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Up with India

"India is one of the biggest structural changes taking place in the world today," Jon Thorn, manager of the India Capital Fund, a 21-year-old, $327 million private investment partnership, told the *Grant's* audience, "and unlike, say, Greece, it's a very positive one."

Of course, as Thorn readily acknowledged, the Indian stock market has been on a tear, up by 44% since the lows preceding last year's electoral triumph of Narendra Modi. Not for that reason, though, are Indian stocks expensive, our speaker insisted. At 16.3 times the estimated 2015 earnings and 20.4 times' trailing 2014 earnings, the Bombay Stock Exchange index is "only a little above" its 10-year average price-earnings ratio of 18.1, said Thorn. It happened to be very cheap before.

"Goldman is assuming around 20% to 25% growth in earnings per share for the next two years," Thorn continued, "so even if multiples contract a little bit, that is not so bad I think. The upside risk is the price of oil—if it is lower for longer, then, of course, EPS will rise faster than currently estimated as margins expand."

"Prosperity" and "India" may seem an odd pairing of words. Way back when, say, 1950-1990, the former British colony earned a reputation for state-administered mediocrity. Theorists, eager to make excuses for failed economic policies, propounded the notion of a "Hindu rate of growth." You see, they contended, the passive Hindu mind-set was perfectly content with economic stagnation.

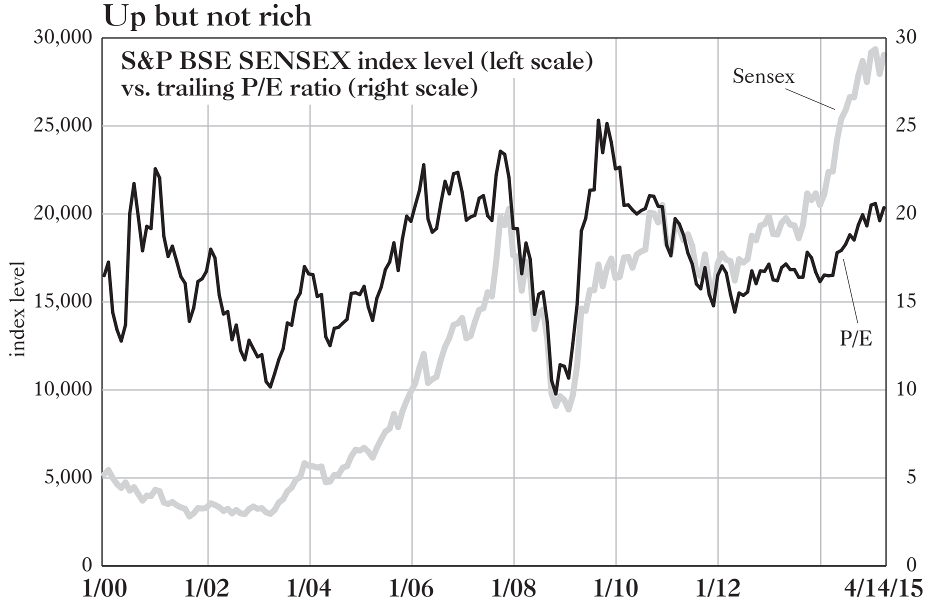
When in 1991, the government fresh out of foreign exchange, implemented some free-market reforms as a condition for accessing profered IMF loans, growth accelerated. Instead of the customary less than 4% per annual pace, the Indian economy expanded at a 6% pace. So, observed Thorn, 50% more over the next eight years. "But I didn't notice that India was any less Hindu."

With respect to India, as well as to innumerable other financial subjects, people are prone to think the same thing at the same time, our speaker went on. So when in 2013, Morgan Stanley named India as one of the "Fragile Five" (Brazil, Indonesia, South Africa and Turkey being the others), many investors solemnly nodded. What the bears misunderstood was that India's troubles were cyclical not secular.

As for Prime Minister Modi, Thorn continued, he is not only a master politician and a successful administrator (for 12 years, he worked economic development miracles in the state of Gujarat), but also one lucky duck. "Things are certainly going his way, with the IMF predicting that India will soon be the fastest growing economy in the world, and perhaps it is now. India's best friend is a low oil price," said Thorn. If the Modi luck continues to hold, the prime minister will win a second five-year term.

"So, how are we investing in India?" Thorn asked, and he proceeded to answer: "As we believe there is a cyclical recovery taking place along with structural improvements, we are focused on the cyclicals: banks and financials. Credit growth should be faster than nominal GDP, and, if so, the best banks

Up but not rich



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will take that to the bottom line, more or less…. The other sector we like is vehicles—personal vehicles and especially commercial vehicles.

"HDFC Bank, one of our holdings, is arguably the best operating bank in the world," he said. "This is sadly not unknown and therefore there is a valuation to pay for this jewel [5.6 times book value and 23.4 times the consensus in the year ending March 31, 2015, earnings estimate], and we decided to pay it. There is an American depository receipt. The ADR and the foreign shares in India both trade at a premium to the local underlying share. This bank should generate 20% bottom line growth for the next few years and is among the highest quality credits in India." Vital signs include net interest margin of 4.4%, return on equity of 21.6% and—over the past five years—compound growth in book value of 24%."

Thorn touched on Reliance Industries Ltd., India's biggest private company and its top exporter: "We used to be strong RIL haters and were probably the only India fund and perhaps Asia fund that did not own it for our first 10 years, as the accounts were impossible to understand; such was the scale of the cap-ex shell game going on. Then things changed enough for us to buy it. We made a lot of money. We sold once a new cap-ex round started and family problems looked a bit scary. Those are mostly over now. The 4G telecom product about to be rolled out is going to be something and will drive commerce in India in a way that's hard to predict. We will see. Other drags have been retail and shale gas. And in contrast to HDFC Bank, it's cheap, so it's reasonable to buy and wait."

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