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HORIZON RESEARCH

INDIAN EQUITY OPPORTUNITIES

This report examines the Indian equity markets, their structure, constituents and metrics over time. There are approximately 4,147 actively traded companies in India, offering a sizeable group of businesses for superior stock selection.

India has a deeply rooted equity culture dating to the period of British rule. The Bombay Stock exchange (BSE), founded in 1875, is Asia's oldest public bourse. In addition to the BSE, investors can trade through the National stock exchange (NSE). There are approximately 18 other stock exchanges in existence but with little traded market volume. At present 1,577 companies trade on the NSE and 4,018 companies trade on the BSE (most companies that trade on the NSE have a dual listing on the BSE). An additional feature of the Indian equity markets is that there is a single stock futures market with 136 companies traded on 30/60/90 day contracts. These future contracts assist the price discovery process and are a vehicle for short selling.

HORIZON PROCESS

Idea generation is a rigorous and often contrarian process and adherence to fundamental discipline in volatile markets is tantamount to success. At the core of our process is identification of securities and sectors for investment along with an on-going maintenance of the valuation and event universe to provide advanced insights to unfolding investment landscapes. Some of the characteristics we look for:

- Discount to Private market value with catalysts that provide opportunities
- A margin of safety during periods of uncertainty is essential
- Attractive risk adjusted returns
- Low PEG ratio
- Strong corporate governance
- Oriented for the growth of the Indian Sub Continent
- Meaningful free cashflow

The Indian equity market has certain attributes that allow us to believe that there are opportunities to earn risk-adjusted returns through superior stock selection using the Horizon process. We believe that it is possible to identify pockets of value/price misalignment especially within domestic demand led industries. With secular trends led by increasing GDP, growing population and increasing disposable income among other long-term trends there are ample opportunities to invest in companies that will benefit.

INDIA EQUITY MARKET ANALYSIS

Trading and participation

The annual value traded on the NSE in 2012 was USD 526 billion and the ratio of value traded to market capitalisation was 42%, which is well below the value traded to market capitalisation ratios of NASDAQ and NYSE of 131% and 79% respectively (Table 1).

Table 1: Annual value of share trading in 2011 and 2012

				As a % of GDP		As a % of Mcap	
Bourse	2011	2012	2013	2011	2012	2011	2012
NASDAQ	28,913	24,479	26,644	186	151	185	131
NYSE	19,329	14,747	15,309	124	91	124	79
NSE	589	526	479	31	29	58	42
BSE	150	112	87	8	6	15	9

Source: Horizon Research, WFE, World Bank

An analysis of trading per market participant reveals that retail investor participation has declined in the past 2 years, from INR 129 billion in FY10 to INR 64 billion in FY13 (Table 2). Retail investor share in the average daily value of share trading declined from 56.9% in FY10 to 49.3% in FY13 (Table 2). To incentivize greater retail participation in the stock market the Indian government is introducing a series of tax policy and legislative changes.

Table 2: Average daily value of share trading and % share of participants

Particulars	FY10	FY11	FY12	FY13
Proprietary trades				
Value of shares traded (INR billion)	58	41	33	30
% of total shares traded	25.5%	22.1%	23.2%	23.4%
Domestic Institutions (excluding MFs)				
Value of shares traded (INR billion)	6	6	5	6
% of total shares traded	2.6%	3.4%	3.9%	4.6%
FIIs				
Value of shares traded (INR billion)	26	28	25	24
% of total shares traded	11.5%	14.9%	17.6%	18.7%
MFs				
Value of shares traded (INR billion)	8	7	6	5
% of total shares traded	3.6%	3.8%	4.1%	4.1%
Retail Investors				
Value of shares traded (INR billion)	129	103	72	64
% of total shares traded	56.9%	55.9%	51.3%	49.3%
Total (INR billion)	**227**	**185**	**141**	**130**

Source: SEBI

Note: Domestic Institutions (excluding MFs) includes Banks, Domestic Financial Institutions (DFIs), Insurance companies and New Pension Scheme. Others Include Retail, Non- resident Indian (NRI) and Qualified Foreign Investor (QFI).

The Indices

There is a heavy concentration of market capitalization represented through, the primary indices. The NIFTY[1], which comprises 50 companies, and the SENSEX[2], which comprises 30 companies, are the two major indices, and represent 60.1% and 49.9% of the total market capitalisation respectively. The stocks that participate in the NIFTY Index represent 48% (USD 218 billion) of the annual value traded in the exchange. The broad market index (we use the CNX 500[3] Index as a proxy for the broad market) with a 12.4% CAGR between 2003-2013 and the NIFTY index with a 12.9% CAGR between 2003-2013 have outperformed both the MSCI EM Index (8.5% CAGR between 2003-2013) and the S&P 500 (5.2% CAGR between 2003-2013) over the past 10 years (Table 3).

Table 3: Performance of Indian Vs. International Indices (2003-2013)

	Index Level			CAGR		
Index	2003	2008	2013	2003-08	2003-13	2008-2013
S&P 500	1,112	903	1,848	-4.1%	5.2%	15.4%
NIFTY	1,880	2,959	6,304	9.5%	12.9%	16.3%
CNX500	1,531	2,296	4,915	8.4%	12.4%	16.4%
MSCI EM - MXEF	443	567	1,003	5.1%	8.5%	12.1%

Source: S&P, Bloomberg (Index level taken at the last trading day of December)

The balance of shares not captured by the indices equates to approximately 3,700 companies, and result in opportunities for superior stock selection. Our efforts emphasize valuations with catalysts, and believe that a significant portion of small and mid-caps present opportunities for investment.

The Indian equity market quantity of traded companies offers investment diversification opportunities within the Indian market itself. The NIFTY also offers diversity of the market, with the NIFTY comprising companies across each of the 10 broad industry segments.

Concentration offers opportunities

A closer look at the market focusing on company size helps identifying divergences among the listed companies. The largest 50 companies by market capitalisation represent 63.8% of the broad market capitalization. An analysis of value traded as a percentage of total traded volume reveals that nearly 59.1% of the total traded volume is restricted to the largest 50 companies by market capitalisation. On an aggregate basis, these companies offer attractive values (Table 4).

[1] The NSE S&P CNX Nifty index is computed using the Free Float Market Capitalisation weighted method, wherein the level of index reflects the free float market capitalisation of all stocks in Index. (Source NSE Website)

[2] The BSE Sensitive Index, or Sensex, consists of companies selected on the basis of market capitalization, liquidity and industry representation. (Source BSE Website)

[3] The CNX 500 Equity Index reflects the market as closely as possible and represents ~96.76% of the free float market capitalization of the stocks listed on NSE as on December 31, 2013. Industry weightages in the index reflect the industry weightages in the market to ensure Industry representation

The largest 50 have a net debt to enterprise value of 19.0%, FY13 FCF yield of 3.0%, FY13 dividend yield of 1.7%, FY13 P/E of 17.6x, FY13 EV/ EBITDA of 10.6x and a FY13 PEG of 1.02x. In contrast after extracting the top 1,000 companies by market capitalisation, the remaining 3,246 companies have a net debt to enterprise value of 72.5%, FY13 FCF yield of -4.7%, FY13 dividend yield of 1.6%, FY13 P/E of 22.3x, FY13 and EV/ EBITDA of 11.9x. As investors, we find opportunities masked in the aggregates and underscore that these broad differences provide opportunities in individual stock selection.

Table 4: Analysis of performance highlights by market capitalisation

BY MARKET CAPITALISATION	Number of Co's	Market Cap in USD MN	Enterprise Value in USD MN	Net Debt in USD MN	ROE:FY13	FCF Yld:FY13	Dvd Yld:FY13	P/E: FY13	EV/EBITDA: FY13	P/BV: FY13	PEG Ratio: Y	Total Return: Y-5 (I)	Total Return: Y-1 (I)	EPS T12M	Annual Value Traded in USD MN	Value Traded as Percentage of All Stocks
BSE SENSEX INDEX	30	572,692	575,567	115,985	27.2%	3.3%	1.7%	17.8	11.0	5.1	1.0	27.3%	15.8%	60.7	269,249	48.4%
S&P CNX NIFTY INDEX	40	689,466	711,998	168,116	25.6%	3.0%	1.7%	17.3	10.4	4.8	1.0	27.6%	14.7%	59.3	330,984	59.5%
All India traded equities, Cap Wgt.	4,246	1,137,493	1,505,524	558,321	20.0%	-1.3%	1.6%	18.3	11.1	4.0	0.8	27.2%	12.7%	49.9	556,117	100.0%
Top 10 Companies by M Cap	10	353,675	353,562	27,561	26.6%	4.1%	1.8%	20.3	11.5	4.9	1.2	28.2%	22.8%	58.4	100,719	18.1%
Top 25 Companies by M Cap	25	562,678	534,659	84,719	27.8%	4.6%	1.7%	17.8	10.9	5.2	1.0	29.0%	19.1%	59.9	224,255	40.3%
Top 50 Companies by M Cap	50	726,074	738,957	140,283	25.2%	3.0%	1.7%	17.6	10.6	4.7	1.0	27.3%	17.0%	57.6	328,795	59.1%
Top 100 Companies by M Cap	100	877,614	1,000,890	262,992	22.9%	0.7%	1.6%	17.1	10.3	4.3	1.0	27.4%	13.6%	55.5	416,472	74.9%
Top 500 Companies by M Cap	500	1,088,847	1,369,369	470,660	20.6%	-0.9%	1.6%	17.9	10.9	4.1	0.9	27.5%	13.0%	51.6	542,735	97.6%
Top 1,000 Companies by M Cap	1,000	1,122,939	1,452,950	520,187	20.2%	-1.2%	1.6%	18.3	11.1	4.0	0.8	27.4%	12.9%	50.5	553,367	99.5%
Remaining 3,246 by M Cap	3,246	14,554	52,574	38,135	2.8%	-4.7%	1.6%	22.3	11.9	1.4	0.0	12.8%	-1.8%	5.1	1,107	0.2%

Source: Horizon Research, Bloomberg

We observe that the market capitalisation of a small number of companies within each industry sector constitute a majority of that industry sectors broad market capitalisation. This heavy concentration is observed in most industry sectors. For example in the broad market there are 772 consumer discretionary companies of which 5 companies constitute 45.4% of the market capitalisation. This trend is repeated in the consumer staples industry where 2 out of 262 companies constitute 54.4% of the market capitalisation (Table 5).

Table 5: Concentration of market capitalisation by industry

	BROAD MARKET		NIFTY		Market Cap of NIFTY securities as a % of the broad market
BY INDUSTRY	Number of securities	Market Cap in USD MN	Number of securities	Market Cap in USD MN	
Consumer Discretionary	772	112,937	5	51,326	45.40%
Consumer Staples	262	113,596	2	61,775	54.40%
Energy	56	148,862	5	126,768	85.20%
Financials	629	195,902	11	121,210	61.90%
Health Care	190	75,662	5	41,872	55.30%
Industrials	586	86,724	3	23,538	27.10%
Information Technology	310	177,807	4	147,869	83.20%
Materials	680	125,496	10	59,119	47.10%
Telecommunication Services	14	39,660	1	19,942	50.30%
Utilities	49	57,738	4	36,047	62.40%

Source: Horizon Research and Bloomberg

Industry sectors oriented for growth

The informational technology, energy, materials, consumer staples and consumer discretionary are amongst the largest industry sectors by market capitalisation in the Indian equity market with respective participations of 15.6%, 13.1%, 11.0%, 10.0% and 9.9% respectively. Only the financial industry, with 17.2% is larger than the aforementioned.

Each sector of the Indian market has its particular economics, and it would not always be accurate to compare two industries using the same financial indicator. However, certain trends are discernible when we analyze performance highlights by industry grouping (Table 6).

Table 6: Analysis of performance highlights by industry

BY INDUSTRY	Number of Co's	Market Cap in USD MN	Enterprise Value in USD MN	Net Debt in USD MN	ROE:FY13	FCF Yld:FY13	Dvd Yld:FY13	P/E: FY13	EV/EBITDA: FY13	P/BV: FY13	PEG Ratio: Y	Total Return: Y-5 (I)	Total Return: Y-1 (I)	EPS T12M	Annual Value Traded in USD MN	Value Traded as Percentage of All Stocks
Consumer Discretionary	772	112,937	155,548	42,510	19.8%	-1.2%	1.2%	16.1	11.2	4.3	0.7	42.6%	19.1%	72.2	48,762	8.8%
Consumer Staples	262	113,596	124,002	10,021	39.8%	1.4%	1.3%	27.6	19.4	12.4	1.8	32.3%	17.8%	22.7	73,316	13.2%
Energy	56	148,862	175,594	25,894	18.7%	4.7%	2.8%	10.8	6.9	1.9	0.7	8.9%	-10.3%	43.2	27,990	5.0%
Financials	629	195,902	227,441	242,957	15.7%	0.0%	1.8%	18.2	7.9	2.4	0.2	23.5%	-9.4%	68.5	213,820	38.4%
Health Care	190	75,662	82,730	6,680	18.8%	0.7%	0.7%	18.3	10.8	4.0	1.1	36.7%	40.8%	32.1	30,182	5.4%
Industrials	586	86,724	170,355	80,384	11.8%	-14.1%	1.3%	22.4	11.2	1.9	0.5	17.7%	-1.9%	30.1	36,593	6.6%
Information Technology	310	177,807	172,525	(4,795)	31.3%	4.0%	1.4%	19.6	14.0	5.5	1.2	48.5%	64.1%	91.6	50,948	9.2%
Materials	680	125,496	211,219	70,022	10.4%	-7.1%	1.2%	14.7	10.7	2.2	0.8	26.1%	0.1%	30.5	29,845	5.4%
Others	698	2,685	2,042	1,336	0.4%	-0.9%	2.7%	4.9	7.6	1.3	0.0	16.2%	1.5%	1.3	1,470	0.3%
Telecommunication Services	14	39,660	66,170	25,477	3.7%	3.2%	0.7%	38.2	7.8	2.1	1.8	5.1%	6.0%	3.5	18,126	3.3%
Utilities	49	57,738	117,537	57,443	11.1%	-17.4%	2.5%	9.6	10.5	1.4	0.1	1.6%	-16.0%	14.7	24,383	4.4%

Source: Horizon Research and Bloomberg

The consumer discretionary industry, which includes textiles, media, automobiles, hotels and household durables, represent 9.9% of market capitalisation and 8.8% of traded volume. This sector has FY13 FCF yield of -1.2%, and FY13 dividend yield of 1.2%. The sector traded at FY13 P/E ratio of 16.1x and 11.2x EV/EBITDA, marginally above the Index. These disconnects in financial ratios versus the index respond to secular trends in the sector (e.g. increasing disposable income leading to higher demand).

The consumer staples industry, which includes alcohol, tobacco, packaged foods, and agricultural products, represents 10.0% of all market capitalisation and 13.2% of value traded. It has a 8.1% net debt to enterprise value ratio, and FY13 ROE of 39.8%, with FCF yield of 1.4% and dividend yield of 1.3%. The sector is trading at 27.6x FY12 P/E and 19.9xFY13 EV/EBITDA. Valuations for the 'consumer staples' sector are a reflection of high growth in this sector with the PEG ratio near 1.8.

The energy industry, which includes oil, gas and coal exploratory companies and allied services represents 13.1% of all market capitalisation and only 5.0% of value traded, has a 14.7% net debt to enterprise value ratio, and FY13 ROE of 18.7%, with FCF yield of

4.7% and dividend yield of 2.8%. The sector is trading at 10.8x FY13 P/E and 6.9x FY13 EV/EBITDA.

The financial industry, which includes banks, asset management, mortgage finance and thrifts represents 17.2% of all market capitalisation and 38.4% of value traded which is the highest amongst all industry groups. The financial industry has weighted average ROE of 15.7% for FY13 and dividend yields of 1.8% for FY13. The sector traded at FY13 P/E of 18.2x and a FY13 P/B ratio of 2.4.

The health care industry represents 6.7% of the total market capitalisation and 5.4% of total value traded. It has an ROE of 18.8%, FY13 FCF yield of 0.7%, and a FY13 dividend yield of 0.7%. The sector traded at FY13 P/E of 18.3x and 10.8x FY13 EV/EBITDA.

Industrials represent 7.6% of all Indian market capitalisation and 6.6% of all value traded. The sector has net debt to enterprise value of 47.2%. The FY13 ROE of the sector is 11.8%, FY13 FCF yield is -14.1% (which is the lowest amongst all industry groups except utilities industry with -17.4%), while still maintaining 1.3% FY13 dividend yield. The sector traded at FY13 P/E of 22.4x and 11.2x FY13 EV/EBITDA.

The information technology industry represents 15.6% of all market capitalisation and 9.2% of value traded. It has a negative net debt (i.e. cash is more than debt). The FY13 ROE of the sector is 31.3%, FY13 FCF yield is 4.0% (the highest amongst all industry groups except Energy with 4.7%), while still maintaining 1.4% FY13 dividend yield. The information technology industry is the only industry group that has seen positive free cash flow yields every year in the past 3 years. The sector traded at FY13 P/E of 19.6x and 14.4x FY13 EV/EBITDA.

The materials industry, which includes chemicals, metals and mining, construction material, paper and pulp and fertilizers, represents 11.0% of all market capitalisation and 5.4% of value traded. The sector has net debt to enterprise value of 33.2%. The FY13 ROE of the sector is 10.4%, FY13 FCF yield is -7.1% and the FY13 dividend yield is 1.2%. The sector traded at FY13 P/E of 14.7x and 10.7x FY13 EV/EBITDA.

Telecommunication services represent 3.5% of all Indian market capitalisation and 3.3% of all value traded. The sector has net debt to enterprise value of 38.5%. A single telecom company Bharti Airtel (BSE: 532454) is responsible for 41.5% of the entire net debt of the industry. The FY13 ROE of the sector is 3.7% (the lowest amongst all industry groups), FY13 FCF yield is 3.2% and the FY13 dividend yield is 0.7%. The sector traded at FY13 P/E of 38.2x and 7.8x FY13 EV/EBITDA.

The utilities industry, which includes independent power producers & energy traders, electric, water and gas utilities represents 5.1% of all market capitalisation and 4.4% of value traded. The sector has net debt to enterprise value of 48.9%. The FY13 ROE of the sector is 11.1%, FY13 FCF yield is -17.4% and the FY13 dividend yield is 2.5%. The sector traded at FY13 P/E of 9.6x and 10.5x FY13 EV/EBITDA.

We observe that companies in the services sector are under represented in the broad market based on their contribution to GDP and that there are opportunities to select stocks within this sector that will benefit from the normalization of this relationship. Agriculture, industry and services sector contribution to GDP was 17.4%, 25.7% and 56.9% respectively in 2012 compared to 20.7%, 26.2% and 53.1% respectively in 2002. Taking the financial, healthcare, information technology, telecommunication and utilities industry as a proxy for 'services', we observe that the services and industry market capitalisation as share of total market capitalisation are 47.7% and 49.7% respectively.

THE INDIAN ECONOMY

While Indian GDP (at market prices) has increased at a CAGR of 13.4% from USD 524.0 billion in 2002 to USD 1,841.7 billion in 2012, the total market capitalisation to GDP ratio is below global levels leading to lower valuations in the Indian equity markets. Indian broad market capitalisation of USD 19,947.3 billion in 2012 represents 68.6% of Indian GDP. This also equals the 12-year average market capitalisation to GDP ratio for India, but is nearly 53% lower than the peak in 2007 of 146.9%. In comparison, the ratio of US market capitalisation to global GDP is ~123% in 2012 (Table 7).

We believe Indian GDP (at market prices) will continue to grow at its 2007-12 CAGR of 8.3% in the long term, which will provide an added impetus to companies across capitalisation and industry sectors. India is the tenth largest economy in the world with an estimated GDP in 2012 of USD 1,841.7 billion in current dollars.[4]

Table 7: Market cap of listed companies as a % of GDP (2001-11)

Indicator	2002	2007	2012	CAGR 2002-07	CAGR 2002-12	CAGR 2007-2012
GDP India (current US$ billion)	524	1,239	1,842	19%	13%	8%
GDP US (current US$ billion)	10,980	14,480	16,245	6%	4%	2%
M Cap India (current US$ billion)	131	1,819	1,263	69%	25%	-7%
M Cap US (current US$ billion)	13,855	11,098	19,947	-4%	4%	12%
M Cap/GDP India (%)	25%	147%	69%	42%	11%	-14%
M Cap/GDP US (%)	126%	77%	123%	-9%	0%	10%

Source: The World Bank

Indian exports are diversified, though in general refined petroleum products, gems and jewelry, software, pharmaceuticals and agri-commodities are the largest export items in most years. With export/GDP ratio increasing, India is becoming more integrated with and sensitive to global economic conditions. The degree of openness to trade represented by the percentage of merchandise trade to GDP is lower in India at 42.5% in 2012, as compared to 47.0% for China and 42.9% for Russia.

[4] Source World Bank

Net FDI that had increased to a record USD 43 billion in 2008, declined to USD 24 billion in 2012 (USD 36 billion in 2011) (Table 8). Portfolio inflows reached a record USD 30 billion in 2010 but declined to a negative 4 billion in 2011. Portfolio inflows in 2012 were USD 22.8 billion.

Table 8: India: Economic indicators for the past 10 years

Indicator	2002	2007	2012
Foreign direct investment, net inflows (BoP, current US$)	5.6	25.2	24.0
GDP growth (annual %)	3.8%	9.8%	3.2%
GDP per capita, PPP (current international $)	1,700	2,758	3,813
Merchandise trade (% of GDP)	20.2%	30.6%	42.5%
Portfolio equity, net inflows (BoP, current US$)	1.1	32.9	22.8

Source: The World Bank

Manjit Singh Kalha, the analyst who prepared this report, hereby certify that the views expressed in this report accurately reflect the analyst's personal views about the subject companies and their securities. The Research Analyst has not been, is not and will not be receiving direct or indirect compensation for expressing the specific recommendation or view in this report.

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A **Buy** rated stock is one that in our view is trading at a meaningful discount to our estimated PMV. We could expect a more modest private market value to increase at an accelerated pace, the discount of the public stock price to PMV to narrow through the emergence of a catalyst, or some combination of the two to occur.

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