

## From the CEO's Desk

Dear Client

Team Alchemy joins me in wishing you and your families a very happy, healthy, peaceful and prosperous 2008.

The start of a new year is a good time to take stock of the past and indulge in crystal ball gazing of the future. And in this issue we do just that.

The big point I want to highlight is that the structural bull phase of the Indian market - which started and we called early in 2002 - is intact. But it is not going to be secular and across the board. It is going to be selective to certain stocks and sectors. As your portfolio manager, this provides us the challenge and opportunity to identify such stocks that have intrinsic growth potential to deliver superior returns.

My colleague, Sachin Shah (now running our Singapore subsidiary), has presented the arguments to back our conviction on the Indian market opportunity. I am sure you will find it engaging and compelling.

Happy Reading.

Warm Regards  
Vaidy

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## INVESTMENT MATTERS

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### Can It Stay This Good

BSE Sensex, up 47% in 2007, has seen a sixth consecutive year of gain, through which it has delivered a CAGR of 35% or absolute returns of 521%. The key question in investors' minds going into 2008 is "*Can it stay this good?*" There is no easy prediction on how global factors will effect Indian markets in 2008 given the wild card factors at hand - is it a US recession or slowdown, will it be a 'U' or a 'V' shaped recovery, how will the US dollar behave, will oil at US\$100 per barrel finally pinch and the geo-political risks surrounding it, can emerging economies decouple from US, can central bankers across the world align their policies to fight global slowdown or will they continue to target inflation, can sovereign wealth funds come to the rescue of riskier assets like equities, will the Chinese juggernaut continue, etc.

However, we still do believe that India provides enough opportunities to global investors to see positive returns, though the road could be bumpy depending on how global factors dictate the year. We think so because:

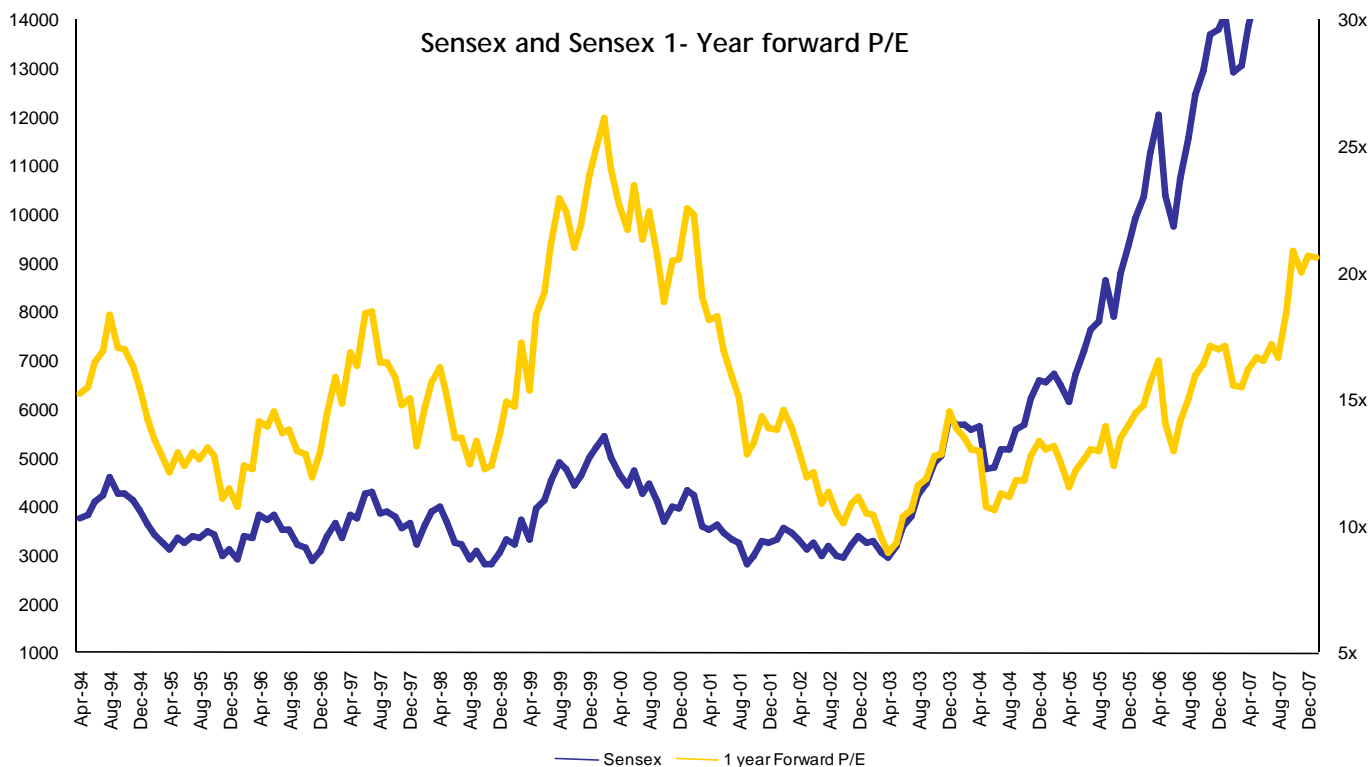
- **Investment cycle continues to be strong.** The strong investment cycle has been the main driver of India's GDP expansion with fixed investment growth of around 15% in recent years. This should continue given that the government has estimated an infrastructure spending of US\$450bn in the 11th Five-Year Plan compared to US\$150bn in the 10th Plan plus the estimated US\$300bn in industrial Capex in the next five years. The recent spate of fund raising from the equity markets does not show that financing these investments would be a problem.
- **Sensex earnings to grow further.** Sensex valuations stand at 20.5x one year forward earnings compared to 17.6x in January'07 and 10.6x at the start of the rally in 2002. However, Sensex earnings are still likely to grow at over 20% over the next two years, which at this stage of the cycle is still good, though it may be slightly slower compared to 25%+ CAGR over last three years.
- **Value creation by Indian corporate will continue.** Value creation through demergers is likely to be a huge theme over the next two years. We have seen great examples in Bharti / Reliance Communication Creating multi-billion dollar valuations in their tower businesses, India Bulls creating a US \$ 5bn business in real estate, now spate of companies creating value in their energy businesses/ financial services etc. We think one reason why Sensex earnings appear

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expensive, is due to the embedded values of Insurance / Gas / Real Estate etc. In some of these companies, such values are large, which correspondingly do not add as much earnings currently as these businesses are in infancy.

- **New business ideas will continue to provide opportunity.** In an emerging country like India, we will continue to see new businesses flourishing. It is only a matter of identifying the trend and profiting from it. For e.g. we saw education companies flourish in 2007, we saw Advanta emerging in seeds business, Reddington in logistics, Sintex in pre-fab and monolithic structures, Prime Focus in special effects. This trend should continue to include gas as an alternative fuel in 2008, opportunities in defence and aerospace, and microfinance.
- **Global liquidity remains abundant.** Though credit continues to be an issue globally, global liquidity remains abundant. Most liquid US assets; bonds and property are not attractive investment destinations in the current environment. Emerging markets like India should continue to benefit from ample global liquidity and remain attractive due to their superior growth prospects. We believe another US\$18-20bn in fresh FII inflows in 2008 versus US\$17bn received in 2007 should not be a problem.
- **Indian household balance sheets continue to be underexposed to equities.** And with no other liquid investment avenues to beat inflation, we should see significant amount of funds being attracted to the equity markets directly or through mutual funds and insurance products. The surge in retail participation in recent primary market IPO portends well for greater allocation.

The key risk for 2008 will be the severity in US slowdown and the resultant increase in volatility that the investors will have to brace up for. At current high valuations, corrections will be steep and will demand high level of conviction from investors to stay invested and benefit in the long run. Given this scenario, we believe market returns of 15-20% should be achievable in line with forecasted earnings growth for Sensex companies. Portfolio returns could be higher, benefiting from stock selection and interesting opportunities thrown up from volatility. **HAPPY INVESTING!**



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## Know an Alchemyst



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Kishan joined Alchemy Capital Management in October 2007 as Business Manager - Bangalore. He is an MBA from Mysore University. He has more than 3 years of experience in financial services with Motilal Oswal and Karvy PCG. He loves listening to music and, like most of us at Alchemy, a compulsive foodie!

## Global Equity Market Performance

Index Performance as on 31-Dec-07	1 month	3 months	6 months	1 year
<b>a) BRIC countries</b>				
Brazil Bovespa	-0.9	4.1	12.9	42.9
Russian RTS	3.9	9.6	17.9	19.2
BSE Sensex	5.3	15.7	38.2	48.2
China Se Shang Composite	19.3	-1.9	39.4	171.6
<b>b) Other EM</b>				
Korea KOSPI	-2.7	-6.9	1.5	33.5
Taiwan TAIEX	-4.8	-14.5	-9.2	3.8
KL Composite	3.0	6.4	5.9	30.4
Stock Exch of Thai	0.4	-1.4	1.4	29.1
Jakarta Composite	-0.4	10.9	24.9	50.4
PSEI - Phillipine Se IDX	-4.5	-7.8	-6.6	15.5
Chili IPSA	-5.2	-9.4	-14.4	9.2
Mexico BOLSA	-3.8	-7.1	-10.4	8.6
Venezuela	-3.4	2.1	-3.7	-30.6
Japanese Nikkei 225	-5.1	-14.0	-19.1	-15.3
Dow Jones Indl Avg.	-1.4	-6.6	-3.8	4.6
Nasdaq Composite	-0.7	-4.8	-1.6	6.1
German DAX	1.3	-0.5	-2.1	18.5
UK: FTSE 100	2.6	-1.0	-2.9	3.1
France: CAC 40	0.0	-4.5	-9.1	-0.5
Singapore: Straits Times	-2.9	-9.5	-3.7	13.2
HK: Hang Seng Index	-4.7	2.0	23.8	37.4

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## Defence and Aerospace

India's ambitions of becoming a 'Super Power' have propelled tremendous growth opportunities for several private sector companies engaged in defence production. The continuous emphasis of the Indian government on achieving self sufficiency in the defence sector has resulted in increasing defence spending and players in the private sector have emerged as the major beneficiaries. This can be proved by the government's encouragement given to the private sector for developing key components for the defence sector.

The Indian government's capital expenditure on defence has doubled over the past 5 years from 0.6% of GDP for FY2000 to 1% for FY2006. In the quest of achieving self sufficiency, the R&D expenditure on defence has also seen an increase of 20% in FY2006. The Indian government is seeking to increase the indigenization of the defence capital expenditure through more private sector participation.

To spur the process of indigenization, a synergy between the public and private sector is being encouraged. Private sector's role has been extended from being a supplier of raw-materials and subsystems to becoming a partner in the entire development process. Private participation is being looked at to translate indigenous technology into commercially viable products for the defence sector. We believe this will augment business prospects for the private sector companies in this sector.

We understand that space technology has a strong link to missile technology. The government has increased the capital expenditure on space technology from Rs2.83bn in FY2003 to Rs6.08bn in FY2006.

### Off-Set Clause

India is the third largest importer of arms and equipment in the world. Every year nearly 30 to 40 % of the defence budget finds its way out of the country towards acquisitions either through direct or indirect imports. This is a major amount for any country leave alone India. The bottom line is that a substantial amount of precious National resources move out without giving corresponding benefit to the nation.

The commercial logic of Defence imports is most exploitative for any economy. When a country imports Defence equipment without offsets, it not only robs the country of dignity and makes it vulnerable to denial regimes, it also does not add to the economy of the country, either as capital / infrastructure or as consumption (money spent).

In order to leverage this buying power of the country, to achieve greater self reliance in defence production, Ministry of Defence, Government of India has announced the Offset Policy as part of the Defence Procurement Procedure (DPP) 2005.

The offset policy mentions inclusion of an offset clause amounting to a minimum of 30 percent of the indicative costing in the RFP where the indicative cost of the contract is Rs 300 crores or more. India would buy \$100 billion worth of military equipment over the next five years. As stated above, 30 per cent of the contract value will be offsets that are co-production or purchase agreements with Indian defence producers. Should India's \$100 billion be spent on foreign equipment, Indian private sector will benefit from offset opportunities worth \$30 billion (Rs.120,000 crores)!

A lot of the large private sector companies with engineering skills have entered or are in the process of entering into technological tie-up with Global defence majors. Many are also in the process of setting up the basic infrastructure for the same. Companies who have past experience in the products have already started getting orders from Global companies. We believe, that this sector provides high growth and superior returns investment opportunity.

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