

Elections: Political Stability to re-rate markets

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RESEARCH

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Singh is King! Sensex rally to 14500?

Election results have proved to be a complete surprise with the Congress-led UPA sweeping to a near majority on their own as against consensus expectations of a hung Parliament. With Prime Minister Manmohan Singh no longer hostage to the Left/other allies, we expect major economic reforms to re-rate the Indian markets. Expectations of structural reforms like reducing fiscal deficit through disinvestment of Government companies, opening up economy to attract FDI and infrastructure and banking reforms can lead to 15%-20% rally (index of 14500).

What does the election mean?

The elections have (a) provided a majority to the Congress with no need to take the support of the Left parties who were seen to be holding back reforms (b) no worries of early elections due to an unstable coalition and (c) reduced bargaining power of the allies giving Congress the ability to keep key economic ministries. Overall, the electoral mandate provides the Congress freedom to do reforms.

Will the rally be sustainable?

We expect markets to be re-rated to relatively expensive territory in anticipation of major reforms by the Government. While our election worries have disappeared, earnings are still likely to be subdued. Hence, Government needs to actually implement reforms to ensure a sustained re-rating of the markets. 2 other factors to watch will be (a) global economy and markets and (b) huge supply of paper from private sector as well as Government will cap markets.

Buy beta/reform plays

We would not play PSUs (Public Sector Units) for divestment since it is a stake sale only to portfolio investors. But other likely gainers are likely to be:

1. Increase in FDI in insurance: ICICI, HDFC
2. Increase in FDI in retail: Pantaloon
3. Infrastructure reforms: BHEL, L&T, IVRCL, Reliance Infra
4. Banking sector reforms : SBI, PNB
5. Rural plays : Hero Honda, Jain Irrigation

Model Portfolio - cutting defensives/software

We have increased weight on infrastructure stocks like BHEL, L&T, Reliance Infrastructure and financials like ICICI and PNB in our model portfolio. We have correspondingly cut weight on sectors like to be adversely hit by rupee appreciation like software, healthcare and defensives like consumer.

Table 1: High beta stocks

Company	Raw Beta
Unitech Ltd	2.16
Indiabulls Real	1.87
Reliance Infracore	1.79
Jaiprakash Assoc	1.78
Reliance Capital	1.76
Nagarjuna Const	1.74
Icici Bank Ltd	1.71
Ivrc Infrastructure	1.69
Jindal Steel & P	1.64
Suzlon Energy Lt	1.62

Source: BAS-ML Research, Bloomberg

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Table 2: Seat tally of different parties

	2009	2008	Change
Congress	201	145	56
BJP	120	138	-18
SP	23	36	-13
JD(U)	20	8	12
BSP	20	19	1
AITC	19	2	17
DMK	18	16	2
CPM	15	43	-28
BJD	13	11	2
Shiv Sena	11	12	-1
AIADMK	9	0	9
NCP	9	9	0
IND	8	5	3
TDP	7	5	2
CPI	5	10	-5
RLD	5	3	2
RJD	4	24	-20
SAD	4	8	-4
JD(S)	3	3	0
NC	3	2	1
AUDF	2	0	2
RSP	2	3	-1
FB	2	3	-1
MUL	2	1	1
JMM	2	5	-3
AGP	2	2	0
TRS	2	5	-3
MDMK	1	4	-3
Independents and Others	11	21	-10
Total	543	543	

Source: Media, BAS-ML Research

A Stable Government

The Indian voter had delivered a surprise once again. We went into elections expecting a hung Parliament and all political parties were busy trying to work on permutations and combinations that would enable them to cross the majority mark of 272. Regional parties like Mayawati's BSP and Jayalalita's AIADMK were wooed by all the 3 contenders for power (ie the Congress-led UPA, the BJP-led NDA and the Third Front).

UPA close to majority on its own

We had expected the Congress-led UPA to have a slight edge and thought they could form a Government with their erstwhile allies of the Fourth Front and the Left parties. Its not often that you feel happy when you are wrong but this is one of the occasions. There is no hung Parliament and the UPA has a virtual majority of its own. They do not really need the Fourth Front or the Left to form a Government though they make take the Fourth Front to ensure greater stability.

Table 3: Party seat position in the Lok Sabha post 2009 general elections

Congress & likely Allies	Seats BJP & Likely allies	Seats Third Front	Seats
Congress	201 BJP	120 CPM	15
AITC	19 JD(U)	20 CPI	5
DMK	18 Shiv Sena	11 FB	2
NCP	9 SAD	4 RSP	2
NC	3 AGP	2 Total Left	24
JMM	2 RLD	5 BSP	20
MUL	2 Total NDA	162 BJD	13
KEC	1	AIADMK	9
Total UPA	255	TDP	7
Independents & Others *	15	TRS	2
SP*	23 Independents & Others	MDMK	1
RJD*	4	Total 3rd Front	76
Total 4th Front	27		
Total Congress & likely Allies	280+		
Total No. of Seats	543		
Seats Required for Majority	272		

Source: Media, BAS-ML Research

Note *: Congress Party negotiating for support

So what does this mean?

There are 3 key positives from the elections:

- 1. Free Hand on Reforms:** The Congress has now got a free hand to do reforms since it does not need the support of the Left parties. While most parties in India have a broad consensus on the reform agenda, the Left parties had a different view. Over past 5 years, the Government has not been able to reform partly due to the opposition from the Left parties.
- 2. Bargaining power of allies of the Congress has reduced:** The Congress itself has got over 200 seats, their best showing since 1991. The BJP on the other hand had its worst showing since 1991. Given the size of the mandate for the Congress party, the bargaining power of other allies in the Government has reduced considerably. The SP, which gave outside support to the Congress after the Left withdrew support last year, is not really required to form the Government and the other parties too know that the Congress could continue in power without them.

Table 4: Tally in different general elections

	1991	1996	1998	1999	2004	2009
Congress	244	140	141	114	145	201
BJP	120	161	182	182	138	118

Source: Media

Table 5: Coming state assembly elections

State	Elections due	Incumbent Party
Maharashtra	Oct-09	UPA (Congress + NCP)
Haryana	Feb-10	Congress
Jharkhand	Feb-10	President's Rule
Bihar	Oct-10	NDA (BJP + JDU)
Assam	Apr-11	Congress
Tamilnadu	Apr-11	UPA (Congress + DMK)
West Bengal	Apr-11	Left Front
Kerala	Apr-11	Left Front

Source: Media

- 3. Government stable for 5 years:** The Congress knows it can rule for 5 years. Hence, it can do tough measures on reforms over next 2 years without worrying about electoral implications. State assembly elections too over next 18 months are few (Maharashtra and Bihar are the only ones). Thus the market does not have to worry about major political noise from the market.

Good governance pays in elections - long term positive

India had a trend where the incumbent Government was generally thrown out since the electorate wanted change after 5 years. However, there has been a perceptible change over past few years where a Government which performs is elected back to power. In the current elections too, we have seen a repeat victory for the Congress in states like Delhi and Andhra Pradesh, for the BJP in states like Madhya Pradesh, Gujarat and Karnataka and for other regional parties like Naveen Patnaik in Orissa. The common thread here is all these Chief Ministers are regarded as having given good governance in their respective states.

Market to re-rate: Sensex 14,500 level likely

We think politics can be a major positive for the market as the Government now will have no impediment in undertaking reforms. Over the next few years, the Government can structurally improve India's economy by undertaking reforms towards (a) lowering fiscal deficit through sales of Government companies (b) infrastructure reforms (c) labor reforms (d) increasing FDI through opening up the economy and (d) banking and pension sector reforms.

We expect markets to be buoyant in anticipation of acceleration in reform measures by the Government. A re-rating of the markets is likely to take markets to expensive territory relative to current earnings. A pump priming of the economy, sharp foreign inflows leading to lower interest rates and stronger rupee and an improving fiscal situation would improve the optimism regarding growth next year.

Reforms required to sustain re-rating; supply of paper can cap upside

Near term, the market will give the Government the benefit of doubt on the reform agenda. Apart from our worries on politics, we have been cautious on the markets due to the global slow-down and slowing economy/earnings. These worries are not going away but can be mitigated if reform measures lead to likelihood of strong earnings growth for next year.

We believe earnings in current year FY10 will disappoint consensus estimates. We estimate EPS growth to see a 5-10% drop. However, our current expectations of a 17% EPS growth for FY11 could see an upgrade if reforms are accelerated. Our economist, Indranil Sengupta estimates that 0.5% additional pump priming can lead to a 0.75% increase in the economy.

Valuations for the market are not cheap at 15x FY10 EPS and 12.6x FY11 EPS. However, reform expectations could take market to above average valuations – we think market could trade at around 15x FY11 EPS ie around 14,500 levels.

We also expect to see a sharp pick up in supply of paper, both from the private sector as well as Government through disinvestment as it seeks to bridge the fiscal deficit gap. This will cap the upside in the secondary markets.

Lower interest, rising rupee

We expect a relatively softer rate regime as (a) PSU banks cut deposit and lending rates and (b) Government reduces fiscal deficit by disinvestments and 3G auction. We also expect a stronger rupee due to better flows. Our economist, Indranil Sengupta had anyway highlighted even earlier that the market worries of a Balance of Payment (BoP) crisis was overdone.

What are the reforms to watch out for?

1. Fiscal Deficit Reform

We expect the Government to undertake (a) aggressive sale of PSU companies and (b) auction of 3 G license to try to improve the fiscal deficit.

2. Increase FDI limit in insurance, retail

We expect Government to increase FDI limit in insurance (gainers ICICI Bank, HDFC, Aditya Birla Nuvo) and possibly retail (gainers: Pantaloon).

3. Infrastructure reforms

We expect Government to continue to accord highest priority to infrastructure reforms including awarding power (Ultra Mega Power Projects), roads and highways, ports etc. Gainers include companies like L&T, BHEL and IVRCL.

4. Banking reforms

M&A in govt. banks- Government banks could see consolidation with large government banks taking over weaker govt. banks (whose Government of India holdings are closer to 51%). Key beneficiaries- SBI, PNB, BOI, BOB

Relaxation of 51% GOI holding- We could also see relaxation of current 51% GOI holding in govt. banks to possibly 33%. Although we believe this is less likely given govt. banks (+75% market share) are proxy for GOI's transmission of policies to the common man. **Key beneficiaries:** Govt. banks

NBFC's could become banks: We could also see NBFC's like Reliance Capital and IDFC being allowed to convert to banks or acquire mid-sized banks. **Key beneficiaries:** Reliance Capital, IDFC

Aligning equity holding and shareholding / increasing FII limits: We could also see RBI / GOI aligning shareholding aligned to FII equity holdings.

Also, we could increase in FII limits from current 20%. **Key beneficiaries:** All Govt. banks.

5. Disinvestment of Government companies

We think this will be sale of stake to portfolio investors rather than strategic sale where management is also transferred.

6. Labor Reforms

We think this is the most difficult and will take longer to materialize. It is likely to be a phased process with companies being gradually provided greater flexibility towards their workforce.

Model Portfolio: Adding beta, reducing defensives

We have made some changes to our model portfolio to:

1. Add beta and reduce defensives given that we expect markets to take the Congress victory positively.

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2. Adding sectors/companies that will gain from likely reform measures.
3. Reducing weight on companies hit by rupee appreciation.

Adding weight to industrials, utilities and financials

We have made 3 major changes to our model portfolio (apart from small changes to real estate and energy):

1. We have added weight to industrials by increasing weight to both BHEL and L&T. Industrials is now our largest O/W in the model portfolio.
2. We have added weight to financials slightly. However, we have done a re-allocation within the financial sector by removing HDFC Bank and adding the weight to ICICI (insurance play) and PNB (lower yields).
3. We have added Reliance Infrastructure to our model portfolio as they will gain from the likely power projects to be announced by the Government.

Reducing weight from consumers, pharma, software and telecom

We have reduced weight on defensives like pharma, consumers and telecom. We have also reduced weight on software that has been a strong performer YTD given likely worries on the rupee.

Table 6: Model Portfolio

	Symbol	Rating	Price	MSCI Wt	Recommended ML Wt.	Points O/W
Industrials/Cement				9.0%	15.0%	6.0
: BHEL	BHHEF	C-1-7	1707		8.0%	
: L&T	LTOUF/LTORF	C-1-7/C-1-7	989		7.0%	
Financials				21.6%	27.0%	5.4
: SBI	SBINF/SBKFF	C-1-7/C-1-7	1314		11.0%	
: ICICI Bank	ICIJF/IBN	C-1-7/C-1-7	575		11.0%	
: PNB	PUJBF	C-1-7	575		5.0%	
Consumer Discretionary				4.6%	8.5%	3.9
: Hero Honda	HRHDF	C-1-7	1222		8.5%	
Telecom				2.6%	5.0%	2.4
: Bharti Tele	BHTIF	C-1-7	800		5.0%	
Real Estate				1.0%	1.0%	0.0
: DLF	XVDUF	C-2-9	258		1.0%	
Energy				23.6%	23.5%	-0.1
: Reliance Inds.	XRELF	B-1-7	1951		17.5%	
: HPCL	XHTPF	C-1-7	260		6.0%	
Utilities				6.3%	5.0%	-1.3
: Reliance Infra	RCTDF/RELFF	C-1-7	820		5.0%	
Software				14.7%	10.0%	-4.7
: TCS	TACSF	C-1-7	644		5.0%	
: Infosys	INFYF/INFY	C-2-7/C-2-7	1593		5.0%	
Consumer Staples/ Pharma				10.1%	5.0%	-5.1
: Hindustan Unilever	HINLF	C-1-7	224		5.0%	
Metals				6.6%	0.0%	-6.6

Source: BAS-ML Research

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Table 7: Companies with high beta

ML Code	Company	Price (INR)	Rating	Raw Beta
UTKIF	Unitech Ltd	51	3 - Underperform	2.16
IBELF	Indiabulls Real	148	2 - Neutral	1.87
RCTDF	Reliance Infrac	820	1 - Buy	1.79
JPRKF	Jaiprakash Assoc	141	1 - Buy	1.78
RLCCF	Reliance Capital	592	1 - Buy	1.76
NGRJF	Nagarjuna Const	83	1 - Buy	1.74
ICIJF	ICICI Bank Ltd	575	1 - Buy	1.71
IIFRF	IVRCL Infrastruc	162	1 - Buy	1.69
XJDLF	Jindal Steel & P	1,604	3 - Underperform	1.64
SZEYF	Suzlon Energy Lt	77	1 - Buy	1.62
XJWJF	JSW Steel Ltd	419	3 - Underperform	1.61
NFACF	Nagarjuna Fert	24	3 - Underperform	1.61
YESBF	Yes Bank Ltd	95	3 - Underperform	1.59
XBWTF	Aban Offshore Lt	619	2 - Neutral	1.58
XVDUF	DLF Limited	258	2 - Neutral	1.54
TAELF	Tata Steel Limit	272	3 - Underperform	1.52
XTNDF	Sterlite Industr	460	3 - Underperform	1.51
TVIEF	Triveni Engineer	62	1 - Buy	1.49
EXLS	Exlservice Holdi	9	3 - Underperform	1.48
BJJHF	Bajaj Hindusthan	108	3 - Underperform	1.46
EUSOF	Educomp Solution	2,376	1 - Buy	1.45
ANSFF	Ansal Props & In	34	3 - Underperform	1.44
IBLFF	Indiabulls Finan	146	1 - Buy	1.44
CHBZF	Chambal Fertiliz	48	1 - Buy	1.42
HNDFF	Hindalco Inds	70	3 - Underperform	1.42
IFDFF	Infrastruct Dev	95	3 - Underperform	1.41
SLAUF	Steel Authority	122	3 - Underperform	1.36
UTBKF	Axis Bank Limit	660	3 - Underperform	1.31
LTOUF	Larsen & Toubro	989	1 - Buy	1.29
RLCMF	Reliance Communi	233	2 - Neutral	1.28
XSGAF	Sesa Goa Ltd	146	3 - Underperform	1.27
XRELF	Reliance Inds	1,951	1 - Buy	1.24
NEYVF	Neyveli Lignite	92	2 - Neutral	1.23
XDIIF	Bank Of India	247	1 - Buy	1.23
SRNKF	Shree Renuka Sug	113	1 - Buy	1.22
TTCXF	Tata Chemicals	183	1 - Buy	1.22
XOMXF	Omaxe Ltd	56	3 - Underperform	1.20
MAHMF	Mahindra & Mahin	513	3 - Underperform	1.19
XJSHF	Jaiprakash Hydro	40	3 - Underperform	1.19
BMPRF	Balrampur Chini	77	1 - Buy	1.16
ABSHF	ABG Shipyard	156	3 - Underperform	1.16
XDBIF	IDBI Bank Ltd	63	3 - Underperform	1.14
JTAIF	Jet Airways Indi	214	2 - Neutral	1.12
HGDFF	Housing Dev Fin	1,939	1 - Buy	1.11
XHDFE	HDFC Bank Ltd	1,185	1 - Buy	1.11
BKBAF	Bank Of Baroda	342	2 - Neutral	1.10
BHHEF	Bharat Heavy Ele	1,707	1 - Buy	1.10
XTAWF	Tata Power Co	909	2 - Neutral	1.10
TENJF	Tata Motors Ltd	265	3 - Underperform	1.09
ADYAF	Aditya Birla Nuv	550	2 - Neutral	1.09
IDEAF	Idea Cellular	65	2 - Neutral	1.08
UDSRF	United Spirits	676	3 - Underperform	1.08
VLSLF	Tata Communicati	524	3 - Underperform	1.07
CNRKF	Canara Bank	229	3 - Underperform	1.07
XCVFF	Mcleod Russel Lt	90	1 - Buy	1.05
PUJBF	Punjab Natl Bank	575	1 - Buy	1.04
UBOIF	Union Bank India	175	1 - Buy	1.02
ORBCF	Oriental Bank Of	143	3 - Underperform	1.02
SBINF	State Bank Ind	1,314	1 - Buy	1.00

Source: BAS-ML Research, Bloomberg

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