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India Market Outlook

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PREPARED BY BNP PARIBAS SECURITIES ASIA

Time to revisit sectors and stocks

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- **Shift in source of growth from stimulus-driven consumption to industrial production.**
- **We expect acceleration in credit growth and IP; yield curve to flatten as rates tighten.**
- **Feedback from conference: buoyant consumer demand and government policies will likely help capital flows and infrastructure build-out.**
- **Overweight: banks, autos, infrastructure, IT, utilities and pharmaceuticals.**

Some things have changed, some haven't

Since our previous rebalancing of the model portfolio ("Changes in our model portfolio", dated 14 Jan 2010), bank credit growth, which was hovering at 11-12% around late December, has accelerated to c15%. Industrial growth, rather than consumption growth, is clearly driving economic growth, as we anticipated. Some other data points are new. 1) The recent budget signals fiscal consolidation, albeit by relying on one-off non-tax revenue than on reducing expenditure or by increasing the tax-to-GDP ratio. 2) The budget also provides additional impetus to consumer discretionary with the tax-slab adjustments, leading to an increase in personal disposable income. 3) From our recently concluded Investors' Conference at Delhi, the key message was that the policy framework in all departments (finance, urban development, roads, external affairs, telecom) would focus on facilitating: a) foreign capital inflow, b) acceleration in infrastructure build-out and flow of private capital to infrastructure, and c) access to free trade.

Slight changes to earnings estimates; retain Sensex target at 21,000

Recent earnings revisions from India BNPP analysts have led to earnings growth forecasts declining in energy (particularly Reliance Industries) and increasing in autos (Tata Motors), real estate (DLF) and IT (Wipro). We forecast 31% Sensex EPS growth for FY11 and 15% for FY12. After the recent earnings revisions, BNPP's estimates for Sensex EPS are INR840 for FY10, INR1,096 for FY11 and INR1,264 for FY12. On these estimates, the Sensex would trade at 15.6x 1-year forward PE – only 3% higher than the long-term average of 15.1x. On P/BV, Sensex would trade at 15.6x versus the 10-year average of 15.1x.

Overweight: banks, auto, infrastructure, IT, utilities, pharma; Neutral: property

Our sector allocation remains largely intact. We continue to prefer the interest-rate sensitivities. We include property (through IBREL), where we had zero weight earlier. Within banks, we exclude Union Bank, include HDFC Bank, reduce weight on PNB and increase weight on ICICI. Clearly, we move away from PSU banks to private banks. Within utilities, we allocate more weight to merchant-power plays through the inclusion of Adani Power. Within IT, we now focus entirely on IT services; we exclude Tech Mahindra and allocate the weight to Infosys. We also increase weight on Reliance Industries, as we believe the period of severe underperformance for the stock has come to an end.

Top picks: Axis Bank, Dr Reddy's, M&M, IRB and TCS

Our top picks tie-in with the themes that we highlight. Credit-growth acceleration, infrastructure build-out (particularly roads, urban infrastructure and power), increased boost to consumption leading to further acceleration in discretionaries, and healthy cash flows from companies in developed economies leading to higher IT spending are the key investment themes to consider. We try to find reasonably valued exposures for these themes.

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What's changed and what hasn't

Since our previous rebalancing of the model portfolio (14 January 2010), macro-economic variables have panned out largely in line with our expectation. Bank credit growth, which was hovering at 11-12% around late December, has now accelerated to c15%. Industrial growth, rather than consumption growth, is clearly driving economic growth, as we anticipated. Some other data points are new, which we have taken into account in reshuffling our portfolio.

1) The recent budget signals fiscal consolidation, albeit by relying on one-off non-tax revenue rather than on reducing expenditure or by increasing the tax-to-GDP ratio. We believe this should allay concerns about possible crowding out of private investment by the large government-borrowing program and a near-term spike in sovereign bond yields.

2) The budget also provides additional impetus to consumer discretionary with the tax-slab adjustments, leading to INR50,000/annum additional disposable income for annual income levels of INR800,000 or above.

3) From our recently concluded Investors' Conference at Delhi, the key message about future policy direction was that policy framework in all departments (finance, urban development, roads, external affairs, telecom, to name a few) would focus on facilitating: a) foreign capital inflow, b) acceleration in infrastructure build-out and flow of private capital to infrastructure (particularly roads, power, urban infrastructure, irrigation), and c) access to free trade.

4) Feedback from corporates at the conference also suggests that domestic demand will likely remain strong, which may help to kick-start corporate capex (possibly towards 4Q10) as current capacity utilization levels are high for most industries.

It is also necessary to take a look at broader market valuations and relative valuations across sectors to arrive at sector-specific and stock-specific recommendations.

Where is the market headed?

Recent earnings revisions from BNPP analysts have led to earnings growth forecasts declining in energy (particularly Reliance Industries) and increasing in autos (Tata Motors), real estate (DLF) and IT (Wipro). We forecast 31% Sensex EPS growth for FY11 and 15% for FY12.

Exhibit 1: Sensex Earnings Growth

(%)	2010E	2011E	2012E
Auto	1104	48	33
Banks and FIs	15	31	21
Pure cement	(4)	12	(4)
IT Services	15	11	19
Conglomerates	27	(4)	20
Engineering	32	24	16
Consumer staples	19	17	16
Metals	(75)	251	4
Oil & Gas	14	11	7
Petrochemicals	9	47	11
Pharmaceuticals	(7)	6	18
Power	(4)	12	(2)
Telecom	(6)	(6)	13
Property	(62)	47	17
Sensex	4	31	15

Source: BNP Paribas estimates

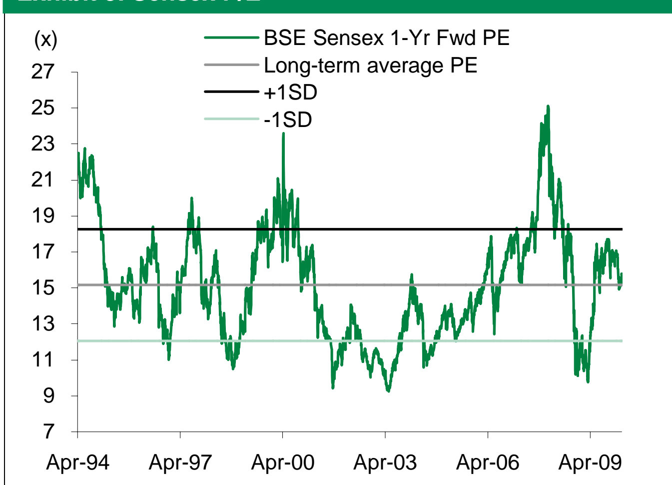
Exhibit 2: Sensex P/E And PEG

	SENSEX P/E				PEG ratio	
	2009E	2010E	2011E	2012E	(09-10F)	(10-12F)
Auto	192.1	20.4	13.7	10.3	0.7	0.5
Banks and FIs	24.1	20.7	15.8	13.0	1.0	0.8
Pure cement	15.9	16.5	14.7	15.4	4.3	4.7
IT Services	25.9	22.5	20.3	17.0	2.0	1.5
Conglomerates	11.6	9.2	9.6	7.9	1.1	1.2
Engineering	35.1	26.7	21.4	18.5	1.3	1.3
Consumer staples	28.4	23.9	20.5	17.6	1.6	1.5
Metals	10.5	40.6	11.6	11.1	(2.2)	0.4
Oil & Gas	12.9	11.3	10.2	9.6	1.0	1.3
Petrochemicals	24.5	22.5	15.2	13.7	0.9	0.8
Pharmaceuticals	37.0	18.4	17.4	14.8	0.8	1.6
Power	18.4	19.1	17.1	17.5	5.1	4.2
Telecom	10.9	11.6	12.3	10.9	(1.9)	3.6
Property	13.9	36.7	24.9	21.3	(0.5)	1.2
Sensex	20.8	20.7	15.9	13.8	1.4	0.9

Source: BNP Paribas estimates

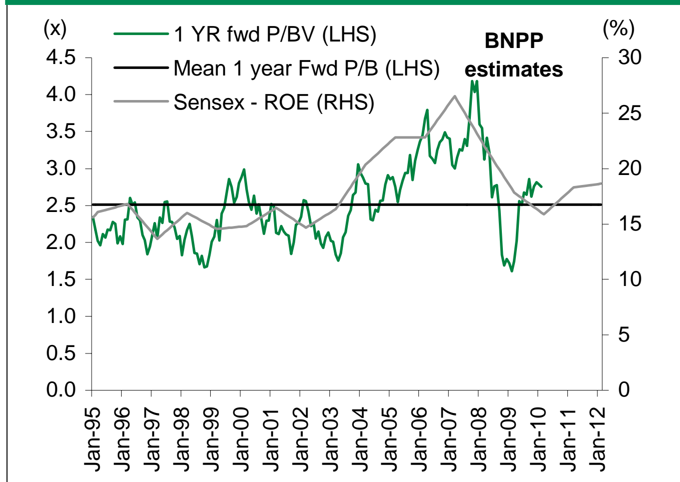
After the recent earnings revisions, BNPP's EPS estimate for Sensex is Rs840 for FY10, Rs1,096 for FY11 and Rs1,264 for FY12. On these estimates, Sensex would trade at 15.6x 1-year forward PE – only 3% higher than the long-term average of 15.1x. On P/BV, Sensex would trade at 2.67x, versus the 10-year average of 2.57x. However, we see significant divergence between the valuations of different sectors on a "nominal" basis and on a "growth-adjusted" basis (i.e. PEG).

Exhibit 3: Sensex P/E



Sources: Bloomberg

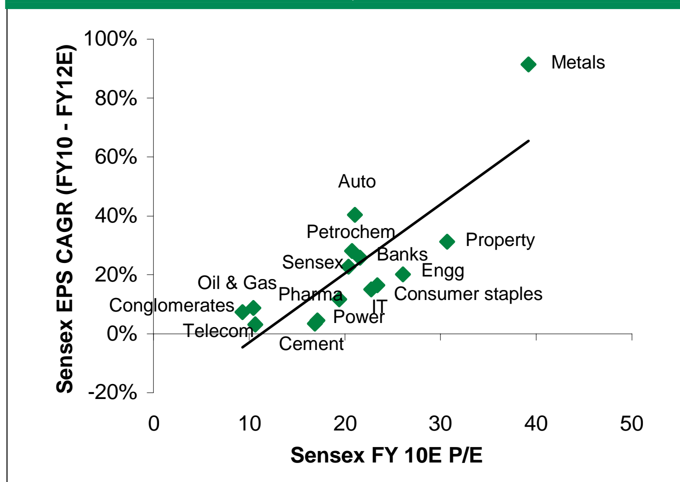
Exhibit 4: Sensex P/BV (x)



Sources: Bloomberg

The difference in growth-adjusted valuation multiples becomes even more apparent when one considers PE relative to earnings growth.

Exhibit 5: Sensex EPS CAGR, FY10-12E



Sources: BNP Paribas estimates

Our Sensex target by end-2010 is unchanged at 21000, based on BNPP's EPS estimates of INR1,096 for FY11 and INR1,264 for FY12. At our target index, the Sensex would trade at a 1-year forward PE of 17.3x – 11% higher than the current Sensex PE.

Bottom-up Sensex target

In the past 4-5 months, bottom-up forecasts of our analysts have turned significantly more bullish. There has been a significant increase in our earnings estimates and price targets for the auto and property sectors. Price targets have also increased for energy (Reliance) despite the decline in earnings estimates. BNPP oil & gas analyst, Amit Shah, has ascribed a mid-cycle multiple to the refining and petrochemical business in view of the bottoming out of margins in these businesses. Price targets have also increased in IT and autos as our analysts have become more confident of margin expansion by cost-cutting in auto and by demand recovery supporting top line for IT companies. As a consequence, our bottom-up Sensex target has increased from 17,100 in November 2009 to 18,619 now.

Exhibit 6: Bottom-Up Sensex Target

Stock	BBG code	CP (INR)	Price target (INR)
Hero Honda	HHI IN	1,913	1,800
M&M	MM IN	1,122	1,200
Maruti	MSIL IN	1,478	1,675
Tata Motors	TTMT IN	797	900
HDFC	HDFC IN	2,611	3,000
HDFC Bank	HDFCB IN	1,784	1,900
ICICI Bank	ICICIBC IN	923	1,050
SBI	SBIN IN	2,065	2,700
ACC	ACC IN	990	604
Infosys	INFO IN	2,659	3,100
Tata Consultancy Serv	TCS IN	762	910
Wipro	WPRO IN	697	790
Grasim Industries	GRASIM IN	2,822	2,467
Larsen & Toubro	LT IN	1,603	1,541
Jayprakash Associates*	JPA IN	148	266
BHEL	BHEL IN	2,431	2,343
Hindustan Unilever	HUVR IN	239	300
ITC	ITC IN	251	297
Sterlite Industries*	STLT IN	813	876
Hindalco	HNDL IN	166	129
Tata Steel*	TATA IN	622	542
ONGC	ONGC IN	1,100	1,363
Reliance Industries	RIL IN	1,004	1,010
Sun Pharma	SUNP IN	1,640	1,695
Tata Power	TPWR IN	1,346	933
NTPC	NATP IN	205	265
Reliance Infra	RELI IN	1,019	1,266
Bharti-Airtel	BHARTI IN	293	300
Reliance Communication	RCOM IN	164	150
DLF	DLFU IN	317	249
Implied bottom-up Sensex price target			**18,619**

*Source: * Bloomberg consensus target prices; all others are BNP Paribas estimates*

What to expect going forward

We expect:

1) Further acceleration in credit growth and IIP growth.

2) Increase in benchmark interest rates, but no immediate changes to banks' deposit rates or lending rates.

3) Flattening of the yield curve as the RBI begins to sterilize short-term liquidity as the government's borrowing program for FY10 is almost over and FY11 borrowing is unlikely to crowd out private borrowing.

Automobiles: retain Overweight but with reduced weight

We retain Overweight and our relative preference for four-wheeler and CV players, owing to the continued buoyancy in industrial production and high pricing power. CV demand has

high correlation to industrial production. Our Asia economist, Richard Iley, expects 9-10% industrial production growth for India in FY11-12, so we believe CV demand will stay robust for the next couple of years. Four-wheeler manufacturers still retain considerable pricing power, as evidenced by the full pass-through of excise duty hikes in the budget. Both long-term (under-penetration and increasing urbanization) and short-term (higher disposable income, availability of financing and improvement in job market) drivers of auto demand remain in place, in our view. Higher disposable income as a result of tax cuts should more than offset the higher financing costs due to the rise in interest rates and potentially higher car prices due to the increase in input cost. We add to our weight on M&M and reduce Exide in an attempt to find low-valuation exposure to the auto sector.

Banks: retain Overweight; shift bias to private banks

As highlighted above, credit growth has recovered as we expected and is likely to accelerate along with the infrastructure build-out and eventual corporate capex. As growth accelerates the RBI is likely find it more justifiable to hike rates. We anticipate a 100-125bps tightening in FY11. We expect yield curve to flatten on possible monetary tightening and withdrawal of short-term liquidity, particularly as the overhang from the aggressive government-borrowing program recedes. We shift our portfolio focus to private banks, on account of:

1) strong retail-deposit franchise, which we believe will allow them to withstand any margin pressure from liability repricing in a rising interest-rate environment;

2) an improvement in asset quality, due to the peaking of retail delinquencies and lack of widespread restructuring of corporate and SME loan portfolio;

3) higher incremental loan growth prospects in an environment of rapidly rising credit growth, which should support margins through higher LDR as funding costs increase;

We increase weight of ICICI Bank in our portfolio, as we believe balance-sheet growth will start as the 4Cs (CASA, Cost Control, Credit Quality, Capital) appear in place. We also add HDFC Bank to our portfolio as, we believe, its liability franchise will stand the bank in good stead in a rising interest-rate environment. We fund these changes by reducing weights of Axis Bank and PNB and by excluding Union Bank. These banks have been relative outperformers in the recent past and they have a relatively high proportion of stressed assets.

Engineering and capital goods: retain Overweight

Infrastructure development, along with inclusive growth, is at the top of the government's priority list. The recent budget sharply increases the plan allocation by 30-35% for key sectors, such as roads and power, even in the face of the tight fiscal situation. Corporate and policy-makers who presented at our conference highlighted the fact that other bottlenecks to infrastructure build-out, such as land acquisition and concession agreements for PPP projects, are close to resolution. Therefore, we retain our Overweight stance on the engineering and capital goods segments. We turn more positive on Crompton Greaves, due to the continued momentum in orders from the domestic T&D segment, revival in order flow in the Industry segment and potential for medium-term improvement in European business margins. Another medium-term trigger could be if Crompton Greaves finalizes its plans to list its power subsidiary, Avantha Power.

Energy: maintain Underweight, but with higher allocation

The sector has underperformed the benchmark index in the past couple of quarters. Following the upgrade of Reliance Industries to HOLD (see report, "On an even keel" dated 15 Feb 2010) by our analyst, Amit Shah, we believe it is time to increase portfolio allocation to the sector. As highlighted in our note "Refining bottom in sight", dated 17 Feb 2010, Amit believes that refining margins have bottomed as product prices remain stable. However, he does not expect a strong recovery in margins as demand for high-margins products remains subdued. Potential catalysts for RIL stock could be news flow from the ongoing court case with RNRL and news flow regarding the proposed acquisition of Lyondell Bassell. On the latter, Amit believes RIL is unlikely to overpay, which could come as a relief to the market.

Property: Neutral

We increase allocation to the property sector from zero weight previously to Neutral. Our Underweight call on the sector has been counter-consensus. The sector has been a large underperformer in the past quarters, so we believe it is time to increase exposure to the sector. However, as highlighted in our 24 Feb 2010 note, "Hinged on Office recovery", residential real-estate volumes have picked up on the back of availability of easy financing and more affordable pricing. On the commercial-property front, our analyst, Sandeep Matthew, does not expect a strong recovery in FY11. We add Indiabulls Real Estate to our portfolio as the stock on our forecasts is trading significantly below its mid-cyclical averages and, hence, we believe offers better risk-adjusted returns. Moreover, investors' concerns about the company post the change in auditors appears to have abated with management clarification.

Consumer staples: retain Underweight

We now play the consumer-staples sector only through ITC. Notwithstanding the tax increase on cigarettes in the recent budget, we retain ITC in our model portfolio and increase its weight post the stock's policy-driven underperformance. As highlighted in our budget note, "Decent deal on the whole", dated 26 Feb 2010, cigarette demand is relatively inelastic – ITC has, historically, been able to pass on duty hikes and maintain both revenue growth and market share. ITC's non-cigarette businesses, which until now were an overhang on the stock, particularly FMCG and hotels, are showing considerable improvement. The company expects the non-tobacco business to break-even in FY11.

IT services: maintain Overweight; shift allocation to tier-I players

Our IT analyst, Abhiram Eleswarapu, has noted in the sector report, "More evidence of a solid FY11", dated 10 Feb 2010,

that healthy US corporate free cash flows will drive increased spending on technology. Recent deal flow trends suggest that cost efficiency has been the biggest driver of IT outsourcing decision-making, which underpins our belief, confirmed by channel checks, that Indian vendors will likely gain market share in the IT-services segment. Moreover, we see evidence of broadbasing of offshore services demand from BFSI to retail, telecom and possibly manufacturing. Recent salary-hike announcements and INR appreciation have raised doubts about the sustainability of IT players' EBIDTA margins. However, we believe there exist levers within the system, in the form of capacity utilization, which should protect margins in such a scenario. Abhiram believes that in the current environment larger players offer relatively low risk exposures. We, therefore, exclude Tech Mahindra from our model portfolio, but reallocate its weight to Infosys, due to its sector capability (strengths in financial services, telecom and manufacturing) and margin levers (comparatively lower utilization rates and hedging policies).

Utilities: maintain Overweight; increase allocation to merchant players

We continue to maintain our Overweight on Utilities, but with a reduced weight, as we believe the current procyclical growth environment offers better opportunities elsewhere. We also fine-tune our stock selection. We include Adani Power, funding it by reducing weight on NTPC. Our utilities analyst, Girish Nair, believes Adani Power will be able to execute its planned 10-fold rise in power-generation capacity given the track record of the promoters. As highlighted in our initiation report, “The live wire”, dated 1 Mar 2010, even with our conservative merchant-power tariff assumptions, we expect Adani Power to deliver strong revenue and EBIDTA growth in FY11-13. We believe the company should trade at a premium valuation given its growth prospects.

Performance of our model portfolio

Since its inception on 14 November 2008, the BNP India model portfolio has significantly outperformed its benchmark, the MSCI India. Since its inception on 14 November 2008, the BNP India model portfolio has returned 135%, while the MSCI India has returned 105%. Post inception of our portfolio, we have had four rebalancings (prior to today) – on 24 April, 6 July and 3 August and 13 January. A notional USD100 invested in our portfolio on 14 Nov 2008 would be worth USD238.6 today, while the same amount invested in the MSCI India would be worth USD211.1.

A look at Exhibit 8 shows that for the first half of this period, the portfolio performed in line with the benchmark. The portfolio started outperforming around late May, primarily due to our large exposure to private banks (ICICI Bank, Axis Bank), Infrastructure (IVRCL, BHEL) and select consumer discretionaries (especially M&M).

Exhibit 7: Top Picks – Valuation

	Share price (INR)	Target price (INR)	Rating	EV/EBITDA ‘09 (x)	EV/EBITDA ‘10E (x)	EV/EBITDA ‘11E (x)	P/E ‘09 (x)	P/E ‘10E (x)	P/E ‘11E (x)	P/BV ‘09 (x)	P/BV ‘10E (x)	P/BV ‘11E (x)	3-mth avg daily vol (USD m)
Top BUYs													
Mahindra & Mahindra	1,122	1,200	BUY	10.44	7.65	7.03	20.47	13.54	10.68	4.09	3.23	2.57	28.0
Axis Bank	1,129	1,250	BUY	-	-	-	21.63	16.65	13.44	3.87	2.78	2.40	45.2
IRB Infrastructure	261	293	BUY	22.90	11.84	9.12	48.69	23.64	15.93	4.95	4.20	3.39	8.5
Dr Reddy's Laboratories	1,169	1,363	BUY	14.51	14.86	12.01	-	22.66	17.14	4.64	3.96	3.29	13.7
Tata Consultancy Services	762	910	BUY	20.75	17.01	14.22	28.86	22.03	19.34	9.47	7.09	5.59	33.9
Top SELLs													
ABB India	846	623	REDUCE	28.15	18.93	14.93	49.12	33.52	26.15	7.16	6.01	4.98	5.8
Reliance Communications	163	150	REDUCE	5.55	6.98	7.17	5.76	7.52	8.84	0.86	0.79	0.71	38.8
DLF Ltd	317	249	REDUCE	11.20	18.84	15.83	12.07	30.62	20.82	2.23	2.08	1.91	114.8

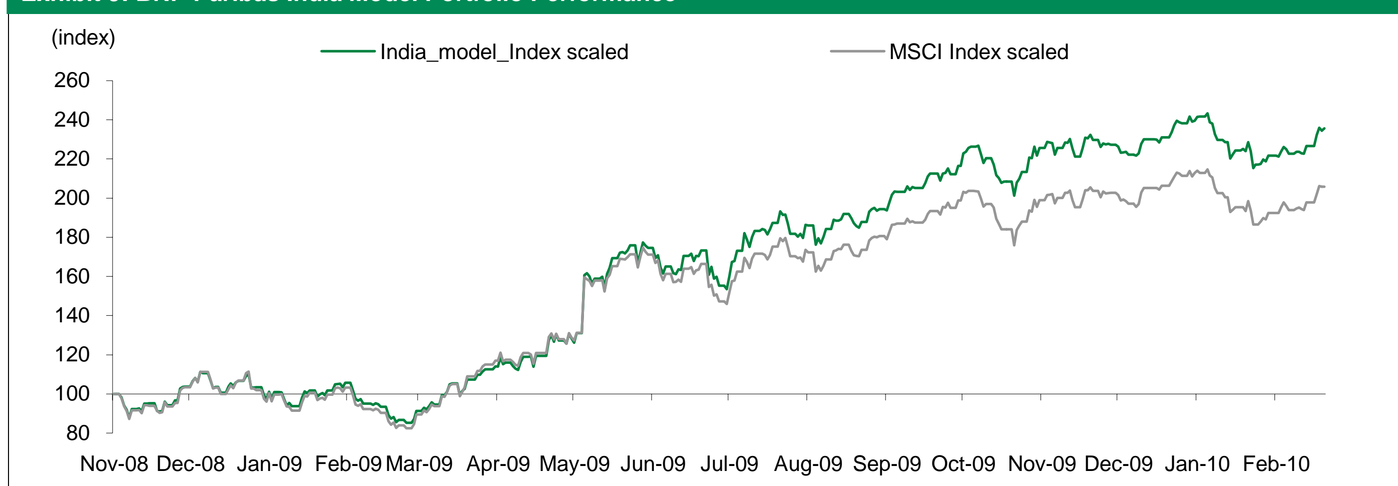
Notes: ABB (ABB IN); Dr Reddy’s (DRRD IN); IRB Infrastructure (IIRB IN); Axis Bank (AXSB IN)
Source: BNP Paribas estimates

Exhibit 8: BNPP Model Portfolio

Sector	Sector stance	Stock	Recommended stock weight (%)	Weight of stock in benchmark (%)	BNPP rating	Sector wt in portfolio (%)	Sector wt in benchmark (%)
Auto	Overweight	Maruti	2	0.9	BUY	7.0	5.6
		M&M	3	1.5	BUY		
		Ashok Leyland	2	1.5	BUY		
Capital goods/engineering	Overweight	BHEL	4	2.5	HOLD	12.0	8.5
		Crompton Greaves	4	—	HOLD		
		IRB Infrastructure	4	—	BUY		
Telecom	Neutral	Bharti Airtel	2	—	BUY	2.0	1.3
Pharmaceuticals	Overweight	Sun Pharma	2	1.0	BUY	6.0	3.9
		Aurobindo Pharma	2	—	BUY		
		Dr Reddy's Lab	2	1.0	BUY		
Banks	Overweight	ICICI Bank	6	6.0	BUY	24.0	21.0
		Axis Bank	4	1.7	BUY		
		HDFC	4	4.9	HOLD		
		HDFC Bank	4	4.3	BUY		
		SBI	4	1.3	BUY		
		Punjab National Bank	2	1.0	BUY		
Consumer staples	Underweight	ITC	4	2.5	BUY	4.0	5.3
Cement	Neutral	Ultratech Cement	2	—	HOLD	2.0	1.5
IT services	Overweight	TCS	9	3.4	BUY	19.0	17.2
		Infosys	10	11.3	BUY		
Metals	Underweight	JSW Steel	2	0.8	Not rated	4.0	10.1
		Sterlite	2	2.3	Not rated		
Energy	Underweight	Reliance Industries	10	11.8	HOLD	12.0	17.4
		ONGC	2	2.8	BUY		
Utilities	Overweight	NTPC	2	0.3	BUY	6.0	4.9
		Power Grid Corporation	2	0.5	BUY		
		Adani Power	2	—	BUY		
Property	Neutral	India Bulls Real Estate	2	0.7	BUY	2.0	2.5
Total			**100**			**100**	

Notes: Ashok Leyland (AL IN); Crompton Greaves (CRG IN); Aurobindo Pharma (ARBB IN); Punjab National Bank (PNB IN); Ultratech Cement: (UTCM IN); JSW Steel (JSPL IN); Power Grid (PWGR IN); Adani Power (ADANI IN); India Bulls (IBREL IN)
Source: BNP Paribas estimates

Exhibit 9: BNP Paribas India Model Portfolio Performance



Sources: Bloomberg; BNP Paribas

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The analyst(s) named in this report certifies that (i) all views expressed in this report accurately reflect the personal view of the analyst(s) with regard to any and all of the subject securities and companies mentioned in this report; (ii) no part of the compensation of the analyst(s) was, is, or will be, directly or indirectly, relate to the specific recommendation or views expressed herein; and (iii) BNPP is not aware of any other actual or material conflicts of interest concerning any of the subject securities and companies referenced herein.

Recommendation structure

All share prices are as at market close on 8 March 2010 unless otherwise stated. Stock recommendations are based on absolute upside (downside), which we define as (target price* - current price) / current price. If the upside is 10% or more, the recommendation is BUY. If the downside is 10% or more, the recommendation is REDUCE. For stocks where the upside or downside is less than 10%, the recommendation is HOLD. In addition, we have key buy and key sell lists in each market, which are our most commercial and/or actionable BUY and REDUCE calls and are limited to at most five key buys and five key sells in each market at any point in time.

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

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

Should you require additional information please contact the relevant BNP Paribas research team or the author(s) of this report.

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