CLSA ASIA-PACIFIC MARKETS

India

Market strategy

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India
Strategy

2010 outlook

Notwithstanding the strong 81% rise in the Sensex in 2009, we see double-digit return for the market in 2010, as pick-up in the investment cycle and global recovery drive the next leg of earnings upgrades. However, 1Q will be choppy, on revival of macro concerns like inflation, monetary and fiscal tightening and the large pipeline of pending equity issuances; autos, property and power look most vulnerable. ICICI Bank, IDFC, Infosys, Sun Pharma and Tata Steel are our top BUYs.

A super 2009 doesn't preclude a healthy return in 2010

- Of the six instances of +50% annual return during the past three decades, only two – 1986 (-0.9%) and 2000 (-21%) saw negative returns in the following year.
- Accelerating GDP growth and earnings recovery – our base case for 2010 – can offset pressures from monetary tightening, as seen in 2004.
- Capital goods, Banks, Healthcare are seen to be late cycle outperformers; autos and consumers tend to underperform.

1Q looks set to be volatile…

- With the revival of macro concerns on inflation, monetary and fiscal tightening and a lull in the earnings upgrade cycle, markets can be quite volatile in 1Q.
- Analysis of previous bouts of inflation reveals that markets can withstand inflation during a recovery phase; cost push inflation in a phase of weak growth hurts.
- CLSA sees rising WPI inflation in 1Q leading to CRR, reverse repo rate hikes.
- While the market is anticipating tightening in monetary policy, surprises on the degree and timing of policy actions could be a source of volatility.
- A +US$10bn equity pipeline, excluding targeted US$5-6bn of government disinvestment, will also weigh on performance in 1Q.

… but the next leg of recovery will also unfold

- The recovery in consumption is on track and will be supported by improving hiring trends. Investment growth has, however, lagged.
- Capex intentions are rising and project starts in roads, power should get the cycle going. RBI's recent measures will help reduce cost of financing infrastructure.
- With over 70% of Sensex earnings linked to investment upturn and global recovery, the earnings upgrade cycle should resume in FY11.

Sector stance and top picks

- Our 12m target for the Sensex is 19,250, which assumes no re-rating from the current P/B multiple, given the expected rise in risk free rates.
- Industrials, IT and materials which play into the second leg of the recovery are key O-WTs; Consumer discretionary (Autos), Power and Energy key U-WTs.
- Our top BUYs are ICICI Bank, IDFC, Infosys, Sun Pharma and Tata Steel.
- Biggest U-PF/SELLs are DLF, NHPC, Ambuja Cement and Tech Mahindra.

Top buys and sells

	Mkt cap	P/E		P/B		RoAE	Perf	
	(US$-m)	FY10	FY11	FY10	FY11	FY11	3-m	Reco
Top Buys								
ICICI Bank	21,027	24.4	19.8	1.8	1.7	7.9	(5)	BUY
IDFC	4,306	19.8	17.1	2.6	2.2	15.9	(0)	BUY
Infosys	32,203	24.3	21.0	5.4	4.4	28.5	12	BUY
Sun Pharma	6,690	26.5	20.4	3.4	2.9	17.6	8	O-PF
Tata Steel	11,809	41.2	9.7	1.7	1.4	19.6	21	BUY
Top Sells								
DLF	13,210	27.9	23.5	2.3	2.1	10.2	(18)	SELL
Ambuja Cement	3,404	13.0	15.2	2.1	1.9	14.7	1	U-PF
Tech Mahindra	2,610	19.8	19.6	3.9	3.2	22.1	5	SELL

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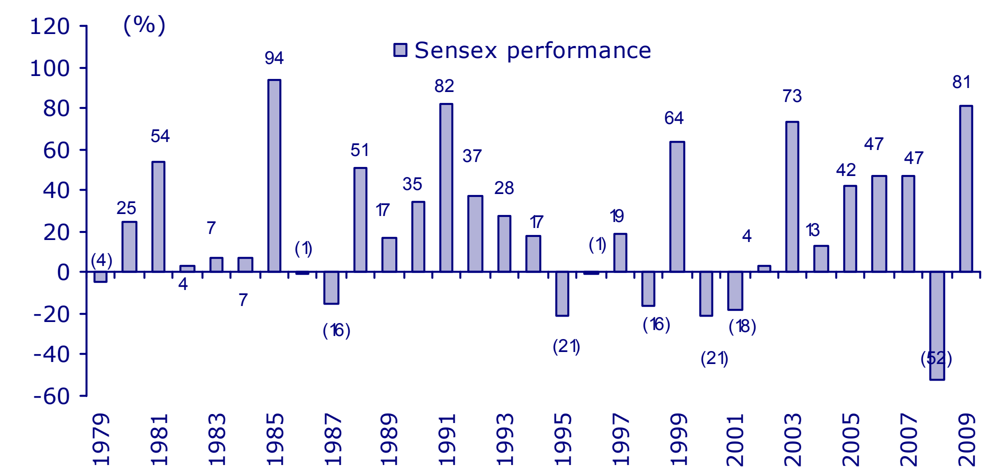
A super 2009, but room for more upside

2009 was the third best year for the Sensex in the last three decades

In 2009, the Sensex has risen 81% (89% in US$ terms), implying that 2009 could go down as the third best year for the Indian market over the last three decades. From the start of the rally in early March-09, the run has been fairly steady with 0.63% return in 1Q, 49.3% in 2Q, 18.2% in 3Q and 5.4% in 4Q. For the year, the USD denominated MSCI India Index was up 100%, outperforming the MSCI World Index by 73ppt and also beating performance of the MSCI Asia ex-Japan and EM Indices by 24-32ppts.

Figure 1

Sensex returns over the past three decades



Source: Bloomberg, BSE, CLSA Asia-Pacific Markets

History shows that in 4/6 years of exceptional performance, there was +ve return in the subsequent year as well

The strong performance in 2009 may itself raise question marks on the outlook for 2010, given the stock market's tendency to discount ahead. However, we see that of the six instances of +50% annual return for the Sensex over the past 30 years, there were negative returns in the subsequent year in only two cases – 1986 (-1%) and 2000 (-21%, the year when global markets sold off following the burst of the technology bubble).

Figure 2

Index returns, growth and interest rates across years

	Price performance (%)			Growth (%)		Rates, monetary stance	
	Sensex	MSCI World	MSCI Ind (US$)	Sensex EPS	Nominal GDP	Bond yld (%)	T/E/S
1989	16.9	14.0	NA	34.9	17.0	10.0%	T
1990	34.6	(17.5)	NA	31.9	16.8	10.8%	T
1991	82.1	10.9	NA	19.7	14.9	10.8%	S
1992	37.0	(1.0)	NA	38.0	14.9	11.7%	S
1993	27.9	18.6	NA	30.3	15.0	13.1%	S
1994	17.4	2.8	9.0	(30.4)	17.3	12.6%	E
1995	(20.8)	18.4	(31.5)	9.4	17.3	13.4%	T
1996	(0.8)	12.1	(4.2)	12.9	15.7	13.9%	S
1997	18.6	14.6	9.4	(3.1)	10.8	12.3%	E
1998	(16.5)	22.8	(22.9)	20.3	14.7	12.3%	T
1999	63.8	23.4	84.7	8.6	11.5	11.9%	E
2000	(20.6)	(13.9)	(22.8)	10.4	7.7	11.1%	E
2001	(17.9)	(17.8)	(21.2)	26.3	8.4	9.6%	E
2002	3.5	(21.1)	5.9	23.5	7.7	7.3%	E
2003	72.9	30.8	73.9	33.9	12.2	5.7%	E
2004	13.1	12.8	16.5	21.5	14.3	5.8%	T
2005	42.3	7.6	35.4	31.0	13.7	6.9%	S
2006	46.7	18.0	49.0	16.1	15.3	7.6%	S
2007	47.1	7.1	71.2	11.5	14.4	7.9%	T
2008	(52.4)	(42.1)	(65.1)	10.9	14.2	7.9%	E
2009	81.0	26.9	100.5	(3.2)	6.0	6.8%	E

Source: CLSA Asia-Pacific Markets. Stance: T=tightening, E=easing, S=stable. Bond ylds are avg for year

+ve growth momentum drives the market, even in phases of tightening

What is apparent from Table 1 is that economic recovery and strong earnings are enabling factors for reasonable market returns even after a period of exceptional appreciation in equity indices. This is best reflected in the strong performance of the market in 1992 (+37%) and 2004 (+13%), which were also periods of rising bond yields/tightening in monetary policy. In fact, strong performance continued for three years following 2004, despite rising rates and some bouts of monetary tightening.

Autos, metals recover early in the cycle, but cap goods, banks can see extended outperformance

We have looked at sector performance during the 2002-04 period to discover patterns, if any, of relative performance during periods of recovery. A comparison of 2009 with 2003 – the first year of the recovery in that cycle - shows that metals and autos are among the strongest performers in that phase. In 2004, as the recovery gathered momentum, capital goods and banks continued to outperform, even as autos and consumer staples (FMCG) underperformed. On our expectation that the investment cycle will pick-up in FY11, it would intuitively appear that the pattern should repeat in 2010.

Figure 3

Relative performance of sectors during the recovery phase

	Outperformance/(Underperformance)				
	2002	**2003**	**2004**	**2008**	**2009**
BSE Auto	31	77	(1)	(4)	123
BSE Capital Goods	45	95	15	(13)	23
BSE Consumer Dur	15	20	(5)	(20)	17
BSE Healthcare	(1)	23	10	20	(12)
BSE Metal	59	139	1	(22)	153
BSE Oil & Gas	69	54	(14)	(2)	(8)
BSE Bank	25	36	20	0	3
BSE IT	1	(49)	13	2	52
BSE FMCG	(15)	(37)	(18)	38	(41)
Sensex absolute perf	**3.5**	**72.9**	**13.1**	**(52.4)**	**81.0**
Real GDP growth*	**3.8**	**8.5**	**9.1**	**6.7**	**6.3**

Source: Bloomberg, CLSA Asia-Pacific Markets * for the fiscal Y/E March in the following year

1Q looks set to be volatile…

Policy stance has remained easy all through 2009…

Along with many other markets around the globe, the Indian market has benefited from easy monetary policy and fiscal stimulus being maintained through most of 2009, though the Reserve Bank of India (RBI) started to caution on inflationary pressures as early as Jul-09 and declared the need for an earlier 'exit' for India vis-a-vis most developed economies. A benign macro environment and steady earnings upgrades have helped sustain the rally.

… but concerns on inflation and consequent tightening will regain centrestage

Monetary policy stance set to reverse

However, heading into 2010, we see concerns on macro variables like inflation and monetary and fiscal policy tightening regaining centre stage. Headline WPI inflation has started accelerating, with YoY numbers reflecting the wear off of the global commodity induced high base of mid-2008. YoY WPI inflation rose to 4.78% in Nov-09, from 1.34% in Oct-09, implying 9.8% rise in prices on a QoQ annualised (and seasonally adjusted) basis, led by primary articles, particularly food. While we do see further rise in YoY inflation due to the base effect and also expect a pick-up in inflationary pressures as the recovery gains momentum, demand-pull inflation has been muted; airline fares remain under pressure despite pick-up in demand, the rise in hotel tariffs has been muted and auto companies too appear reluctant to raise prices to protect margins.

Figure 4

WPI inflation rising sharply

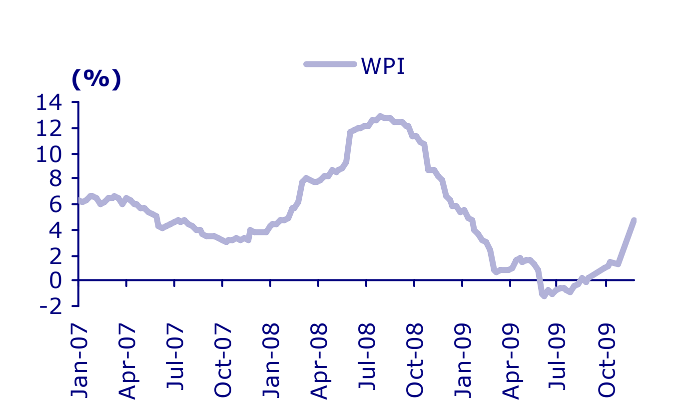
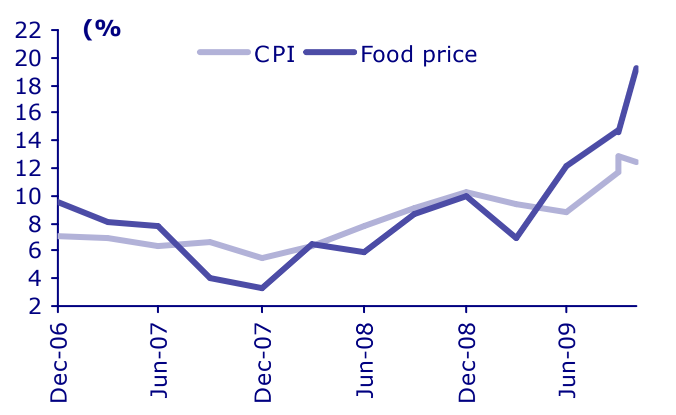


Figure 5

CPI has remained high, driven by food prices



Source: Bloomberg, RBI. CLSA Asia-Pacific Markets

We see monetary tightening from 1Q 2010

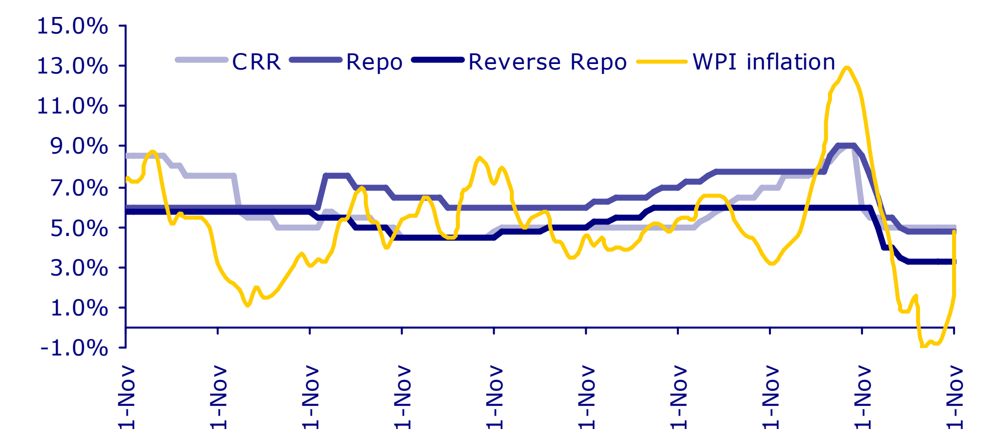
However, sustained high CPI inflation (12.4% YoY in Sep-09 and in the 8-10% range since March 2009), led by 10-19% YoY rise in food prices will, in our view, invite action from policy makers. Although much of the CPI inflation arises from supply-side issues, the RBI is concerned about inflation expectations building-up due to prices having remained at elevated levels for a fairly long period; rise in food prices, in particular, is a very 'visible' manifestation of inflation since it has a high share of the consumption basket for most households and is a politically sensitive subject.

Uncertainty on timing, degree of actions will lead to volatility

CLSA Economics expects hike in cash reserve ratio (CRR) for banks and 2ppt increase in reverse repo rates between now and end-FY11, with the first steps being taken in the Jan-10 monetary policy review.

Figure 6

Trend in key policy rates



Source: RBI, Bloomberg, CLSA Asia-Pacific Markets

Markets can shrug off inflation if growth signals are positive

Rising inflation does not per se imply weak equity markets since it could also be viewed as evidence of a stronger growth momentum and thus likely upgrades to earnings forecasts. During the four cycles in this decade when inflation rose significantly, we found that the Sensex continued to return 16-17% when growth was strong; however, on the two instances when a weak economy was faced with supply-side inflation, the market lost 17-22% during the period. While there is no clear trend across sectors, it does appear that consumer staple stocks underperform during periods of demand-pull inflation, despite the perceived high pricing power of the underlying companies. For the purpose of this exercise we have avoid YoY inflation data (given that they primarily reflect history) and used annualized 6m changes in the inflation index to better reflect inflationary trends.

Consumer staples underperform during periods of demand pull inflation

Figure 7

Performance of sectors during periods of inflation

	CYCLE 1	CYCLE 2	CYCLE 3	CYCLE 4
Relative returns (%)	**Feb 02-Apr 03**	**Oct 03-Feb 04**	**Apr 06-Jan 07**	**Sep 07-Jun 08**
BSE Auto	14.1	11.7	(17.6)	(10.6)
BSE Capital Goods	55.9	3.5	(9.4)	(9.2)
BSE Consumer Dur	18.8	(4.1)	(7.1)	(5.5)
BSE Healthcare	8.9	(0.4)	(19.3)	32.2
BSE Metal	39.9	(1.7)	(30.8)	16.9
BSE Oil & Gas	39.9	6.1	(0.4)	16.4
BSE Bank	34.4	(0.7)	21.4	(15.4)
BSE IT	(18.6)	(3.8)	14.3	9.0
BSE FMCG	(10.2)	(5.2)	(34.6)	18.4
BSE SENSEX perf	**(16.9)**	**15.5**	**17.0**	**(22.1)**
Inflation move	1.6 to 7.1%	2.4 to 8.5%	3.3 to 7.1%	1.8 to 15.8%

Source: CLSA Asia-Pacific Markets

The FY11 Budget should clearly signal fiscal tightening as well

Fiscal stimulus – unwinding should happen in the FY11 Budget

We expect the Finance Minister to roll back the cuts in excise duties (4-6ppt) and service taxes (2ppt) that had been announced during Dec08-Jan09 as part of the government's 'stimulus' package in the FY11 Budget in Feb-10, with some steps possibly coming through earlier. This will bring about some uncertainty on the outlook for demand and margins – depending on whether companies decide to pass on the impact of the higher tax burden on ex-factory prices to consumers. We are already seeing evidence of an exit from the loose fiscal policy stance, with the government committing to new expenditure programmes only if there is a corresponding saving in an existing scheme and also calling for a 10% cut in expenses on travel, publicity and administrative expenses per 'austerity measures' announced in Sep-09.

Risk is that of volatility – due to surprises on degree/timing of policy actions

Thus the key risk to the market will be that of volatility, on any surprises on the degree and/or timing of policy actions, even if markets are anticipating tightening in monetary policy. With the demand outlook in the OECD still somewhat fragile and the domestic investment cycle too yet to take off, the markets will have to contend with alternate bouts of "inflation scare" as well as "growth scare".

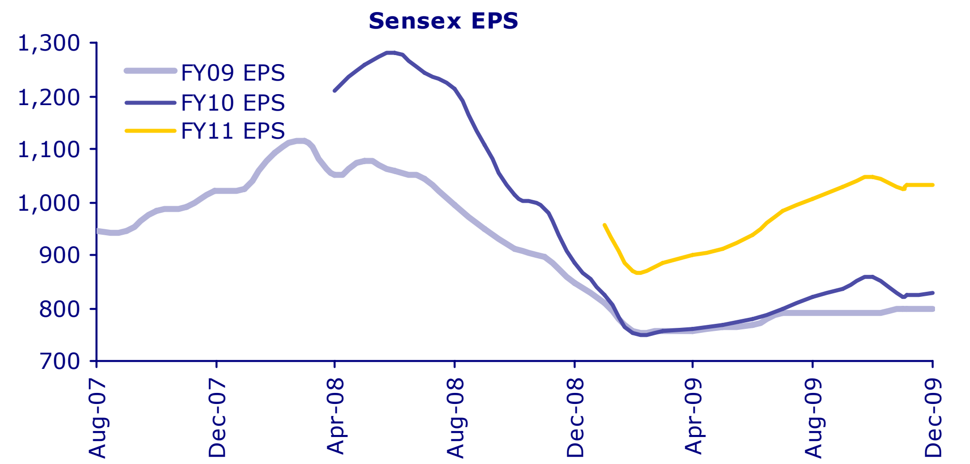
Earnings upgrades have leveled off

After 8 mths of steady upgrades, we see a lull

We also see little support to the market from earnings upgrades in the early part of the year. In fact, the momentum in earnings upgrades has already levelled off; after a phase of steady upgrades for eight months, mixed trends in earnings revisions have brought our FY11 Sensex EPS forecast below the end-Oct value. FY10-F11 forecasts for Sensex EPS are now 1.3-3% off the peak, albeit still 9-19% above the Feb-09 low.

Figure 8

Moderation in earnings growth momentum



Source: CLSA Asia-Pacific Markets

Some sectors seeing cuts, but deceleration in upgrades across the board

Aggregate earnings for the CLSA Universe has seen moderation in growth momentum with FY10 and FY11 earnings revised marginally upwards between September to December 2009. While cuts in earnings for heavyweights like Reliance Industries, Bharti Airtel and Reliance Communication has been a key driver (14-19% cut in Telecoms FY10-11 EPS since end-Sep; 3-4% for Oil & Gas) for this, about a quarter of our universe of 88 large-cap stocks have seen earnings cuts. In sectors like capital goods, cement, metals and property, there is a visible de-celeration in the momentum of earnings upgrades.

Figure 9

Earnings revision across sectors

	FY2010CL (% chg)		FY2011CL (% chg)	
	Mar-Sep	**Sep-Dec**	**Mar-Sep**	**Sep-Dec**
Telecoms	2.5	(13.8)	1.7	(19.4)
Oil & Gas	5.8	(3.8)	5.8	(2.7)
Consumer	0.6	(0.3)	0.6	0.6
Power	22.9	(0.0)	15.8	10.4
CLSA universe	**15.1**	**0.8**	**17.8**	**0.3**
Capital Goods	16.2	1.1	21.7	0.7
Others	NA	1.2	NA	(0.0)
Financial services	8.1	1.3	9.3	0.7
IT	17.7	3.7	25.6	3.9
Pharma	(2.3)	6.0	(2.2)	10.1
Cement	40.7	6.4	49.4	7.2
Media	34.1	7.2	40.6	10.4
Metals	69.6	9.2	78.6	0.2
Automotive	34.4	20.7	62.5	21.2
Property	69.4	21.3	66.6	10.1
Sugar	(7.7)	34.8	(3.9)	25.5

Source: CLSA Asia-Pacific Markets

Autos, consumers, telecoms have downside risk; only metals, sugar, IT can still see upward revisions

We see highest risk of a quick reversal in earnings momentum for autos, as the combination of tightening in monetary policy and withdrawal of fiscal stimulus poses a risk to FY11 passenger vehicle demand: escalation of costs on account of emission related improvements, stronger input prices could lead to margin pressures as well. Consumer stocks could also see earnings impacted by rising input cost and pressure on A&P spend. The ongoing tariff war in the mobile segment suggests risk of further downside to forecast FY11 earnings for telcos. On the other hand, we see potential for continued earnings upgrades in metals, IT and sugar.

Figure 10

Earnings outlook

Sector	FY11CL EPS growth (%)	3m chg in FY11 EPS (%)	Earnings outlook	Comments
Automotive	40.7	21.2	Downside	Tightening in monetary policy, withdrawal of fiscal stimulus pose a risk to FY11 passenger vehicle demand. While rising competition and higher raw material prices present are a risk, better-than-expected volumes for Bajaj Auto and M&M's tractors division could result in some upside for these stocks. Tata Motors earnings could see some upside from better-than-expected volumes/margins at JLR
Capital Goods	24.6	0.7	Downside	Raw material cost correction already factored in the margins; key risk to our view is better than expected execution on projects
Cement	(20.7)	7.2	Downside	While we are modelling in a 9% correction in cement prices already, there remains a further downside risk considering sharp corrections witnessed in the markets of south in the last few months which were more than our estimates. Cost pressures and a potential reversal in excise duty benefits remain a further headwind.
Consumer	17.4	0.6	Downside	While we are modelling in a stable margins in FY11 on a YoY basis along with continued volume growth momentum. Inflationary pressures and higher A&P expenses on the back of increased competitive activity are risk to our estimates
Financial services	9.4	0.7	Downside	PSU banks: Negative: Increase in NPL coverage to 70% and new salary hike/ pension agreement, fall in treasury gains (19% of PBT in 1HFY10). Private banks: Positive: Likely pick-up in loan growth and moderation in delinquencies
Pharma	53.4	10.1	Upside	We expect reported earnings for the sector to be upgraded as a number of potential exclusivities translate to launches. Growth in core earnings for the sector remain steady though rupee appreciation will impact negatively
Media	16.6	10.4	Upside	While we factor in mid-teen ad revenue growth; media companies can record both ad volume as well as ad price increase posting higher than expected gains
Metals	58.6	0.2	Upside	Mothballing of TCP could result in some upside to our Tata Steel estimates. Current spot aluminium and zinc prices are higher than our FY11 forecasts, and could lead to an earnings upside for non-ferrous metal companies.
Oil & Gas	22.4	(2.7)	Upside	Some downside to FY10 downside for Reliance on account of slower gas ramp-up, weaker GRMs. Lower subsidy sharing could result in upside for R&Ms.
Power	9.9	10.4	Upside	Tata Power can see earnings upsides if the coal prices remain strong going into next year
Property	20.1	10.1	Upside	Commercial property recovery may be faster, given the pick-up in the broader economy. Rebound in IT business, low mortgage rates support strong volumes.
IT	16.1	3.9	Upside	We continued to see upward bias to our earnings driven by deal flows which should take the volume growth of the sector above 20% for FY2011
Telecoms	7.5	(19.4)	Downside	Even as mobile net additions remain ahead of estimates MoU's and Arpu's are under high pressure with the step-up in competition particularly from CDMA players expanding GSM services.

Source: CLSA Asia-Pacific Markets

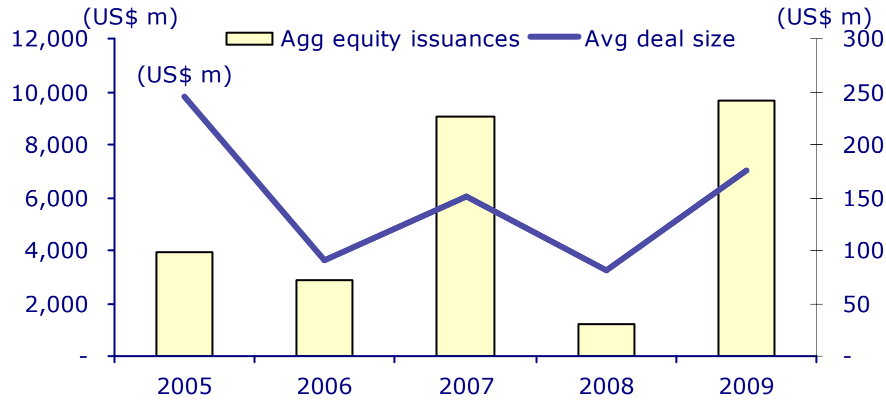
The equity pipeline is well over US$10bn, even after a record US$9bn raised in 2009

The equity pipeline remains high

The pick-up in capital market activity since mid-year has resulted in a record level of equity issuance in 2009. However, a number of issues remain pending and are likely to hit the markets in early 2010. With the government disinvestment programme too set to pick-up in 2010 and issuances from NTPC, Sutlej Jal Vidyut Nigam and REC targeted to be completed before Mar-10, the potential equity pipeline for 1Q 2010 looks to be well over US$10bn.

Figure 11

Equity issuances – a new record in 2009



Source: Bloomberg, SEBI, CLSA Asia-Pacific Markets

Many large offerings planned in the Power, Property sectors

In terms of capital being raised, there is a concentration of issues from the power and property sectors, where private developers are kicking off large projects. However, filings with the regulator reveal that the pipeline extends well beyond this, although many of the issues outside these sectors are relatively small in size.

Figure 12

Significant equity issuances* in the pipeline

Company	Value Rs bn
Jindal Power	72
Sterlite Energy	51
Emaar MGF Land	39
Reliance Infra Tel	30
Sahara Prime City	30
Godrej Consumer Products	29
Lodha Developers	28
GMR	23
JSW Steel	23
Ananth Raj	20
Omaxe	17
Jaypee Infratech	17
DB Realty	15
Adani Ent	14
Ansal Properties	14
Yes Bank	12
Ambience	11

Source: CLSA Asia-Pacific Markets * IPOs/FPOs/QIPs. Based on public filings/enabling resolutions

Large PSU disinvestments planned; c.US$5-6bn targeted for the remainder of FY10

The government has laid down a policy on disinvestment, which envisages listing and disinvestment of at least 10% stake in profit-making Central Public Sector Undertakings (CPSUs). A list of about 30 companies has been shortlisted based on discussions with the administrative ministries. While issues relating to corporate structure and employee unions will need to be resolved in some cases, the government is keen to push ahead with follow-on offerings of 5-10% stake in large listed PSUs like NTPC, Satluj Jal Vidyug Nigam, REC and NMDC even before the end of the fiscal year (Mar-10).

Figure 13

Some key PSU disinvestments being targeted

Company	Listed/ unlisted	Likely stake sale (%)	Value of stake (Rs bn)
NTPC*	Listed	5%	80
REC*	Listed	20%	35
Satluj Jal Vidyut Nigam*	Unlisted	10%	12
NMDC	Listed	8%	120
SAIL	Listed	10%	100
BSNL	Unlisted	10%	150
MMTC	Listed	9%	150
Coal India	Unlisted	10%	100
Total			**747**

Source: CLSA Asia-Pacific Markets * Targeted pre Mar-10

... but next leg of recovery will also unfold

Recovery in consumer spending is well underway...

Data on the broader economy, trends in sales of consumer products and anecdotal evidence confirm the recovery in consumer demand. The exceptionally strong 7.9% YoY growth in real GDP in 2Q FY10 did reflect stronger than expected consumption growth (6% YoY); auto sales (up 38% YoY for cars, 18% for 2-wheelers and 41% for CV segment in Nov-09) and production indices for consumer goods (up 21% YoY for Oct-09) remain buoyant.

Positive employment indicators

... and improving employment prospects will support this

While the failure of the monsoon in the 2009 (rainfall deficit of 23%, which will likely result in -2% agri GDP growth) will have some dampening impact on rural consumption growth, the improving employment scenario will drive stronger growth in consumption in urban India. All sectors where net hiring was hit by the downturn, whether due to high export dependence (IT, textiles, gems & jewellery) or high dependence on external capital (property, financial services, retailing) have seen a revival in hiring. The Naukri JobSpeak Index, run by India's largest job portal, has been rising for 5 of the past 6 months and is up 12.3% from its low.

Figure 14

Naukri Index shows signs of recovery in hiring ...

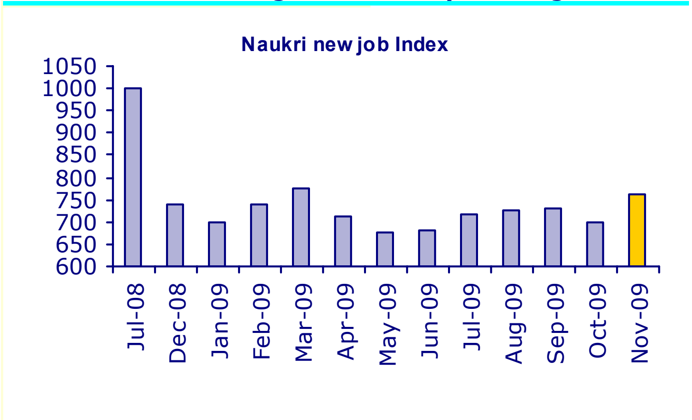
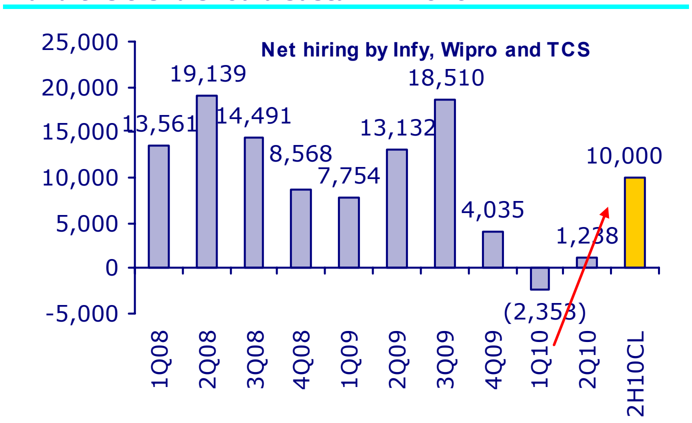


Figure 15

...and the trend should sustain in 2010



Source: Company, CLSA Asia-Pacific Markets

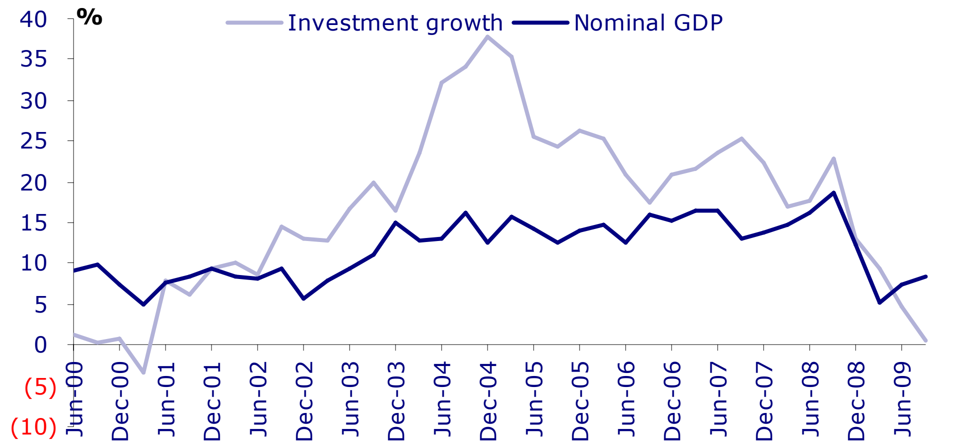
The capex cycle should get underway

Investment has, however, remained sluggish

In our view, the rebound in GDP growth in FY10 reflects the recovery of the Indian consumer as well as the impact of government's stimulus policies and the relief on the import bill. The revival in consumption is clearly seen in buoyant sales of autos, consumer durables and revival in leisure and travel sectors. On the other hand, growth in investment spending (1.9% YoY in 2Q FY09, in real terms) has continued to trend down even as consumption growth (6% YoY) and overall GDP growth (7.9% YoY) have picked-up.

Figure 16

Investment growth has lagged overall GDP growth by 2-3 quarters



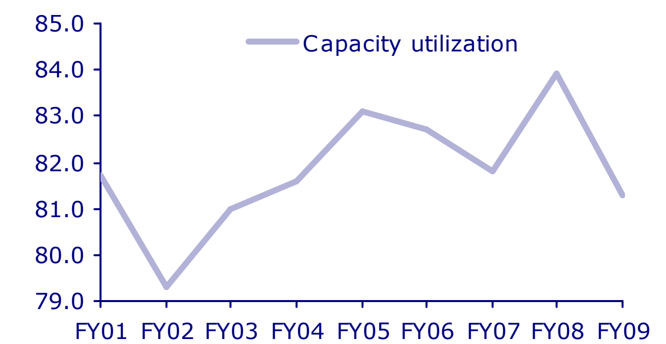
Source: Bloomberg, RBI, CLSA Asia-Pacific

We see enabling conditions for an upturn in corporate capex

A review of previous cycles suggests that the investment upturn lags overall GDP by 2-3 quarters. While we sense a higher degree of caution among corporates this time around, which we see as the scars of the sharp downturn in 2008, we still see enabling conditions for an uptrend in investment to be in place by 1H 2010 – driven by a revival in corporate capex as well as infrastructure project starts. With improving end-user demand, over 80% capacity utilisation across most major industries, relatively low corporate gearing and interest rates a little below the ten-year average, capex plans should come to fruition fairly soon.

Figure 17

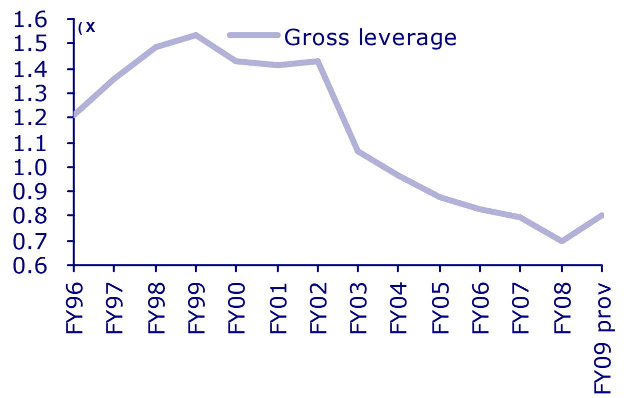
Aggregate capacity utilization remains above 80%



Source: RBI, CLSA Asia-Pacific Markets

Figure 18

Aggregate gross leverage has substantially reduced



Source: CMIE, Capital Line, CLSA Asia-Pacific Markets

SMEs are signalling intent to start investing

The signals from small and medium enterprises (SMEs) are encouraging. 55% of SMEs polled in our quarterly survey in late-October 2009 are looking to undertake capex in the next six months; in April, this number was just 34%. Engineering companies' order books seem to be reflecting a pick-up in capex intention; 2Q FY10 saw a pick-up in aggregate order book for industry leaders, after 9-15% sequential decline in the previous two quarters.

Figure 19

4Q 09 SME survey: will you invest in the next six mths?

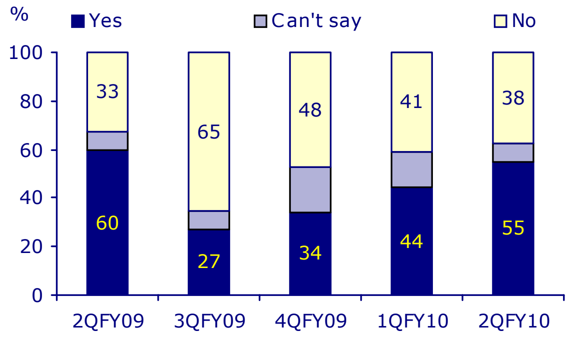
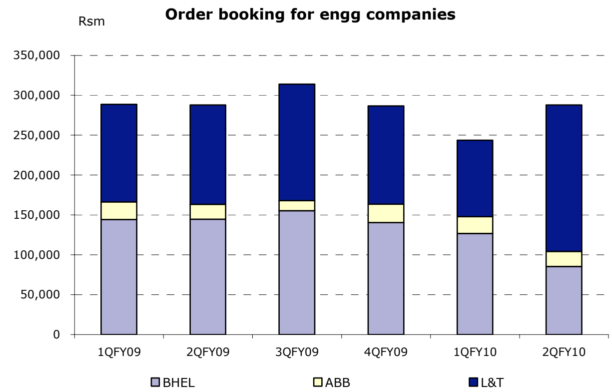


Figure 20

Order inflow for engg cos starting to pick-up



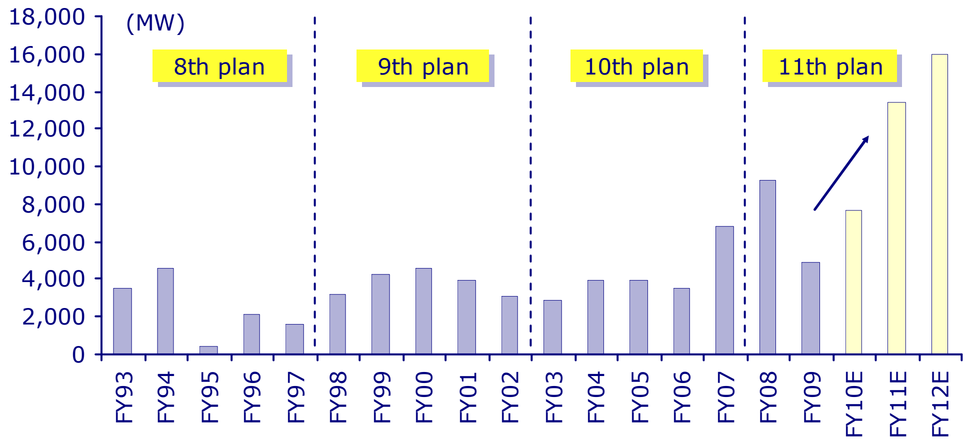
Source: CLSA Asia-Pacific Markets

Power, roads should see project starts

We also see acceleration in project starts in sectors like power and roads, which together account for 50% of targeted infrastructure spending. The government plans to award more than 40 road projects, including ten mega projects worth an aggregate US$10bn, over the next year or two; with IRRs looking better due to cost-restructuring, front-ending of viability gap support and lower borrowing costs, we expect a healthy takeup from developers. Likewise, for the power sector, while the surge in equity raising by private developers will support progress of these projects, expected placement of 'bulk orders' for 22x660MW supercritical in FY11 will boost capex by state-owned utilities as well.

Figure 21

Trend in power generation capacity addition



Source: CLSA Asia-Pacific Markets

RBI recent measures suggests that supporting infrastructure investment is a key objective

The moot point is whether RBI's actions will stymie the upturn in the investment cycle. We do not think so. In our view, corporates' cautious stance on new projects has had more to do with the uncertainties in the demand environment and diminished risk appetite, rather than the cost or availability of credit or equity capital. We do not see a 1-2ppt rise in borrowing costs (from current levels of 8-12% for project loans of large companies five year tenure) becoming an issue for project viability; for our large cap coverage universe, ROAE, at 18%, is well above estimated COE of 13%. Moreover, the RBI's actions suggest it accords high priority to supporting the pick-up in investment; a measure introduced in the Oct-09 policy review to like risk

Banks, Oil & Gas, Metals, IT, Capital Goods together account for 70% of earnings

weights for loans to infrastructure-focussed finance companies like IDFC, PFC, REC, to credit ratings will help lower their borrowing costs.

Investment upturn, global recovery are key to earnings upgrades

A strong investment upturn and well established global recovery will result in a resumption in the earnings upgrade cycle as well. The pick-up in the investment cycle will translate into stronger loan growth for banks and new orders for capital goods, while global recovery should lead to stronger commodity prices and higher outsourcing revenues. Banks, Oil & Gas, Metals, IT, Capital Goods together account for 70% of FY10 earnings for the CLSA Universe and contribute 81% to FY11 Sensex EPS growth. This is particularly significant since the expected exit from monetary and fiscal stimulus will weigh on the momentum of consumption demand in FY11.

Figure 22

FY10 earnings composition

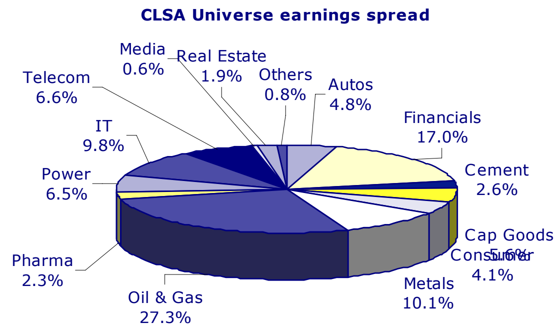
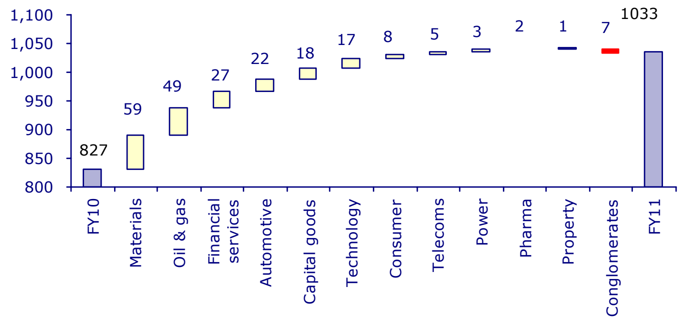


Figure 23

FY11 Sensex EPS build-up



Source: CLSA Asia-Pacific Markets

O-WTs – Industrials, IT, Materials, Consumer staples, Telecoms

U-WTs - Consumer disc., utilities, energy, property

Neutral – banks, healthcare

Sector stance and top picks

In our model portfolio, we are O-WT plays on the investment upturn (Industrials) and global recovery (IT, Materials). In that context, our neutral rating on Banks reflects our tactical U-WT on PSU banks, where we see risks to valuations (currently above the historical average in most cases) arising from likely slippages in restructured loans and MTM losses on the treasury portfolio; low coverage ratios for banks like SBI and Canara will bring in additional provisioning requirements following RBI's recent directive to raise coverage levels to 70% by Sep-10.

We are U-WT Consumer discretionary (primarily Autos), Energy and Power Utilities.

Auto, property will be vulnerable to monetary tightening

In our view, auto, along with property stocks would be the most vulnerable to the change in policy stance expected in 1Q 2010. The combination of tightening in monetary policy and withdrawal of fiscal stimulus could reflect in a quick de-celeration in FY11 passenger vehicle demand; escalation of costs on account of emission related improvements, stronger input prices could lead to margin pressures as well. A look back at performance of sectors during periods of monetary tightening reveals that in 8/10 cases, autos have underperformed the market over a 1m, 3m period after announcements of hikes in reserve ratios.

Figure 24

Impact of CRR hike in sector performance

Announcement Date	Pre	Post	Rise	3m Relative Performance post Rise in CRR									
				BSE Auto	BSE Capital Goods	BSE Consumer Dur	BSE Healthcare	BSE Metal	BSE Oil & Gas	BSE Bank	BSE Realty	BSE IT	BSE FMCG
21-Jul-00	8.00	8.50	0.50	(6.0)	(4.9)	7.8	13.1	(6.5)	3.6			0.5	(2.1)
08-Dec-06	5.00	5.50	0.50	(3.6)	(1.2)	11.3	(0.7)	(4.6)	6.9	(4.9)		3.3	(9.6)
12-Feb-07	5.50	6.00	0.50	(6.8)	7.5	2.7	1.1	19.6	13.8	(3.4)		(6.4)	(1.7)
30-Mar-07	6.00	6.50	0.50	(14.1)	22.1	8.0	(7.8)	14.3	7.4	8.1		(12.1)	(6.2)
31-Jul-07	6.50	7.00	0.50	(13.8)	20.5	(0.4)	(22.9)	19.3	14.9	2.2	2.4	(32.3)	(18.9)
30-Oct-07	7.00	7.50	0.50	(1.9)	(6.2)	8.3	1.8	(2.5)	4.4	17.4	9.9	(13.0)	8.3
17-Apr-08	7.50	8.00	0.50	(1.0)	(0.4)	4.1	20.9	5.1	(1.0)	(11.2)	(21.1)	9.6	3.8
05-May-08	8.00	8.25	0.25	(7.8)	1.6	(0.7)	13.8	(0.4)	2.1	(10.1)	(24.3)	4.2	2.0
24-Jun-08	8.25	8.75	0.50	2.7	8.7	(10.8)	(5.2)	(23.4)	3.5	10.1	(18.9)	(11.3)	3.6
29-Jul-08	8.75	9.00	0.25	3.6	(5.7)	(9.6)	2.9	(26.5)	(6.0)	10.4	(23.8)	10.4	18.6

Source: Bloomberg, CLSA Asia-Pacific Markets

Model portfolio changes

Additions
Zee (2ppt)
Tata Motors (2ppt)
Sun Pharma (2ppt)
Bharti (2ppt)
Shree Cement (2ppt)
Sesa Goa (2ppt)

Wt increase
Tata Steel (+1ppt)

Deletions
Maruti (1ppt)
HUL (2.5ppt)
Ranbaxy (2ppt)
RCom (3ppt)
Educomp (1ppt)

Wt reduction
Bajaj 1ppt
Cairn 1.5ppt
Cipla 1ppt

Model portfolio

Given our cautious view on autos, we have deleted Maruti and cut 1ppt weight for Bajaj in our model portfolio. We have, however, added Tata Motors, since demand for its commercial vehicles is more geared to a pick-up in the investment cycle and global recovery can drive improvements in the JLR business. We have also taken out HUL, since we see risk to valuations with rising input costs.

Our positive view on materials is reflected in addition of Sesa Goa (+1ppt) and a 1ppt weight increase for Tata Steel; we see raw material led price increases reflecting positively on earnings in 1Q. We have also added Shree Cement as a play on the seasonal hardening in cement prices; power revenues will add to earnings stability going forward.

Other intra-sector rotations, based on relative performance/valuation are addition of Sun Pharma against deletion of Ranbaxy, cut in Cipla and introduction of Bharti, at the expense of RCom.

Figure 25

CLSA India model portfolio

	CMP (Rs)	Market Cap (US$m)	CLSA Rec Wt (%)	Stance	FY09-12 EPS Cagr (%)	FY11 P/E (x)	FY10 div yield (%)	3m Perf. (%)	CLSA Rec
Consumer discretionary			**3.0**	**U-WT**					
Bajaj Auto	1,762	5,493	1.0		44.2	14.1	2.0	16.6	O-PF
Zee	257	2,402	2.0		13.1	23.9	0.9	7.8	O-PF
Financials			**23.0**	**Neutral**					
HDFC Bank	1,700	15,723	5.0		19.1	22.8	0.7	3.5	BUY
HDFC	2,678	16,494	6.0		16.8	24.1	1.3	(0.8)	BUY
ICICI Bank	876	21,027	8.0		17.5	19.8	1.4	(5.3)	BUY
IDFC	154	4,306	2.0		22.5	17.1	1.0	(0.3)	BUY
Union Bank	264	2,874	2.0		8.8	6.7	2.8	8.4	O-PF
Energy			**13.5**	**U-WT**					
Reliance	1,089	76,777	12.0		17.0	14.9	0.6	0.4	O-PF
Cairn	281	11,503	1.5		112.4	9.8	-	7.8	BUY
Consumer staples			**6.0**	**O-WT**					
Dabur	159	2,966	2.0		20.9	23.4	1.4	11.0	O-PF
United Spirits	1,259	3,408	2.0		56.6	26.9	0.2	36.3	O-PF
Bajaj Hindusthan	225	857	2.0		67.6	10.4	0.2	24.0	BUY
Industrials			**13.5**	**O-WT**					
Thermax	608	1,562	1.5		10.7	21.2	0.8	13.4	O-PF
Bharat Electronics	1,941	3,347	2.0		#DIV/0!	-	1.3	23.3	No Rec
Tata Motors	793	8,869	2.0			20.7	1.6	36.6	O-PF
L&T	1,679	21,726	3.0		20.4	22.2	0.7	0.8	U-PF
Crompton Greaves	426	3,364	2.0		19.5	18.7	0.6	32.7	O-PF
BHEL	2,406	25,384	3.0		34.8	19.9	0.8	2.4	U-PF
Health care			**4.0**	**Neutral**					
Sun Pharma	1,507	6,690	2.0		(0.6)	20.4	0.6	7.9	O-PF
Cipla	336	5,807	2.0		24.4	20.3	0.7	23.3	O-PF
Infotech			**19.0**	**O-WT**					
Infosys	2,605	32,203	13.0		10.7	21.0	1.5	12.0	BUY
HCL Tech	371	5,387	2.0		(100.0)	14.1	1.1	10.1	O-PF
TCS	750	31,626	4.0		14.9	20.1	1.1	18.6	O-PF
Materials			**13.0**	**O-WT**					
Sesa Goa	411	7,262	2.0		(0.4)	22.1	60.9	53.6	No Rec
Shree Cement	1,926	1,446	2.0		(0.0)	15.3	0.6	17.2	BUY
Grasim	2,478	4,896	2.0		1.7	10.1	1.2	(8.3)	O-PF
Tata Steel	618	11,809	4.0		0.6	9.7	1.6	21.0	BUY
Sterlite	862	15,605	3.0		22.9	11.8	0.5	10.7	BUY
Utilities			**2.0**	**U-WT**					
Tata Power	1,378	7,044	2.0		11.4	18.3	0.8	6.8	O-PF
Telecoms			**2.0**	**O-WT**					
Bharti	330	26,984	2.0		9.3	12.6	0.4	(24.2)	O-PF
Property			**1.0**	**U-WT**					
HDIL	361	2,688	1.0		12.5	15.7	0.8	7.9	O-PF
Total			**100.0**						

Source: CLSA Asia-Pacific Markets

Top picks

ICICI Bank

- We estimate ICICI Bank to report 17% Cagr in earnings over FY09-12 led by pick up in lending activity, improving margins and decline in loan loss charges. Reported RoE estimated to double over next three years, resulting in further re-rating potential for the stock.

- ICICI Bank has the most seasoned loan portfolio (loan book has been flat for past two years) which will lead to an absolute level of decline in loan loss charges, at a time when most other banks are likely to report 40-50% increase in their loan loss provisions
- Improvement in proportion of low cost demand deposits and re-pricing of high cost deposits, pick up in lending activity to drive fee growth
- Listing of non banking subsidiaries could also act as a re-rating catalyst

IDFC

- Loan growth likely to be +20% over FY09-12CL led by pick-up in demand for infrastructure loans and increase in leverage to 6x by Mar-12
- Healthy loan growth will be supplemented by lower borrowing costs (fall in cost of wholesale borrowings and lower risk-weights on bank loans) and rise in contribution of fee income
- We expect earnings to grow at Cagr of 22% over FY09-12 (RoE to rise to 19% by FY12) and valuations at 2.7x FY12CL book are reasonable.

Infosys

- Synchronous spending up-tick in BFSI (~35% of revenues) and Retail (~15% of revenues) clients suggests upside risk to topline growth.
- Gains from vendor consolidation at top clients like BP/Telstra flowing through
- Material pick-up in lateral hiring and up-coming campus visits indicate order-book confidence
- Expect 20%+ $-revenue growth in FY11
- Utilization ex-trainees at 71% gives high operating leverage for FY11
- Valuations at 5-year averages and can sustain at current levels

Sun Pharma

- With core earnings continuing to grow at 18%,Sun Pharma, one of India's most profitable pharma companies, should be reporting YoY earnings within two quarters, as the high base effect due to exclusivities (Protonix) in FY09 wears off.
- Core earnings too should accelerate, with additional approvals for controlled substances segment (hydrocodone, oxycodone already approved in early 2009) expected in 2H 2010.

- For Sun, any positive developments on Taro acquisition could signal prospects for EPS accretion; Sun could easily finance the additional US$250m investment, given US$600m cash on its books. We see all negatives of the FDA issues at Caraco now being in the price.

- Sun, which has maintained ROCEs of +30%, has traded at peak valuations of 25x and we see room for re-rating as news flow turns positive.

Tata Steel

- Tata Steel offers a strong 150% EPS CAGR over FY10-12, even without any improvement in steel prices, through restructuring gains at European subsidiary Corus and capacity ramp-up at India operations

- At Corus, cost-cutting measures are well underway. Headcount reduction, part mothballing of the Teesside plant and realignment of production facilities will raise EBITDA/t to US$75 (on a large 18mt capacity) by mid-FY11. The well-integrated, highly profitable India operations will see strong profit growth in FY12 as the 3mt brownfield expansion comes in, accompanied by product-mix improvement and further headcount reduction.

- Balance sheet delveraging and enhanced earnings stability (due to rising share of India in total capacity and higher raw material integration + improvement in cost structure at Corus) should drive re-rating as well. The stock currently trades at 9x Mar11 P/E and 6.8x Mar11 EV/EBITDA. The stock offers 33% upside on a 24 mths view.