

February 20, 2014

India Equity Strategy

Will FIIs Give Up on Indian Equities?

FIIs are bullish on Indian equities. Since the end of 2008, they have bought US\$91 billion of Indian equities, including US\$45 billion in 2012 and 2013. India's rising relative multiple vs. its relative growth to emerging markets indicates that foreign investors believe that India's growth is likely to pick up, and, hence, stocks are being re-rated. We hear the same bullish undertone from investors in our conversations. However, portfolio returns are shrinking and the life IRR (IRR on portfolio flows since inception using annual flow numbers) is approaching its 2002 low. We estimate that FIIs, on the aggregate, have extracted an IRR of 9.1% (10.3% including dividends) from Indian equities. This compares with the peak of 31% they were earning at the end of 2007. Indeed, the incremental IRR has been negative since the end of 2009. Unless, the IRR picks up measurably in the coming months, the long-term money parked in Indian equities could become impatient.

FII portfolios have outperformed the MSCI India index and SPX by 220bp and 190bp, respectively, over 21 years. We think the outperformance over SPX should have been higher to justify diversification, i.e., the realized risk premium is low. For the life IRR to rise to say 15%, which would make Indian equities look worth the effort, the value of FII portfolios would need to rise by a notable 80% in a year from now. If the hurdle rate is reduced to 12%, Indian equities would still need to rise 39% from current levels with no further investments by FIIs over the course of 2014.

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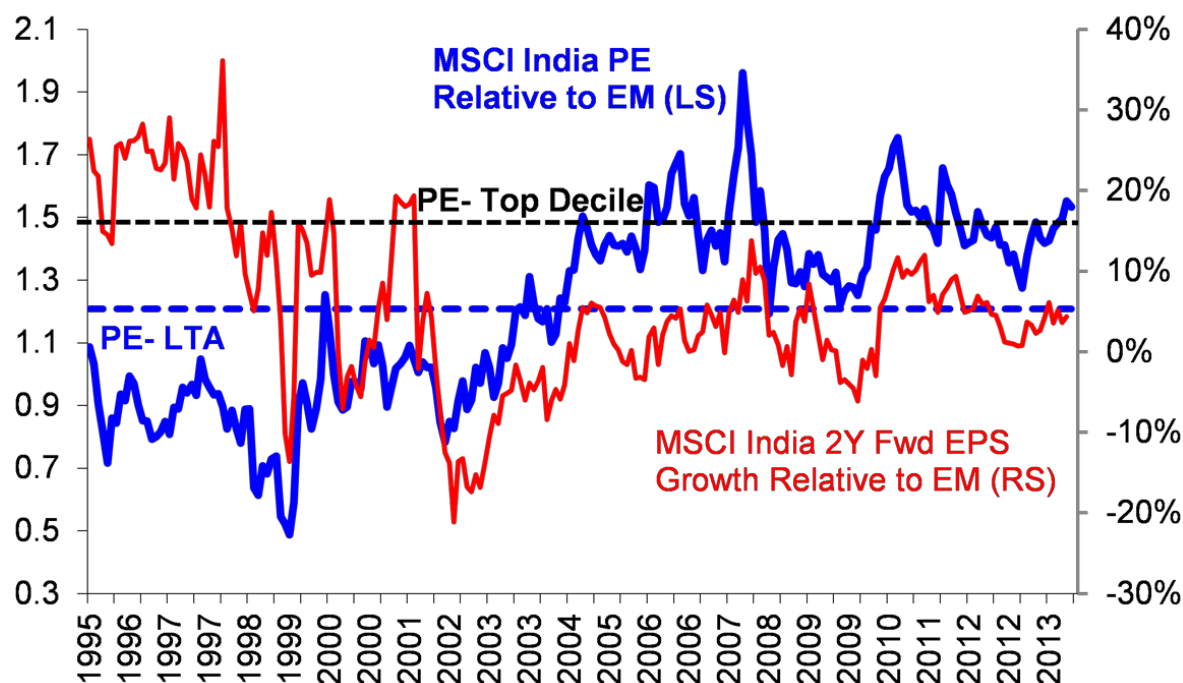
Returns Need to Rise for Investments To Be Justified

Exhibit 1 shows that India's relative P/E is rising relative to its relative growth outlook when compared to emerging markets. To us, this is an indication that foreign investors are bidding up share prices in anticipation of better growth in the coming months, underscoring their bullish view on India's macro. This is corroborated by portfolio positions that are skewed toward domestic cyclicals, strong portfolio flows, India's rising relative performance to emerging markets and anecdotal evidence in the form of conversations.

Exhibit 2 shows the time series of the value of FII portfolios versus the cumulative investments made by them. The cumulative flows have been US\$146 billion, whereas the value of investments as of the end of December 2013 was US\$252 billion, implying an absolute gain of 73% over 21 years of investing.

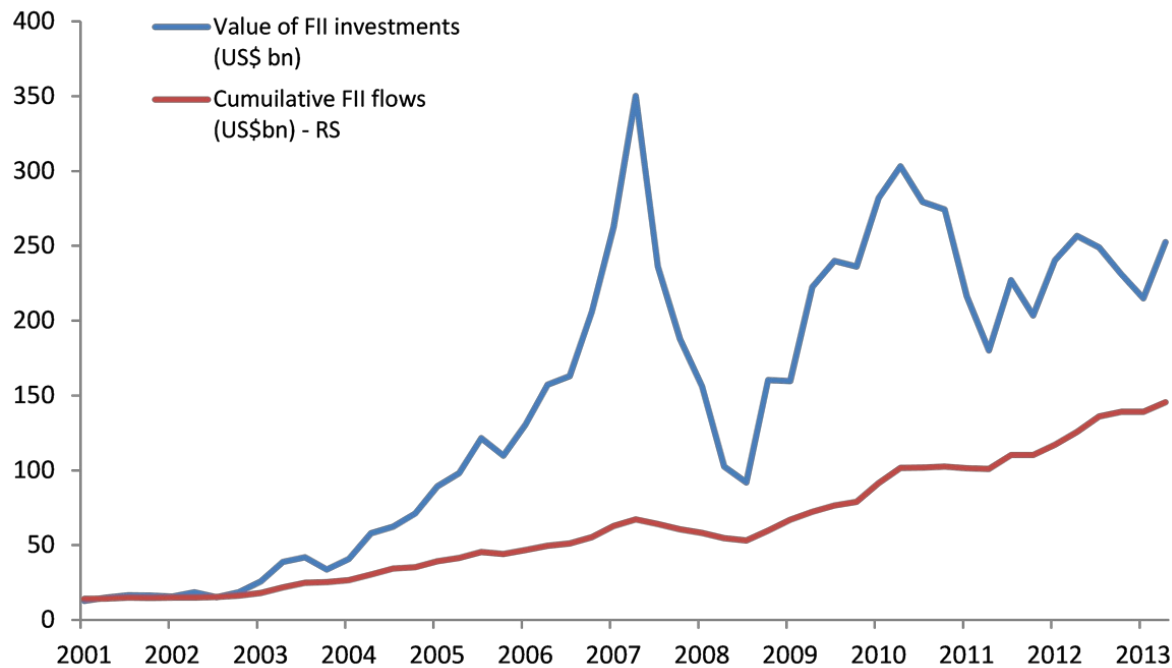
Exhibit 3 shows the progression of IRR of these investments. The IRR was in single digits at the start of the last decade when Indian equities were perched in a prolonged bear market. It swung into the 30s by the end of the bull market in 2008, and has now returned to single digits. No doubt, FII portfolios have outperformed the dollar return from Indian stocks represented by the MSCI India index (**Exhibit 4**), but the relative return to the SPX appears to be mediocre in the context of the risks.

Exhibit 1: Relative P/E Leading Relative Earnings Growth - FIIs Bullish on Earnings Growth



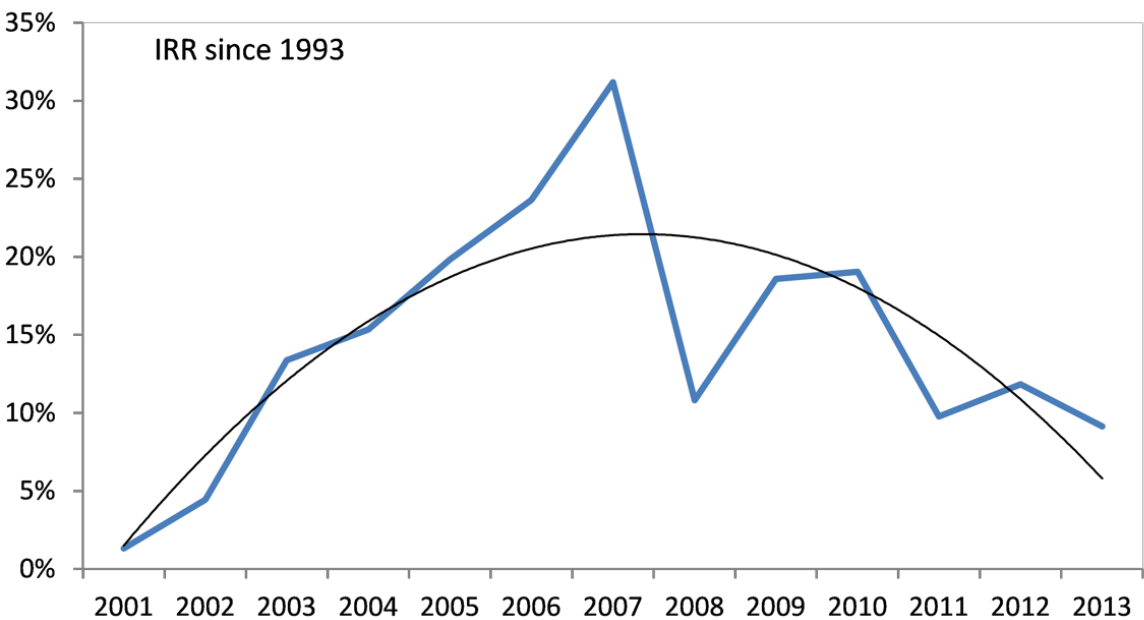
Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 2: Value of FII Investments Exceed Cost by 73%



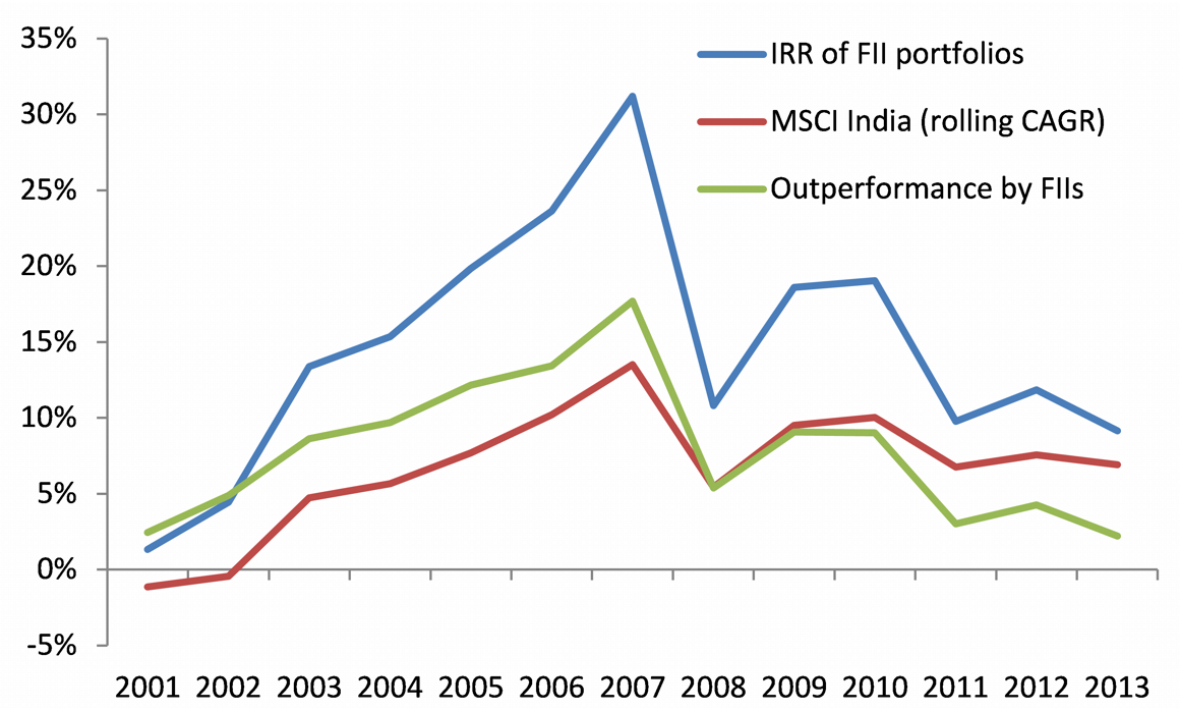
Source: SEBI, Capitaline, Morgan Stanley Research

Exhibit 3: FII Portfolio Life IRR Falls to Decade Lows to Single Digit



Source: SEBI, Capitaline, Morgan Stanley Research

Exhibit 4: FIIs Outperform the Index but Outperformance at Historical Low



Source: SEBI, Capitaline, Morgan Stanley Research

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(as of January 31, 2014)

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STOCK RATING CATEGORY	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)		
	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY
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Equal-weight/Hold	1315	44%	392	48%	30%
Not-Rated/Hold	101	3%	26	3%	26%
Underweight/Sell	543	18%	96	12%	18%
TOTAL	2,973		825		

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