

India Strategy

High on risk - reward



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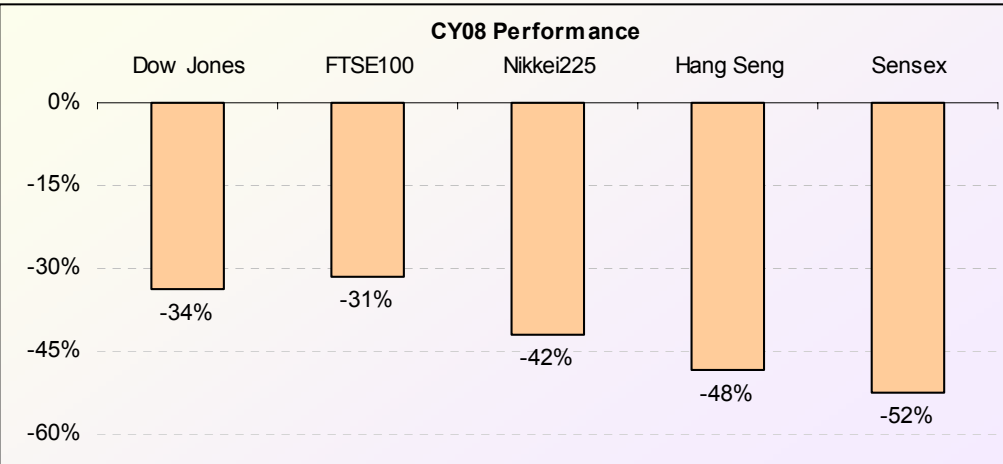
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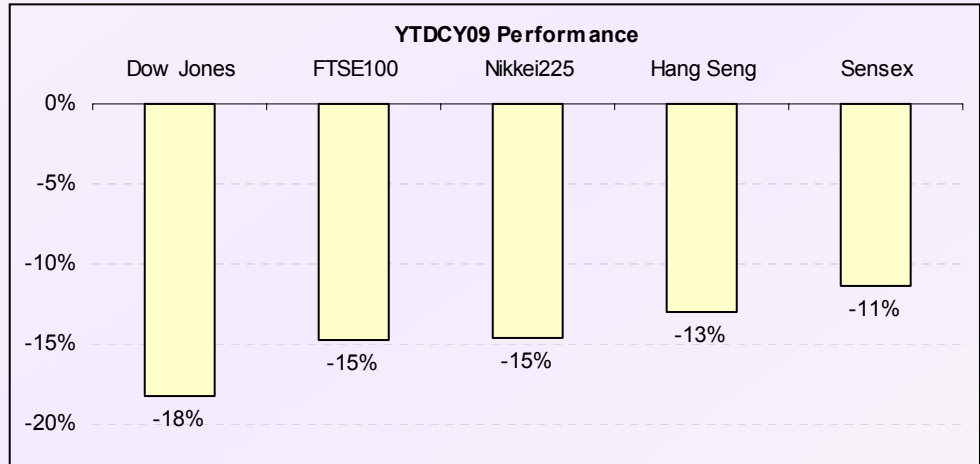
Bears continue to be on a rampage...globally

Global indices - the fall of 2008...



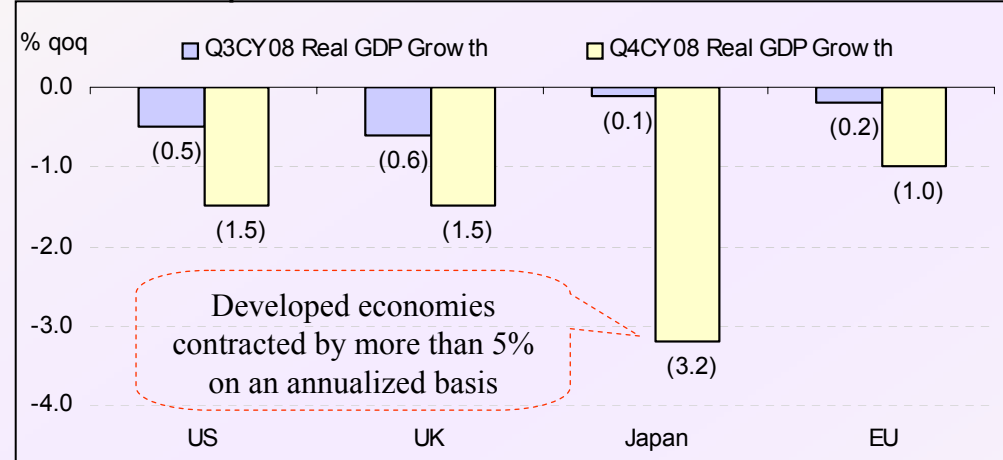
Source: Bloomberg

..extends into 2009...



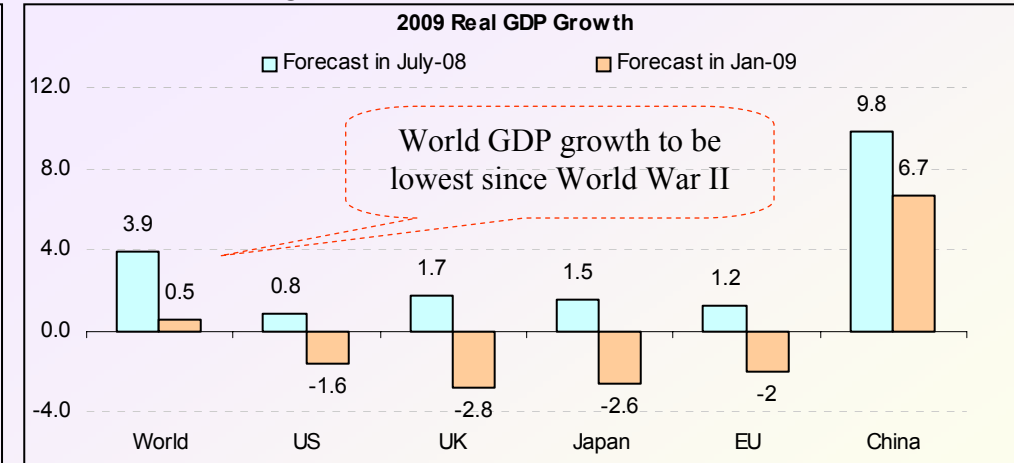
Source: Bloomberg

...as the developed world contracts...



Source: Bloomberg, IMF

...and the outlook gets uncertain



Source: Bloomberg, IMF

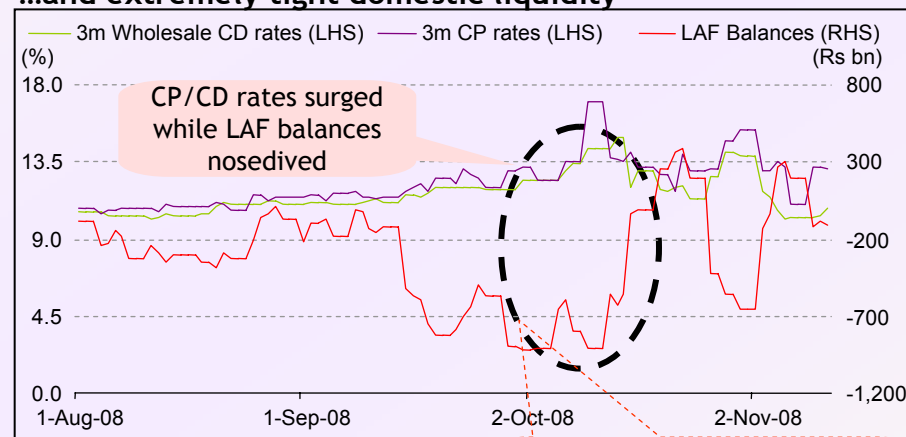
The developed world - in throes of a recession

India, too, saw a sharp deterioration...

A global collapse...

- Global credit markets froze post Lehman Brothers' bankruptcy
- US, EU equity indices nosedived - saw the worst week in history in Oct-08
- India Inc. caught between a global credit squeeze and extremely tight domestic liquidity

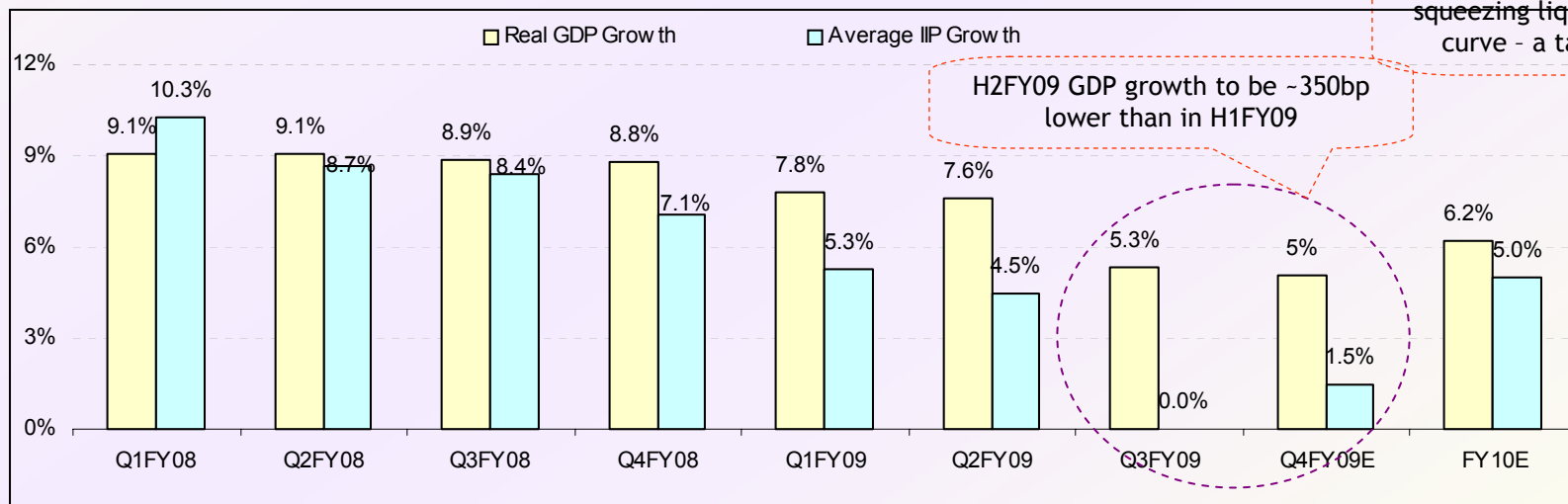
...and extremely tight domestic liquidity



Source: Bloomberg

Advance tax collections were squeezing liquidity; RBI behind the curve - a tad too late in easing

Growth - off a cliff

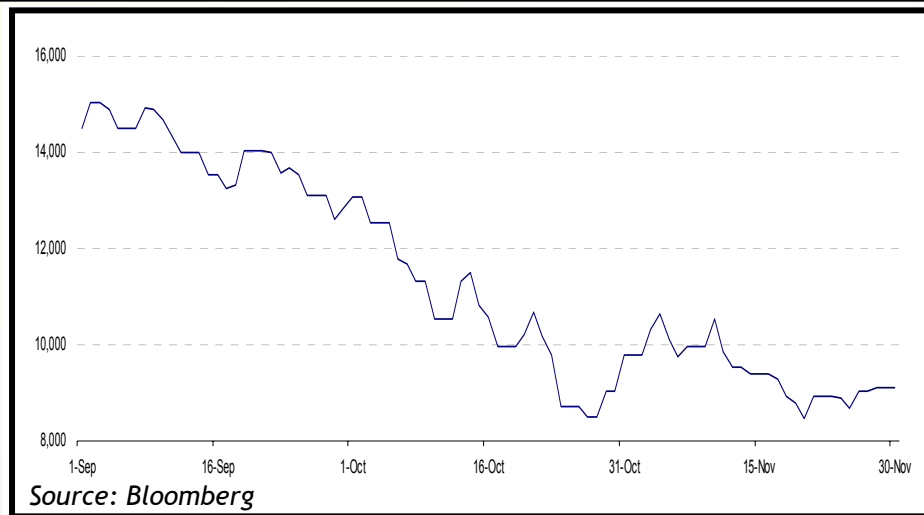


Source: Bloomberg, IDFC-SSKI Research

Liquidity crunch exacerbating the cyclical slowdown

...the capital market followed suit...

Sensex fell ~25% in Oct-08



...negative newsflow has continued unabated since

Half a
India

Brace yourselves for record corporate defaults in 2009

Slowdown hits tourism

SME units in north India could face closures

Three directors on the board of Subhiksha Trading Services Ltd resigned over the past six months as the dis-

Truck repossessions soar as owners default

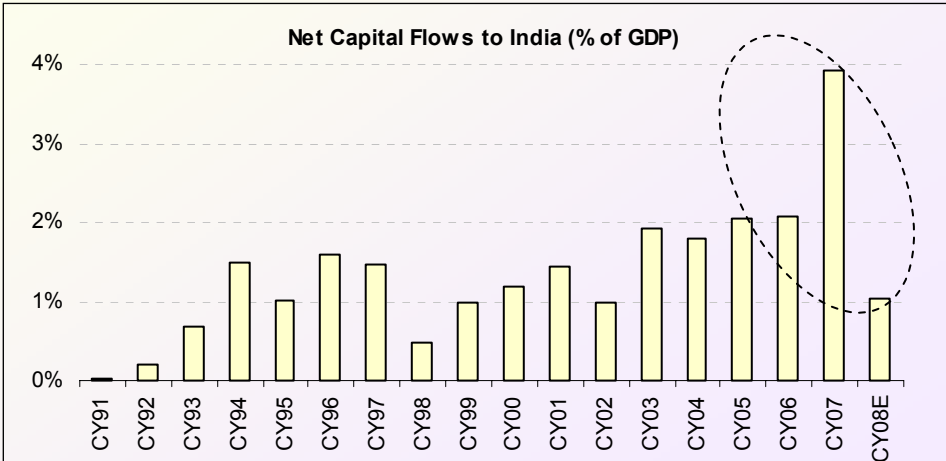
MAXIMUM FINE

Exports shrink 16% in Jan, sharpest in 10 years

Deterioration in the real economy continued through Q3FY09

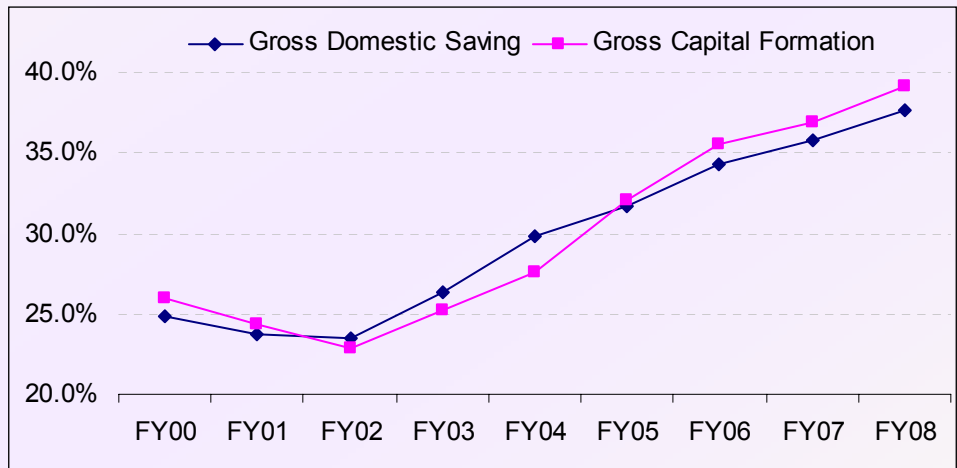
External growth engine is gone

Record capital inflows...



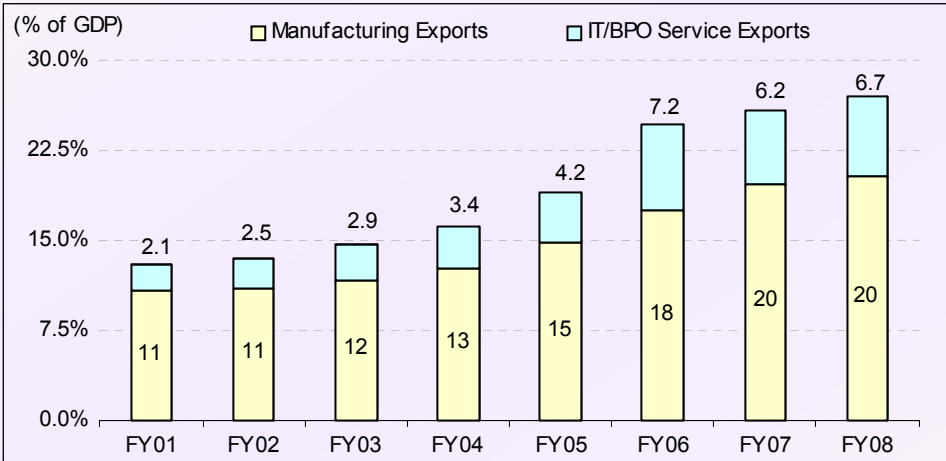
Source: Bloomberg

...that filled the savings-investment gap...



Source: Bloomberg

...the external growth engine is no longer revving

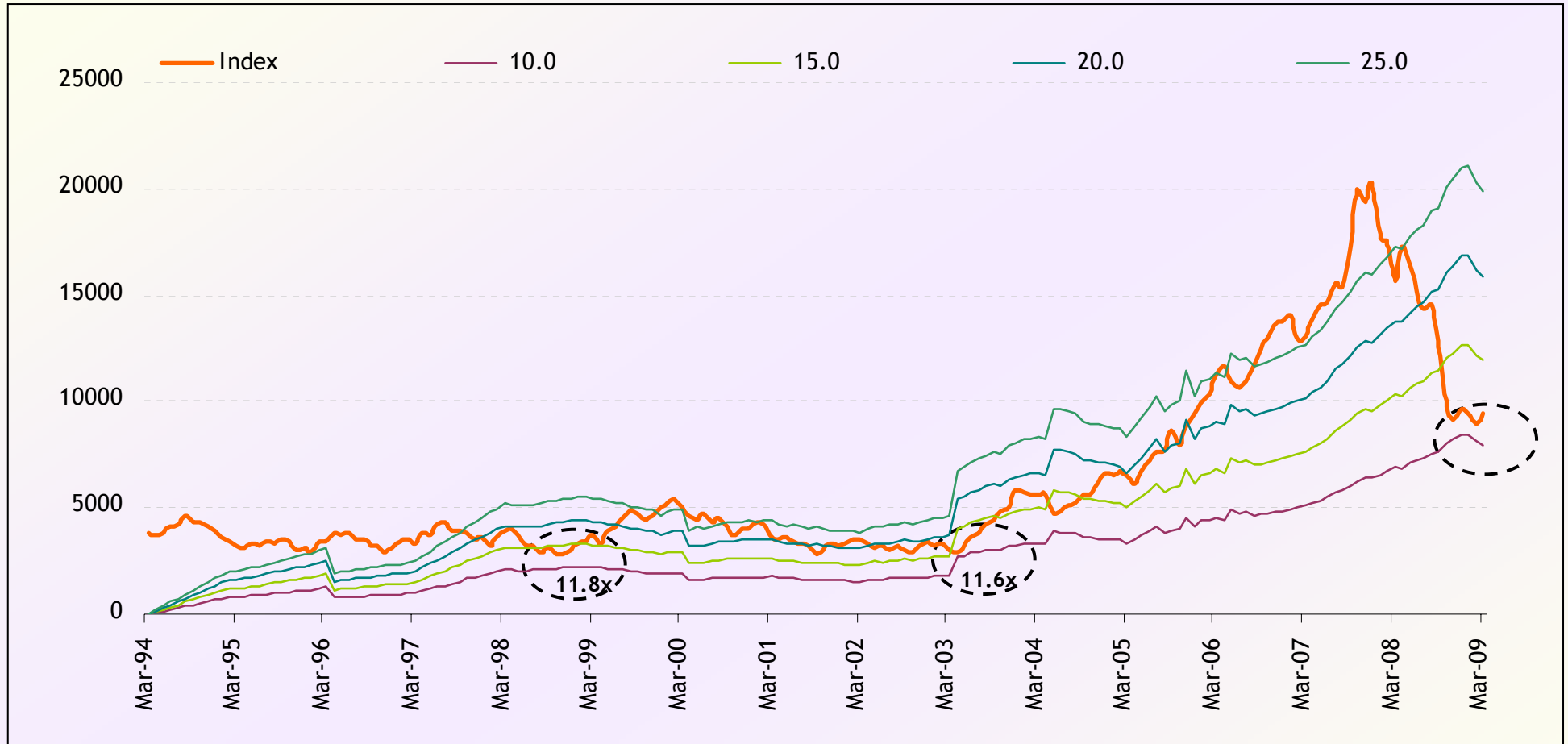


Source: Bloomberg

- ✓ Growth, driven by low-cost external capital - that fueled domestic investment, is tapering
- ✓ External demand, driving local consumption (primarily urban), hit badly

“History never looks like history when you are living through it”
- John Gardner

Valuations are at historic lows

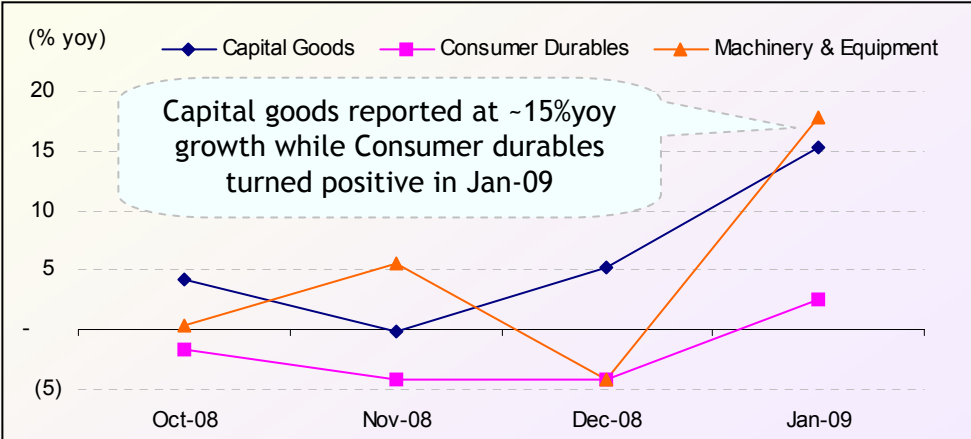


Source: IDFC - SSKI Research

**Sensex had historically rebounded sharply from the trough of ~11x trailing earnings;
We believe it has bottomed out at ~8000 (10.1x FY08 earnings)**

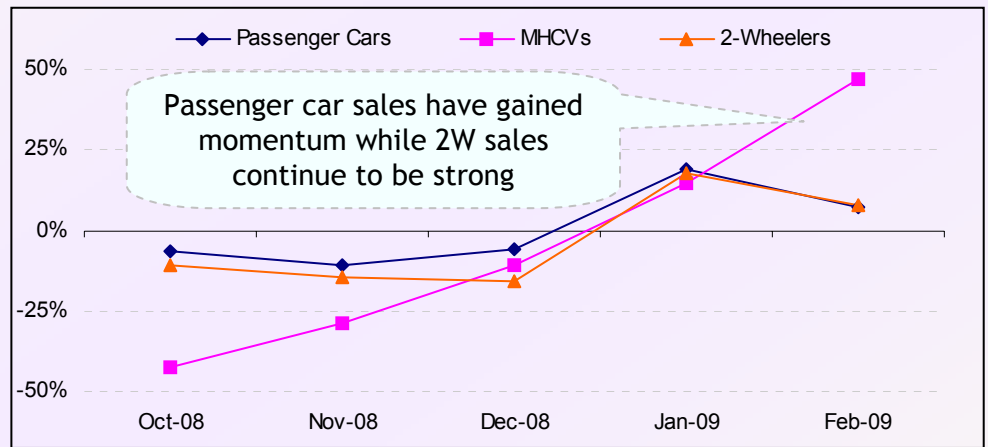
First signs of an economic turnaround...

IIP showing signs of a slow march up...



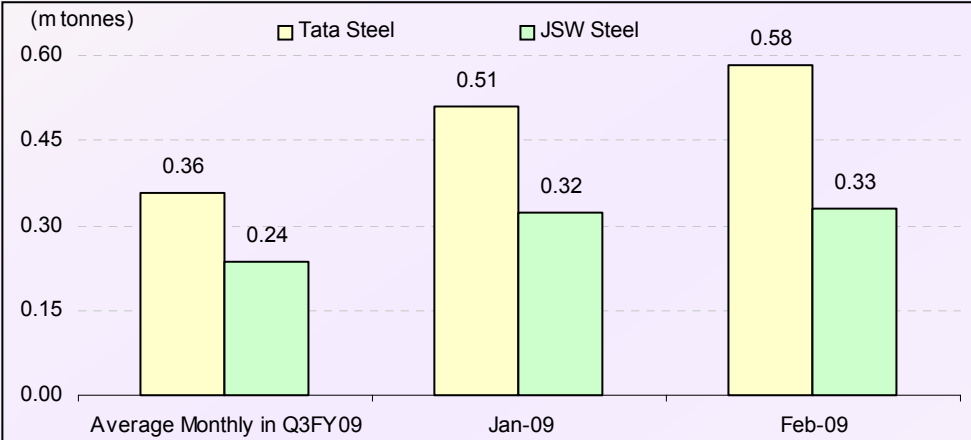
Source: Bloomberg

...and Auto sales have surprised positively



Source: Bloomberg

Leading steel producers have seen a jump in production



Source: Bloomberg; IDFC - SSKI Research

- Railways freight rates have started inching up; from a negative zone, 3%yoy growth for Jan-09
- Channel checks reveal that real estate prices have crashed and sales have begun
- FMCG sales are still robust in Tier-II & Tier III cities

The indicators point to slow restoration to normalcy

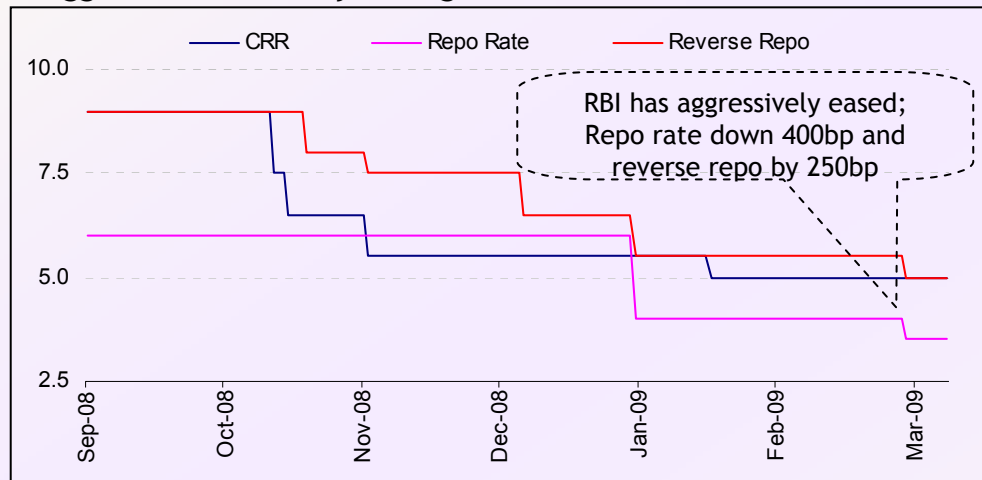
Unprecedented policy response

The fiscal stimulus (I+II+III)...

	Impact (Rs bn)	Comments
Duty Cuts	500	Cenvat cut to 4%; excise duty to 8%
Additional Expenditure	1,000	Increased allocation to flagship programmes
Sixth Pay Commission	157	A consumption kicker; to continue in FY10
Farm Loan Waiver	600	Indirect impact
Total	2,257	
% of GDP	4.0%	

Source: IDFC - SSKI Research

Aggressive monetary easing....



Source: Bloomberg

...driving order flows

Sector	Orders announced since Dec-08 (Rs bn)
Metro	96.8
Power (Generation & T&D)	150.3
Petrochemicals	80.8
Irrigation	40.8
Buildings	26.2
Roads	23.1
Steel	16.5
Industrial plant project	11.1
Railway	7.2
Urban Development	4.9
Airport	2.6
Urban Water Supply	2.1
Grand Total	462.4

Source: IDFC - SSKI Research

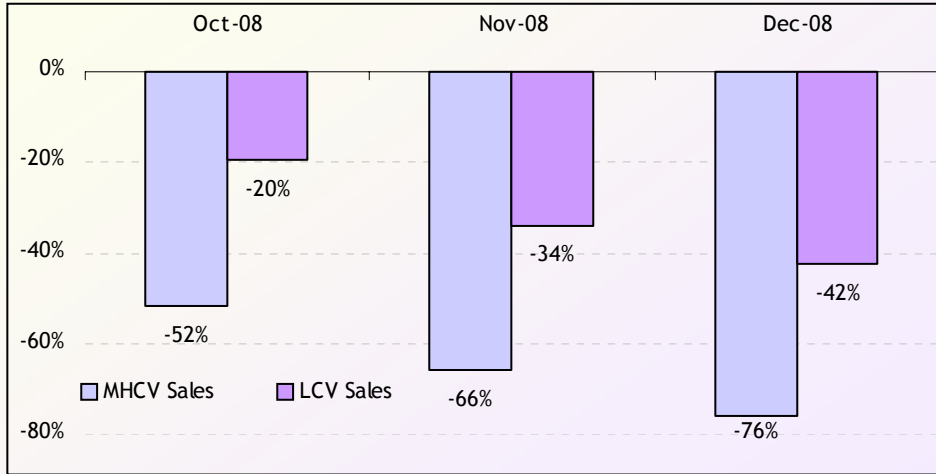
- **Automobiles uptick** - as lower interest rates lead to increased financing for vehicles
- **Metals demand reviving** - as plants go slow on shutdowns and inventory builds up
- **Election spending** - the invisible stimulus?

A gradual pick-up in sight, led by lower interest rates

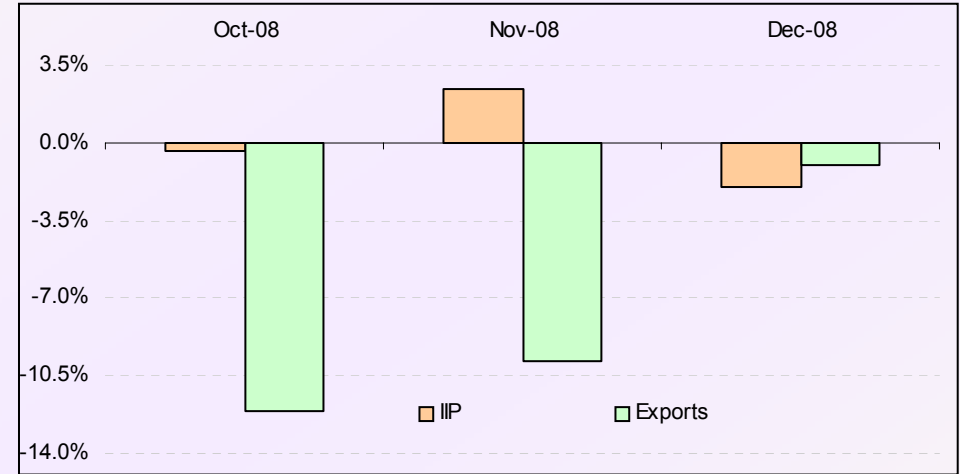
In India's diversity lies its growth

Oct-Dec '08 marked the low of economic activity

CV sales fell to a record low

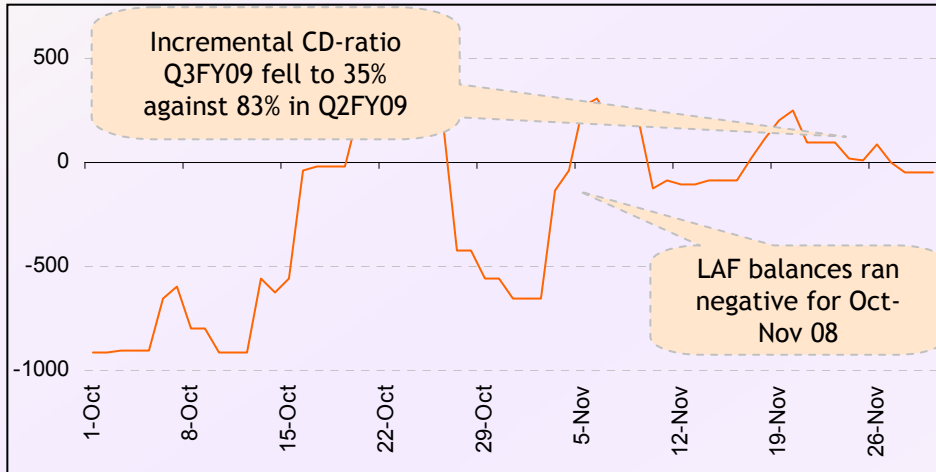


Industrial production turned negative



Source: Bloomberg

Lending came to a virtual standstill



Source: Bloomberg

- Corporates pushed to the verge of (technical) default
- Leading banks/ companies borrowed at sky-high rates
- Mutual funds faced steep redemptions and queued up to the RBI for funds
- RBI injected Rs3.8tn of liquidity during Oct-Dec08

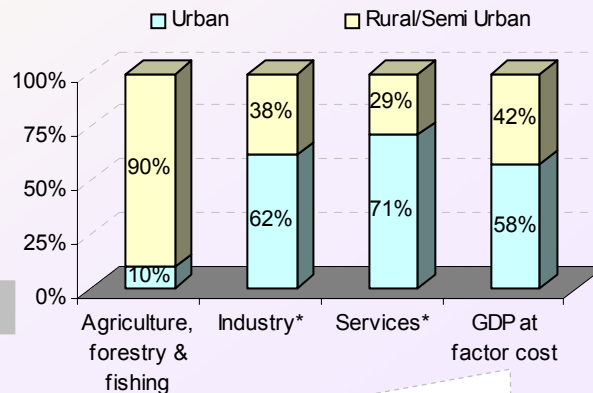
Corporate India came to a virtual standstill

The 'resilient' India...

The Urban India

- The key beneficiary of capital inflows and asset price inflation over FY03-08
- Urban India now a victim of massive wealth destruction - hit by capital scarcity
- Industry to see sudden drop in investments, witness "de-leveraging"

Significant wealth destruction

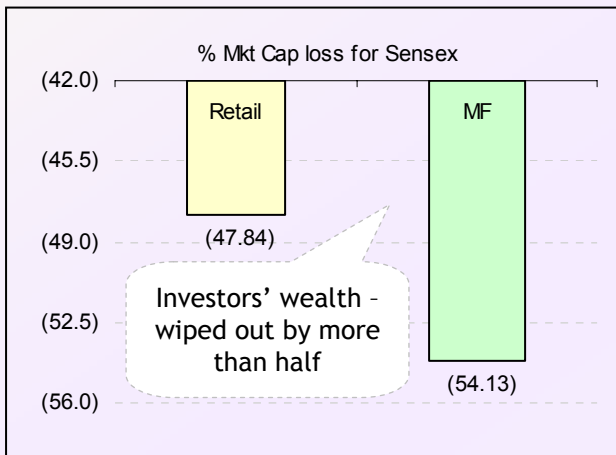


An evenly balanced rural-urban split

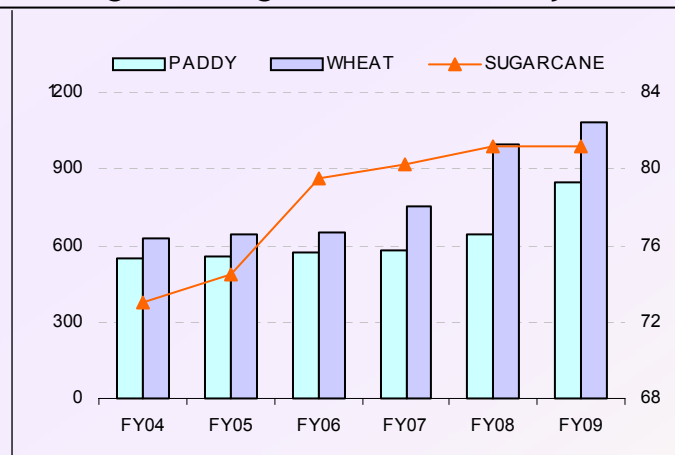
Riding on strong MSPs and Sixth Pay Commission

The Rural/ Semi-urban India

- Comprises over 80% of India's population
- Benefit of economic development comes with a lag
- Will help support overall consumption and economic growth



Source: Gol Data, IDFC - SSKI Research



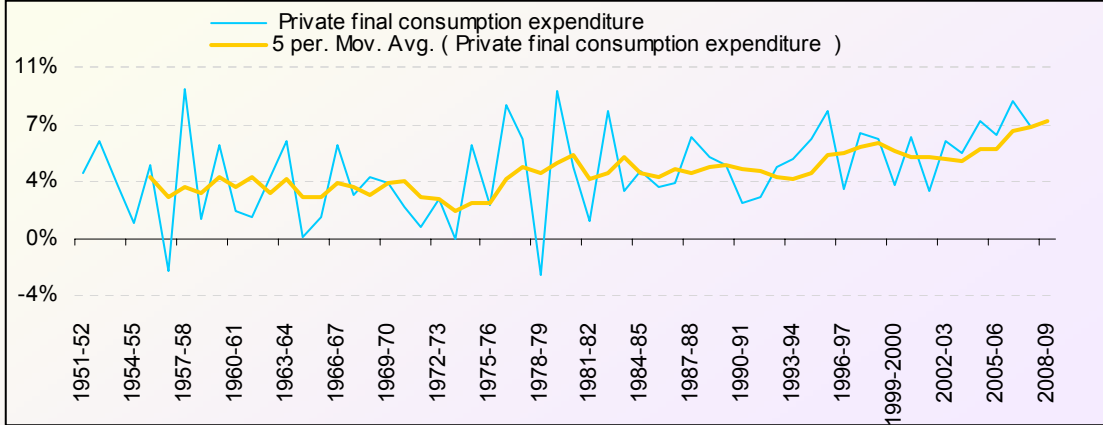
Source: Gol Data, IDFC - SSKI Research



Rural/ Semi-urban India is supporting demand

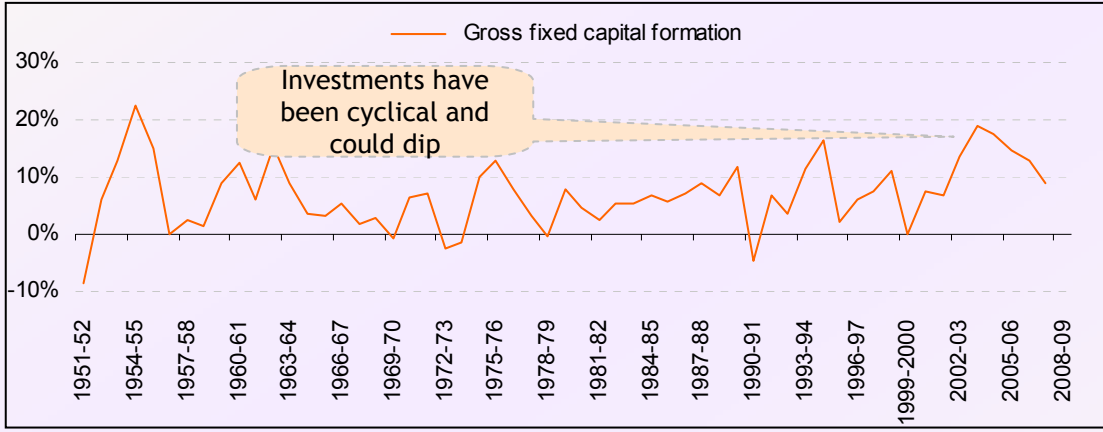
...will consume

Consumption in India has been non-cyclical...



Source: Bloomberg

Investments - a function of credit, interest rates and capital flows



Source: Bloomberg

...driven by favorable demographics

Year	Below 5 years	Between 0-15	Between >15 - 59 years	+ 60 years
1991	12.80	37.76	55.58	6.67
2001	10.70	34.33	58.70	6.97
2011	10.10	28.48	63.38	8.14
2016	9.7	27.73	63.33	8.94

Source: Gol Data

The consumers

(% of GDP)	FY09	Comments
Private final consumption expenditure	57%	Driven by lower interest rates and falling asset prices
Government final consumption expenditure	11%	Counter cyclical stance to spur consumption
Gross fixed capital formation	32%	Government's share to improve substantially from ~33% currently

Sustainable growth of ~6% still possible

The “twin deficit” risks...have peaked

Fiscal deficit

(Rs bn)	FY10 BE	FY09 RE	% growth
Receipts			
Gross tax collections	6,713	6,279	6.9
of which: Direct Tax	3,800	3,450	10.1
Indirect Tax	2,913	2,829	2.9
Less: states' share	1,712	1,602	6.9
Net Tax Revenue	4,976	4,660	6.8
Non-Tax revenue	1,196	962	16.4
Total Revenue Receipts	6,096	5,622	8.4
Capital Receipts	3,437	3,388	1.4
Total Receipts	9,532	9,010	5.8
Expenditure			
Non-plan expenditure	6,681	6,180	8.1
Plan Expenditure	2,851	2,830	0.8
Total Expenditure	9,532	9,010	5.8
Add: Fiscal Stimulus III	(300)		
Gross Fiscal Deficit	(3,628)	(3,224)	1.9
% of GDP	6.0%	6.1%	-
States' Fiscal Deficit	3.5	3.0	
Off-budget liabilities	-	2.1	
Consolidated (as a % of GDP)	9.5%	11.2%	

* No off-budget items estimated in FY10; Source: IDFC - SSKI Research

Current Account deficit

(Rs bn)	FY09E	FY10E
Exports	167,377	152,867
Imports	287,201	257,336
Trade Balance	(119,824)	(97,405)
Invisibles, net	90,004	85,221
Current Account Balance	28,920	(12,184)
(%of GDP)	4.0	2.2

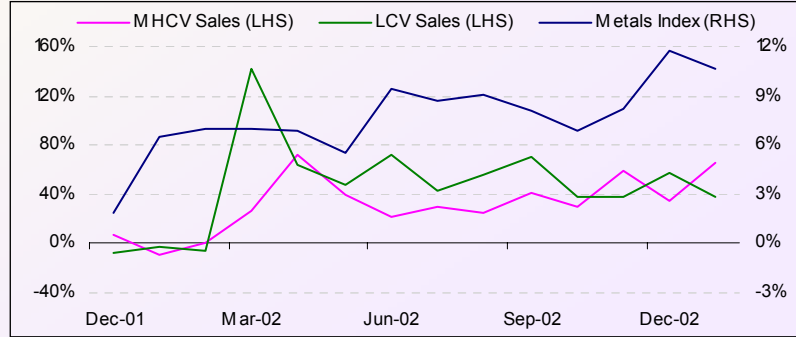
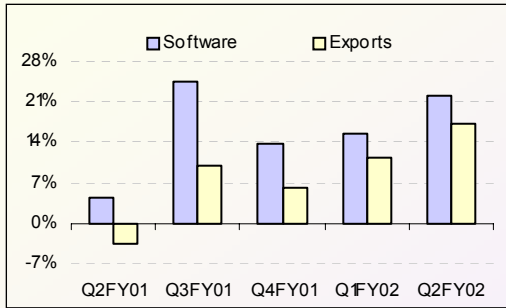
Source: IDFC - SSKI Research

- **Fiscal deficit** - will remain elevated in FY10 (though come-off relatively) as government spends on infrastructure and other consumption-driving measures
- Absence of off-budget liabilities (oil bonds, fertilizer bonds)- is driving the deficit down
- **Current Account Deficit** - expected to halve in FY10; to ease pressure on the currency

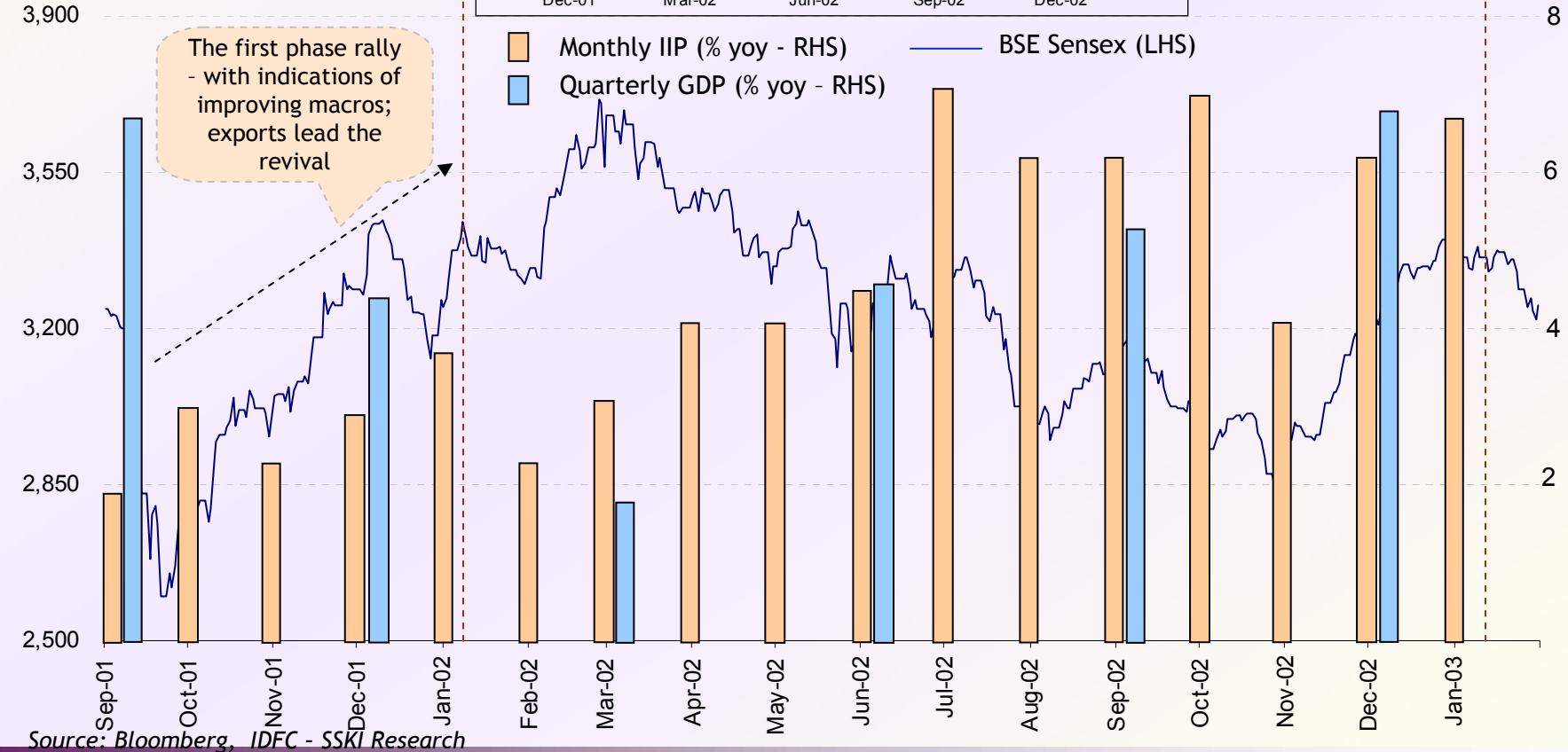
Current Account deficit to see significant reduction;

Fiscal deficit to remain high - for the right reasons - a natural outcome of a counter-cyclical stance

Flashback to the previous cycle (Sep01-Jan03)...



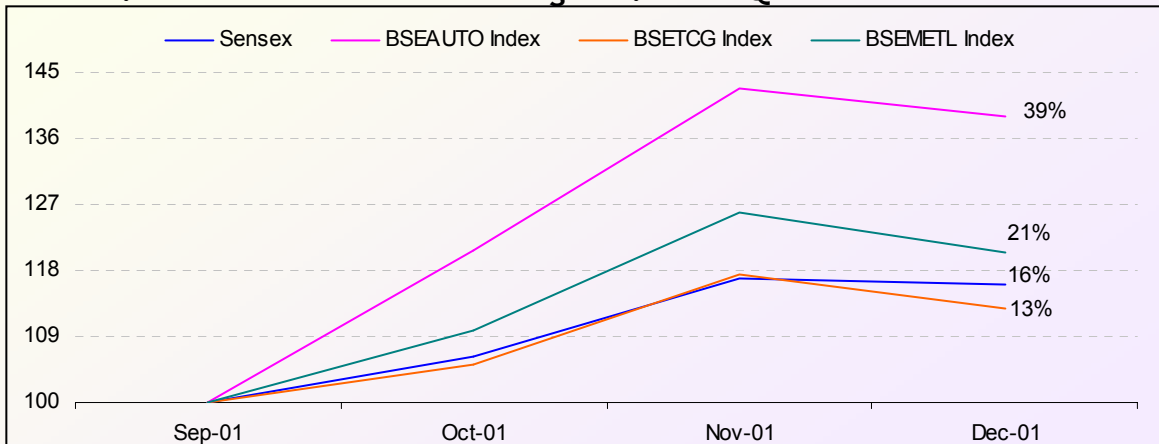
- Domestic demand followed
- led by commodities
- commercial vehicles
- Passenger car sales zoomed to 30% plus from Jan03



Source: Bloomberg, IDFC - SSKI Research

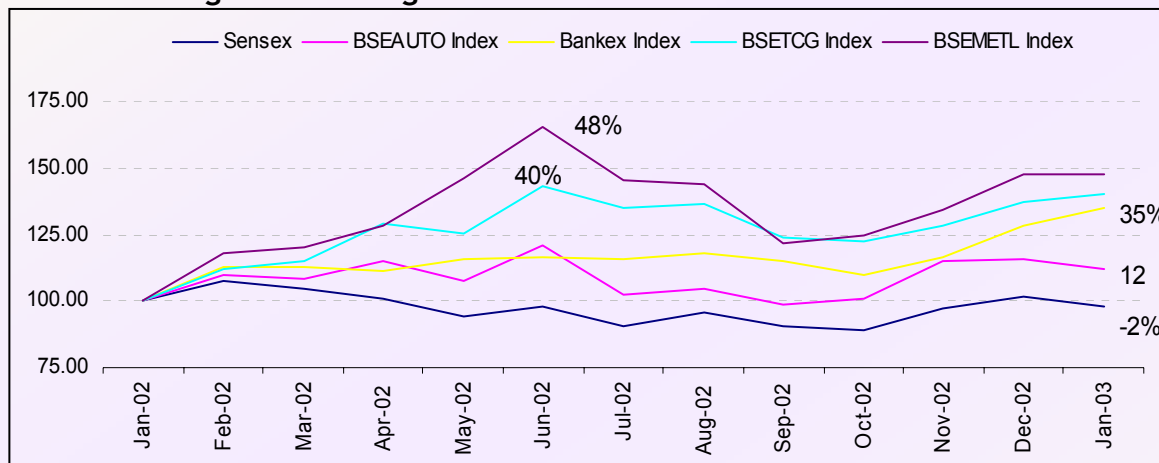
...stocks reacted sharply to the uptick

Phase I: IIP bottomed out and averaged 2.7% for Q3FY02



- **Automobiles led the turnaround** - first beneficiaries of economic recovery; low interest rates led to demand revival

Phase II: IIP growth averaged ~5%



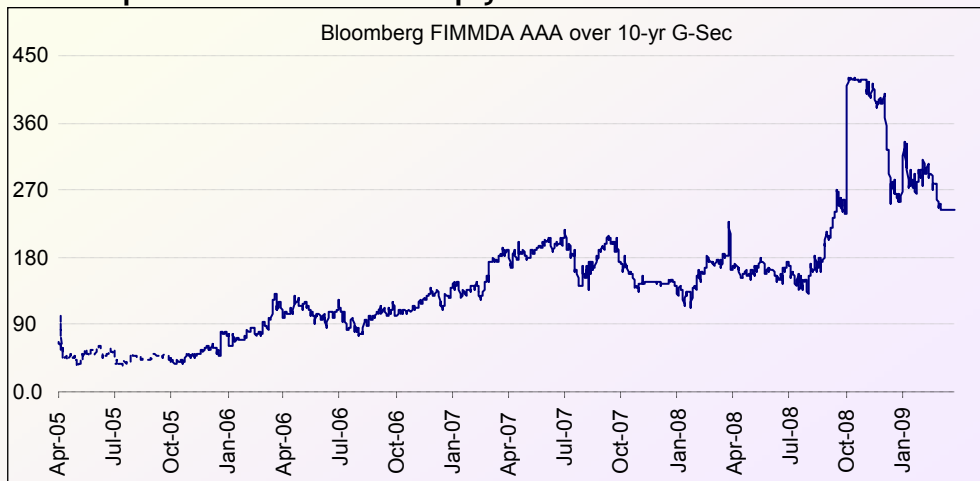
- **Metals** - the best performers with recovery in global commodity prices
- **Capital Goods** - driven by uptick in investment demand and increased availability of capital
- **Financials** - low interest rate regime and strong earnings visibility

Source: Bloomberg

Commodities, Capital Goods and Automobiles led the recovery; current scenario reminiscent of Phase I

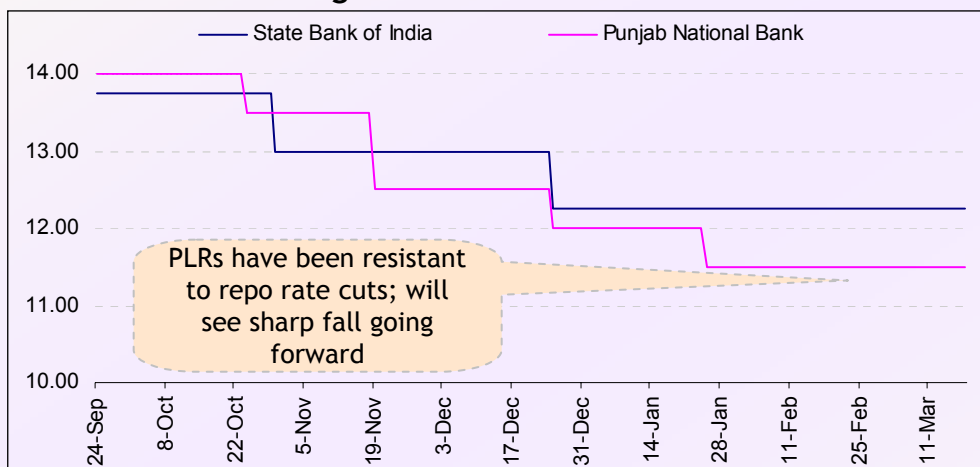
What lies in store in the coming months...

Credit spreads to correct sharply



Source: Bloomberg

Banks to drive lending... as interest rates fall



Source: Company

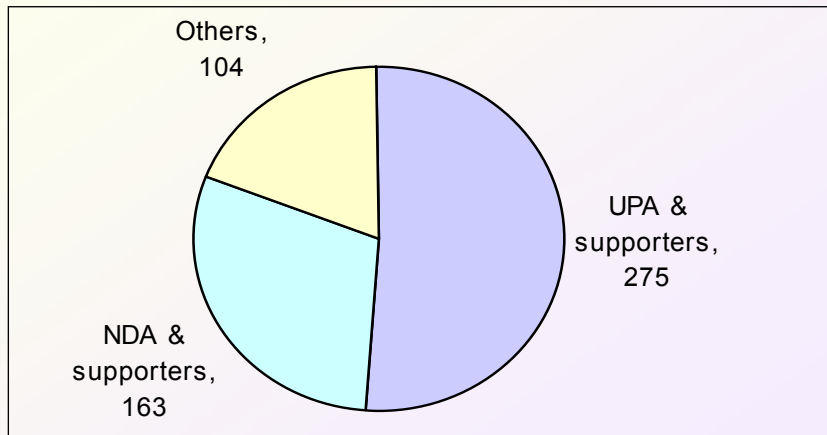
- Long-term credit spreads still perched above the mean levels; will see sharp contraction
- The decline in short-term spreads has been due to improved liquidity

- PSU banks have been the frontrunners in easing PLRs (and rates for retail loans); partly driven by government push
- Private banks to join in

Lower cost of capital to lead to re-rating in the markets

...and a few uncertainties

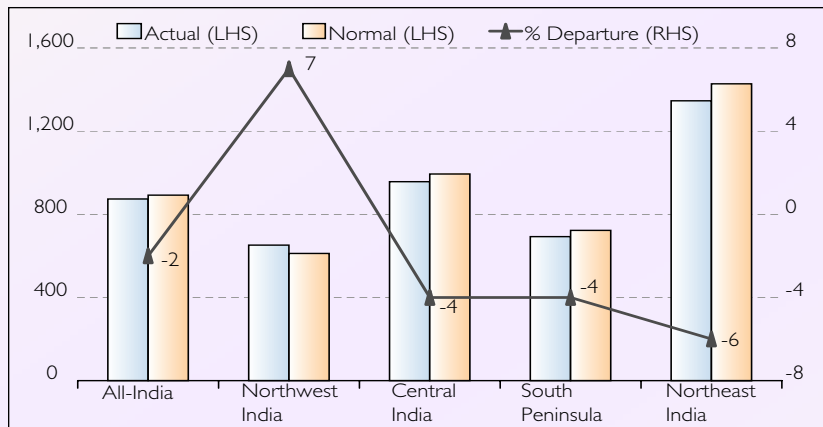
Elections - wide possibilities



Source: Gol Data; IDFC-SSKI Research

- Most quarters expect UPA/ NDA government to come to power
- Negative surprises could derail the reforms process
- However, higher government spending is inevitable

Monsoons - the wildcard



Source: Gol Data; IDFC - SSKI Research

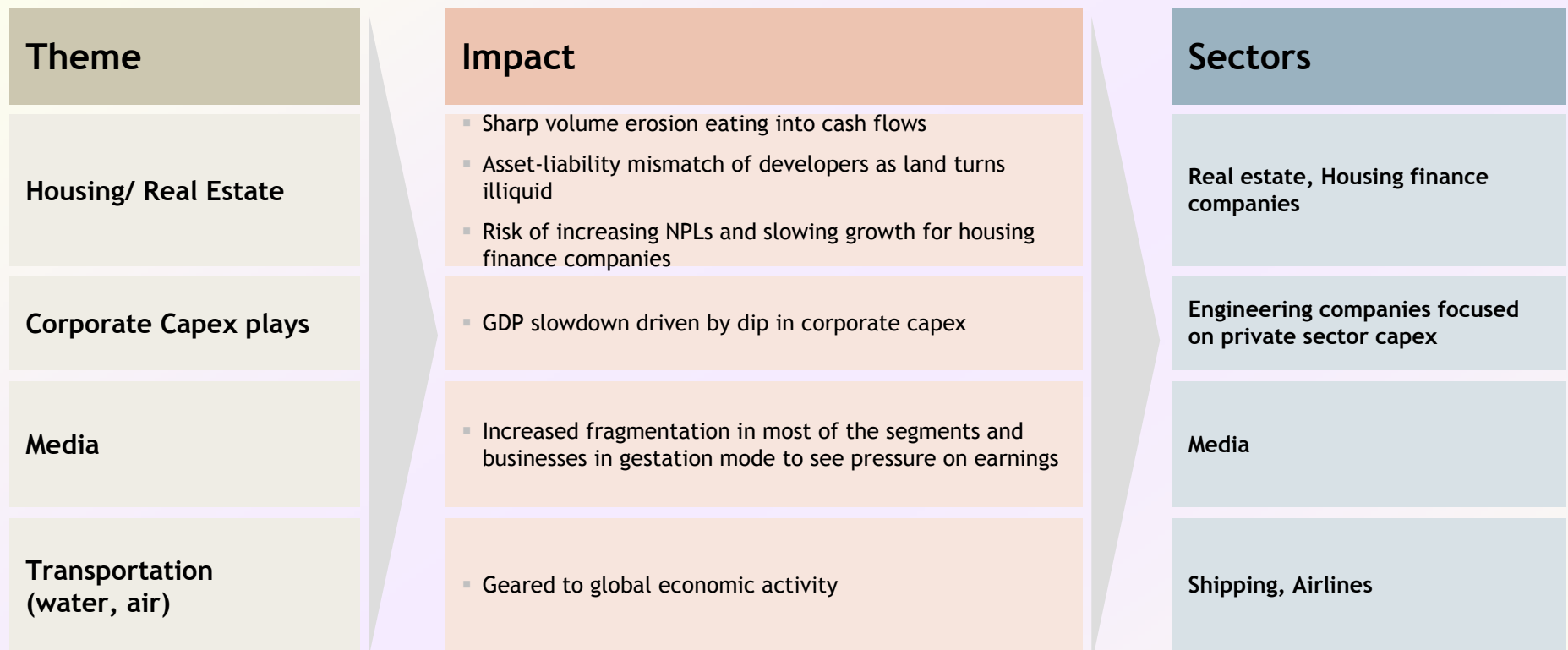
- Monsoons have been strong for the past five years (with 2008 being the best)
- A deficient monsoon could significantly dent rural consumption

Key themes to play...

Theme	Sectors	Stocks	FII Holding (%)		MF Holding (%)		Price correction from peak
			Mar 08	Dec 08	Mar 08	Dec 08	
Government spending: Only sponsor to provide fiscal stimulus to a sagging economy	Capital Goods	BHEL	18.1	16.0	5.6	6.0	(42.6)
		KEC Intl	12.9	6.1	23.3	30.4	(82.3)
	Construction	Nagarjuna	34.8	26.4	22.4	24.9	(85.6)
Interest rate sensitives: lower interest rates to eventually improve demand outlook	Automobiles	Mah & Mah	33.3	24.2	5.2	3.5	(56.2)
	Infra Developers	Reliance Infra	21.1	17.8	5.0	5.3	(79.2)
		GVK Power	24.9	19.8	5.1	5.7	(74.9)
	Financials	ICICI Bank	68.9	36.6	6.1	7.9	(74.5)
		Axis Bank	37.5	25.4	7.6	8.4	(68.6)
		Bank of Baroda	19.8	17.4	11.5	11.7	(54.2)
		HDFC Bank	47.5	27.4	2.8	5.0	(45.7)
		PNB	20.0	18.3	6.4	18.3	(44.0)
	Competitive commodity producers: first beneficiary of pick-up in commodity prices, attractive valuations	Steel	JSPL	22.9	18.1	4.8	5.6
Non-ferrous Metals		Sterlite Industries	23.2	6.8	3.4	3.9	(67.5)
Quality mid-caps at distressed valuations	Diversified	UPL	43.3	35.3	13.9	19.6	(54.0)
		Jain Irrigation	39.8	41.1	7.9	7.4	(54.6)
		Sintex	39.7	41.1	15.5	17.2	(83.8)

Source: IDFC - SSKI Research

...key themes to avoid



Our top picks

Company Name	Price	Mktcap	EPS (Rs)			EPS CAGR	P/E (x)		
	(Rs)	(Rs bn)	FY08E	FY09E	FY10E	FY08-FY10	FY08E	FY09E	FY10E
Bharat Heavy Electricals	1482	725	56.7	64.8	86.1	23.3	26.2	22.9	17.2
KEC International	145	7	29.9	32.9	39.0	14.2	4.9	4.4	3.7
Nagarjuna Construction*	53	12	7.5	7.7	10.3	17.2	6.9	6.7	5.0
Mahindra & Mahindra	379	91	76.0	47.2	51.0	(18.0)	5.0	8.0	7.4
Jindal Steel & Power	1213	187	81.3	166.0	148.7	35.3	14.9	7.3	8.2
Sterlite Industries	347	246	61.5	47.0	32.4	(27.4)	5.6	7.4	10.7
United Phosphorus	95	42	8.4	10.9	14.1	35.0	10.6	7.8	5.8
Jain Irrigation Systems	335	24	16.5	26.3	35.3	46.0	20.3	12.7	9.5
Sintex	93	14	15.2	23.6	24.8	27.9	6.1	3.9	3.7
Reliance Infrastructure	538	127	43.4	63.2	68.4	25.6	12.4	8.5	7.9
GVK Power	21	30	0.7	0.6	1.3	37.1	31.8	33.8	16.9
							P/B (x)		
Axis Bank	398	142	33.5	47.9	59.4	33.2	1.6	1.4	1.2
ICICI Bank	366	407	37.4	37.3	39.5	2.8	0.9	0.8	0.8
Bank of Baroda	225	82	39.3	52.8	59.7	23.3	0.7	0.6	0.5
HDFC Bank	972	345	47.2	53.7	65.1	17.4	3.0	2.8	2.1
Punjab National Bank	398	126	65.0	91.1	101.4	24.9	1.3	0.9	0.8

*Unadjusted for BOT and Real estate; Source: IDFC - SSKI Research

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