Current Topic

PRADEEP CHOKHANI
GENERAL PARTNER INDIA
MOUNTHILL INVESTMENT
ADVISORS PVT. LTD.

Sub-prime woes at Wall Street - An opportunity for India?

The author makes a pointer to the sub-prime problems, the reasons for recent fall out of U.S. banks and subsequent crisis in the Wall Street. He, however, notes the spring back by the US after crisis and chalks out future impact of large bailout packages of US Government and expects growth in trade between two countries and more capital inflow in India.

Introduction

1. What is the sub-prime problem? Loans are given to the borrowers who are not eligible for normal home loans. Thus, it forms the bottom of the banking mortgage segment.

Why did it happen? Banks chose to lend higher to this segment as it was showing very high growth rate, without providing for provisions.

Theoretically, out of 5 variables such as:

(*a*) Cash reserve ratio (CRR)

(*b*) Statutory liquidity ratio (SLR)

(*c*) Non-performing loans (NPL)

(*d*) Provisions

(*e*) Tax rate,

if the CRR and SLR ratios are on the lower side, any increase in non-performing loans without adequate provisions would de-stabilize the economy. This is not the case with the US.

Both ratios have been comfortable, but market forces wherein the lower disposable incomes than the cost of goods without a compromise on living standards have had a major impact of general US citizens paying for EMI's (equated monthly instalments). In banking terms, high leveraged exposure to real estate market without provisions led to fall of I-banks who are typically not regulated like the commercial banks. This led to the first major fall in the mortgage category by making the default.

The first impact is seen on major investment banks, starting with Bear Sterns, in the following series of events:

March 2008: Bear sterns sold to JP Morgan for US$29bn

The eventful month September 2008:

Sept. 8: Effective nationalization took place on Sept. 8 of mortgage giants Fannie Mae and Freddie Mac

Sept. 12: Lehman Brothers, considered as one of the four pillars of Wall Street i-banking lane, stock Fell sharply due to fear of its financial condition. Banker's effort to bailout Lehman, which had bet heavily in the sub-prime mortgage market failed. It files for Chapter 11 on Sept. 15th for bankruptcy.

Sept. 14: Merrill Lynch sold to Bank of America for about $50 billion.

Sept. 15: Investors concern about AIG, a giant US insurance, failure of which would have implications on US elections given that general US citizens are insured by this company. AIG goes for massive fund raising.

Sept. 16: The Federal Reserve arranges to lend $85 billion to AIG in exchange for a 79.9 per cent equity stake.

Sept. 18: Morgan Stanley comes up with a merger talks with Wachovia. Lending programmes by Fed starts to get noticed by way of pumping money into the US financial system operated by several overseas central banks. Action begins on the hugest bailout of all, committing hundreds of billions of taxpayer dollars to buy troubled mortgage assets from beleaguered financial institutions.

Sept. 19-23: Another set of 2 more I-banks, Goldman and Morgan Stanley goes for a spin but Fed's intervention makes them turn into retail banks. US Government announces US$1.8 trillion bailout package using a combination of purchases, investments, special allowances, etc., in the month of September. Financial institutions can avail discount loans to fund purchase of assets from money market funds to aid redemptions.

Why did I-banks fall? They invested their own and clients money into high-risk high-return securities. Later, they borrowed more from banks and invested further.

Overexposure and fall in prices due to which need for cash arose which didn't find any buyer, led to the entire collapse of the large i-banking companies.

Following is the list of global write-downs by companies:

Firm	*Writedown & Loss*	*Capital Raised*
Citigroup	55.1	49.1
Merrill Lynch	51.8	29.9
UBS	44.2	28.3
HSBC	27.4	3.9
Wachovia	22.5	11
Bank of America	21.2	20.7
KB Deutsche	15.3	12.6
Royal Bank of Scotland	14.9	24.3
Washington Mutual	14.8	12.1
Morgan Stanley	14.4	5.6
JP Morgan Chase	14.3	7.9
Deutsche Bank	10.8	3.2
Credit Suisse	10.5	2.7
Wells Fargo	10	4.1
Barclays	9.1	18.6
Lehman Brothers	8.2	13.9
Credit Agricole	8	8.8
Fortis	7.4	7.2
Other European banks	7.2	2.3
HBOS	7.1	7.6
Societe Generale	6.8	9.8
Bayerische Landes	6.4	-
Canadian Imperial	6.3	2.8
Mizuho Financial	5.9	-
ING Groep	5.8	4.8
National City	5.4	8.9
Lloyds TSB	5	4.9
Indy Mac	4.9	-
WestLB	4.7	7.5
Other Asian banks	4.6	7.8
Dresdner	4.1	-
BNP Paribas	4	-
LB Baden-Wuerttemberg	3.8	-
Goldman Sachs	3.8	0.6
E*Trade	3.6	2.4

Firm	*Writedown & Loss*	*Capital Raised*
Nomura Holdings	3.3	1.1
Natixis	3.3	6.7
Bear Stearns	3.2	-
Other U.S. banks	2.9	1.9
HSH Nordbank	2.8	1.9
UniCredit	2.6	-
Landesbank Sachsen	2.6	-
Commerzbank	2.4	-
ABN Amro	2.3	-
DZ Bank	2	-
Bank of China	2	-
Fifth Third	1.9	2.6
Other Canadian banks	1.8	-
Rabobank	1.7	-
Bank Hapoalim	1.7	2.4
Mitsubishi UFJ	1.6	1.5
Royal Bank of Canada	1.5	-
Marshall & Ilsley	1.4	-
Alliance & Leicester	1.4	-
U.S. Bancorp	1.3	-
Keycorp	1.2	1.7
Dexia	1.2	-
Caisse d'Epargne	1.2	-
Sovereign Bancorp	1	1.9
Hypo Real Estate	1	-
Gulf International	1	1
Sumitomo Mitsui	0.9	4.9
Sumitomo Trust	0.7	1
DBS Group	0.2	1.1
TOTAL	**501.1**	**352.9**

Source : Bloomberg

US springs back after crisis

2. What goes down must come up, is the perfect example for US markets since traditionally, US markets have sprung back after every crisis.

Following Table is emperial evidence of US property boom bust-boom history:

Table 1. Historical Evidence of U.S. Home Price Booms and Busts, 1978-2003

Region and City Year-->	78	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	00	01	02	03
California																										
Chico, CA																										41
Fresno, CA																										37
Los Angeles-Long Beach-Santa Ana, CA	47											48						-19								35
Madera, CA																										35
Merced, CA																										40
Modesto, CA													32													44
Napa, CA													34												46	
Oxnard-Thousand Oaks-Ventura, CA		39										50						-17								35
Redding, CA																										39
Riverside-San Bernadino-Ontario, CA		40																	-18							36
Sacramento-Arden-Arcade-Roseville, CA		30											32													40
Salinas, CA																								49		
San Diego-Carlsbad-San Marcos, CA		45										32														41
San Francisco-Oakland-Fremont, CA	38											40												44		
San Jose-Sunnyvale-Santa Clara, CA	40											49											51			
San Luis Obispo-Paso Robles, CA													44					-16							46	
Santa Barbara-Santa Maria-Goleta, CA												34														45
Santa Cruz-Watsonville, CA												45												48		
Santa Rosa-Petaluma, CA													41											48		
Stockton, CA																									38	
Vallejo-Fairfield, CA																									45	
Yuba City, CA																										42
Other Western Locations																										
Bellingham, WA														43												
Bend, OR														32												
Boulder, CO																	31							31		
Corvallis, OR																	36									
Denver-Aurora, CO		34																								
Missoula, MT																	30									
Mount Vernon-Anacortes, WA														36												
Ogden-Clearfield, UT																			30							
Provo-Orem, UT																		34								
Salt Lake City, UT																		36								
Seattle-Tacoma-Bellevue, WA	45												34													
Oil Patch																										
Anchorage, AK												-29														
Austin-Round Rock, TX													-25													
Casper, WY											-33															
Fort Worth-Arlington TX																										37
Grand Junction, CO										-29																
Houston-Baytown-Sugar Land, TX											-22															
Lafayette, LA											-40															
Midland, TX										-31																
Odessa, TX												-22														
Oklahoma City, OK											-26															
San Antonio, TX														-17												
New England																										
Barnstable Town, MA										62							-15								48	
Boston-Cambridge-Quincy, MA-NH									74																36	
Bridgeport-Stamford-Norwalk, CT										71																
Burlington-South Burlington, VT											32															
Hartford-West Hartford-East Hartford, CT											61						-17									
Manchester-Nashua, NH									55								-20								35	
New Haven-Milford, CT										76							-16									
Norwich-New London, CT											50						-16									
Portland-South Portland-Biddeford, ME										47																
Providence-New Bedford-Fall River-Warwick, RI										69																39
Springfield, MA										63																
Worcester, MA-CT									71																34	
Other Northeast																										
Albany-Schenectady-Troy, NY										49																
Allentown-Bethlehem-Easton, PA-NJ											48															
Kingston, NY																										33
New York-Northern NJ-Long Island, NY-NJ										65																32
Ocean City, NJ																									37	
Philadelphia-Camden-Wilmington, PA-NJ-DE-MD											41															
Poughkeepsie-Newburgh-Middletown, NY										63																35
Scranton-Wilkes-Barre-Hazelton, PA											31															
Trenton-Ewing, NJ										61																
Washington-Arlington-Alexandria, DC-MD-VA-WV											31															31
Florida																										
Cape Coral-Fort Myers, FL																										31
Miami-Fort Lauderdale-Miami Beach, FL																										36
Naples-Marco Island, FL																									32	
Port St. Lucie-Fort Pierce, FL																										37
Punta Gorda, FL																										31
Other																										
Honolulu, HI			31										60									-16				
Niles-Benton Harbor, MI								30																		
Peoria, IL							-17																			

Legend

BOOM = Years where real home prices increased at least 30 percent from 3 years earlier.

BUST = Years where nominal home prices declined from 5 years earlier.
(City must include at least one 5-year period where nominal price declined by more than 15 percent.)

Numbers in bold indicate maximum 3-year real price increase in a boom, or maximum nominal 5-year price decline in a bust.

N/A = Sporadic or missing price data.

Source: FDIC FYI "U.S. Home Prices: Does Bust Always Follow Boom?" February 10, 2005. (Office of Federal Housing Enterprise Oversight Home Price Index, nominal and real, using Bureau of Labor Statistics Consumer Price Index less shelter inflation index).

The above table summarizes number of individual metro-area price booms since 1978 wherein 63 different U.S. metropolitan areas and 24 cities have experienced at least one boom during that period. Geographically, home price booms have been concentrated in cities in California and the Northeast, which account for almost 70 per cent of 63 boom markets. This share may be overstated, however, due to the limited availability of data for many cities outside these areas prior to 1990. Average U.S. home prices rose 13% in the year-ending September 2004 and are up almost 50 per cent over five years. Government office quoted that the growth in home prices in 2004-06 surpasses any increase in 25 years. Thus, the boom period was noticed.

This boom was noticed a year after the technology bubble began with rapid growth in population driving demand for houses which mainly came from Asian immigrants, driven by the rapid growth in tech employment. As soon as the tech bubble burst the home price, appreciation stopped and prices began to decline.

But something dramatically changed soon after the tech bubble burst in 2000. High levelled techies, who were very heavily speculating in the local tech stocks, because they knew the industry along with companies involved, suddenly learned a lesson in diversification into US Treasuries and other high quality bonds. So, quite a few plunged, head first, into residential real estate and some ventured far but many speculated locally.

Strong rise in home prices in the year after tech bubble was noticed and it was assumed that people taking money out of stocks had invested in real estate. Such signs are not signs of investments and, hence, tilt towards speculative ventures. Just as the demand for housing began to decline in 2001 along with the nationwide recession with jobs being lost, the real explosion in home sales began in 2002, the worst year for the local economy following the tech bust. This had to be because of the housing bubble that began in Southern California (with San Diego being the leading edge) in 2000 spreading to rest of California.

Once again, people diversifying from stocks was probably the most important factor in the beginning of the home price appreciation but later on the bubble took a life of its own. Hence, when raw material price starts to rise, product price goes up too and *vice versa*. That is what the speculative bubbles are all about.

Having seen the main cause for the US turmoil, empirical evidence has proved that US comes out of crisis each time as explained by the market forces theory: as the value of the property comes down from its threshold level by steady decline of, say, 10-15% over 5-7 years, new set of buyers tend to emerge looking out for value BUY's. During the phase of downturn, the number of transactions comes down drastically wherein the price stabilizes at a particular point due to intervention of new set of buyers. At this stage, exciting offers start building up for investors to make good returns which start the boom phase once again, thus, concluding to a boom-bust-boom era.

Overall, as we see the large bailouts happening in US with European banks witnessing the same stretch of bailouts also, the decline in property prices would enable new set of investors to lookout for value BUY's.

Current US crisis - Opportunity for India?

3. The large bailout package of US $1.8 trillion by the US Government would see some smoothness in the Nuclear deal between US and India.

As US goes to final leg on presidential elections, the current fall in financial system would mean lots of processes to be built with the new President who would like to smoothen nervous investors' confidence to bring stability in the financial system.

Hence, while US is expected to come back to stability in the next 12 months, India's current stability would be marred by upcoming political elections. Simple majority at the Centre would bring confidence in stock markets.

The growing trade exchange between US and India would mean more business to Indian companies.

(*a*) IT is one sector wherein Indian IT companies have high exposure to US clients such as Merrill (client of TCS), Lehman (client of Wipro and HCL), Morgan Stanley (client of TCS) and Goldman Sachs (client of Infosys). Change from Investment banks to retail banks by Morgan and Goldman would mean enhanced business for Indian companies. This is largely due to the fact that traditional banks have more processes than investment banks and they would need to adopt more systems in the areas of retail and consumer banking, card and corporate banking. Hence, existing vendors would have an edge on any new back office exposure, *i.e*, off-shoring since the most significant difference between last slowdown in 2001-02 and now the immense amount of creditability Indian companies have built with US companies.

Large bailout packages by the US Government would start building up confidence for investors to look out for good value buys. Once the entire circle is evolved, stability would start to form to look out for the next level-growth.

(*b*) Expectations of capital flows impact on Indian companies sourcing international funds would be seen time-and-again by the Fed and RBI's policy going forward. Traditionally, in the past 4 years, these policies have been making an impact on inducing asset re-location which resulted in increased capital flows to India given the high differential in interest rates and steady returns from private equity investments.

(*c*) High regulated market makes India a defensive country for investments. And, in this kind of global scenario wherein marred investors would look out for regulated markets to give them security. With planned expenditure going up with expenditure on roads, highways, power and adequate provisions in terms of high CRR and SLR with high provisioning norms makes India a defensive with growth story.

Since Indian companies have grown to the extent of being qualitatively rated by global rating agencies, the spread between US and India without much risk would induce banks to re-allocate more assets to Indian companies.

Respite has also come in the form of higher ceilings from US $100mn to US $500mn for Indian infrastructure companies who could now borrow from international markets for spending in India. External commercial borrowings are loans raised by companies from international markets wherein interest rates are lower with 3 to 5 years of maturity. The new regulation would mean large projects execution of which is to be completed at lower cost than current interest rates prevailing in India. Indian companies can borrow at LIBOR *plus* 4.5 per cent making a total of apprx. 7.5 per cent while the PLR in India is at least 13.25 per cent making a clean gain to large projects.

Demand creation in India is purely domestic since exports are only 17 per cent of GDP including software with specific sectors such as cement and sugar remaining as pure domestic plays without much of imports-exports impact.

The two large concerns of capital inflows and demand for a continued growth in India are addressed to large extent. Hence, overall, the past strong growth reflected in higher returns to investors would be an oasis going forward while at the same time expectation of a recession is ruled out given the moderate 15 per cent year-on-year in FY 09-10 growth in large Indian companies.