Why this emerging market isn’t having a Lehman Brothers moment

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Ocean Dial’s Gaurav Narain says investors should not allow the recent spike in volatility to distract them from the immense opportunities in India.

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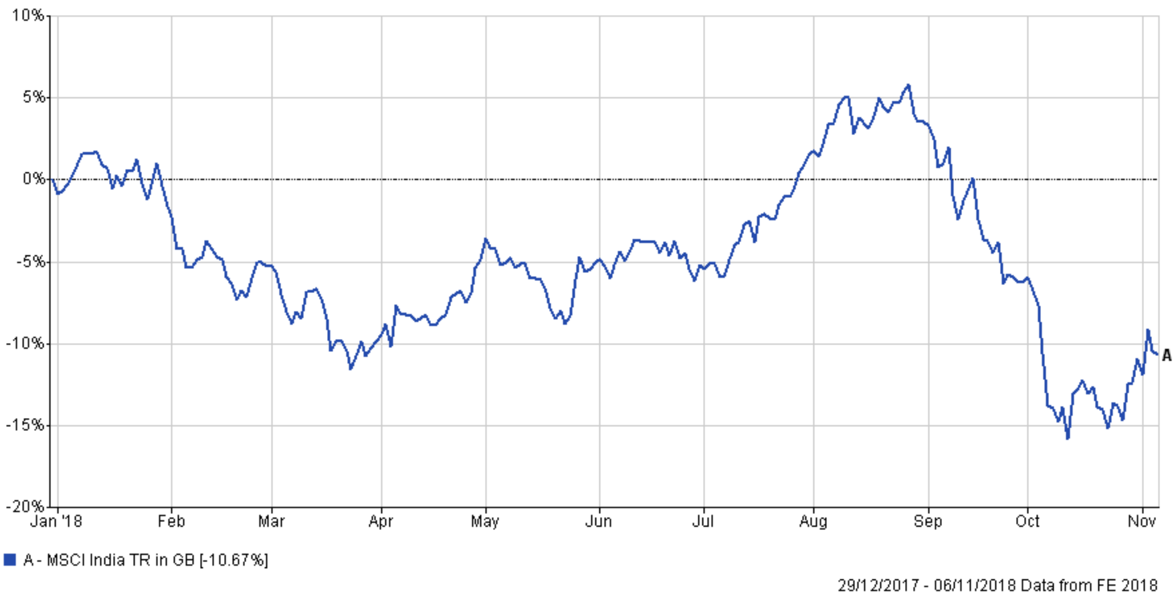
India is not having a Lehman Brothers moment, according to Ocean Dial’s head of equities Gaurav Narain, who says the recent freeze in liquidity is an over-reaction to an isolated incident rather than symptomatic of a wider problem.

The MSCI India index fell 20 per cent in less than two months after the end of August, although it has staged something of a recovery since then.

Performance of index year-to-date



Source: FE Analytics

This has been blamed on a sharp increase in the price of oil – imports still account for 80 per cent of India’s usage of this commodity – and disruption associated with

wide-reaching reforms implemented by prime minister Narendra Modi
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However, Narain *(pictured)* said the main trigger for the crash was a default by Infrastructure Leasing & Financial Services (IL&FS), an unlisted non-banking finance company which had borrowed about $13bn.

“It spooked the bond market because a lot of the banks and debt funds had paper of this security and it got downgraded from ‘AAA’ to ‘D’ the moment the default happened,” said the manager.

“This caused big redemptions in domestic mutual debt funds which started selling a lot of corporate paper in order to create liquidity in their own portfolios, and that spooked the market because one housing finance company with six-month commercial paper was sold at 11 per cent when the coupon was about 9.2 per cent.

“It created a flash point which began with finance companies falling and it really created the trigger factor.”

However, Narain said the government acted decisively to prevent contagion, sacking IL&FS’s entire board of directors in a matter of days and replacing them with a group of experienced professionals led by one of the most respected bankers in the country.

Meanwhile, the central bank eased liquidity conditions to help the lending system, although Narain said that mutual funds remain risk-averse and are refusing to lend to many financing companies like IL&FS.

“Initially everyone thought this was India’s Lehman Brothers moment,” he added, “but clearly in the short term the problem is being pushed back.

“The government feels the central bank should do a bit more because they fear that this one issue could create a cascading effect, but the central bank has said ‘look we are aware of the situation [but] we find that there’s no problem with these non-bank finance companies’.”

Narain said corporate-governance failings such as this are not as common as they used to be in India, with the market forcing tighter standards on large companies, driven by the influence of western investors and changing attitudes among family-run businesses.

“But I would say the market is still very inefficient,” he added. “The key to our investment strategy is getting the management right. And that’s where our biggest amount of due diligence happens.

“We do it a lot on the data side, we go into 10-year historical track records and we see where all the capital is being allocated, we look at who the auditors are, who the board members are.

“And if you get the right management in India, I would say the opportunities are immense.”

David Cornell, chief investment officer and managing director at Ocean Dial, said there are two reasons why India differs from other emerging markets – its size and its growth rate.

On the first point, he noted that there are 1.3 billion people living in India, 50 per cent of whom are under the age of 25.

“This is not China where the one-child policy in the 1960s has meant that actually population growth is slowing now and income per household is beginning to peak out,” he said.

“And it is certainly not Japan which is an economy that is hardly growing at all – that’s essentially a community where savings are mobilised for old age.

“In India the dependency ratio, which is the number of non-working people per 100 working people, is falling and that means that any income generated can be mobilised for consumption as opposed to anything else.”

Cornell said the second point to note is that all of this is coming off a low base – whereas GDP per capita in India is $2,000 a head, it is about $8,000 in China and $23,000 in Mexico. This puts the India of today where Mexico was 36 years ago, even though its population is 10-times the size.

“And that population, the penetration of basic consumer goods is so low that as that GDP per capita starts to rise in the next five-to-10 years, then obviously the consumption opportunities will be huge,” the managing director added.

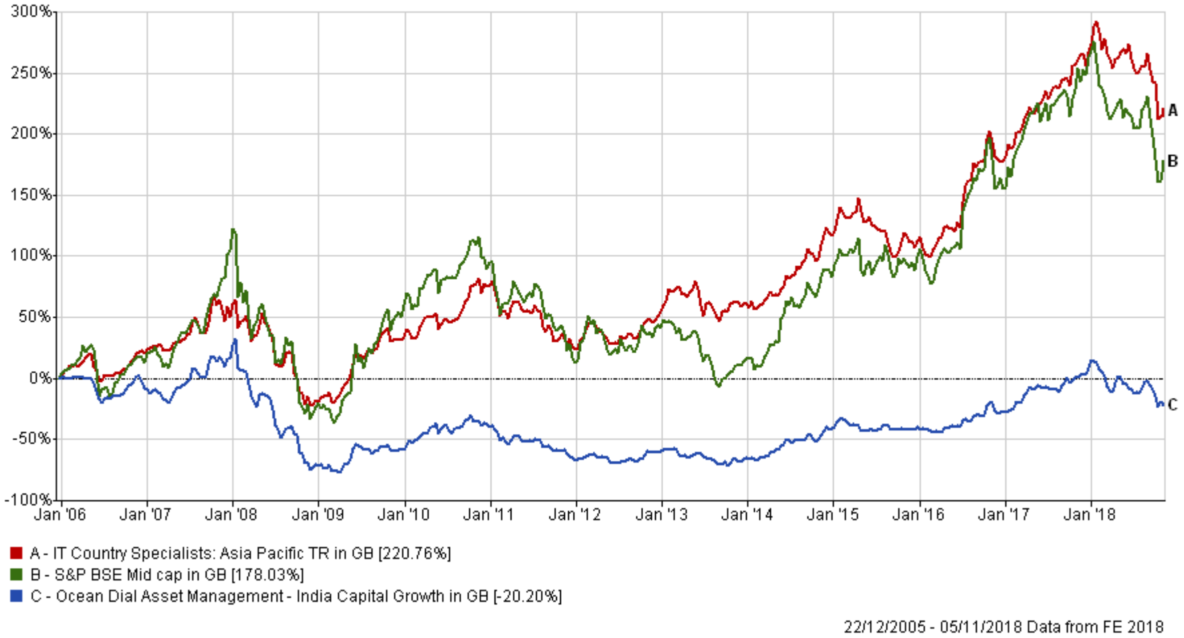
Cornell also said that while at $2.3trn the Indian economy is the sixth largest in the world, it is still one-10th the size of the US – but is expected to reach this level in 10 years.

“This is an economy that is becoming much more relevant today than it has ever been before. And yet in terms of investment and in terms of savers, it’s really kind of not even on the map,” he finished.

Data from FE Analytics shows that India Capital Growth, which is run by Ocean Dial, has made 97.56 since Cornell took charge at the start of 2010, compared with 74.13 per cent from the S&P BSE Mid Cap benchmark.

However, the trust is still down 20.2 per cent since launch at the end of 2005.

Performance of trust vs sector and index since launch



Source: FE Analytics

India Capital Growth has ongoing charges of 1.87 per cent. It is on a discount of 12.37 per cent compared with 12.84 per cent and 16.52 per cent from its one- and three-year averages. It is not currently geared.