INDIA RESEARCH

India Strategy: Changing tack to "bottom-up"

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Indian markets – *UP*…

Over the last three months, the Indian markets have witnessed a rerating and headline indices have bounced back from the lows hit in October 2008. We believe the rally has been fuelled by declining cost of capital and marginal improvements in economic data-points with some help from a global rally. (We had argued for this rerating in our report "India Strategy: High on risk-reward" dated 27 March 2009.) However, investors – wary of the outcome of general elections – chose to wait on the sidelines, which meant a slow rally in the initial phase and that unconvinced investors booked profits at every level. Thus, even as the Sensex crossed the 11000 mark, cash levels in the domestic market rose to 10-15% with hardly any participation from foreign money. In a sudden turn of events, the 'surprise' return of the UPA-led (pro-reforms) government propelled the market into the next orbit with panic buying that made local funds deploy their surplus cash and foreign funds realign their India weightage.

In the pre-election phase, the market was driven by large caps as risk-averse investors were playing the India-revival story through large cap liquid stocks available at extremely compelling valuations. Post the election surprise, investors rushed to midcaps (and smallcaps) which were trading at huge discounts; the BSE SmallCap and BSE MidCap Indices soared 18% and 12% during the week ended 22 May '09. The promise of a pro-reforms and stable government without the Leftist interference has boosted investor confidence on the possibility of a swifter-than-anticipated economic recovery. Enthused by a change in India's structural growth rates, FIIs have poured in ~US$1.7bn in the Indian markets in a span of just two weeks.

…Away!

India has risen to the stature of being among the best performing markets in the world in 2009. Nevertheless, the current Sensex valuations of 16.7x FY10E earnings, we believe, are pricing in an extremely quick recovery in corporate earnings. Multiple positives – strong capital flows, improved corporate confidence and across-the-board reforms – are expected to lead to better profitability for companies. However, we believe these factors will play out only over a 8-12 month period.

Time to change the tack? : To "bottom-up" from a top down strategy

As key macro risks have played out favorably, current valuations more-than-adequately price in the anticipated structural change. In this backdrop, we believe the market has ceased to be a top-down story for now and we recommend a bottom-up approach in the coming period. We see markets consolidating, or even correcting, in the near term before moving northwards over a 12-month horizon. However, a highly reform-oriented budget statement (which the government is making initial noises about) could further stretch the "re-rating rally".

Our argument of the near-term consolidation/ correction is based on the following:

***1. Earnings will likely disappoint in short term:* Corporate earnings could largely disappoint in H1FY10 before they eventually revert to the growth path. In such a cloudy outlook, we would seek earnings safety AND**

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reasonable valuations. We expect the Sensex earnings to decline ~16% in H1FY10 before rising ~30% in H2FY10. Overall FY10 earnings are estimated to be flat and we estimate FY11 Sensex earnings to grow 14.3%.

2. The paper craze is here again: **With restoration of confidence in global markets, risk appetite is increasing and riding on the improved sentiment, markets are flush with follow-on equity offerings. Ranging from cash-strapped realtors, infrastructure developers to construction and engineering companies, all hit hard by high leverage, there is a big rush to raise equity with US$10bn-12bn of equity offerings lined up over the next 2-3 months. However, we believe the market would find it difficult to continue its upward march in the wake of such paper supply.**

Back to basics: Focus on earnings!

We believe earnings growth in the current fiscal would be rear-ended towards H2 in FY10 (~30% yoy growth) and that Financials, Infrastructure and Automobiles would lead the earnings revival. These are also sectors with the highest probability of earnings upgrades. In a blue-sky scenario, we expect Sensex earnings to grow 7.8% in FY10 and ~18% in FY11.

Sectors expected to be at the forefront of upgrades:

Sector	Triggers for earnings upgrades	Key stocks
Automobiles	Strong pick-up in volumes as the CV-cycle recovers	**4W Wheelers:** Tata Motors, Maruti Suzuki
Financials - Private Banks (with a preference over PSU Banks) & wholesale funded finance companies	Lower provisioning costs as asset quality surprises on the positive and wholesale funding costs remain at current low levels, driving margins	**Private Banks:** Axis Bank, HDFC Bank, ICICI Bank **Finance companies:** HDFC, Shriram Transport Finance **PSU Banks:** Bank of Baroda, Canara Bank
Infrastructure companies	Order momentum pick-up with resumption of private capex orders as also margin expansion driven by lower commodity prices	**Construction**: Jaiprakash Associates, HCC, NCC **Infra Developers**: Reliance Infrastructure, GVK Power & Infra **Power Equipment:** KEC International

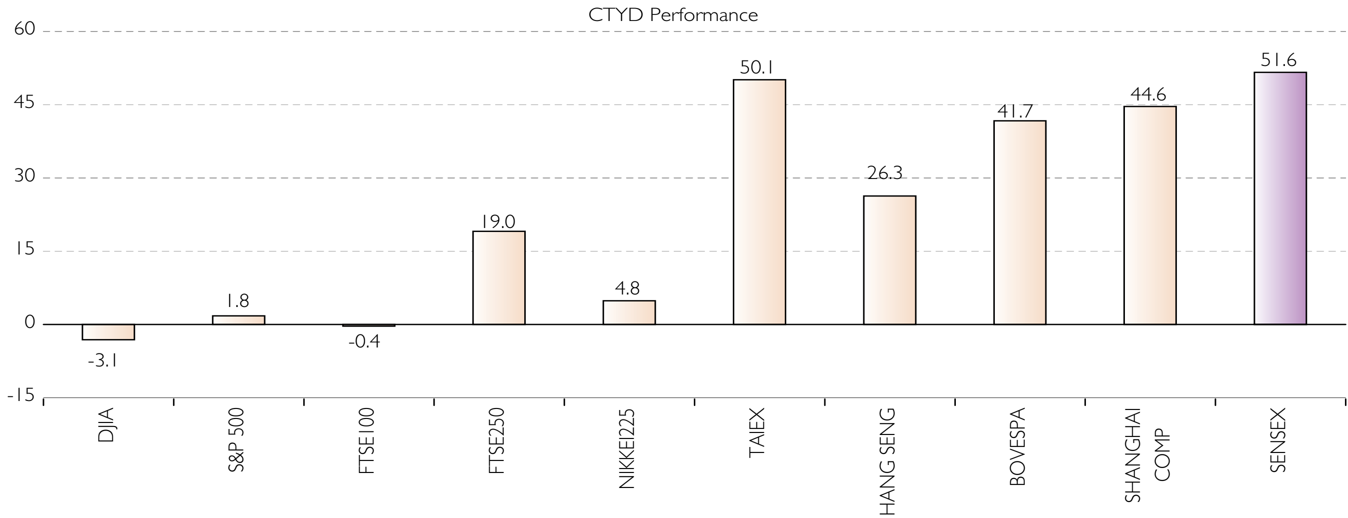
We would recommend realigning portfolios in favor of sectors offering the highest earnings upgrades on the back of a swifter economic recovery. Incidentally, Financials and Infrastructure are also the sectors which will be at the forefront of the government's reform agenda.

ELECTION RESULTS: THE LAST LEG IN RE-RATING

❑ India turns one of the best performing markets for the year…

- With the results of the General Elections 2009 for the 14th Lok Sabha throwing up a strong mandate for the incumbent Congress-led UPA, Indian markets saw the best week (ended 22 May 2009) in 17 years with the Sensex gaining 14.1%.

Exhibit 1: Global markets performance



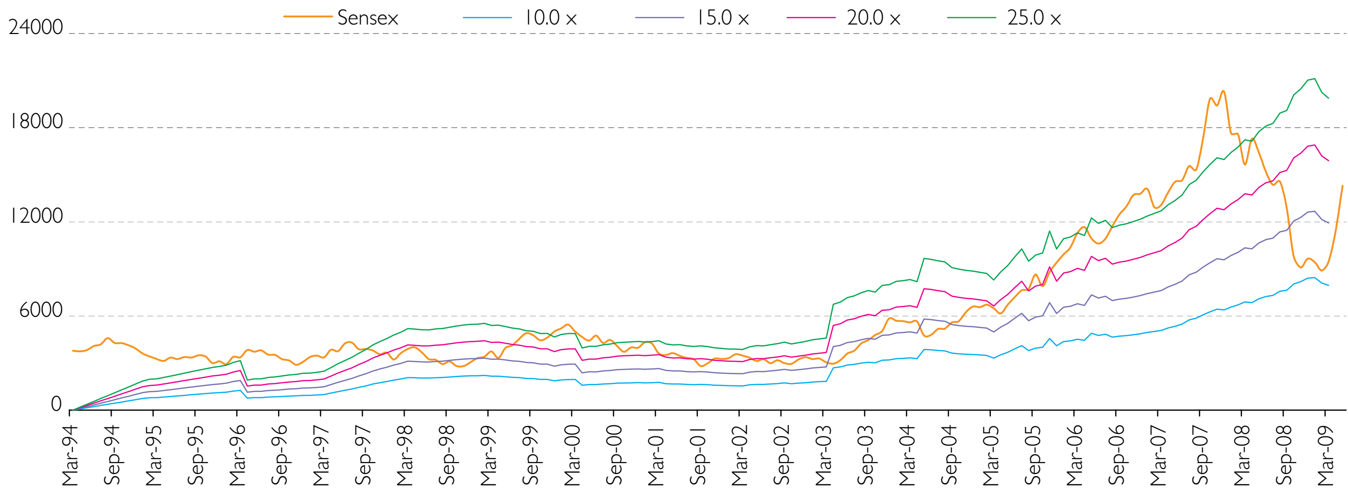
Source: Bloomberg

- While we had expected a knee-jerk reaction to the surprisingly positive election results as investor confidence received a major boost (please refer to our report *"India Strategy: 'Decisively' northbound!"* dated 17 May 2009), the sharp rally has for sure surprised everyone.

❑ …as markets got re-rated

- We had first argued for a re-rating of assets to be driven by declining cost of capital in our report "*India Strategy: Welcome to volatility*" (dated 18 February 2009), and expected the Sensex to reach levels of 12,750 over a 12-month period. Historically, the Sensex had always bounced back from ~11x trailing earnings. In the recent rally, Sensex valuations have moved up sharply from 11.2x to ~17x on a 1-yr trailing basis.

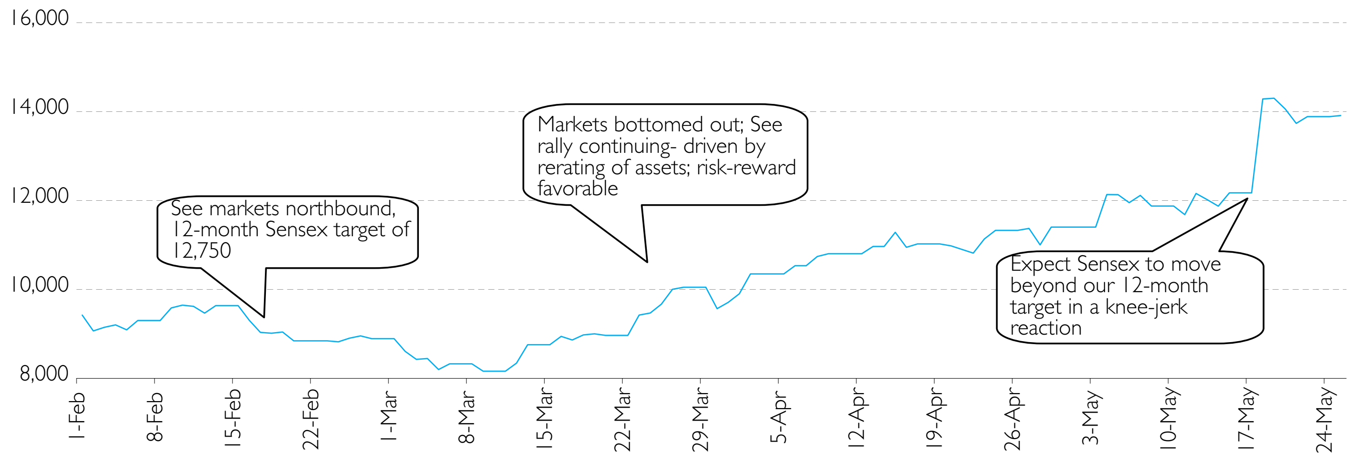
Exhibit 2: Sensex valuations surge sharply



Source: IDFC-SSKI Research

- While the Indian economy has been emitting initial signs of a revival since Mar-09, we had highlighted that a hung parliament was a key risk to the medium-term outlook for the markets. (Please refer to our report "*India Strategy: High on risk-reward*", dated 27 March 2009). This risk had kept investors at bay during the pre-election rally.
- Contrary to the belief across most quarters, we had argued that the new government – irrespective of being led by UPA or NDA – would have to increase expenditure to pump-prime the economy to revive growth. Additionally, as probability of a non-UPA/ non-NDA government receded, we turned increasingly confident in Mar-09 of a continued re-rating and believed that risk-reward was favorable over a 12-month period.

Exhibit 3: What we said...



Source: Bloomberg, IDFC-SSKI Research

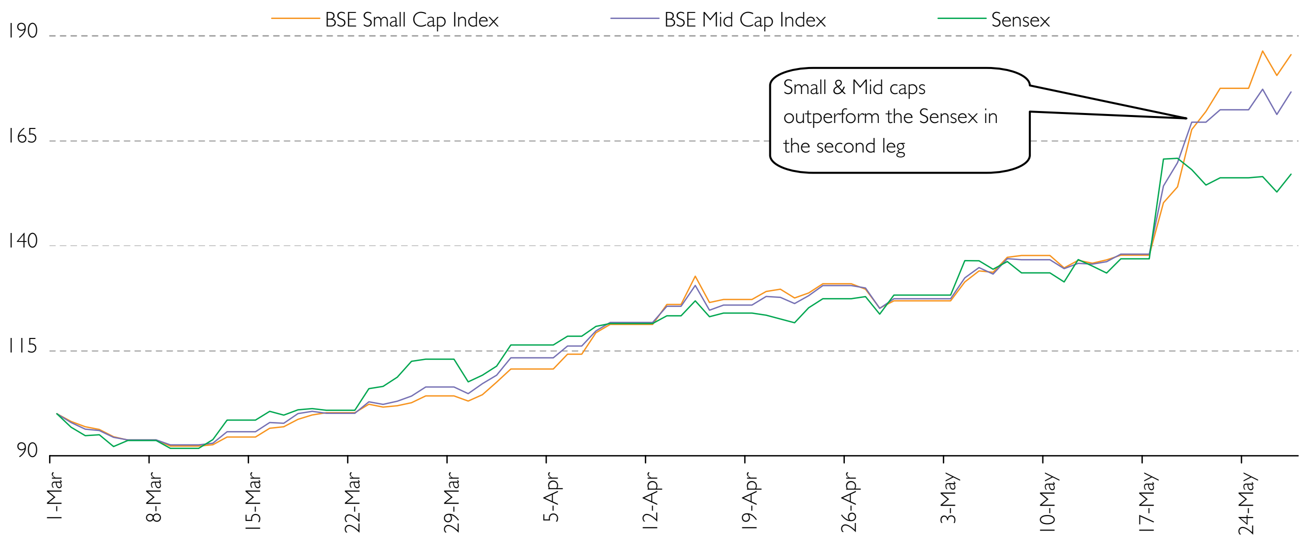
❑ Large caps lead from the front

- Driven by the significant decline in cost of capital, Indian markets got rerated and surged sharply from the bottom with marginal improvement in economic data. Investors – skeptical of the sustenance of the rally – waited on the sidelines and cash levels in the system rose to astonishingly high levels of 15-20%. As visible in headline indices (Sensex and Nifty), large caps led this rally from the front.
- This rally was also aided by favorable global cues as first signs of global economy bottoming out appeared on the radar during Mar-Apr '09 and global markets rallied from multi-year lows globally.

❑ Midcaps surge – in a mad rush to catch up on performance

- Investors had been significantly underweight on India as the event risk (of a hung parliament) played out market-wide. However, with surprisingly positive election results, midcaps have surged as fund managers rushed to play beta in order catch up with market's performance.
- Driven by deployment of cash as also due to relatively higher risk appetite (with increased confidence on Indian economy) mid caps drove the second leg of the rally in the Indian markets.

Exhibit 4: Mid/Small Caps surge in the second leg of the rally

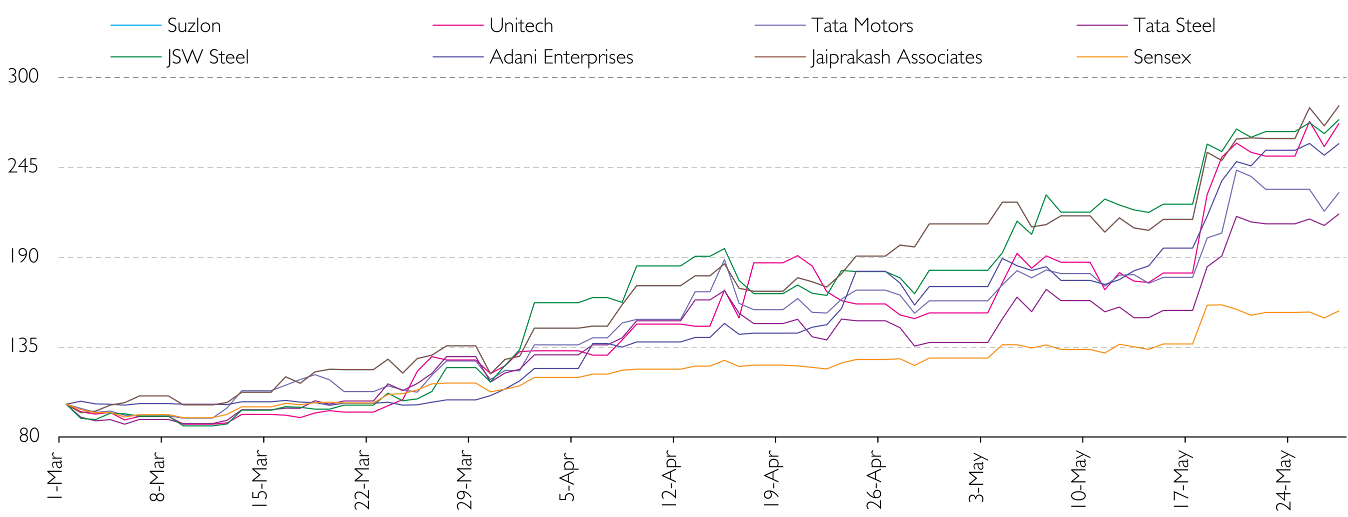


Source: Bloomberg

❑ The "distressed ones" soared!

- Companies which were hit the hardest during the falling markets due to multiple concerns on leverage, promoter pledges and corporate governance have delivered the maximum outperformance during the current rally.
- The stocks of such companies had been hammered the most on the bourses (down by 75%+ from the peak) and valuations were pricing in a probable bankruptcy. With these companies reeling under high-debt obligations and given the financial crisis, investors saw a significant wipe-out of shareholder wealth as repayment schedules neared.
- These companies had been striving to survive the downturn through various efforts including restructuring of debt, follow-on equity issues, asset sales, etc. With easing of liquidity (driven by policy measures), significant decline in interest rates and by raising of equity capital through follow-on offerings, these corporates have managed to tide over the crisis. Consequently, they have just transitioned from pricing a bankruptcy to a "no-bankruptcy" scenario while business fundamentals have changed only marginally. Despite this, stocks of such companies have soared.

Exhibit 5: Distressed companies outperform the Sensex



Source: IDFC-SSKI Research

A case for a bottom-up approach over top-down strategy

- Indian markets have been driven by improvement in macroeconomic fundamentals, viz.
  - improved liquidity, and strong policy and fiscal actions
  - a sharp decline in cost of capital
  - another stint of a reforms-oriented government; and
  - resilient, inward looking growth
- While the decline in cost of capital drove the initial leg of the rally, we believe the return of the UPA government with a strong mandate saw the last leg of the "re-rating rally" led by improved investor confidence.
- We believe that re-rating of assets has reached its fag-end and given the sharp upward surge, we see two key concerns emerging in the near term:
  - Expensive valuations given the earnings pain over H1FY10
  - Significant amount of paper supply expected to hit the market
- Consequently, we would choose to adopt a bottom-up approach and recommend companies with strong earnings visibility over the medium term as well as sectors that would see earnings upgrades in H2FY10 on economic recovery.

VALUATIONS NOW BEYOND THE COMFORT ZONE…DESPITE IMPROVING FUNDAMENTALS

We see a near-term consolidation…in a staircase formation for markets

- While the return of a reform-oriented government makes us increasingly confident of an H2FY10 economic recovery, we believe that in the recent run-up in the markets, valuations have risen beyond our comfort zone. The Sensex currently trades at 16.7x FY10E earnings and ~17x FY09 earnings.
- We uphold our view that multiple positives – across-the-board reforms, higher capital flows to India, increased infrastructure spending and improved corporate confidence – will surely put India back on the growth path. However, we expect these positives to play out gradually over an 8-12 month period.
- We believe that current market valuations leave room for disappointment in the near future as the macroeconomic turnaround will take some time to translate into corporate earnings.

Earnings growth will catch up only with a lag

- While markets naturally have re-rated ahead of an "earnings turnaround", further re-rating from the current levels seems unlikely as earnings pain would likely persist for two more quarters (i.e. over H1FY10).
- In the intervening, we believe, while we expect a consolidation/correction in markets as earnings catch up with valuations.

THE PAPER CRAZE: A WORD OF CAUTION

Markets awash with follow-on equity offerings

- As markets have rallied (Sensex up by 73% since 9 March 09), companies desperate to raise equity capital have rushed with "at the market" issues. With the key risk of elections now behind, the pipeline for investment banks for follow-on stock offerings is burgeoning by the day.
- The initial round of equity-raising has been dominated by real estate companies that have been reeling under immense lender pressure and have scrambled to raise cash. While these companies have already raised ~US$1.2bn from the market in this round, we estimate that further equity-raising of US$10bn-15bn is in the offing over the next two months across sectors. Corporates – ranging from other cash-strapped realtors, infrastructure developers to construction and engineering companies – are lining up equity offerings.

❑ Can the market absorb all the offerings?

- While companies have lined up with equity issues, we believe that despite high levels of cash in the system, the absorption of all this paper supply could pose a challenge.
- Domestic MFs are estimated to have US$5bn-6bn of cash (~6% of AUM) in their kitty while insurance companies would expect an inflow of ~US$2bn over the next three months.
- Hence, even with a generous assumption of US$2-3bn on inflows from FIIs over the next 2 months and given that the incremental flows could also be diverted towards absorption of this paper; we believe the market would see a challenge to continue its upward march.

❑ Who would be the winners?

- We believe that Indian promoters – coming from a highly entrepreneurial culture and with a vision to grow – would surely get support from these timely equity issues so as to tide over the troubled times. Over the longer term, with relatively strong economic growth, we expect them to deliver value for shareholders.
- However, we would caution investors from opportunistic companies that would use the present market rally to raise capital from shareholders but fail to create value.

TIME TO GO BOTTOM-UP; FOCUS ON EARNINGS

❑ Earnings growth remains the key theme

- With the re-rating phase driven by a significantly lower cost of capital, we would focus on earnings growth as our key theme over the medium term.
- While FY10 earnings growth for the Sensex is expected to be muted, we expect H2FY10 earnings to pick up with the revival in economy. Going forward, we see modest recovery in Sensex earnings in FY11 with a growth of 14.3% yoy to an EPS at Rs963 (14.3% yoy growth).

Exhibit 6: Sector-wise growth for Sensex

% yoy growth	Sales		EBITDA		PAT	
	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E
Automobiles	14.3	13.9	3.5	15.8	18.1	16.5
Cement	3.6	9.8	6.4	0.2	2.2	0.2
Construction	29.2	28.2	24.9	49.8	10.3	36.5
Consumer goods	0.2	13.8	8.4	14.4	7.0	14.7
Financial	14.1	15.4	15.3	17.6	11.5	19.7
Metals	(36.1)	3.9	(37.9)	14.7	(68.3)	31.5
Oil & Gas	11.9	(10.5)	13.9	-6.8	3.0	(9.1)
Petrochemicals	33.6	19.4	51.9	25.0	8.7	28.1
Pharmaceuticals	4.1	18.4	(14.9)	39.9	(3.5)	53.8
Power Equipment	19.2	20.4	42.9	28.0	34.2	33.0
Power Utilities	15.4	21.0	23.8	13.3	18.1	10.6
Real Estate	(40.8)	14.5	(50.2)	14.5	(61.3)	17.5
Software	6.7	7.8	(0.4)	7.2	(2.1)	6.3
Telecoms	23.3	14.7	19.8	14.3	7.6	10.9
Sensex	**3.7**	**11.7**	**8.7**	**13.3**	**0.2**	**14.3**

Source: IDFC-SSKI Research

- Construction, Metals and Power Equipment would be the key sectors likely to drive earnings growth in FY11.

❑ Earnings growth to be rear-ended and non-uniform

- As the economy revives in H2FY10, we expect corporate earnings to revive in pockets first before any secular pick-up across sectors.

- We see the following sectors driving earnings growth for the Sensex in H2FY10: Financials, Power Equipment, Construction Companies and Infrastructure Developers.
- Overall, we expect Sensex earnings growth to be rear-ended with H2FY10 witnessing a growth of 30.7% as against a decline of 16.3% in H1FY10

Exhibit 7: Sensex earnings growth to rebound in H2FY10

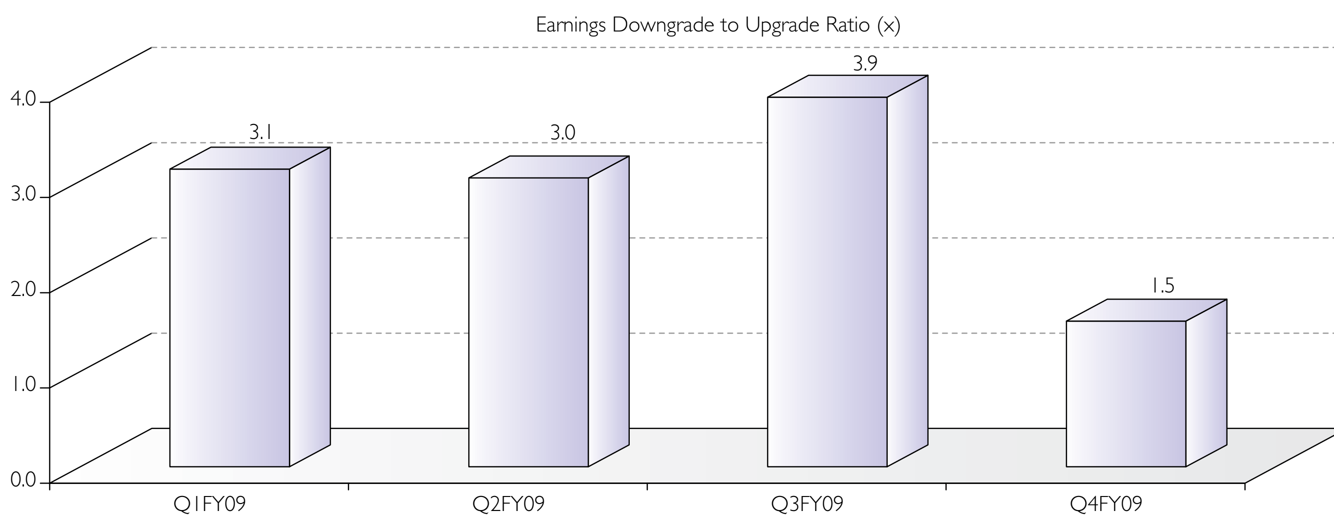
	H1FY10	H2FY10
Automobiles	(20.3)	205.2
Cement	5.8	(3.6)
Construction	30.5	(14.2)
Consumer goods	19.7	13.4
Financials	8.0	14.3
Metals	(76.4)	126.1
Oil & Gas	(19.5)	33.6
Petrochemicals	3.4	228.2
Pharmaceuticals	(42.1)	(65.5)
Power Equipment	28.2	37.7
Power Utilities	4.7	20.5
Real Estate	(72.8)	27.8
Software	(6.8)	(11.9)
Telecoms	18.0	17.4
Sensex	**(16.3)**	**30.7**

Source: IDFC-SSKI Research

❑ Downgrade cycle reaches the fag end; earnings surprises could be in store

- With the view that the real economy has bottomed out firmly in place, we believe that the downgrade cycle has reached its fag end.
- Our analysis of IDFC-SSKI Universe (of 146 companies) earnings upgrades and downgrades over the past year reveals that the pace of downgrade has slowed down significantly in Q4FY09 and is expected to end in Q1FY10.

Exhibit 8: Earnings downgrade to upgrade ratio has come off sharply



Source: IDFC-SSKI Research

Exhibit 9: FY09 Earnings downgrade cycle – at its fag end

	Q1FY09	Q2FY09	Q3FY09	Q4FY09
Revenues				
Total No. of companies	146	146	146	73
No. of downgrades	52	69	90	37
Average downgrade (%)				
For FY09	(4.5)	(4.3)	(4.7)	NA
For FY10	(6.5)	(7.1)	(10.4)	(7.0)
No. of upgrades	27	42	26	14
Average upgrade (%)				
For FY09	6.90	8.1	6.70	NA
For FY10	5.90	7.1	8.70	6.90
EBITDA				
No. of downgrades	61	73	91	35
Average downgrade (%)				
For FY09	(8.6)	(11.3)	(11.9)	NA
For FY10	(11.3)	(13.9)	(13.6)	(11.0)
No. of upgrades	29	45	26	14
Average upgrade (%)				
For FY09	7.90	9.8	8.80	NA
For FY10	7.50	9.2	6.80	12.0
EPS				
No. of downgrades	75	94	97	26
Average downgrade (%)				
For FY09	(10.6)	(15.0)	(20.9)	NA
For FY10	(12.3)	(19.0)	(18.3)	(13.2)
No. of upgrades	24	31	25	17
Average upgrade (%)				
For FY09	3.60	10.0	8.70	NA
For FY10	4.90	9.0	7.50	19.0

Source: IDFC-SSKI Research

- On the other hand, we believe that as the economy revives in H2FY10, some sectors could witness an upgrade in earnings. As against our base case estimate of 14.3% growth in Sensex earnings for FY11, our bull case estimates for Sensex earnings growth stand at 18.1% yoy. For FY10, Sensex earnings growth is expected to be 7.8% in a blue-sky scenario as against 0.2% in the base case.

Exhibit 10: Sensex earnings blue-sky scenario

	Base case estimates		Blue-sky estimates	
% yoy growth in EPS	**FY10E**	**FY11E**	**FY10E**	**FY11E**
Automobiles	18.1	16.5	18.1	30.1
Cement	2.2	0.2	2.2	0.2
Construction	10.3	36.5	10.4	38.0
Consumer goods	7.0	14.7	10.2	17.3
Financial	11.5	19.7	22.2	27.2
Metals	(68.3)	31.5	(68.3)	31.5
Oil & Gas	3.0	(9.1)	40.7	(6.6)
Petrochemicals	8.7	28.1	26.2	33.6
Pharmaceuticals	(3.5)	53.8	(3.5)	53.8
Power Equipment	34.2	33.0	48.0	30.0
Power Utilities	18.1	10.6	18.1	10.6
Real Estate	(61.3)	17.5	(61.3)	17.5
Software	(2.1)	6.3	(2.1)	12.3
Telecoms	7.6	10.9	7.6	10.9
Sensex	**0.2**	**14.3**	**7.8**	**18.1**

Source: IDFC-SSKI Research

- Key sectors that could witness an upgrade in earnings as the economy revives in H2FY10 are: ***Automobiles, Financials, and Infrastructure companies.***
- We would recommend realigning portfolios in favor of sectors offering the highest earnings upgrades on the back of a swifter economic recovery. Incidentally, Financials and Infrastructure are also the sectors which will be at the forefront of the government's reform agenda.

Exhibit 11: Our top picks:

Sector	Triggers for earnings upgrades	Key stocks
Automobiles	Strong pick-up in volumes as the CV-cycle recovers	**4W Wheelers:** Tata Motors, Maruti Suzuki
Financials - Private Banks (with a preference over PSU Banks) & wholesale funded finance companies	Lower provisioning costs as asset quality surprises on the positive and wholesale funding costs remain at current low levels, driving margins	**Private Banks:** Axis Bank, HDFC Bank, ICICI Bank **Finance companies:** HDFC, Shriram Transport Finance **PSU Banks:** Bank of Baroda, Canara Bank
Infrastructure companies	Order momentum pick-up with resumption of private capex orders as also margin expansion driven by lower commodity prices	**Construction**: Jaiprakash Associates, HCC, NCC **Infra Developers**: Reliance Infrastructure, GVK Power & Infra **Power Equipment:** KEC International

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