# India Investment Strategy

*Stay put but hold on tight*

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# Executive Summary

- We expect above trend GDP growth to sustain despite some slowing globally, highlighting the uniqueness of the India story – our estimate is 7.5%+ in FY08
- Corporate earnings growth will slow somewhat, with return ratios peaking, tracking top-line growth; our estimate is 17% for FY08
- Interest rates will be firm with one more 25 bps hike likely as the RBI balances inflation and growth
- Capital spending continues to be strong; M&A and IPO activity will continue and the share of FDI will increase
- Our key theme for 2007 is infrastructure, on the back of a heightened level of spend and announcements
- Valuations are now rich and there appears lower tolerance for disappointment; we recommend investors to budget for volatility – shifting to quality (select large and mid caps that play on the long term India themes) and using derivatives products for hedging & yield enhancement
- Risks: high inflation, lower global risk appetite, higher volatility, UP state elections

# In 2006, the world came to India's doorstep…

**Economy**

* Sound fundamentals: GDP growth at 9.1% for H1 FY07 – strongest growth in any six months since H1 FY04
* Uptrend in industrial cycle: Avg. IIP growth at 10.2% being the strongest run in the past 11 years

**Politics**

* Signing nuclear deal: Highlights India's importance in the global context opening up many opportunities
* Chinese President Hu's visit: Will improve trade and other ties between two of the fastest growing economies

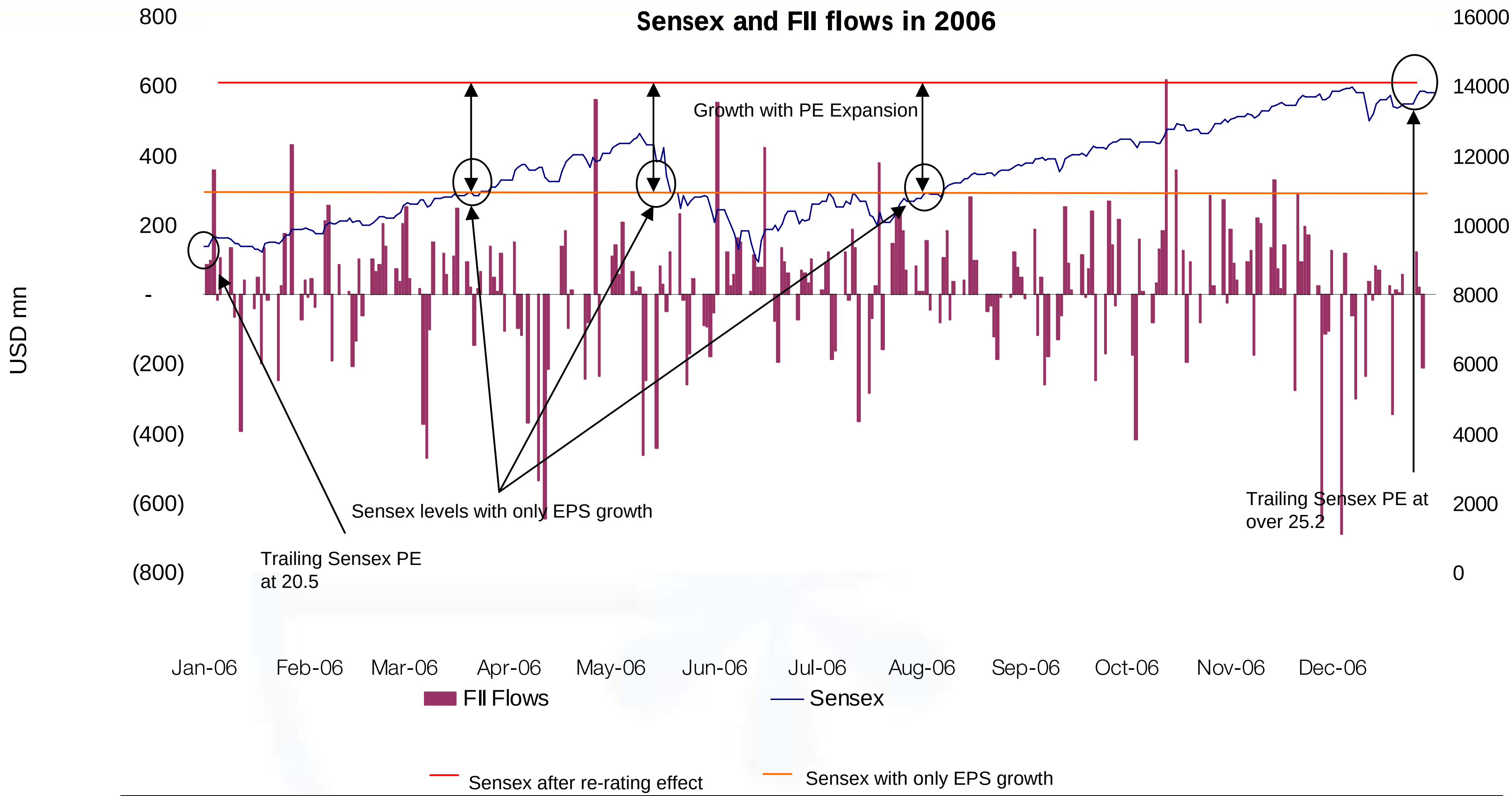
**Markets**

* Strong foreign inflows: Portfolio flows of ~USD 9.2bn took Sensex to 14,000+ (~50% higher)
* IPOs: ~USD 6bn raised. QIP guidelines created a new window for raising equity capital
* Credit growth: Growing at ~ 30%, it continued the trend of last 5 years where it has averaged around 25%
* M&A activity: Was at a new high with sectors beyond IT and pharma making global & domestic acquisitions

**Sectors**

* Banking: Banks can now raise hybrid capital which opens new avenues for funding credit growth
* Power: Announcement of 9 ultra mega projects (4,000 MW each) provides visibility on power & infra front
* Retail: Point of inflection with major Indian corporates announcing plans, entry of world majors like Walmart & foreign investment allowed in single brand retail
* Real Estate: Huge build-out plans, SEZ, first IPOs (Sobha, Parsvanath) & AIM listings (Unitech, Raheja, Hirco)

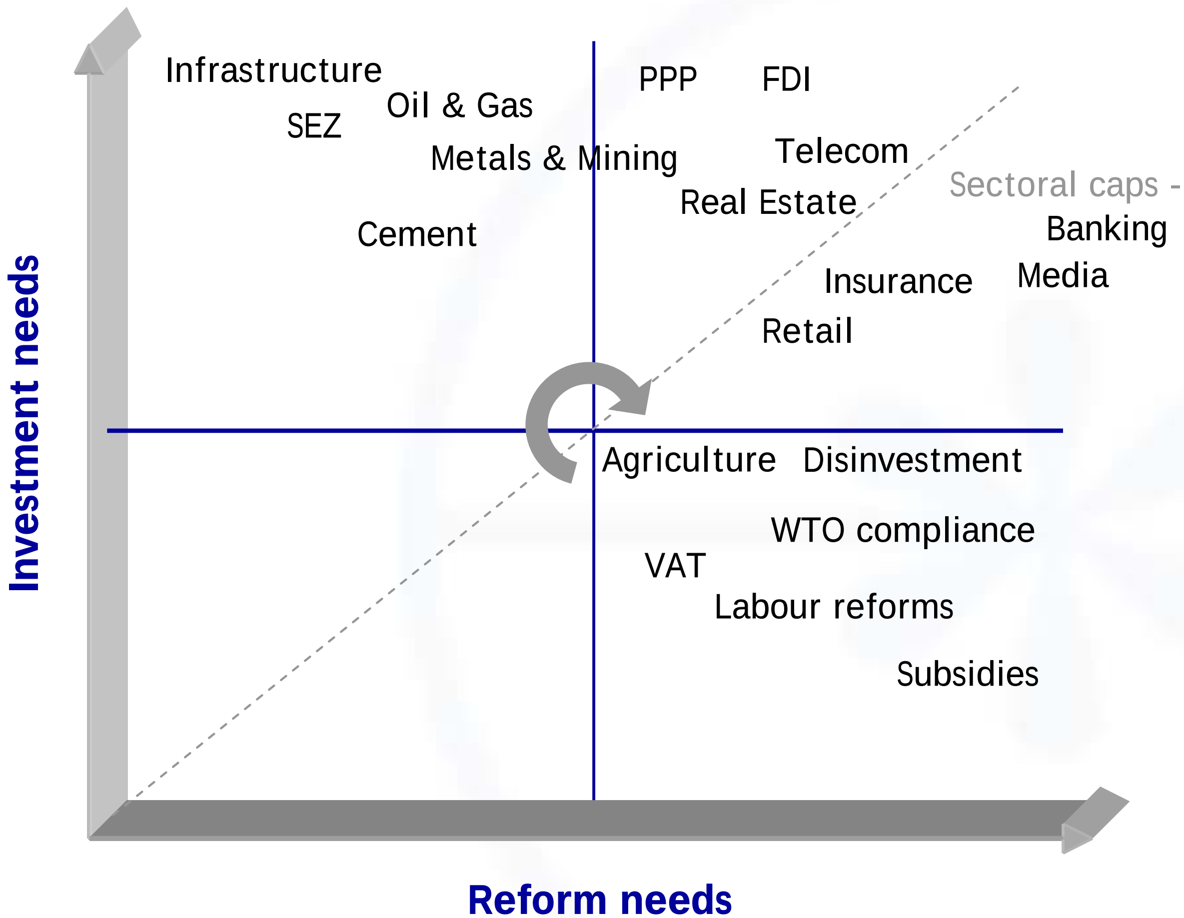
# ... and the market came into its own




Source: Edelweiss Research

- Strong underlying strength reflected in secular rising trend in the Indian capital market
- FII outflow in May-June reflected in a fall in Sensex, partly explained by concerns about world economic slowdown
- Surprise tightening by the Central bank – rate hike in June and CRR hike in Dec have been associated with market dips

# The India story is one of Reform through Investment



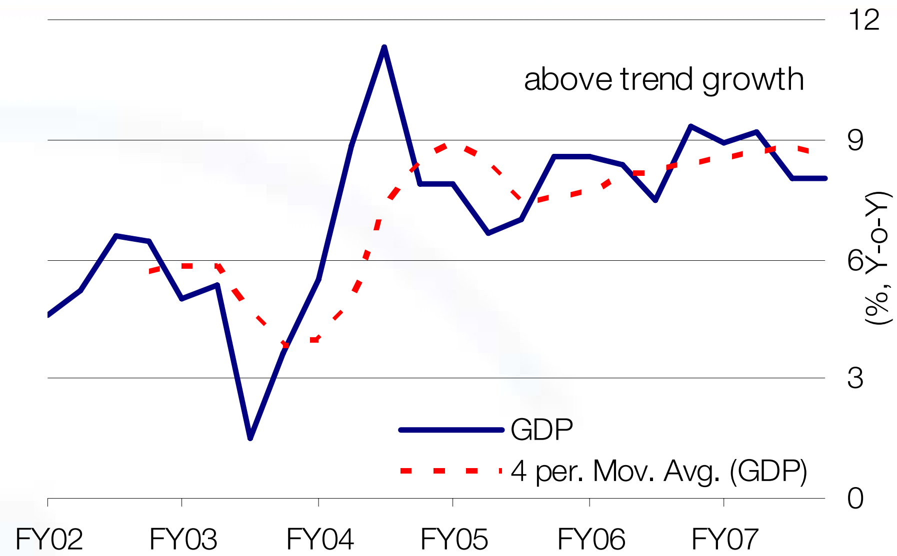

- The pace of reform has always been an issue holding growth and the markets back
- The composition of the government at the centre as well as the ground realities in India make reforms very challenging
- We believe it is important to separate investment and reform in the Indian context
- Reforms are inevitable but will be driven through the investment route – through public private participation and increasing FDI, which will create its own need for reform

# Message for 2007: Stay invested but hold on tight

* Above trend GDP growth to continue
* Corporate earnings growth to start slowing
* Interest rates will be firm
* Infrastructure is our key theme for 2007
* Consumption-led growth will continue
* Flows to sustain
* Prepare for volatility

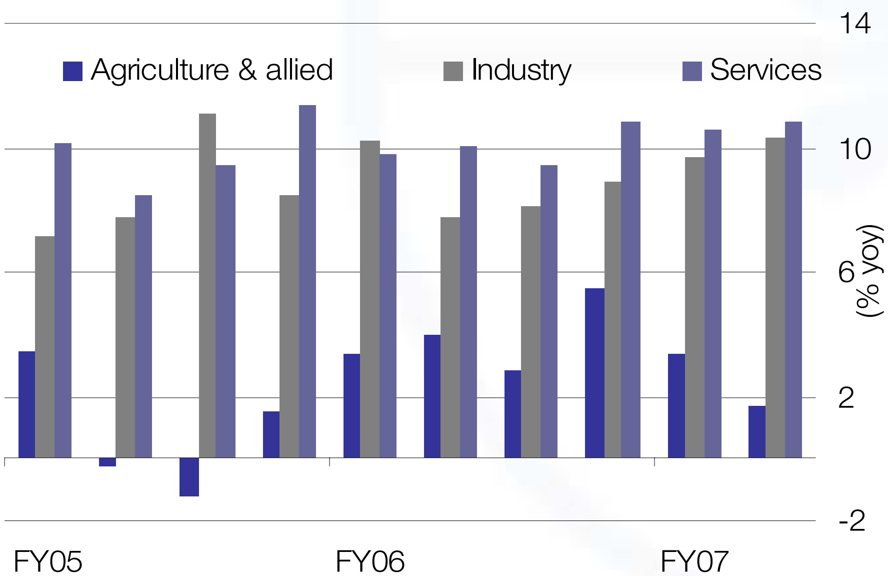
# Above trend GDP growth will continue …

- We expect above trend GDP growth to sustain in the context of a slowing global economy. India has the advantage of being largely domestic driven with infrastructure and domestic consumption being key growth drivers

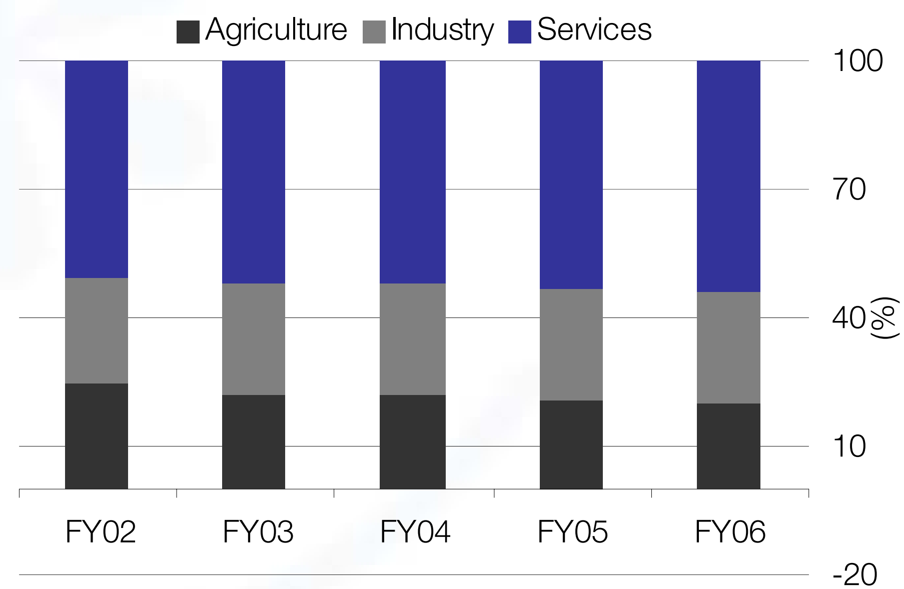



Source: Edelweiss Research

## Based on an industry and services led boom




Source: Edelweiss Research

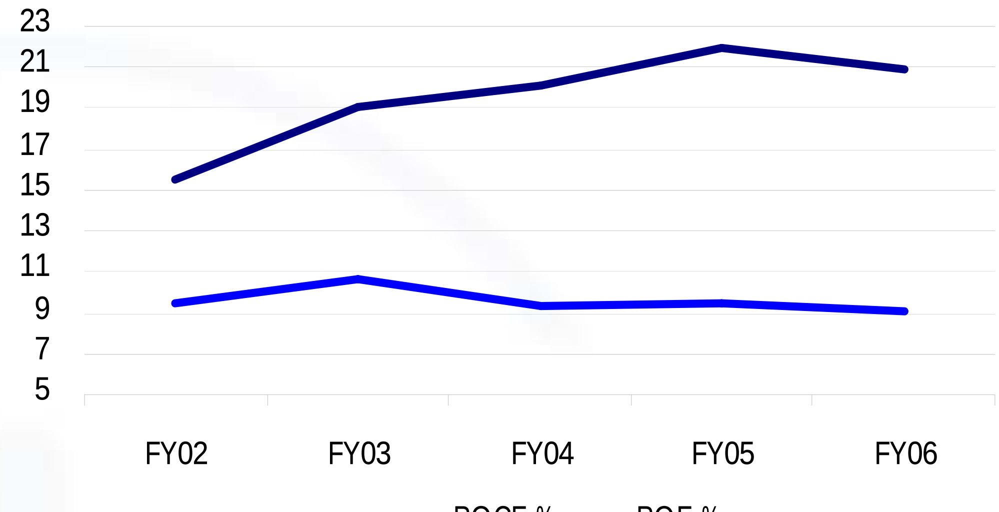



Source: Edelweiss Research

# ... but corporate earnings growth will start slowing ...

- Corporate earnings growth is likely to start slowing somewhat in 2H 2007 as operating leverage is exhausted and wage costs increase; RoEs / RoCEs are also likely to peak in FY07 but stay at attractive levels
- We estimate topline growth for the Sensex in FY08 of ~17% with matching earnings growth

**Sensex ROE & ROCE (%)**

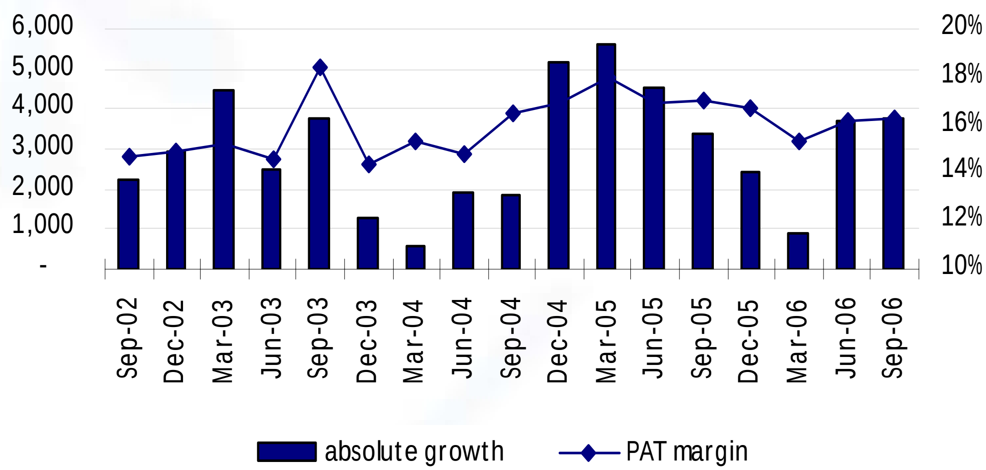



Source: Edelweiss Research

**Sensex Y-o-Y Revenue Growth**


Source: Edelweiss Research

**Sensex Y-o-Y PAT Growth**




Source: Edelweiss Research

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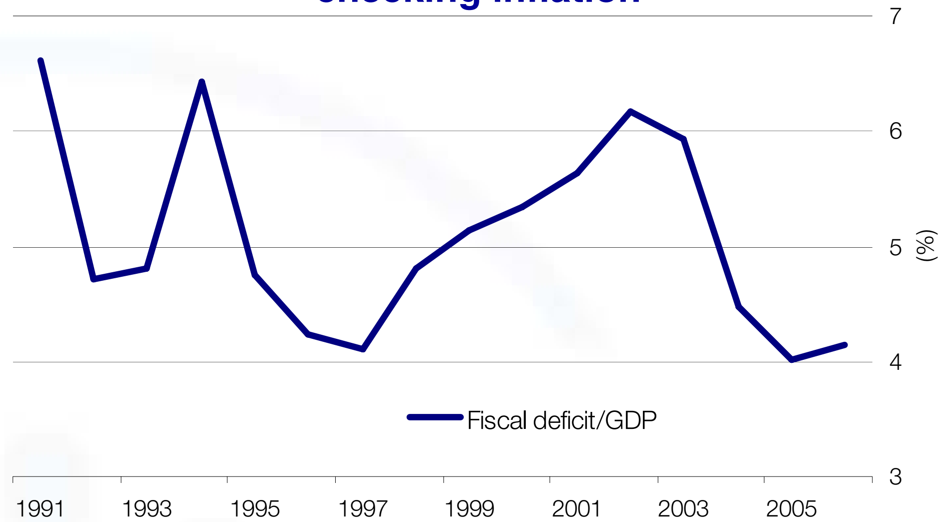
# … in a firm interest rate environment

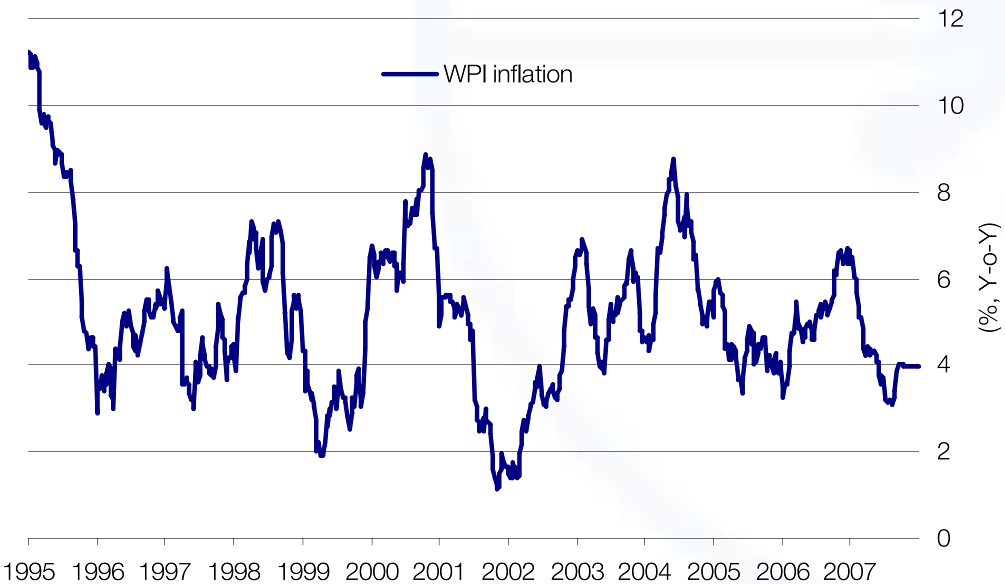
- We believe interest rates will be firm with one 25 bps hike expected in this FY; the CRR increase in end 2006 will provide legroom for a subsequent liquidity infusion.
- The RBI has been proactive in battling inflation and credit growth should moderate; however, the strategy of surprising rather than preparing the markets is debatable

**Government commitment to keep fiscal deficit clamped down checking inflation**




Source: Edelweiss Research

**Inflation could be a source of concern in H1 FY08, though the situation should ease in H2…..**

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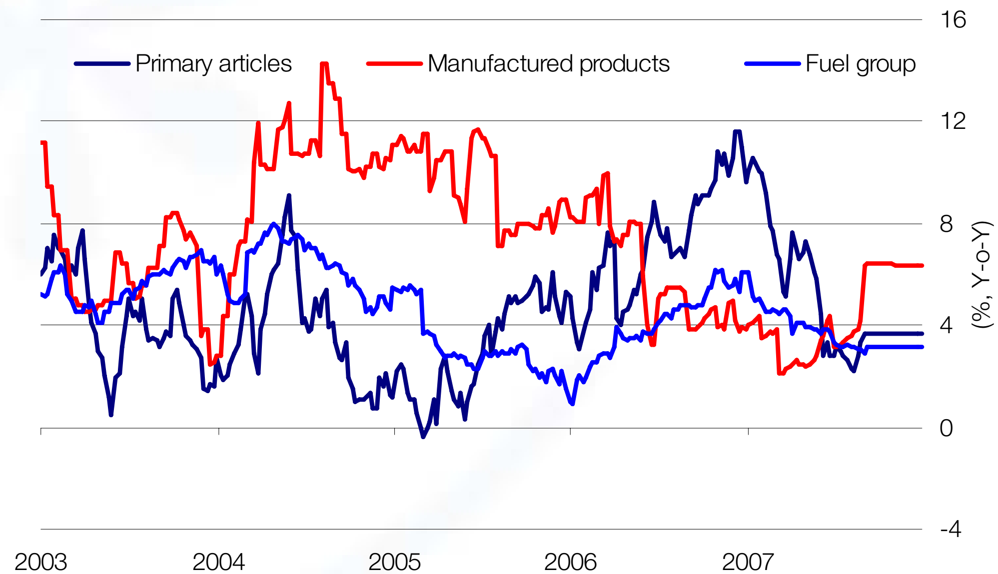


Source: Edelweiss Research

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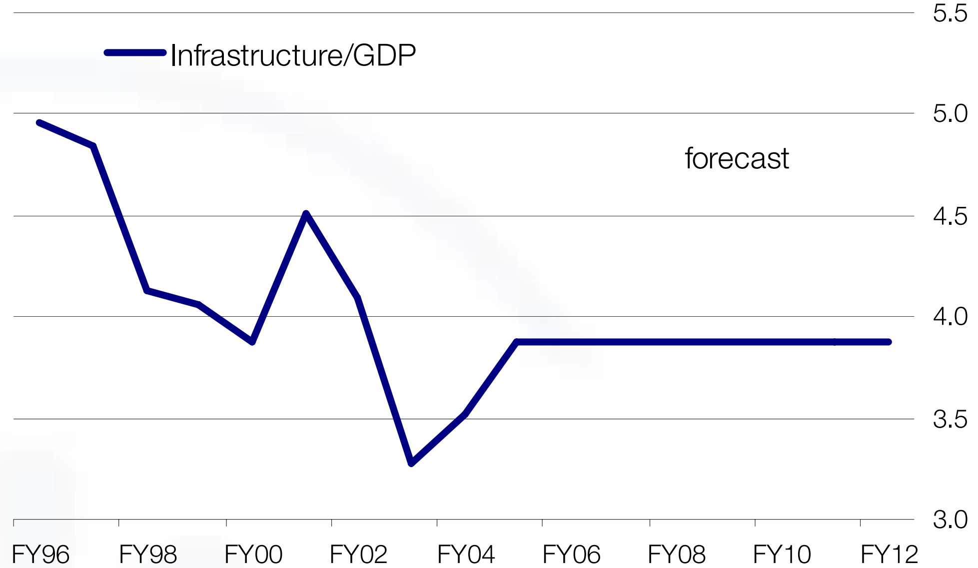
# Infrastructure is our key investment theme for 2007

- Infrastructure is our key theme for 2007 with investments and announcements likely to roll in at a significantly higher plane (Annexure 1)
- The end of the current 5-year plan (in March 2007) including spillovers and the window before the term of the current government at the centre ends are both conducive to a scaleup on this front
- The traction seen on the UMPP front lends further credibility to this
- We favour the infrastructure creators as project announcements and tender invites will provide added visibility on the revenue front

**Above trend infra spend**




Source: Edelweiss Research

Expected investment on infrastructure in India

| Sectors | FY06E-FY12E (INR bn) | USD bn |
|---|---|---|
| Roads | 1,520 | 34 |
| Power | 4,812 | 107 |
| Railways | 1,100 | 24 |
| Telecom | 1,227 | 27 |
| Aviation | 370 | 8 |
| Ports | 800 | 18 |
| O&G | 2,201 | 49 |
| Urban Infra | 1,974 | 44 |
| Total spend | 13,973 | 311 |

*Source: RBI, Edelweiss research*

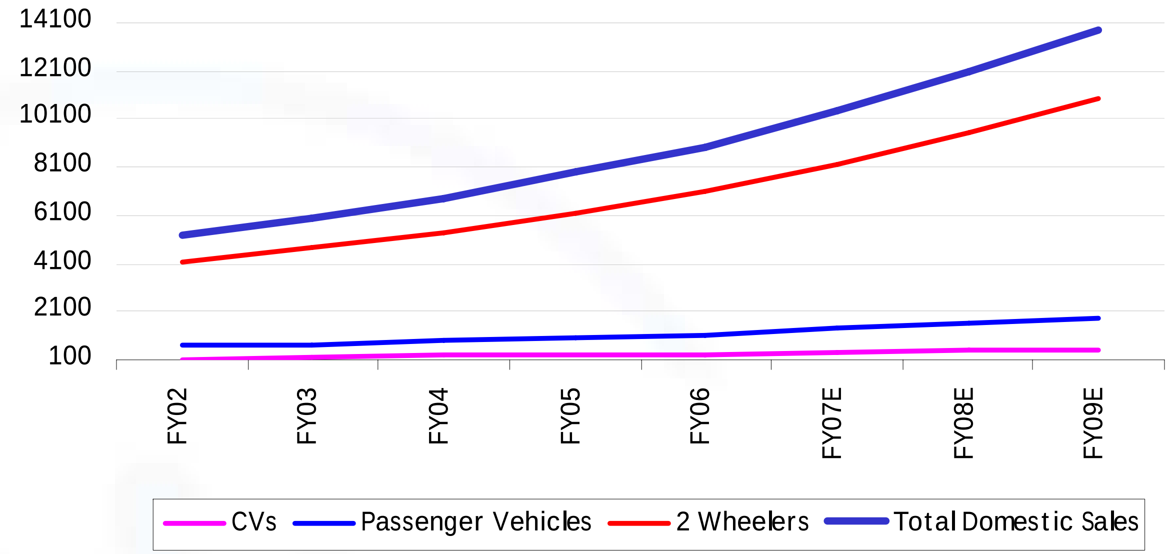
*Note:(1) # USD/INR rate of 45*

Source: Edelweiss Research

# Consumption-led growth too will continue

- Consumption-led growth driven by growing incomes and higher wages (plus possible tax cuts in the budget) will benefit telecom, media / entertainment, consumer electronics and organized retail. Firm interest rates will partially offset this in the case of 2/4-wheelers and housing demand

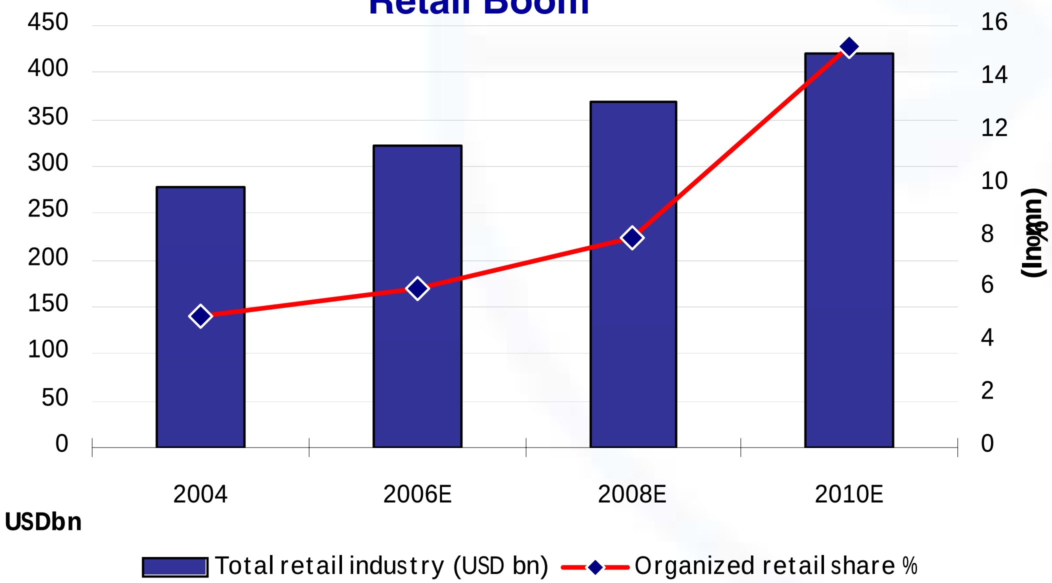
## Growth in domestic automobile sales




Source: Edelweiss Research

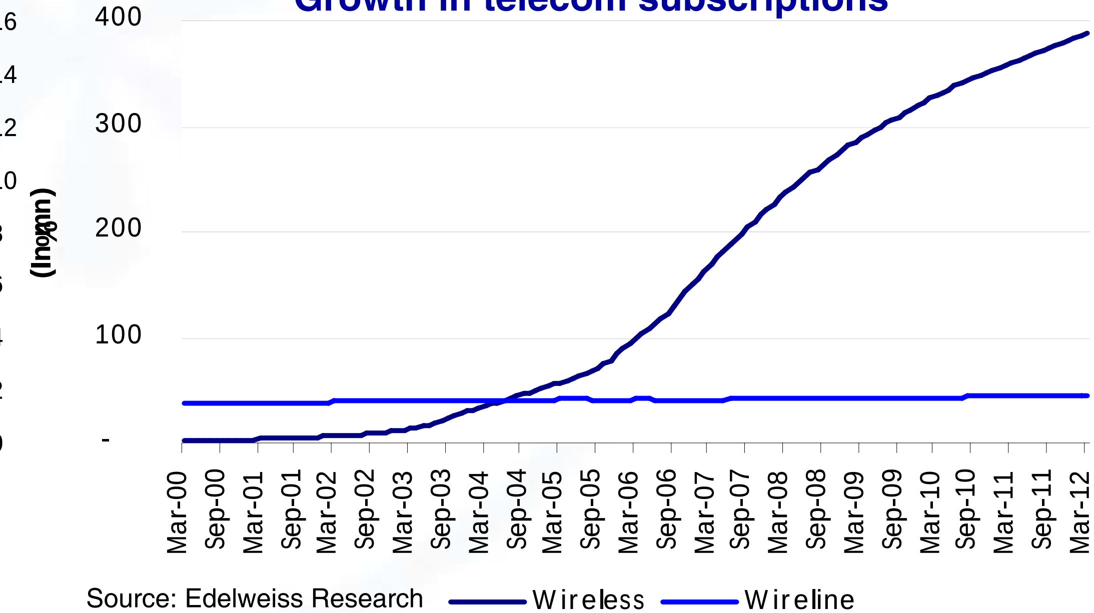
No. of units in '000

## Retail Boom




Source: Edelweiss Research

## Growth in telecom subscriptions




Source: Edelweiss Research

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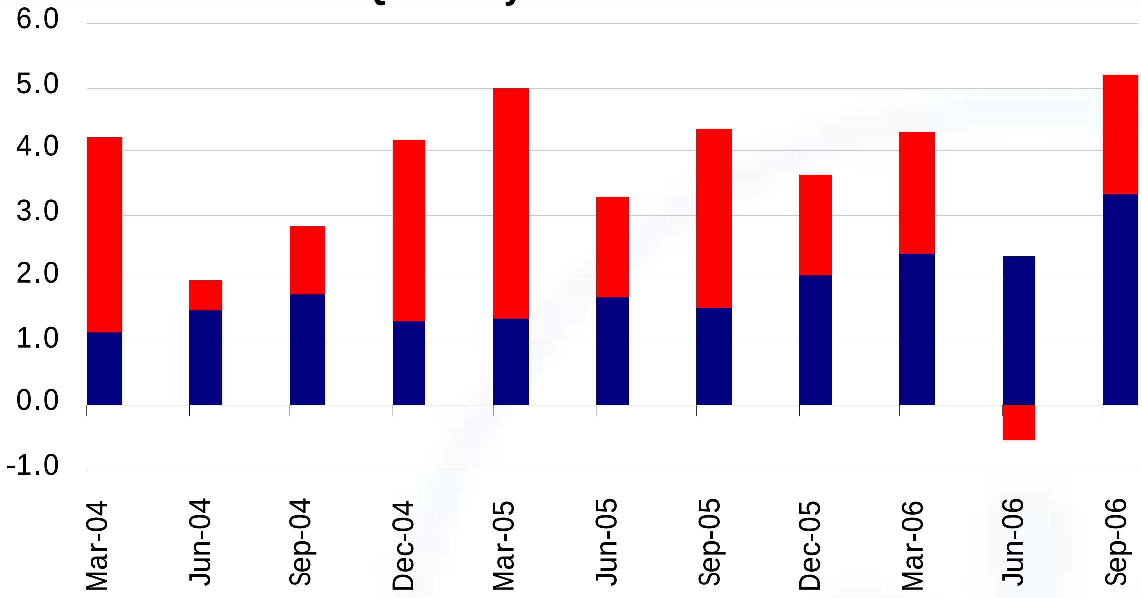
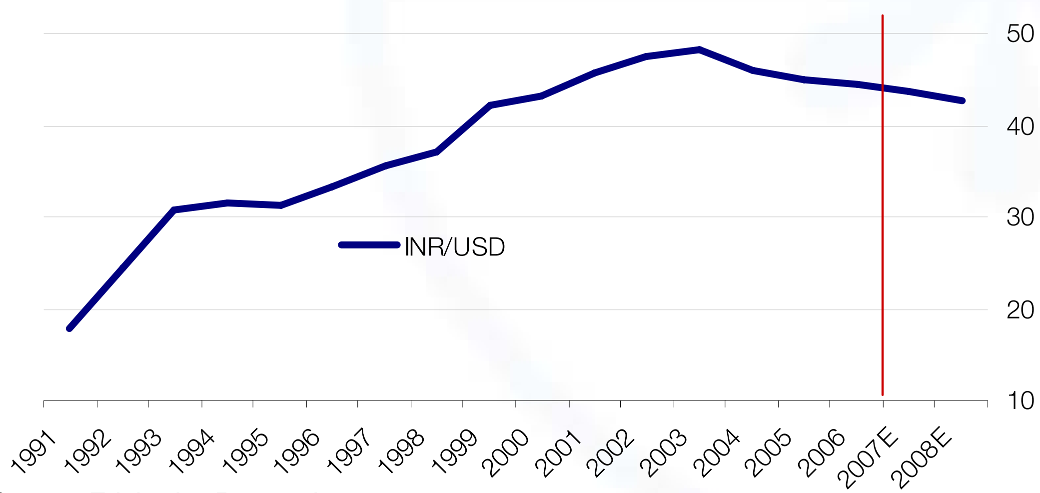
# Portfolio flows are likely to sustain…

Quarterly FDI & FII net flows




Source: Edelweiss Research

Exchange rate movement

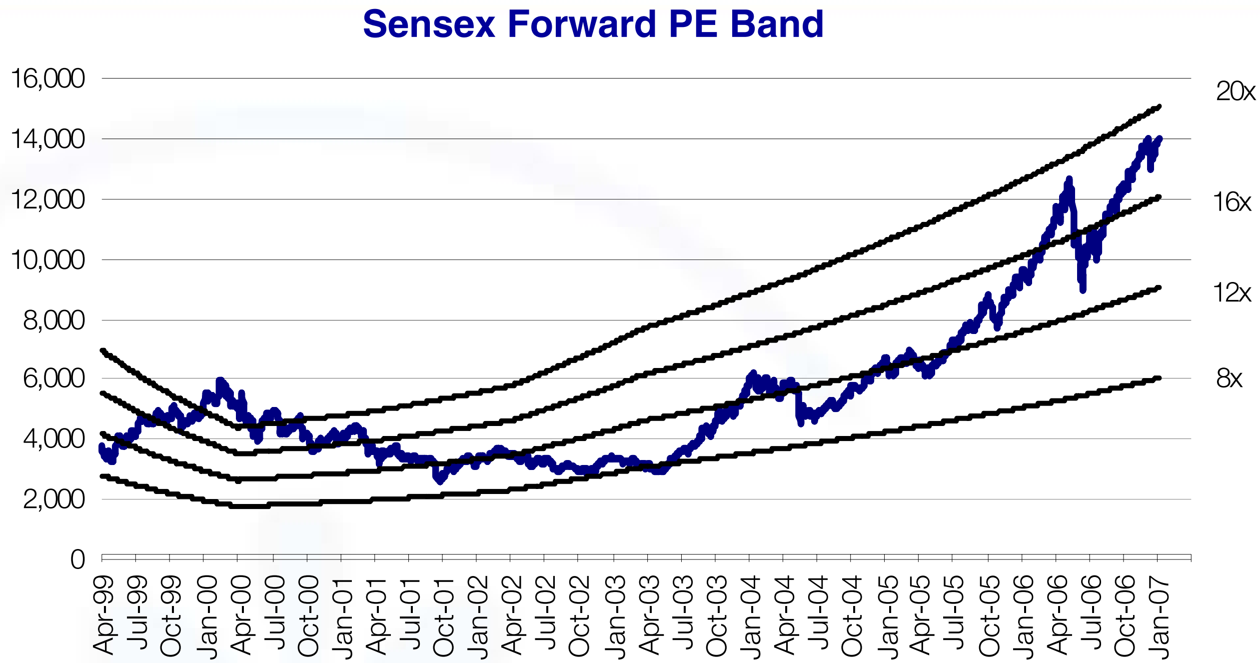



Source: Edelweiss Research

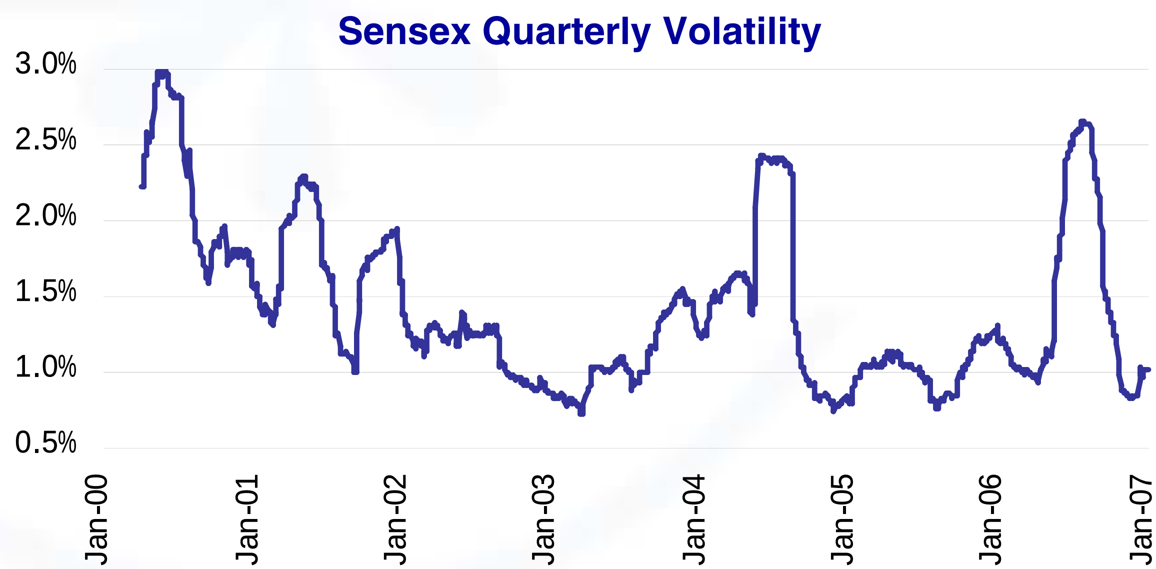
- Portfolio flows have seen a scale change in the last few years and driven market re-rating, but a slowing US economy could temper this going forward
- We believe India's emergence as an 'asset class' in itself and low, though increasing, correlations with global markets would be advantages
- However, given the markets sensitivity to and dependence on flows, increased volatility is in order
- We are particularly positive on FDI flows into India given the higher levels of investment needs and activity
- Our call of a strong rupee in 2007 also supports this view

# … but be prepared for lots of volatility

- Financial markets in India and globally have seen little volatility over the last few years
- There have been only two spikes in India – in April 2004 when the UPA government came to power and in May 2006
- With significant growth expectations built into current prices (Sensex P/E 18x forward), we should expect volatile markets as the effect of any surprises on either side will be magnified.
- In India, stock markets will be the most impacted by negative news flows as other areas where shocks can be absorbed such as the currency, interest rate and corporate bond markets are not free or well developed
- Investors should look to actively using the derivatives markets to hedge their long positions




Source: Edelweiss Research




Source: Edelweiss Research

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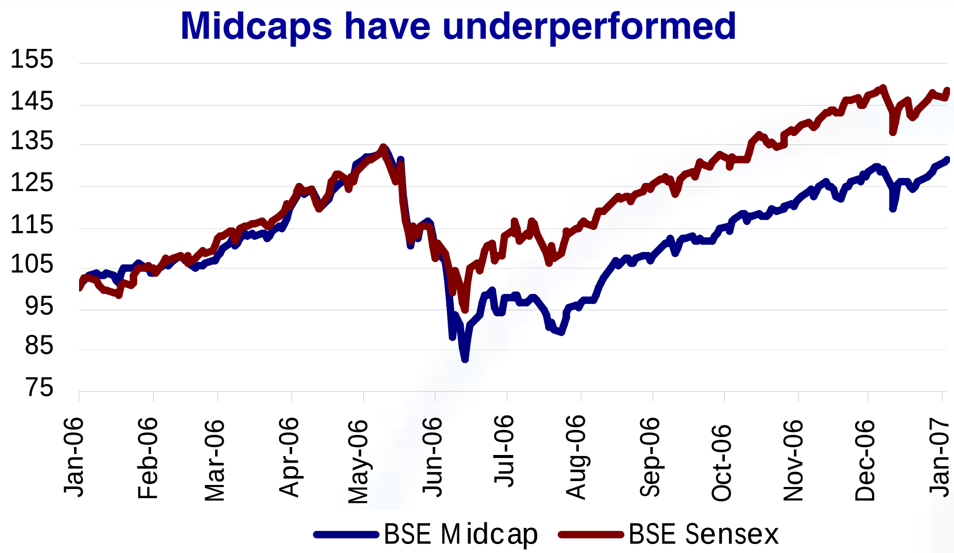
# The last three years: a perspective before we look ahead

* The last three years were a process of discovery of India and value; globally also value did well
* Over this period, the market has moved from undervaluation to fair valuations
* This can be termed a move from value to growth – India has the best of both: value in the balance sheet, high RoEs and strong growth in the revenue statement
* First, earnings were recognized for their quantum and quality; growth then started kicking in, surprising at every stage
* In the last twelve months particularly, we have also seen balance sheet value being unlocked – through monetization of embedded assets, demergers, IPOs, etc., a trend with still much steam left
* Today, while there is still value to be found in the balance sheet, earnings undervaluation is a thing of the past with significant forward growth expectations built into prices
* Indian companies continue to build value in the balance sheet as newer opportunities emerge – through smart capex, inorganic growth and extracting value thru the revenue statement - but the evaluation of this will have to be concurrent
* The India investment story is also getting more inclusive, penetrating into the 2/3rd of the country that is not urban – with telecom, 2-wheelers, micro credit, rural retail, logistics/agriculture supply chain, SEZs and spend on infrastructure

# What to buy in 2007




**Y-o-Y Growth rates (%)**

| Index | Revenue | EBIDTA | PAT |
|---|---|---|---|
| **BSE Sensex** | **17%** | **15%** | **15%** |
| **BSE Midcap** | **18%** | **18%** | **15%** |

- Post May '06, the BSE Midcap Index continues to underperform the BSE Sensex
- However, strong revenue and earnings growth make the case for mid caps compelling given their attractive valuations

- We believe investors can generate alpha in two ways:
  1: buying select large caps that will lead Sensex earnings growth
  2: investing in quality midcaps that provide strong growth with relative undervaluation, with the objective of generating 5-10% additional return
- Our top picks discussed in the next two slides reflect the above

# Our top picks - Rationale

- We are very positive on the infrastructure creators and L&T is our top pick here, with its presence across verticals besides value embedded in its subsidiaries. Jyoti Structures for power T&D, BL Kashyap for construction/real estate and India Cements as a price leverage play are also preferred
- Bharti Airtel and Tata Motors are our preferred stocks to play the secular consumption-led growth story; TAMO is also a play on sustained GDP growth and trade and a beneficiary of lower commodity prices
- Banking is another way to play the growth story: we like PNB for its size and low cost deposit base and Centurion BoP as a quality play on retail credit
- Outsourcing remains a continuing strong theme: HCL Tech (big deal wins; growth outside top-10 clients) and Sasken (product upside) are our picks in IT
- Besides the above, we like ONGC for its deep undervaluation and expected new find announcements and PSL, which is a play on pipeline capex in India and overseas

# Our top picks – Key parameters

| | Company | Sector | CMP | Market Cap | | EPS Estimate | | | EPS CAGR | PE(x) | | | EV/EBITDA(x)# | | | Mcap/Sales(x) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | (INR) | (INR Mn) | (USD Mn) | FY06 | FY07E | FY08E | 06-08E | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E |
| | **Large Caps** | | | | | | | | | | | | | | | | | |
| ~ | Tata Motors | Auto | 900 | 356,501 | 8,112 | 35.6 | 47.5 | 56.6 | 26% | 25.3 | 19.0 | 15.9 | 17.5 | 13.9 | 11.3 | 1.7 | 1.4 | 1.2 |
| ~ | Punjab National Bank | Banks, Fin. services | 507 | 159,857 | 3,637 | 46.9 | 58.8 | 74.6 | 26% | 10.8 | 8.6 | 6.8 | 1.8 | 1.5 | 1.3 | 2.6 | 2.3 | 2.0 |
| | Larsen & Toubro | Engg, Capital goods | 1,443 | 401,573 | 9,137 | 45.4 | 59.7 | 79.2 | 32% | 31.8 | 24.2 | 18.2 | 26.5 | 19.3 | 14.5 | 2.4 | 1.9 | 1.5 |
| | HCL Tech | IT | 649 | 211,411 | 4,810 | 24.0 | 33.6 | 40.8 | 31% | 27.1 | 19.3 | 15.9 | 21.0 | 14.9 | 11.4 | 4.8 | 3.4 | 2.8 |
| | ONGC | Oil & Gas | 870 | 1,860,946 | 42,344 | 72.0 | 87.9 | 96.8 | 16% | 12.1 | 9.9 | 9.0 | 5.5 | 4.1 | 3.5 | 2.5 | 1.8 | 1.7 |
| | Bharti Airtel | Telecom | 629 | 1,191,823 | 27,118 | 12.0 | 21.9 | 31.8 | 63% | 52.3 | 28.7 | 19.8 | 28.5 | 17.1 | 11.8 | 10.2 | 6.3 | 4.4 |
| | **Mid Caps** | | | | | | | | | | | | | | | | | |
| ~ | Centurion BoP | Banks, Fin. services | 31 | 54,957 | 1,250 | 0.6 | 0.9 | 1.5 | 54% | 49.5 | 33.7 | 20.8 | 4.7 | 3.2 | 2.9 | 7.6 | 5.6 | 4.0 |
| | India Cements | Cement | 235 | 51,823 | 1,179 | 2.4 | 18.1 | 20.2 | 191% | 99.0 | 13.0 | 11.7 | 24.8 | 9.7 | 7.8 | 3.4 | 2.6 | 2.3 |
| | BL Kashyap & Sons | Construction | 1,437 | 14,653 | 333 | 28.0 | 72.6 | 116.2 | 104% | 51.4 | 19.8 | 12.4 | 27.2 | 11.7 | 7.1 | 3.1 | 1.5 | 1.1 |
| ~ | Jyoti Structures | Engg, Capital goods | 131 | 10,087 | 230 | 4.0 | 7.3 | 12.3 | 75% | 32.8 | 17.9 | 10.7 | 15.4 | 9.8 | 7.4 | 1.5 | 1.0 | 0.7 |
| | Sasken Comm Tech | IT | 536 | 15,008 | 341 | 9.1 | 18.4 | 35.0 | 96% | 59.0 | 29.1 | 15.3 | 30.9 | 17.3 | 9.6 | 4.9 | 3.0 | 2.1 |
| ~ | PSL | Oil & Gas/Pipes | 205 | 8,037 | 183 | 15.3 | 20.5 | 27.7 | 34% | 13.4 | 10.0 | 7.4 | 10.3 | 6.8 | 5.1 | 0.6 | 0.5 | 0.4 |

# P/BV for banking stocks

~ standalone

Prices as of December 29, 2006

# Annexure 1: Infrastructure – *Power full play (1)*

- Visibility to remain robust for FY2008 with total capacity of ~10,700MW under the award process. Additionally ~ 6,000MW of capacity planned in 10th plan is likely to slip to 11th plan

| Sector, in MW | Thermal units for 10th plan, slippage to 11th plan | Projects under award process |
|---|---|---|
| Central | 4,890 | 2,600 |
| State | 560 | 4,660 |
| Private | 520 | 3,475 |
| **Total** | **5,970** | **10,735** |

Source: CEA

- Strong growth in power generation expected fuelled by severe regional power deficit – capacity of ~5,800 MW added in FY2006, further ~3,400MW capacity added in April-November 2006, against the planned addition of ~7,000MW in the same period. Planned capacity addition for FY2007 was ~17,700MW, however likely addition is to be ~9,000MW for the same period
- Power T&D capacity additions have been ahead of plan. For FY2006 ~9,400ckms of transmission lines added compared to a plan target of ~6,900ckms
- However for FY2007 there is a substantial lag in the 400 kV substation capacity addition which is likely to slip to the 11th plan
- As of Nov-2006 ~INR 95bn worth of contracts were awarded under the RGGVY scheme. Consequently contracts worth ~INR 55bn need to awarded over the next 3-4 years

# Annexure 1: Infrastructure – *Power full play (2)*

- **Demand is likely to remain robust** with the planned increase in the interregional transmission capacity from ~11,500MW currently to ~37,150MW by the end of the eleventh plan, entailing additional ~96,000 ckms of transmission lines

**Transmission lines capacity additions**

| All figures in ckm | Programme FY2006 | Achievement FY2006 (3) | Achievement ahead of programme (%) FY2006 |
|---|---|---|---|
| 765 kV lines | 105 | 287 | 173% |
| 500 kV lines | 0 | 0 | NA |
| 400 kV lines | 3,850 | 6,260 | 63% |
| 220 kV lines | 2,738 | 2,871 | 5% |

Source: CEA

**Substations capacity addtions**

| All figures in MVA | Programme FY2006 | Achievement FY2006 (3) | Achievement ahead of programme (%) FY2006 |
|---|---|---|---|
| 500 kV HVDC | 0 | 0 | NA |
| HVDC B/B S/S | 0 | 0 | NA |
| 400 kV S/S | 7,455 | 10,265 | 38% |
| 220 kV S/S | 7,760 | 7,505 | -3% |

Source: CEA

**Transmission lines capacity additions - FY2007**

| All figures in ckm | Programme for FY2007 | Achievement April - Nov 2006 | Remainder for FY2007 |
|---|---|---|---|
| 765 kV lines | 660 | 292 | 368 |
| 500 kV lines | 0 | 0 | 0 |
| 400 kV lines | 7,948 | 4,498 | 3,450 |
| 220 kV lines | 4,268 | 2,480 | 1,788 |

Source: CEA

**Substations capacity addtions -FY2007**

| All figures in MVA | Programme for FY2007 | Achievement April - Nov 2006 | Remainder for FY2007 |
|---|---|---|---|
| 765 kV | 2,331 | 0 | 2,331 |
| 400 kV | 11,130 | 6,037 | 5,093 |
| 220 kV | 8,183 | 4,180 | 4,003 |

Source: CEA

# Annexure 1: Roads – *Pathfinder (1)*

- Project tendering process likely to gain momentum in 2007 post temporary slowdown in 2006…

  …..contracts for ~3,000 kms of roads likely to be tendered in 2007 alone under various NHDP programs vis-à-vis 14,000 kms awarded in last six years

- Contract sizes likely to increase from ~INR 2.5bn to ~ INR 10bn *plus* going forward as NHDP Phase III- VI roll out

- Private sector participation to take a giant leap…

  ……with all the contacts under NHDP Phase III – VI coming under the BOOT structure

- With the learning curve behind, increased protection from traffic risks under the new MCA and larger number of operational roads being tendered for expansion and maintenance, PPPs are likely to witness renewed interest

- Development under the PMGSY likely to continue. Since inception 57,444 road works worth ~INR 350bn have been sanctioned of which 33,658 roads have been completed so far

- Planned investment of INR 600bn over 2007-2010 under PMGSY likely to be funded through cess and external assistance

# Annexure 1: Roads – *Pathfinder (2)*

* Implementation pace to speed up…

……with 96% of the GQ nearing completion and ~80% of contracts under NHDP Phase I and II already awarded, construction is likely to be completed by December, 2010

**Table: NHDP & other NHAI project status as on May 31, 2006** *(km)*

| | NHDP | | | | | | |
|---|---|---|---|---|---|---|---|
| | **GQ** | **Phase I & II*** | **Phase III -A** | **Total** | **Port Connectivity** | **Others** | **Total** |
| Total length | 5,846 | 7,300 | 4,015 | 17,161 | 380 | 945 | 18,486 |
| Completed till date | 5,360 | 822 | 30 | 6,212 | 110 | 287 | 6,609 |
| Under implementation | 486 | 5,019 | 1,090 | 6,595 | 249 | 638 | 7,482 |
| Contracts awarded (no.) | 39 | 101 | 7 | 147 | 7 | 11 | 165 |
| Balance length for award | - | 1,433 | 2,889 | 4,322 | 21 | 20 | 4,363 |

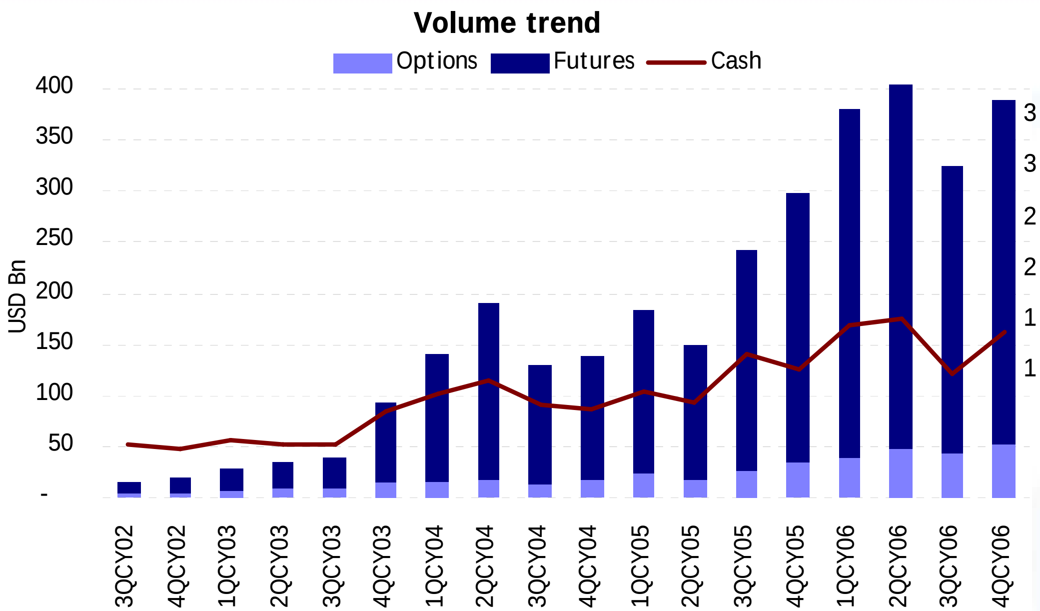
*Source: NHAI, Edelweiss research* ** Phase I & II are the phases of NSEW corridor*

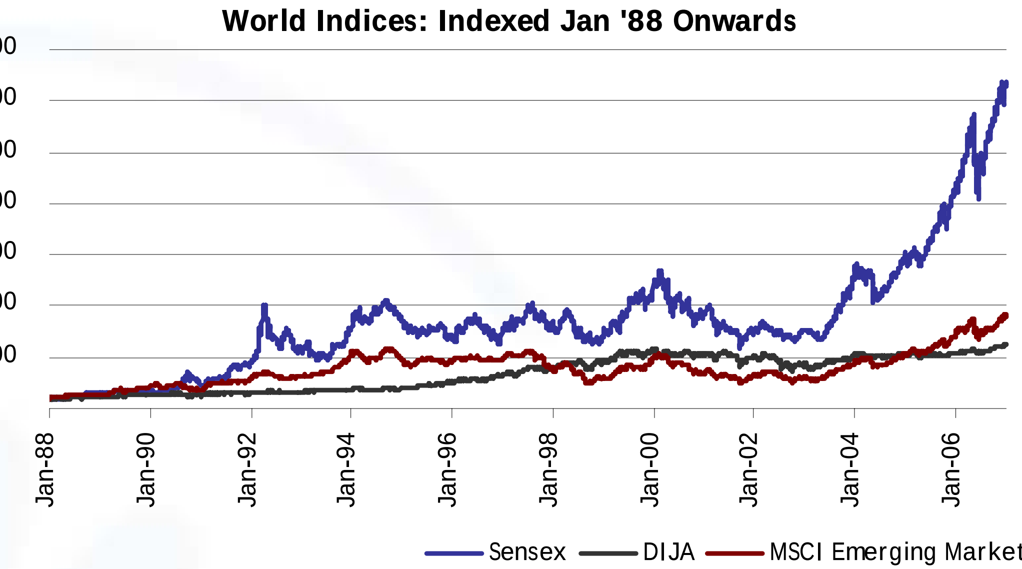
# Annexure 2: Economy snapshot

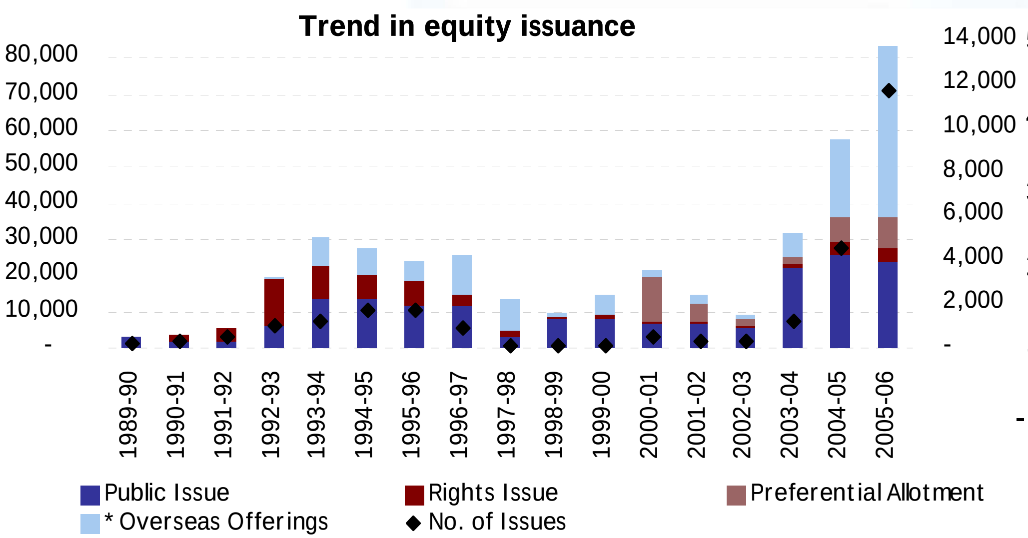
| Indicator | FY-04 | FY-05 | FY-06 | FY-07(YTD) |
|---|---|---|---|---|
| Real GDP (% Y-oY) | 8.5 | 7.5 | 8.4 | 9.1 |
| Agriculture | 10.0 | 0.7 | 3.9 | 2.5 |
| Industry | 7.6 | 8.6 | 8.8 | 10.0 |
| Services | 8.2 | 9.9 | 10.1 | 10.7 |
| Credit (% Y-o-Y) | 17.5 | 32.6 | 32.3 | 29.6 |
| M3 (% Y-o-Y) | 15.8 | 14.4 | 17.0 | 18.8 |
| WPI inflation | 4.5 | 5.7 | 3.5 | 4.7 |
| Imports (USD bn) | 77 | 107 | 134 | 115 |
| Exports (USD bn) | 63 | 79 | 94 | 78 |
| Current account balance (USD bn) | 14.1 | (5.4) | (10.6) | (6.0) |
| Capital account balance (USD bn) | 16.7 | 31.0 | 25.6 | 11.8 |
| Fiscal deficit/GDP (%) | 4.5 | 4.0 | 4.1 | 5.2 |

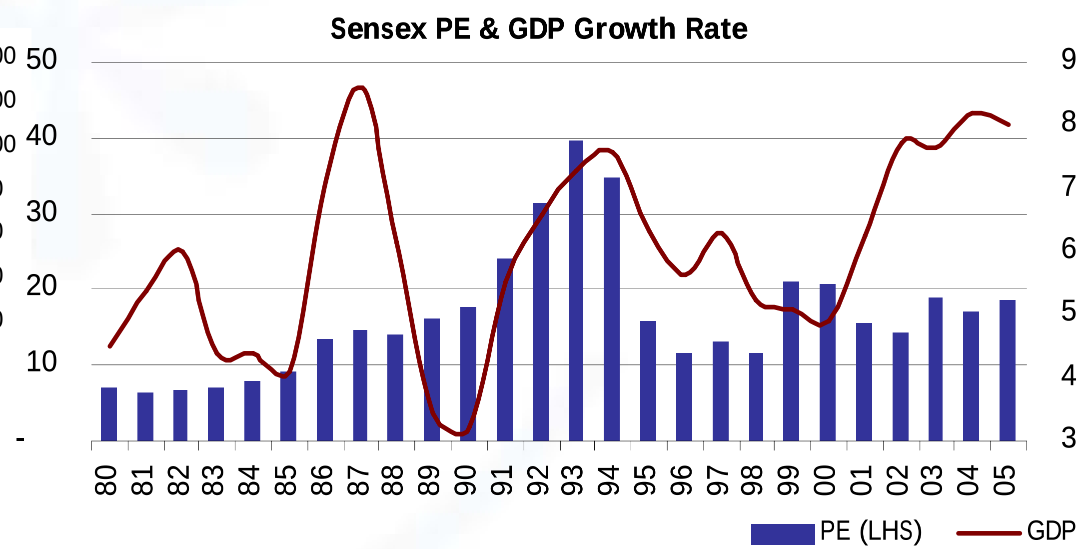
*Source: CMIE, RBI, Ministry of Commerce, Office of Economic Advisor*

# Annexure 3: The story so far in pictures (1)

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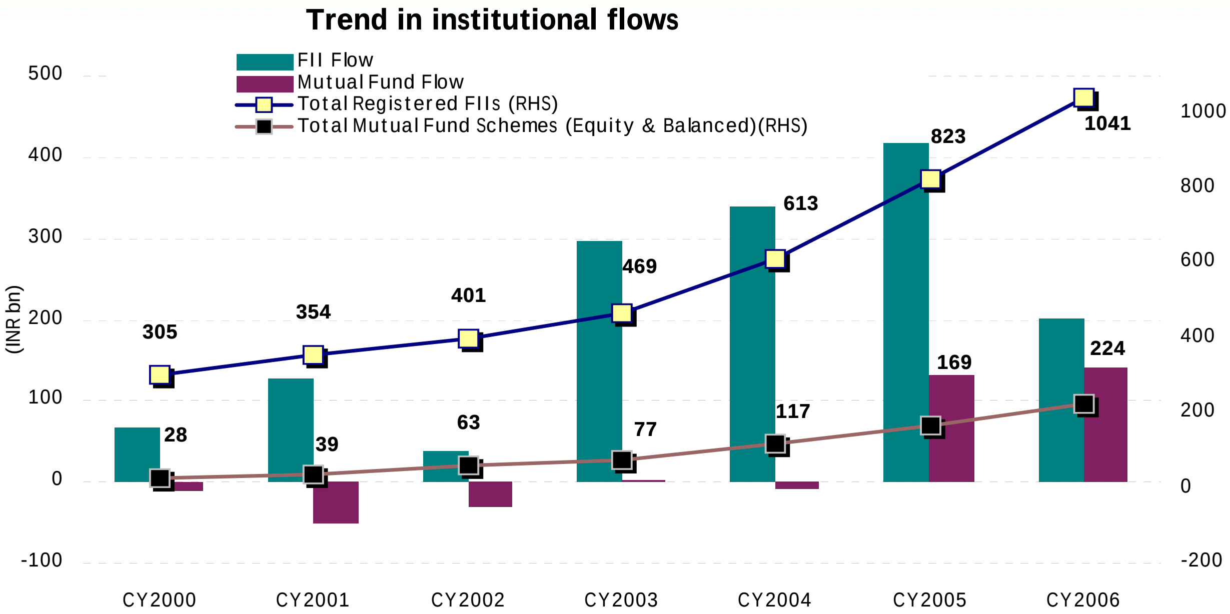
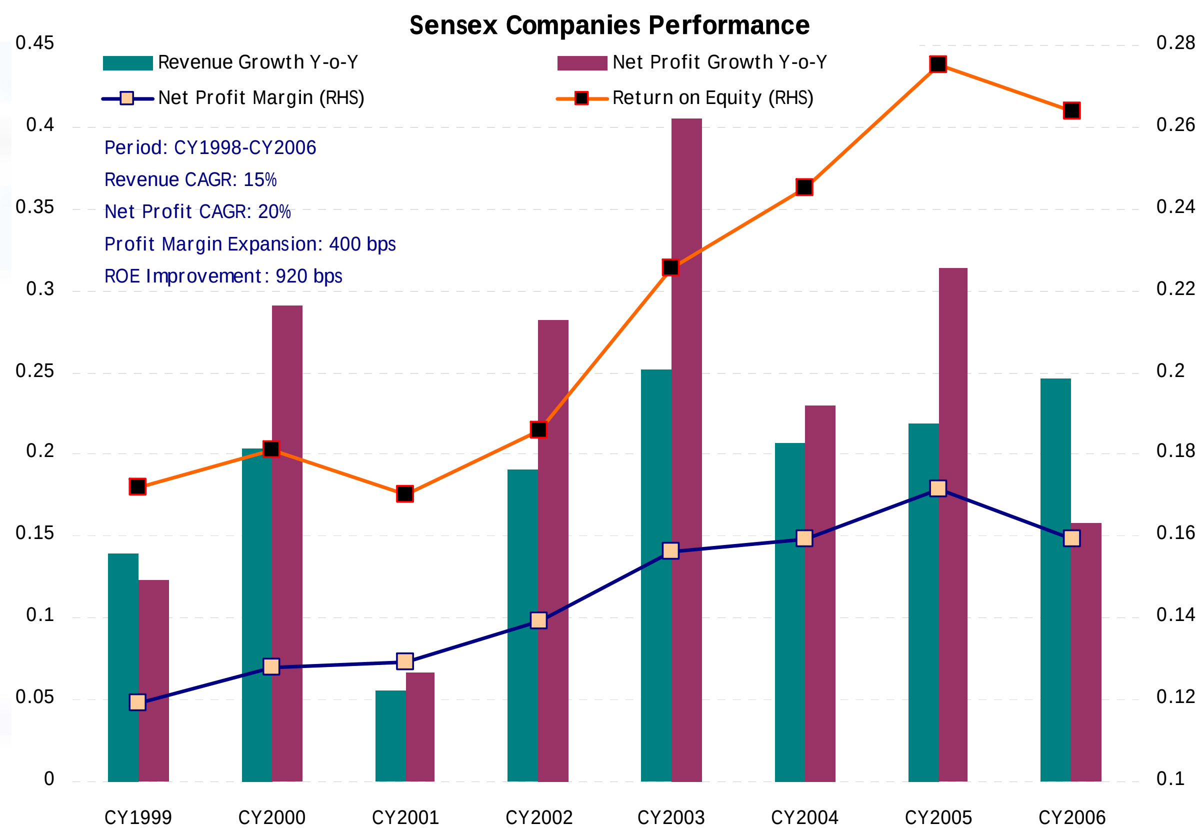
# Annexure 3: The story so far in pictures (2)

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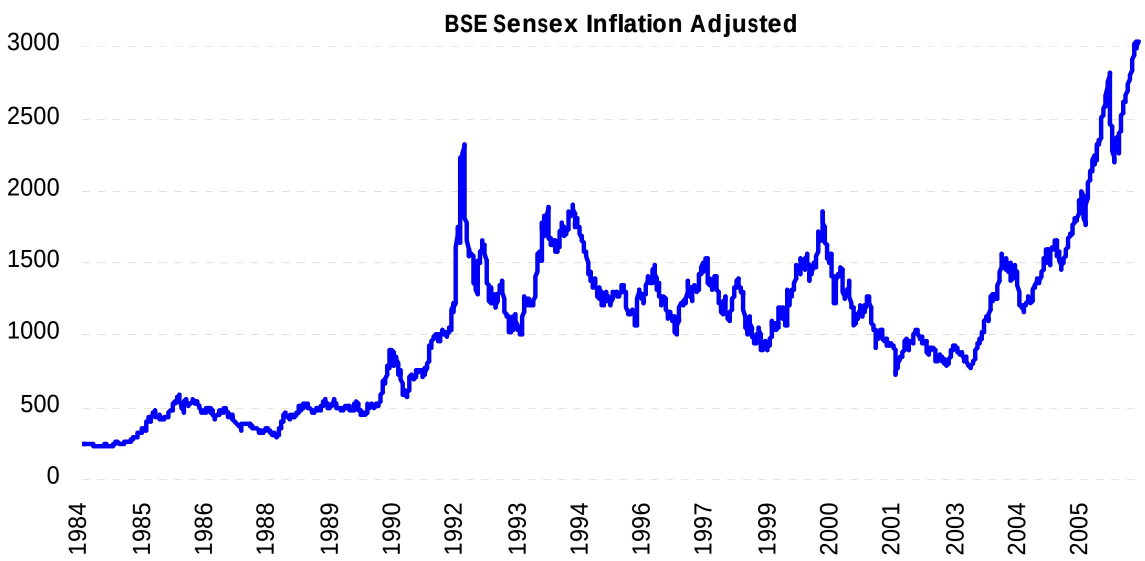
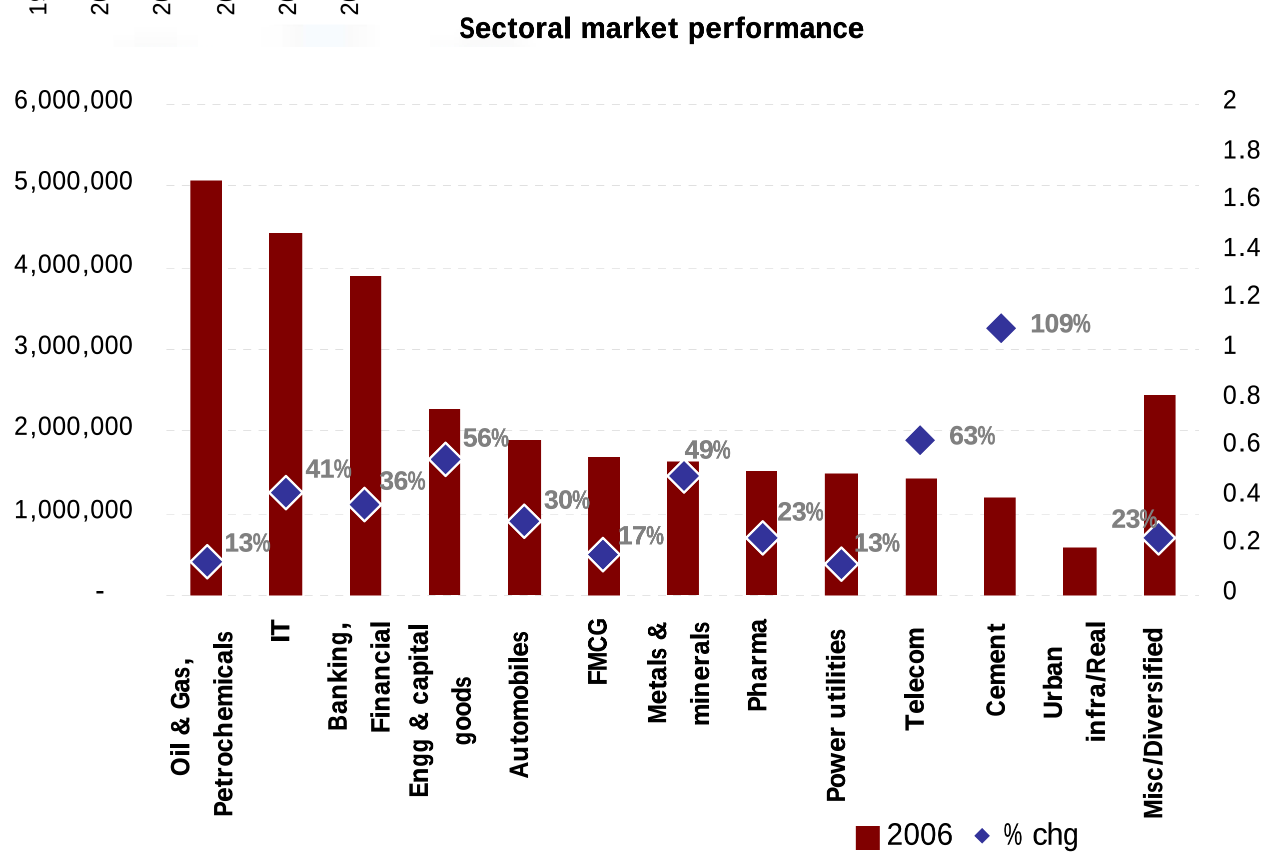
# Annexure 3: The story so far in pictures (3)

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