INDIA

4 April 2011

Macrocentric

Negotiating the new normal - A revisit

Summary

The macro challenges reinforce our view of a new normal growth, lower than the much claimed 9% (vs our expectation of 7.6%) for FY12E. A moderation in broader earnings estimates is camouflaged by steep upgrades in a few companies, leading us to a selective market view.

- **Overstatement of GDP growth; FY11 probably inflated by 90bp:** Over the past two years, several changes have been made in GDP numbers, including disproportionately large revisions, change in base year to 2004-05, change in deflator, and expansion in coverage for various components. While these changes have resulted in an obfuscating flux and increased frequency, of errors the disconnection with a wide set of leading indicators suggest inconsistencies. Our analysis indicates widespread up-scaling, but the largest bias to GDP growth comes from financial & trade services and manufacturing. Working backwards to extend the old series leads us to real GDP growth for Q1-Q3FY11 of 7.7% vs CSO's estimate of 8.6%
- **"Negotiating the new normal" is intact; FY12E GDP at 7.6% with an upside bias:** While the finance minister maintains an optimistic 9% GDP growth forecast in FY12, the RBI's statements are sombre. In our view, FY12 will see a transition from the stimulus-driven economic rebound to a new normal trend around 7.5-8% growth. In our view, the near-term downside risks would dominate the upside impulses, which would likely emerge gradually and more strongly in FY13. We maintain our 7.6% GDP growth estimate for FY12 with an upside bias. Contraction in real fiscal spending would potentially create positive supply impulses, its instant impact will be contractionary. Every 100bp negative shock in real fiscal spending growth translates into a 50bp fall in GDP growth. The factors weighing on our outlook include subdued investments, lagged negative impact of past fiscal expansion, downward inelastic interest rates. Amplified inclusion of informal sector in CSOs is an estimation risk for our projections. Low risk could arise from tightening of global financial conditions – rate hikes in the US and Europe and decline in savings in Japan.
- **Declining food inflation and rising cost pressures:** Inflation in Feb 2011 rose to 8.3% from 8.2% in Jan 2011 despite the sharp fall in food inflation. While manufactured product inflation climbed up, it is relatively small compared to persistent rise in cost of raw materials. Implying intensifying margin pressure and declining pass-through coefficient. While the risk of further escalation of costs persists, we believe the onward trend in inflation is likely to decline due to demand moderation. We expect WPI inflation to decline to 5-6% in FY12 with a reasonable probability of a 100bp upside from potential increase in fuel prices.
- **Food surplus beats the facile structural demand-supply shortage thesis:** Qfficial position that food price shocks resulted from structural supply-demand deficit, a thesis we have consistently refuted, is challenged by recent government decision to lift export ban on rice, sugar and onions to stabilise declining domestic prices. Wheat export is expected to follow. These imply an oversupply situation. WPI for most protein based items have declined from their 2010 peaks
- **Ballooning under-recoveries of oil PSUs:** If crude prices remains at US$115 levels (Brent), under-recoveries would be fairly large (Rs1.75-1.8trn with INR/USD at 46). Our oil analyst believes average crude price would be US$95 in FY12E, translating into under recovery of around Rs1trn. While this is manageable, sustenance of crude prices at US$115 would imply intense liquidity pressure.
- **Rural theme – Rising NPA in agri-lending:** We maintain our theme "Fragility of rural growth". As per recent reports, PSU banks are reporting sharp rises in farms loan NPAs, between 80%-2,000% during Q1-Q3FY11. While Budget FY12 enhanced agri credit target to Rs4,750bn, we believe volatility in farm income arising from supply surpluses, high indebtedness and rising NPAs will force banks to concentrate on recoveries. While aggressive lending may have fed into consumption spending, rising indebtedness will result in a bigger default and fiscal problem in the future.
- **Market strategy:** The continued moderation in earning estimates for the boarder markets, though camouflaged by steep upgrades in a few companies, reflect better expectations for global-oriented companies and domestic macro stress. While structural changes in the composition of index earnings make historical comparison less relevant, we believe at 15.32 x FY12E EPS, the market may still be expensive. Factors that are likely to be critical in the coming quarters are margin pressure, volume growth moderation, upside risk to lending rates, and the multiplier impact of fiscal contraction. Hence, we are overweight global/export-dependent themes (tactical positive on IT), sectors less sensitive to commodity prices (pharma), and consumer non-durables. Rate-sensitive like infrastructure and real estate sectors would continue to be under stress. While not so positive on two-wheelers and commercial vehicles, we have a constructive view on LCVs and passenger vehicles. The steel sector will likely see margin pressure beyond the short-term improvements.

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Summary – Overstatement of GDP growth: FY11 probably inflated by 90bp

Estimation process in a state of flux: All parts moving: Over the past two years several changes have been made in GDP numbers including disproportionately large revisions, change in base year to 2004-05, change in deflator and expansion in coverage for various components.

- While change in base year should not result in a change in nominal GDP, as it results from a change in base year for the deflators and hence, also the real GDP, recent modifications have resulted in all three parts moving simultaneously. Nominal GDP in the new series (base year 2004-05) shows a widening trend over the old series (base year 1999-00) with a projected upside deviation of 20% in FY11. From our analysis it appears that FY11YTD GDP growth is inflated by 90bp.
- While the new GDP deflator and the embedded inflation (a) has been scaled up, it has been lesser than for the nominal GDP growth (b) there by resulting in an upside bias for the estimated real GDP growth (b-a) potentially by about 100bp.
- The Central Statistical Organisation (CSO) has chosen to make these changes incrementally – first the annual GDP figure and later adjusting each quarter. Hence, quarterlies do not add up to annual numbers

The result – Frequent errors

1. Q1FY11 initial release showed real expenditure GDP growth at 3.7% which was corrected to 10% subsequently citing an error in the deflator used.
2. Over-reporting of capital goods production – over 200% YoY growth for insulated cables for most of FY10-FY11. The 20.4% QoQ fall in real gross capital formation in Q1FY11, the steepest fall since Q1FY98, was subsequently revised to -8.4%.
3. Understatement on import data in recent months.

Inconsistencies galore

Disconnect between leading indicators and GDP data (detail list in Exhibit 63, page 23).

1. **Investments:** While real gross fixed capital formation in GDP grew 20% during Q4FY10 - Q2FY11 (6% in Q3FY11), and also reflected in a huge 34% growth in capital goods production, capital goods imports grew modestly at 10%. FDI has been contracting consistently since Q2FY10.
2. **Agriculture:** Food grain production estimated at 232.07MT for FY11 (advance estimate) is 1% lower than 234.47MT in FY09, but the Real Agri GDP for FY11 is shown to be 5.8% higher.
3. **Manufacturing:** Bulk of the manufacturing sector (76% weight) grew modestly at 5% YoY during Q1-Q3FY11 vs 9.2% for overall manufacturing, which is influenced by volatile components. The manufacturing sector GDP data shows even higher growth of 9.5%YoY.
4. **Core sector:** Leading indicators such as electricity generation (4.5% YoY during Q1-Q3FY11), cement (4.4%), coal (0.8%) and mining ex-crude do not support claims of robust recovery.
5. **Construction:** Recovery in construction GDP (9% YoY CY2010) coincides with rebound in steel production (8% in CY2010). Cement growth on the contrary declined (5.6% in CY2010). Growths for seven construction related industries (bars & rods, cranes, construction equipments, pipes & tubes, steel-railways, structures & telecom cables) have been much softer in FY11 than in 2004-2008.
6. **Trade services:** GDP for trade services grew 11.2% in CY10, stronger than 10.3% during FY05-Q2FY10. Q3FY11 has shown a decline to 9.4%. Leading indicators however suggest slowdown since Q3FY10. These include aviation (cargo & passengers), foreign tourists, cargo handled (ports, railways) and outstanding mobile connectivity.
7. **Financial services:** Notwithstanding recent improvements, average growth in M3, total bank assets, bank deposits and market cap, are far too modest to generate the 10.6% FY11 real growth as per CSO's advance estimates. Gap between the new and old nominal GDP series may have widened by a huge 40%. It will require 57% YoY in Q4FY11 to match CSO's advance estimates.

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Inflated FY11 real GDP growth

Our analysis indicates widespread up-scaling, but the largest bias to GDP growth comes from financial & trade services and manufacturing. Working backwards to extend the old series leads us to real GDP growth for Q1-Q3FY11 of 7.7% vs CSO's estimate of 8.6%.

1. **Industrial GDP:** Dependence of manufacturing GDP growth on volatile components has increased. Balancing out abnormalities would scale down FY11 (Q1-Q3) GDP growth by 270bps to 6.7% vs. 9.5%.
2. **Financial sector GDP:** Disproportionate revision in financial sector GDP contributed nearly 70% of added on services GDP in FY09. Financial services GDP growth is potentially scaled up 3-3.5% due to wider coverage of informal services. Assuming a lower 38% YoY FY11 growth for the add-on component would imply real GDP of 5.5-6% for Q1-Q3FY11 vs 9.1% as reported by CSO.
3. **Trade services:** The key issue here is the lack of supporting evidence from leading indicators. Trends in leading indicators and normalised IIP growth (adjusted for aberrations) prompt us to a trade services GDP growth of 9.7% in Q1-Q3FY, 110bp lower than the reported 10.8%.

Outlook: "Negotiating the new normal" is intact; FY12E at 7.6%

Mixed official views – RBI sounding less optimistic than the finance minister: While the finance minster maintains 9% GDP growth in FY12, recent RBI statements have been more sombre. With concerns on global crude prices and non-food inflation rising, the RBI is now finding it difficult to put into context its anti-inflationary stance given its recent acknowledgement that investments are declining. Misjudgements on both growth, engendered by inflated GDP numbers and inflation profile can result in RBI overacting on the tightening side, thereby hampering growth.

Outlook – Upside risk will emerge; but downside to dominate the near-term: We believe FY12 will see a transition from the stimulus-driven rebound during Q2FY10- Q2FY11 to a new normal trend around 7.5-8% (Exhibit 2). In our view, the near-term downside risks will dominate the upside impulses. Positive impulses would likely emerge gradually and more strongly in FY13. We maintain our 7.6% GDP growth projection for FY12 with an upside bias, which will be roughly similar to our estimate of effective growth of 7.7% in FY11 (lower compared to 8.6% projected by CSO's advance estimates).

Downside risks arising from:

- Initial negative shock from contraction in fiscal spending – 3.4% expansion in expenditure budget for FY12 will imply contraction in real term after 20% average growth during FY08-FY11. Our estimates show that for every 100bp negative shock in real government consumption spending translates into a 50bp cumulative four quarter fall in GDP growth (Exhibit 4).
- Subdued investments in the past three years would constrain future growth. Gross fixed capital formation/GDP fell to 27.3% in Q3FY11 after a rebound to 33% in the previous three quarters.
- Lagged negative impact of huge fiscal expansion during FY08-FY11 reflecting in elevated cost of production & living, downward inelastic interest rates and higher taxes. Risk of further tightening in policy rates and lagged impact of earlier tightening on lending rates.
- Lingering impact of high inflation for raw material inflation averaged 25% in FY11 and possibility of further increase in fuel prices due to elevated crude prices.
- Low risk arising from tightening of global financial conditions: potential rate hikes in US and Europe. Decline in savings in Japan in response to post-quake reconstruction activities.

Upside risks arising from:

- Fiscal moderation should create positive supply responses - Lower the pace of inflation, ending of rate tightening cycle after a quarter. Reversing the crowding out effect will result in positive investment impulses, translating into a firming up of the investment cycle. Estimated impulse response function indicates a lag of 4 quarters for the positive multiplier to emerge (Exhibit 4).

Risks to our view of 7.6% in FY12E with upside bias:

- The biggest risk arises from potential changes in GDP estimation. CSO can potentially post a 9% GDP growth due to amplified inclusion of intractable informal sector.
- Early correction in commodity prices can be a big fundamental positive, in our view.

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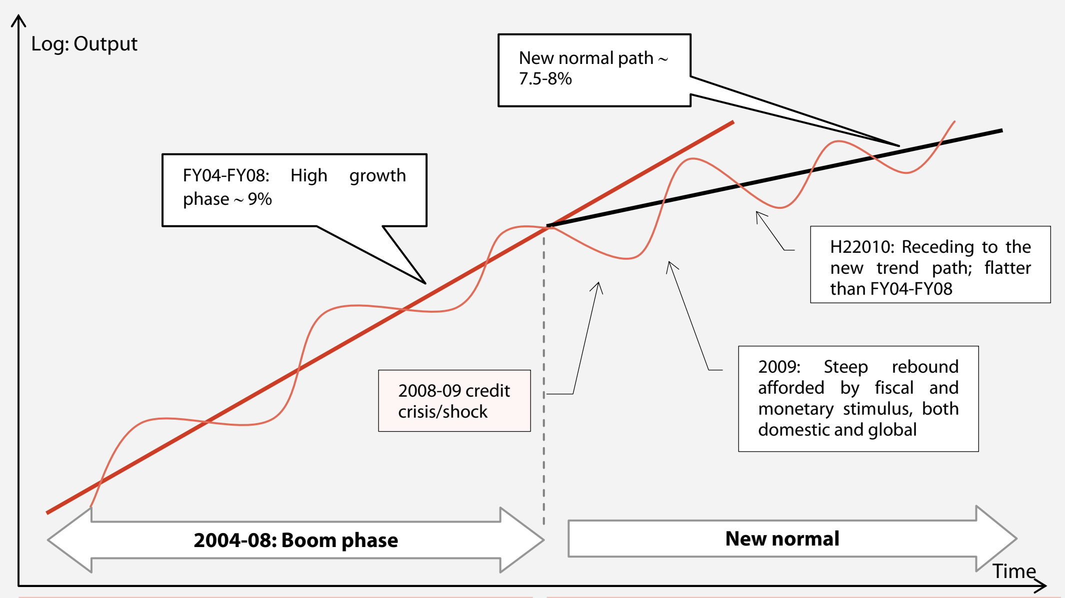
Exhibit 1: Production GDP break up

		FY09				FY10				FY11			Annual		
	Sectors (YoY %)	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**FY10**	**FY11AE**	**FY12E**
1	Agriculture & allied	4.8	2.6	(1.3)	3.3	1.8	1.2	(1.6)	0.7	2.5	4.4	8.9	0.4	5.4	3.0
2	Mining & quarrying	1.0	0.0	1.2	(0.3)	6.9	6.6	5.2	14.0	8.4	7.9	6.0	6.9	6.2	7.6
3	Manufacturing	6.4	6.3	1.9	0.6	2.0	6.1	11.4	16.3	13.0	9.8	5.6	8.8	8.8	7.5
4	Electricity, gas & water	5.1	6.2	5.9	4.1	6.2	7.5	4.5	7.1	6.2	3.4	6.4	6.4	5.1	7.0
5	Construction	9.7	7.2	1.1	5.7	5.4	5.1	8.3	8.7	10.3	8.7	8.0	7.0	8.0	8.5
6	Trade, hotels, transport & comm	10.1	10.4	4.3	5.7	5.5	8.2	10.8	12.4	11.0	12.1	9.4	9.7	11.0	9.8
7	Finance, ins, real estate, bus services	10.1	9.8	10.8	12.3	11.5	10.9	8.5	7.9	7.9	8.2	11.2	9.2	10.6	9.5
8	Community, social & personal services	8.3	9.4	22.6	8.8	13.0	19.4	7.6	1.6	7.8	7.4	4.8	11.8	5.7	5.0
9	**GDPfc**	**8.0**	**7.8**	**5.6**	**5.8**	**6.3**	**8.6**	**7.3**	**8.6**	**8.9**	**8.9**	**8.2**	**8.0**	**8.6**	**7.6**
11	Agriculture	4.8	2.6	(1.3)	3.3	1.8	1.2	(1.6)	0.7	2.5	4.4	8.9	0.4	5.4	3.0
12 (2.5)	Industry	6.8	6.0	1.9	2.1	3.7	5.9	9.5	13.3	11.3	8.9	6.4	8.0	8.1	7.8
13 (6-8)	Services	9.7	10.0	10.2	8.3	9.0	11.6	9.4	8.4	9.3	9.8	8.8	10.1	9.6	8.6
	GDPfc (Rs bn)	**9,843**	**9,745**	**10,865**	**11,100**	**10,465**	**10,587**	**11,661**	**12,051**	**11,392**	**11,526**	**12,617**	**44,937**	**48,792**	**52,489**

Base year 2004–2005

Source: CSO, Centrum Research

Exhibit 2: India's growth cycles migrating to a new path: stylized depiction



2004-08: Boom phase

- Strong global growth aided by leveraged spending, widening US current account deficit (CAD) and the credit asset market boom.
- India benefited from the global scenario; growth characterized by low inflation and the credit- asset market boom.
- Comfortable CAD conditions, rising investments.
- Improvement in fiscal balances and corporate profitability implied a surge in domestic savings.
- Low inflation counterbalanced INR appreciation, resulting in a comfortable level of external competitiveness.

New normal path: flatter post-2008

- Global demand is softer as the impact of stimulus efforts recede; fiscal stress forcing austerity.
- India's superior growth was supported by aggressive fiscal expansion in 2008-09, but the effect is now fading; Structurally, high fiscal spending.
- High inflation and INR appreciation eroding external competitiveness; demand leakage, moderation in savings/investment rates.
- Revival of external competitiveness and productivity critical for sustenance of recovery.
- Fiscal consolidation to create positive supply responses over the medium term, but slower near-term growth.

Note: Log scale linearize the compounding impact of growth rates

Source: Centrum Research

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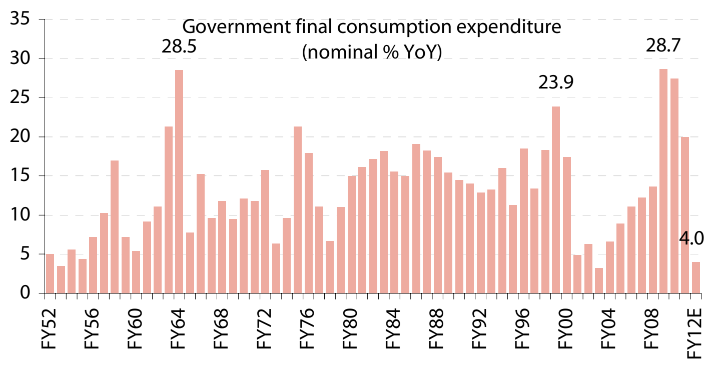
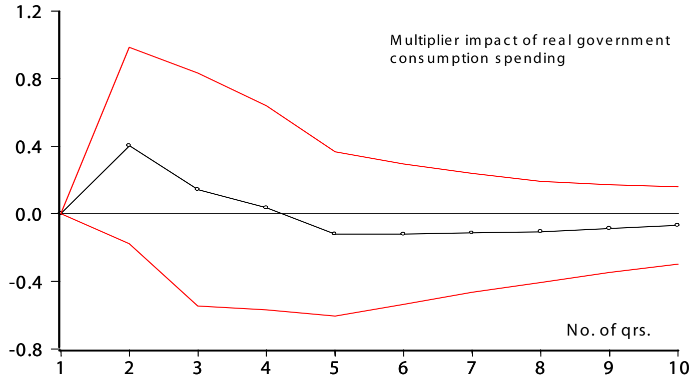
Exhibit 3: Fiscal moderation after a steepest ever expansion



Source: CSO, Centrum Research

Exhibit 4: Hyper-fiscal expansion helped create recovery, but withdrawal symptoms will prolong



Red lines = 95% confidence interval; estimated from quarterly GDP data for Q1FY01-Q1FY09

Source: CSO, Centrum Research

- The fiscal multiplier represented above shows the progression of the multiplier impact of 1% exogenous shock in real government consumption spending on real GDP growth. A 100bp shock in spend would translate into a 50bp cumulative four quarter rise in GDP growth; 40bp at the peak
- The multiplier turns negative subsequently, due to: a) slowdown in spending momentum, clustering of demand in the earlier period, b) rise in interest rates, c) increase in taxes through reversal of fiscal incentives or rise in inflation and, d) leakage of demand expansion to the external sector, implying widening external deficits/reduction in surplus.

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Summary of our recent macro thoughts

Declining food inflation and rising cost pressures: Inflation in Feb 2011 rose to 8.3% from 8.2% in Jan 2011 despite the sharp fall in food inflation. The rise is attributed to the sharp increase in global cotton and oil seed prices. While manufactured product inflation climbed to 4.9%, it is relatively small compared to persistent rise in cost of raw materials – 11.5% and 25%, respectively, for fuels and primary ex-food, implying intensifying margin pressure and declining pass-through coefficient. While the risk of further escalation of costs persists, we believe the onward trend in inflation is likely to decline due to demand moderation. Recent decline in food inflation and moderation of prices of some raw material components are indicative trends. While we expect WPI inflation to decline to 5-6% in FY12 there is a reasonable probability of a 100bp upside from potential increase in administered fuel prices.

Food surplus beats the facile structural demand-supply shortage thesis: While the official position has been that food price shocks resulted from structural supply-demand deficit, a thesis we have consistently refuted , recent developments substantiate our view. Government has decided to lift export ban on rice, sugar and onions to stabilise declining domestic prices. Wheat export is expected to follow. The expected 82mt wheat production in 2010-11 is in excess of annual consumption of 76mt. Total food grain production of 232mt and large buffer imply an oversupply situation. RBI till recently argued that rising incomes and consequent increase in protein diet resulted in increase in prices of milk and non-vegetarian items. But we do not hear that argument any more. The reason: WPI for most protein based items have declined from their 2010 peaks: pulses (-14%), milk (-2%), poultry (-17%), eggs (-8.2%) and mutton (-4%). Overall, misplaced assessment is bound to lead to misplaced policy responses. Along with the declining trend in manufactured food prices, food inflation declined to 6.5% in Feb 2011 (10% in Dec 2010). Going forward, it will be cost factors that will be more important for food economy than demand pressures.

Monetary policy measures

March 16, 2011

- Repo rate and reverse repo rate hiked by 25bp from 6.50% to 6.75% and from 5.50% to 5.75% respectively
- Unchanged CRR at 6% , SLR 24%

Expected outcome

- Continue to rein in demand side inflationary pressures while minimizing risk to growth
- Manage inflationary expectations and contain the spillover of food and commodity prices into more generalized inflation

Monetary policy – RBI's stance could be a reaction to cost pressures: In our view, given the cost pressures and recent moderation in manufacturing sector and investments growth, the RBI's anti-inflationary stance can result in the central bank erring on the tightening side, which could adversely impact growth. The RBI increased the inflation target to 8% in its March 2011 statement. Rise in crude prices continues to pose serious risk to inflation and fiscal management. We believe beyond maintaining the current level of monetary tightening, the RBI can do little to control it. In our view, rising cost pressures can itself contract demand. RBI will find it difficult to increase rates beyond mid-2011. Liquidity conditions may not ease substantially due to increased borrowing by PSU oil companies to fund their under recoveries which will balance out moderation in government gross borrowing in H1FY12 atRs2,500bn.

Fiscal – Pro-stability FY12 budget, but managing subsidies will be tricky: The moderation in spending in budget FY12 to a modest 3.4% and lower fiscal deficit comes from lower budget for both non-plan revenue and capital expenditure, despite higher commitment for plan spending. Lower fiscal deficit of Rs4,128bn vs our expectation of Rs4,500bn is arrived at based on an optimistic disinvestment target of Rs400bn and conservative spending. This translates into an optimistic fiscal deficit/GDP number of 4.6%. Lower net market borrowing of Rs3,580bn also assumes an optimistic 36% growth in mobilization through small-savings schemes. We believe a realistic net market borrowing number could be around Rs4,200bn. Overall, we expect significant compromises on social and capital spending in the consolidation process.

Ballooning under-recoveries of oil PSUs: If crude prices remains at US$115 levels (Brent), the under recovery would be fairly large (Rs1.75-1.8trn with INR/USD at 46). Our oil analyst believes average crude price would be US$95 in FY12E, translating into under recovery of around Rs1trn. Out of this, about 40-45% would be borne by upstream companies and oil marketing companies (OMCs), and the balance by the government. Given the budget provision of Rs236bn, the government needs to provide for another Rs300-400bn. Overall, this means higher fiscal borrowing or credit demand by OMCs, thereby putting pressure on liquidity. While this is manageable, sustenance of crude at US$115 would imply intense liquidity pressure.

Exhibit 5: Agri NPAs of select banks

Rs crore	Q1-Q3FY10	Q1-Q3FY11	% YoY
SBI	2,322	3,717	80
Corporation Bank	122	309	205
Allahabad Bank	215	470	157
Andhra Bank	26	57	168
Bank of India	490	857	100
State Bank of Bikaner & Jaipur	7	106	2,000

Source: Finance ministry data, Times of India (Mar 7, 2011

Rural growth theme – Rising NPA in agri-lending: We continue hold our macro theme view "Fragility of rural growth" (May 2010 and update in Nov 2010). As per recent media reports , PSU banks are reporting sharp rises in farms loan NPAs - between 80%-2,000% during Q1-Q3FY11 (Exhibit 5). SBI reported bad loans of around Rs372mn (80%YoY). While Budget FY12 enhanced agri credit target to Rs4,750bn, we believe volatility in farm income arising from supply surpluses, high indebtedness and rising NPAs will force banks to concentrate on recoveries rather than lending. We maintain that while aggressive lending may have fed into consumption spending, rising level of indebtedness and rising risk of default will result in a bigger default and fiscal problem in the future.

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Market strategy: Macro stress still significant

- **Wider earnings downgrades overwhelmed by sharp upgrades in few companies:** While the BSE Sensex EPS estimates for FY12 and FY12 has undergone only a moderate corrections (2.4% for FY11E at Rs1,067 and 3% for FY12E at Rs1,269), the underlying components show a fairly divergent trend. 18 companies have seen an average downgrade of 10.4% (FY11E) while the remaining 12 have seen an upgrade of 13.6%, dominated by 187% for Tata Motors and 20% for Hindalco Industries. Similar pattern holds true for FY12E. Overall, better expectations for global oriented companies have helped keep index EPS stable reflecting domestic macro stress. Hence overweight global / exports dependent companies will be a good theme to play. While structural change in the composition of index makes historical comparison less relevant we believe at 15.32 x FY12E EPS, the market may still be somewhat expensive. The key risk would arise if developed markets undergo renewed slowdown.
- **Margin pressure – Overweight sectors less sensitive to commodity prices:** Commodity prices have been rising since mid 2009 and have sustained longer than our expectation. Inline with our long standing view, earnings expectations are moderating and would possibly intensify due to contraction in fiscal spending against the backdrop of modest pricing power pricing power and rising cost. In our view, there is a strong likelihood for this scenario sustaining in the coming quarters. To summaries our earlier findings (Feb 2010), while sectors like automobiles, FMCG, oil & gas, power and metals are more susceptible to rise in commodity prices, pharma and real estate are less impacted. Auto and auto ancillary being the most vulnerable. Consumer durables seem to have a low correlation and the cement sector has no meaningful correlation. For most sectors, rise in commodity prices impacts the raw material/sales ratio with a lag of two quarters. Hence, overweight sectors enjoying strong pricing power or low sensitivity.
- **Moderation in government spend to result in lower cash for rural India:** Moderation in government spending support on social, correction in food prices and focus on recoveries of farm loans will imply lower cash flow for the rural story. We believe the agri-driven story would sober down. Consumption-led demand recovery would be oriented towards non-durables, but the volatility in food grain procurement-related flows would slow growth for durables and autos. Concerns on credit risk would have implications for PSU banks.
- **Interest rate sensitive — End of the tightening cycle still some time away:** Notwithstanding the positive signals from the budget, we believe the lending rates would continue to harden given the RBI's hawkish stance. Liquidity scenario will likely ease in the initial quarters due to lower government gross borrowing of Rs2,500bn in H1FY12 (60% of total annual of Rs4,171bn). Gsec yield curve will likely undergo bull flattening implying short-term positive for banks. Overall, the rate scenario will continue to impact infrastructure and real estate sectors adversely. Our stand can potentially change if crude price corrects below USD 100/bl in a sustainable fashion.
- **Overweight sectors benefiting from rising commodity prices:** We would overweight selective energy stocks (which benefit from higher crude price, GRMs, pet chem margins).
- **Consumer space:** Overweight non-durables, underweight durables and pharma (non-correlated with interest rates). Decline in prices of primary food articles will benefit FMCG companies dependent on cereal inputs.
- **IT services sector:** We are tactically positive on the sector due to our cautious stance on interest rate sensitives. The sector is also likely to benefit from upgrades in economic growth estimates of US and Europe. Structurally, intensifying competition with MNCs would lead to slower growth and pressure on margins. We are expecting 18-22% volume growth for Tier I IT companies in FY12 with an upward bias.
- **Automotives:** Overall we see moderation in volume growth, particularly for 2Ws and CVs. However, we are somewhat positively disposed towards LCVs and passenger vehicles. Broadly we expect moderation in demand, weakening pricing power and margin pressures. The backdrop for M&HCVs is not favourable, in our view, given the challenge arising from subdued cargo movement data for both railways and major ports, notwithstanding the stronger performance of the container segment. Port volume grew just 1.1% in the 11mFY11..
- **Metals:** We are not very favourably inclined towards domestic steel industry though recent hikes in product prices in Jan 2011 and stable to marginal increase in quarterly contract raw material prices in Q4FY11 are expected to improve margins in Q4FY11. However, we expect this to be short lived as product prices have corrected by 10-12% globally in last 6 weeks and contract prices of raw materials are expected to show a significant jump from Q1FY12E (20-45% hikes expected in iron ore and coking coal), we expect margins to get squeezed in H1FY12E.
- **Please see the summary of our Sectoral strategy in Exhibit 6.**

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Exhibit 6: Sectoral strategy summary (For valuation summary see page 24)

Sector	Underweight/ Overweight		Sector View	Key Ideas
Automobile	Two-wheelers: Neutral		We remain Neutral on two-wheelers as we expect volume growth to moderate to 10-11% over FY12E and FY13E vs 25% in FY11. Pricing power to be limited due to increased competition (aggression from Honda post the JV exit with Hero Honda).	**Top Buy: Bajaj Auto** Strong margin profile and better revenue visibility Trades at 12.7x FY13E Core EPS) **Top Sell: Hero Honda (HH)** We believe that a de-rating is likely as margin pressures get accentuated in FY12-13E consequent to the exit of Honda Motors from the JV. Risks associated with HH's ability to scale up its R&D and launch of new products from its stable Lower RoEs (average of 37% over FY120-13E vs average of 54% over FY10-11E) will also drive this de-rating
	CV:	Neutral	We remain neutral on the commercial vehicles (CV) sector largely on M&HCV (Goods) segment. We believe moderation in GDP growth/IIP growth coupled with pressure on fleet operators' profitability would keep demand under check. As a result, we expect volume growth to moderate to 11%-12% in FY12E-13E compared to 25% in FY11E. Also, pricing power would be limited with expected moderation in growth. We, however, remain more positive on LCV growth story and expect volume growth of 20+% for FY12E/FY13E compared to 27% in FY11E.	**Top Buys: Tata Motors** Domestic CV business to remain under pressure in line with our industry call. However, JLR to continue to register strong volume and profitability growth. JLR now accounts for 55% of Conso revenues and 65% of Conso EBITDA Trades at 7.8x FY13E Consensus EPS **Top Sells: Ashok Leyland** Pure CV play. Pricing power to get limited with moderation in growth. Trades at 9.8x FY13E compared to historical average of 10.5 x. Limited upside on absolute basis.
	PV:	Overweight	We remain positive on Passenger Vehicles and expect volume growth of 13-14% in FY12E and FY13E.	**Top Buy's** **Mahindra & Mahindra** Metamorphosis of business-mix over the next few years. Only player to be present across the entire auto value chain ranging from two-wheelers, PV, Commercial Vehicles and Tractors. Pricing power better on account of dominance in both UV's and Tractors segments. Trades at 11.5x FY13 Core EPS. **Maruti Suzuki** Holds on to market share in excess of 50% despite increase in competitive intensity. We expect the company to remain market leaser in passenger car segment. Trades at 11.4x FY13E Core EPS.
Banking	Sector:	Overweight	Immediate outlook clouded by tight monetary stance, liquidity problems and asset quality concerns. However, near term outlook to improve as monetary tightening comes to an end and liquidity deficit eases. Moreover concerns over NIM compression and asset quality though valid seem overblown. Current valuations are undemanding. Overweight from medium term to long term perspective	**Top Buy: ICICI Bank** Refocusing on growth, improved liability profile to drive NIM expansion, revival in retail credit demand, declining credit costs to boost bottom-line, 2.1x FY12E book value per share
Cement	Sector:	Underweight	Oversupply is expected to persist till FY13E Effective utilization rate of the industry will remain below 80% Recent price hike does not seem sustainable and could go down during monsoons	**Top Buy: Grasim Industries** A proxy to cement and offers an exposure to VSF business. VSF prices are on an upward trend (current price is at Rs 136/kg, up 22% YoY). VSF business contributes 36-38% of consolidated EBITDA, has strong entry barriers and attractive EBITDA margins (26%-40% over the last 3.5 years except in Q4FY09 -17.3% and Q2FY09- 21.4%). Valuations for Grasim is attractive as it trades at 10.2x FY13E EPS and 4.4x EV/EBITDA. **Top Sells: UltraTech and Ambuja Cement** Expensive valuations as these companies are trading at 40% premium to replacement cost in the scenario of bleakish cement pricing outlook, rising energy and freight costs UltraTech's 51% capacities are in the southern and western regions, where we expect utilization rate to remain 70-73% till FY13E, whereas Ambuja Cement's 42% of dispatches are in the West region.

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Sector	Underweight/ Overweight	Sector View	Key Ideas
IT services	Large-Caps : Neutral Mid-caps: Underweight	We are tactically (next 3 months) positive on the sector due to our cautious stance on interest rate sensitive stocks and would remain so if crude price do not correct below $100/bl. However structurally, we believe intensifying competition with MNCs would lead to slower growth and pressure on margins. We are expecting 18-22% volume growth for Tier I IT companies in FY12.	**Top Pick : Infosys Technologies** Better positioned than others to sustain margins, Sets industry benchmark with highest ROIC and superior margins **Top Sell: Wipro** Low ROIC owing to its capital inefficiency and sluggish growth should translate into higher discount to Infosys
Logistics	Container logistics - Overweight Transporters - Underweight -	Overall sector is facing a challenge in terms of volumes growth which is impacting pure transporters. This is also reflected in the lower port volumes which have grown just 1.1% in the 11mFY11. However, this growth is largely contributed by the 12.5% growth in container volumes negating the 12.6% decline in iron-ore volumes. Thus we expect container volumes to remain steady in FY12 and estimate 8.2% volume growth (in TEU terms) to 8.1mn TEUs for FY12E on the back of improved performance during FY11.	**Top Buy: Allcargo Global Logistics** We estimate consolidated earnings growth of 16.5% over CY10-12E with RoCE of 13-14% and low debt to equity of 0.2x Attractive valuations. Currently trading at a P/E of 8.7x CY12E and 4.7x EV/EBITDA **Top Sell: Container Corp (Concor)** We estimate earnings growth of just 10.2% over FY11-13E with RoCE declining from 18.6% in FY11 to 117.7% in FY13E High valuations : Currently trading at a P/E of 15x FY13E and 9x EV/EBITDA
Metals & Mining	Steel : Neutral Base Metals : Overweight	Domestic steel industry is expected to show improved margins in Q4FY11 on the back of product price hikes in the range of 10-14% effected since the start of January 2011 and stable to marginal increase in quarterly contract raw material prices in Q4FY11. Product prices have corrected by 10-12% globally in last 6 weeks and have now started to stabilize at a lower base. With contract prices of raw materials expected to show a significant jump from Q1FY12E (20-45% hikes expected in iron ore and coking coal), we expect margins to get squeezed in H1FY12E. We remain neutral on the overall domestic steel space with concerns over margin pressure due to high raw material costs.	**Top Buys: Sterlite Industries, JSW Steel** Sterlite is expected to register strong earnings growth ahead backed by improving volumes and strong product prices; trades at 9x FY13E EPS JSW Steel's volume growth and Ispat's turnaround are key triggers; trades at 8x FY13E EPS and 5.5x FY13E EV/EBITDA **Top Sell: SAIL** Volume growth delayed, margin pressure increasing; trades at 12x FY13E EPS and 6.5x EV/EBITDA
Shipping	Tanker operators - Overweight Dry bulk carriers - Neutral	The global shipping sector is facing a huge oversupply and decline demand, led by the metal industries. We expect shipping sector to remain under pressure for two more years (FY13-14) to absorb the excess supply and demand to recover. However, we prefer Indian shipping players as they are better placed vs global peers due to their large tanker fleet (80-85%) and under-leveraged balance sheets.	**Top Buys: GE Shipping, SCI** GE Shipping is likely to benefit from the timely capex (US$573mn in shipping and US$362mn in the offshore) and the expected upturn in the shipping cycle. We are also positive on GE Shipping due to its large presence in the offshore services segment which we believe is more stable that the shipping business We are positive on SCI's business portfolio mix as 83% of its fleet is in the tanker segment, which is likely to be more stable than the dry bulk segment. Further with the FPO and huge cash on books (Rs30bn as on 31-Dec10), the company is all set to expand its fleet in the next two years, just in time to benefit from the upturn in the shipping cycle expected from FY13.
Telecom	Sector: Overweight	Business dynamics improving for incumbents with stabilization of revenue per min. Regulatory clarity to emerge with New Telecom Policy 2011. Sector valuation captures negatives.	**Top Buy: Bharti Airtel** Business environment improving with stability in revenue per min in the domestic market. Better placed to absorb regulatory challenges, one time payouts; trades at 6.5x FY13E EV/EBITDA

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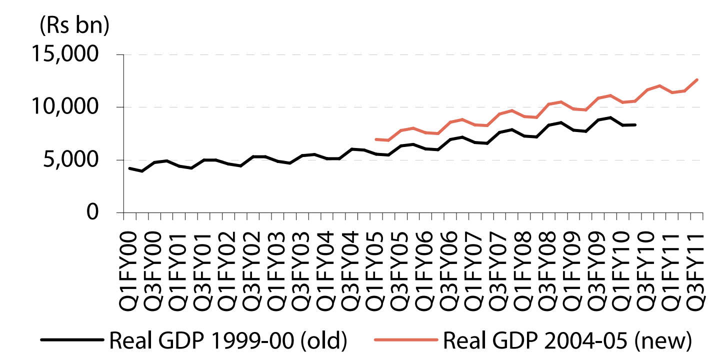
Assessing the GDP estimation bias

Estimation process in a state of flux

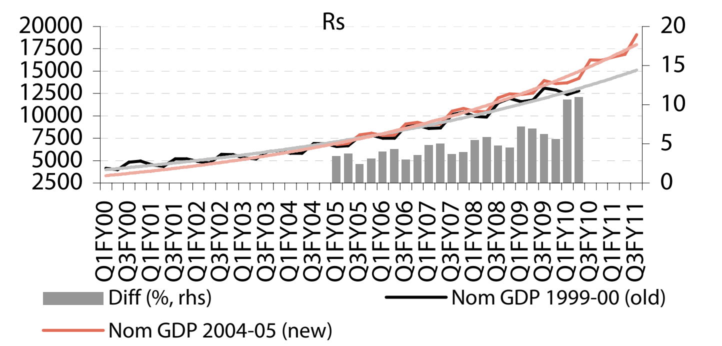
- Nominal GDP in the new series (base year 2004-05) shows a widening trend over the old series (base year 1999-00) with a projected upside deviation of 20% in FY11.
- While the new GDP deflator and the embedded inflation (a) has been scaled up, it has been lesser than for the nominal GDP growth (b) thereby resulting in an upside bias for estimated real GDP growth (b-a) potentially by about 100bp.
- The CSO has chosen to make these changes incrementally – first the annual GDP and later adjusting each quarter. Hence, quarterlies do not add up to annual numbers. The CSO's web-link to quarterly data is seen inactive after every recent release, probably to reflecting the adjustment process underway.

Exhibit 7: New series has lifted up real GDP by 24.9%



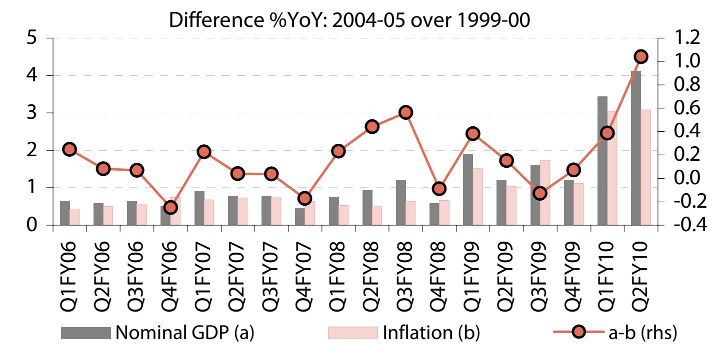
Source: CSO, Centrum Research

Exhibit 8: Re-basing has also shored up nominal GDP with progressively higher bias for recent releases



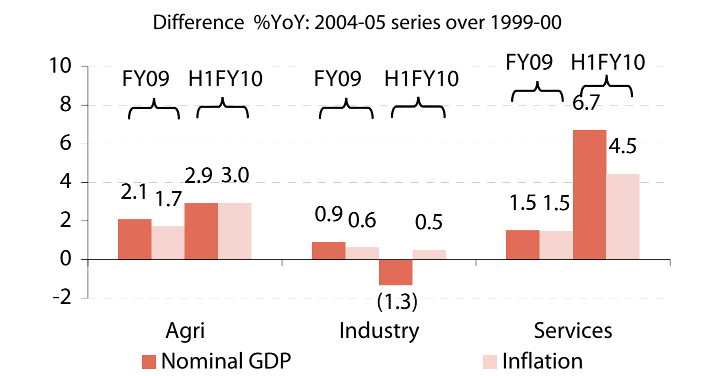
Source: CSO, Centrum Research

Exhibit 9: Caused by stronger upside bias in nominal GDP growth than growth in deflators



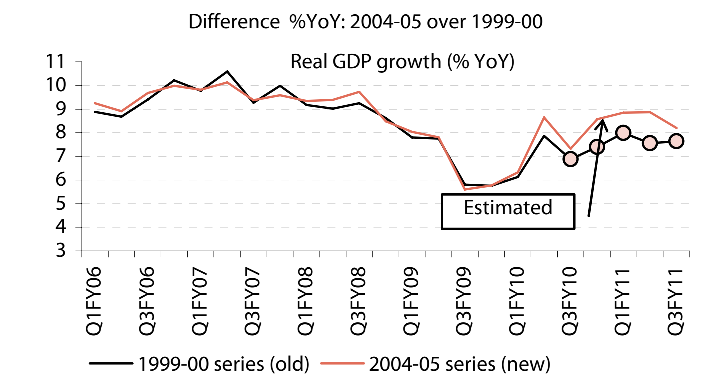
Source: CSO, Centrum Research

Exhibit 10: Upside bias in new real GDP growth originating from services sector



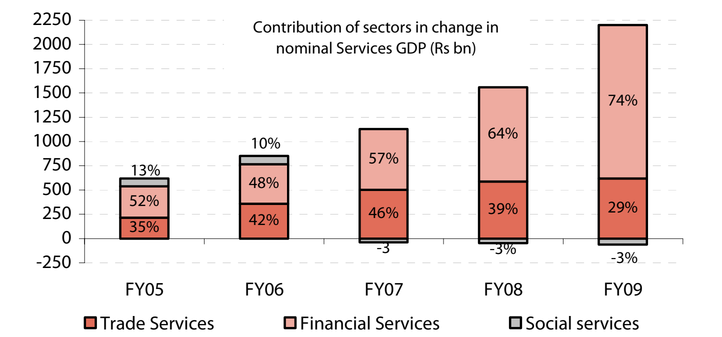
Source: CSO, Centrum Research

Exhibit 11: Upside bias in new real GDP growth originating from services sector



Source: CSO, Centrum Research

Exhibit 12: Upside bias in services GDP from financial services



Source: CSO, Centrum Research

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Agri GDP: 8.9% YoY growth in Q3 helps shore up FY11 GDP, but surprises still unexplainable

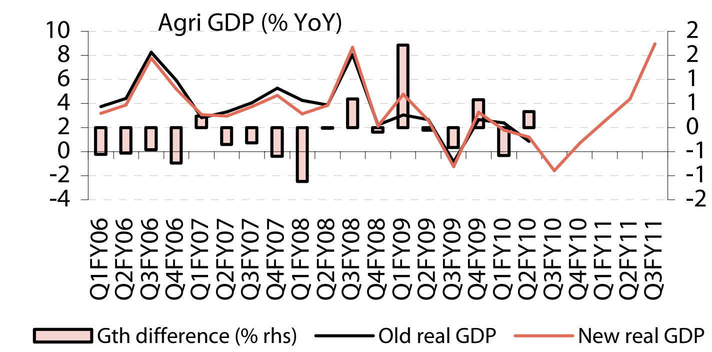
The high 8.9% Q3FY11 growth in agri GDP is broadly in line with the estimated 6.4% food-grain production growth FY11 (CSOs advance estimates). While there has been some alterations in GDP estimates (both nominal and real) in the new series (base year 2004-05) they are not very significant. Nevertheless we do find some surprises:

a) The overall food grain production estimated at 232.07MT for FY11 (advance estimate) is 1% lower than the peak of 234.47MT in FY09, but real agri GDP for FY11 is shown to be 5.8% higher. The seasonal peak in Q3FY11 in Agri GDP (68%QoQ) is higher than in FY09 (66% QoQ).

b) The positive 0.44% growth in real agri GDP in FY10 even with a 19% deficiency in monsoon which was nearly as bad as 20% in FY03 when real agri GDP contracted 7.24%. A flat growth is also in contrast with the 12% and 1.9% contractions in Kharif and Rabi crop production in FY10. In its initial estimates for FY10 CSO had indeed indicated 2% contraction in real Agri GDP growth. The swing from -2% to 0.44% is unexplainable.

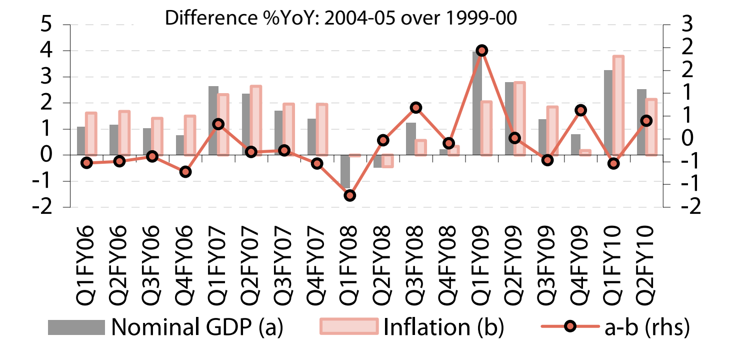
While historical trends indicate strong correlation between real Agri GDP growth and food grain production (Exhibit 18) recent surprises suggest structural changes in estimation process or a break in historical trend, both of which are difficult to comprehend.

Exhibit 13: Agri GDP real growth



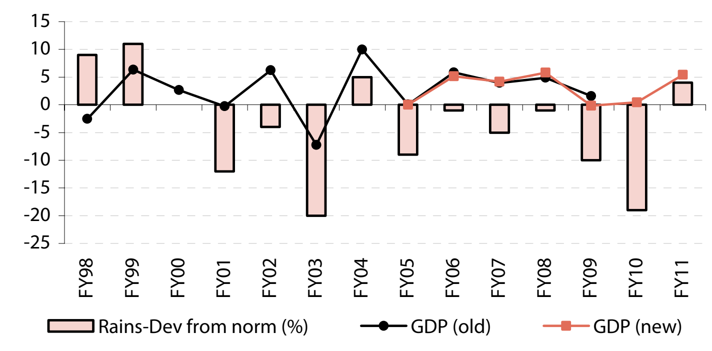
Source: CSO, Centrum Research

Exhibit 14: Agri GDP nominal growth and inflation



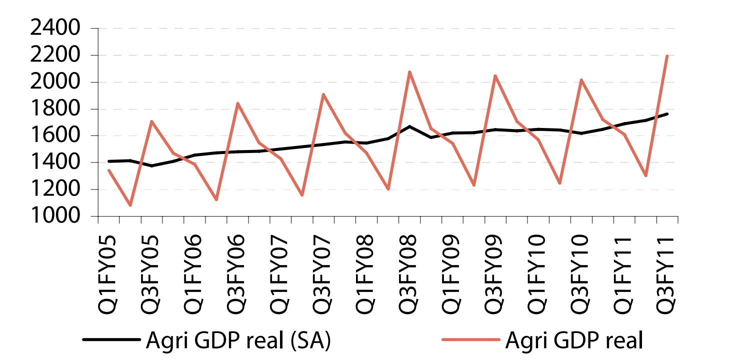
Source: CSO, Centrum Research

Exhibit 15: Flat Agri GDP growth (%) in FY10 was surprising given the sharp negative deviation in rainfall



Source: CSO, Centrum Research

Exhibit 16: Real Agri GDP making new highs (Rs bn)



Source: CSO, Centrum Research

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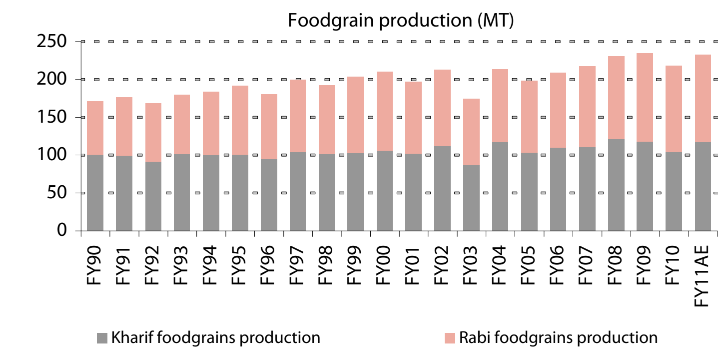
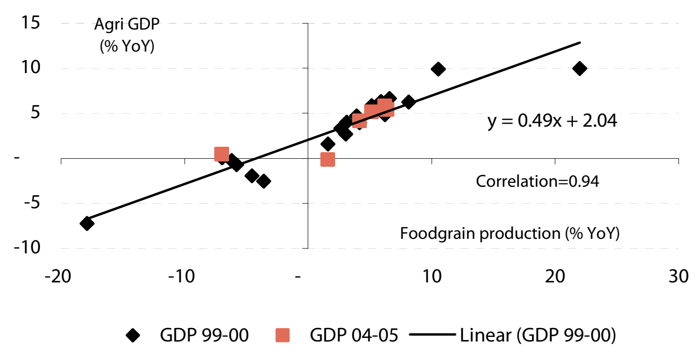
Exhibit 17: But food grain production FY11E at 232MT is lesser than the peak of 235MT in FY09



Source: CSO, Centrum Research

Exhibit 18: Food-grain production and Agri GDP are highly correlated



Source: CSO, Centrum Research

Industrial GDP: Propped up by reducing deflator; Large recent volatility out of sync

Upside bias in industrial GDP: Elevation in nominal GDP (average 4% for FY08-FY09) and downward revisions in deflators amplified upward revision in real GDP for industrial sector (Exhibit 20) and the impact came largely from the manufacturing sector. Critical thing to observe is that downward revisions in the deflators for industrial sector are contrary to the upward revisions for other components of GDP. Larger revisions for FY09 has however, resulted in slower YoY growth for FY10 compared to the old series (1999-2000).

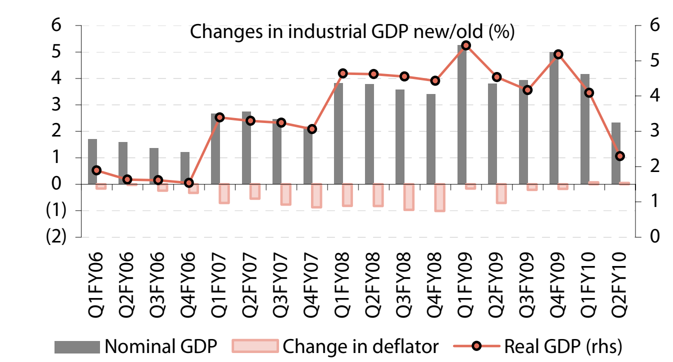
High dependence on volatile components: Break up of the manufacturing sector (from industrial production data, Exhibit 23) shows that the bulk of manufacturing sector (76% weight in manufacturing index of IIP) grew modestly at 5% YoY during Q1-Q3FY11 compared to the overall manufacturing sector at 9.2% YoY. The manufacturing sector GDP data however shows higher growth of 9.5%YoY.

Our analysis indicates that the dependence of manufacturing GDP growth on volatile components has increased in the new series (Exhibit 23-27). Balancing out the abnormalities (giving higher weight to broader trend in manufacturing sector, Exhibit 28) would probably scale down FY11 (Q1-Q3) manufacturing GDP growth by 270bps to 6.7% from 9.5% reported by CSO.

High volatility in industrial production growth and industrial GDP growth has been caused by four sectors or Big 4 sectors (machinery, transport equipments, metal products and other manufacturing, 24% weight in manufacturing index of IIP) which posted a growth of 26% during Q3FY10-Q2FY11, which is a 20 year high. While some of this is explainable, given the concentrated rebound in auto sector, a large part of the abnormality is attributable to reduction in deflators which resulted in significant over estimation in capital goods sector[3].

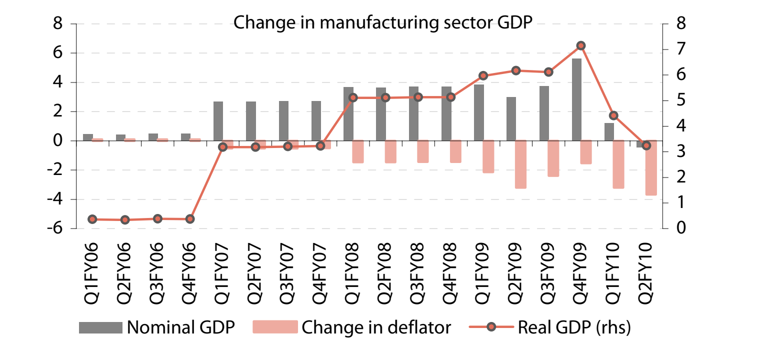
In addition, trends in leading indicators such as electricity production (4.5% YoY during Q1-Q3FY11), cement (4.4%), coal (0.8%), mining ex-crude and investment trends indicate a slowdown in industrial growth. Recovery in FY09-FY10 has largely been concentrated in consumption sectors (autos and durables in particular) and consumption dependent sectors.

Exhibit 19: Industrial GDP growth scaled up by lowering the deflator



Source: CSO, Centrum Research

Exhibit 20: Largely contributed scale up by manufacturing sector GDP



Source: CSO, Centrum Research

3 Our analysis has earlier indicated that a significant portion of data for capital is collected in nominal terms and the real value is arrived at by assuming a deflators.

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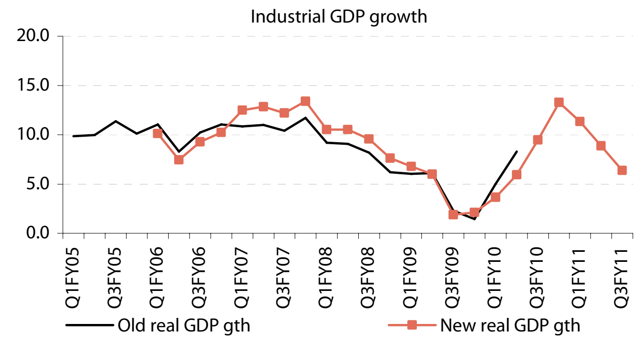
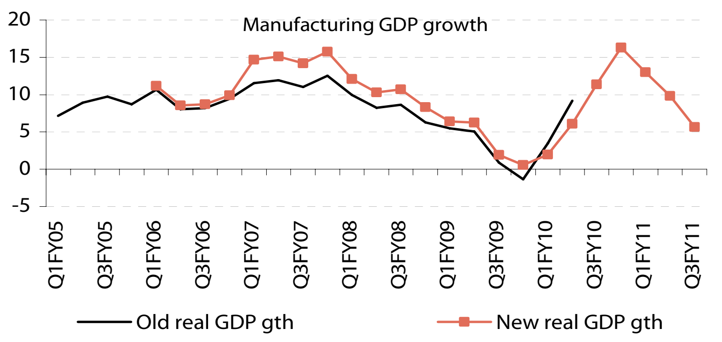
Exhibit 21: Industrial GDP : 2004-05 series vs. 1999-2000



Source: CSO, Centrum Research

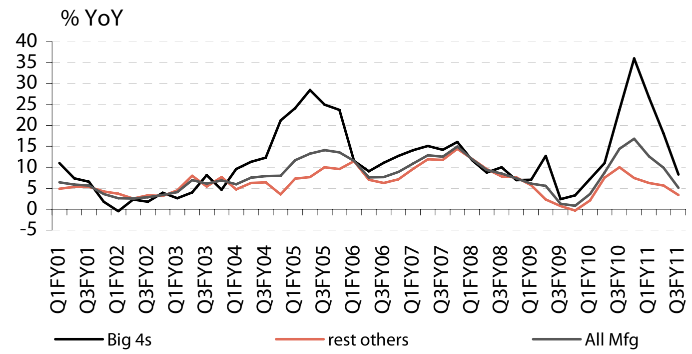
Exhibit 22: Manufacturing GDP : 2004-05 series vs. 1999-2000



Source: CSO, Centrum Research

- Manufacturing sector rebound has not been broad-based. A more subdued core sector growth provides little support to CSO data suggesting 20-year high in industrial growth during Q2FY10-Q2FY11.

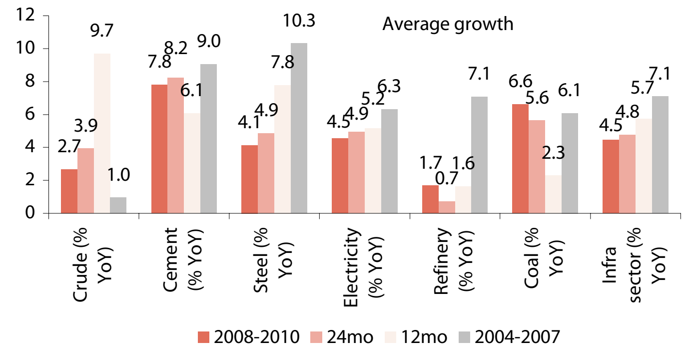
Exhibit 23: Manufacturing sector rebound has not been broadbased



Big 4 sectors (machineries, transport equipments, metal products and other manufacturing, 24% weight in manufacturing index of IIP) Rest others weigh 76%

Source: CSO, Centrum Research

Exhibit 24: Core infra recovery softer than 2004-07 cycle

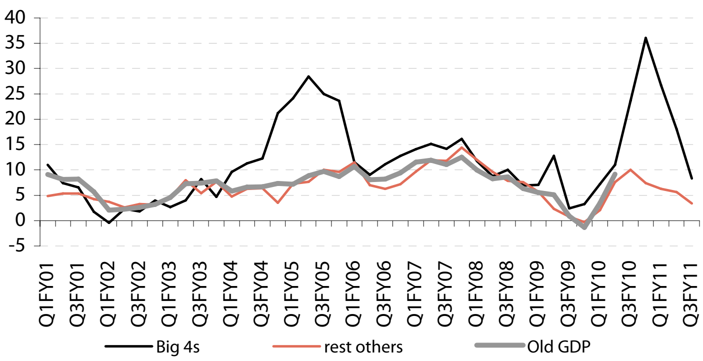


Updated till Dec 2010

Source: Bloomberg, CSO, Centrum Research

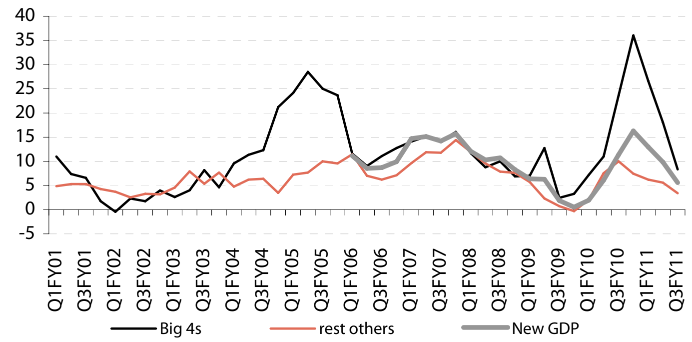
- New manufactured sector GDP series (base year 2004-05) show higher dependence on volatile components in manufacturing sector production than the earlier series (base year 1999-2004) suggesting presence of upward bias.

Exhibit 25: Manufacturing GDP growth (old) vs. manufacturing sector growth



Source: CSO, Centrum Research

Exhibit 26: Manufacturing GDP growth (new) vs. manufacturing sector growth



Source: CSO, Centrum Research

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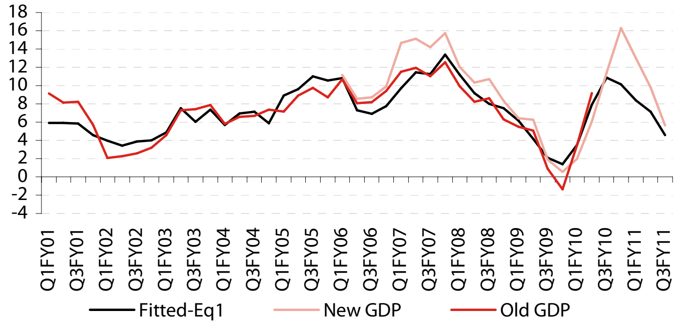
- FY11 manufacturing sector GDP growth may be 270bps lower than the reported 9.5% reported.

Exhibit 27: High dependence of manufacturing GDP on volatile manufactured components in recent periods

Dependent	Manufacturing GDP					
Equations	Eq 1		Eq 2		Eq 3	
GDP series	Old		New		New	
Sample	**Q1FY01-Q2FY10**		**Q1FY06-Q3FY11**		**Q3FY10-Q3FY11**	
	Coeff	**t-stats**	**Coeff**	**t-stats**	**Coeff**	**t-stats**
Constant	**1.3**	2.5	**0.2**	0.3	**2.8**	6.3
Big 4	**0.1**	2.5	**0.3**	6.2	**0.4**	20.3
Rest others	**0.7**	9.2	**0.8**	9.2	**-0.1**	-0.7

Source: CSO, Centrum Research

Exhibit 28: Manufacturing GDP during Q1-Q3FY11 could be lower at 6.7% vs. the reported 9.5%



Source: CSO, Centrum Research

Construction industry performance does not support 9% construction GDP growth in FY11

The new GDP series has scaled down construction sector GDP growth (Exhibit 29) for the period prior to Q1FY10 by an average of 3.4% over the old series but there is an up-scaling of about 2% since Q1FY10, indicating upside bias in the 9% Q1-Q3FY11 growth. We also note the down-draft in real GDP growth is arrived at by elevating nominal GDP (Exhibit 30) in earlier period particularly in the base year FY05 (3.4% average Q1FY05-Q4FY08) and reduction in deflator (average -1.3). In effect while both real and nominal GDP have increased in absolute terms the rate of growth has declined.

Our assessment of leading indicators corroborates the existence of upside bias in recent construction GDP growth.

Lesser linkage with cement production than steel: The reported real construction GDP growth is strongly linked to aggregate steel production and cement. Empirically, however, we found stronger influence from aggregate steel production than cement, which is surprising. The recovery in construction GDP growth (average 9% CY2010) coincides with rebound in steel production (8% in CY2010). Cement growth on the contrary declined (5.6% in CY2010).

Construction related industries post modest growth: Average growth and the first principal component (captures the core characteristic of multiple related series) for seven construction related industries (bars & rods, cranes, construction equipments, pipes & tubes, steel-railways, steel structures & telecom cables Exhibit 34) has been much softer in FY11 than 2004-2008 suggesting that construction sector growth may actually be much softer than indicated by construction sector GDP growth. Even if we consider steel production specific to construction the picture is no different (Exhibit 33). Hence, with construction related sectors averaging at 6.7% in Q1-Q3FY11 construction GDP at 9% in FY11YTD seems to be lopsided.

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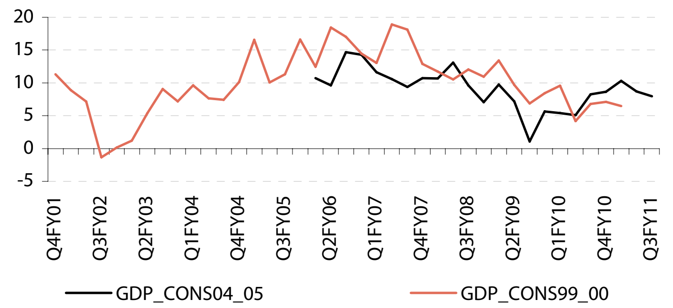
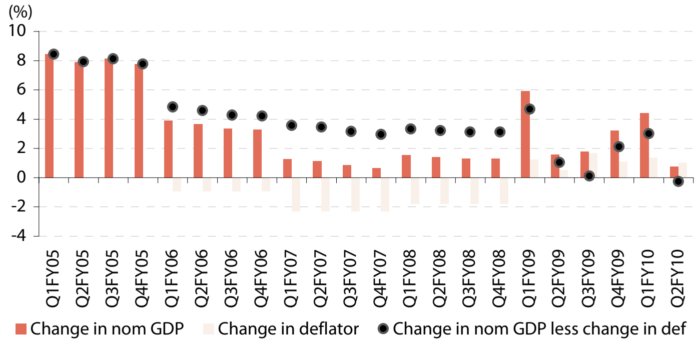
Exhibit 29: Construction real GDP averaged 9% in Q1-Q3FY11



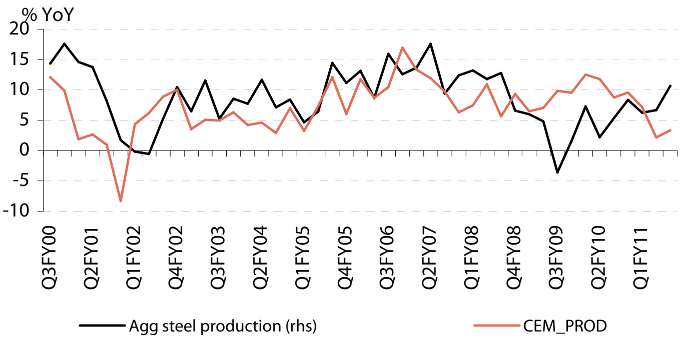
Source: CSO, Centrum Research

Exhibit 30: Change nominal construction GDP 2004-05 series over 1999-2000



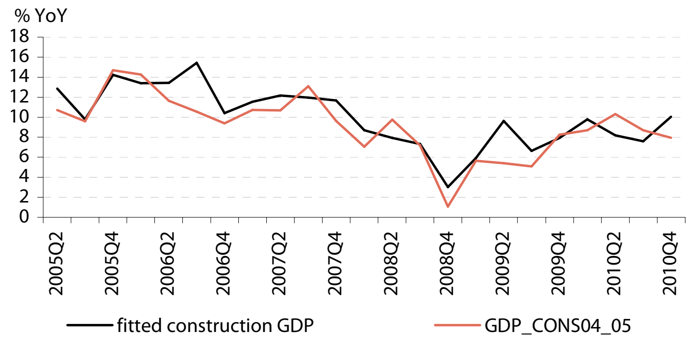
Source: CSO, Centrum Research

Exhibit 31: Rebound in steel production and modest 4.2% (YTDFY11) growth in cement production



Source: CSO, Centrum Research

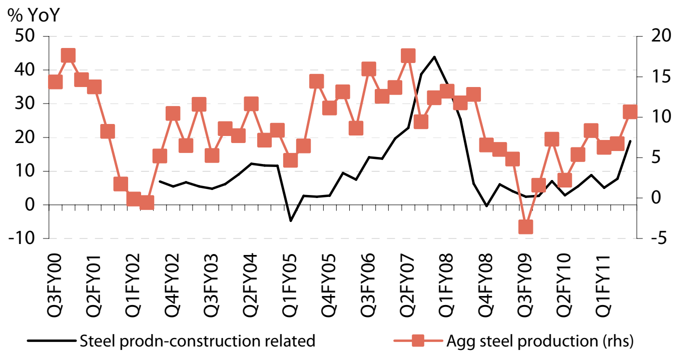
Exhibit 32: Construction sector GDP growth influenced by aggregate steel production



Derived from regression equation using steel & cement production

Source: CMIE, Centrum Research

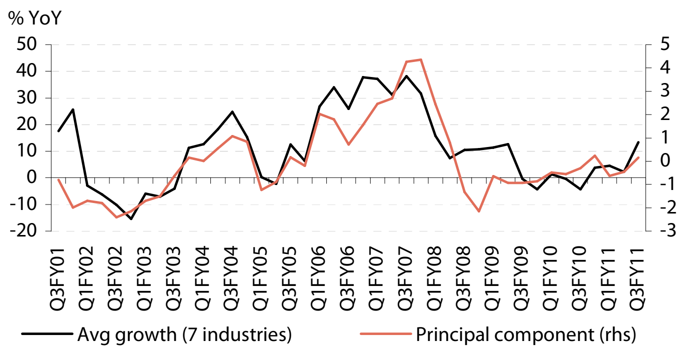
Exhibit 33: Construction related steel production average 6% since Q3FY08 vs. 15% between Q1FY04-Q2FY08



Construction related steel includes production of bars & rods, pipes & tubes, steel-railways related, steel & structures , Aggregate includes flats and not relevant from construction

. *Source: CMIE, Centrum Research*

Exhibit 34: Construction related industries averaged 4.7% growth vs. boom 21% Q1FY04-Q2FY08



Includes production of bars & rods, cranes, construction material equipments, pipes & tubes, steel-railways related, steel structures & telecom cables

Source: CSO, Centrum Research

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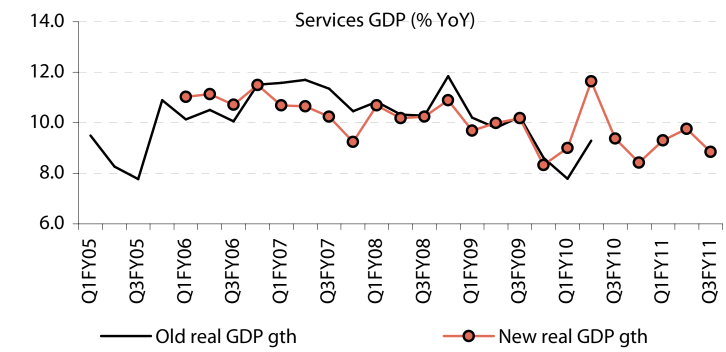
Services sector GDP: Significant ramp-up in estimated financial services GDP

The ramp-up in estimated services sector GDP has been the largest and it is the largest contributor to the upward revision of both nominal and real GDP in the new series (2004-05 vs 1999-2000). Netting off the change in deflators the readjustment has resulted in upward revision in real GDP; there is a downside bias to FY07-FY09 growth and upside bias for recent growth.

A break-up of services sector shows that there has been disproportionately large upward revision in financial sector GDP which contributes nearly 70% of added on nominal FY09 GDP. Since social services GDP is closely linked to government spending, data for which is largely available, there has been little change in this component.

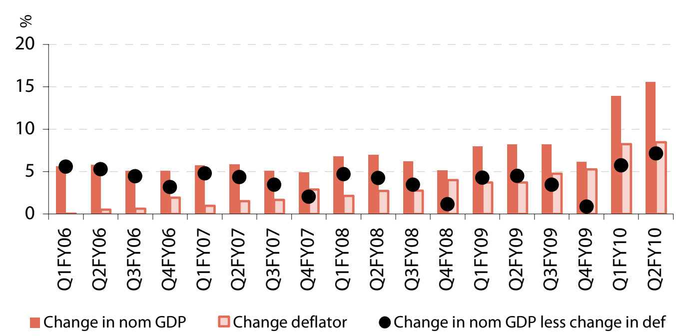
In the following two sections we examine trade services (trade, transport, communications and business services) and financial services. Broadly, while industry data indicates downtrend in trade services growth since Q3FY10 contrary to official claims we believe there is disproportionate upside bias in the reported financial sector GDP growth.

Exhibit 35: Real services GDP: Upside bias for recent period downside for prior



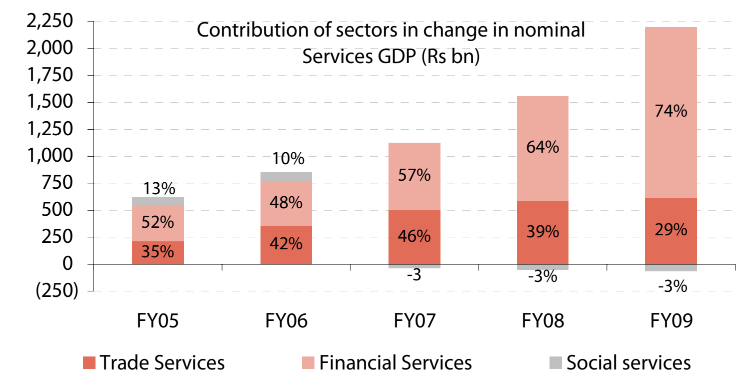
Source: CSO, Centrum Research

Exhibit 36: Arrived from ratcheting up nominal services sector GDP



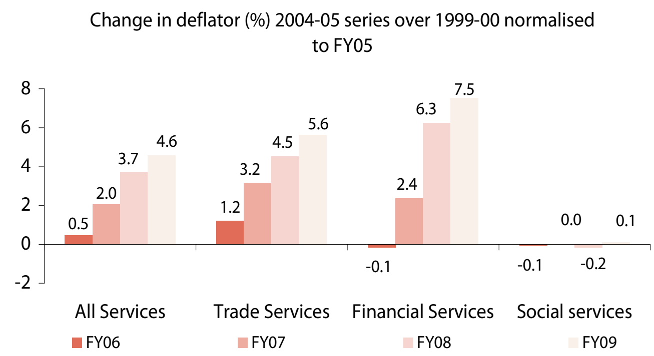
Source: CSO, Centrum Research

Exhibit 37: Upside bias in services GDP from financial services



Source: CSO, Centrum Research

Exhibit 38: Upward revision in deflator overpowered by increase in nominal GDP



Source: CSO, Centrum Research

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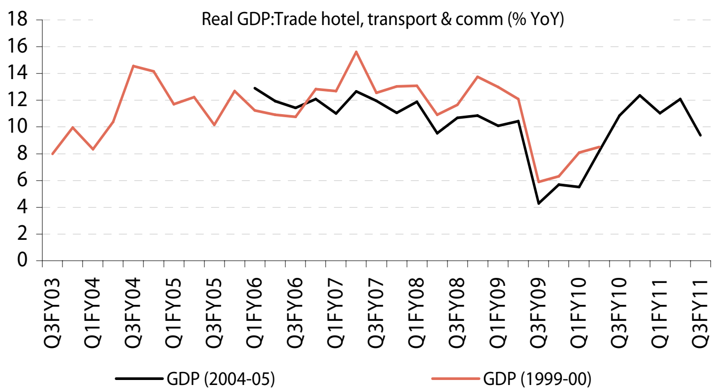
Trade services: Leading indicators contradict the robustness in trade services GDP growth

In case of trade services (trade, transport, communications and business services), the nominal GDP has been scaled up on average by 4% (FY05-FY10) over the old series, the deflator has increased by 2.7% leaving an upside of 1.3% in real GDP. However, with larger impact happening at the earlier period the growth rates have been generally lower (Exhibit 39).

But the key issue is the higher average growth of 11.2% for CY10 vs 10.3% during FY05-Q2FY10. While Q3FY11 has shown a decline to 9.4% it remained fairly strong (in excess of 11%) in the preceding three quarters. Leading indicators (principal component of growths from six industries), however suggest that the sector has consistently slowed since Q3FY10 (Exhibit 40). RBI has often relied on data such as aviation (cargo & passengers) and foreign tourist arrivals to suggest robust trade services growth; industry level data show deceleration since Q4FY10. Conventional indicators such as cargo handled by major ports, railways and even outstanding mobile connectivity have shown clear softening (Exhibits 42-43).

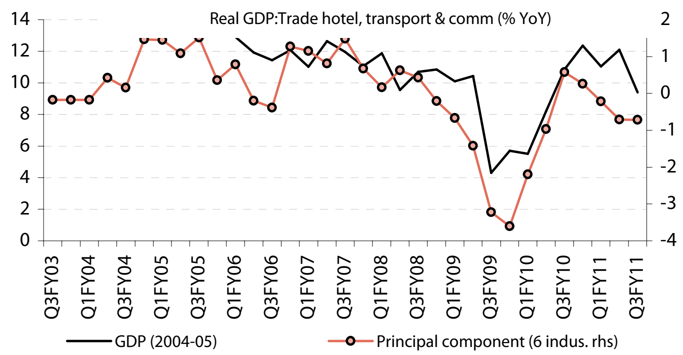
Inclusion of IIP growth along with the services industry data (principal component) in our regression equation shows strong fitness for trade services GDP growth (Exhibit 42). But as explained earlier, large upside aberrations in IIP growth prompts us to rely more on trade industry data which **indicates nearly a 120bp upside bias** in the services sector GDP data for Q1-Q3FY11.

Exhibit 39: Growth scaled down due to larger absolute upside revision in initial real GDP



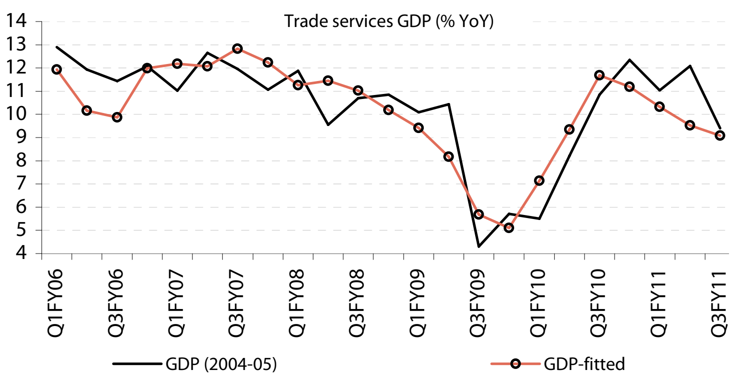
Source: CSO, Centrum Research

Exhibit 40: Leading indicators suggest upside bias in real GDP growth; deceleration stated in Q3FY10



Source: CMIE, Centrum Research

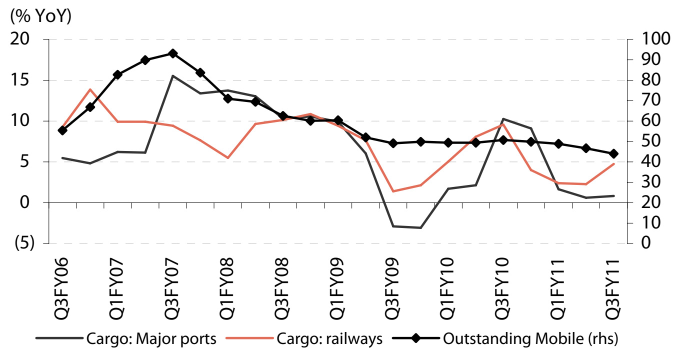
Exhibit 41: Inclusion of IIP growth improves fitness



Fitted series based on normalized IIP growth (adjusted for aberrations) and principal component as explanatory variables

Source: CSO,CMIE, Centrum Research

Exhibit 42: Leading indicators: Recovery has failed to sustain beyond FY10



Source: CMIE, Centrum Research

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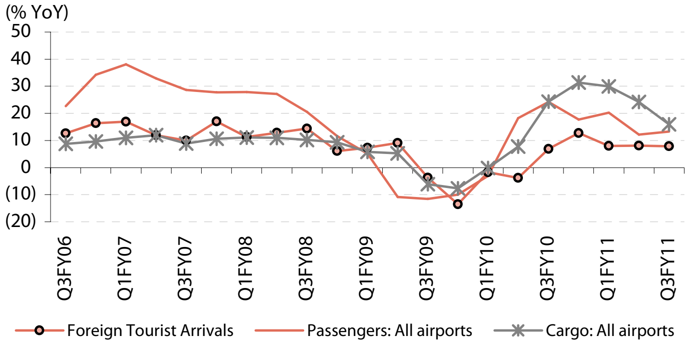
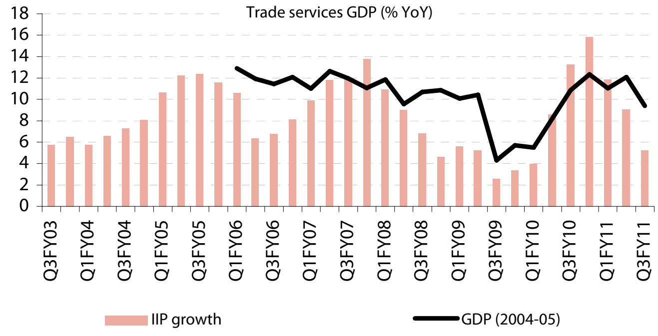
Exhibit 43: Leading indicators: Aviation and tourist arrivals



Source: CMIE, Centrum Research

Exhibit 44: Real trade services GDP and IIP growth



Source: CSO, Centrum Research

Financial services: Estimated real GDP growth potentially scaled up 3-4%

Perhaps the biggest deviation in the GDP data (vs 1999-2000 series) comes from financial services GDP. While the base year nominal GDP for the sector for FY05 was revised up by 7.6% over the earlier series, it may have widened to nearly 40% in FY11 assuming CSO's advance estimate of Rs1,2990bn. Taking into account the released data for Q1-Q3FY11, CSO's advance estimate for FY11 implies nominal GDP growth for the sector at a huge 56.5% YoY in Q4FY11E and 13.7% YoY in real terms, something we have not seen even during the most robust 2004-2008 phase.

As per the CSO, the 2004-05 series covers a wider sample of informal financial services (non bank and informal finance) and informal services relating to real estate, renting of machinery, computers, legal, accounting, ownership of dwelling and research. Though forming a smaller portion (about 24%) of the sectoral GDP, in the case of the latter, upward revisions have been in the region of 120% for the base year.

We find these numbers inconsistent, and on assessment of quarterly data we further observe that:

- The add-on GDP (difference between new and old series) grew at a phenomenal 55%YoY (average for FY05-FY10E) leading to an increase in overall financial services nominal GDP growth from 13% YoY to 18%YoY. In addition, we notice that the new series has been arrived at by adding almost constant amounts to the earlier series (Exhibit xx) indicating that quarterly data has been computed from some annual number and not from any additional data source.
- Given that informal financial services have been in existence longer than formal financial services and possibly over time the spread of formal sector should have increased, we believe it is unlikely for informal services to have grown more rapidly than the formal. Hence, the new series potentially embeds scaling factors resulting in significant blow up in GDP numbers.
- In addition, lack of visible leading indicators to capture informal services and mathematical generation of quarterly data exposes us to large predictive error.
- Notwithstanding the recent improvements in basic financial indicators like growth in broad money supply, total liabilities of scheduled commercial banks, deposit growth and market cap in stock exchanges, average growth for these indicators are more modest than revealed by the new GDP series.
- Assuming a modest FY11 38% YoY growth in GDP attributable to informal financial services sector (63% average during FY07-FY10) and lower inflation of 6.7% (new series assumes 9%), we arrive at financial sector real GDP of 5.5% as per the old series compared to the 9.1% reported for the new series. Higher than 38% growth for the informal component and higher inflation will imply lower growth for the old series.

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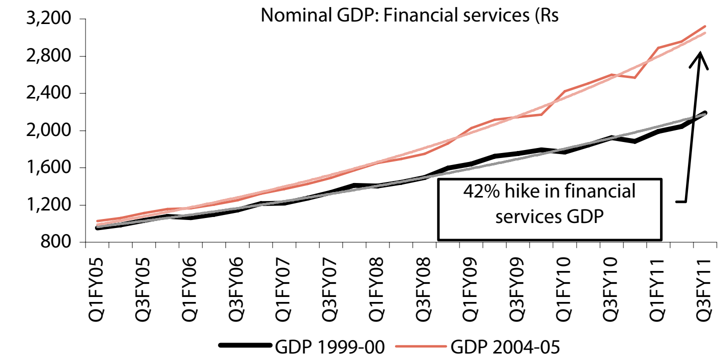
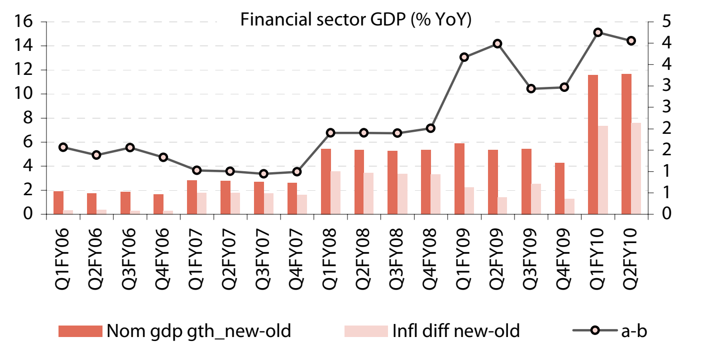
Exhibit 45: Financial services GDP 2004-05 inflated by 40%



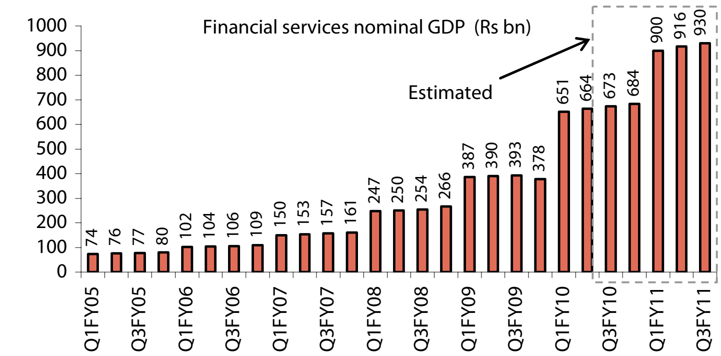
Source: CSO, Centrum Research

Exhibit 46: How financial services GDP growth is scaled up?



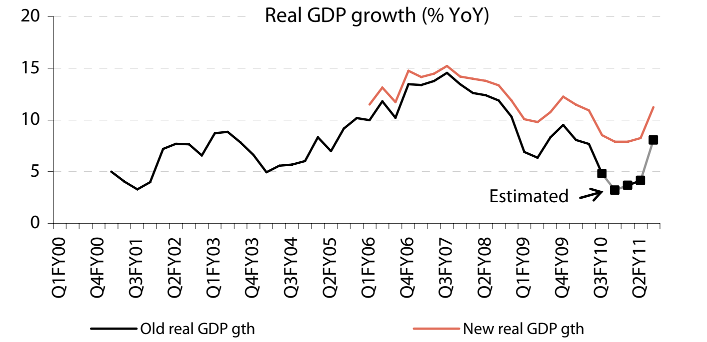
Source: CSO, Centrum Research

Exhibit 47: Constant numbers added to quarter nominal GDP



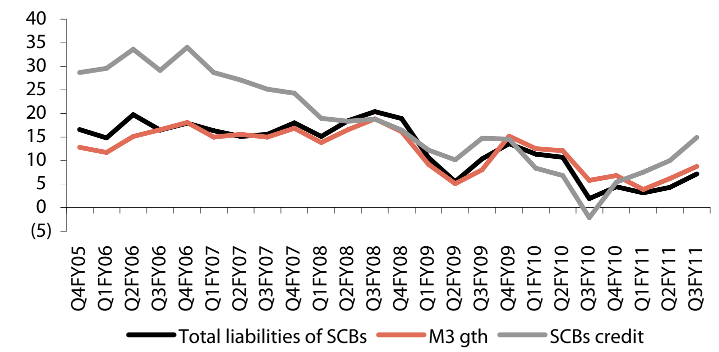
Source: CSO, Centrum Research

Exhibit 48: Re-adjusted real growth much lower



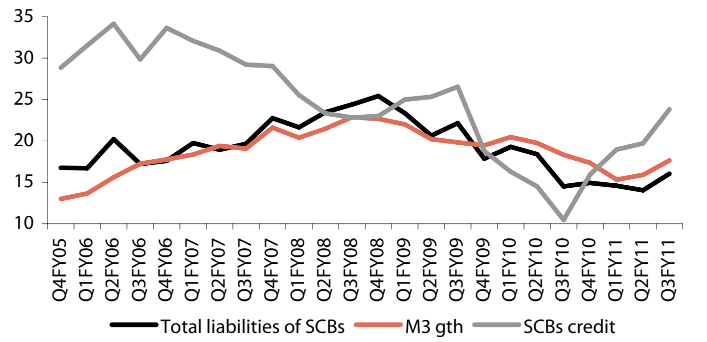
Source: CSO, Centrum Research

Exhibit 49: Leading indicators: Lower growth than 2005-08



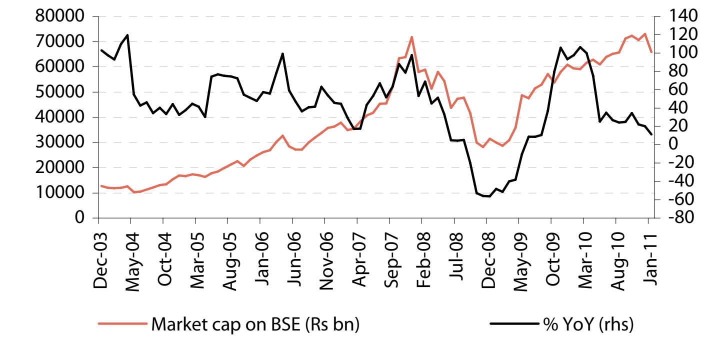
Source: RBI, Centrum Research

Exhibit 50: Leading indicators: Real growth



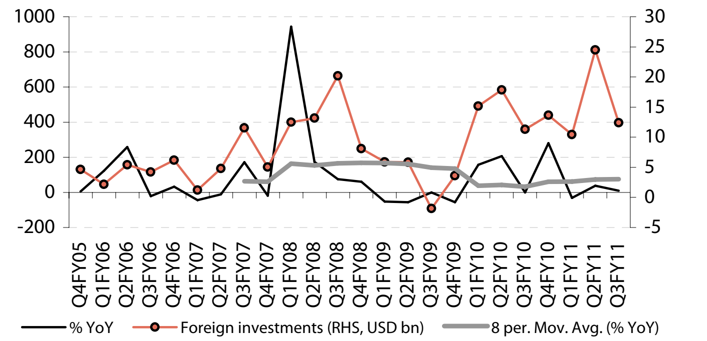
Source: RBI, Centrum Research

Exhibit 51: Equity markets market caps has failed to extend the 2009 rebound



Source: RBI, Centrum Research

Exhibit 52: And so have growth in foreign investments



Source: RBI, Centrum Research

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Investments have indeed slowed; revival requires series fiscal consolidation

The recent data of both GDP and industrial production substantiates our long held view that investments have been slowing. Gross fixed capital formation (GFCF)/GDP declined to 27.3% in Q3FY11 (Exhibit 53) and capital goods growth contracted 19% in Jan 2011. Earlier IIP data for capital goods gave gives an impression of a very strong investment cycle-it shows a huge average of 43%YoY for 12 months ending Jun 2011. However, excluding the aberrations in IIP date it was clear that investment growth started slowing since Dec 2009 (*Exhibit (54)*. Over estimation of capital goods growth were found to be related to aberrations in insulated cables (grew at 500%+YoY in few months) and readjustments for reduction deflators for components for which data is collected in nominal terms.

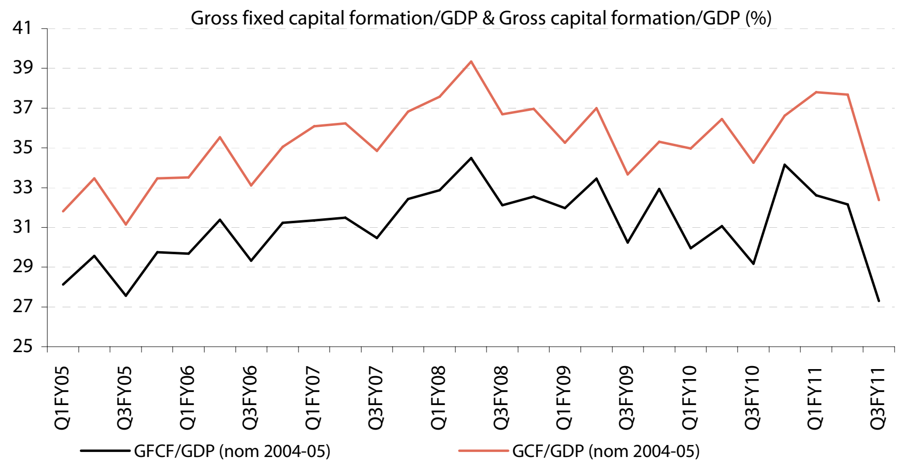
Additional data corroborating investment slowdown include:

- Tepid 10% YoY growth in capital goods imports in FY11YTD compared to the steep 44% in FY08.
- FDI flows in FY11 have contracted 50% over last year.
- Sharp decline in growth of order book of capital goods and construction companies: 26% in Q3FY11 from 47% a few quarters back (Exhibit 56)
- Continued softening investment projects under implementation for manufacturing and services industries (Exhibit 57-60)

In our view, the slowdown in investments has been caused due to decline in domestic saving rate to sub 30%. Private import of gold contracted 18-19%.

Reversal in investment cycles will likely emerge from a meaningful fiscal consolidation and reduction in inflation. We believe, H2FY12 and FY13 will see emergence of a sustainable investment cycle.

Exhibit 53: Investment cycle has moderated after a brief recovery in FY10-FY11



Source: CSO, Centrum Research

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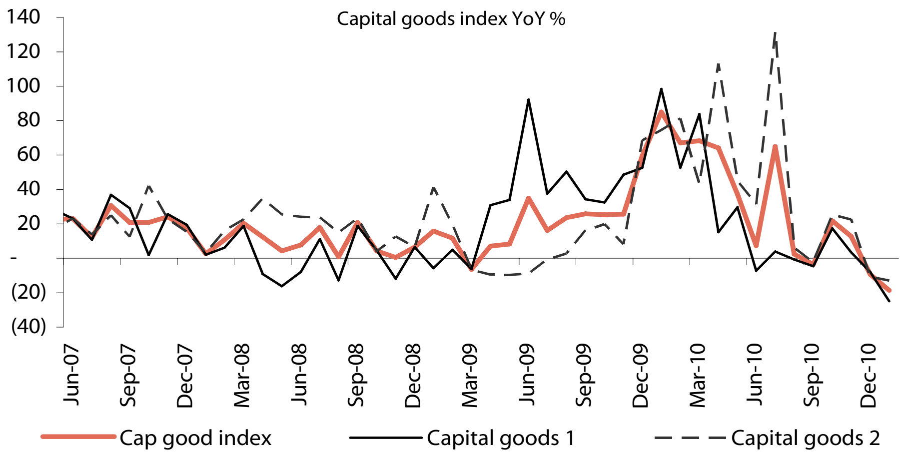
Exhibit 54: Capital goods: Bulk of capital goods has been slowing since Dec 2009; Distortions in some components created perception of robust investment cycle in 2010



Note: Capital goods-1 includes 22 components weighing 57% in aggregate capital goods index. This is an imputed index, as CSO reports these components in nominal terms. Capital goods-2 includes the remaining 31 components weighing 43% in capital goods index, included insulated cables) and are reported in physical terms

Source: CMIE, Centrum Research

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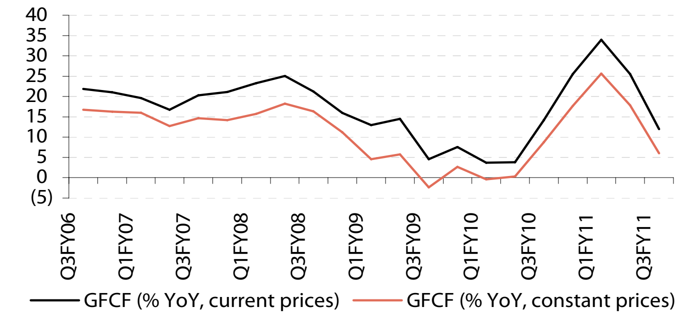
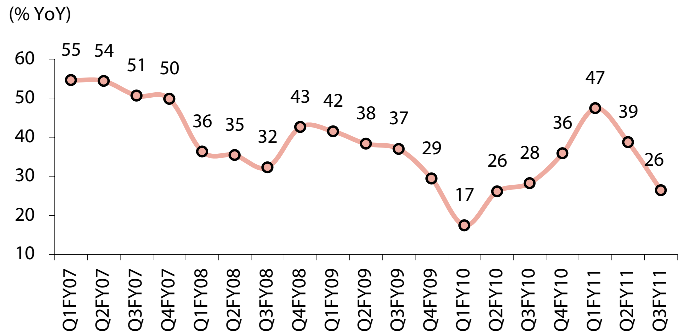
Exhibit 55: Growth in fixed capital formation



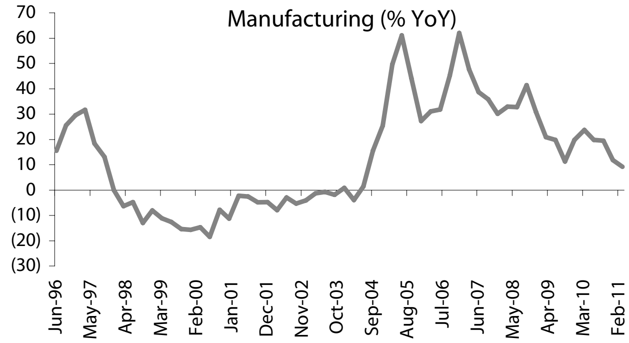
Source: CSO, Centrum Research

Exhibit 56: Order book of key cap goods and construction companies



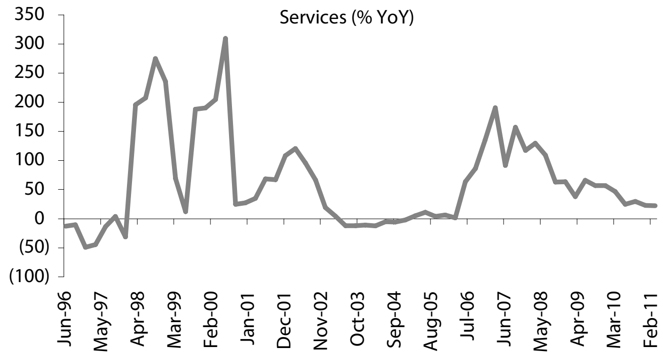
Source: Company, Centrum Research

Exhibit 57: Projects under implementation-Manufacturing



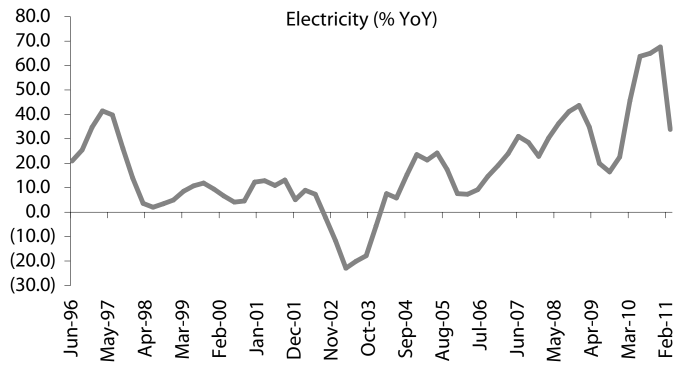
Source: CMIE, Centrum Research

Exhibit 58: Projects under implementation-Services



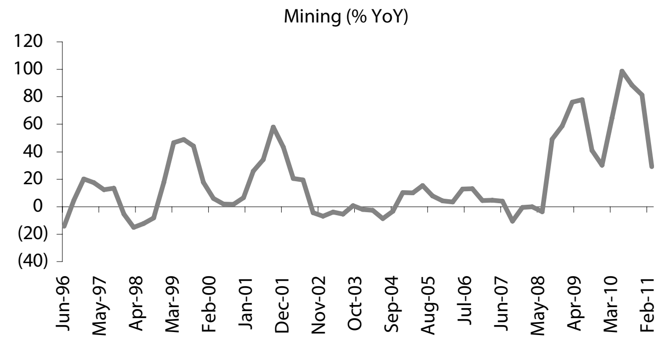
Source: CMIE, Centrum Research

Exhibit 59: Projects under implementation-Power



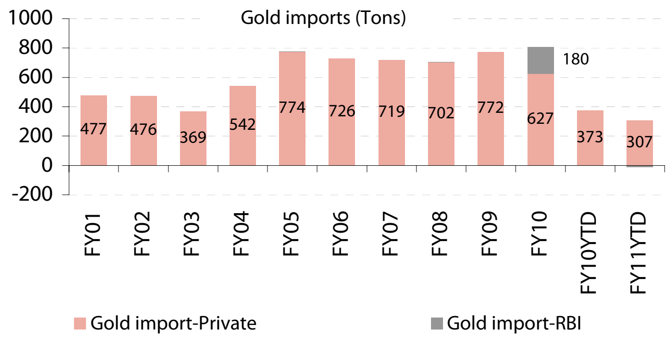
Source: CMIE, Centrum Research

Exhibit 60: Projects under implementation-Mining



Source: CMIE, Centrum Research

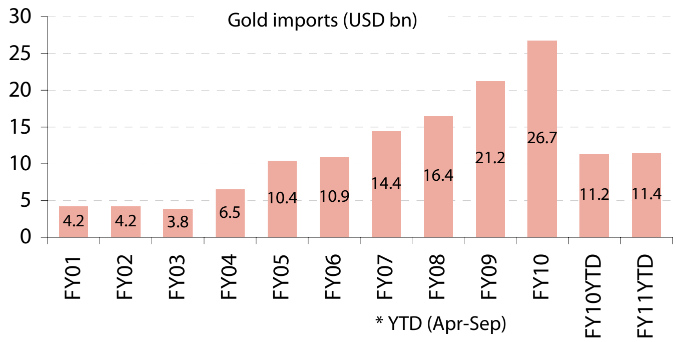
Exhibit 61: Gold imports by private sector has contracted



Note: Gold imports by private sector is estimated using monthly import data deflated by gold prices and subtracting changes in RBI gold holdings

Source: RBI, Centrum Research

Exhibit 62: Even while import value grew



Source: RBI, Centrum Research

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Exhibit 63: Leading indicators for real GDP growth

	Units	FY04-FY08	FY08-FY09	FY 09-FY11Q3	FY10	FY11
Agriculture						
Agriculture & allied (GDP at constant prices) (2004-05 series)	% YoY	4.4	3.4	2.5	0.5	5.3
Food-grain % YoY	% YoY	6.1	3.9	0.3	(7.0)	6.4
Rabi food-grain production % YoY	% YoY	4.7	4.4	1.6	(1.9)	0.7
Kharif food-grain production % YoY	% YoY	7.7	3.5	(0.5)	(12.0)	12.7
Food-grain (average)	MT	213.6	232.6	228.2	218.1	232.1
Kharif food-grain production (average)	MT	112.3	119.5	113.1	104.0	117.2
Rabi food-grain production (average)	MT	101.3	113.1	115.1	114.2	114.9
Manufacturing						
Industry (GDP at constant 2004-05 prices)	% YoY	10.5	6.9	6.9	8.1	8.9
Manufacturing (GDP at constant 04-05 prices)	% YoY	11.6	7.1	7.2	8.9	9.5
Mining & quarrying (GDP at constant 2004-05 prices)	% YoY	4.6	2.1	5.2	10.4	7.4
Electricity, gas & water supply (GDP at constant 2004-05 prices)	% YoY	8.4	6.9	5.7	6.5	5.3
IIP		9.3	6.0	7.7	10.4	8.3
Manufacturing(IIP)	% YoY	10.3	6.4	7.7	10.9	8.6
Big 4(Weight 23.8)	% YoY	14.8	7.9	14.2	19.5	17.7
Rest others(Weight 76.2)	% YoY	8.6	5.7	4.6	6.8	5.1
Infra sector	% YoY	6.8	2.9	5.2	5.6	5.2
Crude	% YoY	0.7	(1.7)	5.1	10.4	12.0
Steel	% YoY	9.8	1.6	5.6	7.6	7.4
Electricity	% YoY	6.1	2.8	5.4	5.0	4.5
Refinery	% YoY	6.7	2.8	0.7	1.7	1.9
Coal	% YoY	6.1	8.2	5.3	2.4	0.8
Mining	% YoY	4.0	2.8	9.3	9.8	9.5
Construction						
Construction (GDP at constant 2004-05 prices)	% YoY	11.0	8.0	7.1	6.9	9.0
Construction & real estate	% GDP	46.9	96.1	49.9	56.4	25.0
Avg production growth of 7 industries	% YoY	19.7	8.0	3.6	0.1	6.7
Steel prodn Construction related	% YoY	14.2	10.3	6.5	6.0	10.5
Agg steel prodn	% YoY	11.0	6.6	5.0	5.8	7.9
Bars & rods	% YoY	14.5	10.5	7.4	7.7	12.1
Cranes	% YoY	39.8	12.8	2.2	(12.1)	12.4
Meterial handling equipments	% YoY	56.8	(8.5)	7.0	25.5	0.3
Pipes & tubes	% YoY	15.8	18.1	14.9	3.2	12.8
Steel-railways related	% YoY	4.5	5.9	(1.0)	(9.0)	(0.6)
Steel-structures	% YoY	18.6	9.2	2.6	4.4	5.8
Telecom cables	% YoY	(11.9)	7.6	(7.7)	(18.9)	4.2
Agg cement prodn	% YoY	9.0	7.3	8.1	5.7	4.4
Trade service						
Trade, hotel, transport & comm. (GDP at constant 2004-05 prices)	% YoY	11.5	9.2	9.1	9.2	10.8
Outstanding Mobile	% YoY	93.7	64.1	49.7	7.0	45.8
Foreign Tourist Arrivals	% YoY	18.1	10.4	3.8	5.3	8.6
Passengers: All airports	% YoY	23.2	19.6	6.9	19.0	13.6
Cargo: All airports	% YoY	12.6	9.8	12.1	21.3	21.3
Cargo: Major ports	% YoY	10.6	11.1	3.0	6.7	0.3
Cargo: railways	% YoY	8.9	9.8	5.0	6.8	3.4
Financial services						
Finance, insurance, real estate and business services (GDP at constant 2004-05 prices)	% YoY	12.3	12.0	9.9	9.7	10.3
Total liabilities of SCBs	% YoY	17.2	14.1	7.6	7.1	4.9
Total assets of SCBs	% YoY	19.3	16.7	8.1	7.4	6.5
SCBs credit	% YoY	25.6	15.5	9.3	4.6	10.8
M3 gth	% YoY	15.5	12.9	8.5	9.3	6.3
Market cap on BSE (Rs bn)	% YoY	56.1	16.7	49.3	29.8	11.3
Social Services						
Social and personal services (GDP at constant 2004-05 prices)	% YoY	5.7	9.4	10.1	6.0	6.6
Central govt. expenditure (,Total current prices)	% YoY	11.8	23.1	19.6	15.9	18.8
Government final consumption expenditure (at constant 2004-05 prices)	% YoY	13.1	19.7	23.8	27.4	NA
Investments						
Gross capital formation/GDP (nominal 2004-05)	%	35.3	36.9	36.8	36.7	38.3
Gross fixed capital formation/GDP (nominal 2004-05)	%	31.0	32.6	31.6	31.1	30.7
Manufacturing (projects under implementation)	% YoY	28.7	32.9	21.7	18.6	15.1
Mining, *CSO, Centrum Research)*	% YoY	2.9	21.7	57.7	53.4	74.5
Electricity, *CSO, Centrum Research)*	% YoY	13.3	33.6	40.9	26.2	57.6

Source: CMIE, CSO, Centrum Research)

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Valuation Summary

Price as of 01 Apr 2011		Price Performance				MCAP	3M Avg Daily	EPS		P/E		P/BV		EV / EBITDA		ROE	
Company Name	Rating	CP	1M (%)	1Y (%)	Price Target	(US$MM)	Volume (MM)	FY11E	FY12E	FY11E (x)	FY12E (x)	FY11E (x)	FY12E (x)	FY11E (x)	FY12E (x)	FY11E (%)	FY12E (%)
Auto & Auto Ancillary - Ajay Shethiya (+91 22 4215 9855)																	
Bajaj Auto	Buy	1,459	9.2	46.1	1740	9,468	0.8	86.0	102.3	17.0	14.3	9.7	6.9	12.1	9.9	68.2	56.5
Hero Honda	Sell	1,603	7.4	-14.3	1392	7,178	0.6	97.9	99.8	16.4	16.1	6.9	5.5	11.8	11.2	48.4	38.2
Banking & Financial Services - Bhavesh Kanani (+91 22 4215 9636)																	
ICICI Bank	Buy	1,103	7.5	15.8	1228	28,489	4.9	47.2	58.8	23.4	18.7	2.2	2.1	15.1	14.2	9.9	11.4
Cement - Sanjeev Singh (+91 22 4215 9643)																	
Ambuja Cements	Sell	147	20.6	24.3	113	5,038	2.1	7.9	7.3	18.5	20.2	3.1	2.8	11.7	10.7	17.6	14.6
Grasim Industries	Buy	2,531	10.4	19.9	2697	5,205	0.1	205.3	226.0	12.3	11.2	1.9	1.6	5.2	4.9	13.2	13.0
Ultratech Cements	Sell	1,111	16.3	-2.9	784	6,830	0.1	50.3	52.5	22.1	21.2	2.9	2.6	11.4	10.5	13.3	13.2
Information Technology - Girish Pai (+91 22 4215 9699) / Abhishek Kumar (+91 22 4215 9644)																	
Infosys Technologies	Hold	3,218	4.4	21.7	3340	41,440	1.2	121.7	141.2	26.4	22.8	7.0	6.0	18.4	15.6	27.7	28.4
Wipro	Sell	476	7.4	10.0	348	26,204	1.6	21.8	22.9	21.8	20.8	5.0	4.2	16.9	15.0	22.9	20.2
Logistics - Siddhartha Khemka (+91 22 4215 9857)																	
Allcargo Global Logistics	Buy	173	19.4	-7.9	217	505	0.1	13.1	15.3	13.2	11.3	1.8	1.6	8.3	6.7	15.3	14.8
Container Corp of India	Hold	1,222	6.5	-9.4	1290	3,561	0.0	66.3	73.7	18.4	16.6	3.2	2.9	12.2	10.5	18.6	18.3
Shipping - Siddhartha Khemka (+91 22 4215 9857)																	
Great Eastern Shipping	Buy	271	2.8	-8.1	410	926	0.3	36.7	44.1	7.4	6.1	0.7	0.6	9.6	6.0	9.3	10.2
Shipping Corporation of India	Buy	112	7.8	-29.0	134	1,171	0.9	13.8	9.1	8.1	12.3	0.7	0.7	9.1	9.8	9.3	5.7
Telecom - Abhishek Anand (+91 22 4215 9853)																	
Bharti Airtel	Buy	355	5.2	17.6	424	30,261	4.4	16.4	19.8	21.7	17.9	2.9	2.5	10.4	8.1	18.6	22.8

Appendix A

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