INVESTMENT MANAGEMENT

Morgan Stanley

Connecting The Dots

2012

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December 2012

India is a land of many contrasts, and it is perhaps no surprise that Indian equity markets present myriad opportunities and pitfalls. There are few markets globally, and fewer in the emerging world, that give investors such diversity of choice and rewards for long term thinking and a disciplined approach.

In a year when it would seem that global risk-on/risk-off was the only determinant of Indian market performance, we tried to delve deeper to see if there are other factors at play. It is with this thought that we started a monthly investment newsletter called 'Connecting the Dots'.

This series, written by two of our senior fund managers, Amay Hattangadi and Swanand Kelkar, looks at drawing data points from the macro environment, the corporate world and global cues to present a holistic picture – hence the name. They have tried to steer clear of short-term market gyrations and noise to focus more on developing a framework for long term investing.

We started this journey with the first article titled 'Vulnerability' in April 2012, and close the year with introspection into what Mr. Market taught us in 2012.

This annual issue is a compilation of the articles written through the year. I am sure that you will find this compendium a riveting read, and I wish you all the best for 2013.

Sincerely,

Anthony Heredia
Managing Director and CEO
Morgan Stanley Investment Management, India

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Connecting *the dots*

December 2012

Simhavalokana

As we bid adieu to the year 2012, it is time for our very own form of Simhavalokana. Wildlife enthusiasts, or should we say Indian philosophers, may well know the fact that as the lion walks some distance in the jungle, it looks back to examine the path it chose and how it covered that distance. This retrospective glance in Sanskrit is known as Simhavalokana.

It is human nature to obsess about the future. We don't blame market forecasters for being pre-occupied in attempting to look at the crystal ball while trying to predict index targets for 2013. After all Charles Kettering[1] once said, "My interest lies in the future, because I am going to spend the rest of my life there". However, as lifelong students of the stock market we think it is as important to reflect on the year gone by, as it is to try to make forecasts. We often get so absorbed in the daily noise surrounding investing, that we tend to forget the importance of reflective Simhavalokana. In this year-end edition of ***Connecting the Dots***, we make an attempt to summarise ten lessons learnt from the markets in 2012.

1. Market timing is dangerous

As investors, our holy grail for generating alpha is to look for through-cycle winners, who we call The Dependables (refer ***CTD: The Dependables***). We don't categorise stocks or sectors as defensives or cyclicals, but rather as those with dependable growth and capital allocation characteristics versus those without. We think market timing is a dangerous game and in 2012 we refrained from trying to time the market by avoiding tactical trades in high beta stocks in anticipation of a rally.

As Vitaliy Katsenelson[2] said, "It is hard if not impossible to create a successful market timing process. Aside from the fact that it demands that you be correct twice – when you buy and when you sell – emotions are in the driver's seat of the market especially at the tops and bottoms".

[1] An American inventor, engineer, businessman, and the holder of 186 patents; Credited with the invention of the electric motor.
[2] The Little Book of Sideways Markets by Vitaliy Katsenelson.

2. Don't let the consultants dictate

We are wary of investing in companies whose senior managers tell us that they relied on consultants' advice before taking strategic decisions. The same applies to our business of investing. While intuitively we always felt India was the most over-researched market in the world, we recently stumbled across a very interesting statistic. There are only 51 stocks in the world that are rated by more than 50 sell-side research analysts. Of these 49 are in India. The only two stocks outside India are Apple and Intel. We will listen to the army of consultants, but do our own bidding.

Display 1: Research coverage of Indian stocks by sell side analysts

Number of analysts rating the stock	Number of stocks
60 and more	20
50 to 60	29
30 to 50	61
10 to 30	161
Less than 10	307
Total stocks researched in India	**578**

Source: Bloomberg.

3. Read the odds

Investing is all about understanding starting point expectations, reading the odds and then making your bet. In our edition of ***CTD: Great Expectations***, we looked at how expectations play an important role in investing. A great company might not always be a great stock if the embedded expectations are going to be difficult to meet.

Display 2: Stock price volatility of a leading IT sector company on the day of announcement of quarterly results

Quarter	Revenue Growth (USD)		Stock price movement on the day of announcement of quarterly result
	Expected	Actual	
Dec-10	7.0%	6.0%	-5.1%
Mar-11	3.5%	1.1%	-9.6%
Jun-11	5.0%	4.3%	-4.4%
Sep-11	5.4%	4.5%	7.0%
Dec-11	3.4%	3.4%	-8.4%
Mar-12	1.0%	-1.9%	-12.9%
Jun-12	0.0%	-1.1%	-7.8%
Sep-12	3.5%	2.6%	-5.5%

Source: CLSA, Bloomberg, Company data

4. Know who you are

Adam Smith[3] famously said, "If you don't know who you are, the stock market is an expensive place to find out." It is important to define what you will and won't do and stick to that discipline. Any attempts to chase momentum in 2012 led to investors getting whipsawed. We had our gut wrenching moments too. Morgan Stanley Growth Fund had a turbulent start to the year when markets saw a seven week risk-on rally. We stuck to our philosophy and were eventually rewarded as is evident from Display 3.

Display 3: Year to Date (YTD) Morgan Stanley Growth Fund Alpha relative to BSE 100 Index (bps)

Source: Bloomberg, Morgan Stanley Research. The returns are not annualised. Data as of Nov. 30, 2012
For Performance disclosure, please refer to our monthly Fact Sheet on our website.

5. You can't win everyday

Like any investor, we often rue the stocks that we miss but console ourselves with the thought that even the greatest of investors don't make money everyday or on every bet. It is important to remember that you can't win 5-0 against the markets, a score-line of 3-2 is good enough to win this game, if you have sized the bets well.

[3] The Money Game by Adam Smith (George Goodman)

Display 4: Top performers from BSE 100 as of Nov. 30, 2012

Company Name	YTD Returns %
United Spirits	305.6
HDIL	111.8
Godrej Consumer	90.9
IDFC*	88.6
Yes Bank*	85.4
IndusInd Bank*	85.3

Source: Bloomberg. The returns are not annualized.

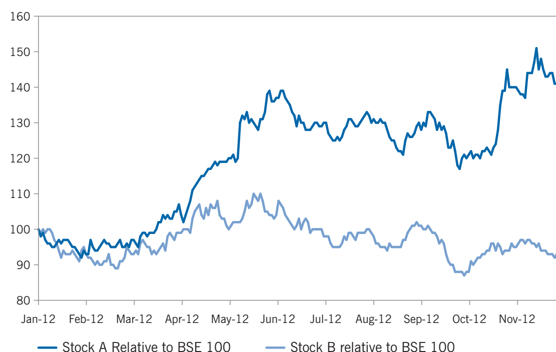
*Stocks owned in MSGF Portfolio as of Nov. 30, 2012.

6. High quality - Necessary but not sufficient

Buying high quality stocks purely because they meet all the criteria of quality is not the only consideration in building a good portfolio. If growth characteristics and valuations of these stocks are not supportive, they may not outperform, as the re-rating to factor for quality might have already played out. For the stock to sustain outperformance, it needs to score well on all the three facets – quality, growth and valuations.

In the chart below we compare two companies in the consumer sector – stock A is a company that the markets did not put on the same pedestal as stock B which was considered the gold standard in quality. If you compare the relative performance of both stocks over the year it is evident that stock A was re-rated as the underlying fundamentals were stronger, whereas stock B had a slowdown compared to its own historical track record.

Display 5: High quality – Necessary but not sufficient

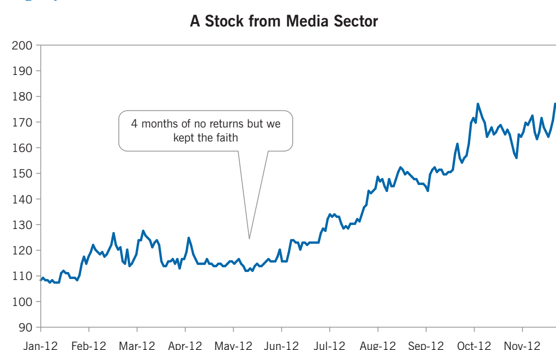


Source: Bloomberg

7. Be Patient

Market in its own style tests the patience of investors. At any point of time, there will be stocks in the portfolio that are not firing. It is important to be patient here, ensure that your original rationale is being borne out and then wait for the story to play out. It is almost impossible to perfectly time stock purchases and sales. We usually work with much lower churn ratios than the average of our peer group, as we think high portfolio turnover rates eat into portfolio returns and investors miss the big stock moves if they trade too frequently.

Display 6: Patience paid off in the media sector in 2012

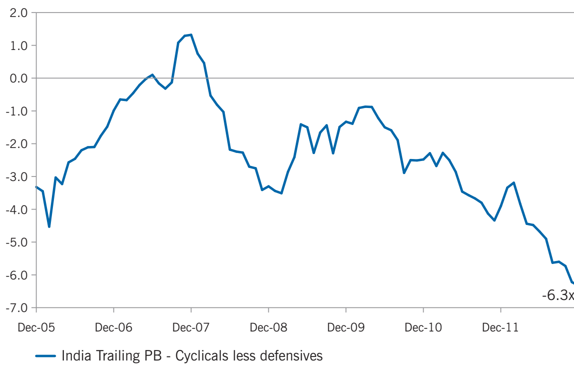


Source: Bloomberg

8. Mean reversion is never automatic

Investors show signs of impatience when a sector outperforms or underperforms for a few months. They start believing that markets should mean-revert and start itching to sell the winners and buy the losers. It is difficult for us to buy or sell stocks and sectors based on the sole rationale of divergent relative valuations. Mean reversion does not happen unless supported by an underlying change in dynamics. More importantly, trends can last for longer than you expect, as is evident in *Display 7*.

Display 7: Cyclicals vs. Defensives



Source: Company data, MSCI, Credit Suisse estimates

Note: As per Credit Suisse, "Defensives" include Consumer Staples, Telcos, Utilities and Healthcare. "Cyclicals" include Energy, Materials, Industrials, Consumer Discretionary and Technology.

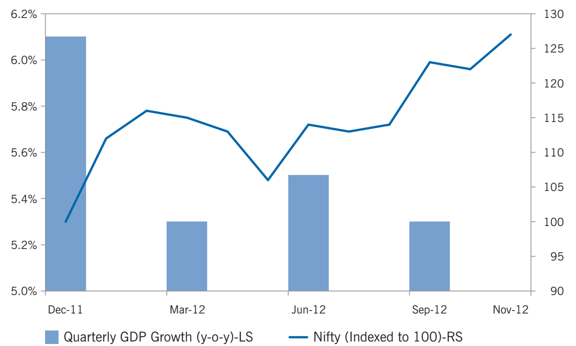
9. Don't gamble

Market participants often spend disproportionate time and effort in trying to predict binary events. These range from trying to guess when the Government might announce subsidy reduction measures to forecasting M&A activity. We resisted the temptation of participating in binary events such as chasing stocks on the back of rumoured M&A in the airlines and liquor sectors. While hindsight vision is a perfect 20-20 and some of these "event plays" might seem like misses in our portfolio, writing a convincing rationale without factoring in the event would have been difficult for us.

10. Bad Macro ≠ Bad Stock returns

Market indices are up 30%[4] this year as this edition of ***Connecting the Dots*** goes into print. If we look back at all the gloomy economic commentary at the beginning and through most of the year it would have been almost impossible to predict such respectable returns. Year to date, India is among the best performing markets in the world. Amongst the 45 countries included in the MSCI All Country World Index, India this year ranks at #5. So while macro factors play an important role in defining the regime in which companies operate, it is incorrect to give up on a country just because its macro environment is challenged. We strongly believe that despite the macro vulnerabilities, India's allure for investors lies in the bottom up micro stories.

Display 8: Strong markets despite slowing GDP Growth



Source: CEIC, FactSet, Morgan Stanley Research

We recently watched the movie Life of Pi[5] and it set us thinking about the deeper philosophical message from a seemingly simple story. The protagonist who goes by the nickname Pi survives a shipwreck on a boat with a Bengal tiger. After narrating his bizarre, almost implausible story, he says to the doubting officials who are investigating the shipwreck, "I know what you want. You want a story that won't surprise you. That will confirm what you already know. That won't make you see higher or further or differently." He then tells an alternate, far more gruesome and tragic story about his survival. Even the hard-nosed officials in the end believe the fantastic yet happy narrative. Isn't the India story similar? While the problems are well known, we need to dream of a story that does not confirm what we already know. In a year where doubt and skepticism abound, the Indian markets are likely to end 2012 at the top of the heap. While there are multiple excuses for not investing in the market, we continue to believe that a well-constructed portfolio can give decent returns. Investors need to choose what they want to believe. As Pi says "To choose doubt as a philosophy of life is akin to choosing immobility as a means of transportation." Happy investing.

[4] YTD return for BSE 100 as on December 6, 2012

[5] The movie Life of Pi is based on a book by the same name by Yann Martel.

Great Expectations

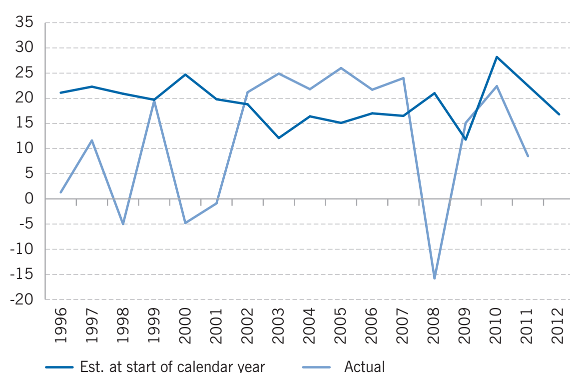
A few months ago, one of India's biggest automobile firms reported its annual results. They had sold the highest ever luxury vehicles in the history of that company and had declared record profits. After long, they had generated a respectable amount of free cash flow and were quite upbeat about new product launches in the coming months. Seemed like a very good achievement but unfortunately, the equity markets thought differently. The stock lost almost 20% in the week following the results announcement. A distraught friend of ours called us to check what was wrong – he worked in the sales division of these luxury cars and thought they were doing phenomenally well. We tried to explain to him that the market expected an even better performance from them. His lament was that things had never been in a better shape from a business standpoint and yet the market was unimpressed; we don't think we explained it too well to him for he hung up blaming us "market-types" of being ignorant of business realities. Similarly, it is not difficult to understand the disappointment of Apple Inc.'s design and marketing teams when their stock gets punished just because one out of thousands of free Apps malfunctions. The disappointment is compounded when they see their embattled competitor RIM's (makers of Blackberry) stock price surge 15% in a day for reporting a quarterly loss of USD 235 million[1]. It would perplex a layman if he were told that the next bullish thing for the world markets is if Spanish Banks concede that they are bankrupt and apply for a bailout. The disconnect between how good or bad the outcome is when measured by a conventional yardstick versus the market reaction lies in this thing called "expectations".

We again turn to Physics to see if there is a parallel here. Think about a car travelling at a certain speed (velocity) – this is the first derivative of a position with respect to time. The change in speed (acceleration or deceleration) is the second derivative. The rate of change in acceleration (technically known as jerk in Physics) is the third derivative. Expectations are like the third (or even higher order) derivative of any variable. That vehicle sales at our friend's company are at a certain absolute level is not enough, that they have grown over the corresponding period is not enough either – whether the change in the rate of growth meets expectations is what matters.

[1] See "Winning (losing) by losing (winning): The power of expectations" by Aswath Damodaran

Were there any lessons for us as investors here? We went back to how all of us have been taught to think about fundamentals and valuations. The preferred method is to forecast the financials of a company through making various assumptions about sales growth, margins, debt, capital intensity, etc. to arrive at a fair value of the company. When we started making financial models, we used to often struggle with forecasting how much the company will grow in say three years from now, where will some of the raw material prices be, as without that input predicting margins is difficult. What would be the interest rates then? What would be the firm's priorities when investing their cash? It became difficult to forecast these variables so we relied on history. What has sales growth for the past three years been, how have margins behaved and then we put in forecasts which were more or less similar to the recent past. An added advantage was that these forecasts could then be easily defended as they conformed to historical trends. This is what behavioral scientists called "anchoring bias" – your forecast is anchored to the past. We came across this interesting chart that shows the consensus sell side estimate of earnings growth for MSCI India at the beginning of each year. *(Display 1)* The estimate is generally around the 15-20% mark at the beginning of the year but you can see what the actual outcomes were and how they materially differed from the initial forecast. We see similar anchoring biases in predicting macro economic variables as well – inflation, industrial production or even GDP.

Display 1: MSCI India EPS growth (%)



Source: Jefferies, Bloomberg, FactSet.

There might be an easier way for the investor to think about forecasts. The approach outlined above opts to disregard one very important piece of information that all of us have – the stock price[2]. The stock price provides the investor with a lot of information on what expectations are built in by the market. Trying to decipher these in-built expectations is in a way inverting the valuation process. One way to arrive at these expectations is to see what the consensus assumptions on sales, margins, cash flows, etc. are. With that information, the investor is now asking "Do you think sales growth next year will be better or worse than 20%?" rather than "What will be the sales growth next year?" The former question seems easier to answer. Betting odds are an interesting parallel. For an India – Australia game, to figure out the probability of India winning, one would have to think about many variables – weather, pitch conditions, probable playing squads, their relative strengths and weaknesses, etc. It is a tough task indeed. But if you are offered 3:2 odds on India (i.e. you will make INR 3 if India wins and lose INR 2 if India is defeated, for simplicity it is assumed that no other outcomes are possible), you can quickly compute that the "price" is implying India's probability of winning at 40%. Now it is easier to answer "Are India's chances of winning better than 40%?" than "What are India's chances of winning?" If you feel, based on your analysis or even gut feeling, that it is better than 40%, you will go ahead and bet in India's favour or buy the stock. To be clear, this approach won't allow you to totally avoid making a forecast, neither does it eliminate errors in judgement – just that it allows you to make a relative "better or worse" bet versus expectations rather than making an absolute forecast.

That's the market reality – when investing with a twelve to eighteen month horizon, reading the odds plays a critical role in the process. As the old adage goes – "A great company may not be a great stock", just as our friend has now realized that selling record number of cars was not good enough, as the markets expected a larger acceleration.

[2] For more details on this approach, read "Expectations Investing" by Michael Mauboussin.

Déjà vu

At a sell-side conference held last month in Hong Kong, former heavy weight boxing champion Mike Tyson regaled the audience comprising investment professionals and corporate leaders from across the world, with his punchy one-liners. Tyson is famous for his quote "Everybody has a plan until they get punched in the face." Most investors in India, we would assume, are empathizing with this quote right now. Every investor who thought he/she had a plan for stock picking, within the framework of a "policy paralysis", seems to have been shaken off that complacency. The Government appeared to suddenly want to move ahead full throttle as it came out with a slew of announcements to revive the sagging economy. Central bank action from US and Europe provided added boost to sentiment. Market participants, not quite ready for this sudden change, responded by going into overdrive by chasing "low quality beta" and shedding "high quality defensives". After all, with the benefit of hindsight it appeared obvious that the valuation gaps between the two groups had widened to unsustainable levels, and the convergence trade had to play out. In our last edition of ***Connecting the Dots: Mean Reversion?***, we had analysed how these mean reversion or convergence trades in the past have eventually met with limited success. In this edition we look at the performance of these high beta stocks during and after the high beta rally and ask if this is a déjà vu rally.

We analyse two previous episodes of high beta rallies, more popularly known these days as "risk-on trades". The first risk-on phase began in the first half of 2009 and the second one in early 2012. The methodology we adopt here is to filter the top decile performers in the BSE 100 Index (i.e. the top ten performers in the BSE 100 Index) during the risk-on phase, and compare how these stocks performed over a longer period, once the risk-on phase was over.

Display 1 shows the Top 10 performers of the 2009 rally with their relative rankings amongst BSE 100 stocks over the subsequent one and three years.

Display 1: Beta rally of 2009

Companies	Mar. 31, 2009 - Jun. 1, 2009		Mar. 31, 2009 - Mar. 31, 2010		Mar. 31, 2009 - Mar. 31, 2012	
	% Returns	Rank within BSE 100	% Returns	Rank within BSE 100	% Returns	Rank within BSE 100
HDIL	276%	1	250%	11	5%	86
NMDC	193%	2	89%	60	3%	87
Reliance Capital	177%	3	114%	46	11%	84
Suzlon Energy	169%	4	70%	70	-40%	96
Unitech	164%	5	111%	47	-18%	93
Adani Enterprises	164%	6	251%	9	128%	47
Jaiprakash Associates	162%	7	167%	29	46%	71
Yes Bank	153%	8	412%	3	638%	3
Reliance Infrastructure	153%	9	94%	56	14%	81
DLF	148%	10	85%	61	21%	79

Source: Bloomberg. The returns are not annualised.

The results show that only two of the top ten performers managed to retain their Top 10 position over a one year period, and just one over a three year period. Moreover most of the top decile performers during the risk-on phase actually had much lower absolute returns over the longer period indicating that they had negative absolute returns in the subsequent period after the risk-on phase.

The rally that began in January 2012 has a similar story to tell (See Display 2). The attrition among the top decile performers is again 90%. That is, only one stock in the top 10 list of performers retains top decile performance till the end of August 2012.

Display 2: Beta rally of early 2012

Companies	Jan. 2, 2012 - Feb. 22, 2012		Jan. 2, 2012 - Aug. 31, 2012	
	% Returns	Rank within BSE 100	% Returns	Rank within BSE 100
HDIL	122%	1	24%	34
Reliance Capital	91%	2	37%	16
Reliance Infrastructure	84%	3	33%	24
Reliance Power	75%	4	9%	60
Unitech	69%	5	-4%	78
Suzlon Energy	57%	6	-17%	95
IDFC	57%	7	46%	7
Indiabulls Financial Services	55%	8	31%	25
Axis Bank	53%	9	25%	31
Jaiprakash Associates	52%	10	23%	37

Source: Bloomberg. The returns are not annualised.

Lastly, let's look at the stocks that have been first off the gates this time (See Display 3). We begin our analysis period just before Ben Bernanke's Jackson Hole speech, the ECB meeting and Indian reform announcements. The pattern seems to be repeating once again. In fact from the top decile performers over this period, four stocks were among the top decile performers in the last two risk-on rallies as well, and not quite surprisingly, the best performer BSE 100 stock in all three rallies has been the same – HDIL.

Display 3: Current market rally

Companies	Sept. 6, 2012 - Sept. 28, 2012	
	% Returns	Rank within BSE 100
HDIL	42%	1
Canara Bank	38%	2
Union Bank of India	33%	3
Unitech	32%	4
Reliance Capital	31%	5
Reliance Communications	31%	6
Adani Enterprises	31%	7
Bank of Baroda	31%	8
GMR Infrastructure	28%	9
Jaiprakash Associates	26%	10

Source: Bloomberg. The returns are not annualised.

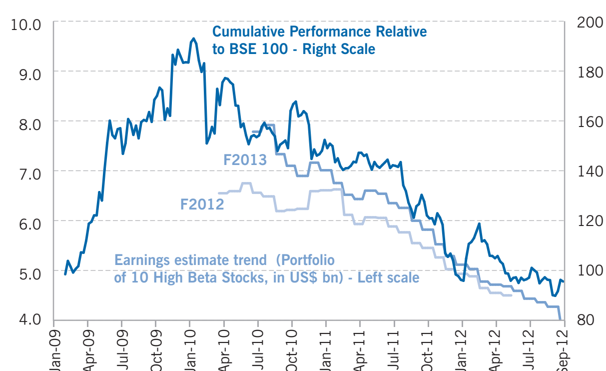
It does appear that market is not trying to be too different with what it considers high beta in a risk-on rally. We guess it is almost like automated programme trading. The minute you switch on the risk-on rally button, the list of stocks that are first off the blocks seem quite predictable. However, in our view, to use an analogy from horse racing, often the

horse that is the first to start the race when the gates open, is unlikely to be the winner.

In markets too, it appears that the stocks that show the first spurt at the beginning of the rally, are rarely able to maintain the momentum. Investment professionals often get tempted to change their style of investing during such rallies as they attempt to chase these stocks in an effort to recoup lost alpha. We think there is no need to change our batting style, as it is almost impossible to time such rallies. We continue to have faith that just as the low quality beta rallies petered out in the two episodes highlighted above, this time too we will see a similar pattern emerge. We are not saying this rally cannot sustain longer or be larger; in fact, the odds are high that it might. Instead, what we are saying is that the change in leadership from pure beta stocks to fundamentally driven stocks will likely follow a similar course as in the past. Therefore, in that sense, this time is a déjà vu.

We thought it was essential to draw lessons from these rallies and understand why most of the top decile performers have been unable to hold on. Very clearly in the beginning of the rally these stocks have very low Price/Earnings multiple which makes the convergence rationale look convincing. The initial move is driven purely by re-rating. If you take the basket of stocks in Display 1, the P/E (weighted by market capitalization) almost quadrupled from a low starting point of about 5x to about 20x. However this re-rating needs earnings support in order to sustain. This was clearly lacking as is evident in Display 4. Consensus earnings estimates of these stocks for the financial years 2011-12 and 2012-13 were consistently getting downgraded. At the end of the day, Stock Price = P/E Ratio X EPS, and if there are EPS downgrades, P/E starts coming off too, causing a double impact on Price. As investors, we confess our inability of timing these re-rating events but instead attempt to seek out earnings upgrades possibilities or stocks whose growth potential is under-appreciated today. In our experience, if we get that part of the equation right, over time, a P/E re-rating follows.

Display 4: Portfolio of 10 High Beta Stocks



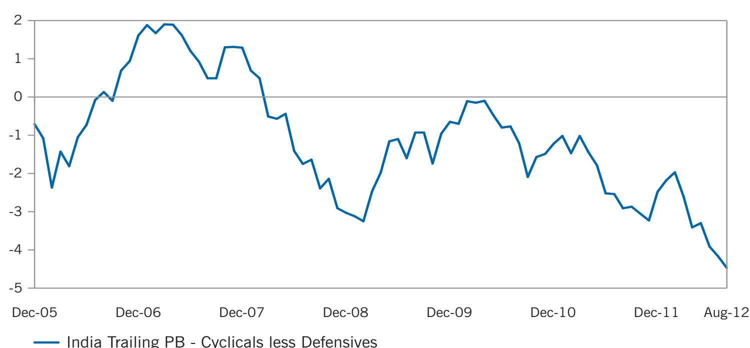
Source: FactSet, IBES Estimates, Morgan Stanley Research

Wayne Gretzky, often regarded as the greatest ice hockey player ever, was fond of quoting his father who told him to “skate where the puck’s going, not where it’s been”. Anticipating rather than chasing should help investors as well.

Mean Reversion?

The divergence in the performance of different sectors in the Indian market has recently drawn a fair bit of comment. Specifically, "Defensive" sectors like Consumer Staples, Healthcare are doing exceedingly well while "Cyclicals" like Energy and Materials are languishing. This also manifests itself in valuations of these sectors. A recent report by CSFB[1], measures this by comparing the relative Price to Book of these two groups. As *Display 1* shows, in India, Defensives have never been as expensive relative to Cyclicals and hence the recommendation to sell the former and buy the latter. This divergence began over two years ago but valuations haven't converged, in fact they have expanded even more. Sure, there have been small periods when it felt like mean reversion is happening (typically, periods of so called "risk-on") but once that phase subsided, Defensives have come back with gusto.

Display 1: Cyclicals vs Defensives



Source: Company data, MSCI, Credit Suisse estimates

Note: As per CSFB, "Defensives" include Consumer Staples, Telcos, Utilities and Healthcare. "Cyclicals" include Energy, Materials, Industrials, Consumer Discretionary and Technology.

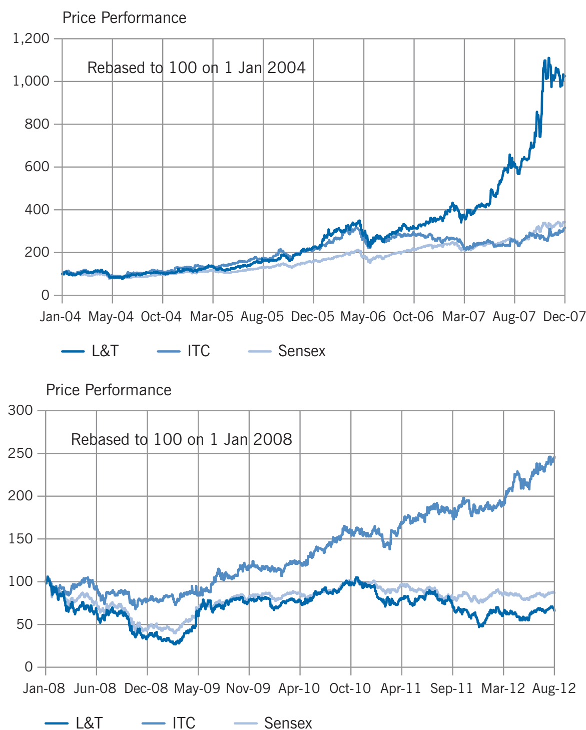
Two thoughts on this – First, as investors we have never really slotted stocks as Defensives or Cyclicals. We highlighted in an earlier edition of ***"Connecting the Dots - The Dependables"***, that we prefer screening investment ideas based on rate of growth and capital allocation characteristics, rather than using broad brush, sector aggregates.

[1] Mumbai the home of expensive defensives? by Sakthi Siva, August 2012

Second, we have never been fans of **automatic** mean reversion i.e. just because any variable has deviated substantially from its historical mean does not imply that it will automatically revert to its long term average. In fact, if one is seeking out new themes and trends this approach can act as a deterrent. Yes, we do realise that when things get over-extended and if they indeed mean revert, there is a lot of money to be made or lost. However, it is difficult for us to buy or sell stocks and sectors based on the sole rationale of divergent relative valuations. To borrow a phrase from PIMCO, our approach in such cases is Newtonian[2]. One of the very few things we remember from our Physics lessons is Newton's first law of motion – "An object set in motion remains in motion and an object at rest remains at rest, unless an external unbalanced force acts on it". We need to think about these external unbalanced forces that could change the current landscape of things. In our example of Cyclicals versus Defensives, this involves two questions – Why the divergence? (i.e. why are some bodies/sectors at rest while others are in motion?) What will make it change? (i.e. what could be the external unbalanced force that will put the body in motion to rest and vice versa?)

We have argued in one of our earlier missives ***"Connecting the Dots - The Truth Lies Somewhere In The Middle"*** that post 2009, the Indian economy switched from being a supply led to a demand driven economy. Fiscal stimuli, income supports and wealth transfers have kept the consumer demand for goods and services fairly upbeat while the now chronic "policy paralysis" has kept new investments and supply side of the economy hamstrung. The change in the driving force of the economy is probably best seen in the stock price performance of Larsen and Toubro (a proxy for the investments/supply side of the economy) and ITC (a proxy for the consumer demand side of the economy). The role reversal of these two in 2004 – 2007 period and 2008 till date is evident in *Display 2.*

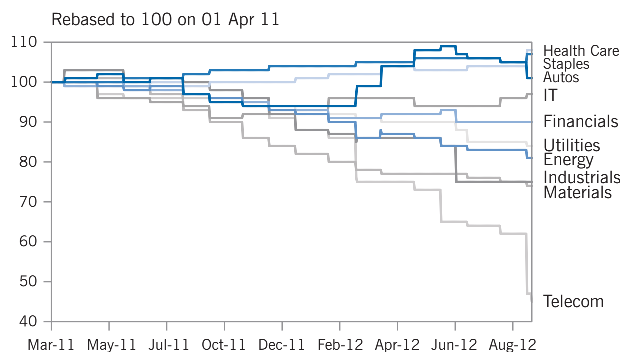
Display 2: Supply and Demand side of the Economy



Source: Bloomberg, IIFL Research

Change in economic drivers reflect in the earnings growth profile of various sectors as well. Consumer facing sectors, especially Staples and Healthcare, have shown steady earnings growth while the Cyclicals have suffered continuous downgrades. In an environment of slow growth, predictable, steady earnings growth has been worth its weight in gold and investors have bid up stocks in these sectors. (*Display 3*)

Display 3: Sectoral consensus estimates for F13 earnings



Source: CSFB, IBES Consensus

Another reason why valuations seem over-extended is lack of new listings especially in Staples and Healthcare space over the last few years, unlike the 2003-2007 era when we saw a large number of new listings in the Cyclicals space. This meant that

[2] Newtonian Profits by Neel Kashkari. Source: PIMCO, April 2012

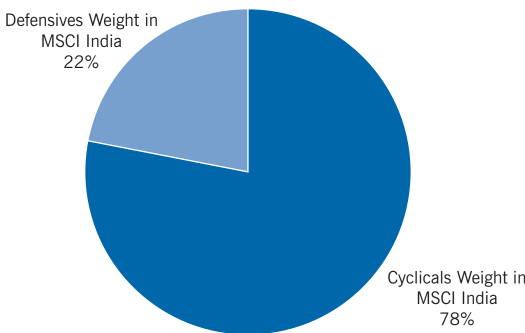
investors had the option to evaluate and invest in new stocks within those sectors rather than pile into the familiar ones. *(Display 4)*. Today for a large India investor the TINA (There is No Alternative) constraint comes into play while investing in steady earnings and cash flows streams. This also reflects in the weights of these sectors in MSCI – the Cyclicals weight steadily climbed in 2003-2007 era because of new listings and dilutions but Defensives still remain under-represented in the indices *(Display 5)*.

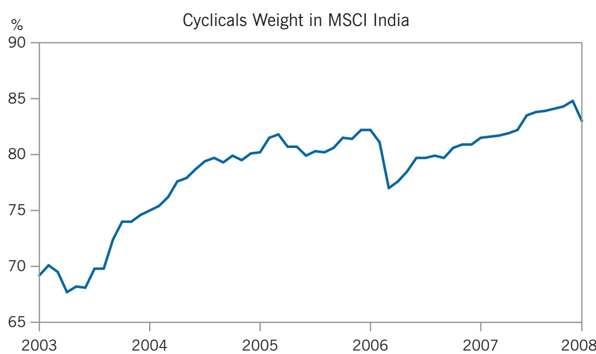
Display 4: Sectoral Capital Raised

Capital Raised (Rs. bn)	Healthcare + Staples	Cyclicals
2003 - 2007	115	2,003
2008 to July 2012	160	2,085

Source: Prime Database, Morgan Stanley Research

Display 5: MSCI India Index Weights





Source: FactSet, MSCI, Data as of August 2012

So, what could make this change? The simple answer is - opportunity for investors to invest in steady, predictable growth companies expands beyond these sectors. In the earlier cycle, there were plenty of opportunities to invest in companies with steady strong earnings growth across sectors – think Industrials, Energy, Information Technology, etc. If that environment of "plentiful growth" were to return, Defensives will definitely lose their sheen. A breakdown of the relative earnings stability for these sectors could also be a negative catalyst for Defensives to underperform – though we don't see that happening in the near future. Finally, if we were to see more opportunities to invest in the space either through new listings or dilutions, then the current darlings would have to share some of the limelight, bringing down valuation extremes.

As a cricketing analogy, we are reminded of India's disastrous Test tour of England in 2011, in which India could not convincingly cross 300 runs in any innings. Rahul Dravid in his steady, almost boring style scored a whopping 23% of the entire team's runs in the series[3] (For a top 6 Test batsman about 11-13% is the median range). No other batsman was pulling his weight in a run-scarce environment. The situation, we think, will "mean revert" in a run fest of a Test series played probably at home on flat, dry pitches when each of the top batsmen will score heavily.

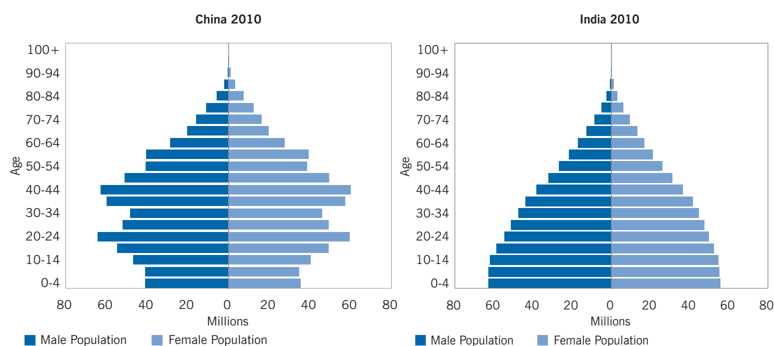
And that's our bet, mean reversion will happen when the Cyclical sectors get their act together of delivering consistent, high growth – something that we don't foresee happening immediately. Until then, we put up Dravid's poster on the pin-up board in front of us and try to seek his replicas for the portfolio.

[3] Source - http://stats.espncricinfo.com/ci/engine/stats/index.html

The Truth Lies Somewhere In The Middle

Ten years ago the famous Goldman Sachs' BRIC report highlighted how 50 years hence India would be among the largest economies in the world after China and the USA. The report highlighted that India had the potential for low volatility and steady compounding of GDP compared to any other large EM economy thanks to the low base effect of per capita income. The "population time bomb" of the 1970s had been magically transformed into the "demographic dividend" of the 2000s. Indian policymakers and economists extolled the virtues of having a young population while making it a point to compare that China might get older before it gets richer. China's children, we were told, would soon not know the meaning of a 'cousin' thanks to the one-child policy introduced in 1978! India, in contrast, had an almost perfectly shaped demographic pyramid.

Display 1: A comparison of China and India's population demographics



Source: UN, CLSA Asia Pacific Markets

The per capita story made for a compelling rationale for business optimism. When you have a billion people in the denominator, the per capita consumption of products from toothpastes to shampoos to automobiles could only rise. Experts told us that at the $1000 per capita income threshold, India was at the upward inflection point of a J-shaped curve. International magazines featured not so long ago how India would become the fastest growing economy in the world, outpacing China's growth rates. At the World Economic Forum 2006 it was 'India Everywhere'[1], as a 150-member delegation from India, including

[1] 'India Everywhere' in the Alps, January 26, 2006, New York Times.

three cabinet ministers and 41 CEOs made a blitz in the Alpine resort of Davos in Switzerland. As per a New York Times report, never before has a country mounted such an elaborate charm offensive at Davos. It was an extravagant public relations campaign to promote India as the world's next superstar.

Today, the script looks very different. Magazine covers, both Indian and international, have been featuring how the India story has lost its way. Now, it's all about policy paralysis and under-achievers. Economists, spooked at the last reading of 5.3% GDP growth, are pondering about the "new Hindu" rate of growth that they need to build in, as they lower their forecasts for the current fiscal year. The word "chronic" is often used in conjunction with Current Account and Fiscal deficits and Wholesale and Consumer Price Inflation indices. In short, sentiment today is uniformly negative. Crony capitalism, coalition politics, policy paralysis, corruption scams would possibly be the most oft used phrases in any economic commentary today.

The scepticism surrounding India today, reminds us of the movie "The Best Exotic Marigold Hotel" which follows a group of British retirees who decide to 'outsource' their retirement to less expensive and seemingly exotic India. The guests are initially disillusioned by the rundown 'palace hotel' which is a far cry from the alluring advertisements that had brought them to stay there. The lead actor Dev Patel, playing the role of the hotel manager, tells a cynical foreign guest - "In India we have a saying that everything will be alright in the end; so if it's not yet alright, it's not yet the end". While we may not share the same level of enthusiasm as Dev Patel, we do think in the midst of the gloom and doom scenario painted by many others, *the truth lies somewhere in the middle.*

In our last edition of ***Connecting the Dots*** (The Dependables, June 20, 2012), we looked at the traits of companies that have been through cycle winners. We argued that these companies had continued to report superior and consistent performance metrics despite the macro headwinds. In fact, in the four quarters of financial year 2012 the revenue growth, even for a broader group of companies has averaged about 20% (see Display 2). The earnings growth, of course, has been weaker and more volatile, owing to inflationary pressures, high interest rates and weak currency.

Display 2: Revenue/Earnings Snapshot

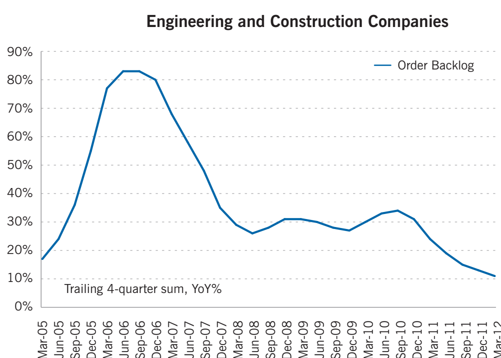
YoY Revenue Growth	Q1F12	Q2F12	Q3F12	Q4F12
MS coverage	26%	21%	26%	22%
MS coverage ex-oil PSUs	25%	21%	24%	18%
Broad Market	28%	19%	25%	18%
Broad Market ex-oil PSUs	28%	19%	21%	15%
BSE Sensex	25%	23%	23%	19%

YoY Earnings Growth	Q1F12	Q2F12	Q3F12	Q4F12
MS coverage	11%	-6%	18%	33%
MS coverage ex-oil PSUs	13%	6%	4%	10%
Broad Market	15%	-23%	1%	17%
Broad Market ex-oil PSUs	16%	-4%	-5%	2%
BSE Sensex	9%	15%	1%	19%

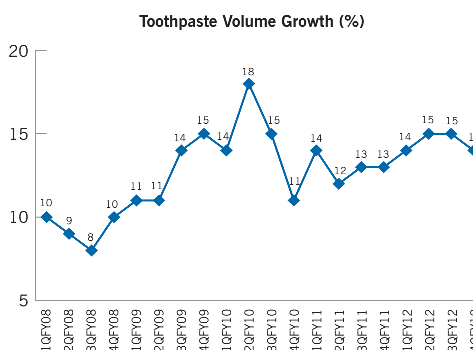
Source: Company data, Capitaline, Morgan Stanley Research

The widening contrast among sectors is also apparent. Engineering companies have reported shrinking order backlogs, whereas consumer product companies have seen a robust pace of growth, signalling that the economy and the markets have seen a shift from the supply side to the demand side. (See Display 3)

Display 3:



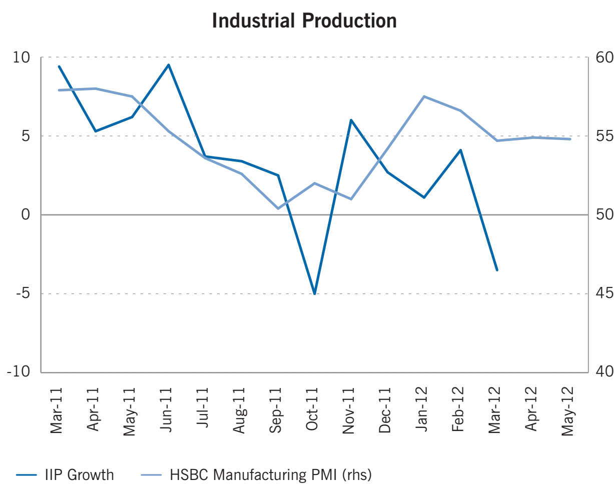
Source: Company data, Morgan Stanley Research



Source: Company data, Motilal Oswal

The volatility in the Index of Industrial Production (IIP) has caused much consternation to policy makers and markets alike. A point to note, is that the HSBC Manufacturing PMI has been far more steady than the IIP numbers released by the Central Statistical Organization (CSO). While the IIP has gone into negative territory twice in the last one year, the HSBC PMI has never gone below a reading of 50 (a reading above 50 indicates that growth is positive) (See Display 4).

Display 4: Industrial Production

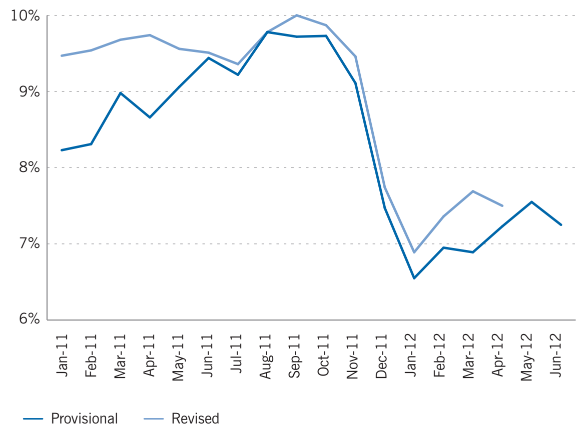


Source: CSO, Bloomberg, IIFL Research

Policymakers have had to rely on such economic data releases that have often been contradictory and subject to revisions. As the charts show (See Display 5), final data released after a lag often varies significantly from the provisional data released. As ex-Governor of Reserve Bank of India, Dr. Y. V. Reddy[2] once commented while referring to modern economies, which might be more apt to the situation in India today - "…data to monitor the economy are sometimes inadequate, or delayed, and often revised. It is said that in regard to modern economies, not only the future but even the past is uncertain, due to significant revisions in data."

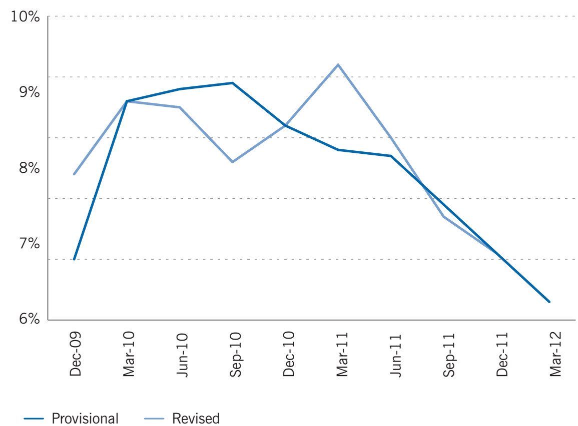
Display 5:

WPI Inflation: Provisional and Revised



Source: CSO, Morgan Stanley Research

GDP Growth Rates: Provisonal and Revised



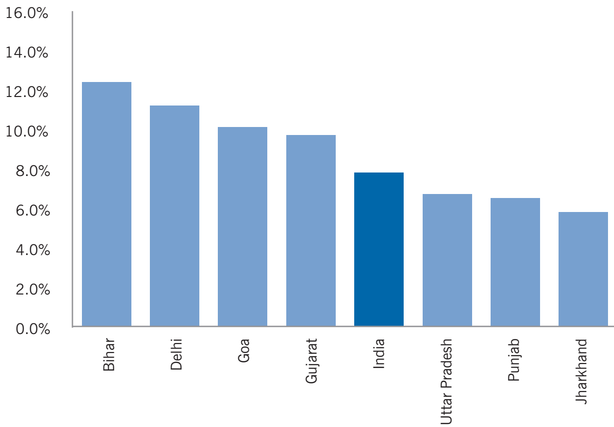
Source: CSO, Morgan Stanley Research

In the maze of national data releases, one should not lose sight of interesting trends at the Indian State level. There are clearly some bright spots emerging in some Indian States, which have consistently shown above average growth trends in the last five years. (See Display 6). Corporate India is recognising this trend as it charts out new growth strategies by aligning its marketing effort and distribution network to account for differential growth rates among States and between metro cities and smaller towns. As investors, we are increasingly focusing on granular data from corporate India rather than macro data releases owing to the complexities outlined above.

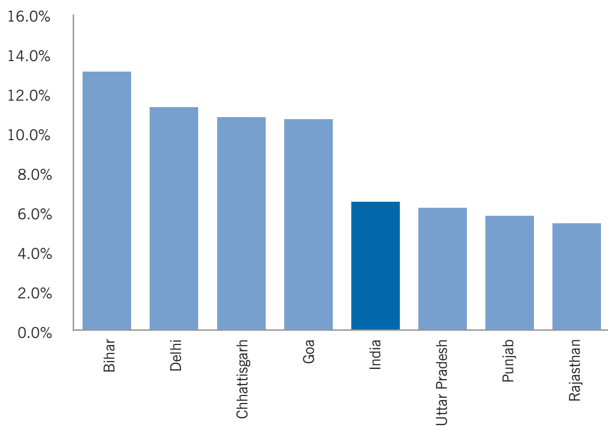
[2] "Parameters of Monetary Policy in India" - speech delivered in January 2002 by Dr. Y. V. Reddy, then Deputy Governor, Reserve Bank of India at the 88th Annual Conference of The Indian Econometric Society at Madras School of Economics.

Display 6: Growth in Indian States

GDP Growth CAGR (FY07-12)



GDP Growth CAGR (FY12)



Source: CSO, Barclays Securities India

So what does that mean for the markets? Many investors in the recent past have been whipsawed trying to play the mean-reversion trade. The argument, of course, is how long can the markets trade below its long term averages. We don't profess to be clairvoyant on market direction, nor can we predict with any degree of certainty as to which would be the new emerging sectors in the market that will assume leadership position. In this context, we would like to believe that markets are in the process of bottoming out. It is always darkest before dawn, and almost impossible to write a rationale of the drivers of the new bull market before it emerges.

Moreover, the more one hopes for markets to bottom out, the more they have a way of testing the grit and patience of investors. To end, we quote a memorable line from legendary investor and ex-colleague at Morgan Stanley Investment Management, Barton Biggs, who passed away earlier this month "We forget that Mr. Market is an ingenious sadist, and that he delights in torturing us in different ways".

The Dependables

In early May 2012, as we wrote our monthly equity commentary we were intrigued by the fact that returns for Bombay Stock Exchange 100 Index (BSE 100) for the past one month, three months and even six months were about zero. Essentially, on a point to point to basis, the index was absolutely flat for these time periods. In fact, we first reached the current index levels about four and half years ago in late 2007, so market returns since then have been naught; but this flat outcome masks a whole lot of individual constituent diversity. In one of our earlier missives of ***Connecting the Dots*** (Vulnerability, April 2012) we tried to lay out a macro framework that causes alternating bouts of extreme sentiment. Being cognizant of the macro vulnerability is an important input into portfolio management, in that it tells you that the seas are going to be rough but has little information on how to navigate these choppy waters.

We had a lively debate on this issue in one of our recent Investment Committee meetings with two broad approaches being advocated. One suggested approach was to "trade the market" with a broad price band for index levels as well as individual stocks. The other approach, which we espoused, was to look for through-cycle winners that would deliver steady outperformance in a volatile market.

In this edition, we present our argument, filter out stocks that weathered the cyclicality and look for common traits.

Our first screen looks for stocks that outperformed the BSE 100 during each of the following time frames – six months, one, three, five and seven years. We think seven years is a good starting point as it takes you close to the base of earlier bull market. 27 stocks out of the current index satisfied this criterion. Frankly, at first glance we were surprised at the large number of index stocks that survived this filter but the interesting part is that of these 27 only 14 were part of the index seven years ago. So index inclusions have happened AFTER some of these stocks have had a stellar run. Think about one of the latest inclusions in NIFTY - Asian Paints, and you would know what we mean. Thus even passive investing, due to the algorithms used for index inclusion, becomes more like momentum investing, but more on that in a subsequent edition.

As we look at our list of 27 names, we think about the caveat for any point-to-point analysis – the fact that starting or end point, if abnormally high or low, can skew the results. So within these 27 stocks we ran another test to see

in how many individual calendar years since 2005 (seven data points for each stock until calendar year 2011) did these stocks outperform the benchmark. We used a cut-off of at least four calendar years of outperformance to come up with the list of 22 stocks which we call "The Dependables" (Display 1). The stocks that were weeded out here from the original list of 27, are ones that have had strong near-term performance like Tata Motors.

Display 1: Index Stocks that outperformed the BSE 100 Index: The Dependables

Stock	Sector	Years of out-performance to Index	Stock Price Performance				
			6 Months	1 Year	3 Year	5 Year	7 Year
ACC	Materials	5	2%	12%	23%	7%	18%
Asian Paints (India)	Materials	5	13%	28%	59%	34%	38%
Colgate-Palmolive (India)	Consumer Staples	5	7%	24%	33%	23%	28%
Cummins India	Industrials	4	25%	0%	50%	17%	29%
Dabur India	Consumer Staples	5	10%	10%	29%	18%	28%
Divi's Laboratories	Health Care	4	14%	21%	27%	18%	38%
Dr. Reddy's Laboratories	Health Care	5	9%	5%	48%	20%	27%
Federal Bank	Financials	4	1%	3%	31%	18%	21%
GlaxoSmithKline Pharmaceuticals	Health Care	4	3%	-5%	23%	13%	17%
HCL Technologies	Information Technology	4	20%	1%	59%	9%	17%
HDFC Bank	Financials	5	14%	23%	36%	22%	26%
Hero MotoCorp	Consumer Discretionary	5	5%	35%	24%	26%	23%
IndusInd Bank	Financials	4	16%	34%	100%	47%	30%
ITC	Consumer Staples	4	17%	31%	37%	25%	26%
Kotak Mahindra Bank	Financials	5	16%	42%	45%	16%	38%
LIC Housing Finance	Financials	5	10%	24%	53%	53%	26%
Lupin	Health Care	5	15%	29%	56%	30%	39%
Nestle India	Consumer Staples	4	6%	15%	39%	34%	32%
Sun Pharmaceutical Industries	Health Care	4	18%	33%	33%	24%	29%
Tata Consultancy Services	Information Technology	4	14%	11%	60%	15%	24%
Titan Industries	Consumer Discretionary	5	13%	29%	87%	38%	53%
UltraTech Cement	Materials	4	24%	37%	36%	11%	22%
Simple average returns of The Dependables			12%	20%	45%	24%	29%
BSE 100 returns			0%	-6%	16%	5%	15%
Outperformance of The Dependables			13%	26%	29%	19%	13%

1. For the purpose of this exercise, we have used price returns and not total returns
2. All returns are annualised except for the 6M returns
3. For aggregate analysis, we have used simple average
4. Last price data as of May 2, 2012

Source: FactSet, Morgan Stanley Research

A few observations on the family of The Dependables:

- For the seemingly boring four and half years when index returns were almost flat, an equal weighted portfolio of The Dependables would have delivered a Compound Annual Growth Rate (CAGR) of about 20%.
- An equal weighted portfolio of The Dependables would have delivered an absolute positive portfolio return for all the studied time-periods – even on a one-year basis where index returns are negative 6%. On a risk adjusted basis, the relative returns would be even more superior given the relative stability of these stocks.
- We are also heartened by the sector diversity of the family. Consumer Staples and Healthcare names do find a disproportionate representation, but names from "cyclical" sectors like Financials and Materials also make the cut. So this is not just about being in the right sectors. Almost all

major MSCI Sectors find representation on the list.

- All constituents derive the bulk of their business value from a single line of business. There are no conglomerates here with 'sum of the part valuations'. Thus the number of moving parts is fewer for these companies and hence there is relative ease of understanding.

We try to delve further to see if there are any other characteristics that typify the members of this club. In one of our earlier editions, we said "India was a land of abundant growth opportunities but starved of stable, reasonably priced capital to fund that growth". If that were true, a successful company would be one that captured these growth opportunities profitably while not depending on external capital for its growth. To test this hypothesis, we tried to study the income statement characteristics (for the growth argument) and balance sheet parameters (for the capital efficiency argument). Here is a summary of the tests we did:

- **Is the Sales growth faster than nominal GDP growth?** – This is a proxy for being in the growth sectors. You can achieve this by either being a part of a fast growing industry and/or gaining market share within your industry.

  The average sales growth for The Dependables is 23%, about 7% ahead of the nominal GDP growth of 16% for the period. The same number for the BSE 100 as a whole was 22%. Also, the number of individual exceptions to this rule was only 3. So this is not just about a large stock skewing the average[1].

- **Is Profit growth faster than Sales growth?** – This to us is the key test of any company. There will be periods when this filter may not be met but on a reasonably long term basis this should hold true. It signifies a combination of several dimensions - market dominance and hence pricing power, an eye for cost management, judicious investments (i.e. neither under-investing so as to miss the growth opportunity nor over-investing to be saddled with heavy interest and depreciation costs) and right mix of debt and equity.

  The profit growth for The Dependables is almost 29%, about 10% ahead of that for BSE 100 as a whole. Individually, 17 out of the 22 companies meet this criterion.

- **Is Earnings per Share (EPS) growth broadly in line with Profit growth?** – This is the test that links growth and capital efficiency. A company that grows profits rapidly but does so by frequently issuing new equity would have its EPS growth materially lower than its profit growth. In other words an individual shareholder does not proportionately participate in the company's growth. We scan The Dependables for profit and EPS growth and if the difference is less than 3%, we deem the performance to be satisfactory. The 3% leeway is allowed to accommodate for Employee Stock Option Plan related dilutions, which to us are more incentivisation tools rather than capital need.

  EPS growth for The Dependables is 26% while the profit CAGR is 29%. There are a larger number of individual exceptions to the rule (five out of 22) but all of these are from the banking sector, which require a regulatory minimum capital and are hence required to grow their capital base in line with growth in their risk weighted assets.

- **On Balance Sheet and cash flow parameters**, average Net Debt/Equity for our group (ex-financials) is a negative 0.11 (indicating that they actually have net cash on the balance sheet) and in the past five years it has actually fallen signifying the fact that even after taking care of their growth requirements, these companies had enough spare cash flow to pay down debt. Also, all 22 companies paid dividends in the year 2011. Return on Equity (RoE) for the group is a robust 38%, more than double the index RoE of 18%.

The overall results are summarized in Display 2.

Display 2: Overall Results

India's Nominal GDP Growth	16%	
	The Dependables	**BSE 100**
Avg. Net Sales Growth	23%	22%
Avg. Net Profit Growth	29%	20%
EPS Growth	26%	17%
Current Net Debt/Equity	-0.11	0.39
Avg. RoE	38%	18%

1. Growth is defined as 5-year CAGR until Financial Year 2011, Calendar Year 2011 wherever applicable
2. Average is the simple average for all companies taken together; for index, we use the aggregate data.

Source: FactSet, Morgan Stanley Research

We understand that past performance is no guarantee of future results so we will refrain from making comments on the individual members of The Dependables. However, their commonalities are instructive in the process of bottom up stock picking. Until the macro vulnerabilities are decisively addressed, we think there will be alternating bouts of extreme sentiment

[1] We are aware of the limitations of the concept of average. A day temperature of 50 degrees C and night temperature of -10 degrees C can be factually described as being "pleasant on an average" but is actually, far from being so.

but when the dust settles, index returns may not be too impressive. In this environment, we will stick to our knitting by looking for profitable growth and the optimum use of capital.

For those hoping to “time the market”, we sincerely wish them luck and leave them with a memorable quote from William Sharpe, winner of the 1990 Nobel Memorial Prize in Economic Sciences and creator of the Sharpe Ratio, “Attempts to time the market are not likely to produce incremental returns.... It is said that the military is usually well prepared to fight the previous war. A number of investors now engaging in active market timing appear to be preparing for the previous market. Unfortunately for the military, the next war may differ from the last one. And unfortunately for investors, the next market may also differ from the last one”.

Connecting *the dots*

May 2012

Thirst for Capital

At an ADR-listing road-show of a prominent IT Services company in 1999, the founder-CEO when asked why was he raising money, quipped in response, "We don't need the money. We are doing the listing for better visibility among our Fortune 500 clients". Fast-forward to 2007, at a similar equity raising road-show of an infrastructure company, the promoter-CEO says, "My raw material, as well as bottleneck for growth, is 'capital', and my biggest conundrum is to be able to raise capital through SPVs so as to not dilute my stake to below 51%". Note the contrast and needless to add, the former today has well over $2 bn on its balance sheet despite making some global acquisitions and the latter has a debt-equity ratio of well over 2x, and reported a loss in the just concluded quarter owing to high interest burden.

In our first edition of ***Connecting the Dots*** (Vulnerability, dated April 2012), we highlighted the growing dependence of foreign capital to fund India's growth story. Higher, and almost chronic, Current Account deficits are leaving the country at the mercy of strangers (read foreigners), we said in that edition. In this edition of ***Connecting the Dots*** we try to analyse if the equity markets' dependence on foreign flows has become more pronounced because the sectors that have been the drivers of the 2003-2007 bull market, i.e. Infrastructure and Real Estate, are ever-thirsty for capital.

While we are well aware of the dependence on foreign flows for the economy as a whole, the sectors that drove the stock markets from 2003-2007 were also capital guzzlers. Infrastructure and Real Estate companies typically work on long build-out cycles before they start seeing cash inflows. To add, any delays in project execution further consumes capital and suppresses project returns. Moreover, there has been something akin to a gold rush among Indian infrastructure companies trying to secure mining rights in countries from Bolivia to Mozambique and Indonesia to Australia in a bid to make their projects financially and operationally viable. In a country like India where the corporate bond markets for long dated instruments are virtually non-existent, the dependence on equity capital to fund growth is even more acute. The result is that the Indian stock market has become even more correlated to global risk-on/risk-off trades than in the past.

To test our hypothesis, we did a sector-wise analysis of equity issuances made by Indian companies over the last twelve years (see Display 1). For

simplicity, we have divided these into three phases. Phase 1 from 1999-2002 captures the TMT (technology, media, and telecom) boom-bust cycle. Phase 2 from 2003-2007 represents the Infrastructure and Real Estate boom era and Phase 3 from 2008-to-date represents the market ups and downs coinciding with the US and European credit crisis.

Display 1: Equity Issuance Data

(as of March 31, 2012)

Sectors	1999 - 2002 Phase 1	2003 - 2007 Phase 2	2008 - to date Phase 3
Consumer Staples & Healthcare	8%	5%	6%
Autos & Other consumer discretionary	8%	7%	10%
Energy & Materials	10%	23%	23%
Technology & Telecom	45%	8%	3%
Infrastructure & Industrials & Utilities & Real Estate	1%	17%	34%
Banks and Financial Services	27%	30%	24%
Total	100%	100%	100%
Total issuances (Rs. bn) (a)	**222**	**2,344**	**2,742**
Of which, Divestments (Rs. bn) (b)	**121**	**256**	**612**
Net Issuances (Rs. bn) (a) - (b)	**101**	**2,088**	**2,130**

Note: The issuances data includes IPOs, FPOs, QIPs, ADRs, Rights issues

Source: Morgan Stanley Research

As expected Technology and Telecom represented 45% of the equity raising in Phase 1. Infrastructure and Real Estate companies took over in Phases 2 and 3 accounting for 17% and 34% respectively. Energy and Materials too saw an uptick from 10% in Phase 1 to 23% in Phases 2 and 3.

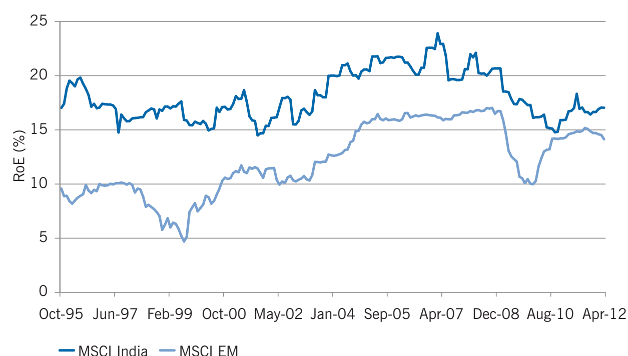
While it is not surprising that the sectors that have caught the fancy of the investor community often also have the largest equity issuances, what is interesting to note is that the magnitude of net issuances saw an increase of twenty times over Phase 1.

Further analysis of the net data shows how Consumer Staples or Healthcare companies rarely come to the stock market for repeated equity raising (barring the few that are on a global acquisition spree). If these sectors were to become the leaders of the next bull market rally and Infrastructure and Real Estate fade into the periphery, will the markets become less correlated to global flows?

The other point that is often made is that Indian market that traded at a premium to the MSCI Emerging Markets Index, is seeing a de-rating owing to falling Returns on Equity (RoE). India's RoE was its standout quality compared to other Emerging Markets. This was attributed to prudent use of capital by Indian entrepreneurs who were used to doing business in a tough environment with high interest rates. We remember a great line from an upcoming entrepreneur, "When you don't have resources, you become resourceful". However, data from the last few years suggests otherwise. RoEs have been coming off.

India's RoE premium over Emerging Markets has shrunk. From a premium of 8% in RoE over Emerging Markets in 2007-2008, it is now down to about 2%. (See Display 2)

Display 2: Return on Equity (RoE): India versus Emerging Markets

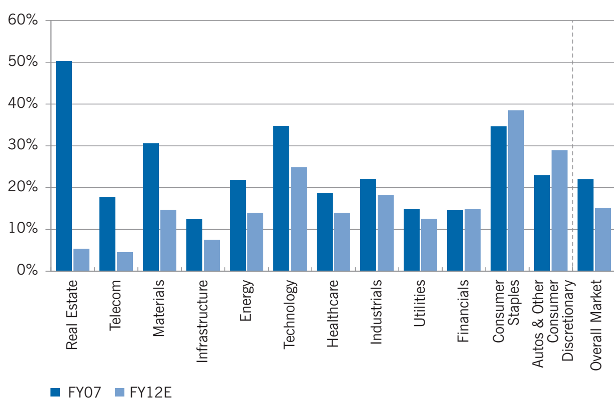


Return on Equity (RoE): India premium over Emerging Markets

Source: Citi Investment Research

A study of the sectors that have contributed to the declining trend do not throw up any major surprises. Again, these are Infrastructure, Real Estate, Utilities and Materials. (See Display 3). These sectors along with Technology and Telecom have seen the sharpest fall in RoE over the last five years.

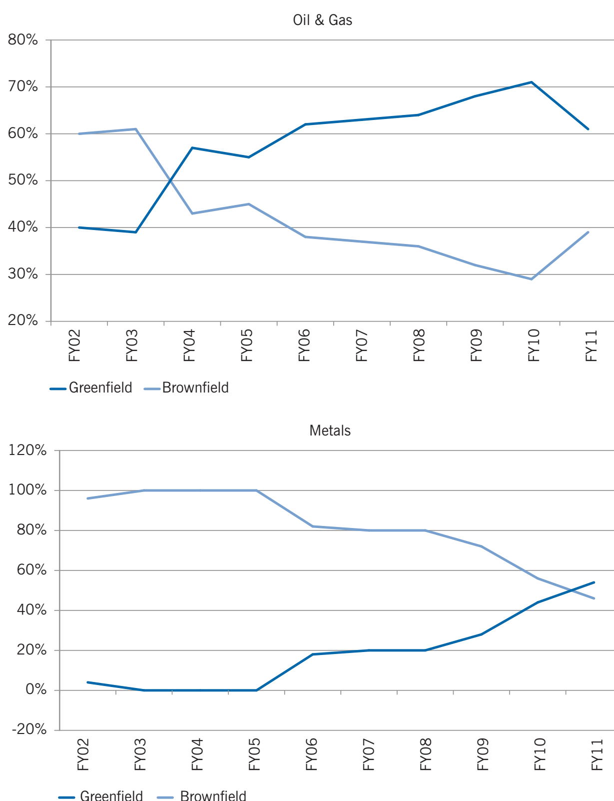
Display 3: India Sector-wise RoE: Then and now (2006-07 vs 2011-12)

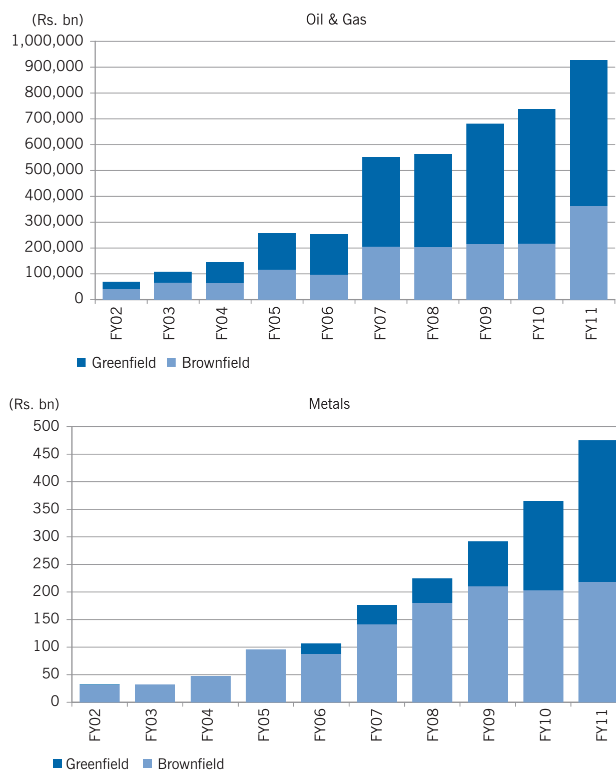


Source: Citi Investment Research

We decided to investigate the fall in RoE one step further. We noticed that in the two largest sectors that constitute bulk of India's corporate capital spending, namely Oil & Gas and Metals, there is a marked increase in capital spending on Greenfield projects compared to Brownfield expansions. The former has higher risk (land acquisition, environmental clearances, fuel linkages) and longer gestation (slower utilization pick up) leading to lower RoEs.

Display 4: Brownfield versus Greenfield Capital Expenditure in Oil & Gas and Metals sectors





Source: IDFC Research

In summary, we hope that when the next bull market in India emerges, the new sectors that will catch the investor's fancy may not be as dependent on capital for growth as those sectors that were in the limelight in the 2003-2007 rally. Along with a general upturn led utilisation pick-up, if these companies are able to deploy capital more productively, we could see India's RoEs trending upwards again. If that be so, we might see the Indian markets regain their resilient premium valuation, although the Indian economy may continue to be just as dependent on foreign capital thanks to its twin deficits. Focus on capital discipline and productivity maybe the key to investing across market cycles. But more of that in our next edition of ***Connecting the Dots***. Stay tuned.

Vulnerability

Circa 2006. The India Story had its script well laid out like a Bollywood blockbuster. What made the story even more predictable was that the plot was written on an Excel spreadsheet. You put demographics, rising incomes, consumption and savings rate into a regression equation and voila you had a smooth upward sloping trajectory for the country's growth path.

Once you extrapolate this for a couple of decades, the results were flattering. Do a quick sanity check on the numbers – the ever increasing army of youth is still joining the workforce and none of the per capita metrics ring any alarm bells which means that consumption, savings and investments still have legs to go.

From the early part of last decade, this algorithm or some combination thereof has been the consensus long term view on India. Every research report we read during that period had a per capita comparison of India versus other Emerging Markets within the first few pages. When you have a billion in the denominator, justifying the rise, and rise, of anything from cement consumption to mobile penetration is easy and convincing. A Teflon coated argument in favour of secular growth indeed and as George Orwell said "Whoever is winning at the moment will always seem to be invincible".

So, the Excel spreadsheets were winning. Stock research analysts extended "the per capita" logic to its natural conclusion – if fundamentals were upward sloping, how could stock prices be any different. India was a growth market driven by the aspirations of a billion people getting ready for their tryst with destiny. But every Achilles eventually discovers that he has a heel.

The credit crisis seems to have thrown a spanner in the works. For the past four years, the stock markets have had alternating bouts of manic-depression. The easy explanation is that the world has been in a risk-on and risk-off mode and fundamentals haven't really mattered in this period. While this is true, shouldn't a story with such secular credentials have been a much steadier ship in these choppy waters? Why is a domestic driven economy like India subject to the volatility of global risk-on/risk-off trades? The ASEAN growth stories have been much more resilient in these years and their equity markets have convincingly scaled the 2007 highs. Indian markets on the other hand have been buffeted by winds of volatility ending most of the last few calendar years close to the top or bottom of Emerging Market

league tables. What's even more interesting is that we have had Russian markets for company in most of these periods and have underperformed and outperformed in sync (See Display 1). The contours of both the economies and their stock markets are vastly different to justify this correlated behaviour, but it does appear that they are affected by a similar cyclical element. Energy prices for Russia and foreign capital flows for India have both been driven by the ebb and flow of global liquidity.

Display 1: MSCI India and MSCI Russia Returns

(as of March 31, 2012)

(USD Returns)	YTD 2012	CY 2011	CY 2010	CY 2009	CY 2008
MSCI India	20%	-38%	19%	101%	-65%
MSCI India Rank	6	20	11	3	22
MSCI Russia	19%	-21%	17%	100%	-74%
MSCI Russia Rank	7	12	14	4	23
EM Universe (no. of countries)	21	21	21	23	23

Source: Morgan Stanley Research, FactSet, MSCI

That brings us to an uncomfortable truth - the consumption driven, domestic led secular growth story of India depends a lot on the kindness of strangers (read foreigners) to fund its growth. And that kindness, we have realised over the past few years, is anything but neatly upward sloping. Moreover it does not fit into any regression equation with domestic-only variables like demographics.

Reliance on imported savings to fund growth adds to the cyclicality in investment rate – probably the most important driver of India's growth. Private, Government and Imported savings put together are more cyclical than Household savings, creating ups and downs in the investment rate and by proxy, capacity creation. In Financial Year (FY) 2004, household savings accounted for almost 88% of India's total savings, with cyclical component accounting for only 12% of the overall number, but by 2011 it had fallen to about 65% (See Display 2). Though savings rate as a whole went up in FY 2004-2008 period from 27% to 38%, the increase was led by cyclical elements which have since reversed, creating volatility in the overall investment rate. The delays in project approvals and execution have further accentuated the problem, crimping private corporate investment and making the supply curve in India fairly inelastic. This manifests itself in what now seems like chronic, if not ever-rising Current Account deficits (See Display 3).

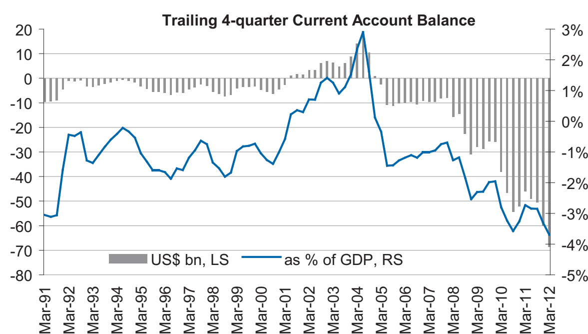
Display 2: Savings Rate Decomposition

	Total (domestic + Current Account Deficit)	Household Saving (a)	Public (b)	Private (c)	Foreign (d*)	Cyclical Components Subtotal (b+c-d)	Cyclical Components as % of total
F2004	27.5%	24.1%	1.1%	4.6%	2.3%	3.3%	12.2%
F2008	38.1%	22.4%	5.0%	9.4%	-1.3%	15.7%	41.1%
F2011	35.0%	22.8%	1.7%	7.9%	-2.7%	12.2%	34.9%

*Current Account Surplus (Deficit) detracts (contributes) from/to the overall savings rate

Source: RBI, CEIC, Morgan Stanley Research

Display 3: Current Account Deficit



Source: RBI, CEIC, Morgan Stanley Research

So when you intersect growing demand (led by growing wealth, better demographics and rising aspiration) with a fairly inelastic aggregate supply curve that India has, even a small shift in the aggregate demand function creates a large change in price levels. Investment rate cyclicality creates inflation cyclicality and this has been another feature of India post credit crisis. As recent research from IIFL shows, 2003-2007 was the only five-year period with sustained benign inflation and we seem to be going back to the growth-inflation-tightening-lower growth stalemate of the earlier era, which could act as a glass ceiling on trend growth rates. (Display 4).

Display 4: Stable Inflation - A Rarity

	GDP Deflator			
Period	5yr CAGR	Max	Min	Range
FY78 - FY82	9.0%	15.1%	1.9%	13.2%
FY83 - FY87	7.8%	8.5%	6.9%	1.7%
FY88 - FY92	10.1%	13.7%	8.3%	5.4%
FY93 - FY97	9.1%	10.0%	7.8%	2.2%
FY98 - FY02	4.8%	8.1%	2.9%	5.2%
FY03 - FY07	4.8%	6.4%	3.7%	2.7%
FY08 - FY12E	7.4%	8.5%	6.0%	2.5%

Source: CMIE, IIFL Research

Does that mean a secular story has hopelessly fallen prey to the vagaries of cyclical elements? While this may be partly true, it will serve investors well to not take their eyes off inflation and current account data. However from an equity investor's standpoint, India's allure lies in its micro story characterised by sector diversity and strong culture of entrepreneurship. We think that the key to investing in India is to seek out these bottom-up stories, while being cognizant of the macro vulnerabilities and resultant volatility. The earlier template of taking the surfboard to the beach and merrily riding the waves has given way to hard rowing, often against the current. So look for an oarsman who understands this reality and remains prepared to bend his/her back.

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