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Research
India

India Strategy

Revisiting the Road to 50K

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Revisiting the Road to 50K

- **Implied long term returns seem attractive:** One way of looking at market valuations is to find out the number of years it could take the market to reach a certain level. In our base case, using our residual income model, the BSE Sensex (used as a market proxy) could take about nine years to breach 50,000 from its current level. If the assumptions are made optimistic, the period to 50K shrinks to seven years. When we last did this exercise in January 2007, we had estimated the road to 50K to be around 13 years. To that extent, Indian equities are distinctly cheaper than they were in early 2007 (index level was around 14,000). Even in our bear case, investors may still go home with double-digit long-term returns, something which they could have not have expected for most of the past three to four years save for the period starting November 2008.

- **Critical success factors:** The critical success factors for returns and hence the period to reach 50K include some obvious ones such as GDP growth, interest rates, the inflation rate, and the success of India's infrastructure roll-out and fiscal consolidation. A less obvious but increasingly accepted factor is global risk appetite, which has a bearing on the expected rate of return and hence the actual rate of return. Some of the least obvious factors include the pace at which Indian companies globalize, the rate of wage increases, the investment rate, the estimated asset life in the books of accounts, and capital structure alterations.

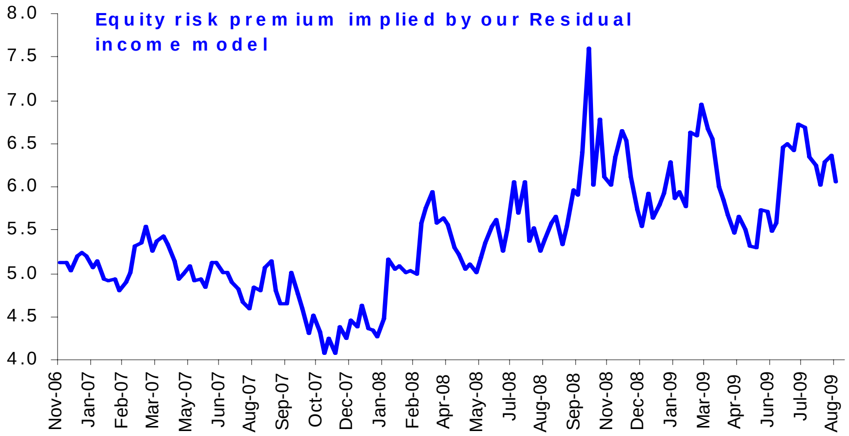
- **Short-term volatility an opportunity:** The short-term outlook is mired by excessive volatility that the market is going through as it grapples with the pace of growth recovery versus the prospects of Central Bank tightening both at home and abroad. Other factors such as equity supply, monsoons, and crude oil will also influence share prices. Indeed, the market is pricing in almost all the growth recovery that we are forecasting in the coming six months.

- **12-month and 10-year outlook both look rewarding:** However, we see more growth in F2011 and that is not in the price. More importantly, for long-term investors, our residual income model suggests that the market is delivering an equity risk premium of 6%. Put another way, the market is likely to deliver a long-term annual return of 13% same as the 10-year trailing return. This is based on an assumption that earnings will grow at 15%. If instead earnings compound annually at say 19%, the returns could be around 18% compounded annually for the next 10 years. Versus long bonds, equities appear to be at fair value. A bit more than half the index value is ascribed to future growth, which is more or less in line with history, whereas growth is likely to be better in the coming 15 years compared to the trailing 15 years (industrial growth averaged 7%, GDP growth averaged 6.9%, and BSE Sensex earnings CAGR was 13.9%).

- **Sensex target a tad higher:** Our Sensex target for June 2010 is 17,600 (600 points higher than our previous June 2010 target as we adjust F2009 earnings for actual numbers). The bull case implies upside of 41% from current levels, while we think the market is unlikely to go below its post election result day level in our bear case. Key catalysts could be reforms and infrastructure spending, although investors should be prepared for heightened volatility, which could make trading a less-rewarding strategy compared with "buy on dips and hold".

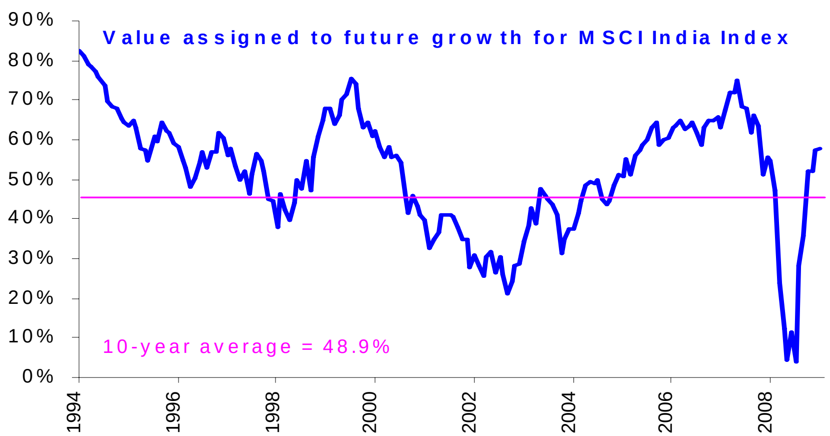
What Is the Market Pricing In?

Implied ERP: Comfort for Long-term Investors

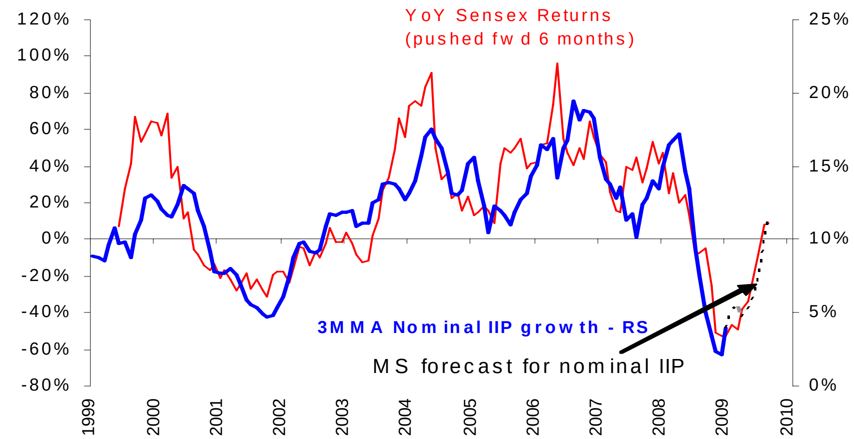


- For long-term investors, the equity risk premium implied by the market (represented by the BSE Sensex) using our residual income model is currently around 6%. We think this is a fair level of risk premium for investors looking to make a long-term commitment to Indian equities. Put another way, using the current local risk-free rate of 7%, investors will likely earn an annual compounded annual return of 13% from their investments in the BSE Sensex over the coming decade. This compares with the 13% that investors earned from the index over the past 10 years and the 10% investors were likely to earn when they were investing at the end of 2007.
- The short-term call is less clear. The market is pricing in the growth recovery we are forecasting in the coming six months. However, with a 12-month view, the market offers upside since we expect that growth will continue to accelerate in F2011.

Equities Appear Fairly Valued Versus Long Bonds



Market Pricing In a "V" Shaped Recovery in IIP Growth



Source: Bloomberg, CEIC, Morgan Stanley Research

Sensex Value Drivers

BSE Sensex: Key Value Drivers

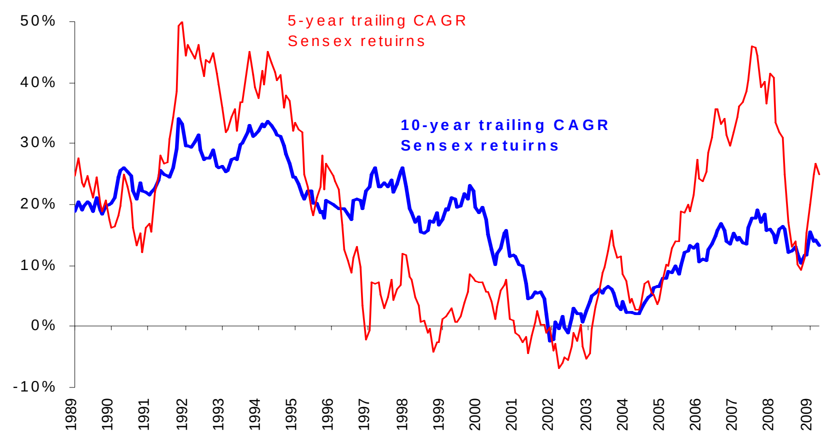
	Base Case	Bear Case	Bull Case
Revenue growth	5% premium to nominal GDP growth (16%)	4% premium to nominal GDP growth (15%)	1% higher than base case (17%)
EBIT margin (over cycle average)	Annual fall of 20 bps	Annual fall of 25 bps	Annual fall of 15 bps
Average interest cost	At F2010 level (5.8%)	50 bps higher than base case (6.3%)	50 bps lower than base case (5.3%)
Tax rate	25%	25%	25%
Asset Turn (over F11)	Annual increment of 0.008	Annual decrease of 0.001	Annual increment of 0.001
Debt to Equity	36%	36%	36%
Terminal growth rate	6.00%	5.75%	6.25%
Implied TV multiple	15.1	13.6	17.0
Equity Risk Premium	6.0%	6.5%	5.5%
BSE Sensex Fair Value	**16,692**	**12,959**	**21,741**
Years to 50,000 sensex	9.0	10.7	7.1
Implied CAGR in returns	**12.6%**	**10.7%**	**15.9%**

- At the end of the day, what investors earn from the market will depend on long-term earnings growth. Our view is that the Sensex constituents will likely grow earnings at an annual compounded rate of 15% on an aggregate basis. If growth turns out to be say 20%, returns from the market will be significantly superior to what investors have earned over the past 10 years. The trailing 10-year earnings growth for the Sensex has been 15.7% (as at the end of F2009).

Implied Long-term Returns vs. ERP & Earnings Growth

Long term return	13%	15%	17%	19%	21%	23%
ERP						
2.0%	42,066	48,826	56,756	66,036	76,869	89,484
3.0%	29,976	34,412	39,616	45,704	52,812	61,089
4.0%	22,871	25,966	29,596	33,845	38,805	44,582
5.0%	18,247	20,487	23,116	26,192	29,786	33,973
6.0%	15,032	16,692	18,641	20,923	23,590	26,700
7.0%	12,692	13,940	15,407	17,126	19,136	21,483
8.0%	10,930	11,876	12,990	14,297	15,828	17,617
9.0%	9,568	10,288	11,137	12,135	13,306	14,678

BSE Sensex: Long-term Trailing Returns

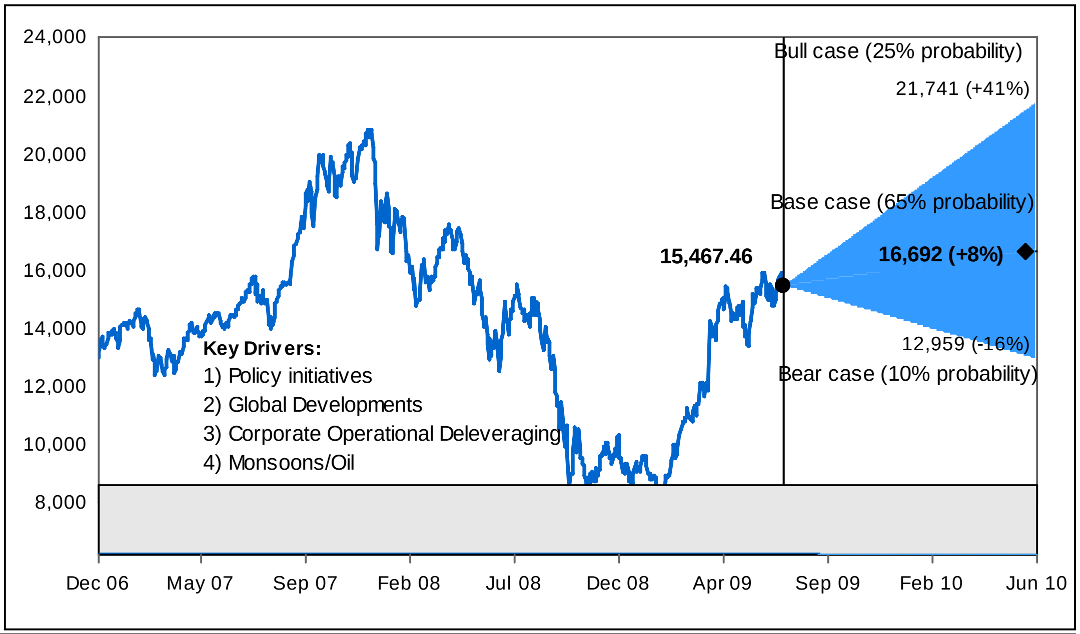


Source: Bloomberg, Company data Morgan Stanley Research

BSE Sensex Outlook: More Upside than Downside Risk

Scenario Analysis for Indian Equities

BSE Sensex: Outcomes for June 2010



Source: Morgan Stanley Research. Current Sensex as of 2 September 2009.

Investment Thesis

We assign a 65% probability to our base case, a 10% probability to our bear case, and a 25% probability to our bull case.

Our base case calls for fiscal measures and other policy initiatives in FDI, infrastructure, and rural growth, flat monsoons for the rest of the season, some corporate restructuring that arrests the fall in earnings by 4Q09, and steady improvement in the global situation.

Our bear case assumes weak policy action, with corporate India slow to restructure, so that earnings fall quite sharply, compounded by bad monsoons, and the global situation remaining fragile.

Our bull case assumes global calm and recovery in global growth, strong policy action, and sharp recovery in earnings as the corporate sector delevers its operations at a hectic pace, which allows liquidity to stay strong in 2009.

Our probability-weighted outcome for the BSE Sensex is 17,600 for June 2010. This implies 14% upside from current levels.

Source: FactSet, Morgan Stanley Research

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