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Continue Buying Industrials: Private Corporate Capex May Have Troughed

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- **The Debate: Will Private Corporate Capex Recover Soon?** Most investors reckon that infrastructure capex is likely to rise in the coming three to five years. This is one of the strongest themes in India, and accordingly industrial stocks have outperformed the market year-to-date by nearly 30%. However, the jury is still out on whether private corporate capex (which was the key reason behind the peak in the previous investment cycle) is likely to recover in a hurry. After all, the elevated levels of capital spending in the previous cycle has probably led to excess capacity creation, and growth is perceptibly lower than the previous cycle, implying that excess capacity may persist for some time. However, we believe that the trough in corporate capex may be behind us. We see both supply- and demand-side factors supporting a recovery in private capex in the coming 12-24 months. This is probably still not priced into industrial stocks, and hence we expect industrials to continue their outperformance versus the market in the coming months.

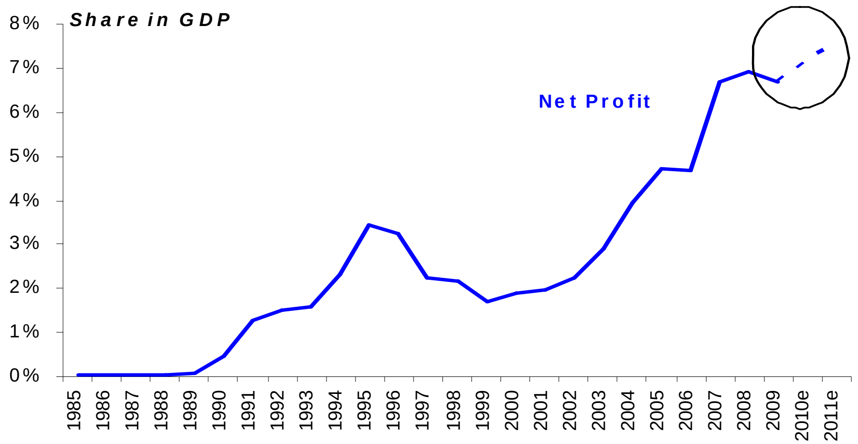
- **Eight Factors Supporting a Recovery in Private Capex Beyond F2010:** Our analysts expect capex to continue to decline in F2011, whereas our top-down analysis suggests that capex will likely trough in the current financial year:

  - Corporate profits are on a recovery path after consolidating over the past 12 months.
  - Capital is cheap. With equity multiples rising and interest costs relatively benign, the cost of money is well off the highs and below the average for the past five years.
  - The supply of capital is set to rise after a steep decline in 2008. The election results changed the medium-term outlook for capital flows into India. The recovery in global financial markets is also helping.
  - Corporate balance sheets are in great shape on an aggregate basis.
  - Debt issuances have recovered. The cash costs associated with debt in the form of interest payments and principal repayments mean that companies do not usually issue debt unless it is being put to use for cash flow generation (either capex or working capital).
  - Capex has declined quite sharply post its peak. In F2010, the aggregate capex by the companies in our coverage universe will likely revert to the F2006 level, and around 15% below historical averages. Indeed, capital spending is forecast to decline in absolute terms in F2010, and that has happened only once before (F1996).
  - Corporate activity has dipped to all-time lows on almost all counts. This is indicative of weak corporate psychology, which is usually a good turning point for capital spending.
  - Industrial growth is ahead of expectations and this, combined with favorable supply-side factors, may trigger a recovery in capital spending.

- **Investment Implication – Continue to Buy Industrials**: Industrial stocks lead industrial growth. We expect industrial growth to continue to rise in 2010, and that augurs well for industrial stocks. Valuations are at average levels whereas earnings revisions continue to be strong. We would argue for premium valuations as the capital spending cycle gains momentum. Infrastructure capex is likely to support earnings and, if private corporate capex is troughing as we argue, then industrials will likely continue to outperform. We are overweight the sector and our favorite stocks are Larsen and Toubro (LART. BO, Rs1,683) and Jaiprakash Associates (JAIA.BO, Rs237).

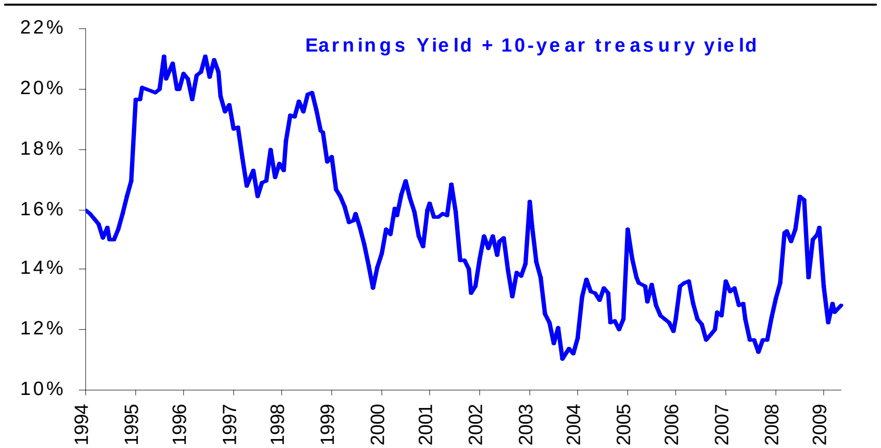
Supply-side Factors Favor Recovery in Capex

Corporate Profits Have Troughed

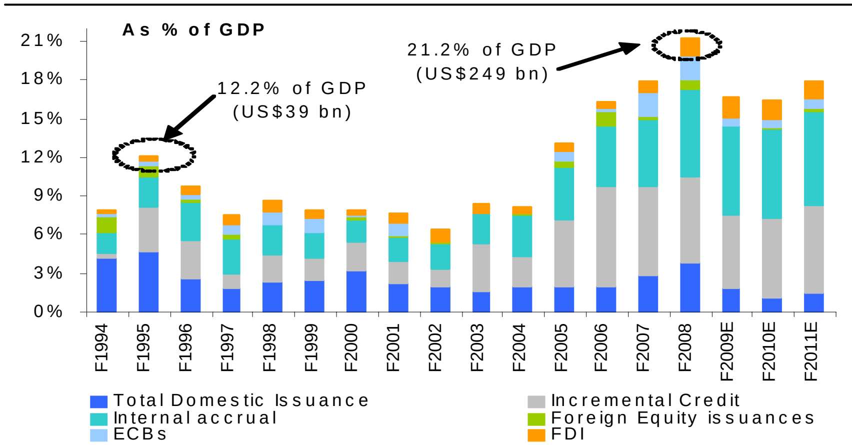


- The key supply-side factors driving private corporate capex are in a good shape. Thus, corporate profits are on a recovery path after going through some consolidation over the past 12 months. Capital is cheap. With equity valuation multiples rising and interest costs relatively benign, the cost of raising money is well off the highs and below the average for the past five years. Most important, the supply of capital is set to rise after a steep decline in 2008. The election results changed the medium-term outlook for capital flows into India. The recovery in global financial markets is also helping. Our economist Chetan Ahya forecasts that aggregate capital flows will likely revert to F2007 levels by F2011 (18% of GDP).

Capital Is Cheap



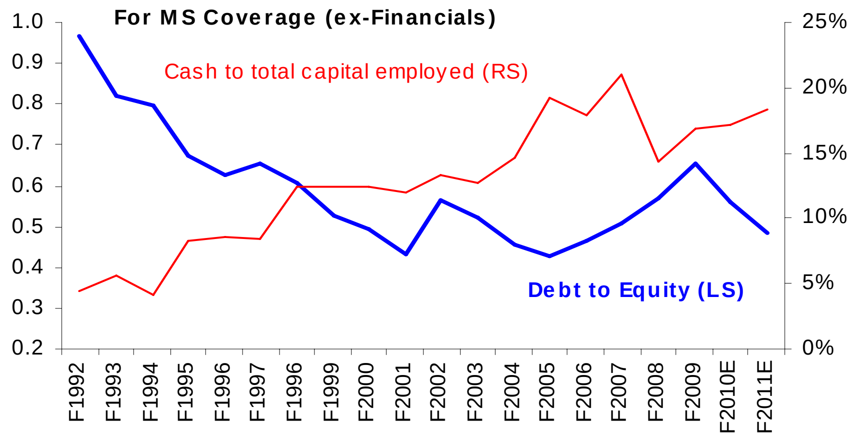
Capital Supply Likely to Rise



Source: RBI, DIPP, CMIE, Capitaline, Bloomberg, Morgan Stanley estimates, Morgan Stanley Research

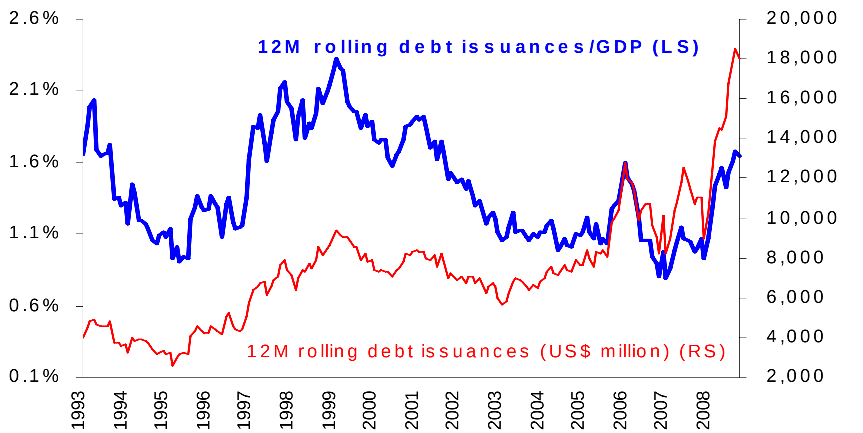
Supply-side Factors: Improvement in the Numbers

Corporate Balance Sheets: Fit and Fine

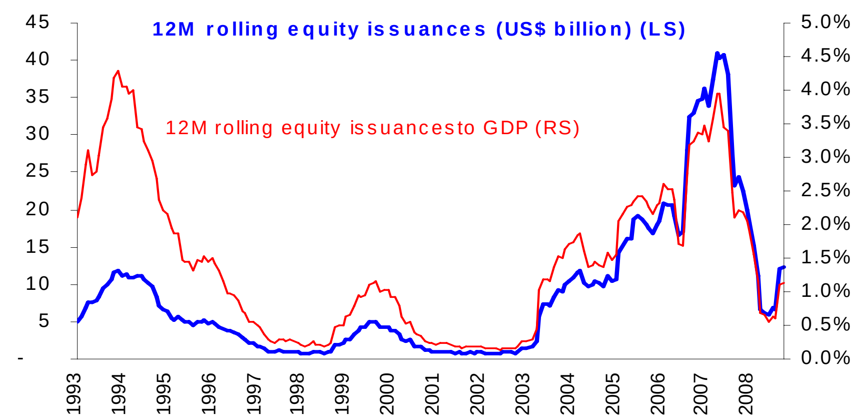


- Corporate balance sheets remain in the pink of health save for a few companies. Some of these companies that have been under stress have recapitalized balance sheets. The key metric to track is the increase in debt issuances, which suggests that companies may be gearing up for increased spending. No doubt equity issuances have picked up pace. Collective corporate psychology is that equity is free given that equity capital does not entail a fixed cash flow obligation. While the issuance of equity is closely linked to the cost of equity (i.e., valuations), companies rarely issue debt just because it is cheap. The cash costs associated with debt in the form of interest payments and principal repayments mean that companies do not usually issue debt unless it is being put to use for cash flow generation (either capex or working capital).

Debt Issuances Have Surged



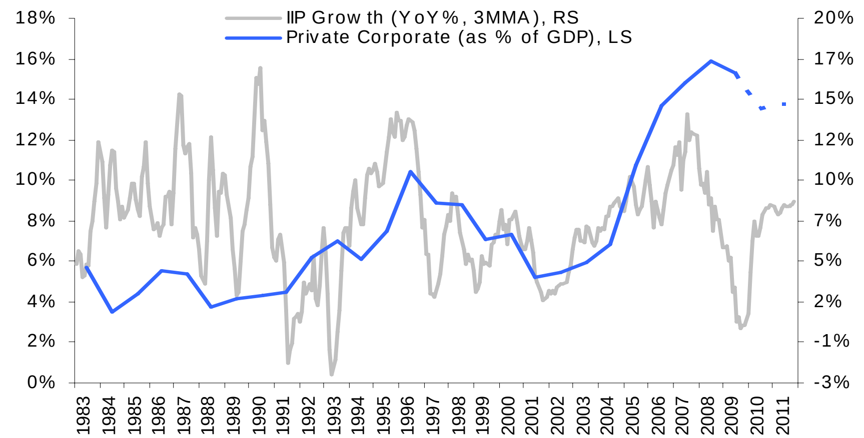
Improving Appetite for Equity Issuances



Source: Company data, CMIE, Morgan Stanley Research E: Morgan Stanley estimates

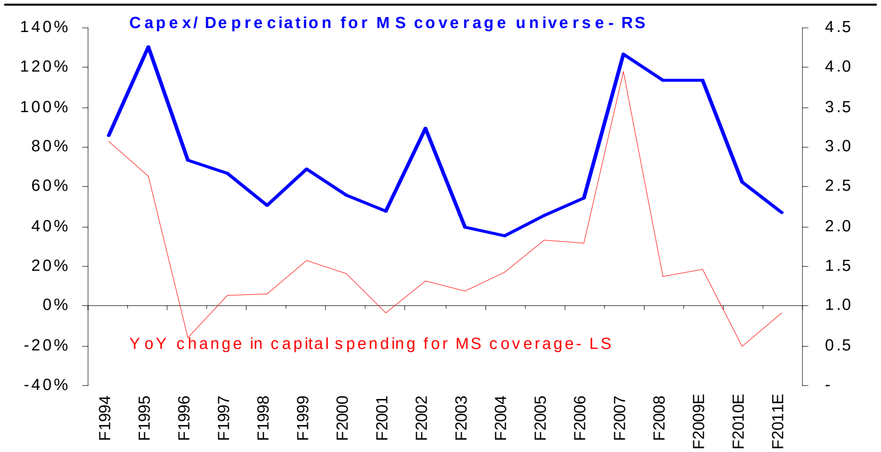
Demand Side Supportive of Capex Trough

Output Gap Could Close Faster than Expected



- The big problem for a recovery in private capex cycle is the excess capacity created during the previous cycle. Indian companies built capacity for 8%+ GDP growth. To the extent that we will not see a return to this growth rate in the coming quarters, there may still be some excess capacity in the system. The good news is that industrial growth is coming ahead of expectations, and this, combined with favorable supply-side factors, may trigger a recovery in capital spending. The other thing to note is that capex has declined quite sharply post its peak. In F2010, the aggregate capex by the companies in our coverage universe will likely revert to F2006 levels and around 15% below historical averages. Indeed, capital sending is forecast to decline in absolute terms in F2010, which has happened only once before (F1996). The decline is fairly broad-based if we use our analyst estimates, with the exception of the Materials sector. Our analysts expect capex to continue to decline in F2011, whereas our top-down analysis suggests that capex will likely trough in the current financial year.

Private Capex Collapsing in F2010



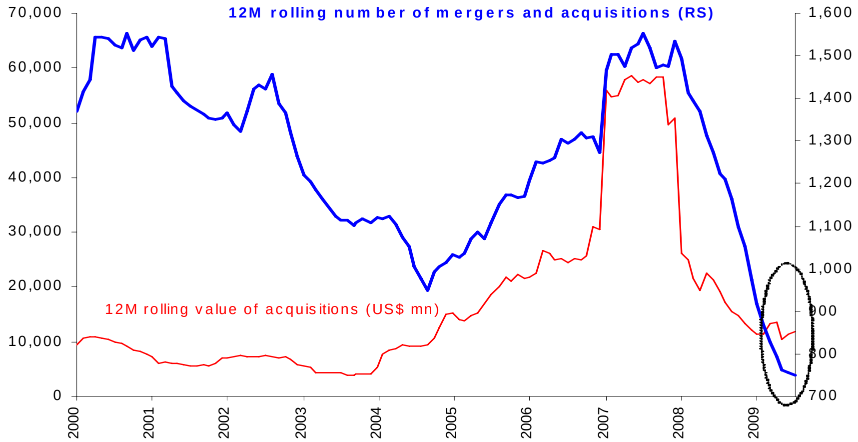
Broad-based Decline in Capex

Capex to Dep	Avg F93 to F07	F2007	F2010E	F2011E	Change (F11 over F07)
Cons. Staples	1.93	3.44	2.28	2.37	-31%
Cons. Disc.	1.58	5.30	3.04	2.21	-58%
Energy	1.75	3.96	2.21	1.65	-58%
Healthcare	2.48	4.00	1.22	1.20	-70%
Industrials	1.98	4.90	3.84	2.03	-59%
Materials	1.32	2.73	2.78	3.59	31%
Technology	1.28	2.52	0.93	1.52	-40%
Telecom	1.16	4.97	2.65	1.58	-68%
Utilities	1.60	4.74	3.26	7.12	50%
Total	**1.64**	**4.16**	**2.49**	**2.26**	**-46%**

Source: Bloomberg, CEIC, Morgan Stanley Research E = Morgan Stanley Research estimates

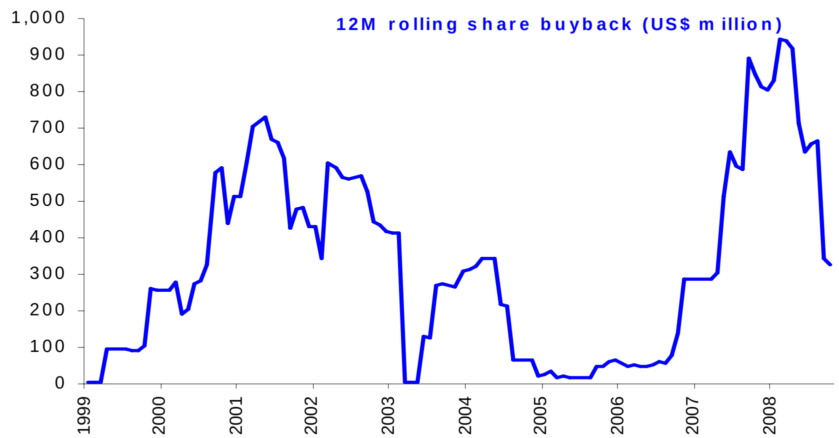
Most Measures of Corporate Activity at a Low Point

M&A: A Complete Collapse

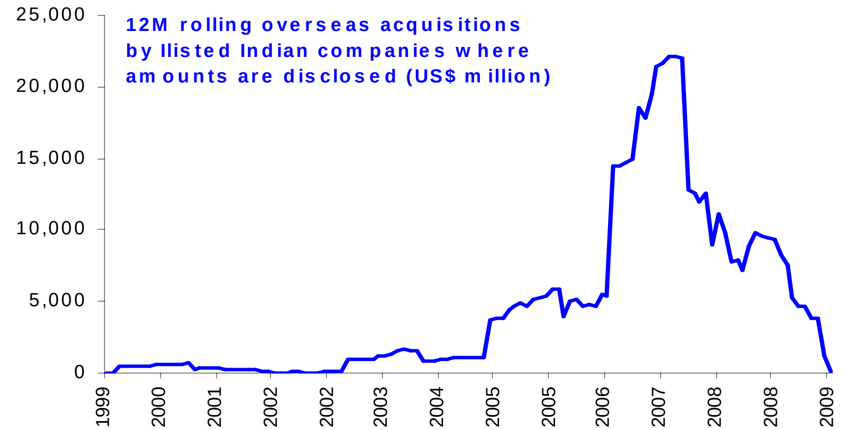


- We like the fact that corporate activity has dipped to all-time lows whether measured by direct capital spending or by M&A/buy-back programs. Of course, corporate psychology is weak, and will need to recover for a full-blown capex cycle. However, we see this as a good indicator for a bottom in capital spending and the start of a new cycle.

Share Buyback Coming Off the Highs



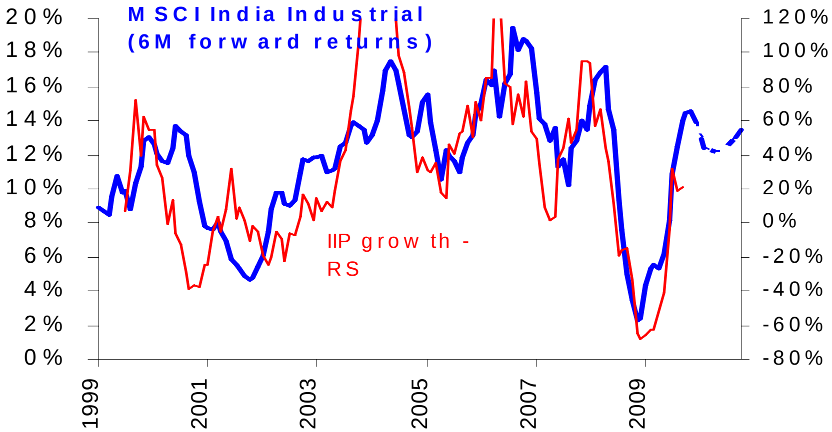
Overseas Investments: The Frenzy Has Died



Source: FactSet, CMIE, Bloomberg, Morgan Stanley Research

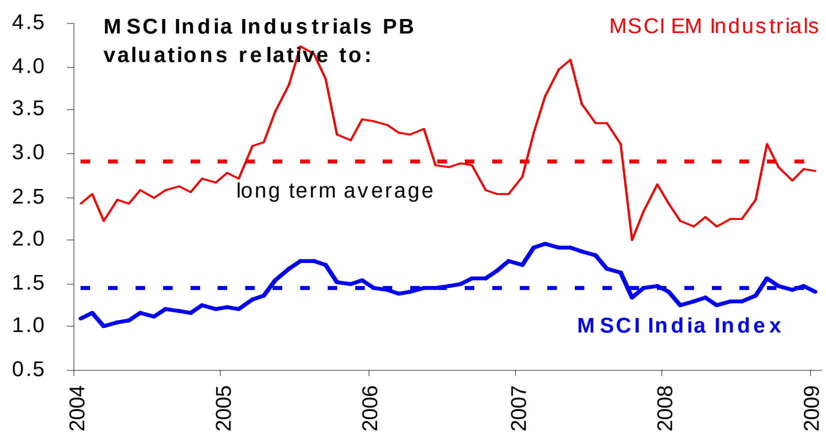
Continue to Buy Industrials

Industrial Stocks: IIP Growth - A Key Performance Driver



- Industrial stocks lead industrial growth. We expect industrial growth to continue rising into 2010, and that augurs well for industrial stocks. Valuations are at average levels whereas earnings revisions continue to be strong. We would argue for premium valuations as the capital spending cycle gains momentum. Infrastructure capex is likely to support earnings and, if our thesis that private corporate capex is troughing is right, then industrials will likely continue to beat the market for the coming months. We are overweight the sector and our favorite stocks are Larsen & Toubro and Jaiprakash Associates.

Industrial Sector: Valuations Around Average



Positive Earnings Revisions Likely to Continue

	F2010e			F2011e		
	1M	3M	6M	1M	3M	6M
Cons. Disc	1%	-1%	-7%	1%	11%	17%
Cons. Staples	1%	2%	2%	1%	3%	4%
Energy	2%	8%	14%	2%	2%	11%
Financials	1%	4%	7%	0%	4%	14%
Healthcare	-1%	-6%	-6%	-1%	-4%	-4%
Industrials	0%	8%	13%	1%	4%	20%
Materials	0%	9%	23%	2%	10%	30%
Technology	1%	11%	6%	1%	15%	13%
Telecom	0%	2%	2%	0%	-1%	0%
Utilities	1%	4%	7%	2%	5%	9%
MS Coverage	**1%**	**6%**	**10%**	**1%**	**5%**	**13%**

Source: Bloomberg, FactSet, MSCI, IBES, CEIC, Morgan Stanley Research

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Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
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Equal-weight/Hold	**1,062**	**46%**	**316**	**49%**	**30%**
Not-Rated/Hold	**26**	**1%**	**3**	**0%**	**12%**
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Total	**2,305**		**645**		

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