Investing in Indian Public Equity Markets

By Parag Patel

Investing in the Indian public equity markets poses both challenges and opportunities. Currently, only individual investors who are Persons of Indian Origin (PIOs) are allowed to invest in the public equity markets. Non-PIOs are compelled to find funds that focus on India. Institutional investors either can invest in India through offshore derivative instruments (ODI) or directly if they obtain a foreign institutional investor (FII) license. Investing through ODI poses greater costs and restrictions; therefore, it generally is advantageous to invest directly if investors can obtain an FII license. An individual investor, regardless of the amount of assets, does not qualify for an FII license.

Government and Democracy
Since India’s financial crisis in 1991, successive governments have maintained a strong commitment to free market economics and successfully reformed India’s prior semi-socialist economy. Real gross domestic product (GDP) growth has averaged around 8 percent over the past five years, making India the second-fastest growing economy in Asia. The government has liberalized many sectors, significantly reduced tariffs and other barriers to global trade, encouraged foreign direct investment, and simplified the tax structure. Additionally, India is less vulnerable to a U.S. slowdown than its Asian peers because its economy is less dependent on exports. A further source of strength has been India’s robust banking system. India’s banking sector has dramatically improved performance by implementing sound policies and regulations that conform and sometimes exceed global standards. Through all these reforms, India has successfully maintained a stable democracy with a free media, independent judiciary, and vigorous debate among a large number of national and regional political parties. India’s civilian governments since Independence in 1947 always have controlled the Indian military. The fact that India never has had a military coup is impressive given its hostile and politically/economically unstable neighbors (e.g., Pakistan, Nepal, Bangladesh, Sri Lanka) and the nation’s historical corruption, gross economic mismanagement, and misallocation of capital.

Demographics, Diversity, and Entrepreneurial Drive
No other nation or common market has the uniquely positive combination of democracy, demographies, diversity, and entrepreneurial drive of India. These four sustainable attributes, coupled with rising incomes and increasing investment in infrastructure development, offer patient investors the opportunity to generate excess returns. India is the largest democracy in the world and has one of the youngest populations; 50 percent of the population is under age 25 and 70 percent is under age 35. India also has the second-largest pool of English-speaking university graduates in the world and is a culmination of centuries of assimilation of different ethnic and religious groups. India has the second-largest population of Muslims and various minorities that actively participate in both politics and commerce. Despite the fact that 81 percent of the population practices Hinduism, Prime Minister Manmohan Singh, former President Abdul Kalam, and Sonia Gandhi, head of the ruling Congress Party, are from the minority Sikh, Muslim, and Christian religious communities, respectively. Additionally, the minority Parsi community in India, which totals approximately 70,000 people, manages at least 4 percent of India’s GDP and is deeply respected and admired for its many charitable activities.

Challenges Facing the Country
India’s widely expected economic transformation is by no means certain because the country faces many significant challenges, including the following:

- inadequate infrastructure
- restrictive labor laws and limited vocational training opportunities
- large fiscal public-sector deficits (both central and state government)
- continued corruption by politicians and bureaucrats
- inefficient and ineffective civil court system
- poverty, illiteracy, and ineffective public education

We believe that India has the political and economic leadership and an as-
The Investment Opportunity

India offers attractive long-term investment opportunities in many industries that focus on both the export of globally competitive manufacturing or services and domestic demand. India has one of Asia’s oldest stock markets and its regulator, the Securities and Exchange Board of India (SEBI), is internationally recognized for its sound regulatory and enforcement decisions. The valuation of large-cap stocks in India is about 20 times current-year earnings and 18 times forward earnings. These valuations are high on an historical basis and when compared with other emerging markets in the world.

Most of the domestic and foreign portfolio investment in India has been channeled into these large-cap stocks (i.e., stocks with a market capitalization of greater than $1 billion) for the following reasons:

- desire for liquidity
- inability to acquire a meaningful position given the small float in small- and mid-cap stocks
- lack of institutional research coverage for small- and mid-cap stocks
- inability to tolerate drawdowns (small- and mid-cap stocks historically have shown greater volatility in market corrections)
- management teams with limited experience and lack of governance oversight
- lack of personnel to communicate effectively with the investment community

Investing in stocks of emerging market countries such as India will generate optimum returns with a long-term investment horizon—at least three years. Contrarian investors would argue that appreciation might be limited because the Sensex (the Indian Index equivalent to the Dow) has appreciated 130 percent in the past three years. If investors can tolerate lower liquidity, they will have the opportunity to generate greater returns by investing in funds that emphasize small- and mid-cap stocks. In most global markets, small- and mid-cap stocks present greater opportunities for finding undervalued companies because they are not properly researched. Investors who are willing to do extensive fundamental research on small- and mid-cap firms in India will find well-managed and well-governed companies with return on investment capital greater than 17 percent trading at less than nine times earnings—where earnings are reasonably forecasted to grow at greater than 25 percent over the next three years. Approximately 1,250 companies with market capitalizations between $25 million and $1 billion represent an aggregate $200-billion market cap and $100-billion free float (see figure 1).

Investing in an India-focused Fund

Investors need to carefully consider a number of critical questions when investing in India-focused funds, including the following:

1. What is the historical performance?
2. How does the investment manager generate investment ideas?
3. What type of fundamental research process does the manager follow and what is the range of time that it would take to complete this process?
4. What innovative sources and/or techniques does the manager employ when trying to have a dialogue with industry participants?
5. Does the investment manager strive to maintain an active dialogue with the management, board, and other significant shareholders of the company?

6. Does the manager have the investment professionals in India necessary to follow a disciplined research process? Many people can articulate a plan, but fewer have the will and human resources to follow through.

7. Does the investment team work in a collaborative environment where critical questioning and discussion are encouraged?

8. What process does the investment manager follow to monitor the investments in the portfolio? Does the investment team regularly seek out contrary data and opinion and retest the investment thesis?

9. Does the fund have the flexibility to maintain large cash balances when valuations are high?

10. Does the fund have redemption penalties so as to minimize the presence of less-stable, speculative investors? How large can the fund grow and stay consistent with its investment philosophy and methodology?

To be successful small- and mid-cap investors in India, funds need a long-term investment horizon and a patient investor base. Investors in small- and mid-cap stocks must accept greater management and execution risk. Therefore, it is critical to select a manager with significant experience in and a deep commitment to performing extensive fundamental research and analysis. Additionally, it is important that managers have an active dialogue with the management, board, and significant shareholders of the companies. When necessary, the manager should be willing to write formal letters with specific recommendations and comment on historical or future decisions. Publicly traded Indian companies generally welcome constructive comments from long-term-oriented shareholders. Language is not a barrier to communication; all Indian companies are comfortable communicating in English.

In India, as in the United States, the new wealth creators (both for shareholders and society) in 2006 were different than they were in 2000, and they will be different in 2009 as well. Managers that have a thorough research process will be in a better position to identify these companies. One undeniable investment theme we see is the development of the rural economy in India. There are many compelling reasons for why this will be an increasingly important factor in economic growth. Indian companies are being forced to use their resources more efficiently and the cost of labor, land, and materials in the rural regions is substantially cheaper. The forecasted development of the rural economy will allow new economic leaders to emerge, creating attractive investment opportunities for patient investors. We believe that investors have the potential to earn excess returns by focusing on small- and mid-cap stocks with a three- to five-year investment horizon.

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