

**UBS Investment Research****India Market Strategy**

## The safest and the riskiest

### ■ Valuation risk bigger than earnings risk

In the current environment changes in risk appetite are governing stock price movements. Valuation risk appears more important than earnings risk. We identify stocks with low and high valuation risk using long and near term measures.

### ■ IEG provides a good screening tool

Using the dividend discount (DDM) model for fair P/BV we calculate IEG for the UBS universe in India. We further refine our list of undervalued stocks by selecting those on which UBS has “Buy” ratings. In our list of overvalued stocks we select only those which are rated “Sell” or “Neutral”. This helps avoid a usual deficiency of quant models like IEG – their failure to capture fundamental changes in a company or in its operating environment. Finally from our undervalued list we eliminate stocks that appear overvalued on near-term growth-adjusted PE or EV/EBITDA.

### ■ The overvalued stocks

We believe GMR, Aurobindo Pharma, NTPC, Shoppers’ Stop and Suzlon are overvalued. All of them have IEG higher than the theoretically justifiable 8-12%.

### ■ The undervalued stocks

We highlight Grasim, Maharashtra Seamless, PNB, Tata Motors, M&M, Wockhardt, Subex, Hexaware, DLF, Tata Steel and SAIL. DLF is the surprise inclusion, contrary to common general perception of overvaluation. However, our conclusion depends on robustness of earnings estimates. For example in a recent note (“A reality check on volumes” dated Aug 7) we have highlighted risk to volume and earnings estimates of Tata Motors and M&M.

10 August 2007

[www.ubs.com/investmentresearch](http://www.ubs.com/investmentresearch)**Manishi Raychaudhuri**

Analyst

[manishi.raychaudhuri@ubs.com](mailto:manishi.raychaudhuri@ubs.com)

+91-22-2286 2025

**Navin Kumar Gupta**

Associate Analyst

[navin-kumar.gupta@ubs.com](mailto:navin-kumar.gupta@ubs.com)

+91-22-2286 2121

This report has been prepared by UBS Securities India Private Ltd

**ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 6.**

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## Recapitulating the theory behind our model

The dividend discount model (DDM) provides a “justifiable” P/BV multiple for stocks according to the formula:  $P/BV = (ROE - g)/(COE - g)$ , where

1. ROE is the sustainable ROE of the company,
2. ‘g’ is the long term earnings growth rate
3. COE is the long term sustainable cost of equity.

Re-arranging the terms in the above-mentioned equation, we arrive at:

$$(A) \quad \dots \quad g = ((P/BV * COE) - ROE) / (P/BV - 1),$$

Equation (A) tells us what the P/BV multiple of the share is implying about the long-term earnings growth of the company. However, for equation (A) to give meaningful result, three conditions must hold for the stock: (i)  $ROE > COE$ , (ii)  $P/BV > 1$ , and (iii) P/BV not close to 1 (if P/BV is close to 1, g would turn out to be infinitely large). Hence, from our universe of stocks we look at those stocks which satisfy conditions (i), (ii) and (iii).

To approximate long term sustainable ROE we use the past five year’s average ROE. However, we appreciate that the market’s consensus belief about long-term sustainable ROE may be influenced by the near-term history – i.e. ROE in FY07. We consequently look at implied earnings growth under two assumptions of sustainable ROE – last 5 year’s average ROE and ROE in FY07. As Table 1 illustrates, change in the sustainable ROE assumption makes significant difference to IEG for several stocks – viz. HCC, Aurobindo Pharma, Maruti, ACC, DRL, Glenmark, Grasim, DLF, Lupin and Subex.

**Table 1: Implied earnings growth estimates for UBS coverage universe.**

Company	P/B (FY08E)	COE	Avg. ROE (03-07)	Implied g	FY07 ROE	g based on 07 ROE
IVRCL	3.25	15.0%	17.9%	14%	15.0%	15%
United Spirits Ltd	7.59	13.6%	15.0%	13%	21.5%	12%
Hindustan Construction	3.33	14.6%	17.4%	13%	6.9%	18%
GMR Infrastructure	11.95	13.5%	15.2%	13%	17.4%	13%
Pantaloon Retail	6.75	13.2%	14.3%	13%	9.7%	14%
Aurobindo Pharma	1.94	12.8%	13.6%	12%	22.8%	2%
L&T	7.85	13.4%	23.2%	12%	32.2%	11%
NTPC	2.52	12.1%	12.6%	12%	13.9%	11%
BHEL	7.79	12.9%	21.5%	12%	32.6%	10%
Shoppers' Stop	5.95	12.1%	14.3%	12%	9.4%	13%
Bharti Televentures	7.90	12.6%	20.8%	11%	37.4%	9%
ICICI Bank	1.58	13.0%	14.0%	11%	13.4%	12%
Maruti	2.74	13.8%	18.4%	11%	24.9%	7%
Reliance Industries	4.04	13.2%	19.8%	11%	22.5%	10%
Sun TV	8.49	13.2%	29.6%	11%	33.7%	10%
Suzlon Energy	8.50	14.5%	42.4%	11%	27.7%	13%
Mphasis BFL	5.27	11.9%	17.4%	11%	18.2%	10%

HDFC Limited	7.24	13.0%	27.6%	11%	29.8%	10%
Dabur India	14.63	12.8%	44.3%	10%	65.0%	9%
ACC	4.36	12.6%	19.9%	10%	40.2%	4%
Ranbaxy Laboratories	4.89	13.6%	26.6%	10%	20.3%	12%
Satyam	4.51	13.0%	23.2%	10%	28.0%	9%
Dr. Reddy's Laboratories	2.44	12.5%	15.9%	10%	32.2%	-1%
Unitech	12.07	13.4%	50.0%	10%	167.7%	-1%
Gujarat Ambuja	4.09	12.6%	21.4%	10%	33.5%	6%
Hindustan Lever	13.41	13.1%	58.6%	9%	61.2%	9%
SBI	2.21	13.2%	17.9%	9%	15.4%	11%
Nicholas Piramal	4.33	13.9%	29.8%	9%	21.9%	12%
Bajaj Auto	3.44	12.7%	21.6%	9%	22.9%	9%
Cipla	3.85	13.7%	27.2%	9%	25.5%	10%
Glenmark Pharma	6.39	12.9%	34.2%	9%	59.8%	4%
Wipro	5.91	12.9%	32.9%	9%	36.3%	8%
ITC	5.12	12.3%	27.1%	9%	27.7%	9%
Asian Paints	10.15	11.1%	34.4%	9%	39.5%	8%
HDFC Bank	2.73	12.3%	18.9%	8%	19.5%	8%
Nestle	26.68	11.2%	86.2%	8%	84.5%	8%
Infosys	7.42	12.6%	40.8%	8%	42.3%	8%
Grasim Industries	2.96	13.2%	24.4%	7%	34.5%	2%
DLF Limited	5.63	19.8%	78.6%	7%	174.5%	-14%
M&M	2.53	13.1%	24.2%	6%	30.4%	2%
Patni	2.59	11.7%	21.2%	6%	18.7%	7%
Tata Motors	2.85	13.4%	28.6%	5%	31.3%	4%
TCS	8.84	12.3%	75.9%	4%	54.5%	7%
Lupin Limited	3.12	12.0%	29.1%	4%	40.7%	-2%
Subex Azure	1.98	12.2%	20.5%	4%	13.5%	11%
Maharashtra Seamless	3.12	12.8%	33.8%	3%	34.2%	3%
Sun Pharma	4.11	11.8%	44.4%	1%	41.7%	2%
ONGC	2.24	13.1%	28.2%	1%	33.9%	-4%
Hexaware	1.93	12.0%	22.2%	1%	23.6%	0%
Hero Honda	4.47	12.2%	60.6%	-2%	38.2%	5%
SAIL	2.66	14.2%	43.3%	-3%	41.5%	-2%
Wockhardt	2.25	12.5%	34.9%	-6%	32.0%	-3%
PNB	1.22	13.4%	21.4%	-24%	16.0%	1%
Tata Steel	1.56	14.6%	42.5%	-35%	34.7%	-21%
IOC	1.22	12.6%	25.8%	-49%	21.9%	-31%

Source: UBS estimates

At this stage we would make two points:

1. There are four kinds of companies in our universe: (i) the “secular performers” or steady ROE companies – e.g. those IT Services,

consumer staples, banks and select pharmaceutical companies, (ii) the “structurally growing” companies or companies in their initial growth phase – e.g. telecommunication, real estate companies, and (iii) the “deep cyclicals” – e.g. the metal companies, cement companies, and (iv) Companies with significant regulatory influence on their ROEs, e.g. oil & gas companies, etc.

2. Implied long term earnings growth of a company should roughly equal long term nominal GDP growth of the economy that the company operates in – a conjecture that is broadly borne out by Table 1. If we believe that medium-to long term real GDP growth of India is likely to be in the 5-8% range and inflation is likely to be in the 3-4% range, then most companies in Table 1 should have IEG in the 8-12% range. This is indeed the case for almost 60% of the companies in Table 1.

Point 1 above tells us which estimate of sustainable ROE (i.e. latest data or long term average) we should choose for our analysis. We conclude that for “secular performers” any estimate of ROE can be chosen – the conclusion would be pretty much the same. For “structural growth” stories, near term ROE gives a relatively better estimate of sustainable ROE. For “deep cyclicals” the long term average (or “cycle-average”) ROE gives a better estimate of sustainable ROE.

## The undervalued stocks

Table 1 is an important tool for stock screening. We notice that there are quite a few stocks whose IEG is clearly lower than the lower limit of the “theoretical” 8-12% range. We believe these stocks are undervalued. However, we apply another screening tool – for the list of undervalued stocks we choose only those where UBS has a “Buy” rating. A deficiency of quant models like IEG is that these models often fail to take into account future fundamental changes in a company or in the environment in which a company operates. We believe such changes can be captured in the analysts’ bottom-up recommendation. Similarly, there are stocks with IEG higher than the theoretical 8-12% range – these are the overvalued stocks. In preparing a list of overvalued stocks we choose only those on which UBS has a “Sell” or “Neutral” recommendation.

Table 2: Undervalued stocks on IEG measure

Company	Avg. ROE (03-07)	Implied g	FY07 ROE	g based on 07 ROE	5-yr EPS CAGR	Forecast 2-year EPS CAGR	UBS Rating
Grasim Industries	24.4%	7%	34.5%	2%	52%	20%	Buy
DLF Limited	78.6%	7%	174.5%	-14%	-	111%	Buy (CBE)
Mahindra & Mahindra	24.2%	6%	30.4%	2%	75%	21%	Buy
Tata Motors	28.6%	5%	31.3%	4%	55%	14%	Buy
Tata Consultancy Services	75.9%	4%	54.5%	7%	37%	25%	Buy
Subex Azure	20.5%	4%	13.5%	11%	29%	49%	Buy
Maharashtra Seamless	33.8%	3%	34.2%	3%	36%	30%	Buy
Sun Pharma	44.4%	1%	41.7%	2%	32%	23%	Buy
Oil & Natural Gas Corporation	28.2%	1%	33.9%	-4%	20%	1%	Buy
Hexaware Technologies	22.2%	1%	23.6%	0%	102%	18%	Buy
Steel Authority of India	43.3%	-3%	41.5%	-2%	34%	11%	Buy

Wockhardt	34.9%	-6%	32.0%	-3%	23%	28% Buy
PNB	21.4%	-24%	16.0%	1%	11%	12% Buy
Tata Steel	42.5%	-35%	34.7%	-21%	41%	16% Buy

Source: UBS estimates

All stocks that come up in our IEG screening tool have IEGs significantly lower than previous 5-years EPS CAGR, and significantly lower than forecast EPS CAGR over next 2 years. This suggests that the market is too pessimistic about the long term earnings growth prospects of these companies.

Finally, we apply a third screening measure – that of near term valuations. Implied earnings growth, after all, is a measure of market's belief about a company's *long term* earnings growth. Presently, stock prices are being governed by near-term changes in risk appetite, and under these circumstances, valuations based on near-term and medium-term earnings estimates are also important determinants of share price movement. We therefore look at PE and EV/EBITDA multiples of our selected stocks, and eliminate those with PEG or EPEG multiples of >1.

Table 3: PE and EV/EBITDA multiples for stocks with low IEG

Stock	Rating	UBS Price Target		EV/E BITD A				PE				PEG (FY07- 09E)	EPEG (FY07- 09E)
		10-Aug-07	10-Aug-07	FY 06	FY 07	FY 08E	FY09E	FY 06	FY 07	FY 08E	FY09E		
Tata Motors	Buy	669.1	910	11.2	8.8	7.5	6.4	15.2	12.5	11.1	9.5	0.87	0.52
M&M	Buy	671.1	1000	12.7	10.3	8.8	7.3	15.5	11.6	9.6	7.9	0.55	0.56
ONGC	Buy	842.8	1063	6.1	4.7	4.5	4.4	11.7	8.4	8.3	8.2	7.47	1.40
Wockhardt	Buy	371.5	570	15.7	12.9	8.0	6.1	15.8	13.5	13.2	10.2	0.92	0.29
Sun Pharma	Buy	915.0	1215	32.5	22.6	17.0	12.8	29.8	22.9	20.2	15.2	1.01	0.69
TCS	Buy	1145.1	1570	28.3	20.5	16.6	13.0	38.9	27.1	22.4	17.4	1.08	0.79
Subex	Buy	530.3	840	41.6	42.9	16.5	11.7	30.5	27.3	17.0	12.2	0.55	0.47
Hexaware	Buy	122.4	170	14.9	12.6	10.2	8.0	17.0	14.0	12.9	10.2	0.80	0.50
Grasim	Buy	2884.3	3535	12.3	6.5	5.2	4.9	25.7	13.4	10.0	9.4	0.68	0.43
Maharashtra Seamless	Buy	575.5	706	12.0	7.3	5.1	3.8	23.8	17.2	12.4	9.3	0.47	0.19
Tata Steel	Buy	635.9	800	5.0	3.8	1.9	1.8	10.0	8.7	6.9	6.5	0.56	0.08
SAIL	Buy	149.5	180	4.8	3.2	2.8	2.6	15.1	9.9	8.6	8.0	0.91	0.27
DLF	Buy (CBE)	584.5	750	-	-	-	-	519.4	51.3	16.0	11.5	0.46	-
PNB	Buy	497.8	620	-	-	-	-	11.2	10.2	9.4	8.1	0.86	-

Source: UBS estimates

The third screen eliminates ONGC, Sun Pharma and TCS. We thus highlight the following stocks as undervalued and therefore low-risk, we believe, under the present circumstances:

Tata Motors, M&M, Wockhardt, Subex, Hexaware, Grasim, Maharashtra Seamless, Tata Steel, SAIL, DLF and PNB. Clearly, DLF is the surprise in this

list – contrary to common perception, the stock appears undervalued on every one of our screens.

## The overvalued stocks

At polar opposite end (in Table 1) of the undervalued stocks are the overvalued stocks – those which have IEG higher than 12%. For companies in their initial growth phase, (e.g. Shoppers' Stop, Suzlon) we consider near term (FY07) ROE as a relatively better measure of long-term ROE. We consider those overvalued stocks on which UBS rating is "Sell" or "Neutral".

**Table 4: Over-valued stocks on IEG measure**

Company	Avg. ROE (03-07)	Implied g	FY07 ROE	g based on 07 ROE	5-yr EPS CAGR	Forecast 2-year EPS CAGR	UBS Rating
GMR Infrastructure	15.2%	13.3%	17.4%	13%	44%	33%	Sell
Aurobindo Pharma	13.6%	12.0%	22.8%	2%	19%	23%	Neutral
NTPC	12.6%	11.8%	13.9%	11%	15%	5%	Neutral
Shoppers' Stop	14.3%	11.6%	9.4%	13%	25%	42%	Sell
Suzlon Energy	42.4%	10.7%	27.7%	13%	123%	44%	Neutral

Source: UBS estimate.

This screen throws up 5 names – GMR, Aurobindo Pharma, NTPC, Shoppers' Stop and Suzlon.

## ■ Statement of Risk

The principal risk to investing in Indian equities arises from premium valuations, potential domestic political uncertainty, and possible spike in inflation and interest rates, though the concern on inflation has subsided considerably.

## ■ Analyst Certification

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### UBS Investment Research: Global Equity Rating Allocations

UBS 12-Month Rating	Rating Category	Coverage <sup>1</sup>	IB Services <sup>2</sup>
Buy	Buy	48%	39%
Neutral	Hold/Neutral	40%	37%
Sell	Sell	12%	26%
UBS Short-Term Rating	Rating Category	Coverage <sup>3</sup>	IB Services <sup>4</sup>
Buy	Buy	N/A	N/A
Sell	Sell	N/A	N/A

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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

### UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	Definition
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

**KEY DEFINITIONS**

**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).

**Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

**Short-Term Ratings** reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case.

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**US Closed-End Fund ratings and definitions are:** Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.

**UK and European Investment Fund ratings and definitions are:** Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.

**Core Banding Exceptions (CBE):** Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned or Company Disclosure table in the relevant research piece.

**Company Disclosures**

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
Aurobindo Pharma Limited	ARBN.BO	Neutral	N/A	Rs619.40	10 Aug 2007
DLF Limited <sup>2, 4, 5, 20</sup>	DLF.BO	Buy (CBE)	N/A	Rs584.45	10 Aug 2007
GMR Infrastructure	GMRI.BO	Sell	N/A	Rs826.90	10 Aug 2007
Grasim Industries <sup>16</sup>	GRAS.BO	Buy	N/A	Rs2,884.25	10 Aug 2007
Hexaware Technologies <sup>13</sup>	HEXT.BO	Buy	N/A	Rs122.35	10 Aug 2007
Maharashtra Seamless <sup>13</sup>	MHSM.BO	Buy	N/A	Rs575.45	10 Aug 2007
Mahindra & Mahindra	MAHM.BO	Buy	N/A	Rs671.05	10 Aug 2007
National Thermal Power Corporation Ltd.	NTPC.BO	Neutral	N/A	Rs164.80	10 Aug 2007
Punjab National Bank	PNBK.BO	Buy	N/A	Rs497.75	10 Aug 2007
Shoppers' Stop Ltd.	SHOP.BO	Sell	N/A	Rs541.00	10 Aug 2007
Steel Authority of India	SAIL.BO	Buy	N/A	Rs149.50	10 Aug 2007
Subex Azure Limited <sup>2, 4, 13</sup>	SUBX.BO	Buy	N/A	Rs530.30	10 Aug 2007
Suzlon Energy	SUZL.BO	Neutral	N/A	Rs1,300.25	10 Aug 2007
Tata Motors Ltd. <sup>16, 22</sup>	TAMO.BO	Buy	N/A	Rs669.05	10 Aug 2007
Tata Steel Ltd. <sup>5, 22</sup>	TISC.BO	Buy	N/A	Rs635.90	10 Aug 2007
Wockhardt <sup>13</sup>	WCKH.BO	Buy	N/A	Rs371.50	10 Aug 2007

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

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

For a complete set of disclosure statements associated with the companies discussed in this report, including information on valuation and risk, please contact UBS Securities LLC, 1285 Avenue of Americas, New York, NY 10019, USA, Attention: Publishing Administration.

Additional Prices: Asian Paints Ltd., Rs950.00 (10 Aug 2007); Associated Cement Companies Ltd., Rs1,000.90 (10 Aug 2007); Bajaj Auto, Rs2,318.70 (10 Aug 2007); Bharat Heavy Electricals Limited, Rs1,694.50 (10 Aug 2007); Bharti Airtel Ltd., Rs838.80 (10 Aug 2007); Cipla Ltd., Rs184.75 (10 Aug 2007); Dabur India Ltd., Rs102.65 (10 Aug 2007); Dr. Reddy's Labs, Rs632.85 (10 Aug 2007); Glenmark Pharmaceuticals, Rs631.00 (10 Aug 2007); Gujarat Ambuja Cement, Rs126.60 (10 Aug 2007); HDFC Bank Ltd., Rs1,131.70 (10 Aug 2007); Hero Honda Ltd., Rs659.65 (10 Aug 2007); Hindustan Construction Company, Rs127.35 (10 Aug 2007); Hindustan Unilever, Rs195.65 (10 Aug 2007); Housing Development Finance Corporation, Rs1,947.30 (10 Aug 2007); ICICI Bank, Rs865.70 (10 Aug 2007); Indian Oil Corp., Rs401.60 (10 Aug 2007); Infosys Technologies Ltd., Rs1,952.25 (10 Aug 2007); ITC, Rs163.35 (10 Aug 2007); IVRCL, Rs380.75 (10 Aug 2007); L & T, Rs2,432.05 (10 Aug 2007); Lupin Limited, Rs629.25 (10 Aug 2007); Maruti Udyog Limited, Rs810.25 (10 Aug 2007); Mphasis BFL, Rs297.70 (10 Aug 2007); Nestle India Ltd., Rs1,270.00 (10 Aug 2007); Nicholas Piramal India Limited, Rs257.40 (10 Aug 2007); Oil & Natural Gas Corporation, Rs842.80 (10 Aug 2007); Pantaloon Retail (India) Ltd., Rs495.05 (10 Aug 2007); Patni Computer Systems, Rs423.80 (10 Aug 2007); Ranbaxy, Rs367.80 (10 Aug 2007); Reliance Industries, Rs1,810.75 (10 Aug 2007); Satyam Computer Services Ltd., Rs479.40 (10 Aug 2007); State Bank of India, Rs1,607.25 (10 Aug 2007); Sun Pharmaceuticals Industries Limited, Rs915.00 (10 Aug 2007); Sun TV Limited, Rs358.95 (10 Aug 2007); Tata Consultancy Services Ltd., Rs1,145.05 (10 Aug 2007); Unitech, Rs512.30 (10 Aug 2007); United Spirits Ltd, Rs1,419.85 (10 Aug 2007); Wipro Ltd., Rs480.25 (10 Aug 2007); Source: UBS. All prices as of local market close.

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