India: Downloading the Dream

In November 2014 we spent a couple of days in Delhi and Mumbai meeting the new generation of Indian internet companies. There has been much publicity about the meteoric rise of the internet in China, but the situation in India is less talked about. We believe India is at a tipping point now and the profile of the industry will rise quickly.

Smartphone Revolution

The reason behind this view is that smartphones have finally become affordable for a large chunk of India's population. GDP per capita is still only US$1,500, so even the $100 level represents a significant outlay but it is a considerable improvement from a US$500 iPhone. Smartphones account for 30% of all phone shipments to India of which 75% are low cost smartphones. 18m smartphones per quarter are coming into India. Local brands like Karbonn and Micromax have piggybacked on Chinese white label producers to build double digit market share in next to no time. Samsung still has a 29% market share, but is having to compete head to head with Chinese made phones and competition in India inevitably means driving prices down.

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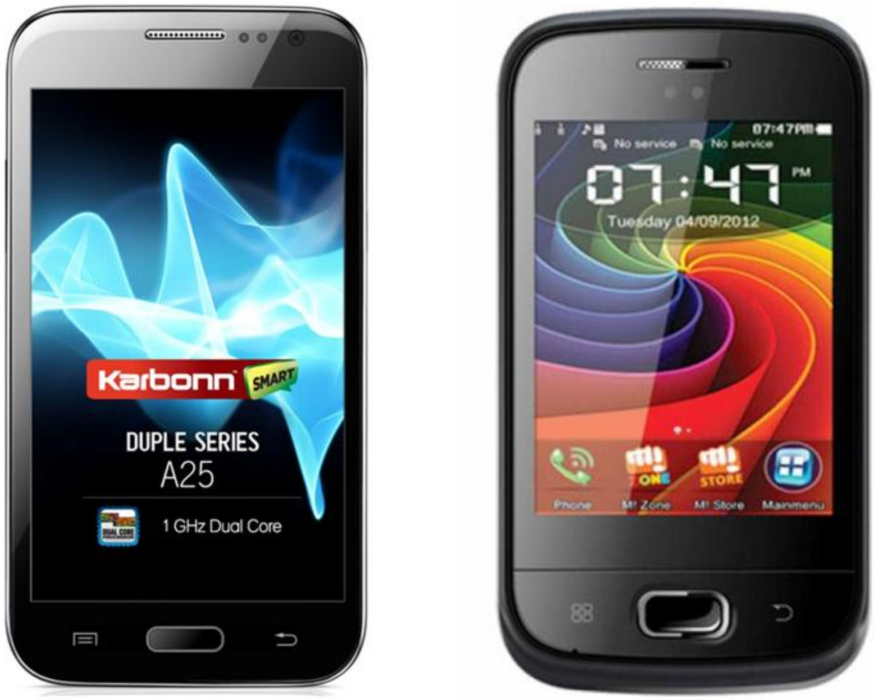
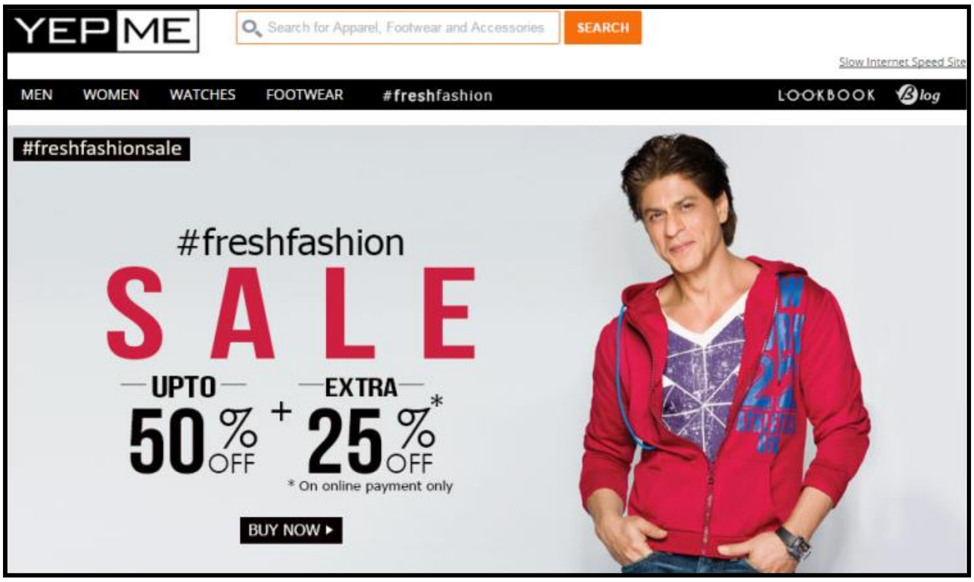


Local brands like Karbonn and Micromax have piggybacked on Chinese white label producers to build double digit market share in next to no time. (Karbonn A25 & Micromax X446 pictured above)

The first experience of the internet that most Indians will have will be through a smartphone. At present only 17% of the population have access to the internet. Of them, 93% access it wirelessly. The headline figure also masks massive inequality. 37% of urban dwellers can access the internet but only 8% can in the country. Though 3G services have been available for years, the major telcos are only beginning to straighten out their networks properly. Cutthroat pricing and repeated spectrum auctions have impeded capex but on both counts things are starting to improve. The industry is consolidating and Bharti, Vodafone and Idea have emerged as the national heavyweights accounting for 70% of the market. The government's Spectrum auction shakedown is also beginning to end. 4G services will probably begin in 2015 and the incumbents will be hurried along in developing their own services by the entrance of Reliance JIO, a new well-funded competitor.

China's decision to force China Mobile to develop its own 3G technology called TD-SCDMA has ultimately accelerated smartphone adoption in developing countries by driving handset pricing down whilst simultaneously increasing their flexibility. The dominant 3G standard uses separate frequencies for upload and download, in contrast TD (time duplexing) standards use the same bandwidth for both, alternating between the two. This is useful in situations where bandwidth is constrained – like in India. Handset manufacturers could afford to ignore TD technology as long as the other two Chinese Telcos were performing well with 3G subscribers. The iPhone for example wasn't available for China Mobile until last year. All this changed when, perhaps as a reward for developing the 'Chinese' technology, China Mobile was given its 4G license in 2013, a year ahead of its two rivals. They were once again required to use a Time Duplexing technology known as TD-LTE but with 803m subscribers, the handset makers had to seriously rethink their product offering for 4G. If handset manufacturers want to compete in China then they need to build 5 mode handsets which cover all 3G and 4G standards and sell them for low prices. Clearly this is what has happened because as of November 2014, China Mobile had 71m 4G subscribers and 242m 3G subscribers.

Unlike China, where language and law barriers allowed a unique ecosystem of domestic internet companies to grow, India has always been open to the large American companies. As a result Google, Facebook and Youtube are the top 3 most visited sites in India. The first phase of desktop browsing did create Indian champions like Naukri (Jobs) and various matrimony (not dating!) sites but the battle for search, video and social media was lost to America years ago. To survive as an Indian Internet company, the business model can't be replicated remotely on a server in California or it must serve demand peculiar to the country.



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The second, 'mobile' phase of the internet has seen far more local companies appear. E-commerce is one such business which requires a local presence. Three large horizontal operators (FlipKart, Amazon and Snapdeal) are currently slugging it out between themselves for dominance. Each buoyed either with PE money or a rich parent, they have reached a too big to fail stage for their backers so the only logical action is to give them more money to 'invest' in customer acquisition. These companies have been selling items below cost, even before considerations such as shipping, head office costs, advertising etc. Stories abound of shop vendors recruiting students to take advantage of promotional deals on these websites for consumer electronics and then reselling them for considerable profits in their shops. The CEO of a local internet venture company dubbed it 'the largest ever subsidy given to the Indian middle classes'. That being said, not every company we met was as gung ho with investors' cash or as me-too with their business model. Vertical fashion players YepMe and Zovi are making profitable use of the extensive garment industry in the country to provide fast fashion for the masses with extremely low lead times. Major clothing brands have not been able to properly penetrate India to date. Both companies were already in the country's top 10 brands after only a few years of operation.

The sector is awash with cash from foreign investors who are anxious either to recreate their success in China or avoid missing out again on what will eventually become one of the biggest markets in the world. None of the dozen companies we met were even considering an IPO. Some even thought that they never would because of the transparency burden it

Top 10 websites in India

	No. 1	No. 2	No. 3	No. 4	No. 5
Website	Google.co.in	Facebook.com	YouTube.com	Flipkart.com	Yahoo.com
Purpose	Internet Portal	Social Networking	Videos	E-commerce	Internet Portal

	No. 6	No. 7	No. 8	No. 9	No. 10
Website	Amazon.In	Wikipedia.org	Blogspot.in	Snapdeal.com	IndiaTimes.com
Purpose	E-commerce	Information	Blogging	E-commerce	Internet Portal/News

Source: CLSA

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would entail. So what investable themes are left for the hopelessly out of fashion equity investor which benefit from the rise of the Indian internet consumer? Directly listed companies are few and far between though are of decent quality. Infoedge (US$1.6bn mkt cap) owns Naukri, the dominant online recruitment company and has a promising investment in Policy Bazar, a fast growing insurance product comparison website. Just Dial (US$1.6bn mkt cap) is a local search company much like Yelp but with a cash cow premium telephone line business as well. MakeMyTrip (US$1.1bn mkt cap) is listed in the US and offers travel search and booking services. The lack of listings is surprising, especially given the IT talent that the country so obviously has, but it is testament to how nascent the industry is in India and how much money has been thrown at it by private equity investors.

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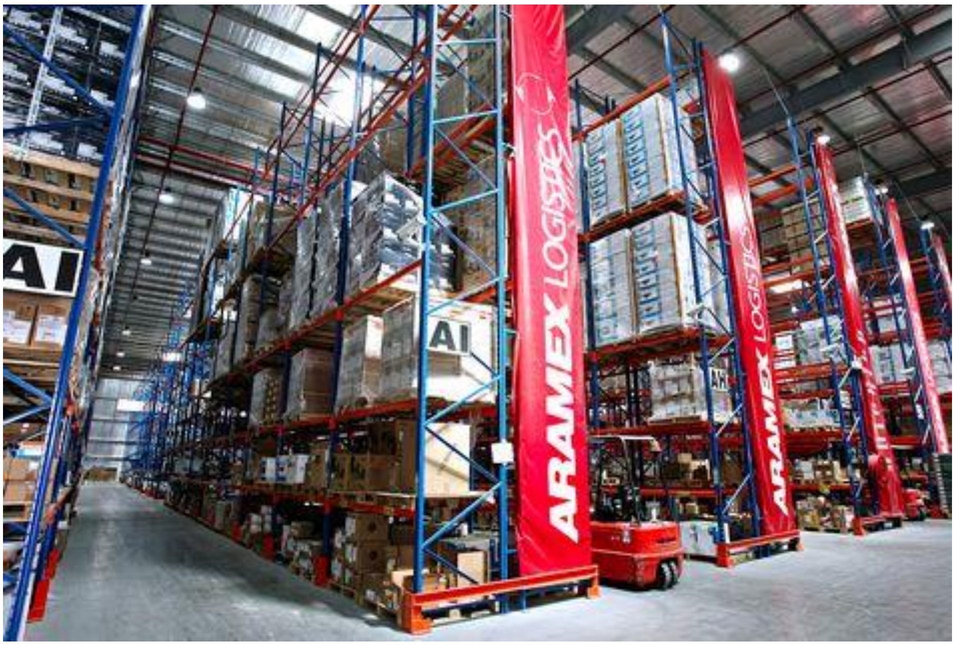

Aramex (US$1.2bn mkt cap), has been operating in India for years and has also had its capacity block booked by the e-retailers but is valued on a more prosaic 1.2x sales.

There are more choices to invest in e-commerce enablers. Logistics is a clear beneficiary, and an area where India has an obvious deficiency. Blue Dart Express (US$2.6bn mkt cap) which is a DHL subsidiary, owns and operates a small fleet of cargo planes in India. All of their capacity has been block booked by Amazon for the next year. Aramex (US$1.2bn mkt cap), has been operating in India for years and has also had its capacity block booked by the e-retailers. We think there are more opportunities with the data demand story. Mobile data is expected to have a 50% cagr over the next 4 years and the market should be worth US$15bn by 2018. On the data side, the two telcos Bharti Airtel (US$22.9bn mkt cap) and Idea Cellular (US$8.56bn mkt cap) are both listed. Investors though are quite gun-shy about the sector after years of spectrum license uncertainty, high leverage and dismal profitability. Bharti Infratel (US$10.5bn mkt cap), a pan-India telecom tower company, has a more promising outlook as operators build out their networks and begin to share infrastructure.