COMMENTARY

November 19, 2010

Dear clients and colleagues,

Many investors have increased their exposure to emerging markets - particularly BRIC, as fund flows to those regions have reached record levels – largely because these countries have less debt and faster economic growth than in the developed world. This week let's look at some of the pros and cons of Investing in India.

For starters, The Bombay Stock Exchange's Sensitive Index with its 20% return YTD is the best performer among the world's 10 biggest stock markets by market capitalization. It's currently valued at 17.8x earnings, compared with 14.1x for Brazil's Bovespa Index, 8.6x for Russia's Micex Index and 18.4x for China's Shanghai Composite Index. In contrast, the S&P 500 trades at 14.9x earnings.

Following a careful assessment of the country, we would be sellers for the time being. We do not doubt its growth potential, but fail to see the sustainability of valuation premiums.
Will there be a correction in the stock market? We believe it is overdue.

India hopes to achieve an economic growth rate of 9% in 2011. India's economy is currently estimated to be approximately $1.3 trillion, the same size as Canada's.

India has one of the youngest populations in the world with over 400 million people currently less than 15 years old. This is a much better demographic profile than China or Russia.

India's savings rate is 33.4% and the private sector investment rate is 24.9%. Capital stock invested in India has been historically low mainly due to the economic policies of the past. In fact it wasn't until 2007 that private sector investment surpassed household investment. India has a low capital-to-labour ratio, which will be boosted by these investments, which will help achieve economies of scale.

India's capital, New Delhi, has the sixth-largest airport in the world. Here, you can pass through immigration and customs faster than in London, New York or Washington. When you step outside, however, you see the real India, whose infrastructure is failing. India is among the world's worst for infrastructure according to the World Economic Forum.

India's robust economic growth is being built on the shakiest of foundations. Highways, modern bridges, world-class airports, reliable power and clean water are in desperately short supply. Only 25% of India's highways are two- or four-lane.

The government plans to spend $1 trillion between 2012 and 2017. India today is where China was a decade ago. Back then, China's economy was shifting into overdrive, but its roads and power grid weren't up to the task. The government has also launched various market-friendly policies; now a third of these projects are financed by private sector, vouching for the projects' financial feasibility and turnaround time.

India's food inflation rate is 10.3%. In fact turmeric (a yellow spice) has soared 64% and the cost of onions rose 50%; these being the basic ingredients of an Indian meal. Residential rentals have increased between 12 to 20%. The rising cost leaves little available disposable income.

Rural India accounts for 70% of India's population. A move to cities as we saw decades ago in China will no doubt contribute to growth. Only 35% of the population currently has access to banking services. The government is relying on improving credit delivery to help reach out to those untouched by the nation's economic progress.

All the above-mentioned issues can be resolved by investment and time; however, the most crucial factor facing the country at the present time is corruption. India suffers from systemic corruption as opposed to personal corruption as we sometimes see in China. In fact, the situation in India has reached the point where you pay for a service and you do not know if your job will ever get done.

The corporate space is no different; in fact, India does not have any laws to safeguard whistle-blowers. Corruption is the elephant in the room that needs to be tackled.

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, 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 fast growing due to lifestyle changes.

Nakanishi, a leader in dental products. The company is growing fast in India as 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 some eye diseases such as glaucoma, which is mainly caused by heredity.

Going back to infrastructure, Autogrill operates Food and Beverage services in Bangalore and Hyderabad airports as well as retail and duty free in Cochin and Delhi airports and is looking to grow its airports and highway food, beverage and retail services business segments.

Like any growing economy, India has its share of problems. We expect them to be resolved over time, but at this point we would suggest *caveat emptor*.

Regards,
The Global Alpha Team