India strategy: 2008 outlook

20 December 2007

Top Picks

	Code	Price (Rs)	Rec	TP (Rs)
DLF Ltd	DLFU IN	950.90	OP	1,220.00
Reliance Communications	RCOM IN	710.95	OP	865.00
HDFC Ltd	HDFCB IN	1,656.95	OP	2,114.00
Tata Steel	TATA IN	824.20	OP	1,000.00
Reliance Industries	RIL IN	2,704.75	OP	3,415.00

Source: Macquarie Research, December 2007

Top Underperforms

	Code	Price (Rs)	Rec	TP (Rs)
ONGC	ONGC IN	1,180.50	UP	985.00
SBI	SBIN IN	2,258.30	UP	1,715.00
Maruti Suzuki	MSIL IN	995.30	UP	900.00

Source: Macquarie Research, December 2007

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Solid economy, liquid markets, no gas!

Event

- We believe that India will be in a ‘sweet spot' in 2008, with domestic growth bolstered by capital flows even as the US slows without slipping into recession. We explore the key themes that we think will dominate 2008.

Impact

- **The economy.** In terms of macroeconomic factors, we see a “sweet spot” scenario playing out for India. Growth will slow slightly in the first half of the year, but much of that is already in expectations. We believe that the US will not slip into recession but could escape with a slowdown – which should keep liquidity abundant and, despite the RBI's concerns, interest rates drifting down. All this plays out into a sharp bounceback in 2H08. The big risk is, however, that we are wrong on the US and there indeed is a recession; India will offer plenty of places to hide in that scenario. Our pick is telecoms.
- **Policy – elections cloud the scenario.** Policy will be dominated by elections – scheduled in 1Q09 but possibly brought forward by a fluid political scenario. We revisit our list of key policy measures that could be affected by “election inertia” and find that some issues have changed. We think the best play on the elections is the infrastructure and capital goods space, as the government races to finish projects ahead of the polls.
- **Themes of the year – spin-offs and sell-downs**. As liquidity chases stocks in India, we see companies realise value in subsidiaries and ancillary businesses during the next year. Almost all sectors have a play in this – insurance subs of banks, towercos out of telcos and asset spin-offs from infrastructure companies are three such examples.
- **Comfortable with valuations**. One common concern among investors is whether India is too expensive. We do not share that fear: India is below historic peaks, despite interest rates being lower and GDP growth faster. Even compared to other regional markets, India's valuations are respectable, despite the fast pace of growth and deep markets. We stay with our view that India will structurally re-rate over the next few years.

Outlook

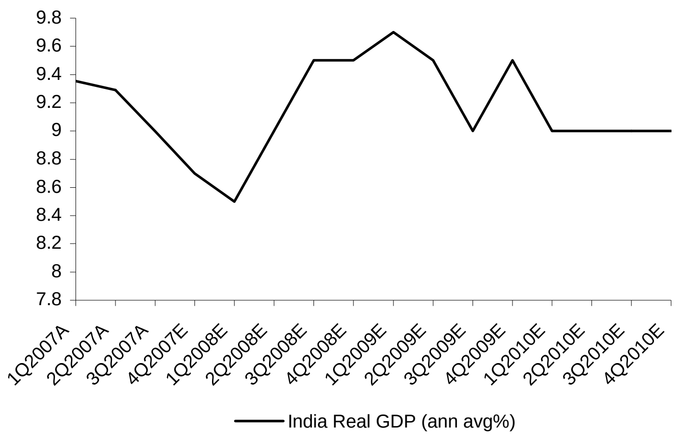
- India is now too important a market to ignore and we recommend investors stay invested. We think that 2008 has the possibility of being, yet again, a great year for the Indian market. Our end-year index target is revised to 24,000, while we recommend investors stick with three simple themes – domestic consumption, easing rates and capital spend. Our top picks in the country are therefore DLF, Reliance Communications, HDFC Ltd, Tata Steel and Reliance Industries. Our top Underperforms are ONGC, SBI and Maruti Suzuki.

The economy

Slower growth, bounceback in 2H

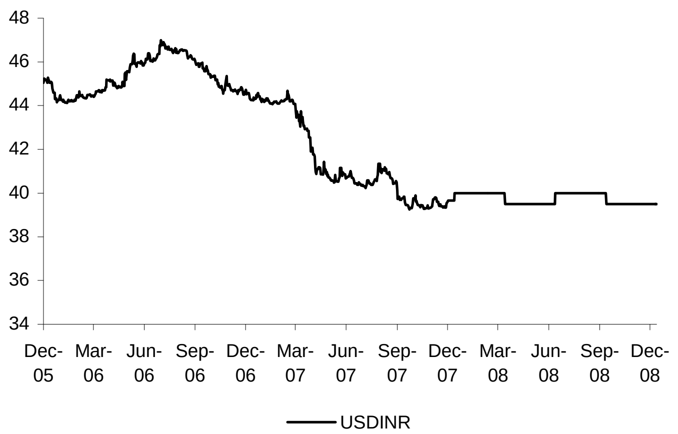
Our regional economist, Bill Belchere, believes that GDP growth will slow into 1H08 as a result of the lagging effects of rising rates, appreciating currency and capacity constraints. These three factors are being addressed in the latter part of 2007, and the effects will be seen in 2H08, when we expect growth to start bouncing back.

Fig 1 GDP growth, slowing before a pickup



Source: Macquarie Research, December 2007

Fig 2 The rupee: stable outlook from here



Source: Macquarie Research, December 2007

Fig 3 Key metrics that the RBI tracks

Measure	1Q 2007	4Q 2007	RBI comfort zone	Concern factor for RBI?
Headline WPI inflation	5-6%	3-3.5%	<4%	Partly: may pick up
Credit growth	c30%	23-24%	23-24%	No
GDP growth	9%+	<9%	<9%	No
Capacity utilisation	90%+	Not known	Not known	We think, yes
Household inflationary expectation	Not known	Not known	Not known	We think, yes
US rates	Flat	falling	Need not follow	No
Asset inflation, esp property	Galloping	More steady	Below current levels	Partly, less so than 1Q

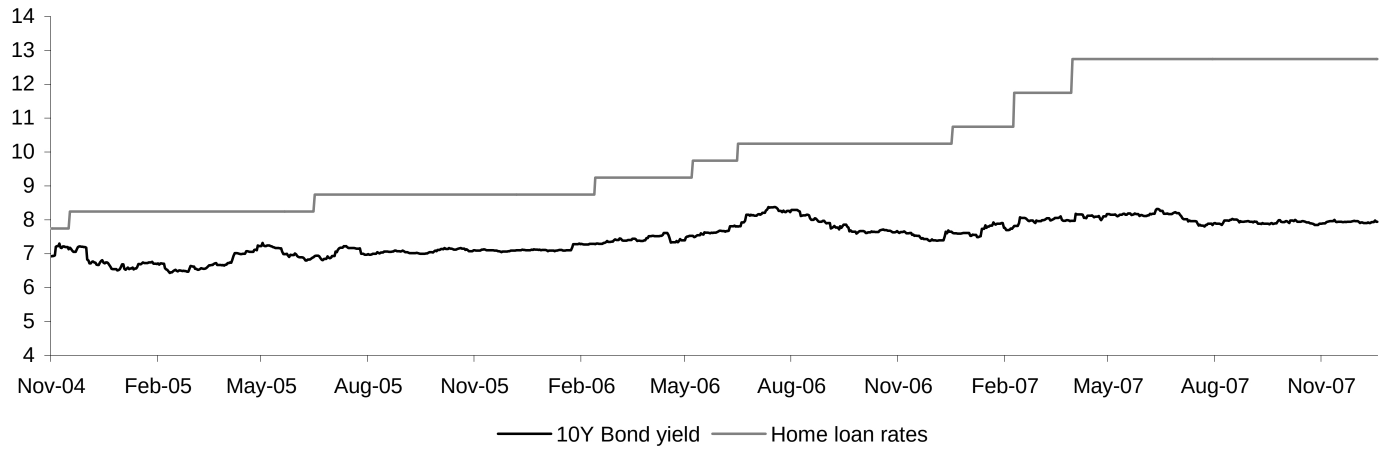
Source: Macquarie Research, December 2007

Interest rates should drift down

Our general view on interest rates is that we expect them to drift down. However, there are a few nuances to this view:

- We do not expect policy rates to drop in the next 12 months. There is, no doubt, downward pressure from the fact that headline inflation pressures are lessening and monetary aggregates are accelerating, leading to excess liquidity in the system. However, we think that the RBI is still not comfortable with the various metrics that it tracks (see table above). Under these circumstances, the RBI is unlikely to cut policy rates.
- Government bond yields have been remarkably stable through the last two years of volatility. This is because of the “excess” demand created for government bonds – net issuance of government bonds has been declining as a percentage of incremental deposits. In a situation in which banks must use at least 25% of incremental deposits for gilts, this puts an artificial cap on gilt yields. We expect this trend to continue, as the RBI seems to be in no mood to address this structural issue in the near term.
- We think loan and deposit rates will drift downward. This is because the excess liquidity in the system will find its way into pricing, especially now that demand has slackened slightly. The three successive CRR hikes in late 2006/early 2007 had delivered a shock to the system that, we believe, had taken loan/deposit rates to above-equilibrium levels. We believe normalisation will take place over the next year or so, with rates drifting down slowly.

Fig 4 Home loan yields rising faster than gilt yields



Source: Macquarie Research, December 2007

Our favourite plays on falling rates are financials and property stocks. In financials, the top pick is HDFC Ltd, which benefits from what we perceive to be rising CRRs as capital flows continue unabated into the economy. DLF is our top pick in properties.

US recession: places to hide

Our base-case assumption on the above is that the US will slow but not slide into recession, despite the pressures playing out today. We think that the Fed responded early and decisively, and will be willing to cut rates further until it arrests the slowdown – this being an election year, it is unwilling to put growth at risk.

What if we are wrong on the US economy and there indeed is a recession? We expect that multiple factors will play out – a detailed sectoral analysis follows.

Fig 5 US recession

Sector	Metric	Macq forecast	Nuances	Sensitivity to current forecast	Current view on sector	Is this view at risk?	Best stocks to play	Additional comments
Auto	1H/2008 eco growth	Slow – c8.5%	Rates/currency-led sectors affected more	Marginal Downside	Negative	No	TTMT IN	In case of economic growth slowing down earnings growth for automobile companies should be lower than current estimates (in particular for Tata Motors where we have a positive view)
	2H/2008 eco growth	Accelerated – c 9.25%	Robust investment/infra demand the key drivers	Upside	Negative	Marginally	TTMT IN	Demand for M&HCV should increase with strong economic growth
	1H/2008 interest rates	Soft	Policy rates neutral, deposit/lending rates drift down, CRR raised continuously	Upside	Negative	Marginally	TTMT IN	Easing of credit should support automobile sales, particularly CVs
Banks	1H/2008 eco growth	Slow – c8.5%	Rates/currency-led sectors affected more	Neutral	Positive	No	HDFC IN	
	2H/2008 eco growth	Accelerated – c 9.25%	Robust investment/infra demand the key drivers	Neutral	Positive	Marginally	HDFC IN	Higher loan demand and improved loan quality will be offset by harder interest-rate outlook
	1H/2008 interest rates	Soft	Policy rates neutral, deposit/lending rates drift down, CRR raised continuously	Neutral	Positive	Marginally	HDFC IN	Already in our numbers
Infrastructure	1H/2008 eco growth	Slow – c8.5%	Rates/currency-led sectors affected more	Neutral	Positive	No	NJCC, PEC, IVRC	Play construction over capital goods
	2H/2008 eco growth	Accelerated – c 9.25%	Robust investment/infra demand the key drivers	Positive	Positive	No	NJCC, LT	
	1H/2008 interest rates	Soft	Policy rates neutral, deposit/lending rates drift down, CRR raised continuously	Positive	Positive	No	IVRC, PEC	Prefer plays with larger real estate exposure
Metal /Mining	1H/2008 eco growth	Slow – c8.5%	Rates/currency-led sectors affected more	Neutral	Positive	No	JSTL IN, STLT IN, GRASIM IN	Our numbers are based on individual companies' triggers and we have incorporated slowdown in demand
	2H/2008 eco growth	Accelerated – c 9.25%	Robust investment/infra demand the key drivers	Positive	Positive	No	JSTL IN, STLT IN, GRASIM IN	
	1H/2008 interest rates	Soft	Policy rates neutral, deposit/lending rates drift down, CRR raised continuously	Positive	Positive	No	JSTL IN, STLT IN, GRASIM IN	Soft interest rate regime to boost demand
Oil	1H/2008 eco growth	Slow – c8.5%	Rates/currency-led sectors affected more	Neutral	Negative	No	RIL, ABAN	Positive on oil services companies (ABAN) and integrated companies (RIL)
	2H/2008 eco growth	Accelerated – c 9.25%	Robust investment/infra demand the key drivers					
	1H/2008 interest rates	Soft	Policy rates neutral, deposit/lending rates drift down, CRR raised continuously					
Retail								
	1H/2008 eco growth	Slow – c8.5%	Rates/currency-led sectors affected more	Neutral	Positive	No	PF IN, SHOP IN, PROV IN	
	2H/2008 eco growth	Accelerated – c 9.25%	Robust investment/infra demand the key drivers	Upside	Positive	No	PF IN, SHOP IN, PROV IN	Discretionary spend would rise
	1H/2008 interest rates	Soft	Policy rates neutral, deposit/lending rates drift down, CRR raised continuously	Neutral	Positive	No	PF IN, SHOP IN, PROV IN	This is not an interest-rate-sensitive sector

Fig 5 US recession

Sector	Metric	Macq forecast	Nuances	Sensitivity to current forecast	Current view on sector	Is this view at risk?	Best stocks to play	Additional comments
Consumers								
	1H/2008 eco growth	Slow – c8.5%	Rates/currency-led sectors affected more	Neutral	Neutral	No	ITC IN, DABUR IN, MRCO IN	No significant impact, given the fact that this is not discretionary spend
	2H/2008 eco growth	Accelerated – c 9.25%	Robust investment/infra demand the key drivers	Upside	Neutral	No	ITC IN, DABUR IN, MRCO IN	Impact will be positive but no leverage, given the fact that this is not discretionary spend
	1H/2008 interest rates	Soft	Policy rates neutral, deposit/lending rates drift down, CRR raised continuously	Neutral	Neutral	No	ITC IN, DABUR IN, MRCO IN	This is not an interest-rate-sensitive sector
Property								
	1H/2008 eco growth	Slow – c8.5%	Rates/currency-led sectors affected more	Downside	Positive	No	UT IN, DLFU IN	Demand may come under pressure but lower interest rates may boost residential demand
	2H/2008 eco growth	Accelerated – c 9.25%	Robust investment/infra demand the key drivers	Upside	Positive	No	UT IN, DLFU IN	Positive but higher growth could result in targeted tightening of monetary policy.
	1H/2008 interest rates	Soft	Policy rates neutral, deposit/lending rates drift down, CRR raised continuously	Downside	Positive	Yes	UT IN, DLFU IN	Overall negative but mixed impact of lower liquidity and lower interest rates

Source: Macquarie Research, December 2007

Fig 6 India recession

Sector	Company	Direct exposure to US	Indirect exposure to US	Likely impact of US recession	Likely impact of India growth slowing to 7.5%	Comments
IT	Infosys	63%	72%	In case of hard landing of US economy the earnings of Indian IT bellwether will be at risk. But we view a soft landing of US economy as positive-to-neutral for the earnings of these companies.	A slowdown in Indian growth will have positive impact on Indian IT bellwether, as the wage inflation will come down a bit, hence helping them improve margin. The slowdown in demand will improve the labour-supply situation of Indian IT.	
	TCS	56%	57%			
	Wipro	51%	62%			
	Satyam	58%	74%			
	HCL Tech	54%	60%			
	Firstsource	47%	47%			
	Rolta	23%	23%	There will be minimal impact of recession on the earnings of Rolta, given that the major revenue is earned from JVs	Rolta rides on the story of Indian infrastructure spending and slowdown of Indian growth could dampen the earnings.	
	NIIT	45%	45%	Negative impact on the earnings of NIIT, as the corporate business, which contributes 50% of revenue, has about 90% exposure to US market. And the corporate training is discretionary in nature.	Little impact on earnings, as the “new business” initiatives are exposed to demand from the Indian market. But this segment contributes <5% of revenue.	
Metals/Mining	HNDL IN	25%	N/A	Negative – A significant portion of revenue comes from sale of beverage cans and automobile parts.	Neutral – Diversified customer base in a large number of countries	Commodity prices are tagged in USD, so relative movement of exchange rates among USD/INR, USD/AUD, USD/RMB, and USD/EUR will play an important role.
	TATA IN	6%	N/A	Neutral – Not significant dependence on US	Neutral – Diversified across continents	
	JSTL IN	15%	N/A	Neutral – Will be affected only if oil & gas exploration and transmission companies scale down their expansion plans. However, these capex plans are long-term in nature and are not significantly dependent on quick economic cycles.	Neutral – Almost 39% of revenues coming from a large number of countries	
Oil	RIL IN	0	0	Negative impact because of decline in global commodity demand/prices	Negative. Petrochemicals demand will be hurt, retail business will be hurt	
	ONGC IN	0	0	Large negative. US recession will mean lower crude prices globally	Minor negative	

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Sector	Company	Direct exposure to US	Indirect exposure to US	Likely impact of US recession	Likely impact of India growth slowing to 7.5%	Comments
Property/Retail/ Consumer	DABUR IN	None	None	Neutral	Negative	Because this sector is primarily non-discretionary, we expect low leverage to these factors
	MRCO IN	None	None	Neutral	Negative	Because this sector is primarily non-discretionary, we expect low leverage to these factors
	ITC IN	None	None	Neutral	Negative	Because this sector is primarily non-discretionary, we expect low leverage to these factors
	HUVR IN	None	None	Neutral	Negative	Because this sector is primarily non-discretionary, we expect low leverage to these factors
	PF IN	None	None	Neutral	Negative	Discretionary spend may be impacted
	SHOP IN	None	None	Neutral	Negative	Discretionary spend may be impacted
	PROV IN	None	None	Neutral	Negative	Discretionary spend may be impacted
	UT IN	None	Through IT/ITES sector	Negative	Negative	US recession would affect commercial real estate demand in the IT/ITES sector, which impacts residential demand
	DLFU IN	None	Through IT/ITES sector	Negative	Negative	US recession would affect commercial real estate demand in the IT/ITES sector, which impacts residential demand
Auto	TTMT IN				Negative	Demand for CVs will slow down in case of growth slowing to 7.5%
	AL IN				Negative	Demand for CVs will slow down in case of growth slowing to 7.5%
	Autos in general				Negative	Automobile sales will decline in case of economic slowdown particularly that of Commercial Vehicles
Telecom	Bharti Airtel	Negligible – Retail calling cards to India	Nil	Nil	Marginal – Low spend per month on wireless (US$9 per month), only 20% penetration of wireless as of now, very high value for money utility	
	Reliance Communications	Negligible – Retail calling cards to India	Nil	Nil	Marginal – Low spend per month on wireless (US$9 per month), only 20% penetration of wireless as of now, very high value for money utility	
	Idea Cellular	Nil	Nil	Nil	Marginal – Low spend per month on wireless (US$9 per month), only 20% penetration of wireless as of now, very high value for money utility	

Source: Macquarie Research, December 2007

The IT/ITES industry will probably be badly hit, leading to slowing urban employment and possibly a slippage in consumer confidence. We think this will play itself out in terms of demand for property, loan growth and loan quality for banks, and a slowdown in demand for discretionary consumer purchases.

The best place to hide in a US recession will be sectors that are purely domestic in nature, with low levels of domestic spend: telecoms stand out as an example. Our top pick here is Reliance Communications. Also, Reliance Industries, where much of the upside is driven by its ability to find new oil and gas, will be relatively immune.

Policy – elections cloud the scenario

Elections dominate the policy landscape

The policy scenario will be dominated by the spectre of elections. Nine states are due to go to the polls in 2008 – leading up to scheduled national elections in 1Q09. However, the relationship between the ruling United Progressive Alliance and the Left Front continues to be very unstable. The "crisis" of September passed with both sides making compromises – however, we still do not rule out national elections ahead of schedule.

The preponderance of elections means that two key trends will be discernible:

- **Policy inertia**: Key policy decisions will be governed by electoral compulsions – many will get held up beyond the elections. The next section includes a table which is an updated list of how we think each sector will be affected by the elections.
- **Acceleration in infrastructure spend**. As was illustrated by the announcement of major road projects last week, we think that the government will accelerate infrastructure spend – it has the effect of improving perception of the government as well as creating a trickle-down effect in terms of incomes and employment of the immediately surrounding geographies in which the spend takes place.

Fig 7 Key issues in the run-up to elections

Policy measure	Who decides?*	Due when?	How will politics affect delivery? **	If postponed, until when?	Impact on Sector	Stocks impacted negatively	Stocks impacted positively	Who decides?*
Auto								
Revision of petroleum prices	Ministry	Was expected soon	Likely to be postponed	Indefinitely	Positive		Tata Motors, Ashok Leyland	Ministry
Banks								
Lowering Govt's holding in SBI from 55% to 51%	Parliament	Was expected in September/October	Delayed	Unpredictable	Mildly negative	SBI		Parliament
De-regulation in the insurance sector (relaxation of capital norms or raising overseas investment limit)	Parliament	Probability of happening before election was low anyway	Delayed	After elections, very likely	Negative	Insurance companies in which local parent is constrained for capital: Tata, ING Vysya, Aviva	Insurance companies in which local parent has access to capital: HDFC, ICICI Pru, Reliance, SBI Life	Parliament
Infrastructure								
Approval of model concession agreement in ports	Cabinet		Delayed	Until new government is in place	Negative	Nagarjuna, Patel, IVRCL, L&T		Cabinet
Approval of additional phases of NHDP	Cabinet		Delayed	Until new government is in place	Negative	Nagarjuna, Patel, IVRCL, L&T		Cabinet
Approval for greenfield airports at Noida, Mumbai and Chennai	Cabinet		Delayed	Until new government is in place	Negative		GMR, GVK	Cabinet
Metals/Mining								
Mining policy (Hoda committee)	Cabinet	Winter Session	Delayed	Budget Session	Positive	None	SAIL, Sesa Goa	Cabinet
Oil								
Increase in retail prices of Petrol and Diesel	Union Cabinet will approve the MoPNG's proposal	Was expected in September 2007	Unlikely that this unpopular step shall be taken before elections	Small price revision may come after the Gujarat elections	Negative	IOCL, HPCL, BPCL, ONGC, GAIL		Union Cabinet will approve the MoPNG's proposal
Increase in prices of APM gas	Union Cabinet will approve the tariff commission's recommendation	Was expected in July 2007	Government may go ahead after the Gujarat elections by 1QCY08	It was postponed, as majority of gas consumers are in Gujarat	Negative	ONGC		Union Cabinet will approve the tariff commission's recommendation
Property								
SEZ policy	Ministry of Commerce & Ministry of Finance		This could lead to delays in (or at worst cancellation) development of SEZs	Next government	SEZs are a politically sensitive issue and hence exposed to risk of delay in policy guidelines or approvals.	Mahindra Lifespaces		Ministry of Commerce & Ministry of Finance
Real Estate Regulator	State/ local governments	Not decided	Delhi government declared its plans to come with regulator in 2008. Other states not decided yet.	Indefinitely	Neutral			State/local governments
Relaxation of capital controls aimed at real estate developers	RBI		Capital controls may not be relaxed (in fact may be tightened)	Indefinitely	Negative	All real estate sector stocks – likely to have a more significant impact on smaller companies		RBI

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Policy measure	Who decides?*	Due when?	How will politics affect delivery? **	If postponed, until when?	Impact on Sector	Stocks impacted negatively	Stocks impacted positively	Who decides?*
Retail								
FDI regulation in retail sector	Ministry of Commerce & Ministry of Finance	Not decided	The decision to allow FDI in multi-brand foreign retail outlets could get delayed indefinitely	Indefinitely	Local retailers will benefit, as they will be insulated from foreign competition for some time. Long-term negative for the sector as the entry of foreign players would increase efficiency in the sector and create strong competition for the domestic players		Pantaloon (PF IN); Shopper's stop (SHOP IN); Provogue (PROV IN); RIL Retail (subsidiary of RIL IN)	Ministry of Commerce & Ministry of Finance
Permission to open organised retail chain stores	State/local governments	Ongoing	Organised retailers affect business for small traders/ shopkeepers and middlemen. This makes permissions for chain stores politically sensitive.	Indefinitely	Organised retail players with aggressive expansion plans would face delays. Longer term, we expect the noise to reduce and growth to resume.	Pantaloon (PF IN); Shopper's stop (SHOP IN); Provogue (PROV IN); RIL Retail (subsidiary of RIL IN)		State/ local governments
Telecom								
Spectrum Allocation	Telecom Ministry, Department of Telecom, Government of India	By January 2008	Potential delay	3-6 months	Negative	All GSM operators, namely Bharti Airtel, Idea	Reliance Comm	Telecom Ministry, Department of Telecom, Government of India

* Ministry/Cabinet/Parliament
** Unaffected/delayed/scrapped

Source: Macquarie Research, December 2007

Themes of the year – spin-offs and sell-downs

Capturing value in the rising tide of liquidity

We see a major theme for the next year as spin-offs and sell-downs, when companies look to unlock further value in new businesses. We see this as partly a function of rising liquidity in the system – especially with the advent of private equity funds looking for new businesses in which to invest. As the liquidity flows continue and the markets remain buoyant, we see value-unlocking as a major theme for 2008. The following table gives a detailed sector-wise update on the major deals we expect for 2008.

Fig 8 Large volume of transactions expected

Sector	Stock code	Event	In our numbers?	Potential impact	Likely date	Comments
Auto	TTMT IN	List one of its arm HV Axles/ HV Transmission	Yes	Positive	2Q	
	BJA IN	Demerger of Insurance & Investment businesses	Yes	Positive	1Q	
	MM IN	IPO of Mahindra Holidays	Not under coverage	Positive	1Q	Company has already filed the DRHP with SEBI
			Yes/No	Positive/negative	1Q/2Q/etc	
Banks	ICICIBC IN	Dilution in insurance businesses	Partially	Positive	1Q 2008	If RBI permission for holdco does not come through, individual businesses will list
	SBIN IN	Dilution in insurance businesses	Partially	Positive	3Q 2008	
Infrastructure	PUNJ	Pipavav IPO	No	Positive	1Q	We have UP on the stock
	GMON	GIPL IPO	NA	Positive	1Q	Cant write on this due to restriction
	HCC	Lavassa PE deal	No	Positive	1Q	
	PEC	NHPC IPO	No	Positive	2Q	
Metals/Mining	STLT IN	PE deal for its 100% subsidiary, Sterlite Energy	Yes	Positive	1Q	
	STLT IN	Buyout of Govt. of India's 49% Stake in Balco	Yes	Positive	1Q	
	STLT IN	Buyout of Govt. of India's 29.5% stake in Hindustan Zinc	Yes	Positive	2Q	
	JSTL IN	Environment clearances for Iron ore mines	No	Positive	2Q	
Oil	ABAN IN	Public Issue and subsequent listing of Singapore subsidiary	No	Positive	1H CY08	Value unlocking
	RIL IN	Stake sale in retail subsidiary, oil and gas assets	No	Positive	1 year	Value unlocking
	BPCL IN	IPO of Bharat Oman Refinery	No	Positive	2QCY08	Value unlocking
	ONGC IN	IPO of Oil India	No	Positive	1QCY08	ONGC's valuations will get benchmarked against Oil India's potentially higher valuations
Property/Retail/ Consumer	UT IN	Listing of Commercial REIT in Singapore	No	Positive	1Q	Issue size could be US$1-2bn; may lead to 7-8% upside if it lists at 8% cap-rate
	UT IN	Listing of retail investment trust overseas	No	Positive	2H2008	
	DLFU IN	Listing of Commercial REIT in Singapore	No	Positive	1Q	Issue size could be US$2-3bn; may lead to 9% upside if it lists at 8% cap-rate
	DLFU IN	Listing of retail investment trust overseas	No	Positive	2H2008	
	PF IN	Spin off of Future Capital	We have valued this at US$700 m	Positive	1Q	May list at valuation of US$1bn
	PF IN	Spin off media/internet business	No	Positive	2H2008	Difficult to quantify
	PROV IN	Spin off retail real estate business	Yes	Positive	2H2008	Difficult to quantify but valuation likely to be higher than currently in our valuation
	MRCO IN	Overseas acquisition	Yes	Positive	CY 2008	Difficult to quantify
	DABUR IN	Overseas acquisition	Yes	Positive	CY 2008	Difficult to quantify
Telecom	BHARTI IN	Private equity sell-down in Bharti Infratel (100% owned Tower subsidiary) and IPO in Indus Towers (42% owned)	No	Positive	Mid 2008	Value unlocking, higher leverage
	RCOM IN	IPO of RTIL (95% owned TowerCo), Private equity sell-down in FLAG Telecom (100% owned submarine cable subsidiary)	No	Positive	1HCY2008	Value unlocking, higher leverage
	IDEA IN	IPO in Indus Towers (16% owned TowerCo subsidiary)	No	Positive	Mid 2008	Value unlocking

Source: Macquarie Research, December 2007

Key plays

We believe the best plays on this theme are telecoms and banks, where the value unlocking could result in major positive surprises for the overall parent company valuations. Reliance Communications, Bharti Airtel and ICICI Bank would be the stocks to watch, in our view.

Comfortable with valuations

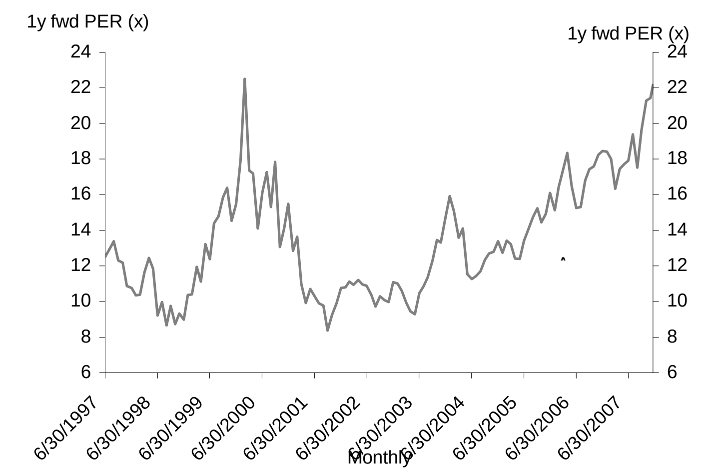
Cheap compared to history

While India does appear expensive on absolute levels, we argue that it does not look as scary when viewed on an historical basis. The PER chart of the MSCI in the chart below shows India's valuations still below the peaks of the 2000 tech bubble. It does look perilously close, however, which we attribute to two factors:

a) MSCI weights the PER on foreign free float. This is why the market-cap weighted PER of our universe is 20% lower than the MSCI index.

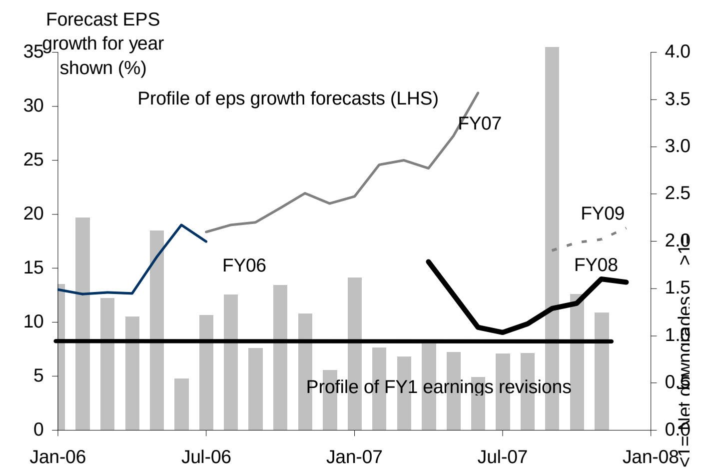
b) As the subsequent chart shows, Indian stocks see continuous earnings upgrades towards the end of the year – valuations have to be assessed in that context.

Fig 9 Free-float PER rising, but still below peaks



Source: Datastream, Macquarie Research, December 2007

Fig 10 Upgrade season about to begin?

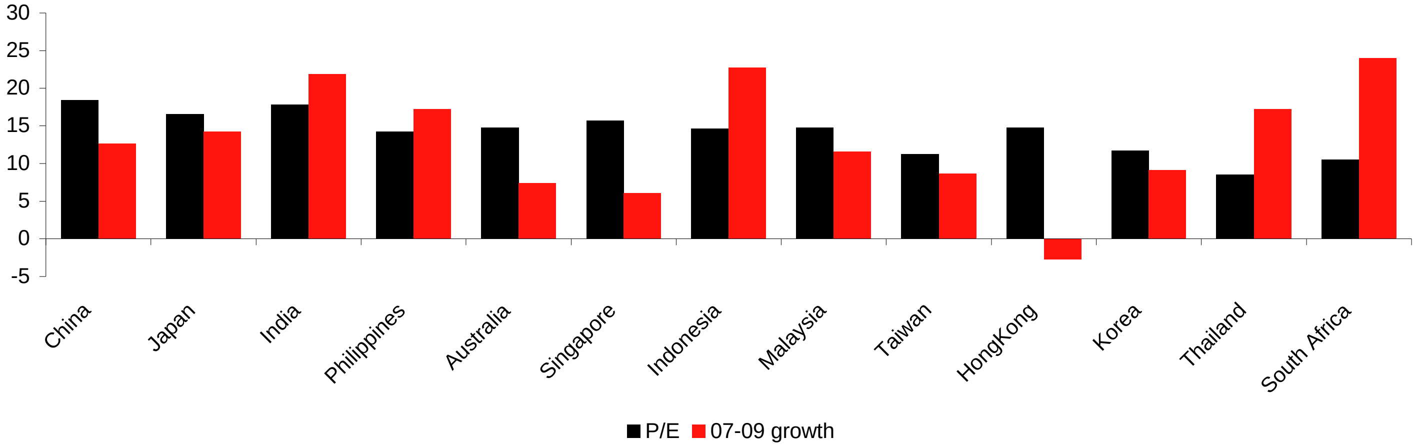


Source: Datastream, Macquarie Research, December 2007

Stands up to regional comparisons

In a regional context, India stands up to scrutiny as well. As the charts below show, India is not as expensive as some of the other markets, especially in a growth adjusted context. Given the depth of the markets and the structural high growth economy, we think India's valuations are very reasonable in the regional context.

Fig 11 India cheap, relative to growth



Source: Macquarie Research, December 2007

A structural re-rating

We argued for a structural re-rating of India in our note, *India Strategy: A structural re-rating,* published 15 October 2007, which will see India break out of recent PER bands. Those factors are still in place – continuing capital flows into India, improved sustainability of India's growth, efficiency of capital usage and a surge of flows from domestic savings into equity.

Important disclosures:

Recommendation definitions

Macquarie - Australia/New Zealand
Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts)
Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)
Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)

Macquarie - Asia
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie First South - South Africa
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie - Canada
Outperform – return >5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return >5% below benchmark return

Macquarie - USA
Outperform – return >5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return >5% below benchmark return

Recommendations – 12 months
Note: Quant recommendations may differ from Fundamental Analyst recommendations

Volatility index definition*

This is calculated from the volatility of historic price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.
* Applicable to Australian/NZ stocks only

Financial definitions

All "Adjusted" data items have had the following adjustments made:
Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 30 September 2007

	AU/NZ	Asia	RSA	USA	CA
Outperform	47.39%	64.32%	64.58%	54.55%	71.65%
Neutral	40.77%	19.28%	33.33%	27.27%	25.98%
Underperform	11.85%	16.40%	2.08%	18.18%	2.36%

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