India Revisited

Executive summary

1. Superior and sustainable growth underpin our long-term outlook for India.

   - India’s powerful demographic advantage drives a superior growth profile. The combined forces of an increasing working-age population, a growing middle class and rising urbanization are driving rapidly increasing demand for consumer goods and infrastructure upgrades.

   - India’s healthy financial system and domestically driven economy will support sustainable economic growth potential. Low levels of private and corporate leverage, conservative regulation and banking practices and a domestically driven economy insulated India from some of the worst effects of the recent global economic downturn.

   - May 2009 election results established a stable coalition government that can provide effective governance and accelerate infrastructure modernization.

2. Valuations are attractive given the superior growth outlook and high returns on equity.

   - We believe current valuations are attractive relative to historical averages and to many other equity markets, particularly in light of India’s favorable economic, structural and corporate environment.

   - Indian companies have amongst the highest returns on equity in the world, despite similar or lower levels of leverage than regional peers.

   - India’s liquid and diversified equity market offers a wealth of investment opportunities to investors.
I. Superior and sustainable growth outlook support long-term investment

The economic reforms of the 1990s jump-started the Indian economy with GDP growth rates accelerating to high single digits\(^1\). India’s real GDP has grown over 7% annualized during the past decade\(^1\) and continued at 6.6% in 2009\(^2\), during the recent global economic downturn. Over the coming decades, India’s real GDP is estimated to grow by around 7-9% annually\(^3\), a pace that could make it the third largest economy in the world by 2030, behind only China and the US. By 2050, the Indian economy is projected to be similar in size to that of the US (Exhibit 1).

**Exhibit 1: Largest economies in 2010 and 2050**

India is in the midst of a demographic shift that is expected to drive much of this growth. We see the country’s population is changing in three main ways: the proportion of working age people is growing significantly, people are moving to cities, and they are getting wealthier.

**More workers, better skills, higher productivity**

India’s working-age population (people aged between 15 and 60 years) appears to be on track to grow as a proportion of its total population over the coming decades and peak significantly later than in other countries (Exhibit 2 – below left). India is likely to be in the demographic “sweet spot” countries pass through as fertility rates begin to decline. Generally this rising percentage of working age people has fewer older and younger dependents and therefore more disposable income. By 2030, the global labor force is expected to grow by 300 million, with India projected to enjoy a vastly disproportionate two thirds of this growth, while major developed markets are expected to range from very modest increases to decreases (Exhibit 2 – below right).

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\(^1\) Source: UBS Research as of Feb-10.

\(^2\) Source: Goldman Sachs Research, as of Feb-10. GSAM leverages the resources of Goldman Sachs & Co. subject to Chinese Wall restrictions

\(^3\) Source: UBS estimates, as of Feb-10.

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Rapid urbanization adds to productivity and growth potential

India’s urban population is also forecast to rise rapidly over the coming decades, which could add up to 1% in annual GDP growth as labour is shifted from agriculture to the industrial and service sectors. India has 10 of the 30 fastest growing cities in the world and by 2050, 60% of India’s population will live in its cities, up from about 30% in 2010 (Exhibit 3).4

Growing middle class fuels demand for consumer goods

The Indian economy is currently enjoying a virtuous cycle of strong growth translating into rising incomes, supporting higher spending and consumption as well as demand for, and investment in, infrastructure. In 2002, India’s middle class consisted of just over 50 million households representing 27% of the population. Today it has almost doubled to nearly 100 million and accounts for approximately 44% of the population in 2010 (Exhibit 4, overleaf). This growing middle class is fuelling demand for personal items such as mobile phones, televisions, personal computers and autos, while also contributing to increased demand for infrastructure services such as electricity, transportation and

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4 Source: Goldman Sachs Global Economics Research, BRICs and Beyond, As of Nov-07. GSAM leverages the resources of Goldman Sachs & Co. subject to Chinese Wall restrictions
banking. However, there still seems to be significant room for consumer spending growth as India is substantially behind other rapidly growing emerging economies such as China and South Korea in per capita consumption for most services (Exhibit 5).

Exhibit 4: Growing middle class (% share of households)

Exhibit 5: Per capita consumer comparison of India, China and South Korea

<table>
<thead>
<tr>
<th>Year</th>
<th>India</th>
<th>China</th>
<th>South Korea</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per Capita Nominal Income, US$ *</td>
<td>2009E</td>
<td>1082</td>
<td>3678</td>
</tr>
<tr>
<td>Penetration Comparison</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Electricity (Consumption per capita kWh) **</td>
<td>2007</td>
<td>704</td>
<td>2179</td>
</tr>
<tr>
<td>Telephone Mainlines (per 1,000 people) *</td>
<td>2009</td>
<td>32</td>
<td>238</td>
</tr>
<tr>
<td>Mobile Phones (per 1,000 people) *</td>
<td>2009</td>
<td>451</td>
<td>568</td>
</tr>
<tr>
<td>Household with Television (%) **</td>
<td>2007</td>
<td>47</td>
<td>95</td>
</tr>
<tr>
<td>Personal Computers (per 1,000 people) **</td>
<td>2007</td>
<td>24</td>
<td>65</td>
</tr>
</tbody>
</table>


Infrastructure upgrades further drive growth

We expect rising incomes and urbanization to fuel substantial demand for urban housing and basic infrastructure such as electricity and transportation. The new government has emphasized infrastructure as a key priority, which will probably directly boost industries such as power generation and road construction and provide cascading benefits to the manufacturing and services sectors (Exhibit 6, overleaf). Infrastructure spending is estimated to have more than doubled to over US$400 billion from India’s 10th Five Year Plan (2002-2007) to the 11th (2007-2012)\(^5\). India’s spending on infrastructure is likely to top US$1.5 trillion over the coming decade, about half of which will go to roads and power generation resulting in a multiplier effect on growth across various core industrial sectors.\(^5\)

\(^5\) Source: Goldman Sachs Research, as of Sep-09. GSAM leverages the resources of Goldman Sachs & Co. subject to Chinese Wall restrictions. This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. Please see additional disclosures.
The combination of a healthy financial system and a domestically driven economy provides a strong foundation for continuing growth.

**Strong financial system and lower leverage**

India’s private sector debt, at about 50% of GDP, is amongst the lowest of the BRICs and significantly below that of the developed markets which range from 100-200%. A number of factors have contributed to India’s strong financial system and its lower levels of corporate leverage. India’s banks have not been significantly exposed to foreign assets as they were not allowed to own them due to capital account restrictions on convertibility. As a result, many domestic Indian banks had no exposure to foreign investments at all, including the troublesome assets that forced huge write downs at many developed market banks through 2009. Additionally, more conservative regulation and accounting practices, particularly with regard to mortgage financing and securitization, helped India fare better in the recent financial crisis than some other countries. India’s banking system is also well capitalised, with capital adequacy in the low teens and non-performing loans (NPLs) in the low single digits.

India’s total debt - the sum of government, household and corporate debt - is 129% of GDP and comparable to China, though only a fraction of that of the US and other developed countries. Importantly, this number is predominantly a reflection of India’s higher domestic government debt, which we believe is manageable considering the high growth and developmental phase that the economy is going through.

**A domestically driven economy is more resilient in a global slowdown**

India’s economy is still primarily domestically driven with exports generating less than a quarter of GDP (Exhibit 7), a much lower proportion than most other Asian countries. We believe India’s economy will continue to be more insulated from the developed market economic uncertainty and can offer uncorrelated growth opportunities.

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6 Source: Goldman Sachs Global Economics Research, “BRICs Monthly” Issue 09/09, data as of 2008. GSAM leverages the resources of Goldman Sachs & Co. subject to Chinese Wall restrictions

7 Source: FactSet, MSCI, GS Global ECS Research, “India CAN Afford its Massive Infrastructure Needs”, Sep-09.

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Exhibit 7: Market exports as a % of 2008 GDP

Elections bring significant potential for important reforms

The Indian stock market rose more than 17% the day after the May 2009 elections, as the pro-reform United Progressive Alliance (UPA), India’s incumbent coalition led by the Indian National Congress Party, won by the largest margin in a general election in India since 1991. The stock market reaction reflected investors’ confidence that a strong government at the center will provide more effective governance, smoother implementation of reform policies and increased focus on infrastructure creation.

Our India team strongly believes that the significance of these election results should not be underestimated. After many terms of a weak coalition, the Indian electorate has given a clear mandate for a stable government with a developmental agenda. Top priorities of the new government include governance reform, prudent fiscal management, accelerating economic growth, and creation and modernization of infrastructure. As an example, the new Minister of Road Transport and Highways has set a target of building 20km per day of highway over the next 5 years, compared to the 4km per day being built today. Early signs of the new government’s performance have been very encouraging. These initiatives are hugely beneficial for a stronger and more sustainable economy, thus, creating a more favorable environment for corporate earnings and equity returns.

II. Valuations are attractive given the superior growth outlook and high returns on equity

The Indian market currently trades at about 15-16x forward earnings, which is in line with its 20-year historical average of 15.7x (Exhibit 8). India’s superior GDP growth combined with higher levels of corporate profitability should drive corporate earnings growth of 15-20%. At this pace, corporate earnings are projected to double in the next four years. If market multiples were to remain at current levels, such earnings growth should translate into similar returns for the equity market.

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8 Source: Bloomberg. Data for the BSE Sensex 30 Index.
9 Source: Prabhudas Lilladher, “Indian Highway Sector – BOT Projects”, as of 18-Feb-10.
10 Source: GSAM estimates, as of Feb-10.
Exhibit 8: Sensex historical forward-looking P/E

Source: GSAM, Citigroup, RBI, as at 28-Feb-10.

We believe that India’s valuation premium to developed markets and other emerging markets is appropriate due to its attractive growth profile and higher returns on capital. Furthermore, the composition of the Indian benchmark should also be taken into account. Low P/E commodity-based industries, such as Energy and Materials, comprise only about 25% of the Indian market, while the BRIC average is over 50%. Similarly, Information Technology, which comprises 17.2% of the MSCI India versus 6.2%, 2.2%, and 0% in the MSCI China, MSCI Brazil, and MSCI Russia respectively, tends to be a higher P/E sector.\(^1\)

**Consistently higher returns on equity (ROE)**

Indian companies have earned relatively higher ROEs than their regional peers, despite having similar or even lower leverage profiles. During the period from 1995 to 2008, average ROEs for corporate India were 17.5%, higher than both the developed world and emerging market averages (Exhibit 9). Coupled with fast growing sales, this has resulted in earnings growth compounding at a mid-to-high-teens rate over the last 2 decades.\(^2\)

We believe the ownership structure of many Indian companies contributes to higher ROEs. The first generation entrepreneurs continue to own substantial stakes in their listed companies and can afford to maintain a high hurdle for returns on their investments, given the vast spectrum of investment opportunities presented by a rapidly growing and capital scarce economy.


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\(^1\) Source: MSCI

\(^2\) Source: Citigroup, Government of India, as of Mar-09. Based on the Sensex Index.

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Average ROE (1995 – 2008) (%)

<table>
<thead>
<tr>
<th>Region</th>
<th>ROE (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>17.5</td>
</tr>
<tr>
<td>China</td>
<td>12.7</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>11.5</td>
</tr>
<tr>
<td>AC Asia Pacific Ex Japan</td>
<td>10.9</td>
</tr>
<tr>
<td>AC World</td>
<td>10.9</td>
</tr>
</tbody>
</table>


Vast universe of companies

The Indian stock exchange is the oldest in Asia, founded in 1875, and currently boasts over 7000 listed stocks. India ranks second only to the US, with approximately 4700 in the S&P, in terms of listed stocks and its US$1.3 trillion market capitalization ranks in the top 10 globally. The Indian market offers good sector diversification as illustrated below.

Exhibit 10: Sector breakdown and market cap breakdown of India market

Exhibit 11: BSE500 Index vs MSCI India: key differences

Investing in India is subject to market risk as the value of the securities may fluctuate in response to the prospects of individual companies, particular industry sectors and/or general economic conditions. The securities markets of this country and other emerging countries are volatile, less liquid and are subject to substantial currency fluctuations and sudden economic and political developments. The securities markets of emerging countries may have less government regulation and may be subject to less extensive accounting and financial reporting requirements than the markets of more developed countries.

13 Source: Bloomberg, as of 22-Mar-10.
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