November 20, 2012

Indian Economy Thematic

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Megathemes 3.0: India - Moving beyond GDP growth

The erosion of the growth premium of a country that shot to fame owing to its stellar GDP growth rate has given rise to a generation of sceptics. Instead of relying on the one dimensional (and grossly inadequate) lens of GDP growth, we capture the evolution of India through the lens of four irreversible structural changes that are likely to render redundant the traditional constructs used by investors to understand this country and, in doing so, spawn a new generation of winners and losers in the Indian stock market.

In politics, it is relatively easy to identify when a country leaves behind a certain party or an ideology and embraces a new creed. The challenge in economics and sociology is that such changes are slower and harder to spot. And yet these structural changes in a country's economy and society are incredibly powerful. Not only can they transform countries, but they can also render investors' and analysts' old models (both, mental and spreadsheet-based) redundant. In this note, we zoom in on four mega-trends that look likely to transform India in such a profound fashion:

Theme 1 - The utter fragmentation of political power in India: Whilst the Congress dominated Indian politics through the 1950s and the 1960s, the 1970s heralded the erosion of the absolute power of this national political party. This disintegration of political might took place along the following three axes: **(1)** a shift away from national parties and towards smaller regional parties; **(2)** a shift towards economic regulators that operate independently from the Government; and **(3)** the rise of an increasingly agitated 'civil society,' which is using recent legislation, such as the Right to Information Act, in a proactive way to question the Government.

Theme 2 - The splintering of the "aspirational consumption" story: Two decades of economic growth and liberalisation has resulted in the proliferation of aspirations, thereby driving the next leg of outperformance of the aspirational consumption theme from a 5-year perspective despite the current cyclical slowdown. In particular, the aspirational consumption story is splintering along three separate dimensions, namely: **(a)** traditionally backward regions are likely to drive the next leg of aspirational consumption growth; **(b)** the 'sub-35 years' end of the age spectrum is likely to account for the lion's share of total consumption going forward; and **(c)** rising literacy, greater labour force participation, delayed marriages and lower fertility amongst women is making them increasingly powerful consumers in a traditionally patriarchal society.

Theme 3 - The advent of export-led industrialisation: The 49% correction that the INR has experienced vis-à-vis the RMB since 2007 is making India more competitive in export markets. In parallel, the high cost of capital in India and relatively low-cost access to higher education has meant that Indian manufacturers excel in knowledge-intensive but capital-light industries. This rise of the relatively unnoticed light industrials export sector (spanning Auto, Auto Ancillary, Consumer Durables and Capital Goods sectors) presents attractive investment opportunities especially in the small-midcap space.

Theme 4 - The challenge of a compromised banking system: Banks in India account for 60% of the financial system's assets, and they are the core source of funding for India's corporate sector. Whilst the banking sector in India is in a structural sweet spot owing to India's capital-scarce nature, only sensibly run banks with clean accounts are likely to be a good cross-cycle investment. In this note, our Banks team highlights our proprietary forensic tools to help investors wade through the deceptively pristine waters of the Indian banking sector.

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Summary of Investment Implications

Theme 1 - The utter fragmentation of political power in India	
Politically linked stocks and companies reliant on Govt. sign-offs to underperform	**Investment Implications**
Reliance Industries	SELL
Crompton Greaves	SELL
L&T	BUY
Theme 2 – The splintering of the "aspirational consumption" story	
Aspirational demand-related stocks to outperform	**Investment Implications**
TTK Prestige	BUY
Page Industries	Not Rated
TVS Motors	Not Rated
Theme 3 – The advent of export-led industrialisation	
Exporters of light industrials to outperform	**Investment Implications**
Cummins India	BUY
Balkrishna Industries	BUY
Elgi Equipments	Not Rated
Theme 4 - The challenge of a compromised banking system	
Sensibly run banks with clean accounts to outperform	**Investment Implications**
Bank of Baroda	BUY
Axis Bank	SELL
State Bank of India	SELL

Source: Bloomberg, Ambit Capital research

In a related Strategy note published today by our colleague, Gaurav Mehta, the Megathemes framework is used to identify entries into and exits from the Nifty by 2022.

Gaurav's note also looks at churn in the Nifty over the last 20 years and correlates that to the structural changes that have taken place in the Indian economy over this period.

Please refer to "The Nifty by 2022" for more details.

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Executive Summary

Introduction

In politics, it is relatively easy to identify phase shifts (when a country leaves behind a certain party or an ideology and embraces a new creed). These phase shifts may or may not be demarcated by specific elections but they take place in 3-5 years and are relatively easy to spot (even in real time). So, for example, the Reagan-Thatcher revolution that the US and the UK went through in the late 1970s to the early 1980s was a seismic change for these countries, and it was recognised by commentators even then. From the pseudo-socialism and stagflation of the 1970s, these two leaders dragged their economies towards a more aggressive free market regime buttressed by a hardline Monetarist stance against inflation. In response, after going nowhere from 1967 to 1983, the American stock market started rising again and rose, with two major corrections (1987 and 2000), for more than 20 years.

The challenge in economics and sociology is that such changes are slower and harder to spot (almost impossible to spot in real time, we would say). And yet these structural changes in a country's economy and society are incredibly powerful. Not only can they transform countries, they can also make investors' and analysts' old models (both, mental and spreadsheet-based) redundant. In this note, we focus on four mega-trends that look likely to transform India in such a fashion:

- Theme 1: The utter fragmentation of political power in India;
- Theme 2: The splintering of the "aspirational consumption" story;
- Theme 3: The advent of export-led industrialisation; and
- Theme 4: The challenge of a compromised banking system.

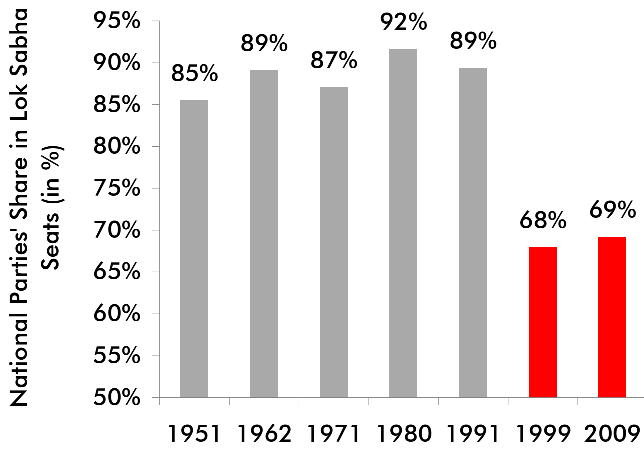
Theme 1: The utter fragmentation of political power in India

Forty years ago, a single national political party (namely the Congress) had complete control over the Indian economy. The party commanded **70% of the seats in the Lok Sabha on a standalone basis**. Furthermore, the Indian economic landscape was regulated solely by the Government and was characterised by the complete absence of independent regulators. Institutions as well as citizens were yet to be activated by leaders and tools that could counter the power of the State.

However, multiple streams of institutional changes that came into play in the 1970s eventually led to the transformation of India by the noughties. Specifically, from the zenith of the 1970s, political might in India began to disintegrate along the following three axes:

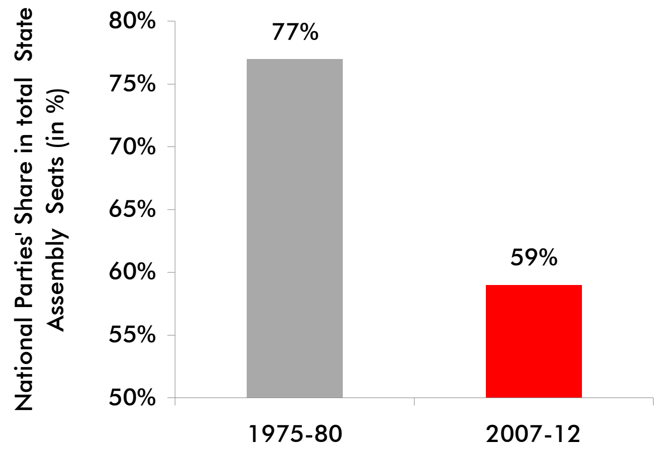
- From the 1970s onwards, the electorate's attention began moving away from national issues (such as the freedom struggle) towards issues of regional import, thus leading to the gradual and then **meteoric rise of smaller regional parties** and the decimation of national parties (refer to Exhibit A and B below).
- The administration of piece-meal economic reforms in the 1980s and the announcement of a big-bang package of economic liberalisation in 1991 led to the **rise of a dozen economic regulators** that operated independently from the Government.
- The evolution of India as a democracy led to the enactment of new laws (such as the **RTI Act, 2005**) and the coming of age of public institutions established in the decade after independence (in 1947) put an end to the notion of 'political immunity'. The activation of the **Election Commission** by TN Seshan in the 1990s or the activation of the **Comptroller & Auditor General** (CAG) by Vinod Rai in the noughties are examples of this dynamic.

Exhibit A: The seat share of national parties in the Lok Sabha has declined since the noughties



Source: Election Commission, Ambit Capital research

Exhibit B: The decline in National Parties' seat share in State Assemblies since independence

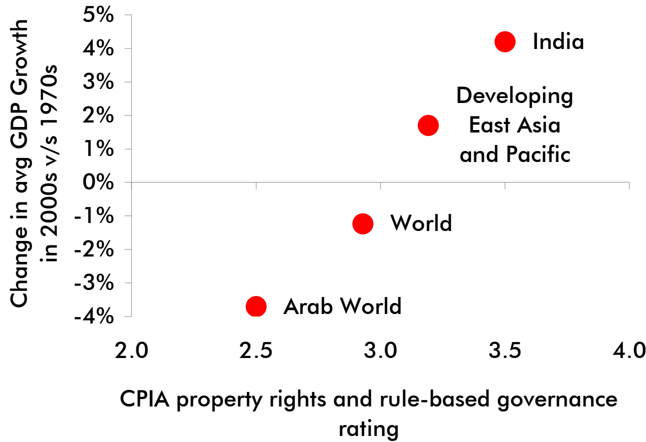


Source: Election Commission, Ambit Capital research

Investment Implications of Theme 1

At the macroeconomic level, the simultaneous advancement of the above three forces over the coming years is likely to spell an improvement in India's growth potential as history points to the tight correlation between institutional development and economic growth (refer to Exhibit C below).

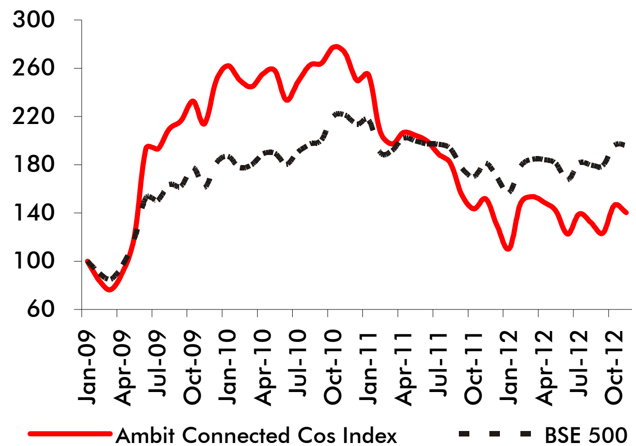
Exhibit C: International experience points to the positive correlation between rule-based governance and GDP growth potential



Source: World Bank, Ambit Capital research

Note: Country Policy and Institutional Assessment (CPIA) ratings range from 1=low to 6=high.

Exhibit D: Politically linked companies likely to continue their underperformance that began in 2010



Source: Bloomberg, Ambit Capital research

In terms of company specifics, politically connected companies are likely to continue their underperformance that began in 2010, owing to the gradual demise of the concept of 'political immunity' (refer to Exhibit D above).

In the table below we highlight stocks that are likely to be negatively impacted owing to their core operations persisting in sectors that by definition require a high degree of dependence on political connects. In addition, we highlight stocks that are exceptions to the norm and despite operating in heavy sectors are characterised by impressive franchises that do not rely on political connectedness (refer to Exhibit E below).

Exhibit E: Stock-specific Investment Implications of Theme 1

Theme 1 : The utter fragmentation of political power in India					
Company	**Bloomberg Ticker**	**Mcap (US$ mn)**	**ADV (US$ mn)**	**Stance**	**Comments**
Reliance Industries	RIL IN	47,045	56.2	SELL	RIL's business activities span across exploration and production (E&P) of oil and gas, petroleum refining, petrochemicals, retail, telecom, etc. Backward vertical integration has been the cornerstone of the evolution and growth of RIL. Starting with textiles in the late 1970s, RIL pursued a strategy of backward vertical integration in polyester, fibre intermediates, petrochemicals, refining and E&P. RIL's E&P business may continue to face challenges because we neither expect a significant ramp up in gas production before FY15, nor do we foresee the Government accepting RIL's demand for import parity pricing for its gas. Whilst downstream margins are likely to remain at mid-cycle levels, volume growth from the downstream business would remain muted, given that the petchem capacity expansion will come on-stream only by end-FY14. Hence, earnings growth is unlikely to revive any time soon and we expect EPS CAGR of 6% over FY13-15.
Crompton Greaves	CRG IN	1,306	6.8	SELL	Crompton Greaves derives more than 50% of its revenue from its international operations. In the domestic business, over the past couple of years, the company has been losing market share given the rising competitive intensity on the back of the competition from its Chinese peers that are beginning to dominate over their Indian counterparts. In the past five years, the company has seen 15% revenue CAGR only and 6% profit CAGR.
Cairn India	CAIR IN	11,553	37.8	SELL	Cairn India is an independent oil and gas exploration and production (E&P) company, with most of its assets in India. Cairn India currently produces ~25% of India's domestic crude production, but ~95% of its production comes from only one asset in Rajasthan. The company expects production from the Rajasthan block to increase by 70% over the next 3-4 years, but that is subject to faster government approvals to its exploration and development programme. Even though the company's strategy is to expand beyond Rajasthan and have a diversified and sustainable E&P portfolio, it has met with limited success so far. Cairn India's earnings are positively linked to global crude price, with every US$1/bbl increase in Brent crude price translating into a 1.7% increase in FY14 EPS.
L&T	LT IN	18,041	48.3	BUY	L&T is the largest and the most diversified Indian industrial company, thus making it a clear play on the India capex story. It derives most of its revenues and cash flows from the contracting business wherein it is gaining market share on many of the smaller/mid-sized players due to the latter's profligacy in managing their balance sheets. An expected near-term pick up in capex (public and private) will enable L&T to expand at an industry leading pace alongside maintaining its RoICs. The company's near-term strategy is to foray more into international markets, scouting for large projects especially hydrocarbons, and to strengthen its balance sheet. Understanding the adverse fallout of the increased equity commitments made towards long gestation heavy engineering and infrastructure subsidiaries, L&T will be limiting incremental equity investments and raising equity in subsidiaries, thus further improving the cash flow profile.
Cummins India	KKC IN	2,453	2.6	BUY	Cummins is the strongest player in the engines segment given its superior presence (70% of its sales) in the large engines segment. This is backed by superior technology (only domestic player allowed to sell gensets above 550 KVA), strong brand recall in gensets (given that 65% is sold as backups i.e. critical application) and engines (preferred supplier for MNCs given its MNC pedigree), and a strong dealer network. Besides, Cummins' number one position appears defensible in spite of the presence of strong global players, such as Volvo, GE, Mitsubishi, Perkins, Caterpillar and Honda, in India. The revenues and PAT of the company over the past four years have seen a CAGR of 11% and 14%, respectively.
Voltas	VOLT IN	680	4.2	BUY	Voltas is a unique play on the rising HVAC/ Electrical spend on Indian commercial real estate and the increasing penetration of room air conditioners (RAC) in the country. Whilst Voltas is the leading RAC player with a superbrand status, it is one of the strongest MEP contractors in the country, with an unleveraged balance sheet (and high net worth) and established credentials. Voltas' near-term strategy is to increase its leadership in the RAC segment by increasing geographical penetration and product innovation. In the MEP projects segment, the company is looking to improve the quality of orders by focusing on client quality, payment terms and maintaining bidding rationality. Its credentials in water treatment and manufacture of cooling products are yet to provide business momentum with a pick up in investments in water and cold chains.
Tata Steel	TATA IN	6,813	35.9	BUY	Tata Steel is levered to continued investments in the infrastructure and construction sectors, increasing sales of cars as well rising consumption of white goods. Currently the company derives ~26% of total revenues from India, which is set to increase as the ongoing India expansions come through over the next few years. Tata Steel's strategy is to increasingly focus on expanding steel capacities in India, which will enjoy access to captive iron ore and hence will have superior profitability as compared to its international operations. Moreover, over a period of time, this will also ensure that exposure to the weaker European business, which is not integrated for raw materials, is reduced. In FY12, India volumes of 6.6mt accounted for ~27% of total steel volumes of 24.2mt. This is likely to increase to ~40% by end-FY14.

Source: Bloomberg, Ambit Capital research

Theme 2: The splintering of the "aspirational consumption" story

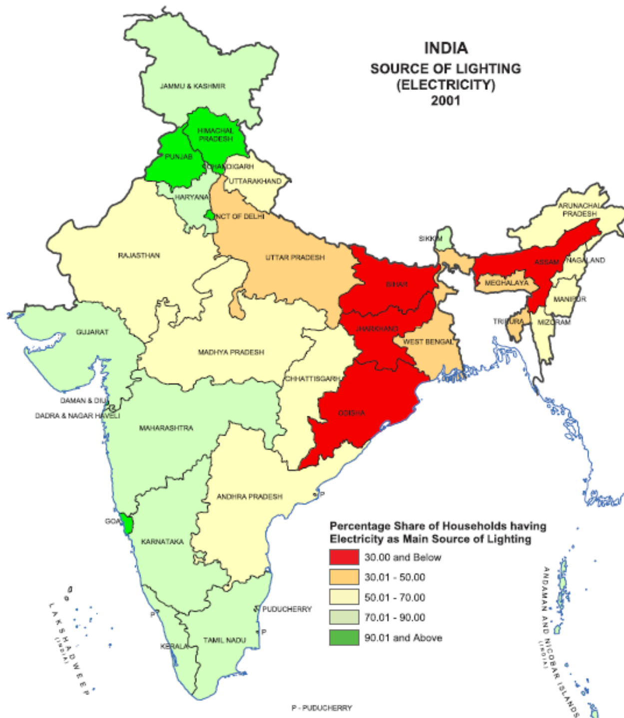
Even in the post-liberalisation era of the late 1990s, aspirational consumption was an elitist story with only the economically well-off regions (such as Punjab, Delhi and Kerala or more generally 'urban India') being the prime drivers of the same.

In fact even until ten years ago, in a patriarchal developing country such as India that is characterised by limited social and economic rights for women, aspirations and the ability to execute the same was limited largely to men. Moreover, despite the youth accounting for more than a third of the total population, limited economic empowerment and low general awareness levels meant that the Indian youth were not a critical driver of aspirational consumption.

In this note, we highlight that two decades of economic growth and liberalisation is likely to translate into the proliferation of aspirations geographically, demographically and gender-wise, thereby driving the next leg of outperformance of the aspirational consumption theme from a 5-year perspective despite the current cyclical slowdown. In particular,

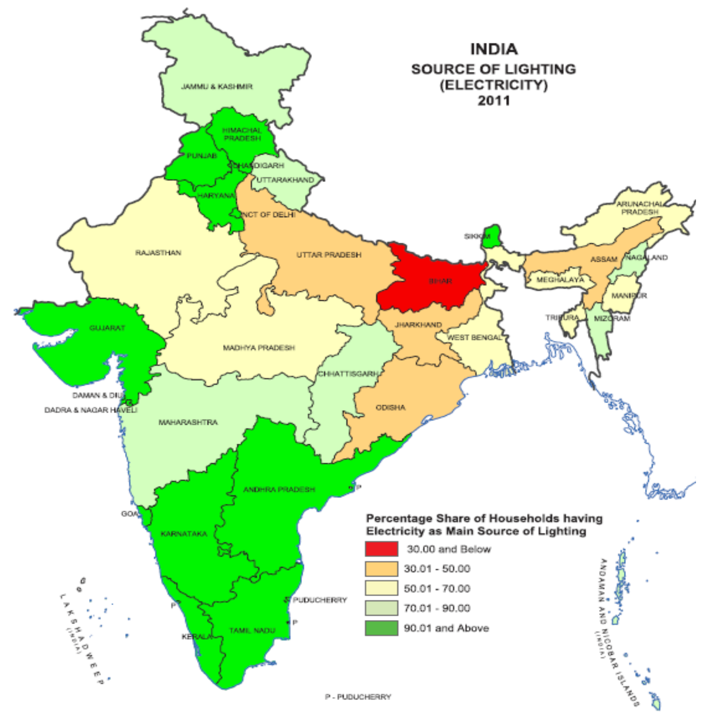
- **Geographically**: Traditionally backward regions (such as Uttarakhand and Bihar) are likely to drive the next leg of aspirational consumption growth in India. Besides rising incomes, improved access to electricity (refer to Exhibit F and G below), improved levels of sanitation and a revolution in awareness levels (regarding the availability of aspirational products) is likely to drive the geographic proliferation of aspirational consumption in India.

Exhibit F : Households having access to electricity increased from 56% in CY01 at the pan-India level…



Source: Census 2011, Ambit Capital research

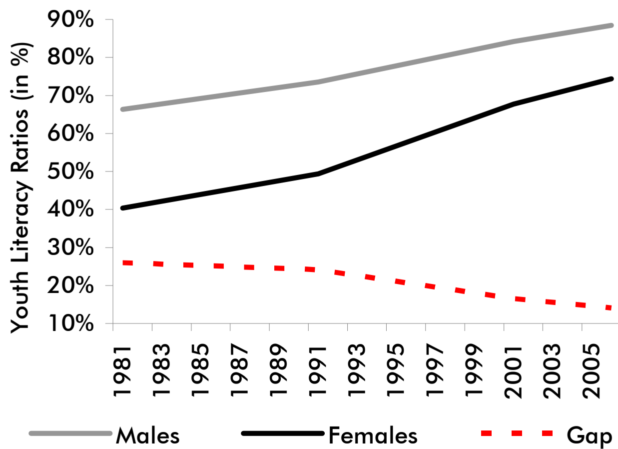
Exhibit G :. . . to 67% in CY11 with Orissa, Jharkhand and Assam recording significant improvements



Source: Census 2011, Ambit Capital research

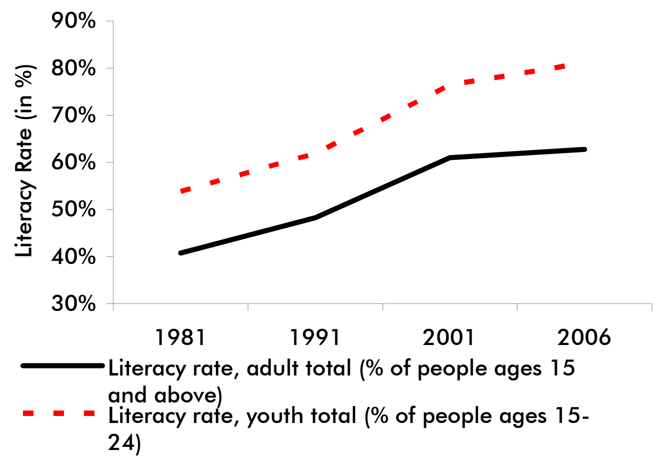
- **Gender-wise**: Women-oriented consumer products are likely to experience exponential growth in categories such as personal care products, jewellery, consumer durables as well as 2Ws, given that women are being increasingly empowered, socially and economically (refer to Exhibit H below) in a traditionally patriarchal society.

Exhibit H: Female literacy levels are rising faster than male literacy levels in India



Source: CEIC, Ambit Capital research

Exhibit I : Rising literacy levels in the youth of India



Source: World Bank, Ambit Capital research

- **Demographically**: The lower end of the age spectrum i.e. sub-35 years of age is likely to account for the lion's share of total consumption going forward as Indians born in the post-1991 era (and hence unscarred by the penurious memories of the 1970s and the 1980s) come to enjoy the benefits of economic prosperity, higher literacy levels (refer to Exhibit I above) and better employment opportunities.

Investment Implications of Theme 2

In the table below we highlight stocks that are structurally well-positioned to benefit directly from the proliferation of aspirations across geographic, demographic and gender lines over the next five years.

Exhibit J: Stock-specific Investment Implications of Theme 2

Theme 2 : The splintering of the "aspirational consumption" story					
Company	**Bloomberg Ticker**	**Mcap (US$ mn)**	**ADV (US$ mn)**	**Stance**	**Comments**
TTK Prestige	TTKPT IN	687	8.2	BUY	TTK Prestige, India's largest kitchenware company, has migrated from being a single product company to expanding its product offering and distribution channels to include a whole range of cookers, cookware and kitchen appliances. TTKPT's manufacturing facilities are located at Hosur, Coimbatore and Roorkee. The company currently sells its products in India under the brand name 'Prestige' and exports pressure cookers, pressure pans and non-stick cookware to countries including the US, the UK and the Middle East under the brand name 'Manttra'. The company has recorded revenue CAGR of 32% over FY07-12 and net profit CAGR of 57% over FY07-12.
TVS Motors	TVSL IN	334	1.1	NOT RATED	Amongst the listed two-wheeler companies, TVS Motors has the highest proportion of contribution from the scooters segment, with scooters contributing ~25% of its total volumes. Especially for TVS Motors, domestic scooters have seen a CAGR of 15% over FY07-12 v/s a decline of 6% CAGR for domestic motorcycle. The entry of newer players such as Hero MotoCorp, Mahindra and Yamaha in recent years has impacted TVS Motors' scooter segment volumes. However, TVS Motors commands a strong brand image, particularly in the scooter segment, which places it well to ride the growth opportunity in that segment.
HUL	HUVR IN	20,918	21.7	NOT RATED	HUL is a market leader in the skincare, haircare and deodorants space as well as the soaps & detergents segment with a product portfolio that spans from mass to premium, with a strong aspirational demand for the premium segment of its offering. Its personal products division accounts for around 50% of profit and we expect the business to expand faster than its other divisions. Over the past five years (FY07-12), the company has seen revenue CAGR of 12% and profit CAGR of 11%.
United Spirits	UNSP IN	4,378	111	NOT RATED	We expect higher spends by the youth to drive growth in alcohol consumption volumes, mainly led by: (1) low per capita consumption in the country, (2) rising income levels, and (3) declining average age of initiating alcohol intake. With more than 40% volume market share, access to the largest liquor distribution network in the country and the increased financial firepower with the Diageo deal, we expect United Spirits to be a large beneficiary of rising demand for alcoholic beverages.
Dabur	DABUR IN	3,988	3.1	NOT RATED	Dabur is a play on the Indian FMCG sector, with a product portfolio across personal products and foods. Through its brand 'Real', Dabur is now the market leader in the fruit juices segment, which now constitutes ~10% of its revenue. Besides recording continuous market share gains in the space, it is also a strong player in the health supplements, haircare and skincare space, whilst having a strong acquisition-led international portfolio. The company's has recorded revenue CAGR of 21% over FY07-12 and net profit CAGR of 18% over FY07-12.
Marico	MRCO IN	2,642	1.4	NOT RATED	Marico is the market leader in the haircare and premium edible oils space with its marquee brands 'Parachute' and 'Saffola' respectively. The company has also recently forayed into the skincare and health foods space and has a strong international presence led by both organic initiatives as well as acquisitions. Through continuous market share gains in its both Parachute and Saffola, the company's has recorded revenue CAGR of 21% over FY07-12 and profit CAGR of 25% over FY07-12.
Godrej Consumer	GCPL IN	4,314	3.2	NOT RATED	Through a series of acquisitions, the erstwhile soap manufacturer now derives 20% of revenue from its domestic soap business and 40% from its overseas businesses. In the domestic market, it is also the market leader in powdered hair dyes and insecticides. The company follows a 3x3 strategy of operating in three continents, i.e. Asia, Africa and Latin America, in three categories, i.e. haircare, personal wash and insecticides. Due to its numerous acquisitions, the company has recorded revenue CAGR of 39% over FY07-12 and net profit CAGR of 32% over FY07-12.
GSK Consumer	SKB IN	2,343	1.5	NOT RATED	GSK Consumer is a play on the aspirational demand for packaged foods. It derives 94% of its revenue from health drinks (the marquee brand Horlicks accounts for more than 80% of revenue). The company's strategy lies in expanding its portfolio by launching functional food variants in Horlicks through Mother's Horlicks (for lactating mothers), Womens Horlicks (addressing osteoporosis concerns) as well as entering new categories such as biscuits, noodles and oats. The company has recorded revenue CAGR of 19% over CY06-11 and net profit CAGR of 23% over CY06-11.
Bata	BATA IN	1,001	5.1	NOT RATED	Bata is the largest shoewear company in India, with a presence across men, women and kidswear. Through a series of initiatives comprising management changes, employee cost rationalisation, outsourcing, and operating efficiencies, the company has turned around to being profitable with EBITDA margins improving from 5.7% in CY06 to 14.8% in CY11. The company has recorded revenue CAGR of 15% over CY06-11 and net profit CAGR of 57% over CY06-11.
Arvind Mills	ARVND IN	408	2.4	NOT RATED	Arvind is amongst India's leading textile companies with strong operations in denims, knitted and woven fabrics, retail of Indian and international brands, and with a presence in engineering, telecom and real estate. Its presence in the branded garments space is likely to be a key driver of growth in the future. The company has recorded revenue CAGR of 18% over FY07-12 and net profit CAGR of 29% over FY07-12.
Page Industries	PAG IN	663	0.5	NOT RATED	Page is the exclusive licensee for the manufacture and distribution of the Jockey brand in India, Sri Lanka, Bangladesh, Nepal and the UAE, and the Speedo brand in India. It has a distribution network of more than 23,000 retail outlets in 1,200 cities and towns. The company also has 79 exclusive Jockey outlets in India. The company has recorded revenue CAGR of 38% over FY07-12 and net profit CAGR of 40% over FY07-12.

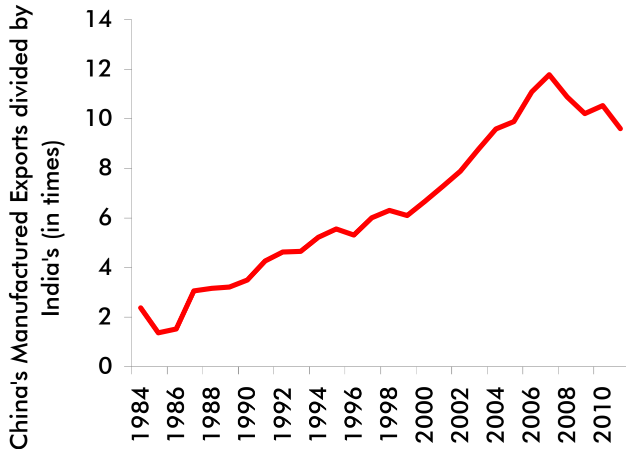
Source: Bloomberg, Ambit Capital research

Theme 3: The advent of export-led industrialisation

The erosion of China's competitiveness in the export market for manufactured goods is likely to translate into an opportunity for Indian exporters over the next five years benefiting specific corporates in a non-linear fashion.

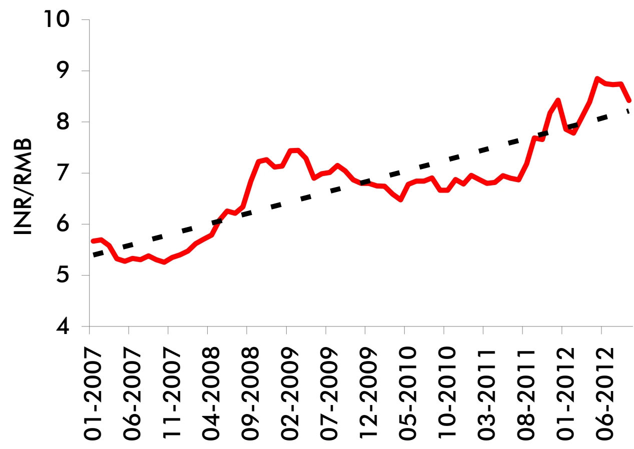
Early signs of the coming change are evident from the fact that India's exports growth in manufactured products has been exceeding that of China's since CY07 (refer to Exhibit K below).

Exhibit K : Manufactured exports growth in India has been exceeding China's since CY07



Source: World Bank, Ambit Capital research

Exhibit L: The INR has depreciated by 49% against the RMB since 2007



Source: CEIC, Ambit Capital research

This inflexion point in the chart above is indicative of a slow but sure increase in demand for India's manufactured goods since 2007 owing to the erosion of China's competitiveness in the manufactured goods market.

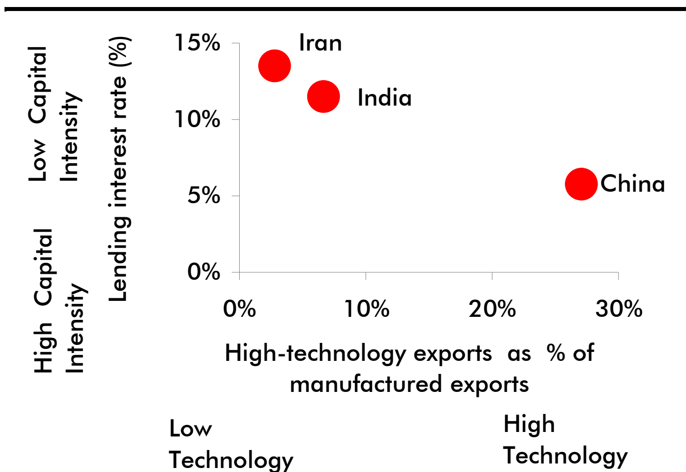
- **The loss of price competitiveness**: due to the unwinding of the RMB's undervaluation. Consequently the RMB has depreciated by 49% against the INR since CY07 to date (refer to Exhibit L above).
- **The need to rebalance growth in favour of consumption:** The Chinese administration has begun focussing on reviving domestic demand often at the cost of negative side-effects for the exports sector. For instance, labour costs have increased in China at a rapid rate over the past five years owing to increases in minimum wage **rates.**
- **China's unenviable record at production quality:** The final reason behind China's decreasing share in manufactured goods' exports is China's unenviable track record in production quality with the situation being exacerbated by a series of cases being brought to public attention since CY07.

Indian exporters of "light industrial manufacturing" likely to benefit disproportionately

"Engineering goods" in specific and "light industrial manufacturing" in general within the broader manufactured goods space are likely to gain disproportionately owing to the erosion of China's export competitiveness. This is so because India's competitive advantage lies in the manufacturing of these products (refer to Exhibit M below) owing to:

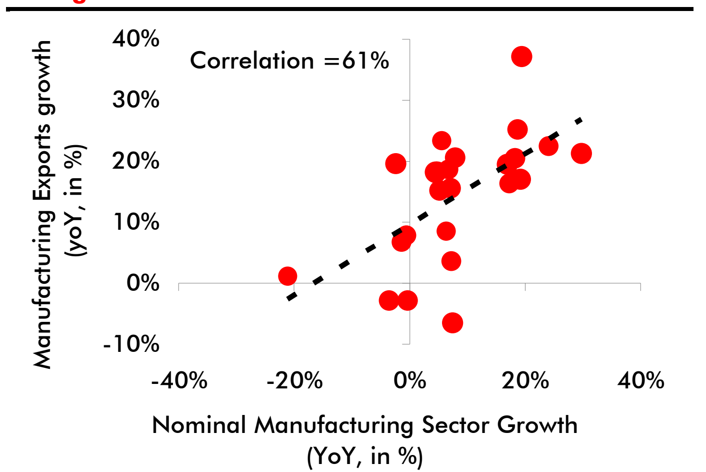
- The low-to-medium degree of technological know-how required to manufacture these products as opposed to say technology-intensive items such as electronics where India struggles; and
- The undemanding capex or infrastructure requirements for manufacturing these products makes production a viable option as the prohibitively high cost of capital in India inhibits her ability to produce heavy manufactured products at competitive prices.

Exhibit M : India's competitive advantage lies in low-to-medium technology, low-capital-intensity products



Source: World Bank, Ambit Capital research

Exhibit N: The high positive correlation between manufactured goods' export growth and manufacturing GDP growth in India



Source: CEIC, Ambit Capital research, Note: Data pertains to FY89-12

Finally, the existence of meaningful domestic demand for 'engineering goods' and 'light manufactured goods' products is likely to allow domestic manufacturers to achieve economies of scale at a rapid pace. Additionally, the ability to grow a domestic franchise allows exporters to diversify their end markets.

Investment Implications of Theme 3

Given the meaningful correlation between manufacturing sector GDP growth in India and manufacturing exports growth (refer to Exhibit N above), the increase in India's market share in the global manufactured goods' export market is likely to provide a fillip to manufacturing sector GDP growth in the medium term.

A few Indian manufacturers have already shown that India can succeed in the global export markets of manufactured goods, with Bajaj Auto and Cummins India being noteworthy examples. Amongst the smaller companies we highlight Balkrishna Industries, and Elgi Equipments. TTK Prestige and AIA Engineering are plays on India's rise as a manufacturing exporter (refer to Exhibit O below for details).

Exhibit O: Stock-specific Investment Implications of Theme 3

Theme 3 : The advent of export-led industrialisation

Company	Bloomberg Ticker	Mcap (US$ mn)	ADV (US$ mn)	Stance	Comments
Cummins India	KKC IN	2,388	2.5	BUY	Cummins India (a subsidiary of Cummins Inc.) is India's number one player in engines with a strong presence in the medium and large engine segment (76% of its sales), thanks to its American parentage. We expect Cummins' exports to increase from 29% of revenue in FY12 to 57% in FY17, given that Cummins India is setting up a dedicated manufacturing facility in a special economic zone (SEZ) on the outskirts of Pune for supplying gensets to Cummins Inc.
Bajaj Auto	BJAUT IN	9,812	11.5	BUY	Bajaj Auto is the second-largest two-wheeler and the largest three-wheeler (3W) player in India. Exports accounted for 35% of Bajaj Auto's revenue in FY12. Bajaj aims at increasing its exports and expects exports to outstrip domestic sales in the near future (export of motorcycles accounted for 33% of total motorcycle sales in FY12 whereas 3W exports have already surpassed domestic sales). In addition, the company continues to scout for and invest in newer geographies. Bajaj has the benefit of significant experience in the export business and has a strong balance sheet (net cash of US$1bn as at end-FY12).
Balkrishna Industries	BIL IN	456	0.47	BUY	Balkrishna Industries (BKT) is the leading exporter of off-highway tyres (OHT) from India currently occupying close to 4% of the global OHT market. BKT continues to focus on export markets with increasing focus on newer geographies such as Africa and sub-segments such as industrial/construction tyres where it has a low market share. Given that the existing facilities are operating at full capacity utilisation, the company is undertaking significant capacity expansion, increasing its capacity by 75%.
Elgi Equipment	ELEQ IN	258	0.2	BUY	In the air compressor market, Elgi Equipments is a market leader with a market share of ~30% in India. The firm is also Asia's largest manufacturer of air compressors. In FY11, it acquired a French company, Belair S.A. to expand its presence in the European markets and more recently acquired a 100% stake in Rotair S.p.a., a company based in Italy, which is engaged in the design, manufacture and distribution of compressors.
TTK Prestige	TTKPT IN	687	8.2	BUY	TTK Prestige, India's largest kitchenware company, has migrated from being a single product company to expanding its product offering and distribution channels to include a whole range of cookers, cookware and kitchen appliances. TTKPT's manufacturing facilities are located at Hosur, Coimbatore and Roorkee. The company currently sells its products in India under the brand name 'Prestige' and exports pressure cookers, pressure pans and non-stick cookware to countries including the US, the UK and the Middle East under the brand name 'Manttra'. It has recorded revenue CAGR of 32% over FY07-12 and net profit CAGR of 57% over FY07-12.
AIA Engineering	AIAE IN	610	0.2	UNRATED	AIA Engineering is one of the leading suppliers of high-chrome cast grinding media (for grinding mineral ores, cement clinker, coal in utilities) globally. Nearly 53% of the volumes in FY12 (142K tonnes) were sold to the cement industry globally and 45% volumes to the mining sector (mainly iron ore). AIAE is India's largest grinding media company and meets ~90% of the Indian cement industry's requirements. AIAE's consolidated revenue, EBITDA and PAT have seen a CAGR of 17%, 10% and 8% respectively over FY08-12. We believe increasing traction with international mining clients and increasing capacities will drive market share gains globally and hence drive growth.

Source: Bloomberg, Ambit Capital research

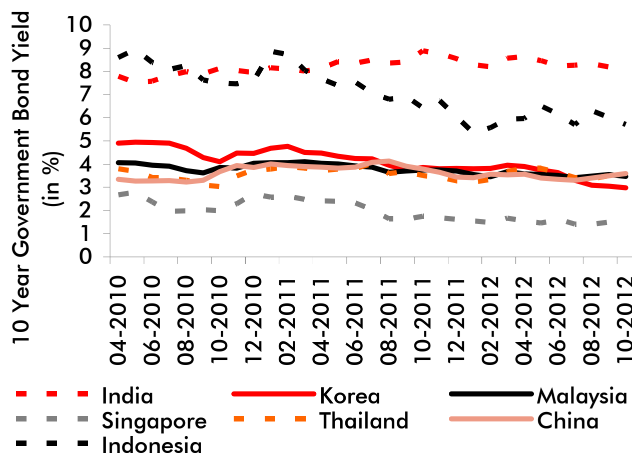
Theme 4: The challenge of a compromised banking system

India is a capital-scarce economy

Despite being characterised by a high savings ratio comparable with other Asian economies before their respective high growth phases, two factors impede the translation of these savings into plentiful access to capital in the Indian context. Firstly, half of Indian household savings are invested in physical assets (such as gold and real estate), thus foreclosing a large chunk of the savings pie at the outset. Secondly, only a small slice of these financial savings ends up being available for productive investment as (1) More than one-tenths is held in the form of currency and as (2) Banks lend only half the deposits to the private sector after adjusting for the mandatory priority sector lending requirements imposed by the RBI.

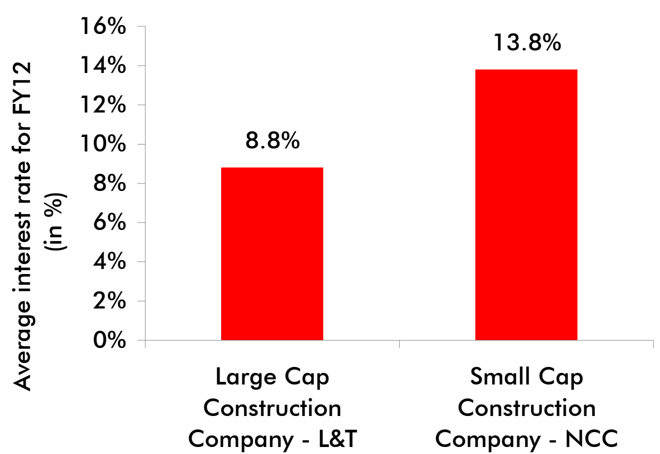
Thus not only does India depend meaningfully on FIIs for equity capital with only 2-3% of household saving flowing into markets, **the cost of debt capital in India is amongst the highest across emerging markets** owing to the large quantum of the Govt.'s borrowing pgme (refer to Exhibit P below). Furthermore this capital constraint is particularly prohibitive for smaller corporates and for corporates needing funds for longer durations (refer to Exhibit Q below).

Exhibit P: India's risk free rate is one of the highest amongst peers. . .



Source: Bloomberg, Ambit Capital research

Exhibit Q :. . . with the cost of debt capital being substantially higher for smaller Indian corporates



Source: Annual Reports of Cos, Ambit Capital research.

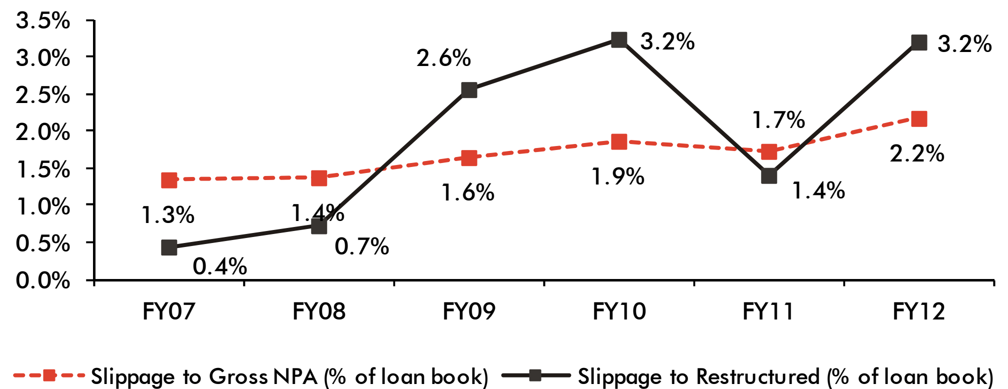
Banks in a structural sweet spot in a capital scarce economy

Banks in India account for 60% of the financial system's assets, and they are the core source of funding for India's corporate sector. A porter analysis of Indian banks' highlights the favourable industry structure of this sector characterized by in a capital- scarce economy such as India namely, (1) low bargaining power of suppliers of deposits owing to low levels of financial literacy, (2) moderate competition in the sector with the top 8 banks accounting for more than half of total bank credit extended, (3) high bargaining power of users of capital being restricted to top rated corporates and (4) low threat of substitution from other sources of finance as India lacks a well developed corporate bond market and as restrictions exist on access to foreign capital.

Investment Implications of Theme 4

Whilst the banking sector in India is in a structural sweet spot owing to India's capital-scarce nature, only sensibly run banks with clean accounts are likely to be a good cross-cycle investment as asset quality deteriorates and is under-stated owing to lax regulation (see exhibit R and S below). Exhibit U below highlights our banks' team's preferences in the banking sector based on our proprietary forensic tools (see Exhibit T below for summary accounting scores) to help investors wade through the deceptively pristine waters of the Indian banking sector.

Exhibit R : The rise in "slippages to gross NPAs" and "slippages to restructured assets" as a percentage of loan book



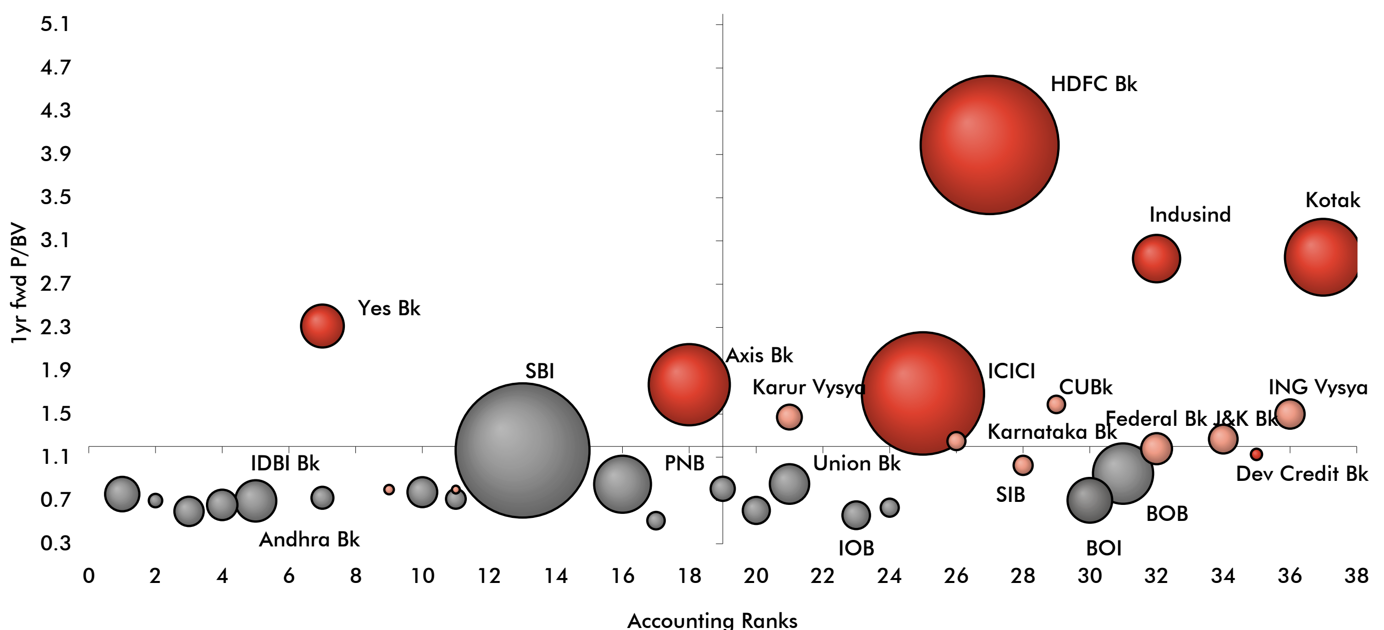
Source: RBI, Ambit Capital research

Exhibit S: The surge in NPAs across the Indian Banks

Gross NPAs (as a % of gross advances)	FY09	FY10	FY11	FY12
State Bank of India	2.5	2.7	3.4	4.6
Public Sector Banks	1.7	2.9	2.1	2.8
Old Private Sector Banks	**2.4**	**2.3**	**1.9**	**1.8**
New Private Sector Banks	**3.1**	**2.9**	**2.7**	**2.2**
All Scheduled Commercial Banks	2.3	2.4	2.5	3.1

Source: RBI, Ambit Capital research

Exhibit T : 1-year forward P/Bs v/s our forensic accounting scores



Source: Company, Ambit Capital research. Note: The size of the bubble represents the current market capitalisation; P/B for ICICI Bank, Kotak Mahindra Bank and SBI are on a consolidated level.

Exhibit U : Stock-specific Investment Implications of Theme 4

Theme 4: The challenge of a compromised banking system

Company	Bloomberg Ticker	Mcap (US$ mn)	ADV (US$ mn)	Stance	Comments
Axis Bank	AXSB IN	9,556	52.4	SELL	Axis Bank is India's third-largest private sector bank with a loan book of US$31bn. With a ~30% loan book CAGR since FY09 and with its large exposure to the infrastructure sector (especially power), Axis Bank has seen a definitive upward shift in its risk profile, manifested in an increasing proportion of sub-optimal yielding assets.
Bank of Baroda	BOB IN	5,439	11.2	BUY	Bank of Baroda, with a loan book size of US$53bn, has consistently exhibited loan book growth a few percentage points ahead of the system and has gradually outperformed the larger and older banks to emerge as the third-largest state-owned bank in the system. BoB has benefited from a large overseas book (~1/4th the total portfolio), which is a perfect complement to the bank's domestic lending operations.
City Union Bank	CUBK IN	445	0.5	BUY	City Union Bank is the oldest among the old private sector banks, with a network of 230 branches and a loan book of slightly more than US$2.4bn. CUB is an SME-focused, working-capital-intensive bank with a system-high proportion of secured lending.
Federal Bank	FB IN	1,453	4.4	BUY	Federal Bank is India's fifth-largest private sector bank with a loan book of US$6.6bn. With a comfortable tier-1 ratio (14%) and restructuring of its credit underwriting process, FB is putting in place the building blocks necessary to capitalise on an economic recovery.
ICICI Bank	ICICIBC IN	22,221	66.1	BUY	ICICI Bank is the largest private sector bank in India (by network size) with a loan book of US$50bn. The bank consciously brought down its troublesome unsecured retail book between March 2008 and September 2010 and has since doubled its exposure to corporate loans (up from 12% of the book to 29% of the book), whilst simultaneously altering the mix of retail loans towards secured advances (predominantly housing loans).
State Bank of India	SBIN IN	26,843	121.0	SELL	State-run State Bank of India is India's largest bank with a loan book of US$174bn, accounting for more than 16% market share on either side of the balance sheet. SBI is now saddled with a high proportion of non-performing loans (gross NPLs at 5.2% and net NPLs at 2.4%) that threatens to meaningfully disrupt its financial stability. Tier-I capital, although crawled at ~9% (due to recent equity infusion of $1.6bn and accrued profits of first half), is insufficient to support the imminent balance sheet stress.

Source: Bloomberg, Ambit Capital research

Changes in the Nifty over the next ten years

In a strategy note - 'The Nifty in 2022' - published alongside this thematic, our strategists, Gaurav Mehta and Saurabh Mukherjea highlight that 'churn' is the only constant with respect to the constitution of the Nifty, with the churn ratio being as high as 48% for the 10-year period beginning April 2002. Even if one were to conservatively assume a 40% churn ratio going forward, 20 companies would likely be ejected from the Nifty over the next ten years, and 20 new firms would enter the Index. Our Strategy team then goes on to highlight the list of likely exits (refer to Exhibit V below) and entrants (refer to exhibit W below) using a framework based on Megathemes 3.0.

"Churn" is a constant

Of the initial 50 constituents of the Nifty Index in November 1995, 44% were out by April 2002. This "churn" ratio was at 48% for the 10-year period beginning April 2002. Churn in the Indian market is almost twice as high as it is in the US market; churn also appears to be higher in India than in other large emerging markets.

Of the 50 firms in the Nifty in 1995, 22 were out by 2002. Of the 22 firms exiting the Nifty by 2002, four belonged to the BFSI and three each to the Automobile, Refineries and Metals/Steel sectors. Of the 22 firms entering the Nifty by 2002, five firms belonged to the FMCG sector whilst four each belonged to the Pharma and IT sectors. Barring this, there was no obvious sector concentration. But what does appear clear from these trends is the replacement of economy linked cyclical plays with defensive (or less cyclical) names.

Of the 50 firms in the Nifty in 2002, 24 were out by 2012. Of the 24 firms exiting the Nifty by 2012, barring FMCG (six firms exiting); there was no obvious sector concentration. Among the entrants, four belonged to the BFSI and Power & Capital Goods sector whilst three belonged to the Metals/Steel sector. **The trend, thus, is a complete mirror image of the previous decade, with economy linked names replacing defensives.**

Fifteen of the 24 exits in 2002-12 are firms that had entered the Nifty in the previous decade, underscoring just how hard it was to stay at the top of the Indian market for a sustained period.

'Megathemes 3.0' to define 'churn' in the Nifty over the next ten years

Clearly, an investor who can exit/enter stocks that will exit/enter the Nifty over the next decade will have an advantage over his/her peers (this point is illustrated in great detail in the strategy note from which this summary is taken – stocks heavily outperform in the run-up to their Nifty entry and the outperform tails off sharply post entry).

Even if we conservatively assume a 40% churn ratio going forward, 20 companies will be ejected from the Nifty over the next ten years and 20 new firms will enter the Index. Using "Megathemes 3.0" our strategists identify the following factors as key determinants of these potential Nifty entries and exits:

1. Intuitively and empirically, the firm's current size has an important bearing on whether or not it will be a part of the Nifty ten years hence.

2. The fragmentation of political power in India has negative implications for firms where political links form the core competitive advantage as well for firms which rely heavily on Government approvals.

3. The structurally high cost of capital in India implies that capital-intensive businesses would continue to take it on the chin.

4. A compromised banking system means that a number of lenders would get punished in the coming decade.

5. Ambit's "greatness" model and "forensic accounting" model (refer to our notes published on 19 January 2012, and 20 January 2012, respectively for more details)

Exits from and entries into the Nifty by 2022

Based on the framework above, we highlight the list of likely exits from and entries into the Nifty by 2022 in the tables below.

Exhibit V: Likely 'exits' from the Nifty over the next decade (names in RED indicate likely exits)

Probability zones based on free float	Stock	Ticker	P75?	Banking/ fin services with structural challenges?	Capital intensive/ government approvals?
Low probability of attrition (10% of exits) No of exits: 2	ITC	ITC IN			
	Reliance Inds.	RIL IN	●		
	ICICI Bank	ICICIBC IN			
	H D F C	**HDFC IN**		●	
	HDFC Bank	HDFCB IN			
	Infosys	INFO IN			
	Larsen & Toubro	LT IN	●		●
	TCS	TCS IN			
	St Bk of India	**SBIN IN**		●	
	Hind. Unilever	HUVR IN			
Medium probability of attrition (25% of exits) No of exits: 5	**O N G C**	**ONGC IN**			●
	Tata Motors	TTMT IN			
	M & M	MM IN			
	Bharti Airtel	BHARTI IN	●		
	Axis Bank	**AXSB IN**		●	
	Tata Steel	**TATA IN**			●
	Sun Pharma.Inds.	SUNP IN			
	Bajaj Auto	BJAUT IN			
	Kotak Mah. Bank	KMB IN			
	Dr Reddy's Labs	DRRD IN			
	Coal India	COAL IN			●
	NTPC	**NTPC IN**			●
	Grasim Inds	GRASIM IN			
	Cipla	CIPLA IN			
	I D F C	**IDFC IN**		●	
	UltraTech Cem.	UTCEM IN			
	Maruti Suzuki	MSIL IN			
	Wipro	WPRO IN			
	Asian Paints	APNT IN			
	Hero Motocorp	HMCL IN			
High probability of attrition (65% of exits) No of exits: 13	**B H E L**	**BHEL IN**			●
	Tata Power Co.	**TPWR IN**			●
	Power Grid Corpn	PWGR IN			
	Ambuja Cem.	ACEM IN			
	GAIL (India)	**GAIL IN**			●
	HCL Technologies	HCLT IN			
	Jindal Steel	**JSP IN**	●		●
	Hindalco Inds.	**HNDL IN**			●
	Cairn India	**CAIR IN**	●		
	Lupin	LPC IN			
	ACC	ACC IN			
	Bank of Baroda	BOB IN			
	Punjab Natl.Bank	**PNB IN**		●	
	JP Associates	**JPA IN**	●		
	B P C L	**BPCL IN**			●
	Ranbaxy Labs.	RBXY IN			
	DLF	**DLFU IN**	●		
	Sesa Goa	**SESA IN**	●		●
	Reliance Infra.	**RELI IN**	●		
	Siemens	**SIEM IN**			●

Source: Bloomberg, Ambit Capital research

Exhibit W: Likely 'entrants' into the Nifty over the next decade (shaded names indicate likely entrants)

	Stock	Sector	Ticker	Clears "Greatness" cutoff?	Clears "Accounting" filter? #
Next 50 on free float High probability of inclusion (80% or 16 of the 20 entrants come from these 50 stocks)	Nestle India	FMCG	NEST IN	●	●
	Sterlite Inds.	Non Ferrous Metals	STLT IN		
	Titan Inds.	Diamond, Gems and Jewellery	TTAN IN	●	●
	IndusInd Bank	Banks	IIB IN	^	^
	United Spirits	Alcoholic Beverages	UNSP IN		
	Zee Entertainmen	Entertainment	Z IN	●	
	Yes Bank	Banks	YES IN		
	Colgate-Palm.	FMCG	CLGT IN	●	●
	Glaxosmit Pharma	Pharmaceuticals	GLXO IN	●	●
	JSW Steel	Steel	JSTL IN		
	Bosch	Auto Ancillaries	BOS IN	●	●
	Godrej Consumer	FMCG	GCPL IN	●	
	Federal Bank	Banks	FB IN	^	^
	Dabur India	FMCG	DABUR IN	●	●
	Divi's Lab.	Pharmaceuticals	DIVI IN		
	Shriram Trans.	Finance	SHTF IN		
	GlaxoSmith C H L	FMCG	SKB IN	●	●
	LIC Housing Fin.	Finance	LICHF IN		
	Rural Elec.Corp.	Finance	RECL IN		
	Power Fin.Corpn.	Finance	POWF IN		
	Idea Cellular	Telecomm-Service	IDEA IN		
	NMDC	Mining & Mineral products	NMDC IN	●	●
	Cummins India	Capital Goods-Non Electrical Equipment	KKC IN	●	●
	Canara Bank	Banks	CBK IN		
	Adani Ports	Infrastructure Developers & Operators	ADSEZ IN	●	
	Exide Inds.	Auto Ancillaries	EXID IN	●	●
	Tata Global	Plantation & Plantation Products	TGBL IN		
	Glenmark Pharma.	Pharmaceuticals	GNP IN		
	I O C L	Refineries	IOCL IN		
	United Breweries	Alcoholic Beverages	UBBL IN	●	*
	Adani Enterp.	Trading	ADE IN	●	
	Apollo Hospitals	Healthcare	APHS IN	●	
	Bank of India	Banks	BOI IN		
	Hind.Zinc	Non Ferrous Metals	HZ IN		
	Union Bank (I)	Banks	UNBK IN		
	Tata Chemicals	Fertilizers	TTCH IN		
	Reliance Power	Power Generation & Distribution	RPWR IN	●	
	Wockhardt	Pharmaceuticals	WPL IN		
	Bajaj Finserv	Finance	BJFIN IN		
	Bajaj Holdings	Finance	BJHI IN		
	Marico	FMCG	MRCO IN	●	
	Aditya Bir. Nuv.	Textiles	ABNL IN		
	Container Corpn.	Logistics	CCRI IN		
	H P C L	Refineries	HPCL IN		
	Cadila Health.	Pharmaceuticals	CDH IN	●	●
	S A I L	Steel	SAIL IN		
	Reliance Capital	Finance	RCAPT IN		
	Indiabulls Fin.	Stock/ Commodity Brokers	IBULL IN		
	Oracle Fin.Serv.	IT - Software	OFSS IN	●	●
	Castrol India	Chemicals	CSTRL IN	●	●
The four entrants from free float ranks 101-150	M & M Financial	Finance	MMFS IN	^	^
	CRISIL	Miscellaneous	CRISIL IN	●	●
	Torrent Power	Power Generation & Distribution	TPW IN	●	●
	Bata India	Leather	BATA IN	●	**

Source: Bloomberg, Ambit Capital research

Theme 1: The utter fragmentation of political power in India

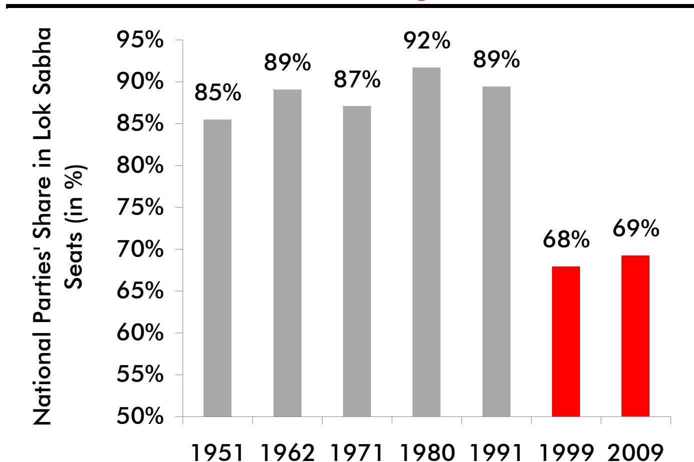
Forty years ago, a single national political party (namely the Congress) had complete control over the Indian economy. The party commanded 70% of the seats in the Lok Sabha on a standalone basis. Furthermore, the Indian economic landscape was regulated solely by the Government and was characterised by the complete absence of independent regulators. Institutions as well as citizens were yet to be activated by leaders and tools that could counter the power of the State.

However, multiple streams of institutional changes that came into play in the 1970s eventually led to the transformation of India by the noughties. Specifically, from the zenith of the 1970s, political might in India began to disintegrate along the following three axes:

Axis 1: The meteoric rise of regional parties and the decline of national parties

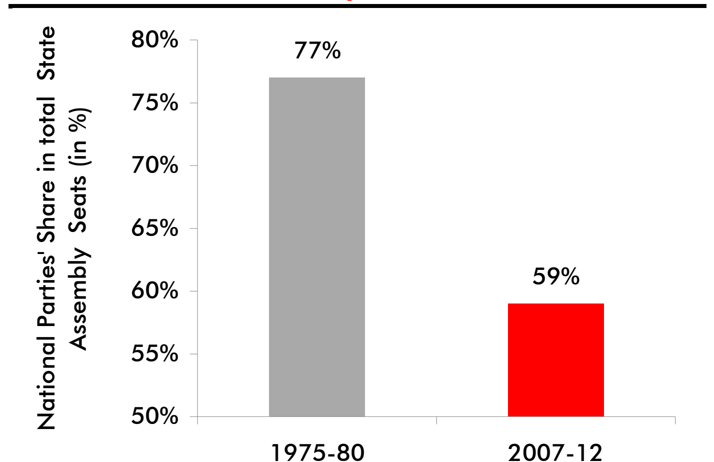
National parties commanded a firm grip on India over 1950-90 by accounting for ~80% of the seats in the lower house of the parliament as well as in the State Assemblies.

Exhibit 1: The seat share of national parties in the Lok Sabha has declined since the noughties



Source: Election Commission, Ambit Capital research

Exhibit 2: The decline in National Parties' seat share in State Assemblies since independence



Source: Election Commission, Ambit Capital research

However, from 1970s onwards, the electorate's attention began shifting towards issues of regional import and moved away from national issues such as:

- the hardships of the national freedom struggle (a sentiment that was responsible for the overwhelming support for the Congress),
- the national emergency imposed in the 1970s by the Congress (that led the electorate to gravitate towards the Janata Party), or
- religious sentiment (that was largely responsible for the rise of the Bhartiya Janata Party).

In fact, by the turn of the century, the electorate was almost solely focussed on regional issues of well-being at the grass-root level and the practicalities of day-to-day economics. National parties failed to keep abreast with this structural change whilst smaller left-leaning parties (such as the SP, AITC, JD(U) and BJD) were formed in the 1990s with a focus on this very plank.

These small parties then raised their seat share at the State level dramatically in the noughties (refer to Exhibit 3 below), with regional parties such as the Samajwadi Party (SP), Janata Dal (United) (JDU), Biju Janata Dal (BJD) as well as

All India Trinamool Congress (AITC) becoming parties to reckon with at the national level over a brief period of a decade. For instance, over a decade, the JD(U) increased its seat share in Bihar from a negligible 6% in 2000 to an imposing 47% in 2010. Similarly, AITC in neighbouring West Bengal drove the Communists out of this state by ramping up its seat share from 20% in 2001 to 63% in 2011.

Exhibit 3: Prominent regional parties that emerged over the noughties

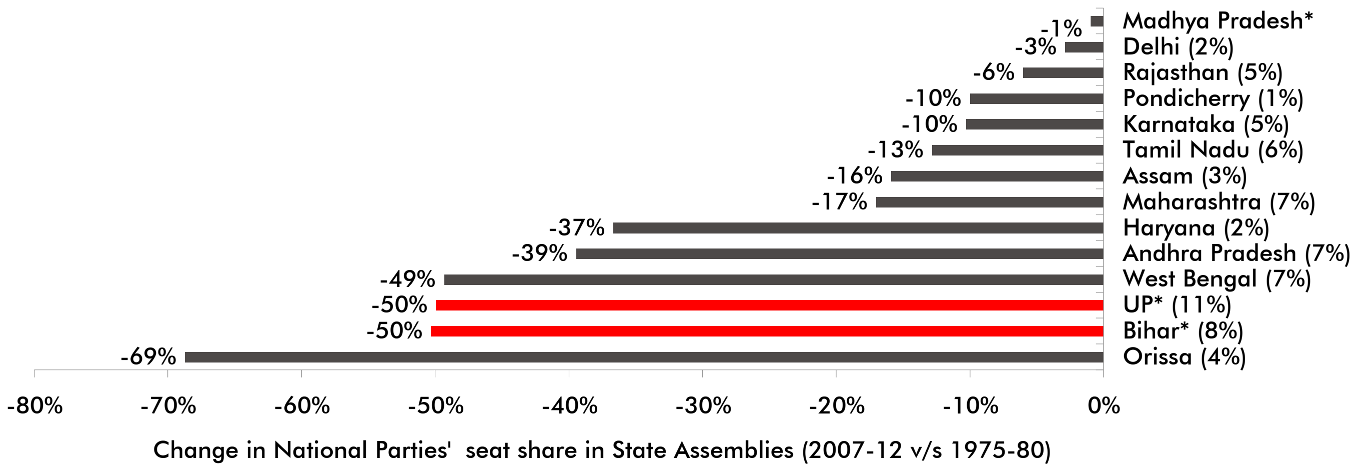
Regional Party	Year of formation	General Election Seat share in Lok Sabha		Assembly Elections						Details
				West Bengal/ Tamil Nadu		Uttar Pradesh		Bihar/Orissa		
		1998	2009	2001	2011	2002	2012	2000	2009/10	
SP	1992	3.7%	4.1%			**35%**	**56%**			The Samajwadi Party (SP) was one of the several splinter parties that emerged when the erstwhile Janata Dal fragmented into several regional parties. Its majority support base comprises a social grouping called Other Backward Classes (OBC).
JD (U)	1999	1.1%	3.7%					**6%**	**47%**	The Janata Dal (United) (JDU) was formed before the 1999 General Elections when a faction of the Janata Dal lent support to the NDA. The Samata Party led by George Fernandes merged with the JD(U) in 2003.
AITC	1998	1.3%	3.5%	**20%**	**63%**					After being a part of the INC for more than two decades, the All India Trinamool Congress (AITC) was formed under the leadership of Mamata Banerjee in mid-1997.
DMK	1949	0.9%	3.3%	13%	10%					Dravida Munnetra Kazhagam (DMK) was founded in 1949 and is a state political party with a centre-left ideology.
BJD	1997	1.7%	2.6%					**46%**	**70%**	The Biju Janata Dal (BJD) too had its origins in the erstwhile Janata Dal and was formed in 1997 with a 'secular' and centre-left political position.
AIADMK	1972	3.3%	1.7%	56%	64%					The All India Anna Dravida Munnetra Kazhagam (AIADMK) party was formed in 1972 as a breakaway faction of the DMK.

Source: Election Commission, Ambit Capital research

Consequently, by 2012, all national parties 'together' accounted for 70% of the seat share in the Lok Sabha as against the 1970s situation of a 'single' national party commanding 80% of the Lok Sabha seats.

The extent of the decline in power of the national parties in the noughties vs the 1970s comes to the fore when the seat share is analysed at the State Assembly level. The seat share of national parties has declined in States that together account for 76% of the total State Assembly seats over a four-decade period.

Exhibit 4: The seat share of national parties declined in States that account for 76% of the total State Assembly seats

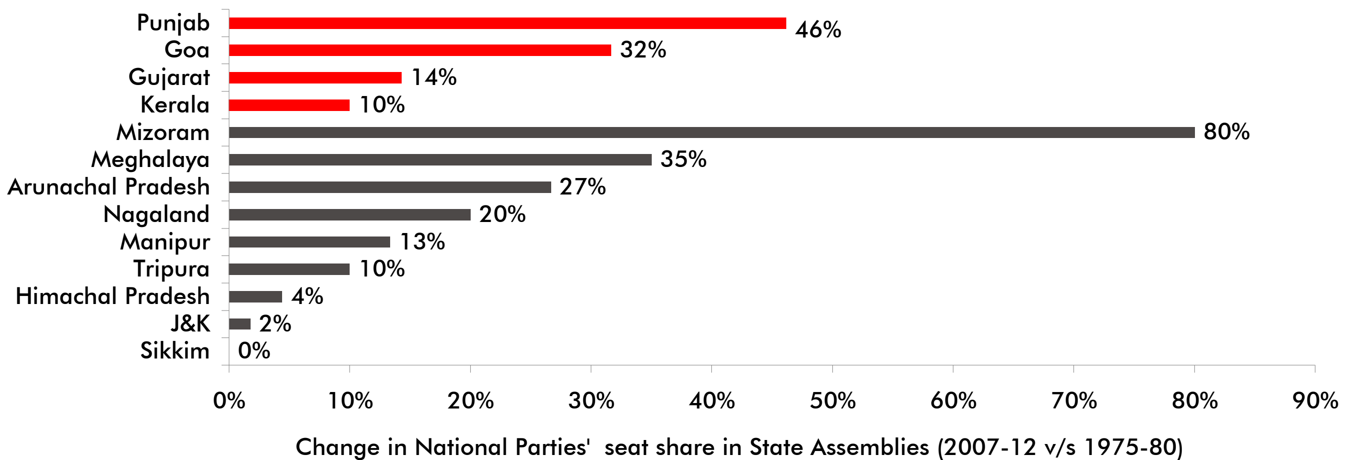


Source: Election Commission, Ambit Capital research

Note: (1) 1975-80 is used as a base year for comparison, because the first round of assembly elections took place for all States during this period. (2) Madhya Pradesh includes Chhattisgarh, Uttar Pradesh includes Uttarakhand and Bihar includes Jharkhand.*

Furthermore, all but four States, where the share of national parties in State Assemblies has increased, enjoy 'Special Status' (i.e. a status that constitutionally requires the Centre to provide additional funding to such states), thus highlighting the dramatic loss of control of national parties over the national seat share.

Exhibit 5: All but four States (highlighted in red), where the share of national parties in State Assemblies has increased, enjoy 'Special Status'



Source: Election Commission, Ambit Capital research

Axis 2: The rise of independent regulators

In the pre-liberalisation era in India, the Indian economic landscape was regulated solely by the Government and was characterised by the complete absence of independent regulators. The Reserve Bank of India (RBI) was the only regulator that existed but its independence was compromised with the RBI issuing ad-hoc treasury bills to fund the Government borrowing programme directly until 1997.

The administration of the New Economic Policy in 1991, which was characterised by a policy thrust on liberalisation and privatisation, was succeeded by the formation of a series of independent economic regulators.

In fact, ten new independent/semi-independent economic regulators were statutorily empowered over the past two decades, thereby ending the monopoly that politicians had on economic regulation.

Exhibit 6: The rise of ten independent economic regulators has ended the monopoly of politicians over economic regulation

Independent Economic Regulators in India					
Sector	**Abbreviation**	**Full-form**	**Year of establishment**	**Current head**	**Composition**
Banks	RBI	Reserve Bank of India	1934	Dr. Subbarao	1 Governor, 4 Deputy Governors, and 10 Directors from various fields, 2 government officials and 4 Directors from four local boards
Housing Finance	NHB	National Housing Board	1988	R V Verma	1 Chairman, 8 Directors
FIs	SEBI	Securities & Exchange Board of India	**1992**	U K Sinha	1 Chairman, 6 whole-time members, 1 part-time member
Telecom	TRAI	Telecom Regulatory Authority of India	**1997**	Dr. Rahul Khullar	1 Chairman, 2 full-time members, 2 part-time members
Ports	TAMP	Tariff Authority for Major Ports	**1997**	Rani Jadhav	1 Chairman, 2 full-time members
Electricity	CERC	Central Electricity Regulatory Commission	**1998**	Pramod Deo	1 Chairman, 3 full-time members
Insurance	IRDA	Insurance Regulatory & Development Authority	**1999**	Hari Narayan J	1 Chairman, 5 full-time members, 4 part-time members
Multi-sector	CCI	Competition Commission of India	**2002**	Ashok Chawla	1 Chairman, 6 members
Mid/ Downstream Petroleum	PNGRB	Petroleum and Natural Gas Regulatory Board	**2006**	S Krishnan	1 Chairman, 4 full-time members
Airports	AERA	Airports Economic Regulatory Authority	**2009**	Yashwant S Bhave	1 Chairman, 2 full-time members

Regulators in-waiting				
Sector	**Abbreviation**	**Full-form**	**Year of establishment**	**Executive action required for empowerment**
Commodities Trading	FMC	Forward Market Commission	1952	Awaiting parliamentary approval to the Forward Contracts Regulation Act (FCRA) Bill that aims to provide financial autonomy to the regulator.
Pension Funds	PFRDA	Pension Fund Regulatory and Development Authority	2003	Awaiting parliamentary approval to the PFRDA Bill that aims to provide the PFRDA statutory status to be able to regulate pension fund managers independently.

Source: Regulators' websites, Ambit Capital research

Whilst some regulators are yet to be granted a statutory or independent status (such as the Forward Market Commission (FMC) and the Pension Fund Regulatory and Development Authority (PFRDA)), several regulators have risen as powerful agents in the economy, often undertaking unexpected decisions that could be contrary to the respective Ministry's view or could be adverse for the private sector.

Exhibit 7: Indian regulators have made a series of unexpected decisions in the past 24 months

Regulator	Sector Impacted	Date	Regulator decision
CCI	Real Estate	August 2011	The CCI, in one of its first judgements as a re-energised regulator with a new leader, imposed a penalty of Rs6.3bn on DLF (whose proximity to the first family is now public knowledge) for abusing its dominant position.
RBI	Gold loan NBFCs	March 2012	The RBI in an unexpected move called for the capping of LTV at 60% for loans against gold jewellery for all NBFCs. The RBI also barred NBFCs from giving loans against gold bars and gold coins.
PNGRB	Oil and Gas	April 2012	The PNGRB passed an order for cutting network tariff by 63% and compression tariff by 59% for IGL's Delhi CGD network with retrospective effect.
RBI	NBFCs	May 2012	The RBI issued revised final securitisation guidelines, thereby directing "direct assignments" to be "true sale" in nature i.e. in case of "direct assignment" of loan portfolios, the originator will not be permitted to offer credit enhancements or liquidity facility in any form on the pool assigned.
CCI	Cement	June 2012	The CCI imposed a penalty of ~Rs62bn on 11 leading cement companies for price cartelisation.
TRAI	Telecom	April 2012	The TRAI recommended a reserve price of Rs36bn per MHz for a pan-India spectrum in 1,800MHz for the upcoming 2G auctions. This price was significantly higher than the TRAI expert pricing committee's recommendation given in 2011, which suggested a pan-India spectrum charge of Rs18bn for spectrum below 6.2MHz held in 1,800MHz. The increased spectrum reserve price (although diluted to Rs28bn by DoT), increased the cost of running the business not only for new telcos but also for incumbents, because these reserve prices would be applicable for renewal of existing licences as well.

Source: Media reports, Ambit Capital research

So, why have India's independent regulators come to life over the past three years and taken a series of remarkable decisions? Based on our discussions with policymakers, the reasons are as follows:

- With the **Centre weakening** (as highlighted in the preceding pages), these regulators have identified, and then moved into a power vacuum in which they can extend their ambit of operation.

- As the Indian economy becomes a more complex free market economy (as opposed to a socialist one), the usual **conflicts of interest** that characterise such an economy (for example, the abuse of dominant positions by cartels, the conflict of interest between the needs of the public and the profit-seeking motive of the suppliers of public utilities) have come to the fore, thereby creating an obvious need for firm regulatory intervention.

- A generation of bureaucrats, who were born in the early years after independence, who joined the IAS in the late 1960s and the early 1970s, and then rose to power in the 1990s and noughties are running these regulatory agencies. These civil servants have strong views about the way large **industrial houses have colluded with politicians**, particularly in the noughties, to corner specific segments of the Indian economy, and they intend to act as a remedial force in what remains a highly corrupt country.

Given that India continues to tread the path of greater economic liberalisation and given that existing regulators have been empowered with powerful regulatory mandates, the political community will have to continue to share the regulatory function with independent economic regulators.

Furthermore, India is likely to traverse the journey of installing powerful regulators faster than the developed countries of today as India draws from their regulatory experiences. A prime example is India's Competition Act that empowers the multi-sector regulator CCI, because this relatively new legislation is comparable with the power granted to India's Western counterparts at a later stage of their evolution.

Axis 3: The rise of the Citizenry and alternative institutions

The evolution of India as a democracy led to the enactment of new laws (such as the RTI Act, 2005), and the coming of age of previously established institutions (such as CAG, Election Commission, Supreme Court, etc) by inscrutable leaders put an end to the notion of 'political immunity'.

The advent of the Right to Information Act, 2005

The passage of the Right to Information (RTI) Act in 2005 transformed the reach and effectiveness of citizen activism, given that the Act empowers any citizen to request information from a "public authority" which is required to reply expeditiously or within thirty days. The Act has been effectively used thus far to uncover corruption in the Government machinery (refer to Exhibit 8 below), and probing public sector undertakings using this Act is likely to be a natural extension of the same.

Exhibit 8: The rise of Citizenry and alternative institutions

Institution	Landmark reports / verdicts / RTI Act based interventions
RTI Act	The RTI Act has been used by citizens to uncover an irrigation scam in Maharashtra in CY12, a housing scam in Gujarat in CY12 as well as a land allotment scam in Tamil Nadu in CY10.
Election Commission of India	Salman Khurshid, the then Union Minister of Law and Justice received a warning from the EC in early CY12 as he promised to carve out a 9% sub-quota for Muslims out of the quota for OBCs whilst campaigning for the UP elections thereby violating the EC's model code of conduct.
Comptroller and Auditor General (CAG)	The CAG in CY10 highlighted a presumptive loss of Rs310bn to the exchequer owing to the inappropriate allocation of 2G spectrum to telecom players. In CY12, the CAG highlighted that inefficient coal block allocations over CY04-09 made by the Government resulted in windfall gains of Rs107tn to allocate.
Supreme Court / PILs	Responding to a PIL filed by Advocate Prashant Bhushan and Janata Party leader Subramanian Swamy, the SC ordered the cancellation of all the 122 licences issued by the erstwhile Telecom Minister, A Raja, highlighting that the "the Department of Telecom (DoT) had virtually gifted an important national asset at throwaway prices".

Source: Media Reports, Ambit Capital research

The rise of the Election Commission in the 1990s

The Election Commission of India was constitutionally established in 1950 as an autonomous body responsible for administering free and fair electoral processes in the Republic of India. Despite a strong architecture and wide ambit of powers, the institution came to life during T N Seshan's tenure as the Chief Election Commissioner (CEC) of India from 1990 to 1996.

T N Seshan was the first leader of the EC to order re-polls in areas where polling irregularities were brought to the notice of the EC and undertook serious action against those found guilty of malpractices. The political community reacted to the rise of the EC by converting it into a multi-member body in 1993 whereby decisions were to be taken unanimously by three members as opposed to the previous uni-modal structure.

Despite the political community's efforts to restrict the powers of the EC, the activation of the EC by TN Seshan reinvigorated this body permanently thereby structurally curbing electoral malpractices in the country.

The rise of the CAG over the past four years

The institution of Comptroller and Auditor General (CAG) of India was set up in 1860 to bring about transparency, accountability and probity in public life.

The CAG's role and authority was strengthened through subsequent legislation affected in1919, 1935 and 1950. But the appointment of Vinod Rai in 2008 as the CAG transformed this institution making the watchdog a force to reckon with.

Its first landmark report was published in CY10 when the CAG highlighted a presumptive loss of Rs310bn to the exchequer owing to the inappropriate allocation of 2G spectrum by the Government of India. Subsequently a Public Interest Litigation (PIL) was filed by Advocate Prashant Bhushan and Janata Party leader Subramanian Swamy on the issue. In CY12, the Supreme Court in a landmark verdict ordered the cancellation of all the 122 licences issued by the erstwhile Telecom Minister highlighting that the "the Department of Telecom (DoT) had virtually gifted an important national asset at throwaway prices".

Much like the Election Commission whose ability to constitutionally challenge the political community led to its conversion into a multi-member body (thereby diluting the might of a powerful leader), a similar change has been mooted for the CAG. Whilst CAG may well be converted into a multi-member body over the next few years, history suggests that institutions once activated by powerful leaders seldom slip into slumber as the political community is unlikely to forget the damage that this institution can cause to the unbridled rise of the Government's discretionary powers.

Investment Implications of Theme 1

At the macroeconomic level, the simultaneous advancement of the above three forces over the coming years is likely to spell an improvement in India's growth potential as history points to the tight correlation between institutional development and economic growth.

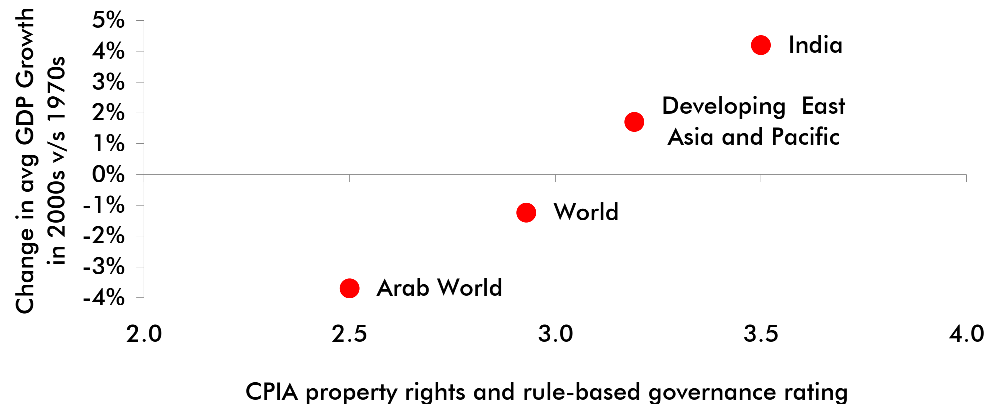
In terms of company specifics, politically connected companies are likely to continue their underperformance that began in 2010 owing to the gradual demise of the concept of 'political immunity'. Separately, the weakening of national political parties is likely to increase the frequency of General Elections, which will paradoxically be a positive for India Inc. The need for political parties to raise funds from India Inc to fight intensely contested elections will result in the administration of economic reforms.

Implication 1: Systematic disintegration of power to lift India's growth potential

Two leading institutional economists, Daron Acemoglu and James Robinson, pointed out that *"extractive political institutions such as (autocracies and dictatorships) lead to extractive economies benefiting elites, and cannot create general prosperity save for limited periods. Inclusive political institutions (such as democracies based on rule based governance as well as powers for all) create inclusive economic regimes with opportunity for all, leading ultimately to long-term prosperity"* (Source: Why nations fail - The Origins of Power, Prosperity, and Poverty; *2012*).

International experience too suggests that high and/or improving economic growth rates are possible only if a nation is characterised by rule-based governance and well-dispersed political power (refer to Exhibit 9 below).

Exhibit 9: International experience points to the positive correlation between rule-based governance and GDP growth potential



Source: World Bank, Ambit Capital research Note: 1. CPIA ratings range from 1=low to 6=high. 2. The Arab World is characterised by monarchies and compromised democracies. Developing countries in East Asia and the Pacific include Vietnam (single party rule), Thailand (constitutional monarchy), Malaysia (elected monarchy), China (single party rule), etc.

These economists also point out that inclusive institutions lead to creative destruction, which is essential for sustained prosperity, and threaten extractive regimes. In fact, we perceive the ongoing political-economic upheaval in India (which has seen the power of national political parties ebb) to be a process of creative destruction and hence an extremely positive phenomenon in the long run.

Implication 2: Continued underperformance of politically linked companies

Whilst the 'License Raj' was the predominant form of cronyism in India until the early 1990s, the new face of the business-politics nexus in India arose from political control over national assets in the form of telecom spectrum, mineral reserves or even land. The political class leveraged its custodian rights over public assets by demanding rents for access to the same. Procedural delays and involvement of multiple Government agencies/bodies was the modus operandi that allowed the Government to extract heavy rents from the private sector. This modus operandi then formed the basis of the implicit contract between the Government and private businesses in post-1991 India.

Given the modus operandi used by the political class, corruption in a sector is likely to be related to the sector's dependence on public assets. In fact global experience suggests that: (1) Public Works, (2) Real Estate, (3) Oil & Gas, (4) Heavy Manufacturing, and (5) Mining, are sectors that are most likely to be characterised with strong political linkages (refer to Exhibit 10 below).

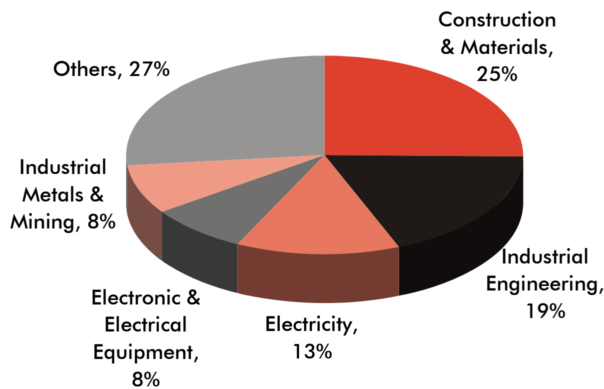
Exhibit 10: Corruption in a sector is directly related to the sector's dependence on public assets

Political exposure risk	Sector	Access to key public asset that yields competitive advantage	Blended score (avg of column A & B)	Bribery of public officials by sectors (column A)	State capture by sector (column B)
HIGH	Public works contracts & constr.	Govt. contracts	5.4	5.2	5.6
HIGH	Real estate & property development.	Land	5.7	5.7	5.7
HIGH	Oil & gas	Oil and gas blocks	5.9	5.9	5.8
HIGH	Heavy manufacturing	Access to raw material and pollution rights	6.0	6.0	5.9
HIGH	Mining	Mineral reserves	6.1	6.0	6.1
MEDIUM	Pharmaceuticals	Patents and licenses	6.2	6.2	6.2
MEDIUM	Utilities	Access to natural resources	6.3	6.3	6.3
MEDIUM	Civilian aerospace	Contracts and regulation	6.4	6.4	6.4
MEDIUM	Power generation, T & D	Networks	6.5	6.4	6.5
MEDIUM	Forestry	Forests	6.5	6.5	6.5
MEDIUM	Telecom	Spectrum/Air waves	6.6	6.6	6.5
MEDIUM	Transportation & storage	Land	6.6	6.6	6.6
MEDIUM	Arms & defence	Govt. contracts	6.7	6.7	6.7
MEDIUM	Hotels, restaurant & leisure	Land	6.7	6.7	6.7
LOW	Agriculture	Land	7.0	6.9	7.0
LOW	Light manufacturing	None	7.0	6.9	7.0
LOW	Information technology	None	7.1	7.0	7.1
LOW	Banking & finance	None	7.1	7.1	7.1
LOW	Fisheries	None	7.2	7.1	7.2

Source: Transparency International (TI), Ambit Capital research. Note: Score is based on TI's Bribe Payers' Index 2008.The lower the score, the greater the corruption quotient.

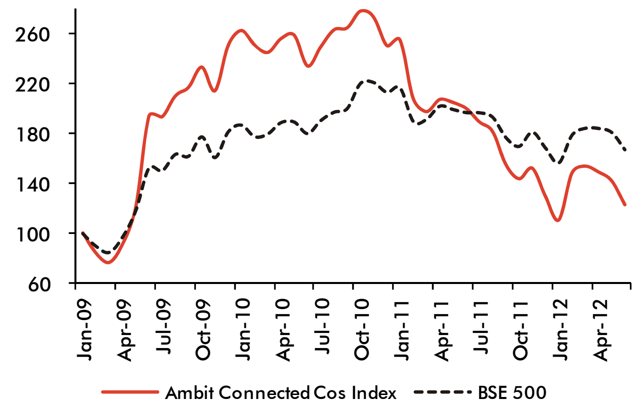
Our own analysis of politically linked stocks in the BSE500 universe suggests that of the 75 politically linked stocks (based on our analysts' promoter integrity checks), a majority belong to the construction or industrial engineering sector as corroborated by global experience (refer to Exhibit 11 below).

Exhibit 11: Construction and Industrial engineering accounts for the bulk of politically linked stocks in the BSE500



Source: Ambit Capital research Note: The pie shows BSE500 companies which our analysts believe make significant use of their political links to further their business interests.

Exhibit 12: Politically linked stocks have been underperforming the BSE500 since November 2010



Source: Bloomberg, Ambit Capital research

Furthermore, this group of politically connected companies have been underperforming the broader market (refer to Exhibit 12 above) since 2010 (the year when the 2G investigation kicked off) and are likely to continue their underperformance owing to the gradual demise of the concept of 'political immunity'.

In the table below we highlight stocks that are likely to be negatively impacted owing to their core operations persisting in sectors that by definition require a high degree of dependence on political connects. Additionally we highlight stocks that are exceptions to the norm and despite operating in heavy sectors are characterised by impressive franchises that do not rely on political connectedness (refer to Exhibit 13 below).

Exhibit 13: Stock-specific Investment Implications of 'The utter fragmentation of political power in India'

Company	Bloomberg ticker	Mcap (US$ mn)	ADV (US$ mn)	Stance	Comments
Reliance Industries	RIL IN	47,045	56.2	SELL	RIL's business activities span across exploration and production (E&P) of oil and gas, petroleum refining, petrochemicals, retail, telecom, etc. Backward vertical integration has been the cornerstone of the evolution and growth of RIL. Starting with textiles in the late 1970s, RIL pursued a strategy of backward vertical integration in polyester, fibre intermediates, petrochemicals, refining and E&P. RIL's E&P business may continue to face challenges because we neither expect a significant ramp up in gas production before FY15, nor do we foresee the Government accepting RIL's demand for import parity pricing for its gas. Whilst downstream margins are likely to remain at mid-cycle levels, volume growth from the downstream business would remain muted, given that the petchem capacity expansion will come on-stream only by end-FY14. Hence, earnings growth is unlikely to revive any time soon and we expect EPS CAGR of 6% over FY13-15.
Crompton Greaves	CRG IN	1,306	6.8	SELL	Crompton Greaves derives more than 50% of its revenue from its international operations. In the domestic business, over the past couple of years, the company has been losing market share given the rising competitive intensity on the back of the competition from its Chinese peers that are beginning to dominate over their Indian counterparts. In the past five years, the company has seen 15% revenue CAGR only and 6% profit CAGR.
Cairn India	CAIR IN	11,553	37.8	SELL	Cairn India is an independent oil and gas exploration and production (E&P) company, with most of its assets in India. Cairn India currently produces ~25% of India's domestic crude production, but ~95% of its production comes from only one asset in Rajasthan. The company expects production from the Rajasthan block to increase by 70% over the next 3-4 years, but that is subject to faster government approvals to its exploration and development programme. Even though the company's strategy is to expand beyond Rajasthan and have a diversified and sustainable E&P portfolio, it has met with limited success so far. Cairn India's earnings are positively linked to global crude price, with every US$1/bbl increase in Brent crude price translating into a 1.7% increase in FY14 EPS.
L&T	LT IN	18,041	48.3	BUY	L&T is the largest and the most diversified Indian industrial company, thus making it a clear play on the India capex story. It derives most of its revenues and cash flows from the contracting business wherein it is gaining market share on many of the smaller/mid-sized players due to the latter's profligacy in managing their balance sheets. An expected near-term pick up in capex (public and private) will enable L&T to expand at an industry leading pace alongside maintaining its RoICs. The company's near-term strategy is to foray more into international markets, scouting for large projects especially hydrocarbons, and to strengthen its balance sheet. Understanding the adverse fallout of the increased equity commitments made towards long gestation heavy engineering and infrastructure subsidiaries, L&T will be limiting incremental equity investments and raising equity in subsidiaries, thus further improving the cash flow profile.
Cummins India	KKC IN	2,453	2.6	BUY	Cummins is the strongest player in the engines segment given its superior presence (70% of its sales) in the large engines segment. This is backed by superior technology (only domestic player allowed to sell gensets above 550 KVA), strong brand recall in gensets (given that 65% is sold as backups i.e. critical application) and engines (preferred supplier for MNCs given its MNC pedigree), and a strong dealer network. Besides, Cummins' number one position appears defensible in spite of the presence of strong global players, such as Volvo, GE, Mitsubishi, Perkins, Caterpillar and Honda, in India. The revenues and PAT of the company over the past four years have seen a CAGR of 11% and 14%, respectively.
Voltas	VOLT IN	680	4.2	BUY	Voltas is a unique play on the rising HVAC/ Electrical spend on Indian commercial real estate and the increasing penetration of room air conditioners (RAC) in the country. Whilst Voltas is the leading RAC player with a superbrand status, it is one of the strongest MEP contractors in the country, with an unleveraged balance sheet (and high net worth) and established credentials. Voltas' near-term strategy is to increase its leadership in the RAC segment by increasing geographical penetration and product innovation. In the MEP projects segment, the company is looking to improve the quality of orders by focusing on client quality, payment terms and maintaining bidding rationality. Its credentials in water treatment and manufacture of cooling products are yet to provide business momentum with a pick up in investments in water and cold chains.
Tata Steel	TATA IN	6,813	35.9	BUY	Tata Steel is levered to continued investments in the infrastructure and construction sectors, increasing sales of cars as well rising consumption of white goods. Currently the company derives ~26% of total revenues from India, which is set to increase as the ongoing India expansions come through over the next few years. Tata Steel's strategy is to increasingly focus on expanding steel capacities in India, which will enjoy access to captive iron ore and hence will have superior profitability as compared to its international operations. Moreover, over a period of time, this will also ensure that exposure to the weaker European business, which is not integrated for raw materials, is reduced. In FY12, India volumes of 6.6mt accounted for ~27% of total steel volumes of 24.2mt. This is likely to increase to ~40% by end-FY14.

Source: Bloomberg, Ambit Capital research

As we enter into an economic recovery in India, investors need to find ways of avoiding politically connected companies if they are to reap the full benefits of this recovery. We continue to believe that investing in "high-quality cyclicals" and avoiding politically connected stocks is a reliable way for institutional investors to beat the broader market on a persistent basis.

Implication 3: Higher frequency of General Elections

The weakening of national political parties and the rise of regional parties is likely to result in the dispersion of political power and hence an increase in the frequency of General Elections.

This is likely to have a decisive impact on the type of reforms that will be passed by the political community and those that will be relegated to the background.

'Pro-market reforms that are populist or electorate neutral' are like to receive an impetus as political parties will need to appease the corporate sector to fight intensely contested elections (refer to Exhibit 14 below).

Exhibit 14: Pro-market reforms that are populist or electorate neutral are like to receive an impetus (refer to highlighted box)

	Populist Reforms or Electorate Neutral Reforms	Non-Populist Reforms	Reforms resisted by Political Parties
Anti-market reforms	(1) Labour Market Reforms aimed at protecting Contract Workers, (2) Passing of the National Food Security Bill, (3) Greater regulation regarding allocation of natural resources , etc	*Not a reform by definition*	Land Acquisition Bill as it limits the discretionary powers of politician and because it may increase the cost of land acquisition for the private sector.
Pro-market reforms	(1) The implementation of the Unique Identification Scheme which will facilitate direct transfer of subsidies and limit pilferage, (2) Allowing Government pension funds to be invested in equity markets , etc	(1) Reduction of Petroleum Subsidies, (2) Reduction of expenditure on account of Government-sponsored schemes such as NREGA, etc	(1) Implementation of GST as it encroaches on State Government's taxation powers, (2) Allowance of greater FDI in any sector is opposed by the opposition as the ruling Government extorts the one-time rents, (3) Enactment of a legally binding fiscal consolidation Act, (4) Grant of bank licenses to industrial houses as this requires, empowering the Banks' regulator, etc

Source: *Ambit Capital research*

At the other end of the spectrum, anti-market reforms that are also resisted by political parties, such as the passage of the land acquisition bill, will be relegated to the background or delayed indefinitely.

Theme 2: The splintering of the "aspirational consumption" story

In our Megathemes 1.0 note (dated 19 November 2010), we made the point that **aspirational consumption** demand is likely to maintain its edge over essential consumption (from a profitability, revenue growth as well as stock price appreciation perspective) owing to powerful structural drivers such as rising incomes, high share of youth and rapid urbanisation.

In our subsequent version titled Megathemes 2.0 (dated 9 November 2011), we highlighted the fact that whilst aspirational consumption is a high growth category, given the rising **MNC focus** on the Indian aspirationals market, Indian companies that are pitted against MNC counterparts are likely to suffer. Consequently, the 43 strong basket of aspirational stocks that we highlighted in that note has since then produced a median return of 18% despite the fact that we built this basket without regard for the underlying quality of the franchise. However in the past one year, we have seen Hero MotoCorp's share price fall by nearly 15% as Honda launches a strong assault on the Indian two-wheeler market.

In this section we highlight the fact that two decades of economic growth and liberalisation is likely to translate into the proliferation of aspirations along three axes namely:

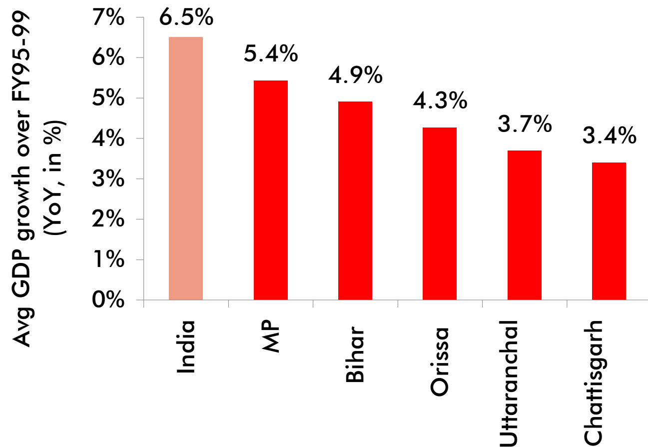
- **Geographically**: Traditionally backward regions (such as Bihar and Uttaranchal) are likely to drive the next leg of aspirational consumption growth in India. Besides rising incomes, improved access to electricity, improved levels of sanitation and a revolution in awareness levels regarding aspirational products availability is likely to drive the geographic proliferation of aspirational consumption in India.
- **Demographically** : The lower end of the age spectrum i.e. sub-35 years of age is likely to account for the lion's share of total consumption going forward as Indians born post-1991 (i.e. in the post liberalisation era) start enjoying the benefits of higher literacy levels and better employment opportunities.
- **Gender-wise**: Women-oriented consumer products are likely to experience exponential growth in categories such as personal care products, jewellery, consumer durables as well as two wheelers as women are increasingly empowered socially and economically in a traditionally patriarchal society.

This in turn is likely to drive the next leg of outperformance of the aspirational consumption theme from a 5-year perspective despite the current cyclical slowdown.

Axis 1: The rise of the backward regions

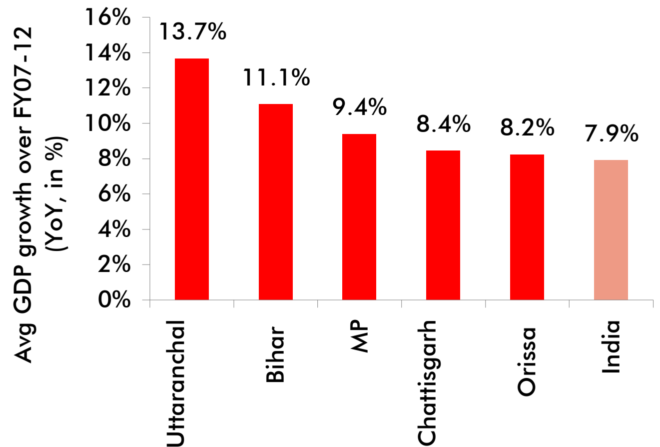
Regional GDP growth rates in India have undergone a phenomenal change over the past decade with traditionally backward Indian states of the late 1990s now leading the charge in terms of economic growth rates (refer to Exhibits 15 and 16 below).

Exhibit 15: The traditionally backward Indian States of the late 1990s. . .



Source: CEIC, Ambit Capital research

Exhibit 16: . . . are now leading the charge in terms of economic growth rates



Source: CEIC, Ambit Capital research

Besides this pick-up in income growth in traditionally backward regions, the phenomenal proliferation of **three drivers of aspirational consumption** over the past decade is likely to propel this story forward namely,

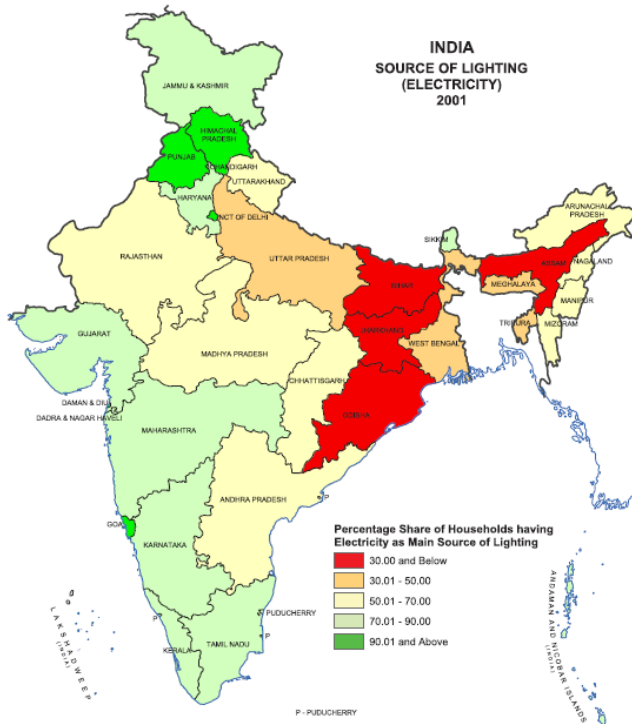
- Improved penetration of electricity access over the past decade which in turn will facilitate consumption of electricity based durables,
- Improved levels of household sanitation which are likely to drive the consumption of personal and home care products and
- Revolution in general awareness levels driven by the jump in penetration of mobile phones and rising penetration of internet.

The combination of improved income growth and the spread of the above three enablers of aspirational consumption growth is likely to facilitate the proliferation of aspirational consumption geographically.

Driver 1: Improved access to electricity

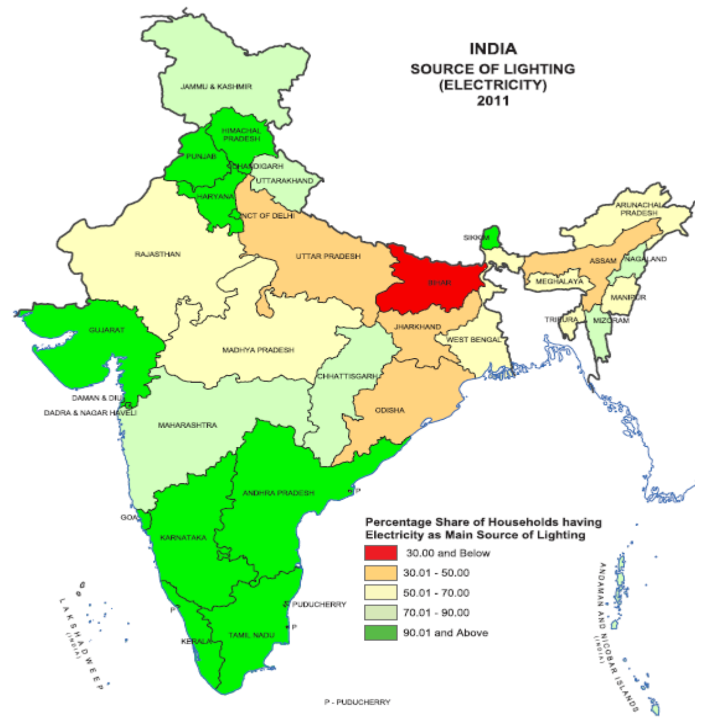
Access to a modern day necessity such as electricity was limited a decade ago with only 56% of Indian households having access to electricity in CY01 with penetration levels in backward states such as Bihar and Orissa being sub-30% (refer to Exhibit 17 below).

Exhibit 17: Households having access to electricity increased from 56% in CY01at the pan-India level



Source: Census 2011, Ambit Capital research

Exhibit 18: . .to 67% in CY11 with Orissa, Jharkhand and Assam recording significant improvements

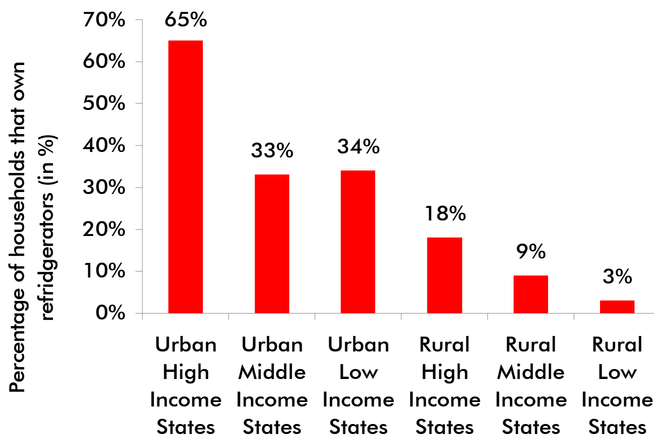


Source: Census 2011, Ambit Capital research

Over the past 10-year period, however, penetration levels at the national level have increased to 67% as of CY11 (refer to Exhibit 17 and 18 above) with backward regions (such as Orissa, Jharkhand and Assam) having experienced the most substantial increases (refer to Exhibit 18 above).

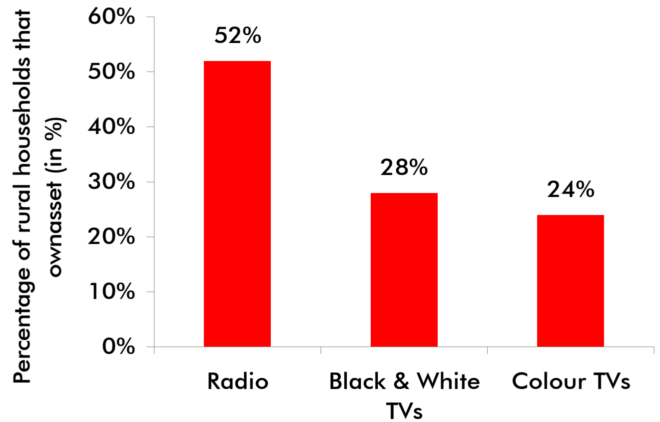
For instance, 65% of urban households in high-income states owned refrigerators in FY05, whilst only 3% of rural households in low-income states owned this asset seven years ago (refer to Exhibit 19 below). Furthermore, research suggests that the abysmally low levels of refrigerator ownership in backward areas were mainly a result of lack of access to electricity as against low purchasing power. Consequently, the spread of access to electricity is likely to result in greater demand for refrigerators even if income growth remains modest.

Exhibit 19: Refrigerator ownership was low in backward areas in FY05



Source: NCAER-CMCR, Ambit Capital research
Note: Data pertains to FY05

Exhibit 20: The need to upgrade outdated assets is likely to drive another wave of demand in backward areas



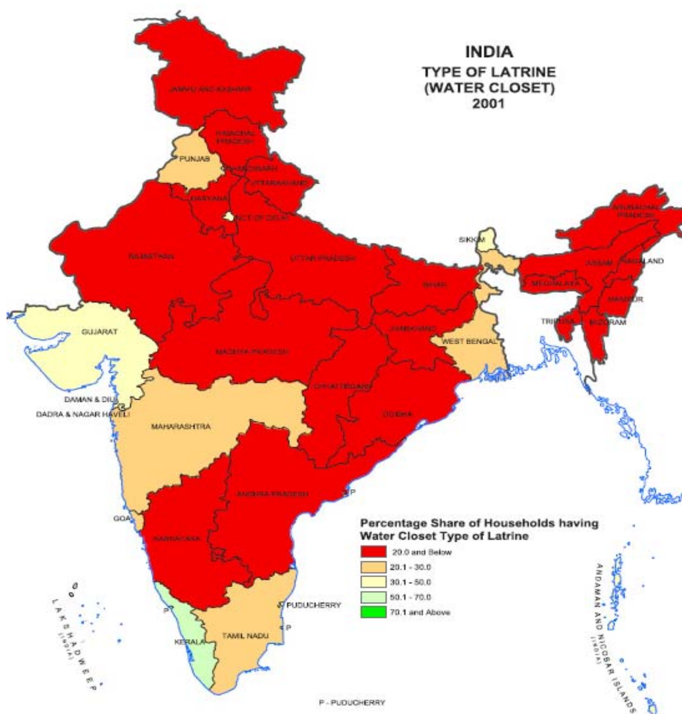
Source: NCAER-CMCR, Ambit Capital research
Note: Data pertains to FY05

In addition, the need to upgrade outdated assets in backward areas is likely to drive another wave of consumption demand. For instance, 52% of rural households in India own radios whilst 28% own black and white televisions. Given that the pricing of colour televisions is broadly comparable to that of black & white televisions and given the improving access to electricity, demand for colour TVs in backward areas is likely to increase as households upgrade assets.

Driver 2: Improved sanitation levels

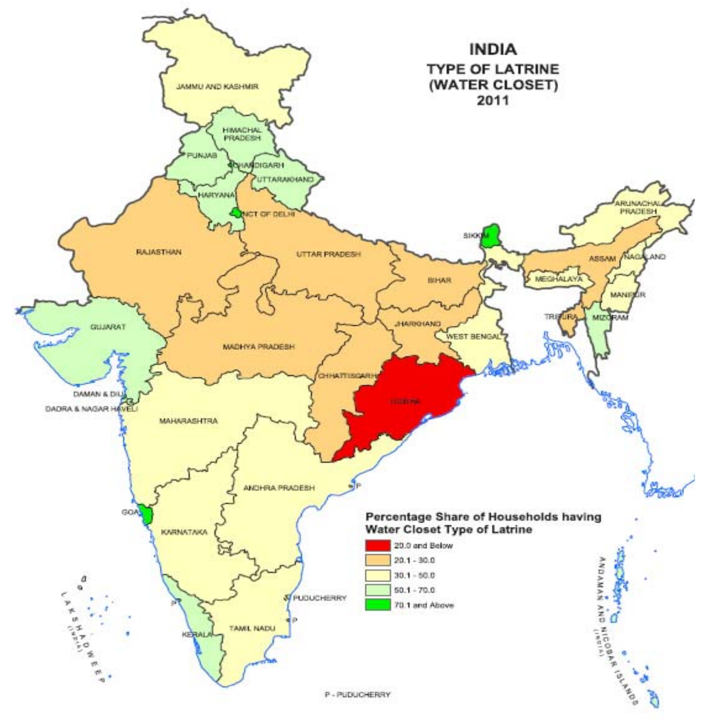
Another modern day necessity is basic sanitation facilities at homes and this is an indicator that India lags on meaningfully. Moreover, household sanitation standards have a direct correlation with demand for household and personal care products.

Exhibit 21: Households having access to water closets increased from 18% in CY01at the pan-India level. . .



Source: Census 2011, Ambit Capital research

Exhibit 22: . . . to 36% in CY11 with dramatic improvements being recorded in backward regions



Source: Census 2011, Ambit Capital research

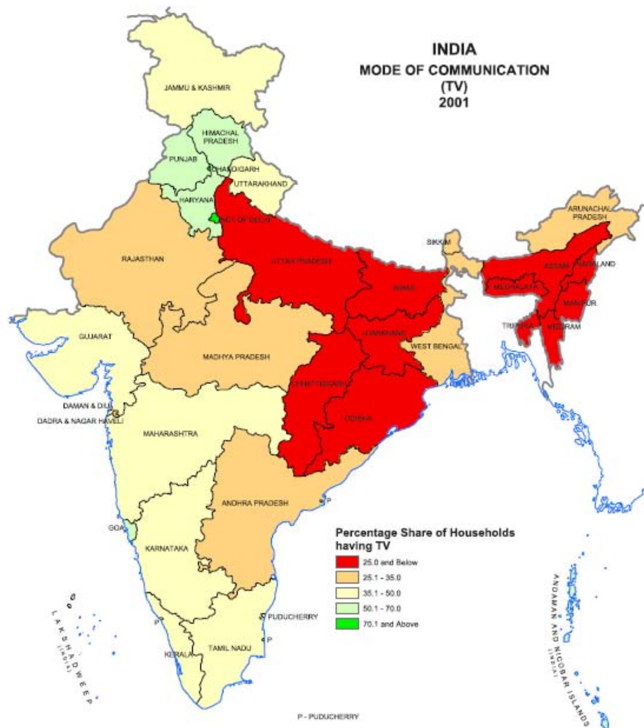
The percentage of Indian households having access to water closets was as low as 18% in CY01 and doubled to 36% in CY11 (refer to Exhibit 21 and 22 above). This in turn is likely to drive the next leg of sales of personal care and homecare products.

As is evident from the two maps above, poorer states such as Bihar, Madhya Pradesh, Uttar Pradesh and Uttaranchal were the leaders in terms of improvements (refer to Exhibit 22 above).

Driver 3: Dramatic increase in General Awareness levels

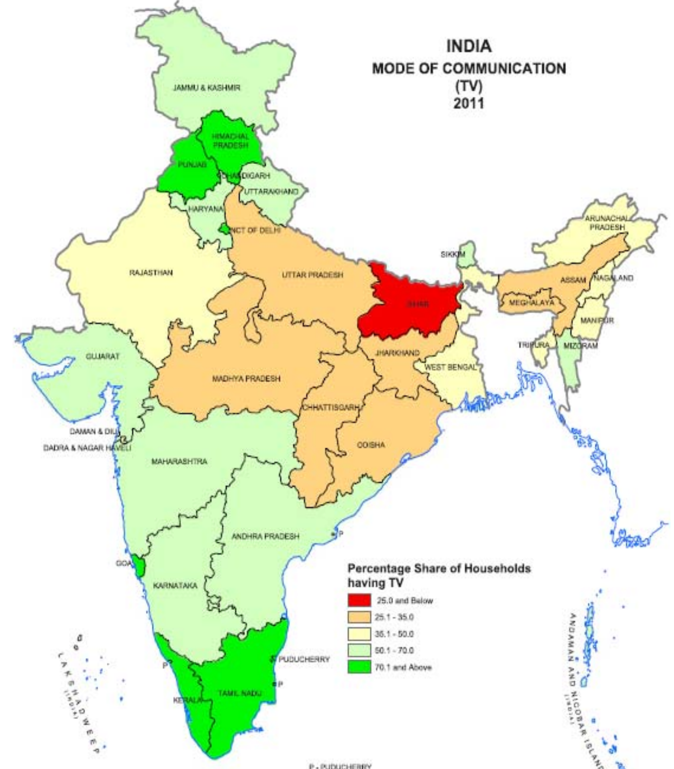
The extent of aspirational consumption is a function of general awareness levels and this parameter has undergone a diametric change over the past decade in India.

Exhibit 23: Households having access to TVs increased from 32% in CY01 at the pan-India level. . .



Source: Census 2011, Ambit Capital research

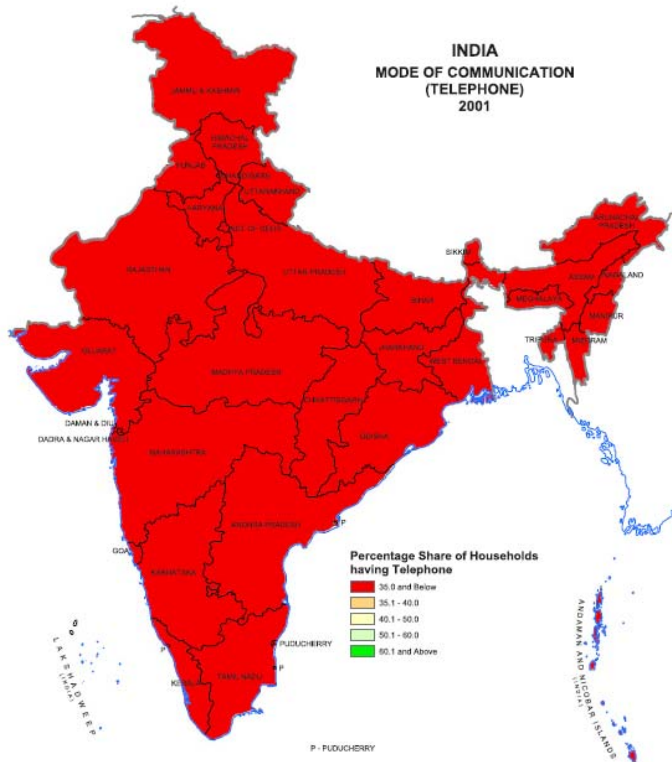
Exhibit 24: . . . to 47% by CY11 with Uttaranchal, Jharkhand, Chhattisgarh, and Orissa being key beneficiaries



Source: Census 2011, Ambit Capital research

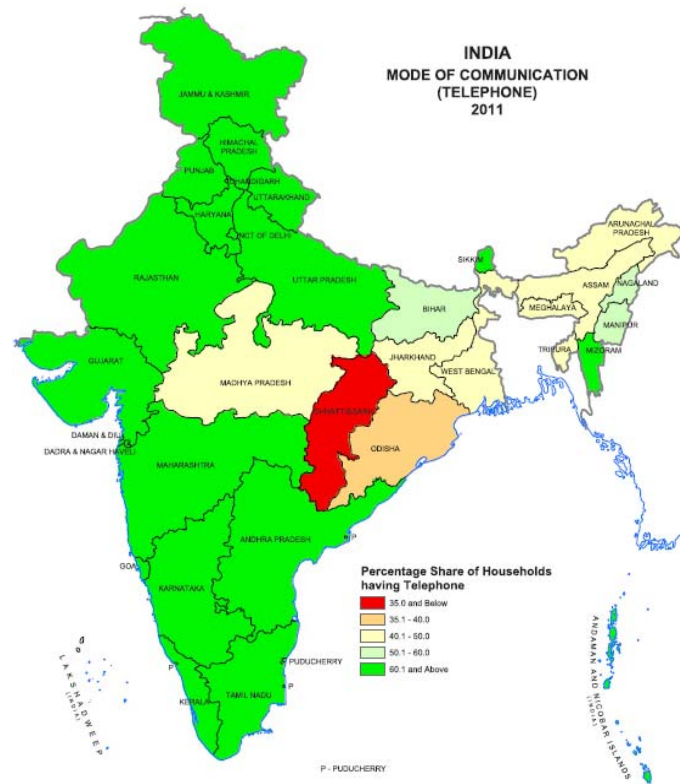
Improved general awareness levels regarding the range of aspirational products available have been driven by the fact that TV (refer to Exhibit 23 and 24 above) and telecom penetration levels (refer to Exhibits 25 and 26 below) in India have increased by leaps and bounds over the past decade. The rapid pick-up in telecom penetration (from 35% in CY01 to north of 60% in CY1)1 in particular has transformed the general awareness landscape even in the hinterlands of India.

Exhibit 25: Whilst less than 35% of Indian households owned telephones/mobile phones in 2001. . .



Source: Census 2011, Ambit Capital research

Exhibit 26: . . . telecom penetration levels increased drastically by CY11, zooming past 60% in most regions



Source: Census 2011, Ambit Capital research

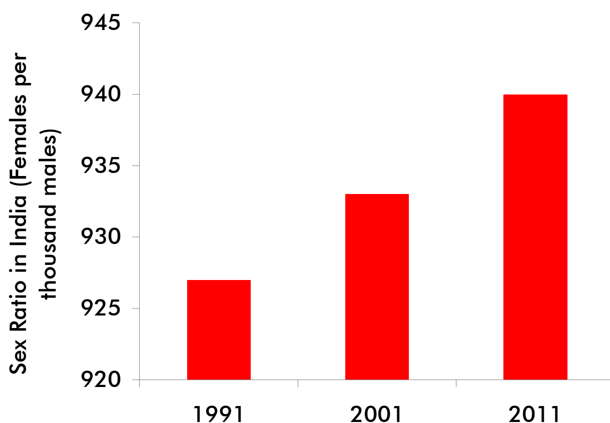
Axis 2: The rise of women consumers

Ten years ago, in a patriarchal developing country such as India, aspirations and the ability to execute the same was largely limited to men; women were largely confined to the kitchen or to menial labour-oriented tasks. With the ongoing social and economic empowerment of women, this gender is likely to contribute meaningfully to the next leg of aspirational demand.

Improving economic opportunities for women

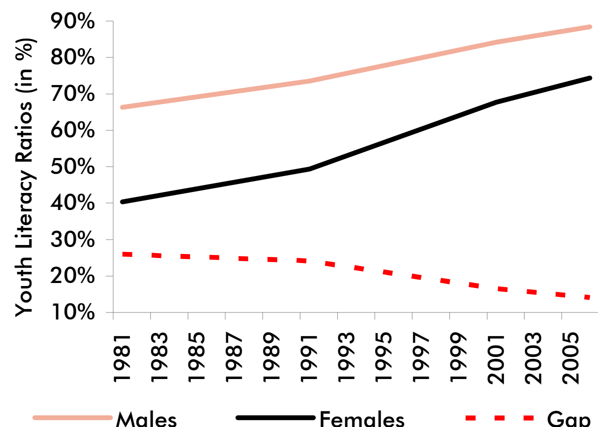
Besides the fact that India's sex ratio has been rising systematically (refer to Exhibit 27 below), there has been a dramatic improvement in the economic power commanded by women.

Exhibit 27: The systematically rising sex-ratio in India



Source: CEIC, Ambit Capital research

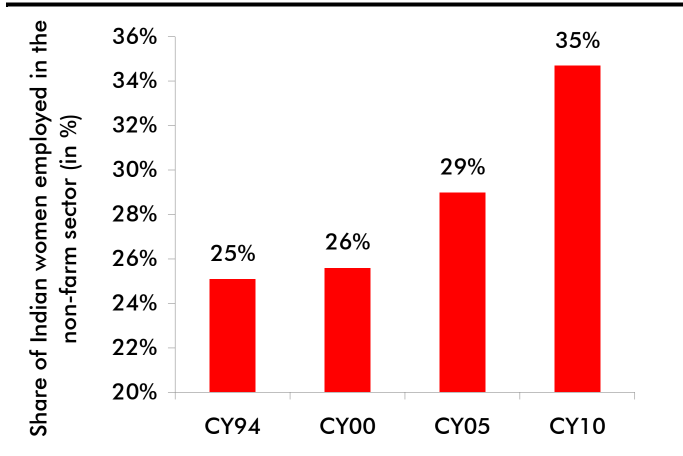
Exhibit 28: Female literacy levels are rising faster than male literacy levels in India



Source: CEIC, Ambit Capital research

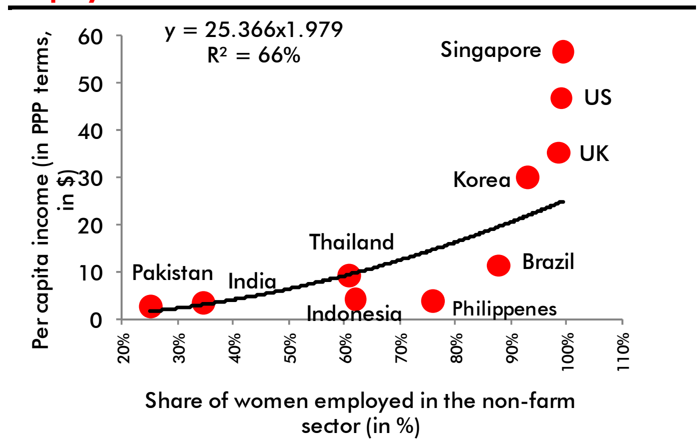
Female literacy levels have been rising systematically and at a pace that is faster than that of men (refer to Exhibit 28 above). Besides, qualitatively increasingly women are being absorbed into the non-farm sector which is characterised by higher income levels vis-à-vis the farm sector (refer to Exhibit 29 below).

Exhibit 29: The rising employment of women in the higher-paying non-farm sector



Source: World Bank, Ambit Capital research

Exhibit 30: History points to positive correlation between economic development and extent of women's employment in the non-farm sector



Source: CEIC,IMF, Ambit Capital research

Furthermore, international experience suggests that as a country develops economically (as measured by per capita incomes), the non-farm sector employs the bulk of women in any country (refer to Exhibit 30 above). For instance, only 35% of India's working women are currently employed in the non-farm sector at a point where India's per capita income is US$3,400 (in PPP terms). At the other end of the spectrum, is USA where 99% of working women are employed in the non-farm sector as its per capita income is at a level of US$46,900 (in PPP terms).

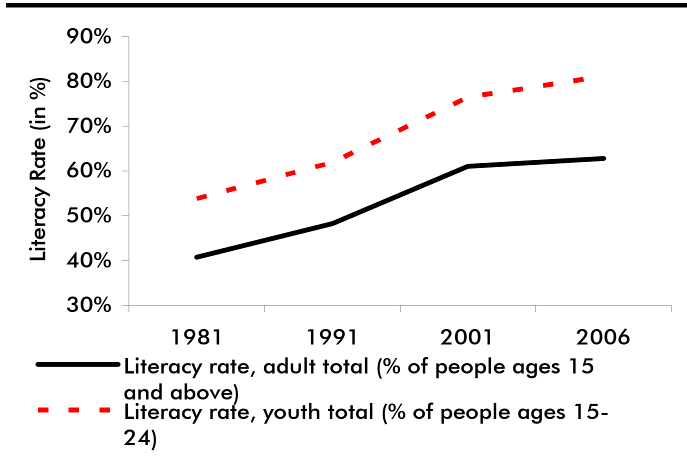
Besides the improving literacy levels and economic empowerment of women, the median family size in India has reduced to four members from more than four a decade ago. Furthermore, the average age at which women marry in India continues to rise, with the age having increased from 20 years in CY05 to 21 years in CY11. This is reflective of women's reduced child-bearing responsibilities as high levels of inflation trigger the need for households to activate a second-stream of income.

Whilst on one hand higher employment in the non-farm sector is translating into higher personal disposable incomes for women, on the other hand, womens' say in household decisions is on the rise as Indian society undergoes an irreversible social change.

Axis 3: The rise of India's baby boomers

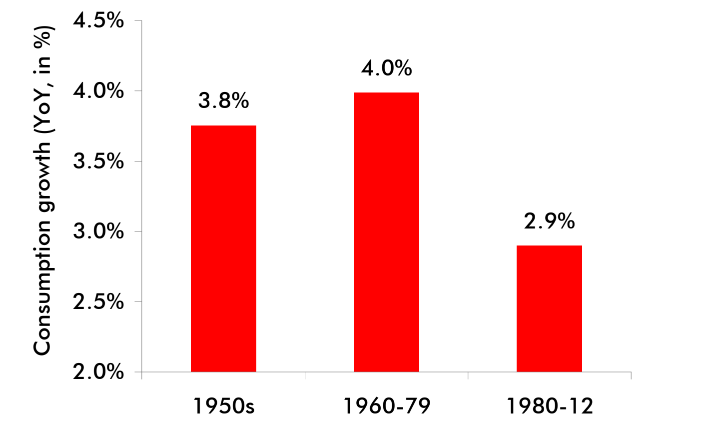
The population in the age group of 20-34 years is likely to account for a third of India's population over the next five years. This coupled with rising youth literacy levels (refer to Exhibit 31 below) and high general awareness levels (as established in the first sub-section) is likely to lead India's baby boomers born in the post-liberalisation (i.e. post 1991) to drive the next leg of consumption growth in India.

Exhibit 31: Rising literacy levels in the youth of India



Source: World Bank, Ambit Capital research

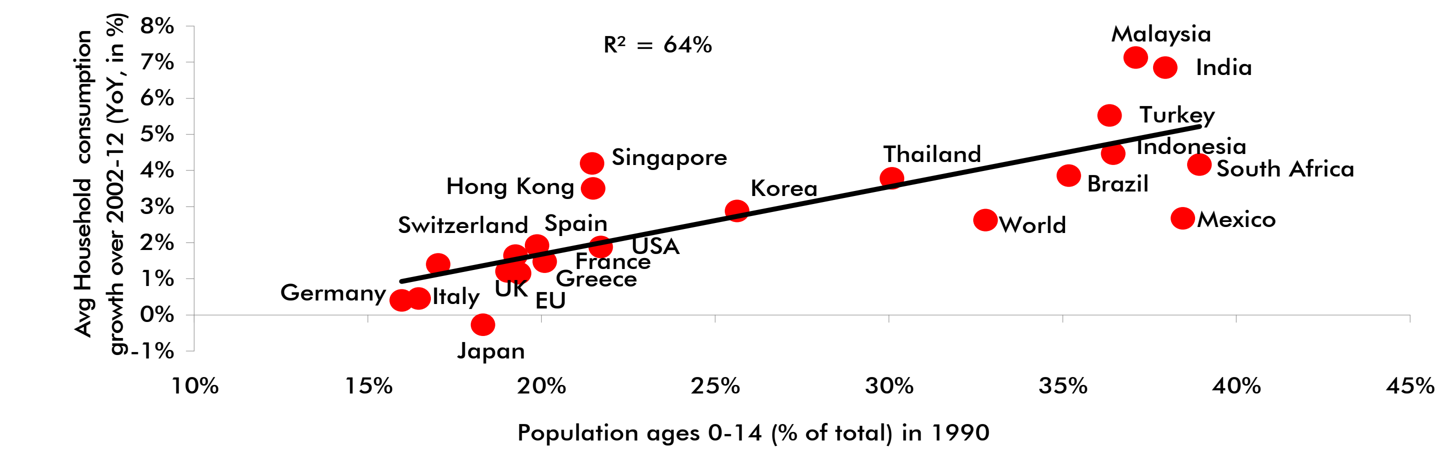
Exhibit 32: Consumption growth in USA peaked from 1960-79 following the birth of USA's baby boomers from 1946-64



Source: CEIC,IMF, Ambit Capital research

In fact, the American baby boomers - born in the post World War II era (from 1946-64) of economic peace and prosperity - drove consumption growth in the US on an unprecedented scale in the 1960s and 1970s. Consequently, consumption growth peaked from 1960-79 i.e. the phase characterised by a high share of youth and relative economic peace in the decades following World War II (refer to Exhibit 32 above).

Exhibit 33: International experience points to a positive correlation between youthful population* and consumption



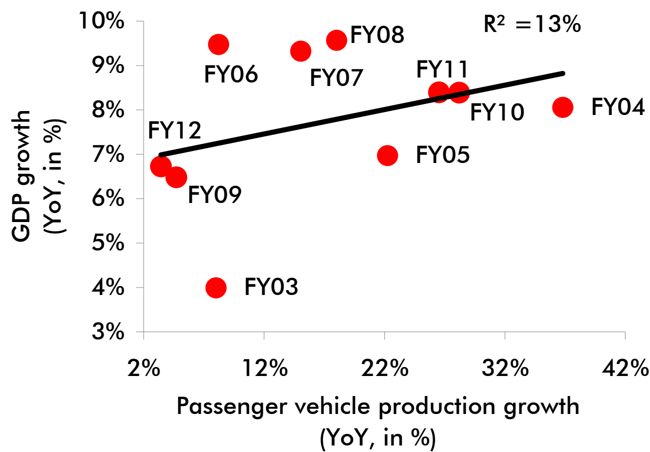
Source: World Bank, Ambit Capital research. Note : In the absence of uniform data on share of population in the age-group of 20-34 years of age across countries in CY10, we use data on population aged 0-14 years in 1990 to proxy the same.

In fact international experience too points to a positive correlation between the share of population in the age group of 20-34 years and the pace of consumption growth in a country (refer to Exhibit 33 above).

Is aspirational consumption likely to suffer owing to the growth slowdown?

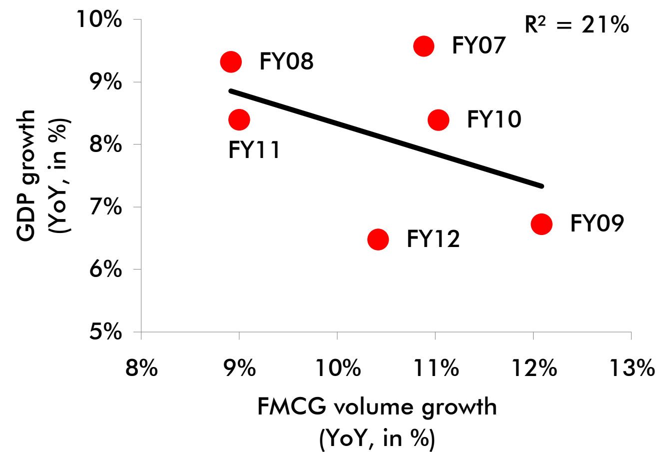
Economic theory suggests that consumption growth is primarily a function of income growth. Moreover, this text book tenet critically assumes that actual income growth is fairly reflected by national accounts data. However, 90% of India's workforce is engaged with the unorganised sector and the size of India's black economy is estimated to be as large as 40% of GDP. These two features of the Indian economy mean that the GDP growth rate (as measured by official data) is, at best, an imperfect driver of consumption growth - a fact that is corroborated by the poor correlations between GDP growth and volume growth in the Auto as well as FMCG sector (refer to Exhibit 34 and 35 below).

Exhibit 34: No meaningful correlation exists between GDP growth and passenger vehicle production



Source: CEIC, Ambit Capital research

Exhibit 35: No meaningful correlation exists between GDP growth and FMCG volume growth



Source: Companies, Ambit Capital research Note: FMCG includes Colgate, Godrej Cons - Soaps, GSK Cons, HUL, Marico – Refined Oil and Nestle.

In addition, it is critical to realise that income growth is only one determinant of aspirational consumption growth with variables such as economic liberalisation, literacy levels, electricity availability, economic empowerment of women as well the share of youth in the total population not only driving consumption but also known to lend non-linearities to the process of aspirational consumption growth. (In fact, such non-linearities are what Economists define as "structural changes" in their econometric models.)

Given that each of the above highlighted variables continues to grow in India, we expect aspirational consumption growth to continue outperforming essentials over the next five years despite concerns related to cyclical GDP growth.

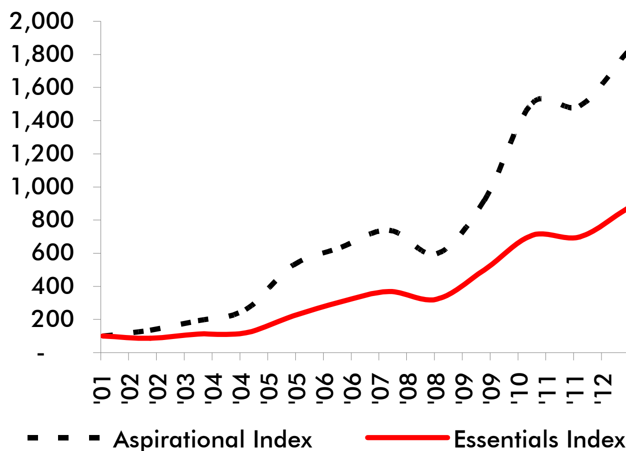
Investment Implications of Theme 2

The proliferation of aspirations along geographic, demographic and gender lines is likely to drive the next leg of outperformance in aspirational consumption stocks from a long term perspective despite the current cyclical slump.

Despite the current slump, aspirational products are likely to outperform essentials

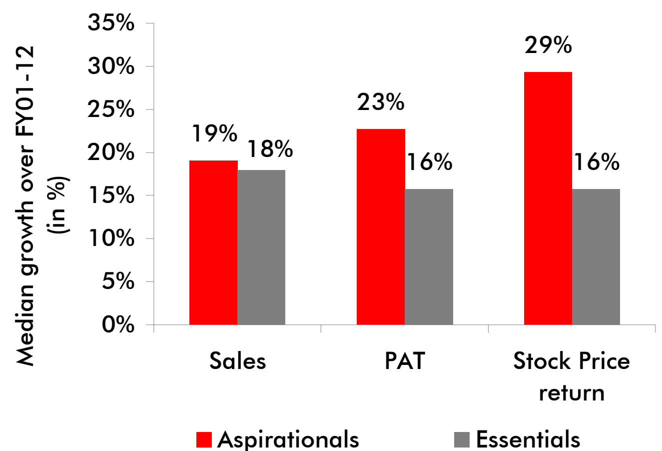
Slicing the BSE500 into two categories of aspirationals and essentials (please refer to Appendix on page 42 for details on composition) reveals that aspirationals have consistently outperformed essentials in terms of stock price appreciation, sales as well as profitability over the past decade (refer to Exhibit 36 and 37 below).

Exhibit 36: Aspirational stocks have outperformed essentials by over 100% in the past decade



Source: Bloomberg, Ambit Capital research
Note: Refer to the Appendix for details regarding composition.

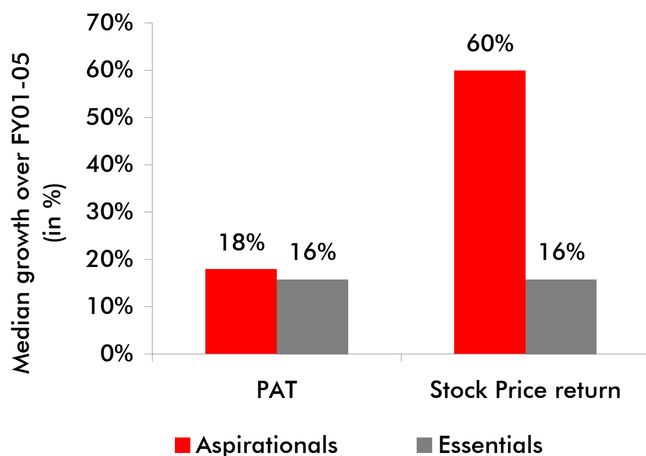
Exhibit 37: Aspirationals have outperformed essentials on both fundamentals and stock prices over FY01-12



Source: Bloomberg, Ambit Capital research
Note: Period under study- FY01-12. Refer to the Appendix for details regarding composition

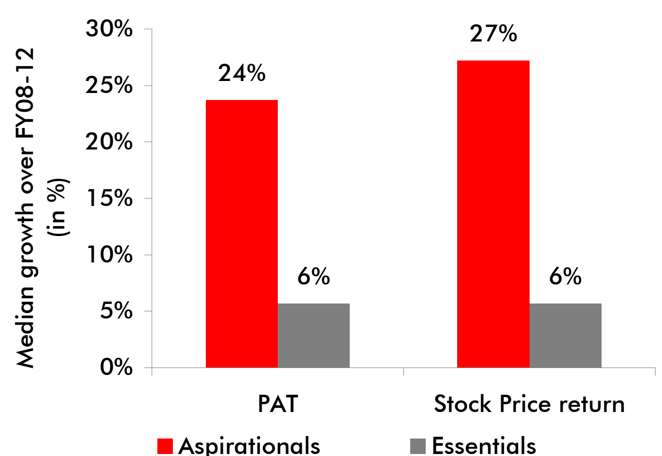
More interestingly, the stock price appreciation in aspirationals exceeds that of essentials by a wider margin over a 5-year period even when one or more of the years are characterised by a dip in GDP growth rates (refer to Exhibit 38 and 39 below).

Exhibit 38: Aspirationals outperformed essentials over FY01-05 despite growth dipping in FY01 and FY03



Source: Bloomberg, Ambit Capital research

Exhibit 39: Aspirationals outperformed essentials over FY08-12 despite growth dipping in FY09 and FY12



Source: Bloomberg, Ambit Capital research

Given that the next leg of aspirational consumption is likely to be driven by consumers that were hitherto non-participants (such as consumers from traditionally backward areas, women as well as the economically empowered youth), we expect consumers to continue to gravitate to this consumption category over the next five years.

High-growth aspirational categories of the next five years

Our Consumer analyst, Rakshit Ranjan, highlights specific categories that are likely to make the most profound gains, owing to the proliferation of aspirations along geographic, demographic and gender lines (refer to Appendix 2 for more details):

Implications of the rise of traditionally backward States/regions

Better access to enablers of aspirational consumption such as sanitation coupled with rising income growth in the traditionally backward states is likely drive growth of underpenetrated categories such as **skincare, insecticides** (59% penetration in urban and 18% in rural) and **milk drinks** (22% penetration in urban and11% in rural).

Whilst skincare will see aspirational demand flow through in terms of volumes and premiumisation, insecticides will be driven by a higher need for hygienic living conditions. We expect the aspirational **milk drinks category** to be driven by a stronger focus on health and nutrition. Outside the FMCG sector, we expect small ticket size utility oriented categories such as **kitchen appliances and white goods** to be disproportionately larger beneficiaries of geographic proliferation.

Implications of the rise of the rise and rise of women

Women-oriented consumer products are likely to experience disproportionate growth in products such as **haircare, skincare** and **ready-to-eat foods** as women are empowered socially and economically.

We expect their increased spending power to be diverted towards aspirational and convenience based spends with the categories of haircare (penetration of 57% in urban and 37% in rural for shampoos), skincare (penetration of 32% in urban and 18% in rural) and ready-to-eat (noodles penetration of 19% in urban and 3% in rural) being the key beneficiaries. Haircare and skincare will be driven by aspirational spends and will see premiumisation benefits as the women-led focus on beauty and personal hygiene rises. Ready-to-eat foods will benefit from the associated convenience in terms of ease of preparation as well as associated time benefits. Non-FMCG categories which are likely to benefit from gender based proliferation include **Quick Service Restaurants and kitchenware** as well as **scooters**.

Implications of the rise of young consumers

A combination of large numbers (with the population group between 20-24 years accounting for a third of the Indian population), rising economic empowerment of the Indian youth and increased awareness are likely to propel demand for youth-oriented categories, which have low penetration levels and are relatively more aspirational in nature. In the FMCG sector, these categories are likely to include **skincare** (penetration of 32% in urban and 18% in rural), **noodles** (penetration of 19% in urban and 3% in rural) and **fruit juices** (our estimate of overall penetration of <10%). Amongst other product categories, we expect **apparel and footwear** to benefit as well from the rise of India's baby boomers.

In terms of stock specifics, we highlight the following stocks that are likely to gain disproportionately due to the proliferation of aspirations.

Exhibit 40: Stocks-specific investment implications of Theme 2

Company	Bloomberg Ticker	Mcap (US$ mn)	ADV (US$ mn)	Rating	Comments
TTK Prestige	TTKPT IN	687	8.2	BUY	TTK Prestige, India's largest kitchenware company, has migrated from being a single product company to expanding its product offering and distribution channels to include a whole range of cookers, cookware and kitchen appliances. TTKPT's manufacturing facilities are located at Hosur, Coimbatore and Roorkee. The company currently sells its products in India under the brand name 'Prestige' and exports pressure cookers, pressure pans and non-stick cookware to countries including the US, the UK and the Middle East under the brand name 'Manttra'. The company has recorded revenue CAGR of 32% over FY07-12 and net profit CAGR of 57% over FY07-12.
TVS Motors	TVSL IN	334	1.1	NOT RATED	Amongst the listed two-wheeler companies, TVS Motors has the highest proportion of contribution from the scooters segment, with scooters contributing ~25% of its total volumes. Especially for TVS Motors, domestic scooters have seen a CAGR of 15% over FY07-12 vs a decline of 6% CAGR for domestic motorcycle. The entry of newer players such as Hero MotoCorp, Mahindra and Yamaha in recent years has impacted TVS Motors' scooter segment volumes. However, TVS Motors commands a strong brand image, particularly in the scooter segment, which places it well to ride the growth opportunity in that segment.
HUL	HUVR IN	20,918	21.7	NOT RATED	HUL is a market leader in the skincare, haircare and deodorants space as well as the soaps & detergents segment with a product portfolio that spans from mass to premium, with a strong aspirational demand for the premium segment of its offering. Its personal products division accounts for around 50% of profit and we expect the business to expand faster than its other divisions. Over the past five years (FY07-12), the company has seen revenue CAGR of 12% and profit CAGR of 11%.
United Spirits	UNSP IN	4,378	111	NOT RATED	We expect higher spends by the youth to drive growth in alcohol consumption volumes, mainly led by: (1) low per capita consumption in the country, (2) rising income levels, and (3) declining average age of initiating alcohol intake. With more than 40% volume market share, access to the largest liquor distribution network in the country and the increased financial firepower with the Diageo deal, we expect United Spirits to be a large beneficiary of rising demand for alcoholic beverages.
Dabur	DABUR IN	3,988	3.1	NOT RATED	Dabur is a play on the Indian FMCG sector, with a product portfolio across personal products and foods. Through its brand 'Real', Dabur is now the market leader in the fruit juices segment, which now constitutes ~10% of its revenue. Besides recording continuous market share gains in the space, it is also a strong player in the health supplements, haircare and skincare space, whilst having a strong acquisition-led international portfolio. The company's has recorded revenue CAGR of 21% over FY07-12 and net profit CAGR of 18% over FY07-12.
Marico	MRCO IN	2,642	1.4	NOT RATED	Marico is the market leader in the haircare and premium edible oils space with its marquee brands 'Parachute' and 'Saffola' respectively. The company has also recently forayed into the skincare and health foods space and has a strong international presence led by both organic initiatives as well as acquisitions. Through continuous market share gains in its both Parachute and Saffola, the company's has recorded revenue CAGR of 21% over FY07-12 and profit CAGR of 25% over FY07-12.
Godrej Consumer	GCPL IN	4,314	3.2	NOT RATED	Through a series of acquisitions, the erstwhile soap manufacturer now derives 20% of revenue from its domestic soap business and 40% from its overseas businesses. In the domestic market, it is also the market leader in powdered hair dyes and insecticides. The company follows a 3x3 strategy of operating in three continents, i.e. Asia, Africa and Latin America, in three categories, i.e. haircare, personal wash and insecticides. Due to its numerous acquisitions, the company has recorded revenue CAGR of 39% over FY07-12 and net profit CAGR of 32% over FY07-12.
GSK Consumer	SKB IN	2,343	1.5	NOT RATED	GSK Consumer is a play on the aspirational demand for packaged foods. It derives 94% of its revenue from health drinks (the marquee brand Horlicks accounts for more than 80% of revenue). The company's strategy lies in expanding its portfolio by launching functional food variants in Horlicks through Mother's Horlicks (for lactating mothers), Womens Horlicks (addressing osteoporosis concerns) as well as entering new categories such as biscuits, noodles and oats. The company has recorded revenue CAGR of 19% over CY06-11 and net profit CAGR of 23% over CY06-11.
Bata	BATA IN	1,001	5.1	NOT RATED	Bata is the largest shoewear company in India, with a presence across men, women and kidswear. Through a series of initiatives comprising management changes, employee cost rationalisation, outsourcing, and operating efficiencies, the company has turned around to being profitable with EBITDA margins improving from 5.7% in CY06 to 14.8% in CY11. The company has recorded revenue CAGR of 15% over CY06-11 and net profit CAGR of 57% over CY06-11.
Arvind Mills	ARVND IN	408	2.4	NOT RATED	Arvind is amongst India's leading textile companies with strong operations in denims, knitted and woven fabrics, retail of Indian and international brands, and with a presence in engineering, telecom and real estate. Its presence in the branded garments space is likely to be a key driver of growth in the future. The company has recorded revenue CAGR of 18% over FY07-12 and net profit CAGR of 29% over FY07-12.
Page Industries	PAG IN	663	0.5	NOT RATED	Page is the exclusive licensee for the manufacture and distribution of the Jockey brand in India, Sri Lanka, Bangladesh, Nepal and the UAE, and the Speedo brand in India. It has a distribution network of more than 23,000 retail outlets in 1,200 cities and towns. The company also has 79 exclusive Jockey outlets in India. The company has recorded revenue CAGR of 38% over FY07-12 and net profit CAGR of 40% over FY07-12.

Source: Ambit Capital research.

Appendix I

Exhibit 41: Ambit's Basket of 43 aspirational stocks in India

Bloomberg Code	NAME	Sector Name	PE FY12	PE FY13	Market Cap (US$ mn)	6 month ADV (US$ mn)
ITC IN	ITC	Tobacco	34.8	29.4	40,134	28.1
TTMT IN	TATA MOTORS	Industrial Engineering	6.8	7.4	14,558	55.3
BJAUT IN	BAJAJ AUTO	Automobiles & Parts	17.4	16.6	9,651	14.1
NEST IN	NESTLE INDIA	Food Producers	53.4	41.3	8,273	2.5
MSIL IN	MARUTI SUZUKI	Automobiles & Parts	25.2	22.2	7,718	22.0
APNT IN	ASIAN PAINTS	Construction & Materials	38.7	32.9	6,965	5.8
HMCL IN	HERO MOTOCORP	Automobiles & Parts	15.5	17.2	6,710	14.4
TTAN IN	TITAN INDUSTRIES	Personal Goods	43.8	35.5	4,798	9.2
UNSP IN	UNITED SPIRITS	Beverages	122.4	70.4	4,327	81.5
UBBL IN	UNITED BREWERIES	Beverages	166.7	95.0	3,751	7.5
SUNTV IN	SUN TV NETWORK	Media	21.1	20.4	2,660	7.0
EXID IN	EXIDE INDUSTRIES	Automobiles & Parts	26.0	19.0	2,111	3.6
PIDI IN	PIDILITE INDUSTRIES	Chemicals	32.2	26.3	1,909	1.0
JUBI IN	JUBILANT FOODWORKS	Travel & Leisure	82.2	56.1	1,552	12.6
GILL IN	GILLETTE	Personal Goods	94.5	NA	1,306	0.1
VCLF IN	VIDEOCON INDUSTRIES	Leisure Goods	(3.8)	NA	992	1.0
BRGR IN	BERGER PAINTS	Construction & Materials	26.7	22.9	873	0.7
AKZO IN	AKZO NOBEL	Construction & Materials	12.1	19.8	811	0.3
PF IN	PANTALOON RETAIL INDIA	General Retailers	148.9	35.0	789	19.9
MM IN	MAHINDRA & MAHINDRA	Industrial Engineering	16.9	14.3	10,024	17.4
MRF IN	MRF	Automobiles & Parts	7.0	7.9	784	2.5
APTY IN	APOLLO TYRES	Automobiles & Parts	10.1	6.8	750	6.0
GITG IN	GITANJALI GEMS	Personal Goods	7.7	6.9	718	5.9
TTKPT IN	TTK PRESTIGE	Household Goods & Home Constru	337.6	28.7	697	7.7
TRENT IN	TRENT	General Retailers	(67.8)	130.6	680	0.3
VOLT IN	VOLTAS	Industrial Engineering	22.6	14.5	664	4.8
JETIN IN	JET AIRWAYS	Travel & Leisure	(2.5)	NA	642	13.9
SHOP IN	SHOPPERS STOP	General Retailers	177.2	532.2	616	0.7
WHIRL IN	WHIRLPOOL OF INDIA	Household Goods & Home Constru	26.1	20.2	587	0.4
VST IN	VST INDUSTRIES	Tobacco	46.6	18.9	522	0.6
RW IN	RAYMOND	Personal Goods	16.3	15.6	463	2.7
MHRL IN	MAHINDRA HOLIDAYS	Travel & Leisure	23.1	20.1	433	0.1
ARVND IN	ARVIND	Personal Goods	5.1	8.6	407	2.4
COXK IN	COX AND KINGS	Travel & Leisure	46.3	8.8	350	1.0
ZYWL IN	ZYDUS WELLNESS	Food Producers	27.7	23.7	341	0.5
RDCK IN	RADICO KHAITAN	Beverages	29.1	20.9	337	0.7
TVSL IN	TVS MOTOR CO	Automobiles & Parts	13.8	9.8	333	1.4
DELTA IN	DELTA CORP	Personal Goods	37.2	31.9	306	4.4
TC IN	THOMAS COOK (INDIA)	Travel & Leisure	22.4	21.1	229	0.4
KAIR IN	KINGFISHER AIRLINES	Travel & Leisure	(0.3)	NA	200	5.1
VIP IN	V.I.P. INDUSTRIES	Household Goods & Home Constru	16.3	17.8	200	2.9
SKNL IN	S. KUMARS NATIONWIDE	Personal Goods	1.1	1.1	75	1.6
PROV IN	PROVOGUE (INDIA)	Personal Goods	7.4	NA	29	0.1

Source: Bloomberg, Ambit Capital research

Exhibit 42: Ambit's basket of 20 essential stocks in India

Bloomberg Code	NAME	Sector Name	PE FY12	PE FY13	Market Cap (US$ mn)	6 month ADV (US$ mn)
HUVR IN	HINDUSTAN UNILEVER	Personal Goods	41.2	35.7	20,891	20.9
BHARTI IN	BHARTI AIRTEL	Mobile Telecommunications	26.4	28.3	20,492	28.3
IDEA IN	IDEA CELLULAR	Mobile Telecommunications	44.4	30.0	5,836	3.6
GCPL IN	GODREJ CONSUMER PRODUCTS	Personal Goods	30.9	31.6	4,281	4.1
DABUR IN	DABUR	Personal Goods	34.7	29.3	4,058	2.7
CLGT IN	COLGATE PALMOLIVE	Personal Goods	41.8	41.0	3,301	1.8
MRCO IN	MARICO	Personal Goods	44.0	34.5	2,687	1.4
RCOM IN	RELIANCE COMMUNICATIONS	Mobile Telecommunications	14.2	17.9	2,398	13.5
SKB IN	GLAXOSMITHKLINE CONSUMER HEALTH	Food Producers	35.7	28.8	2,300	1.5
TGBL IN	TATA GLOBAL BEVERAGES	Food Producers	30.9	25.1	2,001	6.7
HMN IN	EMAMI	Personal Goods	36.5	30.5	1,719	1.1
PG IN	PROCTER & GAMBLE HYGIENE	Personal Goods	44.7	36.2	1,464	0.1
BRIT IN	BRITANNIA INDUSTRIES	Food Producers	28.1	22.8	1,019	0.9
MCLR IN	MCLEOD RUSSEL INDIA	Food Producers	12.2	10.4	636	2.1
JYL IN	JYOTHY LABORATORIES	Household Goods & Home Constru	64.0	35.8	519	0.7
RSI IN	RUCHI SOYA INDUSTRIES	Food Producers	24.6	13.9	392	0.7
NPI IN	NAVNEET PUBLICATIONS INDIA	Media	17.5	13.8	247	0.1
REIA IN	REI AGRO	Food Producers	2.9	2.4	205	0.5
KSO IN	KS OILS	Food Producers	1.0	NA	35	0.2
DECH IN	DECCAN CHRONICLE HLDGS	Media	0.6	NA	21	0.7

Source: Bloomberg, Ambit Capital research

Appendix II

Exhibit 43: Aspirational Product Categories that are likely to gain owing to the proliferation of aspirations

	Product Categories that are likely to gain	Rationale
Demographic proliferation	Skin care/Deodorants	The skin care and deodorants category has been witnessing strong premiumisation trends besides volume growth too holding up. Being an aspirational category that is predominantly driven by the youth, we expect the category to be a key beneficiary of increasing spends by the youth.
	Noodles	Increasing penetration as well as higher consumption frequency will be key drivers for the growth of this category, enabled by higher spending power in the hands of the youth. Other drivers to the category include the ease of preparation as well as the associated convenience and time benefits
	Fruit Juices	Youth driven spends are likely to boost the fruit juice segment as (1) preferences swing in favour of fruit juices away from carbonated beverages owing to the perceived health benefits and (2) the penetration and frequency of fruit juice consumption increases.
	Footwear and Apparel	These categories are likely to grow significantly due to: (a) a shift of purchases from unorganised to organised sellers; (b) a rising share of the wallet being allocated to these categories as discretionary spending increases; and (c) youth-driven spends being the biggest driver of these categories.
Gender-based proliferation	Haircare	We expect the haircare category to be a key beneficiary the rising number of working women with higher personal disposable incomes owing to: (1) the increasing focus on appearances, (2) the rising aspirational demand for specialised product offerings, and (3) a shift of purchases from unorganised to organised sellers.
	Skincare	The skin care category has been witnessing strong premiumisation trends besides volume growth holding up in the space. Being an aspirational category, predominantly women and youth driven, we expect the category to be a key beneficiary of increasing spends by women.
	Quick Service Restaurants	This category is likely to grow due to: (1) Only 10% of the overall eating out market is organised currently and (2) eating out frequency is increasing significantly due to both convenience related to cooking increased spends on this discretionary category.
	Kitchenware	With this category being largely women oriented in India, we expect strong growth rates driven by: (1) shift from unorganised to organised sellers, (2) nuclearisation of families leading to increase in the number of households, and (3) higher frequency of consumption due to the demand for greater variety kitchen appliances/goods demanded and shortening replacement cycles
	Ready-to-eat	Increasing penetration as well as higher consumption frequency will be key drivers of growth in this category. Working women with cooking related time constraints will aid the category growth given the associated convenience and time benefits
	Scooters	For the industry as a whole, domestic scooter segment has expanded at a CAGR of 22% over FY07-12 vs 9% CAGR for the domestic motorcycle segment for the same period. This has been facilitated due to strong demand from the female population (who prefer scooters) in the recent years. Going forward, we expect key drivers for the scooter segment to be: (a) continuing high demand from the female population, (b) many newer manufacturers entering the segment (such as Yamaha recently), and (c) increasing adoption by the male population too due to higher levels of safety and comfort in scooters vs motorcycles.
Geographic proliferation	Skin care/Deodorants	Given the aspirational value attached to the skincare and deodorant categories, we expect economic development in the backward states to disproportionately benefit these categories as the consumer focus towards personal care increases. The skincare and deodorants category has been witnessing strong premiumisation trends and we expect volume growth to hold up in the space especially as the MNC's get more aggressive.
	Mosquito Repellents	Geographic penetration of mosquito repellents will drive growth in this category as: (1) the focus on hygiene-related spends increases, (2) category penetration increases from the current 18% in rural areas, (3) the frequency of consumption increases, and (4) distribution reach of insecticide producers widens.
	Kitchenware	With this category being largely women oriented in India, we expect strong growth rates driven by: (a) shift from unorganised to organised, (b) more nuclear families leading to increase in number of households, and (c) higher frequency of consumption due to a desire to increase the number of kitchen appliances/goods and shortening replacement cycles
	Milk Drinks	We expect the milk drink segment to gain from geographics proliferation by: (1) increasing penetration from the current 11% in rural areas, (2) increasing focus on health and nutrition, (3) increase in frequency of consumption, (4) increasing distribution in rural areas, and (5) product portfolio focusing on all segments spanning children, mothers,

Source: Ambit Capital research

Theme 3: The advent of export-led industrialisation

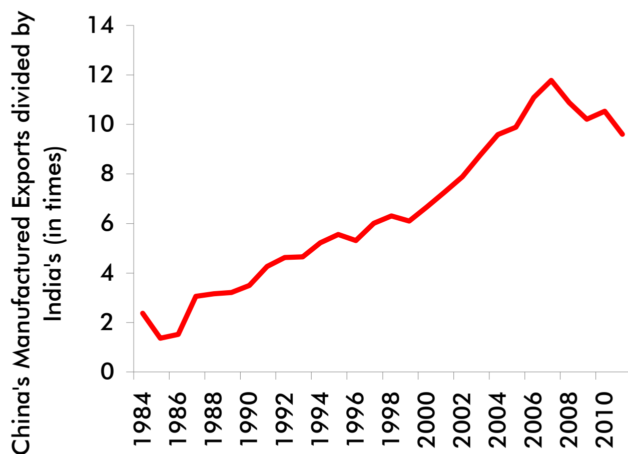
China's eroding competitiveness in the manufactured goods' export market

China devalued its currency by 46% against the USD in 1994. From thereon China broadly held its currency constant for the next decade inspite of the decade being characterised by a persistent current account surplus (which should in normal circumstances have lead to a currency appreciation).

A combination of export-supportive Government policies and an undervalued currency led China to increasing its share in global exports from 2% in CY94 to 7% in CY06 whilst India's share remained unchanged at 1% for the entirety of this period.

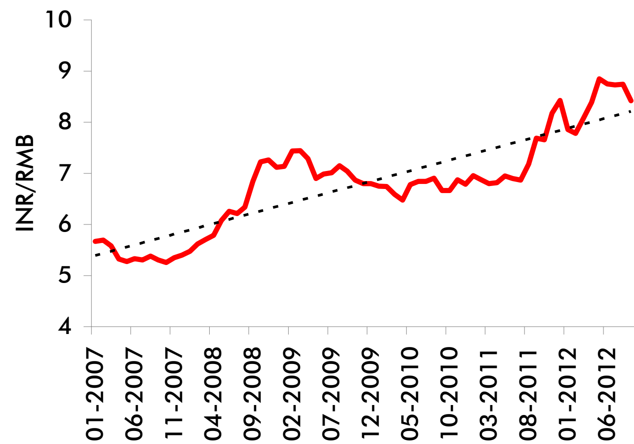
Whilst China's total exports continue to be 5x times India's exports as of today, interestingly India's manufactured products' exports growth has been exceeding that of China's since CY07 (refer to Exhibit 44 below).

Exhibit 44: Manufactured exports growth in India has been exceeding China's since CY07



Source: World Bank, Ambit Capital research

Exhibit 45: The INR has depreciated by 49% against the RMB since 2007



Source: CEIC, Ambit Capital research

This inflexion point in the chart above is indicative of a slow but sure increase in demand for India's manufactured goods owing to the systematic erosion of China's competitiveness in the manufactured goods market.

This erosion can be attributed to three powerful changes that have swung the balance in India's favour namely: **(1)** The loss of China's price competitiveness, **(2)** A shift in Government priorities away from export promotion and towards consumption growth, and **(3)** The loss of quality competitiveness.

The erosion of price competitiveness

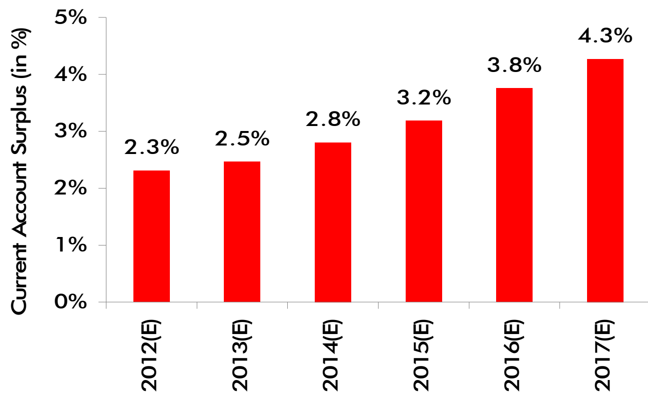
China's rise as an exports powerhouse was critically hinged on the Government's strong resistance to currency appreciation coupled with the administration of a 46% devaluation in the RMB against the USD in 1994. China's currency, quite deliberately and strategically undervalued, thus drove the spectacular growth in its exports with the quantum in value terms – exports increased 8x from CY94 to CY07.

China's rising current account surplus (which peaked at 10% of GDP in CY07) contributed famously to the rise of global imbalances which in turn reached a tipping point in CY08 when Lehman Brothers collapsed and triggered a global financial crisis.

Post-Lehman, a combination of mounting Western pressure on China and China's own need to reduce its reliance on exports as an engine of growth forced China to

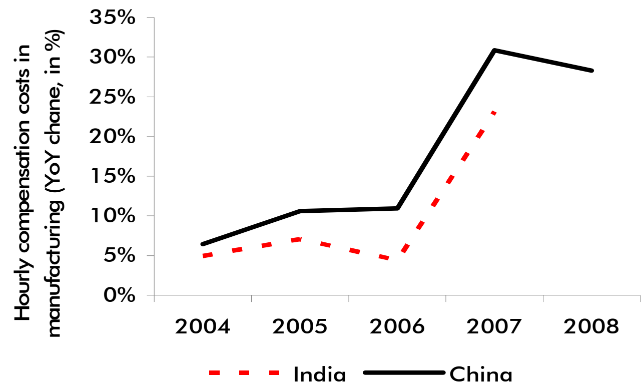
unwind the RMB's undervaluation. Consequently the RMB appreciated by 19% against the USD from CY07 to date. The INR in turn depreciated by 20% against the USD over the same period owing to a widening of India's current account deficit. The combination of these two forces has meant that the INR depreciated against the RMB by 49% over a 5-year period (refer to Exhibit 45 above), thereby providing automatic competitiveness to a series of Indian products.

Exhibit 46: The IMF expects China's current account surplus to widen over the next five years



Source: IMF, Ambit Capital research

Exhibit 47: Pace of wage cost growth has been lower in India as compared to China



Source: Bureau of Labour Statistics, Ambit Capital research. Note : Reliable data on wage costs is unavailable for China but anecdotal evidence systematically points to rising wage costs in China

Given that China's current account surplus is expected to increase over the next five years by *(Source: IMF,* refer to Exhibit 46 above) and given the backlog of currency adjustment, the RMB is likely to maintain this upward bias over the next few years thereby ensuring the competitiveness of Indian exports against China

Switch in China's attention from supporting exports to supporting consumption

Besides the exchange rate dynamics which are undermining China's export competitiveness, China's policy focus has undergone a dramatic change since the global imbalances driven sub-prime crisis of CY08. Realising its own vulnerability to economic slowdowns in the West, the Chinese administration has begun focussing on reviving domestic demand often at the cost of negative side-effects for the exports sector.

For instance, rising labour unrest as well as the need to support domestic consumption growth has led the Chinese Government to administer pro-worker legislative changes such as the passing of the new labour contract law of 2008 and increasing minimum wages. Whilst increasing purchasing power of wage-earners on one hand, this has meant that labour costs have increased rapidly in China since CY08 making other labour rich countries' (such as India, Bangladesh and Vietnam) more competitive (refer to Exhibit 47 above).

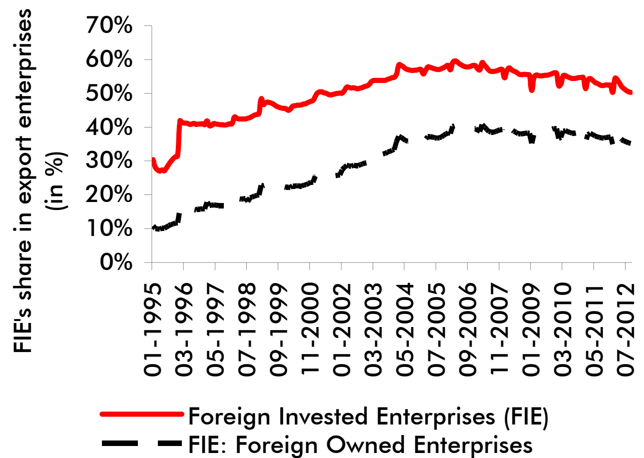
Another key policy move that has affected exports growth is the Chinese Government's decision to withdraw a series of tax sops available to Foreign Invested Enterprises (FIEs) from 2008 onwards (refer to Exhibit 48 below). FIEs are typically joint ventures between Chinese enterprises and overseas companies supplying FDI, product designs or international sales networks. These entities played a critical role in driving exports growth from China with FIEs' share in export enterprises amounting to 40% in CY08. However, following the withdrawal of tax sops, their role in driving exports growth has been diminishing (refer to Exhibit 49 below).

Exhibit 48: The withdrawal of tax incentives for FIEs* in China

	Tax regulations before 2008	Tax regulations after Jan, 2008
Income Tax	FIE's paid a 15% tax on income, whilst local companies faced a 33% tax rate.	A unified 25% tax rate for both FIEs and domestic companies was introduced.
Tax Holidays	FIE's were subject to a top income tax rate of 15% and 24% (depending on factors such as location, industries etc). These rates came into effect only after a 2-year tax holiday and a 3 year period under half-rate tax. Domestic enterprises on the other hand pay a standard tax rate of 33% which may be reduced depending on regions and sectors.	The two-year tax holiday and three-year half tax policies for manufacturing and exported oriented FIEs are abolished. However, FIEs established before March 2007 can still avail the benefit of this tax holiday.

*Source: Media Reports, Ambit Capital research. * FIEs is the abbreviation for 'Foreign Invested Enterprises'*

Exhibit 49: Foreign Invested Enterprises (FIEs) share in exporting peaked out in CY08



Source: CEIC, Ambit Capital research.

On the contrary, the Indian Government is keen to provide a policy-booster to exports growth realising India's vulnerability to a rise in global commodity prices (with the country being a net importer of commodities). Our discussions with senior civil servants suggest that the Government is set to direct its policy support machinery to boost exports growth as there has been a strategic realization that: **(1)** this is the only way India can limit its current account deficit; and **(2)** this is potentially a route to lifting investment demand in India.

The first line of attack is likely to be to provide a booster to Special Economic Zones (SEZs) in the country. The SEZ Act which was passed in CY05 allows for the creation of tax free export havens. However, owing to land acquisition related issues the development of SEZs has been delayed and overseas shipments from the existing 153 operational SEZs in India have diminished to 12% of total exports v/s 30% of total exports over the previous few years.

Some of the proposed measures to boost exports growth through SEZ's include: **(1)** reducing minimum land requirements for SEZs, **(2)** easing contiguity norms, and **(3)** easing non-processing zones requirement if the SEZ is located near a major urban centre

China's unenviable record at production quality

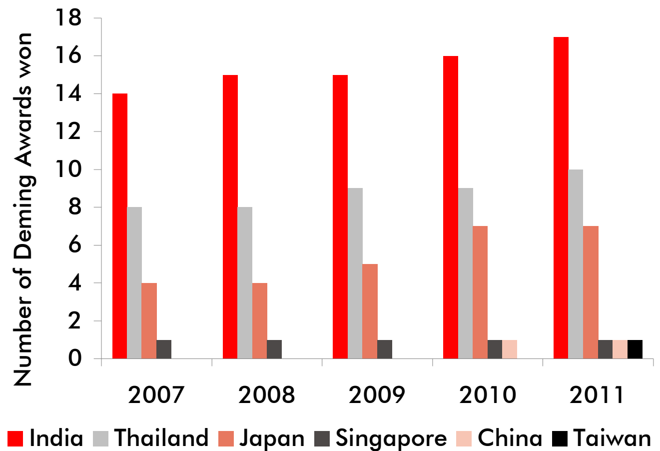
The final reason behind China's decreasing share in manufactured goods' exports is China's unenviable track record in production quality with the situation being exacerbated by a series of cases being brought to public attention since CY07 (refer to Exhibit 50 below).

Exhibit 50: China's unenviable track record in production quality

Date	Major Product Recall Cases
Jan-08	US pharmaceutical company Baxter withdrew Chinese-made batches of the blood-thinning drug heparin after 81 patients died
CY07	A series of product recalls and import bans were imposed by the product safety institutions of several developed countries against products exported from China because of consumer safety issues.
Jan-07	Some 300,000 China-made tower fans are recalled in the US after it is found that electrical arcing in the fan's wiring can cause a fire hazard.

Source: Media Reports, Ambit Capital research

Exhibit 51: India's high and rising tally of Deming awards for production quality



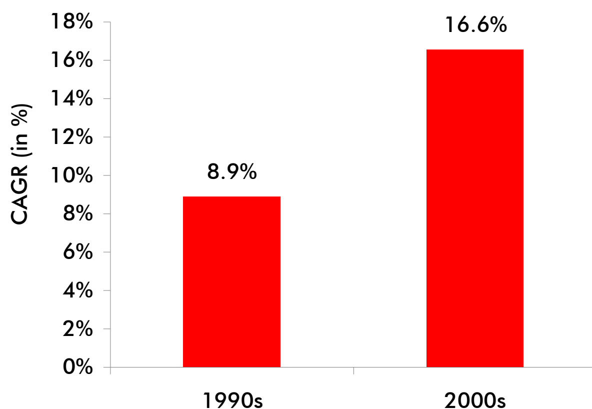
Source: Media Reports, Ambit Capital research

On the contrary, manufacturers in India have built a global reputation of producing low to medium technology products with minimal defects and with superior production processes. India' rising reputation as a producer of high quality products is exemplified by India's high and rising tally at the Deming awards for production quality (refer to Exhibit 51 above).

Indian exporters of "light industrial manufacturing" likely to benefit disproportionately

The improved price competitiveness of India's exports has already translated into the near doubling manufactured exports growth from the nineties to the noughties (refer to Exhibit 52 below) with the pace of growth of India's manufactured exports exceeding that of China's since CY07.

Exhibit 52: Manufactured goods exports growth has almost doubled in the noughties



Source: CEIC, Ambit Capital research

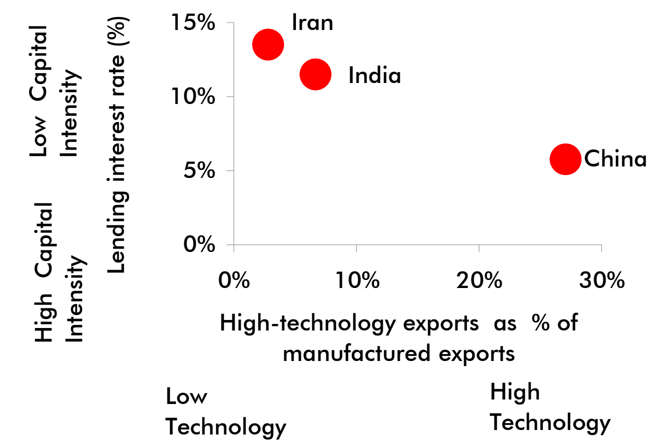
Exhibit 53: Engineering Goods' exports growth rates have more than doubled over the past decade

Product Category	1990s (median YoY growth, in %)	2000s (median YoY growth, in %)	Chg
Petroleum Products	**5%**	**44%**	**38%**
MG: Engineering Goods	13%	28%	15%
Manufactured Goods	**8%**	**20%**	**11%**
MG: Leather and Manufactures	2%	12%	9%
MG: Chemicals and Allied Products	12%	20%	9%
MG: Gems and Jewellery	12%	20%	9%
Primary Products	**8%**	**17%**	**9%**
MG: Textile & Textile Products	9%	10%	2%
MG: Work of Arts	11%	-3%	-15%

Source: CEIC, Ambit Capital research.

However it is interesting to note that within the broader manufacturing space "engineering goods" has been the best performing category in the noughties in India recording a 15 percentage points improvement in growth rates (refer to Exhibit 53 above).

Exhibit 54: India's competitive advantage lies in low to medium technology, low capital intensity products



Source: World Bank, Ambit Capital research.

Exhibit 55: India's rising specialisation in medium technology merchandise goods

Trade balance by technological group divided by total trade (in %)	1985-86	1995-96	2001-02
Low Tech	14%	19%	14%
Medium-low Tech	**-10%**	**-4%**	**0%**
Medium-high Tech	**-15%**	**-8%**	**-2%**
High Tech	-7%	-5%	-4%

Source: World Bank, Ambit Capital research

This is so because "Engineering goods" in specific and "light industrial manufacturing" in general is where India's competitive advantage lies (refer to Exhibit 54 and 55 above) owing to:

- The low to medium degree of technological knowhow required to manufacture these products as opposed to say technology intensive items such as electronics where India struggles; and
- The undemanding capex or infrastructure requirements for manufacturing these products makes production a viable option as the prohibitively high cost of capital in India (refer to our Theme 4 on pg 52 for details) inhibits her ability to produce heavy manufactured products at competitive prices.

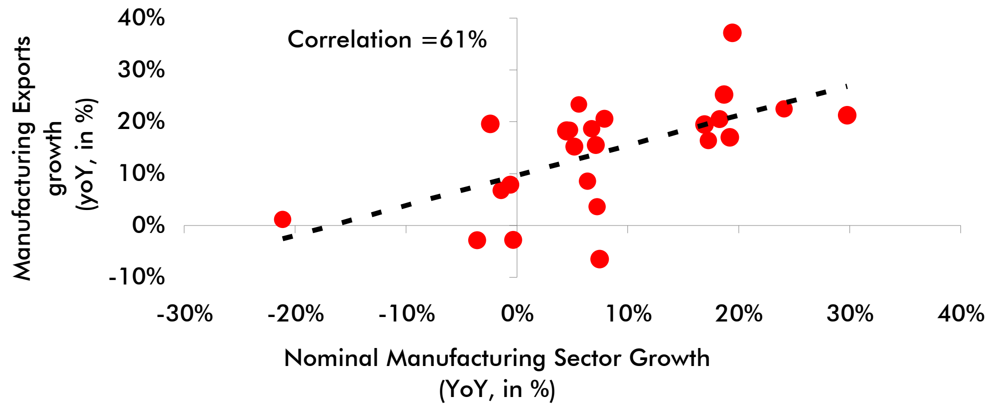
Whilst both of the bullets listed above are also applicable to labour intensive exports, such as textiles and sports goods, India's wretched transportation infrastructure and the thin operating margins available in these products compromises the country's competitiveness in labour intensive exports. By the time, Indian made apparel reaches the shops in Europe and North America, it has spent 3-4x longer travelling than, say, Vietnamese exports. That sort of working capital hit has, sadly, made Indian manufacturers uncompetitive in labour intensive sectors.

Finally, the existence of meaningful domestic demand for 'engineering goods' and 'light manufactured goods' products is likely to allow domestic manufacturers to achieve economies of scale at a rapid pace. Additionally, the ability to grow a domestic franchise allows exporters to diversify their end markets.

Investment Implications of Theme 3

Given the meaningful correlation between manufacturing sector GDP growth in India and manufacturing exports growth (refer to Exhibit 56 below), the increase in India's market share in the global manufactured goods' export market is likely to provide a fillip to manufacturing sector GDP growth in the medium term.

Exhibit 56: The strong positive correlation between manufacturing sector GDP growth and manufacturing exports growth in India



Source: CEIC, Ambit Capital research

India's prowess in relatively capital-light but knowledge-intensive light industrial manufacturing is relevant to both the B2C and B2B sector. On the B2C side, this theme is applicable manufacturers such as Whirlpool, Bajaj Electrical and TTK Prestige. On the B2B side, genset manufacturers such a Kirloskar Oil Engines, air compressor manufacturer Elgi Equipment and plastics specialist Supreme Industries all part of this theme.

Somewhere in the middle lies the Auto and Auto Ancillary sector which is clearly becoming very export focused with the big auto players (Maruti, Bajaj, Honda, Volvo, etc) clearly intent upon turning India in a major export hub. Some factors which plays in favour of developing India as an export hub are: (a) favourable currency movement with rupee witnessing significant depreciation against major global currencies recently; (b) abundance of labour and significant labour cost advantage; (c) significant development of component vendor base over the years; and (d) government support in the form of incentives such as tax benefits for exports etc. However on the flip side, there are some factors which may sow seeds of concern on committing investments in India towards export facilities such as: (a) labour issues; (b) unless the a manufacturer achieves significant degree of localisation (and thereby bring down dependence on imports); he may not be able to reap significant benefits of a favourable currency environment.

Moving on to investable companies, a few Indian manufacturers have already shown that India can succeed in the global manufactured goods' export markets with Bajaj Auto and Cummins India being noteworthy examples. Amongst the smaller companies we highlight Balkrishna Industries, Elgi Equipments, TTK Prestige and AIA Engineering as plays on India's rise as a manufacturing exporter (see Exhibit 57 below for details).

Exhibit 57: Stock-specific Implications of 'The advent of export-led industrialisation'

Company	Bloomberg Ticker	Mcap (US$ mn)		Rating	Comments
Cummins India	KKC IN	2,388	2.5	BUY	Cummins India (a subsidiary of Cummins Inc.) is India's number one player in engines with a strong presence in the medium and large engine segment (76% of its sales), thanks to its American parentage. We expect Cummins' exports to increase from 29% of revenue in FY12 to 50% in FY17, given that Cummins India is setting up a dedicated manufacturing facility in a special economic zone (SEZ) on the outskirts of Pune for supplying gensets to Cummins Inc.
Bajaj Auto	BJAUT IN	9,812	11.5	BUY	Bajaj Auto is the second-largest two-wheeler and the largest three-wheeler (3W) player in India. Exports accounted for 35% of Bajaj Auto's revenue in FY12. Bajaj aims at increasing its exports and expects exports to outstrip domestic sales in the near future (export of motorcycles accounted for 33% of total motorcycle sales in FY12 whereas 3W exports have already surpassed domestic sales). In addition, the company continues to scout for and invest in newer geographies. Bajaj has the benefit of significant experience in the export business and has a strong balance sheet (net cash of US$1bn as at end-FY12).
Balkrishna Industries	BIL IN	456	0.47	BUY	Balkrishna Industries (BKT) is the leading exporter of off-highway tyres (OHT) from India currently occupying close to 4% of the global OHT market. BKT continues to focus on export markets with increasing focus on newer geographies such as Africa and sub-segments such as industrial/construction tyres where it has a low market share. Given that the existing facilities are operating at full capacity utilisation, the company is undertaking significant capacity expansion, increasing its capacity by 75%.
Elgi Equipment	ELEQ IN	258	0.2	BUY	In the air compressor market, Elgi Equipments is a market leader with a market share of ~30% in India. The firm is also Asia's largest manufacturer of air compressors. In FY11, it acquired a French company, Belair S.A. to expand its presence in the European markets and more recently acquired a 100% stake in Rotair S.p.a., a company based in Italy, which is engaged in the design, manufacture and distribution of compressors.
TTK Prestige	TTKPT IN	687	8.2	BUY	TTK Prestige, India's largest kitchenware company, has migrated from being a single product company to expanding its product offering and distribution channels to include a whole range of cookers, cookware and kitchen appliances. TTKPT's manufacturing facilities are located at Hosur, Coimbatore and Roorkee. The company currently sells its products in India under the brand name 'Prestige' and exports pressure cookers, pressure pans and non-stick cookware to countries including the US, the UK and the Middle East under the brand name 'Manttra'. It has recorded revenue CAGR of 32% over FY07-12 and net profit CAGR of 57% over FY07-12.
AIA Engineering	AIAE IN	610	0.2	UNRATED	AIA Engineering is one of the leading suppliers of high-chrome cast grinding media (for grinding mineral ores, cement clinker, coal in utilities) globally. Nearly 53% of the volumes in FY12 (142K tonnes) were sold to the cement industry globally and 45% volumes to the mining sector (mainly iron ore). AIAE is India's largest grinding media company and meets ~90% of the Indian cement industry's requirements. AIAE's consolidated revenue, EBITDA and PAT have seen a CAGR of 17%, 10% and 8% respectively over FY08-12. We believe increasing traction with international mining clients and increasing capacities will drive market share gains globally and hence drive growth.

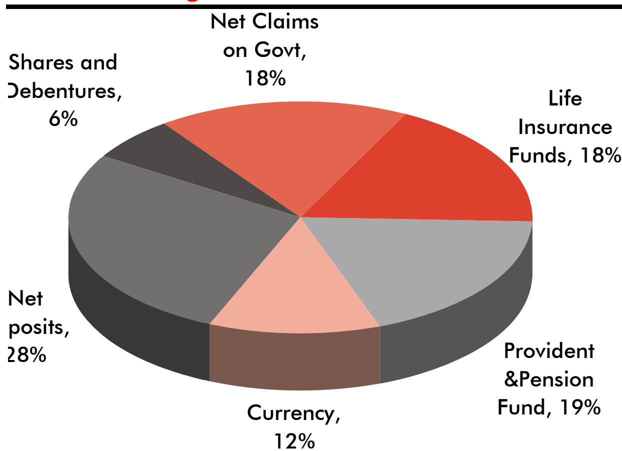
Source: Ambit Capital research.

Theme 4: The challenge of a compromised banking system

The paradox of capital scarcity alongside copious savings

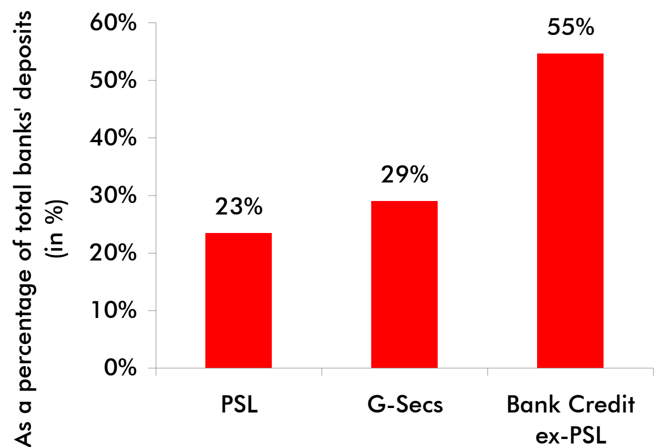
Despite being characterised by a high savings ratio comparable with other Asian economies before their respective high growth phases, two factors impede the translation of these savings into plentiful access to capital in the Indian context. Firstly, half of Indian household savings are invested in physical assets (such as gold and real estate), thus foreclosing a large chunk of the savings pie at the outset.

Exhibit 58: More than one-tenths of Indian household financial savings is held in the form of hard currency



Source: CEIC, Ambit Capital research
Note: Each metric is expressed as a percentage of financial savings; Data pertains to the average over FY99-08, the latest period for which continuous data is available.

Exhibit 59: Banks lend only about half the deposits they collect, to the private sector



Source: CEIC, Ambit Capital research
Note: PSL refers to Priority Sector Lending, Each metric is expressed as a percentage of bank deposits, Data pertains to FY12

Secondly, only a small slice of these financial savings ends up being available for productive investment as:

- More than one-tenths is held in the form of currency (refer to Exhibit 58 above),
- Banks lend only half the deposits to the private sector after adjusting for the mandatory priority sector lending requirements imposed by the RBI (refer to Exhibit 59 above),
- The Government forecloses a substantial portion of savings directly (through small savings schemes) as well as indirectly via the imposition of statutory liquidity requirements (SLR) on banks, and
- The shape of regulations in India mandates the bulk of public funds to be invested in the public sector (the Government or its enterprises) with only a small sliver being allowed to be invested in the private sector or lower rated private corporates (in the form of debt).

Exhibit 60: The shape of Indian regulation forces the flow of household savings into the Government sector

Institution	Investment rules	Size of portfolio
Banks	The RBI mandates Indian banks to maintain 23% of its deposits in the form of cash, gold, Govt. and Govt. approved securities under the Statutory Liquidity Requirement (SLR). Given that both cash and gold do not earn interest, the majority of SLR assets are maintained in the form of G-Securities. Additionally, whilst G-Secs are allotted a risk weight of zero, and corporate debt investments attract a risk weight exceeding 1 thereby discouraging banks' investments in these instruments. Banks are also mandated to mark-to-market their corporate bond portfolio which acts as a key disincentive for banks to purchase corporate bonds.	29% of commercial bank deposits in India as at FY12 end was recorded at ~US$330bn
Insurance Companies	At least 50% of a life insurer's funds should be invested in Govt. and Govt. approved securities whilst investment in other than Govt. approved securities cannot exceed 15% of the fund.	AUM of Life Insurers as at FY10 end was recorded at ~US$270bn

Source: SEBI, IRDA, Ambit Capital research

The limited flow of household savings into markets

Given that all major domestic financial institutions (insurers as well as banks) are forced to maintain limited exposure to investments (refer to Exhibit 60 above), only a trickle of the Indian household financial savings ultimately flows into markets thought this indirect route.

Back of the envelope calculations suggest that less than 3% of Indian household savings enters the Indian markets after factoring in flows through both direct and indirect routes (refer to Exhibit 61 below for details). This in turn means that the Indian economy relies disproportionately on FIIs for its capital requirements and this, unfortunately, locks the Indian market into the Western risk capital cycle.

Exhibit 61: Only ~3% of Indian household savings enter the Indian markets

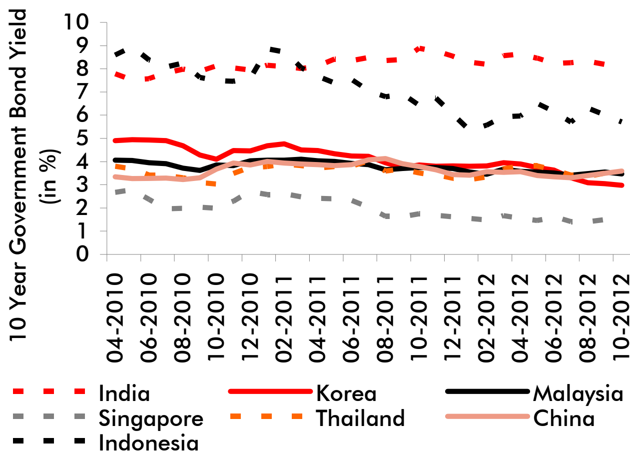
	Details	FY11	FY12	Source
	Direct inflows into markets			
A	India's nominal GDP (in INR tn)	76,741	88,558	CSO
B	Indian households' savings ratio (in %)	23%	23%	CSO
C	Nominal savings (in INR tn)	17,651	20,368	C = A x B
D	Investments ratio (in %)	3%	3%	Assumed to be the long term average over FY99-FY08 in the absence of more recent data
E	Nominal investments (in INR tn)	529	611	E = D x C
	Indirect inflows into markets			
F	Annual Mutual Fund flows into markets (in INR bn)	-200	-14	F , SEBI
G	**Total inflows into markets (in INR bn)**	**330**	**597**	**G = E + F**
H	**Total inflows into markets (as a % of savings)**	**2%**	**3%**	**H = G / C**

Source: CEIC, Ambit Capital research.

The inimical cost and limited access to debt capital in India

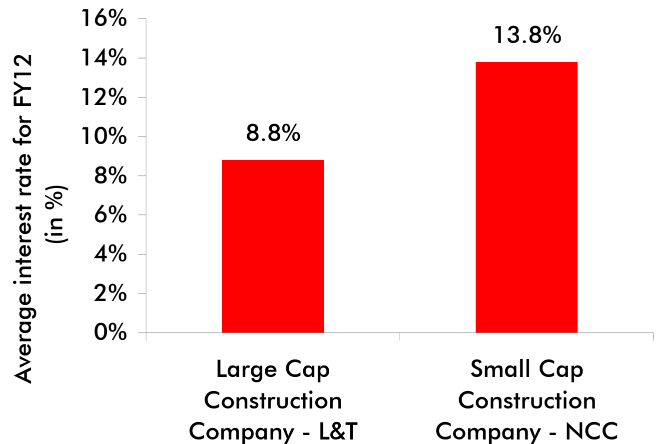
Not only does India depend meaningfully on FIIs for capital, the cost of debt capital in India is amongst the highest across emerging markets (refer to Exhibit 62 below) with the capital constraint being more meaningful for smaller corporates and for corporates needing funds for longer durations (refer to Exhibit 63 below).

Exhibit 62: India's risk free rate is one of the highest amongst peers. . .



Source: Bloomberg, Ambit Capital research

Exhibit 63: . . . with the cost of debt capital being substantially higher for smaller Indian corporates



Source: Annual Reports of Cos, Ambit Capital research

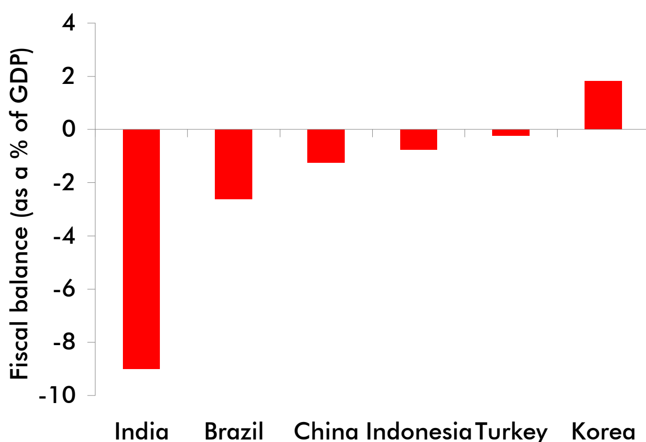
Unique set of institutional factors drives up the cost of debt capital in India

A unique set of institutional factors drives up the cost of debt capital in India. The massive borrowing programme of the Indian Government drives up the risk-free rate in the Indian economy, as the more the Government borrows, the higher the Indian bond yields rise. To compound matters, regulatory barriers impede access to external as well as non-bank sources of debt capital. Moreover, banks in India are the largest financial intermediaries and have a near monopoly over the supply of credit. We now look at each of these structural issues in detail.

(1) The massive borrowing programme of the Government

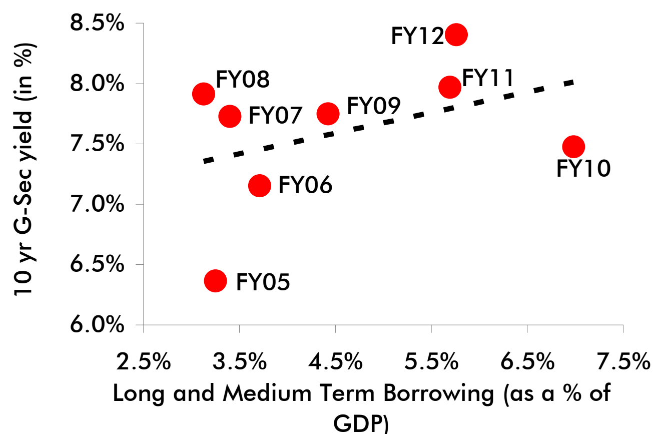
India is characterised by one of the highest fiscal deficits amongst emerging markets (refer to Exhibit 64 below) and this is a key driver of the high risk-free rate of borrowing in India, as the more the Government borrows, the higher Indian bond yields rise (refer to Exhibit 65 below).

Exhibit 64: India is characterized by one of the highest fiscal deficits amongst EM peers



Source: IMF, Ambit Capital research
Note: Data refers to CY11 and captures the General Government fiscal deficit as a percentage of GDP.

Exhibit 65: The positive relationship between the size of Government borrowing and the risk-free rate

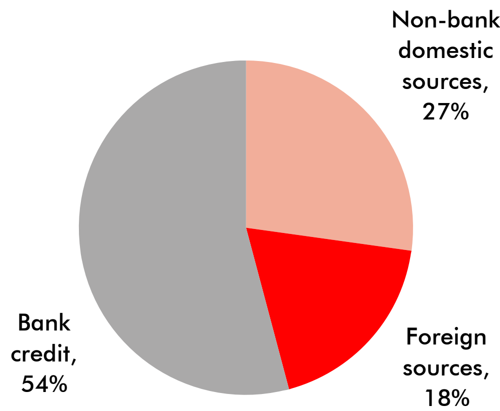


Source: CEIC, Ambit Capital research.

(2) The near monopoly that banks enjoy over the supply of credit

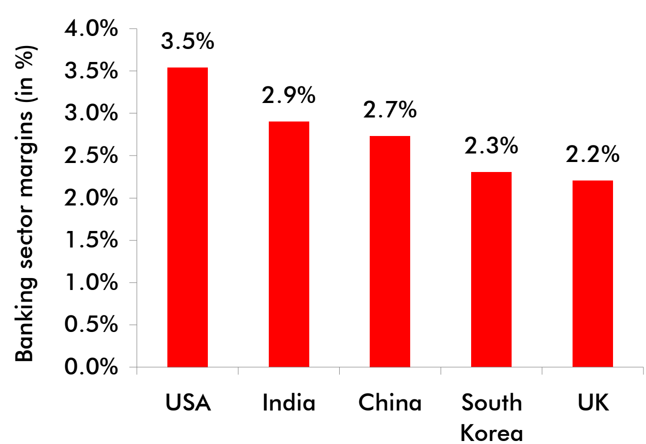
Banks are the key providers of capital in India (refer to Exhibit 66 below) with bank assets accounting for ~60% of financial system assets.

Exhibit 66: Banks are the key suppliers of credit in the Indian economy



Source: RBI, Ambit Capital research
Note: Data pertains to FY12 and reflects exhaustively the flow of financial resources to the commercial sector in India.

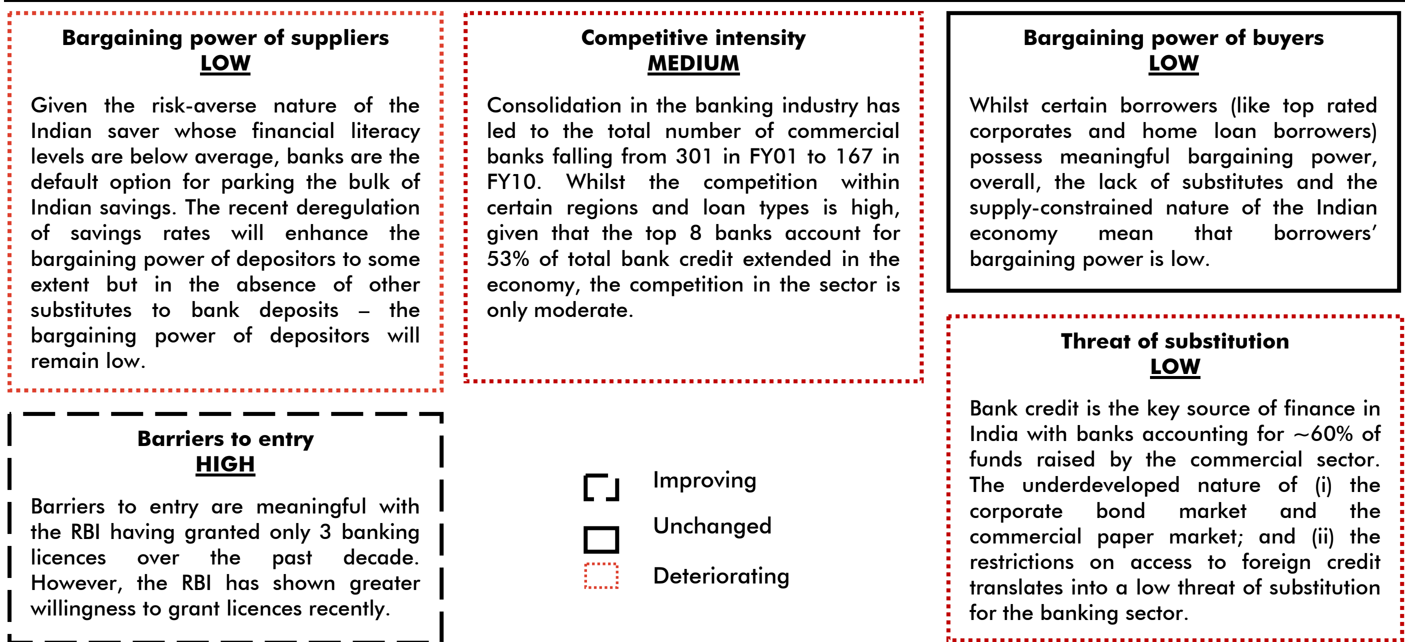
Exhibit 67: By global standards, Indian banks enjoy some of the healthiest net interest margins



Source: Various, Ambit Capital research
Note: Data pertains to the most recent financial year

The underdeveloped nature of alternative sources of funding (such as the corporate bond market) and the existence of regulatory barriers (as in the case of NBFC funding or external borrowing) means that banks enjoy a near monopoly over the supply of credit. This is partially responsible for the fact that Indian banks enjoy some of the highest net interest margins globally (refer to Exhibit 67 above).

Exhibit 68: A Porter analysis of Indian banks' points to the favourable industry structure of this sector



Bargaining power of suppliers
LOW

Given the risk-averse nature of the Indian saver whose financial literacy levels are below average, banks are the default option for parking the bulk of Indian savings. The recent deregulation of savings rates will enhance the bargaining power of depositors to some extent but in the absence of other substitutes to bank deposits – the bargaining power of depositors will remain low.

Competitive intensity
MEDIUM

Consolidation in the banking industry has led to the total number of commercial banks falling from 301 in FY01 to 167 in FY10. Whilst the competition within certain regions and loan types is high, given that the top 8 banks account for 53% of total bank credit extended in the economy, the competition in the sector is only moderate.

Bargaining power of buyers
LOW

Whilst certain borrowers (like top rated corporates and home loan borrowers) possess meaningful bargaining power, overall, the lack of substitutes and the supply-constrained nature of the Indian economy mean that borrowers' bargaining power is low.

Barriers to entry
HIGH

Barriers to entry are meaningful with the RBI having granted only 3 banking licences over the past decade. However, the RBI has shown greater willingness to grant licences recently.

Improving
Unchanged
Deteriorating

Threat of substitution
LOW

Bank credit is the key source of finance in India with banks accounting for ~60% of funds raised by the commercial sector. The underdeveloped nature of (i) the corporate bond market and the commercial paper market; and (ii) the restrictions on access to foreign credit translates into a low threat of substitution for the banking sector.

Source: Ambit Capital research, Industry

(3) Barriers to access non-bank sources of debt finance

Despite the evident differential between domestic and foreign interest rates, restrictions on access to external debt prevent the arbitrage opportunity from being exploited (refer to Exhibit 69 below).

Exhibit 69: RBI restricts access to external commercial borrowings (ECBs)

ECBs	Quantitative restrictions	Interest rate restrictions
Automatic route	The maximum amount of ECBs that can be raised by a corporate is US$750mn during a financial year. Hotels, hospitals and the software sector are allowed to avail of ECBs up to US$200mn in a financial year.	All-in-cost ceilings for the approval route means that no debt with a maturity of 3-5 yrs can be raised priced at more than 350bps + LIBOR. For a term exceeding 5 years, this spread has been fixed at 500bps.
Approval route	Eligible borrowers under the automatic route can avail of ECB beyond US$750mn or equivalent per financial year. Hotels, hospitals and software sector are allowed to avail of ECB beyond US$200 million for meeting foreign currency and/ or Rupee capital expenditure for permissible end-uses.	All-in-cost ceilings for the approval route means that no debt with a maturity of 3-5 yrs can be raised priced at more than 350bps + LIBOR. For a term exceeding 5 years, this spread has been fixed at 500bps.

Source: RBI, Ambit Capital research

Our discussions with the management teams of companies in capital heavy sectors such as Infrastructure, Power and Metals & Mining suggest that the quantitative restrictions on ECBs prevent larger companies from accessing this route whilst smaller companies cannot access this route on account of interest rate restrictions.

In addition, access to domestic alternatives to bank credit are either inaccessible, involve limited access or are prohibitively expensive (refer to Exhibit 70 below).

Exhibit 70: The inaccessibility of alternative sources of finance

Sources of non-bank domestic finance	Accessibility barrier
Borrowing from NBFCs	40-50% of NBFCs' funds are sourced from banks. Hence, loans made by an NBFC in India have a mark-up of 200bps-300bps over the corresponding bank lending rate.
Issuance of commercial paper (CP)	A corporate is eligible to issue CPs provided the tangible net worth of the company is not less than ₹40mn (44% of 16,643 registered companies in India have a net worth of less than Rs40mn). The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies.
Issuance of corporate debt	India's corporate debt market is highly underdeveloped with AA and AAA corporate bonds accounting for 80% of volumes.

Source: SEBI, Ambit Capital research

Investment Implications of Theme 4

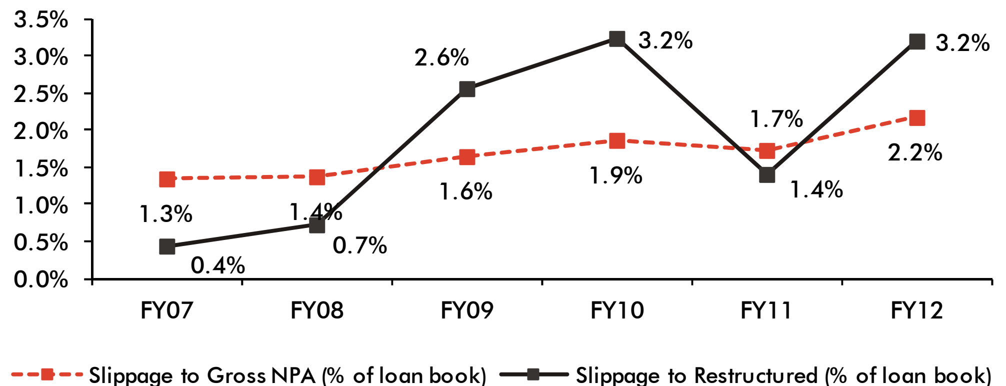
Aggressive CEOs in charge of banks is nothing new (whether it be in the public sector or in the private sector, in India or abroad). The very nature of the sector encourages such aggression because the CEO knows that if he/she grows the Balance Sheet aggressively for two years, gathers plaudits from the Government and from the media, by the time the chickens come home to roost 3-4 years out (in the form of bad debts), he/she will be long gone. This is especially true for long-term loans in sectors such as Power, Roads, Telecom and Real Estate and it is notable that loans to all of these sectors have grown much faster than broader lending in India over the past four years.

However, during the previous economic boom (2003-07) the RBI could check such aggression by bank CEOs by summoning them to its HQ, rapping their knuckles for aggressive lending (and the attendant posting of unrealistic results) and forcing them to, both, come clean (by writing down dud loans) and tone down the aggression (by reducing loan book growth). The threat that the RBI used in such circumstances was that of a forced merger with a public sector bank at a depressed share price.

This sensible mode of bank regulation started unraveling in the months running up to the Lehman Brothers crisis. On 27 August 2008, towards the fag end of his tenure, Dr. YV Reddy, former governor of the RBI, in keeping with the stress building up in the banking system, allowed a degree of regulatory forbearance and permitted banks to restructure loans without having to downgrade the asset classification (therefore, a standard asset remained a standard asset even upon restructuring).

Indian banks needed no second invitation - the proportion of additions to restructured as a proportion of loans outstanding, soared over the past four years to ~3% as of March 2012 and has continued rising further during 1HFY13.

Exhibit 71: The rise in "slippages to gross NPAs" and "slippages to restructured assets" as a percentage of loan book



Source: RBI, Ambit Capital research

Even more damagingly, the signal that such a retrograde intervention gave to the banking sector was that the RBI was seemingly willing to turn a blind eye to banks that padded their balance sheets i.e. those that kept restructuring assets, which were palpably dud and those that even refused to restructure assets, which were clearly underperforming.

Subsequently, during FY11 and FY12, even as the economy slowed down and even as some of the public sector banks stepped up their restructuring, the private sector banks decided that they were simply not going to come clean vis-à-vis the quality of their assets (see the table on the next page). Now, given the challenges around raising equity capital in FY12 and 1HFY13, this was an understandable (albeit unethical) tactic from the private banks. However, rather than stepping in to

check the private banks from indulging in such creative accounting, the RBI has kept mum perhaps because of the fear that if public sector banks too are forced to do sensible accounting then the recapitalisation that it implies will widen India's budget deficit even further and, perhaps, seal the downgrade of India's sovereign credit rating.

Exhibit 72: The surge in NPAs across the Indian Banks

Gross NPAs (as a % of gross advances)	FY09	FY10	FY11	FY12
State Bank of India	2.5	2.7	3.4	4.6
Public Sector Banks	1.7	2.9	2.1	2.8
Old Private Sector Banks	**2.4**	**2.3**	**1.9**	**1.8**
New Private Sector Banks	**3.1**	**2.9**	**2.7**	**2.2**
All Scheduled Commercial Banks	2.3	2.4	2.5	3.1

Source: RBI, Ambit Capital research

Here are some back-of-the-envelope mathematics that give you a sense of how meaningfully Indian banks have overstated their financial position:

- Loans to the Power, Roads, Commercial Real Estate, Telecom and Aviation sectors amount to more than US$140bn (or ~20% of system assets).
- Now, assume that only a quarter of these assets (or 5% of system assets) will end up being economic losses.
- Of the rest of the loans in the Indian economy (the other 80%), assume that only 5% will end up being economic losses due to the prolonged effects of the economic downturn. (Gross NPAs as a percentage of loans outstanding averaged 2-3% in the glory days of the Indian economy in FY04-07. So a doubling of that is not unreasonable given the marked slowdown of the economy.)
- Adding the two set of economic losses (5% + 4%) suggests that 9% of Indian banks' assets have little or no economic value and hence, cannot be recovered. This, in effect, amounts to ~100% of their shareholders' equity.
- Compare this 9% to the currently declared NPA figure for the banking system at 4% (of loans outstanding) and you get a sense of how useless the currently published financial statements of the Indian banks are.
- If our estimate of the proportion of loans that are dud in the Indian banking system is right (at 9%) then that implies that Indian banks' Tier 1 is 5% (and not over 10% as the banking system and the RBI often claims it to be). Obviously, 5% is significantly short of the RBI's core Tier-1 requirement of 8% (under Basel-III) suggesting that we have a grossly under-capitalized banking system.

The scale of this Balance Sheet challenge facing Indian banks acts as a major qualifier to the investment opportunities presented by the Indian banking sector.

Sensible banks should outperform

Given the scarcity of affordable debt capital in India, given Indian banks' almost impregnable position as the main suppliers of capital to the economy and given the regulatory barriers to entry into this sector, banking will continue to be an attractive business to be in. Hence, investing in sensibly run banks (which can capitalise on the high spreads available in India without getting steamrolled by impaired credit quality) should prove to be a good idea on a cross-cycle basis. The two relevant questions therefore are: **(a)** Which are these sensibly run banks? **(b)** Which of these banks are available at attractive valuations?

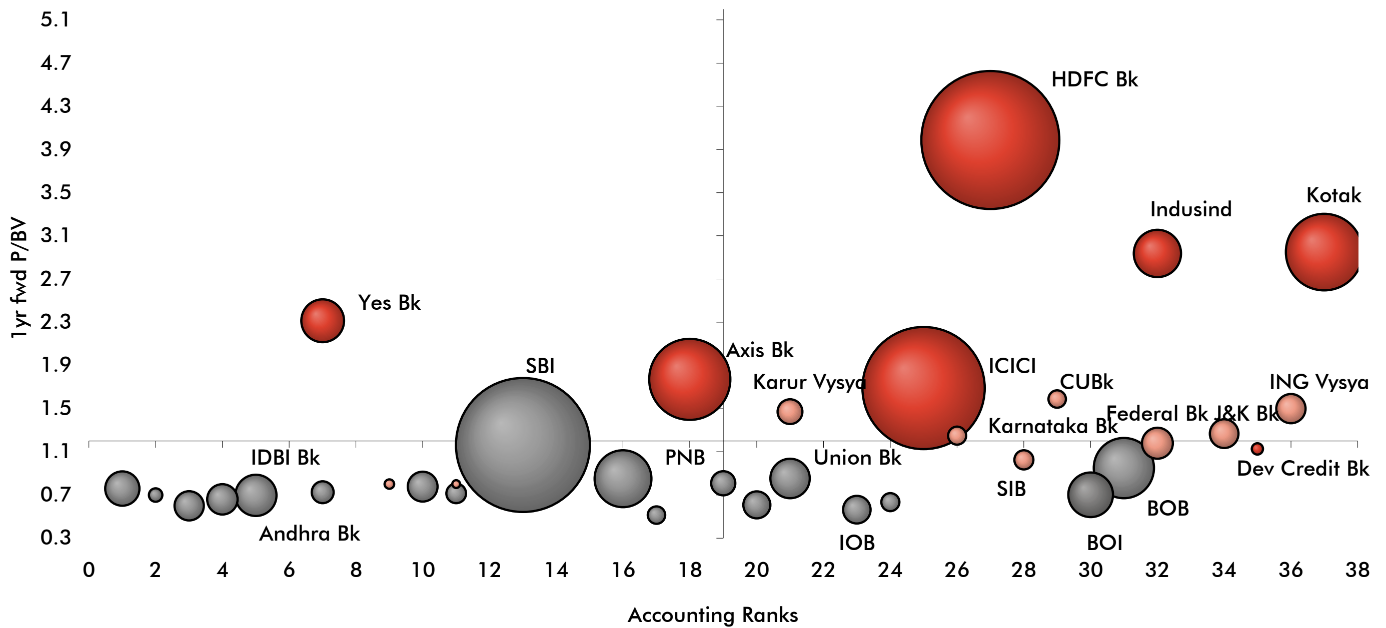
On point (a), please refer to the table on the next page which shows the ranking of Indian banks based on the level of disconnect in their reported numbers. In this table, the banks ranked at the top of the table (i.e. Kotak Mahindra Bank, Federal Bank, Bank of Baroda, etc.) demonstrate relatively lower disconnect in financial

statements. Banks at the bottom of the table (for example, Andhra Bank, State Bank of India, and Punjab National Bank) are at the other end of the risk spectrum. Now, given these varying levels of disconnect, which banks look to be the most interesting? The chart below addresses this point.

According to the chart, amongst the banks whose financial statements are relatively realistic, the following appear to have relatively attractive valuations - **Bank of Baroda** (BOB IN, mkt cap US$5.4bn, BUY), **Federal Bank** (FB IN, mkt cap US$1.4bn, BUY), **ICICI Bank** (ICICIBC IN, mkt cap US$21.8bn, BUY) and **City Union Bank** (CUBK IN, mkt cap US$447mn, BUY).

Our Banks team will shortly publish a detailed forensic accounting on this subject where they will provide more clarity on how investors can use our proprietary forensic tools to wade through the deceptively pristine waters of the Indian banking sector.

Exhibit 73: 1-year forward P/Bs v/s Ambit's forensic accounting scores for Indian Banks



Source: Company, Ambit Capital research. Note: The size of the bubble represents the current market capitalisation; P/B for ICICI Bank, Kotak Mahindra Bank and SBI are on a consolidated level.

Exhibit 74: Consolidated ranks based on three categories of risk metrics

Name	Composite Accounting Rank	P/ABV (x)	Market Cap (Rs bn)	6-yr cross-cycle Net NPA (%)*
Kotak Mah. Bank	37	3.0	469	1.5
ING Vysya Bank	36	1.5	71	0.8
Dev.Credit Bank	35	1.1	11	1.8
J & K Bank	34	1.3	67	0.7
Federal Bank	32	1.2	79	0.4
IndusInd Bank	32	2.9	180	1.2
Bank of Baroda	31	1.0	294	0.4
Bank of India	30	0.7	159	0.9
City Union Bank	29	1.6	25	0.8
South Indian Bank	28	1.0	31	0.6
HDFC Bank	27	4.0	1,526	0.4
Karnataka Bank	26	1.2	27	1.4
ICICI Bank	25	1.7	1,199	1.4
Vijaya Bank	24	0.6	27	1.1
I O B	23	0.6	61	1.3
Karur Vysya Bank	21	1.5	50	0.2
Union Bank (I)	21	0.9	126	0.9
Corporation Bank	20	0.6	59	0.5
UCO Bank	19	0.8	49	1.7
Axis Bank	18	1.8	525	0.4
United Bank (I)	17	0.5	25	1.5
Punjab National Bank	16	0.9	258	0.7
Canara Bank	13	0.8	193	1.1
Central Bank	13	0.9	56	1.5
State Bank of India	13	1.2	1,440	1.7
Bank of Maha	11	0.7	33	1.1
Dhanlaxmi Bank	11	0.8	5	0.9
Syndicate Bank	10	0.8	74	0.9
Lak. Vilas Bank	9	0.8	7	1.9
Dena Bank	7	0.7	39	1.2
Yes Bank	7	2.3	150	0.1
Andhra Bank	5	0.7	59	0.3
IDBI Bank	5	0.7	135	1.2
Indian Bank	4	0.7	75	0.5
Allahabad Bank	3	0.6	70	0.8
Pun. & Sind Bank	2	0.7	16	0.6
Oriental Bank	1	0.8	94	1.0

*Source: Company, Ambit Capital research. Note: *As a percentage of the net loan book*

Exhibit 75 : Stock-specific Investment Implications of Theme 4

Theme 4: The challenge of a compromised banking system					
Company	**Bloomberg Ticker**	**Mcap (US$ mn)**	**ADV (US$ mn)**	**Stance**	**Comments**
Axis Bank	AXSB IN	9,556	52.4	SELL	Axis Bank is India's third-largest private sector bank with a loan book of US$31bn. With a ~30% loan book CAGR since FY09 and with its large exposure to the infrastructure sector (especially power), Axis Bank has seen a definitive upward shift in its risk profile, manifested in an increasing proportion of sub-optimal yielding assets.
Bank of Baroda	BOB IN	5,439	11.2	BUY	Bank of Baroda, with a loan book size of US$53bn, has consistently exhibited loan book growth a few percentage points ahead of the system and has gradually outperformed the larger and older banks to emerge as the third-largest state-owned bank in the system. BoB has benefited from a large overseas book (~1/4th the total portfolio), which is a perfect complement to the bank's domestic lending operations.
City Union Bank	CUBK IN	445	0.5	BUY	City Union Bank is the oldest among the old private sector banks, with a network of 230 branches and a loan book of slightly more than US$2.4bn. CUB is an SME-focused, working-capital-intensive bank with a system-high proportion of secured lending.
Federal Bank	FB IN	1,453	4.4	BUY	Federal Bank is India's fifth-largest private sector bank with a loan book of US$6.6bn. With a comfortable tier-1 ratio (14%) and restructuring of its credit underwriting process, FB is putting in place the building blocks necessary to capitalise on an economic recovery.
ICICI Bank	ICICIBC IN	22,221	66.1	BUY	ICICI Bank is the largest private sector bank in India (by network size) with a loan book of US$50bn. The bank consciously brought down its troublesome unsecured retail book between March 2008 and September 2010 and has since doubled its exposure to corporate loans (up from 12% of the book to 29% of the book), whilst simultaneously altering the mix of retail loans towards secured advances (predominantly housing loans).
State Bank of India	SBIN IN	26,843	121.0	SELL	State-run State Bank of India is India's largest bank with a loan book of US$174bn, accounting for more than 16% market share on either side of the balance sheet. SBI is now saddled with a high proportion of non-performing loans (gross NPLs at 5.2% and net NPLs at 2.4%) that threatens to meaningfully disrupt its financial stability. Tier-I capital, although crawled at ~9% (due to recent equity infusion of $1.6bn and accrued profits of first half), is insufficient to support the imminent balance sheet stress.

Source: Bloomberg, Ambit Capital research

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Explanation of Investment Rating

Investment Rating	Expected return (over 12-month period from date of initial rating)
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Sell	≤5%

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