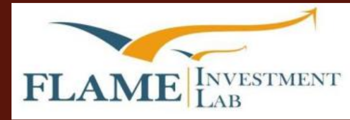
The FIL Newsletter

Issue 01, February, 2012



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From the President

The FLAME Investment Lab (FIL) is about willingness to learn and passion to perform. It is a student-run initiative that aims to provide members with skills to help them bridge theory with practice and provides a platform to lean and enhance their knowledge.

And by attempting to accomplish these objectives, FIL aims to stimulate a holistic development of its members, thereby acting as a differentiating advantage in a generation that has witnessed much economic insecurity.

FIL truly believes that the best investment is investing in yourself. Go ahead and enjoy this aggregation of articles as we present to you the very first edition of the FIL Newsletter.

From the editor

By the time this first issue of the FLAME Investment Lab Newsletter reaches you, deliberations and discussions on possible bailout options for Greece will be completed. What happens if Greece defaults?

With possibilities of extreme market reactions and contraction of world economies at one end of the spectrum, an evaluation of the current Eurozone crisis warrants attention.

We also bring you a complete showdown on one of the hottest debates dominating the headlines in India – FDI in retail.

All this and more, in the very first edition of the FIL newsletter!

FDI in retail

A complete showdown on one of the hottest debates in India

For any kind of development, capital is the most important prerequisite. Since capital is a scarce resource in underdeveloped countries, they always long for foreign funds, which come in two forms - foreign direct investment (FDI) and foreign portfolio investment (FPI). The latter is also referred as Foreign Indirect Investment or Foreign Institutional Investment.

FDI refers to the investment in physical assets in the country. FPI refers to investments in financial assets of the country; for example, external commercial borrowings.

FDI has some inherent advantages over FPI; FDI reinforces long term investment in the country while FPI is short term capital. Further, short term fluctuations result in the flight of capital, which is visible in the crumbling of stock markets. Such fluctuations have little impact on FDI. Since FDI is investment in physical assets, it directly results in employment generation and infrastructure development.

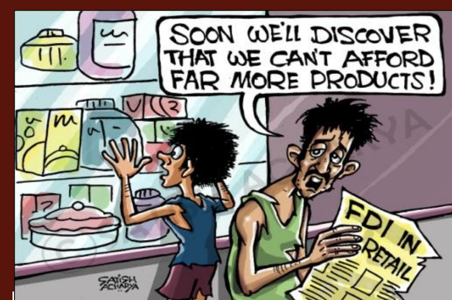
The industrial policy resolution of 1948 heavily controlled the inflow of foreign capital in the country. Though these provisions were relaxed in 1956, foreign capital was still under high regulation.

The industrial liberalization of 1991 brought major charge in the FDI policy of the country and foreign capital was assigned a critical role in economic development. Many industries were deregulated and liberal FDI was allowed.

In the post 1991 era, two routes were devised to increase the flow of FDI in the country; automatic approval and the Foreign Industrial Promotion Board (FIPB) route.

Under automatic approval, foreign companies do not have to seek permission before investing in India but have to inform the RBI within 30 days of bringing the investment in India. Under the FIBP route, foreign investment in sectors having long term consequences are cleared on the case-by-case basis.

FDI in retail has been the most debated topic in the country in recent times. In India, more than 90% of the retail trade is in the unorganized sector. Retail trade accounts for around 14% of the national GDP and provides employment to the 7% of the work force, largest after agricultural employment.



FDI Fact File

A Citi report says $15-20 billion in FDI could flow into the country over the next 10 years as a result of FDI in multi-brand retail.

The report also says the move would help enhance the share of organized players in the overall retail sector, which currently account for about six per cent of India's $470-billion retail market.

Kaushik Basu, one of Manmohan Singh's close advisers, says allowing global chains to open their first stores in India would be one of the most effective ways to help the country deal with food inflation, which stands close to 10 percent.

What happens if Greece defaults?

Why is Greece in so much trouble, given it has received £97billion in bailouts?

For the last decade the country has lived beyond its means. Despite promising to rein in spending and sell off the family silver, the markets have all but given up hope Greece will ever pay off its debts in full and they expect the country to default. Greece has a colossal £305billion of debts – equivalent to more than 160 per cent of its annual economic output.

What does a default mean?

A country in default effectively admits it is bankrupt and can no longer meet either the interest or the capital repayments on its debt. The talk at the IMF in Washington over the weekend is that the face value of the debt will have to be cut by at least 50 per cent. This means an investor holding Greek bonds with a face value of 10,000 Euros would only get back 5,000. The value of the Greek debt has already been plummeting, which is why the French and other European banks, which own a very large number of these IOUs, are now under the spotlight.

How big a crisis would a default be for French banks?

It is a potential disaster. French lenders have a gigantic £36billion exposure to Greece, according to the Swiss-based Bank for International Settlements. The shadow of debt hanging over French banks is forcing them to sell assets to raise capital. In the event of a Greek default, the French may have to inject new funds into the banks and part-nationalize them to prevent their collapse. In a sign of the mounting crisis, French authorities have denied speculation such plans are being drawn up. If the debt contagion were to spread beyond France, things could get far worse. The total exposure of European banks to all ClubMed nations – Greece, Spain, Portugal and Italy – is estimated at a terrifying £1.3trillion.

Can anything be done to prevent a calamity?

European finance officials are under pressure to put a safety net under the euro by the time of the Cannes G20 summit in early November. Officials are introducing speedy legislation across the eurozone to implement a new bailout fund known as the European Financial Stability Facility. This will be combined with the resources of the European Central Bank to produce a fighting fund of trillions of Euros. The fund has been designed to provide money to countries in difficulty as well as to rescue and re-capitalize banks, as happened in Britain and the U.S. in 2008 when Lehman Brothers collapsed.

What happens if Germany torpedoes this plan?

It could create a market shock as serious as the collapse of Lehman Brothers. The European Central Bank, which has been propping up the Greek banking system for almost two years, would be required to call back loans it has made to Greece as the collateral provided, in the shape of Greek bonds, would be worthless. This would cause a cascading series of collapses through the Greek financial system and the contagion would spread across the whole euro area and beyond.

Kingfisher crisis and what ails the aviation industry

It's the irony of Indian aviation that despite a market growing at 18 per cent for last 11 months, five out of six Indian airlines are bleeding. If Air India was in the news for the last few months over the CAG report, aircraft purchases, and merger issues, Kingfisher Airlines has been in the focus in the last few days for flight cancellations, cash shortages, and survival fears.

Kingfisher hoped that the press interaction on November 15, 2011 would clear much of the negative air. The airline listed out a few options in its kitty to tide over the turbulent times. But the statement that the airline was "in discussions with a strategic Indian investor," was perhaps, the most attractive of all solutions provided by the airline. After all, such an investor will certainly help the airline tide over its additional working capital need of Rs 800 crore and also address the issue of its nearly Rs 7,500 crore worth of debts.

Kingfisher's chairman Vijay Mallya said on November 19 that the strategic investor could put in upwards of Rs 1,000 crore in the airline. He also said that the airline has applied for working capital loans from banks worth Rs 600 crore. This will certainly provide the airline the much needed fresh lease of life. At least till the aircraft reconfiguration and route rationalization measures start showing results.

But Kingfisher's pains are mirrored -in a lesser extent- in the operations of its peers as well. All the three listed airline companies have shown a loss for the June to September period. High aviation fuel prices and depreciating rupee is where the blame has been assigned. Then there are policy issues, like high sales tax on aviation fuel and airlines having to fly unviable routes to develop connectivity in the country, that are adding to the hardship. Lastly, it's the inability of Indian airlines to hike ticket prices that is hitting them the hardest.

Vijay Mallya, in his interaction with the press, did admit that one way to fly Kingfisher out of the mess was to raise prices. But he also conceded that the airline had "got stuck" while trying to raise prices. Dinesh Keskar, India head for aircraft manufacturer Boeing, estimates that Indian carriers are under-cutting themselves by as much as Rs 1,000 on prime routes like Mumbai-Delhi. It's the way the market is structured that prevents any airline in India from raising prices. No airline owns a significant chunk of the market, which means that if one airline does try to hike fares and others don't follow suit, its fliers will be easy business to its competitors. This means that no airline raises prices until it knows that others are likely to do the same.

So until one of them decided to turn bold, bank on its product and hike fares, airlines can merely hope for another consolidation -like how Jet Airways bought Air Sahara and Kingfisher Air Deccan and got some control over the market. Or they can hope for some relief in terms of economic conditions or policy changes.

Rupee depreciation – Are we on the same page?

That is what the Reserve Bank of India (RBI) Governor D Subbarao would like everyone to be on while discussing the sharp rupee depreciation against the US greenback. The Indian rupee has been mauled nearly 20 per cent in the last one year. And the downslide is unstoppable. The rupee closed at 52.22 against the dollar on Tuesday, the second week of December 2011. Why the dramatic slide

Some trigger happy commentators are quick to fire the central bank for not selling dollars from its foreign exchange reserves kitty of $300 billion, an action that could have cushioned the rupee's plunge. But that's easier said than done. There are far reaching implications of a forex sale that can outweigh the expected gains. Remember, India had foreign exchange reserves of just $10 billion exactly two decades ago when Prime Minister Chandra Shekhar's coalition government was at the centre and Yashwant Sinha was the finance minister. Thanks to FII inflows into Indian equity markets, the foreign exchange reserves have grown big time since the early 90s. But a big chunk of the reserves actually started flowing from the early 2000 period when foreign institutional investors (FIIs) started investing dollars in the Indian market. The rupee, too, appreciated big time to 38-39 levels in early 2008.

So what's pulling the rupee down now? Clearly, dollar inflows - especially short-term hot inflows into the Indian equity market - are vanishing fast because of global troubles and high valuations of Indian companies. The RBI Governor will surely rest his case on the lack of focus in terms of attracting longer term foreign direct investments into India.

Past governments were never able to pull their act together enough to attract more stable dollar inflows through the FDI route. Whatever little FDI that comes into India is also on the decline from $40 billion in 2008 to $25 billion in 2010. That amount is peanuts compared with neighboring China. China, which unlike India has no sectoral limits for FDI, pocketed $185 billion in 2010. The Chinese FDI inflows were always well over $100 billion annually in the past. China runs a trade surplus and the currency is also inherently quite strong, though they peg it at a fixed rate to the dollar. India could have attracted FDI inflows had it relaxed foreign investments in retail, insurance, pension, defense, aviation and a host of other sectors. Some of these reforms have been pending for nearly a decade. Call it a last minute desperate measure or a larger reform exercise, the move to allow FDI in multi-brand retail brands last fortnight also fell flat because of stiff opposition from UPA allies and opposition parties.

There are also softer measures - besides the FDI cap - that need attention from the government, say some experts.

"There is also a perception issue," says Frank Richter, chairman of Horasis, a Zurich-based global business community forum. Frank highlighted issues like corruption, bureaucracy, regulations, delays in land acquisition and environmental issues as obstacles to global investors.

"India needs a stronger export focus," advises Richter, who worked in China and Japan for well over a decade. "FDI will only make Indian companies more competitive in the global marketplace," he adds. If Indian companies have to adapt to more competition at home, they'll be better placed in the global market. China is a great example of allowing foreigners in all sectors and then competing with them head on.

The strength of a currency always reflects the demand and supply of dollars in the market. India historically runs a huge current account deficit (more imports than exports, meaning more dollars are going out of the country than are coming in).

So be it a trade window or an investment window, dollars are in short supply. The FIIs are also pulling out dollars from the Indian stock market to shift to other attractive destinations.

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Investopedia

Definition of 'Return On Equity - ROE'

The amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

ROE is expressed as a percentage and calculated as:

Return on Equity = Net Income/Shareholder's Equity

Definition of 'Price-Earnings Ratio - P/E Ratio'

A valuation ratio of a company's current share price compared to its per-share earnings.

Calculated as:

Market Value per Share/Earnings per Share

Definition of 'Earnings Per Share - EPS'

The portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serves as an indicator of a company's profitability.

Calculated as:

(Net Income-Dividend on Preferred Stock)/Average Outstanding Shares

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For suggestions and queries, you can write to us at fil@flame.edu.in

Upcoming Events

Back to Basics - for all those who would want to learn or brush up their financial concepts. And guess what? We have our own students donning the hats of professors!

Movie Screening – a chance to get together and watch some of the best movies and documentaries out there!

Foundation for Liberal and Management Education

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