

## Explaining the divergence between the economy / equity markets

### Differentiating the listed companies' performance from the rest of the economy

- It is now commonplace to highlight the divergent trends between the record-high equity markets and declining to marginal growth in economic activity. In this note, we argue that such divergent trends should not be surprising, considering that the former is entirely linked with the performance of listed companies, while the latter has a much broader scope.
- The strong performance of the equity market is a reflection of the fact that the gross value-added<sup>1</sup> (GVA) of the listed non-financial companies<sup>2</sup> (NFCs) grew ~14% YoY in 2HCY20 and 36% YoY in 1QCY21. The GVA of the rest of the economy (RoE), however, shrank ~2% YoY in 2HCY20 and grew 6.7% (slower than the pre-COVID trend) in 1QCY21.
- The Corporate sector (Financial + Non-Financial) in India accounts for about 45% of the national GVA (vis-à-vis ~75% in the US). However, the GVA of listed NFCs is just a fifth of the entire corporate sector. This implies that the GVA of listed NFCs accounts for less than 10% of the national GVA. Furthermore, fixed asset investments by listed NFCs are also less than 10% of the total investments in the economy, while their share is just ~3% of the total non-farm employment in the country.
- The two very important inter-linked questions to ask, then, are “*Why have listed companies done so much better?*” and “*Will the better financials of listed companies pull up the rest of the economy?*” The objective of companies is to maximize shareholders' value, which is achieved by generating maximum profits. As we have discussed [earlier](#) in detail, corporate profitability could improve owing to either (a) better economic growth (led by investments) and/or (b) other factors such as higher fiscal deficit, lower household savings, and/or better current account balance. As listed NFCs have lowered their investments, it is clear that higher corporate profitability is being driven by other factors.
- Coming to the second question, we do not believe that listed NFCs, accounting for <10% of the national economy, could bear the entire burden of driving growth higher. As we have explained in earlier reports, with weaker [household](#) and [government](#) financial positions, the two primary drivers of GDP growth in the pre-COVID period – private consumption and fiscal spending – would be missing in India for the next few years. Furthermore, while listed companies have strengthened their balance sheets, unlisted corporate businesses (4x that of listed in terms of GVA) continue to struggle. Therefore, it may prove challenging to strongly revive RoE, which would weigh on overall economic growth.

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**The diverging trends in equity markets / the economy...:** The benchmark equity indices in India, such as the NIFTY50 or SENSEX, have risen to all-time new highs, while the real economy remains very weak. A comparison between the trends in the NIFTY (or SENSEX) with the Index of Industrial Production (IIP) captures these diverging trends comprehensively (*Exhibit 1 on the following page*). After falling 37% in a single month in Mar'20, the benchmark equity indices have since more than doubled to new highs. On the other hand, growth in economic activity managed to edge up into the positive territory in late 2020. Furthermore, while the benchmark equity indices in India scarcely witnessed a speed bump due to the second COVID wave, posting all-time high levels, the IIP plummeted once again over Apr–May'21. Accordingly, it is commonplace to highlight these divergent trends. In this note, we argue that such diverging trends should not be surprising, considering that the former is entirely linked with the performance of listed companies, while the latter has a much broader scope.

<sup>1</sup> GVA = Value of production – Cost of goods sold = Employee costs + Interest + Depreciation + Profit before taxes (PBT)

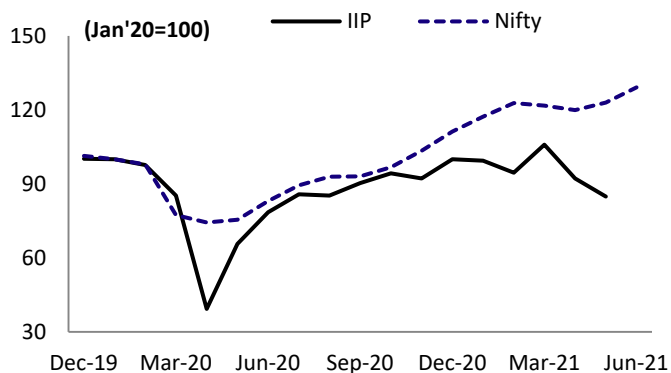
<sup>2</sup> Listed NFCs include almost 2,700 non-government non-financial companies (NGNF) in RBI's sample and another 46 government companies in BSE500

Equity markets are entirely linked with the performance of listed companies, while economic activity includes a lot of other participants

**...can be explained by differentiating the performances of listed companies vis-à-vis the rest of the economy (RoE):** As explained previously, the performances of the equity markets and listed companies are linked. However, economic activity comprises various other participants (non-listed companies, individuals, MSMEs, the government, etc.) and thus has a much wider scope.

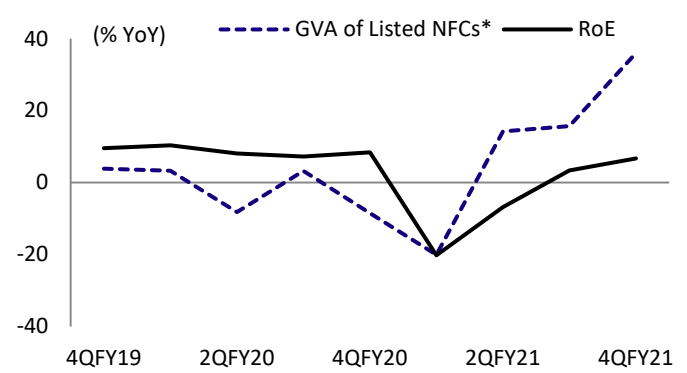
The strong performance of the equity markets is a reflection of the fact that the GVA of listed NFCs (based on ~2,750 companies) grew ~14% YoY in 2HCY20 and 36% YoY in 1QCY21. The GVA of the RoE, however, shrank ~2% YoY in 2HCY20 and grew just 6.7% (slower than the pre-COVID trend) in 1QCY21 (*Exhibit 2*). From this perspective, the strength in the performance of the equity markets and weakness in economic recovery are not enigmas. The former has done exceptionally well as listed companies have performed better vis-à-vis the RoE.

**Exhibit 1: Equity markets have outpaced real economic growth in the past few months...**



Source: RBI, MoF, CAG, Bloomberg, company reports, CEIC, MOFSL

**Exhibit 2: ...as listed companies have performed much better than the rest of the economy**



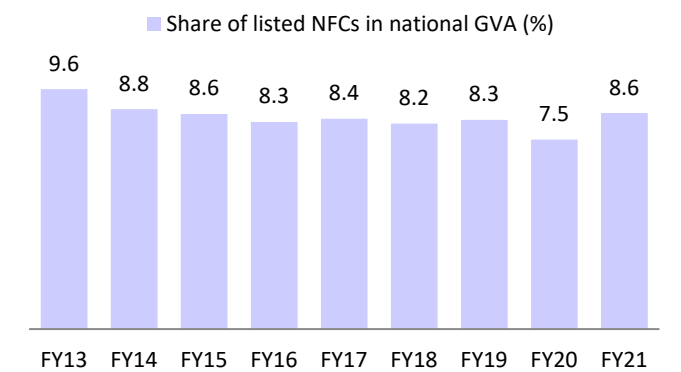
\* NFCs GVA = Value of production – Cost of goods sold = Employee costs + Interest + Depreciation + Profit before taxes (PBT)  
# RoE (Rest of the economy) = National GVA – listed NFCs GVA

The GVA of listed NFCs is less than 10% of the national GVA

**How large are the listed companies for the Indian economy?** The diverging trends between the listed companies vis-à-vis the RoE beg the question, what is the overall contribution of listed companies in India's economic activity? To answer this question, we look at three different parameters – the GVA of listed NFCs, fixed asset investments by NFCs in the BSE500, and the total employment generated by the listed companies. Here are our key findings:

- The Corporate sector (Financial + Non-Financial) in India accounts for ~45% of the national GVA (vis-à-vis about 75% in the US). However, the GVA of listed NFCs is just a fifth of the entire corporate sector. This implies that the GVA of listed NFCs accounts for less than 10% of the national GVA (*Exhibit 3 on the following page*).
- The fixed asset investments of BSE500 non-financial companies (estimated using data on the purchase and sale of fixed assets from cash flow statements) amounted to ~18% of the total investments by the entire Corporate sector and less than 10% of the total investments in the country (*Exhibit 4*).
- Lastly, the total number of employees in all of the listed companies stood at ~6m each in FY18 and FY19, amounting to less than 3% of the total non-farm employment in the country.

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**Exhibit 3: Listed companies account for less than 10% of the national GVA...**

\* NFCs GVA = Value of production – Cost of goods sold = Employee costs + Interest + Depreciation + Profit before taxes (PBT)

The Household sector in India accounts for as much as 45% of the economy, similar to the Corporate sector (v/s just 12–13% in the US)

These facts confirm that listed NFCs do not account for a very large proportion of the Indian economy. This is because unincorporated enterprises (proprietorships, partnerships, etc.) account for a much larger share of the economy – they are a part of the Household sector. Therefore, the Household sector in India accounts for as much as 45% of the economy, similar to the Corporate sector (v/s just 12–13% in the US).

The two very important inter-linked questions to ask, then, are “*Why have listed companies done so much better?*” and “*Will the better financials of listed companies pull up the rest of the economy?*” Let’s address these questions by one-by-one.

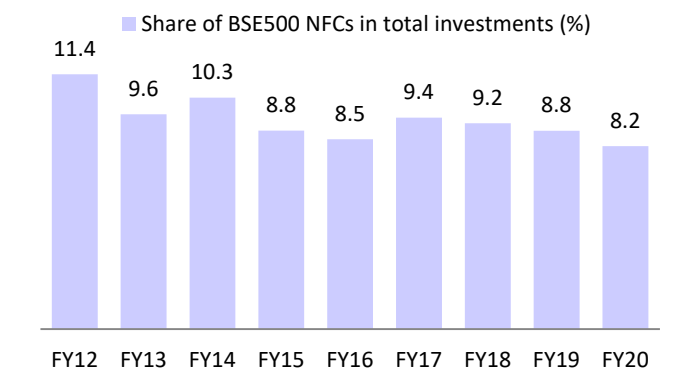
### Why have listed companies done so much better in India?

Although the nominal GDP contracted for the first since the mid-1950s by 3% YoY, net profitability for listed companies grew by almost 60% in FY21. Even if we adjust for the weak base of FY20, the profitability CAGR was in the double digits for the past 2–3 years. Not surprisingly, then, profitability for listed companies improved to an eight-year high of 3% of GDP from an almost two-decade low of 1.8% of GDP in FY20 (*Exhibit 5 on the following page*). What has led to this better performance from listed companies vis-à-vis the rest of the economy (RoE)?

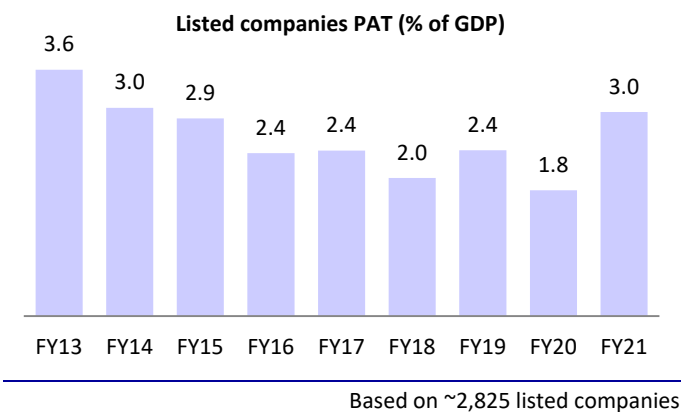
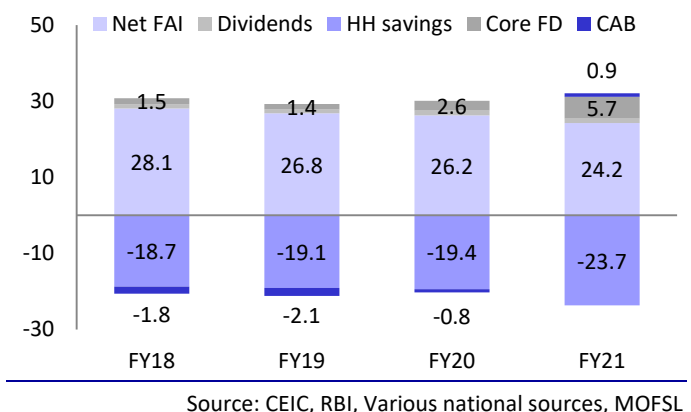
While listed companies certainly benefitted from cutting costs, their actions hurt the Unlisted Corporate and/or Household sector

A simple answer to this question is that cost savings helped listed companies post better profits in FY21. According to RBI data on some 2,700 non-government non-financial (NGNF) companies, while sales (or value of production) declined ~6% last year, total expenditure fell by almost 10% – leading to 17% growth in operating profits. However, as macroeconomics tells us, corporate spending is income for the recipient, including other companies and the Household sector. Therefore, while listed companies certainly benefitted from cutting costs, their actions hurt the Unlisted Corporate and/or Household sector.

Separately, higher corporate profitability could also be explained using the ‘Theory of Everything’. As we have discussed [earlier](#) in detail, corporate profitability could improve on account of either (a) better economic growth (led by investments) and/or (b) other factors such as a higher fiscal deficit, lower household savings, and/or better current account balance (which may be linked with a weak economy).

**Exhibit 4: ...and less than 10% of the total investments in the country**

NFCs investments = purchase *minus* sale of fixed assets  
Source: CapitalLine, CEIC, MOFSL

**Exhibit 5: Listed companies witnessed strong growth in profitability in FY21...****Exhibit 6: ...led by higher core fiscal deficit and improved current account balance**

From a macro perspective, corporate profitability is a function of total investments, household savings, fiscal deficit, and current account balance. The basic 'Theory of Everything' states:

$$\text{Total investments} = \text{domestic savings} + \text{current account deficit (CAD)}$$

We can reclassify this identity as:

$$\text{Corporate profits} = \text{total investments} - \text{corporate depreciation} + \text{dividends paid} - \text{household savings} - \text{government savings} - \text{CAD}$$

$$\text{Or, Corporate profits} = \text{Net corporate investments} + \text{Valuables} + \text{E\&O} + \text{dividends paid} - \text{Household net financial savings} + \text{Core fiscal deficit} - \text{CAD}$$

India's corporate profitability fell to 8.4% of GDP in FY21 (from 9.8% of GDP in FY20); however, the entire loss was incurred by unlisted companies

Our calculations suggest India's corporate profitability (for listed and unlisted companies) fell to 8.4% of GDP in FY21, from 9.8% of GDP in FY20 (*Exhibit 6*). Lower net investments and higher household savings dragged down corporate profitability. This was partly offset by higher (core) fiscal deficit and current account surplus (or lower CAD). They further suggest the decline in profitability was incurred by the Unlisted Corporate sector, as listed companies actually reported an improvement in profitability.

### Will the better financials of listed companies pull up the Indian economy?

Listed companies account for <10%, unlisted companies account for as much as 35%, and the Household sector constitutes another 45% of national GVA.

Overall, our thesis is very straightforward. The divergence between the equity markets and economic growth is explainable by differentiating the performance of listed companies vis-à-vis the rest of the economy (RoE). A look at the composition of national GVA suggests that while listed companies account for <10%, unlisted companies account for as much as 35%, and the Household sector constitutes another 45% of national GVA. The government sector accounts for the remaining 10%.

Of these four major economic participants, listed companies have improved their profitability significantly by reducing their expenditure. However, their actions have impacted income growth in the Unlisted Corporate / Household sector. Before COVID-19, private consumption and government spending were the two primary

drivers of India's economic growth. We have explained earlier ([here](#) and [here](#)) that the Indian Household sector has been disproportionately impacted by COVID-19. While governments have incurred the maximum income losses in most nations, in India, the Household sector has borne as much as 60% of the total income loss in CY20.

Growth in fiscal spending could be much slower over the next few years v/s the average growth during the pre-COVID period

The lower losses borne by the Government sector in India are not an indication of strength in the government's financial position. Although the central government has announced a fiscal deficit of ~4.5% of GDP by 2024–25 and provided some relaxation to states as well, our [calculations](#) suggest growth in fiscal spending (consumption + investments) could be much lower over the next few years vis-à-vis the average growth during the pre-COVID period.

In short, both of the pre-COVID drivers of India's GDP growth would be missing in the post-COVID period. Moreover, while unlisted corporate businesses have suffered in terms of profitability during COVID-19, listed companies have certainly strengthened their balance sheets.

Even if listed companies start increasing their investments, the rest of the economy may remain weak, keeping GDP growth subdued

To conclude, we believe that even if listed companies start increasing their investments (less than 10% of the total investments in the economy) – which is doubtful, to begin with, considering the weak demand environment – it would be extremely difficult to offset the lost ground due to the weak financial positions of the Household, Unlisted Corporate, and Government sectors. The rest of the economy, thus, may remain weak, keeping GDP growth subdued.

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