Macquarie
India Essentials

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The Asia Specialist

Monday, 21 February 2011

Indian banks 3

FY2012 Outlook – A tale of two halves — Suresh Ganapathy

We believe FY2012 is likely to be a tale of two halves where the first half is likely to see subdued credit growth and margins whereas the second half is likely to see materially falling credit costs with a recovery in margins. We do see some downside in the near term due to pressure on NIMs and opex due to pensions; however we believe the downside is limited after the sharp underperformance of financials and most of the worries are captured in the price.

Bank of India (Upgrade to Outperform) 4

You can finally bank on this — Mudit Painuly

We upgrade the stock to Outperform from Neutral as we believe the worst of asset quality is behind the bank. We increase our target price from Rs475 to Rs530. Asset quality – leaving the worst behind in FY12. We believe that the worst of asset quality may be finally behind the bank in FY12.

Canara Bank (Upgrade to Neutral) 5

Cheap valuations but concerns do remain — Mudit Painuly

Upgrade to Neutral - We upgrade Canara Bank to Neutral from Underperform given cheaper valuations and a better asset quality outlook. Our TP increases from Rs520 to Rs650 chiefly driven by a 150bp improvement in sustainable ROE. Asset quality – done a better job than peers. The bank has done a better job than its peers on delinquencies.

IDFC (Upgrade to Outperform) 6

Concerns well in the price — Suresh Ganapathy

Upgrade to Outperform and raise TP by 5% to Rs170: We upgrade IDFC to Outperform after a sharp price correction and increase our TP by 5% to Rs170 due to a minor cost of equity adjustment. NIM decline already factored in: We have a factored in close to 50bps decline in NIMs over the next two years which we believe is sufficient.

Punjab National Bank (Upgrade to Outperform) 7

Pain over now with some gains — Suresh Ganapathy

Upgrade to Outperform: We upgrade PNB to Outperform from Neutral and increase our TP by 8% to Rs1,300 due to a 100bp increase in PNB's sustainable ROE to 19%. After the recent sharp correction, we believe the current stock price offers an attractive entry point. Credit costs to decline significantly in FY12: We expect credit costs for PNB to decline from 80bps in FY11E to 50bps in FY12E, mainly due to lower slippages from restructured assets and the conscious decision by the bank to reduce sensitive sector exposures like commercial real estate.

Reliance Capital (Upgrade to Outperform) 8

At distressed valuations — Suresh Ganapathy

Upgrade to Outperform on improving profitability in non-life businesses: We upgrade Reliance Capital to Outperform. However, we reduce our TP by 18% to Rs600 due to very conservative assumptions on life insurance business valuation. In our view, the results of the past two quarters demonstrate improving profitability across its non-insurance businesses which now constitute more than 80% of overall reported profits.

State Bank of India (Upgrade to Neutral) 9

Some worries still there — Suresh Ganapathy

Upgrade to Neutral, raise TP by 20% to Rs2,750: We upgrade SBI to Neutral from Underperform and raise our TP by 20% to Rs2,750 mainly on account of higher sustainable RoE emanating out of higher NIMs. Excellent liabilities franchise should arrest margin erosion: SBI with a CASA ratio (low cost deposit mix) of 48% has the best deposit franchise amongst PSU banks as a result of which NIM compression due to rising interest rates could be lower in SBI compared to other banks.

Fresh Money Ideas

Company	Rec	Target px (lcy)	Closing (lcy)	Upside/Downside (%)
Jubilant Lifesciences Limited (JOL IN)	OP	270.00	168.60	60
Jindal Steel and Power (JSP IN)	OP	962.00	679.40	42
Larsen & Toubro (LT IN)	OP	2,215.00	1,639.75	35
Bharat Petroleum (BPCL IN)	OP	788.00	593.50	33
Tata Power (TPWR IN)	OP	1,553.00	1,264.40	23
Reliance Power (RPWR IN)	UP	127.00	113.80	12
MTNL (MTNL IN)				
Maruti Suzuki India (MSIL IN)	UP	1,050.00	1,228.80	-15
State Bank of India (SBIN IN)	UP	2,300.00	2,755.30	-17
Idea Cellular (IDEA IN)	UP	35.00	63.30	-45

OP = Outperform, UP = Underperform, N = Neutral
Source: Factset, Macquarie Research estimates
Data as at 21/02/2011

Union Bank of India (Upgrade to Outperform) — 10

The worst is likely over — Mudit Painuly

Upgrade to Outperform, raise TP by 28% to Rs405: We are upgrading Union Bank to Outperform from Underperform and raising our target price by 28% to Rs405, mainly due to a 200bp improvement in sustainable ROE to 18% on account of higher NIMs and lower credit charges. Asset quality likely to significantly improve: Nearly 30% of the slippages reported this year for Union Bank have come from restructured assets and agri debt waivers, which are unlikely to be present next year, in our view.

India Infrastructure — 11

Takeaways from panel discussion — Inderjeetsingh Bhatia

We hosted an infrastructure panel during our India conference this week. The participants included senior management from top infrastructure companies and private equity investors in India (see table on left hand side). While the considerable investment potential is well known, the panel expected fast resolution on key impediments like clearances, land acquisition, etc.

Guanxi — 12

Ideas from across Macquarie and beyond … — Mark Matthews

Food inflation Þ pgs. 2-6. Bad weather and China's soaring feed grain needs have caused grain and oilseed prices to spike. Corn futures are up 80% from where they were last summer; soybean and wheat are up 50%. Even the humble potato's price has risen 40%. Politics, developed vs. emerging, China, eye on prices Þ pgs.

Macquarie Agri-view — 13

Near term supply risks are rising for cocoa — Kona Haque

The political unrest in Ivory Coast is not getting any better, while sanctions are crippling the cocoa sector. Cocoa supplies out of the country risk grinding to a halt if the one-month ban imposed on exports is extended into Mar/Apr, when the mid crop commences. Although the global cocoa market is still forecast to be in surplus, the market should prepare for major supply disruptions out of Ivory Coast.

Oil market - week in review — 14

Spreading unrest in the Middle East — Jan Stuart

Brent was slightly higher week over week, gaining +1.6% to just over US$103/b, while WTI continued to show relative weakness, ending the week up +0.6% near US$86/b. Brent's premium to WTI is slightly lower but still above US$16/b. The week's economic calendar continued to show a strengthening US recovery, though continued and rising tensions in the Middle East have remained a cause for concern.

China Commodity Call — 15

Chinese aluminium market tight in 2H10 and 1H11; China steel update — Bonnie Liu

This week we assess the Chinese aluminium market for 2010 and 2011. We believe that Chinese aluminium stocks fell by 450kt last year, compared to a 760kt increase in 2009. Capacity ramp up slower than anticipated The major reason for this year's deficit is the slower than anticipated ramp up in smelter capacity following last year's closures.

Macquarie Commodities Comment — 16

Building a stronger 2011 — Hayden Atkins

We review the outlook for global construction, with Chinese construction likely to slow but not disastrously, with construction in the G3 likely to add to the commodity demand for the first time in 3 years. Copper fell 1.1% over the week and underperformed on Friday, with ex-China exchange stocks rising by 14,498t over the week and SHFE stocks up 16,865t over the week.

INDIA

Inside

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21 February 2011

Indian banks

FY2012 Outlook – A tale of two halves

Risk-reward now favourable; we turn positive on financials

We believe FY2012 is likely to be a tale of two halves where the first half is likely to see subdued credit growth and margins whereas the second half is likely to see materially falling credit costs with a recovery in margins. We do see some downside in the near term due to pressure on NIMs and opex due to pensions; however we believe the downside is limited after the sharp underperformance of financials and most of the worries are captured in the price. Earnings downgrades due to NIM compression could be very limited as banks have already surprised positively on margins in 3QFY11 and moreover banks have raised lending rates simultaneously to deposit rate hikes. Positive surprises from lower credit charges (more likely to be back-ended in FY12) should give added cushion to earnings. With valuations now back to comfortable levels, we believe risk-reward at the margin is favourable and we turn positive on Indian financials.

NIM compression – too much pessimism unwarranted

We believe concerns on margin compression are overdone. We have factored in around 20bps NIM compression for FY12E (40ps lower than 3QFY11 NIM levels) which is more than sufficient. NIMs are unlikely to compress to the levels seen during global financial crisis when NIMs went down more than 50bps. This time around deposit rate hikes have been accompanied with lending rate hikes which should arrest margin decline. We are also seeing at the margin a broad-based loan recovery which should impart some pricing power to banks.

Credit charges – the biggest driver of earnings in FY2012

We believe the biggest driver of earnings in FY12E is likely to be sharply falling credit costs due to rapid improvements in asset quality. We expect credit costs to be 20bps lower on an average for the system. Rating agencies have already done a flurry of upgrades indicative of the health of corporate India. Slippages from restructured assets are likely to be minimal and even beleaguered sectors like exports are expected to do well in the wake of global recovery. Retail NPLs have already started coming down. We are adequately building in a slippage ratio of 1.5% for banks in FY12E.

Credit growth could sustain at 20% though challenges exist

Credit growth in our view is unlikely to see the heady levels of 25%+ observed in the past. We expect credit growth to be at 20% levels though in the near term it could come down to sub-17% levels by 1QFY12 due to absence of 3G funding this year. The key issue has been a failure in pick up of capex cycle owing to the delay in project approvals and executions which are bogged down by environmental clearance, fuel linkage issues etc. However even during the global financial crisis credit growth was at 18% and we think a slowdown in infrastructure sector could be partly offset by higher working capital borrowings especially by oil companies and export oriented sectors. Rising interest rates are unlikely to be a major impediment as credit growth even in the past has been robust when rates were rising. The major driving factor is economic buoyancy and rising incomes.

Top picks: leveraged to NPL improvements - ICICI & PSUs

We believe the best way to play the cycle is to take exposure to banks that are significantly leveraged to improvements in asset quality cycle. ICICI Bank is our top pick followed by PSU banks where our top pick is PNB. We upgrade BOI, PNB, Union Bank, IDFC, RCAP to Outperform and SBI and Canara Bank to Neutral.

Macquarie
Equities Research

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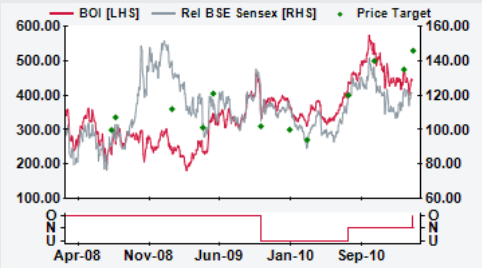
INDIA

BOI IN		Outperform
Price 16 Feb 11		Rs442.75
12-month target	Rs	530.00
Upside/Downside	%	19.7
Valuation - Gordon growth methodology	Rs	530.00
GICS sector		Banks
Market cap	Rsm	232,532
30-day avg turnover	US$m	1.5
Market cap	US$m	5,144
Number shares on issue	m	525.2

Investment fundamentals

Year end 31 Mar		2010A	2011E	2012E	2013E
Net interest Inc	bn	57.6	74.9	85.6	102.8
Non interest Inc	bn	26.2	24.5	27.2	30.8
Underlying profit	bn	47.0	56.8	63.7	76.7
PBT	bn	24.9	38.9	51.4	62.2
PBT growth	%	-40.1	56.0	32.0	21.2
Reported profit	bn	16.7	26.1	34.4	41.7
EPS rep	Rs	31.74	49.54	65.37	79.20
EPS rep growth	%	-44.4	56.0	32.0	21.2
PER rep	x	13.9	8.9	6.8	5.6
Total DPS	Rs	8.15	7.50	7.50	7.50
Total div yield	%	1.8	1.7	1.7	1.7
ROA	%	0.7	0.9	1.0	1.0
ROE	%	12.1	17.0	19.3	19.7
Equity to assets	%	5.2	5.0	4.9	4.9
P/BV	x	1.6	1.4	1.2	1.0

BOI IN rel BSE Sensex performance, & rec history



Note: Recommendation timeline - if not a continuous line, then there was no Macquarie coverage at the time or there was an embargo period.

Source: FactSet, Macquarie Research, February 2011
(all figures in INR unless noted)

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21 February 2011

Bank of India

You can finally bank on this

Event

- We upgrade the stock to Outperform from Neutral as we believe the worst of asset quality is behind the bank. We increase our target price from Rs475 to Rs530.

Impact

- **Asset quality – leaving the worst behind in FY12.** We believe that the worst of asset quality may be finally behind the bank in FY12. Bank of India was one of the first banks to face large slippages from its restructured book. Over time, the slippages have fluctuated in quantum. However, total slippages in 9M FY11 have been significantly lower at 1.5%, compared to 2.9% in FY10. We believe delinquencies will tail off further in FY12E vs FY11E due to the following reasons:
  - ⇒ Already 19% of the restructured book has turned delinquent significantly reducing the scope of further delinquencies from that book. 18% of total delinquencies in 9M11 came in from restructured book.
  - ⇒ Agri debt waiver related delinquencies contributing another 10% of 9M11 delinquencies would not be there.
- **Improving return ratios driven by falling credit costs.** The fall in credit costs should be the key driver in improving profitability of the bank. We expect ROA to expand from the low of 0.7% in FY10 to 0.95% in FY12E. ROE should expand from 12% to 19% in the same period. The improving return ratios in our view justify a higher multiple.
- **Margins' smart pick up – likely to moderate.** NIMs have recovered smartly over FY11 in tandem with the decline in delinquencies and cost of funds. However, we do expect 3Q11 margins to moderate on the back of higher funding costs. Management has stated its intention to improve CASA from the current 32%. However, given the higher interest rates, we believe it would be difficult to do so.
- **Fees still a sore point.** Core fee has struggled to pick up at the bank even though it has a sizeable international presence. We expect some pick-up in fees in FY12E on the back of better corporate lending but should remain moderate overall.

Earnings and target price revision

- We are lowering our FY11E and FY12E earnings by 2–4% on lower margin assumptions offset by lower provisions. We increase our TP by from Rs475 to 530 on back of higher ROE driven by lower credit costs. We upgrade the stock to OP.

Price catalyst

- 12-month price target: Rs530.00 based on a Gordon growth methodology.
- Catalyst: Lower credit costs in FY12E.

Action and recommendation

- We believe the improving return ratios driven by falling credit costs should drive a multiple expansion. Our TP values the stock at 1.8x FY12E BVPS.

INDIA

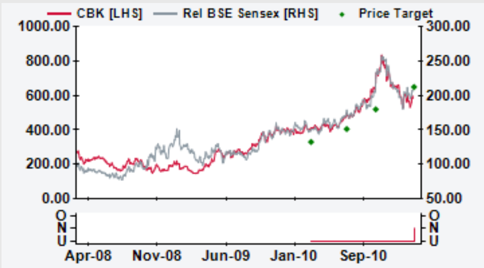
CBK IN	Neutral
Price 16 Feb 11	Rs590.00

12-month target	**Rs**	**650.00**
Upside/Downside	**%**	**10.2**
Valuation	**Rs**	**650.00**
GICS sector		**Banks**
Market cap	**Rsm**	**241,900**
30-day avg turnover	**US$m**	**1.8**
Market cap	**US$m**	**5,351**
Number shares on issue	**m**	**410.0**

Investment fundamentals

Year end 31 Mar		2010A	2011E	2012E	2013E
Net interest Inc	bn	56.8	79.4	92.3	109.4
Non interest Inc	bn	28.6	24.2	26.5	29.0
Underlying profit	bn	53.6	58.9	65.4	77.0
PBT	bn	38.2	51.4	56.2	66.7
Recurring profit	bn	38.2	51.4	56.2	66.7
CFPS	Rs	nmf	nmf	nmf	nmf
Equity to assets	%	5.5	5.7	5.7	5.7
EV/EBITDA	x	1.8	1.4	1.2	1.0
PER rep	x	8.0	5.9	5.4	4.6
Total DPS	Rs	10.00	10.00	10.00	10.00
Total div yield	%	1.7	1.7	1.7	1.7
ROA	%	1.2	1.4	1.2	1.2
ROE	%	22.5	24.9	21.9	21.4
Equity to assets	%	5.5	5.7	5.7	5.7
P/BV	x	1.6	1.3	1.1	0.9

CBK IN rel BSE Sensex performance, & rec history



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21 February 2011

Canara Bank

Cheap valuations but concerns do remain; Upgrade to Neutral

Event

- **Upgrade to Neutral** - We upgrade Canara Bank to Neutral from Underperform given cheaper valuations and a better asset quality outlook. Our TP increases from Rs520 to Rs650 chiefly driven by a 150bp improvement in sustainable ROE.

Impact

- **Asset quality – done a better job than peers**. The bank has done a better job than its peers on delinquencies. Total slippages out of the restructured book have also been at ~7.5% vs 9-18% for peers. Recoveries have been encouraging, increasing 25%YoY in 9M11 over 9M10. Delinquencies for FY11 are likely to be ~1.4% better than its peers. With the macro environment improving, we believe the delinquencies should come further down in FY12. Accordingly we have cut our credit cost estimates for FY12E and FY13E driving the earnings increase.
- **Some potential asset quality risks do remain** in the form of slippages from the restructured book increasing and also automation of NPL recognition where management is facing difficulty in automating all accounts by March 2011, particularly for agri accounts.
- **Poor CASA means NIMs more vulnerable**. Poor CASA ratio of 29% remains the biggest concern with the bank. Accordingly we believe NIM compression for Canara may be higher than its peer banks, moderating its earnings. Management has been optimistic on increasing the CASA, but we believe that may be difficult to achieve with rising retail term deposit rates.
- **ROEs at ~21%**. We believe that credit costs in FY12 are unlikely to increase significantly and the bank is likely to achieve ROEs of ~21%. We therefore believe that bank should trade at slightly higher multiples. However given the concerns on the poor liabilities franchise, we believe the bank should trade at a discount to its peers. Our TP values the stock at 1.5x adjusted FY12 BVPS vs 1.4x currently and compared to ~1.8x for its peers.

Earnings and target price revision

- We have increased our FY12E and FY13E earnings by 8% and 9% respectively. The earnings increase has been driven by a reduction in credit costs for the two years. Our TP increases by 25% to Rs650 driven by an improvement of 150bp in sustainable ROE.

Price catalyst

- 12-month price target: Rs650.00 based on a Gordon Growth methodology.
- Catalyst: Better asset quality in FY12.

Action and recommendation

- **Fairly priced**. The asset quality outlook has improved for the stock. However given the poor liabilities franchise, we believe the stock should trade at a discount to peers. Our TP values the stock at 1.5x FY12 adjusted BVPS.

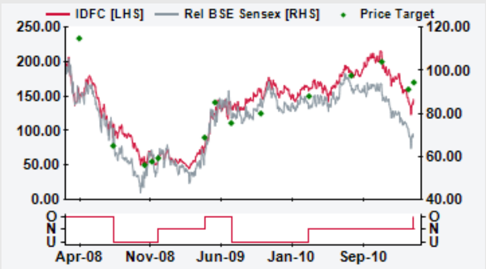
INDIA

IDFC IN		Outperform
Price 16 Feb 11		Rs138.65
12-month target	Rs	170.00
Upside/Downside	%	22.6
Valuation - Sum of Parts	Rs	170.00
GICS sector		Diversified Financials
Market cap	Rsm	202,560
Market cap	US$m	4,451
Number shares on issue	m	1,461

Investment fundamentals

Year end 31 Mar		2010A	2011E	2012E	2013E
Net interest Inc	m	11,170	13,753	17,179	20,292
Non interest Inc	m	9,900	11,098	13,171	15,445
Underlying profit	m	15,580	19,346	23,646	27,379
PBT	m	14,280	17,589	21,281	24,324
PBT growth	%	38.1	23.2	21.0	14.3
Recurring profit	m	14,280	17,589	21,281	24,324
Reported profit	m	10,620	13,015	15,535	17,759
Adjusted profit	m	10,620	13,015	15,535	17,759
EPS rep	Rs	8.17	8.92	10.30	11.77
EPS rep growth	%	41.4	9.3	15.4	14.3
EPS adj	Rs	8.17	8.92	10.30	11.77
EPS adj growth	%	41.4	9.3	15.4	14.3
PER rep	x	17.0	15.5	13.5	11.8
PER adj	x	17.0	15.5	13.5	11.8
Total DPS	Rs	1.75	1.92	2.12	2.33
Total div yield	%	1.3	1.4	1.5	1.7
ROA	%	3.2	3.2	3.0	2.7
ROE	%	16.1	14.7	13.3	13.2
Equity to assets	%	20.1	23.1	21.8	18.9
EV/EBITDA	x	12.6	11.5	9.8	8.6
P/BV	x	2.6	1.9	1.6	1.5

IDFC IN rel BSE Sensex performance, & rec history



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21 February 2011

IDFC

Concerns well in the price

Event

- **Upgrade to Outperform and raise TP by 5% to Rs170:** We upgrade IDFC to Outperform after a sharp price correction and increase our TP by 5% to Rs170 due to a minor cost of equity adjustment**.**

Impact

- **NIM decline already factored in:** We have a factored in close to 50bps decline in NIMs over the next two years which we believe is sufficient. NIMs are unlikely to decline to the levels seen during the previous rising rate cycle as IDFC after getting the infrastructure financing company status has access to external commercial borrowings, retail tax free bonds and greater access to bank funding all of which could ease pressure on cost of funds.
- **Loan growth could be in the range of 25-30%:** Despite the macro headwinds and the ongoing delays in infrastructure projects, management expects loan growth to be around 25-30% over the next two years. They have assessed their sanction pipeline thoroughly and they believe documentation is in place and don't see any issues with respect to achieving a 25-30% loan growth for the next two years.
- **Prudential provisioning an added advantage:** Despite having reported nil increase in NPLs for the past few years, IDFC has been making provisions close to 50-60bps of outstanding loans which is encouraging. Most of the other infrastructure financing peers are currently not making any prudential provisions.
- **Fee income businesses to be under pressure:** We expect investment banking and asset management business to be under pressure owing to increased competition and regulatory changes respectively. Environment for further mobilisation of funds in their private and project equity structures doesn't look conducive either.

Earnings and target price revision

- No EPS changes. However we increase our TP by a modest 5% to Rs170 on account of minor change due to cost of equity. As a result our target multiple increases from 1.8x to 1.9x.

Price catalyst

- 12-month price target: Rs170.00 based on a Sum of Parts methodology.
- Catalyst: Strong loan growth and stable asset quality

Action and recommendation

- **Good price point to enter:** With IDFC having corrected 35% from its peak we believe the current price offers an attractive entry point. Upgrade to Outperform with TP of Rs170.

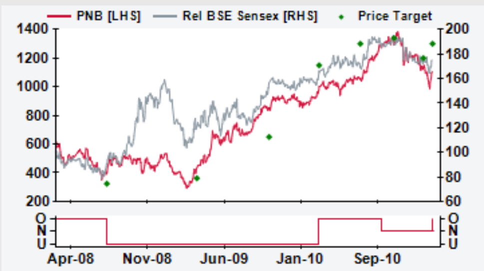
INDIA

PNB IN		Outperform
Price 16 Feb 11		Rs1,100.95
12-month target	**Rs**	**1,300.00**
Upside/Downside	**%**	**18.1**
Valuation	**Rs**	**1,300.00**
- Gordon Growth Model Gordon Growth Model		
GICS sector		**Banks**
Market cap	**Rsm**	**347,132**
30-day avg turnover	**US$m**	**0.9**
Market cap	**US$m**	**7,628**
Number shares on issue	**m**	**315.3**

Investment fundamentals

Year end 31 Mar		2010A	2011E	2012E	2013E
Net interest Inc	bn	87.2	116.6	132.6	159.0
Non interest Inc	bn	33.7	32.9	37.7	43.1
Underlying profit	bn	73.3	86.1	98.3	121.0
PBT	bn	59.0	63.9	80.7	99.9
PBT growth	%	23.9	8.2	26.4	23.8
Recurring profit	bn	59.0	63.9	80.7	99.9
Reported profit	bn	39.1	43.2	52.5	64.9
Adjusted profit	bn	39.1	43.2	52.5	64.9
EPS rep	Rs	123.85	136.91	166.35	205.92
EPS rep growth	%	26.3	10.5	21.5	23.8
EPS adj	Rs	123.85	136.91	166.35	205.92
EPS adj growth	%	26.3	10.5	21.5	23.8
PER rep	x	8.9	8.0	6.6	5.3
PER adj	x	8.9	8.0	6.6	5.3
Total DPS	Rs	12.00	20.00	20.00	20.00
Total div yield	%	1.1	1.8	1.8	1.8
ROA	%	1.4	1.3	1.3	1.4
ROE	%	24.1	22.1	22.3	22.7
Equity to assets	%	6.0	6.0	6.0	6.1
EV/EBITDA	x	2.2	2.0	1.6	1.3
P/BV	x	2.0	1.6	1.3	1.1

PNB IN rel BSE Sensex performance, & rec history



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21 February 2011

Punjab National Bank

Pain over now with some gains

Event

- **Upgrade to Outperform:** We upgrade PNB to Outperform from Neutral and increase our TP by 8% to Rs1,300 due to a 100bp increase in PNB's sustainable ROE to 19%. After the recent sharp correction, we believe the current stock price offers an attractive entry point.

Impact

- **Credit costs to decline significantly in FY12:** We expect credit costs for PNB to decline from 80bps in FY11E to 50bps in FY12E, mainly due to lower slippages from restructured assets and the conscious decision by the bank to reduce sensitive sector exposures like commercial real estate. Accordingly, we expect earnings growth to be strong at 20% over the next two years.
- **Cushion of high margins – the biggest positive:** In an environment of continued pressure on asset quality and opex due to pensions, a high margin structure is essential to maintain profitability, in our view, and we think PNB has done a commendable job of raising its NIMs to 4.15%. Although we think it is unlikely to be sustained at current levels, we expect PNB's NIMs to stay around 3.7%, which is still one of the best in the sector.
- **Excellent deposit franchise:** PNB's CASA ratio at 40% is second to SBI, and we think it is likely to protect NIMs in a rising rate environment. As the bank predominantly has a presence in the northern part of the country, its CASA is structurally higher than its peers and we believe PNB has successfully demonstrated in the past an ability to keep CASA at those levels.
- **One of the best return ratios among PSU banks:** The bank has consistently maintained an ROA of around 1.3-1.4% and an ROE above 20% for several quarters now, which is quite encouraging and, hence, deserving of premium valuations, in our view.
- **Management stability an added positive:** PNB's CMD is likely to stay with the bank for the next four years, which we view as very comforting, as management changes in PSU banks can be quite disruptive at times.

Earnings and target price revision

- Minor EPS changes. We have increased our TP by 8% to Rs1,300, mainly due to a 100bps increase in PNB's sustainable ROE to 19% from higher NIMs.

Price catalyst

- 12-month price target: Rs1,300.00 based on a Gordon Growth Model methodology.
- Catalyst: Improvement in asset quality and lower credit costs.

Action and recommendation

- **One of our favourites among PSU banks:** The ability of PNB to consistently maintain its margins at high levels gives us confidence that its strong return ratios are here to stay. We upgrade PNB to Outperform from Neutral.

Macquarie
Equities Research

MACQUARIE

Incorporating FPK, the Global FIG Specialist

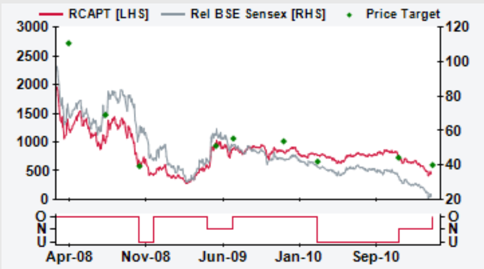
INDIA

RCAPT IN		**Outperform**
Price 16 Feb 11		**Rs476.55**
12-month target	**Rs**	**600.00**
Upside/Downside	**%**	**25.9**
Valuation	**Rs**	**600.00**
- Sum of parts		
GICS sector		**Diversified Financials**
Market cap	**Rsm**	**117,056**
Market cap	**US$m**	**2,572**
Number shares on issue	**m**	**245.6**

Investment fundamentals

Year end 31 Mar		2010A	2011E	2012E	2013E
Net interest Inc	m	6,247	5,647	6,040	6,513
Non interest Inc	m	41,835	45,851	52,599	60,876
Underlying profit	m	5,923	7,361	9,402	11,546
PBT	m	5,923	7,361	9,402	11,546
PBT growth	%	-50.8	24.3	27.7	22.8
Recurring profit	m	5,923	7,361	9,402	11,546
Reported profit	m	4,432	5,521	6,863	8,428
Adjusted profit	m	4,432	5,521	6,863	8,428
EPS rep	Rs	18.00	22.43	27.88	34.24
EPS rep growth	%	-56.7	24.6	24.3	22.8
EPS adj	Rs	18.00	22.43	27.88	34.24
EPS adj growth	%	-56.7	24.6	24.3	22.8
PER rep	x	26.5	21.2	17.1	13.9
PER adj	x	26.5	21.2	17.1	13.9
Total DPS	Rs	7.59	8.00	8.00	8.00
Total div yield	%	1.6	1.7	1.7	1.7
ROA	%	1.8	1.9	1.8	1.6
ROE	%	5.8	7.0	8.3	9.5
Equity to assets	%	29.5	24.2	19.2	14.4
EV/EBITDA	x	18.3	14.7	11.5	9.4
P/BV	x	1.5	1.5	1.4	1.3

RCAPT IN rel BSE Sensex performance, & rec history



Note: Recommendation timeline - if not a continuous line, then there was no Macquarie coverage at the time or there was an embargo period.

Source: FactSet, Macquarie Research, February 2011

(all figures in INR unless noted)

Reliance Capital

At distressed valuations: Upgrade to Outperform

Event

- **Upgrade to Outperform on improving profitability in non-life businesses:** We upgrade Reliance Capital to Outperform. However, we reduce our TP by 18% to Rs600 due to very conservative assumptions on life insurance business valuation. In our view, the results of the past two quarters demonstrate improving profitability across its non-insurance businesses which now constitute more than 80% of overall reported profits.

Impact

- **AMC business – profitability is improving:** The improved profitability in the AMC business is mainly on account of cost rationalisation as well as a change in product mix. The company has increased its exposure to the retail debt portfolio where the charges/fees are 70–80bps.
- **Consumer finance – lower losses in unsecured segment:** Losses in the unsecured segment have been consistently coming down and the personal loans portfolio now stands at less than 3% of the overall loan book. The gross NPLs are down to 2% from the 5.2% level observed about 12 months ago.
- **Broking and distribution business – profit margins are increasing:** The consolidation exercise in terms of cost rationalisation carried out last year is now paying dividends in the form of improvement in profit margins in its distribution as well as broking business where pre-tax profit margins have more than doubled, from 7% to 16% in a year.
- **Life insurance business – healthy NBAP margins this quarter:** The life business has been reporting close to 18% NBAP margins. We have built in 12% NBAP margins into our numbers, thereby providing sufficient cushion. YTD (April–Dec'10) new business premiums have declined 16% YoY and we have factored around a 30% decline for FY11E.

Earnings and target price revision

- No EPS changes. We reduce our TP by 18% to Rs600 mainly on account of reducing our insurance valuation of the business from Rs461 to Rs318. We are now assuming a 30% decline in FY11E new business premiums compared to flat premiums assumed earlier.

Price catalyst

- 12-month price target: Rs600.00 based on a Sum of parts methodology.
- Catalyst: Further increase in profitability of AMC, consumer finance business.

Action and recommendation

- **Upgrade to Outperform with TP of Rs600:** Reliance Capital is down 30% since the start of the year and 45% over the past six months and we believe the current price offers an attractive entry point. Reiterate Outperform.

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21 February 2011

Macquarie
Equities Research

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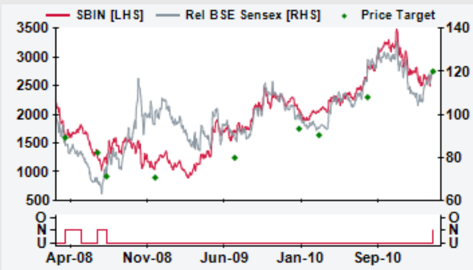
INDIA

SBIN IN		**Neutral**
Price 16 Feb 11		**Rs2,752.95**
12-month target	**Rs**	**2,750.00**
Upside/Downside	**%**	**-0.1**
Valuation - Sum of parts	**Rs**	**2,750.00**
GICS sector		**Banks**
Market cap	**Rsbn**	**1,748**
Market cap	**US$m**	**38,412**
Number shares on issue	**m**	**635.0**

Investment fundamentals

Year end 31 Mar		2010A	2011E	2012E	2013E
Net interest Inc	bn	334.4	440.0	483.0	575.6
Non interest Inc	bn	337.7	345.9	417.1	497.3
Underlying profit	bn	248.0	318.1	362.6	447.9
PBT	bn	186.8	195.8	253.4	314.6
PBT growth	%	2.3	4.8	29.4	24.1
Recurring profit	bn	186.8	195.8	253.4	314.6
Reported profit	bn	120.2	127.3	162.2	204.5
Adjusted profit	bn	120.2	127.3	162.2	204.5
EPS rep	Rs	189.26	200.48	227.94	287.35
EPS rep growth	%	3.5	5.9	13.7	26.1
EPS adj	Rs	189.26	200.48	227.94	287.35
EPS adj growth	%	3.5	5.9	13.7	26.1
PER rep	x	14.5	13.7	12.1	9.6
PER adj	x	14.5	13.7	12.1	9.6
Total DPS	Rs	30.00	34.00	37.00	37.00
Total div yield	%	1.1	1.2	1.3	1.3
ROA	%	0.9	0.8	0.9	0.9
ROE	%	15.5	14.4	14.9	15.4
Equity to assets	%	5.7	5.5	6.0	5.6
EV/EBITDA	x	4.7	4.5	4.3	3.5
P/BV	x	2.1	1.9	1.6	1.4

SBIN IN rel BSE Sensex performance, & rec history



Note: Recommendation timeline - if not a continuous line, then there was no Macquarie coverage at the time or there was an embargo period.
Source: FactSet, Macquarie Research, February 2011
(all figures in INR unless noted)

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21 February 2011

State Bank of India

Some worries still there

Event

- **Upgrade to Neutral, raise TP by 20% to Rs2,750:** We upgrade SBI to Neutral from Underperform and raise our TP by 20% to Rs2,750 mainly on account of higher sustainable RoE emanating out of higher NIMs.

Impact

- **Excellent liabilities franchise should arrest margin erosion:** SBI with a CASA ratio (low cost deposit mix) of 48% has the best deposit franchise amongst PSU banks as a result of which NIM compression due to rising interest rates could be lower in SBI compared to other banks. SBI also has close to Rs500bn (6% of deposits) of high cost deposits taken at 10.5%+ rates during Oct'08-Dec'08 coming up for repricing in FY12 which could give some cushion. Also the bank has been steadily reducing its recourse to bulk deposits which is very encouraging.
- **Near-term pressure on asset quality to continue:** SBI's slippage ratio continues to be high and we expect the asset quality to be under pressure in the near term. The bank has yet to reach an NPL coverage ratio of 70% and moreover it has yet to provide close to Rs5bn for teaser loans. As a result we expect credit charges to remain high in the near term thereby potentially resulting in weak earnings growth in the near term.
- **Pensions could negatively surprise us:** SBI has yet to account for pensions according to the ninth bipartite settlement. Moreover, the subsidiaries have yet to provide for the second pension option. The current pension calculation also uses aggressive assumptions like a lower wage hike and higher discount rate to arrive at the pension liability, and hence we believe there could be a negative surprise on opex due to pensions.
- **Management change could cause some temporary instability:** The incumbent Chairman Mr. Bhatt retires by the end of March-11 and is likely to be taken over by the international business head Mr. Pratip Chaudhuri in April. There could be some uncertainty with respect to the following strategy, thereby resulting in some temporary instability.

Earnings and target price revision

- We raise our TP by 20% mainly on account of an increasing sustainable RoE by 200bps to 18% on account of higher margins. Consequently we raise our target FY12 P/BV multiple from 1.3x to 1.6x.

Price catalyst

- 12-month price target: Rs2,750.00 based on a Sum of parts methodology.
- Catalyst: Weak earnings growth in 4Q FY11/1Q FY12.

Action and recommendation

- **Near-term worries, Upgrade to Neutral:** We believe in the near term there could be pressure on earnings due to higher credit costs and opex. We upgrade to Neutral with a TP of Rs2,750.

INDIA

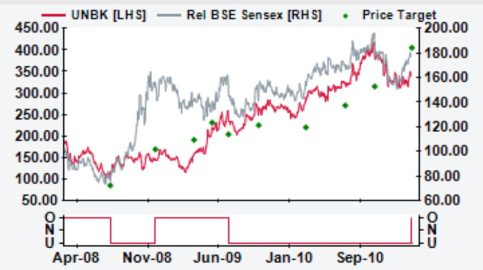
UNBK IN	Outperform
Price 16 Feb 11	Rs347.00

12-month target	**Rs**	**405.00**
Upside/Downside	**%**	**16.7**
Valuation - Gordon Growth	**Rs**	**405.00**
GICS sector		**Banks**
Market cap	**Rsm**	**175,276**
30-day avg turnover	**US$m**	**0.4**
Market cap	**US$m**	**3,851**
Number shares on issue	**m**	**505.1**

Investment fundamentals

Year end 31 Mar		2010A	2011E	2012E	2013E
Net interest Inc	bn	41.3	60.1	69.8	81.0
Non interest Inc	bn	20.4	19.5	22.0	23.3
Underlying profit	bn	36.6	46.1	51.6	58.5
PBT	bn	28.3	30.3	39.1	45.7
PBT growth	%	20.8	6.8	29.3	16.8
Recurring profit	bn	28.3	30.3	39.1	45.7
Reported profit	bn	20.7	21.2	27.4	32.0
Adjusted profit	bn	20.7	21.2	27.4	32.0
EPS rep	Rs	41.08	41.94	54.21	63.32
EPS rep growth	%	20.2	2.1	29.3	16.8
EPS adj	Rs	41.08	41.94	54.21	63.32
EPS adj growth	%	20.2	2.1	29.3	16.8
PER rep	x	8.4	8.3	6.4	5.5
PER adj	x	8.4	8.3	6.4	5.5
Total DPS	Rs	5.50	5.00	5.00	5.00
Total div yield	%	1.6	1.4	1.4	1.4
ROA	%	1.2	1.0	1.1	1.0
ROE	%	21.7	18.7	20.3	19.8
Equity to assets	%	5.3	5.2	5.3	5.3
EV/EBITDA	x	1.3	1.3	1.0	0.8
P/BV	x	1.7	1.4	1.2	1.0

UNBK IN rel BSE Sensex performance, & rec history



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21 February 2011

Union Bank of India

The worst is likely over

Event

- **Upgrade to Outperform, raise TP by 28% to Rs405:** We are upgrading Union Bank to Outperform from Underperform and raising our target price by 28% to Rs405, mainly due to a 200bp improvement in sustainable ROE to 18% on account of higher NIMs and lower credit charges.

Impact

- **Asset quality likely to significantly improve:** Nearly 30% of the slippages reported this year for Union Bank have come from restructured assets and agri debt waivers, which are unlikely to be present next year, in our view. Slippages from restructured assets have already reached 18%, and we do not see many slippages from this portfolio from next year onward. Consequently, we expect credit costs to come down significantly, from 110bp in FY11 to 60bp by FY12.
- **Liabilities franchise is also improving:** Union Bank has done a good job of improving its CASA ratio from 31% to 33% over the past 12 months, driven by rapid opening of new branches over the past few years. The bank has also invested heavily in rebranding and technology, due to which the liabilities franchise is steadily improving.
- **Return ratios to improve:** We expect ROE to drop by 300bp YoY in FY11E but to improve by 160bp to 20% in FY12E, driven by strong earnings growth of 29%.
- **Current CMD could get an extension:** Mr. Nair, who is currently the CMD of Union Bank, could possibly get an extension when his tenure expires in April 2011. The retirement age for CMDs of PSU banks is 60, and we believe Mr. Nair could get a one-year extension. Thus, we do not believe there will be instability due to management change at the bank.

Earnings and target price revision

- We are increasing our earnings for FY11E and FY12E by 2% and 9%, respectively, on account of lower credit costs. We are increasing our target price by 28% to Rs405, due mainly to a 200bp improvement in sustainable ROE to 18% on account of higher NIMs and lower credit charges.

Price catalyst

- 12-month price target: Rs405.00 based on a Gordon Growth methodology.
- Catalyst: Improvement in asset quality, strong earnings growth.

Action and recommendation

- **Worst is over, current price offers a good entry point:** With asset quality expected to improve, earnings growth is likely to be strong, and we believe the current price offers an attractive entry point. Upgrade to Outperform with a new TP of Rs405.

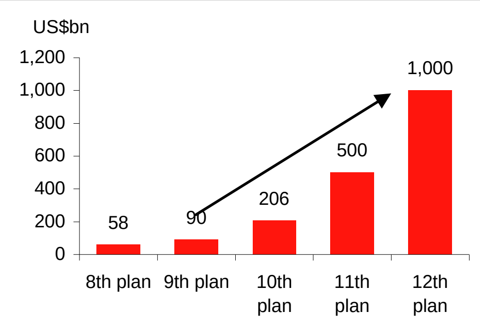
INDIA

Speakers in infrastructure panel

Person	Designation	Company
Anil Ahuja	Head (India invsts)	3i Singapore
Issac George	CFO	GVK Power
Lalit Jalan	CEO	Reliance Infrastructure
Rohit Modi	Deputy MD	Gammon Infrastructure
Samir Palod	Partner	3i India

Source: Macquarie Research, February 2011

Infra spending will double in 12th plan



Source: Planning commission of India, Macquarie Research, February 2011

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21 February 2011

India Infrastructure

Takeaways from panel discussion

Event

- We hosted an infrastructure panel during our India conference this week. The participants included senior management from top infrastructure companies and private equity investors in India (see table on left hand side).
- While the considerable investment potential is well known, the panel expected fast resolution on key impediments like clearances, land acquisition, etc. from the government to fast track development in this sector.

Impact

- **Award activity to resume in roads sector:** The hiatus in road sector awards is likely to end in FY12 with the appointment of the new road minister. The awarding activity after being hit by low base in FY10–11, would show a major improvement in FY12. Pickup in broader infrastructure projects awards is contingent on improvement in government action.
- **Concerns on environmental approvals easing:** Recent concerns of projects in various stages of construction getting impacted by environmental clearances have eased in the recent past. The environmental minister has cleared certain key projects like 6m ton steel plant of Jindal Steel and Power (JSP IN, Rs680, OP, TP: Rs962, covered by Rakesh Arora) and resolving no-go areas for coal mines with the coal ministry. This is likely to spur activities and reduce delays in the infra space.
- **Long time taken in dispute resolution is a major area of concern:** Dispute resolution in the infrastructure space tends to be a long-drawn process which can hurt the developers' interests. While regulations in sectors like roads and power sectors are mature, helping them attract high investor interest, the evolution of regulations in the airport sector has been a major worry area for most of the investors and developers.
- **Regulatory clearances continue to be the key bottlenecks:** Large gap between planned and actual expenditure and physical asset creation in infrastructure space in 5-year plans has been largely due to delay in securing regulatory clearances for the projects.
- **Roads can remain competitive with contractors entering the space:** The road sector may continue to witness high competition for some more time to come with big engineering and construction contractors entering the asset owner business. However, irrational bidding from companies may ease as they may find equity raising to be challenging in soft equity markets.

Outlook

- **Long-term story remains intact despite near-term concerns:** We believe that the Indian infrastructure is intact despite near-term hiccups like environmental clearances, land acquisition, etc.
- **Play the secular infra growth story through our top picks – LT and CRG:** L&T with no promoter holding and unparalleled execution capabilities is our top pick in the large cap infrastructure space in India. We also like CRG which is poised to benefit from the upcoming mega T&D capex in India.

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The Asia Specialist

ASIA

Alternative inflation indices

Macquarie thematic strategist Peter Eadon-Clarke wrote about soft commodity prices and their implications in his 18 Feb 69-page report. Whereas the Global Financial Crisis stopped prices from rising further in 2008, Peter says this time we won't be so lucky.

Indeed, it seems these days everyone is sounding the alarm on inflation. But is it flavour of the month, or something more serious?

Using software that continually scans the websites of retailers around the world, professors at MIT have been running Daily Price Indices since Oct-07. The chart to the right shows the US one vs. the CPI Index. It's a short chart, yet two observations can be made:

1. Since Jul-08, prices are only up 2.3%, which is not the sort of thing that will make the Fed panic. In fact, it should rejoice.

2. Since Jun-10, the index began diverging from CPI, and is now rising at a very sharp pace. If it continues, it certainly has implications for interest rates, markets, etc.. *… Continued on page 2*

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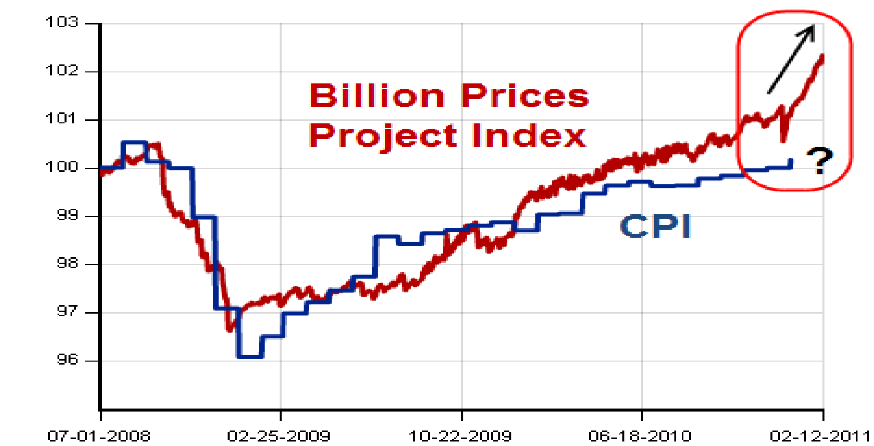
21 February 2011

Guanxi

Ideas from across Macquarie and beyond …

Inside

The Billions Prices Project Index vs. CPI, since July 2008



Source: bpp.mit.edu

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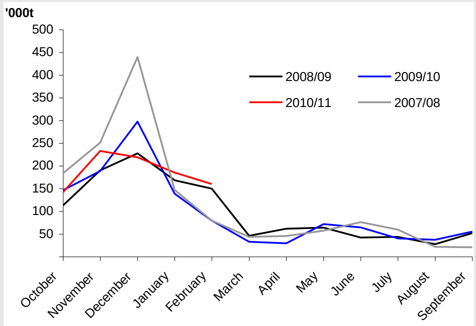
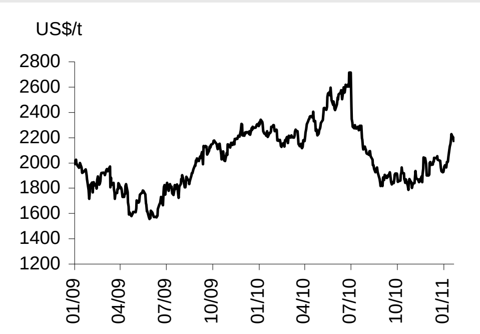
GLOBAL

Ivory Coast cocoa arrivals – strong pace will stop soon



Source: Macquarie Research, February 2011

London cocoa futures – rallying due to uncertainty in Ivory Coast



Source: Macquarie Research, February 2011

Macquarie Agri-view

Near term supply risks are rising for cocoa

Feature article

- The political unrest in Ivory Coast is not getting any better, while sanctions are crippling the cocoa sector. Cocoa supplies out of the country risk grinding to a halt if the one-month ban imposed on exports is extended into Mar/Apr, when the mid crop commences. Although the global cocoa market is still forecast to be in surplus, the market should prepare for major supply disruptions out of Ivory Coast. This, in turn, will raise the upside risks for prices in the short term to $3,700/t as we approach the second quarter.

Latest market update

- **Sugar** prices moved sideways this week, after retreating to 30c/lb last Friday. The continued deferral of demand by consumers and importers in view of high front month prices is dampening prices. The white sugar premium is particularly under pressure due to weak refinery demand and good availability of Thai and Indian whites (Macquarie remains of the view that this premium will have to rise sharply in H2 when the refined market is set to tighten). Signs of easing food inflation in India, coupled with growing pressure from mills complaining of declining margins, are reigniting speculation that India may export 500kt of sugar next month. Good rains in CS Brazil, along with brownfield expansion in sugar production capacity should see 1-2mt of additional sugar production in the upcoming crop. However, as explained in our report last week, the market will need this, as import demand is set to intensify from next quarter.

- **Coffee** futures soared to yet new highs to 267c/lb this week amid a lack of origin sales, new speculative interest and industry buying. Roasters are still not adequately covered, and remain a supportive factor to the rally as they keep buying on dips. Despite data from Central America showing a rise in exports in the Oct-Jan season so far from last year, this has failed to prevent the rally in price. Instead, the market is looking to the prospects of a smaller mitaca crop in Colombia next quarter (the current supply problems due to the truck strike notwithstanding), as well as the daunting “off year” in Brazil. With Brazilians around 75% sold out of the old crop, and ICE stocks continuing to fall, the scramble to secure good quality coffee will intensify, and we remain very bullish the Arabica market.

- **Cotton’s** gravity-defying ascent took prices closer to the 200c/lb mark this week. A series of limit-up prices moves on ICE have seen cotton futures rise over 40% since beginning 2011. Even at these lofty prices it is clear that demand destruction is proving to be much harder than thought, with entities across the mills/textiles/retail chain successfully passing on or absorbing the cost increases. The still-strong US export sales pace is creating a sense of panic that US cotton supplies will dry out in a few months - well before the new crops are due, further depleting ending stocks. Strong price increases in corn, wheat and soybeans is also spilling over to forward dated cotton futures, which needs to remain attractive enough on a comparative basis to ensure it gains maximum acreage during the upcoming US planting period

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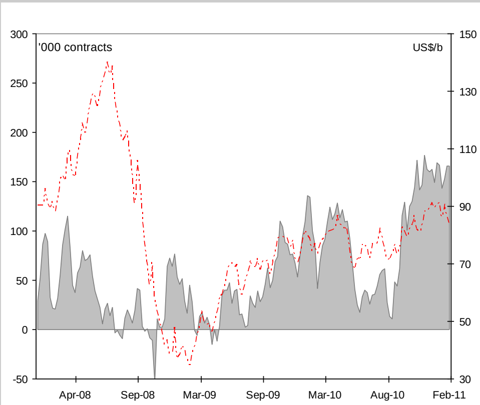
18 February 2011

GLOBAL

WTI net spec futures position vs price



Source: CFTC, Macquarie Capital (USA), February 2011

WTI futures two-week trading action

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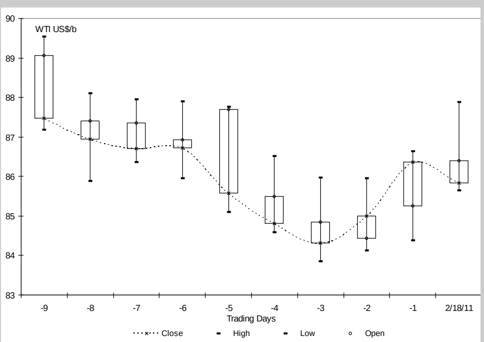

Source: Bloomberg, Macquarie Capital (USA), February 2011

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18 February 2011

Oil market: week in review

Spreading unrest in the Middle East

- Brent was slightly higher week over week, gaining +1.6% to just over US$103/b, while WTI continued to show relative weakness, ending the week up +0.6% near US$86/b. Brent's premium to WTI is slightly lower but still above US$16/b. The week's economic calendar continued to show a strengthening US recovery, though continued and rising tensions in the Middle East have remained a cause for concern. Spot correlation between crude and other macro benchmarks (FX, equities and US treasuries) was insignificant. DOE data was constructive for the first time in several weeks, with a small headline crude build, a large draw in product stocks, and a healthy rebound in demand. The CFTC report showed no change in non-commercial net futures positions, while total open interest increased to a new 40-month high.
- Equity markets had another strong week, rallying to end the week at new pre-crisis highs on Friday. The S&P500 gained +1.0% w/w to close above 1342.
- Looking forward, we are becoming increasingly concerned with the unrest in the Middle East and Northern Africa, and continue to keep a close watch on the region, but particularly the oil producing nations.

CFTC Commitments of traders report

Disaggregated data on WTI crude oil contracts ('000 contracts)

	NYMEX WTI	1 week chg	1 month chg
Non-Commercial			
Net Position	165514	6	-1037
Producer/Merchant			
Long	263053	-19260	-4975
Short	459320	-949	35767
Net Position	-196267	-18311	-40742
Bullish (%)	-42.7%		
Swap Dealers			
Long	237017	3040	19332
Short	257306	-19725	-14357
Net Position	-20289	22765	33689
Bullish (%)	-7.9%		
Managed Money			
Long	218807	-11808	-29366
Short	55137	2954	-1833
Net Position	163670	-14762	-27533
Bullish (%)	296.8%		
Other Reportables			
Long	102360	9885	23703
Short	100516	-4883	-2793
Net Position	1844	14768	26496
Bullish (%)	1.8%		
Non-Reportables			
Long	111349	1613	14964
Short	60307	6073	6874
Net Position	51042	-4460	8090

Source: CFTC, Macquarie Capital (USA), February 2011

Macquarie
Commodities Research

The Global Commodities Specialist

GLOBAL

Shanghai Futures Exchange

		Week on week
Cash price	**RMB/t**	**% change**
Copper	73,100	-1.81
Aluminium	16,845	-0.53
Zinc	19,450	2.61
Stocks	**Tonnes**	**Change**
Copper	161,062	16,845
Aluminium	426,978	4,378
Zinc	332,302	**5,682**
Open Interest	**Contracts**	**% change**
Copper	329,596	-3.75
Aluminium	250,686	1.68
Zinc	414,942	14.24
Other prices (from Antaike)		
Cash price	**RMB/t**	**% change**
Alumina	2,800	-1.80
Nickel	215,500	-0.69
Lead	17,250	0.58
Tin	203,000	6.70
Steel prices (From Mysteel)		
Cash price	**RMB/t**	**% change**
HR coil (3mm)	4,880	-1.0
CR coil (1mm)	5,775	1.1
Galvanised (1mm)	5,765	0.3
Rebar (20mm)	4,755	-1.7
SHFE Steel futures	**RMB/t**	**% change**
Rebar (1 month forward)	5,061	-0.1
Rebar (3 month forward)	4,934	-3.2
Wire rod (1 month forward)	5,005	3.2
Wire rod (3 month forward)	4,767	-3.9
Iron ore import (from TSI)		
CFR N. China port	**$/t**	**% change**
62%Fe	189.3	-1.4
58%Fe	163.3	-0.3

Exchange rate	
US$/Rmb	6.57

Source: LME, Comex, Nymex, SHFE, Metal Bulletin, Reuters, LBMA, Macquarie Research, February 2011

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18 February 2011

China Commodity Call

Chinese aluminium market tight in 2H10 and 1H11; China steel update

- This week we assess the Chinese aluminium market for 2010 and 2011. We believe that Chinese aluminium stocks fell by 450kt last year, compared to a 760kt increase in 2009.

Capacity ramp up slower than anticipated

- The major reason for this year's deficit is the slower than anticipated ramp up in smelter capacity following last year's closures. In addition, the commissioning of new projects has also been slow reflecting concerns over the tightening of liquidity and deterioration of domestic aluminium prices since 4Q last year.
- The combined impact of idled capacity means the market will be getting tighter as we move into what is traditionally the peak demand season over the second quarter.

Capacity ramp up slower than anticipated

- Assuming no further release of material from SRB warehouses, we believe Chinese aluminium inventory at reported warehouses will fall to 7-8 days of consumption over the coming quarter. This will lead to solid support for aluminium prices in the next 3-4 months.

Steel prices pulled back this week

- After rising for 13 consecutive weeks, Chinese steel prices pulled back this week with rebar down 1.7% to RMB 4755/t ($618/t ex Vat) and HRC down 1.0% to RMB 4755/t ($634/t). With steel prices lacking momentum, spot iron ore prices also levelled out, with TSI reporting prices for 62% Fe material at $189.3/t CFR N.China, up only 0.2% WoW.

We check in with mills and traders

- In an attempt to gain some insight into why the market is pausing, we spoke to several smaller Hebei based steel mills and we visited the steel market in Shanghai to talk to traders.
- There appears to be a gap in the timing of the upstream restock and the return of end users to the market following the holiday period, and this has lead to very thin transactions over the last week. We expect the return of end users to the market over the coming weeks to drive another leg of demand driven price increases.

GLOBAL

LME cash price

	US¢/lb	% change day on day
Aluminium	115	2.2
Copper	448	0.5
Lead	121	3.0
Nickel	1321	2.3
Tin	1465	2.2
Zinc	115	1.7
Cobalt	1828	0.1
Molybdenum	1764	0.0

Other prices

		% change day on day
Gold (US$/oz)	1384	0.3
Silver (US$/oz)	31.94	4.3
Platinum (US$/oz)	1836	0.1
Palladium (US$/oz)	847	1.0
Oil WTI	85.00	-0.1
USD : EUR exchange rate	1.370	0.7
AUD : USD exchange rate	1.015	0.2

LME/COMEX stocks

	Tonnes	Change
LME Aluminium	4,593,175	-5,025
LME Copper	407,925	725
Comex Copper	72,508	1,868
Lead	296,975	-225
Nickel	129,396	-528
Tin	17,610	0
Zinc	708,775	-100

Source: LME, Comex, Nymex, SHFE, Metal Bulletin, Reuters, LBMA, Macquarie Research, February 2011

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18 February 2011

Commodities Comment

Building a stronger 2011

- We review the outlook for global construction, with Chinese construction likely to slow but not disastrously, with construction in the G3 likely to add to the commodity demand for the first time in 3 years.

Latest news

- Copper fell 1.1% over the week and underperformed on Friday, with ex-China exchange stocks rising by 14,498t over the week and SHFE stocks up 16,865t over the week. Aluminium rose by 2.6% over the week to their highest level since before the 2008 crisis, as SHFE aluminium stocks fell by 4,378t to 426,978t. We expect aluminium draws will continue over the coming month.
- Nickel was also stronger over the week, up by 3.0% to $29,123/t (13.21/lb). Demand for nickel and ferrochrome is rising as a function of strong stainless steel production, notably in China, where stainless steelmakers use a higher proportion of primary raw materials than in other major producing regions since stainless steel scrap is less readily available. Spot market prices are rising in response and we anticipate that producers will be in a position to secure higher contract prices for 2Q11. At this stage a rise in a range from about 5-10c/lb might be anticipated. The European headline contract price for South African charge chrome was settled at 125c/lb delivered duty paid in 1Q11.
- Vale is set to lose an estimated 15,000t of finished nickel output this year owing to a stoppage of one of the two furnaces at its Copper Cliff smelter in Sudbury, Canada. Due to an unspecified problem the No 2 furnace will remain shut for a minimum of 16 weeks. The loss will account some 5% of Vale's total nickel production planned for 2011, the company said on Friday.
- Australia's Minara Resources reported a 14% YoY fall in year nickel production of 28,378t (2% of world total) in 2010, which was broadly in line with our expectations. The company has said that it expects to produce 33-37,000t in 2011. Our current estimate is towards the lower end of this range.
- China's Securities Regulatory Commission has given the greenlight for the Shanghai Futures Exchange (SFE) to launch a lead futures contract. The SFE has not yet said when it intends to introduce such a contract but we anticipate its introduction would be positive for lead prices.
- Anglo released more details on the impact of the "catastrophic failure" which occurred at the shiploader at Collahuasi's Patache port in its 2010 annual report, stating that the port will be repaired during the 1Q11. Lost shipments were around 20,000t in December according to Anglo, and from this we estimate at least 30-40,000t of copper was not shipped as per plan over the past 3 months. Anglo also noted that the 35-40ktpa Barro Alto nickel project ended the year 99% complete, remaining on schedule to deliver first production in the first quarter of 2011.
- Meanwhile, the Anglo's Los Bronces copper expansion project in Chile is on schedule for first production in the fourth quarter of 2011. The growth in supply from this project, of 200,000t, is the largest single addition for copper output in 2012 relative to 2011, so its development is worth watching. In iron ore, the Minas-Rio iron ore project in Brazil should be commissioned in 2H13, subject to a number of licences and permits being obtained during the next 6 months.

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Recommendation definitions

Macquarie - Australia/New Zealand
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

Macquarie – Asia/Europe
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 (Buy) – return >5% in excess of Russell 3000 index return
Neutral (Hold) – return within 5% of Russell 3000 index return
Underperform (Sell)– return >5% below Russell 3000 index return

Volatility index definition*

This is calculated from the volatility of historical 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/Canada stocks only

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

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 31 December 2010

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	46.38%	62.62%	52.17%	44.99%	67.57%	50.90%	(for US coverage by MCUSA, 13.59% of stocks covered are investment banking clients)
Neutral	37.68%	18.58%	34.78%	50.61%	28.83%	35.48%	(for US coverage by MCUSA, 15.22% of stocks covered are investment banking clients)
Underperform	15.94%	18.80%	13.04%	4.40%	3.60%	13.62%	(for US coverage by MCUSA, 0.00% of stocks covered are investment banking clients)

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Asia Sales

Regional Heads of Sales

Robin Black (Asia)	(852) 3922 2074
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Peter Slater (Boston)	(1 617) 598 2502
Jeffrey Shiu (China & Hong Kong)	(852) 3922 2061
Thomas Renz (Geneva)	(41) 22 818 7712
Andrew Mouat (India)	(9122) 6653 3200
Kenneth Yap (Indonesia)	(6221) 515 1555
JJ Kim (Korea)	(822) 3705 8799
Jason Lee (Malaysia)	(603) 2059 8888
Chris Gould (Malaysia)	(603) 2059 8888
Gino C Rojas (Philippines)	(632) 857 0761
Greg Norton-Kidd (New York)	(1 212) 231 2527
Luke Sullivan (New York)	(1 212) 231 2507
Eric Roles (New York)	(1 212) 231 2559
Sheila Schroeder (San Francisco)	(1 415) 762 5001

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Miki Edelman (Taiwan)	(8862) 2734 7580
Angus Kent (Thailand)	(662) 694 7601
Michael Newman (Tokyo)	(813) 3512 7920
Angus Innes (UK/Europe)	(44) 20 3037 4841
Rob Fabbro (UK/Europe)	(44) 20 3037 4865
Sean Alexander (Generalist)	(852) 3922 2101

Regional Head of Distribution

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Sales Trading

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Phil Sellaroli (Japan)	(813) 3512 7837
Matthew Ryan (Singapore)	(65) 6231 2888
Mike Keen (Europe)	(44) 20 3037 4905

Sales Trading cont'd

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Stanley Dunda (Indonesia)	(6221) 515 1555
James Aitchison (Korea)	(822) 3705 9990
Kenneth Cheung (Malaysia)	(603) 2059 8888
Michael Santos (Philippines)	(632) 857 0813
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Alternative Strategies

Convertibles - Roland Sharman	(852) 3922 2095
Depository Receipts – Seung-Jin Lee	(65) 6231 1150
Derivatives – Mark Holland	(852) 3922 2081
Futures - Tim Smith	(852) 3922 2113
Structured Products - Andrew Terlich	(852) 3922 2013