Market Commentary/Strategy

India Portfolio Strategy

Looking for Rebalancing

Buy interest rate-sensitive sectors, avoid US exporters

- After the recent strong run, market valuations have become quite expensive compared with historical levels. However, the declining global interest rate environment coupled with strong flows could mean that the market remains expensive.

- In this heady environment, it is important to look at relative sector picks. The key message of this report is to shuffle the sector weights in response to the changing interest rate environment. We believe that the important trends are slower global growth, a strengthening rupee, correction in interest rates on the downside and political uncertainty in the run up to the elections.

- We think capex spending, both by corporates and spending on infrastructure, will likely remain very strong, at least for the next 2-3 years.

- We overweight domestic cyclicals, especially those for which interest rates are key inputs in driving demand and valuations. These include banks, automobiles and utilities as key sector plays. We also recommend overweighting construction stocks given strength in both corporate and infrastructure capex. Moreover, we expect large consumption buoyancy, especially in durables, following the award of Sixth Pay Commission.

- We would avoid sectors with INR costs and USD revenues. This means underweighting the technology and pharmaceutical sectors. We would also underweight global cyclicals such as metals at this time.

- Ten large cap picks that fit our rebalancing theme include Reliance Industries, ICICI Bank, Larsen & Toubro, Maruti Udyog, Mahindra & Mahindra, Union Bank, SBI, Nagarjuna Construction, NTPC and Zee Telefilms.

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Table of Contents

Executive summary 3
What happens now? 12
Portfolio allocation 16
How important is the slowdown in global growth? 20
Dissecting the growth periods 22
Capex theme: A multi-year boom path 27
Sixth Pay Commission: Impact and portfolio positioning 31

Executive summary

The Indian stock market is up 26.1% YTD. Though the market performance has been reasonably strong, the breadth has been narrow, with the market driven by relatively few stocks. Additionally, the stocks with higher market caps have generally done better.

Figure 1: Indian outperformance – Narrow breadth

	Number	% out performers
Total out performers in Nifty index out of 50 stocks	20	
Out of this - out performers from top 10 mkt cap companies	6	60
Out of this - out performers from top 20 mkt cap companies	12	60
Out of this - out performers from top 30 mkt cap companies	15	50
Out of this - out performers from top 40 mkt cap companies	18	45
Out of this - out performers from all 50 mkt cap companies	20	40

Source: Lehman Brothers research

Later in this report, we look at the reasons for this narrowness. We conclude that some of the laggards may start to outperform the overall market, especially the ones with high interest rate sensitivity.

We believe that slowing global growth would mean that India's high interest rates may either stabilise or see minor downward bias. This is especially true for loans to consumers and Tier III corporates in which interest rates have risen faster than 10-year treasury yields. We believe the current liquidity surplus and low credit offtake is a direct result of the tightening cycle which has played out rapidly, and which has served to deflate a speculative bubble in property markets and reduce demand growth in sectors such as automobiles. We therefore think that an intermediate slowdown in the economy as reflected in slower credit growth would lead to a rebalancing of interest rates alongside income levels. While in the very short term it is likely to lead to slower earnings growth, we believe the early bust of speculative bubbles should pave the way for more sustainable growth in the future.

We also believe that India will not be impacted significantly from a US slowdown, primarily because we think net export dependence (i.e. exports after netting out imports, which are used exclusively for exports after processing) is less than what is apparent at first glance.

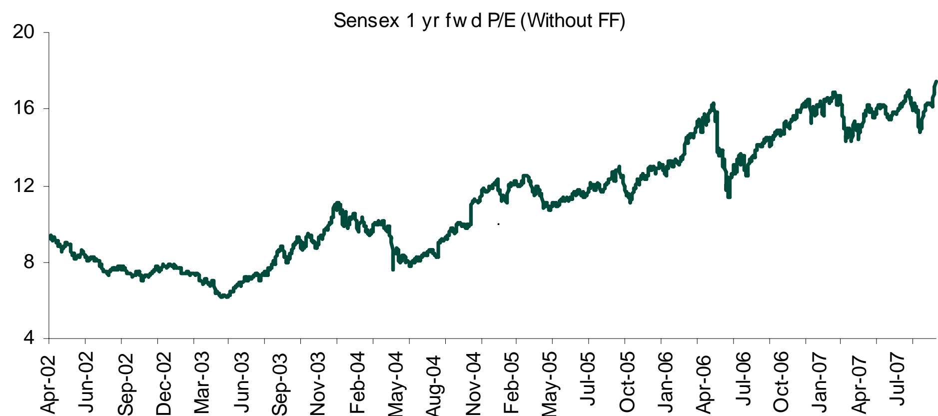
India's high growth rates are being driven by an all-time high investment to GDP, which is running close to 35% according to the last published data of CSO. At this point, we see no signs of any let-up in investment. On the contrary, our meetings with various constituents suggest that spending on infrastructure, especially in roads and ports, could see further impetus in the second half of the year. The risk to our strong growth scenario could come from a significant collapse in commodity prices and earnings of companies in commodity sectors; this could lead to a strain on the capex cycle in India (please see Appendix II for a discussion on various phases of India's growth, post its liberalisation in the early 90s).

While global risks relating to a possible slowdown are well known, we think that policy and the political environment (or at least the perception of it) will likely worsen in the days to come. The UPA government is built with the support of parties that compete at the state level. As central elections draw near in early CY2009, we think the state parties will likely start distancing themselves from the Indian national congress (INC), as they would not likely want their vote banks to shift to INC. While these noises are already manifesting themselves from the left parties, the pitch could become more feverish.

We also believe that in this environment, consumers are unlikely to see a policy action that could hurt their pocketbooks. Thus, we do not expect a pass-on of higher global oil prices to consumers (to the detriment of oil-marketing company stocks). There could be more impetus on infrastructure projects that generally leads to significant job generation. It is possible that the Sixth Pay Commission would lead to substantial increase in salaries before the elections. This could lead to significant impact on sectors and companies. PSU employees, whose salaries were due for revision from 1 January 2007, should also see significant increase in salaries; this could lead to a pick-up in consumption, especially for higher-end durable companies.

Market valuations are the biggest risk at this point, in our view. As the P/E chart in Figure 2 shows, the Indian stock market is trading at the top-end of its multiple range. This is happening amid increased global uncertainty and some slowdown in corporate earnings due to base effect. Given these valuations, it is our view that the market may not be in a position to withstand potential shocks from global and local risk events. However, we also acknowledge upward risks to the market in the short term from the recent 50 basis point (bp) interest rate cut.

Figure 2: Market P/E



Source: Bloomberg and Lehman Brothers research

Though we believe that the short-term risks in the markets are running high given current valuations, the question of whether India might experience bubble valuations is not an easy one to answer. We think it is possible, especially considering the demand and supply of equities, and low floating stocks compared with demand (public holdings of Indian equities is roughly 25%, or approximately US$300 bn – against which inflows in the market are running at US$20 bn). It may well turn out that the market can continue to surprise on the upside. However, it is important to keep the following in mind:

- Indian equity valuations are running at close to historical peaks,
- We think the political situation has worsened compared with the past, and
- Risks to global growth are reasonably high.

A better way to play the markets therefore is to look at rebalancing. We believe that portfolios should be weighted in favour of interest rate-sensitive stocks (especially those that are still cheap). We prefer domestic cyclicals vs. global cyclicals. We also favour capex plays, especially those with a focus on infrastructure sector spending. We believe that after the recent fed rate cuts, rupee appreciation should continue. Thus, we recommend avoiding stocks that have USD revenues but have rupee costs (even though technology and pharmaceutical stocks have become cheap with respect to the market, we remain cautious for now). In line with our rebalancing theme, we highlight the following sectors:

- Automobiles: eg, Maruti and M&M
- Banks: eg, ICICI Bank, SBI and Union Bank
- Construction and infrastructure plays: eg, L&T and Nagarjuna Construction
- Utilities: eg, NTPC
- Media: eg, Zee Telefilms and Zee News
- Others: eg, Reliance Industries

We are neutral on the following sectors:

- Telecom: If the proposed regulation in telecom goes through, we would take a more negative view of the sector and vice versa. We are neutral with respect to benchmarks. Example: Bharti.

We are negative on the following sectors:

- Energy sector (due to policy issues in the run-up to elections): Avoid oil-marketing companies.
- Pharmaceuticals: eg, Sun Pharmaceuticals
- Information Technology: eg, Infosys
- Cement (we expect overcapacity next year).
- Global cyclicals – ferrous and non-ferrous: eg, Tata Steel, Underweight the sector

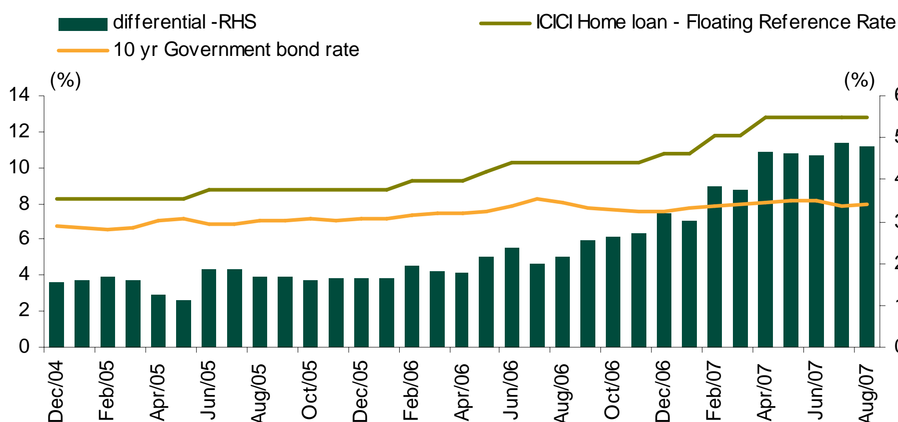
Reflecting over the past 18 months

We think the most important trends in the last 18 months have been: 1) a significant rise in domestic interest rates, led by policy action from the central bank, 2) a pick-up and subsequent reduction in headline inflation and, 3) there has been no let up, anecdotal or otherwise, from companies in making investments.

The last 18-24 months have corresponded with the following key trends:

- Rising interest rates: Over the past two years, 10-year bond yields have risen by about 150 bp. However, the spread of consumer and other loans to 10-year government bond yield has risen significantly. The bulk of this increase, as can be seen from Figure 3 below, happened between December 2006–May 2007 (which incidentally corresponded to market reaction interest rate concerns), and was engineered by tightening liquidity, as the central bank did a succession of rate hikes and increased cash reserve ratios.

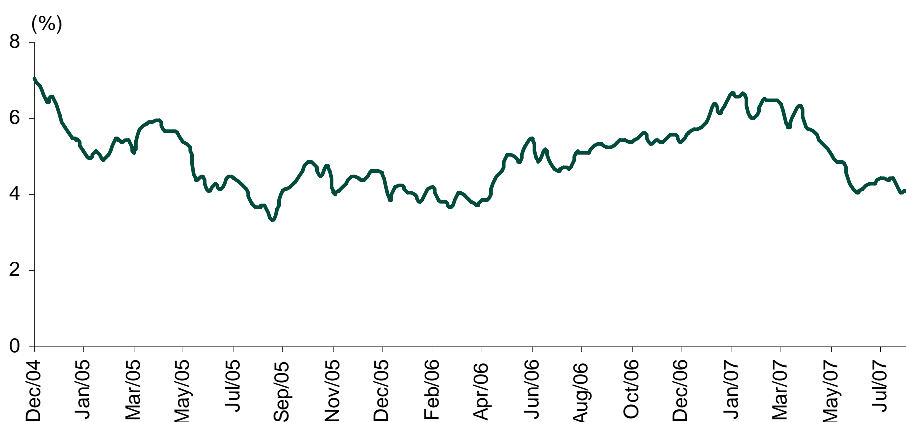
Figure 3: Interest rates in the economy: divergence between home loans and bond yields



Source: Lehman Brothers, ICICI Bank and Bloomberg

Inflationary pressures, especially on account of global commodities: A large part of RBI's tightening stance has been governed by inflationary pressures that surfaced in large part due to global commodity inflation. These have since abated even though RBI's tightening bias has remained in place. Note that property prices in most of the cities have seen some amount of correction and the composite index likely shows more bias on the downside on an overall basis.

Figure 4: WPI Inflation

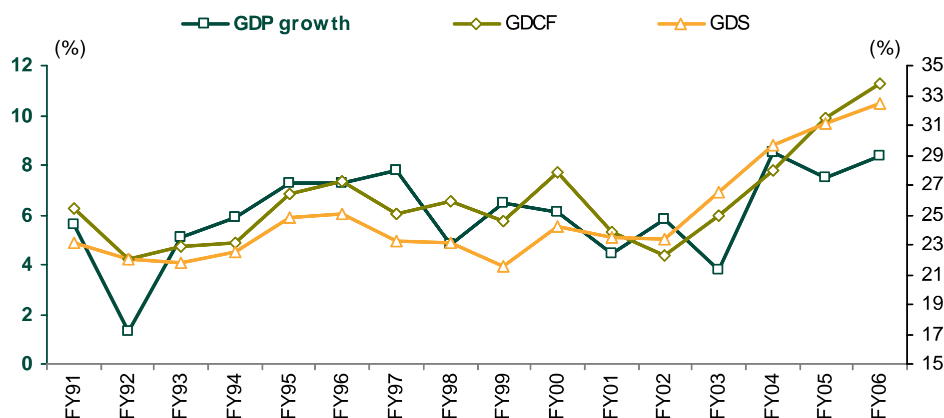


Source: Central Statistical Organisation (CSO)

We believe that RBI's future actions will likely be driven more by liquidity management than by issues of inflation.

- Significant momentum builds up in economy-wide investment: The other trend over the past few years has been a dramatic increase in investment to GDP, from 22% in FY02 to 35% in FY07. The good news is that this has happened along with a significant improvement in savings rate and has not resulted in a large current account deficit (which we think would have been unsustainable).

Figure 5: Savings, capital formation and GDP growth

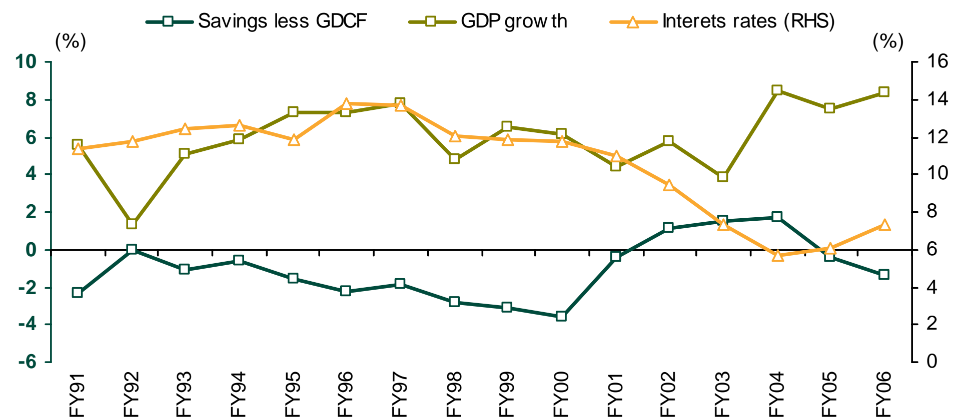


Source: CSO

To us, this is the most important development; we think a healthy investment cycle should continue to support growth through a self-perpetuating cycle of income creation, savings and investment. The question is whether this will continue, given the significant implications on growth and stock selection from this angle.

Figure 6 shown below is important as it shows why sustainability of the cycle is higher today than at any time in the past. Interest rates in the past periods of growth were higher than GDP growth. Remember that the interest rate line here is the government's borrowing cost and not rate to consumers. The premium of rates on loans to consumers and corporates over the 10-year yield in FY97 was much higher than it is today (AAA rated corporates were raising debt at an 18% interest cost in FY97).

Figure 6: Savings less investment and interest rates



Source: CSO

- **Rising political uncertainty:** India's general elections are due in May 2009. The table below (Figure 7) shows the make up of the current government. Note that the UPA coalition is made up of parties that compete at the state level. For example, CPM and CPI compete with Congress at the state level while supporting the government at the center. This essentially means that as the elections come closer, several elements of UPA would have to be seen to be separate from INC, a process that is starting to become more evident from increasing dissidence by the left party on several issues, including the nuclear issue. We believe that minor quibbling of this sort will likely continue and gather pace as the elections draw near. We think this has the potential to unsettle the markets somewhat.

Figure 7: Make up of current ruling coalition

Party	No of MPs	Comments	% to total
INC	146		27
RJD	23	Seat-sharing with INC	4
DMK	16	Seat-sharing with INC	3
NCP	10	Seat-sharing with INC	2
PMK	6		1
JMM	5		1
Lok Janshakti	4		1
Kerala Congress	2		0
Indian Union Muslim League	1		0
J&K People's Democratic Party	1		0
Republican Party of India	1		0
All India Majlis-e-Ittehadul Muslimeen	1		0
Subtotal	216		40
External support from:			
Left Front:			
CPI	10	Direct contest with INC	2
CPI(M)	43	Direct contest with INC	8
Revolutionary Socialist Party	3		1
All India Forward Block	3	Direct contest with INC	1
Bahujan Samaj Party	19	Direct contest with INC	3
Total strength	294		54

Source: Election Commission

- Significant paper supply and equally strong demand: Figure 8 below shows supply of paper from Indian corporates. Demand has been stronger, as evidenced by clear oversubscription across most paper issuances. As can be seen, total inflows have risen substantially, partly in response to more paper supply and partly due to higher direct inflows. Despite higher paper supply, demand for equities outstripped supply by a good margin.

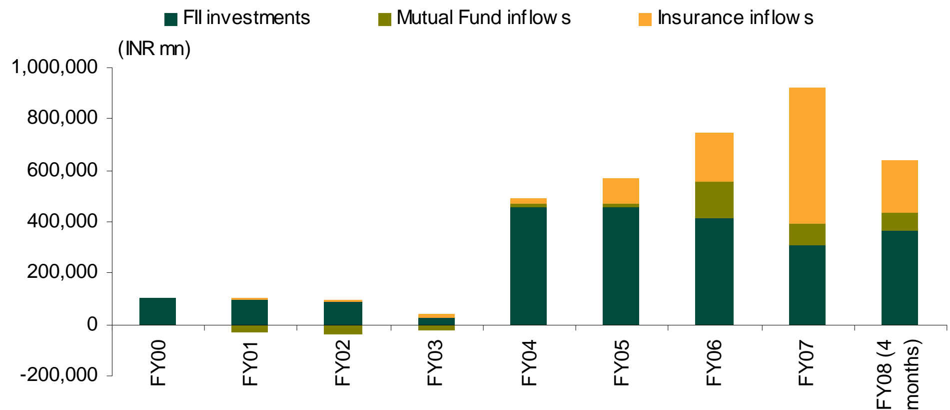
Figure 8: Equities: Supply vs. Demand *(INR in mn)*

Year	Total inflows	Inflows/primary issuance	Market performance (%)
FY00	100,274	1.28	
FY01	75,020	1.23	-27.9
FY02	55,475	0.74	-1
FY03	16,222	0.4	-14.6
FY04	492,806	2.12	83.7
FY05	570,855	2.02	15.9
FY06	746,928	2.73	73.7
FY07	646,921	1.93	15.9
FY08 (4 months)	640,028	2.32	18.6

Source: Securities and Exchange Board of India (SEBI)

Note that the inflows in Figure 8 build in our estimates of inflows into equity from insurance companies. It is very important to look at insurance money because it does not get captured in data reported by the exchanges and has become a very large source of demand for equities in the past few years (see Figure 9 below). In fact, insurance inflows alone were more than supply of equities in FY07. Given the growth in insurance premiums, the trend of higher demand for equities than supply seems likely to continue.

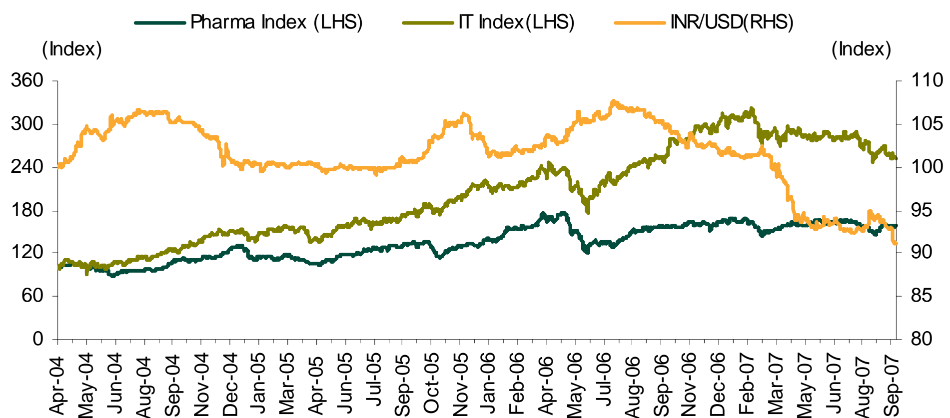
Figure 9: Make up of flows



Source: SEBI and Lehman Brothers estimates for insurance

- Rising INR: Appreciation of INR has been the other key trend that has played a significant part for the direction of the markets. Technology stocks have been hurt by continued outperformance of the INR against the USD. We think that from RBI's perspective, the biggest challenge has been to fight excess capital inflows and manage money supply and rupee at the same time. RBI's move to stop defending currency appreciation did cause significant changes in the performance of stocks. Significant underperformance of technology stocks on the whole had much to do with rupee appreciation, in our view. The same trend has been reflected in the performance of pharmaceutical stocks. Our economics team expects the trend of INR appreciation to continue.

Figure 10: Rising INR and technology and pharma stocks



Source: Bloomberg and Lehman Brothers research

Looking back, the play out of these events has been reflected in the following market behavior:

- Move to safety: As interest rates have risen (we take interest rates as the proxy for perception of risk), investors have moved from taking a risk bias to a safety bias. This has been apparent in the outperformance of growth sectors on the one hand and outperformance of large caps vs. small caps on the other. The sectors with high visibility include capital goods and telecom. Note that the performance of Reliance Industries has driven 27% of the absolute index (Nifty) move from the start of the year.

Figure 11: Indian outperformance: Narrow breadth

Total outperformers to index out of 50	20
Out of this - top 10 market cap	6
Out of this - top 20 market cap	12
Out of this - top 30 market cap	15
Out of this - top 40 market cap	18
Out of this - top 50 market cap	20

Source: Bloomberg and Lehman Brothers research

- Move away from sectors sensitive to interest rates and commodities: These include stocks in the bank, auto and property sectors and are generally anti-interest rate plays. In case of autos, commodities serve as inputs (commodity spurts would also feed into inflation).

Figure 12: Sectoral performances *(%)*

Index	Sensex	Auto@	Bankex@	CapGoods	FMCG	Pharma#	IT#	Metal	Oil&Gas
FY02-FY06	202	434	329	899	111	159	136	407	218
FY06-YTD	43	-8	49	75	-2	-3	19	52	80
YTD	8	-16	9	45	0	-8	-15	24	28

@ Interest rate sensitive, autos are also impacted by increasing commodity costs; # INR costs/USD revenues

Source: Bloomberg and Lehman Brothers research

Sectoral performances

- Move into commodities: Commodity stocks, especially steel stocks have performed well during the market rally. Other commodity stocks, especially non-ferrous stocks, have not been as strong due to concerns about global growth, which have dragged down non-ferrous prices.

- Stay away from USD revenues/INR costs: We think the continuing underperformance of technology and pharmaceutical stocks is a clear indication of the way the market seems to be viewing companies with INR costs and USD revenues.

What happens now?

Tightening cycle has played its part

The tightening cycle is playing out in various forms:

- Retail credit demand has turned weak, reflecting in overall credit numbers: The fallout of the interest rate tightening cycle has already started playing out in the significant drop in credit demand, especially for consumer-facing businesses. Banking sector results for FY1Q08 suggest that growth in credit to the retail sector has come off significantly.

Figure 13: Credit offtake: Banking system as a whole *(INR bn)*

Credit offtake data	FY07	FY08	YoY (%)
Deposits till first week of September	1,249.62	1,348.28	7.9
Credit offtake till first week of September	669.5	91.32	-86.4

Source: Reserve Bank of India (RBI)

- Liquidity has increased, though central bank/government remains hawkish: On an overall basis, the improvement in domestic liquidity has come from higher savings and lower credit offtake. Additionally, significant capital inflows have raised domestic liquidity. RBI has responded by significantly hiking cash reserve ratios at banks. The government of India has also clamped down on external commercial borrowings by a set of guidelines which would slow inflow of foreign debt significantly.

- An intermediate slowdown in industrial growth: As the interest rate led slowdown has taken effect, its lagged impact on industrial growth has begun to come through. Recent data suggests slowdown in industrial activity, part of which is due to slowdown in consumer demand, which has been impacted by higher interest rates.

We expect that this would have played out in couple of quarters

We believe that the demand adjustment in response to higher interest rate would have played itself out in couple of quarters going forward (at worst). Overall, we think economic activity should remain buoyant and support from the investment cycle would ensure that income levels and jobs continue to grow strongly. We therefore believe that demand pick-up in interest rate-sensitive sectors is just a matter of time. We think markets will start discounting it in advance.

We expect the investment cycle to continue to support growth...

Growth in the economy has remained strong despite recent softness seen in consumption, especially in housing and auto sectors. This is primarily because the investment cycle across sectors continues to remain strong. As Figure 14 below shows, almost all delta in overall investment to GDP has come from manufacturing. This is on the back of a significant ramp-up in corporate profits over the past few years (See Appendix III for a more detailed discussion of corporate capex cycle).

Figure 14: Gross fixed capital formation by industry *(% of sectoral GDP)*

	FY01	FY02	FY03	FY04	FY05	FY06
Agriculture, forestry and fishing	10	12	13	11	12	13
Agriculture	10	11	12	10	11	12
Forestry and logging	6	6	5	8	4	5
Fishing	27	37	37	32	34	36
Mining and quarrying	14	19	18	29	26	28
Manufacturing	49	36	50	59	80	95
Registered	49	40	51	57	85	109
Unregistered	49	27	48	64	69	64
Electricity, gas and water supply	86	91	81	94	84	83
Construction	8	14	14	14	10	10
Trade and hotels	8	8	2	6	5	5
Trade	6	7	1	4	4	4
Hotels and restaurants	19	18	12	19	23	20
Transport, storage and communication	51	37	40	34	33	29
Railways	24	28	33	33	33	33
Transport by other means	48	31	47	46	46	36
Storage	86	93	94	79	-14	-5
Communication	73	52	29	13	15	17
Financing/insurance/real estate/business services	33	40	36	34	25	25
banking and insurance	6	8	3	5	3	4
real estate, ownership of dwellings/business services	53	64	63	57	42	42
Community, social and personal services	21	24	26	26	29	35
public administration and defense	31	35	36	34	40	46
other services	12	16	19	19	21	26
Total	25.2	24.4	26.2	27.1	29.5	32.1

Source: CSO

We also believe that investments in infrastructure will start revving up further in the second half of the year. Starting October, we expect significant awards in roads and ports to start getting handed out to the private sector. These awards have been delayed pending finalisation of model concession agreements (MCAs). Momentum of investments in airports and the power sector is already in high gear and visibility of growth remains strong, as evidenced by the orderbooks of engineering and construction companies.

Figure 15: Government projections of investments in select infrastructure sectors

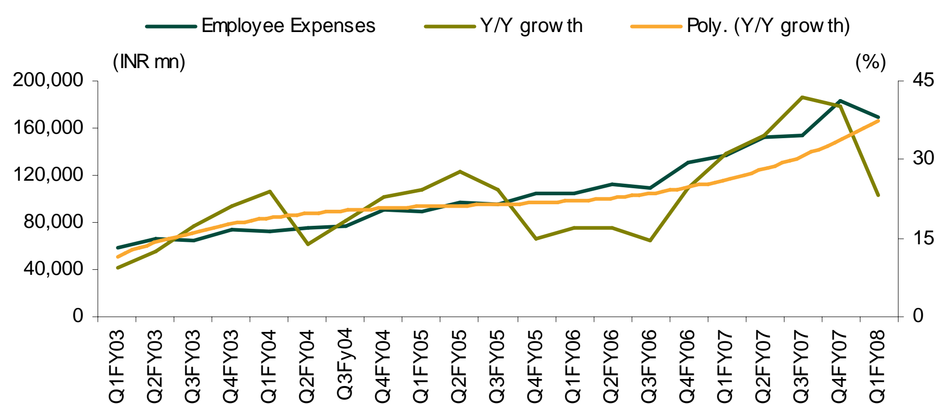
INR, bn	FY07	FY08	FY09	FY10	FY11
Ports	19	24	64	82	738
Minor airports	13	16	13	11	87
Power	900	13223	1740	22478	2527
National highways	102	305	362	388	302
Total	1034	1668	2179	2728	2910
USD bn	25.	42	54	68	73
% of GDP	2.6	4.2	5.4	6.8	7.3

Source: Various ministries and Lehman Brothers research

...and income vs. interest-rate rebalancing starts to kick in...

As a result of the strong growth in GDP, per capita incomes should catch up to the higher levels of affordability due to higher interest rates. Figure 16 below shows quarterly salaries bills of BSE100 companies and their YoY growth. Incomes have been rising much faster than in the past. In addition to increments in salaries of existing employees, the uptrend in salary growth has also been a result of job growth, primarily due to heavy hiring by corporates as they put up new capacity.

Figure 16: Trend in employee costs of BSE 500 companies



Source: Lehman Brothers research

Looking at the liquidity situation and credit offtake numbers, we lean towards the view that costs of consumer loans are likely to fall, which might not fully coincide with the drop in 10-year government bond yields. We are already starting to get some feedback about rate cuts in consumer loans.

...leading to a positive impact in interest rate-sensitive trades

We believe that the interest rate sensitive sectors should start to perform going into the second half of the year. The sectors in this category include banks, automobiles and utilities.

On the policy side, the government likely to shy away from tough decisions

As we have mentioned earlier, we expect political risks to grow over a one-year period. In such an environment, populism may take precedence over prudence. With fewer tough decisions to be made by the government, we think consumers should benefit. A very important piece in this process could be Sixth Pay Commission which we discuss in greater detail elsewhere in this report.

Market on balance has readjusted to a higher level of risk

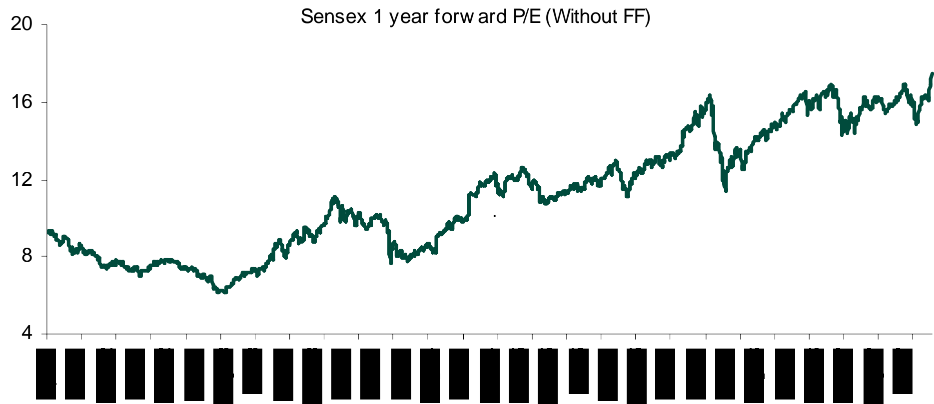
From a valuation perspective, the stock market has rewarded secure themes adequately, as is evidenced by the performance of stocks with good earnings. We believe that further premium expansion of these stocks is unlikely given that our expectation of earnings for a number of these companies has not shifted upwards. The rise in the market from current levels would essentially put it in expensive territory. However, at this time, we do not see a near-term catalyst that could lead to a correction in the market in meaningful way.

Portfolio allocation

Overall market at the upper-end of its trading band

Making a market call purely from a fundamental perspective is not a good one relative to history (see Figure 17 below). From a pure multiple perspective, the market is trading in valuation bands that has met significant resistance in the past. Without any particular trigger to move it into new territory in the short term, in our view, we expect little by the way of further market performance.

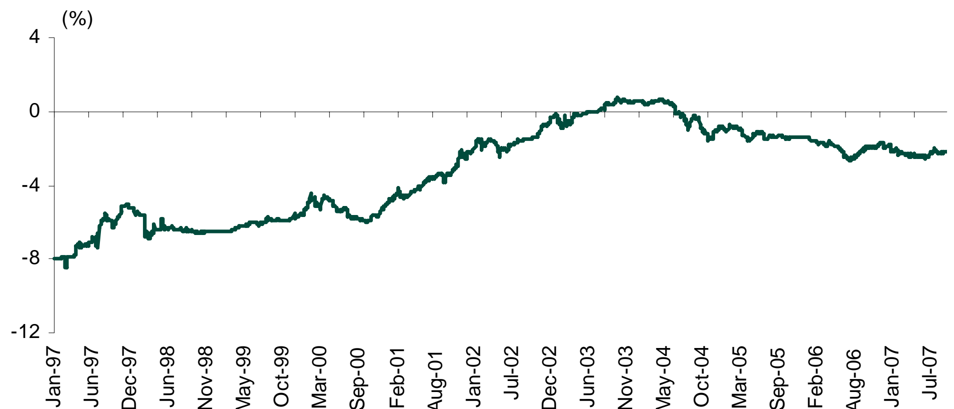
Figure 17: Market P/E chart



Source: Lehman Brothers research

Earnings vs. bond yields also remain at historically low levels. The only note of caution here is that the chart below (see Figure 18) does not adjust for improvement in corporate ROEs across the board. As corporate ROEs improve, growth premium of equities over bonds should improve, as same earnings yield would signify higher earnings growth.

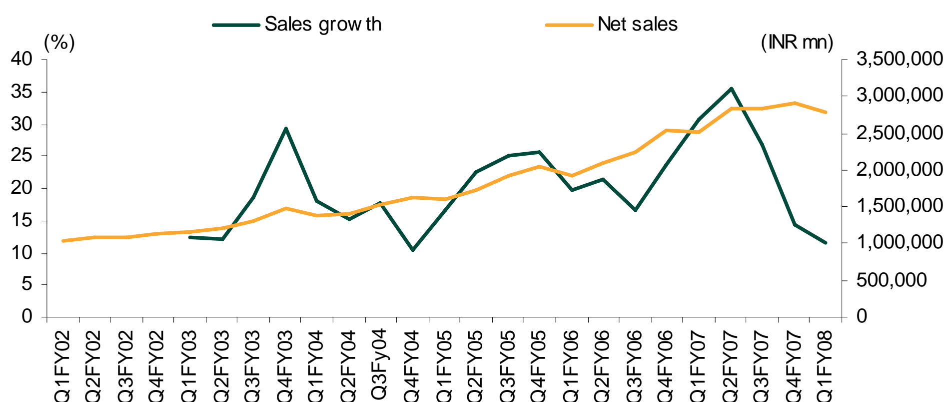
Figure 18: Earnings less bond yields



Source: Lehman Brothers research

The earnings environment has slowed, as is apparent from sales growth of BSE 100 companies (ex banks).

Figure 19: BSE100: sales and net sales growth



Source: Lehman Brothers research

Key themes we expect to play out over the next few quarters are as follows:

- Interest rates cycle has peaked or is close to peaking: We believe that Indian interest rates are close to their peak. Firstly, we believe that Indian interest rates have pretty much caught up to the higher rate of growth of the country. Secondly, demand for credit has tapered in recent times even as deposit growth at banks has been strong, creating strong liquidity. Thirdly, government finances continue to improve which would mean that finally, a global growth slowdown would mean that Indian interest rates are unlikely to move up if US interest rates are cut.

- Economic growth would remain underpinned by investments: We expect income growth to remain robust. Our economics team expects that Indian per capita income growth will remain strong in the foreseeable future. While the spike in interest rates has resulted in a sort of affordability shock, income should continue to play catch-up. In absence of further interest rate hikes, we expect demand growth to return to sectors such as automobiles and housing (albeit at lower housing prices).

  - Corporate earnings could slow, but not collapse: Indian corporate earnings have historically grown at a rate similar to long-term nominal growth in GDP. Consensus forecasts for corporate profit growth for the next two years is in line with nominal GDP growth, which means that corporate profits as a percentage of GDP are forecast to remain flattish.

  - Significant capital inflows to fund the infrastructure sector: As mentioned before, we think spending on infrastructure will likely continue to ramp up. Given government finances, a lot of this funding may have to come from private sources.

- **Rupee will likely remain strong**: Over the longer term, strong growth compared to the rest of the world and specifically the US should ensure that INR remains strong against the USD. Our economics team forecasts INR at 39 by December 2007 and 36 by December 2008. This means that from its bottom in May 2002, INR would have moved 27% in a period of 6.5 years against the USD. This is a large move and would at the margin impact export industries negatively.

- **Global growth bias has softened**: Our economics team has sliced its US GDP forecast to 1.8% YoY from 2.1% earlier. This includes lowering consumption, home construction and fixed business investment. We have also cut growth forecasts for the Euro and other regions. We now expect three more Fed rate cuts in December 2007, March 2008 and June 2008.

- **Political environment to worsen:** While global risks relating to a possible slowdown are well known, we believe that policy and the political environment (or at least the perception of it) is likely to worsen in the days to come. The UPA government is built with the support of parties that compete at the state level. As central elections draw near in early CY09, the state parties will likely start distancing themselves from INC as they would not want their vote banks to shift to INC. While these noises are already manifesting themselves from the left parties, we think the pitch might become more feverish.

  We also think that in this environment, consumers are unlikely to see policy actions that would hurt their pocketbooks. Thus, we do not expect a pass-on of higher global oil prices to consumers (to the detriment of oil-marketing stocks). There could be more impetus on infrastructure projects that would lead to significant job generation. We think it is possible that the Sixth Pay Commission might lead to a substantial increase in salaries before the elections. This could have a significant impact on sectors and companies (see Figure 20).

Figure 20: Possible Impact of Sixth Pay Commission

	FY06	FY07	FY08E	FY09 (Scenario 1)	FY09 (Scenario 2)	FY09 (Scenario 3)
Possible increment (%)				30	50	70
Center plus state salary bill (INR bn)	1,867	2,033	2,202	2,862	3,303	3,743
GDP (INR bn)	28,425	31,084	35,435	40,751	40,751	40,751
% of GDP	6.60	6.50	6.20	7.00	8.10	9.20
Increase in fisc as a result (%)				0.80	1.90	3.00
Extra disposable income – (INR bn)				661	1,101	1,541
– (In USD bn)				17	28	39
Car industry in India (size in INR bn)				11		

Source: Finance ministry, RBI and Lehman Brothers research

PSU employees, whose salaries were due for revision from 1 January 2007, should also see significant increase in salaries. This could lead to a pick-up in consumption, especially for higher-end durable companies.

We believe portfolios should be weighted in favour of interest-rate-sensitive stocks (which are still at attractive levels, in our view). We favour domestic cyclicals vs. global cyclicals and favour capex plays, especially ones on infrastructure sector spending. We believe that after the recent Fed cuts, rupee appreciation might continue. We think stocks with USD revenues and INR costs should hence be avoided for some time (even though technology and pharmaceutical stocks are cheaper with respect to the market, we remain cautious). Overall, we are positive on the following sectors:

- Automobiles: eg, Maruti and M&M
- Banks: eg, ICICI Bank, SBI and Union Bank
- Construction and infrastructure: eg, L&T and Nagarjuna Construction
- Utilities: eg, NTPC
- Media: eg, Zee Telefilms and Zee News
- Others: eg, Reliance Industries

We are neutral on the following:

- Telecom – if the proposed regulation in telecom goes through, we would take a more negative view of the sector and vice versa. We are neutral with respect to benchmarks. Example: Bharti.

We are negative on the following:

- Energy sector (due to policy issues in run-up to elections) – Avoid oil marketing companies
- Pharmaceuticals: eg, Sun Pharmaceuticals
- Information Technology: eg, Infosys
- Cement (we expect overcapacity next year).
- Global cyclicals – ferrous and non-ferrous: eg, Tata Steel, Underweight the sector

Appendix I

How important is the slowdown in global growth?

This question gains relevance given three main factors as follows:

- Impact on exports: As the chart below (see Figure 21) shows, India's export dependence has risen over the past four years, but actual export dependence on India is not very large. We therefore doe not expect a significant impact on merchandise exports.

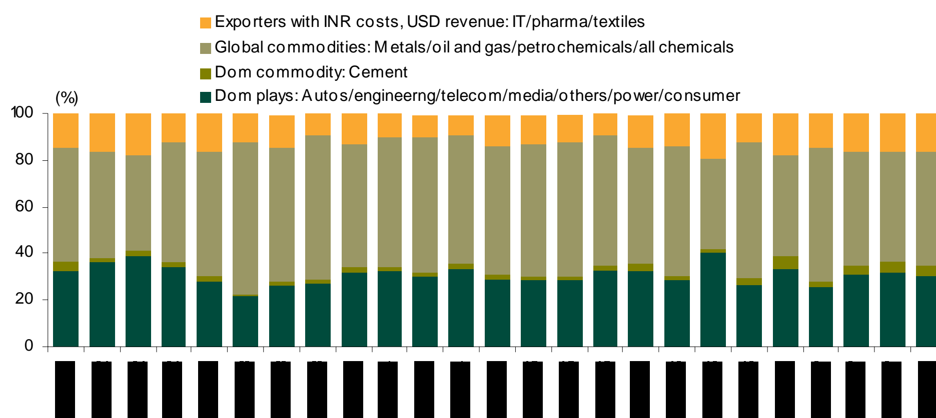
Figure 21: Merchandise exports adjusted for re-exports *(USD mn)*

	FY04	FY05	FY06	FY07	Change (FY04-07)
Total exports	63,8423	83,536	103,091	126,331	
As a % of GDP	11.50	13.10	14.00	15.30	3.80
Ex-petroleum and gems and jewellery	51,115	64,860	78,639	95,607	
As a % of GDP	9.20	10.20	10.70	11.60	2.30

Source: Commerce Ministry

- Impact on corporate profits: The Figure below gives a breakdown of corporate profits in India. We have taken a sample of BSE100 companies where profit data of 1Q08 is available. A large part of revenues is still derived from global commodity companies. A major collapse in global commodity prices would thus have a significant impact on corporate India's profitability and capex plans. Note that a large part of global commodity profits come from the oil and gas & petrochemical sector, in which the impact of a global slowdown might have a relatively limited impact on margins.

Figure 22: Make up of BSE100 profits by sectors (ex banks)



Source: Lehman Brothers research

- Impact on economic growth: As mentioned earlier, a large part of profits for corporate India comes from commodity companies. The table below (see Figure 23) shows that the increase in domestic savings (which is underpinning the investment cycle) has come from the private corporate sector. We believe that significant pressure on corporate profits would impinge on corporates' ability to invest and would impact economic growth negatively.

Figure 23: Breakdown of Indian Savings *(%)*

	FY00	FY01	FY02	FY03	FY04	FY05 (Provisional Estimate)	FY06 (Quick Estimate)
1. Household savings of which:	21.1	21	21.8	22.7	23.8	21.6	22.3
Financial assets	10.6	10.2	10.8	10.3	11.3	10.2	11.7
Physical assets	10.5	10.8	10.9	12.4	12.4	11.4	10.7
2. Private corporate savings	4.5	4.3	3.7	4.2	4.7	7.1	8.1
3. Public sector savings	-0.8	-1.9	-2	-0.6	1.2	2.4	2
4. Gross domestic savings	24.8	23.4	23.5	26.4	29.7	31.1	32.4

Source: RBI and Lehman Brothers research

Appendix II

Dissecting the growth periods

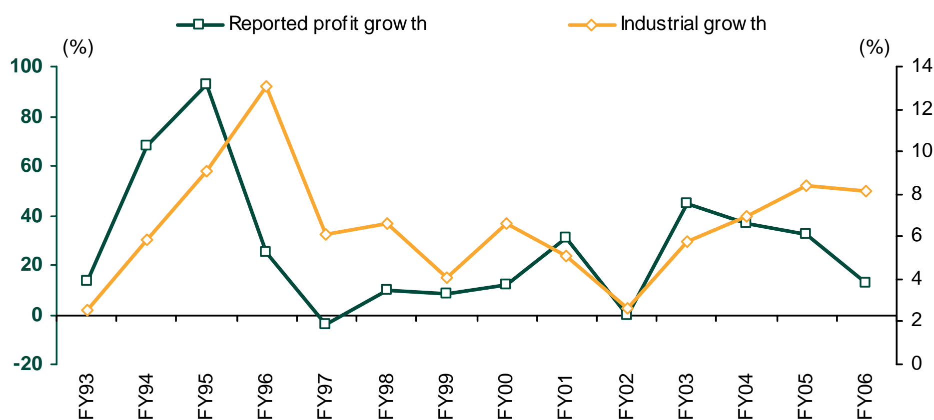
On an overall basis, growth since 2002 can be divided into two phases: 1) 2002-2005 – a phase led by consumption and exports, and, 2) 2005 onwards (current phase) – when investments and consumption complement each other to sustain a broad economic rally. In this section we offer a historical context to explain the factors driving the current market strength.

Pre-boom period: 1997-2002

Corporates faced severe stress post-1997 financial crisis

After the economic stress that came post the economic boom which lasted until 1997, the Indian economy could be characterised by low industrial growth, significant overcapacity and low corporate profitability. See the charts below.

Figure 24: BSE500 companies ex-banks PAT growth vs. industry growth

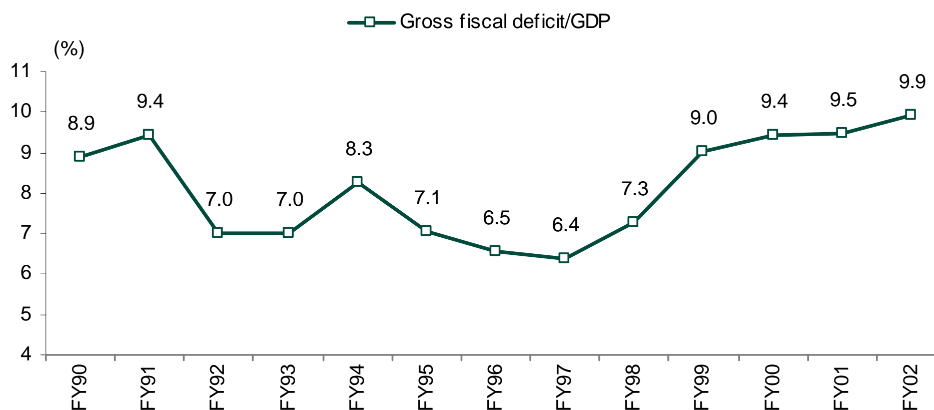


Source: Lehman Brothers research

It is interesting to note that profit growth seems to be the lead indicator of economic activity (in FY06, this trend was broken primarily because FY06 was characterised by falling steel prices and stress on oil companies' profitability due to rising crude prices. Profit growth has since bounced back strongly).

The period following the slowdown in the economy was particularly painful for government finances. The picture by the end of FY02 looked alarming. A large part of this fiscal slippage resulted from low economic growth and significant increases in expenditure on account of Fifth Pay Commission. This high level of fiscal deficit was crowding out private sector investment and did not allow the government to invest in much needed infrastructure bottlenecks.

Figure 25: Combined fiscal deficit of states plus center



Source: RBI and Lehman Brothers research

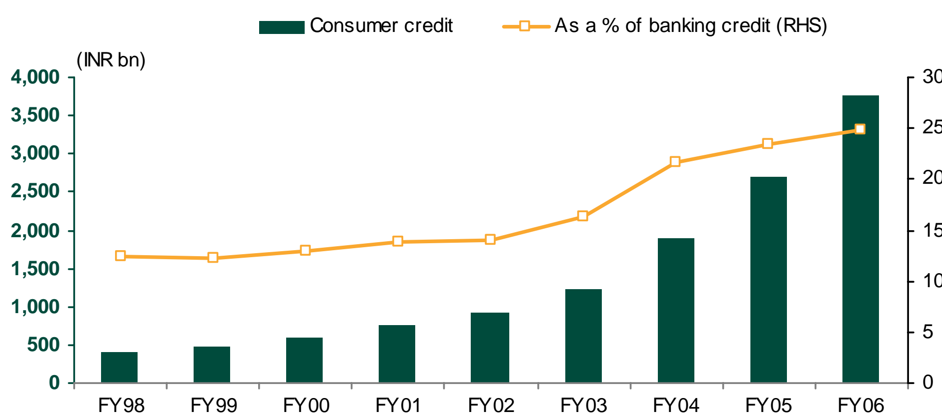
Phase 1 of economic pick-up 2002-2005 – Consumer credit and policy framework

The first phase of economic pick-up was led by the uptick in consumer spending, primarily on the back of low interest rates. The policy framework in the meantime became fairly supportive in many of the infrastructure sectors. This led to a start of a pick-up in the investment cycle across infrastructure sector.

Pick-up in consumer spending reflected in rising consumer credit of banks

The pick-up in consumer spending was reflected in rising consumer credit of banks in this period. As can be seen from Figure 26 that consumer credit as a percentage of overall bank credit inflected from FY02 onwards.

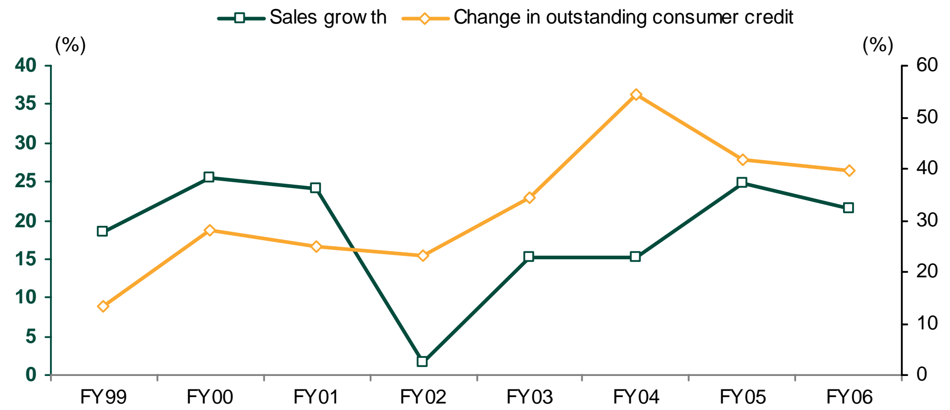
Figure 26: Consumer credit in India



Source: RBI and Lehman Brothers research

While it is difficult to make an exact assessment of how much this would have meant in terms of corporate bottomline, the sales momentum of Indian corporates have shifted up in this period (as can be seen from the charts below).

Figure 27: BS500 companies sales growth and change in consumer credit



Source: Lehman Brothers research

Phase 2: Infrastructure: investment boom sparked by policy framework

The second — and possibly more important — change in India in this period was from policy changes (that had been in the making since the late 1990s) that started to be reflected in several infrastructure sectors during the boom period. These included the telecom, roads, ports and power sectors. A summary of reforms in these sectors is given below.

Figure 28: Important policy changes in infrastructure and their impact

	Policy action	Impact
Telecom		
	Shift from flat fee to revenue share	Immediate bankability of the sector
	Introduction of 'calling party pays'	Increased affordability
	More licenses through CDMA route	Reduction in tariffs
	Reduction in revenue share	
Roads		
	Formation of National Highway Authority of India (NHAI)	Road building professionalised
	Evolution of separate road funding through central road fund	Ability to fund large-scale road projects
	Private sector participation through BOT route	Ability to fund more road building activity
	Finalisation of model concession agreement	In several instances, private players paid money to the government for road building
Power		
	Electricity Act 2003	Unbundling of distribution and generation proposed - still in process
	Clearance of State Electricity Board (SEB) dues through debt swap scheme	Enhanced ability of SEBs and NTPC to invest in generation
	Selective privatisation of distribution	Jury is still out
	Ultra Mega Power Project (UMPP) policy	Significant step-up in momentum in generation, two UMPPs approved
Ports		
	100% FDI under the automatic route is permitted for port development projects	Private ports beginning to take off
	100% income-tax exemption is available for a period of 10 years	
	Tariff Authority for Major Ports (TAMP) regulates the ceiling for tariffs charged by major ports/port operators (not applicable to minor ports)	
	A comprehensive National Maritime Policy is being formulated to lay down the vision and strategy for development of the sector till 2025.	
Airports		
	Privatisation of select airports	Mumbai, Delhi, Hyderabad, Kochi airports privatised - Investment starting to pick up
	Modernisation of airports by Airport Authority of India (AAI)	35 airports are identified for modernisation
	100% FDI is permissible for existing airports; Foreign Investment Promotion Board (FIPB) approval required for FDI beyond 74%	
	100% FDI under automatic route is permissible for greenfield airports.	
	49% FDI is permissible in domestic airlines under the automatic route, but not by foreign airline companies	
	AAI Act amended to provide legal framework for airport privatisation	
	100% tax exemption for airport projects for a period of 10 years	
SEZs		
	SEZ policy in place	A significant boom in SEZs.
Mining	Privatisation of mining, especially in coal blocks	
Railways		
	Public private partnership (PPP) envisaged in new routes, railway stations, logistics parks, cargo aggregation and warehouses etc.	Yet to take off in a meaningful way

Source: Various Ministry websites and Lehman Brothers research

Economic boom had a significant impact on government finances

One of the largest positive effect of the growth has been significant improvement in combined fiscal deficit of the government. After peaking at almost 10% of GDP in FY02, the deficit numbers have declined sharply, thus creating room for extra investments in the economy and consequently for higher growth. The combined fiscal deficit of center and states is expected to fall below 6% in FY08E.

Phase 3: Synchronicity: Consumption and investments moving in tandem

We believe that India is now in a phase where investments and consumption should continue to complement each other, which would keep growth at elevated levels in the time to come.

With the policy framework in place, corporate profits are at an all-time high. Investments in infrastructure and by corporates in capacity are expected to remain strong. We believe that this would aid significantly in job growth, which was tepid between FY97-FY05. To us, this would mean that consumption increases would happen in tandem, thus creating a cycle which would continue to feed into itself.

In Appendix III we have given a view of corporate capex and its impact on manufacturing growth. In the table below, we give annual planned capital expenditure under some of the major infrastructure heads. Planned expenditure will likely continue to accelerate, creating buoyancy in economic growth, in our view.

Appendix III

Capex theme: A multi-year boom path

Corporate capex has emerged as a key investment driver in the last few years…

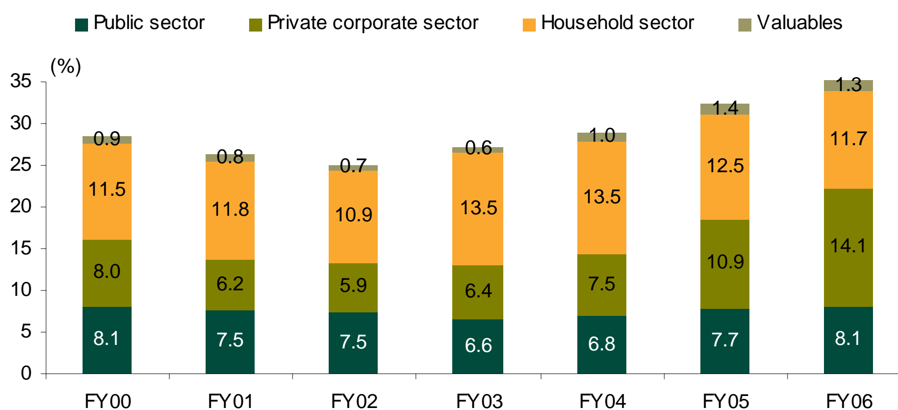
Gross fixed capital formation (GFCF) in the economy has some interesting trends. As the table below shows, corporate capex has been instrumental in raising the investment-GDP ratio from FY03 to FY06 (no data is available for FY07).

Figure 29: GFCF by sector (at current prices) *(INR bn)*

	FY00	FY01	FY02	FY03	FY04	FY05	FY06
Public sector	14,461.00	14,463.90	15,654.40	14,932.40	17,459.70	22,048.70	26,442.60
% growth		0	8.2	-4.6	16.9	26.3	19.9
Private corporate sector	14,347.50	11,990.10	12,335.00	14,558.00	19,135.00	31,004.50	45,971.60
% growth	-	-16.4	2.9	18	31.4	62	48.3
Household sector	20,591.40	22,691.70	22,948.20	30,581.90	34,406.70	35,604.30	38,065.50
% growth	-	10.2	1.1	33.3	12.5	3.5	6.9
Valuables	1,551.90	1,472.40	1,418.70	1,395.70	2,457.20	4,105.40	4,245.70
% growth	-	-5.1	-3.6	-1.6	76.1	67.1	3.4
Total	50,951.80	50,618.10	52,356.30	61,468.00	73,458.60	92,762.90	114,725.40
% growth	-	-0.7	3.4	17.4	19.5	26.3	23.7

Source: CSO and Lehman Brothers research

Figure 30: Investment-to-GDP ratio

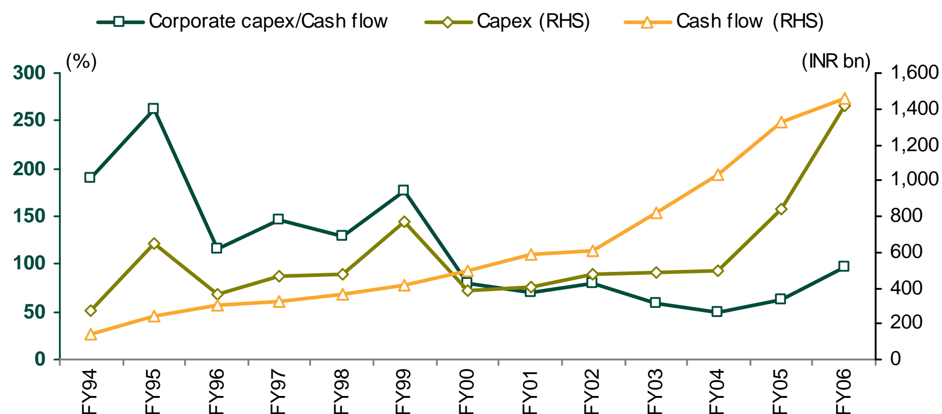


Source: Lehman Brothers research

…but note that corporate capex has trailed profits in this period

This is an important point for any forecast of corporate capex, in our view. We find that BSE 500 companies' capex as a proportion of their cash flows declined significantly till FY05. On an absolute basis, capex in FY05 was almost equal to that in FY99, even though cash flow had more than tripled in the period. But capex picked up sharply in FY06, catching up with cash flow.

Figure 31: Corporate cash flow and capex



Source: Lehman Brothers research

We believe that the increase in capex seen in FY06 marks the beginning of a secular increase in investment, for which Indian companies have been preparing by building up balance-sheet leverage. The table below (see Figure 32) gives some anecdotal evidence for this.

Figure 32: Capex plans *(INR bn)*

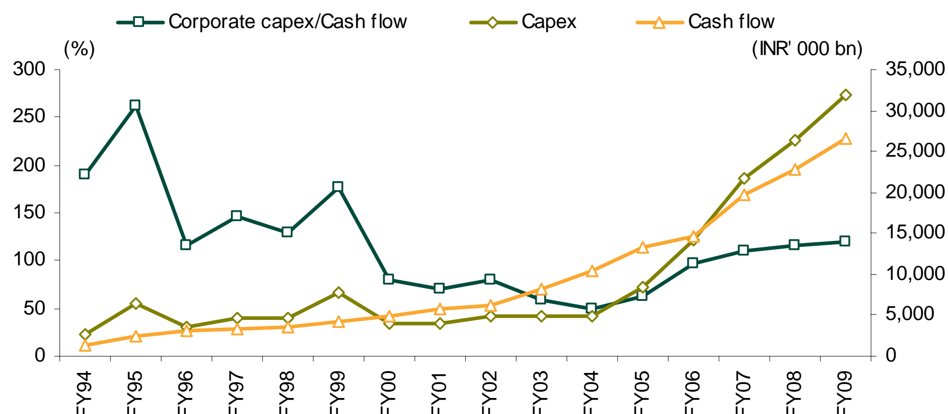
Company	Capex over last three years	Capex plans now
Tata Motors	28	100 in 3 years
Tata Steel	41	660 in 10 years
SAIL	22	320 in 6 years
JSW Steel		92 in 3 years
Maruti	5.2	90 in 3 years
Bajaj Auto	2.8	5.3 in 3 years
Hindalco	20	50 in 5 years
Reliance group	330 (including Infocomm)	800 in 5 years (including Infocomm)

Source: Lehman Brothers research

Capex could potentially triple from FY05 levels

The chart below shows corporate capex in relation to profits. As the data is not yet available for all companies in the BSE500 universe for FY06, we have made some assumptions regarding profit growth and incremental leverage. Growth in profits assumed for BSE500 is in line with growth in BSE100 profits. As can be seen, the level of corporate capex could potentially rise 2.5x from FY06 levels, and we think would likely grow at the rate of 30% compound annual growth rate (CAGR) over the next three years (FY06-FY09).

Figure 33: How capex could inflect



Source: Lehman Brothers research

Correlating economy-wide private capex and BSE500 capex

So far, we have made a case for an upturn in corporate capex on the basis of data for BSE500 companies. However, this data fails to capture not only the rest of the listed and unlisted companies, but also the unorganised sector. One could argue that the growth in BSE500 companies might be at the expense of the unorganised sector. We think it is not so, as we explain below.

Capex growth likely to be broad-based…

We have analysed the link between corporate sector capex in the overall economy from national income statistics and juxtapose it with data from BSE500 companies. The table below (see Figure 34) gives the results.

Based on the data below, we think it is difficult to make a case that large companies' capex has been gaining at the expense of smaller companies' capex. We therefore expect overall corporate capex to follow a similar growth trajectory to BSE500 capex.

Figure 34: Historical capex *(INR bn)*

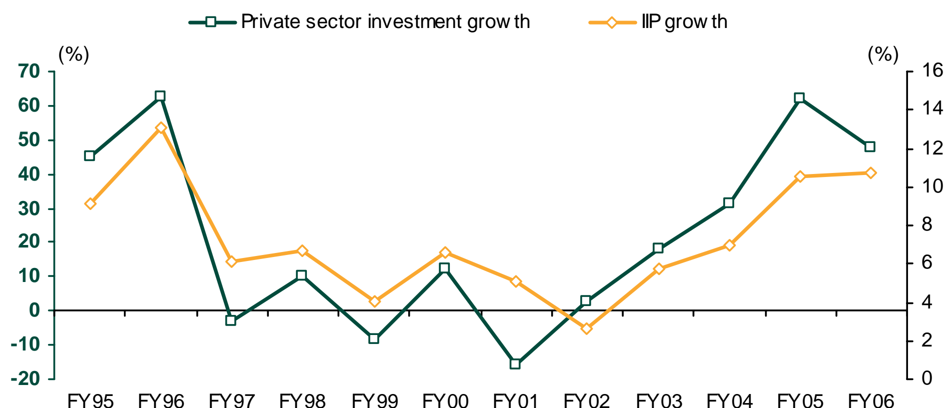
	FY00	FY01	FY02	FY03	FY04	FY05	FY06
Corporate capex from national accounts	140,088	119,993	127,503	141,659	188,728	257,478	347,698
% change		-14	6	11	33	36	35
BSE500 capex	39,152	40,172	47,090	48,197	51,055	84,010	140,205
% change		3	17	2	6	65	67
BSE500 capex/overall corp capex	28	33	37	34	27	33	40

Source: Lehman Brothers research

...and drive significant industry growth

We believe that corporate capex is a much more powerful driver of the economy and industry than are household investments or public sector investments. The chart below (see Figure 35) bears out our observation, highlighting the correlation between corporate capex growth and index of industrial production (IIP) growth.

Figure 35: Growth in private sector investment and IIP



Source: Lehman Brothers research

We believe that growth in investment will remain strong in the foreseeable future. As such, industry growth should accelerate in the years ahead.

Quantifying industry growth: it could even exceed 12%

In our assessment, there is a strong possibility that industry growth can climb above 12% in FY09. Note that industry currently forms only 25% of GDP. While we concede that corporate profits also include services, we doubt that the contribution of services exceeds 30% (around 15% from banks, 5-6% from software, and not more than 10% from the rest). This means that as a proportion of industry GDP, investments in manufacturing would form a much higher part. We expect this to drive growth in the industry at a very rapid pace. The next section identifies sectors best placed to gain from overall economic growth.

Figure 36: Corporate capex and GDP

	FY09
BSE500 capex (USD bn)	71
Economy-wide corporate capex (USD bn)	177, assuming 60% outside BSE500
GDP (USD bn)	891, assuming 9% growth on 750 bn
Corporate capex/GDP	19.80%
FY05 level	Around 9%

Source: Lehman Brothers research

Appendix IV

Sixth Pay Commission: Impact and portfolio positioning

We think that Sixth Pay Commission would have significant impact on the economy and spending. While there is no fixed timeline for the final recommendations of Sixth Pay Commission, do note that the date for final suggestions to the commission was 30 August 2007. We expect that the final recommendations of the Sixth Pay Commission to happen before the elections.

The last pay commission which increased the salaries of government employees significantly post-FY96 had significant consequences for central and state government finances. As the table below shows (see Figure 37), while the overall impact on savings was negligible, the pay commission transferred savings from government to households in a significant way. Coming at a time of slowdown in the economy and in the era of high interest rates, its impact on consumption was limited. As a result, the pay commission led to deepening of economic slowdown in that period.

Figure 37: Impact of Fifth Pay Commission on savings *(% of GDP)*

	FY96	FY97	FY98	FY99	FY00	FY01
Household savings	17.4	17	17.6	18.8	21.3	21.2
Increment		(0.4)	0.6	1.2	2.5	(0.1)
Public savings	2	1.7	1.3	(1.0)	(0.9)	(1.8)
Decrement		(0.3)	(0.4)	(2.3)	0.1	(0.9)

Note: Increment/decrement refers to percentage point change over the previous year.
Source: Planning commission

This time around, however, there are crucial differences.

- Economy is booming: Deterioration in government finances post the award of Fifth Pay Commission coincided with a downturn in corporate capex and exacerbated the overall economic cycle post-FY97. However, the current cycle is characterised by significant improvement in corporate profitability, strong capex cycle and comparatively lower interest rates. A hefty increase in government pay packets could thus actually enhance consumption spending in the economy significantly.

- Private partnership in infrastructure is well established: The ability of government to finance infrastructure diminished significantly following the Fifth Pay Commission. This time around, however, we believe the channels to invite private participation in infrastructure have been well established. As a consequence, we think deterioration in government finances should not lead to a pause in infrastructure spending.

As a consequence, we expect consumption spending could see a serious tailwind due to the increase in salaries of government employees. This would have an adverse impact on government finances and could set the fiscal responsibility management act off target by a couple of years. Nonetheless, we advise investors to position themselves for the likely spending increase that would likely follow the Sixth Pay Commission award.

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Important Disclosures:

STOCK	TICKER, PRICE (28 Sept 07), RATING
Reliance Industries	(RIL IN, INR2296, 1-OW)
ICICI Bank	(ICIICIBC IN, INR1063, NR)
Larsen & Toubro	(LT IN, INR2813, NR)
Maruti Udyog	(MSIL IN, INR1000, 1OW)
Mahindra & Mahindra	(MM IN, INR752, NR)
Union Bank	(UNBK IN, INR163, NR)
SBI	(SBIN IN, INR1951, NR)
Nagarjuna Construction	(NTPC IN, INR253, NR)
NTPC	(NTPC IN, INR193 NR)
Zee Telefilms	(Z IN, INR342, NR)
Zee News	(ZEEN IN, INR63, NR)
Bharti	(BHARTI IN, INR941, 1-OW)
Sun Pharmaceuticals	(SUNP IN, INR966, NR)
Infosys	(INFO IN, INR1897, NR)
Tata Steel	(TATA IN, INR850, NR)

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