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India

UBS Investment Research

India Market Strategy

Equity Strategy

Market Comment

A more aggressive portfolio stance

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- **Strong capex cycle and peaking interest rates are key themes**

We believe the key investment themes going forward shall be continued strength of the capex cycle and peaking of interest rates. UBS economist Philip Wyatt believes inflation is likely peaking out, and that should reduce concerns on rise in interest rates.

- **Increasing weight on capex-related stocks and interest rate sensitives**

From the capex-related names we add Maharashtra Seamless and Tata Steel, as they appear relatively cheap. We also include IDFC and HDFC Bank and increase weight on M&M. Consequently auto goes to neutral (from underweight), though bank remains underweight. Within pharma, we replace Glenmark by Ranbaxy.

- **Overweight Engineering, IT, pharmaceuticals, cement**

IT is the only sector that has significant currency-related earnings concerns, but we believe the best part of INR appreciation is behind us. We are underweight on energy, with exposure only to Reliance.

- **Top picks: Reliance, Grasim, BHEL, Reliance Communication, Ranbaxy**

For Reliance, announcements of field development plans (FDP) and resolution of gas pricing issue could be major triggers. BHEL and Grasim are strong plays on capex cycle. For Ranbaxy a big trigger could be a ruling in Canada, permitting RANB to launch Lipitor.

Table 1: Valuation of top picks

Stock	Rating	EV/EBITDAx			PER (x)			PEG	EVEG
		FY 06	FY 07E	FY 08E	FY 06	FY 07E	FY 08E	(FY06-08E)	(FY06-08E)
Reliance Industries	Buy 2	12.9	10.1	8.8	26.3	21.9	18.4	1.35	0.61
Ranbaxy Laboratories	Buy 2	67.9	20.5	16.1	55.4	26.4	19.9	0.83	0.65
Reliance Communications	Buy 2	25.5	11.0	7.4	233.4	35.3	24.7	1.13	0.30
Grasim	Buy 2	12.3	6.6	5.7	24.7	13.3	11.0	0.50	0.26
BHEL	Buy 2	19.6	13.1	10.9	45.7	29.2	24.4	1.24	0.58

Source: UBS estimates

Key theme #1: Investment cycle to strengthen further

In a recent report ("How to play the investment boom" dated July 5), we argued that the Indian capex cycle is durable, and the targets are broadly achievable. We also believe that financing of infrastructure and industrial capex is easier today than in the past because budget deficits are lower than earlier; bank finances to infrastructure, though low, are rising rapidly, corporate cash flows are strong and balance sheets are deleveraged and interest from private equity (PE) funds in infrastructure is rising rapidly. We believe over next 4-5 years both infrastructure capex and industrial (i.e. corporate) capex shall be 2-3x the capex witnessed in last 5 years.

We believe the beneficiaries of this large capex cycle are likely to be: (i) The service providers, like engineering, capital goods and construction companies, (ii) The material providers like cement companies, steel and steel pipe manufacturers, construction equipment manufacturers etc., (iii) The finance providers – banks and financial institutions, especially those having larger focus on corporate loans or infrastructure loans, and (iv) The takers of infrastructure project risk – i.e. dedicated infrastructure holding companies.

Key theme #2: Interest rates peaking out

In a recent report ("India: Inflation peaking out" dated June 22) UBS economist Philip Wyatt argues that inflation is likely to peak out in FY08, and sustainable inflation rate should slow towards 5% - close to the Government's and RBI's comfort zone. Philip believes peaking of inflation should reduce local interest rate expectations. This obviously has significant positive implication for financial markets. Recent anecdotal evidence also points to peaking of interest rates. Both ICICI Bank and HDFC have reduced home loan interest rates recently – by 50bps.

Changes to model portfolio

Above-mentioned themes call for two actions on our model portfolio:

(i) Increase exposure to direct plays on capex cycle, preferably those which remain relatively cheap even after the recent run-up in the infrastructure-related plays. We include Maharashtra Seamless (MSL) and IDFC I our portfolio on this theme. MSL is highly leveraged to pipeline expansion for oil exploration and gas transportation, and trades at 10.3xFY09E despite 37.5% forecast earnings CAGR over FY07-09E. IDFC at P/BV of 3.7xFY09E may appear expensive, but we think it has significant embedded values due to its stakes in NSE, SSKI and other investments (refer "IDFC: Revising price target to Rs160" dated July2, by Mahrukh Adajania). Our valuation of the core lending business is based on P/BV of 2.3xFY09E.

(ii) Increase weight on interest rate sensitives like banks and autos. We include HDFC Bank and raise weight on M&M marginally. After this change autos are upgraded to neutral, though banks remain underweight.

(iii) We finance these changes by taking away some weight from energy (ONGC excluded, sector weight goes from neutral to underweight), consumer staples (from ITC, sector goes from overweight to neutral), and IT Services (from TCS, though our stance on the sector remains overweight).

Table 2: UBS model portfolio sector tilt

Sector	Our portfolio weight	Benchmark weight	Recommendation
Engineering / Capital goods	12.5	7.5	Overweight
IT Services	23.0	19.3	Overweight
Pharmaceuticals	7.0	4.0	Overweight
Cement & conglomerates	4.5	3.4	Overweight
Automobiles	7.0	6.1	Neutral

Telecom	10.0	9.2	Neutral
Metals	3.0	2.5	Neutral
FMCG	6.0	5.6	Neutral
Utilities	0.0	1.1	Underweight
Energy	15.0	19.0	Underweight
Banks & FIs	12.0	21.1	Underweight

Source: UBS estimates

Table 3: UBS India model portfolio

Sector	Tilt	Stocks	Portfolio weight
IT Services	Overweight	Satyam	8
		Infosys	7
		TCS	8
Pharmaceuticals	Overweight	Ranbaxy Laboratories	3
		Sun Pharmaceuticals	4
Consumer staples	Neutral	HLL	2
		ITC	4
Cement		Grasim Industries	4.5
Engineering / Capital goods / construction	Overweight	Larsen & Toubro	5
		BHEL	5
		Maharashtra Seamless	2.5
Energy		Reliance Industries	15
Banks and FIs		HDFC Bank	5
		ICICI Bank	3
		IDFC	2
		Punjab National Bank	2
Metals	Neutral	Tisco	3
Automobiles		M&M	4
		Tata Motors	3
Telecommunication		Bharti Televentures	5
		Reliance Communication Ventures	5

Source: UBS estimates

■ Statement of Risk

Risk to investing in India arises primarily from relatively expensive valuations, possibility of rise in inflation and interest rates, and possible domestic political uncertainty.

■ Analyst Certification

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UBS Rating	Definition	UBS Rating	Definition	Rating Category	Coverage[1]	IB Services[2]
Buy 1	FSR is > 6% above the MRA, higher degree of predictability	**Buy 2**	FSR is > 6% above the MRA, lower degree of predictability	**Buy**	48%	39%
Neutral 1	FSR is between -6% and 6% of the MRA, higher degree of predictability	**Neutral 2**	FSR is between -6% and 6% of the MRA, lower degree of predictability	**Neutral**	40%	37%
Reduce 1	FSR is > 6% below the MRA, higher degree of predictability	**Reduce 2**	FSR is > 6% below the MRA, lower degree of predictability	**Sell**	12%	26%

1:Percentage of companies under coverage globally within this rating category.
2:Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Ratings allocations are as of 30 June 2007.

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Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.
Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).
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Company Name	Reuters	Rating	Price	Price date
Bharat Heavy Electricals Limited	BHEL.BO	Suspended	Rs1,555.85	06 Jul 2007
Bharti Airtel Ltd.[2b]	BRTI.BO	Buy 2	Rs866.40	06 Jul 2007
Glenmark Pharmaceuticals[20]	GLEN.BO	Neutral 2 (CBE)	Rs677.00	06 Jul 2007
Grasim Industries[16]	GRAS.BO	Buy 2	Rs2,773.15	06 Jul 2007
HDFC Bank Ltd.[1, 2b, 4b, 5, 16]	HDBK.BO	Buy 1	Rs1,153.35	06 Jul 2007
Hindustan Unilever	HLL.BO	Buy 2	Rs199.95	06 Jul 2007
ICICI Bank[2b, 4b, 16]	ICBK.BO	Neutral 2	Rs981.55	06 Jul 2007
Infosys Technologies Ltd.[2a, 4a, 16]	INFY.BO	Buy 2	Rs1,971.25	06 Jul 2007
Infrastructure Development Finance[2a, 4a, 5]	IDFC.BO	Buy 2	Rs122.80	06 Jul 2007
ITC	ITC.BO	Neutral 2	Rs155.50	06 Jul 2007
L & T	LART.BO	Neutral 2	Rs2,364.55	06 Jul 2007
Maharashtra Seamless[13]	MHSM.BO	Buy 2	Rs636.10	06 Jul 2007
Mahindra & Mahindra	MAHM.BO	Buy 2	Rs787.35	06 Jul 2007
Oil & Natural Gas Corporation	ONGC.BO	Buy 1	Rs879.35	06 Jul 2007
Punjab National Bank	PNBK.BO	Buy 2	Rs524.25	06 Jul 2007
Ranbaxy[2b, 4a]	RANB.BO	Buy 2	Rs361.95	06 Jul 2007
Reliance Communication Limited	RLCM.BO	Buy 2	Rs550.50	06 Jul 2007
Reliance Industries[2b, 4b, 5]	RELI.BO	Buy 2	Rs1,711.45	06 Jul 2007
Satyam Computer Services Ltd.[16]	SATY.BO	Buy 2	Rs489.20	06 Jul 2007
Sun Pharmaceuticals Industries Limited	SUN.BO	Buy 2	Rs1,012.10	06 Jul 2007
Tata Consultancy Services Ltd.[8]	TCS.BO	Buy 2	Rs1,159.05	06 Jul 2007
Tata Motors Ltd.[16]	TAMO.BO	Buy 2	Rs710.60	06 Jul 2007
Tata Steel Ltd.[5]	TISC.BO	Buy 2	Rs623.15	06 Jul 2007

Source: UBS. All prices as of local market close.
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