Cycle getting back in gear

The year 2014 will herald the beginning of a more broad-based market rally and will be a better year for Indian equities. Most macro variables, including real growth and current account, will turn for the better, inflation will likely peak in the early part of the year, and rate cycle will gradually become supportive. Quality of growth will be better as a gradual turnaround in the investment cycle will lead the recovery. The momentum in earnings downgrade will reverse and there is a rising probability of an upgrade cycle kicking in. Thus, the environment will be supportive for a valuation re-rating. The key known unknown is the outcome of the May 2014 elections and as of now, it is too close to call.

Investment cycle – turning around: Private sector capital formation, the key swing factor in capital formation growth (down from +12% during FY07-11 to -5% in FY14ii), will start to recover this year, driven by an acceleration in execution rates. Given the large size of projects under implementation (~US$1.4 trillion) a pickup in execution rates from the current historic lows would by itself have a more-than-proportionate impact on growth in capital formation.

Earnings, rate cycle - will be supportive: A continued slowdown in demand side pressures, slower growth in wages, lower food inflation, and a more stable rupee, augur well for mitigation of inflationary pressures. The monetary policy will gradually turn more accommodative. The turnaround in ex-agricultural GDP growth will drive the recovery in Ebidta and net profit margins; in all likelihood, FY15/FY16 earnings estimates will see upgrades.

Portfolio positioning - cyclical bias: In the backdrop of a broader cyclical recovery, we overweight financials and domestic industrials. IT and Autos are the other key O/Ws as we believe that both these sectors will see positive earnings surprises. In contrast, FMCG will be negatively impacted due to the consumption slowdown and earnings momentum will be weak. Apart from FMCG, Energy is the other key underweight, given lacklustre growth.

Top large-cap buys

- Dr Reddys
- Hero Motocorp
- ICICI Bank
- L&T
- Wipro

Top mid-cap buys

- Crompton Greaves
- IPCA Labs
- The Ramco Cements
- Motherson Sumi
- Shriram Transport

Dark horses

- Ashok Leyland
- Bharti
- Infosys
- SBI
- Sesa Sterlite

Key overweight sectors

- Consumer Discretionary
- Financials
- Industrials
- Information Technology

Key underweight sectors

- Consumer Staples
- Energy
- Materials

2013 Top BUYs performance	Absolute return (%)	Relative to Nifty
Nifty	6.8	
Large-cap Buys		
Dr Reddys	39.4	32.7
HDFC Bank	-1.1	-7.8
ITC	13.9	7.2
M&M	2.8	-3.9
Ultratech Cement	-10.8	-17.5
Top Mid-cap Buys		
Amara Raja	42.9	36.1
Shree Cements	-6.1	-12.9
Shriram City Union	9.5	2.7
Tech Mahindra	97.9	91.1
Torrent Pharma	34.3	27.5

Source: Bloomberg, IIFL Research

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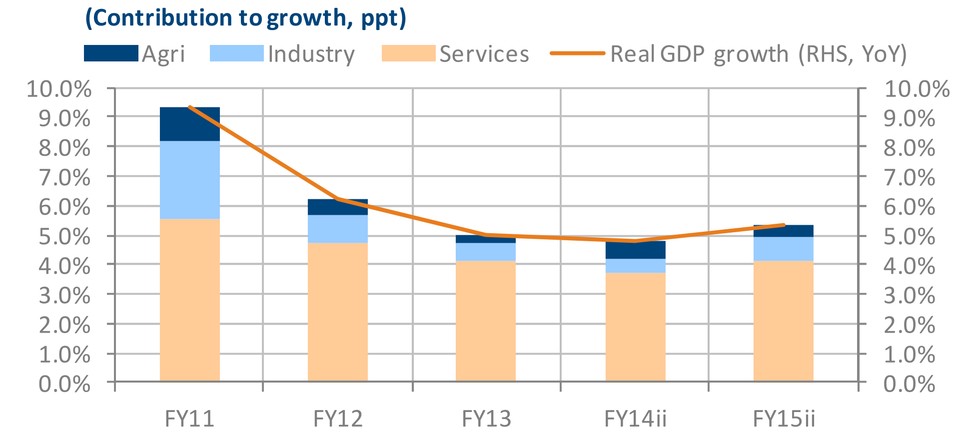
We believe that 2014 would be a much better year for Indian equities for the following reasons:

1. The macro economic outlook will turn for the better. GDP growth will pick up pace, current account will further improve, inflation will peak in the early months, and the rate cycle will eventually turn more supportive.
2. A revival in the investment cycle will lead the turnaround in growth ; a likely pickup in execution rates from the current historic lows will be the initial driver for the turnaround and in our view, growth will be much more broad based and qualitatively better.
3. The downgrade momentum in earnings estimates will likely reverse and the favorable turnaround in macro economic variables will drive upgrades in FY15/FY16 consensus estimates; Ebidta and PAT margins will likely trough out in FY14.
4. An improving macro outlook will mitigate the pressure from rising NPLs in the banking system and the trend will stop worsening; credit costs may still be high, but may not surprise on the negative side.

Valuations, which are at median or below median levels for large-cap and mid-small cap indices, will likely see an expansion as earnings upgrades start to kick in and cost of capital / equity risk premium comes down. We assume that the global growth environment will be supportive and price of risk will remain range bound at the current levels. The outcome of May 2014 elections potentially remains a market moving event and a determinant of a more sustained upturn in the growth cycle; as of now, it is too close a contest to call.

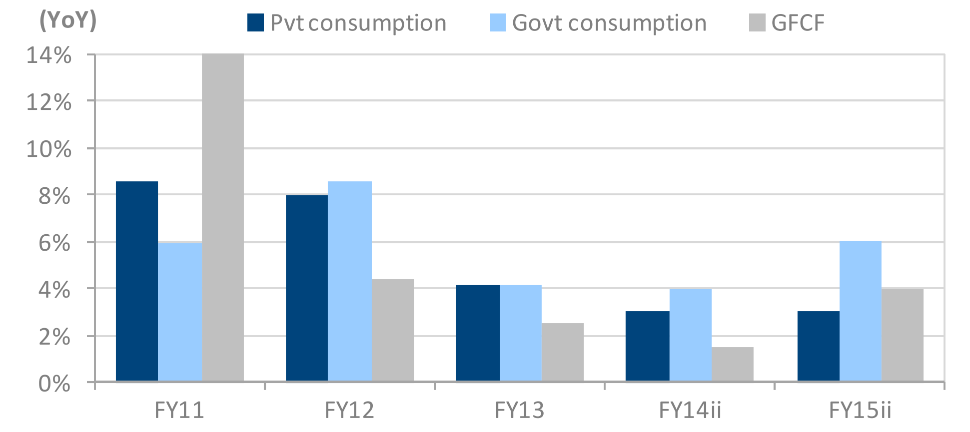
GDP growth – improving outlook
After near halving of growth rates between FY11-FY14 from 9.3% to an estimated 4.8%, we believe that growth rates will see a gradual acceleration to 5.3-5.5% in FY15. FY14 will likely be the trough year in the current growth cycle. A pickup in the capital formation cycle will principally lead the recovery in growth; the consequent recovery in industrial growth will have a benign impact on services sector growth. Between FY11 and FY14, YoY growth in the industry collapsed from 9.2% to 1.6% and that of fixed capital formation from 14% to 2% (real terms).

Figure 1: GDP growth : Bottoming out



Source: CSO, IIFL Research

Figure 2: Growth in gross capital formation: A favourable turnaround



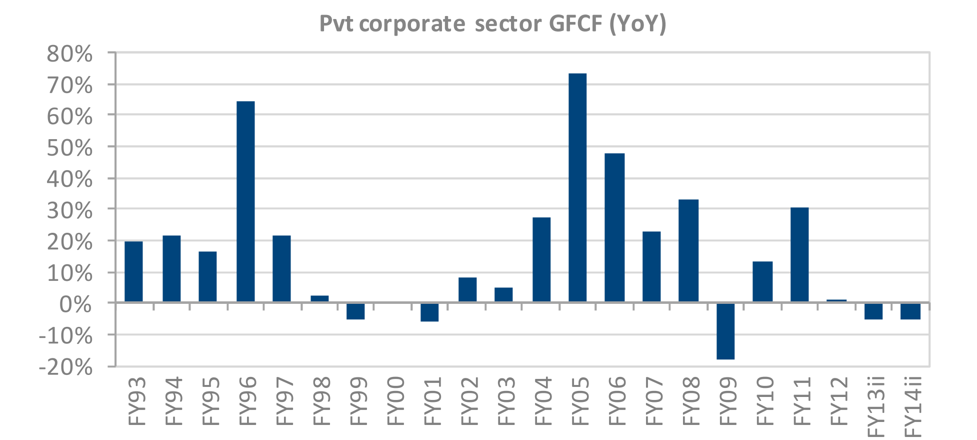
Source: CSO, IIFL Research

As we argue in the following section, a pickup in execution rates from the current abysmally low levels will lead the recovery in growth in capital formation. Exports will be an added engine of growth. In our view, the cyclical upturn in investments would more than make up for the potential slowdown in consumption growth. A sentiment turnaround in the event of a stronger pro-growth political combination being elected to power in the May 2014 general elections will accelerate the pace of recovery and drive upgrades to FY16 GDP growth estimates.

Investment cycle – likely to turn around

As we highlighted in our 25th Nov13 note '*Capex cycle – close to trough*', we believe that the investment cycle is bottoming out and capital formation growth will turn around in FY15. Household and government capex have held up reasonably well through the current slowdown. However, growth in private sector capital formation has collapsed from an average of 12% in FY07-FY11 to an estimated –5% in FY14 (in nominal terms). The reasons for the collapse in growth are well documented; inter alia, these include policy inaction, mining bans as a consequence of past irregularities, issues relating to fuel availability / PPAs / health of SEBs for the power sector, the rising share of non-productive CWIP, weakening balance sheets, and a sharp downswing in business sentiment. Not only have new project announcements hit an all-time low at 3.5% of GDP (from the FY07-09 average of 40%), execution rates (defined as projects completed in a year as a % of total projects under implementation) are down to nearly a third of FY05-10 average.

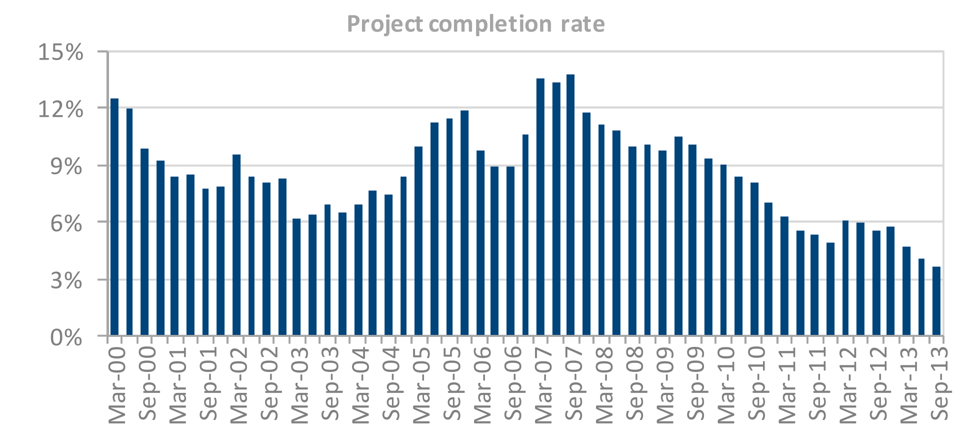
Figure 3: Private sector capital formation: From +30% in FY07-09 to -5% in FY14



Source: CSO, IIFL Research

While a turnaround in new project announcements is sometime away, execution rates can pick up quickly if approvals are expedited or sentiment turns around. Given the large size of projects currently under implementation (US$1.4 trillion or 80% of GDP - 2x that of the FY01-03 downturn as % of GDP), even a retracement to historic median levels would mean a more than 2x jump in execution rates and a concomitant recovery in capital formation growth. As project completion quickens, asset sweating, cash flows and capital productivity will all get better.

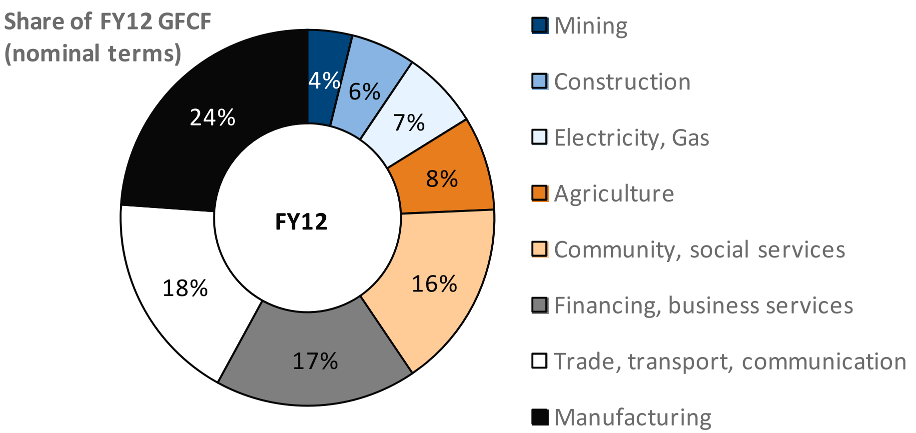
Figure 4: Project completion rate: almost at one-half of FY02-04 downturn



Source: CMIE, IIFL Research

In the past few months, we have already seen some positive policy action in the power sector: loan restructuring of large loss making SEBs is complete, an improved model PPA is in place, a few FSAs have been signed and approvals have been expedited. In the case of roads where no construction has started in almost 8000kms of highway projects awarded in the past two years, the government is trying to design a package to alleviate cash flow issues for aggressively bid projects; a few contracts may get cancelled as well, but either factors would help revive the sector over the next 2-3 quarters. Faster environmental clearances, now all the more likely with the change in the environment minister (the earlier one was perceived to have created many roadblocks delaying key approvals), will positively impact investments in the mining and metals sector. The tailwind of improved export competitiveness and faster growth in exports will be one of the drivers for a pickup in manufacturing investments, although a broader sentiment turnaround would be crucial to accelerate the pace.

Figure 5: A pickup in execution rate, better growth will drive the turnaround in GFCF



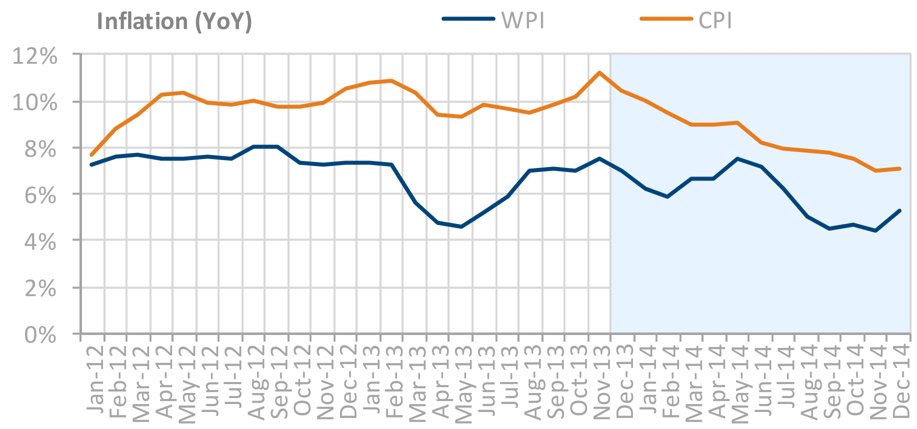
Source: CSO, IIFL Research

Of course, for sustainability of the recovery a few more factors such as more concerted government effort to expedite approvals for large projects, better profit outlook, and lower cost of capital, have to fall into place. More importantly, the May 2014 elections need to throw up a stronger pro-growth political coalition to power as that can drive faster improvement in business confidence and sentiment. All said it is fair to say that the share of GFCF in GDP will rise in FY15 and it now looks increasingly probable that this momentum will further gain strength in FY16.

Inflation – sticky but peaking out

Of all, high inflation has been the biggest thorn in India's flesh. The disinflationary impact from a sharp slowdown in growth has had little impact on headline inflation numbers as pressure from food prices have remained unrelenting, despite abundant monsoon rainfall. However, we believe that inflation is close to its peak for the following reasons: 1) the momentum of unabated rise in vegetable prices (up almost 100% YoY in WPI, 60% YoY in CPI for Nov-13) is now behind us; 2) the arrival of new crop and a bumper winter crop should ease the price pressures on cereals (up 11% YoY currently) even as prices for non food-grain crops in general continue would see a downward bias; 3) although high wage growth has already started to weaken both in urban and rural areas, in our view it will continue to weaken; 4) a continued slowdown in consumption momentum will further mitigate demand-side pressures, 5) rupee will likely be stable at 61-63/USD (as argued below) keeping inflation from imported goods in check. As of now, the government still seems committed to containing fiscal deficit close to budgeted levels, although some slippage is inevitable, given the slowdown in revenue collections.

Figure 6: Inflation: Sticky but the bias is on the downside



Source: CEIC, IIFL Research. Note: Shaded region denotes IIFL projection till December 2014

While inflation may remain elevated in the initial months and would rather ease gradually, the bias is on the downside. By Dec 2014, we estimate WPI to come down to 5.5% (down 200bps from the last print) and CPI to 8.0% (down 320bps from last print). More structurally, inflation can come down only if the supply-side response sees a significant improvement and from that perspective, a turnaround in investment cycle will be critical; however, it is fair to assume that cyclical and food-price linked pressures would wane in 2014 and headline inflation will gradually fall.

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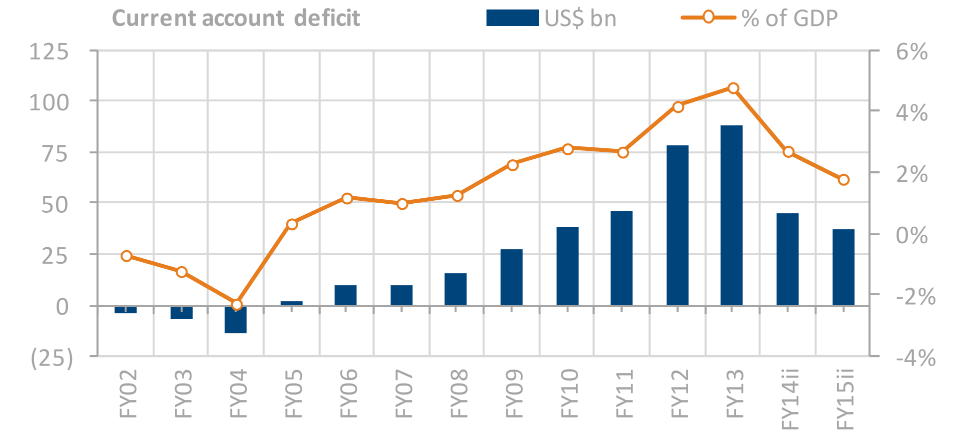
Current account deficit: under 3% of GDP

It is a well known fact that India's current account deficit (CAD) worsened substantially in FY13 (US$88bn, 4.8% of GDP). Between FY10-13, net oil and gold imports almost doubled. This, coupled with a slowdown in export growth, had a debilitating impact on India's current account. The 11% depreciation of INR vs. USD in the past 18 months has restored considerable competitiveness; export growth has already seen a sharp pickup and non-oil / non-gold imports are on a declining trend. Quantitative restrictions and a sharp increase in import duty have had the effect of driving down FY14 gold imports by almost 50%. We estimate that FY14 CAD will be down 50% YoY to US$45bn or 2.5% of GDP. CAD is unlikely to be an intractable issue in the next 12-18 months.

Figure 7: Current account deficit will decline sharply this year and further in FY15



Source: RBI, IIFL Research

Capital flows and rupee: well-behaved

Through the rupee's tumultuous phase in 2012 and 2013, FII flows into equities and FDI remained remarkably sticky and stable. An estimated cumulative amount of US$100bn came under these two heads and this helped India offset the sharp deterioration in FY13 current account. However, FII flows into debt markets were much more volatile with US$7bn of inflows in 2012 and US$8bn of outflows in 2013. The good news is that the total FII stock of ownership in debt is US$20bn, one that India can comfortably manage in the event of any further outflows. RBI has also further shored up its FX reserves through the US$35bn swap (from non-resident deposits and fresh banking capital). If our hypothesis of pickup in growth and a slowdown in inflation plays out, capital inflow momentum will likely remain benign. RBI's interventions in FX market has also sent out an unambiguous signal that it is comfortable with the 61-63 range for the INR/USD; current REER calculations too suggest that rupee is under-valued at these levels. In our view, the rupee is unlikely to see any material swings in 2014, barring unforeseen events.

Figure 8: Capital flows would be supportive and easily fund the reduced CAD

US$ bn	FY10	FY11	FY12	FY13	FY14ii	FY15ii
Exports	182	250	310	307	320	333
Imports	301	381	500	502	475	489
Trade deficit	118	131	190	196	155	156
Invisibles	80	85	112	107	110	119
Current account Deficit	**38**	**46**	**78**	**88**	**45**	**37**
Capital Flows	**52**	**62**	**68**	**89**	**65**	**55**
Net FDI	18	9	22	20	20	20
Portfolio flows	32	30	17	27	5	10
Loans	12	28	19	31	10	15
Others	(11)	(6)	9	11	30	10
Discrepancies	(0)	(3)	(2)	3	-	-
BoP Surplus	**13**	**13**	**(13)**	**4**	**20**	**18**

Source: RBI, IIFL Research

Fiscal deficit: Still early to call FY15

Between FY08 and FY12, India's fiscal deficit rose fourfold and there was a palpable deterioration in government finances. Since Chidambaram took over as Finance Minister in July 2012, his focus on expenditure management has helped contain fiscal deficit at close to budgeted levels. However, the environment remains challenging, as FY14 tax collections are likely to be 8% lower than budgeted levels. As of now, indications are that the FM's focus on expenditure control is unrelenting, though there is a lurking fear that the government may turn populist in the run-up to the May 2014 elections. We estimate FY14 fiscal deficit at 5.1% of GDP, marginally higher than the budgeted 4.8%. One of the key challenges for the new government would be to bring down fiscal deficit to more manageable levels and we may have to wait until the outcome of May 2014 elections to have a better view on the likely FY15 / FY16 fiscal roadmap.

Figure 9: Summarised central government finances

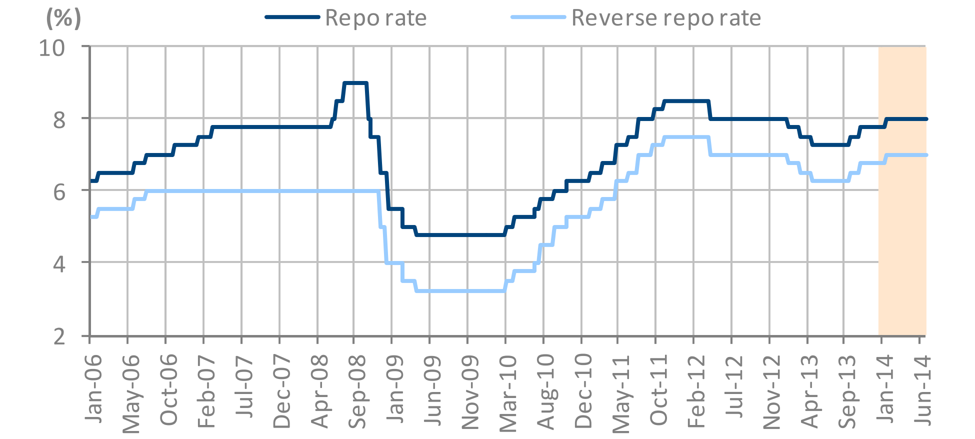
(Rs bn)	FY11	FY12	FY13 (P)	FY14ii
RECEIPTS				
Revenue Receipts	**7,885**	**7,512**	**8,788**	**9,797**
Tax Receipts	5,699	6,295	7,411	8,074
Non-Tax revenue	2,186	1,217	1,377	1,723
Capital receipts	**353**	**370**	**407**	**457**
- Disinvestment	223	181	259	350
- Others	130	189	148	107
Total Receipts	**8,238**	**7,881**	**9,195**	**10,254**
EXPENDITURE				
Non-Plan Expenditure	8,183	8,920	9,951	11,091
Plan Expenditure	3,790	4,124	4,143	4,823
Total Expenditure	**11,973**	**13,044**	**14,094**	**15,914**
Fiscal Deficit	3,735	5,162	4,899	5,660
Fiscal deficit % GDP	**4.8%**	**5.8%**	**4.9%**	**5.1%**

Source: Budget documents, IIFL Research

Rate cycle: will turn benign

Despite a sharp deceleration in growth, RBI's leeway to use monetary policy as a tool to revive growth was constrained by continued negative surprises on inflation and the sharp depreciation of the rupee in mid-2012. Rates may still go up in 1Q14, if headline WPI and CPI surprise on the negative side, but we believe that the interest rate cycle is close to the peak, given our hypothesis that inflation will gradually come off in the coming months. Policy rates may remain elevated in the initial months, but we believe that the rate cycle will turn more benign in the latter part of 2014.

Figure 10: Policy rates may remain elevated for some time, but rates are about to peak



Source: Bloomberg, IIFL Research. Note: Shaded region denotes IIFL projection till June 2014

Politics: improving tidings, still a close call

The outcome of the May 2014 general elections can potentially be a market-moving event; understandably so, as the policy morass of the Congress-led UPA-II government is one reason why growth in capital formation and business sentiment has been so badly dented. There is justifiable hope that the emergence of BJP-led coalition can help turnaround sentiment and growth. There is no denying the fact that BJP is on the ascendancy. However, to get close to the magic number of 190-200 seats (from 116 in the current Lok Sabha), the minimum that BJP will need to put together a post-poll coalition, the party needs to dramatically improve its tally in the states of UP and Bihar (and our recent road trip to UP suggests that BJP has started to make significant inroads there), do better in the states of Maharashtra and Karnataka, as also get coalitions in some of the states such as AP right. While this seems achievable, it is still a daunting task. The chances of a third front (a coalition of non-Congress, non-BJP regional parties) emerging as the largest political coalition with or without the outside support of Congress is no less either. Unfortunately, markets may not perceive a third front as growth-friendly and that makes the May 2014 election a potential binary event. The situation could of course change in the coming months but for now it is too early to place odds on the potential election outcome especially in the context of the emergence of anti-corruption party AAP (but for whose emergence, BJP would have won significantly more seats in the recent Delhi state elections). The Congress party slumping to its worst ever seat share looks probabilistically more likely.

Figure 11: BJP will need to increase its tally by 60-70 seats if it aspires to get to power

States	1999	2009	Total Seats
Uttar Pradesh	29	10	80
Maharashtra	13	9	48
Andhra Pradesh	7	0	42
Bihar	23	12	40
Madhya Pradesh	29	16	29
Karnataka	7	19	28
Gujarat	20	15	26
Rajasthan	16	4	25
Orissa	9	0	21
Jharkhand	NA	8	14
Chhattisgarh	NA	10	11
Delhi	7	0	7
Uttaranchal	NA	0	5
Others	22	13	167
Total	**182**	**116**	**538**

Source: CSO, IIFL Research

Earnings cycle: Momentum to reverse for the better

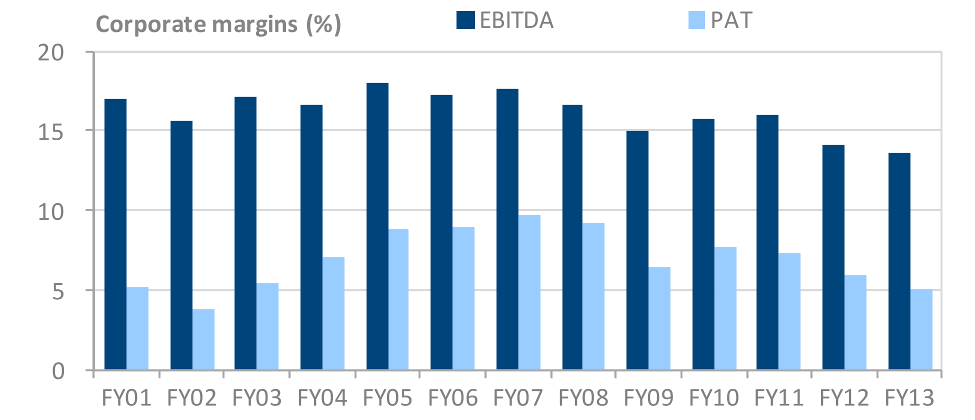
From the FY11 peak of 9.6% India's real ex-agricultural GDP growth will nearly halve to 4.8% in FY14. As we had highlighted in our earlier note (What drives corporate profit growth, 10 April13) corporate profit growth has a high degree of correlation with real ex-agricultural GDP growth. It is understandable that such a sharp fall in real growth in the past three years would thus have had a more-than-proportionate negative impact on margins and profit growth during this period.

For a static universe of 140 companies within IIFL coverage universe, FY14 profit growth of 5.5% would just be marginally better than the FY09-crisis year growth but almost two-thirds lower than the past decade's average. Profit growth between FY11 and FY14 (when real GDP growth significantly slowed) for this universe averaged 7.5% against preceding five-year average of nearly 20%.

For smaller companies outside our coverage, the fall in earnings has been even stark. For a broader sample of 1800 companies, FY13 Ebidta and PAT margins were at decade low of 13.6% and 5.1% respectively; for the bottom 1000, the respective numbers were 9.2% and -1.4%. Sharp spike in NPLs and higher credit costs have hurt earnings of banks and that has been an added drag.

In our view, the broader market earnings growth will bottom out in FY14 and as real GDP growth starts to turn around, corporate profit growth will pick up too. Better operating and financial leverage will aid a recovery in net profit margins, although the fuller impact of the recovery will reflect in earnings with a lag. We believe that the earnings downgrade cycle is behind us and current consensus FY15/FY16 earnings estimates will see upgrades. Earnings momentum will thus be supportive.

Figure 12: Ebidta and profit margins of top 1800 companies are at decade lows

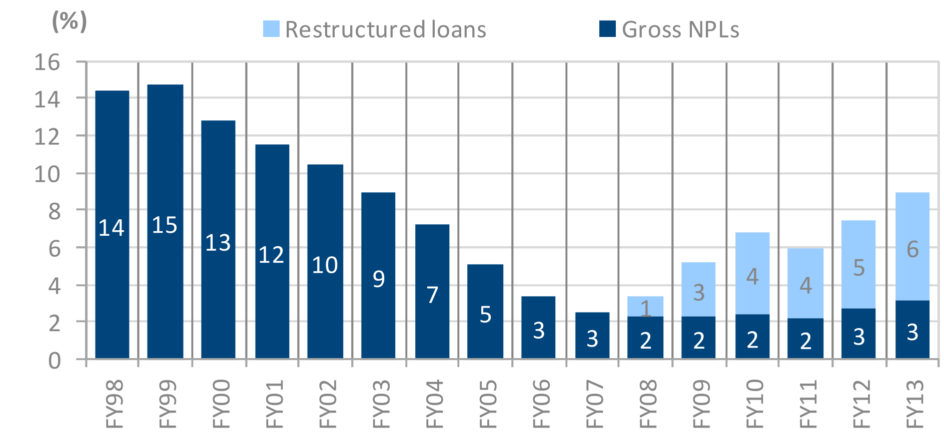


Source: CMIE, IIFL Research. Note: Excludes financials and PSU OMCs

NPLs: Pain may linger for some time, unlikely to worsen

Between FY11-FY14 when ex-agriculture real GDP halved, gross non performing loans (GNPLs) of the IIFL banking coverage universe doubled from 2.2% of loans to an estimated 4.4%; restructured loans rose from 3.7% to an estimated 7.0%. PSU banks account for 85% of GNPLs, 95% of restructured loans although they account for only 76% of system loans. The sharp deterioration in asset quality is attributable less to the cyclical slowdown and more to the stress arising from infrastructure projects (infra sector alone accounts for 21% of bad loans) stuck due to a number of prickly issues. As we have highlighted in the earlier section (on why Investment cycle is on the road to recovery), the government has started to address some of these issues in the power and roads sector. However, while we wait for the new government to more aggressively address some of the sticky issues the momentum has already started to turn for the better. Given our hypothesis of a cyclical turnaround in 2014, we expect the stress that arose because of growth slowdown will likely start to wane as well. The improvement in the macro-economic environment typically reflects on asset quality with a lag and it is possible that credit costs may still be high in FY15. However, outlook and direction of change will be more important; in our view, that trajectory will turn for the better in the coming months.

Figure 13: Stressed assets are elevated but the pace of accretion will moderate in FY15



Source: RBI, IIFL Research

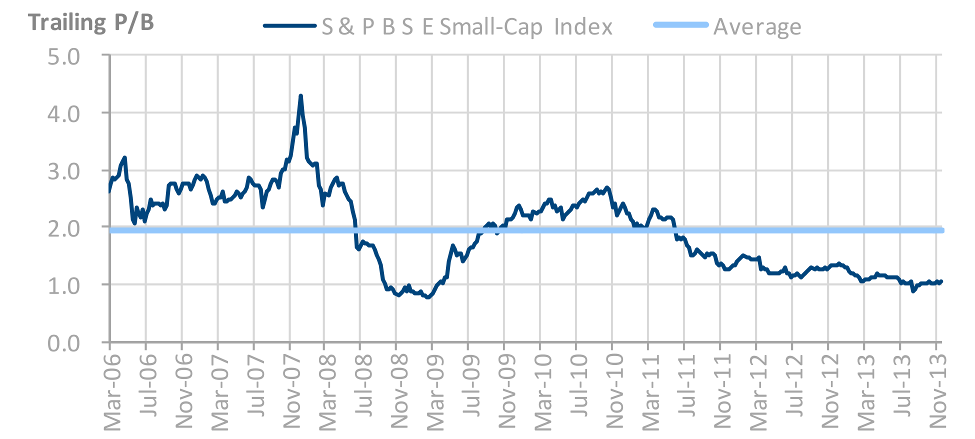
Nifty: current valuations assume a high equity risk premium

Market valuations have seen a de-rating over the past three years; large-cap indices like Nifty are still trading close to the historic median whereas mid-small caps are trading at much lower than median levels, especially on a price-to-book basis. This is understandable as earnings downgrades have been much more severe for mid-small caps as they had to bear the brunt of the slowdown pain. Cyclical downturn adversely impacted Ebidta margins, even as higher borrowing costs accentuated the pain at the PAT margin level. As macro variables start to look up as we hypothesize earnings outlook will start to improve. Earnings recovery for mid-small caps will understandably be sharper.

Figure 14: Mid caps are trading at a large discount to their long-term average PB

Source: NSE, IIFL Research

Figure 15: Small caps are trading at a significant discount to their long-term average PB



Source: BSE, IIFL Research

Our two-stage earnings discount model also suggests that at the current levels of Nifty, implied Equity Risk Premium (ERP) is close to 6.5% (this assumes a risk free rate of 9% and a terminal growth of 7%). Current ERP is well above its historic median. As we have highlighted in the table below, even marginal changes in ERP or terminal growth tends to have an exaggerated impact on fair value. In our view, current valuations do not price in a potential earnings upgrade cycle and thus the risk-reward for the Nifty at current valuations is favorable.

Figure 16: Nifty Fair Value

		Equity risk premium (%)					
		2	3	4	5	6	7
Terminal growth rate (%)	4	9,623	8,220	7,169	6,353	5,700	5,166
	5	11,285	9,376	8,013	6,992	6,198	5,563
	6	13,779	10,994	9,139	7,813	6,820	6,048
	7	17,936	13,422	10,714	8,909	7,620	6,654

Source: Bloomberg, IIFL Research. Note: Using 3 stage earnings discount model.

Portfolio Strategy – Overweight IT, domestic cylicals

We are moving away from a pure bottom-up portfolio construction to a mix of top-down and bottom-up. We would have a neutral bias for telecom and pharmaceutical sectors whereas our key overweight and underweight sectors would be as follows:

Key overweight sectors:

1. Information Technology: Earnings momentum remains strong, upgrade cycle is still intact, and valuations are reasonable despite the stellar performance in the past year. Our bias is towards large caps as valuation gap vs. mid-caps is too narrow.
2. Financials: This sector remains a good proxy to play the improving top-down story. Our bias would be to own cheaper private sector banks and NBFCs as larger weights within the sector.
3. Engineering & Construction: A play on the upturn in the investment cycle, this sector will see sustained earnings upgrades and valuations will re-rate.
4. Autos: A large number of good companies to own, valuations are attractive, growth momentum is reasonable.

Key underweight sectors:

5. FMCG: Consumption growth is weakening, earnings upgrade cycle is behind us, risk of downgrades rising, valuations are too rich and the sector will underperform in a cyclical upturn.
6. Energy: Earnings momentum remains lacklustre, valuations are cheap, but we do not see any re-rating drivers.

Figure 17:IIFL recommended portfolio stance

Sectors	Nifty weight	IIFL weight
Consumer Discretionary	9.0	10.0
Consumer Staples	10.5	7.0
Energy	11.7	7.0
Financials	26.5	30.0
Health Care	6.0	6.0
Industrials	5.2	8.0
Information Technology	17.0	20.0
Materials	8.3	6.0
Telecommunication Services	1.9	2.0
Utilities	3.9	4.0
Total	**100.0**	**100.0**

Source: NSE, IIFL Research

Top large-cap buys

Company	Mkt-Cap (US$ m)	Valuation PE (x) FY15ii	PB (x) FY15ii	EPS Cagr (%) FY14-FY16ii	RoE (%) FY15ii	Investment rationale
Dr Reddy's (DRRD IN CMP: Rs2,535)	6,973	17.0	3.8	20.5	25.0	• Recent limited-competition product launches and pipeline provide comfort of sustained high-teen growth in the US; the business grew 27% in FY13, expect FY14 growth >23% (all in USD). • India business should sustain mid-teen growth; large established Russia and smaller 'other emerging market' branded businesses will continue to deliver ~20% growth. One of the front-runners in biosimilars world-wide; already launched several products in EMs; partnership with Merck KGaA for regulated markets. • We project 17%+ core earnings Cagr over FY14-FY16, better than what we believe is priced in the stock. Valuation at ~17x FY15ii core earnings is still at 10-20% discount to peers; potential to re-rate 15-20%.
Hero Moto (HMCL IN CMP: Rs2,075)	6,706	13.8	5.6	27.2	45.7	• Consumer acceptance of the new brand, confidence in product quality as affirmed by the 5-year warranty program and resultant stabilization in market-share places Hero in a strong position into a potential recovery in 2W demand. • Stable market share will bring back pricing power and margins. In addition, Hero is working on a "margin transformation project", which can drive 300-400bp of margin gains led by alternative sourcing and cost cutting. Launch of new models based on Hero's own R&D will remove Street concerns on technology. • Stock is trading at 13.8x FY15 EPS. Our estimates do not build in margin expansion; a 100bp cost saving can add 8% to our EPS estimate.
ICICI Bank (ICICIBC IN CMP: Rs1,099)	20,527	11.8	1.6	15.7	13.9	• ICICIBC is strongly positioned as regards profitability, capitalization and financing flexibility. A cyclical upturn may further improve the operating environment in the medium term. • Asset quality is likely to be tackled through pro-active loan workouts like restructuring, forcing asset sales and re-financing. Hence, we believe ICICIBC should be able to contain slippages and GNPA ratios. • We estimate 15.5% earnings CAGR through FY14-16ii with ROA of 1.6% and RoE of 14-15% through FY16ii. The bank will easily comply with Basel III requirements of capital and could potentially monetize investments in subsidiaries.
L & T (LT IN CMP: Rs1,070)	16,038	18.4	2.8	11.7	15.9	• As the cycle turns, there is a sharp pickup in execution rate – FY03 witnessed 8ppt improvement YoY. With order coverage of 2.6x, every ppt improvement in execution will drive 2% upside to revenue estimate. This would more than offset margin risks. • Domestic order inflow has lagged so far but improved political will and administrative efficiency could kick start investments in roads, railways and metros. Sustained activity in Middle East and better hit rate will drive overseas inflows as well. • Better traction in monetisation of asset business will reduce funding requirements from the parent balance sheet.
Wipro (WPRO IN CMP: Rs559)	22,309	15.8	3.4	13.6	23.6	• Signs of restructuring that were visible only in lower attrition and higher client satisfaction have started becoming evident in a better revenue growth and large deal wins. Healthy traction in infra. services and deal wins even in BFSI gives confidence over the sustainability of an improvement in its revenue growth • Wipro's has amongst the best margin levers within top-4 vendors. A greater increase in SG&A expenses than peers over the past two years is one of the reasons for its margin levers • Despite the narrowing of gap in growth rates, its valuations continue to be at a material discount to TCS.

Top mid-cap buys

Company	Mkt-Cap (US$ m)	Valuation PE (x) FY15ii	PB (x) FY15ii	EPS Cagr (%) FY14-FY16ii	RoE (%) FY15ii	Investment rationale
Crompton Greaves (CRG IN CMP: Rs129)	1,336	19.0	2.0	51.4	11.0	• Profitability of domestic power systems business being supported by higher contribution from exports. This should continue helped by favourable currency. Completion of low-margin orders means that risks to profitability remain low. • Healthy margin for consumer product segment despite seasonally lower revenues in 2Q lends comfort. Enhanced distribution and lower competition from Chinese imports would help sustain segment performance. • Despite constant currency revenue decline, overseas subsidiaries have turned the corner with Ebitda breakeven in 2Q. Except Canada and USA, other subsidiaries have become profitable. Management remains confident of full year breakeven for overseas subsidiaries.
IPCA Labs (IPCA IN CMP: Rs724)	1,479	15.6	3.7	21.7	26.5	• Large contribution from domestic formulations business (32%); strength in chronic pain medicines and anti-malarials. Expect to deliver mid-high teen growth in medium term. • Focus on branded formulations in global emerging markets; management plans to tap newer geographies to maintain high growth. Institutional anti-malarial business sales remain strong as well. • USFDA clearance of Indore plant raises growth prospects in the US market. • Trading at ~15x FY15ii core earnings, at discount to large cap peers; gradual re-rating to large cap multiples likely.
Motherson Sumi (MSS IN CMP: Rs183)	2,604	13.6	4.2	27.0	35.0	• Motherson Sumi's (MSSL) wiring harness business is a direct play on recovery in the Indian auto sector as well as on India's emergence as a production hub for exports. MSSL's India revenue has outpaced auto industry by a big margin; hence, a recovery in Indian auto will drive an even stronger revenue/earnings growth for MSSL. • MSSL's subsidiaries (SMR & SMP) will benefit from an increasing order book (EUR6.6bn new orders in last 1.5 years) and a potential recovery in the European car market. We estimate 10% revenue Cagr over FY14-16 combined with margin expansion from operational improvement to result in earnings of these subsidiaries doubling over FY14-16. • We forecast a 27% consolidated EPS CAGR over FY14-FY16. Stock is trading at 13.8x FY15 EPS.
The Ramco Cements (TRCL IN CMP: Rs192)	738	19.6	1.7	25.2	9.2	• We expect demand to revive in southern region in FY15 after remaining sluggish for the past 4 years with likely improvement in political environment in Andhra Pradesh. • Pace of cement capacity addition is likely to reduce in the southern region going forward and is likely to improve utilisation gradually in the next 2-3 years (from ~60% now to ~70% in FY16). • Ramco Cements, a south based cement company with 12.5mtpa capacity is trading at USD 74/tonne (40% discount to replacement cost), which is attractive from a medium term perspective, in our view. Any revival in discipline in south region could boost earnings.
Shriram Transport Fin. (SHTF IN CMP: Rs673)	2,469	9.2	1.6	19.6	18.1	• We believe STFC will incrementally benefit from increasing financing requirements in the CV space, medium term impact of better monsoons, partial removal of bans on mining and better outlook for the capital goods sector. • Despite the adverse operating environment, STFCs business model has been intact. An improvement in the CV cycle could drive a large upgrade in our earnings outlook driven by better growth, margins and credit cost estimates. • Over FY14-16ii, P/E re-rating to 12.5x 12-month forward EPS (last cycle peak 15.7x, currently 9.3x FY15ii EPS) and a ~45% earnings growth over FY14-16ii suggest a large upside.

Dark horses

Company	Mkt-Cap (US$ m)	Valuation				Investment rationale
		PE (x) FY15ii	PB (x) FY15ii	EPS Cagr (%) FY14-FY16ii	RoE (%) FY15ii	
Ashok Leyland (AL IN CMP: Rs17)	743	13.9	1.1	NM	7.9	• M&HCV volume growth has a very strong correlation with IIP growth. Improvement in IIP may drive demand for M&HCVs in FY15. Also the current CV down-cycle has been longer than past down-cycles (12-18 months), implying that an uptick may not be too far. • Ashok Leyland has the highest operating and financial leverage among Indian Auto companies. Its employee cost is the highest among auto peers. While these factors hurt in a slowdown, it magnifies earnings growth in a recovery. • Stock is trading at 14.0x our FY15 EPS. However, if the CV cycle picks up pace, earnings can potentially double in FY16 over FY15 levels.
Bharti Airtel (BHARTI IN CMP: Rs330)	21,362	24.8	1.9	50.8	8.0	• While overall industry dynamics in India has improved, Bharti has also streamlined distribution/employee base, launched innovative products to seed the data market and improved capex productivity. We build in 18% India Ebitda Cagr over FY13-16ii. • Africa operations' performance improved in 2QFY14 and we believe it is close to bottoming out. We estimate 2.5%/8.5%/8.5% Ebitda growth (in US$) in FY14/15/16. • 900/1800MHz base prices have been cut by 57%/26% from March 2013 levels and hence spectrum payouts would get crystallised at significantly lower levels. Valuation is attractive at 6.7x FY15ii EV/Ebitda and 16% FY13-16ii Ebitda Cagr.
Infosys (INFO IN CMP: Rs3,486)	32,388	16.1	3.6	17.1	24.3	• Margin fall at Infosys in the past two years was primarily led by deterioration in its delivery levers (age pyramid, onsite cost inflation etc.). While 'correcting' its delivery is a delicate issue and will take time, the margin levers are significant. • Infosys' earlier re-organization has streamlined its sales operations and has improved its deal traction. The company has also been aggressive in bidding for infrastructure services deals which has resulted in a better growth for the company in 2013. • Given the narrowing of gap in growth rate vs TCS and margin levers, we expect its re-rating to continue.
State Bank of India (SBIN IN CMP: Rs1,767)	19,553	9.1	1.0	18.1	12.0	• SBIN is currently facing a number of headwinds such as poor asset quality, slowing loan growth and gross under-provisioning all culminating into significantly eroded tier 1 capital. • Despite this, any change in the economic and regulatory environment, improving corporate credit cycle or pickup in loan growth would provide a disproportionately beneficial environment to SBIN. • The stock may potentially re-rate faster in such a case. Its ROA and ROE profile could improve materially (from the 0.7% and 12% trajectory estimated now).
Sesa Sterlite (SSLT IN CMP: Rs202)	9,688	5.9	0.8	18.0	14.4	• SSLT trades at a discount to the sum of intrinsic value of its businesses due to lack of fungibility of cash of Cairn and Hindustan Zinc (HZ). • Buyout of government's stake in HZ - a potential trigger, and subsequent merger of HZ could unlock value (Rs42/share) for SSLT's shareholders. Similarly, merger of Cairn could add Rs24/share. • Stable operating performance of zinc and oil businesses (~70% of attributable Ebitda), resumption of iron ore operations and likely improvement in copper and aluminium businesses suggest a better outlook for FY15. Improving cash flow and moderate capex would reduce leverage and strengthen balance sheet over FY14-16.

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, i.e. a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, i.e. return of less than 10%.

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