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India Strategy

Road to 50K

Conclusion: 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, the BSE Sensex (used as a market proxy) could take almost 13 years to breach 50,000 from its current level. If the assumptions are optimistic, the period to 50K shrinks to under ten years.

What's New: 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. 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.

Implications: That the long-term return implied by the BSE Sensex using our residual income model is 11% under the most probable outcome is not a source for comfort since this return may not be able to compensate investors for the risks involved in investing in India. However, this return appears consistent with the current low levels of risk appetite still making Indian equities attractive in the context of current high levels of risk love. If things turn for the worse, the probability of which appears to be higher than usual, long-term returns could end by being just a tad better than the yield offered by government long bonds. For investors to be compensated with the return and risk premium they deserve (which we think is 14% given the risks associated with Indian equities), the critical success factors listed above may have to exceed our most bullish assumptions over the coming years.

Financial Leverage, Asset Turn, Margins and Growth – The Obvious Key Ingredients

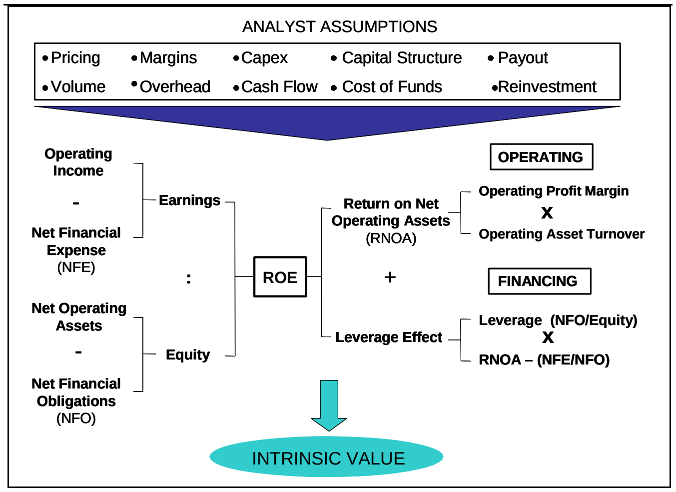
India brings to the table four advantages that are long-term value drivers for equities. The macro story lends itself to strong dividend growth, with falling volatility in dividend growth. The demographic story could translate into a favorable structural liquidity story, while robust capital market infrastructure allows investors to leverage India's ROE-obsessed entrepreneurs. However, the equity market's long-term outlook is being vitiated by rich current valuations. This effectively pushes down long-term return – pretty much consistent with the low equity risk premium that investors seem to be seeking in a world that is abundant with risk appetite.

The question that comes to mind is 'how will the BSE Sensex (as a market proxy) perform over the coming years?'. The answer to this question, we think, lies in our residual income model for the aggregate of the BSE Sensex constituents (see *An Approach to the Market's Fair Value*, dated November 29, 2006). The residual income model is anchored around the dynamics of value creation – i.e. excess return. Excess return, in turn, is a function of the spread between ROE and the expected return or cost of equity. ROE is driven mainly by revenue growth, operating margins, asset turn and capital structure (Exhibit 1).

The most important ingredient is revenue growth, which will likely be a direct function of domestic nominal GDP growth, but may also be influenced by the pace at which Indian companies globalize (larger companies could be better at this). We think that, for India's top 30 companies (which is what the BSE Sensex represents), revenue growth will exceed GDP growth (we assume 5% excess growth in the decade beyond the next three years of explicit analyst forecasts). On the other hand, Indian companies will likely have to give up margins to achieve this growth. For one, wage growth could be much sharper than the trailing three or four years. Second, gross margins will likely decline to reflect a structural fall in inflation rate coming out of lower tariffs, slower depreciation in the currency and narrowing infrastructure inefficiencies. Third, the depreciation rate will have to rise since we reckon that Indian companies are currently underinvested and are also possibly overestimating the life of the assets on their balance sheet (see *India's Secret Sauce*, dated January 15, 2007).

Similarly, asset turn may decline from its current heady level. The present picture on asset turn looks brighter than the sustainable one, given that it comes off an underinvested balance sheet. The underinvestment is relative to potential

Exhibit 1
The Dynamics of Value Creation



Source: Morgan Stanley Research

demand and is now showing up in the current account and in consumer price inflation. It goes without saying that sustaining higher GDP growth will require more investment than corporations have put to work over the past five years and, hence, lower asset turn. Part of the decline in fixed asset turn could be offset by a slight improvement in working capital turnover as infrastructure bottlenecks recede.

Of all the ROE drivers, Indian corporations have the most flexibility on capital structure. While we are assuming that companies will hold debt-equity constant at F2009E levels (at 23%), the fact is that these levels may still indicate under-gearing, leaving room for aggressive debt issuance. Indian companies will need to increase balance sheet leverage if they are unable to deliver the operating metrics or ROA to ensure that excess returns do not fall below market expectations.

High Risk Love Distorts Intrinsic Worth of Indian Equities

Excess return, in our view, could be more sensitive to the right hand side of the excess return equation – i.e. the cost of equity or expected return. Top down, we think Indian equities have benefited immensely from the drop in equity risk premium (ERP). The declining price of risk is suggestive of a moderating view on the volatility in future cash flows or dividend growth. A drop in ERP makes future cash flows more valuable than before. However, it also implies that the volatility of future dividends or cash flow growth will be lower. Expected volatility in cash flow growth should be differentiated from the expected growth in cash flows – i.e. growth expectations can still be high, which is not inconsistent with India's long-term story, but that does not necessarily mean that these cash flows will not exhibit volatility normally associated with a developing economy such as India. That said, the lack of risk aversion or the change therein is not specific to India and is a pervasive global phenomenon. The dramatic moves in ERP over the past few months underpin the market's dilemma about the volatility of future cash flow growth. The market's changing view of expected volatility in future cash flow growth has produced exaggerated effects on share prices and will probably continue to do so in the foreseeable future.

All this said, there has been some structural decline in ERP related to the cumulative effect of reforms over the past 15 years and the evolution of demographics. In our base case, we think that investors deserve a premium of 6% over the risk-free rate – or, put another way, a return of 14% from Indian equities (6% risk premium plus 7.9% risk-free rate as in the 10-year government bond yield). Our base case assumptions imply that the BSE Sensex will need less than 13 years to reach 50,000. This implies an annual return of 10.4% from current levels for the next 13 years (Exhibit 2). If we alter our assumptions (on ROE and expected return) to the bull case, the BSE Sensex reaches 50,000 in just under ten years with an implied compounded annual return of 13.5% – just about the return that we think investors should expect based on the risk profile of the Indian equity market. If things turn bad, returns could shrink to annual rate of 8.6%, implying that it would require more than 15 years for the BSE Sensex to reach 50,000. An 8.6% return would represent a meager premium over the risk-free rate and we would advocate that investors avoid equities under such circumstances.

In conclusion, while the returns implied by the market (BSE Sensex) in our base case do not seem inconsistent with current levels of risk love (and hence risk appetite), they may not be high enough to compensate equity investors for the real vagaries or risks in India's equity markets.

Exhibit 2

BSE Sensex: Key Value Drivers

	Base Case	Bear Case	Bull Case
Ist Stage F2007 to F2009	MS analysts' est	MS analysts' est	MS analysts' est
2nd Stage F2009 to F2019			
Revenue growth	5% premium to nominal GDP growth (16%)	1% lower than base case (15%)	1% higher than base case (17%)
EBIT margin	Annual fall of 20 bps over F2009 level	Annual fall of 30 bps over F2009 level	F2009 level sustained
Average interest cost	At F2009 level (6.6%)	50 bps higher than base case (7.1%)	50 bps lower than base case (6.1%)
Tax rate	22%	22%	22%
Asset Turn (over F09 level)	Annual increment of 0.01 Over F2009 level of 0.9	Annual decrease of 0.005 over F2009 level of 0.9	Annual increment of 0.02 over F2009 level of 0.9
Debt to Equity	Held constant at F2009 level (23%)	Held constant at F2009 level (23%)	Held constant at F2009 level (23%)
Terminal growth rate	6.0%	5.5%	6.5%
Implied terminal value multiple	14.3	12.6	16.7
Equity Risk Premium	6.0%	6.5%	5.5%
BSE Sensex Fair Value (as at December 2007)	11,485	7,842	16,926
Years to 50,000 Sensex	12.7	15.2	9.9
Implied CAGR in returns	10.4%	8.6%	13.5%

Source: Morgan Stanley Research estimates

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