

May 2, 2012

ASIA INSIGHT

India Strategy

Asia Insight: Road to Wealth Creation – Formula = GARP

1,613 stocks have delivered median 18.4% CAGR in price return over the past decade

This implies a realized equity risk premium of 11% on median returns. The common threads for the best performing stocks of the past ten years were: a) they were small – 85% of the bottom quintile delivered better than market returns; b) they benefited from strong earnings growth through a combination of reasonable return on capital and judicious accumulation of capital; c) they had reasonable valuations.

Today's large-caps may not be tomorrow's winners

Buying today's largest-cap stocks does not assure better returns. Ten of the top 20 stocks by market cap in 2002 no longer feature in the list of top 20 companies. The average return from the top 20 stocks in 2002 is 13% – worse than the market median. Eleven of these 20 stocks underperformed the market.

What should we do today?

The key differentiating factor for forward returns is long-term earnings growth and, hence, our difficulty in nailing the list. That said, on page 11, we highlight stocks that meet any of two (valuations, ROE) of the three criteria needed for superior returns from a list of 449 stocks with market cap exceeding US\$200 million. Prospects for returns appear only slightly inferior to ten years ago.


Stocks that have delivered highest returns since 2002


Stocks with highest returns (CAGR) from 2002 to 2012	
Titan Inds.	58%
Lupin	47%
Exide Inds.	46%
Adani Enterp.	44%
Kotak Mah. Bank	44%
Crompton Greaves	43%
Hind.Zinc	43%
Bosch	43%
CRISIL	42%
Godrej Consumer	41%
Sterlite Inds.	41%
Siemens	41%
Axis Bank	40%
Larsen & Toubro	40%
Marico	38%
Glenmark Pharma.	38%
Alfa Laval (I)	38%
M & M	38%
Blue Dart Exp.	37%
Bata India	36%


Source: Capitaline, Bloomberg, Morgan Stanley Research


MORGAN STANLEY RESEARCH
Asia/Pacific

Morgan Stanley India Company Private Limited+

Ridham Desai 
+91 22 6118 2222

Sheela Rathi 
+91 22 6118 2224

Amruta Pabalkar 
+91 2261182225

Utkarsh Khandelwal 
+91 22 6118 2226

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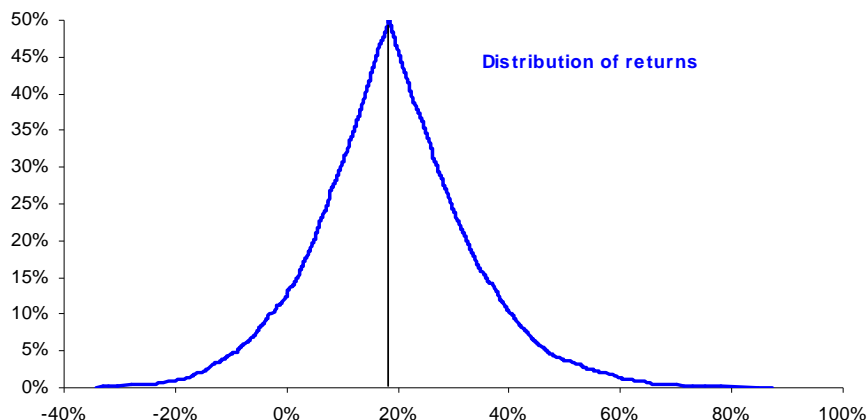
The Road to Wealth Creation: The Formula = GARP (Growth At a Reasonable Price)

- **What we have done:** Our sample of 1,613 stocks includes every stock that was trading in both March 2002 and March 2012. Consequently, companies de-listed during the past decade or that merged with other companies are excluded. Companies that listed during this decade and hence have a less-than-10-year price history are also excluded from our analysis (TCS, Coal India, NTPC, Maruti, Reliance Communications and DLF as examples). We have tested the causality to returns of stock size (i.e., market cap), capital efficiency of the company issuing the stock (i.e., change in ROE over 10 years), capital accumulation (i.e., growth in book equity per share), growth (EPS growth) and starting point of valuations (dividend yield and P/B).
- **How good are equity returns?** The median 10-year return for a sample of 1,613 stocks that were listed and traded in 2002 is 18.4%, while the average price return is 18.7%. This compares with the 10-year bond yield of 7.5% in March 2002, implying a realized equity risk premium of 11% on median returns. The best performing sector was Utilities, followed by Energy, whereas Technology was the worst performing sector (trading at twice the market multiple even as the tech bubble had burst). Real estate was the best sub sector with a CAGR of 31%.
- **Back micro-caps:** Wealth creation is the best in micro-cap stocks. The average return in the first and second deciles of market cap was 23%, superior to the median return of 18%. Nearly 85% of these stocks delivered returns better than the market's.
- **Growth is critical:** Capital efficiency (ROE) and capital accumulation (book equity) fail to explain returns on their own, but the combination – which is nothing but growth – is the most powerful single factor driving stock returns. Hence, the lesson from history is to back companies that are improving return on equity combined with judicious accumulation of capital.
- **Starting point of valuations matters:** Stocks that had a rich valuation at the start of the decade failed to deliver superior returns and vice versa, on average. We also note that middling valuations fail to work for long-term stock-picking, i.e., the value trap is in the middle of the market, or stocks that trade around the market multiple. Deep value, in contrast, is a good winning strategy. Just because a stock is trading at a rich valuation does not preclude it from beating market returns – stocks of such companies sometimes deliver superior growth and strong returns.
- **Today's large-caps may not be tomorrow's winners:** Buying the largest-cap stocks does not assure returns. Ten of the top 20 stocks by market cap in 2002 do not feature in the list of top 20 companies today. The average return from the top 20 stocks in 2002 is 13% – worse than the market median. Eleven of these 20 stocks underperformed the market. See page 9 for the winners of the last decade.
- **What about the coming decade?** Arguably, returns are likely to be a tad lower. Valuations are higher than in 2002 but not rich by any measure. The starting point on ROE is also attractive. The only unknown is the growth in earnings. Various metrics we track suggest that the market is expecting long-term earnings growth to slow from the levels of the trailing decade. The market metrics are implying a return of around 15%, which would also be lower than in the past decade. See page 11 for some stocks that could be on the winners' list for the coming decade.

Sensex Underperforms the Broader Market

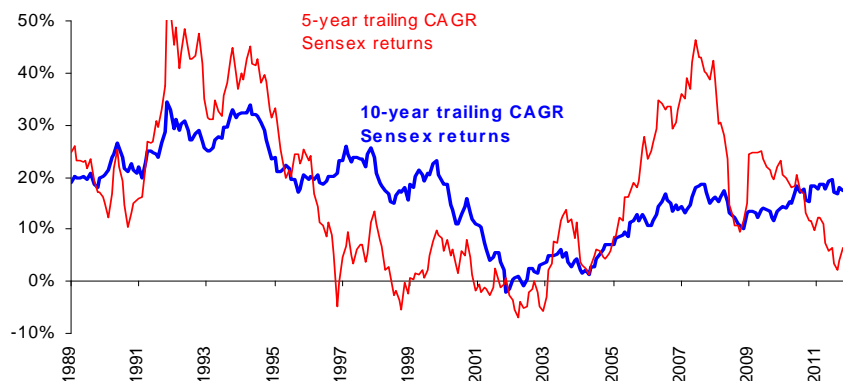
Dispersion of Stock Returns (1,613 stocks)

Skewed to right – bias towards positive returns



Broad Market Beats BSE Sensex

Over the decade, broad market has outperformed Sensex by 54bps annually



Source: Capitaline, Bloomberg, Morgan Stanley Research

Long-term Returns a Tad Better for the Broader Market

- The median 10-year return for a sample of 1,613 stocks that were listed and traded in 2002 is 18.4% while the average return is 18.7%. The return distribution is skewed to the right – a reminder that distribution of returns does not necessarily mirror theoretical assumptions.
- The median return exceeds the 10-year government bond yield or risk-free rate, which was 7.5% in March 2002, by almost 11ppts.
- The Sensex has underperformed the broad market sample by 54bps annually.

What's Worked Over the Past 10 Years

10-yr Annual Returns Across Percentiles for Critical Factors

Valuations, Growth and Size Matter

10-yr Annual Returns Across Percentiles for Critical Factors							
Percentiles	Market Cap in 2002	Div Yield in 2002	2002 ROE	Book Value CAGR	ROE change over 9 years	EPS CAGR	2002 PB
10th	26%	25%	18%	13%	14%	5%	26%
20th	19%	20%	18%	3%	14%	11%	23%
30th	19%	22%	17%	8%	14%	14%	22%
40th	19%	17%	19%	14%	16%	18%	21%
50th	19%	18%	17%	16%	21%	19%	22%
60th	17%	5%	19%	19%	20%	24%	20%
70th	17%	17%	20%	21%	22%	26%	16%
80th	16%	20%	19%	26%	26%	30%	14%
90th	17%	21%	20%	29%	24%	33%	12%
100th	17%	22%	21%	38%	18%	36%	13%

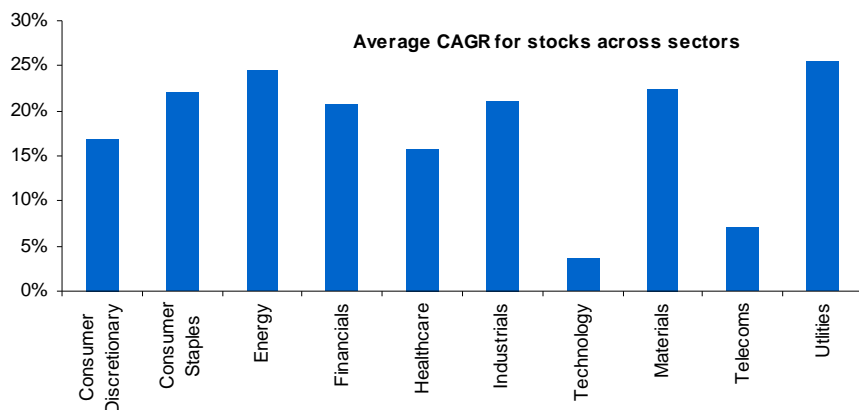
Book Value and EPS Growth Remain Key for Returns

- Capital efficiency (ROE) and capital accumulation (book equity) fail to explain returns on their own, but the combination – which is nothing but growth – is the most powerful single factor driving stock returns. Hence, the lesson from history is to back companies that are improving return on equity and judiciously accumulating capital.
- As expected, growth alone is not enough. Valuations matter. Stocks that had a rich valuation at the start of the decade failed to deliver superior returns and vice versa, on average.

Back Micro-caps for Outsized Returns

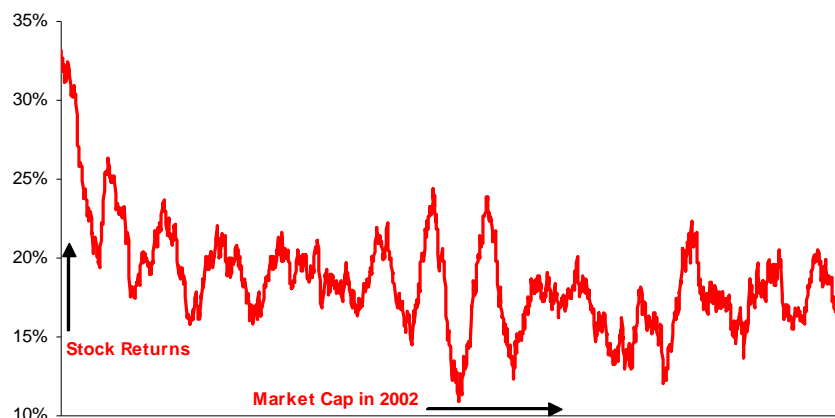
Dispersion of Sector Returns, 2002 to 2012

Utilities lead, Tech trails



10-year Annual Returns Along the Cap Curve

Returns drop off as capitalization grows



Source: Capitaline, Morgan Stanley Research

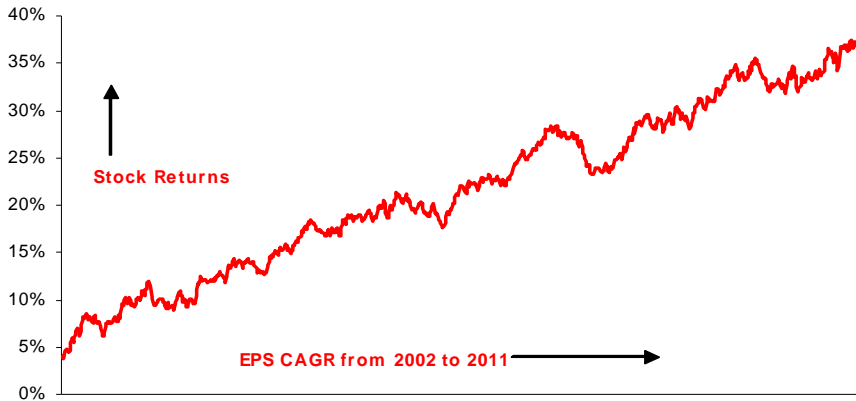
Small Is Big

- Wealth creation is the best in micro-cap stocks. The average return in the first and second deciles of market cap was 23%, superior to median return of 18%.
- Surprisingly, Utilities was the best performing sector in the trailing decade and Technology the worst. Nothing underpins the point better than this evidence that the starting point of valuations is crucial to long-term returns. The average EPS growth for Tech stocks was 12% compared with an average return of 4%. Tech stocks started this period at twice the market valuation.
- Despite the post 2008 carnage, Real Estate still ends up as the best sub sector with a 31% CAGR.

Growth is a Key Driver to Returns

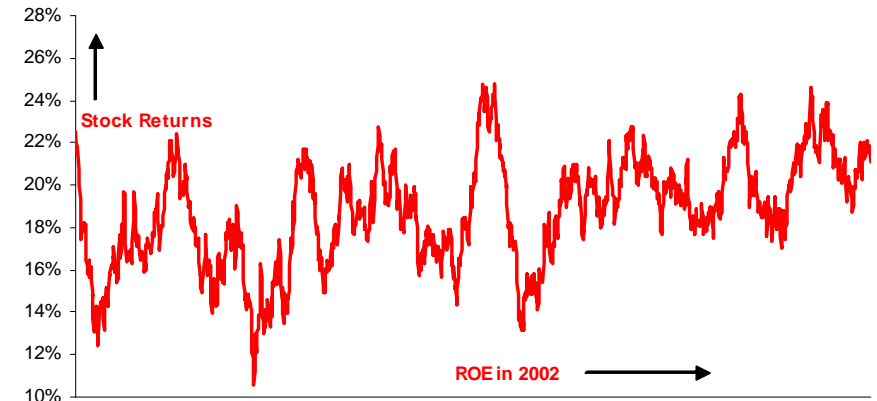
10-year Annual Returns Along the EPS Growth Curve

Growth is crucial to returns



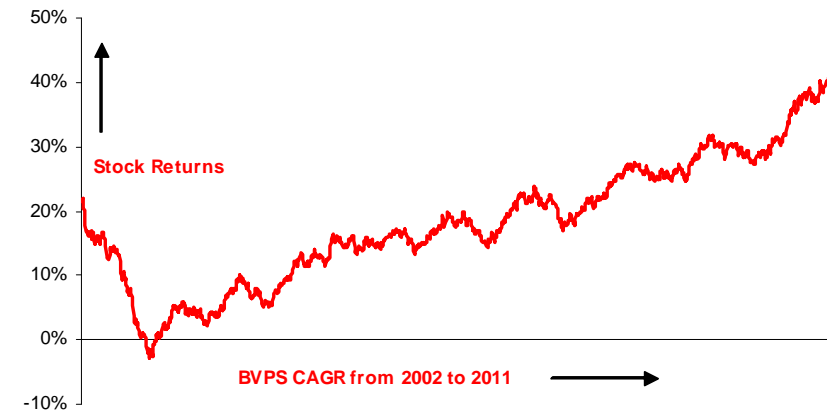
10-year Annual Returns vs. ROE in 2002

ROE is not as important



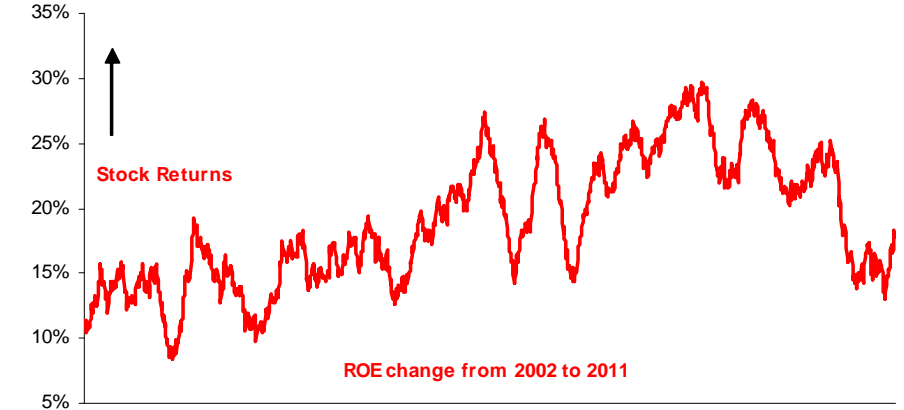
10-yr Annual Returns vs. Book Value Growth Curve

Accumulating capital is necessary but not sufficient to returns



10-yr Annual Returns Along the ROE Change Curve

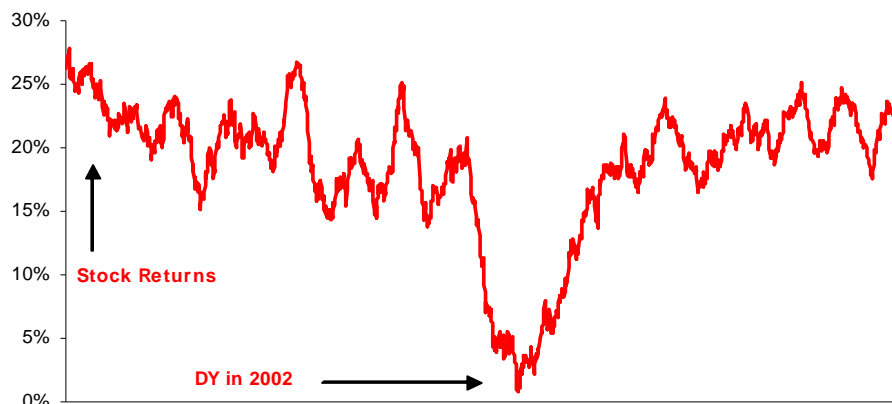
Positive change in ROE may be more important



Starting Point of Valuations Matters

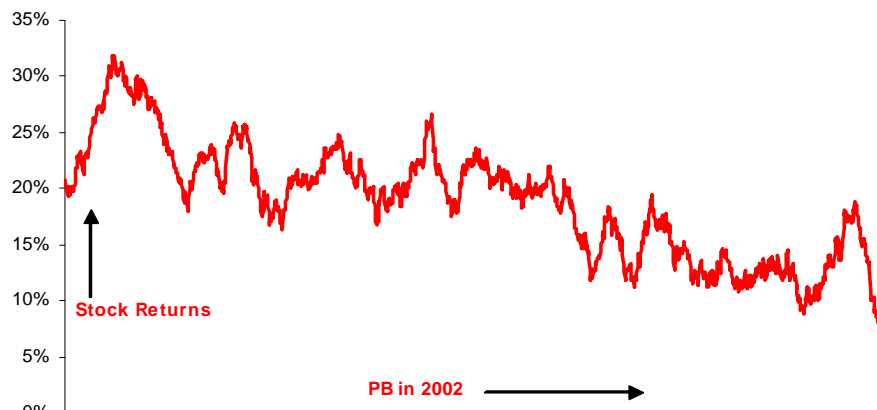
10-year Annual Returns vs. Dividend Yield in 2002

High Dividend Yield and Growth Stocks delivered highest returns



10-year Annual Returns vs. PB in 2002

Low valuations are significant drivers of stock returns and vice versa



Source: Capitaline, Morgan Stanley Research

Middling Valuations Are Bad

- Middling valuations fail to work for long-term stock-picking, i.e., the value trap is in the middle of the market, or stocks that trade around the market multiple.
- Deep value, in contrast, is a good winning strategy.
- Just because a stock is trading at a rich valuation does not preclude it from beating market returns – stocks of such companies sometimes deliver superior growth and strong returns.

Today's Large-caps May Not Be Tomorrow's Winners

10-year Annual Returns of the Top Stocks by Market Cap in 2002 and in 2012

Top 20 stocks by Market Cap in 2002	Compounded Annual Stock Returns from 2002 to 2012	Top 20 stocks by Market Cap in 2012	Compounded Annual Stock Returns from 2002 to 2012
Bharti Airtel	33%	Larsen & Toubro	40%
HDFC Bank	27%	Bharti Airtel	33%
St Bk of India	26%	B H E L	31%
ITC	26%	Tata Motors	28%
H D F C	26%	HDFC Bank	27%
Reliance Inds.	20%	St Bk of India	26%
Infosys	20%	ITC	26%
Hero Motocorp	19%	H D F C	26%
O N G C	19%	ICICI Bank	21%
HCL Technologies	14%	Reliance Inds.	20%
I O C L	14%	Infosys	20%
Dr Reddy's Labs	12%	O N G C	19%
Wipro	10%	Wipro	10%
B P C L	7%	Hind. Unilever	6%
Hind. Unilever	6%	TCS	NL
Ranbaxy Labs.	6%	NTPC	NL
Zee Entertainmen	4%	NMDC	NL
H P C L	0%	MMTC	NL
Satyam Computer	-5%	Coal India	NL
M T N L	-15%	Cairn India	NL

Large-caps Underperform

- Buying the largest-cap stocks does not assure returns. Ten of the top 20 stocks by market cap in 2002 no longer feature in the list of top 20 companies (see those marked in red in the adjoining table).
- The average return from the top 20 stocks in 2002 is 13% – worse than the market median. Eleven of these 20 stocks underperformed the market.

And the Winner Is ...

The Best and Worst Stocks of the Past Decade

Out of 1,613 listed in 2002 and 2012

Top 20 performers (Compounded Annual Returns) from 2002 to 2012		Bottom 20 performers (Compounded Annual Returns) from 2002 to 2012	
United Phosp.	87%	Baffin Engg.	-34%
Kitex Garments	85%	Maars Soft.Intl.	-33%
Ashiana Housing	78%	Padmalaya Tele.	-32%
India Securities	75%	Pentamedia Graph	-31%
Himadri Chemical	73%	PVP Ventures	-30%
TTK Prestige	71%	Hind.Bio Science	-28%
Jindal Steel	70%	Brijlaxmi Leas.	-27%
NESCO	70%	Morepen Labs.	-24%
Sunteck Realty	70%	Quintegra Soln.	-23%
Kw ality Dairy	66%	Mega Corp.	-23%
Sesa Goa	65%	Cybermate Info.	-23%
Phoenix Mills	65%	Odyssey Tech.	-22%
Kemrock Inds.	65%	Quadrant Tele.	-21%
P I Inds.	64%	Ambica Agarbat.	-20%
Balkrishna Inds	63%	Venus Universal	-20%
Guj Fluorochem	63%	Moschip Semicon.	-20%
Bhushan Steel	62%	Oxford Inds	-20%
Lloyds Metals	62%	Sh. Rama Multi.	-19%
Poddar Developer	62%	GSL Nova Petro.	-19%
Radhe Develop.	61%	Intense Tech.	-18%

The Best and Worst Stocks of the Past Decade

Out of top 200 stocks by market cap in 2002

Top 20 performers (Compounded Annual Returns) from 2002 to 2012		Bottom 20 performers (Compounded Annual Returns) from 2002 to 2012	
Titan Inds.	58%	Baffin Engg.	-34%
Lupin	47%	Pentamedia Graph	-31%
Exide Inds.	46%	PVP Ventures	-30%
Adani Enterp.	44%	Morepen Labs.	-24%
Kotak Mah. Bank	44%	MPS	-17%
Crompton Greaves	43%	Aftek	-16%
Hind.Zinc	43%	H F C L	-16%
Bosch	43%	MTNL	-15%
CRISIL	42%	Moser Baer (I)	-15%
Godrej Consumer	41%	Gufic BioScience	-14%
Sterlite Inds.	41%	Sahara One Media	-7%
Siemens	41%	Essel Propack	-7%
Axis Bank	40%	Mastek	-7%
Larsen & Toubro	40%	Balaji Telefilms	-6%
Marico	38%	Uniphos Enterp.	-6%
Glenmark Pharma.	38%	Welspun India	-5%
Alfa Laval (I)	38%	Smartlink Netw r.	-5%
M & M	38%	Satyam Computer	-5%
Blue Dart Exp.	37%	Sterling Biotech	-4%
Bata India	36%	MIRC Electronics	-3%

What Are the Prospects for the Next Decade?

Market Statistics in 2002 and Now

Median							
Median	Market Cap (US \$ mn)	PB	ROE	EPS CAGR	Book Value CAGR	ROE Delta	Annual Return
Then	1.4	0.38	5.1%	16.8%	8.1%	0.4%	18.4%
Now	8.1	0.79	11.0%	-	-	-	-

Returns could be a tad lower for the next decade

- The starting points look okay. Valuations are higher than in 2002 but not rich by any measure (median P/B is around 0.8 times). The starting point on ROE is also attractive. The only unknown is the growth in earnings. However, various metrics we track suggest that the market is expecting long-term earnings growth to slow from the levels of the trailing decade. The market metrics are implying a return of around 15%, which would also be lower than in the trailing decade.

Tomorrow's Winners Could Come from Some of These Names

Broad Market 12M Trailing Valuations and ROE

The market cap cut-off for this list is US\$200 million (from a total of 449 stocks)

Stocks	12M Trailing PB (Bottom Quintile)	Stocks	12M Trailing Dividend Yield (Top Quintile)	Stocks	12M Trailing ROE (Top Quintile)
MTNL	0.3	Clariant Chemical	8.9%	Colgate-Palm.	113.6%
Indbull.RealEst.	0.3	C P C L	7.7%	Hero Motocorp	77.0%
H D I L	0.4	Guj Gas Company	6.9%	Castrol India	70.7%
S C I	0.4	SRF	5.9%	eClerx Services	70.3%
Dalmia Bhar.Ent.	0.4	Hero Motocorp	5.3%	Nestle India	69.9%
SREI Infra. Fin.	0.4	UCO Bank	5.3%	Page Industries	69.3%
Rel. Comm.	0.4	H P C L	5.0%	Hind. Unilever	67.9%
Anant Raj Inds.	0.5	Indiabulls Financials	4.8%	Satyam Computer	58.9%
IVRCL Assets	0.5	Corporation Bank	4.8%	TTK Prestige	58.2%
Amtek Auto	0.5	India Infoline	4.6%	Tata Motors	54.1%
NCC	0.5	Guj NRE Coke	4.6%	Bajaj Auto	53.9%
Jai Corp	0.6	Andhra Bank	4.5%	VST Inds.	50.9%
Alok Inds.	0.6	Bajaj Holdings	4.3%	Bata India	47.6%
G N F C	0.6	SJVN	4.1%	Havells India	46.1%
Vardhman Textile	0.6	I O B	4.1%	CRISIL	45.5%
JM Financial	0.6	Oriental Bank	4.1%	Coal India	44.9%
Pun. & Sind Bank	0.6	Gateway Distr.	4.0%	Dabur India	44.7%
GE Shipping Co	0.6	Vijaya Bank	3.9%	Zydus Wellness	44.4%
Ballarpur Inds.	0.6	Graphite India	3.9%	Asian Paints	41.8%
Electrosteel St.	0.6	G N F C	3.9%	TCS	41.5%
Videocon Inds.	0.6	JM Financial	3.9%	Titan Inds.	40.2%
C P C L	0.6	I O C L	3.9%	NMDC	40.1%
D B Realty	0.6	Rolta India	3.8%	WABCO India	38.5%
Reliance Infra.	0.6	Blue Star	3.7%	Petronet LNG	38.0%
Unitech	0.6	Guj Inds. Pow er	3.7%	Whirlpool India	37.7%
Punj Lloyd	0.6	St Bk of Bikaner	3.6%	V I P Inds.	37.7%
Rain Commodities	0.6	Jagran Prakashan	3.5%	Jubilant Food.	37.6%
Piramal Health	0.7	Deepak Fert.	3.5%	Glodyne Techno.	37.0%
Suzlon Energy	0.7	Ashok Leyland	3.5%	Supreme Inds.	36.7%
Bajaj Hindusthan	0.7	Rural Elec.Corp.	3.4%	Emami	35.8%
Jindal Stain.	0.7	Union Bank (I)	3.3%	Sw an Energy	35.6%
IVRCL	0.7	GE Shipping Co	3.3%	Dr Reddy's Labs	35.2%
H P C L	0.7	O N G C	3.3%	Opto Circuits	34.5%
Karnataka Bank	0.7	Hexaw are Tech.	3.3%	Coromandel Inter	34.1%
Oriental Bank	0.7	IDBI Bank	3.3%	Astrazeneca Phar	34.0%
United Bank (I)	0.7	Indian Bank	3.3%	Engineers India	33.8%
GVK Pow er Infra.	0.8	Oil India	3.2%	Tech Mahindra	33.7%
Guj Inds. Pow er	0.8	Karnataka Bank	3.2%	GRUH Finance	33.4%
I O B	0.8	Sh.Renuka Sugar	3.2%	Britannia Inds.	32.9%
IFCI	0.8	S B T	3.2%	BGR Energy Sys.	32.7%

A Bit More about Listed Entities, Then and Now

Total Listed Companies in 2002 and Today

Broad-based growth in market capitalization

Market Cap		# Companies	
		2002	2012
Mega Caps	More than US\$5bn	5	49
Large Caps	Betw een US\$ 2bn and US\$ 5bn	6	54
Mid Caps	Betw een US\$ 250mn and US\$ 2bn	50	306
Small Caps	Betw een US\$ 50mn and US\$ 250mn	124	438
Micro Caps	Betw een US\$ 25mn and US\$ 50mn	101	267
Nano Caps	Less than US\$ 25mn	1837	2141
Total		2123	3255

Total Listed Companies in 2002 and Today

Sectorwise Breakup

Sector	# Companies	
	2002	2012
Consumer Discretionary	505	754
Consumer Staples	157	220
Energy	22	35
Financials	271	514
Healthcare	130	172
Industrials	309	534
Materials	492	718
Technology	206	249
Telecoms	22	32
Utilities	9	27
Total	2123	3255

Prices of Stocks Mentioned in This Report

Ticker	Stock	Price Apr 27, 2012	Ticker	Stock	Price Apr 27, 2012	Ticker	Stock	Price Apr 27, 2012	Ticker	Stock	Price Apr 27, 2012
ADE IN	Adani Enterp	275	HMVN IN	Emarni	449	JDSL IN	Jindal Stain.	78	RCOL IN	Rain Commodities	39
AFTK IN	Aftek	10	ENGR IN	Engineers India	251	JSP IN	Jindal Steel	482	RBXY IN	Ranbaxy Labs.	500
ALFA IN	Alfa Laval (I)	Delisted	ESEL IN	Essel Propack	34	JM IN	JM Financial	14	RCOM IN	Rel. Comm.	74
ALOK IN	Alok Inds.	19	EXID IN	Exide Inds.	126	JUBI IN	Jubilant Food.	1181	RIL IN	Reliance Inds.	742
AMBA IN	Ambica Agarbat.	5	GNFC IN	G N F C	82	KBL IN	Karnataka Bank	89	RELI IN	Reliance Infra.	512
AMTK IN	Amtek Auto	126	GDPL IN	Gateway Distr.	150	KRI IN	Kemrock Inds.	508	RLTA IN	Rohta India	87
ARCP IN	Anant Raj Inds	57	GESCO IN	GE Shipping Co	256	KTG IN	Kitex Garments	52	RECL IN	Rural Elec.Corp.	206
ANDB IN	Andhra Bank	113	GNP IN	Glenmark Pharma.	329	KMB IN	Kotak Mah. Bank	582	SBTR IN	S B T	541
ASFI IN	Ashiana Housing	174	GLOT IN	Glodyne Techno.	376	KLD IN	Kw ality Dairy	35	SCI IN	S C I	59
AL IN	Ashok Leyland	31	GCPL IN	Godrej Consumer	527	LT IN	Larsen & Toubro	1221	SHRA IN	Sahara One Media	135
APNT IN	Asian Paints	3516	GRIL IN	Graphite India	91	LYDM IN	Lloyds Metals	23	SCS IN	Satyam Computer	75
ASTR IN	Astrazeneca Phar	2047	GRHF IN	GRUH Pharma	684	LPC IN	Lupin	539	SESA IN	Sesa Goa	184
AXSB IN	Axis Bank	1103	GSLN IN	GSL Nova Petro.	2	MM IN	M & M	713	SRMT IN	Sh. Rama Multi.	3
BHEL IN	B H E L	228	CF IN	Gufic BioScience	7	MTNL IN	M T N L	25	SHRS IN	Sh.Renuka Sugar	31
BPCL IN	B P C L	662	GFCL IN	Guj Fluorochem	454	MRSSI IN	Maars Soft.Intl.	0	SIEM IN	Siemens	790
BEP IN	Baffin Engg.	Suspended	GGAS IN	Guj Gas	323	MRCO IN	Marico	178	SJVN IN	SJVN	19
BJAUT IN	Bajaj Auto	1583	GIP IN	Guj Inds. Pow er	68	MAST IN	Mastek	97	SMNS IN	Smartlink Netw r.	49
BJH IN	Bajaj Hindusthan	29	GNC IN	Guj NRE Coke	20	ASMI IN	Mega Corp.	0	SREI IN	SREI Infra. Fin.	25
BJHI IN	Bajaj Holdings	839	GVKP IN	GVK Pow er Infra.	15	MIRC IN	MIRC Electronics	14	SRF IN	SRF	235
BLJT IN	Balaji Telefilms	44	HDFC IN	H D F C	675	MMTC IN	MMTC	676	SBBJ IN	St Bk of Bikaner	385
BIL IN	Balkrishna Inds	293	HDIL IN	H D I L	79	MORE IN	Morepen Labs.	3	SBIN IN	St Bk of India	2126
BILT IN	Ballarpur Inds.	24	HMFC IN	H F C L	11	MCST IN	Moschip Semicon.	4	SLT IN	Sterling Biotech	10
BATA IN	Bata India	858	HPCL IN	H P C L	296	MBI IN	Moser Baer (I)	14	STLT IN	Sterlite Inds.	104
BGRL IN	BGR Energy Sys.	329	HAVL IN	Havells India	554	MPS IN	MPS	42	SRIN IN	Sunteck Realty	379
BHARTI IN	Bharti Airtel	308	HCLT IN	HCL Technologies	511	NJCC IN	NCC	50	SI IN	Supreme Inds.	208
BHUS IN	Bhushan Steel	420	HDFCB IN	HDFC Bank	541	NSE IN	NESCO	646	SUEL IN	Suzlon Energy	21
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Total	2,926		1088		

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The Americas

1585 Broadway
New York, NY 10036-8293
United States
+1 212 761 4000

Europe

20 Bank Street, Canary Wharf
London E14 4AD
United Kingdom
+44 (0)20 7425 8000

Japan

4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
+81 (0) 3 5424 5000

Asia/Pacific

1 Austin Road West
Kowloon
Hong Kong
+852 2848 5200