

Investment Matters

From the CEO's Desk

Dear Client

In October 2007, we found that the P-Note issue - that potentially threatened to break the back of FII flows - turned out to be P-Silent. And the market moved forward happily.

However, over these past few months, there is another 'P' that has been slowly but steadily acquiring significant status in the market place. And that is 'Primary Markets'. Yes, IPO are back in favor - not just for institutional PE investors but also for retail Indian investors. And that is both good news and bad news.

In this issue, Hiren Ved dissects the impact of this renewed interest in IPO from a market standpoint. And shares with us the challenges and opportunities that he is focused upon.

In our Alchemy Academy, we have continued with our series on 'rationale behind themes' and shared with you our interest in select companies within pharma sector. I am sure you will find it insightful.

Happy Reading.

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CAPITAL MANAGEMENT

INVESTMENT MATTERS

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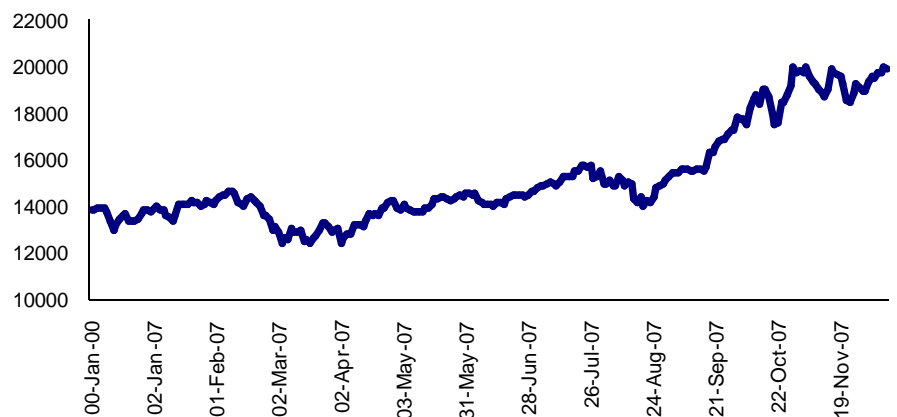
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"Powering" to a close.... 2007

As we approach the end of 2007, the broad markets have continued to surprise consensus. At the beginning of the year most market participants (including ourselves) had very modest expectations of returns, coming as it were on the back of 3 years of 40%+ index returns. But as things stand today, this year too has turned out to be stellar with YTD returns on Sensex/Nifty and the CNX Midcap of 44%/45% and 53% respectively. India went from being a being a laggard (amongst the EM universe) in the early part of the year to being one of the strongest markets after China, Brazil and HK.

Sensex



The FII's accelerated their pace of investments (especially after the fed rate cut in July) having invested a total of USD 16.6bn and seemed relatively unperturbed by the SEBI restrictions on P-Notes. The domestic investor participation though seems to have been muted if one were to look at the net MF flows. YTD the MF flows are a mere \$385 mn, \$165 mn of which has happened in November. Part of the reason for this is the continued caution amongst domestic investors and partly because the action has shifted to the IPO market. IPO's have been returning robust gains on listing and have enthused retail investors into participating wholeheartedly.

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The most significant highlight of recent market behavior has been the massive re-rating many sectors (power, ports, mineral resources and financial services to illustrate a few) have experienced as a result of the valuation benchmarks set by IPO and / or PE deals. The game in many sectors has moved from absolute valuations to relative valuations, from focusing on value creation via execution to value creation via de-mergers and primary/secondary offerings. These are phenomena one typically experiences during a mid- to late cycle bull markets. They also happen in sectors and themes which have the best justifiable future potential. No one can question the massive future potential of infrastructure in a country like India. That is why this is such an exciting sector today. The markets are willing to give very high valuations based on future potential and in many cases investors are overlooking potential execution risks. But these are ways of the markets. From an investment strategy standpoint it is important to recognize and understand and profit from this phenomena rather than move into a state of yogic abstinence.

A classic example is the 'power sector' in India - a theme we have been bullish for a long time. Demand for power in India has far outstripped supply for a long time. Capacity creation has lagged because of several reasons - lack of clear regulatory environment, financial state of State Electricity Boards (the major consumers of power), the Enron debacle, lack of long term fuel linkages (gas and coal) and more importantly a regulated cap on returns for generation companies. In an economy growing at 8%+, several other sectors offer entrepreneurs attractive returns on their investments. So why would they invest in a business whose returns are capped at 14%? Recognizing the fact that if the situation was not reversed soon the power shortage in the country would be acute and lack of quality power would become a major limiting factor in sustaining high economic growth. Hence the Electricity Act was passed - which allowed private sector power units to sell merchant power. The idea was to incentivize entrepreneurs to build power plants and earn a higher return by selling power to whosoever is willing to pay the highest price for it! Current power tariffs suggest that thermal power plants can realize upwards of 25%+ ROE at least for the first few years. Recognizing this many PE investors (and potentially listed market players) have given higher valuations to power assets because of the expected improved economics. Encouraged by such market valuations - many entrepreneurs will jump into the fray to raise capital to set up power plants and/or demerge existing power assets to unlock value! In a perverse way by assigning growth valuations to staid utility businesses, the equity markets are in effect incentivizing (luring) entrepreneurs to build more capacity in a capacity starved sector. Also because of the lack of a well developed debt market, equity markets, both private and public, have come to play a major role in infrastructure funding. While power is just an example, I believe this phenomena could be played out across the infrastructure spectrum - Ports, SEZ's, etc.

Empirical evidence suggest that such valuations do not last, as more paper gets issued, returns get normalized over the years and very few of the original contenders - with proven track records and/or execution capabilities - survive and create true stakeholder value. As I mentioned earlier, our endeavor and skills lie in identifying, understanding and positioning ourselves to take advantage of major trends - deciding where to play in the value chain and to pick the right stocks and back the right entrepreneurs.

As things stand today, I expect a year-end rally which may extend to the early part of 2008 as expectations of another fed rate cut start to be priced in. Investors in general continue to be cautious - amidst some pockets of exuberance - which augurs well for the broad markets. The valuation gap between large and mid caps had widened in October by over 500 bps - a point from which in the past our empirical study suggests the process of divergence starts to narrow - and hence I expect the mid caps to lead the rally into the next year. But we have to be cautious about how the US markets and economy shape up early next year. *But amidst all of this, my investment team and I are excited as always to find the next great investment and use all the knowledge, experience and insight to protect and grow your wealth.*

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Know an Alchemist



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Himani joined Alchemy Capital Management in November 2007 as Business Manager - Pune. She is a MBA from Lal Bahadur Shastri- New Delhi and is currently pursuing her Chartered Financial Planning (CFP), USA. She has more than 3 years of experience in financial services and IT, primarily at Kotak Securities in their Portfolio Management division. She loves reading, listening to music and learning new languages!

Global Equity Market Performance

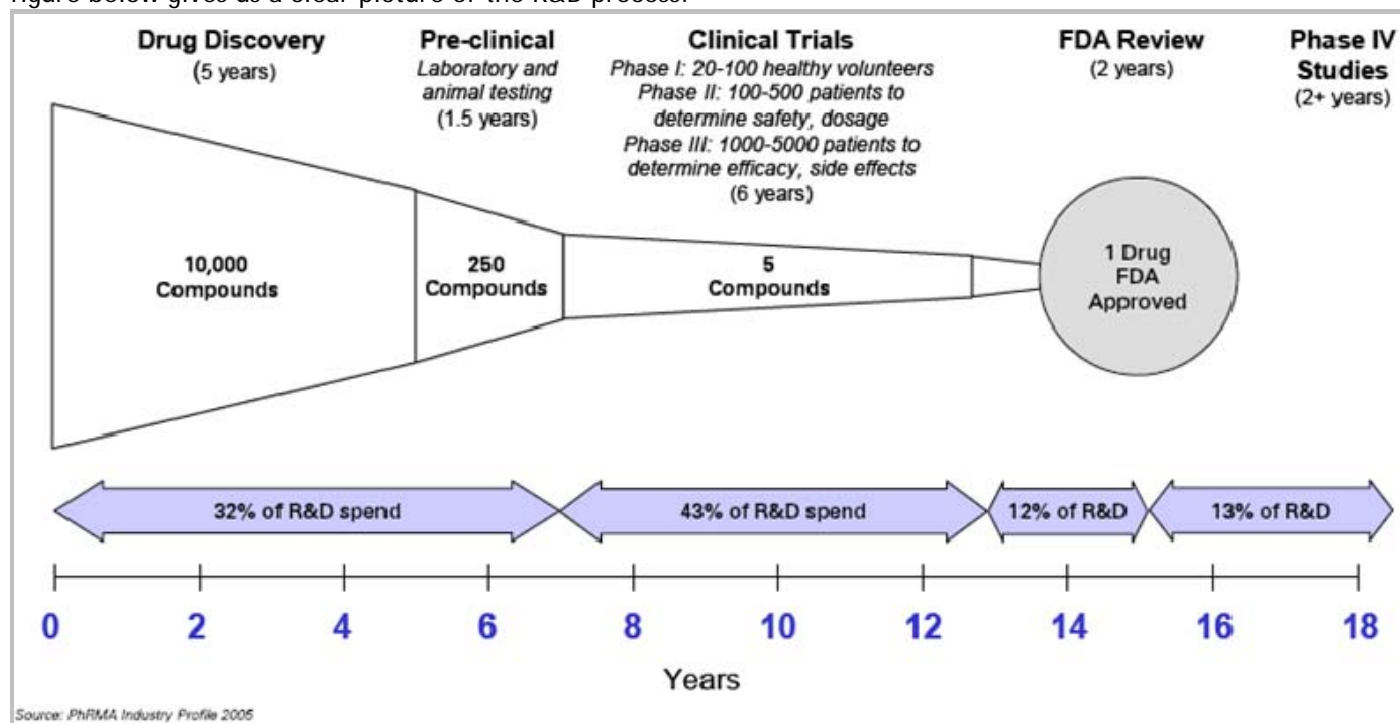
<i>Index Performance as on 10-Dec-07</i>	<i>1 month</i>	<i>3 months</i>	<i>6 months</i>	<i>1 year</i>	<i>YTD Returns</i>
Emerging Market Indices					
a) BRIC countries					
Brazil Bovespa	2.0	21.7	24.4	51.6	46.5
Russian RTS	2.0	20.7	28.3	25.5	21.8
BSE Sensex	5.4	28.2	41.5	48.7	39.7
China Se Shang Composite	4.0	-3.5	15.3	166.5	105.2
b) Other EM					
Korea Kospi	-4.2	3.2	11.1	37.1	37.9
Taiwan TAIEX	-4.2	-4.5	3.1	13.0	11.6
KL Composite	1.6	10.8	5.0	29.4	19.8
Stock Exch of Thai	-3.8	5.0	11.6	13.6	28.1
Jakarta Composite	3.1	26.2	33.9	58.6	57.5
PSEi - Phillippine Se IDX	-0.8	12.5	4.2	29.3	13.3
Chili IPSA	1.7	4.4	-0.6	26.4	12.1
Mexico BOLSA	7.2	3.6	-1.8	21.1	12.3
Venezuela	1.5	-0.4	0.6	-14.1	-12.1
Developed Market Indices					
Japanese Nikkei 225	2.2	0.3	-10.7	-3.7	-9.1
Dow Jones Indl Avg.	4.5	2.4	1.5	10.5	7.5
Nasdaq Composite	3.0	4.2	5.2	10.8	9.6
German DAX	2.7	7.6	4.1	24.0	17.1
UK: FTSE 100	4.1	4.5	-0.1	6.5	4.5
France: CAC 40	3.9	4.7	-3.4	5.7	1.3
Singapore: Straits Times	-1.3	1.7	0.2	23.1	12.2
HK: Hang Seng Index	-1.0	19.0	38.3	50.6	39.5



Value Creation through Monetising R&D

With the introduction of product patent in many countries, including India and intense competition in plain-vanilla generics, it has necessitated investment in innovation. Indian companies were forced to look beyond generics and were required to invest in discovery R&D. With its high quality, low cost scientific skills, India has the potential to become a key R&D player.

Before we try and understand how R&D players in India will benefit, we need to understand the process of R&D. The figure below gives us a clear picture of the R&D process:



The Indian pharma industry is in the initial stage of a drug discovery process. Given the skill set of Indian pharmaceutical industry, increasing spend on R&D is likely to result in a few transformational success stories. We see encouraging trends in Indian R&D - progression from reverse engineering to generic plays and further to developing New Chemical Entities (NCE's) & Novel Drug Delivery System (NDDS), to clinical trials (Phase I and II presently) and out-licencing of early-stage drug candidates. Despite the not so successful record, there have been some flashes of activity in this arena. For example, Ranbaxy licenced the once-a-day Ciprofloxacin to Bayer; Dr. Reddy's Ltd licenced two of its anti-diabetic drug candidates, one each to Novo Nordisk and Novartis; and more recently, Glenmark licenced its lead drug candidate, GRC3886 (Oglemilast), to Forest labs and GRC8200 to Merck KGaA for milestone and royalty payments. This trend is likely to mature further as Indian companies develop capabilities to finance larger trials.

Indian pharmaceuticals are undertaking steps in R&D through deals with strategic partners and financial investors. Such deals limit resource commitment for high risk innovation projects. Alternatively, the base generic business is de-risked as innovation R&D unit is hived off and listed on the exchanges. Such steps led to substantial value unlocking.

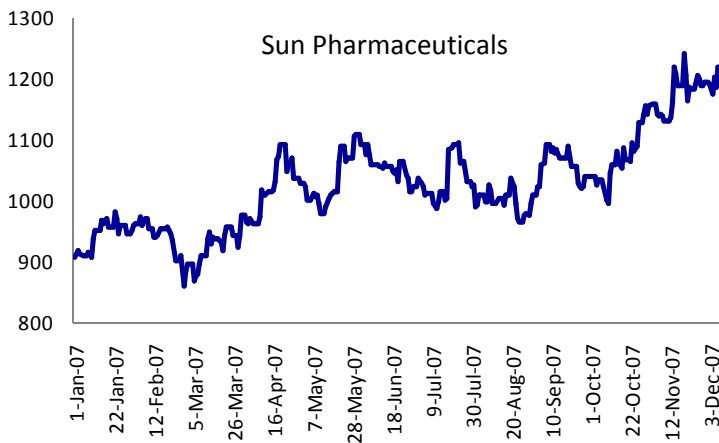
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A number of examples can be cited to demonstrate the kind of returns obtainable from a single success in R&D. Internationally companies like Sepracor (USA), Neutec pharma (UK), Cardiome (Canada) and Glenmark (India) have delivered substantial returns from small R&D pipelines reaching market capitalisations of \$500m-\$5bn.

Case Study:

Sun Pharma demerged its R&D Company, Sun Pharma Advanced Research (SPARC), early this year. The demerger was the first of its kind in the Indian pharma space, which we believe is a step in the right direction. The demerger was aimed at sharpening focus on the two distinct businesses, generics & drug discovery. Consensus pegs SPARC's NPV at US\$620mn. After having nurtured its innovative R&D through cash flows from the generics business and with SPARC's satisfactory progress, the demerger would ensure better focus and operating discipline. SPARC plans to monetise to out-license its assets after the establishment of the proof of concept.

The stock has delivered a 35% return an YTD basis.



Another example is Glenmark Pharmaceuticals. The company has recently announced that it will demerge its R&D arm into a separate company. Glenmark has a very good track record of monetizing research. It has received a lot of milestone payments from Forest Labs.

The stock has delivered 68% return on an YTD basis.



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Examples of some Licensing deals by Indian pharma companies:

Indian	Partner	Details	Comment
Dr Reddy's	Rheoscience	DRF 2593 (EU and China)	Phase II completed
	Novo Nordisk	DRF 2593	Deal ended
	Novartis	DRF 4158	Deal ended
	Novo Nordisk	DRF 2725	Discontinued
	ClinTec	DRF 1042	Joint development
Glenmark	Forest	GRC-3886 (US market only)	In phase-II trials
	Teijin	GRC-3886 (Japan market)	
	Merck KGaA	GRC-8200	In phase-II trials
Ranbaxy	Bayer	Cipro XR	Launched in US
	Schwarz	RBX2258	Discontinued
	PPD	RBX10558	Phase I

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