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India Equity Strategy

L'Earnings' – Don't Be Defensive

- Equities

Aditya Narain, CFA
+91-22-6631-9879
aditya.narain@citi.com

Jitender Tokas,CFA
jitender.tokas@citi.com

- **Earnings growth revival is slackening, but still double digit** — India's earnings growth - which was showing signs of reviving – is once again slackening. The improving downgrade/upgrade ratio has slipped, and forward looking EPS has slipped marginally. That said, we still expect 11% and 14% growth in FY13 and FY14 respectively.
- **And stocks have followed earnings upgrades** — Earnings upgrades have been rewarded with stock performance (+17% yoy), and earnings downgrades have hurt (-43% yoy). We expect earnings leaders/laggards to change going forward: the current year's stock/sector leaders could be very different from last year's.
- **Defensive to cyclical valuation premium at a peak** — India's defensives are trading at 90%+ premium to cyclicals, a near 5-year peak. The extreme valuation gap, some mean reversion on earnings growth, should see the premium moderate.
- **And slower GDP growth should not translate into slower earnings** — Earnings growth usually falls in the year GDP growth falters. With the GDP drop likely behind – earnings risks should be a lot less than the markets' bearishness on GDP growth.
- **Sales growth will struggle, not so margins** — Expect the earnings mix to change. Sales momentum – a dominant theme so far – should ease off, and margins should expand (lower costs, input costs, corporate focus on profitability). This could impact the more top-line sensitive sectors – usually the defensives.
- **Remain positive, and cyclically biased** — We remain positive on the market (18,400, Sensex target), cyclically biased and believe defensives – star performers over the last year – are vulnerable. We remain OW Financials, Capital Goods and Auto, UW on Consumer Staples, Energy and Commodities. While we see gains on the currency, we hedge risks of further depreciation in INR through Pharma (OW) and IT services (Neutral).

Figure 1. Valuation (PE) premium of defensives vs. cyclicals

Source: Factset, Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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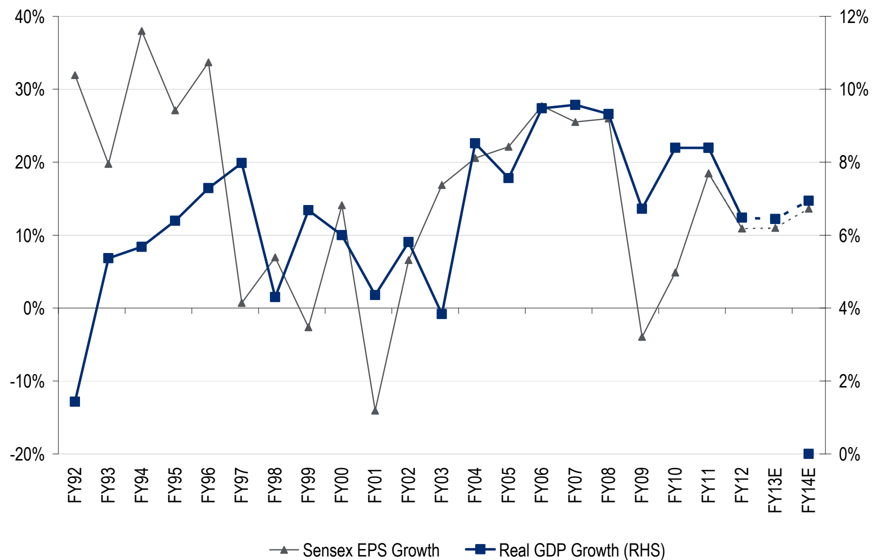
Don't Be Defensive

Lot of L'earnings'

It has been coming apart…GDP growth, the currency and increasingly confidence

There is a lot going on with earnings – particularly as the market has seesawed, GDP growth expectations have dived, the currency has collapsed and the mood has soured. The market's most recent bounce notwithstanding, there remains gloom about India's economic growth prospects.

Figure 2. GDP growth vs. Sensex earnings growth



Source: CSO, Citi Research

Earnings growth is meaningfully impacted in the year GDP growth drops – the corporate sector manages to look after itself the year after

But are the GDP growth level and expectations necessarily reflective of corporate profitability and growth? We think not: more specifically, we believe earnings growth is meaningfully impacted in the year GDP growth drops – the corporate sector manages to look after itself the year after. If our FY13 GDP growth estimate holds (6.4% - against 6.5% in FY12), we believe the downward pressure on earnings growth has played out.

But earnings revival is slackening – though the level is fair

Earnings were beginning to look up – possible market performance or currency weakness induced…but that trend has stalled

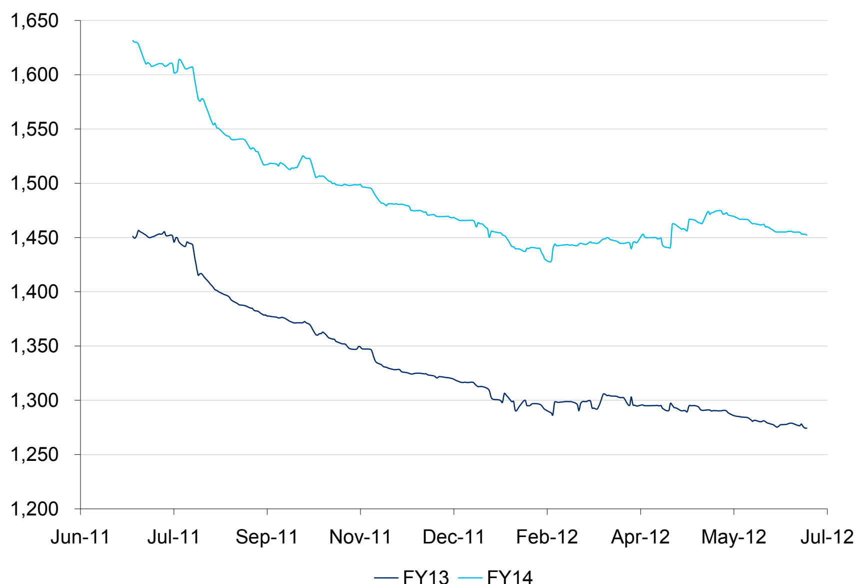
India's earnings trajectory – a consistent downward trend until earlier in the year – did show signs of recovering in March-April 2012, when the downgrade/upgrade ratio started moderating. And market EPS estimates for FY14 actually moved up. It might have been the substantially more robust equity market (Feb-March), or the INR's depreciation (net earnings gain for the market), but data now suggest the earnings revival (or upgrade expectations) is now stagnating. We believe this is fair and more reflective of the underlying economic and corporate environment – and is not too dissimilar to EM and global trends.

* Cyclical sectors: Financials, Consumer Discretionary, Materials, Energy and Industrials

* Defensive sectors: Consumer Staples, IT, Healthcare and Telecom

EPS expectations for FY14 rose more than for the current year…but both have now tapered off

Figure 3. Trends in consensus EPS estimates for Sensex



Source: Bloomberg

Low double-digit earnings growth ahead…largely in line with peers

We estimate a modest, but still double-digit earnings growth for Sensex of about 11% in FY13 and 13.6% in FY14. We also expect this trajectory and level of earnings to broadly hold over the next 3-6 months. This should be largely in line with broader emerging market growth.

Figure 4. Earnings Growth Estimates (%)

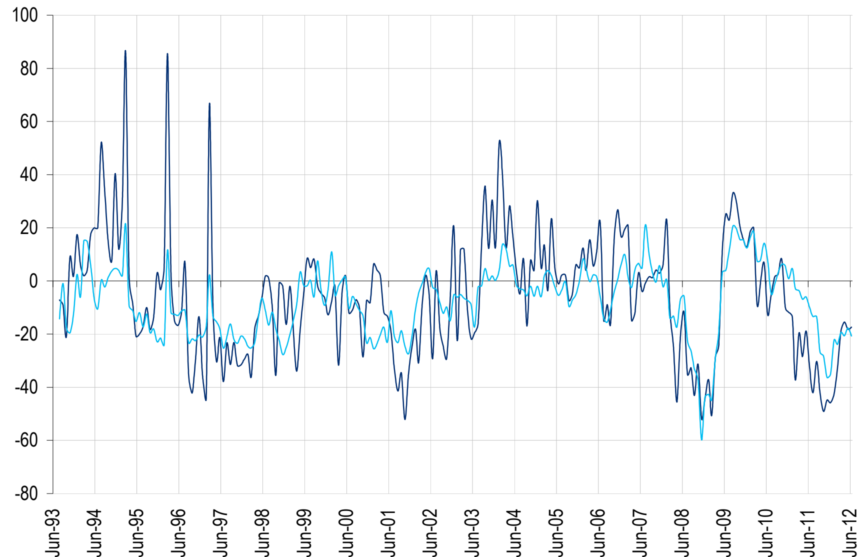
	12E	13E
India*	11.0	13.6
Asia Ex Japan	10.6	13.3
EM	9.8	12.5
Europe	6.0	12.3
US	8.5	12.7
DM	9.4	13.7

Source: Citi Research, MSCI, Factset Consensus Estimates

* For India, estimates are for FY13 and FY14 respectively

Upgrade-downgrade ratio which was looking up…and in sync with emerging markets….has stalled

Figure 5. Earnings Revisions Trends*: India vs. Global Emerging Markets



Source: Factset, IBES, Citi Research

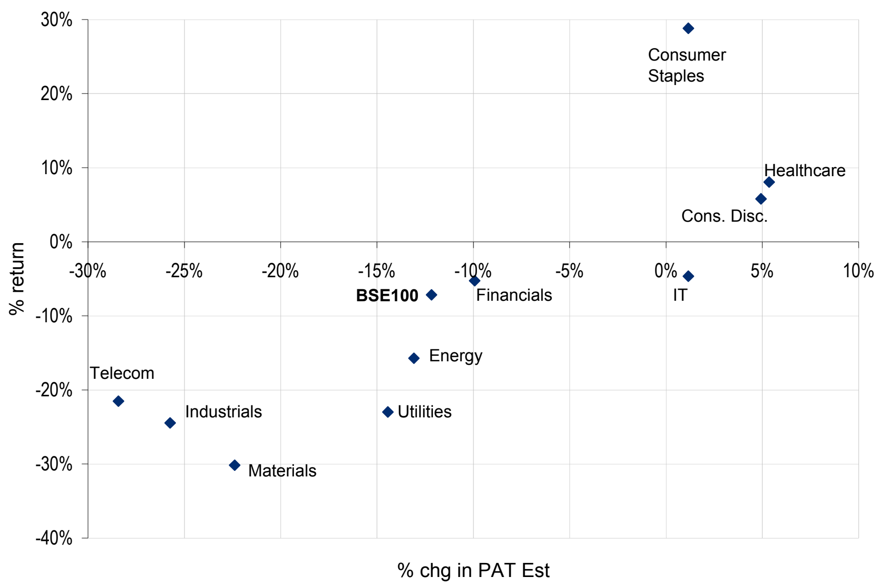
*Index above 0 when more upgrades than downgrades and vice versa

Earnings revisions matter – Meaningful driver of performance

Earnings have mattered….sectors with upgrades led the upside…

The market appears to have followed earnings revisions over the last year. Upward earnings revisions were rewarded with substantial outperformance (Consumer staples) - Healthcare and Consumer discretionary also recorded positive performance. The only sector with upward revisions that did not generate a positive return was IT services, possibly explained by a sharply deteriorating business outlook (earnings boosted by currency gains).

Figure 6. Change in FY13 cons. earnings est vs. return (Jun'11 – Jun'12)



Source: Factset, Bloomberg, Citi Research

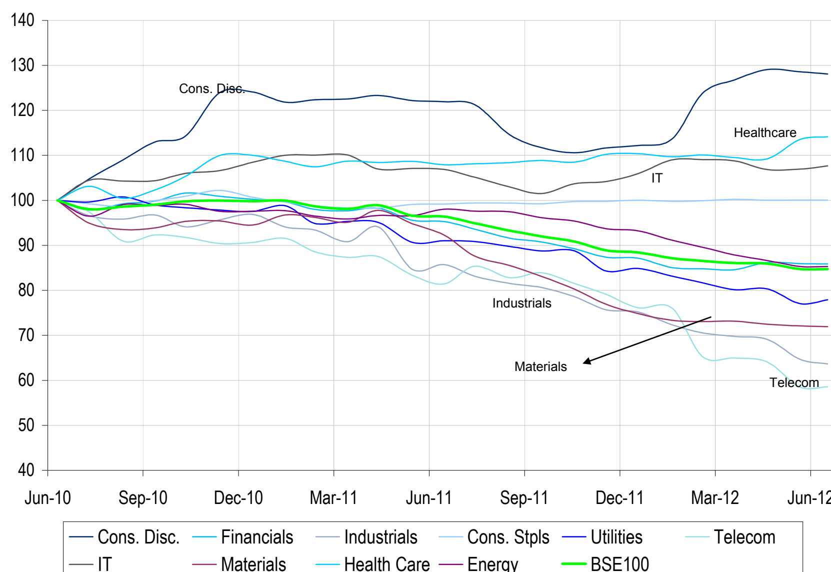
Those with downgrades… the downside

It has been just the opposite for sectors that have seen earnings expectations drop over the last year – weak stock performance, almost across the board. While each of these sectors would have been impacted by specific issues/expectations, the direction of earnings expectations has been a dominant driver of performance. Not a single sector with earnings downgrades generated positive performance.

Portfolio risk aversion has possibly furthered the performance differential

We would argue that the performance has been further skewed as global uncertainties have prompted investors to seek more safety than risk, and there has been an added portfolio positioning bias that would have further accentuated the return gap. There would have been disconnects over shorter intervening periods too – i.e., when it has been a 'risk on' environment – but the last year has been characterized by meaningfully lower risk appetitive. While we see this in an India context, our Global strategists argue it is a global phenomenon, with the trend more pronounced in some markets than others (Global Equity Strategist - Defensives vs Cyclicals: Priced For Recession).

Figure 7. Trends in consensus FY13 estimates for BSE100 companies



Source: Factset, Citi Research

Earnings revisions and market correlations hold at the stock level too ….though not as robust as at the sector level

The earnings upgrade/downgrade and stock performance correlations stand at the sector level; they are fairly robust at the stock level too albeit not as rigorous. Not surprisingly, the strongest performers have been the traditional defensives sectors, while it is the rate cyclicals, commodities and infrastructure that have been the poorest performers.

Figure 8. Stock performance vs. FY13 earnings estimate changes over last 1 year

Stock	Sector	Chg in FY13E PAT	Chg in stock price
BSE100 stocks with largest upgrades in last 12 mths			
Tata Motors Ltd.	Consumer Discretionary	20.1%	22%
Ranbaxy Laboratories Ltd.	Health Care	19.4%	-9%
UltraTech Cement Ltd.	Materials	15.4%	62%
Reliance Capital Ltd.	Financials	12.9%	-38%
Idea Cellular Ltd.	Telecommunication Services	11.7%	-5%
Godrej Consumer Products Ltd.	Consumer Staples	11.4%	33%
Hindustan Unilever Ltd.	Consumer Staples	10.2%	33%
Hero MotoCorp Ltd.	Consumer Discretionary	9.0%	14%
Divi's Laboratories Ltd.	Health Care	7.3%	31%
Reliance Infrastructure Ltd.	Utilities	7.1%	4%
BSE100 stocks with largest downgrades in last 12 mths			
JSW Steel Ltd.	Materials	-38.0%	-23%
Adani Enterprises Ltd.	Industrials	-39.0%	-69%
United Spirits Ltd.	Consumer Staples	-42.8%	-30%
Tata Steel Ltd.	Materials	-43.9%	-28%
Crompton Greaves Ltd.	Industrials	-51.6%	-53%
Unitech Ltd.	Financials	-53.1%	-31%
Essar Oil Ltd.	Energy	-58.3%	-56%
GMR Infrastructure Ltd.	Industrials	-60.7%	-23%
Adani Power Ltd.	Utilities	-79.5%	-55%
Suzlon Energy Ltd.	Industrials	-89.6%	-61%

Source: Factset, Citi Research

So where are we likely to see upgrades?

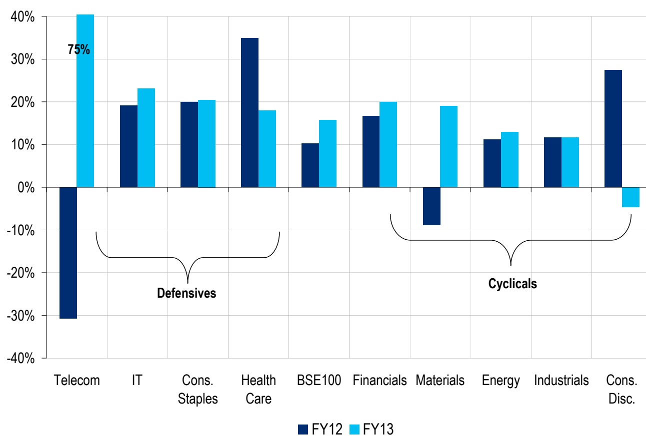
Where could the upgrades come from…Cement, Oil, Banks and the currency hedges – Healthcare and IT services

Since earnings revisions have had such a significant impact on stocks and sectoral performance, it is worth trying to predict which sectors would see earnings upgrades going forward. There are no obvious ones – else they would be in the numbers. But our bottom up sense from Citi's Research Team suggests the upgrades could potentially lie with the Cement Sector, Oil names – based on Citi's oil forecasts, possibly the financials. The currency gainers – Pharmaceuticals and IT services, could also see upgrades. We see risks of downgrades in consumer staples, refining space, non-ferrous, finance companies, telecom, automobiles, and possibly utilities. We would expect no material change in earnings amongst the Industrials. This indicates a slight tilt toward the cyclicals as far as potential upgrades are concerned.

FY13 earnings upgrades and revisions over the last quarter… are however still evenly spread across defensives and cyclicals

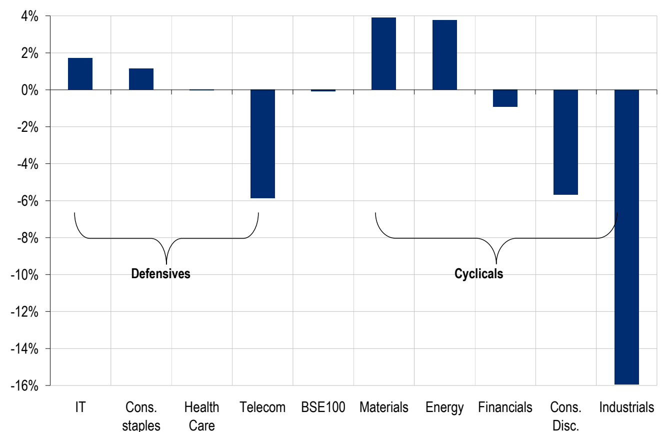
How do growth numbers stack up for sectors bunched into defensives and cyclicals? Relatively evenly spread, with a greater share of cyclicals currently expected to grow stronger in the current year than defensives. But the difference is clearly not striking and cylicals will be dependent on how the domestic economy and the global macro play out.

Figure 9. BSE100 PAT growth: FY12 vs. FY13E



Source: Citi Research, IBES

Figure 10. Change in Citi FY13 PAT estimates over 1QF13



Source: Citi Research

Stocks with the biggest revisions, and current year growth expectations

How does one play this at the company level? We would argue that the earnings upgrade/downgrade and stock correlations are unlikely to be as consistent as the sectors ones. But we highlight stocks that have already the most substantive earnings revisions over the last quarter. And we also highlight stocks that are expected to record the sharpest jumps/falls in earnings in the current year over FY12.

Figure 11. Citi FY13E Earnings growth: top/ bottom 10 stocks

Top 10			Bottom 10		
Stock	**Sector**	**FY13 Earnings Growth**	**Stock**	**Sector**	**FY13 Earnings Growth**
JSW Energy Ltd	Utilities	1026.2%	Petronet LNG	Energy	-2.5%
Adani Power	Utilities	625.9%	Oil India	Energy	-2.6%
GMR Infrastructure	Industrials	220.1%	Hindustan Zinc	Materials	-2.8%
JSW Steel	Materials	111.9%	Oil & Natural Gas	Energy	-3.6%
Jaiprakash Power Ventures	Utilities	109.1%	Reliance Infrastructure	Utilities	-6.5%
Unitech	Financials	87.0%	Tata Power	Utilities	-10.5%
Tata Steel	Materials	86.6%	Glenmark Pharma	Health Care	-14.8%
Dish TV	Consumer Discretionary	84.5%	Thermax	Industrials	-16.0%
IDEA Cellular	Telecom	83.9%	Jaiprakash	Industrials	-17.1%
Bharti Airtel	Telecom	80.5%	Tata Motors	Consumer Discretionary	-18.4%

Source: Citi Research

Figure 12. Citi FY13E Earnings growth changes over Apr-Jun ‘12: top/ bottom 10 stocks

Top 10			Bottom 10		
Stock	**Sector**	**FY13 Earnings Growth Chg since April'12**	**Stock**	**Sector**	**FY13 Earnings Growth Chg since April'12**
UltraTech Cement	Materials	68.7%	DLF	Financials	-11.5%
Ambuja Cements	Materials	57.0%	United Spirits	Consumer Staples	-12.3%
ACC	Materials	53.3%	Tata Motors	Consumer Discretionary	-13.1%
Dish TV	Consumer Discretionary	41.5%	Unitech	Financials	-14.7%
Oil India	Energy	34.1%	Reliance Comm	Telecom	-16.6%
Grasim Industries	Materials	19.9%	Shriram Transp. Finance	Financials	-20.9%
Oberoi Realty Limited	Financials	16.9%	Adani Port And SEZ	Industrials	-22.3%
Maruti Suzuki India	Consumer Discretionary	16.4%	Tata Steel	Materials	-26.6%
Coal India	Energy	9.9%	Adani Enterprises	Industrials	-32.6%
Oil & Natural Gas	Energy	7.5%	Adani Power	Utilities	-38.7%

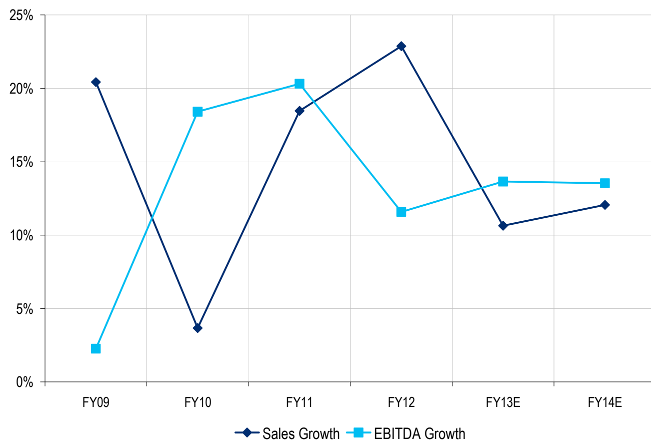
Source: Citi Research

The earnings mix – Margin rather than sales driven

Earnings should now be driven by falling sales growth but rising margins…from strong sales growth that was being offset by falling margins….the mix of earnings should be changing

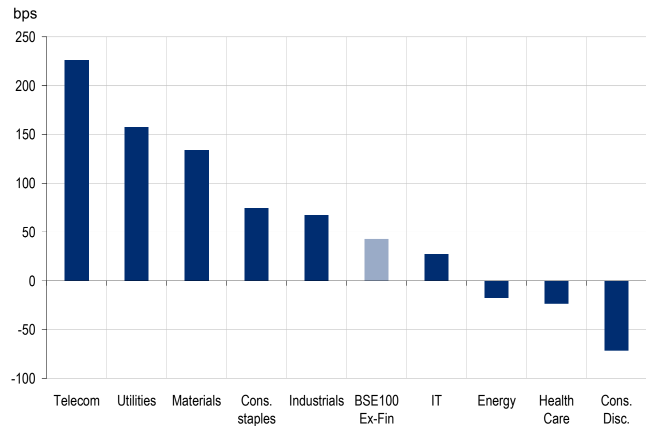
While we expect shifts in earnings leadership into the current year, we believe the earnings mix is likely to change more dramatically. In our view, Sales growth, which has been the primary driver of earnings (offset by moderating margins), is likely to witness a material step down in momentum into the current year. This is a reflection of slowing demand and a moderation in pricing power. This should be more than offset by a rise in margins at the aggregate, and almost across the board sectorally. We believe this is the result of a confluence of several factors - slowing growth, easing costs (particularly on raw materials), and most tellingly – cost and profitability focus by businesses. We believe the market’s focus will also shift a little more to the bottom line than the top line. This shift would tend to reflect some characteristics of developed markets’ earnings: where bottom-line has racked well ahead of top-line momentum.

Figure 13. BSE 100 Ex Fin : Sales and EBITDA growth



Source: Citi Research, IBES

Figure 14. Sector-wise FY13 EBITDA margin chg exp. for BSE100 Co's



Source: Citi Research, IBES

So here's why we should play cyclicals rather than defensives

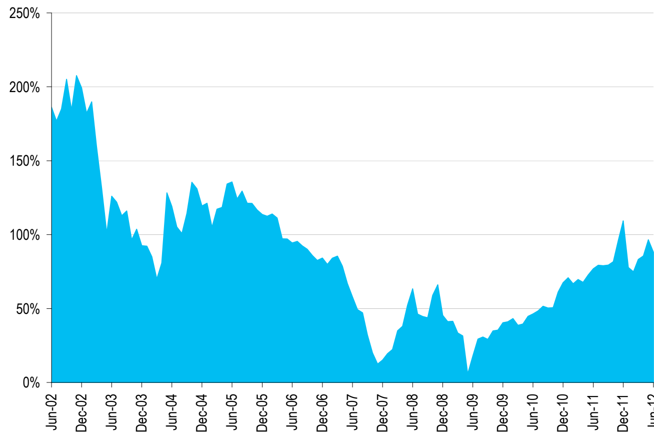
Defensives are expensive

We believe there's greater value and return in cyclicals than defensives because a) the valuation premium of defensive/cyclicals is excessive – at a 5-year high and b) earnings upsides are more biased for the cyclicals – and more biased on the downside with the defensives, particularly consumer staples.

Defensive to cyclical premium at a 5-year year peak ... and the economy has changed over the last decade, when these premiums were even higher

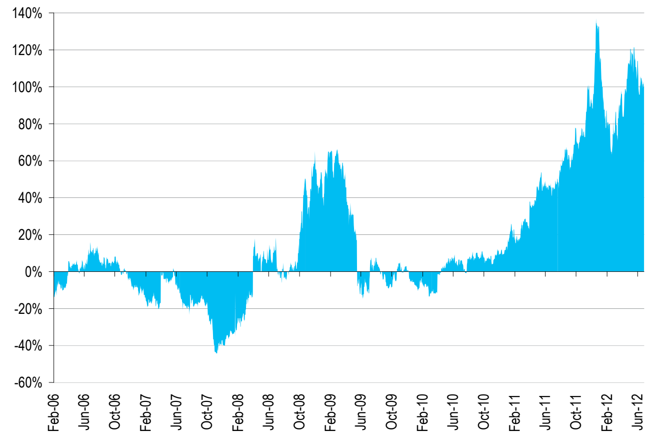
Is the 5-year peak defensive/cyclicals premium such an issue, given that the premium has been substantially higher in the earlier part of the decade? We would argue that the underlying economic structure is very different today than what is was at that stage (Investment to GDP ratio in the mid 20's vs. mid 30s currently), the level of investment was significantly lower. Importantly, a lot of the consumption trends seen in the economy have been a result of the aggressive investment momentum witnessed in India over the last couple of years (which has created the jobs, some infrastructure, and provided the government some of the revenues that have supported its social spends). Continuation of the weakness in the cyclical and investment part of the economy (fairly well reflected in cyclical stocks) would inevitably hit consumption and defensive stocks, both on earnings levels and their lofty valuation levels.

Figure 15. Valuation (PE) premium of defensives vs. cyclicals



Source: Factset, Citi Research

Figure 16. Valuation (PE) Differential: Consumer Staples vs. Cap Goods



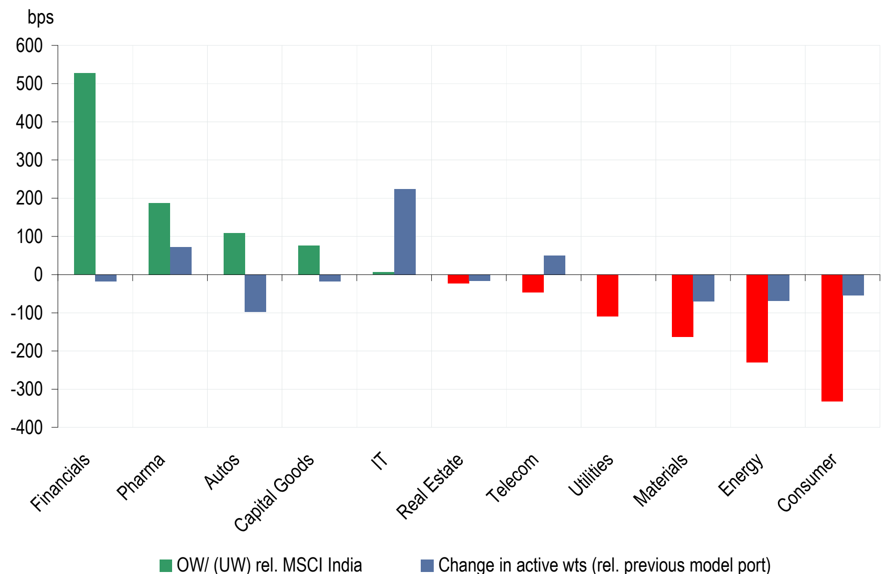
Source: Bloomberg, Citi Research

Citi Model Portfolio positioning

Our Portfolio positioning – Cyclically biased

We have been running a cyclically biased model portfolio over the current year – into which we built some currency protection in April (IT services upgraded to Neutral, and Pharmaceuticals a more aggressive OW). This has delivered decent outperformance YTD (app 3.5%) – we would expect more outperformance ahead. We expect gains ahead for the Indian market – but relatively modest ones from current levels, with an 18,400 Sensex target (+5.6%) by December 2012.

Figure 17. Model Portfolio Sector Positioning



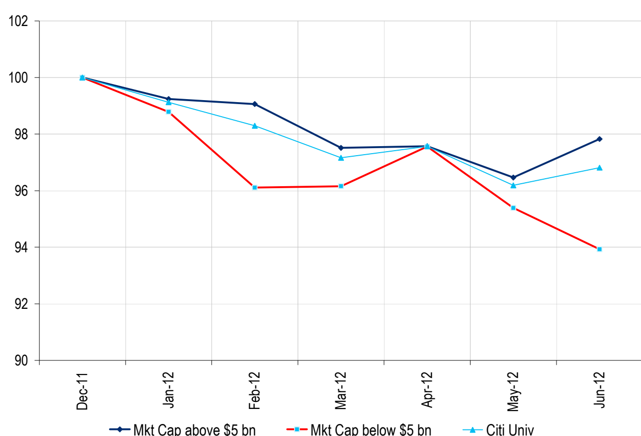
Source: Citi Research

Are mid caps synonymous with cyclicals and risk?

The valuation gaps between defensives/cyclicals and large-caps/small-mid caps is a lot less….so cyclicals and risk do not necessarily imply small cap.

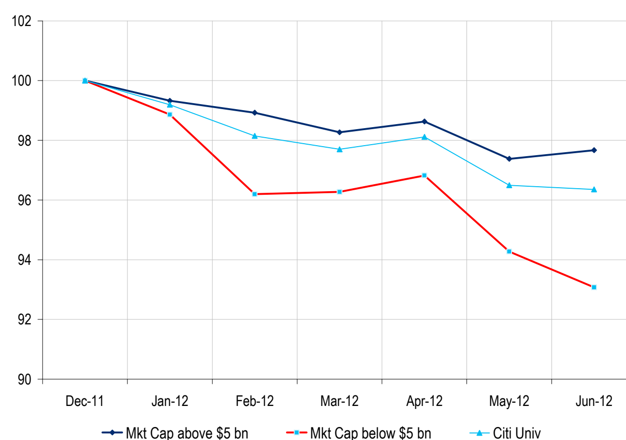
No. There is a difference – in the earnings risks and trajectory. Mid-caps earnings downgrades have been substantially more, have tended to only rise over the recent past, and a slower economy (and tighter funding) would clearly raise the risk for them and limit some of the consolidatory gains of the larger players.

Figure 18. Large vs. small/ mid caps: FY13 CIRA earnings changes YTD



Source: Citi Research

Figure 19. Large vs. small/ mid caps: FY14 CIRA earnings changes YTD



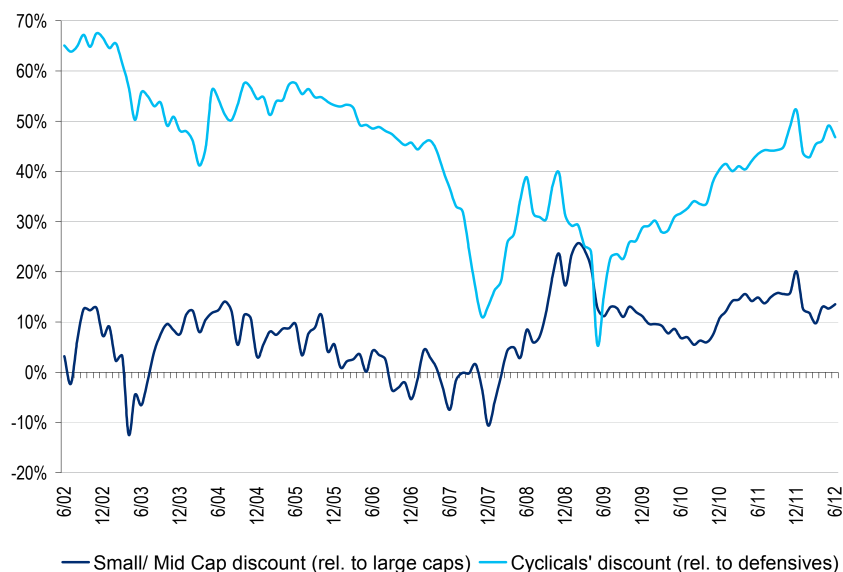
Source: Citi Research

Earnings downgrades for the mid-caps continue to be substantially more than the larger companies…so reversals, at aggregate, could also be tougher

Equally tellingly, the valuation differential between defensives/cyclicals remains substantially more than that between large caps/small caps. If anything, this would suggest that business/stock characteristics have likely been bigger drivers than scale. While we are not suggesting that one specifically stays away from small caps –we would argue that the valuation differential between defensives and cyclicals is far more compelling than the small cap/large cap one.

The valuation gaps between large-caps/small-mid caps is a lot less compared to defensives/cyclicals gap….so cyclicals and risk do not necessarily imply small cap

Figure 20. Valuation (P/E) discount



Source: Citi Research

Figure 21. Citi India Model Portfolio

	Price 2-July-12 (Rs)	YTD Perf. (%)	YTD Rel. Perf.	RIC	Rating	MSCI Weight (%)	Portfolio Weight	OW/ UW/Rel. MSCI (bps)	FY13 PE (x)	FY13 EPS Growth (%)	FY13 PB (x)	FY13 ROE (%)
Automobiles and Components						**7.8**	**8.9**	**109**				
M&M	713.8	4.5%	-8.8%	MAHM.BO	2		2.2	O/W	16	4.3%	2.9	20.8%
Maruti	1180.6	28.3%	15.1%	MRTI.BO	1		2.5	O/W	17	26.6%	2.0	12.8%
Tata Motors	238.4	33.6%	20.3%	TAMO.BO	1		4.2	O/W	7	-18.4%	1.7	30.2%
Banks & Diversified Financials						**25.3**	**30.6**	**527**				
AXIS Bank	1029.1	27.6%	14.3%	AXBK.BO	1		4.0	O/W	9	14.4%	1.6	19.2%
IDFC	137.7	50.1%	36.8%	IDFC.BO	1		1.0	M/W	11	11.8%	1.5	13.7%
HDFC Bank	573.9	34.4%	21.1%	HDBK.BO	2		5.5	U/W	20	26.8%	3.6	19.7%
ICICI Bank	894.0	30.6%	17.3%	ICBK.BO	1		6.0	O/W	13	21.0%	1.6	12.4%
State Bank of India	2179.6	34.6%	21.3%	SBI.BO	1		3.5	O/W	10	20.0%	1.5	16.2%
Yes Bank	343.5	43.9%	30.7%	YESB.BO	1		1.0	O/W	10	23.5%	2.1	23.3%
Kotak Mahindra	598.2	38.4%	25.1%	KTKM.BO	2		1.0	U/W	20	23.8%	3.0	16.2%
MMFSL	647.0	6.8%	-6.5%	MMFS.BO	1		1.0	O/W	9	15.2%	1.8	22.4%
Bank of Baroda	727.7	10.1%	-3.1%	BOB.BO	1		1.0	O/W	5	18.2%	1.0	20.9%
MCX	1063.7			MCEI.BO	1		0.5	O/W	15	24.9%	4.6	32.9%
Industrials & Capital Goods						**6.7**	**7.5**	**76**				
Larsen & Toubro	1399.4	40.6%	27.4%	LART.BO	1		4.0	O/W	18	10.0%	3.0	18.0%
Adani Port & SEZ	124.9	3.6%	-9.7%	APSE.BO	1		1.5	O/W	16	31.4%	3.8	26.2%
Havells	583.0	51.9%	38.7%	HVEL.BO	1		1.0	O/W	19	20.4%	3.8	21.2%
IRB Infra	132.3	1.8%	-11.5%	IRBI.BO	1		1.0	O/W	8	7.2%	1.3	16.8%
Energy						**11.4**	**9.2**	**-229**				
Reliance Industries	737.5	6.4%	-6.8%	RELI.BO	1		7.0	U/W	12	1.8%	1.3	11.5%
Cairn	314.2	0.2%	-13.0%	CAIL.BO	1		2.2	O/W	5	46.4%	1.0	22.0%
Consumer						**9.5**	**6.2**	**-332**				
ITC	250.1	24.2%	11.0%	ITC.BO	1		3.7	U/W	27	19.7%	9.3	37.0%
United Spirits	714.4	45.4%	32.2%	UNSP.BO	2		1.5	O/W	23	16.3%	1.9	8.5%
Hindustan Unilever	447.1	9.6%	-3.6%	HLL.BO	3		1.0	U/W	32	18.5%	23.1	80.0%
Materials						**10.3**	**8.7**	**-163**				
Coal India	349.8	16.3%	3.0%	COAL.BO	1		1.0	U/W	13	13.6%	4.3	36.0%
Hindalco	121.1	4.6%	-8.6%	HALC.BO	1		1.0	U/W	9	0.6%	0.7	8.3%
Jindal Steel & Power	457.8	1.0%	-12.2%	JNSP.BO	1		1.7	O/W	10	11.0%	1.9	22.4%
Grasim	2709.6	8.0%	-5.2%	GRAS.BO	1		1.0	O/W	8	12.1%	1.3	15.9%
Ambuja Cement	175.8	13.1%	-0.2%	ABUJ.BO	1		3.0	O/W	14	36.8%	2.9	21.5%
JSW Steel	679.2	33.9%	20.7%	JSTL.BO	1		1.0	O/W	8	111.9%	0.8	11.1%
Pharmaceuticals, Biotechnology, Agrochem						**5.1**	**7.0**	**187**				
Ranbaxy	495.9	22.4%	9.1%	RANB.BO	1H		1.5	O/W	19	43.1%	3.6	30.6%
Dr Reddy	1643.6	4.2%	-9.1%	REDY.BO	1		2.5	O/W	16	36.6%	3.6	26.8%
Lupin	543.4	21.5%	8.3%	LUPN.BO	1		1.5	O/W	19	31.5%	4.8	27.8%
IPCA Lab	361.1	31.4%	18.2%	IPCA.BO	1		0.5	M/W	12	26.3%	2.8	26.2%
United Phosphorous	124.6	-1.8%	-15.1%	UNPO.BO	1		1.0	M/W	6	36.7%	1.2	19.6%
Software & Services						**17.1**	**17.2**	**6**				
Infosys Technologies	2501.1	-9.5%	-22.8%	INFY.BO	1		12.0	O/W	15	16.3%	3.6	26.3%
Tata Consultancy Services	1260.2	8.5%	-4.7%	TCS.BO	2		2.0	U/W	18	28.5%	6.0	37.1%
Wipro	400.3	0.4%	-12.9%	WIPR.BO	1		1.8	O/W	14	21.5%	2.9	21.9%
HCL Technologies	484.1	24.7%	11.4%	HCLT.BO	1		1.4	O/W	13	26.2%	2.9	24.9%
Telecom Services						**2.5**	**2.0**	**-47**				
Bharti Airtel	309.9	-9.6%	-22.9%	BRTI.BO	1		2.0	O/W	15	80.5%	2.0	13.7%
Utilities						**3.1**	**2.0**	**-110**				
Tata Power	104.4	19.7%	6.4%	TTPW.BO	2		1.0	O/W	26	-10.5%	2.1	8.1%
Power Grid Corp	112.7	12.8%	-0.4%	PGRD.BO	1		1.0	M/W	15	16.8%	2.0	14.4%
Real Estate						**1.0**	**0.8**	**-23**				
DLF	204.6	11.8%	-1.5%	204.6	2		0.5	U/W	22	32.9%	1.3	6.2%
Phoenix	178.1	7.7%	-5.5%	178.1	1		0.3	O/W	23	4.4%	1.5	6.4%
Total						**100.0**	**100.0**					

Source: Citi Research

*Weights may not add up to 100 due to regulatory restrictions

Appendix A-1

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