India Strategy

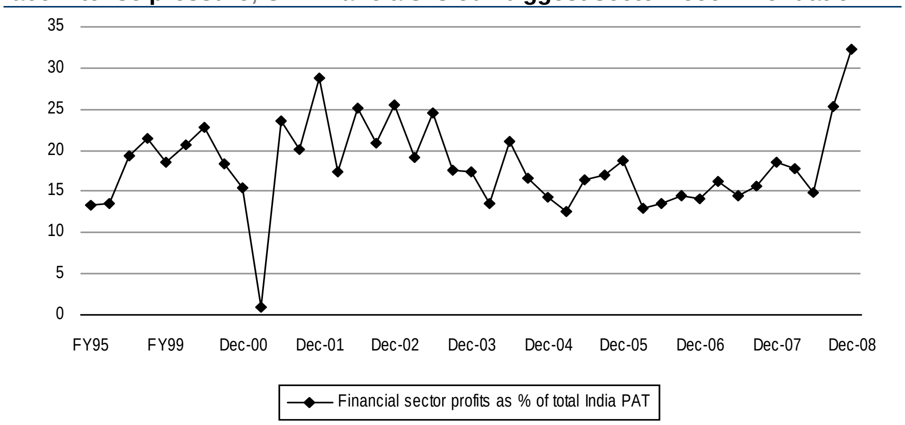
Research Analysts
Nilesh Jasani
9122 6777 3720
nilesh.jasani@credit-suisse.com
Arya Sen
9122 6777 3807
arya.sen@credit-suisse.com

STRATEGY

Sensex FY10E EPS at '6xx'?

- **Bottom-up consensus estimates for Sensex FY10 EPS have come off by 25% in recent months. Finally, it is forecast to be below the record level in FY08. We expect it to fall another 25% to between 600 and 700 as the year progresses**.
- **December 2008 was the first quarter in the cycle to see a revenue deceleration. The deceleration was sharp but the cycle has just begun. We expect top-line growth to reduce from around 15% to less than -5% in 2009.**
- **As revenues decelerate, margin pressures will intensify. With simultaneous other income pressure, overall profit for FY10 could fall further by 25% making FY10E ROE around 12-13%, still higher than the lowest 10% ROE recorded in each year between 1998 and 2001.**
- **Financials' profits as a percentage of total reached the unsustainable and record high 30%+ level. In both the bull and bear cases, their profits should underperform in the quarters ahead.**
- **We do not think FY10E EPS downgrades will depress the equity market further as long as the hopes of a sharp FY11 bounce stay high. The positive medium-term recovery expectations hinge on the new government and its policies. For now, we maintain that the market will likely ignore the possibility of FY10E EPS of '6xx', and hover around the Sensex level of 9,000; whether the next stage is priced on a recovered FY11 earnings or depressed FY10E EPS will depend on the election results in early June.**

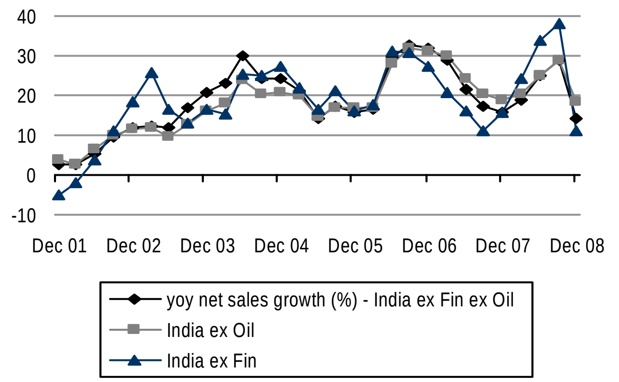
Figure 1: **The financial sector's profits, currently at a record high, are likely to face intense pressure; UW financials is our biggest sector recommendation**



Note: For a set of 750 largest companies by market-cap;
Source: CMIE, Credit Suisse estimates

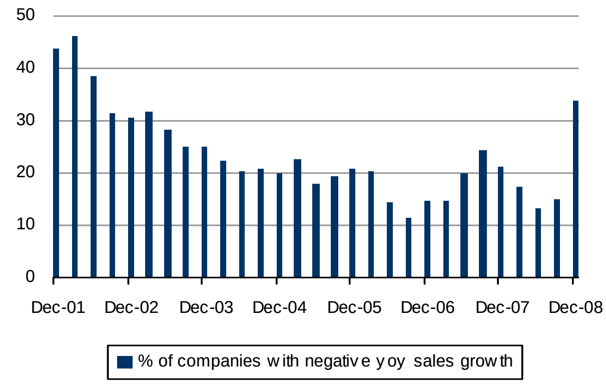
Focus charts

Figure 2: Sales growth has been accelerating so far; likely to head towards negative in the quarters ahead



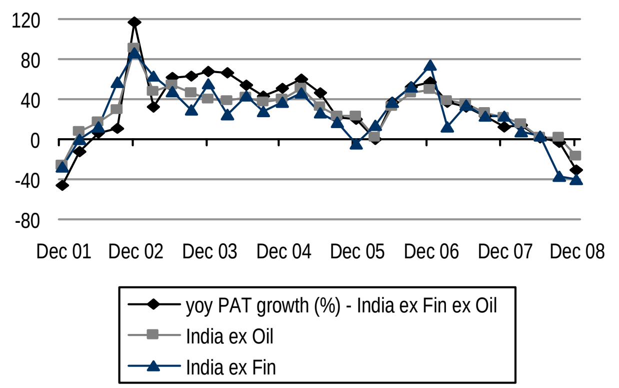
Note: India numbers calculated by aggregating numbers for 750 largest companies by market-cap; Source: CMIE, Credit Suisse est.

Figure 3: Nearly a third of corporate India (ex financials) witnessed YoY sales decline but still lower than 2001-02



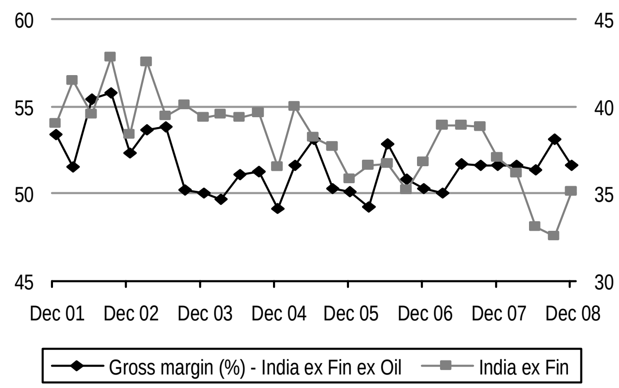
Source: CMIE, Credit Suisse estimates

Figure 4: Non-oil companies too have started seeing profit de-growth, unlike in the previous quarter



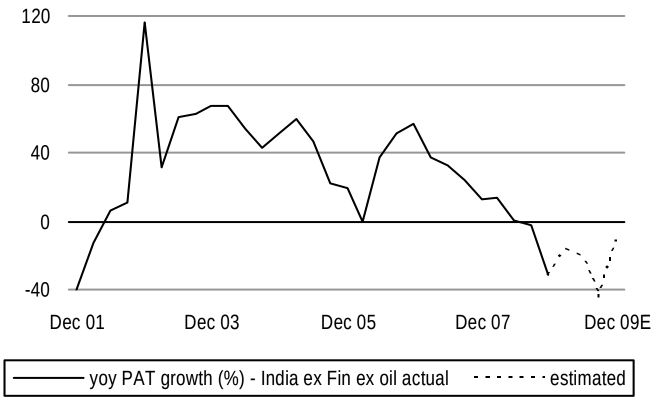
Source: CMIE, Credit Suisse estimates

Figure 5: Gross margins have not fallen yet – a pressure point for earnings ahead



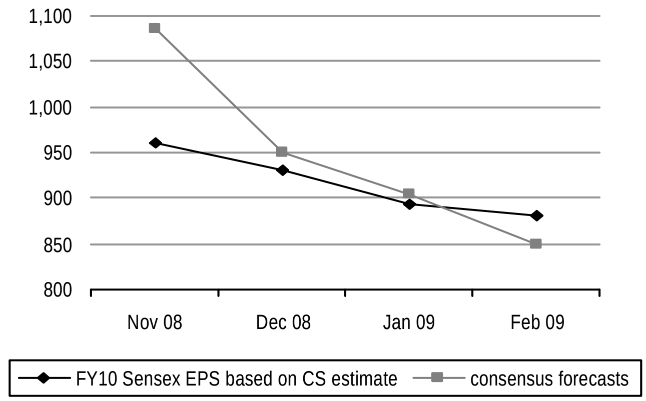
Source: CMIE, Credit Suisse estimates

Figure 6: Impact of shrinking revenues on profits suggests significant potential downside to current FY10 estimates



Source: CMIE, Credit Suisse estimates

Figure 7: FY10E Sensex EPS likely to fall to less than 700 as ROE heads to low teens – levels common in down cycles



Source: Bloomberg, Credit Suisse estimates

Much more potential downside to FY10E earnings

Revenue collapse begins

The most distinguishing feature of the latest quarterly results is the first drop in revenue growth for the cycle. The drop was quite sharp too: for the universe of all non-financial companies, sales growth is down from almost 40% in the previous quarter to barely 10%. While a part of this was due to falling commodity prices, a volume decline on the account of a demand slowdown also played a role, particularly in autos and property. Worryingly, sales growth is likely to deteriorate further because of the continuing economic deceleration and worsening high base. We expect revenue growth to continuously fall to reach the lowest recorded rates at less than -5% in 2009.

Finally, revenue growth stops accelerating and plunges. We expect revenue growth to possibly go to the lowest recorded rates in a decade at less than -5% by end-2009

Profit fall to worsen on top-line pressure

Profits declined in Sep-quarter at a historic rate due to oil losses. The pace of the decline in the Dec-quarter was same as the previous one, but the reasons were more broad-based rooted in the economic slowdown. Effectively, ex-oil universes' profits have started contracting only now. The worst hit have been companies and sectors with high operating and financial leverage. The trend in other income has also reversed sharply and could deteriorate further in the coming quarters because of falling interest rates, weak financial markets and overall economic conditions. The only exception has been financials with YoY PAT growth of ~30%, which is unlikely to be sustained going forward. Overall market profit could remain in deep negative territory at less than -20% YoY for the rest of 2009.

Profits could continuously record less than -20% growth for the rest of 2009

Financials' profits untenable

The financial sector's profits as a percentage of total had never been higher at 32%. For financials' profits to grow at over 30% YoY while the rest of the corporate world is witnessing a contraction of the same magnitude is unsustainable, in our view. Financials' profits were not just from mark-to-market gains on bond portfolio, but strong loan growth, margin expansion and strong fee income also contributed to over 30% net interest income and net profit growth. A likely 250-300 bp decline in interest rates over the next few months could lead to substantial margin pressure. Government banks' bottom lines could see more pressure as their asset-liability mismatch is larger. A loan demand deceleration and weaker fee growth are likely the other outcomes of a weak economic environment. Most importantly, it is unlikely that NPLs and provision ratios could remain near the all-time low level in this environment despite regulatory forbearance. Risk for earnings (FY03/10E) is a significant 15-90%, on sensitivity of 200 bp higher NPLs. We remain UNDERWEIGHT on the sector and expect it to be the main contributor to depressed FY10E earnings.

Last shoe to drop? Financials' earnings growth is unsustainable given what is happening in the rest of real economy

FY10 estimates still off by 25%

Since November, estimates for Sensex's earnings for FY09 have been down more than 15% and for FY10 nearly 25%. While we had been expecting a decline in consensus estimates, the magnitude was a surprise. Yet the downgrades are far from over, in our view. With revenue deceleration likely to continue, YoY PAT declines of as much as 30-40% in some quarters in the next year cannot be ruled out. This would mean at least another 20-25% downside to current FY10 estimates and possibly Sensex EPS of between 600 and 700 with the market's ROE falling to low teens for FY10. Will this matter to the market? We think the market will begin to trade at a low P/E on FY10E EPS (i.e., Sensex below 7000) only if the hopes of medium-term or FY11E EPS growth vanish. If economic growth returns, the prospects of near 40-50% EPS growth in FY11E will help investors ignore the current year's numbers. Essentially, we deem a sharp decline in FY10 EPS forecast as inevitable but not an attendant fall in equity indices.

Another 20-25% downside is likely to current FY10 estimates and possibly Sensex EPS of less than 700. However, Sensex will trade below 7,000 on such low FY10E earnings only if the hopes of FY11E sharp EPS growth are dashed – something which is not given

Portfolio recommendation

Figure 8: **Portfolio recommended**

Sector	Neutral weight	CS rec. weight	CS rating	2008 perf. (%)	Key stocks
Financials	22.5	20.0	UW	-62.1	
- Private banks	*12.8*	*13.5*	*MW*	*n.a.*	NEUTRAL HDFC Bank
- NBFC	*7.5*	*6.0*	*UW*	*n.a.*	UW stock brokers. OUTPERFORM HDFC
- Real estate	*0.9*	*0.0*	*UW*	*n.a.*	UNDERPERFORM DLF, NEUTRAL Unitech
- PSU banks	*1.3*	*0.5*	*UW*	*n.a.*	UNDERPERFORM SBI
Industrials	8.9	7.0	UW	-65.7	OUTPERFORM BHEL, UNDERPERFORM L&T
Energy	22.0	18.0	UW	-55.1	OUTPERFORM ONGC; NEUTRAL Reliance
Software	14.9	19.0	OW	-46.1	OUTPERFORM Infosys, TCS, Wipro
Consumer staples	8.3	10.0	OW	-10.8	OUTPERFORM ITC, HUL
Consumer discretionary	3.4	7.0	OW	-49.6	OUTPERFORM Hero Honda, Maruti
Materials	7.3	8.0	OW	-72.4	OUTPERFORM SAIL, India Cement
Healthcare	3.8	4.0	OW	-26	OUTPERFORM Sun Pharma
Telecom	2.4	3.0	MW	-67.4	OUTPERFORM Bharti
Utilities	7.0	4.0	UW	-52.2	OUTPERFORM NTPC. Coverage to resume shortly on others.

Source: Company data, Credit Suisse estimates

Figure 9: **Earnings for Credit Suisse versus consensus by calendar year**

	12-m	Trailing	EPS growth (%)			P/E (x)		
Index	**fwd PE**	**P/B**	**CY07**	**CY08**	**CY09**	**CY07**	**CY08**	**CY09**
MSCI India	10.2	2.1	20.2	-4.9	11.2	10.0	10.5	9.4
Sensex – CS	10.9	2.1	29.9	1.1	4.2	11.6	11.4	11.0
Sensex – consensus	11.1	2.1	29.8	2.2	1.8	11.6	11.3	11.1
Nifty – CS	11.0	2.1	29.2	3.7	8.6	11.5	11.1	10.2
Nifty – consensus	11.1	2.1	29.4	2.9	3.9	11.5	11.1	10.7
CS India	9.2	2.2	26.7	3.2	5.7	10.1	9.8	9.3

Source: Bloomberg, Datastream, Credit Suisse estimates

Figure 10: **Earnings for Credit Suisse versus consensus by fiscal year**

	Earnings growth (%)			P/E			Earnings integer (EPS)		
Index	**FY08**	**FY09**	**FY10**	**FY08**	**FY09**	**FY10**	**FY08**	**FY09**	**FY10**
Sensex – CS	27.3	(7.3)	11.6	10.9	11.8	10.6	851	789	881
Sensex – consensus	27.4	(5.5)	5.2	10.9	11.5	10.9	855	808	850
Nifty – CS	25.9	(0.3)	12.0	10.9	10.9	9.7	262	261	292
Nifty – consensus	25.8	(3.1)	6.3	10.9	11.2	10.6	261	253	269

Source: Bloomberg, Datastream, Credit Suisse estimates

Revenue collapse begins

The most distinguishing feature of the latest quarterly results is the first drop in revenue growth for the cycle. The drop was quite sharp too: for the universe of all non-financial companies, sales growth is down from almost 40% in the previous quarter to barely 10%. While a part of this was due to falling commodity prices, a volume decline on the account of a demand slowdown also played a role, particularly in autos and property. Worryingly, sales growth is likely to deteriorate further because of the continuing economic deceleration and worsening high base. We expect revenue growth to continuously fall to reach the lowest recorded rates at less than -5% in 2009.

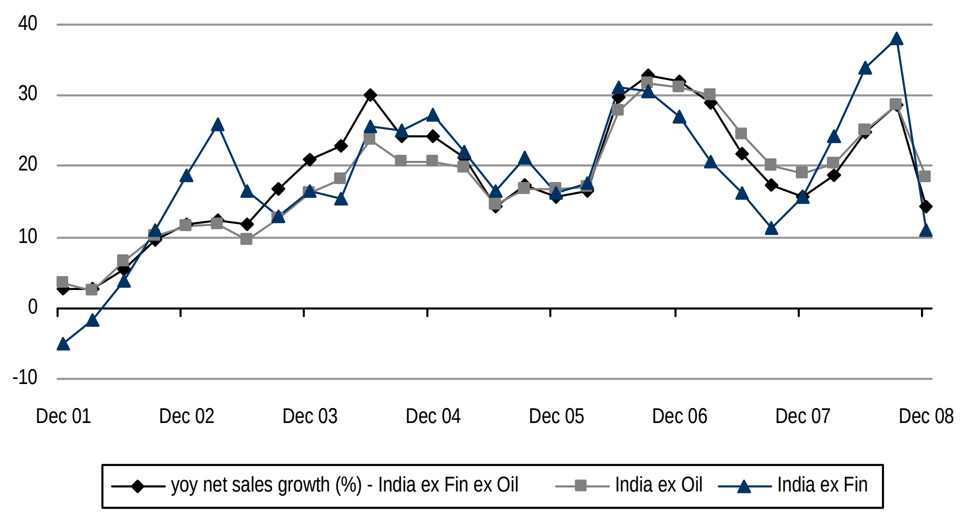
Finally, revenue growth stops accelerating and plunges. We expect revenue growth to possibly go to the lowest recorded rates in a decade at less than -5% by end-2009

Top-line growth drops off a cliff

The most distinguishing feature of the latest quarterly results was the sharp drop in revenue growth. Prior to that, revenues were accelerating. The trend reversed comprehensively. Annual revenue growth of all non-financial companies dropped from the recorded all-time high of 38% to a five-year low of 11%, all in just one quarter.

The sharp deceleration in sales was the most distinguishing feature of the latest quarterly results

Figure 11: **Sales growth fell off a cliff in the past quarter**



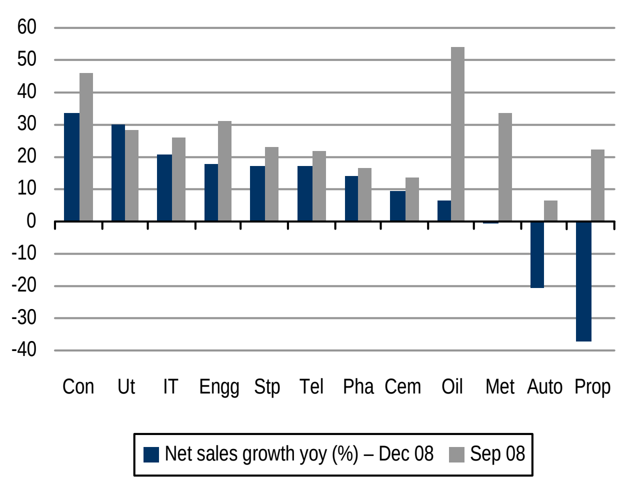
Note: India numbers are calculated by aggregating numbers for 750 of the largest companies by market-cap; Source: CMIE, Credit Suisse estimates

One of the key reasons behind the sharp decline in top lines for corporate India is undoubtedly the corrections in oil and other commodity prices, the impact of which was finally visible in the previous quarter. On a YoY basis, oil and gas companies' revenues grew in single digits, down significantly from 50%+ YoY in the September quarter.

Falls in crude oil and other commodity prices are certainly one of the main reasons

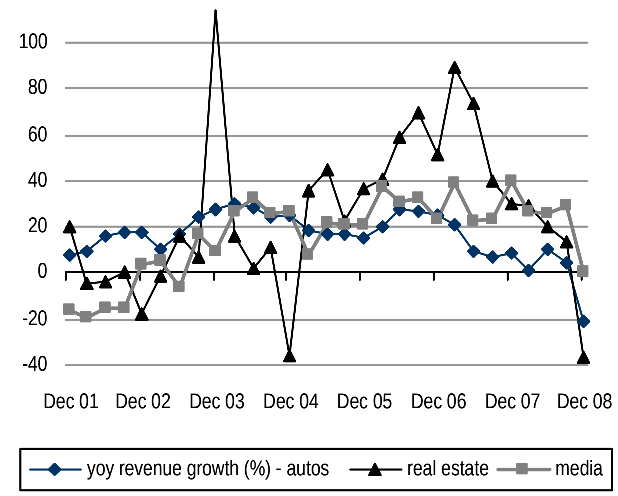
While the sales growth decline was relatively moderate if excluded oil companies' revenues, the following chart shows except utilities, every other sector witnessed a revenue growth deceleration. Huge negative growth was observed in automobiles and property – an indication of sharp distress at high-ticket consumption.

Figure 12: Most sectors saw decelerations in their top lines …



Source: CMIE, Credit Suisse estimates

Figure 13: … but in the commodity-related sectors, prices came off sharply, and autos and real estate appear to have been the worst hit



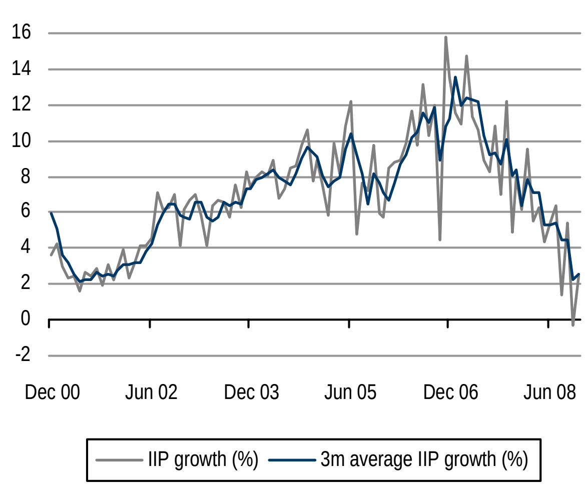
Source: CMIE, Credit Suisse estimates

Revenue numbers start to reflect the reality of the economic slowdown …

Most economic/macro data points and anecdotal evidence indicate a slowdown

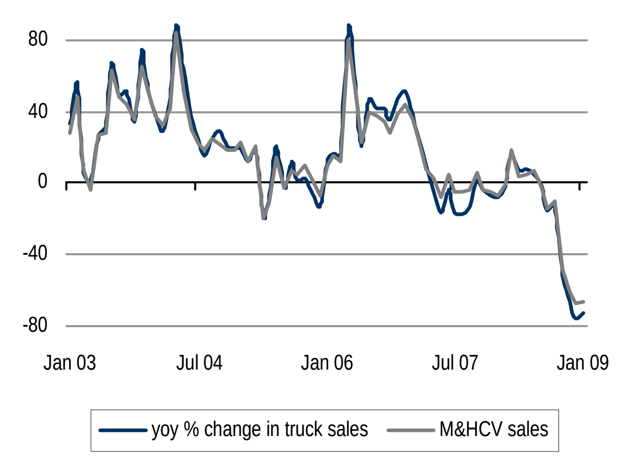
The 15 p.p. drop in sales growth from 29% in the September quarter to 14% in the December quarter in the ex-oil universe is not a surprise. In a way, the surprise is how fast revenues are growing even now. The worrying feature, though, is that revenue numbers only partly reflect the pattern that is visible in many other indicators: 1) negative IIP growth, 2) a 50% drop in the sales of trucks and other commercial vehicles, 3) the anecdotal evidence of a severe drop in real estate transactions, 4) slowing order inflows for the engineering and construction companies, 5) a sharp drop in advertising revenues for media companies, and 6) weak volumes in IT services companies even though this has been offset to a large extent by a weak rupee.

Figure 14: IIP growth has been declining and was negative in October



Source: CMIE, Credit Suisse estimates

Figure 15: M&HCV sales were down 60%+ compared with the last year

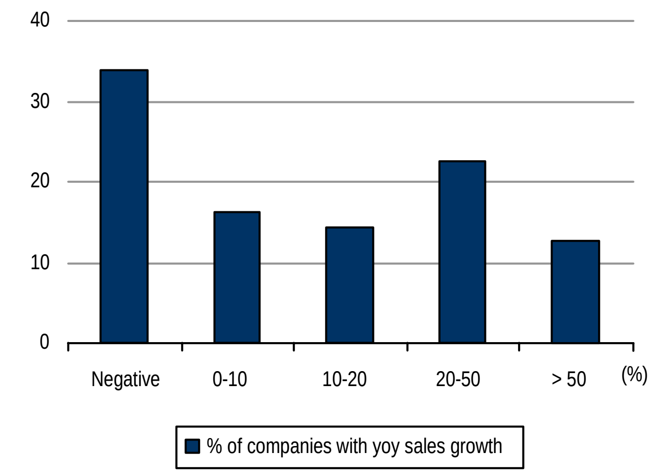


Source: SIAM, Credit Suisse estimates

The broad-based nature of the decline is more visible in the charts below. Over 30% of the non-financial companies analysed by us witnessed negative revenue growths in the last quarter and nearly two-thirds witnessed profit declines.

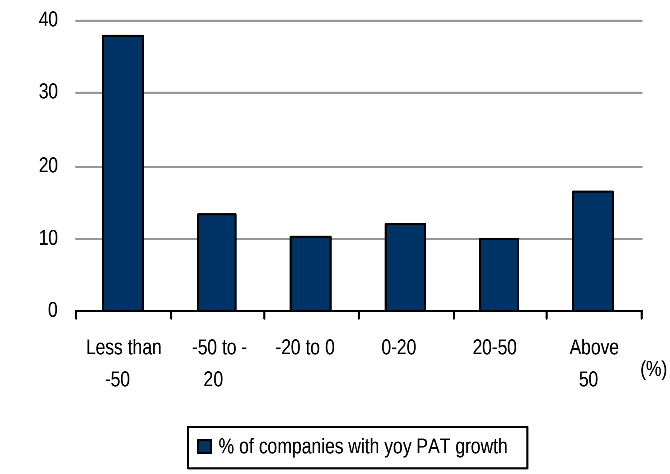
The decline was broad-based – few companies can expect to remain unaffected

Figure 16: Over 30% of the non-financial companies witnessed revenue de-growth in the previous quarter



Source: CMIE, Credit Suisse estimates

Figure 17: More than 60% saw their profits shrink compared with the last year



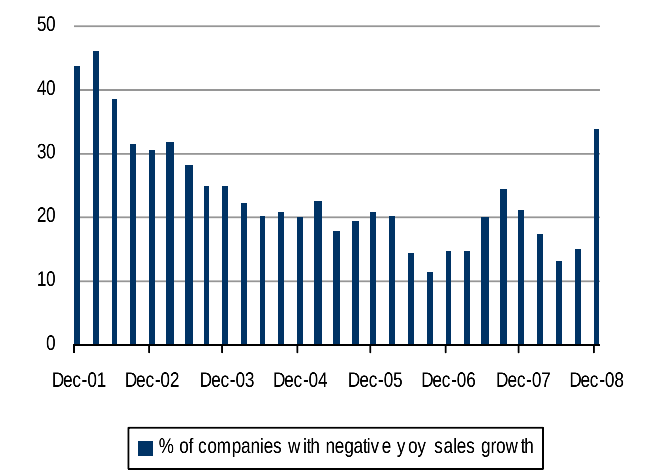
Source: CMIE, Credit Suisse estimates

… and it is likely to get worse

The most important point and one that needs special attention is that it all happened in one quarter. Owing to the continuing economic deceleration and high base, it is almost inevitable that revenue and profit growths will continue to go down further, and likely equally sharply, for a few more quarters. We expect revenue growth to possibly go to the lowest recorded rates in a decade at less than -5% by end-2009. The percentage of companies with negative revenue growth could easily rise to half given that the current slowdown is worse than the one in 2002, with a worse base impact and added pressure of deflation.

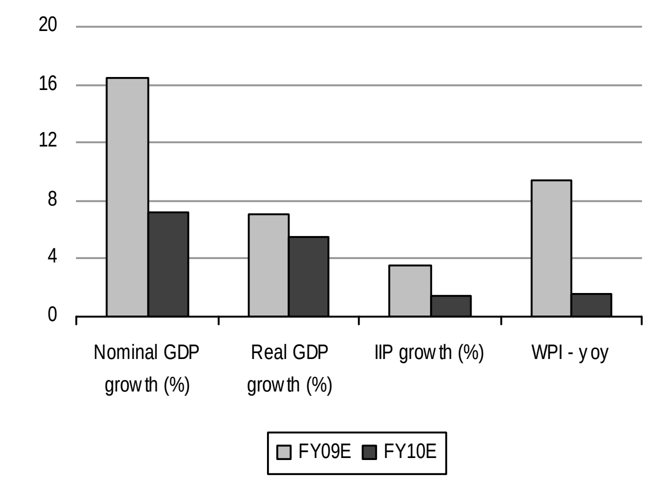
We expect revenue growth to possibly go to the lowest recorded rates in a decade at less than -5% by end-2009

Figure 18: The proportion of companies with YoY sales declines is more than a third but still well below the levels of the previous downturn



Source: CMIE, Credit Suisse estimates

Figure 19: The macro environment is expected to worsen from here



Note: WPI forecast is full-year average; Source: CMIE, Credit Suisse estimates

Profit fall to worsen on top-line pressure

Profits declined in the September quarter at a historic rate due to oil losses. The pace of the decline in the latest quarter was same as the previous one, but the reasons were more broad-based and rooted in the economic slowdown. Effectively, ex-oil universes' profits have started contracting only recently. The worst hit have been companies and sectors with high operating and financial leverage. The trend in other income has also reversed sharply and could deteriorate further in the coming quarters because of falling interest rates, weak financial markets and overall economic conditions. The only exception has been financials with YoY PAT growth of ~30%, which is unlikely to be sustained going forward. Overall market profit could remain in deep negative territory at less than -20% YoY for the rest of 2009.

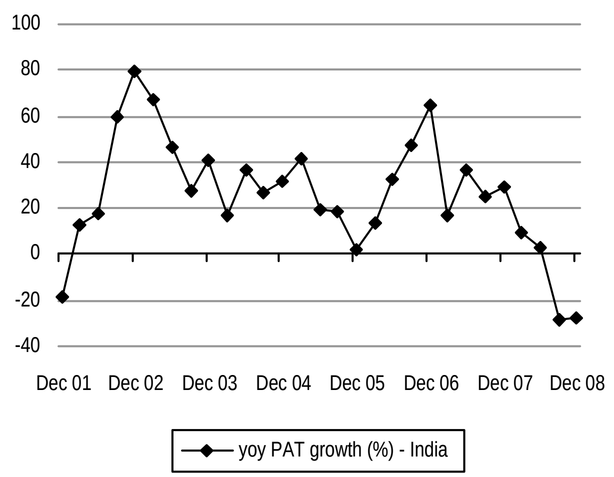
Profit growth could continuously record numbers less than -20% for the rest of 2009

Margins decline due to the adverse impact of operating leverage …

When one simply looks at the chart on YoY net profit growth, it appears that net profits had already collapsed in the previous quarter and we should be close to the bottom. However, as the following chart shows, the annual declines in profits are largely due to oil companies' losses. Ex-oil universes' profits have started contracting only recently.

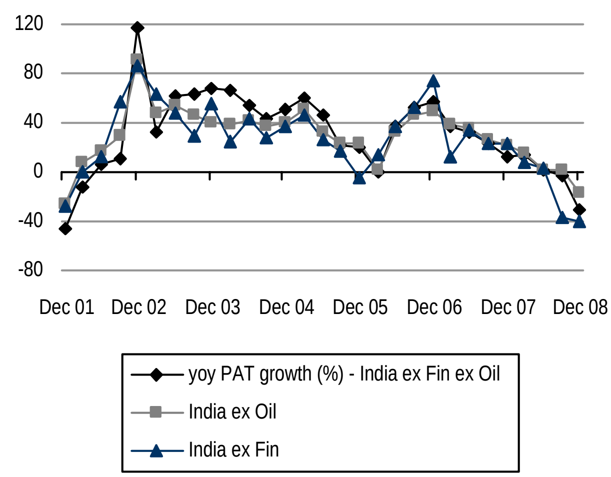
Profits for the universes ex. oil and ex financials were down 30% YoY

Figure 20: **Corporate India's profits were down more than 30% YoY in the December 2008 quarter …**



Source: CMIE, Credit Suisse estimates

Figure 21: **…as non-oil companies have also started seeing profit de-growth, unlike in the previous quarter**

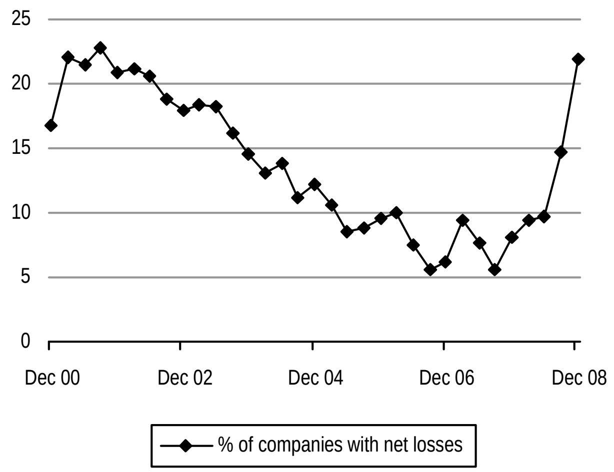


Source: CMIE, Credit Suisse estimates

Profit decelerations in the December quarter were almost as sharp as those in revenues. For most universes with or without oil and with or without financials, the falls were at or close to the lowest levels seen in the last eight years. And again as in the case of revenue decelerations, declines were broad-based – new records are being set, in terms of the percentage of companies announcing losses or having contractions in their reported profits.

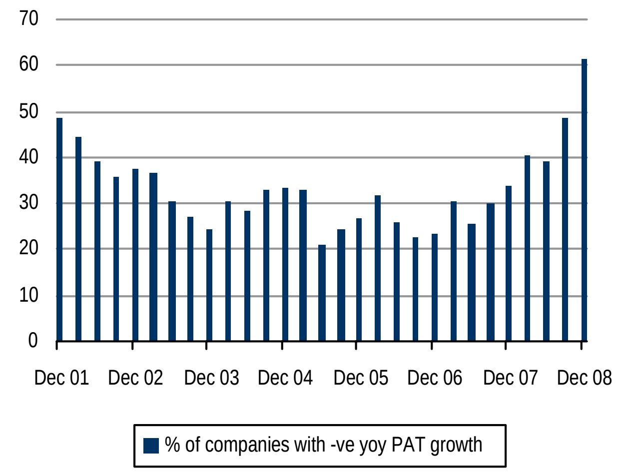
Declines in profits have been broad-based – more than 60% of the companies saw profits shrink YoY

Figure 22: A record high number of companies announced quarterly losses …



Source: CMIE, Credit Suisse estimates

Figure 23: … and contractions in profits, although the record is for a short history

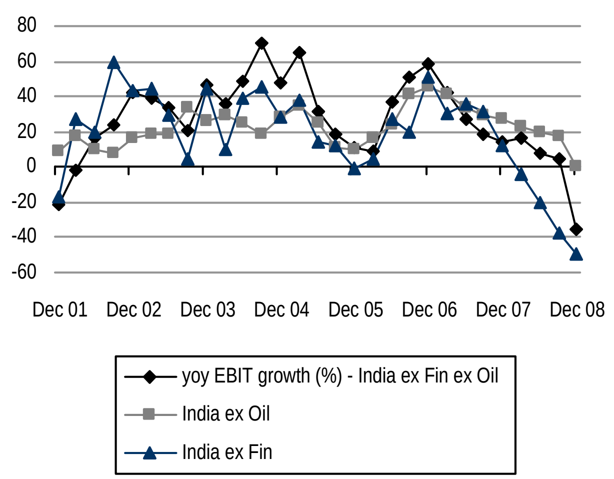


Source: CMIE, Credit Suisse estimates

Operating margins of non-financial companies reached the level not seen previously. While oil and gas companies were particularly hit on account of lower refining margins and inventory losses, operating profits for the rest were also down 40% albeit from last year's inflated levels. Figure 25 shows that operating margins of ex-oil, non-finance company universes could fall further by 3-4 p.p. to reach the previous record low in 2001. More worrying, however, are profit margin charts, which include finance companies or margins of finance companies, which we discuss in the following section.

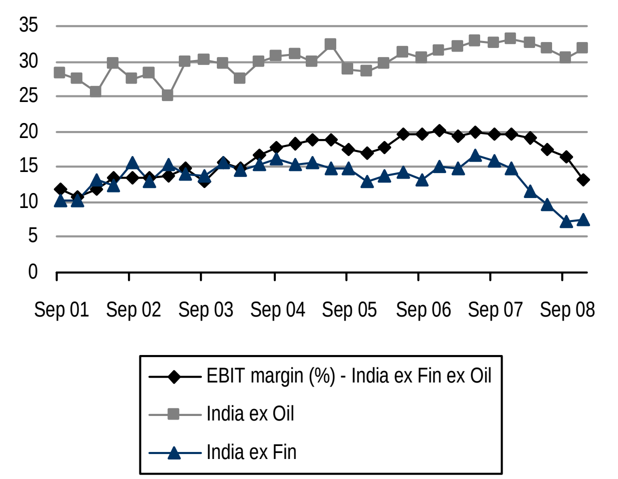
Operating margins have started coming off for ex-oil, ex-finance universes but more falls are possible

Figure 24: Operating profits for non-oil companies have shrunk for the first time since 2001 …



Source: CMIE, Credit Suisse estimates

Figure 25: … as operating margins fell by 650 bp from the peak for ex oil, ex financials; more fall possible, though



Source: CMIE, Credit Suisse estimates

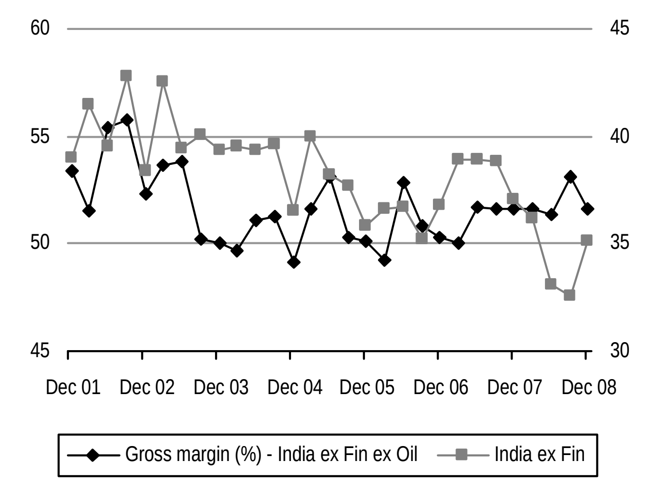
Outside of oil companies, gross margins were largely maintained indicating that the pressure for most was mainly on account of the adverse impact of operating leverage. With the demand environment likely to remain weak for the next few quarters, we expect the trend of YoY declines in profits to continue. Moreover, if pricing power remains weak, there could be more potential downside as gross margins too come under pressure.

Gross margins could come off their high levels with weakening pricing power in the quarters ahead

Whether or not the worst annual declines in reported profits for this down cycle is around is debatable – what is more pertinent in our view is how long will it take for growth to swing back into positive. Investors in equity markets are mostly interested in profits stabilising but not profit decline stabilising.

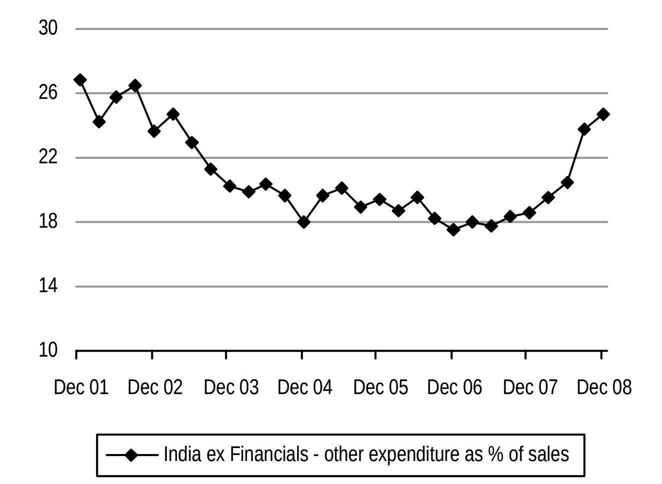
Profits must stabilise for investors to turn more positive

Figure 26: **Gross margins did not fall in line with operating margins …**



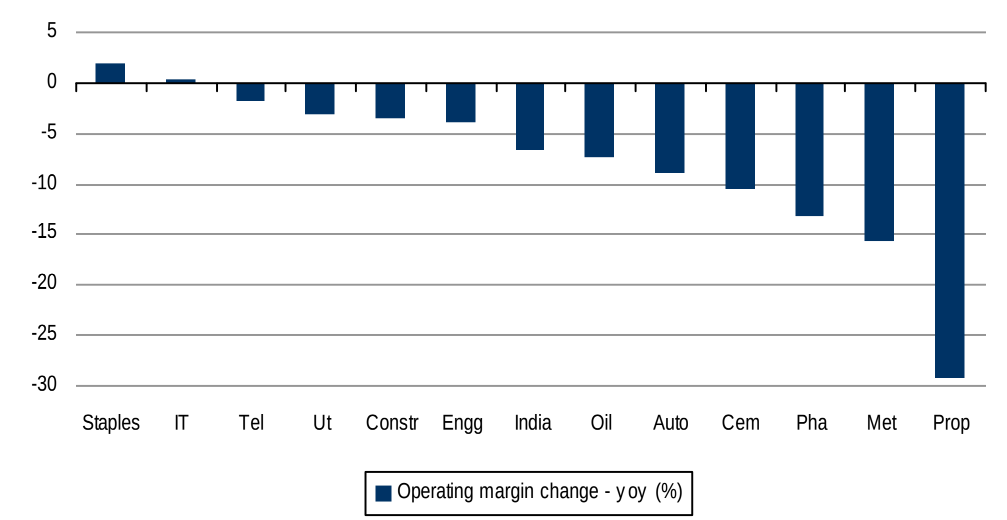
Source: CMIE, Credit Suisse estimates

Figure 27: **… as pressure was more from the fixed cost side**



Source: CMIE, Credit Suisse estimates

Figure 28: **Operating margins (EBITDA) have fallen substantially for almost all major industries over the last few quarters**



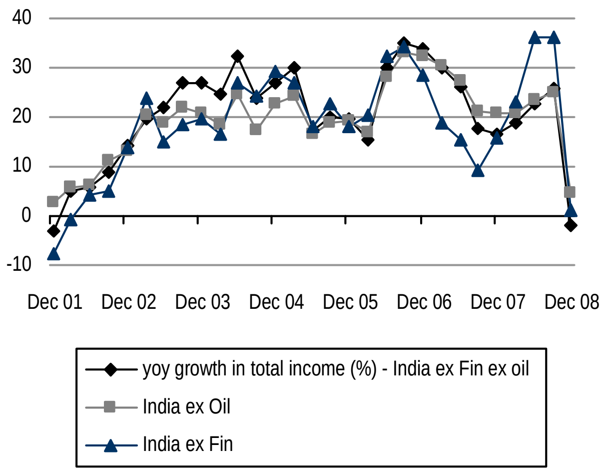
Source: CMIE, Credit Suisse estimates

… non-operating items will likely be hurt, financial leverage less so

In the post-Satyam world, where auditors are stricter, accountants have donned their most conservative attires and where companies' managements would probably want to err on the cautious side in reporting profits, biggest surprises are likely to emanate from the non-operating side, especially in other income. We expect other income to drop substantially in the coming quarters because of falling interest rates, weak financial markets and overall economic conditions.

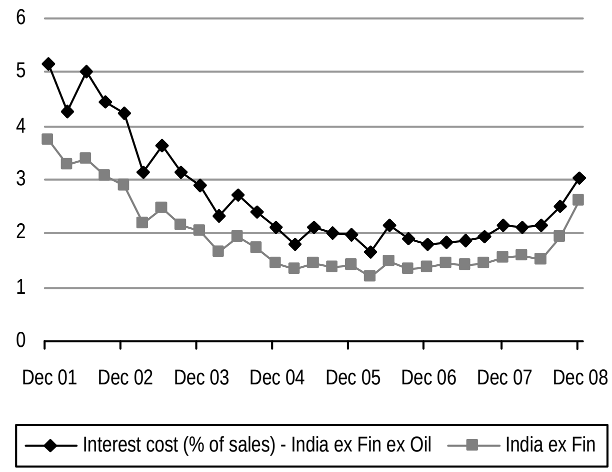
Non-operating items like other income should drop significantly due to falling interest rates, weak financial markets and overall economic conditions

Figure 29: **Non-operating income saw sharper decline than operating revenues – a trend that could worsen in the quarters to come**



Source: CMIE, Credit Suisse estimates

Figure 30: **Adverse impact of financial leverage showed up in the December quarter results, though falling interest rates may provide some respite going forward**

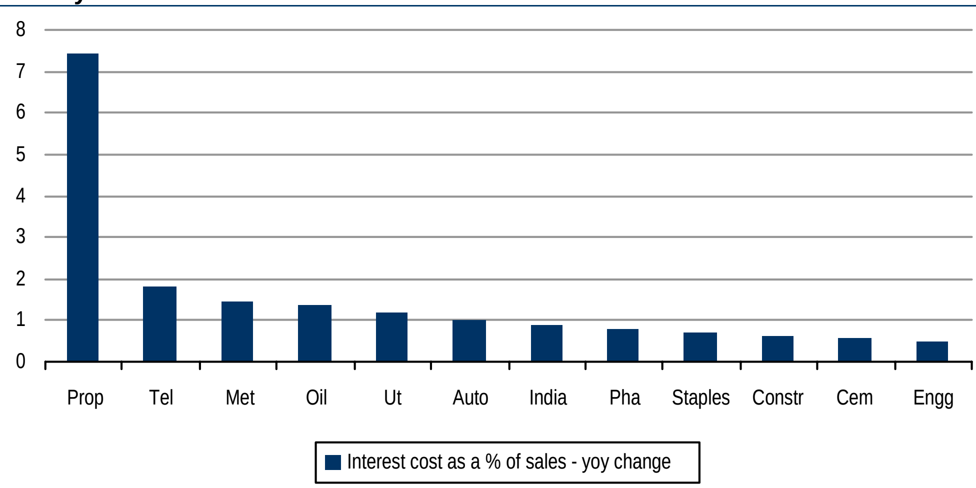


Source: CMIE, Credit Suisse estimates

The impact of financial leverage was relatively less on aggregate though individual companies and sectors like real estate were badly hurt. While falling interest rates could provide relief in the near term, we expect interest cost as a percent of sales to remain relatively high in FY10.

Real estate was one of the worst hit on account of financial leverage as interest costs went up and volumes collapsed

Figure 31: **Real estate was the worst hit by the impact of financial leverage; other sectors relatively less**



Source: CMIE, Credit Suisse estimates

Further drops in revenues imply margins could worsen

Margins could worsen as sales could decelerate further

We conclude from the analysis above that the key determinant for margins and profit going forward is likely to be the top-line trend. As highlighted in the previous section, indications from both the macro data points and anecdotal evidence are not encouraging. Revenue declines could accelerate over the next few quarters as both volumes and prices could come under pressure. In fact, a 5% YoY top-line decline is possible, if not likely, some time in the next few quarters. Profits could decline 30-50% YoY as a result. We provide below a sensitivity analysis of the potential impact of declining revenues on profits.

Figure 32: **Case 1: Revenue growth of -10% YoY**

	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09E	Jun-09E	Sep-09E	Dec-09E
EBITDA margin (%)	23.4	22.4	20.8	19.6	16.8	11.3	10.2	7.3	6.4
EBIT margin (%)	19.8	19.1	17.4	16.4	13.1	7.6	6.4	3.7	2.2
PBT margin (%)	20.5	19.6	18.2	16.0	12.6	8.6	7.3	5.3	4.0
PAT growth (YoY %)	12.3	13.3	0.8	(2.5)	(31.3)	(51.5)	(56.7)	(65.0)	(65.4)

Source: CMIE, Credit Suisse estimates

A 30-50% drop in profits in some of the next few quarters cannot be ruled out

Figure 33: **Case 2: Revenue growth of -5% YoY**

Revenue growth of -5%	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09E	Jun-09E	Sep-09E	Dec-09E
EBITDA margin (%)	23.4	22.4	20.8	19.6	16.8	13.4	12.3	9.6	8.7
EBIT margin (%)	19.8	19.1	17.4	16.4	13.1	9.9	8.8	6.2	4.8
PBT margin (%)	20.5	19.6	18.2	16.0	12.6	11.0	9.8	7.9	6.7
PAT growth (YoY %)	12.3	13.3	0.8	(2.5)	(31.3)	(34.2)	(38.3)	(44.4)	(38.1)

Source: CMIE, Credit Suisse estimates

Figure 34: **Case 3: Flat revenues YoY**

Revenue growth of 0%	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09E	Jun-09E	Sep-09E	Dec-09E
EBITDA margin (%)	23.4	22.4	20.8	19.6	16.8	15.3	14.3	11.7	10.9
EBIT margin (%)	19.8	19.1	17.4	16.4	13.1	12.0	10.9	8.5	7.2
PBT margin (%)	20.5	19.6	18.2	16.0	12.6	13.3	12.1	10.3	9.2
PAT growth (YoY %)	12.3	13.3	0.8	(2.5)	(31.3)	(16.8)	(20.0)	(23.9)	(10.9)

Source: CMIE, Credit Suisse estimates

Figure 35: **Case 4: Revenue growth of 5% YoY**

Revenue growth of 5%	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09E	Jun-09E	Sep-09E	Dec-09E
EBITDA margin (%)	23.4	22.4	20.8	19.6	16.8	15.4	14.4	11.9	11.0
EBIT margin (%)	19.8	19.1	17.4	16.4	13.1	12.3	11.2	8.8	7.5
PBT margin (%)	20.5	19.6	18.2	16.0	12.6	13.7	12.5	10.3	8.7
PAT growth (YoY %)	12.3	13.3	0.8	(2.5)	(31.3)	(9.9)	(13.0)	(20.2)	(11.7)

Source: Company data, Credit Suisse estimates

Figure 36: **Case 5: Revenue growth of 10% YoY**

Revenue growth of 10%	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09E	Jun-09E	Sep-09E	Dec-09E
EBITDA margin (%)	23.4	22.4	20.8	19.6	16.8	17.1	16.1	13.7	12.9
EBIT margin (%)	19.8	19.1	17.4	16.4	13.1	14.1	13.0	10.7	9.5
PBT margin (%)	20.5	19.6	18.2	16.0	12.6	15.6	14.4	12.4	10.8
PAT growth (YoY %)	12.3	13.3	0.8	(2.5)	(31.3)	7.4	5.4	0.2	15.0

Source: CMIE, Credit Suisse estimates

Figure 37: **Case 6: Revenue growth of 15% YoY**

Revenue growth of 15%	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09E	Jun-09E	Sep-09E	Dec-09E
EBITDA margin (%)	23.4	22.4	20.8	19.6	16.8	18.6	17.7	15.3	14.6
EBIT margin (%)	19.8	19.1	17.4	16.4	13.1	15.7	14.7	12.5	11.3
PBT margin (%)	20.5	19.6	18.2	16.0	12.6	17.3	16.2	14.2	12.8
PAT growth (YoY %)	12.3	13.3	0.8	(2.5)	(31.3)	24.8	23.7	20.7	41.8

Source: CMIE, Credit Suisse estimates

Financials' results outperformed; but are they sustainable?

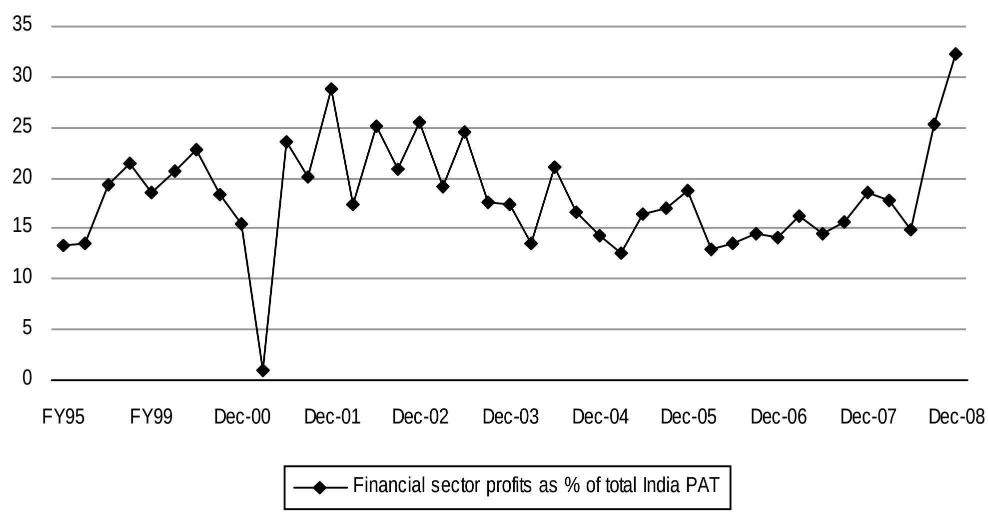
In summary, aggregate net profits could drop further due to the impact of falling revenues on operating leverage as well as non-operating items. However, the real pressure on aggregate earnings is likely to be on account of the financial sector if the recovery does not transpire soon. This is elaborated in the following section.

Financials' profits untenable

The financial sector's profits as a percentage of total had never been higher at 32%. For financials' profits to grow at over 30% YoY while the rest of the corporate world is witnessing a contraction of the same magnitude is unsustainable, in our view. Financials' profits were not just a result of mark-to-market gains on bond portfolio, but strong loan growth, margin expansion and strong fee income also contributed to over 30% net interest income and net profit growth. A likely 250-300 bp decline in interest rates over the next few months could lead to substantial margin pressure. Government banks' bottom-lines could see more pressure as their asset-liability mismatches are larger. A loan demand deceleration and weaker fee growth are likely the other outcomes of a weak economic environment. Most importantly, it is unlikely that NPLs and provision ratios could remain near all-time low levels in this environment despite regulatory forbearance. Risk for earnings (FY03/10E) is a significant 15-90%, on sensitivity of 200 bp higher NPLs. We remain UNDERWEIGHT on the sector and expect it to be the main contributor to depressed FY10E earnings.

Last shoe to drop? Financials' earnings growth is unsustainable given what is happening in the rest of real economy

Figure 38: **Financial sector's profits, currently at record high, will likely face more pressure**



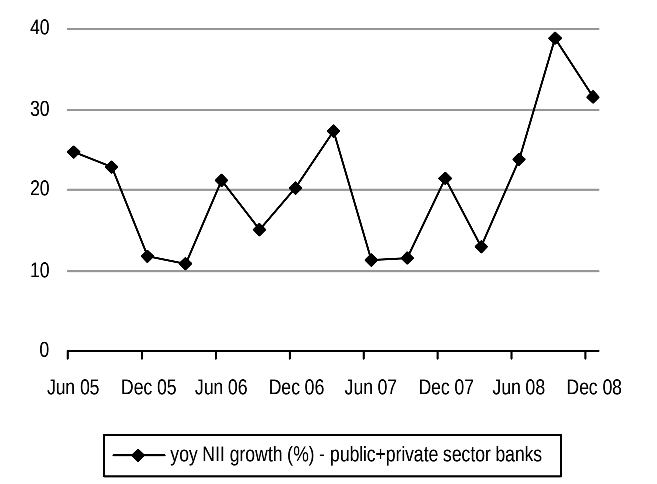
Source: CMIE, Credit Suisse estimates

Strong loan growth, strong fee and non-interest income led to significant profit growth in 3Q …

Results for the financial sector clearly stand out. In contrast to a 30% decline in others' profits, financials saw 30% growth YoY. This was driven by 1) strong loan growth, particularly for the public sector banks, 2) margin expansion due to banks' pricing power in a tight liquidity environment, 3) gains on bond portfolio, 4) strong fee income, again particularly for the public sector banks, and 5) lower-than-expected delinquencies in many cases.

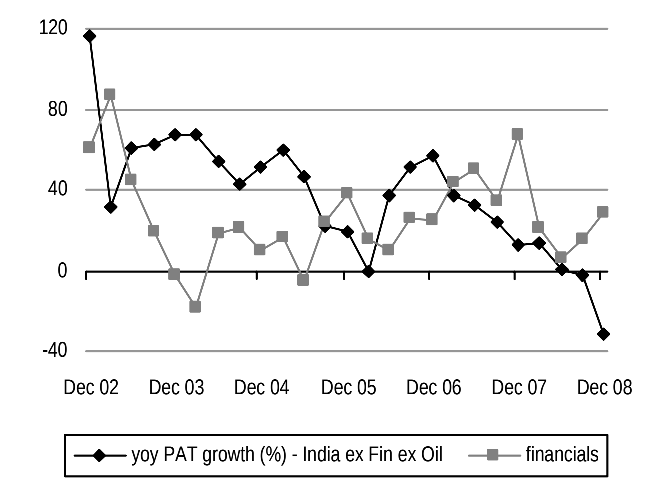
Financials' profits went up 30% YoY in 3Q compared with similar declines for others

Figure 39: NII growth continues to be strong



Source: Credit Suisse estimates

Figure 40: The only sector to have shown significantly positive profit growth

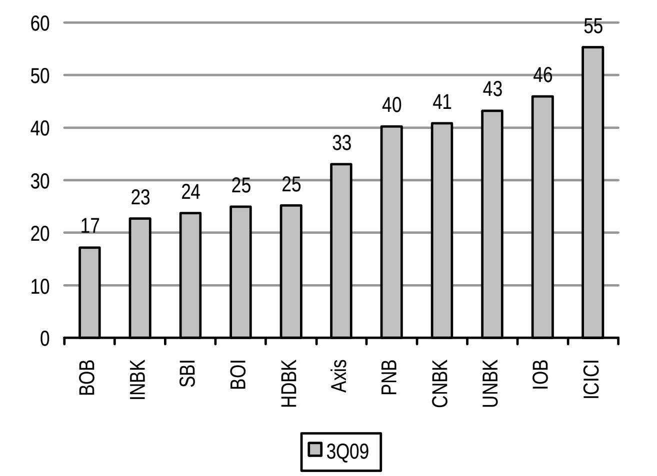


Source: CMIE, Credit Suisse estimates

Treasury incomes could continue to be strong for at least another quarter as interest rates will likely decline further and not all banks have completely booked the unrealised gains on their bond portfolios. Moreover, at March-end, banks can shift their HTM portfolios to AFS and book gains.

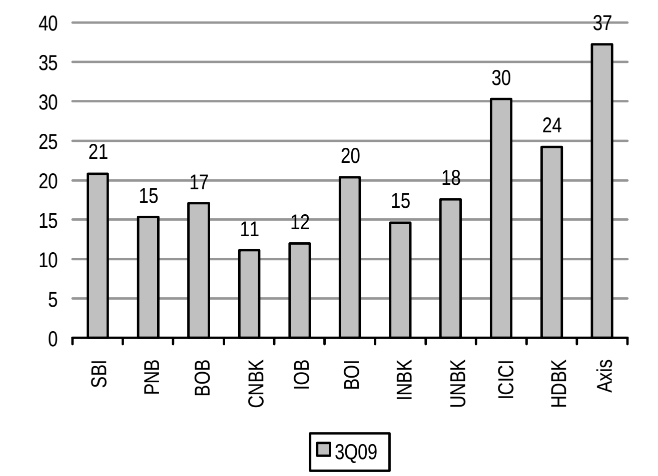
Treasury income could remain strong for one more quarter

Figure 41: Treasury income (including write-back on depreciation on investment) as a percent of PBT



Source: Company data, Credit Suisse estimates

Figure 42: Core fee income (CEB + exchange) as a percent of PBT

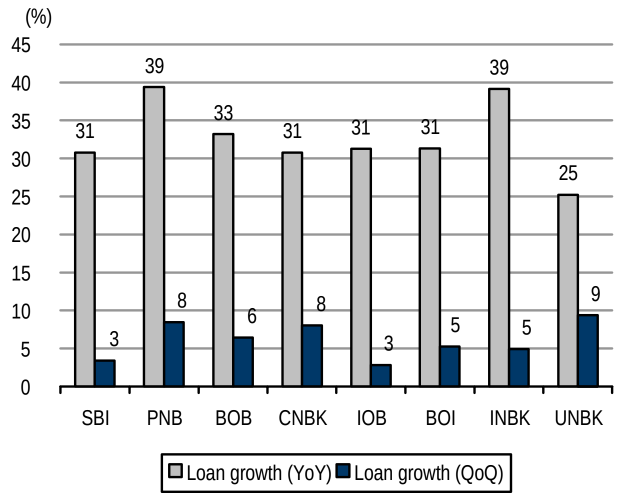


Source: Company data, Credit Suisse estimates

3Q results also showed a divergence in the performance of public and private sector banks. While public sector banks had strong growth, modest asset quality deterioration and rising margins, hardly suggesting a weak economic environment, private banks' loan books contracted QoQ, asset quality deteriorated significantly and margins were flat-to-negative.

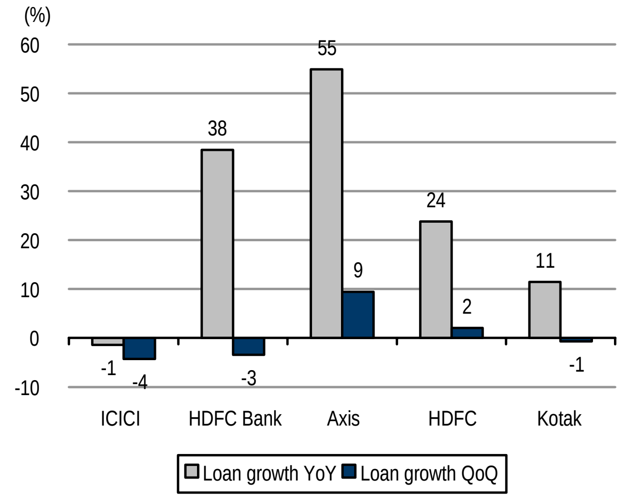
Government banks in particular delivered strong 3Q results

Figure 43: **Loan growth of 3-9% QoQ for public sector banks …**



Source: Company data, Credit Suisse estimates

Figure 44: **… even as average QoQ loan growth for private banks fell to -2%**



Source: Company data, Credit Suisse estimates

… but unlikely to be sustained in the next few quarters

However, this trend is unlikely to continue for too long. We expect financials' profits to come under significant pressure from hereon despite potentially more gains on the bond portfolio. Our concerns are on several fronts:

1) We expect a 250-300 bp decline in interest rates over the next few months which could lead to huge pressure on margins in the next 12-18 months. Government banks are likely to see more pressure as their asset-liability mismatches are larger.

A 250-300 bp decline in interest rates could lead to huge pressure on margins

2) We expect loan demand to be significantly weaker and drive weaker fee growth for government banks. Fee income for private banks should also remain slow due to weak markets.

Fee income likely to worsen materially for government banks

3) Most importantly, asset quality risks are much more imminent. Despite strong loan growth, NPLs remain at historic lows which are unlikely to be sustained. While restructuring could push back reported NPLs, we believe the market would de-rate reported earnings and book value. We continue to expect significant increases in NPLs for the Indian banks over the next two-three years. Risk for earnings (FY03/10) is a significant 15-90%, on sensitivity of 200 bp higher NPLs.

Asset quality risks are the biggest concern

FY10 estimates still off by 25%

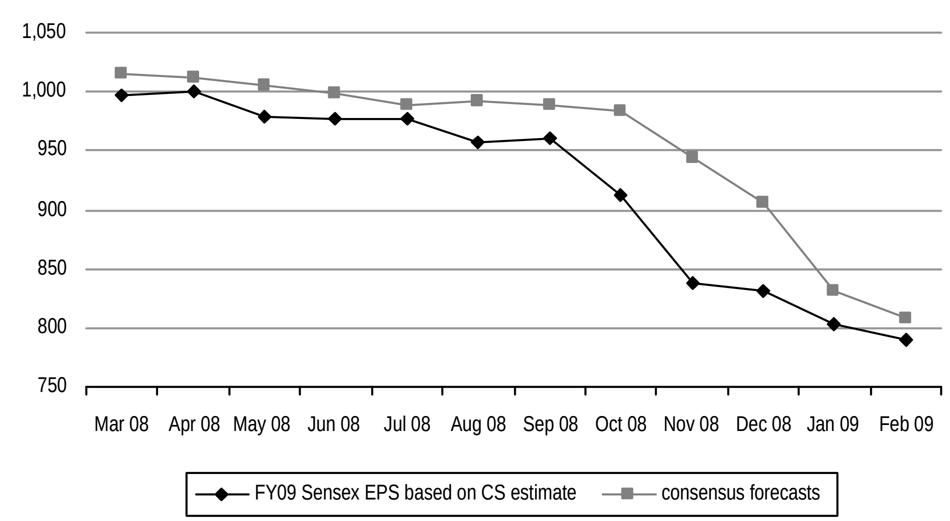
Since November, estimates for Sensex's earnings for FY09 have been down more than 15% and for FY10 nearly 25%. While we had been expecting declines in consensus estimates, the magnitude was a surprise. Yet the downgrades are far from over, in our view. With revenue decelerations likely to continue, YoY PAT declines of as much as 30-40% in some quarters in the next year cannot be ruled out. This means at least another 20-25% downside to current FY10 estimates and possibly Sensex EPS of between 600 and 700, and the market's ROE falling to low teens for FY10E. Will this matter to the market? We think the market will begin to trade at a low P/E on FY10E EPS (i.e., Sensex below 7000) only if the hopes of medium-term or FY11E EPS growth vanish. If economic growth returns, the prospects of near 40-50% EPS growth in FY11E will help investors ignore the current year's numbers. Essentially, we deem a sharp decline in FY10 EPS forecast as inevitable but not an attendant fall in equity indices.

Another 20-25% downside is likely to current FY10 estimates and possibly Sensex EPS of below 700. However, Sensex will trade below 7000 on such low FY10E earnings only if the hopes of FY11E sharp EPS growth are dashed – something which is not given

Unprecedented capitulation in consensus estimates over the last two months

The last couple of months have witnessed sharp declines in consensus earnings estimates for both FY09 and FY10. Since November, estimates for Sensex's earnings for FY09 have been down more than 15% and for FY10 nearly 25%. While we had been expecting declines in analysts' estimates, the magnitude was a surprise. Disappointing earnings season and overall growth deterioration – from both economic data points and anecdotal evidences from companies – may have acted as triggers for these downgrades, in our view.

Figure 45: **FY09E earnings capitulation has been happening over the last few months**



Source: Bloomberg, Credit Suisse estimates

Sharp declines in consensus estimates over the last two months …

Figure 46: Earnings for Credit Suisse versus consensus by calendar year

	12-m fwd	Trailing	EPS growth (%)			P/E (x)		
Index	P/E	P/B	CY07	CY08	CY09	CY07	CY08	CY09
MSCI India	10.2	2.1	20.2	-4.9	11.2	10.0	10.5	9.4
Sensex – CS	10.9	2.1	29.9	1.1	4.2	11.6	11.4	11.0
Sensex – consensus	11.1	2.1	29.8	2.2	1.8	11.6	11.3	11.1
Nifty – CS	11.0	2.1	29.2	3.7	8.6	11.5	11.1	10.2
Nifty – consensus	11.1	2.1	29.4	2.9	3.9	11.5	11.1	10.7
CS India	9.2	2.2	26.7	3.2	5.7	10.1	9.8	9.3

Source: Bloomberg, Datastream, Credit Suisse estimates

Figure 47: Earnings for Credit Suisse versus consensus by fiscal year

	Earnings growth (%)			P/E			Earnings integer (EPS)		
Index	FY08	FY09	FY10	FY08	FY09	FY10	FY08	FY09	FY10
Sensex – CS	27.3	(7.3)	11.6	10.9	11.8	10.6	851	789	881
Sensex – consensus	27.4	(5.5)	5.2	10.9	11.5	10.9	855	808	850
Nifty – CS	25.9	(0.3)	12.0	10.9	10.9	9.7	262	261	292
Nifty – consensus	25.8	(3.1)	6.3	10.9	11.2	10.6	261	253	269

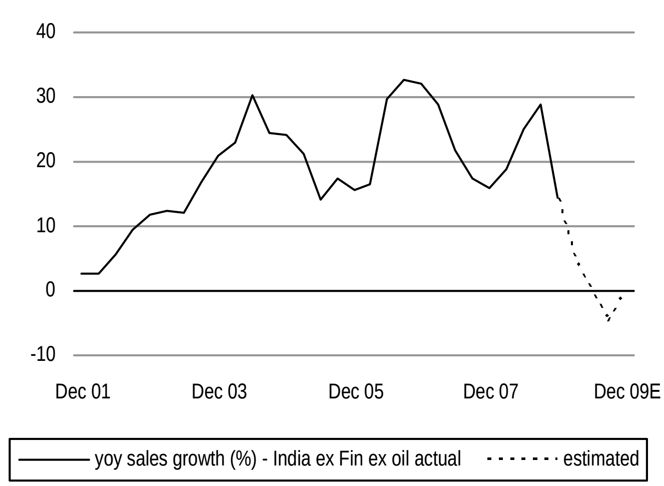
Source: Bloomberg, Datastream, Credit Suisse estimates

FY10E Sensex EPS could come down to below 700

… but more downgrades are likely

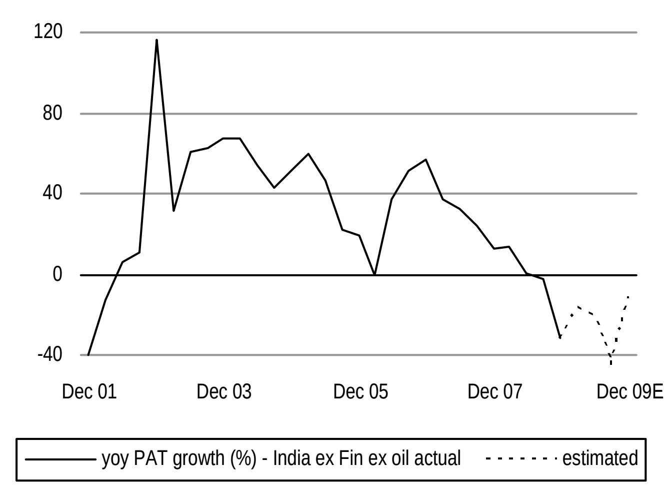
Nevertheless, more downgrades are likely. Our expectation of flat-to-negative revenue growth over the next few quarters implies profits in FY10 are likely to be down ~ 20% from FY09. We feed some of the assumptions described in above sections in our top-down estimates to conclude that final Sensex EPS of less than 700 for FY10E cannot be ruled out. The impact could be more on the Sensex than other broader universes as the index is more heavily skewed towards financials, where we see larger potential downsides in earnings.

Figure 48: Sales growth could remain flat or in negative territory for the next few quarters



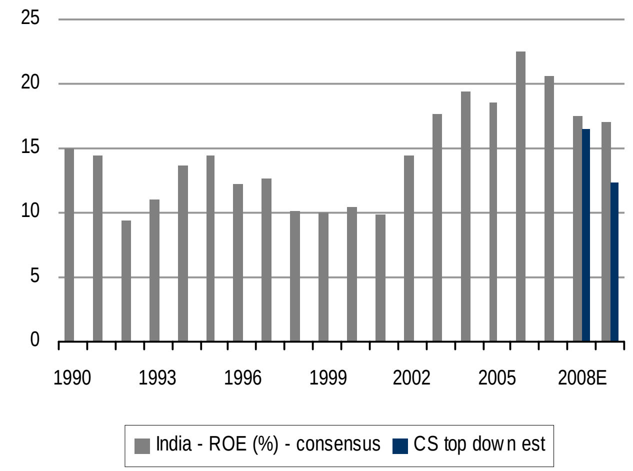
Source: CMIE, Credit Suisse estimates

Figure 49: Attendant impact on profits suggest a significant potential downside to current FY10 estimates



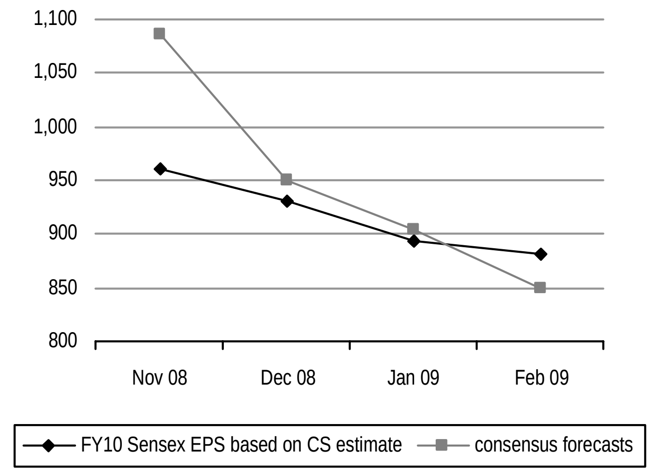
Source: CMIE, Credit Suisse estimates

Figure 50: **ROEs likely to revert to 12-13% in 2009, still above the historic low of 10% in 1998-2001**



Source: CMIE, Credit Suisse estimates
Note: All years are calendar years

Figure 51: **FY10E Sensex EPS could be below 700**



Source: Bloomberg, Credit Suisse estimates

Sensex is stable for now, but prefer quality and UNDERWEIGHT banks

Earnings downgrades will happen but unlikely to be immediately

The key question for investors should be how much will FY10E earnings matter? Based on the arguments above, we feel that almost irrespective of the timing of the next economic upcycle, FY10E EPS is likely to be far below the current projections of bottom-up analysts. That said, it must be noted that just like what happened in the case of FY09 earnings forecasts, the steepest of the downgrades for FY10E too are likely to be later towards the end of the year rather than now.

FY10E earnings cuts amid optimism/pessimism for FY11 will decide whether Sensex will ever trade at a low multiple on depressed FY10E EPS

So, if the recovery is already underway while FY10 EPS forecast is being reduced from around 800 to less than 700, chances are that the Sensex would never have the reason to trade at bottom of the cycle P/E of 10 or so times FY10E EPS. Conversely, if the downgrades happen at a time when FY11 prospects too turn bleak, just like what happened recently, both the first and second year earnings forecasts could be cut simultaneously with the market downside rising materially.

We maintain our current, pre-election Sensex target of 9000 and reassert that the better time to take a view on how material these near-term earnings are and how sharp and quick the next phase of recovery is going to be will be immediately after the elections and with the formation of the new government. Sectorally, however, one way or the other, the high base of financials implies weak relative prospects for the sector in the quarters to come.

Appendix: India quarterly P&L

Figure 52: **India quarterly P&L**

	India ex Financials with oil					India ex Financials ex oil				
India P&L	**Dec-07**	**Mar-08**	**Jun-08**	**Sep-08**	**Dec-08**	**Dec-07**	**Mar-08**	**Jun-08**	**Sep-08**	**Dec-08**
Revenue from operations	94.1	94.2	93.4	94.7	94.4	96.0	96.0	96.2	97.2	96.4
YoY growth (%)	15.6	24.3	33.9	37.9	11.1	15.7	18.7	24.9	28.8	14.3
RM cost	58.2	61.2	65.3	65.8	57.9	46.1	47.8	48.9	47.1	47.2
Inventory change	1.1	(1.0)	(2.8)	(1.9)	3.3	0.4	(1.3)	(2.1)	(1.6)	(0.6)
Gross margin (%)	37.0	36.2	33.0	32.6	35.1	51.6	51.6	51.4	53.2	51.6
YoY growth in contribution	16.3	15.6	13.7	15.6	5.4	18.8	22.4	24.0	32.6	14.4
Salaries and wages	5.7	5.8	5.7	5.5	6.1	8.5	8.5	8.9	8.8	8.9
YoY growth (%)	21.4	18.1	30.3	26.7	26.1	22.7	25.5	25.4	28.2	21.3
Other expenses	12.1	14.2	13.3	15.8	16.7	18.6	19.5	20.5	23.8	24.7
YoY growth (%)	19.0	28.0	41.4	54.6	36.9	21.7	27.3	34.4	53.5	37.8
Operating margin	18.1	15.0	12.7	10.1	11.0	23.4	22.4	20.8	19.6	16.8
Operating profit YoY growth	12.0	0.1	(15.3)	(28.0)	(32.8)	14.2	15.4	9.6	8.0	(17.9)
Depreciation	3.1	3.2	2.8	2.6	3.3	3.5	3.2	3.3	3.1	3.6
YoY growth (%)	10.4	15.9	18.5	12.7	14.3	19.4	12.1	13.4	12.9	11.1
EBIT margin from operations	14.8	11.6	9.7	7.3	7.5	19.8	19.1	17.4	16.4	13.1
YoY growth (%)	12.6	(4.4)	(20.4)	(37.5)	(48.9)	14.3	16.8	7.4	4.5	(34.8)
Interest cost	1.5	1.6	1.5	1.9	2.6	2.1	2.1	2.1	2.5	3.0
Interest cover	12.7	10.3	10.2	6.3	4.7	10.6	10.2	9.5	7.4	5.2
YoY growth (%)	35.0	43.9	47.2	87.3	93.2	41.5	48.4	39.2	66.8	61.6
Other and extra-ordinary income	5.9	5.8	6.6	5.3	5.6	4.0	4.0	3.8	2.8	3.6
PBT margin	18.1	14.7	14.1	10.2	9.6	20.5	19.6	18.2	16.0	12.6
YoY growth (%)	21.1	0.6	2.6	(28.8)	(46.3)	13.4	15.3	0.4	(4.8)	(39.8)
PAT margin	10.8	8.6	8.1	5.3	5.8	12.4	11.5	10.9	9.9	7.5
YoY growth (%)	23.1	7.2	2.5	(36.7)	(40.0)	12.3	13.3	0.8	(2.5)	(31.3)

Note: numbers are as a % of total revenue (including other income and exceptional income) unless specified otherwise

Source: Credit Suisse estimates

Disclosure Appendix

Important Global Disclosures

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**The industry average refers to the average total return of the relevant country or regional index (except with respect to Europe, where stock ratings are relative to the analyst's industry coverage universe).*

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Overweight: Industry expected to outperform the relevant broad market benchmark over the next 12 months.

Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

Underweight: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

**An analyst's coverage universe consists of all companies covered by the analyst within the relevant sector.*

***The broad market benchmark is based on the expected return of the local market index (e.g., the S&P 500 in the U.S.) over the next 12 months.*

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CREDIT SUISSE (Hong Kong) Limited
Asia/Pacific: +852 2101-6000