Strategy In-Depth

17 June 2007 | 7 pages

India Equity Strategy

Credit Moderation to Limit Positive Growth Surprises

Ratnesh Kumar[1]
+91-22-6631-9888
ratnesh.kumar@citi.com

Tirthankar Patnaik[2]
tirthankar.patnaik@citi.com

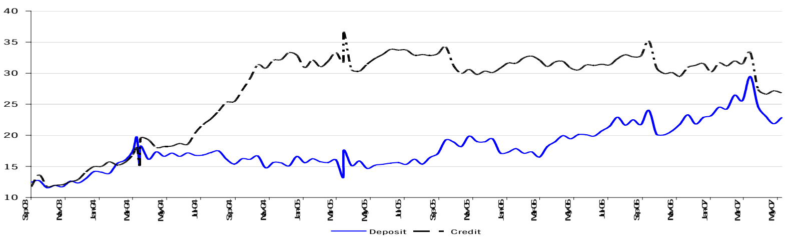
- **Credit growth is rapidly moderating** — Latest data on credit growth up to end-May indicates a growth of ~27% yoy (vs. 35% in the last couple of years). So the expected and desired credit moderation has already been set in motion. We expect it to slow further to around 22% in the next 3-4 months. Moderation in credit growth is welcome from an inflation and banking sector liquidity perspective.

- **Excess credit expansion one of the drivers of growth surprises** — Huge +35% credit expansion over the last couple of years has been one of the key factors driving significant growth surprise in India – for corporate earnings as well as the economy.

- **Dim chances of a repeat of last 2 years' earnings surprise** — The last couple of years have seen market earnings growth starting at 18-20% and ending at +30%. We do not think a repeat is likely, as moderate credit will limit positive demand surprises, while margin expansions will be limited by cost inflation and lack of operation leverage. Already, credit sensitive sectors like autos and real estate are showing a significant dip down in volumes.

- **Four sectors we prefer account for 75-80% of earnings growth** — IT services, Telecom/Media, Capital Goods and Financials account for 75-80% of incremental earnings growth we see in India over FY08 and FY09. Credit moderation is either already factored into those expectations or will not make a material impact.

Figure 1. India Trends in Credit Deposit Growth (Percent YoY)



Source: Citigroup Investment Research

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

[1]Citigroup Global Market India Private Limited; [2]Citigroup Global Markets India Private Limited

Credit Moderation to Limit Positive Growth Surprises

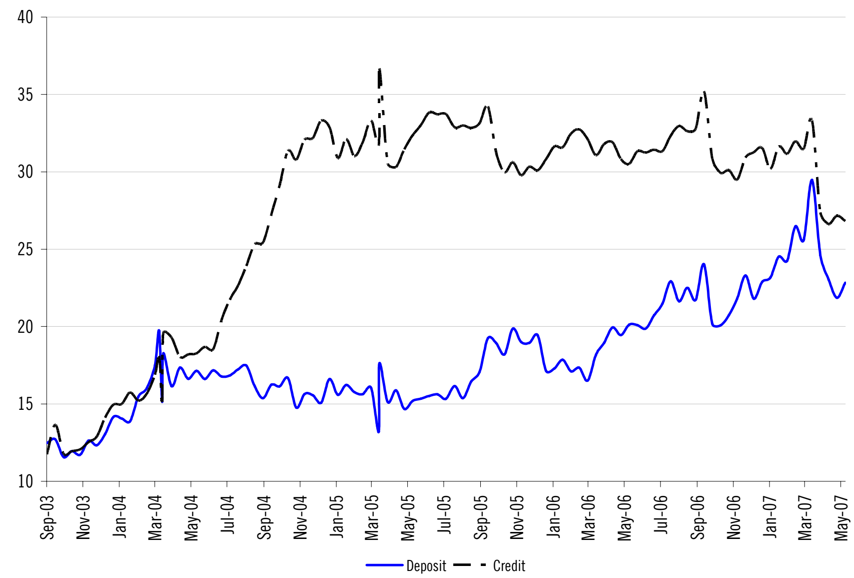
Scorching +35% credit growth over the last couple of years was a major driver of positive growth surprises in India- both in corporate earnings as well as for the overall economy. As the desired and expected credit moderation sets in, we argue that growth surprises of such extent will be harder to come by.

Credit growth is moderating, a welcome sign

Credit growth, after averaging around 35% over the last couple of years, is finally slowing down. The latest data up to end-May indicates credit growth of around 27%. In the next 3-4 months, we expect it to slow further to around 22%.

This credit moderation is very much desired from the point of view of inflation and banking sector liquidity. Inflation is already down to below 5%, and we expect further declines in the next couple of months, before it moves up again to end FY08 at around 5%. A moderate credit growth will help keep inflation under check. Credit moderation is along expected lines, as a series of interest rate hikes and liquidity tightening measures by the central bank over the last 6-12 months were intended to achieve just that.

Figure 2. India Trends in Credit Deposit Growth (Percent YoY)



Source: Citigroup Investment Research

Credit moderation to limit growth surprises

While moderation of excess credit growth is good from an inflation and banking sector liquidity perspective, it is bound to affect demand growth in many areas of the economy.

Already, we are seeing the impact on volume growth of certain highly credit sensitive sectors like automobiles and real estate. In the real estate sector, the problem of slower mortgage growth is affecting transaction volumes, which is being compounded by credit restrictions on developers.

Dim chances of a "three"-peat of huge earnings surprise

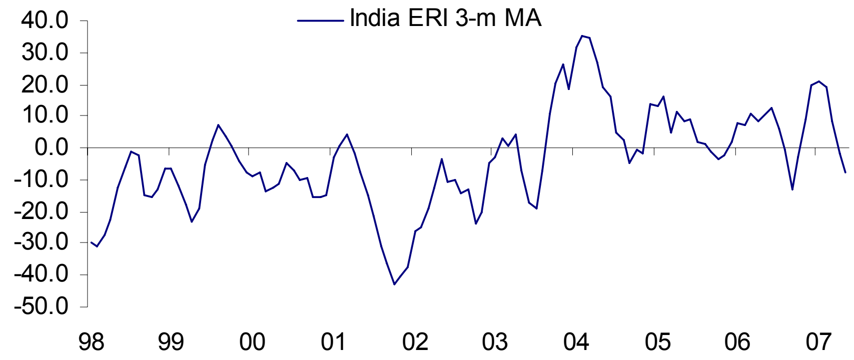
In the last couple of years, expectations of market earnings growth has started the year at around 18-20% and ended at +30% by the time the year got done. There are very dim chances of a repeat this year, and slowing credit is one of the major factors behind that.

There have been many factors behind the huge scale of positive earnings surprise in the last couple of years — stronger than expected demand growth, operating leverage, margin expansion and positive momentum in commodity prices. We think scorching credit expansion of +35% had a significant role (direct as well as indirect) to play in demand growth coming in well ahead of expectations in many sectors of the economy. As credit growth quickly slows to around 22%, we see a significantly reduced ability of the corporate sector to deliver the demand growth surprise.

On margins, as we noted in a recent report (*India Equity Strategy – Margin Trends, Earnings Surprises, Sector Choice*, 21 May 2007, https://www.citigroupgeo.com/pdf/SAP05593.pdf), lack of operating leverage and some cost inflation factors (wages, property rentals) are going to hold back margin expansion for the market as a whole. We did note, however, that there are still a few sectors where we see margin expansions — Telecom, Media and Upstream Oil.

Earnings revisions momentum has already taken a sharp turn down in recent months, driven by adjustment of forecasts for sectors adversely affected by Rupee appreciation, higher interest rates and moderating credit (see Figure 3).

Figure 3. India Earnings Revision Index



Source: IBES, Citigroup Investment Research, Earnings Revisions Index = (Number of companies with earnings being revised up - Number of companies being revised down)/Total number of companies being revised

So where do we see earnings growth in India and how does it stack up against the headwind of credit moderation? Four sectors account for 75-80% of forecast profit growth of 15-16% over FY08 and FY09 — Telecom/Media, IT Services, Capital Goods and Banks/Financials. Citigroup's India model portfolio is Overweight in all these sectors, plus Consumer non-durables.

Figure 4. Sectoral Contributions to Sensex Earnings Growth

Sector	2008E	2009E
Autos, Ancillaries, Transportation	6.0%	6.8%
Banks, Financial Services	14.9%	23.1%
Building Materials	-2.9%	-5.9%
Consumer, Retail	5.7%	6.6%
Engineering, Power, Construction	17.6%	15.6%
IT Services	17.9%	23.3%
Metals, Mining	-1.0%	2.8%
Oil & Gas, Chemicals	19.2%	3.7%
Pharmaceuticals, Healthcare	-0.9%	3.6%
Telecom	23.6%	20.5%

Source: Citigroup Investment Research

Telecom/media and IT services are not credit sensitive, while Rupee appreciation is also now factored into IT services forecasts. Banks/Financials are indeed credit sensitive, but our forecasts there already factor in credit moderation to around 22%. In Capital Goods, higher interest rates and slower credit may affect some weakly funded projects, but the overall momentum in capex upturn is so large and broad-based that it will not be material to growth prospects, at least for the majors we prefer in this space. Capital goods majors have a well-diversified order-book and a few projects being delayed / cancelled should carry lesser risk to their forecasts than for mid-caps.

Figure 5. India Sectoral Earnings Growth (Percent YoY)

	2007E	2008E	2009E
Sensex	**34.3%**	**14.8%**	**11.9%**
Sensex ex-oil	**36.4%**	**16.3%**	**15.5%**
Citigroup India Universe	**35.7%**	**17.1%**	**12.3%**
Citigroup India Universe ex-oil	**35.4%**	**16.9%**	**12.7%**
Autos, Ancillaries, Transportation	11.0%	13.4%	1.6%
Banks, Financial Services	11.2%	22.7%	21.1%
Building Materials	240.6%	60.4%	-15.6%
Consumer, Retail	28.0%	17.3%	19.2%
Engineering, Power, Construction	31.6%	26.0%	17.6%
Hotels	67.5%	24.5%	5.0%
IT Services	44.8%	22.1%	21.1%
Media	55.7%	55.6%	26.6%
Metals, Mining	46.5%	-17.9%	-6.5%
Oil & Gas, Chemicals	30.5%	3.3%	1.5%
Pharmaceuticals, Healthcare	66.5%	16.8%	25.5%
Real Estate	605.8%	66.1%	72.3%
Sugar	-100.1%	nm	24.8%
Telecom	142.2%	43.3%	19.1%
Textiles	23.8%	26.3%	26.3%

Source: Citigroup Investment Research

Appendix A-1

Analyst Certification

I, Ratnesh Kumar, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability, which includes revenues from, among other business units, the Private Client Division, Institutional Sales and Trading, and Investment Banking.

For important disclosures (including copies of historical disclosures) regarding the companies that are the subject of this Citigroup Investment Research product ("the Product"), please contact Citigroup Investment Research, 388 Greenwich Street, 29th Floor, New York, NY, 10013, Attention: Legal/Compliance. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments and historical disclosures, are contained on the Firm's disclosure website at www.citigroupgeo.com. Private Client Division clients should refer to www.smithbarney.com/research. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company. Historical disclosures (for up to the past three years) will be provided upon request.

Citigroup Investment Research Ratings Distribution

Data current as of 31 March 2007	**Buy**	**Hold**	**Sell**
Citigroup Investment Research Global Fundamental Coverage (3215)	45%	40%	15%
% of companies in each rating category that are investment banking clients	45%	42%	32%

Guide to Fundamental Research Investment Ratings:

Citigroup Investment Research's stock recommendations include a risk rating and an investment rating.

Risk ratings, which take into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S).

Investment ratings are a function of Citigroup Investment Research's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings are: Buy (1) (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold (2) (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell (3) (negative total return).

For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings are: Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

Guide to Corporate Bond Research Credit Opinions and Investment Ratings:

Citigroup Investment Research's corporate bond research issuer publications include a fundamental credit opinion of Improving, Stable or Deteriorating and a complementary risk rating of Low (L), Medium (M), High (H) or Speculative (S) regarding the credit risk of the company featured in the report. The fundamental credit opinion reflects the CIR analyst's opinion of the direction of credit fundamentals of the issuer without respect to securities market vagaries. The fundamental credit opinion is not geared to, but should be viewed in the context of debt ratings issued by major public debt ratings companies such as Moody's Investors Service, Standard and Poor's, and Fitch Ratings. CBR risk ratings are approximately equivalent to the following matrix: Low Risk Triple A to Low Double A; Low to Medium Risk High Single A through High Triple B; Medium to High Risk Mid Triple B through High Double B; High to Speculative Risk Mid Double B and Below. The risk rating element illustrates the analyst's opinion of the relative likelihood of loss of principal when a fixed income security issued by a company is held to maturity, based upon both fundamental and market risk factors. Certain reports published by Citigroup Investment Research will also include investment ratings on specific issues of companies under coverage which have been assigned fundamental credit opinions and risk ratings. Investment ratings are a function of Citigroup Investment Research's expectations for total return, relative return (to publicly available Citigroup bond indices performance), and risk rating. These investment ratings are: Buy/Overweight the bond is expected to outperform the relevant Citigroup bond market sector index (Broad Investment Grade, High Yield Market or Emerging Market), performances of which are updated monthly and can be viewed at http://www.sd.ny.ssmb.com/ using the "Indexes" tab; Hold/Neutral Weight the bond is expected to perform in line with the relevant Citigroup bond market sector index; or Sell/Underweight the bond is expected to underperform the relevant sector of the Citigroup indexes.

OTHER DISCLOSURES

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the subject company(ies) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. The Firm's research department has received assistance from the subject company(ies) referred to in this Product including, but not limited to, discussions with management of the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and these, plus any other information contained in the Product, are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Notwithstanding other departments within the Firm advising the companies discussed in this Product, information obtained in such role is not used in the preparation of the Product. Although Citigroup Investment Research does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of Citigroup Investment Research to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by. The Product is made available in Australia to wholesale clients through Citigroup Global Markets Australia Pty Ltd. (ABN 64 003 114 832 and AFSL No. 240992) and to retail clients through Citigroup Wealth Advisors Pty Ltd. (ABN 19 009 145 555 and AFSL No. 240813), Participants of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in Australia to Private Banking wholesale clients through Citigroup Pty Limited (ABN 88 004 325 080 and AFSL 238098). Citigroup Pty Limited provides all financial product advice to Australian Private Banking wholesale clients through bankers and relationship managers. If there is any doubt about the suitability of investments held in Citigroup Private Bank accounts, investors should contact the Citigroup Private Bank in Australia. Citigroup companies may compensate affiliates and their representatives for providing products and services to clients. If the Product is being made available in certain provinces of Canada by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. The Product may not be distributed to private clients in Germany. The Product is distributed in Germany by Citigroup Global Markets Deutschland AG & Co. KGaA, which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). Frankfurt am Main, Reuterweg 16, 60323 Frankfurt am Main. If the Product is made available in Hong Kong by, or on behalf of, Citigroup Global Markets Asia Ltd., it is attributable to Citigroup Global Markets Asia Ltd., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citigroup Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Product is made available in Hong Kong by The Citigroup Private Bank to its clients, it is attributable to Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. The Citigroup Private Bank and Citibank N.A. is regulated by the Hong Kong Monetary Authority. The Product is made available in India by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. Bakhtawar, Nariman Point, Mumbai 400-021. If the Product was prepared by Citigroup Investment Research and distributed in Japan by Nikko Citigroup Ltd., it is being so distributed under license. Nikko Citigroup Limited is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Akasaka Park Building, 2-20, Akasaka 5-chome, Minato-ku, Tokyo 107-6122. The Product is made available in Korea by Citigroup Global Markets Korea Securities Ltd., which is regulated by Financial Supervisory Commission and the Financial Supervisory Service. Hungkuk Life Insurance Building, 226 Shinmunno 1-GA, Jongno-Gu, Seoul, 110-061. The Product is made available in Malaysia by Citigroup Global Markets Malaysia Sdn Bhd, which is regulated by Malaysia Securities Commission. Menara Citibank, 165 Jalan Ampang, Kuala Lumpur, 50450. The Product is made available in Mexico by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, which is regulated by Comision Nacional Bancaria y de Valores. Reforma 398, Col. Juarez, 06600 Mexico, D.F. In New Zealand the Product is made available through Citigroup Global Markets New Zealand Ltd., a Participant of the New Zealand Exchange Limited and regulated by the New Zealand Securities Commission. Level 19, Mobile on the Park, 157 lambton Quay, Wellington. The Product is made available in Poland by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Papierów Wartosciowych i Gield. Bank Handlowy w Warszawie S.A. ul. Senatorska 16, 00-923 Warszawa. The Product is made available in the Russian Federation through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in Singapore through Citigroup Global Markets Singapore Pte. Ltd., a Capital Markets Services Licence holder, and regulated by Monetary Authority of Singapore. 1 Temasek Avenue, #39-02 Millenia Tower, Singapore 039192. The Product is made available by The Citigroup Private Bank in Singapore through Citibank, N.A., Singapore branch, a licensed bank in Singapore that is regulated by Monetary Authority of Singapore. Citigroup Global Markets (Pty) Ltd. is incorporated in the Republic of South Africa (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments and services contained herein are not available to private customers in South Africa. The Product is made available in Taiwan through Citigroup Global Markets Inc. (Taipei Branch), which is regulated by Securities & Futures Bureau. No portion of the report may be reproduced or quoted in Taiwan by the press or any other person. No. 8 Manhattan Building, Hsin Yi Road, Section 5, Taipei 100, Taiwan. The Product is made available in Thailand through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 18/F, 22/F and 29/F, 82 North Sathorn Road, Silom, Bangrak, Bangkok 10500, Thailand. The Product is made available in United Kingdom by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. This material may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA and further details as to where this may be the case are available upon request in respect of this material. Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB. The Product is made available in United States by Citigroup Global Markets Inc, which is regulated by NASD, NYSE and the US Securities and Exchange Commission. 388 Greenwich Street, New York, NY 10013. Unless specified to the contrary, within EU Member States, the Product is made available by Citigroup Global Markets Limited, which is regulated by Financial Services Authority. Many European regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. The policy applicable to Citigroup Investment Research's Products can be found at www.citigroupgeo.com. Compensation of equity research analysts is determined by equity research management and Citigroup's senior management and is not linked to specific transactions or recommendations. The Product may have been distributed simultaneously, in multiple formats, to the Firm's worldwide institutional and retail customers. The Product is not to be construed as providing investment services in any jurisdiction where the provision of