

March 1, 2011

India Strategy

The Inflation Conundrum: Corporate India's Perspective

- **Key Debate:** Is high headline inflation hurting corporate margins and hence corporate profits?
- **Our Conclusion:** Companies either start adding capacity and protect volume growth or start pushing prices higher to regain gross margins. The former is what we are betting on, and will be good for the markets, in our view, since final product inflation remains reigned in and profit growth comes through. An aggressive focus on the latter will push inflation higher, causing growth to slow eventually and is not good news for the market.

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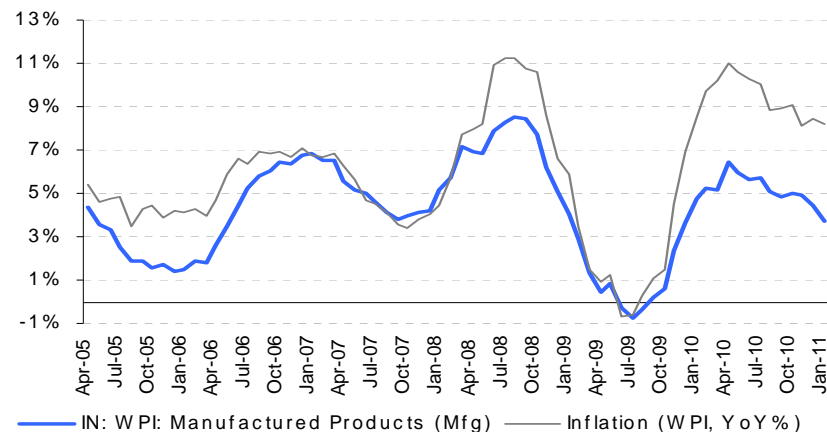
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Manufactured Product Inflation Has Been Low

First, let's delve into India's inflation. The WPI index (current print 8.2% and the most widely tracked inflation index), consists of three key components – primary articles (weight: 20%), fuel (weight: 15%), and manufactured products (weight: 65%). Headline inflation is above its trailing five-year average (of 6.3%), but is largely driven by food and fuel. Indeed, manufactured product inflation (which affects corporate gross margins) is at 3.8%, below its trailing five-year average of 4.6%. Thus, Corporate India does not have a detrimental “high inflation” environment as far its gross margins are concerned.

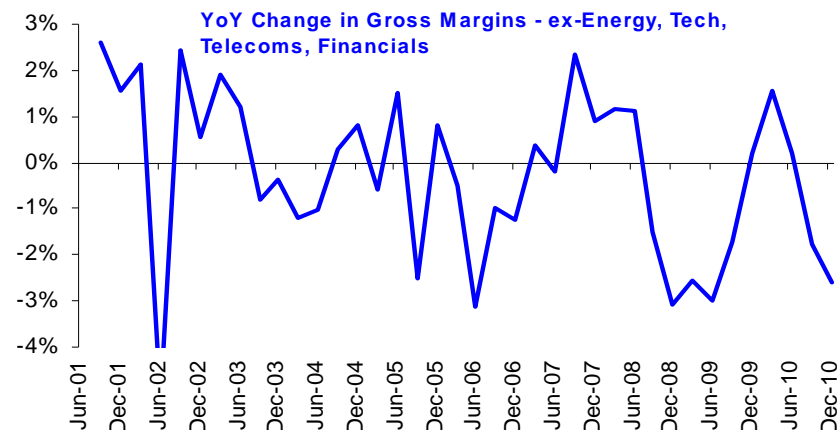
Headline Inflation Hides the Lack of Manufactured Product Inflation



Lack of Pricing Power Hurts Margins

The low level of inflation in manufactured products implies that rising raw material costs are not finding their way into prices of semi-finished goods. It also possibly explains why gross margins for Corporate India (using Morgan Stanley's Coverage Universe) have dropped to close to an all-time low, signifying the lack of pricing power.

Pricing Power Drops Further

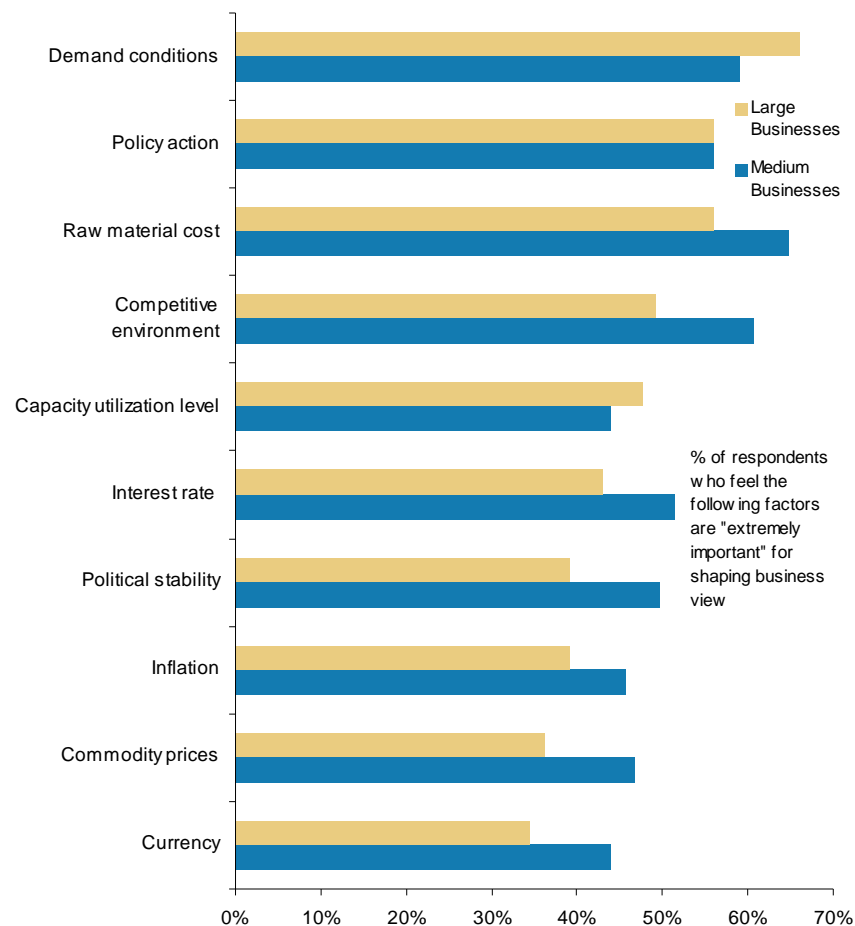


Source: Company data, Morgan Stanley Research

Macro Indicators that Businesses Watch Out for in Their Business Decisions

This lack of pricing power has to be seen in the context of rising capacity utilization and reasonable underlying growth (corporate revenue growth for the quarter ended December 2010 was 19%) It probably adds to the reasons why companies are not building capacities. Our AlphaWiseSM survey of companies points out that companies rely on six indicators for business confidence: demand conditions, policy action, raw material costs, competitive environment, capacity utilization and interest rates. One can say that not all these six factors are decidedly in favor of businesses.

Business Decision Drivers Different for Large and Medium Companies



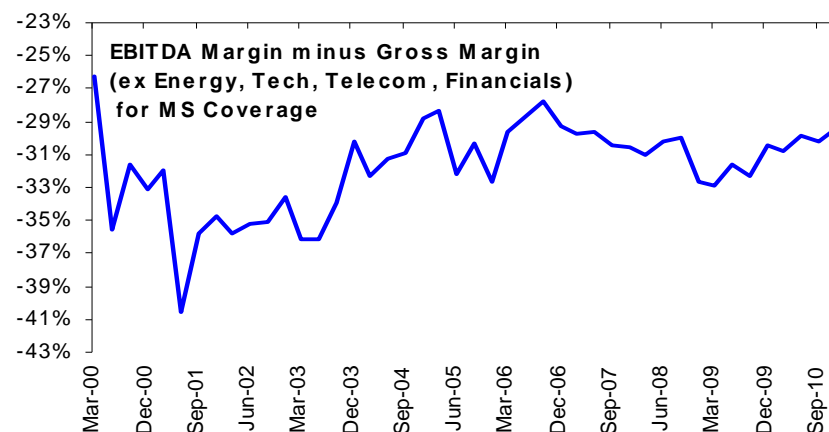
Source: Morgan Stanley AlphaWiseSM

Operating Leverage Is High

Another theory could be that companies are protecting profits by focusing on volume growth rather than pricing power. Given the high levels of operating leverage, this makes sense to us. However, rising utilization levels should lead to more capex, otherwise companies will soon run out of volume growth.

Something has to give in the current scenario. Companies will either start adding capacity and protect volume growth or start pushing prices higher to regain gross margins. The former is what we are betting on, and in our view will be good for the markets since final product inflation remains reigned in and profit growth comes through. An aggressive focus on the latter will push inflation higher, causing growth to slow eventually and is not good news for the market

Operating Leverage Is High





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Total	2,906		1028		

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