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STRATEGY

Lengthening Shadow

India Equity Research | Strategy

As we step into 2012, the investment scenario is characterised by poor macro backdrop. Externally, China's slowdown will likely become the focus of markets. Domestically, RBI's likely rate cuts and REER depreciation will help, but fiscal consolidation and pick up in pace of government project approvals are also essential. Our base case FY13 GDP growth is ~7%, which can slip to ~5.8% in bear case. We believe that a bottom up strategy will continue to work in the near future till state elections get over in March. We are biased towards companies with good quality management, strong earnings visibility and durable cash flows.

Global economy: On thin ice

Western economies remain fragile. Improved US data is surely comforting, but may not foreshadow a sustainable turn-around due to structural overhangs. In Europe, economic outlook is deteriorating as public and private sectors are deleveraging at the same time. However, ECB's recent actions inspire confidence that if situation reaches the brink, it will shed reluctance to support sovereigns. Meanwhile, China needs close monitoring as the construction boom is losing steam, external demand is weakening and RMB is losing competitiveness. For India, all this is a mixed blessing—slower growth and weak flows on one hand and competitive INR and softer commodities on the other.

Indian economy: More than a normal business cycle slowdown

A multiplicity of factors is weighing on Indian macros. While RBI has overdone the tightening in our view, govt. policy hurdles, large fiscal slippages and uncertain external backdrop are added drags. Our analysis of past crises (FY92, FY01 and FY09) suggests that the current macro deterioration is on 1992 lines, although India's vulnerability indicators are much healthier. We believe that rate cuts alone will be inadequate to engineer a turnaround. Further, neither big-bang reforms ('a la 1992) nor synchronised global stimulus (like 2008) are likely, hence the current slowdown could be a bit prolonged. In the base case, we expect FY13 GDP growth of ~7%, which can slip to ~5.8% in a bear case. We believe fiscal consolidation and a kick-start of mining can help bolster the investment cycle. Neither of these steps requires any wide political consensus.

Markets: Concerns persisting, still favouring defensives

In our macro base case, FY13 Sensex EPS is expected at INR1,260 while in the bear case, it dips to INR1,143. As yet, valuations are not compelling as despite converging RoEs, India is still trading above peers (in BRICs) and risk of EPS downgrades looms large. Thus expect markets to be range-bound (14,000-17,000) in CY12, exhibiting high volatility. We remain defensive, favouring sectors/stocks with robust RoEs and strong cash flows. Key themes are: (1) INR to remain weak (OW pharma, move IT from UW to EW); (2) domestic demand still healthy (OW consumers); and (3) no visibility on capex revival yet (move industrials to UW). We prefer TCS, Bharti Airtel, Coal India, HDFC Bank and Lupin in large caps and Glenmark, Hexaware, LICHFL, Petronet LNG and Zee in mid caps.

Nischal Maheshwari
+91-22-6623 3411
nischal.maheshwari@edelcap.com

Kapil Gupta
+91-22-4063 5406
kapil.gupta@edelcap.com

Dipojjal Saha
+91-22-6623 3377
dipojjal.saha@edelcap.com

Toshi Jain
+91-22-6623 3322
toshi.jain@edelcap.com

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The year 2011 can be characterized by worsening European debt crisis, weakening global economic growth, anemic business sentiments and heightened volatility across asset classes. In some sense, the biggest disappointment of 2011 has been on the policy front, be it the rapid deterioration in the European debt crisis or US debt ceiling stalemate, culminating in the US debt downgrade. Indeed, in our view, domestic policy paralysis has been one of the key contributors to the ongoing downturn in the Indian economy. Below we present our analysis of domestic and global economy and how the markets are likely to behave in the coming quarters.

Western economies: In the lurch

As we step into 2012, the external environment is no less uncertain than 2011. In Europe, the political leadership remains divided and so far, has failed to produce a comprehensive plan to address the spreading contagion from smaller economies (so-called PIGS) list to larger ones like Italy and eventually threatening even France. Meanwhile, the EU banking system with a huge exposure to sovereign debt is facing elevated stress. Not only have they seen their USD funding drying up (as US money market funds retrenched their European exposures), but also a decline in the inter-bank lending volume. In this regard, ECB's much more aggressive stance (such as rate cuts, unlimited liquidity under LTRO, accepting wide range of collaterals etc.) in supporting the EU banking system has been crucial in keeping banks afloat (more than 500 EU banks borrowed a record EUR489bn from ECB's LTRO facility). This will ensure that the deleveraging process by banks will not be very disruptive.

However, while the likelihood of an event risk materializing has reduced, the economic outlook for the region has continued to worsen amidst single minded focus on fiscal austerity even as the private sector is deleveraging. As growth falters, debt dynamics would worsen thereby increasing the risk of additional ratings downgrades. This in turn would further raise the cost of borrowing. We believe that as the situation nears the brink - where euro would face an existential threat - ECB will step up its lender of last resort operations by supporting sovereigns. This will not only put a cap on borrowing costs of sovereigns (hence improve their debt sustainability) but also induce weakening bias in EUR which is highly desirable for European economies. Even then, this might not enough to prevent a recession in few economies in 2012 though could surely limit its severity.

Chart 1: ECRI hints at weak US growth ahead

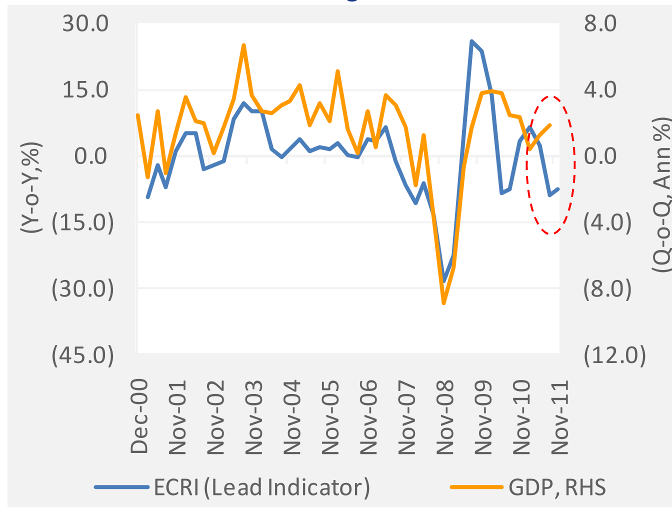
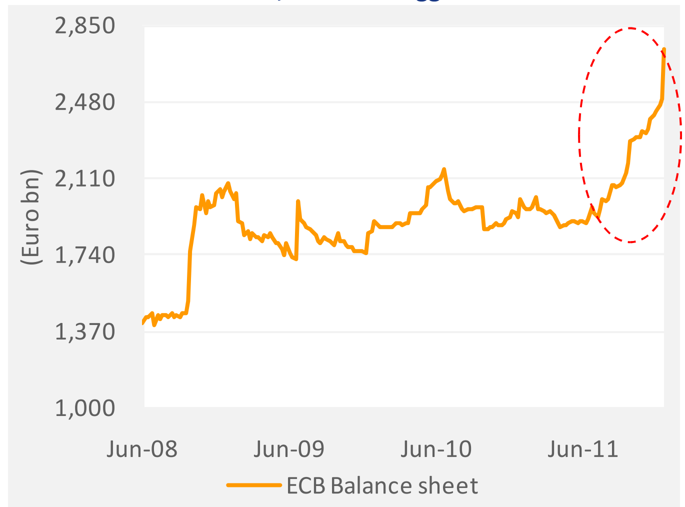


Chart 2: Post–Trichet, ECB turns aggressive



**ECRI has been a widely tracked lead indicator for US GDP*

Source: Bloomberg

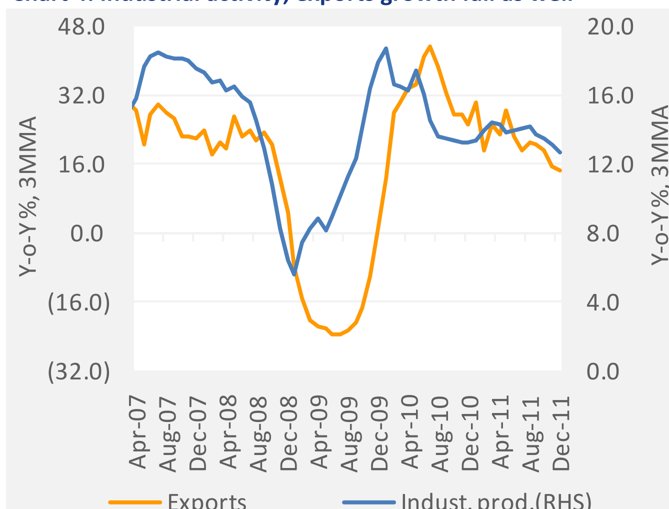
Across the Atlantic, the US economic data has been better than expected in recent months, be it retail sales, weekly jobless claims or homes sales suggesting that Q4 GDP growth would be much better compared to previous quarters. There is some improvement in confidence indicators, be it consumer confidence or business sentiments. However, while the data has been better than expected, it may not foreshadow a sustainable turn-around. The household deleveraging process is far from over and the fiscal retrenchment of states and the federal government is underway even as the external environment remains far from being favourable. Indeed, the broader indicator of growth, ECRI points towards renewed weakness ahead although the economy may still avoid a recession.

China: Outlook deteriorating

The economic weakness in Western economies is gradually spilling over to EM economies as seen in the declining PMIs across the region. This is the result of a weakness in external demand as well as aggressive monetary tightening by their central banks in the wake of high inflation. With the slowdown deepening, monetary policymakers are now leaning towards supporting growth, moving away from fighting inflation.

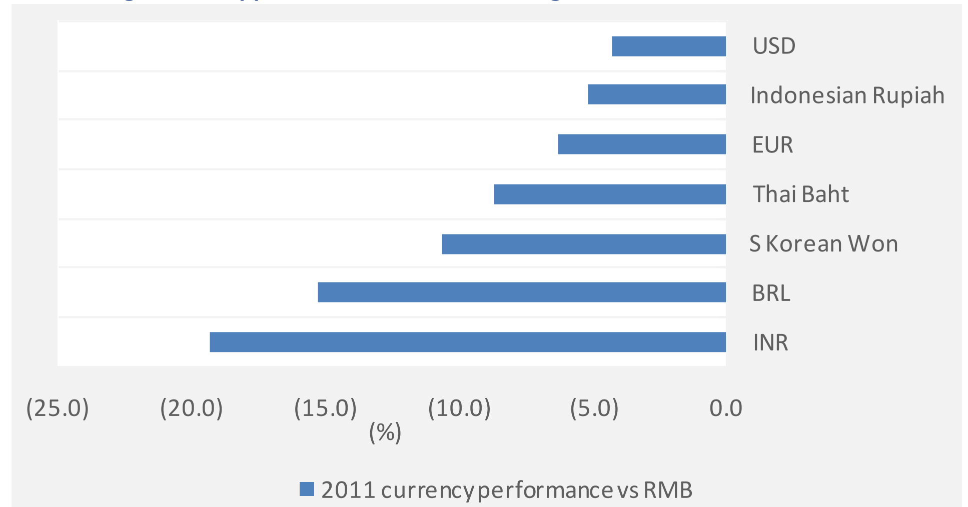
Chart 3: Chinese property market cooling off rapidly

Chart 4: Industrial activity, exports growth fall as well



Source: Bloomberg

Chart 5: Significant appreciation in RMB - a strong headwind



Source: Bloomberg

The most crucial characteristic to watch out for in 2012 would be the intensity of the impending economic slowdown in China. The construction boom which was triggered by massive lending by banks following 2008 crisis seems to be losing steam in the wake of aggressive monetary tightening by authorities. For example, property prices in key cities such as Beijing and Shanghai have started declining on MoM basis. Exports, meanwhile, have also eased on account of demand weakness while the recent RMB appreciation against major currencies has added to the deterioration in trade outlook.

For India, these global trends are mixed blessings. On the one hand, the global slowdown means that India's growth would also decelerate markedly given the high correlation with the world economy, but on the other, INR weakness against RMB and a likely fall in global commodity prices augur well for India's macros.

Indian economy: More than a normal business cycle slowdown

Severe deterioration in macros

Presently, the Indian economy is facing a severe slowdown, much sharper than a normal business cycle weakness. This is clearly evident from the data which shows that investment growth more or less has been stalled and consumption growth - which was buoyant at start - is also increasingly coming under pressure.

Chart 6: Sharp slowdown in both infra and capex investments

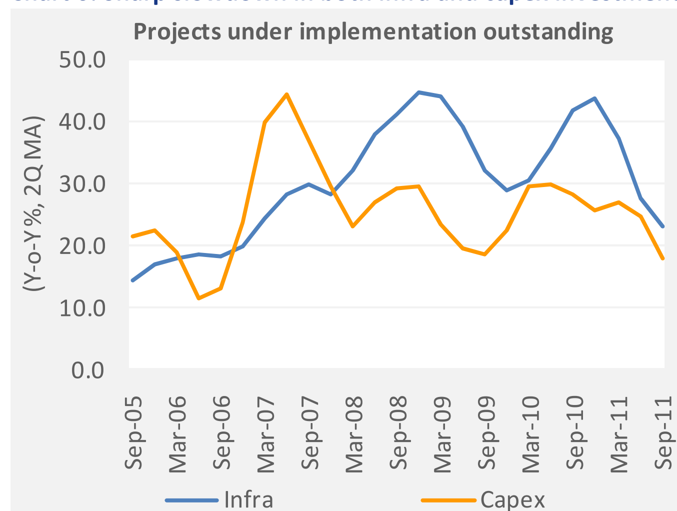
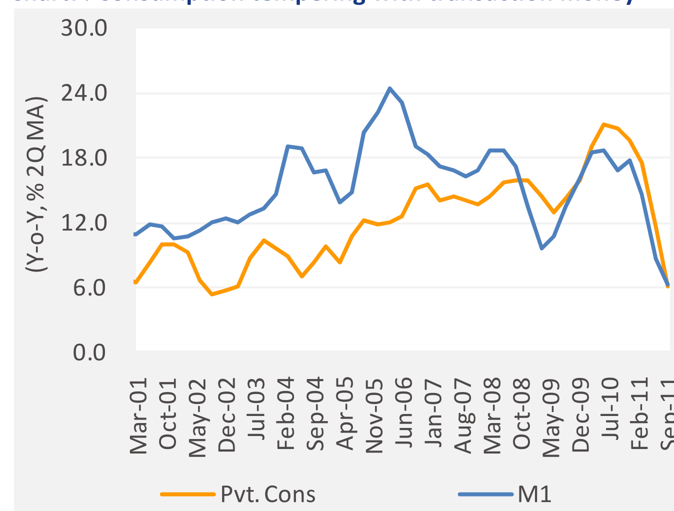


Chart7: Consumption tempering with transaction money



**Infra projects include: power, ports, roads etc while capex include manufacturing, mining etc*

Chart 8: Credit to infra also falling

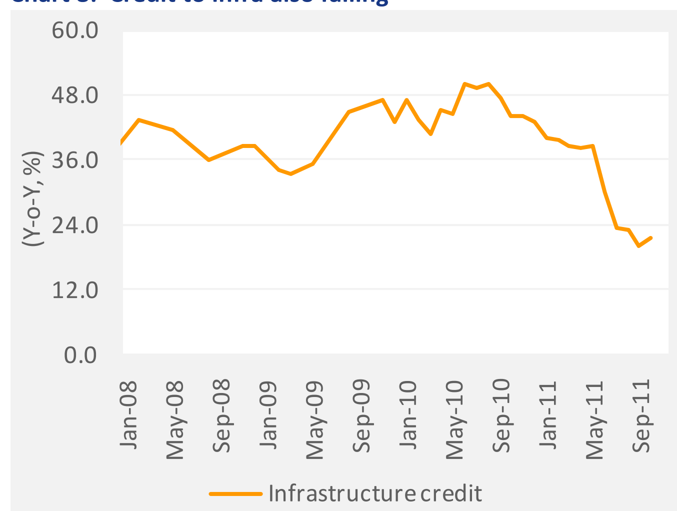
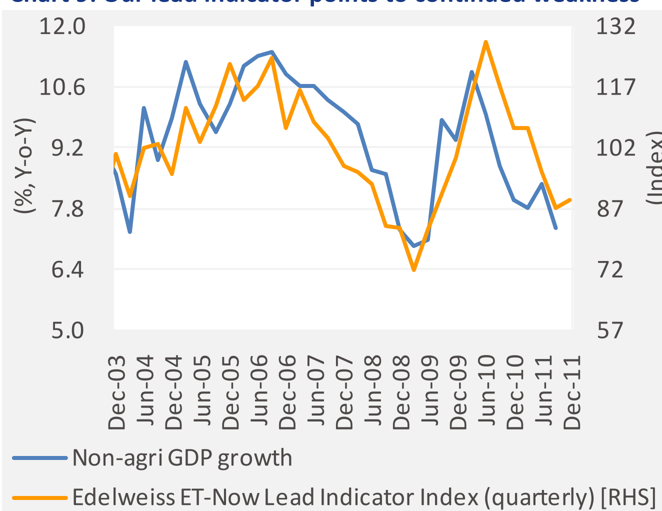


Chart 9: Our lead indicator points to continued weakness



Source: CMIE, Bloomberg, Edelweiss research

Steep fall in projects under implementation and credit to infrastructure sector indicates that the capital formation in the economy has slowed down substantially while a decline in the transaction money (M1) is signaling tempering consumption growth. Furthermore,

worryingly too, EELI our lead indicator to Non-Agri GDP growth points out that this weakness would persist.

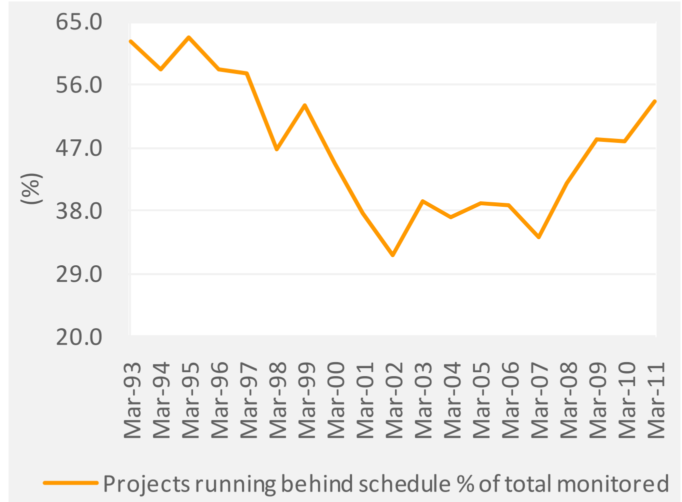
What are the causes?

Main reasons for the severe deterioration in Indian macros are:

a) **Domestic policy paralysis**

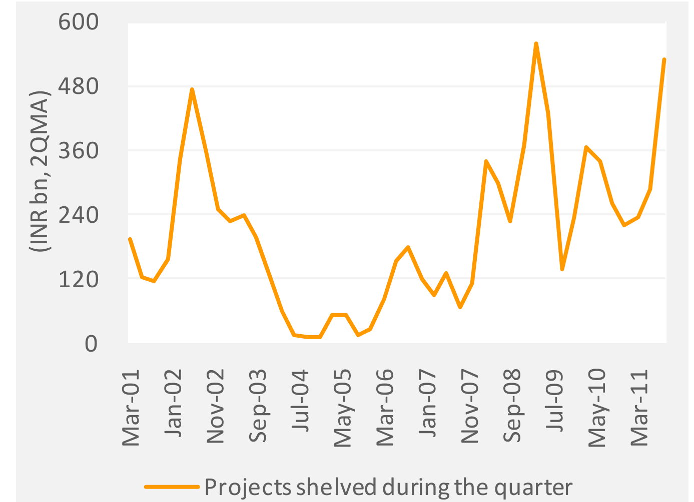
As clear from the charts below, a log jam in the approval process coupled with unfavorable government policies (like green issues) has led to an across the board delays, severely denting the investor confidence. This decline in confidence is one of the main reasons behind the sharp slowdown in investments.

Chart 10: More and more projects* running behind schedule



As per MOSPI project implementation status report, March 2011 - for projects costing INR150cr and above (607 projects monitored of which 157 are mega projects with a total cost of more than INR7lac cr)

Chart 11: Sharp rise in no. of projects shelved



Source: MOSPI, CMIE

Table 1: Delays observed across sectors

	Projects under monitoring	No of projects delayed	% Delayed
Roads/Highways	135	113	83.7
Coal	45	20	44.4
Steel	19	10	52.6
Petroleum	82	38	46.3
Power	87	46	52.9
Railways	148	33	22.3
Shipping/Ports	26	18	69.2

Source: CMIE

b) **Aggressive monetary tightening**

In order to control inflation, in 2011 the RBI pursued the most aggressive tightening (225 bps) of the last decade. After April 2011, the central bank started raising policy rates aggressively even though a lot of incremental data was pointing at a marked decline in growth. This tightening (amidst the slowdown) eventually hurt growth severely, forcing us to believe that RBI may have gone overboard with rate hikes. Indeed, in CY2011, RBI's technical advisory committee (TAC) on monetary policy had recommended (of majority of members) an increase in policy rates by only 75 bps whereas RBI undertook a hike of 225 bps. This worked as an added dampener on business sentiments.

Chart 12: Inverted yield curve foreshadows weakness in IIP

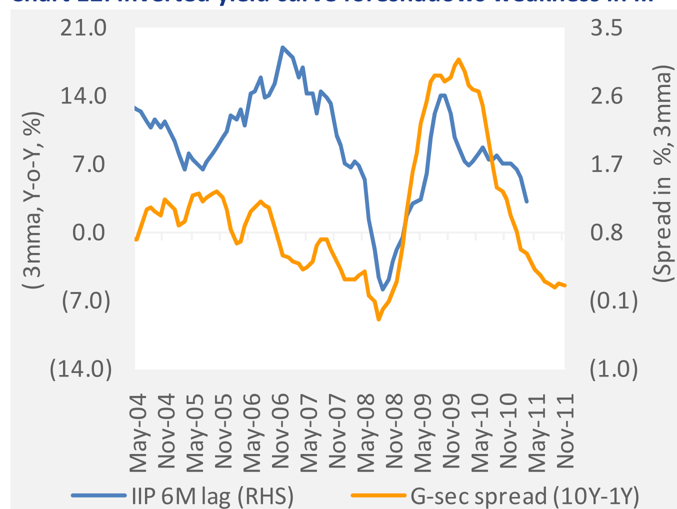
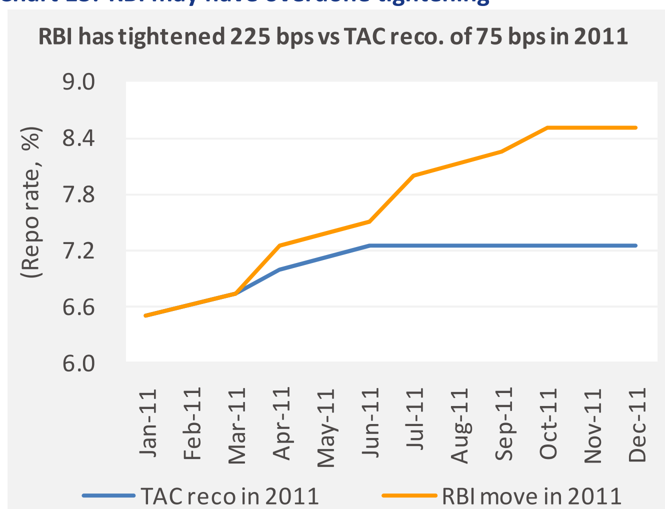


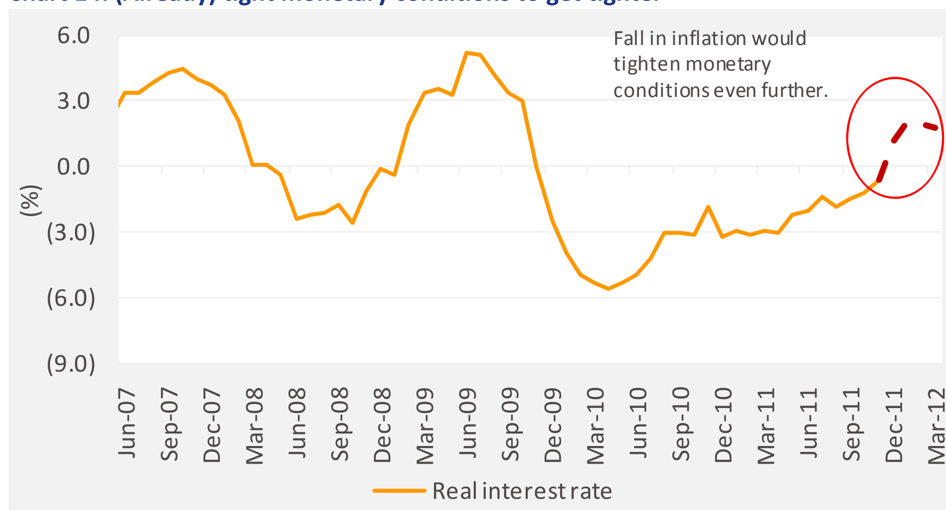
Chart 13: RBI may have overdone tightening



Source: RBI, Bloomberg and CMIE

Note: TAC - Technical Advisory Committee to RBI, recommendations are by majority of members

Chart 14: (Already) tight monetary conditions to get tighter



Source: RBI, Bloomberg and CMIE

Note: Real rate is based on repo rate and WPI

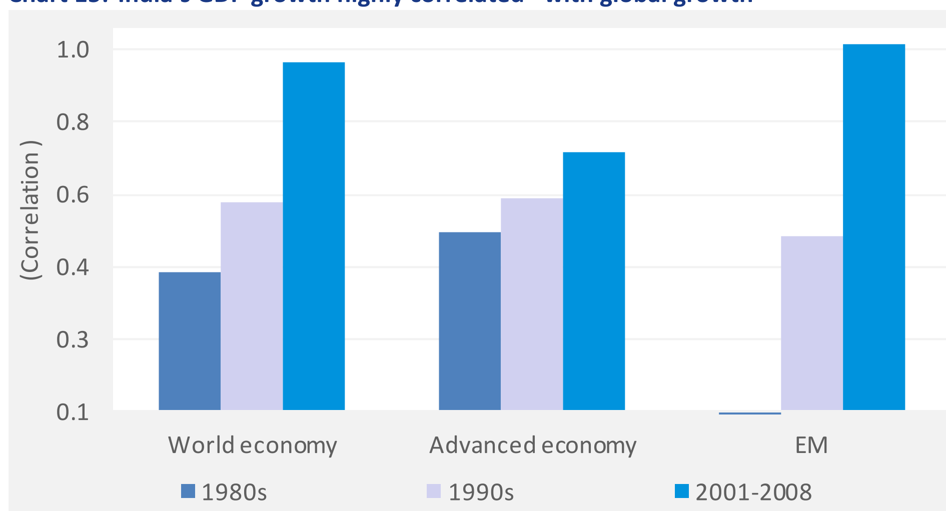
This excessive tightening would continue to have an adverse impact on the industrial production in coming months as seen from the chart above which shows that flattening of the yield curve has a ~6 month lagged impact on industrial production.

Going ahead, an expected fall in inflation rates would further tighten the monetary policy conditions, implying that RBI is expected to start easing sooner rather than later.

c) **Highly uncertain external macro and markets backdrop**

India's linkages with the world, especially emerging economies, have increased significantly over the past decade. This means that India will find it difficult to grow at or above its potential level when external economies are facing a slowdown. Already, the impact is being felt on the Indian economy via trade channels, capital flows and most importantly, through the sentiments channel. Based on the above, a weak global economy has been an important dampener on India's growth.

Chart 15: India's GDP growth highly correlated* with global growth



Source: Source: RBI

**From RBI report "Currency and Finance- FY09"*

How bad can it get? - Reminiscing 1991-92, 2000-01 & 2008-09 crises

In order to understand and analyse the current slowdown, we looked at the past three crises in the Indian economy - namely, the balance of payments crisis (1991-92), technology bubble (2000-01) and the great recession (2008-09). On due analysis, we came to conclusion that in terms of macro deterioration, the present situation is akin to the 1991-92 crisis though we are much better placed in terms of our shock absorbing capacity (like forex reserves, import cover etc). Overall, this means that while we would not face a crisis like the balance of payments like in 1991-92 but our growth slowdown would be in similar tones.

Detailed analysis of the past crises:

a) **Balance of payment crisis: 1991-92**

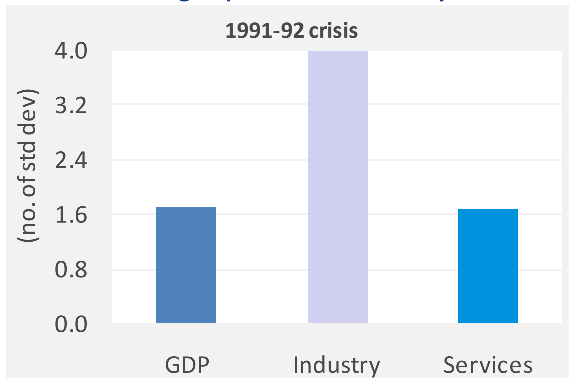
The run-up to the crisis saw an acute decay in domestic macros. Economy faced persistent twin deficits, an elevated inflation, severe drought and a higher recourse to short term debts (like ECB) to fund CAD. Further, pegged INR inhibited any adjustments which could happen via depreciation of currency.

Meanwhile, the country's ability to withstand the crisis was low due to the absence of shock absorbers like forex reserves (which came down ~70% in a span of just 11 months during the crisis) and the government's ability to provide a fiscal stimulus. The trigger of the crisis was the Gulf war, leading to a spike in crude oil prices. The shock mainly impacted industries as the overall slowdown lasted 4-5 quarters.

Table 2: Domestic macros & vulnerability ratios deteriorated significantly

Macro indicators	FY89	FY90	FY91	FY92	FY93	FY94
GDP growth	10.2	6.1	5.3	1.4	5.4	5.7
Fiscal deficit (% GDP)	7.3	7.3	7.8	5.6	5.3	6.9
Inflation (YoY %)	7.5	7.4	10.2	13.8	10.0	2.6
CAD (% GDP)	(2.7)	(2.3)	(3.0)	(0.3)	(1.7)	(0.4)
Vulnerability indicators						
Import cover in mnts	2.4	1.9	2.5	5.3	4.9	8.6
CAD+Net FDI (% GDP)	(2.7)	(2.3)	(3.0)	(0.3)	(1.6)	(0.2)

Chart 16: Strong impact felt on industry ...



Source: CMIE

**Shock has been calculated by dividing the growth slippage in shock year by S.D of the preceding five years*

The recovery came through massive structural reforms including de-licensing of industries, reducing import duties and liberalizing various sectors for foreign investments. The sharp recovery in the US also helped the resurgence.

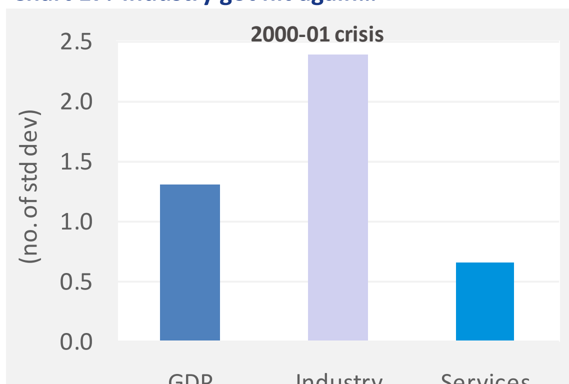
b) Technology bubble burst: 2000-01

The shock was mainly external. The run up to the crisis did not see any worsening of domestic macros. However, a drought in FY01 along with a jump in crude prices by ~70% YoY complicated matters (just as FY92). The slowdown lasted four quarters and like the previous crisis, industry bore the maximum brunt.

Table 3: Domestic economy well placed to survive shocks

Macro indicators	FY98	FY99	FY00	FY01	FY02	FY03
GDP growth	4.3	6.7	7.6	4.3	5.5	4.0
Fiscal deficit (% GDP)	5.8	6.5	5.4	5.7	6.2	5.9
Inflation (YoY %)	4.4	6.0	3.3	7.1	3.6	3.4
CAD (% GDP)	(1.4)	(1.0)	(1.0)	(0.6)	0.7	1.2
Vulnerability indicators						
Import cover in mnts	6.9	8.2	8.2	8.8	11.5	14.2
CAD+Net FDI (% GDP)	(0.5)	(0.4)	(0.6)	0.4	2.2	2.5

Chart 17: Industry got hit again...



Source: CMIE

The recovery was helped by a gradual monetary easing (400 bps over next 2-3 years) in India and a sharp monetary easing in the US. Further, fiscal consolidation in the following 4-5 years led to sharp rise in India's investment rate.

c) **Great recession: 2008-09**

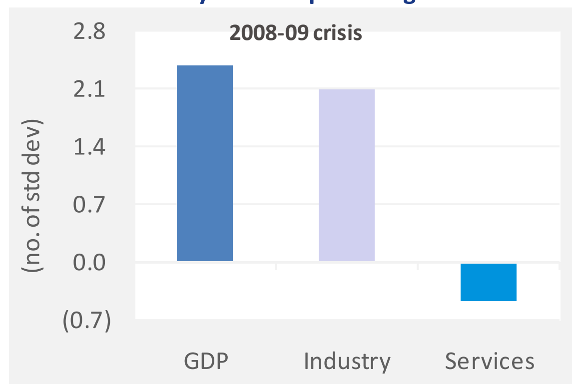
The due to the crisis in the Western world (mainly US and Europe) inflicted profound external shock. Domestic macros, however, were strong; fiscal deficit was shrinking, CAD was healthy and forex reserves were at record levels (though just before the crisis, demand-led inflation had started picking up and crude prices spiked to ~USD140/barrel).

Growth declined sharply with the industry getting more impacted than services (like earlier crises). Moreover, a drought in FY09 complicated matters further. The slowdown lasted ~3 quarters.

Table 4: Domestic economy well positioned to bear up shocks

Macro indicators	FY06	FY07	FY08	FY09	FY10	FY11
GDP growth	9.5	9.6	9.3	6.8	8.0	8.6
Fiscal deficit (% GDP)	4.0	3.3	2.6	6.0	6.4	5.1
Inflation (YoY %)	4.4	5.4	4.7	8.4	3.9	9.9
CAD (% GDP)	(1.2)	(1.0)	(1.3)	(2.3)	(2.8)	(2.6)
Vulnerability indicators						
Import cover in mnts	11.6	12.5	14.4	9.8	11.1	9.6
CAD+Net FDI (% GDP)	(0.9)	(0.2)	-	2.3	(1.4)	(2.2)

Chart 18: Industry more impacted again…



Source: CMIE

The domestic economy, hale and hearty in the run up to the crisis, recovered strongly on the back of a solid fiscal stimulus (~3.5% of GDP) and a sharp monetary easing (~425 bps in seven months). Moreover, the recovery also got a boost from synchronized monetary and fiscal stimulus globally.

d) **Current situation**

Domestic macros have seen a severe deterioration last year. Growth has slowed down sharply, the economy is facing twin deficits, inflation remains elevated and reliance on debt flows to fund CAD has gone up. All these resemble the deterioration in macros seen in the year 1991-92. An unfavorable external economy and persistently high crude oil prices also continue to pose risks.

However, unlike 1991-92, the country is better placed on vulnerability indicators. Presently, Indian commands decent forex reserves and low external debt while the INR depreciation of ~20% is expected to facilitate adjustments in CAD.

Worsening macros within the back drop of decent shock absorbers like forex reserves and INR depreciation would mean that India might not face a `balance of payments crisis like situation'. However, the slowdown in growth would be on similar lines.

Table 5: Macros worsening

Macro indicators	FY10	FY11	FY12(E)	FY13(E)
GDP growth	8.0	8.6	7.0	7.0
Fiscal deficit (% GDP)	6.4	5.1	5.8	5.4
Inflation (YoY %)	3.6	9.9	8.6	6.0
CAD (% GDP)	(2.8)	(2.6)	(3.0)	(2.4)
Vulnerability indicators				
Import cover in mnts	11.1	9.6	8.2	7.2
CAD+Net FDI (% GDP)	(1.4)	(2.2)	(2.3)	(1.4)

Source: CMIE

Based on the above scenario, we come to the conclusion that the current slowdown might be a prolonged one given the fact that there is no scope for a fiscal stimulus (both domestically and globally) even as unleashing reforms like 1992 is quite unlikely. Admittedly, monetary easing would provide some support, but that would not be sufficient for the economy (especially investments) to come out of woods.

Accordingly, in calculating our growth outlook, we consider the impending shock to the industry to be as severe as (that of) 1992. However, we account for higher shock in services (than 1992) as its vulnerability due to the changed nature (e.g. financial sector today is more market oriented) has gone up.

Growth outlook

	FY12	FY13 (Base case)	FY13 (Bear case)
Fiscal deficit (%)	* ~5.8	~5.4	~6.2
Industry/Service %	* ~4.0/9.2	~5.9/8.2	~4.0/7.1
INR(avg.)	* ~48.6	~50	~52
Inflation(avg. %)	* ~8.6	~6.0	~4.0
Monetary easing	* 0 bps	125 bps	200 bps
CAD % GDP	* ~3.0-3.2	2.3-2.5	1.6-1.8
GDP growth(%)	* ~7.0	~7.0	~5.8

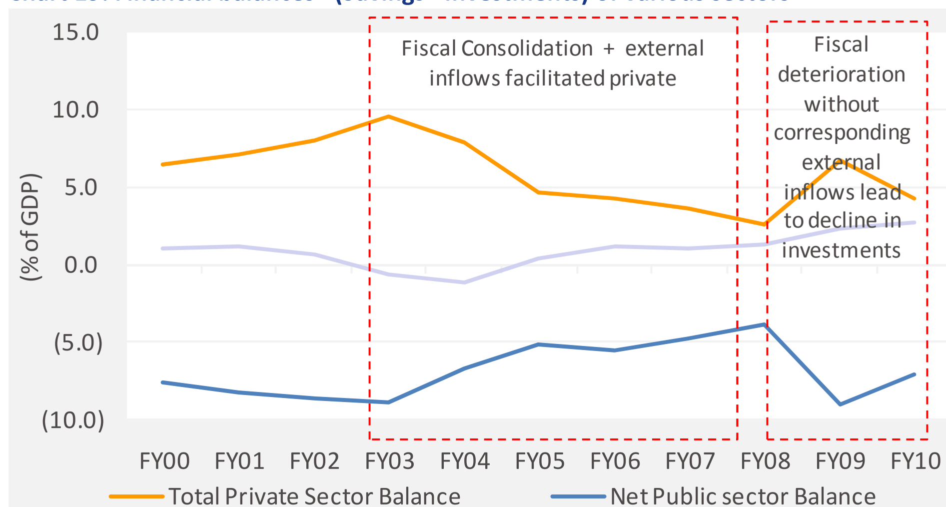
What needs to be done?

As seen above, we assume a sub-par growth for FY13 as we think the investment cycle would not pick up in a hurry. However, if the government decides to undertake fiscal retrenchment and some basic policy decisions (no big bang, but simple administrative measures), we think it would give a big boost to investments which will in turn help the economy to recover from the slowdown.

a) **Fiscal consolidation**:

The chart below is based on the universal identity that net funds balance (saving – investment) of external, private (house-holds and private corporate) and public sector (govt. + public sector co's) of a country should be equal to 0.

Chart 19: Financial balances* (Savings –Investments) of various sectors



Source: CMIE

Public sector bal+ Private sector bal* + external sector bal= 0

The above chart directs that in the first phase (FY03 – FY08), private sector investments picked up as the government made more funds available by cutting down the fiscal deficit. Moreover, a surge in external inflows provided additional funds to the private sector for investment. In contrast, the second phase in the chart (FY08-FY10) shows that as the fiscal deficit ballooned without a corresponding jump in external flows, private sector investments got retrenched on account of a shortfall in funds. Accordingly, for an investment cycle to pick up, fiscal consolidation is a must especially since external flows are unlikely to be strong.

b) Policy announcement:

We believe that the starting point on this front could be de-bottlenecking of the coal production as coal has significant linkages with various industries like power, steel, aluminium and cement. The step is largely administrative and could go a long way in boosting investments in the broader economy. In addition to this, other reforms which could boost investments include SEB reforms to help address the slump in power capex, implementation of DTC and GST to simplify tax collection and increase tax buoyancy, and passing the Land Acquisition Bill. Most importantly, the government should boost confidence of the bureaucracy to take decisions as post the high profile graft cases (2-G, Common Wealth Games etc), bureaucrats have started avoiding some basic policy decisions for the fear of getting involved in a graft cases later. This has been causing unnecessary delays in approvals.

What does it mean for India Inc?

We investigated implications of a base case and bear case macro assumptions on the overall earnings growth as well. Based on our base case macro assessment of GDP growth of 7.0% and average USDINR=50, FY13 earnings is expected to come in at INR1,261. On our bear case assumptions of GDP growth of 5.8% and USDINR at 52, stress case earnings for Sensex for FY13 could come in as low as INR1143, implying a growth of just 5.2%. On our base case assumption of INR1270 for FY13, biggest contributors to this growth would be banks, energy, metals and tech while in our bear case, sectors expected to drag down earnings growth include metals, cap goods and autos. The earnings trajectory has already seen sharp downgrades (FY13E estimates down 10% this year already) and if the stress case assumptions are any indication, there could be more pain ahead.

Chart 20: Base case forecast for Sensex EPS

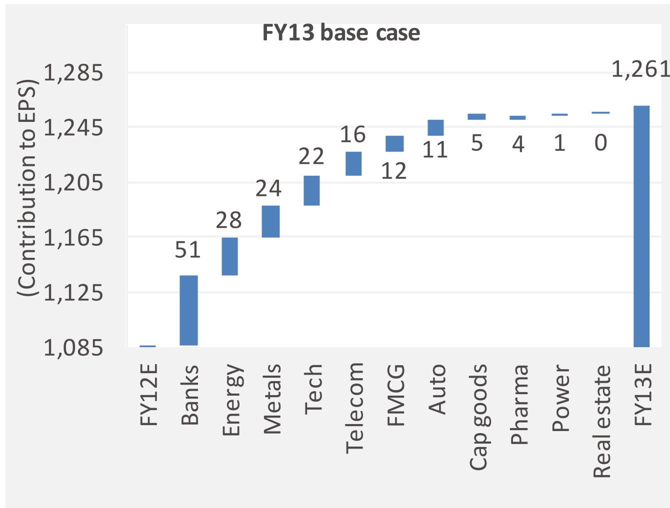
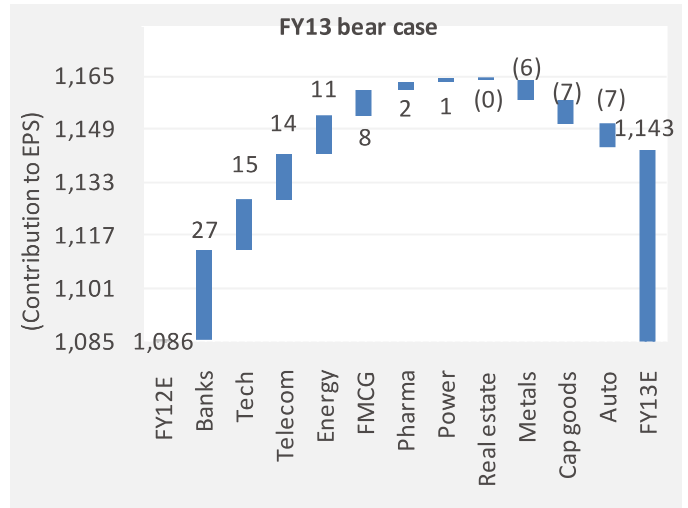


Chart 21: Bear case forecast for Sensex EPS



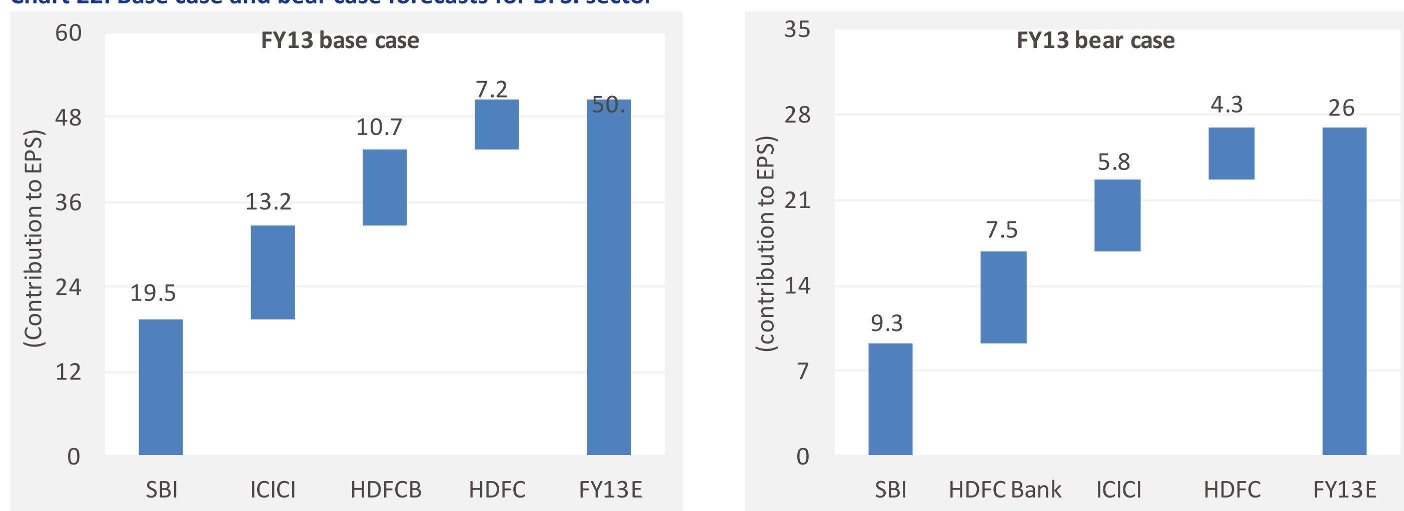
Source: Bloomberg, Edelweiss research

For major sectors, the earnings breakdown for FY13 for both base case and bear case assumptions is given below.

BFSI sector

On our base case assumption, the incremental contribution of banking sector to the total Sensex EPS is INR50.6. The biggest contributor from the BFSI sector is SBI followed by ICICI Bank, HDFC Bank and HDFC. In bear case, we expect the overall earnings contribution of the BFSI sector to decline to INR26.9 dragged down by NIMs declining by about 30bps on a YoY basis and credit costs moving higher by 20-30bps considering the stress in power, aviation, agri and SME sectors.

Chart 22: Base case and bear case forecasts for BFSI sector



Source: Bloomberg, Edelweiss research

Table 6: Higher credit costs drag down stress case earnings

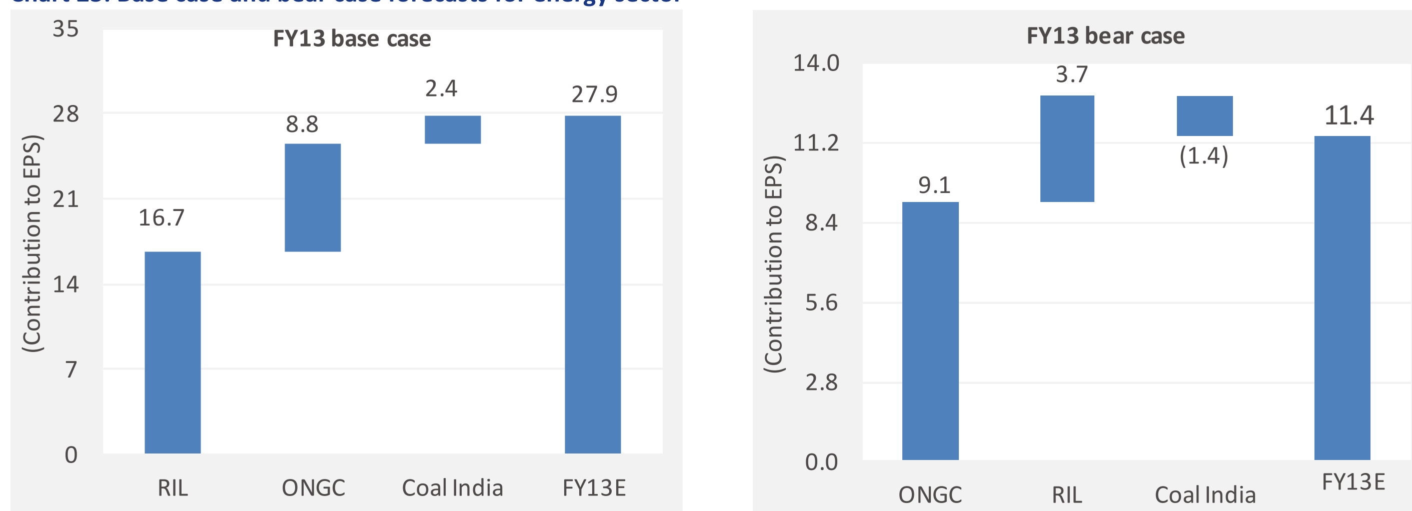
	Base case	Bear case
Credit growth	Assuming a GDP growth of 7% , we have assumed industry credit growth of about 17%.	Assuming a GDP growth of 6% , we have assumed industry credit growth of about 14%.
NIMs	Given the reversal of interest rate cycle, we are assuming NIMs to see a decline of upto 15 bps on a YoY basis	Given the reversal of the interest rate cycle and lower CD ratio, we are assuming NIMs to see decline of upto 30 bps on a YoY basis
NPLs	Credit costs moving higher by 10-20bps	Credit costs moving higher by 20-30bps, considering the stress in power, aviation, agri and SME scetors

Source: Edelweiss research

Energy sector

On our base case assumptions, the incremental contribution of the energy sector to the total Sensex EPS is INR28.0. The biggest contributor from the energy sector is RIL followed by ONGC and Coal India. For our bear case assumptions, we expect the overall earnings contribution of the energy sector to decline to INR11.4. The biggest drag will be the earnings from RIL wherein we expect GRMs to decline from USD9.5/bbl (base case) to USD8/bbl (bear case). Our assumption is based on the fact that since FY04 (except in the period of the FY08 financial crisis), GRMs for RIL have never troughed below USD8/bbl. For Coal India, we expect sales volume to decline to 420mt from our base case assumption 440mt and blended realisation to decline from INR1,430/t to INR 1,385/t. The only silver lining within our bear case assumptions would be a positive EPS contribution between the base case and the bear case estimates for ONGC which is expected to benefit from the INR depreciation.

Chart 23: Base case and bear case forecasts for energy sector



Source: Bloomberg, Edelweiss research

Table 7: Stress case earnings affected by low RIL GRMs

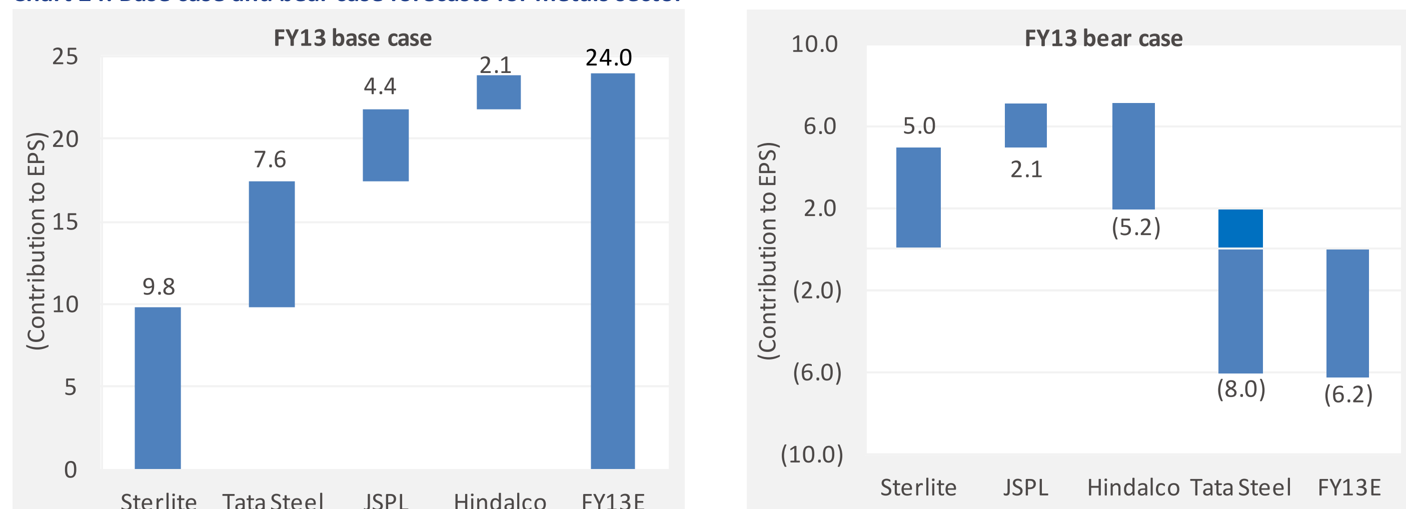
	Base case	Bear case
Crude oil assumption	USD95/bbl	USD90/bbl
GRMs	Maintaining RIL's GRMs at USD9.5/bbl	Slashing RIL's GRMs to USD8/bbl (excluding the crisis, it is the lowest since FY04)
Under-recovery and subsidy sharing	Upstream sharing at 50% and industry recovery of INR835bn implies ONGC net realisation of USD50.3/bbl	Upstream sharing at 50% and industry recovery of INR802bn implies ONGC net realisation of USD48.9/bbl; INR depreciation leads to positive EPS change for ONGC.
Coal	Sales volume for Coal India at 440mt, blended realisation at INR1,430/t	Sales volume for Coal India at 420mt, blended realisation at INR1,385/t

Source: Edelweiss research

Metals sector

On our base case assumptions, the incremental contribution of metals sector to the total Sensex EPS is INR24.0. The biggest contributor from the metals sector is Sterlite followed by Tata Steel and JSPL. For our bear case assumptions, we expect metal sector earnings to reduce the overall Sensex EPS by INR6.2. The biggest drag will be the decline in EPS from Tata Steel where we have assumed a realisation decline of INR1,000/t. Within the non-ferrous pack too, we have assumed a decline in realisations for both aluminum and zinc (revising down aluminum assumption to USD2,100/t and cutting zinc price assumption to USD1,800/t). This is expected to drag down earnings for both Hindalco and Sterlite.

Chart 24: Base case and bear case forecasts for metals sector



Source: Bloomberg, Edelweiss research

Table 8: Drop in realisations to hurt stress case earnings

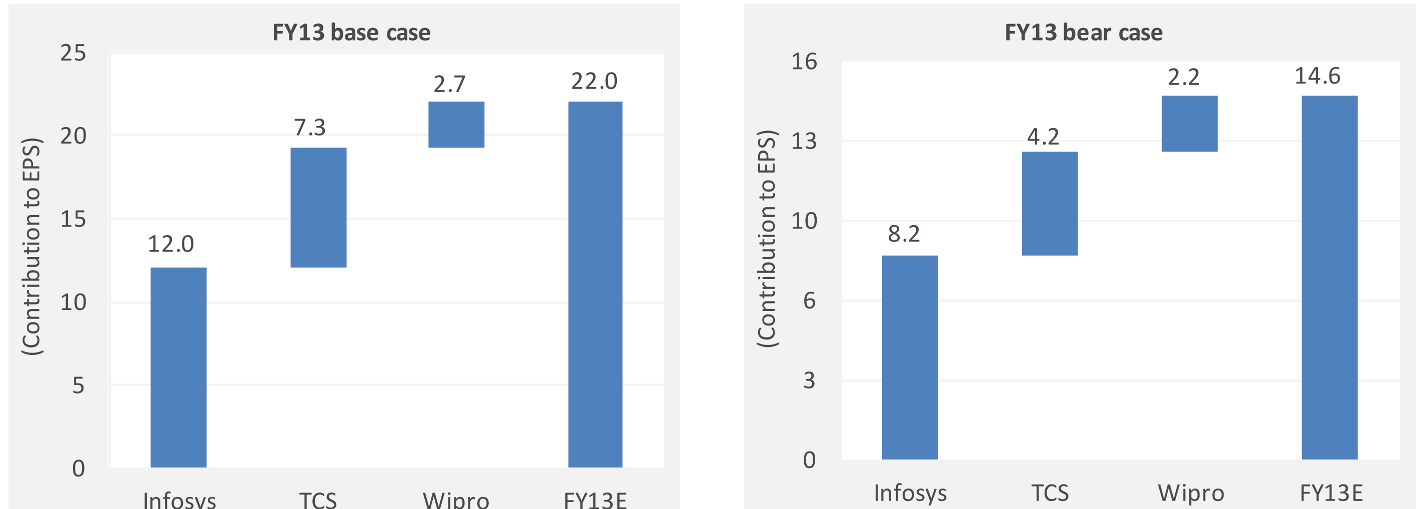
	Base case	Bear case
Steel		
Realisation	Unchanged from the current assumption of INR35,000/t	Steel realisation reduced by INR1,000/t to INR34,000/t
RM costs	Reduced prices of coking coal by USD30/t	Reduced prices of coking coal by USD20/t
Non ferrous		
Aluminum	Considering the weak macro, revising down realisation of Aluminum to USD2,400/t from USD2,550/t	Revising down realisation of Aluminum to USD2,100/t from USD2,550/t
Zinc	Zinc price assumption maintained at USD2,100/t	Zinc price assumption cut to USD1,800/t

Source: Edelweiss research

Tech sector

On our base case assumptions, the incremental contribution of IT sector to the total Sensex EPS is INR22.0. The biggest contributor from the IT sector is Infosys followed by TCS. In bear case, we expect the overall earnings contribution of the tech sector to decline to INR14.6. Within our bear case assumptions, we expect volume to grow by just 2%-3%, sharply lower than the 14%-16% growth expected within our base case assumptions. Notably, even in recessions, volume has never declined and even in a crisis period like CY09, volume growth was 4%-5%. Further, in our base case, we are assuming a pricing cut of 2.0% while in bear case, we are assuming a pricing decline of 3%.

Chart 25: Base case and bear case forecasts for Tech sector



Source: Bloomberg, Edelweiss research

Table 9: Tepid volume growth, pricing decline key concerns

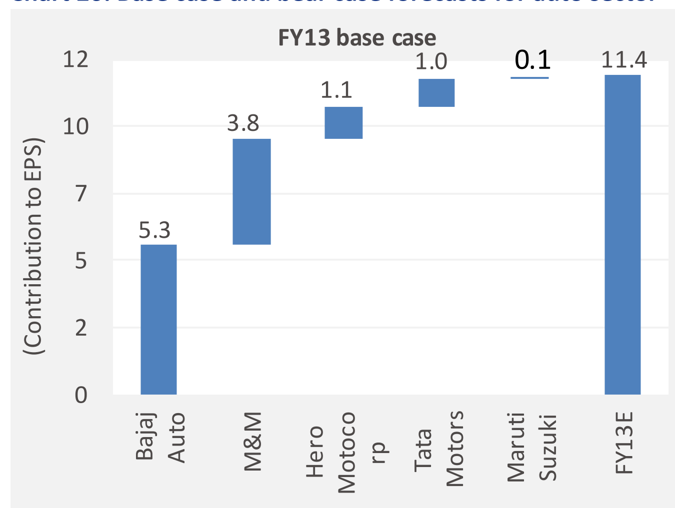
	Base case	Bear case
Overall scenario	Due to delay in decision making, volume growth would moderate and there could be marginal price cuts	If the US economy faces recession, then we could revisit FY10 growth scenario which is single digit volume growth combined with pricing pressure
Volume growth	Assuming volume growth to moderate to 14-16%	Volume growth of 2-3% (historically even in recesssions, volumes have never declined. Even in CY09, volume growth was 4-5%)
Pricing	Pricing to decline by 2%	We are assuming pricing decline of 3%

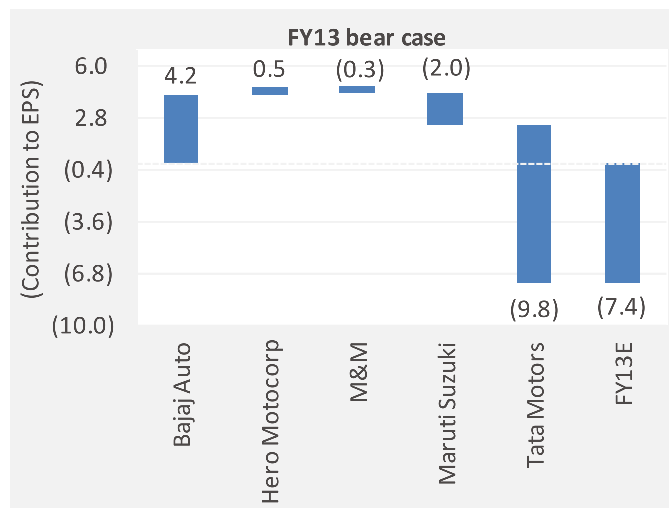
Source: Edelweiss research

Auto sector

On our base case assumptions, the incremental contribution of auto sector to the total Sensex EPS is INR11.4. The biggest contributor from the metals sector is Bajaj Auto followed by M&M. For our bear case assumptions, we expect metal sector earnings to reduce the overall Sensex EPS by INR7.4. Within our bear case assumptions, we expect volume growth to slowdown sharply to 0-2% for cars, 8% for LCV, 8% for tractors and 4% for 2 wheelers. For JLR, we expect the volume to decline by 5% in our bear case estimates. This is expected to impact Tata Motors, resulting in a negative contribution of INR9.8 to FY13 EPS.

Chart 26: Base case and bear case forecasts for auto sector





Source: Bloomberg, Edelweiss research

Table 10: Bear case EPS affected by slower volume growth

	Base case	Bear case
Volume growth	At 7% GDP growth, sales growth is likely to moderate to 5-6% for cars, low single digit for trucks, 15% for LCVs, 10% for tractors, 8% for two wheelers. JLR volumes: 8% growth for LR, flat for Jaguar	At 6.0% GDP growth, sales growth to further slowdown to 0-2% for cars, -10% for trucks, 8% for LCVs, 8% for tractors, 4% for two wheelers. JLR volumes: 5% decline
Margins	USDINR at 50 likely to provide margin relief vs H2FY12	In case of a recession, there could be a decline in metal prices which could be margin accretive

Source: Edelweiss research

Valuation indicators

Absolute valuations below long term averages

Overall, on an absolute basis, valuation indicators suggest that Indian markets are trading well below the long term averages. On the forward P/E, markets are trading at 12.2x, well below the trailing five year average of 15.3x. On the book multiple too, markets are below the long term average (current P/B at 2.5x vs 5 year average of 3.4x).

Chart 27: P/E below average levels

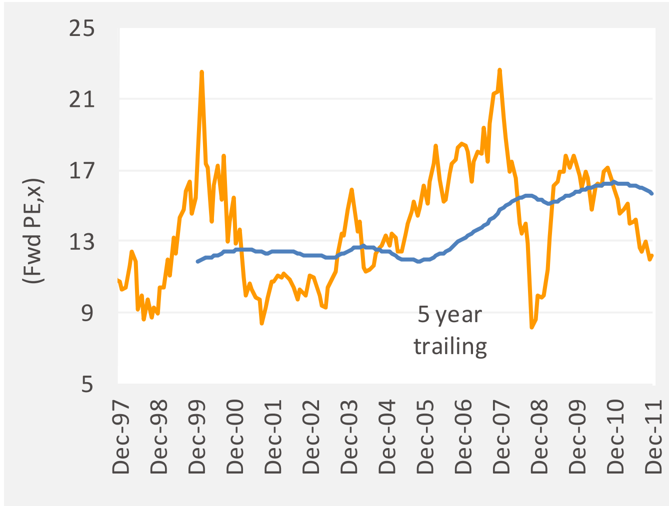
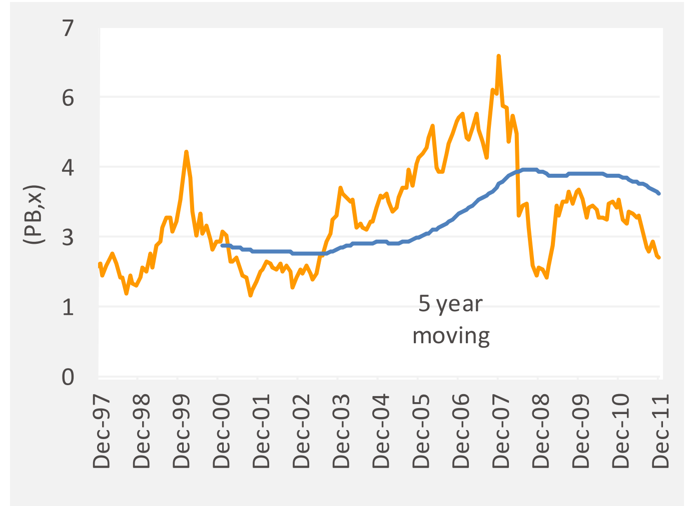


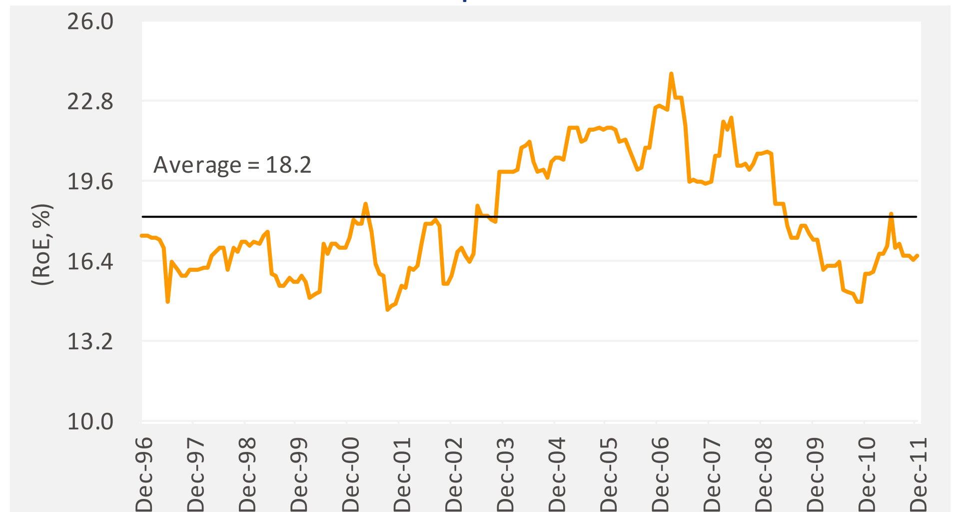
Chart 28: P/B also coming off



Source: Bloomberg , Edelweiss research

However, worryingly RoEs are also coming off steadily. FY02-FY08 witnessed a structural increase in RoEs with a remarkably high average of ~20%. However, post the crisis, the RoEs have dipped to 15%-16% levels- they remained stable since then, but are way off the 20%+ levels observed over the better part of the decade.

Chart 29: RoEs stable but well below the peaks



Source: Bloomberg, Edelweiss research

Note: Data for MSCI India

Relative valuations: Expensive compared to BRICs

While on an absolute level, markets are trading below their long term averages, on a relative basis, India is still expensive compared to BRICs peers. On a relative earnings multiple, India is trading at 12.2x FY13 earnings, which is still way above the BRICs average. On a P/B basis and on PEG ratios, India is trading at a premium which is higher than the historical averages.

Chart 30: India trading at a premium compared to peers

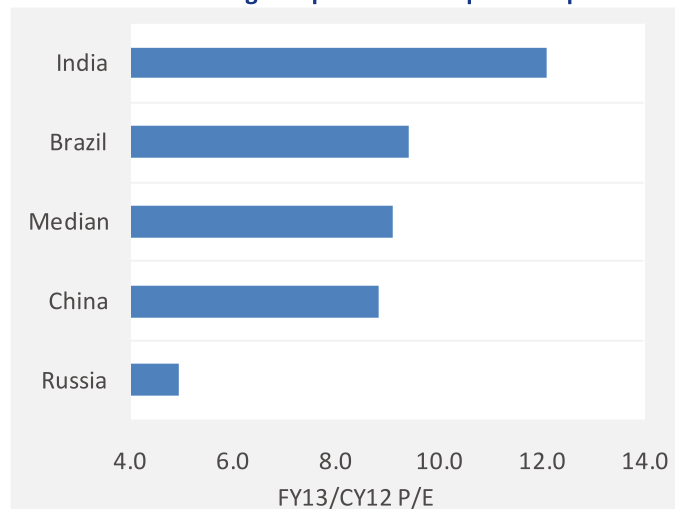
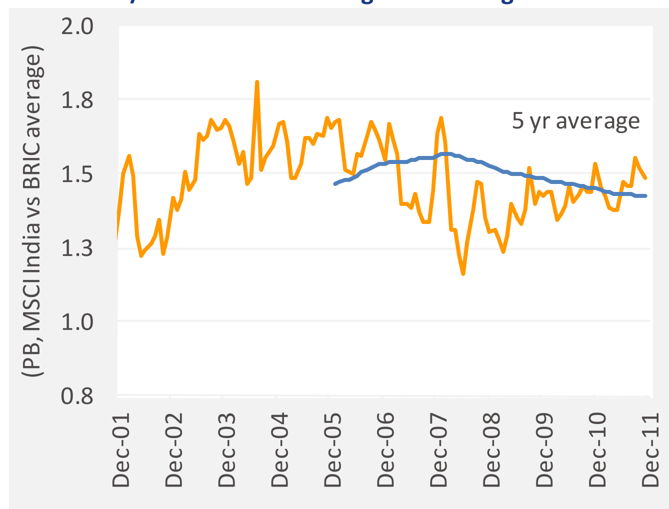


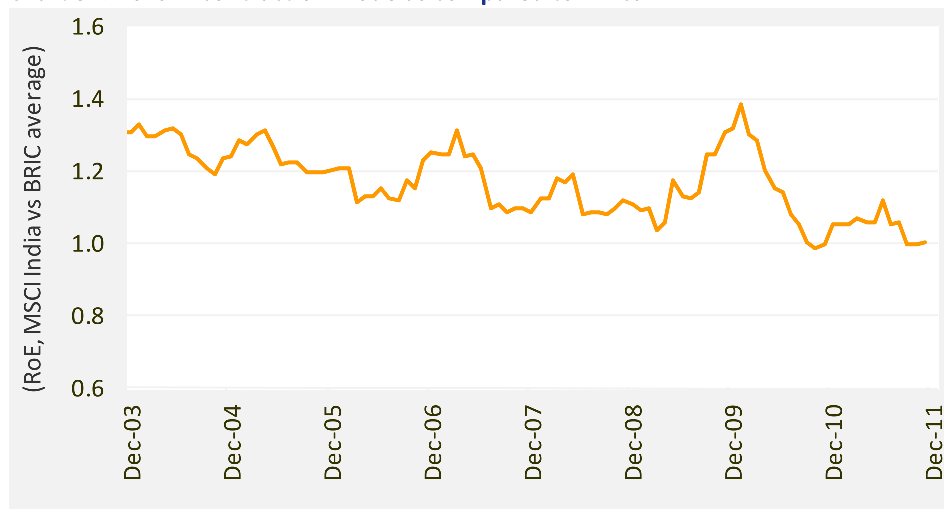
Chart 31: P/B still below the long term average



Source: Bloomberg, Edelweiss research

India has traditionally enjoyed a multiple premium over its peers. One of the reasons ascribed for this premium, was the relatively high RoE of India. However as compared to peers this RoE advantage may be shrinking. India's RoE which was almost 40% higher than the BRIC average in FY09 has shrunk rapidly and currently RoE s have almost converged.

Chart 32: RoEs in contraction mode as compared to BRICs



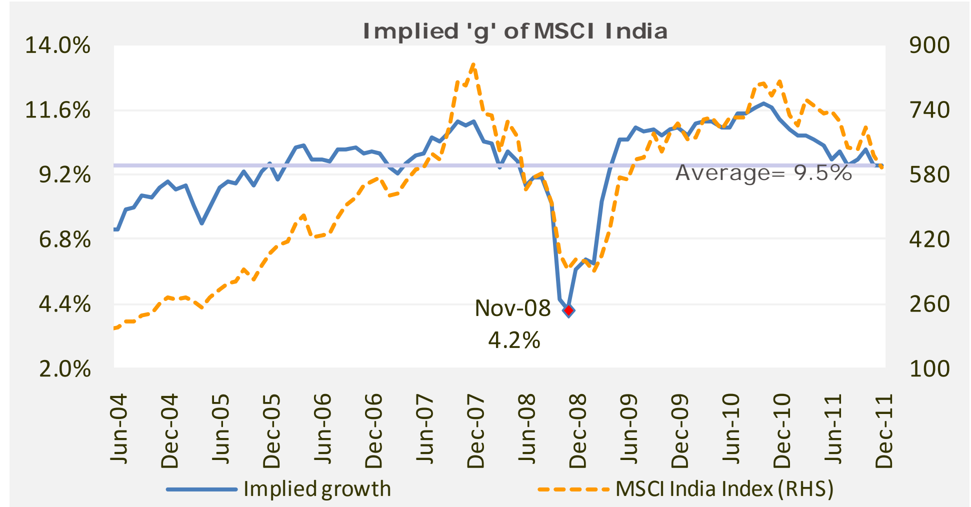
Source: Bloomberg, Edelweiss research

Note: 'BRIC' data calculated on market cap weighted basis

What's in the price?

Towards Q3FY11, stock markets were pricing in an implied growth rate of ~11.0%, one of the highest in the decade. Given the then prevailing regime of high and volatile input costs, such an assumption seemed aggressive and the market was clearly ignoring the risks of further earnings downgrade. However, after the recent correction, the implied growth expectations have fallen off steadily. At the current level of 9.0%, the growth is slightly below the decadal average.

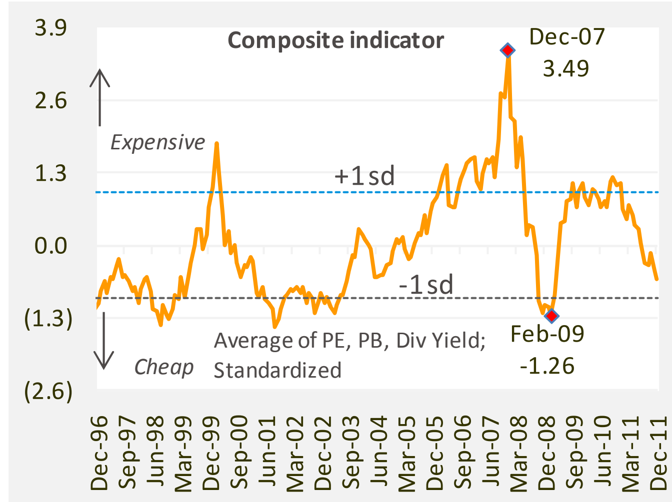
Chart 33: Growth expectations also beginning to decline



Source: Bloomberg, Edelweiss research

Our composite indicator - a standardized average of PE, PB and div yield – which had started trending down from the previous quarter has dipped further and at current levels, is implying that equities are at their cheapest since the crisis in FY09. Meanwhile, Shiller's PE (inflation adjusted price to 10 year average EPS ratio) has dipped below its average levels (current Shiller PE of 20x as compared to long term average of 27x).

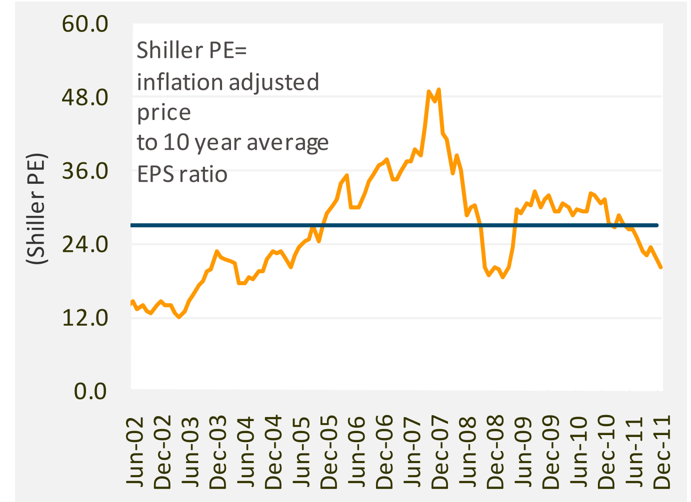
Chart 34: Composite indicator headed towards being cheap



Source: Bloomberg, Edelweiss research

Note: Data for MSCI India

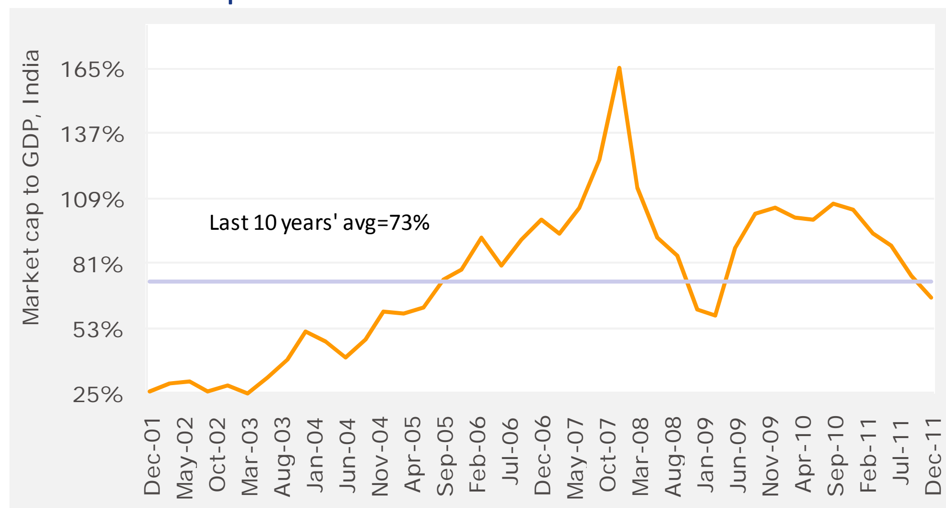
Chart 35: Shiller PE close to historical lows



Source: BSE, Robert Shiller, Edelweiss research

On a market cap to GDP basis, we are trading slightly below the long term average. India's market cap to GDP had peaked to about 150% in FY08, but subsequently fell sharply to 55%, during the crisis.

Chart 36: Market cap to GDP below historical levels



Source: Bloomberg, Edelweiss research

Thus overall on our pricing indicators, we are either at the average or just a notch below the average levels. Given the overall scenario of rapid earnings downgrades, lower RoEs and generally weak macros, we do not think that valuations look compelling, as yet.

Are markets overly pessimistic?

Sentiments took a hammering in the wake of a deepening European crisis, worsening macro fundamentals and a decline in earnings trajectory as markets recorded their second worst annual performance. It is interesting to note that in CY11, markets were in the red for nine months, the highest since 1996. This is a record of sorts given that even in a bad year such as in CY08, markets were in the red for seven months although it must be argued that the level of correction was much steeper then.

Fig. 1: Markets were in the red for 9 months this year

Monthly returns (%)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YOY Return %
2011	(10.2)	(3.1)	9.4	(1.4)	(3.3)	1.6	(2.9)	(8.8)	(1.2)	7.8	(9.3)	(4.3)	(24.6)
2010	(6.1)	0.8	6.6	0.6	(3.6)	4.4	1.0	0.6	11.6	(0.2)	(2.6)	4.6	17.9
2009	(2.9)	(3.9)	9.3	15.0	28.1	(3.5)	8.0	0.6	9.0	(7.3)	6.8	3.3	75.8
2008	(16.3)	1.7	(9.4)	9.1	(5.7)	(17.0)	7.2	0.6	(10.1)	(26.4)	(4.5)	7.4	(51.8)
2007	2.9	(8.3)	2.0	7.0	5.1	0.5	4.9	(1.4)	12.5	17.5	(2.3)	6.5	54.8
2006	5.8	2.5	10.7	4.6	(13.7)	1.9	0.5	8.6	5.1	4.3	5.6	0.3	39.8
2005	(1.1)	2.2	(3.2)	(6.5)	9.7	6.4	4.1	3.1	9.1	(8.9)	11.9	6.9	36.3
2004	(3.7)	(0.5)	(1.6)	1.4	(17.4)	1.5	8.4	(0.0)	7.0	2.4	9.6	6.2	10.7
2003	(4.7)	2.1	(8.0)	(4.5)	7.8	12.6	4.6	14.4	4.5	9.8	3.8	16.4	71.9
2002	2.0	5.7	(1.1)	(4.0)	(5.1)	2.8	(9.3)	5.4	(4.7)	(1.2)	10.4	4.1	3.3
2001	8.6	(1.5)	(15.0)	(2.0)	3.8	(5.1)	(3.2)	(1.8)	(13.3)	6.4	9.8	(0.8)	(16.2)
2000	4.4	7.0	(7.6)	(8.0)	(1.9)	6.6	(9.4)	4.6	(8.8)	(7.8)	8.1	(0.4)	(14.7)
1999	9.3	1.6	9.9	(9.3)	15.8	4.9	10.3	7.8	0.1	(6.2)	3.8	7.6	67.4
1998	(10.7)	10.1	5.3	3.8	(8.3)	(11.4)	(1.1)	(8.4)	6.1	(8.9)	(0.8)	8.1	(18.1)
1997	8.2	8.3	(8.1)	11.5	(2.7)	13.5	2.4	(9.5)	1.7	(3.4)	(5.6)	5.4	20.1
1996	(6.6)	17.0	(0.7)	13.1	(2.2)	2.9	(7.1)	(1.3)	(8.3)	(3.7)	(8.7)	8.3	(1.0)

Source: Bloomberg, Edelweiss research

In CY11, with a net FII outflow of USD600mn, flows were unsupportive. This is in sharp contrast to CY09 and CY10 when net FII flows were to the tune of USD18bn and USD29bn respectively. DIIs were net buyers at USD5.9bn but it was simply not enough to protect markets from a slide.

Table 11: Flows were tepid

(USD bn)	Net FII	Net DII
CY06	7.9	3.4
CY07	17.4	5.6
CY08	(13.3)	16.6
CY09	18.2	5.3
CY10	29.3	(4.7)
CY11	(0.6)	5.9

Source: Bloomberg, Edelweiss research

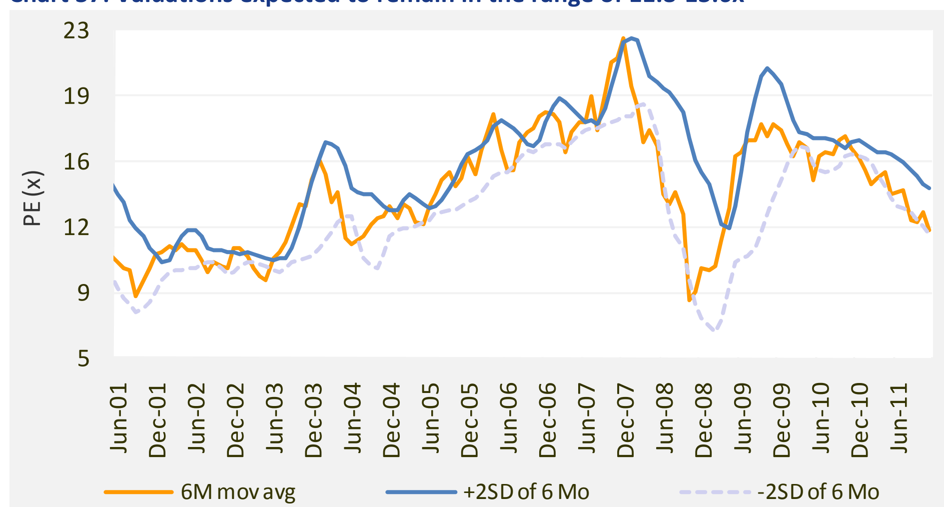
Valuations: Where are we headed?

Our analysis suggests that over the next 3-6 months, markets could well be trading within a zone of 11.8x-13.6x. We have based our assumptions based on two historical observations:

1) On a rolling six months data, markets have historically traded in a tight band of +/-2 sd. At current levels of ~12.2x forward PE, markets are trading closer to the lower 2sd band of 11.8x.

2) The long term historical average P/E is 13.6x. Even assuming a modest 15% returns from equities, markets at 11.5-11.6x could warrant a fresh buying opportunity.

Chart 37: Valuations expected to remain in the range of 11.8-13.6x



Source: Bloomberg, Edelweiss research

Thus based on the triangulation of above assumptions, we can infer that the lower end of the trading band could be restricted to 11.5-11.8x while on the higher end, markets may ultimately drift towards the long term average of 13.6x.

Key themes to play on

Overall, we expect markets to trade in a broad range in CY12 amidst high volatility. Thus, we favour sectors/stocks with good quality management, strong earnings visibility and durable cash flows and we position our portfolio with a clear large cap defensive bias. On the significant changes within our portfolio, we move industrials back to underweight as we believe that without any traction on the policy front and generally weak investments scenario, a rate cut alone will not be enough to engineer a turnaround in capex. Our outlook for USDINR in FY13 makes us bullish on exports - especially within sectors such as tech and pharma where the earnings visibility is also stronger. We are already overweight on the pharma and move tech from under-weight to equal-weight. Based on our macro-economic assessment, the broad themes to focus on are:

- Weak rupee to support earnings in export oriented sectors (increasing overweight on pharma and moving tech to equal-weight)
- Domestic demand stays healthy (maintain OW on consumer sector)
- No immediate visibility in revival of capex (UW on industrials)

Weak rupee to support earnings in export oriented sectors: As per our base case macro assumptions, we expect the USDINR to average ~50 levels in FY13 as compared to an expected ~48.6 for FY12. This should support earnings growth in sectors such as pharma and tech. From an industry perspective, pharma sector is expected to gain from a recovery in domestic growth and huge patent cliff opportunities in US over the next 12-18 months (drugs worth USD50bn going off-patent). Within the tech sector, recent commentary may be pointing towards growth moderation but we still favor the sector on two counts. While IT budgets are expected to remain flat or decline marginally, offshoring is expected to increase. Revenue growth may moderate between FY12E and FY13E but rupee depreciation would lead to higher earnings growth.

Domestic demand stays healthy: In our view, despite the recent moderation, domestic demand still remains healthy and thus, we continue to maintain our over-weight stance on the consumer sector. A declining inflation trajectory and a healthy rural demand will continue to support consumption and a steady volume growth is expected to continue into FY13. Further with raw material prices and ad rates also coming off, there should be some improvement in margins as well.

No immediate visibility in capex revival: Given the overall weak sentiments, we do not believe that a reversal in the rate cycle alone would be sufficient to engineer a turnaround in the capex cycle. Accordingly, we are moving industrials from equal-weight to under-weight. The main risk emanates from a slowdown in the power generation equipment market which might show a sharper than expected decline between FY12E and FY13E. Further, sustained government policy hurdles might lead to swift downgrades in consensus numbers for various infra verticals.

Table 12: Top Picks

	Current market cap	CMP	P/E (x)		P/B (x)		ROE (%)		Div yield (%)
	USD bn	INR	FY12E	FY13E	FY12E	FY13E	FY12E	FY13E	FY12E
Large-caps									
TCS	42.8	1,161	21.3	17.8	6.9	5.4	36.7	34.2	1.2
Bharti Airtel	24.6	344	20.7	11.8	2.5	2.1	12.5	19.0	0.4
Coal India	35.8	301	11.8	10.1	4.2	3.2	41.1	36.2	2.0
HDFC Bank	18.8	427	20.1	16.4	3.4	2.9	18.1	19.3	0.9
Lupin	3.8	448	19.8	16.8	4.9	3.9	27.3	26.0	0.8
Mid-caps									
Glenmark	1.5	294	15.9	12.5	2.9	2.4	20.1	20.2	0.2
Hexaware	0.4	75	9.2	8.5	2.0	1.8	23.7	22.7	4.1
LIC Housing Finance	2.0	221	10.4	8.2	2.2	1.8	22.4	23.9	1.9
Petronet LNG	2.2	156	11.4	11.2	3.4	2.8	33.6	27.3	1.9
Zee	2.2	118	18.5	15.5	3.3	2.9	18.8	19.7	1.7

Source: Edelweiss research

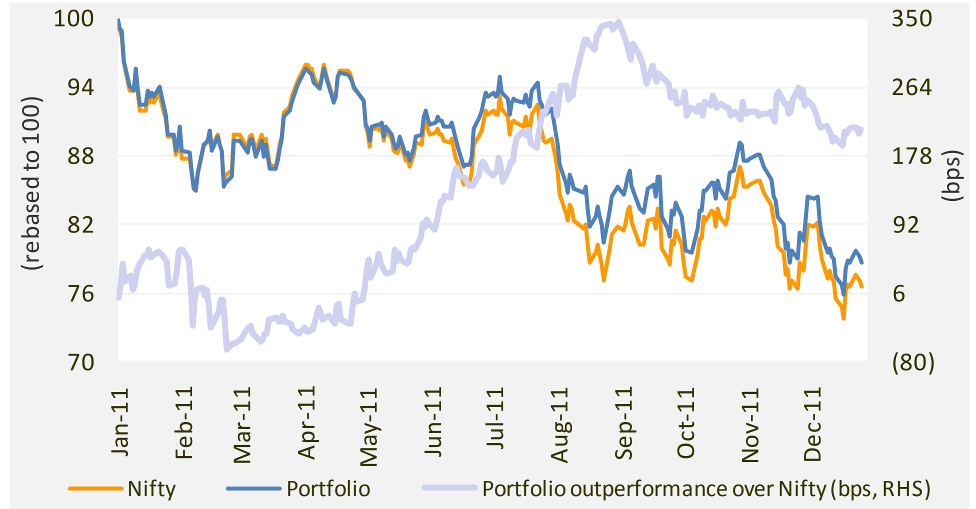
Table 13: Model portfolio

Stocks	Mkt Cap (USD bn)	Price (INR)	Portfolio wt (%)	Nifty wt (%)	Rel wt (bps)	P/E (x) FY12E	P/E (x) FY13E	P/B (x) FY12E	P/B (x) FY13E	RoE (%) FY12E	RoE (%) FY13E	Div Yld (%) FY12E
Health Care			**6.6**	**4.3**	**230**							
Dr Reddy's Laboratories	5.0	1,578	2.8	1.4	140	20.8	16.2	5.0	3.9	33.5	29.9	0.9
Lupin	3.8	448	1.4	0.0	140	19.8	16.8	4.9	3.9	27.3	26.0	0.8
Glenmark Pharmaceuticals	1.5	294	1.4	0.0	140	15.9	12.5	2.9	2.4	20.1	20.2	0.2
Torrent Pharmaceuticals	0.9	540	1.0	0.0	100	13.0	10.6	3.5	2.8	30.0	29.2	1.3
Telecommunication Services			**4.8**	**3.2**	**160**							
Bharti Airtel	24.6	344	3.8	2.8	100	20.7	11.8	2.5	2.1	12.5	19.0	0.4
Idea Cellular	5.1	82	1.0	0.0	100	32.8	18.3	2.1	1.9	6.7	11.0	0.0
Energy			**16.0**	**14.7**	**130**							
Reliance Industries	42.8	693	7.5	8.5	-100	10.0	9.1	1.3	1.2	14.0	13.8	1.1
Oil & Natural Gas Corp	41.4	257	2.5	2.5	0	8.7	7.4	1.7	1.5	20.9	20.6	3.9
Coal India	35.8	301	3.3	1.3	200	11.8	10.1	4.2	3.2	41.1	36.2	2.0
Bharat Petroleum Corp	3.3	478	1.4	0.4	100	26.3	7.9	1.1	1.0	4.2	13.0	2.9
Petronet LNG	2.2	156	1.2	0.0	120	11.4	11.2	3.4	2.8	33.6	27.3	1.9
Consumers			**11.9**	**10.6**	**130**							
ITC	29.6	201	7.7	7.7	0	25.5	21.6	8.7	7.8	36.1	38.6	2.5
Hindustan Unilever	16.6	407	3.0	3.0	0	35.8	30.6	25.7	20.5	80.4	75.2	1.8
Zee Entertainment Enterprises	2.2	118	0.7	0.0	70	18.5	15.5	3.3	2.9	18.8	19.7	1.7
Dish TV India	1.2	59	0.6	0.0	60	NM	NM	NM	NM	NA	NA	0.0
BFSI			**24.5**	**24.5**	**0**							
State Bank of India	19.4	1,619	3.0	3.0	0	9.2	7.1	1.4	1.2	16.2	18.5	2.5
HDFC Bank	18.8	427	6.4	5.4	100	20.1	16.4	3.4	2.9	18.1	19.3	0.9
HDFC	18.1	652	6.2	6.2	0	23.0	20.1	4.8	3.8	22.3	21.5	1.3
ICICI Bank	14.9	685	5.6	5.6	0	12.8	10.6	1.3	1.2	10.8	12.0	2.0
Axis Bank	6.3	808	1.5	1.5	0	10.1	8.5	1.8	1.6	19.5	19.9	2.1
LIC Housing Finance	2.0	221	1.0	0.0	100	10.4	8.2	2.2	1.8	22.4	23.9	1.9
M&M Financial Services	1.2	610	0.8	0.0	80	11.2	9.2	2.2	1.8	20.6	21.4	1.6
Information Technology			**15.7**	**15.7**	**0**							
Tata Consultancy Services	42.8	1,161	4.2	4.2	0	21.3	17.8	6.9	5.4	36.7	34.2	1.2
Infosys	29.9	2,768	9.4	9.4	0	18.8	16.5	5.1	4.3	29.8	28.4	1.8
Wipro	18.5	399	1.4	1.4	0	17.3	14.8	3.5	3.0	21.9	22.0	1.5
Hexaware Technologies	0.4	75	0.7	0.0	70	9.2	8.5	2.0	1.8	23.7	22.7	4.1
Autos			**8.1**	**8.1**	**0**							
Tata Motors	9.9	179	2.3	2.3	0	9.1	7.8	2.3	1.9	29.9	27.7	0.0
Bajaj Auto	8.7	1,591	2.1	1.5	60	14.6	12.1	6.9	5.2	55.1	49.3	2.5
Mahindra & Mahindra	7.9	682	2.9	2.2	70	14.4	11.5	3.4	2.8	25.7	26.5	0.0
Maruti Suzuki India	5.0	918	0.9	0.9	0	16.0	11.8	1.8	1.6	11.7	14.2	0.6
Utilities			**4.1**	**4.1**	**0**							
NTPC	25.0	161	1.5	1.5	0	15.2	13.4	1.8	1.7	12.4	13.0	2.6
Power Grid Corp of India	8.7	100	1.0	1.0	0	16.8	14.9	2.0	1.8	12.4	12.8	1.6
Mundra Port and SEZ	4.5	120	0.6	0.0	60	18.9	14.2	4.6	3.5	26.8	28.1	0.8
Tata Power Co	3.9	87	1.0	1.0	0	8.8	9.9	1.3	1.2	16.8	13.2	1.6
Industrials			**4.7**	**5.9**	**-120**							
Larsen & Toubro	11.5	995	3.8	3.8	0	12.8	11.1	2.1	1.9	17.8	17.8	1.6
Bharat Heavy Electricals	11.0	239	0.4	1.3	-90	9.2	8.1	2.4	2.0	28.3	26.2	2.8
Havells India	0.9	385	0.6	0.0	60	13.0	10.9	4.9	3.5	45.5	37.7	1.2
Metals & Materials			**3.5**	**5.6**	**-210**							
Tata Steel	6.1	335	1.6	1.6	0	8.3	6.6	0.7	0.7	9.4	10.6	3.6
Sterlite Industries India	5.7	90	0.9	0.9	0	5.9	4.3	0.7	0.6	11.8	14.3	1.0
Coromandel International	1.5	277	1.0	0.0	100	11.4	8.8	3.2	2.6	31.5	32.4	2.5
Cement			**0.0**	**2.7**	**(270)**							
Real Estate			**0.0**	**0.5**	**(50)**							
Model Portfolio	**500**		**100**	**100**	**0**	**13.6**	**11.3**	**2.5**	**2.1**	**18.0**	**18.7**	

Source: Edelweiss research

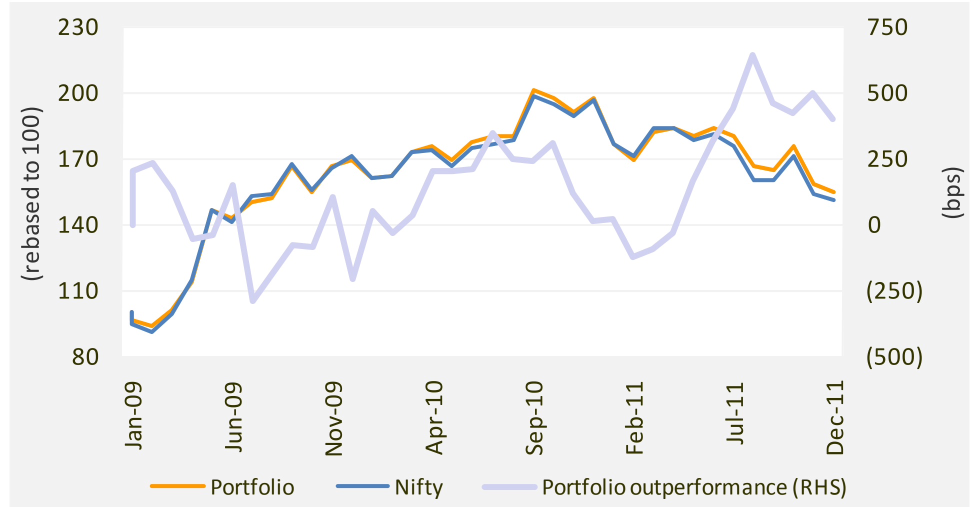
Portfolio performance

Chart 38: Model portfolio has outperformed Nifty by 200bps in CY11



Source: Edelweiss research

Chart 39: Since inception model portfolio has outperformed Nifty by 400bps



Source: Edelweiss research

Edelweiss Securities Limited, Edelweiss House, off C.S.T. Road, Kalina, Mumbai – 400 098.
Board: (91-22) 4009 4400, Email: *research@edelcap.com*

Vikas Khemani	Head Institutional Equities	vikas.khemani@edelcap.com	+91 22 2286 4206
Nischal Maheshwari	Co-Head Institutional Equities & Head Research	nischal.maheshwari@edelcap.com	+91 22 6623 3411

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