

23 August 2008 | 11 pages

# India Equity Strategy

## Earnings Growth: 20% No More

- Down she goes – 17% for now** — There's been much skepticism on India's '20%-as-usual' Sensex earnings growth estimates for FY09. Well, the first earnings growth hurdle has been hit — post results revisions, it's down to 16.9%. Will India's earnings growth hold its wobbly stride or stumble? (Olympics-speak: a few things are actually looking up in India – not just rates and inflation, but 3 medals, a first.) The jury remains out on earnings (and medals too), though risks remain high.
- At the broader level too, more downgrades** — Broader CIR universe (146) growth also steps down over the quarter: 24% to 20% (some things don't change easily), with 191 downgrades vs. 101 upgrades YTD, and sharper 68/22 down/upgrade ratio since June08. FY10 growth expectations inched up to 14.4% (from 13.3%), which is surprising but likely suggesting analyst adjustments remain more near-term biased (and due to base effect). Earnings growth expectations are now lower than Jan 08, peak of market, and GDP growth forecasts.
- Downgrades concentrated in cyclicals, offsets in commodities** — The Financials, Real estate, Cap goods and Autos dominate the downgrades, while the upgrades (limited and modest in number) are commodity-driven, primarily energy and metals. That's not surprising, though the risk is that analysts are following rising rates and prices, not calling them.
- Macro deterioration ahead of earnings easing...more to come?** — India's macro variables –rates, inflation, currency and Oil– have deteriorated sharply over the year. Earnings growth expectations have however only eased. *Suggests more downside?* Commodity-offsets, possibly more realistic analyst expectations than in Jan 08 (particularly cyclicals impacted by interest rates), should provide cushion. But macro deterioration remains ahead of earnings deterioration. *Possibly yes.*

**Aditya Narain, CFA<sup>1</sup>**

 +91-22-6631-9879  
 aditya.narain@citi.com

**Tirthankar Patnaik<sup>1</sup>**

 +91-22-6631-9887  
 tirthankar.patnaik@citi.com

**Figure 1. Sensex FY09E, FY10E Profit Growth Estimates and Macro Drivers**

Sensex	31-Dec-07	31-Mar-08	3-Jul-08	18-Aug-08	Dec-08E
FY09 Profit Growth	19.06%	20.81%	20.60%	16.87%	
FY09 Median Growth	17.98%	17.84%	20.90%	13.56%	
FY09 Equally Weighted	17.51%	17.06%	16.60%	12.97%	
FY10 Profit Growth	12.86%	10.74%	13.35%	14.45%	
10-year Bond Yield	7.79	7.93	8.83	9.08	9.25-9.50
Inflation	3.83%	7.75%	11.89%	12.63%	11.5-12%
USDINR	39.4055	40.0005	43.1955	43.4875	43.0
Brent (US\$/bbl)	93.9	100.22	145.7	109.9	122

 Source: Citi Investment Research. Sensex composition pre-28<sup>th</sup> July retained to facilitate comparison.

See Appendix A-1 for Analyst Certification and important disclosures.

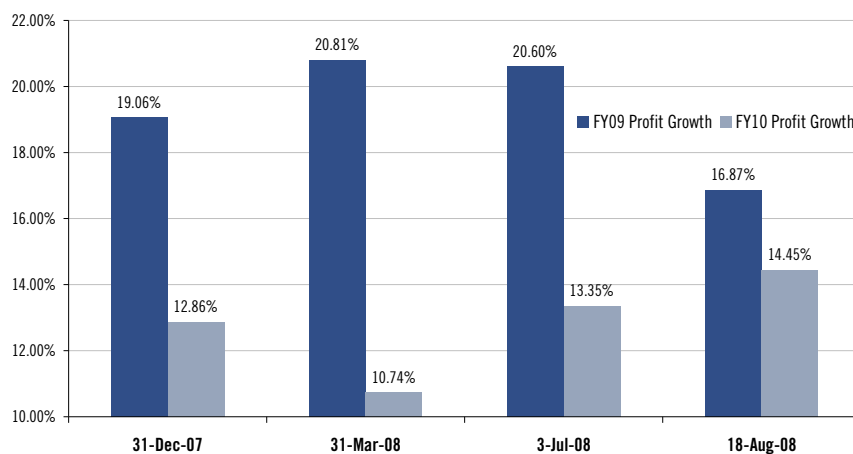
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<sup>1</sup>Citigroup Global Markets India Private Limited

## FY09 Earnings Growth: 20%, No More

The slip is showing...20% growth does not appear to hold, after surprisingly holding out for the first half of the year. The surprise is the rise (albeit small ones) of FY10 earnings growth, due in part to the base effect, possibly the earnings mix, but possibly suggesting analysts remain more focused on the immediate term and not extrapolating changing dynamics into the next year.

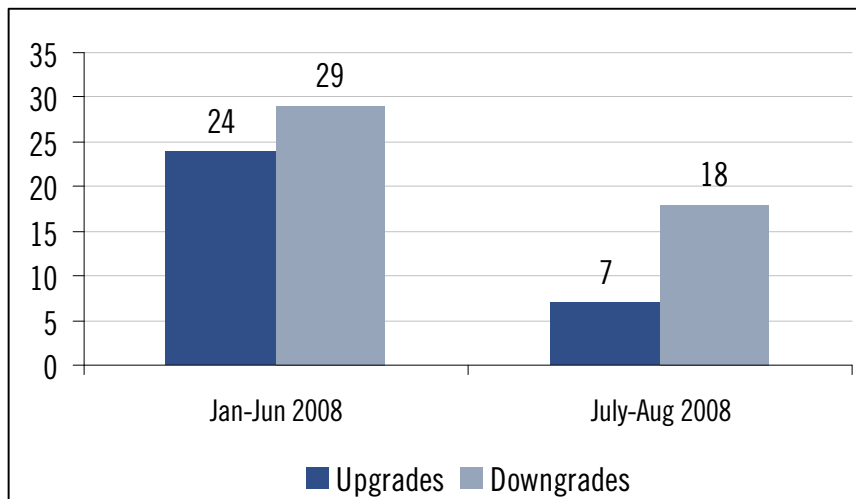
Figure 2. Sensex FY09E and FY10E Profit Growth Estimate (2008YTD)



Source: Citi Investment Research

Downgrade/upgrade ratio rises sharply and is even more pronounced for the wider CIR universe, where it's over 3X (68/22) over the quarter.

Figure 3. Upgrades/Downgrades on Sensex Stocks, 2008YTD



Source: Citi Investment Research

Energy and Oil lessen the earnings moderation. Financials lead the fall-off, followed by other cyclicals impacted by interest rates.

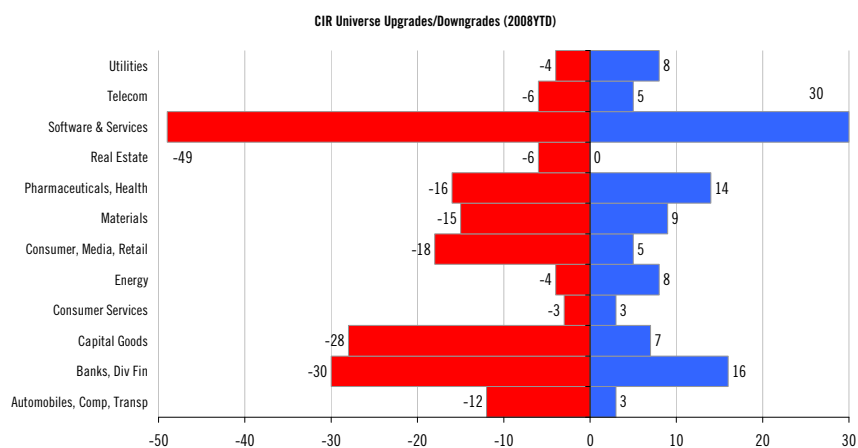
Figure 4. CIR Universe FY09 Earnings Revisions by Sector, 2008YTD

Sector	Cos.	Upgrades	Downgrades	YTD FY09 Revision
Automobiles & Components	9	3	9	-20.2%
Banks	15	15	21	-9.9%
Capital Goods	15	7	28	-17.7%
Consumer Services	4	3	3	-8.6%
Diversified Financials	6	1	9	-24.8%
Energy	11	8	4	3.1%
Food Beverage & Tobacco	4	2	6	-13.0%
Health Care Equipment & Services	2	1	1	-15.0%
Household & Personal Products	4	3	4	9.7%
Materials	13	9	15	5.4%
Media	5	0	6	-14.6%
Pharmaceuticals, Biotech	14	13	15	7.6%
Real Estate	6	0	6	-10.9%
Retailing	2	0	2	-22.5%
Software & Services	16	30	47	-0.6%
Technology Hardware & Equipment	1	0	2	-145.8%
Telecommunication Services	8	5	6	-5.1%
Transportation	2	0	3	-297.9%
Utilities	9	8	4	-1.0%
<b>CIR Universe</b>	<b>146</b>	<b>108</b>	<b>191</b>	<b>-4.2%</b>

Source: Citi Investment Research

Our IT analysts are clearly the most active with earnings revisions, but almost the entire team has been revising down more than up.

Figure 5. CIR Universe FY09E Profit Growth Estimate Revisions by Sector



Source: Citi Investment Research

Energy now contributes over a third of Sensex profit growth. The banks have fallen off sharply and contribute a mere 3%. Autos is the only sector suggesting negative growth, as of now

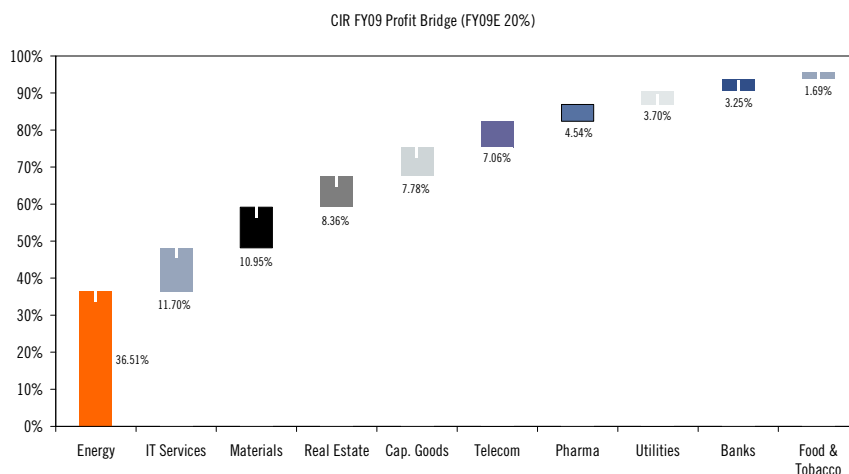
67% of CIR's Universe profit growth is accounted for by 5 sectors – concentrated, but less so than the Sensex, where top 5 sectors account for 85% of profit growth.

Figure 6. Sensex Contribution to FY09 Profits by Sector

Sector	3-Jul-08	18-Aug-08
Autos, Anc, Transportation	-0.2%	-0.8%
Engg., Power, Construction	11.7%	12.1%
Metals, Mining	10.4%	12.6%
Building Materials	-1.8%	3.7%
Consumer, Retail	4.2%	3.6%
Pharma, Healthcare	0.6%	0.2%
IT Services	13.1%	13.3%
Telecom	13.5%	10.9%
Real Estate	6.1%	6.8%
Oil & Gas, Chemicals	30.9%	34.3%
Banks, Financial Services	11.5%	3.3%

Source: Citi Investment Research

Figure 7. CIR Universe FY09E Profit Growth Contribution by Sector



Source: Citi Investment Research

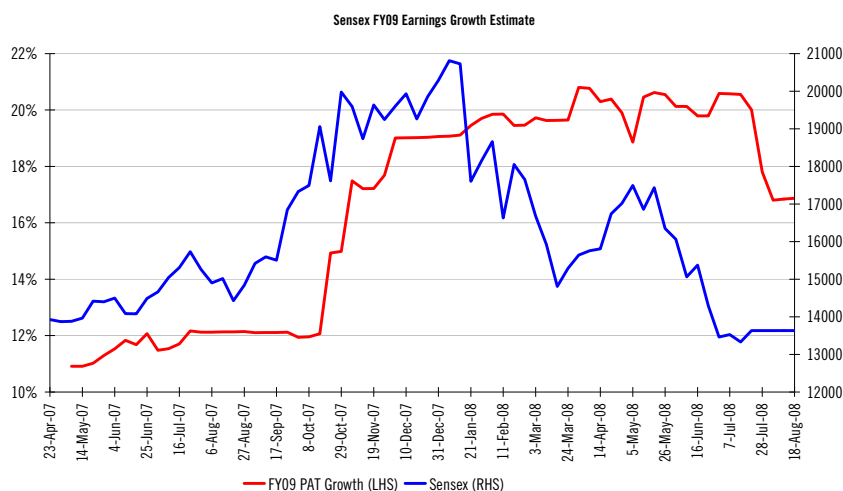
Figure 8. Sensex Profit Revision Analysis, Post-30-Jun 2008

RIC	Company	PAT Upgrades	PAT Downgrades	Adj. PAT Revision	Profit Share 31Dec2007	Profit Share Now	FY09E Earnings Growth Now	FY09E Earnings Growth 31Dec2007
ACC.BO	ACC	0	1	-13.2%	0.8%	0.6%	-21.56%	-18.50%
BHEL.BO	B H E L	1	0	0.9%	2.9%	2.3%	26.77%	32.84%
JAIA.BO	Jaiprakash Assoc	0	0	0.0%	1.0%	0.6%	62.03%	62.03%
BRTI.BO	Bharti Airtel	1	0	0.6%	5.8%	5.8%	26.78%	29.58%
CIPL.BO	Cipla	0	0	0.0%	0.4%	0.5%	3.52%	8.26%
ABUJ.BO	Ambuja Cem.	0	1	-15.3%	0.9%	0.7%	-21.57%	-11.76%
GRAS.BO	Grasim Inds.	0	1	-7.0%	1.2%	1.1%	-18.08%	-8.36%
HALC.BO	Hindalco Inds.	0	0	0.0%	1.2%	2.3%	45.49%	-19.12%
HDBK.BO	HDFC Bank	0	0	0.0%	1.4%	1.6%	44.62%	30.54%
HLL.BO	Hind. Unilever	0	0	0.0%	1.4%	1.7%	na	16.95%
MAHM.BO	M & M	0	1	-24.8%	0.7%	0.6%	-9.43%	10.18%
ICBK.BO	ICICI Bank	0	1	-29.5%	3.8%	2.3%	-17.27%	34.47%
INFY.BO	Infosys Tech.	1	2	-0.7%	3.6%	4.0%	24.85%	18.54%
ITC.BO	ITC	0	1	-6.6%	2.7%	2.3%	10.81%	21.97%
LART.BO	Larsen & Toubro	0	0	0.0%	1.9%	1.9%	35.67%	40.06%
MRTI.BO	Maruti Suzuki	0	1	-7.6%	1.3%	1.2%	-0.12%	14.44%
NTPC.BO	NTPC	0	0	0.0%	5.9%	6.1%	11.47%	11.47%
ONGC.BO	O N G C	0	0	0.0%	16.4%	17.0%	13.24%	13.24%
RANB.BO	Ranbaxy Labs.	0	1	-12.9%	0.6%	0.6%	7.13%	10.62%
DLF.BO	DLF Ltd	0	0	0.0%	6.5%	6.4%	20.24%	42.83%
RELI.BO	Reliance Inds.	0	0	0.0%	12.5%	13.5%	34.30%	31.95%
RLCM.BO	Reliance Comm	0	1	-13.8%	4.4%	4.3%	13.72%	25.35%
RLIN.BO	Reliance Energy	0	1	-24.6%	0.8%	0.7%	1.70%	13.82%
SATY.BO	Satyam Computer	0	2	-0.3%	1.3%	1.5%	31.04%	20.73%
SBI.BO	St Bk of India	0	1	-7.0%	4.2%	4.7%	1.84%	18.07%
TAMO.BO	Tata Motors	1	0	3.4%	1.7%	1.0%	-6.62%	12.83%
TCS.BO	TCS	0	1	-3.4%	3.9%	3.8%	12.69%	16.44%
TISC.BO	Tata Steel	2	1	2.9%	6.4%	6.4%	21.56%	na
WIPR.BO	Wipro	1	1	-1.1%	2.7%	2.7%	24.74%	23.90%
	<b>Sensex</b>	<b>7</b>	<b>18</b>	<b>-3.5%</b>	<b>100.0%</b>	<b>100.0%</b>		

Source: Citi Investment Research. Upgrades/Downgrades, and Profit Revisions are after 30<sup>th</sup> June 2008. Sensex composition is kept unchanged to enable comparison with earlier revisions.

Market falls now accompanied with earnings growth fall, unlike in the previous big Feb08 market fall.

Figure 9. Sensex and FY09E Profit Growth Estimate over Fiscal 2008



Source: Citi Investment Research

Are our target price multiple contractions leading or lagging earnings growth revisions?

Figure 10. CIR Universe Revisions in Target and FY09E Earnings Multiples, Then And Now

Sector	Cos.	Then (31-Dec-07)		Now (18-Aug-08)		Then	Now	Then	Now
		Actual FY09E PE	Target FY09E PE	Actual FY09E PE	Target FY09E PE	31-Dec-07 Upside	18-Aug-08	31-Dec-07 FY09E Earnings Growth	18-Aug-08
Automobiles & Components	9	15.3	16	11.8	13	2.3%	12.5%	16.6%	2.4%
Banks	15	21.4	20	14.4	17	-4.5%	16.0%	24.6%	4.7%
Capital Goods	15	28.4	31	24.4	30	8.1%	22.3%	35.2%	33.4%
Consumer Durables & Apparel		17.2	16			-6.3%		33.0%	
Consumer Services	4	19.0	19	13.0	14	-0.7%	6.8%	15.3%	17.0%
Diversified Financials	6	23.9	18	13.4	13	-25.5%	-0.3%	38.9%	35.5%
Energy	11	15.6	15	12.0	15	-2.3%	28.9%	28.4%	28.0%
Food Beverage & Tobacco	4	19.1	20	21.2	25	4.7%	15.7%	28.0%	14.9%
Health Care Equipment & Services	2	46.3	51	44.1	49	10.2%	10.5%	227.9%	948.8%
Household & Personal Products	4	19.8	23	20.8	23	17.3%	9.1%	17.0%	21.7%
Materials	13	13.8	12	7.9	10	-11.7%	24.3%	5.5%	16.6%
Media	5	29.1	28	24.0	28	-3.3%	17.8%	29.8%	13.8%
Pharmaceuticals, Biotech	14	16.8	18	16.9	20	5.7%	16.7%	21.2%	25.1%
Real Estate	6	18.6	16	8.7	10	-12.8%	15.5%	51.4%	29.1%
Retailing	2	46.7	35	30.3	42	-24.1%	37.7%	29.6%	32.7%
Software & Services	16	17.5	20	14.7	16	15.6%	8.4%	20.9%	24.7%
Technology Hardware & Equipment	1	11.2	13	(8.0)	(9)	19.2%	11.9%	149.5%	-2.0%
Telecommunication Services	8	23.6	27	17.7	23	13.5%	28.4%	21.0%	18.9%
Transportation	2	20.2	16	(5.3)	(5)	-21.4%	-0.9%	127.7%	-3.1%
Utilities	9	23.5	20	16.8	22	-17.0%	29.8%	12.0%	10.6%
<b>CIR</b>	<b>146</b>	<b>19.0</b>	<b>19</b>	<b>13.9</b>	<b>17</b>	<b>-0.3%</b>	<b>21.4%</b>	<b>24%</b>	<b>20%</b>

Source: Citi Investment Research

CIRs stock recommendations have clearly become more cautious over the year ... cautious enough?

Figure 11. CIR Universe Recommendation Changes, 2008YTD

Sector	31-Dec-07			18-Aug-08		
	Buy	Hold	Sell	Buy	Hold	Sell
Automobiles & Components	4	2	2	3	4	2
Banks	10	5	1	9	2	5
Capital Goods	12	1	2	10	1	4
Cons. Durables & Apparel	3	0	2			
Consumer Services	2	0	1	1	0	2
Diversified Financials	1	0	3	0	0	4
Energy	5	1	3	6	0	3
Food Beverage & Tobacco	5	0	3	3	0	1
Health Care Equip & Serv	2	0	0	1	0	1
Household & Pers. Products	5	0	0	2	2	0
Materials	9	1	6	6	1	5
Media	4	1	2	4	1	1
Pharma, Biotech	9	0	6	11	1	3
Real Estate	3	0	3	1	1	4
Retailing	1	0	1	0	0	2
Software & Services	12	0	5	6	2	8
Tech. Hardware	0	0	1	0	0	1
Telecom Services	2	3	2	3	3	2
Transportation	1	0	1	1	0	1
Utilities	7	0	2	9	1	0
<b>CIR</b>	<b>97</b>	<b>14</b>	<b>46</b>	<b>76</b>	<b>19</b>	<b>49</b>
<b>Buy-Sell</b>	<b>61%</b>	<b>9%</b>	<b>29%</b>	<b>52%</b>	<b>13%</b>	<b>34%</b>

Source: Citi Investment Research

Macro has been challenging. We largely hold the middle ground for the year ahead.

**Figure 12. Macro Environment Remains Challenging**

Factor	31-Dec-07	18-Aug-08	Dec-08
10-year Bond Yield	7.79	9.08	9.25-9.50
Inflation	3.83%	12.44%	11.5-12%
USDINR	39.4055	43.4875	43
Crude Oil (\$)	60	119	122

Source: Citi Investment Research

A lot has changed since the beginning of the year.

**Figure 13. Sensex Valuation Summary @14544 (20-Aug-2008)**

Year to 31 March	FY05	FY06	FY07	FY08E	FY09E	FY10E
EPS growth (%)	36.5%	18.9%	40.5%	31.6%	18.2%	14.4%
P/E (x)	36.2	30.4	21.7	16.5	13.9	12.2
Div. yield (%)	1.0%	1.0%	1.1%	1.4%	1.6%	1.8%
P/B (x)	6.8	5.8	4.5	3.4	2.9	2.4
ROAE (%)	24.3%	23.6%	25.9%	24.6%	22.4%	21.6%
EV/EBITDA* (x)	21.5	19.0	13.8	11.2	9.4	9.0
Net Debt/Equity* (%)	12.3%	14.4%	10.2%	7.4%	3.4%	0.3%
EPS growth ex-oil (%)	31.4%	23.2%	47.6%	33.2%	19.2%	18.5%
P/E ex-oil	43.0	34.9	23.6	17.7	14.9	12.6

Source: Citi Investment Research. Sensex Composition is current, i.e., includes changes of 28<sup>th</sup> July.

## Appendix A-1

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