20 August 2013 │ 18 pages

Equity Strategy (Citi)
Asia

India Equity Strategy

The Old Normal

- **The new uncertainty** — India's one near-given was falling interest rates & inflation; with RBI's currency defense, that has fallen. India is now swamped with uncertainty – monetary/currency policy, economic/investment revival, earnings, flows and elections. That is smashing the market currently, but more fundamentally it pushes out any economic/earnings/valuation based revival. We lower our Sensex target to 18,900 Dec-end (from 20,800) – a 12.5x target multiple (95-03 averages); it's the Old Normal.
- **Defenses breached** — The INR's defense hasn't worked, but it has raised & inverted the yield curve (2nd time in 10 years), eroded wealth/value (equities, now fixed income - waiting for property) and is stalling the funding market. It hurt the market (-11%$ rel. GEMs in 1m) & it might not be over yet, albeit such falls could offer some near-term bounces (rate/liquidity policy reversal, global support). Defenses down, risks up.
- **FY14's gone – it's FY15 & beyond that is the challenge** — This is the fundamental question – how hard has medium-term growth been hit? That's because there is now a corporate confidence/credit crunch, likelihood of it spilling to the consumer, challenges on reform/regulatory issues (in spite of govt.'s efforts), and tough markets are making it harder. It's going to hurt – FY14's gone, start thinking about FY15 and beyond.
- **Don't write India off; it has fixed itself before** — India has been here before and fixed itself. On macro - currency (2002), fiscal deficit (2003-08) and inflation (2001-03). And bottom-up too – asset quality (1999-07), tech bubble (2002), retail credit (2009) and most recently telecom (2012). India needs a policy/bottom-up pullback, some luck and time, and don't write it off. But currently, there's little to write home about.
- **The Old Normal (FY95-03) and … patience** — India seems set to go back to its 'old normal' (FY95-03): lower growth, higher uncertainty and yes, lower market multiples. That's where we peg our market target; 12.5x 1 Yr fwd earnings, or a Sensex target of 18,900 (+3%). In our model portfolio, we OW: Pharma, Telecom, Energy and IT services (up from Neutral); Neutral Banks (d/g from OW); UW Consumer staples, materials. India's 'New Normal' from here is very likely to be its 'Old Normal', which lasted a while.

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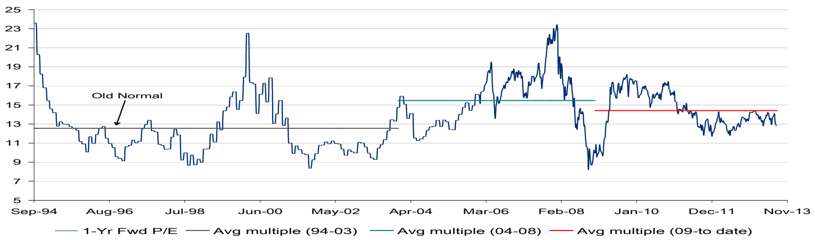
Figure 1. India's Valuations (1-Yr Fwd P/E)



Source: MSCI, Datastream and Citi Research

The Old Normal

We believe India's outlook from here – given macro, growth and market changes – will most likely resemble its longest normal growth phase (FY95-03). This was before the global emerging market boom, and also excludes the post GFC bounce. Let's just call it India's 'Old Normal'.

Figure 2. Key economic & market parameters

	FY95-03 (Old Normal)	FY04-08	FY09-13	FY14E/ FY14 YTD Avg
Avg GDP growth	6.00%	8.70%	7.20%	5.4% #
Avg IIP growth	6.30%	10.40%	4.40%	-1.00%
Avg INR depreciation (against USD)	5.00%	-3.50%	6.30%	15.2% #
Avg WPI inflation	5.90%	5.40%	7.50%	5.50%
Avg 10-yr Govt. yield	10.80%	6.90%	7.90%	7.70%
Avg household savings (as % of GDP)	18.80%	23.20%	23.70%	22.3% (FY12)
Avg equity market return	-1%	42%	10%	-2.80%
Avg Earnings growth	9.90%	27.40%	7.70%	6.4% #
Avg (1-Yr Fwd) P/E multiple	12.5	15.2	14.3	13.5
Avg loan growth	18.10%	26.70%	17.40%	14.30%
Avg deposit growth	16.90%	20.20%	16.10%	13.80%

Source: CSO, GoI, Bloomberg, MSCI, Datastream, RBI and Citi Research

* Mkt-cap/ GDP data is available from FY99 onwards; 10-yr interest rates are available from FY97 onwards; #: Full year estimate

Because there's a lot of uncertainty …

Uncertainty…. is now probably India's only certainty

Most currently, on the Currency and Rates: (a) RBI's Three Arrows to Stem Rupee Volatility and (b) Currency Crunch…Rate Punch

But also on growth: Revising Our GDP Estimate to 5.4%YoY; External Imbalances Take a Toll

The Investment cycle: (a) Revisiting India's Capital Formation and (b) New Projects Announcements – Going From Bad To Worse

Earnings: Q Preview: Oh … it's Zero

Capital flows and Ownership skews: Owning India Inc: Trouble at the Top

And off-course the elections: The Election Run

…. which is damaging financial markets

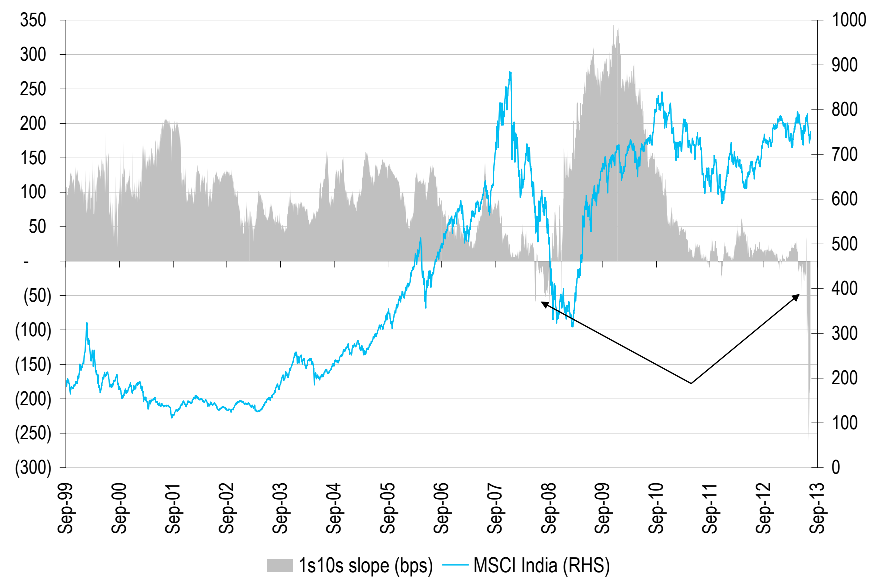
It's impacted the currency … absolutely and relatively….raising balance-sheet risks

Figure 3. Performance of INR vs. EM Fx

Source: Bloomberg and Citi Research

Inverted, and meaningfully raised, the yield curve …stalling funding markets, and marking down banks' bond books

Figure 4. MSCI India vs. Yield Curve (10yr/ 1yr yield) slope



Source: MSCI, Datastream, Bloomberg and Citi Research

And has now impacted financial returns even for the risk averse investor (in debt) – corporate and retail…and increasing risks for those hiding in Real Estate

Figure 5. Returns across asset classes

	Sensex	Govt. bonds	Gold (Rs)	Gold ($)	Real Estate
1 month	-10%	-4%	17%	6%	2%
3 months	-10%	-9%	19%	1%	3%
6 months	-7%	-4%	5%	-15%	5%
12 months	3%	3%	4%	-15%	12%
36 months	-1%	19%	67%	11%	42%

Source: Bloomberg, PropEquity and Citi Research

* Real Estate returns are average of key cities but doesn't include Mumbai; last available data point is as of May'13

All India's markets (Rates/FX/Equity) have hit lows. India has been a laggard among weak EM peers, and this has raised the risks of a market-induced spiral even from here….

Figure 6. Equity markets' performance

	India	China	Brazil	Russia	Asia ex-Japan	GEMs	DM
Local Currency terms							
1 week	-1%	4%	2%	0%	2%	2%	-1%
1 month	-6%	7%	6%	-2%	1%	2%	0%
3 months	-9%	-3%	-5%	0%	-5%	-4%	-1%
6 months	-5%	-8%	-6%	-6%	-4%	-5%	8%
12 months	5%	9%	-6%	-4%	6%	3%	20%
36 months	0%	-4%	-14%	0%	8%	5%	36%
USD terms							
1 week	-2%	4%	-2%	0%	2%	1%	-1%
1 month	-10%	7%	1%	-3%	1%	1%	1%
3 months	-19%	-3%	-18%	-3%	-7%	-8%	0%
6 months	-16%	-8%	-22%	-13%	-7%	-10%	7%
12 months	-5%	9%	-19%	-6%	5%	-2%	18%
36 months	-24%	-4%	-36%	-6%	7%	-3%	36%

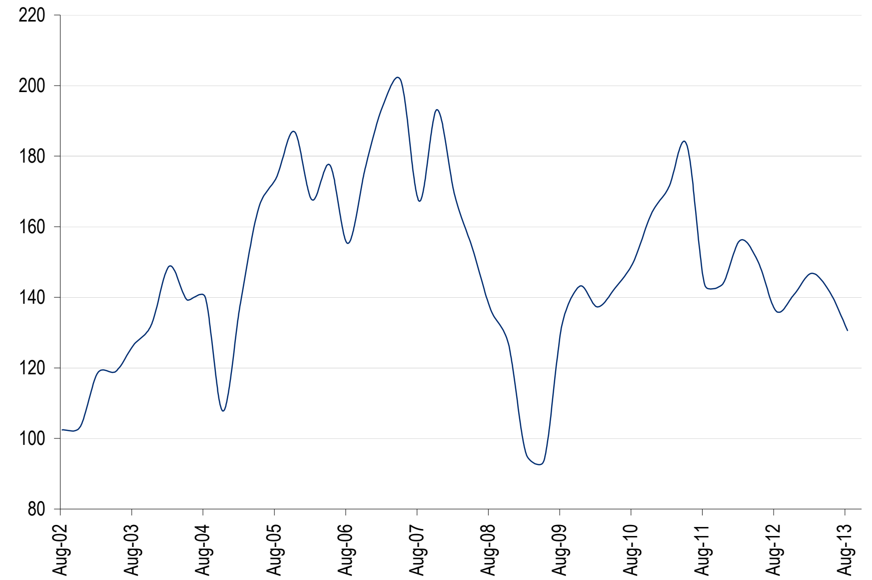
Source: MSCI, Datastream and Citi Research

Though while the mood and moves are very negative, do watch for any short-term reversals. These could be triggered by anything ranging from the market being oversold to a potential change/relaxation in the RBI's current currency defense/ rate rise/liquidity policy, and/or any global developments (most notably an easing in tapering expectations). This would however be a market – rather than an economic – event.

But the bigger question/risk is….what happens to growth in the medium term?

Given that corporate confidence, even before the recent market shenanigans, was low….recent markets could push this down materially

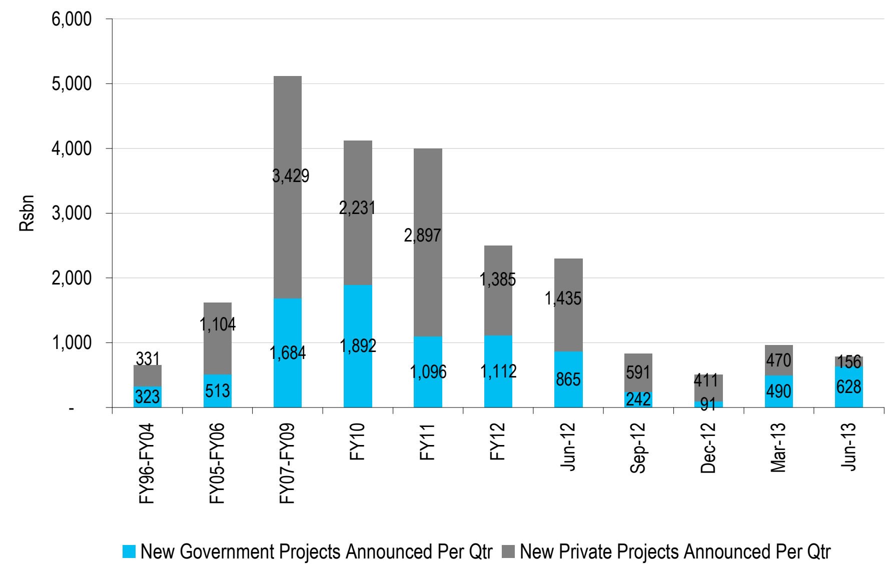
Figure 7. B&D India Business Optimism Index



Source: B&D, CEIC; * The latest available reading is as of 8th Jul 2013

The investment cycle has been weak and is vulnerable

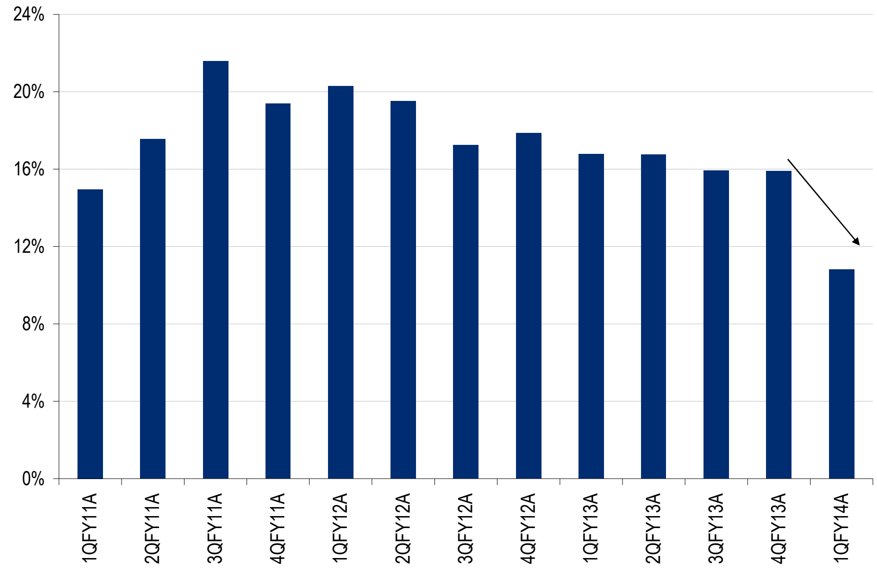
Figure 8. Trends in investment project announcements



Source: CMIE and Citi Research

The consumer – resilient so far and about the last one standing in the economy….is beginning to feel the pain…and the last month will likely add to it.

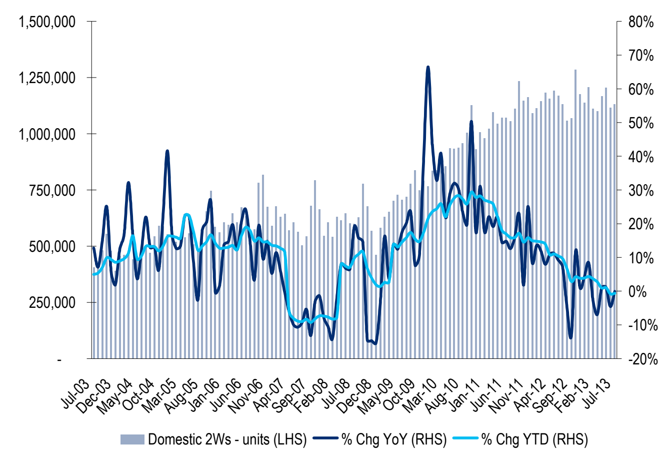
Figure 9. Trend in consumer staples top-line growth



Source: Company reports and Citi Research; includes ITC, HUL, Colgate, Dabur, Marico, Nestle India, GSK Consumer and GCPL

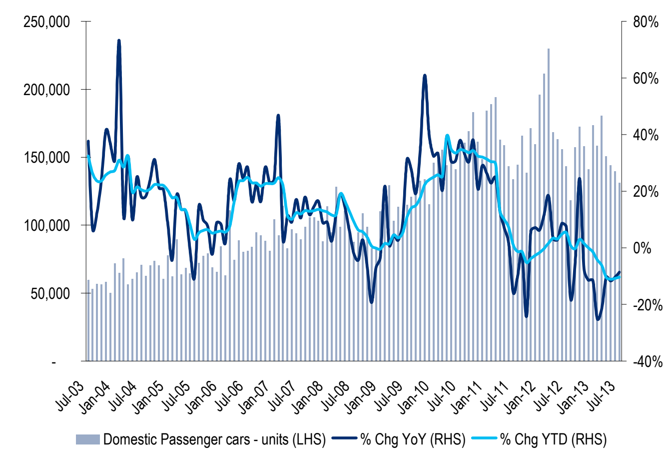
Given that discretionary spending has dropped off materially in any case

Figure 10. Domestic 2-wheelers sales trends



Source: SIAM and Citi Research

Figure 11. Domestic car sales trends

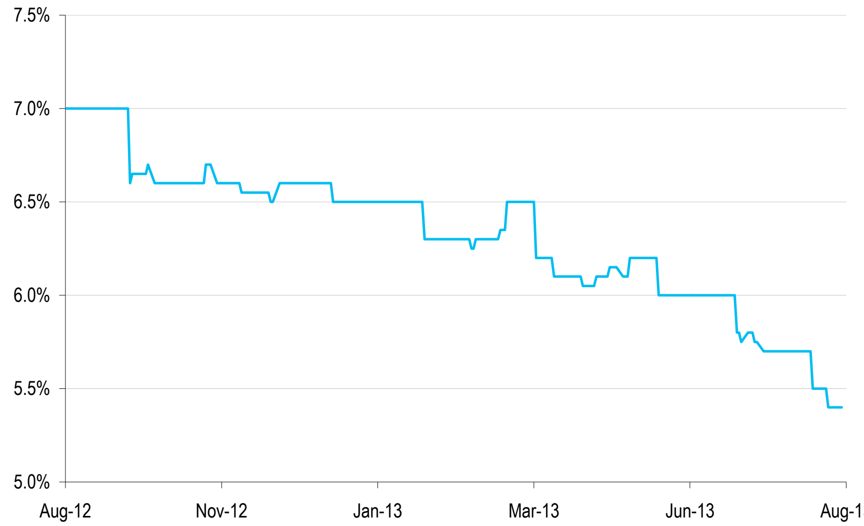


Source: SIAM and Citi Research

The market's GDP growth consensus is in the 5-5% range for FY14 and about 6% for FY15. We see little investment growth momentum possible in FY14 – although good rains will probably lend agri support for GDP. But FY15 – no one's really talking about it, but that's where higher expectations (and probably) bigger downside risks now reside.

Started at 7%...and are now down to 5.4%

Figure 12. Trend in consensus FY14 GDP growth estimates



Source: Bloomberg

Write off India? – not just yet

It has looked bad before

India has seen such market months before, and bounced back. But more important, it has been able to materially address macro-economic and business challenges, after it had been written off.

Each of the fisc/currency/inflation and interest rates have been fixed from a far worse position, before….but with a boost from a supportive global environment

This holds true for at the macro-economic levels: be it its fiscal deficit, which it reduced from 6%+ to under 3% over the 2003-08 period; inflation – which it sustainably reduced to sub 5% in the 2001-03 period; and its currency, which appreciated almost 25% (Rs49 to sub Rs40) over 2001-07. These no doubt were very strong growth years, boosted by global capital, but there was method and direction from the policy makers. Can this be done again? Hard to call, but there is government intent (an execution on fiscal consolidation in FY13, and some success on inflation), but it will need a supportive global and market environment, and a fair degree of patience.

The corporate sector has fixed itself even better….on its own, with little help from the government…..

This is even truer for the corporate sector, and we have more confidence in its ability to fix itself (from the current stretched position for some) with or without the government's help. This was very much in evidence with the IT services, which re-grouped very effectively after the 2000 technology/Y2K bust, and came out much stronger. It's the case with the recent consumer credit cycle in 2009: post aggressive restructuring, it is among the stronger and safer growth businesses currently. And of course, the Telecom sector - an outcast until the last year - is now one of the few well-placed sectors in the market (even as governmental challenges have continued), and it is one of the primary OWs in our model portfolio. We would keep an eye out for Power, Infrastructure, and Real estate!!

India's 'new normal' valuations …will likely be its old, 1995-2003, valuation averages…..which is about 12.5X Fwd P/E multiples….as you sync your growth and macro parameters with that period…you should also align the multiples

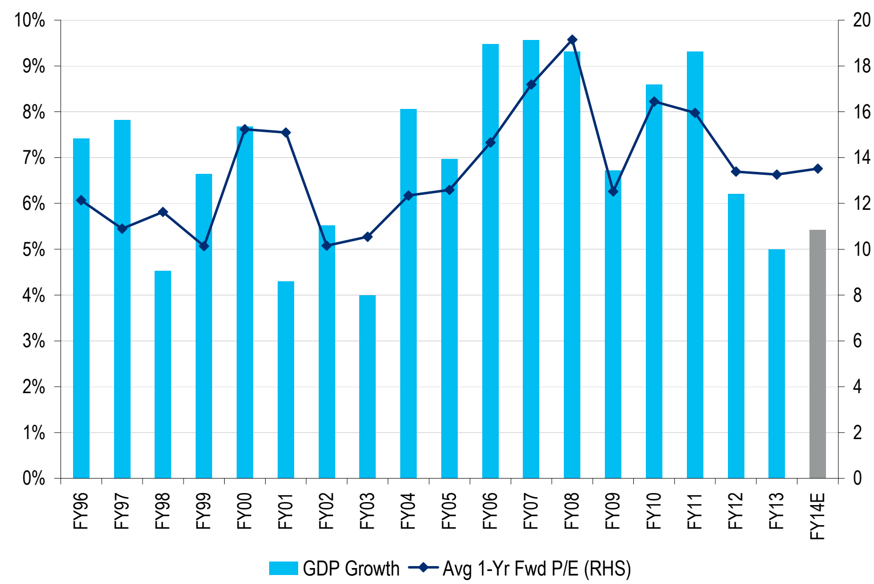
The Old Normal …. Valuations

Figure 13. Valuation (1-Yr Fwd P/E) trends for Indian equities

Source: MSCI, Datastream and Citi Research

GDP doesn't tell you everything about multiples……but it does tell you a bit

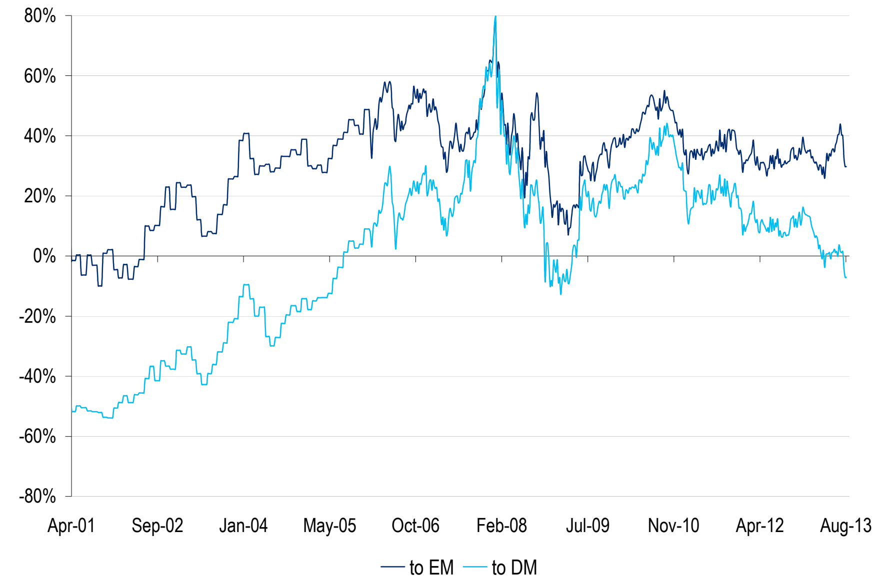
Figure 14. Valuation of Indian stocks vs. GDP growth



Source: MSCI, Datastream, CSO and Citi Research

And while India has become cheaper than DM for only the second time in a decade….that's the way it actually was in the old normal

Figure 15. India's valuations (1-yr fwd P/E) relative to global peers



Source: MSCI, Datastream and Citi Research

Financials, IT, Healthcare and staples did well over that long cycle…our preferred plays at this stage would be Healthcare, Pharma, Telecom and Energy…with Financials as a Neutral

Figure 16. Sector performances relative to the market

	Cons. Disc	Cons. Stpls	Energy	Healthcare	Industrials	IT	Materials	Telecom	Utilities	Financials
FY96-03	-13%	6%	-2%	12%	-13%	23%	-6%	-11%	-1%	33%
FY04-08	13%	-13%	16%	-19%	37%	-11%	9%	-8%	13%	10%
FY09-13	20%	9%	-13%	12%	-5%	13%	6%	-40%	-16%	5%

Source: MSCI, Datastream and Citi Research

It might look a little like chasing performance (we did have Pharma, Telecom and Energy as OWs)… and cutting losses (Banks – cutting to Neutral from OW; beaten down too much)…but given the certainty of uncertainty….we would go where demand risks are low (big UW on Staples, cut Discretional/cap goods to small UWs)…rather than where hope is high

Figure 17. Performance of MSCI India and sector indices (relative to market) in local currency

	MSCI India	Cons. Disc	Cons. Stpls	Energy	Healthcare	Industrials	IT	Materials	Telecom	Utilities	Financials
1 week	-1%	4%	0%	-2%	4%	-2%	0%	1%	2%	0%	-2%
1 month	-6%	7%	-2%	-2%	3%	-17%	16%	-5%	7%	-3%	-6%
3 months	-9%	5%	6%	2%	8%	-23%	35%	-10%	20%	-6%	-16%
6 months	-5%	3%	20%	-3%	23%	-22%	21%	-18%	31%	-9%	-14%
12 months	5%	12%	25%	-10%	22%	-34%	31%	-29%	56%	-28%	-12%
36 months	0%	50%	97%	-17%	72%	-56%	35%	-37%	-48%	-43%	-9%

Source: MSCI, Datastream and Citi Research

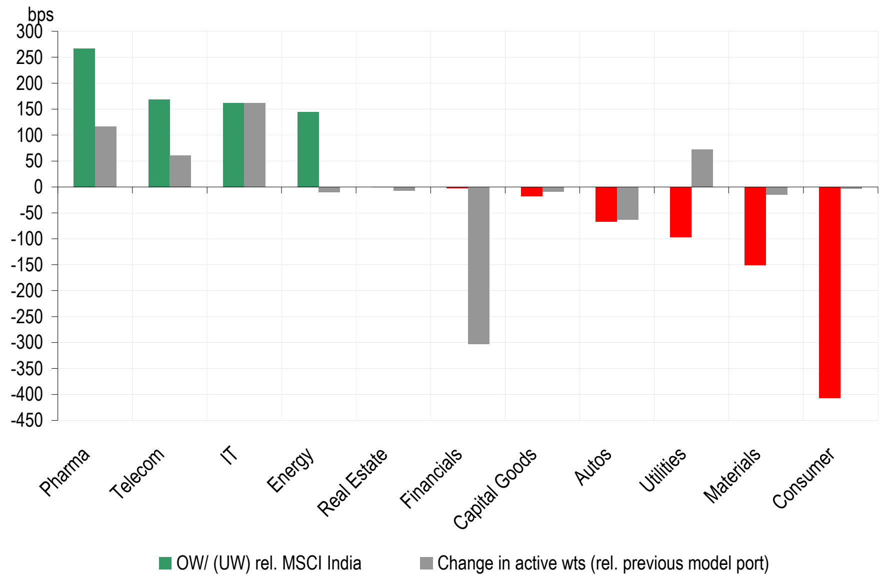
The sector skew is very tempting…but we stay middle ground…play moderately high valuations (Pharma/IT/ Telecom)….stay away from extreme (Staples) and stay neutral on the moderately cheap Financials

Figure 18. Standard deviation of sector valuations

Source: MSCI, Datastream and Citi Research

Largely raising IT to OW (from Neutral) and cutting Financials to Neutral …..Auto/Cap goods also go a little UW

Figure 19. Sector OW/ UWs in the model portfolio



Source: MSCI, Datastream and Citi Research

Figure 20. Citi India Model Portfolio

	Price 19-Aug-13 (Rs)	YTD Perf. (%)	YTD Rel. Perf. (%)	RIC	Rating	MSCI Weight (%)	Portfolio Weight	OW/ UW/Rel. MSCI (bps)	FY15 PE (x)	FY15 EPS Growth (%)	FY15 PB (x)	FY15 ROE (%)
Automobiles and Components						**5.47**	**4.80**	**-67**				
M&M	811	-14%	-7%	MAHM.BO	2		1.5	U/W	13	13%	2.4	20%
Maruti	1,309	-14%	-7%	MRTI.BO	1		1.5	O/W	11	20%	1.7	16%
Tata Motors	302	-5%	2%	TAMO.BO	1		1.8	M/W	9	8%	1.5	19%
Banks & Diversified Financials						**25.87**	**25.85**	**-2**				
AXIS Bank	987	-28%	-21%	AXBK.BO	1		2.5	O/W	6	21%	1.0	18%
IDFC	101	-42%	-35%	IDFC.BO	1		1.0	O/W	7	10%	0.9	14%
HDFC	735	-12%	-5%	HDFC.BO	2		8.8	O/W	17	18%	3.6	23%
HDFC Bank	584	-15%	-8%	HDBK.BO	2		8.0	O/W	13	25%	2.7	22%
ICICI Bank	815	-30%	-23%	ICBK.BO	1		3.0	O/W	8	19%	1.1	15%
State Bank of India	1,530	-37%	-30%	SBI.BO	1		1.0	U/W	8	15%	0.9	12%
Kotak Mahindra	620	-5%	2%	KTKM.BO	2		1.6	O/W	13	25%	2.1	17%
Industrials & Capital Goods						**3.68**	**3.50**	**-18**				
Larsen & Toubro	738	-32%	-25%	LART.BO	2		3.0	O/W	13	8%	1.9	15%
Adani Port & SEZ	132	-4%	2%	APSE.BO	1		0.5	M/W	13	19%	2.5	21%
Energy						**11.45**	**12.90**	**145**				
Reliance Industries	819	-3%	4%	RELI.BO	2		8.0	M/W	10	8%	1.1	12%
ONGC	262	-2%	4%	ONGC.BO	2		1.8	O/W	6	63%	1.2	23%
Cairn	303	-6%	1%	CAIL.BO	1		2.5	O/W	6	-10%	0.9	16%
BPCL	288	-19%	-13%	BPCL.BO	1		0.6	O/W	13	42%	1.2	10%
Consumer						**13.42**	**9.35**	**-407**				
ITC	314	9%	16%	ITC.BO	1		6.0	O/W	23	20%	8.8	40%
HLL	589	11%	18%	HLL.BO	3		2.0	U/W	33	12%	26.7	91%
Marico	211	-4%	2%	MRCO.BO	1		1.4	O/W	25	19%	4.9	21%
Materials						**6.01**	**4.50**	**-151**				
Coal India	257	-29%	-22%	COAL.BO	1		1.0	M/W	10	3%	2.7	28%
Jindal Steel & Power	219	-53%	-46%	JNSP.BO	1		1.5	O/W	5	13%	0.7	16%
Tata Steel	247	-44%	-37%	TISC.BO	1		2.0	O/W	8	39%	0.6	9%
Pharmaceuticals, Biotechnology, Agrochem						**7.33**	**10.00**	**267**				
Dr Reddy	2,141	17%	23%	REDY.BO	1		2.5	O/W	17	16%	3.3	22%
Sun Pharma	520	41%	47%	SUN.BO	1		3.0	O/W	19	19%	5.1	30%
Lupin	794	29%	36%	LUPN.BO	1		1.0	O/W	17	27%	4.3	28%
Aurobindo Pharma	184	-5%	2%	ARBN.BO	1H		1.0	O/W	7	33%	1.4	23%
IPCA	645	23%	30%	IPCA.BO	1		1.0	O/W	12	28%	3.2	29%
Glenmark	533	-1%	5%	GLEN.BO	1		1.0	O/W	14	23%	3.0	24%
Ranbaxy	381	-25%	-19%	RANB.BO	1H		0.5	O/W	15	57%	1.9	31%
Software & Services						**19.63**	**21.25**	**162**				
Infosys Technologies	3,005	30%	37%	INFY.BO	1		10.5	O/W	15	13%	3.2	23%
Tata Consultancy Services	1,778	41%	47%	TCS.BO	2		6.0	U/W	19	11%	5.4	32%
Wipro	456	31%	37%	WIPR.BO	1		1.8	M/W	14	10%	2.8	23%
HCL Technologies	929	49%	56%	HCLT.BO	1		2.5	O/W	13	14%	2.9	26%
MindTree	986	43%	49%	MINT.BO	1		0.5	O/W	10	-1%	2.1	24%
Telecom Services						**2.82**	**4.50**	**168**				
Bharti Airtel	317	-1%	6%	BRTI.BO	1		2.5	O/W	18	45%	1.9	11%
Idea Cellular	167	61%	68%	IDEA.BO	1		1.3	O/W	21	36%	3.0	15%
Bharti Infratel	149	-25%	-18%	BHRI.BO	1		0.8	U/W	19	6%	1.5	8%
Utilities						**3.72**	**2.75**	**-97**				
Tata Power	75	-32%	-26%	TTPW.BO	2		0.8	O/W	18	8%	1.4	8%
Power Grid Corp	97	-15%	-9%	PGRD.BO	1		1.0	O/W	8	13%	1.3	17%
NTPC	97	-15%	-9%	NTPC.BO	1		1.0	U/W	8	13%	1.3	17%
Real Estate						**0.61**	**0.60**	**-1**				
Phoenix Mills	227	-12%	-5%	PHOE.BO	1		0.3	O/W	10	88%	1.5	15%
Prestige Estates	119	-36%	-30%	PREG.BO	1		0.3	O/W	9	22%	1.2	14%
Total						**100.0**	**100.0**					

Source: MSCI, Datastream and Citi Research estimates

For those of us who have sat through the ‘Old Normal’, it probably wasn’t as testing a time as it appears right now…but it clearly did call for a lot of patience.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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