Morgan Stanley

MORGAN STANLEY RESEARCH

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Research
India

India Strategy

Model Portfolio & Focus List: Overweight Financials

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Model Portfolio & Focus List: Overweight Financials

- ***We are increasing our position on Financials by 100bp and thus going to overweight the sector***. This follows an upgrade in sector view to Attractive by our India Banks Team, driven largely by a positive view on SOE banks (*see note Becoming Very Positive on SOE Banks, dated August 28, 2009*). We are already constructive on India real estate and this change on SOE banks makes us positive on financials. The key reasons are:

- a) Earnings recovery led by better NIMs and likely higher loan growth: Net interest margins are set to expand, especially for SOE banks as deposits are re-priced in the coming weeks. The environment for loan growth recovery looks good with commercial banks flushed with liquidity and economic activity picking up pace. Loan growth tends to lag industrial growth by around six months.

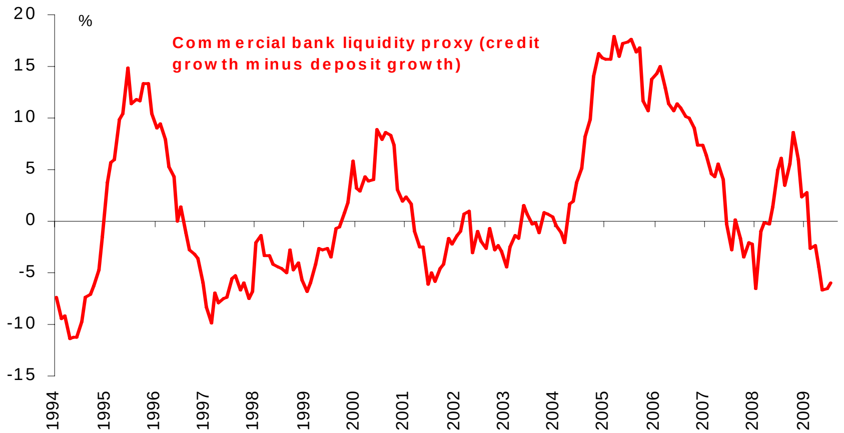
- b) Attractive valuations and poor stock price performance: Inexpensive valuations provide a margin of safety against risks. SOE banks trade at an average 3.5x F2011e PPOP and 1.1x F2010e BV. Hence, a lot of the key risks in the form of asset quality deterioration and potential extreme policy response to the drought seem to already be reflected in stock prices. Any pick-up in profitability could cause stocks to re-rate materially. In addition, the sector has underperformed both the country index and the Asian peer group year-to-date. We prefer the SOE banks over their private sector counterparts, which still appear rich to us in terms of valuation.

- c) We think concerns on bond yields and NPAs are priced in. Indeed, the long bond yield may crest soon as relative to liquidity in the system (liquid mutual funds and Reverse repo balances), the government borrowing program is likely to peak in the coming weeks. SOE banks are now relatively immune from MTM losses, unless yields spike more than 200bp. Moreover, the five-year trend of contracting spreads on bond portfolios is behind us – implying rising yields will cause NIM's to move up. NPAs may not have bottomed for this cycle, but their incremental impact on book may no longer be relevant for share prices.

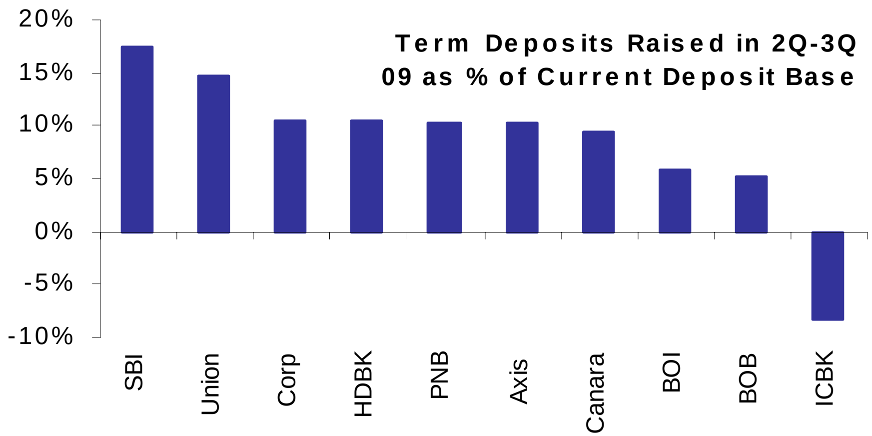
- Our sector model portfolio remains biased for a recovery in economic activity. Thus ,we are backing the financials, infrastructure, and consumer discretionary sectors while remaining underweight in materials. ***We are funding the upgrade in financials by reducing our position in telecoms to neutral***. Our top picks in the financials sector are State Bank of India and DLF.

Earnings Recovery in the Pipeline: NIM Expansion and Loan Growth Coming

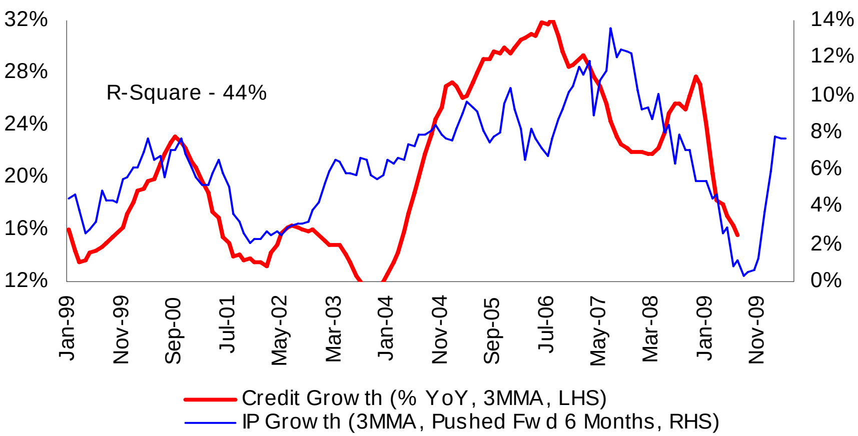
Commercial Bank Liquidity: Supportive for Loan Growth



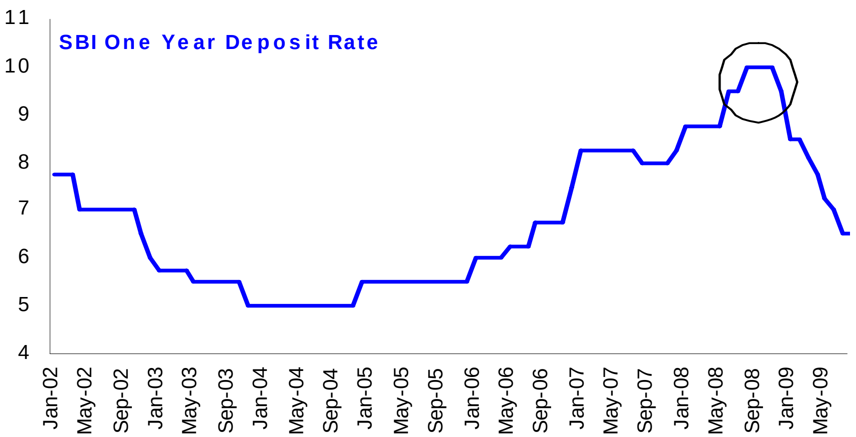
High Cost Deposit of F2Q-3Q09 to Be Re-priced Soon…



IP Growth Recovery Likely to Support Credit Pick-up



… At Much Lower Rates



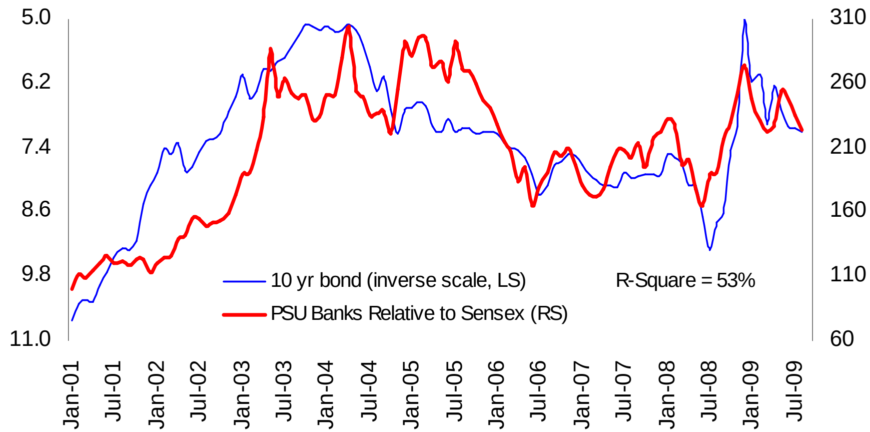
Source: RBI, Company data, Morgan Stanley Research

Concern on Bond Yields and NPAs Probably Priced in

Assessing Adequacy of Liquidity for Funding Government Borrowing Program

	For Period Between August – March 2010	Rs bn	US$bn
	Required Funding		
	Central Government	2135	44
	State Government	1260	26
	Additional State Government Offtake	210	4
A	**Total**	**3605**	**75**
	Sources of Funds		
	MSS	211	4
	Other Sources of Funding		
	(insurance, small savings etc)*	901	19
B	**Total**	**1112**	**23**
C	**Required Funding from Banking Sector (A-B)**	**2493**	**52**
D	Deposit Intake	6130	128
E	Credit Offtake	4616	96
F	Liquid Funds Bal	1396	29
G	Reverse Repo Bal	1420	30
	Available Funding from Banking Sector (D-E+F+G)	**4330**	**90**
	Assumed Credit Growth (Full year F2010)	18%	
	Assumed Deposit Growth (Full Year F2010)	20%	
	Credit Deposit Ratio (Mar-2010)	71.10%	

PSU Bank Performance Still Driven by Bond Yields



Stress-testing Valuations for Asset Quality Deterioration#

Rs mn.	Impact as % of BV (D/E)	P/Adj BVPS
Bank of Baroda	7%	1.1
Bank of India	8%	1.1
Canara Bank	16%	1
Corporation Bank	6%	1.1
Oriental bank	13%	0.6
Punjab National bank	10%	1.4
State bank of India	13%	2
Union Bank	10%	1.2
Axis Bank	4%	2
HDFC Bank	3%	3.7
ICICI Bank	12%	1.9

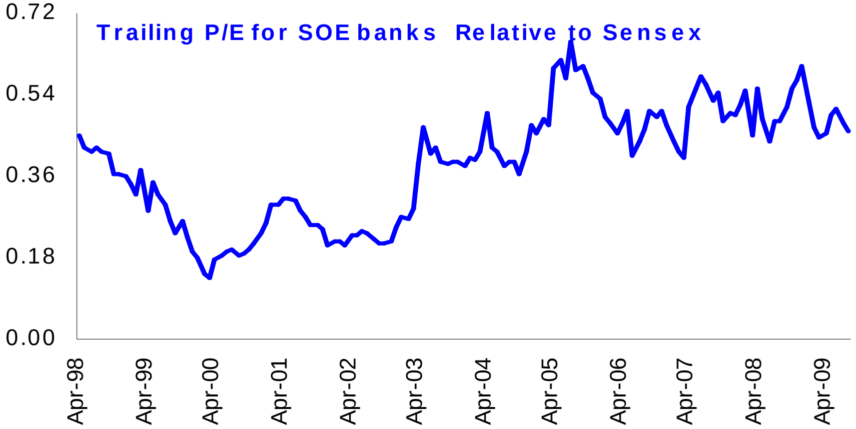
Source: RBI, Company data, Morgan Stanley Research; * Assumed based on past trends. #For details & methodology please see "Becoming Very Positive on SOE Banks" dated August 28, 2009

Valuations and Performance Support Our View

Regional Bank Stocks Performance: India Among the Underperformers

	Performance vs. Country Index		
	1M	3M	09 YTD
Asian Banks	**3%**	**5%**	**5%**
Thai	-2%	6%	19%
Korea	3%	12%	19%
Australia	8%	8%	18%
Malaysia	-1%	5%	11%
China	-1%	4%	0%
Singapore	2%	-2%	0%
HK	-2%	6%	-6%
India	**-2%**	**-6%**	**-10%**
Indonesia	2%	0%	-17%
Philippines	-1%	-15%	-18%
Taiw an	-7%	-10%	-21%

SOE Banks: Relative Valuations Are Attractive



SOE Banks Look More Attractive on Most Valuation Metrics

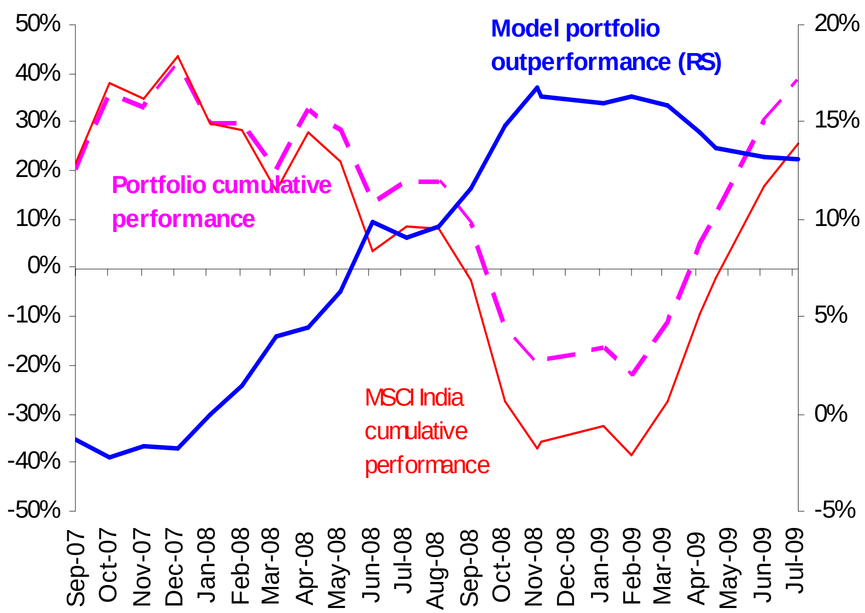
	Core PPOP Growth			P/Core PPOP		PB	ROE	Div Yield	PE	
	F06-F09	F2010	F2011	F2010E	F2011E	F2010E	F2010E	F2009	F2010E	F2011E
SOE Banks										
BOB	26%	13%	39%	3.7	3.7	1.2	18%	2.1%	7.1	7.3
BOI	41%	3%	36%	3.9	2.9	1	20%	2.5%	5.8	5.1
Canara	11%	-4%	41%	4.5	3.2	1	13%	3.0%	8.2	5.9
CRPBK	16%	3%	38%	5.1	3.7	1	18%	3.3%	5.9	5.5
OBC	7%	16%	13%	3.3	2.9	0.5	12%	4.9%	4.8	5.5
PNB	21%	8%	33%	4.3	3.3	1.3	18%	3.0%	7.7	6.4
SBI	34%	16%	43%	6.8	4.8	1.7	16%	2.0%	11.5	9.4
Union	19%	5%	36%	4.5	3.3	1.3	18%	2.3%	6.4	5.6
Average	**22%**	**7%**	**35%**	**4.5**	**3.5**	**1.1**	**16%**	**2.9%**	**7.2**	**6.3**
Pvt Banks										
Axis	65%	16%	21%	10.3	8.5	2.2	15%	1.1%	18.3	16.6
HDBK	35%	19%	20%	10.5	8.8	3.6	17%	0.7%	22.6	18.2
ICBK	43%	-2%	13%	12.5	11.1	1.6	7%	1.4%	24.2	19.4
Average	**47%**	**11%**	**18%**	**11.1**	**9.5**	**2.5**	**13%**	**1.1%**	**21.7**	**18.1**

MS estimates
Source: Bloomberg, Company data, Morgan Stanley Research

Sector Model Portfolio

Our sector model portfolio remains biased for a recovery in economic activity. Thus, we are backing financials, infrastructure, and consumer discretionary sectors while remaining underweight in materials. Our top picks in the financials sector are State Bank of India and DLF.

Sector Model Portfolio Performance Since Inception



Source FactSet, MSCI, Morgan Stanley Research

India Sector Model Portfolio: Latest Positions

Sector	MSCI Weight (%)	Portfolio Weight (%)	Over/Under - Weight (bps)	Perf Rel. To MSCI India (YTD Perf.)	(12M)
Consumer Disc.	4.4	5.4	100	28%	43%
Consumer Staples	5.7	5.7	0	-30%	3%
Energy	18.9	19.9	100	-3%	-10%
Financials	24.1	25.1	100	-3%	0%
Healthcare	3.2	2.2	-100	-24%	-18%
Industrials	10.0	11.0	100	17%	11%
Technology	15.3	15.3	0	12%	5%
Materials	9.5	7.5	-200	38%	6%
Telecom	2.2	2.2	0	-33%	-35%
Utilities	6.6	5.6	-100	-13%	7%
Cash	0.0	-			

Focus List

Stocks	Sector	Ticker	Analyst Rating	Price (Rs) 26/08/09	MCap (US$ bn)	Avg 3M T/O (US$ mn)	Relative to MSCI India	
							YTD Perf (%)	12m Perf (%)
Maruti Suzuki	Cons Disc	MSIL IN	Overweight	1,405	8.3	24	59%	106%
Zee Entertainment	Cons. Disc	Z IN	Overweight	218	1.9	7	-8%	-6%
Hindustan Unilever	Cons Staples	HUVR IN	Equal-Weight	263	11.7	25	-38%	-2%
Reliance Ind	Energy	RIL IN	Overweight	2,040	68.5	217	-2%	-13%
ONGC	Energy	ONGC IN	Equal-Weight	1,173	51.3	58	3%	7%
DLF	Financials	DLFU IN	Equal-Weight	399	13.9	142	-17%	-26%
HDFC	Financials	HDFC IN	Overweight	2,512	14.6	56	-1%	-1%
State bank of India	Financials	SBIN IN	Overweight	1,744	22.5	98	-20%	18%
Jaiprakash Asso.	Industrials	JPA IN	Overweight	221	5.3	101	57%	31%
Larsen & Toubro	Industrials	LT IN	Overweight	1,575	18.8	100	20%	11%
Infosys Tech	Technology	INFO IN	Underweight	2,181	25.5	65	15%	19%
Reliance Infra	Utilities	RELI IN	Overweight	1,147	5.3	102	17%	6%

Focus List Timeline Since Inception

	Date Added	Dated Removed	MSCI India price (in Rs) on date when removed or current	when removed or current price	Dividend if any	Stock return*	Stock Relative return to MSCI India
DLF	15-Jul-09		627	399	3	24%	12%
HDFC	22-Aug-07		627	2512	35	32%	21%
Hindustan Unilever	21-Aug-08		627	263	9	9%	-1%
Infosys Technologies	29-Nov-07		627	2181	27	39%	74%
Jaiprakash Associates	29-Nov-07		627	221	1	-39%	-23%
Larsen & Toubro	15-May-09		627	1575	12	59%	21%
Maruti Suzuki	15-May-09		627	1405	4	66%	26%
Oil & Natural Gas Corp.	22-Aug-07		627	1173	34	45%	33%
Reliance Industries	22-Aug-07		627	2040	16	15%	5%
Reliance Infrastructure	15-Jul-09		627	1147	8	4%	-7%
Zee Entertainment	21-Aug-08		627	218	2	3%	-6%
State bank of India	13-Aug-09		627	1744	33	-3%	-5%
Union Bank of India	22-Aug-07	13-Aug-09	615	213	5	70%	58%
Arvind Ltd.	22-Aug-07	4-Dec-08	334	15		-65%	-41%
Bharti Airtel	22-Aug-07	15-Jul-09	564	780	1	-8%	-7%
Cipla Ltd.	4-Dec-08	15-May-09	478	231	3	25%	-8%
GAIL (India)	22-Aug-07	29-Nov-07	784	418	8	40%	2%
Marico	22-Aug-07	15-May-09	478	63	1	9%	31%
Reliance Infrastructure	22-Aug-07	29-Nov-07	784	1664	8	130%	68%
Sobha Developers Ltd.	27-Sep-07	21-Aug-08	583	279	4	-67%	-62%
Sun Pharmaceutical	22-Aug-07	15-Jul-09	564	1216	7	32%	34%
Tata Steel	22-Aug-07	21-Aug-08	583	605	14	6%	5%
Tata Consultancy Services	22-Aug-07	27-Sep-07	687	1062	14	4%	-14%

Source: FactSet, MSCI, Bloomberg, Morgan Stanley Research

* Stock return is excluding dividend received. Stocks marked in red are the ones removed from the focus list, and stocks marked in blue are those added to the focus list. The stocks marked in maroon have been removed from the focus list over time .Past performance is no guarantee of future results. Results shown do not include transaction costs.

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