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Research
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India Strategy

Does India Deserve a P/E Premium?

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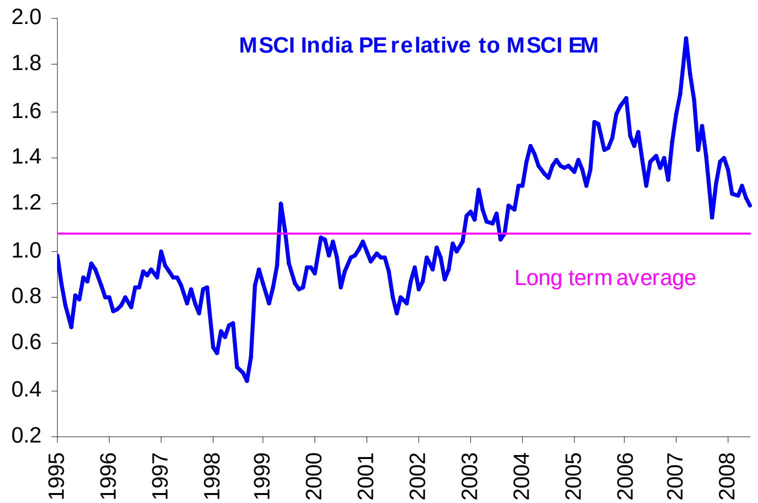
PE Premium: Is It Sustainable?



Source FactSet, MSCI

Does India Deserve a P/E Premium?

- At the outset, we have to state that in our view the P/E metric is quite a flawed one when used as a valuation measure for equities (see our essay from last week titled "*Genuine GARP – A Debate*", dated March 24, 2009). The debate on whether India deserves to trade at a P/E premium to emerging markets could still be of interest. The question is not what will happen over the next 12 months when it is difficult to predict with conviction where the relative multiple is heading. We could construct the argument both ways depending on inputs from the global economic cycle, election results, corporate sector operational deleveraging and the size of the NPL cycle. The long-term relative multiple, in our view, is driven by the factors listed below. Our conclusion is that India could end up trading at a premium to emerging markets more often than not over the coming decade. We believe the level of this premium could be better than the average of the past 15 years (around 7%).

- **The demographic dividend**: India is likely to add around 10 million new workers to its workforce on an annual basis. As the workforce grows, so will the savings and hence the growth rate. This will be the key driver to profit growth.

- **The demographic sword:** The fact is that to employ the accretion to the work force, we estimate India would need to grow at 7% or more. This means the country is underinvested and will guzzle capital in the coming years. As India will need to keep importing capital in the medium term (a savings deficiency is corollary of the high required growth rate), a current account deficit will remain (even as it turns into a surplus later this year purely for cyclical reasons). The implication is that India will depend on global capital market cycles unless it shifts funding sources to FDI. Bottom-up, this has implications on the payout ratio which needs to rise for a sustained premium multiple.

- **The political factor:** Fiscal deficit is the key manifestation of the political factor. Public debt and fiscal deficit (read politics) will drive long term interest rates or cost of capital (in the absence of large scale capital flows). Another aspect of politics is the democratic system which works in India's favor with respect to property rights even as it works against India in terms of driving capital accumulation and capital efficiency.

- **Capital efficiency:** The country's macro is struggling with capital efficiency whereas bottom-up ROEs continue to score well. Ultimately for the bottom-up ROE to sustain, capital efficiency at the macro level will need to improve. Higher capital efficiency would partly offset the need for capital as well and vice versa and hence this becomes a factor with multiplier effects.

- **Corporate governance:** This factor drives the quality of earnings and hence equity risk premium. Historically, India has been a mixed bag on corporate governance. While India's ROE-focused entrepreneurs provide interesting investment opportunities, the recent Satyam episode may have dented investor confidence.

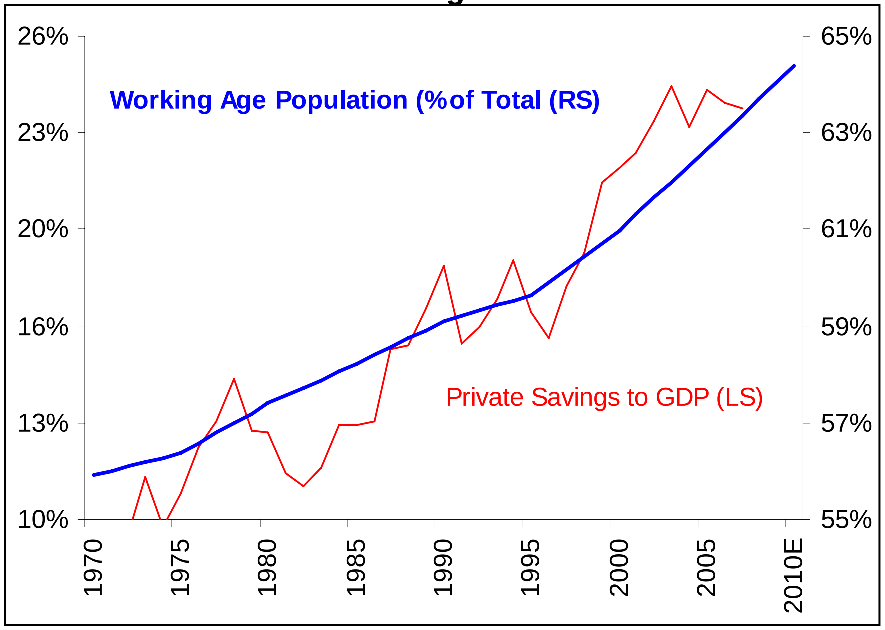
- **Structural liquidity story:** A side effect of the demographic dividend is the structural liquidity story. As domestic savings rise, a younger population will likely take more risk with its savings causing higher flows into riskier asset classes like equity shares.

- **Capital market infrastructure**: The starting point on capital markets is good relative to the physical economy, i.e., the financial economy seems more well developed than the physical economy. Evolution of this capital market infrastructure determines access to stock markets and influences the market's multiple.

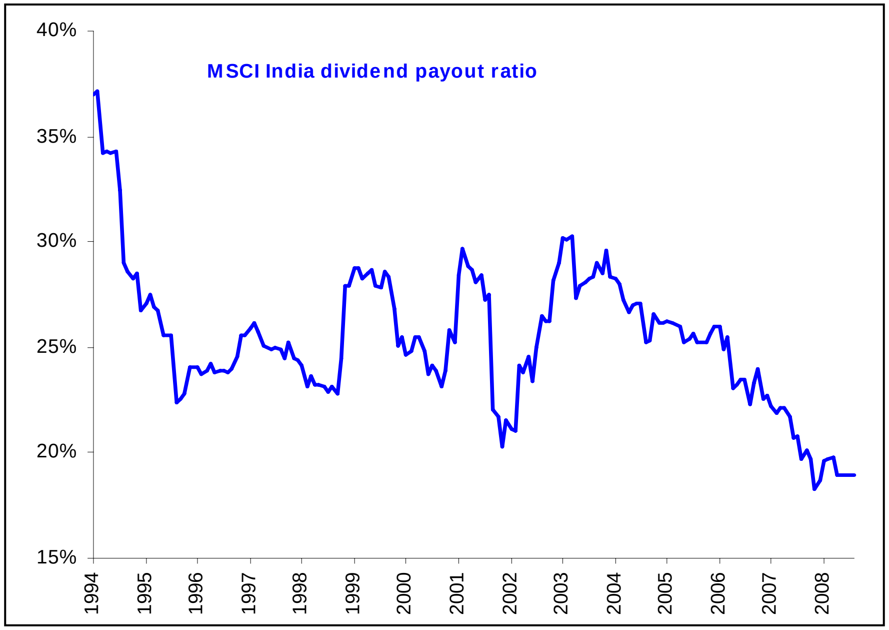
Demographic Dividend vs. Demographic Sword

The push and pull between a growing working population and India's capital needs will be key ingredients to the relative multiple. Ultimately, India's payout ratio will need to rise for a sustained P/E premium to emerging markets.

Rising Share of Working Age Population Will Driven Private Savings and Growth



Payout Ratio Needs to Rise

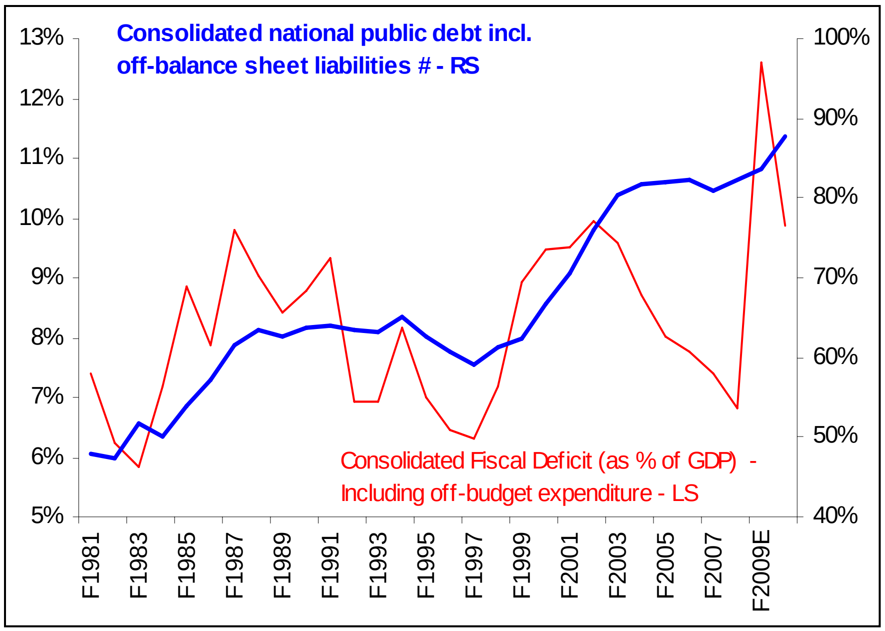


Source: CSO, UN, FactSet, MSCI, Morgan Stanley Research E= United Nations Research Estimates

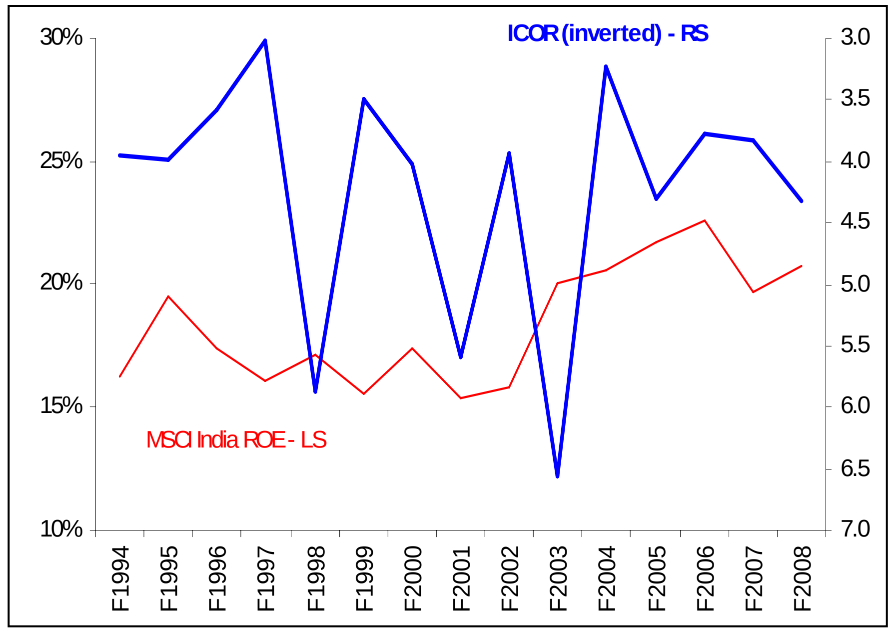
Fiscal Consolidation and Capital Efficiency

The fiscal deficit (read politics) will drive the cost of capital whereas capital efficiency at the macro level will drive the return on capital. The gap between the two will influence the sustainable P/E multiple.

Fiscal Deficit => High Cost of Capital



Capital Efficiency =>High ROE

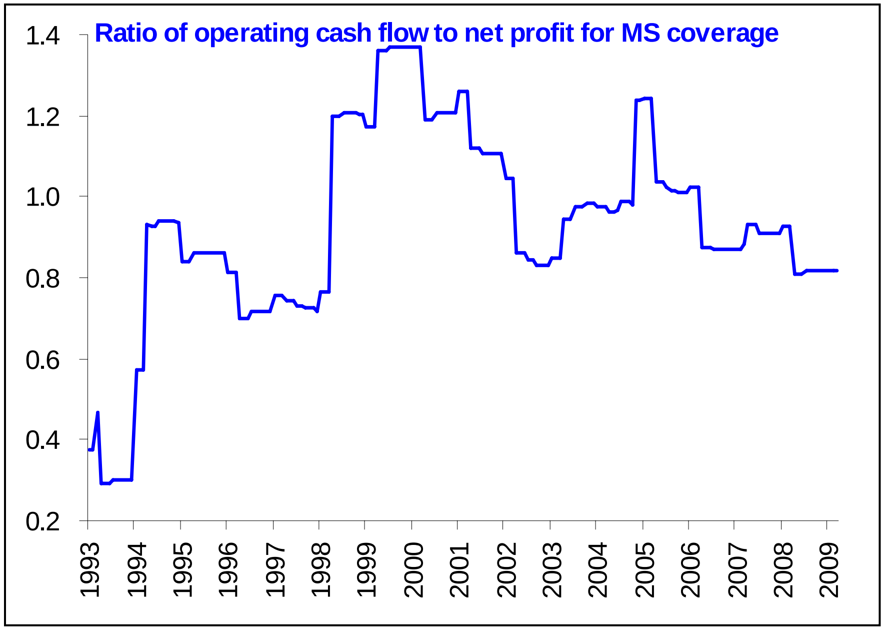


Sources: FactSet, MSCI, RBI, Economic Survey, Ministry of Finance, Morgan Stanley Research; E= Morgan Stanley Research Estimates # If off-balance sheet liabilities were funded by direct government borrowing. Note that this is just an estimate to illustrate the impact of off-balance sheet expenditures and should not be construed as an outstanding government liability.

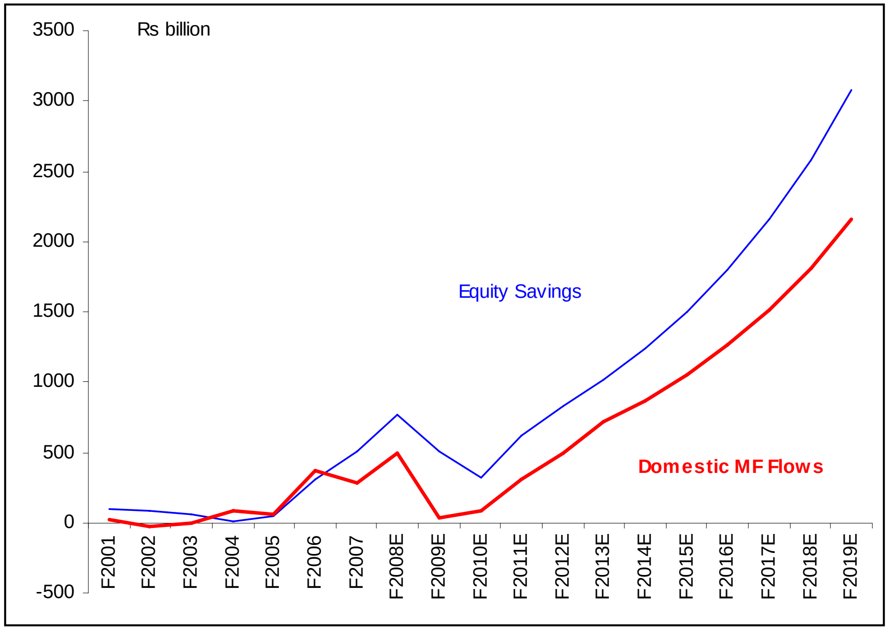
Corporate Governance vs. Structural Liquidity

Corporate governance and capital market infrastructure drive equity risk premium or cost of capital whereas the savings in equities can be a balancing force.

Earnings Quality is an Issue, At least Cyclically



Equity Savings Outlook Seems Bright

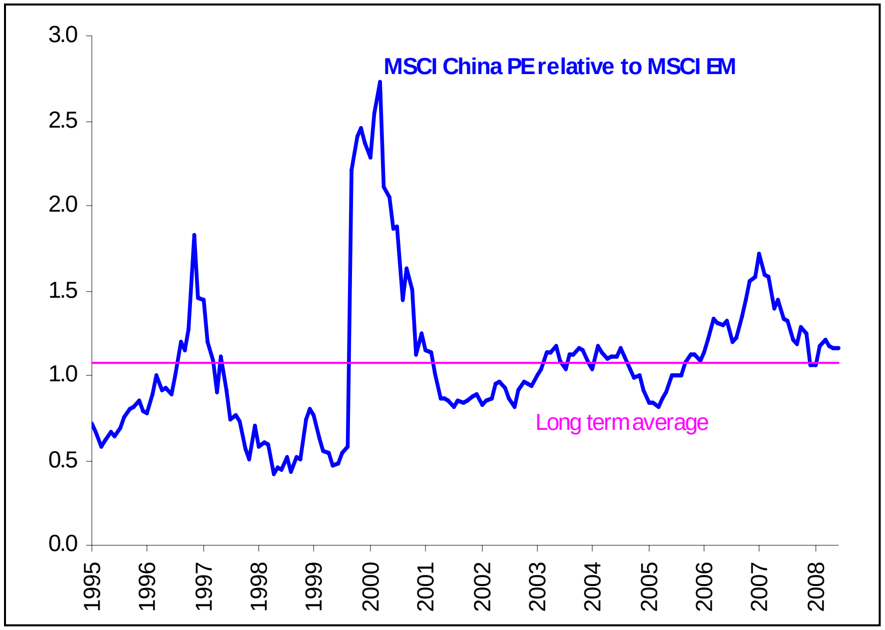


Sources: AMFI, Morgan Stanley Research

The Lesson From China and Beyond

China's average P/E premium over emerging markets has been no different from India's over the past 15 years even though its economic growth has been far superior. The lesson is that growth alone is not the panacea for a sustained premium multiple. A glance at the sectoral P/Es suggests that India's P/E premium to EM will struggle to average higher than its current level of 20% over the long term. A more plausible long-term average could be in the teens, which would still be better than the 7% average of the past 15 years.

High Economic Growth ≠ Premium P/E



Sectoral Composition: Limited Room for Maneuverability

P/E	Current MSCI India	Current MSCI EM	India's PE Rel to EM	MSCI India wt	MSCI EM wt
Consumer Discretionary	11.0	10.6	1.0	3.9	4.8
Consumer Staples	22.8	16.8	1.4	7.8	5.3
Energy	13.4	6.1	2.2	23.7	16.0
Financials	11.5	9.3	1.2	20.1	21.6
Health Care	15.1	18.5	0.8	3.9	2.8
Industrials	14.4	8.9	1.6	8.6	7.4
Technology	10.6	11.0	1.0	14.0	12.5
Materials	3.9	6.9	0.6	8.1	13.4
Telecom	7.3	10.4	0.7	2.4	12.2
Utilities	13.7	13.7	1.0	7.5	4.0

Sources: FactSet, MSCI, Morgan Stanley Research

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