BOTTOMLINE

The half-yearly finance magazine of IIM Bangalore

EDITION 2, MARCH 2014

COMMODITY SUPERCYCLE ...

Is it over??

M&A Coverage:
FB- Whatsapp Deal

Interviews:
Vijay Singh Chauhan, Director (FMO)
C. B. Bhave, Ex-Chairman, SEBI

Indian Equity Market:
Past Tense, Future Perfect

IIMB Investment Fund:
IT Industry: Sector Report

The Finance Club of IIM Bangalore

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Dear Readers,

We are pleased to present to you the second edition of "Bottomline", the bi-annual finance magazine of Indian Institute of Management, Bangalore, brought to you by Networth – The Finance Club at IIMB. The magazine is now a year old. Continuing with the tradition set by the inaugural edition, we seek to bring to you perspectives in the field of finance and economics from the academia, industry practitioners and students. In addition, factual news and happenings from the sector, along with relevant market data is also included. As a cover story for this edition, we ponder over the question if it is an end of the "Commodity Super Cycle?", an issue that has been much debated in finance circles around the world. With no conclusive judgment out yet on the issue, we believe it is a good time to bring it forth among our readers.

We have also covered opinions on banking licenses in India, interviews from the who's-who of Indian finance and a host of other topics. We would like to express our gratitude to everyone who has contributed in helping us come out with this edition. A special mention of thanks goes out to Prof. Charan Singh for arranging interviews for us. We thank Mr. Vijay Singh Chauhan and Mr. C.B. Bhave for agreeing to interview with us. We also thank Prof. P.C. Narayan and Mr. Ravi Gupta for their article contributions. Also deserving mention are the fellow student contributors from IIMB.

We would love to hear from you about our magazine. Feel free to send in your feedback, comments and suggestions to the following email ID:

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Editorial Team

Bottomline

ACADEMIA SPEAKS

New Bank License – Panacea or Paradox

Prof. P C Narayan

True Investor Returns In Mutual Funds

Loganathan B, Vinoth R

End of great Commodity Cycle

Rahul Ghosh

New Bank License

– Panacea or Paradox

Indian banks were owned largely by industry houses like Tata and Birla in the post-independence era but were taken over by the government (nationalized) in the late 1960's. Strangely, the Reserve Bank of India is now looking at the possibility of granting bank licenses to Industry houses! Sounds paradoxical?

Nationalization of banks in the late 1960's was seen as a decisive step to extend banking services to the unbanked majority of the Indian population. Yet the recent (2013) guidelines by the Reserve bank of India (RBI) for granting new bank licenses to private enterprise lays significant emphasis on 'financial inclusion' suggesting that government ownership of banks over the last several decades has perhaps not fully achieved the goal of 'financial inclusion'. Sounds paradoxical too!

In fact, government ownership of banks not only made the banks inefficient operationally over the years but also imposed an enormous financial burden on the government to meet the ever-increasing capital adequacy requirements as per the Basel norms. Perhaps to overcome this twin problem of operational inefficiency and capital adequacy, all nationalized banks were asked to list their equity shares in stock exchanges as part of the government's economic reforms agenda in the mid-1990s. Post the public listing of equity shares, the government's shareholding in banks reduced to 51% or thereabouts.

Professor P C Narayan is a faculty member in the Finance & Control area at IIM Bangalore with specific focus on banking & financial markets. He has rich and varied experience in the banking sector.

Effectively, the government ceded almost half of its 'cash-flow rights' without ceding its 'control rights' on the banking system. This was perhaps intended to ensure that the operational efficiency and profit performance of banks improved without seriously jeopardizing the larger socio-economic agenda that the government wished to pursue through the formal banking system.

Over the last decade and a half, however, the government has been confronted with a plethora of issues vis-à-vis government ownership of banks: (a) with the economy growing around 8% (GDP y-o-y), demand for credit in the economy has been going up exponentially; (b) the loan to GDP ratio in India is relatively low compared to similar economies like Brazil and consequently reflecting the potential for further credit growth in the system; (c) in the absence of alternate channels of credit delivery such as a vibrant corporate bond market, borrowers have little alternative but to turn to banks to meet their credit requirements. Unfortunately, capital in the banking industry is a linear function, i.e. for every additional rupee lent by a bank, ten to thirteen paisa has to be set aside as capital.

With the projected exponential credit growth in the economy, compounded by 51% equity ownership of banks by the government, the capital infusion by government is estimated to be between Rs. 100,000 and Rs. 120,000 crores in the next three years, even higher going forward. This financial strain on the national exchequer has slowly but surely imposed constraints and perhaps stunted the growth of the banking industry and consequently the credit growth in the economy.

One possible solution to this problem actively considered in the past was to reduce government ownership of banks in a staged manner from the current 51 % to a lower level say 33% in the near term and to 15% percent in a subsequent phase. However, attempts by the government in this direction have met with extreme resistance, even from those with a rightist political ideology! Hence, barring a political miracle, this alternative seems farfetched. A very viable (and obvious) alternative to meet the growing demand for credit, at the same time negate the need for government to continuously infuse more capital into the public sector banks, is to open more banks in the private sector! Industry observers are therefore not surprised by the government's decision to induct more private sector participation in the banking sector.

But this approach too is fraught with several problem and limitations. The 'guidelines' issued by the Reserve Bank of India (RBI) in February, 2013 for opening new banks in the private sector is very stringent, from several perspectives: (a) 'fit and proper' criteria for promoters, including past record of sound credentials and integrity of the promoter group, and their business culture not being misaligned with the banking model, (b) setting up a Non-Operative Financial Holding Company (NOFHC) to be registered as an Non-banking Finance Company (NBFC) with RBI and to be governed by the set of directions issued by RBI, (c) new bank to have a minimum paid-up equity voting capital of Rs 500 crores, with ownership rights of the promoter group through the NOFHC at a minimum of 40% of the paid-up equity voting capital, (d) shareholding of the NOFHC in the bank to be brought down to 15% within twelve years from date of commencement of business of the bank, (e) shares of the new bank to be listed on the stock exchanges within three years of commencing banking business, and (f) foreign shareholding in the new bank not to exceed 49% for the first five years.

In addition, the RBI guidelines state that the Board of Directors of the new bank should comprise a majority of independent directors, no entity other than the NOFHC shall have more than 10% shareholding in the bank, arms length relationship between the promoters/ promoters' group companies and the bank, priority sector lending (as per prevailing norms) at 40% of total credit and 25% of the bank branches to be located in unbanked areas of the country, with population less than 10,000. NBFCs already licensed by the RBI and currently operating in the country could convert to a bank through the NOFHC route.

The above guidelines together with stringent provisioning requirements for bad loan and the prevailing mandate for banks to maintain CRR at 4% and SLR at 23% of net demand

and time liabilities (NDTL), imposes enormous challenges for new entrants to sustain and grow their banking business profitably at least in the initial years.

The private sector banks that were licensed in the mid-1990s, particularly HDFC Bank, ICICI Bank and Axis Bank, have garnered near 20% market share between them and have demonstrated significantly superior financial performance vis-à-vis their public sector counterparts. So too Kotak Mahindra Bank and Yes Bank which came into being almost a decade later. The success of all these institutions can, to a large extent, be attributed to their 'pedigree', having been promoted by large institutions and/or individuals with experience in managing diverse financial assets. Other banks that were licensed around the same time that did not have a similar pedigree and came into being based on the entrepreneurial energy and enthusiasm of (avaricious?) promoters have all been merged, by force or by choice, with other banks. There are certainly lessons to learn from that experience when granting new bank licenses in 2014!

Furthermore, the issue of granting bank license to big names in Industry has evoked mixed response across-the-board. The very stringent guidelines by RBI to 'ring-fence' the banking business from the rest of the businesses of the promoters are laudable but difficult to oversee and regulate on an on-going basis. While several of the 'industry' applicants for new bank license already operate a financial services business, such as retail loans, leasing, mutual funds, brokerage, etc., hard-core banking business is a different species altogether, with stringent provisioning, liquidity and capital requirements, far tougher regulations to comply with and operating margins that get even thinner when 25% of the branches have to be located in unbanked parts of the country. With several mid-sized banks already 'jostling' for their share in what is perceived to be an already overcrowded market, the jury is still out on whether institutions that have applied for a new bank license are being driven by their sense of *hubris* or by a candid assessment of viable financial performance in the long term! Common sense suggests that if casting the net wider into unbaked areas would be a profitable proposition, why have existing banks not already entered that 'unchartered' territory in a significant way? In fact, the rather poor record of rural penetration by the newer private sector banks perhaps reflects the financial non-viability of entering that segment. Extending that argument, why would the newly licensed banks feel motivated to grow their business through 'financial inclusion' and setting up branches in unbanked areas?

Rather than enforcing stringent financial inclusion rules such as 25% of branches in unbanked areas, RBI may consider incentivizing all banks (not merely the newly licensed banks) to expand into unbanked areas by exempting the CRR and SLR requirements on deposits raised through branches in unbanked areas. We have precedence of such an incentive yielding good results in the case of non-resident deposits. In any case, current CRR and SLR requirements are way too high and Dr. Raghuram Rajan, in his statement when

taking charge as RBI Governor on 4th September, 2013, had alluded to '…reduce the need for banks to invest in government securities in a calibrated way'. A relief on CRR and SLR for deposits mobilized from unbanked areas would have a favourable impact on the interest income of banks and, to some extent, off-set the higher cost of doing business in unbanked and remote areas. We have an opportunity to knock-two-birds-with-one-stone!

In the final analysis, new bank licenses would perhaps ease some of the immediate pressures, particularly on the government. But the ever-increasing demand for credit to fund the expected economic growth is unlikely to be fully met by licensing new banks.

A multi-pronged approach is needed including (a) reduction in SLR that would free up funds to be deployed for industry credit rather than investing in low yielding government securities, (b) strengthening the interest rate deriva-

-tives market to enable banks and corporates to hedge against interest rate risks and (c) creating a vibrant corporate bond market that would ensure coupon rates on bonds commensurate with the credit risk of the issuers.

All these in turn would ensure a more predictable interest rate regime, an effective mechanism for credit delivery and an environment for more efficient monetary policy transmission. Last but not the least, the 'financial inclusion' agenda of the government can be achieved only by making it financially viable through innovative structures and incentives, not through regulatory enforcements!

TRUE INVESTOR RETURNS IN MUTUAL FUNDS

Introduction: Mutual Fund industry is fast growing with a CAGR of 18% between 2009 and 2013. Major contributions to mutual fund industry arise because of the advertised returns. The advertised returns represents fundamental fund's return, it may not represent the true investor returns. Our motivation is to study the actual returns earned by the investors to understand the performance of the mutual fund industry.

Loganathan B and Vinoth R are 2nd year students pursuing their Post-Graduate Programme in Managament at IIM Bangalore

Actual Returns:

Mutual Funds advertise their returns based on Buy and Hold which represents the returns earned by the investors who buy the units during the start of the fund and hold until end of the period. But in reality, the investors invest in and out of the fund throughout the life cycle of the open ended mutual fund and hence the actual returns would differ from buy and hold return as the magnitude and timing of cash flows would have an effect. When the asset under management is small in size during the initial stages of the fund, the managers would be able to deliver superior performance with respect to their respective benchmarks, thus attracting investors later into the fund.

With increase in size of the fund, the investment opportunities might cease to exist or the fund managers may not be able to allocate the funds efficiently to maintain the performance leading to decrease in returns in the successive periods. Since the fund size increased after the boom period majority of the investors would have lost money but buy and hold returns might still seem attractive since it assumes equal weights to both periods whereas in reality the initial boom period has less weight compared to later higher weighted slower period. Thus in order to measure the true returns of the fund, dollar weighted returns should be used.

Data Description

The data for mutual funds related information such as AUM, NAV and age are obtained from the Mutual Fund Industry Explorer database provided by the Investment Information and Credit Rating Agency of India Ltd. (ICRA). The sample that is being considered for analysis includes 303 funds and the sample period is from 2002 to 2010. Out of the 303 funds the analysis is restricted to 180 mutual fund schemes which are operating for more than 3 years. In India, the mutual fund companies report the past one, two and five year returns of the fund, which are essentially buy and hold returns. Similarly, dollar weighted returns are calculated for the above periods.

Empirical Results

The spread in returns between buy and hold and dollar-weighted returns are calculated for each of 180 funds (in case of 1 & 3 year rolling returns) and 100 funds (in case of 5 year rolling returns) across the available period of data. The spreads are historical values of individual mutual funds with no specific time hori-

Table 1: Historical Spread between Buy & Hold and Dollar Weighted Returns

	Median (Buy & Hold			Average (Buy & Hold		
All funds	**1 yr**	**3 yr**	**5 yr**	**1 yr**	**3 yr**	**5 yr**
Average	3.70%	3.50%	5.01%	4.20%	3.63%	5.50%
No. of non negative spreads	152	137	81	152	127	84
Median	3.74%	3.06%	4.05%	4.01%	3.26%	4.37%
Percentage of funds	84.44%	76.11%	81.00%	84.44%	70.56%	84.00%
Min	-2.47%	-13.39%	-22.79%	-10.56%	-12.36%	-22.60%
Max	22.37%	22.03%	20.10%	21.93%	21.44%	22.63%

-zon (some of the funds are younger). Since rolling returns are used, the median and average for individual funds are calculated to compare the results. The spreads are calculated as difference between buy & hold and dollar weighted return. It can be seen from the table that on an average the difference between advertised returns and the true investor returns is 3.70% for 1 year. Also 84% of the funds exhibit positive spreads which means the dollar weighted returns are lower than buy and hold returns in majority of the cases. From 3 year and 5 year rolling periods, it can be said that an investor acquires less than 4-5% of what is being advertised. It is also to be noted that these are gross returns without including management and other fees which could possibly reduce the returns further by 0.5-1%.

Systematic Investment Plan:

The difference between buy&hold and dollar weighted returns is majorly because of bad timing of the investor. For a lump-sum investment, it is very important to time the market correctly because when the market tanks, the returns earned would be negative.

One way to minimize the timing risk would be to invest through systematic investment plan. In SIP, the desired investment is broken into equal instalments over the entire period of investing horizon, for example Rs 1,80,000/- can be invested as Rs 5,000/- monthly for a period of 3 years. The regular investments can be made in different time periods like daily, monthly, quarterly etc. Therefore, when SIP is executed in a mutual fund, it will buy higher number of units in periods of market dips and vice versa. The returns difference between lump-sum and SIP is hugely dependent on the volatility of the market. Because market timing becomes crucial in volatile markets and hence SIP outperforms lump-sum in such cases. Hence investing through SIP will be beneficial to the investor.

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End of Great Commodity Cycle

– Rahul Ghosh

Rahul Ghosh is a first year student at IIM Bangalore , pursuing his Post Graduate Programme in Management. He has worked as a trader in the financial industry previously.

THE COMMODITY SUPERCYCLE: HOW IT BECAME SO LARGE.

The current commodity super cycle followed a great price depression in 1980-2000. The secular Bull Run which started around 2000 – 02 coincided with the spectacular rise of the emerging nations, the housing bubble and the unconventional monetary policy. Meanwhile it did suffer a huge setback in 2007 during the great recession. Moreover, it is not having the greatest of times today. But even with the occasional rough patches, commodities have generated mind boggling returns in the past decade.

IT'S JUST SUPPLY AND DEMAND

The prices of commodities are driven by the factors of supply and demand. Prices rise when demand exceeds supply and prices fall when the opposite happens. Hence, the study of commodity prices is essentially the analysis of the forces behind supply and demand. Producers of commodities are profit seeking entities and will boost or cut production to maximize profits. To understand their incentives very simply, consider the case of 1970s. The commodities prices were on a continuous rise. This incentivized the producers to increase the capital expenditure (capex) to develop mines and wells. This caused supply to increase. The period of supplies exceeding demand is particularly long in the commodity business because these are extremely capital intensive industries. Mines continue their production even when they make losses. As long as they cover their fixed cost operating a mine is justified. Eventually a time comes when supply outstrips demand and the prices begin to fall. This can be due to rise in supply, a fall in demand or growth in supplies exceeding the growth in demand. As a result of falling prices, the producers begin to invest lesser in mines. This occurs because excess inventory has associated cost. It has deterioration risk, hedging risk, warehouse and insurance charge and opportunity cost. In fact in extreme cases mines are shut completely. This entire cycle is slow and may take a decade to happen.

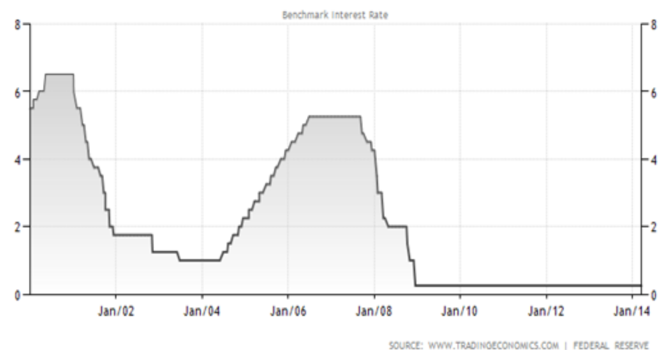
This production cut (and possibly demand increasing simultaneously) causes demand to exceed supply and the producers start again with their capex cycle. However, mine production requires a lot of time due to capital intensity and legal proceedings which result in a lag. This causes sudden rise in prices. This attracts further investment and the process continues. The above explanation is extremely simple but only looks at the producers of commodities. However, in reality there are numerous other factors like interest rates, supply shocks, new technology etc. that determine the prices.

But all of them can be classified as altering the forces of supply or demand only.

2002 - 07 ERA

In the opinion of several investors the current bull market originated around 2000. However, in my opinion it truly began in 2002 when price on the CRB commodity index broke past its all-time high as shown in figure 1. This period coincided with the low interest rate regime followed by the Fed post the dot com bubble burst and the rise in demand from the emerging nations.

The ultra-low interest rate regime that followed caused the world interest rates to drop. Anyone could borrow and lend at the very low interest rates in the open economy. Countries and companies all around the world started borrowing and investing at a rapid pace. Countries like China, India, Brazil etc. started consuming humongous amounts of commodities to satisfy their growth trajectory. This resulted in a sudden growth in the demand for commodities. However, during the 1990s the investment into commodities had died.



When there was a sudden spike in demand the supply side did not have adequate inventory to satisfy the demand. Furthermore, as already explained the capex starts generating result only after a considerable lag. Hence, supply growth lagged demand growth for a considerable period.

Additionally, there was another major development that was going on in the advanced economies of the world. The housing prices picked up massively till 2007. This resulted in the wealth effect propping up consumption. As the economy started heating up, Fed started hiking the interest rates from 2005. (1) When Fed started rising the rates, the producers started monetizing more of their stock. . By monetizing their stocks they were locking in higher interest rates rather than reinvesting in their business. This occurs due to the inherent risk in such businesses as already mentioned. Producers are always worried about excess inventories. This aggravated the supply crunch post 2005 and resulted in a huge run up in commodity prices till 2007.

Then came the great recession. Housing prices fell and so did the interest rates, stock markets and the commodities markets. This caused a huge shock in the economy. Wealth got destroyed in nightmarish proportions.

As expectations about the future state of economy turned gloomy, financial markets tanked. This was the first major pause in the secular Bull Run of the commodities market.

THE QE ARRIVES TO SAVE THE WORLD

The Fed started its unconventional monetary policy, quantitative easing (QE), in 2008 whereby it printed money and bought toxic assets, primarily Mortgage backed securities (MBS). QE pumped in vast quantity of money into the global money supply. This raised the inflation expectation which never actually materialized. Nevertheless, the easy money led to a rally in global markets.

One of the major cause that has been attributed to this rally is the financialization of commodities. In 2000, the commodities futures market was deregulated and speculative position limits were relaxed substantially. As a consequence the futures options trading volume rose five times from 630 mn contracts in 1998 to 3.2 bn contracts in 2007. Further, commodities became favorite among investors due to their low correlation with other markets. This idea and its strong correlation with inflation was sold aggressively among the clients by brokerages, banks and hedge funds. Also as the futures markets gained volume, their prices became the primary determinant of all the decisions regarding investing in commodities. Many index funds were opened and investors poured in the cheap money aggressively. Studies have showed strong correlation between funds inflow in index funds and futures prices.

Additionally, as the prices of commodities rose more funds got invested due to momentum trading activities. This is in sharp contrast to the fact that had most of it been a part of the consumption basket, its demand would have decreased.

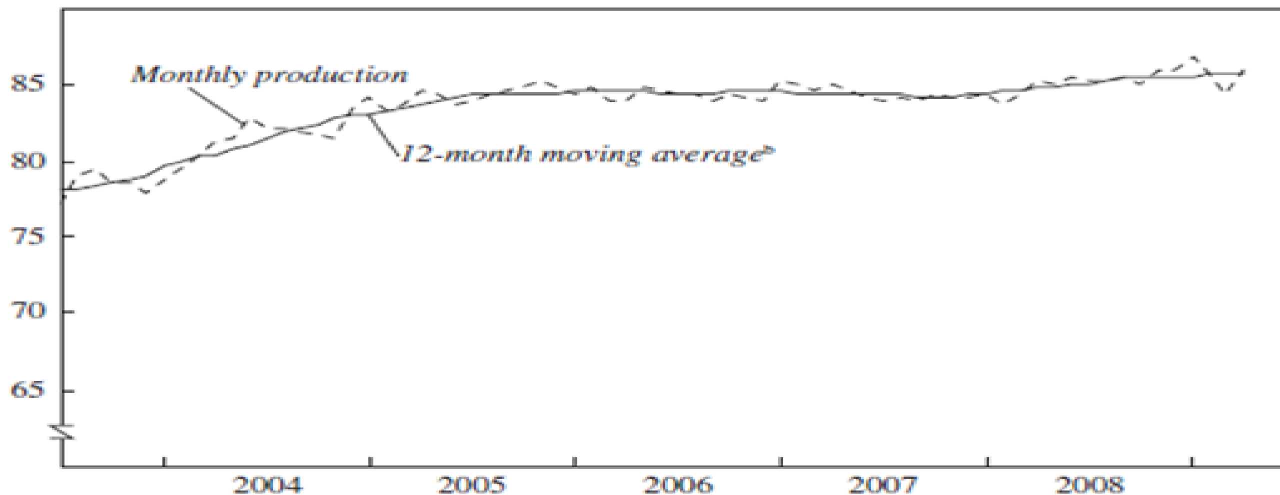
This gives some strength to the hypothesis that financialization of commodities might have resulted in commodities prices boom. This argument is further strengthened by the fact that commodities like oil, gold etc., which could be easily invested in through the futures market gained much more that the markets like iron ore, coal etc. which lack a developed financial market.

SUPPLY SHOCKS

Like the previous Bull market, this one also witnessed a supply shock. But the only major one was the 2013 agriculture market shock. This was the result of one of the worst draught in past 70 years in the US. Although many attribute the 2007 run up in oil price to supply shock from turmoil in Nigeria, strife in Iraq etc. data proves that the world supply of crude oil was quite stable in 2000s. In fact it had more to do with the lack in increase in production in 2005-07, which was primarily due to extraction from older wells whose efficiency decrease when the pressure falls.

CURRENT SCENARIO

The commodity supercycle might have ended according to many. But at the same time many veteran investors believe that it is just a major correction. Every commodity is off its all-time highs and equity markets are gaining strength around the world. Many path breaking technologies like fracking, cheaper alternative energy etc. are altering the supply – demand scenario for commodities.



The emergence of the technology sector seems much stronger than a decade ago. Sentiments and optimism all around the world is improving. China and India have slowed down considerably compared to the previous decade. Moreover, the key selling point for commodities, the QE, is off the way. Further, the commodities financial market has become much more mature and price manipulation can be expected to become all the more difficult. In fact, many large banks have shut down their commodity businesses.

The factors seem to be aligned against the commodity bulls right now. But it is near impossible to predict the future with accuracy. We were almost on the verge of a political crisis in Ukraine. There can be many others to come. History tells us that the last major commodity bull market high made during the much unexpected Iranian revolution.

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INDUSTRY SPEAKS

Interviews:

Mr. C B Bhave

Mr. Vijay Singh Chauhan

Article:

Indian Equity Market

-Past Tense, Future Perfect

Ravi Gupta

C B Bhave

Interview Excerpts

Q: *SEBI's work has been commended globally by other regulators. Now, comparing SEBI to other international regulators, say the SEC of US, what are the areas you see where SEBI has scope for improvement?*

A: One of the things that doesn't directly relate to SEBI, but needs to be sorted out is the amount of time it takes for a case to reach conclusion in India. There are certain offences in the capital market which can be handled by suspension of the intermediary or by levying a fine etc. But for some others, there is criminality involved and needs criminal prosecution. The paradox we have today is that we are able to enforce against those who have committed a lesser violation of law, while it takes inordinately long time to complete a criminal proceeding of a more severe crime in the market. This is not a case with other jurisdictions, where the cooperation between the criminal law enforcement authorities and the regulator in the investigative process is fairly well established and has developed over a period of time. In India, it is yet to develop, as SEBI is a relatively young institution.

Secondly, whenever there is wrongdoing in the market, invariably, the profit is cornered by a few at the cost of others. There is the concept of restitution in law – that is, the profits from the entities gaining illegally are taken away and restored to those who lost money for no fault of theirs. This mechanism is not as strong as it should be and there remains a scope for improvement.

Mr. C B Bhave has been the former Chairman of the Securities and Exchange Board of India. He has also been the Chairman and executive Director of national Securities depository Limited.

Q: *What was the role of SEBI during the Global Financial Crisis, and how effective was it in discharging them, given the fact that we were more of a victim of the crisis with its centre elsewhere?*

A: As you rightly pointed out, we were not at the centre of the crisis in 2008. But the integration of global markets meant that we could not have been immune to such shocks. One of the things that happened was that the credit markets froze. As we (RBI, SEBI and other financial institutions of the country) realised that about $50 billion had been raised by Indian corporates as short term credit, which became unavailable to them with the crisis in markets. The corporates then started to access the Indian markets. But what was a small amount for international markets, was a large one for the domestic market. Corporates started withdrawing from mutual funds (MF) for need of cash. The MFs had no buyers, in turn. The RBI then provided temporary liquidity and special line of credit to these MFs to prevent loss of investor money. RBI did not directly lend to MFs, it allowed banks to engage in those transactions. Liquidity fears are self-

feeding, and hence the problem, if not addressed soon, amplifies, as everyone starts hoarding. The RBI's liquidity injection was more than sufficient to get the fear out of people's minds. Within one month of this action, no mutual fund was using the credit facility. Yet, the RBI let the facility remain, just as an indicator of its commitment to maintain market liquidity and hence the confidence in our markets.

Q: *Quite a few new products have come up in the Indian markets. In 2011, CDS was allowed, and shortly afterwards the interest rate futures were allowed. There was also a proposal to introduce Gilts. With the evolving complexity of these products, how difficult does SEBI's job become?*

A: SEBI's stand has always been not to influence the levels at which markets function. Instead, what is tries to ensure is that the markets are safe. Safe doesn't mean that the investor doesn't make a loss. But that, he should not make a loss for a default on the stock exchange. Margining is one way SEBI tries to reduce the probability of default by looking at likely variations in the value of the instrument in different scenarios. The incentive to default is thus reduced. There is also the Settlement Guarantee Fund that the clearing corporations are required to maintain.

Q: *There have been various attempts to introduce REITs in Indian markets. What is the viability of such a step given the challenges related to taxation, foreign investments, stamping of units ?*

A: Real estate market is difficult as it not transparent. Any market in which the price of the underlying is not transparent, it is challenging to build a derivative on top of that. There is a lot unaccounted money in these markets, and unless the real estate market is cleaned, there is little advancement that can be expected from a derivative on top of it. The attempts, however, must carry on simultaneously on both developing REITs and on making the realty market more clean and transparent.

Q: *The MCX has recently been permitted to trade equity, options and futures. How effective do you think is the role of MCX in bolstering market competition and trading?*

A: The permission was indeed given to promote competition, but now the debate is whether the MCX is a fit and proper entity to have an exchange at all. Unless that issue is resolved, can be expected. There has been some decision on the commodities side, but that has been challenged in the High Court and the decision is pending. During my time at SEBI, we had refused permission for trading in equity. But subsequently, they were given the permission.

Q: *One of the more talked about issues in Indian markets has been the lack of retail participation. Even the existing participation comes mostly comes from areas of Mumbai and Gujarat. What do you think is a possible solution to increase retail participation?*

A: As people increase their savings, they look for new avenues to invest, such as corporate bonds and equity etc. The other aspect is information. Capital markets are considered unsafe as people perceive that they are risking everything. But these markets are very safe and robust when it comes to transactions and settle-

ments. People need to be conveyed the real risk of participating in capital markets.

Q: *High frequency or algorithmic trading has picked up trend recently. One view is that they reduce arbitrage opportunities, the counterview is that they make the system more risky. What are your views on algo trading?*

A: Whenever technology changes, such contrary views always come up. What we need to do to is to cope up with the change. We can't gain too much by resisting technology. Sooner or later, it has to be accepted and brought in the system. It only remains a matter of time.

Q: *There have been many cases of insider trading internationally. Are such cases prevalent in India as well, and what can the SEBI do in this context?*

A: SEBI can do only what any other regulator internationally does – to investigate the offence quickly and bring the parties concerned to justice. The difficultly I mentioned earlier comes up here. If the insider trading offence is large enough, you would want to prosecute the party criminally. But then, the larger cases go unpunished, defeating the overall objectives.

Vijay Singh Chauhan

Interview Excerpts

Mr. Vijay Singh Chauhan is Executive Assistant/officer on special duty to the Finance Minister. He is an officer of Indian Revenue Services (Customs & Central Excise) since 1992. He is currently posted as Director in the Finance Minister's Office. He has served as a member of a number of committees such as Cash & Debt Management of GoI and RBI, Technical Working Group of the 13th Finance Commission to review Debt Consolidation and Relief Facility (DCRF) implemented under the 12th Finance Commission award .

Q: *There have been constant measures taken by the government to discourage gold imports, with the current duty as high as 10%. In case the government plans to bring down the import duty to levels that were persistent some years ago, how sustainable would be the control on CAD? Are there some more fundamental, structural changes required to reduce the CAD?*

A: CAD is essentially the gap between the imports and exports and remittances. If you look at the $88 billion CAD we had in 2012, gold alone accounted for roughly $55 billion. Now, there are three ways to tackle CAD – reduce imports, increase exports and increase other inflows or a combination of some or all of these. Given the subdued economic outlook of India's trading partners, the scope for increasing the exports is not very high. The government's response, however, has to be a combination of promoting exports and reducing imports, particularly of those items which do not have a widespread impact on growth or on any other substantial economic activity. There has been an improvement of $36 billion in the current year CAD, upto December. One-third of it is roughly on account of increased exports, while two-thirds can be attributed to decline in imports. Within imports, the decline is not confined to gold alone. It has been in other commodities as well. To understand commodity composition of our import basket consider items like crude oil, gold, pulses, oil-seeds etc. which are used after limited processing.

Gold forms the second biggest import item after crude oil. Therefore, gold recommends itself to be curbed in the short-run, as it is not put to any productive use. Other items like crude, pulses cannot be curbed without an impact on the economy. Since gold is also purchased as hedge against inflation, the government has introduced inflation-indexed bonds to provide alternative safe-instrument option to the people. Since not an ounce of gold is produced in India, we cannot afford to spend $55 billion on gold imports, unless our measured to boost exports have been successful enough to allow such indulgence.

Q: *The critics of the Interim Budget have questioned the quality of the accounts. They say that while ₹88,000 crores have been taken as one-time dividends from the PSUs, some of the expenditure on subsidies has been shifted to the next year. How would this be tackled in the forthcoming years?*

A: The numbers, I believe, include the dividends as well as the profits of the RBI transferred to the government. The profits of the RBI arise from its earnings on forex reserves as well as the interest on the securities it holds in its portfolios.

So they go up as the interest rates on US Treasury and on domestic bonds go up and as RBI's forex reserves go up.

As far as the dividends are concerned, one of the reasons government invest in PSUs are dividends themselves. Chinese government has on record said that their interest in PSUs are the dividends. The government has been closely monitoring the performance of the PSUs through the year, and there has been the clear directive to either use the cash for capital expansion or to pay the government higher dividends. You cannot sit with idle cash. Also, the PSUs declare their dividends in two parts – the interim dividend and the final dividend. The budgeted amount for the next year is the final dividend due to be declared. If you include the interim dividend as well, the numbers would increase for the coming year as well.

Q: *The government has missed the revenue targets for quite some years. This year it was missed by close to ₹76,000 crores. Also, the budgeted tax revenue growth has been less than expected. What is the roadmap for future to bridge this growing gap?*

A: It would be incorrect to say that the revenue targets have been missed in all years. For all taxes put together also, the revenue targets have been exceeded in many year. For individual taxes also, we have had excesses in many years. Last year, for example, the service tax target was exceeded. Secondly, a target set is always ambitious. Drawing an analogy from sports, a pole-vaulter always sets the bar high. A higher revenue target makes the revenue department perform better.

Also, the department itself faces a few constraints. The finance ministry has approved a restructuring of the direct and indirect tax departments, and both have committed to getting additional revenues as a results of this change. As an example for direct taxes, as per government records, there were some 13 lakh individuals, who had engaged in activities that prima facie indicated that they had income above the threshold level. But they had not filed any return. The 13 lakh notices issued to these people has led to payment of around ₹1800 crore as taxes. In fact, there is a vast database on information with the government regarding tax-defaulters. Once these people are put to task, the revenues would go up.

Q: *The government has been missing the divestment targets for past four year. The target was ₹40,000 crore for this year, while only 6,000 crore has been raked up. Do you think there has been too much emphasis on divestment as a source of revenue for these years?*

A: I am not very well-versed with the divestment issues for now. But suffice it to say that targets have been met for a couple for years in the past. This year's shortfall has been on account of certain specific issues, like the case of Coal India. It was the biggest divestment target for the year. Now, divestment did not happen, but they declared a dividend instead. So the money came in the government coffers nonetheless. We need to look as these issues from a broader perspective, as to whether the basic requirement of government getting the money has been achieved.

Q: *There has been a lot of debate around the implementation of GST. Given the current polit-*

ical environment, do you think there is a possibility of GST coming into play sometime in near future?

A: GST has been accepted globally as a good form of indirect tax. There is no disagreement amongst the states in the basic issue of moving to GST. The exact contours and the mechanism of compensating the states in case of a revenue loss are under discussion. It is only a matter of time before the GST is brought in.

Q: *Also, there were debates surrounding the retrospective tax measures adopted the government. Critics say that there has been a loss in terms of investment due to the uncertain business climate. How do you respond to that?*

A: The basic issue you are referring to is essentially a clarification that has retrospective implications. It is not as if the tax was being levied retrospectively. Also, it is not as if retrospective amendments are not made to the budgets.

Even in 2013-14, three retrospective amendments were made through the finance bill. These were of the nature that they were beneficial to the tax payers. Therefore, very few people would even be aware of it.

Let us understand when a retrospective amendment is made. A law is passed by the legislature, the interpretation of which is the job of the judiciary. The judiciary might interpret the law differently at different levels, and the government feels that the interpretation at a particular level, say High Court level actually reflected the intent of the legislation, the government goes back to the legislature to clarify the intent.

India continues to be one of the most sought after locations for FDI. The decision of MNCs to invest is based on a gamut of issues. Retrospective amendments is just of these issues. We should not overemphasize issues without understanding them in entirety. Vodafone has pumped in around $10 billion in the past four years while they were at the receiving end of said the clarification issued.

Indian Equity Market: Past Tense, Future Perfect?

Ravi Gupta is an equity research analyst with UTI Asset Management Company. He has research experience of over 7 years in Automobile, Healthcare and Telecom sectors.

The bull-run in the global equity markets came to an abrupt halt in late 2007. The global financial crisis brought to the fore some glaring short-comings in the financial systems and processes followed in the world's most advanced economies leading to closure of a few large financial institutions and bail-outs for some others.

The aftermath of the crisis was enormous for capital markets all across the world and India, till then believed to be decoupled from global markets due to its domestic focus, wasn't spared either.

Six years after the shock, most economies are still struggling to regain momentum; European economies have constantly been in news for their massive debt defaults, manufacturing and commodity export driven emerging countries (EM) are struggling to find alternate means of growth, while US which was the epicenter of all the troubles has somehow managed to get back on its feet. How does India fare in all this pandemonium?

The past, the present and the hope

Whichever parameter one chooses to evaluate India's performance over the previous five years, the conclusion isn't very different.

Growth has slowed down to the lowest rate in over a decade, inflation is high and sticky, rising interest rates have made capital needed for business expansion more expensive, there is wide-spread policy paralysis and investors, both domestic and foreign, are losing interest with every passing day.

As a result, the equity market is struggling to gain the momentum required to breach the highs seen in 2007-08 and sustain the upwards move. The narrative isn't very impressive and the outlook is gloomy. And in such a scenario, how does an investor get the courage to put money in the equity market?

Global slowdown has been a key catalyst in slowing growth since the Lehman collapse. But a look at the table shows that the Indian experience is not unique. Almost all emerging markets are now operating below their potential growth.

But India is bottoming out at a higher growth level than other emerging markets while India's inflation is in line with them (China being the only exception).

Various studies project growth in the global economy to be driven by emerging economies and their share in world GDP to increase from ~38% in 2010 to ~63% in 2030. The global middle class is expected to expand rapidly, with most of the new members coming from Asia.

And while China, which is already the second largest economy in the world, will continue to grow (though at a much lower rate than the last couple of decades), India (which wasn't even in the top 10 in 2010) is expected to be the 5th largest economy by 2020 and 3rd largest by 2030. Even if the theme plays out partially, the scope of growth for Indian economy is massive. And it is this very potential that has led to the outperformance of Indian equity markets over developed as well as key emerging markets since the global financial crisis.

Growth drivers for the future

The most potent factor in India's favour is the country's demographic profile and the consumption demand it generates. India is amongst the youngest countries in the world with close to half the population under the age of 35 years. This means that the country is flush with working age population which currently is ~800 million and is likely to cross the 1 billion mark by 2035-36 (by UN Population Database estimates), even larger than China at that time. If provided with a correct policy environment, this can lead to tremendous rise in mid and high income households. Rising per capita GDP will lead to higher disposable incomes, better lifestyles and strong consumption demand. This is probably the most potent growth driver for India.

	Growth			Inflation		
EM's	Pre-crisis	Crisis	Current	Pre-crisis	Crisis	Current
India	9.3	8.6	4.8	7.7	10.4	6.3
Brazil	6.1	-0.3	1.5	4.5	4.3	5.8
Russia	8.1	-7.9	3.1	11.9	8.8	6.1
China	14.2	9.2	7.7	6.5	1.9	2.8
Turkey	4.7	-4.7	2.7	8.4	6.5	8.3
Indonesia	6.3	4.6	6	5.4	2.8	5.8
Mexico	3.3	-6.0	2.7	3.8	3.6	3.7

Source: BofA Merrill

The second growth driver is the increasing contribution of exports in India's growth. Including services, exports currently account for ~24% of India's GDP.

And while IT services is the key contributor currently, exports of pharmaceutical products and automobile components are growing at a much faster rate. As per NASSCOM, Indian ITES exports accounted for USD 76.2 billion in FY13growing at a CAGR of ~13% since FY2008 and ~28% since FY1998.

The global delivery model pioneered by Indian IT services companies is becoming mainstream model for business delivery in mature economies like US and UK. There is still room for higher penetration in Europe and Emerging economies and also for expanding into higher value service offerings in Consulting, Systems Integration, Infrastructure Management Services and newer technologies like Social, Mobile, Analytics and Cloud.

Increasing comfort of clients towards off-shoring, investments in new technologies and favorable operating environment should lead to market share improvements benefiting Indian ITES companies.

Industry data shows that India's overall pharmaceutical export has grown from USD 4 billion in CY06 to USD 14.6 billion in CY12 at a CAGR of 24% and has led to the share in the US Generics market (world's largest generic drug market) growing from 4.5% to ~10% over the same period. In addition, most emerging countries are structurally similar to India, which puts Indian companies in an advantageous position to tap these markets.

Over the last few years, India has emerged as the preferred destination for Contract Research and Manufacturing Services due to strong chemistry skills, lower costs and highest number of USFDA approved plants outside US. All these create a very strong growth environment for Indian pharmaceutical exports. Besides, Export of auto parts from India (USD 9.3 billion in FY13) has seen a CAGR of 28% in the past 10 years (FY03-13). Auto Component Manufacturers Association of India projects exports from India to touch USD 30 billion by 2021.

These are all very strong indicators to highlight the enormous potential India has to grow in exports. The final theme that will enable India to grow even faster going forward is Infrastructure creation. India's industries suffer from chronic power cuts, exports are delayed because of poor roads and congested ports, office-goers spend hours stuck in traffic and villages get electricity for only 6 to 8 hours a day. And due to all these problems, ~2 percentage points is lost in economic growth owing to poor infrastructure.

According to planning commission, to sustain a GDP growth of 8-9%, investments in infrastructure should be 10-11% of GDP (compared to 7.9% achieved over FY08-12). Accelerated infrastructure investments will not only de-bottleneck the system, it will also create its own demand. There can't be a better example than China, which has built infrastructure at a spectacular pace and has seen double digit growth for over 2 decades. Infrastructure creation will not only generate jobs in the short run but also lower the cost of doing business in the country, thereby generating long term benefits to sustain economic growth.

Risk Factors

In the very near term, QE Tapering by the US Fed Reserve is the primary risk for Indian equity market. In the latest round of volatility starting end-May 2013, India initially witnessed net outflows of investments made by FIIs in both debt and equity and also steep depreciation in the Indian Rupee. However it must be pointed out that the net outflow from equities was short lived and the markets saw net investments into equities. As can be seen in the table below, the cumulative investments in Equity for period May 2013 to January 2014 are showing a net positive figure. On December 18, 2013 when the US Fed finally announced a modest tapering of QE from January 2014, INR exhibited strong resilience in relation to other EM currencies in terms of exchange rate movements and its volatility.

The longer term and more potent threat to the Indian story revolves around poor standards of governance. From difficulty of establishing and doing business, lack of transparency and effectiveness in policy making, unplanned infrastructure, to the ordeals every citizen faces in daily life, there are either no systems and policies in place, or established procedures are not followed properly.

This has led to large scale wastage of resources and sub-optimal standards of performance. The current uncertain political environment will keep the markets volatile for some time. But the result of the Lok Sabha elections will play a crucial role in the formation of a stable and efficient government that can lead to realization of India's vast growth potential.

What does the future hold?

That India has a number of factors in its favour to enable sustained long term growth is beyond any doubt. The spirit of the Indian entrepreneur as well as the common worker is indomitable. Aspirations are rising, skill sets are evolving and propensity to consume is at an all time high.

From an equity market perspective, valuations on both Price-to-Earnings and Price-to-Book Value parameters are much below the long term averages. There should be no doubt in anyone's mind that the great Indian story is far from over. Let us hope all of us press the right button needed to unleash our potential.

Investments (net) made by Foreign Institutional Investors (FII) in India , INR Bn

Month	Equity	Debt	Total	USD/INR
Jan-13	220.6	29.5	250.1	53.3
Feb-13	244.4	40.0	284.4	53.8
Mar-13	91.2	58.0	149.2	54.4
Apr-13	54.1	53.3	107.5	54.2
May-13	221.7	59.7	281.4	56.5
Jun-13	(110.3)	(331.4)	(441.6)	59.7
Jul-13	(60.9)	(120.4)	(181.2)	61.1
Aug-13	(59.2)	(97.7)	(157.0)	66.6
Sep-13	130.6	(56.8)	73.8	62.8
Oct-13	157.1	(135.8)	21.3	61.4
Nov-13	81.2	(59.8)	21.3	62.4
Dec-13	160.9	52.9	213.8	61.9
Jan-14	(1.4)	123.6	122.1	62.5
May'13-Jan'14	519.6	(565.7)	(46.1)	

Source: SEBI, RBI

Sources:

Bloomberg data

http://planningcommission.nic.in/

http://www.rbi.org.in/home.aspx

http://www.sebi.gov.in/sebiweb/

BofA Merrill Lynch Global Research

SECTOR TALKS

IIM B Investment Fund

Sector Report– IT Industry

Akhil Mittal

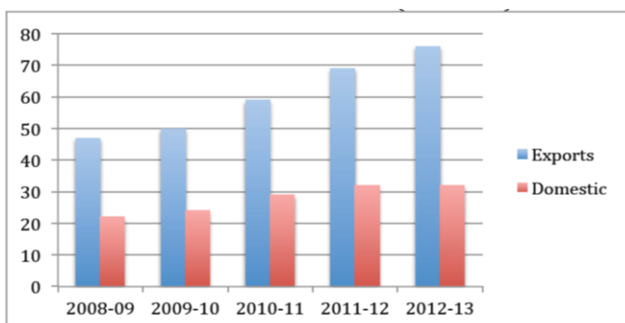
IIMB INVESTMENT FUND
SECTOR REPORT—*IT INDUSTRY*

The IT and Software Services Industry has become a major component of India's growth story. According to NASSCOM estimates, from a mere 1.2% contributor to the GDP in 1997-98, it has become worth 7.5% of the GDP in 2012-13.

Akhil Mittal is a First Year student at IIM Bangalore. Previously, he has worked as an Equity Analyst with J. P. Morgan. for 2.5 years.

Highlights

- At the end of the last fiscal year, India's share in the global sourcing industry was 52%
- Relative to India's exports, IT exports was about 25%, which was a 6x growth in the last 15 years
- The sector provides direct employment to 3mn Indians, and indirect employment to 9.5mn Indians, and is by far, the largest private sector employer
- The sector is ranked 4th in India's total FDI share, at 7%
- IT accounts for 32% of the total PE/VC investments in India, at $3.2 bn



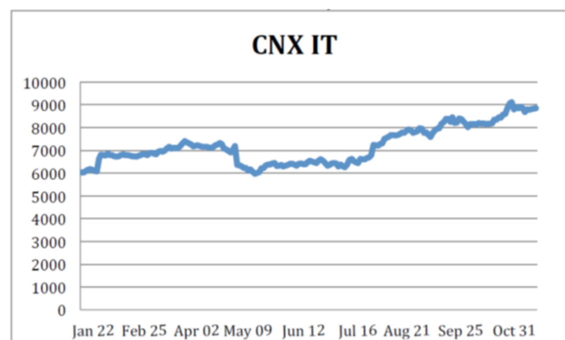
Source: NASSCOM

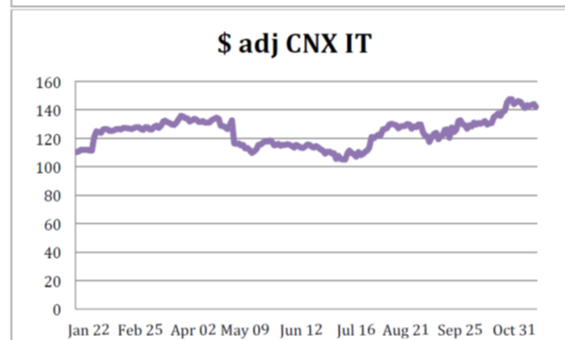
***Chart 1: IT Revenues** (’00 Crores)*

Key Points

INR/USD Exchange Rate

On average, INR has depreciated close to 12% versus USD last year. Since the major business of the IT industry is through exports, this should provide a boost to the earnings. However, this could also lead to the companies being more aggressive on their quotes and can lead to price-cutting. Although, the fluctuation in INR/USD could be a deterrent to that.





Source: Bloomberg

Chart 2: CNX IT Index and $ adjusted CNX IT

However, whereas the CNX IT index has shown a 46.73% appreciation since the start of the year, on taking the index after adjustment for the INR/USD exchange rate, it has still appreciated 28.94% (Chart 2 *Prev. Page*).

Demand Growth

All major IT companies are expecting a growth in demand this fiscal year. Demand is also expected to rise for bundled IT services. It has been the observation that the IT clients have been breaking large projects into small subprojects and awarding contracts for execution on a piecemeal basis.

US Immigration Bill

The Indian IT industry is shifting the tide in its favor, but there is still a long way to go. Although the industry has been preparing itself for higher costs, and this has been reflected in the stock prices, the 'outplacement clause' of US Immigration Bill could be detrimental to the business model followed by most players.

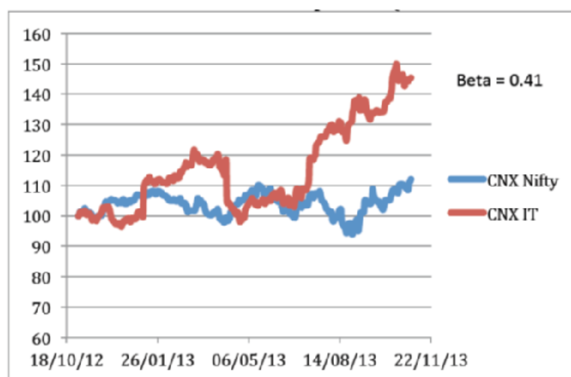


Chart 3: 1 Year Performance Comparison
(index 100 on Oct 31, 2013)

Market Analysis

The CNX IT index provides investors and market intermediaries with an appropriate benchmark that captures the performance of the Indian IT companies. The CNX IT Index comprises of 20 companies listed on the National Stock Exchange (NSE) and uses the free-float market capitalization method to assign them weights.

As expected, the rally post May 2013 is attributed to a weakening rupee, in addition to governance improvements in the major IT firms. As seen from the above data, the valuations are expected to improve for 2013, after a bad 2012. However, the margins are expected to drop on the back of more intense competition and higher investment in newer technologies, which should provide higher valuations in the long run.

	FY 2013E	FY 2012	FY 2011	FY 2010	FY 2009
P/E	17.85	14.80	19.16	26.71	22.64
P/B	4.57	3.92	4.s82	6.84	5.98
EV/Sales	3.15	2.75	3.64	5.52	4.78
EV/EBITDA	12.40	10.55	13.98	20.98	16.98
Div Yield	1.45	1.82	1.34	1.55	0.88

Table 1: BSE IT Index Valuation Metrics

	FY 2013E	FY 2012	FY 2011	FY 2010	FY 2009
Gross Margin %	37.91	38.97	36.94	35.47	39.68
Operating Margin %	22.77	23.92	24.50	25.30	25.20
Profit Margin %	19.50	20.84	20.58	21.94	22.30
ROA %	22.92	21.50	20.68	20.80	20.63
ROE %	29.63	28.59	27.40	27.51	29.66

Table 2: BSE IT Index Fundamentals

MERGERS AND ACQUISITIONS

Here, we focus on the most talked about deal of the year:

Facebook-WhatsApp Deal

BRIEF OVERVIEW

The year 2013 witnessed slightly lower M&A activity compared to 2012. Overall the deal count and volumes across the globe were relatively flat. However analysts predict that 2014 shall witness a surge in M&A activity, owing to the ongoing recovery in United States.

Global M&A Activity	2012	2013
Volume	$2.33 trillion	$2.24 trillion
Number of Deals	27,965	27,830

Source: Bloomberg

Shubham Agrawal is a First Year student at IIM Bangalore. Previously, he pursued B.Com.(H) from Shri Ram College of Commerce.

REGIONAL BREAKDOWN BY TARGET REGION/COUNTRY

The United States was at the heart of M&A activity across the globe in 2013, though the volumes were relatively flat. Maximum growth in volume was fuelled in Asian region led by China and Hong Kong, while Japan and India had lower volumes by more than a third.

TARGET REGION/ COUNTRY	2013		2012		VOLUME CHANGE
	VOLUME		VOLUME		
	US $ (M)	DEAL COUNT	US $ (M)	DEAL COUNT	
Americas	**$1,151,562**	**12,693**	**$1,134,137**	**13,144**	**1.54%**
Latin America	$94,572	900	$112,642	1,055	-16.04%
North America	$1,068,805	11,929	$1,050,844	12,200	1.71%
Canada	$87,180	1,539	$126,289	1,554	-30.97%
United States	$962,759	10,162	$886,671	10,460	8.58%
EMEA	**$672,577**	**7,004**	**$636,683**	**6,726**	**5.64%**
Eastern Europe	$82,569	1,174	$129,026	952	-36.01%
Western Europe	$533,282	5,199	$460,029	5,173	15.92%
UK	$128,083	1,863	$179,541	1,874	-28.66%
Germany	$87,255	758	$63,750	744	36.87%
France	$57,935	487	$33,627	512	72.29%
Asia-Pacific ex-Japan	**$444,338**	**6,418**	**$372,927**	**6,333**	**19.15%**
Australia	$65,512	910	$54,880	860	19.37%
New Zealand	$3,064	109	$4,388	132	-30.18%
China	$182,830	2,308	$133,634	2,382	36.81%
Hong Kong	$28,366	421	$17,346	349	63.53%
South East Asia	$70,177	1,070	$75,222	982	-6.71%
India	$20,949	602	$32,545	704	-35.63%
Japan	**$58,368**	**1,543**	**$90,129**	**1,597**	**-35.24%**
Global	**$2,330,349**	**27,890**	**$2,235,357**	**27,966**	**4.25%**

Source: Bloomberg

LEAGUE TABLE

The investment banks in the top 3 were able to maintain their position in 2013 with no change in the rankings based on volumes.

However, there has been a churn in rankings in the lower order of the table.

Firm	2013				2012		Market Share Change
	Rank	Market Share	Volume ($million)	Deal Count	Rank	Market Share	
Goldman Sachs & Co	1	24.5	5,69,728	350	1	25.3	-0.8
Morgan Stanley	2	21.1	4,91,145	291	2	21.4	-0.3
JP Morgan	3	21.0	4,89,946	244	3	20.1	0.9
BofA-ML	4	19.9	4,62,769	217	8	14.9	5.0
Barclays	5	17.0	3,84,679	197	6	17.0	-0.5
UBS AG	6	12.0	2,80,622	162	10	8.8	3.2
Citigroup Inc	7	10.2	2,37,620	200	4	18.6	-8.4
Deutsche Bank AG	8	9.7	2,26,864	156	7	16.4	-6.7
Credit Suisse Group AG	9	8.7	2,03,582	211	5	17.1	-8.4
Lazard Ltd	10	8.4	1,96,119	204	11	8.1	0.3
Total			**2,330,349**	**27,890**	**2,235,357**		

Source: Bloomberg

DEAL WATCH

Among the notable deals in 2014, the acquisition of messaging giant WhatsApp by Facebook for a whopping $19 billion on 19th February, 2014 is drawing attention across the globe for various reasons.

FACEBOOK - WHATSAPP DEAL

The technology sector in the United States has often drawn jaw-dropping valuations in the past few decades. The recent takeover of WhatsApp

by Facebook for $ 19 billion has been flagged by many analysts as overpriced, reminding the dot-com bubble. The valuation is more than the nominal GDP (2012) of more than 40% of countries globally The deal is divided between $ 4 billion cash and $ 12 billion Facebook shares, and another $ 3 billion of restricted stock units RSUs) for the promoter group and employees of WhatsApp after 4 years. The key PE investor in WhatsApp is Sequioa Capital, set to make a windfall gain. Interestingly, one of the co-founders Brian Acton was rejected for a job at Facebook 5 years ago.

Facebook has been on a buying spree shelling out $ 1 billion for Instagram, while failing to acquire Snapchat last year for $ 3 billion. The deal comes at a time when its own user base has grown at a declining rate, while WhatsApp grows at unprecedented levels (more than 100% in 2013). Of the many reasons that back the decision, capturing the intensive growth of WhatsApp of more than 1 million users a day comes first. As Zuckerberg puts it: 'shared mission to bring more connectivity and utility to the world'. Facebook's strategic shift to mobile advertising platform earned more than half of revenues in 2013, and the acquisition is supposed to facilitate building that ecosystem.

On the other hand, some speculators ensign this as Facebook buying out the 'Next Facebook', while others believe it is similar to Google's acquisition of YouTube. However, uncertainty musters over the ability to monetize WhatsApp. According to media reports WhatsApp earned merely $ 20 million in revenues in 2013, driven by its policy of free-use period of 1 year, and extending it under competitive pressure.

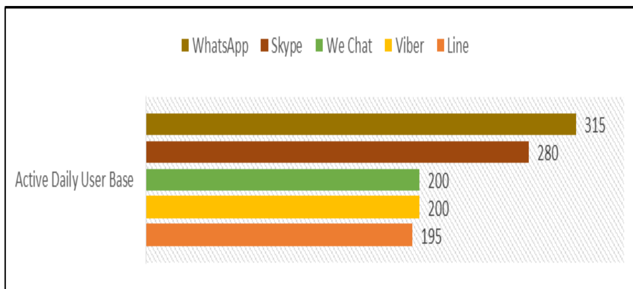
Facebook intends to keep its messenger service and WhatsApp co-exist, with the latter retaining its brand. The two companies have different policies with respect to display of advertisements, storing content, privacy policies, etc. A note on WhatsApp co-founder Jan Koum's desk reads 'No Ads, No Games, No Gimmicks' – underlining their commitment to quality user experience at almost no cost. Questions emerge whether the deal permits sharing information with Facebook against its current policy of conversations stored on users' phones only. The extent of overlap between their users is not known explicitly. A contrast between the two companies is compiled below.

	FACEBOOK **(DEC '13)**	WHATSAPP **(FEB '14)**
INCORPORATED	2004	2009
REVENUES	$ 7.87 billion	$ 20 million
PROFITS	$ 1.50 billion	N.A.
NUMBER OF EMPLOYEES	6,337	55
ACTIVE MONTHLY USER BASE	945 million	450 million (more than Twitter)
ACTIVE DAILY USER BASE	757 million	315 million
DEAL ADVISORS	Allen & Company LLC ; Weil, Gotshal & Manges LLP	Morgan Stanley; Fenwick & West, LLP

The deal is valued at 19 times projected sales or roughly $ 40 per user. Phone carriers lost a whopping $ 33 billion in revenues due to free social-messaging applications. A peer-to-peer comparison of messaging-cum-voice apps available on ac-

tive daily user basis outlines WhatsApp as the leading player.

Rivals like Google are not much worried as its



user base is more small-medium business based. Blackberry's shares soared more than 10% on the date of announcement, though analysts predict the economies of scale shall enable WhatsApp to grow while pushing out competitors. Other internet companies like Twitter, Linkedin are under pressure to perform after this deal. WhatsApp's rivals have been aggressive in expanding user base and are not far behind, particularly We Chat and Line.

WhatsApp has been a phenomenal success in substituting SMS just the way Skype replaced International calls. In fact 3 days after the announcement, WhatsApp announced the addition of voice calls to its platform. The success or failure of the deal shall unfold gradually, with history against it: internet takeovers of more than $10 billion have not succeeded till date.

Sources:

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PERSONALITY PROFILES

This section covers the following:

Janet Yellen

Mario Draghi

Janet Yellen

15th Chair of the Federal Reserve, Washington, United States.

With her historic ascent as the first woman lead, Janet Yellen sworn in as the 15th Chair of U.S. Federal Reserve on February 3, 2014. She has been the President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, Chair of the White House Council of Economic Advisers under President Bill Clinton.

Known for her calm, methodical demeanor, Yellen is a Keynesian economist and believes in the modern version of the Phillips curve, which, in its original, pre-1970s form, stated a simple inverse relationship between unemployment and inflation. Because of her predominant focus on unemployment rather than inflation, she is considered to be a “dove” by many on Wall Street. She said during her White House nomination. "Too many Americans still can't find a job and worry how they'll pay their bills and provide for their families.

The Federal Reserve can help if it does its job effectively." In her first Capitol Hill outing as chairwoman of the Federal Reserve on Feb 11, 2014 Janet Yellen said that if economy keeps improving, the Fed will take "further measured steps" to reduce the support it's providing through monthly bond purchases.

Most recently praised for helping smooth emerging-market concerns by the Group of 20 nations, Yellen had once correctly suggested that US might be "beyond the brink of recession" in the 2008 Federal Open Market Committee meetings.

Mario Draghi

President of the European Central Bank

Previously the governor of the Bank of Italy, Mario Draghi succeeded Jean-Claude Trichet as the President of the European Central Bank on 1 November 2011. Forbes nominated Draghi as the 9th most powerful person in the world in 2013.

Amidst the renewed fears about sovereigns in the Eurozone in July 2012, Draghi stated in a panel discussion that the ECB "...is ready to do *whatever it takes* to preserve the Euro. And believe me, it will be enough." The statement led to a steady decline in bond yields (borrowing costs) for Eurozone countries and in light of slow political progress on solving the Eurozone crisis, it has been seen as a key turning point in the fortunes of the Eurozone.

In the recent turn of events, the European Central Bank not only left its interest rates unchanged, (holding its key lending rate, the refi rate, at 0.25%) but also chose not to take any “non-standard” measures to pep up the economy and keep the threat of deflation at bay. That gave President Mario Draghi the awkward task of walking a fine line between explaining why the ECB is not ready to take decisive measures right now, when the situation is in many people’s eyes already dangerous enough to warrant it.

He said though there are currently no signs of deflation in the euro area, policy makers are ready to add to stimulus if the outlook for prices deteriorates. Draghi also cited the need for “more information” in order to explain the reason for ECB not adding more stimuli yet. He heralded a month of scrutiny on data that have veered between growth outperforming economist forecasts to deterioration in survey indicators.

NEWS ROUNDUP

The latest happenings in the world of finance

News Round-up

YELLEN SUCCEEDS BERNANKE TO BECOME HEAD OF US FED

Janet Yellen, a key force behind the Federal Reserve's unprecedented and controversial efforts to boost the U.S. economy, was confirmed by the Senate to lead the central bank just as it begins to unwind that stimulus. She became the first woman to run the Fed in its 100-year history and just one of a handful of women heading central banks globally. She was previously Fed's vice chair. Yellen began her four-year term on February 1.

Source: Reuters

FED TRIMS QE PACE TO $65 BILLION ON LABOR MARKET OUTLOOK

The Federal Reserve trimmed its monthly bond purchases to $65 billion from $75 billion (Previously in December 2013, the Fed had trimmed its bond purchases to $75 billion from $85 billion), moving steadily towards unwinding the unprecedented stimulus that Chairman Ben S. Bernanke put in place to help the economy recover from the worst recession since the 1930s.

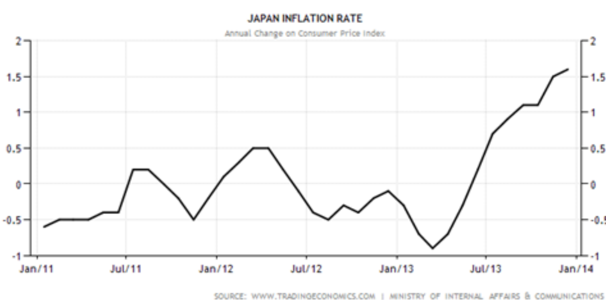
“Reflecting cumulative progress and an improved outlook for the job market, the committee decided today to modestly reduce the monthly pace at which it is adding to the longer-term securities on its balance sheet,” Bernanke had said, during the first trimming announcement. The Fed said its benchmark interest rate is likely to stay low “well past the time that the unemployment rate declines below 6.5 percent, especially if projected inflation continues to run below” the Fed’s 2 percent goal.

The jobless rate fell to 7 percent in November, a five-year low, as employers added a greater-than-forecast 203,000 workers to payrolls. Unemployment was down from 10 percent in October 2009, during the recession, and up from 4.4 percent in May 2007.

Source: RGE Monitor, Bloomberg

JAPAN'S INFLATION ACCELERATES TO THE FASTEST PACE SINCE 2008

Japan's inflation accelerated to the fastest pace since 2008 in November-December 2013, bringing the rate closer to policy makers' target of 2%, as a weaker yen and higher costs of energy spur broader price increases. Prices excluding fresh food rose 1.2 percent from a year earlier, more than the median forecast of 1.1%.The increased inflation is also likely to erode household spending power unless employers boost wages.



Source Bloomberg

BITCOIN TRADING EXCHANGE COINSETTER FILES TO RAISE $1.5 MILLION

Coinsetter Inc. filed to raise $1.5 mn as venture capitalists flock to companies tied to the digital currency. Venture investors have been seeking out Bitcoin-related companies amid a surge in the value of the currency. Bitcoins, introduced in 2008, topped $1,000 earlier this year, up from about $12 a year ago, and have since fallen to $716.12.

Source Bloomberg

RBI TO LAUNCH RETAIL INFLATION—LINKED BONDS IN DECEMBER

The Reserve Bank of India (RBI) launched retail inflation-linked bonds in the second half of December, offering households a shield against negative returns on their savings. The 10-year bonds, available through banks, have a face value of Rs.5000. Investment in the bonds has been capped at Rs.5 lakh per applicant per year.

Interest on these securities is based on the Consumer Price Index (CPI) with a three-month lag, plus 1.5%, compounded in the principal on a half-yearly basis and paid at the time of maturity. So, if a bond is being valued in December, the reference rate will be CPI of September.

Source Mint

INDIAN WPI INFLATION TOUCHES EIGHT MONTH LOW OF 5% ON DECLINE IN FOOD INFLATION

Wholesale Price Index (WPI) inflation eased considerably to an eight-month low of 5.0% YoY in January 2014 compared to 6.2% in De-

-cember 2013 and 7.3% in January 2013, mainly on account of a sharp moderation in inflation in manufactured goods and also food inflation. On MoM basis, there was deflation in the primary articles index, especially the food article sub-index, which fell ~2.7% MoM. A correction (MoM) in the prices of cereals, pulses and vegetables led to a deflation of 0.2% MoM in WPI inflation. We expect inflation in February 2014 to tread lower at 5.3% compared to 7.3% in February 2013, mainly on account of the decline in food inflation. Consequently, we expect WPI inflation to moderate to 5.9% YoY in FY14 and to 5.6% YoY in FY15.

Source ETIG

RBI'S LATEST MONETARY POLICY REVIEW

In a surprising policy move, RBI announced an increase in key policy interest (repo) rate in its Third Quarter Monetary Policy Review, thereby continuing with the pursuance of the objective of targeting inflation and anchoring inflationary expectations to further build an environment conducive to growth in the long run. The market had been expecting status quo on the policy front. By increasing rates this time, Dr Raghuram Rajan has increased rates by 50 bps after taking over as Governor. Currently, the repo rate under liquidity adjustment facility (LAF) stands at 8%, Marginal Standing Facility (MSF) rate stands 100 basis point above the repo rate (@ 9%) and the Cash Reserve ratio (CRR) stays unchanged at 4% of NDTL.

Source ETIG

JP MORGAN TO PAY MORE THAN $2BN IN PENALTIES FOR MADOFF TIES

JP Morgan has agreed to pay a record $2bn to settle charges that it knowingly ignored evidence that convicted fraudster Bernard Madoff's massive Ponzi scheme was "too good to be true." The US attorney's office lodged two charges against the bank to which the bank agreed to pay $1.7bn. JP Morgan will pay another $350m to settle with the US Office of the Comptroller of the Currency over related issues.

Source: The Guardian

MARKET DATA

Index	Q4 2013 Open	Q4 2013 Close	% Change	Q1 2014 Open	14/3/2014 Close	% Change	Half Yearly % Change
US Markets							
DJIA	15132.49	16576.66	8.71	16576.66	16576.66	0.00	9.54
S&P 500	1682.41	1848.36	8.98	1848.36	1841.13	-0.39	9.43
Nasdaq Composite	3744.18	4176.59	10.35	4176.59	4245.40	1.62	13.39
Russel 2000	1073.69	1163.64	7.73	1163.64	1181.41	1.50	10.03
European Markets							
STOXX 50	2890.00	3108.00	7.01	3108.00	3003.00	-3.50	3.91
FTSE	6462.22	6749.09	4.25	6749.09	6527.89	-3.39	1.02
CAC 40	4150.04	4295.95	3.40	4295.95	4216.37	-1.89	1.60
DAX	8618.59	9522.16	9.49	9522.16	9056.41	-5.14	5.08
Asian Markets (excluding India)							
Shanghai Composite	2171.90	2115.98	-2.64	2115.98	2004.34	-5.57	-7.72
Hang Seng	22997.21	232306.39	90.10	232306.39	21539.49	-978.51	-6.34
Nikkei 225	14517.98	16291.31	10.89	16291.31	14327.66	-13.71	-1.31
FTSE Straits Times	3180.72	3176.43	-0.14	3176.43	3073.72	-3.34	-3.36
Indian Markets and Sector Indices							
Nifty	5756.10	6304.00	8.69	6304.00	6504.20	3.08	13.00
Sensex	19452.05	21170.68	8.12	21170.68	21809.80	2.93	12.12
BSE Midcap	5624.30	6705.56	16.12	6705.56	6656.18	-0.74	18.35
BSE Smallcap	5849.69	6551.13	10.71	6551.13	6627.68	1.16	13.30
Bankex	11047.94	13001.94	15.03	13001.94	13756.15	5.48	24.51
BSE IT	7865.98	9081.78	13.39	9081.78	8940.05	-1.59	13.65
BSE Auto	11054.89	12258.83	9.82	12258.83	12808.16	4.29	15.86
BSE Metals	8308.19	9964.29	16.62	9964.29	8897.93	-11.98	7.10
BSE Healthcare	9513.99	9966.26	4.54	9966.26	10196.57	2.26	7.17
Commodities							
WTI Crude ($/bbl)	102.31	98.42	-3.95	98.42	98.89	0.48	-3.34
Brent Crude ($/bbl)	108.38	110.80	2.18	110.80	108.57	-2.05	0.18
Comex Gold ($/oz.)	1328.00	1202.30	-10.45	1202.30	1379.00	12.81	3.84
CRB Commodity Index	285.13	280.17	-1.77	280.17	302.88	7.50	6.23
Copper	332.45	339.65	2.12	339.65	301.30	-12.73	-9.37
Natural Gas	3.56	4.23	15.91	4.23	4.43	4.41	24.40
Exchange Rates							
USD INR	62.52	61.80	-1.17	61.80	61.19	-1.00	-2.13
GBP INR	101.61	102.08	0.46	102.08	101.62	-0.46	0.01
EUR INR	84.70	85.06	0.43	85.06	84.84	-0.27	0.16
JPY INR	0.64	0.59	-8.53	0.59	1.65	64.47	159.30
Government Bond Yields							
US 10 Year Yield	2.61	3.03	13.75	3.03	2.65	-14.09	1.63
German 10 Year Yield	1.78	1.93	7.72	1.93	1.55	-24.77	-13.15
Japan 10 Year Yield	0.69	0.74	7.02	0.74	0.63	-18.18	-9.00
India 10 Year Yield	8.71	8.83	1.30	8.83	8.79	-0.38	0.94

NETWORTH

About Us:

-Team

-Activities

IIMB ROUNDUP

MISSION

We stand for the following at IIMB:
a) To coordinate and organize all finance related activities on campus.

b) To be the single touch point for all finance related events and queries

c) To provide platform for increased interaction between student body, industry and faculty

d) To increase awareness and provide the platform of learning for finance

TEAM

1. 9 members from PGP2 (Senior Coordinators): Networth has a post of **Secretary** to co-ordinate the various club activities through the year.One of the Senior Coordinators to be designated as **Treasurer** to keep account of club funds and expenses.

2. 9 members from PGP1 (Junior Coordinators)

ACTIVITIES

I. Events

1. **Animal Spirits**: We conducted a series of 4 *intersection competitions* for PGP1 batch to give them a flavor of various finance domains. These include trading events like "The PIT" & "Munaafa", finance quiz "FinQ" & stock pitching "Stock 20-20".

2. **Vista Events**: Networth conducted 3 events at Vista, the IIMB Business festival. These include game-theory based Get-Nashty, portfolio trading based Master the Market, and Convexity Calls. Eximius Events: Networth conducted Next-Up at Eximius, the IIMB Entrepreneurship Festival. Next-Up is a start-up valuation competition.

3. **Events in collaboration with corporations**: Bloomberg Aptitude Test, National FLIP Challenge, ICICI StockMind.

4. **Fin Gyaan Sessions:** We conducted sessions and mock interviews for the PGP1s to help them prepare for finance interviews for summer internships.

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