

November 26, 2009

Research
India

India Strategy

Seven Themes for 2010

Key Debate: Investors are looking at several headwinds for equity markets in 2010 – the DXY trade seems to be a consensus one, a lot of the coming growth acceleration seems to be priced in, inflation is likely to rise and cause tightening, whereas equity valuations appear middling.

Amidst these concerns, and since leading indices have more than doubled in less than nine months, we ask – where is alpha going to come from in 2010?

These seven themes are our highest conviction ideas for 2010:

- Buy SOE Banks
- Shift Bias from Rural to Urban Plays
- Avoid Technology
- Buy Mid-caps
- Buy Energy
- Stock Picking Could be in Vogue in 2010, Market to be Driven by Earnings
- Buy Industrials

MORGAN STANLEY RESEARCH

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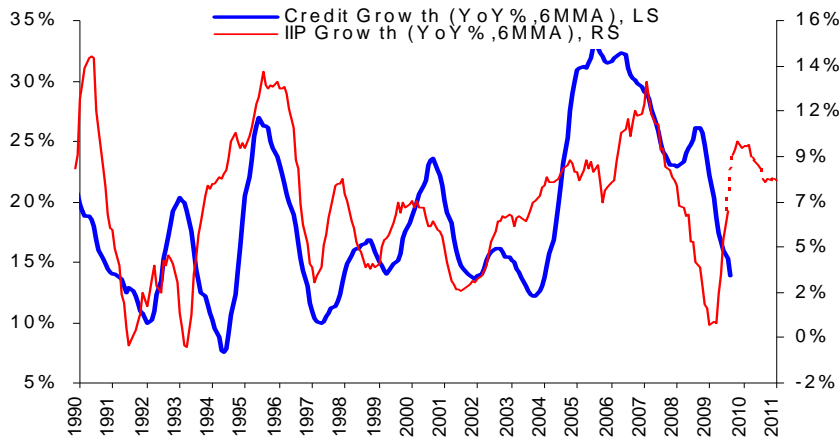
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Seven Themes for 2010

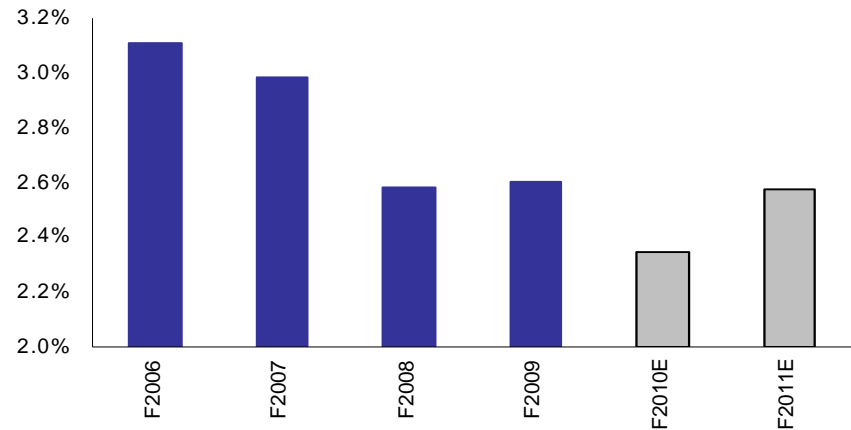
- **I: Buy SOE Banks:** The Central Bank is likely to start raising rates in January 2010. Rising rates favor Indian banks as they run a maturity mismatch on their balance sheets (liabilities have a longer maturity). Thus NIMs will rise; coupled with acceleration in loan growth (which trails IIP growth), this will help earnings. The stocks of SOE banks trade at better valuations than their private sector counterparts and SOE banks will also be helped by a declining fiscal deficit, which will likely cap long bond yields. Our favorite stock is SBI (SBIN IN, Rs2305)
 - **II: Avoid Technology:** Tightening by the Central Bank will put upward pressure on the rupee with negative consequences for technology stocks. Tech stocks have done particularly well over the past six months and also suffer on a relative basis in an accelerating domestic growth environment. Tech stocks correlate negatively with INR.
 - **III: Buy Energy:** Energy, especially Reliance Industries, has delivered its worst relative performance ever on a trailing-six-months basis. The sector correlates positively with crude oil, short-term yields (read: local inflation) and industrial production. Thus it provides a hedge against a spike up in crude oil prices.
 - **IV: Buy Industrials:** Acceleration in industrial growth will help close the output gap faster than what is possible in the price right now. This will help a new private capex cycle to start in 2010 and further boost performance of industrials. Our favorite stock: Larsen & Toubro (LT IN, Rs1648).
 - **V: Shift Bias From Rural to Urban Plays:** No doubt rural growth remains very strong, helped by rising food prices and government spending. Yet at the margin, urban growth will close the gap vs. rural growth as industrial activity picks up. Two-wheeler and large cap staple stocks tend to correlate negatively with industrial growth and should be avoided in 2010. In contrast, media and niche mid-cap staples may still perform well.
 - **VI: Buy Mid-caps:** The broader market is likely to generate faster earnings growth of around 25% in 2010, trades at better valuations than the narrow market, and accordingly could outperform the narrow market. See our Mid-cap picks on page 10.
 - **VII: Stock Picking Could be in Vogue in 2010, Market to be Driven by Earnings:** A high market effect, high sector correlation and middling micro factors such as valuation, fundamental and return dispersion sets us up for a better stock picking environment in 2010. Most of the market returns in 2009 have come from a PE rerating, and as the key driver of returns shifts to earnings in 2010, so will the key driver of stock prices from macro to idiosyncratic stock related factors.
 - **Sector Portfolio Changes:** We add 100 bps each to Financials and Energy, funding this by reducing consumer discretionary and technology by similar amounts. Consumer discretionary has been the best performing sector over the past two years; we think most of the growth story is in the price. We are now overweight Energy, Financials and Industrials and underweight Healthcare, Materials, Technology and Utilities.
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Theme #1 : Buy SOE Banks

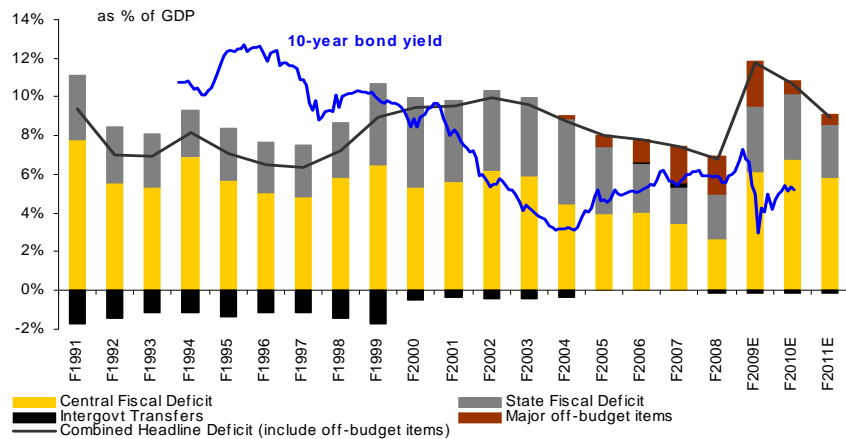
Credit Growth Likely to Recover in 2010



Net Interest Margins Likely to Expand

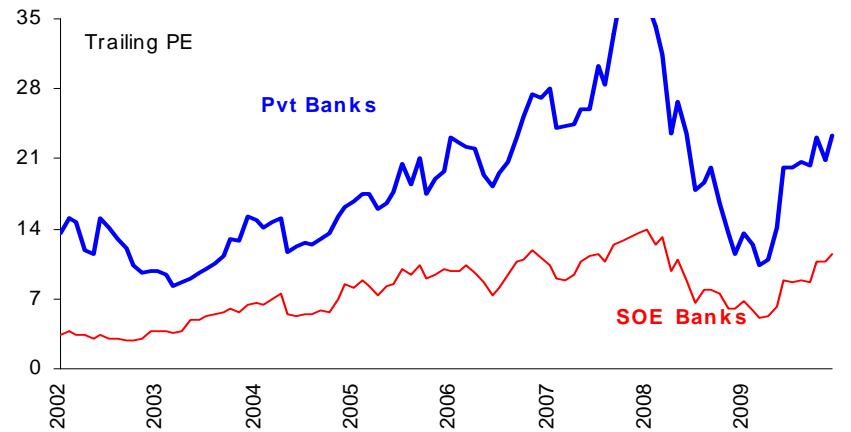


Fiscal Deficit Decline Likely to Cap Long Bond Yields



The off-budget items include expenditure on food, fertilizer, oil and waiver of farm loans. We have included the full amount of farm loan waiver in the year in which the expenditure has been incurred i.e. F2009. The government has planned to amortize the cost over the period of four financial years. E= Morgan Stanley Research estimates

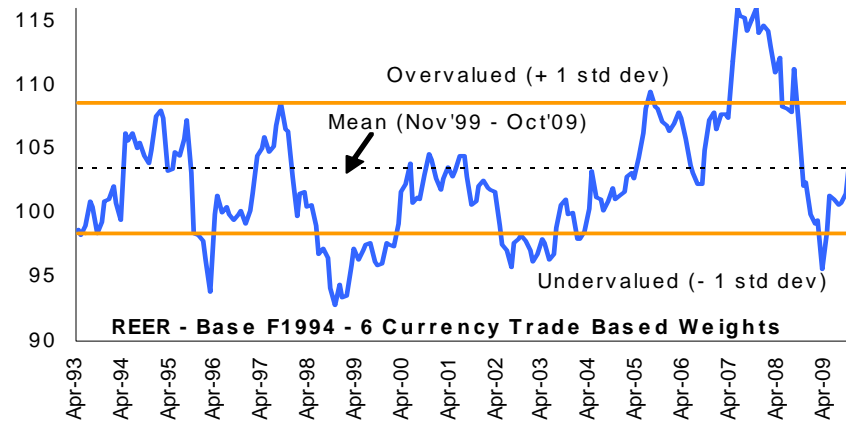
PSU Banks: Better Valuations



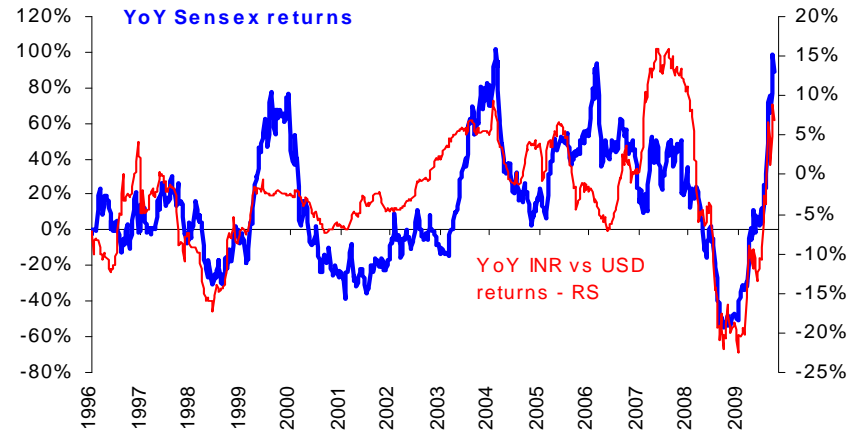
Source: RBI, E: Morgan Stanley estimates, Morgan Stanley Research

Theme #2 : Avoid Technology

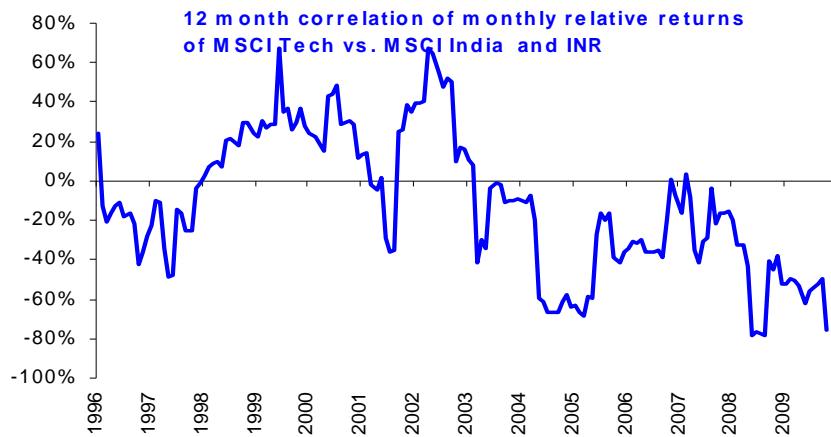
INR: An Appreciation Bias Likely in 2010



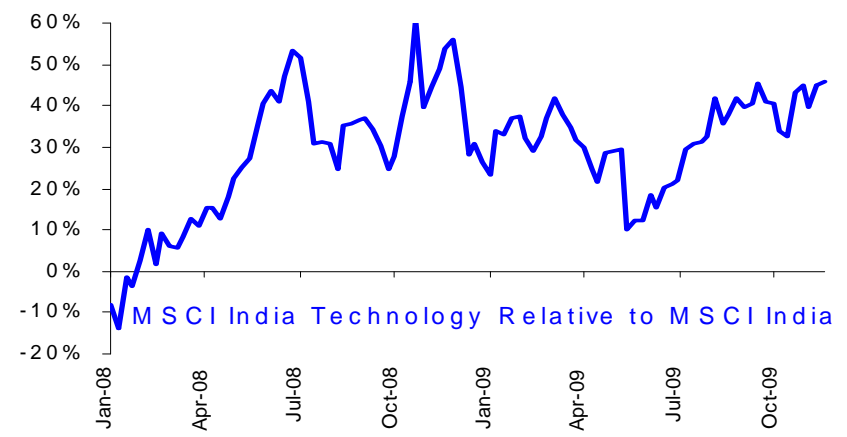
Equities and INR Positively Correlated



Tech Sector Correlates Negatively with the INR



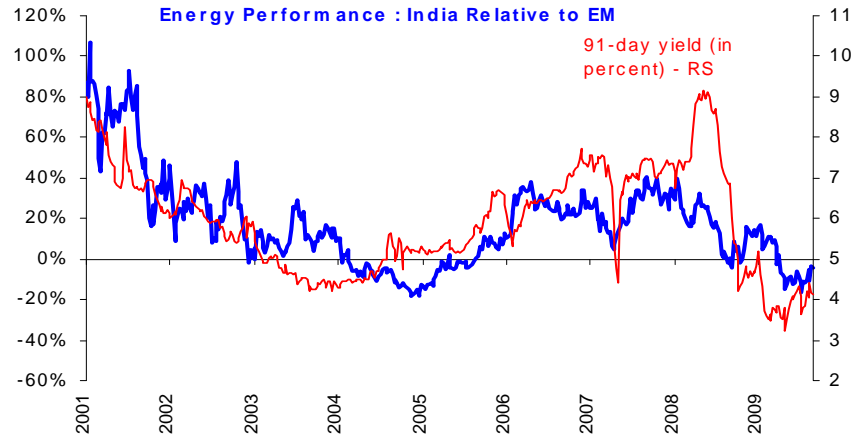
Strong Relative Performance From Tech Sector



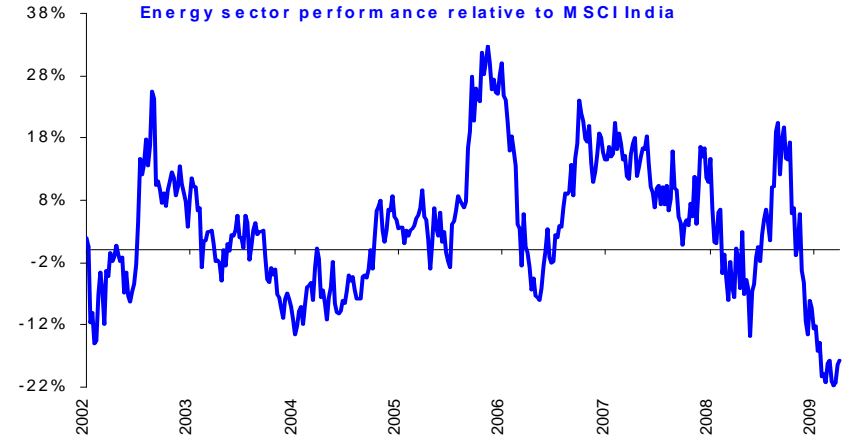
Source: RBI, FactSet, MSCI, Morgan Stanley Research

Theme #3 : Buy Energy

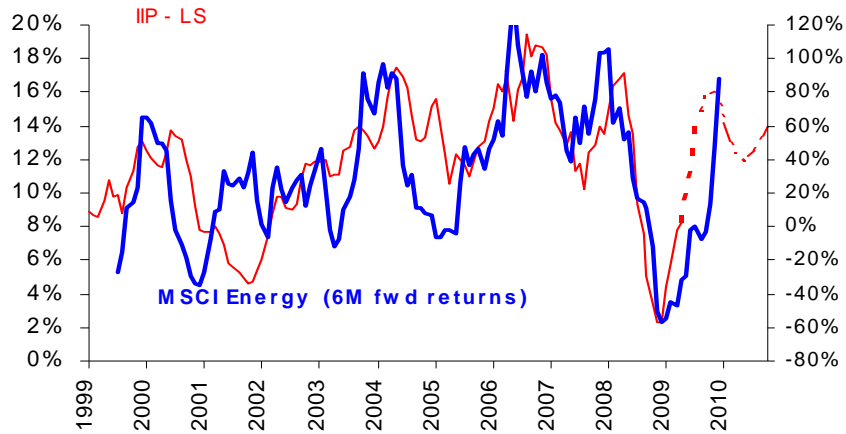
Energy Stocks Move with Short-term Yields



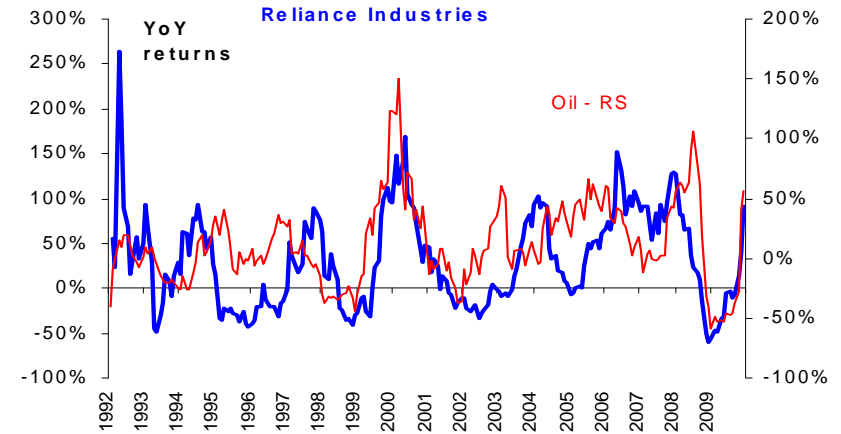
6M Relative Performance: At a Trough



IIP Growth Matters to the Energy Sector Performance



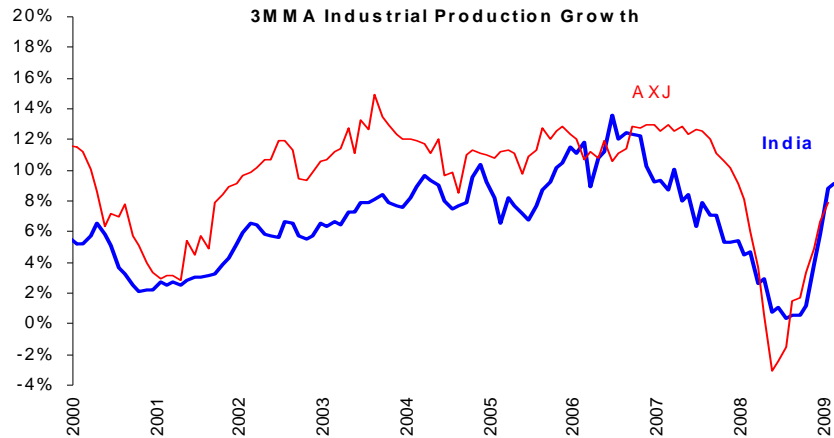
Rising Oil Prices Good for Reliance Industries' Shares



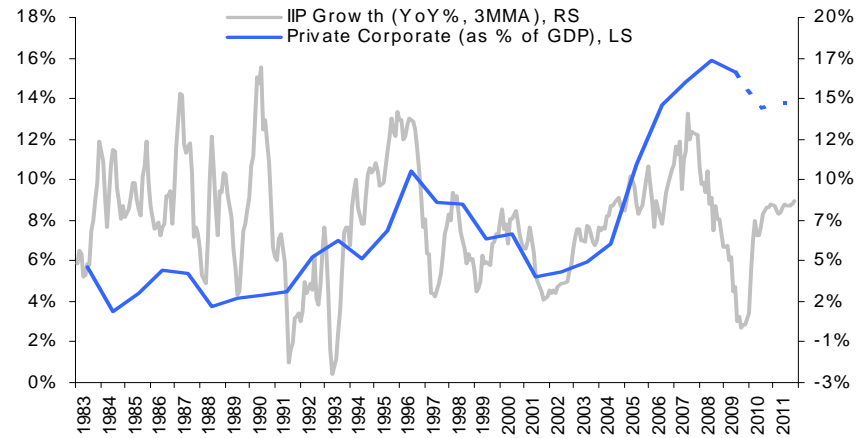
Source: CEIC, FactSet, MSCI, Bloomberg, Morgan Stanley Research

Theme #4 : Buy Industrials

Growth Will Continue to Improve in 2010



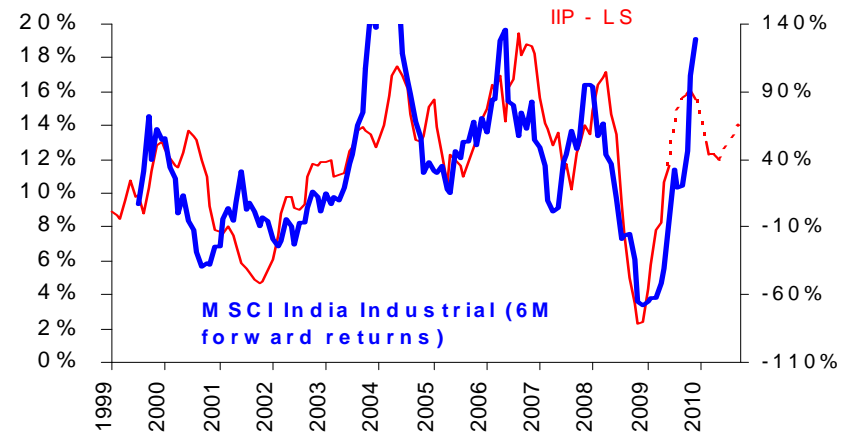
Output Gap Could Close Faster Than Expected



Supply Side Factors Favor Capex: Capital is Cheap



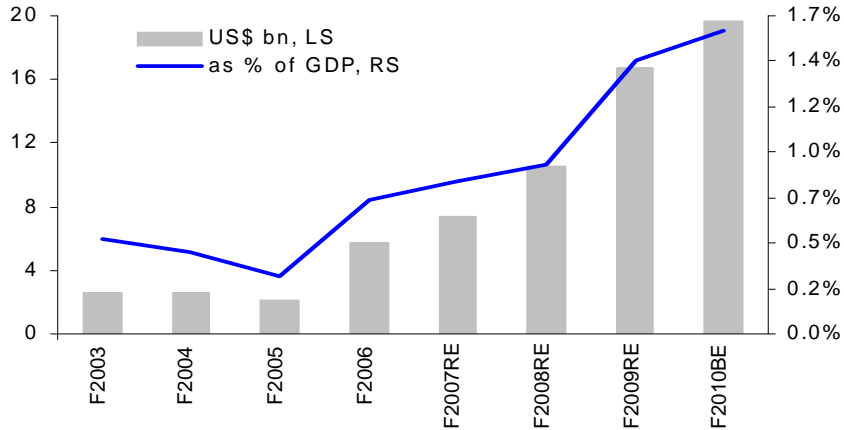
Industrials: IIP Growth - A Key Performance Driver



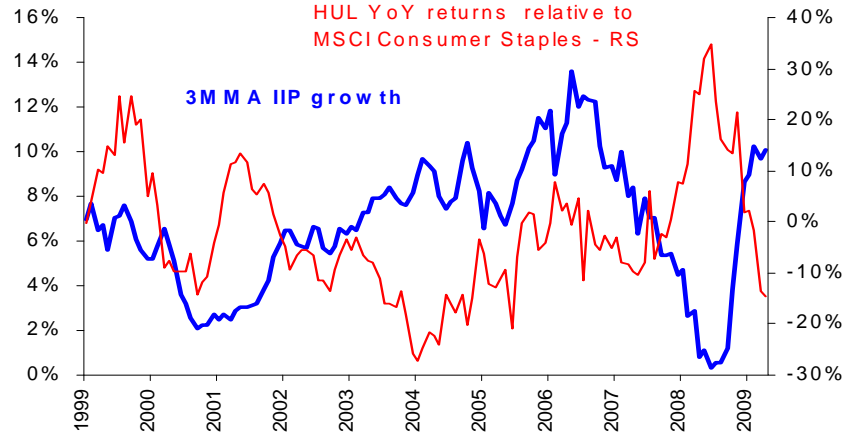
Source: FactSet, MSCI, CEIC, Bloomberg, Morgan Stanley Research

Theme #5: Shift Bias From Rural to Urban Plays

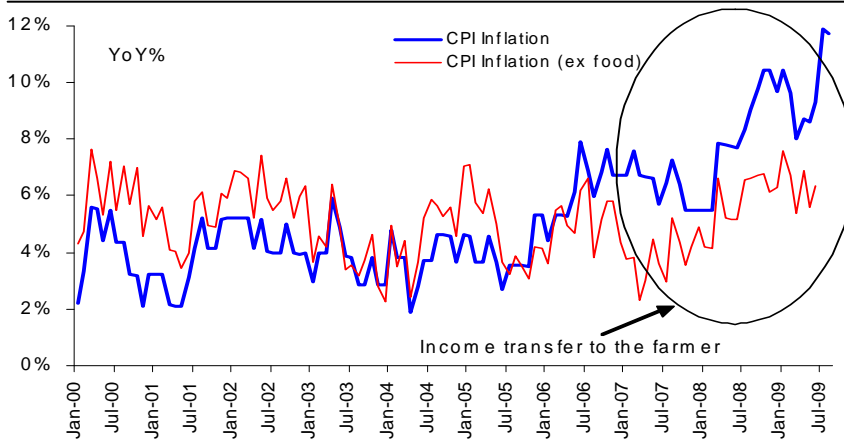
Soaring Government Spending on Rural India*



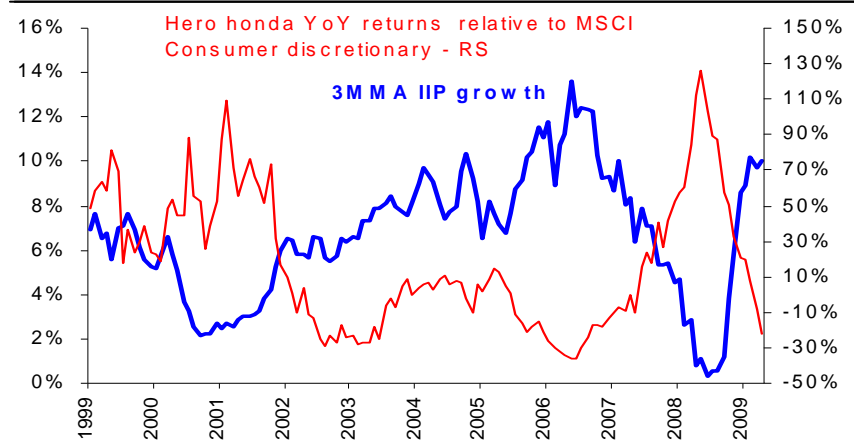
HUL: Inverse Correlation with Industrial Growth



Food Price Inflation: Transferring Income to Farmers



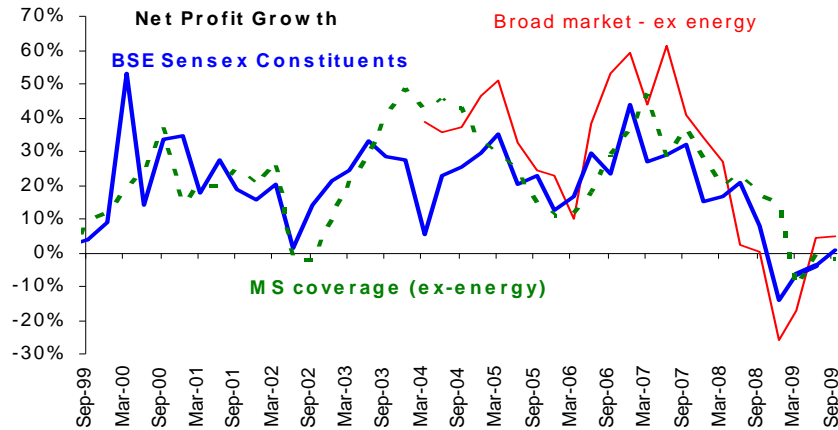
Hero Honda: Inverse Correlation with Industrial Growth



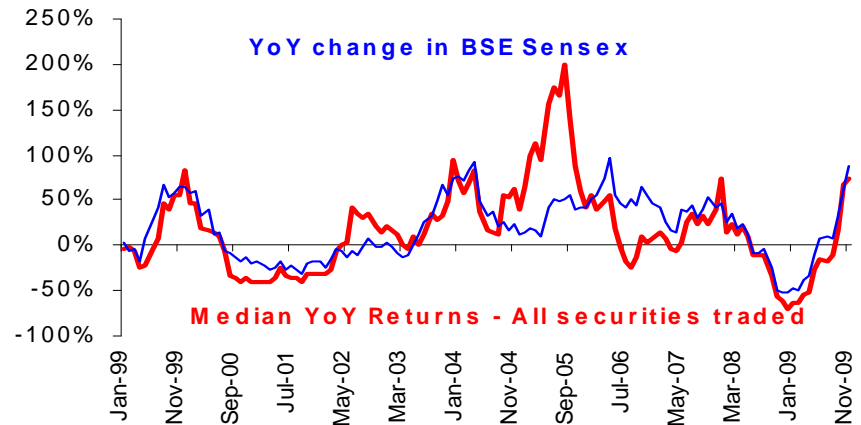
Source: FactSet, MSCI, CEIC, Budget Documents, CEIC, NCAER, * - Rural Spending includes Bharat Nirman Yojna, NREGA and Accelerated Irrigation Benefit Program, E = NCAER Estimates, RE = Revised Estimates of the Government of India, BE = Budget Estimate of the Government of India

Theme #6: Buy Mid-caps

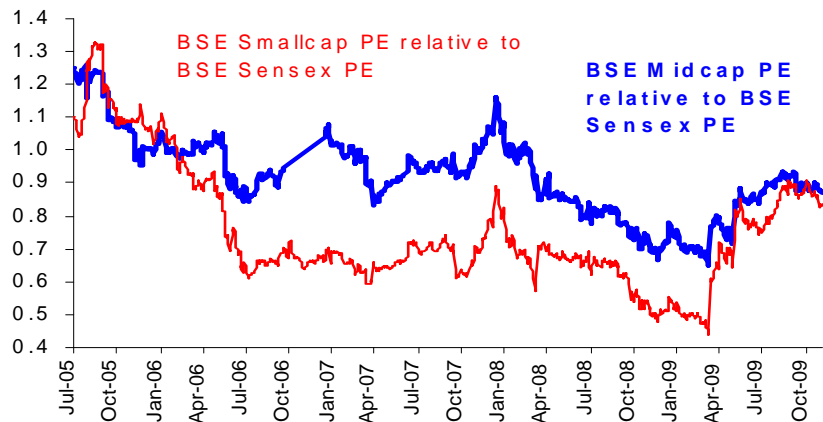
Broad Market: Earnings Will Likely Accelerate Faster



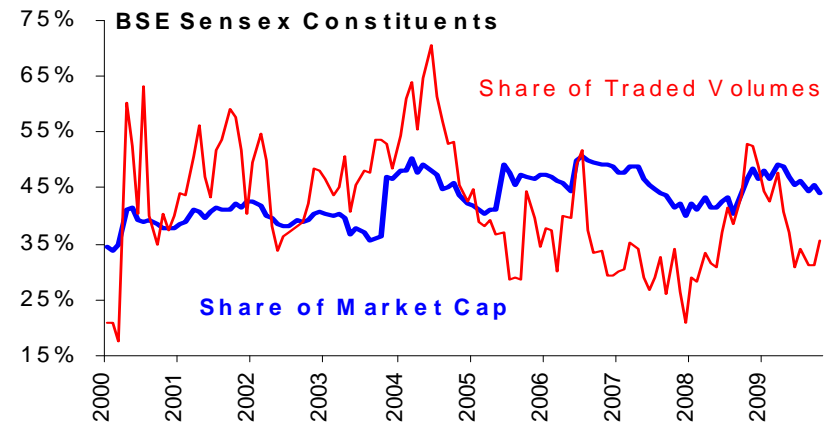
Broad Market Returns Catching Up With Narrow Market



Broad Market: Do Not Rule Out Premium Valuations



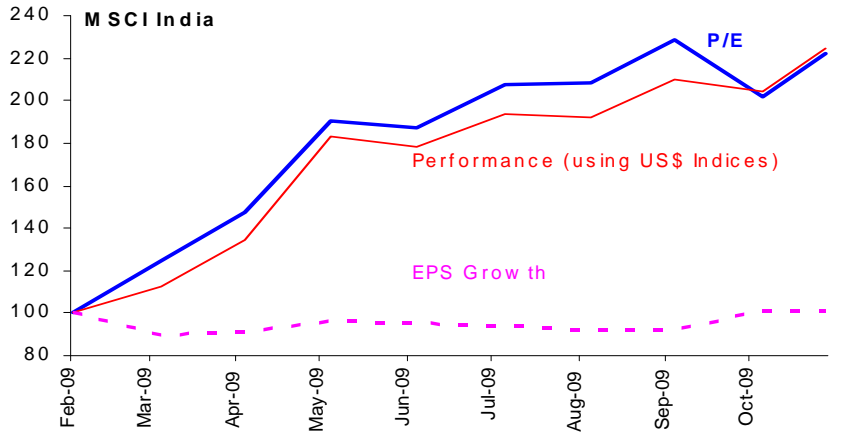
Broad Mkt. Gaining Share in Trading Volumes Faster than Capitalization



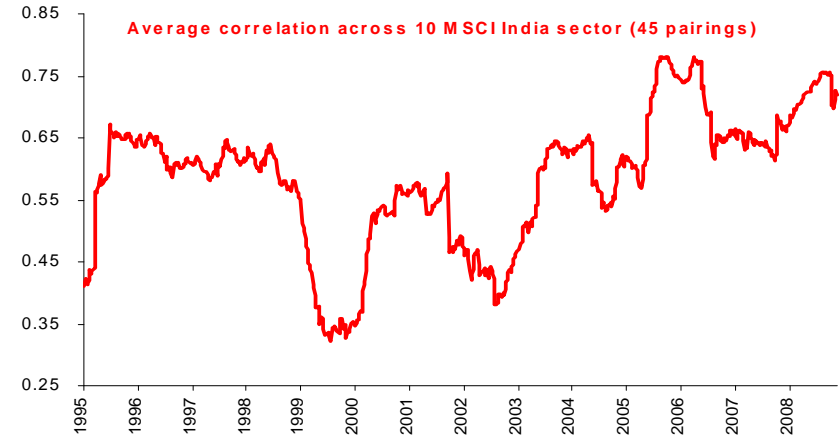
Source: Bloomberg, Capitaline, Company data, Morgan Stanley Research

Theme #7: Stock Picking Could be in Vogue in 2010, Market to be Driven by Earnings

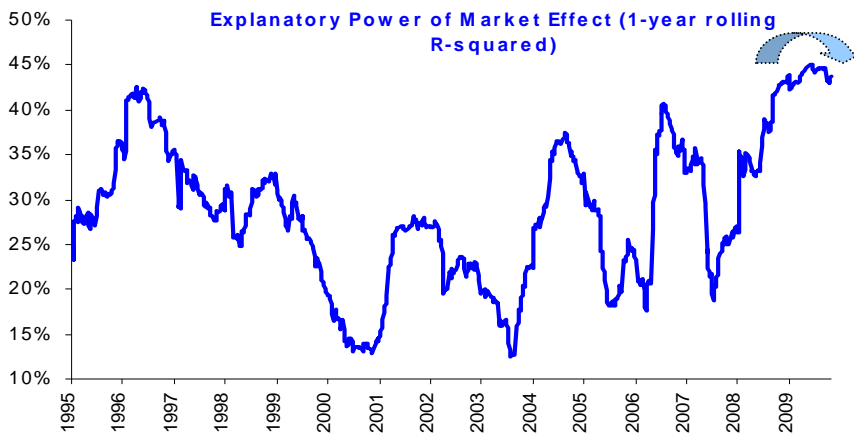
PE Rerating Drives 2009 Equity Returns



Sector Correlations: Just Off Highs



Market Effect Appears to be Topping Out



MSCI India Sectors: Z-Score of Current Return Correlations, Energy Correlations Low Vs. History

Current Z Values	Cons. Disc.	Cons. Staples	Energy	Financials	Health-care	Industrials	Software	Materials	Telecom
Cons. Staples	1.49								
Energy	0.73	0.57							
financials	1.17	0.99	0.16						
Healthcare	1.72	0.89	0.51	1.53					
Industrials	-0.10	0.74	0.27	1.33	1.51				
Software	1.63	0.61	0.20	1.86	1.31	0.99			
Materials	-0.28	0.53	0.50	1.26	0.96	0.45	0.22		
Telecom	1.55	0.71	0.11	1.70	1.10	0.53	1.02	0.56	
Utilities	1.04	0.94	-0.67	1.31	1.41	0.39	1.40	0.46	1.13

Source: FactSet, MSCI, Bloomberg, Morgan Stanley Research

Focus List and Sector Model Portfolio

Focus list

Stocks	Ticker	Analyst Rating	Price (Rs) 24/11/2009	MCap (US\$ bn)	Avg 3M T/O (US\$ mn)	Relative to MSCI India	
						YTD Perf (%)	12m Perf (%)
Maruti Suzuki	MSIL IN	Overw eight	1,599	10	35	64%	48%
Zee Entertainment	Z IN	Overw eight	262	2	9	0%	9%
ITC	ITC IN	Overw eight	264	21	27	-18%	-25%
Cairn India	CAIR IN	Overw eight	283	11	20	-12%	3%
Reliance Ind	RIL IN	Overw eight	2,176	77	213	-6%	-7%
DLF	DLFU IN	Equal-Weight	373	14	133	-29%	-4%
HDFC	HDFC IN	Overw eight	2,813	17	47	1%	0%
SBI	SBIN IN	Overw eight	2,305	31	140	-5%	-2%
Jaiprakash Asso.	JPA IN	Overw eight	228	6	88	47%	95%
Larsen & Toubro	LT IN	Overw eight	1,648	21	74	13%	6%
Infosys Tech	INFO IN	Underw eight	2,426	30	74	16%	-1%
Reliance Infra	RELI IN	Overw eight	1,069	5	61	-2%	4%

Sector Model Portfolio

Sector	MSCI Weight (%)	Portfolio Weight (%)	Over/Under - Weight (bps)	Perf Rel. To MSCI India (YTD Perf.)
MSCI India (Abs Perf)				88% 105%
Consumer Disc.	4.6	4.6	0	40% 33%
Consumer Staples	5.7	5.7	0	-29% -33%
Energy	17.0	19.0	200	-7% -8%
Financials	25.5	27.5	200	-2% 10%
Healthcare	3.5	2.5	-100	-13% -19%
Industrials	8.9	9.9	100	10% 12%
Technology	16.0	15.0	-100	15% -4%
Materials	11.2	9.2	-200	54% 74%
Telecom	1.3	1.3	0	-61% -60%
Utilities	6.4	5.4	-100	-20% -16%
Cash	0.0	-		

Source: FactSet, MSCI, Bloomberg, Morgan Stanley Research
Past performance is no guarantee of future results. Results shown do not include transaction costs.

Mid Cap Picks

Stocks	Ticker	Analyst Rating	Price (Rs) 25/11/2009	MCap (US\$ bn)	Avg 3M T/O (US\$ mn)	YTD Perf	12m Perf
						(%)	(%)
Balrampur Chini	BRCM IN	Overw eight	135	757	19.9	171%	301%
IVRCL Infrastructure	IVRC IN	Overw eight	378	1,055	22.5	163%	205%
Lupin Ltd.	LPC IN	Overw eight	1,330	2,410	6.6	115%	143%
Pantaloon Retail	PF IN	Overw eight	342	1,343	3.4	57%	63%
Yes Bank	YES IN	Overw eight	252	1,589	68.7	236%	314%

Changes in Sector Model Portfolio

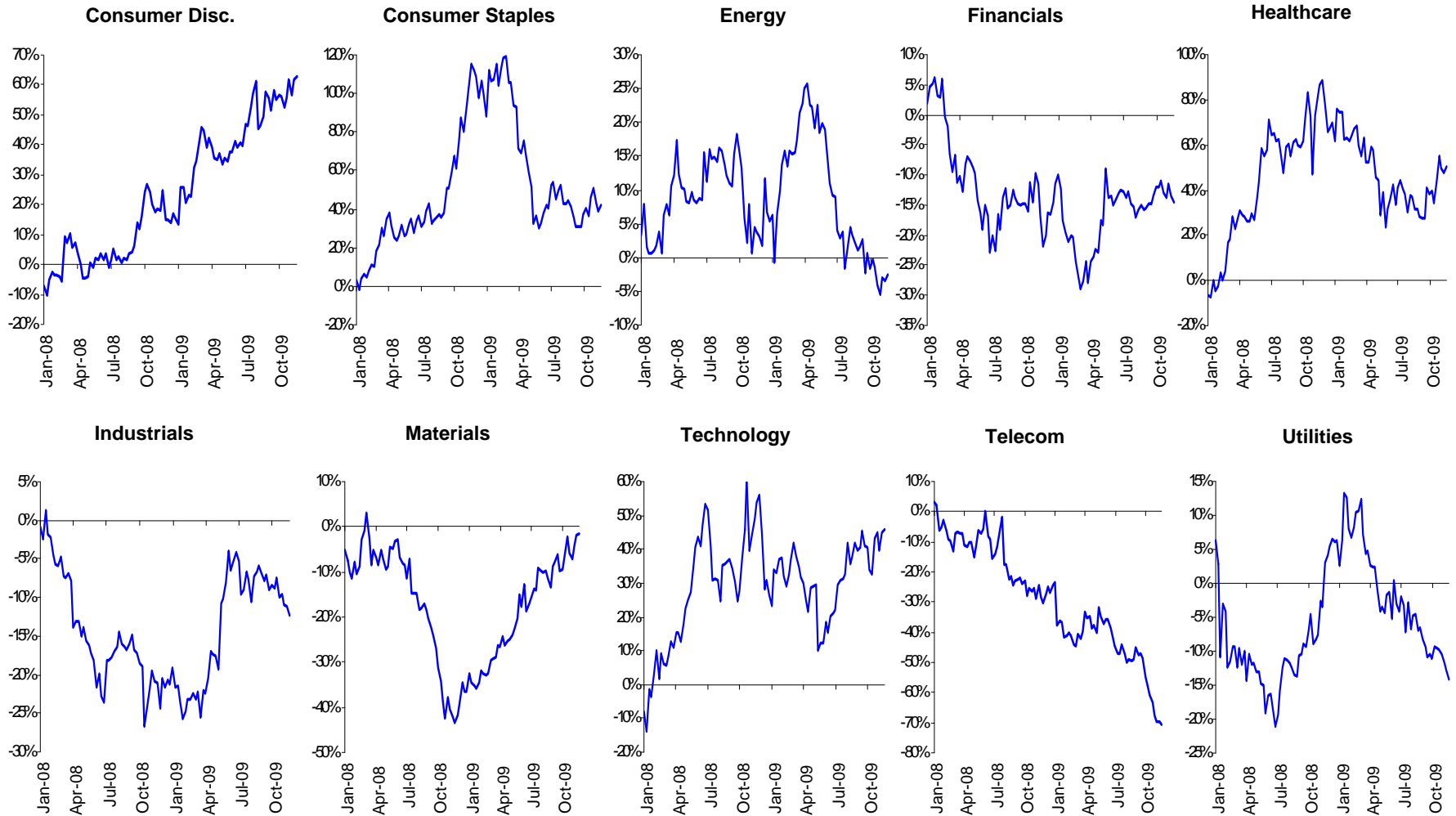
in bps vs. MSCI India Index	From	To	Change
Consumer Disc.	100	0	-100
Technology	0	-100	-100
Energy	100	200	100
Financials	100	200	100

Sector Snapshot : Earnings, Valuations, Performance and Ownership

F2010E		Earnings revision			F2011E		Earnings revision											
MS	Consensus	1M	3M	6M	MS	Consensus	1M	3M	6M	MSCI India	Abs PE	Relative to EM	Relative to APxJ	Abs PB	Relative to EM	Relative to APxJ	Value assigned to future growth	
Cons. Disc	252%	20%	1%	-1%	-7%	21%	39%	1%	11%	17%	Consumer Discretionary	23.1	1.0	1.0	5.9	2.5	2.7	91%
Cons. Staples	17%	13%	1%	2%	2%	22%	16%	1%	3%	4%	Consumer Staples	31.0	1.3	1.5	10.7	3.0	3.8	62%
Energy	21%	35%	2%	8%	14%	36%	17%	2%	2%	11%	Energy	21.0	1.6	1.2	3.3	1.9	1.4	51%
Financials	-9%	15%	1%	4%	7%	21%	9%	0%	4%	14%	Financials	26.0	1.4	1.2	3.1	1.4	1.7	55%
Healthcare	110%	5%	-1%	-6%	-6%	30%	19%	-1%	-4%	-4%	Health Care	48.4	2.0	2.2	5.8	1.9	1.5	80%
Industrials	16%	18%	0%	8%	13%	6%	13%	1%	4%	20%	Industrials	33.4	1.1	0.9	5.4	2.8	3.2	62%
Materials	-34%	-23%	0%	9%	23%	59%	43%	2%	10%	30%	Technology	19.4	0.2	0.1	6.1	2.4	2.4	61%
Technology	11%	9%	1%	11%	6%	12%	12%	1%	15%	13%	Materials	13.7	0.6	0.5	3.0	1.5	1.2	52%
Telecom	5%	4%	0%	2%	2%	14%	9%	0%	-1%	0%	Telecoms	6.6	0.4	0.5	1.8	0.7	0.8	10%
Utilities	11%	19%	1%	4%	7%	19%	12%	2%	5%	9%	Utilities	21.3	1.3	0.8	2.8	2.3	1.7	63%
MS Coverage	7%	13%	1%	6%	10%	25%	17%	1%	5%	13%								
in USD (Absolute Perf)			1 Mth	3 Mths	6 Mths	12 Mths	YTD											
MSCI India			3%	17%	28%	121%	97%											
MSCI EMF			0%	13%	30%	100%	71%											
MSCI Europe			1%	4%	19%	24%	24%											
MSCI ACWI			1%	7%	24%	42%	30%											
MSCI Asia Pacific			-1%	12%	32%	97%	65%											
BSE Sensex			2%	10%	23%	92%	78%											
BSE Midcap Index			0%	14%	33%	124%	101%											
BSE Smallcap Index			-1%	15%	32%	126%	107%											
in local currency			1 Mth	3 Mths	6 Mths	12 Mths	YTD											
MSCI India			3%	12%	26%	105%	88%											
Cons. Discretionary			9%	21%	50%	171%	163%											
Consumer Staples			3%	10%	31%	38%	33%											
Energy			5%	8%	2%	87%	74%											
Financials			-1%	11%	23%	124%	84%											
Healthcare			12%	28%	37%	66%	63%											
Industrials			1%	5%	22%	128%	107%											
Information Tech.			8%	19%	71%	95%	115%											
Materials			4%	24%	57%	256%	190%											
Telecommunication			-23%	-34%	-47%	-18%	-27%											
Utilities			-3%	3%	9%	72%	50%											
											Domestic							
											Domestic		Mutual	Total		MSCI	Position	
											Fils	Institutions	Funds	Institutional	Holdings	Weight*		
											Consumer Discretionary	5.9%	7.3%	5.2%	6.2%	4.6%	1.6%	
											Consumer Staples	4.5%	10.6%	14.3%	7.4%	5.1%	2.3%	
											Energy	13.1%	16.4%	15.6%	14.3%	17.6%	-3.3%	
											Financials	32.0%	17.8%	19.0%	26.6%	25.8%	0.8%	
											Healthcare	2.6%	2.9%	2.7%	2.7%	3.4%	-0.7%	
											Industrials	8.4%	12.9%	18.1%	10.8%	9.5%	1.3%	
											Materials	8.6%	12.9%	5.9%	9.4%	10.4%	-1.0%	
											Technology	15.0%	4.7%	7.2%	11.3%	15.4%	-4.1%	
											Telecom	6.2%	6.0%	5.5%	6.1%	2.2%	3.9%	
											Utilities	3.7%	8.5%	6.5%	5.3%	6.1%	-0.8%	

Source: FactSet, MSCI, Morgan Stanley Research

Sector Performance Since Jan-08



Sources: FactSet, MSCI, Morgan Stanley Research



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Global Stock Ratings Distribution

(as of October 31, 2009)

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Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	875	37%	277	40%	32%
Equal-weight/Hold	1,082	46%	318	46%	29%
Not-Rated/Hold	26	1%	3	0%	12%
Underweight/Sell	392	17%	87	13%	22%
Total	2,375		685		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

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Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

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Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

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Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

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