Indian Economy Thematic

Five megathemes which will dominate the next five years

The five megathemes that will characterize the Indian economy over the next five years are the persistence of high inflation, the rise of the "aspirational consumer", a capex boom, the rise of financial intermediation and the spread of social unrest and civil conflict. The sectors best placed to benefit are NBFCs, Aspirational Consumer Goods manufacturers and Capital Goods providers. The sectors which stand adversely exposed are export oriented ones, particularly IT.

Narratives on India, especially those written in a rising stock markets, tend to paint a picture of a country with limitless investment opportunities. Whilst we believe that there are several structural drivers of such opportunities (for example, the economic and demographic boom which is driving a **surge in aspirational spending** on goods as diverse as cars, LCDs, designer underwear, jewellery and high protein food – see pg 14), we also highlight in this note several major qualifiers to these opportunities. In particular, the biggest negatives for India are **structurally high inflation** (see pg 5) which will consistently erode profit margins of all but the strongest companies and **rising social unrest** and civil conflict (see pg 33) driven by deep rooted divisions in Indian society.

Amidst these conflicting forces, the best positioned sectors are:

- **NBFCs**: Not only are NBFCs well placed to benefit from the surge in household financial savings, they are also the least exposed to high structural inflation (see pages 10 & 28 for details).
- **Aspirational Consumer Goods manufacturers**: The high share of youth and rising affluence suggest that consumer goods with an "aspirational" spin will outperform essentials (see pg 18 for details).
- **Capital goods manufacturers**: Cross-country experience suggests that India is primed for a capex boom. Capital goods manufacturers stand to benefit most from this development (see pg 25 for details).

The sectors most adversely exposed are export oriented ones (and particularly **IT**) as high inflation, high interest rates (which are likely to prevail to dampen such inflation) and a strong rupee are likely to combine to erode their competitiveness. See pg 13 for details.

Sectors where the prognosis is more mixed are:

- **Banks:** Whilst banks are well-placed to gain from the rise of financial intermediation, high structural inflation will be a clear headwind on account of exposure to high employee costs (see pages 10 & 28 for details). However, historical evidence suggests that banks outperform in a high inflation environment.
- **Mining & metals:** Escalation of the Maoist insurgency in the mineral-rich areas of India spells headwinds for this sector. However, if you believe global commodity prices are set to rise then this sector is the obvious hedge against inflation (see pages 11 & 35 for details).

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Reccommendations based on Megathemes

NBFCs	Analyst : Krishnan ASV Phone : +91-2230433216		
Company	Mkt Cap ($ mn)	ADV ($ mn)	Stance
Shriram Housing Transport Finance (SHTF)	4,200	6	Buy
M & M Financial (MMFS)	1,700	3.9	Buy

Aspirationals	Analyst : Vijay Chugh Phone : +91-2230433054		
Company	Mkt Cap ($ mn)	ADV ($ mn)	Stance
Titan (TTAN)	3,669	11.7	Buy
Bajaj Auto (BJAUT)	10,039	16.5	Buy

Banks	Analyst : Krishnan ASV Phone: +91-2230433216		
Company	Mkt Cap ($ mn)	ADV ($ mn)	Stance
Bank of Baroda (BOB)	7,752	9.3	Buy
City Union Bank (CUBK)	435	1.9	Buy

Source :Bloomberg, Ambit Capital Research
Note : ADV is for a 6 month period

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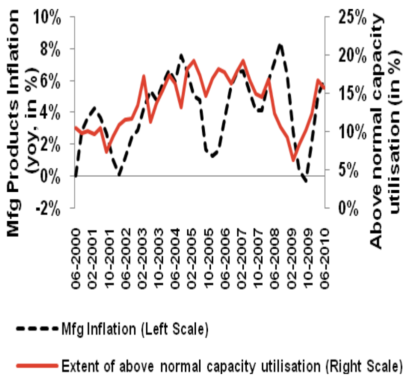
Executive summary

Exhibit A : Manufacturing inflation spikes when capacity utilisation rises



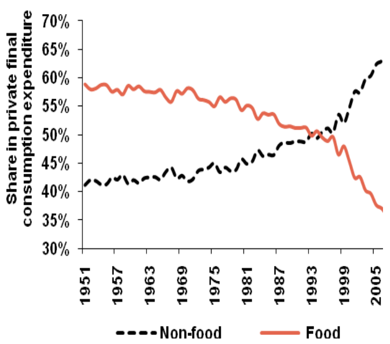
Source : RBI, CSO, Ambit Capital Research

Exhibit B : High inflation crunches stock returns

(Average monthly returns in %)	High Inflation	Low Inflation
Sensex	0.8	2.9
BSE 100	0.7	3.2
BSE 200	0.8	3.3
BSE 500	0.8	3.4

Source: BSE, Ambit Capital Research, Period under study: CY01-10 where high inflation is defined as WPI based monthly inflation ahead of 5% yoy

Exhibit C : Indian's spend more of their wallet on non-food items



Source: CSO, Ambit Capital Research

Megatheme 1: Structurally high inflation (pg 5)

Supply constraints in India's manufacturing sector have historically caused core inflation to spike every time the economy expands rapidly (see Exhibit A on the left). Limited access to finance, hard infrastructure deficits and labour market issues have and will prevent timely supply responses in this demand powerhouse thus driving manufacturing inflation higher. Furthermore, a growing and young population with rising incomes will cause food demand to grow rapidly, while supply responses continue to be weak. This supply-demand mismatch will drive food prices higher over the next decade.

High inflation has historically been a negative for stock market returns (see Exhibit B on the left) as it crunches companies' margins through higher input costs. Financial services' companies emerge as being the most inflation-immune due to their limited exposure to employee costs as well as to raw material costs. Commodity-driven sectors emerge as an obvious hedge against higher commodities' prices. IT and other labour-intensive export-facing sectors appear to be the most vulnerable to high inflation as higher domestic wages erode their price competitiveness.

Megatheme 2: the rise of the "aspirational" consumer (pg 14)

As a country's per capita incomes rise, the consumption basket of its citizens changes away from food (see Exhibit C on the left) and essentials to non-food and aspirational items (such as cosmetics, motorbikes and jewellery). India's consumption basket has been undergoing just this sort of change. **Given the structural drivers of this trend (rising incomes, high share of youth and urbanisation), investors should focus on aspirational product manufacturers vis-à-vis essentials within India's broader consumption story. Exhibit 25 on pg19 gives a list of aspirational stocks. Exhibit 23 & 24 on pg 19 show the outperformance of aspirational stock vis-à-vis consumer essentials.**

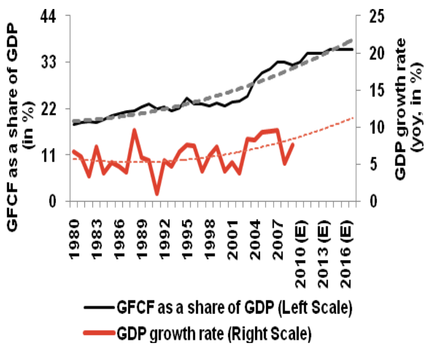
Megatheme 3: a capex boom in the making (pg 21)

The experience of India's Asian neighbours suggests that a high GDP growth rate coupled with the investment:GDP ratio hitting 33% triggers a surge in capex (see Exhibit D below). These trigger points along with India's infrastructure deficit and the Government's desire to address this deficit has set the scene for a seven year surge in capex. **History suggests that the Indian Capital Goods sector stands to gain most, both from profitability and from a stock price perspective, from this impending surge in capex.**

Megatheme 4: The coming of age of financial intermediation (pg 26)

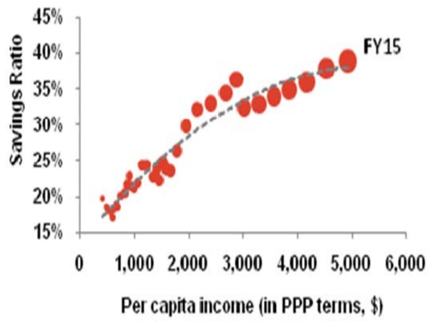
India's per capita income in PPP terms recently breached the $ 3K and its savings to GDP ratio stands at a healthy 32%. Cross country experience suggests that India's savings ratio should touch ~40% in FY15(see Exhibit E on the left) and will continue to rise until India's per capita income reaches $ 8 K

Exhibit D : India primed for a capex boom



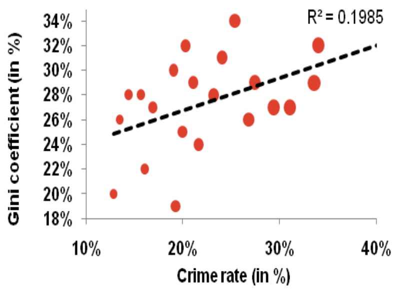
Source : RBI, CSO, Ambit Capital Research

Exhibit E : Savings ratio to hit ~40% by FY15



Source: IMF, Ambit Capital Research

Exhibit F : Positive relation between crime and inequalties



National Crime Records Bureau, Planning Commission, Ambit Capital Research, Data pertain to CY04

(in PPP terms) and will max out only at 46%. **The disproportionate rise in the quantum of India's savings over the next decade heralds tremendous opportunities for financial intermediaries as the Indian saver looks to channelize these savings into not just bank accounts but into stocks and bonds as well.**

Megatheme 5: India will become a hotbed of conflicts (pg 35)

Whilst the ongoing and widespread conflict in central India between the Indian establishment and Maoists generates headlines, we see a broader theme in these stray instances of conflict and expect their intensity to trend upwards over the next decade as inequalities persist.

As corroborated by cross country experience, the unequal distribution of gains of economic development across social groups and individuals will be the main driver of this trend (see Exhibit F on the left). A vast and stratified populace with a youth bulge will add to the conflict risk.

The escalation of the Maoist movement, indisputably the biggest threat to internal security will pose challenges for the Metal and Mining Sector (refer to Exhibit 59 on pg 36 for details of company-level exposure to Maoism). Security costs for the corporate sector as a whole will rise as crime rates and the frequency of conflict trends upwards. Indirect costs in terms of political donations, bribes and CSR initiatives will be the other head under which costs will rise. Additionally, the corporate sector will continue to partially fund the Government's fiscal transfers directed at rural India. FMCG and aspirational product companies stand to gain from these transfer payments.

Megatheme 1: Structurally high inflation

Summary: Supply constraints in India's manufacturing sector have historically caused core inflation to spike every time the economy expands rapidly. Limited access to finance, hard infrastructure deficits and labour market issues have and will prevent timely supply responses in this demand powerhouse thus driving manufacturing inflation higher. Furthermore, a growing and young population with rising incomes will cause food demand to grow rapidly, while supply responses continue to be weak. This supply-demand mismatch will drive food prices higher over the next decade.

High inflation has historically been a negative for stock market returns as it crunches companies' margins through higher input costs. Financial services' companies emerge as being the most inflation-immune due to their limited exposure to employee costs as well as to raw material costs. Commodity-driven sectors emerge as an obvious hedge against higher commodities' prices. IT and other labour-intensive export-facing sectors appear to be the most vulnerable to high inflation as higher domestic wages erode their price competitiveness.

Manufacturing and food to drive inflation higher

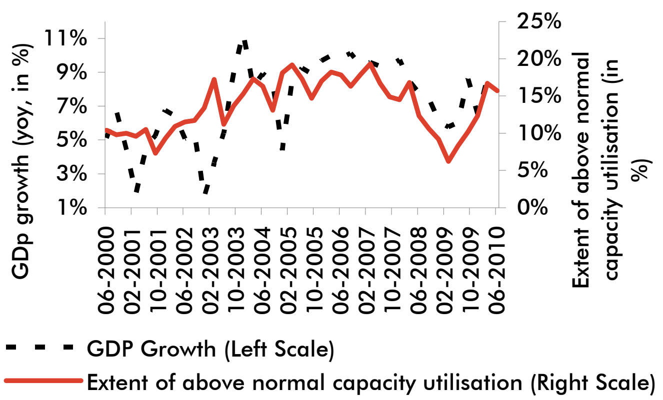
India being a 'supply' constrained economy is likely to face higher inflationary pressures in the oncoming decade as aggregate supply grows incrementally while demand grows rapidly. The continued growth of real domestic demand will be propelled by the rise of incomes (India's per capita GDP has grown at 7% p.a. over the past two decades) as well as the persistence of the youth bulge (nearly 50% of the total populace in India lies in the age group of 0-24 years). This interplay between burgeoning aggregate demand and weak supply growth will be particularly evident in the manufacturing and food space – two sectors where the price dynamics are largely domestic. These two sectors together account for nearly 70% of the wholesale price index (WPI is India's headline inflation metric) basket and structural supply deficiencies in each of these will drive inflation higher over the next decade.

Inflation in manufactured goods

Manufactured products (excluding food and metals) account for 44% of the WPI basket

The presence of supply constraints in the manufacturing sector in India is most evident when capacity utilisation levels are looked at against the backdrop of GDP growth and inflation (see Exhibit 1 & 2 below).

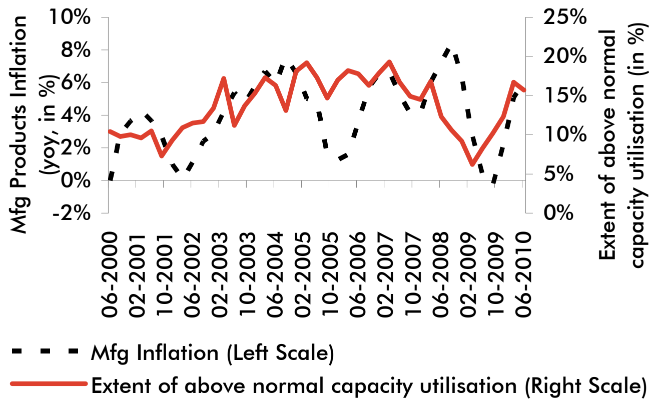
Exhibit 1: Higher GDP growth pushes-up capacity utilisation



Source : RBI Survey, CSO

Note : Extent of above normal capacity utilization is based on respondents' views from the RBI's Industrial Outlook Survey

Exhibit 2: . . . and higher capacity utilisation translates into higher manufacturing inflation



Source : Office of the Economic Adviser, RBI Survey

Note : Extent of above normal capacity utilization is based on respondents' views from the RBI's Industrial Outlook Survey

The noughties have been consistently characterised by high GDP growth pushing up capacity utilisation levels which in turn translates into higher manufacturing inflation. The only time this relationship breaks down is when a statistical base effect clouds the GDP growth or the inflation metric which is measured on a yoy basis. For instance, despite above average capacity utilization during Q2 FY06, the yoy inflation metric was recorded at 2% on account of a high base effect.

Despite the shortage, the supply response is muted

Now an obvious question to ask would be "Why don't producers step-up capacity expansion when high GDP growth has historically pushed up capacity utilization? After all, the most fundamental law of markets is that 'supply follows demand'." Three key factors in India impede the ability of manufacturers to respond to this evident supply gap. The high cost of capital, the presence of hard infrastructure deficits as well as labor market issues. Each of these supply impediments appear to be structural in nature. Despite the government's recent commitment to lift hard infrastructure commitments, the supply constraints will ease only incrementally over the next five years.

- **Limited access to finance**

Finance is a key constraint impeding supply expansion in India. The real cost of capital in India is one of the highest amongst developing nations with the average real interest rates in CY00-09 being recorded at a staggering 6.7% p.a. as opposed to 1.9% p.a. in China (see Exhibit 3 below for details). Additionally the risk free rate in India as measured by the yield on the 10 year G0sec too is one og the highest in the region (see Exhibit 4 below).

The high cost of bank loans is attributable to the repressed nature of the Indian banking system whereby banks are statutorily mandated to deposit a quarter of their deposits with the central bank. Lack of full capital account convertibility complicates matters by preventing market forces from bringing down India's benchmark lending rates to rates in line with international benchmark lending rates.

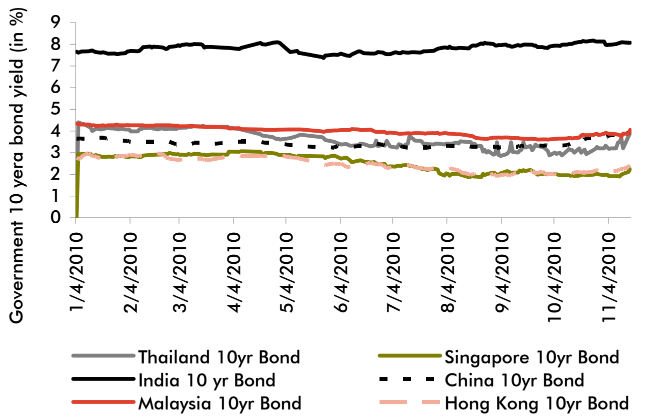
While top rated corporates have access to bank loans (with a smaller spread over the base rate), to external commercial borrowings (ECBI and to the corporate bond market, medium and small scale enterprises (MSME's account for 40% of India's manufacturing output) are left with limited access to finance. Unrated MSMEs are particularly crunched for funding with the ECB route as well as corporate bond route not being an option.

Exhibit 3: High real interest rates in India

Real interest rate over CY00-09 (in % p.a.)	Median	Average
India	**7.5**	**6.7**
Philippines	4.4	4.4
Korea, Rep.	3.6	3.8
Thailand	3.6	3.8
Indonesia	3	3.6
Malaysia	2	2.8
China	2.4	1.9
Singapore	5.2	4.3
Russian Federation	-4.1	-2.4

Source IMF, Ambit Capital research

Exhibit 4: The consistently high cost of debt in India



Source Bloomberg, Ambit Capital research

The underdeveloped corporate bond market in India acts as a further constraint to the commercial sector. Liquidity in the corporate bond market in India is thin with lower volumes as compared to cash market in equities and Government bonds. Furthermore, the spread over government bonds makes the cost of finance through this route prohibitively high

- **Hard infrastructure deficit**

The gaping hard infrastructure deficit in India is the root cause of India's limited manufacturing ability. Well-known deficiencies abound in terms of roads, power, ports, telecom, railways, airports as well as irrigation (see Exhibit 5 below for details) thus imposing additional costs on the manufacturer's cost of production.

Exhibit 5: India's gaping "hard" infrastructure deficit

Sector	Deficit	Variable & quantity for India	Global Rank (1 being the best)
Power	13.8% peaking deficit; 9.6% energy shortage; transmission and distribution losses; absence of competition	Electric power transmission and distribution losses as a share of output stood at 25% in CY07	Rank 147 of 159 nations
Roads/Highways	The 65,590 km of national highways comprise only 2% of total network but carry 40% of traffic. Of the total road network, only 12% are 4-laned, 50% are 2-laned and 38% are single-laned.	Average paved roads as a % of total roads stood at 52% over CY90-07	Rank 92 of 206 nations
Ports	Inadequate berths and rail/road connectivity	Quality of port infrastructure rating stood at 3.5 in CY09 (1=extremely underdeveloped to 7=well developed and efficient by international standards)	Rank 110 of 156 nations
Telecom/IT	Only 18% of market accessed; obsolete hardware; acute human resources' shortages	Information and communication technology expenditure as a % of GDP stood at 4% in CY09	Rank 80 of 90 nations

Source: Planning Commission, IMF, UNDP, Ambit Capital Research

The inability of the State to support and finance infrastructure development in the early post-independence decades has resulted in this glaring gap. A fiscally hobbled central government has historically spent more on interest payments (26% of total expenditure over past two decades) than on infrastructure development (15% of total expenditure over past two decades) with the orientation improving only in the late noughties. Consequently, compared to China, India's investment to GDP ratio has been consistently lower since the 1970s with an average difference of 1600 bps per annum over the past 4 decades.

Not only has the Government been unable to fund infrastructure growth, it has also struggled to provide the a policy environment conducive to private sector investment in the infrastructure sector. The power sector is a prime example of this phenomenon. Despite the sector being liberalised in 2003, the average monthly demand deficit in power generation over the past 5 year period has been recorded consistently (standard deviation of 2%) at 10% of demand.

Off-late the government has shown a credible commitment towards infrastructure creation as evinced by its plans of creating infrastructure worth $ 1.5 trillion (at FY07 prices) over the 11th (FY08-12) and 12th (FY13-17) five year plans. Despite the Government's apparent commitment to catch-up, constraints are expected to ease only incrementally given the Government's abysmal execution record as well as tremendous back-log.

- **Labour market issues**

The complexity and inflexibility of labour laws and skill related issues are the two key issues holding-back manufacturers' ability to tap the abundant labour in India.

The nature of Indian labour regulation has been a meaningful factor (see Exhibit 6 for details) in restricting India's manufacturing capacity as well as investment. Such is the employer-unfriendly orientation of Indian labour laws that in the infamous case of *Uttam Nakate*, the judicial system pronounced the dismissal of an employee for repeated sleeping on the factory floor was illegal. In 2005, after two decades a higher judicial body finally came to conclusion that the company had the right to fire him.

Exhibit 6: India's complex and unfriendly labor laws

Indian Labour laws	Details
Rigid and inflexible	The Industrial Disputes Act, 1947 renders inflexibility in retrenchment of workers and closure of enterprises with 100 workers or more. India ranked 125 of 206 nations on World Bank's rigidity of employment index (0=less rigid to 100=more rigid) in CY09 with countries like Malyasia, Singapore and even Bhutan offering more flexible employment regulation.
Large and complex	Labour as a subject figures on the 'concurrent list'. This means that both Centre and States can legislate in this area, which explains why India has one of the largest and most complex body of labour legislations.
Adversely affect investment in manufacturing	Pro-worker amendments to the Industrial Disputes Act are associated with lowered investment, productivity and output in registered manufacturing in India (Besley & Burgess 2002)
Other issues	Provisions enable excessive Government interventions, laws provide wide scope for initiating industrial disputes and settlement procedures are near- ineffective

Source: Ministry of Labour & Employment, Various, Ambit Capital Research

In fact, the applicability of these laws to firms hiring more than 100 persons has incentivised manufacturers to limit the number of labourers they employ thus limiting economies of scale. Given the weight that the Indian labour force has in the vote banks of the democratically elected government, the labour regulation landscape is unlikely to be reformed in favour of employers in India.

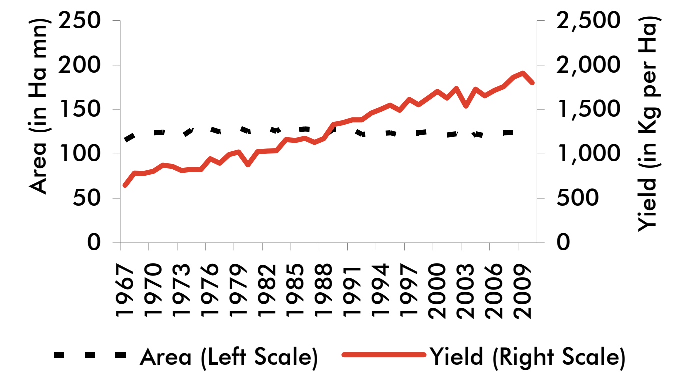
Besides labor law issues, there is a significant skill deficit as the country struggles to educate and train its youth. According to the World Bank, more than 40% of the Indian labour force is unlettered and less than a fifth has secondary schooling as opposed to China where access to secondary education is nearly universal. Also, the relative share of persons with tertiary education as a share of the total number of unemployed, has been trending upwards (increased from 23% in 1987 to 33% in 2005) thus indicative of the absence of a targeted education system.

Food Inflation

While the supply of food in India remains inelastic, demand will continue to grow as incomes rise, the population expands and does so with nearly 50% of the population below the age of 24 years.

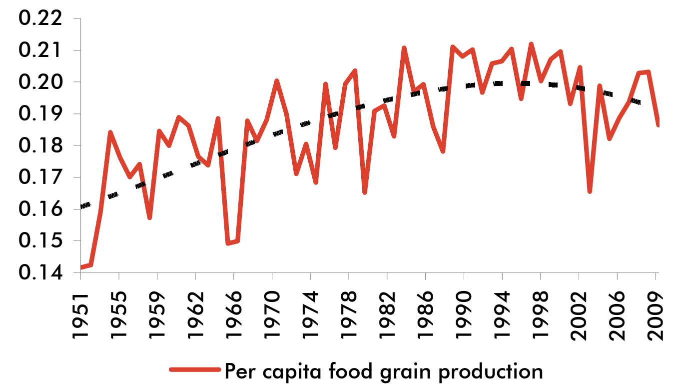
The area under cultivation has been nearly constant over the past four decades whilst agricultural yield expansion has been sluggish (See Exhibit 7 below). Whilst food grain production in India has expanded at 1.1% p.a. over the past two decades, India's population has expanded at 1.8% p.a. thus crunching per capita food grains production (see Exhibit 8 below).

Exhibit 7: Sluggishly growing yields in India



Source : Ministry of Agriculture, Ambit Capital Research

Exhibit 8: Declining per capita food production in India



Source : Ministry of Agriculture, Ambit Capital Research

Pulses, milk, eggs and meat are the key sources of protein in India and rising affluence will mean a disproportionate rise in their demand as the demand for the same will also be aspirationally motivated. While the per capita availability of pulses has stagnated, that of eggs & meat has been volatile historically. As regards milk, while the per capita availability has been improving, the growth rate of milk production has been declining. Going forward, India's youthful demographic structure and the significance of milk as a source of protein will cause demand to grow quickly.

Investment Implications

We expect strong inflationary pressures in the manufacturing and food sector to drive average inflation over the next decade higher and we estimate average inflation for the period 2010-20 to be recorded ahead of 7% as opposed to 5.5% over 2001-10. Higher inflation will translate into higher policy rates in India given the Indian central bank's aversion to high inflation as well as its hawkish inclinations.

High Inflation has historically compressed equity returns

High inflation in India's wholesale price index (WPI) has historically been a negative for equity markets with returns being systematically lower in a high inflation environment. Average monthly returns over the past decade in a low inflation environment were recorded at 3.4% for the BSE 500 vs 0.8% in a high inflation environment (see Exhibit 9 below for details).

Exhibit 9: Banks , Capital goods and PSUs outperform in a high inflation environment

Average monthly investment returns	High Inflation	Low Inflation
Sensex	0.8	2.9
BSE 500	0.8	3.4
BSE Auto	1	4.7
BSE Bankex	1.9	4.4
BSE Durables	1.4	3.8
BSE Cap Goods	1.8	5.3
BSE FMCG	1.2	1.5
BSE Healthcare	1.2	2.1
BSE IT	0	2.7
BSE Metal	1.3	5.6
BSE Oil and Gas	1.3	4.3
BSE PSU	1.7	3.9
BSE TMT	0	2.3

Source: BSE, Ambit Capital Research. Period under study: CY01-10 where "high" inflation is defined as WPI based monthly inflation ahead of 5% yoy

History suggests that Banks, Capital Goods and PSUs outperform the broader market in a high inflation environment while the IT sector is worst hit.

High inflation squeezes equity returns as it adds to production costs through increased raw material costs as well as higher employee costs.

Financial Services firms are the most inflation-immune to higher raw material costs

Banks, Stock-brokers and other Financial Services providers appear to be the most immune to high inflation from a raw material cost perspective (see Exhibit 10 below). This largely explains the outperformance of the BSE Bankex and the PSU index (with a significant weightage for Finance Companies) in a high inflation environment.

Exhibit 10: Financial services providers are the most insulated from a raw material cost inflation perspective

Raw material cost relative to sales	Sectors
More than 60%	Auto , Consumer durables , Capital goods , Paints
40 to 60%	Realty , Non-ferrous metals , Refineries , FMCG , Agro chemicals , Tobacco products
20 to 40%	Textiles , Steel , Pharma , Castings, forgings & fastners , Fertilizers , Infrastructure developers , Plantation & plantation stocks , Trading
Less than 20%	Alcoholic beverages , Construction , Cement , Hotels & restaurants , Gas distribution , IT - Software , Mining & mineral products , Power generation & distribution , Crude oil & natural gas
0%	Banks , Computer education , Finance ex-Banks , Stock/commodity brokers ,Telecom service

Source: CapitalLine, Ambit Capital Research, Period of study: FY01-10

Computer education providers as well as telecom service providers are other sectors that seem to be immune to high inflation from the higher physical input cost perspective.

Financial Services companies also appear to be relatively immune to high wage inflation but IT firms and Banks stand exposed on this front

Given the relatively low exposure of Financial Services companies (excluding Banks) to high inflation from the raw material cost (see Exhibit 10 above) as well as the employee cost perspective (see Exhibit 11 below), this sector stands to be least affected from high inflation imposing cost pressures.

However IT and Banks emerge most vulnerable to high structural inflation eating into margins through the employee cost conduit given that these costs amount to more than 50% of their sales.

Exhibit 11: Financial Services companies are relatively immune to higher employee costs while IT and Banks stand exposed

Employee cost relative to sales	Sectors
More than 50%	Hotels & restaurants, IT , Plantation & plantation Stocks , Banks
30 to 50%	Capital Goods , Steel , Stock / Commodity Brokers , Textiles
10 to 30%	Consumer Durables , FMCG, Mining & mineral products, Paints , Alchoholic Beverages , Infrastructure developers & operators , Pharma , Tobacco , Computer education, Auto , Power Generation & Distribution , Cement , Castings , forgings & fastners, Non-ferrous metals , Construction , Fertilisers , Crude Oil & Natural Gas , Telecom service, Realty
Less than 10%	Agro-chemicals , Gas distribution , Finance , Refineries , Trading

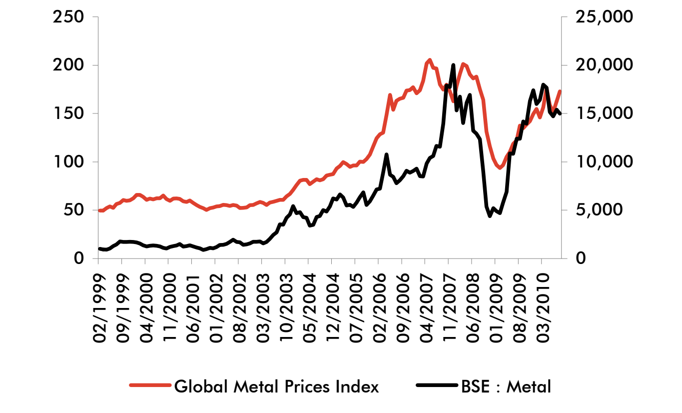
Source: CapitalLine, Ambit Capital Research, Period of study: FY01-10

Commodity-driven sectors' fortunes tied to global commodity prices

Both non-ferrous metals and steel sectors stand exposed to high inflation imposing cost pressures through the raw material cost conduit (see Exhibit 10 above for details). The crude oil & natural gas sector too stands exposed to higher raw material costs although to a lesser degree.

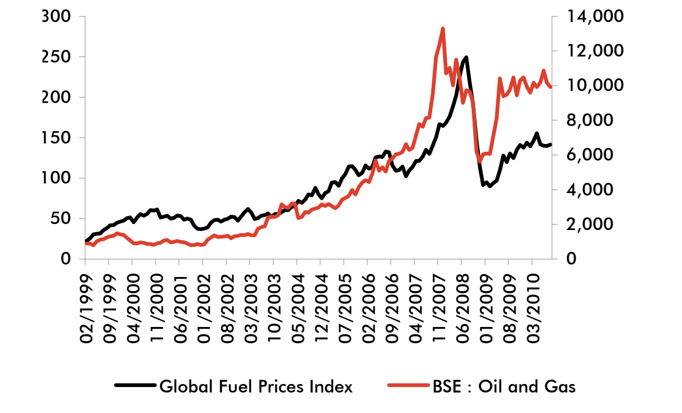
However, historically commodity-driven sectors' fortunes in India have been closely tied to global commodity prices (see Exhibits 12 & 13 below). If you believe that global commodity prices are set to rise then investing in domestic metals and oil & gas sectors appears to be a good hedge against commodity price inflation.

Exhibit 12: BSE Metals tracks global metal prices



Source IMF, BSE ,Ambit Capital research

Exhibit 13: BSE Oil and Gas tracks global fuel prices



Source IMF,BSE , Ambit Capital research

Headwinds for export-based sectors as high inflation erodes price competitiveness

The presence of structural inflationary pressures will prove to be a negative for exports-based sectors such as Information Technology (IT) as persistent inflation could erode the price competitiveness of their offerings.

Given that employee costs amount to more than 50% of this sector's sales and given its export facing orientation, IT has been the worst performing sector in a high inflation environment (see Exhibit 9 & 11 above). Over the next 2-3 year period, the excess supply at the fresher-level may partially off-set the adverse impact of higher wage inflation on this sector, but in the long term – high inflation will prove to be a clear headwind.

Besides software services, merchandise exporters will also face pressures as high domestic inflation erodes the sector's competitiveness.

Exhibit 14: Engineering goods industry to face headwinds on account of higher structural inflation

Commodity	Share in total exports in FY09
Engineering Goods	26%
Gems and Jewellery	15%
Petroleum Products	15%
Chemicals and Allied Products	12%
Textile & Textile Products	11%
Agriculture and Allied Products	9%
Iron Ore	3%
Leather and Manufactures	2%

Source: Ministry of Commerce, Ambit Capital Research

Engineering goods, gems & jewellery and petroleum products will see their price competitiveness erode as high inflation persists over the next decade.

As regards others, only those with competitive advantages will thrive

As regards other sectors, only firms with strong competitive advantages and pricing power will be able to withstand the margin pressures that high inflation will impose. The Capital Goods sector is an example of this phenomenon. Despite raw material costs and employee costs on an average (40-60% each as a percentage of sales) accounting for a reasonable chunk of this sector's costs, this sector tends to outperform despite higher inflation as capital goods' producers command pricing power in this supply-constrained economy.

Going forward, we will maintain a strong focus on analyzing stocks from the perspective of competitive advantage help you identify inflation immune stocks.

Megatheme 2: the rise of the "aspirational" consumer

Summary: As a country's per capita incomes rise, the consumption basket of its citizens changes away from food and essentials to non-food and aspirational items (such as cosmetics, motorbikes and jewellery). India's consumption basket has been undergoing just this sort of change over the past decade. Given the structural drivers of this trend (rising incomes, high share of youth and urbanisation), investors should focus on aspirational product manufacturers vis-à-vis essentials within India's broader consumption story.

India is a formidable consumer market

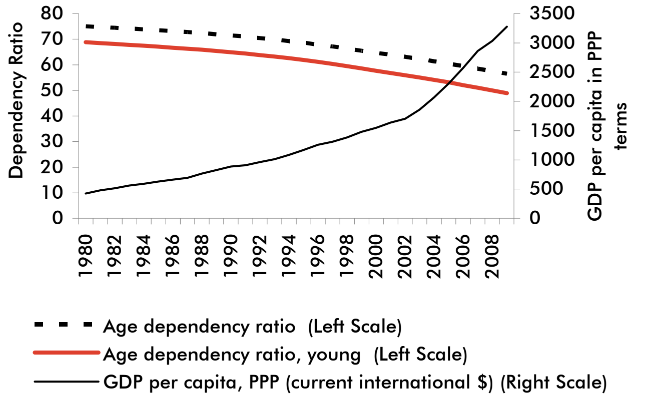
India as a nation is a voracious consumer with private final consumption expenditure accounting for nearly 60% of India's GDP. India's stellar demographic features and rapid economic growth (on both parameters we are second only to China) make it a formidable market for consumer goods.

India's total population has expanded at a CAGR of 1.4% p.a. over the past decade and the under-24 aged populace accounted for nearly half the total population. What this means is that India adds population equivalent to half the size of the USA every ten years with the number of under-24 citizens equaling the size of the UK.

The demographic orientation of the population means that the country's dependency ratios are on a downtrend (see Exhibit 15 below) and this will lead to increased incomes as well as consumption. In fact, where India scores over China is the fact that nearly a third of India's population is below the age of 15 years vs 20% for China. India's youth bulge will persist beyond the coming decade while China's will not.

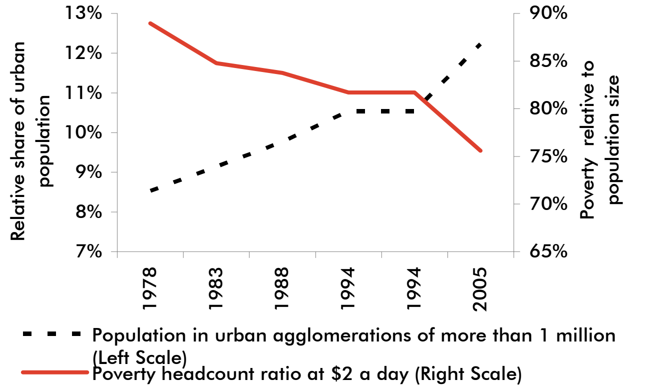
Simultaneously, incomes in India have been rising. Over the past two decades (CY90-09) the pace of per capita GDP growth (in PPP terms) for the world was recorded at 4% p.a. while India's per capita GDP growth rate has been at 7% p.a. Rising incomes and increasing urbanization with declining poverty (see Exhibit 15 & 16 below) spell a prolific consumption market in India.

Exhibit 15: A predominantly young population whose purchasing power is improving



Source: MoSPI, Ambit Capital research

Exhibit 16: Increasing urbanisation coupled with declining poverty



Source: Various Govt websites, World Bank, Ambit Capital research

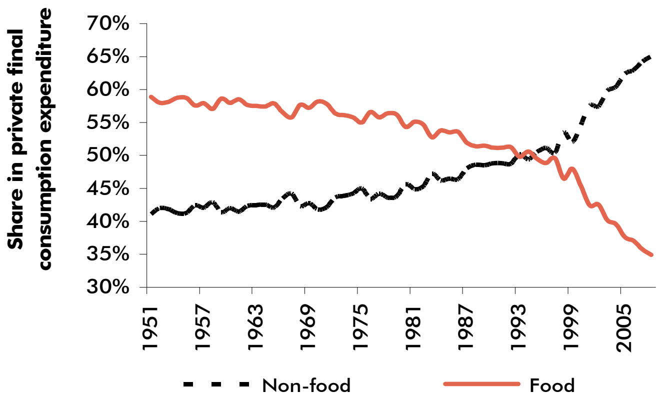
The aspirational demand story in India

The fact that India is a large and growing consumer goods market is well known. But within this broader consumption theme there is a further wrinkle which makes India an even more attractive market than its sheer size might suggest – over the past six decades Indian consumers' consumption baskets are shifting away from essential purchases (such as food grains) towards aspirational goods (such as meat, motorbikes, jewellery and appliances).

The strong rural demand for automobiles, telecom, white goods and personal products over the past five years is a strong indication of not just rising rural incomes but also aspirations which are fast converging with those of its counterparts in urban areas.

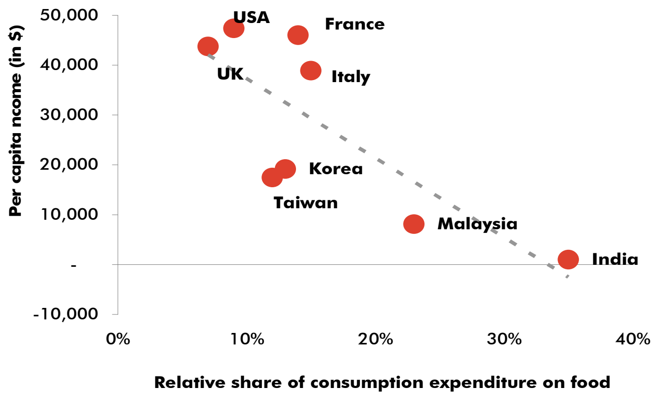
At a macro level, the most obvious manifestation of the 'aspirational' theme is the tectonic shift in India's consumer spends that took place in the mid-nineties when the nation began spending more on non-food items vis-à-vis food items (see Exhibit 17 below). In the early fifties Indians spent close to 60% of their wallet on food while today this share has shrunk to less than 35%.

Exhibit 17: The non-food basket eclipsed the food basket in India in the mid 90s



Source: MoSPI, Ambit Capital research

Exhibit 18: Negative correlation between food spends and per capita income



Source: Various Govt websites, World Bank, Ambit Capital research

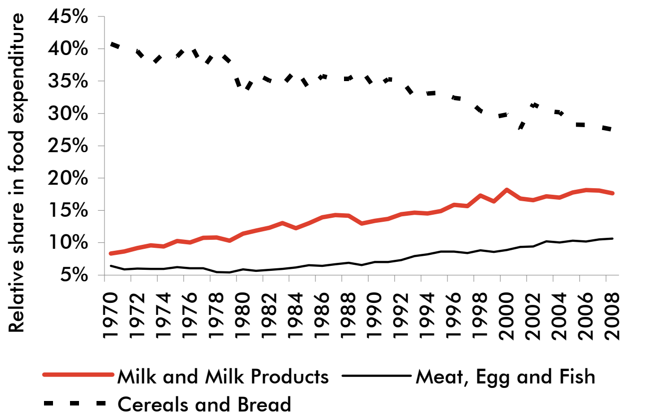
**Data pertains to CY08*

With rising incomes and affluence, consumers spend less on food – a trend that is corroborated by cross country experience (see Exhibit 18 above). Though the progressive change in favour of non-food items has been taking shape in India over the past six decades, cross-country experience suggests that this change will continue to play-out over the next few decades until the share of food is pushed down to a sub-10% level (the UK for example with a per capita income of $44K spends only 7% of its wallet on food).

More manifestations of the 'aspirational' consumption theme

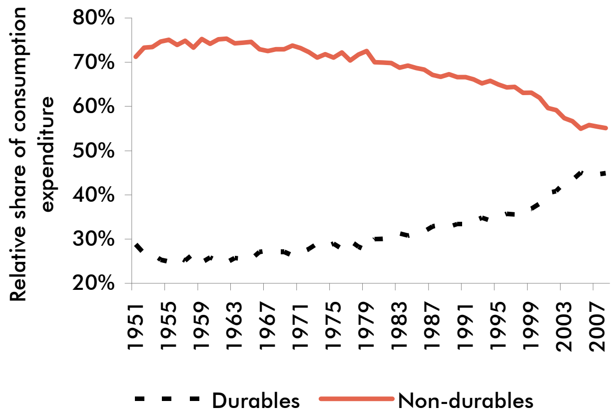
The aspirational consumption theme in India can be discerned at various levels. While food as a consumption category is being disfavoured on aspirational grounds, within this category consumers are exhibiting a clear preference for protein-based food items as opposed to carbohydrates as the latter is perceived as an inferior good (see Exhibit 19 below). While the share of cereals and bread in India's food basket has systematically trended downwards (from 41% in FY70 to 28% in FY08), the share of protein-based food items has only expanded (from 15% in FY70 to 28% in FY08).

Exhibit 19: The rising share of proteins in India's food basket



Source: MoSPI, Ambit Capital research

Exhibit 20: The rising share of durables in the Indian consumers' wallet

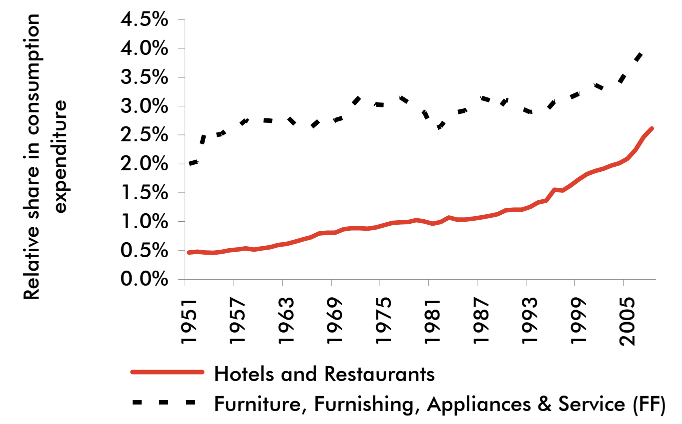


Source: MoSPI, Ambit Capital research

The aspirational demand story in India also jumps out if one breaks down the consumption basket on the basis of durability of consumer products. Indians have been systematically raising their spend on durables (like cars, bikes and white goods) while cutting down spends on non-durables (like food) over the past six decades (see Exhibit 20 above).

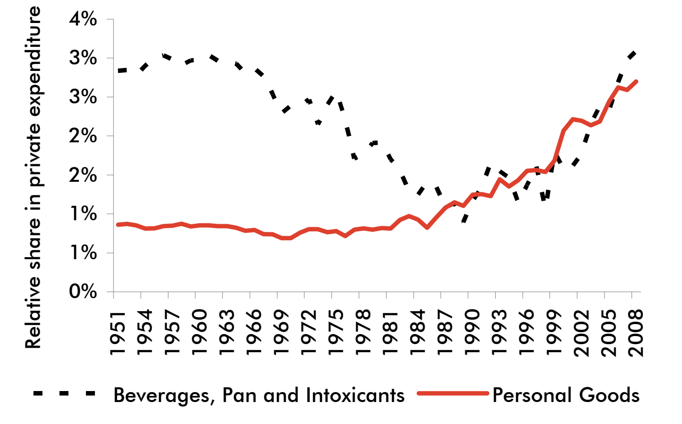
The rise of the aspirational Indian is also evident in the uptrend in spending on hotels, restaurants, furniture and appliances (see Exhibit 21 below).

Exhibit 21: Increasing spends on hotels, restaurants and appliances



Source: MoSPI, Ambit Capital research

Exhibit 22: Increasing spends on beverages , intoxicants and personal goods



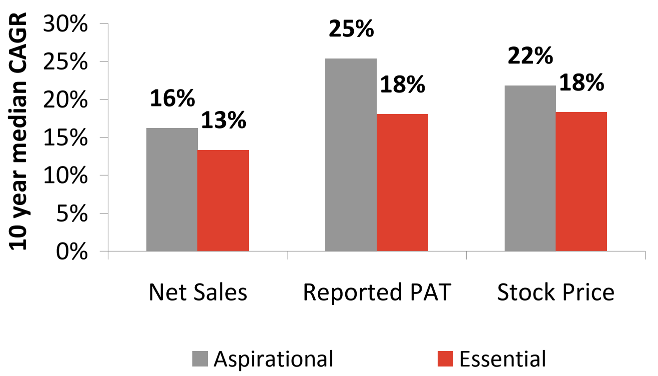
Source: MoSPI, Ambit Capital research Note : "Pan" is a betel nut leaf and nicotine consumable

Within the fast moving consumer goods (FMCG) space too, product categories (like fairness creams vs regular creams, coffee vs tea, therapeutic oils vs regular oils) as well as specific products that are positioned with an aspirational spin exude a stronger pull on the consumer. Beverages, intoxicants and personal goods (like watches, jewellery, clocks, etc) will be other beneficiaries of the aspirational demand story (see Exhibit 22 above) that will continue to unfold in India.

Investment Implications

Slicing the BSE 500 into two categories of aspirationals and essentials (please refer to Appendix to Megathemes 2 for details on composition) reveals that aspirationals outperformed essentials in terms of profitability, sales as well as stock price appreciation (see Exhibit 23 below) over the past decade. While the median CAGR in PAT for essentials was recorded at 18% over FY01-10, the same metric for aspirationals was recorded at a higher 25%. The higher profitability of aspirational product companies was also reflected in the higher stock price appreciation witnessed in this category with the median CAGR during FY00-10 being recorded at 22% as against 18% in essentials.

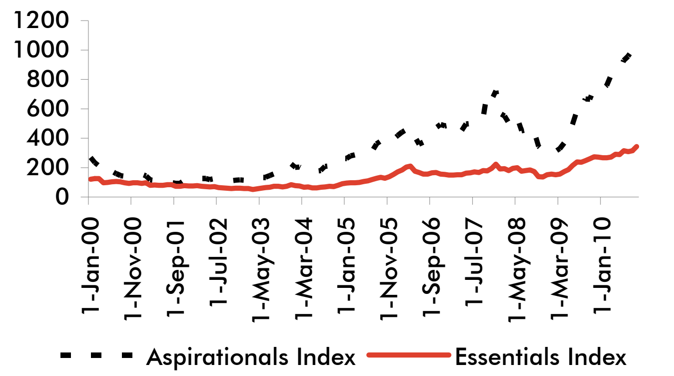
Exhibit 23: Aspirationals have outperformed essentials over the past decade



Source : CapitalLine, Bloomberg, Ambit Capital Research

Note: Median CAGR for net sales and reported PAT has been calculated for the 10 year period from FY01 – FY10. Median CAGR for stock prices have been calculated for FY00-FY10

Exhibit 24: Aspirationals' stock prices systematically outperformed essentials over past decade



Source : Bloomberg, Ambit Capital Research

Note: Index is calculated on a price weighted basis for the asporationals and essentials universe as defined in the Appendix to Megatheme 2

In fact, stock prices of aspirationals have systematically outperformed essentials since the early noughties (even after excluding auto companies) (Exhibit 24 above).

Given the durability of the macroeconomic forces propelling aspirational demand and given the historic outperformance of aspirational stocks, we urge investors to focus on aspirational product companies as consumers continue to gravitate to this consumption category over the next decade.

Appendix to Megatheme 2

Exhibit 25: Constituents of the 'Aspirationals Index'

Unit	Market Cap (USD bn)	FY10 Sales (INR mn)	FY10 PBDITA (INR mn)	FY10 PAT (INR mn)	1 yr FWD P/E Ratio
Maruti Suzuki	9.8	2,90,989	44,510	24,976	18.2
Bajaj Auto	9.6	1,15,085	25,500	17,027	16.9
Hero Honda Motor	8.4	1,57,582	30,253	22,318	16
Nestle India	7.4	51,317	10,297	6,550	41.1
Asian Paints	5.4	53,727	11,845	7,745	26.4
United Spirits	4.5	49,289	8,961	3,760	36.8
Titan Inds.	3.6	47,764	4,068	2,503	42.8
Exide Inds.	3	42,135	9,046	5,371	19.7
United Breweries	2.4	19,842	2,949	970	57
Pantaloon Retail	2.3	63,167	6,766	1,796	47.1
Pidilite Inds.	1.6	19,297	4,078	2,891	20.6
Emami	1.6	9,906	2,707	1,654	28.5
P & G Hygiene	1.5	9,045	2,587	1,798	25.7
Gillette India	1.4	8,525	2,253	1,371	NA
Britannia Inds.	1.1	34,014	1,664	1,165	28.7
Blue Star	0.9	25,250	3,197	2,115	18.5
MRF	0.9	56,575	7,167	2,530	11.7
Whirlpool India	0.9	25,441	2,552	1,450	19.3
Berger Paints	0.8	16,865	2,006	1,201	22
TVS Motor Co.	0.8	43,631	2,541	880	17.6
Bajaj Electrical	0.6	22,286	2,463	1,171	17.6
Shoppers' Stop	0.6	15,684	1,191	502	40.4
Raymond	0.6	13,465	2,271	251	47.7
Gitanjali Gems	0.6	33,550	2,675	1,421	9.5
Radico Khaitan	0.5	8,289	1,501	415	28
KF Airlines	0.5	50,679	-11,586	-16,472	-2.6
Trent	0.5	5,716	712	402	97.5
S Kumars Nation	0.5	21,548	4,272	1,061	6.8
Kwality Dairy	0.4	5,828	272	94	NA
V I P Inds.	0.4	6,335	898	501	18.3
Amara Raja Batt.	0.4	14,652	3,055	1,670	11.6
Navneet Publicat	0.3	5,222	1,176	680	18.5
JK Tyre & Indust	0.2	36,777	4,242	1,635	4.3

Source: Capitaline, Bloomberg, Ambit Capital research

Exhibit 26: Constituents of the 'Essentials Index'

Essentials	Market Cap (USD bn)	FY10 Sales (INR mn)	FY10 PBDITA (INR mn)	FY10 PAT (INR mn)	1 yr FWD P/E Ratio
ITC	28.9	1,81,532	67,143	40,610	26.2
Hind. Unilever	14.3	1,75,017	30,105	22,020	28.8
Dabur India	4	28,569	5,722	4,333	29.8
Colgate-Palm.	2.7	19,625	5,239	4,233	25.9
GSK Consumer	2	19,249	4,028	2,328	31.7
Marico	1.9	20,243	3,361	2,350	28.1
Tata Global	1.7	16,979	5,639	3,915	17.4
Nirma	0.8	31,180	6,282	2,379	NA
Ruchi Soya	0.8	1,34,188	5,536	1,725	18.9
Bajaj Hindusthan	0.6	15,964	7,032	1,562	30.6
K S Oils	0.5	40,270	4,877	2,244	9.2
Balrampur Chini	0.5	17,199	4,655	2,265	10.3
Lakshmi Energy	0.1	6,914	2,183	916	4.5

Source: Capitaline, Bloomberg, Ambit Capital research

Megatheme 3: a capex boom in the making

Summary: The experience of India's Asian neighbours suggests that a high GDP growth rate coupled with the investment:GDP ratio hitting 33% triggers a surge in capex. These trigger points along with India's infrastructure deficit and the Government's desire to address this deficit has set the scene for a seven year surge in capex. History suggests that the Indian Capital Goods sector stands to gain the most, both from profitability and from a stock price perspective, from this impending surge in capex.

The macroeconomic underpinnings

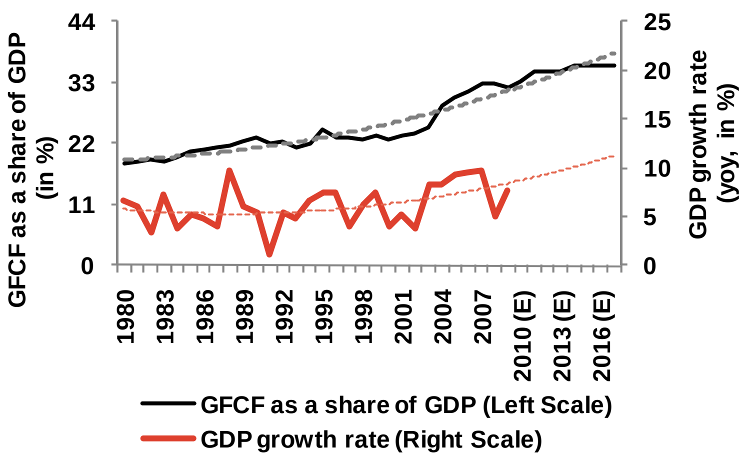
Of the major Asian economies, India is the sole country that is yet to experience an investment boom. While Japan's investment ratio peaked in the early 70s, China's investment boom continues to play-out. The experiences of India's Asian peers suggest that once a 33% investment:GDP ratio with an average GDP growth rate of 5% p.a. over 5 years is hit, the country experiences a period of prolonged capex activity for a period ranging from eight years (Japan) to nearly three decades (Singapore). We characterize this phenomenon as a capex boom whereby more than a third of the nation's national income each year is diverted towards fixed capital formation (refer to Exhibit 27 for details).

Exhibit 27: Experiences of Asian economies' Capex Booms

Country	Capex Boom Period	GFCF to GDP ratio (in %) during Capex Boom: Average	GFCF to GDP ratio (in %) during Capex Boom: Peak	Average GDP growth in 5 yrs before Capex Boom
India (E)*	FY11 onwards	35	37	8%
China	1993 onwards	37	42	9%
Japan	1968-75	35	37	10%
Malaysia	1990-97	39	44	5%
Korea	1989-97	36	39	9%
Thailand	1989-97	39	42	8%
Singapore	1971-99	37	48	13%

Source : WB, MoSPI, Ambit Capital Research

Exhibit 28: Positive correlation between the investment ratio and GDP growth in India (correlation 26% for CY61-09)



Source : WB, MoSPI, Ambit Capital Research

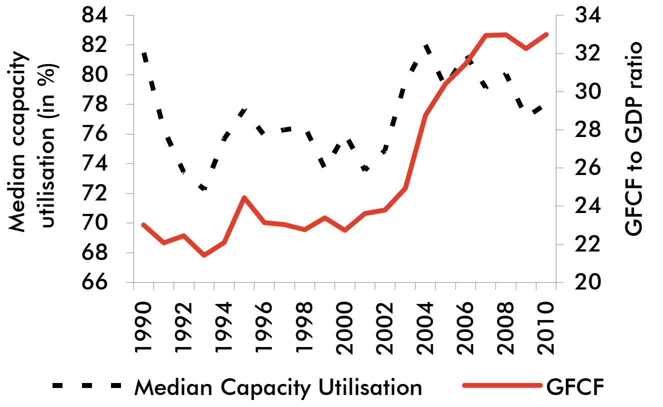
This phenomenon unfolds because there exists a two-way relationship between the real GDP growth rate and investment: GDP ratio of a country. Once GDP expansion hits a threshold rate of growth of 5%+, capacity constraints become material. That triggers a wave of capex which the private sector is willing to fund given the promise of a reasonable return on the capital to be deployed (as evinced by the buoyant past GDP growth rate).

Over and above this, in most Asian countries the Government has also tended to get actively involved in investing taxpayers' dollars to create the enabling infrastructure to support economic growth as buoyant GDP growth affords the state greater fiscal headroom. This phenomenon of enabling infrastructure creation by the State induces the private sector to continue capacity creation given the promise of buoyant demand coupled with State support.

India's macroeconomic parameters suggest that it is well placed for such a surge in capex. India's gross fixed capital formation (GFCF i.e. aggregate investment) as a percentage of GDP hit the critical 33% level in CY08 and India's GDP growth rate has averaged at 8% yoy over the past 5 years (see Exhibit 28 above) . Following the unfolding of the sub-prime crisis in CY08, India's investment: GDP ratio eased marginally to 32.3% in CY09. Despite the global recession and an internal drought, the Indian GDP growth rate suffered only marginally (7.4% yoy growth in FY10). Having established the resilience of its domestic economy, India is now ready for a capex boom.

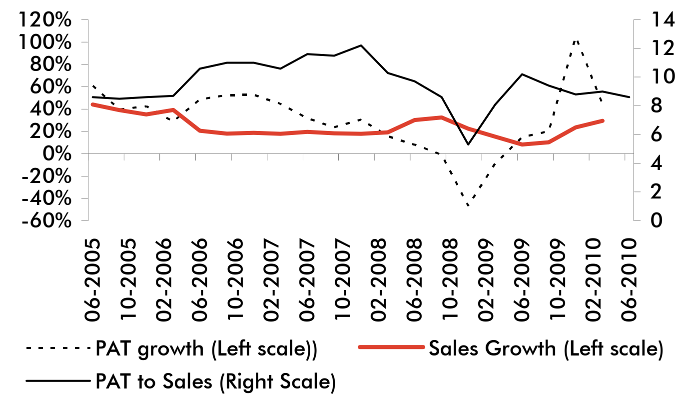
Moreover, even if one ignores the historical experience of the Far East Asian economies, there are good reasons within India to expect a surge in capex over the next decade:

Exhibit 29: Rising capacity utilisation in India



Source : IMF, MoSPI, Capital Line, Ambit Capital Research

Exhibit 30: Broadly stable PAT margins in India along with healthy sales growth



Source : CapitalLine , Ambit Capital Research

- **Increase in capacity utilization is invariably followed by investment ratio expansion**

  The median capacity utilization in India increased from 77% in FY09 to 78% in FY10 (see Exhibit 29 above). There exists a 65% positive correlation between the median capacity utilized in a given year and the investment:GDP ratio in the next year thus suggesting that FY11 in all likelihood will mark the beginning of a period where investment expansion exceeds the pace of GDP growth thus generating a capex boom.

  This coupled with broadly stable margins and healthy sales growth is implicative of improved financing capacity of India Inc (see Exhibit 30 above).

  Early signs of capacity expansion are evident in the industrial capex data. The private sector announced 820 (vs 743 in Q2 FY10) new projects in Q2 FY11 whose cumulative value amounts to Rs. 3.3 tn thus taking the total value of projects under implementation in India in Q2 FY11 to Rs. 60 tn (Source : CMIE).

- **Back-loaded spend during current five year plan and improved fiscal situation to set-off the capex boom**

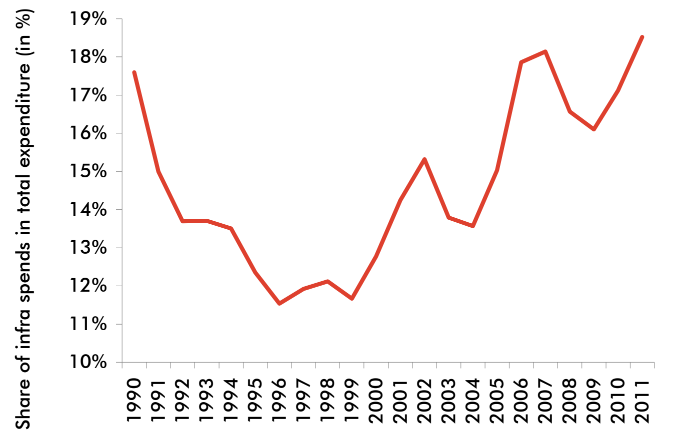
  While the Indian state was late to start its involvement in engineering a capex boom, several developments now suggest that the State's 'big push' will now gradually fructify.

  Firstly, capex spends will receive a disproportionate push in FY11 & FY12 as the Government jostles to achieve its 11th five year plan targets whose term ends in FY12. For instance whilst annual average spending on infrastructure in the first three years amounted to Rs. 2 tn, the terminal years of the current five year plan (FY11 & 12) are projected to see an annual average spend of Rs. 3 tn (at FY07 prices). This greater urgency on the Government's part to achieve its targets will lead to a capex push with particular benefits for the electricity, roads and bridges sector.

Secondly, the Indian government's infrastructure expenditure as a share of total Central Government expenditure has been rising systematically from 12% in FY99 to 19% in FY11 thus indicative of the increasing State role in infrastructure creation (See Exhibit 31 below). Moreover, for the 12th five year plan (FY13-17) the Government has already highlighted that it will target $1 trillion (at FY07 prices) of investments, representing a doubling of infrastructure spends as compared to the 11th five year plan.

Hence even after assuming an 80% achievement ratio for the 12th five year plans, India is likely to see a $160 bn (at FY07 prices) per annum outlay from FY13-17 as opposed to the less than $100 bn per (at FY07 prices) annum during the 11th five year plan.

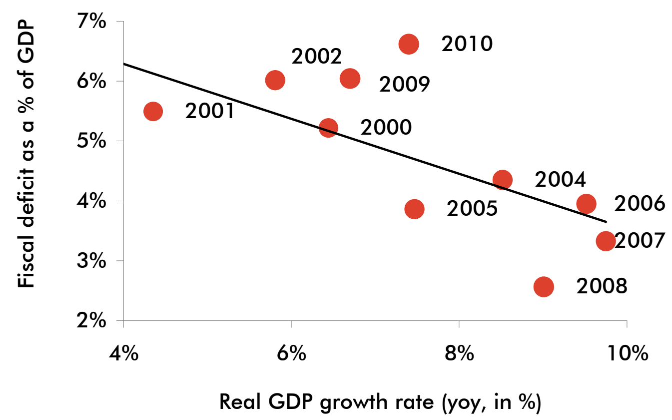
Exhibit 31: Share of infrastructure spends in the Government's total expenditure has been rising



Source Union Budgets, Ambit Capital Research

Note : Years are based on financial year basis

Exhibit 32: Government finances improve automatically when GDP growth is buoyant (Exception :FY09 & FY10)



Source Union Budgets, Ambit Capital Research

- **Improved fiscal health of the State**

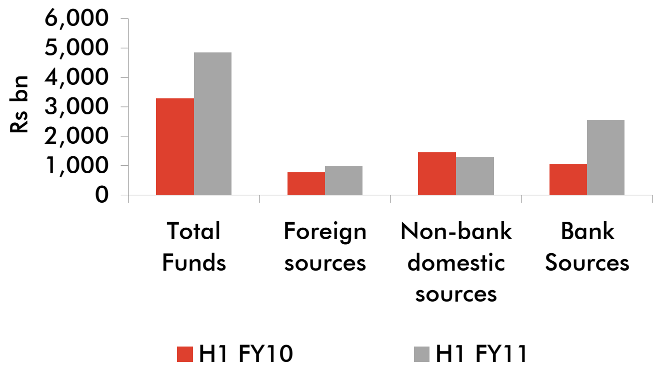
Thirdly, as the overall economy clocks-up healthy rates of economic growth over the next few years, the Exchequer's ability to fund infrastructure will improve as history suggests that government finances improve automatically when GDP growth is buoyant (see Exhibit 32 above).

So why hasn't the capex boom started as yet?

Cynics are well within their rights to ask "Why hasn't the capex boom started as yet?" After all, we are over 18 months into an economic recovery and yet the latest factory numbers (for September 2010) suggest a tepid 4.4% yoy growth while the core sector grew at an even paler 2.5% yoy.

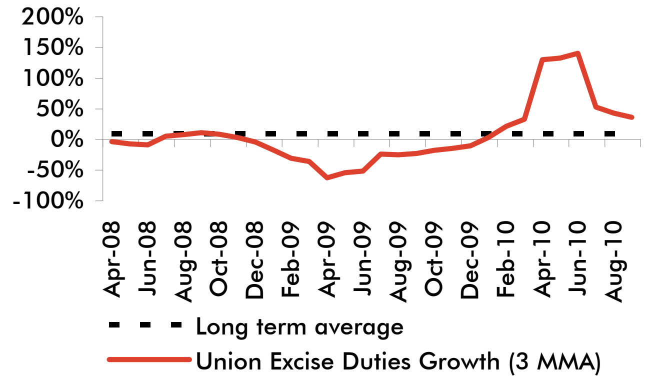
The pace of industrial expansion has slowed since August 2010 but the extent of the slowdown has been accentuated by a high base effect which was previously absent. Other indicators of industrial growth (like total flow of funds to the commercial sector and union excise duty collections, See Exhibit 33 and 34 below for details) suggest that the recovery has not lost steam but is undergoing a temporary moderation as producers wait on the sidelines to assess the pace of the recovery in the Western world. As regards the core sector numbers, weakness in the same is partially attributable to increased imports of coal, crude oil and steel.

Exhibit 33: Healthy expansion in total fund flows to the financial sector continues



Source Union Budgets, Ambit Capital Research

Exhibit 34: Union excise duty collections' yoy growth well above its long term average



Source Union Budgets, Ambit Capital Research

The scorching pace of industrial expansion from August 2009 to July 2010 (average pace of IIP expansion 13% yoy) was the result of a catch-up effect after a period of subdued industrial activity (average pace of IIP expansion 5% from October 2008 to July 2009). Clearly, industrial expansion has moderated as the catch-up effect fades.

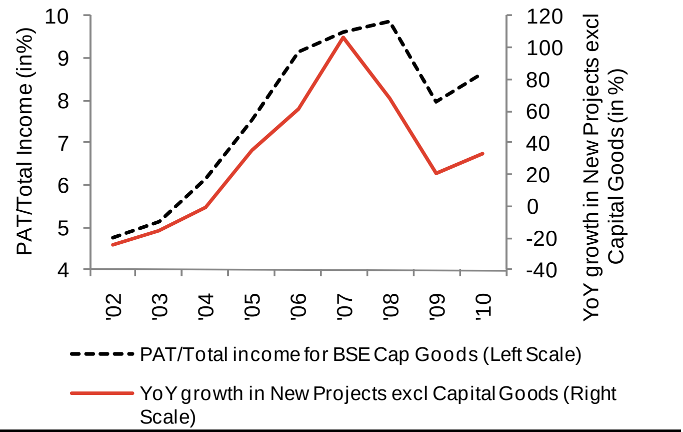
Furthermore, other indicators of industrial activity such as union excise duty collections (average yoy growth of 88% in H1 FY11 vs -37% in H1 FY10) and flow of funds to the commercial sector (47% yoy growth in H1 FY11) continue to record yoy improvements (see Exhibit 33 & 34 above).

Investment Implications

BSE Capital Goods companies will be an obvious beneficiary of the coming capex boom. Historically, the profitability as well as stock returns for companies comprising the BSE Capital Goods index has been closely tied to the nation's capex demand cycle.

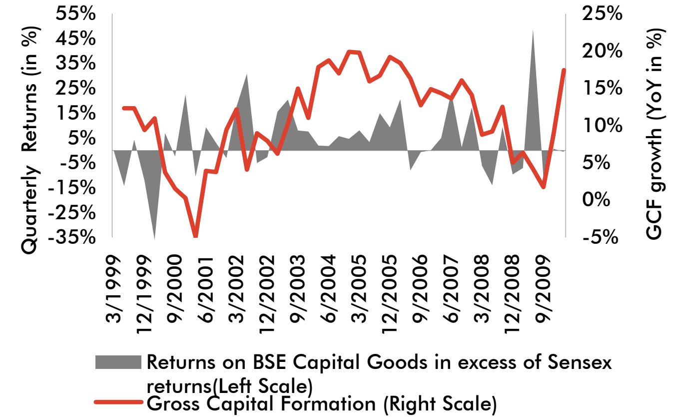
The profit margins of the BSE capital goods index and yoy growth in the nation's capex demand have fully tracked one another over the past few years (see Exhibit 35 below).

Exhibit 35: Profit margins for the BSE Capital Goods index are tied to the nation's capex cycle



Source CapitalLine, Ambit Capital Research

Exhibit 36: History suggests that Capital Goods outperform during a capex cycle upturn



Source BSE, CSO, Ambit Capital Research

Furthermore, history suggests that the BSE capital goods index outperforms the broader market during an upturn in the gross capital formation cycle (see Exhibit 36 above).

Given the close linkage between the country's capex cycle and the returns of the capital goods sector, we urge investors to focus on Capital Goods producers to benefit from the oncoming capex boom. If the Indian economy is to grow along expected lines, it is inconceivable that it will do so without a sustained capex boom over the next 5-7 years.

Megatheme 4: The coming of age of financial intermediation

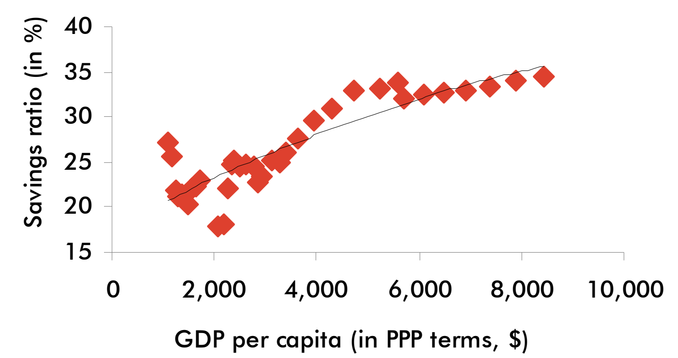
Summary: India's per capita income in PPP terms recently breached the $ 3K and its savings to GDP ratio stands at a healthy 32%. Cross country experience suggests that India's savings ratio should continue to rise until India's per capita income reaches $ 8 K (in PPP terms) and will max out only at 46%. The disproportionate rise in the quantum of India's savings over the next decade heralds tremendous opportunities for financial intermediaries as the Indian saver looks to channelize these savings into not just bank accounts but into stocks and bonds as well.

India's savings ratio can rise to 46%

India's per capita income in PPP terms has more than tripled over the past two decades with its savings ratio rising from 22% in CY90 to 32% in CY09. India, like its Asian peers has historically displayed a high propensity to save as compared to other nations. This has helped India cross the 30% savings mark at modest per capita income levels of $ 3K (in PPP terms).

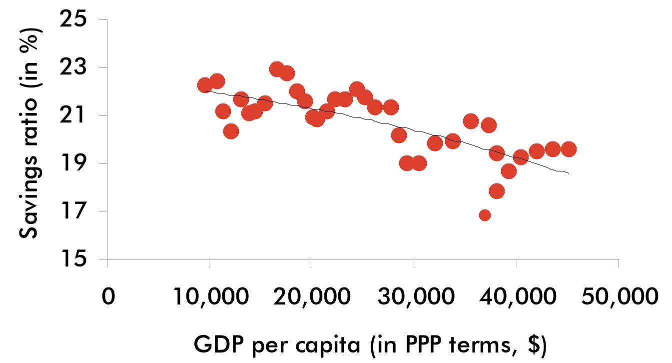
A cross-country comparison of per capita incomes and savings ratios suggests that savings ratios follow an inverse U-shaped pattern (see Exhibit 37 & 38 below). As incomes rise until a critical per capita income level (of $ 10 K in PPP terms), the savings ratio expands as illustrated by the experience of other emerging and developing economies (see Exhibit 37 below). From thereon, the experience of advanced economies points to an eventual downtrend in savings ratios that kicks-in as incomes continue to rise beyond $ 10 K (see Exhibit 38 below).

Exhibit 37: Savings rise until with increasing incomes till per capita income hits $10K (in PPP terms)



Source : IMF, Ambit Capital Research

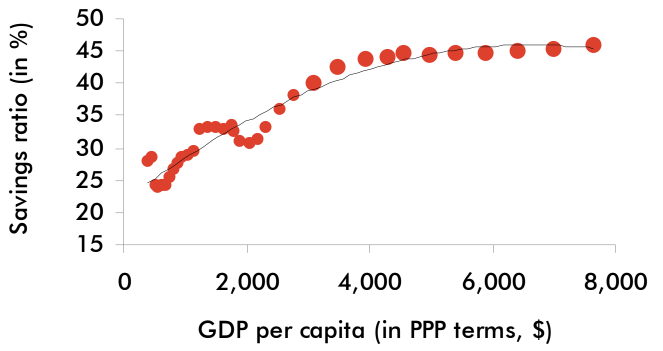
Exhibit 38: After hitting the $10K (in PPP terms) mark, the savings ratio declines



Source : IMF, Ambit Capital Research

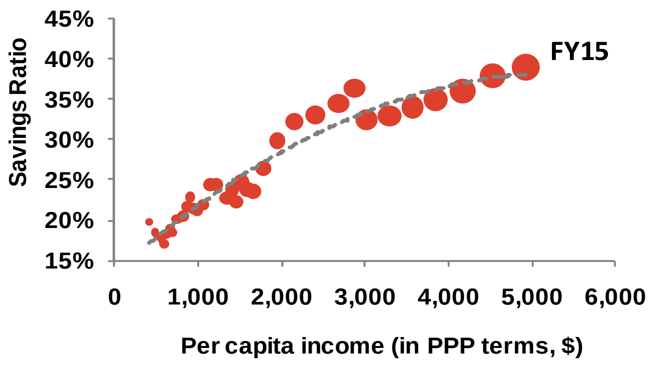
Whilst the global experience suggests that this critical per capita income level which marks an inflexion point in the savings ratio is $10 K (in PPP terms), the inflexion point for developing Asian economies is lower at $ 8K (in PPP terms) given the region's higher propensity to save (see Exhibit 39 below). The corresponding peak savings ratio too is higher for developing Asian economies at 46%.

Exhibit 39: Developing Asia's peak savings rate is 46%



Source: IMF, Ambit Capital Research

Exhibit 40: India to hit a ~40% savings ratio by FY15



Source : IMF, Ambit Capital Research

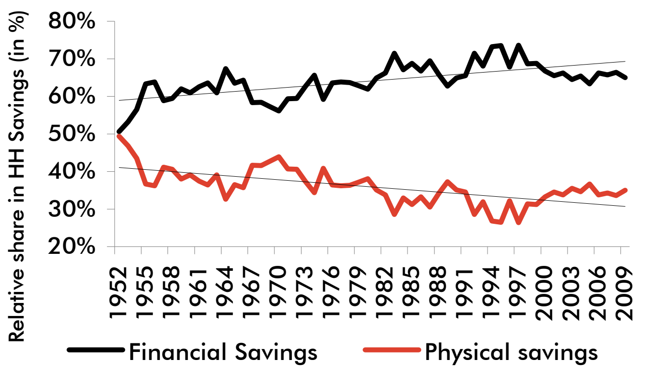
Given that India's per capita income is a modest $3K (in PPP terms) at this juncture, the quantum of India's savings will rise disproportionately as her income grows. This disproportionate expansion in India's savings is likely to continue until India's per capita income hits $ 8K (in PPP terms) and the savings ratio rises to a nadir of 46%.

The IMF expects India's per capita income to rise to $5K (in PPP terms) by 2015. Developing economies savings ratio at $5K per capita income levels has been 33% globally and 45% in Asia. Given that India's savings behavior has closely followed developing Asia's model historically, we expect India's savings ratio to hit at least 39% by FY15 (see Exhibit 40 above) – a development which will unlock a savings pool of more than $ 3 tn over the next five years with more than a third of this constituting household financial savings.

Structural transformation in favour of financial savings to continue

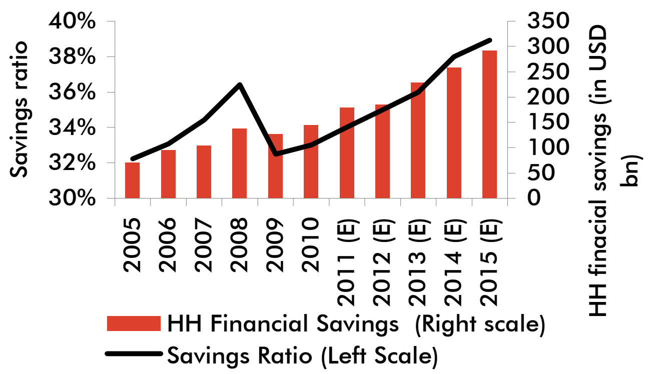
Over the next decade two key trends will unlock a world of opportunity for the financial intermediation sector in India. On one hand, the total quantum of India's savings will rise disproportionately and on the other hand, the ongoing structural transformation in favour of financial savings at the household level will continue, if not intensify (see Exhibit 41 and 42 below).

Exhibit 41: ...while the structural transformation in favour of financial savings will continue. . .



Source: MoSPI, Ambit Capital Research

Exhibit 42: ...thus unlocking household financial savings to the tune of $1.1 bn over FY11-15



Source : MoSPI, IMF, Ambit Capital Research

The orientation of Indian households' total savings pie has been tilting away from physical savings over the past six decades whose share has come down from 47%

post independence to 35% in FY09. Correspondingly, the relative share of financial savings has grown from 53% in FY50 to 65% in FY09. The financial savings ratio of Indian households is closely related to the movements of the Indian stock market and hence a market rally in the oncoming years could intensify the share of financial savings.

$ 1.1 tn market for household savings financial intermediation by 2015

The combined effect of the above two trends will translate into a corpus exceeding $ 1.1 tn flowing into the financial intermediation sector over the next five years as opposed to the $700 bn which has flowed in over CY05-10 (see Exhibit 43 below for details).

Exhibit 43: Rapid income growth coupled with rising savings should unlock a $ 3.5 tn savings pool- a third of which will comprise HH financial savings

CY	Nominal GDP (in USD tn)	Savings Ratio	Savings Pool (in USD bn)	HH Financial Savings Ratio	HH Financial Savings (in USD bn)
2005	0.7	32%	233	10%	71
2006	0.8	33%	277	11%	95
2007	1	34%	327	11%	104
2008	1.2	36%	450	11%	138
2009	1.2	32%	395	10%	127
2010	1.3	33%	436	11%	145
2011 (E)	1.5	34%	507	12%	179
2012 (E)	1.7	35%	590	11%	185
2013 (E)	1.9	36%	686	12%	229
2014 (E)	2.2	38%	818	12%	258
2015 (E)	2.4	39%	947	12%	292

Source: CSO, Ambit Capital Research
Assumptions Used

1. Nominal GDP growth rate: We have assumed a modest 13% yoy expansion in nominal GDP growth rate over 2010-15, an assumption which is arguably prudent.

2. Savings ratio: The savings ratio refers to the ratio of savings to GDP. The projection of 39% savings to GDP ratio is based on cross country experience. In 2015, India per capita income in PPP terms is forecast to cross $ 5K (Source: IMF) – a per capita income level at which developing Asia'a savings ratio was 45%. Thus, even the savings ratio assumed is prudent.

Investment Implications

Income expansion in this low-income economy will open the sluice gates to a surge in household financial savings over the next decade. Developed country experience suggests that as an economy develops, households channelize their financial savings away from hard currency and bank deposits to more complex and risky financial products. Banks, insurance & brokerage firms will be the clear beneficiaries of the rise in the household savings pool in India.

Deposit-takers

- **Commercial Banks**

Banks account for more than 60% of the Indian financial system's total assets. Despite this, deposit and credit ratios in India as a percentage of GDP are lower than most Asian peers. India's commercial bank penetration is only greater than that of Indonesia and Philippines thus pointing to the potential upside for flows into banks as the savings ratio rises and banks' penetration increases.

Exhibit 44: Commercial bank deposit and credit penetration In India is one of the lowest in the region

Outstanding deposits with commercial banks (as a % of GDP) in CY09		Outstanding loans from commercial banks (as a % of GDP) in CY09	
Country Name	**In %**	**Country Name**	**In %**
Hong Kong	389	Hong Kong	197
Japan	172	China	109
Singapore	152	Singapore	109
China	139	Japan	96
Malaysia	126	Malaysia	96
Thailand	78	Thailand	78
Korea	74	Korea	74
India	**64**	**India**	**46**
Philippines	49	Philippines	26
Indonesia	33	Indonesia	24

Source: IMF, Ambit Capital Research

- **Other deposit–taking corporations like insurance-providers**

Whilst vanilla banks dominate the Indian financial landscape, insurance institutions (share in financial system assets: 13%) and mutual funds (share in financial system assets: 5%) accounting for the rest.

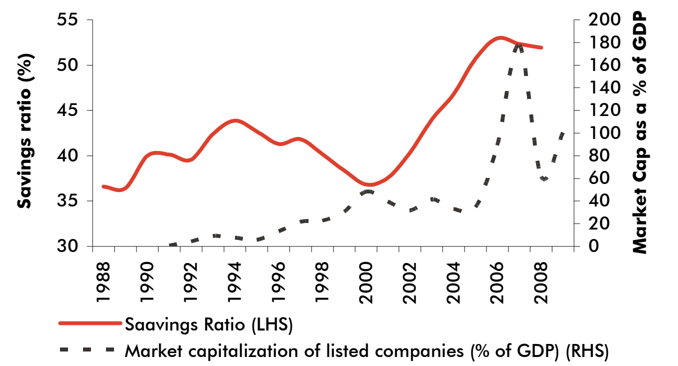
Cross-country experience suggests that as a nation develops and its per capita incomes rise, citizens divert a greater share of their savings to other deposit-taking corporations (ODCs). For instance Philippines with a per capita income of $ 3.5K (in PPP terms) has 512 depositors with ODCs per 1000 adults as opposed to Malaysia whose per capita income is $ 14 K (in PPP terms) and has 2061 depositors with ODCs per 1000 adults.

Given that insurance penetration (insurance premiums as a per cent of GDP in India is 4% for life business and 0.6% for non-life business) is low, this sector will see a significant increase in its assets under management over the next decade.

Brokerage firms to benefit

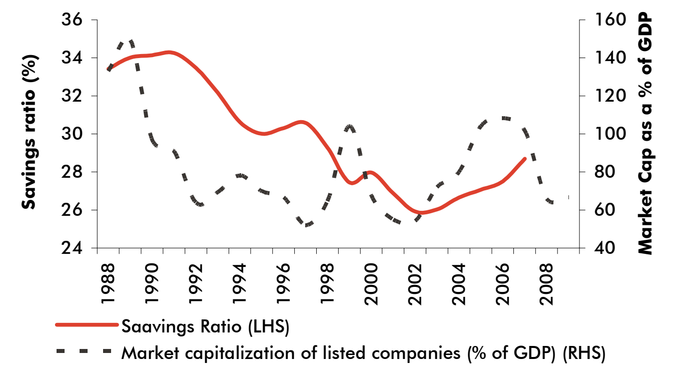
Currently, only a sliver of Indian households' savings pie flows into equity markets with investments in equities accounting for less than 2% of GDP. However, the experience of Asian economies suggests that the market capitalizations of a country and savings ratio are positively correlated (see Exhibit 45 & 46 below).

Exhibit 45: China's market cap continues to grow as savings rise. . .



Source: MoSPI, Ambit Capital Research

Exhibit 46: . . .whilst Japan's market cap is shrinking as savings fall



Source : MoSPI, IMF, Ambit Capital Research

India's market capitalization as a percentage of GDP was recorded at 90% in CY09 whilst its savings ratio stands at 32%. Going forward, as the Indian saver matures her participation in equity markets will increase meaningfully thus leading India's market capitalization in India to expand.

As incomes rise, households will route a greater share of their savings into equity markets through brokerage firms and mutual-funds. These sectors are well-poised to benefit from increased retail participation in stock markets in the oncoming decade. For an in-depth analysis of the implications for stock brokers, refer to our thematic on the subject to be published later this month.

Megatheme 5: India will become a hotbed of conflicts

Summary: Whilst the ongoing and widespread conflict in central India between the Indian establishment and Maoists generates headlines, we see a broader theme in these stray instances of conflict and expect their intensity to trend upwards over the next decade as inequalities persist.

As corroborated by cross country experience, the unequal distribution of gains of economic development across social groups and individuals will be the main driver of this trend. A vast and stratified populace with a youth bulge will add to the conflict risk.

The escalation of the Maoist movement, indisputably the biggest threat to internal security will pose challenges for the Metal and Mining Sector. Security costs for the corporate sector as a whole will rise as crime rates and the frequency of conflict trends upwards. Indirect costs in terms of political donations, bribes and corporate social responsibility (CSR) initiatives will be the other head under which costs will rise. Additionally, the corporate sector will continue to partially fund the Government's fiscal transfers directed at rural India. FMCG and aspirational product companies stand to gain from these transfer payments.

Worsening inequalities in India unlikely to ease

- **Taking stock of inequalities in India**

Despite recording a 6.5% p.a. CAGR in GDP growth since FY91, income distribution in India has been increasingly inequitable. After being constant in the 1980s, inequalities in India have worsened in the post-liberalization era. Quantitatively, India's Gini co-efficient (a measure of income inequality, with a value of 0% indicating perfect equality and 100% representing perfect inequality) has worsened from 33% in 1994 to 36% in 2005, the latest year for which data is available..

Besides inequalities at the aggregate level, inter-regional inequalities abound. More than 85% of inequalities in India are accounted for by intra-state differences (see Exhibit 47 below) indicative of the uneven spread of growth economic growth across India.

Exhibit 47: Intra-state inequalities account for the lion's share of overall inequalities in India

	1994	2005
Gini coefficient	**33%**	**36%**
Intra-state share	90%	86%
Inter-state share	10%	14%

Source: Vakulabharanam (2010), Ambit Capital Research

Exhibit 48: Rural India is the focal point of inequalities in India

	1994	2005
Gini coefficient	33%	36%
Rural intra-group share	57%	51%
Urban intra-group share	30%	30%
Rural-urban inter group share	13%	19%

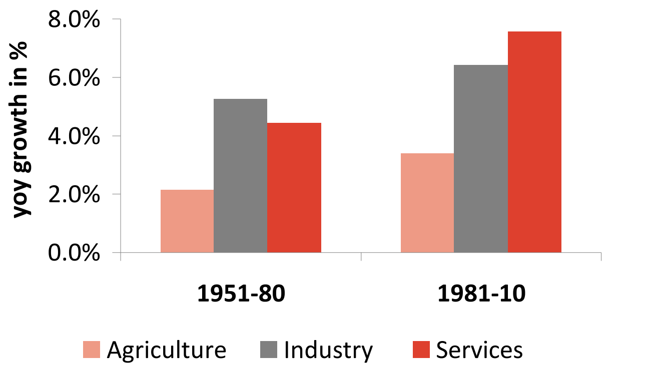
Source: Vakulabharanam (2010), Ambit Capital Research

Furthermore, the inability of the Government to execute land reforms in rural areas over the past six decades has made rural India the focal point of inequalities. Intra-group inequalities in rural India account for more than half of overall inequality in India (see Exhibit 48 above).

- **Inequalities are likely to persist in India**

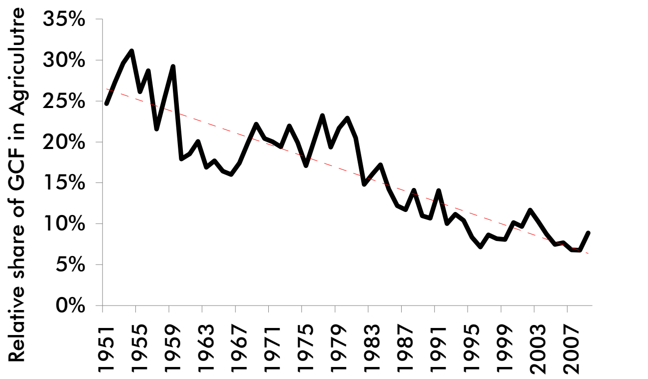
The widening differential between growth in the agricultural sector (a sector that employs nearly 50% of Indians) and the non-agricultural sector is the key cause of rising income inequalities in India (see Exhibit 49 & 50 below). While agricultural growth has been a tepid 2.7% p.a. since FY91, non-agricultural growth has been 7% p.a. thus leaving those dependent on agriculture (especially landless rural laborers) outside the realm of the Indian growth story.

Exhibit 49: Widening gap between agricultural and non-agricultural GDP growth



Source: MoSPI, Ambit Capital Research

Exhibit 50: Gross capital formation in agriculture on a downtrend since independence



Source: MoSPI , Ambit Capital Research

The other key factor perpetuating rural income inequalities is the inequitable ownership of land. 70% of India's populace lives in rural areas. Of these, nearly 40% comprise the rural elite who are typically landowners (and usually belong to the upper castes) while the rest are landless laborers. Despite land reforms being the obvious solution, the domination of local politics by the higher classes prevents the equitable distribution of productive assets.

The state of Bihar is a clear case in point. The nexus between upper classes and the administration accentuates the repression of the underclass in Bihar. Wherever the underclass has been politicised and demands reform, there ensue conflict between the dominant upper caste militias and the police on one side and the lower castes on the other (Chakravarti, 2001). While the most recent state elections in Bihar saw drastic land reforms appearing prominently on manifestoes, the situation on the ground is still grim.

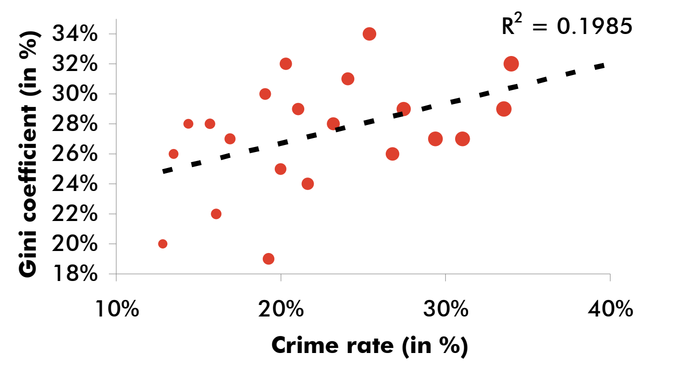
Given the declining trend in the relative share of gross capital formation (GCF) in agriculture, the wide gap between growth rate in agricultural and non-agricultural sectors and the durable nexus between politics and the upper-classes in most of rural India, income inequalities in India are unlikely to improve if not worsen going forward.

India could become a hotbed of conflicts over the next decade

- **Persistence of inequalities to drive crime rates higher**

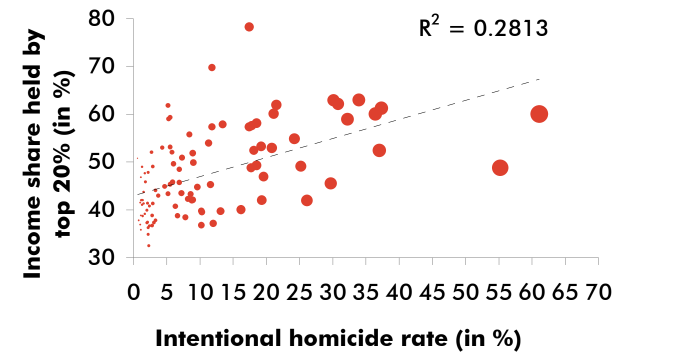
Inequalities between individuals (also called "vertical" inequalities) are known to fuel crime (see Exhibit 51 and 52 below) as corroborated by international (i.e. experience across countries) as well as intra-national experience (i.e. experience within countries).

Exhibit 51: Inter-state comparisons suggest positive correlation between inequalities and crime



Source: National Crime Records Bureau, Planning Commission, Ambit Capital Research , Data pertain to CY04

Exhibit 52: Cross country evidence points to positive relation between income inequalities and homicide rates



Source: UNDP , Ambit Capital Research

Crime rates in India are lower than the global average despite income inequalities being higher. For instance, the intentional homicide (i.e. murder) rate in India stood at 6% per 100,000 people in 2004 while the top 20% income earners in India commanded 45% of the national income. The Russian Federation recorded a homicide rate of 30% in the same year despite the top 20% commanding 46% of total national income.

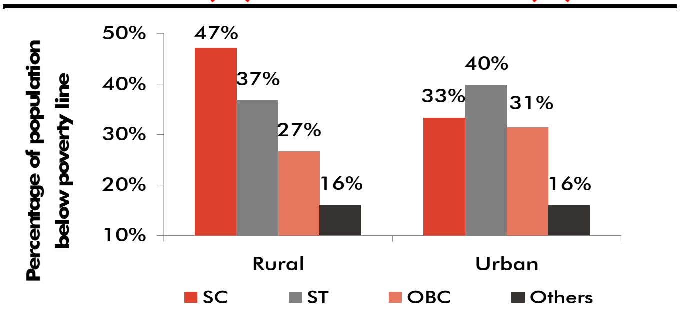
Given the strong positive correlation that exists across the world between crime rates & income inequalities and given the high incidence of inequalities in India, crime rates in India look as if they are waiting to explode.

- **Presence of 'horizontal inequalities' to ignite internal conflict**

International experience also points to the potency of 'horizontal inequalities' (HI) as a catalyst for conflict (refer to Exhibit 64 in the Appendix to Megathemes 5 for a list of global instances where HIs have been the root cause of internal conflicts). HI is defined as the marginalization of a social group that may be bound together by history, caste or creed. Vertical inequalities on the other hand refer to differences between individuals.

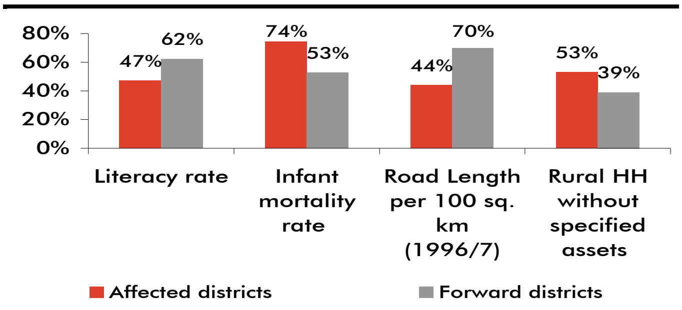
A clear case of HIs igniting conflict is the marginalization of 'scheduled caste (SC) & scheduled tribes (ST)' for over a century (see Exhibit 53 & 54 for details) which has translated into the Maoist insurgency – a movement which has infected more than 40% of the Indian geographical landmass and fatalities on account of which have been growing at a 32% p.a. CAGR over the past three years.

Exhibit 53: Higher incidence of poverty amongst Schduled Castes (SC) and Scheduled Tribes (ST)



Source: Ministry of Tribal Affairs

Exhibit 54: Naxalism affected districts systematically worse-off

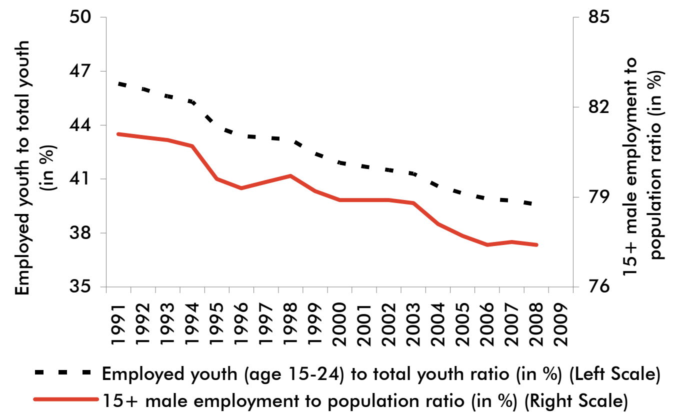


Source: Planning Commission

- **A vast, young , unemployed and illiterate population to shore up conflicts**

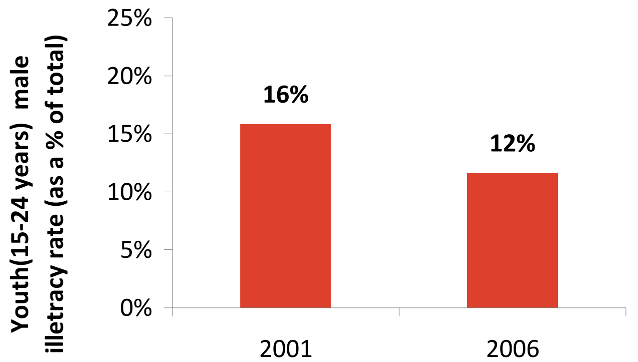
India is the second most populous country of the world accounting for nearly a fifth of the world's population. What makes India extremely vulnerable from a conflict point of view is that its vast and young population is increasingly unemployed. While 46% of Indian youth had jobs in 1991, this number shrank to 40% in 2008. Furthermore, unemployment amongst males aged 15 years and above, continued to rise over the past two decades (see Exhibit 55 below). Besides unemployment, illiteracy amongst Indian male youth compounds the conflict risk further (see Exhibit 56 below).

Exhibit 55: The increasingly unemployed working age population of India



Source: UNDP, Ambit Capital Research

Exhibit 56: More than a tenth of India's male youth is unlettered



Source: UNDP, Ambit Capital Research

The inability of the state to educate and provide jobs to its vastly young population will add to the frustration of the youth of India leading to increased social unrest and lead individuals to seek empowerment through anti-establishment movements such as the Maoist movement of central India.

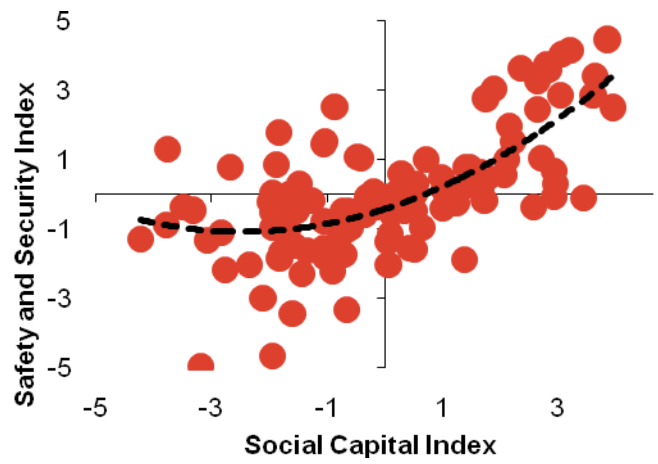
- **Besides, India abounds with a multitude of conflict risk factors**

In 2009, a total of 19 conflicts were raging within India with the Maoist insurgency topping the list in terms of intensity alongside the longstanding Hindu-Muslim conflict (refer to Exhibit 63 for the list of currently brewing conflicts in India). India is most likely emerge as a hotbed of internal conflict over the next decade mainly because India abounds with what sociologists call a multitude of conflict risk factors (see Exhibit 65 in the Appendix to Megathemes 5 for details of the 14 risk factors that India faces). The vast, young, unemployed and stratified population as well as an overburdened judiciary will spell greater conflict for this low per capita income democracy over the next decade.

Investment implications

Worsening inequalities breed discontent which translates into internal conflict. While 'conflict' is seldom studied as an economic variable, global experience points to the relevance of this variable in affecting investment decisions. A rise in social conflict (measured by a fall in what sociologists "social capital") typically entails reduced internal security as well as slower economic growth (see Exhibit 57 & 58 below).

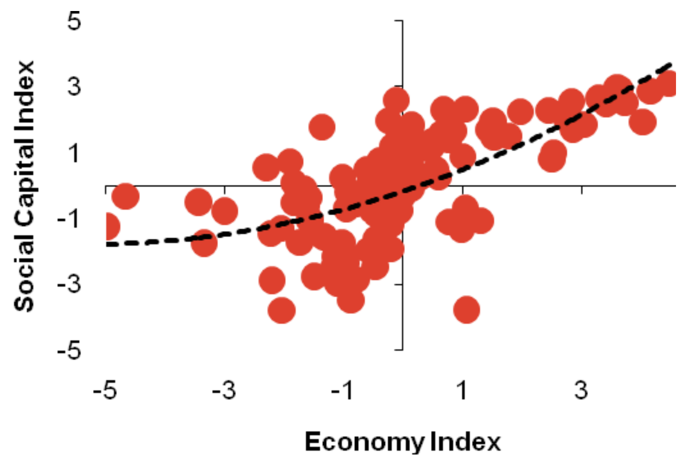
Exhibit 57: Positive relation between a nation's social capital and internal a safety & security



Source: Legatum Prosperity Index, Ambit Capital Research

Note: The exhibit is based on data for 110 countries in 2010.

Exhibit 58: Positive relation between a nation's social capital and economic well-being



Source: Legatum Prosperity Index, Ambit Capital Research

Note: The exhibit is based on data for 110 countries in 2010.

- **Escalation of Maoism to pose challenges mainly to extractive industries**

The intensification of the Maoist movement will adversely affect the profitability of firms in the Metals and Mining space through two conduits – disruption of business activities as well as regulatory risks imposed by the possible passage of the Mines & Mineral Development and Regulations (MMDR) Bill, 2010

Given that the five most Maoist affected states namely Andhra Pradesh, Chattisgarh , Orissa , Bihar and Jharkhand (also known as the Red corridor) account for more than half of India's mineral production – the escalation of the Maoist movement will have grave implications for the Metals and mining sector- a business for which relocation is not an option.

The Maoist movement has imposed costs on India Inc in terms of damage to assets, disruption of production activities and imposition of constraints to further expansion (see Exhibit 59 below and Exhibit 66 in the Appendix to Megathemes 5 for details of the BSE 100 companies with plants located in these five Maoist violence affected states).

Exhibit 59: Impact of Naxalism on businesses

Sector	Company	Risks posed by Naxalism
Railways	Indian Railways	The Indian Railways are losing about 40% of their business due to various Naxal incidents, *bandhs* (shut downs) and strikes. There was, for instance a shortfall in throughput of 15,000 to 20,000 tonnes a day when the Naxals called a bandh on July 7-8, 2010.
Telecom	Airtel , BSNL , Bharti	Several mobile telecommunication towers of Airtel, BSNL and Reliance destroyed by Maoists.
Metals	NMDC	Net profits dropped by almost Rs 1,000 crore in FY10 due to a series of Naxal attacks on its facility in Chhattisgarh
	Essar	Naxals blew up a portion of Essar Steel's 267-km pipeline that carried iron ore slurry from Bailadila to Visakhapatnam in June 2009
	SAIL	Rowghat project in Chhattisgarh delayed over a decade. SAIL had planned to start operations in the Rowghat mines by 2014-15 for its BSP project for a 14mtpa steel plant. Delay of each year has an opportunity cost of Rs2 400cr p.a. (assuming first phase of 3mtpa).
	Hindalco	Mining facility at Saridih in Chhattisgarh attacked, officials abducted, transportation of bauxite from mines in Gumla and Lohardaga districts of Jharkhand halted. Maoist issue violence in May 2005 resulted in damage to property to the tune of Rs. 1cr.
	Nalco	In April 2010, alumina and bauxite mining complex in Koraput, Orissa attacked. Estimated costs amounted to about Rs. 20 crore including additional security costs, insurance costs and redevlopment funds to the area.
Coal	Coal India	CCL's coal warehouse was raided in late October 2010. In another incident, CCL lost 1.126 million tonnes of coal production from April to June due to Maoist activities imposing a cost of about Rs28 crores. Coal transportation affected in a big way.
Power	NTPC	49% of operational coal based power-plants located in the 5 main Maoist affected states.
	Reliance Power	51% of operational gas based power-plants located in Andhra Pradesh
	GVK	100% of operational gas based power-plants located in Andhra Pradesh
	Lanco Infratech	50% and 86% of operational coal and gas based power-plants located in Chattisgarh & Andhra Pradesh respectively.

Source: SATP, Press Reports, Ambit Capital research

The Mines & Mineral Development and Regulations (MMDR) Bill, 2010 will be introduced in the ongoing winter session of Parliament and proposes to make miners and captive miners share 26% of their net profit on an annual basis with the people affected by the project. Additionally, miners as well as captive miners might be statutorily mandated to offer shares to displaced families.

Our Metals and Mining analyst, Chandrani De, believes that the profit sharing proposal is likely to come into force over the next few years but in a more diluted form (profit sharing formula to be less than 26%). While this will ease the structural tensions between this sector and the locals, the possible implementation of this regulation will eat into the profitability of all companies in Metals and Mining sector when implemented.

- **Conflicts to increase costs for India Inc.**

Increased conflict imposes higher costs on businesses directly (see Exhibit 60 for details) as well as indirectly (like political donations, corporate social responsibility related expenses or bribes).

Exhibit 60: Direct cost of conflict to businesses

Cost	Details
Security	Higher payments to state/private security firms
Risk Management	Insurance, loss of coverage, specialist training for staff, reduced mobility and higher transport costs.
Material	Destruction of property or infrastructure.
Opportunity	Disruption of production, delays on imports.
Capital	Increased cost of raising capital.
Personnel	Kidnapping, killing and injury; stress; recruitment difficulties; higher wages to offset risk; cost of management time spent protecting staff.
Reputation	Consumer campaigns, risk-rating, share price, competitive loss.
Litigation	Expensive and damaging law suits.

Source: International Alert, Ambit Capital research

Security related costs in India are one of the lowest in the world and account for about 0.1% of sales in India as opposed to the global average of 1.5% (see Exhibit 61 below for details). In fact, just about a tenth of firms operating in India identify crime, theft and disorder as a major constraint to busnies operations significantly lesser than the global average of 26%. Even compared to Brazil, an emerging market economy with a stratified population India's conflict related costs are significantly lower.

Exhibit 61: Crime & conflict related costs in India are low currently

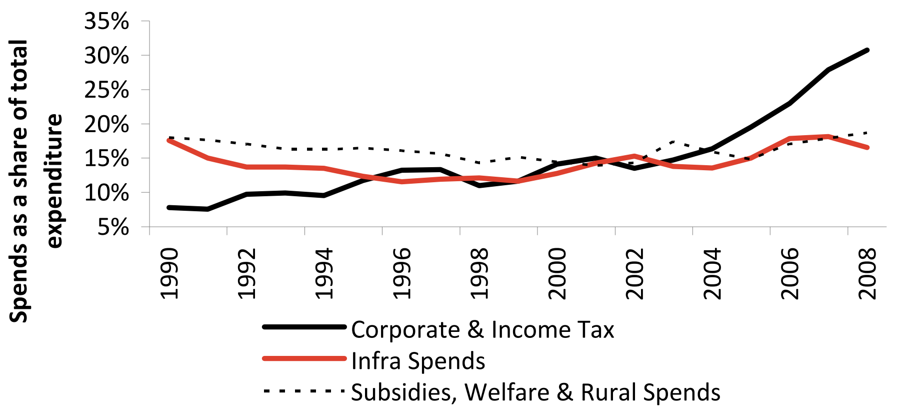
Country	Losses due to theft, robbery, vandalism, and arson Against the Firm (% of sales)	Security costs (% of Sales)	% of firms identifying crime, theft and disorder as major constraints
All countries	*1*	*1.5*	*25.5*
South Asia	0.6	1	20.9
Brazil (CY09)	1.7	2.5	57
India (CY06)	0.1	0.8	11.9

Source: Enterprise survey

- **Corporate India to continue funding cost of Government sops to the have-nots**

In a democratic political structure the Government will have to placate the disadvantaged underclass to buy votes. The purchase of votes in all likelihood will be operationalised through increased cash/food transfers (as opposed to empowering reforms due to reasons discussed earlier) to the disadvantaged which has and will continue to be partially funded by the corporate sector (see Exhibit 62 below).

Exhibit 62: The spread between the rising tax collections and infra spends has been partially funding the Government sops to rural India



Source: Various Union Budgets, Ambit Capital research

Be it the Mahatma Gandhi National Rural Employment Guarantee (MGNREGA) (a government sponsored scheme that guarantees hundred days of employment in a financial year to a rural household) or the farm loan debt waiver scheme declared in FY09 – rural transfer payments are the perfect *modus operandi* for the state to instantly augment rural incomes. These payments directly benefit sectors whose key audience is the rural masses. The increased transfer of incomes will be a positive for FMCG sellers in general and aspirational product (like motorbikes and fairness creams) manufacturers in specific.

Appendix to Megatheme 5

Exhibit 63: Currently brewing conflicts in India

Name of conflict	Conflict Parties	Conflict Items	Started in	Intensity in 2009
India (Maoists)	CPI-M vs. government	System/ideology	1997	4
India (PULF)	PULF vs. government autonomy	System/ideology	1993	3
India (JeM, LeT, HM et al./Kashmir)	JeM, LeT, HM vs. government	Secession	1947	3
India (NSCN/Nagaland)	NSCN-IM, NSCN-K, NSCN-U vs. government	Secession	1947	3
India (MPLF, ZRA, KCP/Manipur)	MPLF, ZRA, KCP vs. government	Secession	1964	3
India (Tripura)	ATTF, BNCT, NLFT vs. government	Secession	1980	3
India (Hindus - Muslims)	Hindus vs. Muslims	Regional predominance	1853	3
India (Nagas - Kukis)	KNF, KLA, KNA vs. NSCN, UNPC	Regional predominance	1947	3
India (NSCN-K - NSCN-IM)	NSCN-K vs. NSCN-IM	Regional predominance	1988	3
Pakistan - India	Pakistan vs. India territory	International power	1947	3
India (ULFA, NDFB, Black Widow, DHD/Assam)	ULFA, NDFB, BW, DHD vs. government	Autonomy	1979	3
India (various Islamist militants)	JeM, HuJI, LeT, IM, SIMI vs. government	System/ideology	2001	2
India (ATTF, ULFA, NLFT - Biharis, Bengalis)	ATTF, ULFA, NLFT vs. Biharis, Bengalis	Regional predominance	1981	2
India (Hindus - Christians)	VHP, Bajrang Dal, Hindus vs. Christians	Regional predominance	1999	2
India (Sikhs - DSS)	Sikhs vs. DSS	Regional predominance	2007	2
India (DHD - HPC-D)	DHD vs. HPC-D	Regional predominance	1986	1
India (Bodos - Santhals)	Bodos vs. Santhals	Regional predominance	1994	1
India (LTTE)	LTTE vs. government	Other	1987	1
India (Sikhs/Punjab)	Akali Dal, KLF, BKI vs. government	Autonomy	1929	1

Source: HIIK, Ambit Capital Research, Note: Levels of intensity: 5 = war; 4 = severe crisis; 3 = crisis; 2 = manifest conflict; 1 = latent conflict

Exhibit 64: The potency of horizontal inequalities in igniting conflicts

Region	Form of Horizontal Inequality	Conflict form assumed	Conflict parties
Srilanka	Sri Lankan Tamils felt politically and economically threatened by the Sinhalese	Long lasting violent conflict	LTTE vs. government
Uganda	The northerners controlled the political system, while the southerners were economically privileged	Long lasting violent conflict	Bantu vs. non-Bantu-speaking peoples
South Africa	Black/white differentials in economic and socio-economic spheres in favour of the latter	Long lasting violent conflict	Blacks vs. whites
North Ireland	Considerable and consistent inequalities with respect to economic, social and political life in favour of Protestants	Long lasting violent conflict	Catholics vs. Protestants
Chiapas, Mexico	Chiapas- a Mexican state with a high concentration of indigenous people has suffered political, economic and social deprivation	Less severe rebellion	Zapatista Army of National Liberation (A Chiapas based extremist group) vs. government
Fiji	Economically, severe imbalances exist but in different directions for different elements	Coups	Indigenous Fijians vs. Indo-Fijians
US	Black/white differentials in economic, social and political spheres in favour of the latter	Periodic riots and criminality	Blacks vs. whites
Malaysia	Horizontal inequalities considerable addressed by systematic affirmative action	Occasional racial riots	Malays vs. Chinese minority
Brazil	Inequities in the economic and social status particularly affect Afro-Brazilians. Poor youth too are marginalised. The various aspects of economic inequality in Brazil are often termed as 'social apartheid'.	High level of criminality	Rich vs. poor , White vs black
India	Sustained economic, political and human deprivation of tribals	Sporadic high intensity violent conflict	CPI-M vs. government
India	Economic deprivation with seeds of discontent sown at the time of the Indo-Pak partition	Sporadic high intensity violent conflict	Hindus vs. Muslims

Source: Stuart (2002)

Exhibit 65: India abounds with a multitude of conflict risk factors

Variable	Risk Posed	Details	Rationale
Institutional			
Freedom and independence	**Medium**	India was given a rating of 2.5 (a rating of 1 being the most free and independent nation) by Freedom House's Annual Report 2010	Democracy is an indicator of the potential for peace only in a developed country and not in an LDC like India.
Effectiveness of judiciary	**High**	The Indian judiciary is overburdened and timely delivery of justice is rare. According to a 2009 report by the Chief Justice of the Delhi High Court, at the current pace it would take 466 years to clear the backlog	From a conflict perspective, dispute resolution is one of the State's most important functions.
Corruption	**Medium**	India was ranked 87th of 178 countries (rank 180 being the most corrupt) on Transparency International's Corruption Perceptions Index 2010.	Government corruption is highly correlated with violent conflict as it is indicative of low responsiveness of the govt to citizens' concerns.
Economic			
Existence of horizontal inequalities i.e. the presence of consistently disadvantaged social groups	**High**	SCs, STs , OBCs and Muslims are some of the key disadvantaged social groups in India. The	Historical evidence suggests that the presence of horizontal inequalities (i.e. inequality amongst identifiable social groups) is strongly correlated with group discontent and hence conflict.
Incidence of vertical income inequalities	**High**	The lowest 20% of Indians share in total income is 8% while that of the highest 20% is 45% (UNDP)	Presence of vertical inequalities (i.e. inequality amongst individuals) is a major cause of conflict.
Human underdevelopment	**High**	India was ranked 134th of 182 countries (rank 182 being the most underdeveloped) on UNDP's HDI Index 2007	Human underdevelopment is the primary motivating factor of violent conflict in developing nations.
Persistence of regional disparities	**High**	Documented evidence of the rural-urban divide as well as state-wise disparities.	Geographical inequalities are often a proximate cause of conflict.
Employment to population ratio, ages 15-24, total (%)	**Medium**	The ten year average for this variable (1997-2008) has been recorded at 58% (UNDP)	High unemployment, particularly among the youth is generally an indication of economic instability and a leading indicator of conflict.
Demographics			
High quantum of population	**High**	India is the second most populous nation of the world with a population of 1.2 bn in 2010 expected to grow at a CAGR of 1.9% over the next decade (UNDP's medium variant population forecast).	Countries with large populations are characterised with an increased risk of violence. Moreover, rapid population growth and demographic change impose social tensions on a population that often express themselves violently.
Share of persons aged 0-14 yrs	**High**	The ten year average for this variable (2000-09) has been recorded at 33% (UNDP)	This demographic variable is an indicator of an impending youth bulge and is a leading indicator of conflict.
Conflict & fragility			
History of internal conflict in the country	**High**	While the Hindu vs Muslim is the oldest ongoing internal conflict in India (started in 1853) , Indian history is replete with instances of violent internal conflicts. 36,000 battle related deaths have occurred in India over the ten year period of 1999-2008 (UNDP)	Countries with a history of violent conflict are more likely to experience future violence than countries with a peaceful past.
Presence of armed state opposition groups	**Medium**	Maoists and Islamic extremists are the two dominant armed groups engaged in an ideology based war with the Indian State.	This is a clear indicator of potential or existing conflict.
Occurrence of conflicts with a regional dimension	**Medium**	In 2009, 8 regional predominance centric and 2 autonomy centric conflicts were recorded in India (HIICR)	Regional violence has important implications for conflict and political stability.
Instances of conflict in neighbouring states	**Medium**	India is surrounded by non-democratic conflict-ridden nations.	Known as the 'bad-neighbour effect', countries that border conflict-affected areas face a greater risk of conflict.

Source: International Alert, Ambit Capital Research

Exhibit 66: BSE 100 stocks with plants located in the 5 Naxalism affected states

Company	Sector	Total	Chhattisgarh	Jharkhand	Andhra Pradesh	Bihar	Orissa
Dr Reddy's Labs	Pharmaceuticals	21	0	0	21	0	0
NTPC	Power Generation & Distribution	12	3	2	2	2	3
Hindalco Inds.	Non Ferrous Metals	7	1	2	1	0	3
ITC	Tobacco Products	7	0	0	6	1	0
Jindal Steel	Steel	7	3	1	0	0	3
ACC	Cement	6	2	2	1	0	1
Tata Steel	Steel	5	0	2	0	0	3
Divi's Lab.	Pharmaceuticals	4	0	0	4	0	0
India Cements	Cement	4	0	0	4	0	0
Larsen & Toubro	Infrastructure Developers & Operators	4	0	0	2	0	2
Natl. Aluminium	Non Ferrous Metals	4	0	0	1	0	3
United Spirits	Alcoholic Beverages	4	0	0	2	1	1
S A I L	Steel	3	1	1	0	0	1
UltraTech Cem.	Cement	3	1	0	1	0	1
Wipro	IT - Software	3	0	0	3	0	0
NMDC	Mining & Mineral products	2	2	0	0	0	0
Reliance Inds.	Refineries	2	0	0	1	0	1
Ambuja Cements	Cement	1	1	0	0	0	0
Ashok Leyland	Automobile	1	0	0	1	0	0
Asian Paints	Paints/Varnish	1	0	0	1	0	0
Cairn India	Crude Oil & Natural Gas	1	0	0	1	0	0
B H E L	Capital Goods - Electrical Equipment	1	0	0	1	0	0
Century Textiles	Diversified	1	1	0	0	0	0
Cairn India	Crude Oil & Natural Gas	1	0	0	1	0	0
H P C L	Refineries	1	0	0	1	0	0
Grasim Inds	Diversified	1	1	0	0	0	0
I O C L	Refineries	1	0	0	0	1	0
M & M	Automobile	1	0	0	1	0	0
Reliance Infra.	Power Generation & Distribution	1	0	0	1	0	0
Tata Power Co.	Power Generation & Distribution	1	0	1	0	0	0
Tata Motors	Automobile	1	0	1	0	0	0
Siemens	Consumer Durables	1	0	0	1	0	0
Sesa Goa	Mining & Mineral products	1	0	0	0	0	1

Source: Capital Line, Ambit Capital research

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