CLSA
ASIA-PACIFIC MARKETS

India

Market strategy

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16 May 2009

India
Market

Model portfolio changes

Change in sector stance
Cons disc (Neutral to O-WT)
Industrials (Neutral to O-WT)
Cons staples (O-WT to Neutral)
Utilities (Neutral to U-WT)
Healthcare (O-WT to U-WT)

Stock changes
Additions
-
Deletions
Sun Pharma (2%), CESC (2%)

Wt increase
RCom (2% to 4%),
ICICI Bank (7% to 9%),
HDFC (6% to 7%),
BHEL (2.5% to 3.5%),
L&T (2% to 3%),
Maruti (1% to 3%),
Sterlite (2.5% to 3.5%)

Wt decrease
TCS (2% to 1%),
Infosys (11% to 10%),
ITC (4% to 2%),
HUL (3% to 2%)
Bharti (3% to 2%)

A bullish mandate

The 2009 general election has thrown in a big positive surprise, with the Congress-led UPA coalition positioned to achieve a majority with little external support. With big gains for the Congress party and marginalisation of smaller regional parties, the new government will be well positioned to pursue a stronger reform agenda. With political risk less of an issue, we see the market – still under owned by FIIs – being re-rated. Banks, infrastructure plays will be stronger beneficiaries.

Strong mandate for UPA – a big positive surprise

- Congress-led UPA wins 263/543 seats – 50 ahead of the most optimistic exit polls.
- We see the UPA bridging the nine seat gap to the half-way mark rather easily, as smaller regional parties and independents will vie to join the winning coalition.
- The Congress made big gains in the states of Uttar Pradesh, Andhra Pradesh, Kerala and Maharashtra. The Left parties got just 24 seats, versus 59 in 2004.
- Dr Manmohan Singh will be the Prime Minister once again. The Congress' strong show in UP, however, sets the stage for Rahul Gandhi's ascent as the next leader.

Strong coalition augurs well for governance

- The biggest positive of the elections was vote for stability, reflected in the defeat of opportunistic regional parties. The Congress and the BJP together won 321 seats.
- With the strong mandate for the Congress-led UPA alliance and the party's own tally of 206 seats, bargaining power of smaller partners has eroded significantly.

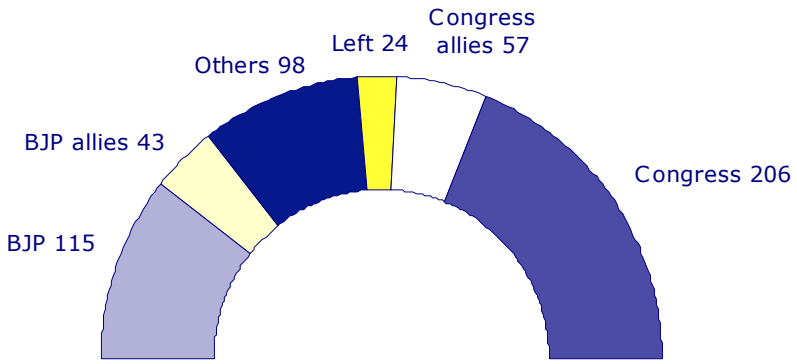
Reduced political risk will reflect in re-rating of equities

- The political risk factor was holding back FII investments - reflected in FII ownership of the market remaining c.20% below the MSCI benchmark.
- While radical reform looks unlikely, we are optimistic about higher FDI limits for insurance and retailing and quicker resolution of project specific bottlenecks.
- Sensex P/B remains 35% below the historical average. While a 50bps fall in risk premium suggests 25% re-rating, ROAE below mean will limit it to 10-15%.
- While FY10 EPS outlook remains geared to global recovery, we see market re-rating supporting a 12mth target of 14,000 for the Sensex.
- Signals of fiscal consolidation will be key to sustainability of the rally.

Winners and losers

- The immediate rally will be broad-based, with focus on large cap, index majors.
- Banks and infrastructure plays will be top beneficiaries of improvement in capital market, corporate confidence. ICICI, HDFC also gain from insurance reform.
- ICICI Bank, HDFC, Reliance Ind., Reliance Comm. and Sterlite are our preferred picks. We have cut weight for consumers, software in the model portfolio.

Seats in the 15th Lok Sabha



Source: CLSA Asia-Pacific Markets

A near majority for the UPA – a big surprise

Strong mandate for UPA – a big positive surprise

The Congress-led UPA has emerged the clear winner in the Lok Sabha polls. Most exit polls had predicted a hung Parliament with a lead for the Congress Party and UPA but certainly not as decisive a victory as the eventual result. With 263 seats, UPA is now short of the half-way mark by just 9 seats and should have little difficulty in forming a government with the help of independents and a few small regional parties. The Congress party itself crossed the 200 seat mark, its best performance since 1991. The Congress' tally not only puts it in the driver's seat in the UPA but also gives it the stature to lay down engagement terms with its allies.

Major Gainers
Congress
Trinamool Congress
JD (U)

Major Losers
Left Front
BJP
RJD
Samajwadi Party

Figure 1

Party-wise seat positions*

	2009	2004	Change
UPA			
Congress	206	145	61
NCP	9	9	0
DMK	18	16	2
Trinamool Congress	19	1	18
National Conference	3	2	1
JMM	2	5	(3)
Muslim League	2	1	1
Others	4	1	3
Total	**263**	**178**	**83**
NDA			
BJP	115	138	(23)
Shiv Sena	11	12	(1)
JD (U)	20	8	12
TRS	2	5	(3)
AGP	1	2	(1)
SAD	4	8	(4)
RLD	5	3	2
Total	**158**	**176**	**(18)**
Others			
Left Front	24	59	(35)
BSP	21	19	2
BJD	14	11	3
SP	23	36	(13)
TDP	6	5	1
RJD	4	24	(20)
JD(S)	3	3	0
Independents & Others	27	30	(5)
Total	**122**	**187**	**(65)**

Source: Rediff, CLSA Asia-Pacific Markets *as on 17th May 09,

The anti-incumbency factors appears to be waning

The Lok-Sabha (lower house of Parliament) election results reinforce a trend visible in recent state elections – where incumbents have come back to power, in contrast to the historic trend where the anti-incumbency factor was very prominent. Prima facie, the election verdict appears to be driven by local developmental issues and strength of personality of local regional leaders.

Strong regional leaders and populist schemes helped

Figure 2

Pro-incumbency in many large states

Chief Minister	State	Major pro-poor policies
Narendra Modi	Gujarat	Schemes on agriculture and protect the girl child
Y S Rajashekhar Reddy	Andhra Pradesh	Rice at Rs2/kg. Free surgeries and houses to poor
Raman Singh	Chattisgarh	Provision of cheap rice
Shivraj Singh Chauhan	Madhya Pradesh	Schemes to prevent female infanticide
M Karunanidhi	Tamil Nadu	Free colour televisions, Rice at Re1/kg
Nitish Kumar	Bihar	Re-opening of sugar mills and incentives for women
BS Yeddyurappa	Karnataka	Free power for farmers, Insurance scheme for girls

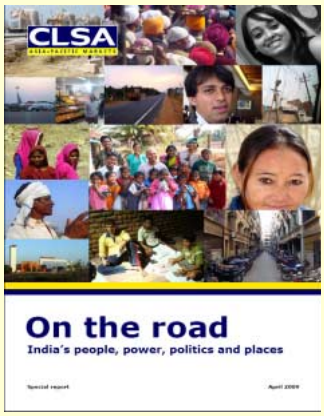
Source: CLSA Asia-Pacific Markets

Figure 3

Trends in performance across states

	NDA	UPA	Others	Surprises	Comments
Andhra Pradesh	2	33	7	Congress performance across the state	Telangana issue and the consolidation of opposition parties could not prevent Congress' hold over the state.
Assam	5	8	1	No surprises	BJP-AGP alliance did not work at the ground level and helped the Congress
Bihar	32	2	6	No surprises	JD(U)-BJP victory was attributable to the positive image of the chief minister Nitish Kumar and failure of the RJD-LJP to tie-up with the Congress
Chhattisgarh	10	1		No surprises	In-fighting in Congress and BJP Chief Minister Raman Singh's popularity helped BJP
Gujarat	15	11		BJP performance below expectations	Wrong choice of candidates by Narendra Modi impacted BJP's chances in multiple constituencies
Haryana		9	1	No surprises	INLD-BJP alliance did not work well on the ground
Jharkhand	8	3	3	No surprises	
Karnataka	19	6	3	BJP's victory in coastal Karnataka	BJP continued the momentum of 2008 Assembly elections. The backlash to moral policing was expected to hurt BJP in coastal Karnataka but it did not.
Kerala		16	4	No surprises	In-fighting in the Left Front expectedly helped Congress-led UDF.
Madhya Pradesh	16	12	1	Congress performance in Malwa	Continued water crisis in the Malwa region impacted BJP's performance. BSP also opened its account in the state.
Maharashtra	20	25	3	Congress performance especially in Mumbai & adjoining areas	MNS factor impacted NDA performance especially in Mumbai and surrounding areas giving the UPA an edge. NCP performance was poor in its stronghold of Western Maharashtra.
Orissa		6	15	BJD swept the polls	Lack of alliance with BJP was expected to impact BJD but absence of a proper organisational set-up for the Congress aided BJD's performance.
Punjab	5	8		No surprises	Anti-incumbency against the SAD-BJP state government was expected to help Congress.
Rajasthan	4	20	1	Congress sweep	Consolidation of Meena, Jat and Muslim votes helped the Congress
Tamil Nadu		27	12	DMK's performance in Southern Tamil Nadu	Despite AIADMK's alliance with PMK, MDMK and the Left, UPA managed to retain the state. Victory is being attributed to freebies distributed by the state government.
Uttar Pradesh	15	21	44	Congress performance all over the state	Consolidation of Muslim votes and return of upper caste votes helped the Congress. Farm loan waiver scheme has also likely helped Congress.
West Bengal	1	26	16	UPA performance in South Bengal	The Left Front's handling of Nano project and Rizwanur Rehman episode impacted votes in rural areas and from the minority community
Other States	6	29	5		
Total	**158**	**263**	**122**		

Source: Rediff, CLSA Asia-Pacific Markets *as on 17th May 09,



Our "On the road" report dated Apr-2009 had indicated BSP's loosening grip over the electorate in UP

The advent of caste-based and religion-based politics had seen the Congress getting marginalized in UP, politically the most important state in India. However, the aggressive campaign run by Rahul Gandhi saw Congress' traditional voters the Muslims, upper castes and non-chamar dalits voting for Congress in large numbers. Congress' tally of 21 seats in the state is more than double its tally of 9 in the last elections. This resurgence in UP augurs well for Congress in the Hindi heartland where it has been marginalized over the last two decades. It also sets the ball rolling for Rahul Gandhi's coronation as the next leader of the Congress.

Strong coalition augurs well for governance

*"**The series of state elections in 2008 showed that anti-incumbency is not a given.** It seems – miraculously at times – that incumbent government's won elections on the back of good performance and strong local leadership. If the trend persists, it will augur well for Indian democracy."*

National parties have gained at the expense of regional parties

We wrote the above in Jan-09 and while the UPA is set to return to power for a second term, the most heartening aspect of the result has been the gain of national parties at the expense of the smaller regional parties. The Indian voter has unarguably voted for stability and importantly, the two national parties, Congress and the BJP managed to garner 321 seats between themselves, an increase of 38 seats over the last election.

UPA will easily find support to get past the halfway mark

With existing UPA constituents together winning a near-majority, we see a number of independent candidates/small regional parties vying to align with them. Moreover, with such a strong mandate in favour of the Congress-led UPA alliance, regional parties like Rashtriya Janata Dal (RJD) and Samajwadi Party (SP) will no longer be a stumbling block in government formation.

Independents likely to support the UPA

Figure 4

Potential UPA supporters

Definite Support From		
Independent	Madhu Koda	Jharkhand
Independent	Baliram Jadhav	Maharashtra
Independent	Sadashiv Mandlik	Maharashtra
Independent	Raju Shetty	Maharashtra
Other likely supporters		
Independent	Kirori Lal Meena	Rajasthan
Independent	Inder Singh Namdhari	Jharkhand
Independent	Babulal Marandi	Jharkhand
Independent	Bhajan Lal	Haryana
Independent	Digvijay Singh	Bihar
Independent	O P Yadav	Bihar
Independent	Hassan Khan	J&K
Sikkim Democratic Front	Prem Das Rai	Sikkim
AUDF	Badruddin Ajmal	Assam

Source: CLSA Asia-Pacific Markets

One of the regional parties could be invited for government formation

However, with capricious allies like the Mamta Banerjee headed Trinamool Congress and the DMK holding a sizeable number of seats, it is likely that Congress would invite a regional party like the Samajwadi Party for government formation just to add stability and serve as an effective foil to these two parties.

Left will have no say and bargaining power of small constituents reduced

A decisive mandate and the absence of the Left parties in the support base open the gates for the Congress-led UPA to push a stronger reform agenda. With the Congress itself having 206 seats, the reduced bargaining power of smaller constituents should pave the way for smoother policy formulation and better implementation.

Reduced political risk will reflect in re-rating of equities

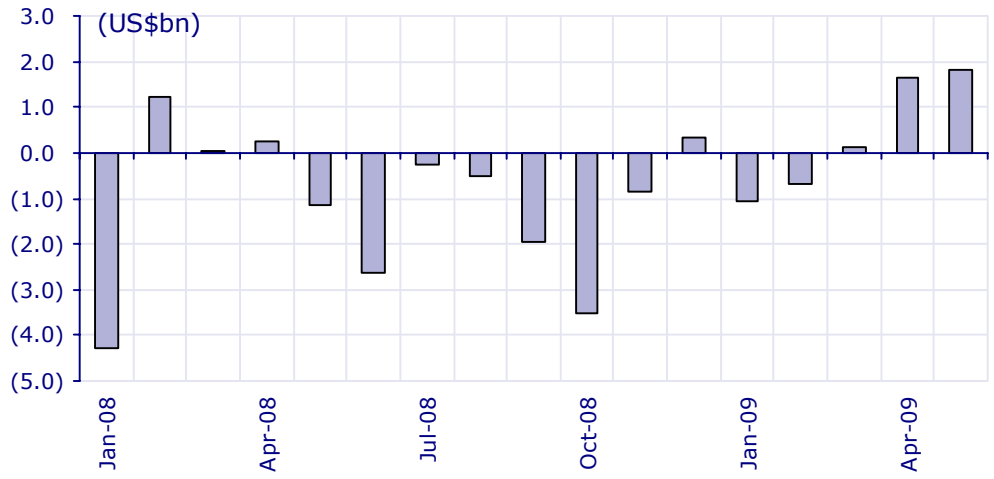
'Political risk' is no longer a significant factor

The strong performance of the Congress-led UPA will drive further re-rating of equities, in our view. With concerns about a weak, ineffective coalition or even a 'disruptive' event like the emergence of a Third Front government now out of the way, we see softening in bond yields and a strengthening of the INR. The 'political risk' factor had held back foreign flows into equities. Reduced risk perception on the India growth story will reflect in lower equity risk premium as well.

FII inflows have turned positive from late March

Figure 5

Trend in FII inflows



Source: CLSA Asia-Pacific Markets

FII have been under investing...

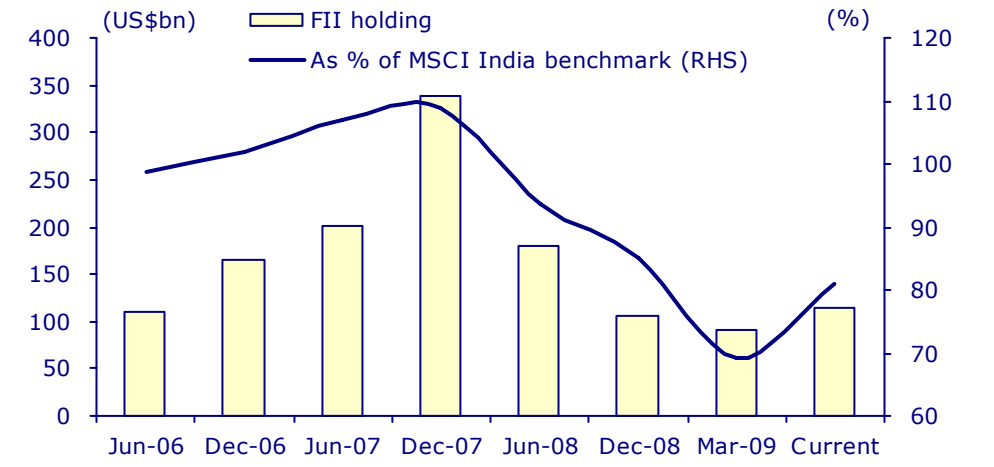
Reduction in U-WT stance will drive inflows

Notwithstanding the significant pick-up in foreign inflows from April 09, foreign investors remain underweight on India to the extent of c.20% - based on a comparison of their holdings in Indian equities against the MSCI India benchmark. Based on the same parameter, during the peak of the market in early Jan-08, foreign investors were overweight on India to the extent of +10%.

... and FII holding remains 20% below the MSCI benchmark

Figure 6

FII holding relative to MSCI benchmark



Source: Bloomberg, CLSA Asia-Pacific Markets

Radical reform is unlikely...

Where will the reform push come in?

While the strong mandate for the UPA and specifically for the Congress will allow for a much bigger push for economic reforms, in the backdrop of the global financial crisis, we expect the new government's response to be moderate, rather than radical. Senior leaders of the UPA have been maintaining that it was their 'measured' approach to reform that precluded a domestic financial crisis similar to seen in developed markets in 2008.

... but we could see focus on addressing a number of pending measures

However, the political leadership of the UPA will also recognise the need for higher economic growth to avoid a situation where India's demographic dividend becomes a demographic curse instead, especially with the stretched fiscal situation limiting the options for direct government intervention. We

would expect the government to use the opportunity provided by the strong mandate to;

- Push ahead with legislation/policy measures that were stalled on account of opposition by the Left or other allies.
- Focus on kick-starting investment/growth in sectors where there have been delays due to administrative/governance issues.
- Revive the disinvestment programme, since this will be an important element for addressing the challenging fiscal situation.
- Support measures that will encourage inflows into capital markets.

Insurance, Banking, Pension reform will help provide longer-term funding for investment

In the first category, the key steps would relate to raising the FDI limit in insurance companies (to 49%, from 26% currently), pushing forward the pending Banking Regulation Amendment Bill (which will facilitate equity participation by foreign banks in Indian banks), putting in place a Pension Fund regulator and getting the Land Acquisition (Amendment) Bill (which provides a framework for rehabilitation/compensation for people displaced as a result of the acquisition). These steps can be significant growth enablers, since they will help channel the pool of long-term savings towards much-needed investment projects.

Figure 7

List of major bills pending in the parliament

Title	Date	Overview
The Insurance Laws (Amendment) Bill, 2008	22 Dec 08	To increase the permitted limit of foreign equity in Indian insurance companies from 26% to 49%.
The Forward Contracts (Regulation) Amendment Bill, 2008	13 Mar 08	To transform the role of the Forward Markets Commission (FMC) from a government department to an independent regulator with powers similar to that of SEBI
The Land Acquisition (Amendment) Bill, 2007	6 Dec 07	Provide for rehabilitation and compensation framework, where land is acquired by government for public use or by corporate
The Unorganised Sector Workers' Social Security Bill, 2007	10 Sep 07	Provide for the social security and welfare of unorganised sector workers.
The Gram Nyayalayas Bill, 2007	15 May 07	Provide for the establishment of Gram Nyayalayas for the purpose of providing access to justice at the grass root level and ensure that opportunities for securing justice are not denied to any citizen
The State Bank of India (Amendment) Bill, 2006	18 Dec 06	To reduce government's shareholding in SBI; Permit SBI to raise capital by way of preference shares
The Communal Violence (Prevention, Control & Rehabilitation of Victims) Bill, 2005	5 Dec 05	To empower the state and central government to take measures to provide for the prevention and control of communal violence and rehabilitation of victims
Labour Laws (Exemption from Furnishing Returns and Maintaining Registers by Certain Establishments) Amendment and Miscellaneous Provisions Bill, 2005	22 Aug 05	The Bill limits the application of the Labour Laws Act to establishments with 500 or fewer employees
The Factories (Amendment) Bill, 2005	16 Aug 05	The Bill allows women to work night shifts in factories
The Banking Regulation (Amendment) Bill, 2005	13 May 05	Some of the main objectives are: regulating acquisition of shares in banking companies, include preference share as capital and restriction of 10% voting rights on any shareholder is being revoked
The Pension Fund Regulatory and Development Authority Bill, 2005	21 Mar 05	To develop and regulate the new pension system (NPS), which is a defined contribution scheme unlike the earlier defined benefit scheme and provides for a set of pension fund managers
The Scheduled Castes, Schedules Tribes and Other Backward Classes (Reservation in Posts and Services) Bill, 2004	22 Dec 04	To provide for reservation of posts in civil services for members of the scheduled castes and scheduled tribes and other backward classes

Source: PRS Legislative Research, CLSA Asia-Pacific Markets

Retailers, Airlines, Nuclear deal plays likely beneficiaries

We also expect the government to support proposals to allow FDI in retailing (currently permitted only for single brand retail outlets) and strategic stakes by foreign entities/airlines in domestic airlines. They will also look to quickly move ahead with the next steps towards operationalising the Indo-US nuclear deal, capitalising on the defeat of the Left parties who had withdrawn support to the previous government in protest against the Indo-US nuclear deal.

Infrastructure, mining plays can benefit from focus on kick-starting investment

Sectors that have been dogged by administrative/governance issues include power, roads and mining. We believe the government will look to speed up the approvals for pending infrastructure projects, focus on quicker resolution of land acquisition/rehabilitation issues holding back large projects, hasten the award of captive coal/mineral blocks and kick-start the process for bulk ordering for the identified supercritical power projects.

The PSU disinvestment agenda will be revived...

Given the Congress party's stated policy stance against 'blind privatisation' and the socialist leanings of many party leaders, we do not expect to see privatisation on the agenda. However, we do expect the government to push ahead with minority stake sales in listed public sector undertakings and IPO/stake sale for some large unlisted companies. The Congress does favour public ownership in PSUs and even the previous UPA government had undertaken 5-10% stake sale along with listing of Power Grid and Rural Electric Corporation. They had also proposed 10% stake sale in BHEL, though this has to be shelved due to stiff opposition from Left parties.

... since the fiscal challenge will also demand bolder steps

The challenging fiscal situation, reflected in the consolidated fiscal deficit/GDP running at +10%, will also be a key driver for the government to push ahead with disinvesment. The Government of India's holding in listed PSUs alone is worth US$176bn and a reduction in stake to 51% across all these entities could bring in US$62bn at current market prices. We believe the government will, however, test the waters with small stake sales in PSUs where investor appetite is known to be high. 10% stake sale in the ten large PSUs that are likely disinvestment candidates can bring in US$17bn.

Figure 8

Potential disinvestment candidates

Company	Value of 10% stake (US$m)	Free Float (US$ m)	% of Free Float
NTPC	**3,147**	**3,305**	**95**
NMDC Ltd	1,705	276	617
B H E L	1,694	5,468	31
S A I L	981	1,392	71
Power Grid Corpn	808	1,102	73
GAIL (India)	656	2,322	28
Hind.Zinc	465	258	181
Unlisted Companies	**US$ m**	**Remarks**	
Coal India	2,300	For 10% Stake, based on 10(x) FY10 Profit	
BALCO	300	For 10% Stake, based on proposed IPO	
Oil India	360	For 49% Stake, based on CLSA Estimates	

Source: CLSA Asia-Pacific Markets

Expect more focus on PF, Pension reforms

Since stronger capital market inflows can help kickstart private investment by providing equity capital and also counter the impact of the high fiscal deficit, we see the government taking some action on this front. In our view, the government would support higher investment in equities by the Employees Provident Fund Organisation (EPFO), which manages over US$48.7bn of employees' provident fund assets. Although the EPFO is permitted to invest upto 5% of its corpus into equities, actual investment has been negligible due to opposition from the Left parties. A 10% allocation to equities can itself bring in US$4.8bn – significant in the context of FY09 inflow from domestic mutual funds being only US$10m.

Figure 9

Key reforms likely to be undertaken by the UPA government

Measure	Impact	Key beneficiaries
Raise FDI limit in insurance companies	Value unlocking through existing / additional stake sale	ICICI, HDFC, Max India
Facilitate equity participation for foreign banks in Indian banks	Capital raising through existing / additional stake sale	Yes Bank, Fedral Bank, Karnataka Bank
Rehabilitation / compensation for people displaced as a result of land acquisition	Obstacles to project development will get reduced	Mining companies, SEZ developers
Allow FDI in retailing	Capital raising through existing/ additional stake sale	Pantaloon, Shoppers Stop
Allow strategic stake by foreign airlines in domestic airlines	Capital raising through existing/ additional stake sale	Kingfisher, Jet, Spice Jet
Speed up approvals for pending infrastructure projects	Increase in order book, reduced risk of project delays	BHEL, L&T, Reliance Power, Reliance Infrastructure
Minority stake sale in listed public undertakings and IPO/stake sale in some large unlisted companies	No change in control but opportunity for minorities to gain exposure in strong asset plays	Power Grid, MMDC, SAIL

Source: CLSA Asia-Pacific Markets

Reduced risk premium will drive market re-rating

What does this mean for the market?

With a significant 'political risk factor' out of the way, we see the equity market set for a re-rating as the fall in risk premium drives inflows from foreign investors – who currently remain Underweight on India relative to the MSCI benchmark. In the backdrop of the recessionary conditions in developed economies, investors will find it difficult to ignore a relatively large, domestic driven market like India. Current valuations remain broadly in line with regional benchmarks, when viewed in the context of India's superior growth and its relatively stable earnings.

Figure 10

India market vs regional peers

Market	PER (x)		EPS Growth(%)		ROAE (%)	PB (x)	Div yld (%)	Net Gearing (%)
	2009	2010	2009	2010	2009	2009	2008	2008
China	14.8	11.8	(3.7)	25.8	13.0	1.8	2.8	20.8
HK	14.3	13.8	(1.9)	3.8	7.6	1.1	5.6	25.0
Indonesia	11.9	11.4	(4.7)	4.2	21.5	2.4	3.8	34.2
India	**14.3**	**12.4**	**(12.9)**	**14.9**	**15.3**	**2.0**	**1.8**	**29.1**
Korea	18.3	13.3	(15.7)	37.4	6.7	1.2	1.6	29.5
Malaysia	18.4	15.4	(17.0)	19.3	9.8	1.7	4.9	37.4
Phillipines	13.9	15.2	(8.8)	(8.5)	10.3	1.4	4.8	29.9
Singapore	17.8	17.4	(35.2)	2.2	8.2	1.4	4.5	22.4
Thailand	12.4	10.3	(9.3)	20.7	11.2	1.4	5.1	45.7
Taiwan	54.9	26.9	(58.0)	104.1	3.5	1.9	3.4	17.1

Source: CLSA Asia-Pacific Markets

12mth Sensex target now 14,000

The Sensex is currently trading at 35% below its historic average P/B and a small 50bps change in risk premium can raise the market P/B multiple by 25%, based on our Gordon Growth model assumptions. However, with ROAE (16% for FY10) too well below historical averages, we believe the extent of re-rating would be capped at 10-15%. We set a 12month target for the Sensex of 14,000, based on target P/B multiple of 2.6x. This will imply a target P/E multiple of 15.4, on our current FY11 Sensex EPS estimate.

Figure 11

Sensex 1yr forward P/E

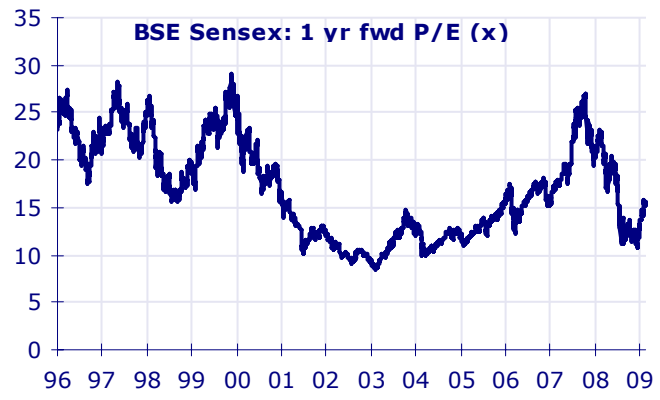
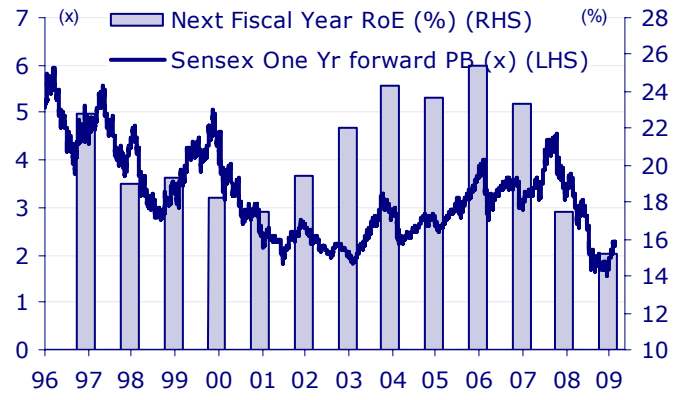


Figure 12

Sensex 1yr forward P/B and RoE



Source: CLSA Asia-Pacific Markets

FY10 Sensex EPS still more geared to global scenario

The upgrade to our Sensex target (earlier 11,000 for end-2009) arises primarily from expectations of re-rating; we continue to believe that a significant upgrade to FY10 Sensex EPS will require a meaningful improvement in global economic conditions, since aggregate earnings remain significantly geared to commodity plays (especially Reliance Industries) and IT services. Banks do have room for upside, but a rise in bond yields later in the year – a possibility if the fiscal deficit remains unchecked - could mar this.

Stance on fiscal consolidation will be key for sustaining the rally

Managing the fiscal challenge will be key...

While we do see a relief rally in the near-term, the sustainability of the rally will depend on the government's actions on pushing ahead with pending reform and their stance towards fiscal consolidation.

... since the double-digit fiscal deficit is undesirable

The consolidated fiscal deficit/GDP (including states and off-balance items like oil/fertiliser/food bonds) for FY09 surged to +11%, due to the combination of soft tax revenues and increased expenditure due to higher social spending, pay increase for government employees, farm loan waiver and subsidies. We see the deficit remaining at similar levels for FY10, which will translate into Rs3.1tn net borrowing by the government – 2.4x that in the pre-FY09 period.

Figure 13

Consolidated fiscal deficit

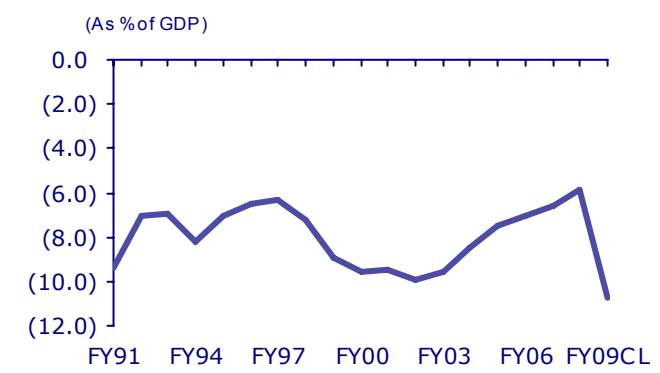
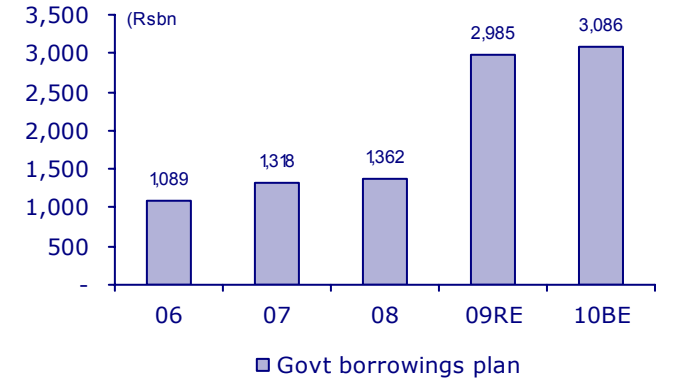


Figure 14

Government borrowing programme



Source: CLSA Asia-Pacific Markets

If not tackled, the fiscal position could hinder the recovery

For now, the surge in the government borrowing programme has had a limited impact on interest rates, since this has been offset by the fall in credit demand from the private sector, the cut in policy rates (a further 25bps in

Apr-09) and unwinding of market stabilisation scheme (MSS) bonds by the RBI and near-zero headline inflation. However, a lax attitude towards reining in the fiscal deficit would create upward pressure on bond yields as private credit demand, WPI inflation pick-up in 2H FY10 and equities would react negatively to any prospect of the accommodative monetary policy stance being reversed.

The FY10 Budget will provide signals

We are optimistic about some steps towards fiscal consolidation being visible in the FY10 Budget itself, including signals on disinvestment. In our view, the government does have some cushion on the expenditure side, since some of deterioration has come on account of populist pre-election measures and tighter control on social spending schemes can curb expenditure without impacting outcomes.

Winners and losers

Banks, capital goods/infrastructure will outperform in the rally

The immediate post-election rally will be fairly broad-based, since the riddance of the 'political risk factor' will be a strong catalyst for foreign investors, currently Underweight, to raise their exposure to Indian equities. The focus will be on large cap, index heavyweights. However, we do see potential for a further leg-up for banks, insurance plays, airlines, retailing, leveraged companies (especially property stocks), capital goods and PSUs. Software and Consumer stocks are likely to be underperformers in this rally.

Favoured picks

Our favoured picks are ICICI Bank, HDFC, Reliance Communication, Sterlite and Reliance Industries.

Banks – multiple positives

Banks – likely boost from insurance, potential dilution of ownership norms

Banks will benefit from the pick-up in corporate and investor confidence arising from the favourable election outcome. Improved prospects for equity raising will reduce concerns on the stress assets in their portfolio and also support the revival of corporate capex plans. While RBI has been a bit hesitant in opening doors to foreign banks due to stress in their home markets, if permitted, mid-tier private banks could get re-rated. Expectations that the government may agree to lower its holding in PSU banks, support moves for consolidation of PSU banks will drive PSU bank stocks. Enactment of higher FDI limits for insurance companies will be a positive for ICICI, HDFC and Max India as it will facilitate value unlocking in insurance business

Capital goods/infrastructure – many positives for BHEL

Capital goods – to benefit from revival of investment plans

Expectations of revival in investment intentions will translate into re-rating of capital goods/infrastructure stocks; large cap companies like BHEL, L&T, that had good near-term visibility on account of strong order books, will be particularly benefited. The continuity in leadership will be positive for the development of the Power sector, since the progress of the Power sector was closely monitored by the Prime Minister. For NTPC, any doubts on the continuity and implementation of the new tariff regime (which offers higher returns to NTPC) will now be laid to rest. BHEL will be the biggest beneficiary, on reduced risk of power project delays, prospects of earlier award of bulk orders, continued government support for indigenous equipment suppliers over Chinese suppliers and upside potential from development of nuclear power plans.

Leveraged companies – hopes of a virtuous cycle?

Stocks of leveraged companies have higher re-rating potential

The pick-up in market sentiment can spell significant upside for stocks of companies with high leverage, since equity raising will actually drive re-rating of stocks as balance sheet stress is relieved. Stocks with high leverage that could witness a technical rebound are Jet Airways, United Spirits and Jain Irrigation

Figure 15

List of stocks with high leverage

Company	Net Debt/ Equity (FY09)
Jet Airways India	1,612.3
United Spirits Ltd	244.2
Unitech	232.6
Jain Irrigation	185.7
Wockhardt	162.6
Hindalco	158.4
Pantaloon	150.1
Power Grid	144.6
Educomp Solutions	142.9
Jaiprakash Associates	138.0
Reliance Petroleum	137.2
Shopper's Stop	110.6
JSW Steel Ltd	108.2
Indian Oil	106.3
Ranbaxy	102.6
Areva T&D	100.1

Source: CLSA Asia-Pacific Markets

Potential upside for retailers, airlines

Retail, airlines – easier access to capital for growth?

We expect the new government to initiate opening-up of the retail and the aviation sector to FDI. Presently, in the retail sector only two segments qualify for FDI- cash and carry (100% FDI permitted) and single brand retail (51%). We believe that the new FDI guidelines announced in Feb-09, are ambiguous and necessitate a complicated holding structure - Pantaloon Retail through its new holding structure will be testing the new guidelines. In the aviation sector, government has been planning to permit foreign airlines to acquire up to 25% stake in Indian airlines. This will ease balance sheet stress of airline companies and drive re-rating.

PSUs – disinvestment positive in some cases

PSUs – mixed bag

For PSU stocks, disinvestment of government stake will not necessarily be positive, since there will be no change in control as long as the government stake remains >51%; in fact, for stocks like BHEL, NTPC, the additional supply could be a temporary overhang on the stock. On the other hand, in cases like NMDC, Coal India, PowerGrid, SAIL, the offering will likely result in the stock being considered more 'investible' and seen as an opportunity for minorities to gain exposure to strong asset plays. Sterlite will benefit if it is able to acquire full control over Balco and Hindustan Zinc, through purchase of residual government stake. If the government were to allow dilution of stake in PSU banks to 33% from 51% presently, it will improve prospects for growth, since they will be less constrained in raising capital.

Defensives, exporters will be relative underperformers

Relative losers – IT, Consumers

The definitive election results will change markets' focus on the sector, looking at investing the sector on its own merits rather than as a defensive on account of companies' relatively strong cash flow profile. With sector leader Infosys now trading at 15-16xMar10 earnings and other stocks playing catch up, the absence of any meaningful uptick in demand will result in sector underperformance. Likewise, consumers will continue to underperform, since prospects of earnings upgrades will be relatively limited.

Model portfolio

Figure 16

CLSA model portfolio

	Current Mkt Price (Rs)	Market Cap (US$m)	Current MSCI Wt (%)	CLSA Rec Wt (%)	Stance	FY09-11 EPS Cagr (%)	FY10 P/E (x)	FY09 div yield (%)	3m Perf. (%)	CLSA Rec
Consumer disc			**4.6**	**7.0**	**O-WT**					
Maruti	848	4,967	0.8	3.0		17.2	15.3	0.7	36.6	U-PF
Bajaj Auto	793	2,327	-	2.0		15.5	16.6	2.5	70.2	O-PF
Educomp	2,378	834	-	2.0		51.0	18.6	0.1	15.7	BUY
Financials			**22.1**	**25.0**	**O-WT**					
Axis Bank	659	4,802	1.8	3.0		14.5	11.5	1.5	57.5	BUY
HDFC	1,936	11,168	5.7	7.0		13.9	20.9	1.5	29.2	BUY
ICICI Bank	574	12,969	6.2	9.0		10.5	16.3	1.9	40.4	BUY
Union Bank	175	1,790	-	2.0		3.6	5.1	2.9	23.9	BUY
Bank of India	246	2,621	-	2.0		2.5	4.4	3.3	3.4	O-PF
SBI	1,312	16,899	1.2	2.0		3.9	8.8	1.9	15.5	U-PF
Energy			**22.9**	**20.5**	**U-WT**					
Reliance	1,948	62,194	17.1	17.5		34.1	15.5	0.7	47.7	O-PF
Cairn	199	7,642	0.8	3.0		155.5	31.1	-	25.6	BUY
Consumer staples			**6.0**	**6.0**	**Neutral**					
ITC	186	14,252	2.8	2.0		17.2	18.4	1.9	3.2	BUY
United Spirits	675	1,372	0.5	2.0		26.0	19.2	0.4	0.2	O-PF
HUL	224	9,918	2.7	2.0		6.9	20.3	3.1	(12.3)	O-PF
Industrials			**8.3**	**10.0**	**O-WT**					
Thermax	281	679	-	1.5		(1.8)	16.1	2.5	78.8	O-PF
L&T	988	11,739	2.7	3.0		7.3	22.4	1.0	48.3	U-PF
Crompton Greaves	176	1,307	-	2.0		7.0	12.6	1.4	33.3	O-PF
BHEL	1,707	16,953	2.8	3.5		31.7	19.1	1.0	21.8	U-PF
Health care			**3.5**	**3.0**	**U-WT**					
Cipla	231	3,637	1.0	3.0		29.0	16.3	0.9	21.4	O-PF
Infotech			**13.8**	**11.0**	**U-WT**					
Infosys	1,594	18,525	10.2	10.0		0.8	15.9	1.7	30.5	O-PF
TCS	646	12,823	1.8	1.0		3.9	12.2	3.8	29.0	U-PF
Materials			**8.4**	**6.5**	**U-WT**					
Grasim	1,882	3,499	0.9	3.0		(19.5)	9.4	1.2	39.4	O-PF
Sterlite	460	6,609	1.6	3.5		4.5	15.8	0.9	75.2	BUY
Utilities			**6.9**	**5.0**	**U-WT**					
Tata Power*	909	4,081	1.0	3.0		(11.0)	12.1	1.2	17.1	O-PF
GAIL	269	6,933	1.4	2.0		(6.9)	3.4	2.6	29.9	O-PF
Telecoms			**2.4**	**6.0**	**O-WT**					
Reliance Comm.	233	9,734	2.0	4.0		5.4	8.0	-	35.8	BUY
Bharti	800	30,797	-	2.0		15.9	16.0	0.3	25.4	BUY
Total			100.0	100.0						

Source: Bloomberg, CLSA Asia-Pacific Markets. Priced on May 15, 2009

Summary of changes

Figure 17

Change in sector stance

Sector	Change
Cons disc	Neutral to O-WT
Industrials	Neutral to O-WT
Cons staples	O-WT to Neutral
Utilities	Neutral to U-WT
Healthcare	O-WT to U-WT

Source: CLSA Asia-Pacific Markets

Preferred picks

ICICI Bank

- ICICI Bank, India's largest private sector bank and the second largest in the domestic banking system, is well geared to any improvement in capital market, corporate confidence following the positive election outcome.
- The sharp fall in wholesale borrowing costs, along with the stability in its fresh slippages in asset quality, has been the key driver of re-rating of the stock. Further softening in rates will help sustain the rally.
- Over FY10, ICICI will focus on improving its liability-mix which will help maintain stable and healthier NIMs and RoE.
- In case the government raises the FDI limit from 26% to 49%, it could help ICICI to unlock the value in ICICI Pru Life- largest private insurer.

HDFC

- For India's leading mortgage company HDFC, an improvement in the economic environment will be positive for growth and margins.
- The pick-up in growth in approvals to 17% YoY in 4Q was a catalyst for re-rating. Visibility on loan growth has improved and NIMs are likely to improve due to sharp fall in wholesale funding costs.
- While securitization of part of loans to HDFC Bank could pull down reported loan growth, these transactions are RoE accretive for HDFC Ltd.
- Asset quality remains the best in the sector (net NPLs of 0.1%) and insurance reforms can drive value unlocking for the stock.

Reliance Industries

- As the largest constituent of all benchmark indices, Reliance is geared into a broad market rally. With the stock still U-WT across foreign and domestic institutional investor portfolios and with earnings growth leading overall market earnings growth, re-rationg potential is high.
- Reliance is set to report +30% EPS Cagr, on the back of ramp-up of refining and E&P projects commissioned in late FY09. Better than expected ramp-up in the new projects also holds upside to FY10 earnings (around 10pc). While this would add only marginally to valuations, it does reduce perceptions of execution risk.
- Valuation multiples in refining and petrochems have re-rated recently to midcycle levels; this can potentially add Rs300/sh to our estimates of the valuation of the refining and petrochems.
- We also expect exploration intensity to increase as well with newsflow accelerating around mid CY-2009. Success (probable in our view) could add Rs250/sh to overall SOTP.
- In an optimistic case, Reliance could thus trade at Rs2150/sh (cf. our target price of Rs1625/sh). Key risks include the court case with RNRL (where we do not expect an adverse outcome for Reliance, however) and the Section 80-IB risk (where we expect clarity to emerge soon given the political stability).

Reliance Communications

- Notwithstanding the high subscriber take-up reported in recent months, mobile major RCom's stock trades at a 47% discount to market, at 8x P/E due to concerns on execution risk, large capex commitments and balance sheet pressures.
- RCom is due to benefit from its recent GSM foray, expansion into rural India (71% population, 14% penetration) and plays into multiple investment themes.
- The company is past its peak investment as GSM network is rolled out. Foreign debt is high but repayments only start in FY11. Reduced balance sheet concern will also help RCom during the upcoming 3G auctions which will be an opportunity for RCom to augment growth.
- Improved capital market conditions will ease concerns on balance sheet gearing and support re-rating of the stock.

Sterlite

- Non-ferrous metal major Sterlite is our top pick in the Indian metals space and offers strong profit recovery in fY11 even without any improvement in commodity prices.
- We forecast 87 % EPS growth in fy11 driven by commissioning of Sterlite energy's 2400 MW power plant, expansion of HZL's zinc-lead capacity to 1.1 mn tpa and falling production costs at Vedanta Aluminium driven by captive bauxite supply.
- With a strong Congress-led government (sans association with communist parties) set to take office and pressures from the higher fiscal deficit, we see a high probability of Sterlite completing purchase of residual stakes in HZL and BALCO from the government, which could drive a re-rating of the stock.
- LME zinc prices have improved sharply in the last month and we see upside risk to our EPS estimates and target price for Sterlite. Sterlite also has a clean balance sheet with a net cash position. The ongoing fight to acquire Asarco is an overhang but we think it unlikely that Sterlite will enter into a bidding war with Grupo Mexico.

Key to CLSA investment rankings: BUY = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local market by 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).