24.7
Profit	13.8	13.6
Net profit	13.1	10.2
Other & extraordinary income	4.5	29.8

Q-O-Q (SEQUENTIAL) COMPARISON

NUMBERS TURN NEGATIVE

	Jun 08	May 08	Jun 07
Income	-0.5	1.9	1.9
Profit	-1.4	1.9	1.9
Net profit	-4.4	1.9	1.9
Other & extraordinary income	25.8	1.9	1.9
Revenue share percentage (change for 214 companies)	100.0	100.0	100.0
Revenue (declined by 0.2% over reports filed)	100.0	100.0	100.0

SHRINKING MARGIN

	Jun 08	May 08	Jun 07
Profit margin (%)	12.8	13.1	13.8
Profit (excl. other income) (%)	10.2	10.2	10.2

NON-FINANCIAL CO'S

BATTLING RISING COSTS

	Jun 08	May 08	Jun 07
Income	13.8	13.8	13.8
Profit	10.2	10.2	10.2
Net profit	10.2	10.2	10.2

MARFCOST HEADS

	Jun 08	May 08	Jun 07
Raw material	10.2	10.2	10.2
Salaries & wages	10.2	10.2	10.2

COST-CUTTING HAS BEGUN

	Q-O-Q (June 08/May 08)
Income	-0.2
Profit	-0.2
Net Profit	-0.2

MARFCOST HEADS

	Q-O-Q (June 08/May 08)
Raw material	0.0
Salaries & wages	0.0
Interest expenses	0.0

NON-FINANCIAL CO'S

	Jun 08	May 08	Jun 07
Income	13.8	13.8	13.8
Profit	10.2	10.2	10.2
Net Profit	10.2	10.2	10.2

FINANCIAL CO'S

WHA & CAUSE FOR CONCERN

	Y-o-Y (Jun 08/Jun 07)
Income	71.5
Profit	10.2
Net Profit	10.2

INTEREST EXPENSES

	Q-O-Q (Jun 08/May 08)
Income	10.2
Profit	10.2
Net Profit	10.2

PROFITS TAKE A HIT

	Q-O-Q (Jun 08/May 08)
Income	10.2
Profit	10.2
Net Profit	10.2

NUMBERS SHOW 'TOUGH CHARGE'

For 20 financial companies from Jun 2007 whose results have been disclosed by 100%

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plans). Such a strong swing indicates that perhaps many corporate treasuries got tempted by the bull run, and instead of investing conservatively, went in for equity investments. If they had invested in debt instruments alone, the decline would not have been so drastic."

Another explanation for the drastic swing in 'other income' lies in hedging losses on forex. "Till March the rupee was appreciating, and after that it has depreciated. So calculations about currency movements have gone awry," says Shashikant.

Sequential numbers turn negative

The year-on-year numbers show that while income and earnings have slowed down, the growth rate is still positive. But quarter-on-quarter numbers are all in the negative. Does that indicate that the situation worsened

Other income has come down drastically due to investment and forex losses

in the last quarter? Says Shashikant: "Since all the numbers have turned negative, they do confirm the fear that a slowdown is underway."

However, Shriram Iyer, head of research at Edelweiss Securities, sounds a note of caution. "Q-on-q comparisons don't mean too much. Only in case of IT and telecom are income and profitability smooth round the year, otherwise in most sectors there is a seasonal effect. For instance, consumer goods sell more in the festive season. Government clients give out more orders in the fourth quarter of the financial year, and so on." Hence, he says, Q1 of a financial year is often weaker than Q4 of the previous financial year.

Next we have segregated the 114 companies into non-financial and financial companies. Here's what the numbers indicate about these sectors.

NON-FINANCIAL COMPANIES. Top line growth (at 33.8 per cent) continues to be good. But what has pulled PBDIT and net profit down (to around 18 per cent) is escalating costs — of raw materials, wages, and interest cost.

FINANCIAL COMPANIES. For financial companies, the growth in net NPA is a cause for concern. When interest rates rise, lenders raise interest rates and pass on costs to customers, as a result of which defaults begin. Financial companies (banks) have also had to make provision for mark-to-market losses on their investment portfolios.

"When interest rates go up, net interest margins of banks shrink. The broking business too has been down," says Shah. All these factors have pulled the growth in financial companies' profitability down to a bare 2.1 per cent.

Corporates hurting

What the above numbers unambiguously indicate is that inflation and high interest rates are hurting corporates. The downturn in corporate performance has begun, and it will take some time for the corporate sector to turn around. With the central bank also in monetary tightening mode, growth is likely to be affected. So, all glib assertions of a quick turnaround in corporate performance should be treated with scepticism. There will be some lagged impact of high inflation and high interest rates, and this is likely to show up in corporate performance over the next couple of quarters.

Remember that an investor, in response to macro economic developments, can respond quickly and shift his investments. But the real economy, that is, businesses, can't adjust so fast to high inflation and high interest rates. What are the adjustments that companies will try to make? They will try to bring about efficiency in production, and will go slow on expansion plans and hiring. All this will not happen overnight. Declining q-on-q costs show that the process is underway.

Finally, one would like to add a caveat here. The sample size is still small, so the present results could be skewed because of some sectors being represented more than others (like IT, which announces results early). With a larger sample size, of say, 1,000 companies, we would be on more solid ground. Nonetheless, what the early results do indicate is that costs are up, and this is likely to slow down profitability growth — this quarter and in the next quarter or two. We should count ourselves lucky if corporate profits grow in the low double digits in Q1FY09. ■

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