

Assessing India's Investment Potentials

A Rendezvous with Global Experts



As an outcome of its endeavor to assess the investment potentials in India Wells Fargo Advisors recently released a report titled “India Comes of Age” which takes a fresh look at the risk and return characteristics of the Indian markets and identifies their relationships adopting a macroeconomic perspective.

In this exclusive endeavor for ChindiaBiz™ the ICA Institute presents **Paul Christopher, CFA, and Sean Lynch, CFA, of Wells Fargo**, in an interview with Prashant Das and Anitha Vadavatha of the India China America (ICA) Institute.



Paul Christopher, CFA

Chief International Investment Strategist, Wells Fargo Advisors, USA

Paul is based in St. Louis, MO, focuses on the international economic outlook and offers investment advice on international equities and debt, as well as currencies and commodities.



Sean Lynch, CFA

Global Investment Strategist, Wells Fargo Private Bank, USA

Based in Omaha, Neb. Sean Lynch is responsible for developing and implementing global strategy across all asset classes, researching investment opportunities around global themes and coordinating global research strategy.

Anitha: Given that demographics are the main drivers of the emergence of BRIC economies, how sustainable such a growth is? Are these nations, in your opinion, planning sufficiently for the future when the population starts ageing?

Paul: The two components of national saving are the population growth rate and the saving behavior of the average individual. India has the largest share of population under age 30 among the BRIC¹ countries, and we do not envision a significant drop in birth rates (though a change in birth rates is certainly possible in the coming generations). The second element – per person saving – runs between 25 percent and 30 percent. While this is lower than in China (50 percent savings rate), the Indian saving rate is significant.

An alternative way to think of this issue is to ask how India will improve its productivity. GDP growth can be proxied by population growth plus productivity growth. While the population growth rate is important, the productivity growth rate may be a richer source of growth improvement. At the present, the infrastructure deficit imposes high costs across the economy. In a service-oriented economy, productivity growth is especially important as a way to maintain India's comparative advantage.

Sean: Both India and China have young populations. We also see demographics and education as important drivers to watch. How these countries address these two issues could help us understand growth and its sustainability. As far as china is concerned, how the Chinese government

¹ Brazil, Russia, India, and China

handles healthcare for their ageing population will be critical. They have managed education and jobs well so far and have enjoyed the demographic dividend. The difference between India and China is that the population make up (in China) is 15 years ahead of India. If India can execute and handle the demographic dividend that will be coming its way in the next 15 years, it could set its economy up for impressive growth.

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Prashant: It seems that India has been successful in producing skilled manpower which, perhaps, is a step towards reinforcing the productivity growth. At the same time, questions have been raised about the quality of manpower being produced. Moreover, a large proportion of skilled manpower moves to other countries in search of opportunities. How do you perceive these phenomena when assessing the investment potentials of the country as a whole?

Paul: It’s an interesting question, but we had no direct answer to this question during our trip. In general, the so-called brain drain has been a factor for many decades, but productivity (and ultimately

wage) gains do not have to be curtailed, just because of emigration.

Sean: One observation I have concerns wage inflation. Can India keep up with the growing demand for food & oil, skilled labor, and high-end jobs? We are unlikely to see much wage inflation much if India continues to develop the skills of its workforce. Over the past 10 years, the literacy rate in India has risen from 65% to 74%. At the base level, this is a huge increase. The worry is whether ten years down the line we will continue to see this trend and whether those looking for jobs will have the necessary skills - As investors we will be watching that movement closely.

Anitha: The Prime Minister of India has set 'Decade of Innovation 2010-2020 National Innovation Policy' to promote innovation in all walks of life, with a focus on inclusive growth". How do you see this government mandate influence/impact the investment culture, climate and opportunities in India? - What about technological investments?

Paul: The answer is an emphatic yes. India has a history of local innovation but we need to be careful of defining it. It is much more than scientific breakthroughs. The decree is a good sign. Certainly there is a lot of demand & it’s a good thing. That’s why we are optimistic.

Sean: During our recent trip to India, we saw the commitment to innovation & technology, from hearing public companies in Delhi talk about the commitment to technology to Hyderabad, where there is movement towards building very vibrant

downtown 'tech' areas. We gathered the same information when meeting with Indian-based companies, including large multinationals.

“...Inflation appears to us to be the most obvious symptom of India's most pressing policy problems...”

Prashant: Inflation portrays a stark difference between economies like India and the United States. As global investment advisors, how do you perceive this difference: as an opportunity or a threat?

Sean: One thing we are watching is the rising food prices, which initially were caused by a bad monsoon season. Food inflation can creep into wage inflation. We need to keep a close watch on these trends as investors. We found that it (wage inflation) is currently 15% and is expected to be 30%. Energy and food inflation could have an impact on demand of skilled labor. How all of this pans out could be important when assessing Indian market.

Paul: Inflation appears to us to be the most obvious symptom of India's most pressing policy problems. On the one hand, the inflation can result from the cost-push. High and rising costs due to inadequate infrastructure have been well-documented in the Indian press, and the requisite infrastructure improvements have been formalized in the current five-year development plan. Cost-push inflation can

also result from conflict between development and environmental protection policy. India imports nearly all her crude oil, but coal is available locally. The dilemma is that developing the coal reserves has been hampered by environmental regulations that work counter to this coal development. These policies should be harmonized, in order to develop this natural resource.

From our perspective, a second policy threat to inflation comes from the Union budget, which still runs a deficit estimated at between 3.5 percent and 4 percent of GDP. The government puts a high priority on subsidies and income support programs, but the high deficit crowds out private investment and raises borrowing costs. Put simply, the government budget deficit benefits many people, but the restraint on the private capital market also carries a cost in lost opportunity for organic growth. This is a difficult tradeoff to face, but the budget deficit is coming down, if slowly.

Prashant: This appears to be a classical issue with the democratic set up. How would you compare the Chinese market in this context?

Paul: The Chinese case seems to turn on government dictates, which of course can produce capital misallocations of their own. For example, it seems that in China the government's employment goals in the 1970s and 1980s produced large state-owned industries that were inefficient. More recently, the social policy has been about housing, which has become a source of inflation pressure.

Sean: Many investors like to compare the two countries, but India distinguishes itself from China in a number of ways. Many Indians are proficient in English, the political system is a strongly democratic one, the legal system is more structurally sound than China's, and the information technology sector is first-rate.

The Chinese financial markets are gradually opening, but still remain relatively inaccessible to many investors. Chinese companies lack the transparency that is necessary to do proper due diligence effectively, and many do not follow international accounting standards. In addition, because of the speculative nature of equity markets and poor liquidity in some stocks due to large government stakes, the prices of individual equities can be volatile.

“... It's very difficult to appraise the (mid- and small-cap) firms and their assets from an investment perspective...”

Anitha: In India, Entrepreneurship is rising dramatically and thriving. Changes in opportunities with factors such as access to capital, freedom from rising market efficiency, governmental involvement, and infrastructure combined with a seemingly 'woken up' ambition of a billion+ populace is fueling a sense of urgency. How do you think this movement of entrepreneurship affecting and shaping the future investment climate?

Paul: A combination of early aspirational drive and a momentum for achievement—in the last 20 years as you pointed out – are evident in India— On our way to Taj Mahal (from New Delhi) we saw people living in corrugated aluminium huts, yet holding Vodafone sets. Advertising placed on the roofs of the huts was ubiquitous.

However, the fund managers we spoke with are quick to advise that it's very difficult to appraise the firms and their assets from an investment perspective. The price discovery and valuation of mid- and to small - cap companies is very challenging as it is difficult to get accurate information. So, it may discourage the investors. Yet, larger tech companies seem to be doing great (in this regard).

Sean: In some of the large cities we visited we saw that Indian youth appear to exhibit unbridled ambition. As a result of the optimism generated by the country's 8-9% growth rate, we heard the statement 'this time we're not going back' a number of times. It is a very positive sign for the long-term development of India. Obviously, the commitment towards technology is a great driver.

Determining how much you can trust company management is a key factor in figuring out whether this optimism is justified. In the U.S., due to regulatory controls, U.S. corporate managers are unable to give you detailed company information. . This does not seem to be the case in India. We talked to mutual fund managers and some Private Equity managers (in India); we found it interesting that many require on site visits with



company management teams multiple times during a year. This is reminiscent of what value investors in the United States were doing 20-30 years ago. Capital is likely to flow to these entrepreneurs more freely and rapidly when that trust is developed.

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Prashant: *(In the report) You mention three main causes of volatility in the emerging markets: infrastructure constraints, inflation and corruption. The scenario is not likely to change any time soon in India. What, then, makes the investors perceive a higher reward compared to the risks inherent in this market? Are they more interested in long or short term investments?*

Paul: We do see a trajectory of improvement (though we mean to return to India frequently to confirm the trend). The government's long-term financial commitment to infrastructure development is encouraging. As for corruption, it is important for investors to realize that corruption exists in all economies, including in developed countries. Our conversations with Indian business leaders indicated that day-to-day corruption (e.g., speed money) shows no signs of diminishing. However, the treatment of the 2G scandal was a good

sign. The handling of the scandal in the press, and by the prosecutors was heartening.

We also noted progress in some states (e.g., Gujarat). In fact, many Indian business people contrasted government efficiency at the state level versus the greater inefficiency at the national level. While this difference frustrates businesses and consumers, some business and media leaders expressed the hope that strong state leaders may eventually rise to the national level and forge a strong consensus that may accelerate reforms in terms of the budget, corruption, and inflation.

In the end, we saw a very strong further growth potential in India – the country managed 8-plus percent annual economic growth for most of the past decade, even with all these problems. We see some progress on the problems but are even more persuaded by the aspirational drive of Indian households and businesses across classes in the society. We expect to return in the coming months to confirm this conclusion but are convinced enough to recommend that our clients take the same long-term perspective on opportunities in India that her people themselves take.

Sean: Given the nature of the three sources of volatility (infrastructure constraints, inflation and corruption) the investment horizon is long term. In fact, in the Private Bank we have a long-term bias towards Emerging Markets investments for this very reason. Each one of these points inherently has risks that, if not properly addressed, have potential for significant loss to investor capital. Investors will need to be

compensated for additional risks in the form of higher rate of return.

Prashant: With an investment perspective, how do you differentiate between Indian companies listed in India versus the Indian companies listed in the United States? Does it mitigate any exchange rate risks?



Paul: ADR's² are can be convenient for (our) clients. For the U.S.-listed Indian companies, we would follow the sensitivity of earnings to exchange rate changes (economists call this a version of the price elasticity of revenue). This measure also matters for Indian-listed companies. In terms of the ease it is hard to beat the ADRs as they provide access to capital appreciation but we still have to face the exchange rate exposure.

Sean: A good number of large (Indian) companies are available through ADR investments. We continue to look for opportunities in ADRs, especially for high

net-worth clients. Also, we keep looking at broad-based diversified "pooled vehicles", such as exchange traded funds (ETF's), to generate exposure to the India story.. From a diversification perspective, we want to be careful with individual ADRs – understanding what the exposure to individual companies represents.

Prashant: The debt markets (domestic as well as corporate) are yet to mature in India. How would you interpret this attitude of Indians: undervaluing the benefits of leverage or being too careful about leverage?

Paul: We did not get a strong sense about Indians' attitudes about leverage. We did see that mortgage companies have taken a more careful approach to leverage than U.S. companies did in the past decade. Still, our clients are more directly affected by the Indian government's limit on foreign debt ownership. The limitation's rationale seems to follow from the goal of avoiding the disruption that may come from rapid inflows and outflows of foreign investment capital. However, this ceiling on foreign ownership seems an obvious constraint on the market's development. The fixed income market from a foreign investor standpoint creates a little bit of frustration. The (corporate) bond market is not as developed. Some capital (for the infrastructure development) can come from debt financing; so the local debt markets need to be ready. We expect further bond-market development.

Sean: One of the bankers (in India) that we talked to asserted that they do not let the LTV (Loan to Value Ratio) goe too high.

² American Depositary Receipts

India, culturally, is more about equity. Similarly, there is a long history of bank financing in Europe. In China, a large portion of the savings is motivated by a sense of security. This (the attitude towards saving) could change due to the increased appetite for consumption among the younger population.

Paul: Not sure how much of it (saving) is cultural – Earlier the US, too, stressed on saving. But U.S. saving rates declined beginning in the mid-1960s, coinciding with a significantly expanded social safety net.



Anitha: *Since the industrialization & liberalization of Indian economy in early 90's, with private sectoral reforms, policy and regulation played both a favorable and unfavorable role in accelerating growth opportunities in India. Apart from the markets' commercial attractiveness, the continuous evolution of policy framework and regulatory structure is seen as a hindrance to some extent with respect to the pace of growth. How critical is the role of policy reforms in looking at India as*

the choicest investment markets for foreign investors? Also how do you see the overall FDI attractiveness of India as compared to other emerging nations?

Paul: Also, the issue with the government is how much leadership it could provide. Land zoning, especially in regard to agriculture, is a special hindrance. Starvation and food crises are results of the policies of the last 200 years and probably motivate zoning laws that rigorously protect individual families' access to land for farming. Breaking up land holdings into small pieces may avoid some problems but creates others – mainly agricultural inefficiency and constraints on business expansion. Over time, India's land management policies need to adapt as the disadvantages of the current laws become more costly. One interesting thing about India is its pluralistic society; there are states and there is a 'union'. Pluralism is a large advantage for long-run economic development. However, pluralism that cannot settle on strong leadership can delay development and frustrate progress. So, the business people we talked to mention that India's 20 years of coalition government have not always provided decisive leadership. For example, the tension between environmental protection and energy development was mentioned as one area for clearer policy. Land zoning was another. In general, business people were frustrated by the number of cabinet-level committees that discuss issues at length but delay policy decisions. Meanwhile, some state leaders have acquired popularity and political power for their parties by focusing

on implementing development policy – Gujarat, for instance.

Sean: Well said.

Prashant: A fundamental question: what makes an emerging market like India more appealing to global investors compared with developed markets like Europe and less developed markets like Africa?

Paul: Good question. The developed markets of Europe we would still include in a core, diversified investment, but their slow growth, poor trade competitiveness, and heavy debt burdens argue for underweighting, compared to markets (e.g., India) that have better growth prospects, including trade markets. On the other hand, quite a few markets in the world (mostly what are known as “frontier markets”) are not suitable, because many of their risks are not priced. African and some other markets face challenges still from religious turmoil, military interference in politics, chronic civil war, and unreliable rule of law. People sometimes forget that it took today’s emerging markets generations to resolve these mostly institutional problems. Today’s frontier markets may seem to be where yesterday’s emerging markets were 20 years ago, but there is no assurance that these difficult challenges -- which have been challenges for centuries – can necessarily be solved in the coming 10-20 years or even in the lifetime of any investor today. In all, liquidity, transparency and the rule of law differentiate the attractive emerging markets from the other, not-quite-ready developing markets.

Sean: Opportunity set; this is one of the biggest values that a growing economy (like India) has to offer. India is witnessing (the emergence of) some very exciting companies and sectors. – Liquidity is another factor that encourages us to invest in India. Frontier markets, like many of those in Africa, by definition are usually tough to access. Growth may be positive in some of those regions, but with India, we can hopefully have the growth along with very liquid and well established exchanges.

Prashant: Finally, could we have some comparative remarks from you on India and China on their investment potentials?

Paul: Investors should not think of India versus China but India and China and Asia. China is a state-driven economy and is a world-class manufacturing hub. India with a more diverse way of pursuing development has built a knowledge & service-based economy and intends to take the economy further in that direction. Strategic development, education and business remain the focal points to government policies in both the economies.

Sean: John Flannery, India’s GE President and CEO, said it very well—that India is starting to develop managerial talent but does not have legacy senior management-level expertise. That’s what is lacking. From a firm perspective on where we need to invest – the first two places we have visited and done extensive research are China & India – their importance on global stage is critical.



About India China America (ICA) Institute

The ICA Institute is a non-profit research institute working to foster research and dissemination of knowledge on the rise of China and India and their impact on global markets, global resources and geopolitics of the world. The ICA Institute's mission is to generate new perspectives on the role of market and resource driven economic development. ICA Institute fosters interaction and dialogue between academic scholars, industry leaders and policy makers on the impact of emerging economies in general and China and India in particular. Specifically, ICA Institute is positioned to be a catalyst between faculty and students in International Business and industry leaders and managers.

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