Banking on India

(April 4, 2014) On average, the Indian stock market—the topic of the travelogue in the prior issue of *Grant's*—is neither cheap nor dear. The heart of the investment narrative is rather revealed in the valuation peaks and valleys.

Now in progress is an exploration of the opportunities in a market that's already rallied and might just continue to rally. Perhaps Narendra Modi, the great white hope of India's business and financial community on the eve of what the Indians call their "dance of democracy," one of the world's largest and longest and most prodigiously financed national elections, will become the prime minister who unclogs the stopped-up Indian economy. From the *Grant's* observation tower in lower Manhattan, the situation seems hopeful. How might a foreign investor lay down a few well-placed chips on one of mankind's forever-latent growth stories?

For the casual American individual, the choices are plain vanilla: an open-end mutual fund, the Matthews India Fund (MINDX), which is managed in San Francisco; the closed-end India Fund (IFN), which is managed in Singapore and trades at a 10% discount to net asset value; and a pair of India-themed exchange traded products, iPath MSCI India Index (INP) and Wisdomtree India Earnings (EPI). The market caps of the four funds sum to all of $2.6 billion, which works out to $2.17 for every Indian man, woman and child.

It's slim pickings for any who would do his own stock picking. Professionals can register with the Securities and Exchange Board of India, apply for a license and, in the fullness of time, expect to win permission to operate locally (much as they can do in South Korea). Without going to the trouble of registering, the investor's choices are restricted to the few big-cap stocks for which American depository receipts or global depository receipts are listed. HDFC Bank, ICICI Bank, Infosys, Wipro and Tata Motors constitute the heart of the individually accessible Indian equity universe.

Is that all? Not quite. India Capital Fund, a Mauritius-domiciled, London-based partnership managed (and co-founded) by Jon Thorn, is an alternative. No index-hugger is he; India Capital, which welcomes qualified investors of the long-term, quiet, contrary, uncomplaining, patient, unleveraged, *Grant's*-reading type, has an outsize position in Indian financials.

"This is a situation that will not last," says Thorn of the self-imposed isolation of Indian finance. "The Indian market will open up more and is doing so, but they have no interest in global day traders, and I tend to agree with them."

It seems to us that investing in India is like planting a tree. Buy a sapling, dig a hole, water and prune. Do not—repeat, not—yank the tender growth from the ground to examine the progress of its root formation. Nature and sunlight willing, trees grow. Politics and ideology willing, societies prosper. The bullish macroeconomic argument with respect to India is that better politics and a less corrosive ideology are in the works, come what may in the springtime elections. It's a view to which we subscribe, though we have no notion of when the payday will arrive—possibly, our grandchildren will collect.

Or, just maybe, our children. "A staggering 814.5 million Indian citizens are eligible to vote in the forthcoming elections," advises Thorn and his team, "and significantly, there are now over 23 million electors in the 18- to 19-year age group, compared to 5.3 million in 2009. India's demographic profile has a political dimension as well as its lauded economic one."

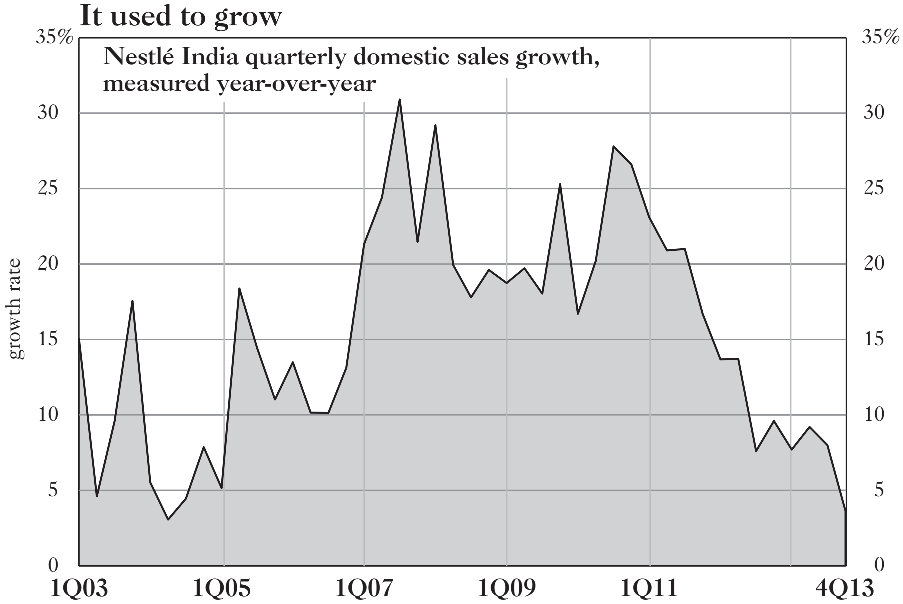
Value-minded investors pride themselves on tuning out the macroeconomic theme music to focus on a microeconomic margin of safety. "Good things happen to cheap stocks" is a mantra that gives good service whatever the political backdrop of the society in which securities happen to change hands. What are the values in India?

"If you compare the valuations right now with the five-year averages and 10-year averages," Sunil Asnani, co-manager of the Matthews India Fund, advises colleague David Peligal, "we're still slightly below the average. If you look at trailing price-to-earnings ratios, it's about 16.3 times for the S&P BSE 100 index [i.e., the Bombay Stock Exchange 100 Index]. And if you look at the five-year and 10-year averages, it's 17.5 and 17 times, respectively. So it's slightly below the five-year and the 10-year averages. If you look at price-to-book, it's about 2.3 times. For the BSE 100, the five-year average is 2.7 times and the 10-year average is 3.1 times. So if you think about valuations historically, it is slightly below, not a lot below."

So say the averages. Thorn, whose preferred India market metric is the Sensex index (30 component companies to the BSE's 100), observes that the Indian stock market is anything but a monolith. There are the companies that are valued as if the Sensex were quoted not at today's 20,000, but at, say, 40,000. And there are companies that trade as if the index were quoted at 10,000.

"It's an extraordinary bifurcation between some really expensive, 'safe'

It used to grow



source: IDFC Securities Ltd.

companies like Nestlé India, and a whole bunch of other companies, including banks, which are really historically cheap, excluding the global financial crisis," says Thorn. "So if you look outside the main banks, which are trading at 2.0 to 2.5 times book, you can find banks that are trading materially under book.

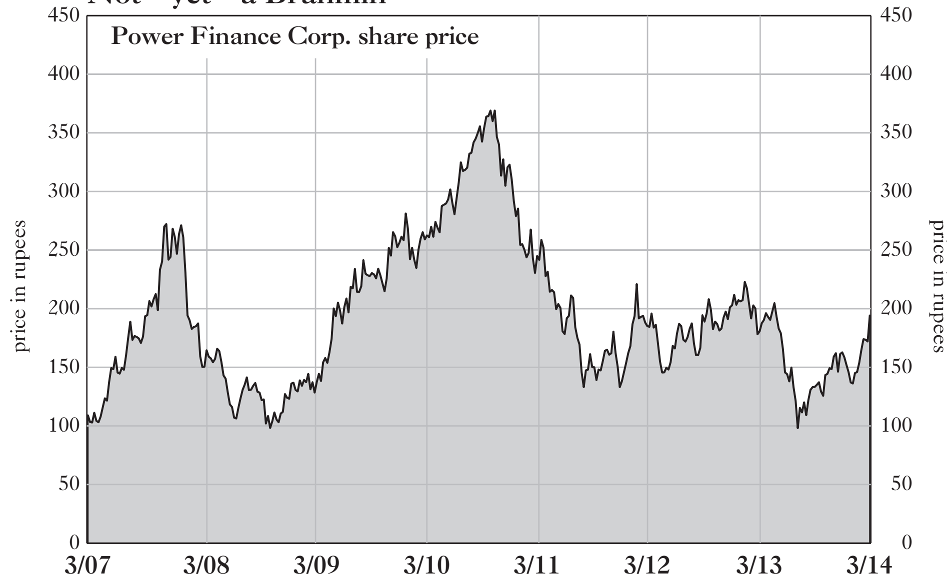
"If you assume anything except the worst case and a reasonable adjustment to the growth in nonperforming loans," Thorn goes on, "it's really hard to see how they're not going to go up a lot. On earnings and P/Es, you have banks at seven to nine times, and credit growth this year is expected to be around 14%. So they will disperse 14% more loans than they did a year ago. What you've got is valuations representing, in some cases, extremely negative and difficult credit conditions, with, nevertheless, extraordinarily good—compared to the rest of the world—credit growth. It's not extraordinarily good vis-à-vis India, but it's still pretty good."

Indian stocks operate in a kind of caste system. Consumer products' companies are among today's equity-market Brahmins. To the international Graham-and-Dodd diaspora, it's puzzling just why this is so. Prices of such basic inputs as wheat, coffee, skim milk powder, palm oil, vinyl acetate monomer and high-density polyethylene have been on the hop, crimping sales and margins.

In consequence, relates the Indian brokerage house Prabhudas Lilladher in a March 24 note, "Companies have increased prices of detergents, toilet soaps, skin care, paints, malted food drink and oral care by 3% to 6%, which will delay recovery in volume growth, given sustained inflation and poor consumer sentiment. We believe sector valuations will continue to correct either by way of absolute correction in stock prices or time corrections." Be that as it may, Nestlé India, which in February disclosed its lowest quarterly domestic sales growth in 10 years, trades at 35.7 times the consensus sell-side estimate for fiscal year 2014 net income and 30.7 times the fiscal 2015 estimate.

In response to Peligal's question—why?—Amnish Aggarwal, one of the authors of the Prabhudas Lilladher report, kindly e-mailed: "Valuations are still sustaining as India is being seen as a long-term consumer growth demand story. In fact, most bullish are global funds."

Not—yet—a Brahmin



source: The Bloomberg

Not every global fund is bullish in just that headlong, high-P/E fashion. Thorn's fund, which he helped to establish in 1994 and which has delivered a 6.3% compound annual return over the 20 years (compared to 4.4% per annum for the Sensex), is one exception. To disclose an interest, Thorn is a paid-up subscriber to this publication, and his inimitable chairman, Marc Faber, is a past speaker at *Grant's* events. Certainly, the principals' refined taste in financial journalism reflects well on their fund. We are drawn to something else. India Capital, which charges a 1 1/4% per annum management fee and takes 20% of the earnings above a 5% hurdle rate, is out on a limb and says it means to remain there.

The limb on which the fund is perched is a banking and financial services' limb; half of its $220 million in assets are allocated to those allied businesses, 2½ times the weighting to banks and finance in the Sensex. Thorn contends that India's banks are in better shape than they seem and that the country's well-ventilated asset-quality problems are less severe than many analysts believe. Perhaps the bearish analysts are remembering 2013 rather than anticipating 2015; last year, Thorn's fund, heavily laden with financials, was down by 21.7%, compared to a 3.5% loss for the Sensex.

A meaningful portion of nonperforming loans are traceable to India's dysfunctional regulatory system, Thorn says. Loans to the energy and power industries, specifically, are hostage to bureaucratic delay. It's a problem that a strong reforming hand at the top of the Indian government might set about fixing—Modi's hand, for instance.

In India, there's a great divide between banks in which the government owns a majority interest (the result of a past nationalization) and the ones in which it holds no such interest. State Bank of India is the prototypical government-controlled institution, HDFC the quintessential private kind. Entrepreneurial and light on its feet characterizes only one of the two kinds of Indian bank, and HDFC is that kind.

You, gentle individual-investor American reader, could buy HDFC on your own, if you chose (it is accessible as a New York-listed ADR). You could not independently purchase other favorites of Thorn's, including IndusInd Bank Ltd. (IIB IN on Bloomberg) or Power Finance Corp. (POWF IN on Bloomberg).

Power Finance, 74% owned by the government, is one of the stocks that is valued as if the Sensex were closer to the recent lows than to an all-time high. Based on Thorn's 2015 projections, the shares change hands at four times' earnings and 90% of year-end 2013 book value; they yield 6%.

"The company makes 20% of all the power finance loans in India," Thorn tells Peligal. "For example, if you're one of these power projects, or even, in some cases, a power distributor, you'll take a loan from the Power Finance Corp.

PFC will usually be the lead lender on any power project. Any project that PFC does not lend on will be a tricky loan to get done, because the other lenders will look to PFC—and they have a couple of thousand specialists working for them—to give a lead in terms of, 'Is this project feasible, doable, quantifiable in terms of money and time?'"

Operating under the sovereign umbrella, PFC is a low-cost lender, Thorn adds. For the same reason, it tends to get repaid. Then, too, "you're almost guaranteed top-line growth, because they're lending into a fast-growing sector, i.e., power projects."

Peligal pressed Thorn for the bear story; no company trading at four times the estimate is without one. Thorn replies that the market is worried about credit stresses. It is concerned that, in case of a meltdown of the rupee, PFC's foreign borrowings would become crippling (though the currency has rallied by 15% from last summer's lows). Finally, some fret that the government will coerce the company into lending against bad projects for political reasons. "So far it has not done this," Thorn says. "Why would it start now?"

"I recently had a meeting with one of my ex-investors," Thorn says in conclusion, "and he gave me a 35-page report from Credit Suisse saying how the Indian banking system is going to hell and back—and actually wasn't coming back at all without a lot more capital. I sat there and told him that all this was completely wrong. There are plenty of people out there who will tell you radically, diametrically the opposite story to our view. I think our investors, who have suffered with having 50% exposure to banks when nobody wanted to own banks—everyone wanted to own software, pharma and consumer staples (we don't own any of these)—our investors would say to us, 'When will the banks start to work?' And our answer is that they never stopped working, it's just that nobody has noticed. So the question we often get is, 'Why do you have this extreme portfolio allocation?' And the simple reason is that it's the best and cheapest growth in the market. Where else can you go to find something at four times earnings trading for less than book and yielding more than 5%? Those are not the characteristics of Blue Dart Express [at 52 times the estimate]—never have been, never will be."

•

Upside breakout on heavy volume

(May 30, 2014) "Bullish" isn't a word that suits every vegetarian, but it fits the new prime minister of India to a "T." Narendra Modi, who won the world's largest election not so much in a landslide as in an earthquake, has already achieved the seemingly impossible. "For the first time ever," to quote Sadanand Dhume in the May 19 *Asian Wall Street Journal*, "India's traditionally left-leaning politics has moved decisively to the right." The meaning of this signal event for the readers of *Grant's* is the subject at hand.

We would say, skipping down to the bottom line, that the Modi triumph is bullish for India's stocks, bonds and currency. It is bullish for the long run as well as for the medium run. As for the short run, Power Finance Corp., the Indian non-bank finance company featured in these pages on April 4, has rallied by 56%. Since May 9, when a leaked exit poll tipped the prospect of a transformation of India's politics, the broad Indian market has rallied by almost 7%. Taking a broader view of the situation, we would call the election results bullish for even that 83% of the world's seven billion people who do not happen to carry an Indian passport. India may or may not redeem your editor's hopes of becoming the world's next big growth story. At least now—perhaps more than at any time since independence—it has the opportunity.

Inconsiderately, the British left behind their ideological baggage when they sailed away in 1947. Adopting the Brits' Fabian socialism as its own, India's Congress Party proceeded to govern for all but 13 of the next 67 years according to the doctrine that the state knows best. More than a personal achievement, Modi's election was a triumph for the idea that the individual can—or may or at least could—know better than politicians, ministers and license-dispensing bureaucrats set over him to rule.

What the term "right" may mean in practice in Indian politics remains to be seen. At a minimum, it means not left: not the incentive-quashing and initiative-dampening statism of the Nehrus and Gandhis, still less the aspirational collectivism of the once-influential (now happily marginalized) Indian communists. Candidate Modi promised that, if elected, he would achieve "more governance, less government." Hopeful words, perhaps, but still only a slogan.

Americans, ever prone to see the world through the narrow prism of their own experience, will likely draw comparisons between Narendra Modi and Ronald Reagan—bullish comparisons, if the Gipper is your cup of tea. Modi in 2014, like

Now less cheap

source: The Bloomberg