Prabhudas Lilladher

INDIA
Strategy Report

Market Outlook 2008

Seventh positive year in a row?

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Contents

Summary

- The key drivers in 2008 for the market are likely to be growth in order books, interest rates, US slowdown effects, foreign & local liquidity and finally corporate earnings growth vis-à-vis consensus
- We expect accelerated infrastructure-related order flows as the government gets into election mode over the next 18-months, flattish interest rates, decent liquidity in the markets and strong earnings growth in 2008
- Risks of a deeper than expected US slowdown, poor monsoons (we've had four good ones in a row) and politics remain real and material
- On the whole, the environment for equities remain modestly positive. We estimate the Sensex to remain in the 19-23k band through the year ending at about 23-24k (20x FY10)
- Our best sectors for 2008 are banking, financial services, capital goods, engineering, media and oil & gas. Auto remains contrarian idea. Some interesting themes could also be Natural Resources and Renewable Energy

Top Picks

- Reliance Industries
- Larsen & Toubro
- ICICI Bank
- Reliance Communications
- Voltas
- Bank of Baroda
- HDFC / IDFC
- Jet Airways
- Akruti City
- Suzlon Energy

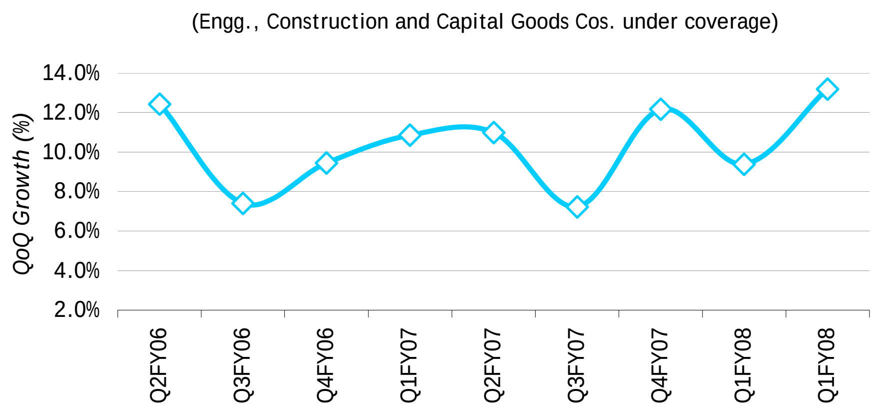
Midcap Ideas

- Rajesh Exports
- XL Telecom & Energy
- Country Club
- Bhagwati Banquets & Hotels
- Hindustan Dorr Oliver
- Sujana Towers

Order book growth by way of capital / infra spending

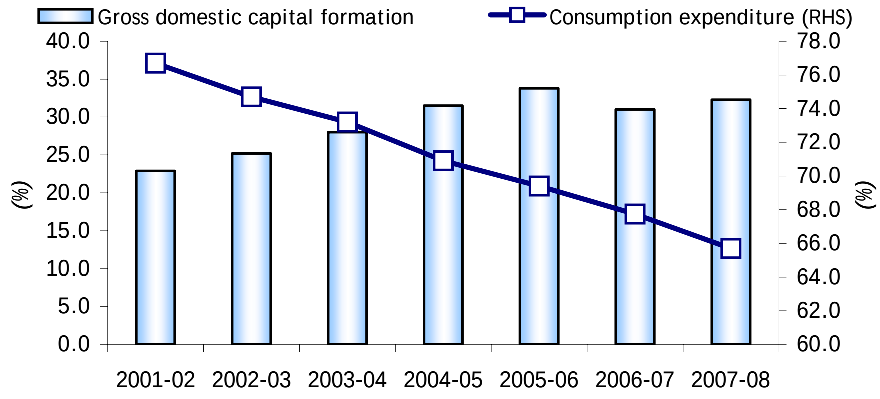
- Order book growth of companies under our coverage have held out well for the last 8-10 quarters
- Sustenance of this growth will be crucial as proof of continuing capital and infrastructure spending in India
- Based on our interaction with companies and reading of macro-economic data, we believe this number can grow between 40 to 50% YoY in 2008

Order book growth



Source: PL Research

Capital and consumption expenditure



Source: CMIE, PL Research

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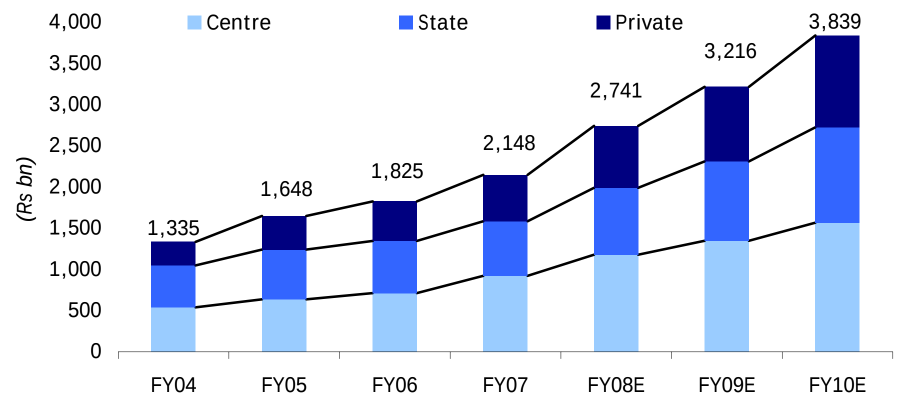
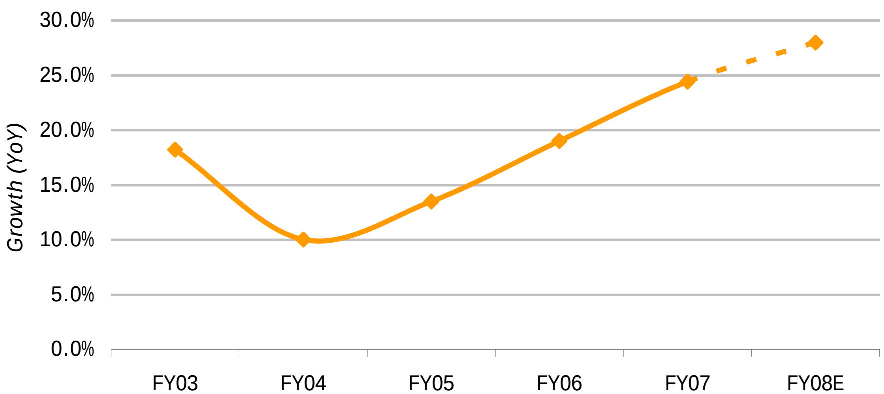
- Expect acceleration of infrastructure orders as the government readies itself for elections in 12-18 months time
- Annual capex by Nifty companies has grown at a CAGR of 19% in the last 3 years. Given the continuing expansion, we expect this growth to be 27-28% in FY08E

Infrastructure spend



Source: Planning Commission

Gross fixed assets of Nifty companies



Source: PL Research

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Interest rates and credit growth

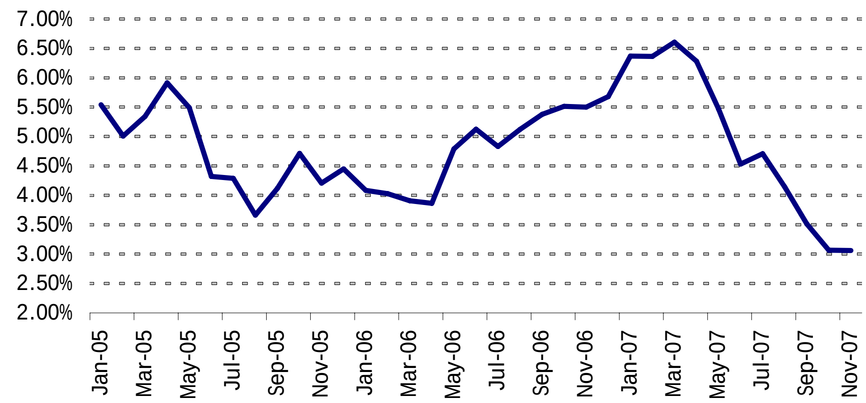
- Markets in 2007 were lent a helping hand by benign interest rates. However, the same is only holding steady and not falling much further

- We believe, given the lurking inflation fears (oil prices must sooner or later be passed on), the Reserve Bank is unlikely to loosen its monetary stance and hence interest rates are likely to remain at current levels

5-year Indian G-Sec. yields

Source: Bloomberg

Indian WPI inflation



Source: RBI

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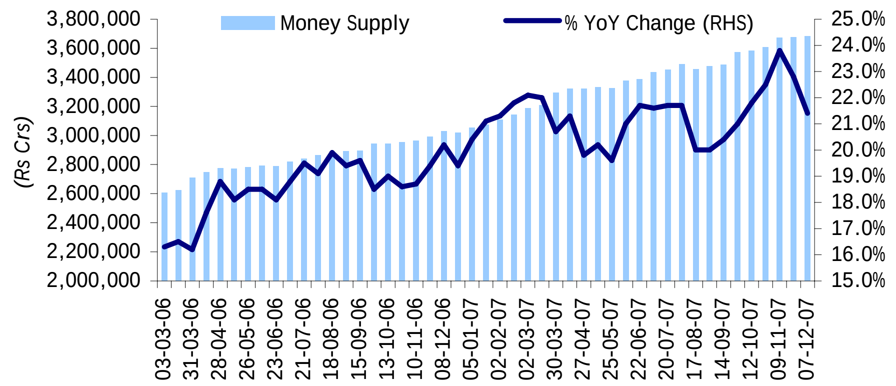
- Further, given the modest credit growth and global economic uncertainty, the Governor is not likely to risk a tightening either

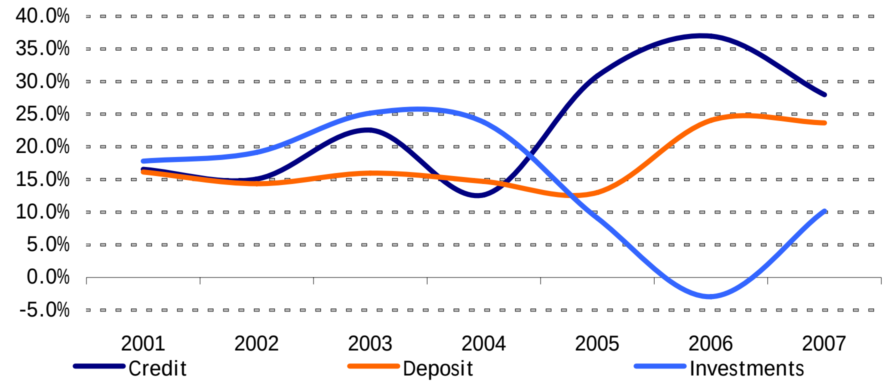
- Credit growth has dropped to about 23% YoY in Dec ‘08 (from a peak of 37% in March ’06) driven largely by slower retail credit growth. We expect this to improve, partly due to retail and partly due to capital and infrastructure spending by private sector

Money supply (M3)



Source: RBI

Banking statistics



Source: RBI

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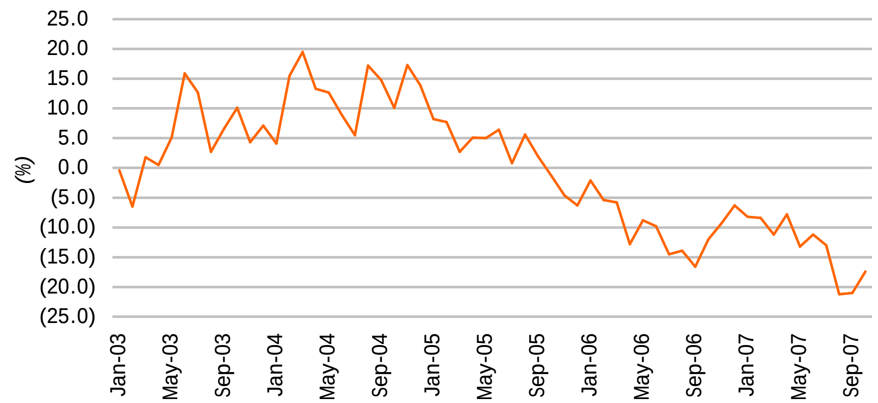
US and G7 economic growth

- US accounts for 25% of India's merchant exports, 65% of IT/BPO exports and certainly over half of our FII inflows

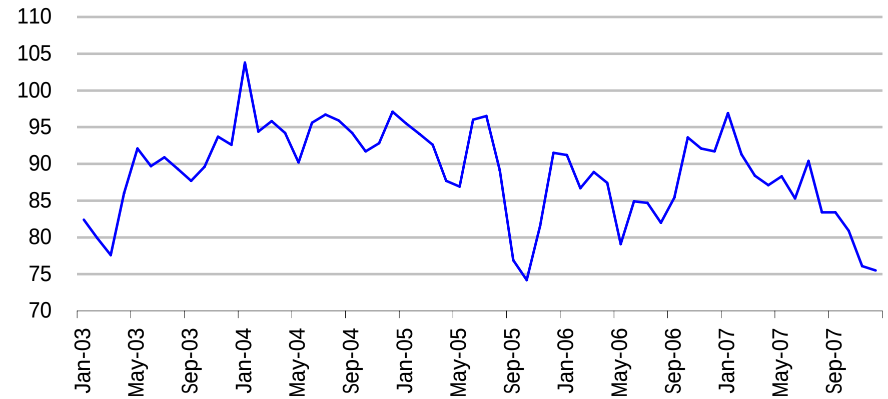
- US appears to be heading for a slowdown over the next few quarters due to its housing woes, credit problems and consumer confidence

US pending home sales



Source: Bloomberg

US consumer confidence index



Source: Bloomberg

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- Initial signs of trouble have also appeared in other G7 countries like UK, Japan, etc.

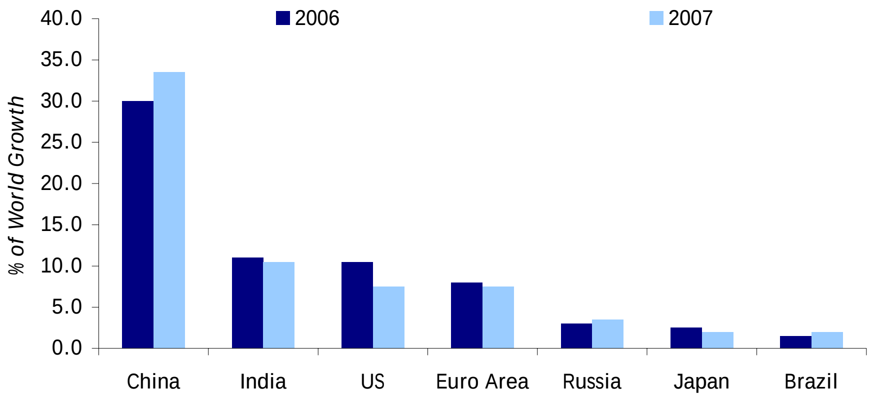
- We expect a recessionary US to impact, however, a mere slow down may not. This is essentially due to much reduced contribution of US and other G7 countries to global growth

World GDP outlook

	Actual		Projection	
	2005	2006	2007	2008
World output	4.8	5.4	5.2	4.8
USA	3.1	2.9	1.9	1.9
Euro Area	1.5	2.8	2.5	2.1
Germany	0.8	2.9	2.4	2.0
Japan	1.9	2.2	2.0	1.7
Africa	5.6	5.6	5.7	6.5
China	10.4	11.1	11.5	10.0
India	9.0	9.7	8.9	8.4

Source: IMF

Contribution to global economic growth (based on PPP)



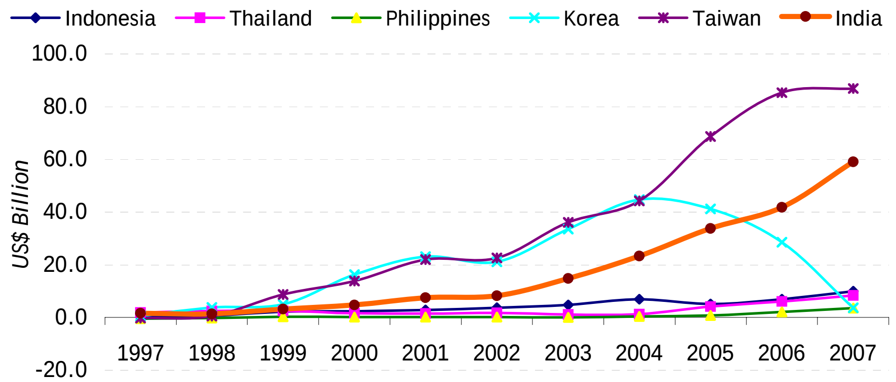
Source: IMF

Global and local liquidity in equities

- FIIs and local institutions poured in US$17bn and Rs68bn into Indian equities in 2007. Compared to US$ 8bn and Rs153bn by FIIs and locals respectively in 2006.

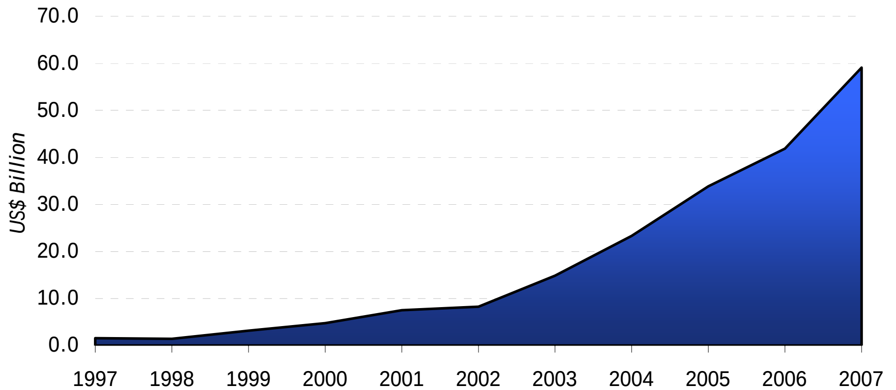
- While the flow was distinctly slow from October onwards, overall the strong inflow has been a key driver of market returns (56% Nifty) in 2007

Cumulative FII flows into Asia



Source: Various exchanges

Cumulative FII flow into India



Source: SEBI

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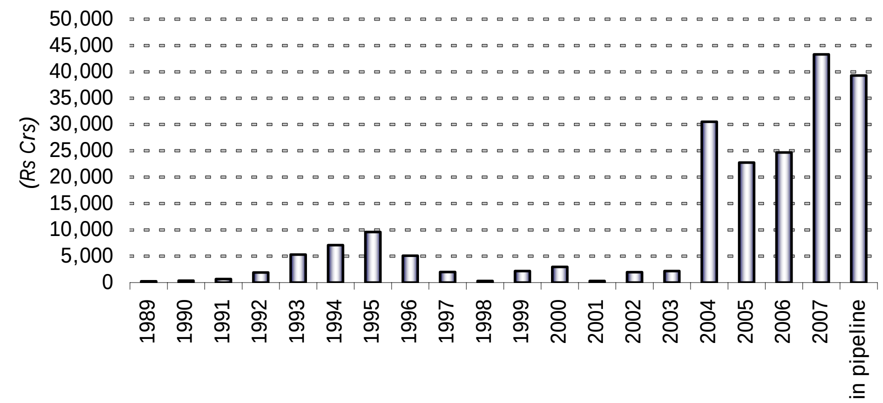
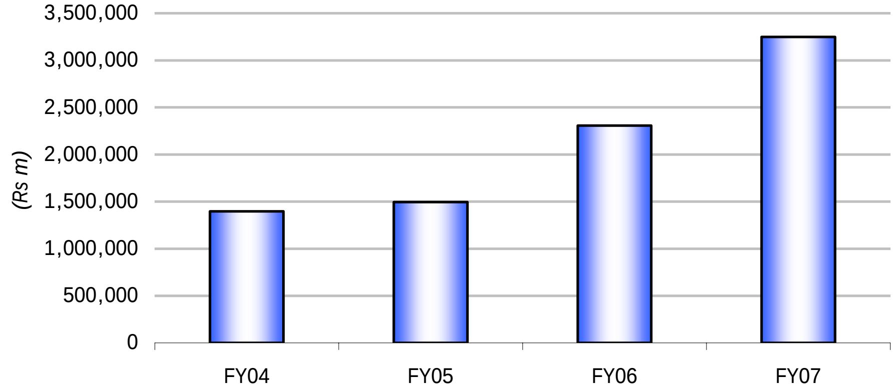
- Key drivers of foreign liquidity will be stronger rupee, continuing corporate performance and capital raising by way of IPOs, QIPs, etc.
- Key drivers of local liquidity will be rising insurance AUMs and increasing retail participation via local mutual funds

Initial public offerings



Source: Prime database

Indian mutual fund AUMs



Source: AMFI

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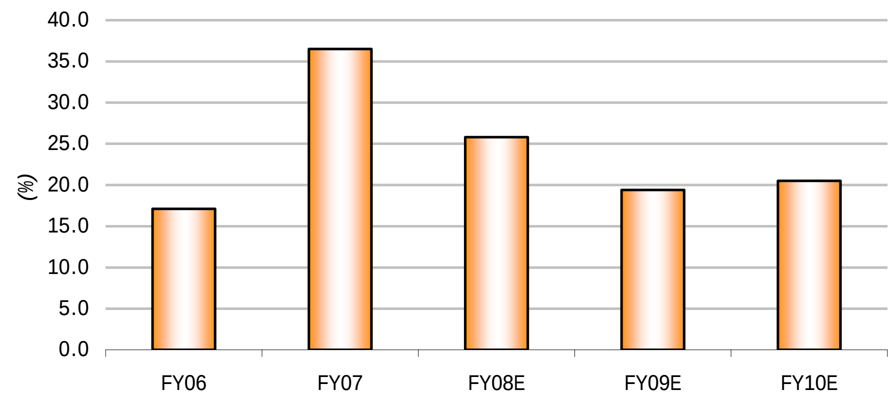
Corporate earnings growth versus consensus

- Consensus expects FY09 Nifty earnings to grow by 19% YoY. PL universe (our coverage) is expected to grow by about 20% in FY09

- Consensus numbers have been upgraded by about 10-12% every year for the past 2-3 years

- Achievement and upgrading of numbers will hinge on sectors such as oil & gas, IT, metals and banks

Nifty earnings growth



Source: PL Research

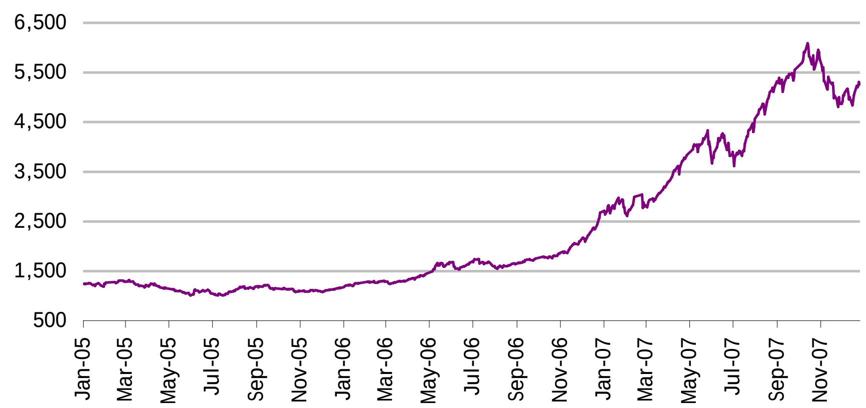
Potential Black Swans – The Known Unknowns

- **Monsoon:** India has had good monsoons from 2003 onwards. We think poor rains could jack-up already high food inflation and pose a challenge to monetary policy management

- **Politics:** While there is no apparent threat to the government, politics in India is notoriously unpredictable

- **China:** While the contribution of US to global growth has reduced, China is now responsible for nearly a third of global growth. With inflation running at 10-year highs, stock markets in bubble territory and a possible US slowdown, economic turbulence in China and its consequent impact on regional economies remains a worry

Shanghai Composite Index



Source: Bloomberg

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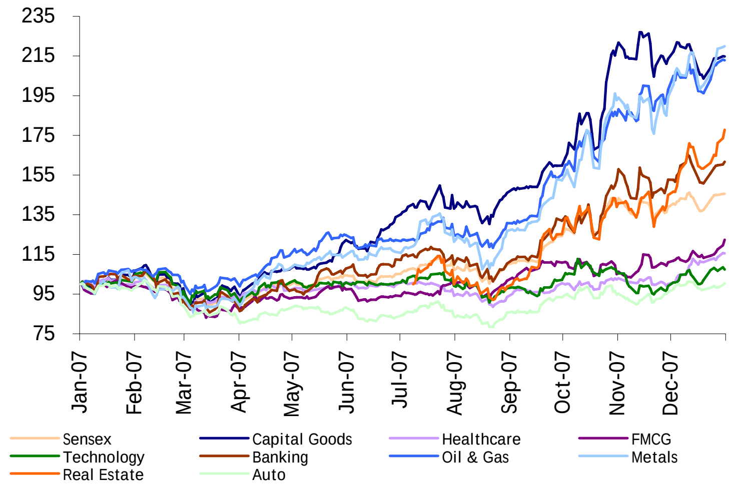
The eternal question of valuations

- Nifty is quoting at 19.7x FY09 earnings currently. At 1.7x m.cap GDP India is in the top quartile globally and the highest amongst all emerging markets
- Key to sustaining this valuation will be continuing corporate performance, strong order flow, benign interest rates and good domestic / foreign liquidity
- We believe most of these factors are likely to be positive in 2008 and hence expect valuations to sustain at about 20x 1-year forward

Sensex sector-wise returns in 2007



Source: BSE

Sector	FY08E		FY09E		FY10E	
	Earnings Growth %	PER (x)	Earnings Growth %	PER (x)	Earnings Growth %	PER (x)
Auto	3.4	16.6	14.8	14.5	7.6	13.4
FMCG	11.0	25.9	16.7	22.2	18.0	18.8
Tech	21.6	21.0	21.3	17.3	11.0	15.6
Metals	33.6	12.0	2.8	11.7	9.8	10.6
Pharma	3.9	27.2	15.7	23.5	15.9	20.3
Telecom	66.3	32.9	29.1	25.5	26.4	20.2
Oil&Gas	20.8	23.6	24.7	18.9	26.5	14.9
Cement	33.0	13.8	6.4	13.0	-7.0	13.9
Power & Engineering	26.5	36.8	20.6	30.5	26.2	24.2
Media	36.6	39.0	33.0	29.3	26.8	23.1
Banking	25.3	24.9	23.4	20.1	21.9	16.5
Nifty	25.8	23.5	19.4	19.7	20.5	16.4

Source: PL Research

Interesting themes to play

- **Natural resources:** Expect scramble for natural resources all across the spectrum. Iron ore, non-ferrous ores, coal, oil, gas etc. Companies to play include Sesa Goa, Adhunik Metal, Raipur Alloys, GMDC, etc.

- **Financial services:** Several IPOs, QIPs, NFOs, etc are lined up for 2008. With growing branch network that can rival banks, leading financial services players will take market share in retail /mortgage market. Companies to play include Motilal Oswal, Edelweiss, India Infoline, etc.

- **Renewable energy:** Europe and other western countries are likely to greatly enhance focus on renewable energy. Players like Suzlon, Moser Baer, Xl Telecom, etc. likely to benefit.

- **Agriculture:** The government is likely to be in election mode in the next 18-months and the agriculture (esp. fertilisers, given likely improvement in gas availability) sector could be a beneficiary of the same.

So, Finally What?

- Despite some looming global risks on the horizon, our probabilistic scenario for India is one marked by slowing economic growth by about 0.5-1.0% (to 8.0-8.5%), flattish interest rates, pumped up government spending and decent local & foreign liquidity.
- Earnings growth is likely to remain strong, but with lower RoEs due to reducing leverage and significant capacity expansion (using substantial equity funding).
- Recent political developments may be positive for the market, with the government accelerating infrastructure order flow to gear up for 2009 elections.
- Sectors to play will be banking & fin. services, engineering, oil & gas, media and capital goods & power equipments.
- Interesting themes to play would be natural resources, renewable energy and agriculture (esp. fertiliser).
- On others, we believe the environment remains modestly positive for equities in 2008. We estimate the Sensex to remain in the 19-23k band through the year ending at about 23-24k (20x FY10).

Sectoral Outlook

Sector	Key drivers	2008 outlook	Sector rating	Top picks
Auto & ancl.	Interest rate stability, GDP growth	Expect CV sales & 2 wheelers sales momentum to return with growth rates of ~8-10% in FY09. Car sales growth expected to slowdown YoY due to high base year. Competition expected to intensify with a number of launches slated for FY09	Over-Weight	Maruti, Ahmednagar Forgings, Amtek India
Aviation	Robust tourism flows, rational pricing, increasing air freight demand	Consolidation would ensure improving yields. Airlines expected to return to profitability in FY09. Rising oil prices may prove to be a concern	Over-Weight	Jet Airways, SpiceJet
Banking	Interest rates, credit growth, value unlocking in key investments/subsidiaries	Expect interest rates to have peaked out. Capital raising plans, value unlocking in key investments/ subsidiaries coupled with potential consolidation of the banking sector post March '09 hold significant positives for the banking sector going into 2008. Credit growth also expected to pick up	Over-Weight	ICICI Bank, BoB, Kotak Bank
Capital goods & power equipments	Order book growth, government spending & industrial capex	Expect order book to maintain 30% + growth. Capacity expansion by companies to help speed up execution	Over-Weight	BHEL, KEC International, Voltas, AIA Engineering, Thermax

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Sector	Key drivers	2008 outlook	Sector rating	Top picks
Cements	Cement prices, variation in the prices of imported coal and oil	Prices to remain stable across regions, except southern region, where supply deficit is likely to sustain for another couple of years. Imported coal/pet coke prices are expected to rise by 5-10% from current levels	Under-Weight	India cement, Madras cement
Construction & engineering	Order flows and new forays	Order flows, which had slowed down recently for construction, are likely to accelerate. Success of new forays such as ports, shipbuilding, etc. will be key driver	Over-Weight	IVRCL, L&T, Gammon, HCC, Punj Lloyd
Financial services	Volumes, new forays	Expect significant scale-up in IPOs, NFOs, QIPs, etc. Players will also make new forays and scale in existing businesses	Over-Weight	IDFC, HDFC, India Infoline (rating under review)
FMCG	Budget, monsoon, new business forays	Expect 7% to 8% effective duty hike on cigarettes. Sector to grow at about 15%. Success of new forays will be trigger	Under-Weight	ITC, Colgate, Marico
Media	Capital issues, new business forays	Expect capital raising / value unlocking in several media companies. Success / execution of new forays and launches will determine stock performance	Over-Weight	UTV, PVR, Deccan Chronicle, TV18, GBN (report under prep.)

Contd...

Sector	Key drivers	2008 outlook	Sector rating	Top picks
Metals	Steel: Finished product prices, policy changes in china, variation in prices of key inputs - coking coal and iron ore	Steel: Steel prices are expected to rise by 10-15%, while iron ore prices would rise in the range of 30-35%. Coking coal prices are likely to spurt in the range of 25-30%. Seeing this scenario, integrated players would be benefited most	Equal-Weight	Tata steel, JSW steel, SAIL
Oil & gas	Robust refining margin, stable petrochemical margin, increasing gas availability and volumes	Expect re-rating of refining and marketing sector on stable to robust outlook and with range bound movement of crude prices. Slew of IPOs in refining will act as additional triggers	Over-Weight	BPCL, RIL, ONGC
Pharma	Re/US$ rate, pricing pressure in US generic mkt, US slowdown, probable enhancement of DPCO	Earning growth expected between 15-20%, expect good growth for CRAMS players due to increase in outsourcing, domestic market growing at 12-13% and is likely to grow at this rate over next 2-3 years. US generic market will continue to witness pricing pressures, European market is likely to have lower growth due to reduction in govt. spending on healthcare	Under-Weight	Ankur drugs, Dishman Pharma, Sun Pharma, Pfizer

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Sector	Key drivers	2008 outlook	Sector rating	Top picks
Real estate	Demand supply mismatch across all segments, fund flow through REITs, repeal of ULCRA	Continuing economic growth and strong hiring trends across sectors (incl. IT) will result in continuing demand for residential and commercial space. REITs and FII inflow will provide further fillip	Over-Weight	Akruti City, Anant Raj, HDIL
Shipbuilding	Order book growth, progress of expansion plans, subsidy payout	Order book expected to maintain 50%+ growth. Execution to happen largely on schedule, with some modifications. Subsidy payout started in 2007 is small, could be material in 2008	Over-Weight	Bharati Shipyard
Technology	Re/US$ Rate, US tech spending	Expect 4-5% appreciation of Re vs. US$. Tech spending growth likely to be modest. Earnings growth in FY09 expected at about 22%	Equal-Weight	Rolta, Satyam, HCL Technologies
Telecom	Rural penetration, sub US$20 handsets with aggressive penetration pricing, unlocking value through tower companies spin-off	Expect subscriber net addition to maintain a monthly run rate in excess of 8m, infrastructure sharing shall reduce overall opex & capex, regulatory hurdles to pave way for 2-3 new operators, mobile number portability to be implemented	Over-Weight	Reliance Communications

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PL's Recommendation Nomenclature

BUY	:	> 15% Outperformance to Sensex	**Out Performer** (OP)	:	5 to 15% Outperformance to Sensex
Market Performer (MP)	:	-5 to 5% of Sensex Movement	**Under Performer** (UP)	:	-5 to -15% of Underperformance to Sensex
Sell	:	<-15% Underperformance to Sensex			
Not Rated (NR)			**Under Review** (UR)		

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