March 9, 2012

Dear clients and colleagues,

Emerging markets have experienced a turnaround from last year as investor demand for equities and bonds has resulted in a strong few weeks. This week we revisit Investing in India.

The Bombay Stock Exchange's (BSE) Index went from being an underperformer last year to one of the top performers in this liquidity-driven rally. India has once again emerged as the most sought-after destination for investments by foreign institutional investors (FII). To put things in perspective, BSE with its 16% return YTD is currently valued at 15.9x earnings, compared with 12.9x for Brazil's Bovespa Index, 5.8x for Russia's Micex Index and 12.8x for China's Shanghai Composite Index. In contrast, the S&P 500 trades at 14.1x earnings.

Liquidity-driven rallies are like ocean waves; they come and go and have been a key feature of BSE movements in the last four years. For instance, in 2007 FII pumped $16B into India and the market rose 48%. However, this rise was followed by an abrupt 52% drop in 2008 when FIIs withdrew $12B.

Last year low growth and rising interest rates kept investors out of Indian markets. This year, although rates appear to have dropped, anemic growth and government deficit are the elephants in the room. Corporate earnings are also in a downtrend; however, inflation appears to be under control for the moment.

Higher oil prices may inflate India's import bill and deteriorate both the current account and fiscal deficit, thereby putting pressure on the rupee. Inflation has a 3–4 month lag and can prematurely derail the rate-easing cycle. An empirical study by IMF estimates an impact of over 100bps on GDP growth of countries whose oil imports exceed 5%+ of their GDP; India is at worrisome 7%.

Most Indians are already suffering as a result of inflation, which dropped as low as 6.5% last year, but nevertheless remains higher than the 4.5% the Reserve Bank of India (RBI) considers manageable. This year, the major issue is that incomes will likely remain flat or rise only marginally, while the effects of long-term inflation play havoc with rents, interest on loans and education, and also expenses such as domestic help.

Education expenses have increased by more than 10% every year since 2005 and in most cases, private coaching constitutes a significant portion of students' educational expenses, sometimes even more than the expenditure on school fees. Add inflation and these expenses could easily go up by 15%.

According to a survey by Towers Watson, demand for healthcare in India is expected to increase at the staggering rate of 25% a year, driven by the rapidly-rising cost of medical treatment and a growing middle class. As a result, the costs of hospital care and medication are on the rise.

The biggest expense in most homes is the monthly repayments of loans taken for apartments, cars, holidays or even televisions and luxury items. RBI has raised rates 13 times since March, 2010. These increases have resulted in higher monthly repayments and a reduction in disposable incomes.

In the past, the effects of inflation were balanced to a large extent by salary increases. However, this year salaries are anticipated to increase between 8 to 10% compared to the habitual 12 to 15%. Companies are feeling the pinch of high inflation and interest rates. Sensex companies reported 24% sales growth in 2Q2011; however, profit after tax grew at just 5%. The Indian rupee has depreciated 17% against the US dollar in the past few months, a hard hit for companies that depend on imports.

Inflation, however, could provide volatile Indian markets with a silver lining. Developed economies will grow at a slower pace and FII's will go looking for more attractive opportunities in emerging markets. India will be able to attract FII's if it makes its policies more investment-friendly. Around 85% of India's aggregate economic demand is domestically driven. India's demographic dividend of a growing, young and educated middle class should continue to drive strong domestic demand.

Liberated in 1947, India is still a young country. Twenty years of economic reform have helped transform India from an elephant to a tiger. Like any growing economy, India has its share of challenges. We expect them to be resolved over time. Having said that, the Sensex is at the lower end of the long-term range; therefore, it may not fall significantly unless there is a catastrophic event.

There are ways to benefit from the growth of India with less risk. Healthcare, Infrastructure, Technology are sectors that come to mind. Among the companies in the portfolio that may benefit investors, let's consider:

Furiex Pharmaceuticals, which has an important diabetes drug. India has a diabetes epidemic with over 100 million people currently affected. This number is growing fast due to lifestyle changes.

Nakanishi, a leader in dental products. The company is growing fast in India where there is one dentist for 10,000 people; 5 times less than in developed markets.

Carl Zeiss Meditec, a leader in therapies for eye diseases. It is also seeing fast growth as Indians and Asians in general have a much higher occurrence of certain eye diseases, such as glaucoma.

Autogrill operates Food and Beverage services in Bangalore and Hyderabad airports as well as retail and duty free in Cochin and Delhi airports. It is looking to grow its airports and highway food, beverage and retail services divisions.

Have a nice weekend.

Regards,

The Global Alpha Team