



Investing in India

GSAM Fundamental Equity Team

Investors have a lot of questions right now when considering Indian equities. How might Indian equities fare in a global economic downturn? Is the Indian equity market attractively valued? We believe an allocation to Indian equities offers the opportunity to capture India's once-in-an-era economic growth through highly profitable companies serving a strong domestic market. Furthermore, in the near term, we believe India's economy may prove relatively more resilient in a global economic downturn. With the Indian equity market now significantly off its highs – roughly 17.2% in INR and 24.4% in USD year-to-date through September 30¹ – we believe this presents an attractive entry point for investors. Below we offer a few of our current thoughts for investors considering Indian equities.

Once-in-an-era economic growth; many highly profitable companies

India is one of the fastest growing economies in the world, driven by rapidly rising incomes and consumption and significant spending on transformational infrastructure. Indian equities have typically traded at higher price-to-earnings (P/E) multiples because of this strong economic growth as well as the high profitability, as measured by returns on equity (ROE), earned by Indian companies. Between 1995 and 2009, the average ROE of Indian companies was 17.4% compared with an average of 11.6% for all emerging market companies and 10.8% for those in developed markets². We believe one of the reasons for the consistently high ROEs of Indian companies is that a large proportion are owned by family entrepreneurs who make decisions and allocate resources to maximise returns on invested capital. In addition, the Indian equity market has a larger than average representation of companies which require little capital expenditure but can offer high growth potential, such as information technology services.

India could prove resilient in a global economic downturn

While a slowdown in global growth may dampen investor sentiment generally, we believe Indian equities could prove resilient in such an environment for three main reasons:

1. Domestically-oriented growth

India's economic growth comes primarily from domestic consumption and investment to modernise infrastructure, with merchandise exports accounting for less than 14% of India's GDP³, significantly less than most of its Asian peers. As a result, the Indian economy is relatively more insulated from the global turmoil. This helped India maintain a robust 6.8% growth rate even during the 2008-2009 global financial crisis.

¹ Source: Bloomberg.

² Source: Worldscope, FactSet, Morgan Stanley Research. Data provided for each calendar year from 1995 to 2009.

³ Goldman Sachs Global Investment Research.

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2. Twin benefits from falling commodity prices

As a net importer of commodities, including significant volumes of oil, India's economy benefits more than many others from falling prices. In addition, commodity-oriented companies, which tend to trade in the same direction as commodity prices, comprise a relatively small proportion of India's equity market.

3. Inflation and interest rate stabilisation or reduction

The sharp increase in commodity prices late last year, particularly oil, was a key driver of inflation and rising interest rates, which have, in turn, weighed on equity markets for most of this year. However, the current weakening global economic outlook has reduced pressure on commodity prices and should continue to ease inflationary pressure over the next few months. As a result, we believe the Reserve Bank of India (RBI) is unlikely to raise interest rates further and may instead look to cut them as inflation moderates, boosting investment spending and Indian corporate earnings.

We believe Indian equities are attractively valued

As previously discussed, the Indian equity market has a greater proportion of higher ROE, and therefore higher P/E, companies. At the same time, India has relatively fewer commodity and cyclical companies, which typically trade at significantly lower P/E multiples in all markets. With the Indian equity market currently trading on 12.3X earnings on a 12 month forward basis – a 21% discount to its long-term average of 15.6X⁴ – we believe valuations already reflect many of the concerns in the marketplace, such as rising inflation, monetary tightening and slowing economic growth. We believe current valuation levels present an excellent opportunity for investors with a long-term time horizon to enter the asset class.

Risks to our view

Whilst we are enthusiastic about the potential for Indian equities, we acknowledge that there are always some risks to our view. Going forward, a severe global economic slowdown is likely to impact all economies to some degree and weigh on equity markets. Although we would expect India to be relatively more resilient in such an environment, its stock market may still decline in absolute terms. In addition, whilst we believe commodity prices are more likely to decline rather than rise from current levels, if they were to rally sharply once again, this would have a negative impact on the Indian economy and stock market. If inflation persists or rises from current levels – either through commodity price increases or strength in the domestic economy – the RBI may have to raise interest rates, which is also likely to be viewed negatively by the market. Finally, any further corruption scandals involving Indian companies is likely to hurt investor confidence and slow the pace of policy reforms.

How GSAM invests in Indian equities

GSAM's six person Mumbai-based team focuses exclusively on Indian equities and uses a fundamental, bottom-up investment process that aims to generate a majority of excess returns via stock selection. Our team-based approach is designed to leverage the insights of its experienced sector specialists while our local, on-the-ground presence gives us timely access to relevant information and proximity to company management. Our team typically conducts more than 1000 meetings with company management teams over any 12 month period. This intensive bottom-up process enhances the potential to generate excess returns by exploring mid- and small-cap companies that are not widely followed, in addition to companies that are not included in the benchmark. During the second quarter, nearly 50% of the GS India Equity Portfolio was invested in mid- and small-cap stocks, versus a benchmark weighting of 20%⁵, offering investors greater exposure to local Indian companies which we believe will continue

⁴ Source: Reuters, Citigroup, RBI as of September 30, 2011.

⁵ Benchmark: MSCI India IMI.

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to be less correlated to the global economy over the longer term. We believe that GSAM's local presence will continue to provide an important competitive advantage as we monitor the changing global macroeconomic conditions and their effects on India's economy, companies and equity market.

In conclusion, we remain excited about the potential of Indian equities because:

- India is experiencing once-in-an-era growth from rising incomes and consumption and transformational infrastructure spending.
- India's economy and equity market could relatively outperform in a global economic downturn because: 1) much of India's growth is domestically-oriented, 2) falling commodity prices would help India's economy more than most others while having less of an adverse effect on the equity market due to a smaller proportion of commodity companies, and 3) inflation and interest rates should stabilise and possibly ease.
- Following the recent correction of the Indian market, we believe current valuations offer investors the opportunity to invest in Indian equities at very attractive prices.

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