Strategy In-Depth

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India Equity Strategy

Margin Trends, Earnings Surprises, Sector Choice

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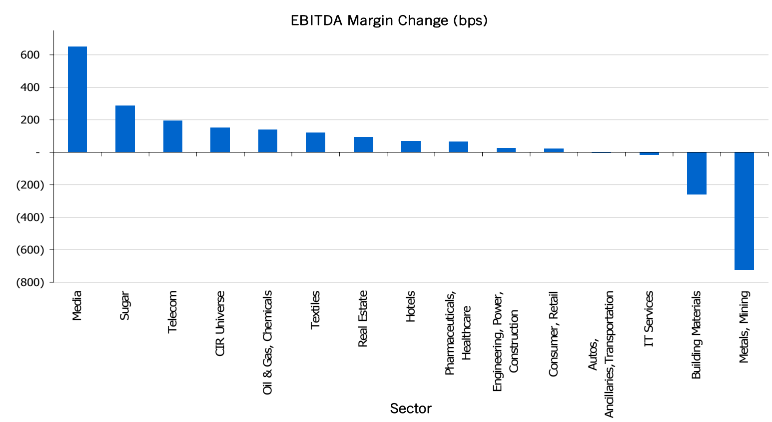
- Margin surprises can be big drivers of earnings surprises — Even when consensus gets the direction of margin changes right, the quantum of change can often be under-estimated, leading to earnings surprises and stock performance.
- As operating leverage runs out, big surprises will be fewer — We expect overall earnings growth in India to moderate to around 15% over FY07-09, vs. 25-30% in the last 5 years. As aggregate profit growth moderates on lack of operating leverage, the extent of margin and profit surprises will significantly decline.
- Factors driving margin surprises ahead — Strong demand growth, cost factors (higher premises and wage costs), impact of higher interest rates and currency appreciation will be the key drivers of margin surprises in FY08. For the Citigroup India coverage universe (138 companies), we expect margins to hold in FY08 and FY09 despite the above challenges.
- Sectors where we foresee significant margin change — We expect the biggest margin gainers in FY08 to be Media, Telecoms and Upstream Oil. Not surprising, as these are sectors that structurally have high operating leverage. Significant margin declines are being forecast mainly in the Building Materials and Metals sectors.

Figure 1. India - Sectoral EBITDA Margins Change FY08E over FY07E (bps)



Source: Citigroup Investment Research

See Appendix A-1 for Analyst Certification and important disclosures.

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Margin Trends Dictate Earnings Surprises, Sector Choice

Margin surprises can be a big driver of earnings surprises and stock performance. Even when consensus estimates get the direction of margin change right, the quantum of that change can often be under-estimated, leading to earnings surprises. In this note, we highlight sectors and stocks where we expect the most margin change in FY08.

As operating leverage runs out, big earnings surprises will be fewer

After 5 years of 25-30% earnings, we expect Sensex ex-oil earnings growth to moderate to around 15% over the next 2 years. As operating leverage runs out, despite high top-line growth, margin surprises will be fewer. That, we expect, will mean fewer earnings surprises and to a lesser extent.

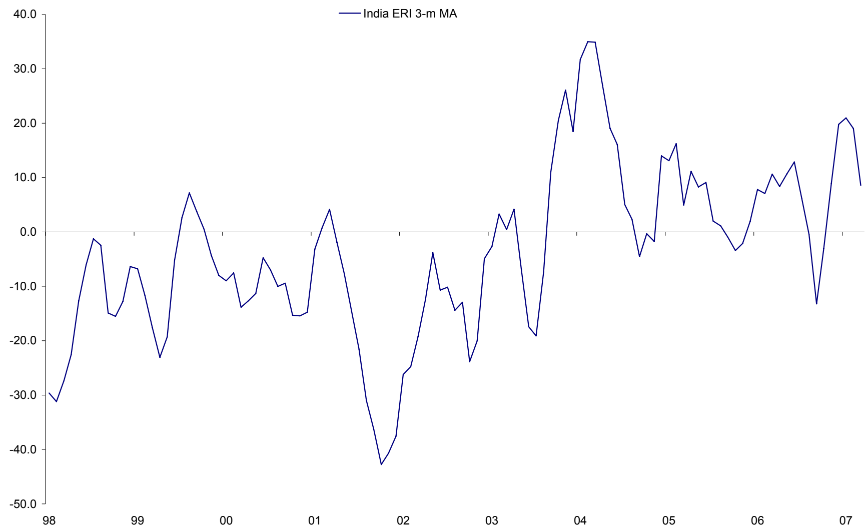
Figure 2. Sensex: Valuation Summary @14303

Year to 31 March	FY05	FY06	FY07E	FY08E	FY09E
EPS growth (%)	36.50%	23.0%	34.8%	13.6%	12.0%
P/E (x)	32.8	26.6	19.8	17.4	15.5
Div. yield (%)	1.0%	1.1%	1.3%	1.6%	1.7%
P/B (x)	6.8	5.8	4.9	3.9	3.3
ROAE (%)	24.3%	24.6%	27.0%	25.2%	23.8%
EV/EBITDA* (x)	19.5	17.3	13.7	11.4	10.0
Net Debt/Equity* (%)	12%	15%	11%	7%	2%
EPS	436.5	537.1	723.7	822.4	921.1
EPS growth ex-oil (%)	31.40%	28.8%	36.9%	14.8%	15.6%
P/E ex-oil	39.4	30.6	22.3	19.4	16.8

Source: Citigroup Investment Research. * ex-financials

Higher interest rates, tighter liquidity and rapid currency appreciation have already moderated estimates somewhat. India's Earnings Revisions Index (ERI) has turned down in recent months (see Figure 2) capturing some of that caution, although it still remains in the positive territory.

Figure 3. India 3-month Earnings Revision Index



Source: Citigroup Investment Research, IBES. Note: Earnings Revisions Index = (No of companies with earnings being revised up – No of companies being revised down)/Total number of companies being revised

Before we look at margin trends across sectors, it is important to see where India's forecast earnings growth is coming from to determine whether any segment is at risk from our margin expectations. For FY08, most of Sensex earnings growth is being contributed by four sectors - Telecoms (26% of total), IT Services (24%), Capital Goods (17%) and Banks (16%). Contribution to growth by these sectors is similar (83%) for FY09. So clearly, any risk to margin forecasts in these sectors can have the most influence on overall earnings.

Figure 4. Sectoral Contributions to Sensex Earnings Growth

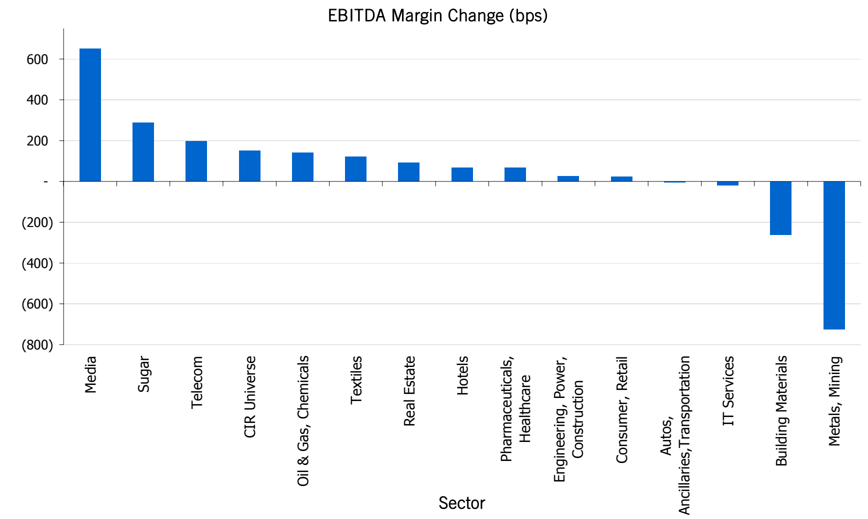
Sector	FY08E	FY09E
Autos, Ancillaries, Transportation	7.3%	7.3%
Engineering, Power, Construction	16.7%	12.2%
Metals, Mining	-3.0%	4.9%
Building Materials	-3.2%	-5.9%
Consumer, Retail	3.1%	6.5%
Pharmaceuticals, Healthcare	1.3%	3.3%
IT Services	24.3%	26.4%
Telecom	25.8%	20.7%
Oil & Gas, Chemicals	11.6%	1.4%
Banks, Financial Services	16.2%	23.2%

Source: Citigroup Investment Research

Sectoral margin expectations

For the Citigroup India coverage universe (138 companies), we expect EBITDA margins to hold well over FY08 and FY09 despite some of the challenges mentioned earlier (cost inflation in office rentals, wages, higher interest rates potentially slowing demand, currency appreciation) . EBITDA margins for Citigroup India universe ex-oil are expected to be 22.1% in FY07, 22.3% in FY08 and 22.4% in FY09.

Figure 5. India - Sectoral EBITDA Margins Change FY08E over FY07E (bps)



Source: Citigroup Investment Research

Figure 6. Citigroup India Universe: Sectoral EBITDA Margins

Sector	FY05	FY06	FY07E	FY08E	FY09E
Autos, Ancillaries, Transportation	14.0	13.2	12.1	12.1	11.3
Engineering, Power, Construction	17.2	17.4	18.1	18.3	18.7
Metals, Mining	36.2	34.6	33.8	26.6	26.7
Building Materials	24.4	24.6	34.2	31.6	26.4
Consumer, Retail	19.5	19.0	19.4	19.6	19.8
Sugar	26.5	28.8	13.1	16.0	16.9
Hotels	26.7	31.4	35.5	36.2	34.1
Media	26.4	20.0	22.6	29.1	33.2
Textiles	15.8	17.0	18.4	19.6	20.4
Pharmaceuticals, Healthcare	19.6	16.9	20.9	21.6	22.1
IT Services	26.9	25.8	25.2	25.0	24.7
Telecom	30.6	27.4	35.9	37.9	39.6
Oil & Gas, Chemicals	14.9	11.1	11.2	12.6	13.3
Real Estate	56.6	64.4	73.8	74.7	76.9
Citigroup India Universe	**17.1**	**14.5**	**15.6**	**17.1**	**18.1**
Citigroup India Universe ex-oil	**20.4**	**20.0**	**22.1**	**22.3**	**22.4**

Source: Citigroup Investment Research

The picture at the sectoral level is much more divergent. We expect to see significant margin improvements for Media, Telecom and Upstream Oil & Gas players. Not surprisingly, these are also sectors that structurally have high operating leverage. For them, when the growth and pricing environment is supportive (which is the case currently for all these sectors), then their margins should expand. Sugar is another sector where margins are expected to be better after hitting rock bottom in FY07, but improvement is mainly the base effect.

On the negative side, Building Materials and Metals are sectors likely to see the most margin erosion. In IT services, our forecasts do indicate margin erosion due to currency appreciation, but it is expected to be small (around 20-30bps) as high growth helps and companies take measures to combat currency and cost inflation challenges.

From the overall market earnings growth perspective, we note that key contributing sectors (IT Services, Telecom, Capital Goods and Banks) are quite well positioned on margins and potential surprises. Currency appreciation has caused much angst and discussion for the IT services sector in the last couple of months, leading to the sector's underperformance. As higher Rupee/US$ numbers have gotten built into forecasts for IT services companies and the pace of currency appreciation slows, we expect lesser negative surprises there.

These margin forecasts (and potential earning surprises driven by them) and sectoral contribution to the overall market's earnings growth are quite supportive of our recommended sector positioning for India. Citigroup India Model Portfolio suggests Overweight on Banks, Capital Goods, IT Services, Telecom and Consumer; Underweight on Energy, Materials including Metals, Pharmaceuticals and Utilities; and Neutral on Autos.

In Figure 6 below, we highlight companies where we expect the most significant margin changes in FY08, on the positive as well as negative side.

Figure 7. Select Companies With Significant EBITDA Margin Change In FY08 (Bps)

Rank	RIC	Company	Rating	Change
Gainers				
1	ANSP.BO	Ansal Properties & Infrastructure	3H	1,349
2	ABAN.BO	Aban Loyd Chiles Offshore	1H	906
3	CAST.BO	Castrol	1M	707
4	ZEE.BO	Zee	1L	674
5	HTML.BO	HT Media	1L	613
6	GLEN.BO	Glenmark Pharma	1M	539
7	TTML.BO	Tata Tele (Maharashtra)	1M	516
8	PARV.BO	Parsvnath Developers	3H	452
9	BACH.BO	Balrampur Chini Mills	1M	412
10	COLG.BO	Colgate-Palmolive India	1L	408
11	RLEN.BO	Reliance Energy	3L	392
12	GGAS.BO	Gujarat Gas	1L	370
13	GSPT.BO	Gujarat State Petronet	1M	343
14	SKCT.BO	Sasken Communication Technologies	1M	296
15	RLCM.BO	Reliance Communication Ventures	1M	296
Losers				
Rank	**RIC**	**Company**	**Rating**	**Change**
1	GATE.BO	Gateway Distriparks	1M	(992)
2	ACC.BO	ACC	3M	(634)
3	GACM.BO	Gujarat Ambuja	3M	(611)
4	SCI.BO	Shipping Corporation of India	3M	(568)
5	HALC.BO	Hindalco	3M	(542)
6	NALU.BO	Nalco	3M	(539)
7	GAMM.BO	Gammon India	1L	(398)
8	UNPO.BO	United Phosphorus	1L	(366)
9	ABGS.BO	ABG Shipyard	1M	(264)
10	BHAR.BO	Bharati Shipyard	1M	(247)
11	UNTE.BO	Unitech	3M	(175)
12	MTNL.BO	MTNL	3L	(116)
13	SATY.BO	Satyam Computers	1M	(93)
14	IPCL.BO	IPCL	2L	(92)
15	EKCL.BO	Everest Kanto Cylinder	1M	(90)

Source: Citigroup Investment Research

Appendix A-1

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