The Front Page

September 11, 2008

- What's Inside: Midcap Construction, Reliance Comm (ADD), Britannia (BUY), Apollo Tyres (ADD), Events calendar

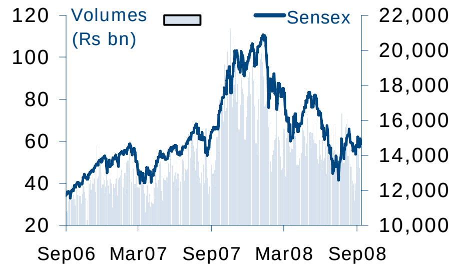
Market Front Page

Index Movements	Closing	% Chg	% YTD
Sensex	14,663	(1.6)	(27.7)
Nifty	4,400	(1.5)	(28.3)
BSE Smallcap	6,903	(0.9)	(48.3)
CNX Midcap	5,710	(0.8)	(37.9)
Nasdaq	2,229	0.9	(16.0)
DJIA	11,269	0.3	(15.0)
IBOV	49,633	2.5	(22.3)
FTSE	5,366	(0.9)	(16.9)
CAC	4,284	(0.2)	(23.7)
Turnover		US$m	% Chg
BSE		1,123	13.3
NSE		2,656	15.2
Derivatives (NSE)		11,684	19.3
FII F&O (US$m)		Index	Stocks
Net buying		(172)	(108)
Open interest		8,153	4,889
Chg in open int.		52	4
Equity Flows (US$m)	Latest	MTD	YTD
FII (9/9)	(46)	(99)	(7,357)
MF (8/9)	22	38	2,560

ADR/GDR (US$)	Latest	% Chg	% Prem
HDFC Bank	88.7	2.0	4.6
Reliance	92.6	(3.3)	0.3
Infosys	39.2	1.9	0.5
Satyam	21.5	1.1	14.6
Wipro	11.3	(0.2)	18.1
ICICI Bank	31.2	3.1	0.4
SBI	68.6	(1.3)	(1.2)
ITC	4.3	(2.3)	(1.6)
Commodities	Latest	%Chg	%YTD
Gold (US$/ounce)	757	0.6	(9.3)
Crude (US$/bl)	103	(0.7)	6.9
Aluminium (US$/MT)	2,626	0.9	9.0
Copper (US$/MT)	6,840	0.1	2.5
Forex Rates	Closing	% Chg	%YTD
Rs/US$	45.1	0.2	14.5
Rs/EUR	63.8	0.5	9.8
Rs/GBP	79.6	0.7	1.1
Bond Markets		Closing	bps Chg
10 yr bond		8.4	(9.0)
Interbank call		8.8	0.0

Charts Front Page

Sensex price volume



Sensex intraday

Corporate Front Page

- The government is planning to transfer the power management functions of **Power Grid Corp of India** into a new entity (Mint)
- **Dr Reddy's** is revamping its business model to focus on niche services; combining its custom pharmaceutical services (CPS) and API divisions (Mint)
- **Bajaj Auto** plans four new passenger and cargo vehicles (Mint)
- Saab AB, the Swedish maker of Gripen fighter plane, intends to establish an aerospace development centre in India with **TCS** (Mint)
- **Educomp Solutions** buys 50% in Eurokids for Rs390m (Mint)
- **Siemens Healthcare** to pay Rs451m on buyout of a diagnostic firm (Mint)
- **IL&FS** to pick up 50% stake in **NTPC-Bhel** venture (Mint)
- Temasek keen on part of Suuti stake in **Axis Bank** (Mint)
- **Unitech** in talks to sell stake in wireless unit (Mint)
- **TCS** and **Infosys** expect more delays in orders from US market (Mint)
- **HCL Enterprise** plans to form a venture-capital arm (BS)
- Government restarts efforts to sell **IFCI** stake (BS)
- **Electrotherm India** signs a JV with **Grasim** for captive mining of coal block in Chattisgarh (BS)
- **Gujarat NRE Coke** plans rights issue (BS)
- **L&T** gets US$160m order from Petrobras (BS)
- Vodafone fears **Essar** may further dilute BPL stake (BS)
- A shareholder of **GHCL** has filed a petition to seek adjournment of the AGM on fears of destabilisation of existing management (BS)
- **Kingfisher Airlines** plans to raise US$400m (BS)
- The research arm of **Orchid Chemicals** is planning a public issue by June 2009 (BS)
- **Dewan Housing** arm lines up US$250m real-estate fund (BS)
- Japanese spirits giant, Suntory, is looking to acquire 10-15% stake in **United Sprits** (ET)

Market Front Page

Top Movers BSE 200

Top Gainers	Price (Rs)	Chg (%)	YTD (%)	Top Losers	Price (Rs)	Chg (%)	YTD (%)
Adani Enterprise	657	7.5	-42.8	Sterlite Ind.	508	-11.8	-51.0
EIH	156	7.2	-15.6	Jindal Steel & Pow	1659	-7.9	-46.1
Bank Of Baroda	309	5.5	-32.7	JSW Steel	661	-7.5	-49.9
Bajaj Auto	620	4.6	-	SAIL	139	-6.9	-51.1
Madras Cements	2645	3.6	-41.7	Tanla Solutions	199	-5.9	-47.7

Volume spurts

Company	CMP	M.Cap	Vol. (in '000)	10D A.Vol (in '000)	% Chg
EIH	156	1,361	2,942	402	631
Jindal Saw	631	729	1,499	213	603
Corporation Bank	280	890	813	139	486
United Breweries	172	917	667	127	425
Adani Enterprise	657	3,592	1,171	289	305
Sterlite Ind.	508	7,969	13,364	3,403	293
Tata Teleservice	27	1,150	23,320	6,724	247
Mphasis	247	1,142	1,394	407	242
Zee Ent	234	2,252	3,706	1,167	218
Gujarat Fluoro	205	525	223	70	217

FII - FII trades

Scrip	9/9/2008			10/9/2008		
	Volume '000	Price	Prem %	Volume '000	Price	Prem %
Tata steel	1,028	570	1.0	1,047	550	0.2
Sbi	50	1,608	3.2	1,070	1,605	2.5
Grasim inds	18	2,074	1.5	12	2,074	1.5
Union bank	85	160	5.5	1,627	159	5.0
Obc	120	185	2.5	-	-	-
Pantaloon	10	415	21.0	3	410	19.0

Corporate Front Page

- **Reliance Industries** incorporates two wholly-owned subsidiaries for London and Singapore market (BL)
- Bharti promoters acquire additional 0.5% stake in **Bharti Airtel** for Rs8.3bn (ET)
- Nokia Siemens, Ericsson, Alcatel-Lucent, Huawei and ZTE submit bids for US$9bn **BSNL** tender (ET)
- **Gammon India** acquires 50% stake in Italy-based power company Sofinter (ET)
- Israel's SC stops **Sun Pharma** from closing Taro open offer (ET)
- Awaita properties acquire controlling stake in **JPT Securities** (ET)
- **NHPC** plans a follow-on offer after its proposed IPO in October (ET)
- NTT DoCoMo in talks to pick up stake in **Tata Teleservices** (ET)
- **Usher Agro** enters into MoU with Satake Corp, Japan, for expansion of rice-milling capacity (ET)
- **Bank of Rajasthan** enters into MoU with **ICRA** (FE)
- **United Breweries**, Heineken in discussion to resolve Asia-Pacific issue (BL)
- **JSW Steel**, **Ispat Industries** cut prices by Rs2,000 per tonne effective from 1 September (BL)
- **Sel Manufacturing** to set up textile park for an investment of Rs5bn (BL)
- **Era Infrastructure** secures order worth Rs1.29bn from AAI (BL)
- **GVK Power** and NPCIL plan to buy reactors from GE Westinghouse (BL)
- **BPCL**-Kochi refinery to set up bottoms upgradation project (BL)
- **Reliance Industries** evaluating development plans for D6 satellite fields (BL)
- **Sobha Developers** to construct 40 premium villas in Kerala for Rs1bn (BL)
- **DLF** secures SEBI approval to buy back shares worth Rs11.10bn at a price not exceeding Rs600/share (BL)

Economy Front Page

- Shipping companies plan fixed rates for long-term deals (Mint)
- Banks have three months left for complying with a directive by RBI to treat advances given to equity-oriented mutual funds as capital market exposure (Mint)
- India's ranking falls two notches to 122 in a global list that ranks the ease of doing business in 181 economies (BS)
- Core infrastructure growth slows to 4.3% in July from 7.2% in the corresponding period last year (ET)
- Rupee hits two-year low, breaches 45 against the dollar (FE)
- Finance Ministry asks DoT to consult on the fees to be paid by telecom operators to extend license for 10 more years (ET)
- DTH service providers in talks with media planners and brands to sell space for advertisement (ET)
- Railways record 9% increase in freight traffic during April-August 2008 (ET)
- Government to consider proposal to enable banks and financial institutions to fund acquisition of farm land overseas (ET)
- Private companies may be allowed to run, operate and own metro rail networks (ET)
- Central Drug Standard Control Organisation set to simplify regulatory norms for Pharmaceutical industry (ET)
- Government to consider TRAI proposal to hike FDI in news channels (BL)

Insider Trading

Company	Name of Acquirer / Seller	Transaction Date	Buy / Sale	Quantity	Price (Rs)	Deal Size (Rs m)	Shares Transaction (%)	Holding after Transaction (%)
Arshiya International Ltd	Mrs. Archana A Mittal	05/09/2008	Buy	310,656	167.0	52	0.5	37.0
BSEL Infrastructure Realty Ltd	Contact Consultancy Services Pvt Ltd	04/09/2008 - 08/09/2008	Buy	301,138	42.0	13	0.4	3.9
Core Projects & Technologies Ltd	Wisdom Global Enterprises Ltd	05/09/2008	Buy	1,650,000	283.0	467	1.9	48.2
IOL Chemicals & Pharmaceuticals Ltd	Mayadevi Polycot Ltd	--	Buy	1,645,500	139.0	229	10.8	46.0
Shree Ashtavinayak Cine Vision Ltd	Dahlia Traders Pvt Ltd	08/09/2008	Buy	25,000	540.0	14	0.2	32.4
Shree Ashtavinayak Cine Vision Ltd	Dahlia Traders Pvt Ltd	09/09/2008	Buy	25,000	543.0	14	0.2	32.6

Deal Size worth more than Rs10m considered

BSE/ NSE - Bulk Deals

Company	Name of Acquirer / Seller	Transaction Date	Buy / Sale	Quantity	Price (Rs)	Deal Size (Rs m)
Apar Industries Limited	Reliance Capital Trustee Co Ltd-A/C Reliance Diversified Pow	10/9/2008	Buy	362,600	164.5	60
Apar Industries Limited	Allianz Bajaj Life Insurance Co.Ltd.	10/9/2008	Sell	362,859	164.5	60
Jindal Saw Limited	Merrill Lynch Capital Markets Espana S.A. Svb	10/9/2008	Buy	396,884	628.3	249
Usher Agro	Swiss Finance Corporation Mauritius Limited	10/9/2008	Sell	188,550	184.1	35

Annual report analysis — 11 Sep 2008

Mid-cap contractors would continue to face margin pressures due to rising input prices and borrowing costs. Most contractors' leverage has increased but there is still room for further debt-raising to fund growth in the core business. However, increasing leverage would temper contractors' enthusiasm for asset ownership businesses. Based on growth profile and ability to withstand external headwinds, IVRCL and Simplex remain our top picks.

Divergent impact of input price inflation: In addition to analysing proportion of fixed-price contracts in order books, we also examined companies' accounting policy for inventory valuation, to assess the extent of margin compression in FY09. In an inflationary environment, FIFO method of valuing inventory would result in delayed transmission of input prices into margins. Based on order book profile and accounting policy followed, we believe that Simplex's margins should be the most resilient, whereas those of Gammon should witness the most compression (in the organic business).

Worsening working-capital cycle would entail higher short-term borrowings: Over the past 2-3 years, the operating cycle has worsened for most construction companies. The consequent increase in short-term borrowing combined with the upward trend in interest rates caused a rise in interest expenses. Patel Engineering (112 to 139) and HCC (130 to 146) have seen the highest increase in working-capital cycle in FY08, while Simplex's working-capital intensity has abated by 20 days (106 to 86).

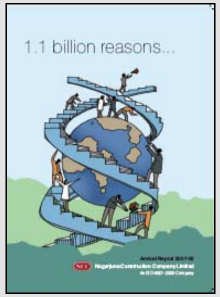
Increasing leverage to translate into higher interest costs: Almost all contractors under our coverage increased borrowings to finance the increase in working capital and investment commitment in their infrastructure and real-estate subsidiaries. Although debt-equity ratios have increased (1.7x to 1.9x for HCC, 0.5x to 1.2x for Patel), they are still low compared to historical levels, and there is still room to fund growth by raising debt. Nonetheless, increasing leverage would translate into sharp increases in interest costs, resulting in net margin compression. Also, the companies would likely reduce focus on asset businesses.

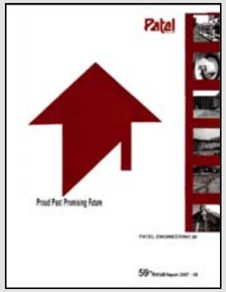
Decreasing profitability and higher working-capital affecting return ratios: Construction contractors' returns on equity have deteriorated over the last couple of years on account of increased investment in subsidiaries, lower profitability and increase in interest expenses. With margins remaining under pressure, return ratios are unlikely to improve.

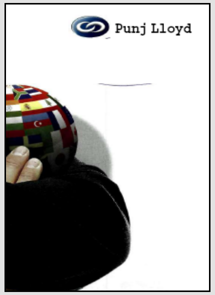
Financial summary

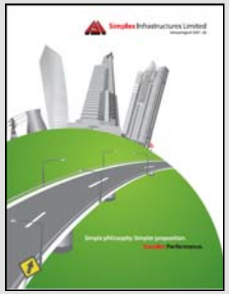
		Mkt cap	Order book	Book-to-bill	FY08-10ii	PER (x)		Adjusted PER (x)	
Company	CMP (Rs)	(US$ m)	(Rs bn)	(x)	EPS CAGR	FY09ii	FY10ii	FY09ii	FY10ii
Punj Lloyd	301	2,142	201.6	2.2	38%	16.4	14.1	15.4	13.3
IVRCL Infra	301	907	124.0	3.2	15%*	17.8	14.6	10.8	8.8
Nagarjuna	135	691	121.5	3.3	18%	17.7	13.8	9.8	7.7
Gammon	214	542	90.0	3.8	31%	19.6	16.0	9.8	8.0
HCC	100	568	82.6	2.5	15%	21.7	17.7	17.3	14.1
Patel	406	537	60.0	3.0	-1%*	19.9	16.4	15.5	12.8
Simplex Infra	469	571	100.0	3.1	58%	16.9	11.6	16.9	11.6

*We assume full tax rate of 33% over FY09-10ii, resulting in lower EPS CAGR. Source: IIFL Research









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Raw-material price inflation is a concern

During our recent interactions, almost every contractor mentioned increase in raw-material prices as one of the key concerns. However, the degree of concern varied across companies. Those with large proportions of order books having pass-through clause—IVRCL Infra, Patel Engineering and Simplex Infra—were less concerned than others about impact of raw-material prices. Hence, we build in stable margins over FY08-10ii for these companies.

In comparison, HCC, Nagarjuna and Gammon have smaller buffers from pass-through clauses. We have built greater EBITDA margin erosion for these companies. However, HCC's reported EBITDA margins should improve as cessation of losses on its Bandra-Worli sea-link project should offset impact on gross margins. Gammon's reported EBITDA margins would also witness an expansion due to merger of its associate ATSL, whose margins are substantially higher than its parent company's.

IVRCL, Patel Engineering and Gammon determine inventory holding (and hence raw-material expenses) on 'first in first out' (FIFO) basis. In the current situation of rising raw-material prices, this would lead to lower EBITDA margins, as the high-cost raw-material inventory is accounted. Other companies use the weighted-average method to determine inventory holding.

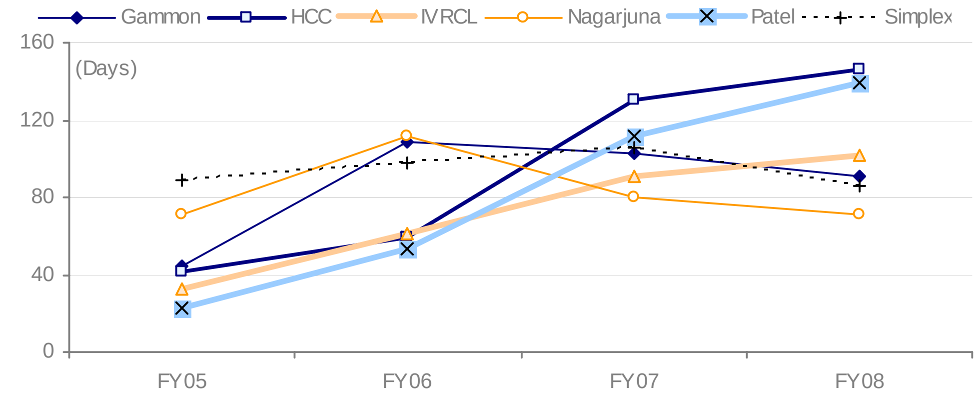
Based on order book profile and accounting policy followed, we believe that Simplex's margins should be the most resilient, whereas those of Gammon should witness the most compression (in the organic business).

Working-capital cycle worsened during FY08

The working-capital cycle worsened for most contractors during FY08. A longer working-capital cycle would translate into an increase in short-term borrowing. Combined with the upward trend in interest rates, this would result in higher interest expenses. We estimate a sharp increase in these companies' interest costs.

Some contractors have tried to contain increases in their operating cycle through sharp increases in current liabilities. In our view, this would not be of much help. Sharp increases in creditors, either due to delayed payments to raw-material suppliers and sub-contractors, or due to increased contractee advances, would show up in EBITDA margin contraction.

Figure 1: Working-capital cycle has worsened over the years



Source: Company, IIFL Research
Note: Current assets are adjusted for loans to subsidiaries

For HCC, adjusted operating cycle increased from 130 days in FY07 to 146 days in FY08, driven by higher inventory days (the company classifies receivables in uncompleted contracts also as inventory), and reduction in current liabilities. However, a reduction in loans and advances days helped contain the overall increase in operating cycle.

Figure 2: HCC's operating cycle has worsened

	FY05	FY06	FY07	FY08
Inventory days	136	154	220	230
Debtor days	1	1	0	0
Loans and advances days	20	27	42	38
Current liability days	109	116	123	110
Provision days	6	6	7	6
Operating cycle	**41**	**61**	**134**	**153**
Adj. operating cycle*	**41**	**59**	**130**	**146**

Source: Company, IIFL Research *adj. for loans and advances to subsidiaries

IVRCL's adjusted working-capital cycle worsened in FY08, driven by an increase in inventory at both factory and project sites and higher loans & advances. Loan to IVR Prime declined as it repaid ~Rs1bn to IVRCL. However, loans to other subsidiaries/associates increased by Rs777m. Decrease in current liability days also led to a worsening in the working-capital cycle. The company opted for cash purchase from suppliers to avail the offered discount, leading to a decrease in current liabilities. The overall increase was contained on account of the decline in receivable days from 88 days in FY07 to 64 days in FY08.

Figure 3: IVRCL Infra increased cash purchases to avail discount

	FY05	FY06	FY07	FY08
Inventory days	6	6	9	14
Debtor days	84	96	88	64
Loans and advances days	28	24	65	74
Other current assets days	83	90	85	85
Current liability days	152	142	115	90
Provisions days	3	3	3	2
Operating Cycle	**47**	**70**	**129**	**146**
Adj. operating Cycle	**33**	**61**	**91**	**102**

Source: Company, IIFL Research *adj. for loans and advances to subsidiaries

Nagarjuna's adjusted working-capital cycle improved from 80 days in FY07 to 71 days in FY08. While the inventory increased in line with revenue, debtor days increased sharply, to 76 days from 56 days in FY07. Loans and advances too increased sharply, driven by higher advance to subsidiaries. However, overall adjusted working-capital cycle improved owing to the increase in payable cycle and increase in advance from clients. The improvement in headline working-capital intensity is driven by a sharp jump in current liabilities. In our view, this would translate into EBITDA margin pressures, as higher advances from suppliers and customers come at a cost.

Figure 4: Higher current liabilities helped reduce Nagarjuna's operating c-cycle

	FY05	FY06	FY07	FY08
Inventory days	39	54	50	50
Debtor days	42	49	56	76
Loans and advances days	68	85	92	124
Current liability days	71	66	100	144
Provision days	8	8	11	17
Operating Cycle	**71**	**114**	**89**	**89**
Adj. operating Cycle	**71**	**112**	**80**	**71**

Source: Company, IIFL Research *adj. for loans to subsidiaries

Patel Engineering's adjusted working-capital cycle increased from 112 days in FY07 to 139 days in FY08. This was driven by inventory days increasing by 19. Receivable cycle too increased by 8 days to 2.5 months during FY08. Patel Engineering does not include advances from clients in current liabilities; it reports it as client advances in liabilities. For the purpose of comparison we have included client advance in current liabilities.

Figure 5: Patel's inventory and receivable days have increased consistently

	FY04	FY05	FY06	FY07	FY08
Inventory days	43	65	86	103	122
Debtor days	35	48	55	67	75
Loans and advances days	71	75	74	78	75
Current liabilities days	132	165	162	137	133
Provision days	1	2	1	0	0
Operating cycle	**17**	**23**	**53**	**112**	**139**

Source: Company, IIFL Research, *Adjusted for advance from clients which is reported as debt

Simplex Infra's adjusted working-capital cycle improved from 106 days to 86 days, primarily driven by a significant decline in debtor days. Its overall payable days remained stable despite an increase in proportion of advance from clients (driven by a strong increase in order inflow).

Figure 6: Simplex Infra improved its operating cycle

	FY05	FY06	FY07	FY08
Inventory days	45	46	50	49
Debtor days	121	128	149	129
Loans and advances days	16	19	27	30
Other current asset days	10	10	9	8
Current liability days	102	103	128	129
Provisions days	1	1	1	1
Operating Cycle	**89**	**98**	**106**	**86**

Source: Company, IIFL Research

Gammon's operating cycle improved, led by increase in payables cycle and increase in provisions. The overall improvement was limited, as receivable days increased.

Figure 7: Gammon

	FY04	CY04*	FY06**	FY07	FY08
Interest accrued receivable days	1	1	1	1	1
Inventory days	73	96	127	99	96
Debtor days	52	63	76	53	64
Loans and advances days	33	45	73	84	81
Current liabilities days	142	153	114	114	122
Provisions days	2	2	3	13	22
Operating Cycle (days)	**15**	**50**	**116**	**110**	**98**

Source: Company, IIFL Research, *9 months **15 months

Punj Lloyd's operating cycle remained stable, as the increase in receivable days was offset by a similar increase in payables days. Similar to NJCC, Punj Lloyd's increase in liability days is a cause of worry, despite headline net working capital days remaining constant.

Figure 8: Increase in payables helped Punj Lloyd to maintain stable operating cycle

	FY05	FY06	FY07	FY08
Inventory days	86	147	89	88
Debtor days	57	80	58	78
Loans & advance days	36	44	24	26
Current liabilities days	71	99	116	138
Provision days	2	5	12	11
Operating Cycle days	**106**	**170**	**49**	**50**

Source: Company, IIFL Research

Increase in leverage to translate into higher interest costs

Almost all of the construction contractors under our coverage increased borrowings to finance increases in working capital and investment commitments in their infrastructure and real-estate subsidiaries. Though debt-equity ratios increased, they are still low compared to historical levels and there is still room to fund growth by raising debt. Nonetheless, increasing leverage would translate into sharp increases in interest costs, resulting in net margin compression.

Figure 9: Leverage has increased

Debt/Equity (x)	FY05	FY06	FY07	FY08
Gammon India	0.8	0.2	0.3	0.3
HCC	1.2	1.5	1.7	1.9
IVRCL Infra	0.6	0.8	0.4	0.7
NJCC	0.4	0.2	0.4	0.4
Patel Eng	1.6	1.8	0.5	1.2
Punj Lloyd	1.4	0.5	1.3	0.6
Simplex	3.3	1.9	2.5	1.0

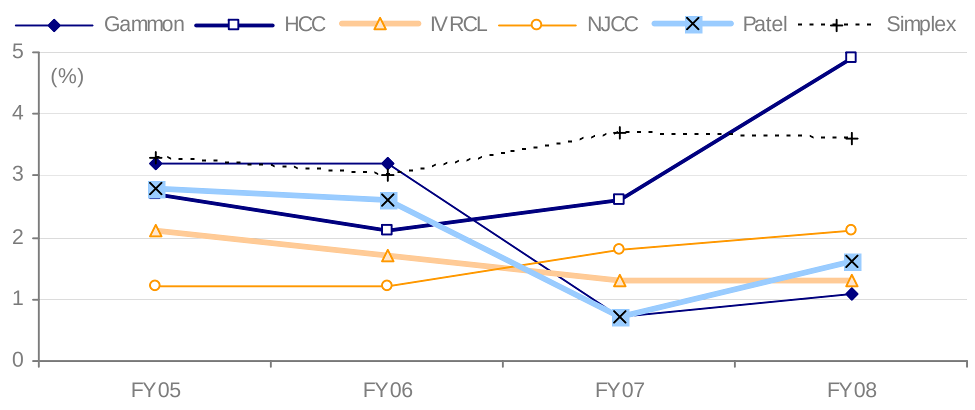
Source: Company, IIFL Research

- HCC's debt-equity ratio increased from 1.7 as at end-FY07 to 1.9x as at end-FY08. Debt includes Rs4.46bn FCCB raised in end-FY06. The FCCB has 5-year tenure and a conversion price of Rs248. However, 6.5% YTM means that FCCB holders would break even if the stock price is Rs340 by FY11.
- IVRCL's overall debt-equity ratio increased from 0.4x as at end-FY07 to 0.7x as at end-FY08.
  - IVRCL raised Rs268m debt to part-finance its capex. It also raised a working-capital loan of Rs1.6bn for infra projects, where no project-specific funding has been done. This was 45.3% of the working-capital loan as at end-FY08.
  - Short-term unsecured loans increased significantly, from Rs549m to Rs4.6bn for temporary needs. These are due for payment by end-FY09.

- Patel Engineering's debt-equity ratio increased from 0.5x to 1.2x. The money raised through FPO in FY07 was fully utilised, so the company increased its total borrowings from Rs3.42bn in FY07 to Rs9.76bn to FY08.
- Nagarjuna's total debt went up from Rs6.4bn to Rs8.9bn, primarily because of an increase in working-capital requirement. Working capital demand loans went up from Rs1.98bn to Rs4.2bn. However, D/E remained unchanged at 0.4x because of equity dilution to Blackstone Group.
- Simplex Infra's debt-equity ratio currently stands at 1x, sharply lower than the 2.5x in FY07, as the company raised Rs4bn through a QIP and also issued warrants to promoters. Borrowings increased marginally.

Higher borrowings combined with higher interest rates led to a sharp rise in interest costs. Interest cost as proportion of sales increased across companies.

Figure 10: Interest expense as proportion of revenue has increased



Source: Company, IIFL Research

Returns under pressure

Construction companies' returns on equity have declined primarily because of decline in net profit margins and higher investments in subsidiaries

- Patel Engineering and IVRCL continue to claim tax benefits under section 80IA and hence have a lower tax rate, resulting in better return on equity and on invested capital.
- Patel Engineering also benefits from better EBITDA margins due to its focus on hydro power, water and sewerage sector.
- Simplex Infra's higher ROE as compared to peers is driven by higher asset turns.
- Improvement in HCC's return ratios was driven by a marginal increase in net profit margin, combined with better asset turnover and higher leverage.

Figure 11: RoIC has remained stable

%	FY05	FY06	FY07	FY08
Gammon India*	18.6	14.6	9.3	8.0
HCC	17.8	9.4	6.8	11.0
IVRCL Infrastructure	15.8	16.2	13.3**	12.9**
Nagarjuna Construction	16.6	13.5	16.1	15.3
Patel Engineering	19.7	21.5	13.4**	11.9**
Punj Lloyd	13.6	9.6	12.8	13.9
Simplex Infrastructure	15.1	14.3	14.3	15.5

Source: Company, IIFL Research, *Gammon FY05~9MCY05, FY06~15MFY06
Note: RoIC = (PAT+Interest)/(Fixed asset + Net CA), **adjusted assuming tax rate of 30%

Figure 12: RoE has deteriorated because of increased investments in subsidiaries

%	FY05	FY06	FY07	FY08
Gammon India*	18.6	12.5	9.5	7.4
HCC	26.6	13.3	8.8	11.5
IVRCL Infrastructure	18.4	21.1	14.4**	13.6**
Nagarjuna Construction	23.5	16.4	15.3	12.6
Patel Engineering	35.5	43.9	19.3**	15.3**
Punj Lloyd	2.2	6.6	16.4	16.0
Simplex Infrastructure	26.3	24.5	21.1	17.5

Source: Company, IIFL Research, *Gammon FY05~9MCY05, FY06~15MFY06
**adjusted assuming tax rate of 30%

Other annual report highlights

Gammon India – auditors draw attention to contingent liabilities and weak internal audit systems

- Auditors draw attention to recognition of turnover of Rs570m and the recoverability of the said amount of sundry debtors, which is dependent upon the final outcome of the appeals/disputes getting resolved in favour of the company.
- Unlike peers, the Company has been setting some amounts into special contingency reserves to meet any possible contractual losses/liabilities/claims. During this year, an amount of Rs200m was transferred to the Special Contingency Reserve. However, the reserves are carved from general reserves and not provisions charged to the P&L.
- Although the Company has an internal audit system, in the opinion of the auditors, "*the same requires to be further strengthened to make it commensurate with the size of the company and the nature of its business".*
- Company's leave encashment liability is entirely unfunded.
- Outstanding unsecured loans of Rs296m to subsidiaries have no stipulations for repayment of interest and principal.
- Counter-guarantees given to Bankers and other corporate guarantees on behalf of subsidiaries, associates and JVs stand at Rs23bn vs. Rs15.7bn in FY07. This would further increase by Rs3.1bn in FY09 on account of debt raised for funding the Italian acquisitions.
- Consolidated statements - Change in policy of amortisation of goodwill resulted in profit for the year being higher by Rs1.4bn
- The Company has also entered into five cross-currency forward contracts of JPY1.5bn, which are outstanding towards hedging of a specific currency risk. In respect of one currency-swap derivative contract entered into by the Company, the Company has mark-to-market loss of Rs46m as of FY08, for which company has made a provision (included in finance expense).
- Un-hedged foreign currency exposure as at end-FY08
  - Receivables - Rs612m vs. Rs1,854m in FY07
  - Payables - Rs1,284m vs. Rs1,069m in FY07
- The company added 400 employees during the year. Further, in order to retain the trained manpower, the company had introduced a stock option scheme in FY07. Out of the total 2m options, 1.5m options have been granted to employees till date.
- Considering the significant opportunity in the rail transportation sector, the company is planning to bid for the planned dedicated rail corridor.

Figure 13: Loans to subsidiaries

Rs m	Addition	As of FY08
Gammon & Bilimoria Ltd.	(3)	88
Gammon Infrastructure Projects Ltd.	266	290
Gammon Realty Ltd.	(408)	3
Gammon International FZE	65	65
Kosi Bridge Infrastructure Company Ltd.	0	0
P. Van Eerd Beheersmaatschappij BV	2	2
Sikkim Hydro Power Ventures Ltd.	(3)	-
Tidong Hydro Power Ltd.	6	6
Andhra Expressway Ltd.	1	1
Rajahmundry Expressway Ltd.	3	3
Gammon Cooling Towers Ltd.	3	3
Total	(67)	461

Source: Company, IIFL Research

IVRCL Infrastructure

- The company commenced operations at its factory to manufacture transmission line towers.
- Work on the three toll road projects is running on schedule
  - Salem Tollway: As at end-FY08, ~27% of the project was complete. Till date company has invested Rs711m against the total commitment of Rs801m.
  - Kumarapalayam Tollway: As at end-FY08, ~33% of the project was complete. IVRCL has invested 100% of the required equity contribution of Rs651m.
  - Jalandhar Tollway: As at end-FY08, 49% of the work was complete and the company expects to complete the project by

3QFY09. Till date, the company has invested Rs330m against the total commitment of Rs413m.
  - Chennai Desalination Project: The deadline was rescheduled to 4QFY09 vs. the earlier deadline of 2QFY09 on account of delays in certain clearances and abnormal climatic conditions.
- The company entered the oil & gas sector with acquisition of a majority stake in Alkor Petro. Alkor Petro has 25% participating interest in three oil exploration blocks (blocks 19, 28 and 57 in Yemen) and 20% in two blocks (blocks 6,8 in Egypt) as member of consortiums.
- Capital structure
  - Of the total issued FCCBS of US$65m, US$57.40 has been converted till date.
  - 4.2m options under ESOP 2007 scheme – no options have been granted to employees so far.
- Special reserve created for purpose of adjustment of disputed tax liability that may arise in case of disallowance of deduction under 80IA. Total special reserve is Rs1.04bn currently.
- Employee cost increase 69% YoY driven by 39% increase in staff numbers to 6,500 and annual increment in salaries.
- Corporate guarantees issued by the company on behalf of subsidiaries and other associates amounts to Rs2.1bn, up from Rs677m in FY07. The increase was driven by guarantees given for Alkor Petro.
- IVRCL Building Products Ltd is planning to acquire mining leases at various places like Bangalore, Chennai, Pune etc.

- **IVR Prime**
  - IVR Prime had raised Rs7.78bn through an IPO during the year. Hence, the current cash position is comfortable, with cash balance of Rs3.6bn and a debt-equity ratio of 0.37x
  - During FY08, IVR Prime agreed to acquire 822.80 acres of land for Rs2.94bn around Hyderabad, Vizag, Bangalore, Pune and Chennai
  - Loans and advances including advance for purchase of land increased from Rs987m to Rs1.7bn.
  - During FY08, IVR Prime paid Rs2.1bn to IVRCL Infra in respect of development rights for the project in Noida. The balance outstanding as at end FY08 amounts to Rs4.05bn.

Figure 14: IVRCL invested Rs581m in subsidiaries in FY08

Rs m	Investment in FY08	Total investment
Hindustan Dorr Oliver	11	615
IVR Prime	0	400
IVRLC Water Infrastructures	500	619
IVRCL Road Toll Holdings	-	1,667
Alkor Petro	70	70
Other subsidiaries	-	11

Source: Company, IIFL Research

Figure 15: IVR Prime repaid Rs786m worth of loans to parent

Rs m	Loans given (repaid) in FY08	Total loans
IVR Prime	(786)	2,850
Chennai Water Desalination	135	316
Salem Tollways	347	347
IVRCL Building Products	127	127
Alkor Petro	167	167
Others	(172)	117

Source: Company, IIFL Research

Nagarjuna Construction

- The company formed a 100%-owned subsidiary, NaftoGaz Engineering, for executing oil & gas pipeline orders.
- Nagarjuna Construction formed a new company along with Maytas Infra and Paschal-WerkGmaier GmbH, Germany (leading formwork producing companies) for setting up a factory near Vishakhapatnam for producing formwork.
- The company stopped its employee stock option scheme and introduced employee incentives instead. Its overall employee strength increased to 3,620 members, with more than 60% engineers.
- Outstanding corporate guarantees for financial assistance to subsidiaries, associates, and JV amount to Rs4.6bn. Further,

performance guarantees given on behalf of subsidiaries amount to Rs331m.

- 9.1m convertible warrants issued at Rs225/share to Blackstone unlikely to be exercised, given market conditions.
- Capex of Rs1.61bn, primarily on machinery for road project in Muscat.

Figure 16: Nagarjuna invested Rs880m in subsidiaries and associates in FY08

Rs m	Investment in FY08	Total investment
NCC Vizag Urban Infra Ltd	22	499
Patnitop Roapway	10	11
OB Infra Ltd	-	468
Jubilee Hills Project	61	489
Tellapur Techno City	730	730
Pondicherry Tindivanam	20	20
Others	37	3,432

Source: Company, IIFL Research

Figure 17: Nagarjuna's commitment to real-estate projects have increased

Rs m	Loans given (repaid) in FY08	Total loans
NCC Urban Infra	1,163	1,458
NCC Vizag Urban	257	523
Jubilee Hills Project	(286)	202
Brindavan Infrastructure	24	24
Others	2	70
Share application money pending allotment	1,195	
Total	2,354	

Source: Company, IIFL Research

Patel Engineering

- Without qualifying, auditors draw attention to the company's claim of tax benefits under section 80IA.
- The company is non-compliant with the clause of independent directors forming half of the board of directors. Currently, one-third of the board is formed by independent directors.
- Management discussion and analysis (MD&A) mentions shortage of skilled manpower as a key concern for the construction industry and expresses concerns on increased attrition. It also considers delays in clearances and approvals by statutory bodies as a major impediment.
- MD&A also highlights the increasing difficulty in raising funds, particularly for long-gestation projects. Patel would need funds for its real-estate subsidiary and also its foray into thermal power generation based on imported coal.
- For the proposed 1,200MW thermal power project in Gujarat, the company is in the process of finalising the DPR. It is close to finalising acquisition of a coal mine in Indonesia to secure fuel requirement for the plant.
- For the 120MW hydropower project in Arunachal Pradesh, the company is in the process of finalising the DPR.
- The company expects significant order inflow in the water segment, driven by pick-up in project awards in the states of Andhra Pradesh, Tamil Nadu and Maharashtra.
- Patel Engineering is expanding its overseas operations and is seeking complimentary acquisitions.
- Also, where the company is bearing significant risks in a project, customer-furnished material and resources at fixed cost or at no cost are included as cost of construction and as construction revenue at market price. Amount in FY08 Rs329.53m.

Punj Lloyd

- The company had not provided for losses expected to arise on a long-term contract from SABIC currently in progress. If the loss had been so recognised, the effect would have been to reduce the carrying amount of construction WIP by Rs2.6bn, increase provisions by Rs465m, reduce revenue by Rs1.2bn and decrease PBT by Rs3.05bn. After management's negotiation with the client, the client has agreed to partial reimbursement and the loss stands at Rs1.95bn as at end-1QFY09.
- Without qualifying, auditors draw attention to customers withholding Rs461m in aggregate on various accounts, which are being carried as sundry debtors. The company also has work-in-progress inventory of Rs64m relating to these contracts.

- Corporate guarantees given on behalf of subsidiaries, JV and associates amount to Rs32.6bn; significantly higher than Rs18.4bn as of FY07.
- The company increased its average order size from US$100m in FY07 to US$150m in FY08. Larger orders should translate into operating efficiencies.
- Punj Lloyd paid Rs340m for a 33% stake in Airworks India, which provides service support for corporate aviation in India.
- Estimated future investments in JV and other companies in terms of respective shareholder agreement amounts to Rs290m.

Figure 18: Loans to subsidiaries and associates

Rs m	Investment in FY08	Total as of FY08
Punj Lloyd Kazakhstan LLP	(42)	266
Punj Lloyd Pte Limited	37	622
Simon Carves Limited (UK)	400	400
Punj Lloyd Aviation Limited	151	151
Punj Lloyd Infrastructure Limited	892	892
Spectra Net Limited	9	9

Source: Company, IIFL Research

Simplex Infrastructure

- Auditors have qualified the accounts with regards to mark-to-market losses on outstanding derivative instruments amounting to Rs72.47m. As at end-1QFY08, MTM losses stood at Rs67.9m. The company has provided Rs37.5m towards losses in these contracts.
- The company intends to increase proportion of short-duration projects to increase fixed-asset turns. As on date, the company is working on 156 projects catering to about 190 contracts.
- Considering the slowdown in the real-estate market, the company is minimising exposure to mass and middle-class housing.
- Simplex established a branch office in Oman in order to expand its footprint in the Middle East. The company already has presence in Dubai, Qatar and Bahrain.
- The company has 7,082 employees as at end-FY08. The company has amongst the lowest attrition rates in its senior and middle management. Average stay of middle and senior-level employees is more than 13 years.
- A significant part of other income is duty-free credit entitlement (Rs207m out of total other income of Rs246m).

Reliance Communications – ADD

RCOM IN	Rs404	Telecom	11 September 2008	FY08 Annual Report Review

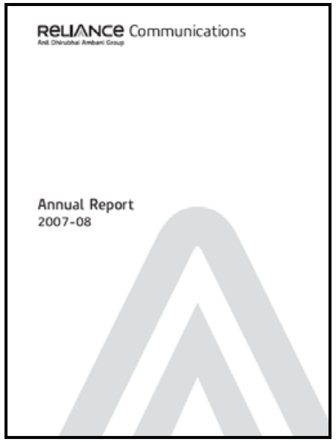
Expensive investments

Reliance Communications's (RCOM) Broadband business came out with the highest asset-turnover ratio as well as profitability amongst all its businesses in FY08, while the Global division dragged down aggregate measures. RCOM's strategy of leaving forex loans unhedged proved 340bps more expensive than its investment yield, amplified by the massive size of the investments (US$3bn). On the same basis, RCOM may make an FX loss of more than Rs4bn in 2QFY09. Per-tower procurement cost is 13% higher than Bharti's, despite lower visibility of multiple occupancy. We downgrade RCOM's FY09 earnings by 21% (for FX and expectation of weakness in wireless results) and the rating to ADD, with a DCF target price of Rs529.

Revenue growth lower than peers, asset turnover lower than in FY07: The business mix for RCOM is similar to that of Bharti, but RCOM's aggregate revenue growth for FY08 was only 31% compared to 46% for Bharti. Broadband (which includes enterprise business) grew by 56%, almost double Bharti's rate, whereas Global revenues grew only by 6%. In the flagship wireless business, the ARPU declined sharply relative to peers, and while RCOM's subscriber additions were robust, they did not accelerate from these levels.

Aggressive investment plans and but less conservative depreciation rates: Not only did Global have the lowest asset turnover relative to other businesses and relative to Bharti's long-distance business, but also Global had the lowest EBITDA margins in FY08. Global's margins fell further by 570bps in 1QFY08, sending worrying signals. RCOM's Broadband business lags Bharti in asset turnover, but compensates with superior EBITDA margins (48% vs 42%). Similarly, per-tower cost is higher for RCOM by 13% relative to Bharti, which has better visibility on external tenants for its towers. If Bharti's depreciation rates had been applied on RCOM, EBIT margins would have been lower by 610bps relative to the reported level of 27.4%.

FX losses can reach Rs4bn: RCOM's unhedged FX exposure was more than US$3.5bn as of 31 March 2008. The company reported a loss of Rs14bn (adjusted against assets) in 1QFY09, but could be looking at further losses in 2Q, as US$/INR has moved further. RCOM's subsidiary Reliance Infratel also imports towers, and FX exposure can be expected to increase. We rate the stock an ADD.



Financial summary

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenues (Rs m)	144,050	188,274	237,730	318,804	392,876
EBITDA Margins (%)	39.3	42.3	42.7	43.7	43.3
Pre-Exceptional PAT (Rs m)	31,638	54,023	46,087	60,131	70,364
Reported PAT (Rs m)	31,638	54,023	46,087	60,131	70,364
EPS (Rs)	15.5	26.2	22.0	28.8	33.7
Growth (%)	609.5	69.2	-15.8	30.5	17.0
PER (x)	26.2	15.5	18.4	14.1	12.0
ROE (%)	18.2	20.8	14.5	16.1	16.2
Debt/Equity (x)	0.1	0.5	0.7	0.7	0.5
EV/EBITDA (x)	**15.1**	**12.3**	**10.7**	**8.1**	**6.4**
Price/Book (x)	3.6	2.9	2.5	2.1	1.8

Price as at close of business on 09 September 2008

12-mth Target price (Rs) 529 (31%)

Market cap (US$ m)	**18,475**
52Wk High/Low (Rs)	845/380
Diluted o/s shares (m)	2064
Daily volume (US$ m)	88.4
Dividend yield FY08ii (%)	0.4
Free float (%)	33.9

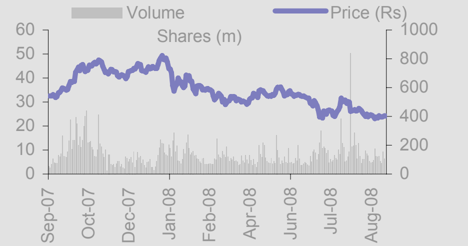
Shareholding pattern (%)

Promoters	66.1
FII	10.0
Domestic MF/Insurance	9.1
Others	14.8

Price performance (%)

	1M	**3M**	**1Y**
RCOM	-8.2	-26.8	-25.8
Rel. to Sensex	-5.6	-26.0	-20.6
Bharti	-1.3	6.9	-2.5
Idea	-5.6	-14.7	-30.5
MTNL	-8.2	5.9	-31.2

Stock movement



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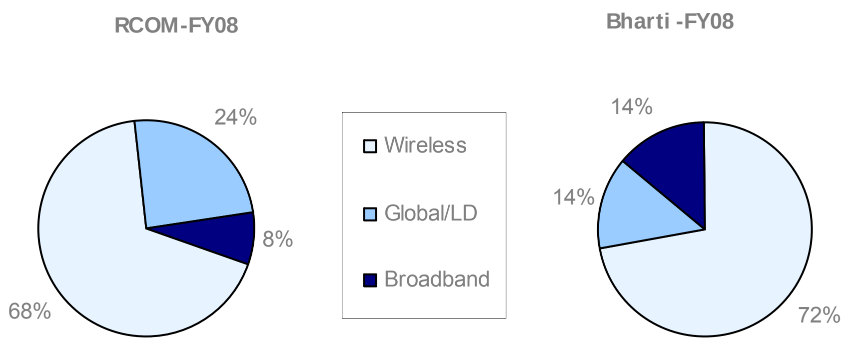
Broadband outshines other businesses

Figure 1: Revenue mix was similar for RCOM and Bharti



Source: Company, IIFL Research

While the revenue split is similar for RCOM and Bharti, RCOM's growth rate has lagged that of Bharti in the wireless and long-distance space. In the wireless segment, while both companies have sported robust subscriber growth, structural problems have dogged CDMA. In particular, retailers in remote areas have been finding it difficult to sell their inventories of RCOM's *Classic* handsets. Secondly, RCOM also faced significant execution challenges. Consequently, its large capital spending translated into Rs149bn of CWIP as at 31 March 2008, whereas Bharti accelerated its subscriber addition. Finally, RCOM's ARPU was less resistant to competitive pressures than Bharti's.

Figure 2: However, RCOM's aggregate revenue growth was slower than Bharti's

YoY Revenue growth	RCOM	Bharti
Wireless	42%	54%
Global/LD	6%	23%
Broadband + Enterprise	56%	30%
Total	31%	46%

Source: Company, IIFL Research

EBITDA%: Broadband carries long-distance (not the opposite)

Though Global (long-distance) is supposed to carry part of Broadband traffic, in RCOM's case, looking at the profitability of the two divisions, it was Broadband that carried long-distance. Broadband (which includes the Enterprise business) had the highest margins, significantly higher than Bharti's, whereas Global (dominated by FLAG) lagged behind. RCOM's strategy has been to do solo investments in submarine cable capacity, whereas Bharti has always been part of a consortium structure, which partly explains the disparity in margins. In 1QFY09, RCOM's Global EBITDA margins fell by a further 570bps.

Figure 3: EBITDA margins – RCOM does well in Broadband, not so in Global

EBITDA Margins (FY08)	RCOM	Bharti
Wireless	40%	40%
Global/LD	26%	33%
Broadband + Enterprise	48%	42%
Total	42.3%	42.1%

Source: IIFL Research

FY08 asset-turnover – Global squeeze

Figure 4: Asset-turnover – Global lags behind here too

Asset-turnover	RCOM	Bharti
Wireless	0.55	0.67
Broadband + Enterprise	0.54	0.81
Global/Long Distance	0.46	0.66
Total	0.53	0.69

Source: IIFL Research;

RCOM's asset turnover was markedly lower than that of Bharti in all businesses. Significantly, RCOM's FY08 numbers were also lower that its own FY07 numbers, as seen below, with the sharpest decline seen in Global.

While this is explained by the aggressive investment into long-distance, courtesy the US$1.5bn (over three years) investment into FLAG, the sharply-lower asset turnover (so far), allied with the squeeze on margins, sends worrying signals.

Figure 5: Asset-turnover – Global has fallen from last year's level

Asset-turnover	FY07	FY08
Wireless	0.63	0.54
Global/LD	1.02	0.54
Broadband + Enterprise	0.20	0.45
Others	0.22	0.28
Total	0.59	0.52

Source: IIFL Research

Over-investing in towers?

Tower investments responsible for depressing wireless asset-turnover: With RCOM at 52.6m subscribers by July 2008 and 30,295 towers at end-June 2008 and Bharti with 72m and 58,013 towers respectively, the per-tower subscriber count for RCOM is almost 1.5x that of Bharti. This is explained by the superior traffic-carrying capacity of CDMA. However, RCOM's assets/subscriber ratio is 70% higher than Bharti's, which definitely is a cause for concern, as it does not even include the impact of the ARPU differential between the two companies.

Figure 6: RCOM's wireless business model needs to be leaner

Item	RCOM	Bharti
Wireless GFA (Gross Fixed Assets) (Rs m)	420,681	339,814
Subscribers (m)	52.6	72.1
Wireless GFA / subscriber (Rs)	7,998	4,702

Source: IIFL Research

The above analysis also suggests that RCOM's wireless capacity is substantially underutilised, and we estimate that RCOM can create incremental capacity, especially in CDMA, quite economically. We expect that in the next two years, RCOM's capital productivity will begin to improve on the back of decreasing capital intensity, unless RITL goes on a tower overdrive.

We present below a comparison of tower-related investments by RCOM, Bharti and GTLI.

Figure 7: Tower capex – bulking up with GBTs

	BIL	RITL	GTLI
GFA (Gross Fixed Assets) at 31 Dec 07		71,961	
Tower count at 31 Dec 07		23,434	
Average Cost per tower		**3,070,811**	
GFA at 31 March 08	106,214	94,211	21,249
Tower count at 31 March 08	52,865	30,295	6,010
Average Cost per tower	2,009,155	3,109,796	3,535,607
Average tower cost in FY08			**2,929,730**
Average per-tower cost in 4QFY08		**3,242,950**	
GFA at 30 June 08	122,007		
Tower count at 30 June 08	58,013		
Average Cost per tower	2,103,104		
Average per-tower cost in 1QFY09	**3,067,866**		

Source: IIFL Research; GTLI's total includes CWIP; Bharti's existing base is 10x the incremental additions for the quarter so significant replacement capex is involved

By end-FY08, Reliance Infratel (RITL) had 23,434 towers and added 6,861 towers in 1QFY09. Bharti Infratel has 52,865 towers and added 5,148 towers in the same timeframe. Since Bharti Infratel's Tower assets are relatively older, we estimate that around 30% of its tower portfolio would attract replacement capex at 12% pa. RITL's cost for setting up a new tower is Rs28.8m, which makes RITL's towers 13% more expensive than Bharti's.

This higher cost for RITL can be attributed to the higher-capacity towers (4x capacity towers as per the annual report) being built by RITL. Since most of the incremental rollouts by RCOM would primarily be for GSM, RCOM GSM would be the sole occupant on a majority of the incremental towers, suggesting that RITL is targeting 75% of the capacity purely for external tenants. We think that this is an expensive wireless expansion strategy and exposes RCOM to the price risk involved in tower capacity pricing in the following manner:

Should interest rates go down, incremental tower capacity would be financed at lower rates, and lower rentals could be offered by the likes of GTLI. Hence, the benchmark rentals could move down. If RCOM has to bring in external clients, then these lower market rentals would form the competitive benchmark for RCOM.

RITL's rentals above market

Given that the tower business is a low-ROE affair up to the second tenant, this increases the risk for RITL, as it would need to fill up capacity by extending terms to competition.

Figure 8: RITL's task cut out in attracting tenants at high rentals

Monthly amt (Rs m)	BIL*	RITL**	GTLI***
Rentals GBT	35,000		35,000
Rentals RTT	23,000		22,000
Rentals blended (RTT + GBT)	31,893		32,000
Capital charges GBT		38,278	
Capital charges RTT		17,333	
Capital charges blended		30,082	
Fixed pass-through		15,179	
Energy costs	20,147	20,016	23,000
Total (blended rentals + pass through)	**52,040**	**65,277**	**55,000**

Source: IIFL Research; *GBT rentals estimated on the basis of parity with independent providers; others derived accordingly **Estimated from Reliance Infratel's DRHP filed earlier this year ***From company, fuel costs are estimates. #RCOM's average for CDMA and GSM. CDMA is typically higher.

However, given that there are several new players attempting rollouts, Reliance Infratel has a good chance of emerging as a serious pan-India choice for tower capacity. Should it manage to strike deals with more than one new operator on a pan-India basis, it will be a significant positive. In our view, however, RITL's higher-than market rentals are currently a barrier to this.

Depreciation rates less conservative

Figure 9: Depreciation as a % of GFA

FY08	RCOM	Bharti
Wireless (Incl. passive)	5.4%	8.0%
Global / LD	5.0%	4.8%
Broadband/ Enterprise	5.2%	10.2%
Others	4.7%	20.5%
Total	5.3%	7.9%

Source: IIFL Research, depreciation rates calculated as Depreciation / Average GFA

As the table above shows, RCOM's rates are less conservative relative to those of Bharti. Applying Bharti's rates on RCOM assets suggests that RCOM's EBIT margins would have been lower by 610bps (it would have been 21.3% instead of 27.4%).

Figure 10: Impact of applying Bharti's average depreciation rates on RCOM assets

Item (Rs m)	RCOM	Bharti
Average gross fixed assets for FY08	538,729	461,654
Reported depreciation	28,370	36,634
RCOM depreciation using Bharti's average rates*	40,004	
Difference (assuming similar composition in each category)	11,527	
Change in EBIT margin (reported 27.4%)	610bps	

Source: IIFL Research, *: For 'others' category we have assumed RCOM's depreciation rates

Figure 11: Du-Pont analysis – as capex peaks out after FY10, ratios should improve

Rs m	FY07	FY08	FY09ii	FY10ii	FY11ii
Tax burden (x)	0.98	0.76	0.91	0.91	0.88
Interest burden (x)	0.99	1.31	0.88	0.90	0.94
EBIT margin (x)	0.23	0.29	0.28	0.28	0.29
Asset-turnover (x)	0.33	0.28	0.30	0.34	0.38
Financial leverage (x)	2.55	2.58	2.70	2.66	2.42
ROE	**18.2%**	**20.8%**	**18.3%**	**20.7%**	**22.2%**

Source: IIFL Research

FCCBs in FY08 – 40% of Rs480 bond converted

RCOM issued ZC FCCBs in May 2006 and Feb 2007, for amounts totalling US$1.5bn (convertible to Rs.66bn). These were in two tranches—a US$500m tranche convertible at Rs480 and a US$1bn tranche convertible at Rs661. These had got converted to the extent of 40% and 1% respectively by FY08, raising the equity capital by Rs97m, while the share premium account increased by Rs9.35bn.

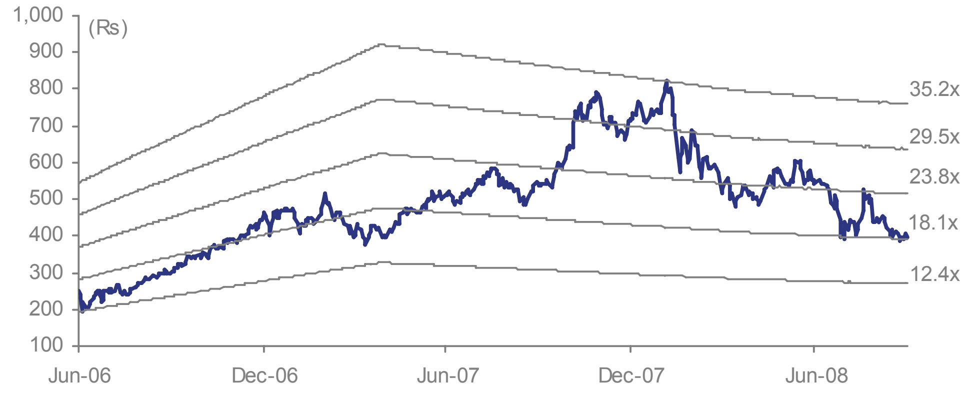
Rs661 tranche unlikely to be converted in FY09: Now, to trigger a conversion, we assume a premium of 10% over the Rs661 conversion price, which requires a nearly 80% rise in the stock price from current levels. This is unlikely during FY09, in our opinion. A similar assumption for bonds with a conversion price of Rs480 implies a required jump of 30% and a 23x FY09ii, which based on historical trends, seems possible.

Figure 12: FCCB conversion – Rs480 bonds may still get converted in FY09

	10% premium to conversion price	P/E multiple FY09
FCCB (US$500m)	523	23x
FCCB (US$1bn)	722	31x

Source: IIFL Research

Figure 13: P/E band chart for RCOM



Source: IIFL Research

It can be seen that RCOM has traded above the 29x band only for a very short period of time, adding to the likelihood that the Rs661 tranche stays unconverted this year.

Now if all of the remaining FCCBs priced at Rs480 were to be converted in FY09 there would be a 1.25% dilution, and the net debt to equity would fall from 0.48 to 0.42.

Figure 14: If all the Rs480 FCCBs are converted, D/E would fall by 600bps

Item (Rs bn)	Old	If Rs480 FCCB converted
Debt	258.21	245.44
Cash and cash equivalents	8.78	8.78
Other liquid investments	109.99	109.99
Net Debt	139.44	126.67
Net worth	289	302
Net debt/Equity	0.48	0.42

Source: IIFL Research

Hence, FX exposure related to US$1bn Rs661 tranche will continue: But more pertinently, the lower probability of the US$1bn tranche being converted indicates that the FX exposure will remain at a higher level for this year, unless RCOM moves into a hedged position. But we estimate that this will be easier said than done, especially since RCOM has recorded significant unrealised FX losses (Rs9.54bn) in 1QFY09 and since then US$/INR has moved by Rs1.9.

Inclusive of FX loss in 1QFY09, loans cost 11.2%

As of 1QFY09, the losses incurred as a result of dollar fluctuations due to rupee depreciation were as follows:

Figure 15: Losses due to fluctuation in fx

Item (Rs m)	Total amount (31-3-08)	Losses (1QFY09)
FCCB	54,932	3,991
Foreign currency loans	119,185	10,633

Source: IIFL Research

It can be seen from the above that both the losses correspond to approximately Rs3 of movement in the US$/INR rate. This was indeed the rate movement, suggesting that RCOM's FX losses largely stemmed from unhedged exposures.

We isolate the non-FCCB loans for the purpose of comparing investment yields and effective financing costs. An analysis of the non-FCCB foreign exchange loans reveals that RCOM's cost of financing has proved to be 340bps more than its investment yields, primarily because its strategy of leaving FX loans unhedged has seriously backfired. We analyse over a time horizon including 1QFY09, since RCOM reported unrealised losses in 1Q.

Figure 16: Non-FCCB gain (loss) analysis

	Item (Rs m)	AMT
A	**Average Interest cost in FY08**	
	Interest cost	10,681
	Average interest bearing (non-FCCB) loans in FY08	155,675
	Effective Interest cost	6.9%
B	**FX losses on non-FCCB FX loans derived from 15m period end 30 June 08**	
	FX gain in FY08	4,223
	Estimate of gains attributable to non-FCCB FX loans in FY08	2,220
	FX losses on non-FCCB FX loans in 1QFY09	10,633
	Total loss over 15 month period ending 30 June 08	8,413
	Loss as % of average o/s non-FCCB loans	5.4%
	Equivalent % for a 12m period	4.3%
	Total effective cost of non-FCCB loans (annualized)	11.2%
C	**Yield on investments (INR)**	10,455
	Average investments + cash for FY08	133,940
	Yield on investments %	7.8%

Source: Company, IIFL Research

RCOM could be in for a Rs4bn loss in 2QFY09: RCOM would also have been faced with a decision problem at the end of 1QFY09—to hedge or not to hedge—since its unrealised losses were 90% of total FX losses (excluding FCCB-related loss). To hedge would have locked in the unrealised FX loss. Assuming that RCOM did not, since the US$/INR has moved by approximately 3% in 2QFY09 already, RCOM could be making a loss of at least Rs4bn in 2QFY09 if US$/INR stays at these levels.

RCOM should become FCF-positive in FY11

In FY08, RCOM's capex of Rs212bn was financed as follows:

Figure 17: RCOM's cash balance and borrowings financed capex

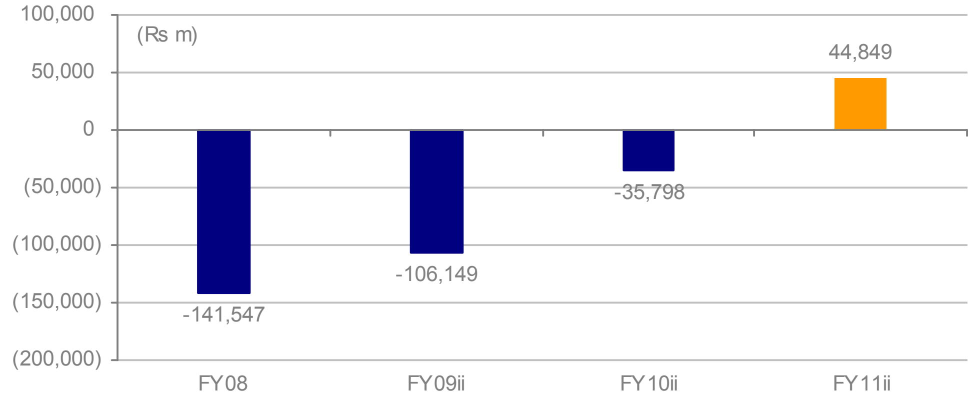
Item	Amount (Rs m)
Capex	212,040
Capital credit increase	35,101
Cash generated from operations	46,625
Run-down of cash balances	63,224
Increase in borrowings	67,090
Total	212,040
Cash generated from operations	
PAT	54,023
Depreciation and amortisation	28,045
Working-capital changes	-35,443
Total	46,625

Source: Company AR, IIFL Research

Non-Wireless business leads to increase in debtors: Working capital was positive despite the traditional wireless business being pre-dominantly pre-paid. This was because of the expansion into the enterprise segment directly and through Reliance Globalcom's international businesses such as Yipes, which resulted in an increase in debtors by almost 50% to Rs27bn.

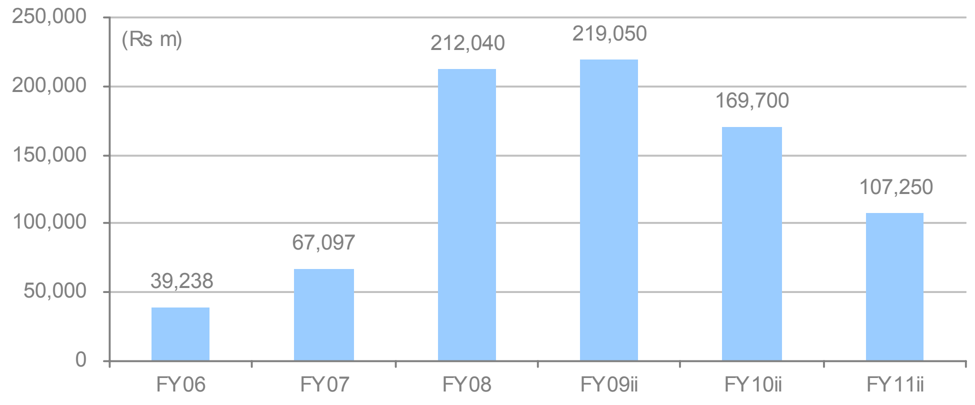
We expect RCOM to become FCF-positive in FY11, as the capital intensity winds down.

Figure 18: RCOM should become FCF-positive by FY11



Source: Company, IIFL Research

Figure 19: Capex projections for RCOM



Source: Company, IIFL Research

Financial summary

RCOM's FX exposures have proved to be expensive, as aggregate FX losses in 1QFY09 exceeded Rs14bn

RCOM has toned down its capex guidance to US$10bn-US$11bn in FY08-09, implying US$4.8bn at the low end of the range

Income statement summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue	144,050	188,274	237,730	318,804	392,876
EBITDA	56,576	79,585	101,621	139,259	170,107
EBIT	**31,922**	**51,540**	**61,768**	**86,017**	**103,858**
Interest income	0	0	557	821	1,144
Interest expense	-4	3,998	-12,131	-21,197	-25,463
Exceptional items	-303	12,829	0	0	0
Others	633	2,404	500	500	500
Profit before tax	**32,249**	**70,770**	**50,693**	**66,141**	**80,039**
Taxes	-611	-2,836	-2,535	-3,307	-6,403
Minorities and other	0	-13,911	-2,072	-2,704	-3,272
Net profit	**31,638**	**54,023**	**46,087**	**60,131**	**70,364**

Cashflow summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Profit before tax	32,249	70,770	50,693	66,141	80,039
Depr. & amortization	24,653	28,045	39,853	53,242	66,248
Tax paid	-611	-2,160	-2,535	-3,307	-6,403
Working capital Δ	102,358	1,382	24,889	17,825	12,215
Other operating items	0	-9,770	0	0	0
Operating cashflow	**158,649**	**88,268**	**112,902**	**133,902**	**152,099**
Capital expenditure	-158,317	-229,815	-219,050	-169,700	-107,250
Free cash flow	**332**	**-141,547**	**-106,149**	**-35,798**	**44,849**
Equity raised	0	0	12,885	0	0
Investments	-76,993	0	0	0	0
Debt financing/disposal	81,407	96,390	100,000	50,000	-35,000
Dividends paid	0	-1,183	-3,669	-3,669	-3,669
Other items	16,305	-16,885	-2,072	-2,704	-3,272
Net change in cash	**21,052**	**-63,224**	**995**	**7,829**	**2,909**

Source: Company data, IIFL Research

RCOM's investment yield was 340bps lower than financing cost if FX losses in 1QFY09 are taken into account

Despite a 200bps cost advantage on spectrum, RCOM's EBITDA margins have not exceeded Bharti's, primarily because of lower ARPU

RCOM's ROA is in single digits, and excessive investment in towers would keep this suppressed

Balance sheet summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Cash & equivalents	72,006	8,782	9,777	17,606	20,515
Sundry debtors	18,316	27,224	33,527	43,087	51,429
Inventories - trade	4,821	4,059	6,833	8,483	9,770
Other current assets	13,884	23,058	25,058	27,058	29,058
Fixed assets	**330,422**	**523,125**	**704,390**	**822,916**	**865,985**
Intangible assets	26,588	35,654	33,586	31,518	29,450
Other term assets	99,217	152,691	154,691	156,691	158,691
Total assets	**565,254**	**774,594**	**967,862**	**1,107,359**	**1,164,899**
Short-term debt	0	0	0	0	0
Sundry creditors	44,423	85,987	78,943	79,042	76,036
Other current liabs	117,059	114,789	159,799	192,736	221,586
Long-term debt/CBs	174,383	258,217	358,217	408,217	373,217
Other long-term liabs	26	1,028	1,028	1,028	1,028
Minorities/other equity	56	24,311	24,311	24,311	24,311
Net worth	**229,306**	**290,263**	**345,566**	**402,027**	**468,723**
Total liabs & equity	**565,254**	**774,595**	**967,864**	**1,107,361**	**1,164,900**

Ratio analysis

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue growth (%)	27.6	30.7	26.3	34.1	23.2
Op Ebitda growth (%)	128.2	40.7	27.7	37.0	22.2
Op Ebit growth (%)	308.8	61.5	19.8	39.3	20.7
Op Ebitda margin (%)	39.3	42.3	42.7	43.7	43.3
Op Ebit margin (%)	22.2	27.4	26.0	27.0	26.4
Net profit margin (%)	22.0	28.7	19.4	18.9	17.9
Dividend payout (%)	3.2	5.7	6.8	5.2	4.5
Tax rate (%)	1.9	4.0	5.0	5.0	8.0
Net debt/equity (%)	11.0	48.0	69.0	69.8	51.8
Net debt/op Ebitda (x)	0.4	1.8	2.3	2.0	1.4
Return on equity (%)	18.2	20.8	14.5	16.1	16.2
ROCE (%)	2.6	2.8	1.8	2.0	2.1
Return on assets (%)	11.8	13.6	8.4	8.9	9.5

Source: Company data, IIFL Research

Britannia – BUY

BRIT IN	Rs 1398	FMCG	11 Sept 2008	Initiation Report

Smart cookie

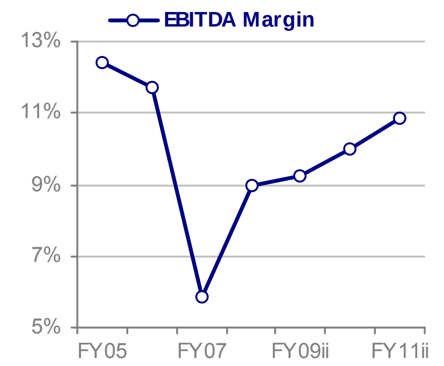
Britannia is the market leader in the Rs80bn biscuits market in India, with brands such as *Tiger, Good Day and 50:50.* The stock has underperformed the BSE FMCG Index by 15.4% over the last 12 months despite a sharp turnaround in its operating performance. Uncertainty on the ongoing legal tussle between the two largest shareholders has been one of the key overhangs on the stock. Other concerns have been rising raw-material prices and Britannia's constrained pricing power in view of intensifying competition. However, with indications of an early resolution of the majority shareholders' dispute and improving outlook on operating conditions, we believe the key concerns should start abating. We expect the operating turnaround at Britannia to gather pace and forecast earnings CAGR of 25% over FY08-11ii. BUY with a one-year target price of Rs1765, based on 14x FY10ii earnings. We value the stock at a 25% discount to its three-year average multiple to factor in the ongoing promoter dispute.

Robust sales growth momentum: The Indian biscuits market is expected to sustain growth at 15%+ pa over the next three years, led by increasing conversion from unbranded to branded biscuits. Britannia, with market leadership and a wide product range, is well-positioned to leverage this growth and deliver sales CAGR of 17% over FY08-11ii.

Earnings growth to accelerate: We expect the turnaround in Britannia's operating performance to continue as raw-material prices stabilise and price competition moderates, enabling further price increases. Britannia has taken a price hike of 9% this year and has indicated another price increase of 3-4 % to offset raw-material price increases. As a result, we expect earnings growth to accelerate from 6% over FY05-08 to 21% over FY08-11ii.

Early resolution of Danone-Wadia dispute would be positive: Recent developments point to an early resolution of the ongoing Wadia-Danone dispute. Danone, in its 2007 annual report, clearly spells out its intent of selling its stake in Britannia to its Indian partner, the Wadias. At this point, the most likely outcome seems to be the Wadias buying out Danone, though the timing remains uncertain. Though remote, the possibility of Kraft buying out Danone's stake would be very positive for Britannia. Having Kraft, the world's third largest foods company, as a parent would enable Britannia access to its superior technical know-how and product portfolio, which boasts such globally renowned brands as *Toblerone*, *Tang*, *Milka* and *Jell O*.

EBITDA margins will improve further



Source: Company, IIFL Research

Financial summary

Y/e 31 Mar	FY07A	FY08	FY09ii	FY10ii	FY11ii
Revenues (Rs m)	21,993	25,848	30,590	35,606	41,449
EBITDA Margins (%)	5.9	9.0	9.3	10.0	10.8
Pre-Exceptional PAT (Rs m)	1,154	2,019	2,498	3,047	3,551
Reported PAT (Rs m)	1,077	1,910	2,498	3,047	3,551
Adj. EPS (Rs)	45.1	80.0	104.6	127.6	148.6
Growth (%)	-26.5	77.4	30.8	22.0	16.5
PER (x)	**31.1**	**17.5**	**13.4**	**11.0**	**9.4**
ROE (%)	17.5	25.3	27.1	27.6	27.3
Debt/Equity (x)	0.0	0.1	0.0	0.0	0.0
EV/EBITDA (x)	**25.6**	**14.7**	**11.7**	**9.0**	**6.7**
Price/Book (x)	5.4	4.4	3.6	3.0	2.6

Price as at close of business on 9 September 2008

12-mth Target price (Rs) 1765 (27%)

Market cap (US$ m)	**741**
52Wk High/Low (Rs)	1700/1189
Diluted o/s shares (m)	24
Daily volume (US$ m)	0.4
Dividend yield FY08ii (%)	2.5
Free float (%)	49.1

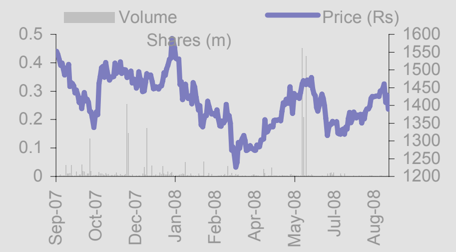
Shareholding pattern (%)

Promoters	50.9
FIIs	7.46
Domestic MFs/Insurance cos	22.3
Others	19.3

Price performance (%)

	1M	3M	1Y
Britannia	2.8	-6.7	-11.7
Rel. to Sensex	4.6	-5.6	-7.3
Nestle	6.7	1.2	39.6
Hindustan Unilever	3.9	8.5	17.6
ITC	2.4	-6.1	9.4

Stock movement



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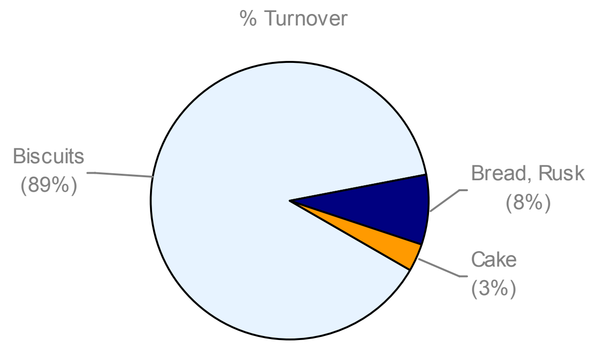
The cookie maker

Britannia is the market leader in the Rs80bn biscuits market, with its brands such as *Tiger, Good Day, 50:50, Nutrichoice* and *Milkbikis* accounting for 35% share of the industry's volume. Biscuits are the mainstay for Britannia, comprising 90% of its FY08 sales. Bread & rusk (8% of sales) and cakes (3%) are its other product segments. Britannia also has interests in the dairy business through its 50:50 JV with Netherlands-based Fonterra, which is the world's second-largest dairy company. Recently, the company acquired a stake in the Dubai-based Strategic Foods International Co LLC and 65.4% in the Oman-based Al Sallan Food Industries.

In biscuits, Britannia leads in all sub-segments, barring the low-priced glucose category, which is dominated by the local manufacturer, Parle. Britannia has largely been able to hold on to its market share despite intense competition from ITC and Parle through such initiatives as continuous product innovation and introduction of lower-priced and smaller packs to encourage out-of-home consumption.

Figure 1: FY08 sales mix - biscuits dominate Britannia's revenues



Source: Company, IIFL Research

A strong re-rating candidate; BUY with TP of Rs1,765

Britannia has underperformed the BSE FMCG Index by 15.4% over the last 12 months despite a sharp turnaround in its operating performance. Uncertainty on the ongoing legal tussle between the largest shareholders in Britannia—the French major Danone and the Wadias—has been one of the key overhangs on the stock. Investors have also been worried about the rising raw-material prices and Britannia's constrained pricing power in view of intensifying competition. However, we expect the margin expansion trend (FY08 margins expanded by 310 bps) to gather pace over the next three years. We believe the key concerns on the stock will start abating as:

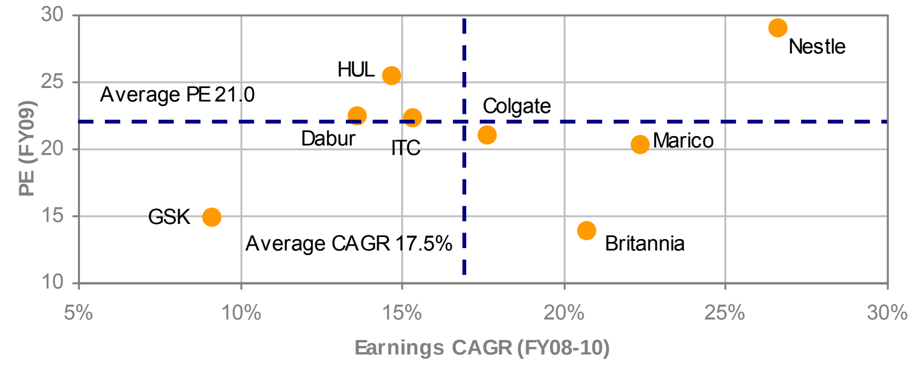
1. Prices of key raw materials such as wheat, edible oil and crude-linked packaging material have started stabilising. Overall, Britannia's costs rose by just 2% in the last 6 months. Despite a 15% increase in its cost index in FY08, Britannia's EBITDA margin expanded by 310bps, signalling a let-up in the commodity pressure.
2. Competition is getting rational. Specifically, ITC is focussing increasingly on profitability. Heavy inflation in key raw materials has forced ITC to scale back its aggressive ramp-up in the glucose portfolio. Inflationary pressures have also compelled Parle, Britannia's largest competitor, to raise prices, after a gap of almost 3 years. This bodes well for Britannia's profitability.
3. An early resolution of the Danone-Wadia dispute seems likely, as indicated by some press reports. Danone's 2007 annual report states Danone's intent of selling its 25.5% stake in Britannia to the Wadias.

Figure 2: Britannia got de-rated as EBITDA margins dropped in FY07

Source: Company, IIFL Research, Bloomberg

We expect cost savings through improving operational efficiency, stabilisation of key commodities and product price increases to aid a 180bps margin expansion over FY08-11ii. Earnings growth will accelerate significantly, from a CAGR of 5.7% over FY05-08 to 21% over FY08-11ii. Robust earnings growth coupled with valuations that are close to their four-year lows place Britannia in the most attractive growth-valuation quadrant in our valuation universe.

Figure 3: Britannia is in the most favourable PE-earnings CAGR quadrant



Source: IIFL Research, Bloomberg

Britannia's current valuation of 11x FY10ii EPS represents a 40% discount to its three-year historical trading average, and builds in extreme pessimism, in our view. With a continuing uptrend in profitability and a potential early resolution of the Wadia-Danone tussle, we expect the stock to start performing. We initiate with a BUY and a one-year target price of Rs1765. We value the stock at 14x FY10ii earnings, at a 25% discount to its three-year average trading PE of 18.6x, to factor in the ongoing conflict between the major shareholders.

Stable sales growth of 16-18% over FY08-11ii

We expect Britannia to maintain the sales growth momentum it has displayed over the last few years (17% CAGR over FY05-08) to continue over FY08-11ii, clocking a CAGR of 17%. Biscuits, which comprise 90% of Britannia's sales, would be the key growth driver. We estimate the company's biscuits revenue will grow at an annualised rate of 16.8% over FY08-11ii, whereas distribution advantages will enable a stable 18% CAGR in the remaining portfolio of breads rusk and cakes. Distribution of breads, which was earlier done through the distribution channel for cakes, would now be aligned with the biscuits channel. This is expected to translate into significant synergies and drive volumes.

Biscuits category: Unbranded to branded shift to drive growth

The Indian biscuits market is characterised by large unorganised presence, estimated at 40% of the total market. The branded biscuits market, estimated at Rs80bn, has been growing at 10-15% pa over the last few years, on the back of increasing consumption led by increasing conversion of consumers from unorganised segment to branded biscuits, rising incomes in urban and rural areas, introduction of lower price points and pack sizes by companies, and continuous product innovation. India's per-capita consumption of biscuits is among the lowest in the world and has significant headroom for further growth. We expect the growth uptrend in biscuits category to be sustained over the next three years.

Growth would be driven by:

1. Continued conversion from unbranded to branded biscuits:
   a. Removal of excise and tax benefits earlier enjoyed by the small and medium-scale manufacturers has levelled the playing field, making it difficult for the smaller players to competing on price.
   b. The inflationary raw-material price environment has made it difficult for the smaller players to sustain, forcing many of them out of the market.
2. Biscuits priced at Rs50/kg and lower, which are exempt from excise duty, will continue to drive demand in the low-end glucose segment.
3. Biscuits are increasingly competing with snack-based products. Leading biscuit-makers like Britannia are offering their products in new packaging formats and are trying to change the mindset that biscuits are to be consumed only with tea. New product packages such as gift assortments are likely to help change the product positioning and drive demand.
4. Sales of biscuits will continue to grow as incomes continue to rise. Biscuits have some characteristics of impulse products and will benefit from the increasing penetration of organised retail.
5. Small-sized and low-priced packs continue to drive out-of-home consumption, particularly at transit points.

Figure 4: Volumes of low-end and high-end biscuits are growing fast

Segment	Price point (Rs/Kg)	% of the market	Growth driver
Low end	< 50	50%	Conversion from unorganized-sector biscuits
Mid-priced	50-80	25%	Not growing as consumers upgrade to high-end biscuits
High-end	> 80	25%	Upgradation from mid-priced biscuits due to rising disposable income and a large number of new launches

Source: Industry data, IIFL Research

Britannia's new product launches are targeted at the biscuit market's top and low ends, which are growing faster. The economy segment continues to benefit from the continued migration of unbranded users to branded products. After the 25% price increase in the low-end glucose segment, the price differential between the mid-price and low-end segment has narrowed. As a result, more consumers are upgrading from the low end directly to the high end of the market.

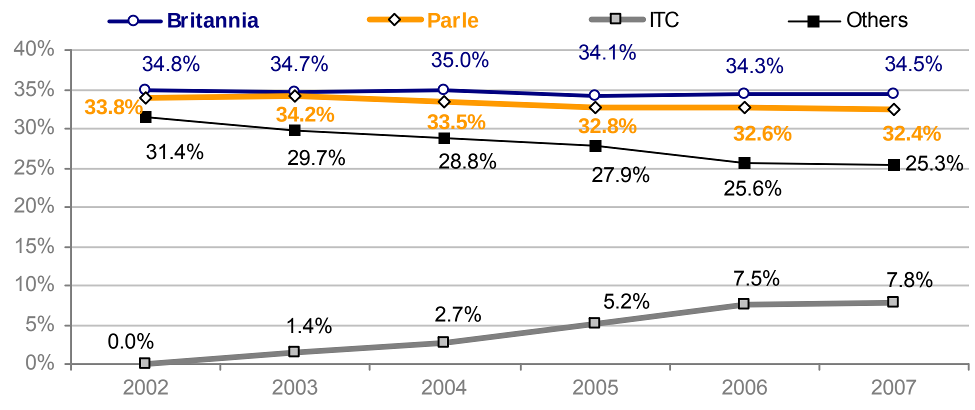
Robust volume growth despite price hikes

Britannia's volume growth has been robust despite price increases, underscoring the strength of underlying demand. Despite an 8-9% price hike in 1QFY09 (25% in the low-end glucose biscuit brand *Tiger*), Britannia's biscuit volumes grew by 9%. This reinforces our confidence that volume growth will remain strong despite price hikes.

Britannia will maintain market share going forward

Until 2002, the biscuits market was largely duopolistic, with Britannia and Parle as the leading players. That changed with ITC's launch of glucose biscuits, with price discounts and consumer promotions. Parle, the leader in the glucose-biscuit segment, followed suit, cutting prices. Britannia, under pressure to maintain its share, was forced to lower its prices as well. Only recently have commodity inflation, continued margin pressure and investment requirements in other segments forced ITC to go slow on its aggressive consumer acquisitions in the glucose segment. Rational competition has enabled Britannia to take a price increase in the glucose biscuits portfolio after 1.5 years.

Figure 5: Britannia maintains share; ITC gains at expense of small players



Source: Company, Press reports, IIFL Research

Going forward, we expect Britannia to maintain its share at 35% through continuous innovation and new product launches (targeted at the premium end, which is growing faster), higher volume sales of lower-priced products (encouraging out-of-home consumption). Britannia is also investing heavily in brands, with advertising expense up from 5.9% (of sales) in FY06 to 6.9% in FY08.

Robust earnings growth of 21% over FY08-11ii

We forecast Britannia's earnings will register 21% CAGR over FY08-11ii as EBITDA margins expand by 180bps. The strong earnings CAGR would be despite an increase in the tax rate, which is likely to gradually increase from 17% in FY08 to 26% in FY11ii, as the tax exemption for the Uttaranchal factory comes down to 30% from the current 100%. Other income will also remain strong on the back of higher yields on investments, but is likely to decline as a proportion of PBT, from 20% in FY08 to 14% in FY11ii.

Below, we detail the key drivers of the 180bps margin expansion that we expect over FY08-11ii:

Stabilisation in raw-material prices

Britannia's key raw materials are wheat, edible oils and sugar. Wheat and sugar have been on a strong uptrend over the past two years, putting Britannia's margins under pressure.

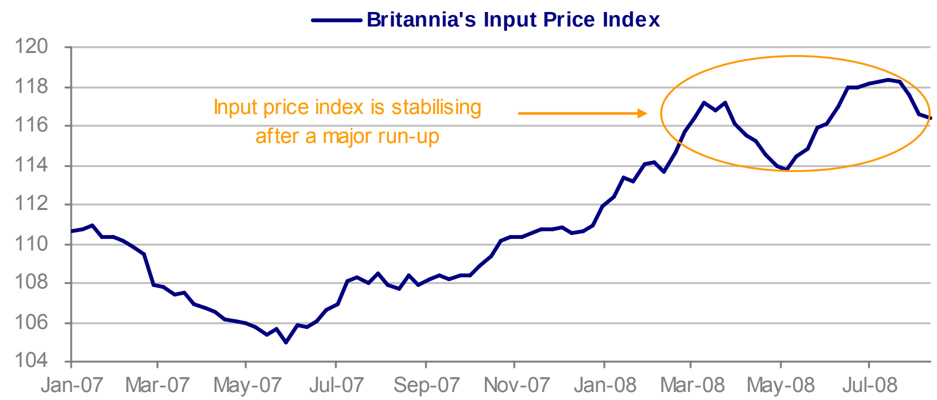
Figure 6: Edible oil and wheat are likely to stabilise going forward

		Price movement			
Raw material	% of sales	1-month	YTD	1 year	Outlook
Wheat	17.7%	0.5%	2.3%	5.1%	Wheat prices in India are insulated from global prices; there has been no sharp drop in India, as has been the case globally
Edible oil	6.5%	-3.3%	7.6%	14.2%	A ~45% decline in global prices of palm oil will bring down prices in India
Sugar	11.5%	5.8%	10.7%	11.8%	Sugar prices will rise as production will be lower this year and stocks will deplete

Source: Bloomberg, Company Data, IIFL Research

However, prices of wheat are showing signs of stabilising, while those of edible oil have actually declined. Overall, the weighted input price index for Britannia, which has seen a continuous rise for the past one year, shows no signs of stabilising.

Figure 7: Input price index is stabilising, but remains higher than year-ago levels

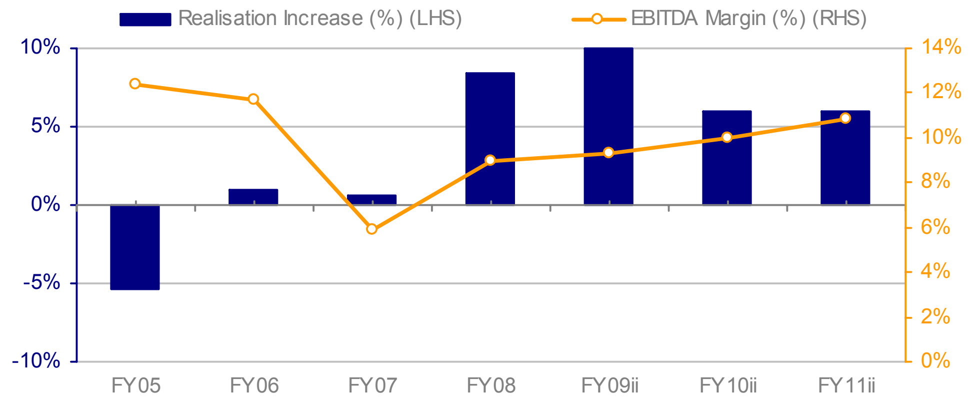


Source: Bloomberg, company data, IIFL Research

Price increases, product mix improvement to expand margins

Management has indicated that it would take further price increase to pass on high raw-material costs. The expected cost push of Rs3bn (10% of FY09 sales) in FY09 would be more than offset through price increases, improved product mix and strong operating leverage. We forecast EBITDA margin expansion of 180bps over FY08-11ii.

Figure 8: Margins will continue to expand over FY08-11ii as realisations improve



Source: Company data, IIFL Research

Early resolution of promoter dispute would be positive

An early resolution of the Wadia-Danone dispute would be positive for the stock performance, in our view. There are clear indications that Danone wants to pave the way for its market entry in the dairy business and seeks an early resolution to its dispute with the Wadias. Its intent to sell its stake to the local partner is clearly stated in its December 2007 annual report. The report states, "As of 31 December 2007, the Group is negotiating with its partner in the holding companies controlling the Britannia Company with a view to selling its indirect investment to the partner". Danone has also restated the investment in Britannia from 'Investments in non-consolidated companies' to the line item 'Assets held for sale'. The report values Danone's 25.5% stake in Britannia at €114m, which translates into a per-share value of Rs1,191, a 9% discount to the CMP.

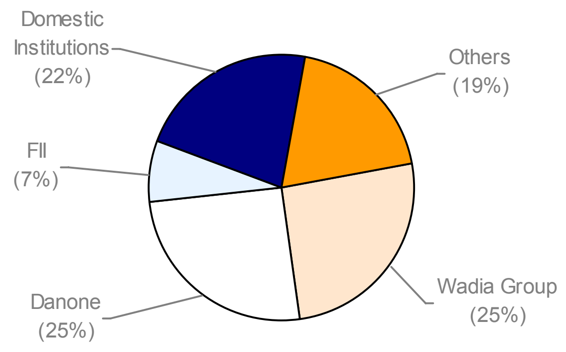
It is too early to predict the final outcome, but it seems almost certain that the Wadias would buy out Danone's stake, the critical factors being timing and buyout price. Though remote, the possibility of Kraft buying out Danone's stake would be very positive for Britannia. Having Kraft, the world's third largest foods company, as a parent would enable Britannia access to its superior technical know-how and product portfolio, which boasts such globally renowned brands as *Toblerone*, *Tang*, *Milka* and , *Jell O,* among many others. While Kraft is keen on entering India, Wadias would have the first right of refusal for buying out Danon's stake.

Wadia-Danone dispute: revisiting history

The major shareholders of Britannia—the Wadias and Danone—hold 25.5% stake each, through a 50:50 JV between the two, named Associated Biscuits International (ABIL). ABIL is a UK-based holding company.

Differences between the Wadias and Danone started when Danone bought a stake in Avesthagen, a bio-nutrition company to enter the dairy market. Wadias objected to the move on the grounds that it was a violation of the Government of India's Press Note 1. The note requires, among other things, that any foreign company operating in India through an Indian partner must obtain the consent of the local JV partner before entering a similar business area, including through a technical collaboration. The FIPB ruled in the favour of the Wadias in 2007.

Figure 9: Britannia shareholding as on 30 June 2008



Source: BSE, IIFL Research

Consequently, the two have been embroiled over IPR infringement of *Tiger*, which the Wadias contend is a brand locally developed by Britannia. The *Tiger* brand has been registered in 35 countries, including Pakistan, Singapore, and Malaysia, without the knowledge and express approval of the Wadias and the Britannia board. Britannia contended that an approval was necessary, since *Tiger* was a home-grown brand. The Wadias and Danone are fighting the *Tiger* IPR case in Singapore. Matters were complicated further with Kraft's acquisition of Danone's biscuits business worldwide. Britannia has been left out of Danone's global deal with Kraft for sale of its biscuits business in 2007, pending a legal resolution of the ongoing tussle with the Wadias. Both parties have maintained that this deal does not change the status quo on the *Tiger* case.

Annexure

Britannia's biscuit brands

Premium-priced

Treat

Nutri-Choice

Good Day

Mid-priced

Marie Gold

50:50

Milk Bikis

Low-priced

Tiger

Financial summary

Revenue growth will be in line with category growth for biscuits, as Britannia will hold marketshare

Other income is substantial and flows from Britannia's large investments portfolio

Income statement summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue	21,993	25,848	30,590	35,606	41,449
EBITDA	1,288	2,317	2,835	3,567	4,497
EBIT	**1,036**	**2,027**	**2,497**	**3,217**	**4,136**
Net Interest expense	-89	-97	-89	-19	-19
Other Income	315	502	638	708	682
Profit before tax	**1,261**	**2,431**	**3,046**	**3,907**	**4,799**
Taxes	-108	-413	-548	-859	-1,248
Exceptional items	-77	-109	0	0	0
Minorities and other	0	0	0	0	0
Net profit	**1,077**	**1,910**	**2,498**	**3,047**	**3,551**

Capex in FY09 would be on capacity expansion

Investments will continue to rise as the board is unlikely to increase the payout till the dispute with Danone is resolved

Cashflow summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Profit before tax	1,261	2,431	3,046	3,907	4,799
Depr. & amortization	253	291	338	350	361
Tax paid	-137	-424	-548	-859	-1,248
Working capital Δ	-125	-1,513	967	503	299
Other operating items	-77	-109	0	0	0
Operating cashflow	1,176	676	3,803	3,900	4,212
Capital expenditure	-880	-654	-728	-180	-180
Free cash flow	**295**	**23**	**3,075**	**3,720**	**4,032**
Investments	303	-584	-1,192	-1,500	-500
Debt financing/disposal	-46	1,013	-936	0	0
Dividends paid	-419	-503	-846	-1,204	-1,603
Other items	0	3	0	0	0
Net change in cash	**133**	**-49**	**102**	**1,016**	**1,929**

Source: Company data, IIFL Research

Debt in FY08 was taken to fund working capital, to increase stock of raw materials as commodity prices were rising

EBITDA margin will continue to improve through better realisations and stabilisation of input cost

Tax rate will increase to 26% as tax exemptions in Uttaranchal factory come down from 100% to 30%

Balance sheet summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Cash & equivalents	486	438	540	1,556	3,484
Sundry debtors	286	463	594	692	805
Inventories - trade	2,149	3,015	3,395	3,952	4,600
Other current assets	892	1,608	1,738	1,669	1,876
Fixed assets	**2,144**	**2,507**	**2,897**	**2,727**	**2,546**
Intangible assets	256	232	232	232	232
Other term assets	3,213	3,832	5,024	6,524	7,024
Total assets	**9,426**	**12,096**	**14,420**	**17,352**	**20,567**
Short-term debt	0	1,042	100	100	100
Sundry creditors	2,367	2,470	3,615	4,206	4,894
Other current liabs	863	1,007	1,470	1,967	2,546
Long-term debt/CBs	48	19	25	25	25
Other long-term liabs	0	0	0	0	0
Net worth	**6,148**	**7,558**	**9,210**	**11,054**	**13,002**

Ratio analysis

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue growth (%)	28.4	17.5	18.3	16.4	16.4
Op Ebitda growth (%)	-35.9	79.9	22.3	25.8	26.1
Op Ebit growth (%)	-42.2	95.7	23.2	28.9	28.5
Op Ebitda margin (%)	5.9	9.0	9.3	10.0	10.8
Op Ebit margin (%)	4.7	7.8	8.2	9.0	10.0
Net profit margin (%)	4.9	7.4	8.2	8.6	8.6
Dividend payout (%)	38.9	26.3	33.9	39.5	45.1
Tax rate (%)	8.5	17.0	18.0	22.0	26.0
Net debt/equity (%)	-7.1	8.2	-4.5	-12.9	-25.8
Net debt/op Ebitda (x)	-0.3	0.3	-0.1	-0.4	-0.7
Return on equity (%)	17.5	25.3	27.1	27.6	27.3
ROCE (%)	19%	29%	29%	35%	43%

Source: Company data, IIFL Research

Apollo Tyres – ADD

APTY IN	Rs37	Tyre	11 Sep 2008	Company update

Decline in crude-oil price augurs well

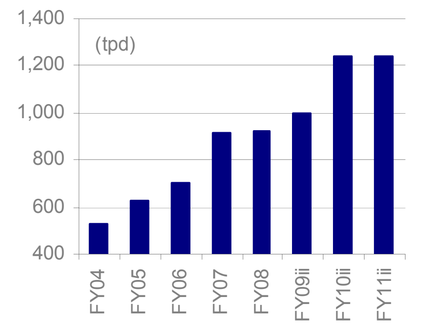
Apollo Tyre's (ATL) brownfield and greenfield expansion projects, which would increase its capacity by ~20%, would enable it to maintain its above-industry-average volume growth. Replacement demand for CV tyres, ATL's key segment, continues to be strong (it rose 10.6% YoY in 1QFY09). We expect a sharp decline in the company's EBIDTA margin to 6.4% in 2QFY09ii on account of high rubber prices from 10.2% in 1QFY09. We expect margins to expand to more than 10% in 4QFY09, as a decline in crude-oil prices causes raw-material prices to ease. We cut our EPS estimate for FY09 by 5% to factor in high rubber prices and retain estimates for FY10. We downgrade our rating from BUY to ADD, as the stock's recent rally has reduced the upside. Our target price remains unchanged at Rs43.

Expanding capacities to meet demand growth: Tyre demand in the domestic market has been growing at about 9-10% pa for the last few years and this momentum looks set to continue. To tap this strong demand growth, ATL has embarked on a Rs15bn capacity expansion programme, which includes capex of Rs11bn on Greenfield expansion near Chennai. This facility would be equipped to have a production capacity of 110tpd of passenger-car radial tyres and 80tpd of CV radial tyres. The greenfield plant is likely to start production by end-2009. ATL is also expanding its Baroda facility by 30tpd through de-bottlenecking. In addition, about 40tpd additional production is expected from productivity improvement at one of its two plants in Kochi.

Natural rubber (NR) price continues to be high on account of synthetic rubber (SR) shortage: Tightness in availability of butadiene, a key raw-material in SR production, has led to a shortage of SR in global markets. An early onset of the monsoon in major south-east Asian countries led to a truncated NR season, and NR production was inadequate to compensate for sluggishness in SR production. We expect SR supply tightness to continue for another month and then start easing, as butadiene supplies in the global market recover with the sharp fall in crude-oil prices.

ATL has increased tyre prices by ~11% since April 2008: To pass on cost increases, ATL has increased tyre prices by 5% in April 2008 and by 7% in July 2008 in the replacement market. ATL has taken small increases in the OEM market as well in the current fiscal. We expect the company to raise prices further if costs remain firm.

Substantial capacity addition in FY10ii (consolidated)



Source: Company, IIFL Research

Financial summary (Consolidated)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenues (Rs m)	42,992	46,912	59,365	65,957	73,779
EBIDTA	3,941	5,924	5,682	6,270	6,655
EBITDA Margins (%)	9.2	12.6	9.6	9.5	9.0
Reported PAT (Rs m)	1,171	2,697	2,449	2,664	2,608
EPS (Rs)	2.4	5.5	4.9	5.3	5.2
Growth (%)	17.5	130.4	-12.0	8.8	-2.1
PER (x)	**15.7**	**6.8**	**7.7**	**7.1**	**7.3**
ROE (%)	12.5	22.8	17.0	15.8	13.6
EV/EBITDA (x)	**6.0**	**3.7**	**4.5**	**5.0**	**4.6**
Price/Book (x)	1.9	1.6	1.3	1.1	1.0

Price as at close of business on 10 September 2008

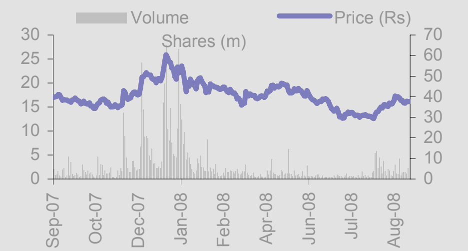
12-mth Target price (Rs) 43 (14%)

Market cap (US$ m)	**421**
52Wk High/Low (Rs)	63/28
Diluted o/s shares (m)	504
Daily volume (US$ m)	0.9
Dividend yield FY08ii (%)	1.3
Free float (%)	62.2

Shareholding pattern (%)	
Promoters	37.8
FIIs	17.0
Domestic MFs/Insurance cos	20.9
Others	24.3

Price performance (%)	**1M**	**3M**	**1Y**
Apollo Tyres	11.2	-0.4	-6.5
Rel. to Sensex	13.3	-0.1	-1.7
MRF	3.9	-9.8	-7.7
CEAT	-7.6	-18.5	-68.6
JK Tyres	-9.5	-20.8	-33.8

Stock movement



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Natural rubber (NR) prices remain high on account of SR (synthetic rubber) shortage: Tightness in availability of butadiene, a key raw material in SR production, has led to a shortage of SR supply in the global markets. This caused prices of SBR (most-used SR in India) to double to US$3670 per tonne from January 2008 to August 2008. With the strong increase in SR price and a supply shortage, demand for NR has increased. We expect SR supply tightness to continue for another month and start easing as butadiene supplies increase. The rupee's depreciation has accentuated the impact of raw-material price increases on domestic producers. NR prices have risen by 17% in international market and 49% in the domestic market since end-2007.

Huge capex by tyre industry to maintain pricing discipline: All major domestic tyre producers are expanding their tyre production capacities, particularly for T&B radials. The capex requirement for radial tyre capacity is much higher compared to bias tyres. Tyre producers have responded to raw material price increases in the past two years and largely maintained margins. We expect the discipline to continue for another one year with huge capex commitment by tyre majors. We expect industry discipline to come under test when Yokohama's Indian production facility commences production from end of FY10.

Import threat receding with Chinese Yuan appreciating against Rupee: Share of imported tyres has increased from 2.2% in FY06 to 4% in FY08 in the domestic market. For the key truck and bus (T&B) segment imports has increased from 4.2% to 9% in this period. Anti-dumping duty is applicable to bias T&B tyre and is not applicable to radial T&B tyre. China was the major source for imports with price differential ranging between 20-30% with domestic tyres. Even though quality is cited as a major issue for imported tyres, huge difference in prices was encouraging use of imported tyres. Chinese Yuan has appreciated 3% against US$ and Indian Rupee has depreciated 12% against US$ since the start of FY09. We expect this to increase the price of imported tyres which would place Indian tyres at a competitive price.

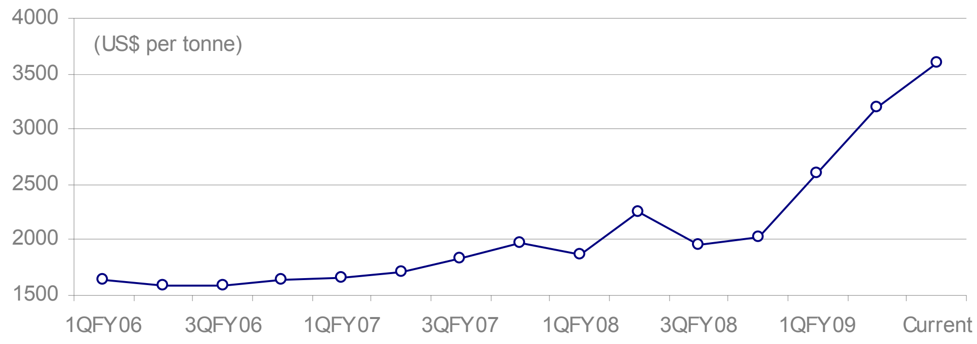
Figure 1: Domestic NR price has been surging…

Source: Capitaline

Figure 2: …while international NR price has eased from its peak

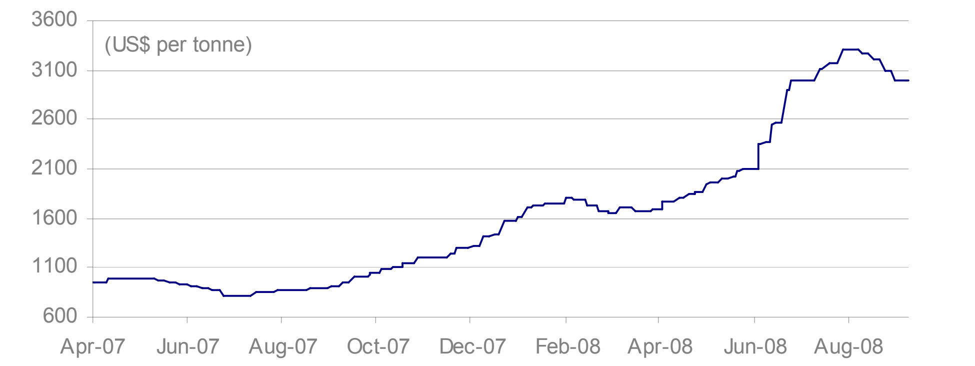
Source: Capitaline

Figure 3: SBR price has been on an upswing for the last three quarters



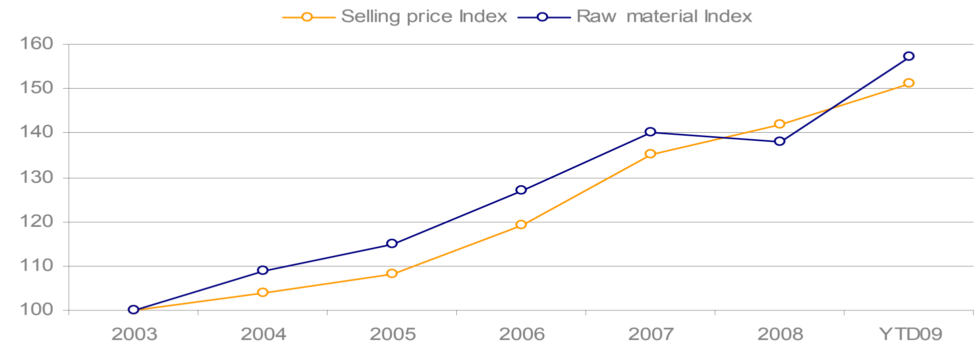
Source: IRSG, IIFL Research

Figure 4: Butadiene price has started easing after a sharp rise; positive impact on SR price is expected soon



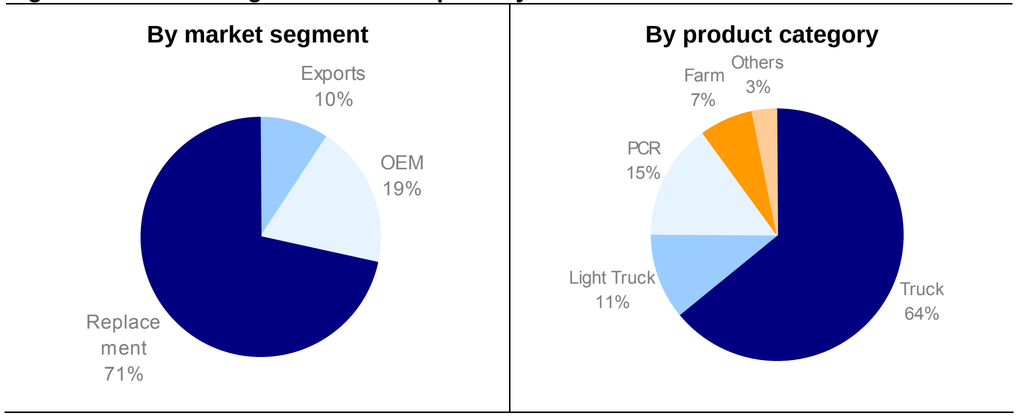
Source: IRSG, IIFL Research

Figure 5: ATL's raw-material index has risen more steeply than selling price



Source: Company

Figure 6: Revenue segmentation of Apollo Tyres



Source: Company

Financial summary

We expect EBIDTA to decline in FY09 and improve in FY10 and FY11 with higher sale volume and increase in realisation

FCF to be negative in FY09 and FY10 on account of huge capex, but largely supported by internal accruals

Income statement summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue	42,992	46,912	59,365	65,957	73,779
EBIDTA	3,941	5,924	5,682	6,270	6,655
EBIT	2,926	4,837	4,491	4,932	4,947
Interest Expense	-962	-785	-862	-1,012	-1,098
Depreciation	-1,172	-1,299	-1,350	-1,494	-1,920
PBT	1,964	4,053	3,629	3,920	3,849
Taxes	-793	-1,356	-1,180	-1,257	-1,241
Net Profit	1,171	2,697	2,449	2,664	2,608
Revenue	42,992	46,912	59,365	65,957	73,779

Cashflow summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
EBIT	2,926	4,837	4,491	4,932	4,947
Depr & Amortisation	1,172	1,299	1,350	1,494	1,920
Working capital ∆	197	-357	-423	-296	-255
Other operating items	2,342	299	0	0	0
Operating Cash flow	6,637	6,078	5,418	6,131	6,611
Net Interest/ Tax/ Others	-1,356	-1,712	-2,042	-2,268	-2,339
Capital Expenditure	-1,688	-1,351	-6,500	-9,500	-3,500
Free Cash Flow	3,594	3,014	-3,124	-5,638	772
Debt financing/disposal	-2,662	-1,731	500	6,500	0
Dividends paid	-292	-142	-283	-283	-283
Other items	-1,018	-229	456	0	0
Net Change in cash	-378	912	-2,451	579	489

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Cash & Cash equivalents	1,989	2,899	448	1,028	1,517
Sundry Debtors	3,674	3,129	3,834	4,264	4,697
Inventories - trade	6,387	7,151	9,155	10,169	11,419
Other current assets	2,136	1,682	1,682	1,682	1,682
Fixed assets	13,463	13,001	18,151	26,157	27,737
Goodwill	260	215	215	215	215
Total assets	27,909	28,077	33,486	43,514	47,267
Short term debt	688	1,112	1,396	1,537	1,715
Sundry Creditors	7,939	6,924	8,925	9,932	11,182
Long term debt	8,232	6,461	6,961	13,461	13,461
Other long term liabilities	1,701	1,756	1,756	1,756	1,756
Networth	9,348	11,825	14,447	16,828	19,153
Total liability and equity	27,909	28,077	33,486	43,514	47,267

Ratio analysis

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue growth (%)	63.7	9.1	26.5	11.1	11.9
Op EBIDTA growth (%)	76.9	50.3	-4.1	10.3	6.1
Op EBIT growth (%)	86.4	65.3	-7.2	9.8	0.3
Op EBIDTA margin (%)	9.2	12.6	9.6	9.5	9.0
Op EBIT margin (%)	6.8	10.3	7.6	7.5	6.7
Net Profit margin (%)	2.7	5.7	4.1	4.0	3.5
Dividend payout (%)	25.7	6.5	15.3	15.7	14.7
Tax rate (%)	40.4	33.5	32.5	32.1	32.2
Net Debt/Equity (%)	66.8	30.1	45.1	73.9	62.4
Net Debt/Op EBIDTA (x)	1.6	0.6	1.1	2.0	1.8
Return on Assets (%)	11.1	17.4	14.3	11.5	10.8
Return on Equity (%)	12.5	22.8	17.0	15.8	13.6

Source: Company data, IIFL Research

Net debt / equity to increase on account of funding for capex

Events calendar – September 2008

Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
1 Jul Imports ↑ 48% July Exports ↑ 31%	2	3	4 WPI for 23 Aug	5	6
8	9	10 SAIL–10	11 **WPI for 30 Aug**	12 July IIP	13
15	16	17	18 WPI for 6 Sep	19	20
22	23	24	25 WPI for 13 Sep	26	27
29	30 1QFY09 BoP				

Blue: Economic data, Orange: AGM

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, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
