Measuring India as an Investment Option

TIFF Investment Team - December 2018

Over the past few years, TIFF's equity team has tended to allocate more capital to specialists than generalists. Within the equity manager universe focused on fundamental research, we believe that true domain experts tend to have a more sustainable competitive advantage, particularly in countries or sectors in which some combination of technical knowledge, local presence, personal networks, or experience are key ingredients to well-informed decisions. As we search for superior specialists, we acknowledge that it's very difficult to research multiple complicated geographic markets simultaneously. So, we decided to be thorough in a few selected markets (as opposed to doing a cursory job in multiple markets) and accept some country-specific risk, at least initially. We discussed the process of focusing significantly on specialists with TIFF's board members over multiple meetings, and they have been supportive of these adjustments.

We invested with several China-focused managers in 2016. Currently, we are in the later stages of considering an investment with a manager in India. We are optimistic about this market for several reasons. Like China, India is a relatively large market with good growth prospects and is underrepresented in global equity benchmarks, such as the MSCI global and regional indices. Also, if historical results are at all indicative of the future, India will bring some diversification value to our existing comprehensive portfolios. Diversification is a complex but critical concept in our analysis. It may seem at first glance that India is merely another populous emerging market like China. However, our in-depth research on the relationship between India's equity returns and those of China shows that an India investment will likely offer diversification effects relative to China as well as diversification benefits to an entire comprehensive portfolio that holds both investments. Put another way, within an emerging markets construct, China's historical returns don't explain much about India's historical returns, and vice-versa. Moreover, the relationship between the two return streams has been weakening for the past decade. While none of this is intuitive, we believe it is all positive.

We are also optimistic about an India allocation because, based on our visits to the country and discussions with investors and companies there, we think India is a relatively distinct and inefficient market, so that a good active manager should be able to add value. Further, while political considerations are not central to our main investment thesis, the current administration of Prime Minister Narendra Modi has enacted a variety of government reforms that may provide tailwinds for public equities over the next few years. The key near-term risk that we see in India is valuation. Unlike our initial foray into China in 2016—when many people we met were surprised to see us, the market was declining, and valuations were attractive—broad Indian markets today do not appear to be cheap, though the Indian currency, the rupee, is near an all-time low vs. the US dollar. However, valuations in India have started to become more attractive over the course of 2018. There are over 800 companies listed on the Bombay Stock Exchange with a market capitalization greater than $100 million, and 542 of them had share price declines of at least 25% (in US dollars) in 2018 as of the end of October.

In terms of market structure, India is like China in certain ways but different in others. India is the second-most under-represented country in global benchmarks (after China) relative to the actual market capitalization of its companies and its share of global GDP. At the end of the third quarter, India was about 3% of global GDP but less than 1% of the MSCI All Country World Index. Also, like China, there are many publicly traded securities to evaluate. Government policy in the 1970s effectively forced many small Indian companies that would generally have stayed private or remained subsidiaries of multi-national companies to list shares on an Indian stock exchange. Consequently, India has more than 7,000 listed public companies, and the Indian subsidiaries of many multi-national global businesses are accessible as “pure play” India investments. Unlike China, India is not a very liquid market, and individuals or families control many companies. Also, India has much less of an “equity culture” than China. While local Indian managers are likely to be much more sophisticated than average Indian citizens, an equity culture has yet to develop, and retail investors are a low percentage of trading volume in India. In China, the active managers in TIFF’s equity portfolios are often taking advantage of the mistakes made by retail investors with very short holding periods (there is still no capital gains tax). In India, local managers are more likely to be in direct competition with foreign institutional investors, many of whom we suspect are generalists or oriented toward gauging broad economic conditions, giving the local managers an information advantage. While representing only roughly 20% of total equity ownership, foreign institutions represent close to half of India’s trading volume. We include key statistics comparing markets in the US, China, and India in Appendix 1.

Of course, there are also key social and cultural differences among the US, China, and India. In general, the US and China are more urbanized and better-educated societies, while India is a materially smaller economy with much lower GDP per capita. India started its economic reforms about a decade and a half after China, and our experience on the ground indicates that the general acceptance of capitalism has been much higher in China, particularly by its Communist government, in comparison to India. In addition, India is a far more heterogenous society, where language and customs can vary greatly by region. While English is widely spoken within the Indian business community, there is not a common country-wide language spoken on the street but rather dominant regional languages. Finally, the general condition of India’s physical infrastructure (e.g., transportation network, housing stock, sanitation) is substantially behind the US and China. We note, for example, that general travel times and the time it takes to transport goods across the country tend to be much higher in India than in the US or China, although it’s tough to capture this in a single statistic. These observations in aggregate may help explain why the more-established brands and businesses with excellent distribution networks in India appear to generate above-average returns and enjoy a sustainable competitive advantage. Replicating a distribution network that reaches a combination of urban and rural customers who speak a variety of languages through a poor transportation system is likely very tough to do. Similarly, building a brand that appeals to such a wide range of Indian cultural groups can also be difficult and time consuming.

India has begun to catch up quickly in digital infrastructure. Today, the country has 1.2 billion mobile phone connections, 300 million smartphone users (compared to the US at 270 million users) and 800 million users of less-functionally sophisticated “feature phones.”[1] Mobile data pricing has fallen dramatically in the last three years, since the launch of the digital network provider Reliance Jio (a subsidiary of the oil giant Reliance Industries). A popular phone plan offered by Jio costs 98 rupees ($1.33) for unlimited voice and 2GB of data per month. A similar plan is at least $50 per month in the US. Cheap data and 4G connection speeds should result in more content consumption and improved access to services, including banking, entertainment, mobile commerce, and social networking, which may offer interesting investment opportunities in a market experiencing secular growth. We include cultural and regulatory observations comparing the US, China, and India in Appendix 2.

[1] Discussion with former country head of Facebook India,
https://www.statista.com/statistics/201182/forecast-of-smartphone-users-in-the-us/

Finally, and less centrally, the Modi administration has instituted multiple reforms that could provide a meaningful tailwind to equity investments in two primary ways. First, if successful, these reforms should increase general economic growth. Second, many of these reforms should enable established businesses to gain market share from smaller competitors, some of which may have made up for their small scale and lack of operating efficiencies by understating revenues or not paying taxes at all. The Goods and Services Tax (GST) is favorable to companies that pay taxes and operate across multiple Indian states. The use of unique identification data for every person ("Aadhaar" in India) and the penetration of mobile devices and e-commerce is beneficial to businesses that can leverage technology expenditures across a large customer base (e.g., build apps, have a team to process data gathered, etc.) The table in Appendix 3 provides a summary of the most significant reforms.

Along with its various positive attributes, India also presents some risks found in similar emerging markets. Mistreatment of minority shareholders and generally weak corporate governance are major risks in this market. Fraud, embezzlement of corporate funds, and conflicts of interest between employees and shareholders are quite common. However, these practices are not representative of the entire market, and we believe there is opportunity to generate outsized returns in India in part by properly managing this risk. Part of the value proposition of active management is that investment firms with large personal networks and extensive local experience should be able to identify corporate management teams that operate with integrity and deploy capital prudently. Other key risks in the Indian market include low market liquidity, relatively high valuations (particularly in certain consumer sectors), occasional management/labor instability, the country's dependence on foreign oil, and a (currently) weak currency. TIFF will seek to mitigate these risks in part through prudently sizing the amount of capital invested; we intend to size any investment in India on the small end of our range and build the position over time.

While different from China and the US, India's large population, inefficient market, growing business culture, and investment diversification benefits make it an interesting market for a portion of TIFF's equity portfolios. Thus far, we have met with nearly 40 India-based investment firms. We've also had meetings with Indian public companies in the financial services, pharmaceuticals, business process outsourcing, and social networking sectors. We believe that the recent drawdown in the Indian markets may provide us with an attractive opportunity to deploy capital as we near the end of our initial research.

Why Now?

In the midst of global trade tensions, it may seem odd to some that TIFF continues to spend time evaluating investment opportunities in volatile foreign markets such as China and India. We see it differently. Whether the current trade battles result in a long-term and significant reset of the global economic pecking order (unlikely, but not impossible, in our view) or become just another minor and arguably pyrrhic victory for the current US administration (see NAFTA and Europe), the near-term disruption those battles are causing can create buying opportunities in capital markets, such as China and India, that we believe will be essential and growing components of well-diversified global portfolios over the next several decades. We have always been willing to be wrong in the short run in an effort to deliver investment excellence over the long run. Investments in emerging markets, even very large ones such as India or China, are not for the faint of heart or for those who measure investment success quarter by quarter, but for those who take the long view when thinking about their institution's financial future, we believe tumultuous times present significant opportunities. We intend to exploit them.

Appendix 1: Market Comparison of US, China, and India [2]

Characteristic	US	China & Hong Kong	India
Equity market cap ($ in trillions)	32.1	13.1	4.7
GDP ($ in trillions)	19.4	12.3	2.6
Number of public companies	5,235	5,603	7,513
Daily turnover ($ in billions)	103	76	5
Number of trades (trillions)	2.8	5.7	2.6
% of MSCI ACWI Index	54%	4%	1%
% of global GDP (2017 data)	25%	15%	3%
% of global market cap (2017 data)	37%	15%	5%

Index sector breakdown [3]	S&P 500	50/50 CSI 300, MSCI China	MSCI India
Consumer Discretionary	13	9	11
Consumer Staples	7	7	11
Energy	6	3	14
Financials	14	35	23
Health Care	15	5	6
Industrials	9	11	5
Info. Tech.	26	13	18
Materials	3	6	8
Real Estate	3	5	0
Telecom	2	2	2
Utilities	3	3	3

Market cap breakdown	Russell 3000	50/50 CSI 300, MSCI China	MSCI India
Mega cap (>$100 bn)	43	20	0
Large ($10-$100 bn)	41	48	75
Mid ($2-10 bn)	12	30	25
Small (<$2bn)	4	1	0
Valuation (as of 10/31/18)			
P/E	18x	11x	19x
P/B	2.9x	1.5x	2.8x
EV/Sales	2.6x	2.1x	2.6x
10-yr bond YTM	3.1	3.5	7.9
LTM inflation, CPI	2.6	2.5	3.7

Appendix 2: Social and Cultural Comparison of US, China, India [4]

Characteristic	US	China	India
Maturity of current system	1776, capitalist from the start	1949, but capitalist reforms began in 1980	1947, but capitalist reforms really began in 1992
Population	330 million	1.4 billion	1.4 billion
Economy			
GDP	$19.4 trillion	$12.0 trillion	$2.6 trillion
GDP per capita (nominal)	$62,000	$8,800	$2,000
GDP per capital (PPP adj.)		$16,700	$7,200
Projected growth	2%	7%	7%
Ease of doing business rank	6	78	100
Language	79% English	100% Mandarin	44% Hindi
	18% Spanish		8% Bengali
			7% Telugu
			7% Marathi
			6% Tamil
			5% Gujrati
			4% Urud
			4% Kannada
			3% Odia
			16% Other
Literacy	99%	96%	71%
Economic mobility	Yes	Yes	Challenging due to legacy of the caste system
Religion	75% Christian	52% Unaffiliated	80% Hindu
	2% Jewish	18% Buddhism	14% Islam
	1% Buddhist	22% folk religions	2% Christian
Religion	1% Muslim	5% Christianity	1% Buddhism
	1% Other	2% Muslim	3% other
	16% Not religious		
Government	Constitutional republic	Single party rule	Federal parliamentary republic
Urbanization rate	82%	59%	34%

Appendix 3: Summary of Recent Reforms in India

Reform / date	Summary	Implication
Financial services reform / 2014	• Expansion of financial services access to the entire country • Bank accounts with no minimum balance • Access to basic account services over the phone • Reduction in the amount of time and paperwork required to open an account	• Much wider access to bank services • Opportunity to develop credit history for many formerly "unbanked" segments of the population
Goods and services tax (GST) / July 2016	• Tax collection centralized with national government • Replaces a complicated collection of local and state taxes with a consistent three-rate national system	• Makes India much more of a single market for business • Increases tax compliance (tax revenue to GDP in India had been well below the average for EM economies) • Simplifies cross-state transactions • Eliminates bribery, corruption • Speeds up the movement of goods (fewer inspections)
Unique ID program (Aadhaar) / started in 2010, but real traction in 2016	• Biometric (fingerprints and retina scans) identification program • Greater than 95% of the country is now included in the database (>1 billion people)	• Enables reliable, secure payments via mobile phone • Enables the government to distribute benefits quickly and directly to intended recipients (eliminates leakages and delays) • Arguably the largest Big Data project in the world
Demonetization / November 2016	• Declaration of the 1,000 and 500 rupee bank notes then in circulation invalid via a live unscheduled press conference • Citizens had fifty days to exchange their old notes for new ones or bank deposits	• Major crackdown on corruption, tax evasion and counterfeit money • Part of a broader effort to shift commerce to mobile payments • Adjustment process was very awkward and disruptive to the economy
Real estate regulation act / May 2017	• All projects greater than 500 square meters must be registered with the government • Depositors have the right to a full refund with interest if a project is not completed on time	• Reduces theft and corruption in real estate development • Provides incentives for citizens to invest in housing improvements (current state of India's housing stock is poor)

Reform / date	Summary	Implication
	• Requires developers to pay depositors interest in the event of project delays • 70% of the deposits collected by developers must be deposited in a segregated bank account (in the past these proceeds could be used for other projects	
Insolvency and Bankruptcy Code (early 2018)	• Designed to dramatically streamline the bankruptcy and reorganization process (used to take years) • Once a company defaults, a court-appointed executive takes over all operations • If the reorganization process does not reach a conclusion in 270 days, the defaulting company will be liquidated	• Should result in a decline in willful defaulters • Likely to eventually lead to better recovery rates and a reduction in the cost of debt capital across the economy

Endnotes:

[2] GDP data, IMF, 2017; Market capitalization data, World Federation of Exchanges, 2017
[3] FactSet data as of 10/31/2018, inflation data as of 9/30/2018
[4] CIA World Fact Book (online), data as of 11/29/2018; World Bank Ease of Doing Business Ranking 2018, http://www.doingbusiness.org/en/rankings/