

September 13, 2012

INSIGHT

India Strategy

ROE: The Secret Sauce Could Turn Sweet Soon

ROE below average in 2011

India's ROE seems to have completed its cyclical correction over the past 12 months. Margins are still falling, but asset turn appears to be recovering, although the balance has tilted in favor of a lower ROA. India's ROE is better than that of its peer group, but the gap is at an all-time low.

Relative ROE should rise in the coming months

We believe that with margins likely to find a floor in the coming 12 months, it is possible that India's ROE gap with emerging markets resumes an uptrend after falling for the past five years. The tailwind for ROE comes from the fact that capex is at six-year lows and that interest rates may have peaked. Indeed, asset turn has picked up to a three-year high, even as interest expense to revenues rose to a 10-year high.

Rising financial leverage

The bad news on the ROE front is that Indian companies have levered up relative to their EM brethren and the relative debt-equity ratios are now at 15-year highs. The

absolute debt-equity for the MSCI companies is at a three-year high (44%), although not at really worrying levels.

Our measure of earnings quality at 10-year high

The good news is that earnings quality (operating cash flow to net profit) and free cash flow have both show improvement and are at multi-year highs.

ROEs of cyclicals way below average

The ROE fell YoY for six out of ten sectors – the exceptions being energy, financials, industrials and telecoms. At the sector level, cyclicals hold the key to ROE improvement, but the key takeaway is that ROEs for these sectors are well below average, so a mean reversion is likely scenario.

Identifying ROE winners

We use our proprietary regression approach to identify stocks where the coming ROE improvement is not priced in. The stocks that appeal to us include Maruti, Coal, Cairn, Oberoi, Jubilant, IRB, HDFC Bank, Tata Steel among others (see page 7)

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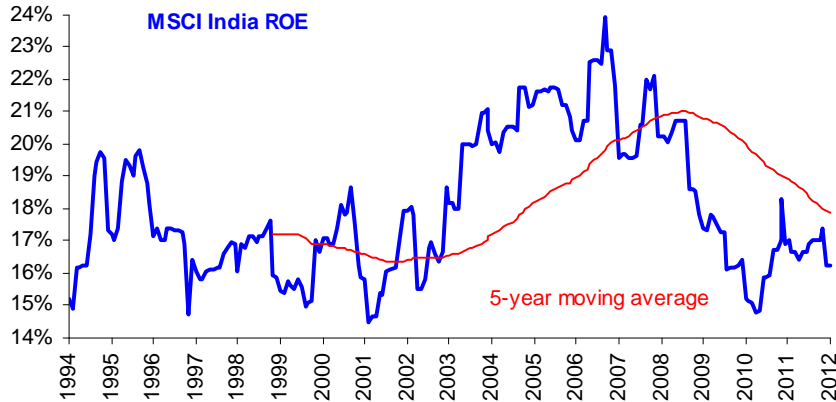
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ROE Bouncing Off Lows Post Steep Cyclical Correction

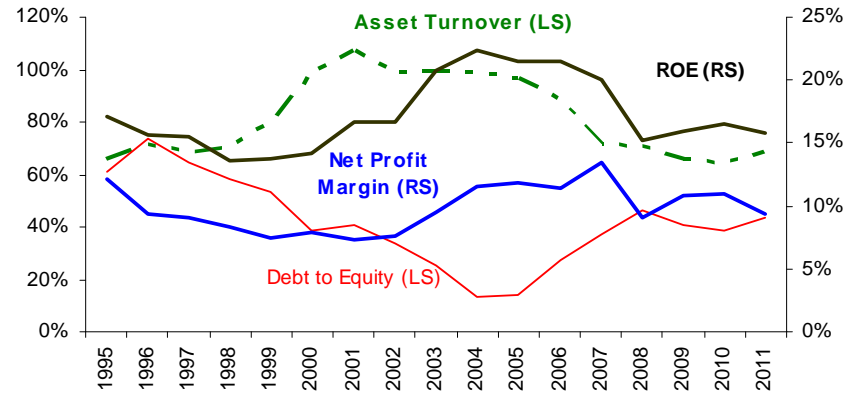
ROE Takes a Cyclical Knock

Absolute ROE coming off lows



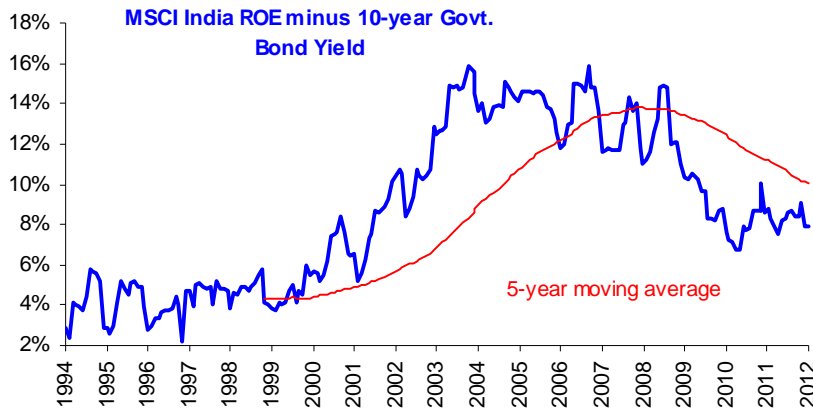
India's ROE Drivers

Pressure on margins preventing a stronger ROE recovery



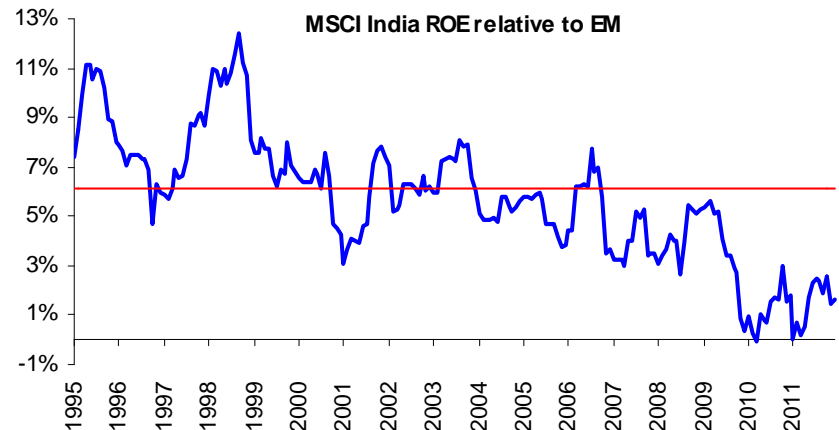
Excess ROE Over Long Bond Yield: 8-year Low

The excess ROE level of the 2004-08 period may not return



India's ROE Relative to EM Off 15-year Low

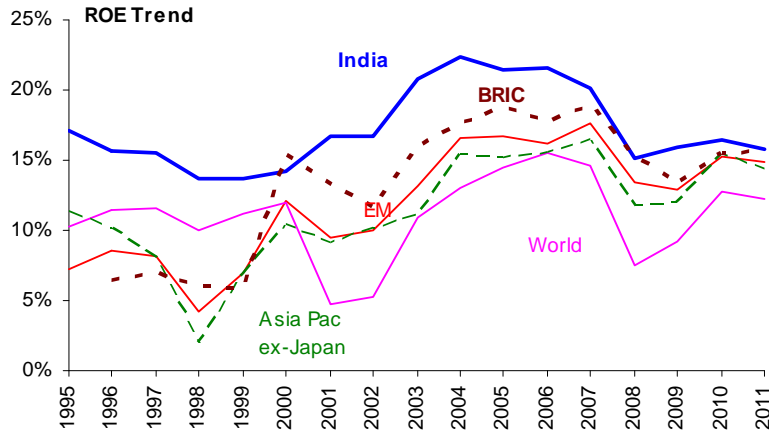
Indeed, the ROE gap almost close to zero



India's ROE Faces Drag from Margin Pressure

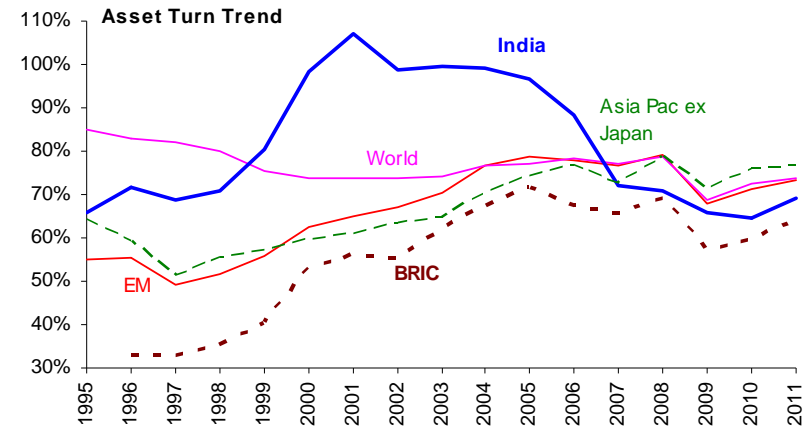
India Still has a better ROE

However, the ROE gap is at a new low



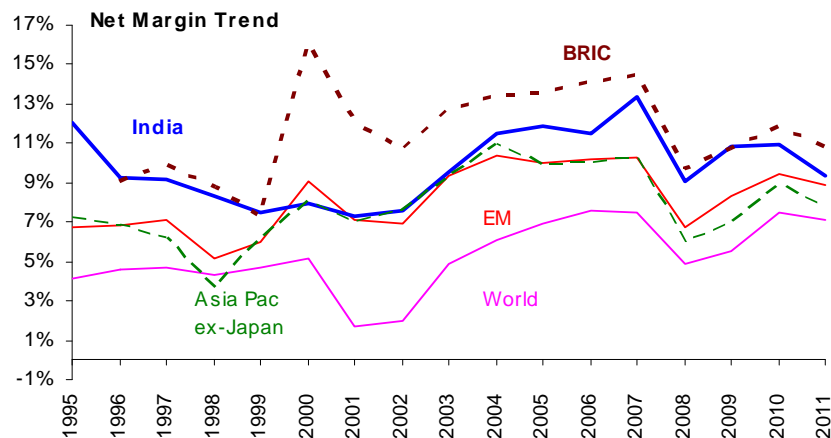
India's Asset Utilization Picks Up in 2011

At a 3-year high



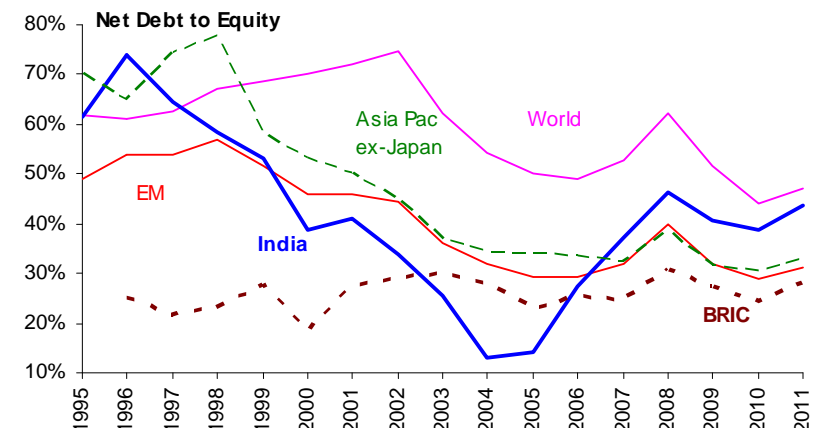
India's Net Margins Fall

At a 3-year low



India's Leverage Above the EM Average

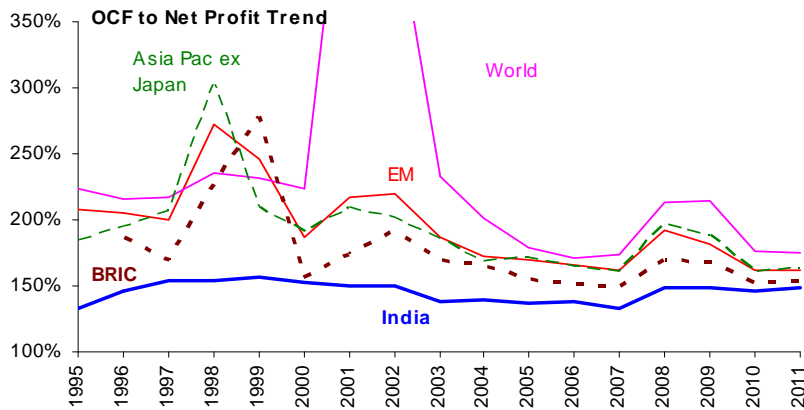
Gap widens to 15-year high



Financial Statements' Quality Improves at the Margin

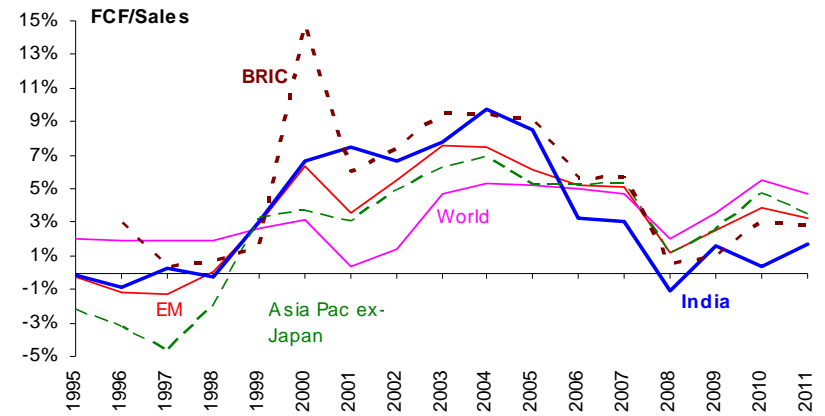
India's Earnings Quality Improves at the Margin

However, below RoW



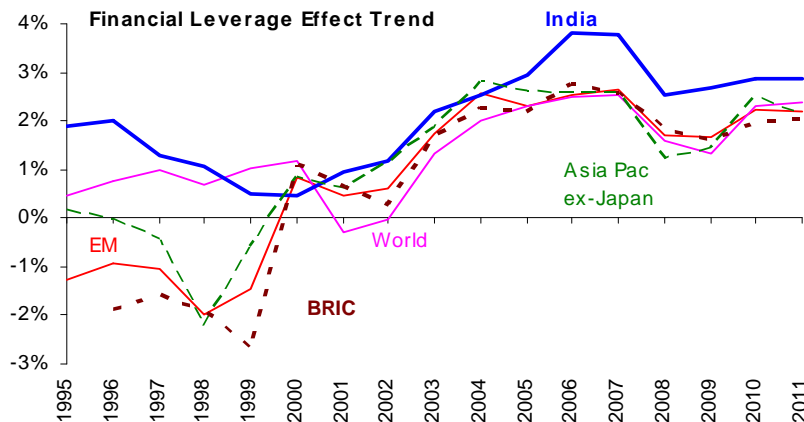
Free Cash Flows Recover in 2011

At a 4-year high



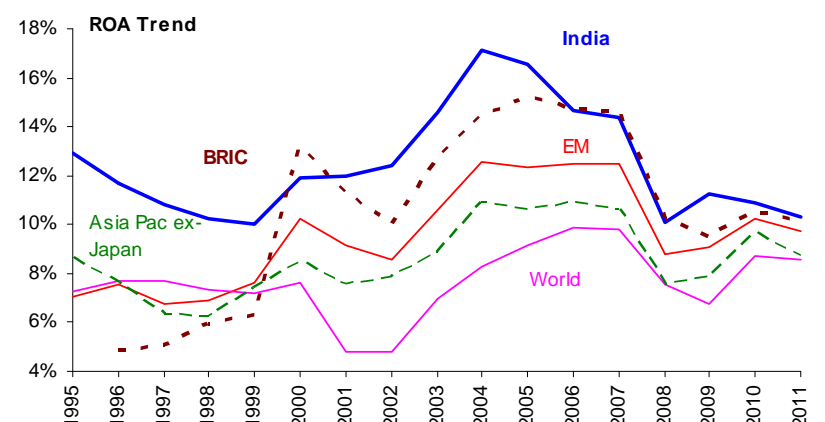
India Enjoys the Highest Financial Leverage Effect

If rates fall, ROEs can surprise



India's ROA Trend in Sync With RoW

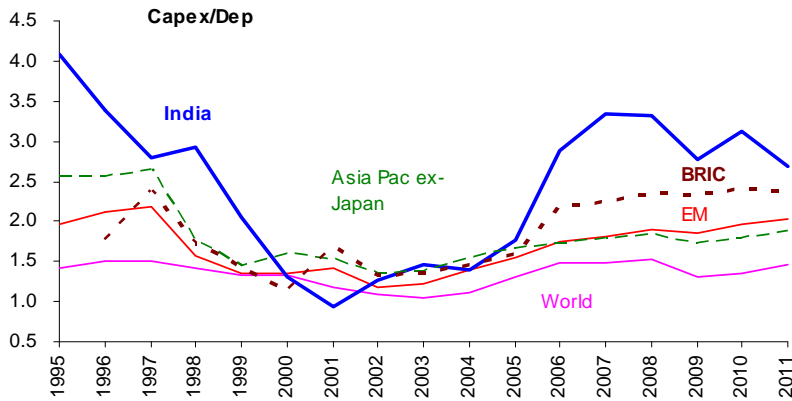
India's poorer ROA reflects challenging margin environment



III Effects of Previous Capex Cycle Waning

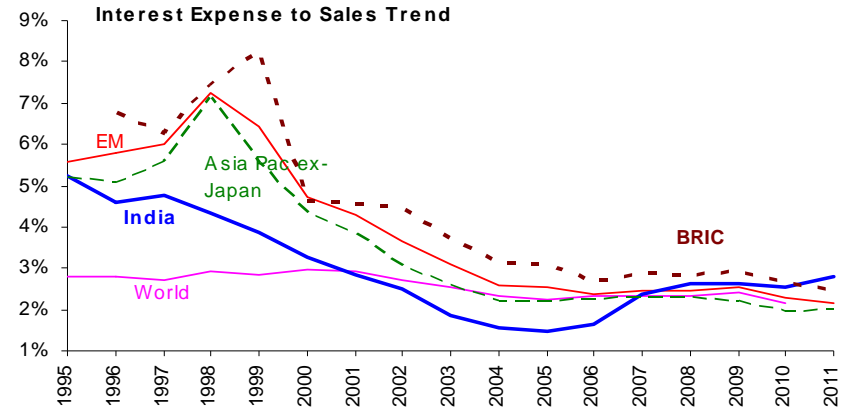
India's Capex Has Gone Through Cyclical Correction

At a 6-year low



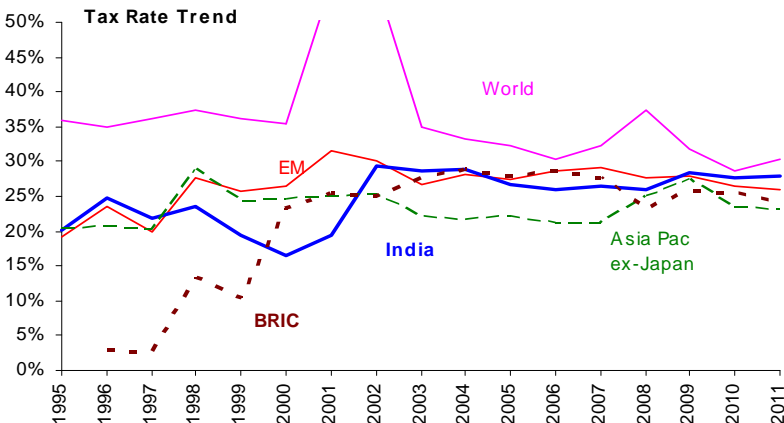
Interest Expense Rises

At a 10-year high



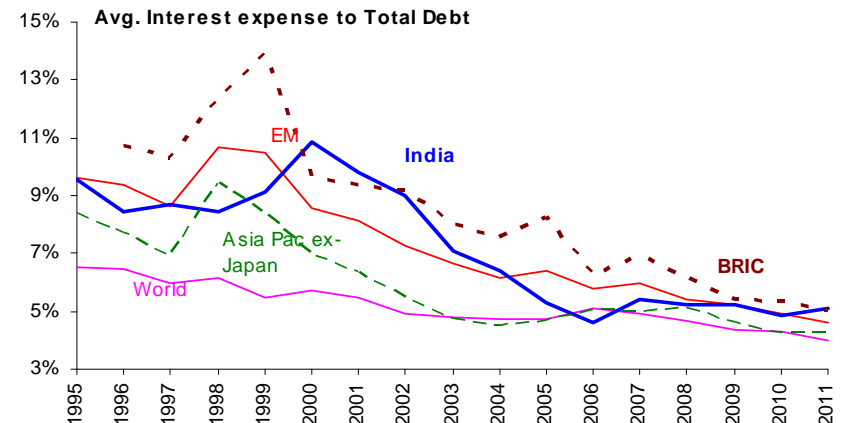
India's Tax Rates Rise Above Region and EM

Gap with ACWI widens



Average Cost of Debt Rises

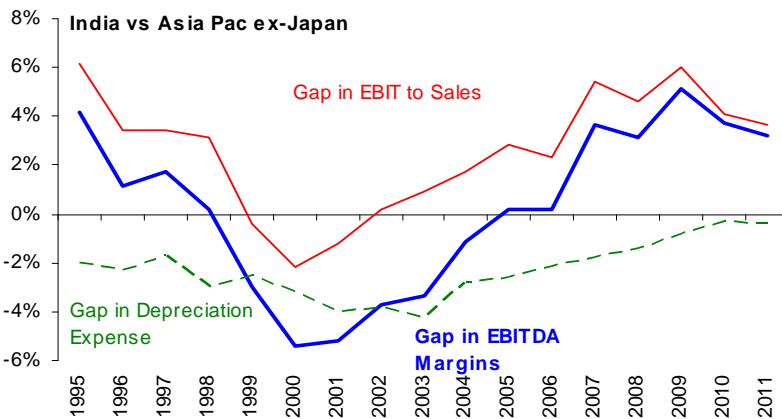
Gap between India and EM widens to a 9-year high



India's ROE Likely to Gap Higher

India Vs. AXJ: Depreciation Expense Gap Closing

Improving ROE quality as depreciation expense gap closes



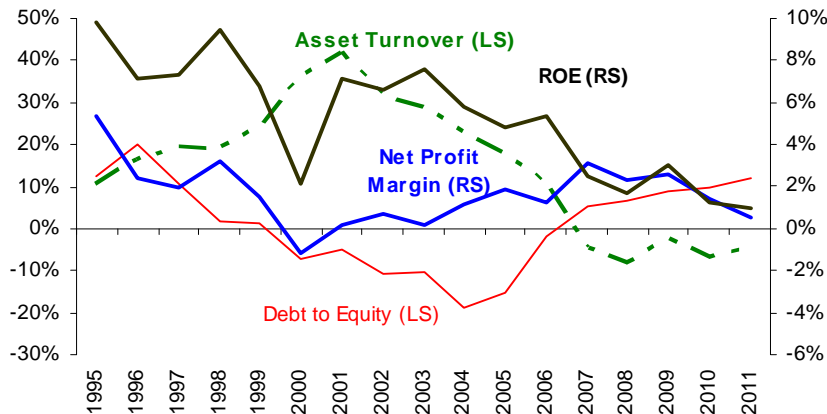
India's ROE: Asset Turn Helps ROE

The compression in margins was a drag

Drivers of ROE Gap with India	2006	2007	2008	2009	2010	2011
EM						
Asset Turn	2.8%	-1.4%	-1.8%	-0.6%	-1.8%	-1.0%
Financial leverage effect	1.3%	1.1%	0.8%	1.0%	0.7%	0.7%
Net margin	2.3%	4.2%	3.6%	3.5%	3.2%	2.1%
Total ROE gap	6.4%	4.0%	2.6%	3.9%	2.0%	1.8%
World						
Asset Turn	2.7%	-1.5%	-1.8%	-0.8%	-2.1%	-1.1%
Financial leverage effect	1.3%	1.2%	0.9%	1.3%	0.6%	0.5%
Net margin	3.5%	6.7%	5.3%	5.9%	4.5%	2.9%
Total ROE gap	7.6%	6.4%	4.5%	6.4%	3.0%	2.3%
BRIC						
Asset Turn	5.6%	1.9%	0.4%	2.2%	1.2%	1.1%
Financial leverage effect	1.1%	1.2%	0.7%	1.1%	0.9%	0.8%
Net margin	-2.1%	-0.6%	-0.2%	0.5%	0.1%	-0.7%
Total ROE gap	4.6%	2.5%	0.8%	3.8%	2.2%	1.2%
APXJ						
Asset Turn	3.1%	-0.2%	-1.7%	-1.4%	-2.9%	-1.8%
Financial leverage effect	1.2%	1.2%	1.3%	1.2%	0.4%	0.8%
Net margin	2.7%	4.2%	4.9%	5.4%	4.1%	3.3%
Total ROE gap	7.1%	5.2%	4.5%	5.2%	1.5%	2.2%

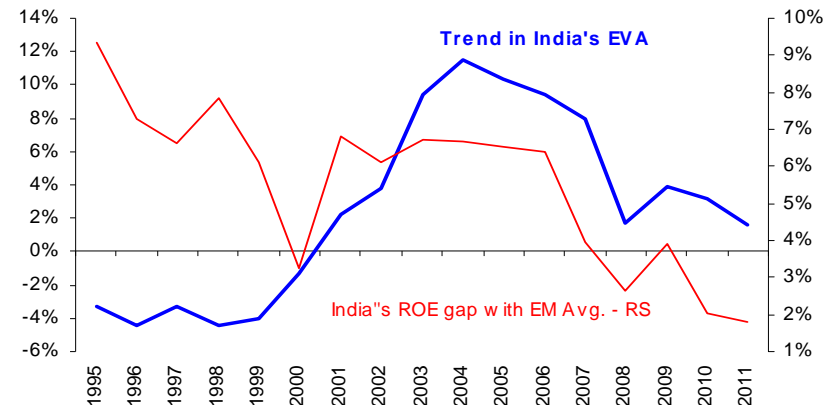
Drivers of India's ROE Gap with EM

Falling relative margins offset by rise in relative financial leverage



India: ROE Gap with EM At Record Lows

EVA Falls to multi-year lows with higher WACC and lower returns



Best 'OW' and Best 'UW' Ideas, Based on Analyst Rating and Valuation Results

Stocks	Sector	MS Rating	Price Sep 12, 2012	Current P/B Relative to Sensex	Current ROE	12M Forward ROE	Fair Level of Relative P/B based on regression model	Under Valued
Pantaloen Retail	Consumer Disc	OW	151	0.3	1.8%	1.7%	1.1	-73%
Cox & Kings	Consumer Disc	OW	129	0.5	-1.0%	20.0%	0.7	-26%
Jubilant Foodworks	Consumer Disc	OW	1,225	8.0	38.2%	40.6%	9.4	-15%
Maruti Suzuki	Consumer Disc	OW	1,219	0.9	11.2%	11.7%	0.9	-9%
Coal India	Energy	OW	376	2.4	43.5%	46.2%	2.6	-9%
Cairn India	Energy	OW	343	0.5	16.4%	17.4%	0.5	-6%
IBREL	Financials	OW	47	0.1	1.3%	1.7%	0.4	-66%
Oberoi Realty	Financials	OW	234	0.8	13.3%	16.7%	1.0	-13%
Yes bank	Financials	OW	337	0.8	20.9%	16.1%	0.9	-11%
HDFC Bank	Financials	OW	599	1.6	17.3%	19.2%	1.7	-2%
Cipla	Healthcare	OW	379	1.5	15.8%	17.3%	1.7	-14%
NCC	Industrials	OW	33	0.2	1.4%	2.7%	0.3	-53%
IRB Infra	Industrials	OW	124	0.5	17.4%	17.1%	0.9	-45%
Adani Enterprises	Industrials	OW	176	0.2	8.0%	14.3%	0.4	-45%
IVRCL Infra	Industrials	OW	40	0.3	2.5%	3.6%	0.4	-39%
Adani Port	Industrials	OW	111	1.5	22.2%	22.9%	2.1	-29%
Jaiprakash Asso	Industrials	OW	69	0.6	8.3%	8.7%	0.8	-25%
Aditya Birla Nuvo	Industrials	OW	770	0.4	12.7%	14.0%	0.5	-13%
IL&FS Transportation	Industrials	OW	159	0.5	18.0%	19.1%	0.5	-7%
Tata Steel	Materials	OW	387	0.3	5.5%	13.2%	0.6	-51%
NMDC Ltd	Materials	OW	189	0.8	31.8%	26.5%	0.8	-6%
Wipro	Technology	OW	384	1.2	19.5%	19.4%	2.2	-47%
HCL Technologies	Technology	OW	582	1.3	22.9%	22.8%	1.7	-20%
OnMobile Global	Telecom	OW	39	0.2	10.6%	8.6%	0.9	-77%
Power Grid	Utilities	OW	121	1.0	13.2%	14.2%	1.0	-1%

Stocks	Sector	MS Rating	Price Sep 12, 2012	Current P/B Relative to Sensex	Current ROE	12M Forward ROE	Fair Level of Relative P/B based on regression model	Over Valued
Educomp Solutions	Consumer Disc	UW	151	0.3	5.3%	5.9%	0.04	630%
Titan Industries	Consumer Disc	UW	238	4.2	42.4%	39.1%	3.50	20%
Hero Moto Corp	Consumer Disc	UW	1,786	2.5	55.4%	45.8%	2.37	6%
GAIL	Energy	UW	367	0.8	17.5%	15.3%	0.75	10%
Kotak Mahindra Bank	Financials	UW	583	1.2	14.2%	13.0%	1.05	17%
Tata Power	Utilities	UW	96	0.8	10.4%	7.2%	0.66	19%

The Regression Approach

- We have regressed the relative P/B to the BSE Sensex for each stock under our coverage with the difference in ROE between the company and the Sensex aggregate. Using the historical regression-based relationship, we compute the fair level of the stock's relative P/B using the 12-month forward ROE difference that our analysts expect for the company vs. the Sensex. By comparing the computed relative P/B with the current 12-forward relative P/B, we can gauge how over- or under-valued a stock may be.
- It is pertinent to note the three assumptions implicit in this exercise. First, ROE is only the metric providing a basis for our valuation call, which is obviously a limited way of approaching valuation. For example, this method ignores growth in earnings as a possible driver of valuation. That said, we think that the change in relative ROE should still reflect the delta in fundamentals. Second, the results are a function of historical relationships and assume that historical relationships will remain intact in the future. Third, the ROE forecasts are Morgan Stanley analyst forecasts and may not reflect the consensus view. Hence, the results are dependent on the accuracy of our analysts' forecasts. Despite these underlying assumptions, we think this analysis is useful to highlight stocks that may be over- or under-valued and especially as a filter or potential starting point for portfolio construction.

At the Sector Level, Industrials is the Key to the Recent Relative ROE fall

Sectoral Drivers for India's Relative ROE Fall

Longer term, healthcare, materials, industrials and utilities the culprits for India's loss of ROE premium

Sector	Current MSCI India ROE	MSCI India ROE 12M back	Current MSCI India ROE Rel EM	MSCI India ROE Rel EM 12M back	12M Δ in MSCI India ROE	12M Δ in MSCI India ROE Rel to EM	5-yr Δ in MSCI India ROE	5-yr Δ in MSCI India ROE Rel to EM
Consumer Discretionary	36.1%	29.3%	18.4%	12.3%	6.8%	6.1%	15.1%	9.5%
Consumer Staples	31.7%	33.2%	16.5%	16.8%	-1.6%	-0.3%	-2.7%	-1.8%
Energy	11.7%	15.2%	-2.4%	-0.4%	-3.5%	-2.0%	-11.0%	-4.3%
Financials	16.2%	13.8%	1.8%	0.2%	2.5%	1.6%	4.8%	4.5%
Health Care	13.0%	14.9%	-0.1%	0.8%	-1.9%	-0.8%	-13.2%	-10.4%
Industrials	15.0%	25.7%	5.5%	11.7%	-10.7%	-6.3%	-10.8%	-6.8%
Information Technology	27.8%	27.6%	16.0%	11.2%	0.2%	4.8%	-4.5%	-2.0%
Materials	11.7%	17.6%	-0.7%	0.9%	-6.0%	-1.6%	-14.7%	-6.9%
Telecoms	5.2%	3.1%	-11.1%	-13.3%	2.1%	2.2%	-5.4%	-3.1%
Utilities	10.1%	10.4%	2.9%	2.7%	-0.3%	0.2%	-5.7%	-5.2%
MSCI India	16.2%	17.1%	1.6%	1.8%	-0.8%	-0.2%	-3.4%	-2.0%

Widespread losses at the Sector Level

- Over the past 12 months, consumer discretionary and technology ROEs have improved the most relative to their respective EM sectors. Over five years, consumer discretionary and financials have gained relative to their EM sectors.
- Over the longer term, the most compression in ROE gap is in the healthcare followed by materials and industrials. In the past 12 months, industrials have contributed the most to India's ROE underperformance.

ROE Rises for Telecoms & Industrials in 2011

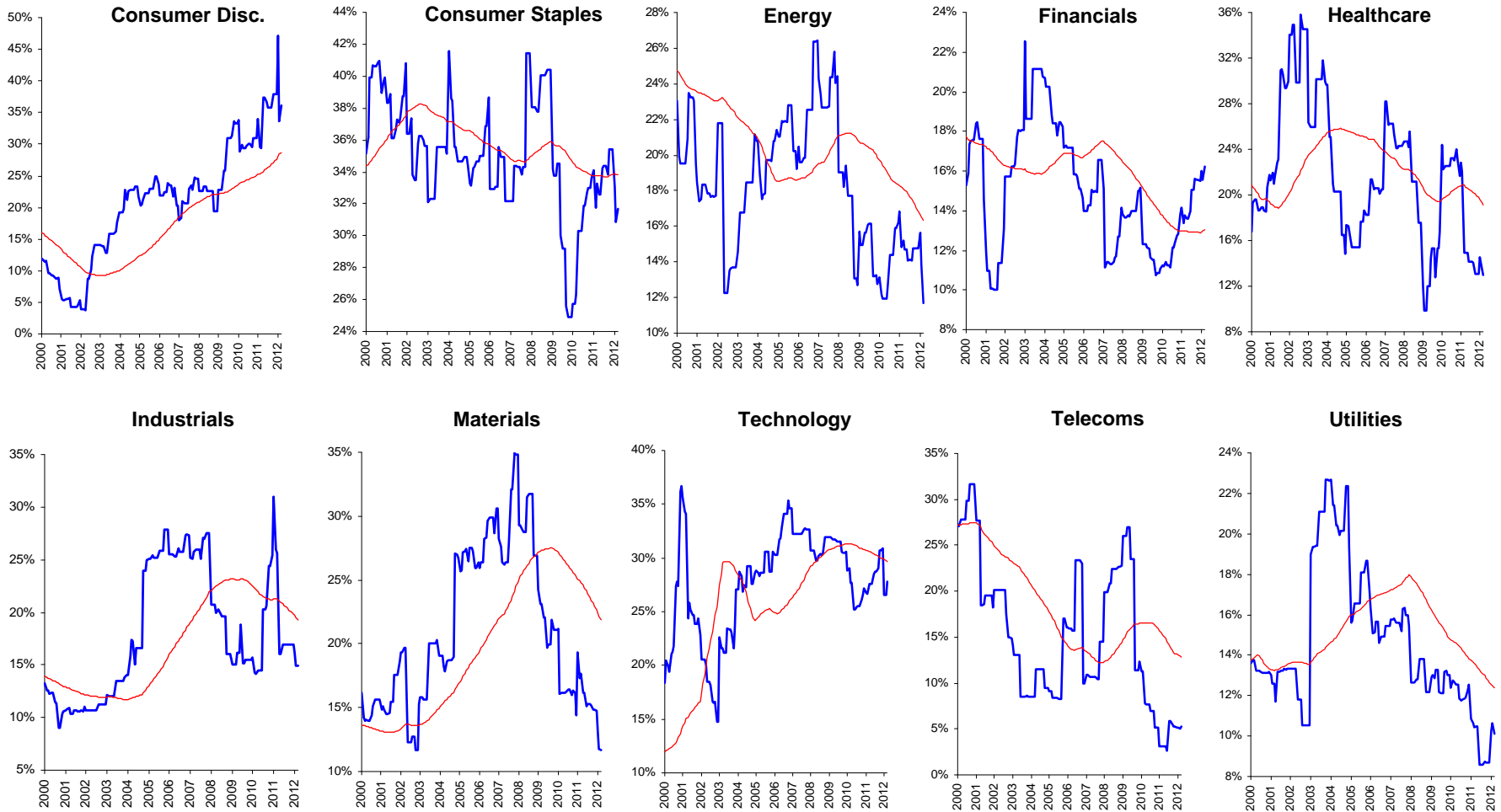
Consumer Staples	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Net Margin	8%	8%	10%	11%	12%	14%	13%	14%	16%	14%	15%	15%	18%	13%	14%	15%	15%
Asset Turn	138%	158%	142%	145%	139%	129%	126%	110%	104%	104%	114%	99%	88%	96%	98%	101%	102%
ROA	21.4%	23.2%	23%	24%	26%	26%	24%	24%	24%	22%	24%	21%	24%	19%	22%	23%	23%
Leverage	2.4	2.4	2.4	2.2	2.0	1.9	2.0	1.9	2.2	2.0	1.9	2.1	2.2	2.2	2.1	2.1	2.1
ROE	27%	30%	34%	33%	33%	34%	32%	30%	35%	30%	32%	30%	35%	27%	30%	34%	33%
OCF/Net Profit	118%	118%	116%	117%	116%	115%	120%	119%	117%	119%	115%	115%	112%	117%	115%	113%	112%
Consumer Disc	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Net Margin	8%	8%	6%	6%	5%	3%	4%	6%	8%	8%	9%	8%	7%	1%	7%	9%	8%
Asset Turn	104%	91%	81%	72%	88%	71%	75%	84%	114%	119%	111%	109%	101%	97%	113%	119%	121%
ROA	14.6%	12.9%	10%	9%	9%	7%	8%	11%	15%	16%	16%	15%	13%	5%	12%	15%	13%
Leverage	2.3	2.2	2.3	2.3	2.1	1.9	2.4	2.4	2.4	2.5	2.5	2.6	2.9	4.2	3.9	3.4	3.2
ROE	18%	16%	11%	9%	9%	4%	6%	12%	22%	25%	25%	24%	22%	6%	30%	36%	31%
OCF/Net Profit	137%	141%	176%	171%	189%	246%	237%	167%	148%	136%	134%	129%	136%	325%	149%	134%	140%
Energy	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Net Margin	19%	8%	8%	7%	5%	4%	4%	5%	6%	10%	10%	9%	12%	8%	11%	9%	9%
Asset Turn	43%	89%	85%	85%	105%	183%	178%	144%	138%	120%	118%	109%	87%	79%	77%	85%	96%
ROA	9.7%	10.1%	11%	9%	8%	12%	11%	12%	13%	18%	18%	14%	15%	10%	12%	12%	13%
Leverage	1.9	2.3	2.1	2.6	2.4	2.3	2.4	2.5	2.3	2.0	1.9	2.2	1.9	2.1	1.9	2.1	1.9
ROE	15%	16%	15%	15%	14%	17%	18%	17%	19%	23%	23%	22%	20%	13%	16%	17%	17%
OCF/Net Profit	133%	143%	152%	150%	155%	179%	161%	160%	152%	151%	147%	155%	150%	165%	167%	170%	144%
Healthcare	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Net Margin	14%	13%	9%	14%	14%	15%	17%	19%	18%	15%	13%	16%	19%	3%	11%	19%	7%
Asset Turn	83%	70%	139%	73%	76%	85%	100%	99%	91%	76%	64%	70%	66%	65%	65%	52%	55%
ROA	18.9%	14.8%	21%	15%	15%	15%	18%	20%	21%	15%	11%	15%	16%	3%	11%	13%	7%
Leverage	1.9	1.6	1.7	1.5	1.5	1.5	1.5	1.6	1.6	1.9	2.2	2.1	1.8	1.9	1.7	1.7	1.8
ROE	22%	15%	21%	15%	16%	19%	26%	29%	27%	22%	19%	23%	23%	4%	13%	16%	8%
OCF/Net Profit	120%	120%	124%	122%	123%	122%	119%	115%	117%	120%	127%	125%	123%	230%	141%	126%	157%
Industrials	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Net Margin	10%	9%	7%	7%	6%	6%	5%	5%	8%	8%	9%	10%	10%	7%	8%	8%	8%
Asset Turn	73%	72%	69%	71%	69%	65%	73%	75%	81%	89%	87%	77%	63%	59%	54%	44%	41%
ROA	11.3%	11.0%	8%	9%	8%	7%	8%	7%	10%	11%	12%	12%	10%	8%	8%	7%	7%
Leverage	2.1	2.1	2.3	2.4	2.4	2.6	2.9	2.8	2.9	3.0	3.0	3.2	3.6	4.0	4.0	4.0	4.6
ROE	15%	14%	11%	12%	10%	10%	11%	11%	17%	21%	22%	26%	22%	17%	18%	14%	15%
OCF/Net Profit	138%	139%	159%	149%	163%	159%	173%	169%	128%	123%	133%	124%	124%	132%	133%	140%	144%

ROE Rises for Telecoms & Industrials in 2011

Materials	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Net Margin	14%	10%	9%	6%	6%	11%	8%	9%	13%	13%	14%	16%	11%	7%	9%	10%	7%
Asset Turn	50%	47%	46%	45%	50%	59%	62%	67%	72%	82%	84%	66%	88%	88%	69%	66%	71%
ROA	12.0%	10.0%	9%	7%	8%	12%	10%	11%	15%	18%	17%	17%	16%	11%	11%	11%	10%
Leverage	2.3	2.3	2.4	2.3	2.3	2.0	2.4	2.7	2.5	2.5	2.3	2.6	3.0	2.8	2.6	2.4	2.5
ROE	16%	11%	10%	6%	7%	13%	12%	17%	23%	28%	26%	28%	28%	18%	15%	17%	13%
OCF/Net Profit	136%	168%	179%	243%	226%	161%	173%	165%	146%	141%	141%	128%	133%	151%	152%	140%	157%
Telecom	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Net Margin		23%	25%	26%	24%	27%	21%	16%	17%	18%	18%	12%	19%	21%	17%	6%	5%
Asset Turn		27%	30%	37%	34%	34%	47%	39%	33%	30%	30%	30%	26%	25%	28%	23%	40%
ROA		11.1%	11%	14%	9%	10%	14%	10%	8%	8%	8%	5%	8%	7%	7%	3%	5%
Leverage		4.2	3.0	2.2	2.1	2.0	1.9	1.8	1.8	1.8	1.8	2.3	2.5	2.6	2.1	2.3	2.8
ROE		26%	22%	21%	17%	19%	19%	11%	10%	10%	10%	8%	13%	13%	10%	3%	6%
OCF/Net Profit		155%	151%	151%	157%	149%	135%	160%	145%	152%	152%	215%	175%	174%	203%	583%	438%
Information tech	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Net Margin				23%	20%	27%	19%	16%	21%	22%	22%	22%	22%	19%	20%	19%	19%
Asset Turn				86%	126%	76%	72%	77%	88%	110%	107%	108%	104%	105%	91%	96%	99%
ROA				25%	30%	24%	14%	16%	22%	28%	27%	27%	26%	24%	22%	24%	25%
Leverage				1.5	1.5	1.3	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.5	1.6	1.4	1.4
ROE				31%	37%	26%	18%	17%	26%	33%	33%	33%	33%	31%	29%	27%	27%
OCF/Net Profit				134%	128%	119%	136%	139%	121%	117%	117%	115%	113%	114%	115%	113%	113%
Utilities	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Net Margin	15%	10%	13%	15%	15%	12%	10%	6%	14%	14%	15%	14%	16%	13%	14%	15%	11%
Asset Turn	50%	52%	48%	40%	46%	46%	48%	61%	63%	61%	60%	54%	42%	44%	41%	35%	37%
ROA	11.8%	10.1%	11%	11%	12%	9%	10%	9%	16%	13%	13%	10%	10%	9%	9%	9%	8%
Leverage	2.0	1.9	1.9	1.9	1.9	1.9	2.2	2.1	2.2	2.3	1.9	2.1	2.0	2.2	2.3	2.4	2.6
ROE	15%	10%	12%	11%	13%	11%	10%	8%	20%	20%	17%	15%	13%	13%	13%	12%	11%
OCF/Net Profit	137%	167%	159%	161%	153%	161%	191%	229%	147%	157%	134%	133%	131%	133%	136%	136%	150%

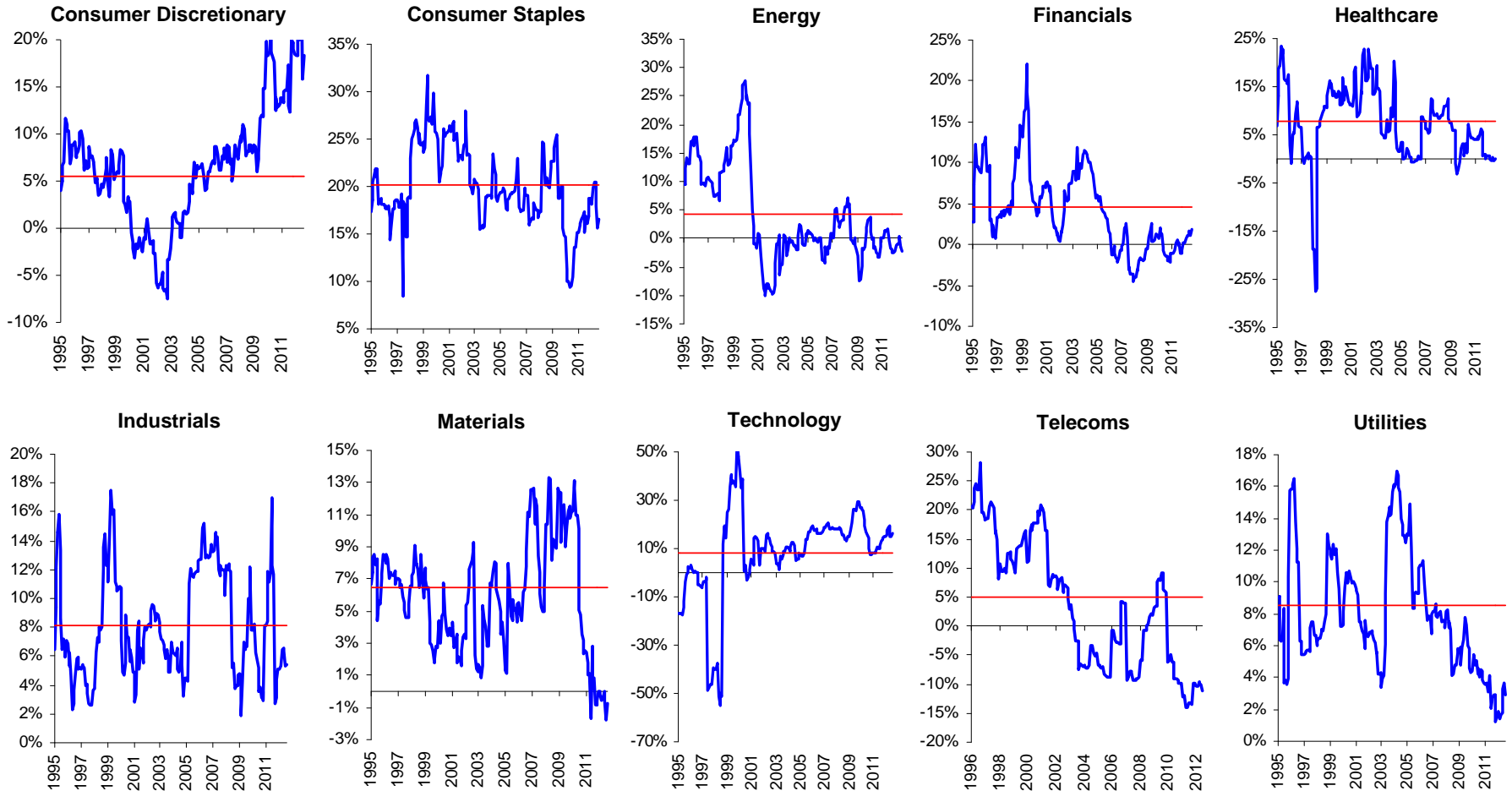
ROE Trends


Dark blue Line – Sector ROE, Light red line – five-year moving avg. ROE



ROE Gap: India vs. EM at the Sector Level

Dark blue Line – MSCI India Sector ROE relative to MSCI EM Sector, Light red line – Long Term Average of Relative Sector ROE



	<p>Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations. For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.</p>
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(as of August 31, 2012)

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Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	1108	37%	445	41%	40%
Equal-weight/Hold	1283	43%	499	46%	39%
Not-Rated/Hold	109	4%	34	3%	31%
Underweight/Sell	469	16%	115	11%	25%
Total	2,969		1093		

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