

# THE ELEPHANT AND THE TIGERS

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The elephant is India, of course. The perception of India as being of limited interest to the global investment community has changed over the past year. Indians and India fund managers have long carried around a chip on their shoulders: that India was the slow lane of Asian investment. A fairer comparison is not only with the once-tiger Asian economies, but also with the ex socialist economies of the world. Happily, the bear is an inappropriate symbol for India.

Following Independence in 1947, India spent over 40 years growing a hybrid private/public economy based on two principles: swadeshi which is the Hindi world for self-reliance (on your own cultural and material goods), and socialism, of the developmentalist type. Various government sponsored initiatives, such as the 'green revolution' were designed to increase agricultural production. New species of rice were promoted and extensive irrigation programmes built.

## THE LICENCE RAJ

The corporate and private capital outcome of this approach was what is now termed the 'Licence Raj'. This describes the development of companies which were de facto import-substitution monopolies in the domestic economy and which were protected from foreign competition at home by a wall of licences and tariffs. For any semi-closed economic system, the pain of change that began in earnest in 1991 has been very sharp, especially in those parts which were most dependent on this system and which now must change to comply with World Trade Organisation (WTO) openness rules.

The Indian stock markets (there are 22 of which only two count) fully reflect GDP. This is the result of both history and tax policy. One of the oldest stock markets in the world is the Calcutta Exchange,

born out of the British Empire's tea industry in India. There are around 5,000 listed companies in India, of which perhaps 3,000 are actually private companies taking advantage of beneficial tax treatment for listed as opposed to private companies. Of the remaining 2,000, a fund manager could arguably usefully research 250-500 companies.

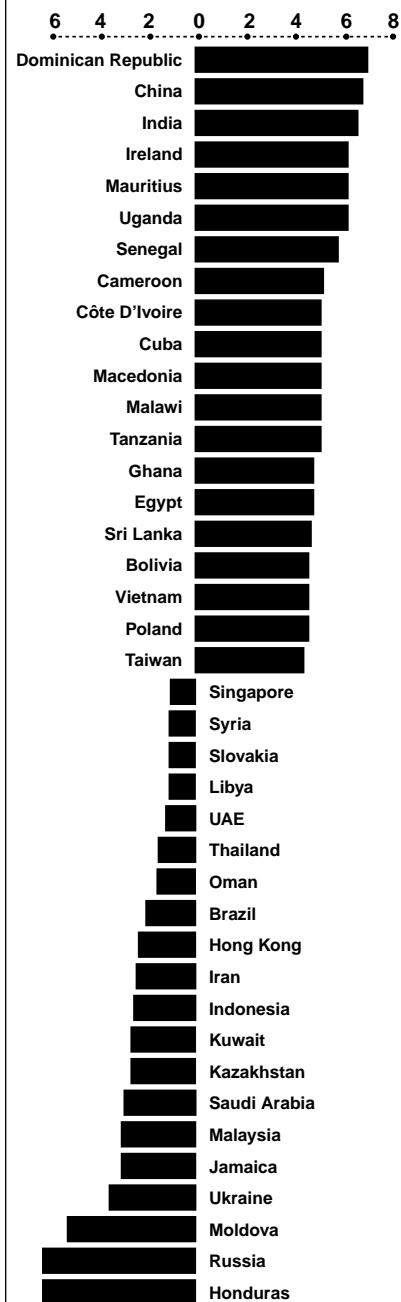
Out of a population of, say, 950 million, less than 200 million are of economic significance, as the rest neither consume nor produce anything of corporate interest. Among this 200 million there is a consumer group that we might call the "middle class" of 80 million that can have a potentially major impact on investable companies.

The macro economic context is a mixed one, albeit far preferable to that of the rest of Asia or most of the current emerging markets. Figure 4 shows the chart GDP estimates, 1999; Year 2000 estimates are around the same level of 4.5-5%. Tables 1 and 2 show the same GDP data, plus a second table for the p/e ratios for the main stock-market indices for the respective countries. This shows that India has the cheapest stock market and the highest GDP growth, which is a strange imbalance of value.

The key leading indicator for where corporate profits are headed is in the Advance Tax payments system whereby companies get credits for early part-payment of tax. These payments are running at 22% higher for 1999 against 1998, which suggests that we will see some positive earnings growth in some sectors and companies. This indicates that India, therefore, currently offers strong and stable GDP growth and corporate earnings growth and low P/E valuations.

Inflation is around 5% and has been on a down trend for over a year. External debt to GDP ratio averages 25%. For instance, statistics show that the 1996 external debt picture is one of great contrast to the rest of Asia and the emerging

Figure 4 GDP Growth Forecasts 1999



Source: The Economist, January 16, 1999

markets. For 1996, 44% of total external debt was on concessional terms, which allows for more flexible and lower repayment terms; Indonesia's concessional debt is 20%, and that of Malaysia is 6%. The proportion of short- to long-term debt is also very favourable, at 7.5 per cent of total external debt, while for Indonesia it

**Table 1 GDP Comparison of Asian Countries**

<b>GDP Growth (%)</b>	<b>1996</b>	<b>1997</b>	<b>1998E</b>	<b>1999E</b>
China	9.7	8.8	7.5	5
Hong Kong	5	5.3	-6	-3
India	7.5	5.1	4.6	5
Indonesia	7.8	4.9	-13.1	-3.4
Malaysia	8.6	7.7	-6.2	-0.9
Philippines	5.5	5.1	0.3	1.3
Singapore	6.9	7.8	1.2	-1
South Korea	7.1	5.5	-7	-2
Taiwan	5.7	6.8	4	3.5
Thailand	5.5	-0.4	-9.6	-2.4

\* For India, 1998E is from 4/98-3/99, 1999E is 4/99-3/2000  
 Source: Merrill Lynch estimates

**Table 2 Market PER**

<b>(x)</b>	<b>1996</b>	<b>1997</b>	<b>1998E</b>	<b>1999E</b>
HSCEI	8.1	8.6	12.6	13.8
HIS	14.7	10.8	16.3	14.4
BSE	12.8	10.6	10.9	9.1
JKCI	20.4	15.5	15.6	11.9
KLCI	20.8	11.2	14.5	10.7
PSI	12.3	15.2	16.5	17.4
DBS50	21	18.6	23.5	17.9
KOSPI	nm	nm	nm	nm
TWII	25.7	25.7	24.6	23.4
SETI	8.9	nm	nm	nm

\* For India, 1998E is from 4/98-3/99, 1999E is 4/99-3/2000  
 Source: Merrill Lynch estimates

growth of the software industry. Thirdly the Indian economy is a predominantly domestic one where exports are less than 10% of GDP. This should be an attraction for the international investor, since it indicates that India is significantly insulated from the prevailing Asia-wide deflationary trends and therefore offers more promising opportunities than elsewhere.

Such a situation favours the growth of many smaller companies, with market capitalisation around \$100 million, expanding within the growing domestic economy. It makes sense, therefore, to operate a smaller companies fund.

On September 15, 1994, the Bombay Stock Exchange (BSE) hit its all time high of over 4,600, and from which it fell to 2,700 during the following 24 months. (see Figure 5). Figure 6 shows the even worse decimation in the small and mid caps, with the 200 index. The first major down break spread like a plague. Hotel stocks imploded. Following on from that, there was a major credit crunch when prime borrowers were lucky to get access to financing and non-prime borrowers could not borrow at any price. At one point a major financial blue chip, ICICI, issued a five-year term bond yielding 20 per cent when inflation was running at 12 per cent. Why risk the stock market in that environment? Few did.

The political scene was also an issue. The natural party of government, who had held power for nearly 50 years, Congress, lost control of Parliament and a strange college of diverse parties formed the United Front (UF) government. The UF was formed by farmers' parties, regional parties, and the Communist (Marxist) party based in West Bengal (Calcutta). The positive management of the economy therefore suffered to some degree.

## **SHAREHOLDER VALUES**

This government held one asset in the form of the Finance Minister, Mr P Chidambaram, a Harvard-educated lawyer whose budget on February 28 1997, was one of the most important events in recent

is 25 per cent. For Thailand, the proportion of short- to long-term debt was 41 per cent: no surprise that this was the first economy to crack. On the dark side, there are big stresses and strains in the federal/state budget management that is a patchwork of inconsistency and incompetence, while there is both a growing trade imbalance and a deficit funding and fiscal shortfall.

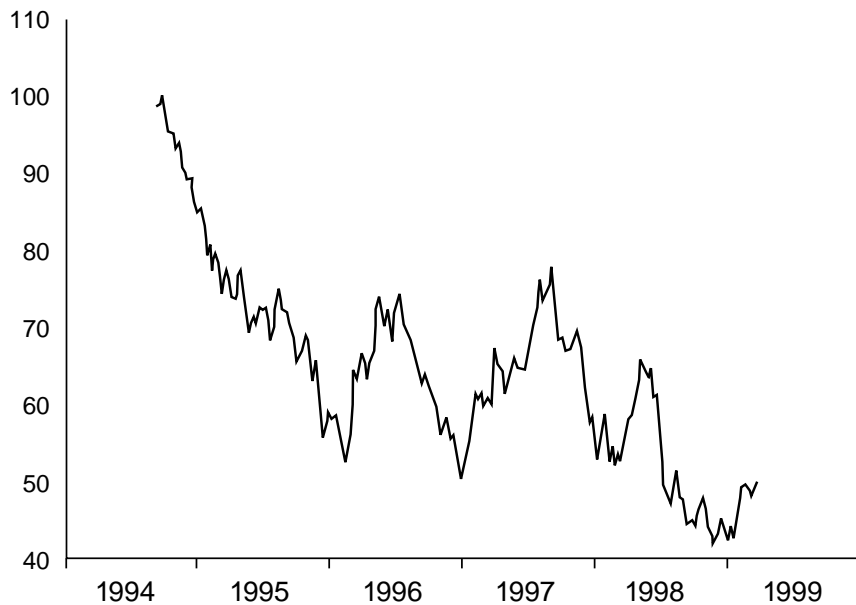
## **INVESTING IN INDIA**

In 1991-92 the Indian economy was forced to open up, and a progressive but cautious policy of liberalisation was introduced by the then, and

perhaps soon to be again, Finance Minister, Manmohan Singh. Direct and portfolio investment was allowed, and the -protecting wall on which the Licence Raj was built started to crumble.

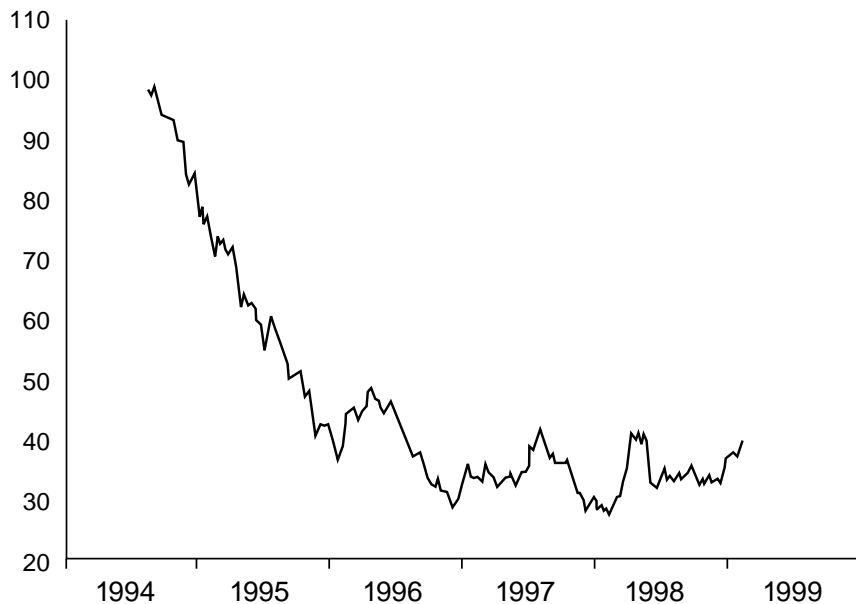
By the early 1990s it had become apparent that there were three major new investment assumptions that could be made about India. First, there was the potential for a rerating of the market and some companies as restructuring took place. Secondly all change, especially rapid and systemic change, throws up unexpected and unforeseen winners and losers, and this has happened hugely with the

Figure 5 **Bombay Stock Exchange Index 1994-1999 (US dollars)**



Source: Datastream

Figure 6 **S&P Crisil Midcap 200 Index**



Source: Datastream

be recognised and valued. At last, and at once, profit payout ratios, asset values and utilisation, and return on equity could be used to price a company's stock. There is today no reason why, in principle, an Indian company should be valued in a different way to a US one. In practice, of course, there are differences but these are to do with context, not assumptions about valuation methods.

The Indian market has not fully re-rated many buy-back stocks. One of the first to raise a board resolution to complete a buy back on January 4, 1999, was Essel Packaging Ltd, the second-largest toothpaste tube manufacturer in the world, and soon to become the largest. Currently, the stock is fully priced at the lower end of its buy-back target. Essel has a five-year EPS growth of 25% current p/e of 15 times '99, and a return on equity of 15-20%. It manufactures the cheapest toothpaste tube in the world, and is by far the dominant supplier domestically. Within three years, Essel will also be manufacturing 500 million tubes in China, and has started operations in Egypt, to supply the African market, and in Germany, to explore Europe. Toothpaste tubes should be a low-excitement, low-margin business, except where the volumes and efficiencies are significant enough to provide a near-monopoly supply. A defensive stock starts to look like a growth stock.

There are good, good-value cash surplus companies, which will start to reward their shareholders using buy-backs. The key point is that there is in India today an evolving, and very Indian, new corporate landscape, where there is every chance of a happy ending for those companies which do the right thing.

### STOCK WINNERS AND LOSERS

Figure 7 outlines the new corporate reality. Re-based to September 1, 1994, this shows the divergent direction of two companies, Hindustan Lever (HLL), by common consent the best managed

### Indian financial history.

The Budget contained three key provisions: (1) ending the double tax on cash dividend payments, which had made it unattractive to pay shareholders dividends in the form of cash; (2) allowing the aggressive takeover of Indian companies; (3) allowing the buy-back of

shares. The objective was to create a basis for good companies to shine and be valued according to a rational basis. This may be the first occasion on which the Communist Party has voted for shareholder value.

This budget underpinned the change from the Licence Raj regime to one where good companies could

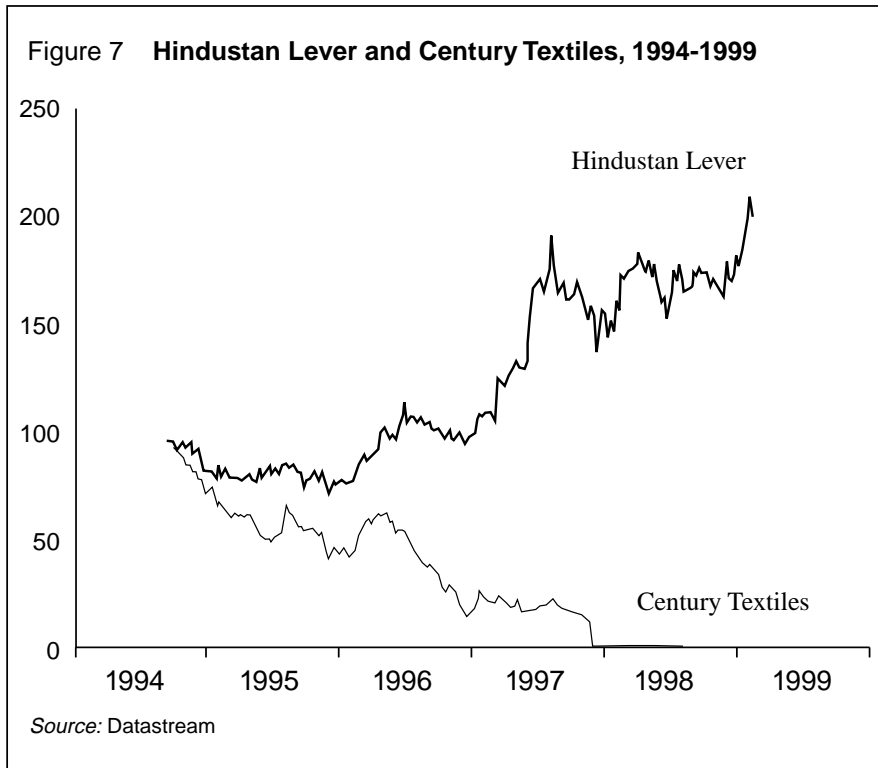
company in India, and Century Textiles (CT) the largest cap textile company and a major beneficiary of the License Raj.

From being under 8% of the index in September 1994, HLL has risen to become 13% while CT has fallen from over 4%. HLL is currently on a p/e of 50 times trailing, while the BSE 30 is on a p/e of 10 - 11 times. This would suggest that with HLL and some other companies skewing the market P/E so vertically, there must be some cheap companies in the BSE 30. There are, if the p of the p/e is of more interest, as CT has not had earnings for the last two years.

The stock price progress of these two companies is clear evidence that the assumption of a rerating has started to bite in a substantial way, and this divergence will continue.

The second assumption, that systemic change cannot be fully plotted is of course, obvious. But as we all keep trying, we also find it a humbling experience as we make bets and win and lose. Five years ago, the Indian software industry was a niche, marginal industry. Today, on price, time zone, supply of competent people, and the English language, India is the killer story in software implementation, Y2K, Euro conversion, data migration, debugging and back office data processing. Swissair now does all of its back office data in India, as do many other global companies. The correct valuation of an Indian software company is only a little less discussed than that of US internet companies. And apart from US internet stocks, Indian software stocks were the best performing equity sector in this world in 1998.

The argument is, where do we go from here? Our view is that the big companies are mature as pure growth investments. But there are other companies that are the next step up from the easy money of just buying the biggest and buying momentum. India has also just had its own IPO frenzy run -up, when Sonata Software rose from 90 Indian rupees (INR) to INR 225 (+150%) on its first day of trading (price on February 25, 1999: INR



360). There will be more as supply meets demand. Also, the first Indian software company, Infosys, has recently been listed on the NASDAQ, which will raise the international profile of these companies dramatically

Systemic change is not confined to software. Wyeth Labs, now re-named Wyeth-Lederle, is a pharmaceutical company which is a joint venture of the US major, American Home Products (AHP), and is the lowest-cost producer of steroids in the world and the only one where they are made entirely on one site, increasing efficiency. AHP is a benign parent; it will not aggressively transfer price its patents to Wyeth in to repatriate profits from its Indian subsidiary but intends instead to import bulk steroids to its global operations, thus giving it the lowest steroid cost base in the world.

Just as, for example, Microsoft is setting up a software development base in India, so the pharmaceutical companies will also take advantage of the cheap educated professionals available to do basic research and testing in India. The development of the Indian pharmaceutical sector is one leveraged by copyright, as is the case globally. Where there is energetic enforce-

ment of product and process patent law, a vigorous pharma industry can develop, and where not, not. India is halfway to achieving that target and can progress much further given the legal framework that exists there.

### **HAIL TO THE NEW RAJ: THE DOMESTIC CONSUMER**

Essel Packaging is a pure domestic consumption play - people don't start and then stop using toothpaste; it is a one-way consumption trip. The key point about Indian toothpaste use is not the low per capita usage of one toothpaste tube per annum, but that between 80%-90% of users uses it only once a day. The brand owners, Unilever and Colgate, are trying to ensure the lowest barrier costs to entry, but at some point they will take the view that the brushing twice a day message can be pushed giving them, and Essel, cheap volume growth. A proof of this model for market development is that we in the West are now being encouraged to brush our teeth three times a day.

Another very domestically focused company is the Fast Moving Consumer Goods sector (FMCG) company, Marico Industries Ltd. Marico is by far the

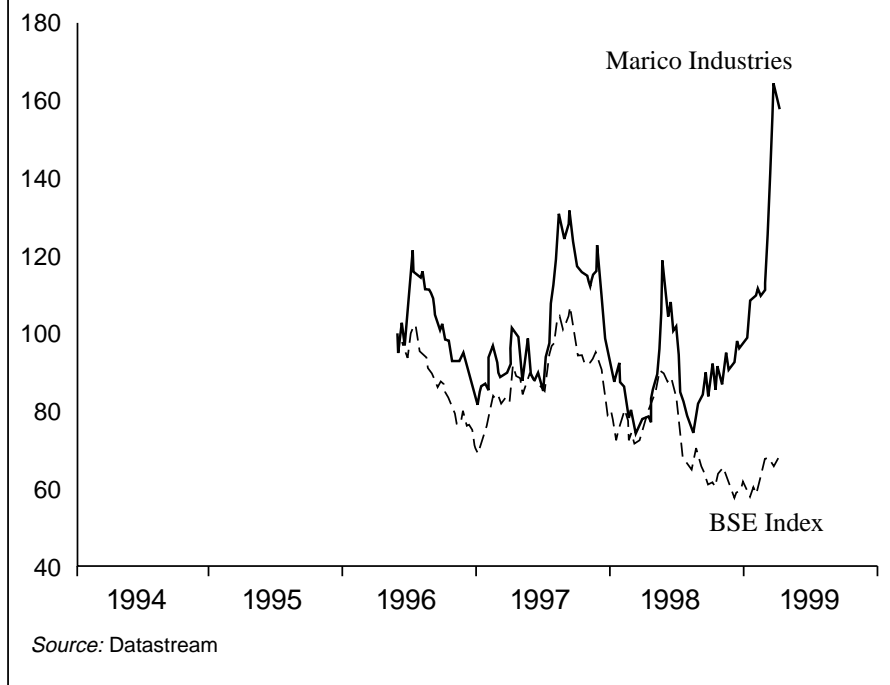
market leader in coconut hair oil, various cooking oils and spray-in starch - none of which products have serious rivals to their market niche. What Marico does even better than brand development is Product distribution. There are around one million retailers in India, and Marico reaches some 400,000 of them with a receivables of 15 days. Marico can now send out its quarterly results by email to shareholders. Marico's trailing p/e is 21 times, return on equity is 35%, five year EPS growth is 25%.

Marico will always trade at a discount to the Indian sector, because of issues related to ownership of its brands and other factors to do with the 60% ownership of the company by one family group. But, until recently, it was trading at a discount of over 60% to its sector, while a 5-10% discount would seem appropriate.

Marico's Parachute coconut hair oil is used by Indian women to create those shiny, black tresses for which they are admired. Parachute is the dominant brand with over 50% of the regulated market. The future is for margin increases and line extensions; for example, Parachute Lite has now been launched, along with more size differentiation. Figure 8 shows Marico's price movements against the market, which shows great volatility due to a series of specific events and, recently, a strong upward price break.

It is also important to consider another issue that is brought up when India is considered: democracy and the rule of law. India is a democracy. A real democracy, and when Indians go the polls to vote, it is the largest organisational event in human history. Governments change by the casting of votes, and political parties exist which have beliefs in such stark contrast as those of Marxist Communists, extreme right wing Hindu purists, and farmers' lobbies, and where they have actually been in power. Politics is about the competition for power and resource allocation, and

Figure 8 Marico Industries and BSE Index, 1996-1999



this is happening in India.

It used to be a spoken - and unspoken - thought among especially Asian investors, that India was a waste of time precisely because it was a democracy, and that it was not a tightly controlled, or authoritarian system where things could be done faster. Lee Kuan Yew, the 'dictator' of Singapore with a democratic veneer, espoused the model of benign autocratic control that was supposed to be the 'Asian way'. Lee was a genius, and honest. Sadly, nowhere else in Asia where this model was more or less universally self-consciously followed, fig leaf or no, was it implemented by people to whom you and I would ascribe the same virtues. The rest is recent history.

### THE NEW TIGERS

Which brings us back to the title of this piece. We know the elephant, it is slow but hard to divert from its course. The tiger is faster on its feet and more aggressive. Malaysia, Thailand, et al, are not at all the tigers I had in mind. My tigers are Essel, Marico, and Wyeth.

New exciting and focused companies that have the underpinning of strong consumer franchises, internationally compliant legal and accountancy standards, and now capital markets, are using the path that the elephant has trodden through the trees. India may now have become the most favourable investment location of any of the emerging markets. The future is very bright for those energetic businesses and managers that can see the future clearly, and now have the opportunity to move towards it.

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