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MARKET VIEW:

Indian markets continue to lack direction as domestic cues are mixed and overhang of Europe continues to impact investor sentiments worldwide.

While inflation numbers are looking much better with the latest weekly food inflation figure even coming negative, biggest concern continues to be the 2 deficits – current account deficit and budgetary deficit. With an uncertain global environment leading to risk averseness in investors, its increasingly difficult for a country like India to cover its current account deficit with capital flows.

A high budget deficit and increased government borrowing is likely to crowd out private investments and keep interest rates high. With investments already at historic lows as seen from IIP data for core sectors, its likely to prolong the investments down cycle.

Its quite likely that RBI may start reducing interest rates and that will give some respite and hope to the markets.

However, we think FII flows are still a few quarters away.

For investors, its important to enter market cautiously and a good strategy will be to gain from potential dips in the market in the first half of this calendar year. We expect FIIs flows to start coming in about 2 quarters from now. However, as markets are leading indicator of change in economy, it may happen sooner as well.

Few sectors like FMCG, Pharma and IT seem to have been overbought and there is an opportunity now to exit some of the fully valued scrips and diversify more into banking and gas companies where valuations are more compelling.

Globally, how bond auctions by countries in Europe perform will determine much of market sentiments in Jan-Mar quarter. Hence, events in Europe will continue to overshadow domestic events as we move forward.

- Rajnish Kumar



SECTOR SNAPSHOT

Sector	View	Top Picks
BFSI	Neutral	ICICI Bank, Indus Ind, BOB, PNB
Healthcare	Neutral	Lupin, Dr. Reddy's, Opto Circuit, Cipla and Glenmark
Power	Underweight	NTPC, Tata Power
Infrastructure	Overweight	IL&FS Trans, IRB Infra, Sadbhav Engineering
Oil & Gas	Neutral	RIL, ONGC
Cement	Neutral	Ambuja Cement, Ultratech Cement
Metals	Neutral	Tata Steel, Hindalco, Sterlite
IT	Neutral	Infosys
Auto	Neutral	Bajaj Auto, M&M, Tata Motors



BFSI – NEUTRAL

We expect focus in banking to remain on loan restructuring in the near future. Both NPLs and margins are likely to remain stable for Q3FY12. Loan growth is likely to moderate.

Private banks should see a healthy double digit growth in earnings YoY while PSU banks are likely to see low growth or marginally negative growth YoY in Q3FY12. NIM is expected to show a growth of 10-15% with PSU banks at high single digit growth. Non-interest income is likely to show a dip due to drop in fee based income.

Margins are likely to remain stable for banks as liquidity has been poor and banks have found the environment favorable for holding on to pricing.

Going forward drop in yield curve should give opportunities to banks to show treasury gains. While drop in sales of 3rd party distribution products will result in pressure on fee income lines. This is likely to keep performance subdued.

Expect credit growth to moderate resulting in slower growth YoY in top line for banks.

Overall, in spite of recent upward run in prices, sector looks attractively priced.

Top Picks – ICICI Bank, Indus Ind, BOB, PNB



HEALTHCARE – NEUTRAL

Major blockbuster drugs like Lipitor, Caduet and Zyprexa will go off-patent in Q3FY12 thus opening up huge opportunity for Indian generic players. Further, we estimate patent opportunity worth USD55bn to arise over the next 18 months that will drive the top-line and bottom-line growth of key players. Going forward, we expect strong recovery in the domestic market and firm sales in US generics to boost revenue growth.

Rupee has depreciated ~20% against USD and ~10% against Euro. Given that they are net exporters, rupee depreciation is a positive for domestic pharma companies. The extent of impact varies though on aspects such as net forex exposure, forward cover taken, operating leverage, near-term debt repayment and interest liabilities in forex. Timing of gain or loss realization will depend on the extent of forex hedging (forward cover) done by companies. Most companies, have hedges for next 3-4 quarters at an average rate of INR47-48.

While the pharma sector has outperformed the broader market in the past three months, valuations have come off the peak. We thus continue to prefer a stock specific approach than remaining overweight on the sector as a whole. Historically during any bear phase and/or consolidation period, pharma has relatively outperformed the market largely due to the sector's defensive nature. However, during a bull run, pharma relatively underperforms the index. Currently, the one-year forward multiple for pharma is trading at 23% premium to Sensex which is higher than the historical range of 10-15%. We believe that multiples could sustain at the current level with a further consolidation in the market, though in the course of a market turnaround, the pharma universe could relatively underperform. We thus remain cautious and prefer a more stock specific approach.

Top Picks – Lupin, Dr. Reddy's, Opto Circuit, Cipla and Glenmark



POWER - UNDERWEIGHT

The Power sector is currently facing two key issues:

Availability of coal:

The domestic availability of coal is unlikely to improve in the near term as India's largest producer Coal India has forecasted a flattish output growth for the current fiscal year.

Deteriorating health of State Electricity Board (SEB):

The SEBs of five key states viz. UP, Rajasthan, Haryana, MP and Tamil Nadu forms about 70% of USD 15bn loss. This loss is mainly due to provisioning of highly subsidized power to agriculture. Over the next few quarters, SEBs situation is expected to improve gradually as they are increasing the customer level tariff while power purchase cost remains lower (under Power Purchase Agreement).

Outlook:

The combined effects of coal shortage and low PPA tariff have put the viability of upcoming private power projects under doldrums. Most of the power generation companies have now requested tariff hikes. We do not see any immediate action on that front. Few quarters down the line, as SEBs financial health stabilizes we would see government increasing PPA tariff thus benefitting private power generation companies.

Valuation:

Most of the power generation companies are trading near the replacement cost indicating limited downside. We recommend stocks that possess coal linkages and have low fuel price volatility.

Top Picks – NTPC, Tata Power

INFRASTRUCTURE – OVERWEIGHT

Easing macro-headwinds: Interest rates have reached a 13 month high and we believe that it has reached peak levels. With GDP growth rates easing to below 7% levels and inflation showing signs of moderation, we believe that it is likely that the RBI will begin to loosen its monetary policy and cut interest rates in the near term. The lower interest rates will make funding of working capital requirements less costly thereby easing balance sheets of construction companies. Additionally, the budget expected in coming fiscal is likely to see increased thrust on infrastructure development, making infra companies the primary beneficiaries.

Competition in bidding process: The infrastructure sector has been seeing some easing of competition in the bidding process for recent road projects from the National Highways Authority of India (NHAI). Firstly, there have been relatively fewer bidders vying for projects and secondly, the spread between the bids of L1 and L2 bids have reduced visibly. However, it has to be noted that while the same is true, bids from construction companies have picked up in the sense that the NHAI has received more bids with premiums than bids where it has to provide grants.

Awarding target for NHAI is achievable: The NHAI has awarded ~60% of its target of 7,300km for the year. This leads us to believe that it is possible for the organization to meet its target by the end of FY12. With the aim to achieve its target for the year, along with plans to award 3000kms-4000kms of projects a year through the EPC route over next two years, the NHAI is likely to pick up its awarding of projects, which would augur well for infra stock order books and provide revenue visibility.

Project execution: With the pickup in pace of road project awarding, we expect that road construction and project execution will also pick up, in order to clear out order backlogs. This, in turn, will quicken the pace of revenue recognition for construction companies. Finally, the implementation of the Land Acquisition Bill will ensure smoother acquisition of land by the NHAI, easing a major hurdle for the road sector.

Outlook: Due to the absence of projects in other sectors we believe that stocks that have a strong presence in the road sector are likely to outperform. Our top picks in the sector include IL&FS Transportation Network due to its strong performance in the sector, diversified portfolio and strong parentage. As competition eases the company stands a good chance to bag a few orders in the coming months, helped by its cautious bidding strategy. Sadbhav Engineering has a similar strategy along with which, it has superior execution capabilities and working capital efficiency. Finally, we like IRB infra for its large portfolio, robust financials and strong experience in toll-based projects.

Top Picks – IL&FS Transportation Network, IRB Infra, Sadbhav Engineering



OIL & GAS SECTOR – NEUTRAL

Crude prices have corrected sharply over last few weeks and this will reduce subsidy on petroleum products in India. Every dollar of drop in crude oil price reduces India's import bill by 700 million USD. Sustained drop in crude prices should also have a positive impact on inflation as oil marketing companies should be able to revise price downwards. Good for both Upstream and downstream companies.

Oil Marketing Companies likely to improve bottom lines:

While the recent price hikes gave some relief to the bottom lines of Oil Marketing companies, sharp reduction in crude prices brings more cheers for them. Subsidy burden for OMCs have come down and with lower crude prices the impact of subsidies will be even lesser. At some point, they will be under pressure to pass on the benefit of reducing prices to the customer but expect the govt to delay price reduction to the extent possible and to minimize price reduction to reduce its own burden. Overall this should be good for OMC's finances. Coupled with this is the recommendation from a committee headed by Nandan Nilekani to do direct transfer of subsidies on LPG cylinders and kero to households. This will give govt the flexibility to price these products as per market forces and in the process reduce overall subsidy.

RIL, KG D-6 mixed news, scrip attractively priced:

CAG audit on RIL's KG D-6 gas fields costs and area seems to be moving in the negative direction for RIL. CAG does not seem convinced by both petroleum regulator and RIL's responses to its queries. This continues to cast a shadow on RIL.

Approval from GOI for RIL-BP deal was positive and will allow the deal to be quickly concluded now. It will give hope to RIL investors of getting a resolution to low productivity issues in KG-D6.

At current price we feel RIL is fully discounted for KG D-6 value, valuing its upstream business at virtually nil. Considering that BP is paying 7 billion USD for 30% of the KG D-6 stake, RIL is highly underpriced. We currently have a Buy rating on RIL.

ONGC likely to perform better going forward:

ONGC's profitability came lower than estimates in Q1FY12 and net realization per barrel of crude at US\$48.8 was below street estimates of US\$50. However, going forward subsidy burden for ONGC is likely to reduce with lower crude prices. This should improve its net realizations going forward. We see significant upside in the stock from here.

Top Picks – RIL, ONGC



CEMENT - NEUTRAL

Demand scenario improving:

The upcoming elections in some large states has in the past lead to ruling parties picking up their infrastructure building activities to meet prior commitments. Elections in several large cement consuming states which are due soon, including Maharashtra, Rajasthan, UP, Gujarat etc, are likely to boost cement consumption. Additionally, the Government has boosted its overall thrust on infrastructure development, especially in road projects. The Twelfth Five Year Plan assumes ~10% of GDP to be spent on infrastructure each year. In the past the ratio of cement demand growth to GDP growth has been in the ratio of 1.2x. Moreover, increased disposable income in rural areas has consequently led to robust rural demand.

Cement dispatches:

The initial set of December 2011 dispatch numbers were better than expected with 13% growth YoY and 10% MoM. Dispatches totaled ~20mnte, which proved to be the second highest monthly dispatch since the 21mnte of March 2011. Mass housing schemes in Gujarat will lead to strong demand in the West while rural demand is expected to boost demand from the North. Central and Eastern regions have also posted decent numbers. A decline in the demand in the South as seen in the past seems to have come to an end as demand has seen a pick up in the region, auguring well for South-based companies.

Raw material costs to rise:

In a recent announcement, Coal India stated that it planned to implement a new pricing strategy which would increase the cost of coal for cement companies. Additionally, the Maharashtra government has hiked electricity duty from 40paise to 150paise per unit on captive power plants. Therefore the advantage enjoyed by companies with captive power plants is likely to be negated.

Capacity addition to slowdown:

Capacity utilization has been in the sub-74% range and is expected to bottom out at these levels as cement companies slow down their capacity additions. Previously seen slowdown in demand, delay in existing expansion plans, and tight liquidity are the key reasons for easing expansion of capacity. Any expansion plans implemented now will be operational only in FY15. Pan-India utilization is expected to improve to 77-78% in FY13 and ~80% in FY14.

Pricing to rise:

Except for the south, cement prices have seen a drastic fall over the last few months due to a slowdown in construction activity and steady monsoons. With the gradual improvement in capacity utilization, we expect cement prices to rise significantly by FY14 due to capacity utilization of 80% and above. However, since the South is expected to have below 70% capacity utilization over the same period, pricing discipline will have to be maintained here. In addition, a boost in demand is also likely to give cement companies pricing power. Finally, prices will also rise as cement companies pass on costs to consumers and as construction activity picks up in the fourth quarter.

Outlook:

Most cement companies are trading at or below their replacement costs and are therefore trading at attractive valuations. With improvement in capacity utilization and pricing power we expect cement companies do well in the FY11-FY14 period.

Top Picks – Ambuja Cement, Ultratech Cement



METALS - NEUTRAL

Slowing signs witnessed in the two main emerging economies of the world, India & China, has led to slump in demand for metals. Companies, which borrowed funds to raise capacities, are witnessing high interest outgoings. We expect q-o-q and y-o-y decline in earnings for the Indian metal companies driven primarily by decline in metal prices (11-19% q-o-q decline in US\$ terms) and mark-to-market losses on unhedged Fx loans.

With improved domestic supplies (hike in export duty to 30%) and declining international prices (increase in global supplies) iron ore prices are expected to ease. On the contrary, thermal coal prices are expected to remain firm as delays in new mine supplies will continue to widen coal deficit in India. With Coal India continuing to reduce coal supplies (priced at subsidized rates) to steel producers, we believe companies with captive coal mine (operational) are better placed than the ones with operating iron ore mines.

We believe metals as a sector, ferrous as well as non-ferrous, continues to witness earnings risk due to uncertain demand outlook. Given weak market conditions we believe companies with stronger balance sheet will be better placed to face the current downtrend without impacting their credit risk.

Metal stocks declined by 40-55% in 2011 and are trading between 0.5-1X book and 5-7X EBITDA. With limited downside in select commodities such as aluminium and zinc from here and attractive valuations, we recommend buying into select names.

Top Picks – Tata Steel, Hindalco, Sterlite



IT – UNDERWEIGHT

While IT has benefitted from about 20% depreciation in rupee in the recent past, it's unlikely to lead to higher volumes. Volume upside is limited as there is not much that can be snatched away from competition due to pricing advantage.

We also expect some of the gain in margin due to currency depreciation to be passed on as discount to target higher volumes. Hence this will limit the benefit of currency gains. Tier-2 vendors are likely to pass on margins more than tier-1 vendors.

There is a risk of IT spending growth slowing down, which can push down revenue growth for IT companies. While currency depreciation remains a cushion for IT industry, combination of currency gain being passed on as discounts and slowing IT dollar spends may put at risk revenue and earnings growth projections.

Most of IT companies currently seem fully valued with limited upside from here.

Top Picks – Infosys

AUTO – NEUTRAL

Four Wheelers

Sales growth strong: Sales figures have been mildly disappointing adding to the general sense of morose in the economy. Passenger vehicles sales continue to witness clear signs of slowdown on account of macroeconomic headwinds in the form of high interest rates and more importantly the disparity between petrol and diesel. However, the impact of headwinds is now being visible via the slowdown of growth in UVs, LCVs, and two-wheelers as well. While in the short run, we expect some hiccups in sales volume, the long term outlook for the industry continues to remain robust with strong economic growth, growing exports and new launches giving a much needed boost.

Tractor segment: Tractor sales growth continues to be strong due to higher rural incomes and increased use of tractors for non-agricultural uses. Rising farm produce prices and increasing cash flows has reduced the dependence of farmers on financing rates. This has made tractor sales more immune to the interest rate cycles. We remain positive on tractor sales growth going forward but expect some moderation in coming quarters.

Improvement in EBITDA margins expected: Increasing competition in the industry is likely to restrict pricing power of auto companies, but any loss on account of this is expected to be offset in part by easing commodity prices. We expect the second half of the fiscal to witness stronger EBITDA margins as raw material costs moderate. Adding to bottomlines of auto stocks will also be measures taken by auto companies to restrict costs, improve product mixes and boost productivity.

Easing macro headwinds: GDP in the September quarter grew at 6.9%, the slowest pace in more than two years. A slowdown in the economy, as seen in this data point, along with easing inflationary levels, leads us to believe that the RBI will put a stop to its interest rate tightening cycle. Additionally, recent food inflation data showed negative growth at -3.36%, leading the central bank to hint at a possible rate cut. Passenger vehicles and M&HCVs are likely to benefit most from this move as they are heavily reliant on financing rates. Rising competition and easing commodity prices will also moderate the cost of ownership of these vehicles, therefore driving demand. A drawback, however, will be an increase in excise duty and the add-on levy of excise duty on diesel vehicles which could dampen demand in the short term.

Two Wheelers

2 Wheeler sales to moderate: Sales in the two-wheeler segment continue to be robust due to their affordability and rising disposable incomes which has led to growing demand. While the segment has been seeing over 25% volume CAGR in the past two years, we believe that FY12 will see some moderation to lower double digits in the range of 10-12%.

Export markets: Indian players have been growing their presence in export markets over the past couple of years. We believe that this trend will continue going forward with the addition of new export markets and increasing market share in the current ones. Bajaj Auto, having had exposure to these markets for a longer time will be the primary beneficiary of any growth in export markets, going forward. Hero Motocorp, a new player in these markets, will see minimal growth in the near term.

Increasing competition: With the advent of Honda into the Indian markets, we believe that Hero Motocorp will be faced with increasing competition in the <125cc segment. Honda is expected to enter the Indian markets via this segment, and given its strong global brand, we expect that it will eat into Hero's market share. On the other hand, Bajaj Auto which plays in the higher end of the motorcycle segment will continue to be safe.

Outlook:

Apart from Tata Motors and Maruti, auto stocks have displayed strong performance in the past few months. We believe that in the near future, with easing of headwinds like interest rates and commodity prices, CVs and passenger vehicles will be key beneficiaries. However, we prefer Tata Motors over Maruti due to its more diversified business models. M&M is also a favourite due to its presence in the tractor market, making it a strong rural demand play. Finally, in the two-wheeler segment, we feel Bajaj Auto is a safer bet due to its limited vulnerability to competition, higher exposure to export markets and relatively more attractive valuation.

Top Picks – Bajaj Auto, M&M, Tata Motors



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