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INDIA STRATEGY

2012 - Emerging out of a maze

Sandeep Shenoy
+91 22 4031 3436
sandeep.shenoy@antiquelimited.com

Sunesh Khanna
+91 22 4031 3437
sunesh.khanna@antiquelimited.com

ANTIQUE

Outlook for 2012: Emerging out of a maze

Foreword

The year CY11 commenced on an uncertain note as dark clouds on our economy re-emerged from international quarters, and domestic factors like inflation, political and policy making slowly turned adverse. Even then, the consensus was that FY11 growth would be maintained and FY12 growth, while a bit muted would still be encouraging. Broader market indices were expected to maintain their sluggish/sideways trend and end the year on an encouraging note.

Come December, Murphy's law seems to be reigning supreme in India. On the macro front, inflation is yet to be tamed (though early signs of respite emerging now) despite our central bank using most of the tools in its arsenal. The unenviable tightrope walk of RBI has resulted in the high interest rates (inflicting pain on India Inc.) with an imminent danger of demand slowdown. In conjunction, elevated crude prices and weakening rupee could emerge as a major derailing factor for all budgetary/financial parameters. The waters have been further muddled by the paralysis on the policy making front resulting in big ticket capex being derailed. Consequently all growth/economic monitoring parameters are exuding negativity.

In this back drop, our markets have undergone a consistent derating along with multiple earnings downgrades. Retardation of earnings growth has been visible and uncertainty is widespread with most observers taking it as given, that the ongoing global slowdown will have an adverse rub off on us. That brings some pertinent questions to the fore: Are we entering a secular bear market, or is it just a corrective phase?; Is the deterioration of performance of India Inc. divergent (less/more) from what is being perceived?; The frames of reference have moved fundamentally, but is it being adequately captured by the markets?

Indications are that our GDP growth will be lower than estimates at the beginning of the year, and mid year review conveys the same. However, the broad consensus is veering towards 7.1-7.2% level and that seems to be achievable. This despite the blip in manufacturing as services and agriculture seem to be on a stable growth path. While demand growth is slowing down, the fears of demand destruction seem to be farfetched at the current juncture. However, sentiments convey that the same is being considered a distinct possibility.

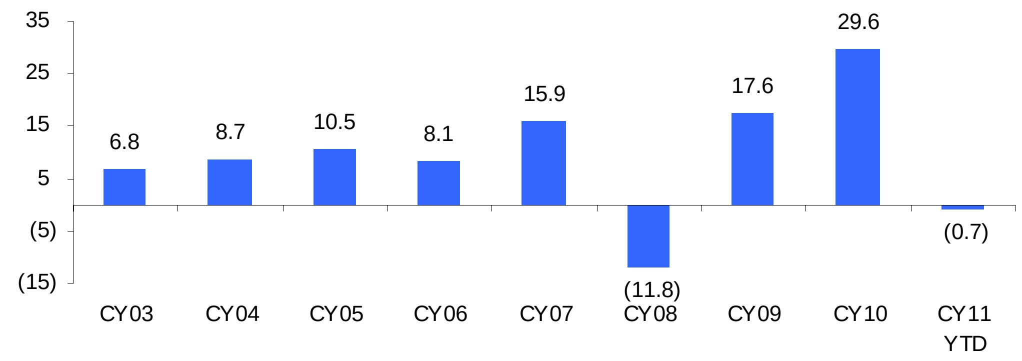
On the corporate front, data flows indicate that large players sensed the rough road ahead and tightened operations on all fronts i.e raw material/manufacturing costing, leverage, financial costs etc. While inflation may have become structural along with high interest rates, India Inc. seems to have aligned its operational metrics to these changed frames of reference much faster that the capital market observers and participants. Hence, most of the numbers flow is usually met with disbelief and skeptics abound on the sustainability of the same.

We at Antique believe that while factors for being a pessimist abound, the stock markets seem to have factored the same to a large extent, much earlier. The consistent downgrade in consensus earnings estimates for FY12e and FY13e was preempted by the flight of smart money (as usual). While the markets have exhibited a slide on a P/E basis, we believe that a large part of the same was on account of P/B derating as India inc. was perceived to have softening RoE and risk free returns (G-Sec, Interest rates) were on a rising trend. As both these anticipated trends fructified and are close to their turning points, a slow reversal of these two key measurable is expected. Thus, we anticipate the markets to exit the calendar year with better P/B ratio and the rub off on P/E could come later, may be nurtured by slow and grudging earning upgrades by the street in 2HFY13e. However, a long term overhang factor could be the derailed/deferred capex which could pose a risk to the FY13e and FY14e earnings growth and can prove to be the proverbial spoilsport.

Thus, we are of the opinion that the markets would find its sweet spot at around the P/E level of 14.5-15 and P/B level of 2.6-2.8 for our FY13e earnings and hence our Sensex target for End CY12e is 18600-19200. However, the route to those levels would be quite tortuous. While there exists a good chance that the valuation and earnings metrics could get revised upwards, indication of the same would be received post 2QFY13e numbers.

The year that was: a roundup

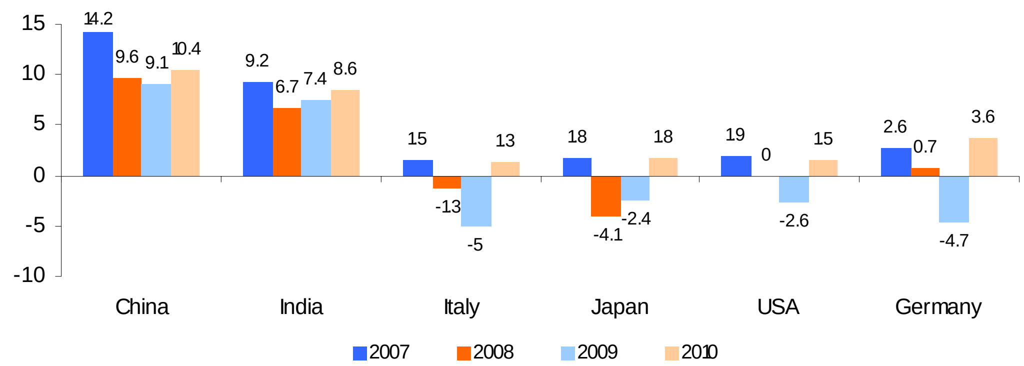
FII flows were impacted drastically (USDbn)



Source: SEBI

Despite confidence at the beginning of CY11, FII's shunned our markets and we witnessed outflows. However, the figure at USD0.7bn is lower than CY08, which was another challenging year globally. Thus our markets can be said have exhibited some resilience.

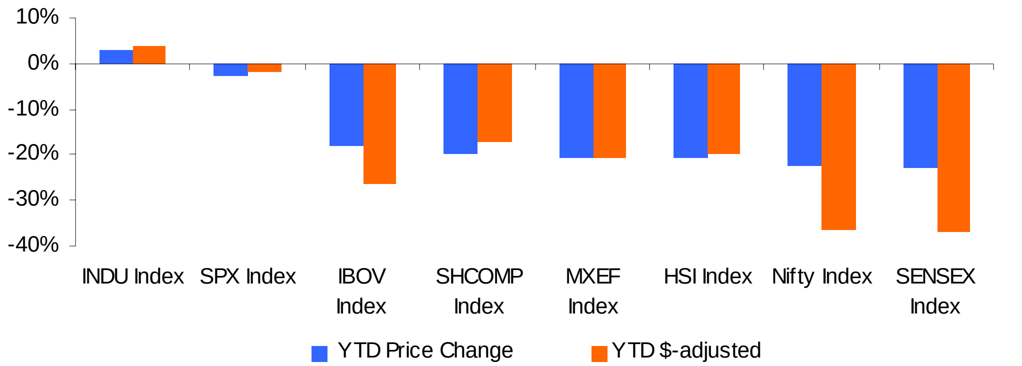
India GDP growth *vs.* its peers (%)



Source: Bloomberg

Indian economy apparently emerged out of the of CY08-09 morass swiftly, due to buoyant internal demand. However, the growth has exhibited slowdown in FY12 as multiple factors, largely internal impacted us. Despite this, India is better off than peer countries.

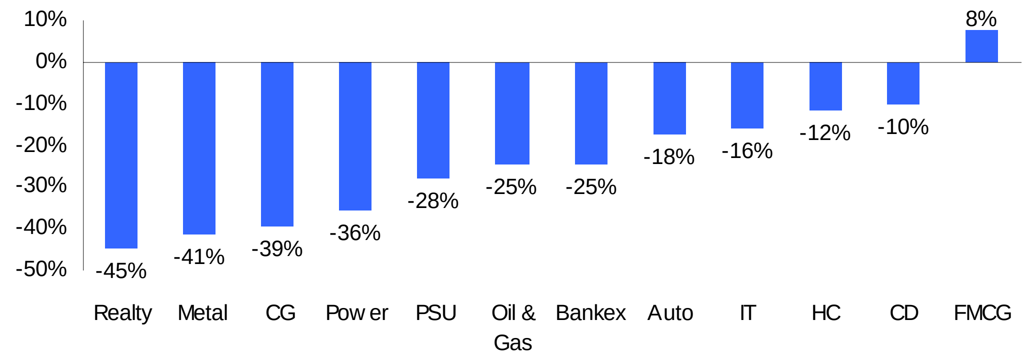
India - One of the worst performing markets in CY11 (YTD)



Source: Bloomberg

Indian indices were the laggards for CY11 on an absolute basis compared to peers and developed markets. On a dollar indexed basis, the performance was even worse as our currency depreciated sharply towards the end of the year.

Most sectors, save for FMCG performed badly in CY11 (YTD)

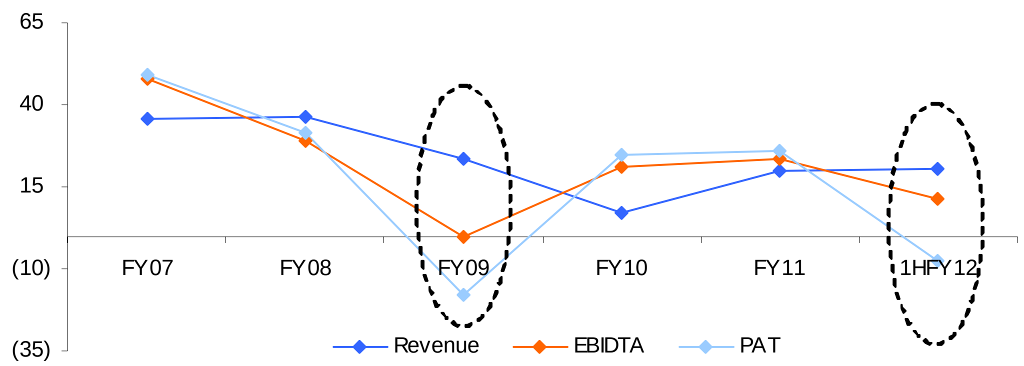


Source: Bloomberg

The corrective phase of our markets was unrelenting and spared no sectors, save for FMCG. Even sectors like IT which were traditionally considered as defensive and had high free cash flows, were not exempt from the punishment.

Corporate Performance was not found wanting

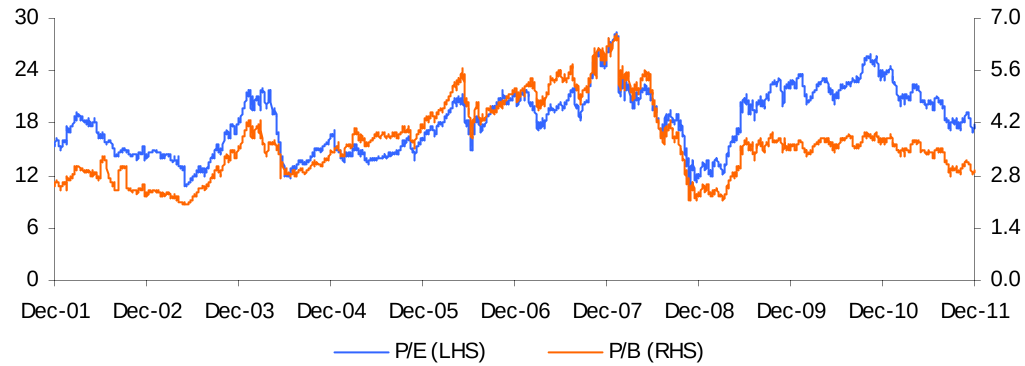
Key growth indicators of BSE500



Source: Ace Equity, BSE500 data excludes Financials & Oil and Gas (consolidated priority)

Despite myriad problems from Q4FY11 onwards, corporate performance has not been slackening. Indications are that FY12 numbers flow, though insipid, would be markedly better that FY09. Could FY13 give a sense of Déjà Vu'?

Trend in P/E and P/BV of Nifty



Source: NSE

Despite decent corporate performance, our markets underwent a severe compression in valuation metrics. While visibility of earnings impacted P/E, rising risk perception (G-sec yields) and softening RoE dealt a severe blow on P/B ratings front.

Sectoral RoCE (%)

	2007	2008	2009	2010	2011	2012 (e)	2013 (e)
Auto	27.8	24.6	11.2	21.1	24.2	26.7	27.6
Capital Goods	33.7	27.7	21.8	20.8	19.8	20.4	21.7
IT	44.9	39.4	34.3	32.4	32.5	34.9	34.5
FMCG	38.4	40.6	33.6	34.7	36.6	38.0	40.4
Metals	41.5	33.2	17.7	19.3	21.1	12.9	13.1
Oil & Gas	22.8	21.9	15.8	17.6	15.5	16.4	17.6
Power	14.1	13.7	11.7	11.4	11.2	14.8	14.8
Realty*	33.8	32.9	14.3	8.7	8.3	4.4	5.1

Source: Ace Equity, Antique. Note: FY-12e & FY13e estimates pertain to Antique coverage universe; * Bloomberg

India Inc. despite the challenges of 2008 did not falter much on the RoCE front. Save for sectors like realty, most others bounced back in FY11. The road ahead for FY12e and 13e (our estimates) convey a positive bias.

Sectoral RoE (%)

	2007	2008	2009	2010	2011	2012 (e)	2013 (e)
Auto	30.0	27.3	8.3	30.3	35.7	27.8	26.8
Capital Goods	31.3	26.6	19.0	19.7	18.2	21.2	21.3
IT	40.5	36.5	33.2	30.6	29.4	38.7	38.4
FMCG	37.2	42.2	33.8	32.7	34.1	36.1	37.3
Metals	41.9	36.1	19.4	20.9	23.4	13.0	13.9
Oil & Gas	23.7	23.8	15.4	19.2	16.2	15.0	15.5
Power	15.0	14.2	12.2	12.9	12.2	17.4	17.3
Realty *	69.1	52.0	18.1	8.4	7.3	7.6	9

Source: Ace Equity, Antique. Note: FY-12e & FY13e estimates pertain to Antique coverage universe; * Bloomberg

In 2008, RoE slide was sharper than RoCE and so was the bounce back. A flat generic trend is expected going forward, except for some sectors (metals and realty). While deleveraging can be a reason (+ve), capex deferral could also be a factor (-ve).

Key differences between 2008 and 2011

The pessimist's outlook

Exports were 13.5% of GDP in FY08 and economy was inward dependent. Domestic consumer growth was around 8% and that ensured sustenance of GDP growth. Circa 2011, exports are now 14.5% of GDP, post a surprising (and skeptical?) rise, and domestic demand growth is exhibiting signs of ebbing. This has all the connotations of turning out to be a spoilsport.

The stimulus package in FY09 ensured soft interest rates, ample capital availability and excise duties were slashed. Global factors like easing crude prices and cool off in commodities enabled alleviation of input costing pressures, thereby providing the much needed succor to India Inc. As demand was intact, pricing power was maintained and India inc. could maintain its EBIDTA. Currently, demand is slackening, pricing power is on the wane and raw material (commodity and crude) prices are elevated. Thus EBIDTA compression seems inevitable for FY13e.

Despite all-around problems, IIP growth had exhibited very slow slide in FY08, conveying that sentiments rather than demand was impacting capex cycle. FY10 and FY11 performance reaped the benefits of capex undertaken during FY05-FY07. In FY12, IIP growth has exhibited a pattern akin to falling off a cliff, portending some sort of capex derailment due to deferrals, shelving etc. Wide ranging reasons i.e unclear policies, red tapism, elusive financial closure etc. are casting a long shadow on the viability of these projects.

On the brighter side

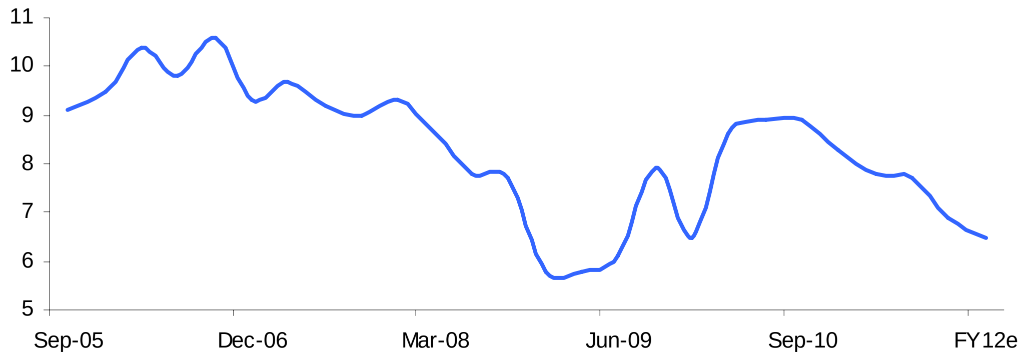
While growth in urban India has been slowing down because of global interlinking, rural India continues to grow on back of trickle down effect of massive social sector spending, appreciation (and liquidation) of latent assets (land, gold etc). This coupled with buoyant agriculture production is likely to keep the rural consumption strong. Thus, demand would be maintained, albeit with an alteration in composition pyramid i.e small ticket items posting higher growth than large ticket items.

Easing growth rates across the world, along with absence of additional QE measures, augurs well for a cool off in commodity prices and should provide relief on imported inflation. However, elevated crude oil could sour the situation. The vicious cycle of cost inflation could now be turning a full circle. While runaway rupee depreciation is a worrisome factor, it is largely linked to global pain rather than India specific factors and thus would normalize in the coming months. Thus margin concern, which is all pervasive, could be fading away in coming quarters.

Elevated Inflation for an extended period of time led to aggressive monetary policy and took toll on growth rates. However, inflation is now exhibiting signs of reversal. While this could be a contentious call, we are of the opinion that factors like consumer pushback, increased supply have the potential to facilitate the same. Right signals from the central bank along with improving liquidity will have a positive effect on India Inc. especially on capex implementation front and also mitigate worries on NPA formation for the banking system. RBI's December meet has indicated a reversal of the hawkish stance a shift of focus to growth. However, there is no visible solution on the policy making/statutory clearances front and this is also a potential spoiler for financial closure and capex implementation.

GDP growth sputtering, but still better than peers

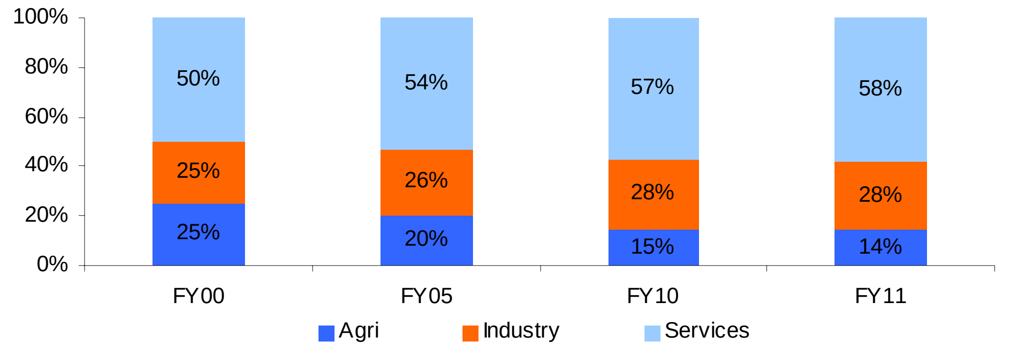
GDP growth faltering (%)



Source: MOSPI

GDP growth has been faltering as global factors i.e EU crisis, high oil prices, runaway inflation, tight monetary policy and slowing investment have taken their toll. However despite a slip below 7%; India still maintains an upper hand in global growth sweepstakes.

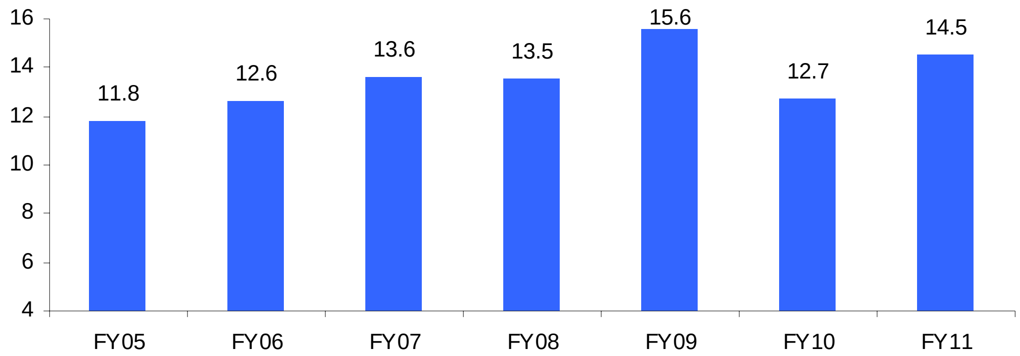
Shift in GDP composition towards services augurs well



Source: MOSPI

There has been a slow alteration in composition of the GDP, with a marked shift towards services. This has been maintained despite the buoyancy in agriculture in the past few quarters, and underlines the maturity of our economy.

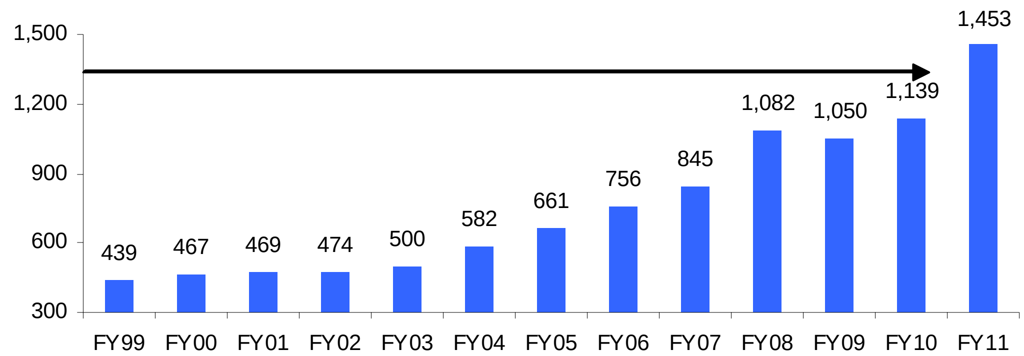
Low share of exports in GDP (%), makes us less vulnerable to global turbulence



Source: MOSPI, Antique

Low reliance on exports, compared to other countries has been viewed as a bane of our economy, especially during turbulent times. While it stood in good stead in 2008, it can be a double edged sword at the current juncture in case of a domestic slowdown.

Per capita GDP on a rise (USD) and past the tipping point

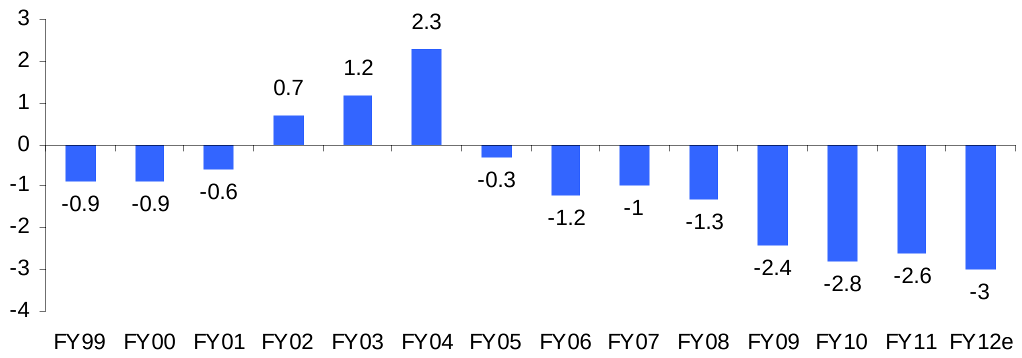


Source: MOSPI, Antique

The sustained GDP growth over the past few years has now taken the per capita income level across the oft watched tipping point i.e., USD1,000-1,200 pa. Empirically, one can expect a smart surge in consumption to emerge sooner rather than later.

Niggling concerns remain

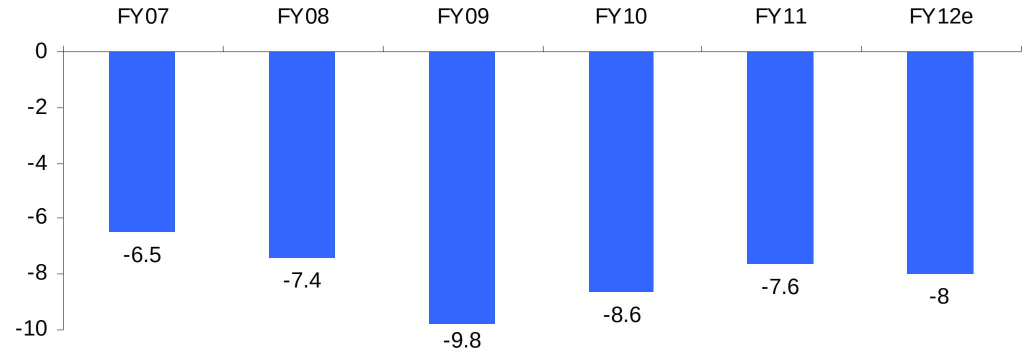
High CAD (% of GDP), an overhang



Source: RBI

The current account deficit (CAD) is at an all time high. It along with high crude prices and low portfolio flows poses a systemic risk. However, higher invisibles (software exports + remittances) can ensure that financing CAD will not be an issue in the short term.

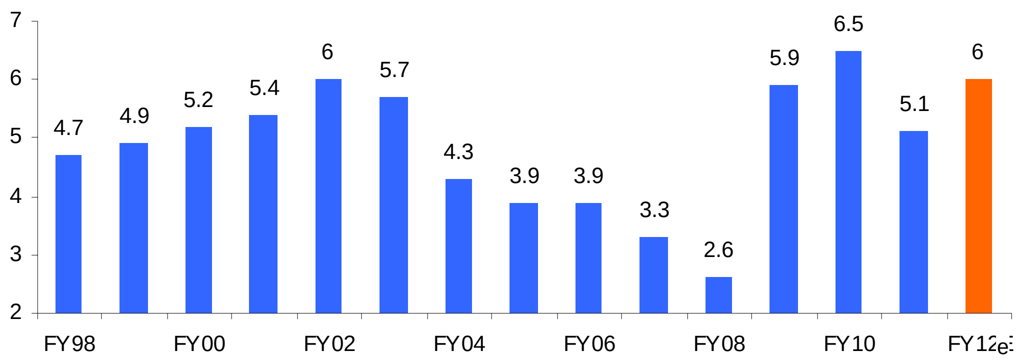
Trade balance: In deficit mode (% of GDP)



Source: Export Ministry/RBI

While India has never been a net exporter, the rapidity of trade deficit rise, despite exports being at record highs is causing concern. It is getting compounded by a weak currency. Export:forex reserve cover is now moving towards uncomfortable levels.

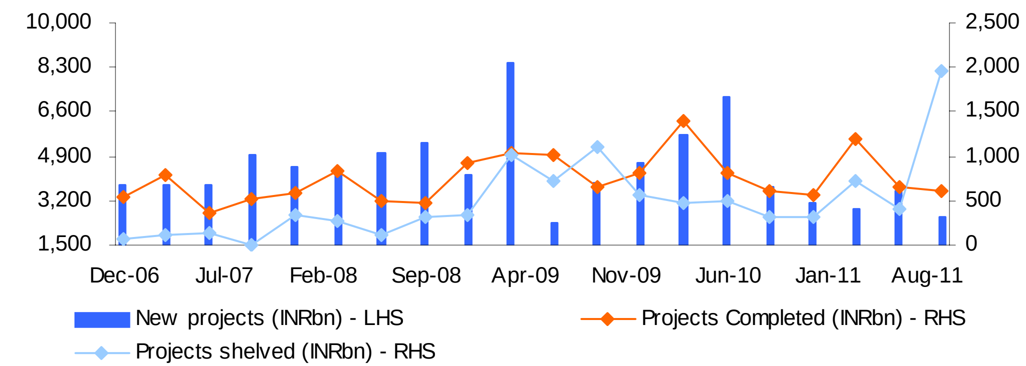
Fiscal consolidation still eludes India (Fiscal deficit in %)



Source: Budget document, Antique

Fiscal deficit target of 4.6% set by government will be difficult to meet as higher subsidy burden on oil, fertilizer (and now food) coupled with sub-optimal tax collections, higher social spending commitment and lower divestment receipts will lead to slippages.

New Projects: Policy log-jam coupled with monetary tightening has taken a toll

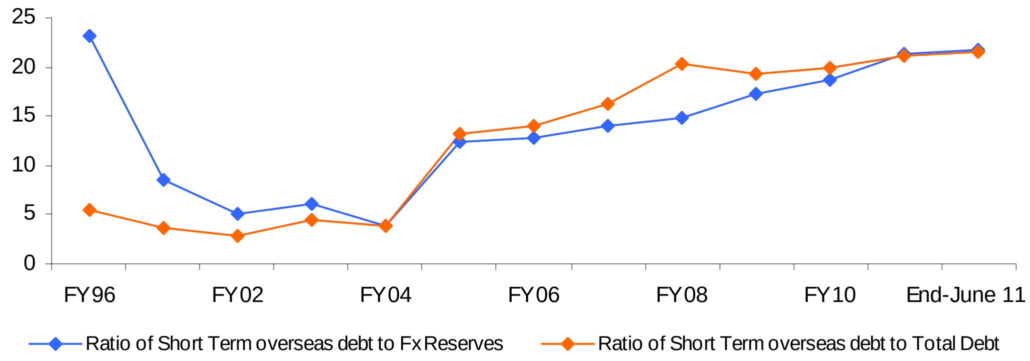


Source: CMIE

Policy paralysis, land acquisition issues, mining ban, labor problem and regulatory hindrances have vitiated the investment climate. The ensuing uncertainty has lead to corporate's putting projects on the back burner.

Niggling concerns remain

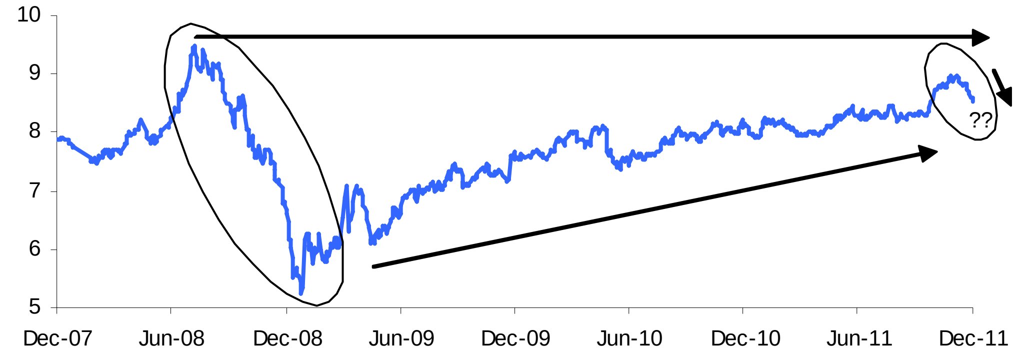
Short term overseas debt/forex: creates short term volatility



Source: RBI

India Inc. over the last few years has been tapping overseas debt to capitalize on interest rate differentials. This has inflated forex debt : total debt ratio to 21.7%, a 2 decade high, posing a risk as sudden outflow of funds could build pressures on currency.

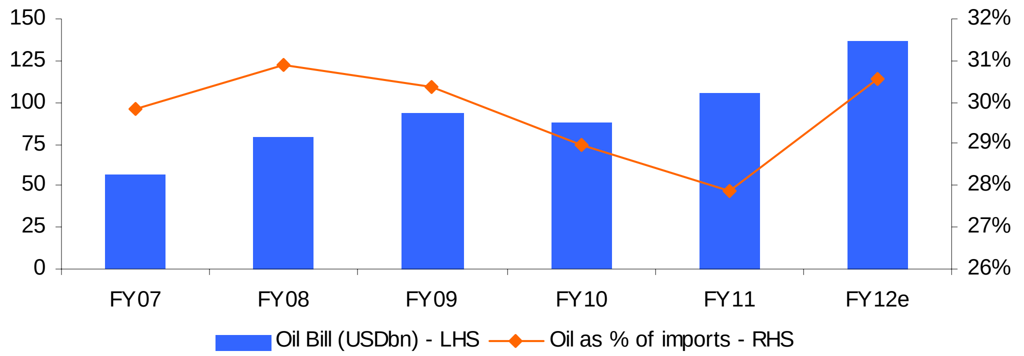
Interest rate upmove could be drawing to an end (10-year G-Sec yield %)



Source: Bloomberg

RBI's hawkish bias in curbing the soaring inflation has lead to an upward pressure on interest rates. Fiscal slippages and higher government borrowing has aggravated the situation. However, we could be topping out in the medium term.

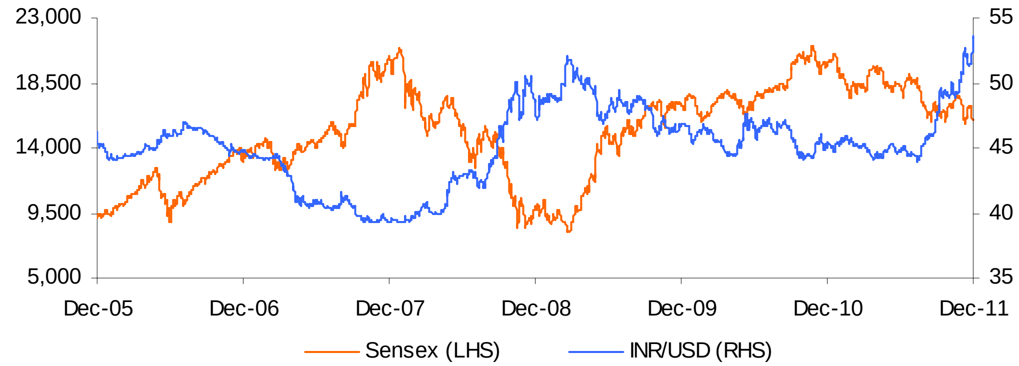
Oil as a % of total imports



Source: RBI, Ministry of Commerce

High oil prices and depreciating currency has been a major cause of worry. As the oil bill >USD125bn (FY12) now forms ~30% of imports, oil price fluctuation makes India vulnerable on various fronts. However, a cool off will have a positive rub off.

Sensex/INR: Co-relation

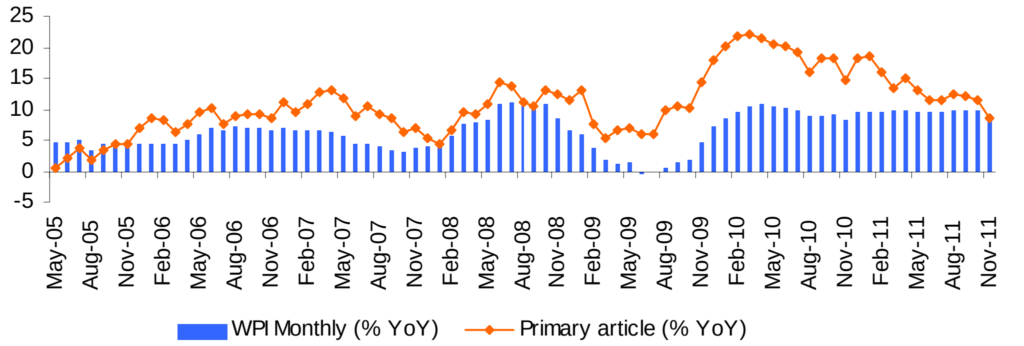


Source: Bloomberg

Risk aversion and global deleveraging has taken INR to an all time low. Extrapolating the past correlation between currency movement and stock market performance, the oncoming INR hardening holds good scope for equity market re-rating

All is not lost

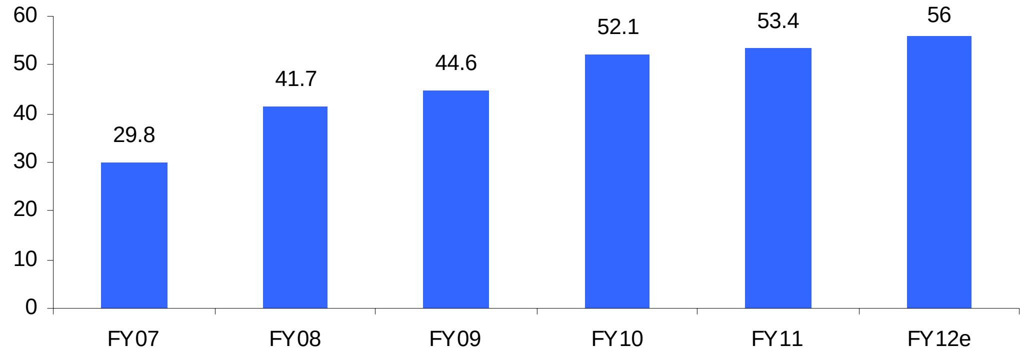
Inflation exhibiting signs of a cool off



Source: Office of Economic Advisory, Bloomberg

Food inflation which has been a key culprit in keeping overall inflation at elevated levels for an extended period. We believe that reduction in WPI will set the tone for reversal of monetary policy regime in FY13e

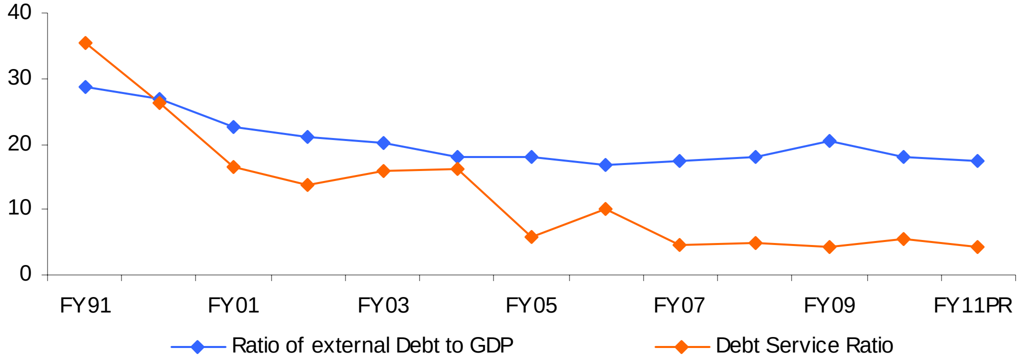
Strong remittances afford a natural hedge (USD bn) to fund CAD



Source: RBI

India attracts highest remittance globally at over USD55bn annually, and the same is one of the safest/stickiest inward money flow. This would go a long way in financing the current account deficit.

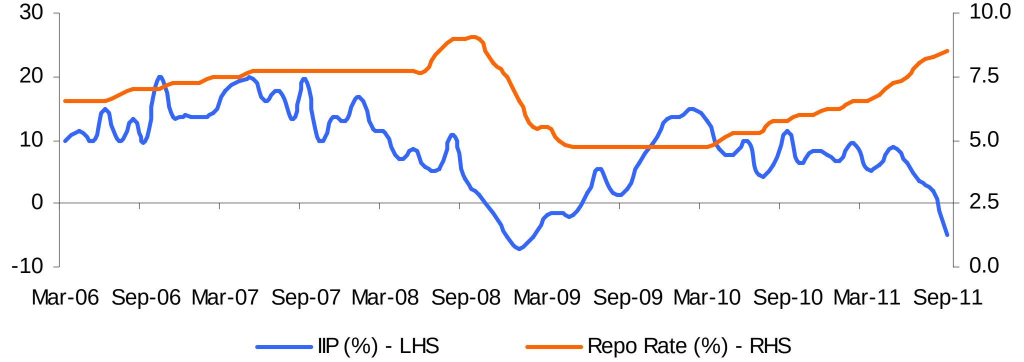
Ratio of external Debt to GDP, and Debt Service Ratio



Source: RBI

Ratio of external debt/GDP and debt service ratio is at a 2 decade low, indicating that we may face short term volatility but the overall debt situation is manageable and under control.

Industrial activity may have bottomed out with rate cycle peaking

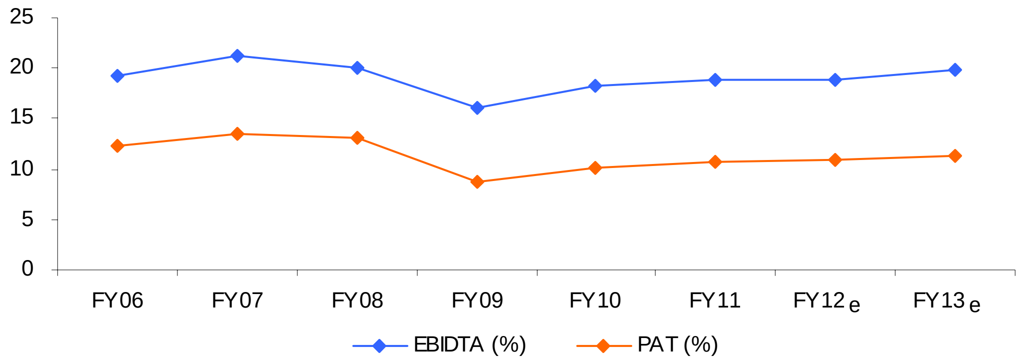


Source: RBI, MOSPI

Industrial growth has suffered on back of monetary tightening, slow decision making and obstacle on environment/ regulatory fronts. However, we are now at an inflection point where pain and pessimism are highest and scope of reversal outlook, brightest.

India Inc has been managing valiantly

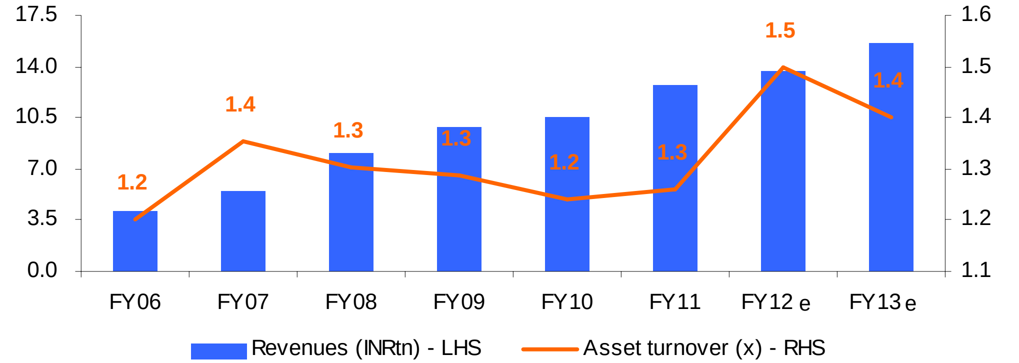
EBIDTA and net profit margins



Source: Ace Equity, BSE500 data excludes Financials & Oil and Gas (consolidated priority), FY12e/FY13e pertains to Antique coverage universe

Despite heavy capex, most companies managed to maintain EBIDTA margins and ensured that interest costs (as a percentage of revenues) did not spin out of control. The trend going forward is expected to be stable, albeit at a lower pace.

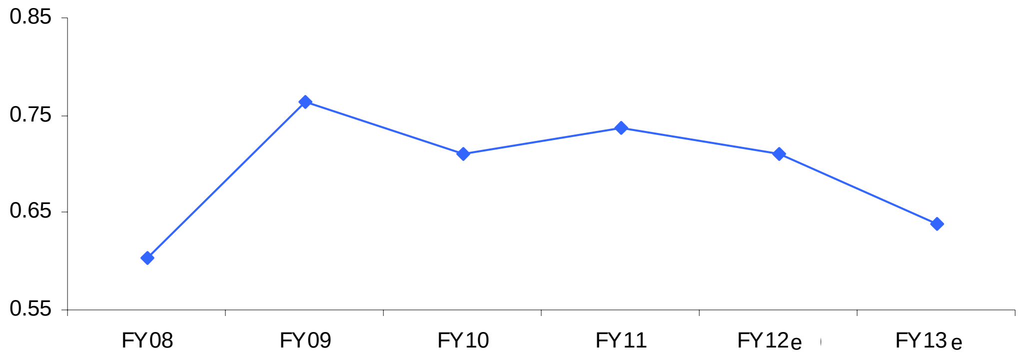
Asset turnover and revenues (Antique coverage universe)



Source: Ace Equity, Antique, FY12e/FY13e pertains to Antique coverage universe ex Financials and Oil & Gas

Revenue growth for FY11e and FY12e is expected to be muted, as most of the capex (standing as CWIP now) will become productive in the coming few quarters. Though the asset sweating is stable, traction is still some time away.

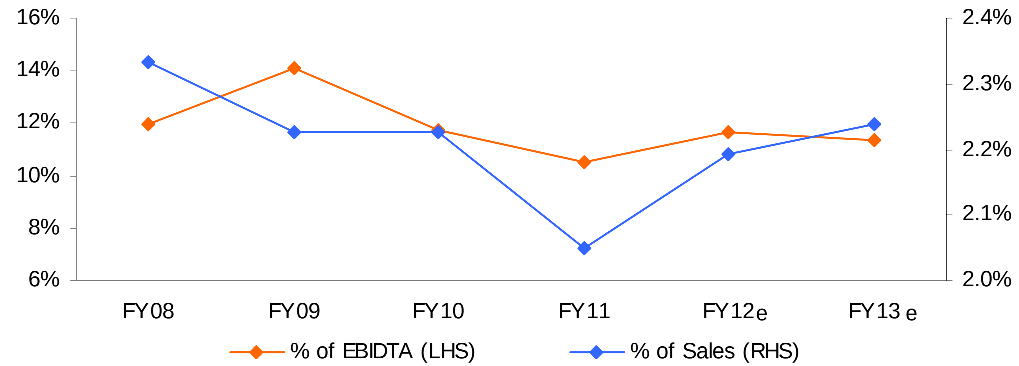
Leverage under control (x) (Antique coverage universe Ex Financials and Oil & Gas)



Source: Antique

Corporate India has been able to maintain its leverage despite its capex, which conveys reliance on funding from internal accruals with minimal recourse to external debt.

Trend in interest cost (% of sales) (Antique coverage universe Ex Financials and Oil & Gas)

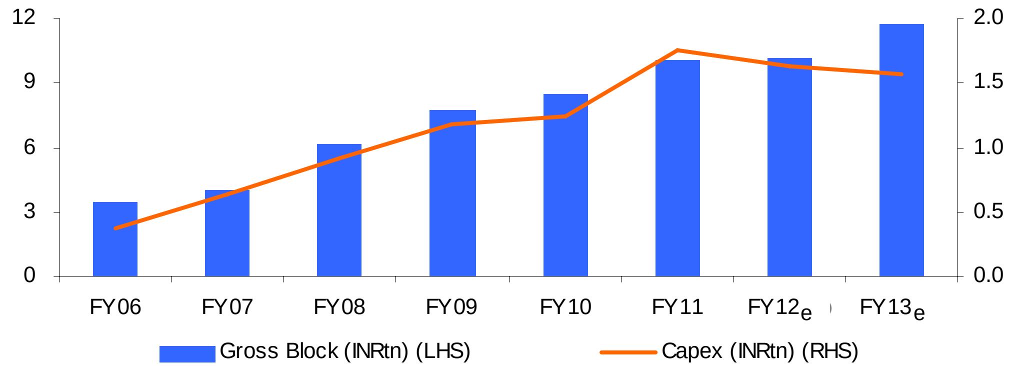


Source: Antique

Despite all the challenges, the operational metrics were maintained over an extended period of time, underscoring the efficiencies of scale of operations of India Inc.

India Inc has been managing valiantly

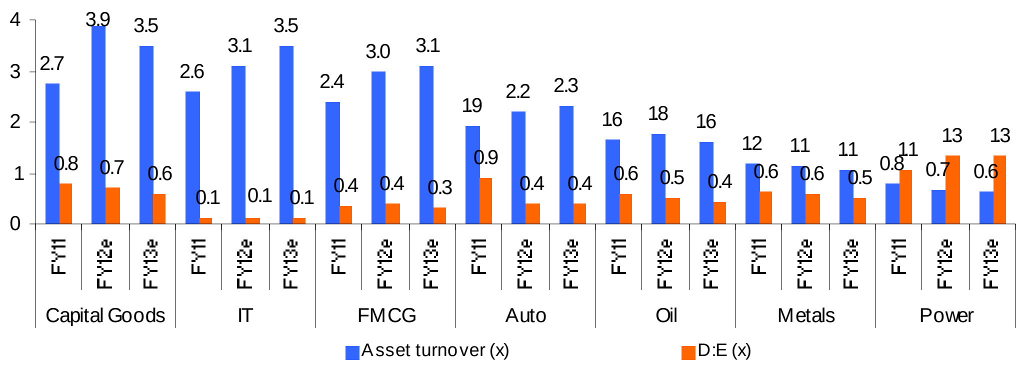
Capex and rising asset block (INRtn). (Antique coverage universe Ex Fin. and Oil & Gas)



Source: Ace Equity, Antique

While India Inc has not witnessed a let down on its capex cycle till FY10, the picture is getting altered FY11 onwards. Rising CWIP due to derailed capex is a reality and is an overhang. But increased capital efficiency and contained leverage will save the day.

Sectoral leverage and asset turnover



Source: Ace Equity, Antique; FY12e/FY13e pertains to Antique coverage universe

Most of the sectors have managed to tide over the capex phase and secure benefits of the same. While sectors like IT and Auto stand out Power and metals are a bit worrisome now. FMCG, Cap goods and oil seem to be chugging along satisfactorily.

India inc. in FY12, has been buffeted by multiple headwinds. Global factors like high energy costs, rising commodity prices, weakening currency etc have dealt a blow on the operational costing front. Additionally, domestic factors like insipid demand have impaired pricing power and factors like wage bill inflation, hardening interest rates etc have been eroding margins at various levels.

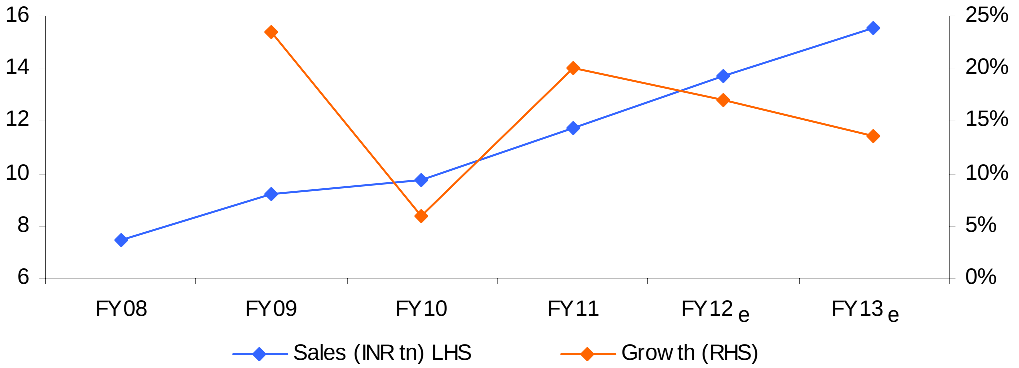
In such a scenario, volume growth and operational scale up have been the only saving grace. While, scale up process depresses RoCE/RoE in initial stages on account of capital being stuck in sub-optimal returns zone, upon stabilizing the restitution of capital efficiency ratios to earlier levels more than makes up for the same.

Sectors which have relatively low capex and high scale potentials like Auto, FMCG, IT, Healthcare will manage to hold on to their metrics. While this stability would stand in good stead in this era of uncertainty, it does not translate into insulation from market volatility.

However some sectors like Metals, infrastructure, Realty, capital goods etc will be impacted as they typically ail from multiple dogmas of low asset sweating, high leverage, long capex cycle etc. Another large sector namely oil & gas sector has also been impacted, but more so from adverse policy decisions. These sectors, have considerable weightage in the markets and being guzzlers of capital, have a huge bearing on health (and investor perception) of another giant sector namely Banking. Thus, it usually evolves into a classical vicious circle, which results in a sustained de-rating, akin to what we have undergone in the past 3 quarters.

India Inc has been managing valiantly

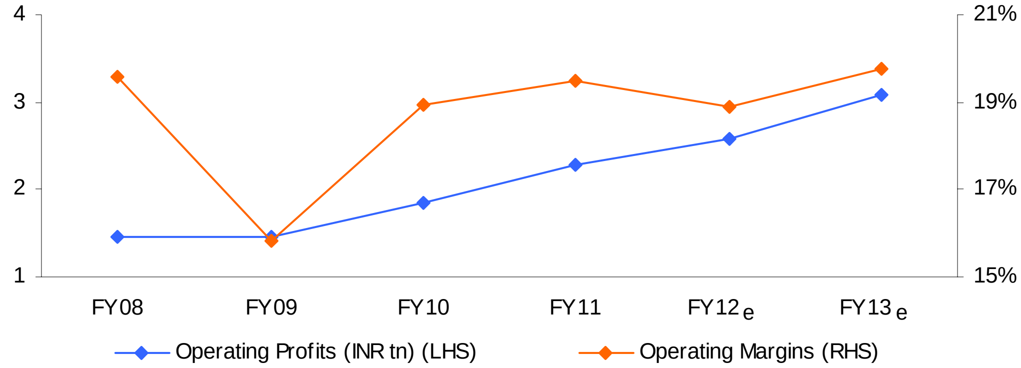
Net Sales & Growth % (Ex banks and oil & gas) (Antique coverage universe)



Source: Antique

The Capex cycle of FY06-FY09 seems to be resulting in strong revenues traction for most of the sectors. While growth rates were skewed earlier, it is now exhibiting some signs of flagging and this could have some adverse impact post FY13.

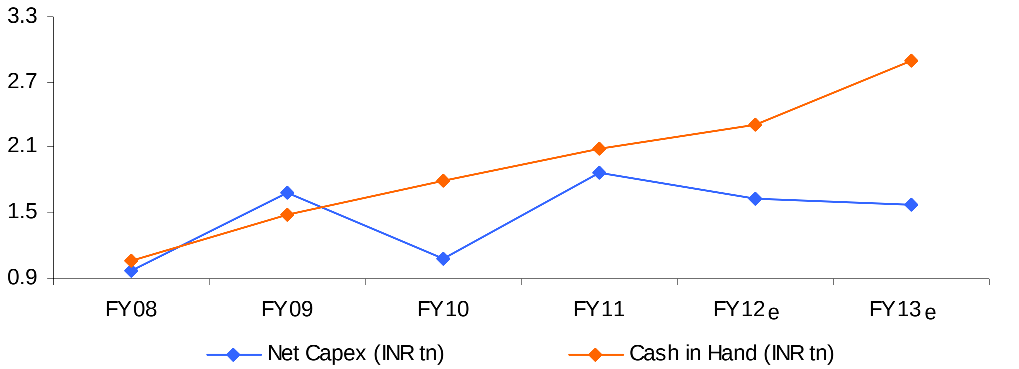
Operating Profits (Ex Banks and Oil & Gas) and Margins % (Antique coverage universe)



Source: Antique

Despite the jagged revenue growth rates, a large number of the companies have maintained their margins. The operating profits trend is pleasantly trending up and imparts a high degree of comfort to market observers.

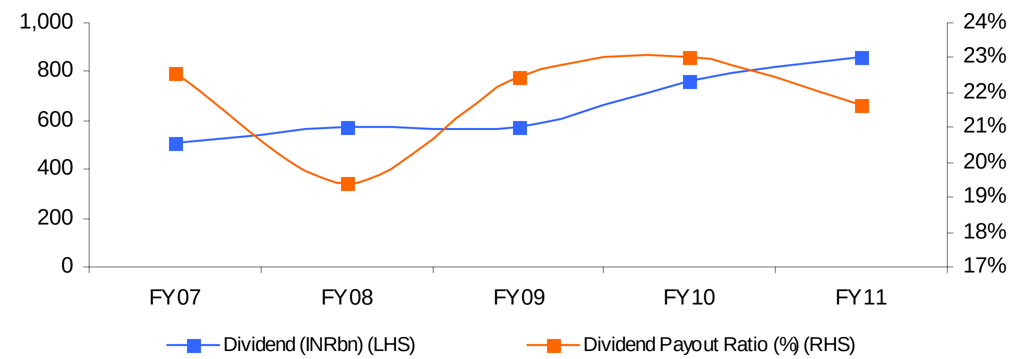
Net Capex and Cash in Hand (Ex banks and oil & gas) (Antique coverage universe)



Source: Antique

Cash hoard of antique coverage universe has been increasing, conveying the balance sheet strength. While the distribution could be skewed, a worrisome sign is that cutting back capex and hoarding money could be detrimental to future growth.

Dividend and Payout Ratio for BSE 500 co's

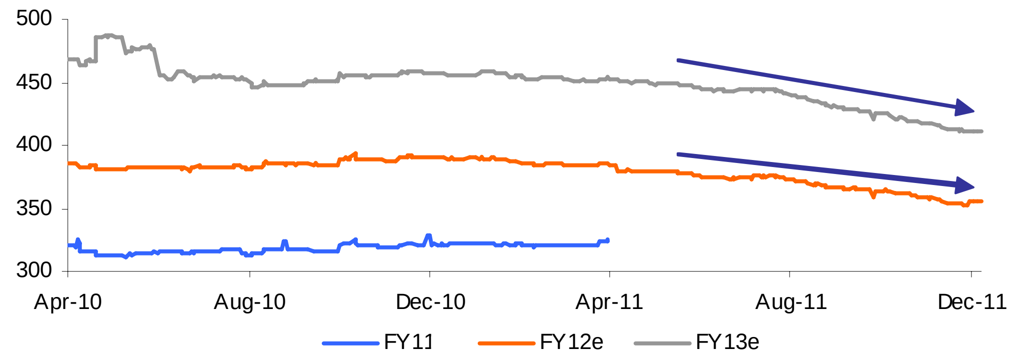


Source: Ace Equity, BSE 500

India Inc. has been maintaining its dividend outflows for the past few years, despite the capex which it has undertaken. While this may not be an apt measure, along with increasing cash hoard it underscores the cash generation ability of Indian corporate's.

Markets apparently have factored the negatives in

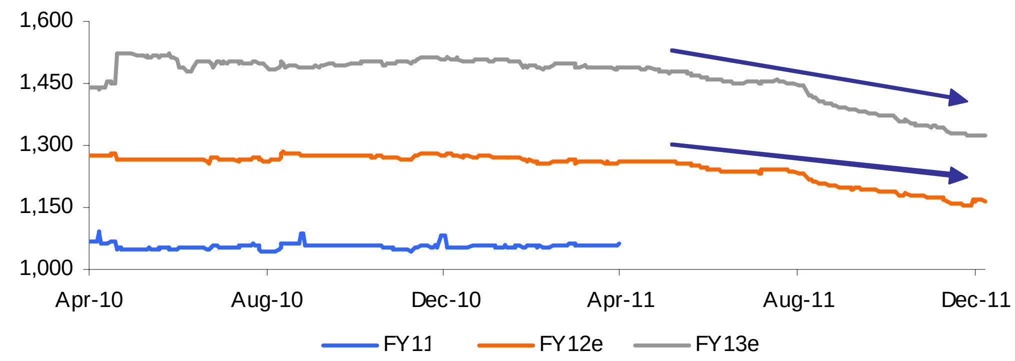
Nifty - Consensus Estimates for FY11,FY12e and FY13e



Source: Bloomberg

The Nifty comprising a larger set of stocks has also been subject to similar downgrades in earnings. The downgrades became more stringent in H2CY11 and may be more of pre-emptive in nature.

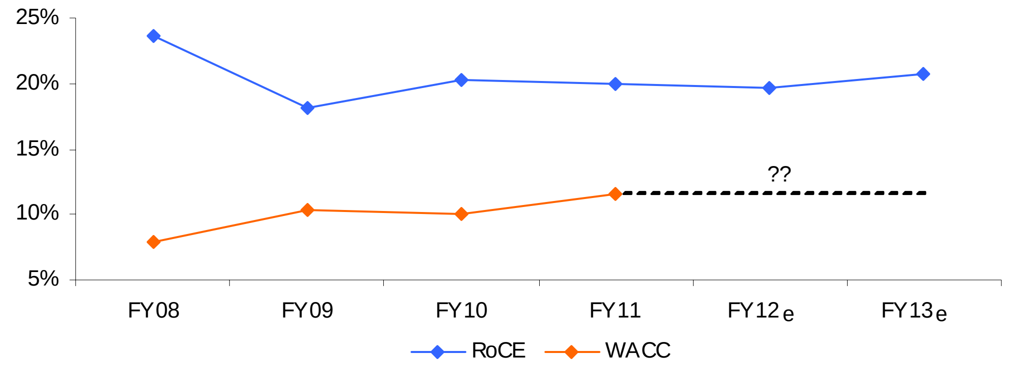
Sensex - Consensus Estimates for FY11,FY12e and FY13e



Source: Bloomberg

While the concerns on earnings have been increasingly getting louder in the recent months, consensus earning has been sliding for much longer time. While the pace has accelerated in the past few weeks, we feel that it has been factored in the Sensex.

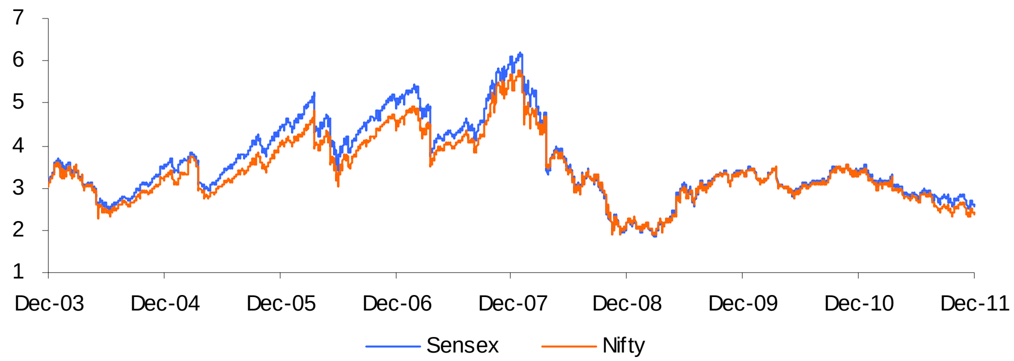
RoCE and WACC profile for Antique Universe (Ex Banks)



Source: Bloomberg, Antique

The India growth story was based on large differential between RoCE and WaCC. However, they have converged in the past three years. While RoCE is expected to bounce back, divergent trend is some time away. But isn't it visible in the valuations?

Trend in PB ratios

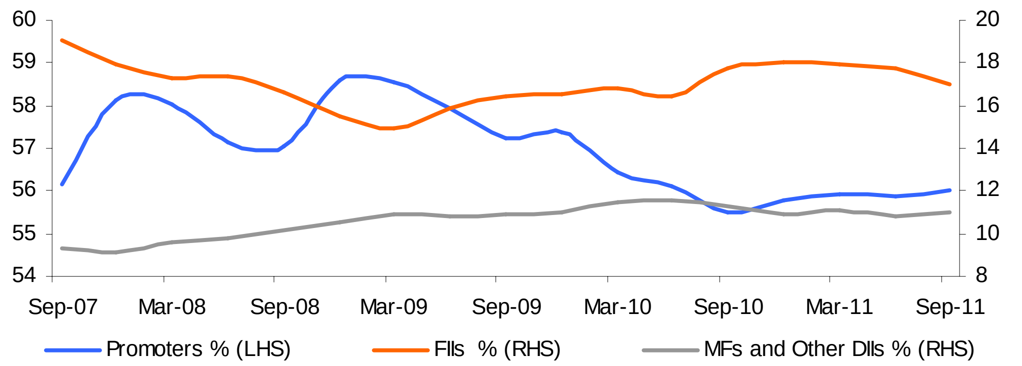


Source: Bloomberg

Market seem to have adjusted toward the changing operational metrics quite quickly. While the RoE for most of the sectors is expected to slowly revert back, the uptick in G-sec has resulted in compression of the P/B ratio of indices and stocks quite severely.

Markets apparently have factored the negatives in

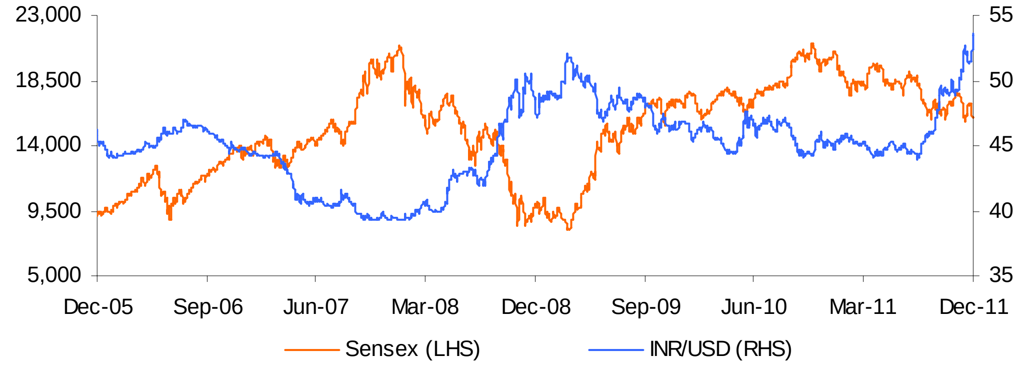
BSE500 Shareholding Chart



Source: BSE

Share holding patterns trends do not convey flight of institutional participants. However, promoter holdings convey a slide. While it can be attributed to routine dilutions; revocation/liquidation of pledged shares is a nagging suspicion.

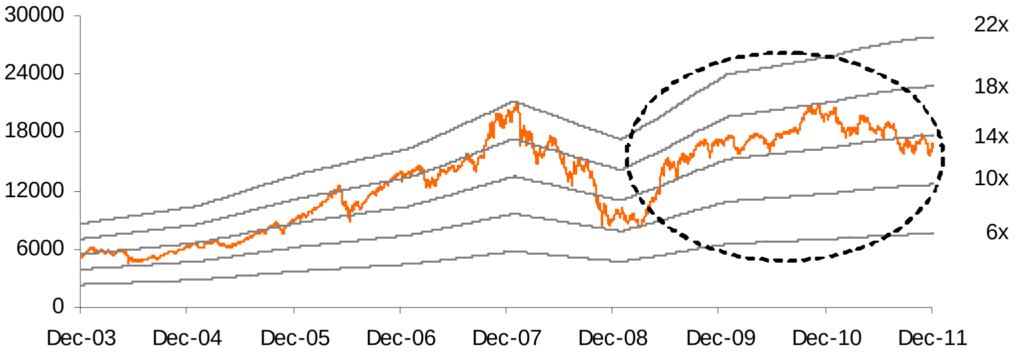
Currency and Index



Source: Bloomberg

There always has been an apparent inverse correlation between currency (USD:INR) and markets. The sudden weakening of INR seems to be coinciding with downslide in markets in a copybook manner. The connotations are positive if INR appreciates.

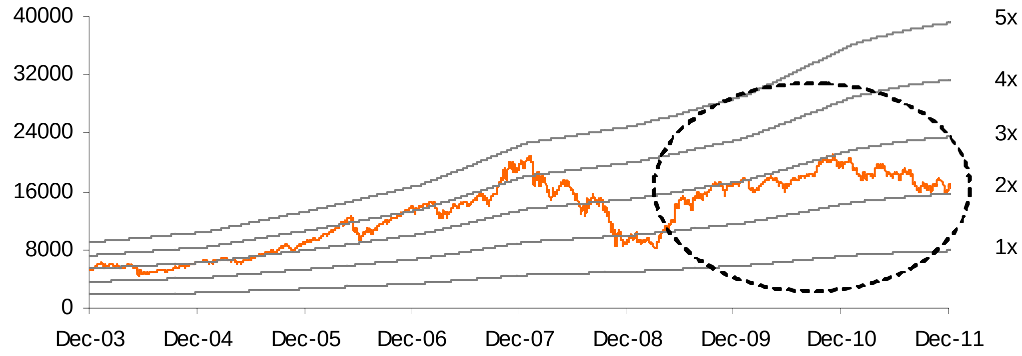
Sensex PE(x) Band



Source: Bloomberg

The corrective move from CY10 end has been relentless. While one can argue that we still have some way to go before we test the lows of CY08, the operational metrics of India Inc are comparatively much better, though the same cant be said about the outlook.

Sensex PB(x) Band



Source: Bloomberg

The markets have also been subject to a P/B compression, which is usually more powerful in an era of rising interest rates (eg G-Sec). Here the scope for rerating is directly dependent of the trend of interest rates, which have been now exhibiting signs of cooling off.

Key assumptions for CY12

Factor	Assumption	Remark
Crude oil (India Basket)	USD102-104	It should average between USD100-105/bbl in 2012, due to staid global oil demand. IEA estimates also corroborate the same.
USD	INR48.5-50	While the currency has exhibited sharp weakening towards end of CY11, global and domestic factors would ensure that the skewed situation reverst to normalcy by 2QCY12e.
Inflation	7-7.4%	High base effect, slow cool off in commodities and agri products prices would offer a conducive environment for inflation cool off in CY12.
G-Sec	7.7-8.3%	There have been some signs of a cool off in end CY11. While naysayers will point out to adverse fiscal situation, the trend with a downward bias is apparent and would be maintained.
Interest Rate (Base rate)	9.75-10.75%	As policy rates could be now getting softer in the 2HFY12e, assuming a cut in the same Base rate of 9.75-10.75% seems to be the norm for CY12.
Credit Offtake growth	17-17.5%	The credit growth multiplier is typically 2.25 to 2.5x of real GDP growth, thus it should be in the range of 17-17.5%.
Sensex EPS (FY13)	INR1,280	
Nifty EPS (FY13)	INR403	

Source: Antique

Our call

As we enter CY12, there is a huge overhang of international factors like EU financial imbroglio, global realignment of investment risk, sluggish global growth etc. and domestic factors like sliding GDP growth, sluggish demand, high inflation and interest rates, logjam on policy making front, derailed capex, sliding currency etc. Aditionally, sluggish capex of the past two years has the making of curtailing our growth in the coming two years. Thus, it is justified for any capital market investor to be pessimistic and bearish.

An old adage conveys that 'market always turn at heights of euphoria or depths of despair', and by all means we are almost at the latter stage. In such a situation what would be the safe havens for investors?.

Taking a call, we at Antique are of the opinion that while markets could be grappling with many factors and be exhibiting sideways movement in the first quarter of the CY12, the stability of earnings and slow traction in growth will play out. In such an environment of skepticism, it would be prudent to invest in companies who have a good degree of advantage on operational and financial costing fronts as sluggish demand and impaired pricing power are a systemic malaise now. At the same time one should also not shy away from loading up on some risk as we feel that post March'12, that would play out significantly.

In such a scenario, sectors like BFSI, Auto, FMCG and IT appear have the traits of both growth and operational ruggedness. Stocks like State Bank of India(CMP INR1,623), Axis Bank(CMP INR854), Rural Electrification Corp(CMP INR160), Mahindra & Mahindra(CMP INR690), Hero MotoCorp(CMP INR1,849), Hindustan Unilever(CMP INR401), Titan Ind.(CMP INR169), Infosys(CMP INR2,744) and TCS(CMP INR1,160) make the case. An unorthodox story like Petronet LNG(CMP INR160) would also make the grade. While some players in the Pharma sector may be sweetly poised as far as the currency movement and growth factors are concerned, things are too nebulous to take a call in the same, hence we are refraining from the sector despite a positive bias.

Sectors which are out of flavor like Cap goods, Cement, Utilities and Oil and gas, have high intrinsic risk perceptions and are hence shirked by a majority. Our call is that some of the stocks like L&T(CMP INR1,001), Shree Cements(CMP INR1,977), NTPC(CMP INR160) could have factored in most of the negatives at the current prices and could prove to be outperformer in H2FY12, as and when the pall of gloom lifts.

Politics: The spanner in the works?

CY12, could be the beginning of election carnival

The popularity of UPA government is now at its nadir as it seems to be lurching from one mess to another. Allegation of large scale corruptions have lead to a political deadlock and policy making log-jam seems to have dealt a severe body blow to India Inc.'s capex cycle. Political instability along with extrinsic factors like global economic shakeout, surging crude prices currency gyrations etc have taken a toll on our economy and issues like ballooning fiscal deficit, elevated inflation, currency depreciation, large trade deficit and external debt have all the makings of a spoilsport and could derail India's growth story.

These issues have emerged as a common cause for the opposition parties as UPA allies to exert a high degree of pressure on the government and the scope of maneuverability is getting increasingly reduced.

For the government, the current budget session is probably the last chance to set the ball rolling for pushing reforms as the next year could be crucial in terms of political fortunes. 2012 will witness the most crucial elections i.e. Uttar Pradesh, which has all the makings of a 'Gamechanger' in the Indian political arena, this will be followed by Gujarat and Punjab elections. Governments usually resort to populist measures before elections to serve their political interests, and in 2009, the government initiated wage hikes for central government employees, pre-election spending, farm loan waivers and expansion of social security schemes like rural employment.

Most recent decisions such as the mining bill, land acquisition bill and food security bill can also be said to be playing to the gallery. However, some of the key bills critical for accelerating India's growth cycle is reforms like GST, direct tax code, Companies Act, FDI in multi-brand retailing, electricity distribution reforms, etc which would take their own course to get implemented. Though the government has recently exhibited its ability to take hard decisions such as on FDI in multi-brand retail, the road ahead is not going to be easy as a dysfunctional parliament has ensured that almost 30 bills are pending.

We managed to tide over the blip of 2008 as our growth was maintained on account of economy being largely in an auto pilot mode with strong domestic demand. Also, the rapidity of the recovery didn't subject the economy to any shocks. However, with a severe policy log-jam hampering investment climate as reflected in IP and GDP nos and a complete standstill on the reforms, we seem to be running out of steam and visible signs of fatigue are building up. We believe that this is the high time for government to take some bold steps in order to put the economy back on track and expect the same to build up traction in months to come.

Election Schedule

UP	Feb-12
Gujarat	Apr-12
Punjab	Jun-12
MP	Mid 2013
Rajasthan	Mid 2013
Karnataka	Mid 2013

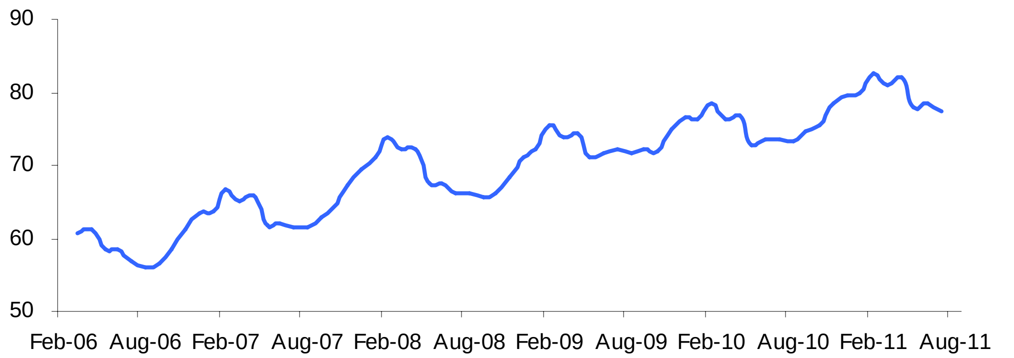
Key Bills pending at the parliament

- Lokpal Bill,
- National Food Security Bill,
- Pension Fund Regulatory and Development Authority Bill,
- Companies Bill,
- Draft Direct Taxes Code Bill,
- Securities and Exchange Board of India Bill,
- Life Insurance Corporation (Amendment) Bill,
- Telecom Regulatory Authority (Amendment) Bill,
- Coal Mines (Nationalisation) Amendment Bill,
- Goods and services tax bill

ANNEXURE

Annexure

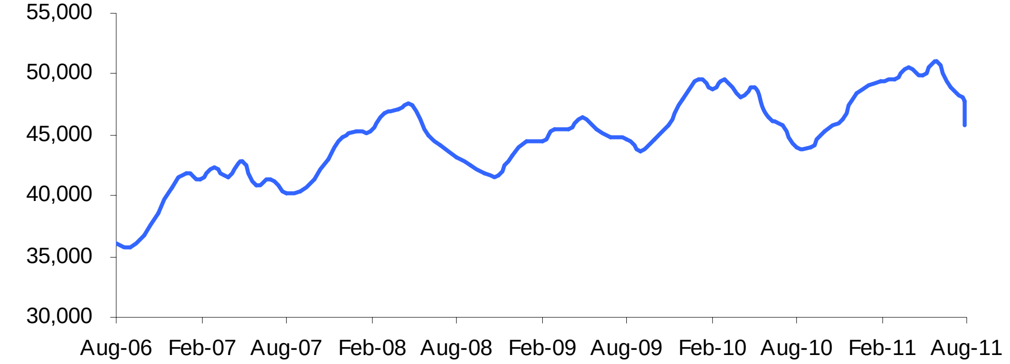
Railway freight traffic (MT)



Source: CMIE

Railway traffic, which is the barometer of industrial activity in India, has maintained its growth trend despite increase in freight rates. This conveys the strength of the manufacturing sector and its ability to absorb the escalation.

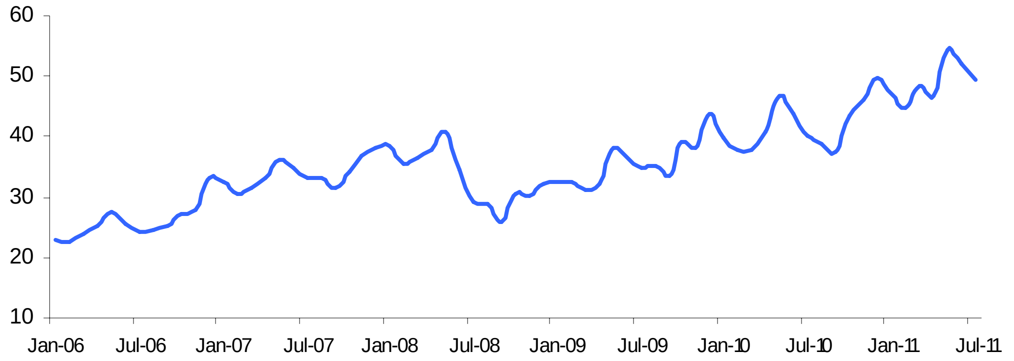
Port Cargo Traffic ('000 tonnes)



Source: CMIE

A benign EXIM trend is borne out by the fact that despite infrastructure bottlenecks, port traffic has exhibited decent growth. Trafffic at minor ports has also posted growth, tracking the increasing trade in coal and containers.

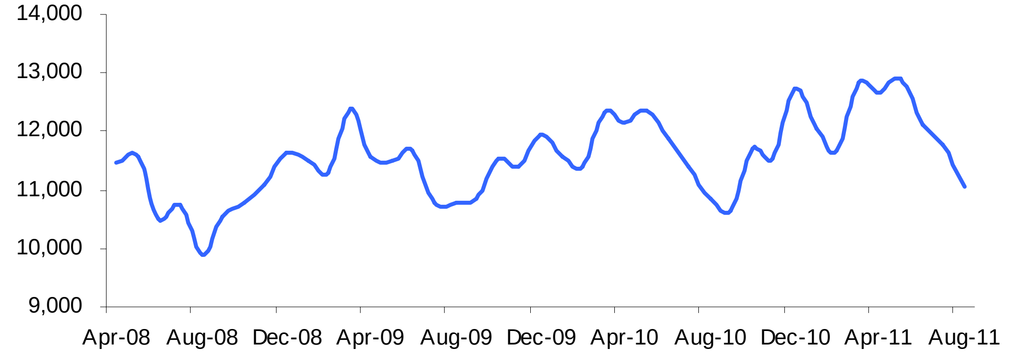
Domestic air passenger traffic (lacs)



Source: CMIE

Despite consistent increase in ticket rates, domestic passenger traffic has maintained its growth, reflecting the rising purchasing power of Indian middle class. The growth has exhibited a GDP multiplier factor of 2x, which is typical of an emerging market.

Consumption of Major Petroleum Products ('000 tonnes)

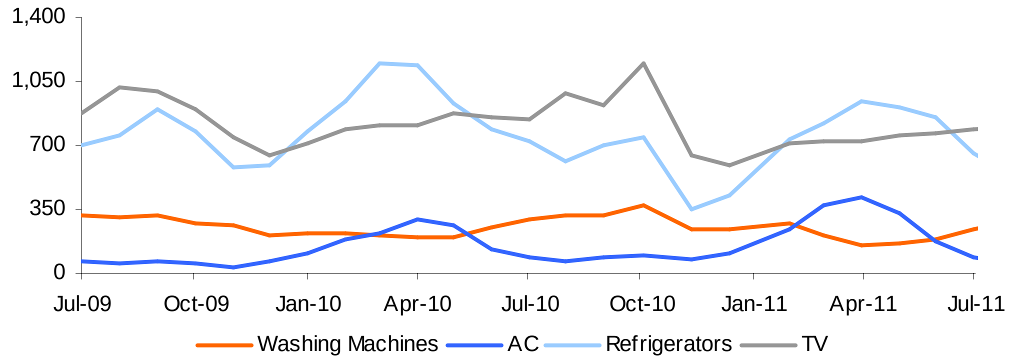


Source: CMIE

However, petro products dynamics could be a source of concern as their consumption is rising sharply due to increased consumerism and industrialisation. High import dependency and weakening INR is a source of concern.

Annexure

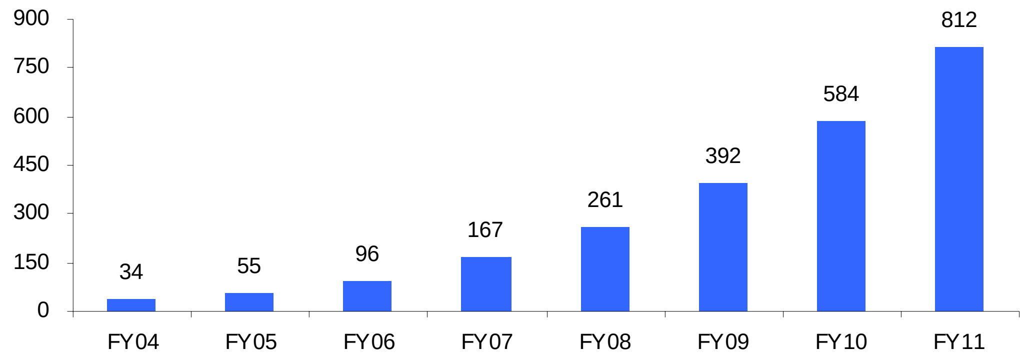
Consumer durable ('000 Nos.)



Source: CRIS Infac

Indian consumers have not cut back on their consumption as is reflected with the sales figures of consumer durables. However, there have been some signs of fatigue from urban agglomerations, but not from the hinterlands.

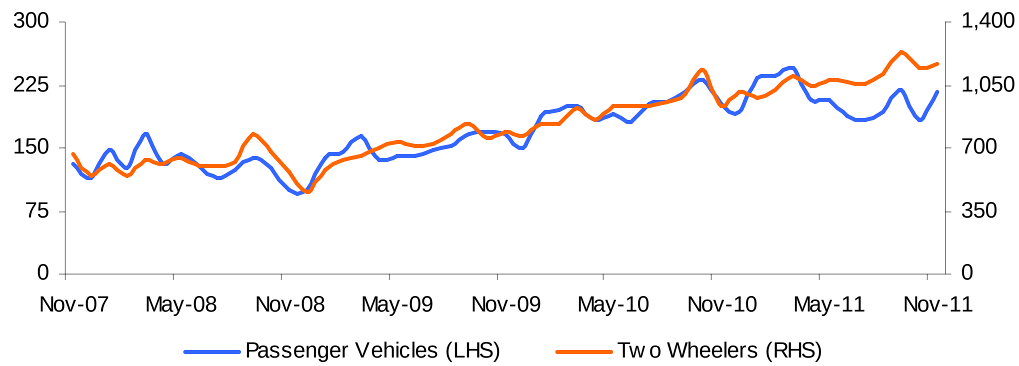
Telecom subscribers (m)



Source: TRAI

Increasing affordability, high impact on life-style, alteration of business dynamics coupled with the changing socio-cultural demographics has spawned a consumption boom in telecom services.

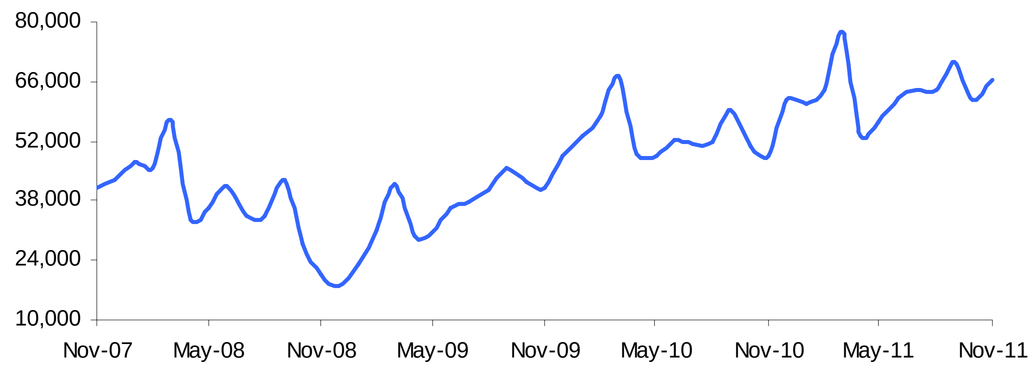
Passenger vehicle and two wheeler sales ('000)



Source: SIAM

The best reflection of rising per capita income is the improvement in passenger and two wheeler sales. The incremental sales from semi-urban and rural markets now outstrips urban sales.

Commercial vehicles sales (Nos.)

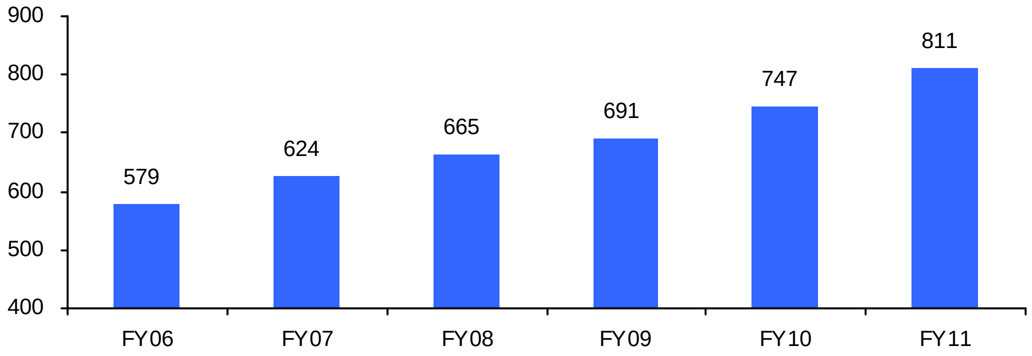


Source: SIAM

Commercial vehicle sales, a barometer of industrial, mining, construction and agriculture activities, has taken a beating during last quarter. However falling interest rates and pick up in mining and agriculture related activities can lead to uptick

Annexure

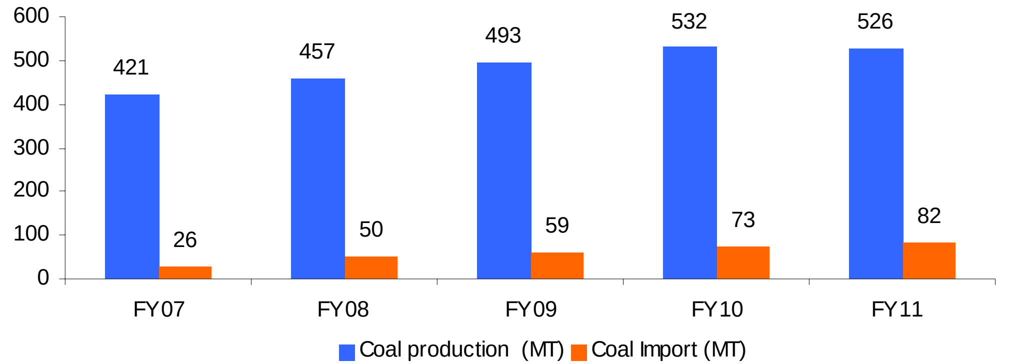
Power consumption (bn kwh)



Source: CMIE

Power consumption has risen in conjunction with GDP, and helped by better supply response in FY10 and FY11. However, a slowing economy and strained financials of SEB's could constrain growth, despite strong demand and huge capacity additions.

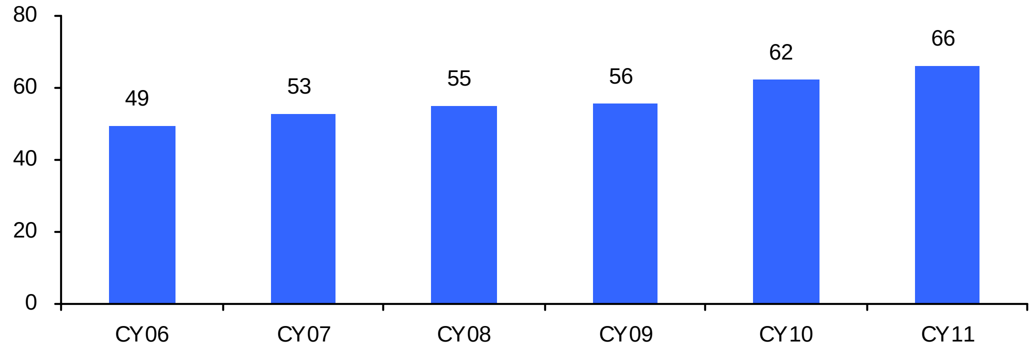
Coal production (mmt)



Source: CMIE

The surge in consumption of coal, on account of India being heavily reliant on thermal power, is borne out by the fact the despite the scale up in domestic production, we still have to import coal.

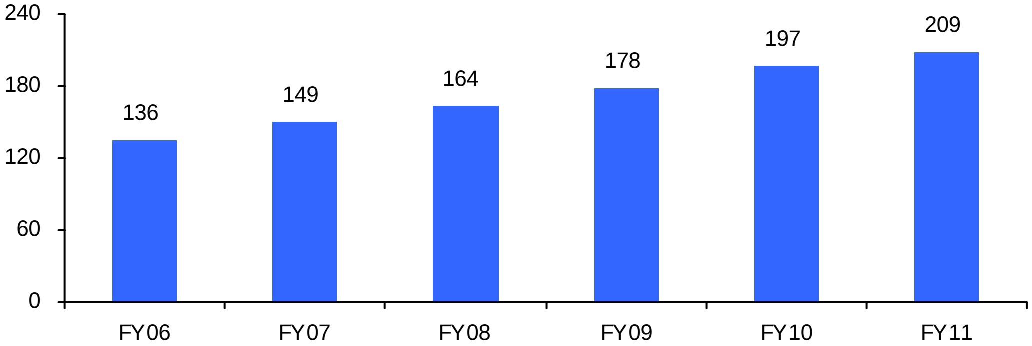
Steel consumption (mmt)



Source: CMIE

While the per capita steel demand has traditionally been low in India, slow and steady urbanisation, boom in sales of consumer durables, Infrastructural and industrial growth have maintained the consumption trend.

Cement consumption (mmt)

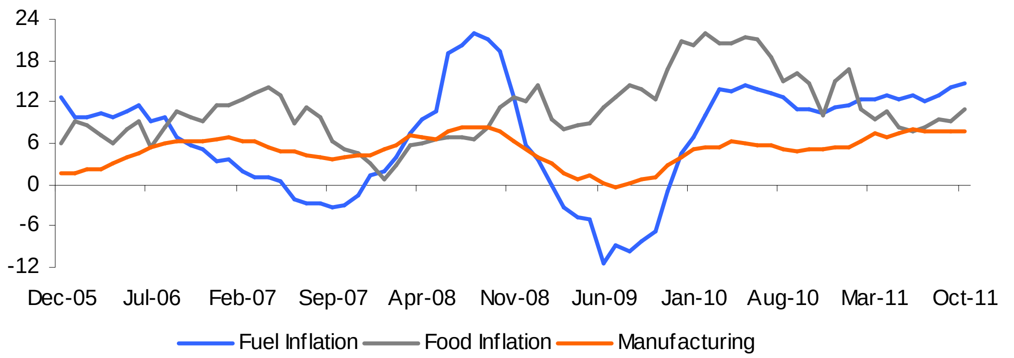


Source: CMIE

Cement consumption is expected to improve from the current growth rate of 4.7% to a more sustainable rate of 7-8%. This would be led by infra spend, corporate capex cycle, housing demand etc.

Annexure

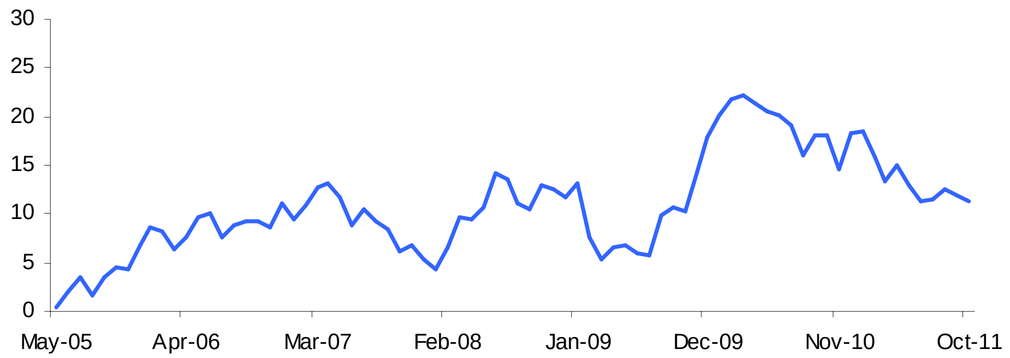
Inflation (% YoY)



Source: Office of economic advisor

Inflation has been a constant overhang as it remained elevated at ~9.7% for a major part of the year despite over 500bps on tightening on the rate front. However, of late it has exhibiting some signs of easing.

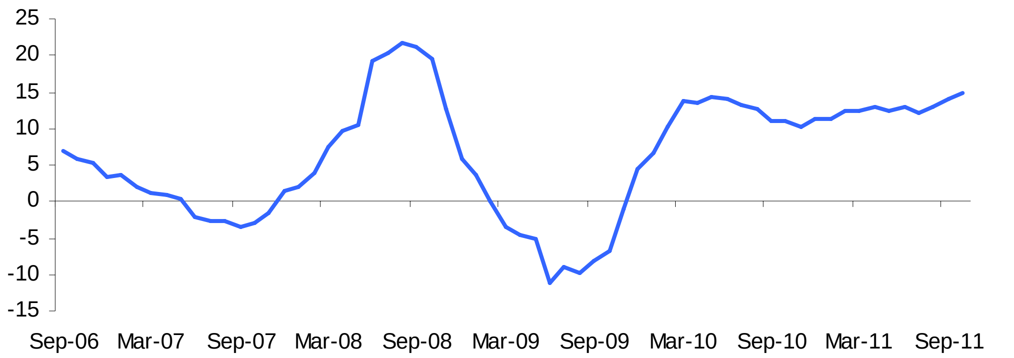
Primary article (% YoY)



Source: Office of economic advisor

Food prices have remained elevated for over a year fuelling primary article inflation for the past one year. However, cooling of food inflation due to increased supply and good agriculture harvest bodes well for us in the coming months

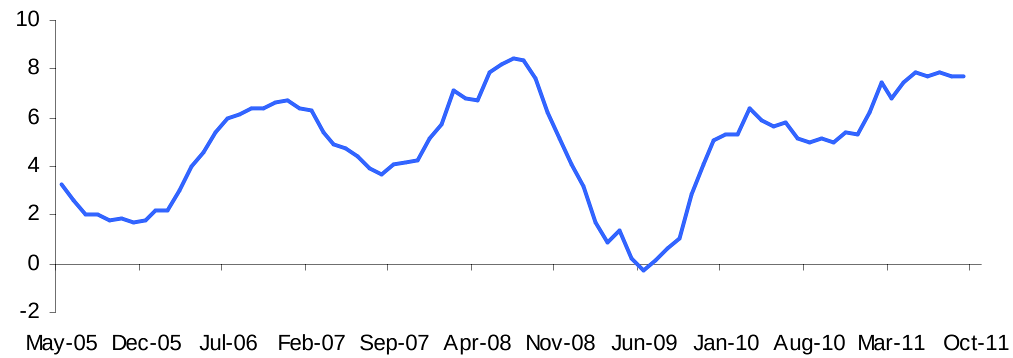
Fuel Inflation (% YoY)



Source: Office of economic advisor

Rising crude prices remain a hanging sword on our country's financial health as the crude prices has been hovering around USD100-110 per barrel. The prices have firmed up post 2Q and expected to continue to exert pressure on our fiscal deficit.

Manufacturing Inflation (% YoY)

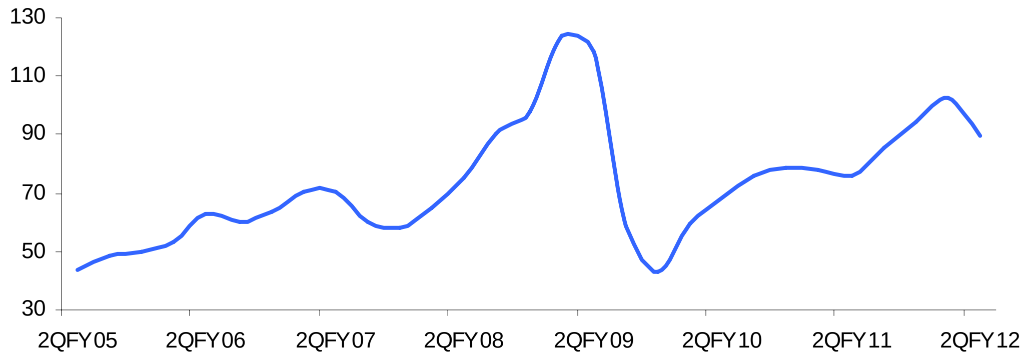


Source: Office of economic advisor

Manufacturing Inflation has been steadily inching up on back of rising input commodity costs, high interest and wages cost. While commodities have shown signs of cooling off, the steep depreciation in currency is playing the spoilsport.

Annexure

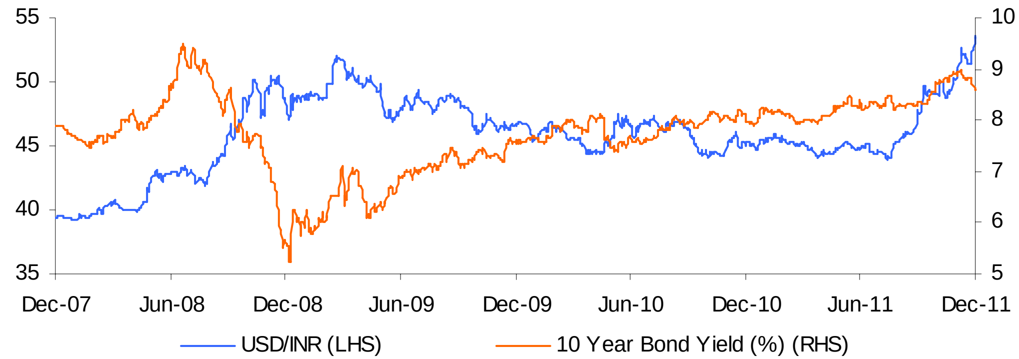
WTI Crude continues to remain a concern (USD/bbl)



Source: Bloomberg

Crude prices hovering at high levels on a sustained basis is putting strain on the fiscal situation. Not so encouraging outlook and weakening currency are compounding the situation further.

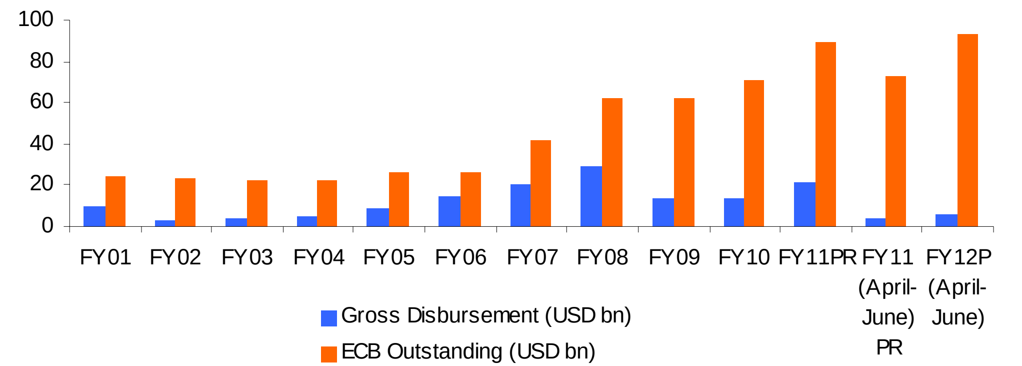
USD:INR



Source: Bloomberg

Bond yield and currency both have inched up. However we believe that with interest rates peaking, bond yields have already started to correct. Post RBI intervention the currency depreciation should also be capped.

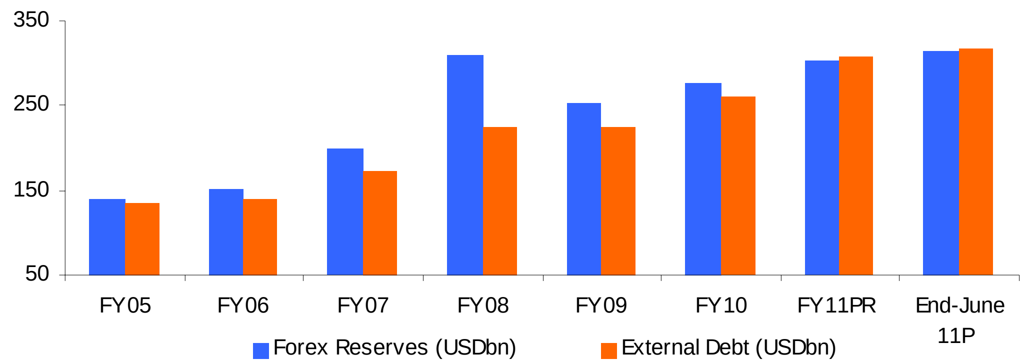
Gross Disbursement and ECB outstanding



Source: RBI

Short term ECB has shot up during last 6 quarter because of steep interest rate arbitrage

External Debt and Forex Reserves

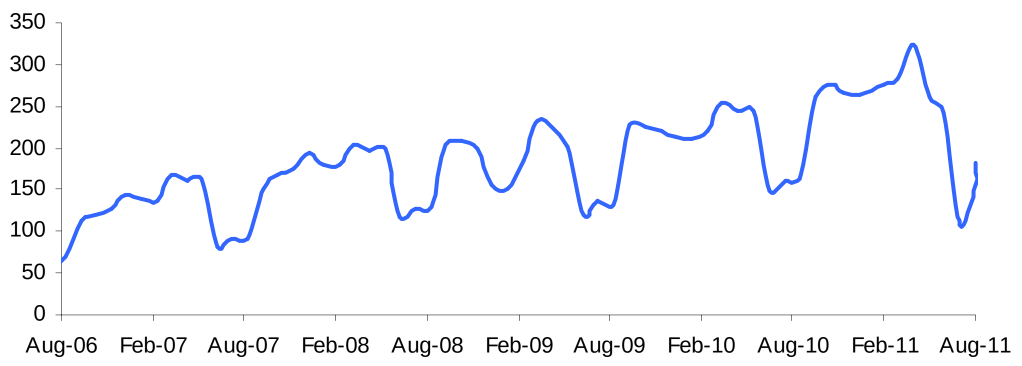


Source: RBI

External debt has moved up because of sharp overseas borrowing, this has lead to the external debt/forex reserves ratio hitting at 100%

Annexure

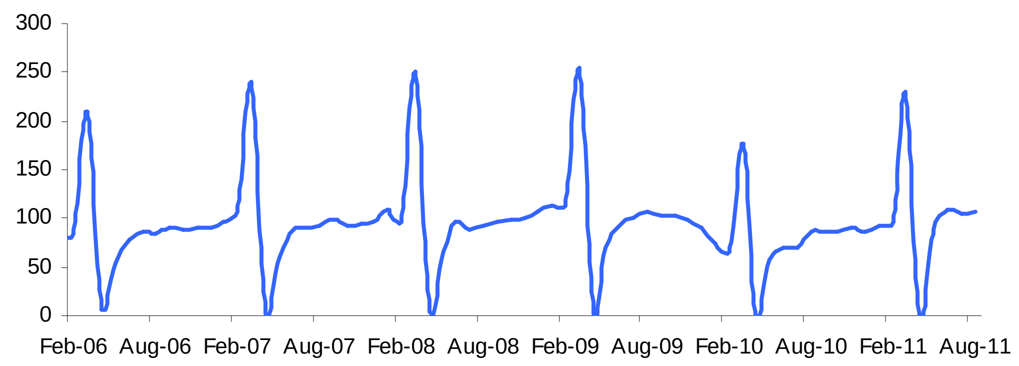
Corporation tax revenues (INRbn)



Source: CMIE

The sustained recovery in the corporate sector is borne out by the fact that tax collections have been on an upsurge after the blip of FY09. While this conveys the buoyancy in operations of India Inc., there are some questions on its sustainance.

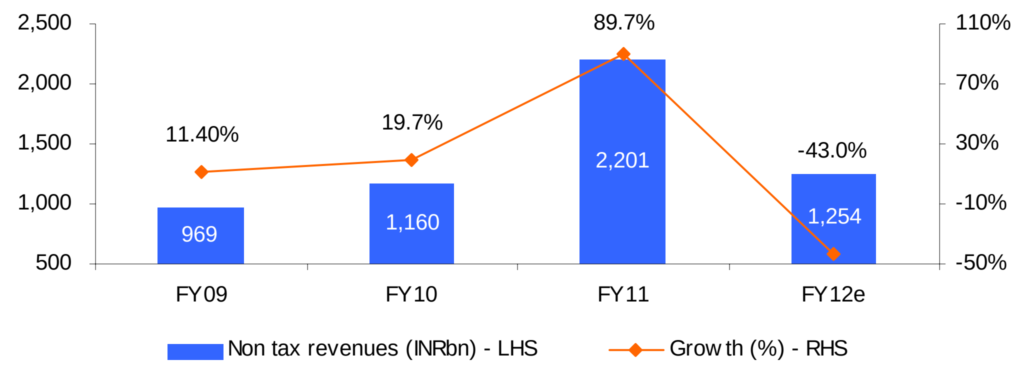
Excise duty collections (INRbn)



Source: CMIE

The improvement in demand as well as scale of operations of India Inc. can also be inferred from the robust collections of excise duty. This should be viewed in the challenging environment and the derailment of the capex cycle.

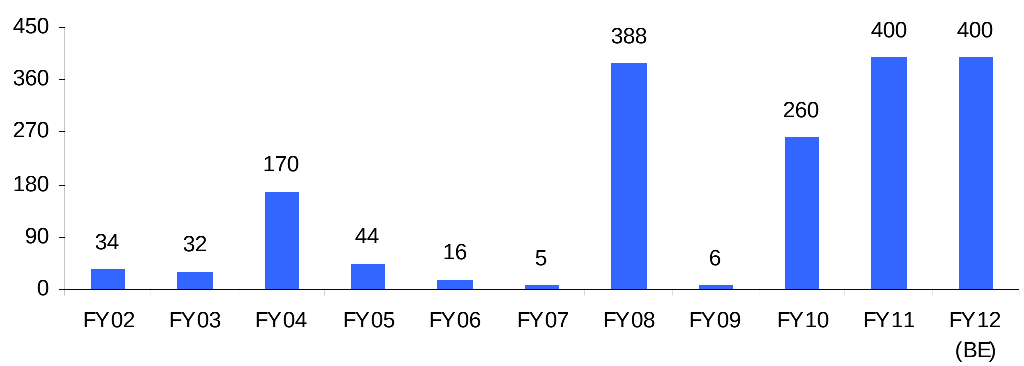
Non-tax revenues



Source: Budget document

While last year revenues from divestment and 3G / BWA auction have led to a significant rise in non tax revenues for the government coffers, this year we have no such exceptional items hence the non-tax revenues will be normalised.

Divestment trends (INRbn)



Source: Budget document

Divestment remains a challenge for government as due to poor market conditions government has not been able to garner money, however government is considering buy back of shares from cash rich PSUs to meet the target

Important Disclaimer:

Antique Stock Broking Limited

Nirmal, 2nd Floor, Nariman Point, Mumbai 400 021.

Tel. : +91 22 4031 3444 • Fax : +91 22 4031 3445

www.antiquelimited.com