India Strategy

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BNP PARIBAS – MARKET OUTLOOK

India in a weak commodity world

- **Recent cuts to global and Asian GDP growth forecasts are predicated on demand shocks, implying further weakness in commodity prices.**
- **Weak commodity prices are marginally negative for India's corporate earnings but tend to reduce CA deficit and fiscal deficit.**
- **BUY BHEL, Maruti, Exide, SBI, BOI, ICICI Bank. REDUCE Infosys, TCS, Wipro, SAIL, Hindalco.**

Weaker global growth, weaker commodity prices

We recently lowered global and Asian economic growth forecasts (refer "Apocalypse Now" dated 6 January), largely due to negative demand surprise - leading to inventory accumulation in most Asian economies. We believe such demand shocks could lead to continued weakness in commodity prices.

Commodity price – a double edged sword for India

Commodity producers contribute 25-30% of India's market earnings and commodity users contribute nearly 20%. An obvious trade to capitalize on weak commodity prices would be to short commodity producers and buy commodity users. There are several other important investment implications of weakening commodity prices.

Weak commodity prices lead to lower twin deficits

An important consequence of weak commodity prices is a sharp decline in current account deficit, as crude oil imports constitute 30-35% of India's total import. Declining commodity prices could also lead to reduction (though less significant than current account deficit) in India's fiscal deficit in FY10 (particularly the off-budget items) as 2.7% of fiscal deficit in FY09 was commodity-related or "one-time" expense.

Therefore: stronger Rupee, lower rates

We believe lower current account deficit would strengthen the Rupee, particularly in H2CY09. A combination of low inflation and lower fiscal deficit should support further monetary easing. We believe RBI could reduce CRR and benchmark interest rates by 150-200bps in the next 1-2 quarters.

FII flows could start trickling back in H2CY09

Concerns on capital outflows still exist (due to deleveraging in developed markets), but our empirical analysis shows currency appreciation is a significant driver of FII inflows. Our outlook on Rupee appreciation implies that FII inflows into Indian equities could restart in H2CY09.

BUY BHEL, Maruti, Exide, SBI, BOI, ICICI Bank

Potential moneymakers in the medium term are to be found among commodity users that have a stable demand profile and among interest rate sensitive stocks trading at attractive valuation. BHEL, Maruti and Exide fall in the first category, though for Maruti, a good buying opportunity may arise post 3Q result (29 January).

REDUCE Infosys, TCS, Wipro, SAIL, Hindalco

Global demand destruction is likely to continue for some more time. We think Infosys's recent outperformance because of its perceived superior corporate governance is providing a selling opportunity.

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Valuation Of Our Top Buys And Sells

	P/E		EV/EBIDTA		P/BV	
	FY09 (x)	FY10 (x)	FY09 (x)	FY10 (x)	FY09 (x)	FY10 (x)
Top BUYs						
BHEL	20.2	14.7	15.5	10.4	5.2	4.1
Maruti	11.3	10.5	7.4	6.2	1.7	1.5
Exide	11.2	8.4	6.4	5.0	2.3	1.8
ICICI Bank	15.3	11.6			1.1	1.0
SBI	10.2	8.8			1.4	1.2
BOI	5.9	5.0			1.2	1.0
Top SELLs						
Infosys	12.6	12.0	9.0	8.3	3.7	3.0
TCS	9.3	9.0	6.4	5.9	3.1	2.5
Wipro	9.0	8.6	6.7	5.7	2.4	2.1
SAIL	6.7	7.6	2.7	3.4	1.1	1.0
Hindalco	6.0	10.8	4.3	4.9	0.4	0.4

Source: BNP Paribas estimates

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Commodity prices drive several macro-economic variables in India

The direct relationship between commodity prices and Indian corporate earnings is well documented. Even though India is a net commodity importer, a larger proportion of earnings in the listed corporate space come from commodity producers.

Exhibit 1: Sector-Wise Earnings And Market-Cap Contribution

	% of total market cap (Free float adjusted) (%)	% of total PAT – FY08 (%)	% of total PAT – FY09E (%)	% of total PAT – FY10E (%)
Auto	2.6	5.2	5.6	5.7
Banks and FIs	22.1	17.2	17.7	19.6
Pure cement	0.8	1.3	1.0	0.8
IT Services	12.4	12.1	15.3	14.4
Conglomerates	1.4	3.1	3.2	2.7
Engineering	10.2	5.7	6.2	7.3
Consumer staples	10.4	5.0	5.7	6.0
Metals	3.9	18.9	12.9	6.7
Oil & Gas	4.1	6.4	5.6	4.5
Petrochemicals	15.1	12.0	10.9	15.1
Pharmaceuticals	0.5	0.4	0.3	0.4
Power	6.0	3.9	5.3	5.6
Telecom	9.5	6.9	8.7	9.7
Property	1.0	1.9	1.7	1.5
Commodity producers	23.1	37.4	29.4	26.3
Commodity users	23.1	15.9	17.5	19.0

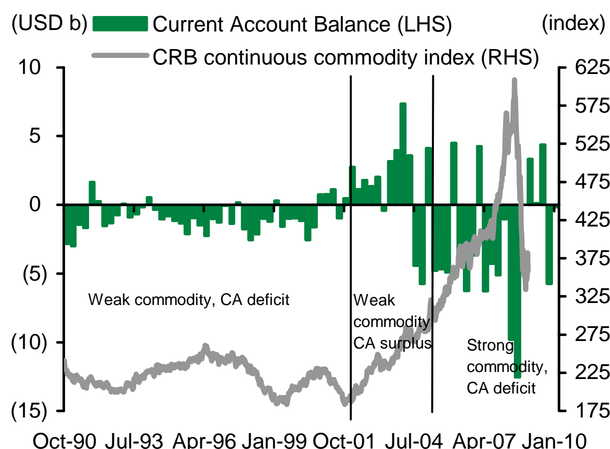
Source: BNP Paribas estimates

However, apart from influencing corporate earnings, and obviously inflation, we believe commodity prices also significantly influence India's current account deficit and fiscal deficit. While the former has a significant impact on the exchange rate, the latter affects interest rates.

Declining current account deficit

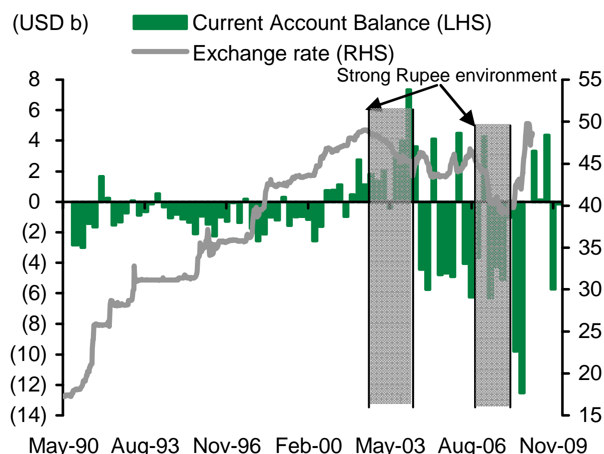
We estimate that India's current account deficit in FY09 is likely to be ~$27b (2.6% of GDP). However, the oil import bill (estimated at $81b) is likely to contribute a large part of the deficit. In FY10, average price of the Indian basket of crude oil is likely to be ~40% lower than in FY09 (even after assuming a significant recovery from current levels in H2FY10). India's consumption of imported crude could also decline slightly as new sources of domestic crude start producing (Cairn - starting production from 2QFY10, and Reliance Industries – ramping up from 1QFY10). Even after factoring in ~10% decline in merchandise exports (non-POL) and 21% decline in remittances (by overseas workers etc.), we estimate that current account (CA) deficit in FY10 could be less than 0.2% of GDP.

Exhibit 2: Commodity Prices And Current Account Balance



Sources: Bloomberg; BNP Paribas estimates

Exhibit 3: Exchange Rate And Current Account Balance



Sources: Bloomberg; BNP Paribas estimates

For the entire decade of 1990s, India's current account was in deficit despite relatively benign commodity prices. From mid-2000 to mid-2004, India's current account was in surplus, driven by rising IT exports and merchandise exports. Exhibit 3 also shows that the USD/INR rate has been influenced by the current account. We believe the impact of a declining CA deficit will be to appreciate the Rupee.

Declining fiscal deficit

Impact of weak commodity price on fiscal deficit is likely to be smaller than the impact on CA deficit. As Exhibit 4 shows, potentially, fiscal deficit in FY10 could decline by 2.7% of GDP, though we believe the actual decline is unlikely to be so sharp – as tax revenue could also decline owing to weak economic growth and corporate earnings growth. Oil bonds and fertiliser bonds comprise 1.5% of fiscal deficit, and the Government of India may not need to issue these bonds in FY10. Due to sharp decline in commodity prices, subsidies to oil and fertilizer companies are likely to be far lower in FY10 than in FY09. Hence, a more benign fiscal balance seems certain in FY10, though the quantum may be in question.

Exhibit 4: Commodity-Related And One-Time Items In FY09 Budgetary Expenses

	Budgeted estimate (INR b)	% of GDP (%)
Commodity-related items in FY09 budget		
- Oil bonds	650	1.2
- Fertiliser bonds	140	0.3
- Fertiliser subsidy	390	0.7
"One-time" items in FY09 budget		
- Farm loan waiver	260	0.5
Total	1,440	2.7

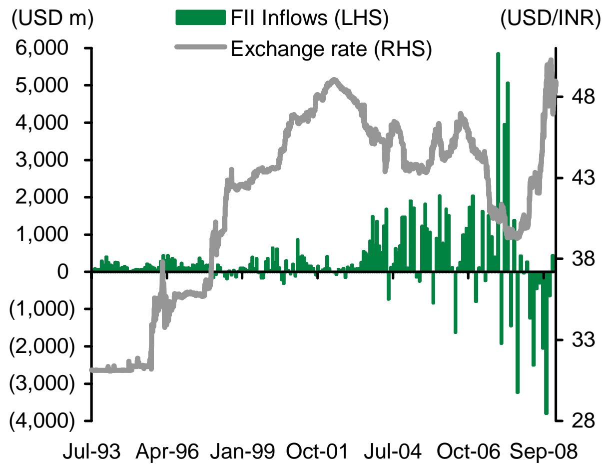
Sources: Ministry of Finance; BNP Paribas

We believe a lower fiscal deficit along with a sharply declining inflation should support a low interest rate environment well into FY2010.

Rupee appreciation should encourage FII flows

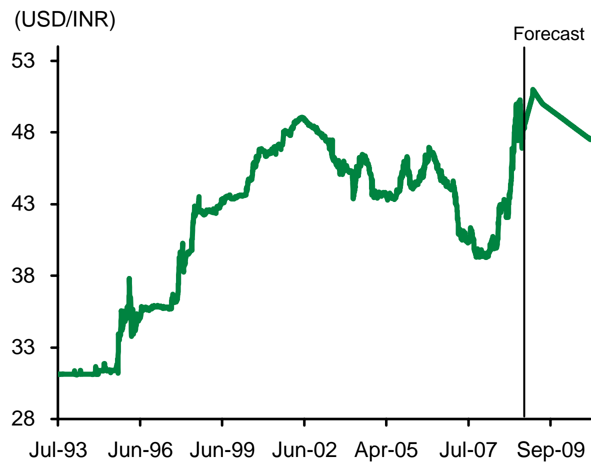
There's a debate about whether currency appreciation causes FII inflows, or vice-versa. The Indian experience shows currency appreciation to be the causal variable. As Exhibit 5 shows, the Rupee started appreciating from mid-2002 and FII flows started accelerating a year later – from mid-2003.

Exhibit 5: FII Flows And Exchange Rate



Sources: SEBI data on FII flows; Bloomberg

Exhibit 6: Our Exchange Rate Forecasts



Sources: Bloomberg; BNP Paribas estimates

Our forecast of INR/USD exchange rates supports our hypothesis that FII flows should start trickling back from H2CY09. Our currency forecast (Exhibit 6) factors in depreciation of INR in the near term (in 1QCY09) and eventual appreciation to Rs47.5 by mid-CY2010.

Sector implications

The macro-economic outcome of global demand destruction (leading to commodity price weakness) and appreciating Rupee and declining rates have important investment implications which tie in with our current portfolio stance (refer "Making money in a muddle-through year" dated 14 November 2008).

Exhibit 7: Macro-Economic Drivers And Their Investment Implications

Driver	Investment implication
Declining interest rates	Overweight interest rate sensitives (banks, autos)
Appreciating Rupee	Underweight exporters (IT)
Declining commodity prices and global demand destruction	Underweight exporters and commodity producers (IT, metals)
Declining commodity prices	Overweight commodity users (Select Auto and capital goods with stable demand outlook)

Source: BNP Paribas

We are selective in our stock choices – especially in the auto and capital goods universe – and we select only those stocks that have a stable demand environment. Auto stocks Maruti and Exide are supported by the income resilience of "middle India" and after market sales, respectively. BHEL's order backlog is supported by predominantly government orders.

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All share prices are as at market close on 21 January 2009 otherwise stated. Stock recommendations are based on absolute upside (downside), which we define as (target price* - current price) / current price. If the upside is 10% or more, the recommendation is BUY. If the downside is 10% or more, the recommendation is REDUCE. For stocks where the upside or downside is less than 10%, the recommendation is HOLD. In addition, we have key buy and key sell lists in each market, which are our most commercial and/or actionable BUY and REDUCE calls and are limited to at most five key buys and five key sells in each market at any point in time.

Unless otherwise specified, these recommendations are set with a 12-month horizon. Thus, it is possible that future price volatility may cause a temporary mismatch between upside/downside for a stock based on market price and the formal recommendation.

*In most cases, the target price will equal the analyst's assessment of the current fair value of the stock. However, if the analyst doesn't think the market will reassess the stock over the specified time horizon due to a lack of events or catalysts, then the target price may differ from fair value. In most cases, therefore, our recommendation is an assessment of the mismatch between current market price and our assessment of current fair value.

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