

<p>India GDP growth will outshine Asia in 2007</p>	<p>Notwithstanding challenges to broader market equity market performance due to a slowing global economy, domestic plays could continue to throw in surprises in 2007. While we expect a visible pick-up in infrastructure project starts during the year, consumption growth could get a boost from tax cuts. We also see select opportunities among beneficiaries of softer global commodity prices and sector laggards of 2006. Our top BUYs are Bharti, Gujarat Ambuja, HLL, Reliance Energy and Satyam,</p> <p>Strong domestic growth outlook. CLSA forecasts 8.3% GDP growth for India in FY08, even in the backdrop of a big fall in growth rates in the US, China and many Asian economies. For India, the rapid-growth of the services sector, improving rural incomes and upswing in the capex cycle will be key growth drivers.</p>
<p>Four investment themes for 2007</p>	<p>Four key themes for 2007. First, likely tax cuts will provide a boost to consumption growth. Second, surge in infrastructure, real estate project starts will boost demand for inputs and orderbooks of equipment suppliers/contractors. Third, softer global commodity prices will drive margin upside for some user industries. Fourth, some sector laggards of 2006 now offer favourable risk-reward.</p>
<p>Tax cuts will help sustain high consumption growth</p>	<p>Consumption boost from tax cuts. As detailed in our "<i>Open letter to the Finance Minister</i>" published along with this piece, the buoyancy in tax revenue, arising from a combination of cyclical upswing in GDP growth and structural factors, provides the government with the opportunity to cut tax rates and support high consumption growth. We expect 3-4% cut in tax rate on income of corporates, individuals to boost demand for consumer goods and services and raise Sensex EPS by c.3%.</p>
<p>Significant pick-up expected in new project starts</p>	<p>Investment spend will pick-up significantly. In terms of actual project starts, investment activity should see a strong upswing in 2007. We thus see potential for cement prices to escalate beyond base-case estimates, while strong order accretion will further boost revenue visibility for contractors/equipment suppliers.</p>
<p>Margin upside from lower commodity prices in select cases</p>	<p>Beneficiaries of softer prices of commodity inputs. Users of crude oil-and its derivatives, metals will gain, but taking into account relative pricing power, consumer staples would be our preferred play on this theme.</p>
<p>Favourable risk-reward in some sector laggards of 2006</p>	<p>Opportunities in sector laggards. After 13% decline in a year of strong market and sector performance, the risk-reward in Reliance Energy stock appears favourable. A win in an ultra-mega power project will certainly be a positive catalyst. Likewise, Satyam's underperformance to other fast-growing IT majors should reverse, as its strong order momentum allows superior % gains on pricing.</p>
<p>Model portfolio changes:</p> <p>Additions: Bajaj Auto, L&T, Ranbaxy, Reliance Energy</p> <p>Deletions: Hero Honda, CESC, Sun Pharma</p>	<p>Top picks, model portfolio. Our preferred plays on stronger consumption demand are telco Bharti, where APRU upside could add to a secular subscriber growth story, and HLL, where forward P/E multiple has dipped below the five-year average, despite improving fundamentals. Gujarat Ambuja is the most attractively-valued option on a stronger-than-expected upswing in cement prices. In our model portfolio, our biggest O-WTs are on consumer staples and industrials; energy, banks and materials are key U-WTs. Performance of TCS, Tata Steel, Pantaloon and Suzlon will be weighed down by company specific issues.</p>

Softer oil prices, productivity improvement can also be growth boosters

Tax collections running well above target

With structural factors also contributing to high tax revenue growth, tax rates can be eased

Step-up in project development in infrastructure as well as real estate

2007: expect boost to consumption, investment

For the Indian economy, 2007 can be a landmark year. CLSA's Economics Team sees a significant US-led slowdown in global economic growth in 2007, but domestic-orientated India will still report +8% growth. Benefits of lower oil prices (0.8ppt addition to GDP, if crude oil were to average US\$50/bbl), productivity gains arising from improvements in the supply chain and increase in farm incomes and impact of new growth engines such as real estate will support high growth.

Consumption could get boost from tax cuts

The economic boom has also resulted in tax revenue growth of 20% Cagr for the past three years, with FY07 tax collection (30% YoY for Apr-Nov06) running ahead of target; the strong earnings momentum for Indian corporates has been a significant contributor to this, with corporation tax rising 54% YoY.

For the government, we see opportunity to keep up sustained high growth rates through tax cuts and policy support for investment and we expect a growth-oriented budget in Feb-07. With the strong growth in corporate profits, rates of excise, customs duty now near a floor and significant scope for increasing coverage of fast growing services, we see potential for double-digit growth in tax revenue, even if the 10% surcharge on corporate tax and income tax is removed.

Investment: from planning to execution phase

While an upturn in investment is already underway, we see a significant pick-up in new project starts in FY08. In the roads sector, US\$17bn BOT contracts are set to be awarded during the next 15 months, 3x that since 1999. Order awards for Power project awards could cross 20,000MW, versus less than 10,000MW during FY07. Real estate development activity is also set to step-up significantly. Based on our survey of six top companies, area developed during FY08 should be 80% higher than that in FY07. With US\$2.7bn equity/FCCB issuances by developers and US\$14bn raised in domestic and India-dedicated offshore real estate funds during 2006, capital will not be a constraint. Kick-off of new SEZs will also boost construction activity.

Figure 1

Themes for 2007

Theme	Sector plays	Preferred plays
Consumption boost from tax cuts	Consumers, Autos, Hotels, Banks, Telecoms	HLL, Bharti, M&M
Surge in actual investment spending	Cement, Capital goods, Utilities	Guj Ambuja, L&T, Reliance Energy
Softer global commodity prices boost margins	Downstream oil, airlines, autos, capital goods	HLL, M&M, L&T
Rotation into sector laggards	All	Reliance Energy, Ranbaxy, Satyam

Source: CLSA Asia-Pacific Markets

Top picks

Figure 2

Top picks

Stock	Ticker	Price (Rs)	Mkt Cap (US\$m)	FY08* P/E	FY06-08 EPS Cagr(%)	ROAE - FY07 (%)	2006 perf (%)	Reco
Bharti	BRTI.NS	630	26,965	22.1	53.7	34.1	83.0	BUY
Gujarat Ambuja	GACM.BO	141	4,831	12.4	27.7	45.8	79.2	O-PF
HLL	HLL.BO	217	10,774	23.4	22.0	63.9	11.1	BUY
Reliance Energy	RLEN.BO	520	2,494	16.0	2.9	8.5	(13.2)	O-PF
Satyam	SATY.BO	484	7,160	18.2	32.6	28.8	32.3	O-PF

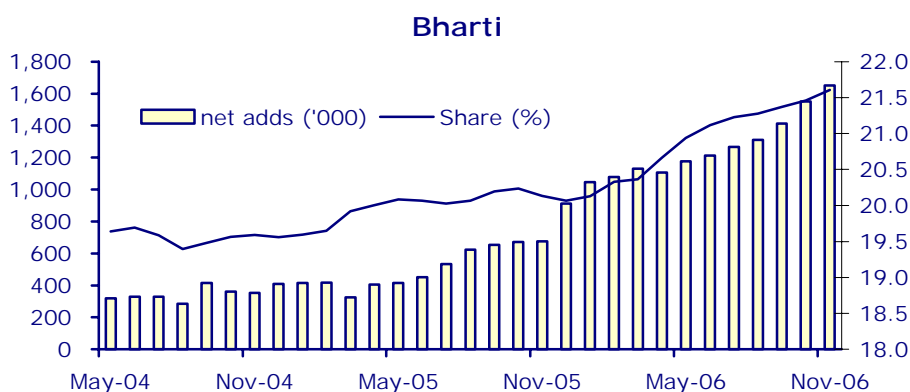
Source: CLSA Asia-Pacific Markets * Normalised across companies, given varying Y/E

Bharti

- ❑ Widening coverage and rising affordability sustaining momentum in mobile net adds. Bharti set to maintain leadership and enter global top 3 mobile operators by FY09
- ❑ Improving quality of traffic and rising acceptance of value-added services aiding to mitigate decline in ARPUs. Bharti leads the industry in innovations reflected in ARPU premium to peers
- ❑ Better asset sweating will result in further improvement in capital efficiency; at 38% ROCE (09CL), Bharti among most capital-efficient telcos globally
- ❑ Market underestimating value creation in mobile business expansion. Premium valuations backed by robust 44% FY06-09CL earnings Cagr.

Figure 3

Rising marketshare, even on a fast growing base



Source: CLSA Asia-Pacific Markets

Hindustan Lever

- ❑ Pricing power firmly returning to HLL. Past 12 months have seen HLL's average realisation improve by nearly 5-6%
- ❑ With revival in agri/rural growth, this segment will be the major growth driver for the sector. HLL has the strongest rural distribution network

- ❑ Improved pricing power, aided by stronger demand growth will support margins (up c.100bps in CY2006); falling crude prices could drive upside
- ❑ The stock now trades at 25xCY2007CL earnings - small 4% discount to the last 5 year average PE.

Figure 4

HLL forward P/E multiple is now below its five-year average



Source: CLSA Evalu@tor

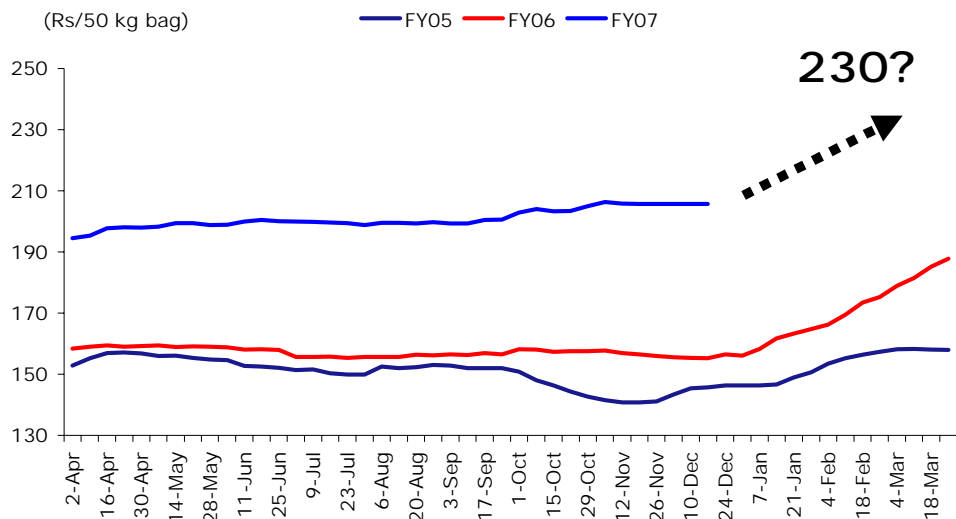
Source: CLSA Asia-Pacific Markets

Gujarat Ambuja

- ❑ Surge in construction activity, 65mt cap on visible supply additions suggest room for further upside to average cement prices
- ❑ Gujarat Ambuja better placed for low-cost expansion (through blending); improving geographical mix with new capacities in East
- ❑ Commissioning of coal fired 60MW power plant will drive nearly Rs400m/year savings from Jan'07.
- ❑ Cheapest large cap cement stock, trading at 12x CY07CL EPS; 8x EV/ebitda

Figure 5

Positive cement price outlook to drive Gujarat Ambuja outperformance



Source: CLSA Asia-Pacific Markets

Reliance Energy

- ❑ The successful award of the two ultra mega power projects (UMPPs) to private players indicates the huge potential for private investments in the Indian power sector.
- ❑ The company has the financial muscle and experience to capitalise on this opportunity.
- ❑ Reliance Energy will be an aggressive player in the power sector. The bids in following rounds of UMPPs are likely to be more reasonable and Reliance Energy stands a chance to win at least one of the projects.
- ❑ Stock is trading at just 16% higher than the distress valuations of Rs435 arrived by fairly conservative sum of parts valuation.

Satyam

- ❑ Financial performance likely to converge with Tier-1 peers as strong orderbook coupled with pricing normalization trends helps buffer margins against wage hikes
- ❑ Wage hike risk for 2007 factored into forecasts, but pricing power still underestimated. Satyam has historically been a price discounter and now has better chances of % hikes
- ❑ PE discounts have expanded from a low of 10% in April 2006 to 30% now. Stock has underperformed the markets by 20%+ in 2006

Preferred mid-cap ideas

India Cements

- ❑ The cheapest cement stock under our coverage trading at 9.5xFY08CL earnings and 6.5x EV/Ebitda
- ❑ India Cements is embarking on the low-cost capacity expansion and increasing the group capacity from 8.8m MT to about 10.8m MT during FY08 at a cost of US\$35/MT
- ❑ Average cement pricing in the south is still relatively low at c.Rs196/bag - 5% discount to the national average, implying greater possibilities of higher price increase in South - the operating area of India Cements.

Prajay Engineering Syndicate

- ❑ Prajay is one of the leading real estate developers from the city of Hyderabad. With 650 acres of land bank and growing, the company has enough work at hand for the next 4/5 years.
- ❑ While the company has undertaken development of 4.5m sqft over the last 20 years, has ambitious plans to develop 18m sqft over the next 4 years with expected project profitability of in excess of Rs12-13bn.
- ❑ While our current NPV/share works out Rs275-300, we believe that the potential for NPV upgrades, driven by aggressive land bank accumulation and potential property price appreciation in Hyderabad exists.

I-Gate Global

- ❑ Significant shift in business mix away from historical low bill rate staff augmentation - seeing 10-15% better prices. Business won in last 3 years is 30% of total and will rise to 70% of total in 2 years time
- ❑ Ebitda margins expected to expand from single digits to mid-teens in 2-3 quarters
- ❑ One of the cheapest stocks in Indian techs trading at 11.5xMar08 earnings

Exide

- ❑ Key beneficiary of buoyant demand from the automotive sector and for industrial batteries from sectors like telecom, malls and multiplexes; EPS forecasted to grow at 42% cagr over FY06-09
- ❑ Even in an environment of high lead prices, margins were maintained in FY06; Lead price softening in 2007 and 2008 should boost margins
- ❑ 50% stake in ING Vysya Life Insurance valued at Rs11.4/ share; Stock attractively valued

BEL

- Expect steady 20-25% growth in profitability
- Company likely to benefit from higher spend on modernization of defence forces
- Stock trading at 14.3x FY08CL with ROCE in excess of 40%; Likely increase in dividend payout given Rs230/ share of cash as at March 2006

Sesa Goa

- Iron ore prices are set to increase by 9.5% in 2007, after 71% and 19% increase in the last two years. Baosteel has settled with CVRD for a 9.5% increase in 2007.
- Coking coal contracts for 2007 have been settled for 15.5% lower prices, which is positive for Sesa's met coke business.
- Meanwhile the stock price has moved up sharply on rumours that major Indian steel companies are likely to bid for Mitsui's 51% stake in Sesa and trading at 7.2x FY08CL. Given strong cash flows and visibility in earnings, we remain positive.

Likely underperformers

Among large-caps, we see risk of near-term underperformance for **TCS**, **Tata Steel**, **Pantaloon** and **Suzlon**, primarily due to company specific issues.

TCS, which is benefiting from significant non-recurring items in FY07 (some exceptional provision reversals and product license fee to the tune of US\$10m+), will enter 2007 with negative margin comparisons. Reversal to trend-line margins in FY08 will adversely impact stock performance.

Tata Steel: The risk that Tata Steel could overpay for Corus, given the aggressive position taken by rival bidder CSN, will weigh on the stock. Even at the current offer price of 515p/share, we see high likelihood of significant equity dilution to fund the deal, without immediate synergistic benefits from the acquisition.

Pantaloon, India's largest organized retailer, is trading at 30x FY08CL. We maintain our SELL, notwithstanding the company's growth plans in the fast growing organized retailing space, due to concerns on diversification in terms of formats and resultant execution risks, increasing competitive intensity from new bulge wallet entrants such as Reliance, Bharti and likely margin decline as employee costs rise.

Suzlon's FY07 earnings are likely to be lower than street estimates, as rising share of exports in revenue will dampen margins. At 23x FY08CL earnings, we believe that valuations factors in the strong demand environment, but do not adequately reflect risks. A favourable development on its overseas acquisition plans could, however, necessitate a review of our recommendation.

Model portfolio changes

We have added Reliance Energy, L&T, Bajaj Auto (as a replacement for Hero Honda, which is still losing marketshare) and Ranbaxy (where resolution of manufacturing issues and potential spin-off of R&D assets will drive upside) into the

portfolio, at the expense of CESC and Sun Pharma. We have also reduced weights for BHEL (by 1ppt, given rising concerns on external competition) and Infosys (adverse impact of seasonality, rupee appreciation).

CLSA model portfolio

Figure 6

	Current Mkt Price (Rs)	Market Cap (US\$m)	Current MSCI Wt (%)	CLSA Rec Wt (%)	Stance	FY08 EPS growth (%)	FY08 P/E (x)	FY07 div yield (%)	3m Perf. (%)	CLSA Rec
Consumer discretionary			9.4	6.0	U-WT					
M&M	906	4,932	1.7	2.0		5.0	24.7	1.3	33.1	BUY
Bajaj Auto	2,619	5,989	1.7	2.0		13.3	19.4	1.7	(12.7)	O-PF
Indian Hotels	155	2,042	0.7	2.0		19.2	20.4	0.9	11.7	No Rec
Financials			20.7	13.0	U-WT					
J&K Bank	620	679	-	3.0		33.2	8.1	1.5	38.2	BUY
PNB	507	3,613	-	2.0		20.7	7.7	1.5	(3.7)	U-PF
ICICI Bank	890	17,907	7.9	6.0		24.3	20.4	1.1	27.4	BUY
SBI	1,246	14,820	1.0	2.0		12.8	12.8	1.2	21.2	O-PF
Energy			15.3	13.0	U-WT					
Reliance	1,270	40,010	11.4	7.0		0.0	18.3	0.9	8.5	O-PF
ONGC	870	42,060	3.2	6.0		12.8	9.3	3.7	11.5	BUY
Consumer staples			6.8	10.0	O-WT					
ITC	176	14,933	2.9	3.0		17.2	21.1	1.8	(6.2)	U-PF
Colgate	389	1,194	0.2	3.0		25.1	22.2	2.3	5.8	BUY
Hindustan Lever	217	10,774	2.6	4.0		19.9	20.5	3.2	(15.5)	BUY
Industrials			6.3	10.0	O-WT					
Concor	2,132	3,132	-	2.0		18.8	19.0	0.9	26.8	BUY
L&T	1,443	9,133	2.1	2.0		27.9	27.9	1.7	13.3	U-PF
Crompton Greaves	209	1,236	-	3.0		42.8	14.1	0.8	18.8	BUY
BHEL	2,298	12,713	2.1	3.0		27.6	18.6	1.1	(4.0)	O-PF
Health care			5.1	7.0	O-WT					
Dr Reddy's	811	3,077	1.2	2.0		(27.0)	21.6	0.9	10.9	BUY
Cipla	251	4,404	1.2	3.0		22.5	19.8	1.0	(4.4)	BUY
Ranbaxy	392	3,299	0.8	2.0		22.6	18.3	2.2	(10.9)	O-PF
Infotech			22.2	23.0	O-WT					
Infosys	2,241	28,144	14.0	14.0		27.9	25.7	1.1	21.2	O-PF
Satyam	483	7,152	3.1	4.0		24.9	18.1	1.0	18.1	O-PF
Wipro	605	19,601	1.7	2.0		25.1	24.1	1.2	15.1	O-PF
HCL Info	159	607	-	3.0		9.5	7.7	5.0	10.2	O-PF
Materials			7.0	5.0	U-WT					
Hindalco	174	4,563	1.2	2.0		(5.8)	7.7	1.2	1.6	O-PF
Gujarat Ambuja	141	4,831	1.1	3.0		3.2	11.7	2.8	20.9	O-PF
Utilities			2.4	5.0	O-WT					
Tata Power	560	2,504	0.6	2.0		3.3	21.4	1.8	(1.3)	BUY
Reliance Energy	520	2,494	0.8	3.0		2.8	16.0	1.2	7.5	O-PF
Telecoms			4.9	3.0	U-WT					
Bharti	630	26,965	-	3.0		42.9	22.1	-	34.2	BUY
Cash				5.0						
Total			100.0	100.0						

Source: CLSA Asia-Pacific Markets

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

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