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Strategy: Lengthening Shadow

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Summary

Global Economy: On thin ice

* EU economies would see recessionary conditions persisting although ECB's incrementally aggressive approach lessens the likelihood of an event risk materialising.
* US macro data has improved to an extent, but lead indicators point towards a weak growth. Slowdown is spreading to EMs including China; 2012 to see growth taking precedence over inflation in policy actions across the region.

Indian Economy: More than a normal business cycle slowdown

* Policy paralysis, fiscal slippages, monetary tightening and uncertain external environment are weighing heavily on the investment cycle. Rate cuts alone would not be adequate to engineer a turnaround.
* Current macro decline is fashioned on the lines of 1992 slowdown even though the economy is better placed on vulnerability indicators. In our base case, FY13 GDP growth is likely to be ~7% but may slip to ~5.8% in a bear case scenario.
* Two key measures, fiscal consolidation & de-bottlenecking of coal production, can help kick start the investment cycle.

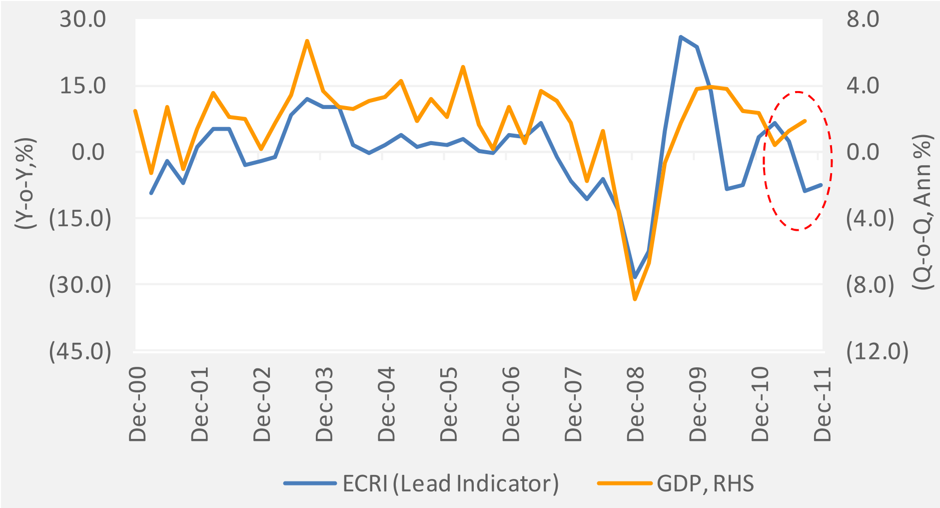
Markets: Concerns persisting, still favoring defensives

* Earnings trajectory continue to face headwinds. Our base case Sensex EPS for FY13 is INR1,261, already downgraded by over 10%, with the risk of further downgrades looming large. However, our bear case estimates put earnings at INR1,143 (GDP growth at 5.8% and USD-INR at 52).
* On an absolute basis, valuations seem fair and below long term averages. But compared to peers in 'BRICS', India is still expensive as FY13 numbers face the risk of further downgrades.
* Given this fragile outlook, the Sensex is likely to be range bound between 14,000-17,000.
* Key themes to play: (a) weak rupee to support earnings in export oriented sectors (maintain OW on pharma , move IT to EW from UW) (b) domestic demand remains healthy (maintain OW on consumer sector) and (c) no immediate visibility on revival of capex (move industrials to UW).
* Model portfolio: Outperformed Nifty by 200bps in CY11; since CY09, outperformance has been by ~400bps.

Global Economy: On thin ice

Western economies: In the lurch

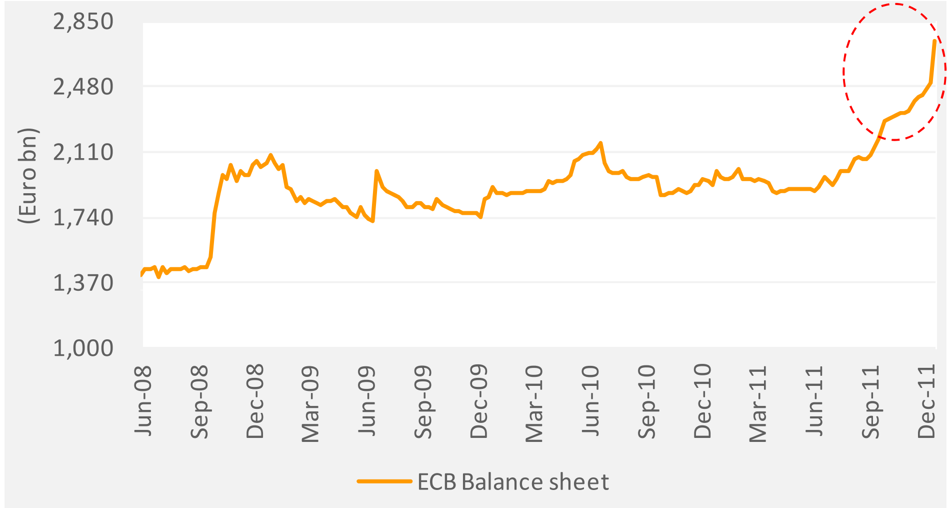
ECRI hints at weak US growth ahead



**ECRI has been a widely tracked lead indicator for US GDP*

Source: Bloomberg

Post –Trichet, ECB turns aggressive in supporting banks



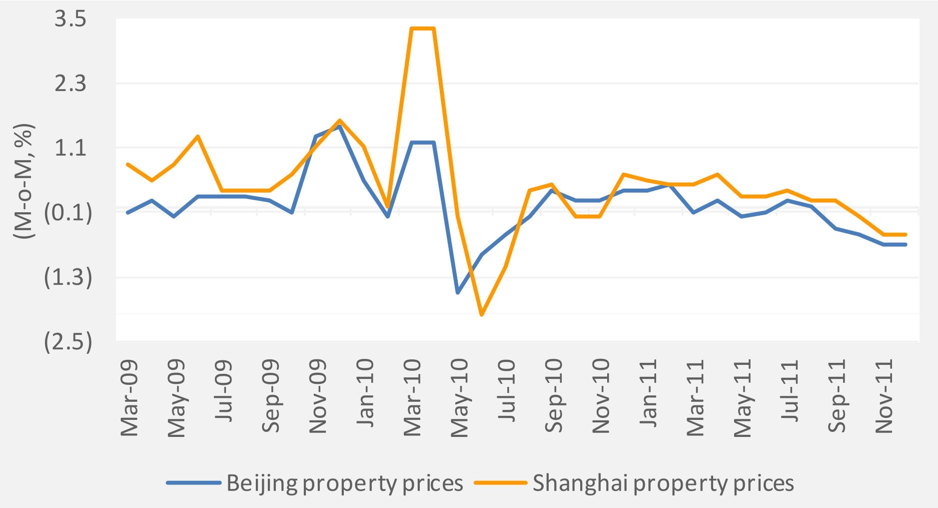
Source: Bloomberg

- US economic outlook for 2012 remains largely delicate (regardless of some recent improvements) as structural constraints linger on.
- In Europe, amidst rising inter-bank stress, ECB has turned more supportive (e.g LTRO, rate cuts etc), ensuring that the EU banking system remains afloat. Indeed, if the situation nears the brim, ECB is likely to shed its reluctance to act as a lender of last resort to sovereigns.
- In sum, while Western economies would continue to see anemic growth in 2012, the likelihood of an event risk materialising has reduced meaningfully.

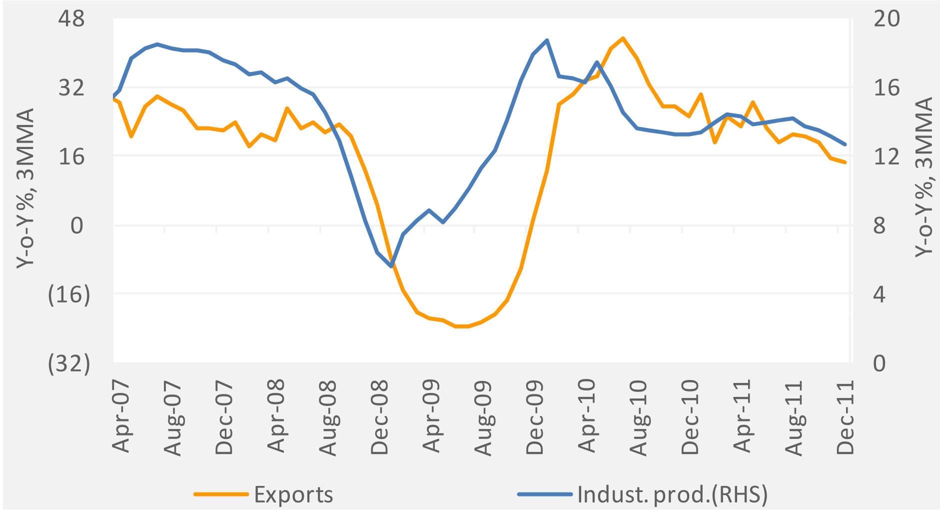
For India, this suggests that foreign inflows would remain weak, keeping INR under pressure

China: Outlook deteriorating

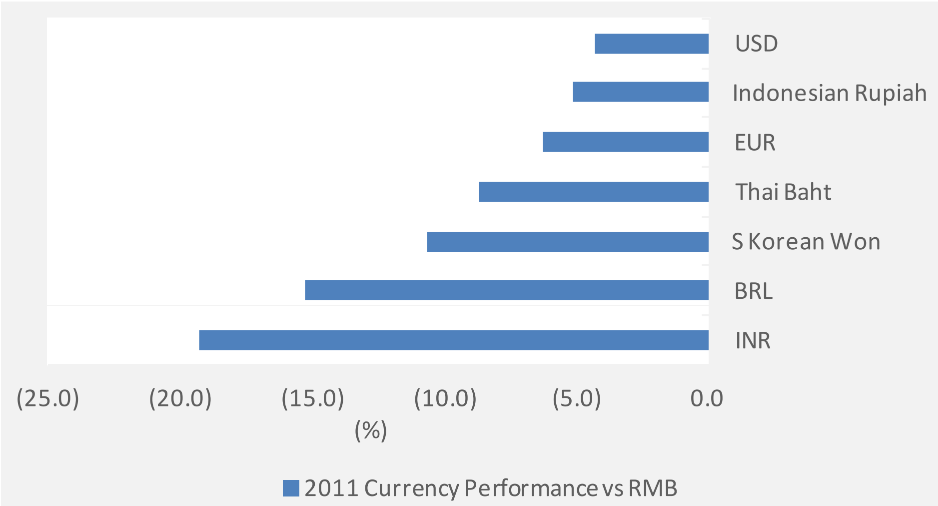
Chinese property market cooling off rapidly



Industrial activity, exports growth fall as well



Significant appreciation in RMB - a strong headwind



Source: Bloomberg

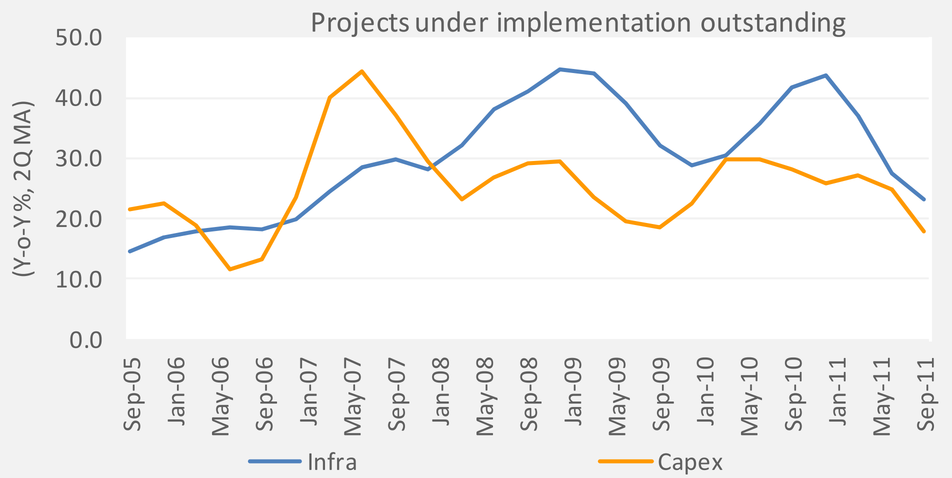
- China's growth is expected to weaken due to the deterioration in both external and domestic environments.
- The scenario will surely impact EM growth and commodity prices as china is a large importer of industrial metals like iron ore, copper, etc.

India to benefit from RMB appreciation and fall in commodity prices

Indian economy: More than a normal business cycle slowdown

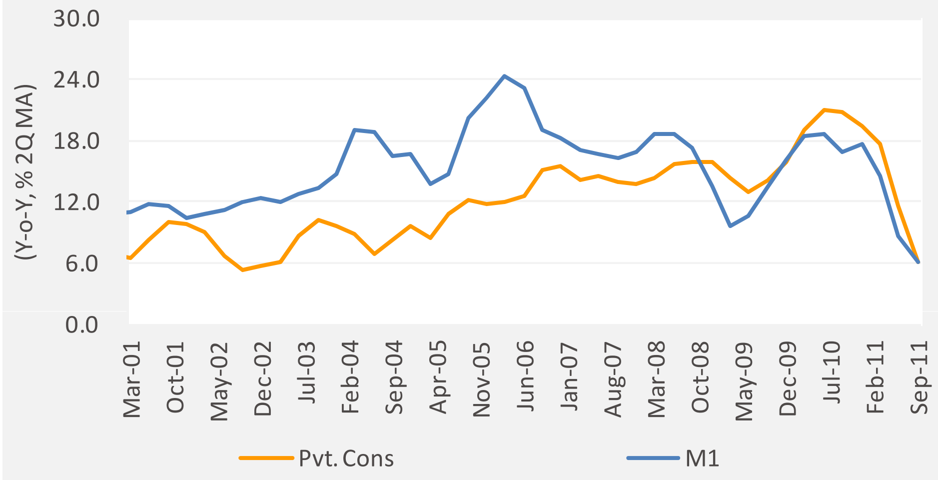
Severe weakening in macros

Sharp slowdown in both infra and capex investments

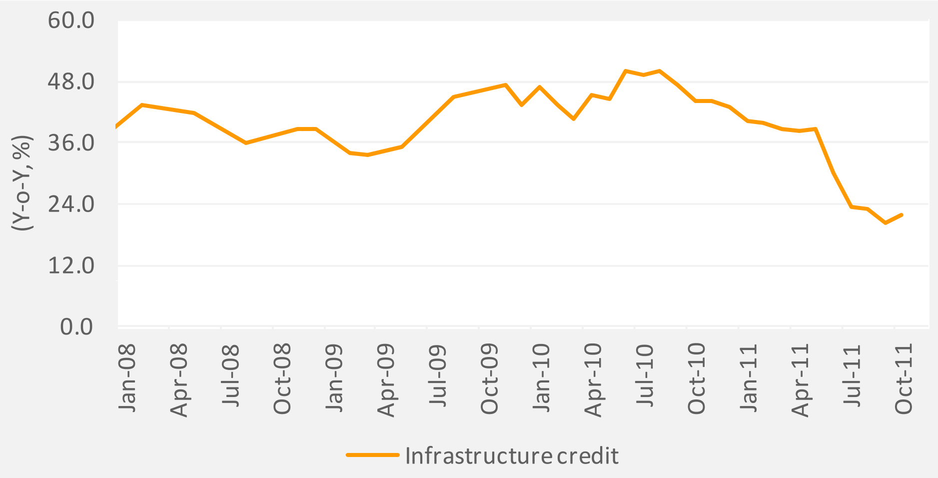


*Infra projects include: power, ports, roads etc while capex include manufacturing, mining etc

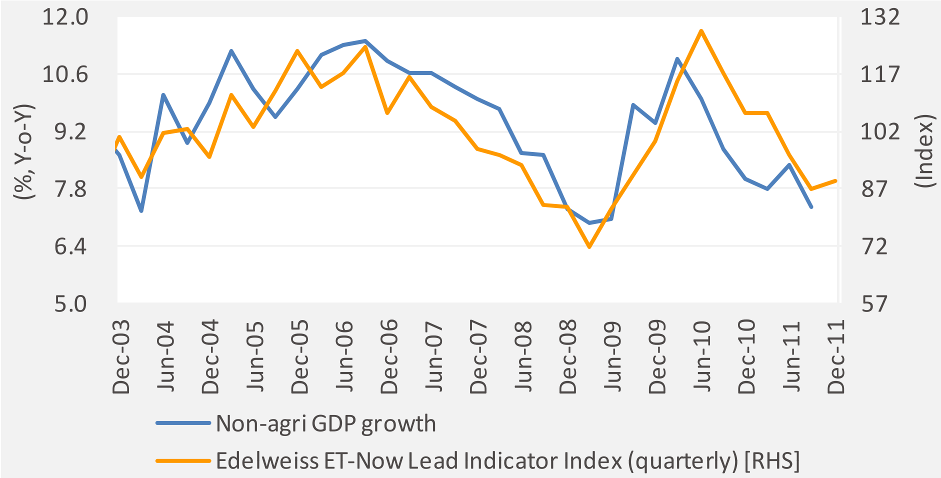
Consumption tempering in line with transaction money growth



Credit to infra also falling



Our lead indicator points to continued weakness



Source: CMIE, Bloomberg, Edelweiss research

Weakness seen across the board

Causes and consequences

What are the causes?

- Domestic policy paralysis
- Aggressive monetary tightening
- Fiscal deficit deterioration
- Highly uncertain external macro and markets backdrop

How worse can it get?

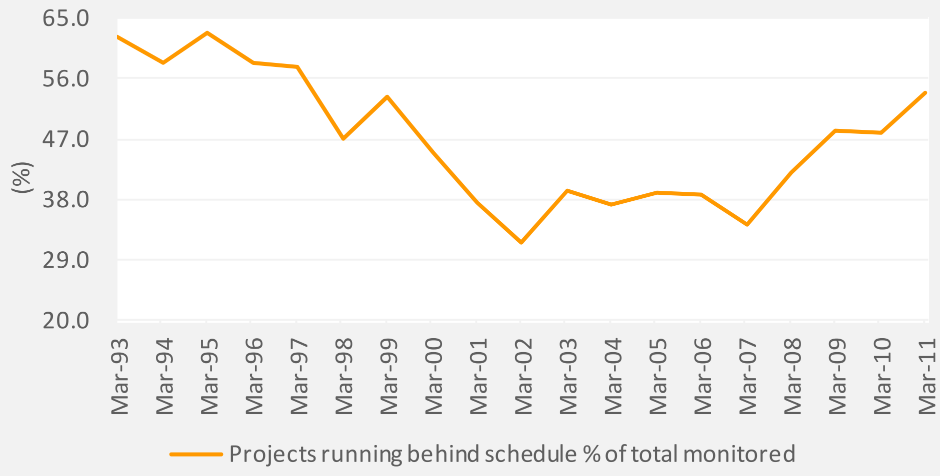
- Current macro deterioration seems modeled on 1992 slowdown, but the economy is better placed on vulnerability indicators.
- In our bear case, FY13 GDP growth is likely to be ~5.8% whereas our base case remains at ~7%.

What needs to be done?

- Monetary easing
- Fiscal consolidation
- Govt policy and reforms
- Govt instilling confidence back in bureaucracy to take decisions

1. Domestic policy paralysis

More and more projects* running behind schedule



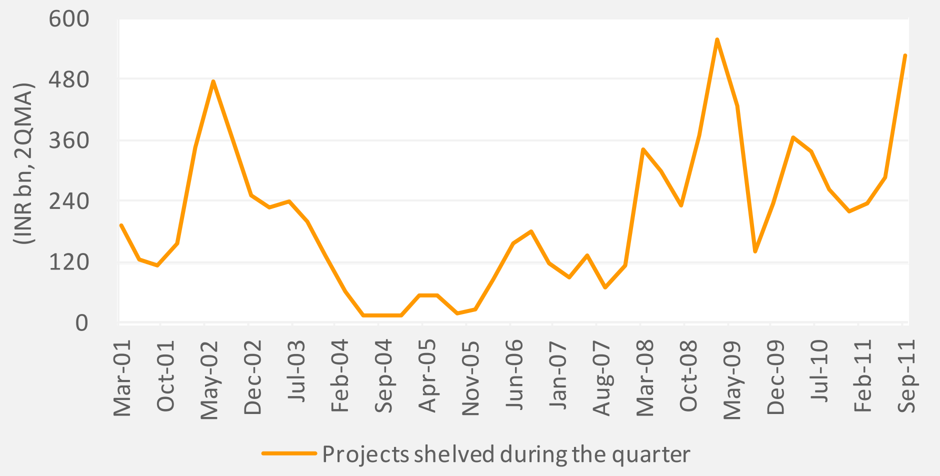
Delays observed across sectors

	Projects under monitoring	No of projects delayed	% Delayed
Roads/Highways	135	113	83.7
Coal	45	20	44.4
Steel	19	10	52.6
Petroleum	82	38	46.3
Power	87	46	52.9
Railways	148	33	22.3
Shipping/Ports	26	18	69.2

Source: MOSPI

*As per MOSPI project implementation status report, March 2011 - for projects costing INR150cr and above (607 projects monitored of which 157 are mega projects with a total cost of more than INR7lac cr.)

Sharp rise in no. of projects shelved since late last year



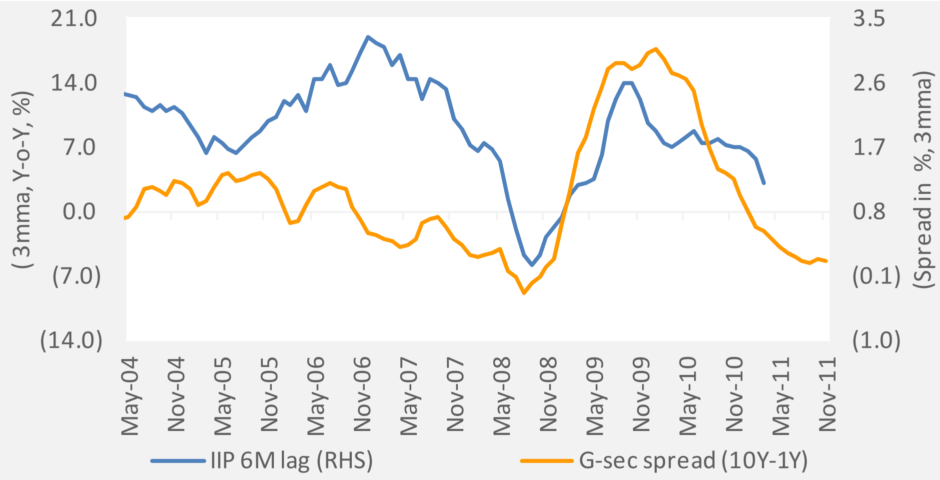
- Project delays have been on rise post 2008 crisis.
- Over the last 8-9 months, policy hurdles such as greens issues have only intensified these delays

Source: CMIE

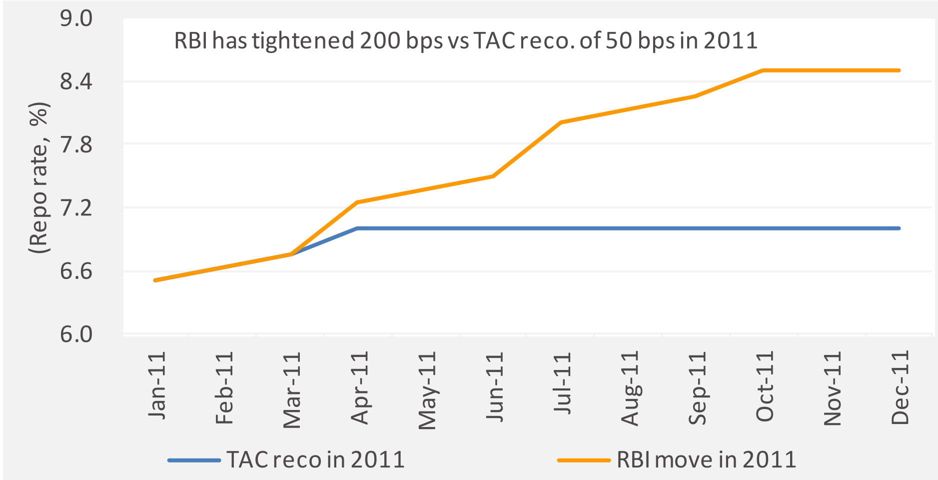
Rising project delays observed across sectors

2. Aggressive monetary tightening

Inverted yield curve foreshadows sustained weakness in IIP

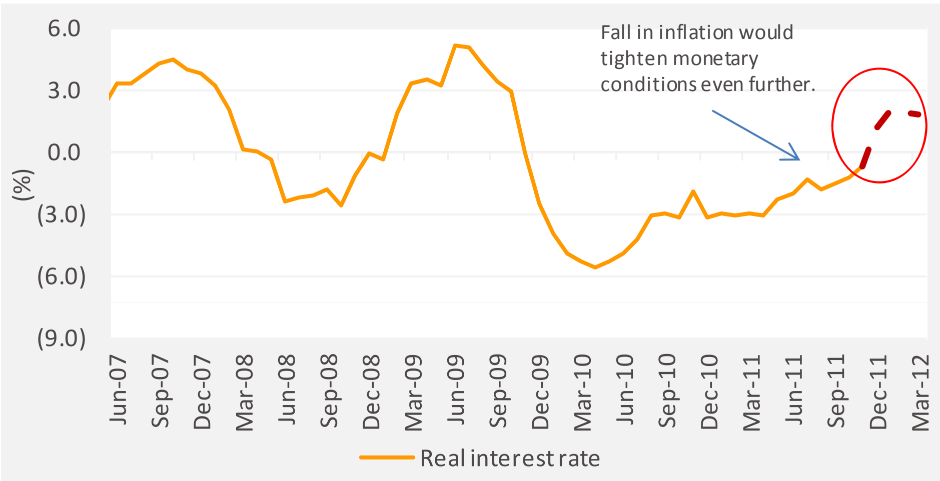


RBI may have overdone tightening



Note: TAC - Technical Advisory Committee to RBI; recommendations are by majority of members

(Already) tight monetary conditions to get tighter



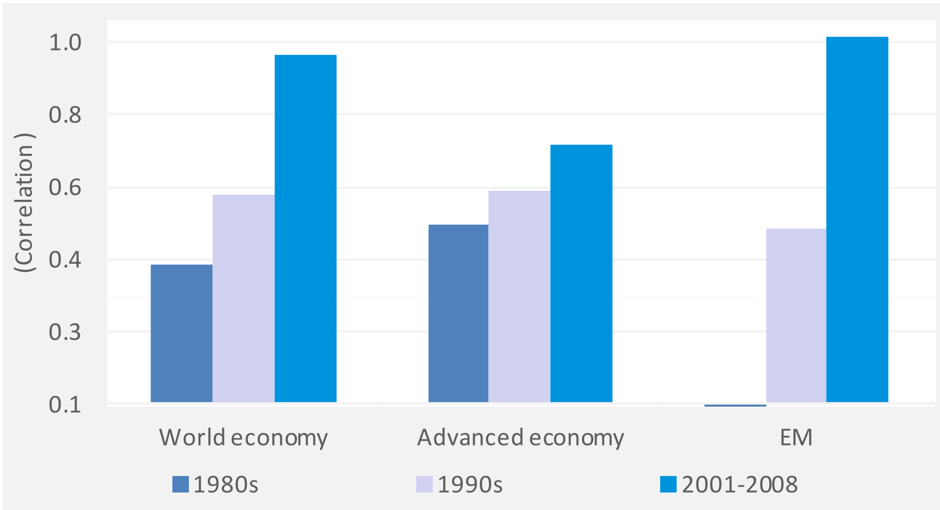
- By far the most aggressive tightening by RBI over the last decade (225 bps in 2011 compared to 125 bps in 2008)
- Persistent inverted yield curve directs towards continued weakness in industry, at least for the 1H FY13
- Aggressive tightening by RBI has hurt investments much more than consumption

Source: RBI, Bloomberg and CMIE Note: Real rate is based on repo rate and WPI

RBI may have overdone the tightening

3. Adverse external economy

India's GDP growth highly correlated* with global growth



Source: RBI

*From RBI report "Currency and Finance- FY09"

- Indian inter linkages with the world have gone up substantially over the last decade.
- Exports and imports (of goods and services) as % of GDP shot up from ~26% to ~46% in the same period.

Weak external economy an added dampener on India's growth

How bad can it get? - Reminiscing 1991-92, 2000-01 & 2008-09 crises

Balance of payment crisis:1991-92

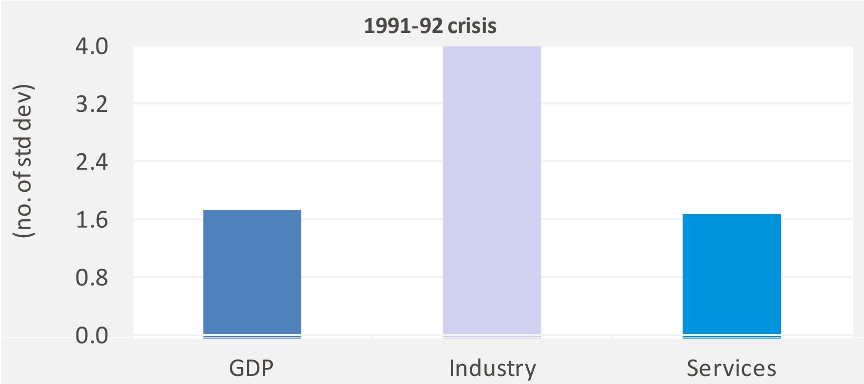
- Acute decay in domestic macros: Economy faced persistent twin deficits, a perched inflation, severe drought and a higher recourse to short term debts (like ECB) to fund CAD. Further pegged INR inhibited adjustments.
- Absence of shock absorbers: Low forex reserves (down ~70% in a span of 11 months) and little room for Govt to provide fiscal stimulus.
- Gulf war spiked crude oil prices while external environment turned hostile with recession in US and UK. Industries bore the brunt as the slowdown lasted 4-5 quarters.

Domestic macros & vulnerability ratios deteriorated significantly

Macro indicators	FY89	FY90	FY91	FY92	FY93	FY94
GDP growth	10.2	6.1	5.3	1.4	5.4	5.7
Fiscal deficit (% GDP)	7.3	7.3	7.8	5.6	5.3	6.9
Inflation (YoY %)	7.5	7.4	10.2	13.8	10.0	2.6
CAD (% GDP)	(2.7)	(2.3)	(3.0)	(0.3)	(1.7)	(0.4)
Vulnerability indicators						
Import cover in mnts	2.4	1.9	2.5	5.3	4.9	8.6
CAD+Net FDI (% GDP)	(2.7)	(2.3)	(3.0)	(0.3)	(1.6)	(0.2)

Source: CMIE

Strong impact felt on industry …



Source: CMIE

*Shock has been calculated by dividing the growth slippage in shock year by S.D of the preceding five years

- Govt measures: Mainly structural reforms including de-licensing of industries, reducing import duties and liberalizing various sectors for foreign investments.
- A sharp recovery in the US helped the resurgence.

Massive changes in Govt policies paved the way for recovery

Technology bubble burst: 2000-01

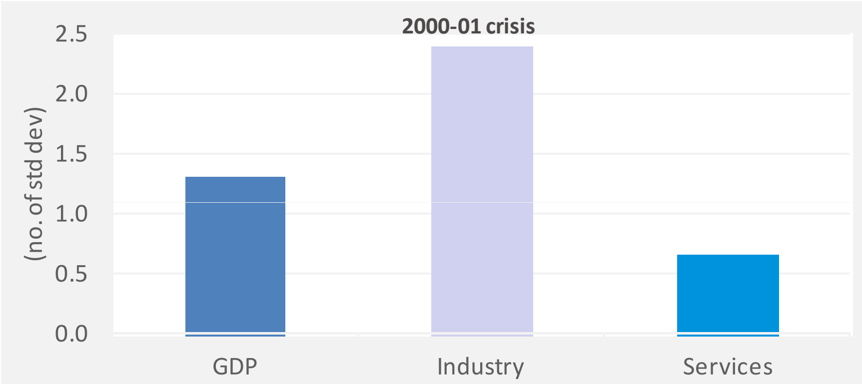
* Domestic macros healthy as shocks came from external economies.
* Drought in FY01 soon complicated matters (just like FY92). Crude prices meanwhile had skyrocketed by ~70% YoY on an average in FY00.
* Like the previous jolt, industry bore the maximum brunt as the slowdown lived on for ~4 quarters.

Domestic economy well placed to survive shocks

Macro indicators	FY98	FY99	FY00	FY01	FY02	FY03
GDP growth	4.3	6.7	7.6	4.3	5.5	4.0
Fiscal deficit (% GDP)	5.8	6.5	5.4	5.7	6.2	5.9
Inflation (YoY %)	4.4	6.0	3.3	7.1	3.6	3.4
CAD (% GDP)	(1.4)	(1.0)	(1.0)	(0.6)	0.7	1.2
Vulnerability indicators						
Import cover in mnts	6.9	8.2	8.2	8.8	11.5	14.2
CAD+Net FDI (% GDP)	(0.5)	(0.4)	(0.6)	0.4	2.2	2.5

Source: CMIE

Industry got hit again…



Source: CMIE

* Gradual monetary easing (400 bps over next 2-3 years)
* No sizeable fiscal stimulus
* Sharp monetary easing in US

External tremors, but a modest monetary stimulus ensures gradual recovery

Great recession:2008-09

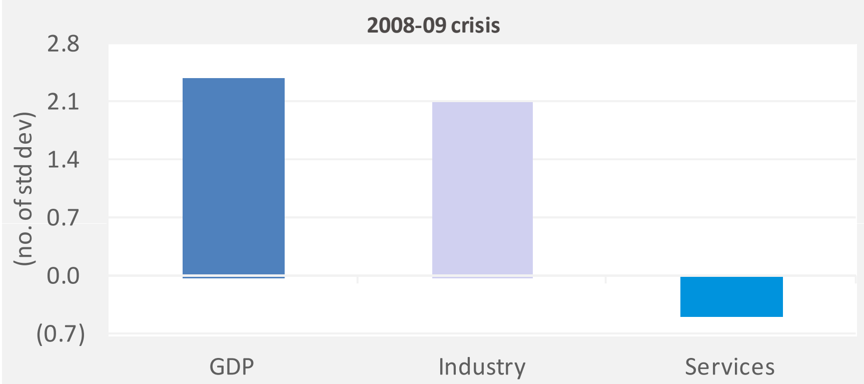
- Domestic economy was healthy, but external shocks were too profound
- Drought in FY09 complicated matters (a 'la FY92, FY01) even as crude ran upto USD140/bbl (~100% YoY growth).
- Industry wobbled as the slowdown persisted for ~3 quarters.

Domestic economy well positioned to bear up shocks

Macro indicators	FY06	FY07	FY08	FY09	FY10	FY11
GDP growth	9.5	9.6	9.3	6.8	8.0	8.6
Fiscal deficit (% GDP)	4.0	3.3	2.6	6.0	6.4	5.1
Inflation (YoY %)	4.4	5.4	4.7	8.4	3.9	9.9
CAD (% GDP)	(1.2)	(1.0)	(1.3)	(2.3)	(2.8)	(2.6)
Vulnerability indicators						
Import cover in mnts	11.6	12.5	14.4	9.8	11.1	9.6
CAD+Net FDI (% GDP)	(0.9)	(0.2)	-	2.3	(1.4)	(2.2)

Source: CMIE

Industry more impacted again…



Source: CMIE

- Sharp monetary easing (425 bps in just seven months)
- Fiscal stimulus (3.5% of GDP – Measures include Sixth Pay Commission, farm loan waiver, excise cut etc)
- Synchronized monetary and fiscal stimulus, globally

Purely a crisis of external origin; a V-shaped recovery took place due to massive stimulus

Current scenario

- Severe deterioration in domestic macros: Economy facing twin deficits, elevated inflation and higher reliance on debt flows to fund CAD (ditto FY92).
- However, it is better placed on vulnerability indicators: Decent forex reserves, low external debt and INR depreciation of ~20% to facilitate adjustments in CAD (unlike 1992)
- Unfavorable external economy and persistently high crude oil prices pose risks.

Macros worsening

Macro indicators	FY10	FY11	FY12(E)	FY13(E)
GDP growth	8.0	8.6	7.0	7.0
Fiscal deficit (% GDP)	6.4	5.1	5.8	5.4
Inflation (YoY %)	3.6	9.9	8.6	6.0
CAD (% GDP)	(2.8)	(2.6)	(3.0)	(2.4)
Vulnerability indicators				
Import cover in mnts	11.1	9.6	8.2	7.2
CAD+Net FDI (% GDP)	(1.4)	(2.2)	(2.3)	(1.4)

Macro indicators are deteriorating – akin to 1992

India is much better placed on vulnerability indicators

Source: CMIE

Our analysis assumes:

- Impact on industry to be as severe as 1992; services are more vulnerable given the changed nature (e.g financial sector today is more market oriented).
- Current slowdown might be a prolonged one given no scope for a fiscal stimulus, both domestically and globally. Unleashing 1992 like reforms are unlikely.

Macro situation tenuously resembles 1992 though India is better equipped in terms of shock absorbers

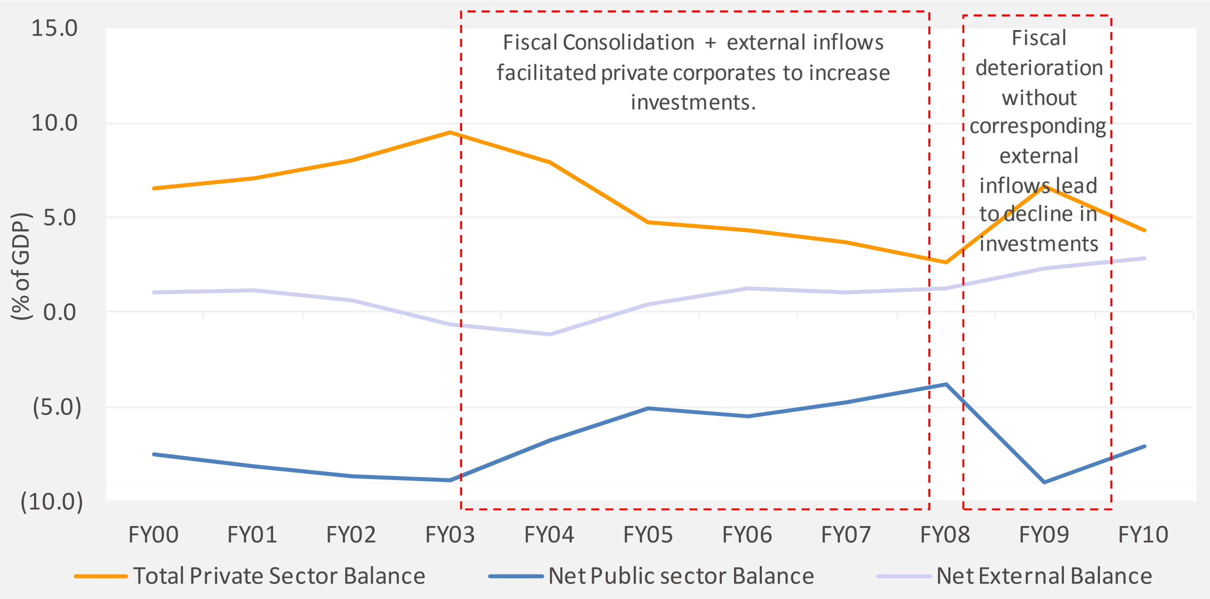
Growth outlook

	FY12	FY13 (Base case)	FY13 (Bear case)
Fiscal deficit (%)	✱ ~5.8	~5.4	~6.2
Industry/Service %	✱ ~4.0/9.2	~5.9/8.2	~4.0/7.1
INR(avg.)	✱ ~48.6	~50	~52
Inflation(avg. %)	✱ ~8.6	~6.0	~4.0
Monetary easing	✱ 0 bps	125 bps	200 bps
CAD % GDP	✱ ~3.0-3.2	2.3-2.5	1.6-1.8
GDP growth(%)	✱ ~7.0	~7.0	~5.8

What can change it ?

1. Fiscal consolidation

Financial balances (Savings – Investments) of various sectors



Source: CMIE

Public sector bal + Private sector bal* + external sector bal = 0

- For private capex cycle to pick up, fiscal consolidation is a must, especially since external flows are unlikely to be strong.

* Balance = Savings - Investments

Fiscal retrenchment - a requisite for investment pick-up

2. Policy announcements

- De-bottlenecking approval process for coal mining given its significant linkages to power, steel, aluminium and cement sectors. This can lift the broader economy
- SEB reforms: To help address the slump in power capex
- Implementation of DTC, GST: To simplify tax collection and increase tax buoyancy
- Passing Land Acquisition Bill
- Govt boosting confidence of bureaucracy to take decisions

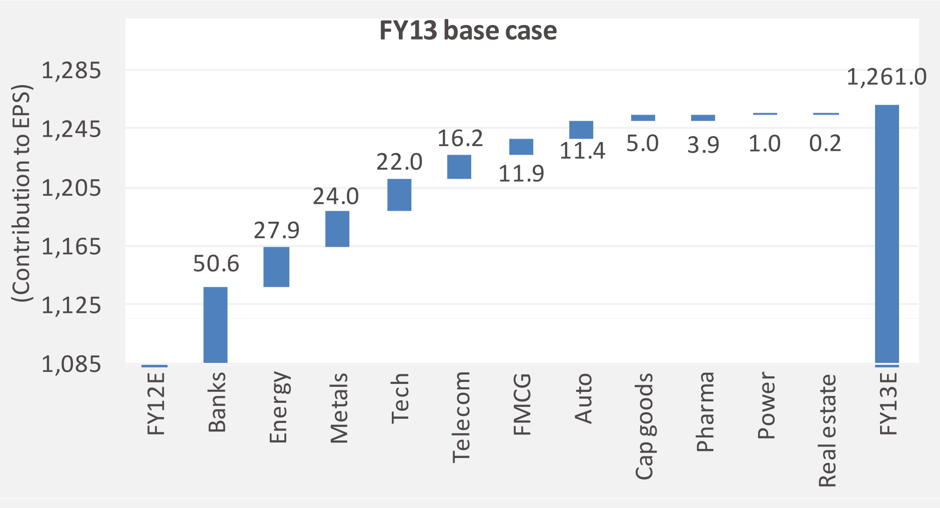
These measures are administrative in nature, not requiring any broad political consensus

What does it mean for India Inc?

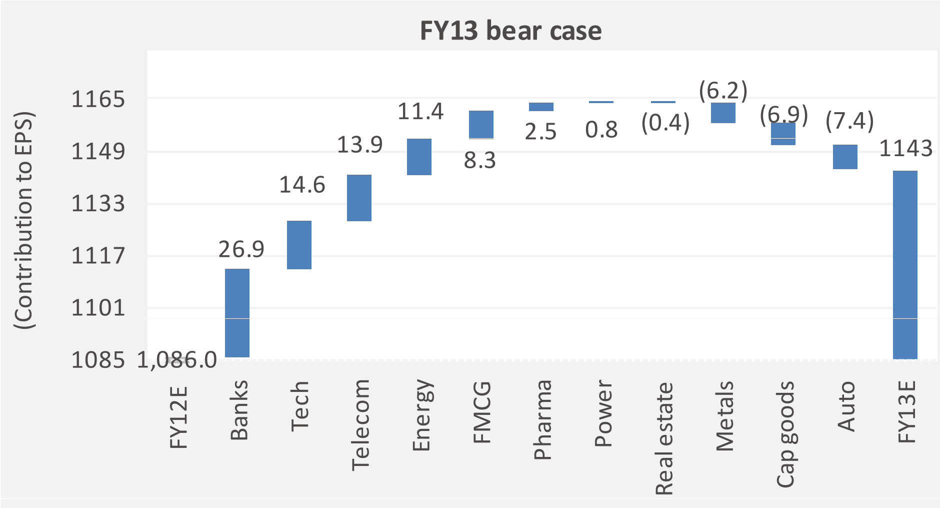
Earnings: More downside risks

- Based on the base case macro assumptions (GDP growth at ~7.0% and USD-INR at ~50.0), FY13E Sensex earnings stand at INR1,261. Key drivers are banks, energy and metals
- Going by stress case assumptions (GDP growth at ~5.8%, USD-INR at ~52.0), earnings are expected to grow by ~5.2%. Sectors likely to drag down earnings growth include metals, cap goods and auto

Base case forecasts



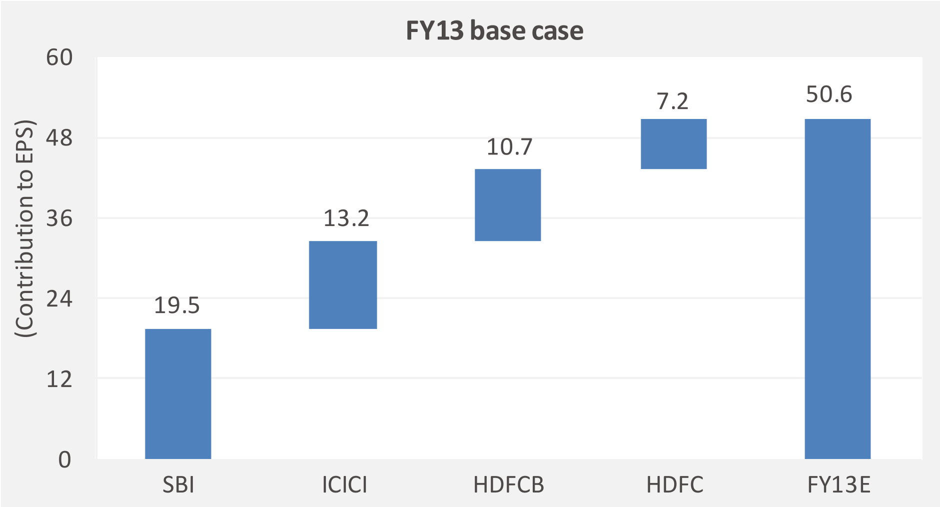
Bear case forecasts



Source: Bloomberg, Edelweiss research

BFSI sector: Higher credit costs drag down stress case earnings

Base case forecasts



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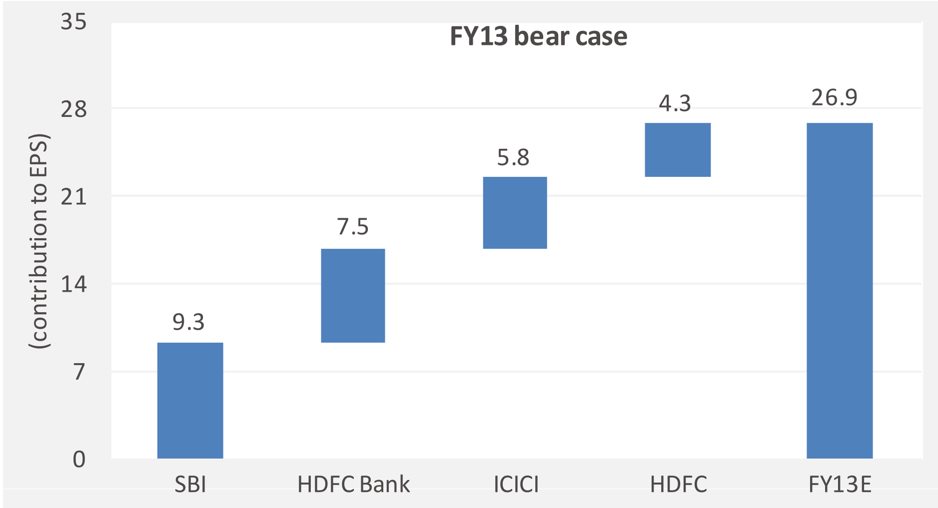


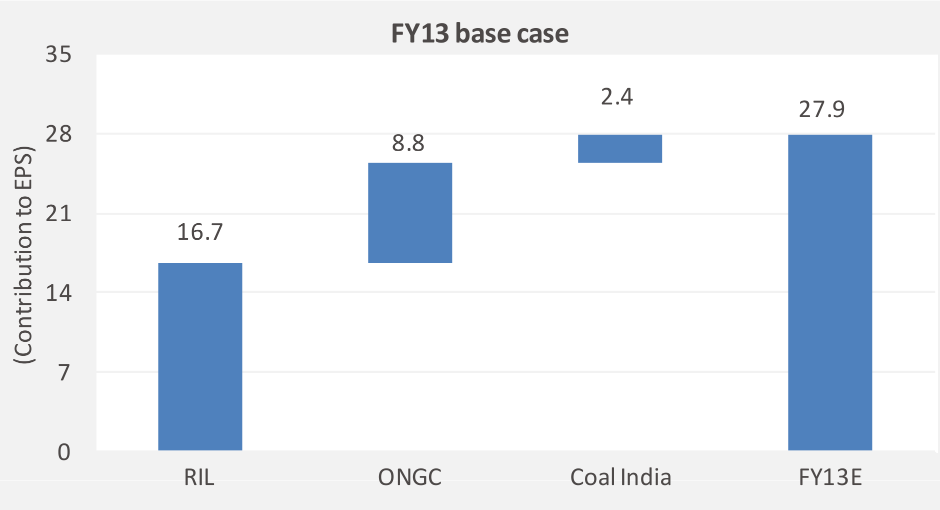
Key sectoral assumptions:

	Base case	Bear case
Credit growth	Assuming a GDP growth of 7% , we have assumed industry credit growth of about 17%.	Assuming a GDP growth of 6% , we have assumed industry credit growth of about 14%.
NIMs	Given the reversal of the interest rate cycle we are assuming NIMs to see decline upto 15 bps on a yoy basis	Given the reversal of the interest rate cycle and lower CD ratio we are assuming NIMs to see decline of upto 30 bps on a yoy basis
NPLs	Credit costs moving higher by 10-20bps	Credit costs moving higher by 20-30bps, considering the stress in power, aviation, agri and SME scetors

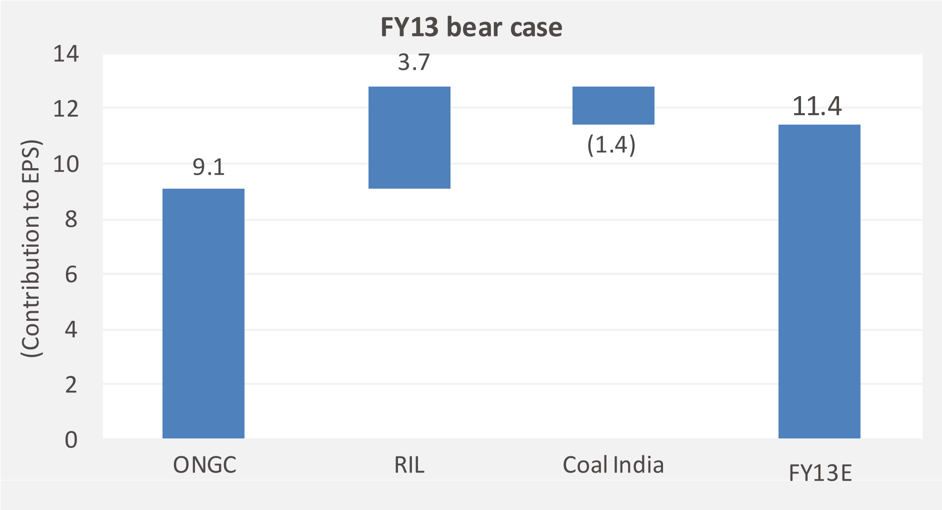
Source: Edelweiss research

Energy sector: Stress case earnings affected by low RIL GRMs

Base case forecasts



Bear case forecasts



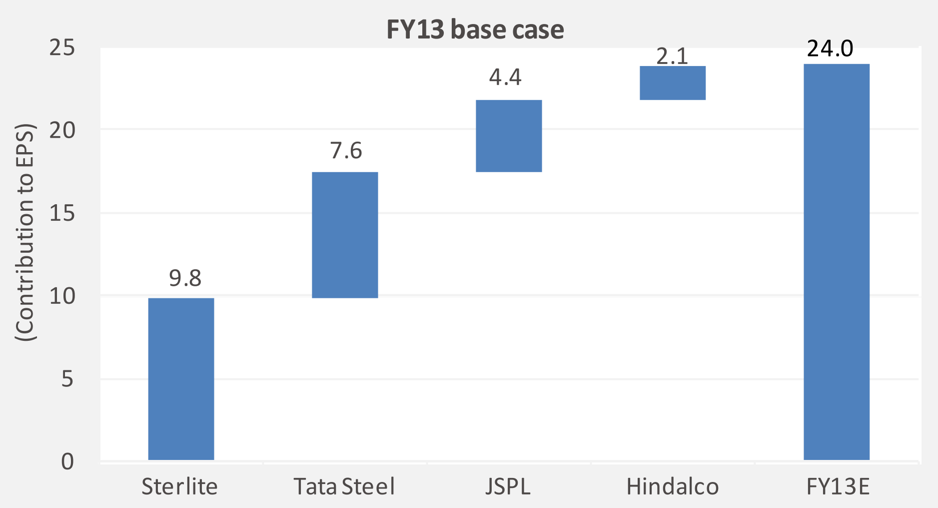
Key sectoral assumptions:

	Base case	Bear case
Crude price assumption	USD95/bbl	USD90/bbl
GRMs	Maintaining RIL's GRMs at USD9.5/bbl	Slashing RIL's GRMs to USD8/bbl (excluding the crisis, it is the lowest since FY04)
Under-recovery and subsidy sharing	Upstream sharing at 50% and industry recovery of INR835bn implies ONGC net realisation of USD50.3/bbl	Upstream sharing at 50% and industry recovery of INR802bn implies ONGC net realisation of USD48.9/bbl; INR depreciation leads to positive EPS change for ONGC.
Coal	Sales volume for Coal India at 440mt, blended realisation at INR1,430/t	Sales volume for Coal India at 420mt, blended realisation at INR1,385/t

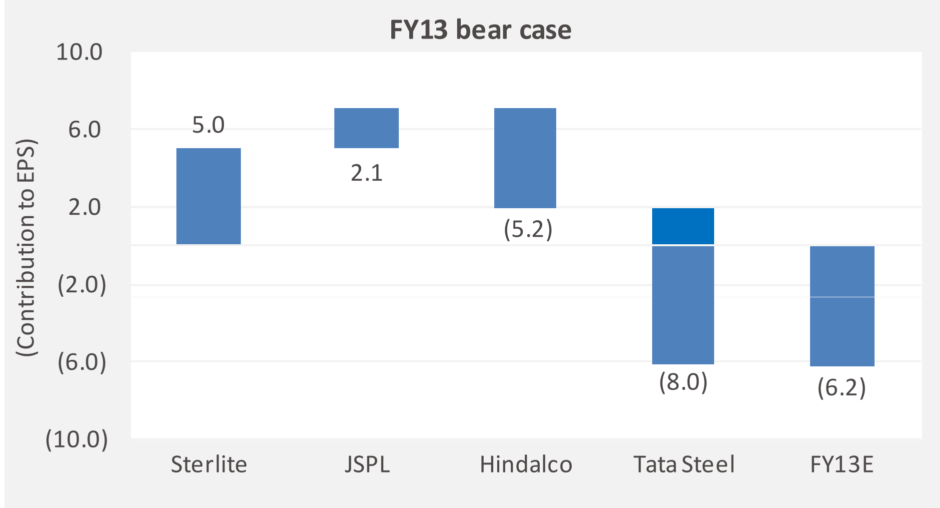
Source: Edelweiss research

Metals sector: Drop in realisations to hurt stress case earnings

Base case forecasts



Bear case forecasts



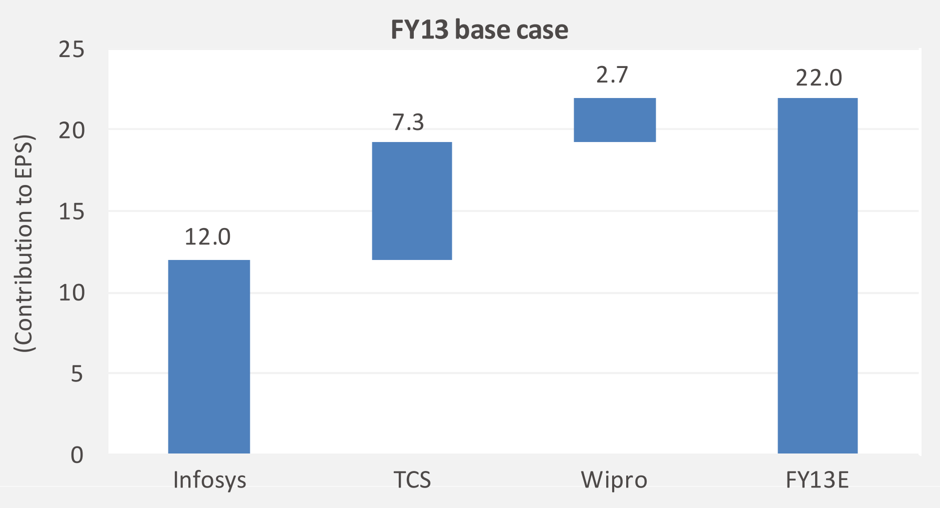
Key sectoral assumptions:

	Base case	Bear case
Steel		
Realisation	Unchanged from the current assumption of INR35,000/t	Steel realisation reduced by INR1,000/t to INR34,000/t
RM costs	Reduced raw material prices of coking coal by USD30/t(current levels)	Reduced raw material prices of coking coal by USD20/t(current levels)
Non ferrous		
Aluminum	Considering the weak macro, revising down realisation of Aluminum to USD2,400/t from USD2,550/t	Revising down realisation of Aluminum to USD2,100/t from USD2,550/t
Zinc	Zinc price assumption maintained at USD2,100/t	Zinc price assumption cut to USD1,800/t

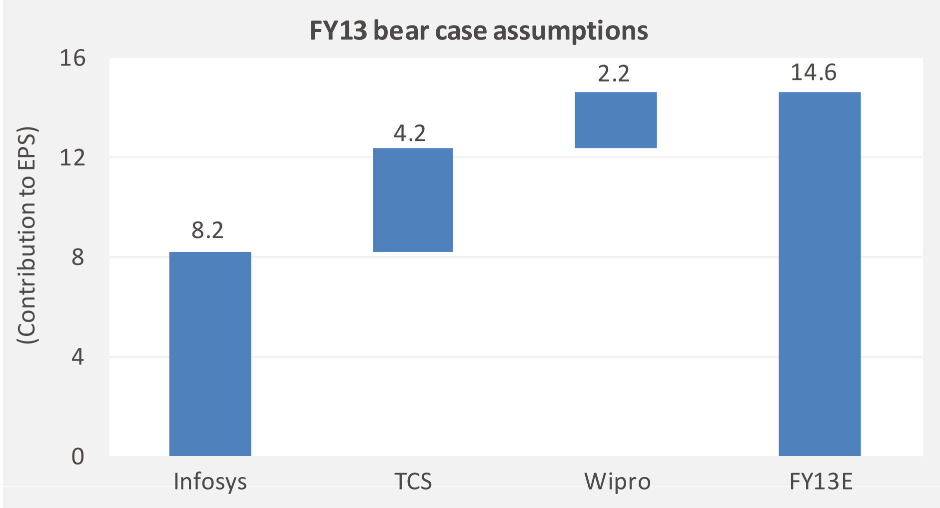
Source: Edelweiss research

Tech sector: Tepid volume growth, pricing decline key concerns

Base case forecasts



Bear case forecasts



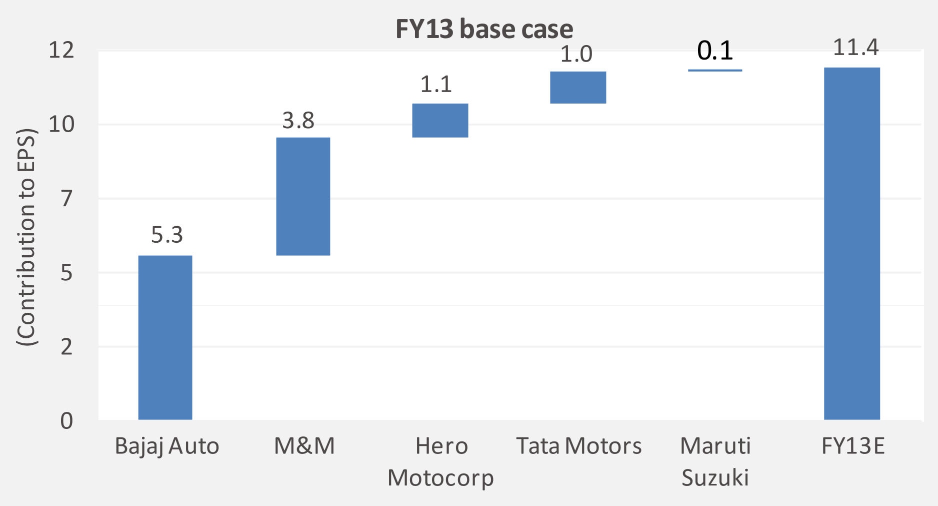
Key sectoral assumptions:

	Base case	Bear case
Overall scenario	Due to delay in decision making, volume growth would moderate and there could be marginal price cuts	If the US economy faces recession, then we could revisit FY10 growth scenario which is single digit volume growth combined with pricing pressure
Volume growth	Assuming volume growth to moderate to 14-16%	Volume growth of 2-3% (historically even in recesssions, volumes have never declined. Even in CY09, volume growth was 4-5%)
Pricing	Pricing to decline by 2%	We are assuming pricing decline of 3%

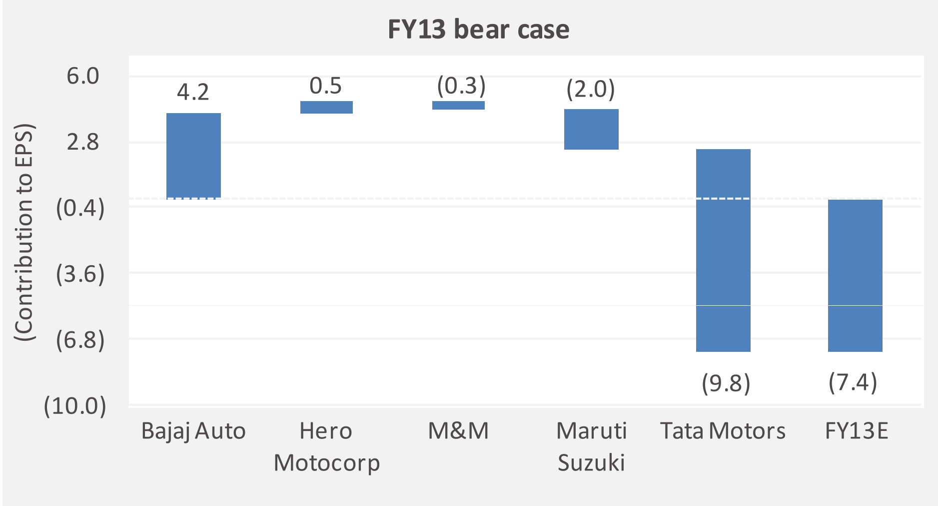
Source: Edelweiss research

Auto sector: Bear case EPS affected by slower volume growth

Base case forecasts



Bear case forecasts



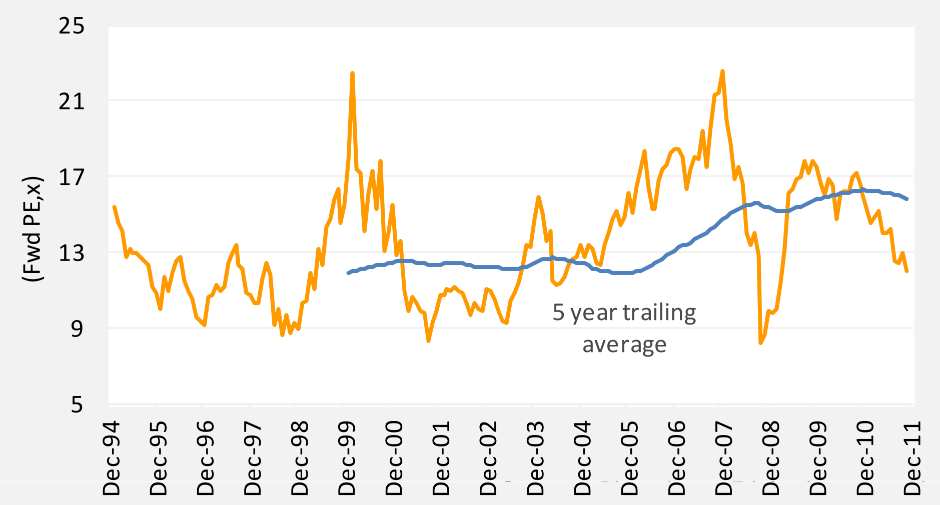
Key sectoral assumptions:

	Base case	Bear case
Volume growth	At 7% GDP growth, sales growth is likely to moderate to 5-6% for cars, low single digit for trucks, 15% for LCVs, 10% for tractors, 8% for two wheelers. JLR volumes: 8% growth for LR, flat for Jaguar	At 6.0% GDP growth, sales growth to further slowdown to 0-2% for cars, -10% for trucks, 8% for LCVs, 8% for tractors, 4% for two wheelers. JLR volumes: 5% decline
Margins	USDINR at 50 likely to provide margin relief vs H2FY12	In case of a recession, there could be a decline in metal prices which could be margin accretive

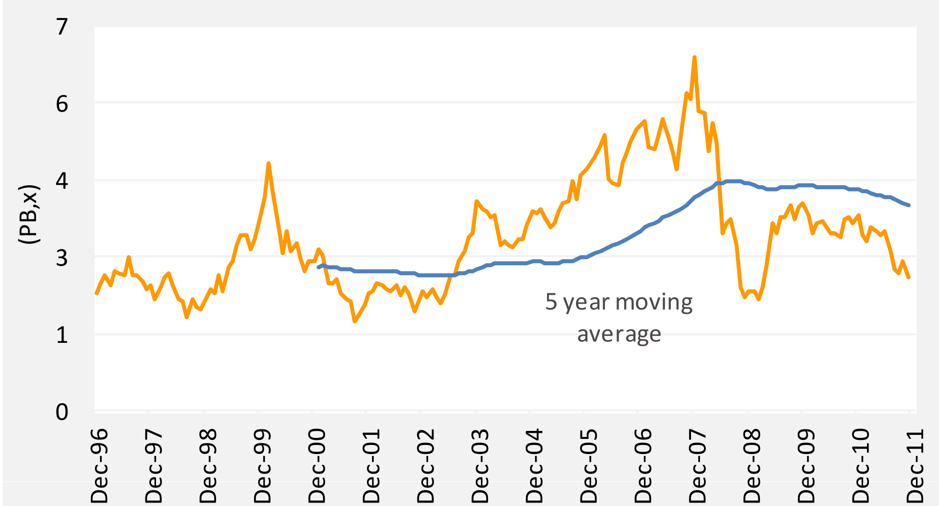
Source: Edelweiss research

Valuation indicators: Trading well below its long term average

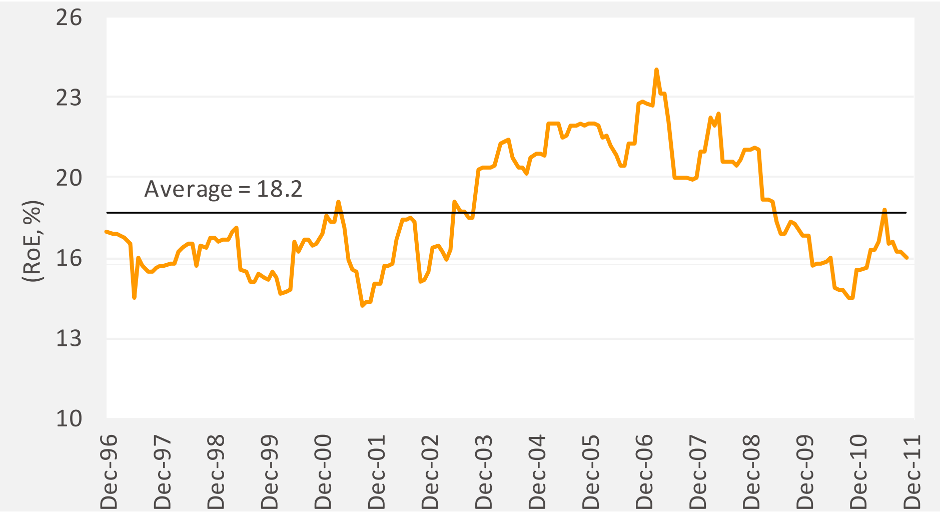
P/E below average levels



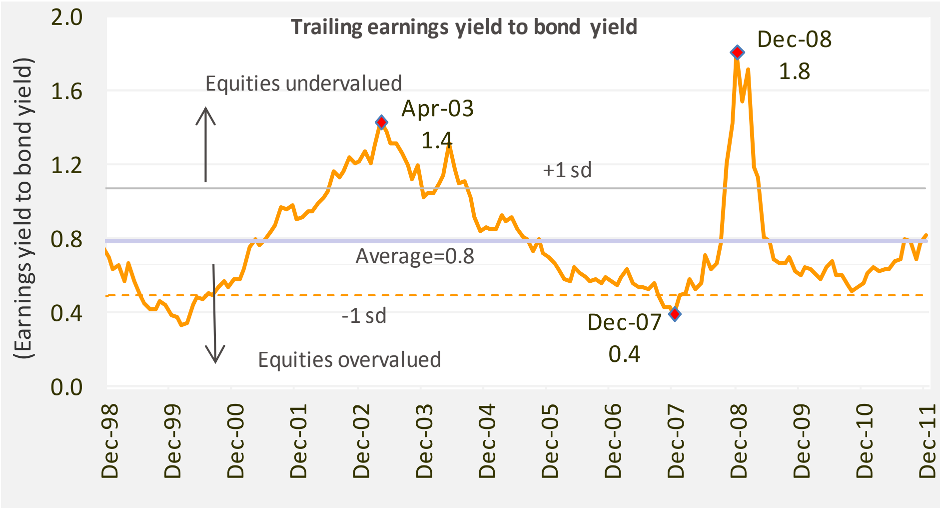
P/B also coming off



RoEs remain stable



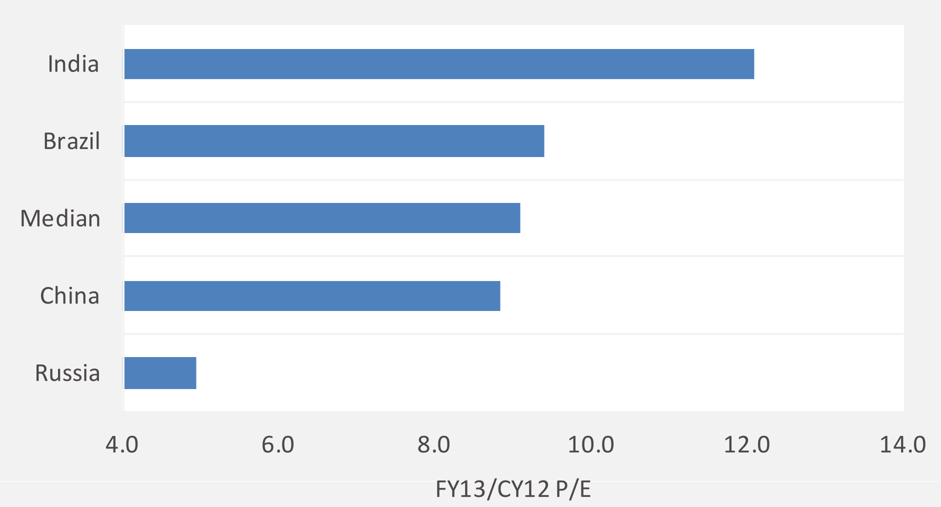
Equity-bond valuation gap indicating fair value



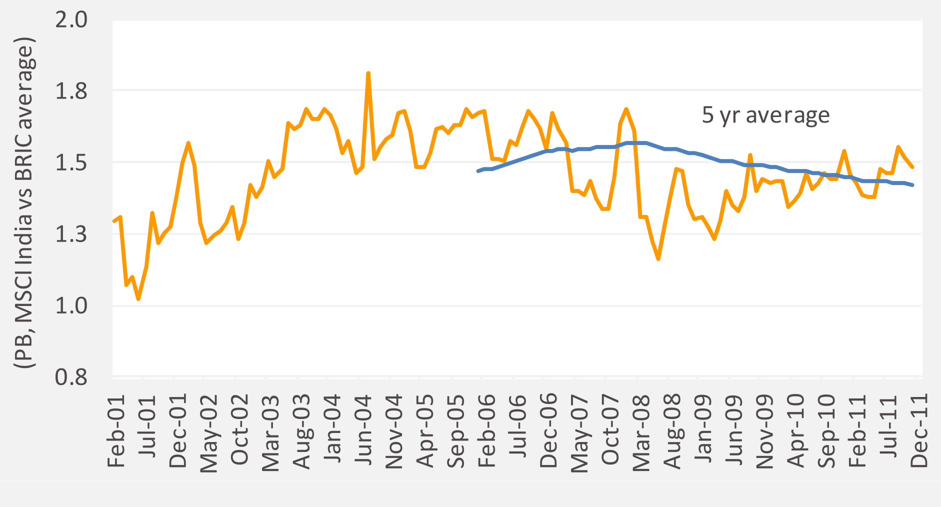
Source: Bloomberg, Edelweiss research, data for MSCI India Index

Relative valuations: Expensive compared to peers in BRICs

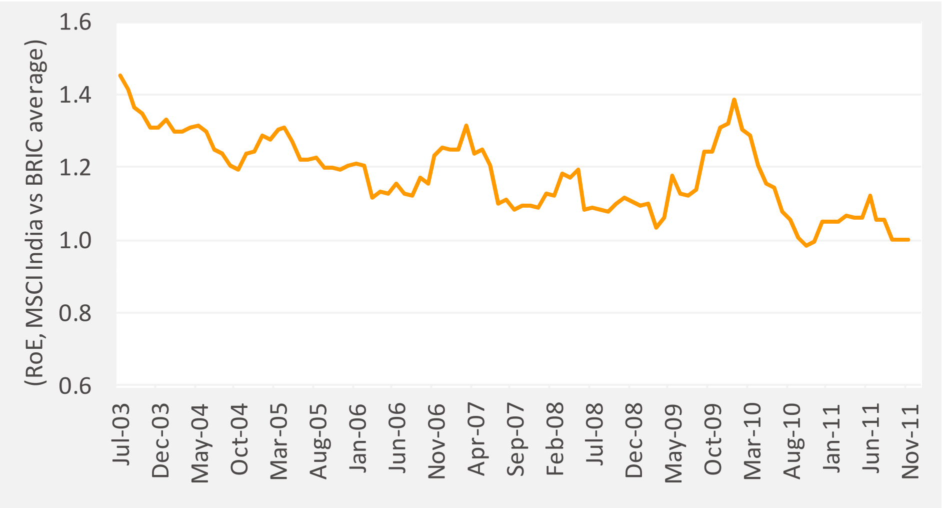
On earnings multiple, India trading at a premium to peers



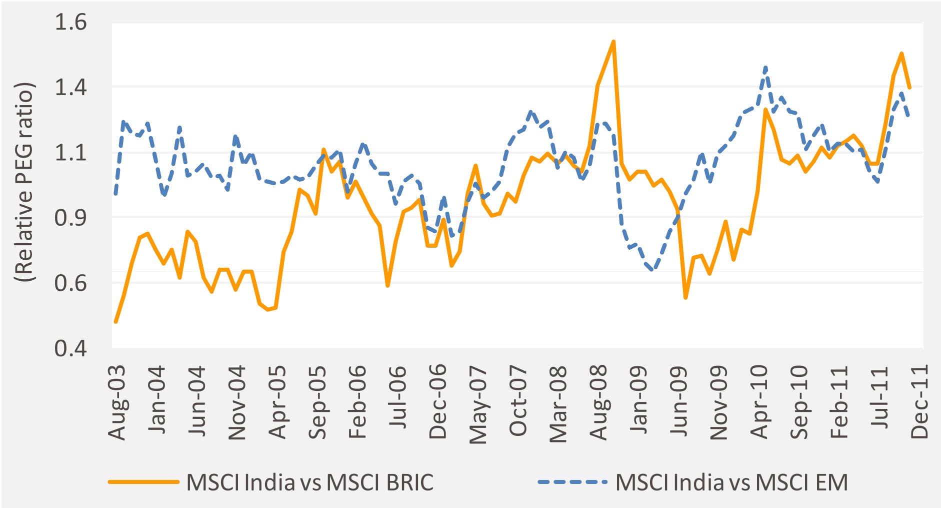
P/B still above 5 year average



RoEs in contraction mode compared to BRICs



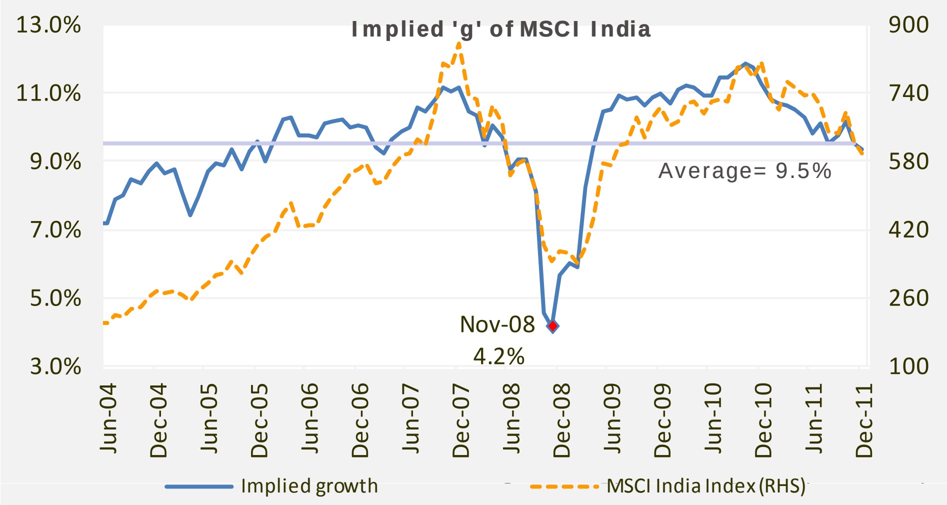
Overvalued on PEG basis too



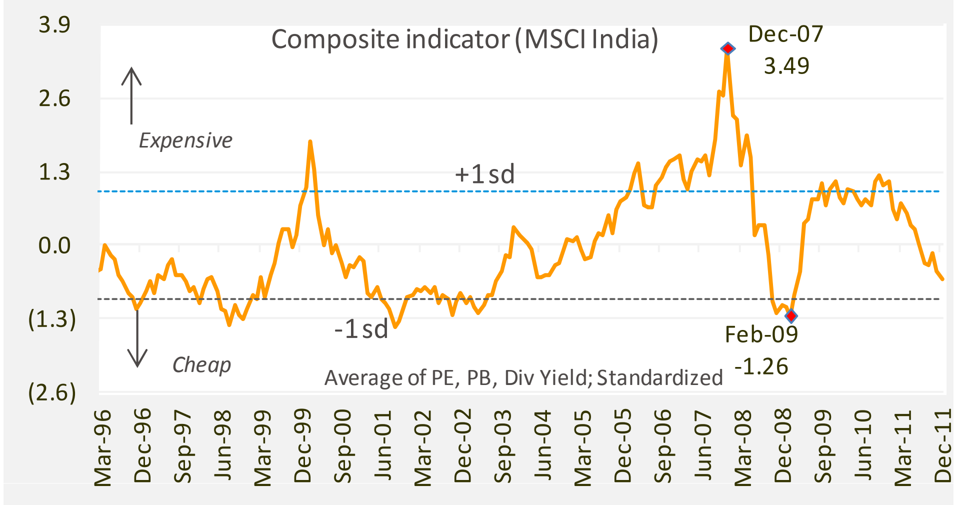
Source: Bloomberg, Edelweiss research, data for MSCI India Index, 'BRIC' data calculated on market cap weighted basis

What's in the price?

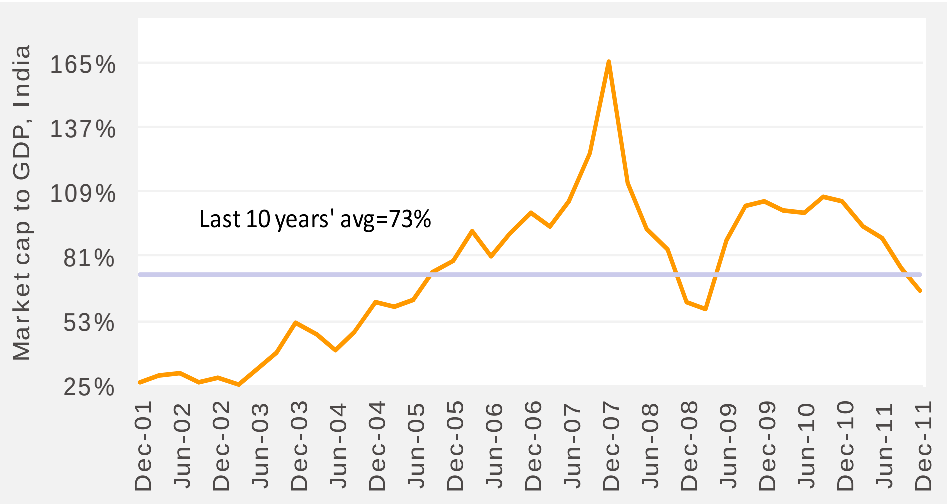
Growth expectations coming off



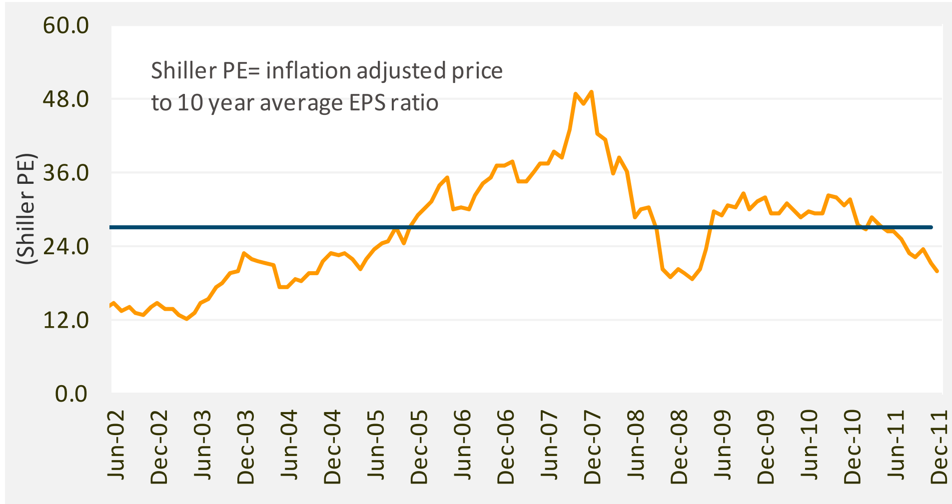
Composite indicator heading towards being cheap



Market cap to GDP below historical average



Shiller PE close to historical lows



Source: Bloomberg, Edelweiss research

Source: BSE, Robert shiller, Edelweiss research

Are markets overly pessimistic?

Markets were in red for 9 months this year

Monthly returns (%)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YOY Return %
2011	(10.2)	(3.1)	9.4	(1.4)	(3.3)	1.6	(2.9)	(8.8)	(1.2)	7.8	(9.3)	(4.3)	(24.6)
2010	(6.1)	0.8	6.6	0.6	(3.6)	4.4	1.0	0.6	11.6	(0.2)	(2.6)	4.6	17.9
2009	(2.9)	(3.9)	9.3	15.0	28.1	(3.5)	8.0	0.6	9.0	(7.3)	6.8	3.3	75.8
2008	(16.3)	1.7	(9.4)	9.1	(5.7)	(17.0)	7.2	0.6	(10.1)	(26.4)	(4.5)	7.4	(51.8)
2007	2.9	(8.3)	2.0	7.0	5.1	0.5	4.9	(1.4)	12.5	17.5	(2.3)	6.5	54.8
2006	5.8	2.5	10.7	4.6	(13.7)	1.9	0.5	8.6	5.1	4.3	5.6	0.3	39.8
2005	(1.1)	2.2	(3.2)	(6.5)	9.7	6.4	4.1	3.1	9.1	(8.9)	11.9	6.9	36.3
2004	(3.7)	(0.5)	(1.6)	1.4	(17.4)	1.5	8.4	(0.0)	7.0	2.4	9.6	6.2	10.7
2003	(4.7)	2.1	(8.0)	(4.5)	7.8	12.6	4.6	14.4	4.5	9.8	3.8	16.4	71.9
2002	2.0	5.7	(1.1)	(4.0)	(5.1)	2.8	(9.3)	5.4	(4.7)	(1.2)	10.4	4.1	3.3
2001	8.6	(1.5)	(15.0)	(2.0)	3.8	(5.1)	(3.2)	(1.8)	(13.3)	6.4	9.8	(0.8)	(16.2)
2000	4.4	7.0	(7.6)	(8.0)	(1.9)	6.6	(9.4)	4.6	(8.8)	(7.8)	8.1	(0.4)	(14.7)
1999	9.3	1.6	9.9	(9.3)	15.8	4.9	10.3	7.8	0.1	(6.2)	3.8	7.6	67.4
1998	(10.7)	10.1	5.3	3.8	(8.3)	(11.4)	(1.1)	(8.4)	6.1	(8.9)	(0.8)	8.1	(18.1)
1997	8.2	8.3	(8.1)	11.5	(2.7)	13.5	2.4	(9.5)	1.7	(3.4)	(5.6)	5.4	20.1
1996	(6.6)	17.0	(0.7)	13.1	(2.2)	2.9	(7.1)	(1.3)	(8.3)	(3.7)	(8.7)	8.3	(1.0)

Source: Bloomberg, Edelweiss research

Let down by tepid flows

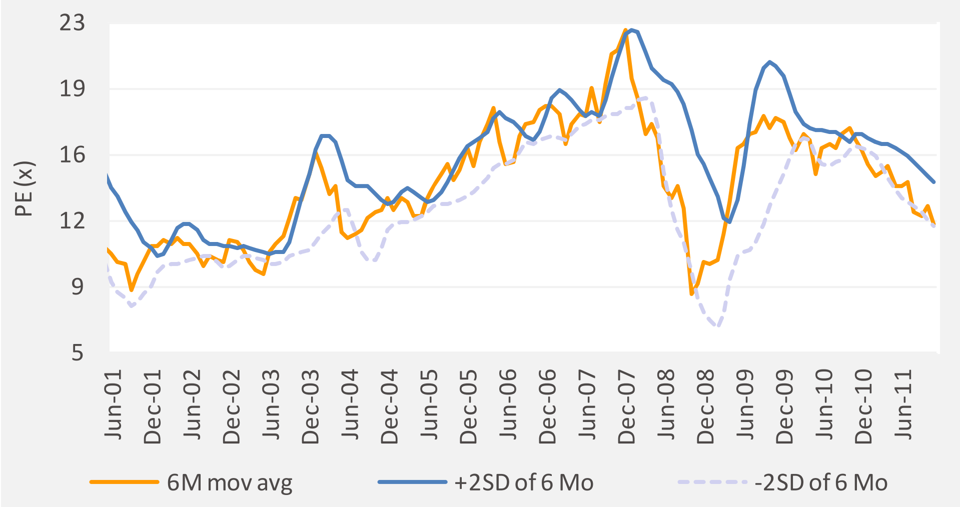
(USD bn)	Net FII	Net DII
CY06	7.9	3.4
CY07	17.4	5.6
CY08	(13.3)	16.6
CY09	18.2	5.3
CY10	29.3	(4.7)
CY11	(0.6)	5.9

Source: Bloomberg, Edelweiss research

- Monthly returns were negative for nine months this year - the worst in recent times, surpassing CY08 when seven months were negative

Outlook for valuations:To remain within a range

Valuations expected to remain in the range of 11.8x-13.6x



Source: Bloomberg, Edelweiss research

- A six monthly moving average of historical PE suggests that markets have traded in a tight band of +/- 2sd. At current levels of ~12.2x forward PE, markets are trading closer to the lower 2sd band of 11.8x
- The long term (16-yr) forward multiple has been 13.6x. If we assume a decent 15% return in CY12, markets at a PE of 11.5x-11.6x could offer a fresh buying opportunity (as markets generally tend to revert to mean)
- In absence of any triggers besides the above arguments, we expect markets to remain in a trading zone of 11.8x on the lower end of the band and 13.6x on the upper end of the band

Key themes to play on

* Weak rupee to support earnings in export oriented sectors
  - Given that the rupee is expected to remain weak, we believe export oriented sectors will stand to benefit
  - We favor pharma as a preferred play followed by IT - not purely for the favorable USD-INR dynamics but also for their inherently strong cash flows and higher visibility in earnings

* Domestic demand stays healthy
  - In our view, underlying trends in consumption still remain strong. A declining inflation trajectory in FY13 and a healthy rural demand will continue to support consumption
  - Accordingly, we continue our OW stance on the consumer sector

* No immediate visibility on capex revival
  - Given the current scenario, a rate cut alone will not be sufficient to spur investment demand in the economy. Accordingly, we are moving cap goods to UW from EW

Key risks

- Event risk materialising in Europe
- China faces a hard landing
- Geo political risks (Middle East, etc) leading to a spike in crude prices
- Significant fiscal deterioration in India

Top picks

	Current market cap	CMP	P/E (x)		P/B (x)		ROE (%)		Div yield (%)
	USD bn	INR	FY12E	FY13E	FY12E	FY13E	FY12E	FY13E	FY12E
Large-caps									
TCS	42.8	1,161	21.3	17.8	6.9	5.4	36.7	34.2	1.2
Bharti Airtel	24.6	344	20.7	11.8	2.5	2.1	12.5	19.0	0.4
Coal India	35.8	301	11.8	10.1	4.2	3.2	41.1	36.2	2.0
HDFC Bank	18.8	427	20.1	16.4	3.4	2.9	18.1	19.3	0.9
Lupin	3.8	448	19.8	16.8	4.9	3.9	27.3	26.0	0.8
Mid-caps									
Glenmark	1.5	294	15.9	12.5	2.9	2.4	20.1	20.2	0.2
Hexaware	0.4	75	9.2	8.5	2.0	1.8	23.7	22.7	4.1
LIC Housing Finance	2.0	221	10.4	8.2	2.2	1.8	22.4	23.9	1.9
Petronet LNG	2.2	156	11.4	11.2	3.4	2.8	33.6	27.3	1.9
Zee	2.2	118	18.5	15.5	3.3	2.9	18.8	19.7	1.7

Our top picks under the lens

TCS

✱ Investment rationale

- TCS continues to witness strong demand despite uncertain macro environment. Overall, it is well poised to deliver better performance compared to peers, thereby gaining market share
- The ability to win 9-10 large deals a quarter in the last few quarters offers strong visibility for FY13 with higher annuity revenues
- From FY11 EBITDA margin level of 30%, we see TCS with increased efficiency managing the EBITDA margins in 29-30% range going into FY13 as well.
- TCS' focus on selling products, platform BPO, and SMB offering iON are finding stronger focus within the organization, which will aid significant increase in its non linear revenue stream.

✱ Potential trigger

- Announcement of multiple large deal closures. It recently announced a 15-year USD 2.2bn deal win from Friends Insurance, UK.

✱ Key risks

- Double-dip recession in the US and Europe and currency appreciation.

✱ Outlook and valuations

- At CMP of INR 1,161, the stock is trading at P/E of 17.8x FY13E.

Financials

Year to March	FY10	FY11	FY12E	FY13E
Revenues (INR mn)	300,289	373,245	493,288	581,509
EBITDA (INR mn)	86,800	111,984	149,442	171,221
Net profit (INR mn)	68,738	87,164	107,171	128,450
Diluted EPS (INR)	35.1	44.5	54.8	65.6
Diluted P/E (x)	33.0	26.1	21.3	17.8
EV/EBITDA (x)	25.8	19.9	14.7	12.4
ROAE (%)	37.6	37.6	36.7	34.2

Bharti Airtel

✱ Investment rationale

- Collaboration between top five operators to share infrastructure including towers and optic fibre would lead to reduction in capital expenditure.
- Tariff hikes and reduction in distributor commissions expected in 1HFY13, which would lead to improvement in cash flows.
- Africa business tracking well with MOU improvement better than RPM decline and consistent margin improvement. Street estimates for EBITDA growth at 6% CQGR over next eight quarters lower than company's internal target of 8%, hence risk of disappointment minimal.
- The negative impact of policy changes assumes spectrum pricing as recommended by the group of experts set up by TRAI. Spectrum prices would be lower than that assumed as, in future, prices discovered through auctions would be used to compute the spectrum fees to be paid on license renewal. This would lead to lower impact than is being assumed currently by street.

✱ Potential triggers

- New Telecom policy, imminent in the next couple of months, would bring in much needed clarity for operators including sharing of spectrum, which would result in capital conservation.

✱ Key risks

- If exchange rate persists at INR 52/USD over next five years, then loan repayment would lead to additional cash outflow of USD2bn.

✱ Outlook and valuations

- At current price of INR 344, the stock is trading at 11.8x FY13 EPS

Financials

Year to March	FY10	FY11	FY12E	FY13E
Net revenues (INR mn)	418,472	594,948	723,998	840,373
EBITDA (INR mn)	167,633	199,996	250,052	327,325
Net profit (INR mn)	89,768	60,803	63,858	111,683
EPS (INR)	23.6	16.0	16.8	29.4
P/E (x)	14.7	21.7	20.7	11.8
EV/EBITDA (x)	8.2	9.7	7.8	5.7
ROAE (%)	24.7	13.4	12.5	19.0

Coal India

✱ Investment rationale

- Coal India (CIL) is the world's largest coal producer with FY11 volume of ~431mt. It controls more than ~80% of the Indian coal market besides owning the world's largest coal reserves of 18bt, 1.8x its nearest competitor.
- CIL will be the prime beneficiary of the expected increase in demand- India's coal deficit expected to rise to 145mt in FY13 from 93mt in FY11.
- Possibility of discount reducing to international coal prices
- The pseudo regulated nature, assured off-take of volume and no prospects of a price cut (FSA coal) position CIL as a utility play rather than a resource company.
- High RoE business; in excess of 30% over the last three years. Net cash of INR 96/share at end of FY12E.

✱ Potential triggers

- Stepping up production in Q4FY12 and FY13
- Ability to take further price hikes for non-power consumers

✱ Key risks

- Proposed tax of 26% on coal mining profits and a higher-than-expected wage revision
- Diversion of cash for buying minority stakes
- Disappointment on volume due to production challenges, slow mining approvals and logistics issues

✱ Outlook and valuations

- At a CMP of INR 301, the stock is trading at 10.1x FY13 EPS

Financials

Year to March	FY10	FY11	FY12E	FY13E
Revenues (INR mn)	466,843	526,162	593,356	643,465
EBITDA (INR mn)	102,632	134,791	177,155	206,797
Net profit (INR mn)	98,294	108,674	160,926	188,006
EPS (INR)	15.3	17.3	25.5	29.8
Diluted P/E (x)	19.6	17.4	11.8	10.1
EV/EBITDA (x)	14.6	10.6	7.2	5.4
ROAE (%)	43.8	36.7	41.1	36.2

HDFC Bank

* **Investment rationale**
  - Stress assets of 34.6% (lowest in our coverage) and negligible restructured assets provide comfort in a difficult macro environment
  - High coverage of 81.3% and Tier 1 of 11.4% also stand out
  - Conservative lending - Downsizing of unsecured loans (9.5% currently, down from 15.5% in FY08), low power book and no major sector concentration
  - Steady profit stream, used to make floating provisions
* **Potential trigger**
  - More resilient to stress from asset quality degradation and this would support the valuation premium which HDFC Bank commands
* **Key risks**
  - Asset quality deterioration - seen in SMEs - flowing into retail assets as well
* **Outlook and valuations**
  - Outperformance to sustain on asset quality management—50% of the book in retail assets—largely secured
  - Valuations at 2.9x FY13E book and 16.4x earnings, delivering RoEs of ~19%-20%

Financials

Year to March	FY10	FY11	FY12E	FY13E
Net revenues (INR mn)	121,942	148,783	177,255	207,295
Net profit (INR mn)	29,487	39,264	49,370	60,679
Diluted EPS (INR)	12.9	16.9	21.2	26.1
Diluted PE (x)	33.1	25.3	20.1	16.4
Price to book (x)	4.5	3.9	3.4	2.9
ROAE (%)	16.3	16.7	18.1	19.3

Lupin

* **Investment rationale**
  - Outpaced the industry growth in the domestic market by 2x over FY06-11 driven by wider therapy coverage, strong traction from new launches and highly effective field force
  - Strong pipeline including niche segments such as OCs, ophthalmology and Para IV opportunities imparts long term growth visibility
  - US branded formulation faces key challenges of slower growth in Antara and Aerochamber, genericization of Tricor and delay in launch over Alllernaze
  - Japan is next big opportunity in generic space (USD 3 bn generic market; likely to expand at a CAGR of 15%) with strong growth (28% Y-o-Y) depicted in Q1FY12
  - Emerging markets including South Africa, Philippines and Australia are depicting significant traction and could be a new growth driver for business
* **Potential triggers**
  - Product specific opportunities such as Zeodon, Combivir and OC's in the US
* **Key risks:**
  - Execution slippage in branded business in the US; Slowdown in domestic formulation market and delay in product approvals in the US
* **Outlook and Valuations:**
  - At CMP of INR448/share, Lupin trades at 16.8x of FY13 EPS

Financials

Year to March	FY10	FY11	FY12E	FY13E
Revenues (INR mn)	48,359	58,195	68,706	79,712
EBITDA (INR mn)	9,728	11,786	14,154	16,434
Adj. Net profit (INR mn)	6,841	8,626	10,088	11,929
Adj. EPS (INR) diluted	15.4	19.3	22.6	26.7
P/E (x)	29.1	23.2	19.8	16.8
EV/EBITDA (x)	21.4	17.6	14.2	12.0
ROAE (%)	34.3	29.5	27.3	26.0

Glenmark

* **Investment rationale**
  - Core business is regaining momentum across geographies after slackened pace of growth over the past two years (16% from 42% CAGR)
  - Glenmark's base business has attained scale which is not only self sustainable, but can also fund its NCE R&D
  - Despite several setbacks, Glenmark persisted with investments in basic R&D (USD 20-25 mn annually) demonstrating its conviction in building business around NCE. The company has a credible track record in terms of monetising R&D pipeline and is one of the most successful NCE players from India
  - Glenmark's focus on improving cash conversion cycle should allay concerns on high receivables
* **Potential triggers**
  - Monetization of R&D pipeline as there are 8 key data points in the R&D space over the next 12 months
  - Deleveraging of balance sheet
* **Key risks:**
  - Disappointments in NCE pipeline, Crofelemer litigation with Napo and regulatory risks in US market
* **Outlook and Valuations:**
  - At CMP of INR294/share, GNP trades at 12.5x FY13 EPS

Financials

Year to March	FY10	FY11	FY12E	FY13E
Revenues (INR mn)	25,006	29,491	37,522	41,303
Operating profit (INR mn)	6,195	6,573	10,097	9,355
Adj. PAT (INR mn)	2,995	3,914	6,697	6,046
Adj. EPS (INR)	269.8	14.5	24.8	22.4
Recurring EPS (INR)	10.4	11.7	15.5	19.8
P/E (x)	26.5	21.2	15.9	12.5
EV/EBITDA (x)	15.6	15.0	9.5	9.9
Core ROE (%)	14.3	14.8	20.1	20.2

Hexaware Technologies

* **Investment rationale**

  - Investment in account managers for top 25 clients is likely to help drive higher client mining among top accounts
  - Long term deals - won in the past 18 months - provides Hexaware with a stronger revenue visibility going into CY12. It also lends itself to building scale in emerging services lines
  - Led by various internal initiatives and long term annuity deals, the company is improving its margin profile. Last four quarters have seen a margin improvement of 10%
  - Timely investments in scaling IMS, Testing and BPO to make it a preferred vendor (outside of scale players)

* **Potential triggers**

  - Strong Q4CY11 results and any large contract

* **Key risks:**

  - Double-dip recession in US, Europe, currency appreciation and attrition

* **Outlook and Valuations:**

  - At CMP of INR75, trading at a P/E of 8.5x and EV/EBITDA of 4.8x CY12E.

Financials

Year to December	CY09	CY10	CY11E	CY12E
Revenues (INR mn)	10,386	10,545	14,139	17,120
EBITDA (INR mn)	2,023	938	2,481	3,116
Net profit (INR mn)	1,343	1,077	2,424	2,624
Diluted EPS (INR)	4.5	3.6	8.1	8.8
Diluted P/E (x)	16.5	20.6	9.2	8.5
EV/EBITDA (x)	8.6	18.1	6.6	4.8
ROAE (%)	17.8	9.4	23.7	22.7

LIC Housing Finance

✱ Investment rationale

- Strong operating performance on all key parameters (Improved margins, asset growth and healthy asset quality performance) despite weak real estate sentiments and competition
- Market share expected to improve (currently at ~9%) aided by its target segment i.e salaried class (80% of its individual loans) and employees of public sector entities (~50%-60% of salaried class)
- Margins to bottom out in FY12 at 2.7-2.8% with maximum pressure seen in Q2FY12- ~20% of loan book (“Fix-O-Floaty” loans) to reprice upwards by 150-200 bps from March’12 onwards

✱ Potential triggers

- Wholesale rates coming off will reduce overall funding costs
- Teaser loans shifting to floating rates wef Apr1,2012
- The company indicated it will evaluate raising equity in H2FY12 . This will act as a trigger since it will be book value accretive

✱ Key risks

- Asset quality deterioration

✱ Outlook and valuations

- Sustained strong performance will lead to re-rating of the stock
  - Valuation discount vis-à-vis HDFC to narrow down (currently at ~50%)
- Valuations attractive at 1.8x FY13E book and 8.2x earnings, delivering RoEs of ~23%-24%

Financials

Year to March	FY10	FY11	FY12E	FY13E
Revenues (INR mn)	10,744	16,024	17,628	22,850
Net profit (INR mn)	6,622	8,428	10,081	12,757
EPS (INR)	14	18	21	27
PE (x)	15.9	12.5	10.4	8.2
Price to book (x)	3.1	2.5	2.2	1.8
ROAE (%)	23.6	22.3	22.4	23.9

Petronet LNG

✱ Investment rationale

- Largest domestic player in the business of importing and re-gasifying LNG; backed by strong promoters (IOCL, BPCL, GAIL, ONGC); low risk business model
- With a dip in domestic natural gas production, PLNG is the only way to play the growth in LNG demand
- Operating at >100% capacity (~10.6mmtpa) since last two quarters due to a dip in domestic natural gas output. Capacity utilisation can be further increased by night berthing.
- PLNG is not impacted by INR depreciation and there is no risk to earnings from the same

✱ Potential triggers

- Kochi terminal operations which are expected to begin in Q3FY13
- Increase in re-gasification charges from 1st Jan 2012. This will lead to a quarterly EPS increase by INR0.2/share

✱ Key risks

- Ramp up in domestic supplies to lead to lower LNG demand, cut in re-gasification charges due to high ROEs and high spot prices may lower LNG demand thus making it unviable for PLNG to source more long term supplies

✱ Outlook and valuations

- At CMP of INR156/share, PLNG trades at 11.2x of FY13 EPS

Financials

Year to March	FY10	FY11	FY12E	FY13E
Net revenues (INR mn)	106,491	131,973	262,184	352,159
EBITDA (INR mn)	8,465	12,163	17,689	19,423
Net profit (INR mn)	4,045	6,196	10,288	10,468
Diluted EPS (INR)	5.4	8.3	13.7	14.0
Diluted P/E (x)	28.9	18.9	11.4	11.2
EV/EBITDA (x)	15.7	11.2	7.8	7.1
ROAE (%)	19.2	25.2	33.6	27.3

ZEE

- **Investment theme**
  - The Cable Digitization Bill passed by the Parliament augurs well for ZEE's subscription revenues
  - MediaPro (Star-ZEE JV) is likely to bolster subscription revenues meaningfully from H1FY13 onwards
  - ZEE has a strong presence in both Hindi and regional GEC space
  - Free cash flow generation remains strong (FCF in FY11 was INR7.2bn)
  - Minimal debt levels (INR17mn at FY11 end)
- **Potential trigger**
  - Potential recovery in ad revenues and market share from H2FY12 onwards
- **Key risks**
  - Sustained drop in GEC rankings can hamper ad revenues
  - Slowdown in ad spends
  - Sports losses could be volatile
- **Outlook and valuations**
  - At CMP of INR118/share, Zee trades at 15.5x of FY13 EPS

Financials

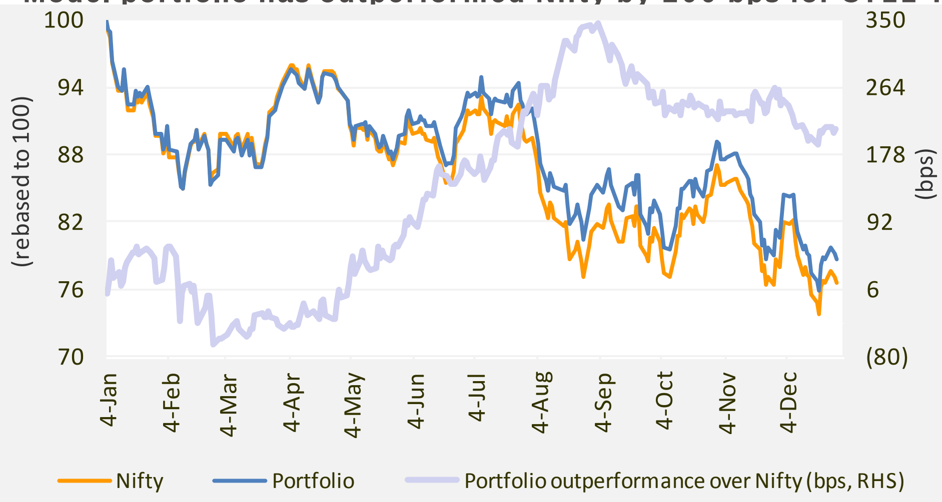
Year to March	FY10	FY11	FY12E	FY13E
Revenues (INR mn)	21,998	30,136	31,628	35,929
EBITDA (INR mn)	6,135	8,266	8,144	9,773
Net profit (INR mn)	5,881	5,913	6,197	7,391
Diluted EPS (INR)	6.2	6.2	6.4	7.6
Diluted P/E (x)	19.0	19.1	18.5	15.5
EV/EBITDA (x)	17.5	12.6	12.1	9.8
ROAE (%)	16.3	17.1	18.8	19.7

Model portfolio

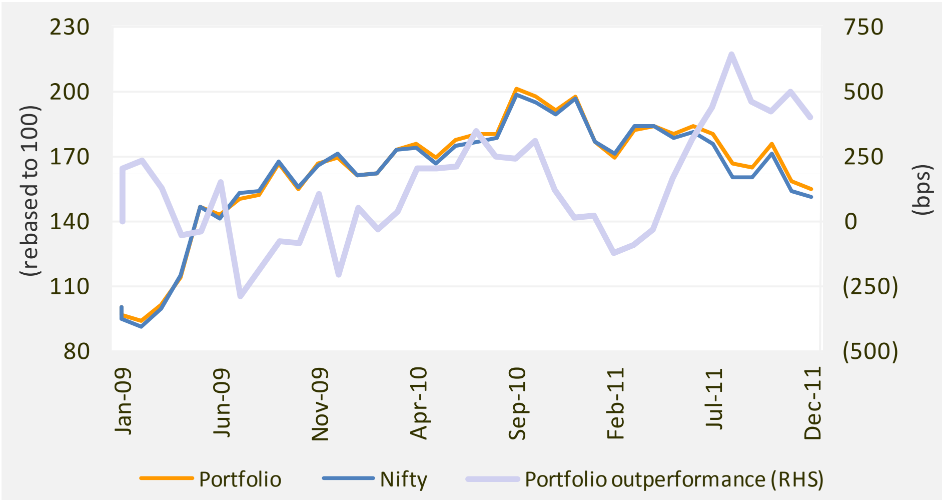
Stocks	Mkt Cap (USD bn)	Price (INR)	Portfolio wt (%)	Nifty wt (%)	Rel wt (bps)	P/E (x) FY12E	P/E (x) FY13E	P/B (x) FY12E	P/B (x) FY13E	RoE (%) FY12E	RoE (%) FY13E	Div Yld (%) FY12E
Health Care			6.6	4.3	230							
Dr Reddy's Laboratories Ltd	5.0	1,578	2.8	1.4	140	20.8	16.2	5.0	3.9	33.5	29.9	0.9
Lupin Ltd	3.8	448	1.4	0.0	140	19.8	16.8	4.9	3.9	27.3	26.0	0.8
Glenmark Pharmaceuticals Ltd	1.5	294	1.4	0.0	140	15.9	12.5	2.9	2.4	20.1	20.2	0.2
Torrent Pharmaceuticals Ltd	0.9	540	1.0	0.0	100	13.0	10.6	3.5	2.8	30.0	29.2	1.3
Telecommunication Services			4.8	3.2	160							
Bharti Airtel Ltd	24.6	344	3.8	2.8	100	20.7	11.8	2.5	2.1	12.5	19.0	0.4
Idea Cellular Ltd	5.1	82	1.0	0.0	100	32.8	18.3	2.1	1.9	6.7	11.0	0.0
Energy			16.0	14.7	130							
Reliance Industries Ltd	42.8	693	7.5	8.5	-100	10.0	9.1	1.3	1.2	14.0	13.8	1.1
Oil & Natural Gas Corp Ltd	41.4	257	2.5	2.5	0	8.7	7.4	1.7	1.5	20.9	20.6	3.9
Coal India Ltd	35.8	301	3.3	1.3	200	11.8	10.1	4.2	3.2	41.1	36.2	2.0
Bharat Petroleum Corp Ltd	3.3	478	1.4	0.4	100	26.3	7.9	1.1	1.0	4.2	13.0	2.9
Petronet LNG	2.2	156	1.2	0.0	120	11.4	11.2	3.4	2.8	33.6	27.3	1.9
Consumers			11.9	10.6	130							
ITC Ltd	29.6	201	7.7	7.7	0	25.5	21.6	8.7	7.8	36.1	38.6	2.5
Hindustan Unilever Ltd	16.6	407	3.0	3.0	0	35.8	30.6	25.7	20.5	80.4	75.2	1.8
Zee Entertainment Enterprises Ltd	2.2	118	0.7	0.0	70	18.5	15.5	3.3	2.9	18.8	19.7	1.7
Dish TV India Ltd	1.2	59	0.6	0.0	60	NM	NM	NM	NM	NA	NA	0.0
BFSI			24.5	24.5	0							
State Bank of India	19.4	1,619	3.0	3.0	0	9.2	7.1	1.4	1.2	16.2	18.5	2.5
HDFC Bank Ltd	18.8	427	6.4	5.4	100	20.1	16.4	3.4	2.9	18.1	19.3	0.9
Housing Development Finance Corp	18.1	652	6.2	6.2	0	23.0	20.1	4.8	3.8	22.3	21.5	1.3
ICICI Bank Ltd	14.9	685	5.6	5.6	0	12.8	10.6	1.3	1.2	10.8	12.0	2.0
Axis Bank Ltd	6.3	808	1.5	1.5	0	10.1	8.5	1.8	1.6	19.5	19.9	2.1
LIC Housing Finance Ltd	2.0	221	1.0	0.0	100	10.4	8.2	2.2	1.8	22.4	23.9	1.9
M&M Financial Services	1.2	610	0.8	0.0	80	11.2	9.2	2.2	1.8	20.6	21.4	1.6
Information Technology			15.7	15.7	0							
Tata Consultancy Services Ltd	42.8	1,161	4.2	4.2	0	21.3	17.8	6.9	5.4	36.7	34.2	1.2
Infosys Ltd	29.9	2,768	9.4	9.4	0	18.8	16.5	5.1	4.3	29.8	28.4	1.8
Wipro Ltd	18.5	399	1.4	1.4	0	17.3	14.8	3.5	3.0	21.9	22.0	1.5
Hexaware Technologies Ltd	0.4	75	0.7	0.0	70	9.2	8.5	2.0	1.8	23.7	22.7	4.1
Autos			8.1	8.1	0							
Tata Motors Ltd	9.9	179	2.3	2.3	0	9.1	7.8	2.3	1.9	29.9	27.7	0.0
Bajaj Auto Ltd	8.7	1,591	2.1	1.5	60	14.6	12.1	6.9	5.2	55.1	49.3	2.5
Mahindra & Mahindra Ltd	7.9	682	2.9	2.2	70	14.4	11.5	3.4	2.8	25.7	26.5	0.0
Maruti Suzuki India Ltd	5.0	918	0.9	0.9	0	16.0	11.8	1.8	1.6	11.7	14.2	0.6
Utilities			4.1	4.1	0							
NTPC Ltd	25.0	161	1.5	1.5	0	15.2	13.4	1.8	1.7	12.4	13.0	2.6
Power Grid Corp of India Ltd	8.7	100	1.0	1.0	0	16.8	14.9	2.0	1.8	12.4	12.8	1.6
Mundra Port and Special Economic Zone Lt	4.5	120	0.6	0.0	60	18.9	14.2	4.6	3.5	26.8	28.1	0.8
Tata Power Co Ltd	3.9	87	1.0	1.0	0	8.8	9.9	1.3	1.2	16.8	13.2	1.6
Industrials			4.7	5.9	-120							
Larsen & Toubro Ltd	11.5	995	3.8	3.8	0	12.8	11.1	2.1	1.9	17.8	17.8	1.6
Bharat Heavy Electricals Ltd	11.0	239	0.4	1.3	-90	9.2	8.1	2.4	2.0	28.3	26.2	2.8
Havells India Ltd	0.9	385	0.6	0.0	60	13.0	10.9	4.9	3.5	45.5	37.7	1.2
Metals & Materials			3.5	5.6	-210							
Tata Steel Ltd	6.1	335	1.6	1.6	0	8.3	6.6	0.7	0.7	9.4	10.6	3.6
Sterlite Industries India Ltd	5.7	90	0.9	0.9	0	5.9	4.3	0.7	0.6	11.8	14.3	1.0
Coromandel International Ltd	1.5	277	1.0	0.0	100	11.4	8.8	3.2	2.6	31.5	32.4	2.5
Cement			0.0	2.7	(270)							
Real Estate			0.0	0.5	(50)							
Model Portfolio	500		100	100	0	13.6	11.3	2.5	2.1	18.0	18.7	

Performance of model portfolio

Model portfolio has outperformed Nifty by 200 bps for CY11 YTD



Since inception model portfolio has outperformed Nifty by 400 bps



Source: Bloomberg, Edelweiss research
Note: Performance chart since inception on a monthly basis

Our model portfolio has outperformed Nifty in 22 out of 36 months

Annexure: Model portfolio construction

- Edelweiss Model Portfolio a long only portfolio benchmarked against Nifty
- Edelweiss Model Portfolio is constructed using a top down approach. The sector allocations are made based on the conviction level for the respective sector, followed by allocation to individual stocks in each sector
- There is no allocation to cash
- We assume nil transaction costs
- Weights are re-assigned for each stock / sector every time we update our view on strategy

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