INDIA

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India Equity Strategy

2Q2006 Outlook – Safety First, As Bubble Arrives

- **End-2006E Sensex fair value remains 8500, 25% below current level. Recent earning upgrades (positive) negated by rise in interest rates (negative) on our market valuation models**
- **Remain defensive; position for market cool off - although not as highly valued as earlier peaks, the Indian market now appears to be in a bubble zone. Flows of recent scale are hard to sustain**
- **Tightening banking sector liquidity - a key fundamental concern Central bank interventions are now needed to avoid tightening liquidity and rising rates becoming detrimental to growth**

CONVICTION BUYS

TCS: Growth visibility, relative value to peergroup
(TCS.BO, Rs1914, 1M, TP Rs2000)

BHEL: Growth visibility from strong order flows
(BHEL.BO, Rs2247, 1L, TP Rs2256)

Bharti Aircel: Sustained growth, improving scale
(BRTI.BO, Rs413, 1M, TP Rs450)

CONVICTION SELLS

Gujarat Ambuja: Near term upside limited by open offer price, valuations
(GACM.BO, Rs103, 3L, TP Rs92)

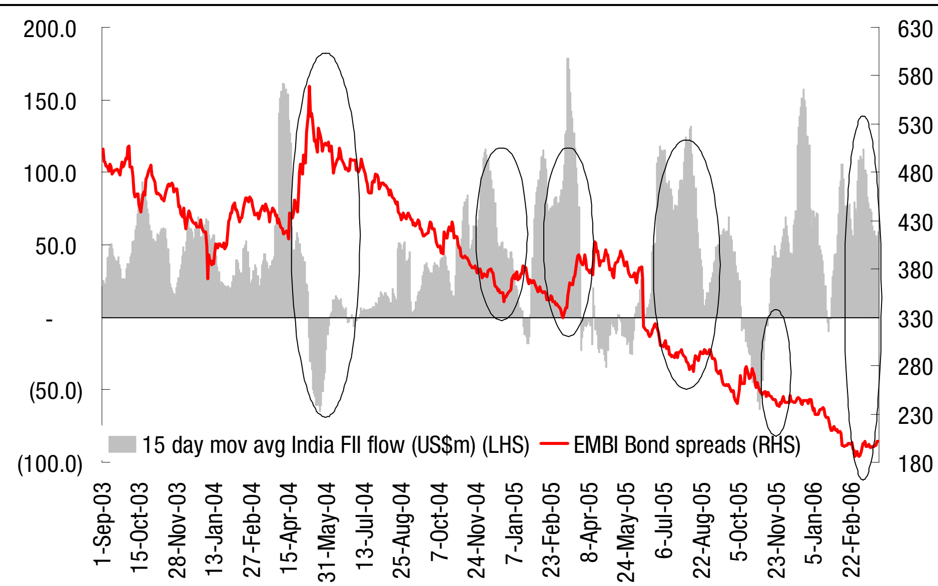
Hindustan Lever: Excessive optimism on rural growth and price increases
(HLL.BO, Rs272, 3L, TP Rs150)

MTNL: Core business continues to be under threat
(MTNL.BO, Rs184, 3L, TP Rs97)

Local flows join the party

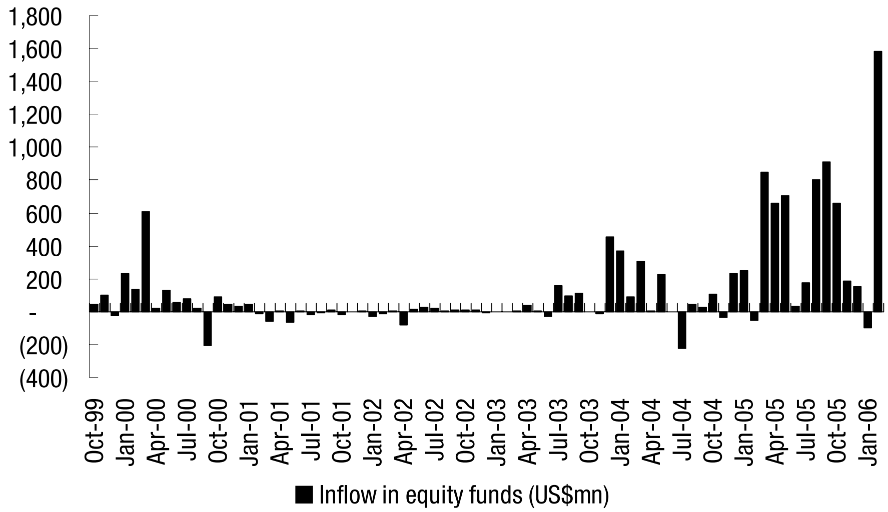
The Indian market's near one-way 23% run up in the first 3 months of 2006 has been characterized by continued big FII inflows and resurgence in flows into domestic equity funds. With EMBI bond spreads bouncing around near all-time lows (indicating high global risk appetite), FII flows have remained very strong at US$3.9bn in 2006YTD (US$10.8bn in 2005). Resurgence of flows in local equity funds has only added fuel to fire. Feb'06 net inflow of US$1.6bn into local equity funds was the biggest in a decade. Considering that local fund buying in the secondary market is only US$0.5bn in 2006YTD (vs. net inflow of US$1.5bn over Jan-Feb'06), there could be more money waiting to come in.

Figure 1. India FII inflows and EMBI Bond Spreads



Source: Bloomberg, SEBI, Citigroup Investment Research.

Figure 2. Inflows into Domestic Equity Funds (US$m)

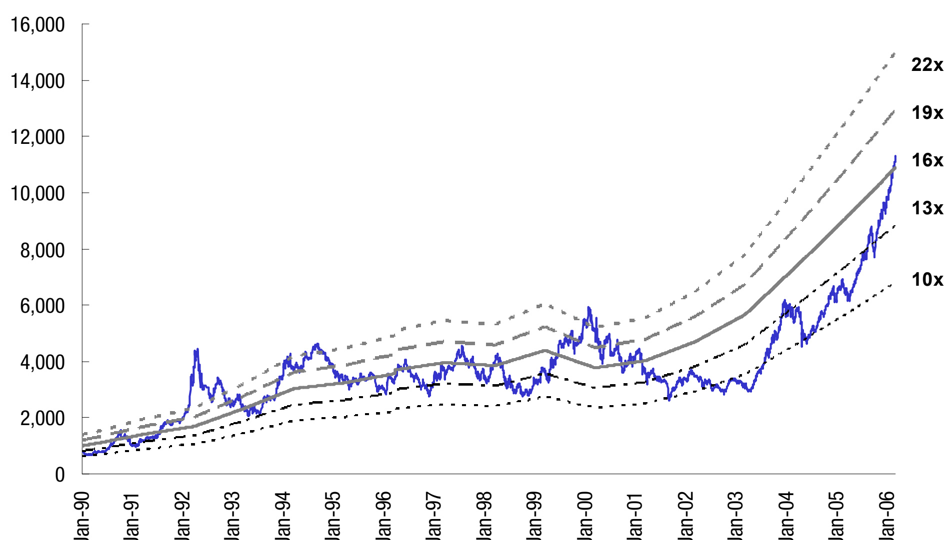


Source: AMFI, Citigroup Investment Research.

Valuations – The Bubble arrives. Caveat emptor!

Relentless flows from foreign as well as local sources appear to have decisively put the Indian market valuations into a bubble zone now. While current level of overvaluation on our market valuation models is still well below those seen in earlier market peaks, current overvaluations have only been seen in bubble periods and warrants extreme caution.

Figure 3. BSE Sensex 12mth Forward PE Bands



Source: Citigroup Investment Research.

On 3 April, 2006 Sensex closed at 11564, the Indian market now trades on FY06E and FY07E PE of 20.4x and 17.0x, respectively. Forecast 2-year earnings CAGR is quite healthy at around 15% and has seen some analyst upgrades recently, but is not sufficient to justify the market's current high ratings, given recent interest rate increases.

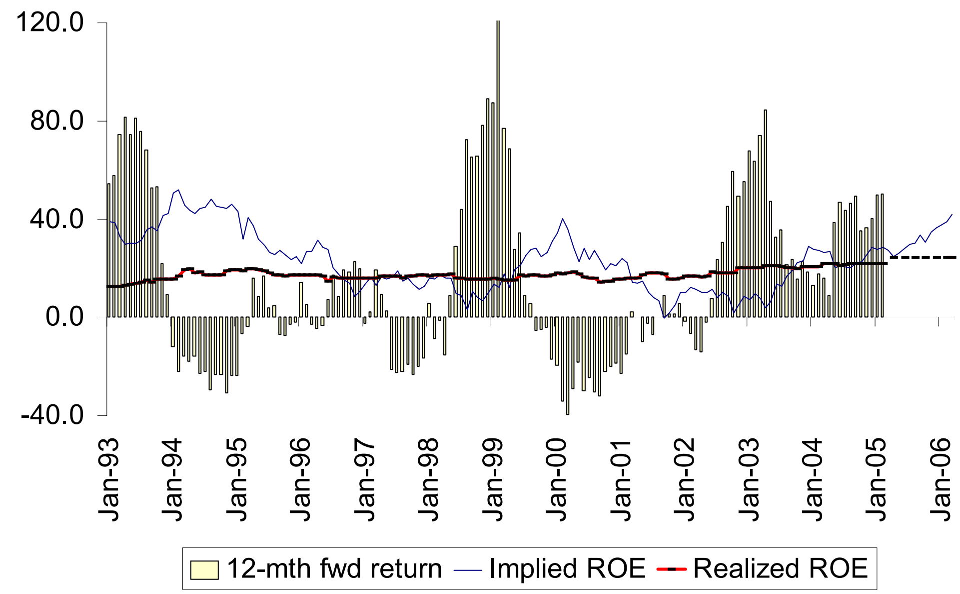
Figure 4. Sensex Valuation Summary (@11,564)

Year to 31 March	FY04	FY05	FY06E	FY07E	FY08E
EPS growth (%)	21.8%	36.7%	18.1%	20.2%	10.3%
P/E (x)	33.0	24.1	20.4	17.0	15.4
Div. yield (%)	1.0%	1.2%	1.4%	1.6%	1.7%
P/B (x)	6.3	5.3	4.4	3.7	3.3
ROAE (%)	21.0%	24.3%	23.6%	23.8%	22.5%
EV/EBITDA* (x)	17.5	13.2	11.3	9.6	8.8
Net Debt/Equity* (%)	20.4%	12.6%	10.0%	8.6%	4.8%

Source: Citigroup Investment Research estimates. *Ex-financials.

For India, we have always recommended looking at valuation tools that look at India as a standalone equity asset (rather than a relative valuation measure vs. Asian or emerging markets. Incidentally, the market is more expensive on relative measures), using its earnings as well as interest rates. Our Price/BV – Implied ROE model (Figure 5 below) highlights bubbles and forward market returns. On this model, there is currently over 50% overshoot of fair value (implied ROE over actual ROE). Overshoots of such scale have happened only in bubble periods of 1999-2000 and 1994-95 (when overshoots were 100-200%), and 12mth forward returns at times of such overshoots are generally negative.

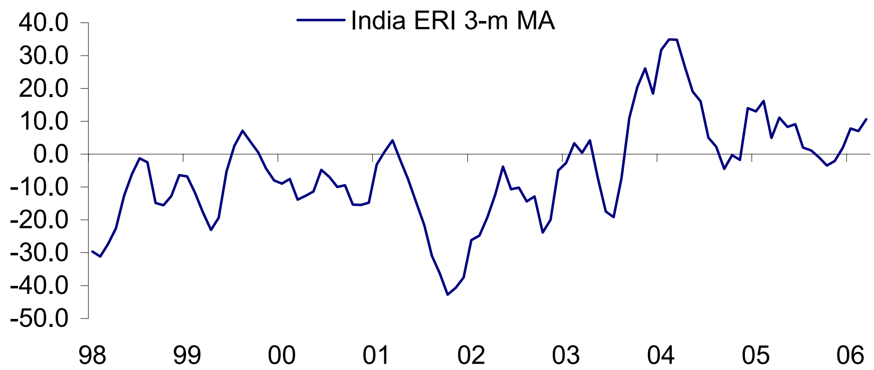
Figure 5. India – Implied ROE-P/B



Source: Citigroup Investment Research.

We have updated our valuation models for recent earning forecast and interest rate changes. Although earning revisions have been positive (see Earnings Revision Index Figure 6), their impact on market fair value has been negated by rise in interest rates recently. In the last 6 months, 10-year govt. bond yields have risen around 50bps to 7.5%, while 3-mth govt. bond yields are up even more sharply by around 100bps to 6.1%. As a result, our end-2006 Sensex fair value remains unchanged at where we set it earlier this year, i.e. 8500, which is around 25% below current market level.

Figure 6. India 3-month Estimate Revision Index

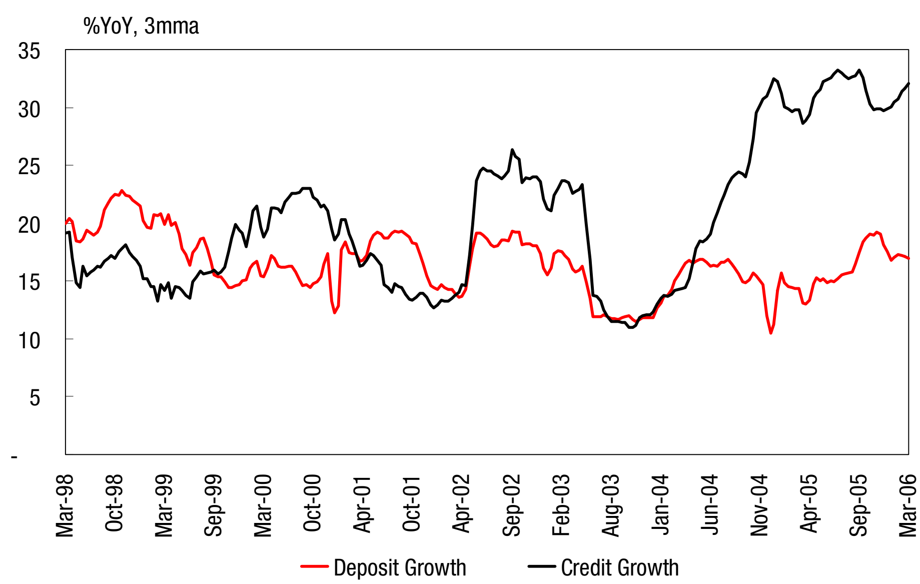


Source: Citigroup Investment Research, IBES. Note: Index= # of companies revised [up-down]/ total companies revised

Tightening banking sector liquidity- a key concern

At this stage of India's economic growth, we believe maintaining adequate liquidity and a benign domestic liquidity are critical to sustain a couple of key economic growth drivers - Investment cycle upturn and urban consumption growth (retail credit has an important role to play in that). Domestic liquidity conditions, which had tightened from mid-December 2005, due to IMD redemptions of US$7.1 billion, were further compounded by sustained high credit demand (+30%) and the government's borrowing program.

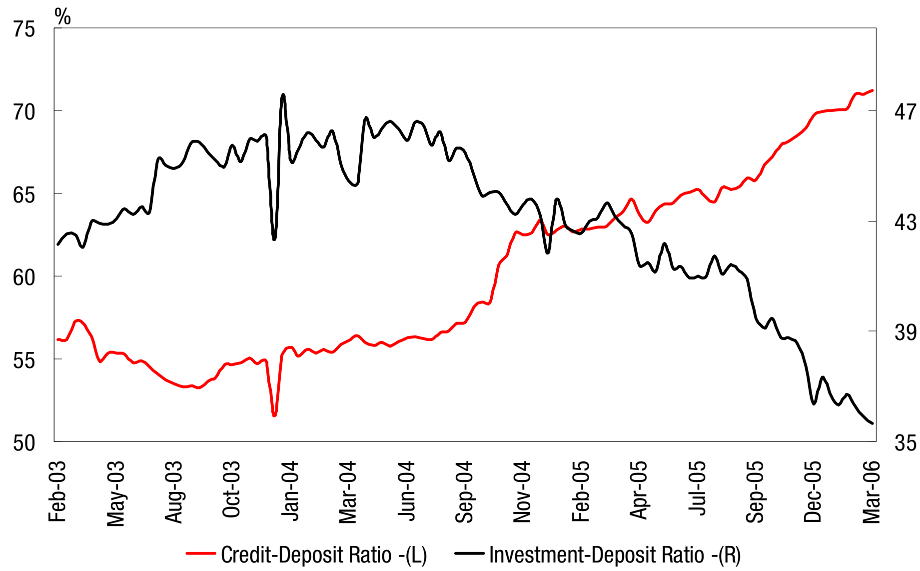
Figure 7. Indian Banks - Credit and Deposit Growth (percent)



Source: RBI, Citigroup Investment Research.

Tightening liquidity has resulted in 10-year govt. bond yields rising around 50bps to 7.5% in the last 6 months. But the bigger impact has been felt at the short-end, with 90-day T-bill yields rising around 100bps to 6.1%. HDFC's housing finance rates are already up 150bps to around 9%, while auto finance rates are up over 200bps to around 10%. With surplus investments in bank balance sheets having already been unwound to feed rapid credit growth over the last couple of years, growth of deposits and more aggressive central bank actions to infuse liquidity are now critical.

Figure 8. Trends in Investment and Credit Deposit Ratios



Source: RBI, Citigroup Investment Research.

Our banking system liquidity model suggests that the central bank has enough firepower and tools to keep the system liquid, if it desires. As the table below indicates, even a 15% deposit growth (currently 17%) can be enough to support a 24% credit growth if the central bank uses the surplus liquidity that it had collected in prior years. For sure, the banking system liquidity on an incremental basis should remain tight and in deficit, and hence we believe active central bank interventions will be a must to avoid further interest rate spikes (either through release of surplus liquidity with itself or reserve ratio cuts or more liberal foreign capital inflow norms). This will be a key variable to watch in 2Q2006, as well as for FY07.

Figure 9. India Banking System Liquidity Demand Supply (Rs Billion)

Year to 31 March	FY07E
Demand	
Bank credit (24% growth)	3,419
Central Fiscal Deficit	1,581
State Govt Borrowings	411
Total	5,412
Supply	
Banking Deposits (15% growth)	3,076
Others	1,406
Net Capital Account	282
Total	4,763
Excess / (Deficit) Supply- Flow Basis	**(649)**
RBI's Excess Liquidity Holdings	1,050
Amount Sterilized	750
Market Stabilisation Bonds	300
REPOs	0
Net Surplus / (Deficit)) liquidity	**401**

Source: Citigroup Investment Research estimates.

Strategy remains the same – Safety First

As outlined in our Year Ahead 2006 report, our recommended strategy remains a safety first approach, by sticking to large caps, visible growth stories and dividend yield plays. Our Overweight sectors are Banks, Capital Goods, IT Services, Energy, and Utilities. Underweights are Autos, Materials, Consumer, and Pharmaceutical sectors. Neutral on Telecom.

We are making some changes to our India model portfolio to reflect stock performance and / or changes in our analysts' views. Replacing HDFC (HDFC.BO Rs1339.50; 3L) (recently downgraded to Sell) with HDFC Bank (HDBK.BO; Rs772.80; 2L) on valuations. Replacing Gujarat Ambuja (GACM.BO; Rs106.30; 3L) with Grasim (GRAS.BO; Rs2145.00; 1L) on valuations. Removing Reliance Energy (RLEN.BO; Rs615.90; 1H) on sluggish business outlook.

Figure 9. India Model Portfolio

	Price 3-Apr-06 (Rs)	YTD Performance (%)	RIC	Analyst's Rating	MSCI Weight (%)	Portfolio Weight (%)	Overweight/ Underweight Rel. to MSCI (bps)	2006E PE (x)	EPS Growth (%)	PB (x)	ROE (%)
Automobiles and Components					**9.5**	**5.0**	**-449**				
Tata Motors	972.0	48.9	TAMO.BO	2L		5.0	O/W	23.2	16.9	6.1	28.6
Banks & Diversified Financials					**17.1**	**22.0**	**486**				
HDFC Bank	772.8	9.2	HDBK.BO	2L		6.0	O/W	22.2	32.2	4.0	19.5
ICICI Bank	604.1	3.3	ICBK.BO	3L		6.0	M/W	17.8	22.7	2.2	13.5
SBI	983.5	8.4	SBI.BO	1L		10.0	O/W	10.7	7.5	1.7	16.6
Capital Goods					**6.2**	**10.0**	**384**				
BHEL	2298.0	65.8	BHEL.BO	1L		5.0	O/W	24.8	43.1	6.2	27.9
L&T	2491.0	35.1	LART.BO	1L		5.0	O/W	29.9	33.1	7.5	27.3
Energy					**14.4**	**18.0**	**362**				
Reliance Industries	829.3	23.1	RELI.BO	--		13.0	O/W				
ONGC	1314.4	11.9	ONGC.BO	1M		5.0	O/W	9.4	22.5	2.8	32.9
Food Beverage and Tobacco, Household & Personal Products						**9.2**	**2.0**	**-718**			
Asian Paints	646.7	12.0	ASPN.BO	3L		2.0	O/W	24.7	20.1	8.4	36.5
Materials					**7.3**	**5.0**	**-235**				
Nalco	298.6	35.9	NALU.BO	1H		2.0	O/W	10.8	30.0	2.8	28.9
Grasim	2145.0	54.2	GRAS.BO	1L		3.0	O/W	18.8	18.2	3.4	19.8
Pharmaceuticals & Biotechnology					**5.8**	**0.0**	**-583**				
Software & Services					**20.5**	**27.0**	**651**				
TCS	1947.5	14.4	TCS.BO	1M		6.0	O/W	26.6	25.0	12.5	55.6
Wipro	560.1	20.9	WIPR.BO	1M		6.0	O/W	32.1	27.8	10.1	34.8
Infosys	3143.3	4.9	INFY.BO	1L		15.0	O/W	29.5	27.7	9.1	35.5
Telecom Services/Media					**5.9**	**6.0**	**14**				
Bharti Tele	421.4	21.9	BRTI.BO	1M		6.0	O/W	25.2	46.1	7.5	33.9
Utilities					**2.7**	**5.0**	**230**				
NTPC	135.4	20.7	NTPC.BO	1L		3.0	O/W	16.8	16.4	2.3	14.4
GAIL	317.7	19.5	GAIL.BO	1L		2.0	O/W	11.3	2.6	2.4	23.2
Others					**1.4**	**0.0**	**-142**				
Cash						**0.0**	**0**				
Total					**100.0**	**100.0**	**0**	**21.8**	**27.0**	**4.6**	**25.2**

Source: Citigroup Investment Research estimates.

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