IDFC SSKI

INDIA RESEARCH

# India Strategy: Opportunity in adversity

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**India has not remained untouched by the unprecedented global financial crisis, wherein tight liquidity has impacted solvency of banks and corporates. Back home too, liquidity has been stretched in the aftermath of monetary tightening and consistent capital outflows over the past few months. The problem has aggravated over the past three weeks on account of advance tax outflows and slowing deposit growth. We see tight liquidity feeding its way through moderation in credit growth as lenders turn risk averse. This would impact the capex plans (especially greenfield expansions) of corporates as reduced availability of funding, both debt and equity, will hit investment demand over the next 12-18 months. On the ground though, there are some positives too; inflation is on a downtrend, falling commodity prices imply easing pressure on fiscal deficit, and most significantly the fact that India is better geared to infuse liquidity into the system (high reserve requirements of 32.5%). Policymakers have also indicated their willingness to pro-actively respond to any crisis…should any unforeseen events deter the economic growth. In totality, the stage is set for monetary easing and this has, in the past (FY01-03), led to growth revival, though with a lag.**

**While global policymakers are going all out to resolve the crisis, the global growth concerns can further compound. In such a scenario, India too will be impacted. But we do not expect the slowdown in India to precipitate into a full-blown crisis given its inward-looking economy and relatively low leverage of government, corporates as also consumers. However, in the worst case, GDP growth could taper by 150-200bp over the next 12-18 months if global variables continue to deteriorate. We have run a sensitivity analysis on IDFC-SSKI universe to gauge the downside risk if this extreme macro environment were to play out. Our worst-case scenario indicates a cut of 12-14% and 23-25% in our FY09 and FY10 base case earnings estimates.**

**Notably, interest rate/ capex cycle plays have been hammered on the bourses given their high sensitivity to economic downturns. The stocks are available at extremely attractive valuations even after factoring in the worst case earnings, and totally ignoring embedded values. Larger stocks within these sectors which also have stronger balance sheets will see a sharp rebound with small positive deltas in the economic landscape, global or local. Our preferred picks within these sectors are BHEL, Reliance Infra and Mundra Port & SEZ in the infra space; and large PSU Banks, ICICI Bank and HDFC Bank among financials. We also like companies within the two-wheeler space, as we believe that any cyclical upturn in the economy (emanating from implementation of Sixth Pay Commission recommendations, consistently higher farm incomes and farm loan waiver) can catalyze growth; Bajaj Auto and Hero Honda are our key picks. To balance the portfolio, we recommend investing in HUL (FMCG), Cipla (pharma) and Concor (logistics), which are our defensive bets. We would refrain from investing in commodities, small banks, media and retail considering the significant downside risk to their earnings.**



"For Private Circulation only" and "Important disclosures appear at the back of this report"

## Preferred picks

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | downside (%) | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| Bajaj Auto | 60.1 | 56.8 | 64.0 | 9.4 | 2.9 | 3.2 | 55.4 | 62.8 | 7.8 | 1.3 | 1.5 | 2.4 | 3.3 |
| Hero Honda | 48.5 | 62.1 | 70.1 | 12.6 | 14.2 | 20.3 | 57.9 | 65.4 | 10.2 | 11.6 | 16.2 | 6.9 | 6.7 |
| HUL | 8.1 | 9.7 | 11.4 | 14.9 | 19.3 | 18.6 | 9.4 | 10.4 | 14.1 | 12.5 | 13.2 | 3.2 | 8.9 |
| BHEL | 56.7 | 71.6 | 95.9 | 27.4 | 32.7 | 30.1 | 66.0 | 83.8 | 20.9 | 22.7 | 21.6 | 7.8 | 12.6 |
| Rel Infra | 40.7 | 49.5 | 57.3 | 21.8 | 25.4 | 24.0 | 48.3 | 55.4 | 19.6 | 20.8 | 21.9 | 2.4 | 3.3 |
| MPSEZ | 5.1 | 13.8 | 29.5 | 81.5 | 85.6 | 141.3 | 12.4 | 22.8 | 73.1 | 73.9 | 112.4 | 10.3 | 22.5 |
| Concor | 57.7 | 68.0 | 77.4 | 17.3 | 16.3 | 15.3 | 64.7 | 71.8 | 15.4 | 13.7 | 11.5 | 4.8 | 7.2 |

*Source: IDFC – SSKI Research*

| | NII | | | | Operating profit | | | | PAT | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FY08-10 CAGR | | % change | | FY08-10 CAGR | | % change | | FY08-10 CAGR | | % change | |
| | Stressed case | Base case | FY09 | FY10 | Stressed case | Base case | FY09 | FY10 | Stressed case | Base case | FY09 | FY10 |
| State Bank of India | 12 | 12 | (3) | (1) | 13 | 16 | (8) | (5) | 7 | 10 | (4) | (6) |
| ICICI Bank (stand-alone) 2 | 16 | 21 | (3) | (8) | 18 | 22 | (11) | (6) | 5 | 16 | (11) | (17) |
| HDFC Bank | 29 | 33 | (2) | (5) | 27 | 32 | (4) | (8) | 25 | 37 | (7) | (16) |

*Source: IDFC – SSKI Research*

## Base case vs Stress case valuations

| | CMP | Mcap | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | OPM (%) | | | PE (x) | | EV/EBITDA (x) | | OPM (%) | | PE (x) | | EV/EBITDA (x) | |
| | (Rs) | (Rs bn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| Bajaj Auto | 460 | 66.5 | 14.5 | 12.5 | 12.8 | 8.1 | 7.2 | 5.3 | 4.5 | 12.2 | 12.8 | 8.3 | 7.1 | 5.4 | 4.7 |
| Hero Honda | 816 | 163.0 | 13.1 | 12.9 | 13.4 | 13.1 | 11.6 | 9.0 | 7.4 | 12.7 | 13.4 | 14.1 | 12.5 | 9.0 | 8.1 |
| HUL | 222 | 483 | 13.7 | 14.3 | 14.8 | 22.8 | 19.4 | 19.8 | 16.3 | 13.4 | 13.3 | 23.6 | 21.3 | 22.2 | 19.7 |
| BHEL | 1351 | 661 | 17.7 | 17.9 | 19.2 | 18.9 | 14.1 | 17.4 | 12.4 | 17.1 | 18.2 | 20.5 | 16.1 | 19.0 | 14.3 |
| Rel Infra | 514 | 121.5 | 7.8 | 7.4 | 8.3 | 10.4 | 9.0 | 16.7 | 2.6 | 7.1 | 8.0 | 10.6 | 9.3 | 17.7 | 2.9 |
| MPSEZ | 349 | 140.0 | 65.4 | 68.2 | 68.3 | 25.3 | 11.9 | 17.9 | 8.7 | 68.0 | 66.1 | 28.2 | 15.3 | 18.6 | 10.1 |
| Concor | 733 | 95.3 | 26.6 | 27.3 | 26.6 | 10.8 | 9.5 | 12.6 | 10.7 | 26.6 | 25.8 | 11.3 | 10.2 | 7.0 | 5.7 |

*Source: IDFC – SSKI Research*

| | Price | M cap | EPS | | | | ROE (%) | | | | Price/Book Value | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | FY08-10 CAGR | | % change | | FY09 | | FY10 | | FY09 | | FY10 | |
| | | | Stressed case | Base case | FY09 | FY10 | Stressed case | Base case | Stressed case | Base case | Stressed case | Base case | Stressed case | Base case |
| SBI | 1353 | 854.1 | 7 | 10 | (4.4) | (6.5) | 13.7 | 14.3 | 13.3 | 14.1 | 1.56 | 1.23 | 1.40 | 1.08 |
| ICICI Bank | 364 | 404.7 | 5 | 16 | (11.0) | (17.0) | 5.9 | 8.8 | 5.6 | 10.7 | 0.50 | 0.81 | 0.48 | 0.74 |
| HDFC Bank | 1048 | 441.6 | 21 | 32 | (6.9) | (16.1) | 15.8 | 16.9 | 15.6 | 18.3 | 3.00 | 2.98 | 2.79 | 2.76 |

*Source: IDFC – SSKI Research*

| | CMP | Mkt cap | EPS | | | EPS CAGR(%) | P/E (x) | | EV/EBITDA (x) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | (INR) | (Rs. bn) | FY08E | FY09E | FY10E | FY08-FY10 | FY09E | FY10E | FY09E | FY10E |
| Cipla | 194 | 151.1 | 9.1 | 11.1 | 13.0 | 19.8 | 17.5 | 14.9 | 18.8 | 15.3 |

*Source: IDFC – SSKI Research*

## LIQUIDITY DRIES UP …

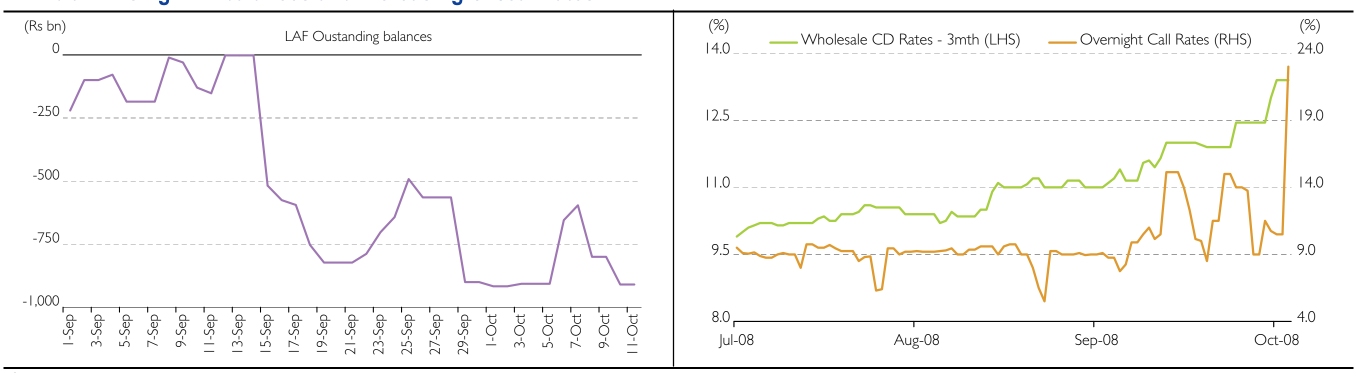
### ❑ Money markets get tighter…

With credit markets drying up globally, the situation on the home front too has assumed worrisome proportions. The domestic money markets are facing a liquidity crunch due to the following:

- Multiple rounds of CRR hike by the Reserve Bank of India (RBI), after which banks' reserve requirements had increased to 9.0% from 7.5% in H1FY09.
- While the aggressive government borrowing programme (running on track) sucked out huge liquidity from the system, the pain was aggravated as only ~37% of the total planned spending has been expended so far.
- The situation deteriorated in second half of Sep08, as banks restricted working capital funding to corporates, as a result of which companies withdrawing funds from their treasury portfolios.
- The equity markets are facing immense redemption pressure from FIIs, which are drastically paring their exposure in response to the global credit crisis and increasing risk in emerging markets.
- The advance tax outflow of Rs400bn in the last week of September 2008 has only added to the pressure in the system.
- These factors prompted the RBI to undertake strong measures, e.g. increasing the frequency of LAF auctions to twice a day. In spite of these measures, LAF balances have turned significantly negative and touched ~Rs900bn in the week ended 10 October 2008.

All these factors have manifested in a spurt in call money market rates which shot up to 17-20% in the previous week. Wholesale CD rates, too, had jumped to ~14% in the last week of September. Some corporates reportedly had to borrow from the market at exorbitant rates (27-30% for meeting working capital requirements).

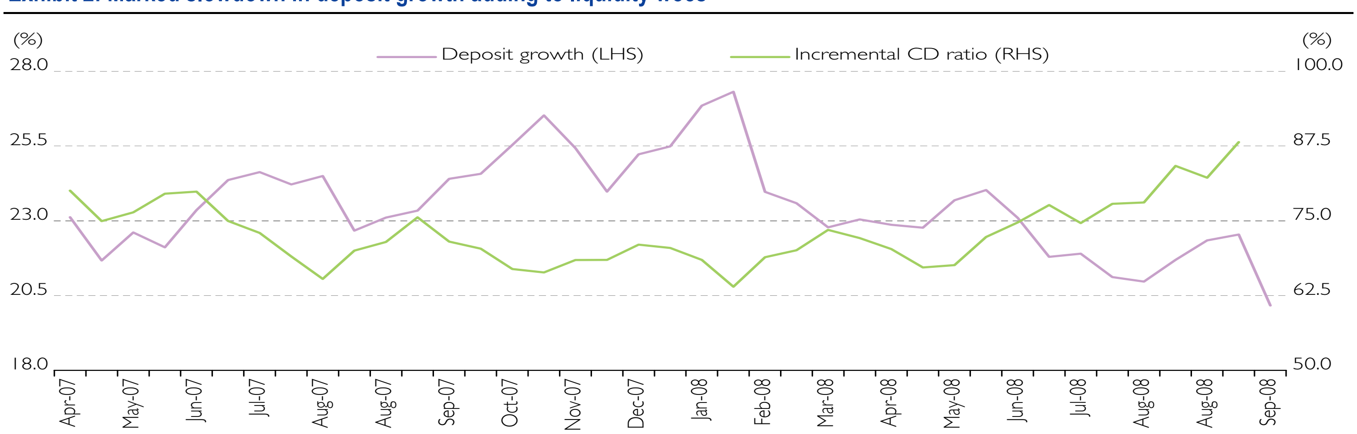
**Exhibit 1: Rising LAF balances and increasing CD/call rates**




*Source: Bloomberg*

### ❑ …and deposit growth is slowing

**Exhibit 2: Marked slowdown in deposit growth adding to liquidity woes**




*Source: Bloomberg*

## …FOREX INFLOWS HAVE WEAKENED SIGNIFICANTLY…

### ❑ Risk aversion takes control

The 'Crisis of Confidence' in global markets has sent investors on a scamper to cut down exposure to emerging equity markets (and India is no exception). Thus, capital flows into the economy have dropped – notably, forex inflows (due to the multiplier effect) have been a significant driver of money supply over the past five years. Drying up of capital flows would put further strain on liquidity in the system, thereby hurting growth.

### ❑ Though FIIs take a U-turn, India remains hot destination for FDI

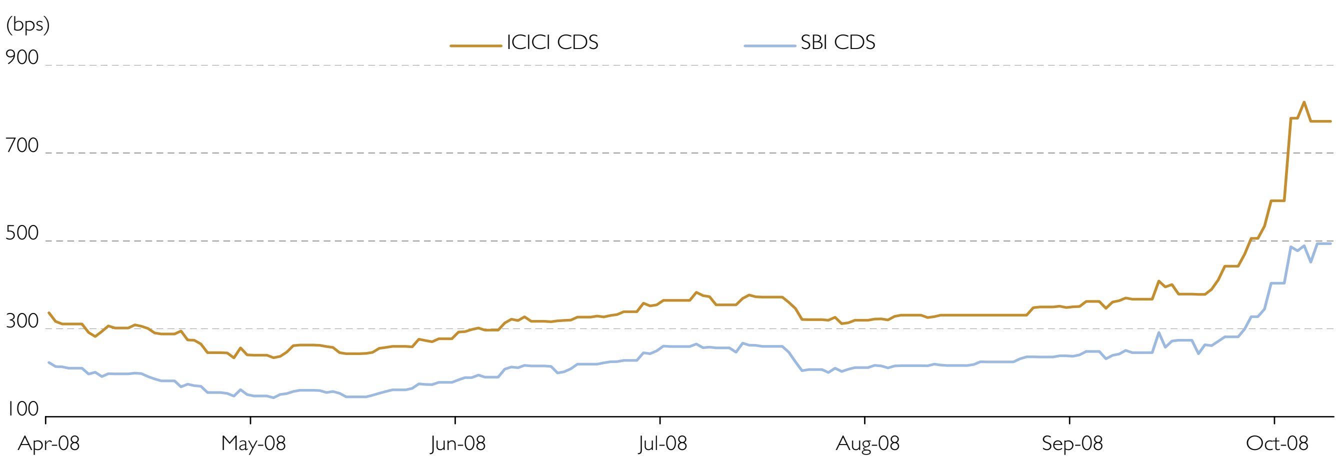
- FII flows have turned negative 9MCY08; outflows of USD 9.1bn over this period as against inflows of USD 12.2bn in 9MCY07.

- However, India has managed to maintain itself as a top investment destination. Despite the global credit woes, FDI flows remained strong with net inflows of USD 14.6bn (up 124%yoy) for Apr-Aug 2008.

### ❑ ECB/ FCCB – a significant drop

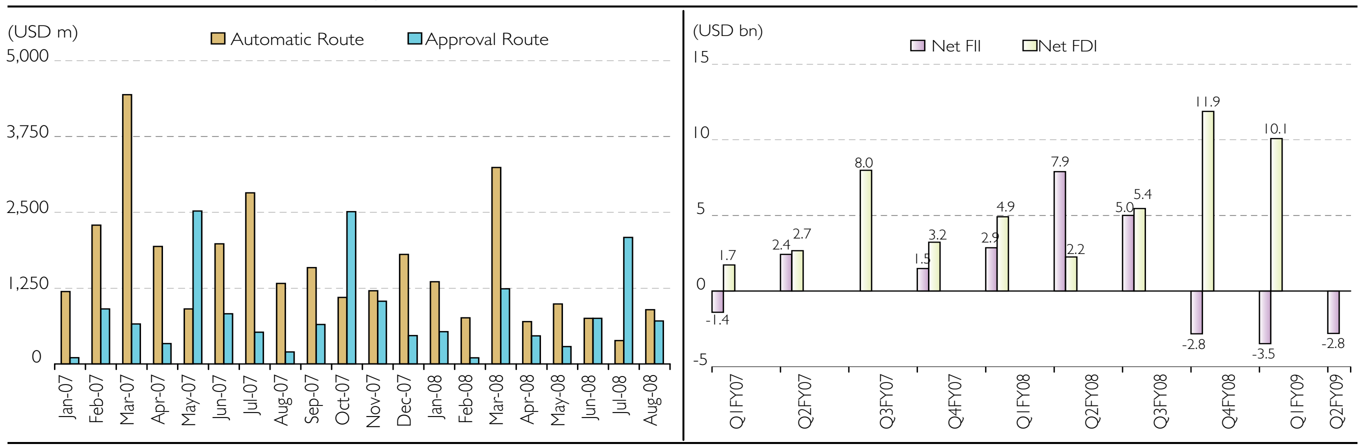
Rising overseas credit spreads for Indian borrowers have put a lid on ECBs/ FCCBs, which are down 34% yoy (CYTD) on comparable basis.

**Exhibit 3: Rising overseas credit spreads**




*Source: Bloomberg*

**Exhibit 4: FII/ FDI flows – a mixed bag**




*Source: Bloomberg*

## …THUS, CREDIT GROWTH WILL SLOW

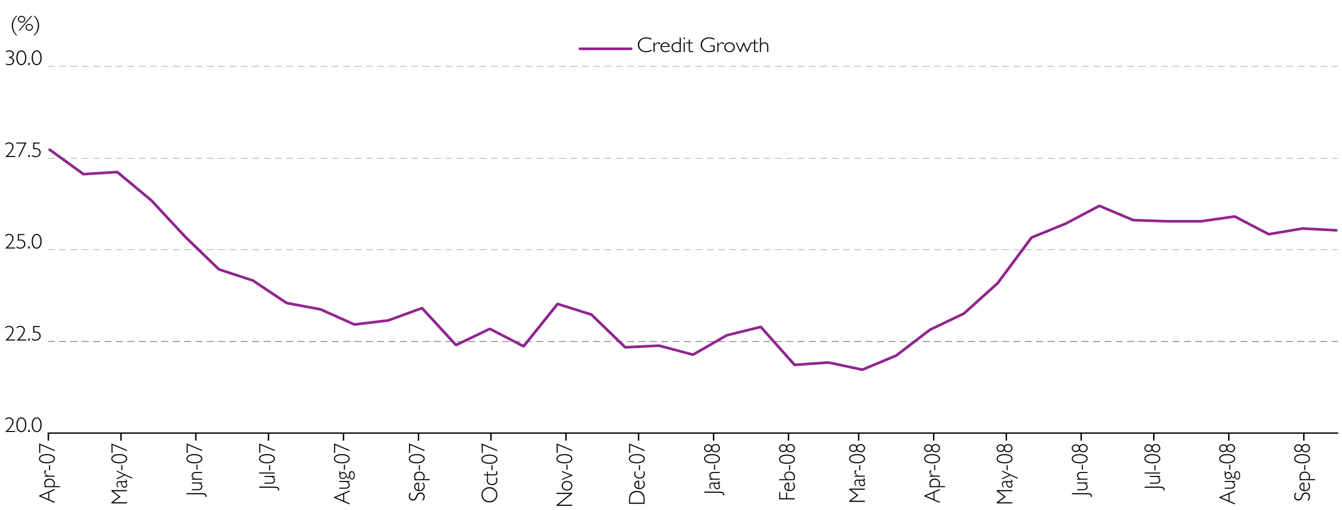
### ❑ Credit growth has remained robust till date…

The monetary tightening engineered by the RBI over the past few years was targeted at credit growth moderation in the system. While credit growth was expected to taper in FY09, it has remained strong at ~25% in H1FY09 owing to:

- High borrowings by OMCs to meet increased working capital requirements due to soaring crude oil prices.
- Deferred disbursal for projects sanctioned in late-FY08.
- Extension of credit lines to fertilizer companies until subsidies get sanctioned.

Barring the 200-300bp impact of the above-mentioned factors, credit offtake has remained strong (higher than RBI's target numbers).

**Exhibit 5: Robust credit growth in H1FY09**




*Source: RBI*

However, we see credit growth coming off significantly as liquidity conditions in the market have worsened – both due to foreign capital outflows and as companies pare treasury portfolios. Despite the recent CRR cut, liquidity is likely to remain tight. Additionally, retail deposit costs have increased to double digits and are currently ruling high at ~11%.

The crisis of confidence which has gripped the global economy will also have a bearing on the domestic financials sector and consequently, banks are expected to adopt a conservative stance on credit growth. This implies delayed disbursals even for sanctioned projects. Banks are also reducing their exposure to retail portfolios.

Going forward, in the worst case, we expect significant moderation in credit growth to 15-16% in the beginning of FY10.

## CORPORATES FEEL THE PINCH…

### ❑ Crunch over working capital finance to tide out…

Stretched liquidity in the system has impacted credit availability (both short- and long-term). However, with liquidity management once again assuming priority for policymakers (recently, CRR was cut by 150bp), respite on working capital financing is at hand for corporates.

### ❑ …but project financing to get tougher

Our interaction with banks and the tightening credit markets globally lead us to conclude that corporates would find it difficult to tie up project financing over the next few quarters. With rising credit spreads, the effect of monetary easing on actual credit offtake would likely come only with a lag. Hence, we see capex plans of corporates taking a sharp hit. Greenfield expansions are expected to suffer more than brownfield ones, as sanctions for new projects will dry up significantly.

### ❑ Management feedback on impact of liquidity crunch on future outlook for India Inc

**Auto/Auto Components**

- Maruti Suzuki, Hero Honda and Bajaj Auto have negative working capital. In terms of capex plans, both the two-wheeler companies are nearing the end of their major capex programmes and also have sufficient cash on balance sheets (Rs19bn for Bajaj Auto and Rs27bn for Hero Honda) to fund future capex. Maruti's incremental capex plan can also be funded with its internal accruals and cash & investments of >Rs55bn. Thus, we do not envisage any funding issues for future capex for any of these companies.
- M&M's ambitious capex plan of ~Rs90bn over the next three years would be funded mainly through internal accruals and debt. Our estimates already factor in higher interest burden for the company over FY08-10. However, M&M may have to rationalize its capex plan as fund raising is becoming increasingly difficult.
- Ashok Leyland is on track with its capex plan of ~Rs30bn over the next three years. It has already raised ECBs of USD 200m and would raise additional debt, if required, in FY10. While interest cost would shoot up, we do not expect the company to encounter any funding problems.
- Tata Motor has a huge capex programme of about Rs120bn over the next three years (excluding the Jaguar-Landrover acquisition), which it proposes to fund through internal accruals, additional debt (higher interest burden), rights issue (worth Rs42bn underwritten by Tata Sons and the investment banker), overseas issue of securities and through selling investments in group companies. However, we believe that fund raising through debt / equity in the global markets would be extremely difficult given the prevailing financial turmoil, and that any fund raising would come at a much higher cost. While interest burden would rise steeply, we feel the backing of Tata Sons would see the company through these challenging times.
- Based on management feedback, we understand that though interest burden would rise significantly for our auto component universe over FY08-10, none of these companies would face any issue in working capital management as well as raising capital for their capex plans.

**Consumer Goods/ Retail/ Media**

- Given the negative working capital requirement of the business and low capital intensity, FMCG companies are largely debt free and hence not sensitive to the tight liquidity scenario.
- However, Godrej Consumer Products and Marico have had gross debt of Rs3.5bn and Rs3.8bn respectively as of June 2008 to fund recent acquisitions. While GCPL has partly repaid the debt through proceeds of the rights issue and now has outstanding debt of Rs371m, Marico's net debt is at Rs2.8bn (EBITDA to interest cost ratio of 8.6x).
- Therefore, we believe none of our FMCG universe companies would take a hit from high interest rates.
- We believe our FMCG coverage universe would largely fund the capex through internal accruals.

- United Spirits has high debt of Rs63bn on books. However, USL has multiple options to de-leverage the balance sheet, primarily from the sale of treasury stock (13.9m shares worth USD300m currently). Also, its EBITDA to interest cost is at 2.3x.
- United Breweries (debt of Rs4bn as of FY08) has raised Rs4.25bn through a rights issue to fund its capex programme of Rs3bn over the next three years and partly repay debt. UBL is expected to generate PAT of Rs788m in FY09.

**Construction/ Capital Goods/ Cement/ Infrastructure**

- Higher interest rates have indeed increased interest cost burden for construction companies by 50-100bp on working capital funding. The funding cost is indicated to rise by another 100-150bp over the next two quarters. Also, bankers of some of the smaller companies have asked them not to borrow for a few days on account of liquidity constraints.
- Gearing for most of our construction coverage companies stands at ~1x, which implies reasonable cushion to borrow and fund their working capital requirements.
- Companies are likely to fund the capex mainly through internal accruals.
- The biggest risk factor faced by construction companies is the delay in financial closure of projects, slowdown in real estate sector and the financial position of clients (which could impact order flows for these companies).
- Power equipment companies have very low gearing, which implies limited impact of rising interest rates on working capital funding. The risk stems from delay in new orders due to delay in financial closure of power projects.
- Infrastructure developers face the maximum risk from liquidity crunch. While higher interest rates impact returns, i.e. IRRs, as interest rates at the time of bidding were 150-200bp lower, tight liquidity in the system is also likely to delay financial closure of projects. Developers are financially closing projects awarded 6-9 months ago and the projects being incrementally awarded can get delayed.

**Engineering**

- Given the relatively lesser capital-intensive nature of engineering sector, and that most of the players have had undertaken capacity expansion over the last 2-3 years, our coverage companies do not require any significant capex in the near term.
- Almost all companies have strong operating cash flows, and are therefore well-placed to fund their incremental capex (limited) from internal accruals.
- Except Elecon Engineering and Carborundum Universal, all other companies in our coverage have a comfortable cash position with low gearing. This gives them leeway to borrow incrementally, if required.
- On the working capital front, the impact has so far been largely limited to higher interest cost burden.

**Financials**

We spoke to the managements to gauge the impact of the liquidity crisis on banks. Key takeaways are:

- Credit growth remains robust – Despite tight monetary measures, credit continues to grow at a robust pace (~25% yoy as on 26 September 2008, well above the RBI's FY09 target of 20%). Even after assuming that a significant proportion of credit growth (200-300bp) has come from oil companies and excluding the same, growth remains strong driven by infrastructure, SME and working capital loans.
- Liquidity strain to dent growth – Banks estimate credit growth to taper to 18-20% across sectors as liquidity crunch takes its toll. Market participants reveal that sanction pipeline of banks is seen to be swelling, as they delay disbursements, and banks have been negotiating for higher rates on sanctioned loans.
- Credit flow to remain scarce in the near term – Though there will be no impact on availability of working capital loans and funding of ongoing projects, banks are adopting a conservative approach for funding new projects (capex).

- Expect monetary easing – All the banks expect the RBI to ease liquidity in the system by cutting reserve requirements (already initiated with the 150bp cut in CRR). Liquidity conditions are expected to improve by November 2008 as the government releases funds towards farm loan waiver, fertilizer subsidies and first installment of the pay arrears into the system.
- Asset quality stress – Despite a surge in interest rates, banks maintain that asset quality stress is not evident yet. However, as banks expect Gross NPAs to rise, they have adopted stringent credit procedures and stepped up monitoring – especially in case of vulnerable sectors (real estate and commodities) to limit the impact. We believe that provisioning costs would increase as the credit cycle turns and recoveries taper with moderation in economic growth. To factor in the higher credit costs, we have already built in a 30-35% rise in provision costs over the next two years.
- Slump in life insurance growth – Companies concede that the life insurance industry has started feeling the heat and APE has declined 30% yoy for the month of August 2008 as against 42% growth last fiscal.
- While LIC continues to de-grow and lose market share, private players are no longer unaffected by the shakeout with top private insurer ICICI Prudential growing by a meager 11% yoy (individual non-single premium).
- Optically, some newer private players continue to grow at exceptionally high rates and beat the industry average, but this exponential growth has been achieved on the back of rapid expansion in distribution.
- Slower growth would imply pressure on NBAP margins and a compression in multiples, leading to lower SOTP valuations for the holding bank.

**Logistics**

- The logistics sector is in the middle of hefty capex plans towards expansion in warehousing and investments in rail business. Though most of the companies have already raised equity funds (TCI has only partially completed fund raising), some businesses – specifically rail – do require equity fund raising. If equity for the projects is not funded, they may have to go slow on rail capex or scout for strategic partners.
- Debt for the expansions is likely to be drawn down in the current year. So far, players have not faced any problem on draw down of debt though interest cost burden would rise due to higher interest rates.
- On the working capital front, most companies have not felt much impact except for higher interest costs.

**Metals and Mining**

- Being capital-intensive in nature, the businesses are highly dependent on banks and financial institutions for term lending as well as working capital financing.
- Most of the managements agree that new projects are witnessing a squeeze in term lending. Thus, we see the risk of delay in financial closure for new projects. Even in cases where financial closure has been achieved, some projects are facing delays in sanctions for term loans. Banks are also re-negotiating contract terms to accommodate the higher credit risk
- Working capital credit, comfortable so far, has become dearer in the last few days due to the tight liquidity scenario. Further, given the shortage of dollar buyers/ suppliers, credit and bill discounting is becoming increasingly difficult. Trade channels too complain of a squeeze in working capital from banks. Most quarters expect cost of borrowing to increase further (at least in the short term) despite the steps taken to ease liquidity.
- Overall, we expect delay in financial closure for new greenfield projects and a 100-150bp increase in cost of working capital loans. As steel projects are long-gestation projects, we expect impact of higher term rates to be capitalized in the near term, which in turn would lead to cost overruns.

**Pharmaceuticals**

- The relatively lesser capital-intensive nature of pharma business and significant expansions undertaken by companies in the last 2-3 years give them leeway to go slow on expansions in the near term which gives them significant flexibility with respect to further expansions.

- With strong operating cash flows, almost all mid- to large-sized companies can comfortably fund most of the incremental capex from internal accruals. We estimate our pharma universe companies to generate Rs140bn-150bn operating cash flow over FY09-10, which is significantly higher than our anticipated capex requirements of Rs70bn-80bn over this period.
- Barring Ranbaxy, Wockhardt and Dishman, a comfortable liquidity position and low gearing for other companies under our coverage would enable them to borrow incrementally, if required.
- Companies will go slow on M&A activity over the next few months.
- On the working capital front, most companies have not felt much impact so far barring some rise in interest costs. Most managements expect the liquidity situation to improve in view of the measures taken by the RBI.

**Real Estate**

- Rising interest rates have affected the demand for residential properties as well as the cost of funds for developers.
- PE funds have adopted a much more cautious approach for investments into the sector by demanding higher rate of return and decreasing the average deal size. The current financial turmoil might actually see dry up of support from PE funds towards the sector.
- Banks are unwilling to lend to the real estate developers due to liquidity crisis. In the current scenario things could be even worse for developers to complete execution of projects in time.
- Developers have been borrowing at the enterprise level to buy land thereby increasing their gearing in order to enhance their market cap which could now start to back-fire.
- Cost of construction has increased over the last twelve to eighteen months. Thus while the demand for the sector is slowing down, higher interest expenses and rising input costs are preventing developers from lowering their prices.
- Volumes are expected to dive further south as developers persist on holding on to their steep prices and buyers anticipate a fall as current property rates have become grossly unaffordable.
- Liquidity concern in the current scenario is likely to impact highly leveraged developers.
- The developers across the industry have high leveraged positions. The debt equity and net debt to equity ratio of all leading developers has increased substantially in Q1FY09 against FY08. D: E for developers in Q1FY09 against FY08 – DLF (0.72/0.62), HDIL (1.048/0.85), Sobha (1.88/1.7) and Unitech (2.44/2.3).

**Media**

- With most of the media companies in scale up mode and in gestation phase, liquidity crisis could have a severe impact.
- Multiplex operators, DTH players and cable operators could hit a roadblock in the absence of adequate capital. Television distribution had envisaged capex plans of over USD3bn, while multiplex industry needed over USD200m to add 400 screens over the next three years.
- While we see slow rollout of multiplex properties, in DTH space we see market share loss to more funded entities like Reliance Big TV, Airtel Digital and Tata Sky.
- IBN18 needs USD125m to fund its GEC venture *Colors*. However, the group is funded to the tune of USD200m.

**Retail**

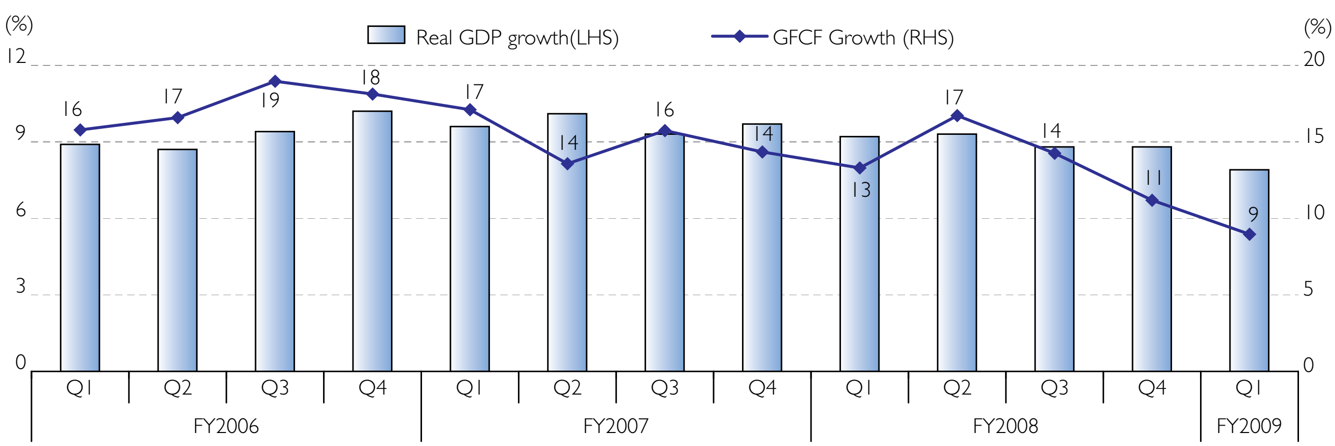
- Liquidity concerns would impact rollout plans of retailers (inadequate funding for retailers as well as real estate developers).
- While Provogue is adequately funded for its growth plans (raised Rs3bn in Provogue and Rs15bn in Prozone), Pantaloon Retail and Shopper's Stop need capital.
- Pantaloon Retail needs growth funding of Rs10bn annually. Of this, Rs3bn has come in the form of part conversion of warrants (assuming non-conversion of the pending warrants) and PRIL adds ~Rs2bn of cash profits annually.
- However, we still build in 15% lower sq. ft addition over the next couple of years for Pantaloon Retail and are factoring in higher interest costs.

## GROWTH TO TAKE FURTHER HIT

Corporate capex has been the key growth driver for the economy over the past few years (after consumer growth slowed down). However, with liquidity streams running dry and credit becoming tougher, investments are bound to slow down. Growth of Gross Fixed Capital Formation (GFCF) has already more than halved from 19% in Q3FY06 to 9% in Q1FY09 (lowest in the last 13 quarters) and is expected to slow down further.

Additionally, as investment plans get hit and credit availability comes under stress, we believe topline growth of corporates will also suffer. We expect GDP growth to be under stress for around four quarters (i.e. CY09) and may taper down by 150-200bp as impact of monetary easing would take some time to play out.

**Exhibit 6: Slowing investment demand**




*Source: MOSPI*

In this backdrop, we have cut our GDP growth forecast from 8% earlier to 7-7.5% for FY09 and FY10.

### ❑ Asset quality would deteriorate…but not drastically

We see increasing stress on unsecured consumer lending and expect Gross NPAs on these loans to rise. Housing mortgage segments are also likely to witness some stress at the margin. Real estate loans – both commercial and individual – sanctioned over the last 18-24 months are expected to lead to higher delinquencies. Rising credit spreads will translate into higher interest costs for corporates, thereby inducing deterioration in asset quality at the margin.

However, factors such as low corporate leverage and significant component of housing prices being financed by owners' equity offer comfort and would prevent a systemic problem. Along with real estate, commodities sectors could also see asset quality stress (attributable to falling commodity prices).

We believe NPAs for the banking system will increase sequentially though asset quality is expected to remain robust (excluding certain segments) relative to the global banking system. We see a 300-400bp rise in system-wide gross NPAs over the next two years.

## ALBEIT, A FEW POSITIVES TOO

Falling international crude oil prices along with prices of other commodities – driven by demand destruction due to economic slowdown and also unwinding of speculative position – have curbed inflation expectations on the domestic front. A good monsoon has contributed to the benign food inflation situation.

Interestingly, monetary easing cycle, which was expected to commence when headline inflation numbers would have shown a significant decline, has been preponed. The action has been triggered by the global credit crisis, which is feeding its way through domestic liquidity.

## ❑ Inflation no more a concern…

The imperatives that had forced the RBI to resort to aggressively increase interest rates over H1FY09 have receded with the collapse in global commodity prices (read crude oil). On the domestic front too, price situation has turned benign and price cuts are being envisaged in commodities such as steel and other metals.

We reiterate our view that inflation would taper to ~8% by March 2009 and ~4% by July 2009. We summarize our estimates below:

| | Weight | Current Index level | Mar-09 | Mar-08 | Inflation at Mar-09 | Jul-09 | Jul-08 | Inflation at Jul-09 | Comments |
|---|---|---|---|---|---|---|---|---|---|
| Primary Articles | 22.0 | 246.1 | 254.7 | 236.8 | 7.6 | 264.5 | 249.8 | 5.9 | Index will mve up sequentially by 3.4% till March 09 and 5.8% by July 09 |
| Food Articles | 15.4 | 241.7 | 242 | 228.2 | 6.0 | 250 | 238 | 5.0 | Largely regulated prices for food grains, favorable monsoons have negated supply fears. |
| Non-Food articles | 6.1 | 243.4 | 255 | 227.2 | 12.2 | 265 | 247.3 | 7.2 | Oilseeds and fibres are key components. Oilseeds prices headed downwards while cotton prices have firmed up which will drive overall index |
| Minerals | 0.5 | 656.2 | 655 | 630.1 | 4.0 | 720 | 656.2 | 9.7 | Dependent on on what price metal ore contracts are negotiated. Assuming a 10% rise, which very optimistic. Current demand outlook points to a decline in prices. |
| | | | | | | | | | |
| Fuel, Power, Light & Lubricants | 14.2 | 375.3 | 373 | 341.8 | 9.1 | 375.3 | 378.2 | -0.8 | CRUDE ASSUMED AT $ 110-120/ BARRELThis is assuming the retail fuel prices remain where they are currently even if crude oil prices fall substantially. Products for which prices are not regulated will directly depend on price of crude oil. |
| | | | | | | | | | |
| Manufactured Products | 63.7 | 207.5 | 213.2 | 197.5 | 8.0 | 219.1 | 206.8 | 6.0 | |
| Food Products | 11.5 | 213.4 | 210 | 203.6 | 3.1 | 230 | 213.1 | 7.9 | Inline with prices of edible oils and foodgrains. Sugar price remains the key concern. |
| Beverages, Tobacco & Tobacco Products | 1.3 | 293.7 | 295 | 276.7 | 6.6 | 310 | 293.7 | 5.5 | |
| Chemicals & Chemical Products | 11.9 | 223.5 | 225 | 210.9 | 6.7 | 250 | 222.2 | 12.5 | Largely correlated with prices of crude oil. Have assumed a 10% yoy hike in most products |
| Textiles | 9.8 | 143.3 | 140 | 127.8 | 9.50 | 160 | 141.8 | 12.8 | Prices of yarn driven by cotton fibre prices. Considering a strong pricing outlook for cotton, textile price should increase by 10-12% only if manufacturers are able to pass-on the input cost hike which seems unlikely. |
| Basic Metals & Metal Products | 8.3 | 299.7 | 335 | 291.6 | 14.90 | 275 | 300.3 | -8.4 | Very conservative estimate of the downward trend in metal prices |
| Machinery & Machinery Tools | 8.4 | 176.4 | 185 | 167.9 | 10.20 | 190 | 176.3 | 7.8 | Machinery prices are linked input prices, mainly metals, which has a negative price outlook. |
| Transport Equipment & parts | 4.3 | 176.3 | 185 | 169.7 | 9.00 | 200 | 175.9 | 13.7 | Mostly consists of automobiles. Linked to flat steel products, and demand scenario. |
| Paper & Paper Products | 2 | 203.4 | 202 | 194.5 | 3.90 | 210 | 200.3 | 4.8 | |
| Leather & Leather Products | 1 | 168.3 | 168.3 | 164.4 | 2.40 | 175 | 168.3 | 4.0 | |
| Wood & Wood Products | 0.2 | 237 | 237 | 215.9 | 9.80 | 250 | 237 | 5.5 | |
| Non-metallic mineral products | 2.5 | 217.8 | 220 | 214.7 | 2.50 | 210 | 215.5 | -2.6 | Mostly consists of cement. Assuming a conservative 2-3% fall in cement prices. |
| Rubber & Plastic Products | 2.4 | 165.7 | 169 | 163.6 | 3.30 | 180 | 165.1 | 9.0 | |
| | | | | | | | | | |
| Overall Index | 100 | 238.7 | 243.4 | 226.7 | 7.40 | 251.3 | 240.7 | 4.40 | |

*Source: IDFC – SSKI Research*

**Liquidity management assumes priority - Government action thus far**

## RBI

**9 Sep 2008: New Governor's first press statement - a less hawkish tone…**

*"First, we will have to watch the impact of the measures already taken. Second, we will be watching the drivers of demand – in particular which sectors are triggering the growth in demand. Third, in a globalised world, we will also have to be watching developments around the world and make an assessment of their potential impact on our economic management…"*

**16 Sep 2008: Eases liquidity…**

- Opens tap of foreign currency deposits by raising the ceiling on interest rates – making them remunerative
- Banks can borrow G-Secs (inclusive of SLR) up to 1% of NDTL – de-facto SLR at 24%

**11 Oct 2008: Cuts CRR by 150bp to 7.5%**

- To add Rs600bn in the banking system

## Finance ministry

**23 Sep 2008: Relaxes ECB norms**

- ECB borrowing limit for infra companies revised upwards to US $500m
- Cost ceilings for loans above five years relaxed to 6mth LIBOR+350bp (from 6mth LIBOR+250bp earlier)

*Source: RBI, Finance Ministry*

With growth concerns overtaking inflationary ones, and as monetary easing becomes the order of the day globally, we believe government bonds are in a firm bull run and would continue to rally over the next 6-9 months.

### ❑ …fiscal situation expected to improve

Fiscal deficit has been the first beneficiary of the falling crude oil prices. With crude oil prices ruling at USD 129/ bbl (when retail fuel prices were increased), we had estimated under-recoveries to the tune of Rs2.4tn – to be financed through issuance of oil bonds. This translated into the central government deficit estimates ballooning to 7.3% of GDP. Crude oil prices have now slid to USD90/ bbl, which implies substantial paring in incremental issuance of oil bonds (from the level of Rs2.4tn). However, our concern persists on funding of cash subsidies to fertilizer companies, which are estimated at Rs1.15tn (of this, Rs300bn have already been budgeted for).

Our estimate for fiscal deficit now stands at 4.6% of GDP for FY09, which also builds in an upward revision of Rs300bn in direct tax collection target as also ~Rs200bn of revenues from sale of 3G telecom licenses.

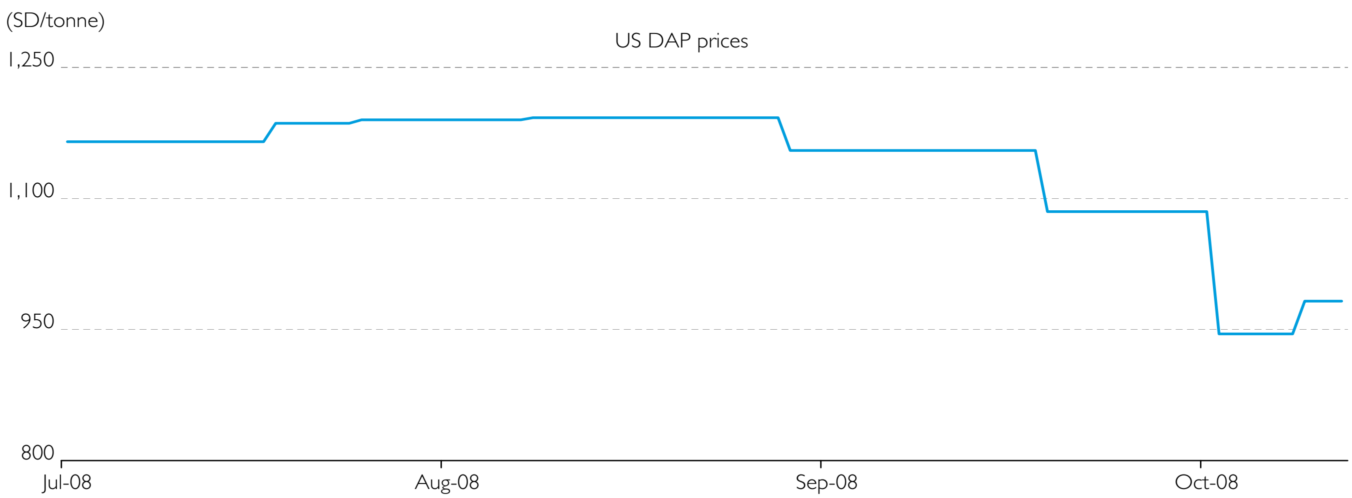
**Exhibit 7: Fiscal deficit**

| Particular (Rs bn) | | | Source/ Comments |
|---|---|---|---|
| Fiscal deficit - Union Budget FY09 estimate | | 1333 | ~2.5% of GDP |
| Impact of OMC duty cuts | | 226 | Ministry of Petroleum |
| Farm Loan Waiver | | 250 | Ministry of Finance |
| Sixth Central Pay Commission | | 157 | Ministry of Finance |
| Fertilizers subsidies | | 1000 | Ministry of Fertilizers (total of 1.19tn, of which Rs300bn already budgeted) |
| | Crude at US$100/bbl | Crude at US$129/bbl | |
| Projection for outstanding oil bonds | 96 | 946 | Under-recoveries now pegged at Rs1.6tn (a drop of Rs850bn), which directly removes the incremental issuance of oil bonds |
| Revision in Direct Tax Collection | 300 | | Takes total direct tax collections at Rs3.95tn, direct taxes growing at 33% against budgeted estimate of 25% |
| Sale of 3G telecom licenses | 200 | | Ministry sources |
| **Gross Fiscal Deficit** | **2462** | **3912** | **Lower oil bonds responsible for the decline** |
| **Fiscal deficit Total (% of GDP)** | **4.6** | **7.3** | |

*Source: IDFC – SSKI Research*

Fertilizer prices have fallen substantially over the past month. With further fall in fertilizer prices, we believe the concern over funding of fertilizer subsidies should recede. Additionally, even if the incremental upgrade in tax collection targets is not met, fiscal position should be comfortable.

**Exhibit 8: Fertilizer prices begin to fall**

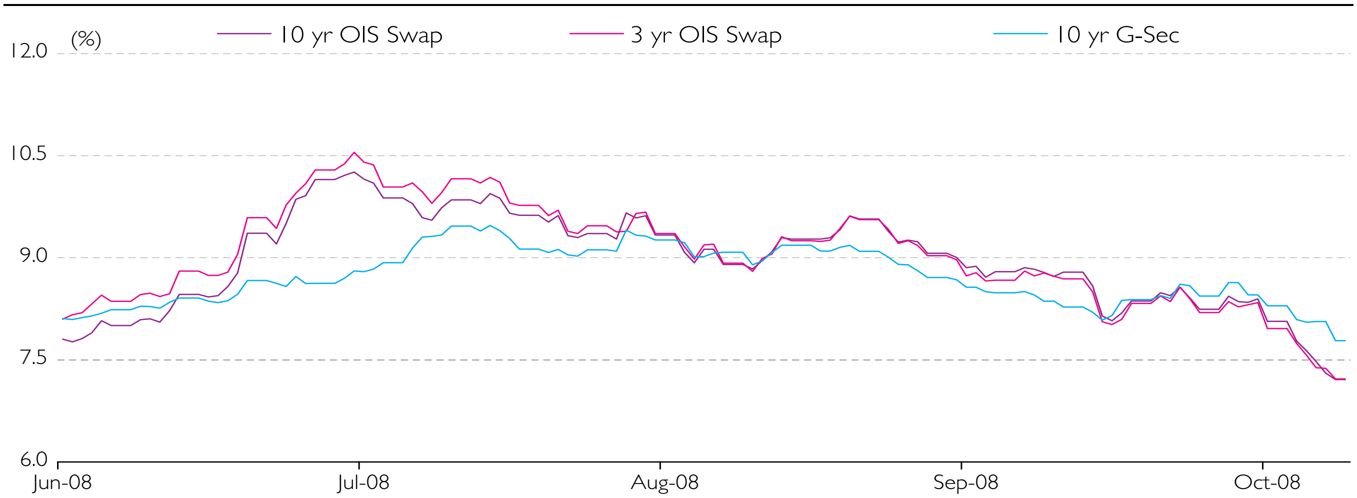



*Source: Bloomberg*

## ❑ Bonds have entered a firm bull run

Bonds have rallied over the past two months as inflation expectations have been trimmed significantly in view of the lower crude oil prices. With growth/ liquidity now taking precedence over inflation, we expect the rally in bonds to continue unabated over the next 6-9 months. This view is further vindicated by the concerted interest rate cuts across the global central banks as recession grips developed economies.

**Exhibit 9: Bonds enter a firm bull run**




*Source: Bloomberg*

On the domestic front, growth – despite the slowdown – remains one of the highest in all the major economies of the world. Hence, liquidity issues will continue to be on the priority list of policymakers. We see further monetary easing ahead and expect the RBI to cut repo rate by Q1CY09.

## ❑ A strong banking system in place

India's reserve requirements are one of the highest among major world economies, thanks to its regulatory requirement of maintaining 25% SLR. Currently, Indian banks' G-Sec portfolios account for ~30% of total deposits.

This gives RBI and the banking system additional wielding power to pump-prime the economy in case of a growth slowdown or liquidity crisis.

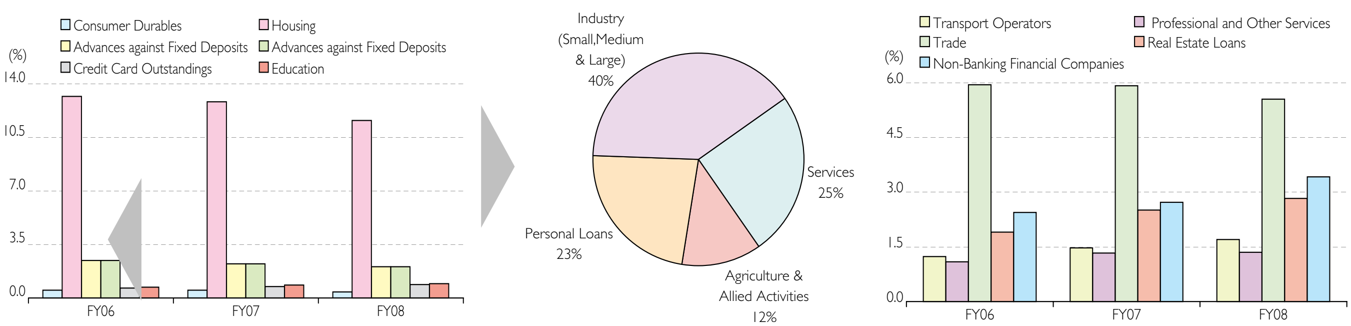
**Exhibit 10: Indian banks – consolidated balance sheet**

| | Assets | | Liabilities | | |
|---|---|---|---|---|---|
| | Public Sector | Private Sector | | Public Sector | Private Sector |
| (% of total) | Banks | Banks | (% of total) | Banks | Banks |
| Cash & other balances | 9.7 | 6 | Capital | 5.56 | 6.78 |
| Loans & Advances | 59.02 | 55.64 | Deposits | 81.73 | 74.05 |
| Investments | 27.24 | 28.8 | Borrowings | 4.99 | 9.41 |
| Fixed Assets | 0.83 | 1.1 | Other Liabilities | 7.72 | 9.77 |
| Others Assets | 3.21 | 3.96 | | | |
| **Total** | **100** | **100** | **Total** | **100** | **100** |

*Source: RBI, IDFC-SSKI Research*

NPAs of Indian banks have been consistently falling over the past five years. In fact, the clean up of the banking system was engineered by the decline in yields of government bonds, which gave banks sufficient gains to clean up their books. While a cyclical downturn in the economy may add to the NPAs, we believe the rise will be within tolerable limits as the exposure to VULNERABLE SECTORS is quite small. Sensitive sectors – real estate and unsecured consumer lending – form a small part of the overall advances of the banking sector.

**Exhibit 11: Sectoral deployment of non-food credit**




*Source: RBI, IDFC-SSKI Research*

While we do expect some deterioration in asset quality across the system as the marginal players in every industry face distress, the impact will not be significant. The basic hypothesis revolves around LOW LEVERAGE of both consumer and corporate balance sheets. We have built in a 30-35% rise in provision costs across our banking universe over the next two years. Our worst case estimates factor in a 70% rise in provisioning costs from current levels for the entire banking system.

## DRAWING PARALLELS TO THE PREVIOUS SLOWDOWN

### ❑ Prelude – the fall of 'Asian Tigers'

In FY98, India's GDP growth fell to 4.3% as the Asian Tigers fell one after the other. During the systemic NPL crisis in 1998, corporates were significantly leveraged as half-complete projects were being funded through debt, which was outsized in relation to their cash flows. As interest rates rose due to inflationary pressures in the economy, corporate delinquencies rose sharply and translated into huge provisioning costs for the banking system over the next five years.

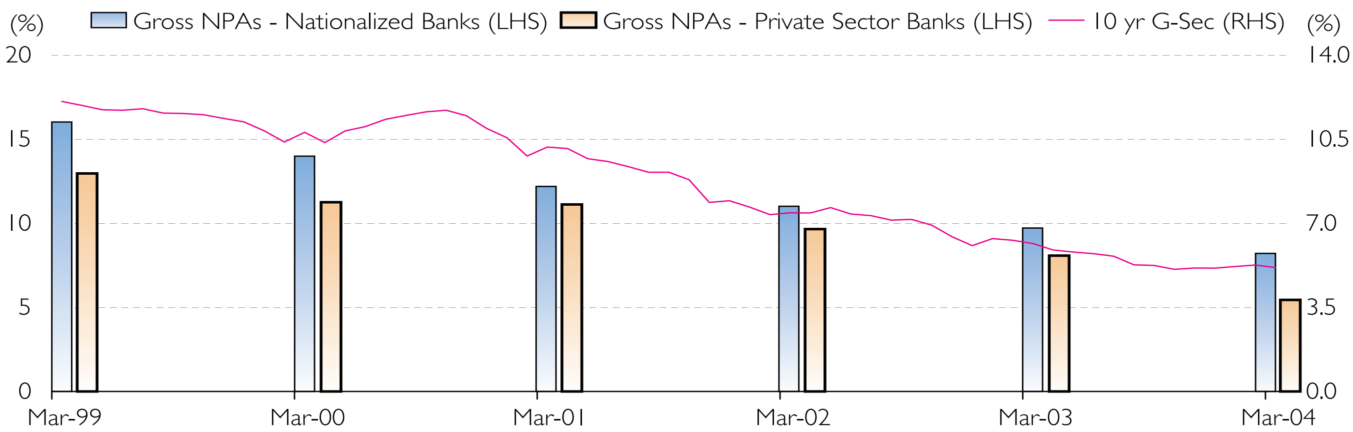
**Exhibit 12: High corporate leverage**

| | Borrowings/Networth | Interest/PBDITA |
|---|---|---|
| 1996–97 | 135% | 45% |
| 1997–98 | 148% | 47% |

*Source: CMIE*

Gross NPLs for PSU Banks (as a percentage of Gross Advances) stood at a staggering 16% for FY98, and 8.67% for Private Sector Banks.

**Exhibit 13: NPA decline with falling bond yields**



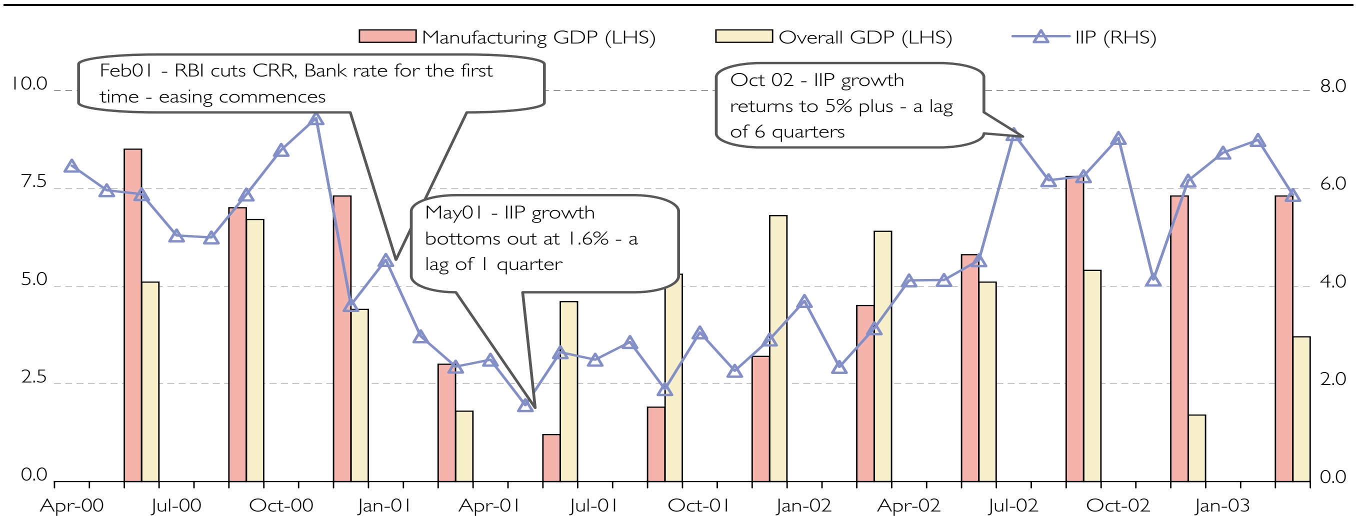

*Source: RBI*

Monetary easing started only when the inflationary environment turned benign and growth began to take a serious hit in FY01.

## ❑ The easing phase

During the slowdown of FY01-03, the RBI had initiated monetary easing in February 2001 and the Bank Rate (benchmark interest rate, then) was cut by 175bp and CRR by 375bp over February 2001-October 2002. It took six quarters for IIP growth to return to 5% plus (in October 2002). GDP growth had bottomed out at 1.9% in the Jan-Mar 2001 quarter, while manufacturing GDP did so (1.2%) with a lag of one quarter. Manufacturing GDP growth revived 4-5 quarters after the monetary policy started easing.

**Exhibit 14: FY01-03 revival**




*Source: IDFC – SSKI Research*

Monetary easing was the key factor driving the growth revival after the FY01 slump. As interest rates started easing, the huge provisioning costs of banks were offset against the humongous gains on their G-Sec portfolios, which eventually enabled them to clean up their balance sheets.

### ❑ What is different this time round?

In the current cycle, NPL levels in the system are significantly lower compared to the FY01-03 period. Though inflation was a major concern three months ago, softening prices of crude oil and other commodities (e.g. steel), inflationary pressures have significantly eased and the key policy concern of rising inflation expectations stands tamed.

In line with this, the RBI has embarked on monetary easing by responding to the liquidity crunch by cutting CRR; a cut in the repo rate has also been indicated, if warranted.

Additionally, the rise in NPAs for the banking system will be offset by huge treasury gains booked on the G-Sec portfolios.

## EARNINGS: A SENSITIVITY ANALYSIS

To gauge the impact of the ongoing liquidity crunch on capex plans of our coverage universe, we have conducted a sensitivity analysis of earnings estimates for FY09-10. The analysis is based on the following parameters:

### ❑ Topline slowdown

As the entire economy slows down (GDP growth expected to fall to ~7%), we have assumed pessimistic growth forecasts for our companies.

### ❑ Credit growth moderation

In the prevailing elevated interest rate scenario and with tightening lending norms by banks, credit growth is expected to moderate to 15-16% as of early-FY10. The benefit of easing interest rates would start accruing only from H2FY09.

### ❑ Falling commodity prices

As recession grips the developed economies, commodity prices are already headed south. Even on the domestic front, prices have started softening and our estimates factor in this scenario of falling prices.

Our analysis reveals that in a pessimistic scenario that builds in topline slowdown, falling commodity prices and overall slowdown in consumer spending, our PAT estimates have a downside of 12-14% for FY09 and 23-25% for FY10. The section bellow explains stress-case estimates (sector-wise) for our coverage universe.

## AGRI

Changes in key assumptions to factor in the stress-case macroeconomic factors:

- Growth in edible oil business (Ruchi Soya) could be impacted in late-FY09 and FY10 on account of the sharp drop in edible oil prices. While palm oil prices have fallen by 40% from the peak of March 2008, soya oil prices are down by over 25%.
- While Ruchi Soya is better placed with its hedged portfolio, higher volume of soya integrated operations and firm soya meal prices, our pessimistic case scenario builds in a 10% drop in Ruchi Soya's FY10E EPS.
  - We are also building in non-conversion of warrants worth Rs2bn+, which would lead to higher debt and thus interest costs.
- Jain Irrigation is relatively less sensitive to the macro environment, but we are factoring in slow growth in piping business (due to slowing capex in telecom, gas distribution and water distribution businesses), food processing business (in line with the expected slowdown in consumer industry) and international operations (particularly in USA). Our worst case revenue CAGR is at 26% vis-à-vis base case CAGR of 28% over FY08-10.
  - Jain Irrigation, however, could be impacted by non-conversion of pending FCCBs of USD12m (conversion at Rs346 per share) and 7.6m warrants (convertible at Rs478 per share). Accordingly, we have assumed a higher debt on books to fund growth and are factoring in YTM of 6.75% on pending FCCBs.
  - Sustained growth momentum and attractive valuations of 11x based on worst case FY09E estimates, reiterate Outperformer on Jain Irrigation.

**Stress case earnings sensitivity: Potential downside of 10-11% in FY10 earnings**

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| Jain Irrigation | 18.6 | 25.5 | 36.1 | 28.3 | 36.0 | 39.3 | 24.5 | 32.2 | 26.1 | 33.0 | 40.5 | (3.9) | (10.9) |
| Ruchi Soya | 8.7 | 9.6 | 11.4 | 7.4 | 12.5 | 14.6 | 9.0 | 10.3 | 7.1 | 9.7 | 8.9 | (6.6) | (9.6) |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | CMP | Mcap | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rsbn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| Jain Irrigation | 263.0 | 18.4 | 15.5 | 16.4 | 17.4 | 10.3 | 7.3 | 6.8 | 5.3 | 16.3 | 17.2 | 10.7 | 8.2 | 7.2 | 5.8 |
| Ruchi Soya | 50.0 | 9.1 | 3.6 | 3.7 | 3.9 | 5.2 | 4.4 | 4.3 | 3.6 | 3.6 | 3.7 | 5.6 | 4.8 | 4.7 | 4.2 |

*Source: IDFC – SSKI Research*

## AUTOMOBILES

To factor in the concerns stemming from stress-case macroeconomic environment, we have:

- Cut volume growth estimates by 3-5% for FY09 and FY10
- Maintained margin estimates for FY10 despite softening raw material prices
- Factored in higher interest burden for FY09

**Stress case earnings sensitivity: Potential downside of 2-11% in FY10 earnings**

| | | Base case estimates | | | | | Pessimistic case estimates | | | | | Potential downside | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS FY08 (Rs) | Rev CAGR FY08-10 (%) | EBIDTA CAGR FY08-10 (%) | FD EPS (Rs) FY09 (Rs) | FD EPS (Rs) FY10 (Rs) | EPS CAGR FY08-10 (%) | Rev CAGR FY08-10 (%) | EBIDTA CAGR FY08-10 (%) | FD EPS (Rs) FY09 (Rs) | FD EPS (Rs) FY10 (Rs) | EPS CAGR FY08-10 (%) | FY09 (%) | FY10 (%) |
| Ashok Leyland | 3.5 | 8.3 | 8.5 | 2.7 | 3.1 | (6.6) | 4.7 | 4.0 | 2.6 | 2.7 | (13.1) | 5.0 | 13.4 |
| Bajaj Auto | 60.1 | 9.4 | 2.9 | 56.8 | 64.0 | 3.2 | 7.8 | 1.3 | 55.4 | 62.8 | 1.5 | 2.4 | 3.3 |
| Hero Honda Motors | 48.5 | 12.6 | 14.2 | 62.1 | 70.1 | 20.3 | 10.2 | 11.6 | 57.9 | 65.4 | 16.2 | 6.9 | 6.7 |
| Mahindra & Mahindra | 71.1 | 19.1 | 20.5 | 58.1 | 67.8 | (2.4) | 17.0 | 18.3 | 55.1 | 65.5 | 4.8 | 5.1 | 4.9 |
| Maruti Suzuki | 61.1 | 18.7 | 14.8 | 60.0 | 68.1 | 5.6 | 13.5 | 10.0 | 58.3 | 62.0 | 0.7 | 2.9 | 9.0 |
| Tata Motors | 46.5 | 13.8 | 13.8 | 41.2 | 50.0 | 3.7 | 11.4 | 10.3 | 38.8 | 45.0 | (1.6) | 6.0 | 10.0 |
| TVS Motor Company | 0.2 | 11.2 | 96.8 | 1.5 | 2.5 | 248.8 | 10.4 | 89.8 | 1.3 | 2.2 | 229.3 | 13.0 | 10.9 |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | | | | Base case estimates | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | CMP (Rs) | Mcap (Rs bn) | OPM (%) FY08A | FY09 | FY10 | FY09 | FY10 | FY09 | FY10 | FY09 | FY10 | FY09 | FY10 | FY09 | FY10 |
| Ashok Leyland | 22.4 | 29.8 | 10.3 | 9.0 | 10.3 | 8.3 | 7.2 | 5.7 | 5.0 | 8.9 | 10.1 | 8.8 | 8.4 | 6.0 | 5.5 |
| Bajaj Auto | 459.9 | 66.5 | 14.5 | 12.5 | 12.8 | 8.1 | 7.2 | 5.3 | 4.5 | 12.2 | 12.8 | 8.3 | 7.1 | 5.4 | 4.7 |
| Hero Honda Motors | 816.4 | 163 | 13.1 | 12.9 | 13.4 | 13.1 | 11.6 | 9.0 | 7.4 | 12.7 | 13.4 | 14.1 | 12.5 | 9.0 | 8.1 |
| Mahindra & Mahindra | 465.2 | 120.6 | 14.0 | 13.9 | 14.3 | 8.0 | 6.9 | 6.2 | 5.6 | 13.9 | 14.3 | 8.4 | 7.2 | 5.8 | 5.7 |
| Maruti Suzuki | 679.85 | 196.5 | 12.8 | 10.9 | 12.0 | 11.3 | 10.0 | 6.8 | 5.4 | 10.9 | 12.0 | 11.7 | 11.0 | 7.1 | 5.9 |
| Tata Motors | 291.45 | 112.4 | 11.8 | 10.6 | 11.8 | 7.1 | 5.8 | 5.6 | 4.6 | 10.3 | 11.6 | 7.5 | 6.5 | 5.6 | 4.6 |
| TVS Motor Company | 30.15 | 7.2 | 1.3 | 3.2 | 4.0 | 20.2 | 12.0 | 9.3 | 6.9 | 3.2 | 3.8 | 23.2 | 13.4 | 9.4 | 7.5 |

*Source: IDFC – SSKI Research*

### ❑ Conclusion

Within our automobile universe, we believe two-wheeler majors – Bajaj Auto and Hero Honda – are the safest bets given their surplus cash position, zero debt, ability to fund capex through internal accruals, reasonable growth outlook and attractive valuations.

Tata Motors, considering its huge fund raising programme (Rs120bn over the next three years excluding Jaguar & Land Rover acquisition), uncertainty over financial outlook for Jaguar & Land Rover and continued slowdown in the domestic CV space, is the most vulnerable within the auto universe

## AUTO ANCILLARY

To factor in the concerns emanating from stress-case macroeconomic environment, we have:

- Cut revenue growth estimates by ~5% for FY09 and FY10
- Factored in higher interest burden for FY09

**Stress case earnings sensitivity: Potential downside of 4-25% in FY10 earnings**

| | | | Base case estimates | | | | Pessimistic case estimates | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS FY08 (Rs) | Rev CAGR FY08-10 (%) | EBIDTA CAGR FY08-10 (%) | FD EPS (Rs) FY09 (Rs) | FD EPS (Rs) FY10 (Rs) | EPS CAGR FY08-10 (%) | Rev CAGR FY08-10 (%) | EBIDTA CAGR FY08-10 (%) | FD EPS (Rs) FY09 (Rs) | FD EPS (Rs) FY10 (Rs) | EPS CAGR FY08-10 (%) | Potential downside FY09 (%) | Potential downside FY10 (%) |
| Amtek Auto | 20.8 | 28.2 | 28.4 | 22.0 | 27.7 | 15.4 | 24.5 | 22.7 | 19.9 | 23.8 | 7.0 | 9.3 | 14.1 |
| Bharat Forge | 12.5 | 16.3 | 24.5 | 14.4 | 20.2 | 26.9 | 13.2 | 21.5 | 14.2 | 18.3 | 21.0 | 1.3 | 9.1 |
| Mico | 166.5 | 13.7 | 14.0 | 199.4 | 218.3 | 14.5 | 11.8 | 12.0 | 196.2 | 209.5 | 12.2 | 1.6 | 4.0 |
| Rico Auto Industries | 2.0 | 15.0 | 14.6 | 2.0 | 2.9 | 20.8 | 13.8 | 13.4 | 1.6 | 2.8 | 17.5 | 21.4 | 5.4 |
| Sona Koyo Steering Systems | 1.2 | 14.4 | 21.9 | 0.7 | 1.4 | 9.0 | 11.1 | 14.4 | 0.6 | 1.1 | (5.1) | 20.1 | 24.2 |
| Sundram Fasteners | 2.9 | 11.4 | 14.9 | 3.5 | 4.0 | 18.9 | 11.4 | 14.9 | 3.5 | 4.0 | 18.9 | 0.0 | 0.0 |
| Apollo Tyres Ltd | 5.5 | 15.2 | 9.0 | 5.0 | 5.5 | (0.3) | 12.8 | 6.8 | 4.5 | 5.1 | (3.7) | 9.4 | 6.8 |
| Balkrishna Industries | 51.4 | 24.8 | 28.3 | 67.1 | 86.7 | 29.9 | 21.1 | 23.3 | 60.0 | 77.4 | 22.7 | 10.5 | 10.7 |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | | | | Base case estimates | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | CMP (Rs) | Mcap (Rs bn) | OPM (%) FY08A | OPM (%) FY09 | OPM (%) FY10 | PE (x) FY09 | PE (x) FY10 | EV/EBIDTA (x) FY09 | EV/EBIDTA (x) FY10 | OPM (%) FY09 | OPM (%) FY10 | PE (x) FY09 | PE (x) FY10 | EV/EBIDTA (x) FY09 | EV/EBIDTA (x) FY10 |
| Amtek Auto | 108.15 | 15.2 | 20.0 | 19.0 | 20.0 | 4.9 | 3.9 | 3.1 | 2.2 | 18.7 | 19.4 | 5.4 | 4.5 | 3.2 | 2.5 |
| Bharat Forge | 142.75 | 31.8 | 15.1 | 15.9 | 17.4 | 9.9 | 7.1 | 5.1 | 3.7 | 15.9 | 17.4 | 10.0 | 7.8 | 5.1 | 3.9 |
| Mico | 3490 | 111.8 | 20.9 | 18.3 | 21.0 | 17.5 | 16.0 | 10.1 | 7.1 | 18.0 | 21.0 | 17.8 | 16.7 | 10.3 | 7.4 |
| Rico Auto Industries | 13.8 | 1.7 | 13.1 | 12.5 | 13.1 | 6.8 | 4.7 | 4.3 | 3.8 | 12.0 | 13.1 | 8.7 | 5.0 | 4.6 | 3.9 |
| Sona Koyo Steering Systems | 11.07 | 2.2 | 9.1 | 8.3 | 10.3 | 15.1 | 7.9 | 7.3 | 5.5 | 7.8 | 9.6 | 18.9 | 10.4 | 7.9 | 6.3 |
| Sundram Fasteners | 25 | 5.3 | 10.2 | 10.8 | 10.8 | 7.1 | 6.2 | 4.9 | 4.4 | 10.8 | 10.8 | 7.1 | 6.2 | 4.9 | 4.4 |
| Apollo Tyres Ltd | 33.25 | 16.8 | 12.6 | 10.6 | 11.3 | 6.7 | 6.1 | 4.1 | 4.0 | 10.4 | 11.3 | 7.4 | 6.5 | 4.4 | 4.2 |
| Balkrishna Industries | 252 | 4.8 | 19.9 | 19.6 | 21.0 | 3.8 | 2.9 | 3.7 | 2.9 | 19.3 | 20.6 | 4.2 | 3.3 | 3.9 | 3.1 |

*Source: IDFC – SSKI Research*

### ❑ Conclusion

The ongoing financial turmoil in the global markets has deepened the slowdown in the US/ European OEM space, and robbed clarity as regards export momentum out of India; although the auto component space would continue to have a steady revenue stream from the domestic automobile market. Given that Amtek Auto generates 65-70% of revenues from the US/ European geographies, its earnings would be the worst hit within the auto ancillary space.

## CEMENT

Our current estimates for cement companies factor in a 3-8% yoy decline in cement prices in FY09 on account of oversupply in the domestic market led by large capacity additions. We further analyze the likely impact on earnings of cement companies, as given below:

- **Volumes:** We have cut our FY09 and FY10 revenue estimates by ~10% to account for a likely slowdown in cement volumes due to the impact of a deteriorating macroeconomic situation, especially on the real estate sector.
- **Operating margins:** For stress case earnings estimates, we have pared our operating margin assumptions for cement companies by ~100bp.
- **Interest costs:** In general, we have assumed average borrowing costs of 11.5% for FY09 and 12-13% in FY10. However, we expect limited impact of the same on earnings of our coverage universe as most of them are net cash positive.

**Stress case earnings sensitivity: Potential downside of 16-22% in FY10 earnings**

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| ACC | 64.1 | 51.9 | 52.4 | 7.2 | (10.2) | (9.6) | 49.3 | 43.9 | 1.7 | (17.1) | (17.3) | 4.9 | 16.3 |
| Ambuja | 8.4 | 6.8 | 6.5 | 8.9 | (10.2) | (12.2) | 6.4 | 5.4 | 3.3 | (16.5) | (19.7) | 4.7 | 16.3 |
| Grasim | 222.3 | 202.5 | 200.1 | 11.6 | 0.5 | (5.1) | 185.6 | 168.3 | 11.6 | 0.5 | (5.1) | 8.4 | 15.9 |
| Ultratech | 80.1 | 57.3 | 59.4 | 10.7 | (35.6) | (13.8) | 50.1 | 46.5 | 5.0 | (12.0) | (23.8) | 12.4 | 21.8 |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | CMP | Mcap | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rs bn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| ACC | 543.9 | 102.0 | 27.4 | 21.5 | 19.2 | 10.5 | 10.4 | 5.3 | 4.4 | 21.0 | 18.2 | 11.0 | 12.4 | 9.1 | 8.2 |
| Ambuja | 64.2 | 97.6 | 35.8 | 26.0 | 24.4 | 9.5 | 9.9 | 4.1 | 3.6 | 25.5 | 23.4 | 10.0 | 11.9 | 9.3 | 9.3 |
| Grasim | 1,475.0 | 135.2 | 29.8 | 26.6 | 24.2 | 9.5 | 9.6 | 4.2 | 3.6 | 26.6 | 24.2 | 10.4 | 11.5 | 4.2 | 4.0 |
| Ultratech | 447.0 | 55.6 | 31.2 | 23.7 | 10.6 | 9.5 | 9.1 | 5.1 | 3.8 | 22.7 | 21.9 | 10.8 | 11.7 | 6.1 | 4.7 |

*Source: IDFC – SSKI Research*

### ❑ Conclusion

While the cement sector may face an oversupply-induced cyclical downturn over the next 12-18 months in the domestic market, companies are unlikely to be impacted by the tight liquidity conditions as a significant portion of the planned capacities are funded and close to commissioning. The pressure on cement prices, arising from oversupply, is likely to drive a 5-14% compounded annual decline in earnings of cement companies over FY08-10E. Any moderation in the economy, by constraining demand, would amplify the problems for the sector and the compounded annual decline in earnings of cement companies may increase to 16-22% over FY08-10. We maintain our Underweight stance on the sector, and our Underperformer rating on ACC, Ambuja and Ultra Tech Cement. We maintain Grasim as Outperformer as it has diversified earnings stream from non-cement businesses.

## CONSTRUCTION

Our current estimates for construction companies factor in 25-50% revenue as also earnings CAGR over FY08-10. We have analyzed below the likely impact on earnings of construction companies based on some key risks / concerns in the prevailing macroeconomic environment:

- **Revenues:** Order book position remains comfortable at 2-3x revenues. We, however, cut our FY09 and FY10 revenue estimates by 5-10% to factor in possible delays in project execution or deferment of projects by clients, given the tight liquidity conditions.
- **Operating margins:** For stress case earnings estimates, we have lowered our operating margin assumptions for construction companies by up to 100bp on the premise that lower revenue growth would adversely impact margins due to negative operating leverage. This would lead to a 15-20% drop in our EBIDTA estimates.
- **Interest costs:** In general, we have assumed average borrowing costs of 11.5% for FY09 and 12-13% in FY10. The higher interest burden would significantly impact earnings of construction companies, specifically in case of companies that are highly levered.

**Stress case earnings sensitivity: Potential downside of 19-46% in FY10 earnings**

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| HCC | 2.6 | 4.7 | 6.5 | 25.6 | 26.4 | 59.2 | 3.4 | 3.5 | 20.1 | 15.6 | 16.6 | (26.9) | (46.4) |
| Gammon | 10.0 | 11.1 | 19.7 | 49.7 | 53.6 | 40.8 | 8.0 | 12.6 | 39.3 | 41.3 | 12.7 | (27.6) | (36.0) |
| NCC | 6.8 | 8.0 | 11.4 | 34.2 | 26.9 | 29.2 | 6.5 | 7.7 | 27.3 | 13.8 | 6.0 | (18.3) | (32.7) |
| Madhucon | 14.2 | 18.3 | 24.8 | 43.9 | 31.1 | 32.0 | 14.3 | 16.0 | 36.6 | 19.2 | 5.9 | (22.1) | (35.6) |
| IVRCL | 16.2 | 18.9 | 24.6 | 33.9 | 31.7 | 22.9 | 15.4 | 15.6 | 27.1 | 17.8 | (2.0) | (18.7) | (36.4) |
| Simplex | 16.4 | 26.5 | 38.2 | 41.5 | 49.6 | 52.7 | 18.3 | 21.1 | 34.2 | 34.9 | 13.4 | (31.1) | (44.9) |
| L&T* | 71.0 | 45.4 | 60.5 | 31.7 | 34.7 | NA | 40.7 | 49.1 | 24.9 | 22.1 | NA | (10.3) | (18.8) |

*Note: * - standalone financials; Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | | | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | CMP | Mcap | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rs bn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| HCC | 47 | 12 | 11.9 | 12.0 | 12.0 | 10.1 | 7.3 | 6.0 | 5.0 | 11.5 | 11.0 | 13.9 | 13.6 | 6.3 | 6.0 |
| Gammon | 105 | 9 | 9.2 | 9.7 | 9.7 | 9.5 | 5.3 | 3.2 | 2.6 | 9.5 | 9.5 | 13.1 | 8.3 | 3.3 | 2.8 |
| NCC | 54 | 12 | 10.6 | 9.7 | 9.5 | 6.7 | 4.7 | 4.2 | 3.4 | 9.2 | 8.5 | 8.3 | 7.0 | 4.4 | 3.7 |
| Madhucon | 105 | 4 | 14.6 | 12.5 | 12.1 | 5.7 | 4.2 | 1.9 | 1.4 | 12.0 | 11.1 | 7.4 | 6.6 | 1.9 | 1.3 |
| IVRCL | 153 | 16 | 9.8 | 9.5 | 9.4 | 8.1 | 6.2 | 5.5 | 4.9 | 9.0 | 8.4 | 9.9 | 9.8 | 5.9 | 5.6 |
| Simplex | 254 | 13 | 9.5 | 10.2 | 10.6 | 9.6 | 6.6 | 4.9 | 3.8 | 9.7 | 9.6 | 13.9 | 12.1 | 5.3 | 4.3 |
| L&T* | 890 | 252 | 11.5 | 11.7 | 12.0 | 19.6 | 14.7 | 11.4 | 7.7 | 11.2 | 11.0 | 21.9 | 18.1 | 12.4 | 9.3 |

*Note: *- standalone financials ; Source: IDFC – SSKI Research*

## ❑ Conclusion

Slowing industrial and infrastructure capex will have a significant adverse impact on future order flows for construction companies. Margin pressure may also increase going forward as muted revenue growth will result in negative operating leverage. Further, committed investments in BOT and real estate projects may stretch near-term cash flows.

In such a scenario, we prefer companies with diversified capabilities, multiple revenue streams and healthy balance sheets. In this backdrop, we see lower risk to L&T's earnings in case of an extended period of slow economic growth and rate it as our preferred pick in the construction sector.

## ENGINEERING

Changes in key assumptions to factor in the stress-case macroeconomic factors:

- Cut revenue growth by 5% for FY09 and 10% for FY10 over base case estimates to account for slower execution and order flow as most of the companies have 12-18 month execution period.
- Lowered operating margins by 50-100bp in FY09 and FY10 as lower revenue growth would impact operating leverage.
- Most engineering companies under our coverage are unlikely to be impacted by higher interest costs and liquidity squeeze as they have surplus cash on books and generate enough operating cash flows. However, we see cost of funding for companies such as Elecon and Carborundum increasing by 100bp for both FY09 and FY10 to reflect higher cost of working capital debt.

**Stress case earnings sensitivity: Potential downside of 14-26% in FY10 earnings**

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| Thermax | 24.2 | 28.5 | 37.2 | 0.0 | 23.4 | 24.0 | 25.6 | 29.7 | 16.0 | 10.9 | 10.8 | 10.0 | 20.1 |
| Voltas | 5.4 | 8.0 | 10.7 | 0.0 | 37.7 | 41.1 | 7.1 | 8.0 | 23.6 | 21.1 | 21.8 | 11.9 | 25.5 |
| AIA Engg | 70.9 | 94.2 | 115.4 | 0.0 | 39.7 | 27.6 | 84.1 | 99.8 | 31.8 | 31.2 | 18.6 | 10.8 | 13.6 |
| Elecon | 7.2 | 9.6 | 12.6 | 36.7 | 35.1 | 31.7 | 8.3 | 10.5 | 30.1 | 26.7 | 20.6 | 13.8 | 16.2 |
| Carborundum | 7.1 | 9.6 | 12.3 | 27.6 | 31.2 | 31.3 | 8.2 | 9.8 | 22.1 | 22.2 | 17.3 | 14.8 | 20.1 |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | CMP | Mcap | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rsbn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| Thermax | 335 | 39.9 | 12.3 | 12.0 | 12.2 | 11.8 | 9.0 | 6.9 | 4.9 | 11.5 | 11.2 | 13.1 | 11.3 | 7.6 | 6.1 |
| Voltas | 65 | 21.5 | 8.2 | 8.5 | 8.9 | 8.1 | 6.0 | 4.9 | 3.0 | 8.0 | 7.9 | 9.1 | 8.1 | 5.5 | 4.0 |
| AIA Engg | 970 | 18.2 | 23.7 | 24.8 | 24.2 | 10.3 | 8.4 | 6.9 | 5.4 | 23.8 | 23.5 | 11.5 | 9.7 | 7.5 | 6.1 |
| Elecon | 55 | 5.1 | 15.8 | 15.3 | 15.4 | 5.7 | 4.3 | 5.6 | 4.6 | 15.0 | 15.0 | 6.6 | 5.2 | 6.2 | 5.4 |
| Carborundum | 96 | 9.0 | 15.1 | 15.9 | 16.0 | 10.0 | 7.8 | 7.2 | 5.8 | 15.1 | 15.1 | 11.7 | 9.8 | 7.9 | 6.7 |

*Source: IDFC – SSKI Research*

### ❑ Conclusion

In the light of the above, we believe companies such as Thermax and AIA Engineering are unlikely to be significantly impacted by the liquidity squeeze in the system. Moreover, we believe AIA Engineering is attractively valued considering its non-cyclical nature of revenues. Similarly, Thermax has witnessed significant order inflows over the last 2-3 quarters and is trading at attractive valuations even on a stress case basis. Remain Overweight on the sector with Thermax and AIA Engineering as our key picks.

## FINANCIALS

Below, we analyze the possible impact of the stress-case macroeconomic scenario on the financials sector. Following are the changes in key assumptions:

- We have cut our credit growth forecast by 400bp for FY09 and 700bp (to 15%) for FY10 for our banking universe to factor in the headwinds emanating from tight liquidity, higher interest rates and asset quality concerns collectively impacting funding of new projects.
- In our stress case, we have built ~70% increase in FY10E NPA provisions over our base estimates – a 50% increase over our FY09E stress provisioning levels. Precipitated by higher interest rates and slowing economy, concerns abound on asset quality in both retail (specifically unsecured loans) and corporate portfolios, as reflected in rising credit spreads (limited availability of capital and subsequently increasing gearing for corporates).
- We have built in a 75-100bp surge in cost of deposits and borrowings, as banks scramble for liquidity. Simultaneously, yields have been increased to factor in some pass-through to customers, which would translate into declining margins over FY09-10.
- Our worst-case estimates factor in a substantial slowdown in fee income (10-15% cut over base estimates) in the context of volatile capital markets, which are specifically impacting advisory, derivative and third party distribution income.
- On the other hand, treasury income has been assumed to increase over FY09-10, buoyed by lower bond yields. Also, banks are estimated to benefit from write-back of MTM provisions on AFS portfolios. PSU banks are likely to be major beneficiaries given their larger AFS exposure.
- For NBFCs, access to funding would be impacted in a tight liquidity scenario, while demand in their specialized verticals (like mortgages and commercial vehicle financing) would be hit by slowing GDP growth and higher interest costs. Elevated interest rates will lead to a rise in Gross NPA levels, though impact on mortgages is likely to be minimal.

**Earnings estimates – stress and base case**

| | NII | | | | Operating profit | | | | PAT | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FY08-10 CAGR | | % cut | | FY08-10 CAGR | | % cut | | FY08-10 CAGR | | % cut | |
| | Stressed case | Base case | FY09 | FY10 | Stressed case | Base case | FY09 | FY10 | Stressed case | Base case | FY09 | FY10 |
| Allahabad Bank | 0 | 7 | -6 | -13 | -9 | -4 | -14 | -9 | -14 | -5 | -18 | -19 |
| Andhra Bank | 2 | 8 | -7 | -10 | -2 | 4 | -14 | -12 | -95 | 6 | -17 | -19 |
| Bank of Baroda | 12 | 16 | -2 | -7 | 12 | 14 | -14 | -3 | -95 | 17 | -9 | -10 |
| Bank of India | 16 | 19 | -1 | -6 | 18 | 22 | -5 | -6 | -96 | 21 | -8 | -11 |
| Canara Bank | 9 | 10 | -1 | -2 | 0 | 5 | -9 | -9 | -95 | 6 | -4 | -16 |
| Corporation Bank | 6 | 11 | -4 | -9 | 4 | 13 | -10 | -14 | -91 | 10 | -15 | -21 |
| Dena Bank | 5 | 7 | -3 | -4 | 5 | 3 | -3 | 4 | -94 | 8 | -16 | -20 |
| HDFC Bank | 29 | 33 | -2 | -5 | 27 | 32 | -4 | -8 | 25 | 37 | -7 | -16 |
| HDFC Ltd (pre-exceptions) 1 | 19 | 23 | -2 | -6 | 5 | 14 | -5 | -14 | 16 | 24 | -9 | -13 |
| ICICI Bank (stand-alone) 2 | 16 | 21 | -3 | -8 | 18 | 22 | -11 | -6 | 5 | 16 | -11 | -17 |
| IDBI | 14 | 23 | -6 | -15 | -5 | -3 | -10 | -4 | -11 | -2 | -15 | -18 |
| ING Vysya Bank | 20 | 29 | -4 | -14 | 26 | 42 | -13 | -20 | 8 | 32 | -20 | -34 |
| MMFS | 12 | 16 | -3 | -6 | 14 | 19 | -5 | -9 | 7 | 17 | -14 | -16 |
| Punjab National Bank | 12 | 15 | -3 | -5 | 11 | 13 | -5 | -3 | 10 | 16 | -7 | -10 |
| Shriram Transport | 33 | 46 | -9 | -18 | 35 | 50 | -7 | -19 | 25 | 51 | -15 | -31 |
| State Bank of India | 12 | 12 | -3 | -1 | 13 | 16 | -8 | -5 | 7 | 10 | -4 | -6 |
| Syndicate Bank | -1 | 0 | 0 | -1 | -5 | -5 | -4 | 0 | -10 | -8 | -6 | -4 |
| Union Bank Of India | 7 | 10 | -6 | -5 | 7 | 9 | -8 | -2 | 2 | 6 | -8 | -8 |
| Axis Bank Ltd | 30 | 37 | -5 | -11 | 28 | 34 | -5 | -8 | 24 | 34 | -11 | -14 |
| Yes Bank Ltd | 38 | 50 | -7 | -15 | 29 | 45 | -12 | -21 | 21 | 42 | -16 | -28 |
| Indian Bank | 7 | 11 | -3 | -6 | 2 | 10 | -10 | -14 | -95 | 10 | -15 | -31 |

*Note : 1 HDFC numbers are pre-exception, excluding any stake sale in subsidiaries*
*2 ICICI Bank numbers are stand-alone, without factoring in numbers of overseas banking subsidiaries*

**Earnings estimates (cont..)**

| | Other Income | | | | NPA Provisions | | | | Provisions | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FY08-10 CAGR | | % cut | | FY08-10 CAGR | | % rise | | FY08-10 CAGR | | % rise | |
| | Stressed case | Base case | FY09 | FY10 | Stressed case | Base case | FY09 | FY10 | Stressed case | Base case | FY09 | FY10 |
| Allahabad Bank | -1 | -8 | -12 | 16 | 11 | -3 | 6 | 31 | 6 | -4 | -6 | 22 |
| Andhra Bank | 5 | 3 | -7 | 3 | 28 | 4 | 25 | 51 | 72 | 15 | -2 | 24 |
| Bank of Baroda | 6 | 6 | -8 | 1 | 43 | 18 | 12 | 45 | 39 | 1 | -28 | 24 |
| Bank of India | 13 | 16 | -5 | -5 | 42 | -7 | 7 | 63 | 28 | 22 | 3 | 9 |
| Canara Bank | -3 | 1 | -4 | -8 | 3 | -9 | 26 | 29 | 29 | -4 | -16 | 9 |
| Corp Bank | 2 | 9 | -12 | -13 | 43 | 34 | 4 | 14 | 58 | 30 | 9 | 13 |
| Dena Bank | 11 | 6 | -1 | 11 | 7 | -20 | 43 | 79 | 15 | -29 | 26 | 73 |
| HDFC Bank | 24 | 29 | -5 | -8 | 42 | 39 | -3 | 3 | 27 | 23 | 2 | 7 |
| HDFC Ltd (pre-exceptions) 1 | -52 | -18 | -33 | -66 | 77 | 31 | 64 | 82 | 77 | 31 | 64 | 82 |
| ICICI Bank (stand-alone) 2 | 5 | 14 | -13 | -14 | 40 | 33 | 3 | 12 | 31 | 24 | 3 | 12 |
| IDBI | -4 | -7 | -8 | 6 | 77 | 50 | 11 | 40 | 3 | -7 | -1 | 21 |
| ING Vysya Bank Ltd | 24 | 29 | -7 | -7 | 130 | 137 | -14 | -6 | 96 | 90 | 0 | 7 |
| MMFS | 50 | 65 | -11 | -17 | 20 | 21 | 4 | -2 | 20 | 21 | 4 | -2 |
| Punjab National Bank | 7 | 4 | -1 | 6 | 8 | -5 | -6 | 29 | 38 | 24 | 1 | 25 |
| Shriram Transport | 28 | 30 | -2 | -3 | 64 | 56 | 12 | 12 | 64 | 56 | 12 | 12 |
| State Bank of India | 15 | 18 | -6 | -5 | 32 | 12 | 38 | 38 | 31 | 32 | -18 | -1 |
| Syndicate Bank | 4 | 5 | -6 | -2 | 11 | -5 | 48 | 35 | 5 | 1 | 0 | 7 |
| Union Bank Of India | 10 | 6 | -3 | 8 | 17 | -1 | 20 | 39 | 14 | 7 | -8 | 12 |
| Axis Bank Ltd | 31 | 36 | -1 | -7 | 50 | 31 | 16 | 32 | 43 | 38 | 8 | 7 |
| Yes Bank Ltd | 23 | 30 | -6 | -10 | 642 | 576 | 19 | 20 | 75 | 60 | 19 | 20 |

*Source : IDFC-SSKI Research*

*Note : 1 HDFC numbers are pre-exception, excluding any stake sale in subsidiaries*

*2 ICICI Bank numbers are stand-alone, without factoring in numbers of overseas banking subsidiaries*

## ❑ Conclusion

### *Earnings*

- Factoring in the stress case assumptions, earnings estimates of private banks have been cut by 21% and of PSU banks by 11% over the base case estimates of FY10. Gains on the larger bond portfolios would cushion earnings of PSU banks.
- In case of NBFCs, FY10E earnings have been cut by 19% from base estimates on account of (i) surge in deposit and borrowing costs as availability of capital could emerge as a constraint, and; (ii) slowdown in disbursements as demand is dented by higher interest rates and slowing economy. In addition, lower treasury gains would impact earnings, specifically in the case of HDFC.
- As evident, earnings of smaller banks (both PSU and private) are more susceptible in such an operating environment. Balance sheet constraints as well as the dual impact of tight liquidity conditions and rising cost of deposits would lead to a more pronounced compression in earnings.

**EPS compression in the stress case analysis**

| | EPS deduction | | CAGR FY08-10 | |
|---|---|---|---|---|
| | FY09 | FY10 | stress case | base case |
| Large PSU banks | 6 | 8 | 8 | 13 |
| Small PSU banks | 12 | 19 | -7 | 3 |
| PSU banks | 8 | 11 | 3 | 10 |
| Large private banks | 9 | 20 | 11 | 24 |
| Small private banks | 18 | 30 | 15 | 38 |
| Private banks | 10 | 21 | 11 | 25 |
| NBFCs | 8 | 19 | 9 | 21 |
| Total coverage universe | 8 | 15 | 6 | 15 |

*Source: IDFC – SSKI Research*

### *Valuations*

- Valuations of PSU banks – currently at a discount to book value – price in the worst conditions and we see limited downside from the existing levels. Earnings would be bolstered by falling bond yields, which would lead to significant gains on G-Sec portfolios. As an implication, higher RoEs will justify higher target prices than the current trading prices. In addition, given the bond proxy nature of PSU banks, they typically outperform private banks in a falling interest rate environment.
- Good quality private bank stocks have been hammered and are available at beaten-down valuations. However, given their higher valuations as against PSU banks and earnings sensitivity to the deteriorating macroeconomic environment, de-rating could continue as target multiples compress to reflect decline in RoEs.
  - ICICI Bank has borne the maximum brunt of the global financial crisis due to higher component of international operations, aggravated by significant rumor mongering. While concerns exist on long-term earnings outlook, the beaten-down valuations offer an attractive opportunity.
  - While HDFC Bank has not corrected to historic valuation lows, we believe the bank is least likely to throw a negative surprise.
- Stock prices of banks/ NBFCs with insurance subsidiaries are factoring in significant correction in SOTP valuations. The downturn in capital markets has manifested in ULIPs, and the life insurance industry witnessed a 30% yoy decline in new premium for the month of August 2008, as against 42% increase in the previous fiscal. While LIC continues to lose market share, private players too are affected by the shakeout (ICICI Prudential, the top private insurer, has registered a meager 11% yoy in individual non-single premium category). SOTP valuations of listed players, such as Max India and Bajaj Financial Services, are under stress as insurance companies impinge on the valuations.

## ❑ Our top picks:

- Large PSU banks (State Bank of India, Punjab National Bank, Bank of Baroda, Bank of India, Union Bank), ICICI Bank and HDFC Bank

**Valuations**

| | Price | M cap | EPS | | | | ROE (%) | | | | Price/Book Value | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Y08-10 CAGR | | % cut | | FY09 | | FY10 | | FY09 | | FY10 | |
| | | | Stressed case | Base case | FY09 | FY10 | Stressed case | Base case | Stressed case | Base case | Stressed case | Base case | Stressed case | Base case |
| Allahabad Bank | 57.75 | 25.80 | -14 | -5 | -17.7 | -19.1 | 12.9 | 15.5 | 11.8 | 14.1 | 0.53 | 0.44 | 0.47 | 0.39 |
| Andhra Bank | 50.7 | 24.59 | -5 | 6 | -16.9 | -19.1 | 13.6 | 16.2 | 13.7 | 16.5 | 0.65 | 0.64 | 0.58 | 0.56 |
| Bank of Baroda | 278.55 | 101.82 | 11 | 17 | -8.9 | -10.3 | 13.1 | 14.3 | 13.7 | 15.1 | 0.79 | 0.78 | 0.68 | 0.68 |
| Bank of India | 262.6 | 138.11 | 14 | 21 | -8.0 | -10.9 | 20.6 | 22.2 | 19.6 | 21.6 | 1.05 | 1.03 | 0.86 | 0.85 |
| Canara Bank | 172.8 | 70.85 | -2 | 6 | -4.0 | -16.1 | 16.7 | 17.3 | 14.8 | 17.3 | 0.71 | 0.71 | 0.61 | 0.60 |
| Corporation Bank | 233.5 | 33.49 | -2 | 10 | -15.1 | -20.9 | 14.7 | 17.1 | 13.9 | 16.9 | 0.69 | 0.68 | 0.61 | 0.58 |
| Dena Bank | 32.4 | 9.29 | -4 | 8 | -16.3 | -19.7 | 16.0 | 18.9 | 14.7 | 17.5 | 0.47 | 0.47 | 0.39 | 0.38 |
| HDFC Bank | 1047.75 | 441.64 | 21 | 32 | -6.9 | -16.1 | 15.8 | 16.9 | 15.6 | 18.3 | 3.00 | 2.98 | 2.79 | 2.76 |
| HDFC | 1721.8 | 489.06 | 6 | 16 | -6.9 | -16.6 | 18.1 | 20.0 | 18.5 | 22.3 | 3.54 | 3.62 | 3.15 | 3.13 |
| ICICI Bank | 363.65 | 404.74 | 5 | 16 | -11.0 | -17.0 | 5.9 | 8.8 | 5.6 | 10.7 | 0.50 | 0.81 | 0.48 | 0.74 |
| IDBI | 65 | 47.08 | -11 | -2 | -15.0 | -18.0 | 8.1 | 9.4 | 7.9 | 9.4 | 0.83 | 0.81 | 0.75 | 0.72 |
| ING Vysya Bank | 181.5 | 18.60 | 8 | 32 | -19.6 | -33.6 | 10.4 | 12.8 | 10.2 | 14.7 | 1.17 | 1.14 | 1.04 | 0.97 |
| M&M Finance | 200 | 19.34 | 7 | 17 | -14.2 | -16.2 | 12.6 | 14.5 | 13.3 | 15.4 | 1.32 | 1.30 | 1.16 | 1.12 |
| Punjab National Bank | 460.5 | 145.20 | 10 | 16 | -6.5 | -10.0 | 16.6 | 17.7 | 16.1 | 17.6 | 0.97 | 0.96 | 0.87 | 0.85 |
| Shri Ram Transport | 228.45 | 46.41 | 20 | 45 | -14.8 | -31.5 | 25.9 | 28.1 | 25.2 | 31.2 | 2.20 | 1.94 | 1.78 | 1.54 |
| State Bank of India | 1352.5 | 854.06 | 7 | 10 | -4.4 | -6.5 | 13.7 | 14.3 | 13.3 | 14.1 | 1.56 | 1.23 | 1.40 | 1.08 |
| Syndicate Bank | 56.25 | 29.36 | -16 | -15 | -6.4 | -3.9 | 12.3 | 13.2 | 13.6 | 14.0 | 0.71 | 0.70 | 0.64 | 0.63 |
| Union Bank Of India | 145.95 | 73.72 | 2 | 6 | -7.9 | -7.8 | 16.0 | 17.2 | 15.9 | 17.0 | 0.83 | 0.82 | 0.73 | 0.72 |
| Axis Bank | 552.6 | 197.67 | 17 | 26 | -11.1 | -14.3 | 14.3 | 15.9 | 15.9 | 18.0 | 2.00 | 1.97 | 1.78 | 1.71 |
| Yes Bank | 71.95 | 21.20 | 21 | 38 | -10.8 | -23.6 | 14.8 | 17.3 | 14.0 | 18.4 | 1.10 | 1.13 | 0.95 | 0.94 |
| Indian Bank | 125.95 | 53.91 | -9 | 10 | -14.5 | -30.9 | 16.0 | 18.5 | 13.0 | 17.9 | 0.89 | 0.86 | 0.78 | 0.73 |

*Source: IDFC – SSKI Research*

## FMCG & ALCOHOLIC BEVERAGES

Changes in key assumptions to factor in the stress-case macroeconomic factors:

### ❑ Revenue growth estimates to be lower by 1-3%

- FMCG companies have witnessed 20% revenue growth in the last couple of quarters, which has largely been price-led (price hikes of 4-15% across portfolios). However, we are building in slower value growth from here on the following counts and cut our 2-year growth CAGR for consumer companies by 1-3%:

    1. Prices of most of the agri commodities have fallen sharply in the past couple of months or have stabilized – e.g. palm oil price is down 40% from the peak, and prices of crude oil have also corrected significantly (impacting LAB and packaging material).

    2. In a softening commodity price scenario, competition escalates from unorganized players, whose business models become viable. To stave off this competition, FMCG companies could play the pricing game (through promotions).

    3. Any slowdown in the economy could impact off-take and induce downtrading.

    4. High base effect would come into play from FY10.

- Growth in the alcoholic beverages industry has been led by 12-13% volume growth. United Spirits is witnessing a higher 15% volume growth against our base case estimates build in just 12% volume growth. However, uptrading could be arrested or slowed in a stress-case macroeconomic scenario, which would then lead to a ~2% cut in 2-year CAGR over base case estimates for our alcoholic beverages universe.

### ❑ Margins building in the downtrading risk

- While softening input prices would support margins, overall EBITDA growth would be lower by 4-8% on account of low price-point SKUs outgrowing premium products due to downtrading in the portfolio.

### ❑ Impact of leverage – only on United Spirits

- Given the negative working capital requirement of the business and low capital intensity, FMCG companies are largely debt free – and hence insensitive to the elevated interest rate scenario.
- We believe that FMCG companies can fund the capex through internal accruals. Though Godrej Consumer Products and Marico had gross debt of Rs3.5bn and Rs3.8bn respectively as of June 2008 to fund the recent acquisitions, GCPL has partly repaid the debt through proceeds of the rights issue and Marico's current debt service coverage ratio is at 8.5-9x. Therefore, we do not see any of the FMCG companies exposed to the risk of increasing interest rate.
- However, United Spirits has a high debt of Rs63bn on books. Nevertheless, it has multiple options to de-leverage the balance sheet, primarily through the sale of treasury stock (13.9m shares worth USD250m currently).
- To factor in the elevated interest rates, we have increased our debt cost. Our base case EPS estimates for United Spirits could be impacted by 9% in FY09 and 12% in FY10.

## ❑ Conclusion

Considering the worst case scenario, we see a potential earnings downside of 5-9% from our base case estimates for FMCG companies and 11-12% for alcoholic beverages companies in FY10. Despite a tougher environment, we maintain our bullish stance on HUL and Nestle given their ability to weather the challenges with strong brand portfolios. We maintain a negative bias on ITC (with increasing pressure on cigarettes portfolio) and the entire mid-tier consumer companies.

**Stress case earnings sensitivity: Potential downside of 5-13% in FY10 earnings**

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| Colgate | 17.4 | 20.5 | 23.7 | 12.0 | 12.3 | 16.6 | 20.1 | 22.4 | 11.3 | 7.9 | 13.5 | 1.9 | 5.2 |
| Dabur | 3.9 | 4.5 | 5.4 | 17.7 | 19.3 | 18.3 | 4.4 | 4.9 | 14.1 | 12.8 | 13.1 | 2.3 | 8.7 |
| GCPL | 7.1 | 7.3 | 8.3 | 14.7 | 14.5 | 8.5 | 7.1 | 7.9 | 13.3 | 10.1 | 5.8 | 3.1 | 4.8 |
| HUL | 8.1 | 9.7 | 11.4 | 14.9 | 19.3 | 18.6 | 9.4 | 10.4 | 14.1 | 12.5 | 13.2 | 3.2 | 8.9 |
| ITC | 8.3 | 9.0 | 10.6 | 16.8 | 13.5 | 12.9 | 9.0 | 10.0 | 14.8 | 10.8 | 10.1 | 0.1 | 5.0 |
| Marico | 2.8 | 3.1 | 3.9 | 19.0 | 22.6 | 18.1 | 2.9 | 3.5 | 17.5 | 16.4 | 12.7 | 4.3 | 8.9 |
| Nestle | 43.0 | 59.7 | 74.0 | 18.7 | 22.2 | 31.3 | 56.3 | 66.7 | 16.8 | 17.8 | 24.7 | 5.7 | 9.9 |
| United Breweries | 2.1 | 3.3 | 4.3 | 16.5 | 21.5 | 43.5 | 2.8 | 3.8 | 14.7 | 13.7 | 35.1 | 15.9 | 11.3 |
| United Spirits | 31.1 | 42.1 | 63.3 | 15.3 | 19.6 | 42.6 | 38.2 | 55.6 | 13.8 | 16.4 | 33.6 | 9.3 | 12.2 |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | | | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | CMP | M Cap | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rsbn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| Colgate | 373 | 51 | 17.1 | 17.0 | 17.2 | 18.3 | 15.8 | 16.4 | 14.0 | 16.2 | 16.1 | 18.6 | 16.6 | 17.1 | 15.2 |
| Dabur | 80 | 69 | 17.3 | 17.3 | 17.8 | 17.8 | 14.8 | 13.8 | 11.2 | 17.0 | 17.0 | 18.2 | 16.2 | 14.4 | 12.6 |
| GCPL | 107 | 24 | 19.5 | 19.0 | 19.4 | 14.7 | 12.9 | 11.7 | 9.9 | 18.0 | 18.4 | 15.2 | 13.5 | 10.9 | 9.5 |
| HUL | 222 | 483 | 13.7 | 14.3 | 14.8 | 22.8 | 19.4 | 19.8 | 16.3 | 13.4 | 13.3 | 23.6 | 21.3 | 22.2 | 19.7 |
| ITC | 163 | 615 | 31.6 | 29.3 | 29.8 | 18.2 | 15.4 | 12.1 | 9.9 | 29.3 | 29.4 | 18.3 | 16.3 | 12.1 | 10.4 |
| Marico | 51 | 31 | 12.6 | 12.9 | 13.4 | 16.7 | 13.2 | 12.1 | 10.0 | 12.0 | 12.4 | 17.4 | 14.5 | 11.1 | 9.2 |
| Nestle | 1,528 | 147 | 19.7 | 20.2 | 20.9 | 25.6 | 20.6 | 16.8 | 13.5 | 19.7 | 20.0 | 27.1 | 22.9 | 17.3 | 14.8 |
| United Breweries | 110 | 24 | 11.9 | 12.2 | 13.0 | 33.6 | 25.4 | 12.1 | 11.2 | 10.9 | 11.7 | 39.9 | 28.6 | 13.6 | 11.2 |
| United Spirits | 748 | 75 | 23.2 | 23.1 | 24.9 | 17.8 | 11.8 | 11.0 | 8.6 | 22.8 | 24.2 | 19.6 | 13.5 | 8.8 | 7.1 |

*Source: IDFC – SSKI Research*

## INFRASTRUCTURE DEVELOPERS

A general economic slowdown may have a negative impact on infrastructure developers in terms of access to funds for financing projects and lower traffic-linked revenues. We have analyzed the likely impact on earnings of infrastructure developers as follows:

- **Passenger / Vehicular / Port traffic:** We have assumed a 10% decline in air traffic in FY09 and no growth in FY10. In case of road projects, we have cut our traffic growth assumptions from 6-9% to 4% yoy for both FY09 and FY10. In case of ports, we have pared our FY09 and FY10 growth assumptions by ~10%.
- **Interest costs:** In general, we have assumed average borrowing cost of 11.5% in FY09 and 12-14% in FY10. For projects under construction, interest rates are usually fixed and hence our assumptions stand unchanged.
- **Real estate / SEZs**: For infrastructure developers with exposure to real estate projects, we have lowered our base case property price assumptions by 25%. We have also increased our absorption assumptions, specifically for SEZ projects in early stages of development.
- **Project funding:** In view of the existing tight liquidity conditions and the state of the equity markets, infrastructure developers may face delays in securing debt as well as equity funding for projects. In the worst case scenario, we have not assigned any value to projects which have not achieved financial closure while valuing infrastructure developers. Revenues and earnings from such projects have also not been considered.
- **Cost of equity:** In line with the current trend of rising interest rates, we have increased our cost of equity assumptions. Hence, while valuing infrastructure developers, our assumptions have used equity discount rates ranging from 15% (for operational projects on fixed return basis) to 20% (for projects in early stages of construction).

**Stress case earnings sensitivity: Potential downside of 23-50% in FY10 earnings**

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| GMR | 1.0 | 1.7 | 2.9 | 38.3 | 74.0 | 66.0 | 1.2 | 1.6 | 28.7 | 56.0 | 24.4 | 28.5 | 43.8 |
| GVK | 1.0 | 1.0 | 2.3 | 56.2 | 73.0 | 54.6 | 0.9 | 1.2 | 33.4 | 35.9 | 9.6 | 13.9 | 49.8 |
| MPSEZ | 5.1 | 13.8 | 29.5 | 81.5 | 85.6 | 141.3 | 12.4 | 22.8 | 73.1 | 73.9 | 112.4 | 10.3 | 22.5 |
| GIPL | 1.3 | 1.6 | 3.6 | 91.9 | 77.5 | 64.9 | 1.4 | 2.4 | 88.0 | 74.8 | 34.9 | 12.8 | 33.1 |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | CMP | Mcap | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rs bn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| GMR | 79.1 | 108.0 | 22.2 | 28.5 | 35.1 | 45.7 | 27.7 | 22.4 | 14.0 | 26.3 | 32.6 | 64.0 | 49.3 | 26.9 | 18.4 |
| GVK | 15.5 | 21.7 | 39.5 | 47.0 | 48.4 | 14.7 | 6.7 | 22.7 | 12.0 | 46.8 | 41.0 | 17.1 | 13.3 | 12.7 | 10.2 |
| MPSEZ | 349.4 | 140.0 | 65.4 | 68.2 | 68.3 | 25.3 | 11.9 | 17.9 | 8.7 | 68.0 | 66.1 | 28.2 | 15.3 | 18.6 | 10.1 |
| GIPL | 55.0 | 8.0 | 72.0 | 48.6 | 61.6 | 35.1 | 15.4 | 18.1 | 10.0 | 48.2 | 62.3 | 40.3 | 23.0 | 18.6 | 10.4 |

*Source: IDFC – SSKI Research*

## ❑ Conclusion

If liquidity squeeze in the domestic market were to persist over the medium term, infrastructure developers will continue to face pressure on securing funding for their projects. Delays in execution of projects on hand will likely lead to deterioration of return ratios and significantly hamper cash flows of infrastructure developers. In such a scenario, we prefer exposure to companies which are fully funded for projects on hand and have completed a significant portion of their ongoing capex, such as MPSEZ. Among infrastructure developers, we believe MPSEZ's earnings face the minimum risk in case of a general economic slowdown. MPSEZ's earnings are also de-risked from a slowing economy as over 50% of the volumes at Mundra port come are generated through long-term contracts, mostly on take-or-pay basis.

## LOGISTICS

Changes in key assumptions to factor in the stress-case macroeconomic factors:

- Cut revenue growth by 5% for FY09 and by 10% for FY10 over base case estimates to factor in lower volumes as capex plans are delayed.
- Operating margin compression by 50-100bp in FY09 and FY10 to reflect lower operating efficiencies and reduced component of value added services
- As most of the logistics companies in our universe are implementing capex plans to set up infrastructure for offering value added services or integrating their service offerings, cost of borrowings could increase by 50bp to 12.5% for FY09 and by 100bp to 13.5% in FY10.

**Stress case earnings sensitivity: Potential downside of 7-42% in FY10 earnings**

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| Concor | 57.7 | 68.0 | 77.4 | 17.3 | 16.3 | 15.3 | 64.7 | 71.8 | 15.4 | 13.7 | 11.5 | 4.8 | 7.2 |
| AGL | 35.2 | 50.5 | 56.1 | 22.7 | 51.5 | 26.3 | 47.9 | 44.8 | 16.4 | 39.1 | 12.8 | 5.3 | 20.2 |
| GDL | 6.3 | 7.6 | 9.2 | 85.8 | 50.5 | 20.8 | 6.8 | 7.6 | 74.6 | 43.9 | 10.3 | 10.4 | 16.5 |
| TCI | 3.5 | 4.7 | 6.6 | 19.6 | 30.6 | 36.4 | 3.5 | 4.2 | 17.4 | 23.7 | 9.5 | 26.2 | 35.5 |
| Gati | 2.9 | 4.8 | 7.3 | 26.8 | 44.2 | 57.3 | 3.2 | 4.2 | 16.9 | 24.8 | 19.5 | 31.6 | 42.3 |
| Sical | 10.2 | 10.2 | 11.6 | 5.5 | 14.3 | 6.9 | 7.4 | 6.9 | 4.8 | 5.2 | (17.4) | 27.4 | 40.3 |
| Arshiya | 7.5 | 11.6 | 25.2 | 83.9 | 141.4 | 83.1 | 11.2 | 19.1 | 92.0 | 151.9 | 59.7 | 3.5 | 23.9 |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | | | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | CMP | Mcap | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rsbn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| Concor | 733 | 95.3 | 26.6 | 27.3 | 26.6 | 10.8 | 9.5 | 12.6 | 10.7 | 26.6 | 25.8 | 11.3 | 10.2 | 7.0 | 5.7 |
| AGL | 772 | 17.3 | 7.3 | 10.6 | 11.2 | 15.3 | 13.8 | 8.5 | 6.1 | 10.5 | 10.5 | 16.1 | 17.2 | 8.9 | 7.4 |
| GDL | 67 | 7.8 | 38.6 | 31.9 | 25.3 | 8.8 | 7.4 | 5.7 | 3.8 | 32.9 | 26.2 | 9.9 | 8.8 | 5.9 | 4.2 |
| TCI | 52 | 3.8 | 6.4 | 7.1 | 7.6 | 8.0 | 5.7 | 5.4 | 4.6 | 6.4 | 7.1 | 15.0 | 12.3 | 6.4 | 5.5 |
| Gati | 33 | 2.8 | 7.9 | 9.2 | 10.2 | 7.0 | 4.5 | 5.7 | 3.7 | 8.5 | 9.0 | 10.2 | 7.9 | 6.5 | 4.9 |
| Sical | 43 | 1.7 | 11.5 | 13.6 | 13.5 | 4.2 | 3.7 | 1.1 | 1.0 | 12.8 | 11.6 | 5.8 | 6.2 | 1.4 | 1.6 |
| Arshiya | 115 | 6.8 | 12.5 | 13.5 | 21.5 | 9.9 | 4.6 | 13.2 | 5.3 | 12.9 | 21.5 | 10.2 | 6.0 | 10.8 | 9.6 |

*Source: IDFC – SSKI Research*

### ❑ Conclusion

We believe Concor is unlikely to be significantly impacted by liquidity squeeze in the system as it has surplus cash on books, which can be utilized to fund capex plans. Moreover, Concor is debt free, which insulates it from rising interest costs. Consequently, the stock remains our top pick in the sector. Arshiya and Gateway Distriparks too are debt free and capex plans in the subsidiary companies (primarily rail and FTWZ) are unlikely to have a significant impact on the parent business. The valuations of these companies are quite attractive. Maintain Overweight on the sector.

## MEDIA

Changes in key assumptions to factor in the stress-case macroeconomic factors:

- Media industry would be more severely impacted by the economic slowdown. Liquidity crisis could also derail growth plans, as most of the media companies are in the gestation phase and thus highly leveraged.
- Slowdown in revenue growth: Media industry typically grows at 2x GDP growth and moderation in GDP growth would impact overall media spends by companies (ad spend market) as well as consumers (multiplex tickets, cable ARPU, etc).
- The following factors could also impact growth in the various media segments:
    - **Broadcasting** – Fragmentation within the genre would impact advertising rack rates and incumbent leaders are most susceptible to this risk. Slow paced digital rollout (lack of capital for DTH and cable operators) would impact pay revenue growth.
    - Business news broadcasting – If the capital market turmoil persists over the longer term, business news broadcasters would be hit by slowdown in IPO/ NFO advertising as also lower spending by the BFSI space. Building in this scenario, TV18's revenue CAGR could drop from 33% to 22% over base case estimates for FY08-10.
    - Print media – With a steep decline in spending by a few larger print advertisers – real estate, BFSI and retail, revenue CAGR for our print media basket (Deccan Chronicle and HT Media) could be lower by 6-8% from the base case estimates for FY08-10.
    - Multiplex – Multiplex industry could be the worst hit. While weakening sentiment would slow down growth in patron numbers, cannibalization is already beginning to drag same property growth. Also, lack of capital (both for multiplex operators and real estate developers) would slow down in new screen rollout. The impact could be more pronounced on a lower base. In the worst case scenario, Fame India's revenue growth could be lower at 41% vis-à-vis our base case estimates of 62%. PVR's growth CAGR in the worst case could be at 30%.
    - Cable digitization and DTH: With customer subsidies moving up on entry of every new player in the DTH space, capital requirement has assumed critical importance. Dish TV is not adequately funded and incremental growth funding is likely to be difficult, a shift in market share is evident to funded players like Reliance Big TV, Airtel Digital and Tata Sky. On the other hand, cable industry could hit a major roadblock with the entire industry funded for less than USD300m.

### Stress case earnings sensitivity

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| Balaji Telefilms | 14.7 | 15.4 | 18.7 | 12.6 | 12.5 | 12.9 | 13.0 | 14.9 | 5.1 | (0.4) | 0.7 | (15.7) | (20.5) |
| Deccan Chronicle | 12.5 | 15.0 | 18.1 | 28.2 | 15.2 | 20.4 | 13.2 | 15.2 | 20.0 | 7.6 | 10.4 | (11.7) | (16.0) |
| Dish TV | (9.7) | (9.3) | (0.9) | 91.6 | - | (68.5) | (10.7) | (4.5) | 72.3 | - | (7.3) | - | - |
| ENIL | (3.6) | 8.3 | 15.8 | 35.8 | 124.4 | - | 4.0 | 10.1 | 28.7 | 96.3 | - | (52.2) | (36.2) |
| Fame | 3.4 | 3.0 | 5.5 | 62.3 | 81.6 | 26.2 | 0.9 | 4.3 | 40.9 | 68.9 | 3.0 | (70.1) | (22.1) |
| HT Media | 4.4 | 6.1 | 9.4 | 19.9 | 40.6 | 46.4 | 5.4 | 6.2 | 13.2 | 16.9 | 18.8 | (11.3) | (34.1) |
| IBN18 | (0.4) | (1.3) | 0.2 | 56.0 | 74.0 | - | (1.4) | (0.7) | 45.7 | 30.8 | 37.9 | 7.7 | (465.7) |
| Jagran Prakashan | 3.3 | 3.8 | 5.1 | 16.6 | 23.0 | 24.5 | 3.4 | 4.0 | 12.4 | 12.4 | 12.4 | (10.6) | (21.7) |
| NDTV | 2.5 | 1.3 | 3.3 | 18.2 | 21.7 | 15.4 | 0.1 | 1.4 | 12.9 | (5.2) | (26.1) | (91.3) | (59.0) |
| Prime Focus | 22.7 | 31.5 | 49.8 | 36.4 | 39.0 | 48.2 | 18.4 | 31.7 | 30.0 | 24.8 | 18.2 | (41.6) | (36.3) |
| PVR | 9.4 | 12.1 | 21.1 | 42.4 | 51.3 | 53.9 | 9.8 | 13.2 | 30.3 | - | 18.3 | (19.1) | (37.4) |
| Sun TV | 8.3 | 10.9 | 14.2 | 28.4 | 30.1 | 31.0 | 9.7 | 11.7 | 19.1 | 18.0 | 18.8 | (11.4) | (17.8) |
| TV Today | 6.9 | 8.2 | 10.6 | 18.2 | 21.0 | 23.7 | 7.8 | 9.0 | 15.7 | 9.4 | 13.9 | (4.8) | (15.2) |
| TV18 | 3.6 | 5.5 | 9.4 | 33.4 | 63.1 | 61.0 | 3.5 | 4.9 | 22.3 | 43.5 | 16.3 | (37.2) | (47.8) |
| UTV | 16.6 | 15.0 | 22.9 | 56.1 | 55.8 | 17.2 | 13.0 | 19.2 | 39.0 | 32.3 | 6.0 | (13.3) | (15.8) |
| WWIL | (7.1) | (5.1) | (6.3) | 79.6 | - | (5.8) | (3.3) | (3.8) | 34.1 | - | (27.0) | - | - |
| Zee Entertainment | 8.8 | 10.9 | 14.1 | 23.5 | 29.4 | 26.5 | 10.1 | 12.0 | 20.5 | 18.7 | 16.4 | (7.9) | (15.2) |
| Zee News | 1.6 | 2.4 | 3.6 | 28.7 | 41.9 | 46.9 | 2.2 | 2.8 | 23.1 | 26.5 | 29.5 | (9.9) | (22.2) |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | CMP | Mcap | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rsbn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| Balaji Telefilms | 116.0 | 7.6 | 35.7 | 34.0 | 35.6 | 7.5 | 6.2 | 4.6 | 3.7 | 28.8 | 32.0 | 8.9 | 7.8 | 5.6 | 4.9 |
| Deccan Chronicle | 62.6 | 15.2 | 61.2 | 49.2 | 49.4 | 4.2 | 3.5 | 2.4 | 1.8 | 48.2 | 49.2 | 4.7 | 4.1 | 2.4 | 1.9 |
| Dish TV | 18.4 | 7.9 | (51.7) | (16.8) | 19.2 | (2.0) | (19.8) | (12.8) | 6.6 | (20.8) | 13.0 | (1.7) | (4.1) | (10.8) | 13.3 |
| ENIL | 185.1 | 8.8 | 7.7 | 16.1 | 21.1 | 22.2 | 11.7 | 11.6 | 6.5 | 13.3 | 18.0 | 46.4 | 18.4 | 15.3 | 8.8 |
| Fame | 17.8 | 0.7 | 13.6 | 14.1 | 17.0 | 6.0 | 3.2 | 3.1 | 0.8 | 13.0 | 19.5 | 20.0 | 4.2 | 6.8 | 2.9 |
| HT Media | 87.5 | 20.3 | 16.0 | 18.0 | 22.0 | 14.4 | 9.4 | 8.0 | 5.2 | 16.6 | 17.0 | 16.2 | 14.2 | 9.4 | 8.3 |
| IBN18 | 88.0 | 12.0 | 7.5 | (0.6) | 9.4 | (66.8) | 452.8 | (779.7) | 40.9 | (1.3) | 6.1 | (62.0) | (123.8) | (399.1) | 72.5 |
| Jagran Prakashan | 65.1 | 19.6 | 21.9 | 21.8 | 24.3 | 16.9 | 12.9 | 9.8 | 7.1 | 20.4 | 21.0 | 18.9 | 16.4 | 10.9 | 4.9 |
| NDTV | 136.1 | 8.7 | 10.5 | 7.9 | 11.2 | 102.7 | 40.9 | 88.6 | 53.1 | 5.3 | 7.4 | 1,180.5 | 99.8 | 126.2 | 79.0 |
| Prime Focus | 259.3 | 3.3 | 30.5 | 25.0 | 31.7 | 8.2 | 5.2 | 3.6 | 2.3 | 23.5 | 28.1 | 14.1 | 8.2 | 3.6 | 2.8 |
| PVR | 104.6 | 2.4 | 18.4 | 18.2 | 20.7 | 8.7 | 5.0 | 5.2 | 3.5 | 17.0 | 17.8 | 10.7 | 7.9 | 5.6 | 4.4 |
| Sun TV | 160.2 | 63.1 | 57.4 | 57.4 | 58.9 | 14.6 | 11.3 | 8.8 | 6.6 | 56.1 | 56.3 | 16.5 | 13.7 | 9.9 | 8.1 |
| TV Today | 51.1 | 3.2 | 27.1 | 26.1 | 28.5 | 6.2 | 4.8 | 1.4 | 0.5 | 24.3 | 24.3 | 6.5 | 5.7 | 1.5 | 0.6 |
| TV18 | 118.3 | 14.1 | 24.5 | 29.9 | 36.5 | 21.4 | 12.6 | 10.0 | 6.1 | 29.6 | 33.7 | 34.0 | 24.1 | 11.2 | 8.2 |
| UTV | 658.2 | 22.5 | 14.6 | 11.7 | 14.6 | 43.8 | 28.8 | 20.9 | 12.5 | 8.5 | 13.2 | 50.5 | 34.2 | 31.7 | 17.6 |
| WWIL | 11.7 | 2.5 | (6.7) | (2.1) | 3.8 | (2.3) | (1.9) | (110.9) | 43.7 | 3.6 | 5.8 | (3.5) | (3.1) | 67.1 | 36.7 |
| Zee Entertainment | 163.0 | 70.6 | 29.5 | 30.6 | 32.4 | 14.9 | 11.5 | 10.4 | 7.9 | 29.2 | 28.7 | 16.2 | 13.6 | 10.9 | 9.4 |
| Zee News | 32.2 | 7.7 | 19.2 | 19.9 | 23.3 | 13.2 | 9.1 | 8.3 | 5.5 | 18.7 | 20.2 | 14.6 | 11.6 | 9.2 | 7.1 |

*Source: IDFC – SSKI Research*

## ❑ Profits could shrink significantly

Slower growth traction would significantly dent profitability given the high operating leverage in the business as also a small base. We see EBITDA growth to drop sharply, with a few segments witnessing a decline. Besides growth slowdown, other factors to likely impact the space:

- Intensifying competition in the broadcast space could lead to deterioration in cost structures due to higher content, people retention and carriage costs.
- Print media is witnessing pressure on account of higher newsprint prices.
- As multiplex industry would grow on the back of new screen addition and existing screens are witnessing a decline in footfalls, margin profile could deteriorate.

## ❑ Financing risks

Barring print media companies and a few players like UTV and NDTV that have recently raised funds, most of our media universe is leveraged and is thus exposed to the risk of higher interest rates. Players like Fame India and Prime Focus run a risk of non-conversion of FCCBs. Though conversion is still some time away (2011-2012), the risk is for real. Prime Focus had raised USD55m through FCCB issuance (70% of the current market capitalization) to be converted at Rs1388 per share (5x the current value). Similarly, Fame India has pending FCCB conversion of USD13m (90% of the current market capitalization) to be converted at Rs90 and Rs107 per share in two tranches (~5x the CMP). Our numbers build in non-conversion of pending FCCBs, which would translate into higher interest expenses.

**Chart: Quantum of pending FCCBs**

| Company | Outstanding FCCB (USD m) | Current Market Cap (USD m) | Conversion Price (Rs) | CMP (Rs m) | PAT – FY08 (Rs m) |
|---|---|---|---|---|---|
| Prime Focus | 55 | 78 | 1388 | 260 | 288 |
| Fame India | 13 | 15 | 90/107 | 18 | 121 |

*Source: IDFC – SSKI Research*

## ❑ Investment outlook

With high correlation of media industry to the macroeconomic environment, stiff execution challenges across segments and concerns on growth funding, we see little merit in investing in these stocks in the near term. While we have always had concerns over value creation potential in print, multiplex and radio industry, we also recently turned negative on broadcasting in the wake of high execution risk. We maintain our negative bias on Zee Entertainment, Dish TV and WWIL, while retain our positive bias on IBN18 post the recent success of *Colors* (emerged as number two GEC property).

## METALS AND MINING

Visibility on steel demand growth is rapidly receding, clouded by uncertainty on the extent as well as duration of the global financial crisis. A Chinese slowdown in now almost a reality and the debate has now shifted to what measures the government would adopt to spur domestic consumption. Back home in India, extremely tight liquidity conditions have edged banks to turn completely risk-averse to the commodities (metals) space, so much so that fund flows to meet even working capital requirements have dried up. Our trade channel checks suggest that in the absence of liquidity, dealers are unwilling to stock inventories and demanding higher credit period from companies; also, falling commodity prices have already put trade channels in an inventory clearance mode. With earnings highly leveraged to prices, commodity stocks are the most vulnerable.

We have analyzed the possible impact of the stress-case macroeconomic scenario on the metals and mining sector, as given below:

### ❑ Visibility on demand growth for steel has blurred

Demand forecasts for steel have changed considerably impacted by the global financial crisis. Demand could dip further as banks have plugged the lending stream to the steel sector, even for economically-viable projects. The severity of the demand crisis is indicated by IISI's (International Iron & Steel Institute) has eschewed from (probably a first in its history) coming out with its annual global steel demand projections, typically presented at the group's annual meeting. IISI has cited that "rapidly changing circumstances" stemming from the US-based global financial crisis makes it impossible to make reliable predictions.

### ❑ Slowdown in China is one of the biggest risks

Slowdown in China (the country accounts for more than 1/3rd of the global steel demand) is the biggest risk for the steel industry. We believe Chinese domestic consumption (and thereby exports) remains the key determinant of global steel prices. Chinese steel exports over the last three months have spiraled, which implies that Chinese consumption may not have sustained post the Olympics. Chinese steel exports for the month of August 2008 stood at 7.68m tonnes (up 43% yoy, 7% m-o-m) – consistently above 7m tpa for the last three months against the psychological level of 5m tpa).

There are various other pointers that are being interpreted by some quarters as early signs of an economic slowdown in China, especially considering the recent softening in monetary policy stance. Power generation, which has a strong correlation with a country's economic growth, has shown a steady decline since the second quarter of CY08. The past 8-month data by the China Electricity Council shows that in August, power generation of large scale plants increased only 5.1% (against 15% for the corresponding month last year), and is up only 3% compared to July numbers, the lowest growth rate in the last 10 years. Other key industries, particularly car making, are also showing signs of a downturn. According to data, auto sales fell 6.3% in August, having already been in the doldrums for several months due to slackening domestic demand. Besides the slowdown in domestic sales, growth in car exports has been much lower, thereby pushing inventories up to a new high in the recent years. The growth rate of container throughput, another valuable economic indicator and closely related to exports, stands at 16% for the previous eight months of CY08, down 7%yoy. Further, there has been significant increase in Chinese durables inventory.

### ❑ Tight liquidity emerging as another key risk

Being capital-intensive in nature, the metals sector is highly dependent on banks and financial institutions for term lending as well as working capital financing. Our interaction with domestic steel manufacturers and trade channels confirms that new projects are witnessing a squeeze in term lending. Thus, we see the risk of delay in financial closure looming large for new projects. Even in cases where financial closure has been achieved, some projects are facing delays in sanctions for term loans. Banks are also re-negotiating contract terms to accommodate the higher credit risk. Working capital credit, comfortable so far, has become dearer in the last few days due to the tight liquidity scenario. Further, given the shortage of dollar buyers/ suppliers, credit and bill discounting is becoming increasingly difficult. Trade channels too are facing a squeeze on working capital funding from banks. Most quarters expect cost of borrowing to increase further (at least in the short term) despite the steps taken to ease liquidity. Our trade channel checks suggest that in the absence of liquidity, dealers are unwilling to stock inventories and demanding higher credit period from companies; also, falling commodity prices have already put trade channels in an inventory clearance mode. Overall, we expect delay in financial closure for new greenfield projects and a 100-150bp increase in cost of working capital loans. As steel projects are long-gestation projects, we expect impact of higher term rates to be capitalized in the near term, which in turn would lead to cost overruns.

### ❑ Stocks are cheap; but no triggers in sight – maintain Neutral on steel sector

Steel stocks are cheap but demand visibility and pricing will have to return to drive a re-rating in multiples and generate buying interest. Over the years, raw material contract prices have largely set the tone for steel price movement. Raw material contract prices were so far assumed to at least remain steady (if not increase further) when they come up for renegotiations in Q1CY09, and hence provide support to steel prices. However, the rapid narrowing of the spread between spot and contract prices indicates that the market is now not fully convinced of raw material prices holding up for the next year. While this may be positive for convertors (non-integrated steel players), we believe steel players rush to clear off their inventories in a falling raw material price scenario, and inadvertently trigger a disproportionate slide in end product prices in the interim. Steel stocks have corrected sharply (26-74% YTD), and are available at attractive valuations (1/3rd of their replacement costs). Though we reckon that stocks would return to fair valuations, we do not see any re-rating trigger in the near term. We await news flow on raw material contract negotiations before reviewing our call on the sector. Even though the current valuations are undoubtedly attractive, we believe emerging uncertainties around Chinese economy would continue to impinge on stock performance. In view of the near-term risk and with no likely triggers in the short term, we remain Underweight on the sector and are lowering our stock recommendations to Neutral.

### ❑ Worst case earnings analysis suggests significant risk to earnings

Below, we present a worst case stress analysis with possibility of 9-23% and 27-48% downgrade to our FY09 and FY10 earnings estimates respectively.

Key assumptions for worst case earnings in FY09:

- We have assumed a drop of US$70 and US$30/tonne in Q3 and Q4FY09 respectively in steel prices.
- We have assumed iron ore spot prices to correct to USD 105/ tonne for companies buying iron ore in the spot market (JSW Steel, Monnet, etc)

Key assumptions for worst case earnings in FY10:

- We have assumed a sharp 18-22% correction in steel prices in FY10 over our base case estimates of FY09. We have assumed benchmark HRC prices to correct to USD 650/tonne.
- We have assumed a 35% correction in freight cost over the average cost in FY09. We have assumed iron ore and coking coal prices to correct to USD 90/tonne and USD 240/tonne respectively.
- Our numbers are based on exchange value of Rs43 per USD.
- Our numbers assume 100-125bp increase in cost of borrowing in FY10.

**Stress case earnings sensitivity: Potential downside of 27-48% in FY10 earnings**

| | FD EPS FY08 (Rs) | Base case estimates: Rev CAGR FY08-10 (%) | EBIDTA CAGR FY08-10 (%) | FD EPS (Rs) FY09 (Rs) | FD EPS (Rs) FY10 (Rs) | EPS CAGR FY08-10 (%) | Pessimistic case estimates: Rev CAGR FY08-10 (%) | EBIDTA CAGR FY08-10 (%) | FD EPS (Rs) FY09 (Rs) | FD EPS (Rs) FY10 (Rs) | EPS CAGR FY08-10 (%) | Potential downside FY09 (%) | Potential downside FY10 (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| SAIL | 18.2 | 17.0 | 7.0 | 18.7 | 19.1 | 2.0 | 8.0 | (9.0) | 16.2 | 14.0 | (12.0) | 13.6 | 26.8 |
| Monnet Ispat | 31.3 | 40.0 | 60.0 | 59.0 | 71.0 | 51.0 | 21.0 | 35.0 | 52.1 | 44.3 | 19.0 | 11.8 | 37.6 |
| JSW Steel | 81.6 | 49.0 | 33.0 | 102.6 | 134.9 | 29.0 | 50.0 | 20.0 | 83.0 | 83.7 | (1.0) | 19.1 | 37.9 |
| Tata Steel | 56.4 | 13.0 | 10.0 | 76.2 | 66.6 | 9.0 | 12.0 | (7.0) | 69.5 | 43.0 | (13.0) | 8.8 | 35.5 |
| Tata Steel (Consol.) | 148.5 | | 9.0 | 114.9 | 125.8 | 9.0 | | (30.0) | 95.7 | 65.4 | (34.0) | 16.7 | 48.0 |
| JSPL | 82.6 | 58.7 | 60.6 | 194.2 | 231.8 | 67.5 | 51.7 | 47.0 | 150.9 | 168.5 | 42.8 | 22.3 | 27.3 |

*Source: IDFC – SSKI Research*

## ❑ Worst case earnings analysis suggests significant risk to earnings of non-ferrous companies

For our FY09 worst case estimates, we have assumed base metal prices for Q3FY09 at existing LME cash levels, and for Q4FY09 at LME 3-month forward levels. Despite most base metal prices trading below their marginal costs of production, we assume conservative LME prices for FY10 and expect stress case earnings for non-ferrous companies to be lower by 14-28% over the base case FY10 estimates. We also expect raw material prices to come down, as alumina prices are benchmarked to aluminum prices, and we have assumed other raw materials derived from crude prices to drop 10% in FY10. We expect worst-case earnings downgrade of 15-30% in FY09 and 17-32% in FY10 from base case estimates.

**Stress case earnings sensitivity: Potential downside of 17-42% in FY10 earnings**

| | FD EPS FY08 (Rs) | Base case estimates: Rev CAGR FY08-10 (%) | EBIDTA CAGR FY08-10 (%) | FD EPS (Rs) FY09 (Rs) | FD EPS (Rs) FY10 (Rs) | EPS CAGR FY08-10 (%) | Pessimistic case estimates: Rev CAGR FY08-10 (%) | EBIDTA CAGR FY08-10 (%) | FD EPS (Rs) FY09 (Rs) | FD EPS (Rs) FY10 (Rs) | EPS CAGR FY08-10 (%) | Potential downside FY09 (%) | Potential downside FY10 (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Nalco | 25.3 | 3.6 | (15.7) | 30.5 | 17.5 | (16.9) | (1.4) | (28.0) | 25.8 | 12.8 | (29.0) | 15.4 | 27.2 |
| Hindalco (S/A) | 17.9 | 12.6 | 0.1 | 16.0 | 11.3 | (20.4) | 11.9 | (3.5) | 13.0 | 9.4 | (27.4) | 18.8 | 17.0 |
| Hind. Zinc | 104.0 | (4.1) | (12.5) | 87.0 | 74.0 | (15.6) | (17.9) | (34.5) | 65.9 | 43.3 | (35.5) | 24.3 | 41.5 |
| Sterlite | 60.7 | 2.8 | (10.4) | 56.6 | 47.5 | (11.5) | (9.9) | (27.6) | 39.8 | 32.2 | (27.2) | 29.7 | 32.2 |

*Source: IDFC – SSKI Research*

## PHARMACEUTICALS

We maintain our view that given the insularity of demand for drugs from the global macroeconomic challenges, India Pharma's growth outlook for the next few years seems secure. In fact, the deteriorating government finances across the western world are likely to encourage higher usage of generics, which is even more positive for Indian generic players. The weakening of the rupee against major currencies including the USD will provide further growth impetus to this increasingly export-oriented sector barring instances of companies taking aggressive bets on currencies. The consistently improving outlook for the highly profitable and lower capital intensive domestic pharma market with improving pricing scenario and companies' willingness to create new demand drivers through penetration in newer markets like rural areas is another pillar of strength. Barring a potential risk to the one-off opportunities in select companies, e.g. Effexor XR launch for Sun Pharma and successful closure of outlicensing deals for Glenmark, we remain fairly positive on the core business growth outlook for most companies in the space. In fact, we believe the weaker rupee may even create upsides to our estimates across most players from 2HFY09 onwards. Further, as most of the players in the IDFC-SSKI Pharma Universe, barring Wockhardt and Ranbaxy, have fairly comfortable cash positions with low leverage along with modest capex requirements, the impact of elevated interest rates and squeezed liquidity will be limited. We do not visualize any material impact of the global macroeconomic challenges on earnings outlook for stocks in the IDFC-SSKI Pharma universe. Cipla, Sun Pharma, Lupin and Glenmark remain our top picks in the space.

## PIPES

We have analyzed the possible impact of stress-case macroeconomic scenario on the pipes sector:

- We expect WGSR's plate mill capacity to operate at 38% and 70% utilization levels for FY09 and FY10 respectively. We also see slabs-to-plate conversion margins decreasing from US$135/tonne in FY09E to US$110/tonne in FY10E.
- We have assumed a 10% drop in spread for SAW pipe business of WGSR, Jindal SAW and PSL.
- Based on this, our pipes universe could see worst-case earnings downgrade of 5-13% and 11-33% for FY09 and FY10 respectively. We see strong order book position and favorable currency movement to lend support to earnings of pipe companies in the medium term.

**Stress case earnings sensitivity: Potential downside of 11-34% in FY10 earnings**

| | | Base case estimates | | | | | Pessimistic case estimates | | | | | Potential downside | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS FY08 (Rs) | Rev CAGR FY08-10 (%) | EBIDTA CAGR FY08-10 (%) | FD EPS (Rs) FY09 (Rs) | FD EPS (Rs) FY10 (Rs) | EPS CAGR FY08-10 (%) | Rev CAGR FY08-10 (%) | EBIDTA CAGR FY08-10 (%) | FD EPS (Rs) FY09 (Rs) | FD EPS (Rs) FY10 (Rs) | EPS CAGR FY08-10 (%) | FY09 (%) | FY10 (%) |
| JSAW* | 114.4 | (17.0) | (4.7) | 50.3 | 67.3 | (23.3) | (20.2) | (9.7) | 46.9 | 59.8 | (27.7) | 6.8 | 11.2 |
| WGSR | 20.5 | 28.7 | 53.2 | 29.3 | 45.2 | 48.5 | 27.4 | 27.4 | 25.3 | 30.0 | 20.9 | 13.6 | 33.7 |
| PSL | 19.9 | 53.0 | 53.7 | 35.4 | 51.7 | 61.3 | 52.2 | 45.0 | 31.4 | 43.6 | 48.1 | 11.5 | 15.7 |
| MSL | 27.7 | 20.9 | 32.2 | 36.7 | 43.7 | 25.6 | 19.1 | 23.0 | 34.8 | 37.3 | 16.1 | 5.3 | 14.6 |

*Note: *Numbers are CY07-09 ; Source: IDFC – SSKI Research*

### ❑ Conclusion

Within our pipe universe, WGSR would take the maximum hit if its plate mill were to take longer than anticipated to stabilize. We see the minimum risk to earnings of Maharashtra Seamless, primarily on the back of a sharp fall in raw material cost (of billets), favorable currency movement and return of pricing power.

## POWER EQUIPMENT

Our current estimates for Power Equipment companies factor in 22-35% revenue CAGR and 14-35% earnings CAGR over FY08-10. Below, we analyze the likely impact of the prevailing macroeconomic environment on earnings of power equipment companies:

- **Revenues:** Despite strong order book positions, we have cut our FY09 and FY10 revenue estimates by 5-10% to factor in possible delays in project execution due to the tight liquidity conditions.
- **Operating margins:** For stress case earnings estimates, we have lowered our operating margin assumptions for power equipment companies by up to 100bp on the premise that lower revenue growth would adversely impact margins due to negative operating leverage. This would lead to a 5-18% drop in our EBIDTA estimates.
- **Interest costs:** In general, we have assumed average borrowing costs of 11.5% for FY09 and 12-13% in FY10. The higher interest burden would impact earnings by 5-25%.

**Stress case earnings sensitivity – potential downside of 13-27% in FY10E earnings**

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| ABB | 23.2 | 31.1 | 42.3 | 31.6 | 35.7 | 34.9 | 29.9 | 34.3 | 23.6 | 22.5 | 21.5 | 3.9 | 18.9 |
| BHEL | 56.7 | 71.6 | 95.9 | 27.4 | 32.7 | 30.1 | 66.0 | 83.8 | 20.9 | 22.7 | 21.6 | 7.8 | 12.6 |
| Emco | 10.7 | 13.8 | 18.6 | 36.1 | 31.9 | 32.0 | 12.0 | 13.5 | 28.4 | 19.2 | 12.2 | 12.5 | 27.8 |
| Crompton | 11.1 | 13.7 | 17.5 | 22.1 | 22.9 | 25.4 | 12.2 | 13.6 | 16.4 | 12.9 | 10.8 | 11.0 | 22.0 |
| KEC | 34.9 | 37.0 | 45.2 | 23.0 | 11.6 | 13.9 | 31.5 | 35.6 | 18.0 | 2.3 | 1.0 | 14.8 | 21.2 |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | | | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | CMP | Mcap | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rs bn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| ABB | 640 | 136 | 12.2 | 12.8 | 13.0 | 20.6 | 15.1 | 23.8 | 17.0 | 12.5 | 12.0 | 21.4 | 18.7 | 24.7 | 20.6 |
| BHEL | 1351 | 661 | 17.7 | 17.9 | 19.2 | 18.9 | 14.1 | 17.4 | 12.4 | 17.1 | 18.2 | 20.5 | 16.1 | 19.0 | 14.3 |
| Emco | 55 | 3 | 13.7 | 13.0 | 12.8 | 4.0 | 3.0 | 2.6 | 2.1 | 12.5 | 11.8 | 4.6 | 4.1 | 2.7 | 2.3 |
| Crompton | 185 | 68 | 10.9 | 10.9 | 11.0 | 13.5 | 10.6 | 7.8 | 6.1 | 10.5 | 10.3 | 15.1 | 13.6 | 8.6 | 7.6 |
| KEC | 235 | 12 | 12.6 | 10.7 | 10.4 | 6.3 | 5.2 | 4.5 | 3.7 | 10.0 | 9.5 | 7.5 | 6.6 | 5.0 | 4.5 |

*Source: IDFC – SSKI Research*

### ❑ Conclusion

Overall, we see power equipment companies to witness a relatively softer impact of an economic slowdown, given the high visibility on revenues by way of robust order backlogs and their strong balance sheets. Moreover, we expect sustained momentum in order flow as power capex, especially on generation and that planned by the central and state utilities, is unlikely to significantly slowdown. We prefer BHEL as our top pick in the sector considering its robust order backlog (4.9x FY08 revenues) and extremely strong balance sheet.

## POWER UTILITIES

Power utilities operate on a fixed return on equity basis, wherein all costs are recovered from end-consumers. Therefore, we do not see any impact of rising costs or increasing interest costs on earnings of these companies. We also do not see any impact on power sales/ generation, considering the high levels of power deficit in the country. However, we have cut our revenue assumptions for Reliance Infrastructure's EPC business by 5% for FY09 and 10% for FY10, to account for any slowdown in execution of projects. We have also moderated our operating margin assumptions for the EPC business by 100bp to factor in any impact of rising costs.

**Stress case earnings sensitivity: Limited/No impact on earnings**

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| Rel Infra | 40.7 | 49.5 | 57.3 | 21.8 | 25.4 | 24.0 | 48.3 | 55.4 | 19.6 | 20.8 | 21.9 | 2.4 | 3.3 |
| Tata Power | 25.2 | 26.4 | 28.4 | 5.6 | 15.5 | 12.5 | 26.4 | 28.4 | 0.1 | 0.2 | 0.1 | 0.0 | 0.0 |
| NTPC | 9.2 | 10.1 | 11.6 | 14.8 | 15.0 | 12.4 | 10.1 | 11.6 | 0.1 | 0.2 | 0.1 | 0.0 | 0.0 |
| CESC | 26.2 | 29.9 | 32.5 | 10.1 | 14.6 | 11.3 | 29.9 | 32.5 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 |
| PTC | 3.2 | 2.9 | 4.2 | 53.2 | 66.1 | 40.4 | 2.9 | 4.2 | 0.5 | 0.7 | 0.4 | 0.0 | 0.0 |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | | | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | CMP | Mcap | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rs bn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| Rel Infra | 513.9 | 121.5 | 7.8 | 7.4 | 8.3 | 10.4 | 9.0 | 16.7 | 2.6 | 7.1 | 8.0 | 10.6 | 9.3 | 17.7 | 2.9 |

*Source: IDFC – SSKI Research*

### ❑ Conclusion

Power utilities are expected to be largely insulated from an economic slowdown, as demand for electricity is unlikely to be impacted given the acute power deficit in the country. Moreover, power utilities operate on a guaranteed RoE basis and therefore we view them as defensive bets in a slowing economy. Within the sector, we prefer Reliance Infrastructure as our key pick considering the stable earnings and cash flows from its existing distribution businesses, high visibility on EPC earnings from a robust order backlog (3.5x FY08 revenues), Rs40bn of net cash on books and equity funding being tied up for Reliance Power.

## RETAIL

Changes in key assumptions to factor in the stress-case macroeconomic factors:

- Weakening sentiment and the liquidity crisis could badly hit the emerging retail industry. Slowing demand, lack of funding for retailers as well as real estate developers could hurt rollout plans.
- Building in the delays, our worst case sq. ft estimate for Pantaloon Retail could be 13.2m by FY10 (standalone) as against our base case estimate of 15.5m sq. ft. We also see Shopper's Stop's sq. ft addition to be lower by 25-30%.
- While for Titan and Provogue, it is not all about sq. ft addition, slowdown in lifestyle business could impact growth.
- In the worst case scenario, revenue CAGR of retail industry could be lower by ~10% than base case estimates for FY08-10.
- However, business economics would tend to improve for incumbent retailers (Pantaloon Retail in particular) as slowdown in retail growth would alleviate pressure on rentals, people cost and marketing spends.
- With ongoing liquidity concerns and building in non conversion of pending warrants, we have assumed a higher interest outflow on Pantaloon Retail's leveraged book (debt of Rs22bn). We see a worst case downside of 25% in EPS from our base case estimates for FY09.
- Provogue is well capitalized for growth – both in Provogue and Prozone. Provouge has raised Rs3bn in Provogue and Rs5bn in one of the SPVs of Prozone.

**Stress case earnings sensitivity: Potential downside of 18-58% in FY10 earnings**

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| Pantaloon Retail | 7.6 | 11.5 | 16.9 | 43.5 | 41.4 | 49.0 | 8.6 | 13.2 | 34.1 | 34.9 | 28.4 | 25.2 | 21.9 |
| Provogue | 2.2 | 3.1 | 4.2 | 31.2 | 35.9 | 37.7 | 2.8 | 3.5 | 23.4 | 22.9 | 25.0 | 10.0 | 17.5 |
| Shopper's Stop | 0.8 | (2.6) | 13.5 | 55.8 | 98.9 | 321.0 | (8.1) | 5.7 | 38.6 | 69.3 | 173.1 | n/a | 57.9 |
| Titan | 33.1 | 44.8 | 61.2 | 30.0 | 32.1 | 35.9 | 40.6 | 51.1 | 20.8 | 22.3 | 24.2 | 9.5 | 16.5 |

*Source: IDFC – SSKI Research*

**Base case vs Stress case valuations**

| | | | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | CMP | Mcap | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rsbn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| Pantaloon Retail | 219.3 | 36.3 | 9.1 | 9.3 | 8.8 | 19.1 | 13.0 | 7.5 | 6.6 | 9.1 | 9.2 | 25.6 | 16.7 | 8.5 | 7.2 |
| Provogue | 124.0 | 14.5 | 14.3 | 14.9 | 15.3 | 39.9 | 29.6 | 20.6 | 16.3 | 13.6 | 14.2 | 44.3 | 35.8 | 24.2 | 19.8 |
| Shopper's Stop | 203.8 | 7.1 | 4.7 | 5.0 | 7.7 | (77.3) | 15.1 | 14.2 | 6.6 | 3.9 | 7.1 | (25.1) | 35.8 | 14.8 | 6.3 |
| Titan | 822.2 | 36.5 | 7.7 | 7.7 | 7.9 | 18.4 | 13.4 | 12.4 | 9.2 | 7.7 | 7.9 | 20.3 | 16.1 | 13.3 | 10.7 |

*Source: IDFC – SSKI Research*

### ❑ Investment case

We believe that price correction in Pantaloon Retail has been ahead of the pessimistic case deterioration in business economics. PRIL is now trading at 17x FY10E earnings and the core retail business is trading at less than 13x FY10E earnings (net of other ventures). Maintain Outperformer.

## OUR KEY THEMES

**Sectors under earnings stress:** Our analysis reveals that the following sectors/ companies are significantly vulnerable to signs of distress in the economy:

- Construction/ Engineering Companies – As clients go slow on expansion plans (especially for greenfield projects), our worst-case estimates indicate a potential downside due to possible delays in project execution or deferment of projects given the tight liquidity conditions.
- Metals – Visibility on steel demand growth is receding, clouded by uncertainty on the extent as well as duration of the global financial crisis. On the domestic front, extremely tight liquidity conditions have edged banks to turn completely risk-averse to the commodities.
- Retail – As consumer spending slows down, and liquidity dries up further (translating into lack of funding) could delay rollout plans.
- Media – Slowdown in ad spends, highly leverage balance sheets make media companies more vulnerable to the economic slowdown.
- Smaller banks – Moderation in credit growth, rising NPAs and slump in fee income growth could hit smaller banks more severely than the larger ones as fee income forms a higher proportion of overall income. Additionally, these banks will have to increasingly rely on bulk deposits – this would further dent their margins.

**Relatively safer havens:** These comprise defensive plays on economy and companies with stronger balance sheets and relatively more insulated to economic downturns.

- Utilities – These companies operate on a fixed return on equity basis, wherein all costs are recovered from end-consumers, and are therefore largely immune to an economic downturn.
- Large PSU Banks – Losses due to high provisioning costs would be offset by significant gains on G-Sec portfolios. While credit growth will remain robust, low exposure to sensitive sectors offers comfort.
- In the private banks space, HDFC Bank is the least vulnerable to earnings stress.
- Pharmaceuticals – Companies are largely insulated from economic upheavals, and visibility on earnings as also favourable currency movement would be positive triggers.
- Consumer goods – Defensive plays, brands with strong pricing power (such as HUL) would benefit more than smaller companies.

Notably, interest rate/ capex cycle plays have been hammered on the bourses given their high sensitivity to economic downturns. The stocks are available at extremely attractive valuations even after factoring in the worst case earnings, and totally ignoring embedded values. Larger stocks within these sectors which also have stronger balance sheets will see a sharp rebound with small deltas in the economic landscape, global or local. Our preferred picks within these sectors are BHEL, Reliance Infra and Mundra Port & SEZ in the infra space; and large PSU Banks, ICICI Bank and HDFC Bank among financials. We also like companies within the consumer goods sector, specifically FMCG and two-wheeler stocks, as we believe that any cyclical upturn in the economy (emanating from implementation of Sixth Pay Commission recommendations, consistently higher farm incomes and farm loan waiver) can catalyze growth. To balance the portfolio, we recommend investing in HUL within the FMCG space, Bajaj Auto in the two-wheeler space and Cipla among pharma companies, which are our defensive bets. We would refrain from investing in commodities, small banks, media and retail considering the significant downside risk to their earnings.

## OUR PORTFOLIO STANCE

### Preferred picks

| | Base case estimates | | | | | | Pessimistic case estimates | | | | | Potential downside (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FD EPS (Rs) | | | FY08-10 CAGR (%) | | | FD EPS (Rs) | | FY08-10 CAGR (%) | | | | |
| | FY08 | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E | Revs | EBITDA | EPS | FY09E | FY10E |
| Bajaj Auto | 60.1 | 56.8 | 64.0 | 9.4 | 2.9 | 3.2 | 55.4 | 62.8 | 7.8 | 1.3 | 1.5 | 2.4 | 3.3 |
| Hero Honda | 48.5 | 62.1 | 70.1 | 12.6 | 14.2 | 20.3 | 57.9 | 65.4 | 10.2 | 11.6 | 16.2 | 6.9 | 6.7 |
| HUL | 8.1 | 9.7 | 11.4 | 14.9 | 19.3 | 18.6 | 9.4 | 10.4 | 14.1 | 12.5 | 13.2 | 3.2 | 8.9 |
| BHEL | 56.7 | 71.6 | 95.9 | 27.4 | 32.7 | 30.1 | 66.0 | 83.8 | 20.9 | 22.7 | 21.6 | 7.8 | 12.6 |
| Rel Infra | 40.7 | 49.5 | 57.3 | 21.8 | 25.4 | 24.0 | 48.3 | 55.4 | 19.6 | 20.8 | 21.9 | 2.4 | 3.3 |
| MPSEZ | 5.1 | 13.8 | 29.5 | 81.5 | 85.6 | 141.3 | 12.4 | 22.8 | 73.1 | 73.9 | 112.4 | 10.3 | 22.5 |
| Concor | 57.7 | 68.0 | 77.4 | 17.3 | 16.3 | 15.3 | 64.7 | 71.8 | 15.4 | 13.7 | 11.5 | 4.8 | 7.2 |

*Source: IDFC – SSKI Research*

| | NII | | | | Operating profit | | | | PAT | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FY08-10 CAGR | | % change | | FY08-10 CAGR | | % change | | FY08-10 CAGR | | % change | |
| | Stressed case | Base case | FY09 | FY10 | Stressed case | Base case | FY09 | FY10 | Stressed case | Base case | FY09 | FY10 |
| State Bank of India | 12 | 12 | (3) | (1) | 13 | 16 | (8) | (5) | 7 | 10 | (4) | (6) |
| ICICI Bank (stand-alone) 2 | 16 | 21 | (3) | (8) | 18 | 22 | (11) | (6) | 5 | 16 | (11) | (17) |
| HDFC Bank | 29 | 33 | (2) | (5) | 27 | 32 | (4) | (8) | 25 | 37 | (7) | (16) |

*Source: IDFC – SSKI Research*

### Base case vs Stress case valuations

| | CMP | Mcap | Base case estimates | | | | | | | Pessimistic case estimates | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | OPM (%) | | | PE (x) | | EV/EBIDTA (x) | | OPM (%) | | PE (x) | | EV/EBIDTA (x) | |
| | (Rs) | (Rs bn) | FY08 | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E | FY09E | FY10E |
| Bajaj Auto | 460 | 66.5 | 14.5 | 12.5 | 12.8 | 8.1 | 7.2 | 5.3 | 4.5 | 12.2 | 12.8 | 8.3 | 7.1 | 5.4 | 4.7 |
| Hero Honda | 816 | 163.0 | 13.1 | 12.9 | 13.4 | 13.1 | 11.6 | 9.0 | 7.4 | 12.7 | 13.4 | 14.1 | 12.5 | 9.0 | 8.1 |
| HUL | 222 | 483 | 13.7 | 14.3 | 14.8 | 22.8 | 19.4 | 19.8 | 16.3 | 13.4 | 13.3 | 23.6 | 21.3 | 22.2 | 19.7 |
| BHEL | 1351 | 661 | 17.7 | 17.9 | 19.2 | 18.9 | 14.1 | 17.4 | 12.4 | 17.1 | 18.2 | 20.5 | 16.1 | 19.0 | 14.3 |
| Rel Infra | 514 | 121.5 | 7.8 | 7.4 | 8.3 | 10.4 | 9.0 | 16.7 | 2.6 | 7.1 | 8.0 | 10.6 | 9.3 | 17.7 | 2.9 |
| MPSEZ | 349 | 140.0 | 65.4 | 68.2 | 68.3 | 25.3 | 11.9 | 17.9 | 8.7 | 68.0 | 66.1 | 28.2 | 15.3 | 18.6 | 10.1 |
| Concor | 733 | 95.3 | 26.6 | 27.3 | 26.6 | 10.8 | 9.5 | 12.6 | 10.7 | 26.6 | 25.8 | 11.3 | 10.2 | 7.0 | 5.7 |

*Source: IDFC – SSKI Research*

| | Price | M cap | EPS | | | | ROE (%) | | | | Price/Book Value | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | FY08-10 CAGR | | % change | | FY09 | | FY10 | | FY09 | | FY10 | |
| | | | Stressed case | Base case | FY09 | FY10 | Stressed case | Base case | Stressed case | Base case | Stressed case | Base case | Stressed case | Base case |
| SBI | 1353 | 854.1 | 7 | 10 | (4.4) | (6.5) | 13.7 | 14.3 | 13.3 | 14.1 | 1.56 | 1.23 | 1.40 | 1.08 |
| ICICI Bank | 364 | 404.7 | 5 | 16 | (11.0) | (17.0) | 5.9 | 8.8 | 5.6 | 10.7 | 0.50 | 0.81 | 0.48 | 0.74 |
| HDFC Bank | 1048 | 441.6 | 21 | 32 | (6.9) | (16.1) | 15.8 | 16.9 | 15.6 | 18.3 | 3.00 | 2.98 | 2.79 | 2.76 |

*Source: IDFC – SSKI Research*

| | CMP | Mkt cap | EPS | | | EPS CAGR(%) | P/E (x) | | EV/EBITDA (x) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | (INR) | (Rs. bn) | FY08E | FY09E | FY10E | FY08-FY10 | FY09E | FY10E | FY09E | FY10E |
| Cipla | 194 | 151.1 | 9.1 | 11.1 | 13.0 | 19.8 | 17.5 | 14.9 | 18.8 | 15.3 |

*Source: IDFC – SSKI Research*

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