BIG CHANGES AND BIG GAINS FOR SOME SMALL STOCKS

Structural Change and Opportunities in the Indian Small Cap Sector

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Cyclical change and structural change both offer opportunities to the investor. Structural change, whether macro or micro can be more challenging and, sometimes, more rewarding.

India has been changing at the macro and micro level since 1991, slowly but significantly. Today, in many respects it has become one of the most attractive Emerging Market investment environments thanks to:

1. *Internationally compliant legal and accountancy standards*

2. *Share buy backs made possible due to legislative changes and a greater focus on shareholder value creation in the corporate sector*

3. *Greater liquidity likely to flow into the stock market as the local mutual and insurance companies raise their equities weighting following interest rate cuts and fiscal inducements announced in the recent Budget.*

Things look good at this point, but it has taken time to get here.

India has never enjoyed the rate of GDP growth, nor the inward foreign direct investment (FDI) achieved by China or the East Asian once-tiger economies. This was mostly its own fault. It is, so far as I am aware, the only stock market where foreign institutions must buy a US$10,000 license to permit them to own stocks. One has to ask, 'why?'. Bureaucracy, rather than corruption, is the major impediment. Just try getting that license. The Indian Diaspora is also more cautious, or cynical, than the Chinese one; they do not invest substantial sums in the old country.

During 1998, the Indian stock market avoided the destruction that took place in the other Asian stock markets, as did its currency, which is not convertible on the capital account. The two main reasons for this were that there had been no major over-investment as had been the case in Asia and that India was already burnt out from a four year domestically driven liquidity crunch and bear market. The stock market nevertheless maintained a reasonable level of domestic liquidity throughout 1997 and 1998, despite a major withdrawal by the foreign funds, as they sought to meet redemptions by selling the only two markets which could handle it; Hong Kong and India.

The License Raj

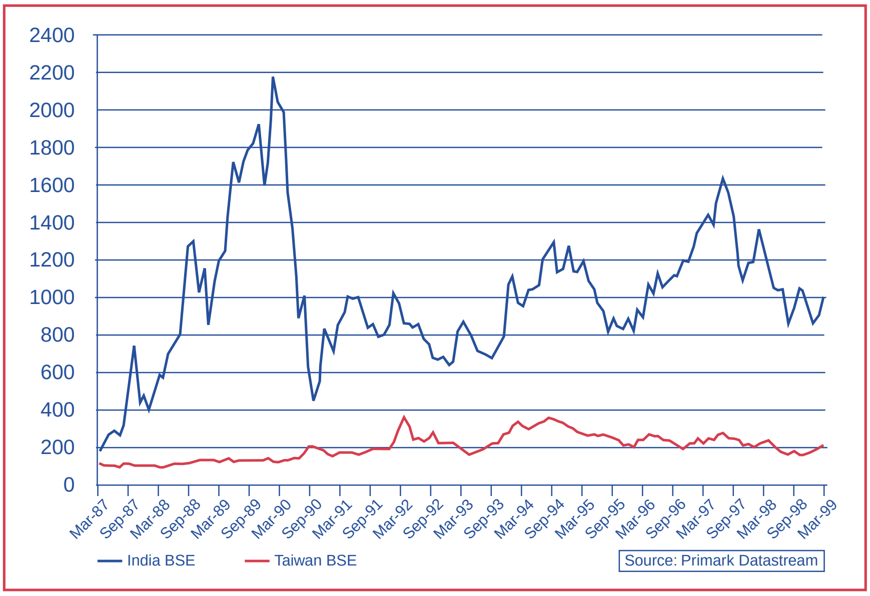
India has been one of the backwaters of Asian investing. Between 1960 and 1990, Indian GDP per person doubled, while that of Taiwan increased by seven times. Between 1990 and 1998, the differential evened out somewhat. The respective stock markets reflect this also, see graph 1.

The model for the Indian economy since independence in 1947 was the License Raj, which is the term coined to describe the import substitution de facto monopoly companies that grew up behind a wall of tariffs and licenses. Since 1991 the economy has started to open up. The pain of this change has been very intense among the dependent companies. That pain translates into, e.g. the largest Indian textile company, Century Textiles, not having made a profit in the last two years. In stark contrast is the progress of the best-managed company in India, Hindustan Lever; see graph 2 for both against the main Bombay SE 30 index. In India it is more beneficial for tax reasons to list a company than not. Thus India is one of the few places where you can buy some multi nationals directly. Both Carrier Aircon and Otis Elevators, two of the four divisions of the US listed United Technologies are listed locally as separate companies.
There are around 5000 listed companies, and the stock market more fully reflects GDP than perhaps any other Asian economy with the exception of Japan.

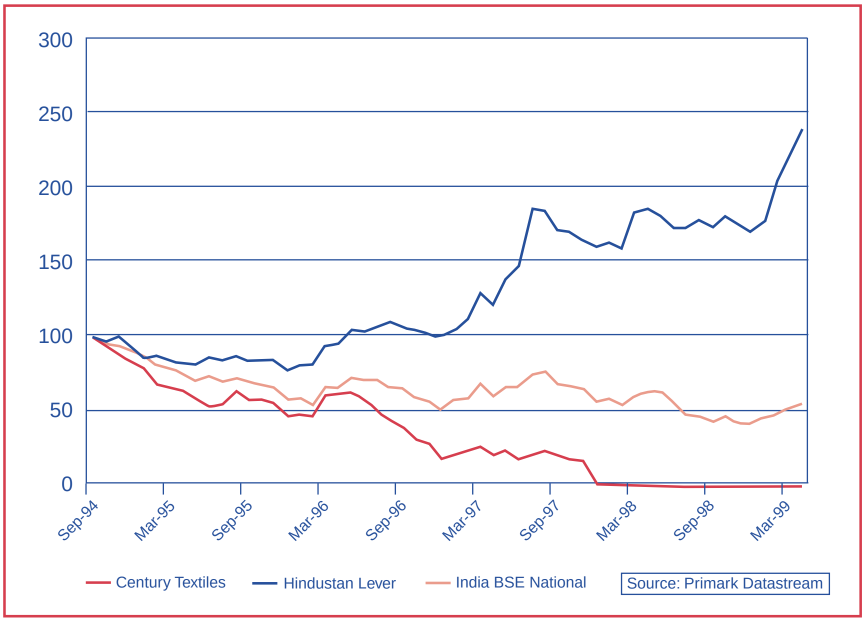
Among the smaller companies there has been a four-year decline, but there is no obvious case that this represents an opportunity to invest in turn-around stories. Better things are available than what can be fished out of this stock market ditch.

As in all periods of change, new leaders emerge to capture new opportunities. We started the Fund in 1994 to find and buy into highly focussed smaller and mid cap companies that were preparing to fill new niches and meet new demands. Those companies that focussed on

***Graph 1:** Stock Market Performance - India (Bombay) Stock Exchange compared to Taiwan Stock Exchange - Weighted Price Index US$ corrected (Mar 87 - Apr 1999)*



Graph 2: *Stock price movements of Century Textiles and Hindustan Lever against India BSE National - Price Index (US$ corrected) (Sep 1994 - Apr 1999)*



these new opportunities and the space left by the industrial junk have prospered while the dinosaurs of the License Raj have been left behind.

Small Caps turn into Big Caps

Five years ago the idea that Indian software companies may within seven or eight years be meeting 3% of global InfoTech (IT) demands would have been incredible. Today they meet over 1% and the lowest eps growth of the main companies is currently around +50% yoy or better. Top-line revenue growth in some cases is +90%. The majority of their customers are US and European companies.

The Indian IT companies enjoy US time zone benefits, allowing overnight de-bugging. English language proficiency, much lower software engineer costs at around a tenth of that of a US engineer, and an annual production of engineers in excess of the rest of Asia put together, ex China and Japan. Over five years the average Indian IT stock is up by 1000%, making it one of the best performing equity sectors in the world over that period, barring, of course, US internet stocks. See graph 3 also for comparison with the NASDAQ.

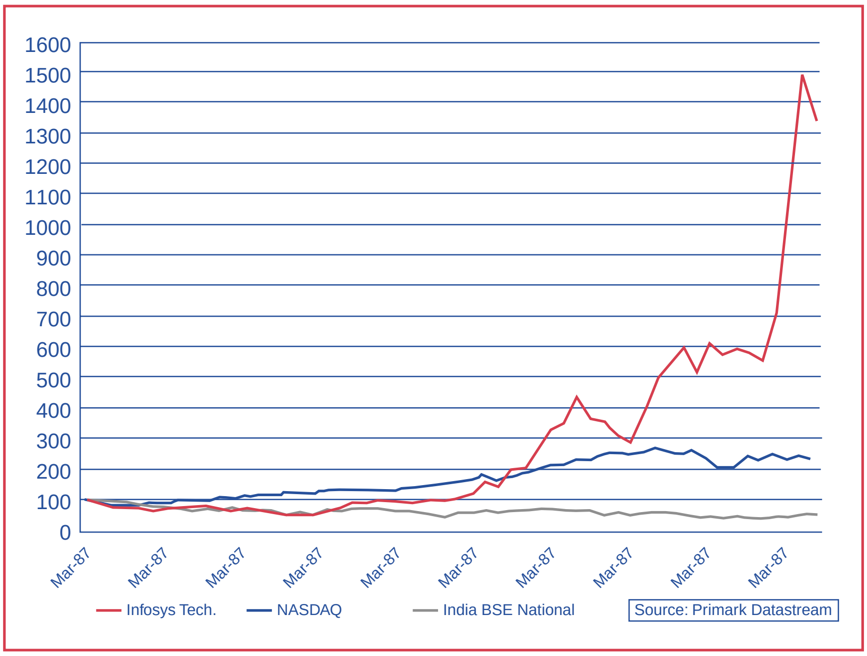
In pharmaceuticals, the story is similar but thus far much less developed. India is the largest Asian market ex-Japan for pharmaceuticals in volume terms. However, local pricing restrictions and low purchasing power make it less than a US$1bn market.

With India embracing the WTO, it seems likely to emerge as one of the foremost Clinical Trial and low cost Research bases in the world (Indian scientists are as technically skilled and as underpaid as their software brethren). Also, with the entry of Insurance companies, the annual spend on healthcare is likely to rise along with price hikes made possible by a freer pricing regime.

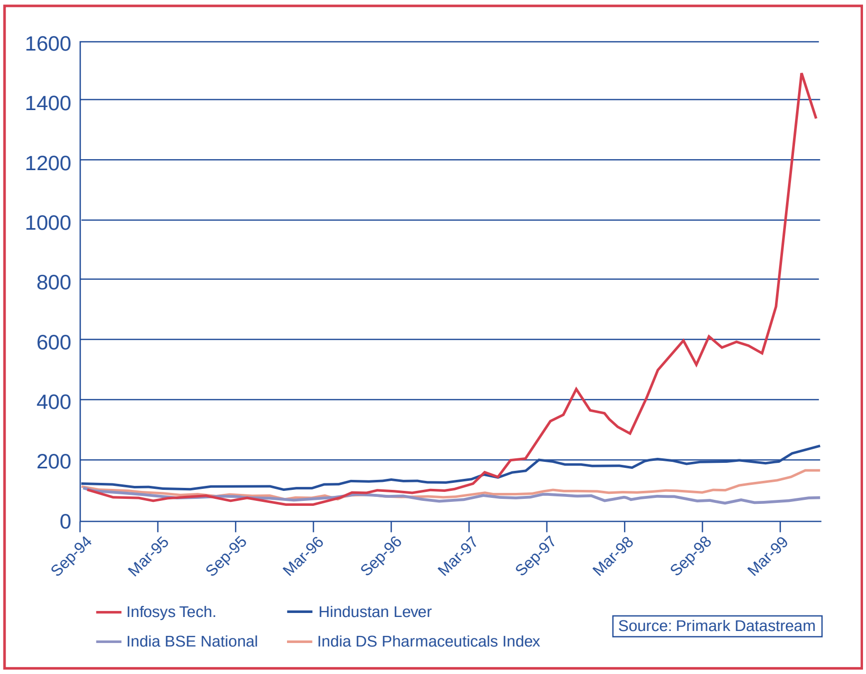
Americal Home Products, the US major, has an Indian subsidiary called Wyeth-Lederle Ltd which is the lowest cost producer of steroids in the world. It imports steroids from India to give itself the lowest cost steroid base globally.

On the purely domestic front, consumer stocks have also done very well, with Unilever, Proctor & Gamble, Cadbury, and others all fighting for market share, as pent up domestic consumer demand is released. A combined graph of the leading IT stock, Infosys, a pharma stock index, and the leading consumer stock, Hindustan Lever, against the broad market Index reflects the structural shake-out which has taken place in the Indian stock markets. The good companies have risen to the top, the bad ones have done nothing, or worse. See graph 4.

Graph 3: *India IT stock performance (Infosys Technologies) compared to NASDAQ Price Index and India BSE National - Price Index (US$ corrected) Sep 1994 - Apr 1999)*



***Graph 4:** Comparison of India-DS Pharmaceuticals Index, India BSE National - Price Index, IT stock performance (Infosys Technologies) and Hindustan Lever (Sep 1994 - Apr 1999) (US$ corrected)*



While this growth and divergence will not continue at this rate, there are still good value small cap growth stocks available to the serious sifter. The problem, as ever, is finding them. Supply is meeting demand even for this. Along with India's IT growth has been a growth of Internet sites some of which give good advice and useful initial analysis.

And Bigger Still

Earlier this year Infosys became the first Indian IT company to list an ADR on the NASDAQ. Infosys is the blue chip of the Indian IT sector. It had two major reasons for listing a US$60mn cap issue in the US, as against a US$1bn cap issue locally in India. Firstly, to comply with staff stock option regulations, as these companies need to attract and retain key overseas staff. Secondly, to raise their profile in the US. The NASDAQ is by far the largest tech investment pool in the world and it will gain corporate stature by listing. At least five other Indian IT companies are due to list on NASDAQ before the end of 1999. Where these companies go five years from now is an interesting question. Currently there is no obvious limit to their growth if they can keep the business fundamentals of price and execution intact. It does not seem likely that a new cheaper source of expert labor will become available, if anything quite the opposite.

How far they go depends on how successfully they can move up the value added chain. And that is yet to be seen. If they can achieve value addition they can power on to become a new division of global IT service providers. We believe that some of them can. We also think that there are some smaller companies that may join them on the upward trending path of market capitalization and value addition. As Indian political volatility reduces its impact on the stock market, so there are fewer reasons to factor anything other than company specific items into the valuation of an Indian company.

The pace and direction of change since 1991 has been greater in India than perhaps anywhere else in Asia, while the depth if not the severity of that change may be equivalent to that experienced by Eastern Europe. This process of structural change is ongoing, while the variables are much clearer and larger now, as are all our expectations for this new corporate landscape.

THE INDIAN SMALLER COMPANIES FUND LTD

The Fund was launched on 1 September 1994.
The Fund supplies NAV data to Lipper, S&P Micropal, Tremont/TASS, Bloomberg, and other databases.
The Investment Manager of the Fund is Asia Pacific Securities Corporation.
The Fund and the Manager are incorporated in Mauritius.

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