

## Newsletter for June 2015

By Homiyar Dara Vasania, CEO

### Musings from India: The Good, the Bad and the Ugly

Jamshed and I were in India last week meeting up with various corporates and market participants. We were also accompanied by Jeetu Panjabi, who we introduced to our investors and other readers in December 2014 and who is a board member of the River Valley Core Compounding Fund. We met a collection of small and large corporates, sell side analysts and strategists. Interestingly we also met some insightful investors running assets in India (family offices, global hedge funds, local mutual funds, etc.).

The broad take aways from this trip are many and, as the heading of this article says, there were a few good ones, plenty of bad ones and a few ugly ones. The economy and the market are at a strange crossroads of expectations coming up against reality. Expectations have been pared down for the near term, though the long term expectation of “Modi being a game changer” is still universal. On the other hand, the reality is relatively grim. The positives are that the good stories of the pre-Modi days still remain on track and these companies continue to be those one would like to own at the right price.

Our ten take aways from this trip are:

1. As always, there are interesting small and mid cap companies one can meet in India. These are companies with strong entrepreneurial spirit, some with good and articulate management, many of them in industries that are growing (with or without Modi), surviving in a competitive environment and coming out stronger, etc. As expected, these come with pitfalls like erratic corporate governance, volatile earnings and high valuation. But this is the universe from which the future blue chips will emerge.

2. Private sector banks' secular story is still on: This continues to be a story where these private banks continue to erode away market share from the comatose universe of PSU banks. They pick and choose clients, are leaders in technology, have much better credit departments and hence make fat ROEs. The quality varies across these banks but all benefit from this positive environment.
3. The consumer discretionary sector is a mixed bag - the consumer durables sector is showing a strong growth, the four-wheeler sector is growing at par but the two-wheeler sector is doing poorly.
4. CV sales are rebounding: Ultimately one can postpone CV purchases only so much. With CVs ageing, underlying transportation demand still growing (though at a slower pace) and fuel price drop improving the ROE of the business, CV demand has strongly rebounded in the last few quarters.
5. Policy change is happening but is not visible at the ground level: We continue to hear about and see the policy change happening at the central government level. However, the actual change at the ground level that a mid size business would want to see is not visible. Company after company that we met mentioned this. Hence Modi's next big push would need to deal with how the state level political leadership and bureaucracy become more responsive and answerable. This is unfortunately a long drawn out process and it is hoped that the electorate will not lose its patience before this happens. Unlike China, India has never been a top down economy or governance structure. The best things in India happen bottom up (as we have always said about the companies in India). Hence the real change in governance will only show up bottom up.
6. Rental drops are a reality: This is a negative or a positive depending on where you stand. Some of the companies using commercial space mentioned spot rates which are 20-30% below the last actual rent paid. This is an obvious consequence of a spot market which has not gone up in the last few years but where long term leases are signed with rent escalation clauses of 10-12% p.a. Also, India is seeing significant pockets of empty commercial space, whether it is in a dead and run down looking Nariman Point (the old CBD of Mumbai), space in IT parks in Bangalore or simply commercial space required by a gym operator in a tier 2 city. The residential market is less transparent but even there the excesses of the past few years are showing up. Agricultural land is where the anecdotal evidence is talking about a sharp drop in prices. These are non transparent markets with many of the transactions happening in cash. With the new government's focus on corruption and a lot more money to be made in the stock market, this demand has dried up quickly.

7. Rural demand looks poor: This is the new hidden weak link in the overall demand story. With a tapering off of subsidies, reduced wealth creation from land sales and now potentially a poor monsoon, rural demand could remain poor. Companies in sectors like two wheelers, farm equipment and cement have mentioned poor rural demand impacting their business.
8. Infrastructure-/ investment-related demand is showing no signs of rebounding: This is where the maximum hope from Modi was. There is no clear turnaround in this trend, although the optimists' point that it is only a question of time before this starts growing is probably true. With a quickened pace of project clearance in some of the industries, coal auctions, etc. we could see some rebound.
9. Corporate earnings remain patchy: We had mentioned this in last month's newsletter. A large number of the companies that we met were struggling to meet long term earnings growth targets.
10. Banks need recapitalisation: The Indian public sector banks are in a dire need of recapitalisation. They still have a 60% market share of the overall banking system but are unable to lend or take deposits because of a depreciated capital base. Either they will need to be given the freedom to undertake asset restructuring of defaulting borrowers and/ or they will need large doses of new capital infusion. This is somewhat similar to what the Chinese banking system requires. Without this, even the good private sector banks' lending ability will be reduced as they will not be able to spread out risk to these banks. This is probably the most urgent requirement from the Modi government and RBI.

Through our trip we have come away with some interesting investible ideas and hope to act on them soon enough.

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