India Equity Strategy

Just What the Doctor Ordered

- Equities

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

Jitender Tokas,CFA
+91-22-6631-9887
jitender.tokas@citi.com

- **The Good Doctor's Dose** — India has been under the weather, but recent fuel price/FDI/divestment reforms suggest the Doctor (Dr. Singh) has finally/correctly diagnosed the problem, is administering the first bitter medicine dose (i.e. political opposition ahead: expect Govt. to hold ground), though the patient (economy) will take time to improve. The direction/platform for policy making does appear to have changed; Equity/Macro markets should lead this change - though economic, investment and earnings growth could well lag these newer expectations (Falling GDP, Rising Market – Here's Why).

- **What will the medicine do?** — So what changes, and over what time-frame? We see a) Macro: Upfront gains (equity/currency), near term (Interest rates/liquidity) and staggered (fiscal), b) Corporate risk/investment appetite: Corporates in risk unwind/profit focus mode (unlikely to U-turn quickly – so will take time). FDI in new areas will also take time, c) Economic/Earnings growth: GDP upside will be back-ended (FY14 only), EPS growth gains modest, d) Corporate/Consumer confidence: Harder they fall, quicker they rise – Corporates to lead revival vs. Consumer (who have actually yet to fall). A mixed bag – but winds shifting from the head to the tail.

- **Flows (the tonic): In the face of reforms, QE3 and performance** — We expect the market to perk up immediately (+2-3%) on sheer and primarily foreign flows: a mix of fairly real policy change, global liquidity (QE3), and yes – fairly substantial outperformance YTD. While India is not particularly well positioned for relative performance on QE3 (High crude/commodities, relative Valuations -QE Cues) – these reforms should drive early gains. There should be some domestic flow tailwinds too (UW Institutions, missing HNI's) – but expect the absent retail investors to participate only after another 10%+ up move from here.

- **Better, but hasn't got its old health back yet: revise target to 19900, Jun'13** — Our 18,400 Dec 12 Sensex target is past - revise up to 19,900 (Jun'13), a little front loaded. We however maintain our target market multiple of 14.5X (roll forward to Dec'13 from Mar'13); suggesting India will trade at lower multiples than historical averages (15-16X), given growth, return and political decision making challenges. We maintain our relatively aggressive portfolio stance (OW rate cyclicals, i.e. Banks, Autos, Capital Goods), switch the currency sensitives (raise IT to OW, lower Pharma to Neutral), and remain UW consumer Staples, Telecom, Utilities, Energy and Materials.

- **Large rather than small cap, some high risk/high returns calls, and some baskets** — We would stick with the larger caps (Axis Bank, ICICI, SBI, L&T, Maruti, Ambuja Cements, Infosys) for gains through this up-cycle; there are High Risk/Return options (JSPL, JPA, Adani Ports & SEZ) and riskier and mid-market plays in PSU banks/Mid-cap construction baskets. Get well soon, investors.

Just What the Doctor Ordered

What's happened?

Ticking off a lot of investor expectation boxes, the Government has surprised (against low expectations)…on policy reform, and resolve

The Indian Government after faltering for a couple of years on economic and policy decision-making (and expectation of any governmental action had dipped to a nadir) has come out and made aggressive policy changes. These measures tick off a lot of the boxes that investors had been expecting of the Government. They cover the gamut of fuel pricing and subsidy adjustments, opening up the market to FDI in retail and aviation, and committing to more aggressive divestments. These collectively have surprised the market, in scale, and the aggressive nature in which they have been projected.

Figure 1. Reforms announced and reforms outstanding

Recent Action	Contours	Comment
Diesel price hiked by Rs 5	Reduces Subsidy	Very pressing - for actual subsidy, demand destruction and messaging - Big actual gain
LPG subsidy capped	Reduces Subsidy - Targets subsidy	Targeted subsidy - the way forward, with actual gains
FDI in multi-brand Retail - upto 51%	Sourcing relaxations in previous unapproved policy	Key for perception - Long term gains for rural infrastructure, investment
FDI in aviation allowed	Airlines can take stakes - previously not allowed	Possible near to medium term bail-outs, capital flow
FDI limit increase in broadcasting infrastructure	Broad array of areas covered	Expanding funding limits
FDI in power exchanges allowed	Up to 49% - Facilitative	Broader based opening up - process/technology rather than capital
Divestment plans announced	Oil India	Part addresses fiscal challenges
Key outstanding issues/ legislations/ reforms	**Contours**	**Comment**
General Sales Tax (GST)	Landmark Change - for efficiency, GDP and tax collections	Delayed, political challenges, but a medium term likelihood
Direct Tax Code (DTC)	A simplified Tax platform	Delayed, but could be executed soon
Land acquisition bill	For commercial land acquisition, and Rehabilitation	Contentious, likely but risk of it being unfavorable for business
2G spectrum auction	To be completed by January 2013	Need to move ahead of Scam - pricing / failure risk
Resolution of coal block allocation controversy	Exercise Under way	Critical an underway - but high political risks
Execution - Environmental and other approvals	The big bottleneck - hard on the ground effort needed	Government seems aggressively working on it - lots of loose ends, outside their control

Source: Citi Research

Will it hold? There's large and loud political opposition

We believe it largely will… or is it just wishful thinking at our end?!

India has taken some measures before (albeit not as large or comprehensive), but they have in quite a few cases been pulled back, or diluted substantially, in the face of resistance from both coalition as well as opposition parties. And there are enough signs of there being a significant level of opposition to reforms this time too. It's loud, and is coming from opposition political parties, its allies, and a fair share of the media. So will it hold this time?

No compromises at all?.... Some possible, but not likely to be too material

A difficult call, but our sense is that there does appear a certain determination in the govt this time that has been missing in the past. The underlying economic momentum is under more stress than it has ever been, and we believe the government is now beginning to lose significant political mileage on account of the economic slowdown. In our view, the bulk of these changes will go through, though there is a slight risk of dilution on the LPG subsidy reduction, but not something we believe will meaningfully dilute the overall thrust and import of the decisions. There will however be a political tussle in play over the next couple of weeks that could be a little jarring for markets

But could the Government itself fall, creating even more problems….a greater possibility than before, but the Governments' allies do not appear to be politically positioned for it

Is there a risk that if the govt maintains a rigid stance on these decisions, it could well fall (or lose its majority)? It is after all a Government that gets it majority through support from allies – most of whom appear to be against these policies. We believe that is a possibility and could be particularly negative for the economy and the market given their relatively precarious state. However, our own sense is that should not be the case given there are few government allies that would want an election at this stage, and the huge uncertainties and risks that go with an election.

It does appear an all or nothing approach…..may or may not work, but clearly about time

So while the government does appear to have taken an 'all or nothing' approach on these measures, we believe it will get by (if anything, it would appear strengthened given that one of its biggest weakness has appeared to be the lack of decision making). So our view is that the bulk of these measures go through, and the government stays.

More top down, than bottom up

It's about the macro top, expectations of further Government action…its less about the specific bottom-up measures

While the measures are fairly specific – diesel pricing, Retail and Aviation FDI, and divestments - we believe their importance is more top down. More specifically, it seeks to address the issue of macro pressures (subsidy), long term growth opportunities (FDI in retail), a more defined and reliable policy frame-work (recent measures on Taxation which seek to unwind earlier policy reversals), and confidence in the legislative frame-work. It also seeks to be specifically foreign investor friendly, which has not appeared to be the case in recent years.

A good platform for more aggressive… particularly execution ….efforts ahead

While India has been hobbled by a poor policy frame-work; the bulk of its problems lie in execution issues. These cover the gamut of its Coal, Electricity, environmental clearance and other bottlenecks – which are not big-picture policy issues, but more mundane nitty-gritty issues. This – the inertia and apparent Government insensitivity towards resolving them - has probably been the biggest challenge. We would argue that time (its been about 2 years mounting problems on this front), much more pressure on the Government, and a significantly enhanced Government effort at resolving these issue – should increasingly culminate in a step up in such decision making. We do sense that a good platform has been created towards quicker resolutions, there is political tailwind to it, and one should expect more rather than less.

Is it all about political resolve and decision making…no…. there's a lot out of its control…. but there is more confidence in Government intent

Is it a done deal? No. There are political, regulatory and judicial challenges (and a lack of coordination and accountability), and there are risks that go well beyond the Government's intent, but we would be biased towards expecting more than less.

Specific sector relaxations – should be a while before meaningful capital actually follows

There are sector specific and stock implications too – we highlight them, though we do not believe that that is the swing element. We also believe that it will be a while before FDI inflows actually follow these policy announcements - are likely to be negligible at best in the near term, and not really material in the medium term. So it's a long term thing, and not something that is likely to drive either economic growth or capital flows in the immediate term.

Does the market valuation framework change? – No

Do not expect India to go back to its average15-16X Fwd trading multiple…expect a 14.5X 1 Yr fwd fair value level

Is all this apparently good and unexpected news likely to change India's valuation framework, and take it back to historically high trading multiples (15-16X)? In our view, no. India has de-rated over the last couple of years, and we believe the new announcements, along with expectations of more, are unlikely to be enough to get India back to its higher multiple path. We see India trading at a 14.5X 1 Yr multiple – and continue to maintain that should be the case.

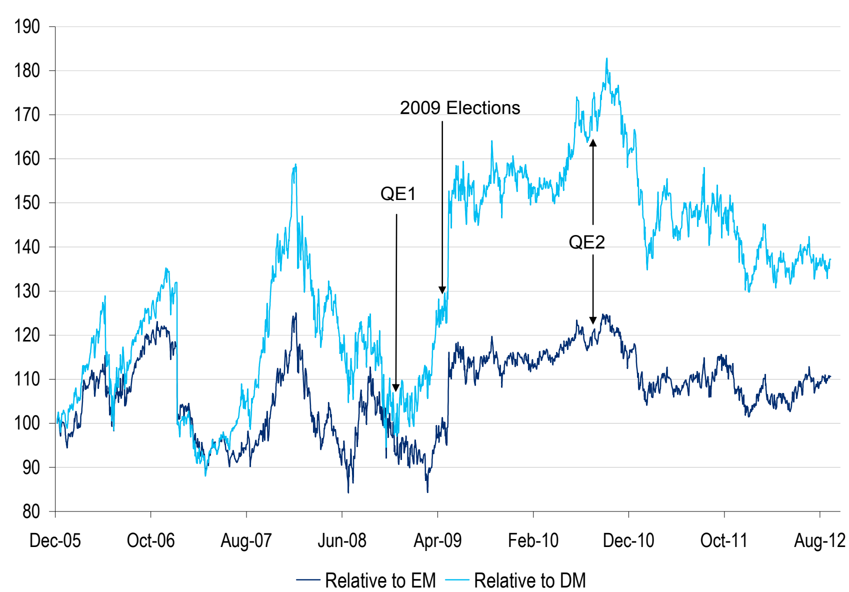
Raise index target to 19,900 for June 2013 (roll forward to Dec 13 EPS)…now that our 18,400 Dec 12 target has been hit

Towards this end, we raise our index target to 19,900 on the Sensex, for June 2013 (from our current target of 18400 for Dec 2012, which has been breached). For India to go back its previous trading averages – its growth needs to quicken, its return structure needs to improve faster, the macro needs greater control and stability, and more importantly, the political decision making process needs to improve substantially (we don't see that happening).

If India were to get back to its old valuation range (15-16X) near term…it would be an overshoot

Effectively, India should get a cyclical bounce from here, but structurally, India will trade lower than its historical averages. If it does go back to its older averages – in a potentially rally following the recent developments – we would argue that it is an over-stretch, rather than a sustainable valuation level.

Figure 2. India's performance relative to EM and DM

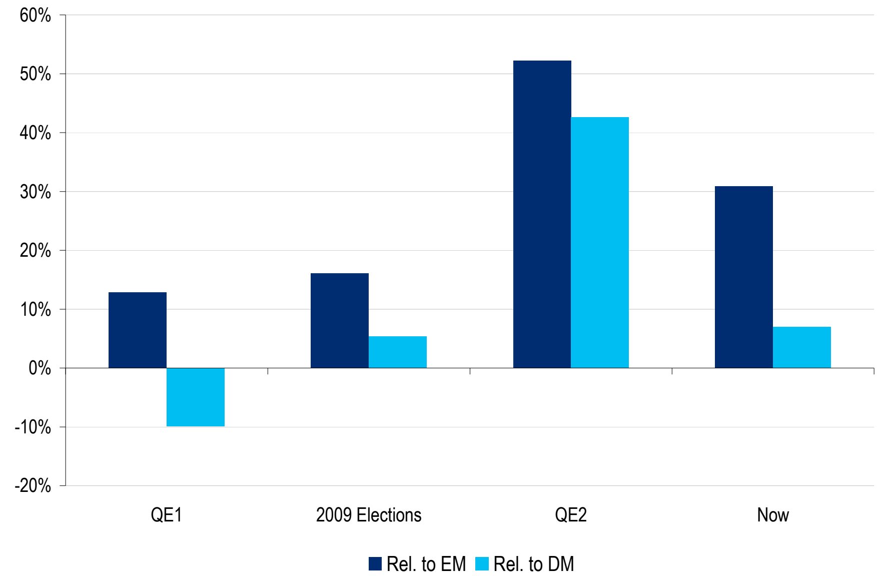


Source: MSCI, Datastream and Citi Research

We expect a 2-3% immediate term bounce in the market

We do believe the market should see anything between a 2-3% bounce as it opens on Monday, with currency gains to boot. The globally positive risk environment should help: and a mix of recent performance, good news, bottom up developments, should add to recent tailwinds.

Figure 3. India's relative valuations (1-Yr fwd P/E) at the starts of key events



Source: MSCI, IBES, Datastream and Citi Research

But how will the equity market rise in a still falling GDP environment?

We recently sought to address the issue of India's relatively strong market performance, in the face of slowing growth (Falling GDP, Rising Market – Here's Why). We believe the same arguments hold in the newer scenario – in fact they probably get amplified.

Gains on macro, and corporate focus ….

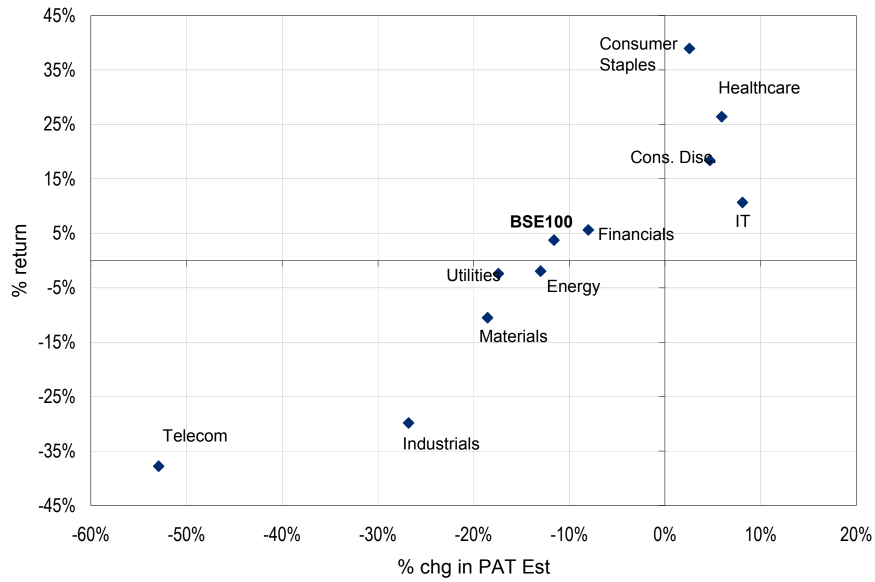
While the mood is clearly upbeat, where would the fundamental support / gains come from? We would argue that the primary gain will come from the improved macro (rates, liquidity and stronger currency). We would also argue that the corporate sector is clearly more focused on profitability, de-risking, and effectively being much more rational in its approach. We believe this should provide some valuation support.

But little progress, or potential disappointments…in any upward swings in growth or earnings.. And corporate risk taking or investing …is not going to revive overnight

But, in the face of greater corporate focus on profitability – we believe broader corporate investing or risk taking will remain relatively subdued, job creation will remain modest, and there will not be the broader market growth that the equity market might well start dreaming up. The same holds for earnings expectations - there could be some upside from analysts moderating their risk aversion; but really underlying businesses are unlikely to see a material step up in the near term. So while there will be an upside on macro and corporate focus, it will be offset by growth that does not bounce-back the way the market might expect it to.

Returns tend to move in tandem with earnings changes..

Figure 4. Change in FY13 cons. earnings est. vs. returns (Aug'11 – Aug'12)



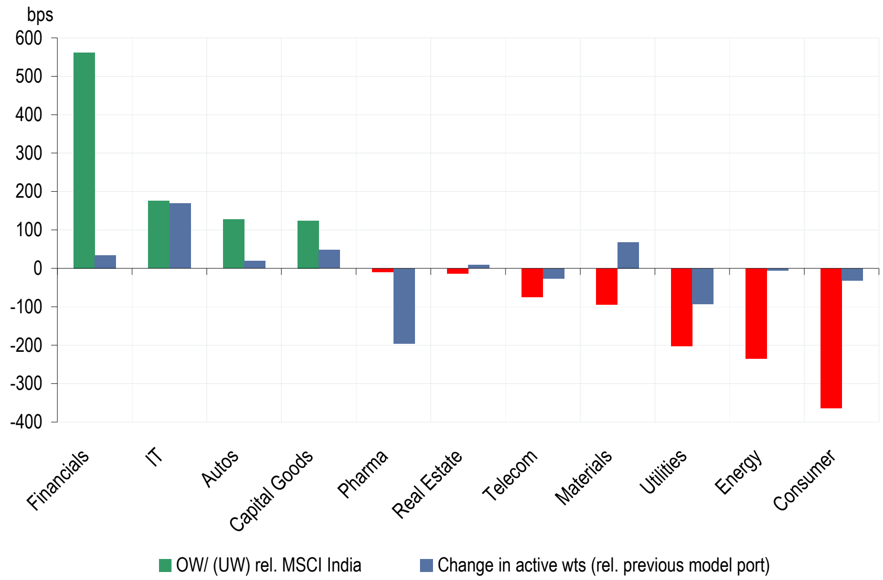
Source: Factset, MSCI, Datastream, Bloomberg and Citi Research

How does one play it?

Clearly cyclicals over the defensives

We continue to believe the market is well set up to play the domestic cyclical story - and expect the Banks, Autos and Industrials to continue to out-perform. We also now argue that the IT sector should be an outperformer so raise it to an OW (from Neutral) – this is offset by reducing Pharmaceuticals to a Neutral. Our UW bias on defensives stays. And while Materials is likely to be a near term beneficiary on account of the global and local risk-on kind of trade – we would remain UW on them looking beyond the immediate near term (we are OW the domestic materials – Cement, which should be a strong beneficiary). We remove United Phosphorus and introduce Tata Steel in our model portfolio and rebalance the existing stocks.

Figure 5. Model Portfolio: sector allocation changes



Source: Citi Research

Still large caps over small caps

We maintain our large cap bias: we believe the macro trade is upfront, but the underlying economic and business challenges will stay. That to us suggests that beyond the initial bounce, it is the larger caps that should continue to generate stronger returns. We would however in most sectors play at a little below the absolute top end of the market (Axis Bank being an example – private sectors, but with some balance-sheet and market perception damage to remain).

And there are of course different horses for courses…and stock pools based on investor appetite

We also highlight what we believe would make good plays in the near term, based on risk appetite. There are the high risk high returns picks, the mid caps, and small cap and potentially leveraged baskets, that we believe could generate meaningful gains, if the near term upsides unfold as we believe they will.

Figure 6. Stock Picks

Stock	RIC	TP (Rs)	Rating
Large Cap Picks			
Axis Bank	AXBK.BO	1320	1
ICICI	ICBK.BO	1100	1
SBI	SBI.BO	2200	1
L&T	LART.BO	1531	1
Maruti	MRTI.BO	1654	1
Ambuja Cements	ABUJ.BO	219	1
Infosys	INFY.BO	2710	1
High risk/ high return picks			
Jaiprakash Associates	JAIA.BO	91	1
Adani Ports and SEZ	APSE.BO	159	1
Jindal Steel & Power	JNSP.BO	636	1
Mid Cap Picks			
LIC Housing Finance	LICH.BO	280	1
MCX	MCEI.BO	1400	1
Cummins	CUMM.BO	536	1
Crompton Greaves	CROM.BO	152	1
IRB Infrastructure	IRBI.BO	238	1
Phoenix Mills	PHOE.BO	255	1
Jet Airways	JET.BO	545	1H
Portfolio plays			
- Basket of PSU banks			
- Basket of construction stocks			

Source: Citi Research

And there should be the flow tailwind

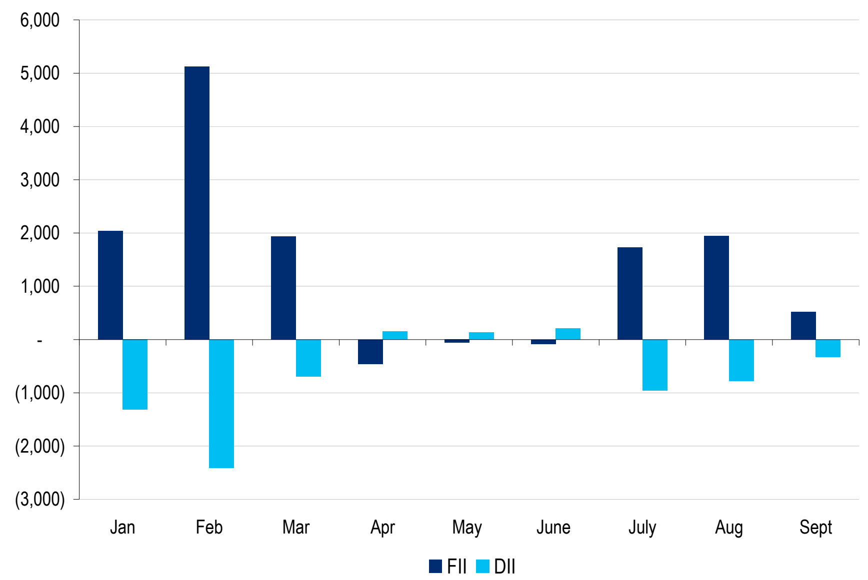
It's been FIIs all the way so far…. this trend should remain

It's been FII's all the way, investing aggressively ($12b+ YTD), unexplainably (where is it coming from) and relatively more in India than peers. We expect this to continue over the near term. But could the domestic outflow tide turn? We do see that possibility – with domestic institutional investors (who have been relatively aggressive and consistent sellers into the market in the current year). And we believe the high net worth Individuals segment could also come back into the market, post fairly decent gains during the year (now 20% YTD) – and the positive pink press market headlines that are likely to follow.

The retail investor has stayed out…and will probably continue to do so for a while

We would argue – primarily on gut – that the absent retail investor needs to see sharper and more substantial gains to start participating. That for us is benchmark sensex level of about 20,000 – we don't see that till June 2013, so if we are right, the retail investor will not be a rally driver.

Figure 7. Net investments in Indian equities in 2012 (USD mn)

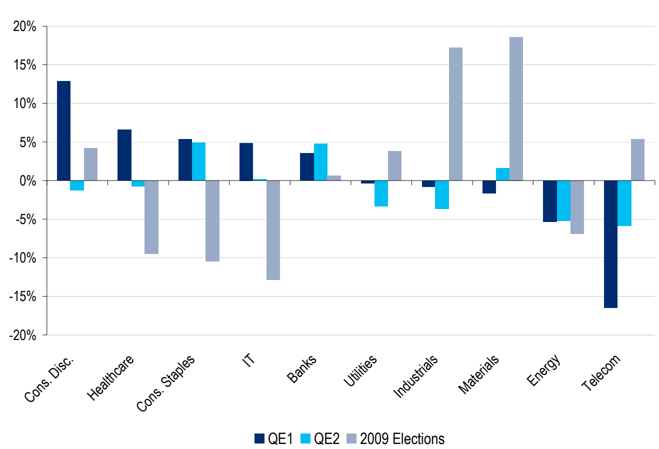


Source: Bloomberg

What's done well in previous risk-on's in India?

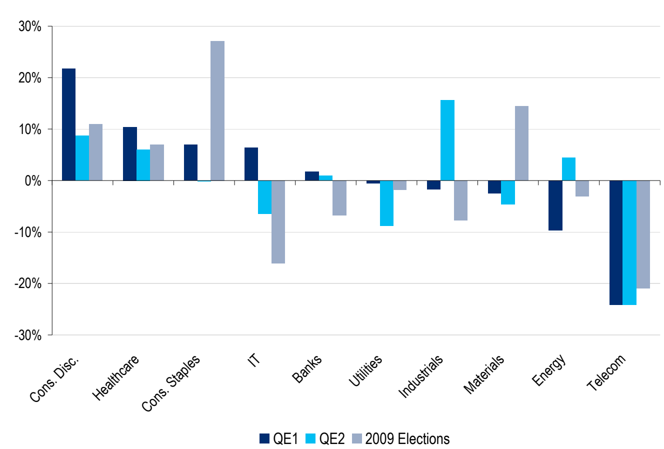
We highlight how sectors have performed in previous change environments. We would highlight the 2009 general elections when India moved 20% over the weekend on the current government winning, against expectations. The recent announcements were almost as much of a surprise but do not expect the market to make the same mistake this time around. So play for gains but do remember, it is not a structural rerating, it is a cyclical pop.

Figure 8. India sectors relative performance: 1mth post events



Source: MSCI, Datastream and Citi Research

Figure 9. India sectors relative performance: 3mths post events



Source: MSCI, Datastream and Citi Research

Every few years, one does see a somewhat or apparent landmark change in India equity market perceptions / expectations – we think this slew of policy measures is one more such kind of scenario. Let's see how they pan out, but some experience (at least in years in the equity markets) suggests that with India, it's often not as bad as it sounds, and also not quite as good as it might appear. Happy and safe investing.

Figure 10. Citi India Model Portfolio

	Price 16-Sep-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						**6.92**	**8.2**	**128**				
M&M	777.1	13.8%	-5.9%	MAHM.BO	2		1.8	M/W	17	0.5%	3.2	21.2%
Maruti	1261.2	37.1%	17.4%	MRTI.BO	1		2.6	O/W	18	26.6%	2.1	12.8%
Tata Motors	270.3	51.5%	31.8%	TAMO.BO	1		3.8	O/W	8	-12.0%	2.0	28.6%
Banks & Diversified Financials						**27.59**	**33.2**	**561**				
AXIS Bank	1009.6	25.1%	5.4%	AXBK.BO	1		4.2	O/W	9	10.9%	1.5	18.9%
IDFC	138.7	51.1%	31.4%	IDFC.BO	1		1.0	U/W	11	18.9%	1.5	14.2%
HDFC Bank	612.1	43.3%	23.6%	HDBK.BO	2		5.5	U/W	22	27.9%	4.1	20.4%
ICICI Bank	1006.4	47.0%	27.3%	ICBK.BO	1		6.3	O/W	14	25.5%	1.8	12.8%
State Bank of India	1970.6	21.7%	2.0%	SBI.BO	1		3.6	O/W	11	3.7%	1.4	14.1%
Yes Bank	356.0	49.2%	29.5%	YESB.BO	1		1.0	O/W	10	29.0%	2.2	24.2%
Kotak Mahindra	606.4	40.3%	20.6%	KTKM.BO	2		1.0	U/W	22	12.5%	3.0	14.9%
MMFSL	795.2	31.2%	11.5%	MMFS.BO	1		1.0	O/W	11	18.6%	2.3	23.0%
Bank of Baroda	678.6	2.7%	-17.0%	BOB.BO	1		1.3	O/W	5	3.3%	0.9	17.8%
MCX	1277.2			MCEI.BO	1		0.5	O/W	21	7.0%	5.6	28.5%
Industrials & Capital Goods						**5.21**	**6.5**	**124**				
Larsen & Toubro	1487.0	49.4%	29.7%	LART.BO	1		4.0	O/W	18	12.5%	3.2	18.3%
Adani Port & SEZ	111.6	-7.4%	-27.1%	APSE.BO	1		1.2	O/W	15	31.4%	3.4	26.2%
Havells	583.3	52.0%	32.3%	HVEL.BO	1		0.5	O/W	20	22.2%	3.9	21.5%
IRB Infra	126.4	-2.8%	-22.5%	IRBI.BO	1		0.8	O/W	8	8.9%	1.3	17.6%
Energy						**12.30**	**10.0**	**-235**				
Reliance Industries	841.0	21.4%	1.7%	RELI.BO	2		8.0	U/W	12	6.2%	1.3	11.7%
Cairn	354.3	13.0%	-6.7%	CAIL.BO	1		2.0	O/W	6	40.5%	1.2	21.2%
Consumer						**11.63**	**8.0**	**-363**				
ITC	268.1	33.2%	13.5%	ITC.BO	1		4.0	U/W	28	19.7%	10.0	37.0%
United Spirits	931.2	89.6%	69.9%	UNSP.BO	2		2.0	O/W	30	16.3%	2.4	8.5%
HLL	547.4	34.2%	14.5%	HLL.BO	3		2.0	U/W	39	18.5%	28.3	80.0%
Materials						**8.75**	**7.8**	**-95**				
Coal India	382.4	27.1%	7.4%	COAL.BO	1		0.5	U/W	14	13.6%	4.7	36.0%
Hindalco	118.1	2.0%	-17.7%	HALC.BO	1		0.8	U/W	6	8.8%	0.6	11.0%
Jindal Steel & Power	372.3	-17.8%	-37.5%	JNSP.BO	1		1.2	O/W	8	13.0%	1.6	22.3%
Grasim	3112.8	24.1%	4.4%	GRAS.BO	1		0.5	O/W	10	12.1%	1.4	15.9%
Ambuja Cement	197.1	26.8%	7.1%	ABUJ.BO	1		2.8	O/W	16	36.8%	3.2	21.5%
Tata Steel	403.8	20.4%	0.7%	TISC.BO	1		2.0	O/W	15	28.2%	0.9	5.9%
Pharmaceuticals, Biotechnology, Agrochem						**5.59**	**5.5**	**-9**				
Ranbaxy	541.3	33.6%	13.9%	RANB.BO	1H		2.0	O/W	20	40.3%	4.9	39.1%
Dr Reddy	1746.0	10.6%	-9.1%	REDY.BO	1		2.5	O/W	18	28.0%	4.1	26.1%
Lupin	575.2	28.6%	8.9%	LUPN.BO	1		0.5	U/W	21	35.3%	5.1	26.7%
IPCA Lab	443.6	61.5%	41.8%	IPCA.BO	1		0.5	O/W	14	22.6%	3.5	28.3%
Software & Services						**16.15**	**17.9**	**175**				
Infosys Technologies	2632.8	-4.8%	-24.5%	INFY.BO	1		12.4	O/W	16	12.4%	4.0	26.3%
Tata Consultancy Services	1412.0	21.6%	1.9%	TCS.BO	2		2.0	U/W	20	28.8%	6.7	37.2%
Wipro	390.1	-2.2%	-21.9%	WIPR.BO	1		1.8	O/W	15	17.3%	2.9	21.2%
HCL Technologies	582.5	50.0%	30.3%	HCLT.BO	1		1.7	O/W	14	28.0%	3.2	25.3%
Telecom Services						**1.74**	**1.0**	**-74**				
Bharti Airtel	255.1	-25.6%	-45.3%	BRTI.BO	1		1.0	U/W	25	-9.9%	1.8	7.4%
Utilities						**3.23**	**1.2**	**-203**				
Tata Power	97.9	12.1%	-7.6%	TTPW.BO	3		0.7	M/W	20	9.2%	1.9	9.8%
Power Grid Corp	120.1	20.2%	0.5%	PGRD.BO	1		0.5	U/W	14	19.5%	2.1	15.7%
Real Estate						**0.89**	**0.8**	**-14**				
DLF	216.8	18.4%	-1.3%	DLF.BO	2		0.5	U/W	23	32.9%	1.4	6.2%
Phoenix	179.4	8.5%	-11.2%	PHOE.BO	1		0.3	O/W	24	4.4%	1.5	6.4%
Total						**100.0**	**100.0**					

Source: MSCI, Datastream and Citi Research

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

Other stocks mentioned:
Axis Bank (AXBK.BO; Rs1,009.55; 1), ICICI (ICBK.BO; Rs1,006.35; 1), SBI (SBI.BO; Rs1,970.55; 1), L&T (LART.BO; Rs1,486.95; 1), Maruti (MRTI.BO; Rs1,261.15; 1), Ambuja Cements (ABUJ.BO; Rs197.05; 1), Infosys (INFY.BO; Rs2,632.80; 1), JSPL (JNSP.BO; Rs372.25; 1), JPA (JAIA.BO; Rs73.70; 1), Adani Ports & SEZ (APSE.BO; Rs111.60; 1), United Phosphorus (UNPO.BO; Rs124.00; 1), LIC Housing Finance (LICH.BO; Rs255.55; 1), MCX (MCEI.BO; Rs1,277.15; 1), Cummins India (CUMM.BO; Rs453.30; 1), Crompton Greaves (CROM.BO; Rs107.45; 1), Infrastructure Developers (IRBI.BO; Rs126.35; 1), Phoenix Mills (PHOE.BO; Rs179.35; 1), Jet Airways (JET.BO; Rs368.35; 1H).

Appendix A-1

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