

Priced to Perfection in a Slowing World

We expect negative returns in 2007 - index target 11,500 for December 2007

Though we are entering a seasonally strong period, we think 2007 will be a negative year for the markets and we have a market index target of 11,500 for December 2007 (15x forward earnings), a 10% drop from current levels. We remain positive on the economy and expect GDP to grow 7.6% in FY08 led by infrastructure spend. However, markets will likely be dragged by:

1. **Near term rising inflation and interest rate worries**
2. **Slowing corporate earnings:** We think earnings growth will slow to around 13% in FY08, lower than the 25% growth seen over the past few years. The slow-down will likely be led by falling commodity prices as the globe slows.
3. **Rich valuations:** Valuations at nearly 18x 1-year forward earnings are expensive in a regional and historical context and are the highest in a post-bubble era. We expect valuations to contract as (a) the market becomes cognizant of the slowing earnings and (b) RoEs fall from FY07 levels by around 130 bps.
4. **Supply of paper:** Increased supply of paper (we expect \$12 bn over next 6 months) will put pressure on flows to the secondary markets.

Sector Overweights are Engineering, Cement, Telecom, Software and Energy

Top Picks: BHEL, ACC, Bharti, L&T, TCS. We believe HPCL is a high risk stock dependent on oil prices and Govt. policy.

Top Under-performers: Hindustan Lever, Hero Honda, Bajaj Auto, Ranbaxy, Hindalco

Mid-caps can outperform large caps

We think mid-caps can outperform large caps given (a) their sharp underperformance and (b) 20% PE discount to large caps.

Top Mid-Cap: Nagarjuna Construction, Panacea Biotech, Divi's Labs, Welspun India, Infotech Enterprises



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Top Switch Ideas

1. From Infosys to TCS
2. From HLL to ITC
3. From Tata Steel to SAIL
4. From Tata Motors to Maruti
5. From Ranbaxy to Dr.Reddy's

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Model Portfolio

Table 1: Merrill Lynch Model Portfolio

	Symbol	Rating	23 Oct 2006	MSCI Wt	Recommended ML Wt.	% Overweight
Consumer Discretionary				8.3%	5.0%	-39.8%
: Maruti Udyog	MUDGF	C-1-7	946		5.0%	
Consumer Staples				7.2%	4.0%	-44.4%
: ITC	ITCTF/ITCTY	C-1-7/C-1-7	185		4.0%	
Energy				15.4%	18.0%	17.0%
: Reliance	XRELF	C-1-7	1,194		13.0%	
: HPCL	XHTPF	C-1-7	316		5.0%	
Financials				18.5%	18.0%	-2.9%
: ICICI Bank	ICIJF/IBN	C-1-7/C-1-7	721		9.0%	
: SBI	SBINF/SBKFF	C-1-7/C-1-7	1,024		9.0%	
Industrials/Cement				9.2%	14.0%	52.2%
: ACC	ADCLF	C-1-7	974		4.0%	
: GACL	XBRIF	C-1-7	121		2.0%	
: BHEL	BHRVF	C-1-7	2,447		4.0%	
: L&T	LTOUF/LTORF	C-1-7/C-1-7	1,274		4.0%	
Pharma				5.1%	4.0%	-21.3%
: Dr. Reddy's	DRRDF/RDY	C-1-7/C-1-7	713		2.5%	
: Cipla	XCLAF	C-1-7	257		1.5%	
Software				22.0%	24.0%	9.1%
: TCS	TACSF	C-1-7	1,079		10.0%	
: Infosys	INFYF/INFY	C-1-7/C-2-7	2,043		6.0%	
: Satyam	SAYPF/SAY	C-1-7/C-1-7	425		8.0%	
Metals				3.5%	0.0%	-100.0%
Telecom				7.2%	10.0%	39.1%
: Bharti Tele	BHTIF	C-1-9	498		6.0%	
: Reliance Communication	RCLMF	C-1-7	369		4.0%	
Others				3.6%	2.5%	-31.2%
: NTPC	NTHPF	C-1-7	126		2.5%	

Source: Merrill Lynch Research

Recent Changes (see "India Snapshot" dated October 26, 2006 for details)

- **Downgrade autos to U/W (from Neutral) by removing Tata Motors from model portfolio**
- **Cut weight of Reliance Industries by 300 bps**
- **Add HPCL to model portfolio with 500 bps weight**
- **Add TCS with 1,000 bps weight and cut Infosys by an equivalent amount**

Top Buys

Table 2: Merrill Lynch Top Buys

Company	ML Symbol	Reco	Price	Mkt Cap	Volume	PE			EPS CAGR	RoE (%)		P/BV
				(US\$m)	(US\$m)	FY06	FY07E	FY08E	06-08E	FY07E	FY07E	FY07E
Assoc. Cement	ADCLF	1 - Buy	974	4,017	22.18	40.0	17.1	13.0	75%	41.2	6.0	
Bharat Heavy	BHRVF	1 - Buy	2,447	13,208	28.28	37.0	25.0	22.2	29%	28.9	6.5	
Larsen & Toubro	LTOUF	1 - Buy	1,274	7,863	29.83	33.3	24.2	19.4	31%	27.4	5.9	
Tata Consultancy	TACSF	1 - Buy	1,079	23,273	23.26	36.6	24.9	19.9	36%	54.4	10.8	
Bharti	BHTIF	1 - Buy	498	20,806	9.51	41.7	27.8	19.2	48%	31.8	7.8	

Source: Merrill Lynch Research

Top Sells / Under-performers

Table 3: Merrill Lynch Top Sells/ Under-performers

Company	ML Symbol	Reco	Price	Mkt Cap	Volume	PE			EPS CAGR	RoE (%)		P/BV
				(US\$m)	(US\$m)	FY06	FY07E	FY08E	06-08E	FY07E	FY07E	FY07E
Hero Honda	XHROF	3 - Sell	749	3,299	11.0	15.4	15.6	15.1	1%	42.3	6.0	
HLL	HINLF	3 - Sell	229	11,149	18.9	38.5	32.5	28.0	17%	65.2	20.5	
Bajaj Auto	BJJAF	2 - Neutral	2,819	6,290	16.0	25.5	22.7	20.5	12%	24.7	5.3	
Ranbaxy Lab	XANBF	2 - Neutral	411	3,374	13.3	71.7	29.6	24.2	72%	21.6	5.7	
Hindalco	HDEIF	2 - Neutral	184	4,697	21.1	11.2	8.6	12.6	-6%	22.9	1.7	

Source: Merrill Lynch Research

Top Mid-caps - Divi's Lab, Panacea Biotech, Nagarjuna Construction, Infotech India, Welspun India

Table 4: Merrill Lynch Top Mid-cap Buys

Company	ML Symbol	Reco	Price	Mkt Cap	Volume	PE			EPS CAGR	RoE (%)		P/BV
				(US\$m)	(US\$m)	FY06	FY07E	FY08E	06-08E	FY07E	FY07E	FY07E
Divi's Lab	XXQPF	1 - Buy	2,477	700	5.1	45.7	29.8	18.1	59%	26.7	6.9	
Panacea Biotec	XPEAF	1 - Buy	415	522	0.2	39.5	20.9	15.7	59%	63.2	10.1	
Nagarjuna Const	NGRJF	1 - Buy	159	726	4.1	31.6	18.5	12.4	60%	18.1	3.1	
Infotech India	IFKEF	1 - Buy	247	250	0.8	22.4	13.9	11.9	37%	32.9	4.0	
Welspun India	WPNIF	1 - Buy	95	151	0.2	19.3	13.2	8.8	48%	10.1	1.3	
Shree Cements	SREEF	1 - Buy	1,132	870	0.8	27.0	12.3	11.4	54%	65.6	6.3	
IVRCL Infrastruc	IIFRF	1 - Buy	276	661	13.8	35.4	21.6	16.4	47%	27.2	4.7	
Bank of India	XDIIF	1 - Buy	148	1,590	6.5	10.3	8.0	6.3	28%	17.0	1.3	

Source: Merrill Lynch Research

Key Economic & Financial Forecasts

Table 5: Key economic and financial forecasts

	FY03	FY04	FY05	FY06	FY07 MLE	FY08 MLE
GDP (% real change)	3.8%	8.5%	7.5%	8.4%	8.0%	7.6%
Components of GDP (% real change)						
Agriculture	-6.9%	10.0%	0.7%	3.9%	1.0%	2.5%
Industry	6.8%	6.6%	7.4%	7.6%	8.8%	7.4%
Services	7.3%	8.5%	10.2%	10.3%	10.0%	9.3%
Wholesale Price Index (Year end)	6.5%	4.6%	5.1%	4.1%	5.4%	4.2%
Exports (fob :US\$ bn)	53.8	66.3	82.2	104.8	125.7	142.5
Exports (% YoY)	20.3%	23.3%	23.9%	27.5%	20.0%	13.3%
Imports (fob.:US\$ bn)	64.5	80.0	118.8	156.3	193.5	224.0
- Oil imports (US\$ bn)	17.6	20.6	29.9	43.8	54.3	57.4
- Non-oil imports, incl. defense (US\$ bn)	46.8	59.4	88.9	112.5	139.2	166.6
Imports (% YoY)	14.5%	24.1%	48.5%	31.6%	23.7%	15.8%
- Oil imports (% YoY)	26.0%	16.8%	44.9%	46.8%	23.8%	5.8%
- Non-oil imports (%YoY)	10.8%	26.9%	49.7%	26.5%	23.7%	19.7%
Trade Balance (US\$ bn)	-10.7	-13.7	-36.6	-51.6	-67.7	-81.6
Current account (% GDP)	1.3%	2.3%	-0.8%	-1.3%	-2.0%	-2.0%
Current Account (US\$ bn)	6.3	14.1	-5.4	-10.6	-17.8	-20.7
Capital Account (US\$ bn)	10.8	16.7	31.0	24.7	29.5	35.6
Total Balance of Payments (US\$ bn)	17.2	30.8	25.6	14.1	11.8	14.9
Fiscal deficit (% of GDP)	5.9%	4.5%	4.1%	4.1%	3.9%	3.6%
Exchange rate INR/USD (Year end)	47.5	43.6	43.7	44.6	45.0	43.0
10-year G-Sec yield (Year end)	6.2	5.2	6.7	7.5	8.1	8.0

Source: CSO, DGCI&S, Office of the Economic Adviser, RBI, Bloomberg, Merrill Lynch Research

Table 6: Sensex valuation estimates

	FY04	FY05	FY06	FY07E	FY08E
P/E (x)	34.2	27.3	23.3	18.7	16.5
EPS (Rs)	369	463	541	676	763
EPS Growth (%)	25.3%	28.3%	18.1%	31.4%	12.9%
P/ CEPS (x)	25.1	20.6	17.9	14.5	12.9
CEPS Growth (%)	18.0%	23.6%	15.7%	27.2%	13.0%
P/ BV (x)	6.9	5.9	5.2	4.2	3.5
RoE (%)	21.3%	24.1%	24.4%	24.5%	23.2%
Cor Gearing (%)	21.5%	16.8%	16.5%	9.0%	3.8%
Dividend Yield (%)	0.9%	1.0%	1.3%	1.3%	1.6%
EV/EBITDA (x)	22.0	17.7	15.5	11.84	10.68

Source: Merrill Lynch Research

1. Markets - We Expect Negative Returns in 2007

1-year index target 10% lower at 11,500

We started this year expecting markets to be flat to slightly down. After hitting that level in mid-year, markets have bounced back to previous highs. We think next year will be a negative year for the markets and we have an index target of 11,500 for the market for December 2007 (at 15x forward earnings), a 10% drop from current levels.

1. We expect the economy to continue to perform strongly led by higher spend on infrastructure. Near term, however, rising inflation and interest rates could worry the markets (Chapter 3)
2. More importantly, we estimate earnings growth will slow to around 11% in FY08, sharply lower than the trend of 25% growth seen over the past few years. The slow-down will likely be led by falling commodity prices as the globe slows. (Ch 5)
3. Reforms will continue to be slow and unlikely to help re-rate the markets. (Ch 6)
4. Valuations at nearly 18x 1-year forward earnings are expensive in a regional as well as historical context and are the highest in a post-bubble era. We expect valuations to contract as (a) market gains cognizance of the slowing earnings and (b) RoEs fall from the FY07 levels by around 130 bps. (Ch 7)
5. Increased supply of paper (we expect \$12 bn over next 6 months) will put pressure on flows to the secondary markets. (Ch 8)

Market rally has been narrow

The recent rally in the markets has been narrow with (a) mid-caps delivering a very poor return and (b) large caps returns being concentrated. Of the 30 Sensex companies, only 13 have touched their previous highs of May though the Sensex has crossed those levels.

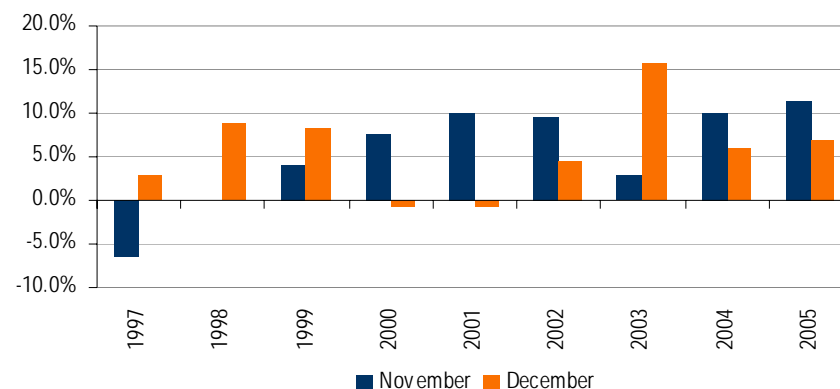
Near term outlook - Mixed picture for markets

The near term picture for markets appears mixed. Going by recent history, markets in November and December are typically buoyant. However, open interest is nearing peak levels and valuations are looking expensive.

November and December have been good months

We have not had a negative return in the period 1 November-31 December since 1997. One reason for that is over past few years, around 45-50% of total FII flows has been seen in the Sept-December period. Hence, past history would make us positive on markets over next 2 months.

Chart 1: Market returns in Nov/Dec months

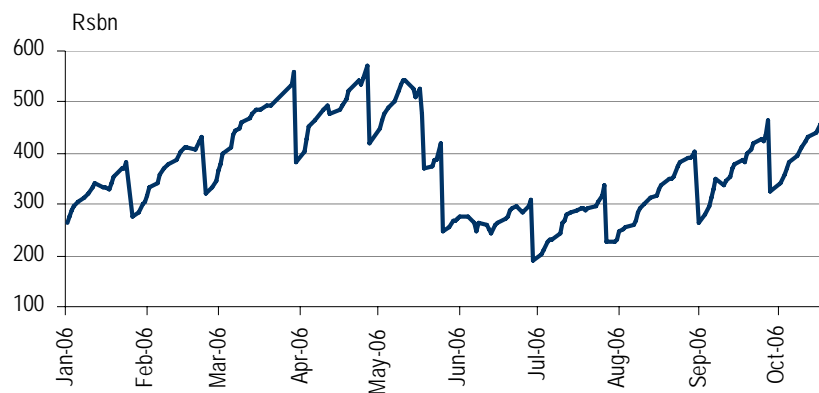


Source: Bloomberg

Open interest nearing May highs

Open interest has been rising over past few months and has come within 10-15% of the levels before the May crash in the markets. This implies that sentiment has turned bullish and the market is not ready to absorb any negative news.

Chart 2: Open interest is rising



Source: Bloomberg

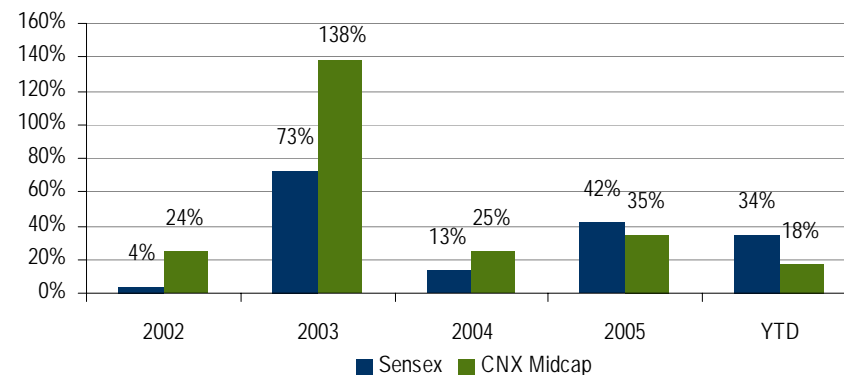
Supply of paper could be strong

Over next 2 months we could see supply of paper of nearly \$5-6 bn. If this is not pushed back, this could hurt secondary market performance.

Mid-Caps could outperform big caps

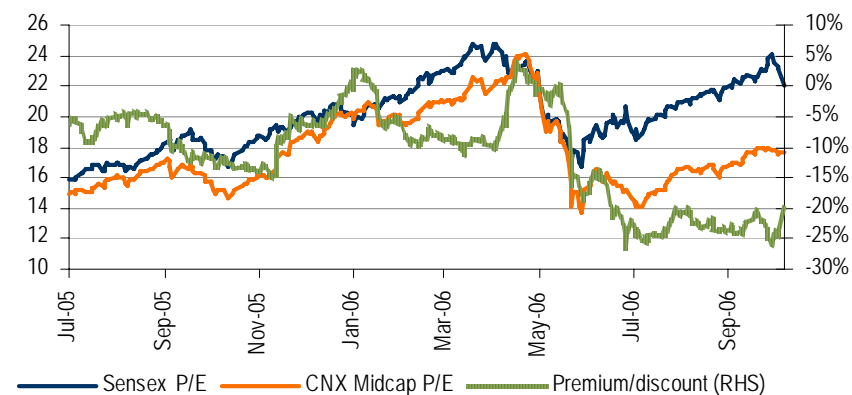
The current rally has been largely led by big caps with mid-caps lagging. However, mid-caps are now trading at a 20% discount to PEs of big caps, amongst the highest in recent history. We believe mid-caps could outperform big caps over the next year though investors could avoid them if the market remains edgy and risk appetite low.

Chart 3: Mid caps have underperformed YTD



Source: Bloomberg

Chart 4: CNX Midcap premium/discount to Sensex PE



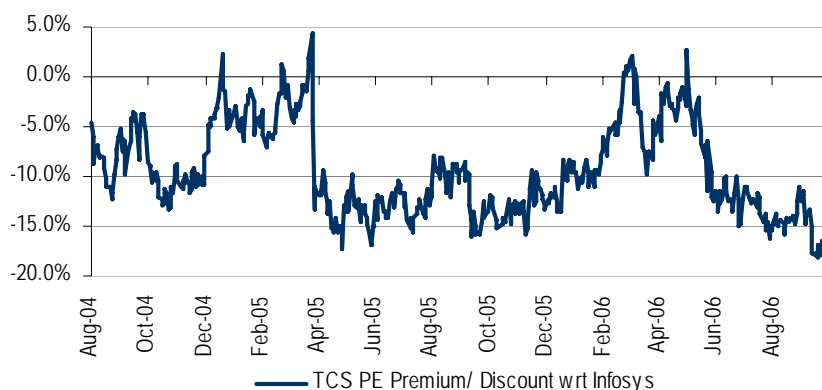
Source: Bloomberg

2. Switch Ideas

#1: Switch from Infosys to TCS

- **More attractive valuations:** TCS trades at a 17.5% PE discount to Infosys, amongst the highest discounts it has traded over past few years. We expect this discount to narrow over next few months as TCS delivers earnings growth in line with Infosys.

Chart 5: TCS PE discount to Infosys



Source: Merrill Lynch Research

- **Earnings growth stronger for TCS over next 6 months:** Over next 6 months, we estimate sequential earnings growth for TCS of 13% vs 6% for Infosys. We expect consensus to upgrade earnings for TCS over next months. Our EPS forecasts for FY07 at Rs 43.4 and for FY08 at Rs 54.2 are 5% over consensus. In FY07-09, we expect TCS to grow earnings at a similar pace as Infosys.
- **TCS could see margin improvement unlike industry peers:** During the quarter, TCS grew margins by 300 bps. We believe TCS is better placed to expand margins due to:
 - Increase in offshore revenues: to 41% this quarter vs 38% last quarter and we could see this increase to 45% over next few years.
 - Improving profitability of large deals (eg ABN Amro) and subsidiaries (eg FNS).

#2: Switch from HLL to ITC

- **Structural growth potential** – ITC's core cigarette business (88% of EBIT) has a penetration rate of <15% (since India is predominantly a 'bidi' market). On the other hand, HLL's soaps and detergents (40% of EBIT) have a penetration rate of over 90%. With growing income levels, we see the 'up-trading' potential more in ITC relative to HLL.
- **Competitive position** – We believe ITC is a virtual monopoly with over 80% value share in cigarettes. Moreover this market share appears protected given the increasing cigarette advertising restrictions. In the case of HLL, competitive threats loom large with P&G keen to build a larger India business and ITC likely to launch its household products business.
- **Rural thrust** – We are excited about ITC's ongoing investments in rural retail infrastructure – e-choupals and choupal sagars. We believe over the next few years, ITC will likely have stronger linkages with rural India relative to HLL. This is important because we believe future growth in the consumer sector will be driven by rural India.
- **Valuations** – Notwithstanding the near term headwinds of VAT levy and excise increase in cigarettes, from a longer term perspective, we believe ITC appears more attractive with profit growth of >20% and trading at 21x FY08E. In the case of HLL, we forecast ~16% profit growth and it trades at 28x Dec07E.

#3: Switch from Tata Steel to SAIL

- **Restructuring potential** – We believe SAIL is today where Tata Steel was a few years back with poor product mix and high labor cost. But we believe SAIL is changing. Over the next few years we expect product mix to improve with share of semi-finished steel to fall from current 17% to less than 5%. Further, labor costs are likely to fall with voluntary retirement schemes and natural attrition. Tata Steel, on the other hand, has benefited from restructuring over the last few years and we believe now unlike SAIL, has limited internal growth drivers.
- **Low cost brownfield capex** – SAIL's capacity expansion from current 12m tons to 20m tons by FY12E will be led by shift from the inefficient ingot casting to continuous casting and re-lining of existing blast furnaces. These should improve production parameters and will likely be lower cost versus Tata Steel's large greenfield capacities planned over the next few years.

- **Less balance sheet risk** – Given the low cost capex and improving efficiencies, we expect SAIL to remain net cash positive over the next few years. In the case of Tata Steel, with all debt financing for the potential Corus acquisition, we estimate gearing will increase to 2.2x in FY08. Moreover, given management's plans to continue pursuing organic growth in India, the stretch on the balance sheet will likely be even greater.
- **Valuation** – SAIL appears more attractively valued than Tata Steel. For FY08, SAIL trades at P/E of 6.5x vs. Tata at 8.5x and in terms of EV/EBITDA 2.8x vs. Tata at 4.8x. Comparing on the basis of pure steel EV, we estimate SAIL trades at EV/ton of US\$410 vs. Tata at US\$765. Although we believe SAIL should trade at a discount given its inferior production assets and higher leverage to steel prices, the current valuation gap looks unjustified.

#4: Switch from Tata Motors to Maruti

- **Stronger growth likely in passenger cars:** Commercial Vehicles (CVs) have seen strong growth this year and will likely end FY07E with a 33% jump in volumes. However, we believe CV sales will slow considerably in FY08 as the base effect of the ban on overloading that drove truck demand in FY07 rolls over. Passenger vehicles on the other hand should show a growth of 15-20%.
- **Maruti gainer from passenger vehicle growth:** Maruti's domestic exposure to this segment is over 95% of revenues (and 67% in compacts which is expected to lead growth), compared to 20% for Tata Motors (only 15% in compacts). Tata Motors has 43% of sales from the truck business.
- **Tata Motors could see earnings downgrades:** While we forecast a growth rate of 28% for Tata Motors in FY07 vs 37% for Maruti, we expect Maruti growth to be under 15% for FY08 compared to over 20% for Tata Motors. However, we expect earnings downgrades for Tata Motors given the likely slow-down in the CV business. However, there is greater visibility on Maruti earnings following Suzuki's decision to leverage growth from a single entity in India and Nissan contracting to outsource cars from Maruti.
- **Valuations adjusted for growth similar:** On a PE basis, both Tata Motors and Maruti trade at similar multiples for FY07 but Tata Motors is more attractive on FY08. Growth visibility is, however, stronger for Maruti. On a growth adjusted PEG basis, both trade at similar multiples of 0.9x

#5: Switch from Ranbaxy to Dr. Reddy's

- **Strong earnings growth for Reddy's over next two quarters vs near-term earnings risk for Rannbaxy:** In our view there could be a risk of near-term earnings downgrades for Ranbaxy. For the 9-month period CY06E, Ranbaxy achieved just 60% of the consensus estimated EPS of Rs14.5 (vs MLe of Rs13.8) and we do not anticipate any significant launches in 4Q. On the other hand we estimate 50% earnings growth for Reddy's for the next two quarters due to a beneficial base and impact of new launches.
- **Relative valuations better for Reddy's with scope for earnings upgrade:** Based on our current estimates, Reddy's trades at 15% PE multiple discount and over 20% EBITDA multiple discount to Ranbaxy. This discount could increase further over the next few quarters given potential upward bias to our estimates on new launches and higher market share in 'big ticket' launches like generic Zocor and Allegra.
- **Near-term catalysts expected for Reddy's vs near-term concerns for Ranbaxy:** In case of Reddy's we anticipate two key near-term catalysts which could support earnings upside for FY08. These include (a) Possible 6-month exclusivity for generic Zofran tablets (Dec 06) and (b) Entry of Balaglitazone NCE into Phase III trials (by year-end). Ranbaxy's near-term product visibility is marred by FDA manufacturing issues.

3. US-led Global Slow-down

We forecast a global slow-down in CY2007

Merrill Lynch economists see a sharp decline in US growth from 3.3% in 2006 to 1.8% in 2007. But growth outside the US could slow only moderately, from 5.6% in 2006 to 5.2% in 2007. This is estimated to lead to a moderate slowing in global growth from 5.2% in 2006 to 4.4% in 2007. (See report "Global Slowdown, local strength: sources of demand in 2007," 13 September, 2006). The 60bps slow-down in growth is within the bounds of a "soft landing" and a slow-down in growth of a similar magnitude in 2005 resulted in no major turbulence in global financial markets.

Two key sources of growth should help cushion the slow-down in the US consumer:

1. The rise of independent domestic demand, and the emergence of regional "poles" of growth. From our perspective the large countries of Asia – India, Korea, China and Japan - form one such pole.
2. The ability of key countries to implement supportive, offsetting macro policies.

Table 7: ML Global Growth Forecasts

	Real GDP Growth (%)		
	2005	2006F	2007F
World	4.7	5.2	4.4
US	3.2	3.4	1.9
Non US	5.0	5.6	5.2
:Japan	2.6	3.1	3.0
:Euroarea	1.4	2.6	2.1
-Germany	1.0	2.3	1.6
-UK	1.9	2.3	2.4
-France	1.2	2.4	2.4
:Brazil	2.3	3.3	3.4
:Russia	6.4	7.0	6.3
:India	8.4	8.0	7.6
:China	9.9	10.3	9.5

Source: Merrill Lynch Research

India can withstand a US-led slow-down

Overall, we think the Indian economy will be relatively immune to a US-led slow-down. Exports (including services) account for around 12% of the economy and domestic drivers for the economy, both investment and consumption, remain strong.

1. **Growth impact low:** India's exports (including software and BPO) to the US are under 5% of GDP. Moreover, given the outsourcing nature of the service exports, they may be relatively insulated in a US slow-down. Domestic drivers, both consumption and infrastructure spend, continue to be strong.
2. **Interest rates to move up lower than expected:** Given the sharp growth in credit in India, interest rate fears continue to be high. However, we expect a 125 bps cut by the Fed in US by end-2007 and this should help moderate rate hikes in India. We expect the Bank of Japan, the ECB and the Bank of Korea to raise rates by a further 75 bps over next 12 months. In India we are looking at a 40-50 bps increase in rates.

Table 8: ML Interest Rate Forecasts

	ST Interest Rates (%)		
	2005	2006F	2007F
US	5.3	5.3	4.0
Non US			
:Japan	0.3	0.5	1.0
:Euroarea	3.0	3.5	3.8
-Germany	3.0	3.5	3.8
-UK	4.8	4.8	4.8
-France	3.0	3.5	3.8
:Brazil	14.3	13.8	12.8
:Russia	11.5	11.5	10.0
:India	7.5	8.1	8.0
:China	6.1	6.1	6.4
:Korea	4.5	4.8	5.3

Source: Merrill Lynch Research

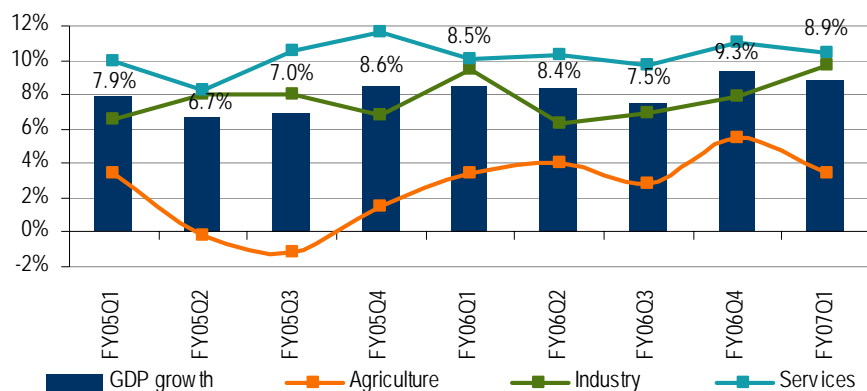
3. **Rupee to strengthen:** Globally, we think that the US dollar should be negatively impacted by the Fed easing cycle that we expect as also by the continued withdrawal of monetary accommodation by other central banks. This will help an appreciation in the Indian rupee also.
4. **Emerging Market Risk Premiums may rise:** The US slow-down is clearly a cyclical headwind. Historically, cyclical downturns are usually difficult periods for Global Emerging Market equities and risk premiums tend to rise.

4. Economy - Led by Infrastructure

Indian GDP continues to surprise positively

We continue to see the economy perform better than our as well as consensus GDP growth forecasts. We have recently raised our GDP forecasts for FY07 to 8% from 7.7% following better than expected 1QFY07 GDP growth at 8.9%. Both services and industrial growth have been strong growing at 10.5% and 9.7% respectively.

Chart 6: Quarterly GDP growth



Source: CSO, Merrill Lynch Research

Investments, esp infrastructure to drive growth

Both consumption and investment demand has been strong over the past few years. We remain bullish on infrastructure spend driving investment demand. Over next year, corporate capex too will likely be strong and drive growth in investment demand.

- Based on our bottom-up approach, we forecast total infra spend at US\$109bn over FY06-08 - 61% rise compared with the FY03-05 spend at 17% CAGR. We expect power sector to be the biggest driver, accounting for 30% of this spend followed by oil & gas, railways, roads, airports and ports.
- Our top-down model forecasts that pent-up demand (deficit of 8.3% on base demand & 12.3% on peak load) and an expanding economy should lead to 53% growth in per capita consumption of power by FY12.

- We estimate India to double the power generation capacity addition by 56GW (government plans to add 62GW) during the XI Plan +90% over the X Plan.

Roads:

NHAI capex plans of Rs1720bn (US\$40bn) improve visibility of road capex over FY06-12E. Consequently, we forecast road capex to double over FY06-08. Key driver of capex over FY06-09E:

- Phase II – NS-EW Corridor – Rs300bn (70% ordered)
- Phase III – BOOT Projects – Rs550bn (27% ordered)

Key driver of capex FY09-12E:

- Phase IV – 20K km Corridor – Rs240bn
- Phase V, VI, VII – BOOT Projects – Rs528bn

Table 9: Share of Sectors In Total Infra Spend

% of Total	FY03-05 (US\$bn)	FY06-08 (US\$bn)	Total Increase	CAGR
Power	22.24	32.31	45%	13%
Telecom	15.75	19.04	21%	6%
Ports	0.34	1.31	286%	56%
Airports	0.81	2.50	208%	45%
Railways	10.41	16.32	57%	16%
Oil & Gas	11.02	22.96	108%	27%
Roads	7.03	14.47	106%	27%
Total	67.60	108.80	61%	17%

Source: Merrill Lynch Research

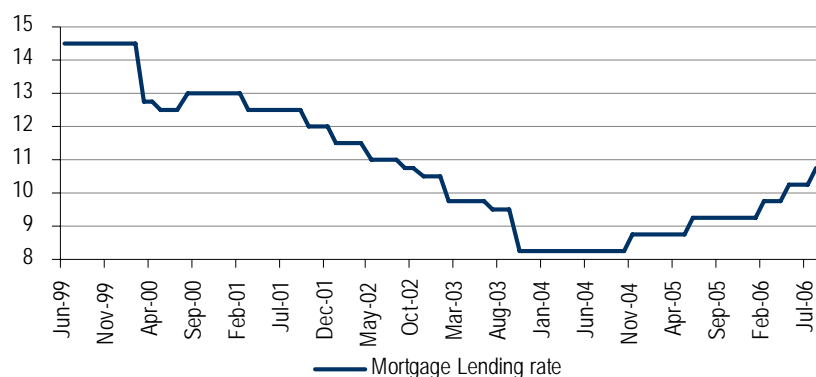
- Future business model:** Most of the NHAI's future projects are likely to be awarded on BOOT toll basis to leverage private capital and entrepreneurship. The projects that are not viable would be given viability gap funding upto 40%. To provide sustainable foundation for PPP model to succeed a new model concession agreement is likely to replace the current concession agreement and hence, there have been delays in awarding the BOOT projects YTD 2006. However, NHAI hopes that the current delay would be offset by accelerated ordering, once the concession agreement is finalized over the next few months.

Where are the worries on growth?

#1: Rising interest rates could slow consumption spend

We believe growth is largely immune from a US-led global slow-down given the structural factors driving consumption growth (demographics, rising income levels and easy availability of retail credit). However, relatively, we could see a slow-down in consumption demand due to rising interest rates in India.

Chart 7: Mortgage lending rates are on a rise

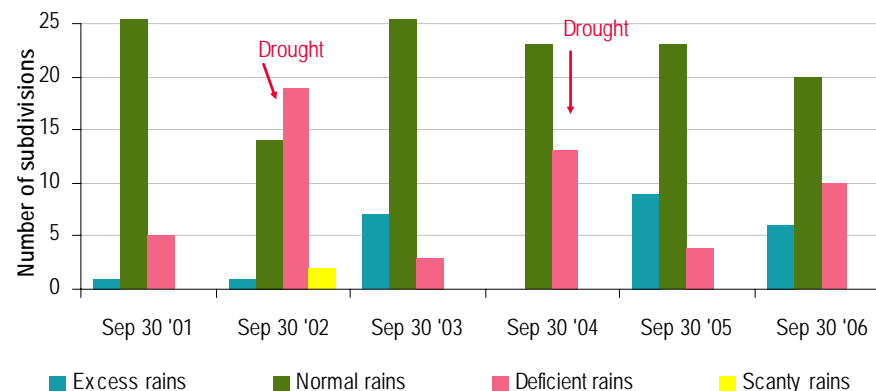


Source: HDFC, Merrill Lynch Research

#2: Patchy monsoon could slow rural demand

Though aggregate monsoon for the season was just 1% below normal, the distribution of rainfall was poor with key farming states like Uttar Pradesh and Haryana receiving deficient rains and states like Gujarat and parts of Maharashtra reeling under floods. Of the 36 met sub-divisions in India, only 20 received normal rains this year – the lowest number since the 2002 drought. Meanwhile, 10 subdivisions got deficient rains, the highest number save for the drought years of 2002 and 2004.

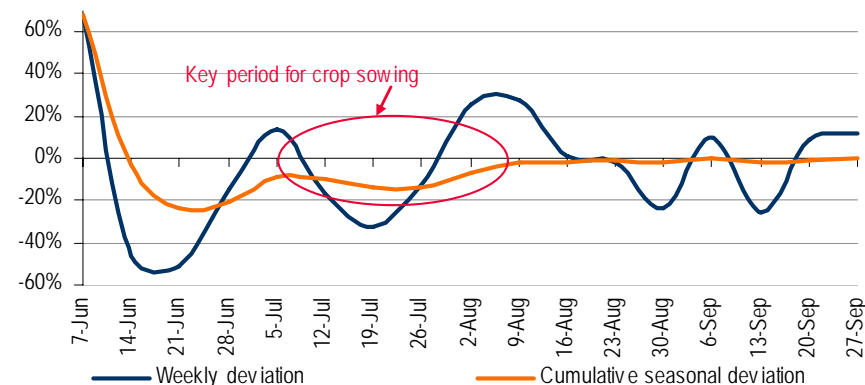
Chart 8: Distribution of monsoon rains in season starting June 1



Source: IMD, Merrill Lynch Research

Similarly the timing of the monsoon was not great with July, the key month for sowing, seeing below normal rains.

Chart 9: Monsoon rainfall deviation from normal



Source: IMD, Merrill Lynch Research

The uneven monsoon has taken its toll sowing with the area planted under the kharif (summer) crop down 2.1%. The Government first advance estimates show that kharif grain output is likely to be down 4.3% yoy. We estimate agriculture growth at 1% for FY07 and hope that the rabi (winter) crop is good given the water stock in India's reservoirs are up 15-20%. However, rural income is likely to see a slow-down compared to the sharp growth post the strong agriculture season in FY06.

Table 10: Summary of progress in Kharif crop sowing (in million hectares)

Crop	Normal	Area coverage up to September 29			
		2006	2005	Difference	% change
Rice	38.2	36.1	36.3	-0.2	-0.5%
Coarse Cereals	22.9	20.6	22.2	-1.5	-6.8%
Sugarcane	4.2	4.4	4.3	0.2	3.9%
Cotton	8.3	8.9	8.4	0.4	5.1%
Oilseeds	15.4	16.3	17.4	-1.1	-6.1%
Pulses	10.9	11.2	11.2	0.0	0.3%
ALL CROPS	99.8	97.7	99.8	-2.0	-2.1%

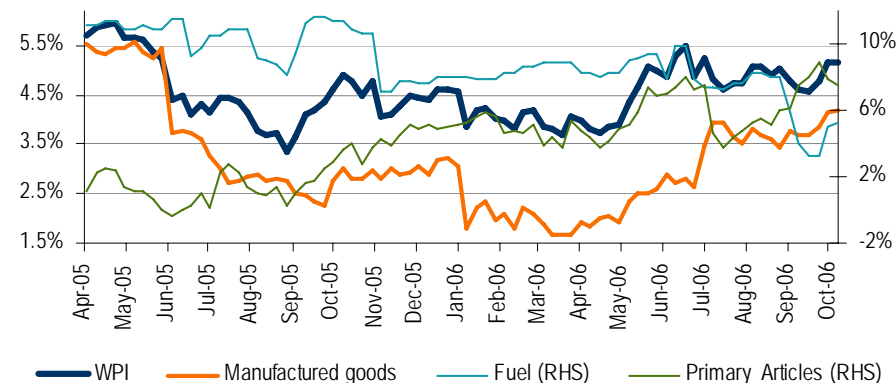
Source: Ministry of Agriculture, Merrill Lynch Research

Inflation to rise near term; fall in FY08

Rise to 6%+ by Q1FY07: We expect inflation currently running at slightly over 5% to hit the 6%+ level by January 2007 primarily due to a rise in manufacturing inflation. Increase in prices of food products (due to weaker monsoons) could also add to inflationary pressures. Our forecasts build in no change in prices of oil products.

Fall to around 4% in FY08: While inflation will hover in the 5.5-6% range for Q4FY07, we expect inflation to come down to under 4% by mid-FY08 with no increase likely in oil prices. Moreover, a slowing global economy will help ease pressure on manufactured products (especially metals and chemical prices).

Chart 10: Wholesale price index and its components

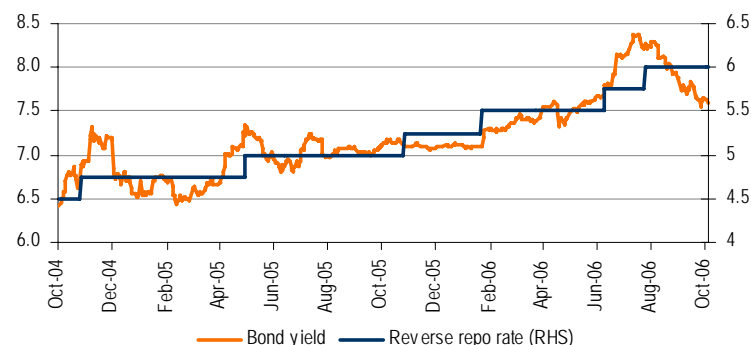


Source: Office of the Economic Adviser, Merrill Lynch Research

Interest rates to rise slower than expected; peak in FY07

Given the expected rise in inflation over next 4-6 months, we expect RBI to increase repo rates by 25 bps (to 6.25%) in Jan, 2007. We expect bond yields to move up by around 40 bps over next 4-6 months with our March, 2007 target being 8.1% for the 10-year G-Sec yield. However, we expect bond yields to be flat in FY08.

Chart 11: The benchmark bond yield versus the policy rate



Source: RBI, Bloomberg, Merrill Lynch Research

Lending rates will outpace G-Sec yields, rising 75-100 bps: While we expect G-Sec yields will rise only 40 bps over next year, we think the increase in bank lending rates will be much sharper at 75-100 bps. The higher increase in bank lending rates will be driven by strong credit growth that will compel banks to borrow through ECBs and subordinate debt which are higher cost borrowings.

Factors driving interest rates

Apart from inflation, we identify 3 factors driving interest rates:

1. **Strong deposit and credit growth:** We expect deposit growth at 22% for FY07 and 19% for FY08, higher than trend over past few years. Stronger deposit growth is led by an increase of around 200 bps in interest rates offered on deposits, making returns on deposits comparable to those on other debt asset classes. We expect loan growth to be 26% for FY07 and 22% for FY08, due to rising infrastructure demand.

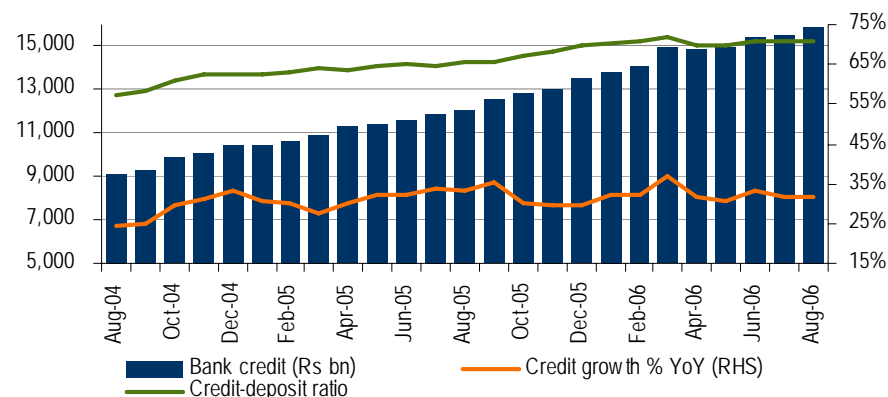
Table 11: Liquidity Analysis

Rs bn	Mar-02	Mar-03	Mar-04	Mar-05	Mar-06	Mar-07	Mar-08
Deposits	10,899	12,809	15,044	17,851	21,090	25,730	30,619
Loans (incl. credit subs)	7,106	8,221	9,828	12,428	16,007	20,230	24,776
Investments	4,369	5,234	6,560	7,203	7,007	7,935	8,974
SLR	40%	41%	44%	40%	33%	31%	29%
YoY growth							
Deposits	15%	18%	17%	19%	18%	22%	19%
Loans (incl. credit subs)	21%	16%	20%	26%	29%	26%	22%
Investments	20%	20%	25%	10%	-3%	13%	13%
YoY/ YTD Growth in Rs bn							
Deposits	1,388	1,910	2,236	2,807	3,239	4,640	4,889
Loans (incl. credit subs)	1,212	1,115	1,608	2,600	3,579	4,222	4,547
Investments	719	866	1,326	642	-195	928	1,039
Surplus / (Deficit)	-542	-71	-698	-435	-145	-510	-697
L-D Deficit	177	794	628	207	-340	418	342
Loan Deposit Ratio (LDR) o/s							
Incremental LDR	65%	64%	65%	70%	76%	79%	81%
Incremental LDR	87%	58%	72%	93%	110%	91%	93%

Source: Merrill Lynch Research

2. **Credit: Deposit ratio continues to be high but stable:** After a sharp increase in C/D ratio over past 2 years, we think the rise will be more moderate. But the C/D ratio will inch higher to around 80% by FY08E, meaning that interest rates are likely to see upward pressure but at a much slower rate.

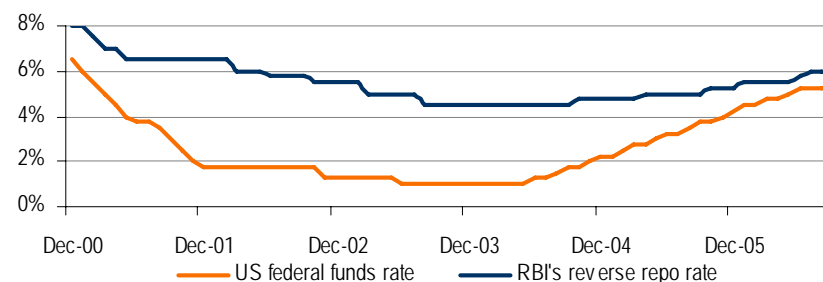
Chart 12: Bank credit trends



Source: RBI, Merrill Lynch Research

3. **Easing US rates:** We expect US interest rates to decline in CY07 by 75 bps that will help ease pressure on interest rates in India. At the same time, the differential between Indian and US rates is low relative to history, such that Indian rates will be stable rather than move down in tandem.

Chart 13: Policy interest rates: US versus India



Source: US Federal Reserve, Reserve Bank of India

4. **G-Secs yield to drop due to high demand:** Given the sharp increase in deposit growth, demand from banks for G-Secs will rise. This will keep G-Sec yields in check. However, lending rates by banks will continue to rise given the credit offtake and increase in funding costs for banks.

Rupee expected to strengthen as trade deficit falls

We expect the rupee to strengthen from current levels by around 2% upto March 2007 and by 4% in FY08. This is led by 2 factors:

1. Weaker dollar as the Fed eases interest rates.
2. Improvement in the trade deficit as oil prices come off and continued strength in the capital inflows. One factor to watch here would be the outflow on FDI front as corporate India is actively acquiring companies abroad.

Table 12: Balance of payments

	FY04	FY05	FY06	FY07E	FY08E
Exports	66.3	82.2	104.8	125.7	142.5
<i>YoY Growth</i>	23%	24%	28%	20%	13%
Imports	80.0	118.8	156.3	193.5	224.0
<i>YoY Growth</i>	24%	48%	32%	24%	16%
Trade balance	-13.7	-36.6	-51.6	-67.7	-81.6
Invisibles	27.8	31.2	40.9	49.9	60.8
<i>YoY Growth</i>	63%	12%	31%	22%	22%
Current Account	14.1	-5.4	-10.6	-17.8	-20.7
Foreign Investment	13.7	12.1	18.2	18.8	22.1
Loans	-4.4	10.8	4.7	8.3	10.1
Banking Capital	6.0	3.9	1.4	1.4	1.3
Rupee Debt Service	-0.4	-0.4	-0.6	-0.5	-0.5
Other Capital	1.7	4.7	0.9	1.5	2.5
Capital Account	16.7	31.0	24.7	29.5	35.6
Errors & Omissions	0.6	0.5	1.0	0.0	0.0
Overall Balance	31.4	26.2	14.1	11.8	14.9
Current Account / GDP (%)	2.3%	-0.8%	-1.3%	-2.0%	-2.2%
Trade Balance / GDP (%)	-2.3%	-5.3%	-6.5%	-7.6%	-8.8%

Source: Merrill Lynch Research

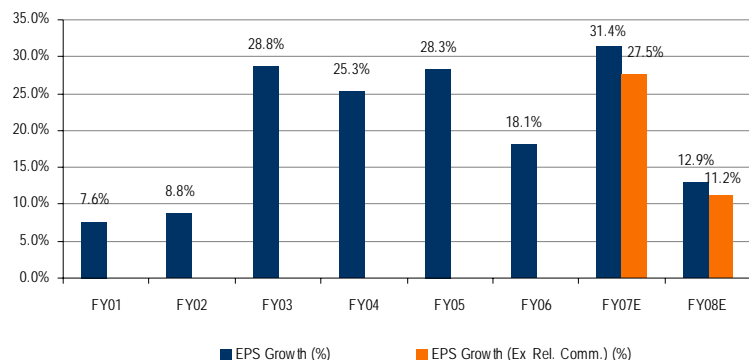
5. Earnings Not as Defensive as Economy

While the economy is likely to be resilient in the face of a US-led global slow-down, we think earnings are more susceptible. Our bottom-up forecast indicates that EPS growth for FY08 for the Sensex companies (ex-Reliance Communication) will be 11%, a significant slow-down from the 27.5% growth estimate for FY07.

We expect earnings to slow in FY08

Our bottom-up forecast indicates that EPS growth for the Sensex companies is set for a significant slow-down in FY08. Excluding Reliance Communications, earnings in FY08 could rise only 11.2% compared to the 27.5% forecast for FY07. (We exclude Reliance Communications since it had no base earnings in FY06 and hence tends to bloat FY07 earnings numbers.) This will be the slowest earnings growth since FY02.

Chart 14: Sensex EPS growth set to slow significantly in FY08



Source: Merrill Lynch Research

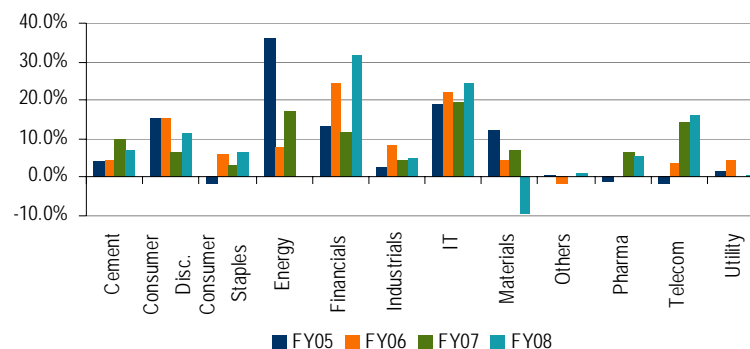
Why will earnings slow?

#1: Global commodities hit by slow-down

One of the biggest reasons for the slow-down in earnings is that global commodity sectors like petrochemicals, oil and metals (Reliance, ONGC, Tisco and Hindalco) will see slower earnings growth as the commodity cycle globally rolls over. These sectors account for 19% of the Sensex and 25% of aggregate earnings in FY08E.

This is best explained by the chart below. In FY05, energy plus metals accounted for nearly 50% of the incremental profit growth and in FY07 they are more likely to be 25%. In FY08, they are likely to contribute negatively to incremental earnings growth.

Chart 15: Sensex EPS growth composition

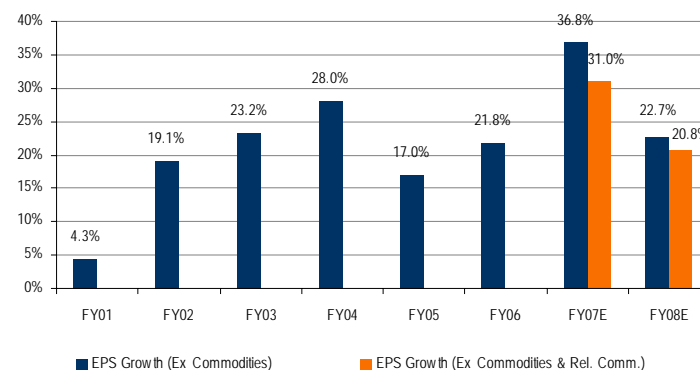


Source: Merrill Lynch Research

#2: Domestically too, earnings could slow cyclically as interest rates rise

Excluding global commodities, earnings will slow from the cyclical highs of FY07. But the impact is not dramatic compared to the aggregate Sensex earnings.

Chart 16: Sensex EPS growth ex-commodities



Source: Merrill Lynch Research

We believe there are 3 factors that will drive a cyclical slow-down in earnings:

1. **Rising interest rates:** The impact will be felt more in slower sales than in the interest cost of companies (since gearing for Sensex companies is practically negligible).
2. **Poor monsoon:** This could hurt rural incomes and affect sales of related companies.
3. **Capacity utilization leverage behind us:** Over the past few years, companies had a high leverage from increased capacity utilization. However, with most companies running at optimum utilization and expanding capacities, this leverage is behind us.

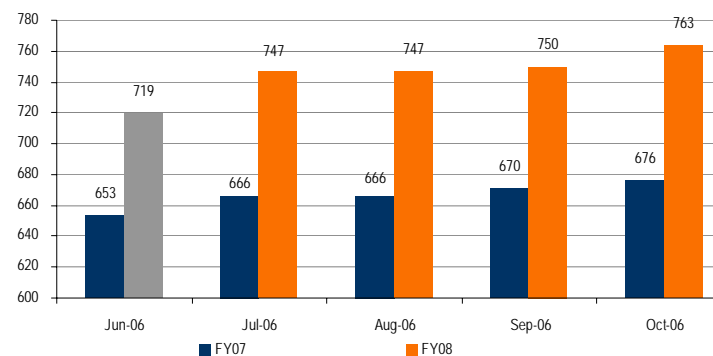
#3: Rupee appreciation to hurt earnings

Rupee appreciation hurts earnings for Indian companies. We find for every 5% appreciation of the rupee, Sensex earnings fall 3.5%. We expect rupee to appreciate over 5% in H2FY07 and FY08.

Will earnings be upgraded?

We have seen a steady stream of earnings upgrades over the past 3 years. Hence, investors remain skeptical that earnings will slow next year. However, FY06 saw EPS downgrades which pushed up FY07 estimates. Also, we have yet to see a slow-down in global growth. We believe if the US slows as forecast by us, EPS growth for FY08 is unlikely to exceed 15% even if we see some upgrades.

Chart 17: Sensex EPS upgrades



Source: Merrill Lynch Research

Will the gainers from falling global commodity prices help earnings growth?

This is a question we get asked from investors very often. The argument is that the contribution to earnings of both segments is similar.

The losers from a slowing global economy are metals, oil and petrochem and arguably software to the extent that pricing power will erode. The gainers are the user industries – autos, engineering and to some extent consumer staples and pharma since they use oil based raw materials. Financials also can be classified as a gainer to the extent of falling interest rates though they could get hit by rising NPLs. The weight of both these gainers and losers in the aggregate Sensex earnings is similar.

Table 13: Sensex earnings gainers vs losers

Sector Positively Effected by global slowdown		Sector Negatively Effected by global slowdown	
Sectors	Contribution to FY08 EPS	Sectors	Contribution to FY08 EPS
Auto	7.7%	Energy	17.3%
Consumer	6.5%	IT	14.1%
Pharma	2.8%	Metals	8.1%
Engineering	5.3%		
Banks	19.2%		
Total	41.4%	Total	39.4%

Source: Merrill Lynch Research

Sensitivity is not similar

However, what is missed out in this argument is that the sensitivity of changes in price is not similar for the user industries. As an example when steel prices fall 5%, earnings for steel companies fall 7.5-12% and for the user industries (eg autos) earnings increase is much lower at around 3.5-5%. This may not materialize if competitive pressure forces this to be passed on to consumers. The sensitivity in the case of pharma and consumers is even lower.

Table 14: Earnings sensitivity to metal price changes

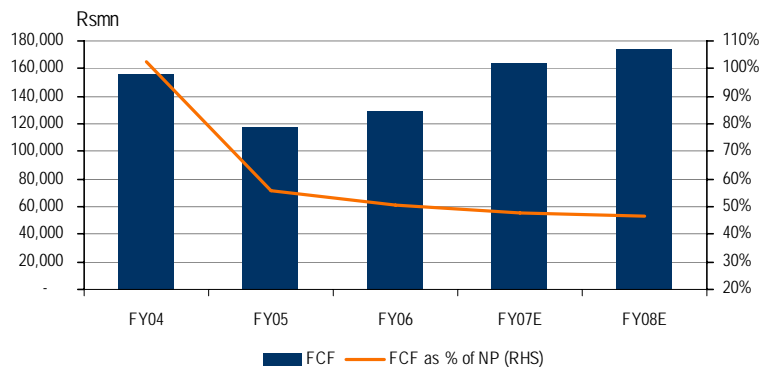
	Earnings drop		Earning rise			
	Tata Steel	SAIL	Hero Honda	Bajaj	Maruti	Tata Motors
5% drop in steel prices	7.5%	12.0%	4.5%	4.0%	3.5%	5.0%

Source: Merrill Lynch Research

Free cash flow continues to rise in absolute terms but falls as % of net profits in FY08

The good news is that free cash flows continue to rise in absolute terms in FY08. The bad news is that they fall as a percentage of net profits. Though capex is rising, given the increase in profits, absolute free cash flow increases.

Chart 18: Free cash flow for Sensex companies

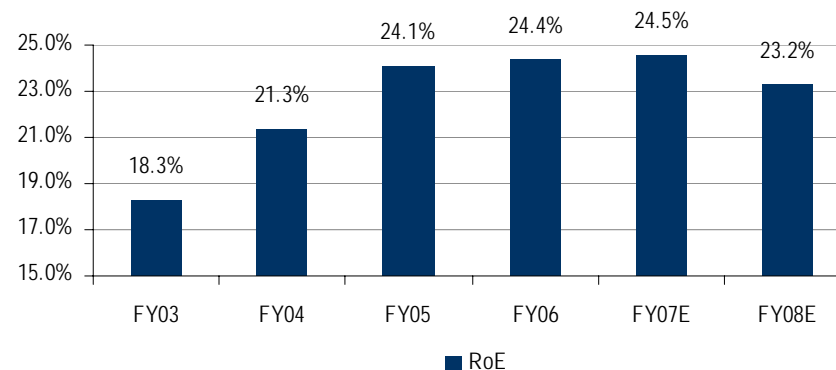


Source: Merrill Lynch Research

RoEs to contract in FY08

Indian RoEs have been on a steady uptrend since FY03. However, we expect RoEs to contract in FY08 as earnings slow and the capex cycle picks up.

Chart 19: Sensex RoE

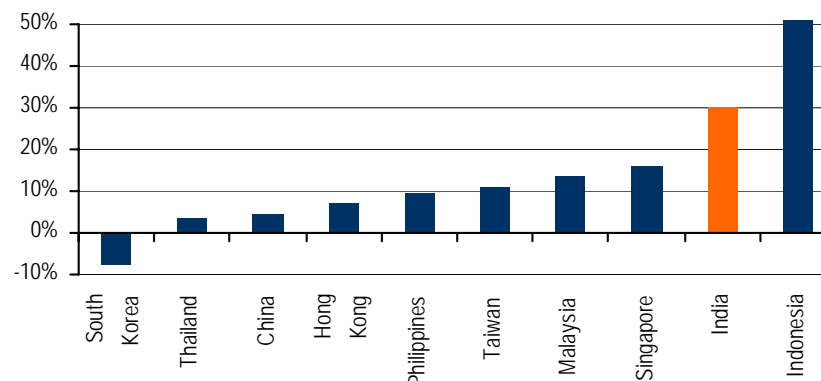


Source: Merrill Lynch Research

Earnings still strong in a regional context

While earnings will slow compared to history, India will still have one of the highest EPS growths in the region. This will continue to attract investors to the India story at a reasonable valuation.

Chart 20: EPS growth among the highest in Asia



Source: Merrill Lynch Research

6. Politics Slows Reforms

No threat to Government

We do not expect any significant threat to the Government and expect the present Congress-led UPA coalition to continue to rule the country. The Government has a comfortable majority with nearly 300 seats in Parliament versus the requisite majority of 272. The other factor helping the Government is that the main opposition party, the BJP, is going through changes with a new generation of leaders getting ready to take charge. This has weakened the opposition to the Government.

Table 15: Present party positions

Congress & Allies	Total Seats	BJP & Allies	Total Seats
Congress Party	145	Bharatiya Janata Party	138
Rashtriya Janata Dal (RJD)	21	Telegu Desam Party	5
Dravida Munnetra Kazagam	16	Janata Dal (United)	7
Nationalist Congress Party (NCP)	9	Shiv Sena	12
Pattali Makkal Katch (PMK)	6	Biju Janata Dal	11
Jharkhand Mukti Morcha (JMM)	5	Shiromani Akali Dal	8
Janata Dal (Secular)	4	Mizo National Front	1
Lok Janasakti Party (LJP)	3	AIADMK	0
Muslim League	1	Others	3
AIMIM	1		185
Republican Party of India	1		
Sikkim Democratic Front	1		
	213		
Outside Support		Others	
Bahujan Samaj Party	19	Samajwadi Party	36
MDMK	4	Telangana Rashtra Samithi (TRS)	5
Rashtriya Lok Dal	3	Asom Gana Parishad	2
PDP	1	CPI (ML)L	1
Left Front		Others	11
Communist Party (M)	43		
Communist Party of India	10		
Revolutionary Socialist Party	3		
All India Forward Block	3		
	86		55
Total	299	Total	240

Source: Merrill Lynch Research

Assembly elections could slow reforms

2007 will see assembly elections to some crucial states like Uttar Pradesh (UP) and Gujarat. UP/Uttaranchal is important since it sends the maximum seats to Parliament and Congress has been struggling to establish itself here. Gujarat is a BJP

stronghold where Congress is the main opposition party. We expect the Government to avoid difficult decisions in the run up to these assembly elections in Q2CY07.

Table 16: Election Timetable

State	Ruling Party	Elections due
Uttar Pradesh	SP-led coalition	Feb-07
Uttaranchal	Congress	Feb-07
Punjab	Congress	Feb-07
Manipur	Congress	Feb-07
Goa	Congress	May-07
Jammu & Kashmir	PDA, Congress coalition	Oct-07
Gujarat	BJP	Dec-07

Source: Merrill Lynch Research

Reforms likely to continue to be slow

Reforms have continued to be hostage to differences between the Congress and some of its principal allies like the Left parties. Uncertainty continues on:

1. **Divestment/Privatization:** Following pressure from its allies, the Prime Minister has decided to put on hold all divestment proposals. The decision was forced on the Prime Minister following the threat of its ally, the DMK, to walk out of the Government for selling a small stake in Neyveli Lignite Corp.
2. **Pension Fund Regulatory & Development Authority (PFRDA) Bill:** This seeks to bring about pension reforms including freedom to invest part of the pension money in equities and privatization of pension funds.
3. **Banking reforms:** The Government is seeking to align shareholding in banks and voting rights and simplify M&A in the banking sector.

But there have been some successes

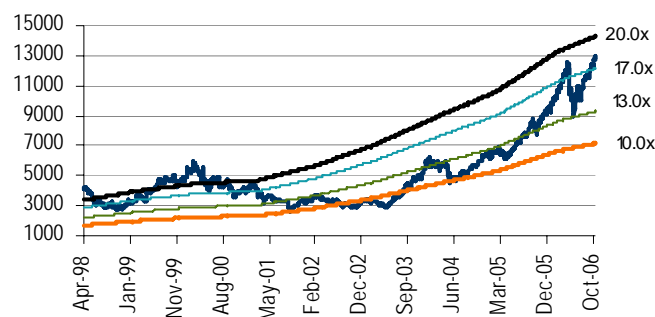
1. **FDI limits:** The Government's major success has been in privatization of Delhi and Bombay airports. The Government has also cleared the increase in FDI limits in telecoms to 74% but this has yet to be made operational.
2. **Capital Account Convertibility (CAC) Roadmap:** We expect measures easing exchange restrictions to be announced over next few months based on the recommendations of the CAC Committee.

7. Valuations are Demanding - Priced to Perfection

Valuations have re-rated sharply

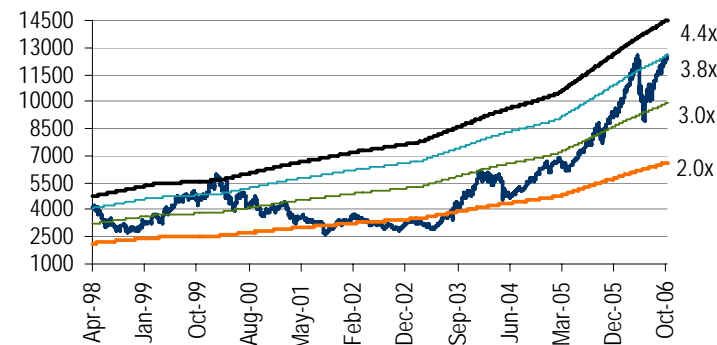
Indian valuations have seen a sharp re-rating from mid-2003 with valuations doubling both on a PE and P/B basis. The 1-year forward PEs for the market at 17.8x are slightly above the 10-year average of 16.2x.

Chart 21: Sensex 1yr forward P/E



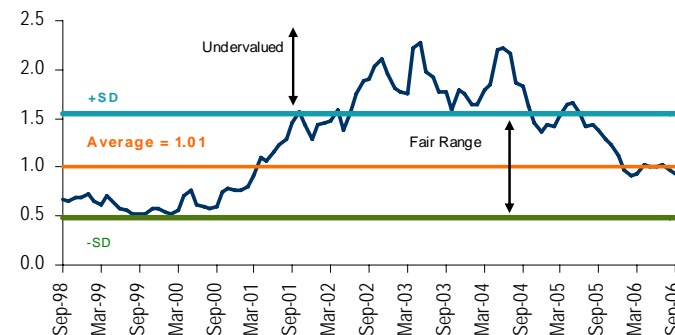
Source: Merrill Lynch Research

Chart 22: Sensex 1yr forward P/B



Source: Merrill Lynch Research

Chart 23: Earnings Yield Gap

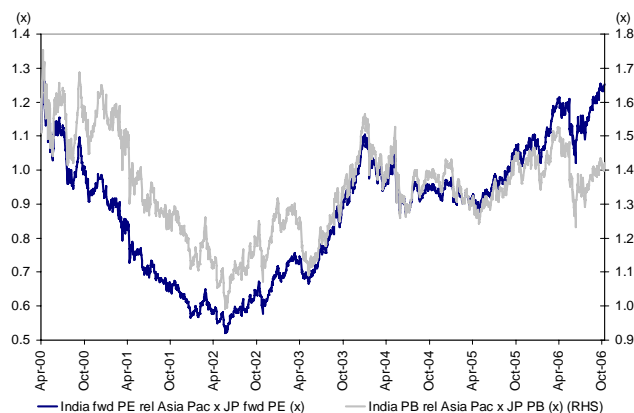


Source: Merrill Lynch Research

India has re-rated compared to Asian peers

The Indian market has re-rated similarly compared to its Asian peers. From its lows of 0.5x for the Asia Pac (ex-Japan) PE in 2002, the market now trades at a 25% premium.

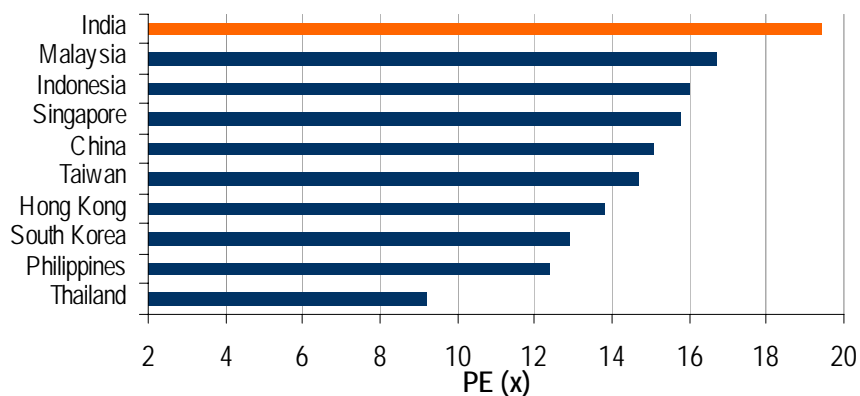
Chart 24: India PE rel to Asia Pac x Japan



Source: Merrill Lynch Research

Similarly, the market trades at the highest end of its PE range amongst its peers.

Chart 25: India has the highest PER in Asia



Source: Merrill Lynch Research

We expect valuation compression next year

We have strong reasons for the re-rating in valuations:

1. After bottoming out in FY02, earnings have seen a sharp growth in the 25% range.
2. Economic growth has been strong with GDP in the 7-8% range.
3. Investors have appreciated India's long term growth story and expect India to deliver sustainable and strong growth over next many years. Also, India is a domestic economy that will be relatively insulated in a slowing global economy.

However, we think India will face cyclical headwinds next year that will drive a valuation compression.

1. Earnings will slow to less than 15% growth. We believe this will lead to a PE compression to around 15x on the Sensex.
2. RoEs will decline, leading to a fall in the P/BV.

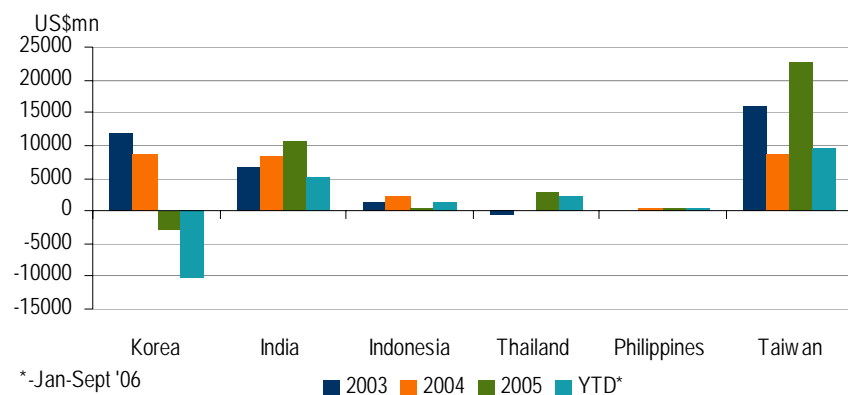
8. Liquidity to Markets - Watch for Supply of Paper

FII have been significant buyers: flows may slow

While it is difficult to predict FII flows, we would expect slower flows going forward led by 3 factors:

1. India has seen disproportionately higher flows than most of Asia over the past 2 years.

Chart 26: India has received disproportionate FII flows



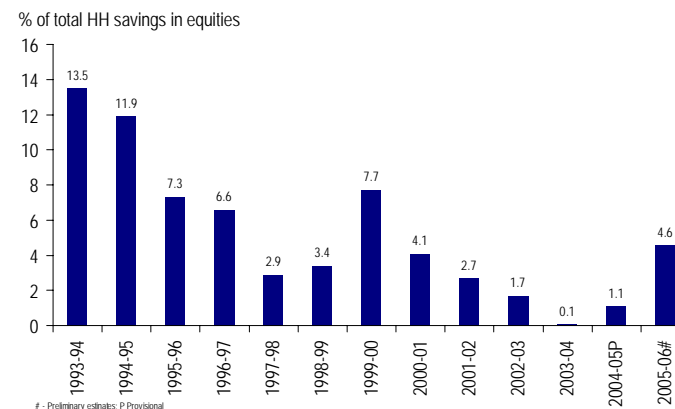
Source: Merrill Lynch Research

2. Valuations in India are now no longer compelling and we expect earnings to slow over the next year.
3. There could be an increase in equity risk premium that hits flows to all emerging markets.

Domestics have increased exposure but are wary at current levels

Structurally we have argued that retail India is under-invested in equities and will continue to increase exposure – we did see it in FY06 when proportion of household savings to equities went up to nearly 5% from 1% in FY05.

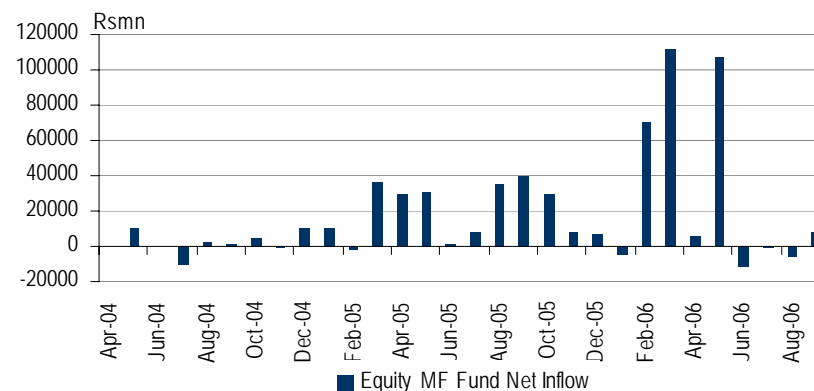
Chart 27: Household savings in equities



Source: Merrill Lynch Research

However, near term domestic investors seem to be skeptical of the markets given that flows to equity mutual funds have been poor over the past few months.

Chart 28: Equity MF's net inflow



Source: AMFI, Merrill Lynch Research

What Can Change?

We believe there are a few events that could improve flows from both FIIs as well as from domestic sources in the secondary markets. However, we do not expect these over the next year.

#1: Increase in MSCI weight

India's market cap is similar to Korea and Taiwan but India's MSCI weight is less than half of these countries.

Table 17: India's MSCI weight

Country	Market Cap (US\$bn)	MSCI Wts	
		EM	Asia ex-Japan
China	512	9.66%	14.49%
India	726	6.67%	10.00%
Indonesia	118	1.60%	2.40%
Korea	760	16.63%	24.94%
Philippines	57	0.50%	0.75%
Taiwan	571	12.65%	18.96%
Thailand	141	1.67%	2.51%

Source: Merrill Lynch Research

This is partly due to lower free float since many large Government companies have low issuance to outside share-holders. However, part of the problem also stems from the restrictions on FII purchases in India. A Government appointed committee (Lahiri Committee) has recommended relaxation of these regulations. But the Government has yet to take a decision on this. We estimate that implementation of the Lahiri committee recommendations could increase India's MSCI weight by 35-45%.

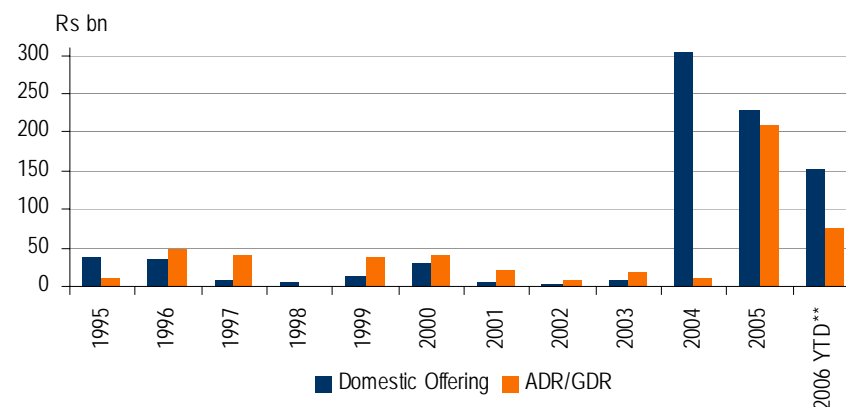
#2: Pension money allowed into equities

In India, pension money is not allowed to be invested into equities. The corpus of pension funds is around \$50 bn. So even if a small part of this comes to the equity markets it could mean huge inflows. The Government has proposed pension reforms that will enable pension money to flow partly to equities. However, given the opposition of the Left allies, the Government has been unable to pass this law.

Watch for increased supply

We expect to see a quantum increase in supply over next 6 months. Our estimate is that we could see supply of \$12 bn which could depress flows to secondary markets. Of course, part of this will lead to new investors in the Indian market and would be good for India longer term. But near term, we expect supply of paper to put pressure on flows to secondary markets. Over the next year, we expect a 30-50% jump in supply of paper at over \$20 bn.

Chart 29: Supply of paper



Source: Prime, Merrill Lynch Research

** upto Sept'06

9. Sector Strategy

As growth slows, we recommend overweighting sectors where we see visible growth over the next year. We give below quick views on our sector strategy. More details are given on each sector in the latter part of this report.

- **Industrials (O/W):** We continue to expect the infrastructure cycle to be a big theme for the next 5 years. While the stocks have seen a significant share price appreciation, we see earnings visibility being strong over next few years.
- **Cement (O/W):** Strong demand and absence of new capacity will likely keep cement prices strong over next 12-18 months. We continue to expect earnings upgrades over next 6 months to drive share prices. The next big addition to cement capacity is likely in CY08/FY09 – in the interim we think cement stocks will outperform.
- **Telecom (O/W):** We forecast telecom subscriber base to grow at a CAGR of 36% over FY06-10. In spite of possible price competition, we expect margins to expand as companies get benefits of scale.
- **Energy (O/W):** Near term prospects for Reliance are encouraging as Q3FY06 was hit by a refinery shut-down and refining margins can see a rebound. We also expect positive newsflow on the E&P business as well as the retail roll-out. We have recently cut Reliance weight in our model portfolio by 300 bps. A slower global growth may prompt a further cut in weight next year. HPCL, a recent addition to our model portfolio, is a hedge against falling oil prices. Also could gain if subsidy is cut due to better targeting of kerosene. For details, see *India Snapshot* dated October 26, 2007.
- **Software (O/W):** Strong near term earnings growth supports our overweight. However, rupee appreciation is a risk to earnings growth. A US slow-down will improve outsourcing volumes but hit pricing power. Overall, we believe the impact will be negative and would cut software weight in Q1/Q2 CY07.
- **Banks (Neutral):** After a rally, we expect banking stocks to correct near term as inflation is expected to rise over next few months taking bond yields up 40-45 bps. However, we would use a correction as an opportunity to increase weight to banks given the strong credit growth and likely rise in lending rates.
- **Autos (Underweight):** We have recently cut banks to underweight and like only the passenger car segment where we expect a strong growth. In the 2-wheeler business we expect margins to be under pressure due to competitive intensity and rising supply. In the CV business, we expect volumes to slow over next few months as the benefit from the ban on overloading rolls over.
- **Metals (U/W):** We expect price cycle to weaken as demand slows due to a global economic slow-down and supply shows a gradual increase next year.
- **Consumer Staples (U/W):** After a recovery in topline, we expect a slow-down especially given the poor monsoon. While falling oil prices will help margins, we expect overall earnings growth to slow. Given steep valuations, we are underweight.
- **Pharma (U/W):** After a jump in profits in FY07, FY08 will see slower growth for pharma companies. There has been a structural erosion in profitability of pharma companies due to price erosion in the generic space while valuations remain expensive.

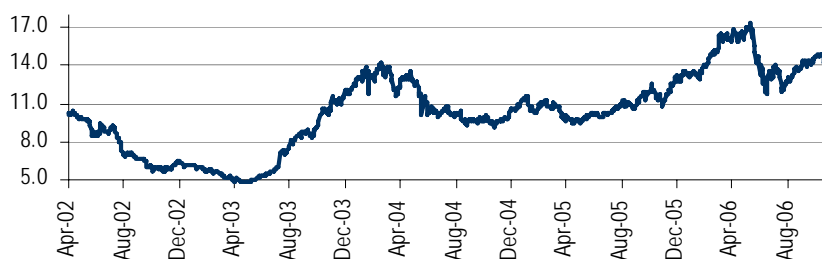
Automobile Underweight

(S.Arun, Vikas Sharda)

Key Drivers of Sector Outlook

- We expect demand to remain strong through to FY08 for passenger cars and two wheelers, driven by strong macro-economic indicators. However, we expect slow down in trucks sans the benefit of overloading ban, as well as tractors due to cyclical catching up. In auto components, exports will continue to be the prime revenue driver. Passenger cars, therefore, is our favored space.
- Competitive intensity and rising supply will put pressure on margins across OEMs, mainly two wheelers. Softer input costs i.e. steel/aluminium expected to partly cushion this impact. Improved utilization on the back of outsourcing is expected to expand margins for the auto components sector.
- We expect earnings growth to slow from H2 FY07. In FY08, we only expect companies in the auto components space and passenger cars to register double-digit profit increase.
- With respect to valuations, most segments trade at the high end of historical average. Potential for de-rating in two wheelers and trucks.

Chart 30: Auto sector 1yr forward PE chart



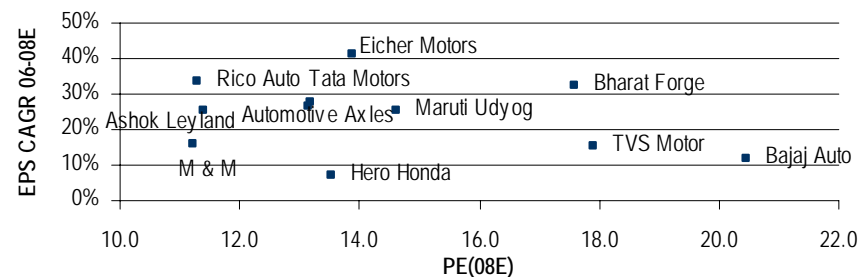
Source: Merrill Lynch Research

Top Buys: Maruti, Bharat Forge, Mahindra & Mahindra Top Underperformers: Bajaj Auto, Hero Honda

Top Stock Pick: Maruti

- Rising disposable incomes and greater affordability are growth drivers for passenger cars (especially compacts, hatchback after excise cuts). We expect this segment to register 20%-plus growth rates over the medium term.
- Maruti's cost competitiveness, franchise in compacts and hatchback, and two new launches over the next quarter will enable the company to lead growth in the domestic market.
- Maruti's growth visibility has improved following Suzuki's decision to leverage growth from a single entity in India, and Nissan contracting to source cars from the company.
- Trades at 16.8x FY07E and 14.6x FY08E EPS, which is ahead of consensus. Expect markets to re-rate the stock for strong growth prospects, with adequate visibility.

Chart 31: PE(08E) vs EPS CAGR (06-08E) scatter graph



Source: Merrill Lynch Research

Table 18: Sector performance

	Absolute Performance			
	1month	3 month	YTD	1year
Ashok Leyland	5.3%	45.7%	43.2%	67.3%
Automotive Axles	-9.8%	18.1%	-13.4%	6.4%
Bajaj Auto	-3.4%	14.6%	40.9%	62.1%
Bharat Forge	-2.8%	20.0%	-12.4%	5.8%
Eicher Motors	45.5%	64.1%	54.6%	38.6%
Hero Honda	-2.2%	5.6%	-12.8%	0.7%
M & M	5.3%	34.5%	34.8%	87.2%
Maruti Udyog	1.0%	33.1%	48.7%	69.8%
Rico Auto Ind	3.7%	14.4%	-19.5%	-9.5%
Tata Motors Ltd.	5.2%	30.6%	34.6%	71.5%
TVS Motor	-0.3%	44.8%	16.5%	29.3%
Sector Average	1.3%	25.0%	26.2%	51.6%

Source: Bloomberg

Table 19: Bull & Bear factors that can change views

Company	Bull Scenario	Bear Scenario
Maruti Udyog	Competitive in compact cars, new launches to enable grow above industry Suzuki's plans in India, and Nissan deal gives long term growth visibility	Intensifying competitive scenario, with entry of global majors; Stock expensive relative to regional peers
M&M	Strong growth in tractors to continue, with export initiatives and inorganic opportunities Unlocking value through listing of subsidiaries	Cyclicality in tractors to catch up soon Rising competition in Utility Vehicles, three wheelers Value of subsidiaries already captured in stock valuations
Bajaj Auto	Ramp up of recent 1 two wheeler launches, three wheelers to drive medium term growth Foray into Indoensia, other key markets to improve long term visibility Margin share expansion to drive rating	Price wars in the 100cc segment to mar profitability Building brand franchise in newer franchise to drag margins Markets already factoring strong prospects, vulnerable to disappointments
Tata Motors	Strong macro-economic indicators, new products to drive growth across operating segments Value unlocking through listing of subsidiaries	One-off demand due to overloading ban not available hereon Intensifying competitive scenario in both trucks as well as cars

Source: Merrill Lynch Research

Table 20: Stock / Sector valuations

Stock	ML Code	QRO	Price	Mkt Cap (US\$mn)	P/E (x)			EPS CAGR		P/B (x)			EV/Ebitda (x)			Div. Yield (%)		RoE			Corp Gearing		
					FY06	FY07E	FY08E		06-08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E
Ashok Leyland	XDBVF	1 - Buy	46	1,317	17.9	14.0	11.4		25%	4.0	3.1	2.7	11.2	8.3	6.7	3.1%	3.5%	24	26	25	6%	-12%	-11%
Automotive Axles	XATOF	1 - Buy	516	172	21.1	17.8	13.2		27%	10.5	8.3	6.5	12.5	10.7	8.6	2.8%	3.9%	55	52	56	76%	93%	83%
Bajaj Auto	BJJAF	2 - Neutral	2819	6,287	25.5	22.7	20.5		12%	6.0	5.3	4.7	22.7	19.6	17.6	2.1%	2.7%	25	25	24	29%	25%	23%
Bharat Forge	XRRGF	1 - Buy	344	1,686	30.7	24.6	17.6		32%	6.1	5.1	4.2	15.7	10.9	8.3	1.2%	1.5%	28	24	28	45%	41%	26%
Eicher Motors	XEICF	1 - Buy	356	220	27.6	15.6	13.9		41%	2.2	1.7	1.6	13.4	8.7	6.7	1.1%	1.4%	11	12	12	34%	-4%	-5%
Hero Honda	XHROF	3 - Sell	749	3,298	15.4	14.1	13.5		7%	7.7	6.0	4.7	11.0	10.1	9.5	2.9%	3.2%	56	48	39	5%	-1%	-9%
M & M	MAHHF	2 - Neutral	690	3,713	15.1	12.9	11.2		16%	4.4	3.4	2.7	11.0	9.8	7.9	1.4%	1.4%	35	30	27	110%	73%	41%
Maruti Udyog	MUDGF	1 - Buy	946	6,027	23.0	16.8	14.6		25%	5.0	3.9	3.2	14.6	11.9	9.9	0.5%	0.8%	24	26	24	-31%	-22%	-21%
Rico Auto Ind	RCATF	2 - Neutral	79	213	20.1	15.6	11.3		34%	6.6	5.1	3.7	10.5	8.7	6.7	1.3%	1.4%	36	36	38	144%	134%	106%
Tata Motors Ltd.	TENJF	1 - Buy	879	7,462	21.4	16.0	13.2		27%	5.5	4.7	3.7	11.7	8.8	7.1	1.6%	1.8%	31	32	31	32%	20%	14%
TVS Motor	XFKMF	2 - Neutral	117	610	23.7	24.2	17.9		15%	3.6	3.3	3.0	14.0	12.4	9.5	1.5%	1.7%	16	14	18	12%	11%	7%
Auto Sector Avg.					20.7	16.8	14.4			5.3	4.4	3.6	13.4	11.1	9.3	1.6%	1.9%	29.4%	29.0%	27.5%	27%	17%	10%

Source: Merrill Lynch Research

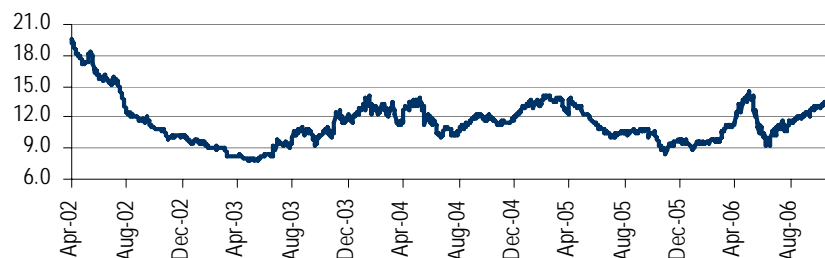
Cement Overweight

(Reena Verma)

Key Drivers of Sector Outlook

- **Firm cement prices:** We expect cement prices to remain on an uptrend through the next 12-18 months, notwithstanding the strong 27% YoY rise in YTD FY07A. At this stage, we do not see material risk of government intervention in pricing.
- **Supply-demand balance to stay tight:** We forecast capacity utilization in the industry at ~90% through FY07-08. We believe such high utilization levels are extremely tight for a process industry like cement and should lift cement prices.
- **Potential for demand surprise:** In 1H FY07, cement demand grew ~11% YoY versus the industry's long-term CAGR of 8%. Our industry interactions suggest that demand may continue to surprise on the upside.
- **Formidable capacity build-up to hurt FY09 earnings:** We expect ~45mn tpa (25% YoY increase) of capacity to be commissioned in CY08/FY09E. Consequent over-capacity will likely hurt prices & profits in FY09E.
- **Earnings upgrades versus valuation compression:** For the next 2 quarters, we expect positive earnings surprises (led by demand & prices) to outweigh long term risks from the formidable capacity pipeline.

Chart 32: Cement sector 1yr forward PE chart



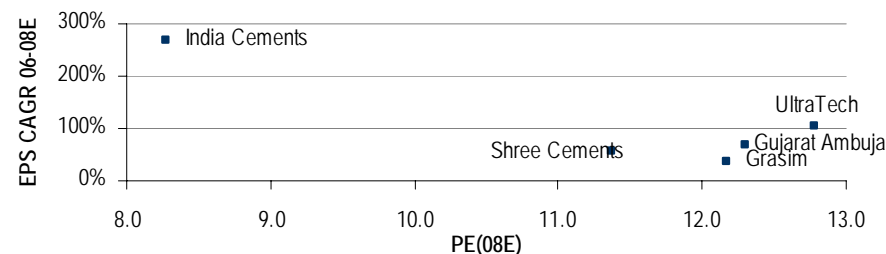
Source: Merrill Lynch Research

Top Buys: ACC, Grasim Top Underperformers: None

Top Stock Pick: ACC

- **Pan-India presence, good management:** ACC is India's largest cement producer. We like the company's diversified geographical exposure and experienced management in the hands of the global cement major - Holcim.
- **Robust earnings momentum:** We expect ACC to post ~75% earnings CAGR over CY05A-07E driven primarily by rising cement prices. ACC's 2007E earnings change by ~3% for every 1% change in cement prices.
- **Comfortable valuations:** The stock is trading at an EV/EBITDA of ~8x 2007E, versus its 1-yr forward trading range of 8-13x, historically. We see room for investment upside despite likely valuation compression in the sector.

Chart 33: PE(08E) vs EPS CAGR (06-08E) scatter graph



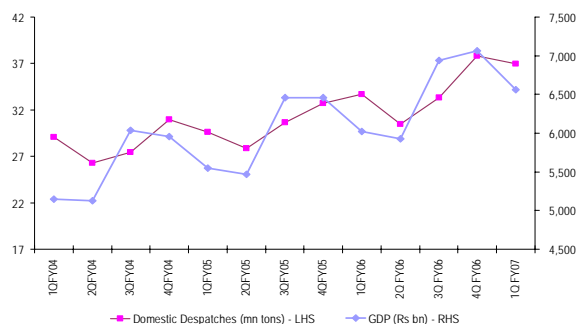
Source: Merrill Lynch Research

Table 21: Sector performance

	Absolute Performance			
	1month	3 month	YTD	1year
Assoc. Cement	-0.6%	23.6%	82.4%	118.4%
Grasim	4.3%	39.5%	88.9%	136.0%
Gujarat Ambuja	2.9%	21.3%	51.8%	75.8%
India Cements	-1.1%	30.7%	119.4%	137.8%
Shree Cements	9.3%	35.4%	131.3%	173.7%
UltraTech Cemen	0.6%	38.2%	103.4%	109.2%
Sector Average	2.2%	30.6%	83.1%	114.4%

Source: Bloomberg

Chart 34: Trend in cement demand versus GDP



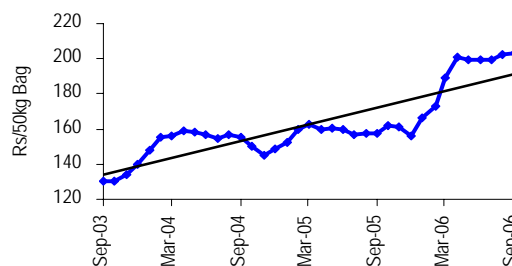
Source: CMA, ML research

Table 22: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
ACC	Sharp further rise in cement prices. Push back in capacity additions.	Government intervention in the cement pricing. Faster the expected valuation compression.
Ultratech Cements	Sharp further rise in cement prices. Push back in capacity additions.	Government intervention in the cement pricing. Faster the expected valuation compression.
Grasim	Sharp further rise in cement prices. Push back in capacity additions. Continued firmness in VSF prices.	Government intervention in the cement pricing. Faster the expected valuation compression. Pressure on VSF prices and demand

Source: ML estimate

Chart 35: Trend in average cement prices over last 3 years



Source: CMA

Table 23: Cement capacity and demand

As on 31 March (mn tpa)	FY05	FY06	FY07E	FY08E	FY09E
Cement Capacity	152	161	170	181	226
Capacity growth	4%	6%	5%	6%	28%
Cement Demand	125	141	155	167	180
Demand growth	7%	13%	10%	8%	8%
Cement - Capacity Utilisation	82%	88%	91%	93%	80%
Clinker Utilisation (incl. Exports)	88%	90%	91%	92%	77%
Clinker Utilisation (excl. Exports)	83%	87%	89%	90%	76%

Source: ML research

Table 24: Stock/ Sector valuations

Stock	ML Code	QOQ Price	Mkt Cap (US\$mn)	P/E (x)				EPS CAGR		P/B (x)				EV/Ebitda (x)				Div. Yield (%)		RoE			Corp Gearing		
				FY06	FY07E	FY08E		06-08E	FY06	FY07E	FY08E		FY06	FY07E	FY08E		FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	
Assoc. Cement	ADCLF	1 - Buy	974	4,015	40.0	17.1	13.0		75%	8.4	6.0	4.5	21.1	10.6	7.6	1.5%	1.9%	31.5	41.2	39.5	38%	4%	-18%		
Grasim	GRSJF	1 - Buy	2628	5,310	22.6	13.9	12.2		36%	8.1	5.6	4.1	12.4	7.3	6.8	1.4%	1.5%	41.7	47.4	38.9	85%	80%	84%		
Gujarat Ambuja	XBRIF	1 - Buy	121	3,619	34.9	15.7	12.3		68%	7.5	5.8	4.6	23.9	9.5	7.3	1.9%	2.8%	22.4	43.8	41.6	42%	7%	-3%		
India Cements	INIAF	1 - Buy	220	1,070	111.5	10.4	8.3		267%	6.1	4.1	3.0	24.1	8.4	6.4	1.4%	3.0%	9.3	47.9	40.6	216%	95%	57%		
Shree Cements	SREEF	1 - Buy	1132	869	27.0	12.3	11.4		54%	11.2	6.3	4.1	19.1	7.3	6.3	0.5%	0.6%	41.5	65.6	43.9	84%	45%	14%		
UltraTech Cemen	XDJNF	1 - Buy	869	2,384	53.6	15.0	12.8		105%	8.6	6.0	4.4	20.7	9.1	8.1	1.3%	1.6%	17.4	47.2	39.5	113%	98%	97%		
Cement Sector Avg.					32.9	14.6	12.1			8.0	5.7	4.2	17.7	8.8	7.4	1.4%	1.9%	28.1%	46.4%	40.4%	78%	49%	40%		

Source: Merrill Lynch Research

Offshore IT and BPO Services

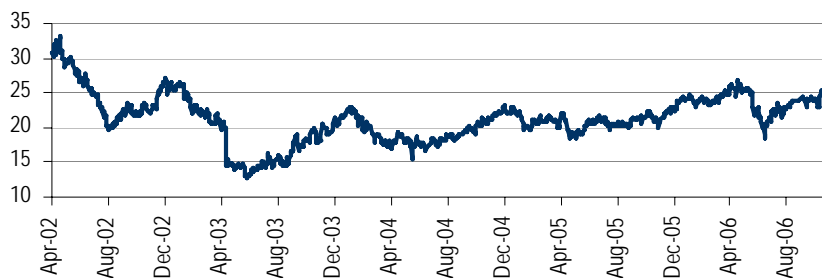
(Mitali B. Ghosh, Pratish Krishnan, Prasad Deshmukh)

Overweight

Key Drivers of Sector Outlook

- Booming demand for offshore IT & BPO services (~30% 5-yr growth forecast), leading to pricing uptick. Given the vast pool of over 0.3m engineers graduating every year, engineers cost one-sixth that in the US, while offering quality solutions.
- More than 4-fold jump in addressable market given expanded service offerings of Indian vendors in software package implementation, remote infrastructure management services, Business Process Management & testing.
- Indian vendors are now getting to play in the multi-year large deals of >US\$50m as these deals are getting broken, and Indian vendors offer quality solutions in the non-asset intensive application management and development space.
- With growing brand and expanded service offerings, large vendors like Infosys and TCS are gaining market share. However, niche players like Infotech Enterprises in engineering services are in a strong competitive position.
- Key risks: Manpower supply challenges, being mitigated by in-house training, Rupee appreciation, risk of US slowdown impacting current pricing strength and growing competition from western Systems Integrators ramping India delivery.

Chart 36: Software sector 1yr forward PE chart



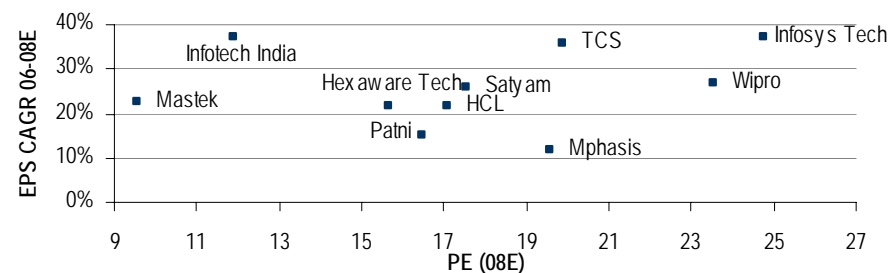
Source: Merrill Lynch Research

Top Buys: TCS, Satyam, Infosys, Infotech Enterprises

Top Stock Pick: Tata Consultancy Services

- An Asia Focus 1 stock, we expect the 15-20% P/E discount to Infosys to narrow to the average 5-10% level, since listing 2 yrs ago, given we forecast 3-yr EPS CAGR of 31%, similar to Infosys.
- We expect scale up in large deals like ABN Amro & Pearl Group (BPO), to help profitability next few quarters. TCS also has a solid margin lever in its potential to increase offshore revenues, currently at 41% vs peers like Infosys at 50%.
- TCS has strong revenue momentum, with an uptrend in prices and strong volume flow, helped by its expanded range of services like business intelligence solutions, testing and BPO. It is close to clinching five deals of >US\$50mn.
- Managing supply pressures nicely. TCS has the lowest employee attrition at 12.4% on a last-twelve-month basis. Job rotation has been one of the key tools used to retain people.

Chart 37: PE(08E) vs EPS CAGR (06-08E) scatter graph



Source: Merrill Lynch Research

Table 25: Sector performance

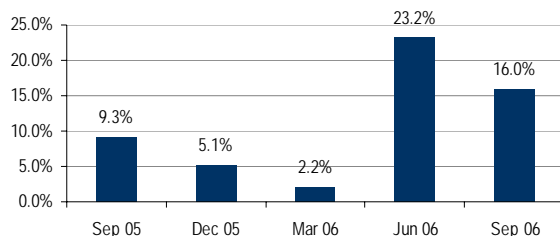
	Absolute Performance			
	1month	3 month	YTD	1year
HCL	9.3%	18.5%	13.4%	34.7%
Hexaware Tech	9.4%	24.5%	32.7%	67.3%
Infosys Tech	11.6%	27.4%	36.3%	60.1%
Infotech India	18.2%	45.9%	39.5%	77.5%
Mphasis	22.2%	79.1%	51.8%	76.4%
Patni	18.2%	70.6%	-9.4%	-3.4%
Satyam	1.5%	23.8%	15.2%	43.0%
Tata Consultancy	3.5%	22.1%	26.7%	50.9%
Wipro	5.4%	22.3%	18.2%	42.0%
Sector Average	7.0%	24.7%	25.1%	48.9%

Source: Bloomberg

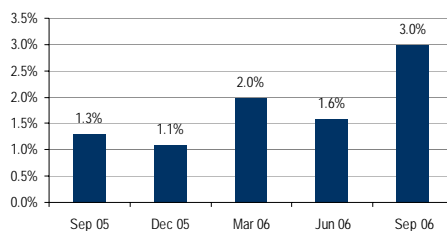
Table 26: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
TCS	Strong revenue momentum with ability to maintain margins within a narrow band by shifting work offshore and improving mix of revenues, should help re-rating	Challenges of scalability and risk of higher wage pressure than peers, will result in revenue and margin disappointment
Infosys	Premium brand, expanded service offerings and tight management will help Infosys maintain superior growth to peers, and premium valuation.	Challenges of scalability will result in slower revenue and profit growth ahead, leading to PE de-rating.
Satyam	The worst is behind in terms of employee attrition challenges and improving brand, domain skills and client relationship management will help it outperform revenue growth guidance, leading to PE re-rating.	Sustained improvement in employee retention is yet to be seen. Higher risks to revenue growth given weaker brand and concentration in enterprise solutions.
Infotech Enterprises	Strong competitive position in engineering services and geo-spatial solutions should help sustained growth and PE re-rating.	Growing competition from larger peers in engineering services and cyclical nature of geo-spatial solutions, poses risks to growth forecasts and valuation.

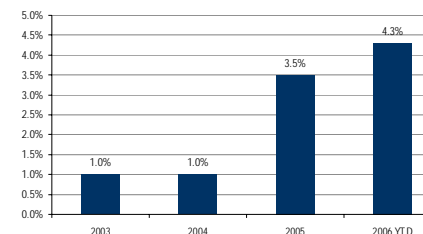
Source: Merrill Lynch Research

Chart 38: Infosys – Newer services sequential growth


Source: Infosys

Chart 39: YoY pricing increase in proj.s OS to Indian vendors


Source: Merrill Lynch CIO survey, Sep 06

Chart 40: Indian vendors' growing share in large deals


Source: TPI, Oct 2006

Table 27: Stock/ Sector valuations

Stock	ML Code	QRQ	Price	Mkt Cap (US\$mn)	P/E (x)			EPS CAGR		P/B (x)			EV/Ebitda (x)			Div. Yield (%)		RoE			Corp Gearing		
					FY06	FY07E	FY08E		06-08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E
HCL	HCLTF	2 - Neutral	611	4,367	25.3	20.5	17.1		22%	4.8	4.3	3.7	18.4	14.3	11.6	2.6%	2.6%	19.7	22.2	23.4	-46%	-44%	-42%
Hexaware Tech	XFTCF	1 - Buy	174	506	23.1	18.3	15.7		21%	5.8	3.1	2.6	20.3	14.2	10.4	0.9%	1.1%	29.4	23.0	19.9	-20%	-54%	-49%
Infosys Tech	INFYF	1 - Buy	2043	25,021	46.6	30.9	24.8		37%	16.0	11.3	8.3	35.2	24.1	18.1	0.5%	0.7%	40.4	44.2	39.4	-69%	-56%	-58%
Infotech India	IFKEF	1 - Buy	247	249	22.4	13.9	11.9		37%	5.3	4.0	3.0	16.4	10.4	8.4	0.3%	0.3%	27.3	32.9	28.9	-15%	-6%	-10%
Mastek	MSKDF	1 - Buy	351	218	14.3	11.1	9.5		22%	3.6	2.9	2.3	7.8	6.6	5.1	1.6%	1.7%	28.3	28.6	26.5	-23%	-24%	-27%
Mphasis	MPSSF	2 - Neutral	226	808	24.3	32.7	19.6		12%	5.5	5.4	4.6	18.2	14.5	9.2	0.9%	1.4%	23.1	18.7	25.3	-14%	-30%	-26%
Patni	PATIF	1 - Buy	449	1,367	21.7	20.7	16.5		15%	3.1	2.7	2.4	13.1	11.5	8.6	0.7%	0.9%	16.5	14.3	16.2	-64%	-52%	-44%
Satyam	SAYPF	1 - Buy	425	6,139	27.7	20.3	17.6		26%	6.4	5.1	4.1	21.3	15.7	12.3	0.9%	1.1%	25.8	28.3	26.6	-70%	-69%	-65%
Tata Consultancy	TACSF	1 - Buy	1079	23,263	36.6	24.9	19.9		36%	18.1	10.8	7.3	28.6	20.1	15.1	1.2%	1.8%	63.8	54.4	43.6	-7%	-33%	-42%
Wipro	WIPRF	2 - Neutral	548	17,296	37.8	28.8	23.5		27%	11.8	9.1	7.0	29.4	22.2	17.2	1.0%	1.1%	34.8	35.7	33.8	-57%	-53%	-53%
Sector Avg.					36.6	26.3	21.3			11.4	8.4	6.3	27.9	20.5	15.6	1.0%	1.2%	35.9%	37.2%	34.3%	-49%	-49%	-50%

Source: Merrill Lynch Research

Consumers

(Vandana Luthra, Vishal Nathany)

Underweight

Key Drivers of Sector Outlook

- Consumer companies have benefited from a sharp recovery in topline growth – a function of higher income levels and importantly better affordability post price cuts in most of the categories. Going forward, we believe topline growth rate is beginning to peak for most companies, however we do expect current rate of growth to be maintained given robust economy.
- Price/mix gains are running at 5-6% in most categories. We believe price increases higher than inflation will likely lead to return of competition, especially low-priced as witnessed in the early part of the current decade. The Procter & Gamble threat has been largely benign during the last two years but we believe this is a large potential risk where timing is difficult to predict.
- Notwithstanding the competitive threat, key positive we would look out for in 2007 is margin expansion. Lower crude oil prices will likely drive down packaging costs for the sector. Further, lower crude prices will likely be especially beneficial for HLL and Asian Paints.
- Longer term, fast growing organized retailing could be a double edged sword. The first phase will possibly bring benefits – superior product mix and explosion in rural income growth – but eventually we expect higher trade margins to eat into the profitability of the manufacturers.

Chart 41: Consumer sector 1yr forward PE chart



Source: Merrill Lynch Research

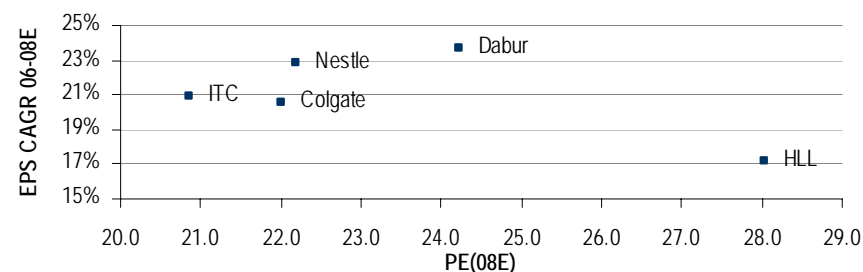
Top Sell: Hindustan Lever

Top Outperformers: ITC, Nestle, Asian Paints

Top Sell: HLL

- We rate HLL a Sell based on our expectation of worsening competitive environment, higher advertising costs to support sales growth and hence earnings growing below market expectations at 16% in 2007. Rich valuations – P/E of 32x, EV/EBITDA of 28x and ~70% premium to the Sensex – leave little scope for disappointment.
- HLL's key competitive threat has been from P&G. Despite the largely peaceful co-existence during the last two years, we believe it is a matter of time before P&G expands its product portfolio in India. In addition, we are concerned about ITC's imminent launch of household staples such as soaps and shampoos.
- Despite the recovery in topline, HLL's market shares in its key categories have not improved. We believe share gains are a priority for the management and in a scenario of increasing competition from P&G and ITC, we forecast advertising costs to increase 29% in the current year and 20% next year.
- We do believe HLL will benefit from robust topline growth and declining crude oil prices but higher ad spend implies that margin expansion will likely be unexciting. As a result our EPS estimates in 2007 are 6% below consensus.

Chart 42: PE(08E) vs EPS CAGR (06-08E) scatter graph



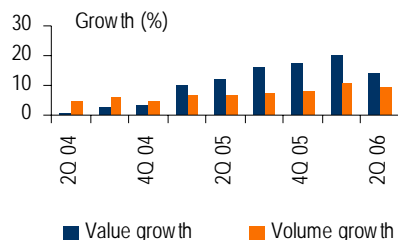
Source: Merrill Lynch Research

Table 28: Sector performance

	Absolute Performance			
	1month	3 month	YTD	1year
Asian Paints	-0.3%	14.2%	15.0%	32.5%
Britannia	15.4%	18.2%	-6.0%	9.7%
Colgate India	2.4%	2.6%	41.1%	55.3%
Dabur India	6.9%	12.1%	39.1%	68.4%
HLL	-10.9%	2.4%	16.2%	33.6%
ITC Limited	-1.5%	10.6%	30.2%	52.4%
Nestle India	5.3%	0.7%	14.8%	29.9%
Tata Tea	1.6%	4.2%	-20.4%	1.9%
Sector Average	-3.4%	7.0%	21.5%	41.4%

Source: Bloomberg

Chart 43: HLL – HPC Volume and Value Growth Trends



Source: Merrill Lynch Research

Table 30: Stock/ Sector valuations

			Price	Mkt Cap (US\$m)	P/E (x)			EPS CAGR		P/B (x)			EV/Ebitda (x)			Div. Yield (%)		RoE			Corp Gearing		
Stock	ML Code	QRQ			FY06	FY07E	FY08E	06-08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	
Asian Paints	XAPNF	1 - Buy	664	1,404	29.9	24.6	20.1	22%	9.9	8.5	7.2	16.7	14.6	12.0	2.2%	2.6%	35.0	37.2	38.9	29%	34%	16%	
Colgate India	CPIYF	1 - Buy	380	1,139	32.0	26.6	22.0	21%	19.1	16.0	13.9	25.2	22.8	18.5	2.4%	3.2%	62.5	65.3	67.6	-31%	-48%	-63%	
Dabur India	DBUIF	1 - Buy	146	1,853	37.0	29.5	24.2	24%	18.1	13.7	10.7	29.5	23.4	19.1	1.5%	1.8%	55.2	53.0	49.6	11%	-12%	-31%	
HLL	HINLF	3 - Sell	229	11,144	38.5	32.5	28.0	17%	21.9	20.5	19.2	34.8	29.3	24.9	2.5%	2.9%	59.6	65.2	70.7	-13%	-25%	-36%	
ITC Limited	ITCTF	1 - Buy	185	15,302	30.5	25.1	20.9	21%	7.7	6.8	6.0	20.7	16.5	13.6	1.9%	2.5%	27.0	28.7	30.4	-8%	-16%	-23%	
Nestle India	XNTEF	1 - Buy	1075	2,285	33.5	27.8	22.2	23%	29.3	24.0	19.5	20.6	17.6	14.2	2.5%	3.2%	91.9	94.7	97.0	-6%	-22%	-46%	
Tata Tea	TTAIF		755	935	14.5	15.0	12.9	6%	2.8	2.4	2.1	10.9	14.0	12.3	1.4%	1.3%	19.8	17.2	17.2	112%	300%	257%	
Consumer Sector Avg.					32.2	27.0	22.6		10.6	9.3	8.2	23.2	19.4	16.1	2.1%	2.6%	35.0%	36.6%	38.4%	5%	18%	6%	

Source: Merrill Lynch Research

Table 29: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
HLL	Key risks to our Sell rating are stronger topline growth and significant savings from lower raw material costs.	We expect competitive environment to deteriorate led by P&G and ITC's new product launches. As a result we expect HLL's adspend to rise sharply.
ITC	Virtual monopoly in cigarettes with underutilized pricing power. Longer term benefits from on-going investments in rural retail infrastructure.	Overhang of VAT levy and excise increase in cigarettes. Also risks of return of capex cycle, especially large greenfield capex in paper.
Dabur	Diversified product portfolio, renewed vigour in some of the legacy brands and presence in new emerging categories - fruit juices and home care.	Increasing investments in international markets may not yield commensurate returns. Possibility of acquisition in the US health care may worsen risk profile.
Colgate	Stronger portfolio to combat low-priced competition and tap the fast growing rural markets. Building presence in future growth categories - liquid soaps.	Virtually single product business and hence high risk especially if P&G launches Crest in India and HLL re-focuses on its oral care business.
Nestle	Strong structural growth drivers as processed foods is huge under-penetrated & Nestle dominates most of its categories. Input cost pressure likely to ease.	Coffee may continue to under-perform owing to higher prices and increased competition from HLL. Raw milk may continue to remain high in 2007 also.
Asian Paints	High quality play on growing housing demand and improving lifestyles. Lower crude oil prices will likely improve margins going forward.	Crude oil prices do not ease materially or stiffer competition leads to input cost savings being passed back to the consumers.
Tata Tea	Tetley's fruit & herbal teas grow significantly faster, Glaceua water earns net margins >10%, merger synergies from EOC coffee and raw tea prices ease.	High raw tea prices and high marketing costs in Tetley pressure EBITDA margins. Recent large acquisitions will lead to sharp increase in interest costs.

Source: Merrill Lynch Research

Energy (Vidyadhar Ginde, Sudarshan Narasimhan)

Overweight

Key Drivers of Sector Outlook

R&M companies

- Lower oil prices are likely to translate into much lower subsidies in 2H FY07E than 1H FY07. Oil prices have declined to below US\$60/bbl from US\$70/bbl in 1H FY07. At current oil prices subsidies have almost halved from 1H levels.
- The amount of oil bonds government issues in FY07E and the subsidy borne by upstream oil companies in 2H will determine R&M companies' FY07E earnings outlook. R&M companies' earnings in FY07E are likely to be YoY higher based on subsidy which we expect upstream to bear.
- R&M companies' subsidy could decline steeply or be eliminated if oil prices decline steeply to below US\$50/bbl and stay there. Even if oil prices do not decline, subsidy could decline steeply or be eliminated in 18-24 months. We expect this due to a change in subsidy sharing between oil companies (as proposed by the Rangarajan committee) and cut in kerosene subsidy by 40% due to better targeting thereof.

Upstream oil companies

- Upstream oil company ONGC will be hurt by weaker oil prices and possible continued significant contribution to subsidy in 2HFY07E.
- Even in the longer term we expect ONGC to gain as much as R&M companies from reduction in subsidies. This is because we believe that the one-third and two-third subsidy sharing between upstream and downstream is a thing of the past. We expect most of the benefit from reduction in subsidy due to domestic price hikes to go the R&M companies.

Reliance Industries (RIL)

- Weakening of regional refining margins is a concern. However on y-o-y basis H2 FY07E refining profit may not be lower as H2 FY06 refining margins were also weak at US\$6/bbl and RIL also had 6-week refinery shut down in Q3 FY06
- H2 FY07E refining profit of RIL may also be boosted by export benefit of Rs10bn under target plus scheme.

- Although petrochemical margins have receded from their 2Q FY07 peaks, we expect petrochemical margins to be YoY higher in 2H FY07E.
- Positive news flow (higher D6 gas production plateau, more clarity on past oil discoveries and possible new discoveries), which may boost RIL's E&P business valuation, is likely in 2H FY07E.

Top Buys: HPCL

Top Underperformers: ONGC

Top Stock Pick: HPCL

- One of the best plays on declining oil prices
- Most attractive among R&M companies on P/E basis and P/BV basis
- Offers the most stock price upside among R&M companies if subsidies are eliminated
- Downside in HPCL may be the least among R&M companies if one believes book value acts as floor (cheapest on P/BV at 1.1x)

Top Underperformer: ONGC

- Neither the best play on rising oil prices nor on falling oil prices. Regional E&P peers are better in a rising/high oil price environment. Indian R&M companies are the best play on declining/low oil prices.
- In a declining subsidy environment, ONGC's gain from subsidy reduction may be far lower than market expectations. This concern of ours is based on Rangarajan committee, which proposed elimination of auto fuel subsidy, cut in LPG and kerosene subsidy and upstream players ONGC, OIL and government bearing the balance subsidy.

Table 31: Sector performance

	Absolute Performance			
	1month	3 month	YTD	1year
BPCL	8.7%	27.9%	-7.6%	1.4%
Gail India	-4.5%	8.9%	-3.8%	-1.0%
Hindustan Petro.	9.2%	47.4%	-3.8%	2.5%
IOC	1.9%	45.9%	-4.8%	17.7%
ONGC	-3.0%	9.4%	-2.2%	20.3%
Reliance Inds	3.4%	23.4%	74.5%	101.5%
Sector Average	0.5%	20.1%	16.5%	38.4%

Source: Merrill Lynch Research

Chart 44: Energy sector 1yr forward PE Chart



Source: Merrill Lynch Research

Table 32: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
HPCL	i) Steep decline in oil prices to below US\$50/bbl, which will mean steep decline in R&M companies' subsidy ii) Even if oil prices do not decline steeply, R&M companies' subsidies may be eliminated or steeply cut if domestic price hikes are made to eliminate on auto fuels and reduce subsidy on LPG and kerosene provided the gain from subsidy reduction due to price hikes is given only to R&M companies with upstream companies getting none	i) oil prices bounce back again to well over US\$75/bbl and no significant hike in domestic prices of the subsidized products are made ii) subsidies decline due to price hikes but subsidy sharing between R&M companies and upstream is two-third and one-third respectively. Thus one-third of benefit of subsidy reduction goes to upstream oil companies
ONGC	i) Large oil/gas discovery ii) Oil prices remains high while there is no subsidy on auto fuels and upstream companies bear just one-third of LPG and kerosene subsidy	i) There is no commensurate decline in ONGC's subsidy in 2H FY07E despite significantly lower oil price than in 1H ii) In the longer term ONGC does not gain as much from subsidy reduction as R&M companies
Reliance	i) Refining margins bounce back strongly and remain buoyant ii) Petrochemical margins remain strong iii) Positive news flow on E&P indicating production volumes and reserves are significantly higher than earlier indicated, oil discoveries made are commercial and significant in size	i) Refining margins weaken further. We see much weaker global/Asian demand than earlier expected to be the main risk to refining margins. In the shorter term a mild Northern hemisphere winter may result in weak refining margins ii) E&P news flow is disappointing iii) Petrochemical margins weaken sharply from 2Q peak and are YoY lower in 2H FY07

Source: DSP Merrill Lynch

Table 33: Stock/ Sector valuations

				P/E (x)			EPS CAGR	P/B (x)			EV/Ebitda (x)			Div. Yield (%)		RoE			Corp Gearing			
Stock	ML Code	QRQ Price	Mkt Cap (US\$m)	FY06	FY07E	FY08E	06-08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	
BPCL	XBPCF	2 - Neutral	401	2,653	25.4	10.4	9.5	63%	1.5	1.4	1.3	13.1	5.9	4.7	3.0%	3.2%	6.2	14.1	14.0	69%	51%	22%
Hindustan Petro.	XHTPF	1 - Buy	316	2,366	26.4	10.4	10.1	62%	1.2	1.1	1.1	20.1	7.4	6.2	3.5%	3.5%	4.7	11.4	11.0	62%	50%	27%
IOC	IOCOF	1 - Buy	530	13,641	13.8	9.3	9.5	20%	2.1	1.8	1.6	10.7	7.6	7.2	5.5%	3.4%	16.3	20.8	17.7	87%	67%	51%
ONGC	ONGCF	2 - Neutral	1149	36,102	10.6	9.3	7.9	16%	2.9	2.5	2.1	5.1	4.4	3.7	3.8%	4.6%	29.3	29.2	28.7	-5%	-13%	-17%
Reliance Inds	XRELF	1 - Buy	1194	36,677	18.3	15.4	16.8	5%	3.3	2.9	2.6	13.6	10.8	11.6	0.8%	0.8%	20.1	20.1	16.2	40%	27%	20%
Energy Sector Avg.				13.9	11.1	10.5		2.7	2.3	2.1	8.5	6.7	6.1	2.8%	2.8%	21.0%	22.7%	20.9%	35%	23%	12%	

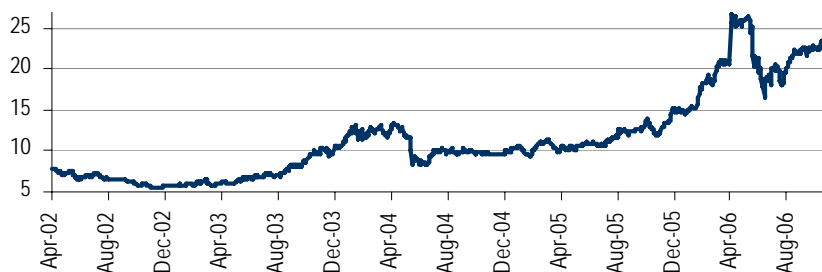
Source: Merrill Lynch Research

Engineering & Construction (Bharat Parekh) Overweight

Key Drivers of Sector Outlook

- Based on our bottom-up approach, we forecast total infra spend at US\$109bn over FY06-08E - 61% rise compared with the FY03-05 spend at 17% CAGR. We expect power sector to be the biggest driver accounting for 30% of this spend followed by oil & gas, railways, roads, airports and ports.
- Our top-down model forecasts that pent-up demand (deficit of 8.3% on base demand & 12.3% on peak load) and an expanding economy should lead to 53% growth in per capita consumption of power by FY12E.
- India plans to double the power generation capacity addition by 56GW (government plans to add 62GW) during the XI Plan +90% over the X Plan.
- We expect total private sector participation to rise to 32-33% from 26-27%; implying a doubling of private sector spend between FY06-08 v/s the last 3 year period owing to much greater regulatory progress seen across sectors.
- We expect the demand led return of pricing power as the key driver of margins. We also note that the financing of our infrastructure spend forecasts are not primarily dependant on budgetary support.

Chart 45: Engg. & Construction sector 1yr forward PE Chart



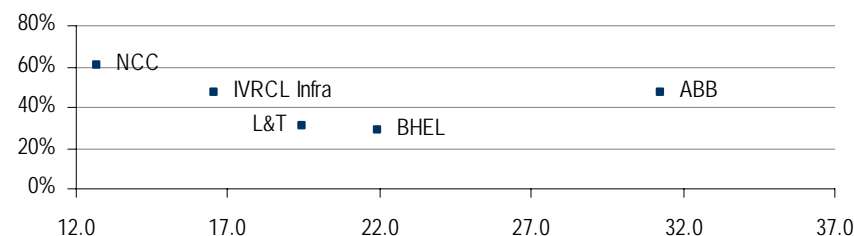
Source: Merrill Lynch Research

Top Buys: ABB India, BHEL, IVRCL, L&T, NCC Top Underperformers: N.A.

Top Stock Pick: BHEL

- Given BHEL's market dominance, we believe it would be the primary beneficiary of doubling of power generation capex especially as it has fixed technology issues, doubling capacity and leveraging its economies of scale.
- To capitalize on the power capex, BHEL has tied-up with 3 international majors to acquire advanced technology i) super critical boilers from Alstom, ii) Higher capacity generators from Siemens and iii) Advance class gas turbine from GE.
- As per our industry checks, CEA has supported placement of bulk orders on BHEL for super-critical technology on negotiated price route v/s international competitive bidding, which could result in a potential order of US\$1.9-3.4bn.
- We believe BHEL will witness improving pipeline of orders led by setting-up of i) Sub-critical plants at NTPC / SEBs / IPPs, ii) Ultra large coal-based projects (9x4GW) led by the Ministry of Power / NTPC and iii) Increased activity to place bulk orders on BHEL of these sets to accelerate indigenization of super critical technology. We estimate 29% earnings CAGR over FY06-08 on 21% YoY sales growth, stable material prices and operating leverage boosting margins.

Chart 46: PE(08E) vs EPS CAGR (06-08E) scatter graph



Source: Respective Company, Merrill Lynch Research

Table 34: Sector performance

	Absolute Performance			
	1month	3 month	YTD	1year
ABB	21.7%	50.1%	82.6%	110.4%
Bharat Heavy	5.8%	36.9%	76.5%	110.5%
IVRCL Infrastruc	15.0%	56.4%	87.7%	106.8%
Larsen & Toubro	-4.1%	26.0%	38.2%	92.2%
Nagarjuna Const	5.4%	57.3%	23.6%	52.8%
Sector Average	4.5%	35.8%	61.8%	102.4%

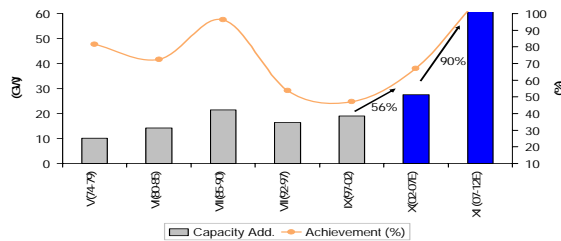
Source: Bloomberg

Table 35: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
ABB India	Improved tailwind for automation capex in India led by resurgence in Industrial capex.	Competition, Delay in Power sector reforms / capex.
BHEL	Key beneficiary of doubling of power capex in XI Plan & potential negotiated orders of US\$1.9-3.4bn for NTPC's Ultra Mega Power Projects	Competition from Chinese players, Project Execution and Cap on FII holding
IVRCL	India's continued focus on water capex, IVRCL's SPV achieving financial closure for road projects, Turnaround of Hindustan Dorr Oliver & value un-locking at IVR Prime, its real estate venture	Slowdown in Government capex, Raw material costs, Competition, Denial of tax benefits, Traffic/Interest rate risk in toll/annuity projects, and Project execution risk.
L&T	Acceleration in domestic / Middle East Infra capex cycle to drive order backlog & sales; value un-locking in IT / Infra / Manufacturing subsidiaries / associates	Raw materials, Increasing competition & Project execution.
NCC	Continued momentum in roads, water, irrigation & Electrification capex, order inflows from NCC's export initiatives & pay-off from its real estate initiatives.	Slowdown in Government capex, Raw material costs, Denial of tax benefits, Traffic/Interest rate risk in Infra projects, & Project execution.

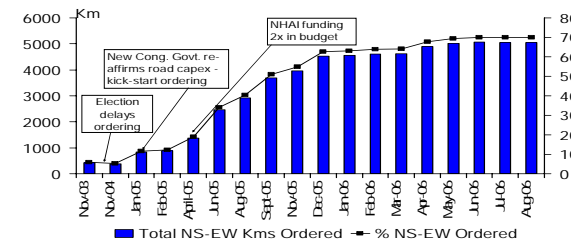
Source: Merrill Lynch Research

Chart 47: India 5-yr Plan wise Power Capacity Creation & MLE



Source: Ministry Of Power, ML Research estimates

Chart 48: NHAI's Execution Of NS-EW Corridor Is Picking-Up



Source: NHAI

Table 36: E&C companies witnessing healthy order books

(Rsmn)	April - June		
Order Backlog	FY06	FY07	% YoY
ABB	18,575	31,375	69%
BHEL	306,000	393,000	28%
L&T	183,170	283,180	55%
IVRCL	35,430	70,000	98%
Nagarjuna	48,722	54,340	12%
Sector	591,897	831,895	41%

Source: Respective Company

Table 37: Stock/ Sector valuations

Stock	ML Code	QOQ	Price	Mkt Cap (US\$m)	P/E (x)			EPS CAGR		P/B (x)			EV/Ebitda (x)			Div. Yield (%)		RoE			Corp Gearing		
					FY06	FY07E	FY08E	06-08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	
ABB	ABVFF	1 - Buy	3522	3,290	68.3	44.3	31.6	47%	16.8	12.7	9.5	45.0	29.5	20.6	0.3%	0.4%	27.4	32.7	34.4	-68%	-69%	-74%	
Bharat Heavy	BHRVF	1 - Buy	2447	13,202	37.0	25.0	22.2	29%	8.2	6.5	5.2	23.0	15.7	13.5	0.7%	0.7%	24.3	28.9	26.1	-36%	-26%	-36%	
IVRCL Infrastruc	IIFRF	1 - Buy	276	661	35.4	21.6	16.4	47%	5.9	4.7	3.8	22.7	14.8	11.4	0.8%	1.4%	20.7	27.2	28.6	10%	40%	35%	
Larsen & Toubro	LTOUF	1 - Buy	1274	7,859	33.3	24.2	19.4	31%	7.2	5.9	5.1	21.7	16.1	13.0	1.0%	1.2%	26.5	27.4	28.3	55%	33%	24%	
Nagarjuna Const	NGRJF	1 - Buy	159	725	31.6	18.5	12.4	60%	3.6	3.1	2.6	18.8	13.0	9.6	0.8%	1.0%	16.8	18.1	22.7	-23%	10%	26%	
Sector Avg.					37.7	25.8	21.4		8.0	6.4	5.3	23.7	16.7	13.7	0.7%	0.8%	24.5%	27.8%	27.3%	-5%	-5%	-14%	

Source: Merrill Lynch Research

Media

Underweight

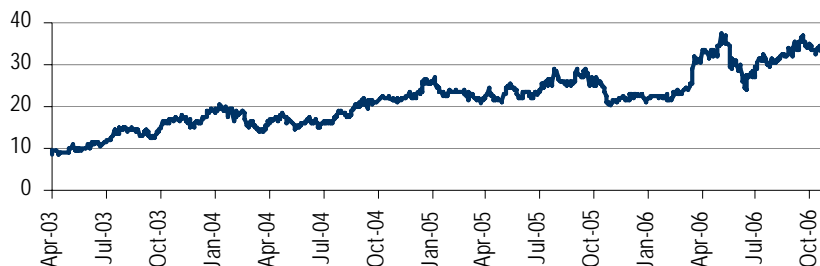
Key Drivers of Sector Outlook

We note that the media industry is poised to witness a take off in growth trajectory on account of

- **Solid demographics.** More than two-thirds of Indian population is below the age of 35 years which represents the major consuming class. Growing education levels and urbanization add to solid demographic profile.
- **Rising income levels.** 19mn households upgrade during FY02-07E.
- **Rising penetration** of TV and C&S households. India is expected to add 12mn C&S homes over FY06-08E.
- **Rising ad spends.** Advertising spends in India are expected to grow at 18% CAGR over 2005-07.
- **Expanding revenue platforms** such as 'pay' revenues, on demand revenues from DTH platform, CAS (digital cable), IPTV, broadband, internet, radio.
- **Global recycling of Indian content** such as news feeds, Indian channels beamed abroad, animation, gaming etc. to drive global pay / content revenues.

(Bharat Parekh)

Chart 49: Media sector 1yr forward PE Chart



Source: Merrill Lynch Research

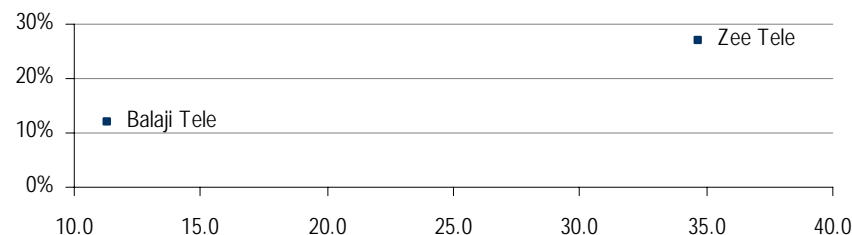
Top Buys: Zee Telefilms, Balaji Telefilms

Top Underperformers: NA

Top Stock Pick: Zee Telefilms

- Zee is the only integrated Indian media conglomerate set to capitalize on the emerging opportunity across content-to-conduit.
- Sustained position of Zee TV as No.2 channel in the General Entertainment space, leadership of Zee Cinema and improving performance of the new channels to drive strong double digit growth in network advertisement revenues.
- Acquisition of compelling content from One Alliance bouquet and availability of Star content since July '06 for Dish TV (DTH service) completes its content offering on DTH platform. This would aid Dish TV's penetration in urban markets.
- Likely value creation in MSO business (erstwhile SitiCable, now WWIL) which should get transformed into a broadband platform offering triple-play services on the back of ensuing implementation of CAS in metros.
- Ensuing de-merger of Zee Telefilms into four business entities paves the way for the entry of strategic partners.

Chart 50: PE(08E) vs EPS CAGR (06-08E) scatter graph



Source: Respective Company, Merrill Lynch Research

Table 38: Sector performance

	Absolute Performance			
	1month	3 month	YTD	1year
Balaji Tele	7.8%	35.2%	-0.9%	18.7%
Zee Telefilms	-2.0%	16.6%	87.1%	103.4%
Sector Average	-1.4%	17.8%	76.2%	93.8%

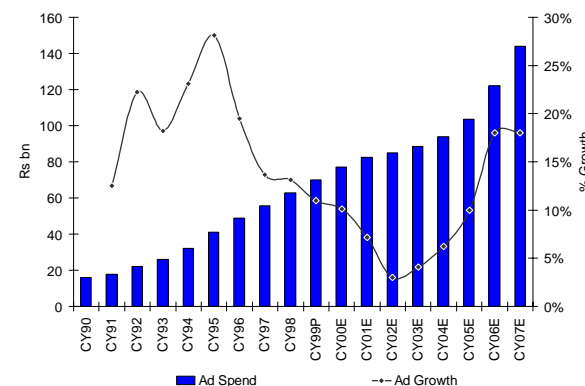
Source: Bloomberg

Table 39: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
Balaji Telefilms	Sustained leadership position in the Hindi General Entertainment space, increase in content offerings in the sponsored category, diversification of content such as movies or markets such as international markets and deployment of surplus cash into productive businesses	To maintain creativity & ratings of serials on Star Plus and Retaining talent / rise in cost of actors.
Zee Telefilms	Sustained rise in ratings, acceleration of subscriber adds in DTH business, implementation of CAS likely to improve subscription revenues / valuation of Zee Telefilms cable assets and new channels achieving break-even.	Competition / World Cup '07, failure of CAS system again, Cap of cable tariffs by TRAI and slowdown in penetration of Zee Turner / Dish TV.

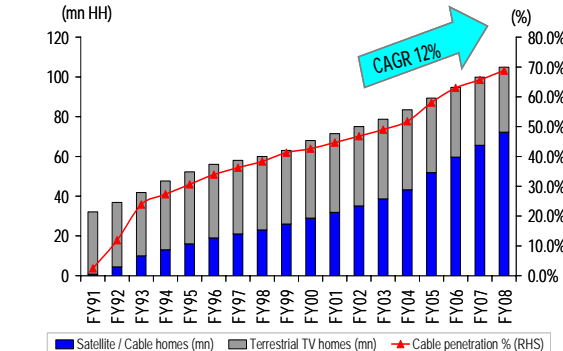
Source: Merrill Lynch Research

Chart 51: Indian Advertisement Spends (Rs bn)



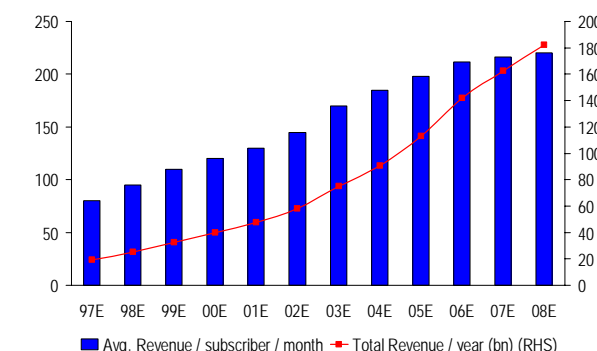
Source: Merrill Lynch Research

Chart 52: Cable TV Penetration On Rise



Source: Merrill Lynch Research

Chart 53: Cable Revenues



Source: Merrill Lynch Research

Table 40: Stock/ Sector valuations

Stock	ML Code	QRO	Price	Mkt Cap (US\$mn)	P/E (x)			EPS CAGR	P/B (x)			EV/Ebitda (x)			Div. Yield (%)		RoE			Corp Gearing		
					FY06	FY07E	FY08E		06-08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E
Balaji Tele	BLJIF	1 - Buy	143	205	15.2	12.2	10.7	19%	3.7	3.2	2.7	9.7	7.9	7.1	2.8%	3.2%	26.4	27.9	27.1	-2%	0%	0%
Zee Telefilms	XZETF	1 - Buy	294	2,754	56.2	45.2	34.8	27%	6.0	5.5	4.8	47.7	30.5	22.8	0.6%	0.7%	13.4	7.9	9.5	15%	13%	7%
Sector Avg.					47.2	38.2	30.2		5.7	5.2	4.6	36.7	26.1	20.2	0.7%	0.8%	10.0%	12.0%	13.8%	13%	12%	6%

Source: Merrill Lynch Research

Metals

(Vandana Luthra, Vishal Nathany)

Underweight

Key Drivers of Sector Outlook

- ML sees global growth moderating from 5.2% in 2006 to 4.4% in 2007. This is underpinned on a consumer-led slowdown in the US. We see US GDP growth dropping sharply, from 3.4% to 1.9% in 2007. Globally long term interest rates have increased from their previous lows, suggesting consumption and investment activities could slow down.
- Eventually a slowdown in global economic activity and a gradual increase in supplies next year should put downward pressure on base metals prices.
- Aluminum – Increased Chinese bauxite imports have led to stronger Chinese alumina and aluminum production. North America aluminum production continues to surprise on upside. Overall the market looks to be heading towards a sizeable surplus in 2007 and we expect aluminum prices to fall 17% in FY08.
- Steel – China, the driver of the current bull run in steel, has finally become a net-exporter in 2006 and will continue to export in future. Low demand from US and rising production from China pose a threat to steel cycle. However, given high raw material costs, we expect the floor to be ~US\$410/t vs. current CIS price of ~US\$500/t.

Chart 54: Metals sector 1yr forward PE Chart



Source: Merrill Lynch Research

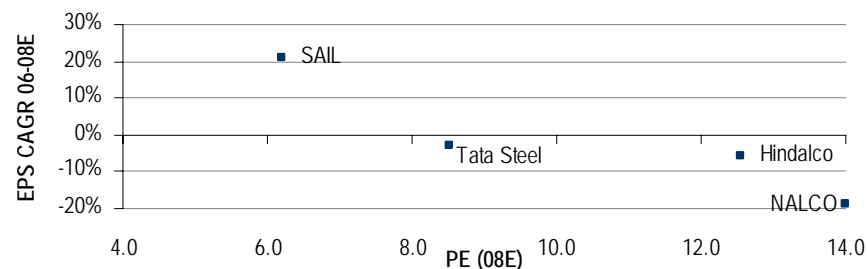
Top Buys: SAIL

Top Underperformers: Nalco, Hindalco

Top Stock Pick: SAIL

- We see SAIL as a restructuring/modernization story available at an attractive valuation. The change drivers are low cost capacity expansion, improving product mix and falling production costs. This is supported by a strong balance sheet – we estimate at end-FY07, SAIL's net cash will be over US\$1.5bn.
- Capacity increase through cost-effective modernization route – we anticipate CAGR 8% volume growth over the next 6 yrs achieved through modernization of existing plants. SAIL will increase its capacity from current 12mt to 20mt by 2012 through this route and hence the balance sheet is unlikely to be unduly stretched.
- SAIL is planning a secular shift to more efficient continuous casting method from 65% currently to ~100% in next 6 years and reduction in proportion of semi finished steel products from 20% in 2006 to less than 5% by 2012.
- Key risks are execution and steel prices falling. The government owns 86% of SAIL and we believe is committed to volume growth and improving production efficiencies. Further, in a down cycle, based on our assumption of floor price of steel to be ~US\$410/t, we forecast SAIL to earn EBITDA margin of over 20%.

Chart 55: PE(08E) vs EPS CAGR (06-08E) scatter graph



Source: Merrill Lynch Research

Table 41: Sector performance

	Absolute Performance			
	1month	3 month	YTD	1year
Hindalco	7.6%	16.7%	28.1%	57.6%
NALCO	7.5%	3.8%	0.4%	26.6%
Steel Authority	19.7%	32.0%	64.3%	69.4%
Tata Steel	2.5%	5.2%	33.8%	38.6%
Sector Average	10.0%	15.9%	35.3%	50.2%

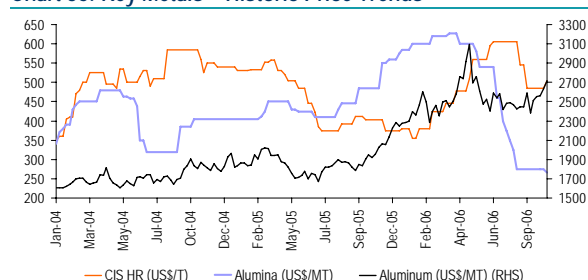
Source: Bloomberg

Table 42: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
Tata Steel	Stronger steel prices coupled with lower green field capacity expansion, especially in post Corus scenario, would make us positive on the stock.	Our Neutral rating is underpinned on our view that steel prices have peaked given rising Chinese exports. We are also worried about balance sheet getting unduly stretched led by management's target capacity of 40m tons by 2012.
SAIL	We are positive on SAIL's restructuring story which we believe should play out over the next 3-4 years. Strong balance sheet and low-cost capex additions (brownfield and modernization) are key positives.	Sharp fall in steel prices led by rising Chinese supplies can cripple earnings growth. Excessive government interference in the modernization plans and inability to cut labour costs can dull our outlook for the company.
Hindalco	Higher than expected commodity prices - aluminum, copper and copper TCRC - can lead to better than our forecast earnings growth.	We are Neutral led by our view that all the three price cycles for Hindalco have peaked. Further, there is no significant volume growth in the key Aluminum div.
Nalco	Despite the sharp correction in alumina prices, aluminum prices continue to hold strong which can lead to better than our forecast earnings growth.	Our Sell call is based on further expected downside in alumina prices, which should eventually lead to aluminum prices also falling.

Source: Merrill Lynch Research

Chart 56: Key Metals – Historic Price Trends



Source: Merrill Lynch Research

Table 43: Metal Price Forecasts

	FY06A	FY07E	FY08E
Steel - HR - US\$/t	503	519	488
Aluminum - US\$/t	2030	2414	2006
Alumina spot - US\$/t	588	400	250
Copper - US\$/t	4099	6944	4630
Copper TCRC - USc/lb	18.1	27	19.6

Source: Merrill Lynch Research

Table 44: Earnings Sensitivity to Metal Price Changes

	Tata Steel	SAIL	Hindalco	Nalco
1% change in Steel	1.5%	2.4%		
1% change in Aluminum			1.8%	1.6%
1% change in spot Alumina				0.2%
1% change in Copper			0.7%	
1% change in Copper TCRC			0.3%	

Source: Merrill Lynch Research

Table 45: Stock/ Sector valuations

Stock	ML Code	QRQ	Price	Mkt Cap (US\$m)	P/E (x)			EPS CAGR 06-08E	P/B (x)			EV/Ebitda (x)			Div. Yield (%)		RoE			Corp Gearing		
					FY06	FY07E	FY08E		FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E
Hindalco	HDEIF	2 - Neutral	184	4,695	11.2	8.6	12.6	-6%	1.9	1.7	1.4	9.0	5.0	6.7	1.2%	1.0%	18.6	22.9	12.5	21%	25%	15%
NALCO	NAUDF	3 - Sell	221	3,135	9.2	7.3	14.0	-19%	2.4	1.9	1.7	4.7	3.4	6.3	1.8%	1.8%	28.9	28.6	12.7	-38%	-48%	-40%
Steel Authority	SLAUF	1 - Buy	89	8,075	9.1	5.8	6.2	21%	2.8	2.0	1.6	4.9	2.7	2.5	3.4%	3.2%	34.9	40.5	29.1	-21%	-52%	-55%
Tata Steel	TAELE	2 - Neutral	509	6,511	8.0	7.0	8.5	-3%	3.0	2.0	1.7	5.4	4.4	4.9	2.5%	2.3%	42.9	35.6	22.0	23%	8%	4%
Sector Avg.					9.1	6.8	8.4		2.5	1.9	1.6	5.4	3.7	4.3	2.5%	2.3%	31.7%	33.2%	21.0%	-2%	-17%	-20%

Source: Merrill Lynch Research

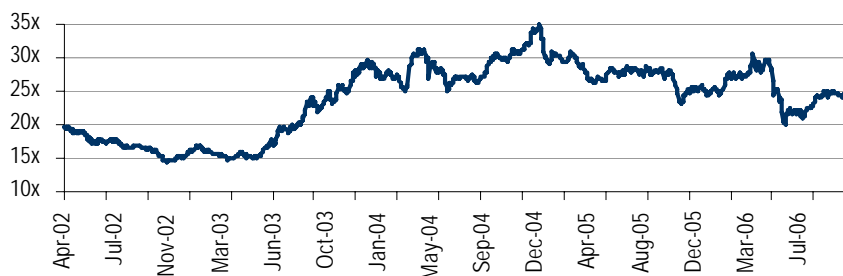
Pharmaceuticals Underweight

(Visalakshi C, Avinash Sule)

Improving earnings visibility trend to continue

- Driven by greater pipeline visibility and a beneficial base effect we estimate 49% and 22% sector EPS growth for FY07 and FY08 respectively vs. 4% EPS growth in FY06E. Maintain a selective stock picking strategy: Dr. Reddy's and Cipla are our top picks in the big cap space while our top mid cap picks are Panacea and Divi's.
- Five focus themes for next 12 months
 1. Upswing in international generic outlook. We estimate 30% CAGR 2006-08E in international generics on new launches and a beneficial base effect.
 2. Potential upside from patent litigation. Over next 12 months, we expect litigation newsflow on over 25 products involving Indian players, eg. Zofran (US\$1.8bn), Avandia (US\$1.8bn) could benefit Ranbaxy & Reddy's.
 3. Heightened M&A activity could drive incremental newsflow for the sector.
 4. Research driven milestones. We expect crucial milestones and clinical data points for two key molecules – Balaglitazone (DRL) and Oglemilast (Glenmark) and remain positive on potential newsflow for both these products.
 5. Indian MNCs - Higher patent visibility. We expect the MNC pharma sector to deliver increased newsflow on patented launches with product-mix led margin expansion in their base business. Top Pick - GSK India

Chart 57: Pharma sector 1yr forward PE Chart



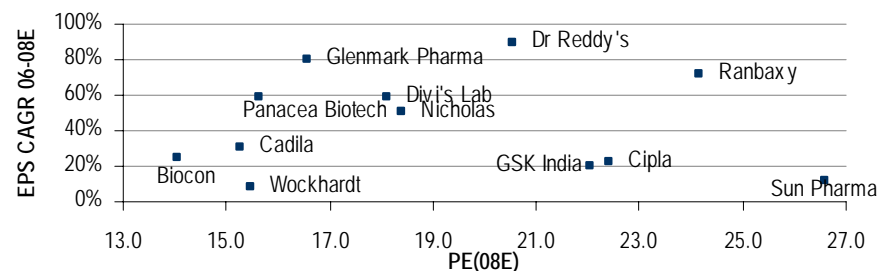
Source: Merrill Lynch Research

Top Buys: Dr Reddy's, Cipla, Panacea Biotech, Divi's Labs Top Underperformers: Ranbaxy

Top Stock Pick: Dr Reddy's

- We see strong visibility in the base business turnaround and expect positive impact from acquisitions, new products and research related progress.
- We expect 20-22% EPS accretion from Betapharm which has a strong presence in Germany with an aggressive growth track record and a niche portfolio focus.
- Rich newsflow ahead: Build up of market share for Generic allegra, clarity on launch of generic proscar, Plavix settlement details, a potential licensing deal for Balaglitazone and clarity on exclusivity for Zofran.
- Our sum-of-the-parts valuation of Rs918/sh values the core business at Rs738/sh and the research pipeline NPV at Rs360/share
- **Key challenges:** Failure of Balaglitazone, US generic pricing pressure, acquisition & domestic challenges

Chart 58: PE(08E) vs EPS CAGR (06-08E) scatter graph



Source: Merrill Lynch Research

Table 46: Sector performance

	Absolute Performance			
	1month	3 month	YTD	1year
Biocon Ltd	-1.3%	14.4%	-23.5%	-28.6%
Cadila Healthcare	-0.2%	25.8%	34.4%	45.0%
Cipla Ltd.	-1.2%	16.7%	44.8%	73.9%
Divi's Lab	15.9%	81.6%	62.4%	78.6%
Dr Reddy's Lab	-4.8%	14.7%	45.7%	69.8%
Glenmark Pharm	5.1%	18.4%	18.2%	26.1%
Panacea Biotech	7.8%	23.2%	39.0%	38.3%
Ranbaxy Lab	-0.8%	16.1%	13.3%	5.4%
Sun Pharma	-1.3%	21.8%	33.8%	41.1%
Sector Average	0.7%	22.3%	19.3%	29.5%

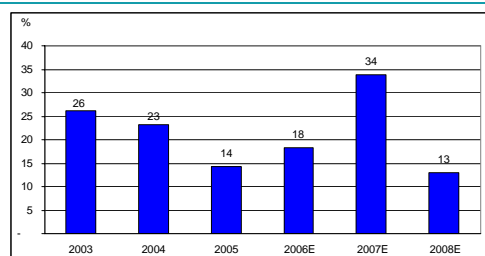
Source: Bloomberg

Table 47: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
Dr. Reddys	Zofran exclusivity; Other patent litigation wins; Research related milestones; Improving generic pricing environment.	Failure of Balaglitazone in clinical could de-rate the stock; Earnings downside from healthcare reforms in Europe and pricing pressure in US generics; Potential equity dilution due to acquisitions.
Cipla	Significant 20-40% earnings upside from product opportunities like Lexapro, Flonase, CFC-free inhalers and Zolof. Significant earnings accretion due to acquisitions; Improving generic pricing environment; Visibility on a few more marketing exclusivities like Pravachol, and worsening generic pricing environment in US; Potential equity dilution due to acquisitions.	Inadequate management disclosure; Drug Pricing related liability of about Rs2bn Failures/delays of product approvals Severance of alliances.
Ranbaxy	which could add to earnings.	Further delay in resolution of FDA issues; Impact of healthcare reforms in Europe

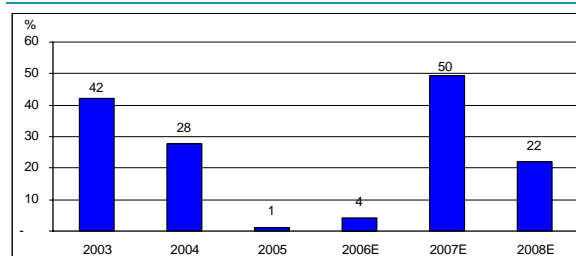
Source: Merrill Lynch Research

Chart 59: Sector Revenue Growth



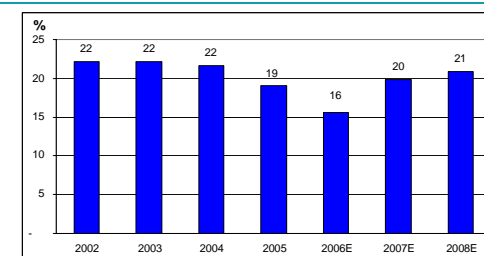
Source: Merrill Lynch Research

Chart 60: Sector PAT Growth



Source: Merrill Lynch Research

Chart 61: Sector EBITDA Growth



Source: Merrill Lynch Research

Table 48: Stock/ Sector valuations

				P/E (x)			EPS CAGR	P/B (x)			EV/Ebitda (x)			Div. Yield (%)		RoE			Corp Gearing			
Stock	ML Code	QRQ	Price	Mkt Cap (US\$m)	FY06	FY07E	FY08E	06-08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E
Biocon Ltd	BCLTF	1 - Buy	378	832	21.7	19.8	14.1	24%	4.3	3.6	2.9	17.0	14.8	11.3	1.3%	1.3%	21.4	19.7	22.9	12%	1%	1%
Cadila Healthcar	CDLHF	1 - Buy	331	917	25.8	19.6	15.3	30%	5.7	4.6	3.6	16.0	12.7	10.5	1.1%	1.2%	24.5	26.0	26.3	42%	26%	14%
Cipla Ltd.	XLCAF	1 - Buy	257	4,401	33.3	27.6	22.4	22%	7.2	6.1	5.1	26.6	21.6	17.6	1.2%	1.2%	27.7	23.9	24.8	7%	6%	5%
Divi's Lab	XXQPF	1 - Buy	2477	700	45.7	29.8	18.1	59%	9.3	6.9	5.2	26.9	18.7	12.3	0.4%	0.4%	22.3	26.7	32.7	41%	38%	30%
Dr Reddy's Lab	DRRDF	1 - Buy	713	2,410	74.2	23.0	20.6	90%	5.3	4.4	3.6	41.7	16.8	15.2	0.7%	0.7%	7.3	20.7	19.3	103%	83%	69%
Glenmark Pharm	XVQWF	1 - Buy	371	972	53.4	19.0	16.6	80%	11.2	7.6	5.2	30.2	13.6	11.7	1.8%	1.8%	25.8	49.3	37.2	104%	62%	42%
GSK India	GXOLF	1 - Buy	1176	2,196	32.0	27.2	22.0	20%	10.5	9.5	8.1	21.7	20.0	16.9	2.4%	2.4%	33.2	36.6	39.7	-4%	-5%	-4%
Max India	XMIF	1 - Buy	913	724	-22.8	-39.2	-45.3	-29%	5.1	5.8	6.7	(50.6)	(126.0)	157.6	0.0%	0.0%	(28.3)	(13.9)	(13.8)	-7%	-12%	-21%
Nicholas	XNIGF	2 - Neutral	237	1,093	41.4	24.6	18.4	50%	5.6	4.8	4.0	22.6	16.5	12.8	1.3%	1.3%	17.2	21.0	23.8	30%	23%	10%
Panacea Biotec	XPEAF	1 - Buy	415	522	39.5	20.9	15.7	59%	15.3	10.1	6.2	20.9	12.5	9.9	0.4%	0.4%	43.4	63.2	49.3	91%	147%	90%
Ranbaxy Lab	XANBF	2 - Neutral	411	3,373	71.7	29.6	24.2	72%	6.2	5.7	5.1	66.6	17.5	16.8	2.2%	2.4%	9.2	21.6	24.1	72%	78%	78%
Sun Pharma	SPCEF	3 - Sell	913	3,762	33.0	29.5	26.6	11%	10.2	7.6	5.9	37.2	29.1	23.5	0.4%	0.5%	41.2	33.0	27.9	86%	36%	8%
Wockhardt	XDUVF	2 - Neutral	390	942	18.0	17.6	15.5	8%	5.6	4.4	3.6	15.4	14.6	11.4	1.9%	2.2%	35.5	28.0	25.5	76%	31%	-8%
Pharma Sector Avg					40.5	26.7	21.8		7.1	5.9	4.9	31.2	19.9	16.6	1.2%	1.3%	20.1%	24.9%	25.3%	50%	39%	27%

Source: Merrill Lynch Research

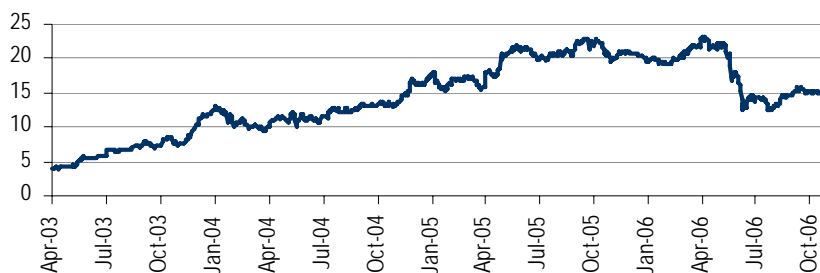
Textiles

(Manish Sarawagi)

Key Drivers of Sector Outlook

- **Export opportunity:** India has emerged as one of the biggest beneficiaries of the dismantling of quotas and subsequent reinstatement of quotas on China, and is gaining market share in several categories.
- **Boom in domestic branded retailing:** The booming consumerism in the domestic market presents an opportunity for textile and apparel brands to establish themselves in the fast-growing Indian market.
- **Aggressive capex phase nearing an end, time to reap the fruit:** The benefits of the aggressive expansions over the last couple of years would start flowing in from FY07.
- **Overseas alliances to help move up the chain, gain global presence:** Indian companies have formed alliances with their global counterparts in a bid to tap technological know-how, design skills and branding and retailing ability.
- **Modest rise in cotton prices:** We expect a modest rise in cotton prices of about 5% in FY07 and FY08 on the back of decent global crop outlook neutralized to some extent by continued higher consumption.

Chart 62: Textiles sector 1yr forward PE Chart



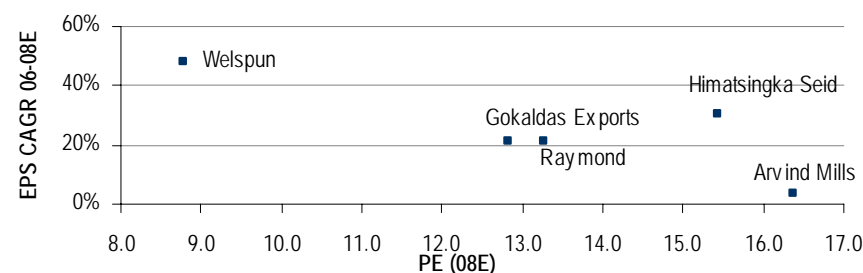
Source: Merrill Lynch Research

Top Buys: Raymond, Welspun India Top Underperformers: Arvind Mills

Top Stock Pick: Welspun India

- Welspun, among the top four terry towel manufacturers in the world, is in the process of executing the most aggressive capacity expansion program in the home textiles space. It set up a new bed linen capacity – the second largest in India - last year, which has turned profitable.
- Welspun's recent acquisition of 85% stake in Christy - UK's leading terry towel brand - will give fillip to its branded business which the company intends to grow progressively and thereby transition from a pure OEM to a branded player.
- We expect earnings to grow at 43% CAGR – the highest among the Merrill India textile universe companies - over the projected period underpinned by the new capacities which have come up and will come up over FY07.
- With the peak capex phase getting over, we expect Welspun to start generating free cash flows from FY08E onwards and improve its return on capital.

Chart 63: PE(08E) vs EPS CAGR (06-08E) scatter graph



Source: Merrill Lynch Research

Table 49: Sector performance

	Absolute Performance			
	1month	3 month	YTD	1year
Arvind Mills Ltd	1.9%	21.8%	-29.7%	-43.7%
Gokaldas Exports	6.2%	28.8%	14.4%	27.8%
Himatsingka Seid	0.5%	44.4%	-6.0%	4.2%
Raymond Ltd	3.6%	33.5%	12.2%	9.1%
Welspun India	2.6%	28.3%	-12.3%	-18.6%
Sector Average	3.0%	31.6%	-4.2%	-8.9%

Source: Bloomberg

Table 50: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
	Strong growth outlook for both exports and domestic market across business segments helped by the overseas JVs.	
Raymond	Turnaround in denim & branded apparel retailing businesses	Spurt in fiber prices.
Arvind Mills		Continued downturn in denim, higher cotton prices.
Welspun		Slower ramp up in bed linen capacity utilization and/or lower margins in that business
India	Volume ramp-up & margin improvement in its new bed linen business	
Himatsingka Seide	Potential overseas acquisition to strengthen its downstream capabilities in branding & retailing	Higher silk prices putting pressure on margins, slow ramp up in the new bed linen business
Gokaldas	Change in labor policy making it more flexible	Lower realizations due to competitive pressure from other low cost countries

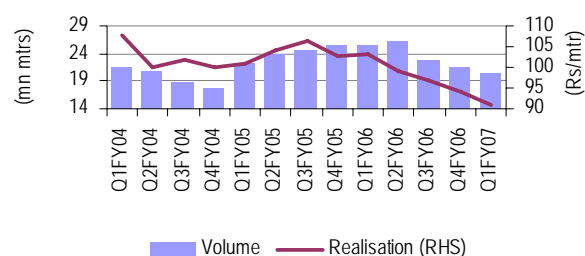
Source: Merrill Lynch Research

Table 51: India's market share in US imports

	Jan-August'06	Jan-August'05	YoY ch (bps)
Textiles & Apparel	6%	5%	57
Apparel	5%	4%	50
Terry towel	25%	19%	637
Bed linen	17%	19%	(244)

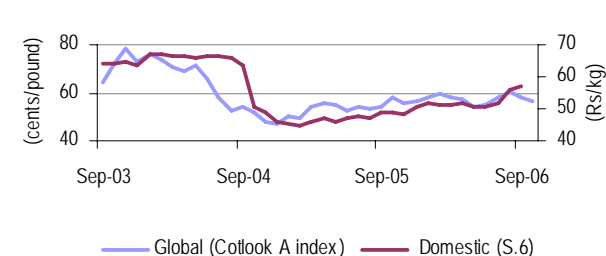
Source: OTEXA, Merrill Lynch

Chart 64: Arivnd's denim volumes and realisations



Source: Arvind Mills, Merrill Lynch

Chart 65: Cotton price trend



Source: Bloomberg, CRIS Infac, Merrill Lynch

Table 52: Stock/ Sector valuations

Stock	ML Code	QRO Price	Mkt Cap (US\$m)	P/E (x)			EPS CAGR		P/B (x)			EV/Ebitda (x)			Div. Yield (%)		RoE			Corp Gearing		
				FY06	FY07E	FY08E	06-08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E
Arvind Mills Ltd	ARVZF	3 - Sell	67	310	17.5	29.4	16.4	3%	1.0	1.0	0.9	7.2	7.4	6.6	1.4%	1.4%	6.3	3.4	5.9	122%	113%	108%
Gokaldas Exports	GKLDF	2 - Neutral	669	253	18.9	15.4	12.8	21%	3.3	2.8	2.3	15.7	11.5	9.3	0.4%	0.4%	23.8	19.6	19.6	61%	46%	33%
Himatsingka Seid	HMKAF	2 - Neutral	132	283	26.4	25.3	15.4	31%	2.3	2.2	2.0	19.4	20.5	11.7	1.9%	1.9%	11.4	8.7	13.4	-45%	-12%	12%
Raymond Ltd	XRAMF	1 - Buy	453	613	19.4	16.2	13.3	21%	2.2	2.0	1.8	15.3	12.0	9.4	1.3%	1.3%	11.3	12.8	14.1	69%	64%	48%
Welspun India	WPNIF	1 - Buy	95	150	19.3	13.2	8.8	48%	1.3	1.3	1.1	11.7	8.0	6.0	0.0%	0.0%	8.9	10.1	13.5	145%	154%	122%
Sector Avg.					19.8	18.4	13.3		1.8	1.7	1.5	11.4	10.0	8.0	1.2%	1.2%	10.3%	9.4%	11.9%	80%	80%	70%

Source: Merrill Lynch Research

Telecom Overweight

(Reena Verma)

Key Drivers of Sector Outlook

- **Continued strong market growth:** We forecast India's wireless sub base to grow at a CAGR of 36% over FY06A-10E. Our forecasts lead to ~28% wireless penetration by FY10E versus ~12% wireless penetration currently.
- **Improving affordability & availability of services:** Falling handset prices and deepening network coverage will likely remain the key drivers of market expansion. Our forecasts assume entry-level handset prices at ~US\$25.
- **Economies of scale:** We see room for margin expansion across the industry as benefits of scale will likely offset competitive pressures on tariffs. We expect ~150bps improvement in wireless margins of the majors, over the next 2 years.
- **No major regulatory issues:** Post the recent 3G recommendations by TRAI, we think there is little room for regulatory surprises in the sector.
- **Good return ranking versus GEM peers:** Our DuPont analysis indicates that return on equity for Indian telecom majors (at ~25-36%) is comparable or higher than peers in other Asian markets.

Chart 66: Telecom sector 1yr forward PE Chart



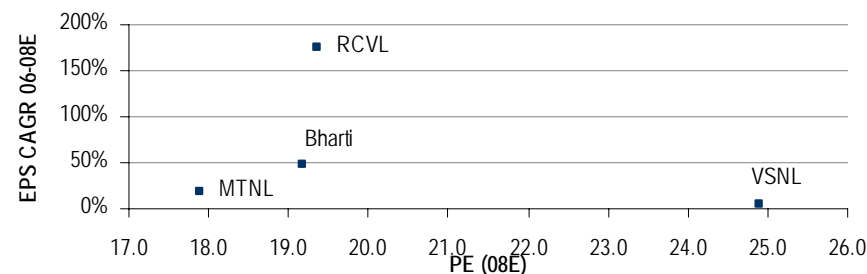
Source: Merrill Lynch Research

Top Buys: Bharti, Reliance Communication Top Underperformer: MTNL

Top Stock Pick: Bharti

- **Leader by subscriber market share:** We expect Bharti to remain the market leader with ~22% share of total subs over the next 2-3 years. We forecast Bharti's wireless sub base at ~51mn by Mar '08 versus ~27mn currently.
- **Room for further margin expansion:** We forecast Bharti's consolidated EBITDA margin at ~40% for FY08E versus ~37% in FY06A. We think scale economies will likely continue to offset tariff pressures.
- **Healthy balance sheet despite strong capex:** We forecast Bharti's net debt/EBITDA at ~0.6x Mar '08, despite forecast capex of ~US\$2bn in both FY07E & FY08E.
- **Higher-than-peers RoE:** Bharti's return on equity (~36% for FY07E) ranks among the highest across AsiaPac wireless majors. We expect this to sustain as improvement in asset turnover should offset lower financial leverage.

Chart 67: PE(08E) vs EPS CAGR (06-08E) scatter graph



Source: Merrill Lynch Research

Table 53: Stock Performances

	Absolute Performance			
	1month	3 month	YTD	1year
Automotive Axles	13.5%	24.2%	-7.2%	11.3%
Bajaj Auto	11.3%	12.7%	54.5%	78.3%
Bharat Forge	5.8%	20.1%	-6.8%	3.8%
M & M	7.4%	15.6%	34.9%	80.6%
Maruti Udyog	0.0%	20.5%	47.8%	64.9%

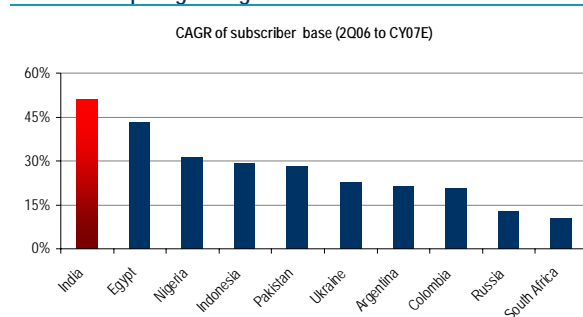
Source: Bloomberg

Table 54: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
Bharti	Higher than anticipated market growth. ARPU support from continued usage growth.	Tariff pressures offset scale of economy. No improvement in capital productivity.
RCom	Higher than anticipated market growth. ARPU support from continued usage growth. Improvement in subscriber base post GSM expansion.	Tariff pressures offset scale of economy. No improvement in capital productivity. Potential weak execution of GSM expansion; consequent weak market share and margins.
VSNL	Higher than expected synergies from recent acquisitions. Improvement in investment value of real estate and of the stake in Tata Tele.	Tariff pressures, especially in data on account of increased competition. Depletion in investment value of real estate and of stake in Tata Tele.
MTNL	Sustenance of wireline market share. Improvement in the share of wireless market. Better than expected revenue contributions from recent broadband and IPTV initiative.	Continued attrition in wireline subscribers. Market share weakness in wireless segment.

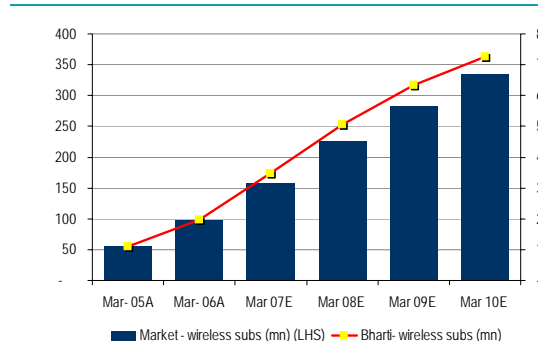
Source: ML estimate

Chart 68: .Top 10 global growth markets



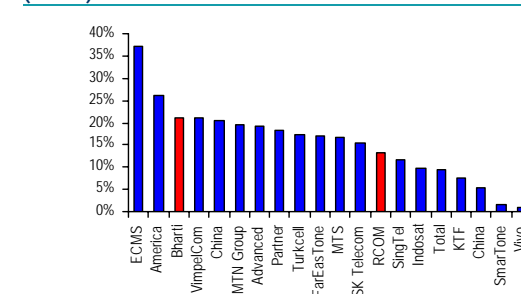
Source: ML estimate

Chart 69: Trend in wireless sub base – Indian Market & Bharti



Source: ML estimate

Chart 70: RoCE of wireless majors in emerging markets (2006E)



Source: ML research

Table 55: Stock/ Sector valuations

				Mkt Cap (US\$m)	P/E (x)			EPS CAGR 06-08E	P/B (x)			EV/Ebitda (x)			Div. Yield (%)		RoE			Corp Gearing		
Stock	ML Code	QRQ	Price		FY06	FY07E	FY08E		FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E
Bharti	BHTIF	1 - Buy	498	20,797	41.7	27.8	19.2	48%	10.3	7.8	5.9	22.6	14.8	10.5	0.0%	1.3%	29.5	31.8	35.1	46%	44%	39%
MTNL	XMTNF	3 - Sell	155	2,148	25.0	19.7	17.9	18%	0.9	0.8	0.8	8.6	5.4	5.2	2.9%	2.9%	3.5	4.4	4.7	-25%	-32%	-32%
RCVL	RLCMF	1 - Buy	369	16,643	147.4	29.7	19.4	176%	6.4	5.4	4.3	31.5	14.3	10.3	0.3%	0.5%	8.7	20.1	25.2	28%	34%	28%
VSNL	VSLSF	2 - Neutral	421	2,646	26.7	25.5	24.9	4%	2.0	1.9	1.8	12.4	11.2	10.5	1.1%	1.1%	7.6	7.6	7.3	-19%	-18%	-17%
Sector Avg.					53.1	27.8	19.5		5.0	4.4	3.7	22.8	13.7	10.2	0.3%	1.1%	9.9%	16.9%	20.7%	9%	12%	12%

Source: Merrill Lynch Research

Power Utilities

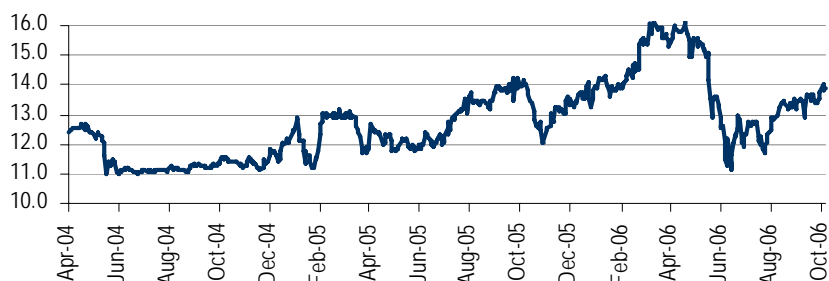
(Bharat Parekh)

Underweight

Key Drivers of Sector Outlook

- Our top-down model forecasts that pent-up demand (deficit of 8.3% on base demand & 12.3% on peak load) and an expanding economy should lead to 53% per capita consumption growth in FY12E.
- We expect opportunity in the Indian power sector with 56GW (government plans to add 62GW) to be added during the XI Plan (FY08-12E) +90% over the X Plan.
- However, as demand is forecast to grow at 8% CAGR by FY12E, we expect continuing power shortages. This should retain pressure on central /state governments to continue to offer attractive returns for utilities of 14%, which underpins our positive argument for IPPs.
- The following features offer an attractive proposition for IPPs
 - Attractive incentives allowed for efficient utilities.
 - Stable & long term (FY04-09) regulatory regime reduces earnings risk.
 - Full cost (variable & fixed) pass-through reduces earnings volatility.

Chart 71: Power Utility sector 1yr forward PE Chart



Source: Merrill Lynch Research

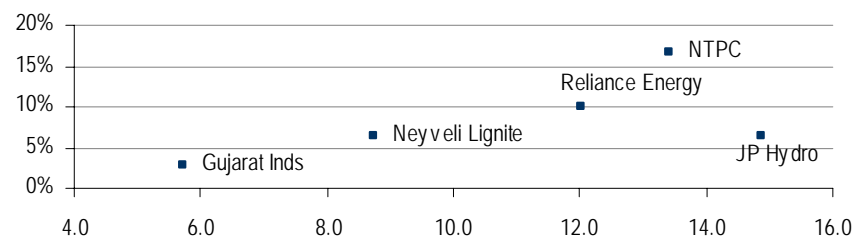
Top Buys: NTPC, Reliance Energy

Top Underperformers: GIPCL, JP Hydro, Neyveli Lignite

Top Stock Pick: NTPC

- We recommend NTPC as our top pick in the sector based on 3 key catalysts
 - **Acquisition of captive coals blocks** with reserves of 4.4bn tn would a) Aid new capacity add / excess generation, which drives its premium power RoE (19%) & b) aid investment of surplus cash into higher yield assets (power).
 - **We have raised NTPC's capacity addition** by 26% to 21.9GW over XI Plan led by improving fuel security. We have also effected substantial changes in fuel mix – added more coal based projects & removed uncertain hydro capacities.
 - **New tariff policy indicates aligning rate of depreciation** recovered in tariff and in P&L. NTPC is the biggest beneficiary at ~10.7% of FY08 PAT on ratification of this provision in the Companies Act.
- We estimate 14% earnings growth over FY06-12E, positive regulatory regime and improving RoE as NTPC swaps low yield treasury into higher yield power / coal assets. Govt. vehicle to drive power capex and hence, has Govt. support.

Chart 72: PE(08E) vs EPS CAGR (06-08E) scatter graph



Source: Respective Company, Merrill Lynch Research

Table 56: Sector performance

	Absolute Performance			
	1month	3 month	YTD	1year
Gujarat Inds	-2.9%	23.9%	-16.2%	-18.3%
Jaiprakash Hydro	11.9%	42.9%	1.2%	-0.9%
Neyveli Lignite	3.8%	25.7%	-16.6%	-6.6%
NTPC Ltd	-2.6%	15.4%	12.1%	28.8%
Reliance Energy	0.6%	5.9%	-23.0%	-13.1%
Tata Pwr. Co.	1.1%	14.4%	22.1%	23.2%
Sector Average	-1.5%	15.7%	6.0%	19.7%

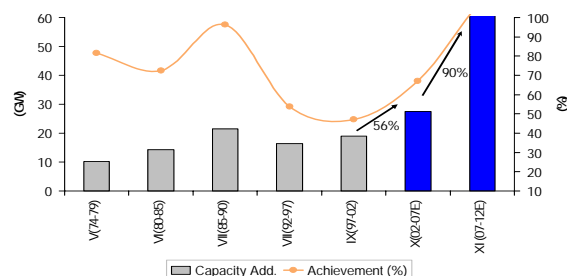
Source: Bloomberg

Table 57: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
NTPC	Incremental power capex would be value accretive as it helps convert low yielding (5%) cash surplus to high yield power assets, which can potentially generate high RoE (19%) through capital base.	Gas supply to existing / new plants till 2008, Upstream Oil Investments and Power reforms.
Reliance Energy	REL/Reliance Natural Resources concluding gas purchase contract with RIL, Start construction of 5600MW Dadri project, Expand generation/acquire distribution franchise and Improve visibility on infrastructure SPVs.	Ability to source quality power / viable gas supply and Discontinuity / delay of power sector reforms.

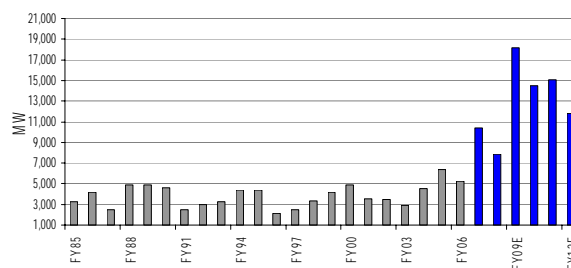
Source: Company, Merrill Lynch Research

Chart 73: India 5-yr Plan wise Power Capacity Creation & MLE



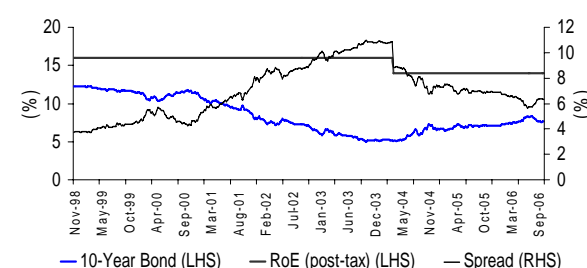
Source: Ministry Of Power, ML Research estimates

Chart 74: India Capacity Addition – Towards Next Level



Source: Ministry of Power, ML Research Estimates

Chart 75: Power RoE vs Indian 10-yr Yield Curve



Source: RBI, Merrill Lynch Research

Table 58: Stock/ Sector valuations

				P/E (x)				EPS CAGR		P/B (x)				EV/Ebitda (x)			Div. Yield (%)		RoE			Corp Gearing		
Stock	ML Code	QRQ	Price	Mkt Cap (US\$mn)	FY06	FY07E	FY08E		06-08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	
Gujarat Inds	GUJIF	2 - Neutral	60	199	6.0	5.8	5.7		3%	1.2	1.0	0.9	5.2	5.6	6.1	3.4%	4.2%	17.7	15.8	14.7	105%	114%	122%	
Jaiprakash Hydro	XJSHF	3 - Sell	33	360	18.0	16.1	15.9		6%	2.4	2.4	2.3	8.5	8.5	8.3	4.8%	4.8%	9.6	13.2	14.5	124%	108%	88%	
Neyveli Lignite	NEYVF	2 - Neutral	66	2,444	9.9	9.2	8.8		6%	1.3	1.2	1.1	5.3	5.2	5.2	3.0%	3.0%	12.9	12.7	12.5	-21%	-13%	-7%	
NTPC Ltd	NTHPF	1 - Buy	126	22,844	18.3	15.4	13.4		17%	2.3	2.1	2.0	17.4	14.1	12.4	2.7%	3.1%	13.1	14.4	15.2	27%	37%	49%	
Reliance Energy	RCTDF	1 - Buy	465	2,186	15.0	12.4	12.4		10%	1.4	1.1	1.1	9.4	7.1	6.9	1.7%	1.9%	9.8	9.9	9.3	-44%	-47%	-41%	
Sector Avg.					16.6	14.2	12.7			2.1	1.9	1.7	13.9	11.9	10.8	2.7%	3.0%	12.9%	13.8%	14.1%	14%	21%	31%	

Source: Merrill Lynch Research

Banks

(Rajeev Varma, Aashish Agarwal)

Neutral

Key Drivers of Sector Outlook

- We expect loan growth for the sector to sustain at 26% in FY07 and +22% in FY08 on enhanced corporate demand arising from the upswing in the capex / infrastructure related lending and sustained retail credit demand at 27-28% yoy.
- Margins are likely to be relatively stable benefiting from a likely rise in lending rates (to outpace bond yields), lower reinvestment risk on G-secs bonds and higher spreads on banks' low cost –fixed rate deposits.
- Fee income to start showing stronger growth at +20% for many govt. banks as they begin to leverage technology more effectively. Private banks to continue see +40-50% growth leveraging their expanding retail client base.
- Investment hits are likely to contract sharply with the 10 year G-sec benchmark yield forecast to peak at around 8-8.1% (bank earnings are hedged upto an equivalent of 8.2%). NPL provisions are however estimated to rise 20-25% pa factoring in our expectations of a cyclical uptick in credit quality cycle.
- Bank earnings are estimated to grow at 30-35% pa in FY08 with ROE for most banks estimated to be in the range of 18-20% by FY08.

Chart 76: Banking sector 1yr forward PE Chart



Source: Merrill Lynch Research

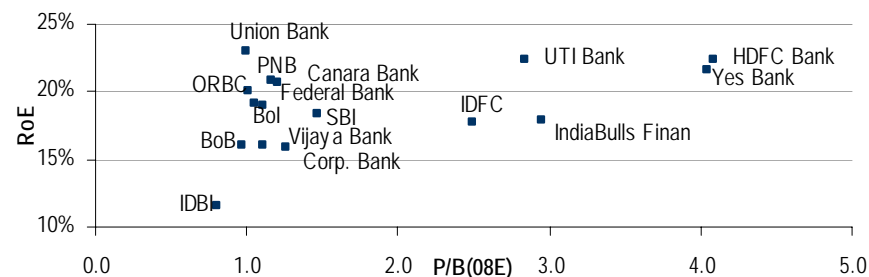
Top Buys: ICICI Bank, SBI, HDFC

Top Underperformers: Corporation Bank, Vijaya Bank

Top Stock Pick: ICICI Bank

- We believe e ICICI Bank, trading at 2.0x FY08E adj book (excluding value of subs), could re-rate to 2.4-2.5X FY08E Adj book due to its visible earnings growth trajectory and expansion of ROE to 16% in FY08E.
- Most leveraged play on India's buoyant retail market, given its dominant position in retail with a 30% market share in most retail credit products. We expect ICICI Bank's growth trajectory to remain strong as the bank benefits from stronger deposit and loan growth in the system.
- ICICI Bank's earnings to grow 21% in FY07 and +30% in FY08-09 due to a) healthy top line growth driven by strong loan growth and expanding margins, b) fee income growth at +35% CAGR and c) improving operating efficiency.
- We have also factored in higher NPL provisioning, building in a 50-60% annual increase in fresh slippages in sync with our view that the asset quality cycle could see an upturn in 12 months.

Chart 77: P/BV(08E) vs RoE (08E) scatter graph



Source: Merrill Lynch Research

Table 59: Sector performance

	Absolute Performance			
	1month	3 month	YTD	1year
Bank of Baroda	-1.8%	40.3%	8.6%	20.2%
Bank of India	-0.1%	66.3%	16.0%	41.8%
Canara Bank	3.3%	60.8%	14.5%	34.7%
Corporation Bank	2.0%	74.8%	4.5%	7.8%
Federal Bank	1.3%	24.9%	15.7%	24.3%
HDFC	1.6%	33.5%	18.6%	54.6%
HDFC Bank	10.8%	36.8%	37.1%	49.8%
ICICI Bank	10.0%	48.6%	23.2%	42.1%
IDBI	11.1%	57.9%	-16.4%	-12.7%
IndiaBulls Finan	6.3%	107.2%	124.4%	137.3%
Infrastruct Dev	12.6%	57.9%	-2.9%	10.0%
ORBC	-4.6%	55.1%	-11.4%	-3.6%
Punjab	2.5%	58.9%	7.3%	25.2%
SBI	5.0%	43.1%	12.9%	15.5%
Union Bank India	-4.5%	41.8%	-0.3%	8.3%
UTI Bank	18.5%	60.6%	46.0%	78.4%
Vijaya Bank	4.2%	59.1%	-11.8%	0.0%
Yes Bank Ltd	25.5%	47.3%	61.4%	73.6%
Sector Average	6.1%	47.3%	17.7%	32.6%

Source: Bloomberg

Table 60: Bull & Bear Factors that can change views

Company	Bull Scenario	Bear Scenario
ICICI Bank	o Dominant retail franchise with 30% market share in most retail products	o Slow down in retail loan growth; sharp rise in interest rates
	o Key beneficiary of the changing demographics	o Likely to raise fresh capital in next 12 months; subdues ROE to 15-16%
	o Strong growth trajectory; earnings growth at 30% CAGR	o Worst impacted in case of rise in retail NPLs
	o Rising value of subsidiaries	
State Bank of India	o Strong Loan growth led by recovery in credit cycle	o Sharp rise in bond yields
	o Margin Expansion due to changing loan profile and rise in lending rates	o Losing market share to private sector players
	o Strong fee income growth as it leverages its +90mn customer base by effective cross selling	
	o Strong franchise with a 30% market share in mortgage financing; Key beneficiary of the changing demographics	o Premium valuations; amongst the most expensive financial stocks in the region
HDFC	o Strong growth trajectory (18% CAGR); ROE at +30% is highest in region	o Rise in rates to impact funding costs; might put pressure on NIMs
	o Superior asset quality with gross NPL at 1%, net <0.5%	o Losing market share to private sector banks
	o Rising value of subsidiaries; likely to contribute Rs584/share in FY08	
	o Key beneficiary of the changing demographics due to its Dominant (presence in retail (30% market share in most retail products excl mortgages)	o Premium valuations: could contract if earnings growth decelerates
HDFC Bank	o Strong growth trajectory: Loan and fee revenues to grow at +40%p.a	o Rising proportion of unsecured personal loans could result in rise in NPLs
	o Benefiting from rising lending rates, higher proportion of low cost fixed demand deposit to help to sustain healthy NIMs (+ 4%)	o Margins could contract if funding costs increases significantly owing to liquidity pressures
	o Earnings growth to sustain at over 30%	
	o Leveraged to the upswing in the agricultural and corporate credit cycle	o Vulnerable to rising bond yields
PNB	o Higher proportion of demand deposits to positively impact margins in rising rate scenario	o Could face margin pressures due to re-pricing of investment portfolio
	o Healthy asset quality to keep provisioning pressure low	o Relatively higher vulnerability to monsoons owing to a high % of agricultural credit
	o Fee income to boost revenues as the bank leverages its technology initiatives to increase cross selling	
	o Leveraged to pick up in corporate credit cycle owing to its stronger presence in western India, the Corporate hub	o Margins could be under pressure owing to rise in funding costs and re-pricing of investment portfolio
Union Bank of India	o Offers the best risk return ratio: Could re-rate owing to rebound in earnings	o Asset quality may deteriorate owing to the strong loan growth in the past two years
	o Estimated ROE to remain over 20%	
	o Best positioned bank in a rising rate environment	
	o Maximum initiative at the margin to a) improve asset quality b) technology ramp up and c) driving fee income	
Bank of India	o Strong re-bounce in earnings	o Slower loan growth (running at 20% v/s sector growth of 30%)
	o Best positioned in a rising rate environment	o Margin pressures owing to high proportion of international business where spreads are lower
	o Beneficiary of the pick up in corporate credit cycle	

Source: Merrill Lynch Research

Table 61: Stock/ Sector valuations

				P/E (x)			EPS CAGR	P/B (x)			P/ Adj. Book (x)			Div. Yield (%)		RoE			Price/ PPP (x)			
Stock	ML Code	QRQ	Price	Mkt Cap (US\$m)	FY06	FY07E	FY08E	06-08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E	FY07E	FY08E	FY06	FY07E	FY08E	FY06	FY07E	FY08E
Bank of Baroda	BKBAF	2 - Neutral	262	2,100	11.6	9.0	6.5	34%	1.2	1.1	1.0	1.3	1.1	1.0	2.3%	2.7%	12.3	12.9%	16.0%	4.7	4.1	3.3
Bank of India	XDIIF	1 - Buy	148	1,589	10.3	8.0	6.3	28%	1.4	1.3	1.1	1.8	1.4	1.1	2.7%	3.4%	14.8	17.0	19.0	3.7	3.1	2.6
Canara Bank	CNRKF	2 - Neutral	275	2,489	8.4	7.6	6.0	18%	1.6	1.4	1.2	1.8	1.5	1.2	2.7%	3.1%	20.3	19.3	20.8	4.3	3.7	3.1
Corporation Bank	XCRRF	3 - Sell	378	1,194	12.2	9.9	8.4	20%	1.6	1.4	1.3	1.7	1.5	1.3	2.4%	2.4%	13.8	15.3	15.9	5.2	4.4	3.7
Federal Bank	XFDRF	1 - Buy	211	398	8.0	7.6	6.0	16%	1.4	1.2	1.1	1.6	1.3	1.1	2.1%	2.4%	22.6	17.4	19.1	4.0	3.3	2.8
HDFC Bank	HDDCF	1 - Buy	970	6,722	34.7	26.0	19.9	32%	5.7	4.9	4.1	5.7	4.9	4.1	0.7%	0.9%	17.7	20.3	22.4	15.4	11.2	8.5
HDFC	HGDFF	1 - Buy	1429	7,862	28.3	24.1	20.6	17%	8.0	6.8	5.8	8.0	6.8	5.8	1.7%	2.0%	30.1	30.4	30.2	22.7	19.3	16.3
ICICI Bank	ICIJF	1 - Buy	721	14,178	23.1	20.9	15.7	21%	2.9	2.6	2.4	3.1	2.9	2.5	1.5%	1.8%	14.6	13.2	15.9	13.7	9.8	7.1
IDBI	XDBIF	2 - Neutral	81	1,297	10.5	8.8	7.2	21%	0.9	0.9	0.8	1.1	1.0	0.8	2.5%	3.1%	9.2	10.4	11.6	7.3	6.6	4.8
IndiaBulls Finan	XPZMF	1 - Buy	427	1,520	28.9	24.2	18.9	24%	5.2	3.7	3.0	NA	NA	NA	0.6%	0.8%	26.9	18.8	17.9	NA	NA	NA
Infrastruct Dev	IFDFF	2 - Neutral	71	1,762	20.4	17.2	14.9	17%	3.1	2.8	2.5	3.1	2.8	2.5	2.0%	2.3%	17.5	17.1	17.7	16.1	13.0	10.5
ORBC	ORBCF	1 - Buy	240	1,326	7.5	7.8	5.4	17%	1.2	1.2	1.0	1.2	1.2	1.0	2.3%	2.5%	18.9	15.2	20.0	5.0	4.2	3.5
Punjab	PUJBF	1 - Buy	500	3,478	11.0	8.6	6.3	32%	1.7	1.4	1.2	1.7	1.5	1.2	1.4%	1.7%	16.4	18.0	20.7	5.5	4.5	3.5
SBI	SBINF	1 - Buy	1024	11,884	12.2	11.0	8.6	20%	2.0	1.7	1.5	2.4	2.0	1.6	1.6%	1.8%	17.0	16.6	18.4	4.8	4.6	3.8
Union Bank India	UBOIF	1 - Buy	122	1,355	9.1	6.3	4.7	40%	1.3	1.2	1.0	1.7	1.3	1.1	4.1%	5.8%	16.5	19.9	23.0	3.8	2.9	2.3
UTI Bank	UTBKF	1 - Buy	418	2,585	23.8	17.7	13.9	31%	4.1	3.4	2.8	4.4	3.7	3.1	1.0%	1.1%	18.4	21.0	22.4	10.7	7.8	6.1
Vijaya Bank	VJYAF	3 - Sell	54	513	18.3	8.5	7.3	59%	1.4	1.2	1.1	1.5	1.4	1.3	2.8%	3.7%	7.8	15.4	16.1	3.2	3.2	2.7
Yes Bank Ltd	YESBF	1 - Buy	111	658	47.0	32.5	20.1	53%	5.2	4.7	4.1	5.1	4.7	4.0	0.9%	1.4%	14.0	15.2	21.7	30.2	17.9	10.5

Source: Merrill Lynch Research

Analyst Certification

We, Jyotivardhan Jaipuria, Manish Sarawagi, Vandana Luthra, Rajeev Varma, Reena Verma Bhasin, CFA, Bharat Parekh, Mitali Ghosh, S. Arun, Visalakshi Chandramouli and Vidyadhar Ginde, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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Buy	1325	44.76%	Buy	434	32.75%
Neutral	1420	47.97%	Neutral	412	29.01%
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