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Investment Strategy

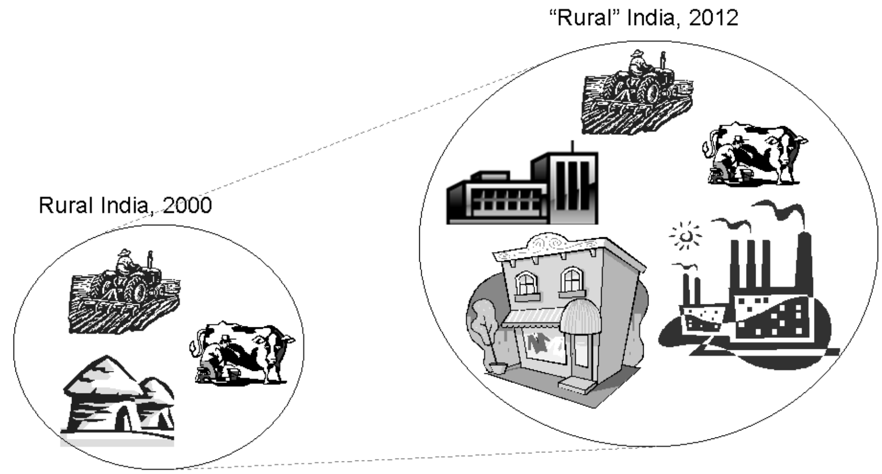
India Market Strategy

Research Analysts
Neelkanth Mishra
9122 6777 3716
neelkanth.mishra@credit-suisse.com
Ravi Shankar
9122 6777 3869
ravi.shankar@credit-suisse.com

STRATEGY

The great Indian equalisation

Figure 1: **Rural India urbanising rapidly**

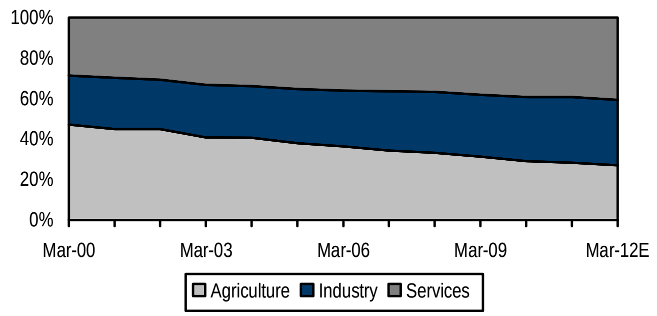


Source: Credit Suisse

- **Rural ≠ agriculture.** While 69% of India is still rural, the widely held view of rural meaning bullock carts and mud huts is no longer appropriate. All agriculture is rural by definition, but the converse is no longer true: the contribution of agriculture to rural GDP has fallen from about half a decade back to only one-fourth now. 75% of new factories in India in the last decade were in rural areas, and the shift of jobs in rural India away from agriculture in the five years to 2010 was equivalent to that over the prior 27 years!
- **Urbanisation of rural India.** This is not just a classification issue. The spread of roads, telephones and electricity is driving unprecedented productivity growth away from the big urban centres. In the districts of Maharashtra, for example, per capita output and its growth have been inversely correlated over the past six years! India's urbanisation is thus increasingly about new urban centres. 'Census towns' in 2011 were 3x that in 2001, and big metro population last decade grew slower than overall urban growth.
- **Market disconnected from the economy.** This productivity growth should help support GDP growth. However, the large, listed companies are mostly still in early stages of exploiting this market, and have high exposure to the slowing parts. As large-scale investments are difficult to come by and the urban middle class gets squeezed further by a falling INR, the broader indices may continue to languish. On the other hand, as wage growth at the lower end stays strong, goods in the 'new urban' consumption basket like two-wheelers, building materials, tobacco, healthcare and media should see robust demand. CS has created a CS India Rural Index to play this basket.

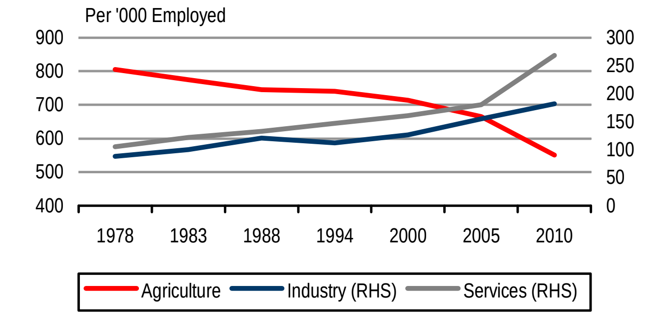
Focus charts

Figure 2: Rural mix of GDP—only 27% is now agriculture



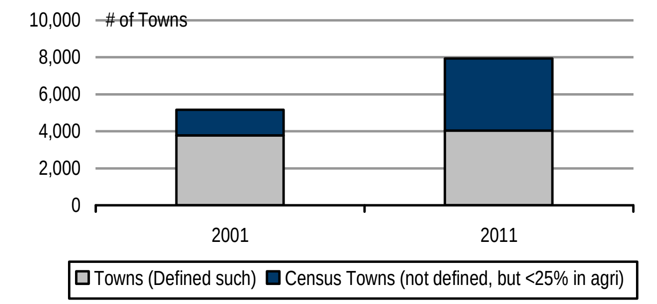
Source: Govt of India, Credit Suisse estimates

Figure 3: Jobs switching from agriculture (rural male)



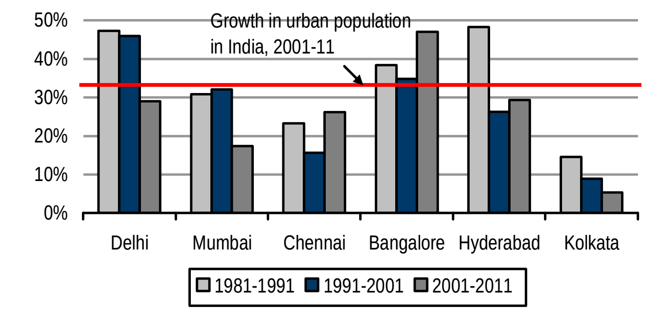
Source: Employment Surveys, Credit Suisse estimates

Figure 4: Towns forming naturally



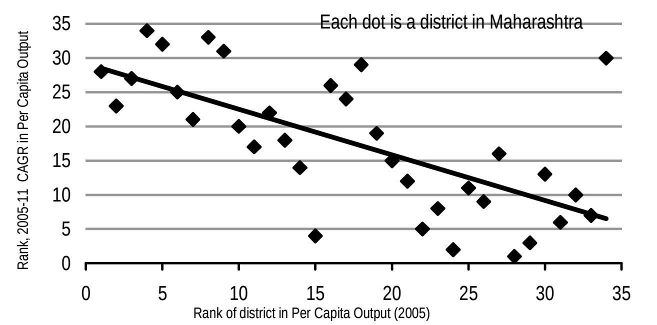
Source: India's Population Census, 2011

Figure 5: Growth in metros slower than urban growth



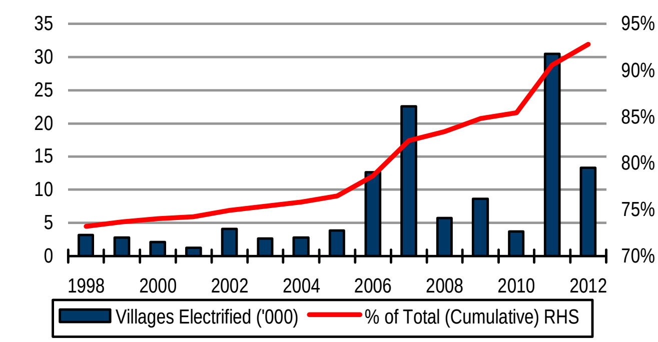
Source: Census Bureau of India

Figure 6: Poorest districts growing the fastest (2005-11)



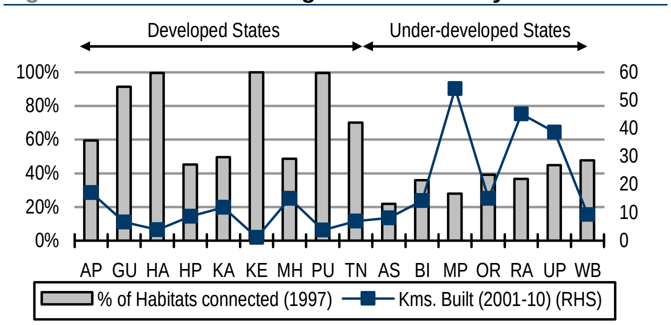
Source: Maharashtra State Government, Credit Suisse estimates

Figure 7: Sharp increase in rural electrification



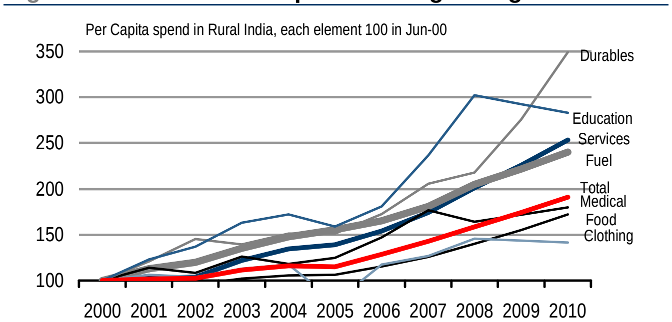
Source: Ministry of Power

Figure 8: Rural roads being built where they are needed



Source: Ministry of Road Transport and Highways

Figure 9: 'Urban' consumption items growing faster



Source: NSSO Surveys, Credit Suisse estimates

The great Indian equalisation

Rural ≠ agriculture

Using the government's methodology for calculating the urban-rural split of GDP, we find that the productivity growth is higher in rural India than in urban India. In fact, the ratio of rural to urban per capita GDP has narrowed from 3x to 2.5x over the past decade. This runs contrary to the trend seen in other emerging economies. Rural India, in our view, is no longer an agrarian economy exposed to the vicissitudes of an erratic monsoon. While all of agriculture by definition is rural, the reverse is untrue. Agriculture is now only about one-fourth of rural GDP—from being close to half a decade back.

Unlike in other emerging economies, rural productivity growth in India is higher than in urban

The transition away from agriculture has accelerated over the past few years: the drop in male employment in agriculture over the past five years is equal to the shift away over the previous 27 years. Almost 75% of the new factories during the last decade came up in rural India, contributing to 70% of all new manufacturing jobs created. As a result, manufacturing GDP in rural India witnessed an 18% CAGR during 1999-09, and is now 55% of India's manufacturing GDP. Growth in services employment is equally robust.

Transition away from agriculture has accelerated over the past few years

The urbanisation of rural India

This is not merely a question of wrong rural/urban classification. Urbanisation in India is progressing along a path very different from the conventional migration from villages to large cities: population growth in the large metropolitan areas past decade has ben lower than overall growth in urban population. Instead, the number of 'census towns' (habitats with population >5,000 where less than 25% of working males are in agriculture) grew three-fold, and is now half of the total number of towns.

Urbanisation in India is progressing along a path very different from the conventional migration to big cities

We also analysed the district-wise data that Maharashtra, an Indian state, makes available: there is a surprisingly consistent trend of mean reversion. The districts with the highest per capita output in 2005 were growing the slowest during 2005-11, and vice versa. This is not consistent with trends seen in other emerging markets. Given the high correlation of output with vehicle ownership, telephone penetration and electricity usage in the districts of Maharashtra, we believe the nation-wide improvement in rural GDP is being driven by rapid strides in the rural roads programme, cell phone penetration and rural electrification.

In Maharashtra, the fastest growing districts in 2005-11 were the ones with the lowest per capita output, and vice versa

As villages start urbanising, their consumption habits change as well. The rural consumption basket of 2010 was surprisingly similar to the urban basket of 1994. The fastest growing consumption items are durables, education and services—hitherto considered 'urban' consumption categories. This trend too accelerated recently.

The rural consumption basket of 2010 was surprisingly similar to the urban basket of 1994

Disconnect between market and economy

Our broader view on the Indian economy is that consumption growth is likely to fall going forward, as a weakening INR forces an adjustment to the current account deficit by making imports more expensive. Productivity growth driven by these above developments, however, is likely to provide some structural support to the ongoing slowdown; we do not expect an acceleration, as this trend is already very much on.

Overall consumption growth is likely to slow as the INR weakens; higher productivity growth in rural India is, however, likely to support overall GDP growth

Thus, (1) consumption will continue to skew towards lower price points and 'rural urbanisation' themes and (2) urban middle classes are likely to see further pressure on their consumption due to weak job creation and persistent inflation. The 'new urban' consumption categories are thus likely to see sustained growth, i.e. two-wheelers, building materials/paints, media, tobacco, footwear, healthcare, personal products with low price points (e.g. toothpaste), etc. On the other hand, categories such as listed real estate, consumer appliances and travel agents may see incremental weakness putting pressure on their high valuation multiples. Unfortunately, the big listed companies are in very early stages of targeting new markets, but heavily exposed to the slowing ones.

'New urban' consumption categories should outperform others: Large listed companies are not focused on these

Consumption baskets

Figure 10: Some companies exposed to the 'new urban' consumption basket

Category	Company	Market cap US$ mn	Avg. daily trading US$ mn	Valuation* FY13 P/E	FY12 P/B	CFROI (5Y hist.)	(Implied)	Performance (%) 3M	6M	12M
Two wheelers	Hero MotoCorp	8,239	22.66	15	11	25.27	28.80	10%	4%	23%
	Bajaj Auto	9,582	17.07	14	7.8	18.06	21.24	10%	5%	17%
Tobacco	ITC	36,423	33.20	26	10.7	17.49	20.92	20%	19%	27%
	VST Industries	581	0.38	19	9.6	15.66	21.57	58%	46%	138%
	Godfrey Phillips	773	0.15	NA	NA	11.25	10.36	30%	8%	103%
Personal products	Colgate	2,969	1.85	30	34	39.72	39.98	18%	15%	25%
	Godrej Industries	1,641	2.57	18	3.8	3.41	11.30	45%	39%	44%
	Emami	1,322	0.96	22	8	23.19	18.51	31%	12%	13%
	Bata India	1,061	7.58	29	21	8.06	18.30	46%	25%	103%
Finance	M&M Fin. Services	1,333	33.23	9.6	2.3	10.14	16.78	1%	6%	-17%
Media	Dish TV	1,273	6.68	145	33	NA	8.75	4%	-18%	-9%
Paint/chemicals	Asian Paints	6,120	5.15	27	11.5	18.76	20.28	22%	10%	29%
	Berger	768	0.34	18	5.2	13.17	10.16	21%	16%	22%
	Kansai	956	0.09	20	4.7	9.74	11.24	7%	9%	10%
	Pidilite	1,727	0.48	21	6.8	11.80	16.64	21%	12%	18%
Healthcare	Cipla	4,863	10.00	19	3.3	12.88	7.83	-6%	10%	-2%
	FDC Pharma	285	0.13	NA	NA	15.01	8.12	-7%	-12%	-24%
	Elder Pharma	129	0.58	5.9	0.95	6.91	2.41	-6%	-15%	-13%
Appliances	TTK Prestige	754	7.45	24	13.6	13.33	21.42	42%	25%	50%
	Hawkins Cookers	167	0.07	NA	NA	22.20	22.06	12%	9%	55%
Batteries	Exide	2,163	4.12	16	3.7	16.27	11.82	5%	11%	-7%
	Amara Raja	524	0.35	11	3.3	11.75	8.76	56%	55%	71%
Building products	Sintex	429	9.77	5.6	0.80	6.90	2.26	14%	-30%	-53%
	Kajaria Ceramics	251	0.47	11.9	4.6	7.17	7.43	59%	55%	121%
	HSIL	206	0.39	7.9	1.5	4.78	2.00	24%	-12%	5%
	Century Ply	261	0.05	6.8	1.7	14.67	4.58	22%	1%	-13%
Food	Hatsun	162	0.03	NA	NA	7.35	4.45	6%	10%	23%
Stationery/media	HT Media	592	0.11	13	2.0	9.18	5.41	5%	-6%	-16%
	Jagran Prakashan	607	0.29	13	4.1	10.91	8.92	1%	-5%	-19%
	Navneet Pub.	265	0.28	13	3.7	10.91	10.24	4%	-11%	-10%

*Source: RAVE, HOLT, Bloomberg, * On consensus numbers*

Figure 11: Stocks exposed to the consumption basket of urban middle classes

Category	Company	Market cap US$ mn	Avg. daily trading US$ mn	Valuation* FY13 P/E	FY12 P/B	CFROI 5Y hist.	Implied	Performance (%) 3M	6M	12M
Staples	Hindustan Unilever	17,619	21.8	31	28	28.9	32.7	10%	4%	23%
Personal products	Gillette	1,607	0.3	NA	NA	12.9	22.7	10%	5%	17%
Food	Nestle	9,207	2.8	33	27	28.3	26.6	20%	19%	27%
	Britannia	1,312	0.9	28	NA	9.9	18.2	58%	46%	138%
	Marico	2,131	1.0	27	19	19.2	16.0	30%	8%	103%
	Glaxo Consumer	2,295	1.2	23	8.9	16.7	20.6	18%	15%	25%
Appliances	Whirlpool	560	0.4	18	5.7	8.5	10.6	45%	39%	44%
	Voltas	747	6.6	14	2.6	16.1	7.0	31%	12%	13%
Retailers	Titan	4,100	17.3	29	15	14.9	21.4	46%	25%	103%
	Pantaloon	685	16.7	19	1.2	3.2	5.3	1%	6%	-17%
	Shoppers Stop	586	1.4	46	5.7	3.7	9.2	4%	-18%	-9%
	Trent	477	0.6	NA	NA	0.5	6.4	22%	10%	29%
Travel	Mahindra Holiday	467	0.1	22	NA	7.2	8.9	21%	16%	22%
	Thomas Cook	279	1.4	20	36	9.2	13.4	7%	9%	10%
Real estate	DLF	6,572	36.9	20	2.5	9.3	5.9	21%	12%	18%
	Unitech	1,470	12.6	13	0.6	12.4	3.9	-6%	10%	-2%

*Source: RAVE, HOLT, Bloomberg, * On consensus numbers*

Rural ≠ agriculture

Over the past two to three years there has been a perceptible change in the market sentiment about rural India. From persistent inflation and robust consumption growth to worrying fiscal deficits, the underlying causes are believed to be all things 'rural.' Unfortunately, the image of rural India in most minds is still of an agrarian economy exposed to the vicissitudes of an erratic monsoon. In our view, this is outdated and, as with most broad-brush descriptions, simplistic. While 69% of Indian population is still 'rural,' not all of it means thatched-roof houses and muddy roads. The formal definition (see Appendix on Page 19), allows for large variations in the definition of 'rural.'

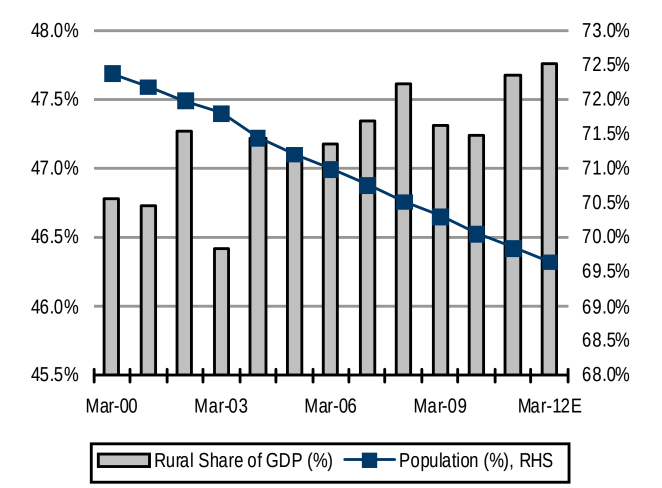
We found some estimates of rural GDP published by the government, and using the methodology, estimated rural GDP from FY00-12: in our view, this analysis has not been done earlier. There were some startling insights.

Rural India catching up on per capita GDP

Rural India drives about half of India's GDP, and this ratio has been mostly unchanged over the past decade (Figure 12). What drove the excitement over the past few years has been the much stronger improvement in per capita GDP, which offset the reducing share of rural population due to urbanisation. Since FY00, per capita GDP in rural India has grown at a 150 bp faster rate than in urban India (Figure 13): 6.2% CAGR vs. 4.7%. This is contrary to the trend seen in other emerging economies where urban productivity growth is higher than in rural.

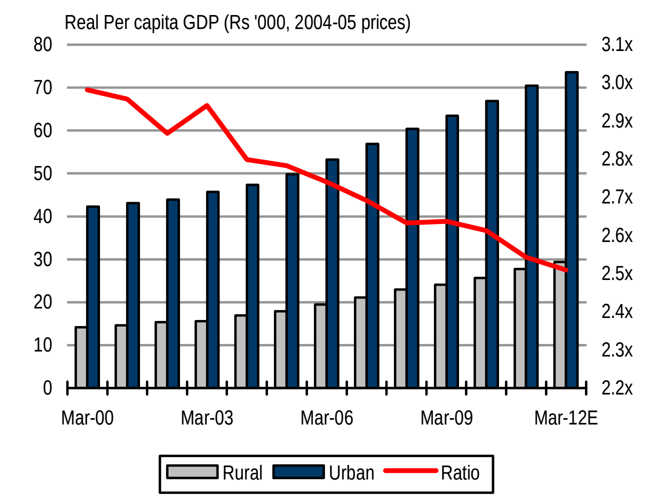
Since FY00, per capita GDP in rural India has grown at a 150 bp faster rate than in urban India: 6.2% vs. 4.7%

Figure 12: **Rural share of GDP and population**



Source: Census Bureau, Govt of India, Credit Suisse estimates

Figure 13: **Per capita GDP growth in rural India is faster**



Source: Census Bureau, Govt of India, Credit Suisse estimates

All agriculture is rural, but not all rural is agriculture

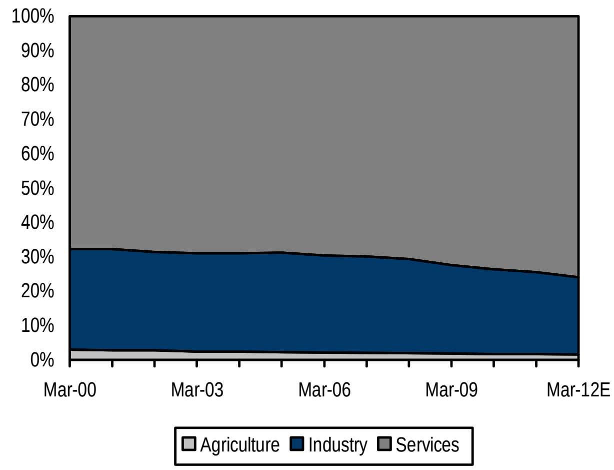
In India 94% of all agricultural activity is carried out in rural areas (96% of farming, 92% of forestry and 74% of fishery). In fact, the percentage of people employed in agriculture is an important criterion for classifying an area as urban or rural: if more than 25% are employed in agriculture, the area gets classified rural. Not surprisingly, agriculture is an insignificant part of urban GDP (Figure 14).

All agriculture can safely be called rural (it is part of the definition): 96% of agricultural GDP is rural

In the popular perception, the reverse holds true as well, i.e., agriculture is the prime driver for the rural economy. This assumption is increasingly becoming invalid. A decade ago agriculture was about half of rural GDP, but it is now only about one-fourth (Figure 15). The transition from agriculture to industry and services has been very rapid in rural India over the past decade.

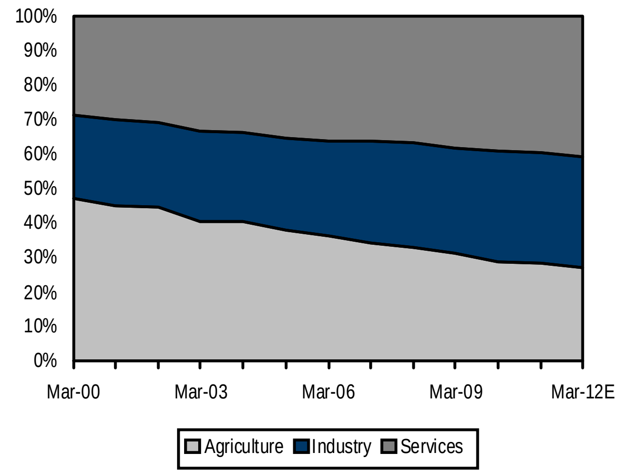
The reverse, i.e. all rural is agriculture, is commonly believed, but is no longer true: agriculture is only one-fourth of rural GDP

Figure 14: **Urban mix of GDP**



Source: Govt of India, Credit Suisse estimates

Figure 15: **Rural mix of GDP: Only 27% is now agriculture**



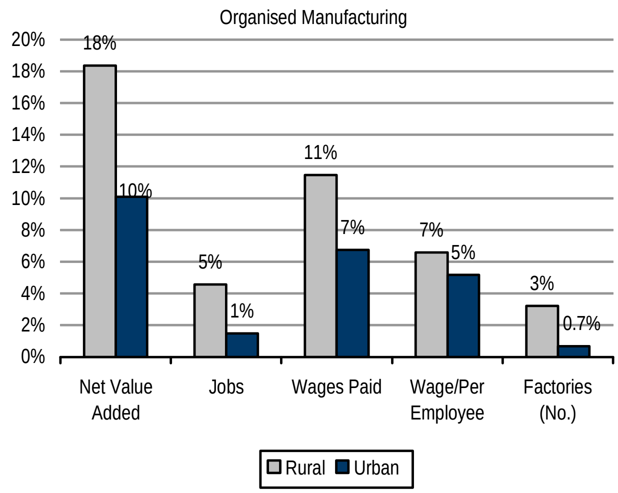
Source: Govt of India, Credit Suisse estimates

Strong manufacturing growth in rural India

Net value added (comparable to GDP) by manufacturing in rural India saw an 18% CAGR (Figure 16) over the ten-year period of 1999-09, much faster than urban manufacturing growth, and is now ~55% of the national total (Figure 17).

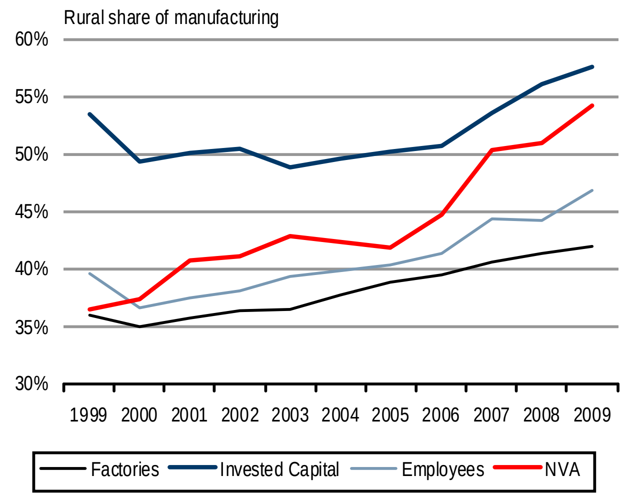
55% of manufacturing GDP is rural

Figure 16: **1999-09 CAGR for rural and urban India**



Source: Company data, Credit Suisse

Figure 17: **Rural share of manufacturing growing steadily**

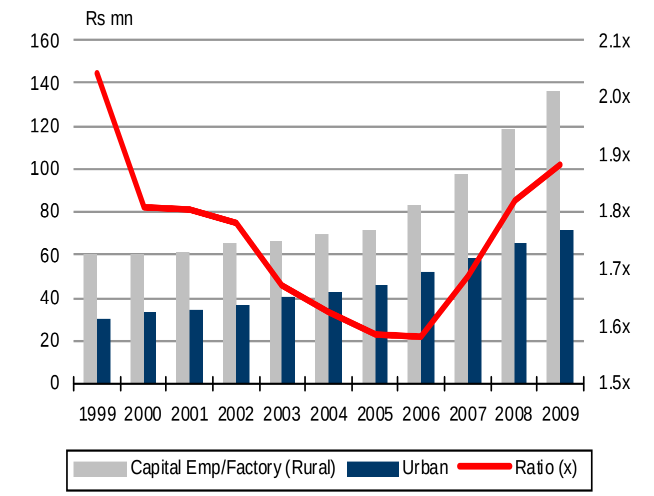


Source: Company data, Credit Suisse

In fact, from 1999 to 2009, 75% of all new factories came up in rural India, and 70% of all manufacturing jobs were created there. This should not be surprising, given that there is so little physical space available in cities: on average rural factories deploy more capital (Figure 18) and also employ more people (Figure 19).

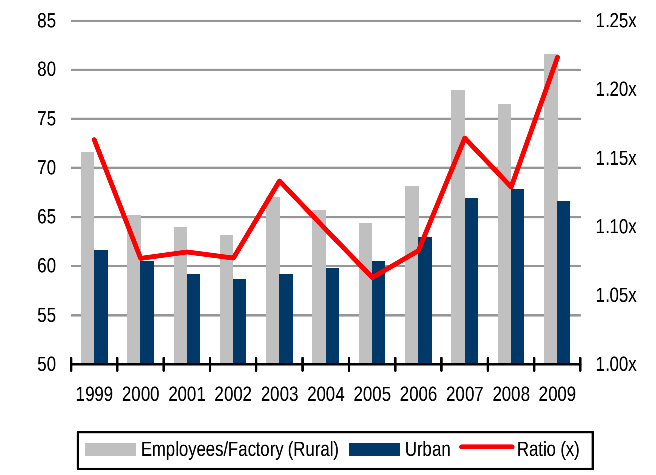
75% of all factories in 1999-09 came up in rural India, and 70% of all manufacturing jobs were created there

Figure 18: Capital employed per factory higher in rural



Source: Annual Survey of Industries, Credit Suisse

Figure 19: Per factory employee count also higher in rural

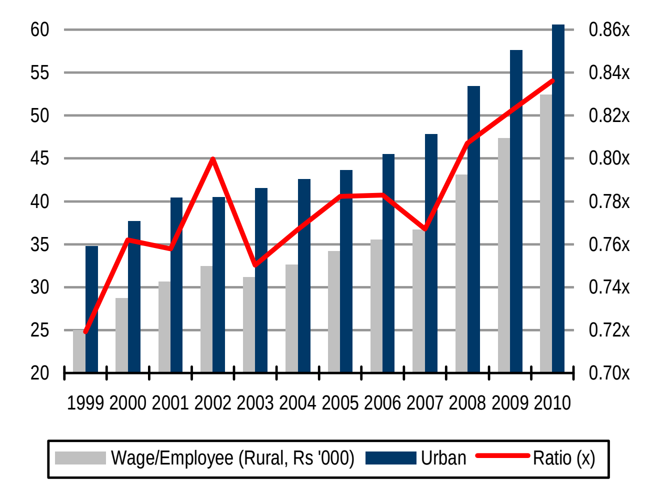


Source: Annual Survey of Industries, Credit Suisse

There remains a meaningful gap in average compensation though this has narrowed sharply, especially since 2007 (Figure 20).

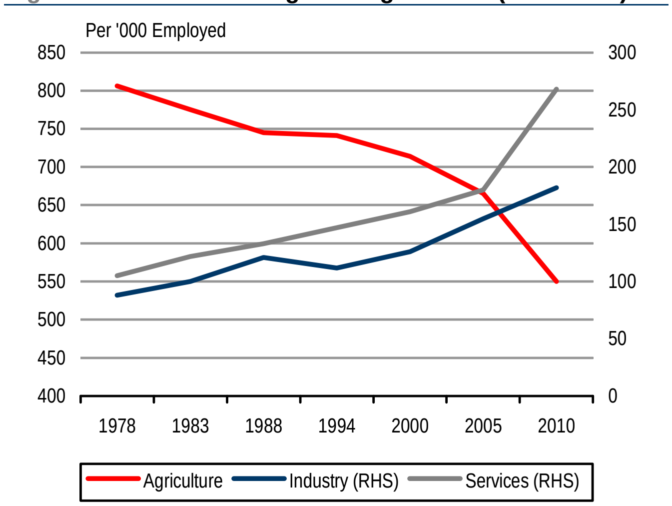
Gap between rural and urban wages is narrowing

Figure 20: Manufacturing wage per employee catching up



Source: Annual Survey of Industries, Credit Suisse

Figure 21: Jobs switching from agriculture (rural male)



Source: Employment Surveys, Credit Suisse

Jobs switching away from agriculture

In 1978, ~81% of rural males considered agriculture as their primary employment. This ratio fell to 67% in FY05 and 55% in FY10 (Figure 21). Thus, the change seen over the five years to FY10 was comparable to that seen over the 27 years to FY05. The trend is similar for female rural employment as well.

The drop in agriculture's share of employment in the five years from FY05-10 was similar to the drop over the previous 27 years

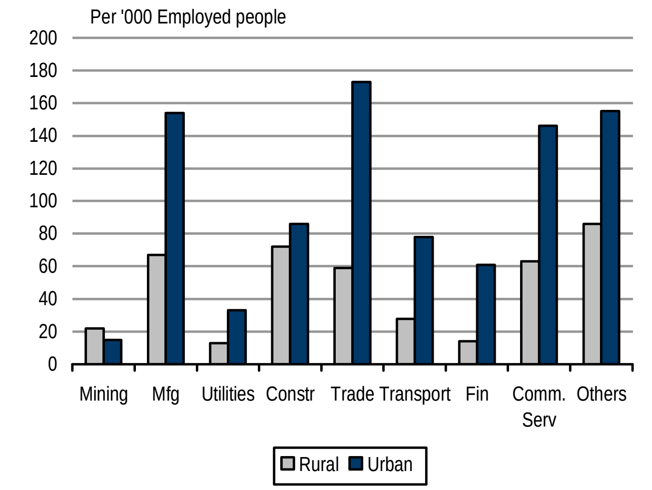
Much of the incremental job creation in manufacturing seems to be in construction and in services: trade (retail/wholesale) and community services. In mining and construction the percentage of employed people working in rural and urban India seems to be similar. The largest gap exists in services such as trade (**Figure 22**) and community services, which are likely to develop naturally as the rural consumption picks up.

As can be expected, productivity and therefore income are on average much higher in non-agricultural pursuits (Figure 23). The transition of the workforce away from agriculture is therefore a much desired trend, and the acceleration since 2005 if sustained can provide a structural support to overall GDP growth.

Productivity in agriculture is still meaningfully lower than in industry and services

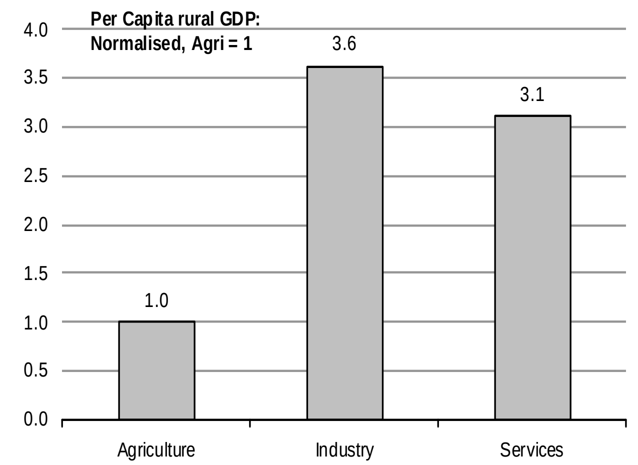
The ‘rural story’ therefore becomes less dependent on the vagaries of the Indian monsoon, but gets linked to national economic cycles, to which it was more or less immune thus far. Given the significantly higher productivity in urban India vs. rural India, the question remains: can rural India urbanise fast enough to offset the economic down-cycle? We explore this in the next section, and conclude in the positive.

Figure 22: Comparing employment in 2010: Rural vs. urban



Source: Employment Survey 2010, Credit Suisse

Figure 23: Productivity still much lower in agriculture



Source: Employment Surveys, Govt of India, Credit Suisse

The urbanisation of rural India

Emergence of 'census towns' and slowing metros

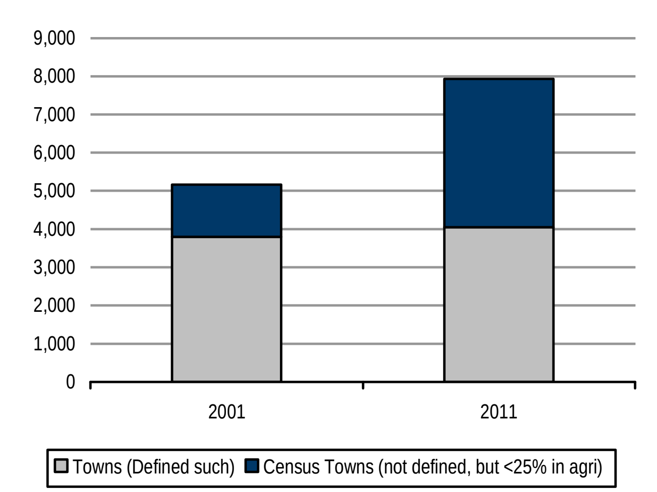
We believe urbanisation need not only mean the conventional migration from villages to big cities. In countries with better urban planning than India (a low hurdle if there was one, in our view) or geographical constraints, that may be the desired configuration. In India, however, a meaningful part of urbanisation is just villages growing larger, merging together, moving away from agriculture, and thus being classified as towns.

Urbanisation should not only mean migration from villages to big cities

This is clearly visible in the sharp increase in the number of 'census towns' in the 2011 census (Figure 24): the number has increased 3x in a decade. These are habitats that are not statutory towns, i.e., have no municipal body, but given population density and employment characteristics, the census classifies them as towns.

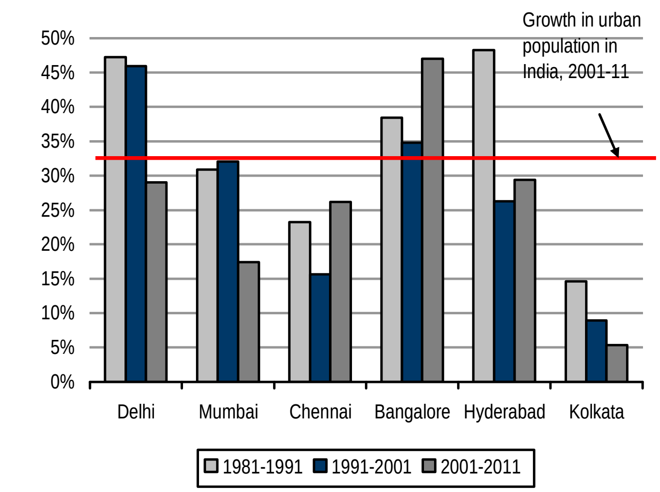
The number of 'census towns' has increased 3x over the past decade

Figure 24: Towns forming naturally



Source: India's Population Census, 2011

Figure 25: Growth in metros slower than urban growth



Source: Census Bureau of India

This is not (yet) to say that big cities will not keep growing bigger—it is just that they are too few given the size of India's population, and there are limits to geographical expansion of a city as well. Population growth in the major metros of Delhi and Mumbai in the 2001-11 decade was meaningfully lower than growth seen in the past in those areas. While central Delhi and Mumbai City stopped growing decades ago, these metropolitan centres kept growing as the surrounding districts provided space.

The big cities are just too few to cope with the expansion, and now hitting the limits of geographical size

But now limits seem to be getting hit, as with the exception of Bangalore (and possibly Delhi), population growth in these areas is lower than the overall growth in urban population in India (Figure 25). In Figure 25:

Population in all except Bangalore grew slower than India's urban population growth in 2001-11

- Delhi includes Delhi, Ghaziabad, Gautam Buddha Nagar (Noida), Gurgaon, Faridabad, Mewat and Palwal (last two carved out of Gurgaon/Faridabad last decade);
- Mumbai includes Mumbai City, Mumbai Suburban and Thane;
- Chennai includes Chennai, Thiruvallur and Kancheepuram;
- Hyderabad includes Hyderabad and Ranga Reddy districts; and
- Kolkata includes Kolkata and Howrah.

India's urbanisation is therefore likely to take a different path as compared to other emerging economies. This different form of urbanisation is still likely to deliver some of the benefits, i.e., higher per capita GDP due to higher productivity, though with natural limits, especially as it has been observed that larger cities have higher per capita GDP.

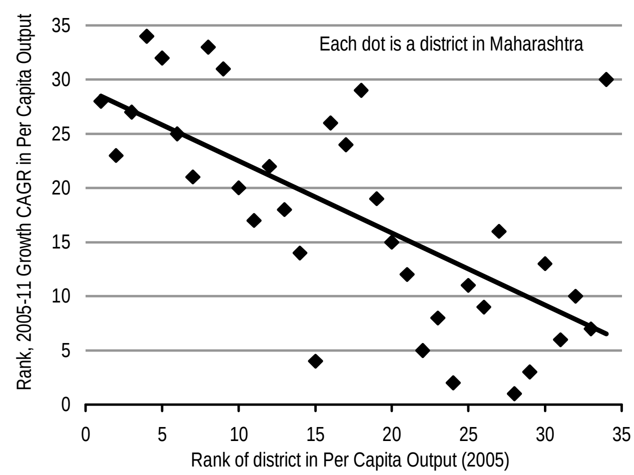
Mean-reversion: 'Rural' districts growing faster

Maharashtra publishes district-wise output details

Maharashtra (the largest state by contribution to India's GDP: 17%, and the second-largest in population) publishes district-wise output details. To our knowledge, this is the only available data with district-level granularity.

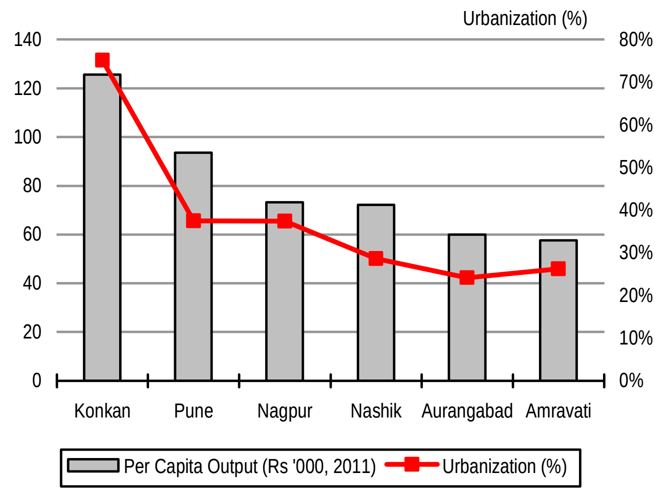
Available data in Maharashtra exhibits a sharp mean-reversion trend over the past six years: the districts with the highest per capita output are seeing the lowest relative growth rates, and vice versa (Figure 26). Given that the richest regions are the most urbanised (Figure 27), this growth profile suggests the growth is faster away from the bigger urban centres.

Figure 26: **Poorest districts growing the fastest (2005-11)**



Source: Maharashtra Government

Figure 27: **More urbanised divisions have higher output**



Source: Maharashtra Government

Roads, electricity and telephones

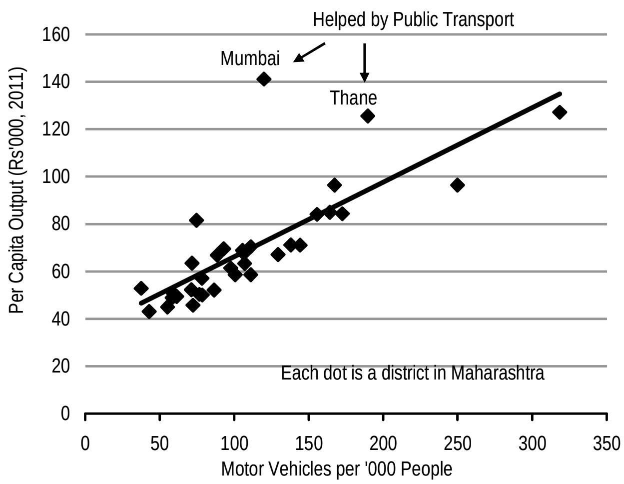
The intuitive assumption that roads, phones and electricity improve productivity can clearly be seen in district-wise data in Maharashtra

The poor state of infrastructure is one important reason why rural productivity was (and despite the catch up still is) considerably lower than the national average. Vehicles, roads and telephones shrink geographies and allow for economies of scale to develop over larger distances. Not surprisingly, districts with greater vehicle ownership also demonstrate greater per capita output (Figure 28: Mumbai and Thane have high productivity despite low vehicle ownership primarily because of higher use of public transport). Similarly, greater output is strongly correlated with electricity consumption (Figure 29) and telephone penetration (Figure 30).

The direction of causality is not the reverse as penetration is still at subsistence levels

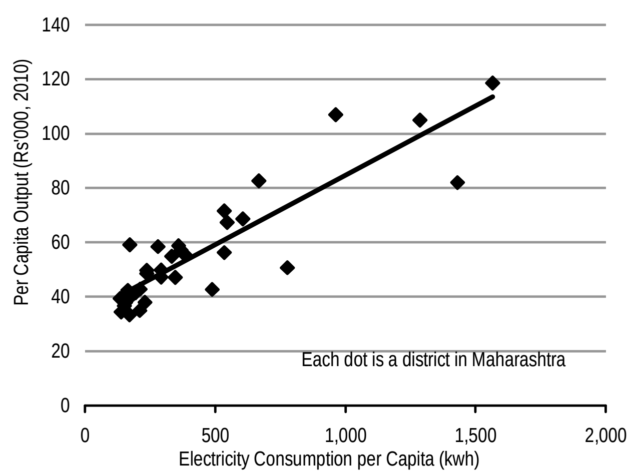
For each, an argument can be made for the direction of causality being the reverse, i.e., greater per capita output leads to greater wealth and therefore higher vehicle ownership as well as higher electricity consumption. That, in our view, is only likely when consumption of both rises beyond subsistence. At current levels, all are productivity tools, no less. The one exception was high telephone penetration in Mumbai, likely only explained by multiple connections per individual (one of the authors of this report uses four SIM cards, for example), which can be considered a luxury. Mumbai was therefore an outlier (Figure 30), and the district has been removed from this figure.

Figure 28: **District-wise vehicle ownership vs. productivity**



Source: Government of Maharashtra

Figure 29: **District-wise power consumed vs. productivity**



Source: Government of Maharashtra

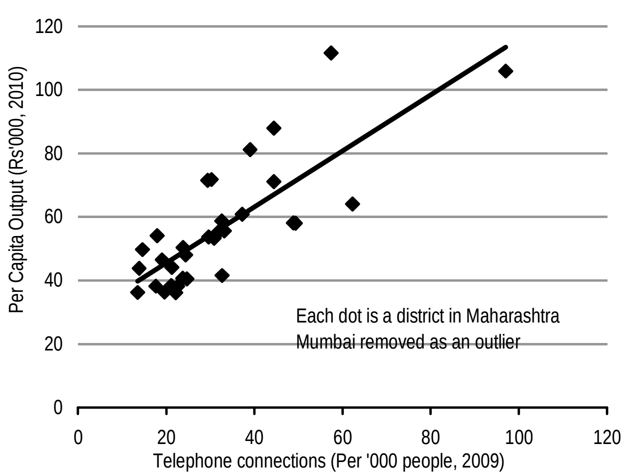
These trends, while plotted for Maharashtra here, apply to most of India, in our view. Therefore, there is likely to be a meaningful impact of the rapid strides made over the past six to seven years in electrifying villages and providing them with road connectivity. These have been primarily funded by the central schemes such as Pradhan Mantri Gram Sadak Yojana (PMGSY: Prime Minister's Rural Roads Programme), and the Rajiv Gandhi Grameen Vidyutikaran Yojana (RGGVY: Rajiv Gandhi Rural Electrification Programme).

These trends, while plotted for Maharashtra, apply to most of India

Over the past 6-7 years there has been a sharp increase in the number of habitations electrified and connected with all weather roads

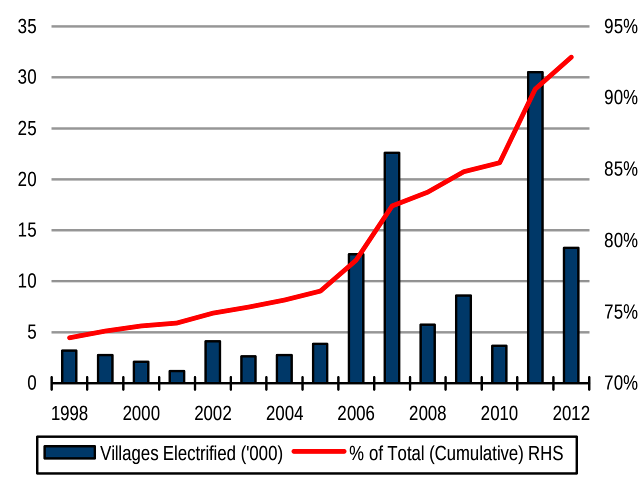
For both these schemes implementation is running behind schedule, and there are several post implementation surveys that suggest the quality of the current implementation too leaves a lot to be desired. Nevertheless, there is a significant increase in the number of villages electrified (Figure 31) and kilometres of rural roads built (Figure 32).

Figure 30: **District-wise telecom spread vs. productivity**



Source: Government of Maharashtra

Figure 31: **Sharp increase in rural electrification**

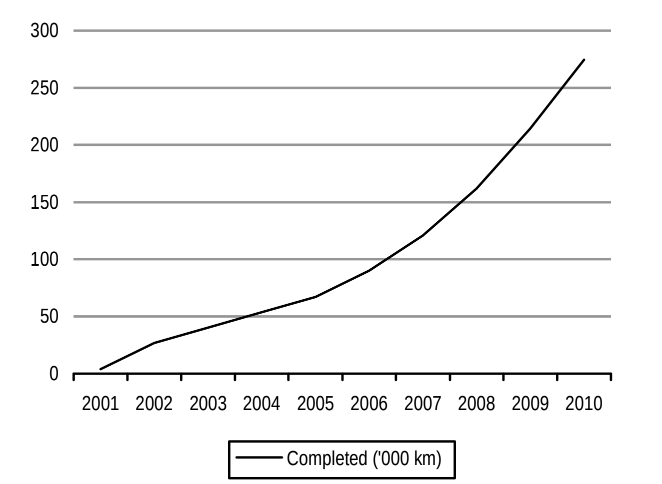


Source: Ministry of Power

More importantly, the focus of the rural roads programme has been on backward areas, e.g., states with higher proportion of habitats without all-weather roads have seen much more road construction (Figure 33). Not coincidentally, these are also states with the lowest urbanisation. These trends should continue, with sizeable allocations in the FY13 budget as well. Further, research suggests that it takes a few years for some of these developments to get fully exploited.

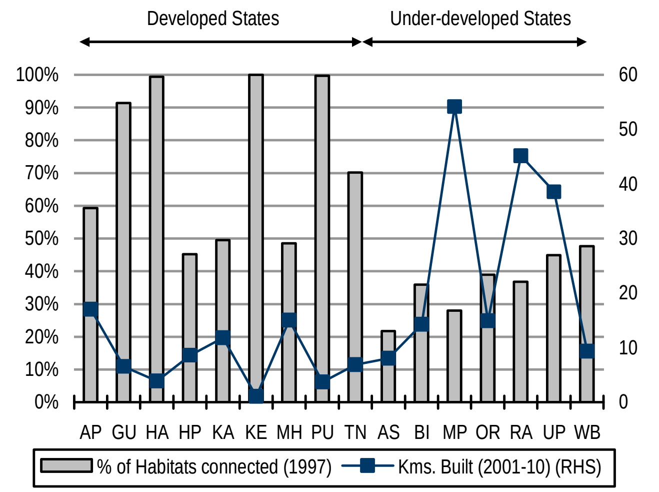
There are sizeable allocations for both centrally funded programmes in the FY13 budget

Figure 32: **Sharp increase in rural roads completed**



Source: Ministry of Road Transport and Highways

Figure 33: **Rural roads being built where they are needed**



Source: Ministry of Road Transport and Highways

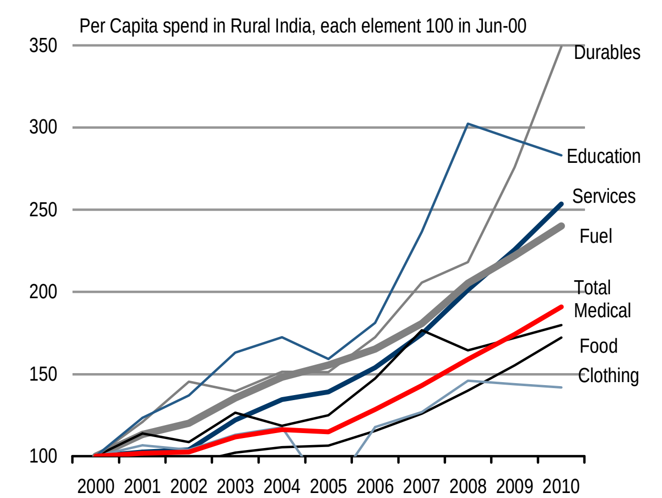
Consumption patterns changing rapidly

As habitations urbanise, jobs migrate away from agriculture and productivity growth as well as awareness gets boosted by the spread of roads, electricity and phones, incomes and consumption patterns have started to change as well.

NSSO surveys of rural consumption have been indicating a continued trend towards a more urban consumption pattern. Spending on durables, education, consumer services (entertainment, transport, etc) and fuel has grown faster than the average in the past decade (Figure 34). Durables, fuel and services in fact did not see the dip in spending growth in 2000-05 that other items saw (Figure 35), suggesting a structural change.

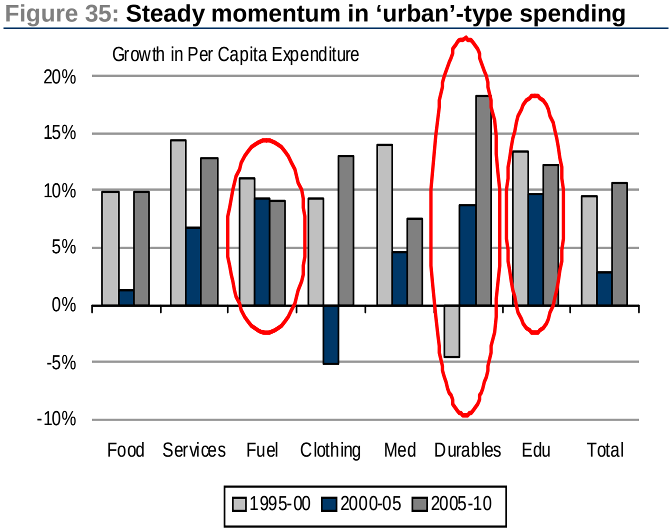
Consumption trends in rural India have been shifting sharply towards a more urban consumption pattern

Figure 34: **'Urban' consumption items growing faster**



Source: NSSO Surveys, Credit Suisse

Figure 35: **Steady momentum in 'urban'-type spending**

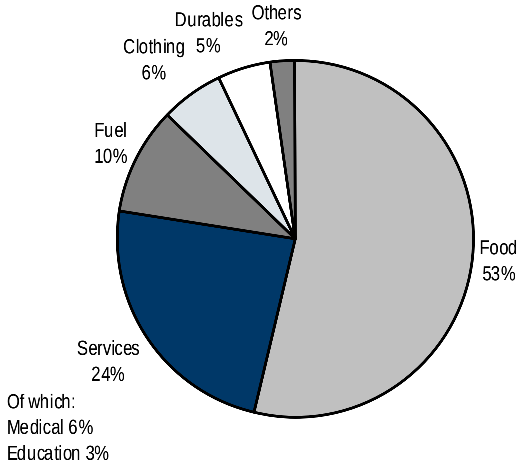


Source: NSSO Surveys, Credit Suisse

This trend has accelerated since the middle of the last decade, and there is striking resemblance between the 2010 rural consumption split (Figure 36) with that of the urban consumer in 1994 (Figure 37). Expectedly, the urban consumer has also moved on in this decade and a half, with the share of food being down to 41% in 2010, and services and durables picking up the slack. However, this similarity is important, as (1) it suggests the rural consumer is not very different from urban peer and (2) with more than 2x the urban population, 'rural' India can have a significantly higher impact on volumes.

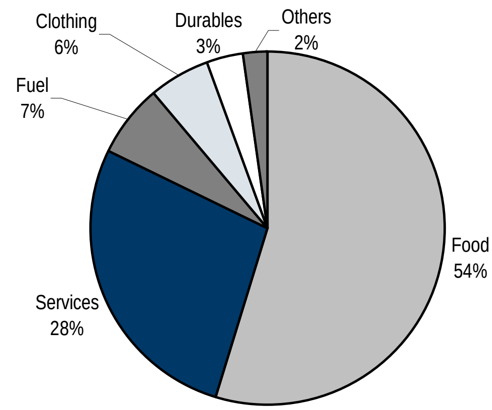
This trend has accelerated since the middle of the last decade

Figure 36: Rural consumption split (2010)



Source: NSSO Surveys, Credit Suisse

Figure 37: Urban consumption split (1994)



Source: NSSO Surveys, Credit Suisse

Banking penetration rising

Over the past few years, there has also been a manifold increase in penetration of banks in rural areas: from about 21,000 brick-and-mortar branches in early March 2010, the number increased to 138,502 outlets as of March 2012. A large number of these were banking correspondents, but have led to a doubling of no-frills accounts to close to 100 mn: in terms of reach that covers a large part of the population. In fact, the RBI had targeted 74,000 unbanked villages with population above 2,000, and 99.7% of the target has been achieved. The RBI is now framing policies to reach out to villages with population less than 2,000.

All villages with population greater than 2,000 now have banking access, as the number of no-frills accounts in villages has doubled to 100 mn over the past two years

Disconnect between market & economy

Overall consumption growth is likely to slow as the INR weakens; higher productivity growth in rural India is, however, likely to support overall GDP growth

Our broader view on the Indian economy is that consumption growth is likely to fall going forward, as a weakening INR forces an adjustment to the current account deficit by making imports more expensive. Productivity growth driven by these above developments, however, is likely to provide some structural support to the ongoing slowdown: we do not expect an acceleration, as this trend is already very much on.

Several policymakers in Delhi are confident that IIP data under-reports growth as the current sample is skewed towards larger companies. These companies are the most exposed to regulatory issues around land acquisition or environmental clearances. There is a view that once Industrial Survey data (which includes SMEs) come in, GDP growth can be revised upwards.

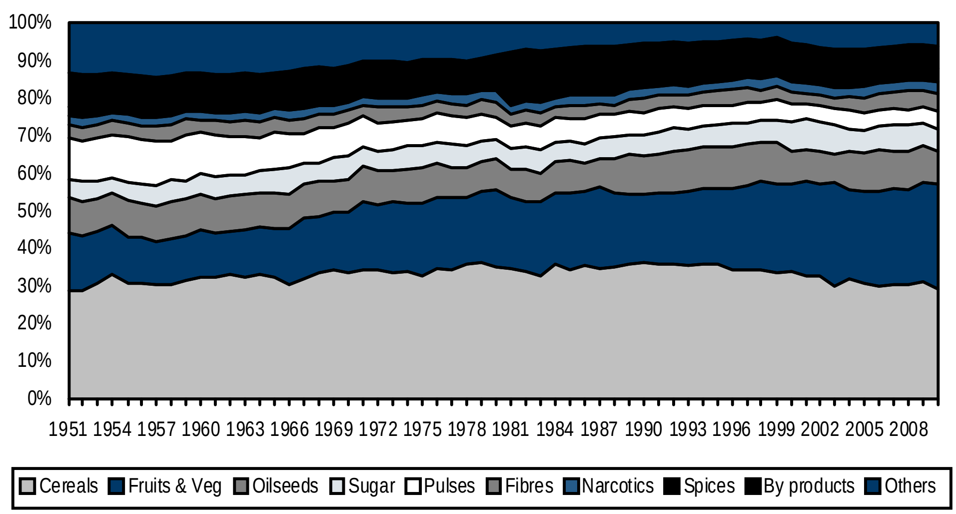
'New urban' consumption categories will outperform others

Thus, (1) consumption will continue to skew towards lower price points and 'rural urbanisation' themes and (2) urban middle classes are likely to see further pressure on their consumption due to weak job creation and persistent inflation. The 'new urban' consumption categories are thus likely to see sustained growth, i.e. two-wheelers, building materials/paints, media, tobacco, footwear, healthcare, personal products with low price points (e.g. toothpaste), etc. On the other hand, categories such as listed real estate, consumer appliances and travel agents, may see incremental weakness putting pressure on their high valuation multiples. Unfortunately, the big listed companies are in very early stages of targeting new markets, but heavily exposed to the slowing ones.

'Rural' consumption to outperform a shrinking basket

In general, parts of the economy that are seeing productivity growth are likely to do much better than the parts that are not. From this perspective the urbanising rural areas are likely to see continued income growth and therefore healthy consumption. Some items such as tobacco and building materials are likely to gain from structural shifts (Figure 39).

Figure 38: Mix of agricultural output



Source: Company data, Credit Suisse

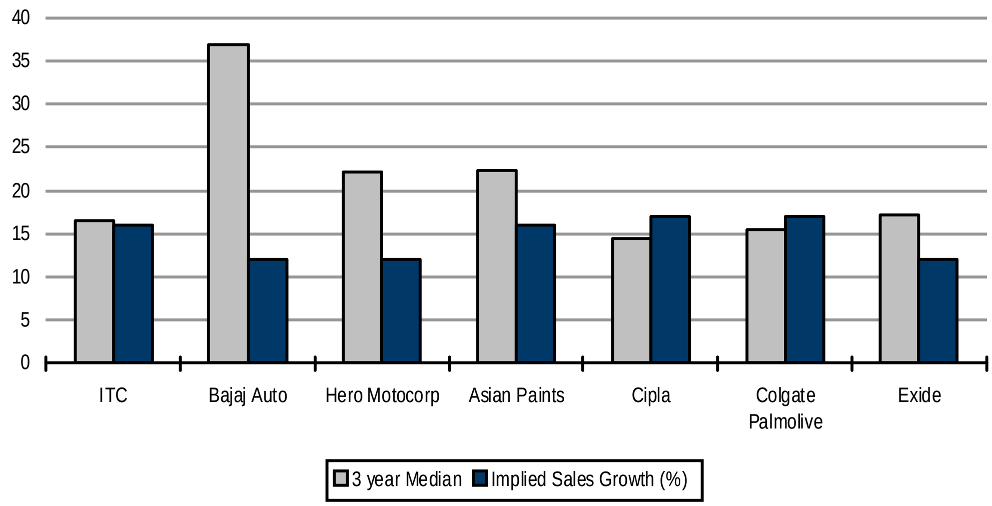
While agriculture is now a much smaller part of the rural economy, a material softening can hurt momentum. Anecdotally, there has been some concern of late about price declines seen in some agricultural commodities like onions, potatoes, cotton and some cereals. We note that these are a small part of the overall mix (Figure 38), and in fact the faster growing areas that count for agricultural GDP are fruits and vegetables (where prices have risen sharply of late after the seasonal correction late last year), and protein items such as milk, eggs and meat.

Figure 39: Some companies exposed to the 'new urban' consumption basket

Category	Company	Market cap US$ mn	Avg. daily trading US$ mn	Valuation* FY13 P/E	Valuation* FY12 P/B	CFROI (5Y hist.)	CFROI (Implied)	Performance (%) 3M	Performance (%) 6M	Performance (%) 12M
Two wheelers	Hero MotoCorp	8,239	22.66	15	11	25.27	28.80	10%	4%	23%
	Bajaj Auto	9,582	17.07	14	7.8	18.06	21.24	10%	5%	17%
Tobacco	ITC	36,423	33.20	26	10.7	17.49	20.92	20%	19%	27%
	VST Industries	581	0.38	19	9.6	15.66	21.57	58%	46%	138%
	Godfrey Phillips	773	0.15	NA	NA	11.25	10.36	30%	8%	103%
Personal products	Colgate	2,969	1.85	30	34	39.72	39.98	18%	15%	25%
	Godrej Industries	1,641	2.57	18	3.8	3.41	11.30	45%	39%	44%
	Emami	1,322	0.96	22	8	23.19	18.51	31%	12%	13%
	Bata India	1,061	7.58	29	21	8.06	18.30	46%	25%	103%
Finance	M&M Fin. Services	1,333	33.23	9.6	2.3	10.14	16.78	1%	6%	-17%
Media	Dish TV	1,273	6.68	145	33	NA	8.75	4%	-18%	-9%
Paint/chemicals	Asian Paints	6,120	5.15	27	11.5	18.76	20.28	22%	10%	29%
	Berger	768	0.34	18	5.2	13.17	10.16	21%	16%	22%
	Kansai	956	0.09	20	4.7	9.74	11.24	7%	9%	10%
	Pidilite	1,727	0.48	21	6.8	11.80	16.64	21%	12%	18%
Healthcare	Cipla	4,863	10.00	19	3.3	12.88	7.83	-6%	10%	-2%
	FDC Pharma	285	0.13	NA	NA	15.01	8.12	-7%	-12%	-24%
	Elder Pharma	129	0.58	5.9	0.95	6.91	2.41	-6%	-15%	-13%
Appliances	TTK Prestige	754	7.45	24	13.6	13.33	21.42	42%	25%	50%
	Hawkins Cookers	167	0.07	NA	NA	22.20	22.06	12%	9%	55%
Batteries	Exide	2,163	4.12	16	3.7	16.27	11.82	5%	11%	-7%
	Amara Raja	524	0.35	11	3.3	11.75	8.76	56%	55%	71%
Building products	Sintex	429	9.77	5.6	0.80	6.90	2.26	14%	-30%	-53%
	Kajaria Ceramics	251	0.47	11.9	4.6	7.17	7.43	59%	55%	121%
	HSIL	206	0.39	7.9	1.5	4.78	2.00	24%	-12%	5%
	Century Ply	261	0.05	6.8	1.7	14.67	4.58	22%	1%	-13%
Food	Hatsun	162	0.03	NA	NA	7.35	4.45	6%	10%	23%
Stationery/media	HT Media	592	0.11	13	2.0	9.18	5.41	5%	-6%	-16%
	Jagran Prakashan	607	0.29	13	4.1	10.91	8.92	1%	-5%	-19%
	Navneet Pub.	265	0.28	13	3.7	10.91	10.24	4%	-11%	-10%

*Source: RAVE, HOLT, Bloomberg, * On consensus numbers*

Figure 40: **Historical sales growth vs. implied sales growth as per HOLT**

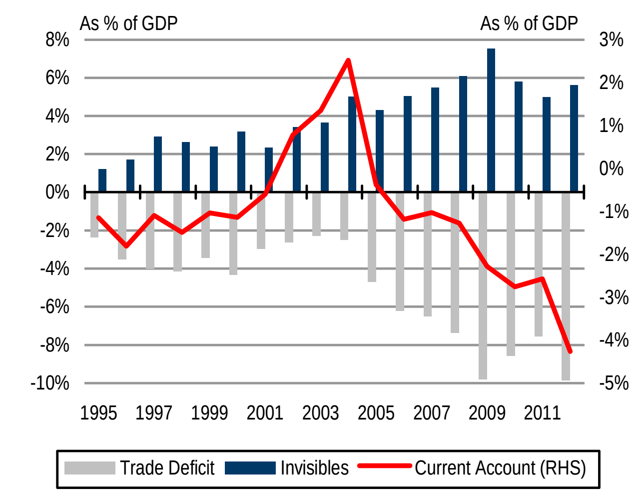


Source: HOLT

Economy over-consuming: Fall in consumption

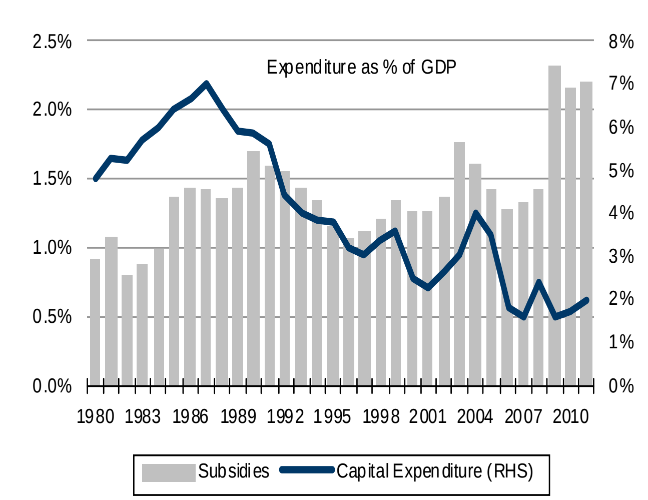
India's growing current account deficit is a reflection of over-consumption in the economy (Figure 41), particularly as investment growth remains weak. From another perspective, the RBI printing money to buy government bonds (Rs1.3 tn worth in FY12, i.e., about US$26 bn), is another signal, especially as government spending is mostly consumption-linked (Figure 42).

Figure 41: **Widening current account deficit**



Source: Company data, Credit Suisse

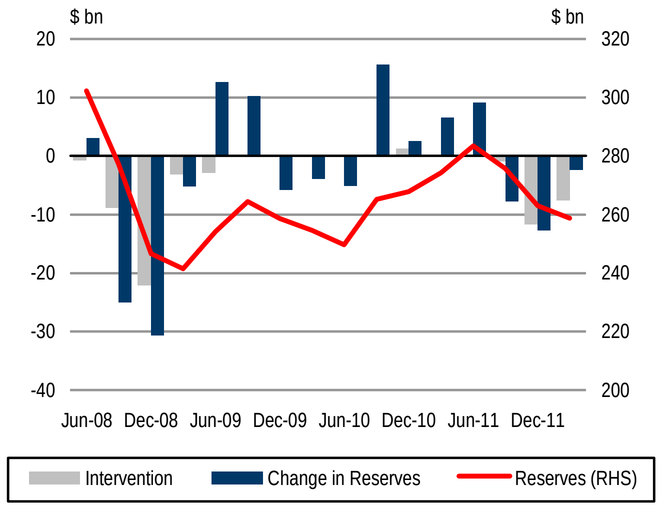
Figure 42: **Government spend only helping consumption**



Source: Government Budget documents

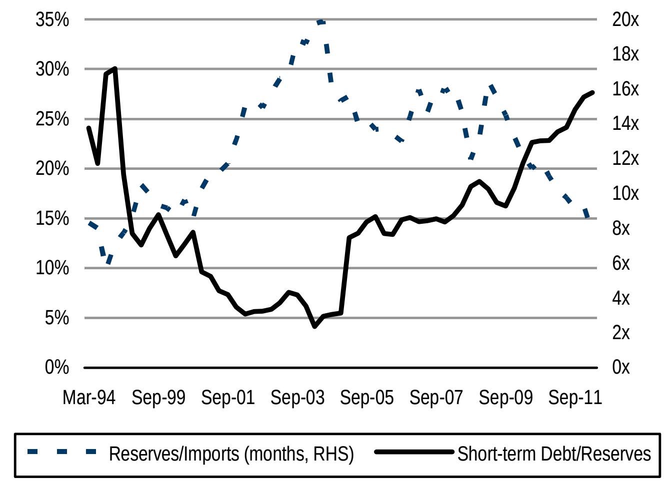
This is the primary reason for weakness in the INR. The RBI intervened meaningfully starting late last year (Figure 43), and in the process subsidised consumption, but it cannot continue doing so given limited currency reserves (Figure 44). Thus, going forward, it is very likely that the INR weakens, imports become more expensive, and consumption falls.

Figure 43: **RBI's intervention supported the INR…**



Source: RBI

Figure 44: **…but health ratios have worsened**



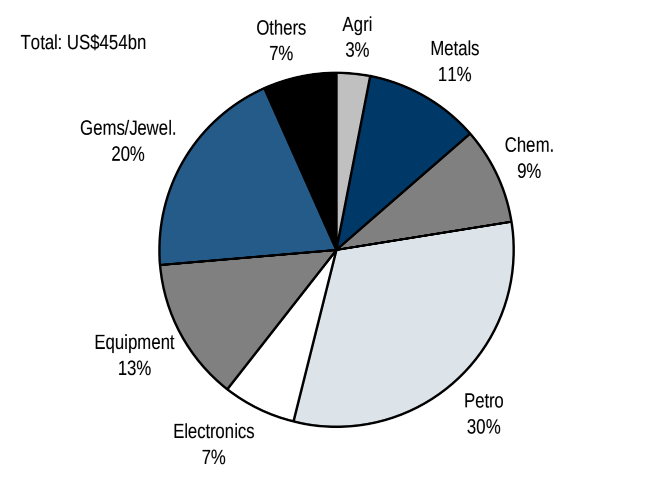
Source: RBI, Ministry of Commerce, Credit Suisse

Urban middle classes may get squeezed further

Half of India's imports are oil and petrochemicals and gems/jewellery (including gold and silver) (Figure 45). Gems/jewellery imports are either for re-export or used by people to protect their savings from inflation. Similarly, oil imports at least from the perspective of consumption volume are price insensitive as a portion is re-exported, and for the rest, government controls prices. And lastly, while capital equipment imports may get affected at the margin, a meaningful chunk does not have replacements.

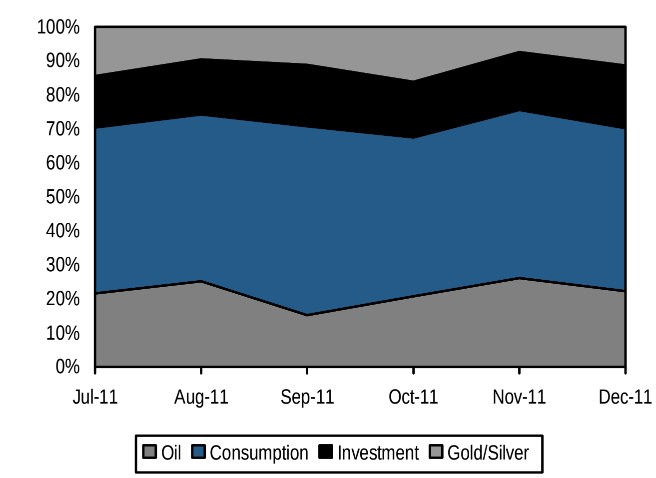
To simplify analysis, we broadly classify net imports into four categories: oil and petrochemicals, capital equipment, consumables and investments (e.g., gold). Consumables in our view are about one-third of the overall import bill (Figure 46).

Figure 45: **Split of imports in CY11**



Source: CMIE, Ministry of Commerce, Credit Suisse

Figure 46: **Real split of imports: Consumption meaningful**



Source: CMIE, Ministry of Commerce, Credit Suisse

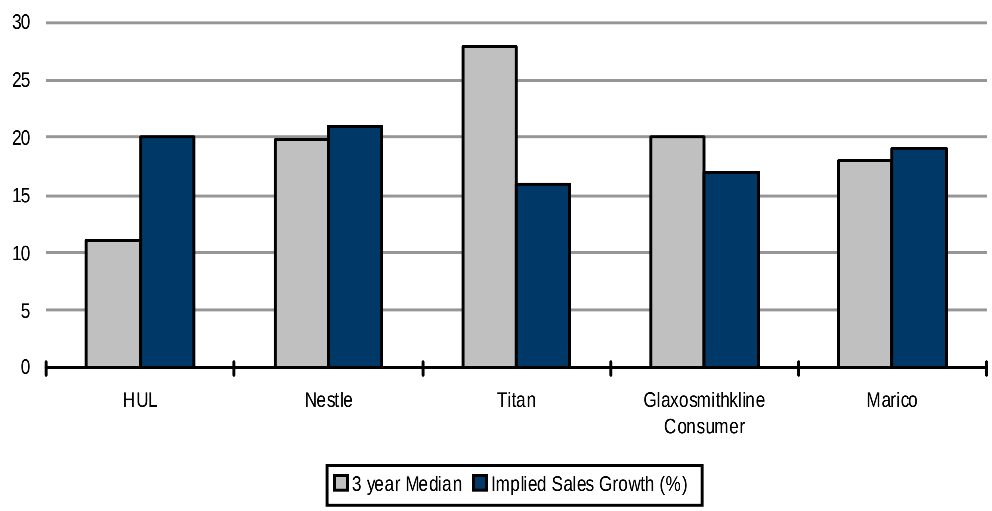
We believe the urban middle classes are the most exposed to inflation resulting from the INR's fall. This is irrespective of whether the government approves petrol/diesel price increases. The primary reason for them to get impacted is that a slowing economy is likely to curtail job opportunities/income growth for them. Some sectors and stocks that are linked to this consumption basket are detailed in (Figure 47).

Figure 47: **Stocks exposed to the consumption basket of urban middle classes**

Category	Company	Market cap	Avg. daily	Valuation*		CFROI		Performance (%)		
		US$ mn	trading US$ mn	FY13 P/E	FY12 P/B	5Y hist.	Implied	3M	6M	12M
Staples	Hindustan Unilever	17,619	21.8	31	28	28.9	32.7	10%	4%	23%
Personal products	Gillette	1,607	0.3	NA	NA	12.9	22.7	10%	5%	17%
Food	Nestle	9,207	2.8	33	27	28.3	26.6	20%	19%	27%
	Britannia	1,312	0.9	28	NA	9.9	18.2	58%	46%	138%
	Marico	2,131	1.0	27	19	19.2	16.0	30%	8%	103%
	Glaxo Consumer	2,295	1.2	23	8.9	16.7	20.6	18%	15%	25%
Appliances	Whirlpool	560	0.4	18	5.7	8.5	10.6	45%	39%	44%
	Voltas	747	6.6	14	2.6	16.1	7.0	31%	12%	13%
Retailers	Titan	4,100	17.3	29	15	14.9	21.4	46%	25%	103%
	Pantaloon	685	16.7	19	1.2	3.2	5.3	1%	6%	-17%
	Shoppers Stop	586	1.4	46	5.7	3.7	9.2	4%	-18%	-9%
	Trent	477	0.6	NA	NA	0.5	6.4	22%	10%	29%
Travel	Mahindra Holiday	467	0.1	22	NA	7.2	8.9	21%	16%	22%
	Thomas Cook	279	1.4	20	36	9.2	13.4	7%	9%	10%
Real estate	DLF	6,572	36.9	20	2.5	9.3	5.9	21%	12%	18%
	Unitech	1,470	12.6	13	0.6	12.4	3.9	-6%	10%	-2%

*Source: RAVE, HOLT, Bloomberg, * On consensus numbers*

Figure 48: **Historical sales growth vs. implied sales growth as per HOLT**



Source: HOLT

Appendix: Definitions

All that is not urban is rural

In India, the definition of 'rural' used by government departments and statistics mostly derives from that used by the Census of India. In the 2011 Census, the definition of urban area adopted is as follows (this was unchanged from the 2001 Census):

(1) All statutory places with a municipality, corporation, cantonment board or notified town area committee, etc (i.e., a statutory town).

(2) All other places which satisfy the following criteria simultaneously (a census town):

a. a minimum population of 5,000;

b. at least 75% of male working population engaged in non-agricultural pursuits; and

c. a density of population of at least 400 per sq km (1,000 per sq mile).

Definitions elsewhere not employment focused

The definition of rural as all that is not urban is similar across the world. However, urban areas are defined in the following way – noteworthy that only Russia includes employment characteristics in defining an urban area:

- **US:** Agglomerations of 2,500 or more inhabitants, generally having population densities of 1,000 persons per square mile or more. There is no categorisation on the basis of type of employment.

- **Brazil:** Urban and suburban zones of administrative centres of municipalities and districts.

- **China:** Cities only refer to the cities proper of those designated by the State Council. In the case of cities with a district establishment, depending on population density:

  - If it is 1,500/sq km or higher, the city proper refers to the whole administrative area of the district.

  - If it is less than 1,500/sq km, the city refers to the seat of the district government and other areas of streets under the administration of the district.

  In case of cities without district establishment, the city proper refers to the seat of the city government and other areas of streets under the administration of the city.

- **Russian Federation:** Cities and urban-type localities, officially designated as such, are usually based on the criteria of number of inhabitants and predominance of agricultural, or number of non-agricultural workers and their families. There are three types of urban localities:

  - Work Settlement: Population of at least 3,000 and with at least 85% of the population being workers, professionals, and the members of their families.

  - Resort Settlement: Population of at least 2,000, with at least 50% of the average annual population being non-permanent residents.

  - Sub-urban Settlement: Settlements with a focus on private summer-time and weekend recreation, with no more than 25% of the permanent population being employed in the agricultural sector.

- **UK:** Urban area is defined as a settlement with more than 10,000.

Figure 49: **Companies mentioned in the report**

Company	Ticker	Currency	CMP	Rating	Target price
Hero Motocorp Ltd	HROM.BO	INR	2193	OUTPERFORM	2245
Bajaj Auto Limited	BAJA.BO	INR	1732	NEUTRAL	1651
ITC Ltd	ITC.BO	INR	244	Not rated	Not rated
VST Industries	VSTI.BO	INR	1928	Not rated	Not rated
Godfrey Phillips	GDFR.NS	INR	3843	Not rated	Not rated
Colgate-Palmolive India Ltd	COLG.BO	INR	1143	Not rated	Not rated
Godrej Indus	GODI.BO	INR	272	Not rated	Not rated
Emami	EMAM.BO	INR	456	Not rated	Not rated
Bata India	BATA.BO	INR	857	Not rated	Not rated
MMFSL	MMFS.BO	INR	677	Not rated	Not rated
Dish TV India	DSTV.BO	INR	61	OUTPERFORM	71
Asian Paints	ASPN.BO	INR	3324	Not rated	Not rated
Berger Paints	BRGR.BO	INR	118	Not rated	Not rated
Kansai Nerolac	KANE.BO	INR	922	Not rated	Not rated
Pidilite Inds	PIDI.BO	INR	175	Not rated	Not rated
Cipla Limited	CIPL.BO	INR	319	OUTPERFORM	360
F D C	FDC.BO	INR	81	Not rated	Not rated
Elder Pharma	ELDP.BO	INR	323	Not rated	Not rated
TTK Prestige	TTKL.BO	INR	3453	Not rated	Not rated
Hawkins Cookers	HWKN.BO	INR	1634	Not rated	Not rated
Exide Industries	EXID.BO	INR	131	Not rated	Not rated
Amara Raja	AMAR.BO	INR	316	Not rated	Not rated
Sintex Ind	SNTX.BO	INR	82	Not rated	Not rated
Kajaria Ceramics	KAJR.BO	INR	179	Not rated	Not rated
Hindustan Sware	HSNT.BO	INR	163	Not rated	Not rated
Century	CNTP.BO	INR	60	Not rated	Not rated
Hatsun Agro	HAPL.BO	INR	81	Not rated	Not rated
HT Media	HTML.BO	INR	132	Not rated	Not rated
Jagran Prakshan	JAGP.BO	INR	99	Not rated	Not rated
Navneet	NAVN.BO	INR	57	Not rated	Not rated
Hindustan Unilever Ltd	HLL.BO	INR	427	Not rated	Not rated
Gillette India	GILE.NS	INR	2587	Not rated	Not rated
Nestle India	NEST.BO	INR	4914	Not rated	Not rated
Britannia	BRIT.BO	INR	572	Not rated	Not rated
Marico	MRCO.BO	INR	177	Not rated	Not rated
GlaxoSmithKline	GLSM.BO	INR	2880	Not rated	Not rated
Whirlpool India	WHIR.BO	INR	226	Not rated	Not rated
Voltas Ltd	VOLT.BO	INR	118	Not rated	Not rated
Titan Industries	TITN.BO	INR	237	Not rated	Not rated
Pantaloon	PART.BO	INR	174	Not rated	Not rated
Shopper S Stop	SHOP.BO	INR	373	Not rated	Not rated
Trent	TREN.BO	INR	918	Not rated	Not rated
Mahindra Holiday	MAHH.BO	INR	287	Not rated	Not rated
TCIL	THOM.BO	INR	68	Not rated	Not rated
DLF Ltd	DLF.BO	INR	201	UNDERPERFORM	167
Unitech Ltd	UNTE.BO	INR	29	NEUTRAL	30

Source: Company data, Bloomberg, Credit Suisse estimates

Disclosure Appendix

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