

India Market Strategy -----Maintain OVERWEIGHT

Radical solutions required for the growing problem of RIL's index weightings

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- Reliance Industries' neutral weights have been rising rapidly, causing problems for all types of long-only institutional investors. The weights in Nifty and MSCI India have crossed 13% and 17%, respectively, and could rise further by 100-200 bp in the months ahead.
- Investors constrained by the ceiling that force them to hold less than 10% of assets under management in the stock have lost over 130 bp of relative performance so far this year simply because of such rules.
- Most foreign investors do not have regulatory constraint holding them back. Such investors should either seek to raise the issue of the limit with their clients or adopt benchmarks like MSCI 10/40 that reduce the tracking error.
- The situation is trickier for local investors. They should urge a regulatory review of the imposed limits or work on popularising a more suitable benchmark with the help of the exchanges.
- Highly underowned Reliance Industries – owned about a third less than the weights in various benchmarks – could begin to command a continuous valuation premium until the ownership constraints are somehow removed or reduced.

The “headache” of RIL outperformance

Long-only investors rarely mind well-deserved, good performance by any stock – except possibly when it comes from Reliance Industries (RELI.BO, Rs1896.00, NEUTRAL [V], TP Rs1424.00) these days. In an otherwise diversified Indian market, RIL's size has begun to create problems for many fund managers. The following table on institutional holding versus neutral weights makes this clear.

Figure 1: On a single stock around 500 bp tracking error and growing

Date	Reliance holding as % of portfolio value					Neutral weight	
	All institutions	Foreign	Local	MFs	Insurers	MSCI India	Nifty wt
12/31/2001	9.5	10.8	8.1	13.5	n/a	n/a	11.9
12/31/2002	9.2	10.4	8.2	12.9	n/a	13.1	12.1
12/31/2003	10.0	13.4	6.2	4.3	n/a	15.0	12.8
12/31/2004	5.7	6.7	4.1	2.5	n/a	12.1	8.3
12/31/2005	5.4	6.3	3.9	2.3	n/a	12.6	9.2
12/31/2006	6.2	6.8	4.9	3.6	7.6	11.5	9.0
12/31/2007	8.0	8.8	6.5	5.3	9.8	15.7	11.9
12/31/2008	7.9	8.9	6.2	5.0	8.7	14.5	10.6
3/31/2009	10.1	11.7	7.8	6.6	10.4	16.9	12.7

Source: CMIE, Bloomberg, MSCI, Credit Suisse estimates.

Institutional investors of all kinds are about 500 bp underweight on RIL, which in most cases is not deliberate but forced. Given the stock's outperformance this year, an average fund manager has likely lost anywhere between 130-180 bp of relative performance simply because of the tracking error on one stock.

The problem could grow further. With the completion of RIL-Reliance Petroleum (RPET.BO, Rs 115.05, Not Rated) merger, the stock's weightings in MSCI India and Nifty could rise by 100 bp and 200 bp, respectively. And this may not be all. With around US\$6 bn of cash on its balance sheet and nearing the end of its major capital expenditure

cycle, there is a possibility that it acquires some large-sized assets globally in the next few quarters. Effectively, one cannot rule out the possibility of the stock's neutral weights moving into the twenties in MSCI India in 2010.

Foreign investors have easier available options

The problem is for benchmark investors. For domestic benchmark investors, there is a regulator-imposed rule that they can not own more than 10% of their assets under management in a single stock. Similar regulatory limits do not exist for those from outside, yet many have such limits either self-imposed or compelled by clients for their Indian portfolio.

For foreign investors who feel constrained by such limits, the first solution should be an attempt to have the limits waived. We calculate that Samsung Electronics (005930.KS, W569,000, NEUTRAL, TP W560,000) in Korea has been more than 20% of total foreign holding in the country for many years. Similar examples may exist for the largest stocks in many other markets. If this is true, it could be possible to have less restrictive limits by explaining the sudden and growing nature of the problem to those involved in setting them.

The other solution is adoption of benchmarks like MSCI 10/40 index which incorporate investment constraints in index performance calculations. MSCI India 10/40 index has underperformed MSCI India by 240 bp since the beginning of 2009, largely because of the lower weight of RIL.

Domestic investors should seek a regulator review

The situation is trickier for local investors. The solution lies with bodies outside the investment community. We feel that the regulator, Securities and Exchange Board of India, should review the problem at the earliest to make sure that performance of the fund industry does not appear worse than it is because of things not in the control of investment managers. It should consider allowing the eventual investors to permit investments up to the neutral weight for large stocks.

Alternatively, the two stock exchanges could be asked to actively develop and promote new benchmarks like their version of MSCI 10/40 index that take into account regulatory limits.

Underownership benefits for RIL stocks

Reliance Industries' stock has become so big in global indices that it has begun to dwarf the weights of a few small emerging markets. For almost all index-linked investor in India, the stock is now an allocation – i.e., underweight or overweight – decision rather than a buy or a sell decision.

There is a popular saying in financial markets that when a market is substantially under-owned, it does not underperform or fall as quickly. This adage should be remembered for the RIL stock going forward. Even without the changes that allow most investors to hold much more of it, the stock could command some valuation premium not justified by its fundamentals simply because few long-only investors could afford to increase the tracking error versus the benchmark.

Companies Mentioned (Price as of 08 May 09)

Reliance Industries (RELI.BO, Rs1896.00, NEUTRAL [V], TP Rs1424.00)

Samsung Electronics (005930.KS, W569,000, NEUTRAL, TP W560,000)

Reliance Petroleum (RPET.BO, Rs115.05, NOT RATED)

Disclosure Appendix

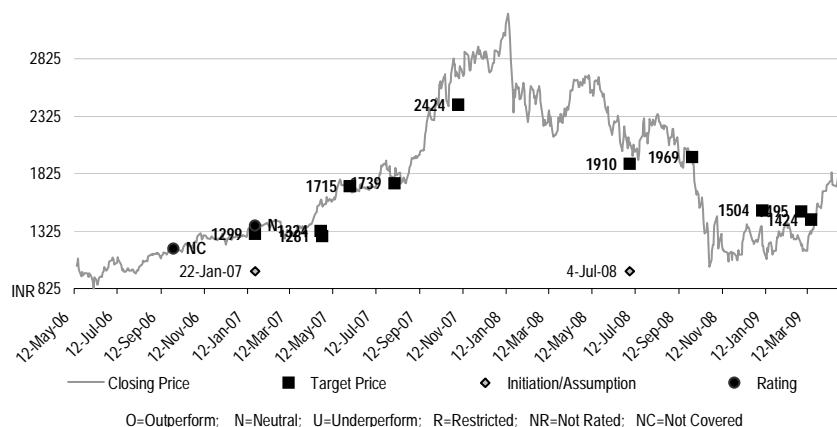
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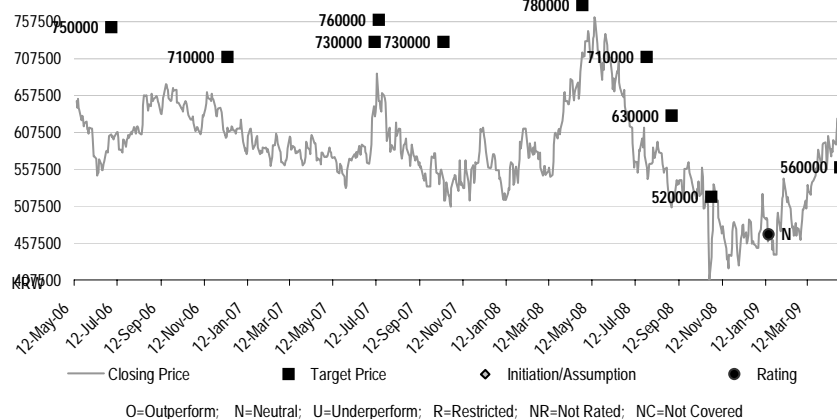
3-Year Price, Target Price and Rating Change History Chart for RELI.BO

RELI.BO Date	Closing Price (INR)	Target Price (INR)	Rating	Initiation/Assumption
29-Sep-06	1,171.05		NC	
22-Jan-07	1,373.45	1299	N	X
25-Apr-07	1,599.85	1324		
27-Apr-07	1,538.2	1281		
5-Jun-07	1,745.05	1715		
7-Aug-07	1,805.85	1739		
5-Nov-07	2,663.65	2424		
4-Jul-08	2099	1910		X
30-Sep-08	1,946.35	1969		
7-Jan-09	1,196.8	1504		
3-Mar-09	1,199.05	1495		
17-Mar-09	1,300.35	1424		



3-Year Price, Target Price and Rating Change History Chart for 005930.KS

005930.KS Date	Closing Price (KRW)	Target Price (KRW)	Rating	Initiation/Assumption
3-Jul-06	605000	750000		
14-Dec-06	614000	710000		
10-Jul-07	629000	730000		
16-Jul-07	650000	760000		
15-Oct-07	542000	730000		
28-Apr-08	716000	780000		
28-Jul-08	560000	710000		
1-Sep-08	506000	630000		
27-Oct-08	438000	520000		
16-Jan-09	469000		N	
27-Apr-09	585000	560000		



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Method: Our target price for Reliance Industries is Rs1,424. We value the company using a discounted cash flow (DCF) based sum-of-the-parts valuation. We use a weighted average cost of capital (WACC) of 12.2%. Our DCF-based valuations for the core business - Chemicals and Refining - imply an EV/EBITDA (enterprise value/earnings before interest, tax, depreciation, amortisation) of 4.2x and 5.3x, respectively, for 2010, in line with its global peers. We value the existing known blocks in E&P at US\$17.9bn, and the exploration at US\$6.9bn for the reserves that have not been discovered.

Risks: There are risks on the downside to our Rs1,424 target price for Reliance Industries if: 1) global growth slows and chemical and refining margins revert back to mid-cycle faster than expected; 2) gas reserves are lower than modelled; 3) gas pricing is lower than modelled; 4) execution of the retail business build-out is short of our expectations on either market growth, or Reliance's market share.

Price Target: (12 months) for (005930.KS)

Method: Our 12-month target price of W560,000 for Samsung Electronics is derived using the average-low historical multiple since 1990, which is based on 1.5x price to book ratio (P/B).

Risks: Potential risks to our 12-month target price of W560,000 for Samsung Electronics are: slowing consumption in developed countries, due to macro concerns and rising interest rates, as well as won appreciation. Rising competition from new entrants in the company's key business area, NAND flash, could increase pricing competition, and market dominance may also have a negative impact on our earnings estimates.

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