India Strategy-- Maintain UNDERWEIGHT

Not the time to sell, even with a dire world view

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- The steep Sensex fall has proven two of our fears: (1) the Indian market is linked to the world if the global slowdown is not mild; and (2) foreign flows are the biggest driver of the market.
- For a value investor that does not have positive views on external flows, only a Sensex fall below 13,000 would represent an entry point justified from a valuation viewpoint.
- That said, we believe that this is not the time to sell even for those with the dire views on the world economy. India is likely to be on a highly reflationary policy drive in the coming weeks unlike most others in the emerging world. We feel that the market fall has raised the chances of both interest and tax rate cuts by Feb-end.
- Investors should remain OVERWEIGHT sectors where underlying earnings growth has little to do with financial markets or the global economy, i.e., engineering goods, construction, natural gas, consumer staples, and domestic growth themes such as rural income. In the likely market rebound in Feb, investors should aggressively trim equity market dependents such as stock brokers, energy companies, corporate-event plays and companies with large subsidiaries without visible income.

Not yet the time to buy for value investors ...

In our year-beginning report, “The flow flaws and follow-ups”, we had highlighted how the Indian equity market is critically dependent on external flows that carried a materially lower cost of capital to justify its lofty levels. We asserted that these flows were our connection to the global economy and could matter if the global economy charted a path worse than generally believed.

In a matter of weeks, the global economy to most appears on a sure path to economic mayhem. It took a while for investors to lose faith in otherwise high-beta India, but the decoupling opinions are now out of window with the Sensex losing nearly a quarter of value in a fortnight.

For those indifferent to 22x-plus multiples, the fall may seem a good buying opportunity. We would disagree on valuations. MSCI India is still at a 25% premium to its 5-year average P/E. In the report mentioned above, we had talked of 16,500 as the end-2008 fair-value for the Sensex without external liquidity support but with highly aggressive assumptions. As risk aversion rises and we see more earnings downgrades, this could easily come down to around 13,000.

Figure 1: End-2008 Sensex fair values under different assumptions for risk premium and EPS year-one growth rate adjustment

	Revision in FY1 earnings (%)				
Risk premium adjustment (bps)	-10	-5	0	5	10
300	14,104	14,854	15,604	**16,355**	17,105
350	13,370	14,082	14,794	**15,506**	16,218
400	12,683	**13,359**	14,035	14,711	15,387
450	12,040	**12,682**	13,324	13,967	14,609
500	11,438	12,048	12,659	13,269	13,880

Note: Sensex fair values calculated by applying a percentage discount/premium of MSCI India to Sensex actual value.
Source: Datastream, Credit Suisse estimates

. . . but no longer the time to sell

The fears, for those worried like us, are (1) actual redemptions (so far, there is no widespread panic selling); (2) institutional investor failures (sharp global equity drops could lead to large losses for some and forced deleveraging, if not outright closures); and (3) retail withdrawal in India where retail participation had reached frenzied proportions. Beyond these, we need to see the actual impact of a global slowdown on earnings/commodity prices as well as the economic impact of less corporate events in the case of our domestic-dependent story.

In short, if the global economy does not perform materially better than what was implicitly feared at the bottom of the market today, the Sensex could have many more lows to register this year. Yet, we would advise even investors with a highly pessimistic global view not to sell at the current point. We see three main reasons for this:

- It is not given that the world economy stands no chance. As policymakers in the developed world put their best feet forward with aggressive reflationary policies, the probability ascribed to the negative eventuality in financial markets will likely fall in the coming weeks at least for a while. (We feel that Bernanke’s 75 bp cut yesterday will not be the last).
- If the central bank was still unsure about the necessity of a rate cut a few weeks back on account of equity market valuations and flows, those fears are now replaced by the opposite. We expect the RBI to announce some policy easing moves, if not outright interest rate cuts, next week.
- The finance minister had hinted a review of income tax rates in the Christmas week given strong tax revenue collection. The government is likely to be more determined to embark on a mildly reflationary policy to make sure the economy and markets remain on a reasonably positive path in this pre-election year.

Stay away from financial market dependents

We have been and continue to remain OVERWEIGHT on most of the defensives, such as staples, healthcare and public sector banks. We also like strong domestic growth themes of which rural income is our most preferred (O/W through select consumer discretionary, farm investment and rural consumption stocks). Other themes we like include natural gas (O/W through GAIL) and Indian education services.

Despite valuation concerns on select high beta sectors, we do not think that it is appropriate to turn completely defensive. We continue to be OVERWEIGHT on engineering/capital goods and construction, where even sharp valuation de-rating near-term could be offset by strong growth in earnings in a few quarters. Investors should look for profit-taking opportunities in what we deem as “reflexive” sectors—i.e., companies whose earnings or market valuations depend on capital market health—those with subsidiaries whose valuations depend on private placement transactions or imminent listing, or companies that are actively involved in capital market trading or investments.

Companies Mentioned *(Price as of 21 Jan 08)*
GAIL (India) Ltd (GAIL.BO, Rs421.60, OUTPERFORM, TP Rs554.00)

Disclosure Appendix

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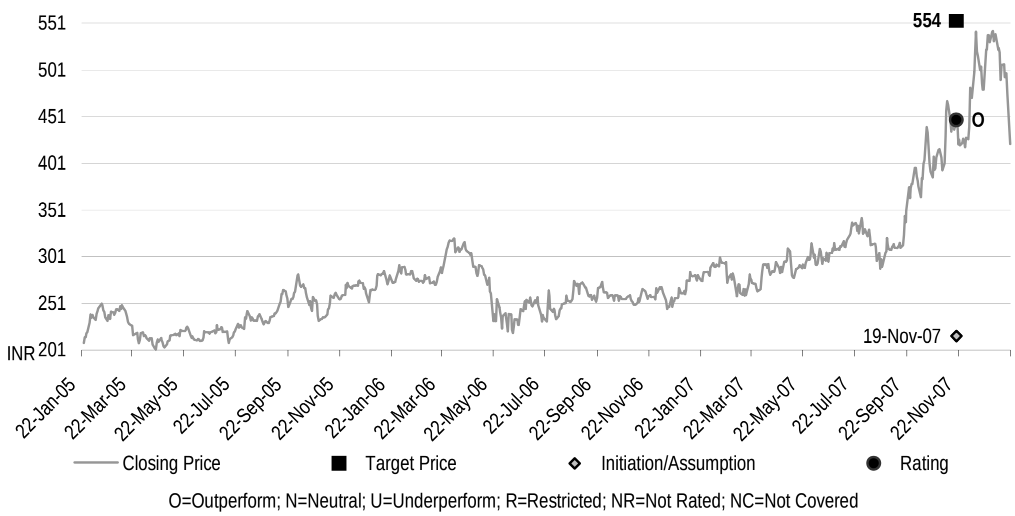
See the Companies Mentioned section for full company names.

3-Year Price, Target Price and Rating Change History Chart for GAIL.BO



GAIL.BO Date	Closing Price (INR)	Target Price (INR)	Rating	Initiation/ Assumption
19-Nov-07	447.4	554	OUTPERFORM	X

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Method: Our target price for GAIL.BO of Rs.554 per share is based on a DCF model using a WACC of 12% plus the value of investments and expected E&P expenditure. We forecast rapid increase in the amount of gas transported on GAIL's pipelines and incorporate specific new pipeline that are proposed to be constructed by the company

Risks: Risks to our target price of Rs.554 for GAIL.BO arise if a) natural gas supplies in India are less than forecasted, b) petrochemical prices decline faster c) large amounts of new gas is consumed on the east coast of India, where GAIL does not have a dominant position

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