Strategy In-Depth

7 December 2006 | 16 pages

India Equity Strategy

Outlook 2007

- Economic growth momentum to sustain — We see sustained economic growth momentum of 8%-plus GDP, generally stable interest rates, a robust external account, and an appreciating rupee.
- Potential positive drivers — Expect capex upturn to gather further momentum, urban consumption to get a lift from wage inflation, FDI inflows to see a scale change, healthy earnings growth of 15-20% (albeit slower than the 25% average for the past 5 years).
- Potential headwinds — Credit growth moderation, talent shortage and wage inflation hitting margins, Uttar Pradesh state elections, and global risk appetite.
- Market view — After 4 years of spectacular performance, we expect 2007 to be a steady year due to valuation hurdles. Introducing Dec-07 Sensex target of 14,700-16,000, a 10-20% premium to fundamental fair values on our valuation models. Widespread belief of a long-term structural growth story in India and robust flows can sustain such premium over fair value, although we do not see it heading toward previous bubble levels of 100-200%.
- Investment strategy: Staying defensive — We retain our preference for a defensive India portfolio of large-cap, visible growth stories, although the recent underperformance has made us more constructive on mid- and small-caps.

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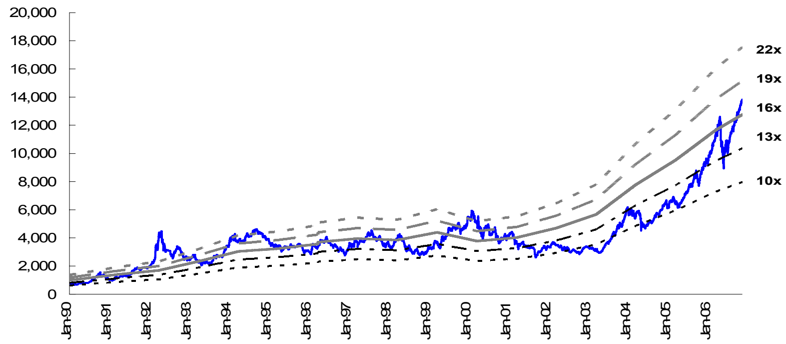
BSE- Sensex 12-Month Forward PE Band Chart



Source: Bloomberg, Citigroup Investment Research

See page 14 for Analyst Certification and important disclosures.

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Key trends we see in 2007

Robust economic growth momentum sustainable

There is upside risk to our GDP growth forecast of 8.3% for FY07 and 8.0% for FY08

Economic growth momentum remains very robust in India, as indicated by the above-forecast 9.2% GDP growth recently reported for 2Q FY07, despite very subdued growth in the agriculture sector. Our economist, Rohini Malkani, has noted that there is upside risk to our GDP growth forecasts of 8.3% for FY07 and 8.0% for FY08, currently being held back to ascertain the impact of evolving El Niño conditions on agriculture growth. The important thing is that the key services and manufacturing sectors are now growing in double-digits, which are healthy signs indeed for macroeconomic growth momentum in India, and we expect that to continue through 2007.

With regard to other economic parameters, we expect one more 25bp hike in the reverse repo rate this fiscal year and stability in rates after that. The external account is expected to stay in good shape, and we expect an appreciation of the rupee (from Rs44.7/US$1 currently to Rs43.2 by end-2007).

Figure 1. Annual and Quarterly — Trends and Components in GDP (% YoY)

	Wts.	FY07			FY06		Full Year Estimates		
		Q1	Q2	1H	Q2	1H	FY06	FY07E	FY08E
Agriculture	**25.3**	**3.4**	**1.7**	**2.6**	**4.0**	**3.7**	**3.9**	**3.0**	**3.0**
Industry	**25.4**	**9.7**	**10.3**	**10.0**	**7.8**	**9.0**	**8.7**	**9.2**	**9.2**
Manufacturing	14.7	11.3	11.9	11.6	8.1	9.4	9.0	9.1	9.2
Mining	2.3	3.4	3.1	3.2	-2.6	0.3	0.9	3.0	4.5
Electricity	2.5	5.4	7.7	6.5	2.6	5.0	5.3	5.0	4.5
Construction	5.9	9.5	9.8	9.7	12.3	12.4	12.1	12.5	12.0
Services	**49.2**	**10.6**	**10.9**	**10.7**	**10.0**	**9.9**	**10.0**	**9.8**	**9.2**
Trade,hotels,comm	21.6	13.2	13.9	13.5	11.0	11.4	11.5	12.0	11.0
Financing, insurance	13.0	8.9	9.5	9.2	10.5	9.6	9.7	9.6	9.0
Community services	14.7	7.4	6.9	7.2	8.0	7.6	7.8	6.0	6.0
GDP at factor cost	**100.0**	**8.9**	**9.2**	**9.1**	**8.4**	**8.5**	**8.4**	**8.3**	**8.0**
Non Farm Growth	**74.7**	**10.3**	**10.7**	**10.5**	**9.3**	**9.6**	**9.6**	**9.6**	**9.2**

Source: CSO, Citigroup estimates

Capex upturn to gather further momentum and remain a big story

Strong economic conditions, all-time-high business confidence levels, robust profitability and infrastructure needs are all set to take capex to even higher levels

Even though it was way back in 2003 that we first spoke about the coming capex upturn in India (*India Strategy: Capex Turnaround – Positive Early Signs,* 31 March 2003), we think it is still at the very early stages and has many years to go. Strong economic conditions, all-time-high business confidence levels and robust profitability are all set to take corporate capex to higher levels. Investment needs in infrastructure sectors keep rising with high economic growth and willingness of the government to open more infrastructure areas for private investments. Overall, we think India is at the very early stages of a multi-year surge in capex and 2007 will be just another step forward.

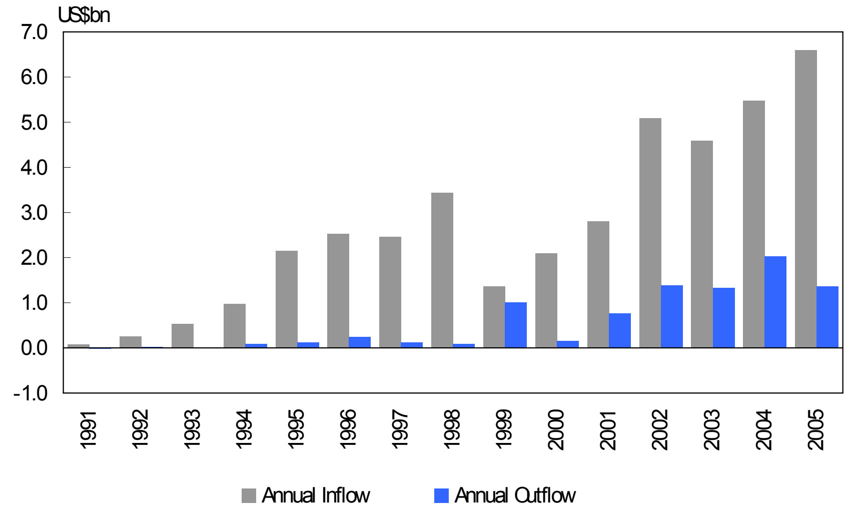
Scale change in FDI flows is just round the corner

While foreign portfolio inflows into India have seen a scale change in the past three years (going from US$2bn-3bn per year to around US$10bn per year), FDI flow improvements have been still very low (averaging around US$5bn per year). We see that changing soon, driven by positive economic growth momentum in India, the country's relatively lesser leverage to slowdown elsewhere (i.e., US housing), a very robust MNC sentiment toward India, widening outsourcing horizons, further regulatory relaxations, and opening up of various sectors (i.e., manufacturing, real estate, infrastructure, property). In all, we expect the annual run rate of FDI flows to cross US$10bn per year, some time in 2007.

The impact of a scale change in FDI inflows can be significant for the external account

All-time-high business confidence, strong corporate cash flows and balance sheets, search for niche front-ends, and the quest for scale and diversification have driven increased acquisition activities from Indian companies in recent years. We expect the trend to continue in 2007, and outward FDI will also keep rising in coming years. The impact of a scale change in FDI inflows can be significant for the external account and will further strengthen India's ability to withstand oil price spikes and volatility in portfolio flows.

Figure 2. FDI — Inflows and Outflows (US$bn)



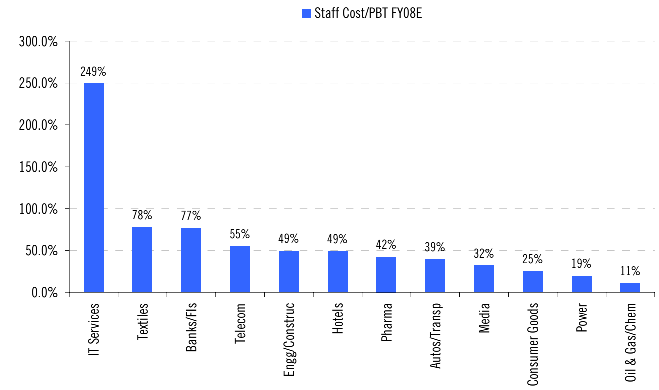
Source: UNCTAD

Talent shortage & wage inflation will be more to the fore, a double-edged sword

Rapid growth and new business areas have kept up the demand for experienced manpower

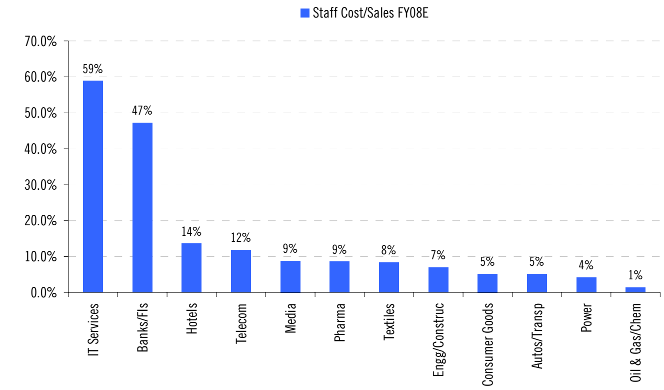
Wage inflation and talent shortage are beginning to be felt across the board in India, as rapid growth and new business areas have kept up the demand for experienced manpower. Local media have been full of stories about mid-year wage adjustments and general 20-25% wage increases being seen. We see wage inflation as a significant threat to corporate profitability in 2007, especially in sectors and companies where either top-line growth is rolling over or pricing power is non-existent due to competitive pressures. Service sectors will be more vulnerable, as wages are more of a key cost item for them. The figures below highlight sectors' and companies' vulnerability to unplanned wage hikes.

Figure 3. Sectoral Staff Costs as a % of Profit Before Tax



Source: Citigroup Investment Research estimates

Figure 4. Sectoral Staff Costs as a % of Sales



Source: Citigroup Investment Research estimates

Figure 5. Selected Companies with High Staff Costs

Company	Staff Cost/ PBT FY08E	Company	Staff Cost/PBT FY08E
MTNL	373%	Infosys Technologies	187%
Jet Airways	362%	JCT	153%
Patni Computer	361%	Hindustan Construction	133%
HCL Technologies	340%	Apollo Hospitals	126%
Wipro	296%	State Bank of India	126%
Satyam Computers	293%	Abhishek Industries	110%
Gokaldas Exports	290%	CESC	110%
I-Flex Solutions	274%	Bank of Baroda	105%
Tata Consultancy	227%	Punjab National Bank	95%
Arvind Mills	196%	Shoppers' Stop	90%

Source: Citigroup Investment Research estimates

We see the shortage of experienced manpower as a temporary one, which can be resolved in 2-3 years

A more fundamental question that arises is whether India's competitiveness is being seriously undermined long-term by the talent shortage and wage inflation. We think not. We see the current shortage of experienced manpower as a temporary one, which can be resolved in 2-3 years. There is abundant supply of graduates and technical staff at the beginner level. The problem has arisen because since the mid-1990s most sectors in India (with the exception of leaders in IT services) hardly invested in training infrastructure and bench strength. The persistent strength of growth in recent years surprised most companies, as did the entry of new players in new business opportunities (i.e., financial services, retailing, telecom, etc). We already see signs of companies investing in training infrastructure and bench strength, which should bear fruit in a couple of years.

Higher incomes will keep consumption growth strong

The flipside of higher wage inflation being felt around the economy is that consumption (most notably urban consumption, as urban areas are the ones seeing all the job creation, not rural) is likely to stay strong throughout 2007. Already, we have seen a trend of higher growth in highest income categories (see Figure 6); we see that trend accelerating further in 2007.

Figure 6. Income Distribution of Households (Million Households)

	FY96	FY02	FY10E
<US$2000	131	135	114
US$2000-US$10,000	33	50	98
>US$10,000	1	3	10
Total no. of households	**165**	**188**	**222**

Source: NCAER, Citigroup

Moderation in credit growth

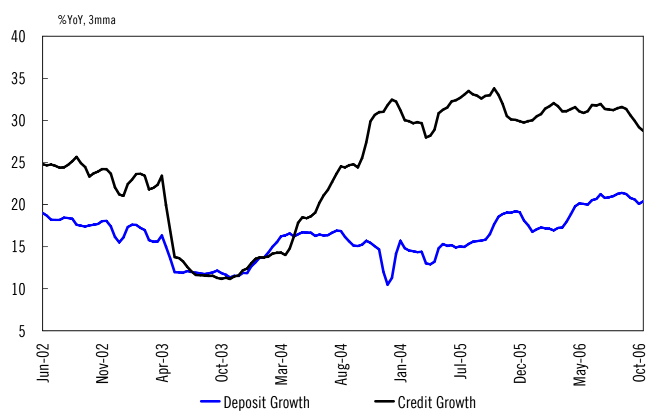
We view the evidence of credit growth moderation as a positive macro development

After over two years of 30-35% bank credit growth (fueled greatly by the boom in mortgages and consumer credit, and a revival in corporate credit demand), we have been making a case for eventual moderation in credit growth since the past few months. We have argued in the past that moderation of credit growth to 20-25% would be great news from the point of view of avoiding further tightening in the banking system, avoiding further interest-rate hikes that can damage key growth drivers (i.e., capex and consumption), and lowering the risk of future bad loans. On that basis, we consider the evidence of credit growth moderation a positive macro development.

Latest banking data suggest that the moderation in credit growth has already begun in the past few weeks (see Figure 8 below). We see that trend continuing through the early parts of 2007 and see loan growth of 20-25% more sustainable going forward.

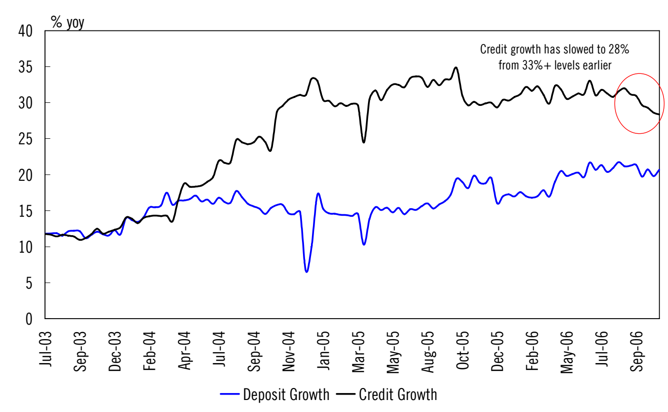
While the macro and long-term benefits of credit moderation are there, what is also a fact is that slower credit will moderate growth rates in certain sectors (i.e., housing, banks in general, and autos), which is something that can present risks to earnings forecasts in those sectors.

Figure 7. Indian Banks — Credit and Deposit Growth



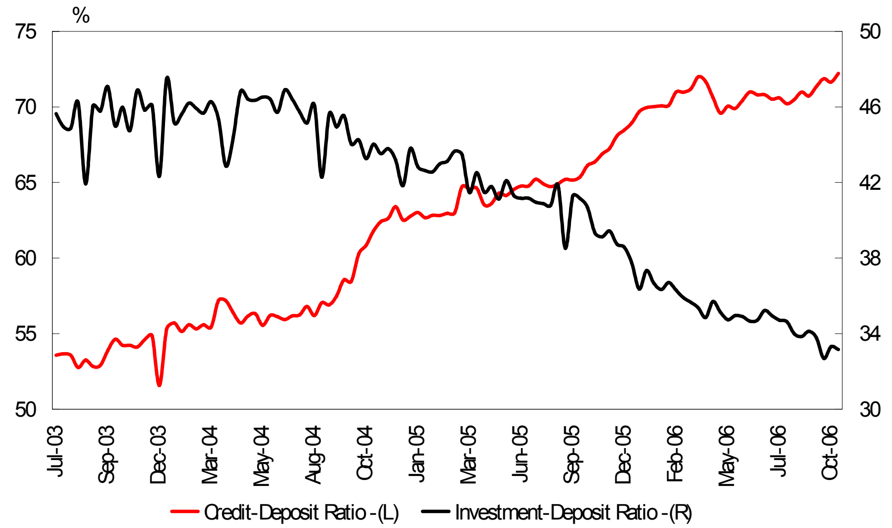
Source: RBI, Citigroup Investment Research

Figure 8. Credit Growth Has Moderated



Source: RBI, Citigroup Investment Research

Figure 9. Trends in Investment and Credit Deposit Ratios



Source: RBI, Citigroup Investment Research

Earnings growth to stay robust, albeit moderate from recent past

It looks like FY07 will end up as the fifth consecutive year of around 25% earnings growth

With a strong 2Q performance and subsequent upgrades, it now looks like FY07 will end up as the fifth consecutive year of around 25% earnings growth in India. We do see earnings growth moderation in FY08 and beyond to around 15-20%, driven by (1) the lack of operating leverage now, (2) the lack of significant positive product price deltas in the commodity sectors, and (3) the impact of slower credit expansion and higher interest rates.

Figure 10. India — Earnings Trend

Sector	2005	2006	2007E	2008E
Sensex	**36.5%**	**19.8%**	**24.9%**	**14.8%**
Sensex ex-oil	**31.4%**	**21.4%**	**28.9%**	**17.3%**
Citigroup India universe	**20.7%**	**16.6%**	**26.3%**	**13.9%**
Citigroup India universe ex-oil	**26.6%**	**24.3%**	**26.8%**	**20.2%**
Autos, Transportation	40.4%	14.1%	10.2%	14.0%
Engg., Power, Constr	24.1%	29.5%	31.3%	16.4%
Consumer, Retail	27.3%	14.0%	23.9%	19.4%
Sugar	118.5%	113.0%	32.7%	20.2%
Hotels	245.9%	112.9%	52.8%	22.5%
Media	7.6%	-24.8%	52.9%	66.7%
Textiles	18.6%	52.0%	30.5%	38.4%
Pharma, Healthcare	-9.8%	43.1%	43.6%	24.7%
IT Services	36.9%	31.4%	42.5%	22.5%
Telecom	32.8%	45.2%	113.7%	41.7%
Oil & Gas, Chemicals	17.8%	6.1%	21.5%	-2.0%
Banks, FIs	11.8%	16.1%	6.1%	27.6%

Source: Citigroup Investment Research estimates

Politics: Uttar Pradesh state election in 2Q key to watch

Being the largest state in terms of population and the number of MPs in Parliament, UP is the most politically significant state in India

The key event in the 2007 political calendar is the local government election in the state of Uttar Pradesh (UP), scheduled for 2Q07. Being the largest state in terms of population and the number of MPs in Parliament, UP is the most politically significant state in India. Results of the UP state election, even though it is only for the local government, will shape political thinking at the central level.

Currently, the UP state government is of a regional party. The Congress party has lost significant ground in the state in the last couple of decades. For the Congress to improve its numbers at the Parliament level, it does need to make a comeback to relevance in UP (and another eastern state Bihar).

If the Congress does extremely well in the UP state election, it would strengthen its position with the ruling coalition at the central level and may even encourage it to call an early Parliamentary election to take advantage of the trend. Any mid-term election will have a negative impact on the market, albeit very short term.

Whatever the result of the UP elections, one thing for certain is that any tough and potentially unpopular policy initiatives will be on hold until then.

Introducing 2007 target

Recapping our Indian market valuation methodology

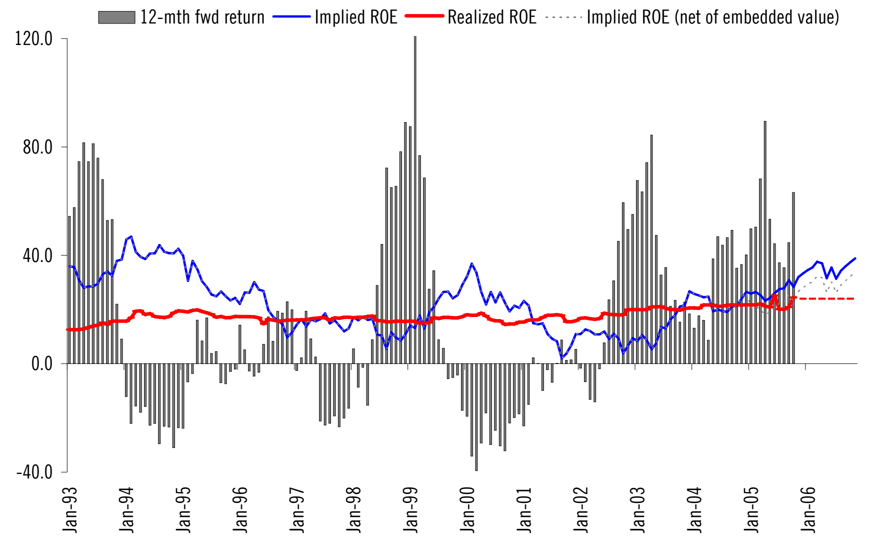
For multiple reasons, we have been advocating an India-specific valuation approach for the Indian market, rather than relative valuations vis-à-vis the region or other countries or emerging markets as a whole.

To recap, the rationale for our India standalone valuation approach has been:

- The Indian market has two distinct fundamental features currently — high earnings growth (an average of 25% over the past 5 years and is expected to remain at 15-20% in coming years) and high ROEs (around 25%). A simple comparison of P/E vs. earnings growth or P/B vs. ROE across markets ends up ignoring one of those features, not to mention that it does not account for differences in interest rates across economies. Our PBV-implied ROE model for India captures growth, interest rates, as well as ROE, and hence we have been using this to compute earnings-based fair value for the Indian market.

- Embedded asset values — In a note earlier (*India Strategy: Back From the Bubble Zone; Looking for Consolidation*, 5 July 2006), we highlighted the rising significance of balance sheet assets over the past year for valuing Indian companies. At this stage of India's economic boom, multiple different business opportunities have been springing up and many leading Indian companies have been setting up new businesses, mostly through subsidiaries. Those new businesses are not contributing to earnings today (even after consolidation accounting) and may not do so for another couple of years, but those assets do have certain value that needs to be captured. Examples are the insurance businesses of Bajaj Auto, ICICI Bank, and HDFC; and gas and other new businesses of Reliance Industries — another reason why an India standalone valuation methodology is more relevant. We have been computing these embedded values on a bottom-up basis and adding them to earnings-based fair values derived from our PBV-implied ROE model.

Figure 11. India PBV-Implied ROE Chart



Source: Citigroup Investment Research

Currently, the India PBV-implied ROE model suggests a Sensex fair value of 9,900 for June 2007, 11,600 for Dec 2007, and 13,700 for Dec 2008. For reference, about four months back, June 2007 fair value on this model was 9,400. The 5% up move in that fair value has been mainly due to earnings being upgraded post strong 2Q FY07 results in October.

Our earlier bottom-up computation of embedded asset value for Sensex was around 1,300 points ('*India Strategy: Back From the Bubble Zone; Looking for Consolidation,* 5 July 2006). Updating for new stock prices and asset values, the embedded value now works out to 1,700 points on the Sensex.

Hence, for Dec 2007, we arrive at a Sensex fair value of 13,300 (ROE model fair value of 11,600 + embedded asset value 1,700).

Cross-check with our bottom-up stock targets: Adding up our bottom-up target prices for various stocks in the Sensex, we get a Sensex fair value of 13,700, which is within 5% of the top-down value we derived above.

Figure 12. BSE Sensex Valuation Summary @ 13,938

Year to 31 March	FY04	FY05	FY06	FY07E	FY08E
EPS growth (%)	23.0%	36.5%	19.8%	24.9%	14.8%
P/E (x)	40.8	29.9	25.0	20.0	17.4
Div. yield (%)	0.8%	1.0%	1.2%	1.4%	1.5%
P/B (x)	7.8	6.5	5.6	4.7	4.0
ROAE (%)	21.3%	24.4%	24.2%	25.3%	24.7%
EV/EBITDA* (x)	19.7	18.1	15.0	12.8	11.5
Net Debt/Equity* (%)	20.7%	12.5%	12.9%	12.3%	6.4%

Source: Citigroup Investment Research estimates *Ex-financials

Setting a market target: At fundamental fair value or beyond?

India is in the fourth year of a market rally that started in 2Q03. A bull market has clearly taken hold. As the PBV-implied ROE model suggests (see Figure 11), in an all-out 'bubble type' bull market, markets have even hit levels 100-200% higher than fair value (e.g., 1999-2000 and 1994-95).

Due to various reasons — dominance of institutions in the market, closer linkage of India to global risk appetite (hence its inability to create a standalone bubble), strong market systems and surveillance — we argue that the possibility of India being able to create a stock market bubble of such proportions this time around is very unlikely (*India Strategy: Safety First; End-2006 Sensex Target of 8500,* 14 Dec 2005).

At the same time, what is indeed very much possible is for the market to continue trading at a small premium to fair value (or ahead of the fair value by a year or two) due to widespread belief of a long-term structural economic growth story, high global risk appetite, and new sources of fund flows for the market. Our valuation work suggests that precisely such a thing has happened over the last couple of years.

Introducing Dec 2007 Sensex target of 14,700-16,000, which works out to 10-20% premium over fundamental fair value

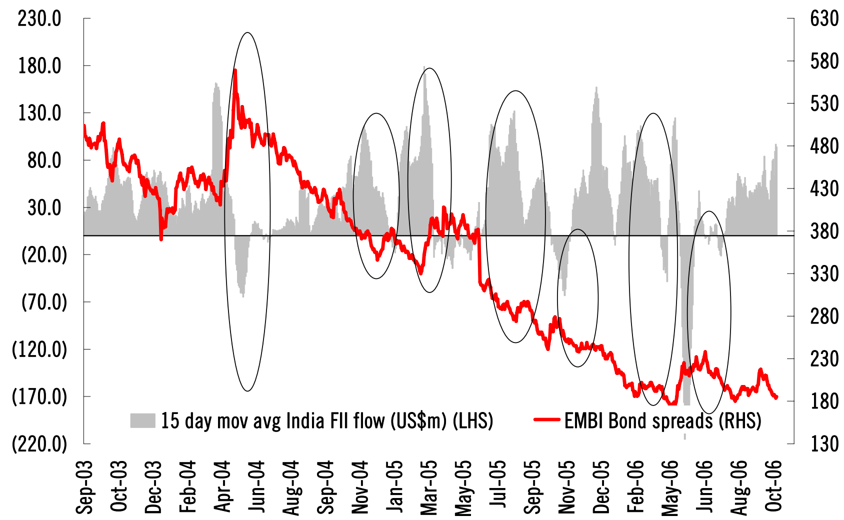
In setting our Dec 2007 market target, we take the above into account for the first time (i.e. a small premium to fundamental fair value) and set a Sensex target of 14,700-16,000, which works out to a 10-20% premium over the fair value of 13,300 as computed earlier in the note.

Vulnerability to global risk appetite

Global risk appetite will have the biggest influence on the ability of the market sustaining valuations at premiums to fair values

One of the key determinants of how long and how much above the fair values the markets can trade is the risk appetite. Given the scale of flows of FIIs vs. local flows, it is the global risk appetite that matters more. As we have highlighted in earlier reports, in the past couple of years there has been a significant increase in the correlation of foreign flows into India and global risk appetite, especially during turning points. In fact, the last two significant corrections in the Indian market (May 2006 and Oct 2005) were both major global risk appetite events, when for a brief duration there was a marked change in global risk appetite due to monetary or currency moves elsewhere. More than any fundamental factors, global risk appetite will have the biggest influence on the ability of the market sustaining valuations at premiums to fair values.

Figure 13. EMBI Spreads vs. India FII Flows



Source: Bloomberg

Investment strategy: Large-caps, visible growth remain at the core

We continue to recommend a cautious, defensive approach in India portfolios

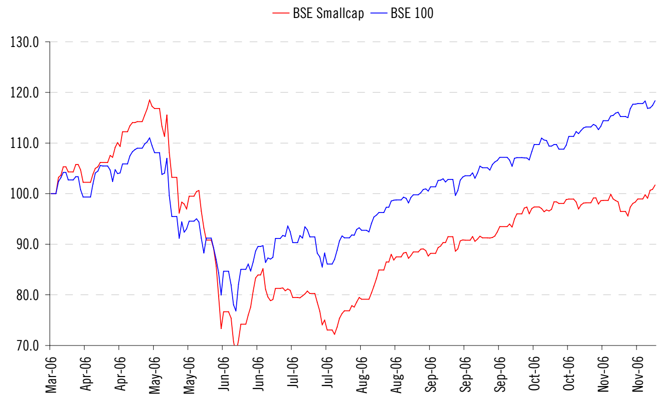
Given the strong performance of the market and valuation overshoot, we continue to recommend a cautious, defensive approach in India portfolios. We continue our 2006 preference for large cap and visible growth stories in sectors benefiting from long-term mega trends that we see in the Indian economy — early stages of a capex upturn, urban consumption growth, and outsourcing. While maintaining the bulk of India investments in large caps, we are now beginning to get more constructive on small / mid caps, explained more in depth in the following section.

Our key Overweight sectors are Capital Goods, Cement, Consumer, IT Services, Telecoms and Utilities. We are Neutral on Energy. Underweight sectors are Automobiles, Banks, Materials and Pharmaceuticals.

More constructive on mid- and small-caps

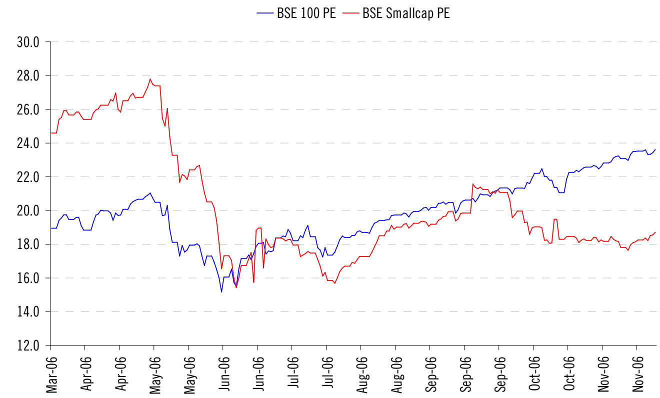
The Indian market's (Sensex) 56% rise from its May 2006 lows has been swift and impressive, but not very broad-based. The rally, driven by a surge in FII inflows, has been very focused on large-cap blue chips. To that extent, our choice of preferring large-cap, visible growth stories for India investing in 2006 has played out quite well so far (even with the market exceeding our expectations), through the turbulent May crash and the subsequent sharp turnaround.

Figure 14. Relative Performance of BSE Indices



Source: Bloomberg

Figure 15. Trailing PE Comparison of BSE Indices



Source: Bloomberg

Local funds have been mostly watching from the sidelines during this period, as net inflows into local equity funds has been virtually nil through May-Oct 2006. Part of the reason for significant mid-cap and small-cap underperformance has been a lack of local flows into the market; the other reason has of course been fresh memories of the hard hits smaller stocks took in the May 2006 crash.

Even as we continue to prefer a safety first strategy for the Indian market and think large-cap visible growth sectors should be destinations for the majority of new money invested in the market, we think it is certainly time to get more constructive on small and mid-caps. Rather than buying small/mid-caps as a segment, we believe the strategy here must be stock-specific, based on valuation arbitrage and business positioning. In certain sectors, where large-caps have a structurally superior business positioning and growth prospects (e.g., IT services, telecoms), it will be a value trap chasing laggard smaller companies.

We already have some mid-caps in our India model portfolio through the year (Asian Paints, United Phosphorus). As part of getting more constructive on the segment, we are adding Federal Bank, Jaiprakash, and United Spirits to our India model portfolio.

India Model Portfolio

								2006E			
	6-Dec-06 (Rs)	YTD Perf (%)	RIC Code	Analyst's Rating	MSCI Weight (%)	Portfolio Weight (%)	OW/UW Rel. to MSCI (bps)	PE (x)	EPS Growth (%)	PB (x)	ROE (%)
Automobiles and Components					7.6	4.0	-358				
Tata Motors	880.6	34.9	TAMO.BO	1L		4.0	O/W	20.6	23.7	5.2	28.0
Banks & Diversified Financials					20.6	14.0	-658				
HDFC Bank	1,088.5	53.9	HDBK.BO	2L		4.0	O/W	31.0	35.1	5.6	19.7
HDFC	1,589.5	31.9	HDFC.BO	--		--	M/W	-	-	-	-
ICICI Bank	870.9	48.9	ICBK.BO	1L		4.0	U/W	26.5	18.1	3.2	13.1
Federal Bank	228.5	36.7	FED.BO	1M		2.0	O/W	7.3	18.6	1.4	20.4
Capital Goods					6.4	12.0	559				
BHEL	2,621.4	89.1	BHEL.BO	1L		5.0	O/W	29.3	45.8	7.3	27.7
L&T	1,462.9	58.6	LART.BO	1L		5.0	O/W	35.3	33.5	8.9	27.3
Jaiprakash	683.4	75.8	JAIA.BO	1L		2.0	O/W	45.1	30.8	6.2	14.9
Energy					15.3	15.0	-26				
Reliance Industries	1,280.1	90.0	RELI.BO	2L		12.0	M/W	18.0	13.9	5.1	29.8
ONGC	864.9	10.4	ONGC.BO	1M		3.0	M/W	10.2	12.5	2.9	30.5
Food Beverage and Tobacco, Household & Personal Products								6.8	12.0	524	
Asian Paints	718.9	24.5	ASPN.BO	1L		3.0	O/W	27.1	38.7	9.7	38.6
Hindustan Lever	238.6	21.0	HLL.BO	1L		6.0	O/W	31.3	19.4	23.0	73.3
United Spirits	871.3	75.4	UNSP.BO	1L		3.0	O/W	42.8	155.5	6.9	17.8
Materials					6.9	3.0	-389				
Grasim	2,745.7	97.4	GRAS.BO	NR		--	O/W	-	-	-	-
Pharmaceuticals, Biotechnology, Agrochem								5.1	3.0	-209	
United Phosphorus	323.3	34.7	UNPO.BO	1L		3.0	O/W	22.6	30.5	4.3	20.8
Software & Services					21.9	27.0	509				
TCS	1,195.8	40.5	TCS.BO	1L		6.0	O/W	31.3	37.9	14.3	55.8
Wipro	589.9	27.3	WIPR.BO	1L		6.0	O/W	32.3	36.0	9.5	32.1
Infosys	2,244.8	49.8	INFY.BO	1L		15.0	O/W	36.9	46.7	13.2	42.0
Telecom Services/Media					6.0	6.0	0				
Bharti Tele	646.8	87.1	BRTI.BO	1L		6.0	O/W	35.6	65.3	10.4	33.9
Utilities					2.4	4.0	162				
NTPC	148.1	32.1	NTPC.BO	1L		2.0	O/W	18.5	21.0	2.5	14.3
GAIL	268.6	1.1	GAIL.BO	1L		2.0	O/W	10.1	1.1	2.1	21.9
Others*					1.1	-	-113				
Cash						-	0				
Total					100.0	100.0	0	26.1	26.6	6.5	26.2

Source: Citigroup Investment Research estimates. *Others – Hotels, tech hardware, transportation. Note: This table provides a guideline for the types of stocks that would fit our investment strategy. Some of the stocks listed are not rated [NR]. They are shown for illustration purposes as the types of companies in their respective sector that would follow a broad-based thematic approach. CIR does not cover these stocks and has no investment opinion or recommendation for them.

Analyst Certification Appendix A-1

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