Best among equals

India's advantages over the other emerging markets being stable earnings growth and insulation from a slowdown in global economy

The Sensex is expected to reach 23,000-24,000 levels in 2008. This appears to be a reasonable target given our expectations of a stable growth in the corporate earnings, peaking out of the interest rates and strong foreign investor interest in the emerging markets (EMs). Though the global economic growth is likely to moderate (the USA and parts of Europe are likely to experience a housing led economic slowdown), compared with the most other EMs India is relatively better insulated from a possible slowdown in the developed economies. Thus, India is expected to continue to grow at a robust rate and attract foreign investments. A populist budget could see a reduction in the direct tax rate, which would be a boost for the market. On the flip side, the implications of the Sixth Pay Commission, greater than expected moderation in the domestic economic growth and a hard landing of the US economy remain the key risks to the market in CY2008. In this issue of Market Outlook we have analysed the positive and negative factors that will affect our market in FY2009. We prefer sectors that are driven by domestic demand and capital spending, and hence are relatively better insulated from a US slowdown. We thus like banking, capital goods, telecom and oil exploration service sectors. However, we continue to believe that the bottoms-up approach can be used to identify promising opportunities in the mid-cap space as well.

Domestic economy: things to be bullish about

We believe the following will be key drivers of the Indian market in FY2009:

- stable earnings growth in the range of 18-20% (a major positive amidst an expected US led global slowdown), which has led to strong tax collections;
- continued focus on infrastructure and industrial capital expenditure (capex), which would help maintain the volume growth;
- Peaking of banks' lending and deposit rates, which would lead to a stable to declining interest rate environment;
- the current account balance that is likely to remain benign with the increased volume of domestic oil and gas production and that will keep the import bill capped;
- easing of Fed rates that are likely to support valuations and induce fund managers across the globe to increase their exposure to the EMs where growth is higher compared with the developed markets.

Stable earnings growth, a major advantage for India

A strong point in favour of the Indian equities is the relative stability of the corporate earnings growth. Despite a global economic slowdown, the Sensex' earnings are expected to grow at a compounded annual growth rate of 18-20% over FY2008-10. The sectors that could be affected by a global slowdown, like information technology, pharmaceuticals and commodities (excluding oil), contribute around 22% of the Sensex' earnings. Hence, compared with our EM peers we remain relatively better insulated from a global slowdown. The Sensex companies reported a year-on-year earnings growth of 26.5% (adjusted for one-time items) in Q2FY2008 against expectations of a 22% growth. Besides liquidity, the other factor that is driving the markets is the impressive performance of the Indian companies. So far we have not witnessed any significant development to assume that the corporate performance might get dented in the near term. Also, the strong corporate tax collection—up 40% year on year (yoy)—is an indicator that the strong growth momentum is being maintained.

Sector-wise profit growth and contribution to total earnings

Sector	Net profit growth (%)		% of PAT	
	FY08E	FY09E	FY08E	FY09E
Auto	11	12	5	5
Banking & finance	24	24	13	14
Capital goods	42	34	5	5
Cement	38	9	4	4
FMCG	8	16	4	4
IT	25	23	13	13
Metal	36	3	8	7
Oil and gas	29	9	29	28
Pharma	-11	10	2	2
Power	40	19	11	12
Telecom	54	31	5	6
Total	28	16	100	100
Total - ex oil	28	19	71	72

Note: We have not considered market cap of recent entrants into the Sensex, eg DLF.
Source: Bloomberg and Sharekhan Research

Benign current account aided by lower import bill

From FY2009-11 we will see increased production from Cairn India, and Oil and Natural Gas Corporation, Reliance Industries' Krishna-Godavari basin and the NEC-25 fields. We estimate that by FY2010, domestic production would substitute about $10-12 billion of oil imports. This would provide a one-time 2-3% boost to the gross domestic product (GDP). It would also reduce our current account deficit from 1% in FY2007 to 0.6% by FY2011. This, in turn, would be a positive for the rupee and the interest rates.

Infrastructure investments to remain in focus

The 11th Five-Year Plan (FY2008-12) has set an aggressive growth target of a 10% GDP growth by the end of the period. The government estimates suggest US$450-500 billion of investment will be needed in infrastructure in the 11th Five-Year Plan period compared with US$150 billion in the 10th Five-Year Plan period. Out of this, around 30-40% is likely to come from public-private partnerships. This would benefit the large-cap and mid-cap infrastructure companies in the medium to long term. The highest growth in infrastructure investments is likely to be witnessed in sectors such as power, ports, railways, airports and roads.

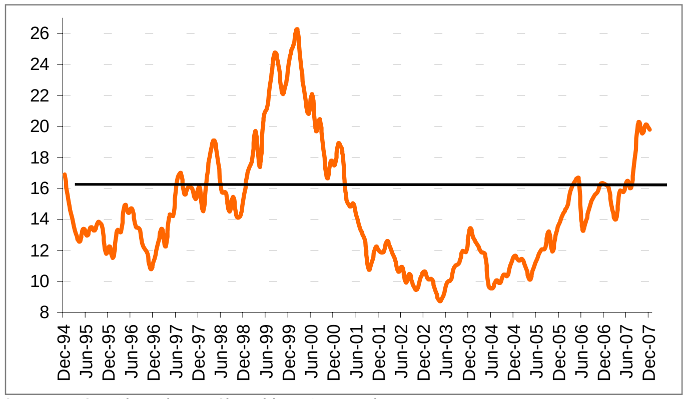
Benign interest rate environment favours equity market

Our domestic interest rate cycle has peaked out and globally major central banks are either withholding policy rate hikes (European Central Bank) or beginning to cut the rates (last year, US Federal Reserve [Fed] cut the Fed funds rate by 100 basis points and Bank of England cut its rate by 25 basis points for the first time in two years). Lending and deposit rates have softened already by 25-50 basis points, even though the Reserve Bank of India (RBI) has not reduced the policy rates. Inflation and credit growth, the two key variables the RBI has historically been concerned about, have declined and now appear within the RBI's comfort zone. Hence, we expect the lending and deposit rates of banks to stabilise at the current levels with a downward bias. Moreover, the RBI is unlikely to turn more "hawkish" in the current global environment of slowing growth and declining rates, as such a stance will put further upward pressure on the rates and accelerate the rupee's appreciation. Thus, the interest rate outlook remains stable with a downward bias, which has been historically good for the equity markets.

Sensex' target at 23,000-24,000

The chart on right depicts that historically Sensex has traded at 16x one-year forward earnings and thus the current valuation of the Sensex at 19.7x looks to have fully factored in the FY2008 estimates. However, excluding the embedded value, the valuation is at 17x, which is reasonable. Many of the companies in the Sensex have in the last two to three years built valuable businesses, which are not yet delivering earnings but growing faster than the core business. For example, ICICI Bank and Bajaj Auto are market leaders among private insurance companies whereas Reliance Industries has valuable oil and gas reserves. Thus, the valuations of these companies with significant embedded value are driving up the markets, though the same are not adequately backed up by earnings at this juncture.

Sensex one-year forward PER



Source: BSE, Bloomberg, Sharekhan Research

Embedded value contributes around 2,800 points

While the market is recognising and paying for this embedded value, the latter is not yet getting added to the earnings. In fact, because these businesses are still being built they are actually making losses and are taking away from the earnings instead of adding to them. The embedded market cap works out to about 14% or around 2,800 points of the total market cap of the Sensex companies.

Calculation of embedded value

Company	Shares o/s (crore)	MCAP (Rs cr)	EMB value (Rs/share)	EMB MCAP (Rs cr)
Bajaj Auto	10.1	28519	1458	14752
HDFC	28.0	87744	800	22374
ICICI Bank	111.2	138185	467	51937
Larsen & Toubro	29.1	123347	250	7281
Reliance Energy	23.5	44951	300	7055
Reliance Inds	145.4	411783	1100	159902
State Bank of India	52.6	126009	840	44209
Others		1705879	1665.4	66199
Total		**2666417***		**373708**

Note: *we have not considered market cap of recent entrants into the Sensex eg DLF.

Sensex likely to get re-rated

We have presented below a scenario analysis where the target for the Sensex has been calculated based on various possible growth rates and multiples for Sensex' earnings. Our year-end target for the Sensex is based on 17x price/ earnings multiple (using December 2009 earnings per share estimate) and is inclusive of its embedded value. The valuation multiple for the Sensex comes out to be slightly higher than the historical average and we feel the same is justified due to the following reasons.

- A likely improvement in the domestic interest rate scenario will lower the risk-free rate, thereby improving the valuations;
- After Bharatiya Janata Party's emphatic win in Gujarat, it could be said that mid-term elections have been conclusively avoided; this can lead to greater political stability in the near term, lower the risk premium and improve the valuations.
- In the past we witnessed that valuation multiples for the emerging markets expanded whenever the Fed rates eased in the USA.

Sensex' target—a scenario analysis

Sensex' earnings growth rate		15%	17%	19%	21%	23%
P/ E multiples	15	20,330	20,634	20,939	21,244	21,549
	16	21,498	21,823	22,148	22,473	22,799
	17	22,667	23,012	**23,357**	23,703	24,048
	18	23,835	24,201	24,566	24,932	25,298
	19	25,003	25,389	25,776	26,162	26,548

India offers higher growth than its peers

Again, India is likely to enjoy higher valuations than its peers due its domestic consumption led growth story. Export-oriented economies are more vulnerable to a global slowdown. Consensus earnings estimates for the emerging equity markets shows that India's earnings growth is expected to be among the highest. Since the imposition of restrictions on participatory notes by the Securities and Exchange Board of India (SEBI) in October 2007, 101 new foreign institutional investors (FIIs) have registered with the market regulator, taking their total tally to 1,214. Many new foreign investors are entering our markets which reaffirms that their belief in the India growth story is intact. India remains under-owned in major global portfolios and even a small increase could result in a sustained inflow of foreign funds into our markets.

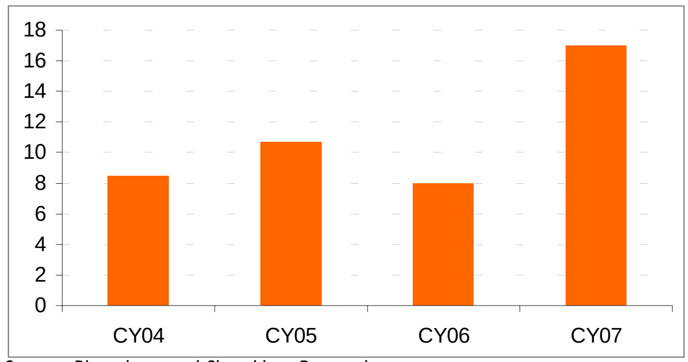
CY2007/FY2008 performance

Emerging markets	PER (x)	EPS growth (%)	YTD change in benchmark index (%)
China	41.9	15.1	66.7
India	24.2	15.3	54.7
Indonesia	19.6	-6.0	49.6
Hong Kong	18.7	-3.1	40.6
Brazil	14.1	7.9	40.4
Korea	14.0	8.4	31.4
Malaysia	16.9	-5.3	15.3
Philippines	18.4	-16.4	14.5
Mexico	15.0	5.0	4.4

Domestic institutions likely to surpass FII flows in CY2008

The FII flows have been the corner stone of the phenomenal rise in the Indian stock markets. But we had also experienced significant volatility too when FIIs have turned net sellers. However we feel all that could change as equity investments from two of our domestic institutions could surpass the net FII flows comfortably by CY2008. FIIs had invested around $17 billion in CY2007, a similar corpus of $15-20 billion is expected to be invested by insurance companies in another two years. If we count the $5-8 billion of investments from the mutual funds then we can definitely expect the domestic institutions to surpass the FII inflows going forward.

Trend in FII inflows ($ billion)

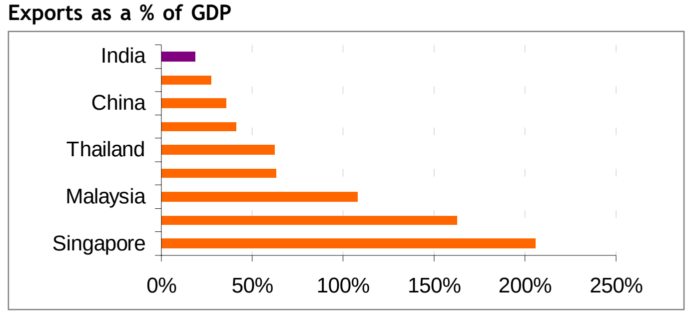


Source; Bloomberg and Sharekhan Research

Domestic economy remains healthy and insulated from a global slowdown

The Q2FY2008 GDP number at 8.9% was marginally lower than expectations with some moderation witnessed in the manufacturing and trade segments. These two sectors are most likely to have been affected by the higher interest rates and a rising rupee respectively. In order to grow at 9% in FY2008, the GDP will have to grow at 8.9% in H2FY2008 after the 9.1% growth registered during H1FY2008. We expect our GDP growth rate to remain stable in the ~ 8.5% region despite a slowdown in the global economy. We are much better placed than most other export-oriented EMs to withstand a global slowdown. A 1% slowdown in the USA is likely to reduce 70 basis points from our GDP growth rate. Several factors like a low trade-to-GDP ratio (at 26%), growing domestic consumption and improved demographics should keep our growth momentum intact.

Exports as a % of GDP



Source: Bloomberg and Sharekhan Research

Rupee appreciation likely to be moderate going forward

The sharp appreciation in the rupee so far has been a cause for concern and despite the government granting sops to certain export-oriented sectors, the scenario has not improved much. However, the export growth continues to surprise on the upside and remains resilient. Exports grew by 35.6% and 17.8% yoy in dollar and rupee terms respectively during October 2007. The finance ministry and the RBI are finalising the mechanism to invest a small part of India's $272-billion-plus foreign exchange (forex) reserves in the India Infrastructure Finance Corporation, a government-owned special purpose vehicle that was set up recently to finance infrastructure development in the country. The company will lend to Indian infrastructure companies for capital expenditure overseas. The development is in advance stages and should create a window for outflow of dollars. This coupled with the RBI's intervention in the forex markets should ease the sustained upward pressure on the rupee and bring some relief to our export-oriented sectors. The rupee appreciated by 11% in CY2007. We expect a moderate increase of 3-5% in its value in this year which bodes well for the various export-oriented sectors.

FY2009 budget expectations

A possible cut in direct tax rates: The centre's net direct tax collections registered a 40% increase in the April 1-December 2007 period. Corporate taxes collections were up by 42% and personal income tax collections recorded an increase of 42.5% during the same period. Tax collections have remained robust mainly due to the growth in the earnings and incomes of corporates as well as better tax compliance. There is news in the market that the government may reduce the corporate and personal tax rates. With inflation under control and populist measures likely to assume precedence before the general elections in 2009, the reduction in the tax rates seems a definite possibility. Tax rate cuts will be a positive for the equity market.

Trusts likely to be allowed to invest in equities: After allowing pension funds to invest a certain amount of their corpus in the equity markets, the government has now allowed trusts to invest in securities and bonds of listed companies. The suitable amendment to the Indian Trusts Act 1882 is likely to be carried out during the budget session of the Parliament. The move could direct thousands of crores of surplus funds to the stock markets.

Some mega capital issues lined up

A huge pipeline of initial public offerings (IPOs) and follow-on public offerings (FPOs) has been lined up for the next two quarters. Our estimates suggest that the market could see total equity issuances of $16.4 billion over the next four to six months. Reliance Power, UTI AMC, State Bank of India and Emaar MGF are some of the companies that are going to tap the market for funds in this year. Last year, it was feared that huge primary market issuances would disrupt the secondary market but in reality the secondary market did not see any significant disruption on account of the large issues of ICICI Bank and DLF. Last year, the possibility of a mid-term election had also cast a shadow over the capital raising plans of Indian companies. But now with the 123 nuclear deal on the back burner, we feel the capital raising plans of India Inc would sail smoothly.

Sector-wise primary market issuances

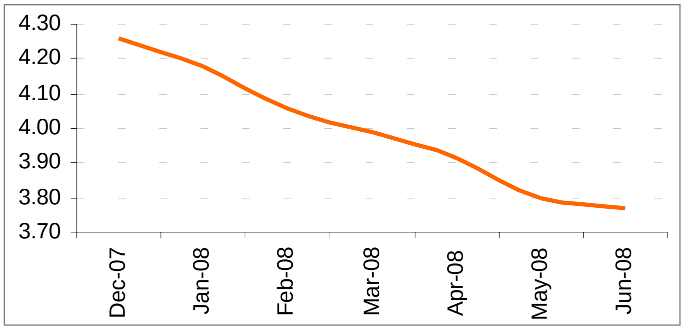
Sector	Amount ($ bn)
Bank and financial service	5.0
Cement	0.3
Energy	4.3
Engineering & infrastructure	2.0
Media	0.2
Property & real estate trusts	4.6
Total	**16.4**

Source: SEBI, Sharekhan Research

Risks to watch out for

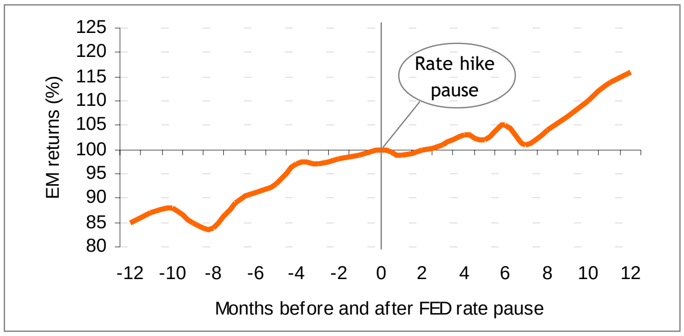
Hard landing of the US economy: So far it has been evident that the USA is going to experience a housing-led economic slowdown. The Fed has officially reduced its economic growth forecast for 2008 to 1.8-2.5% from 2.5-2.75% predicted earlier. Among the other factors, the US subprime issue is likely to have much larger repercussions on the US economy and world financial markets than envisaged earlier. Hence, the US President has announced a housing bail-out plan. The steps taken by the US government to tackle the compounding subprime problem are likely to provide relief to the other financial markets of the world in the near term. The announcement of the bail-out plan also implies that the housing problem is really serious and the Fed needs to cut rates aggressively to save the economy from going into a recession. Thus, expectations have built up that the Fed may continue to cut the rates, as indicated by the Fed interest rate futures. This should be a positive for all the EMs including India. Also, as we have shown in the chart on next page, historically the EMs have performed strongly 6-12 months after the US Fed has effected a pause in rate hikes, as it has taken that much time to determine how growth would shape up after the pause. However, the housing problem must not to affect the other sectors of the economy if moderate growth rates are to be maintained. If the chances of the USA going into a recession increase, then equity markets could take a tumble globally.

Fed futures graph



Source: Bloomberg

Returns on the emerging market equities (%)



Source: Bloomberg, Sharekhan Research

Implications of the Sixth Pay Commission and populist spending: India's Pay Commission is designed to revise the pay and allowances of central government employees. The last Pay Commission had recommended a 30% rise in real salaries and a reduction in the number of government employees. The recommendations were implemented but not fully: While the wage hike was implemented the employee base was not reduced. Hence public finances had deteriorated drastically due to an increase in inflation. After the Bharatiya Janata Party's strong win in Gujarat the government is likely to announce populist policies and schemes in the upcoming budget. For the same reason, a hike in fuel prices can also be ruled out in this year. All this could throw the government's fiscal consolidation process off track. If the fiscal performance deteriorates, leading rating agencies could downgrade the country's sovereign ratings again which would be a negative for our market.

Inflation to be within RBI's comfort zone, food inflation remains a concern

India's inflation rate for the week ended December 8, 2007 stood at 3.6% vs 3.7% a week ago and 5.6% a year ago. Inflation has now settled well within the RBI's comfort zone of 5%. With fuel price hikes being ruled out and expected moderation in the global commodity prices (on the back of a slowdown in the global economy), we feel only higher food prices pose a risk to inflation. Fortunately, agricultural growth in H1FY2008 stood at 3.7%, much higher than the 2.7% growth recorded in FY2007. With higher than expected rainfalls in this monsoon the agricultural production could be expected to improve in FY2008. However, the latest data on *rabi* crop sowing released by the agriculture ministry shows that the acreage under most crops has reduced. This is not a positive development for the agricultural sector and it could also lead to higher food prices and inflation in the medium term.

***Rabi* crop acreage**

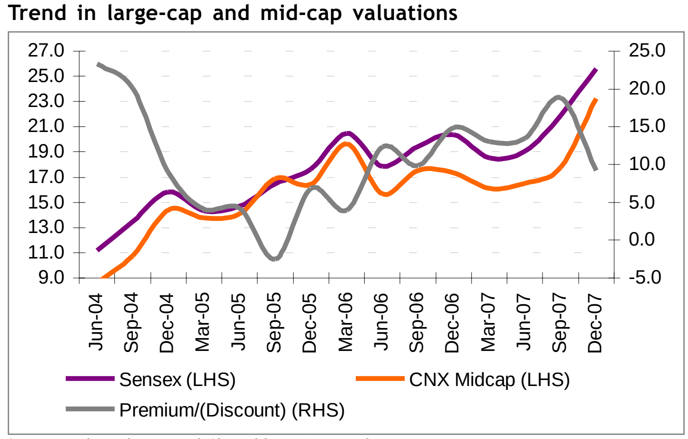
Release dated	Unit- lakh hectares 2007	2006	% yoy chg
14-Dec	460.10	507.55	-9.3
16-Nov	194.39	239.98	-19.0

Source: Ministry of Agriculture

Valuation gap has tilted in favour of large-caps

The valuation gap between the large-cap and mid-cap companies has considerably reduced in the last few months. We have seen the CNX Mid-cap Index register a 29.7% gain in the last three months compared with a 16.9% gain in the Sensex in the same period. We feel that after the sharp rise in the mid-caps in recent times, the valuation gap has tilted in favour of the large-cap companies. We expect this gap to widen going forward.

Trend in large-cap and mid-cap valuations

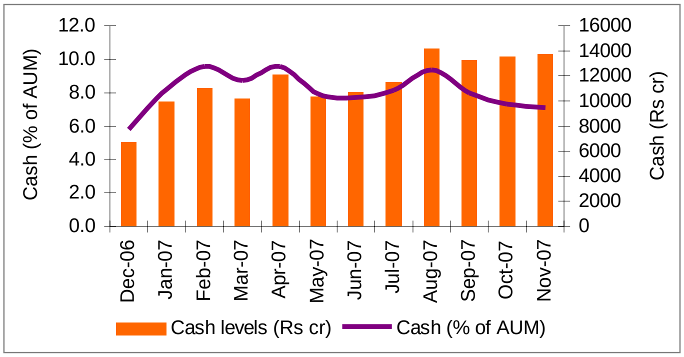


Source: Bloomberg and Sharekhan Research

High cash levels protect downside risks to our markets

We have always been worried about reversals in the FII inflows, as the same have always brought about a serious correction in our markets. But this time around if the FIIs press the sell button, the high cash levels with the domestic mutual funds and the swelling corpus of the life insurance companies could protect our markets from any major downside. Life Insurance Corporation of India (LIC), the largest life insurer in the country, made a net investment of Rs12,000 crore in the stock market in H1FY2008. According to LIC, the total purchases in the equity market would double by the end of the fiscal if the unit-linked insurance plans continue to grow at the current rate. We could definitely expect the insurance companies to continue to make such high levels of investments in future. The cash levels with the domestic mutual funds stand at around Rs14,000 crore or 7.1% of the assets under management compared with Rs7,500 crore a year back.

Trend in cash balances of mutual funds

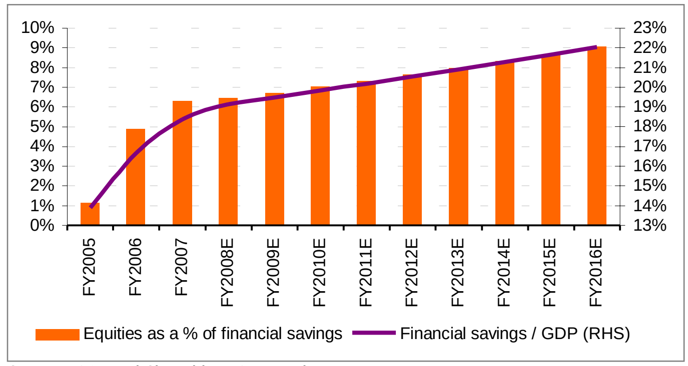


Source: AMFI and Sharekhan Research

Households to become a new force to reckon with in a decade

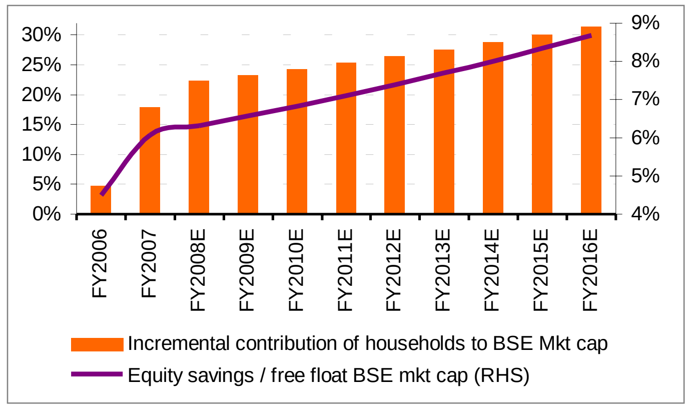
We have gone a decade ahead and tried to see how the Indian households would contribute to the equity markets in future and the findings are really encouraging, as the same indicate that the long-term bull market story will remain intact. Based on our assumptions of a 13% nominal GDP growth (over FY2008-16), we have found that the financial savings-to-GDP ratio would steadily improve from 13.9% in 2005 to 22% in 2016. The share of equity investments in the financial savings would increase from 1.2% in 2005 to 9.1% in 2016. The share of equity investments to free float BSE market cap is going to increase from 1% to in 2005 to 8% in 2016. On an incremental basis, the Indian households are likely to improve their

Trend in financial savings and share of equities



Source: RBI and Sharekhan Research

Trend in household contribution to BSE free-float market cap



Source: RBI and Sharekhan Research

share of contribution to the BSE free float market cap from 5% in 2005 to 31% in 2016. Hence, going forward, money coming from the domestic insurance companies, mutual funds and households into the equity market would be significant enough to counter any sharp fluctuations caused by large-scale FII withdrawals.

The author doesn't hold any investment in any of the companies mentioned in the article.