Equities

1 June 2011 │ 20 pages

India Equity Strategy

Bright Side of the Gloom

- **Such gloom** — Investing in India these days seems depressing; growth has started slipping, anecdotal evidence/signs of an investment implosion, reforms appear on the back burner, the macro appears lost in a maze and not surprisingly, the market is down 9.3% YTD and is one of the biggest underperformers.
- **Though the economy and earnings continue to move** — The economy should clock 8% growth (the second highest among large markets), earnings outlook remains at 18-19% growth. 4QFY11 earnings have held up well – some signs of an investment uptick and consumption momentum has been positively strong. While there clearly is an investment slump, we think it is cyclical and seems to be completely overshadowing an otherwise OK demand and pricing environment.
- **Macro is bad, but incrementally 'falling growth and rising rates'?** — Daunting macro – high and rigid inflation, rising rates – has moderately damaged growth and meaningfully dashed expectations. But the economy is now probably close to peak in terms of incremental pressures, and either growth falls or market rates rise – it is unlikely that both will happen, which is what we believe the market is suggesting.
- **Expectations (low) + risk perceptions (high) + valuations (moderate) = Buy** — Beaten-down economic growth expectations, elevated earnings/macro risk perceptions, resultant moderation in valuations (14x 1-yr Fwd, 10% discount to average) and India's second half seasonality (21% avg. gains over last 7 years) are reasons to buy Indian stocks. We see a 21,500 Sensex at Dec11 (previously 22,000), with OWs in Financials, Energy, Pharma, Property and Telecom.
- **Catalysts** — Easing macro and commodity price pressures, capex revival – government policy or approvals driven, and a widening global growth differential.
- **Structural risk lies in profitability, not growth** — India's fundamental risks are its high ROEs (cyclical boost near term), which will be threatened medium term, not its growth outlook, which we believe is cyclically, not structurally, challenged.

Figure 1. Earnings Yield vs. Bond Yield Trend for India

Source: Factset, Bloomberg

■ Equities

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Bright Side of the Gloom

Such Gloom ……..

One of the worst-performing markets, with a slew of macro and micro issues justifying this poor show

India has been a difficult market. It is down 9.3% YTD and is about the worst-performing regional and global market, and investor sentiment – global and domestic – is fairly pessimistic. While market performance is often a cause for investor disenchantment with the market, there are a slew of real macro and micro issues that justify the bearishness. These include risks to growth, a challenging macro environment, with high and rigid inflation and rising interest rates, and the stalled investment cycle. This is in large measure because of a lack of policy making/execution standstill at the government's end, and the infrastructure deficit, which is stoking inflation. These pressures are being compounded by the growth/investment challenges that higher Interest rates bring. There is not surprisingly an extrapolation to earnings, which are perceived to be at meaningful risk.

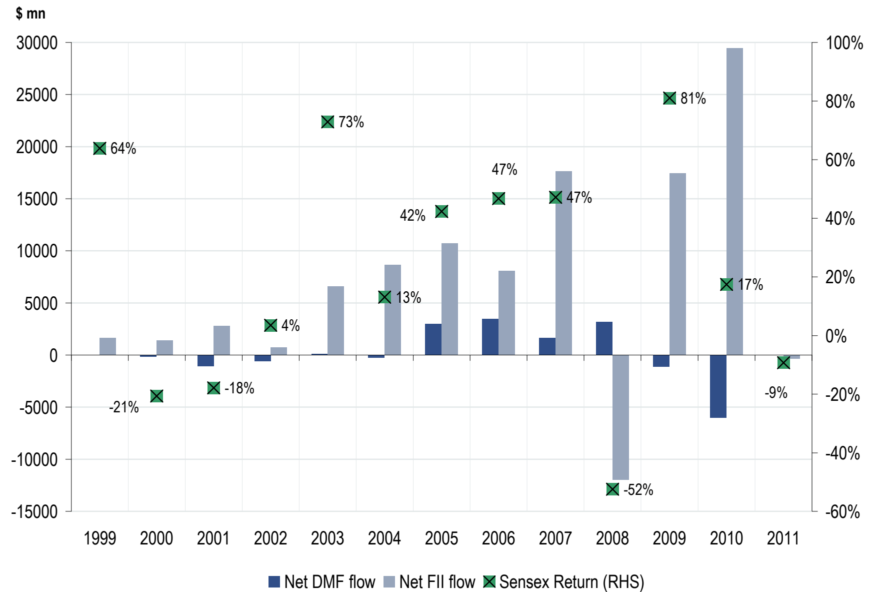
Figure 2. Equity Markets Performance in the last 12 months

Source: Bloomberg

Drivers are largely India specific, and with only about $0.36 bn having moved out, the overhang of outflows is meaningful

While a few of these pressures are global – cost pressures and the risk of inflation – the majority of them are India specific in nature and the reason for the India bearishness. In addition, there is the overhang of the funds outflows – India received almost $30bn in 2011 (167% of its previous net inflow peak), and even though the market is down 9.3%, only about $356mn has moved out…suggesting there remains meaningful risk of substantial outflows (we estimate the value of foreign equity ownership in India at about $280 bn).

Figure 3. Flows and the Market



Source: Bloomberg

Bottom-line, there is a bear case for India, in spite of its weak and sub-peer performance.

Though there is a bright side……

There is a bear case . . .

We do see the bear case – and India will clearly grow slower than recent expectations, high inflation will impact demand and policy making will increasingly veer toward inflation mitigation versus growth support and structural reforms/ corrections.

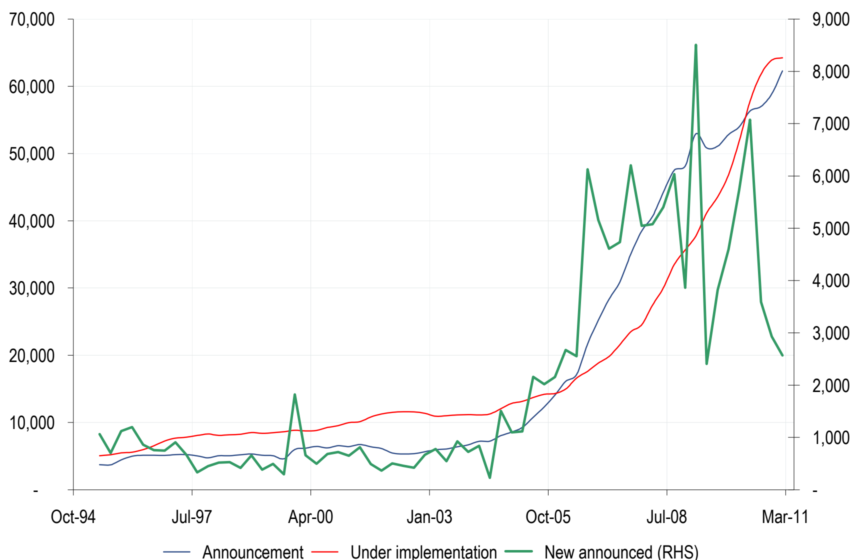
Figure 4. Trends in Inflation (WPI)

Source: Office of the Economic Advisor

. . . Which is snuffing out a high-growth economy, a profitable and reasonable corporate sector, which has at the margin surprised on the upside in-spite of overall economic growth falling off in the quarter

However, we do believe the market's caution is clouding some of the positives visible in the economy. The overall growth outlook continues to be relatively robust; we see it remain marginally above the 8% level (though consensus is in the 7.5-7.9% range, the 4QFY11 did disappointingly drop below the 8% level), the earnings momentum remains fair – we estimate 18-19% in FY12 (and 4QFY11 results have largely been in line with expectations – with a 53/39 positive to negative surprise ratio).

Figure 5. Project Capex in the Pipeline



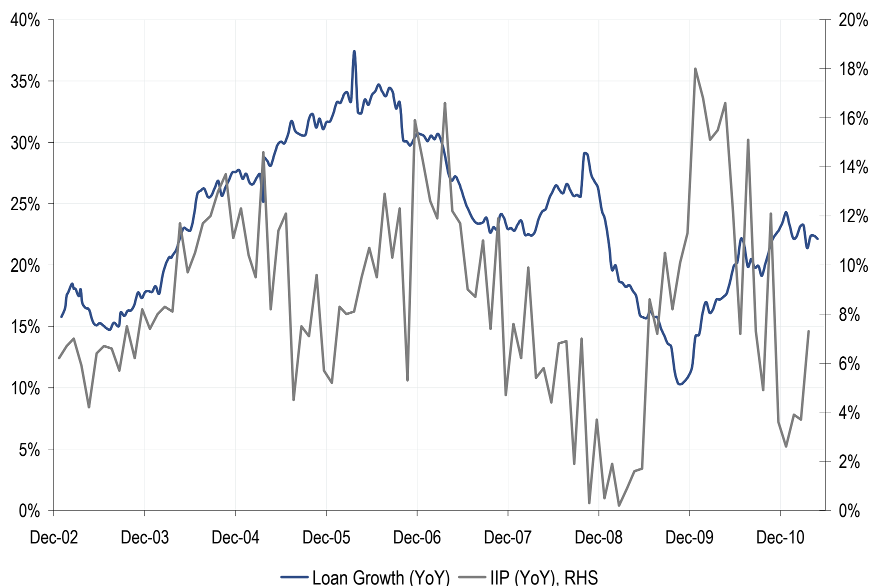
Source: CMIE

Is the capex cycle really dead?… Capital goods companies are actually more optimistic than the top down view, or new announcement data, and there is a pile-up…

We also see some signs of a bottoming out in terms of the capex cycle – with more than a few capital goods companies suggesting a pickup in industrial activity and project ordering, and signs of more optimism from their front. While this appears biased and driven by the industrial rather than the infrastructure and Greenfield project space (which tends to capture the headlines), this does suggest a rising pipeline, and is at odds with the market view that capex is dead. We do believe it needs a lot more – from government approvals/decision making, to easier and cheaper funding for this to turn around meaningfully, but there is cushion in the low expectation levels it is set against.

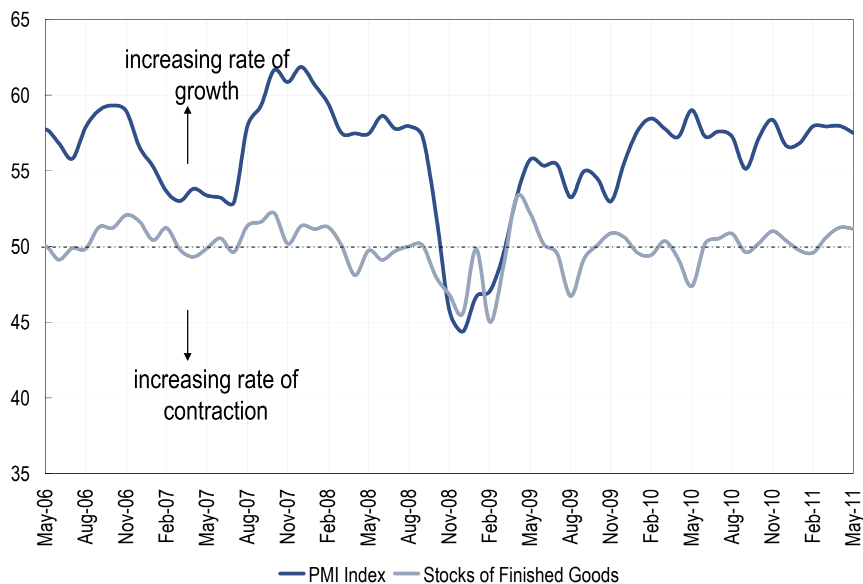
We also see a disconnect between the faltering investment cycle and fairly consistent and robust loan growth (22%+ yoy), which suggests there is reasonable funding demand and does not fully match with the apparent slowdown. While this could in part be inflated due to inflation, or supporting higher inventories (which reflects a further slowdown in the offing), we see only limited evidence of this, suggesting underlying growth is not as weak as is being anticipated.

Figure 6. Trends in Loan Growth & Industrial Production



Source: RBI, Bloomberg

Figure 7. Trends in the Manufacturing PMI and the Inventory Sub-Index



Source: Markit

Consumption has remained on a roll….in spite of the macro, and suggests there is a significant structural element to it

We believe more fundamentally the robustness and in cases the acceleration of consumption demand over the last 6-12 months has been impressive (cars, motorcycles, consumer non durables, telecom). This is particularly so because of the progressively challenging macro – inflation, rates and for automobiles rising fuel price, and an elevated level of political uncertainty in the first quarter of the year.

Growth and profitability have held up well in the face of an extreme macro…might falter in the near term, but will probably be better appreciated when (ever) the macro reverses

Effectively, growth and demand has been relatively robust, and has held up better than would have been anticipated; suggesting that there are structural drivers of demand that are probably more deep seated than the market probably factored in. Yes, there will likely be a demand drop as we go further into the macro cycle, but we believe the robustness/resilience in the face of the sharp macro-deterioration is meaningful. We also believe this suggests that the structural drivers of demand dominate the cyclical elements of it, and will be better appreciated when (and if) the macro eases.

Capex slowdown appears primarily government approval driven…..not demand, sensitivity to interest rates or investor risk appetite driven

We also believe there are traces of this on the investments side too, even though there has been a sharp and well flagged fall-off. We say this is because we believe the slackening investment momentum is primarily on account of regulatory/ government approval/land acquisition bottlenecks – not because demand projections are being questioned, or higher interest rates have diminished the return structures for corporates/investors to shelve projects. Bottom line, while demand and investment is stalling, the willingness to buy and invest for individuals and corporates alike remains fairly structural, and should bloom in a more favorable macro and policy environment.

Bad Macro, but 'Falling growth and Rising Rates'?

Macro is poor….and improvements will only be gradual

The extent of India's macro deterioration – especially on inflation, interest rates and the fiscal deficits vulnerability to petroleum/other subsidies, has surprised on the downside in 2011 YTD. This is particularly so on inflation, where its rigidity is becoming increasingly apparent; risk of pent-up increases on administered prices – fuel and power, and the mix of supply side (food, commodities) and increasingly demand side (pronounced because of infrastructural bottlenecks) suggests little scope for sharp or cyclical reversals near term. The macro therefore is likely to remain an overhang, with few easy or near-term gains.

Economy is unlikely to both slow and see higher market rates … which is what the market appears to be currently factoring in

We do however believe the market has probably become too cautious; and is factoring in slower growth and rising market rates/tight liquidity. We believe all of these risks, in themselves, are meaningful – but we do not believe they go hand in hand. If the slowdown persists and/ or extends, then the pressures on interest rates/liquidity and inflation should fundamentally ease (unless it is supply side driven, the risk of which we believe has eased). On the other hand, if the demand driven inflation/call for money remains high, then it does not fully support the slowing growth hypothesis. Bottom line, there are both growth and interest rate pressures, but in combination, they are probably a little over-stated.

The cyclical slowdown is more approval/ government policy driven, not market or economic growth cycle based…

The government-driven macro environment; policy and reform driven stimulus, execution efficiencies and spend, has been slow and almost at a standstill in recent times. We do also believe the lack of progress – viz. both the need (reflected in the broad-based nature of inflation in the system) and market expectations, is impacting the economy's growth, and the corporate sector's opportunity. We also do not have a strong call on when and if it will see a change for the better, or when one can expect a flurry of policy decisions, reforms and government spend.

Government approval momentum is hard to call, but it is not binary…..some signs of a pickup, but the high profile ones are still to come through

We do however believe the government-induced macro challenge is not as binary as the market has made it out to be. We believe this is particularly the case with environment clearances, land acquisition challenges, and approvals/bids for large projects or corporate action approvals. We actually believe it is a lot more granular – you are beginning to see an increase in the number and environment clearances, there does remain enough land acquisition that continues to happen in specific states where the projects are not high profile, and bidding activity has re-started in the roads sector.

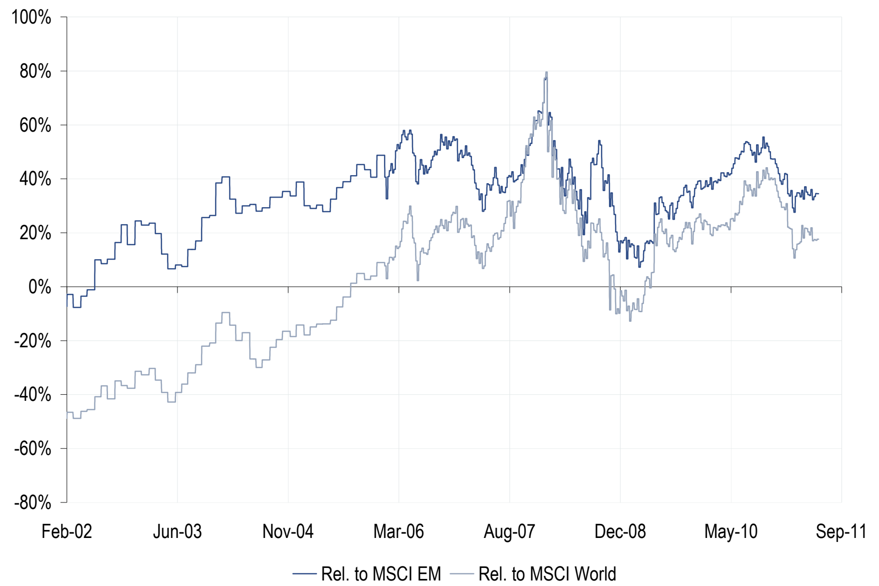
Macro an overhang, possibly past its peak pressures…but no signs of a tailwind

Bottom line, the macro is challenging, but is probably past its peak pressures and is unlikely to deteriorate further. We do also expect a slight improvement – more granular than lumpy, which should be more supportive of the economy and the mood, than it has been during the course of 2011. We do not however see it as a tailwind over the near term, which might meaningfully bolster growth rates or expectations. We believe the market is now expecting very little of the government, so the risks of shifts in the macro expectations – both monetary and governmental – lie on the upside.

So we should buy India, because …

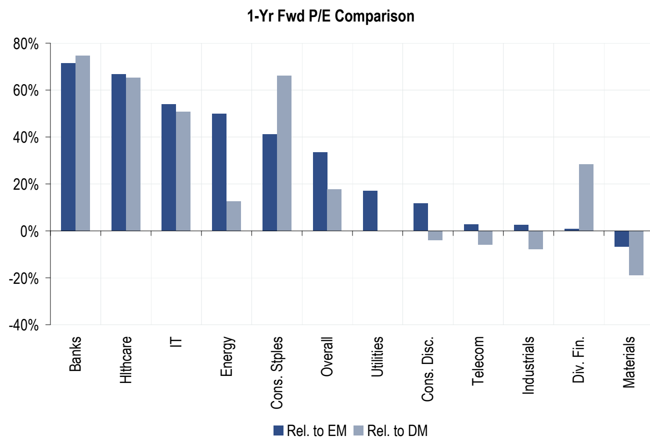
a) Low market growth expectations – consensus GDP growth rate in the 7.5-8% range, b) Macro expected to remain structurally weak – even though if growth does start moderating, it should ease the pressure on interest rates, c) Capex/ government policy reform not seen happening – the current lack of investment activity, is both in the price and the latest economic data, d) Earnings growth holding at the 18-19% level – recently reported 4Q11 was largely in line with more upside than downside surprises, e) Revenue momentum remains very buoyant at 20%+, suggesting demand still robust and cost pressures are in reasonable measure being passed on, f) Valuations are now moderate – at 14x 1-Yr Fwd, multiples at a 10% discount to long-term averages (and an 18% premium to developed markets, while the avg. premium over the last 5 years stands at 23%), the earnings yield gap is moderate relative to history, h) Seasonality: The Indian market has averaged 21% returns over June-December over the last 7 years, with May typically being the poorest month – this could help.

Figure 8. 1YR Fwd PE Premium (Discount) of MS India



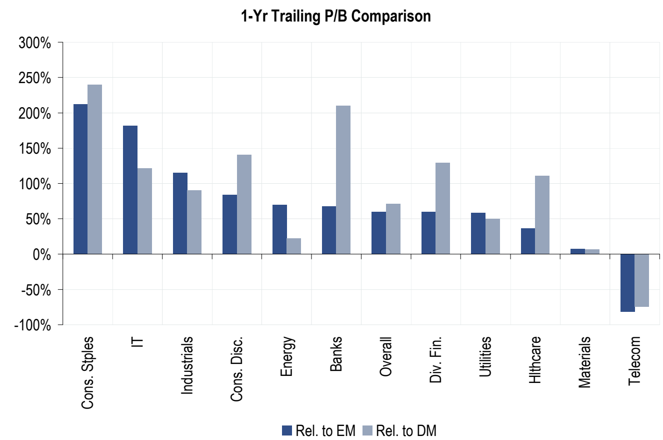
Source: Citi Investment Research and Analysis

Figure 9. Relative P/E Valuation: India Vs. EM/ DM



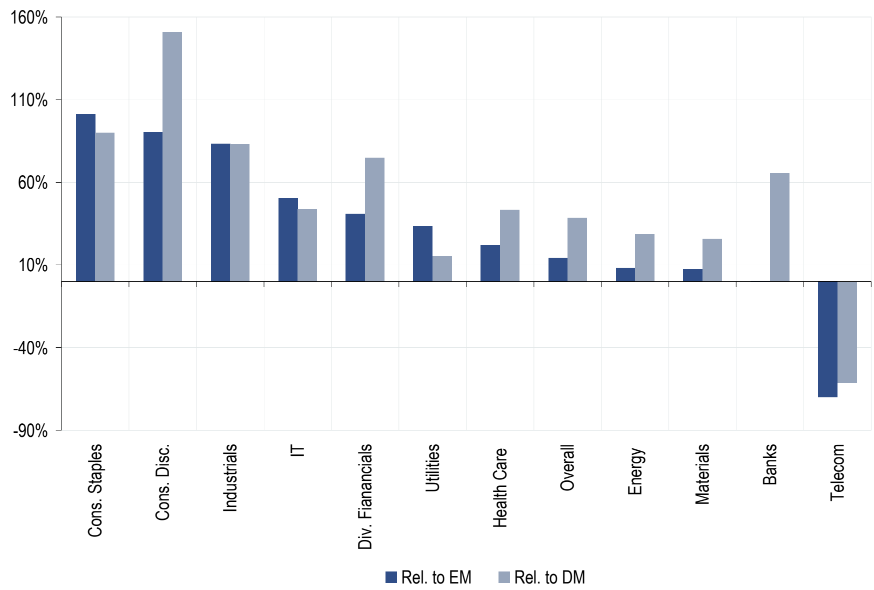
Source: Citi Investment Research and Analysis

Figure 10. Relative P/B Valuation: India Vs. EM/ DM



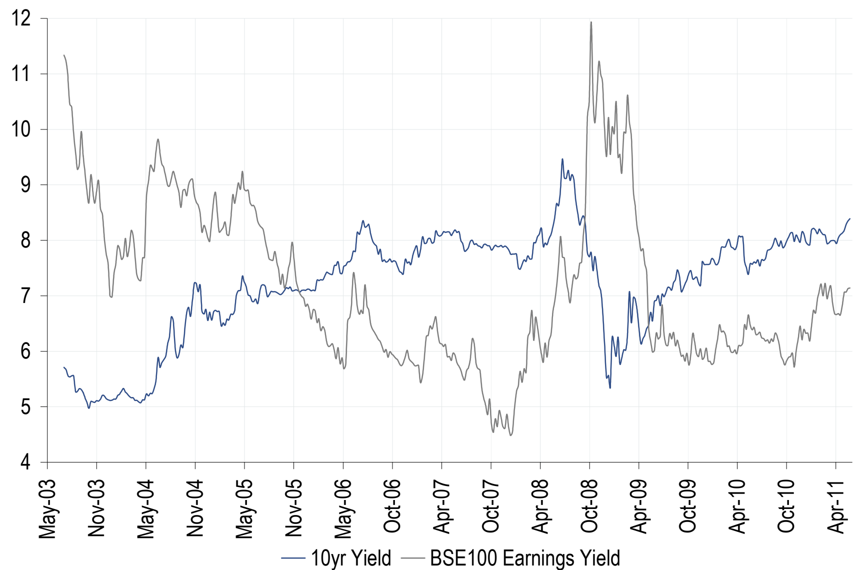
Source: Citi Investment Research and Analysis

Figure 11. Relative ROE: India Vs. EM/ DM



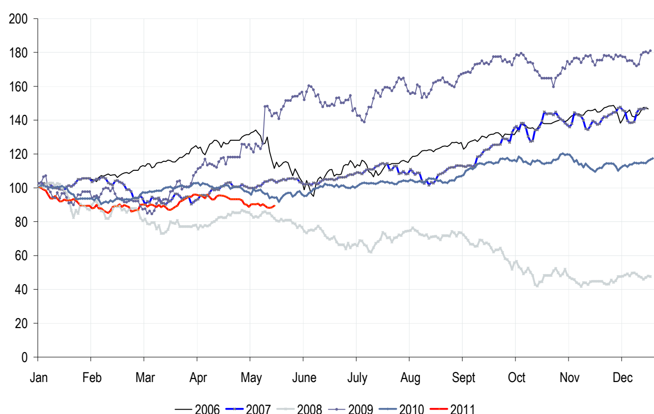
Source: Factset

Figure 12. Earnings Yield Vs. Bond Yield Trend for India



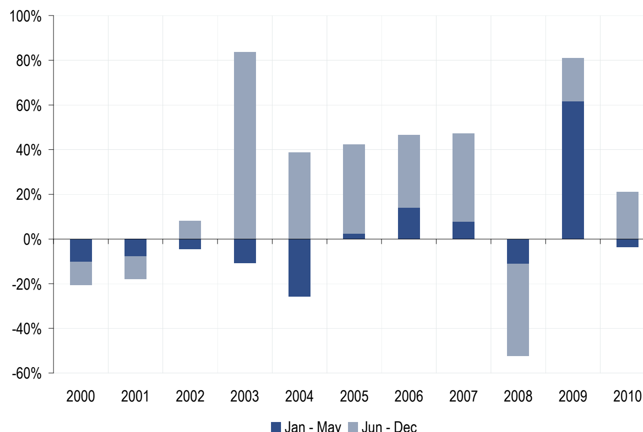
Source: Factset, Bloomberg

Figure 13. Sensex' Evolution Over a Year



Source: Bloomberg

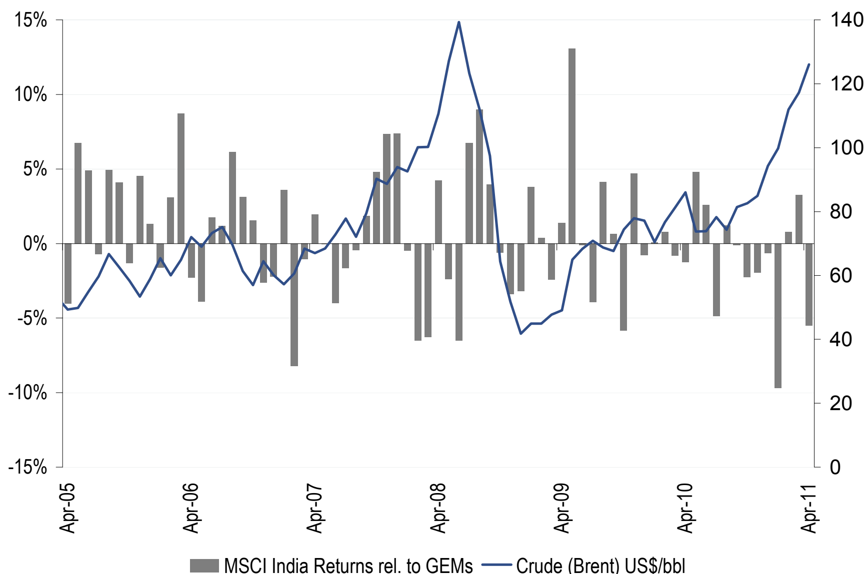
Figure 14. Seasonality in Sensex Returns



Source: Bloomberg

But what could drive this reversal, given the somber sentiment and the unlikelihood of a quick upturn in earnings or overall GDP growth? We believe catalysts lie in a) directional change in the macro (rather than necessarily a sharp one); this includes inflation, government policy/approval decision making, b) an easing in Oil and commodity prices, c) greater comfort on the earnings growth and resilience of the economy – the recent quarterly numbers provide some evidence of that, and d) a widening of, or better recognition of the growth differential vs. developed markets – even after slowing, India will remain about the second fastest growing economy in the world, with a large part of its inflationary pressures likely behind.

Figure 15. India's Performance Rel. to MSCI GEMs & Oil



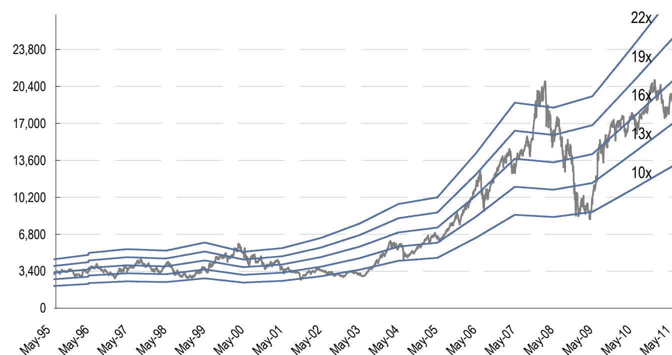
Source: Bloomberg

And what is fair value ……

We believe the Indian market's fair value - in its current stage – is its longer-term average PE multiple, of about 15.5x 1Yr Fwd, or an estimated Sensex target multiple of 21,500 (previously 22,000). Our target multiple is premised on our grind higher hypothesis, with the market largely moving in line with earnings growth, and maintaining its longer-term average. Our slight downward revision on our target multiple is on account of lowering our target multiple from 16.5x to 15.5x – bringing it in line with its long-term average, some erosion in earnings levels (vs. earnings growth expectations) and partly offset by a quarter's roll forward.

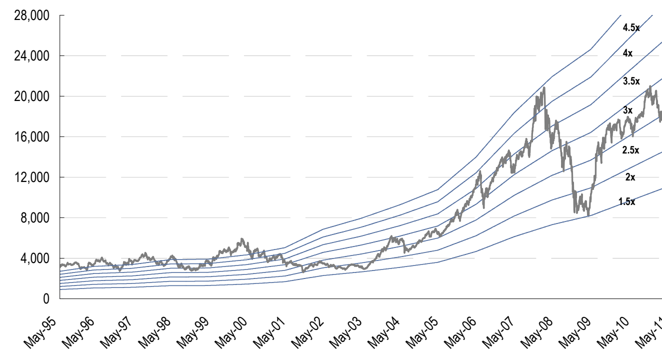
While this is against the backdrop of higher growth risks and a higher interest rate environment than previously anticipated, we do see support from relatively stable earnings momentum, a rising ROE profile and support from rising FCFs. We see directional support from upside risks on macro and government expectations, but believe these if any will tend to be granular, rather than landscape changing.

Figure 16. 1-YR Fwd Rolling P/E Multiple for Sensex



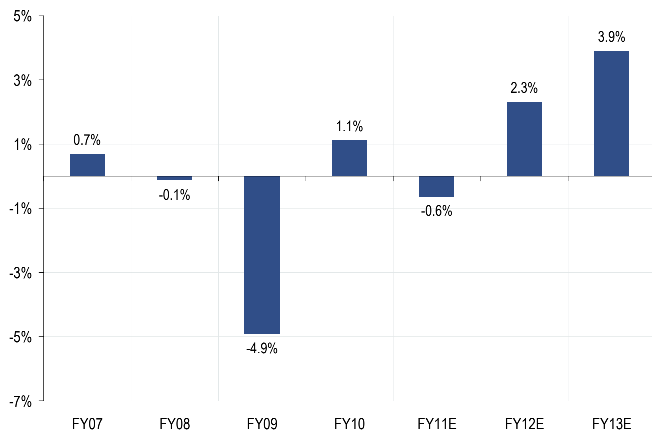
Source: Citi Investment Research and Analysis

Figure 17. 1-YR Fwd Rolling P/B Multiple for Sensex



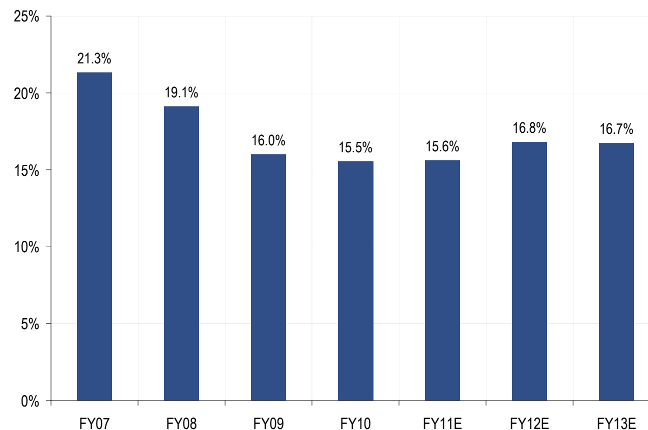
Source: Citi Investment Research and Analysis

Figure 18. . FCF Yield Trend for CIRA Universe



Source: Company data, CIRA Estimates

Figure 19. ROE Trend for CIRA Universe



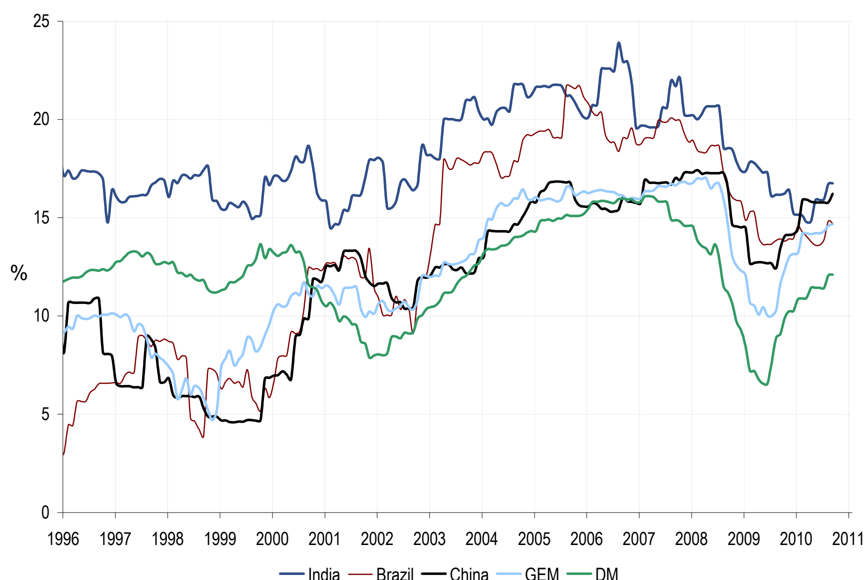
Source: Company data, CIRA Estimates

India's structural challenge is profitability, not growth

Growth is structurally robust …cyclically challenged

We believe the market is offering an opportunity because of the bearishness generated on growth; which we believe is cyclically challenged, but structurally enhanced given how well it has withstood a sharp macro challenge (which arguably will not be a sustained/long-term phenomenon). We believe the market will actually realize this sooner than current sentiment suggests, and this should be a market tailwind.

Figure 20. Trends in ROE for India & Peers



Source: Citi Investment Research and Analysis

ROEs profitability is cyclically on an upswing…but structurally under pressure

We do however believe India's structural problem lies in profitability, and its relatively high ROE structure, which we believe will be under threat and will erode over the medium term. Our view is premised on what we believe is a) excessive competition – both from domestic players as also global ones, which only get exacerbated as the growth differential with developed markets gets entrenched, b) easier access to capital (medium term, rather than in the immediate term) – which will drive capacities and growth, but lower returns structures, c) and return thresholds being relaxed by incumbents and new entrants, as they seek market share and presence and are prepared to trade off profitability. Over the longer term, we believe the cost of capital differential will also moderate as capital chases some of India's relative growth differential, but that is not for now.

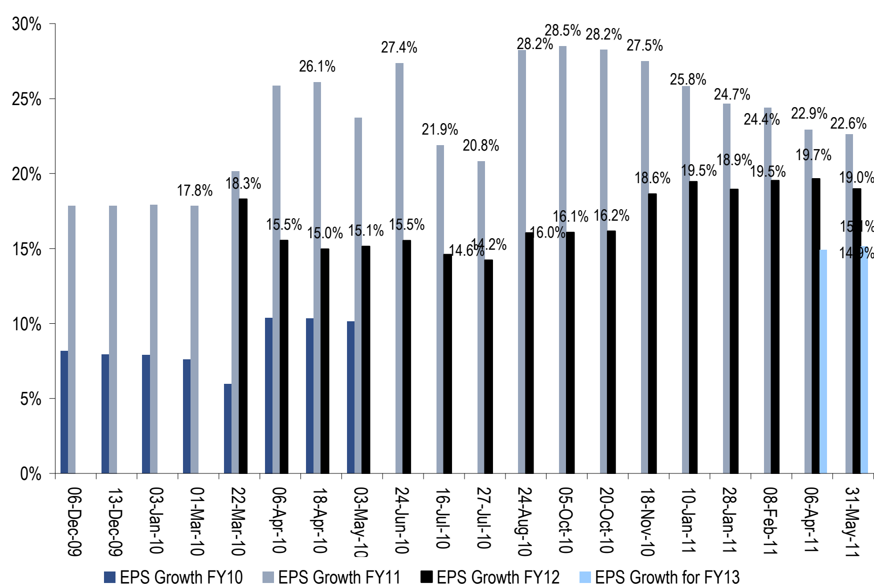
This is already visible in market ROEs – India's recent lows (after an aggressive bout of capital raising) are lower than its previous lows. And we believe going forward, India's ROE's will turn down well short of their previous highs. This is already visible in relative ROEs – with India's premium to peers at a relative low (Figure 19).

Longer term, India will potentially grow faster, but trade lower

We also believe this fundamentally means that India will de-rate over the medium term, or a 2-4 year period, as its historically high (absolute and relative) multiples no longer have the support of relatively high multiples. We do not however believe it will happen in the next 6-18 months – as ROE's are on leverage and cyclical upswing post capital raising and capacities, but they will catch up. We do however see this as a risk; if the market sees through this and does not follow the cyclical margin pop. In addition, if overall growth does remain low, then this might actually support higher ROEs for the market (at the cost of growth), and support valuations, for some time at least.

Sensex EPS Estimates

Figure 21. Evolution of CIRA Sensex EPS Estimates



Source: Citi Investment Research and Analysis

Top Picks

Figure 22. Top Picks

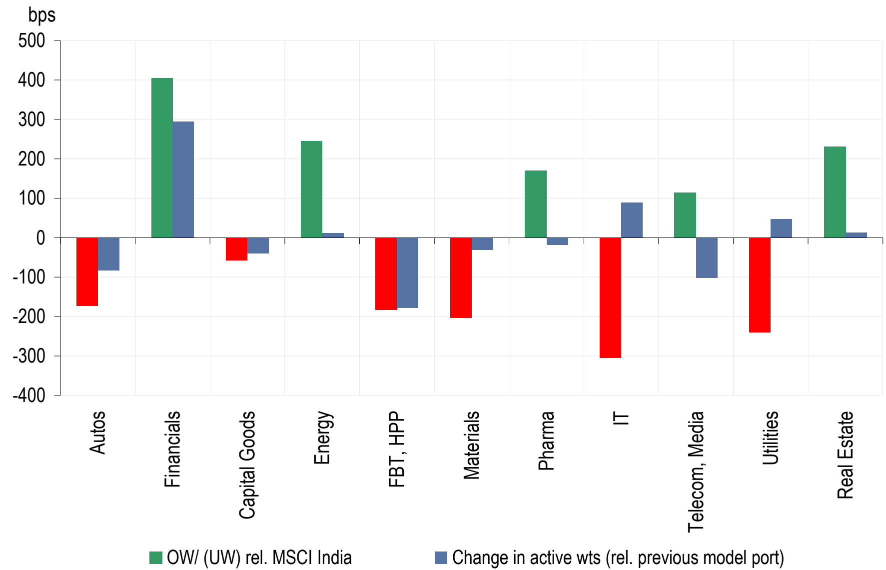
Company	RIC	Rating	Target Price	Current Price	Exp. Return
Axis Bank	AXBK.BO	1L	1,510	1,275	18%
Bharti	BRTI.BO	1L	415	381	9%
Coal India	COAL.BO	1L	471	415	14%
Dish TV	DSTV.BO	1M	84	78	8%
DLF	DLF.BO	1L	295	236	25%
HCL Tech	HCLT.BO	1L	595	514	16%
ICICI	ICBK.BO	2M	1,225	1,085	13%
Lupin	LUPN.BO	1L	500	466	7%
Petronet LNG	PLNG.BO	1L	155	142	9%
Reliance Industries	RELI.BO	1L	1,115	947	18%
SBI	SBI.BO	1L	3,110	2,330	33%

Source: Citi Investment Research and Analysis; Price as of 1 June 2011.

Model Portfolio

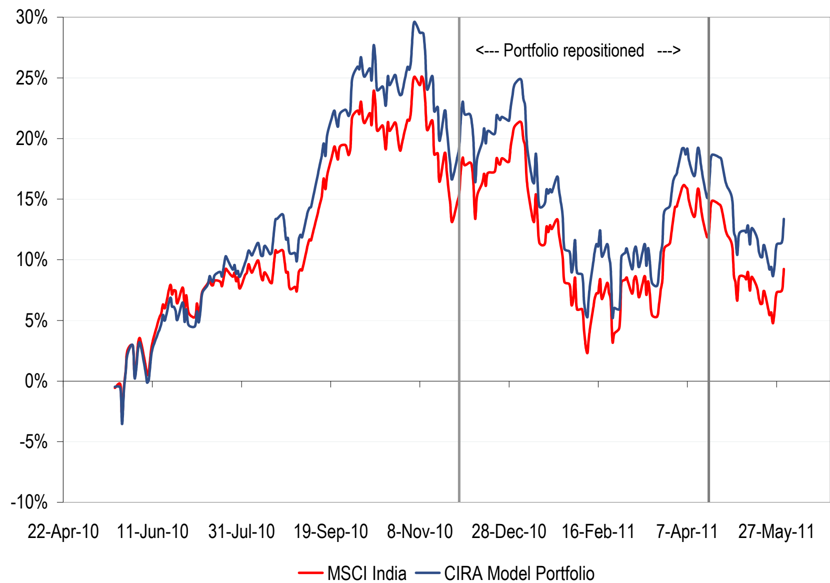
We rejig our model portfolio - raise our OW on Financials, cut Consumers – after a strong show to UW, and further UW Autos. Energy remains a key OW, as do Real Estate, Pharma and Telecom (lower the OW).

Figure 23. CIRA India Model Portfolio OW/ UW Relative to MSCI India



Source: Datastream, MSCI , CIRA

Figure 24. CIRA India Model Portfolio Performance



Source: Bloomberg, CIRA

Figure 25. CIRA India Model Portfolio

	Price 6/1/2011 (Rs)	YTD Perf. (%)	RIC	Analyst's Rating	MSCI Weight (%)	Portfolio Weight	OW/ UW/Rel. MSCI (bps)	FY12 PE (x)	FY12 EPS Growth (%)	FY12 PB (x)	FY12 ROE (%)
Automobiles and Components					6.74	5.0	-174				
M&M	675.7	-13.1%	MAHM.BO	1L		2.5	O/W	15	8.8%	3.1	23.6%
Tata Motors	1079.5	-17.4%	TAMO.BO	1M		2.5	M/W	6	28.5%	2.2	45.8%
Banks & Diversified Financials					25.96	30.0	404				
AXIS Bank	1275.3	-5.5%	AXBK.BO	1L		4.0	O/W	14	16.0%	2.4	19.5%
IDFC	141.0	-22.6%	IDFC.BO	1M		2.0	O/W	13	18.8%	1.6	13.6%
HDFC Bank	2389.3	1.8%	HDBK.BO	2L		4.0	U/W	22	29.9%	3.8	19.1%
ICICI Bank	1085.1	-5.2%	ICBK.BO	2M		9.0	O/W	19	34.0%	2.0	11.5%
State Bank of India	2329.7	-17.1%	SBI.BO	1L		4.0	O/W	10	28.5%	1.7	18.7%
Yes Bank	298.0	-4.7%	YESB.BO	1M		1.0	O/W	11	27.2%	2.2	22.0%
Kotak Mahindra	441.0	-2.5%	KTKM.BO	1M		1.0	O/W	17	20.8%	2.6	16.0%
Capital Goods					7.08	6.5	-58				
Larsen & Toubro	1682.4	-15.0%	LART.BO	2L		2.0	U/W	25	14.4%	4.1	18.0%
BHEL	1951.6	-16.1%	BHEL.BO	2L		2.0	O/W	14	22.0%	3.8	30.4%
Mundra Ports	163.9	14.1%	MPSE.BO	1L		1.5	O/W	23	61.6%	6.3	30.0%
Adani Enterprises	163.9	14.1%	MPSE.BO	1L		1.0	U/W	23	61.6%	6.3	30.0%
Energy					14.55	17.0	245				
Coal India	414.7	31.9%	COAL.BO	1L		4.0	O/W	17	38.7%	5.8	37.9%
Petronet LNG	142.4	13.9%	PLNG.BO	1L		2.0	O/W	14	22.7%	3.3	25.7%
Reliance Industries	946.8	-10.5%	RELI.BO	1L		11.0	O/W	13	21.9%	1.8	15.2%
Food Beverage and Tobacco, Household & Personal Products					5.83	4.0	-183				
United Spirits	193.9	11.1%	ITC.BO	1L		2.0	O/W	25	19.3%	8.0	34.4%
ITC	193.9	11.1%	ITC.BO	1L		2.0	U/W	25	19.3%	8.0	34.4%
Materials					11.04	9.0	-204				
Hindalco	197.3	-19.8%	HALC.BO	1M		3.0	O/W	9	12.1%	1.4	15.5%
Sterlite	173.4	-7.1%	STRL.BO	1M		2.0	O/W	8	49.9%	1.2	16.8%
Tata Steel	582.2	-14.2%	TISC.BO	1M		2.0	O/W	9	4.4%	1.5	17.9%
Grasim	2327.8	-0.6%	GRAS.BO	1L		2.0	O/W	10	2.0%	1.3	14.1%
Pharmaceuticals, Biotechnology, Agrochem					4.30	6.0	170				
United Phosphorus	162.1	-6.4%	UNPO.BO	1H		1.0	O/W	10	22.1%	1.7	18.8%
Ranbaxy	538.9	-10.0%	RANB.BO	1M		2.0	O/W	24	232.1%	2.2	46.3%
Aurobindo Pharma	176.5	-33.0%	ARBN.BO	1M		1.0	O/W	8	33.3%	1.5	24.2%
Lupin	465.9	-3.0%	LUPN.BO	1L		2.0	O/W	19	27.1%	5.0	29.4%
Software & Services					17.06	14.0	-306				
Infosys Technologies	2812.0	-18.4%	INFY.BO	2L		7.0	U/W	20	17.4%	4.8	26.4%
Tata Consultancy Services	1175.3	0.9%	TCS.BO	2L		1.0	U/W	22	18.4%	6.9	35.2%
Wipro	448.1	-8.6%	WIPR.BO	1L		4.0	O/W	19	11.3%	3.8	22.4%
HCL Technologies	514.3	12.8%	HCLT.BO	1L		2.0	O/W	18	35.2%	3.8	23.6%
Telecom Services/Media					0.86	2.0	114				
Bharti Airtel	381.5	6.4%	BRTI.BO	1L		3.0	O/W	17	26.9%	2.7	16.6%
Utilities					5.90	3.5	-240				
Tata Power	1246.3	-8.7%	TTPW.BO	1L		2.0	O/W	38	3.7%	2.7	7.6%
Power Grid Corp	100.7	2.5%	PGRD.BO	1L		1.5	O/W	17	8.6%	2.0	12.2%
Real Estate					0.69	3.0	231				
DLF	236.4	-19.0%	DLF.BO	1L		3.0	O/W	20	15.1%	1.4	7.4%
Others*					0.00	-	0				
Cash						-					
Total					100.0	100.0					

Source: Citi Investment Research and Analysis

Appendix A-1

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