January 4, 2012

Economy & Strategy

CY12 PREVIEW

The final trough before the recovery

With 4QFY12 promising plenty of negative newsflow from India and Europe, our Sensex target of 14,500 remains in play in the first two months of CY12. However, from March onwards, we see the situation improving for the Indian equity market thanks to a reversal in the RBI's monetary policy stance, significant monetary easing in the West and a semblance of order returning to New Delhi's policymaking. On a 12-month basis, we see the Sensex moving towards 18,000.

Sensex 14,500 remains in play in Q1CY12...

The first two months of CY12 will be a challenging period for the Indian market for three reasons. Firstly, the Q3 FY12 **results season** promises to be anything but cheerful and is likely to result in consensus' FY13 EPS estimates being pulled back further by around 3% points. Secondly with key **state elections** being rescheduled to end by 4th March, policy chaos is likely to persist over Jan-Feb 2012. Thirdly, **Europe** is set for a tricky couple of months with: (a) Italy and Spain likely to auction US$180bn of sovereign debt from 12th Jan onwards; (b) European banks must report to their central banks by 20th Jan, as to how they will get their core tier 1 ratio to 9%; and (c) The 17 Eurozone countries will attempt to get their Parliaments to approve the 9th Dec intergovernmental agreement by March 2012.

Hence in the opening 2-3 months of the calendar year, our longstanding Sensex 14,500 target remains very much in play.

... but over the course of CY12, the Sensex should veer towards 18,000

From March 2012 onwards we see the tide swinging in India's favour. Firstly, with the counting of votes for the State elections drawing to a close on March 4, 2012 and with the UPA administration realizing that it is in the last chance saloon, we expect to see more decisive and **more reformist policies** from the Government (including retail FDI) in the Budget session that is likely to open in mid-March. Secondly, with economic growth waning, core inflation (33% weightage) is likely to ease and presuming no further advances in global commodity prices, WPI inflation in India is likely to moderate thus triggering **RBI rate cuts** from March 2012. Thirdly, with the Eurozone heading for a recession, which could slow down the nascent American recovery as well, we expect serious monetary easing (including **QE**) from the ECB, the Federal Reserve and the Bank of England. In totality, we expect this easing to be comparable with what we saw in the months after the collapse of Lehman in CY08.

Hence over a 12-month period, we see a semblance of normalcy returning to the Indian market. Multiplying our FY13 EPS estimate of ₹1,160 (0.1% above our long standing FY12 estimate of ₹1,159: see pg 18) with a forward P/E of 15.5x (in line with India's long term average) gives us a 12-month Sensex target of 18,000.

Stock specific implications

As you would expect, we reiterate our faith in "***Good & Clean 3.0: Battleships***". Since its launch on 19th October this portfolio has outperformed the BSE500 by 377bps and 429bps on a market cap and equal weight basis respectively. Our overall family of Good & Clean portfolios has outperformed the market by over 13% points since launch in mid-March last year.

Beyond Good & Clean, our highest conviction **BUYs** are HCL Tech (HCLT IN, mcap US$5.1bn), Bank of Baroda (BOB IN, mcap US$4.9bn), Ultratech (UTCEM IN, mcap US$6.0bn), Mannapuram (MGFL IN, mcap US$0.7bn), Torrent Power (TPW IN, mcap US$1.8bn), Engineers India (ENGR IN, mcap US$1.3bn), Petronet LNG (PLNG IN, mcap US$2.2bn) and Oberoi Realty (OBER IN, mcap US$1.3bn).

Our highest conviction **SELLs** are Wipro (WPRO IN, mcap US$18.5bn), State Bank of India (SBIN IN, mcap US$19.5bn), Dabur (DABUR IN, mcap US$3.3bn), LIC Housing Finance (LICHF IN, mcap US$2bn) and Axis Bank (AXSB IN, mcap US$6.5bn).

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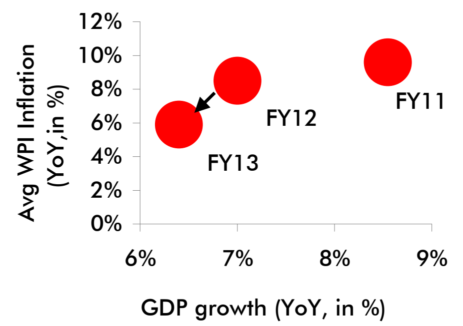
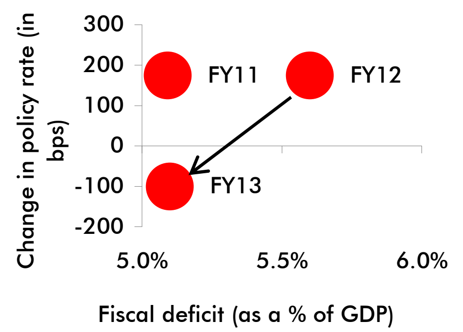
GDP growth in India to be weaker but inflation likely to moderate in FY13



Source: CEIC, Ambit Capital research

Monetary policy likely to turn accommodative whilst fiscal policy to turn incrementally restrictive



Source: CEIC, Ambit Capital research

Note: Fiscal deficit refers to the Central Government Fiscal Deficit

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Section 1: India regains a part of its lost charm

Summary: The persistence of a near-crisis environment in FY13 (as was the case in FY12) is likely to translate into weaker GDP growth in FY13 v/s FY12. Inflation, on the other hand, is likely to moderate in FY13 v/s FY12, as easing GDP growth and a semblance of order returning to New Delhi's policymaking leads to the easing of core inflationary pressures whilst the non-core categories benefit from a high base effect.

This transition from 'low GDP growth, high inflation' in FY12 to 'low GDP growth, moderate inflation' in FY13 is likely to result in the RBI cutting rates (see pg 5)**. Simultaneously, fiscal policy is likely to turn incrementally restrictive as the Central Government prepares fiscal headroom for the pre-General Elections financial year of FY14.**

GDP growth in India to remain weak in FY13 . . .

Over the past year we have been making the point that contrary to popular belief, India's GDP growth rate remains coupled with the fate of the Western World.

The fact that sovereign debt in the West is growing at a much faster pace than nominal GDP in that region points to the forthcoming snowballing of Western sovereign debt:GDP ratios. This portends risks for stability of the advanced economies' banking systems as well as GDP growth rates in that region – a dynamic that is likely to lead to the persistence of a 'near-crisis' environment in FY13 (see pg 8-9 for more details).

More specifically, we expect GDP growth in India to slow further in FY13 mainly on account of: (1) A high base effect impeding farm sector growth; (2) The persistence of macroeconomic uncertainty, which will mean subdued investment growth; and (3) Limited Union Government revenue expenditure growth (see pg 6 for details). However, the eventual cutting of policy rates (see pg 5 for details) is likely to mean marginally higher investment demand growth and hence higher industrial sector growth in FY13. In view of these dynamics, we expect GDP growth in FY13 to be 6.4% YoY (v/s our old estimate of 6.2%: see exhibit 1 below).

Exhibit 1: We expect GDP growth to record 6.4% YoY v/s 7.0% in FY12

(%)	FY11 (actuals)	FY12 (old estimate)	FY12 (new estimate)	FY13 (old estimate)	FY13 (new estimate)
GDP	8.5	7.1	7.0	6.2	**6.4**
Agriculture	6.6	4.0	4.0	1.6	**1.6**
Industry	7.9	6.4	4.8	5.7	**5.1**
Services	9.4	8.3	8.8	7.6	**8.2**
Investment demand	8.6	4.7	3.6	3.0	**4.2**

Source: CEIC, Ambit Capital research

Exhibit 2: Assumptions underlying our GDP growth model for FY13

	Explanatory variable	Key assumption
1	Economic crisis factor	FY13 is characterised by a 'near-crisis' environment.*
2	Rainfall adjustment factor	India is assumed to receive normal rainfall in FY13
3	Minimum support price for paddy and wheat	Wheat and Paddy MSPs are assumed to rise by 10% YoY
4	Policy rate	The repo rate is expected to be cut in 1QFY13
5	Real Union Government revenue expenditure	Inflation adjusted Union Government revenue expenditure is likely to be in FY13 v/s FY12 but lower than previously expected

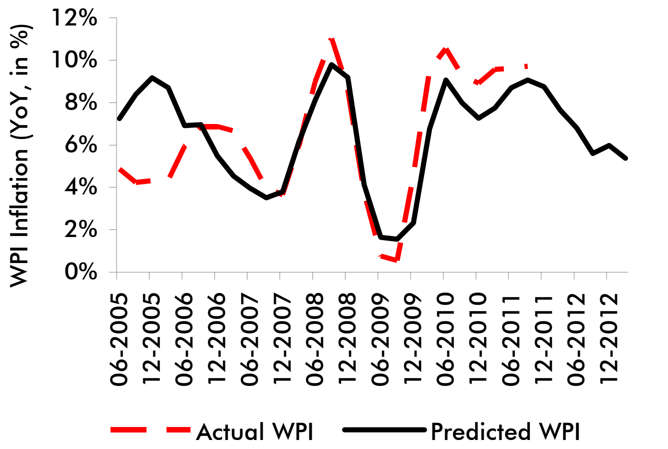
Source: Ambit Capital research

* *Note: To put this assumption into context, the 'economic crisis factor' by definition ranges from '0' to '1'. Its value in years characterised by a full blown crisis (such as FY91, FY97, FY01 or FY09) is fixed at '1' whilst the same is maintained at '0' during years characterised by economic peace (such as FY04-08).*

. . . whilst inflation is likely to moderate in FY13

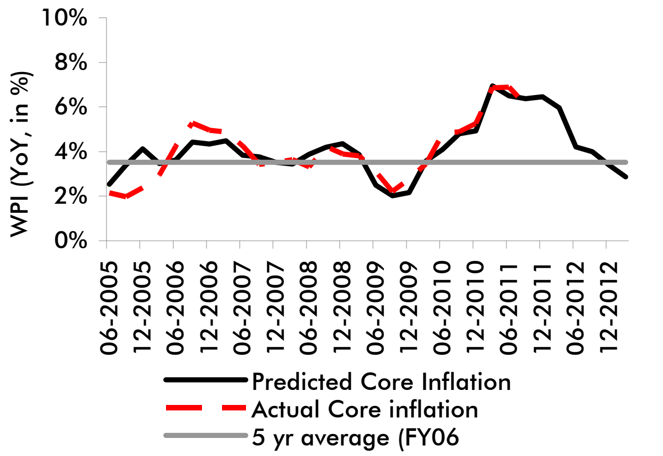
Our quantification of inflation dynamics in India suggests that headline inflation is likely to trend to 5.5% YoY by the end of FY13 (see exhibit 3 below) as: (1) GDP growth slows to 6.4% in FY13 thus easing core inflationary pressures and as a semblance of order returns to New Delhi's policymaking; and (2) despite the persistence of high fuel prices in INR terms, a high base in the case of non-core entities (i.e. food and energy) helps ease the headline inflation metric (see exhibit 4 below).

Exhibit 3: Headline inflation in India is likely to ease to 5.5% by end-FY13 . . .



Source: CEIC, Ambit Capital research

Exhibit 4: . . . as core inflation tends to its long term average rate



Source: CEIC, Ambit Capital research

Key Assumptions made in our inflation model and the 'Hysteresis Factor' in the Indian context

Our inflation model is based on the assumption that global crude oil prices in particular and commodity prices in general persist at the current high levels with relief in dollar terms being neutralized by a concomitant depreciation in the INR.

As regards food prices, historical seasonality trends point to the fact that whilst 4Q on an FY basis experiences a cooling of prices, the remaining three quarters experience QoQ gains. This dynamic is likely to drive the bottoming out of the food inflation gauge in 4QFY12 only to be followed by advances in subsequent quarters.

The most interesting finding of our inflation modeling process has been the **discovery of the 'hysteresis factor' in the Indian context** which kicks-in in 1QFY12. Economic theory suggests that in an excess demand situation (as is typically the case in India), the ebbing of aggregate supply growth rates below a certain threshold empowers existing producers with increased pricing power thus leading **core inflation to bump-up in a non-linear fashion**. The fact that this hysteresis factor has come into play in India from 1QFY12 onwards is telling given that the Government policy paralysis can be said to have kicked-in in 3QFY11. In terms of our model, we assume that this hysteresis factor does **not** grow over FY13 as a semblance of order returns to New Delhi's policymaking with the State elections coming to a close by 4QFY12. (A corollary of this is that pricing power should wane in FY13 and hence operating margins should see greater pressure in FY13 as opposed to FY12).

Exhibit 5: The structure and assumptions underlying our inflation model for FY13

WPI Constituents	Weightage *	Definition	Modeling technique	Key assumption(s) made
Core	32%	Manufacturing excluding chemicals, metals and food	Regression analysis using the following explanatory variables: capacity utilization, output gap, inflation in the 'non-core' category as well as a 'hysteresis factor' (see section above for details).	(1) GDP growth in FY13 is recorded at 6.4%; (2) Two quarters in FY13 experience an increase in capacity utilization levels ; (3) The hysteresis factor does not grow in FY13
Regulated fuel	7%	Diesel, Petrol , LPG and Kerosene	Regression analysis using the retail prices of fuels as explanatory variables	(1) Petrol prices are increased by INR 1.5 over FY13 (2) Diesel prices are increased by INR 2.5 over FY13
Fuel floaters	26%	Fuel excluding regulated fuel, metals (both from primary articles and manufacturing) and chemicals.	Regression analysis using global crude oil prices in INR terms as explanatory variables	Global crude oil prices average INR 5,400 per barrel over FY13.
Food	29%	Primary articles excluding minerals and the food component of manufacturing.	Replication of historical seasonality trends adjusted for deviations	India receives normal rainfall and historical seasonality trends are repeated in FY13.
Coal & electricity	6%		Replication of historical trends	Historical trends are repeated in FY13
WPI	100%			

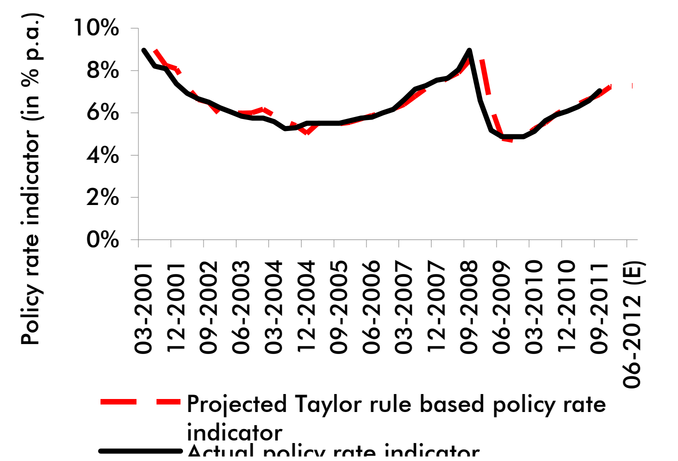
Source: CEIC, Ambit Capital research, Note: The weightages used are as per the WPI's specification only the combinations used by our model are unique.

Consequently monetary policy is likely to turn accommodative ...

In view of weak GDP growth and moderating inflation in FY13, we expect the RBI to reverse its monetary policy stance in FY13 and embark on a monetary policy loosening agenda.

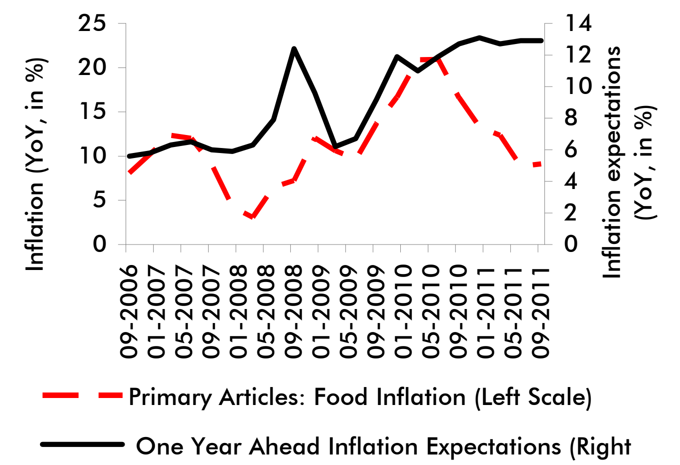
A Taylor modeling exercise suggests that policy rates are likely to be cut in 1QFY13 (see exhibit 6 below for details). However, this will be subject to movements in the inflationary expectations gauge, which, contrary to the RBI's commentary, is not disproportionately affected by food inflation (see exhibit 7 below).

Exhibit 6: Policy rates are likely to be cut in 1QFY13 as per a Taylor Rule simulation . . .



Source: CEIC, Ambit Capital research

Exhibit 7: . . . subject to the trajectory of inflationary expectations



Source: CEIC, Ambit Capital research

History points to the fact that the policy rate cycle typically has flat inflexion points (as opposed to V-shaped ones that materialize in a crisis situation as was the case in September 2008). This dynamic leads us to believe that **the RBI this time too will adopt a wait and watch policy before reversing its monetary policy** stance.

Furthermore, our base case for monetary policy dynamics in India in FY13 is based on the assumption that the 'hysteresis factor' in the Indian context factor does not grow over FY13 as a semblance of order returns to New Delhi's policymaking with the State elections coming to a close by 4QFY12 (see pg 4 for details). The RBI is likely to wait for another quarter of inflation data and only once conclusive evidence regarding this assumption emerges, embark on a policy stance reversal.

Thus in our base case we expect the RBI to administer a cut in the CRR at the mid-March inter quarter monetary policy review and follow this with a cut in the policy rate at a subsequent monetary policy meeting (see exhibit 8 below for details).

. . . whilst fiscal policy turns incrementally restrictive

Our discussions with bureaucrats based in New Delhi suggest that the rescheduling of State elections (whereby counting of votes in five States will now end by 4th March as opposed to stretching into 1QFY13) is a critical development as this allows the Union Government to present a relatively less populist budget post-State elections.

Fiscal regulation likely to be resurrected

Given that the UPA will need meaningful fiscal headroom in FY14 ahead of the General Elections in mid-CY14, the ruling party is likely to be forced to limit its fiscal deficit in FY13. Consequently, at the time of presenting the Union Budget for FY13 the Government is likely to resurrect the Indian fiscal responsibility regulation (FRBM Act, 2003 was suspended in FY09 due to the sub-prime crisis).

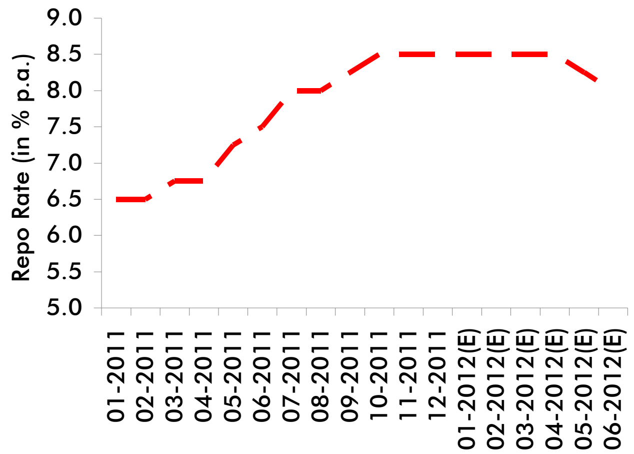
As opposed to its older version which proposed a linear fiscal correction target, the revamped version of the FRBM Act is likely to provide caveats by specifying economic situations that allow for a deviation from the path of fiscal consolidation.

Fiscal jugglery to help limit the damage in FY12 . . .

Whilst the Union Government can afford to deviate from the fiscal consolidation roadmap recommended by the 13th Finance Commission (of curtailing the fiscal deficit as a percentage of GDP to 4.8% in FY12 and to 4.4% in FY13), it cannot declare a higher fiscal deficit for FY13 compared with FY12. Thus the Union Government is likely to:

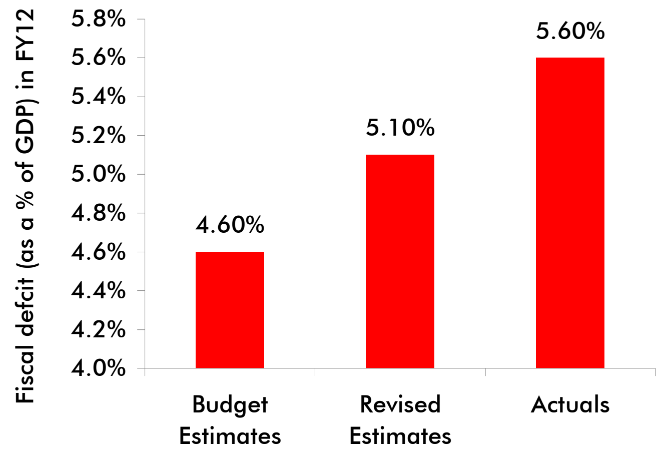
- Announce a fiscal deficit of ~4.5%-5.0% of GDP for FY13; and
- Issue a 'revised estimate' (RE) of ~5.1% of GDP as against the 'budget estimate' (BE) of 4.6% of GDP for FY12. This RE for FY12 is likely to be then revised upwards to ~5.6% of GDP at the time of releasing the 'actuals' for FY12 a year later (see exhibit 8 below). This delayed recognition of a larger fiscal deficit is likely to be executed by delaying the payment of oil subsidies and/or schemes such as the National Rural Employment Guarantee Scheme (NREGS) where the utilisation rates are currently low.

Exhibit 8: The kicking-in of the 'hysteresis factor' in the Indian context is likely to lead the RBI to cut rates from March 2012 onwards



Source: CEIC, Ambit Capital research

Exhibit 9: The likely shape of revisions that the fiscal deficit for FY12 is likely to assume



Source: CEIC, Ambit Capital research

. . . whilst the FY13 fiscal deficit is likely to be limited by taking some hard decisions

Three sets of levers are likely to be used by the Government to deliver this seemingly impossible fiscal math for FY13:

- **Announcement of further diesel price deregulation**: The Government is likely to implement an increase in diesel prices so as to limit the current subsidy on this fuel that currently stands at ₹13 per litre. This politically sensitive decision is likely to be implemented post State elections with the possible announcement of a roadmap for a further increase in diesel prices.

- **Enhancement of tax revenue through improved administration and widening of the service tax base**: The Union Government can augment tax revenues in FY13 by improving tax administration and by expanding the tax base as evident from the fact that the Union Government tax:GDP ratio currently stands at 10% as opposed to the pre-crisis high of 12%. Whilst an increase in indirect tax rates cannot be ruled out, the Union Government is likely to widen the ambit of service taxes and issue a negative list for service taxes thereby also achieving the goal of preparing for GST implementation at a later phase.

- **Implementing a limited or no increase in pro-poor doles:** Utilisation rates on social welfare schemes such as NREGA are currently running low and consequently the likely expenditure for these schemes is likely to be lower than that budgeted in FY12. Furthermore in FY13, the Government is likely to implement a limited or no increase in pro-poor doles with CY12 State elections behind them and with the budget constraint becoming binding.

In the run-up to the presentation of the Union Budget in the first fortnight of March 2012, we will provide greater colour on the likely shape of the Budget.

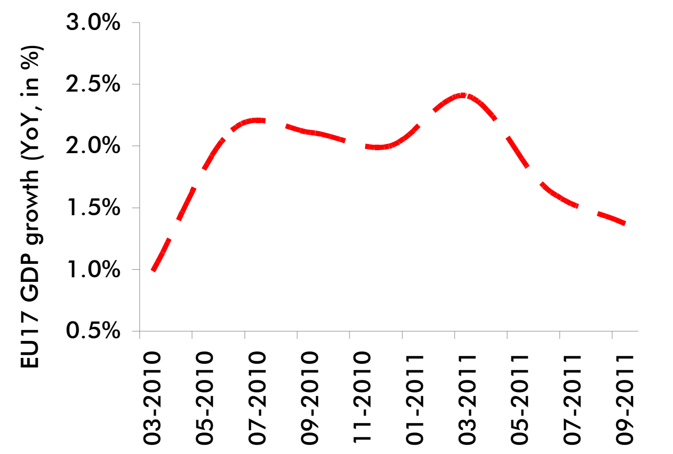
Section 2: Western mess points to heavy QE

Summary: In CY12 Europe seems almost certain to enter a recession. The fatal combination of a recession in Europe and a forced fiscal correction is likely to push US economic growth back down to the sclerotic levels they were at a year ago. Central banks on both sides of the Atlantic are likely to react to this sort of economic weakness with a powerful blast of QE (large enough to rival the post-Lehman blast). As a result, the risk appetite of Western investors will stay at levels which are marginally supportive from an Indian perspective.

Europe will continue to be a major source of stress

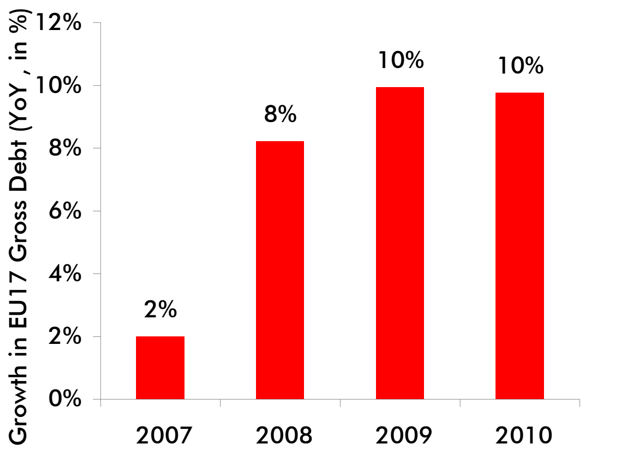
The Euro area's economic growth rate has already come under substantial pressure recently (see exhibit 10 below) and seems highly likely to remain under pressure given the scale of sovereign debt cuts required (see exhibit 11 below) and given the potential banking sector crisis facing the Continent.

Exhibit 10: Growth in EU17 has been flagging. . .



Source: CEIC, Ambit Capital research

Exhibit 11: . . . whilst the pace of debt expansion has been rapid



Source: CEIC, Ambit Capital research

At the root of the impending recession is the fact that both commercial lending and inter-bank lending seem to have come to a halt in the EU driven by:

- Banks' scepticism of each others' underlying Balance Sheet strength – most banks know that their rivals' Tier 1 ratios, hammered by write-downs arising from devalued sovereign debt, are much lower than the numbers being stated in their published results;
- Banks' desire to pull back on risk weighted assets (particularly commercial and SME lending) so as to boost their Tier 1 ratios.

In fact, the plight of European banks and that of the broader European financial system will be particularly stressful in the first 90 days of CY12 as:

- Italy and Spain are set to auction more than US$180bn of debt in 1QCY12 potentially soaking up whatever liquidity is available in the European financial system;
- On January 20,2012 capital deficient European banks have to hand in their plans to national regulators to reach their 9% Core Tier 1 capital target. Several conservative estimates (including estimates from the EU itself) suggest that European banks need to raise at least Euro100bn of fresh Tier 1 capital to reach this 9% target. Given the challenges around raising fresh equity at

present (and hence the challenges around boosting the numerator of the Tier 1 ratio), it is highly likely that the banks will focus on keeping the denominator (risk weighted assets) in check.

- The 17 EU countries who have agreed to sign-up to the "inter-governmental agreement" hammered out on December 9,2012 will need to get their Parliaments to sign-off on these agreements by March, the deadline set by the EU for freezing the agreement. Obviously, given how restrictive this agreement is (in effect, the countries have to agree to balance their budgets or else pay hefty fines), such a Parliamentary sign-off process is likely to generate protest and instability in a synchronized manner across these 17 countries.

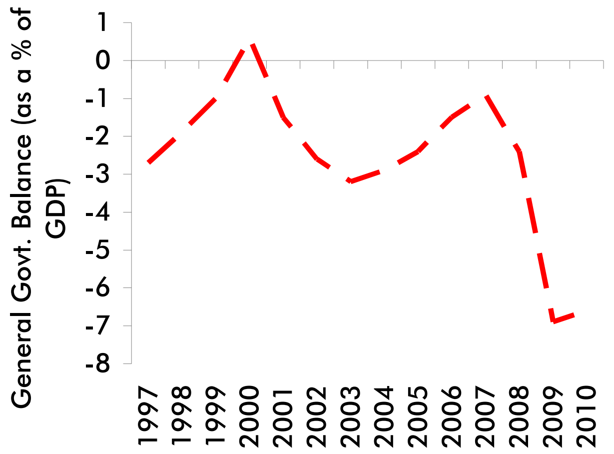
This troika of events could spook the bond markets yet again, impact the planned Italian and Spanish sovereign debt issuances and thereby impact banks' Balance Sheets.

In fact, the OECD highlighted in its December 2011 sovereign borrowing outlook that "*OECD governments are* ***facing unprecedented challenges*** *in the markets for government securities as a result of continued strong borrowing amid a highly uncertain environment with growing concerns about the pace of recovery, surging borrowing costs, sovereign risk and contagion pressures… In comparison with pre-crisis levels, gross borrowing by OECD governments is expected to remain at the elevated level of USD10.4 trillion in 2011. In 2012, the borrowing needs are projected to reach USD10.5 trillion, with a strong increase in longer-term redemptions…****Raising large volumes of funds at lowest cost, with acceptable roll-over risk, remains therefore a great challenge*** *for a wide range of governments, with most OECD debt managers continuing to rebalance the profile of debt portfolios by issuing more long-term instruments and moderating bill issuance.*" (The emphasis in bold is ours.)

Leaving aside matters to do with confidence in banks and financial markets, the brutality of fiscal cuts facing large economies like Italy (Gross government debt:GDP in 2012 as per the IMF stands at 121%), France (89%), Spain (70%) and the UK (85%) and smaller economies like Portugal (112%), Ireland (115%) and Greece (183%) will exert powerful recessionary pressures.

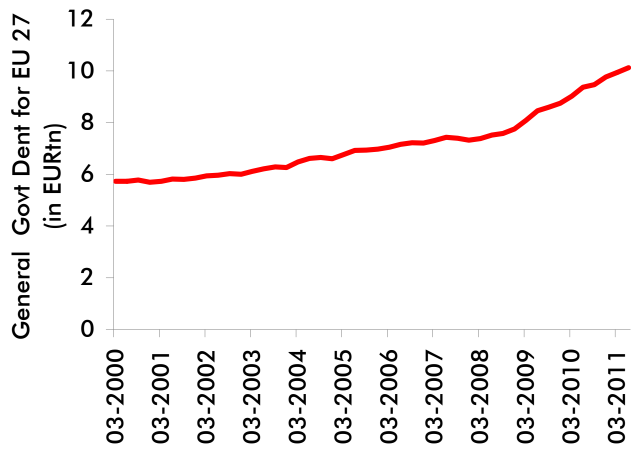
The charts on the next page capture the scale of the challenge facing the EU at an aggregate level as it seeks to pull its budget deficit to less than 3% of GDP and its gross public debt to less than 80% of GDP (these thresholds are defined by the "Stability & Growth Pact" (SGP)).

Exhibit 12: EU 27's widening fiscal deficit



Source: European Banking Federation. 3% is the budget deficit floor specified by the SGP.

Exhibit 13: EU 27 Governments' balloning gross debt

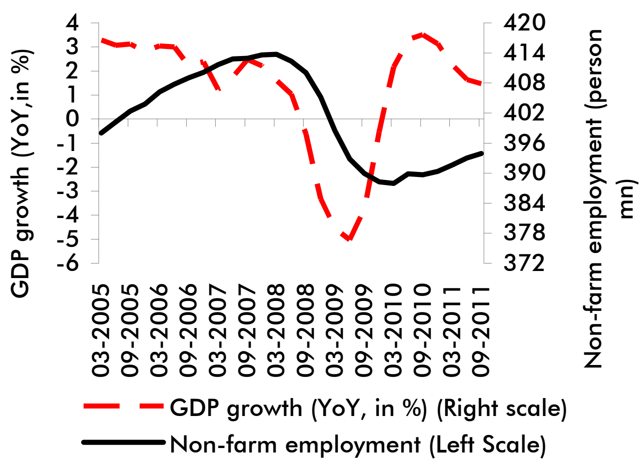


Source: European Banking Federation. 80% is the Gross debt ceiling specified by the SGP.

The US economic recovery looks likely to be arrested

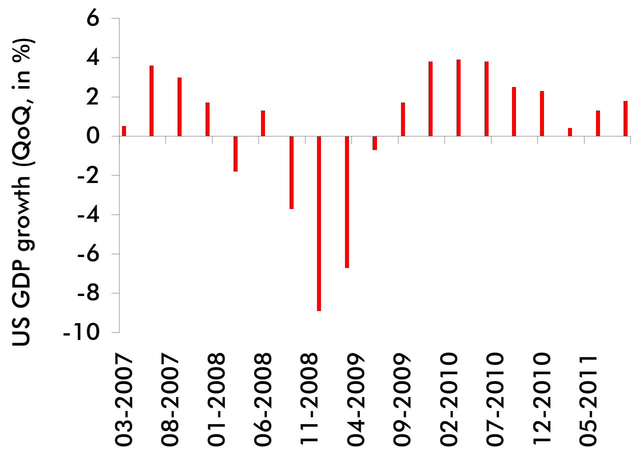
Over the past couple of months a steady stream of positive economic data has emerged from the US. In particular, (a) In 3Q the US economy grew at 1.8% QoQ (compared to 1.3% in 2Q and 0.4% in 1Q); (b) Between November 2010 to November 2011, manufacturing employment in the US grew by 1.82%; and (c) The US consumer confidence index rose in December compared with November's index: the index reached in December to 64.5 (1985=100) an increase from 55.2 in November.

Exhibit 14: US non-farm employment has improved in the later stages of CY11



Source: CEIC, Ambit Capital research

Exhibit 15: US GDP growth improved in 3QCY11



Source: CEIC, Ambit Capital research

Beyond the fact that some of this growth jump is driven by the elimination of the temporary effects of the March 2011 Japanese earthquake, there are three other fundamental reasons why this nascent recovery in the US will be hit hard in the opening months of CY12:

- US exports going to the EU account for around 2% of US GDP. With the EU likely to enter a recession in CY12 (see previous sub-section), these exports will be under pressure.

- On November 21, 2011 the US Congressional 'Super committee' failed to agree on plan to cut the US deficit by US$1.4 trillion. This failure will automatically trigger around US$50 bn of fiscal spending cuts. Furthermore, this failure is likely to mean that the cut in payroll taxes (US$110bn per year) and emergency unemployment benefits (US$50bn per year), both of which are measured that helped the US in CY11, cannot be extended to CY12. So, in totality, around US$210bn (1.4% of US GDP) of fiscal spending will be taken off the table by the US Government in CY12 vs CY11.
- The savings ratio in the US has dropped from 4.8% in 2QCY11 to 3.8% in 3QCY11. Given the challenges that the US consumer faces vis a vis deleveraging, such a large drop could be hard to sustain.

In fact, US growth measured from the income side of the national accounts (GDI) was only 0.4% in 3QCY11, the second successive quarter of near stagnation. GDI is seen by US pundits as a lead indicator for the US economy.

… but the ECB and Federal Reserve will ensure that the financial system holds up

The flipside of all this underlying economic gloom is that big ticket QE by central banks on both sides of the Atlantic is becoming increasingly likely in CY12.

Let's first take the case of Europe. Given the need to hack Government spending and given the core tenets of the intergovernmental agreement negotiated on December 9,2011 fiscal policy cannot aid economic growth in Europe. However, even to finance their pared down fiscal plans, the eurozone sovereigns need access to the sovereign bond market. As recent months have shown, these bond markets can make fresh sovereign issuance prohibitively expensive unless: (a) the European banks are "helped" into participating in sovereign debt actions; and (b) the ECB itself buys sovereign bonds.

Exhibit 16: The key bit of text agreed upon by the EU countries on 9th December

"General government budgets shall be balanced or in surplus; this principal shall be deemed to be respected if, as a rule, the annual structural deficit does not exceed 0.5 per cent of nominal GDP. Such a rule will also be introduced in member states' national legal systems at constitutional or equivalent level. The rule will contain an automatic correction mechanism that shall be triggered in the event of deviation."

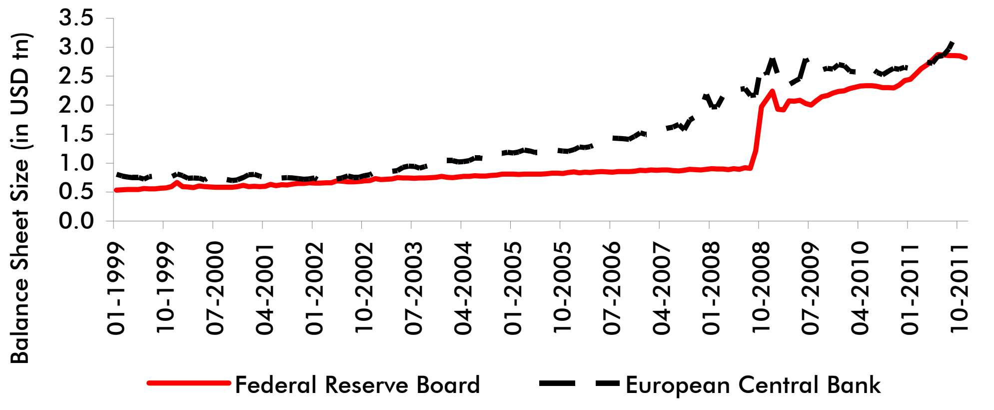
Source: Ambit Capital research

Therefore the ECB is intervening and will continue to intervene in two specific ways:

- As it did on December 21,2011 (and has promised to do again in February 2012), the ECB is giving European banks vast amounts of three year loans (a staggering Euro 490 bn of financing was provided by the ECB in December) at 1%. In return the banks are providing collateral of dubious value - single A asset-backed securities and also bank loan portfolios. This sort of cheap liquidity is allowing the banks to continue functioning even in the absence of an interbank lending market. The banks are in turn being encouraged to use this liquidity to buy sovereign bands (which remarkably still have 0% risk weightings and hence don't pressurize the Tier 1 ratio) thanks to be the 400-500bps carry on offer (borrow from the ECB at 1% and buy a sovereign bond yielding, say, 5%).
- The ECB is buying sovereign debt itself as evidenced by the recent record expansion in its Balance Sheet (which is now around 20% bigger than what it was post Lehman). Overall, the ECB balance sheet has grown by around

Euro500 billion in CY11. In fact, the recent rate of increase has been almost twice as fast as that undertaken by the Fed during QE2. Furthermore, European monetary experts believe that between the September 2011 to February 2012, the ECB's Balance Sheet seems likely to grow further by a punchy Euro800bn.

Exhibit 17: The Fed and the ECB's ballooning Balance Sheets



Source: CEIC, Ambit Capital research

In the US, as is well established now, both QE1 and QE2 increased the availability of risk capital and created pronounced rallies in risk assets classes (QE1 in 2Q & 3Q CY09 and 2Q in 3Q & 4QCY10). The more recent "Operation Twist" (wherein the Fed sold short term bonds and bought long term bonds, thereby pulling long term yields) seems to have also helped US markets without increasing the size of the Fed Balance Sheet (see chart below).

Given that the Fed's QE playbook is now well established, given that the US economy is likely to slowdown in CY12 and given that a Presidential election looms, the probability of further QE in CY12 appears high.

Furthermore, the Bank of England, which has shown itself to be a big QE fan, is also likely to respond to the UK's double dip recession (precipitated by savage fiscal cuts) with more QE.

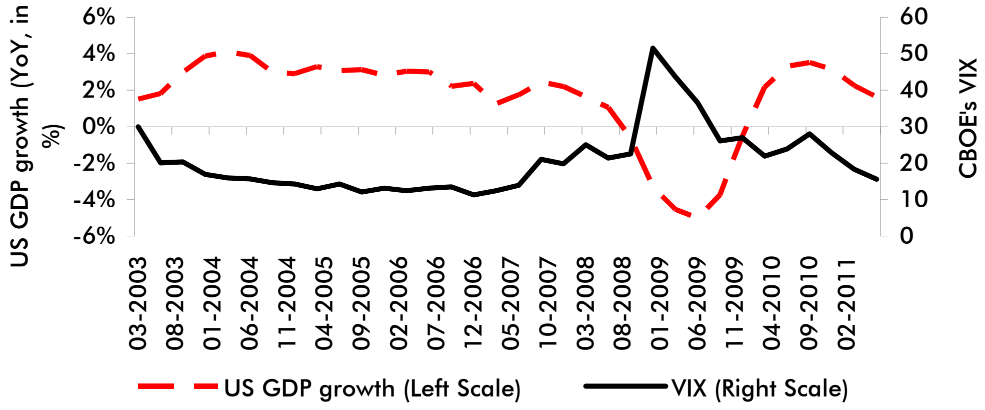
In totality therefore, it is highly likely that the quantum of QE we will see in CY12 will be well in excess on the post-Lehman quantum. Such abundance of liquidity seems likely to provide support to risk asset classes, particularly to commodities.

Result: risk appetite will be low but not at "crisis levels"

Overall, CY12 seems likely to be a year where:

- The growth fundamentals of the large Western economies will be in reverse gear;
- Central banks will intervene actively and directly to provide support to financial markets; and
- Risk appetite is unlikely to plunge to "crisis" levels i.e. the CBOE VIX is likely to be between 30-40 for most of the year (rather than shooting up to 50+ levels seen post-Lehman).

Exhibit 18: The inverse relationship between CBOE's VIX and US GDP growth



Source: CEIC, CBOE, Ambit Capital research

Section 3: Investment Implications

Summary: With 1QCY12 promising plenty of newsflow from India and Europe, our Sensex target of 14,500 remains very much in play in January-February. However, from March onwards, we see the situation improving for the Indian market thanks to monetary easing by the RBI, major monetary easing in the West and due to a semblance of order returning to New Delhi's policymaking. On a 12-month basis, we see the Sensex moving towards 18,000.

1QCY12 promises plenty of negative newsflow…

Over the next 90 days we are likely to see negative newsflow from three distinct sources: (a) The 3QFY12 results season; (b) The Indian Government; and (c) Europe. The sub-section below elaborates upon what we are likely to hear on these fronts and then considers the implication of the same for the Sensex.

(a) The 3QFY12 results season
Seven months ago, when consensus FY12 EPS for the Sensex was around ₹ 1,250 (source: Bloomberg), our estimate for the same was ₹ 1,169. Three months ago we lowered our Sensex FY12 EPS marginally to ₹ 1159. By then consensus had hacked its estimate to ₹ 1200. Now, with the consensus EPS figure almost in-line with our estimate (Bloomberg consensus stands at INR 1165), we reiterate our ₹ 1,159 FY12 Sensex EPS target (implying YoY EPS growth 5%).

Given that the overall market-level FY12 EPS figure has stabilized at the low level, we don't see actual earnings per se being source of concern in the 3Q FY12 results (which starts in mid-January 2012). The negative surprises will come from elsewhere and they are likely to vary by sector (see the table below). The only major sector where the FY13 guidance surprise is likely to be positive is Indian IT which is clearly a major beneficiary of the INR's 7% fall since early November 2011 (following the 12% deprecation over Aug-Nov 2011).

These negative surprises are likely to pull down FY13 EPS growth. The current consensus FY13 EPS figure is ₹ 1,325 (implying 14% YoY growth on our FY12 estimate of ₹ 1,159). As explained further on in this section, we see FY13 EPS figure falling to ₹ 1,160 (implying a YoY growth rate of 0.1%).

Exhibit 19: What to expect from the forthcoming results season

Companies	Comments (stock specific implications and estimates will be published in our 9th Jan 3Q FY12 results preview)
FMCG	Waning volume growth in rural India (driven by a tailing off fiscal transfers to this constituency) is exerting pressure on the topline growth of FMCG companies. Whilst price hikes have helped ease some of the pressure on gross margins (pressures led by rising input cost pressures (driven by the sliding INR)), competitive intensity is increasing amidst this rural slowdown. This is forcing every FMCG company to increase its advertisement spends which in turn is putting pressure on operating margins.
Telecom	With the industry having matured, subscriber growth has slowed down to 2-3% QoQ for the leading players. In such circumstances, the ongoing drop in minutes of usage and in ARPU is hitting the telecom companies with a double whammy. Furthermore, slow 3G uptake, negative price elasticity for 2G voice traffic and reluctance of the newer entrants to raise prices leaves the established giants with no real levers in hand with which to lift revenue growth. Margins of the leading telecom companies are likely to remain under pressure from high interest costs and hedging and translational losses. Although the INR depreciation is unlikely to be felt substantially on the P&L, this is likely to further weaken the sector's Balance Sheet, when the impact is eventually taken, and burden cash flows. Regulatory headwinds from license fees on passive infrastructure and MTC removal are likely headwinds for revenue growth further into CY12.
Auto	While volume growth continues to moderate, rupee depreciation has taken away much of the benefits that would have otherwise accrued from stabilising commodity costs. Furthermore, the increasing presence of foreign players is increasing the competitive intensity in the industry particularly in the passenger car and two wheeler segments.
IT	Late cyclicality has started to bite the IT industry since November with a slowdown in ramp-ups as a weak macro-economic environment finally trickles into the IT decision making process. Growth rates for 3Q and 4Q will be muted due to greater than normal seasonality. Increased scrutiny of smaller deals and delays in ramp-ups seen in the December quarter is likely to impact the budget setting process with weak budgets across the board. The strong appreciation of the US dollar against other major global currencies (GBP, EUR, AUD, etc.) is likely to provide a negative headwind on reported US dollar revenue growth compared to consensus expectations. Although demand and reported USD revenue growth is likely to be soft, the industry is likely to enjoy margin benefits of the ~16-17% currency depreciation and reduced attrition that is likely to aid its ability to: (a) invest in the business; and (b) offer lower billing rates to customers to drive volume growth. The lower billing rates that the IT companies are currently offering will make it hard win back higher prices in the upturn reducing the long term earnings growth potential of the industry. Certain industry participants are also likely to report hedging losses due to hedging contracts entered at lower realisation rates. We expect the industry to increase its hedging volumes to lock in the benefits of the attractive exchange rates.
Real Estate	Balance sheet de-leveraging remains the most common theme in the sector aided by land bank sales amidst the continued rise in cost of funding and weak operating cash flows. Whilst affordable housing projects are seeing strong sales momentum, overall residential sales remain weak for most developers. Players with low gearing on the balance sheet, steady run-rate of cash collection on unit sales and a strong pipeline of new projects launches to capitalise on an upward turn in real estate demand over the medium term future are best placed in the current environment.
Engineering & Construction	Order inflows for the industry remain subdued with only small pockets of opportunities arising from central/state government spending on buildings and roads and sporadic corporate capex by hospitality and pharma sectors. Higher interest rates and credit pullback by bankers to the commercial and infrastructure project developers are keeping project awards and execution/payments slow. Rising labour and material costs and higher interest costs continue to impact margins in projects currently being executed.
Cement	Retail customer/ individual house builder activity remains strong across the country except for a few states in South India. However, institutional activity remains subdued in most regions barring the West and some pockets in North India. Realisation increases have helped manufacturers recover some of the lost profitability on account of higher coal, fuel and power charges but meaningful EBITDA margin improvement may not be possible because of the shortage of domestic coal and the depreciating rupee (which is eroding the benefits arising from drop in international coal prices).
Power	Persisting fuel challenges (due to dismal growth in the domestic coal production plus the rising price of imported coal due to the change in Indonesian regulation), a reluctance on part of SEBs to re-negotiate fixed price PPAs and an unwillingness on the part of banks to lend to the power sector is likely to cause delays in generation projects. Furthermore, the poor financial health of SEBs is likely to continue to be an overhang for the sector.
Capital Goods	Given the multiple challenges in the Indian power sector (fuel, clearances, SEB health, etc.), the outlook for the allied capital goods sector continues to be challenging. Industrial capex too continue to be lackluster given the slowing economy (growth in index of industrial production has slowed down to 3.6% YTD compared to 8.3% in FY2011) coupled with high interest rates. Lastly increasing competitive intensity has meant that prices have dropped to 2009 levels (i.e. corrected by ~15% in the last six to eight months) as players across the board are cutting prices to attract orders.
Oil & Gas	High crude prices and a sharp depreciation in the rupee is positive for private upstream companies, but negative for oil PSUs, particularly OMCs, due to the higher subsidy burden. Furthermore, the tightness in the Government's fiscal situation would keep any clarity on subsidy sharing mechanism at abeyance, acting as an overhang on oil PSUs. In addition, refining and petrochemical margins continue to be under pressure with increasing signs of a weakening global economy. All of that being said, the bleak outlook for domestic gas production over the next 3-4 years means that outlook for growth in LNG imports (to meet India's growing domestic gas demand) is positive.
Banks	Whilst we envisage a reversal in the interest rate cycle post post-Mar'12, from a systemic rates perspective, banks are likely to begin transmitting the benefits of reduced policy rates only beyond the first 25-50bps. Hence, there could be a lag in the pace at which banks will transmit the benefits of lower policy rates. We expect the flip side of base rates to begin affecting banks during 2HCY12 implying a disproportionate pass-through beyond the initial 25-50bps. Hence we expect systemic net interest margins (NIMs) to remain elevated during 1HCY12. In the backdrop of the ongoing slowdown (that has taken its toll on fresh project sanctions) and the elevated interest rate regime, we expect the proportion of sub-optimal yielding assets (restructured + impaired) to peak by 1HCY12 at ~8% (from current level of ~6%). We expect banks to push the RBI for concessions on NPA recognition / provisioning for NPAs. From a capitalization perspective, we expect private sector banks (with Tier-I capital at sub-10%) to gear themselves up to tap equity markets (once these markets stabilize). Whilst we expect the Government to re-capitalize SBI by a token ₹30-40bn during 1QCY12, we expect a more substantial re-capitalization exercise as part of the Union Budget 2012-13.
NBFCs	With final guidelines on priority sector status, securitisation, higher capital adequacy and tougher NPA recognition expected to be out in the 4QFY12, regulatory actions remain the key drivers for the NBFC sector. Whilst the expected reversal in rate cycle should provide some relief from rising cost of funds, we do not expect cost of funds for NBFCs to come down significantly any time soon due to: (i) Incrementally funding from banks becoming hard to access (due to removal of the 'priority sector' route) and; (ii) Some of the NBFCs moving to a higher proportion of fixed rate liabilities. In terms of NPAs, we see the biggest risk for Infra-NBFCs due to the deterioration in the debt servicing capacity of state utilities and private sector power generation companies. The slowdown in the economy would lead to slight uptick in NPAs for Housing finance companies and auto financing NBFCs. We expect gold loan companies to show stable credit quality trends unless there is a sharp fall of more than 25% in gold prices over the next 3-6 months. With the proposed change in securitization guidelines likely to lead to higher capital adequacy for off balance sheet assets and proposed tier 1 ratio of 12%, we expect most of the NBFCs to rush to tap equity capital markets the moment capital markets open.

Source: Company, Ambit Capital research

(b) The Indian Government and policy chaos in New Delhi

Every other month we make a pilgrimage to New Delhi to meet the people to who run India. Our meetings in Delhi in 1Q CY12 had given us (and hence our clients) a clear signal that the Government had hit the "panic" button on inflation. Then, as summer gave to the monsoons, we found the establishment in New Delhi utterly despondent mired in a funk about what they were supposed to do and where the country was going.

However, in our recent meetings in December, we found that the mood in Delhi has changed from policy paralysis to general chaos regarding policymaking with populism emerging as the only coherent strategy. The prevailing mood in Delhi now is that reform will come in fits and starts rather than in a decisive, concerted thrust forward. Furthermore there seemed to be a clear consensus amongst policy-makers that GDP growth in FY13 was likely to be weaker than in FY12 (refer to our note titled 'Cutting FY13 GDP growth to 6.2%' dated 17th October 2011 for details).

This sort of pessimism regarding the Indian Government's capabilities (pessimism which has been heighted by the administration's failure to push through Retail FDI and the Lokpal Bill) is likely to weigh down on the market in parallel with negative high frequency data on the GDP and IIP front.

(c) Europe and its fiscal mess

As we have highlighted repeatedly over the course of CY11, the fiscal policy of the PIGS nations is fundamentally unviable and is likely to result in large scale default unless ECB comes to their rescue. Consider the following facts with respect to the PIGS:

- Over the past five years (spanning CY05-10) PIGS' Net Sovereign Debt has been growing at a CAGR of 6% per annum whereas their Nominal GDP (which is a decent proxy of their ability to service this debt) has grown at a mere 2% per annum over the same period.
- Over the past year the situation has worsened for obvious reasons. Net Sovereign Debt expanded at 8% YoY in CY10 whilst their Nominal GDP growth is 1% YoY in CY10.
- The average Debt-GDP ratio for the PIGS exceeds 100% as at the end of 1QCY11 with Greece recording the highest deb: GDP ratio of 150% (thus marking a 700bps jump over 4QCY10) followed by Italy whose debt GDP ratio stands at 120%.

What will exacerbate matters further in 1Q CY12 is the size of the Italian and Spanish borrowing programs and the passage of the 9th December intergovernmental accord through the parliaments of the 17 euro nations.

Italy and Spain are set to auction more than USUS$180 bn of debt in 1Q CY12:

- In 1Q, Italy has to step up its borrowing to pay off around US$100bn in bond redemptions and interest payments. Overall, Italy has more than USUS$400 billion in debt maturing in CY12. Italy's 1Q borrowing program starts on 13th January.
- Starting 12th January, Spain is likely to auction around US$80 bn on debt in 1Q.

Near term implications for the Sensex

Given the prevalence of domestic policymaking chaos, financial stress in Europe and weak 1Q results, **our Sensex target of 14,500 remains in play in 1Q**. Based on our FY12 EPS estimate of ₹1159 this translates into a market multiple of 12.5x, 19% below the Sensex's long term average multiple of 15.5x.

…but the tide will turn in India's favour as we go through CY12

Post-March we see three sets of forces swinging in India's favour: (a) More direction and better policymaking in Delhi; (b) Monetary easing from the RBI; and (c) Heavy monetary easing in the West. The sub-section below elaborates upon what we are likely to hear from on these fronts and then considers the implication of the same for the Sensex.

(a) Scope for sensible policymaking post-March

Well placed experts tell us that the current general state of chaos is likely to prevail until the state elections are over in March. The good news is that the UPA coalition seems to understand that it is in the last chance last chance saloon and seems likely (once the state elections are done) to make a concerted attempt to inject some order into the currently prevailing chaos. So what will the UPA try to do post-March? Here is what our sources say:

- **Fiscal consolidation**: We understand that the Union Budget is likely to be announced in March (post state elections ending) rather than in late Feb (which tends to be the norm). Furthermore, whilst it is well known that the Government will miss its FY12 budget deficit target of 4.6% of GDP by a mile (5.6% is a more a likely outcome although it will not be until we get the "revised estimate" from the Government that this becomes clear), the Government is likely to aim for 5% in FY13. In order to hit this target, and thereby win back some of its lost credibility, the Government seems likely to undertake measures such as diesel price deregulation, widen the Service Tax base and freeze pro-poor doles such as the NREGA. We also have a modicum of hope that the Government, at the time of presenting the Union Budget for FY13, could resurrect its fiscal responsibility regulation (the Fiscal Responsibility and Budget Management Act, 2003 was suspended in FY09 in view of the sub-prime crisis of FY09).

- **FDI in retail**: As is well known now, the UPA failed to push this piece of reform at the Winter Session of the Parliament largely because of its failure to manage coalition politics. Once the State elections end, floor management in the Lok Sabha is likely to become substantially simpler thereby giving policy makers the headroom to undertake reforms that may displease a section of the electorate.

- **Populist legislation**: The fundamental nature of the Indian democracy (one man, one vote with "first past the post" simple majority arithmetic) makes it difficult for any political party to veer too far away from populist legislation. Hence, we expect the Government to continue focusing on items such as the Lokpal Bill and the Land Acquisition Bill since these burden the exchequer but could win brownie points from an restive electorate.

(b) Monetary easing by the RBI

As highlighted in Section 1, in the transition from 'low GDP growth, high inflation' in FY12 to 'low GDP growth, moderate inflation' in FY13 is likely to be accompanied by a turn in the monetary policy cycle whereby the RBI begins cutting the policy rate (refer to pg 5 of this note for details). Simultaneously, fiscal policy is likely to turn incrementally restrictive as the Central Government prepares fiscal headroom for the pre-general elections financial year of FY14.

(c) Heavy monetary easing in the West

In order to help European sovereigns raise debt at affordable rates and in order to help European banks stay liquid, the ECB is currently in the midst of unprecedented Balance Sheet expansion (see Section 2 for more details). In fact, having grown by Euro 500 bn in CY11, the ECB's Balance Sheet is now 20% bigger than it was post-Lehman. It seems very likely that this sort of Balance Sheet expansion will continue well into CY12 - European monetary experts believe that between the September 2011 to February 2012, the ECB's Balance Sheet seems likely to grow further by a punchy Euro 800 bn.

Whilst the Fed is unlikely to pursue QE at anything like the rate at which ECB is growing its Balance Sheet, given the Fed's "3 out of 3" success record (QE1, QE2 and "Operation Twist") of using QE to stimulate US equity prices and given the pressures of a Presidential election, the Fed is also likely to use another round of QE. However, the Fed might wait until it sees clear evidence that the US economy has relapsed into another slowdown. This is likely to push the Fed's QE efforts into 2Q-3Q CY12.

With the Bank of England being another repeat QE fan, by the middle of CY12, we could see full blast QE action, on a scale comparable to the post-Lehman central bank action, from the ECB, the Fed and the BoE. This should provide support to risk asset prices especially if it helps European sovereigns sell their bonds at increasingly low yields.

Implications for the Sensex in CY12

Whilst we expect the Sensex to veer towards 14,500 in 1Q CY12, post 1Q we expect see a measure of confidence return to the Indian market. So how much can the Sensex rally in such circumstances?

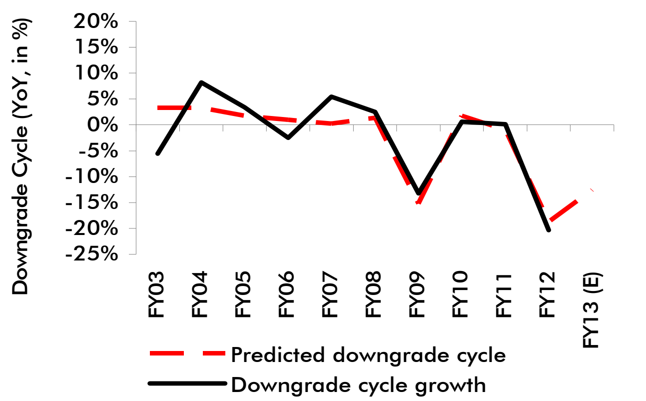
Using an FY13 EPS estimate of ₹ 1,160 (see the exhibits below) and a market multiple of 15.5x (close to the Sensex's long term average P/E), **we see the Sensex gravitating towards 18,000 over the next 12 months.**

Exhibit 20: EPS model specification

Modelling Technique: Regression Analysis
Dependent Variable: YoY Downgrade in Consensus EPS
Independent variables: Economic crisis factor and policy rate cycle
Adjusted R squared: 70%
Predicted downgrades for FY13 from the current EPS level: 11%

Source: CEIC, Ambit Capital research

Exhibit 21: We expect current Bloomberg consensus Sensex EPS estimates to be downgraded by 11% from the current INR1325



Source: CEIC, Ambit Capital research

Note: We define downgrade as the YoY change in Bloomberg consensus estimates from those published in the first month of the financial year to the final estimates published that year.

Stock specific implications

We believe that investment strategies need to be focused on stock specific fundamentals (rather than sector oriented strategies) as the divergence in fundamentals within sectors appears to us to be greater than the divergence across sectors. (Think of the difference between Torrent Power and Lanco's fundamentals or between IVRCL and Voltas' fundamentals or between Bharati and Idea's fundamentals or between SBI's and BOB's fundamentals and you seen realize why it makes very little sense for a broker to recommend that clients BUY/SELL sectors).

So what do we like at present? As you would expect, we continue to reiterate the **"G&C 3.0: Battleships"** portfolio. Since its launch on October 19, 2011 this portfolio has outperformed the BSE500 by 377bps and 429bps on the basis of market cap and equal weight respectively. (See Appendix 1 for a fuller description of how we arrived at these Battleship stocks. See the table at the next page for performance details of the Battleships portfolio.)

Our overall family of Good & Clean portfolios has outperformed the market by in excess of 13% points since launch in mid-March last year.

Exhibit 22: Our Portfolio of 36 "Battleships"

Bloomberg code	Company	Prices (₹)		Performance (%)	Mcap (USUS$ mn)	FF Mcap (USUS$ mn)
		18-Oct-11	3-Jan-12		3-Jan-12	3-Jan-12
SKB IN	GlaxoSmith C H L	2,325	2,519.0	8.4	1,990	997
TTMT IN	Tata Motors	181	190.7	5.2	10,468	5,957
PWGR IN	Power Grid Corpn	98	100.5	2.4	8,744	2,236
PSYS IN	Persistent Sys	315	321.9	2.1	242	68
BDE IN	Blue Dart Exp.	1,588	1,600.0	0.8	713	96
ONGC IN	O N G C	264	262.1	(0.6)	42,119	5,305
ITC IN	ITC	204	201.1	(1.6)	29,441	17,762
BOS IN	Bosch	7,008	6,765.1	(3.5)	3,990	1,102
CDH IN	Cadila Health.	755	710.0	(6.0)	2,731	591
TTKPT IN	TTK Prestige	2,727	2,517.0	(7.7)	535	134
EIM IN	Eicher Motors	1,648	1,503.1	(8.8)	762	274
OFSS IN	Oracle Fin.Serv.	2,062	1,875.0	(9.1)	2,961	530
GDPL IN	Gateway Distr.	145	130.1	(10.1)	264	113
ENIL IN	Ent.Network	249	222.6	(10.6)	199	53
CRIN IN	Coromandel Inter	308	274.4	(10.8)	1,455	452
CSTRL IN	Castrol India	474	421.0	(11.1)	1,957	504
VTEX IN	Vardhman Textile	202	179.0	(11.4)	214	151
SJVN IN	SJVN	22	19.0	(11.6)	1,476	148
PIDI IN	Pidilite Inds.	160	141.0	(11.7)	1,344	396
JUBI IN	Jubilant Food.	886	755.5	(14.7)	921	455
AKZO IN	Akzo Nobel	911	774.6	(15.0)	534	183
SOBHA IN	Sobha Developer.	230	195.5	(15.2)	360	94
SRF IN	SRF	299	254.0	(15.2)	289	145
FAG IN	Fag Bearings	1,245	1,050.0	(15.6)	328	148
IH IN	Indian Hotels	68	56.8	(16.6)	812	408
RBXY IN	Ranbaxy Labs.	503	417.5	(17.0)	3,309	962
HCBA IN	Novartis India	818	668.9	(18.2)	402	90
TTAN IN	Titan Inds.	221	179.7	(18.8)	2,994	1,453
GPPV IN	Guj Pipavav Port	70	56.2	(19.1)	446	231
BIOS IN	Biocon	345	276.7	(19.9)	1,039	313
VST IN	VST Inds.	1,342	1,075.0	(19.9)	312	171
SIEM IN	Siemens	816	650.6	(20.3)	4,155	879
GSFC IN	G S F C	427	334.6	(21.7)	502	254
BPCL IN	B P C L	642	473.9	(26.2)	3,217	957
NMDC IN	NMDC	240	157.8	(34.4)	11,751	588
ARVND IN	Arvind Ltd	105	66.9	(36.4)	320	150
Current Portfolio	**Free Float Mkt cap weighted returns**			**(4.92)**		
BSE500	**Free Float Mkt cap weighted returns**			**(8.93)**		
Alpha	**Free Float Mkt cap weighted returns**			**4.01**		

Source: Bloomberg, Ambit Capital research

Beyond G&C 3.0, here are the strongest picks from our active coverage:

HCL Tech (HCLT IN, mcap US$5bn, BUY)

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We continue to find HCL Tech the best positioned vendor on a structural basis due to its stronger positioning in Remote Infrastructure Management (RIM) services and Enterprise Application Services- the two structurally fastest growing service lines. HCLT is also likely to benefit from strong deal flow momentum over the course of the October-November-December quarter as CFOs and CIOs sign several RIM deals to optimise their cost of operations before budgets for CY12 are decided. Although our view on spending levels in CY12 remains cautious, we see HCL Tech benefit from RIM deals signed in CY11 and stronger presence in new markets (non-US and Europe)- particularly Asia Pacific.

HCL Tech shares have underperformed its Tier 1 peers over the past month driven by both fear of slowing growth, billing rate discounts and technical factors such as exiting the MSCI index. This makes it the most attractively priced Tier 1 IT firm with stronger than peer growth prospects and valuation comfort.

Our free cash flow model values HCLT at ₹550. HCLT now trades at a 30-35% discount to its larger peers on a P/E and EV/NOPAT basis and 40-45% on an EV/EBITDA basis. This makes it a good company and a great investment. We reiterate our strong BUY recommendation on HCLT.

Bank of Baroda (BOB IN, mcap US$5,143mn, BUY)

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- **Measured pace of asset book growth**: Bank of Baroda (BOB), with a loan book of ~US$7bn, has consistently exhibited loan book growth a few percentage points ahead of the system and has gradually pipped larger and older banks (with a longer history) to emerge as the third largest state-owned bank in the system, behind State Bank of India (SBI) and Punjab National Bank (PNB). BOB has benefited from a large overseas book (~1/4th of the total portfolio) that offers a perfect complement to the bank's domestic lending operations (diversified avenues for deployment often help balance the bank's blended profitability in terms of fund-based as well as fee-based income).
- **Disciplined underwriting drives best-in-class asset quality**: BOB has demonstrated a disciplined approach towards underwriting that reflects in system-lowest incremental delinquencies (sub-1% annualized as of Sep'11) despite an economic environment that is not particularly conducive to sustaining such superior asset quality. Over the last 3 years, BOB has gradually re-positioned itself as the most defensive play among state-owned banks from an asset quality perspective.
- **Sustainable cross-cycle RoAs at ~1.3% and RoEs in excess of 20%**: Widely considered as a sensible judge of its own risk appetite, BOB boasts a consistent record of high profitability, superior efficiency ratios (one of the lowest cost-to-income ratios in the system) and high return ratios (with RoAs consistently clocking in the range of ~1.3%).

At ₹700, BOB quotes at 1.2x our FY12E ABVPS of ₹601 and is best positioned among state-owned banks to hold its asset quality and return ratios in this environment. Our target price is ₹1000, implying 43% upside.

Ultratech Cement (UTCEM IN, mcap US$6,050mn, BUY)

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On 19th December we changed our stance on Ultratech from SELL to BUY due to:

- **Higher realizations**: Realizations for 1HFY12 grew 15% on YoY basis mainly on account of a sharp increase in prices in the South (26% of despatches) and due to continuous price hikes since 2QFY12. This could lead to higher realization growth in 2HFY12 as well on account of: (a) input costs stabilizing (prices of imported coal stabilizing and freight costs inching up marginally); (b) some petcoke substitution (10%-12% cheaper than coal); and (c) prices rising post the monsoons, EBITDA/tonne is likely to further improve in 3QFY12 to ₹998 and in FY12 to ₹.1,005.
- **Volumes**: Whilst demand from the rural segment and brand-seeking individual households is likely to improve volumes for 2HFY12, volume growth for FY12 would remain flat on like to like basis mainly owing to exposure to Southern India which is currently witnessing negative growth. We expect the overall capacity utilization of UltraTech to grow marginally from 78% in FY11 to 79% in FY12E and to 82% in FY13E.

UltraTech is currently trading at 9x 1-year forward EV/EBITDA. Whilst on EV/tonne the stock is trading at a 29% premium to its 5-year average (USUS$125/tonne), on 1-year forward EV/EBITDA, the stock is trading at a 20% premium to its 5-year average. We reiterate our BUY on UltraTech with a fair valuation of ₹1,308 (11% upside).

Mannapuram (MGFL IN, mcap US$729mn, BUY)

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Whilst the decline in gold prices can impact both the credit quality and growth of gold loan companies, our analysis suggests that the impact is not as linear as the ongoing fall in stock prices are factoring in. This is because:

- The average loan-to-value (LTV) of the Manappuram loan portfolio is 70%. Hence the chances of willful default are relatively low as the borrower is incentivised to pay up and reclaim his jewelry.
- Mannapuram calculates LTV without including the value of the precious stones embedded in the jewelry. Including the value of stones and taking account of making charges makes it even less likely that borrowers will willfully default on a loan.
- Manappuram offers loan against jewelry, which households have used for some time and to which the borrower usually has an emotional attachment. This further reduces the chances of willful default.
- The average tenure of the loan is ~4 months so the gold prices have to decline very rapidly for the borrower to be out of the money and willfully default on the loan.

Therefore, we expect credit quality trends for Manappuram to remain stable unless there is a sharp correction (of more than 20% in the gold prices in rupee terms over the next three months). However, gold prices have never fallen more than 20% within three months in rupee terms in the past due to the inverse correlation between international gold prices and the INR/USD exchange rate. Our sensitivity analysis based on the LTV breakup and repayment pattern of Manappuram portfolio shows that if we assume a worst case scenario of a 40% fall in the gold prices within three months (this sort of correction has never occurred in rupee terms and has taken place only once in dollar terms) and we assume all the gold loan borrowers to be opportunistic borrowers who would default if they are out of the money (which is not the case looking at ticket size per customer), the total write-offs after recoveries could be ~4.0% of the portfolio which could be absorbed by a year's earning as the company's RoA is ~4.5%.

We continue to highlight Manappuram as the best play in the NBFC space given it is least impacted by: (i) proposed regulatory changes on securitisation, priority sector status, higher capital requirement and tougher NPA recognition norms; (ii) slowing macro demand and rising cost of funds, as it demonstrates sustained growth momentum in an asset class which is rate agnostic at sustained margins and RoAs. We maintain our BUY stance and target price of ₹72 (53% upside, implied valuation of 2x FY13 BVPS and 8.6x FY13 EPS).

Torrent Power (TPW IN, mcap US$1,774mn, BUY)

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Operationally Torrent Power has the best efficiency in the sector (average PLF and average T&D losses in FY10 was 88% and 7.6% compared to India's average PLF of 78% and T&D losses of 25% respectively) and stellar cash flow generation (FY11 CFO/PAT stood at 1.5x v/s peers 1.1x). It also has one of the strongest balance sheet (FY11 net debt:equity was 0.6x), minimal exposure to merchant power (~20%) and zero exposure to Chinese equipments. This compares very favourably to its private sector peers (Adani Power, Lanco Infratech, KSK Energy, JSW Energy) for whom the net debt:equity is at 2.6x, exposure to merchant power is in the range of 20% to 72% and have majority of their equipment being bought from Chinese vendors.

The stock quotes at FY12P/BV of 1.6x, which is at a discount of ~15% v/s peers (we have only considered NTPC and Adani power given that the stock prices of other companies have been severely beaten down given concerns around fuel availability, offtake, land acquisition and leveraged balance sheets). We believe the discount to peers is not justified given Torrent's superior cash flows (FY12 FCF yield of ~16% and a dividend yield of 3%), higher RoE (24% v/s 13% for peers) and improving visibility on pipeline. Note that in our DCF based SOTP (which values the company at ₹322, 62% upside) we have modeled excess cash to earn a pre tax return of 6%. In the event Torrent makes an acquisition (given that there are many projects up for sale on distressed valuations), it will act as a big positive for the stock given that equity IR₹ on a minimum are likely to be 3x of our assumed pre tax return on excess cash (Note Torrent generated operating cash flow of ₹19bn in FY11 which is equivalent to it doubling its installed capacity assuming debt:equity of 70:30).

Engineers India (ENGR IN, mcap US$1,295mn, BUY)

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The Engineering & Constuction sector's overhang has led to EIL's stock price declining 37% over the past year despite revenue growth remaining strong (up 40% YoY in 1HFY12) and the firm's business capabilities being robust. In an industry where companies are shedding strength with rising debt, we recommend EIL based on:

- **Government sponsored enterprises to invest twice in the XIIth plan v/s the XIth plan**: The cyclical nature of refinery and petchem investments can lead to a lack of orders for a brief period. But Government sponsored plans to increase their refinery capacity [by 60% (74mmtpa) by investing USUS$18bn in greenfield capacities and USUS$13bn in upgradations] will provide EIL with growth visibility over FY12-FY17. Further, greenfield petchem capex is expected to be closer to USUS$8bn. Slippage risks are low owing to

Government support for energy PSUs and fewer procedural problems in expansions.

- **Superlative capabilities with flexibility**: EIL's scalable hydrocarbon engineering/project management skills, extensive experience and Government ownership make its offerings flexible — not only E&C services across the contracts spectrum (design to EPC) but also critical path projects, tweaking the usual EPC models (offering open book estimates, OBE) and entering into long-term relationships (MoUs, nominations) with energy PSUs. The cost-sensitive nature of large projects keeps the threat from the high-cost global majors low.

- **Unrivalled CFOs and RoEs**: Over FY08-FY11 EIL leveraged its rising investments by capturing a bigger share of hydrocarbon spend by taking up low EBITDA margin (10%-12%) high volume lumpsum turnkey (LSTK) jobs (144% CAGR) instead of high EBITDA margin (40%) low volume consulting jobs (22% revenue CAGR). Hence, operating cashflows (CFO) rose and RoEs moved to 37%-40% from mid-teens earlier, overriding the declining EBITDA concerns.

Despite a radically better CFO/RoE profile, EIL's stock trades in line with peers. Paltry orders in FY12 and growth deceleration beyond FY13 have led to a gradual derating. We do expect lower revenue growth over FY13-FY15, but believe EIL's multiple should retrace lost ground as the refinery opportunity gets supplemented with fertilizer capex, thus addressing growth concerns. A higher investible float versus many peers addresses low free float concerns.

Petronet LNG (PLNG IN, mcap US$2,201mn, BUY)

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PLNG is a straightforward gas utilities with secure financial positions and good Balance Sheets are worth looking at. Rising domestic gas demand, muted growth in domestic gas production and waning gas pipeline infrastructure bottlenecks places PLNG in a sweet spot to capture the huge domestic gas deficit. Further PLNG would benefit from early mover advantage, as its expanded regas capacity will come up over FY13-FY14, 2 years ahead of competition. The doubling of capex for a greenfield LNG regasification terminal as compared to capex for PLNG Dahej terminal, would mean either: (1) PLNG will be able to generate far higher RoCEs (+25%) versus the new entrants whilst charging the same prices, or (2) as is more likely, cut its prices (and hence take a reduction in its RoEs) to make operations tough for the entrants.

The company has high earning visibility amid global uncertainty given the fact that it does not bear any pricing, volume or margin risk for 80%-85% of its regas volumes due to long term (+20 years) and back to back contract with LNG suppliers and gas offtakers. We don't foresee risk to LNG demand from the industrial segment, as even at high 14.5% linkage to USUS$100/bbl of crude price, LNG prices are 11%-25% lower than the prices of alternative liquid fuels (naphtha, fuel oil and diesel).

The key trigger for the share price is the signing of 3-4mmtpa of long term LNG contracts. With surplus LNG liquefaction capacity being set up to export LNG from Australia, Qatar, Africa etc. and with US planning to set up LNG export terminals to export its surplus shale gas, it will result in availability of more LNG for supply-deficient economies such as India at competitive prices. Thus, despite PLNG share price outperforming the Nifty by 55% over the past year, we find shares still reasonably valued at 12.4xFY12 EPS.

Using a DCF-based model we value PLNG at ₹190, which implies an FY13 P/E of 13.7x, FY13 EV/EBITDA of 9.4x. We expect 20% earnings CAGR over FY11-FY14 on the back of rising volumes and higher re-gas charges. Although PLNG has outperformed the Nifty by 55% over the past year, we find the shares to be reasonably valued at 11.4x FY13 EPS. The key catalyst for the stock would be the signing of a long-term LNG contract and further delay in ramp-up of KG-D6 gas production.

Oberoi Realty (OBER IN, mcap US$1,328mn, BUY)

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With net cash:equity at over 0.4x, healthy customer demand backed by a solid reputation around quality and timely execution, Oberoi is better placed than most developers. Advance received from customers on the balance sheet has increased from ₹3.9bn in Mar 2011 to ₹6.1bn in Sept 2011 whilst sundry debtors remained stable at 0.6bn in 1HFY12. This highlights the extent of conservatism in the group's revenue recognition methodology. Whilst unit sales are likely to decline by 10-15% QoQ for 3QFY12, this is likely to be more than offset by: a) increased realisation rates of 10-30% across its projects; and b) fast pace of construction on ongoing projects leading to accelerated cash collections from customers during the quarter.

Our base case scenario for project based DCF valuation of Oberoi conservatively assumes sluggish demand for the group's properties, no appreciation in realization rates over the next two years, 8% p.a. cost inflation and 1x valuation for surplus capital on the balance sheet. Using a cost of equity of 15% and perpetuity growth rate of 4%, this scenario generates an SOTP valuation of ₹271, 26% upside.

Our highest conviction shorts at present are:

Wipro (WPRO IN, mcap US$19bn, SELL)

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We expect Wipro's resurgence to be impacted by a weak demand environment. We find Wipro's recent outperformance compared to Tier 1 peers short lived and supported by inorganic growth (in 2QFY12) and limited to a few verticals and service lines. Worsening pricing and rising debtor days indicates that management is struggling to grow. We reiterate the point that Wipro is likely to take longer to recover to peer average growth rates and a weak demand environment with likely vendor consolidation is likely to make the going tougher. We would use the recent strength to exit the shares.

After the strong share price recovery over the past month, Wipro trades at a small discount to Infosys on a P/E basis but more importantly at par on EV/NOPAT (ex-cash PE) basis and a premium on an EV/EBITDA basis. This suggests that the market has priced in strong expectations of a recovery that seem prematurely based on the performance of just one quarter. This makes it a weak company and a poor investment. We reiterate our strong SELL recommendation on Wipro and caution investors against a potential value trap. We strongly believe Wipro is likely to substantially disappoint optimistic street expectations.

State Bank of India (SBIN IN, mcap US$20,318mn, SELL)

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The two main concerns that drive our SELL stance on India's largest bank are:

NPL pressures from stressed sector exposure: In light of the sectors that have contributed to SBI's incremental loan book growth (Iron and Steel, Other Metals, Infrastructure, Gems and Jewellery, Engineering and Textiles are the highest contributors to incremental loan book growth), we highlight the balance sheet risks facing SBI. Given these sectors' heavy dependence on domestic as well as global growth outlook, we see further stress building up in SBI's books. Given that SBI is highly levered to the entire Indian economy (in terms of the bank's exposure across various sectors), we anticipate a sharp incremental deterioration in SBI's asset quality across segments. In fact, our analysis of SBI's asset mix over the last three years indicates that loan book growth has been driven by 'large corporate', 'agriculture', 'international' and 'retail' categories.

The table below highlights the industrywise gross NPAs for the bank, the significance of each sector within SBI's books and our near-to medium-term outlook towards a few select sectors.

Exhibit 23: Sector-wise gross NPAs for SBI (in %)

	Gross NPA (%)				Sector significance in SBI's books	Sector outlook
	FY08	**FY09**	**FY10**	**FY11**		
Coal	1.93	0.7	0.58	7.61		
Mining	0.89	0.73	0.96	1.64		
Iron & Steel	1.83	3.2	2.15	3.67	High	Negative - commodity prices geared to global growth
Other metal products	1.65	6.34	4.04	1.91		
All Engineering	3.03	3.15	2.63	2.94	High	
Electronics	1.53	6.93	2.37	1.38		
Electricity	0.56	14.04	0.12	0.11		
Cotton textiles	1.8	2.18	2.46	2.59	High	Negative - falling cotton prices and heavy export-orientation
Jute textiles	4.37	2.85	7.4	6.31		
Other textiles	1.22	1.53	6.03	5.11	High	
Sugar	0.49	0.24	0.31	0.61		
Tea	25.63	17.55	21.68	5.92		
Food processing	4.48	3.14	3.59	3.91		
Vegetable oils & vanaspati	3.17	2.69	3.42	4.94		
Tobacco & tobacco products	1.51	1.01	1.36	10		
Paper / paper products	2.28	3.85	5.97	3.01		
Rubber / rubber products	2.63	1.96	5.15	5.39		
Chemicals / dyes	2.66	1.79	1.99	3.61	High	
Fertilizers	3.76	1	1.12	2.69		
Petrochemicals	0.86	2.84	1.55	2.89		
Drugs & pharmaceuticals	1.53	1.35	2.46	2.27		
Cement	1.44	0.62	0.36	0.84		
Leather / leather products	2.64	1.37	1.77	1.87		
Gems & Jewellery	0.73	1.9	4.56	7.32		
Construction	1.3	2.94	6.59	5.63	High	Negative - low economic activity and high leverage
Petroleum	0.16	0.08	0.21	0.07		
Automobiles & trucks	1.01	1.22	3.22	2.23		
Computer software	1.8	0.1	32.63	31.93		
Infrastructure	0.44	0.94	0.98	0.82	High	
Power	0.53	0.59	1.01	0.42	High	Negative - absence of backward linkages; execution challenges; low project IR₹
Telecommunication	0.48	0.99	1.46	0.63	High	Negative - regulatory uncertainty simultaneous with lower economic viability
Roads & Ports	0.1	0.7	1.14	1.31	High	
Other industries	1.9	1.41	1.7	2.78	High	
NBFCs & trading	1.7	1.78	2.01	5.52	High	Negative - regulatory uncertainty; likely to face margin pressures
Residual advances	4.35	3.78	3.47	2.57	High	Negative - includes retail advances including home loans
TOTAL	**2.54**	**2.49**	**2.66**	**2.93**		

Source: Company, Ambit Capital research

NPL pressures from restructured portfolio: With an ever-ballooning restructured portfolio (at over 4% of the loan book) that has already witnessed slippages at ~20%, we, in fact, see a further upside risk to our FY12E/FY13E NPL forecasts. Our calculation suggests that SBI has made incremental provisioning only to the tune of the regulatory minimum ~15% (beyond the counter-cyclical 70% PCR on gross NPAs as of September 2010), implying a low cushion of safety in the event of persistent high delinquencies.

We remain aggressive SELLers of SBI on the back of risks to asset quality and weak capitalization challenges. We are re-visiting our FY12E/FY13E forecasts to recalibrate the depth of slippages that we have built into our forecasts.

Axis Bank (AXSB IN, mcap US$6,482mn, SELL)

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- **Downside risks to asset quality**: This bank seems to have an ever-increasing risk profile that manifests itself on either side of the balance sheet, especially at this stage of the economic cycle (with the domestic economy staring at sub-7% GDP growth with negative implications for investment-heavy sectors that are likely to pose a downside risk to the bank's profitability). On the asset-side of the balance sheet, our concerns are driven by higher exposure to large ticket advances in the investment-heavy sectors (infra + power) (~18% as of Sep'11), relatively greater exposure to BBB-rated or non-rated borrowers (27% as of Sept'11 vs 25% as of June'11), sub-optimal yields that are not commensurate with an increasing risk profile and a restructured book of ₹24bn heading into an environment of sustained slowdown.
- **2HFY12 margins to remain under pressure**: A bulk of the second half growth is likely to be towards fulfilling priority sector obligations which will further exert a downward pressure on yields. On the liabilities side of the balance sheet, we are cautious about its high repricing ratio and high dependence on volatile bulk deposits making it vulnerable to any movements in the short term yield curve (refer to our thematic: *"Asset-Liability Mismatches: How are Indian banks placed?"* published on 24th March, 2011). Around 37% of Axis Bank's total deposits are greater than ₹50mn in value compared to the system wide average of ~15% (for deposits valued above ₹ 1.5mn).

We remain SELLers in the stock although our valuation is UNDER REVIEW with our previous target price of ₹955 being achieved. While the stock has corrected in recent times, we remain sceptical of the bank's ability to maintain its superior asset quality against the backdrop of its exposure to internally-rated low-investment grade infrastructure projects.

LIC Housing Finance (LICHF IN, mcap US$1,950mn, SELL)

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- Whilst we continue to believe that LIC Housing Finance (LICHF) is a robust franchise given competitive advantages on both sides of the balance sheet, its current valuation (a 24% premium to the NBFC sector) appears to more than factor in these strengths even as cyclical pressures impacting growth and margins coupled with regulatory changes could lead to muted 8% earnings CAGR over FY11-FY13. Falling incremental spreads, a bigger fixed rate portfolio in a high interest rate environment, a lower proportion of the high yield developer portfolio, increased borrowings to refinance the portfolio bought from the parent along with implementation of the recent regulatory change which directs Housing Finance Companies (HFCs) to charge similar rates for old and new customers would lead to a significant squeeze in the NIMs in FY12-FY13 irrespective of what the RBI does with repo rates.

- Rising interest rates, a slowing economy along with a change in the borrower profile could lead to increase in the NPAs which coupled with provisions for standard assets would lead to higher provisioning requirements. LICHF might need to raise capital in 2HFY12 given that its leverage is on the higher side (around 12x) which could further dilute EPS growth and RoE. Moreover, a higher equity capital requirement for HFCs like LICHF, in line with what the RBI is considering for other NBFCs, cannot be ruled out. Such a change could structurally reduce RoEs to 15%-18% v/s the 22%-25% delivered in the past.

Our excess return valuation method gives a fair value of ₹184 per share (19% downside) implying 1.8x FY12 P/BV. The stock is currently trading at 2.1x FY12 P/BV which is at a 20% premium to its cross cycle valuations and at a 24% premium to the rest of the NBFC sector (ex-HDFC). The company's earnings growth disappointing consensus' expectations would be the major negative catalyst for the stock.

Dabur (DABUR IN, mcap US$3,321mn, SELL)

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Dabur's consumer care division witnessed high growth across categories over FY07-FY11 thanks to an unprecedented upsurge in demand from rural and semi-urban areas. With the drivers of rural demand now waning, Dabur is the first well known FMCG company to be adversely impacted as is evident from the firm's 1HFY12 performance (standalone domestic revenue growth down to 11% from 15% a year ago; EBITDA margins down 115 bps). It is worth noting the reasons for this decline as these drivers will continue to hamstring Dabur going forward:

- More than 50% of Dabur's consumer care division sales (which accounted for 68% of the firm's total revenues in FY11) come from rural and semiurban areas. Growth in categories like hair care, oral care, digestives and health supplements was led by these areas over FY07-FY11. Now the rural slowdown in 1HFY12 is adversely impacting these categories.
- Categories like shampoo and skincare have seen MNCs like HUL and P&G increasing their competitive intensity. Dabur's revenue growth and margins in these categories are therefore under pressure. Personal care accounts for 30% of Dabur's consumer care division revenues. During FY11, as gross margins declined by 100bps, the company moderated advertising spending (Advertising:Sales (A:S) declined by 140bps to 13%), resulting in EBITDA margins being maintained at 19.2%. Now, in the increasingly competitive environment, A:S is likely to have to rise thereby impacting EBITDA margins.
- Dabur's opportunity to gain from premiumisation trend is limited to the "Real" beverage offering which, although relatively successful, accounts for a mere 10% of its revenues.
- Exits of senior management at Dabur raises concerns regarding whether Dabur is becoming a poaching ground for talent. In Nov, 2010, 2 senior managers – Mr. Vikas Mittal, EVP and Mr. K.K.Rajesh, EVP - quit. In July, 2010, the company's COO, Mr. VS Kannan Sitaram, quit.

Our DCF Model values the company at ₹93, implying 8% downside, FY13 P/E of 22x, 11% below its five year average of 25x. The current share price is ₹101.

G&C 3.0- Battleship Stocks

Company	MCap (US$ bn)
O N G C	42.12
ITC	29.44
NMDC	11.75
Tata Motors	10.47
Power Grid Corpn	8.74
Siemens	4.15
Bosch	3.99
Ranbaxy Labs.	3.31
B P C L	3.22
Titan Inds.	2.99
Oracle Fin.Serv.	2.96
Cadila Health.	2.73
GlaxoSmith C H L	1.99
Castrol India	1.96
SJVN	1.48
Coromandel Inter	1.46
Pidilite Inds.	1.34
Biocon	1.04
Jubilant Food.	0.92
Indian Hotels	0.81
Eicher Motors	0.76
Blue Dart Exp.	0.71
TTK Prestige	0.54
Akzo Nobel	0.53
G S F C	0.50
Guj Pipavav Port	0.45
Novartis India	0.40
Sobha Developer.	0.36
Fag Bearings	0.33
Arvind Ltd	0.32
VST Inds.	0.31
SRF	0.29
Gateway Distr.	0.26
Persistent Sys	0.24
Vardhman Textile	0.21
Ent.Network	0.20

Source: Company, Ambit Capital research

Appendix 1

A synopsis of our 19th Oct "Battleships" note

Our analysis that Southern Europe's fiscal situation is irretrievable (see our note dated 10th Oct) and our Economics and Strategy team's subsequent decision to revise India's FY13 GDP growth to 6.4% from 7.0% (see our 17th Oct note) prompted us to look for "battleship" stocks which can deal with such an adverse economic situation (see our 19th Oct note).

Moving beyond the realms that are deemed to be traditionally "defensive" sectors, we had used an F-Score based approach to identify financially robust companies that have healthy balance sheets, strong cash flows and well entrenched competitive positions. More specifically, we used 8 financial parameters to capture YoY improvements in a firm's profitability, debt-servicing ability and operating efficiency. A summary of these 8 parameters is shown below.

1. **Profitability**
   a. Positive RoA
   b. Increasing RoA (YoY)
   c. Positive CFO
   d. CFO greater than PAT
2. **Leverage, liquidity and source of funds**
   a. Declining D/E (YoY)
   b. Improving current ratio (YoY)
   c. No equity offering in the previous year
3. **Operating efficiency**
   a. Improving margins (YoY)
   b. Improving Asset Turnovers (YoY)

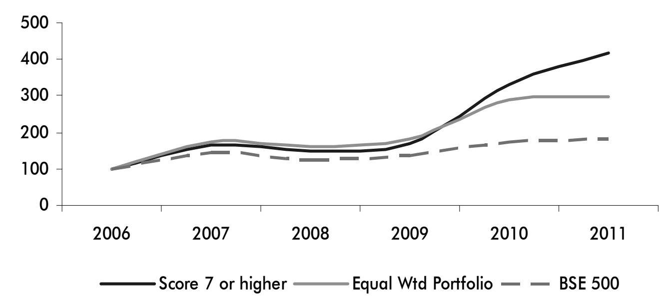
Our backtesting of this approach had shown that stocks with an F-Score of "7 or better" *without any P/B restrictions* was the most preferred combination since it produced portfolios which demonstrated consistently healthy historical outperformance and had at least 15 stocks in the portfolio. As shown in the exhibits below, portfolios constructed based on this method outperformed the BSE500 by an 18% CAGR on a market cap weighted basis and 9% CAGR on an equal weighted basis since FY06.

Exhibit 24: F-Score 7 or better (no price restrictions)

		Performance			
		Equal Weighted		Mkt Cap Wtd	
Year	No. of Stocks	Absolute	Rel. to Eq Wtd Portfolio	Absolute	Rel. to BSE500
06-07	74	65%	-7%	65%	21%
07-08	81	-10%	-3%	-12%	2%
08-09	71	14%	1%	24%	13%
09-10	35	93%	32%	78%	51%
10-11	81	28%	25%	12%	8%
CAGR		**33%**	**9%**	**29%**	**18%**

*Source: Ambit Capital research. * The 06-07 row refers to investment performance from July '06 to June '07 using F-scores based on FY06 data. The 07-08 row refers to investment performance from July '07 to June '08 using F-scores based on FY07 data. And so on.*

Exhibit 25: F-Score 7 or better (no price restrictions)



Source: Ambit Capital research. The above worms show the growth of Rs 100 invested in the beginning and cumulated over the entire period.

Applying this method to the current year gave us 74 stocks which when screened for accounting, corporate governance and political connections led us to 36 stocks that eventually formed our Good & Clean 3.0- Battleships.

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Explanation of Investment Rating

Investment Rating	Expected return (over 12-month period from date of initial rating)
Buy	>5%
Sell	≤5%

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