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MARKET OUTLOOK AND EQUITY STRATEGY

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It is that time of the year when everybody, who is anybody in the capital market, starts making annual prediction as to what lies ahead for us in the year 2012.

At the moment, it has become fashionable (acceptable?) to come out with a very pessimistic view, paint a scary picture and thereby, attract media attention.

But, the fact is that predicting the markets (for 2012) couldn't have been more challenging. However, one thing seems distinctly possible for our markets – it could get worse first before it gets better.

The year 2011 was tumultuous (understatement) for investors and equity markets across the globe, with India suffering from the *dubious* distinction of being one of the worst performer and the broader indices shedding nearly 23 per cent during the year.

2012- THE CHALLENGES AHEAD

EUROPE:

While Europe will remain the single largest 'wild' factor, there is a distinct possibility that as we go beyond the first few months of 2012, Europe will no longer have the same bearing on the Indian markets a much as much as what it did in the year gone by.

And, even as the European leaders have seemingly hashed out a crisis deal, the debt saga is surely far from over. Debt won't go away and people in Europe will have to learn to accept lower standard of living, leading to less consumer spending, higher unemployment and sluggish economic growth.

INFLATION & INTEREST RATES:

Inflation continued to remain a 'dirty' word for the equity markets in 2011. However, there is a distinct possibility of the same coming down in 2012(also aided by the 'base' effect), thereby prompting the RBI (which had come out with a series of 13 interest rate hikes over a period of 19 months) to cut rates. We expect atleast 100 bps of rate cut in 2012.

COMMODITY PRICES & RUPEE DEPRECIATION:

Commodity prices, which have already started weakening could, remain lower on global growth concerns (China is experiencing a distinct slowdown). While this is definitely positive news for India and her 'inflation' problem, a lot will depend on the Indian currency.

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GROWTH: Economic growth has clearly slowed down and estimates have been scaled down considerably to 7 p.c or even lower (from around 9 p.c. at the beginning of the fiscal) for 2011-12. The year 2012 could be a tough walk for the government and the RBI.

POLICY ACTION – JOKER IN THE PACK

Government inaction on the policy front (read 'policy paralysis') has been spoken and written about in great depth and not much is being expected from the policy makers as regards 'economic reforms' are concerned.

However, this is something where we could experience a major positive trigger. Post-the UP elections in February, if we see the FDI in multi-brand retail going through (repeatedly mentioned by the PM and the FM, but, who believes them? Sad…) and a proper plan being put in place for other economic reforms (electricity distribution, introduction of GST, enhancing FDI in insurance, etc.) the market will certainly look at it favourably.

FISCAL DEFICIT:

The slow economic growth has resulted in lower-than-expected December quarter advance tax payments. Also, with disinvestment of PSUs just not taking off this fiscal, the government is finding itself seriously short of funds. On the other hand, the government has to exhibit its generosity and take care of a mounting food and fertilizer subsidy bill, besides bailing out an Air India and the cash-strapped (and, close-to-being declared 'bankrupt') SEBs. The State Bank of India needs immediate funds and the other PSU banks need to be capitalised. The OMCs continue to bleed (the falling rupee to be blamed to some extent) and they too need the government's largesse.

All this should ensure that the government will revise its borrowing programme for the fiscal 2011-12, leading to firm bond yields, which could spell further trouble for the equity market.

BANKING SECTOR – STARING DOWN THE BARREL

A distinct stress is brewing in the banking sector. Even as the earning has been good, the quality of earning has deteriorated considerably. Over the last year, there has been a near 100 p.c. growth in NPAs and a threefold increase in the growth of gross impaired assets.

Some of the PSU banks have been shamelessly postponing NPAs to the future by restructuring these loans. In a macroeconomic situation of a slowdown, the likelihood of these loans turning around is bleaker than before. So, banks are sitting on NPAs without providing them adequately. Today, nearly 80 p.c. of the total NPAs of the banking sector are in infrastructure, real estate and priority sector lending. Add to these numbers, the impending power sector problems – the mounting losses of distribution companies and probable payment defaults of state electricity boards – and, one can sadly conclude that all is not well with the banking sector.

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VALUATIONS:

Considering that we have lost nearly 23 per cent in 2011, we feel that an interesting opportunity awaits equity investors in 2012 where we could see a 20-30 per cent rebound in the stock indices from 2012-low, prompting some of the better names, among stocks, to record even a 30-50 per cent appreciation from their 52-week lows.

While we are sticking to our SENSEX EPS of Rs.1180 for 2011-12, assuming just 8 percent corporate growth, we expect a SENSEX EPS of Rs.1275 in 2012-13 and Rs.1450 for 2013-14.

And, considering that next year this time, the market will start looking at 2013-14 earnings, we could have a SENSEX of over 18500 in place (13 times the earnings estimate for the NIFTY). Corresponding level for nifty is 5600.

STOCK SELECTION:

However, considering the fluid nature of the markets at the moment, we are advocating a defensive strategy for our investors. We have identified 20 scrips (10 among large caps and 10 belonging to the mid-cap space) for investment in 2012. Most of these names are from the better-performing sectors, have a decent business model in place, don't have much exposure to foreign currency issues, are not over-leveraged (in some cases, have decent cash in the books).

We believe that the next fall in the markets (we are not ruling it out) could happen anytime over the next six months. That could provide a lovely opportunity for earning 30-50 p.c. on individual scrips, when a rebound materializes. At that point of time, one could possibly shift from defensive stocks to slightly aggressive bets.

We will come with a fresh list of recommendations when we come to that. Till then, these 20 scrips should suffice.

SUMMARY:

As of today, the four important factors that could dictate the market trend in 2012 (in order) are:

1. Government finances and how it manages to convince marketmen that it is making a conscious attempt to address the growing deficits – fiscal, current account and trade.
2. Europe: If the European Union splits, GOD help investors across the globe.
3. Rupee depreciation and capital inflows
4. Price of Oil: Iran should not cause a problem
5. Reforms back on track? If the government acts fast post-UP elections in February on the reforms front, it could turn out to be a big positive trigger.

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MARKET STRATEGY: Adopt a defensive approach. We have identified 20 scrips where we do not see much damage from present levels.

As and when things show signs of improving or, on the other hand, the broader indices have come off sharply (10-15 p.c.) for any reason (whichever happens first), one could start switching from 'defensive' stocks to slightly more 'aggressive' stocks. The rebound when it materializes, could yield 30-50 p.c. returns (in solid frontline stocks) from the bottom levels. However, stay clear of stocks of companies where promoters have pledged over 50 p.c. of their holding or where the company is highly over-leveraged and has huge exposure to debt.

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LARGE CAP IDEAS

1. **Asian Paints (Present price: 2600)**

Asian Paints is the market leader in the domestic paint industry, accounting for around +50% overall market share and +60% share in the decorative market. The company has clocked 20% higher than industry growth in volume terms over the last five years.

Asian Paints has a strong brand, enhanced dealer network with 27000 outlets and focus on premium emulsion segment. The company has clocked a net profit of Rs.472.4 crore on net sales of Rs.4511 crore during H1FY'12, translating into an EPS of Rs.49.25.

The company's products have a strong replacement demand which should help it sail through tough times. With improving demographics, increasing brand awareness, we expect Asian Paints to emerge as a key beneficiary.

2. **Dabur India (Present price: 100)**

The brandname, Dabur has become synonymous w. The company with its wide range of products is emerging as a key player in the Indian FMCG market. With the acquisition of Fem Care Pharma and Balsara's Hygiene and Home products businesses, the company is strategically placed to reap the benefits.

At present, the company is rejigging its distribution structure and increasing the number of outlets and doubling the rural reach by penetrating sparsely populated areas, the complete benefits of the same should be visible from FY'13E onwards. Dabur India should clock an EPS of Rs.3.6 and Rs.4.3 by FY'12E and FY'13E respectively.

3. **Dr. Reddy's Laboratories (Present price: Rs.1550)**

The company registered strong Q2FY'12 results on the back of significant improvement in the topline. We expect this trend to continue going forward also. We expect significant improvement in earnings by FY'13E since Russia and CIS which contribute 15% to the turnover, are expected to grow by ~20% on the back of significant volume growth in 20 key brands.

4. **Gas Authority of India (GAIL) (Present price: Rs.380)**

Post ~30% correction from its 52-week high levels, GAIL (India) Limited's share has emerged as a significant value-buy at the present levels. The company is the leader in the gas transmission and trading and continues to maintain this position going forward also. With the demand for natural gas from the end-user industry rising, demand for transportation of the same is expected to remain robust going forward.

During H1FY'12, the company registered a PAT of Rs.2079.1 crore on net sales of Rs.18566.4 crore, translating into an EPS of Rs.16.4.

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5. HDFC Bank (Present price: Rs.425)

The Bank has grown it's net profit consistently at a CAGR of +30% over the last several years. More commendable is the fact that this growth has been achieved along with consistent improvement in asset quality. The Bank's loan book is equally divided between the retail and the corporate segments. In the corporate segment, HDFC Bank finances mostly working capital loans in case of corporates.

The Bank has a strong liability franchisee with CASA ratio quoting at 47% of the total deposits. A high CASA ratio leading to effectively lower cost of funds has helped the Bank clock the highest NIMs (next only to Kotak Bank) in the banking space.

During H1FY'12, the Bank has registered an Interest Income of Rs.12695.7 crore, an increase of 37.6% y-o-y. The net profit for the corresponding period stood at Rs.2284.3 crore, an increase of 32.5% y-o-y.

6. Idea Cellular Limited (Present price: Rs.80)

We feel that inspite of a number of policy overhangs, telecom stocks have a significant potential for appreciation going forward. We believe that tariff hikes have seen their bottom levels, which would lead to improvement in revenues as well as margins. Since Bharti is grappled with foreign debt in its books to fund the African acquisition, MTM loss on this debt would lower its PAT, Idea Cellular should emerge as a key beneficiary in the sector.

7. IndusInd Bank (Present price: Rs.230)

With the new management under the leadership of Mr. Romesh Sobti in place, IndusInd Bank's net profit has registered an almost eight-fold jump to Rs.577 crore in FY'11 from Rs.75 crore in FY'08. The Bank has clocked higher than industry growth and almost doubled the Balance Sheet size and the income earned during this period. The CASA ratio has also doubled during FY'08-11 from 14% to 28%. The management has targetted for CASA deposits for FY'14 stands at 34%.

Over the next two years, the management has guided for almost doubling of the branch network compared to the present figure of 350. The major growth in the loan book should come from the consumer finance segment and the enhanced branch network should provide a significant opportunity to cross- sell, leading to higher growth in fee income compared to the loan book growth.

8. Infosys (Present price: Rs.2740)

Unlike in 2008, the IT sector has shown a significant resilience this time and Infosys should be a key beneficiary of the same. The depreciating rupee also augurs well for IT companies and Infosys has the highest proportion of unhedged receivables amongst the top IT players. The management has guided that it may not abe able to achieve the top-end of the guidance, however, we feel that this negative element is already being factored in the present price.

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9. ITC Limited (Present price: Rs.200)

Cigarettes contributed 64% and 80% to the FMCG revenues and gross total revenues during H1FY'12. The contribution of the cigarette segment to the consolidated EBIT stood at 80% during the same period. Cigarette sales are least impacted by factors which impact the markets in general, whether interest rates or high commodity prices. The company has been able to not only sustain volume growth inspite of hike in duties on cigarette but also maintained margins very well.

ITC is the second largest hotel-chain operator and the largest paperboard and packaging companies in the country. The company has scaled up rapidly in the FMCG space, which not only requires establishment of new manufacturing operations but efficient and widespread distribution channels.

10. Sun Pharma (Present price: Rs.495)

Sun Pharma holds 4.4% market share in the highly- competitive domestic pharma market, per latest AIOCD report. The company is now ranked no.1 based on share of prescription classes of specialists. Sun Pharma has 388 ANDA filings till date with 150 ANDAs pending for approval. This is the highest number of filings by an Indian pharmaceutical company. The company has reported excellent financial numbers with net sales and PAT registering a CAGR of 28% and 27% respectively. The company has clocked a 30% growth in topline during H1FY'12. We expect the same trend to continue for the balance portion of the year also.

MIDCAP IDEAS

11. Arshiya International(Present price: Rs.125)

Arshiya International has pioneered the unique concept of setting up Free Trade Warehousing Zones(FTWZ) in the country with first FTWZ already set up at Panvel. The company's other FTWZs are expected to come up at Khurja in the north, Nagpur in Central India and Chennai in South India which would be eventually linked through the rail route. With it's own FTWZs, distriparks and rail network, Arshiya should be able to provide an end-to-end logistics connectivity to all its clients.

12. Delta Corp (Present price: Rs.57)

With 3 out of 6 off-shore licenses in the state of Goa, Delta Corp is the largest and the only listed casino operator in the country. The gaming positions in the company are expected to increase from the present figure of 690 to +3000 over the next 9 to 12 months on the back of addition of a new vessel, Horseshoe, to the existing fleet and commencement of operations of "Thunderbird Resorts" in Daman. The company has got the best parcel of land in Sri Lanka and would be setting up a five-star hotel and a casino.

In addition, the company also operates real estate business in Kenya through a 40: 60 JV with a subsidiary of Reliance Industries Limited. Delta Corp would build around 1.2 million square feet of real estate space in Kenya.

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13. Goodyear India (Present price: Rs.295)

Goodyear has one of the strongest Balance Sheets in the tyre sector. The net cash and cash equivalent of the company stood at Rs.217.9 crore, translating into a cash per share of Rs.94.4. This figure is equivalent to more than 30% of the present price of the company. The company has posted a PAT of Rs.44.3 crore on net sales of Rs.1118.8 crore during 9MCY'11. We expect the operating profit margins to improve going forward on the back of fall in the price of its key raw material, natural rubber.

The parent company had come up with a delisting offer in April 2010 which eventually did not go through.

14. MRF (Present price: Rs.6900)

The company has got an excellent Balance Sheet with reserves to equity ratio quoting almost 400 times. The company has posted a net profit of Rs.338.7 crore on net sales of Rs.9743.9 crore during FY'10(September year-ending company).

On a small equity of Rs.4.24 crore, the EPS stood at Rs.798.8. At the present price, the stock is available at 8.3x its TTM earnings. We expect the company to post an improvement in margins going forward on the back of weakening rubber prices.

15. Navneet Publications (Present price: Rs.51)

The company is one of the pioneers in education field and has a strong foothold in the states of Maharashtra and Gujarat. The company has almost doubled its revenues and PAT over the five year period FY06-11. Navneet has a debt-free Balance sheet and recently the company has entered the Andhra Pradesh education sector by acquiring a stake in K-12 which manages schools under the brandname – Gowtham.

16. NIIT Technologies (Present price: Rs.180)

NIIT Technologies has a strong order book and the company's valuations are compelling at the present levels considering a turnover of Rs.1400 crore and a PAT of Rs.182 crore, translating into an EPS of Rs.30.9 in FY'11. During H1FY'12, the company has clocked a turnover of Rs.700 crore and a PAT of Rs.87 crore. The net cash and cash equivalent in the company's book as on September 30, 2011 stood at Rs.25 per share (~14% of the present price).

The company has a decent dividend yield of approximately ~4.5%. NIIT Technologies has had an excellent dividend payment track record. The dividend ratio for FY'11 stood at 75% and payout ratio stood in excess of 25% over the last five years. We expect this payout policy to continue in future also.

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17. Pfizer (Present price: Rs.1100)

This MNC pharma company has a debt-free, cash-rich Balance Sheet with net cash and cash equivalent totaling to Rs.294 per share. This is equivalent to ~27% of the present price. The company has clocked a PAT of Rs.88.2 crore on net sales of Rs.513.7 crore during H1FY'12. This translates into an EPS of Rs.65 for FY'13. At the present price, the stock is available at 12x 1-year forward earnings(after knocking off the cash). The stock has corrected by one-third from it's 52-week high levels.

18. Polyplex Corporation (Present price: Rs.155)

There is significant value in Polyplex Limited after the correction in the stock price over the last one and a half year. The company has a clean Balance Sheet and is funding the expansion plans in Thailand, USA through internal accruals only. During H1FY'12, the company has posted a net profit of Rs.124.6 crore on net sales of Rs.1251.9 crore, translating into an EPS of Rs.38.9.

19. Vivimed Laboratories (Present price: Rs.225)

Vivimed Laboratories has registered phenomenal growth in performance over the last few years. The net sales of the company stood at Rs.416 crore in FY'11 from Rs.276 crore in FY'09. The net profit during the same period has grown from Rs.19 crore to Rs.48.8 crore.

The company has acquired Spain-based Uquifa and has joined the big league of pharma companies to clock a turnover in excess of Rs.1000 crore in FY'13 (compared to Rs.650 crore in FY'12). The company would be able to maintain the PAT margins equivalent to ~10%, a figure which it had been maintaining in the past also, leading to a two-fold growth in PAT compared to FY'10 figure of Rs.31.01 crore.

20. VST Industries (Present price: Rs.1080)

VST Industries has reported the best sales and PAT figure for FY'11 in it's history inspite of an increase in duties on cigarette imposed during the Union Budget 2010. The company has been clocking a dividend pay-out ratio in excess of 80% over the last three years and we expect the same trend to continue going forward also. During H1FY'12, the company has registered a PAT growth of 61%. We expect the company to end FY'12 with an EPS of atleast Rs.78 and a dividend of Rs.60 per share. This translates into a dividend yield of ~5.5%. VST Industries has a debt-free, cash-rich Balance Sheet to the tune of Rs.134 per share as on September 30, 2011.

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