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Regional Strategy

UBS Investment Research

Asian Equity Strategy: India Underweight

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How far from fair value?

■ SENSEX down 20% from high

In our AES of 6 March "India Underweight - how far from bubble type valuations?", we suggested that India was trading about 35% above its historical average on a range of valuation measures. After the 20% fall in the SENSEX from its recent high, we now find India to be trading about 14% above its historical average. We estimate fair value around 8800 on SENSEX.

■ India's PE, P/ BV, DY - about 14% above historical averages

The chart below illustrates that India's historic PE has dropped from 22x at the high to 17x currently - this is 15% above the historical average of 14.7x from 1995. India's P/ BV has dropped from 3.73x at the high to 3.07x currently - which is 21% above the historical average of 2.5x since 1995. India's DY of 1.64% is 8% below the average of 1.76% from 1995 (charts 1-2).

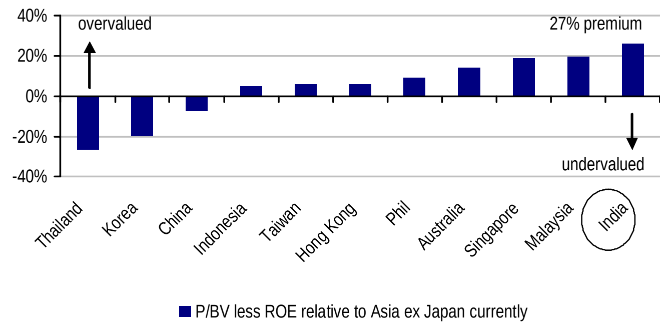
■ Still the most overvalued market in the region

On P/ BV vs ROE relative to the region, the premium has dropped from a high of 40% to 27% currently (chart below on the left). Given the long term growth story - strong domestic demand, high and stable ROE, underleveraged households and low mobile phone penetration - India probably deserves a premium of 15%.

■ Staying Underweight

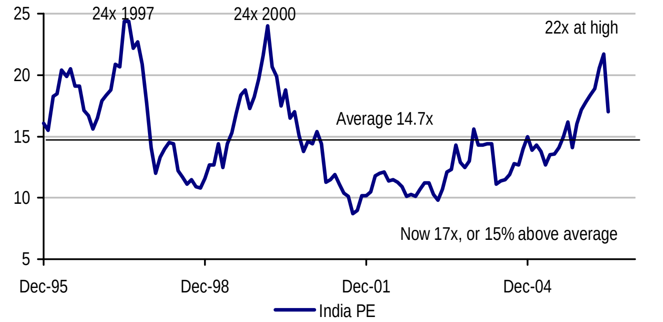
While the SENSEX historically rallies sharply when EMBI spreads peak, we are staying Underweight until we are closer to fair value.

Countries on P/ BV vs ROE relative to the world



Source: UBS estimates

India historic PE



Source: Datastream, UBS estimates

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ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 5

Risks in staying underweight

1st risk in staying underweight – valuations have improved

With the SENSEX falling by about 20% from its recent high of 12620 versus a regional fall of about 11%, we look at whether it is prudent to stay Underweight. **The first risk stems from the fact that valuations have improved on a range of measures:**

Valuations not yet at fair value on PE, DY, P/ BV or P/ BV vs ROE

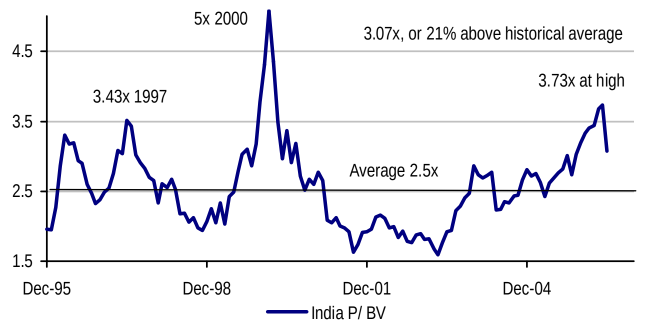
- Historic PE has dropped from a recent high of 22x to 17x. But this is still some 15% above the historical average of 14.7x since 1995 (see chart on the front cover).

- Historic P/ BV has dropped from a recent high of 3.73x to 3.07x currently (see chart 1 below). However, it is still some 21% above the historical average of 2.5x.

- Historic DY has risen from a low of 1.3% to 1.64% currently (see chart 2 below). But the DY is still some 8% shy of the historical average of 1.76% from 1995.

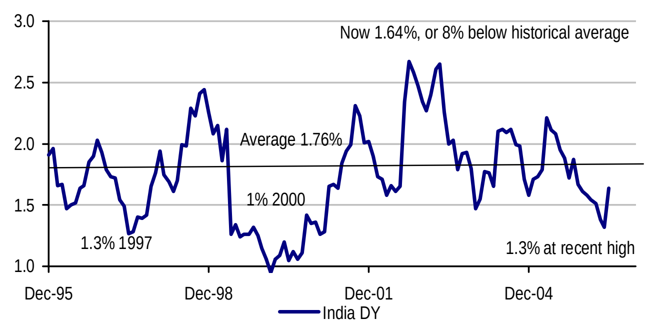
- **On P/ BV vs ROE relative to the region, the premium has dropped from 40% at the recent high to 27% currently. But it remains the most overvalued market in the region (see chart on the front cover).**

Chart 1: India P/ BV



Source: Datastream, UBS estimates

Chart 2: India DY



Source: Datastream, UBS estimates

2nd risk – SENSEX historically rallied sharply when EMBI spreads peaked

The second risk in staying underweight stems from a potential peaking in EMBI spreads. While EMBI spreads rose last night from 212bp to 216bp, the Table below illustrates that the SENSEX has on average rallied by almost 44% in the 12 months after such a peak on the last 3 occasions.

Table 1: Performance of the SENSEX in the 3, 6 and 12 months after the last 3 highs in EMBI spreads

Peak in EMBI	t+3	t+6	t+12
07-May-04	-7.7	4.6	14.3
15-Apr-05	16.4	35.9	84.7
14-Oct-05	13.5	37.0	31.8
Average	**7.4**	**25.9**	**43.6**

Source: Bloomberg, Datastream, UBS estimates

But Table 2 highlights that current valuations on PE, PCF and DY – are about 25% higher than it was during the last 3 episodes when EMBI spreads peaked.

Table 2: Indian valuations currently vs last episodes when EMBI spreads peaked

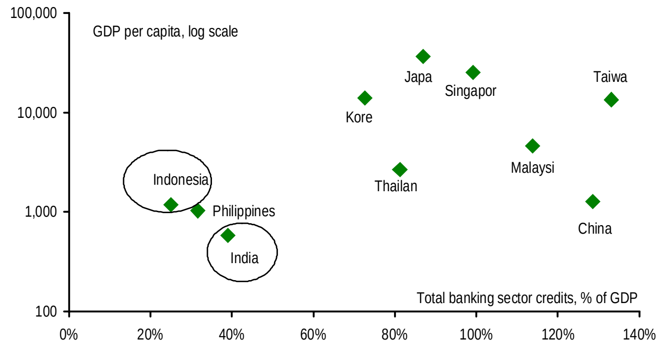
Peak in EMBI	PE	PCF	DY
07-May-04	14.5	6.6	1.6
15-Apr-05	13.4	7.5	2.1
14-Oct-05	15.3	9.6	1.8
Average	14.4	7.9	1.9
Current	17	11.6	1.64
% Difference	**18.1**	**46.8**	**12.8**

Source: Datastream, UBS estimates

3rd risk – attractive long term growth story

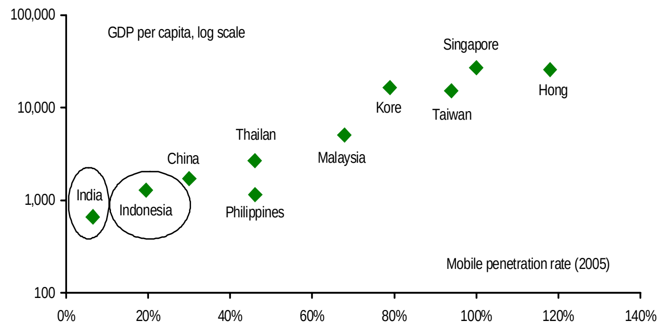
The third risk in staying underweight is the positive long term growth story. India has good long term growth (again reflected in Q4 FY 2006 GDP growing at 9.3%), high and stable ROE (ROE averages 18%), underleveraged households and low mobile phone penetration. As suggested in previous AES, **we think Indonesia is a more attractive way of playing this theme and Indonesia became the 4th cheapest market on P/ BV vs ROE relative to the region last week** (see our AES of 22 May *EMBI spreads*).

Chart 3: Banking sector credits to GDP vs per capita GDP



Source: CEIC, Datastream, UBS estimates

Chart 4: Mobile phone penetration vs per capita GDP



Source: CEIC, Datastream, UBS estimates

4th risk – domestic liquidity

The fourth risk in staying Underweight is domestic liquidity. As highlighted by UBS India Strategist, Manishi Raychaudhuri, in his recent reports (latest is 29 May *India Strategy Update*), there is plenty of cash with domestic fund managers and households' investment in equities is still low.

5th risk – foreign selling abates

The fifth risk in staying Underweight is foreign selling abates. Table 3 highlights that net foreign selling as of 29 May was USD1.6billion. This is already larger than the net foreign selling of US$841million in October 2005 and about US$400 million in March and April 2005.

Despite the net foreign selling in May, year-to-date in 2006 net foreign buying is US$2.5billion – which represents 24% of all net foreign buying in Emerging Asia. This is on top of net foreign buying of US$10.55billion in 2005 – which was 32% of net foreign purchases last year.

Table 3: Net foreign buying of Emerging Asian equities

Net foreign buying/selling							
Source:	stock exch.	stock exch.	stock exch.	stock exch.	stock exch.	stock exch.	stock exch.
US$m	India	Indo	Korea	Philippines	Taiwan	Thailand	EM Asia ex Malay
Jan-05	101	218	717	209	103	1,237	2,585
Feb-05	1,853	69	1,506	51	3,718	822	8,019
Mar-05	1,716	-2,033	-1,988	-54	-753	-263	-3,376
Apr-05	-150	84	-182	-37	-688	-182	-1,154
May-05	-235	-1,898	294	-3	4,424	-76	2,506
Jun-05	1,157	243	101	63	4,574	407	6,546
Jul-05	1,824	211	1,635	-11	1,433	330	5,421
Aug-05	1,161	292	-1,061	36	-333	435	530
Sep-05	1,066	317	-830	36	-366	316	539
Oct-05	-841	583	-2,539	26	-926	-653	-4,351
Nov-05	847	46	138	34	5,706	71	6,842
Dec-05	2,047	128	-1,375	5	7,497	531	8,834
Jan-06	805	231	2,217	40	1,312	1,889	6,494
Feb-06	1,693	74	-445	206	2,182	277	3,987
Mar-06	1,509	211	-603	53	-391	-10	770
Apr-06	130	285	517	51	5,411	485	6,879
May-06	-1,622	69	-4,042	106	-1,090	-863	-7,442
2006 YTD	2,515	870	-2,355	455	7,424	1,778	10,687
2005	10,546	-1,741	-3,584	355	24,389	2,976	32,940
2004	8,430	2,191	11,212	319	8,140	119	30,410
2003	6,595	1,117	12,430	-82	13,542	-634	32,968
2002	751	856	-2,015	-53	517	289	345
2001	2,802	441	6,875	86	8,161	-149	18,216
2000	1,593	86	11,238	-123	5,127	-828	17,093
1999	1,724	1,595	1,197	400	8,261	-65	13,112
1998	-148	526	3,314	264	749	679	5,384
1997	1,569	130	526	-406	-227	1,811	3,404
1996	3,036	1,837	3,933	2,101	2,194	499	13,600
Data upto 29 May 2006							

Source: Various stock exchanges, UBS estimates

The key question for investors who are Underweight India is what premium does India deserve in a regional context. The premium on P/ BV vs ROE has dropped from a high of 40% to 27% currently. We estimate that a fair premium is probably 15%. So we are staying Underweight.

India's premium 27% versus our estimate of fair of 15%. So staying Underweight.

■ Statement of Risk

The risks in staying Underweight India are many. One, it bounces sharply given that it has fallen the most - down 18% vs the region down 11%. Two, EMBI spreads could be peaking and within Asia it tends to bounce the most when they peak at least on the last 3 occasions. Three, the long term growth story remains positive.

■ Analyst Certification

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UBS Investment Research: Global Equity Ratings Definitions and Allocations

UBS rating	Definition	UBS rating	Definition	Rating category	Coverage[1]	IB services[2]
Buy 1	FSR is > 10% above the MRA, higher degree of predictability	**Buy 2**	FSR is > 10% above the MRA, lower degree of predictability	**Buy**	39%	35%
Neutral 1	FSR is between -10% and 10% of the MRA, higher degree of predictability	**Neutral 2**	FSR is between -10% and 10% of the MRA, lower degree of predictability	**Hold/Neutral**	50%	33%
Reduce 1	FSR is > 10% below the MRA, higher degree of predictability	**Reduce 2**	FSR is > 10% below the MRA, lower degree of predictability	**Sell**	11%	27%

1: Percentage of companies under coverage globally within this rating category.

2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 31 March 2006.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.
Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for the equity risk premium and not a forecast).
Predictability Level The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.
Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.
Rating/Return Divergence (RRD) This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

EXCEPTIONS AND SPECIAL CASES

US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.
UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.
Core Banding Exceptions (CBE): Exceptions to the standard +/-10% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned table in the relevant research piece.

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

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