

India Strategy: The squandering of a once-in-a-generation opportunity

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Political in-fighting in Delhi....

On 28th October we described why we found the EU's \$1.4 trillion rescue package non-credible given the lack of details around who would finance such a package and why. In this email we turn our focus back on India and try to give more detail and colour on: (a) the political gridlock in Delhi, and (b) the extent to which it is hurting the economy.

Given that the policymaking mechanism in Delhi has now remained jammed for more than a year, a range of seasoned political observers in Delhi have told us that:

- There is political infighting within both the main political parties in New Delhi. Hence trust is in short supply and even senior political figures don't know quite what is going on.
- The Congress leader's illness has created a vacuum and thereby raised the political stakes for everyone else.
- The plethora of big-ticket corruption investigations has resulted in the unwritten "contract" between the political and business classes being suspended. As a result neither side now knows how to get things done.
- Ministers and civil servants are reluctant to take any decisions for fear of retrospective investigations.

...is resulting in the "India story" unravelling

The trillion dollar question is "How profound is the impact of this on the Indian economy?" As the months go by without any meaningful thaw in the political situation, some of the wiser sages in Delhi are beginning to draw some early conclusions:

- It seems unlikely that the situation in Delhi will improve until the next General Election following which big ticket political changes are likely regardless of which party wins.
- A leadership vacuum of the scale that we see currently is unprecedented in India. Even the late-1980s and the late-1990s (periods which saw a series of Prime Ministers take charge) were more productive periods by way of decision making at the centre. Paralysis of the sort that we see today in unknown territory for India.
- Given that India's institutions of public governance (leaving aside the hyperactive CAG and the Supreme Court) are not particularly robust, the leadership deficit in Delhi has left the country rudderless. This is all too apparent to investors who can see the contrast between India and: (a) an increasingly prosperous Brazil (under Lula's stewardship); and (b) an increasingly aggressive China (even as the leadership at the helm of the Communist Party goes through a generational change).
- Indian companies don't seem to have any one to turn to Delhi with regards to their requests for reform. So whether it is power companies seeking coal, retailers seeking FDI, gas companies seeking price deregulation, etc – no one in Delhi can really help at present.
- India's drift has broader implications for its national security and defense - areas which are outside our remit but ones which have important implications for investors.

Investment implications

Unless the political situation in Delhi changes dramatically in the next 6 months (and that's something we can't rule out given what we know about some of the critical variables in play), India seems headed for a double whammy:

- The problems in Europe are likely to hit investment growth in FY12 and push growth towards 6%. See our economist, Ritika Mankar's 17th October note on this subject (attached). Note that investment accounts for 32% of Indian GDP.

- Unless global commodity prices correct, inflation in India is unlikely to come down meaningfully. This combination of consistently double digit food inflation and rising interest rates could pull down consumption growth. Consumption accounts for 58% of Indian GDP. We still expect consumption to grow by 7% in FY12-13. However, we are perturbed by preliminary primary data that this story might be cracking.

In such a situation, given that we seek to avoid the kool-aid that some others drink, we point clients towards our "Good & Clean 3.0: Battleships" – stocks which have been chosen due to their cash flow generation, Balance Sheet strengths and entrenched competitive positions (see attached our 19th October note on the subject).

For those who have an aversion to Battleship stocks for fear of missing out on a rally in the Indian market, we note that Battleship portfolios have outperformed every single year over the past five years on a market cap weighted basis and outperformed every year bar FY08 on an equal weighted basis.

Our Good & Clean portfolios have outperformed the BSE 500 by 9% points (in market cap weighted terms) since launch in mid-March 2011. The latest Battleships portfolio has outperformed by 6bps since its launch on 19th October.

Outside the battleships portfolio, our strongest stock picks are

- Manappuram Finance Limited (MGFL IN, mcap US\$1.0bn, BUY)
- Voltas Ltd (VOLT IN, mcap US\$681mn, BUY)
- Torrent Power (TPW IN, mcap US\$2.3bn, BUY)
- Oberoi Realty (OBER IN, mcap US\$1.6bn, BUY)
- Bank of Baroda (BOB IN, mcap US\$5.9bn, BUY)
- Indus Ind Bank (IIB IN, mcap US\$2.7bn, unrated)
- HCL Tech(HCLT IN, mcap US\$6.3bn, BUY)
- Exide Industries (EXID IN, mcap US\$2.1bn, BUY)

We suggest that clients use this relief rally to take profits in:

- Infosys (INFO IN, mcap US\$33.9bn, SELL)
- Wipro (WPRO IN, mcap US\$19.2bn, SELL)
- State Bank of India (SBIN IN, mcap US\$24.1bn, SELL)
- Axis Bank (AXSB IN, mcap US\$9.7bn, SELL)
- IDFC (IDFC IN, mcap US\$4.0bn, SELL)
- Thermax (TMX IN, mcap US\$1.1bn, SELL)
- Dabur(DABUR IN, mcap US\$3.6bn, under review)

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Explanation of Investment Rating

Investment Rating	Expected return (over 12-month period from date of initial rating)
Buy	>5%
Sell	≤5%

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