

India: The Best of Times, The Worst of Times

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The Indian stock market is currently cheaper, and in our view offers more secure growth potential, than at any time in the almost seven years we have been running the India Capital Fund. The details of why this is so follow and could easily be the subject of a Hollywood, or Bollywood, movie. *Wall Street* seems dull by comparison. As an ex-employee of Drexel Burham Lambert and a seven-year veteran of

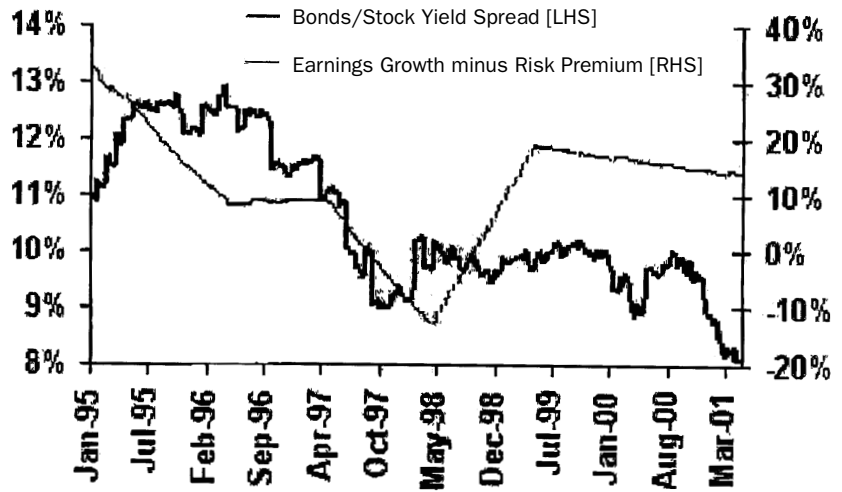
Indian market practices, even I am staggered by these recent events.

The graph plotting the equity earnings yield versus ten-year government bonds shows that the spread between earnings and bonds — the equity/yield ratio once beloved of Dr Alan Greenspan — is at a six-year high, implying that equities are also historically cheap (see Figure 17). This is also in the context of India

having quietly become the global number two in GDP growth in 1990–2000, after China (see Figure 18).

These recent and ongoing events and changes, in our view, change to the positive most assumptions about investing in India. In the last three years, India has moved from being arguably one of the toughest major emerging markets in the world to invest in, to one of the best.

Figure 17
Bond/Stock Yield, 1995–2001

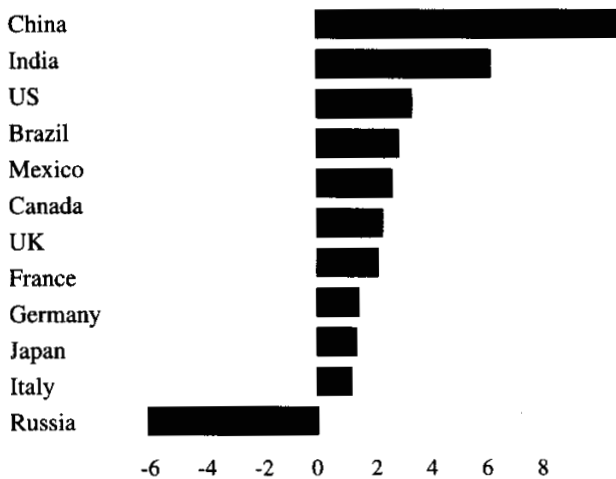


Source: JM Morgan Stanley Securities

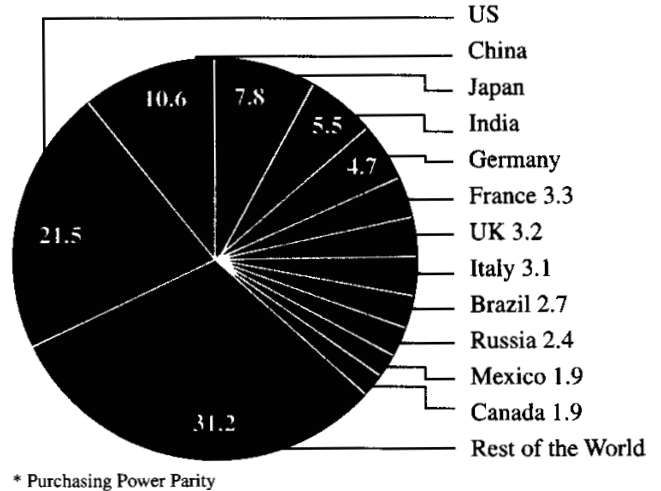
Figure 18 The Potential for Catch-up — India in a Global Context

Real GDP Growth

Annual Average % change 1990-99



% of World GNP at PPP* (\$38,804.9bn in 2000)



* Purchasing Power Parity

Sources: World Bank; Financial Times

WHAT HAPPENED, AND WHY?

February 28, 2001 was Budget day and should have been the start of the best post-Budget stock market rally in India ever — it turned out to be by far the worst. Over the past five months, we have seen collapsing stock prices and market liquidity, insolvent banks and brokers, arrests and firings, plus at least three suicides and hundreds of millions of dollars of bank deposits and broker assets wiped out.

Market liquidity fell by 80% over the following 60 days and some stocks by 40% over the same period, some of which were already down by 80% over the previous year.

So, what exactly went so very wrong, and where do we go from here? The answer to the first question lies in the “business as usual” practices on the Indian stock markets. The answer to the second is now clear and very positive, and will unfold over the coming months.

The day started very well with the best Union Budget ever — the start of second-generation expansionary reforms and the first clear and sustainable evidence that the Indian government is serious about the economy and the market. The Budget included tax rate reductions (personal by 5%, corporate by 3.5%), alongside two 50 basis point cuts by the Reserve Bank of India over six weeks, since followed by a third in May.

Other stellar Budget items were a lower fiscal deficit target, power charges enforcement, privatisation (finally), IPO gains at nil capital gains tax, dividend tax reduced from 20% to 10%, the telecom sector opened up, and visibility on some price decontrol for pharmaceuticals. The market rose by 4.4% and some of our pharma stocks were buying limit up by 8%.

The next few days changed that optimism into fear and panic, and despair for some. The Bombay Stock Exchange (BSE), which is owned and run by the brokers, is 126 years old and is the oldest in Asia; some of its habits are — to some eyes — more to

do with the darker side of history than best practice. Only 15% of trades were settled within the one-week settlement period; the rest were run over into another settlement period with the buyer paying *badla*, or interest, to the stockbroker, similar to margin debt. Many people loan stockbrokers cash or securities to finance that *badla* debt business, who in turn pay interest to the owners and keep some of the spread between the two rates plus the trading sales commission. Without *badla*, many brokers wouldn't make money.

ROLLING THUNDER: BROKERS VERSUS THE REGULATOR

There has been a long-term semi-unacknowledged war between the Indian regulator, SEBI, and the brokers over a number of issues, with the brokers fighting one rearguard action after another to retain bad, opaque, inefficient, and globally discarded practices, because it was more profitable for them. The big and better Indian brokers, and the foreign brokers, all uniformly support SEBI.

Now, after many, many battles, that war is over. SEBI has won. In 1996, SEBI targeted *badla* and dented it somewhat, then it targeted floor-based trading; most trading is now screen-based. Next was dematerialisation of share certificates. Almost all share certificates used to be in multiples of 100 shares, plus each of those would have an attached transfer deed. Both of these had to be signed and stamped correctly, then many bundles of same would be transported around the country, from custodian to company registrar, and back again, always at risk from thieves, forgers, rats, and forgetfulness. Now, almost all trades settle through electronic book entry and the “nightmare by paper” is over.

The most recent battle was over rolling settlement, meaning that if I buy a share on Monday, or Friday, I pay for it five trading days later, known as T+5. Previously, the settlement period was fixed in Bombay, from Monday to Friday. This issue is as fundamental to an orderly

stock market as the end of paper certificates. The fixed settlement period, as used to be the case in London not so long ago, allows the trader to trade in and out of the settlement period, and thus mixes the cash with the futures market. With rolling settlement, the *badla* system becomes harder to operate, less profitable, and ultimately, unworkable; thus lowering the revenues of those brokers who rely on it.

Last October, SEBI introduced a trial rolling settlement for 15 stocks. Daily trading volumes dried up, in some cases from 200,000 to 2,000 shares a day, allowing the brokers who dampened the volumes in those scripts to say to SEBI, “See, we told you so, it won't work.” SEBI rightly didn't listen, but now it needed a big stick to get rolling settlement through.

It got it when, as it is alleged, Mr Anand Rathi, then President of the BSE and a prominent broker in the “bear” camp, apparently sought to extract information about trading on Budget day, and, it is further alleged, about some of the positions of prominent “bull” brokers. As well as fighting SEBI, the brokers are also fighting each other. Many brokers believed that the Budget would be a bad one for the market and so had large short positions. They got caught out badly.

THE BOMBAY BULL

Enter the “Bombay Bull”, Mr Ketan Perekh. India has a tradition of bull and bear “operators” who attempt to move or manipulate stock prices in their favour by doing hundreds of trades at successively higher or lower prices, then — they hope — exiting with a profit. There are higher and lower species of operators and bulls/bears, but most are unapologetic share rampers, insider traders, and price manipulators. The previous Big Bull was Mr Harshad Mehta who, after he crashed, is believed to have cost one foreign bank some US\$200 million. Upon his release from jail, he started an interesting investment website until the police closed it down.

Ketan was the biggest recent bull operator, and he was doubly fortunate

in that he came to prominence during the Nasdaq bubble and focused on tech stocks. He was also a realist and quite plausible — Mr Kerry Packer started a business association with Ketan. Ketan worked what came to be known as the “K-10 Index”; ten stocks that he was long of and promoted heavily. There was also the “KP” effect = stock price goes up. Or not.

The problem for Ketan was that he and his clients were leveraged long of stocks that in some cases were down by 90% from their highs. And every week was another cheque to be paid in to cover the interest on his positions. The information the bears wanted was how could they squeeze Ketan more and thus try to take some of the heat off their shorts and/or losses. The market nose-dived. Deeper and deeper.

The chronology of events then became very exciting. On March 8, Mr Rathi resigned as President of the BSE, and shortly afterwards four finance companies associated with him were suspended from operations by SEBI. On March 13, the board of the BSE was fired by SEBI. On the following day, SEBI announced that rolling settlement for the top 200 stocks would start in July 2001, a number it recently raised to 414. It also announced that the BSE would be corporatised — taken out of broker ownership. The market had a rare up-day and rose 5%.

All the K-10 stocks had limit-down days, day after day, and any stock suspected of a Ketan association was pummelled. All the while, there was constant expectation that Ketan would have to throw in the towel and stop paying margin. Yet he continued to pay. All the local funds, investment companies, brokers, and small investors who had ridden the coat-tails of Ketan all the way up, and then down, were having to sell anything to meet ever larger interest payments to maintain their long positions in the market. All stock prices were marked down, good companies and bad. For a week or so, it seemed that Ketan might not crash, as perhaps there was more cash behind him than people had previously believed. They were both right and wrong.

THE BUST

Ketan finally stopped paying and was arrested on Friday, March 29 and is currently being investigated on charges of conspiracy, breach of trust, and fraud. It is alleged that he was defrauding a co-op bank, using it as his source of cash to meet his extended margin calls. Ketan then started to spill the beans and the bodies started falling out of the closets. The President of that co-op bank is currently being investigated. Co-op banks are forbidden to lend cash to brokers or against securities. The bill for this nexus alone will be around US\$150 million.

There will be further high-profile casualties, and perhaps even at the Unit Trust of India, the combined CalPERS and Fidelity of India, or even at SEBI. On April 3, the Finance Minister made a statement that he will pursue all wrongdoers, wherever they are. He also said that there is sufficient insurance funds to cover all the market liabilities (as opposed to personal losses, of course).

Alongside the Ketan story was the sideshow of the Internet news scoop where, after months of preparation, two reporters recorded Indian defence and ruling party officials taking arms procurement bribes in cash and webcast it. High-level ministerial and other resignations followed, and the political noise continues. Go to www.tehelka.com for the full show. Interestingly, for all the expectation that the Internet would empower the individual versus the state, it is in India that this has become a reality. Tehelka.com was also responsible for widely publicising the cricket match-fixing scandal, resulting in one of the top sporting heroes of South Africa, Hansi Cronje, admitting he took a bribe to lose a match. The promoter of [tehelka.com](http://www.tehelka.com) has also since made the *Business Week* list of top ten future Internet moguls.

Ketan has also revealed that he was involved in massive share price support schemes, where capital was invested through Ketan companies to buy stock in the creditor company to support the price. In another case, Ketan was used as a front to buy large

positions in two small media companies, on behalf of another larger one, without revealing that the larger company was the beneficial owner.

Interestingly, while all this domestic pain was occurring in March, foreign investors were net buyers of US\$450.5 million of Indian stocks. The total net 2001 purchase by foreigners is now US\$2.25 billion, well in excess of the total US\$1.56 billion for the whole year of 2000. Locals were net sellers of US\$62.8 million in March.

THE FUTURE

The bodies seem to have stopped falling now, as the story takes on the more settled character of a criminal investigation. So, where do we go from here? SEBI will control the market, perhaps 25% of brokers will not be in business this time next year, and it will be almost impossible to control the momentum stocks in the way that has been the case in India. That will be good for capital markets and investors.

On May 14, SEBI outlined its plans going forward. All stocks will go into rolling settlement by 2/2002 and all current *badla* forward positions must be closed out by 9/2001. Equity options are now in place instead of *badla*. The other major stock exchanges will also be corporatised. SEBI has finally achieved with these new measures the financial regulator equivalent of a landslide election victory.

AND THEN THERE WAS EVEN WORSE NEWS

All of the above should have started July off to at least a neutral start with a sober review of how trading would work under the new regime. Instead, it just got worse, when the largest mutual fund in India suspended redemptions for six months due to uncertainty over its net asset value and the high level of redemptions it was facing. Compared to this announcement, if the whole of the BSE30 had issued simultaneous profit warnings the negative effect on market confidence would have been much less.

Unit Trust of India (UTI) is by far the largest mutual fund manager in India and is a governmental-organised but not managed entity. It holds US\$12 billion, which is 65% of total Indian mutual fund assets, and has 41 million investors in its 87 funds.

By far the largest of these funds is the US-64 scheme, which has 20 million investors and 25% of UTI assets. The extraordinary thing about US-64 is that while the fund used to have a nominal net asset value and pays a (generous) dividend, both the composition of that NAV and the basis of the dividend pay-out ratio is *not* based on an NAV calculation. The reasons why are many, but are now irrelevant.

UTI and, especially, US-64 are used by corporates and individuals almost like a bank, and originally the investment remit was for yield, rather than capital gain. In the early 1990s, however, the fund started to increase the level of its equity holdings. Today, none of its investors is sure what the NAV is, what is held, and what to do next. The Finance Minister has stated that small investors will be protected.

While this problem was well known, everyone had assumed that a

workout-style solution was being engineered, rather than the PR disaster that was delivered. There is now a large overhang of stock in the US-64 major holdings, a part of which will have to be liquidated. The ultimate solution of the US-64 problem is at present uncertain, but this finally clears the Indian Augean stables.

For India investors such as us, these events are a combination of the most intense pleasure and pain. This is where we have dreamed of getting to for many years, and while the pain of getting here was always going to be bad, we never thought it would be quite this bad. Looking forward, almost all of our wish list for the reorganisation of the Indian market is now in place and we have a secure platform as institutional investors with a long-term view. The worst of times, we hope, are almost over now and better times are visible. At least, domestically.

WHAT REALLY MATTERS NOW?

THE MARKET

The combination of the Nasdaq fall plus the recent local difficulties has

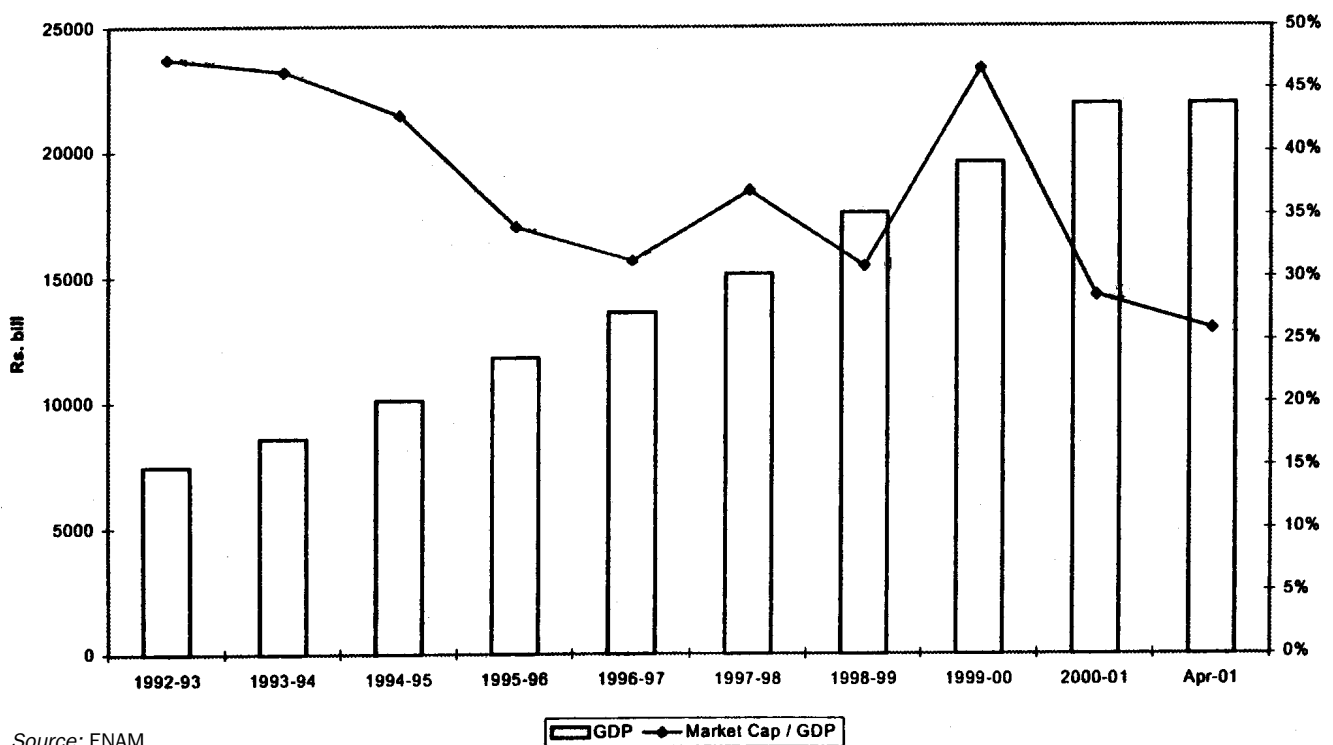
pushed the Indian indices sharply negative recently, and also for the whole period of our operations. A more significant measure of equity value is market cap/GDP (see Figure 19). Here the message is clear, with stock prices having declined significantly relative to wealth and value creation.

But the big question is, what global and Indian GDP/markets/earnings outlook are we facing today? There are three well-known options: first, that we shall have a second-half recovery in the US which will renew confidence/capital investment/EPS growth. Second, that 2002 may be a flat year for GDP/markets/earnings and that things will pick up after that. The third option is the Dark Side, where things will just get worse.

Whichever is the outcome, the GDP/market/EPS that will be affected *the least* is India's (see Table 2). India has the lowest exports as a percentage of GDP of any large economy, and it has the lowest exposure to the US and to US IT capital spending.

In a downturn, size matters. Large domestic economies are more resilient and less dependent on extraneous events and growth to maintain their

Figure 19 GDP and Market Cap/GDP (%)



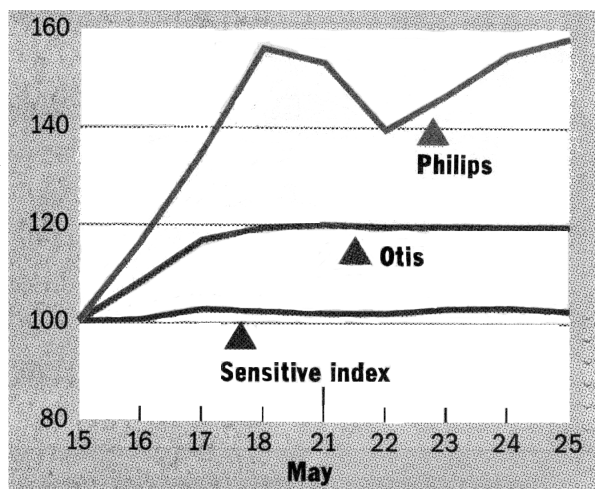
Source: ENAM

Table 2 Asian GDP Exposure to US/Global Slowdown

	Export % of GDP 2000	Exports to US as % of Exports	IT Exports as % of US Exports
India	10	39	30
Japan	10	31	31
China	23	40	30
Korea	37	23	55
Taiwan	48	27	55
Singapore	85	24	73

Source: CEIC/JP Morgan

Figure 20 Taking Off
Comparative performance
of Otis Elevator India's
stock, Philips India's stock
and the Bombay Stock
Exchange's Sensitive Index
(May 15 = 100)



Sources: Asian Wall Street
Journal; Thomson
Financial; Datastream

own momentum. Smaller, export-driven economies are highly leveraged to larger macro growth trends. They pick up more gain, and more pain. At this point in the cycle, they may not be the best places to invest. Whatever the economic outlook turns out to be, the large domestic economies of Russia, China, and India will be affected the least, and India hardly at all.

WHAT SECTORS AND STOCKS TO OWN

There are, in our view, four main themes for Indian stocks going forward: GDP value stocks, especially cement; outsourcers, including software and pharma; telecom infrastructure; and corporate buyouts/action.

We'll start with the last. Currently, 29% of the ICF portfolio is subject to open offer/buyback/buyout; 5% has already been bought back; and, perhaps, another 10% may be subject to some beneficial corporate action/public-sector restructuring. Corporate

actions have gone from nil to one of the most active in the world in under three years, and this gives a floor to stock prices and underpins the index, especially for joint venture companies, where the MNC is always a buyer of last resort.

Another indicator of value available at present in equities is the large number of foreign MNC parents currently on a major shopping spree for their Indian subsidiaries. Otis Elevators is a good example, a good cheap company and one we own. Currently, it offers a 5% yield, a P/E of 9x 4/2002, and ROCE of 79%, up from 48% in 1996.

Parent company United Technologies (UT) of the US typically only has wholly owned subsidiaries globally, but under Indian law many years ago the maximum it could own was 51% (see Figure 20). Currently, UT owns 69% and is now in the middle of an open offer to buy the remaining 31% for INR280 per

share, a 20% premium to the then market price. We are happy to sell but will hardball with other shareholders for a much higher price.

Knoll Pharma is being taken over by its smaller competitor Abbott Labs, as globally Abbot US has bought Knoll from BASF. Abbot India also wants to buy another 20% of Knoll that it will not own via the takeover interest at a 15% premium to the then market price. We are not sellers of our Knoll, as it will be the second-biggest beneficiary of pharma price decontrol and is one of the best-managed, cheapest, and cash-rich pharma companies in India. See Figure 21, where DPCO is the percentage of formulations that are price controlled, and therefore the higher DPCO percentage provides for a greater EPS gain following decontrol.

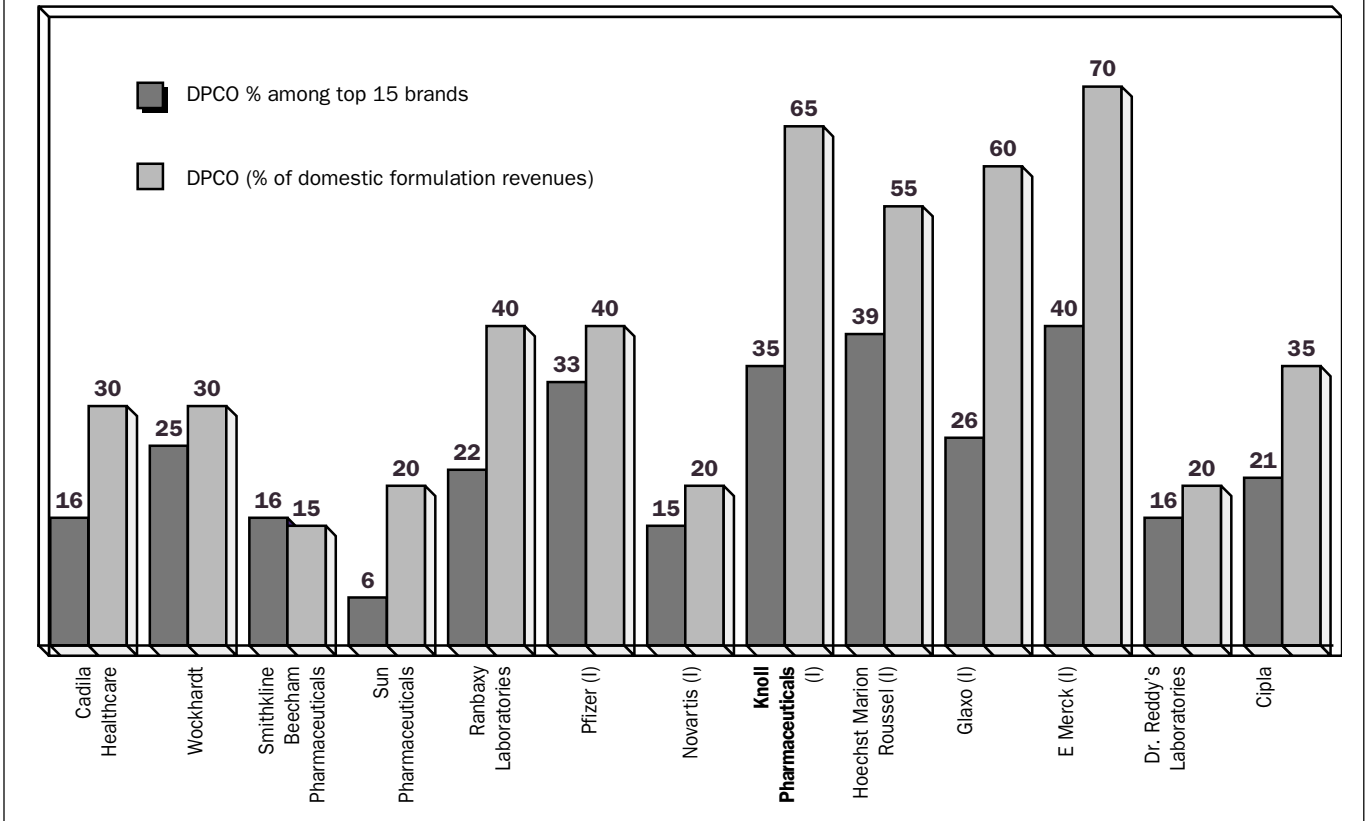
Software is currently disappointing, both on the returns and earnings front. While we believe that some of the Indian IT companies will pick up incrementally more business and become majors in their own right, that will not happen during the current US capital spending collapse. We also believe that some of the smaller and mid-sized IT companies have moved from being potential acquirers to potential acquirees. That is the logical outcome of this cost-based outsourcing model.

Telecoms are now exploding — from a very low absolute and per capita basis, India is now the fastest-growing telecom market in the world. Cellular growth is currently around 90% annually, and Internet users are growing at 130%. The Budget has worked faster and more comprehensively in this sector than was ever imagined. Sterlite Optical Tech Ltd is the domestic infrastructure leader, a P/E of 7x 4/02 with a visible >40% EPS growth.

India has around 25% of investable market cap stocks as public-sector companies with P/Es of <7x with GDP at >5% and visible EPS growth at >15%. Since 1980, India has averaged 5% GDP growth. The fuller privatisation of some very attractively valued state majority-owned or controlled assets looks good. We also like cement in the context of that P/E

Figure 21 Indian Pharma Company Exposure to Price-control Products

Source: Kotak Securities' estimates

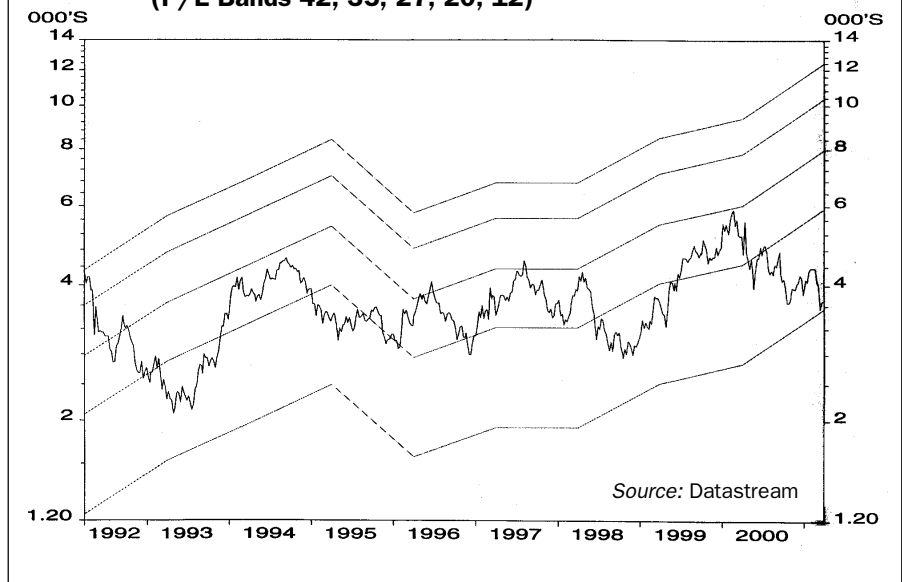


and GDP landscape, alongside the tax cuts, the lowest real interest rates in over ten years, falling inflation, and an expansion of retail banking and mortgage offerings plus government-sponsored infrastructure spending and, sadly, the recent earthquake.

In conclusion, we can see an outlook for Indian GDP/markets/EPS which is at least safe at present values; see Figure 22 for ten-year low P/E bands. India offers the cheapest and the most sustainable growth in the world today, and is more immune than any other GDP to whatever happens on the global playing field. We feel we have earned some respite from danger after these recent events.

What we would like most now, though, is a little less excitement.

Figure 22 India BSE 30 Sensitive — Price Index (P/E Bands 42, 35, 27, 20, 12)



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