India Strategy: Time to go shopping

Consumption trends intact, Expect 20%+ upside on Sensex/Nifty

We set a December '11 Sensex/Nifty target of 24000/7000, indicating a ~21% upside from current levels. Our bullish view is predicated on: (1) Strong rural consumption over the next 12 months due to favourable monsoons that would drive above-trend 7% growth in agriculture and have a positive impact on rural disposal incomes; (2) Urban consumption remaining robust on the back of rising disposable incomes, positive demographics and lifestyle changes; (3) A gradual pick-up in the investment cycle in select sectors (like Autos and Textiles) that would drive sector-specific performance; (4) Continued strength in earnings growth and ROEs leading to sustained above-average valuations, especially for a lack of suitable alternatives; and (5) Sustained capital flows in the light of QE2.

Mapping our top-down positive themes with a bottom-up analysis of company- and sector-specific factors, we recommend Overweight on the Consumer sectors—both Discretionary (autos) and Staples—Banks, and Telecom. Our Underweight sectors are Diversified Financials, Utilities, Infrastructure/ Construction and Energy. We are Neutral on Real Estate, Metals, Cement, Capital Goods, IT Services and Pharmaceuticals. Key risks to our macro thesis include a global shock leading to capital outflows from emerging markets (including India), a sharp rise in commodity prices, especially crude, that would hurt India's fiscal balances, and any rise in political risk that would induce fiscal deterioration.

Our top large-cap picks in India are Bharti Airtel, Hindustan Lever, ITC, Tata Motors, M&M, Tata Steel, State Bank of India and Axis Bank.

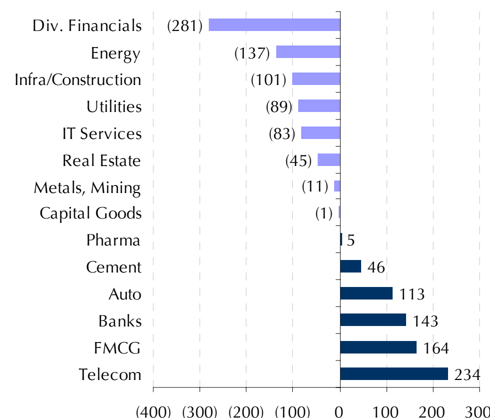
India in a nutshell: Strong growth in the next decade (likely to average 8%+), and the accompanying regime shift in its largely domestic consumption (urban leading to rural) is the key long-term argument for India, and a magnet for global capital, despite rising international linkages. We would be buyers on every dip.

Consumption now, investment for later: Urban consumption is now spilling over to the rural sector, brought about by supplementary non-agricultural income, network effects from improved infrastructure/communication, rural-urban migration, income transfers (NREGA), and improved pricing. Rising consumption builds the case for investment to follow, and capacities are being expanded in many sectors levered to discretionary spends. However, muted figures from power and energy would keep aggregate investment growth low. We are thus selective on playing the turning investment cycle in the country.

Macro headwinds and tailwinds: While the domestic story is strong, it is not without blemish, with stubborn (food) inflation, a widening current account deficit, and rising political risk. However, we believe that global macro dynamics in their current state remain favourable for India.

Earnings and Valuations: High earnings growth is likely to sustain ROEs and valuations—we forecast Sensex profit growth of 21%/16% over FY11/FY12, with steady 20% ROEs. At 17x EPS, our Sensex target works out to 24000 for Dec '11.

RCML Sector preference



RCML House Picks – Large caps

Stock	Sector
Axis Bank	Banks
Bharti Airtel	Telecom
Hindustan Unilever	FMCG
ITC	FMCG
Mahindra & Mahindra	Auto
State Bank of India	Banks
Tata Motors	Auto
Tata Steel	Metals & Mining

RCML House Picks – Small caps

Stock	Sector
Ashok Leyland	Auto
Asian Paints	Chemicals
Aurobindo Pharma	Pharmaceuticals
Dena Bank	Banks
Educomp	Education
Nagarjuna Construction	Const./ Infra
Oberoi Realty	Real Estate
Petronet LNG	Energy
Sintex Inds.	Capital Goods
Voltas	Capital Goods

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RCML: Winner of LIPPER-STARMINE broker award for "Earnings Estimates in Midcap Research 2008" | "Honourable Mention" in Institutional Investor 2009 | Voted amongst Top 5 most improved brokerages by Asia Money Poll 2009 | RCML Research is also available on Bloomberg FTIS <GO> and Thomson First Call

Consumption trends intact, Expect 20%+ upside on Sensex/Nifty

We set a December '11 Sensex/Nifty target of 24000/7000, indicating a ~21% upside from current levels. We believe the Indian market would continue to grind upwards for the medium term driven by accelerating rural consumption, sustenance of urban consumption trends and gradual pick up in investment. At our target the Sensex would trade at 17x CY12E earnings, fair in our view given FY12 expected growth of 16%. We believe that the favourable relative positioning that has helped India outperform thus far would continue as long as global risk appetite (and thus capital flows) is supported by an extended pause on rates, and the absence of a negative global macro event-trigger (like a double-dip recession in the US, or a Eurozone default).

Key risks to our macro thesis include a global shock leading to capital outflows from emerging markets (including India), a sharp rise in commodity prices, especially of crude, that would hurt India's fiscal balances, and any rise in political risk that would translate into fiscal deterioration.

Fig 1 - Sensex Valuation Table

	FY08	FY09	FY10	FY11E	FY12E
PE (x)	23.5	27.5	21.8	18.9	15.8
Dividend Yield (%)	0.9	0.9	1.1	1.1	1.2
P/B (x)	4.8	4.2	3.56	3.7	3.2
RoE (%)	20.3	15.2	16.4	19.7	20.0
EV/EBITDA (x)	11.0	8.6	11.8	9.1	8.0

Source: RCML Research

Fig 2 - Nifty/ Sensex target valuation table (31-Dec-2011)

Target Date	Sensex	Nifty
Sensex Target (Base Case)	24123	6914
12 Mnth forward PE (x)	17	16
CY12 EPS	1419	432

Source: RCML Research

Fig 3 - Sensex PE and EPS Sensitivity

		EPS				
		1391	1405	1419	1433	1448
PE (x)	15	20861	21072	21285	21498	21713
	16	22252	22477	22704	22931	23160
	17	23643	23882	**24123**	24364	24608
	18	25034	25286	25542	25797	26055
	19	26424	26691	26961	27230	27503

Source: RCML Research

Sectoral preferences

India could grow 8% p.a. for the next decade, with expanding consumption patterns, especially in the rural sector

India's strong growth in the coming decade (likely to average 8%+) and the accompanying regime shift in its largely domestic consumption (~60% of GDP) forms the cornerstone of our investment strategy. Even as its international linkages are rising, the Indian economy's strong growth and resilience to global imbalances acts as a magnet to global capital in search of higher returns on investment.

Our sector preference is thus geared towards the consumption theme in India, together with expectations of a turning investment cycle. We are positive on consumer stocks, both discretionary (autos) and staples, telecom, and banks, and negative on diversified financials, energy, utilities, and infrastructure/construction. We are Neutral on pharmaceuticals, real estate, cement, metals, capital goods and IT services.

Fig 4 - Sector preference

Sector	RCML Portfolio	Gap wrt MSCI India	OW/UW wrt MSCI India	Nifty	Gap wrt Nifty	OW/UW wrt Nifty
	100.0			**100.0**		
Autos & Auto Ancillaries	7.8	113	OW	8.9	(117)	UW
Banks	18.0	143	OW	14.8	320	OW
Capital Goods	4.2	(1)	MW	2.7	152	OW
Cement	1.5	46	MW	1.0	53	MW
Div. Financials	5.5	(281)	UW	7.6	(213)	UW
Energy	14.3	(137)	UW	15.6	(133)	UW
FMCG	7.4	164	OW	6.6	76	MW
Infra/Construction	3.4	(101)	UW	6.0	(258)	UW
IT Services	15.7	(83)	MW	14.4	127	OW
Chemicals	1.0	67	MW	0.0	100	MW
Metals, Mining	9.0	(11)	MW	10.7	(175)	UW
Pharma	4.0	5	MW	4.2	(23)	MW
Real Estate	2.3	(45)	MW	0.7	154	OW
Telecom & Media	3.5	234	OW	2.5	99	MW
Utilities	2.6	(89)	MW	4.2	(162)	UW

Source: RCML Research

Consumption picks

Positive on consumer discretionary (autos) and staples, banks and telecom

Negative on diversified financials, utilities, infra/construction and energy

Neutral on real estate, metals, capital goods, it services and pharma

Consumption in the urban sector, one of the key drivers of India's growth over 2003–08[1], is now spilling over to the rural sector, brought about by supplementary non-agricultural income, network effects from improved infrastructure/communication, rural-urban migration, income transfers (NREGA), and improved pricing. While still shy of the US$ 2,000 tipping point, per capita incomes in a largely-young India—50% of the population is below 30 years—are poised for a significant upward change. Hence we are positive on the consumer sectors, both discretionary (autos) and staples, and telecom based on the consumption theme, and banks given the overall India growth story. We like the healthcare and pharmaceuticals but expensive valuations leads to a Neutral weight in our portfolio.

Household spending outpacing incomes leads us to prefer **discretionary consumption** over staples in the medium to long term, and explains our positive stance on autos, despite the recent outperformance and rising input costs. Within the space, we prefer 4-wheelers given their relatively superior growth profile in the next 2–3 years, a turnaround in the CV cycle, and most importantly, their status as the best proxy on the rural growth story. Key picks are **Tata Motors** and **Mahindra & Mahindra (M&M)** among large-caps.

Among **staples**, our choice is based on the strong growth momentum in both urban and rural consumption, which is likely to sustain for a decade or more, well supported by rising incomes, a change in usage pattern, and demographic dividends. We like

[1] The Indian economy's 9% growth in the 2003–07 period could be largely attributed to a sharp rise in corporate capex, urban consumption, and in outsourcing.

Hindustan Lever (HUL) and ITC as the best proxies on the US$ 690bn, 13%-a-year India consumption sector, combined with dominant market positioning, and high cash flows—a key differentiator in market performance this year.

We like the **telecom** sector in India for (a) its strong earnings visibility, (b) direct leverage to rural consumption (given its low voice penetration) and potential to upscale from voice to data in the urban space, (c) ancillary benefits like falling handset prices, and (d) in the near term, because the worst of the regulatory overhang has played out. Our pick is **Bharti** which is best positioned among incumbents in the aftermath of the current imbroglio over 2G licencing, and is reasonably valued at 15x FY12E earnings, discounting the massive upside potential from Africa (which we are quite bullish on – kindly refer our report 'African Safari: This Time for India' dated 18th Nov 2010).

High cash flows are just one of the reasons we like the **pharmaceutical** sector. Earnings growth should remain robust, with multiple patent expiries slated in the coming years, a burgeoning EM opportunity, and the strongest para-IV pipeline in years. Increasing 'Big-Pharma' deals are another positive for the sector. But at ~25x FY12E earnings, Indian generics are not cheap, and valuations leave little upside.

Investment cycle picks

Overall investment figures likely to be muted given the pause in power and energy, even as capacity addition in other sectors continues

Rising consumption builds the case for investment to follow, and true enough, capacities are being expanded in many sectors levered to discretionary spend, especially automobiles and textiles. However, contrary to the heady days of 2003–08, overall investment growth is likely to stay sober after the high base effect from the power and oil & gas sectors, which together comprise ~70% of the total spend. We are thus selective on playing the turning investment cycle in the country.

Choosy about playing investment: We like financing, domestic commodities, and select capital goods plays that have favourable market dynamics, e.g., power transmission over generation.

Negative on contractors, and asset owners (utilities, developers)

We play the turning investment cycle through financing (**banks**), raw materials (**steel**, and **cement** to some extent), and segments with favourable market dynamics (e.g. **power transmission**). We are choosy (and thus neutral) about what we like in the investment space; for instance, capital goods over contractors, power transmission over power generation. Overall, our top picks in large caps does not include any picks in investment space.

We are negative on utilities due to our view of long-term merchant tariffs headed south, and also negative on infrastructure/construction largely due to lack of investment ideas in large-cap space.

We have been positive on cement due to our expectation of demand uptick CY11 but are Neutral on sector now as stocks have run-up.

Banks – best of both worlds

Banks (we prefer high CASA) remain the best play on both sides, especially from the financing side of investment—we like **State Bank of India (SBI)** among PSU banks, and **Axis Bank** among private banks. While concerns persist on tight liquidity and the impact of rising deposit rates on NIMs, we believe overall growth in the economy would continue to support credit growth on a steady state basis.

However we are negative on diversified financials due to rising interest rates.

Global Sectors – Energy and Metals

We believe that the recent run-up in commodities post-QE2 notwithstanding, demand-supply dynamics in a weak global macro environment are expected to cap upsides. With global growth, particularly in the US, meaningfully slowing down in the second half of the year, and China increasingly moving to a soft landing, commodities, and crude in particular are unlikely to repeat the 100% rise seen during 2007–08. That said, investor appetite for hard assets in a low-rate environment remains the big support for global commodities. As such, we expect commodity prices to remain firm largely.

Neutral on commodities globally

Among metals, we like **steel with Tata Steel being one of our top picks** due to forward & backward integration, upcoming capacity additions, strong domestic demand and turnaround in Corus. However, we are Neutral on metals as a sector as we expect investments in India to be largely focused on consumption plans.

We are negative on energy as we believe that India remains a net consumer of oil and high crude price would hurt OMCs as well as ONGC/GAIL due to higher subsidies. Further we expect limited steps on further deregulation of diesel prices due to high inflation and five state elections in 2012.

IT Services

While the recent 'flight to quality' and hopes of a revival in the US economy have brought **IT services** back in focus, expensive valuations and an appreciating currency explain our neutral stance on the sector in the near to medium term.

Getting more constructive on mid-caps

Getting constructive on mid-caps

As the market moves due north and the dust settles on current issues of corporate governance and the consequent flight to safety, we can only get more positive on a broader movement towards small and mid-caps in the market. To that end, we have included ten mid-cap picks from our 170-stock RCML coverage universe in addition to our large-cap picks.

Fig 5 - RCML Model Portfolio

Name	MCap US$m	RCML Portfolio Weight	Portfolio OW/UW	CMP	RCML Target	Upside/downside	Rating	1W	MTD	YTD	1YR
Automobiles											
Mahindra & Mahindra Ltd	10,608	2.750	OW	795	820	3.2	BUY	1.5	(1.0)	1.5	46.0
Maruti Suzuki India Ltd	9,101	1.500	OW	1,408	1,600	13.6	HOLD	0.7	1.1	0.7	(7.8)
Tata Motors Ltd	17,702	3.500	OW	1,358	1,450	6.8	BUY	2.2	3.6	2.2	62.0
Banks											
Axis Bank Ltd	12,671	6.500	OW	1,382	1,800	30.2	BUY	2.6	1.3	2.6	43.2
HDFC Bank Ltd	24,727	5.500	OW	2,383	2,500	4.9	HOLD	1.1	(0.0)	1.1	36.6
State Bank of India	41,940	6.000	OW	2,952	3,700	25.3	BUY	1.8	6.8	1.8	36.1
Div. Financials											
Housing Development Finance Corp	23,063	5.500	MW	705	750	6.4	HOLD	1.4	1.1	1.4	31.7
Real Estate											
DLF Ltd	11,711	2.250	OW	308	380	23.2	BUY	2.4	3.3	2.4	(12.5)
Capital Goods											
Bharat Heavy Electricals Ltd	24,516	2.000	UW	2,239	2,400	7.2	HOLD	0.3	0.5	0.3	(7.1)
Siemens India Ltd	5,913	1.250	OW	784	1,000	27.6	BUY	2.1	(0.4)	2.1	36.1
Cummins India Ltd	3,468	0.950	OW	783	950	21.3	BUY	1.1	5.8	1.1	88.5
Infra/Construction											
Larsen & Toubro Ltd	27,323	3.400	OW	2,009	2,330	16.0	BUY	0.7	(2.7)	0.7	17.9
Cement											
ACC Ltd	4,099	0.750	OW	976	1,180	20.9	BUY	2.3	1.0	2.3	18.3
Grasim Industries Ltd	4,824	0.750	OW	2,352	2,900	23.3	BUY	0.1	3.1	0.1	25.3
Metals, Mining											
Jindal Steel & Power Ltd	14,605	3.500	OW	699	700	0.1	HOLD	2.0	0.9	2.0	(7.5)
Tata Steel Ltd	12,818	5.500	OW	635	780	22.8	BUY	2.4	(2.9)	2.4	(1.5)
Chemicals											
Asian Paints Ltd	5,752	1.000	OW	2,682	3,000	11.9	BUY	1.1	2.9	1.1	50.7
Energy											
Oil & Natural Gas Corp Ltd	63,185	4.000	OW	1,321	1,510	14.4	BUY	1.2	1.0	1.2	8.1
Reliance Industries Ltd	74,688	10.250	UW	1,020	1,210	18.6	BUY	0.0	(1.0)	0.0	(9.0)
FMCG											
Hindustan Unilever Ltd	14,661	3.000	OW	300	330	9.9	HOLD	(0.5)	(1.0)	(0.5)	14.7
ITC Ltd	29,116	4.400	OW	169	210	24.2	BUY	(1.0)	(2.1)	(1.0)	40.5
IT Services											
HCL Technologies Ltd	6,512	2.500	OW	426	525	23.2	BUY	1.7	5.2	1.7	11.9
Infosys Technologies Ltd	40,367	9.500	UW	3,143	3,200	1.8	HOLD	0.0	1.8	0.0	19.5
Tata Consultancy Services Ltd	48,239	3.700	MW	1,102	1,100	(0.2)	HOLD	0.8	7.9	0.8	48.2
Pharma											
Dr Reddy's Laboratories Ltd	6,885	2.000	OW	1,819	1,870	2.8	BUY	(0.6)	(0.3)	(0.6)	56.1
Ranbaxy Laboratories Ltd	5,352	2.000	OW	568	720	26.7	BUY	0.3	2.4	0.3	10.9
Telecom & Media											
Bharti Airtel Ltd	29,340	3.500	OW	345	400	15.8	BUY	(2.2)	6.1	(2.2)	7.1
Utilities											
NTPC Ltd	34,504	1.300	MW	187	205	9.6	BUY	(0.8)	2.5	(0.8)	(21.1)
Lanco Infratech Ltd	3,313	1.250	OW	62	85	38.2	BUY	0.2	(3.9)	0.2	8.2

Source: RCML Research

Fig 6 - RCML House picks – Large-caps

Stock	Sector	M Cap (Rsbn)	Price Target	CMP	Upside / Downside (%)	Rationale
Tata Steel	Metals & Mining	577	780	639.35	22	❖ Set to benefit from strong growth in India operations led by capacity expansion to 10mt from 6.8mt (by H2FY12)—operating profit growth backed by rising steel prices, robust demand growth and improved product mix. ❖ Upside risk emanates from increased EBITDA contribution from Corus on account of: a) successful cost reduction initiatives, b) higher realisations in Europe led by inventory restocking and economic recovery, c) higher capacity utilisation, and d) absence of losses from Teeside. ❖ Currently trading at P/E of 8.7x/8.5x on FY11E/FY12E.
Bharti Airtel	Telecom	1,325	400	348.85	15	❖ To benefit as tariff pressures continue to moderate (leading to a pick-up in growth in the domestic market) and 3G revenues kick in from FY12. ❖ Conservative forecasts for 3G indicate no value destruction, but stronger-than-expected pick-up could result in significant upside to our estimates. We expect 11% EBITDA CAGR over FY10-FY12 for Bharti India operations. ❖ Zain acquisition likely to be EPS-dilutive in FY11; however, Africa a medium- to long-term growth driver and would be EPS-accretive (even on a conservative basis) from FY12 onwards. We estimate 15% EBITDA CAGR (FY10-FY12) for Bharti Africa (based on Zain Africa's FY10 revenue run-rate). ❖ Stock trading at 18.9x/15x FY11E/FY12E earnings
Hindustan Unilever	FMCG	645	330	295.75	12	❖ Significant volume growth improvement with 3 consecutive quarters of double-digit growth (14% in Q2FY11). Volume and value growth trajectory expected to be sustained in future. ❖ Gross margins maintained on account of sourcing and buying efficiencies, with current margin pressure mainly led by higher A&P expenses. A&P could stabilise at current levels, thereby providing some respite to margins. ❖ Currently trading at a P/E of 30.3x/26.2x FY11E/FY12E, broadly in line with some other mid cap consumers stocks. Re-rating expected from current levels on account of the stronger and ahead-of-market growth seen across most product segments.
Mahindra & Mahindra	Auto	478	820	800.95	2	❖ Remains a good play for its exposure to robust agri growth through the tractors business (a play on the good monsoons). Momentum in UV as well as tractor segment to gain further traction with supply chain constraints easing off. ❖ Foray into the LCV (GIO/Maxximo) segment has received a good response, with M&M gaining 25% market share in areas launched. ❖ We see 22% volume growth in FY11 and 14% in FY12. ❖ Standalone business (adj. for value of subsidiaries/associates) trading at 14.3x/12.6x FY11E/FY12E earnings, relatively cheaper when compared to other auto OEMs.
Tata Motors	Auto	778	1,450	1,335.40	9	❖ CV segment expected to record strong volume growth on healthy demand outlook (as per dealer checks), especially in the context of agri-freight outlook, impending road construction activity and comfortable financing scenario. ❖ Volumes of global luxury majors indicative of strong demand in the luxury car segment (JLR's focus market). We expect 17% (ex-Nano) volume growth for the standalone business in FY11 and 20% for JLR operations, at the current average run-rate. Consolidated earnings estimated to grow at 165% CAGR over FY10-FY12. ❖ JLR to remain the principal driver with 740bps margin expansion in FY11E from better operating leverage and focused cost reduction efforts. ❖ Recent QIP to help de-lever balance sheet and pare interest burden. ❖ Consolidated business trading at 10.2x/9x FY11E/FY12E earnings.
State Bank of India	Banks	1,819	3,700	2,864.50	29	❖ Key beneficiary of the improving economy given its extensive distribution network and strong liability franchise. NII growth to remain strong at 23% CAGR over FY10-FY12 driven by 20%+ advances growth and 36bps expansion in NIMs through FY12. ❖ Delinquencies could remain high in the near term but likely to improve significantly in FY12. Recoveries should also pick up with improvement in the economy. ❖ Capital dilution likely to be BV-accretive. Also see upsides to subsidiaries valuations. ❖ Stock trading at P/BV of 3.1x/2.6x FY11E/FY12E.
Axis Banks	Banks	543	1,800	1,324.50	36	❖ Strong play on economic growth; we expect credit growth of 25% CAGR through FY12 backed by strong capitalisation (tier I ratio of 11.2% in FY10). ❖ CASA expected to remain at +40% despite strong balance sheet growth, benefiting the bank in a rising interest rate scenario. ❖ Asset quality the key to stock performance. While slippages could remain high in FY11 at ~1.8%, we expect a decline to ~1.5% in FY12. ❖ Valuation discount to HDFC Bank likely to narrow gradually. ❖ Stock trading at P/BV of 2.6x/2.2x FY11E/FY12E.
ITC	FMCG	1,295	210	168.20	25	❖ Cigarettes business continues to improve QoQ; we expect flattish volumes in FY11 (Q1 4% decline). Overall, we expect 12–13% revenue and 15% EBIT CAGR for the cigarettes business over FY10-FY13. ❖ Hotels business likely to show strong cyclical recovery with EBIT doubling over FY10-FY12. ❖ Other FMCG losses to be maintained at current levels (~Rs 500mn–600mn per quarter) as packaged foods business has achieved break-even. Market share growth in personal care categories expected to show further improvement. ❖ Stock looks attractive at 23x FY12E earnings—a discount to our FMCG universe and most mid caps.

Source: RCML Research

Fig 7 - RCML House picks – Mid-caps

Stock	Sector	M Cap (Rsbn)	Price Target	CMP	Upside / Downside (%)	Rationale
Asian Paints	Chemicals	260	3,000	2,707.65	11	❖ Price increases of 8.1% by APNT in FY11 YTD to pass on the impact of a 10% increase in its RM cost index should help fend off margin pressures. ❖ Growth set to bounce back from Q3 onwards after weak results in Q2 on account of prolonged monsoons, as the spillover of demand from Q2 positively impacts H2FY11 numbers. ❖ Competition unlikely to dent market share in the near term. ❖ Stock trading at 28.8x/23.6x FY11E/FY12E earnings.
Voltas	Capital Goods	79	300	238.45	26	❖ Air conditioning business could surprise on the upside, driven by an increased geographic reach. ❖ Presence extended to markets such as Saudi Arabia, Oman, Singapore and Hong Kong, following the slowdown in Dubai in FY09. Expansion could drive order inflows in FY11 and FY12. ❖ Cash and investment balance of Rs 7bn at FY10-end likely to be used for acquisitions in the water segment. ❖ Stock trades at 17.3x/ 14.6x FY12E/FY13E earnings.
Nagarjuna Construction	Construction & Infrastructure	35	210	135.75	55	❖ Among the leading mid cap contractors with a healthy order backlog of Rs 161bn, 2.5x FY11E sales. ❖ Well diversified order backlog expected to lead to ~20% revenue/ earnings CAGR over FY10-FY12. Exposure to real estate (in India and Dubai) as well. ❖ Near-term triggers include commissioning of three BOT road projects in Dec '10/Jan '11 and clarity on its 1,320MW thermal power project (plans afoot to shift location and get fresh clearances). ❖ SOTP-based target price implies upside of +40%.
Aurobindo Pharma	Pharmaceuticals	74	1,690	1,273.80	33	❖ Steadily transforming its business model towards the high-margin, less-volatile formulations segment (10%/55% of sales in FY05/FY10). Momentum set to continue (66% in FY12E), infusing more stability in the business. ❖ Broad-based portfolio of product filings has introduced new revenue streams through outsourcing deals (Pfizer, Astra Zeneca). Licensing income from such deals to shore up cash flows in the medium term. ❖ Stock trading at P/E of 14.4x on FY12E.
Petronet LNG	Energy	92	165	122.05	35	❖ Natural gas consumption estimated to grow from 173mmscmd in FY10 to 287mmscmd by FY14, while supply from domestic fields is not encouraging over this period, which would leave India heavily dependent on imported LNG. PLNG the largest player in LNG re-gasification and hence stands to benefit. ❖ PLNG's Dahej terminal recently expanded to 10mmtpa with plans to raise this to 12.5mmtpa in the next 30 months. Kochi terminal on track for commissioning by March '12, adding ~2.5mmtpa to its processing capacity, with scope for expansion upto 5mmtpa by FY14. ❖ Promoters includes GAIL and OMCs so there is little gas evacuation/marketing and corporate governance risk. ❖ Stock trading at 15.7x/12.3x FY11E/FY12E earnings.
Dena Bank	Banks	36	170	124.5	37	❖ Strong distribution network of ~1,250 branches (~2/3rd in rural and semi-urban areas) and high brand recognition in western India. Strong presence in rural and semi-urban areas supports one of the highest CASA ratios among PSU banks (39% at the end of Q2FY11). ❖ Operating performance to improve due to pick up in asset quality and higher margins (change in asset mix, focus on CASA and healthy fee income growth), which is expected to improve valuations. Meaningful improvement in asset quality expected in H2FY11 and FY12. ❖ Likely equity capital infusion of Rs 5b–6bn from GoI would be highly positive as it would enable the bank to grow and realign asset composition towards higher yield loans. Higher government holding would also enable further equity capital raising in future. ❖ Stock trading at 1.1x FY12E BV and 6x FY12E EPS.
Educomp	Education	54	820	570.25	44	❖ Education remains one of the most attractive multi-year growth themes in India, with two key growth segments: Multimedia (US$ 1.2bn by FY15), and K-12 schools (US$ 29bn by FY15). ❖ Educomp best positioned to capture the market with its leadership in multimedia (Smartclass) and strong focus on the lucrative K-12 segment. We expect a revenue/EPS CAGR of 23%/18% (FY10-FY12), driven by strong revenue growth of 27% in Smartclass and 66% in K-12. ❖ Securitization model in Smartclass and dry K-12 management should help improve cash generation and ease investor concerns on high capex. ❖ Stock trading at 15.6x/13.6x FY11E/FY12E earnings.
Ashok Leyland	Auto	97	90	72.85	24	❖ Positive on AL led by favourable industry volume and freight outlook, driven by a bountiful monsoon, road construction activity (esp. North-South and East-West corridor projects) and demand from State Transport Undertakings under JNNURM. ❖ Margins to expand in FY12 on the back of a production ramp-up at the Uttaranchal plant. ❖ Stock trading at 15.8x/12.2x FY11E/FY12E earnings.
Sintex Inds.	Industrials	55	270	201.00	34	❖ Leader in monolithic and prefabricated construction in India and has also built a strong presence in plastic composites through a series of acquisitions. ❖ Large part of revenue comes from building products (33–35%) which is driven by government orders. Rising government expenditure on rural infrastructure and mass housing projects offers strong order visibility in monolithic and prefab segments. ❖ India's auto sector boom to also fuel growth in its auto component subsidiary, Bright Autoplast. We forecast a robust earnings CAGR of 25% for SINT over the next two years, which would likely drive a stock re-rating.
Oberoi Realty	Real Estate	90	340	273.20	24	❖ Offers one of the best exposures to Mumbai's real estate space with its presence across markets (south, central and suburbs) and segments (commercial, retail and residential). ❖ Stock expected to trade at premium to peers on account of a strong brand name, robust cash flow visibility and potential value-accretion on deployment of free cash. ❖ Key drivers from here on include investment of free cash in value-accretive projects and the launch of its Worli project. ❖ At our price target, the land value works out to Rs 4,990psf (Rs 3,740 post-tax) as against ongoing TDR prices of Rs 2,800–3200psf in Goregaon where ~50% of Oberoi's land bank is located. Stock trading at 20% discount to our NAV.

Source: RCML Research

Advantage India

Sustainable growth through a structural economic shift

Macro outlook: The current rate of growth (8+%) can be sustained at the minimum for the next decade, with the current set of enabling factors

Consumption patterns are on an upswing not only in urban areas, but now in rural India as well

Some broad truths first: The Indian consumer market is highly heterogeneous with a wide disparity in income levels (top 20% of households have 8x the average income of bottom 20% households). Further, the urban–rural India *income divide* is a misnomer given the large variation in income levels within both urban and rural areas—the top 20% of rural households (by income) have higher incomes than over 80% of the urban households. Consumption patterns are thus more a function of income levels rather than being a part of urban or rural India. Thanks to the recondite nature of income estimation, though, we continue to refer to urban and rural India for want of a convenient alternative.

The broad economy's rev-up to a higher growth trajectory in 2003 was primarily driven by corporate capex, increasing disposable income on account of software exports, and a sharp rise in *urban* consumption. While these factors will continue to stimulate the economy, we believe *rural* consumption is now in a position to pick up the baton some years down the line.

Rural India is transforming structurally and faster than we think: key findings of our primary survey done earlier this year on rural India are:

1) Lower dependency on monsoons with alternative means

2) Land—the new source of wealth (and disposable income)

3) NREGA—a mixed blessing

4) Rise in rural income the root cause of primary inflation

5) Rural penetration still low—immense scope

RCML pan-India survey points to rural transformation

Earlier this year, our analysts travelled over 6,000km on a pan-India rural survey, to get a first-hand view of the country beyond its cities. Interactions with people from over 40 villages and towns across 12 states, with diverse occupations—consumers, distributors, retailers, administrative officials, village heads—brought out some interesting views on rural India.

There is a structural change in income levels and prosperity across rural India, driven by:

Land as the new source of disposable income: Price appreciation over the past 3–4 years has created a feeling of prosperity or the wealth effect among farmers.

Supplementary income schemes such as NREGS[2] and financial inclusion: Our survey indicated a high level of awareness amongst labourers on wages and the scope of work under NREGS. Increase in minimum wage has in turn stemmed the flow of landless or migrant labourers from states like Bihar and Uttar Pradesh to the richer states of Punjab and Haryana. Further, women and elderly labourers who are typically not employed by private farmers (productivity cited as a reason) constitute a major chunk of the workers under NREGS. Their participation in the scheme shores up family incomes and provides assured daily cash flows for a part of the year, cushioning the lumpiness in agri-income.

Diversified income sources and less dependence on agriculture: Improvement in rural infrastructure through the construction of roads and telecom networks has gone a long way in creating employment opportunities in rural India. Industrial development, a natural byproduct of the infrastructure build-up, is supporting wage inflation.

Media penetration and better product availability: Cable and mobile penetration is growing at an unprecedented pace—more than half of the villages and towns on our itinerary had 50%+ cable TV penetration. The increase in cable TV usage has been particularly high over the past 3–4 years and with the advent of direct-to-home (DTH) services which can cater to areas hitherto inaccessible through normal cable operators. The spike in media penetration and consequent exposure to product advertising has created high levels of brand consciousness. Our interaction with retailers revealed that most rural customers were not willing to compromise on their choice of brand.

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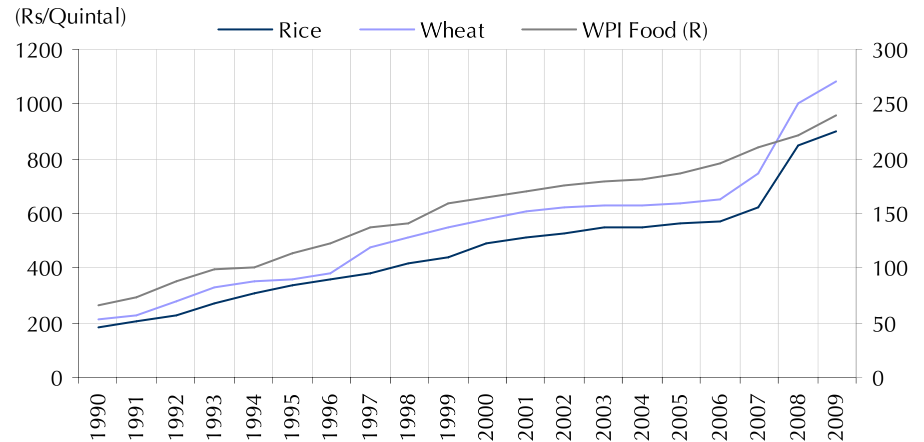
[2] **NREGS:** The National Rural Employment Guarantee Scheme, started by the UPA government in 2006 guarantees 100 days of employment to rural persons at a daily wage rate of Rs 100. The programme acts as a primary source of income for most landless labourers while supplementing the income of marginal farmers whose family members participate in the scheme. NREGS has led to overall wage inflation and income distribution in the rural economy, which are key positives for landless labourers.

In addition to these long-term trends, a good monsoon season this fiscal coupled with an across-the-board rise in MSPs[3] implies that growth might well surprise on the positive side as far as rural consumption is concerned. We expect farm GDP to grow as much as 7% in FY11 on account of a bountiful monsoon and its distribution, improved sown area under the *kharif* (summer) crop, and a good *rabi* (winter) crop output from last year.

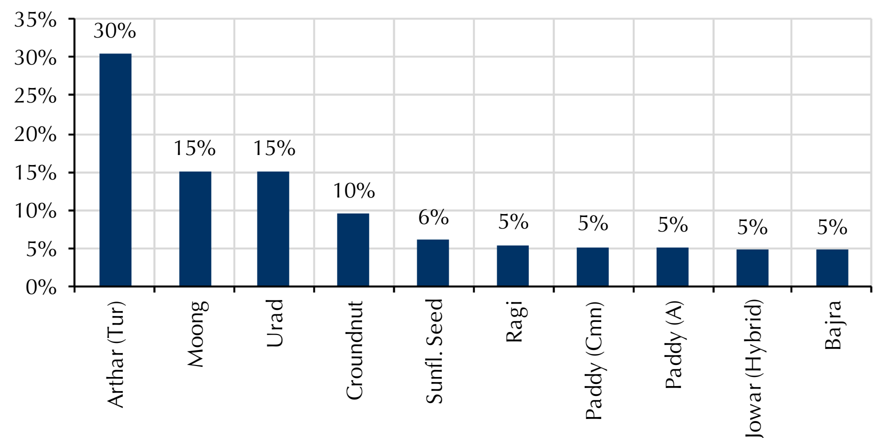
Fig 8 - Wheat and Rice MSP and WPI Food Index



Source: RCML Research, CMIE

In India, farm yields are anywhere between Rs 10,000 and Rs 50,000 per acre and serve as a primary source of income for ~82mn rural farm households. The MSP of wheat (a *rabi* crop), which increased slightly from Rs 1,080/quintal last year to Rs 1,100/quintal this year, provides a good support price for farmers. For rice as well, the MSP was raised from Rs 880/quintal in 2008 to Rs 980/quintal in 2009. The hike for pulses has been anywhere between 5% to as high as 30%. Bumper harvests together with rising support prices will help boost farm income and likewise rural prosperity this year.

Fig 9 - Hike in MSPs for pulses (2010)



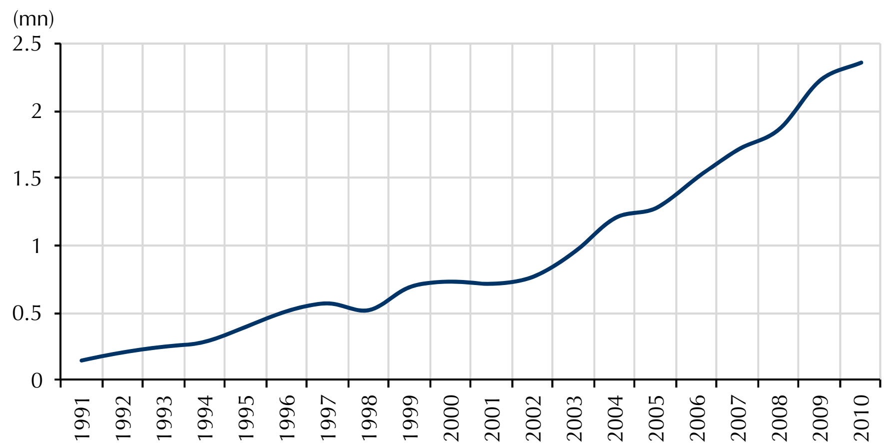
Source: RCML Research, CMIE

[3] MSP: Minimum Support Price for a crop is the price offered by the Food Corporation of India when sourcing foodgrain from farmers. The government offers MSPs (which act as floor-prices) across 21 food crops and 5 non-food crops annually.

Prefer discretionary plays over consumer staples

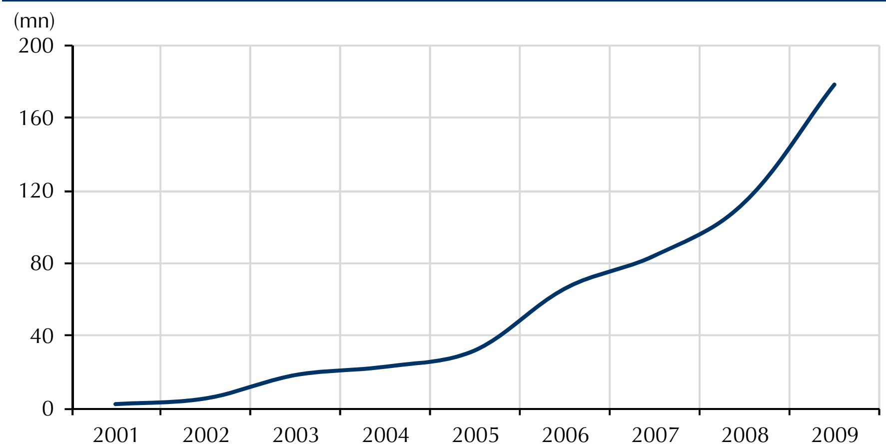
While increased consumption will continue to benefit consumption plays in India, we like consumer discretionary plays more than consumer staples. Historical evidence suggests that India is at a point on the J-curve where discretionary expenditure will increasingly be the dominant factor driving consumption on account of rising disposable incomes, higher aspirations and better awareness. Car sales and mobile subscriber additions are cases in point.

Fig 10 - Passenger vehicle sales



Source: CMIE

Fig 11 - Telecom subscriber additions



Source: TRAI

Q2 GDP growth at 8.9%

Our belief in the relative resilience of the Indian economy to external shocks is vindicated from the recently published Q2 GDP numbers. Q2 GDP growth of 8.9% was supported by 9.8% growth in manufacturing (indicating a slowly and cautiously unfolding capex cycle) and 9.3% growth in PFCE (expect this to continue in future with strong agricultural growth this year supported by a good monsoon season).

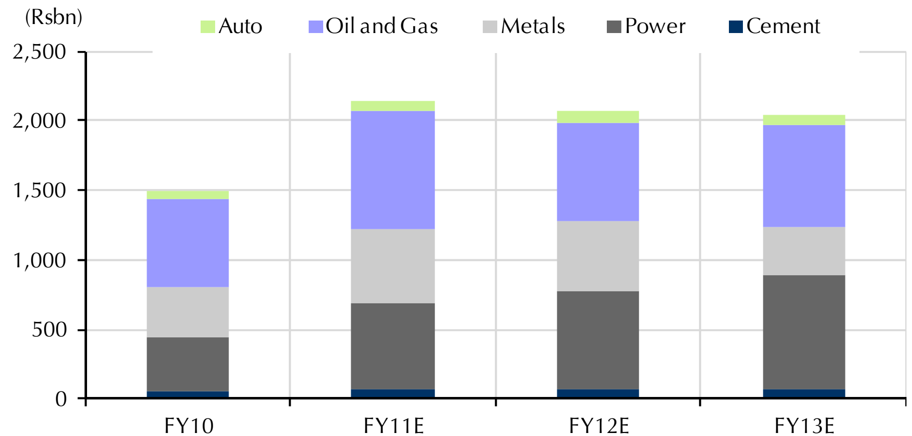
Investment cycle

Selective signs of revival

A stupendous rise in investment (21% in FY91 to 38% in FY08) underlined India's steady rise in growth to 9%+ during 2003–08. While we are well and truly in the midst of a growth cycle, overall investment figures would remain muted for some time. This is primarily due to the high base-effect in the two largest sectors—power and energy—which together comprise nearly 70% of the total capex spend in the country.

Just like earlier years, the power, metals and oil & gas sectors are expected to account for a major chunk of the capex in FY11-FY13, but at sharply reduced rates of growth

Fig 12 - Capex breakup by sector



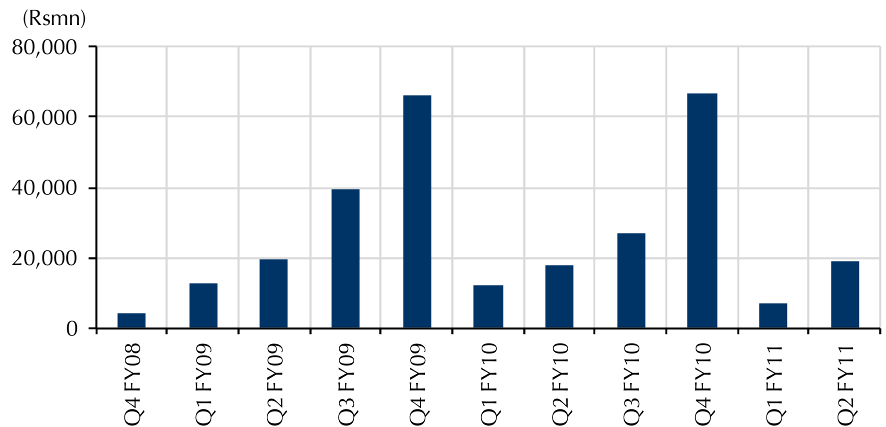
Source: RCML Research

Last investment cycle (FY03-FY08) was the longest since 1952, with an average growth of 17%, much above the 7.6% long-term average. The cycle is likely to revive now after a 3-year hiatus

Overall capex growth in the capital-intensive sectors in the economy (power, oil & gas, cement, steel, and autos[4]) is expected to moderate to 11% (CAGR) over FY10-FY13, over 20%+ earlier. That said, investment activity wildly differs across sectors in the economy. To illustrate, while capacity constraints in sectors like autos (cars, tractors) and textiles (yarn, denim) would lead to capacity expansion next year, some sectors have now reached a level of growth where incremental additions are commensurate with the forecast demand for the country. Capacity additions in a capex-intensive sector like power generation now equal 20,000MW annually, growing at ~11–15%, a rate which is estimated to meet current demand growth scenarios. Others like power transmission face an acute supply crunch, with capex of Rs 500bn over the next five years in high-capacity power transmission corridors (HCPTC).

[4] Telecom excluded due to 3G licence payments.

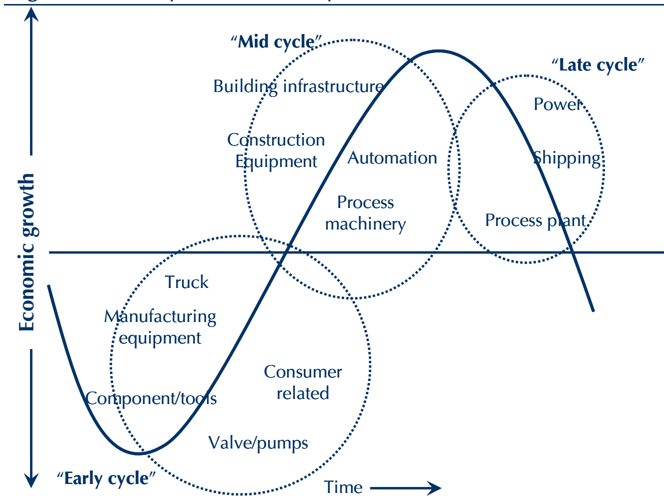
Fig 13 - Value of tenders by PGCIL



Source: Company, RCML Research

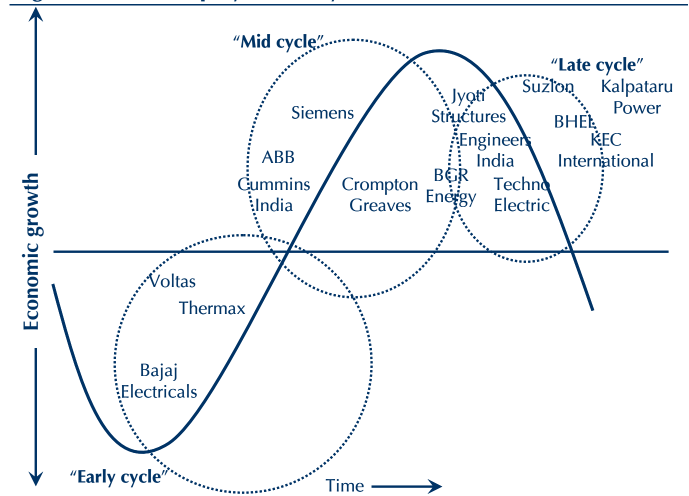
The approach to playing investment in India thus has to be selective, depending on one's positioning in the investment cycle. While we prefer the financing and domestic commodity demand plays like cement or steel, we would prefer to stay clear of contractors and asset owners (utilities and developers). In the capital goods space, the choice has to be based on market dynamics; for instance, power transmission over power generation.

Fig 14 - Industry Investment Cycle



Source: RCML Research

Fig 15 - Stocks to play in the cycle

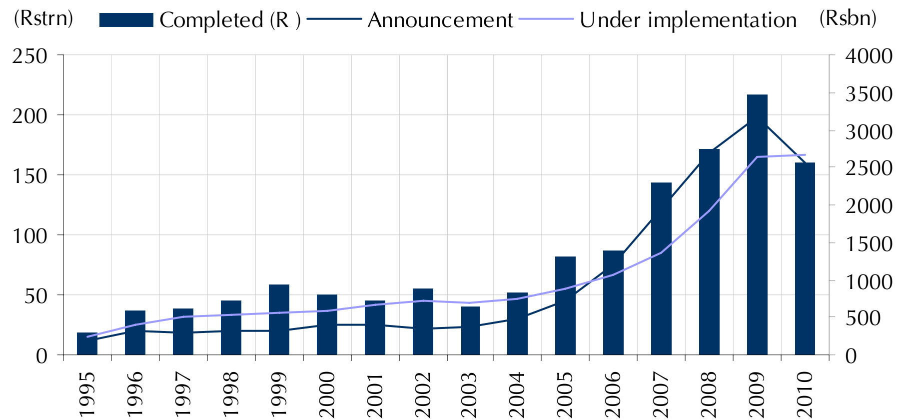


Source: RCML Research

In general, capacity utilisation for the broad economy has remained at moderate levels, given the significant expansion during the euphoric times of FY06-FY08, despite steadily rising demand.

2008 and 2009 saw substantial corporate capex (planned earlier) though there was a slight moderation in demand

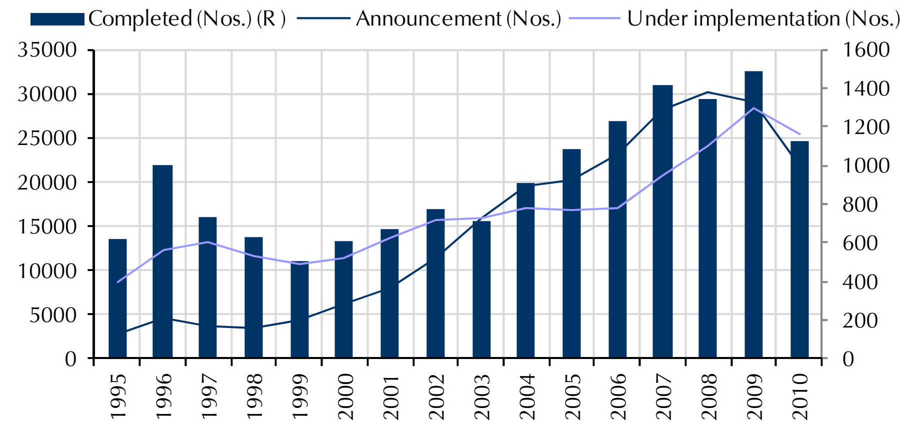
Fig 16 - Capex projects by value



Source: CMIE

With substantial capacity additions in 2008/2009 and low asset turnover ratios compared to historic highs, 2010 has seen moderate capex activity

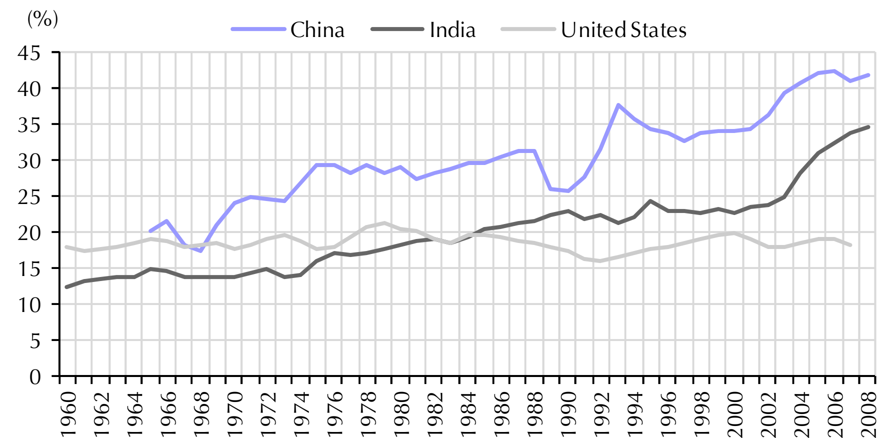
Fig 17 - Capex projects by number



Source: CMIE

The long-time trend of investment in India remains on a steady keel, at ~35% of GDP, lower than China's 40%+ share, but well above the US' 20%.

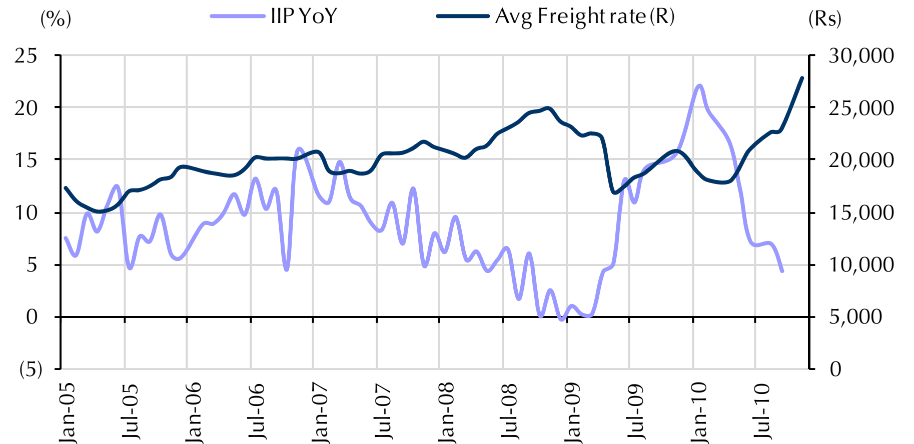
Fig 18 - Gross capital formation as a percentage of GDP



Source: RCML Research, WDI

And in the near term, rising freight rates even after the festive season signal robust demand across the manufacturing sector, not all of which is captured by the IIP.

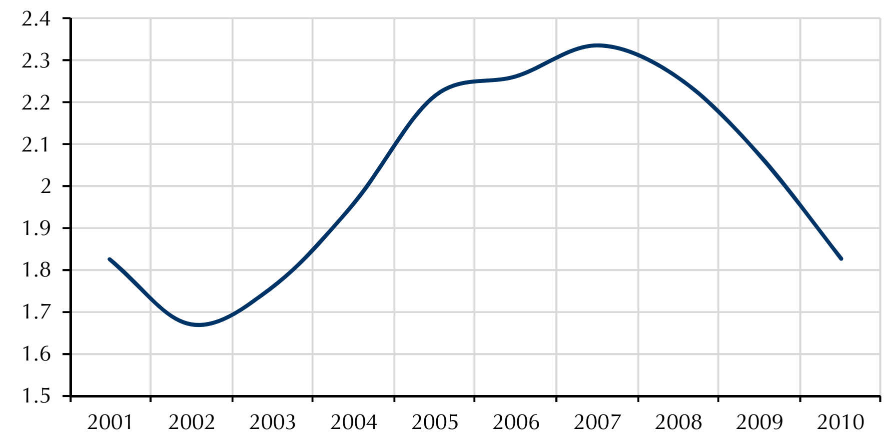
Fig 19 - Average freight rate vs. IIP (YoY Change)



Source: CMIE

A look at asset turnover across different sectors shows that the turnovers are below peak levels in most sectors

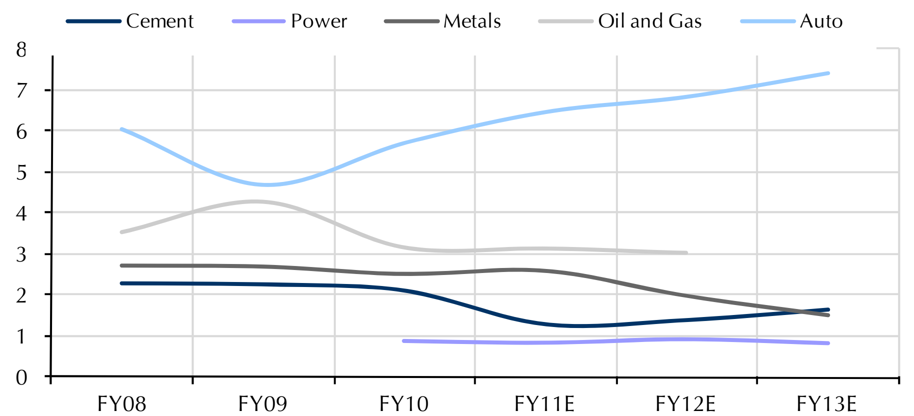
Fig 20 - Asset turnover in non-financial companies



Source: CMIE

While some sectors in the economy, like autos (especially on the ancillary side) have seen very high capacity utilisation, others such as cement are reeling under immense overcapacities

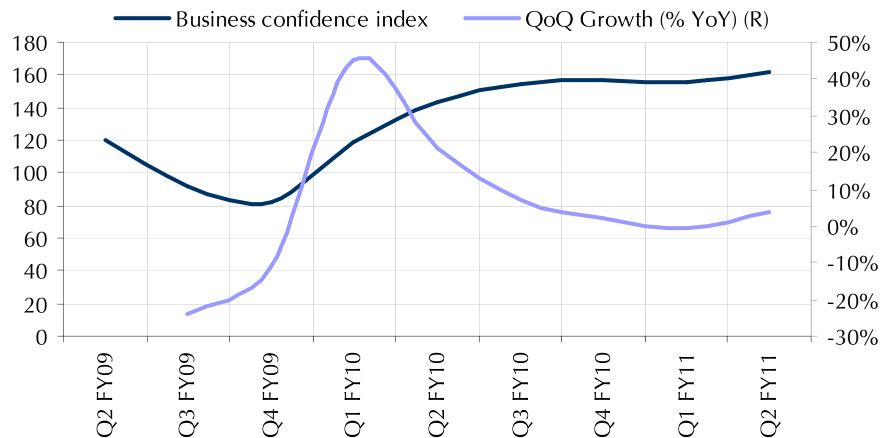
Fig 21 - Asset turnover in different sectors



Source: RCML Research

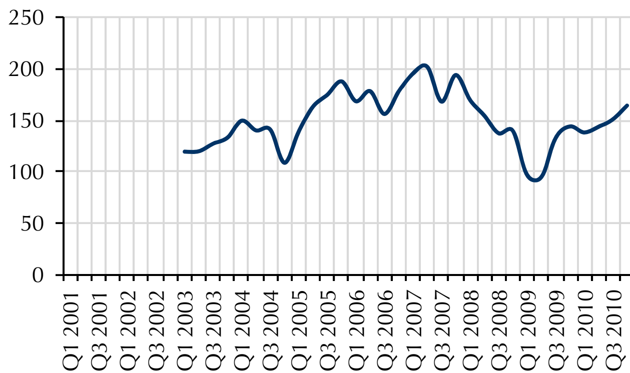
Business confidence is picking up, slowly but steadily

Fig 22 - NCAER Mastercard business confidence index



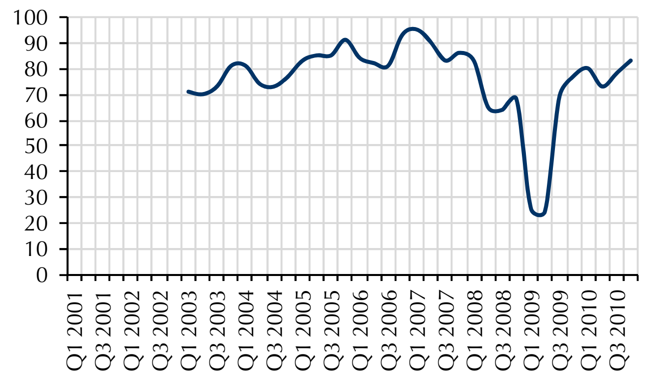
Source: RBI

Fig 23 - RBI survey – Business optimism



Source: RBI

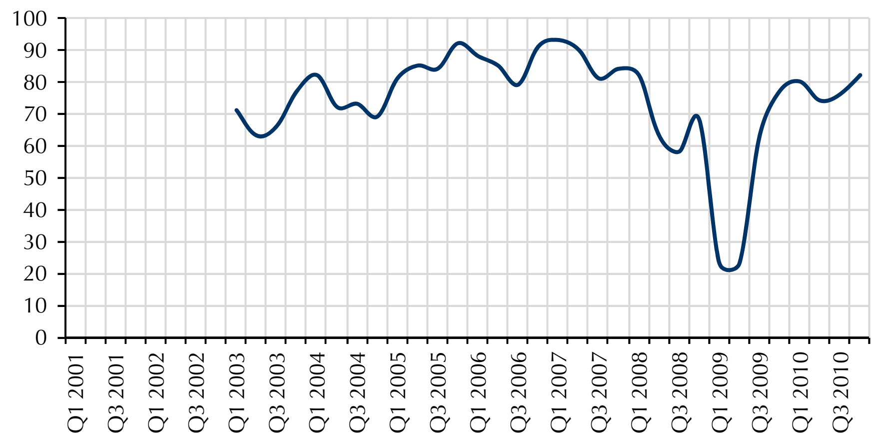
Fig 24 - RBI survey – New orders



Source: RBI

Other business outlook indicators also point to a strong demand

Fig 25 - RBI survey – Volume growth



Source: RBI

Macro outlook: Headwinds and tailwinds

Even as India's growth story looks set for a long innings on domestic steam, the role of the global macro environment has become increasingly important as the Indian economy's linkages with the world rise. While the domestic story is not without blemish, as we shall see, with stubborn inflation, a widening current account deficit, and rising political risk, global macro dynamics in their current state remain favourable for India.

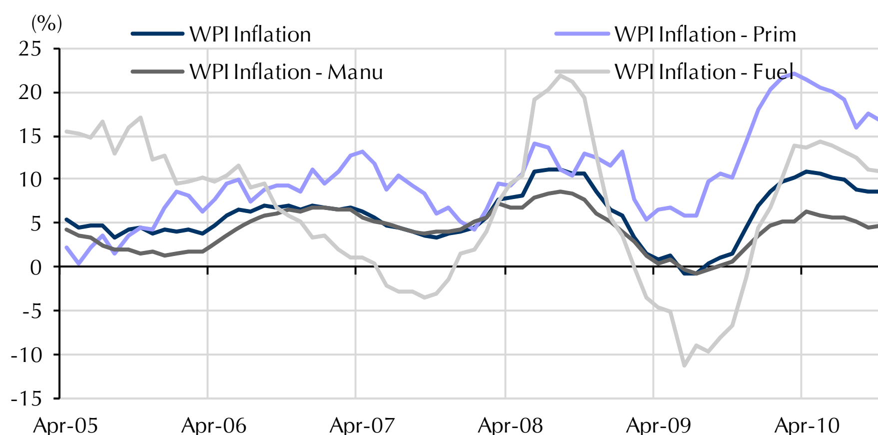
High inflation to persist

High inflation has been the bane of the Indian macro environment and policymaking this year, with the RBI having raised rates no less than six times. Repo and reverse repo are now at 6.25% and 5.25% respectively.

And while clearly showing signs of moderation—having receded from 11% in April to 8.6% now—inflation is still uncomfortably high. We believe the RBI might miss its 6% target for March '11, not only due to unseasonal rains in October–November, which raised prices of perishables, or rising global commodity prices in the near term, but also due to the essentially structural nature of the problem. Food inflation (14%), for instance, is likely to remain in double-digits due to the changing nature of the rural economy, while core (manufacturing) inflation now appears in control at 4.75%.

Inflation has been trending southwards but unseasonal rains and imported commodity inflation on account of ample global liquidity may mean more stubborn inflation in the coming weeks

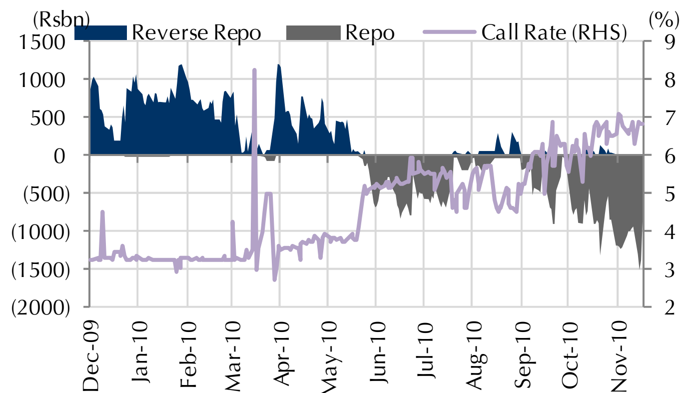
Fig 26 - WPI inflation



Source: RCML Research, Datastream

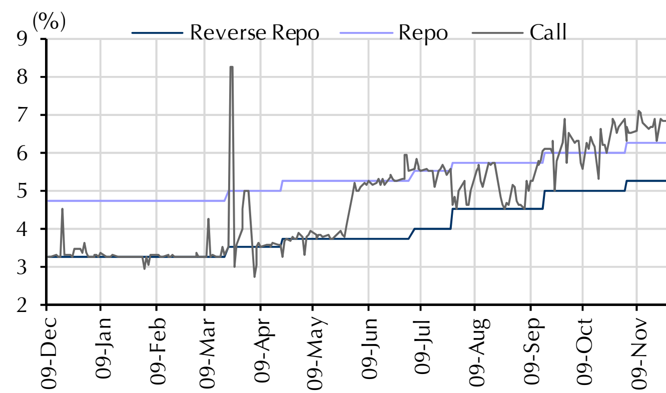
While the strong 8.9% growth seen in the second quarter might invite another 25bps rate hike by the end of the fiscal, we believe the central bank would pause on rates now to let the impact of the hikes flow through the monetary transmission mechanism. In that sense, India is well ahead of many emerging markets in terms of its rate cycle—with the commensurately lower risk of incremental tightening—although sustained capital flows might yet attract selective, sector-specific controls. For instance, the real estate sector saw risk weights being raised, and LTVs capped at 20%.

Fig 27 - Borrowing/lending at LAF window and Call rate



Source: RCML Research, Bloomberg

Fig 28 - Policy rates and exit from loose monetary policy



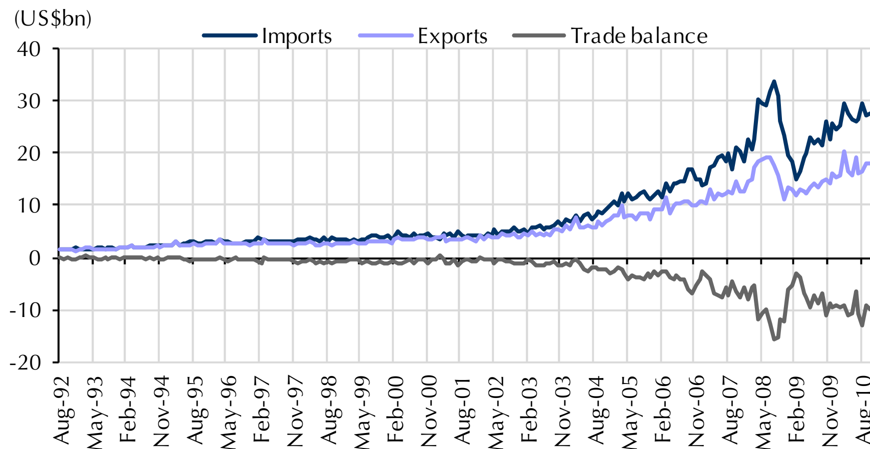
Source: RCML Research, CMIE

Systemic liquidity is very tight—with rising overnight call rates and record borrowing at the LAF window—and does not provide encouraging signals for rate-sensitives, and wholesale-funding. Hitherto negative real interest rates have also capped deposit growth (stagnant at 15%), particularly hurting banks with low CASA[5] ratios.

Widening current account deficit

On the BoP, a rising current account deficit is a matter of concern now, with the trade deficit set to cross US$ 100bn for the fiscal. More worrisome is the composition of rising imports, especially with capital goods now no longer the dominant import in the non-petro space.

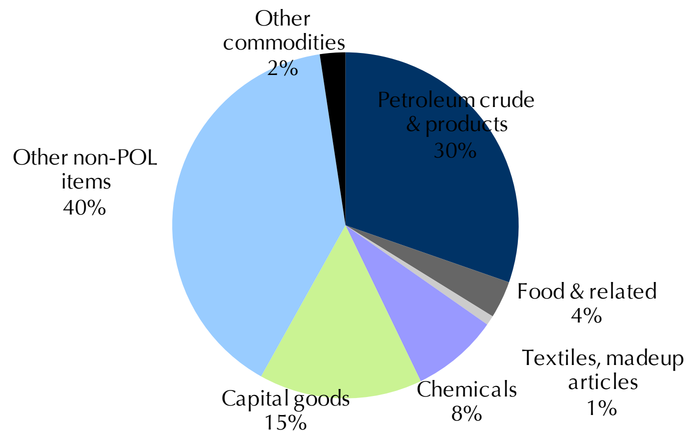
Fig 29 - India's Balance of Payments



Source: RCML Research, CMIE

[5] CASA: 'Current Account, Savings Account'. Banks with high CASA ratios (share of total deposits) have low cost of funding.

Fig 30 - Composition of India's imports (2010)



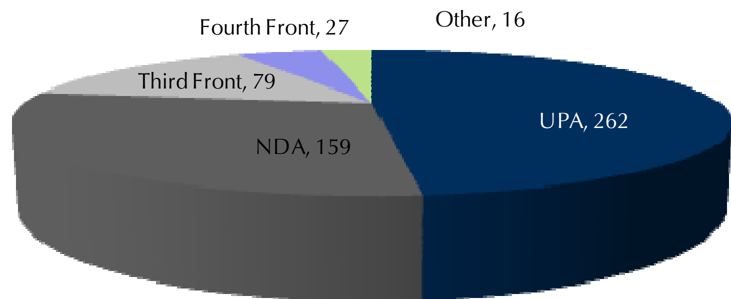
Source: RCML Research, CMIE

Scams: Rising political risk could translate into fiscal risk

Political risk emanating from recent series of political and corporate scams could quickly morph into fiscal exigencies.

The second quarter of FY11 proved to be a highly forgettable one for the UPA-2 government at the centre. A washout in the Bihar elections and a flood of scams starting with the Commonwealth Games to the most recent 'bribes-for-loans' scam have put the government on the backfoot despite a very weak opposition and an almost non-existent Left. These developments point to a government that may turn increasingly populist in the run-up to the state elections, pushing its reform agenda to the backburner.

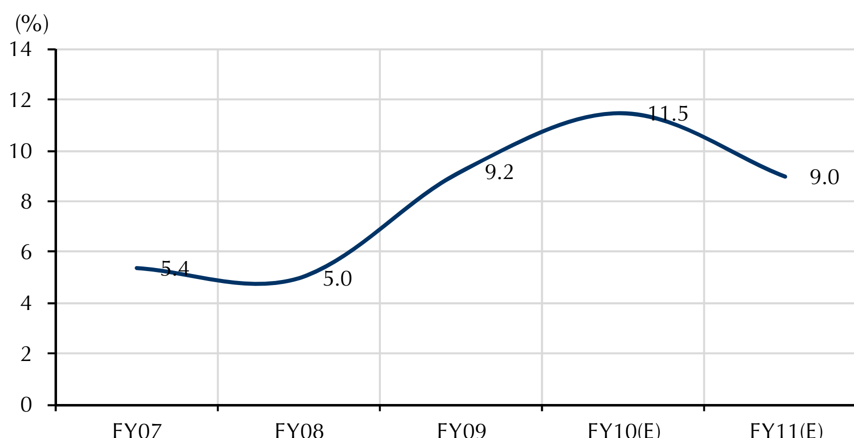
Fig 31 - Composition of 15th Lok Sabha



Source: RCML Research

Turning populist also means that the government may weigh inflation more than growth, especially after the recent robust Q2 GDP numbers. While the government on the one hand is confident of capping the fiscal deficit at 5.5% of GDP, it has also sought approvals for supplementary grants (additional fiscal spends) of nearly Rs 900bn, which surpasses the Rs 700bn windfall gain from 3G auctions earlier this year. It is therefore also unlikely that the government will bring fiscal balances back to FRBM-specifications of 4.1% of GDP in the next two years.

Fig 32 - Centre + State fiscal deficit as a percentage of GDP



Source: RCML Research

Other than the issues with mispricing of 2G licences awarded in 2007, and the recent bribery scam, where senior bankers approved loans for graft, a number of scandals have occupied headline space in the last two months—though largely unrelated to the corporate sector. Market sensitivity to corporate governance, however, has risen sharply, with real estate (-12%) and PSU banks (-5%) suffering the 'flight to quality' as investors switched over to 'safe havens' like consumer staples and IT services.

Many banks have put out statements to clarify the extent of their exposure to the commercial real estate sector and the parties involved in the loan-for-graft scam. We believe that investor perception towards India will hold firm if the guilty are swiftly brought to book and a more transparent regulatory framework put in place to avoid similar mishaps in future. We note that the policy response to the Satyam scam was newly-introduced regulation requiring promoters to disclose pledged shares every quarter, which led to greater transparency and the plugging of a loophole in the system. While the markets may remain cautious in the coming quarters, we believe the lasting impact of recent events would be higher transparency and accountability in the otherwise mature Indian markets.

Other macro risks

The weak global macro environment remains an overhang for exports and private transfers, particularly with rising consumption-based imports. Despite its falling share in national income—17% in FY10—agriculture remains tied with the vagaries of monsoon, given that irrigation covers ~55% of the gross sown area. What's heartening is the rising resilience of agricultural income to natural shocks, thanks to the substitution of pure agriculture-based income with other means. For instance, agricultural GDP growth after last year's drought fell to 1%, well above the -5% figure typically seen during droughts over the last 40 years.

On the upside, better execution of infrastructure projects—physical as well as social—resulting in an easing of some of the supply constraints including those in agriculture, may catapult the economy into a higher growth trajectory of 10% over the next decade.

Global macro: India in a sweet spot

Against the backdrop of the global financial environment, we believe the Indian markets have been in a sweet spot since the beginning of the year—the conditions becoming more apparent during the second half. What's clear is that (a) a weak global outlook, and (b) a structural, predominantly domestic growth story that benefits from the resultant weak commodity outlook, are factors that appeal to global investors in search of higher

ROIs. At the same time, however, domestic investors have their own chimera (regulation, redemptions, or the emergence of a bubble) to worry about.

Growth in a post-financial crisis world (since March '09 when markets recovered) has been led by expectations of a return to economic growth, after an unprecedented globally coordinated fiscal and monetary response to the crisis. While H2CY09, and H1CY10 had seen semblances of a revival (though largely led by inventory restocking across the supply chain in the developed world), early 2010 saw sovereign debt fears in many European countries, where recovery was tepid at best, stoking concerns of another slowdown.

And this was followed by the US economy seizing up in June, where stubborn 9.5+% unemployment and stagnant consumer credit growth have eclipsed a superb 40%+ earnings season. As we write, the US Fed has considerably lowered growth prospects for FY11 from 3.6–4.2% to 3–3.5% and promised not only to keep interest rates low for the foreseeable period, but also to inject additional liquidity (QE2) as needed into the markets. While the US and Eurozone economies retain enough potential to surprise on growth expectations, we do not seem to be there yet.

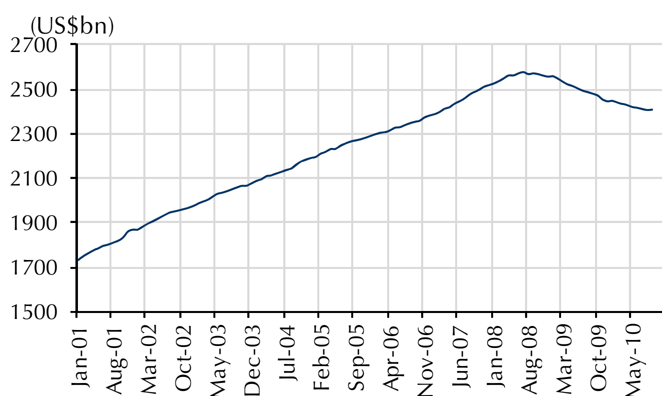
So what are the implications for the Indian markets going forward? We outline three possible scenarios, based on the potential growth path in the developed world over the next 3–4 quarters. This is the period over which we believe the monetary stance of leading global central banks can be ascertained with some degree of certainty.

A fast-paced global recovery

Relatively fast-paced recovery; strengthened commodity prices; attractively priced markets outperform

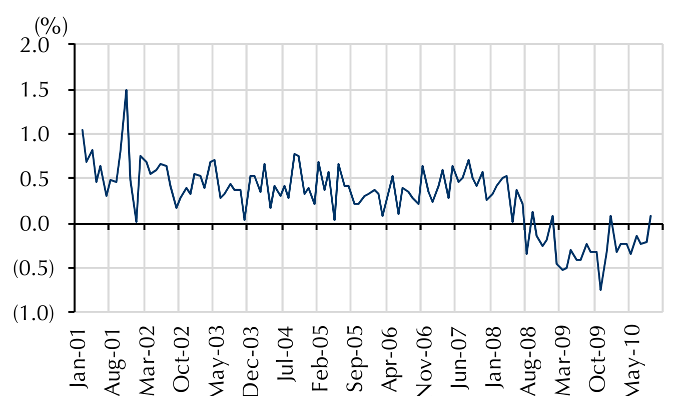
Though unlikely, if the global (read US, Eurozone) economy does recover faster than current expectations, developed market equities that are attractively priced (at least in relation to bonds) will do well. We believe that India's outperformance amongst emerging markets and vulnerability to a global commodity price upturn would weigh against it in such a scenario. The growth premium that India and some other countries around the globe command would contract with a fall in the growth differential with respect to the developed world economies. We believe that such a scenario would be predicated on a return to growth in the US consumer credit market, which has been subdued on account of deleveraging, falling markets and housing sector slump.

Fig 33 - US consumer credit outstanding



Source: RCML Research, Datastream

Fig 34 - US consumer credit growth (% MoM)



Source: RCML Research, Datastream

A double-dip recession

Double-dip recession in the US along with stalled global growth for 3–4 years; a negative event trigger such as a sovereign default

The Indian markets would see outflows like other emerging economies and all risk assets in general (in the medium term), though India's strong (domestic) economic growth profile could be a mitigating factor. Capital outflows would induce a period of pain—not as severe but akin to the one in 2007–08. In our view, a severe double-dip is highly unlikely given the recent quick policy response by central banks and governments around the globe.

A prolonged global recovery – most likely

Weak recovery; soft commodity prices; bonds favoured over developed market equities (partly artificially on account of QE2)

The US economy and markets would be in low-growth limbo for an extended period. The bond market rally would continue in developed markets, though anaemic growth in the US and Eurozone would dampen aggregate demand, hurting export-driven economies like China and Japan. But short of a major negative shock, risk appetite would see capital chasing higher returns across assets, marking India out as a favoured destination across emerging markets, also helped by weak commodity prices.

Fig 35 - EMBI Spread and Sensex

Source: RCML Research, Bloomberg

Meanwhile, even as the weak outlook for developed economies has reined in all risky assets, especially commodities (remember May's sharp ~20% fall in crude), India has benefited, not just for its long-term growth story, but due to the support weak commodities (crude again) provide to its current and fiscal balances. Our energy analyst estimates that domestic OMCs would have positive marketing margins at ~US$ 72–73/bbl, moderating the fiscal support they need. Similarly, US$ 90/bbl is the level at which the Indian economy (and hence the market) turns negative on crude.

While taking a call on final (not necessarily fair) valuations in such a scenario is effectively a call on capital flows, and periods of increased volatility in the near-term cannot be ruled out, we believe the overhang of a sharply reduced pace of global economic growth would reduce the market's upward climb to a grind.

We believe the risks to the market on this 'middle-path' are likely to be domestic-led, be they market-specific such as an above-expected margin contraction in the third quarter (likely), or geopolitical risks (unlikely) such as internal security escalations (Naxalities) or increased populism on the government's part (likely, especially after the recent Bihar polls).

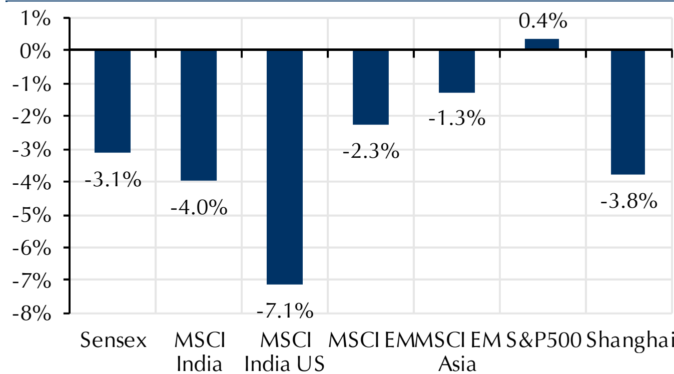
Markets: Performance, valuations and earnings

The recent correction in the Indian markets offers pockets of value, but it's a bit premature to play investment. Premium valuations could expand further with the widening growth differential, but face the overhang of massive primary issuance. Sensex earnings growth is expected at 16% for FY11-12, with a commodity-bias in the near-term, with steady ROEs of 20%.

Outperformance with premium valuations

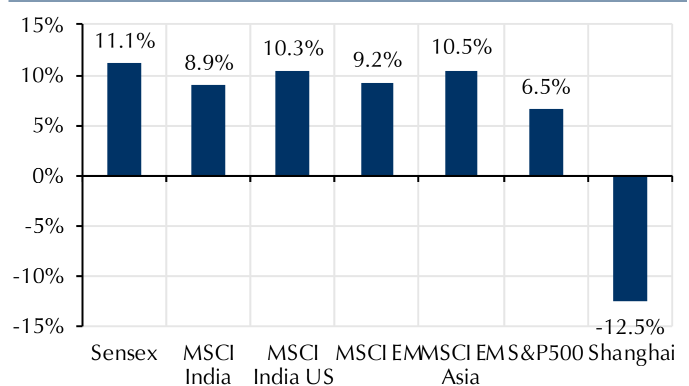
On to the markets now: India's outperformance versus the rest of the world has been tempered in the last month owing to domestic (bribery scam, standoff over 2G licences) and external (European sovereign debt crisis, tension in the Korean peninsula, Chinese monetary tightening) factors. While the market continues to outperform China by a margin of ~24% since the start of the year, it has underperformed the MSCI EM Asia index by ~3% in the last month.

Fig 36 - Performance of major stock indices (1M)



Source: RCML Research, Datastream

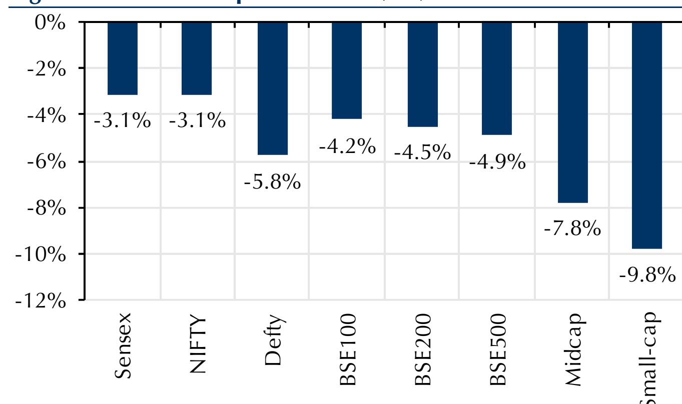
Fig 37 - Performance of major stock indices (YTD)



Source: RCML Research, Bloomberg

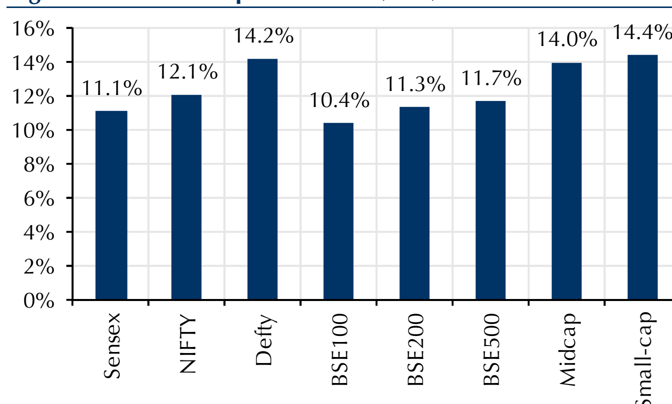
Historical evidence shows that mid-caps and small-caps have outperformed their larger peers in bull markets (in 4 out of the last 6 years). On account of a sharp correction in the last month due to a bout of risk aversion, the BSE mid-cap and small-cap indices have only marginally outperformed the Sensex by ~3%. While recent events have seen a flight-to-safety with large-caps (ex-banks and real estate) doing better than small- and mid-caps, we expect incremental fund flows to resume chasing the high beta universe once risk aversion subsides.

Fig 38 - India indices performance (1M)



Source: RCML Research, Datastream

Fig 39 - India indices performance (YTD)



Source: RCML Research, Bloomberg

Notwithstanding the near-term consolidation, valuations are not cheap. India's trading premium versus other global markets has risen in the wake of the financial crisis. At 19.3x FY11E earnings, the MSCI India index represents the most expensive major market in the world, trading at a significant premium to the 14x levels in both China and the US. Even so, valuations are still only 15% higher than their long-term averages, leaving enough upside to valuations from current levels, before we get into bubble territory.

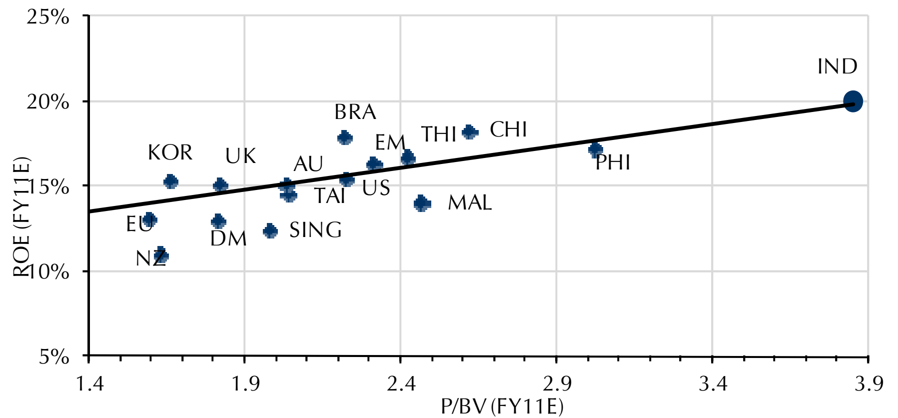
Fig 40 - India's premium valuations with respect to EMs and DMs

Sector	India	Brazil	Russia	China	Indonesia	US	UK
MSCI Index	19.3	12.2	7.1	14.2	17.5	14.2	11.9
Consumer Discretionary	17.2	14.7	NA	18.1	22.1	17.0	13.9
Consumer Staples	28.5	23.3	26.4	21.9	19.0	14.8	14.1
Energy	14.7	10.0	5.4	12.1	18.0	13.5	9.6
Financials	23.7	14.2	15.3	13.2	NA	13.1	13.3
Healthcare	25.2	NA	NA	35.4	19.3	11.7	10.1
Industrials	20.1	32.4	NA	13.7	15.8	16.0	13.1
IT	23.6	10.7	NA	28.2	14.2	14.2	22.1
Materials	11.7	11.0	11.0	16.9	NA	16.7	12.3
Telecom	17.5	7.7	12.0	12.9	15.2	18.9	10.6
Utilities	19.5	9.8	14.6	15.0	17.5	12.4	12.9

Source: RCML Research, Datastream

The premium India has enjoyed over regional and global emerging markets has been a product of its high growth and ROEs, and with a widening differential between growth trajectories, one would not rule out a further expansion in multiples for the medium term.

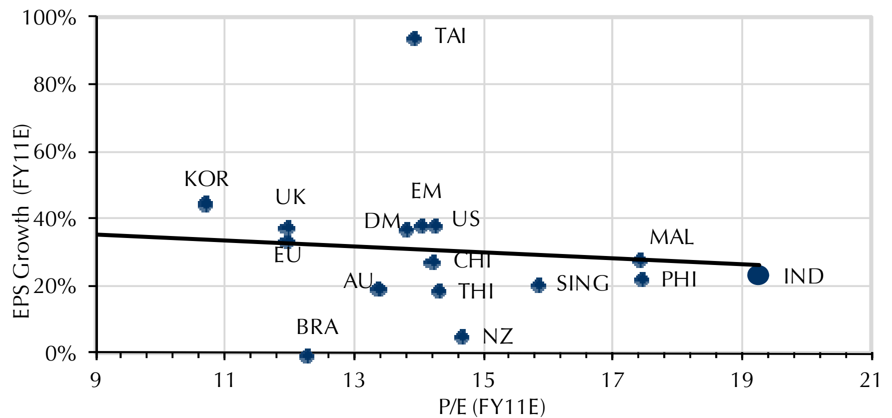
Fig 41 - PB (FY11E) vs. RoE (FY11E)



Source: RCML Research, Datastream

High multiples a byproduct of steady growth for the broad economy; may appear high from a relative perspective but not historically

Fig 42 - PE (FY11E) vs. EPS growth (FY11E)



Source: RCML Research, IBES Datastream

The recent correction has helped keep a check on the runaway valuations; in our view, valuations look fair to attractive at this stage

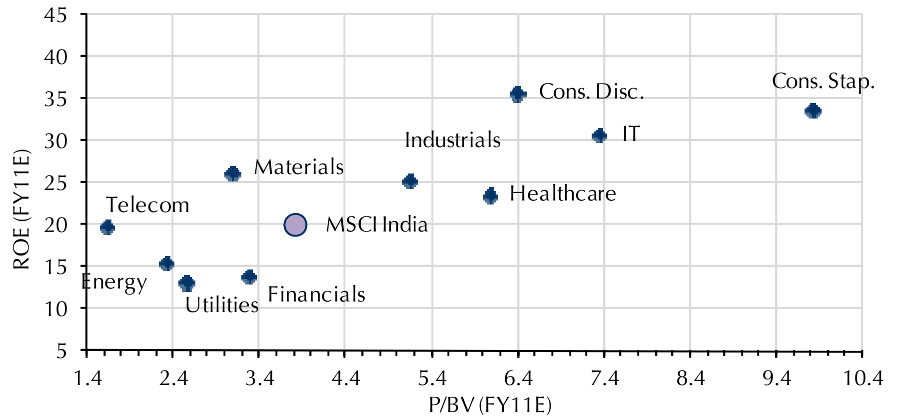
Fig 43 - MSCI India FY1 PE ratio

Source: RCML Research, Bloomberg

The benchmark Sensex currently trades at ~16.5x twelve-month forward earnings, much below the pre-crisis levels of 23x. We think that in the absence of any major external

event shock, the ample liquidity available globally on account of QE2 will see a slight expansion of the Sensex P/E along with other assets.

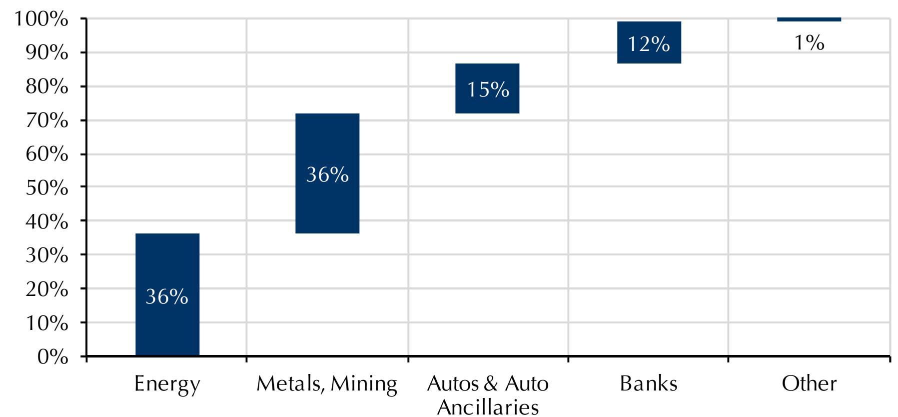
Fig 44 - India sector wise PB vs. RoE



Source: RCML Research, Datastream

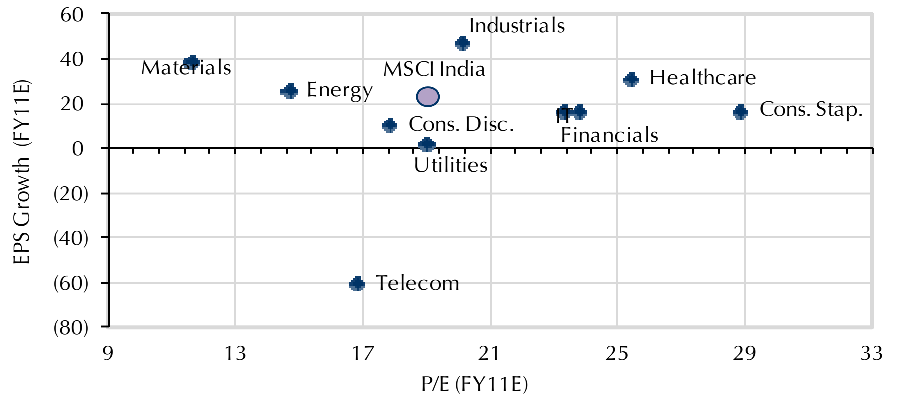
Relative P/B-ROE valuations outline the preference for defensives and consumption stories in the current markets versus rate sensitives and investment plays. Overall earnings growth for the Sensex is likely to come in at ~21% for FY11 and 16% for FY12, with 72% of this growth remaining commodity-driven.

Fig 45 - Sensex FY12 earnings growth contribution



Source: RCML Research

Fig 46 - India sector wise EPS growth vs. PE



Source: RCML Research, Datastream

Fig 47 - MSCI India Sector

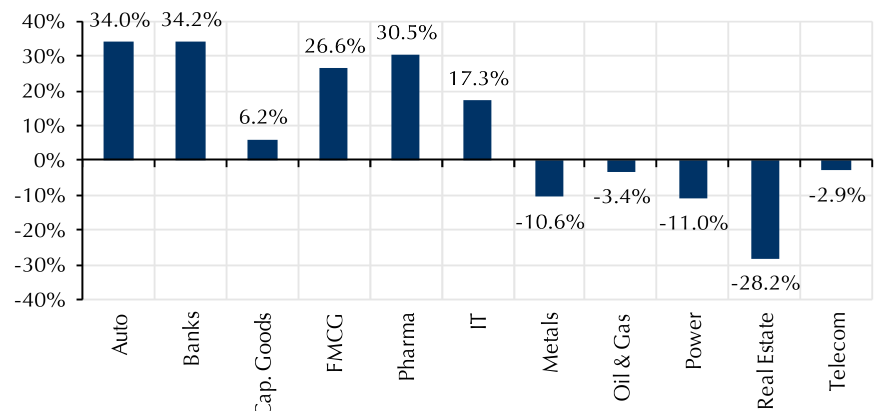
Sector	EPS Growth (% FY11E)	PE (FY11E)	PB (FY11E)	RoE (% FY11E)
MSCI India	**23.1**	**19.1**	**3.8**	**20.0**
Consumer Discretionary	11.4	17.7	6.4	36.0
Consumer Staples	18.0	28.8	9.8	34.1
Energy	26.8	14.6	2.3	15.6
Financials	17.4	23.3	3.3	14.0
Healthcare	32.1	25.3	6.1	23.9
Industrials	48.1	20.0	5.1	25.5
IT	17.6	23.7	7.3	31.0
Materials	39.7	11.5	3.0	26.5
Telecom	-59.7	16.8	1.6	20.0
Utilities	3.6	18.9	2.5	13.4

Source: RCML Research, Datastream

Sector-wise, the market performance this year has belonged to domestic consumption and defensive plays thus far, with autos, banks, pharma and FMCG outperforming on account of a normal monsoon season and the resultant spurt in growth expectations for the agricultural sector. Commodity-related sectors such as oil & gas and metals have underperformed. In stark contrast to the rally in 2007, infrastructure has lagged perceptibly. Real estate has been the top underperformer, with the recent overhang of graft, and the RBI's tightening of lending norms adding to the sector's cup of woes.

Consumption plays – autos, financials, pharma and consumer staples have been top performers since the start of the year whereas real estate, utilities and metals have been laggards

Fig 48 - Performance of various sectors in India (YTD)



Source: RCML Research, Datastream

Fund flows

FIIs remain the drivers; DIIs face regulatory headwinds

Performance this year remains leveraged to capital flows, but the near-lack of domestic participation on both retail and institutional sides, and hence capital waiting in the wings, provides downside support.

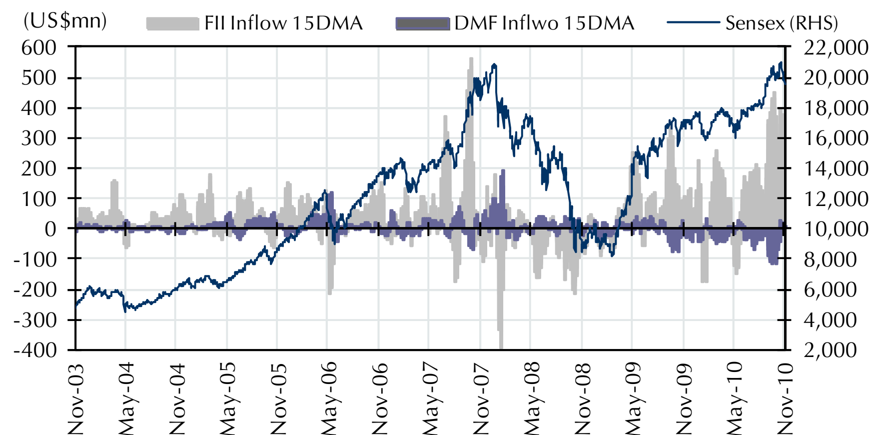
The market has been almost entirely led by capital flows this year, with FIIs pumping in more than US$ 28bn (net)—into primary and secondary markets in equal measure—while domestic investors still have their chimera (regulation, redemptions, or the emergence of a bubble) to worry about

The announcement of QE2 and a large primary issuance pipeline has resulted in an avalanche of FII portfolio flows into Indian markets starting September '10. The YTD FII net inflows now stand at US$ 28.3bn. As we've seen, unless there is a significant change in global macro-fundamentals, India would continue to attract flows in the coming months.

And while many other emerging economics have either implemented or are contemplating capital controls in the near future, the received wisdom here has been to stay clear of controls as long as possible, while letting the flows fund the widening gap on the current account. Forex reserves have risen marginally to US$ 269bn in October '10 as against a massive ballooning in most other emerging markets. The RBI has time and again underlined the importance of capital flows for India and any reversal on that front may be a cause for concern. We thus believe India would be one of the last countries to implement capital controls, if at all.

The last few months have seen an avalanche of foreign capital flows into India with September alone having seen net inflows of US$ 6.37bn – the highest ever monthly figure

Fig 49 - Sensex, FII and DMF flows in India – Long-term

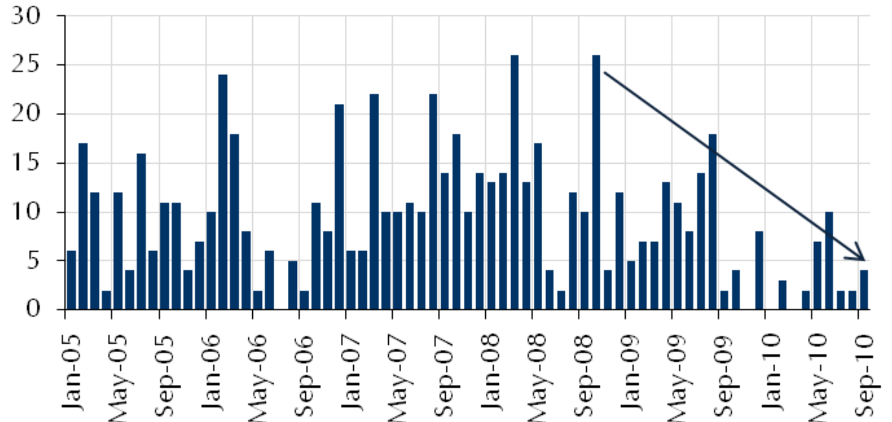


Source: RCML Research, Bloomberg

In contrast to FIIs, domestic mutual funds have yet to surmount issues like regulatory headwinds, a collapsed distribution model, and near-term redemption pressures, and have been net sellers of equities worth US$ 6.2bn since the start of the year. Thus, despite the near-term moderation, we believe foreign flows are likely to continue driving equities further, especially after the recent correction has made valuations attractive in certain pockets.

'Cautious Exuberance' replaces 'Irrational Exuberance', with a mere 30 NFOs thus far vs. 153 in 2007. Part of the story also lies in the collapse of the mutual fund distribution model since August '09

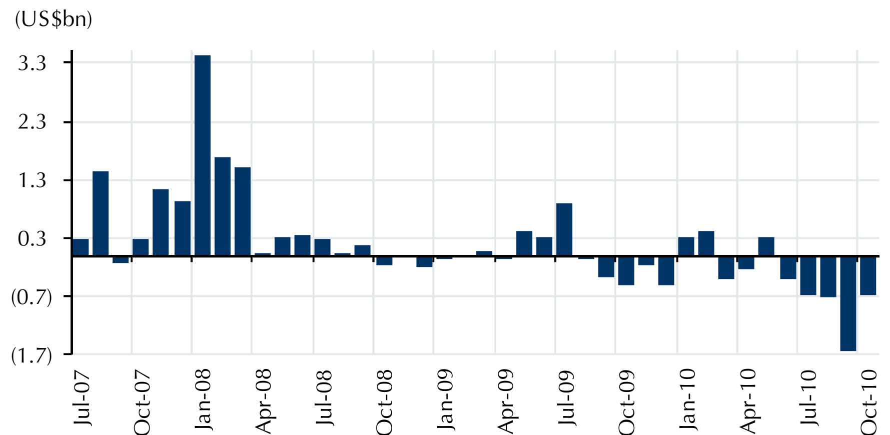
Fig 50 - Equity NFOs



Source: RCML Research, MFI Explorer

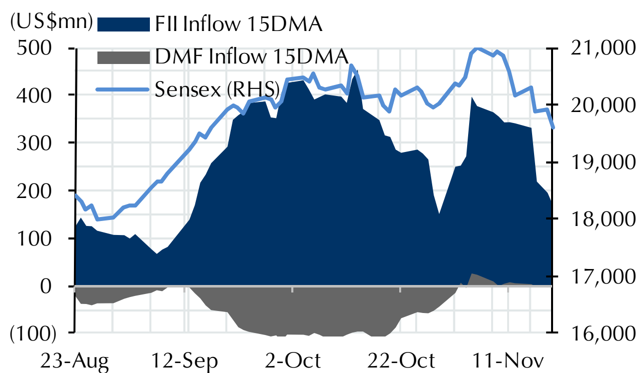
DMFs continue to reel under regulatory changes with October being the 5th month in a row to register net outflows (to the tune of US$ 662mn); YTD net outflows at US$ 3.6bn

Fig 51 - Net inflows into domestic equity mutual funds



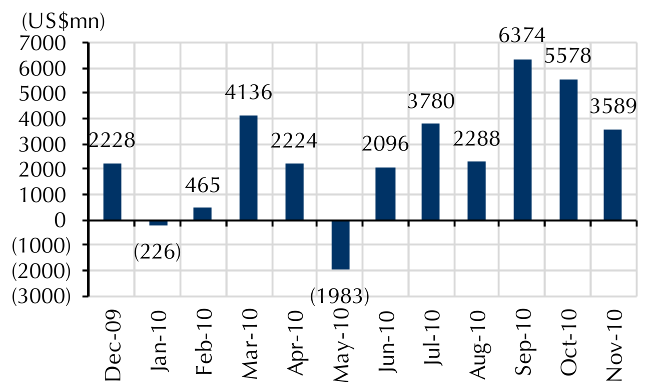
Source: RCML Research, AMFI

Fig 52 - Net FII inflows and Sensex



Source: RCML Research, Bloomberg

Fig 53 - Net FII flows – YTD monthly

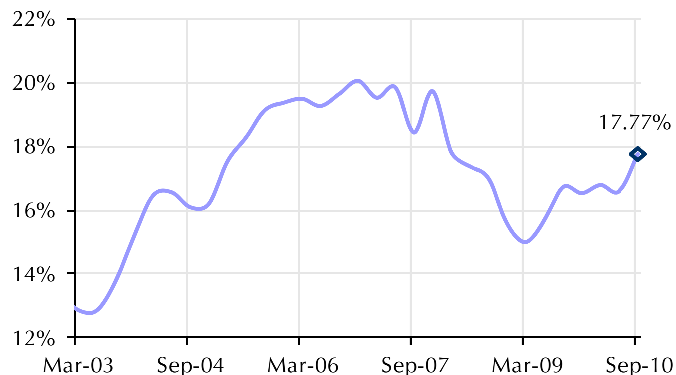


Source: RCML Research, Bloomberg

Sustained one-sided flows now showing up in shareholding patterns

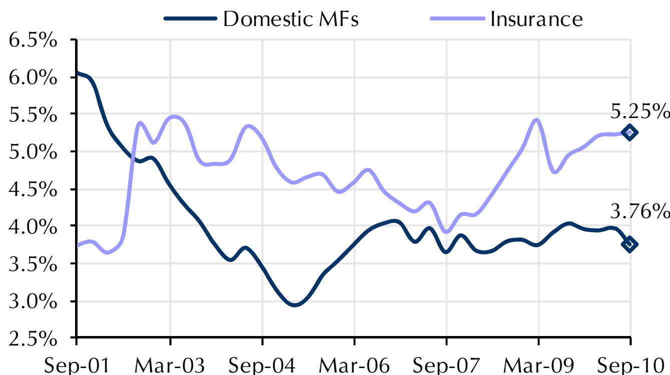
Six months of sustained one-sided flows have now firmly changed ownership trends, with FIIs raising their shareholding in BSE500 companies to 17.8% from 16.6% a quarter ago, registering one of the highest ever quarterly rises, while DMFs have seen their share in the BSE500 fall to 3.76% now. Insurance companies too have seen their ULIP-driven march to gain market share slow down after regulatory hurdles in the last few months.

Fig 54 - FII ownership in BSE500 stocks (Sep '10)



Source: RCML Research, Datastream

Fig 55 - DII ownership in BSE500 stocks (Sep ' 10)

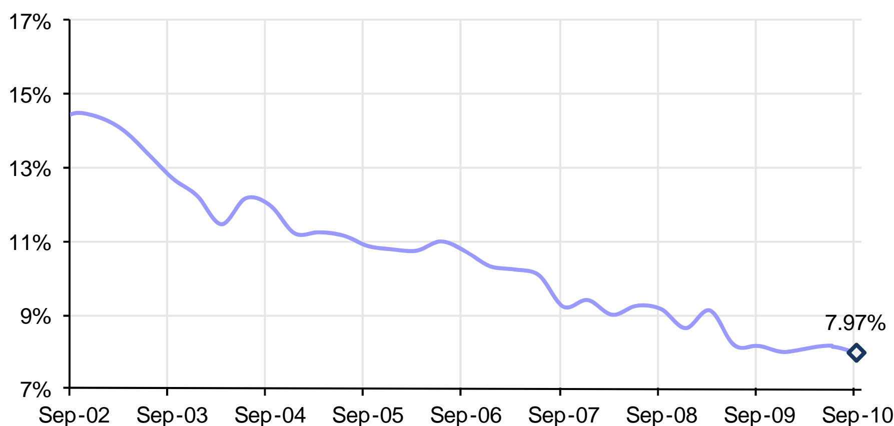


Source: RCML Research, Bloomberg

Recovery rally without retail participation

The market's recovery rally differs from the euphoric bull-run of 2008 in an important way: a near-lack of retail participation. The highs in 2007 were reached with active participation of mutual funds and insurance companies (via equity-linked products), as well as by active, direct participation from the retail public. A look at the shareholding pattern of BSE500 companies shows that the public-shareholding has been dipping over the years and especially post the March '09 lows to reach 7.97% in September '10.

Fig 56 - BSE500 public shareholding (Sep-10)

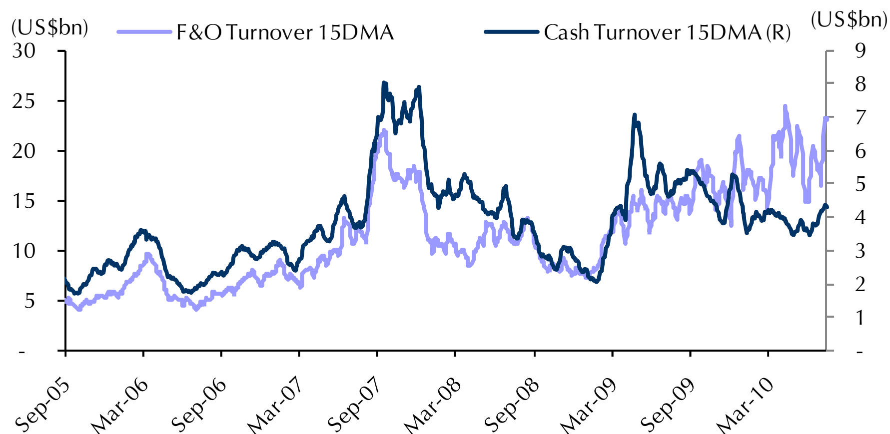


Source: RCML Research, Capitaline

Average daily cash turnover during the euphoric years of 2005 and 2008 rose from US$ 3.8bn to US$ 15.1bn, with the retail share at 62%. A good portion of this participation in the markets was funded by leverage—which was swiftly unraveled when five days of negative returns triggered margin calls in early January '08. Domestic institutions were better prepared, and continued to buy into the market—the US$ 4bn mutual fund inflows in January '08 have been the highest to date. But direct retail interest plummeted as headline indices continued to drop, with daily turnover falling to US$ 9.8bn, and

equity mutual funds seeing redemptions of US$ 408mn in October-December ’08 (first net outflows in a quarter after Q1CY03). While the markets have subsequently inched back to near pre-crisis levels, small investors have stayed cautious (and away).

Fig 1 - Turnover in the Indian markets



Source: RCML Research, Bloomberg

Do we see a return of retail interest in the markets? Or the obverse, are we in a bubble yet? Unlikely, if one looks at domestic participation levels in the markets. While retail participation is showing tentative signs of a pick-up (cf. turnover levels), we believe there’s a long way to go yet. If domestic investors (direct retail or through mutual funds) come back to the markets in a meaningful way, we could see some potential downside support in the event the market corrects further on account of any external event shock.

Fig 57 - Falling share of retail turnover in the market

Source: RCML Research, BSE

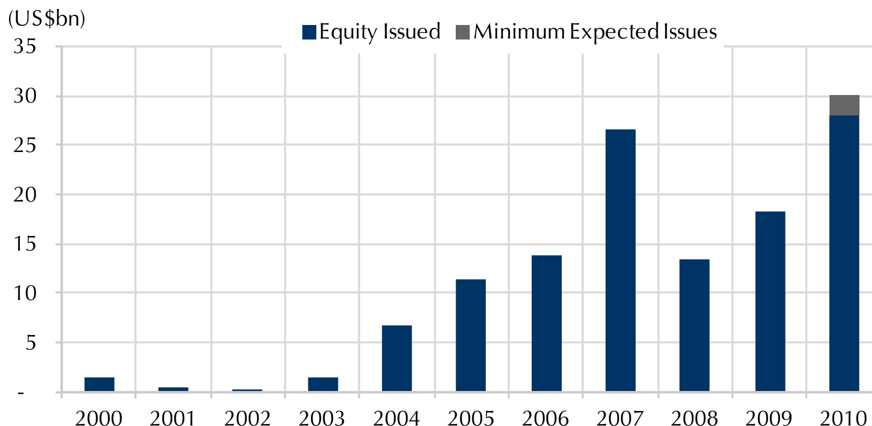
Strong equity issuance pipeline to keep check on runaway valuations

Thanks to the government's massive divestment agenda, 2010 has already seen equity issuance worth US$ 28bn which is amongst the highest ever in the Indian markets, and accounts for a significant chunk of capital flows this year.

2010YTD has already seen equity issuance worth US$ 28bn. With planned mega issues such as IOCL and SBI, the divestment pipeline is healthy in the coming fiscal and would help keep a check on runaway valuations in the Indian markets

In addition, private enterprises are likely to tap the ample global liquidity and increasing risk appetite

Fig 58 - India equity issuance trend

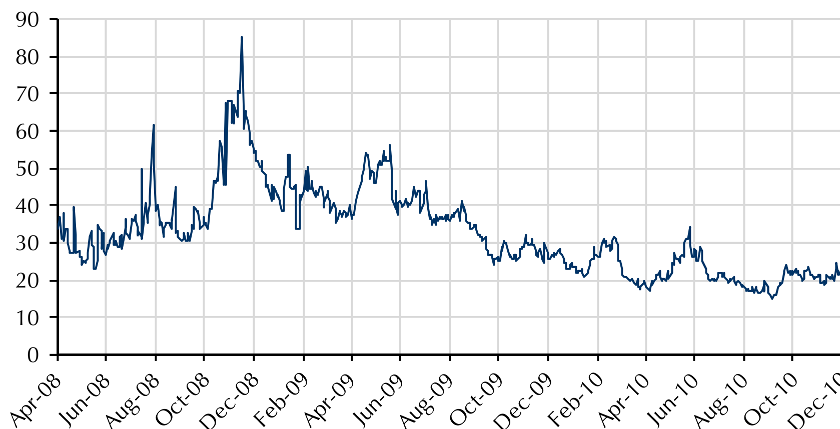


Source: RCML Research, Bloomberg

Reduced INVIX – a comforting factor

Sharply reduced volatility has been one of the comforting factors in the markets this year. Rising implied volatility in a rising market means that investors are buying protection as risk assets rally. But in the current rising markets (in the medium-term), the falling volatility points to better conviction in the market's rise amongst investors. On the back of rising risk appetite, investors appear to be getting more comfortable as risk assets move higher.

Fig 59 - INVIX



Source: RCML Research, Datastream

Appendix

India – Key economic indicators

INDICATORS	FY07	FY08	FY09	FY10(P)	FY11(F)
GDP					
Real GDP (Rs bn) @ FC & 2004-05 prices	35,646	38,934	41,550	44,625	48,450
Real GDP growth (%)	9.7	9.2	6.7	7.4	8.5
Real GDP by production (% YoY)					
Agriculture	3.7	4.7	1.6	0.2	7.0
Industry	12.8	9.5	3.9	9.3	8.6
Services	10.2	10.5	9.8	8.5	9.0
Real GDP (demand side) (%YoY)					
Private final expenditure	8.2	9.8	6.8	4.3	6.5
Government final expenditure	3.8	9.7	16.7	10.5	8.5
Gross capital formation (ex valuables)	16.1	14.8	(1.7)	7.2	11.0
Aggregate ratios (% of real GDP)					
Consumption/GDP	66.1	65.1	66.3	67.9	68.9
Private consumption/GDP	55.9	55.0	54.7	55.1	55.6
Government consumption/ GDP	10.2	10.1	11.6	12.9	12.2
Investments/GDP	35.2	37.6	38.3	33.9	33.7
Monetary aggregates (%YoY)					
Money supply	21.3	21.1	18.9	16.8	16.5
Bank credit	28.0	22.3	18.0	16.7	19.0
Bank deposit	23.8	22.4	19.8	20.0	17.0
INDICATORS	**FY07**	**FY08**	**FY09**	**FY10**	**FY11(F)**
Fiscal aggregates (%GDP)					
GoI fiscal deficit	3.5	2.7	6.0	6.7	5.5
State fiscal deficit	1.9	2.3	3.0	4.5	3.5
Combined deficit (GoI + States)	5.4	5.0	9.0	11.2	9.0
External sector					
Exports (US$ bn)	128.7	166.3	189.2	182.5	205.3
%YoY	22.5	29.2	13.8	-3.5	12.5
Imports (US$ bn)	190.5	257.9	307.9	299.1	331.2
%YoY	21.5	35.4	19.4	-2.9	10.7
Trade deficit (US$ bn)	(61.8)	(91.6)	(118.7)	(116.6)	(125.9)
Invisibles (US$ bn)	52.2	75.7	89.6	78.6	89.4
Current account deficit (US$ bn)	(9.6)	(15.9)	(29.1)	(38.0)	(51.0)
% to GDP	(1.0)	(1.3)	(2.4)	(2.9)	(3.7)
Inflation	**FY07**	**FY08**	**FY09**	**FY10**	**FY11(F)**
WPI (Avg)	5.4	4.7	8.4	3.8	8.5
CPI-IW (Avg)	6.8	6.2	9.1	12.4	11.0
Interest and exchange rates (EOP)					
Reverse repo rate	6.00	6.00	3.50	3.50	5.50
Repo rate	7.80	7.80	4.80	5.00	6.25
Cash reserve ratio	6.25	7.50	5.00	5.75	6.00
INR/USD	43.6	40.1	50.7	44.9	42.0

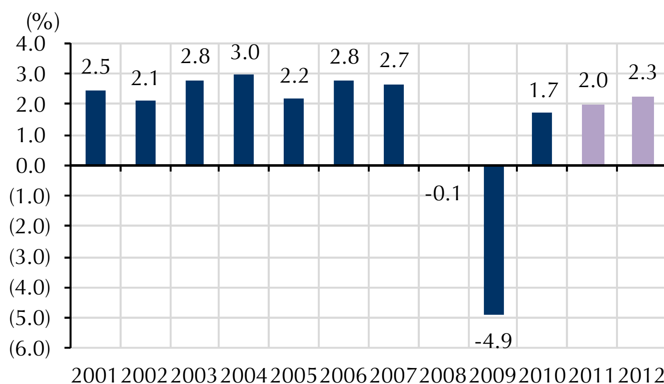
Source: CSO, RBI, RCML Research

Global macro: Miles to go before I sleep…

US – Slow growth, QE2, currency wars and unemployment

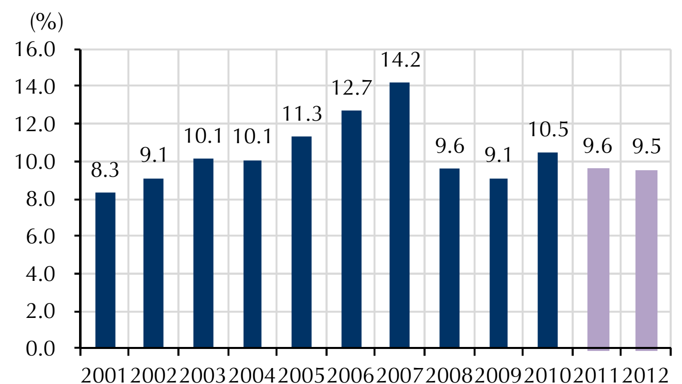
The unprecedented recovery in global markets, following the greatest recession since the 1930s was chiefly driven by expectations of a return to growth. But while H2CY09, and H1CY10 did show signs of a revival, the 'green shoots' started withering in the second half of 2010, when sovereign debt fears reared up in many European countries and the US started seeing a 'jobless recovery'. Recovery was also dependent on the 'growth engine' of the world, China, where overheating of sectors like real estate led to the PBOC's tightening policy.

Fig 60 - US GDP growth – IMF (%)



Source: RCML Research, UNCTAD

Fig 61 - China GDP growth – IMF (%)



Source: RCML Research, UNCTAD

As we write, the Fed has considerably lowered growth prospects for FY11 from 3.6–4.2% to 3–3.5% and promised not only to keep interest rates low for the foreseeable period, but also to inject additional liquidity—QE2—as needed into the markets. The artificial demand (and consequently more expensive bonds and suppressed yields) created in the debt markets on account of QE2 is also likely to make US equities more attractive as opposed to several emerging market equities, as their central banks continue with monetary tightening on account of inflationary pressures. This may see US equities perform well in the coming months.

The dollar index has begun its northwards journey after a brief period of depreciation in the run up to QE2. While ultra-low interest rates do provide an unprecedented amount of potential liquidity to all asset classes, they perversely also serve as a reminder of the seriousness of the US economic conditions. For confirmation, one only has to look at the rock-bottom yields on US 10-year paper, the zooming price of gold, and the strong demand for ultra-low yielding Japanese government bonds (1.03% for 10yr), which has led to the Yen touching 15-year highs against the dollar.

Dollar has appreciated in the month of November after renewed concerns over the European sovereign debt crisis and tensions on the Korean peninsula

Fig 62 - Dollar index (3M)

Source: RCML Research, Datastream

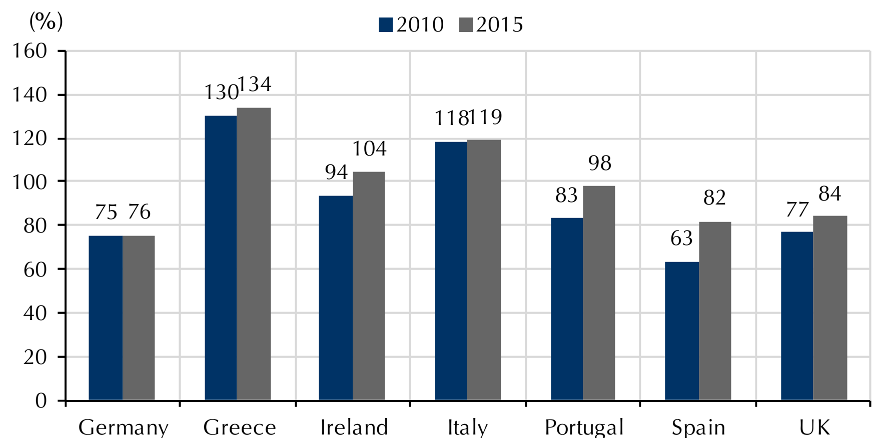
Chinese slowdown to keep commodity markets in check

The Chinese-engineered slowdown on account of fears of asset bubbles in the real estate market has led to a sharp reduction in the incremental demand for commodities. We believe this may keep a check on the runaway speculative price rise in the context of ample liquidity in the markets on account of QE2 and accommodative monetary policies of developed work central banks.

European sovereign debt woes continue to keep bears in play

Recent concerns over the high indebtedness of governments in the euro area have sent sovereign debt CDS soaring northwards. Slow growth on the back of a less accommodative stance by the EU (the austerity way insisted by Germany), fiscal deficits, a strengthening euro, rising indebtedness and lack of a consensus on how to best handle the sovereign debt issue further complicate the situation. While the EFSF is large enough to fund smaller countries such as Ireland and Portugal, larger ones such as Spain would need far more than EFSF's US$ 480bn to effect a bailout. Lack of a consensus means that this issue is going to be around for some time and will continue to spook the markets from time to time.

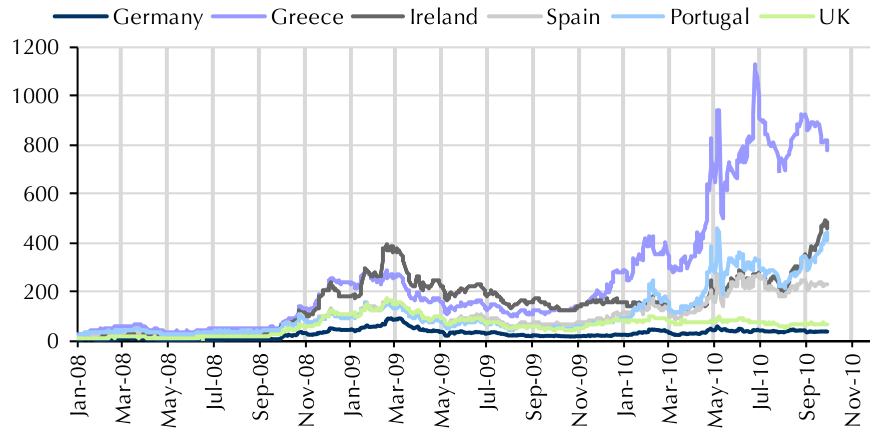
Fig 63 - Govt. debt as a percentage of GDP



Source: RCML Research, IMF WEO

While Ireland's acceptance of EFSF will indeed pacify concerns over sovereign debt in Europe, the bigger question is whether EFSF would be able to meet requirements of larger economies such as Spain (4th largest in EU) if necessary

Fig 64 - CDS spreads for sovereign debt of European countries (5-Yr)



Source: RCML Research, Datastream

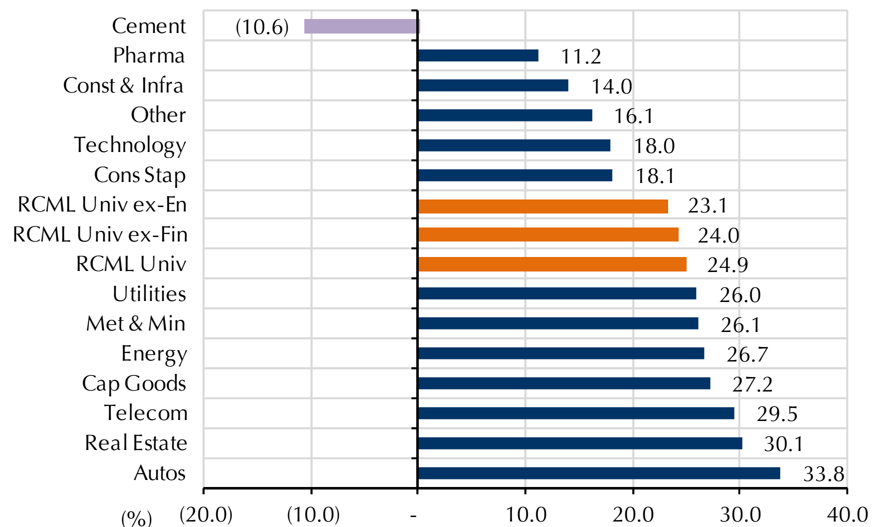
India earnings: Rising RM costs lead to peaking margins

Quarterly earnings in line, but margin pressures begin

The RCML coverage universe posted 25% revenue growth in the July-September quarter (Q2FY11) and 37% EBITDA growth (ex-financials), signifying a 180bps margin expansion YoY (ex-energy margin contraction at 280bps). Net profit for the RCML coverage universe (ex-energy) grew by 5% (cement and telecom skew with the absence of metals) while the broader BSE500 universe ex-energy grew 21%. Cement was the only sector to register negative revenue growth on a YoY basis whereas autos registered a record performance on the back of high volume growth as well as price hikes.

Aggregate revenue growth of the RCML universe stood at ~25% with cement being the only sector to register a decline

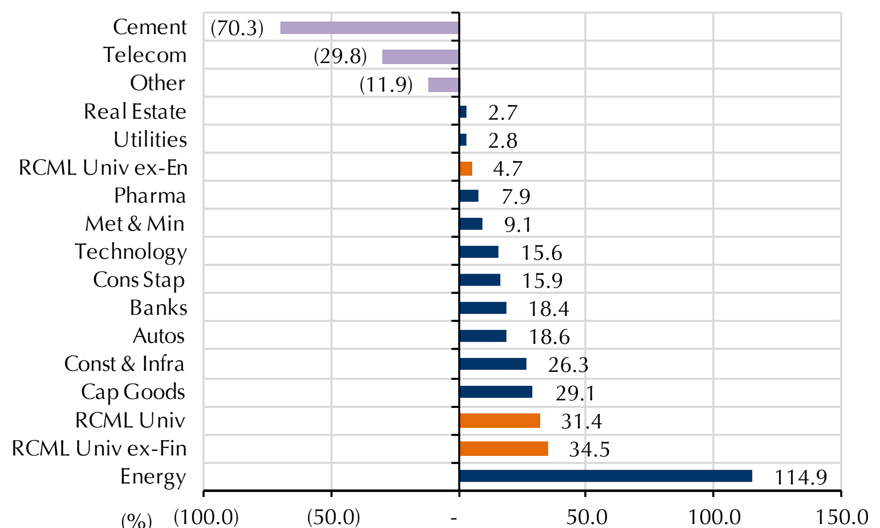
Fig 65 - RCML universe revenue growth by sector (YoY)



Source: RCML Research

The 170-stock RCML universe registered profit growth of 31% with the energy sector (government cash subsidies) registering the highest uptick and cement, telecom registering declines

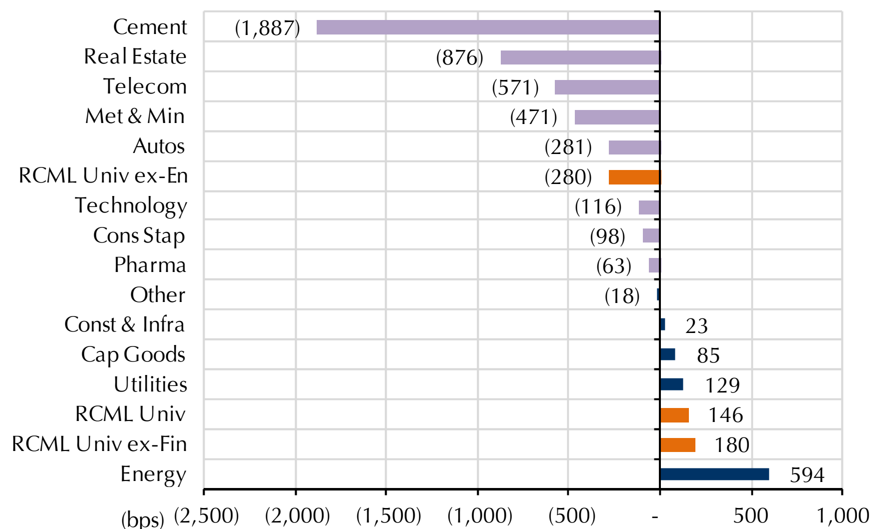
Fig 66 - RCML universe PAT growth by sector (YoY)



Source: RCML Research

Cement, real estate and telecom registered massive margin contraction whereas the energy, utilities and capital goods sectors saw substantial margin expansion YoY

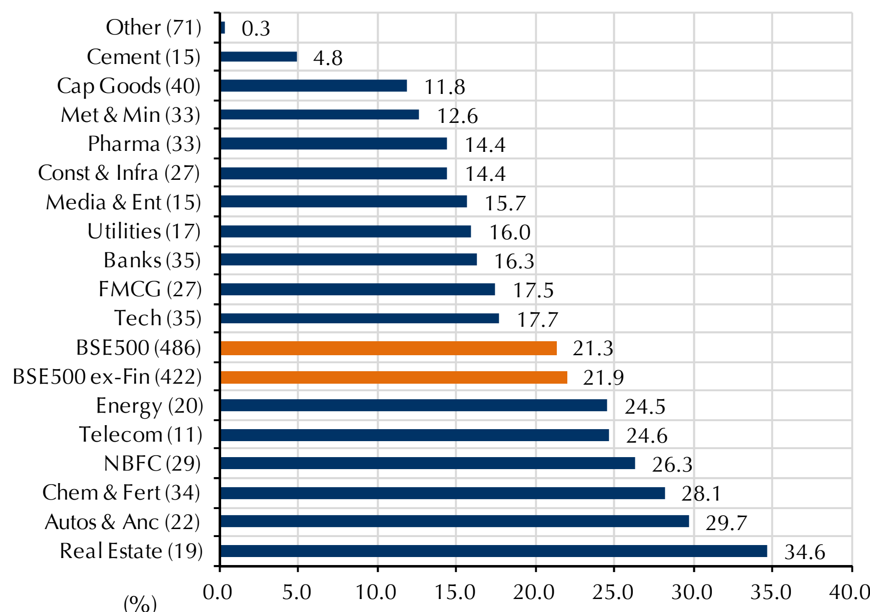
Fig 67 - EBITDA margin expansion/ (Contraction) (bps YoY)



Source: RCML Research

The broader BSE500 universe registered a 21% revenue growth and 33% EBITDA (ex-financials) growth with a 13bps margin expansion YoY (ex-energy margin contraction of 174bps).

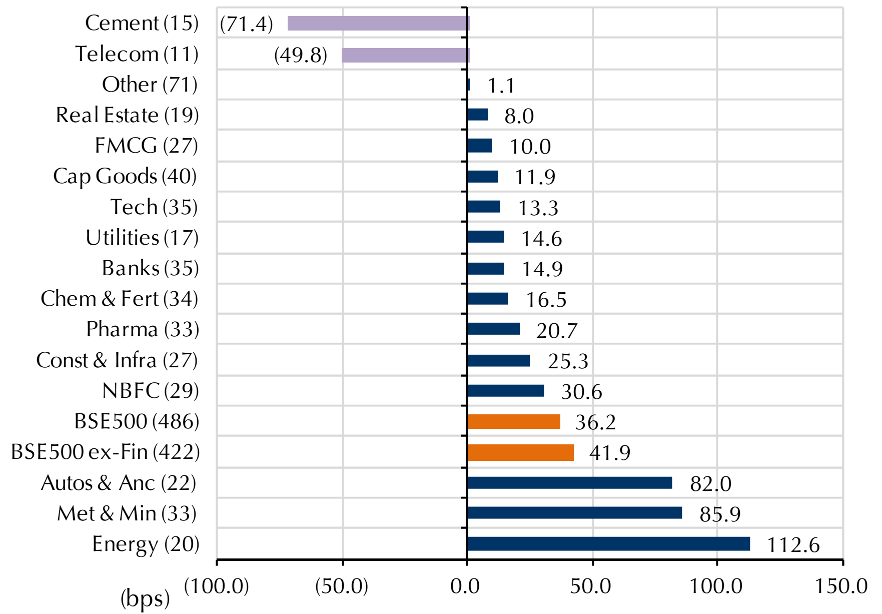
Fig 68 - BSE500 universe revenue growth by sector (YoY)



Source: RCML Research, Capitaline

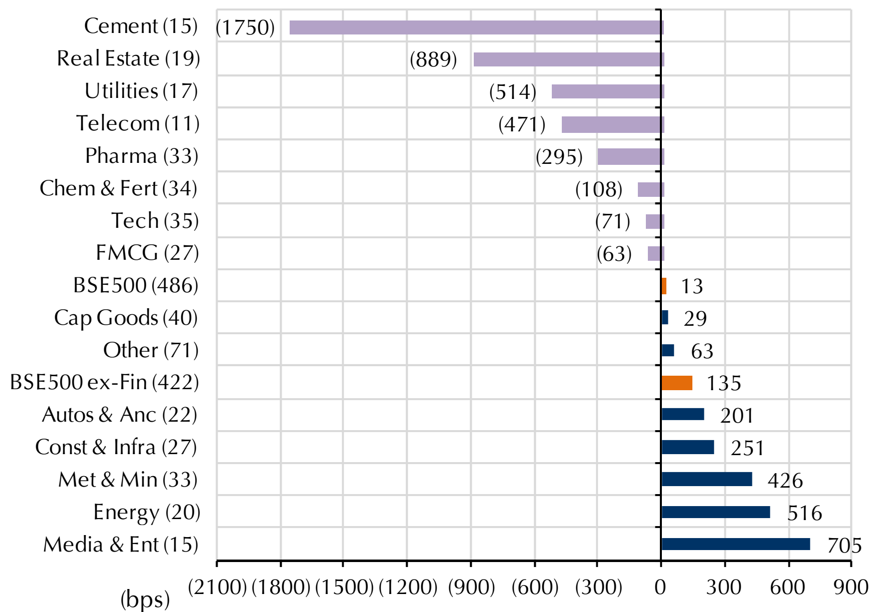
A highlight of the earnings season was the strong volume growth (albeit on a low base) and peaking margins in many sectors. While we believe that the volume growth is indicative of strong demand in the domestic markets, foreign subsidiaries of some Indian companies such as JLR, Corus and Novelis have posted better-than-expected numbers, signifying strong demand in overseas markets as well. IT companies also posted robust volume growth on account of sturdy corporate financials in the US despite a slump in the economy in general. Cement and telecom companies posted a contraction in profit on account of industry-specific headwinds (seasonally weak quarter, excess capacities, competitive pressures).

Fig 69 - BSE500 universe PAT growth by sector (YoY)



Source: RCML Research, Capitaline

Fig 70 - BSE500 universe EBITDA margin expansion/(contraction) by sector (YoY)

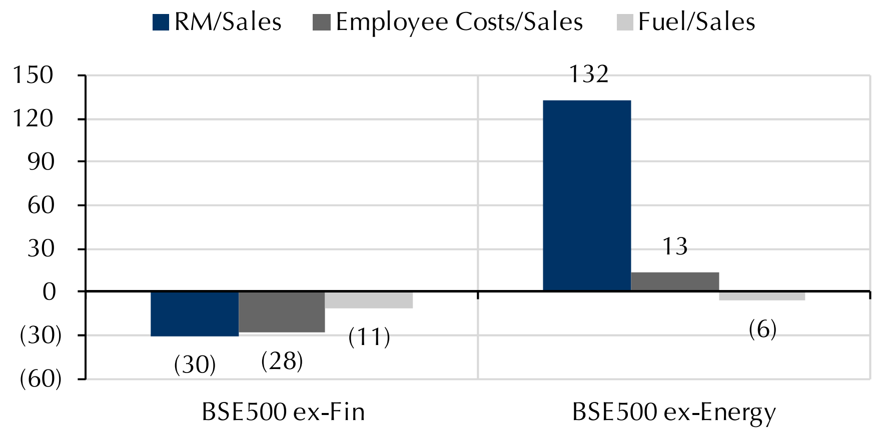


Source: RCML Research, Capitaline

Another highlight of the Q2FY11 earnings season was the margin pressure evident in most of the sectors (8 out of 15 sectors in BSE500). A cost structure analysis of the BSE500 companies suggests that the margin compression was primarily on account of rising input costs. We believe that margins have now peaked in most sectors and will continue to contract in the coming quarters on the back of a firming up of commodity prices globally. A speculative rally in commodities fueled by QE2 remains one of the major concerns for H2FY11.

Margins look to have peaked primarily on account of the increase in raw material costs

Fig 71 - BSE500 cost structure

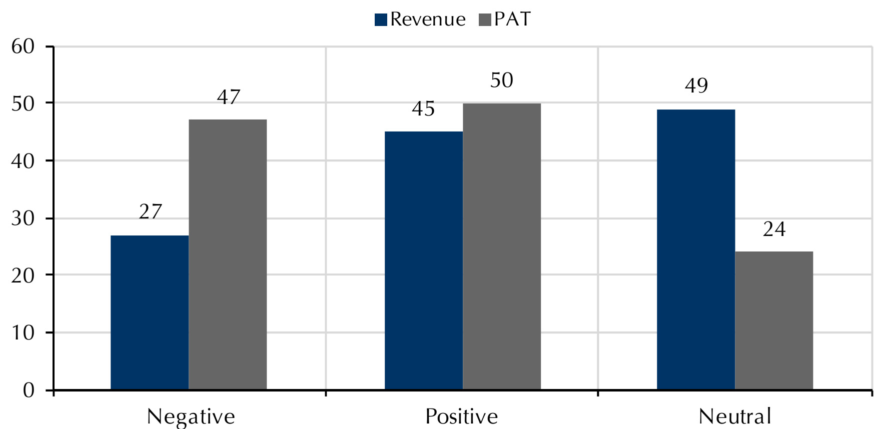


Source: RCML Research

Q2FY11 was mixed in terms of earnings surprises with largest positive surprises coming from energy (govt. cash subsidy) and IT (strong volume growth)

Cement registered the biggest negative surprise (excess capacity, seasonally weak demand)

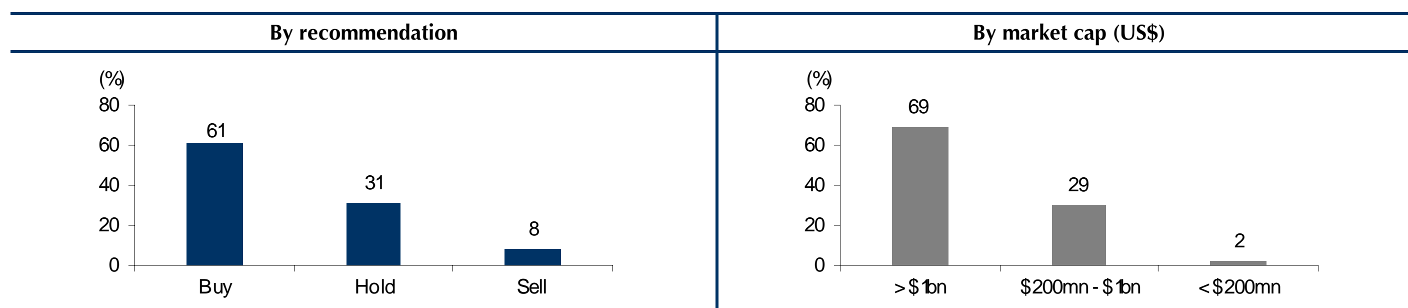
Fig 72 - Q2FY11 results season – A mixed bag



Source: RCML Research

While H1 has been weaker historically, we are on our way to achieve ~20% profit growth for the Sensex (ex-energy) with a stronger H2. However, on the back of peaking margins, one cannot expect any large positive earnings surprises that can act as a catalyst for the markets to rally from here on.

Coverage Profile



Recommendation interpretation

Recommendation	Expected absolute returns (%) over 12 months
Buy	More than 15%
Hold	Between 15% and –5%
Sell	Less than –5%

Recommendation structure changed with effect from March 1, 2009

Expected absolute returns are based on share price at market close unless otherwise stated. Stock recommendations are based on absolute upside (downside) and have a 12-month horizon. Our target price represents the fair value of the stock based upon the analyst's discretion. We note that future price fluctuations could lead to a temporary mismatch between upside/downside for a stock and our recommendation.

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