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An offshore fund spies opportunities in India's new economy

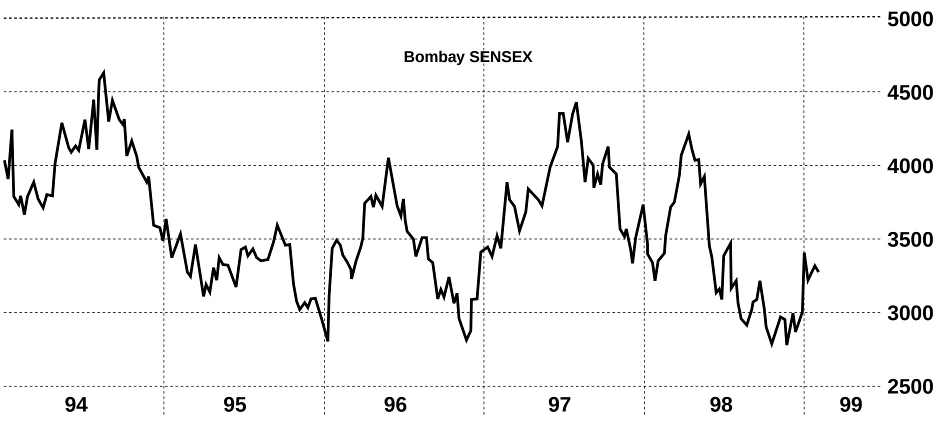
Forget the Raj

An Interview With Jon Thorn • Jon is the portfolio manager, also chief cook and bottle washer, at an offshore investment company domiciled in Mauritius (where it's not subject to India's capital-gains taxes) that has darn near done the impossible over the four-plus years of his fund's existence: produced a small gain, while the main Indian index has lost 60% of its value.

His Indian Smaller Companies Fund, which is managed by Asia Pacific Securities, associated with Marc Faber's institutional investing empire, is not open to U.S. retail investors, only to qualified institutions and (exceedingly well-heeled) individuals. Yet Jon's insights about the market are applicable by any investor interested in the sub-continent. The key one, says the U.K. ex-pat who spent his formative years in Khartoum, Sudan, before picking up a Ph.D. in politics at the London School of Economics, is that as the nation started to open up, the old Licensed Raj companies would crumble, while small and new ones would thrive. But we'll let Jon explain.

- Kathryn M. Welling

INDIA'S LONG DECLINE



Barron's: *Let's get this straight. You're running an Indian portfolio but spend more time in places like London and New York?*

Thorn: I'm trying to reduce my costs. Office rents in Bombay actually are quite steep, even though property values there have fallen by about 50% in the last two years. Prime office space in the business district is much higher in Bombay – Mumbai now – than in New York, even London.

Q: *What are you calling Bombay?*

A: A few years ago when the new government was elected in the state of Bombay, they changed the name from Bombay to Mumbai, after a Hindu goddess. They believe Bombay was a corruption of Mumbai. There are two sides to that story, but the practical effect is that if you want to courier a document to Bombay and you don't write Mumbai, it takes a lot longer to be delivered. If you do that a lot, you tend to internalise it, as I have.

Q: *But New York and London are time zones and worlds away from India's stock market.*

A: I see no advantage – considering the way I run our India portfolio – to being based full-time inBombay. One attraction of being in Bombay, it would seem, would be that you could go to see lots more companies more easily. In reality, communications and transportation difficulties in India are such that you can only see a limited number of companies that are not actually based in Bombay, in any reasonable period, anyway. Besides, this fund's very low portfolio turnover and exhaustive research bias means that the number of companies I have to see on a regular basis is actually very limited.

So there is no attraction, for me, in being in Bombay more than, say, twice a year, for company visits. Granted, a lot of the big brokerage houses have set up shop in Bombay – but that's because they can get cheap analysts there, which I don't need. Then, too, Bombay's market is very information-sensitive, characterized by a lot of ebb and flow. So there is an advantage – if you are a long-term holder of equities, like we are, - to being outside the flow of all those emotions. While some of the Indian markets are among the oldest in the world and there is a long tradition of equity ownership there, there are also thriving "third markets," if you will, or gray markets. For example, when the stock exchange shuts down in the early evening, you'll find crowds of people gathering on street corners. They're all on mobile phones and screaming share prices – bidding up and down prices for the following day.

Q: *A foreigner can't join the fray?*

A: I wouldn't try it, no. The language of that business is Gujrati, the local business language. It is rather like, if you don't speak Cantonese you aren't going to be a floor trader in the Hong Kong market. The other reason not to be in Bombay is that, especially since last August, this is very much a service business, very client-driven. Unless you can talk frequently to your clients and visit them, you're not giving them the service they need.

Q: *Hand-holding, in other words.*
A: Exactly.

Q: *Starting an India fund late in 1994 was terrifically bad timing, wasn't it?*
A: Yes. Particularly the date we chose which was 12 days before the market's all-time high. It took us longer to get all the paperwork processed than we'd ever imagined. Interestingly, though, I know of at least four other India funds that launched on the same day, two of which were also smaller-company funds – one has since been taken over and the other doesn't exist any longer. People don't really realize how bad the stock market in India has been for the last four years. It started in late '94, when there was an airborne plague epidemic, which, of course, collapsed hotel occupancy rates, reduced airline load factors. The market sold off dramatically. Then came a series of macro events within the Indian GDP which compounded with micro events the next year, producing a pretty major credit crunch. At the low point, a premium blue-chip Indian financial institution, ICICI, could sell a five-year term bond only by pricing it to yield 20% in local currency – when inflation was right about 12%. A huge real rate of return. In that context, who wanted stocks? It was not unlike what people are seeing right now in Asia, but without the dramatic collapse. It's just been going on longer.

Q: *Spell out the damage in index terms.*
A: There are several Indian market indexes, but the main one is the Sensitive, sometimes abbreviated SENSEX, and sometimes called the Bombay or the BSE 30. They haven't changed it to the Mumbai 30. On our September '94 launch date, that index was at 4542. By yearend '98 it was at 3055. What's worse, the value of the rupee over that period dropped from 31 to the dollar, 37 spot, to 42 to the dollar, 49 spot. Which means that dollar-based investors lost about 50% over that stretch. And according to Lipper's numbers, that's pretty much what the average mutual fund investing in India has done.

Q: *Is it safe to assume small Indian stocks have fared even worse?*
A: Yes. India actually has a profusion of indexes you could use, but we look at the CRISIL 2000, which at one point early last year had lost something like 80% of its value at the peak. It has recovered substantially now – because there were some software stocks in the index, which have brought it back up.

Q: *Was 3000 or so the bottom in the Sensitive?*
A: The bottom was around 2700 – the worst would have been about a 40% loss. To which you'd have added about a 15% currency loss. Very nasty. Nonetheless, from inception to date, the Indian Small Company Fund is up 3.9%, versus a 60% decline in the BSE. Last year was a very good year for us; we were up 27% and the market was down 21% in dollar terms. So far this year, we're up better than 16%.

Q: *What's your secret – not marking stocks to market?*
A: Oh, right. I value them myself!

Q: *Okay, maybe not yourself – but small companies can be illiquid. So maybe your favourite broker values them?*
A: Hardly. But some of the Indian smaller-company funds – one, for example, saw its net asset value sink from $10 to $1.20 – did hold portfolios of companies which at some point became totally illiquid. The experience would have been exactly the same as that experienced by some Asian fund managers late last year, when they tried to sell some Indonesian stocks.

Q: *Sell – to whom?*
A: Exactly. We've always feared that outcome and therefore we've sought to avoid it, never buying what we believe to be illiquid or other than temporarily distressed stocks. That's also why the majority of our holdings have been in India -based companies involved in joint ventures with major international companies. For example, Wyeth Labs (now Wyeth Lederle), which previously was around 40% owned by American Home Products. And we've had other positions where the joint-venture partners were companies like Saint Gobain, the French glass maker. Investing in these joint ventures with the multi-nationals does two things: generally gives the local company a franchise or reasonably competitive product or service in its home market, and, very important for investors, transparent management and accounting practices.

Q: *So how big, realistically, is your Indian investment universe?*
A: The much-cited statistic that there are 7,000 listed companies in India is a complete fiction. The majority of those are, in fact, private vehicles which have been listed to get corporate tax advantages. The "free float" is held by the brother-in-law, the uncle. And the larger multinationals do the same thing with their subsidiaries to collect tax advantages. So perhaps 2,000 stocks realistically represent any kind of publicly listed company. Probably only 250-400 of those are companies that a brokerage firm would want to pay an analyst to look at.

Q: *And the companies that you look at are the smaller of those 250-400?*
A: That's right. We have an ideal market-cap size of around $100 million. In a U.S. context, that's micro-micro. But in India it gives you a reasonable universe. Because once you are outside of the biggest five or 10 market-cap stocks, the drop-away is very steep. Still, there aren't many people looking at the stocks that we look at. When we first bought Wyeth, for example, its market cap was just slightly under $30 million. As far as I'm aware, no one in the investment analyst community had actually visited it or even tried to seriously look it over. That's changed dramatically – now that Wyeth, through merger and accretion, has grown into nearly a $300 million market cap company. We took a 150% gain on it over the last year.

Q: *Does that one trade explain your out-performance last year?*
A: That gets at the other thing that we do. We've never believed and never operated on the principle that if you hold a basket of companies, you therefore are diversifying either company risk or market risk. Instead, we've always gone for a highly concentrated portfolio – and it has never been as concentrated as it is now. But we believe that if you've done your initial work well – and that the more work you do, before you go in and while you are in – the less risk you have. I believe most people who widely diversify their positions do so more for fiduciary reasons than because they believe it will enhance their investment returns. So on average we have held at least 60% of the fund in around six or seven companies. Right now we've got about 80% of the fund in six companies.

Q: *Are you usually fully invested?*
A: Yes. And we don't try to hedge either the currency or the market risks. That would only distract us. We simply want to find winning small companies and invest our assets in them. That is our expertise. We are not a hedge fund. We don't have the talent or the experience to make macro calls. Besides, India always has a gently depreciating currency, for one very good reason: The Government wants it that way. Has no particular interest in trying to defend it. The currency is not convertible on a capital-account basis, as in Brazil, etc. So you are never going to see that kind of panic run on the currency.

Q: *At the moment, India is quite content to be "backward" on that score.*
A: The recent experiences of the rest of the world, I think, reinforce the view of the majority in the Indian business community that there's no reason to make the rupee freely convertible. I don't see it in the foreseeable future.

Q: *We have to ask, why go to all the bother of investing in stocks in India?*
A: Well, from a macro, global point of view, according to research I've seen, the only major equities markets in Asia, ex-Japan, that are going to show GDP growth this year are China, Taiwan and India. Now, China is problematic, to say the least. Which means Taiwan is, too. Meanwhile, the minimum

consensus expectation for GDP growth in '99 for India is 4.5%. Now, if you look at the P/E ratios for those markets, strangely enough, you find that India's index has the lowest P/E. Then, too, the earnings underlying the P/Es in many of those other Asian markets will be shrinking – and so will those GDPs, sometimes at historic rates. So it's very difficult to imagine those earnings turning around. Which makes India, currently, the cheapest equity market in Asia and one of the few which has very secure GDP growth this year and – projected forward – next year. It's also the only one that hasn't experienced a major market collapse or some political disjuncture. Also, people tend to forget this, but it's rather important – India is a democracy. A real democracy where you have real laws and transparency. The whole rest of Asia has followed the Lee Kuan Yew model, which was great – under him, because he happened to be a genius and honest.

Q: *He hated chewing gum, but he did set up Singapore as a quasi-capitalist – if police –state.*
A: Where you can't chew gum. But he wasn't corrupt. He didn't siphon the nation's GDP into his Swiss bank accounts. The rest of Asia has followed his model, but not his practices. Leading to the troubles you've seen in the last year. Democracies are more resilient.

Q: *Yet the sheer messiness of India's politics puts investors off.*
A: On that score, I refer you to the U.S. Senate, as we speak. Democracies are messy, but that's why they are so resilient. What's more, India has a socialist economy – previously of the developmentalist type – which is now opening up. Which specifically means that in the domestic economy, previously there were barriers erected to free trade, to protect indigenous companies. So most of the big Indian conglomerates grew up as monopolies, utterly protected from free trade. They're extremely inefficient, exactly like to great Chinese industrial empires. The most important fact about India and what, I believe, is one of the biggest reasons for investing there, is that the economy has been opened up to some of the joint-venture-type companies, like **Hindustan Lever**. It's the best-managed company in India - a joint venture of Unilever and local Indian interests, which is now by far the largest-market-cap stock in India. It's P/E is around 50 times earnings. It has, no doubt, the best business franchise in India. The best growth rate of any non-software stack. It's a tremendous company. But it has now grown from 4% to 5% of the index weight, as it was four-five years ago, to 15%-plus of the index.

Q: *So it's the Microsoft, Intel, etc. of the Indian index?*
A: Exactly. If you compare the growth in Hindustan Lever's market cap to what has happened to **Century Textiles** over that span, it's quite telling. Century Textiles was the largest-market-cap textile company in India not long ago. Something you might think, in the context of India, would be a good investment, because of its cheap labor and materials costs, political advantages, etc. Yet its stock-price chart traces out exactly the two years. It is a disastrous company. There are many of these "old Licensed Raj companies" in India – and their unwinding has contributed mightily to the declines in the Sensitive, despite spectacular gains in big winners like Hindustan Lever. So the real story of the index is not losing 30%, but the taking out of the old Licensed Raj and the emergence of great new companies.

Q: *Are the new companies internationally competitive?*
A: They're starting to become so. What I am trying to do is find these companies before their potential is recognized in the Indian market. Which brings me to Essel Packaging, which is internationally competitive in toothpaste - tube manufacturing.

Q: *An exciting business, that!*
A: It is, actually, in the Indian context. Essel is currently the second-largest laminated-toothpaste-tube maker in the world, making something like 950 million tubes a year. An American company, I believe, is currently bigger but at some point this year Essel will surpass it.

Q: *We take it that it can turn out tubes for pennies apiece.*
A: Twenty cents apiece, which is at least 40% beneath the lowest cost you find in the rest of the world. Essel cannot be beaten on price. The vast majority of its tubes are used in India. There is an export trade to Bangladesh and Sri Lanka. Essel is a very smart company. Rather than doing a lot of exporting, they are now trying to grow capacity in other countries. Within two or three years, the plant they're setting up now in China will probably produce between 350 and 500 million tubes. Granted, tubes are not a sexy business. But you have to do key things right. You've got to be able to do the volume, at the quality and at the price the client wants. Essel has developed close relationships with both Unilever and Colgate - both of which have been growing very fast in India. Unilever has been storming ahead, though, on the strength of superior distribution and marketing. For example, late last year Hindustan Lever was selling products below cost and giving away samples in certain neighbourhoods – where people have never used commercial soaps or toothpastes before but are moving into the economic group that could afford to.
Q: *How many of India's millions can afford such luxuries?*
A: Well, think of it this way: Essel makes 950 million tubes annually – that's about equivalent to the population, so the per capita usage in India of toothpaste is one tube per annum. In actuality, there are maybe 80 million people in India who regularly use toothpaste, which brings their per capita usage up. Yet, as I discovered only about a year ago, between 80% and 90% of the people in India who use toothpaste use it only once a day. The message of brushing twice a day -

Q:*Three times, if you listen to your dentist –*
A: who is obviously a shareholder in both Colgate and Unilever – that message is not out there yet. Which means that the market is far from saturated. When that message does get out – Unilever and Colgate are not currently promoting it because, I suspect, they want to keep the cost of starting to use the product as low as possible - there's tremendous built-in upside. That's the beauty of something like toothpaste. Once you start using it, you don't stop. You might put off a holiday in the Himalayas, or buying a new two-wheeler. But not toothpaste. So in betting on companies like Essel, which provide products essential to core domestic consumption, you are more or less assured of continued growth in their markets as the Indian economy expands.

Q: *When did you first buy Essel?*
A: It was a temporarily distressed stock when we bought it. The price, I believe, had dropped from about 160 to 90 – and we continued buying up to 120.

Q: *Where is it now?*
A: At 236. We're not buying here, but if I had a grandmother, I would tell her that, outside of a natural monopoly, like a telecom or utility, this is one of the strongest global business franchises that she could find. It has unbeatable business relationships with Colgate and Unilever in two core markets, India and China. Plus, it just bought a production facility in Eqypt and it's buying a small one in Germany. I can't think of a comparable company which has managed to emerge from a lowest-cost-baseenvironment like India to supply companies around the world. Essel may be the first.

Q: How long have you owned the stock?
A: We've owned it at least 2-2(half) years. And we're now faced with a dilemma. On January 4, Essel's board passed a resolution to buy back 10% of its equity at prices between 250 and 300 rupees. The stock is currently trading around 230. We haven't seen the documents yet. But March is when the buyback will probably be approved and implemented.

Q: *Aren't stock buybacks something new in India?*
A: Essel's is one of the first. Buybacks only became legal last November. Which brings me to some of my other reasons for bothering

with India. The Indian government announced three measures on February 28, 1997 –a day that will live forever in my memory. The first allows aggressive takeovers of Indian companies by other domestic companies – something never thought of before. The second ended the punitive double taxation of dividends. The third, just becoming effective, allowed buybacks. What you now have in principle in India is a stock market you can value on the same basis as the U.S. or U.K. market. In practice, of course, there are still differences. But that companies can buy back stock in India is extraordinary – the only other Asian markets where it is allowed are Japan and Hong Kong, I'm told. Even in Germany, buybacks weren't allowed until last year. What all this means is that the rewards to shareholders can be very straightforward. This should be a very black-and-white market going forward. One where, increasingly, rational and very good companies can evolve.

Q: *Doesn't it still take forever to settle a trade?*
A: India's convoluted and protracted paper-settlement process has been a major issue; horror stories abound of certificates that don't exist because they have been eaten by rats in the vaults, that sort of thing. But over the last two years, something called in India "the dematerialization of share certificates" has been much discussed and is finally being implemented; it became compulsory for the 12 largest-cap stocks at the end of last year.

Q: *This is essentially electronic settlement, we assume.*
A: Yes. All the major stocks are moving in that direction – it's in everyone's interest, except the small retail investor's. They now suddenly have an identifiable tax event, instead of just fewer share certificates under the bed.

Q: *Back to Essel. Are you going to take profits?*
A: Right now, I don't know. My gut feeling is that Essel still has a long way to go on the upside. And the promoter group, which currently owns over 40% of the company, is not going to sell. So that 10% equity shrink is going to be taken out of about 55% of the float. We'll probably just reduce our position some, because we still see very strong potential in it for at least another five to 10 years of strong earnings and revenue growth. It has almost no debt on the books. Lots of flexibility.

Q: *Isn't the promoter's stock a worrisome overhand?*
A: It's possible he may need capital elsewhere at some point. It's actually one man, Subash Chandra, Essel's founder. He started this company when no one had even an idea that you could create this kind of thing in India. He also created the first Hindu satellite-TV company in India. Also something called Essel World, basically a Disneyland for Bombay. All three are now very profitable. He is one of the great entrepreneurs in the emerging world.

"Apart from the U.S. Internet stocks, the Indian software sector was the world's best-performing group last year. Many of those stocks, however, are really just 'body shops' doing repetitive contract work."
Jon Thorn.

Q: *What stocks would you buy here?*
A: The Indian market, as a whole, looks terrible here, because it still contains a lot of the dinosaur Raj companies no one should want – and a lot of software issues that have run up hugely in the last year. Apart from the U.S. Internet stocks, the Indian software sector was the world's best-performing group last year. Not all, but many of those Indian software stocks, however, are really just "body shops" doing repetitive contract work for the likes of Oracle, IBM and Arthur Andersen on data migration, Y2K or euro conversion projects. Which I'd avoid. I do like an Indian software stock, though, called BFL Software, that took a bit of a fall last year for two reasons: Some key management personnel left, and there was a downside earnings surprise. We took the view that this company was very cheap, very strong fundamentally, and took a small position back then at around 450 rupees. About two seeks ago, BFL reported major growth in its fiscal first-half earnings, confirming its turnaround. We doubled our position at around 600. The price is now 900. But there's lots more upside. In '96 and '97 BFL was Compaq's Asian partner of the year. It is quite unlike the majority of India's software companies. BFL's client relationships aren't with the likes of Arthur Andersen or KPMG. It has only five or six main clients for which it works directly. The biggest is Compaq, about 23% of BFL's business. And it brings actual value-added to those relationships, its ability to create software tools at a very low cost. That business is secure; no one else can do it at that price.

Q: *What is its P/E?*
A: Forward earnings are tricky to estimate, but it is at 20 times March 2000 earnings – say 11 times '01. Two years from now, this will seem like an incredibly low price for this stock. Another great stock, one that I've liked for a long time, is **Marico Industries**, which specializes in coconut-oil products. Marico is essentially in the same kind of business as Hindustan Lever. It's a consumer packaged-goods company, with a very restricted product range. All of which is sold to domestic Indian consumers. The first is a coconut hair oil, the No.1 brand by far. Marico's next-largest product is cooking oil, where they have two main and several other brands. This is a slow-growing business, but with lots of untapped potential. As India's GDP rises, more of its population will be able to trade up to Marico's packaged oils instead of buying whatever is ladled out of communal pots on street corners. The other typically Indian product Marico makes is a starch. Rather than wash your shirt every day, they use lots of Marico's Revive spray starch to make them look very fresh and very, very stiff. What's incredible is that in a nation that's estimated to have around one million retailers, Marico reaches upwards of 400,000 of them, either directly or indirectly. And has receivables outstanding which vary between only 19 and 28 days. In the Indian context, that is just astonishing. What's more, any Indian who has a job can afford to buy Marico's products.

Q: How many people is that?
A: In the domestic Indian economy there may be something like 150 million-plus people who can afford to buy Marico's products. The key point is that average per capita income in India is about $350 a year. So the majority, by far, have less than $1,000 of annual income – and nothing that happens to that population is going to touch stock valuations. They essentially neither produce nor consume anything of economic significance. But the 150 million or so people with more than $1,000 in annual income are of great interest. If you assume India's GDP grows 5% annually for the next five years, with flat inflation, it doesn't take a rocket scientist to see a huge increase in the consumer demographic in India. New millions able to buy toothpaste, cooking oil, with per capita purchasing power of the consumer segment growing by something like 45% in the next five years. If the companies in my portfolio capture only half that growth -

Q: *Okay, Jon. Thanks.*