India Rocks!

By Jon Thorn

The global media fixate on China's boundless future. India, the English-speaking democracy with a huge middle class, is a far better bet.

I have been visiting India as a portfolio manager for ten years. But on my last trip earlier this year I found that something very significant had changed from all the previous visits that I have made: now everyone wanted to talk about investing in India.

At the recent Merrill Lynch India conference, some sixty Indian companies made presentations to over one hundred investment managers from around the world. Two other India investment conferences have also been held in the past few weeks; one by CLSA in India, and another by Goldman Sachs in New York.

Rather than the usual suspects, almost half of the greatly increased number of attendees at both the India-based conferences were visiting India for the first time, which means that most will have had few if any investments in India. Even Stephen Roach, the Morgan Stanley chief economist, has also just visited India for the first time, in contrast to—he admits—his (and most of the rest of the world's) China-centric view of Asia, including twenty-five visits to the Middle Kingdom since 1997. He writes, "Quite simply, I was blown away by what I saw on my first trip to India."

We have run the India Capital Fund since 1994 and while we have always been excited about India, we have had more to say about potential, rather than achievement, as far as the second-most-populous country in the world is concerned. That is different now.

The largest infrastructure build-out in the world today is taking place in India. In addition, the world's fastest cell phone growth rate and the second-fastest GDP growth, at around 9 percent, are also found in India.

Since 1980, India has had the second-fastest growing GDP in the world after China. During the global recession of 2001, GDP growth in India and China was hardly affected and combined represented almost 50 percent of total global GDP growth, and we would also assume that Indian numbers are more accurate than Chinese ones. Indian per capita GDP has more than doubled in the past twelve years and the rate of increase is rising.

THE CHANGE J-CURVE

To put things in a general global perspective, it is hugely sobering to remember that it has only been possible to invest in the stock markets of China, Russia, and India for around the past fifteen years or so. Although the Bombay Stock Exchange is the second oldest in the world it only began to open up in 1991.

In that time scale, plus or minus five years, three of the biggest economies in the world have converted themselves from communism/socialism to capitalism, India included. The rest of the world is only now starting to digest both the fact and the ef-

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fects of this change. And the effects on labor and capital markets and in the political arena will be huge, dislocating, and positive, as trade expands and wealth is created.

India is a "real" democracy (meaning there are reasonably fair elections where governments can change without major bloodshed), and as in any political state, leaders must lead to achieve positive change; this is not a universal condition. In India, it required a second generation of reforming figures to make a difference. The most important of these is Arun Shourie, the minister for disinvestment, as privatization is known in India.

Mr. Shourie has a Ph.D. in economics from Syracuse University and was a World Bank economist and crusading "right-wing" journalist before becoming a major force for change and liberalization in the current government. Results, not debate, are his ambition; famously saying, "When it doesn't work to go in like a rhino, be like a swarm of bees." Mr. Shourie's ambition is for more schools, more roads, more airports, and more opportunity, paid for initially by privatization receipts.

British Prime Minister Margaret Thatcher invented mass privatization, a phenomenon that is not very visible in the political consciousness of the United States, as the United States has happily not experienced the political-economic lunacy of nationalization. Most of the rest of the world has. Even Mrs. Thatcher learned that this policy is not a one-way street when the grand old man of the Conservative Party, ex-Prime Minister Harold MacMillan, stood up in the House of Lords and criticized her for selling the "family silver" (or state-owned companies). Privatization was a new and radical notion twenty-five years ago.

Privatization itself, however, is not the source of new economic dynamism, but rather the accompanying increase in competition and choice. Russia failed that test radically when it transferred public monopolies to private hands. India will arguably be the biggest beneficiary of this policy ever as it privatizes state-owned or -managed companies which already compete with each other. Britain had to encourage the creation of competitors, and the state telecom company is still the dominant carrier today. The contrast to China, where "privatization" is more accurately a process whereby foreign investors in effect re-capitalize the largest state-owned enterprises, most of which have a multi-tiered capital structure to make the equity more palatable overseas, is quite stark.

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When major macro change starts to happen, as it did with Deng's famous "Journey to the South" in 1992 which kicked off China's conversion to capitalism (with a small 'c'), the rate of change is at first imperceptible, and then, as in China today, the velocity can become overwhelming. India's "1992" was in 1991. We believe we are now at the point of inflection in India today: fourth-quarter 2003 GDP growth was 10 percent.

Although India is some way off from infrastructural overload, the effects of that phenomenon right now in China are a warning sign. Currently, the Chinese railways cannot move all that needs to be moved; ships full of cargo are in effect being used as storage facilities rather than being unloaded on time; electricity transmission is not constant in all parts of the coastal zone, and dampening measures are being used on the hottest and perhaps the most leveraged—no one knows the real debt load—housing market in the world: Shanghai.

India vs. China

What all other perennially successful economies in the world share with the United States, which allows them to adapt to changes in the global economy with a greater speed and resilience, is not luck. Along with the English language, which has become the channel of global transmission, all have a large and highly trained corps of business professionals: lawyers, accountants, actuaries, statisticians, bankers, liquidators, company secretaries, etc. And so does India; in sharp contrast China does not.

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SUSTAINABLE CHANGE AND GROWTH

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The rest of the world today is seeking to replicate that model—to create an infrastructure of business professionals. In India these professionals are already reading the most recent work by their peers, most of it in English, and now available on the Web.

CORPORATE CRUNCH AND RENEWAL

The corporate sector has changed itself almost completely. There has been a five-year, very painful industrial recession when protected domestic corporations suddenly had to learn to compete.

A recession creates a new landscape for growth. After inefficient capacity gets wiped out, pricing power returns, margins go up, and then so do profits and earnings; which then explode on a year-over-year basis as a sharp recovery starts and both business investment and consumer confidence rise. The beauty is that this recovery appears to be both strong and sustainable over a long period.

A larger slice of GDP and earnings per share will now be due to the top-performing big caps than would have been the case even two years ago. Reliance Industries, the biggest private-sector company in India, will make close to US$1 billion in profit across the current year, while State Bank of India, perhaps the second biggest bank in the world by branches, has shed 10 percent of its headcount in a tightly unionized environment and has brought its cost-to-income ratio down from 64 percent to 50 percent in less than six years.

There is a credit boom taking place in India which underwrites future GDP growth. Retail loans are less than 3 percent of GDP, very low, and average equity in the housing market is 60 percent, extraordinarily high; therefore credit can grow very fast for a long time before India reaches even half the levels of other comparable Asian economies, even economies such as the Philippines or Thailand.

At the macro level, non-performing loans as a percentage of GDP are very low in India compared to the rest of Asia; according to Ernst & Young around 13 percent in India versus 26 percent in Korea and perhaps 40 percent in China. Non-performing loans result from either slack banking standards and/or a sharp rise and fall in the economic cycle. India has had neither. They are also a charge against future growth as a bank's balance sheets have to be restored. The biggest challenge in the world today in that department is in China, where the big four banks will have to issue equity to an apparently insatiably China-equity hungry world to wash their non-performing loans.

LOOKING AHEAD

The trend to outsourcing is unrelenting. Faced in many cases with reduced pricing power and declining margins, U.S. and European companies have sought to cut their capital expenditure and operating costs, both of which impact directly on the headcount of employees. If companies can outsource non-core functions for a fraction of the existing cost, we believe that shareholders should want to know why they are not doing so.

While IT outsourcing and call centers may have had all the headlines, Indian pharmaceutical companies now produce, by one estimate, 20 percent of the generic drugs sold in the United States. This is the fastest and deepest penetration of the U.S. market by any foreign industry in modern times, and it can only increase as any opportunity for health-care cost savings is pursued.

In April and May, India will hold a general election, one of the many important elections taking place in Asia in 2004. It is expected that the current government will be returned with a larger majority and with an enhanced mandate for liberalization and change. They have nailed their colors to the mast by promoting a feel-good campaign called "India Shining" which has sought to promote India as a go-getting, tech-rich young country. This campaign is very much in marked contrast to normal political profiling and the opposition Congress party.

The India Shining campaign has struck a deep national chord and is now endlessly discussed and referred to—and not least because demographically India has the youngest population in the world. Almost half of India's 1.05 billion citizens are under the age of twenty-five, and this group represents one-quarter of the world's population in that age range. India is increasingly visible as a country where the "family silver" is being converted to human gold, as it should be. ◆

Non-Performing Loans: China's Headache

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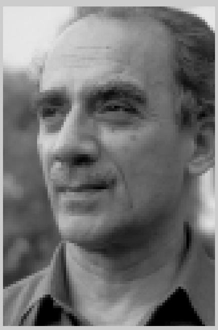
Arun Shourie, Mr. Privatization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