

CAPITAL MARKETS -

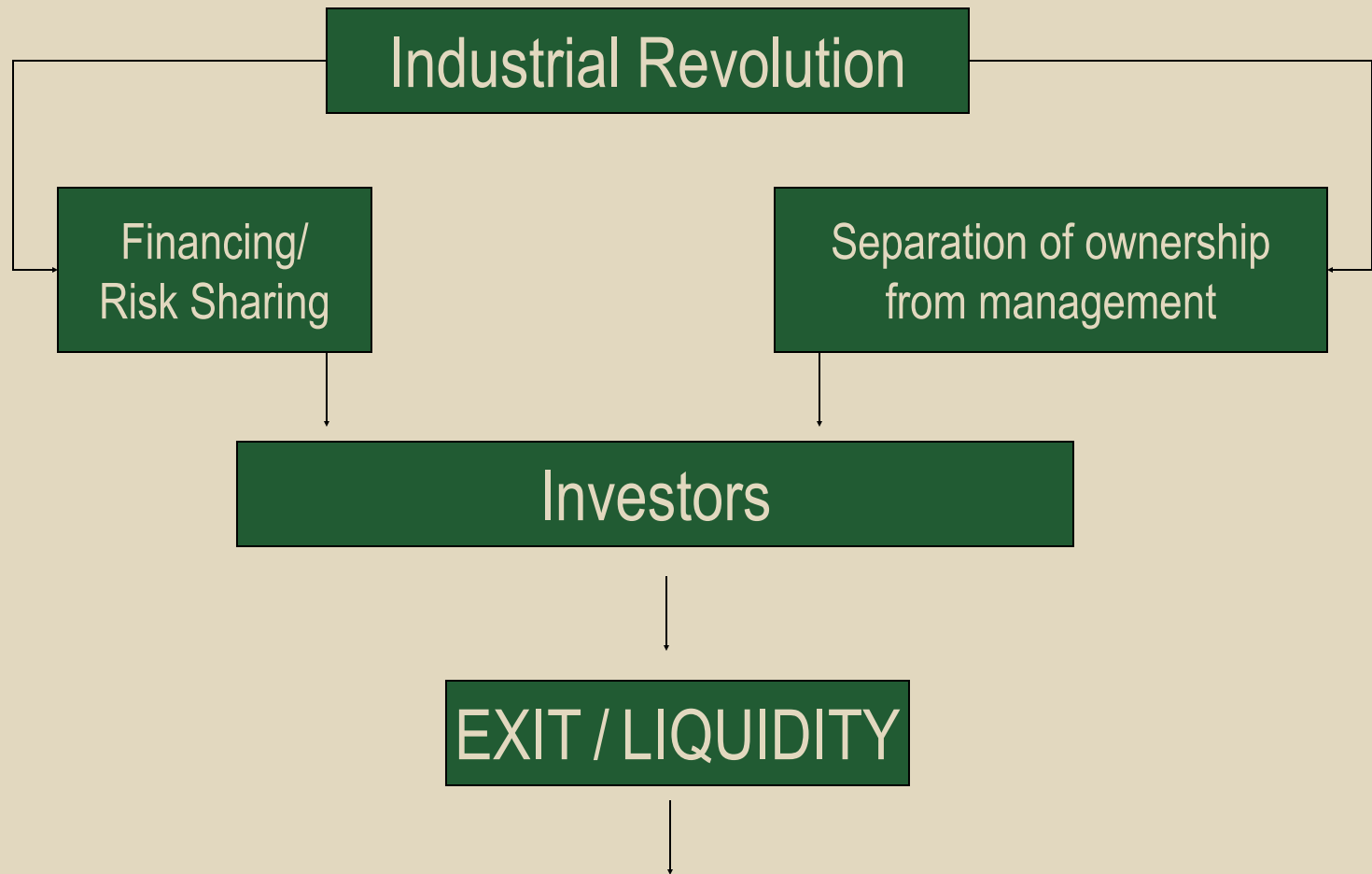
Wealth Creation & Wealth Management ...

A presentation by Rakesh Jhunjhunwala

DISCUSSION OUTLINE

- CAPITAL MARKETS
- INDIA IN A SWEET SPOT
- MY INVESTMENT APPROACH (CIRCA 2002)
- LEVERAGING
- MY LEARNINGS
- OUTLOOK FOR INDIA INC.

CAPITAL MARKETS | EVOLUTION



RAISON D'ETRE OF CAPITAL MARKETS

CAPITAL MARKETS | FUNCTION

- Temples of Capital Allocation . . .
- . . . To channelize Capital to most productive Assets
- Condition precedent for Risk Capital to exist and to grow
- Barometer of Economic environment, Corporate confidence and Capital flows
- In an Efficient Capital Market, appropriate Valuation may be delayed, but cannot be denied

CAPITAL MARKETS | WEALTH CREATION

Wealth

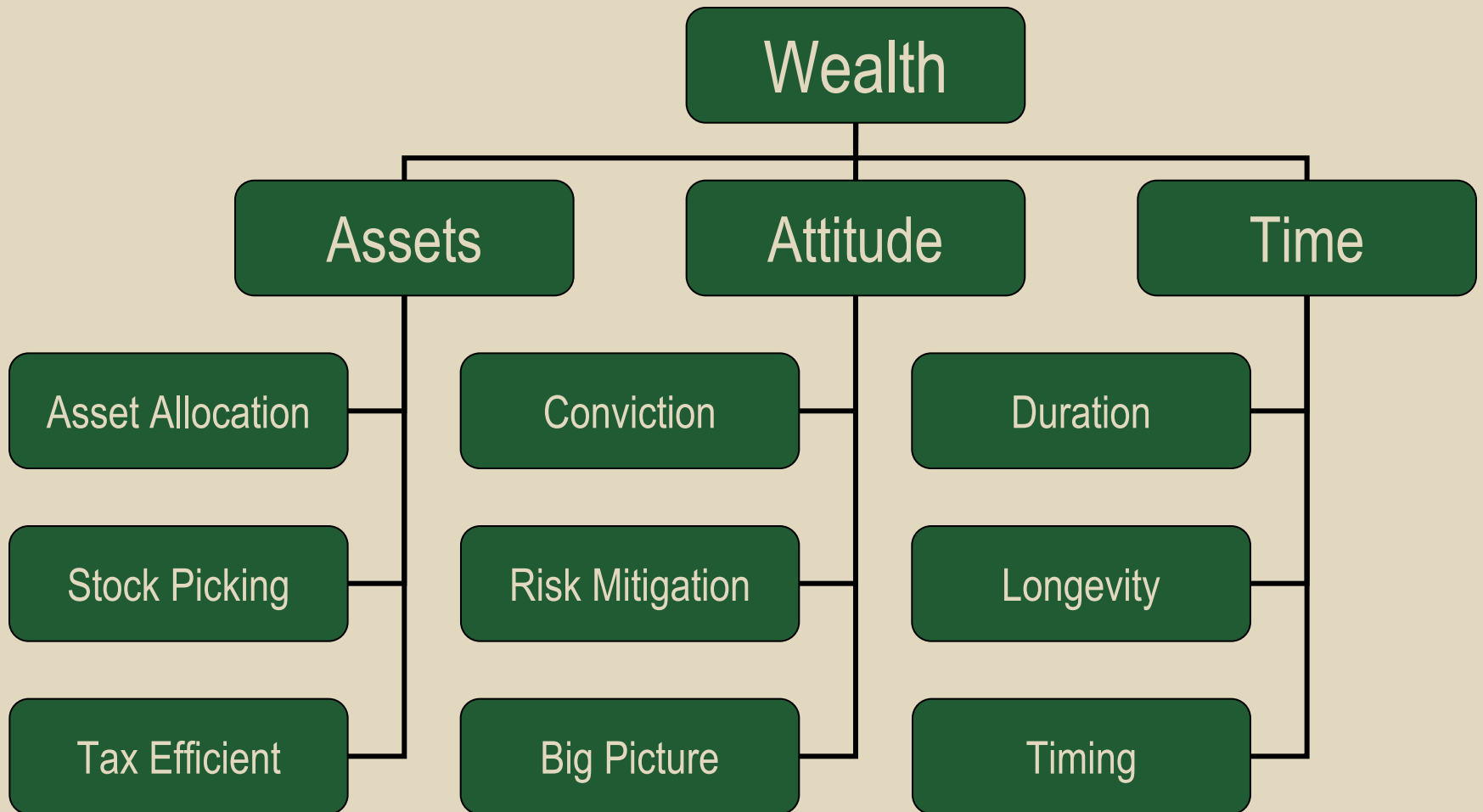
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Hunger

Opportunity

Risk

CAPITAL MARKETS | WEALTH CREATION



CAPITAL MARKETS | WEALTH EFFECT

Future Value of Rs.1 lac per annum

Compound Annual Return

| Years | 5% | 10% | 15% | 20% | 25% |
|-------|--------|---------|---------|---------|----------|
| 5 | 127628 | 161051 | 201136 | 248832 | 305176 |
| 10 | 162889 | 259374 | 404556 | 619174 | 931323 |
| 15 | 207893 | 417725 | 813706 | 1540702 | 2842171 |
| 20 | 265330 | 672750 | 1636654 | 3833760 | 8673617 |
| 25 | 338635 | 1083471 | 3291895 | 9539622 | 26469780 |

CAPITAL MARKETS | WEALTH REALITIES

- From Assets, not income
- Over time, not overnight
- Needs Attitude, not Appearance
- Post-tax, not Pre-tax
- Compounding works
- Reasonable diversification
- Mitigate Extra-financial risks

CAPITAL MARKETS | EXPERIENCES

- 1971 – 80 Gold 30% p.a compounded
- 1981 – 90 Nikkei 21% p.a compounded
- 1991 – 2000 NASDAQ 26% p.a compounded
- Stock, bonds and gold
- 1987 – 2006 Sensex 19% p.a compounded
- Why Equities have / will deliver superior returns

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Impressions on India

- What is happening today is the birth of India as an independent society– boisterous, colorful, open, vibrant and, above all, ready for change. India is diverging from its past, but also from most other countries in Asia. It is not a quiet, controlled, quasi-authoritarian country that is slowly opening up according to plans. It is a noisy democracy that has finally empowered its people economically. In this respect India, one of the poorest countries in the world, looks strikingly similar to the world’s wealthiest country, the United States of America. In both places, society has triumphed over the state.
- “India’s growth is messy, chaotic and largely unplanned. It is not top-down but bottom-up. It is happening not because of the government, but largely despite it.”
- Its society is open, eager, confident and ready to take on the world. But its state-its ruling class-is far more hesitant, cautious and suspicious of the changed realities around it. Democracy makes for populism, pandering and delays. But it also makes for long-term stability.
- Statistics don’t quite capture what is happening. Indians, at least in urban areas, are bursting with enthusiasm. It is as if hundreds of millions of people have suddenly discovered the keys to unlock their potential.
- As a famous Indian once put it eloquently -
“A moment comes, which comes but rarely in history, when we step out from the old to the new, when an age ends and when the soul of a nation, long suppressed, finds utterance.”

Whose Impressions are these ??

FAREED ZAKARIA – Editor Newsweek

INDIA IN A SWEET SPOT

- Indian Equities on a Strong Wicket
 - Fundamentals
 - Valuations
 - Party spoilers
- Equity mindset inevitable
- Long-term perspective

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MY INVESTMENT APPROACH (CIRCA 2002)

- Investment strategy (Flashback 2002)
- Investment belief
- Exit

INVESTMENT STRATEGY (FLASHBACK 2002)

- Once in a lifetime opportunity
- Macro call that India will perform
- Invest in good, scalable businesses / companies
- Invest across diverse sectors
- Select India-linked stories which participate in India's growth story
- Stick with good investments
- Increasing exposure as uncertainty reduces
- Leverage to the hilt, when tailwinds are favorable
- Human psychology

**VINDICATION OF THE ABOVE IS BEING CURRENTLY EXPERIENCED, AND
ACCENTUATING FURTHER**

INVESTMENT BELIEF

1

Realism
as a
Conviction

3

Safety of
Capital as a
Religion

2

Rigidity
as a
Taboo

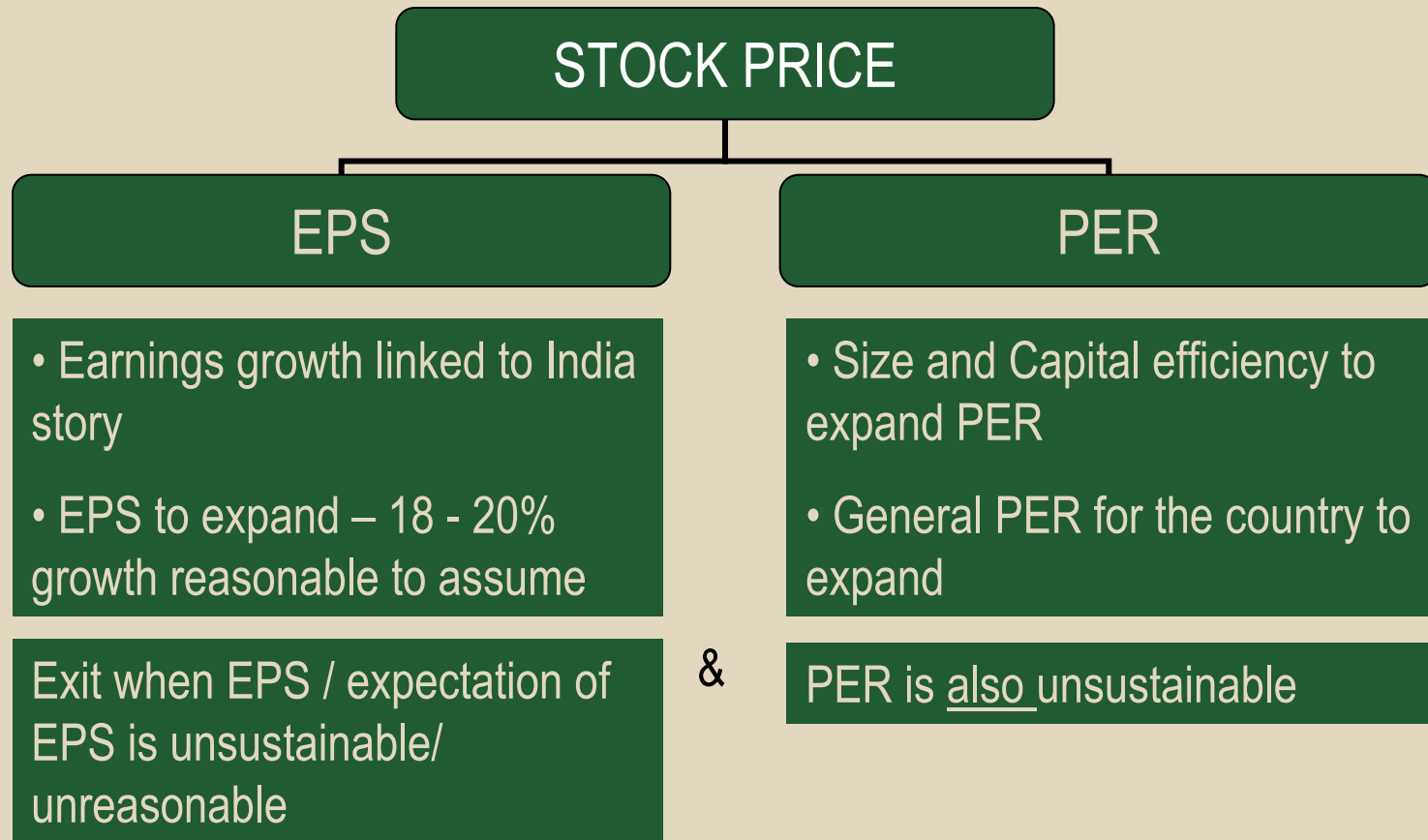
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Absolute
Returns as a
Passion

INVESTMENT BELIEF

- RIGIDITY - A TABOO
 - Do not have fixed rules in investment
 - Investment is both a science and an art
 - Use periods of extreme optimism to exit and extreme pessimism as an opportunity to buy

EXIT – AN INDEPENDENT DECISION



WE BELIEVED IN 2002 THAT EQUITY MARKETS WILL REACH ITS FRENZY WITHIN A DECADE, AND COULD BE THE EXIT TIME SINCE EARNINGS / EXPECTATION OF EARNINGS WILL PEAK AND PER WILL BE UNSUSTAINABLE, SAY 25 - 45

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LEVERAGE ?

- Leverage, equity markets and wealth creation
 - Others averse to leverage, not me
 - Ability to service interest cost and principal repayment
 - Dividend enough to repay interest, establishment costs
 - Principal not to exceed more than 10% of portfolio value

LEVERAGE – KEY TO MY SUCCESS

- Leverage should be value-conscious
 - Eg. GE Shipping at 60% discount to BV and offering 5% dividend yield
- Liquidity – The key to Leveraging!
 - Liquid Assets to be 5x of leverage
- Leverage has no emotions
- Agility and speed, the key to leverage

CAVEAT EMPTOR!

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MY LEARNINGS

- Invest on a broad macro call.
- Invest in the realms of possibilities.
- Invest out of ignorance of detail.
- No religion. Pursue opportunity wherever visible.
- Return dependent on the efforts of the management.
- Valuation = Longevity + Growth + Efficiency.
- Consistent Review. Discipline in Rectifying Mistakes.
- Patience, driven by Conviction, to Buy and Hold.

MY LEARNINGS

1. Be an optimist! The necessary quality for investing success.
2. Expect a realistic return. Balance fear and greed.
3. Invest on broad parameters and the larger picture. Make it an act of wisdom, not intelligence.
4. Caveat emptor. Never forget this four-letter word - R-I-S-K.
5. Be disciplined. Have a game plan.

MY LEARNINGS

6. Be flexible. For Investing is always in the realms of possibilities.
7. Contrarian investing. Not a rule, not ruled out.
8. Its important what you buy. Its more important at what price you buy.
9. Have conviction. Be patient. Your patience may be tested, but your conviction will be rewarded.
10. Make exit an independent decision, not driven by profit or loss.

MY INVESTMENT APPROACH

- External Opportunity
- Competitive Advantage and Ability
- Scalability
- Operating Leverage
- Management Quality – Integrity + Intellect
- Valuation

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OUTLOOK FOR INDIA INC.

- **External Dimension**

- External Opportunity – expanding in many ways
- Competition - quality of competition improving / intensifying
- Capital Availability – no longer a constraint for growth
- Equitable and fair taxation system – level playing field
- Acceleration in pace of change – premium on agility and adaptability
- Infrastructure improvement pace will be better than expected
- Geopolitical tailwinds

OUTLOOK FOR INDIA INC.

- **Perception Dimension**

- Respect for business and entrepreneurship
- Wealth creation is not looked down on
- India Inc. is a brand, a global brand
- Skill sets, human resources and management quality appreciated

OUTLOOK FOR INDIA INC.

- **Resisting temptation - the American lesson**
 - Fund raising for marginal objectives
 - M&A as valuation drivers
 - Creative accounting for predictability of profits

OUTLOOK FOR INDIA INC.

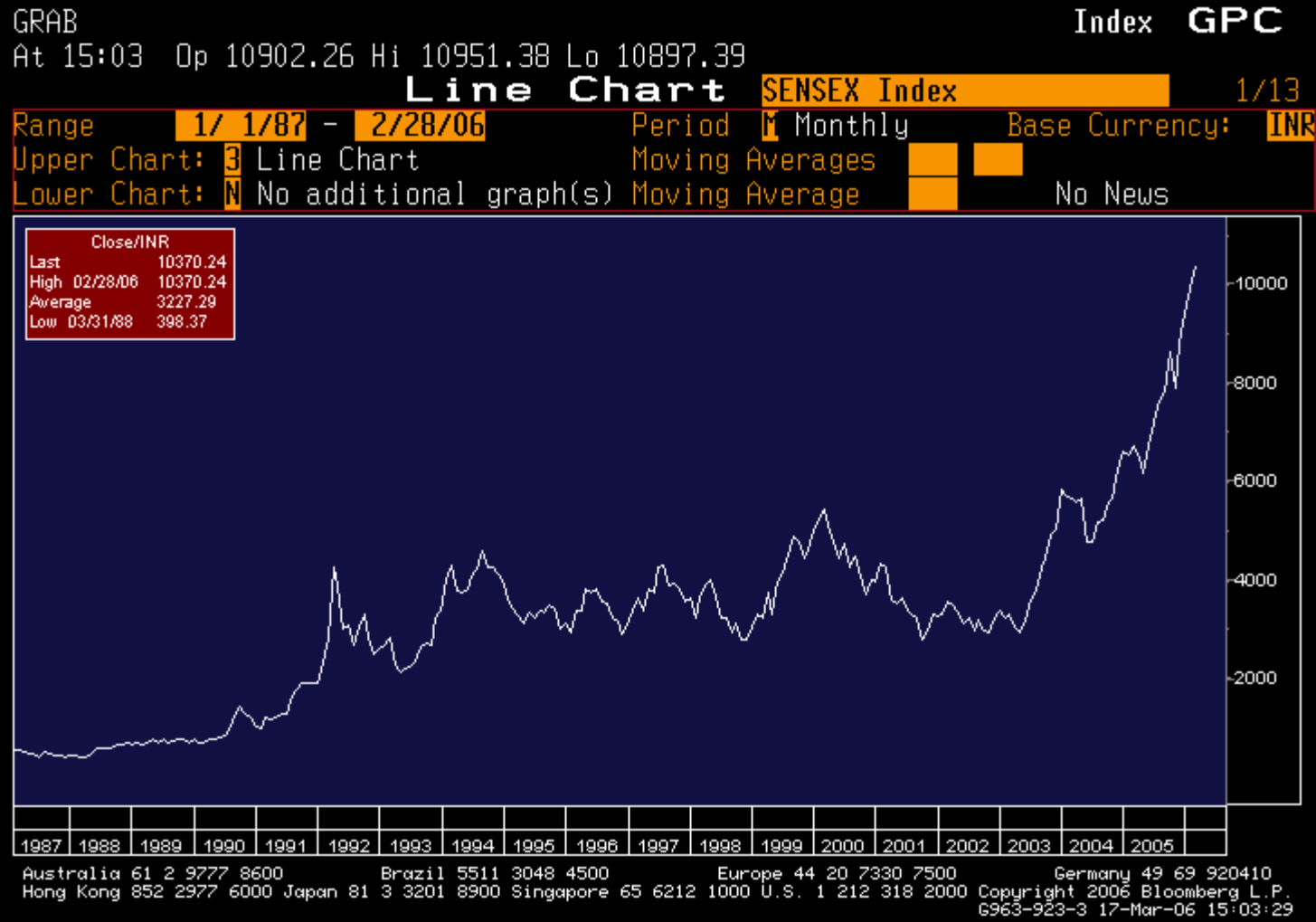
- **Imperatives Dimension**

- Aggressive scaling - order of the day
- M&A and Control sharing inevitable
- Dilution of ownership and control inevitable for growth
- Institutionalisation : financial succession distinct from management succession
- Approach to charity / philanthropy and Social responsibility
- Integrity at a premium



THANK YOU!

BSE-SENSEX – 19% CAGR IN 25 YEARS



[BACK](#)

EQUITIES – A TAX PARADISE

- If you sell your investment in less than 12 months (short term), you pay 10% tax!
- If you sell your investment in more than 12 months (long term), you NO tax!
- And even the Dividends are TAX FREE!

FUNDAMENTALS

- Growth Enablers
- Liberalization catalyst
- Interest rates
- Multiplier Effect
- ROE – DuPont
- Micro Trends

EQUITY MINDSET INEVITABLE

- Consistent profit growth
- Reasonable valuations
- Huge domestic savings
- Low equity exposure
- Lack of investible alternatives
- Equities are a tax paradise

- Modernized trading systems
- Good regulatory environment
- Vibrant & competitive MF industry
- Flow of long-term pension funds money into equities – matter of time

**FLOW OF MONEY INTO INDIAN EQUITIES,
INDIAN AND FOREIGN, IS INEVITABLE**

GROWTH ENABLERS

CULTURAL

Tolerance
Educational base
Skilled People
Savings Oriented

POLITICAL

Democratic
Secular
Populous
Welfare
Consensus
Judicial System

GROWTH ENABLERS

DEMOGRAPHICS

Young working population
54% of population
<25 years old
Vast domestic market
Middle class greater
than Europe

ECONOMICS

Entrepreneurial class
well-developed
Resilience
(no boom-bust cycles)

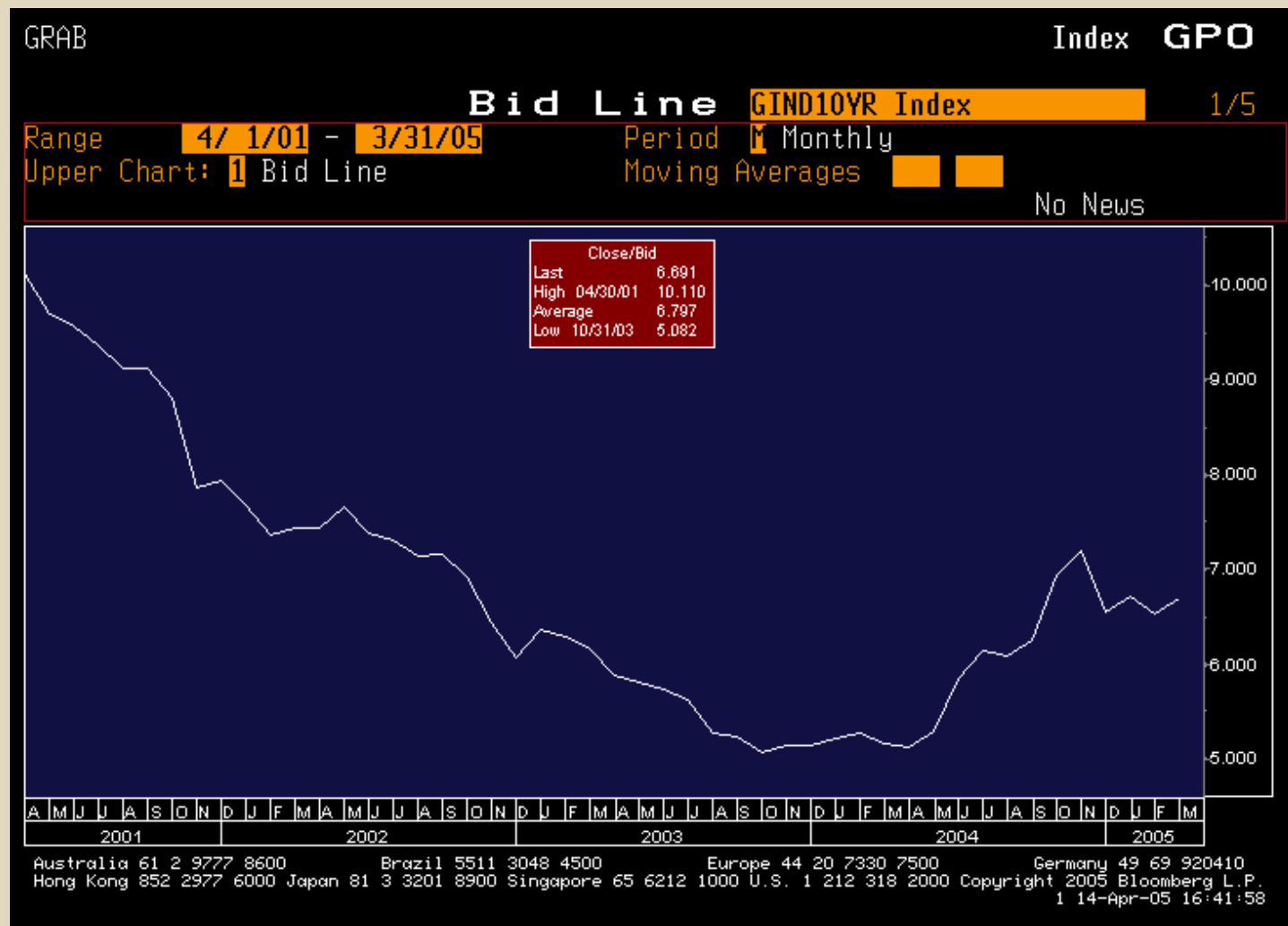
GEO-POLITICAL

Sub-continent
Vast natural resources
Nuclear power
Amongst largest economies
Irrelevance of Geographies

LIBERALISATION CATALYSTS

- Customer is king
 - Increased competition leads to quality and efficiency
 - Inflation under wraps
- Efficient allocation of capita
 - Improving ROI and capital efficiency
 - Improving consolidation in most industry segments
- Government to act as a facilitator rather than a business manager
 - Privatisation and PSU disinvestments
 - De-licensing and appropriate independent regulators across sectors

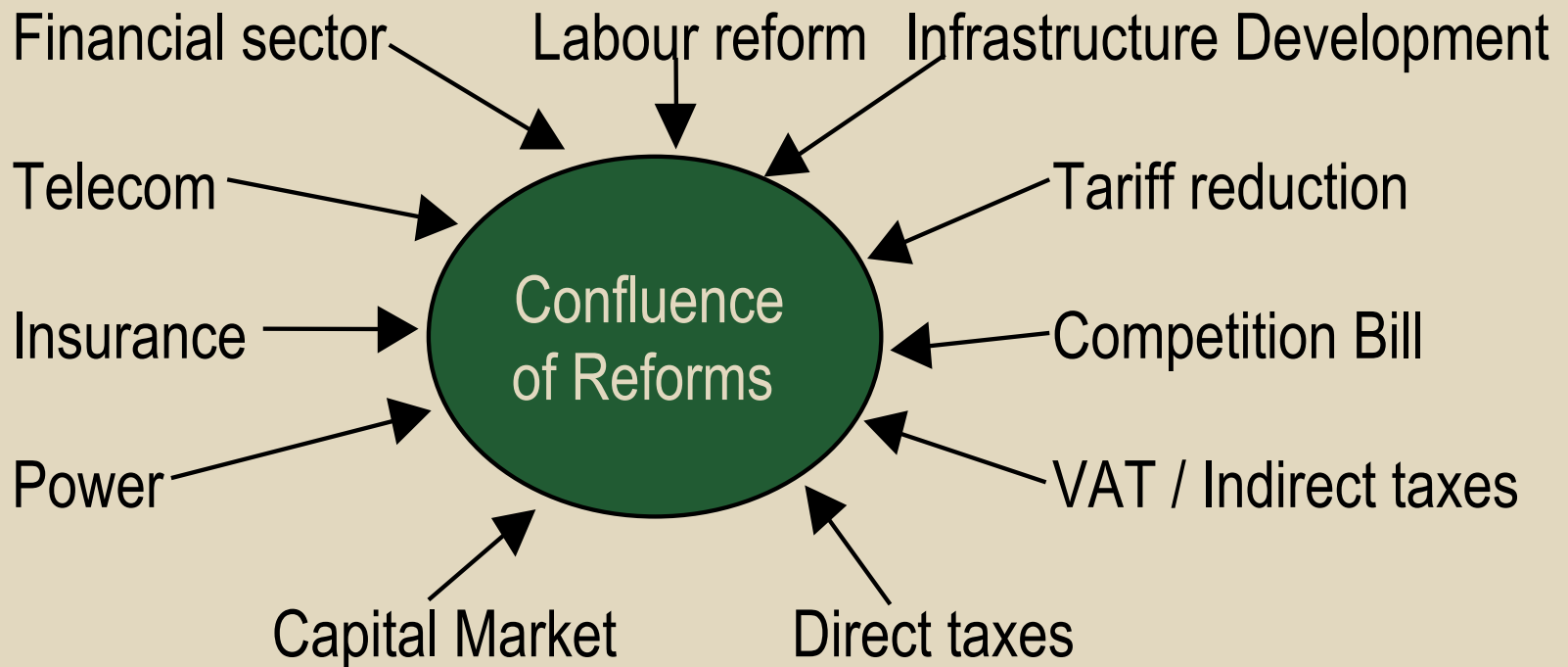
INTEREST RATES – ALL FALL DOWN



FALL IN INTEREST RATE FROM 2001-04

- Lower interest rates have an anti-gravity (growth) effect:
 - Prepones consumer spending by greater availability and lower cost of credit
 - Encourages capital spending, especially
 - Enhances corporate profitability
 - Boosts value of Capital Assets
 - Increases viability of infrastructure projects, enabling debt funding of infrastructure
 - Improves Government finances by lowering the deficits and increasing maturities

MULTIPLIER EFFECT

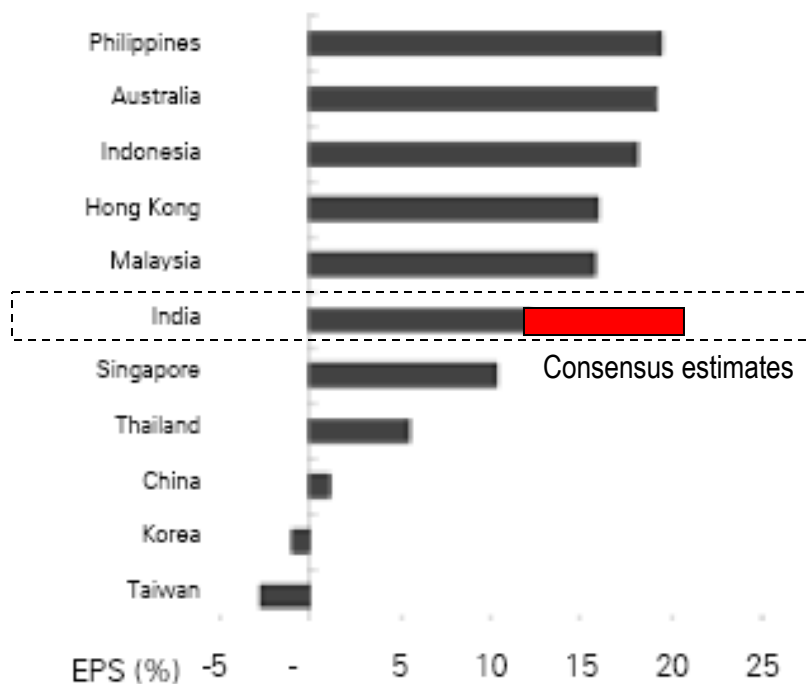


MULTIPLIER EFFECT

- All change is inter-related, and for India all components of change exhibit dynamism and momentum
- India's GDP composition is akin to developed countries with more than 50% coming from Services sector
- Capital spending along with consumer spending will compound GDP growth, which will be leveraged with increasing efficiency and productivity
- Resurgence of all sectors reflects in the breadth of equity impetus
- It's like a pond that doubles every day, and is half-full on the penultimate day though it becomes full on the ultimate day

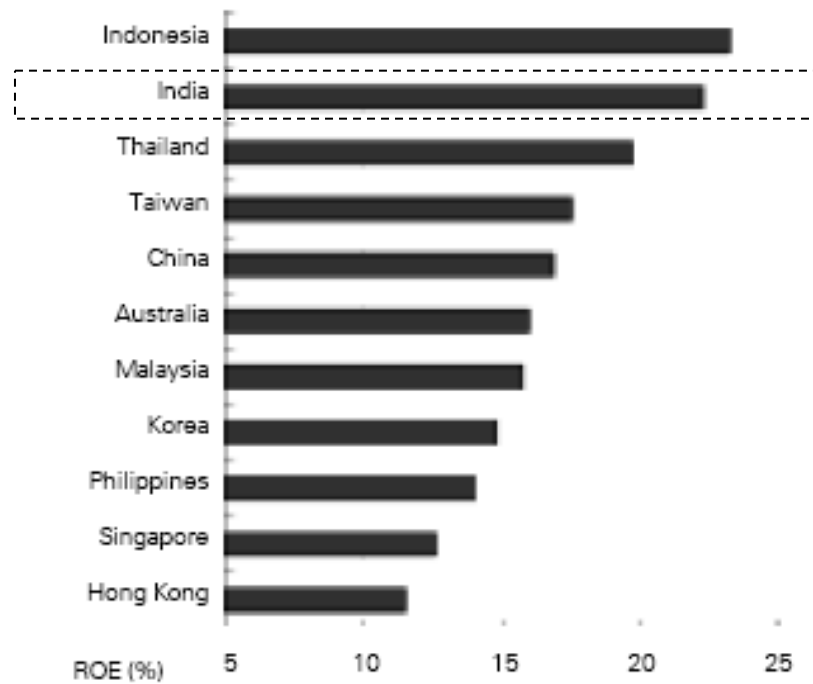
EMERGING MARKET BENCHMARKS

Figure 25: DB 2005F EPS growth (%)



Source: Deutsche Bank AG estimates

Figure 26: DB 2005F return on equity



Source: Deutsche Bank AG estimates

MICRO TRENDS

- Biggest micro trend is the expansion of mindset and horizons
- Indian companies being globally cost competitive
 - Pharma, Software, Tisco, Guj. Ambuja, Tata Motors, Hindalco
- Indian companies acquiring companies globally
 - Ranbaxy, Tata Motors, Tisco, Bharat Forge, Kirloskar Brothers, Amtek, Sun Pharma, etc
- Indian companies gearing up to global size
 - Infosys, Tata Motors, Bharat Forge,
- Indian companies becoming global sourcing hubs
 - Pharma, Textiles , GE, Sundaram Fasteners, Toyota Kirloskar, Cummins, Hyundai,
- Indian companies expanding through internal accruals and focusing on superior cash flows

DU PONT ANALYSIS

Dupont Analysis for India's Top 200 Companies

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|-----------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Aggregate for 200 companies | | | | | | | | | | | | |
| Net Margin | 6.3% | 9.2% | 9.4% | 7.6% | 8.0% | 7.0% | 6.1% | 6.4% | 6.3% | 8.5% | 9.5% | 10.1% |
| Asset Turn | 1.01 | 0.93 | 0.95 | 0.93 | 0.88 | 0.94 | 1.10 | 1.25 | 1.23 | 1.37 | 1.45 | 1.57 |
| ROA | 6.3% | 8.6% | 8.9% | 7.1% | 7.1% | 6.5% | 6.7% | 8.0% | 7.8% | 11.6% | 13.7% | 15.8% |
| Leverage | 2.13 | 1.90 | 1.84 | 1.92 | 1.89 | 1.82 | 1.74 | 1.70 | 1.70 | 1.57 | 1.50 | 1.44 |
| ROE | 13.5% | 16.2% | 16.3% | 13.6% | 13.4% | 11.8% | 11.7% | 13.6% | 13.2% | 18.2% | 20.6% | 22.7% |
| Aggregate Ex-Energy | | | | | | | | | | | | |
| Net Margin | 7.9% | 11.0% | 11.5% | 9.2% | 9.0% | 7.7% | 7.4% | 8.6% | 7.6% | 9.3% | 11.2% | 13.1% |
| Asset Turn | 0.77 | 0.78 | 0.80 | 0.77 | 0.74 | 0.73 | 0.80 | 0.86 | 0.90 | 0.98 | 1.09 | 1.17 |
| ROA | 6.1% | 8.6% | 9.2% | 7.0% | 6.7% | 5.7% | 6.0% | 7.4% | 6.8% | 9.0% | 12.2% | 15.4% |
| Leverage | 2.16 | 1.93 | 1.87 | 1.95 | 1.95 | 1.90 | 1.77 | 1.72 | 1.72 | 1.62 | 1.53 | 1.45 |
| ROE | 13.2% | 16.5% | 17.3% | 13.7% | 13.0% | 10.8% | 10.6% | 12.7% | 11.7% | 14.7% | 18.7% | 22.3% |

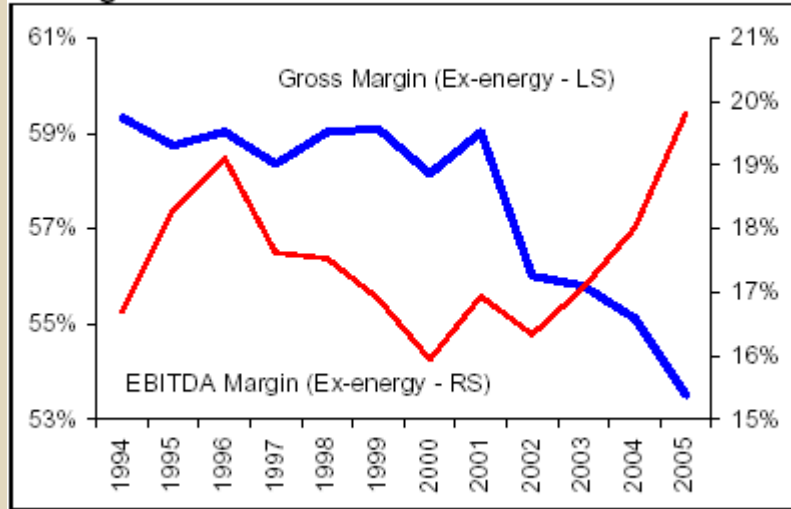
India's Top 200 Companies: Under-levered Balance Sheets

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|----------------------------|------|------|------|-------|------|-------|-------|-------|-------|------|------|------|
| Debt-equity x (year-end) | 1.13 | 0.90 | 0.84 | 0.92 | 0.89 | 0.82 | 0.74 | 0.70 | 0.70 | 0.57 | 0.50 | 0.44 |
| Interest cover x | 2.7 | 3.5 | 3.8 | 3.1 | 3.2 | 2.9 | 3.1 | 3.4 | 3.6 | 6.0 | 8.9 | 11.8 |
| Debt-operational cash flow | 5.3 | 4.0 | 3.7 | 4.5 | 4.4 | 4.3 | 3.7 | 3.3 | 3.2 | 2.2 | 1.8 | 1.5 |
| Interest to sales | 4.7% | 4.5% | 4.2% | 4.7% | 4.7% | 4.8% | 3.9% | 3.5% | 3.4% | 2.4% | 1.6% | 1.3% |
| Interest Rate | NA | 9.9% | 9.3% | 10.2% | 9.3% | 10.0% | 10.1% | 10.9% | 10.4% | 8.6% | 7.1% | 6.7% |

Source: Company data, Morgan Stanley Research

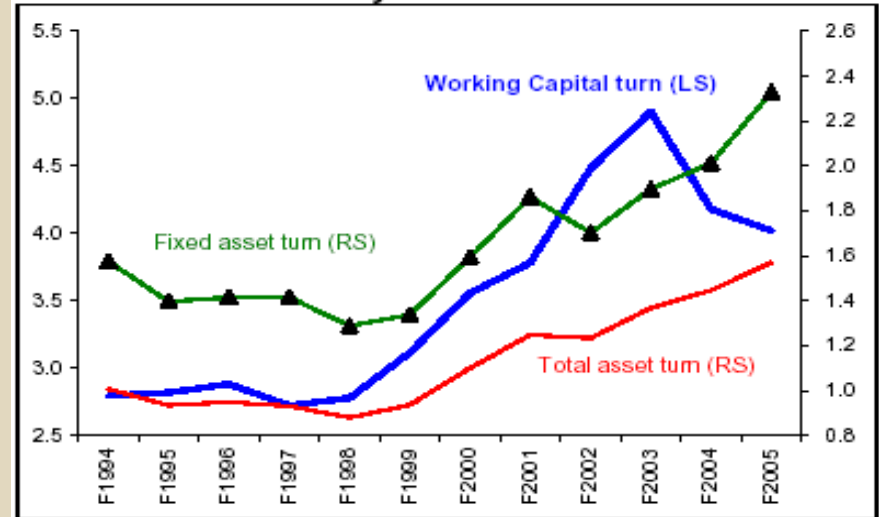
QUALITY OF EARNINGS

Cost Cutting and Operating Leverage Offset Lack of Pricing Power



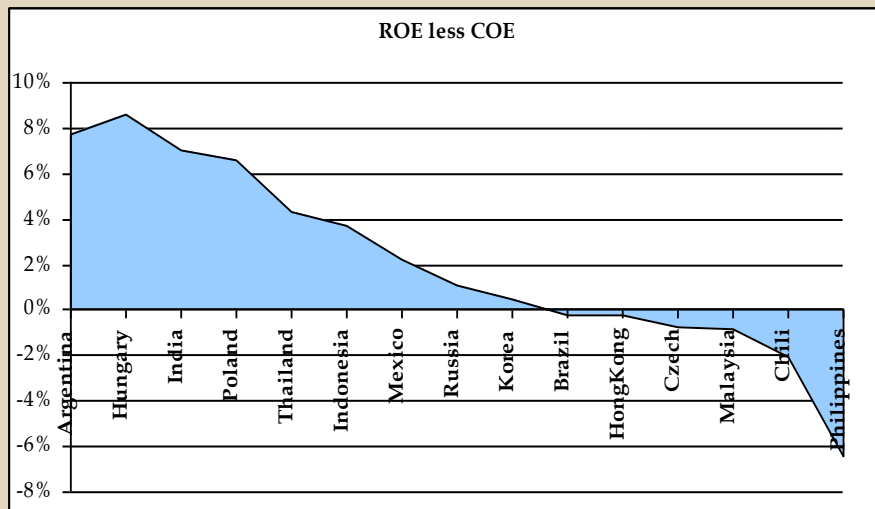
Source: Company data, Morgan Stanley Research

Fixed Assets Turn Key to ROE Success

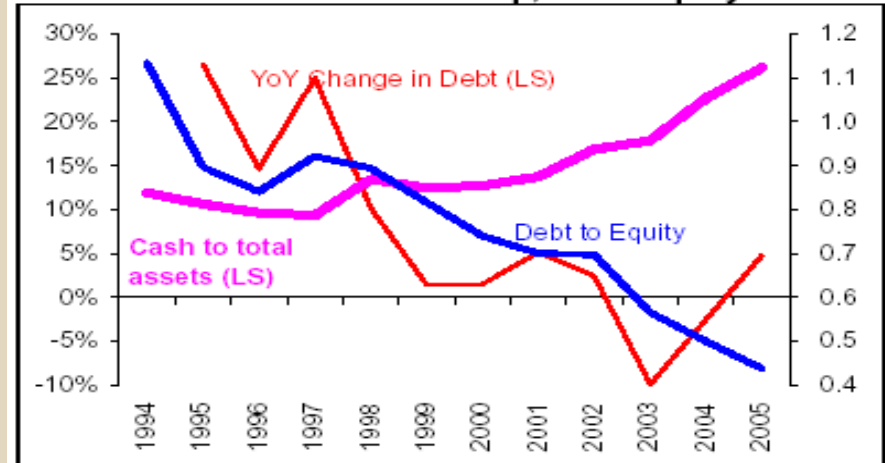


Source: Company data, Morgan Stanley Research

ROE less COE

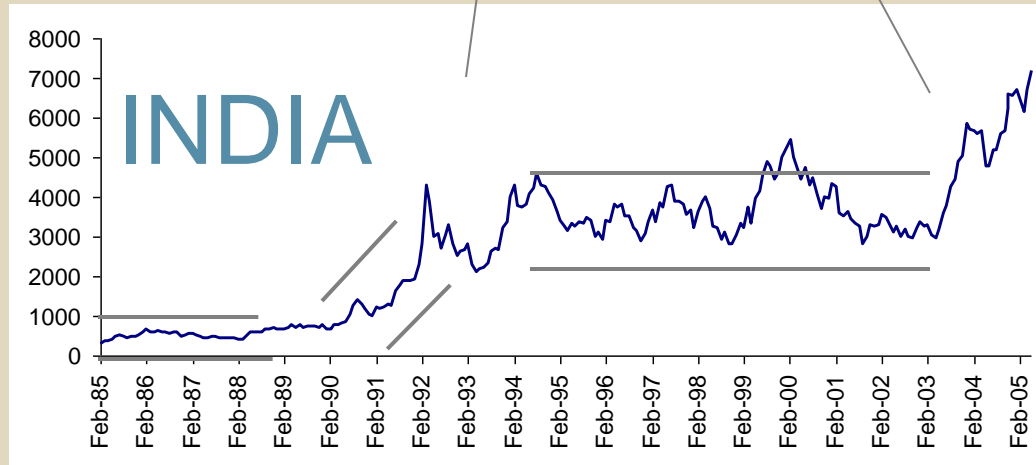
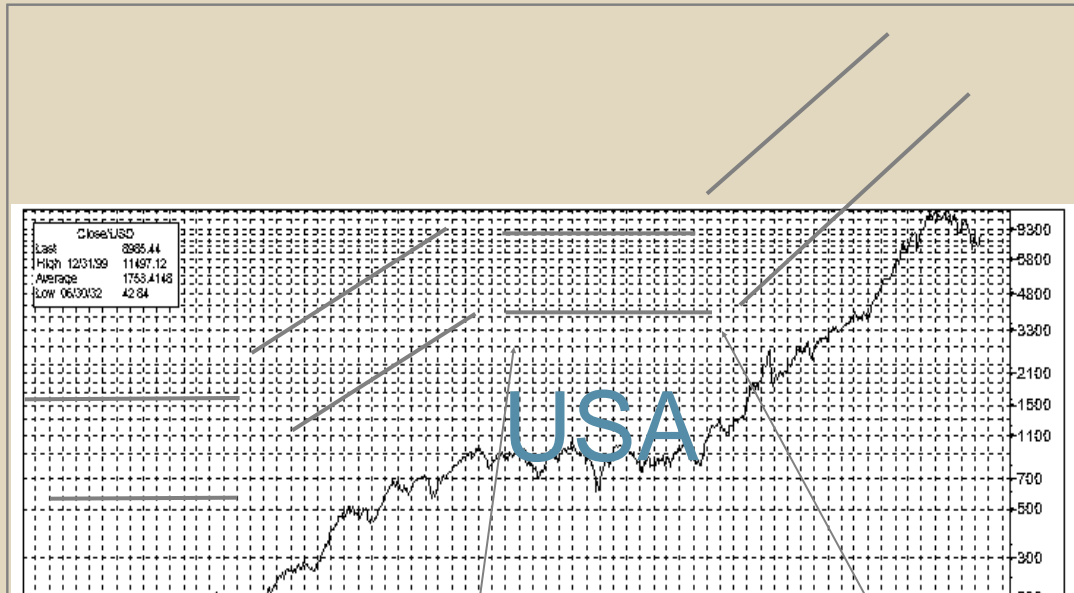


Solid Balance Sheets: Cash Up, Debt/Equity Down



Source: Company data, Morgan Stanley Research

THE LONG TERM PERSPECTIVE



“Bull markets are born in the depths of depression, and are reared on declining interest rates and rising corporate profits.”

~ Dr. Marc Faber

SENSEX POSSIBILITIES

$$\text{SENSEX VALUE} = \text{SENSEX EPS} \times \text{SENSEX PE}$$

← EARNINGS →

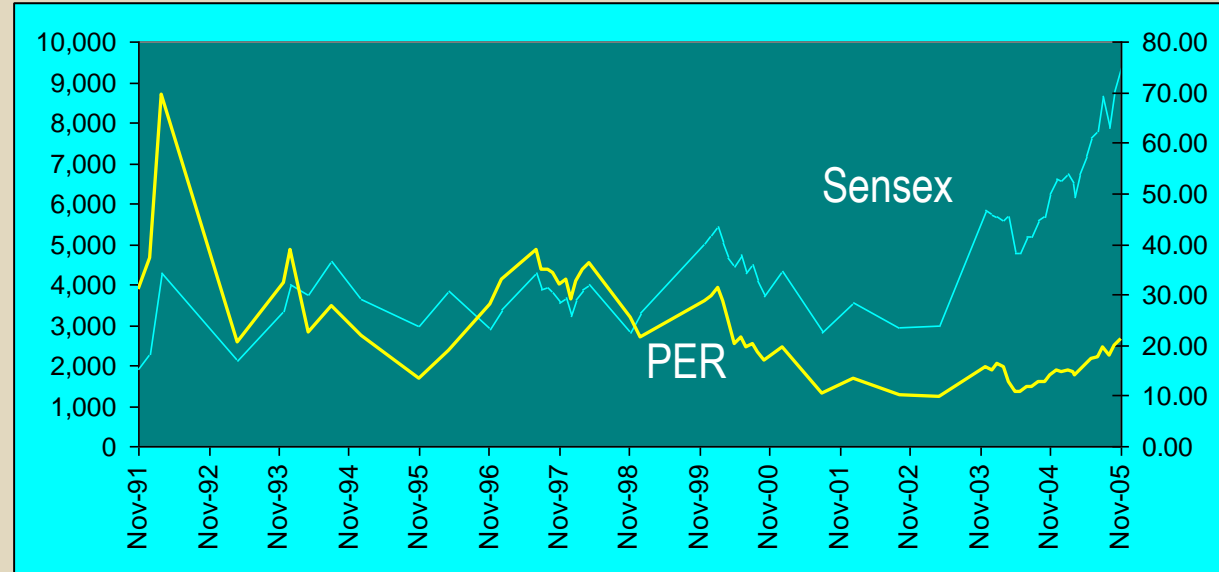
Sensex 2010 - Crystal Gazing

| P/E | ----- CAGR till FY 2010 ----- | | |
|-----|-------------------------------|--------|--------|
| | 10% | 15% | 20% |
| 15x | 11,668 | 14,572 | 18,028 |
| 20x | 15,558 | 19,430 | 24,037 |
| 25x | 19,447 | 24,287 | 30,046 |
| 28x | 21,781 | 27,202 | 33,652 |

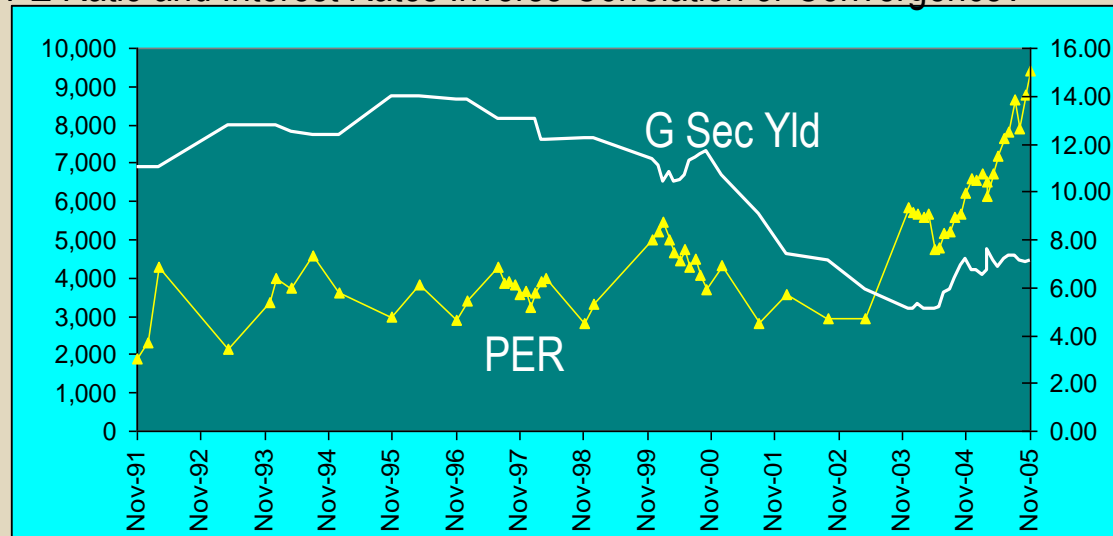
Base Sensex EPS of 483 in FY2005

VALUATION PARADOX

Sensex and PE Ratio, Bubble or . . .



Sensex PE Ratio and Interest Rates Inverse Correlation or Convergence?



FY 06E P/E

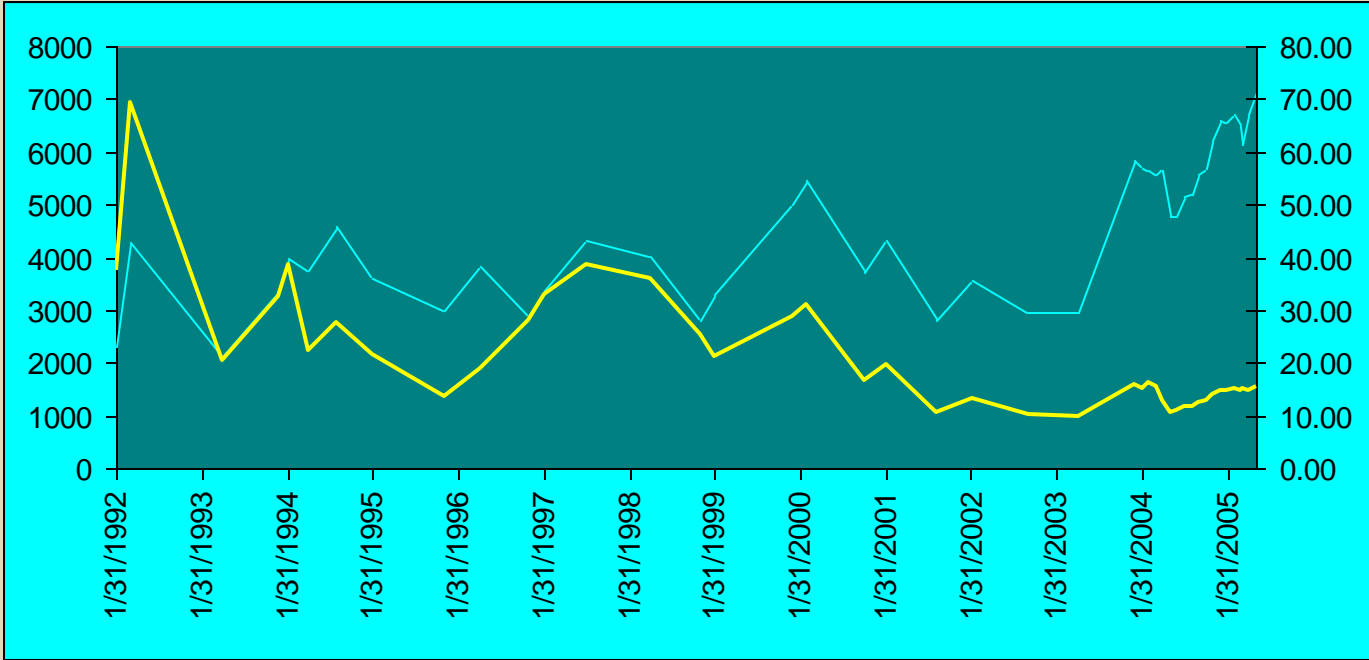
17.80

FY07 P/E

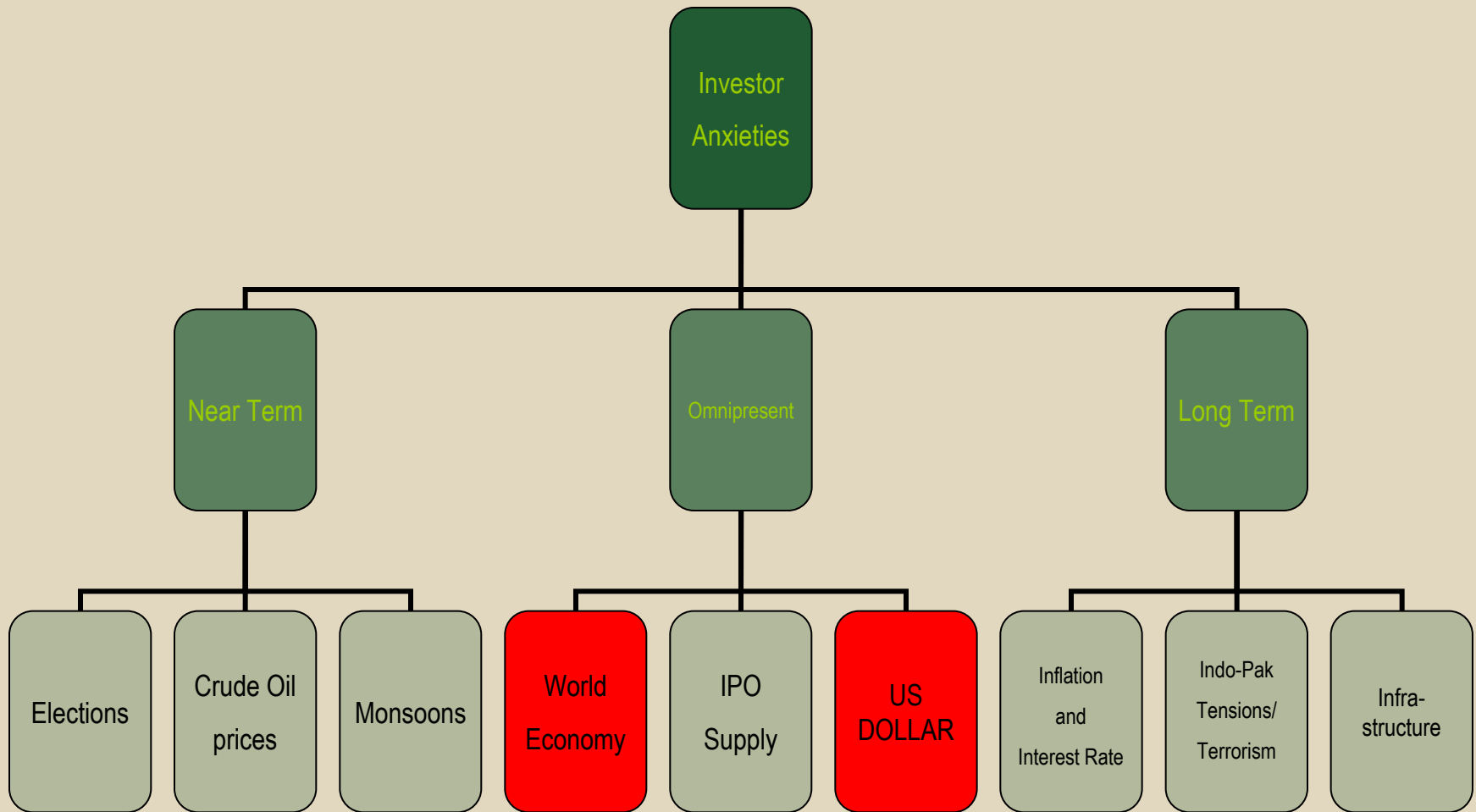
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[BACK](#)

| Date | SENSEX | Trailing PE | G-Sec Yield |
|--------|--------|-------------|-------------|
| Jan-92 | 2,303 | 37.36 | 11.00 |
| Mar-92 | 4,285 | 69.53 | 11.00 |
| Apr-93 | 2,122 | 20.58 | 12.75 |
| Dec-93 | 3,346 | 32.45 | 12.75 |
| Jan-94 | 3,995 | 38.74 | 12.75 |
| Apr-94 | 3,746 | 22.53 | 12.50 |
| Aug-94 | 4,588 | 27.59 | 12.35 |
| Jan-95 | 3,619 | 21.76 | 12.35 |
| Nov-95 | 2,994 | 13.47 | 14.00 |
| Apr-96 | 3,827 | 18.93 | 14.00 |
| Nov-96 | 2,891 | 28.08 | 13.85 |
| Jan-97 | 3,382 | 32.86 | 13.85 |
| Jul-97 | 4,306 | 38.71 | 13.05 |
| Aug-97 | 3,876 | 34.85 | 13.05 |
| Sep-97 | 3,902 | 35.08 | 13.05 |
| Oct-97 | 3,803 | 34.20 | 13.05 |
| Nov-97 | 3,560 | 32.01 | 13.05 |
| Dec-97 | 3,659 | 32.90 | 13.05 |
| Jan-98 | 3,224 | 28.99 | 13.05 |
| Feb-98 | 3,622 | 32.57 | 13.05 |
| Mar-98 | 3,893 | 35.00 | 12.15 |
| Apr-98 | 4,007 | 36.15 | 12.15 |
| Nov-98 | 2,811 | 25.36 | 12.25 |
| Jan-99 | 3,316 | 21.39 | 12.25 |
| Dec-99 | 5,006 | 28.70 | 11.36 |
| Jan-00 | 5,205 | 29.84 | 11.06 |
| Feb-00 | 5,447 | 31.23 | 10.42 |
| Mar-00 | 5,001 | 28.67 | 10.85 |
| Apr-00 | 4,658 | 25.08 | 10.40 |
| May-00 | 4,434 | 20.15 | 10.50 |
| Jun-00 | 4,749 | 21.58 | 10.70 |
| Jul-00 | 4,280 | 19.45 | 11.30 |
| Aug-00 | 4,477 | 20.35 | 11.43 |
| Sep-00 | 4,090 | 18.59 | 11.56 |
| Oct-00 | 3,711 | 16.86 | 11.69 |
| Jan-01 | 4,327 | 19.66 | 10.70 |
| Sep-01 | 2,812 | 10.50 | 9.10 |
| Feb-02 | 3,562 | 13.30 | 7.4 |
| Oct-02 | 2,949 | 10.29 | 7.12 |
| Apr-03 | 2,960 | 9.84 | 5.89 |
| Dec-03 | 5,839 | 15.79 | 5.1 |
| Jan-04 | 5,696 | 15.00 | 5.1 |
| Feb-04 | 5,668 | 16.20 | 5.3 |
| Mar-04 | 5,591 | 15.54 | 5.1 |
| Apr-04 | 5,655 | 12.77 | 5.12 |
| May-04 | 4,760 | 10.74 | 5.1 |
| Jun-04 | 4,795 | 10.82 | 5.2 |
| Jul-04 | 5,170 | 11.67 | 5.8 |
| Aug-04 | 5,192 | 11.72 | 5.9 |
| Sep-04 | 5,584 | 12.60 | 6.4 |
| Oct-04 | 5,672 | 12.80 | 6.9 |
| Nov-04 | 6,234 | 14.07 | 7.2 |
| Dec-04 | 6,603 | 14.91 | 6.71 |
| Jan-05 | 6,555 | 14.80 | 6.7 |
| Feb-05 | 6,715 | 15.16 | 6.5 |
| Mar-05 | 6,492 | 14.65 | 6.7 |
| Apr-05 | 6,154 | 13.89 | 7.63 |
| May-05 | 6,715 | 15.16 | 7.15 |
| Jun-05 | 7,180 | 16.21 | 6.88 |
| Jul-05 | 7,635 | 17.23 | 7.22 |
| Aug-05 | 7,805 | 17.62 | 7.35 |
| Sep-05 | 8,635 | 19.49 | 7.36 |
| Oct-05 | 7,892 | 17.82 | 7.098 |
| Nov-05 | 8,789 | 19.84 | 7.075 |
| Dec-05 | 9,398 | 21.21 | 7.107 |



POTENTIAL PARTY SPOILERS



WHY EQUITIES HAVE / WILL DELIVER SUPERIOR RETURN?

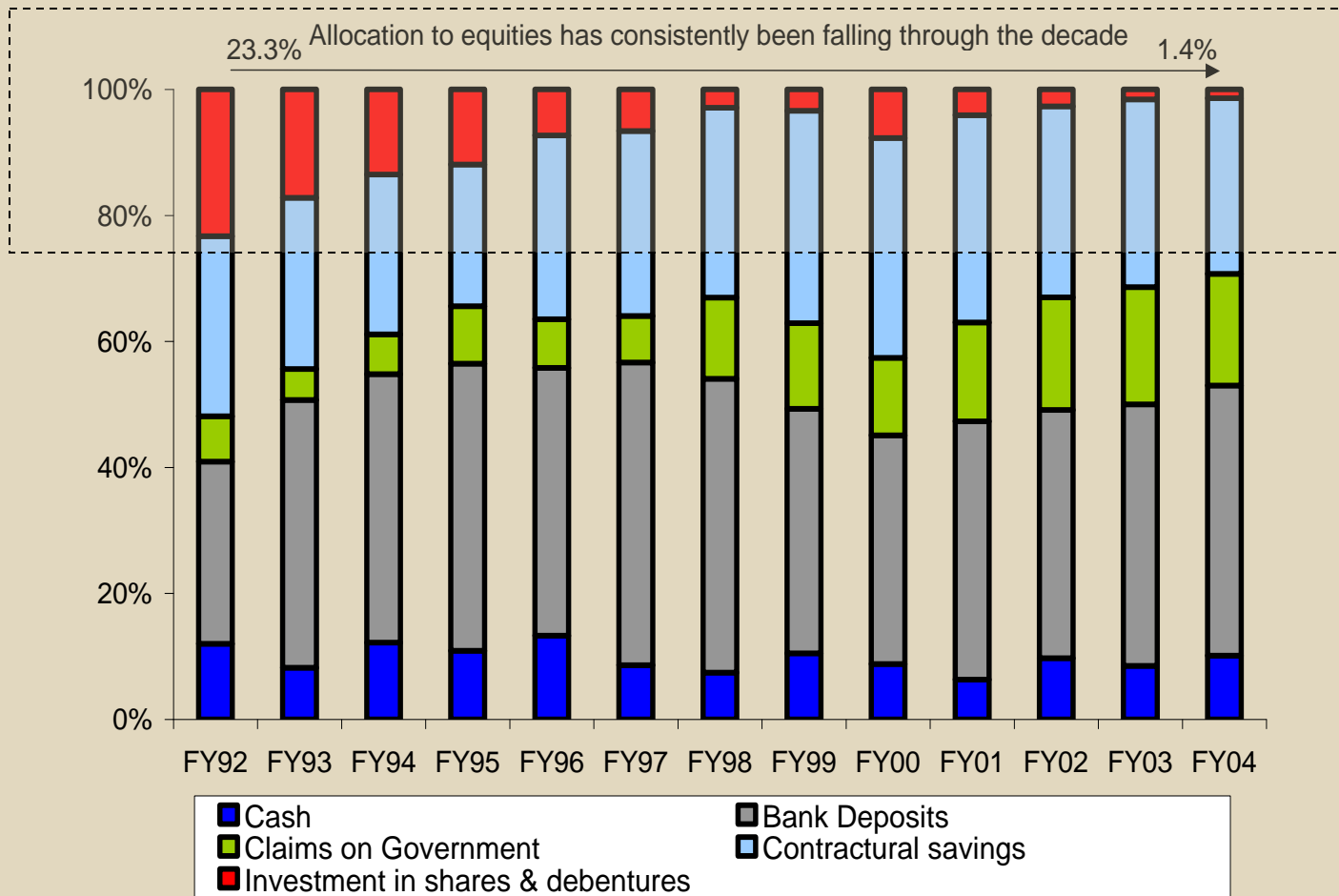
- CONVENTIONAL

Because equities carry higher risk than other asset classes, therefore it has a 'premium' in returns, the Risk Premium; and therefore will / have deliver higher return.

- CONTEMPORARY

Equities deliver superior return to any other asset class because companies have used capital more efficiently than their cost of capital, combined with the effects of inflation.

LOW EQUITY EXPOSURE

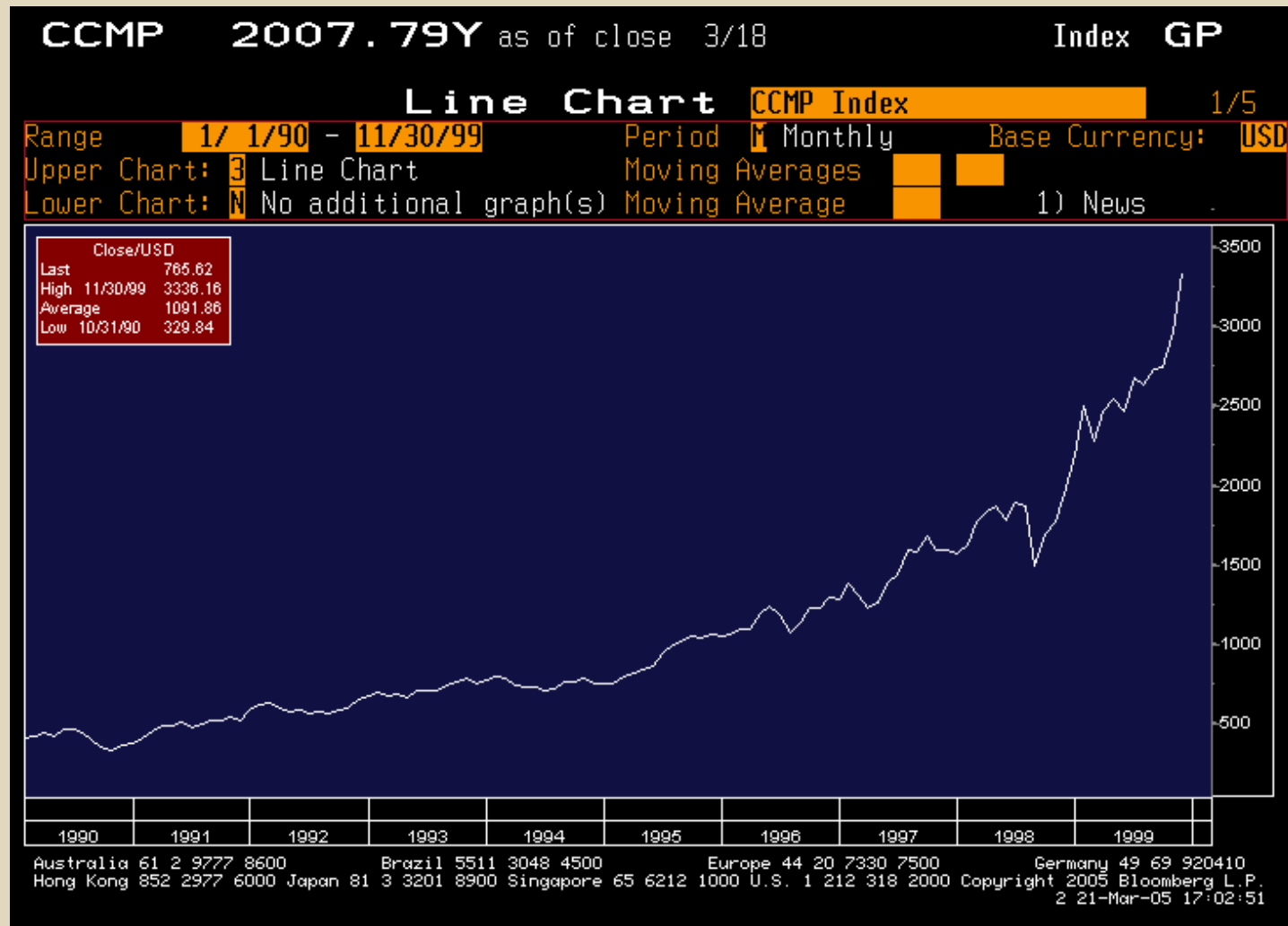


SOURCE : RBI

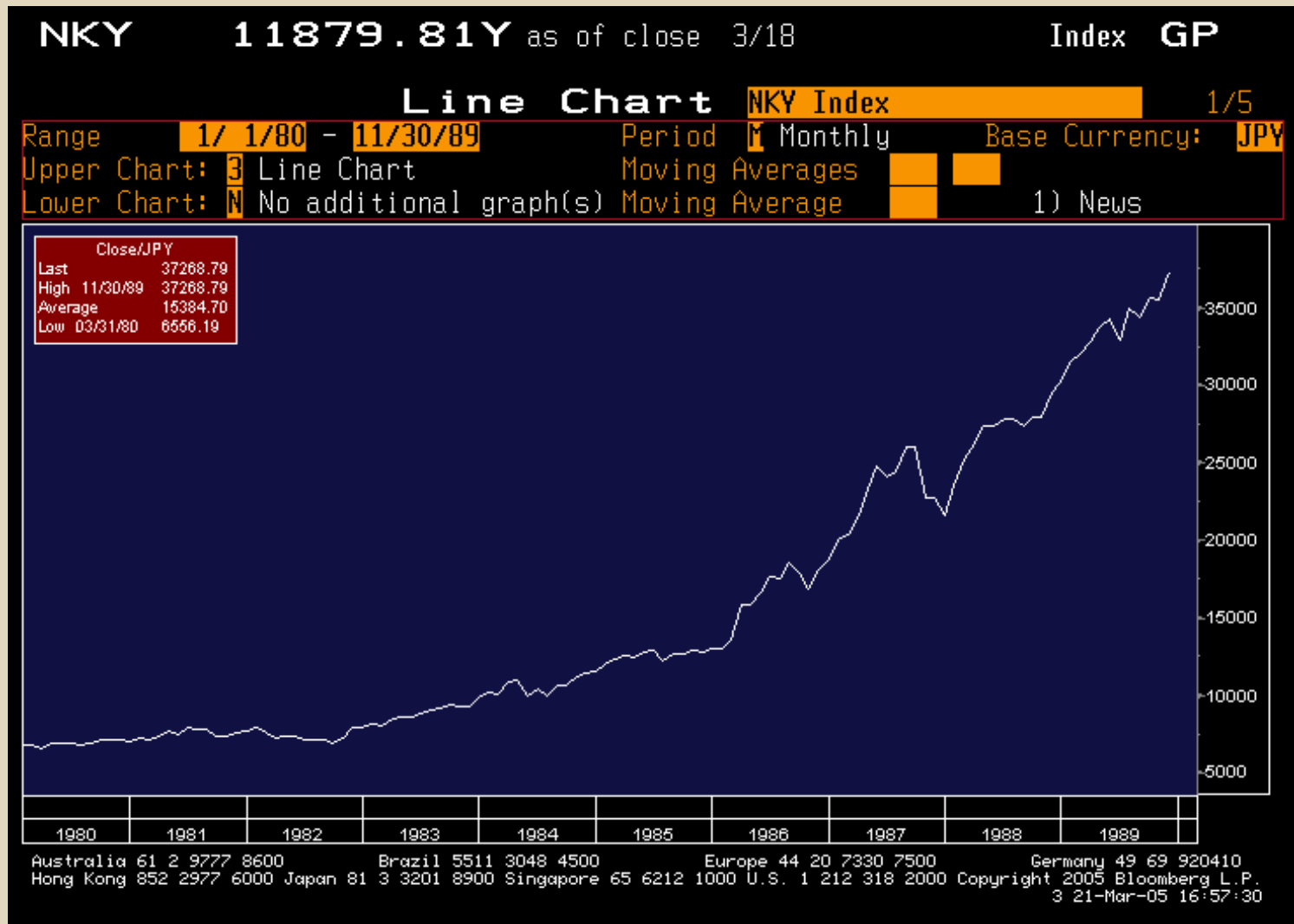
GOLD – 30% RETURN (1971 – 1980)



NASDAQ – 26% (1991 – 2000)

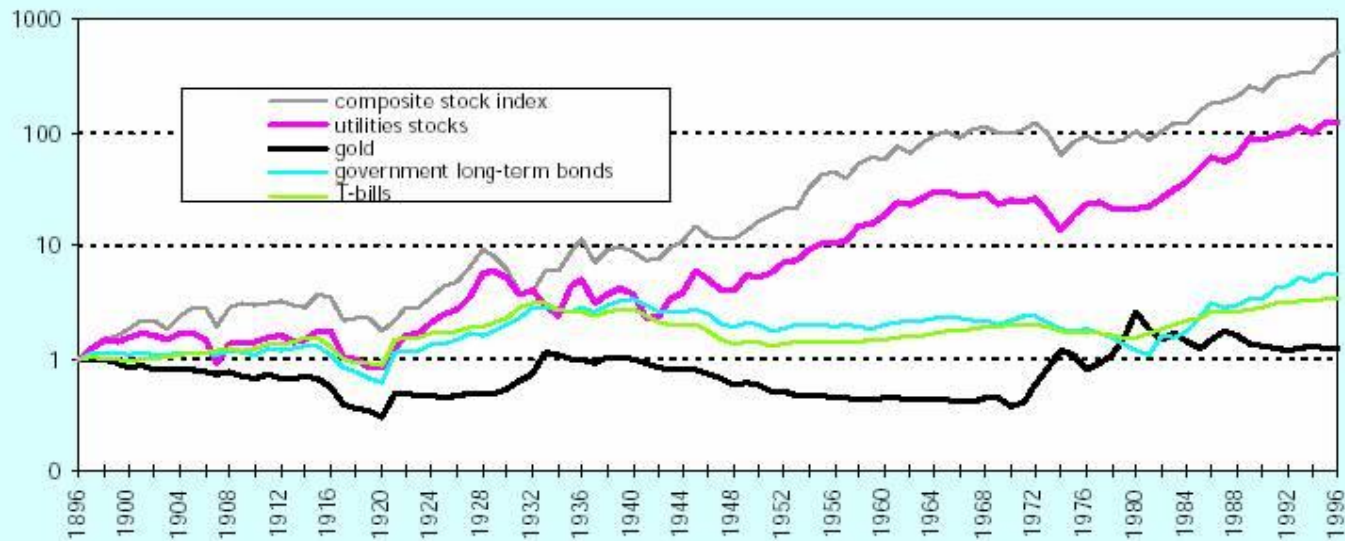


NIKKEI – 21% (1981 – 90)



STOCK, BONDS AND GOLD

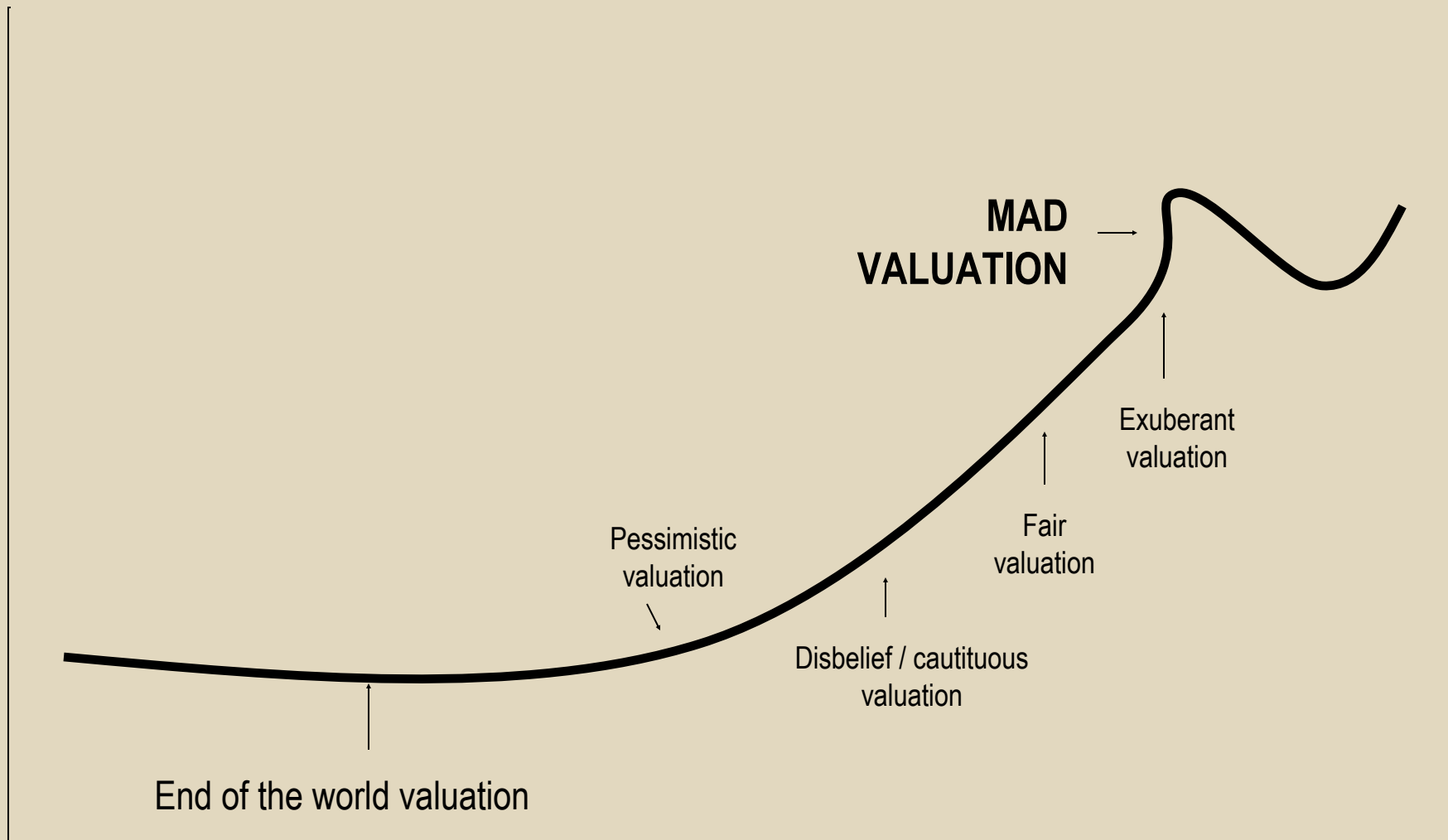
FIGURE 3.1
CUMULATIVE REAL RETURNS ON STOCKS, BONDS, AND GOLD IN THE US 1896-1996
Indices, 1896 = 1, logarithmic scale.



LEVERAGE?

- Leverage, equity markets and wealth creation
 - Others averse to leverage, not me
 - Focus on servicing cost and principal payment at anytime
 - Dividend to service interest payment
 - Exposure such that principal amount not greater than 10% of portfolio value

HUMAN PSYCHOLOGY



HUMAN PSYCHOLOGY

