Asia Insight

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India: Good Growth, Bad Growth

When almost all sectors are growing in India, it is probably fair to be discerning in our investments and avoid the potholes in the path of growth. One can understand the attraction of growth to investors who are looking to beat recessionary forces in developed markets. However, in a blind chase for growth, it is easy to forget that only the growth accompanied by economic profits creates value. Perhaps we should review some of the once-celebrated, top-down investment ideas that did not live up to expectations and compare them to less exciting ideas that actually did deliver.

The Infrastructure Boom

Not long ago, India's infrastructure companies were expected to multiply many times over in just a matter of years. It was hard to argue a few years ago with the need for better roads, more power (clearly needed considering the country's recent massive power outage) and efficient ports in India. Public policy had also laid out ambitious plans to develop infrastructure. Capital availability did not appear to be a major hurdle since many state-owned banks seemed willing to lend. Despite all the positive sentiments, however, negative shareholder returns were generated by some leading developers in the past five years—in sharp contrast to the top-line growth they achieved. This should not have surprised bottom-up investors, given how frequently these companies diluted shareholders by issuing more stock to grow beyond what could be funded through internal cash generation or could realistically be borrowed. Accessing capital markets to fund growth in itself is not value destroying, but developers turned to markets too frequently and made unwise business moves such as overbidding for projects—a recipe for losses. Policy inaction by lawmakers and high interest rates, which the media love to blame, are actually only recent phenomena that have merely compounded an existing problem created by these firms.

In most parts of the world, infrastructure development is perceived to be a tough business since success largely hinges on management acumen and execution, with demands for the right mix of entrepreneurship and cash flow oversight. In India, developers that have recklessly chased growth, perhaps for non-economic reasons such as prestige or track record, have created a classic case of "a winner's curse"—a tendency for the winning bid in an auction to exceed the intrinsic value of the project won. Investors in these firms may also share some blame as their lack of scrutiny could have enabled developers to cheaply access shareholder capital. Investors globally may have viewed Indian firms through a "positive India" lens a few years ago, clouding their judgment. At one point, for example, the market value for a leading developer was at a double-digit price-to-book multiple and triple-digit price-to-earnings ratio, suggesting that too much was baked into its future. Such a valuation creates perverse incentives for companies to raise more capital from markets, which ends up bidding up the prices of the limited infrastructure projects available.

Retail Hyper Growth

Another industry that was hyped a few years ago in India was that of organized retail, which is characterized by its larger scale, a network of stores and corporate ownership (e.g., supermarkets, hypermarkets). The premise was that the less

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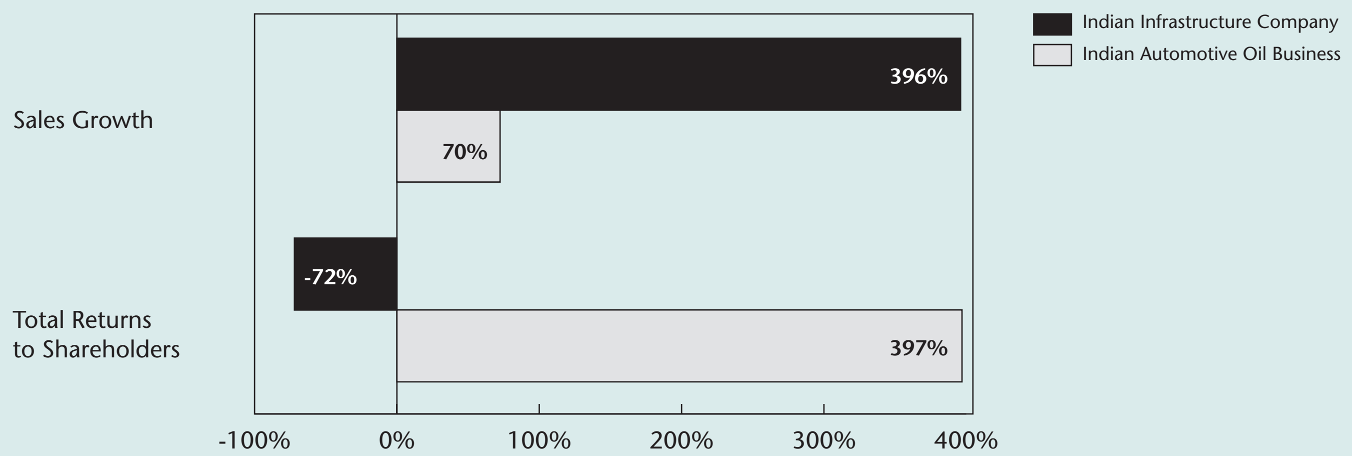
organized "mom and pop" stores did not offer the variety or the ambience expected by newly rich middle class. There was some truth to this and more modern retailers did demonstrate extraordinary sales growth. But many were eventually punished by the market, with some nearly shutting down. No doubt, the retailers offered a greater assortment of products and a better shopping environment, but they also found it hard to go up against less organized competitors who were selling the same products with minimal expenses. Mom and pop stores in India are generally operated by their owners, who are often more committed to their businesses than hired workers. It is also easier for many of these small shops to escape taxes in India, which explains why many hesitate to offer receipts for purchases. The cost of their storefronts are generally low as some have been long-time tenants who may also live behind their stores, own the property or enjoy below-market and rent-controlled prices. In addition, many mom and pop stores provide home delivery to loyal customers. Retailers likely gave little consideration to these factors and their excessive optimism and expansion seemed to only accelerate their downfall. If retailers could not make money by simply increasing sales, neither could their investors.

This case study in retail emphasizes the importance of investing in companies with a long-term competitive advantage. The mere fact that leading firms in this segment required cash infusions just to stay afloat, let alone grow, raises questions about the sustainability of their business models. This is not to say that retail is a flawed business. The situation could actually change in the future if these players were to become big enough to enjoy economies of scale and extract better bargaining terms from their suppliers, gaining cost advantages over the unorganized sector. The increasing purchasing power of the Indian consumer should eventually make sufficient room for big retailers, as it has in other parts of the world. But as of now, retailers that have grown profitably in India

NOT ALL STORIES YIELD THE RESULTS YOU MIGHT EXPECT

Results Over the Last 5 Years



Source: Bloomberg

"Making investment decisions based on a theme of top-line growth alone may not yield desired results in India."

are focused less on mass consumption goods and deal more in differentiated or specialty products. They sell exclusive premium brands (that they may also own) with no pricing pressure.

Less than Exciting Lube Oil Business

Sometimes even a boring industry can make money for investors. One such example is an Indian lube oil company. Understandably, this business may not have much scope for volume growth as technological advances continue to extend the lifespan of lubricants. However, the company has developed wide reach and good branding among otherwise value-conscious customers. With each technological leap, the company has developed products that are priced higher but generate overall savings for consumers in the long run. The company also saves on the cost of manufacturing as the same amount of raw material can be used to produce more units, creating a win-win situation. It's no wonder that this otherwise dull product has enabled this firm to consistently expand margins and create shareholder value. Patient investors have been rewarded with a transparent shareholder policy and a good dividend distribution policy.

The above case study draws attention to a business that has the capacity to generate cash across economic cycles and which allows the management to be "in the driver's seat" rather than be swayed by macroeconomic headwinds. While India's market has been irrational at times, it has been able to distinguish truly valuable companies over time. Long-term investors with a focus on bottom-up stock selection may eventually be rewarded, even if they end up underperforming during euphoric times. Sharp market movements can actually prove to be a friend for investors with patience and a stomach for volatility.

Importance of valuation

Paying a reasonable price for growth is a good discipline to have. But it is easier said than done. First, there are certain well-run businesses in India that can remain expensive for a long time. This can lead investors to wonder if they are missing out on a good opportunity by being too value-conscious. One example is a leading private sector bank that has been able to deliver consistent results on growth and profitability in an ever-changing regulatory and macro environment. A closer look at the bank reveals that its ethos and work culture prepare it for coping in uncertain times, a competitive advantage not easily captured by regular valuation exercises. Investing in such companies can sometimes be less risky than investing in stocks that remain cheap for extended periods due to fundamental reasons of poor governance or weak business models.

No one can know the "right price" for a stock. In our experience, judging valuations is akin to estimating the height of a person from a distance. It is easier to compare height on a relative scale than to estimate in absolute terms. This is not to say that one should not attempt to ascertain absolute value. However, often the best one could do at an absolute level is to judge someone as "tall" or "short", or somewhere in between. Similarly, the value of a stock could at best be ascertained as "expensive" or "cheap", or somewhere in between, depending upon whether aggressive, conservative or reasonable assumptions are priced into the stock.

In summary, making investment decisions based on a theme of top-line growth alone may not yield desired results in India. Bottom-up stock selection, on the other hand, is critical for growth investors in India to mitigate risks that may arise from such factors as weak business, inadequate governance and excessive valuations.

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