J.P.Morgan

Asia Pacific Equity Research
22 June 2009

Stratoscope

Indian Equities - Valuations re-visited

- **Valuations re-visited.** We evaluate market valuations considering different growth assumptions and valuation methodologies. Earnings based valuations, derived from current growth estimates (a CAGR of 14% over FY09-11E) suggest a trading range of 12,500-16,500 for the BSE Sensex for the current fiscal year. Valuation models that do not depend excessively on near term earnings – P/B-RoE and long term DDM – also suggest a reasonable upside.
- **Special focus: Valuations vs macro variables.** An analysis of the relationship between 12 month forward PE multiples and key macro economic variables, suggests a meaningful relationship with IIP and the exchange rate. The relationship with interest rates and inflation is however not significant.
- **Near term consolidation.** We have been arguing for near term consolidation following the sharp rally, post the election results. A substantial equity issuance pipeline and the weak progress of the monsoon are near term pressure points. But we remain constructive on a 12-18 month view, given the policy freedom available to the new Government and await initiatives herein in the Budget scheduled for July 6.
- **Portfolio stance.** We remain positive on local growth, with a bias towards the investment cycle. We are downgrading Consumer Discretionary from overweight to neutral following substantial outperformance over the last three quarters and concerns over the weak progress of the monsoon. We are also adding weight to IT services, given signs of an improvement in tech spending. We are adding Satyam to our model portfolio.

Indian Equity Strategy

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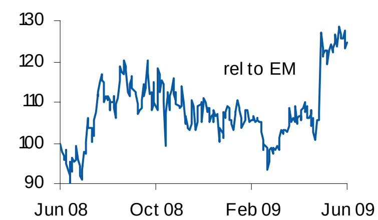
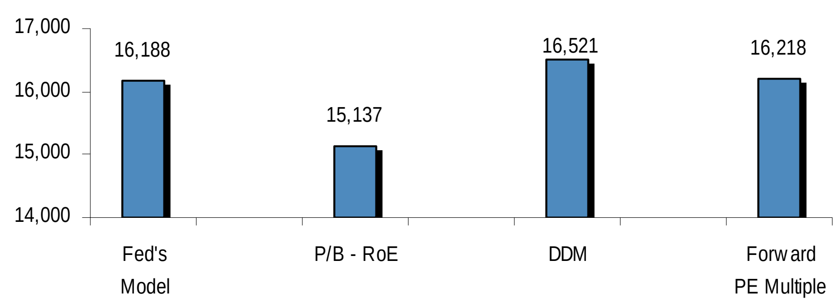
MSCI India relative to MSCI EM



Source: MSCI, Datastream

Sensex – Fair value for March 2010.



Source: Datastream, J.P.Morgan

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Valuations Re-visited

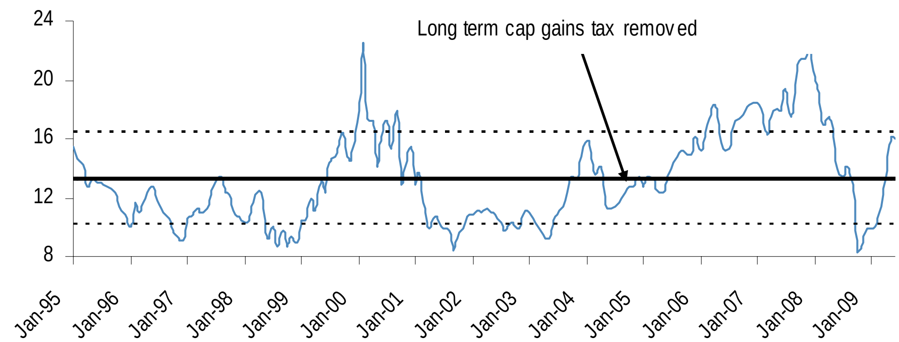
Indian equities have rallied c80 % from the early March lows. Investor sentiment has improved substantially over the last three months boosted by a decisive mandate in the national elections for the ruling UPA coalition and improved economic growth outlook, both locally and globally.

In this backdrop, we thought it would be useful to revisit current market valuations considering a range of growth assumptions and different valuation methodologies.

12 month forward PER model

The sharp rally in the equity markets over the last three months has brought valuations to a premium in relation to historic comparatives. The MSCI India index is currently trading close to one standard deviation above the mean.

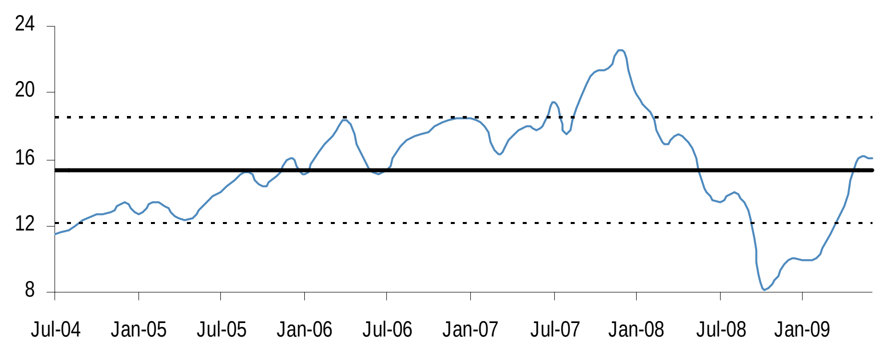
Figure 1: MSCI India - 12 month forward PER



Source: MSCI, IBES, Datastream

But adjusted for the abolition of long term capital gains tax in July 04, the market is currently trading at the average level since.

Figure 2: MSCI India - 12 month forward PER



Source: MSCI, IBES, Datastream

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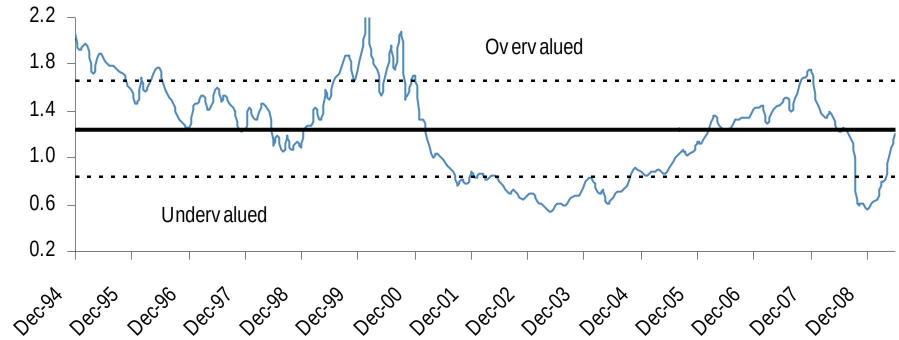
Fed's model

The relative attraction of equity as an asset class as compared to debt for local investors has also reached neutral territory. The Fed model comparing the 10 year treasury yield to earnings yield suggests that valuations are near long term averages.

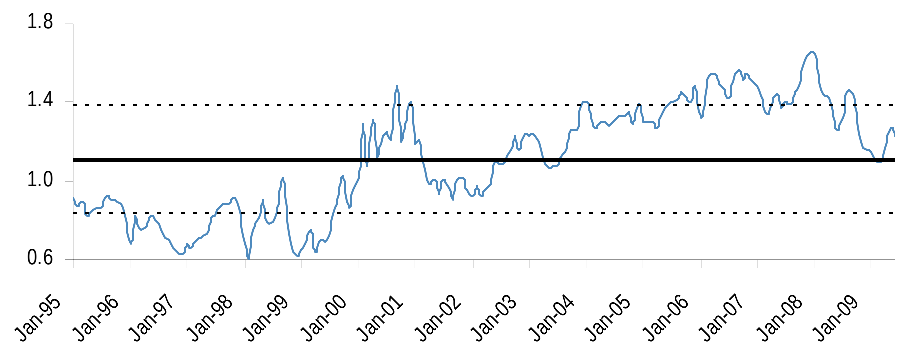
Figure 3: Fed's model – Neutral zone



Source: MSCI, IBES, Datastream

Emerging market comparison

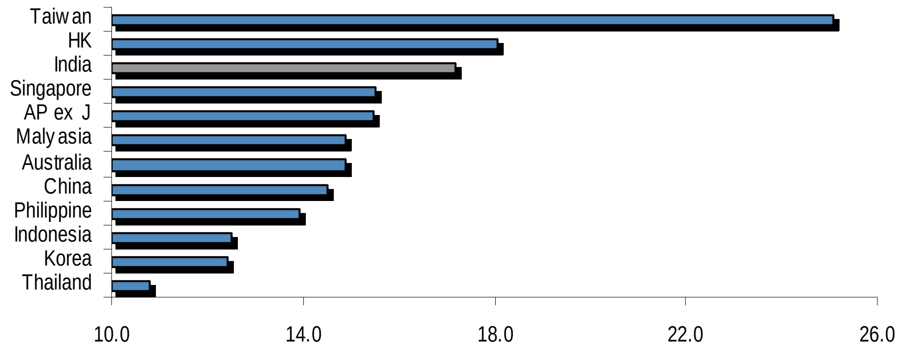
Figure 4: MSCI India vs. EM – 12 month forward PER



Source: MSCI, IBES, Datastream

The Indian markets valuation premium relative to other emerging markets has contracted over the last year. But India still remains among the more expensive markets in the EM universe.

Figure 5: MSCI India and key Asian and EMs – 12 month forward PE



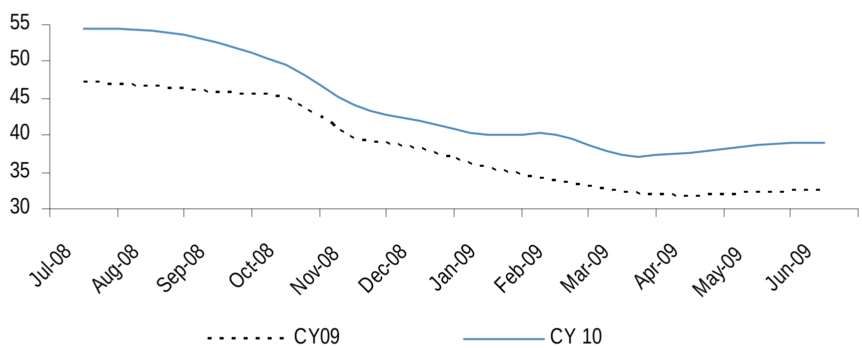
Source: MSCI, IBES, Datastream

While the valuation levels for EMs and the extent of relative premium that India should trade at can be debated upon, most investors agree that India would trade at a premium given the higher growth forecast both over the near term and on a structural basis on the back of diversified growth drivers and higher capital efficiency.

Earnings growth expectations – Upgrades have started

After sustained and substantial cuts in earnings expectations since early 2008, earnings estimates are seeing upward revisions over the last two months. Consensus currently estimates earnings growth of 13% and 15% for FY10E and FY11E respectively.

Figure 6: MSCI India EPS estimates



Source: MSCI, IBES, Datastream

BSE Sensex - Sensitivity Analysis

We present below a scenario analysis of where the BSE Sensex could trade at for different levels of forecast earnings growth and valuation multiples.

Table 1: BSE Sensex – March 10 index value and scenario analysis

	EPS CAGR - FY 09E-11E (%)					
EPS Integer	(5)	0	5	10	15	20
780	704	780	860	944	1,032	1,123
PE						
8	5,632	6,240	6,880	7,550	8,252	8,986
12	8,447	9,360	10,319	11,326	12,379	13,478
16	11,263	12,480	13,759	15,101	16,505	17,971
20	14,079	15,600	17,199	18,876	20,631	22,464

Source: J.P.Morgan

Given the improving economic and earnings growth outlook and risk premium, we believe that early cycle the Indian markets could sustain valuations in the range of 12-16x, at the mid point of the historic trading band. Valuations should also be supported by the policy flexibility and freedom that the Government enjoys following the decisive mandate in the National elections. This flexibility has not been available to Governments over the past two decades and is a structural positive.

In the backdrop of these positives, we believe that current earnings growth estimates support a fair value range of 12,400-16,500 for the BSE Sensex over the next 12 months.

Near term we expect the markets to consolidate, following the sharp post election rally, as investors await the Government's policy initiatives. A substantial equity issuance pipeline should also lead to a better demand supply balance. But down the line we expect the markets to re-rate as confidence levels on growth improves.

Downside risks to our estimates would largely emanate from: a) any worsening in global growth and liquidity outlook. It is worth highlighting that India's growth outlook is relatively less dependent on global growth. But the dependence on global liquidity is substantial; b) Sharper than expected increase in domestic interest rates if fiscal consolidation measures are not implemented. A related risk over the immediate term is the weak progress of the monsoon and the impact it can have on agri sector growth and consumption demand.

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Special focus: PE Multiples and macro variables

We analyzed the relationship between 12 month forward PEs and key macro variables.

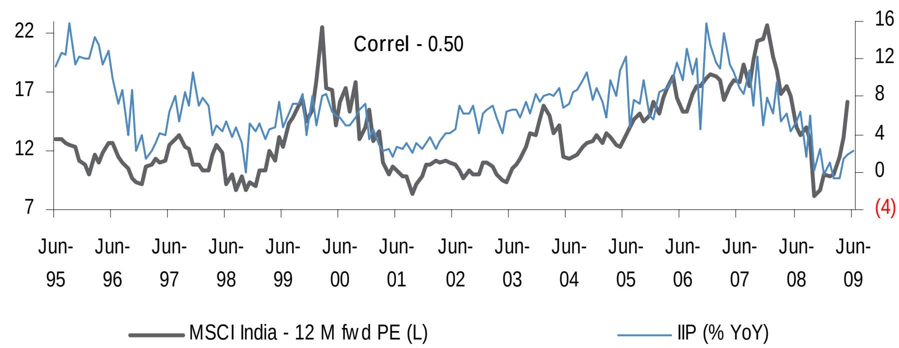
It is interesting to note that the relationship between broad market valuations and IIP and exchange rates is meaningful. But the relationship of market valuations with interest rates and inflation is however not significant.

Applying our estimate of a gradual improvement in IIP to 10.3% by the end of FY10E (and an average of about 6% for the year) to our regression model, suggests a fair value multiple of 14.8x for end FY10E. Based on current earnings estimates this implies a year end Sensex level of 16,600.

Similarly, applying our currency forecast of INR 44 to the US$ by end FY10E (an average of INR 46 to the US$ for FY10E), suggests a fair value multiple of 15x for year end FY10E. Based on current earnings estimates this implies a year end Sensex level of 17,000.

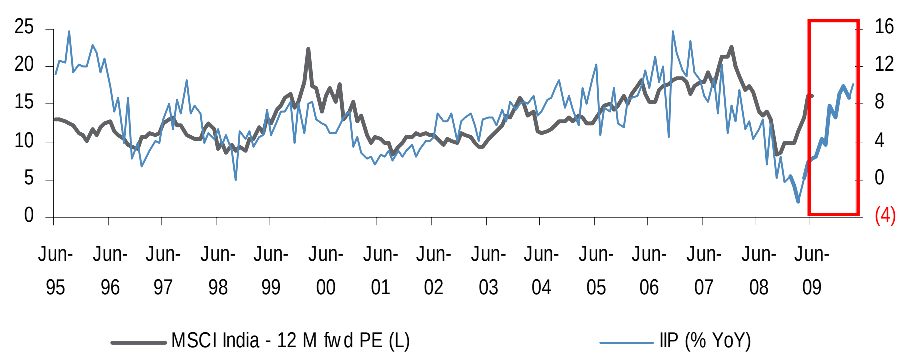
We note that both these estimates are within our estimated trading range for the Sensex for the fiscal year.

Figure 7: Industrial Production vs. MSCI India forward PE



Source: Source: Datastream, IBES. J.P.Morgan

Figure 8: IIP - Improvement expected



Source: Datastream, IBES, J.P.Morgan.

Note – J.P.Morgan forecast highlighted

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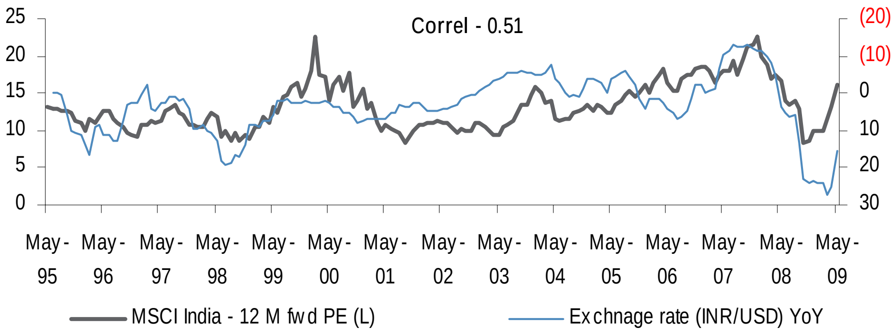
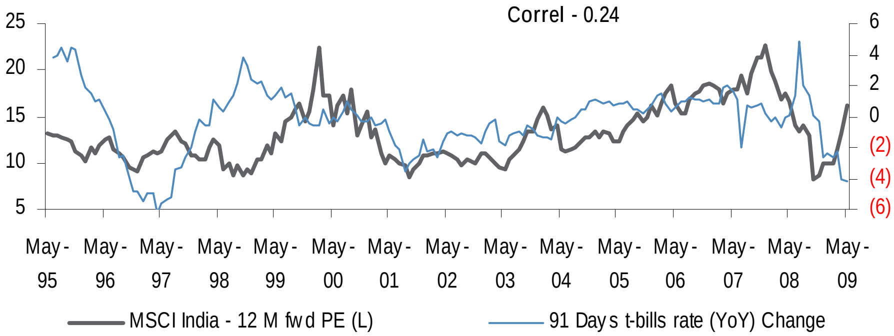
Figure 9: Exchange rate (YoY) vs. MSCI India forward PE



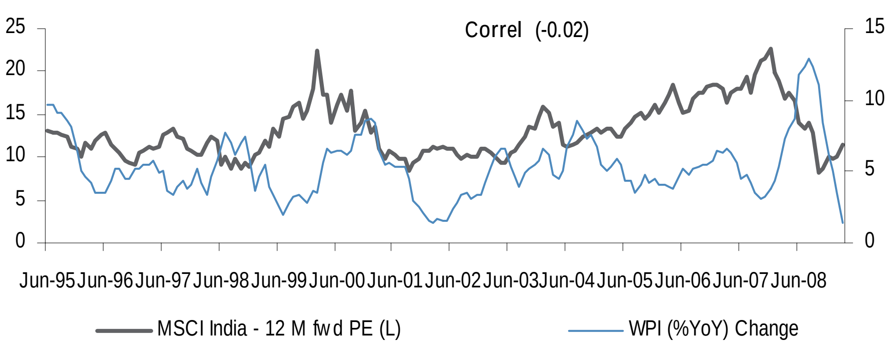
Source: Datastream, IBES, J.P.Morgan

Figure 10: 91 Days t-bill rate vs. MSCI India - 12 M fwd PE



Source: Datastream, IBES, J.P.Morgan

Figure 11: Inflation vs. MSCI India - 12 M fwd PE



Source: Datastream, IBES, J.P.Morgan

Valuations beyond earnings

In the backdrop of the considerable uncertainty surrounding key macro variables, we look at valuations based on parameters that look beyond immediate term earnings estimates.

Discounted Dividend Model

We ran a four stage dividend discount model for the Sensex based on the following assumptions, which we believe are fairly realistic.

Table 2: Assumptions for Sensex DDM

(%)	Earnings growth	Payout Ratio	Cost of equity *	% contribution to total value
FY 10 to FY 12	16.0	30.0	12.9	5%
FY 13 to FY 22	14.0	37.5	12.9	23%
FY 23 to FY 33	10.0	48.5	12.9	27%
FY 33 onwards	4.0	60.0	10.0	45%

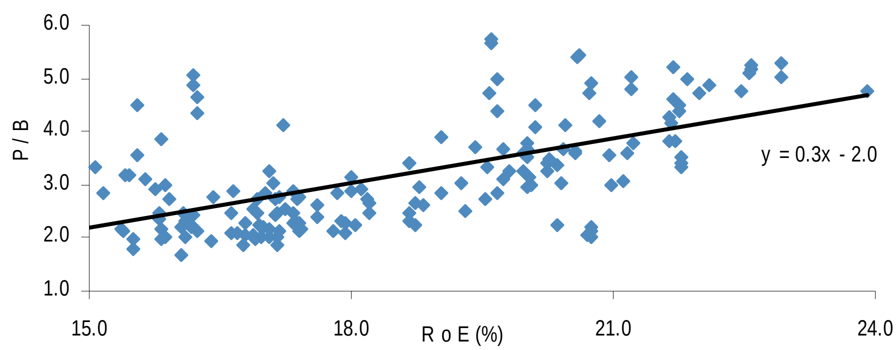
Source: JPMorgan

* - for the terminal value we have assumed 5% risk free rate and 6% Equity risk premium

Based on the above exercise, we arrive at a fair value estimate of 16,800 for the BSE Sensex.

Price/Book - RoE

Figure 12: P/B to RoE trend



Source: MSCI, Datastream

Our P/B vs. RoE model, suggests a fair value estimate of 15,100 for the Sensex. It must be pointed out that after benefiting from both growth and leverage over FY04 to FY08 , RoEs are expected to trend down over the medium term as the corporate sector in India enters a capital intensive phase over the next few years. Any pressure on earnings will marginally accentuate the pressure herein.

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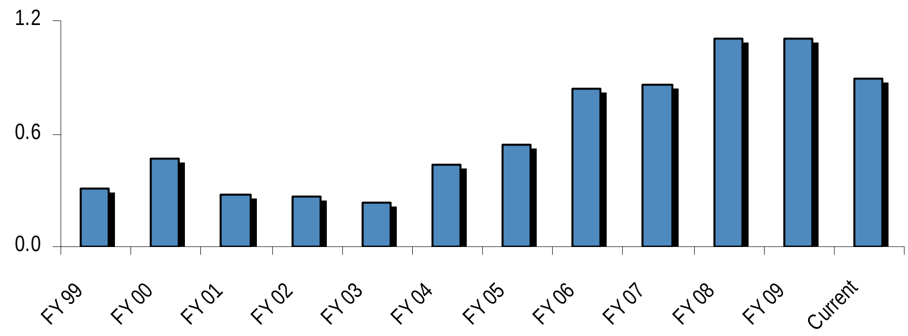
Market cap to GDP ratio

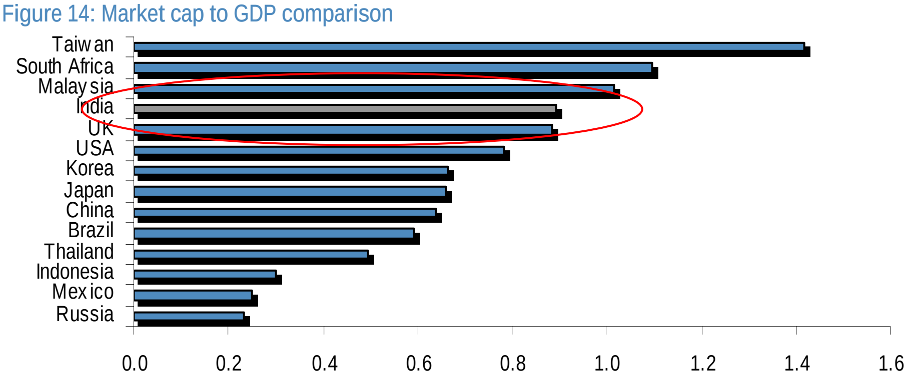
Figure 13: Market cap to GDP ratio



Source: Bloomberg, J.P. Morgan,
Note – Numbers are fiscal year end.

The Indian market has re-rated consistently over the last few years on this measure as a) more segments of the economy have been drawn into the organized sector viz. retail, property, media, transportation, etc, and b) along with the Government sector (Public sector companies) have increasingly opted to be listed on the stock exchanges.

Figure 14: Market cap to GDP comparison



Source: Bloomberg, JPMorgan

Currently India falls in the first quartile of the pack when compared to other markets on this ratio. But it must be pointed out the ratio may be overstated given the sizeable cash / unreported economy that does not get captured in GDP estimates.

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Green shoots rally …

Indian equities rallied strongly over the last month. Apart from an increase in investor risk appetite, outperformance was supported by a decisive mandate for the ruling UPA coalition in the national elections. It is expected that the mandate will provide the Government with the policy flexibility to revive growth and provide for fiscal consolidation. Stronger than expected 4QFY09 GDP at 5.8%oya aided investor sentiment too.

Economic data coming from developed economies has been mixed, but with a positive bias. The recent trend in the US consumer confidence and employment data appears encouraging. Our global economic team expects a broad based global growth recovery over 2H 2010.

Over June YTD FIIs have bought Indian equities aggregating US$1121mn (net buying of US$5.3 billion YTD). Domestic mutual funds were net sellers of US$233 mn (buying of US$ 56 mn YTD).

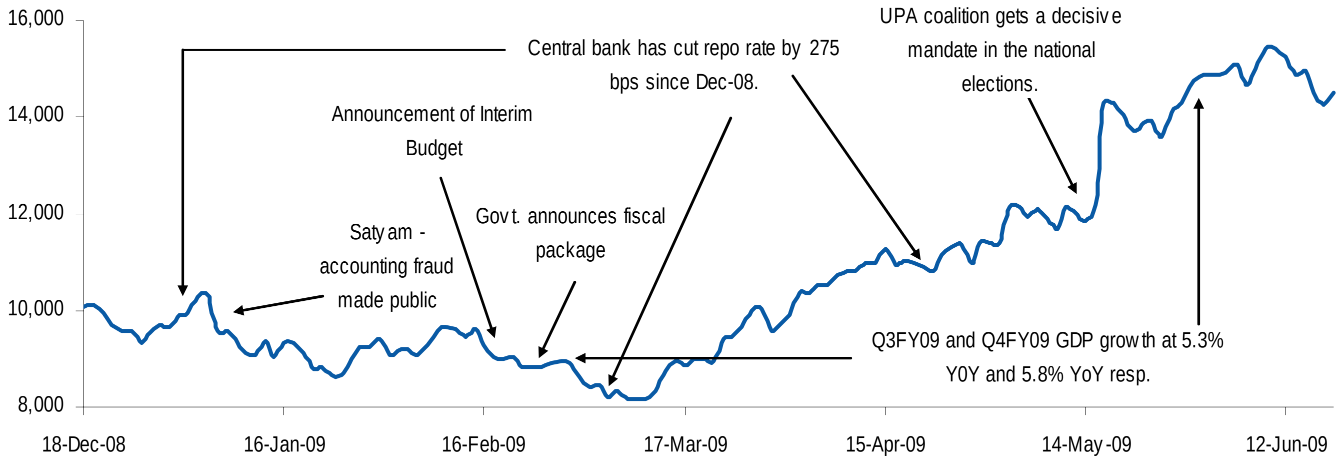
Industrials, Materials, Consumer Discretionary and Financials outperformed a rising market, in the post election euphoria. While Staples, Energy, IT services and Healthcare underperformed.

Table 3: MSCI Index performance

(%)	1 mth	3mth	6 mth	12 mth
World	5	24	10	(33)
USA	4	20	6	(30)
Japan	2	20	1	(27)
Euro	5	22	2	(39)
Emerging Markets	6	36	32	(32)
India - US$	23	72	50	(14)
India	20	63	47	(7)
Consumer Discretionary	25	63	79	24
Consumer Staples	13	16	3	(1)
Energy	8	49	48	(8)
Financials	24	94	47	(1)
Health Care	16	46	27	(16)
Industrials	37	97	74	11
IT	11	41	38	(21)
Materials	32	90	96	(19)
Telecom	23	73	31	(39)
Utilities	21	49	38	8

Source: MSCI, Datastream.

Figure 15: Macro events and Sensex



Source: Datastream, J.P.Morgan

Following the sharp rally over the last month, we expect the market to go into consolidation mode over the immediate term as it awaits the Government's policy initiatives.

A funds-starved corporate India is also rushing through with a number of equity issuances, which should lead to a better demand supply balance (for details please refer to Color *of Money: Rising cash calls*, dated June 04, 2009.)

On balance, we remain structurally positive on Indian equities over a 12-18 month time frame, given the policy flexibility that the new Government has to push through reforms, revive growth and provide for fiscal consolidation. We expect more clarity on their initiatives from the Union Budget, scheduled for July 6.

A key short term pressure point, which however merits monitoring, is the weak progress of the monsoon (for details please refer to *Monsoon woes*, dated June 18, 2009.) While it is early days yet, persistent weakness through to early July would have implications for agri sector growth, inflation and private sector consumption.

Portfolio – key assumptions and stance

Following the decisive mandate, favoring the ruling UPA coalition in the national elections last month we had raised substantially our bias towards local growth sectors (please refer *Stratoscope – Alls well that ends well*, dated May 18, 2009.) This included going overweight the capital goods and infrastructure sectors and raising the extent of our then exiting over weight stance on financials and consumer discretionary.

We were underweight global cyclicals (materials and energy), with the exception of IT services, and defensive sectors including healthcare and staples.

With the exception of the underweight stance on metals, the portfolio bias has largely worked positively.

Going forward we are retaining our bias towards local growth vs global growth, with the exception of IT services, wherein we remain positive due to an improving demand environment and reasonable valuations. We are adding weight to IT services in our model portfolio by including Satyam.

Despite an improving global growth outlook, we are retaining our underweight stance on: a) Energy. As we await clarity on the Government's policy stance on how the increased subsidy burden, arising from the rise in global crude oil prices, will be funded; b) Metals. As valuations for Indian majors appear rich and demanding when compared with international peer group, particularly in the backdrop of higher balance sheet stress.

Within local growth sectors we are adding to our preference for the investment cycle at the expense of the consumption cycle.

We are downgrading consumer discretionary from an overweight position to a neutral position after nearly three quarters. The downgrade follows substantial out performance over this phase. More importantly we are increasingly getting concerned over the impact that the weak monsoon may have on consumption demand, particularly in an environment wherein competitive pressures are increasing.

Over the next month we believe the market will focus on potential beneficiaries of the Government's policy initiatives to be announced in the Union budget scheduled for July 6. We believe financials and infrastructure sectors will likely be the key beneficiaries of the Government's focus, both in terms of long term reforms and immediate term measures to promote growth.

The key risks to the corporate sector from the forthcoming budget may emanate from any roll back in some of the stimuli, particularly excise duty cuts, implemented late last year. Such a roll back could be justified on the basis of the burgeoning fiscal deficit and as growth is beginning to revive. Key sectors that are vulnerable to such a rollback include Consumer Staples, Discretionary and Materials.

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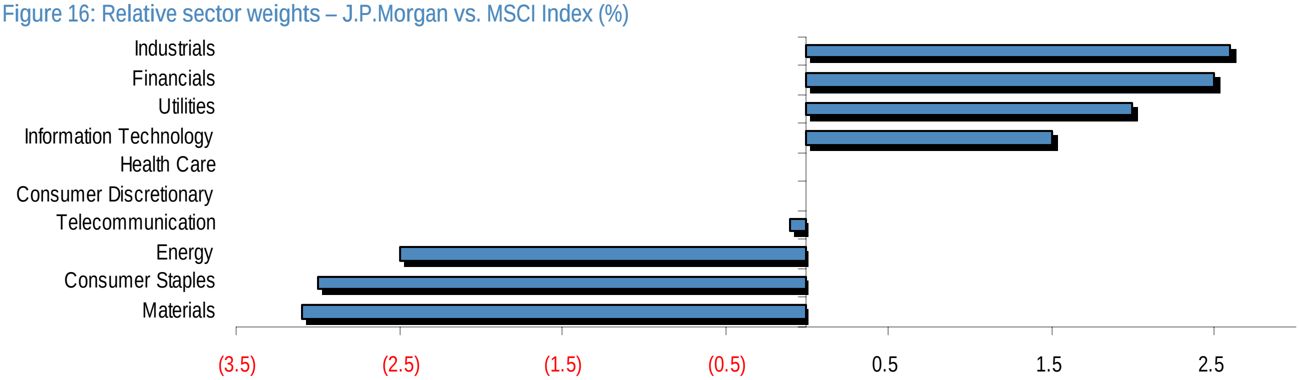
Table 4: J.P.Morgan India model portfolio

				Change (%)		MSCI	JPM	Dev.	PER (E)		DY (E)	ROE
	Ticker	Price	Rating	1M	Ytd	Wt	wt	(%)	FY 10	FY 11	FY 10 (%)	FY 10(%)
Consumer Discretionary		293		9	88	4.2	4.2	0.0	17	14	1.2	23
Mahindra & Mahindra	MM IN	737	OW	18	168	1.1	1.1	0.0	16	12	1.2	16
Hero Honda Motors	HH IN	1,461	OW	9	81	1.3	1.3	0.0	18	16	1.6	37
Maruti Suzuki India	MSIL IN	1,047	OW	5	101	0.8	1.7	0.9	18	16	0.5	17
Consumer Staples		197		10	9	5.6	2.6	(3.0)	20	18	2.0	50
ITC	ITC IN	200	N	5	16	2.5	2.5	0.0	19	17	2.1	26
Hindustan Unilever	HUVR IN	260	UW	14	4	2.6	0.1	(2.5)	23	21	2.9	96
Energy		1,232		(6)	60	20.2	17.7	(2.5)	14	11	1.0	24
Reliance Industries	RELI.BO	2,040	OW	(9)	66	14.8	15.7	0.9	16	12	0.7	19
Oil & Natural Gas	ONGC.BO	1,010	OW	2	51	3.0	2.1	(0.9)	12	11	3.2	20
Financials		3,565		4	54	24.9	27.4	2.5	20	16	1.3	14
Hdfc Bank	HDFCB IN	1,556	OW	11	56	4.9	5.9	1.0	30	24	0.7	16
Housing Development Fin.	HDFC IN	2,295	OW	(2)	54	5.5	6.8	1.3	25	21	1.3	19
ICICI Bank	ICICIBC IN	714	OW	(6)	59	6.4	7.9	1.5	20	17	1.6	7
Axis Bank	AXSB IN	756	OW	(1)	50	1.6	1.6	0.0	13	10	1.2	14
State Bank Of India	SBIN IN	1,724	OW	(2)	34	1.3	2.5	1.2	11	10	1.4	17
DLF	DLFU IN	331	OW	(14)	17	1.5	2.7	1.1	28	25	0.0	6
Health care				11	27	3.5	3.5	0.0	18	15	0.9	24
Industrials		1,141		8	82	10.0	12.6	2.6	27	21	0.6	20
Bharat Heavy Els.	BHEL IN	2,091	N	(3)	53	2.8	2.8	0.0	23	19	1.1	27
Larsen & Toubro	LT IN	1,496	OW	11	93	3.4	6.4	3.0	27	22	0.0	22
Gvk Power & Infr.	GVKP IN	40	OW	5	81	0.0	2.0	2.0	70	53	0.0	3
ABB	ABB IN	742	N	20	64	0.4	1.4	1.0	16	16	0.5	23
Information Technology		387		15	46	13.0	14.5	1.5	16	15	1.4	33
Infosys Technologies	INFO IN	1,771	OW	13	58	9.3	10.8	1.5	17	17	1.7	30
Satyam Computer Services	SCS IN	78	OW	71	(54)	0.0	2.5	2.5	17	6	9.0	18
Tata Consultancy Svs.	TCS IN	381	OW	13	59	2.0	3.7	1.6	7	7	2.3	32
Materials		623		10	102	8.9	5.8	(3.1)	12	10	1.5	18
Grasim Industries	GRASIM IN	2,243	N	(2)	84	0.5	3.5	3.0	11	11	1.1	16
Steel Authority Of India	SAIL IN	152	N	(5)	97	0.8	2.3	1.6	15	11	1.3	16
Telecom Services		94		(7)	26	2.7	2.6	(0.1)	14	13	0.2	18
Bharti Airtel	BHARTI IN	806	N	(12)	13	0.0	2.6	2.6	15	13	1.0	29
Utilities		738		3	41	6.9	8.9	2.0	17	15	1.5	17
Tata Power	TPWR IN	1,164	OW	11	56	1.0	3.0	2.0	21	13	1.5	17
NTPC	NATP IN	198	N	(4)	9	1.9	2.4	0.5	18	17	2.0	15
Reliance Infrastructure	RELI IN	1,262	OW	19	118	1.5	3.5	2.0	23	21	0.0	8
MSCI India		571		4	55	100	100	0	17	14	1.2	18

Source: J.P.Morgan, Datastream,

Figure 16: Relative sector weights – J.P.Morgan vs. MSCI Index (%)



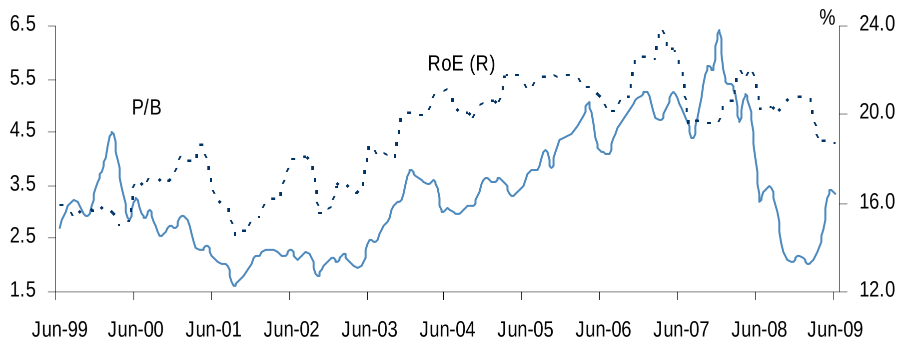
Source: J.P.Morgan

Annexure 1: Valuations

After substantial de-rating over the last one year, valuations bounced back meaningfully over the last quarter.

ROEs, however, continue to remain under pressure due to muted earnings outlook over the near term. Companies are also reviving capital expenditure plans and these will likely pressure ROEs over the near term.

Figure 17: P/B and ROE

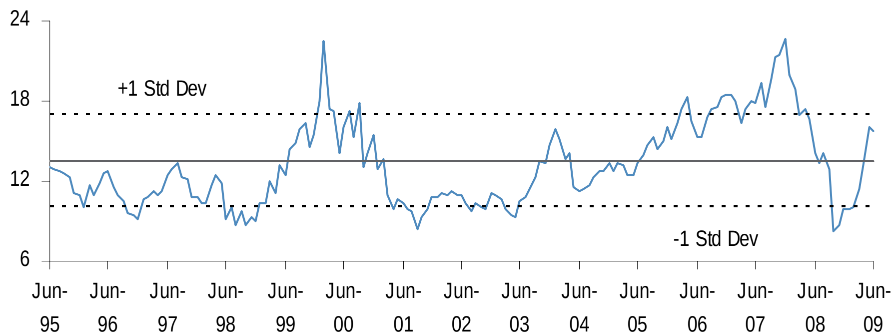


Source: MSCI, IBES, Datastream

Forward PE multiples have bounced back significantly, post the National election results.

The street now estimates an earnings growth of 13% for FY10E and a growth of 15% for FY11E.

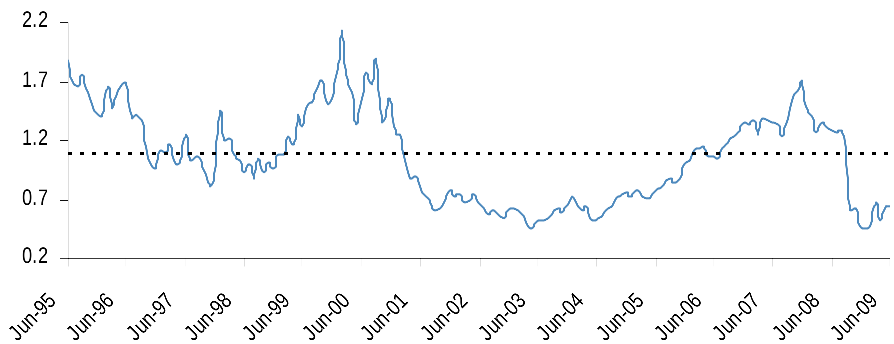
Figure 18: 12 month forward PE



Source: MSCI, IBES, Datastream

While the earnings yield has moderated over the recent past, lower treasury yields at the short end continue to provide relative valuation support to equities.

Figure 19: 1 Year Bond Yield / Earnings Yield



Source: MSCI, IBES, Datastream

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Annexure 2 - MSCI India valuations

Table 5: J.P. Morgan estimates and MSCI India valuations

	PE			Earnings Growth (%)			PB		
	FY 08	FY 09	FY 10 (E)	FY 08	FY 09	FY 10 (E)	FY 08	FY 09	FY 10 (E)
Consumer Discretionary	17	21	18	10	(17)	20	5.0	4.2	3.7
Consumer Staples	28	24	21	5	15	13	11.0	9.3	8.1
Energy	19	20	14	24	(5)	37	4.6	3.7	2.9
Financials	19	22	19	44	(12)	13	5.0	2.9	2.7
Health Care	23	28	18	(9)	(19)	52	4.8	3.8	3.1
Industrials	30	31	27	24	(5)	17	3.8	3.7	2.8
Information Technology	20	17	16	15	21	6	5.6	5.1	4.2
Materials	11	12	11	18	(7)	6	2.6	1.9	1.9
Telecommunication Services	13	12	14	64	12	(18)	2.9	2.4	2.1
Utilities	25	22	20	18	16	7	3.4	2.6	2.3
MSCI India	19.3	19.7	17.0	24	(2)	16	4.4	3.3	2.9

	RoE (%)			EV/ EBITDA			Div Yld (%)		
	FY 08	FY 09	FY 10 (E)	FY 08	FY 09	FY 10 (E)	FY 08	FY 09	FY 10 (E)
Consumer Discretionary	29	20	21	12.4	13.7	11.3	1.2	1.0	1.2
Consumer Staples	40	38	38	16.7	14.8	13.4	1.7	2.0	2.1
Energy	24	19	20	9.8	9.0	7.4	0.8	1.0	1.8
Financials	26	13	14	NA	NA	NA	0.9	0.7	0.8
Health Care	21	13	17	15.0	14.1	13.6	1.1	1.2	1.0
Industrials	13	12	10	18.2	18.0	15.6	1.6	0.8	0.8
Information Technology	27	30	26	12.1	9.3	9.0	3.6	3.1	2.0
Materials	24	16	16	5.4	5.1	6.1	1.6	1.3	1.1
Telecommunication Services	23	21	15	9.5	8.4	7.1	0.5	0.5	0.6
Utilities	14	12	12	15.9	11.3	9.7	1.0	0.9	1.1
MSCI India	22.9	16.9	16.8	10.2	9.5	8.9	1.4	1.2	1.3

Source: J.P. Morgan calculations, MSCI, Datastream

Annexure 3: Key Economics Indicators

Table 6: Key economic indicators

	FY 08	FY 09	FY 10 (E)
Nominal GDP (US$ bn)	1,175	1,170	1,207
Real GDP Growth rates	9.0	6.7	6.2
WPI (%)	4.6	8.6	1.8
INR / US$, (Avg)	40.0	47.0	46.0
10 Yr - T Yield, (%, eop)	7.9	7.0	7.5
Current A/C balance (US$ bn)	(17.8)	(32.0)	5.5
Central govt. fiscal deficit (% of GDP)*	(3.1)	(6.3)	(7.2)

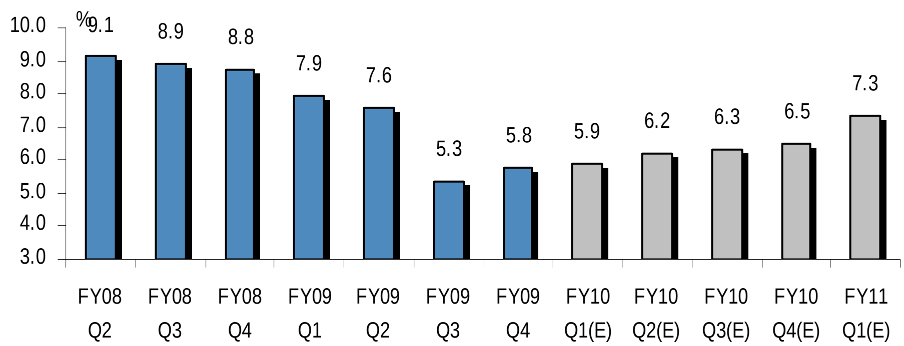
Source: J.P. Morgan Economics

* - J.P.Morgan fiscal deficit estimate for FY09 & FY10 is excluding off-budget items

4QFY09 GDP growth at 5.8% oya was significantly better than expectations.

JPM has revised up GDP growth forecasts to 6.2% for FY10 and 7.2% for FY11.

Figure 20: Quarterly real GDP growth trend

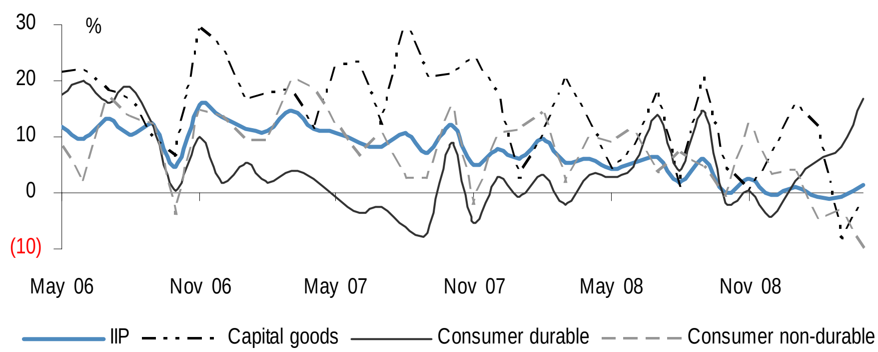


Source: J.P.Morgan estimates

Industrial production surprised on the upside and gained 1.4% oya in April

The near term outlook for IIP remains subdued, particularly given weak investment demand.

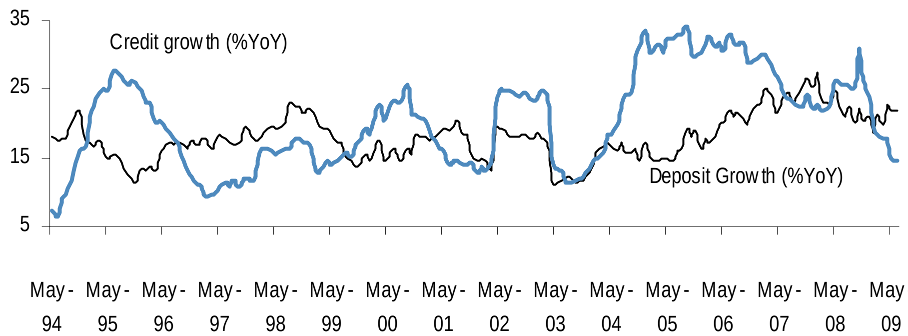
Figure 21: Industrial production (%YoY)



Source: J.P.Morgan Economics

Credit growth has come off sharply on the back of economic slowdown and risk aversion on the part of the banking system. Deposit growth however continues to hold up.

Figure 22: Commercial banks – Deposit & credit growth (%)

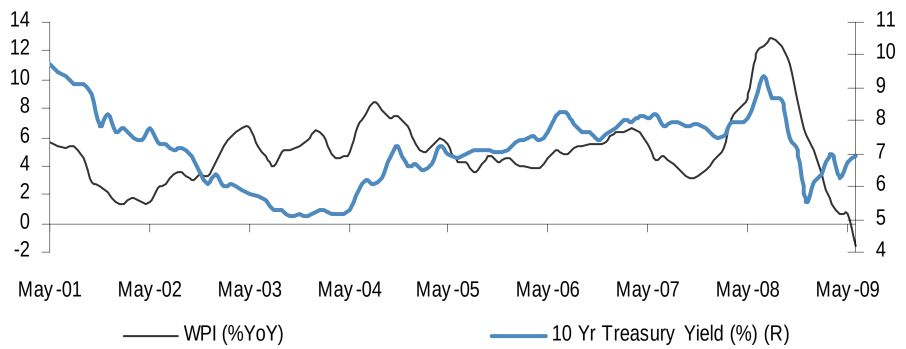


Source: J.P.Morgan Economics

Inflation fell by 1.61% y/y for week ended June 6. The wholesale price index (WPI) went sub-zero for the first time in 35 years.

10 year treasury yields increased meaningfully to 6.9%. The bond markets remain concerned over the Government's fiscal deficit and are awaiting the budget (in July) for clarity herein.

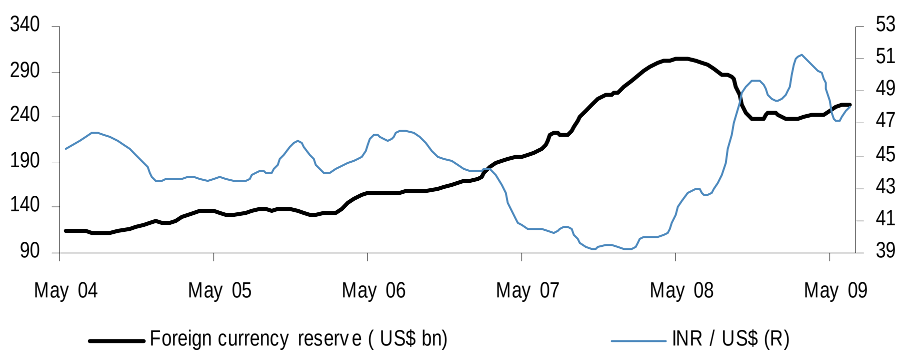
Figure 23: Inflation and treasury yield (%)



Source: J.P. Morgan Economics

INR has depreciated by 2% vs. the US$ in June so far.

Figure 24: Foreign currency reserves and exchange rate



Source: J.P. Morgan Economics

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