

External Environment and Stock Selection

The world is moving at the speed of thought; you must devote more time and efforts to pick the right type of company for your investment needs. Every hour, whether we are awake or asleep, there is somebody who is taking a call on particular company or on industry. Somebody is buying stock, commodities or currencies, which can affect your investments in a particular fashion. This is market dynamism where negative sentiment in the US market can change sentiments in the Indian market. Rise in value of one currency can erase gains of your hard earned portfolio investment.

Here we are going to talk about external environment and stock selection.

Every company operates in an environment. Company's financial position, products or services, business and marketing strategy, employees and workers, skill of the people working in the company, etc. form the internal environment of the company. Government policy, tax structure, interest rate, competition, political climate, socio-economic scene, etc. are part of the external environment. There are people who divide these two into controllable environment and uncontrollable environment - as a company as an entity or its management may control most things within the organization, have a say in its overall development but external forces are out of the company domain for control. Thus, study of these external forces affecting the performance and profitability of the company need analysis before taking any investment decision.

To explain it further, let us take example of Sugar and Cement in India.

India is one of the largest producer and consumer of sugar in the world. Sugar as a sweetener forms part of our daily food intake. Sugar production depends on the availability of sugarcane. Low production of sugarcane will result into low production of sugar; hence price of the commodity rises. Rising prices of sugar may result into high inflation. Though, sugar has a very low weight in wholesale price index but being item of mass consumption, effect of rise in price may become intense.

Government will have to take some immediate steps to curb the price.

Supply of sugar in India is controlled by central government in form of levy and free sale. Price of levy sugar is always lower than that of free sale sugar.

In 2004 and 2005 sugar production declined due to unfavourable weather in India and Thailand and high divergence of sugarcane by Brazil to produce ethanol (ethanol is mixed with petrol and diesel, as crude oil prices were rising we witnessed a global shift towards ethanol or biofuel at global level), price of sugar shot up in international market. Indian sugar producers were able to reap higher profits on back of better price realization. But in July 2006 government banned all exports of sugar from India. India was expecting bumper crop of sugarcane for the season beginning in October 2006, but government did not allow any sugar exports till January 2007. The decision to ban sugar export resulted into higher supplies in the country and price

of sugar in India came down from Rs. 20 per kg in July to Rs. 14 per kg now. Since last two quarters Indian sugar companies' profitability has declined. They are unable to manage high inventory due to high production and low profitability due to lower price realizations. Thus, external forces changed the fate of companies operating in this sector.

Cement sector has the same story, after a decade of low demand, lower operating rates and low profitability companies operating in the sector was not able to perform. Since 2002 the fate of the sector changed. With high economic growth, higher spending on infrastructure demand for cement started rising. Companies were able to scale up their production and were able to fetch higher prices of cement. Performance of companies improved on higher demand and lower supplies of the sector. Stock prices also went up.

Face off between government and cement manufacturers' started in May 2006 when Commerce Minister first indicated that rise in inflation is mainly fuelled by cement prices. Manufacturers held a meeting



with Commerce Minister and agreed to sell cement for government projects at 5% lower than the market prices. The issue was settled then. But, with excise duty change announcement in budget the situation has become worse. Cement manufactures had to bend to government demand for price freeze for one year. Finance minister wants all cement companies to announce price cut. Mr. Chidambaram argues that cement producers are involved in profiteering and has just allowed duty-free imports of cement. This pressure tactics by government will hurt profitability of cement companies and has resulted into erosion of shareholders' wealth.

Understanding of external environment is must for stock

selection, especially in those sectors, which operate in commodity domain. Different commodities have different usage. When prices of one commodity rises it affects inflation, high inflation results into high interest rate. Any price rise has political echo and government will be forced to take political decision, which may generally have a negative impact on the economics of companies. It is advisable for investors to stay away from those sectors or companies where government interference is very high. This advise is particularly true for commodity based stocks which are the backbone of any economy, unbridled price increase is never tolerated ultimately these companies are expected to earn only normal profits.

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