India Market Strategy

STRATEGY

A long winter before the spring

Figure 1: Sell stocks with high multiples and volume risk, e.g. cement

Source: Company data, Credit Suisse estimates

- **12-15 months of growth disruption.** We expect the market to overlook significant but short-term growth disruption from demonetisation for most sectors. However, asset quality impact on Microfinance/Non-Banking Financiers could last longer. Further, it may take many years for currency in the black market to replenish, hurting real-estate (RE)/land transaction volumes and hence prices. Worst affected: NBFCs (LAP/RE), 80% of construction jobs, 60% of cement demand, and discretionary consumption. GST start from 1-April also likely to disrupt the economy for 9-12 months.

- **Rising global bond yields to pressure P/E multiples.** P/E multiples have risen steadily across sectors in India for the last five years, in line with a global re-rating of equities. A steady decline in bond yields driven by easy monetary policy in developed markets helped. With yields now rising, exacerbated by the Trump victory, sectors that saw the strongest re-rating could come under stress: cement, consumer discretionary and NBFCs.

- **Near-term pain to override long-term gains.** There are several long-term gains to look forward to: GST/demonetisation over time should take India out of the low productivity equilibrium of low taxes/small government. Interest rates should fall and a decline in real-estate and land prices could stimulate more activity over time. But markets may focus on volume disappointments for expensive stocks first. On these counts, we downgrade cement (Ultra Tech, Ambuja) and discretionary (Asian Paints, Eicher) to UNDERPERFORM (and Kajaria to NEUTRAL), and maintain UNDERPERFORM on Bajaj Finance and Bharat Financial Inclusion. We revert to an OVERWEIGHT on Indian IT (HCL Tech, Tech Mahindra) and Pharma (Cipla) and Tata Motors. We also believe better liquidity, lower interest rates and higher metal prices should reduce pressure on private sector banks (OUTPERFORM: HDFC Bank, ICICI Bank) and benefit mortgage providers (LIC Housing Finance, HDFC).

Please contact your Sales person to access the supplemental analysis behind this report.

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Focus charts

Figure 2: Sector/market P/E up over 1, 3 and 5 years

- PSU Bank
- Industrials
- Cement
- Metals
- Cons. Dis.
- BSE100
- Telecom
- NBFC
- Staples
- Health Care
- Ptv Bank
- Energy
- Utilities
- IT

Change in 12M Forward PE

Source: RAVE, IBES, Credit Suisse estimates

Figure 3: ...but rising bond yields may reverse this

High diff => Indian equities undervalued
Low diff => Indian equities overvalued

Financial crisis
9/11; Dot-com aftermath
Decelerating growth for India

Source: MSCI, Bloomberg, Credit Suisse estimates

Figure 4: 85% of the currency demonetised

Split of Rs 16.6tn Currency in Circulation by Value in FY16

Source: RBI, Credit Suisse

Figure 5: India has very high cash usage

Source: tradingeconomics.com, Credit Suisse estimates

Figure 6: Real-estate large part of black wealth

Residential real estate
Land and buildings
Precious Metals
Diamonds, Gems
Benami fin. investments
Stocks in business
Assets in business
Foreign holdings
Cash

Mean Difference

Source: NIFM, Credit Suisse estimates

Figure 7: Which is 90%-plus of household wealth

Split of Assets (2013)

Source: NSSO, Credit Suisse estimates

Figure 8: Real-estate is 60% of cement demand

Source: RAVE, IBES, Credit Suisse estimates

Figure 9: GST to disrupt too, e.g. state finances

Source: CMIE, Credit Suisse estimates
A long winter before the spring

A local growth disruption for 12-15 months

We expect the market to overlook near-term disruption in growth from demonetisation for most sectors. However, for some Microfinance/Non-Banking Financiers, where borrowers have thin buffers, it could take longer, exacerbated by lax lending standards of late. Permanent demand destruction would come from the black wealth kept in currency that will not be replaced: this could be 2% of GDP. Further, it may take several years for currency to normalise in the "black" economy. This would slow down transactions, and hurt prices of real-estate and land. Worst affected from this trend: banks with exposure to real-estate developers, NBFCs with Loan against Property books, construction jobs (80% are in real-estate), cement (60% of demand), and discretionary consumption (90%-plus of household wealth in land and real-estate).

Like demonetisation, GST is also a medium-term positive step that can disrupt the economy over the near term, possibly for 9-12 months. Malaysia, a much smaller economy took 3-6 months to stabilise despite there being just one rate, no centre-state complexity, two years of advance notice, and no organisational change in the government. The Indian experience may be more chaotic—it is worse on every metric.

Policymakers would respond to such a slowdown. We believe the widely held notion of RBI transferring gains from cancelled currency to the government as a dividend and thus provide a fiscal boost is less likely. The problem also is the government's lack of institutional capacity to spend, and the time lag for the impact to show up.

P/E ratios to fall with rising bond yields

P/E multiples have risen steadily across sectors in India for the last five years. This was a global phenomenon as India’s P/E premium to various benchmarks has not changed. A primary driver of this global expansion in equity multiples has been a steady decline in bond yields driven by easy monetary policy in developed markets. Indian equities have no capital account restrictions—pricing is thus affected by global trends.

However, bond yields are now rising, reasons being: US wage growth, rebounding commodity prices, positive Chinese PPI inflation, and expectation of policy stimulus moving from monetary (more demand for bonds) to fiscal (more supply of bonds). Trump's victory has sharpened the rise. Some sectors that benefitted more from the P/E expansion could correct: cement, consumer discretionary and NBFCs. These had gained from medium-term growth outlook for India, but also as multiples rose for these sectors globally.

Near-term pain to override long-term gains

Both demonetisation and GST are structural positives that over time should take India out of the low productivity equilibrium of low taxes/small government. Further, the deflationary impact of a growth slowdown should help bring down rates in the formal economy, and a decline in real-estate and land prices could stimulate more activity over time. However, these positives would take time to show up. Given the concurrent de-rating due to rising global bond yields, we believe investors would wait for evidence of the positives to come through before turning constructive on the broader markets: 12-15 months can test investor patience. We nevertheless reflect medium-term views in the choice of stocks to take profits on: there was trouble at the bottom even before these disruptions.

We downgrade cement (ULTC, AMBJ) and discretionary (APNT, EICH) to UNDERPERFORM (and KAJA to NEUTRAL) as growth may disappoint, and valuation is at 10 year highs. Maintain UNDERPERFORM on BFIN, BHAFIN. We revert to Overweight on Indian IT (HCLT, TECHM), Pharma (CIPLA) and TAMO. We believe better liquidity, lower rates and higher metal prices should reduce pressure on private banks (buy HDFCB, ICICI) and benefit mortgage providers (LICHF).
Financial summary

Figure 10: Indian GST implementation to be significantly more complex than Malaysia’s

<table>
<thead>
<tr>
<th>Variable</th>
<th>Malaysia</th>
<th>India</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (mn, 2016)</td>
<td>32</td>
<td>1,310</td>
<td>India’s population is 40x Malaysia’s, making supervision complex, and slow response times.</td>
</tr>
<tr>
<td>PPP adjusted per capita GDP (US$, 2016)</td>
<td>27,234</td>
<td>6,658</td>
<td>Malaysia is nearly two decades ahead of India in PPP adjusted per-capita GDP, indicating better organised systems, and greater government capacity.</td>
</tr>
<tr>
<td>WB ease of doing business (paying tax rank)</td>
<td>61</td>
<td>172</td>
<td>India brings up the rear on ease of paying taxes: this worsens the impact of this transition.</td>
</tr>
<tr>
<td>Number of rates (excluding exempt and 0%)</td>
<td>1</td>
<td>4</td>
<td>Number of rates to map to increases subjectivity in assessments, raising possibility of confusion among tax payers and supervisors, and increasing friction in the transition.</td>
</tr>
<tr>
<td>Tax subsumed (% of GDP)</td>
<td>9%</td>
<td>6%</td>
<td>Malaysia started with a US$20 bn estimate for the GST, but ended the first year with US$28 bn. It is quite possible that once the system stabilises India too would see a higher tax-to-GDP ratio.</td>
</tr>
<tr>
<td>Federal/Unitary</td>
<td>Only Centre</td>
<td>Centre + State</td>
<td>Malaysian GST was only central. As India has a central as well as state GST, there is likely to be additional complexity around the inter-state transactions as well as different levels of preparedness and sophistication across states, and impact on state fiscal capacity.</td>
</tr>
<tr>
<td>Announcement</td>
<td>2 Years back</td>
<td>3 months back</td>
<td>In Malaysia businesses had two years to prepare for the GST transition, even though rates were announced on the last day. In India there is barely any time to prepare.</td>
</tr>
<tr>
<td>Change to enforcing department(s)</td>
<td>None</td>
<td>Overhauled</td>
<td>Both central and state bureaucracies overseeing the new tax would change. Further, there would be a re-mapping of enterprises to the tax officials that they need to deal with.</td>
</tr>
</tbody>
</table>

Source: IMF, World Bank, Credit Suisse estimates

Figure 11: Changes to Model Portfolio

<table>
<thead>
<tr>
<th>Company</th>
<th>RIC</th>
<th>Rating</th>
<th>Mkt Cap $bn</th>
<th>CMP INR</th>
<th>FY16A Target Price INR</th>
<th>FY17E Target Price INR</th>
<th>P/E(x) FY16A</th>
<th>P/E(x) FY17E</th>
<th>P/E(x) FY18E</th>
<th>EPS Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negatively Affected Stocks/Stocks whose weights are cut in model portfolio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ultratech Cement Ltd</td>
<td>ULTC.BO</td>
<td>UNDERPERFORM</td>
<td>15</td>
<td>3,635</td>
<td>2,900</td>
<td>-20%</td>
<td>44</td>
<td>33</td>
<td>29</td>
<td>9%</td>
</tr>
<tr>
<td>Ambuja Cements Ltd</td>
<td>ABUJ.BO</td>
<td>UNDERPERFORM</td>
<td>6</td>
<td>219</td>
<td>180</td>
<td>-18%</td>
<td>42</td>
<td>31</td>
<td>25</td>
<td>-46%</td>
</tr>
<tr>
<td>Asian Paints</td>
<td>ASPN.BO</td>
<td>UNDERPERFORM</td>
<td>14</td>
<td>964</td>
<td>800</td>
<td>-17%</td>
<td>52</td>
<td>47</td>
<td>42</td>
<td>25%</td>
</tr>
<tr>
<td>Eicher Motors</td>
<td>EICH.BO</td>
<td>UNDERPERFORM</td>
<td>9</td>
<td>21,745</td>
<td>18,300</td>
<td>-16%</td>
<td>46</td>
<td>34</td>
<td>27</td>
<td>107%</td>
</tr>
<tr>
<td>Maruti Suzuki India Ltd</td>
<td>MRTL.BO</td>
<td>NEUTRAL</td>
<td>23</td>
<td>5,136</td>
<td>6,000</td>
<td>17%</td>
<td>34</td>
<td>22</td>
<td>19</td>
<td>23%</td>
</tr>
<tr>
<td>Bajaj Finance Ltd</td>
<td>BJFN.BO</td>
<td>UNDERPERFORM</td>
<td>7</td>
<td>858</td>
<td>660</td>
<td>-23%</td>
<td>36</td>
<td>25</td>
<td>20</td>
<td>33%</td>
</tr>
<tr>
<td>Bharat Financial Inclusion</td>
<td>BHAF.BO</td>
<td>UNDERPERFORM</td>
<td>1</td>
<td>691</td>
<td>710</td>
<td>3%</td>
<td>29</td>
<td>13</td>
<td>11</td>
<td>60%</td>
</tr>
<tr>
<td>Kajaria Ceramics Limited</td>
<td>KAJR.BO</td>
<td>NEUTRAL</td>
<td>1</td>
<td>504</td>
<td>525</td>
<td>4%</td>
<td>35</td>
<td>31</td>
<td>27</td>
<td>25%</td>
</tr>
</tbody>
</table>

Positively Affected Stocks/Stocks whose weights are increased in model portfolio

<table>
<thead>
<tr>
<th>Company</th>
<th>RIC</th>
<th>Rating</th>
<th>Mkt Cap $bn</th>
<th>CMP INR</th>
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<th>P/E(x) FY17E</th>
<th>P/E(x) FY18E</th>
<th>EPS Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>HDFC Bank</td>
<td>HDBK.BO</td>
<td>OUTPERFORM</td>
<td>48</td>
<td>1,276</td>
<td>1,470</td>
<td>15%</td>
<td>26</td>
<td>22</td>
<td>18</td>
<td>15%</td>
</tr>
<tr>
<td>ICICI Bank</td>
<td>ICBK.BO</td>
<td>OUTPERFORM</td>
<td>24</td>
<td>277</td>
<td>328</td>
<td>18%</td>
<td>17</td>
<td>15</td>
<td>13</td>
<td>-15%</td>
</tr>
<tr>
<td>Tata Motors Ltd.</td>
<td>TAMO.BO</td>
<td>OUTPERFORM</td>
<td>22</td>
<td>507</td>
<td>720</td>
<td>42%</td>
<td>16</td>
<td>10</td>
<td>8</td>
<td>-25%</td>
</tr>
<tr>
<td>HCL Technologies</td>
<td>HCLT.BO</td>
<td>OUTPERFORM</td>
<td>16</td>
<td>764</td>
<td>975</td>
<td>28%</td>
<td>19</td>
<td>13</td>
<td>12</td>
<td>-23%</td>
</tr>
<tr>
<td>Tech Mahindra Limited</td>
<td>TEML.BO</td>
<td>OUTPERFORM</td>
<td>6</td>
<td>430</td>
<td>575</td>
<td>34%</td>
<td>12</td>
<td>13</td>
<td>11</td>
<td>17%</td>
</tr>
<tr>
<td>Cipla Limited</td>
<td>CIPL.BO</td>
<td>OUTPERFORM</td>
<td>7</td>
<td>550</td>
<td>675</td>
<td>23%</td>
<td>29</td>
<td>31</td>
<td>23</td>
<td>27%</td>
</tr>
<tr>
<td>LIC Housing Finance Ltd</td>
<td>LICH.BO</td>
<td>OUTPERFORM</td>
<td>4</td>
<td>520</td>
<td>700</td>
<td>35%</td>
<td>16</td>
<td>12</td>
<td>9</td>
<td>19%</td>
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Source: RAVE, Credit Suisse estimates
### Companies Mentioned (Price as of 14-Nov-2016)

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<tr>
<th>Company</th>
<th>Code</th>
<th>Price</th>
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<tbody>
<tr>
<td>ACC Limited</td>
<td>ACC.BO</td>
<td>Rs1398.4</td>
</tr>
<tr>
<td>Ambuja Cements Ltd</td>
<td>ABUJ.BO</td>
<td>Rs219.45</td>
</tr>
<tr>
<td>Asian Paints</td>
<td>ASPN.BO</td>
<td>Rs963.6</td>
</tr>
<tr>
<td>Cipla Limited</td>
<td>CIPL.BO</td>
<td>Rs549.7</td>
</tr>
<tr>
<td>Eicher Motors</td>
<td>EICH.BO</td>
<td>Rs2174.5</td>
</tr>
<tr>
<td>HCL Technologies</td>
<td>HCLT.BO</td>
<td>Rs763.6</td>
</tr>
<tr>
<td>HDFC Bank</td>
<td>HDFK.BO</td>
<td>Rs1275.7</td>
</tr>
<tr>
<td>Housing Development Corp</td>
<td>HDFC.BO</td>
<td>Rs1271.5</td>
</tr>
<tr>
<td>ICICI Bank</td>
<td>ICBK.BO</td>
<td>Rs277.9</td>
</tr>
<tr>
<td>Kajaria Ceramics Ltd</td>
<td>KAJR.BO</td>
<td>Rs503.7</td>
</tr>
<tr>
<td>LIC Housing Finance Ltd</td>
<td>LICH.BO</td>
<td>Rs529.05</td>
</tr>
<tr>
<td>Maruti Suzuki India Ltd</td>
<td>MRTI.BO</td>
<td>Rs5136.15</td>
</tr>
<tr>
<td>Tata Motors Ltd</td>
<td>TAMO.BO</td>
<td>Rs507.4</td>
</tr>
<tr>
<td>Tech Mahindra Limited</td>
<td>TEML.BO</td>
<td>Rs429.7</td>
</tr>
<tr>
<td>Ultratech Cement Ltd</td>
<td>ULTC.BO</td>
<td>Rs3694.7</td>
</tr>
</tbody>
</table>

### Disclosure Appendix

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<table>
<thead>
<tr>
<th>Rating</th>
<th>Versus universe (%)</th>
<th>Of which banking clients (%)</th>
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</thead>
<tbody>
<tr>
<td>Outperform/Buy</td>
<td>44%</td>
<td>(63% banking clients)</td>
</tr>
<tr>
<td>Neutral/Hold</td>
<td>39%</td>
<td>(60% banking clients)</td>
</tr>
<tr>
<td>Underperform/Sell</td>
<td>15%</td>
<td>(56% banking clients)</td>
</tr>
<tr>
<td>Restricted</td>
<td>3%</td>
<td></td>
</tr>
</tbody>
</table>

*For purposes of the NYSE and NASD ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, and Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor's decision to buy or sell a security should be based on investment objectives, current holdings, and other individual factors.
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