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Outlook 2012

Investment View

Rocky Path to Recovery

Executive Summary

Indian equity markets were weak even before the global sell-off commenced in August, and have since followed the regional correction. On a year-to-date basis, this has made India one of the worst performing equity and currency markets in Asia. While the earlier weakness was as a result of India-specific factors (growth weakness, stubborn inflation, reform paralysis, and governance scandals), the latest bout of weakness can best be explained by acute global risk aversion. However, despite the accumulation of headwinds in recent quarters the economy's resilience has been impressive, particularly in the services and trade sectors. Despite the high inflation and rising interest rates, consumption demand remains stable and India's rural economy remains on a solid footing.

However we expect headwinds from global conditions and lagged implications of domestic policy tightening are likely to lead to slower growth in the quarters ahead. The next couple of quarters will be crucial and any likely pick-up in project execution (aside from the interest rate dynamics) could be crucially linked to the sentiment factor. The government thus, on its part, needs to move ahead with reform measures. Nevertheless, we believe that part of the investor concerns in relation to lower growth and a lack of project execution are now priced in, as evidenced by India's sustained underperformance versus other Emerging Markets since the beginning of the year. As such, we expect a combination of monetary and government policy action to bring some confidence back and to help capex growth momentum into the second half of financial year 2013.

With the exception of a further sharp rise in oil prices and a potential runaway increase in already elevated commodity prices, we expect to see a gradual recovery in the domestic macro situation as we head into the second half of financial year 2013.

Equity Outlook

In this backdrop, we believe equity markets will mirror the economic recovery. We expect inflation to come down to ~7.5-8% levels by March 2012, post which we expect Reserve Bank to start the monetary easing which should drive the economic growth. We expect market recovery to be back ended and should see Sensex inching up only by latter half of the next year.

Fixed Income Outlook

As far as interest rates are concerned, both domestic as well as international factors indicate towards a bullish bias. Domestically, slower GDP growth combined with fall in inflation may cause RBI to cuts interest rate in Q1 or Q2 of FY2013. At the same time slower growth in the Emerging Markets along with any shocks coming from the Euro zone countries due to the sovereign debt crisis may lead to continued lower interest rates of safe haven economies. This presents a very attractive opportunity for investors in fixed income markets with a time horizon of 6 months or more as there could be a sharp fall in interest rates in the next 2 to 3 quarters. However, in case fiscal deficit continues to be high or if there is a sharp upwards movement in commodities prices globally, the fall in interest rates could be moderate.

The Indian Economy

Slowing GDP Growth Trend

India has generated considerable attention as an investment destination driven by its unique domestic consumption model, attractive demography and low correlation with global GDP growth. Barring the global economic crisis years (2008-2009), India's GDP growth has averaged 9% over past 5 years. While we are not forecasting a slowdown in India's long term GDP growth trajectory, we believe that policy uncertainties, the conflicting demands of a popular democracy on the government (particularly during busy state election years) and India Inc's rising despondency, are increasing the risk of India's - medium term - GDP trajectory slowing towards the 7% level from the average 9% over past five years (ex- crisis period).

Indian economy likely to slow to 6.7% in FY2012E; pick up to 7.3% in FY2013E

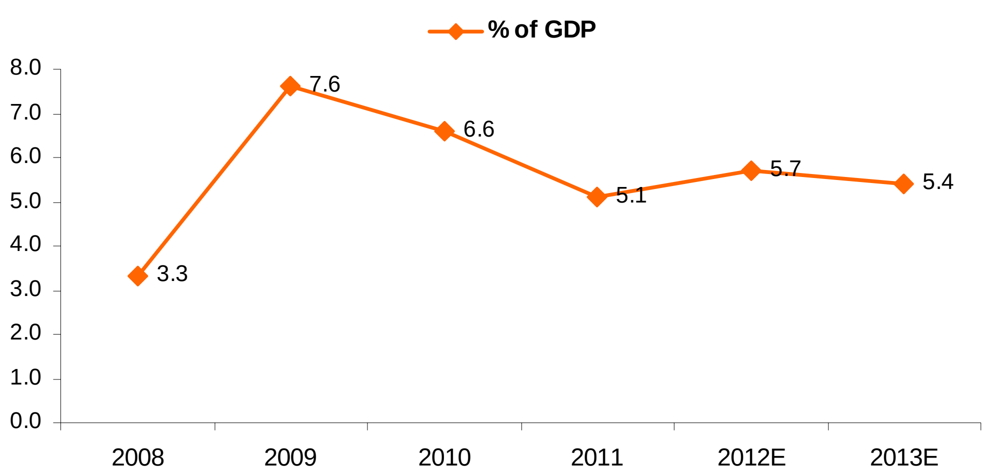
Sector	2009	2010	2011	2012E	2013E
Agriculture and allied activities	1.6	0.2	6.6	3.7	3.6
Industry	3.1	10.6	7.0	3.5	6.0
Services	9.2	8.3	9.1	8.7	8.7
Real GDP at factor cost	**6.7**	**7.4**	**8.3**	**6.7**	**7.3**

Source: CEIC, ING IM India internal estimates, December 2011

These concerns can be alleviated and the risk reduced considerably if (1) global commodity prices come off (2) clarity emerges on coal supply bottlenecks and revision in power tariffs by state electricity boards (3) return of India Inc's business confidence and inclination to invest. Currently, consumption from the Indian hinterland is doing the heavy lifting for the Indian economy. The Government's politically strategic inclusive growth initiatives are driving prosperity in the Indian hinterland.

Moving away from the path of Fiscal Consolidation

India's fiscal situation has deteriorated sharply since the credit crisis. For FY12, we expect India's consolidated fiscal deficit (including off-budget items) to remain high at 5.7% of GDP (excluding state deficits) in the wake of slowing revenue growth and lack of expenditure management by the government, compared with 5.1% of GDP in FY11 (including auction of telecom licence). The fiscal situation has been exacerbated by a combination of high crude oil price and a weak rupee leading to higher subsidy pay outs by the government.

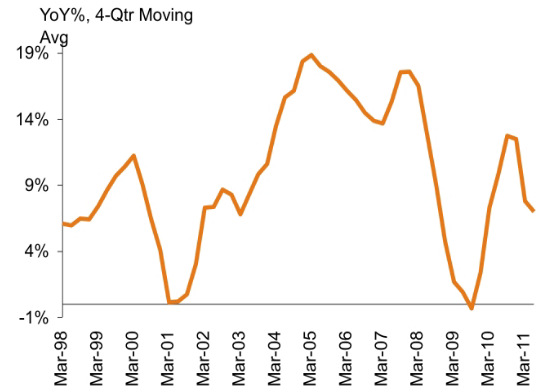


Source: Budget Documents, ING IM India internal research, December 2011

Private corporate capex to remain weak

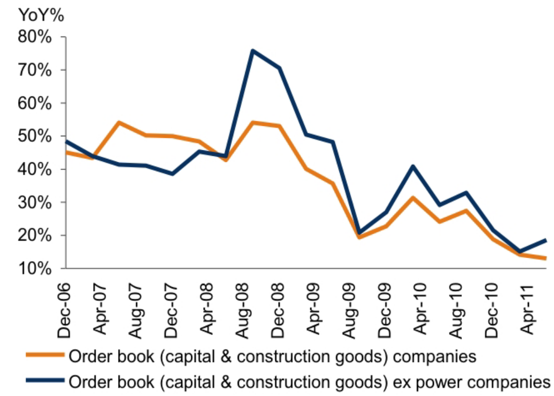
Investments have slowed sharply over the past few months, owing to (a) weak investor confidence on governance issues, (b) higher interest rates and higher inflationary pressures, (c) hindrances to project execution, (d) uncertainty about the global economy and (e) weak global capital markets. During the credit crisis, private corporate capex slowed to 11.5% of GDP in FY09 from a peak of 17.3% of GDP in FY08. While it recovered to 13.2% of GDP in FY10 and to 14% of GDP (Macquarie Research estimate) in FY11, it remains way below the peak.

Investments – Gross Fixed Capital Formation



Source: CEIC, Macquarie Research, November 2011

Order Book of Capital & Construction Goods



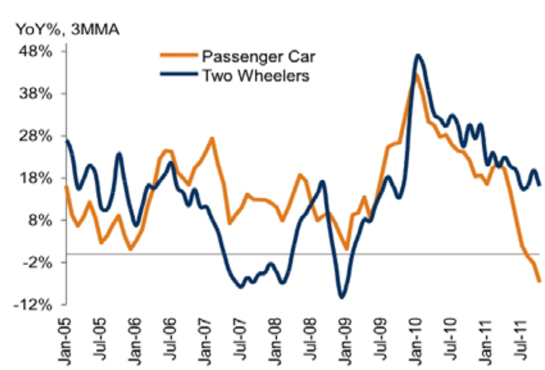
Source: Company Data, Macquarie Research, November 2011

While companies have not shelved plans of increasing capex, they are delaying or postponing it in view of policy uncertainty and slowing demand. While there is some activity in the road sector, the investments in the power sector has been impacted adversely due to concerns on coal linkages and rising losses of state electricity boards (SEBs). While we expect some recovery in corporate capex in 2HFY13, due to long gestation of investment projects, it will be visible in growth numbers only by FY14.

Consumption growth to lend some support

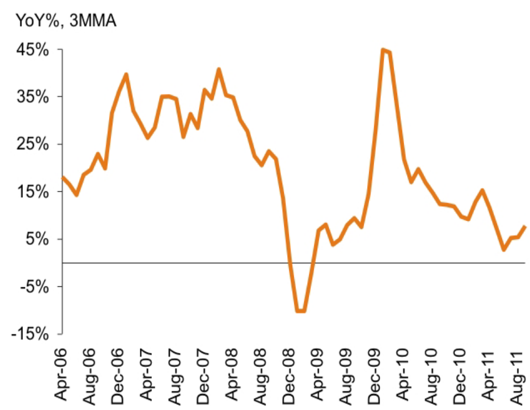
Various interest-rate sensitive consumption indicators, including passenger car sales, credit growth and consumer durables production are already showing signs of a slowdown due to higher cost of capital and loss of purchasing power in view of inflationary pressures. The slowdown in investments should also result in further slowing of consumption demand. While we expect overall consumption to be weaker than estimated earlier, the pursuance of the government's loose fiscal policy and rise in rural wages will continue to lend support to overall demand.

Passenger and 2-wheeler car sales



Source: CEIC, Macquarie Research, November 2011

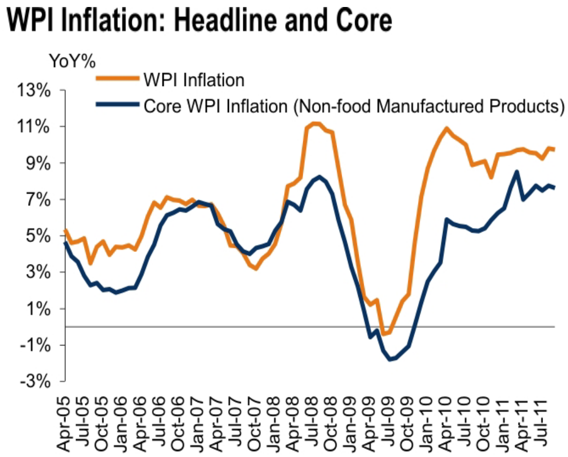
Consumer durables production

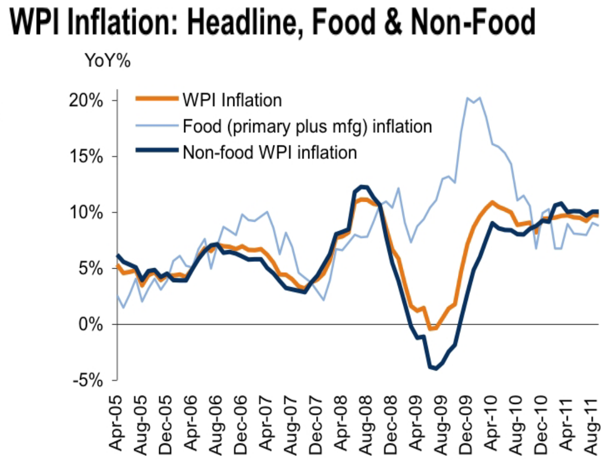


Source: Company Data, Macquarie Research, November 2011

Inflation to Moderate from current levels

Headline inflation in India as measured by the Wholesale Price Index (WPI) remained above the RBI's comfort zone of 5.0–5.5% over the last 22 months. Indeed, WPI headline inflation has averaged 9.5% over this period. On the monthly trend we expect WPI inflation to moderate toward a 7.5–8% range by end-March 2012 from 9.7% as of September 2011. The movement in global commodity prices and currency is key for the inflation trajectory going forward. However, so far any softening in global commodity prices has been largely offset by depreciating rupee.

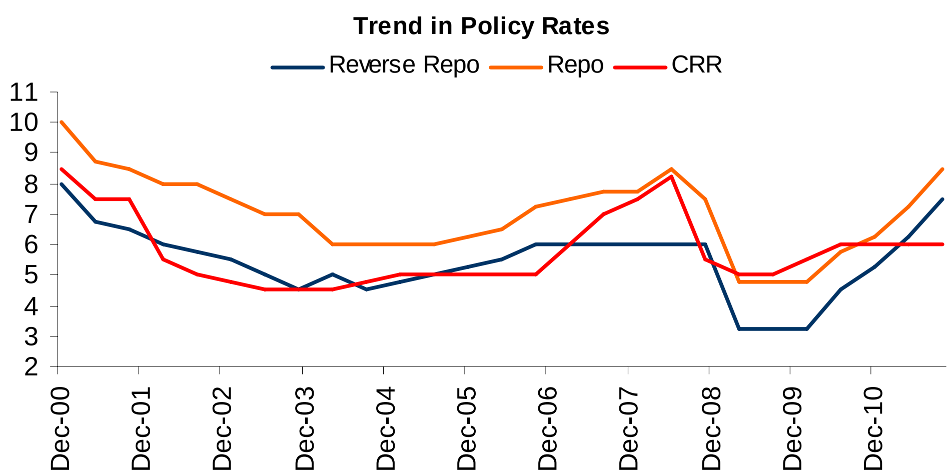




We expect WPI inflation to moderate to around the 7–7.5% level in CY2012/FY13 as the impact of sustained monetary tightening begins to impact demand and capacity utilizations across industries begin to fall. However, inflation will continue to remain above the historical average of 5–5.5%, due to a structural rise in food inflation, high global commodity prices and supply-side constraints including inadequate investment in capacity creation.

Monetary easing to begin with moderating inflation

In the last monetary policy review on October 25 2011, the RBI mentioned that the likelihood of a rate action in the December mid-quarter review is relatively low. Beyond that, if the inflation trajectory conforms to projections, further rate hikes may not be warranted. RBI's actions will depend on evolving macroeconomic conditions. We believe that we are currently at the peak of rate increases, and monetary easing will begin over the next six months. We believe the process of monetary easing will start with easy liquidity and rate cuts will follow as inflation moderates and growth slows down.



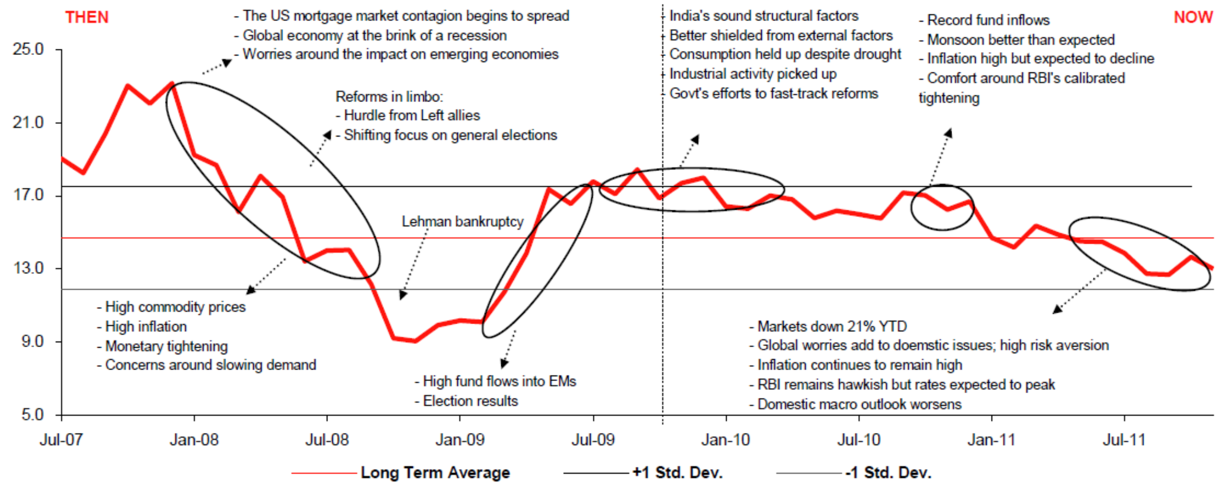
Source: Bloomberg, ING IM India internal research, December 2011

Limited leeway to use policy stimulus to boost economy

During the credit crisis in 2008, the RBI reduced the repo rate quickly by 425bp from the peak to 4.75% in a span of seven months (September 2008 to April 2009). On fiscal policy, the government's consolidated fiscal deficit (including off-budget items) increased significantly, from 4.8% of GDP in FY08 to 10% of GDP in FY09. Unlike in 2008, sticky inflation and an already-high fiscal deficit level limits policy makers' abilities to stimulate the economy via countercyclical policy tools in the event of global risk aversion and a sharp deterioration in the global economic environment.

Market Valuations

What's in the price?

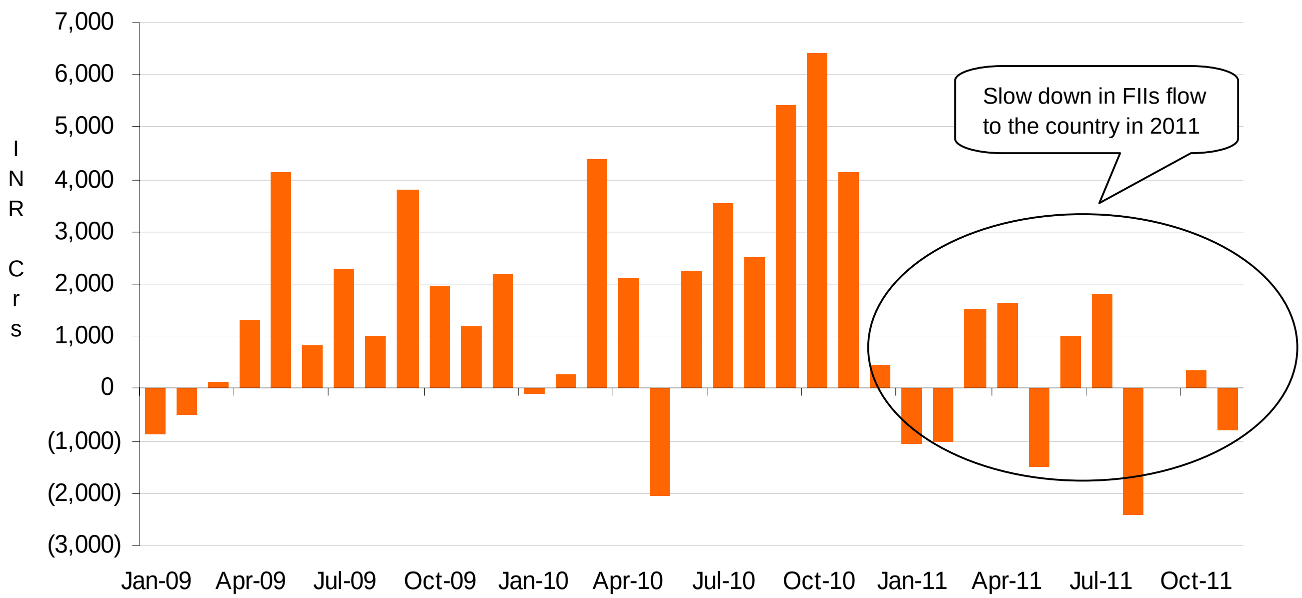


Source: Bloomberg, Macquarie Research, November 2011

Valuation provides comfort but may be misleading

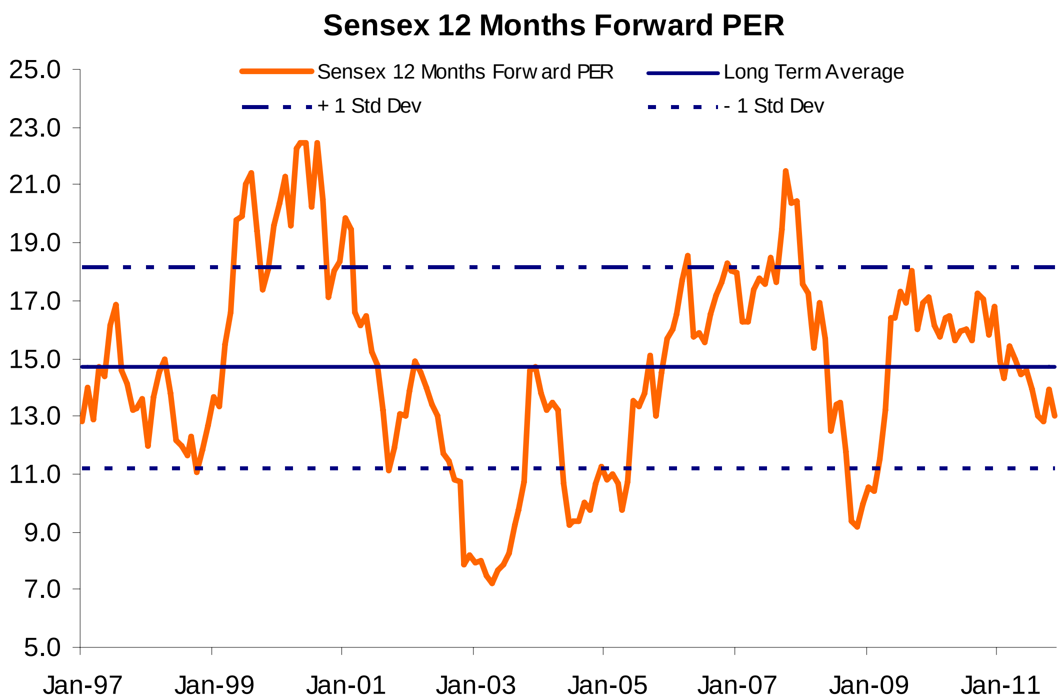
Indian market has fallen almost 18% since beginning of 2011, making it one of the worst performing market globally. While in the beginning of the year the concerns were mostly domestic viz expected slow down in growth, stubbornly high inflation, slowdown in corporate capex, etc., the later half of the year saw global factors taking over. European debt crisis significantly eroded the investors' confidence and we saw huge selling by FIIs in the last four months. In fact, FII flows to Indian market in 2011 have been much lower than the previous two years. And due to multiple macro economic challenges facing Indian economy we don't expect FII flows to turn positive in the immediate future.

Net FII Flows



Apart from the global factors, one of the key reasons for sharp fall in Sensex has been earnings disappointment. The first two quarter of FY12 saw significant slow down in earnings growth which led to sharp downward revision in earning estimates. FY12 earnings growth estimates have seen a decline from around 19% in April 2011 to around 10% currently. We believe there may be further downside risk to these numbers given that macro economic scenario is unlikely to improve in the immediate future.

While FY12E earning estimates have been revised significantly, market still is quite positive on FY13 earnings. Current consensus FY13E earning estimates still factors in ~15-20% earning growth. Unless the corporate capex picks up and government moves out of its inertia, we are unlikely to see 20% growth in FY13E. So while on the face of it the market may look reasonable at ~15.2x FY12E earnings, and 13.2x FY13 earnings, valuation will inch up as further downward revision in earnings takes place. Overall we believe the valuations are reasonable and not cheap given the challenging outlook. So a sharp recovery in the equity market looks very unlikely from valuation perspective. Even at consensus numbers, valuations are just a shade below their long term average and not overtly cheap.



Source: Bloomberg, Macquarie Research

Given this backdrop we expect market to gain meaningfully only on the back of macro recovery. We expect inflation to come down to ~7.5-8% levels by March 2012, post which we expect Reserve Bank to start the monetary easing which should drive the economic growth. We expect market recovery to be back ended and should see Sensex inching up only by latter half of the next year.

Sector Outlook

Auto:

The macro environment for the Indian Automotive Sector continues to look challenging with a sluggish demand outlook coupled with intense competition and high cost pressure. Auto Demand in India has been negatively impacted by:

• *Monetary action by RBI with a hike in policy rates (200bps since Jan-11) has impacted passenger and commercial vehicle segment demand*

• *20% increase in petrol prices along with a price difference (~Rs25/ltr) between diesel and petrol has impacted demand for petrol vehicles*

Demand for automobiles in the first half of 2012 would continue to remain weak due to a low growth outlook, high interest rates and fuel prices. Within the automobile space passenger cars and medium and heavy commercial vehicles are likely to be the worst hit. In the case of cars, lack of major demand catalysts such as 6th pay commission implementation and PSU pay revision, etc, coupled with rising interest rates and inflationary stress will continue to weigh on demand outlook over the next few quarters. Demand for Medium and Heavy Commercial Vehicles will be impacted by a slowdown in economic activity, rising interest rates and pressure on transporters' profitability. However, LCV (light commercial vehicles) and MPV (multi purpose vehicles) continue to grow strongly due to structural changes in intra-city goods transport like hub-spoke models and replacement of three wheeler goods carriers. Two-wheeler sales have continued to remain robust, driven by rural demand. Going forward we expect sales growth for two wheelers to moderate on account of a demanding base effect.

We expect a recovery in car demand in the second half of CY2012 as interest rates and inflationary pressures begin to moderate. Improvement in CV typically lags consumer driven sectors such as cars and hence we do not expect any meaningful improvement in M&H CV demand during CY2012.

Metals

Demand growth for Metals in India has slowed down significantly over the last few quarters amidst growing concerns on inflation and availability of raw materials. We expect this situation to continue in the near term as inflation is yet to be controlled and concerns on raw material availability persist. The slowdown in demand is reflected in the form of lower sales volumes and pressure on prices.

Further, evolving Indian government policies and a highly active judiciary have added to uncertainty for both existing and upcoming projects. A 26% tax on profits/amount equal to royalty has been proposed to be levied as part of the upcoming Mining Policy. This has the potential to reduce earnings by 2–10% for most companies. The recent ban on iron ore mining in Karnataka, enquiries in Goa and efforts to limit the sale of iron ore from Orissa have made near-term projections difficult. The new land acquisition bill can also increase costs for the company.

We expect a pick up in domestic demand for metals towards second half of FY2013 due to a combination of a recovery in infrastructure spending and corporate capex and a reduction in interest rates. In the near term we expect prices of metals continue to be volatile due to an uncertain outlook on the global economy and concerns of a slow-down in China. We would prefer to be invested in companies with a higher degree of raw material integration to protect against cost pressures.

Cement

While peak capacity addition in the cement industry is behind us, the concern looming in the near term is the low visibility of demand growth. The Indian cement market remains highly oversupplied and is operating at around 75% capacity utilization. However, overall prices have held up much higher than can be explained given current low capacity utilization levels in the industry. Moreover, cement prices continue to increase across most regions in the country without any meaningful increase in demand. Cement companies have successfully maintained/increased prices by compromising on capacity utilization. Hence it is supply cuts rather than demand that have driven cement prices higher over the last couple of months. Therefore, in order for cement prices to sustain, it is critical that supply discipline continues while the overcapacity situation persists. While we do expect the current down cycle in cement to have better margins than previous down-cycles, supply discipline is a difficult variable to predict given low utilization rates.

Cost pressures for the cement industry are likely to remain elevated due to higher imported coal prices on account of rupee depreciation and lower availability of coal from Coal India. However, we expect margins for most cement companies to be supported by increases in cement prices across most regions. We also expect improved Y-o-Y demand during the 1st half of CY2012 on likely revival in rural housing and infrastructure segments and a low base effect.

Industrials

2011 has not been a good year for the Industrial sector as the sector has underperformed the broader market indices by a considerable margin. We expect 2012 to be similar with problems related to high inflation and thus the corresponding high interest rates to eat up on companies' net margins and slow down the demand for capital goods. We do not expect the industrial capex cycle to revive any time soon as fears of global recession coupled with high interest rates and stalling of government reforms lead companies to rethink their expansion plans.

Power sector capacity addition has been the major growth driver for order inflows of some of the bigger construction and capital goods companies till mid of 2011, we do not think that this will continue in 2012 due to various bottlenecks encountered by generation utilities. These bottlenecks in the form of lack of environment clearance, non-availability of coal, poor financial health of SEBs, non-availability of water, land acquisition and huge surge in the prices of international coal cannot be addressed in a short span of time. This will impact companies order inflows and future growth.

On the construction sector, there has been some movement in awarding contracts for road construction by NHAI but because of lack of opportunities in the other sectors, various construction companies have been very aggressive toward bidding for these projects. We expect some of these projects to generate negative NPV for the asset owner. We expect competition to remain stiff in the sector till other industrial and commercial projects pick-up which is unlikely in 2012.

Banking and Financial Services

Last year, profitability of public sector banks was mainly driven by robust credit demand and increasing/stable net interest margins (NIMs). Lending rates were re-priced ahead of the deposit rates in a tightening cycle resulting in higher net interest margins which helped banks to offset increase in the provisioning costs for non-performing loans as well as the higher operating costs resulting from pension expense. Profitability of private sector banks was largely driven by declining credit costs.

Going ahead, we expect that the combination of factors including high interest rates, hindrances to project execution, deteriorating business confidence and uncertainty about the global economy to negatively impact investment demand and consequently banking sector will witness slowdown in credit growth. At the same time, asset quality of banks is expected to deteriorate in next 12 months as debt servicing capability of corporates will be negatively impacted due to high interest rates and input prices and weak domestic & international demand.

NIMs have peaked & will likely be under pressure next year even if interest rate cycle reverses as deposits generally re-price with lag effect. Margin pressure coupled with moderation in loan book & rising credit costs will slow down the earnings growth for the banking sector. Hence, we prefer banks with strong liability franchise and seasoned book with good asset quality which shall lower risk of earnings downgrade.

Healthcare

Improving healthcare infrastructure, coupled with rising disposable income and increasing penetration of health insurance, will aid the domestic formulations drug market in India to grow by a CAGR of 13%-14% in the coming years. The growth will largely stem from chronic ailments like diabetes, cardiovascular and neurology, which are witnessing a sharp rise in disease instances and longer treatment cycle (with early onsets).

While the Indian market will continue to be the bread and butter for Indian generic companies' earnings, it is their presence across the global market—both developed and developing—that will aid companies boost their overall growth momentum going forward. With drugs worth US$ 80-90bn losing patent over the next 4-5 years the US market remains the primary market for Indian companies, despite the intensifying competition. US generic market is expected to touch US$ 51.7bn by 2015 from ~US $ 38bn in 2010. Of this the current share of top 6 Indian companies is not more than US $2.5bn. We believe that Indian companies are well placed to tap this opportunity given that they have healthy pipeline of ANDA filings (30% market share), including a substantial presence in Para IVs and FTFs, DMF Filings (50% market share) and highest number of US FDA approved facility outside US (100). Post the patent cliff in the US we expect emerging market to remain a key growth driver in the longer term with a number of MNCs tie-ups. These markets have strong growth prospects, high profitability, low price control and high out-of-pocket expenses. Presence in the right market would be important.

On this backdrop of multiple earnings opportunities targeted by the Indian companies, we continue to remain positive on the sector and believe that the valuation premium that it enjoys is justified. Stock selection would be of utmost important to pick the winners from the sector.

Oil & Gas

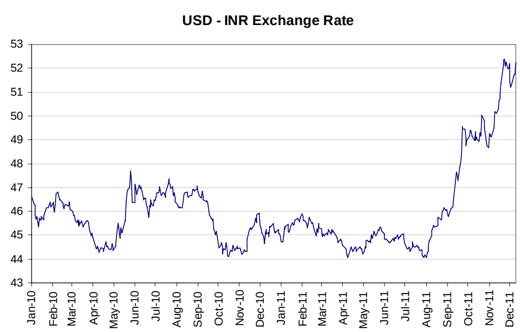
With the world delicately balanced between growth (but at slower growth rates) in China/India, increasing risk-aversion due to concerns on Euro-zone and the US still struggling to grow sustainably, oil prices have remained range bound and are expected to moderate going further. Despite crude prices having been range bound and product price hikes/duty cuts in end-July curtailing losses partially, the under-recoveries on subsidised fuels remain high due to a sharp depreciation of the rupee which has made imports costlier. A weak government fiscal situation has meant that Rs300bn of cash reimbursements promised to Oil Marketing Companies are yet to be disbursed, which has caused the working capital requirements (and hence interest costs) to balloon. While the government has stuck to 33% sharing by upstream firms for H1FY12, with the ONGC FPO being delayed there is the likelihood of a higher share being borne by ONGC/Oil India/GAIL in H2FY12E, which could hurt net realizations.

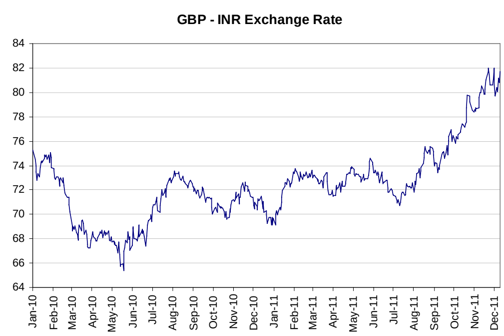
With high distillate cracks (US$13-17/bbl), naphtha/fuel oil cracks also improving due to a few refinery shutdowns in Asia, Singapore GRMs have jumped to 10 year highs. Indian operational GRMs have risen much lesser due to refineries being more leveraged to Diesel (vs. Gasoline which in case of Singapore, which has had higher cracks), but with Gasoline cracks plummeting the situation is set to reverse. However, inventory and forex losses could continue to hurt reported GRMs.

The Comptroller & Auditor General (CAG) issues with Reliance Industries, subsidy concerns due to rupee depreciation, high inflation and a weak fiscal situation have caused stock valuations to drop; presenting value in a weak market. A push towards reforms may be the catalyst needed for stocks to re-rate.

Information Technology

The IT sector in India has performed well in 2011 in spite of the global headwinds. The demand has remained resilient and while margin pressure was quite visible in the first half, significant depreciation of rupee against US$ and GBP in the latter half of 2011 led to easing of margin pressure. Rupee has depreciated almost 15% against US$ and ~10% against GBP in the last six months leading to both higher revenue growth in rupee term as well as improvement in margins.





Going forward, a lot would depend on how the global economies shape up. A deeper crisis in Euro zone can lead to significant pressure for Indian IT services companies. Demand in US has remained strong so far but any macro shock to the slowly recovering economy will have a detrimental impact on IT demand. While weakening currency will provide some cushion to the profits, strength in demand will remain the main catalyst. We remain cautious on IT sector given the macro challenges facing the global economies and expensive valuations relative to the market.

Telecom

Telecom sector has suffered significantly due to the regulatory uncertainties in the past one year and the trend does not seem to be reversing even in the immediate future. However, easing of competitive intensity has allowed some bit of tariff rationalisation which should provide much needed relief to most operators reeling under losses. In fact, Telecom will be one of the few sectors with good earning visibility in the next one year driven by improvement in margins.

We also expect New Telecom Policy to be finalised and implemented in 2012 which should lead to some clarity on the regulatory stance. However, valuations are expensive and to an extent, already discounting the better earning visibility. In this backdrop, we are neutral on the sector with a bias towards large operators.

Consumer Staples

2011 will be a formidable base for volume growth of FMCG sector. The price hikes taken during the year on continuously escalating cost pressures has gone unscathed till now, with minimal down trading. Further rise in crude oil price and a depreciating rupee, might have limited scope to be passed on.

In 2012, we see under penetrated categories, such as skin care (20% penetration) and Packaged food (10% penetration), to drive the sector growth. We expect category volume growths to taper off towards their respective long term averages, because of a higher base. We foresee well diversified players to continue to weather cost pressures through supply chain efficiencies and Advertising and Promotion (A&P) expense rationing.

Utilities

Power: 2011 saw the beginning of, power distribution reforms in the form of price hikes and, power generation uncertainties with coal sourcing. We expect 2012, to see policy initiatives on coal sourcing and mining because of immediate coal shortage. On distribution reforms, we expect more states to announce price hikes. We don't expect any "Transmission and Distribution (T&D) loss reduction" initiatives like distribution franchising etc., in 2012, because of its political implications, though they are very much on the anvil.

Gas: 2011 saw supply exhaustion on imported LNG, with capacity utilization at 115%. Capacity augmentation has already started, but we expect them to become operational by 2013. Also, with no immediate ramp up in gas output from KG basin, we expect gas transmission volume growth to remain tepid next year. City Gas transportation can see additional license issue next year, in Ludhiana, Jalandhar, Asansol-Durgapur, Jamnagar, to name a few.

Mr. Ramanathan K
Chief Investment Officer – Single Manager Division, ING Investment Management (India) Pvt. Ltd.

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Profile: ING Investment Management

ING Investment Management (ING IM) manages approximately USD 445.0 bln* of assets for institutions and individual investors worldwide. Employing more than 3,200 people, ING IM is active in 32 countries across the Americas, Asia-Pacific, Europe and the Middle East. ING IM is a business line of ING Insurance, owned by ING Group, a global financial services company.

ING IM applies its proprietary research and analysis, global resources and risk management to offer a wide variety of strategies, investment vehicles and advisory services in all major asset classes and investment styles.

ING IM is one of the largest asset managers operating in Asia Pacific with Assets under Management of USD 80.8 bln*. With regional headquarters in Hong Kong, ING IM employs nearly 1,000 people across 10 locations.

Visit www.ingim.co.in for more details.

**Figures as of 30 September 2011.*
AuM 2011 figures exclude ING Latin America, following the announced sale of these businesses on 25 July 2011.