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1. Indian Agriculture – Where to?

23 Nov. 05

For most international investors looking at India from the outside, they very rarely if ever think about the agriculture sector in India. The most common assumption is that the agriculture sector in India will grow at about 2% per annum (average for the last decade), or even lower and that India will be able to hit a growth trajectory of 7-8% per annum despite this drag. Most of the new investors into India do not even spare a thought for this sector, blissful in their ignorance. In no investor conference does the topic even merit a guest speaker. Whatever little interest investors have in the space is largely confined to trying to predict the fate of the monsoons.

This lack of interest in trying to understand the agriculture sector is manifest in the fact that I have not seen a single detailed report on the space (at least over the last five to six years) from any of the large foreign research houses. Quite remarkable really this lack of information or interest, considering that even today the agriculture sector is about as large a component of GDP as manufacturing and employs 60% plus of our labour force. If the agricultural sector could grow at 4% plus instead of the trend rate of 2%, this alone may be enough to take Indian GDP to an 8% growth trajectory (taking into account the direct and indirect benefits of higher agriculture growth). This possibility alone makes it worth studying.

In the context of the above I came across an interesting research report on the subject written by Narendar Nagpal and Kishen Daga of Deutsche Bank India. They make a case that Indian agriculture is poised to change and accelerate its growth dynamic. The report first outlines the usual ills afflicting the agriculture sector viz. small fragmented holdings, limited use of modern technology, continued dependence on rainfall, declining public investment, poor availability of credit and archaic laws. All this is well known and does not cover any new ground, but what is interesting in the report is the section detailing how and what is changing.

The report classifies change into four parts, with the most important being at the policy and legislation level. Here the central government has devised model laws and is incentivising the states to modernize and update local rules and regulations. It talks of a new APMC ACT (Agricultural Produce Marketing Committee), where-in farmers are no longer required to buy and sell produce through designated market places. Under the new model law private sector companies will be able to set up new market places and food processing companies will be able to interact and buy directly from farmers bypassing a whole layer of middlemen. Contract farming also becomes much more of a reality in the new set of rules. The report points out that seven states have already passed amendments to their APMC acts and another 14 are poised to do so. Six more states have circulated draft laws based on the model.

The government has also proposed a new integrated food law, which will hopefully simplify the maze of 16 different laws currently governing the food processing industry. The integrated law will also bring food processing under the purview of one single unified regulator as opposed to subjecting the industry to the fancy of 6-7 different regulators as under the old regime. The report also details proposed changes in the Essential Commodities Act and the Warehouse Receipt Act, all of which simplify the regulatory environment for agribusiness.

A second broad theme is the rising corporate involvement in Indian agriculture. Whether it be ITC or an HLL which have always been involved in agriculture as a means to lower their costs of critical inputs or new participants like Sunil Mittal and the Thapars, agriculture is now seen as a viable business opportunity by many. This trend will get only accentuated as food retailing in India gets increasingly organized, and the large food chains start sourcing directly from the farmers.

The third change is in the area of technology, which is improving the price discovery mechanism available to farmers. Whether it be through the setting up of commodity exchanges or the spread of the ITC e-choupal network, farmers now have access to global prices and wider, more timely dissemination of critical price information.

The implications of all this change are quite significant and far reaching. First of all as the private corporate sector gears up to enter agriculture, one should expect significant investment in horticulture, an area where India has competitive advantages. Food processing is also underdeveloped and one should expect large investments in setting up the infrastructure to enable national movement of agriproduce and reduce wastage and rent seeking by middlemen.

But by far the most important implication of all of the above in the long term will be the cleaning up of the existing supply chain and intermediary networks. This will enable food prices to decline but simultaneously allow farmers to improve their economics by capturing a larger chunk of the pie. A combination of falling food prices and rising farmer incomes will lead to rapid growth in rural consumption, and form the basis for an acceleration in rural GDP. Productivity will improve in agriculture as farmers through increased incomes will have the resources to invest in increased mechanization and use of modern agri-inputs.

While the whole world is going gaga over how much more balanced growth is in India compared to China (where investment to GDP ratios are over 40%), imagine how much more durable and powerful our growth metrics would be if one saw a surge in rural consumption and farmer prosperity. Hitting growth rates of 7-8% for a decade would actually look reasonable.

The report is interesting as it showcases many reforms taking place in the agriculture sector quietly and slowly, away from the glare of publicity. If the conclusions of the report that these reforms taken together will accelerate growth in the agriculture sector to 4% and boost rural consumption are correct, then most investors need to understand this space much better. It will have implications for individual stocks as well as any sector dependent on consumption.

Agriculture, long the poor cousin in India's growth equation may actually turn out to be the most underappreciated driver of India's structural growth acceleration over the coming decade.

2. A Counterweight to FII's

09 Nov. 05

There is considerable unease among market participants in India about the growing role and power of the FII's (foreign institutional investor) in driving the Indian capital markets and giving it direction. The recent correction of 13% only goes to underscore the point, driven as it was by a resetting of interest rate expectations in the U.S and a reduction in risk appetite globally. Despite all the talk of mass redemptions and huge selling, FII's sold less than a billion dollars, yet this was enough to force a 13% correction. What will happen if the FII's actually bail and sell \$3-4 billion in a short period? Given the quantum of equity flows into India over the last 2-3 years, a reversal of flows of this magnitude is quite possible. India is now a mainstream Asian market and ranks right up there with Korea and Taiwan in terms of flows, liquidity and interest, and both of these markets have seen outflows significantly greater than \$2-3 billion dollars at various points of time. So if it can happen there, why not in India?

Conventional wisdom in India is that such an outflow would immediately cause a market collapse, and hence the fear, but looking at evidence across Asia this is not necessarily so.

Take the case of Korea and Taiwan in 2005.

Taiwan has seen huge inflows in 2005, attracting over \$12 billion from foreign investors (the highest among all the Asian emerging markets). Despite this huge inflow, Taiwan is the worst performing market in Asia year to date and the only one actually in negative territory (in local currency terms). The reason for this poor performance is the continued and unabated selling from retail investors. Retail investors in Taiwan have been slowly and steadily reducing their domestic equity holdings and have become a structural overhang on the market. Though down from a peak of 47% in 1997, at 31% the share of equities as a percentage of household financial assets in Taiwan is still among the highest in the world. (In U.S the ratio is at 16.3%) This ratio is likely to keep coming down and until it normalizes, is a huge headwind for the financial markets in Taiwan.

Korea is exactly the opposite case, where-in despite foreigners being net sellers of more than U.S \$6 billion year to date, the Korean market is the single best performer in Asia this year. The reason for this is once again domestic flows, with the increased flows here being on both the institutional side as well as retail. Rising pension allocations and equity savings plans are boosting asset managers inflows, as institutions realize they have to raise equity allocations to maintain returns and retail investors work down their cash mountain.

Looking at both of the above examples, it becomes clear that the behaviour of foreign investors is not the only determinant of market performance. Domestic investors, be they institutions or retail are still the majority owners of the market, and they have the influence and ability to act as a counterweight to the foreigners. In both Korea and Taiwan it has ultimately been the domestic investor base that has driven the market irrespective of what the foreigners have been doing, and this despite foreign ownership in both markets being higher than in India (41% in Korea, 32% in Taiwan).

For all the intellectuals constantly worried about the selling out of our companies and our losing sovereignty over our capital markets, they should focus more on how to strengthen and deepen the equity cult in the country, rather than imposing ownership restrictions on the foreigners.

The question then becomes of whether can something similar happen in India? Is our domestic fund management industry developed enough and deep enough to be able to override and compensate for the foreigners. My sense is that while we are not there yet, the signs are clearly visible that this will happen.

Take the institutional side first, it is in my mind inevitable that the rules for pension plans get liberalized to permit them to invest significant chunks of their corpus into equity. With interest rates being where they are and the political compulsions to keep the promised rates of return on pensions and provident funds high, there is no alternative. Increased flows and allocations into equity are inevitable as there is no other fiscally responsible path open to the government. Given the size of these pension and provident plans and their projected growth this asset allocation change will be a very significant source of incremental domestic demand. A similar story can be painted for the insurance sector, which over time will also have to increase its investments into the capital markets.

As for the retail investor, their allocations to equity at less than 1% of household financial assets are at an all time low(were over 10% in the 90's), and can only rise, more so given the decline and outlook for interest rates. Most competing investment alternatives offer you zero to negative real returns. Chidambaram's recent tax changes, offering savers a single consolidated tax credit for any investment they make in savings products(be it debt or equity) should also longer term drive more flows into equity oriented savings products. He has effectively leveled the playing field among competing investment alternatives from a tax incentive point of view. The scrapping of capital gains taxes, only reinforces all of the above and in fact tilts the scales towards equity.

I, for one am convinced that the coming decade will be a period of huge asset growth for the domestic money management business, a sentiment which is slowly becoming conventional wisdom, given the number of foreign money managers desirous of setting up shop in the country. As this domestic industry develops, the power of the FII's to dominate our markets will reduce. Market direction and sentiment will be set locally and not in New York or London.

For anyone worried about the power of the FII's in India, they have to only look towards Taiwan and Korea, to understand that ultimately the domestic investor base is more important and powerful in determining the long term trend. The emergence of a strong domestic money management industry will be the next driver of the bull market in India and their development or lack of will be the real determinant of whether India is in a secular bull phase or not. The government and regulator must do all it that it can to encourage this development.

3. Future Return Expectations

12 Oct. 05

There is a large body of research available in the U.S tracking both long term historical returns of capital markets and the components of this return. The most famous and widely quoted studies are those done by Ibbotson Associates, which track financial market returns typically since 1926. If one were to look at the returns for the U.S stock market the average return delivered since 1926 till date is 10.4% p.a.. Eight decades is a long and credible period of time and this number of 10.4%(average annual return for the stock market) is often used by the buy and hold crowd to justify being fully invested and owning stocks over bonds.

One can break down stock market returns into three components: earnings growth, valuation changes(P/E expansion or contraction) and dividend yield. The breakdown of the 10.4% annual return is as follows.

According to Ibbotson, earnings growth over the last 79 years contributed 5% to the long term average return.

Since P/E ratios were 10.2 in 1926, the effect of the increase in P/E's to 20.7 at the end of 2004 provided .9% to the long term average.

Finally, the dividend yield averaged about 4.5% over this period. Combining all the three components together, the compounded total return for the U.S stock market (before transaction costs and all other expenses etc) averaged 10.4%.

Using these same three components of return and looking at what they are likely to deliver over the coming decades, one easily comes to the conclusion that long term returns in the U.S. from here are likely to be significantly below the 10.4% historical average. First of all the chances of P/E expansion from the current elevated levels is low, thus straight away knocking .9% off the expected returns number. In fact investors in the U.S will be lucky if they do not experience P/E contraction over the coming decades, which would reduce long term returns.

As far as earnings growth is concerned, this is closely linked to nominal GDP. Given the outlook for lower inflation, both nominal GDP and earnings growth are likely to be below the average of the past eight decades. Most observers expect at best earnings growth to average 4%.

As for dividend yields, given the current elevated valuation levels, the best case is 2-2.5%, much lower than the 4.5% average of the last 79 years.

Thus doing a simple break up of the expected long term returns of the U.S equity market from current levels, leads to the simple conclusion that investors will be lucky to get much over 6% over the coming decades. Compared to the 10.4% long term average this is a big drop, and partly explains the strong and growing interest among large institutional investors in the U.S to diversify into emerging markets.(where expected returns are higher)

While numerous studies like the one above have been done for U.S markets, what does this throw up for Indian markets.

If one were to invest in the Indian markets today, what returns can one expect taking a decade long view and breaking up returns into the three components discussed above. This is not an

academic issue as retail investors and FII's are currently flocking to our markets, and it will be interesting to see what type of returns they can logically expect from an index level of 8700.

First of all given current valuation levels, with P/E multiples near 20 times 2005, it is unlikely that P/E multiples will expand further over the coming decade. We should count ourselves lucky if we do not get P/E contraction dragging down expected returns.

For earnings growth, as pointed out earlier it is closely linked to nominal GDP. In fact if one were to look closely at the data, while market earnings track nominal GDP, earnings per share growth trails nominal GDP by about 2% points due to dilution. My best case for nominal GDP over the coming decade is in the region of 10-11% (6.5% GDP and 4.5% inflation), leading to market EPS growth of about 9% (assuming same 2% dilution as in the U.S). If one expects higher inflation to boost nominal GDP and thus earnings, one should bear in mind that higher inflation will lead to higher interest rates as well, which will drag down P/E's. Thus whatever is gained from the higher earnings will be more than given up through lower multiples in such a scenario.

As for dividends the current level of about 2% seems appropriate from a forecasting perspective, as yields are unlikely to rise from here unless multiples contract. Companies do not change payout ratios based on their stock price, thus the same 50% payout gives you a dividend yield of 2.5% at a 20 P/E and 5% dividend yield at a 10 multiple.

Thus even for the Indian markets, for anyone investing today it looks unlikely that they will earn much above 11% over the coming decade and that too assuming current multiples hold and we have no P/E contraction. If P/E's were to contract to say 15, then returns would be below 10%.

As for the flaws in the above arguments, investors may genuinely believe that multiples will expand still further to 25 or even 30 times. While this may even happen over the short term, the history of emerging markets shows that to sustain multiples over 20 for an extended period of time is quite rare.

Investors may also argue that earnings growth in India will be faster than nominal GDP, as the private listed corporate sector is growing much faster than the broad economy. While there is some truth to this argument, the listed equity markets in India have very good sectoral representation, and should mirror the broad economy. Financial History across geographies also shows the difficulty for market earnings to even come close to nominal GDP let alone exceed it.

Thus you have it, looking at the numbers it looks unlikely that anyone buying the Indian market today will be able to get more than a 10-11% return p.a over the coming decade (best case assuming no P/E contraction).

With risk free long bonds yielding 7%, is 3% enough of a return premium for taking equity risk? History and data across emerging markets would argue that the risk premium is too low.

4. Asia's next growth driver

27 Sep. 05

While Asia is undoubtedly currently the fastest growing region in the world, this growth is still largely external driven. There is a strong feeling among investors that Asian growth is still very dependent on the U.S consumer. If and when the U.S consumer were to slow down this would have a disproportionate impact on Asia. Despite the strong internal growth in India and China, there is very little sign of a truly independent domestic demand led story across the region. Demand that would be autonomous and could take over as a driver of global growth when the inevitable day of judgment arrives for the U.S consumer, and U.S consumption slows down and savings rates normalize. If the U.S current account has to ever come into control, then the baton of growth will have to pass onto Asia at some point, the assumption is that at this stage the Asian consumer will have to step up.

To most observers the only reason that Asia has not been able to step up to the plate and make a greater contribution to global growth and determining its own economic destiny is the weakness of the Asian consumer. After all the Asian economic block has a collective GDP of about \$10 trillion, very similar to the size of the U.S and the EU, yet nobody actually thinks the Asian consumer is anywhere near as important as the folks living in the U.S and Europe. In fact the most common question among investors is as to when will the Asian consumer come into his/her own and take off.

This perception of a weak Asian consumer dragging down the ability of Asia to determine and drive its own economic destiny, is largely based on two arguments.

First of all there seems to be real hard economic data showing that consumer momentum and importance has faded across the region. Charts produced by UBS in a recent research paper clearly show the reduced contribution of private consumption spending to aggregate Asian real GDP growth. For the region as a whole (including Japan), households accounted for nearly 3 percentage points of growth in the 80's and less than 1% on average since 1998. (source Jonathan Anderson-UBS).

The second related point is that the Asian households are underleveraged compared to their counterparts in the U.S and Europe, and hence less able to draw on future incomes for current consumption through debt. The feeling is that once consumer finance takes greater hold across Asia, this will provide the momentum consumers need.

Is there any basis to the above two points, or are they just perceptions that will not hold up when scrutinized through the lens of hard numbers?

In reality however neither of these two arguments actually holds up. While it is true that consumption spending has fallen as a share of GDP, this is more due to a declining household income share of GDP, and thus the slowdown in consumption is more a reflection of slower GDP growth rather than a cause. In fact Asian household savings rates have fallen steadily over this period from 10% of GDP in the late 1980's to 8% today. Moreover once you exclude India/China and Japan from the calculation you see a much sharper fall in savings rates from 15% of GDP in 1980's to 8% today. Not a situation of huge pent up consumer demand.

As to why the fall in the savings rate? It could be that either households are saving less on a gross basis or that they have taken on increasing amounts of debt, which addresses the second issue of the big Asian consumer bulls. As it turns out consumers have taken on significant additional leverage in almost every country in the region. If you plot charts of gross debt against per capita income, then no country in Asia looks significantly underleveraged.

UBS has also gone and tried to estimate net household financial wealth for the region, and discovered that while net wealth is rising it is doing so very slowly and not by very much. Even more important, all of the increase in Asian net wealth came during the 1990's, in the past 5 years financial asset positions have stagnated or even fallen.

In summary this is not the type of financial conditions in which one would expect to see a sharp increase in debt or further large decline in savings rate. In the absence of either of these two it is hard to see consumption in Asia accelerating significantly.

If the Asian consumer is not underspending and underleveraged, then from where will the much heralded domestic Asian recovery come from? How will Asian growth de-link from the U.S consumer?

It seems that the main driver of this de-linking process, instead of being the Asian consumer, may turn out to be Asian corporates.

Fixed investment ratios across Asia have fallen significantly, and totally collapsed if one excludes the larger Asian economies (India, China and Japan). Having dropped from 35% (mid 90's) to below 25% today, the overall investment ratio is not significantly different today from the level of the mid 1980's.

While investment ratios are similar to the mid 80's, companies' financial position has improved dramatically. In the mid 90's companies were significant borrowers of household savings drawing down as much as 12-15% of GDP, while today the same Asian companies are actually net savers themselves. As a result the continued large household savings is exported abroad through the Asian current account surplus.

The fact is that relative to their historical position as net borrowers, Asian companies have seen a huge adjustment in their leverage and cash flows over the past eight years.

Thus instead of obsessing about a surge in household consumption, investors in Asia should focus on their corporate sector and figure when and why will they start investing again. The corporates may hold the key to the Asian economies being able to grow autonomously, even more so than the much heralded Asian consumer. Within this Japanese firms have seen the strongest turnaround in savings behaviour and cash flow of any country in Asia. Keep a close eye on Japan, and also watch the smaller Asian countries/corporates as they are likely to be the major drivers of any Asian domestic resurgence. India and China are both growing very fast already and in the case of China facing a looming capex slowdown, thus they will not drive this metric.

5. How did it all start?

13 Sep. 05

After my last article, most people consider me far too cynical and old fashioned for this raging bull market. Trying to understand my own biases, I felt it would be useful to try and trace the origins of this bullrun. If one goes back to Feb-March 2003, that would in my mind mark the beginning of the current bull cycle from where the market has already more than doubled over the past 30 months. If one were to accept this as the starting point, what were conditions like back then which enabled this bull run?

First of all the markets in 2003 were very very cheap, trading at just about 10 times earnings (an all time low), interest rates had bottomed and there was tremendous surplus capacity available with Indian industry. Indian industry had also spent the last 3-4 years prior to 2003 getting its cost position aligned with global benchmarks, and was thus lean, mean and well positioned for any uptick in business. Commodity prices were also just beginning to rise. Basically everything was set for a huge surge in earnings if economic growth were to accelerate (operating leverage), and this is exactly what happened. We had excellent monsoons in 2003-04, and GDP growth accelerated to over 8%, corporate earnings rocketed, rising by over 40% and ROE (return on equity) and ROCE (return on capital employed) expanded as corporate India was able to use its idle capacity. The strong growth in earnings, coupled with rising ROE's and strong free cash flow attracted the attention of investors globally. These trends were only further reinforced in 04-05 and the current financial year as economic growth remained strong and corporate earnings vibrant. The strong commodity price environment of the past three years further reinforced these trends.

Thus one aspect of the bull story has been the good news on earnings and ROE's, coupled with very cheap valuations. India had the highest earnings growth and ROE's in the emerging markets universe.

The second aspect of the bull run was the feeling in mid 2003, of the country beginning to move in the right direction in terms of economic policies and reforms. This was the period when the previous NDA government was seen to be at its most effective.

We had the hope of serious progress on the power front, with the passing of the electricity act and the privatization of distribution in Delhi. The template to solving the country's power woes seemed to have been established. On roads and private sector involvement in ports there was tremendous progress. Airports were firmly on the privatization agenda, with the government calling for bids for Mumbai /Delhi airports. The government clearly indicated its desire to move below 51% in PSU banks, and allow entry of foreign banks. The beginnings of some movement on labour law relaxation was also visible. Disinvestment was strongly on the agenda, as was the desire to implement mega infrastructure projects like the interlinking of rivers. Post their expected re-election, investors were expecting the NDA to liberalize FDI in retail, list LIC, hike FDI limits across sectors and attack many of the other structural issues facing the Indian economy. All of the above was expected to keep the Indian economy on a decade long GDP growth trajectory of 7% plus.

The progress and belief in economic reforms accelerating the growth trajectory of the country was the second part of this bull story. That India had begun its journey to fulfill its economic destiny was a common belief.

The third part of this bull cycle, is related to trends in global liquidity and the general move of investors towards emerging markets. Strong global liquidity encouraged investors to look for returns wherever they could find them, and India's price momentum was self reinforcing.

Now if we were to examine each of these points today one gets a very different picture.

Firstly on valuations, trading at 15-16 times earnings the markets in India are no longer cheap (among the most expensive in the EM universe). Also it is my humble submission that given the slew of capex announcements and fund raisings, ROE's and ROCE's have peaked for corporate India. Most of the idle capacity available has been used and growth from here needs companies to set up new capacity. Interest rates can only rise and operating leverage diminish.

Thus even if GDP growth were to remain strong, the pace of corporate earnings will slow and they can no longer grow at 3-4 times nominal GDP. Free cash flows for corporate India have already turned negative. Slowing earnings, falling ROE's and declining free cash flow is normally a recipe for P/E contraction, not expansion.

On the reforms front the less said the better, not a single item mentioned previously in this article has been implemented or has any chance of being implemented by the UPA alliance. I cannot understand how anyone can genuinely believe that India has entered a new era of 7% plus GDP growth in the absence of progress on power reforms, labour laws and other structural impediments. The UPA alliance has even managed to sidetrack the roads program for the last 12 months. I think investors are deluding themselves if they think economic performance in India has totally delinked from governmental action on reforms/infrastructure and governance in general. If this government does not get its act together on electricity, roads, railways, airports etc. then these infrastructure constraints are bound to eventually short circuit growth. Does any investor truly believe this government will be able to attack the structural constraints holding back industry?

On the liquidity front also the party cannot last forever, emerging markets have had 5 good years in relative terms and could easily reverse. Global interest rates are poised to rise and FII inflows into India are at unsustainable levels.

This bull market began with very cheap markets, strongly accelerating earnings, rising ROE's and the hope that the country was on the right track in terms of structural reforms. The external liquidity environment was also very supportive for investors to buy into a long term story like India. Most of these factors have now reversed, yet the bulls expect markets to keep rising. A period of consolidation is the best case outcome to my mind.