India Strategy

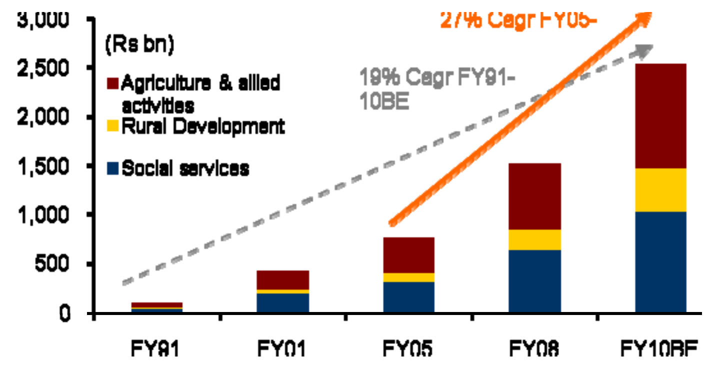
In the twilight zone

4 January 2010

2010, the Year of *The White Tiger*, is unlikely to be as malignantly capricious as the eponymous protagonist of *Aravind Adiga*'s recent prize-winning book, but it will still be one in which delivery of growth expectations will be put to test. Consensus Nifty EPS estimate for FY12 assumes a 50% jump over FY10 levels, which is *prima facie* reasonable, given the big increase in new capacities across sectors and the low base from near zero EPS growth through FY08-10. We believe that the domestic growth cycle is supportive, but the global cycle needs to be complementary enough. Even as the near-term technical momentum for the market seems positive—and the absence of hysterical greed or euphoria is certainly a comfort—a rally is unlikely to sustain if the forecast growth does not come in. The market is set for a roller coaster ride, in our view. We overweight stocks and sectors linked to the domestic consumption cycle, which we believe offer higher growth visibility.

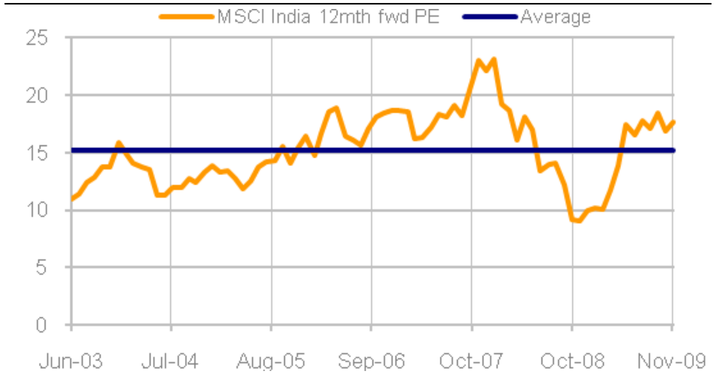
- **The domestic consumption cycle—up and away**: We believe that the mainstay of India's GDP growth in FY11 will be acceleration in personal final consumption spend. Our confidence stems from the improvement in livelihoods of the rural populace led by a marked rise in both farm and non-farm incomes. Industrial capex will likely decelerate this year, the take-off in infrastructure spend will happen rather slowly.
- **A market pricing in a lot of growth**: Notwithstanding the 75% rally in 2009, Nifty is trading at reasonable FY11 PER of 16.5x, FY12 PER of 13.8x. This assumes a sharp acceleration in earnings growth, though; not an unreasonable assumption in itself, but one that depends on a favourable turnaround in the global and domestic business cycle. There will be little tolerance for any slippage, in our view.
- **Portfolio stance—focus on growth visibility**: Given our positive stance on consumption, our portfolio strategy would be to overweight all sectors linked to the consumption chain. In addition, we overweight the software and pharma sectors, as earnings momentum remains strongly positive, with more upgrades to come. While a tightening liquidity environment is not necessarily conducive for banks, we believe that a lot of negative news is in the price, and a revival in credit growth is a matter of time. We overweight banks as well. A major recovery in the global growth cycle would be the key risk to our portfolio stance.

Dramatic surge in Govt. spend on rural development



Source: CMIE, Budget documents, IIFL Research

MSCI India is trading 15% above its average fwd PE



Source: Bloomberg, MSCI, IIFL Research

Top Buys for 2010		
Stock	**FY12 PER**	**FY10-12 EPS Cagr**
Axis Bank	9.8	31%
Dr Reddy's	14.4	23%
Hero Honda	13.3	10%
ITC	17.6	16%
Wipro	16.1	18%

Dark Horses for 2010		
Stock	**FY12 PER**	**FY10-12 EPS Cagr**
Bharti	13.3	5%
DLF	13.0	24%
HCL Tech	12.7	32%
Jaiprakash	9.7	21%
Mahindra & Mahindra	13.8	7%

Performance of 2009 dark horses		
	2009 return	**Rel to Nifty**
Average return	145%	69%
Bajaj Auto	359%	283%
DLF	29%	-47%
ICICI Bank	99%	23%
Suzlon	45%	-31%
Tata Steel	195%	119%
Average return	145%	69%

Source: Bloomberg, IIFL Research

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At the start of 2009, the growth visibility for both India and the rest of the world was quite clouded. We still found it easy to make a call that the Indian equities will deliver positive returns as: 1) pessimism was close to multi-decade high; 2) the price of risk and the cost of capital was elevated (it was a question of time before it came down); 3) the current account was turning around, mitigating pressures on the rupee; 4) stock prices assumed a continued deterioration in the business cycle, leaving enough room for positive surprises. Our 30% return target for the year finally proved to be too modest. The fiscal stimulus reinvigorated the economy and India was lucky to get a stable government, and both these factors aided the return of positive sentiment.

At the start of 2010, the growth visibility for India and most parts of the world is much better. We note that the mood is still one of caution (we are nowhere near the euphoric phase of 4Q2007), mass retail participation is still relatively sparse, and the technical momentum points to a further rally in the near term. Yet, we think that we need loads of luck for the market as a whole to deliver any meaningful return in 2010. Current valuations assume a significant favourable turnaround in the global and domestic business cycle, and do not price in any risk of growth expectations being belied.

The outlook on factors that drive valuation expansion too, is quite mixed. These include: 1) a potential trend reversal in interest rates; 2) swings in the dollar index and consequent volatility in the price of risk; 3) the usual difficulty in predicting most commodity prices, especially after the sharp rise in 2009; 4) the unknown near-term impact from gradual withdrawal of stimulus and liquidity (although we think that the impact will not be material). The street expects FY11 Nifty EPS growth will be 26%, and we suspect any downgrades will negatively impact valuations. FY12 growth visibility now needs to improve as well. The big swing factor will be the earnings of global cyclicals—and therein lays the unknown.

In the above backdrop, we believe that the key indices are most likely set for a roller-coaster ride, and appropriate portfolio positioning will be the key driver for generating superior risk-adjusted returns.

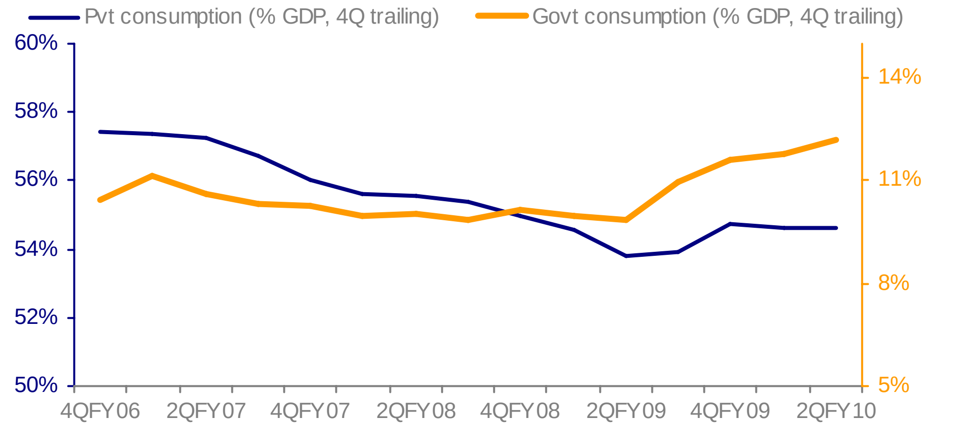
The following is our prognosis for the year 2010.

1) The domestic consumption cycle will gain further momentum and growth rates in personal final consumption will accelerate.
2) The investment cycle will be a laggard, primarily owing to the deceleration in industrial capex. A pick-up in infrastructure spend will happen slowly.
3) Credit growth will pick up sharply in the latter part of the year, aiding sustenance of higher GDP growth of ~8%.

The domestic consumption cycle: up and away

We believe that the mainstay and key contributor to 2010 GDP growth will be further acceleration in private final consumption growth. The previous growth cycle (FY04-08), was principally led by a surge in capital formation. In contrast, growth in the last 18 months was driven primarily due to the fiscal stimulus, with government consumption alone contributing an estimated ~50% of GDP (expenditure side) growth during the October 2008-September 2009 period. The new growth cycle that is setting in and that will play out over the next several years, in our view, will be led by domestic consumption.

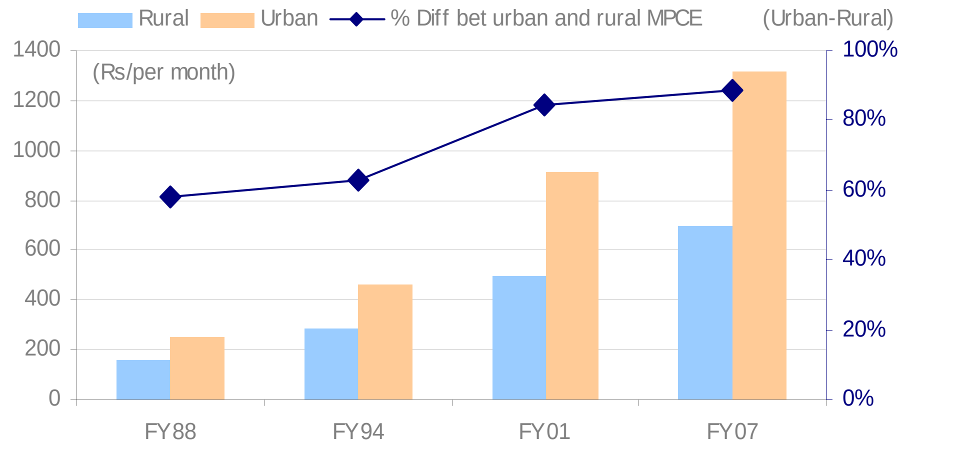
Figure 1: Govt consumption played a key role in boosting GDP in the last 4 quarters



Source: CMIE, IIFL Research

Our confidence stems from the fact that rural India, which has 152m households—70% of the total households in India—are increasingly prosperous. The fortunes of tens of millions of households at the bottom of the demographic development pyramid are turning for the better. This change is being driven by: 1) a marked rise in non-farm incomes, led by rising government spends on the social sector, especially under the National Rural Employment Guarantee Act (NREGA) programme; 2) a rapid rise in farm incomes, thanks to higher prices of produce, rising productivity, reducing cyclicality and favourable change in production mix.

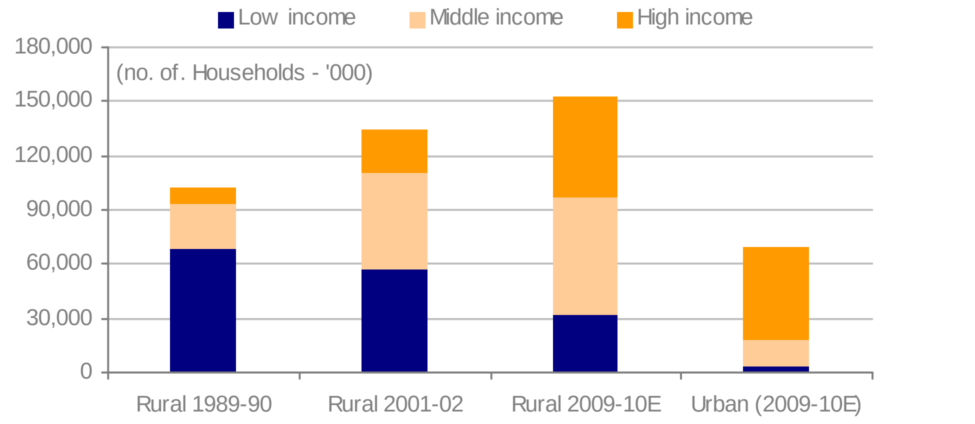
Figure 2: Rural monthly per capita consumption spend has lagged urban spends



Source: NSSO, IIFL Research

It is known that for several decades, personal consumption expenditure in urban India has grown much faster than in rural India. As of March 2007, the last date for which data is available, urban per capita consumption expenditure was almost 88% higher than the equivalent rural spend. In the late 1980s, when the reforms process had just begun, urban spend was only 58% higher. This trend of higher growth in urban spends has already reversed and we expect the trend to gain further momentum in the next few years. As the chart below shows, the size of population in the middle- and high-income brackets in rural India has now started to expand—and the very size of the rural populace will make this change an important driver for acceleration in consumption growth.

Figure 3: Consuming class in rural India is much larger than that in urban India



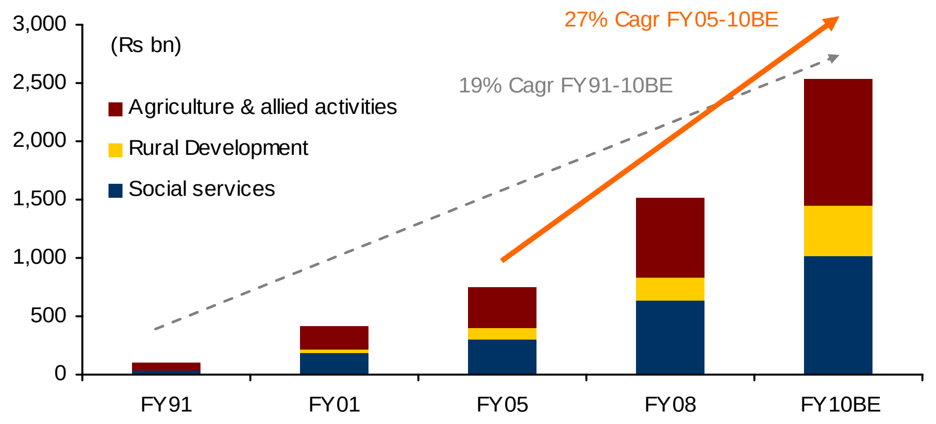
Source: NCAER, IIFL Research

Rising government spend on the rural sector

This change is being led by the rising government spend on social sector schemes in rural India, particularly those under NREGA. Between FY05 and FY09, the total government spend on rural programmes has increased 3.3x to US$23bn. In our view, efficacy of this expenditure is also improving, as the share of spend on food subsidy schemes such as the leakage-prone PDS (Public Distribution System), have been on the decline. More than one third of the rural spend is on NREGA, which assures a minimum 100-day employment for one member of every rural household. This has brought in greater income visibility, reduced rural unemployment, and has buoyed up wages across the board.

NREGA currently covers just 14% of rural households and we estimate its coverage will triple in the next four to five years. Two thirds of this spend is only on 4-5 states, and higher allocations increasingly go to poorer states with larger population. We expect the total NREGA spend to jump from about US$8bn in FY09 to US$15bn by FY13-14. State governments still play a major role in ensuring efficacy of the spend and thus the benefits will be uneven (based on the focus and quality of governance in each of the states), but suffice to say that an increasing number of villagers will continue to see improvements in their incomes and opportunities for better livelihood.

Figure 4: Govt. spend on rural development has seen a dramatic surge

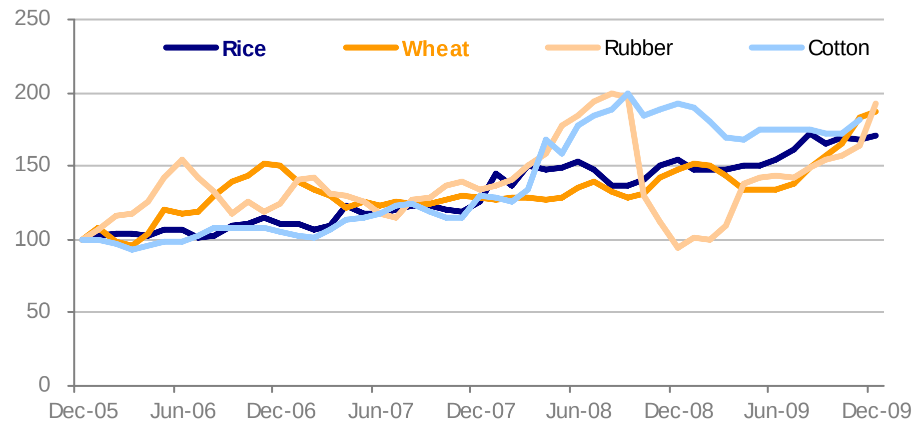


Source: CMIE, Budget documents, IIFL Research

Agriculture: all indicators showing improvement

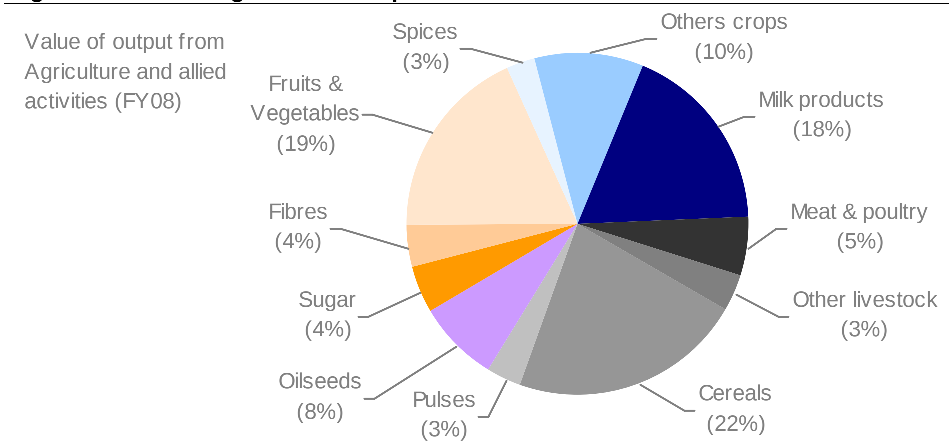
Added to the impetus from government-sponsored schemes, India's agrarian sector is seeing one of the fastest growth rates in income levels than ever in the past. This growth is driven by rising mechanisation, faster yield growth, more remunerative prices, a gradual improvement in road connectivity, reducing cyclicality, easier and more affordable credit availability and improving product mix. Tractor sales, for example, have grown at 11.2% Cagr in the last five years, vs 1.2% Cagr in the previous ten. Outstanding bank credit to agriculture has risen by over 2.5 times between FY05-09. All of this is driving faster growth in capital formation in agriculture, in addition to the benign impact it has on consumption.

Figure 5: Prices of key agri commodities are up 2x in the past 4 years



Source: CMIE, IIFL Research

Figure 6: Value of agricultural output—cereals account for less than 25% of total



Source: CSO, IIFL Research

Figure 7: Indicators of agricultural activity are already showing signs of improvement

	FY94-2004	FY04-09
Agricultural GDP	2.8%	3.2%
Agricultural capital formation	6.60%	9.90%*
Bank credit to Agriculture	15.5%	28.6%
Agricultural exports (US$ terms)	6.5%	18.4%
Total exports	11.1%	23.4%
Road connectivity at the end of the period	<40%	~70%*
Rural literacy levels	45% (1991)	59% (2001)
Growth in prices in agricultural commodities	2.5-4% p.a	10-15% p.a

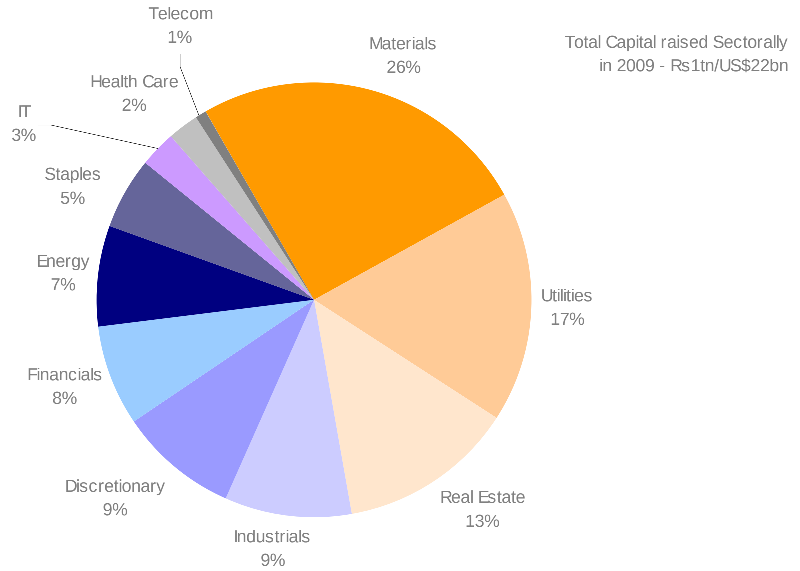
Source: CMIE, RBI, Ministry of Agriculture, IIFL Research. *pertains to FY04-08 period

Investment cycle - Growth will likely decelerate

Of the two key components of the investment cycle—industrial capex and infrastructure investments—we believe that growth in industrial capex will decelerate, while infrastructure investments will be slow to take off. During FY04-08, private corporate capex rose by almost 4x and large capacities have been added or are in the process of being added in sectors like cement, steel, refining, oil & gas and other heavy industries. Almost US$22bn of fresh equity has been raised in the past nine months, but most companies, other than those linked to infrastructure (like power gencos) are using it to retire debt rather than to invest in new capex. Almost half of the new equity raised is by companies in three sectors—materials, real estate and industrials—all of whom have brought down debt levels in the recent past. Utilities is the only key sector that's raising new money to invest in new capacity creation, but that forms part of infrastructure investments. A positive fallout of the deceleration in industrial capex is that capacity utilisation will rise in the coming years, and that will be ROE-accretive.

The slow recovery in the investment cycle will be led by growth in infrastructure spend. Just on roads and power, we estimate over US$180bn spend over the current plan (FY08-12), as compared to ~US$100bn in the preceding five years. However, perceptible growth is likely, possibly 2011 onwards. A meaningful impact on the investment cycle will likely be visible in FY12, in our view. We believe that consumption growth will overwhelm that of investments in 2010.

Figure 8: Materials and real estate account for ~40% of total capital raised in 2009



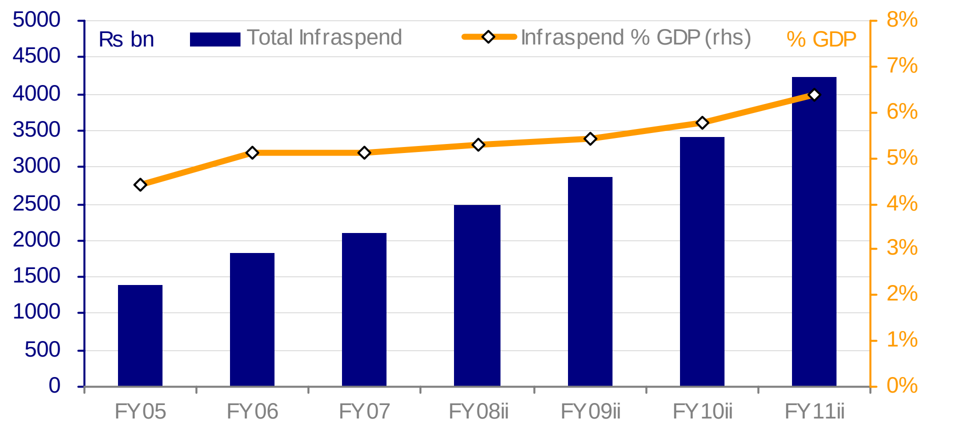
Source: Bloomberg, IIFL Research.

Figure 9: Significant capacity addition underway in key heavy industries

	FY08	FY09	FY10ii	FY11ii	FY12ii	Cagr	Absolute growth (x)
Production capacities							
Cement (mtpa)	198	219	266	302	304	11%	1.5
Steel (mtpa)	55	57	65	75	88	12%	1.6
Aluminium (mtpa)	1.3	1.3	1.9	2.2	2.2	14%	1.7
Refining (mtpa)	127	178	178	194	194	11%	1.5
Electricity (GW)	143	148	163	186	198	8%	1.4
BTG (GW)	7.5	7.5	13.0	13.0	18.0	25%	2.4
Annual production							
Crude oil (m tonnes)	34	34	37	41	44	7%	1.3
Natural gas (mtoe)	28	31	44	56	56	19%	2.0
Coal (m tonnes)	456	493	543	595	654	9%	1.4

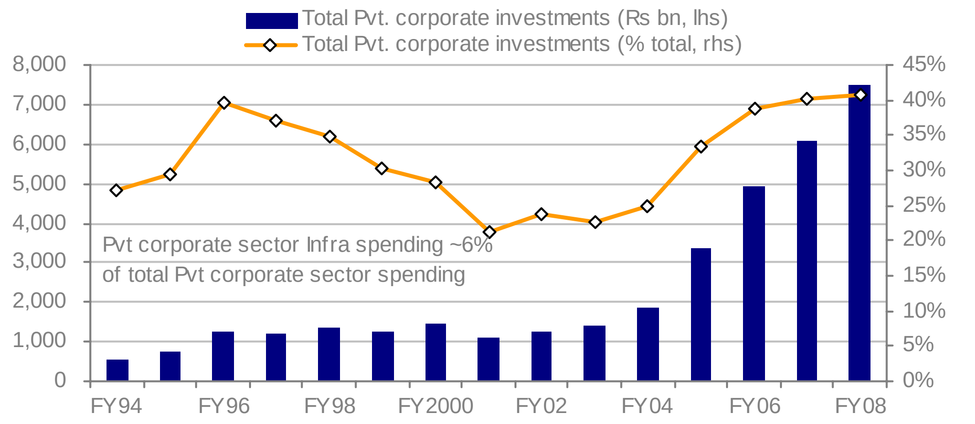
Source: IIFL Research

Figure 10: Annual infrastructure spend will likely double by FY12 from FY08 levels



Source: Planning Commission, IIFL Research

Figure 11: Private corporate sector capex—growth will likely decelerate



Source: CSO, CMIE, IIFL Research

Macro-economic variables—GDP growth on a strong wicket

- **GDP growth**: We expect the acceleration in India's economic growth to continue in 2010, with non-agri GDP growing at ~9-10% and agricultural GDP growth rebounding sharply, owing to the base effect (assuming a normal monsoon). Industrial growth will be quite healthy, given our hypothesis of growth acceleration in consumption and due to large capacity additions. As such, we expect India's full-year FY11 GDP growth will be ~8%.
- **Balance of payments:** After a BoP deficit in FY09, India is on track to return to BoP surplus during FY10, a trend we believe will continue over the medium term. This will be driven principally by fairly modest current account deficits (sub 2% of GDP) due to favorable energy dynamics like increase in domestic crude, gas and refining productions as well as an increase in invisibles especially services exports. The pick up in FDI and FII flows will help India report BoP surpluses of >3% of GDP. Our base case hypothesis is that the rupee will not significantly deviate from the current levels.
- **Fiscal deficit:** Fiscal deficit is and will likely continue to be the biggest macro headwind, although headline FY11 deficit numbers will likely decline, given the recent thrust on PSU disinvestments, reduction in one-off expenditure such as wage arrears under VI Pay Commission. We expect FY11 deficit to decline by ~150bps as % of GDP vs FY10 expected level of 10.5-11% of GDP (Centre + State combined). With the recovery in growth rates and the expected phased withdrawal of stimulus (i.e., hike in excise duty rates), tax collections will likely pick up in FY11. If the government successfully pushes through major disinvestments—and it seems intent on doing so—then FY11 deficit will be lower than we currently expect it to be.
- **Inflation and interest rates:** Notwithstanding the acceleration in WPI—which is attributable largely to soaring food prices—we do not think RBI will hike policy rates any time soon. We believe the current weakness in credit demand precludes the RBI raising policy rates in the near term, as long as core inflation remains stable (capacity utilisation across a number of industries is still at comfortable levels). In our view, the central bank is more likely to focus on draining excess liquidity from the system before hiking policy rates.

Market valuations—sustenance contingent on growth delivery

A large part of the rerating-led big gains in 2009 came from the sharp compression in risk spreads, the consequent decline in cost of capital and, in a few cases, by waning of bankruptcy concerns. There is little room for cost of capital to drop further; in fact, there is a risk that it may go up over the medium term. A fancy for emerging markets, if it gains momentum, can further bring down junk risk spreads, fuelling large capital inflows, and that in turn can drive a near-term rally. But sustenance of any such rally will be tough, unless other fundamental factors are supportive.

The key variable for valuation sustenance or expansion has shifted to delivery of growth that the markets are pricing in. There is no denying that the terminal growth expectations across almost all sectors have risen sharply in the past few months. In fact, the 75% rally in the Nifty last year came amidst a downgrade in FY10 EPS and only a moderate 3% upgrade in FY11 earnings estimates. Current consensus estimates suggest that the street is forecasting a 50% jump (or a 22.5% CAGR) in Nifty earnings between FY10-12.

Figure 12: Nifty—consensus expects 50% jump in earnings over next two years (FY10-12)

Nifty Index	FY08	FY09	FY10E	FY11E	FY12E
EPS	246	239	250	315	376
Growth		-3%	5%	26%	19%
PE @ 5200	21.1	21.7	20.8	16.5	13.8

Source: Bloomberg, IIFL Research

Figure 13: In an optimistic scenario, earnings could come ~10% above consensus

Nifty Index	Bloomberg Consensus		IIFL Optimistic case	
	FY11E	FY12E	FY11ii	FY12ii
EPS	315	376	341	409
Upgrade possible			36%	20%
PE @ 5200	16.5	13.8	15.3	12.7

Source: Bloomberg, IIFL Research.

It is true that Nifty earnings have stayed almost flat over FY08-10. The base effect, no doubt, is coming into play, exaggerating earnings growth over the next two years (this effect was also seen in the initial phase of the previous bull cycle that began in 2003-04). As compared to 2 year EPS Cagr of 22.5% (FY10-12), the 4 year EPS Cagr falls sharply to 11.2% (FY08-12), almost in line with nominal GDP growth during this period. Thus, one can argue that the lag in EPS growth in FY09-10 is getting filled in over the following two years.

A part of this growth is also attributable to large capacity additions. As highlighted in figure 9, installed capacities in FY12 will likely be at least 40-50% higher in most industries, as compared to end-FY08 levels. Capacity scale-up and impact on profitability may be uneven across sectors. For example, in cement, analysts are assuming sharp pricing declines to an extent that aggregate earnings of the sector are expected to decline by 5% CAGR between FY10-12, even with a volume CAGR of 8-9%. In some sectors, among them oil & gas, and coal, demand is not a constraint and profit growth will be a function of growth in production (more linked to timely execution). In refining and metals—which are large swing sectors in determining Nifty earnings growth—global demand and price environment will be the key determining factors.

Figure 14: Save cement, all other sectors are expected to report strong earnings growth

Sector	Consensus earnings growth (FY10-12E)	FY12 earnings weight	Companies
Automobiles	34%	5.4%	Hero Honda. M&M, Maruti, Tata Motors
Cap Goods	26%	9.0%	ABB, BHEL, JPA, L&T, Siemens, Suzlon
Cement	-5%	2.9%	ACC, Ambuja, Grasim
Energy	23%	19.3%	BPCL, Cairn India, ONGC, RIL
Financials	21%	23.4%	Axis, HDBk, HDFC, ICICI, SBI, PNB, IDFC, Rel Cap
FMCG	16%	4.7%	HUVR,ITC
Health Care	22%	1.7%	Cipla, Ranbaxy, Sun Pharma
IT	14%	9.4%	HCLT, Infosys, TCS, Wipro
Metals	60%	13.1%	Hindalco, JSP, SAIL, Sterlite, Tata Steel
Real Estate	36%	1.7%	DLF, Unitech
Telecom	3%	4.5%	Bharti, Idea, Rcom
Utilities	12%	5.0%	GAIL, NTPC, Powergrid, RELI, RPower, TataPower
Nifty	23%	100.0%	

Source: Bloomberg, IIFL Research

Figure 15: Five stocks are forecast to contribute 47% of Nifty earnings growth over the next two years

Company	Sector	Contribution to Nifty Earnings growth (FY10-12)
Reliance Industries Ltd.	Oil & Gas	14%
Tata Steel Ltd.	Metals	14%
I C I C I Bank Ltd.	Financials	8%
State Bank Of India	Financials	6%
Larsen & Toubro Ltd.	Capital Goods	5%

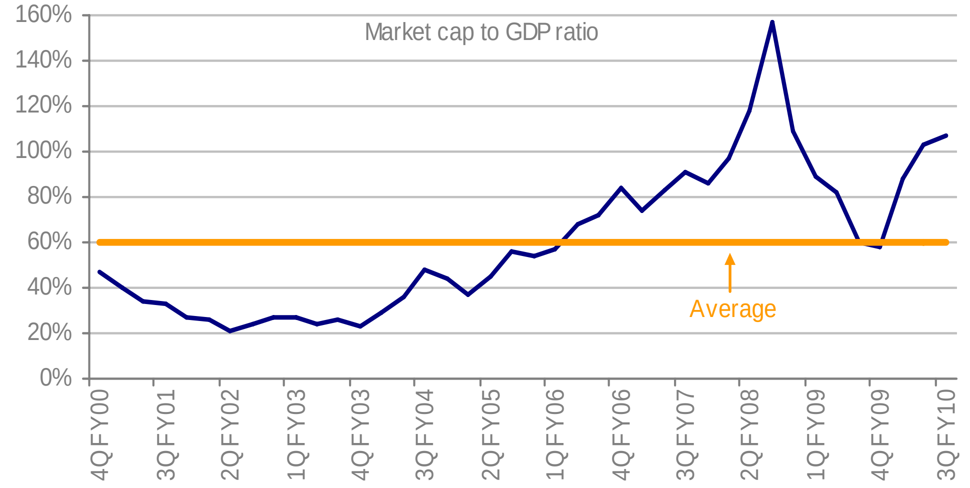
Source: Bloomberg, IIFL Research

Global growth cycle needs to be supportive

Leaving aside near-term aberrations led by the ebb and flow of liquidity, the elevated growth expectations will now need to be delivered for current valuations to sustain or expand. In particular, the outlook for earnings drivers linked to the global cycle need to show sustainable improvement. Prime among these are refining margins and metal prices (which together are estimated to contribute to 40% of Nifty's FY10-12 earnings growth). We are more sanguine about the domestic growth cycle, but the global growth cycle has to be complementary, failing which any liquidity-fuelled rally will lack fundamental support. In our view, moderate earnings upgrades in domestic cyclicals are likely, given our hypothesis of the upswing in domestic consumption. If the global cycle turns benign, then aggregate earnings will see upgrades (figure 13 gives our EPS estimates on an optimistic case), paving the way for a more sustained rally.

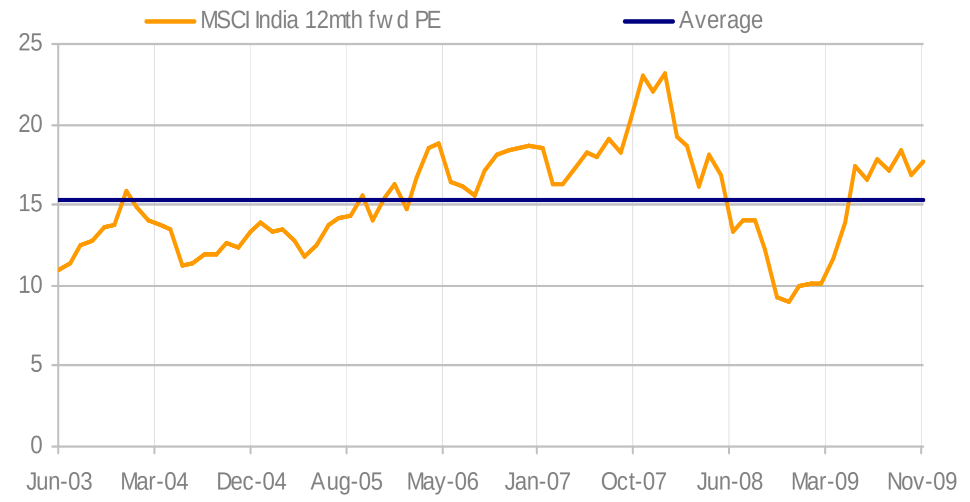
Market valuations are neither bubble-like (making it difficult to argue for a correction), nor in deep value zone (which precludes a more aggressive risk stance). On PER, PB and market cap/GDP, markets are currently 20-40% below the euphoric bubble highs of 2007, but almost in line or marginally higher than the last six years' averages. Rather than attempting to forecast whether liquidity can fuel markets to bubble valuations, we would believe that investors should look for investment themes and stocks with greater growth visibility. In a market where there is little value, we believe that it is better to own names that have less of a doubt on growth delivery.

Figure 16: Market cap to GDP ratio is 30% below 2007 peak



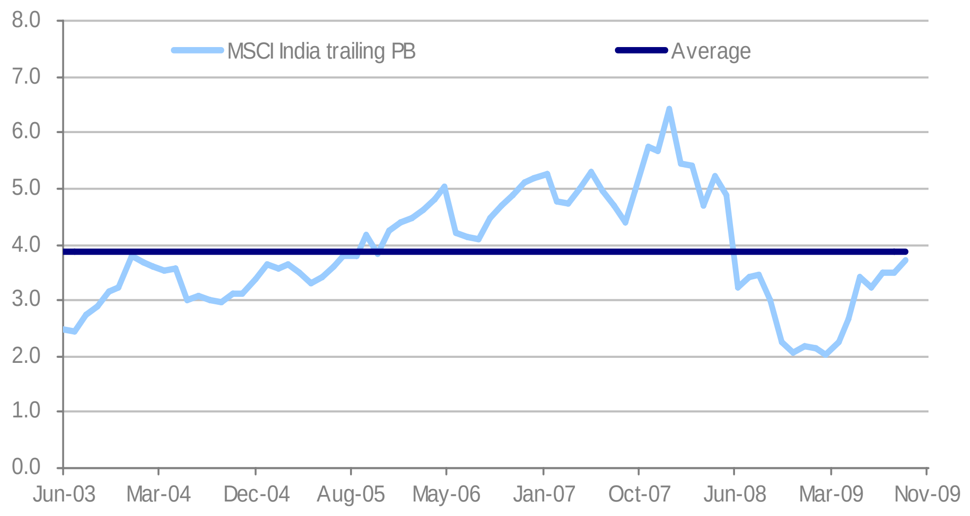
Source: CMIE, CSO, IIFL Research

Figure 17: MSCI India is trading 15% above its average fwd PE



Source: Bloomberg, MSCI, IIFL Research. Average since June 2003.

Figure 18: On PB basis, however, market is in line with medium-term averages



Source: Bloomberg, MSCI, IIFL Research. Average since June 2003.

Institutional flows to remain positive

After a record capital-raising of US$22bn in 2009 (US$4bn IPOs, US$7bn QIPs, US$3bn GDRs, US$4bn CBs), the calendar for 2010 seems full as well. With the government evidently keen on disinvestment, we would be surprised if the capital-raising in 2010 were any lower. We do not think such large capital-raising by itself should have much of an adverse impact on valuations. If anything, large and good-quality paper issuances, such as the expected issue by Coal India, are welcome, as they will help attract more sticky foreign capital and enhance market breadth.

In 2009, net institutional buying in the secondary market amounted to about US$11bn (DIIs 53%, FIIs 47%). Almost 70% of the net FII inflows of US$18bn went into primary issuances. Domestic mutual funds were net sellers of equities in 2009. With insurance companies continuing to see sticky inflows, domestic institutions will remain net buyers in 2010 as well. FII flows will remain positive, in our view, given increased asset allocations to India. As history shows, net institutional buying alone is no guarantee for markets to give positive returns; other fundamental factors also have to lend support for any rally.

Portfolio strategy: Focus on growth visibility

Given our bullish stance on consumption, our portfolio strategy would be to overweight consumer discretionary and non-discretionary sectors. In addition, we overweight the software and pharma sectors, as earnings momentum remains strongly positive. Most of these sectors have outperformed in the last few months and are no longer cheap; but as stated earlier, in a market pricing in significant growth, we would prefer to own sectors with greater visibility and those with structural tailwinds. While a tightening liquidity environment is not necessarily a conducive one for banks, we believe that a lot of negative news is in the price, and a revival in credit growth is a matter of time. We overweight banks as well. All other sectors are underweights. *A major recovery in the global growth cycle will be the key risk to our portfolio stance.*

Figure 19: IIFL portfolio strategy

Sectors	Nifty weight	IIFL weight	Rationale
Cons. discretionary	4%	10%	Demand growth will continue to surprise on the positive side
Consumer staples	6%	11%	Double-digit growth in volumes will likely sustain for the next 3-4 years; smaller cos will do better
Energy	17%	13%	Lower refining margins will remain a drag, risks of lower capacity utilisation
Financials	24%	27%	Growing fee income, moderate credit growth, stable to improving NIMs, abating NPL worries
Healthcare	2%	5%	Select stocks like Dr Reddy's are well positioned to capitalize on the generics opportunity
Industrials	13%	8%	Capital goods will see deceleration in order book growth, given slowdown in corporate capex
Information technology	13%	15%	Margin levers are helping companies to improve earnings
Materials	11%	7%	We expect large volatility in earnings and margins. Markets pricing in positive surprises, earnings upgrades
Telecom	4%	2%	Oversold sector but still strong competitive pressures
Utilities	6%	2%	Too richly valued
Nifty	100%	100%	

Source: Bloomberg, IIFL Research

Top 5 Buys for 2010

Company	Market cap US$ m	2009 return %	Valuations					BUY reco %	Key Investment Argument
			FY11ii PER	FY11ii PB	FY12ii PER	FY12ii PB	2-yr EPS CAGR (%)		
Axis Bank (AXSB IN)	8,405	92	12.7	2.1	9.8	1.8	31%	38%	• Axis Bank has consistently delivered strong and profitable growth over the last five years, with assets growing at 44% Cagr and net profit at 46% Cagr. Despite emerging as the third largest pvt bank, Axis still accounts for only 3% of system loans. • Key strengths: strong loan origination capabilities, diversified loan book spread across retail, SME, mid and large corporate, high fee income and low-cost deposit franchise. • We expect the bank to deliver 30% earnings CAGR over FY10-12, with average ROE of 19% and ROA of 1.5%, among the highest in the peer group, on the back of steady NIMs and asset quality. Valuations remain undemanding, atFY11 P/B of 2.2x and PER of 13x.
Dr Reddy's (RDY IN)	4,063	141	19.8	3.3	14.4	2.8	23%	69%	• Best technological, bio-similar capabilities. Very strong growth momentum in the US generics market, the largest opportunity for Indian players; strong business also in domestic and other emerging markets and in the CRAMS space. • Several potential upside opportunities from new limited-competition product launches in the US market; large medium-term upsides from the GSK partnership for emerging-market generics. • Good earnings growth visibility, limited downside risk and potential upsides. Estimate 25%+ earnings CAGR for the next 3-4 years; trading at 20x FY11ii core earnings.
Hero Honda (HH IN)	7,294	112	14.8	4.8	13.3	3.8	10%	34%	• Increased spending by govt will result in a significant consumption boom in the rural economy; we expect double-digit CAGR in motorcycle volumes in the next five years. • Motorcycle penetration in rural India, at ~10%, is significantly lower than in urban India at ~30%. HH, with a 10% higher market share in rural India, will be a key beneficiary. • Stable margins on account of higher production and increased sourcing from ancillaries from Uttaranchal, and volume surprises, will likely result in earnings upgrades.
ITC (ITC IN)	20,652	48	20.2	5.4	17.6	4.8	16%	61%	▪ Cigarette volume growth is likely to remain strong at 6-7%, while cigarette EBIT margins would expand as they have in each of the last eight years, as ITC has strong pricing power. ▪ Hotels business likely to turn around in FY11, while FMCG losses would also trend lower. This would boost profits and could provide upsides to estimates. ▪ PER of 19.9x FY11ii EPS, cheaper than other FMCG stocks with similar growth profile.
Wipro (WPRO IN)	21,508	193	18.6	4.6	16.1	3.7	18%	31%	• Wipro's diversified service offerings (20% contribution from infrastructure services and 10% from BPO) are enabling it to win large multi-service deals. Its revenue growth was faster than that of Infosys, in six out of the last ten quarters; we expect continued outperformance. • Margin levers are better than those of peers, especially with the pick-up in utilisation rates at Infocrossing, and expected turnaround in engineering unit. • Valuations are at a discount to peers. Wipro is trading at a ~10% discount to Infosys.

Source: Bloomberg, IIFL Research

Dark horses for 2010

Company	Market cap US$ m	2009 Return %	Valuations					Buy reco %	Key arguments
			FY11ii PER	FY11ii PB	FY12 PER	FY12 PB	2yr EPS Cagr		
Bharti (BHARTI IN)	26,546	(9)	15.4	2.7	13.3	2.3	5%	42%	• Major thrust in rural areas—56% of net adds from rural India. Rural revenues still below potential. Bulk of investment already done, operating leverage will kick in. • Likely to comfortably maintain EBITDA margins in high 30s, despite drastic tariff wars on wireless. • Is likely to take the lead in making converged offerings to its consumers, wireless/ DTH/IPTV etc and raise ARPU. Sector and stock oversold; any good news could drive re-rating.
DLF (DLFU IN)	13,325	30	29.4	2.5	13.0	2.1	24%	44%	• DLF can be a big beneficiary of any revival in demand for commercial real estate. It has 16m sq ft of leased space, with an additional 3m sq ft of completed buildings. • Any REIT listing in Singapore at a lower cap rate of 7-8% will drive up valuations and NAV. • Operating cash flows are improving, owing to the slowdown in land acquisition. We expect faster construction of pre-sold properties. • The infrastructure build-out in Delhi and Gurgaon is among the best, and DLF is best positioned to take advantage of any demand acceleration and asset reflation in the NCR region
HCL Tech (HCLT IN)	5,370	224	14.1	2.8	12.7	2.3	32%	35%	• HCL Tech's aggressive bidding in a tight demand environment (early 2009) gave it many large deal wins. They are starting to ramp up now. Margin tailwinds too are relatively better, as acquisition synergies come to the fore. BPO business is also staging a turnaround. • While EAS business (22% of revenues) is likely to remain lackluster, we expect the strong growth in other businesses to compensate. Valuations however, are at a steep 30-40% discount to larger peers.
Jaiprakash (JPA IN)	6,483	158	10.7	2.2	9.7	1.9	21%	52%	• Best play on asset reflation, especially in the NCR, which is witnessing the best infrastructure build-out among Indian cities. 63 msf of inventory in Noida could witness major upward revision compared to our NAV of only Rs207/sq ft for Yamuna expressway. • Set to deliver best volume growth among Indian cement companies. Volumes should double in two years over FY11-12, cushioning the impact of expected price decline. • Value of the power portfolio to gain visibility, as operational capacity increases by 143% to 1.7GW in FY11 and implementation of three thermal plants totaling 3.8GW being executed by the best Indian E&C companies—BHEL and L&T—advances.
Mahindra & Mahindra (MM IN)	6,343	285	15.1	3.6	13.8	3.0	7%	60%	• Tractor industry has structurally entered into a high-growth phase, as NREGA and urbanisation have led to labour becoming expensive and scarce, leading to higher mechanisation. • M&M's market share in passenger UVs has gone up by >10ppt in the last 12 months, as it faces no significant competition in this segment. • M&M is the cheapest auto stock in our coverage, at 11x FY11ii core EPS (assuming a Rs340 value for subsidiaries valued at a 30% holding company discount).

Source: Bloomberg, IIFL Research

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Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
