Ambit Capital Pvt Ltd.

STRATEGY UPDATE

Indian Equity Strategy

In our previous reports, we have been highlighting the negative impact of the turmoil in the global and, specifically, in the Indian credit markets on the country's growth. In the backdrop of high interest rates and declining consumption levels, we believe that falling commodity prices will put pressure on earnings. The country's economy is heading for contraction as deflation sets in and GDP growth rate moderates sharply. The only positive is that the possible softening of interest rates on the back of the Central bank's recent initiatives. Our outlook for the market over the next 12 months is negative despite the sharp rally of the BSE Sensex by 22% from its October 27, 2008, lows on heightened risk aversion due to corporate governance issues and the impeding elections. We believe the GDP growth for FY10E will be close to 4.5% as India's macro environment has deteriorated.

All the three engines of growth, viz. consumption, exports, and industrial production, have slowed down. Relatively high bank lending rates have resulted in a sharp reduction in consumption growth. Export growth has slowed down because of weakening demand in the developed world. Industrial production has also decelerated significantly, resulting in the deferment of the capex cycle. Slippages on the Government of India's (GoI's) revenue receipts make us believe that the fiscal deficit will overshoot the targeted 2.5% of the GDP.

Corporate earnings over the next six quarters are likely to be severely impacted by the credit crunch, high interest rate regime, and high inflation for the greater part of this fiscal. This will be accentuated by falling commodity prices globally and slow down in the capex cycle. We expect both, the topline and bottomline of corporate India to be hit significantly as interest/financing costs erode profitability.

Recent corporate governance issues in the IT sector force us to adopt a cautious approach across other sectors, especially real estate/construction. The leverage effect is also likely to inflate the NPAs of Indian banks as stringency in adherence to accounting standards increases.

Valuation at 10x-14x range would be a favorable risk reward ratio to the investors.

EPS (Rs)	FY08A	FY09E	FY10E
Consensus Mean	856	993	1075
Ambit estimates	856	800	750

We remain positive on domestic sectors where consumption is robust, but are wary of sectors that are exposed to global cyclicality. On an MSCI India weightage, we are overweight on consumer non-durables, telecom, Pharma and utilities; we are neutral on automobiles and capital goods. We are underweight on auto components, cement, financials, metals, real estate/construction, textiles and software. We prefer large caps with positive cash flows in this environment of heightened risk on corporate governance issues.

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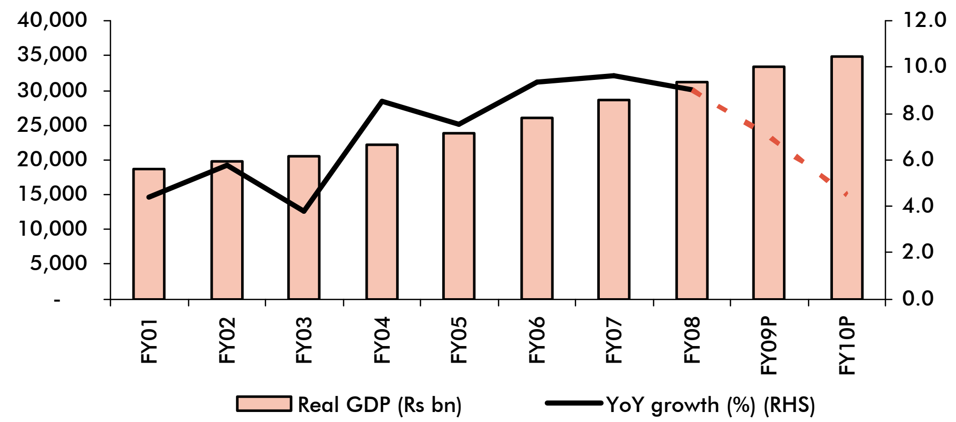
AMBIT

Growth to slowdown significantly....

Acceleration in India's economic growth since FY03 has been driven by private corporate capex. Although some slowdown in consumption was essential to reduce overheating risks (management of aggregate demand), the fear of a prolonged slowdown may seriously derail the overall growth momentum. We believe that this sharp slowdown in demand for goods has started weighing on corporate India's confidence for incremental investments. Weaker sales growth on one hand, coupled with a higher capital charge for new investments on the other, is likely to hurt corporate profitability and sentiments.

GDP forecast



Source: CSO, Ambit Capital Research

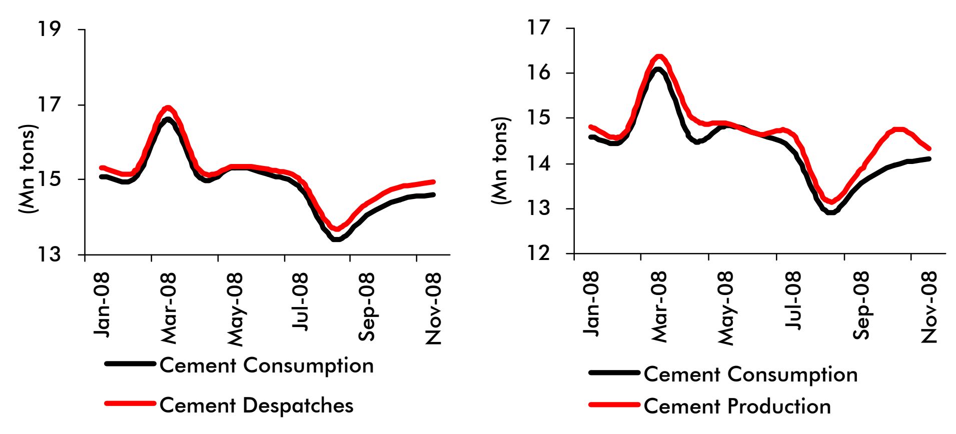
....and impact capex programs

As per a CMIE study, investments worth Rs3,000bn were scheduled to be made during FY08-09. During the first half of FY08-09, only projects worth Rs800bn were commissioned. For October 2008, corporate India announced and commissioned projects worth Rs130bn. The contraction in manufacturing since October 2008 was primarily a result of the global financial crunch and the domestic liquidity crunch. Consequently, most companies are cautious in announcing and executing new projects; not surprisingly, a large number of projects have been deferred or delayed. The negative global sentiment is also likely to delay fresh capital investments. This will clearly subdue order book growth as sales cycles get elongated. This also implies a longer conversion cycle for machinery/construction companies. Companies within the infrastructure, construction, utilities, and capital goods space are facing a negative free cash flow situation; this is likely to be clearly reflected in further derating of valuations for these companies.

....and subdue consumption levels

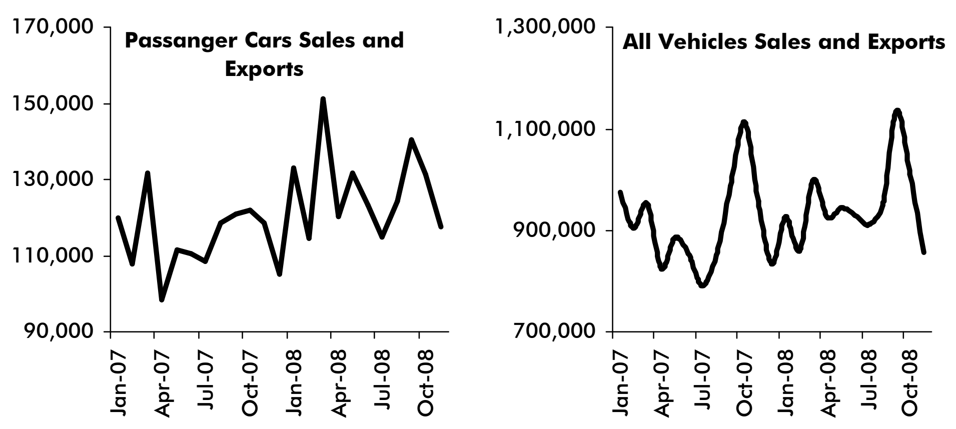
The impact of the liquidity squeeze is clearly reflected in sectors with credit-related consumer sales such as housing and automobiles (especially passenger cars). In the housing sector, our interaction with the market suggests significant slowdown across residential and commercial real estate segments.

Cement - volume trend



Source:Bloomberg, Ambit Capital Research

Automobiles (Units)



Source:Bloomberg, Ambit Capital Research

....and magnify the fiscal deficit

The Government of India (GoI) had targeted a fiscal deficit of 2.5% of GDP for FY08-09. The pace of measures undertaken by the Reserve Bank of India (RBI) for easing monetary pressure has resulted in significant unplanned Government expenditure. Also, given the high rate of interest and the consequent fallout in consumption, tax and excise collections have been dour during the first half this fiscal. With a negative output in the economy, excise and tax collections for the last two months have seen a huge dip. With slippages such as these likely on the receipts front, we expect to see a large gap in GoI's revenue account; this could push fiscal deficit over the targeted 2.5% of GDP during FY08-09.

Slowdown to trigger softening of Interest Rates

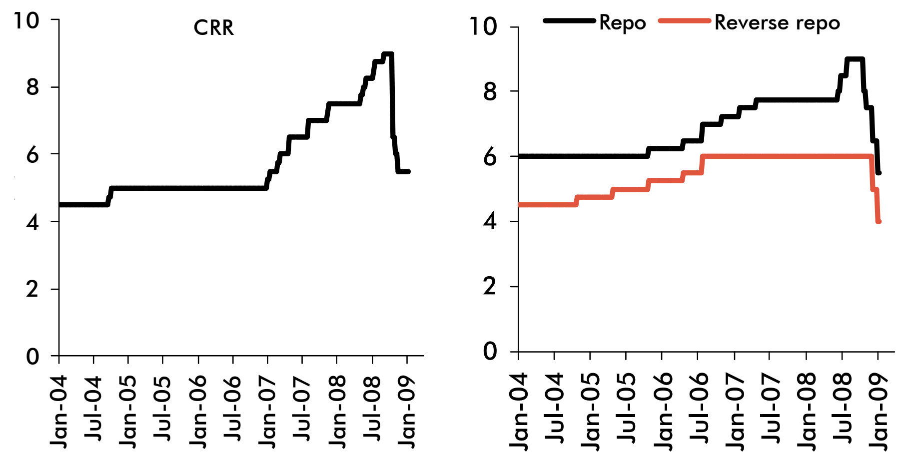
Given the shift in policy focus - from controlling inflation to stimulating growth - the RBI has been on a monetary accommodation spree over the last three months. These measures have infused primary liquidity to the tune of about Rs3000bn into the financial system. As a result, the liquidity position within the system, as reflected in a surplus LAF position, has been comforting, especially since late November 2008.

The RBI has sent a clear signal of a reversal in the interest rate cycle. However, the banking system, especially private sector banks, is awaiting a tangible and visible impact of this reversal on their cost of funds before passing on the benefit to borrowers.

Given the lag effect, banks (mostly private sector) have been slow in easing their respective lending rates. In contrast, public sector banks have been coerced into easing their lending rates; the top five public sector banks have reduced their BPLRs from a range of 13.75-14% to a range of 12-12.5%. However, we believe that private sector banks would have to follow suit for staying competitive on the lending front, given the potential systemic stress that faces corporate India. Private sector banks account for close to one-fifth of the advances within the banking system.

Although recent RBI initiatives have seen some nominal easing in prime lending rates (especially by public sector banks), interest rates have to soften significantly to reverse this trend.

Easing of policy rates (%)



Source: RBI, Ambit Capital Research

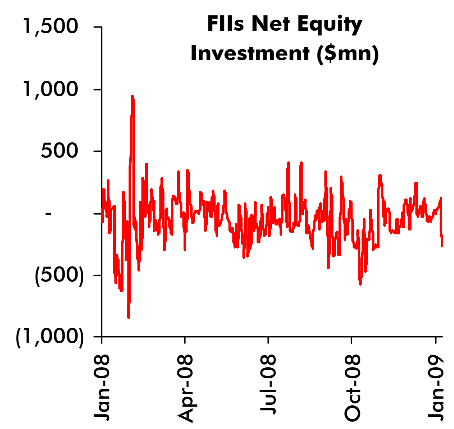
Lag effect to impact corporate profitability

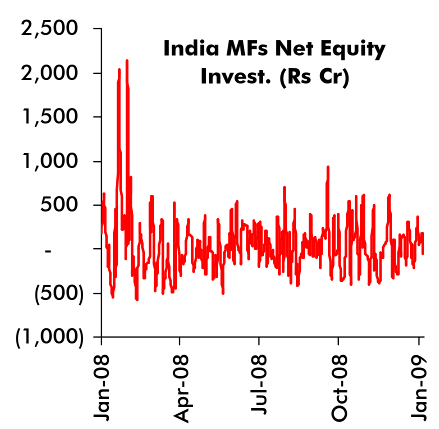
The slowdown in topline from the current quarter is likely to stem from a slowing growth in the sales of the manufacturing sector. Corporate profits are expected to tumble due to muted revenue growth, disproportionate passing on of input costs, rising power and interest costs, and investment down-cycle. The steep fall in commodity prices and lower volume growth would moderate sales growth of the manufacturing sector. High borrowing cost in the current liquidity crunch scenario is expected to impact profitability across the board. Going forward, we expect sectors like metals, cement, edible oils, and automobiles to witness significant slowdown as realizations dip. Export-oriented sectors like textiles, auto components, software, and the tyre industry are also likely to report lower business. Overall, the manufacturing sector is expected to see a downturn due to huge inventory losses by refineries. Aggregate sales growth is likely to be bolstered by the telecom sector.

Earnings to remain vulnerable to negative news and serious corporate Governance issues in the near term

We expect negative surprises on the earnings front and believe that the consensus is too optimistic for FY10. We believe that earnings impact follows the market response to the credit crunch with a lag effect. In the short-term, the market lacks positive catalysts. With corporate governance becoming a serious issue, accounting practices are likely to come under tight scrutiny.

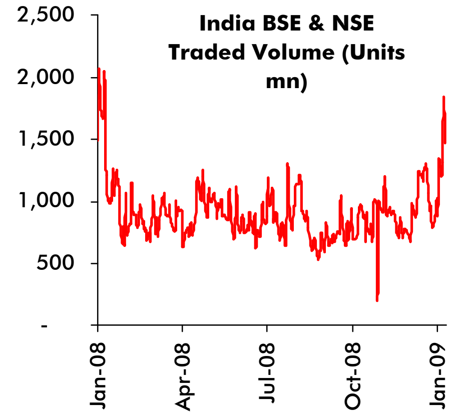
Flows in the equity market

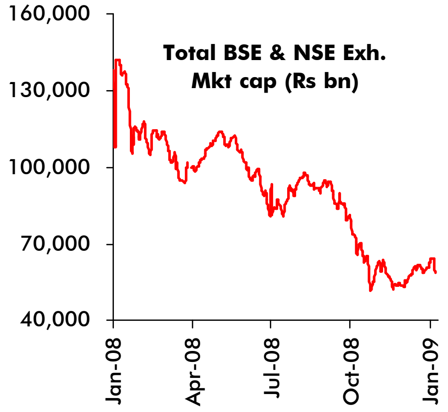




Source: Bloomberg, Ambit Capital Research

Trade in volumes and market cap erosion





Source: Bloomberg, Ambit Capital Research

The ripple effect of high leverage

Earnings are likely to face pressure due to higher base effect arising from record level of margins and high other income. We are now forecasting a slowing topline due to a down-cycle in the global and domestic economy. Sectors that are seriously impacted by leverage include commodities, real estate/construction, banks, and industrial sectors.

Over the past few years, operating and financial leverage supported the growth in earnings. In the current down-cycle and a deflationary environment, we expect the advantage of leverage to reverse.

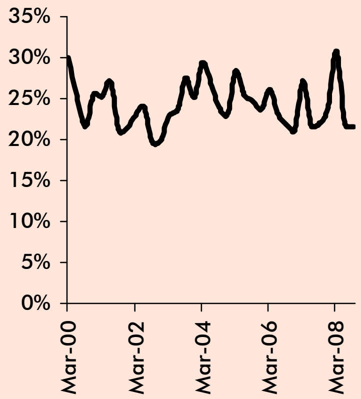
We believe that the high interest rate and high level of debt would result in lower Return on Capital (RoC) as margins decline and asset turnover drops in a down-cycle. RoE is also likely to fall from relatively high levels. The quality of earnings would also be in question. Therefore, we believe that the consensus is still optimistic.

Operating Leverage high: Telecom & Energy are most vulnerable

Delta in Margin (Mar 04 over Mar 08)

	Gross Margin	EBITDA Margin	Gross Margin	EBITDA Margin	Total
Automobiles	28%	10%	-2%	-2%	0%
Cement	61%	26%	3%	-2%	-5%
Energy	36%	22%	-17%	-3%	13%
Engineering & Capital Goods	61%	16%	12%	4%	-8%
FMCG	49%	19%	-2%	-2%	0%
Metals	62%	15%	-1%	-13%	-12%
Pharma	56%	9%	-1%	-7%	-6%
Telecom	78%	42%	-15%	8%	23%
Total	55%	24%	0%	-2%	-1%

Operating Leverage tending Lower Ebitda margins - gross margins for sensex stocks



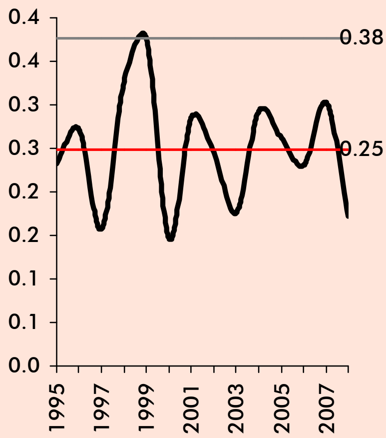
Source: C-line, Ambit Capital Research

Financial leverage to hurt

RoE is high relative to history and as it normalizes on the back of higher interest rates that exist currently, higher debt to equity, the financial leverage will decline sharply.

	Current ROE	Current to Max	Current as SD from Avg	Change in Past 5 years
Automobiles	24%	3%	11%	15%
Cement	30%	0%	8%	18%
Construction	21%	32%	14%	9%
Energy	20%	0%	3%	2%
Engineering & Capital Goods	25%	1%	6%	14%
Financial Services	13%	7%	2%	-6%
FMCG	37%	2%	4%	3%
IT	33%	6%	7%	5%
Metals	15%	12%	6%	-2%
Pharma	24%	10%	8%	-9%
Telecom	20%	7%	7%	20%

Earnings Quality Deteriorating Op Cash Flow to PAT



Source: C-line, Ambit Capital Research

Banks at risk of rising NPAs as systemic risks sets in

Exposure of banks to the three sensitive sectors viz. capital markets, real estate, and commodities, has shown a mixed trend. Over the past three years, advances to capital markets and real estate have grown at a CAGR of 58% and 45% respectively. Exposure to these sectors has grown at a slower pace than the overall credit growth due to tightening of prudential norms. The proportion of loan book exposed to sensitive sectors remained constant at just over 20% of gross bank credit over the last three years.

Apart from this, sectors (within industry) such as infrastructure, metals, and textiles account for a double-digit share at 23%, 12%, and 11% within the systemic gross non-food credit.

Given our outlook of a difficult macro-environment and slackening of demand in the near-term, we expect these key sectors to face systemic stress. As a result, banks are likely to face incremental stress on their loan books; this would start showing up in terms of movement in absolute Gross NPAs. However, for asset quality (as indicated by Gross NPAs as a proportion of Gross advances) to take a sharp hit, gross NPAs would need to grow faster than the growth in loan book. Though we believe that asset quality (at an aggregate level for the system) is unlikely to deteriorate during FY09E, FY10E could witness a marked deterioration unless the demand side is addressed adequately.

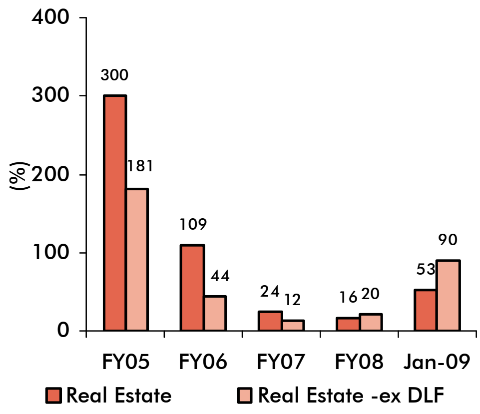
In the worst case scenario, Gross NPAs, as a proportion of Gross Advances (at an aggregate level), could deteriorate from current levels of 2.25% to 2.54% of the gross bank credit by FY10E (assuming overall credit growth slows down to 20% during FY10E).

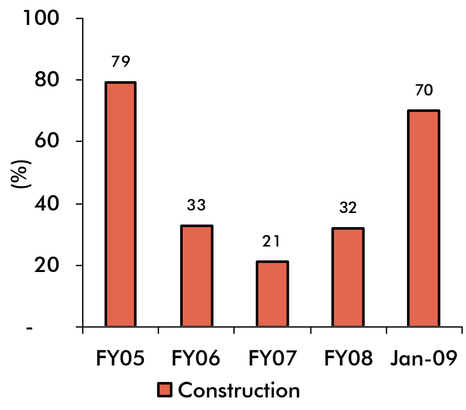
Real Estate/Construction companies to be under the Corporate Governance lens: Our study on the listed companies in real estate sector and data points suggests that the sector has an extremely high exposure to debt; in smaller, mid-rung companies, the debt/market cap is more than 2x (see table below). This exposes these companies and their lenders to high risk of default, should they be unable to sell their inventory; this is because, the cost of carry is very high for the real estate companies and their lenders. This risk has been further accentuated by the recent erosion in the market cap of these companies with the meltdown in the equity markets. Our conversation with real estate/construction and infrastructure companies revealed that their peak borrowing rates had eased by 100bps; moreover, their margins are also likely to squeeze by 150-300bps as sales cycles get elongated and the cost of carry remains high. With new equity financing on hold due to unfavorable capital markets, prevailing high interest rates, and reluctance of banks to lend to real estate sector, the sector is becoming vulnerable to defaults.

Real Estate	D/Mcap (x)
Ansal Properties and Infrastructure	3.2
HDIL	1.0
IVR Prime Urban Developers	1.4
Omaxe	2.2
Orbit Corporation	2.5
Parsavnath Developers	2.3
Sobha Developers	2.5
Unitech	1.4

Source: Companies, Ambit Capital Research

Debt to Market Cap

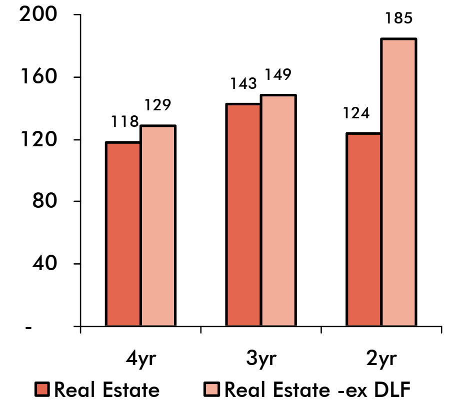


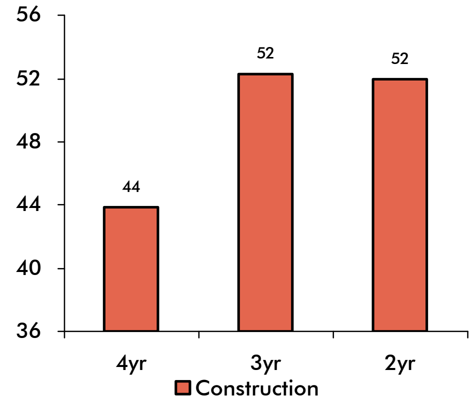


Source: Companies, Ambit Capital Research

Construction and materials segments: Given this sector's correlation to the real estate sector, it has been impacted by the current downturn in the domestic market. Moreover, a slowdown in the IT sector due to the worsening global macro scenario has impacted the development of new SEZs and residential/ commercial properties. Construction companies are reluctant to embark on new real estate projects due to payment delays and a huge order backlog of 3-4x trailing revenues. The elongated sales cycle is also reflecting on their working capital and, thereby, subdued margins. With the new fiscal stimulus in place, the scenario may improve only when interest rates soften by another 150-200bps, facilitating the reduction of the cost of financing working capital to below 12%.

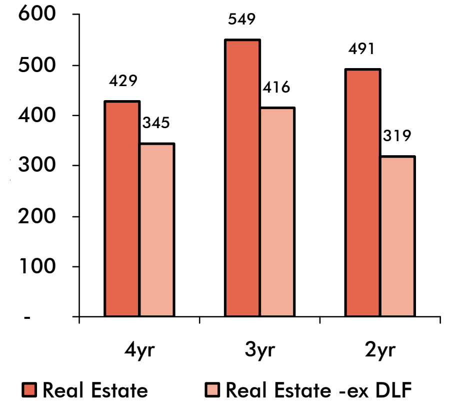
Debt CAGR - FY08 (%)

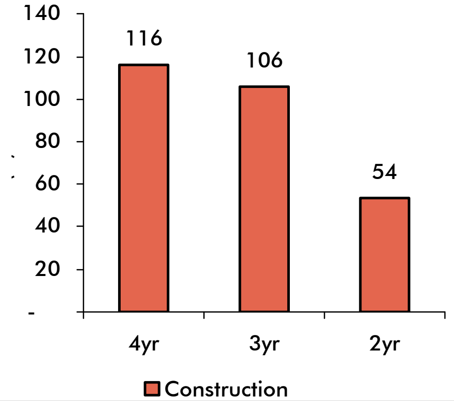




Source: Companies, Ambit Capital Research

Market cap CAGR - FY08 (%)

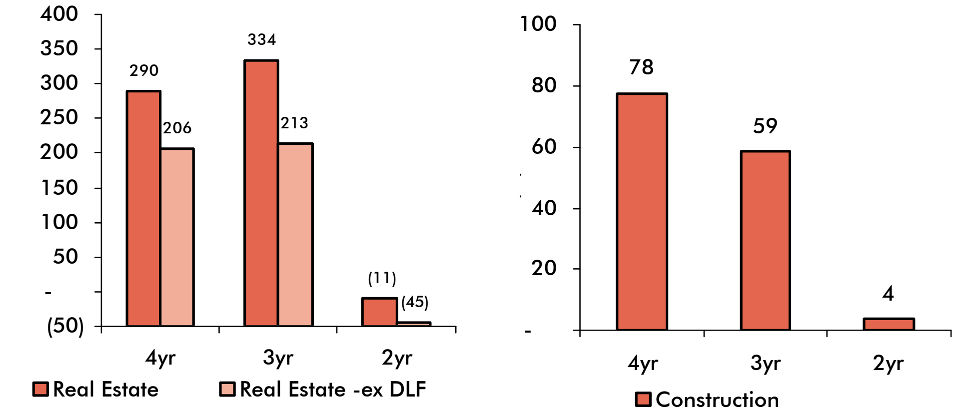




Source: Companies, Ambit Capital Research

The above charts indicate that with the boom in infrastructure spending, the real estate and construction companies raised funds from the market, and the market cap growth over 4yr-3yr-2yr period was higher than debt CAGR. Many developers, that acquired land at high prices due to the property bull-run, are now finding it difficult to service high debt. Moreover, retiring debt by new equity issues does not seem to be a feasible option in the current market scenario. We believe that banks would incrementally put pressure on builders to sell the inventory and take a cut on margins. We would see this happening with some developers announcing rate cuts whereas others using lower floor area and composite materials to cut development costs.

Market cap CAGR - YTD (%)



Source: Companies, Ambit Capital Research

As of January 09, 2008, the market cap CAGR shows a negative divergence for two-year CAGR; debt levels, however, have not come down significantly. This also indicates that developers and construction companies would find it incrementally difficult to leverage equity; hence, they would either have to do better working capital management or delay new order bookings. Since delaying order booking would slowdown the development activity, banks would need to reduce interest rates to fuel infrastructure spending. We believe that financial institutions do understand that they are running a high risk on their exposure to these sectors, and would take favorable steps to curtail this contagion. The GoI is taking adequate steps in terms of monetary and fiscal measures; however, more is expected to bring these sectors in the profitable growth territory.

Valuation at 10x-14x range would be a favorable risk reward ratio to the investors.

EPS (Rs)	FY08A	FY09E	FY10E
Consensus Mean	856	993	1075
Ambit estimates	856	800	750

Over the past 10 years, the Indian markets, on an average, traded at a band of 12x-16x Sensex earnings. In the backdrop of a global slowdown, we could see a significant earnings revision in the Bloomberg Consensus estimates.

We believe that consensus forecast for FY10E is bullish. Bloomberg Sensex consensus Index EPS for the mean average is Rs1,075. We believe that the Sensex will report an EPS of Rs750. The trading band of Sensex will be 7500-10500 at trough valuations of 10x-14x earnings. At the historical decade average of 12x-16x earnings, Sensex should trade in a band of 9000-12000. Our reasoning is that the consensus is still reasonably bullish on sectors such as oil & gas, real estate, software, financials, power, and commodities in FY10E.

The Sensex, at current valuations, trades at a P/BV of 2.0x. Sensex, during 2000-04, has traded at an average of 1.7x at trough valuations.At Rs5,210 estimated Bloomberg Consensus BV for FY09, at trough valuations, it translates into a Sensex target of 8,857.

After the recent Satyam fiasco, good governance, better cash flows, and management quality will emerge as critical issues for blue-chip companies. We believe investors will move to safety due to heightened risk aversion on corporate governance issues. The focus will be on large caps with a positive cash flow and low leverage.

We expect the markets to be range bound with a negative bias till the elections are over and the new Government is in place. The positive trigger could be a strong Government, facilitating a shift of focus from a slowdown to a policy framework that lends support to long-term fundamentals. A potential risk, however, is the formation of a weak Government leading to further stressing of valuations.

Themes for sector selection

MSCI India Sector	Sector Weights	UW/OW/Neutral	Comments
Auto	3.5	Neutral	Car and truck manufacturers to remain under pressure rising costs, declining volumes and pressure on currency. Two wheelers fare better on lower debt levels. But given the current financial condition there are no clear signs of a pick-up. Very sensitive to interest rates.
Banking and Finance	23.2	Underweight	Indian banks are well capitalized and asset quality has been good. In a high interest rate scenario and a downturn as of now we could see the NPL move up.
Capital Goods	6.5	Neutral	Challenging but do not expect it to trade at trough valuations given the huge order backlog and diversified business. Near term risk of order slowdown if high interest rate persists.
Cement	2.3	Underweight	Huge capacity addition presents risk to pricing. Governmental interference on pricing it reflects difficulty in passing on the cost pressures. We are neutral on the sector despite valuations being cheap on a replacement cost basis.
Construction	2.3	Underweight	Fundamentals points to a down-cycle with shortfall in net cash flows, asset-liability mismatches and tightening access to finance .Slowing growth, falling margins, rising debtors and high gearing are all pointers to a fundamental decline.
FMCG	8.5	Overweight	A defensive play and as it is a domestic play and historically the sector had the least volatility in its earnings growth. Decline in commodity prices will help margins.
IT	14.7	Underweight	Valuations are undemanding but face the headwinds in terms of slowdown in the volume growth and pressure on the pricing in short to medium term. A weakening macro environment and an anticipated slow recovery in the US economy will lead to an immediate term slowdown for the Indian IT.
Metals	5.1	Underweight	Cheap valuations camouflage earnings risk on collapse of commodity prices and deceleration in the demand growth
Oil	21.4	Underweight	Margins are likely to come under pressure as companies post their capex phase are faced with high costs (Interest cost mainly) and subdued realizations. Remain neutral on Upstream/Refining in the short term. We are Positive on natural gas space as valuations have turned attractive.
Pharma	4.2	Overweight	Defensive sector in volatile markets but competitive landscape challenging
Power	4.7	Overweight	Order book strong but in a down-cycle. Capex getting postponed as consumption falters.
Telecom	2.9	Overweight	Secular growth story and defensive being a domestic play and continues to benefit from high subscriber base additions. Tower sharing business with the entry of new players to increase the tenancy rates and profitability of tower companies. Regulatory risks exist.

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