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India Notes

As India's month-long exercise in adult franchise enters its final phase, there is no clear indication on who will emerge the winner. The release of exit polls is banned until voting is completed for all phases to avoid influencing the future phases of voting. With neither the Congress Party nor the BJP expected to get a majority, both are scrambling to woo potential allies to cobble together a coalition. But the political scene is fluid, with many smaller groups not indicating which side they will support. With the fourth round of polling, voting has been completed in a large part of the country. The last round will be held next week. Then the focus shifts to the counting of votes on May 16th. The most encouraging signal to emerge from the mammoth electoral effort is that Indian voters have slowly, but surely, recognized that casting a ballot has the potential to change their daily lives. That accounts for the exceptionally large turnout at voting booths of poor people.

Growth estimates for India in CY09 have been revised to 4.5% by IMF from 5.1% projected in January however the Indian government still maintains its 6.1% growth projections. As per IMF, the slowdown in India is primarily a result of weaker investment, reflecting tighter financing conditions and a turn in the domestic credit cycle. Nevertheless, the downward revision in case of India (and China) is much less compared with most developed countries and several Asian peers, reflecting the large domestic market in these countries.

However, many indicators from independent sources, investments that refuse to flag, rejuvenated hiring, sprightly freight movement at major ports and robust data from key manufacturing segments indicate that the downturn has bottomed out and that the economy is poised to regain its vigour.

Nomura's Composite Leading Index (CLI), UBS' Lead Economic Indicator (LEI) and ABN Amro's Purchasing Managers' Index (PMI) all point to a pick-up in growth soon. And CMIE's capex database, which tracks investments by companies, shows no significant slowdown in this space.

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Economy & Markets

India: Real activity subdued; RBI projects ~6% growth for FY10: India's real GDP growth during Q3FY2008-2009* came in at 5.3% Y-o-Y, the lowest since Q4FY2002-2003. The sharp fall in overall GDP was driven almost entirely by the 2.2% Y-o-Y decline in agriculture and allied activities in Q3FY2008-2009. The Index of Industrial Production (IIP) during February 2009 declined 1.2% Y-o-Y. This number puts the FY09 April-February number at 2.8% vis-à-vis 8.7% in FY2007-2008. Analysts believe IIP growth for FY2008-2009 is likely to remain at ~2.5%. RBI has kept its growth forecasts for FY10 at ~6.0% and has implicitly assumed normal monsoon for the year. It has also expressed its assumption of economic activity stabilising to some extent on the back of fast correction in commodity prices along with the stimulus packages introduced since H2FY2008-2009.

** FY refers to financial year in India which starts from 1st April 2008 to 31st March 2009.*

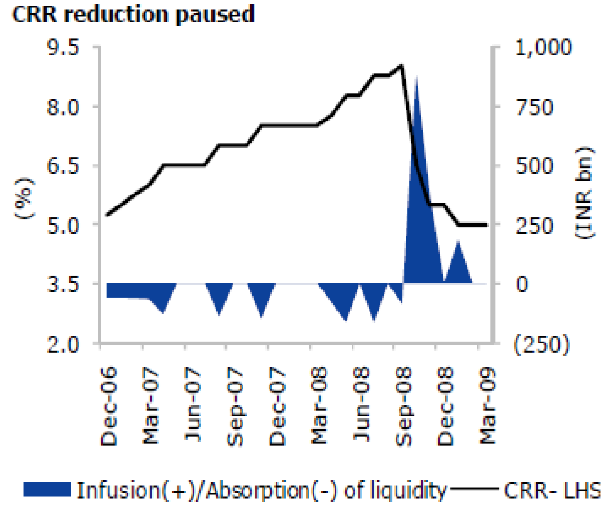
Indian Meterological Department forecasts normal monsoon; inflation in India set to turn negative: IMD, in mid April 2009, issued the first long-range forecast for rainfall in the South-West monsoon season (June-September). It says that the rainfall for the country as a whole in the said period is likely to be near normal. Quantitatively, monsoon season rainfall is likely to be 96% of the long period average with a model error of ± 5%. With rapid correction in commodity prices, both in international and domestic markets, inflation expectations have come down significantly. Base effects for WPI inflation are also likely to remain markedly favourable in the coming months. WPI inflation (Y-o-Y) is all set to fall below zero and will be in the negative zone Q1FY2009-2010 onwards.

Token cuts for key policy rates; CRR and SLR unchanged

In the Annual Policy Review for FY10, RBI cut key policy rates (repo and reverse repo) by 25bps each with immediate effect. The repo and reverse repo rates now stand at 4.75% and 3.25%, respectively. CRR and SLR, however, remain unchanged at 5.0% and 24.0%, respectively. The current move is more of a signal from the central bank indicating that it accords priority to supporting growth and is, thus, committed to a softer interest rate regime.

After the large cut in policy rates since October 2008 (400bps for repo and 250bps already for reverse repo), the current 25bps cut in policy rates is unlikely to have any material impact on the overall liquidity condition. However, the current move is more of a signal from the central bank indicating that currently it accords priority to supporting growth and is, thus, committed to a softer interest rate regime. Analysts believe, the likelihood of continued slowdown in the real economy may induce RBI to cut repo and reverse repo rates further by up to 25bps each over the next three months.

CRR reduction paused



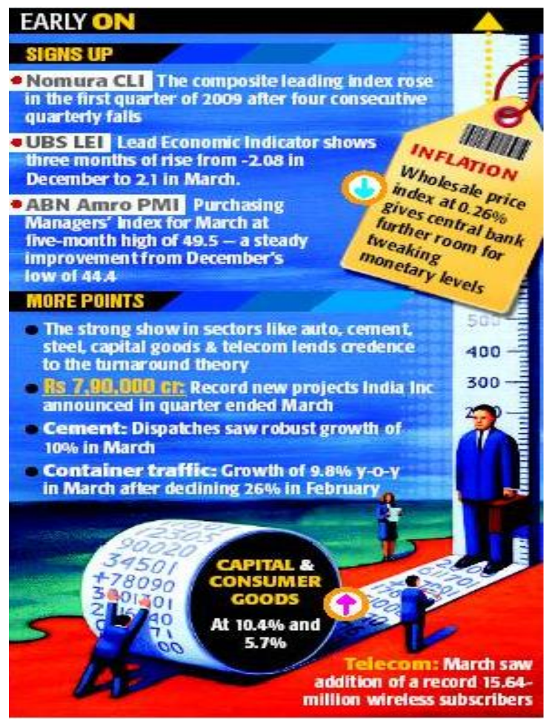
But India is still buying

Telephony creates new records: Total 15.87 million telephone connections (Wireline and Wireless) have been added during March 2009 as compared to 13.82 million connections added in February 2009. The total number of telephone connections reaches 429.72 million at the end of March 2009 as compared to 413.85 million in February 2009. With this growth, the overall tele-density has reached 36.98 at the end of March 2009 as against 35.65 in February 2009. The total wireless subscribers base stood at 391.76 million at the end of March 2009. A total of 15.64 million wireless subscribers have been added during the month of March 2009 as against 13.82 million wireless subscribers added during the month of February 2009. Indian subscriber addition dwarfs China's as China adds 4 million subscribers per month. At this rate it is only a matter of few years for India to become the biggest telecom market. India already is the fastest growing telecom market.

Robust growth in auto sales for fifth straight month: Car and two-wheeler sales saw the fifth straight month of growth in April, strong evidence that the recovery was no flash in the pan and providing increasingly rare good news for a sector reeling under the threat of global bankruptcies. Last month saw market leaders such as Maruti Suzuki, Hyundai Motors, Mahindra & Mahindra and Honda Siel better their performance over the corresponding month of the previous year, helped by the government's stimulus packages, cuts in lending rates and as elections boosted demand for vehicles, especially jeeps and SUVs. Maruti Suzuki, which makes every second car sold in India did particularly well, with a 9% year-on-year growth in April, while close competitor Hyundai Motors sold 4% more this year. Mahindra & Mahindra (M&M), with its array of SUVs and mini-trucks, saw sales jump 36%, as elections boosted demand for its products tailor-made for the rough terrain of rural India.

Preliminary Indicators turn Positive

Nomura's Composite Leading Index (CLI), UBS' Lead Economic Indicator (LEI) and ABN Amro's Purchasing Managers' Index (PMI) all point to a pick-up in growth soon and CMIE's capex database, which tracks investments by companies, shows no big slowdown in this space. A lead indicator is a composite of a variety of indices that track activity in vital economic sectors. Nomura's composite leading index (CLI)—used to identify the turning points in the growth rate cycle—rose in the first quarter of 2009 after four consecutive quarterly falls. The CLI indicates a turnaround in non-agricultural GDP growth rate with a two quarter lead time, the pick-up in the first quarter of 2009 hints at a recovery from the month of June.

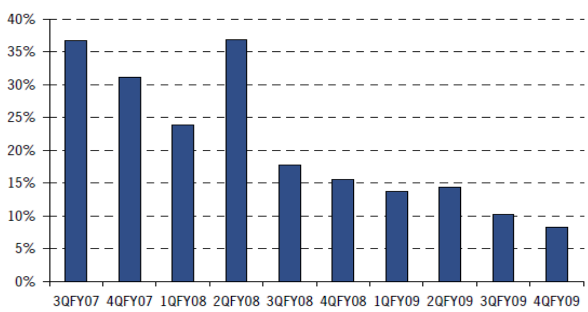


After rising for three successive months, UBS' LEI index for India now stands at 2.1; it touched a low of -2.08 last December. The LEI is a composite indicator of variables like government bond yields, M1 money supply, currency risk premium, foreign exchange reserves and stock market gains

Real Estate

Muted 4QFY09 home loan growth suggests residential demand is still to recover meaningfully. RBI data shows outstanding home loan portfolio of banks grew a modest 8% YoY in 4QFY09, down substantially from 16% seen in 4QFY08. Also growth has slowed during the year from 14% in 2QFY09 to 10% in 3QFY09 and 8% in 4QFY09

YoY Growth in Outstanding Housing Loans of Banks



- Demand for homes has been muted in FY09 on account of low affordability caused by high interest rates and property prices.

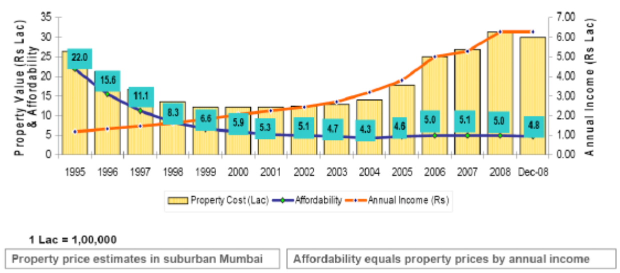
- It is only since Oct 2008 that RBI took the initiative to lower the repo rate by 425bps from 9% to 4.75% currently. Additionally, in Dec 2008 the government capped interest rates on home loans by PSU banks at 8.5%, for loans up to Rs0.5m (~€7,700), and 9.25% for loans up to Rs2m (~€31,000). House prices have also declined substantially in 2HCY08.

- With the decline in interest rates and property prices, affordability has improved. However, this has not yet translated into higher loan growth given that the weak macroeconomic environment and resulting job insecurity, and low income visibility, have adversely impacted buyer sentiment.

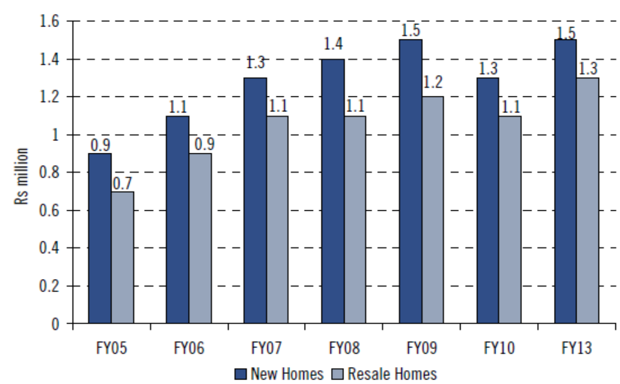
- Moreover, there is a section of buyers who are waiting on the sidelines expecting further reduction in property prices and interest rates. In the current environment buyers are opting for smaller homes and banks are becoming more conservative about LTV (Loan to Value) ratios, thus average ticket size of home loans is expected to reduce which could result in a slowdown in disbursements.

According to Crisil estimates, home loan disbursements are estimated to grow at a CAGR of 5% from FY08-FY13 vs. 31% from FY01-FY08.

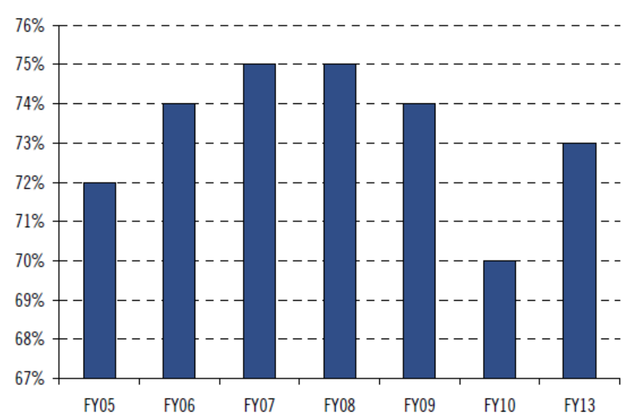
Affordability Index



Average Ticket Size of Home Loans in Urban Areas



Loan to Value Ratio in Urban Areas



Retail malls witness sharp decline in rentals; Supply down as well

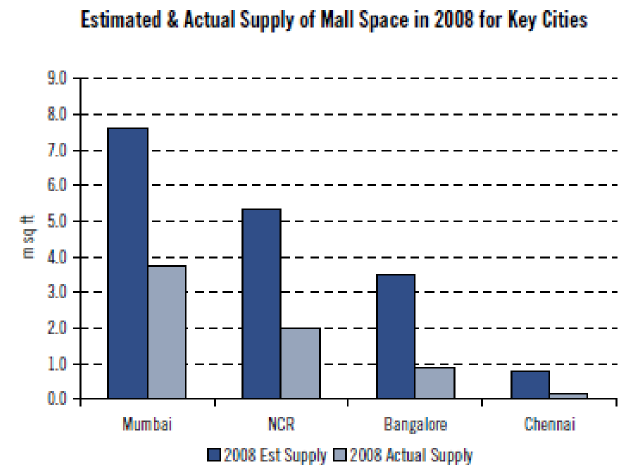
Cushman & Wakefield (C&W) data indicates declining mall rentals while data from Jones Lang LaSalle (JLL) shows a slowdown in supply of retail space and rising vacancy levels.

- Mall/High Street rentals decline 12-19% QoQ – Retail mall rentals declined 12% on an average while main street rentals declined 19% across key cities in Indian in 4Q2008 vs. 3Q2008

- Hyderabad and NCR see sharpest decline in mall rentals – Hyderabad mall rentals declined 13% QoQ in 4Q2008 while rentals declined 20% in Delhi, 21% in Gurgaon and 17% in Noida. Highest decline in main street rentals was seen in Mumbai (24%), Chennai (21%) and Delhi (18%).

- 2008 supply below estimate, slowdown in 4Q08 – Actual aggregate mall supply in Mumbai, NCR, Bangalore and Chennai was 60% lower than estimated supply at the beginning of the year. In addition, mall supply in 4Q08 was lower than that in 3Q08 for all four cities. The gap between estimated and actual supply in 2008 can be attributed to delays in mall completions because of liquidity and absorption issues.

- High vacancy levels of ~15% in Mumbai and NCR – Vacancy levels have risen steadily from 10.9% in 4Q2007 to 15% in 4Q2008 in Mumbai and from 8.8% to 14.5% in NCR. However, Southern cities such as Bangalore, Chennai and Hyderabad have lower vacancies of ~1-5%. With profitability under pressure retailers are renegotiating rentals and scaling down expansion plans suggesting



Indian Developers adopt the QIP route

Unitech has raised Rs16.2bn (€247 mn) through a QIP issue by issuing about 421mn shares at Rs38.5 per share leading to a dilution of 26% in pre-issue share capital with promoter holding falling to 53% from 67%. Halbis (Investment arm of HSBC), Prudential, GIC (the investment arm of the Government of Singapore) Och-Zif, Orient Global, Sandstone Capital & Morgan Stanley are believed to be amongst the largest investors in the QIP. Unitech has indicated that the proceeds of the issue would be utilized for part-payment of maturing debts of approximately Rs25bn (€381 mn) in FY10 with the balance amount being deployed towards construction of ongoing projects and new project launches. The equity infusion is slated to bring down Unitech's debt/equity ratio to 1.2x in FY10E from 2.1x as of March 2009. However, unaudited financial statements in Unitech's QIP document shows its outstanding debt at Rs109bn (€1.6 bn) (including Unitech Wireless estimated debt of Rs21bn (€320 mn)) as of Q3FY09. This factors in repayment of debt of Rs4bn (€4 mn) to Unitech from Unitech Wireless (through first tranche of Telenor inflow of Rs12.5bn (€190 mn) and Rs10bn (€125 mn) in FY10.

The board of property developer Indiabulls Real Estate (IBREL) has approved a plan to raise $600 million (Rs 3,000 crore) through qualified institutional placement (QIP) of securities

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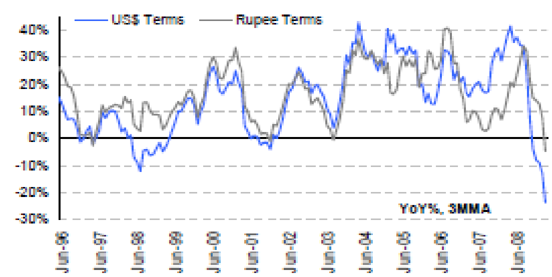
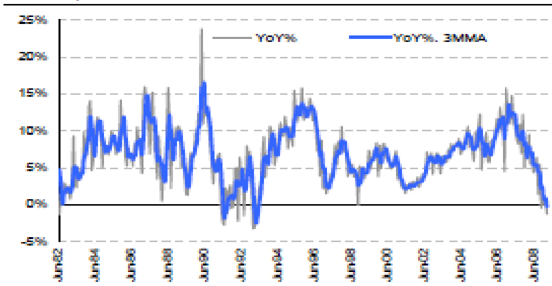
India in Graphs

Export Growth (YoY%, 3MMA)



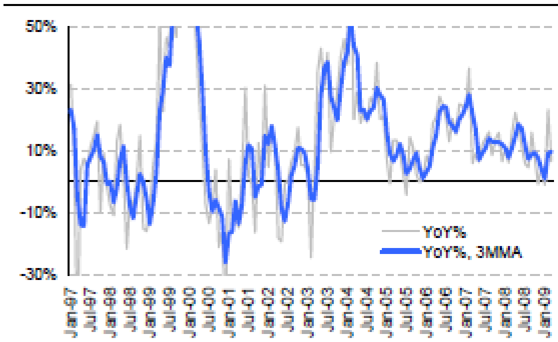
Source: CEIC, Ministry of Commerce, Morgan Stanley Research

Industrial Production Growth (YoY% and YoY%, 3MMA)



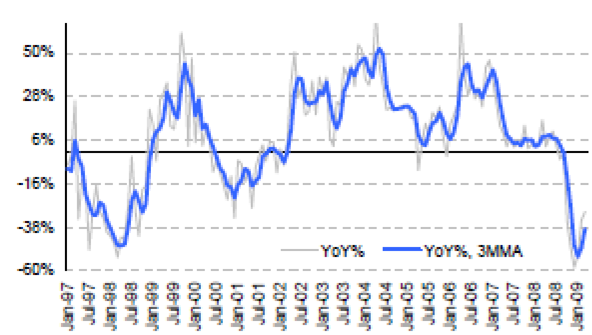
Source: CSO, CEIC, Morgan Stanley Research

Passenger Car Sales (YoY% and YoY%, 3MMA)



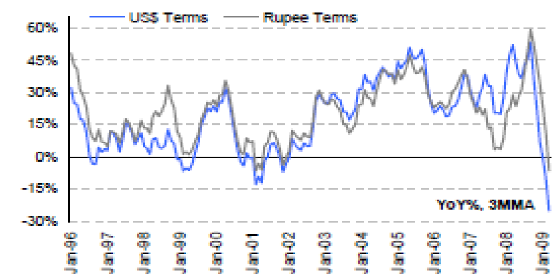
Source: SIAM, Bloomberg, Morgan Stanley Research

Commercial Vehicle Sales (YoY% and YoY%, 3MMA)



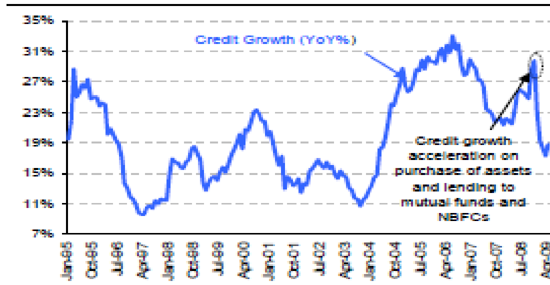
Source: SIAM, Bloomberg, Morgan Stanley Research

Import Growth (YoY%, 3MMA)



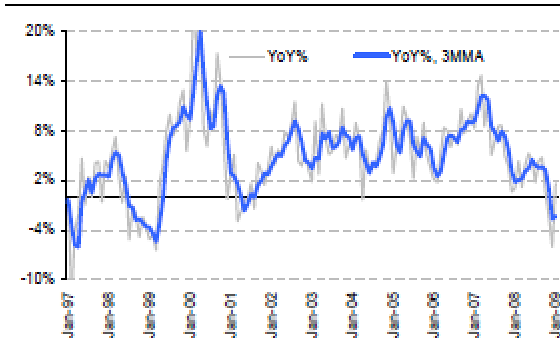
Source: CEIC, Ministry of Commerce, Morgan Stanley Research

Credit Growth (YoY %)



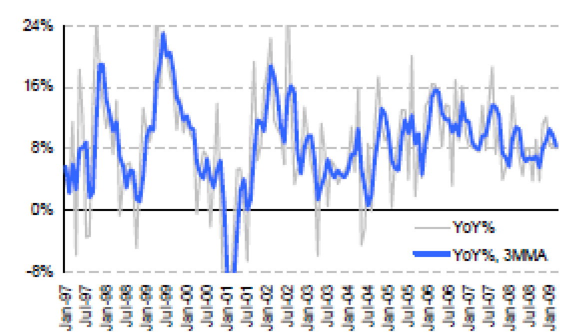
Source: RBI, Morgan Stanley Research

Steel Production Growth (YoY% and YoY%, 3MMA)



Source: CMIE, Morgan Stanley Research

Cement Dispatches Growth (YoY% and YoY%, 3MMA)



Source: CMA, CMIE, Morgan Stanley Research