Sharekhan top picks

With the late upsurge on September 4, 2009, the benchmark indices, the Sensex and the Nifty, managed to report marginal gains of 1.1% and 2.1% respectively since our last ValueGuide issue dated August 6, 2009. Throughout the month the markets remained in a narrow range. Our basket of stocks performed in line with the market, delivering a 2.1% return during the month. Amongst our picks, Godrej Consumer Products continued its smart upmove and gained 9.8% while our new addition last month, Emco, too delivered handsome returns of 8.8% during the month.

For September 2009, we are making two changes in the portfolio. We are replacing Balrampur Chinni Mills and Lupin with IDBI Bank and Ipca Laboratories. Balrampur Chinni Mills could underperform in the near term due to the expected government intervention to control sugar prices. On the other hand, IDBI Bank could get re-rated on the back of capital infusion by the government, as media reports suggest that the World Bank has approved the proposed loan for re-capitalisation of certain public sector banks in India. Our second pick, Ipca Laboratories, is a tactical switch from Lupin within the pharmaceutical space.

Name	CMP* (Rs)	PER (x)			RoE (%)			Target price	Upside (%)
		FY09	FY10E	FY11E	FY09	FY10E	FY11E		
Apollo Tyres	43	20.4	6.6	6.1	7.9	19.9	17.9	53	23.5
Bajaj Holdings	472	21.7	-	-	-	-	-	810	71.6
Bharti Airtel	405	18.2	15.3	13.4	26.2	23.8	21.3	453	11.9
BHEL	2,212	34.5	24.4	18.9	23.8	26.6	27.0	2,335	5.6
Emco	91	10.1	8.3	7.1	13.3	13.5	14.3	115	26.0
Godrej Consumer	237	35.4	25.0	22.0	46.9	38.8	36.1	240	1.2
IDBI Bank	107	9.0	7.2	5.7	12.1	13.2	14.5	169	58.7
IPCA Labs	700	17.4	9.9	8.2	15.2	24.6	25.3	770	10.0
ITC	233	27.1	22.9	19.8	25.3	25.8	25.1	248	6.3
Reliance Industries	1,981	20.0	16.6	12.9	13.2	14.5	15.8	2,020	2.0

* CMP as on September 04, 2009 **Price target under review

Name	CMP	PER			RoE (%)			Target	Upside
	(Rs)	FY09	FY10E	FY11E	FY09	FY10E	FY11E	price	(%)
Apollo Tyres	**43**	20.4	6.6	6.1	7.9	19.9	17.9	**53**	23.5

Remarks:

- Apollo Tyres Ltd (APL) is the market leader in truck & bus tyres and light truck tyres in India. The company also enjoys significant market share in the passenger car tyre segment. While the improving demand in replacement and OEM markets augurs well for the top line growth, much lower rubber prices will help APL post 3x jump in the net profit in FY2010 from domestic operations.
- To improve its market share and expand further the company is increasing its capacity in India from 850 tonne per day to around 1,000 tonne per day by establishing a new greenfield plant in Chennai. In international markets APL has presence in South Africa, and to further augment its international presence the company has recently acquired Vredestein Banden BV, a high-end passenger car tyre manufacturer in Netherlands. We believe the above organic and inorganic expansions coupled with improving business environment in the domestic market would help the company post strong growth in the coming years.
- We believe the key risks for APL lie in any sharp upward movement in rubber prices and crude derivatives used as inputs. Also, the near-term performance of the recently acquired European business is susceptible to difficult business environment in these markets.
- At the current market price the stock trades at 6.6x and 6.1x (its stand-alone) FY2010E and FY2011E earnings respectively. We maintain our Buy recommendation on the stock.

Bajaj Holdings	**472**	21.7	-	-	-	-	-	**810**	71.6

Remarks:

- Bajaj Holdings & Investments Ltd (BHIL) was created by de-merging Bajaj Auto and the company primarily functions in investment space. The company is also on a lookout for new business opportunities.
- BHIL holds Rahul Bajaj Group's strategic investments in Bajaj Auto, Bajaj Finserv, Bajaj Auto Holdings and Maharashtra Scooters. It also looks into other investments in equity markets and government securities, bonds, debentures and mutual funds.
- We value BHIL based on our price target for Bajaj Auto, Bajaj Finserv and other investments at market value and give the holding company a discount of 50% for the same. Moreover, we add the value of its cash and liquid investments, which gives us a fair value of Rs810 for the stock, which is substantially above its current market price of Rs471.
- Further, zero-debt status of the company makes the stock attractive. We therefore maintain Buy recommendation on the stock.

Bharti Airtel	**405**	18.2	15.3	13.4	26.2	23.8	21.3	**453**	11.9

Remarks:

- Bharti Airtel (Bharti) with over 24% market share is a leader in the Indian telecom space. On an average, the company has been adding around 2.8 million subscribers every month and its subscriber base has now crossed the 100 million mark.
- Despite the competition-led pricing pressures, Bharti has been able to sustain its operating margins at 42% on the back of strong growth in subscribers.
- We expect Bharti to maintain the momentum in the net subscriber additions despite the highly competitive environment. Moreover, a less-than-expected fall in the average revenue per user should lead to a stronger operating performance.
- With the entry of Reliance Communications in the GSM market, the competition is expected to increase, which could pressurise the margins. The uncertainty and aggressive bidding in 3G auctions are the risks, which could impact the cash flows of the company.
- At the current market price the stock trades at 15.3x FY2010 and 13.4x FY2011 estimated earnings.

Name	CMP	PER			RoE (%)			Target	Upside
	(Rs)	FY09	FY10E	FY11E	FY09	FY10E	FY11E	price	(%)
BHEL	**2,212**	34.5	24.4	18.9	23.8	26.6	27.0	**2,335**	5.6

Remarks:

- Bharat Heavy Electricals Ltd (BHEL) is a premier power generation equipment manufacturer and a leading EPC company. It has emerged as the prime beneficiary of the four-fold increase in the investments in the power sector in India.
- BHEL currently has orders worth Rs124,000 crore on hand, which provides revenue coverage for the next three to four years. With more than 80% of the orders coming from the government and state utilities, the risk of order cancellation is minimal.
- The company would also be awarded five or six sets of 800MW supercritical technology based units from National Thermal Power Corporation (NTPC) on a negotiated basis. We believe the order inflow momentum would continue to remain strong for the company.
- At the beginning of 2008, the company brought on-stream 4GW of additional manufacturing capacity, taking its total capacity to 10GW per annum. In our view, the stabilisation of the new capacity coupled with the de-bottlenecking of the supply chain would aid BHEL's revenues to grow at a CAGR of 25.9% over FY2009-11E. We estimate the profits to grow at a CAGR of 35% over FY2009-11E. However, the key challenge for BHEL would be the timely execution of projects.
- We have a Hold recommendation on BHEL mainly because at the current valuation of 18.9x our FY2011 earnings per share estimate (the valuation is at a substantial premium to that of the Sensex) the stock price is closer to our fair value for the stock. However, we continue to like BHEL because of its resilient business model that is expected to provide the highest revenue and profit growth among the Sensex stocks. We, therefore, maintain BHEL amongst our Top Picks with a price target of 2,335.

Emco	**91**	10.1	8.3	7.1	13.3	13.5	14.3	**115**	26.0

Remarks:

- Emco is a leading player in the domestic power transmission and distribution (T&D) space and is fast emerging as an end-to-end solution provider in the space. The company offers the widest range of transformers in the country.
- The current order backlog stands at Rs1,505 crore (1.42x FY2009 revenues) imparting visibility to the earnings going forward. Furthermore, with close to 70% of the orders coming from government companies (state electricity boards and public sector undertakings) the risk of order cancellation and delay is lower.
- We believe the order pipeline would continue to be robust for Emco on the back of increased governmental thrust on power T&D spending.
- Key risks to the company are slower-than-expected execution of orders and slower order inflow.
- We expect Emco's revenue and profit to witness a compounded annual growth rate of 17.3% and 19.4% over FY2009-11E. At the current market price the stock trades at 8.3x and 7.1x FY2010 and FY2011 fully diluted earnings per share (EPS) respectively. We recommend Buy on the stock with the price target of Rs115.

Godrej Consumer	**237**	35.4	25.0	22.0	46.9	38.8	36.1	**240**	1.2

Remarks:

- GCPL is a major player in the Indian fast moving consumer goods (FMCG) market with presence in soap, hair dye and hair colour, liquid detergent and toiletries categories. With rural demand remaining strong and the ongoing downturn keeping the demand for FMCG products buoyant at the bottom of the pyramid, GCPL's soap portfolio, which contributes more than half of its annual revenues, will outperform the industry in terms of volume growth. Thus we expect GCPL's top line to grow at CAGR of 15.3% over FY2009-11.
- With the steep correction in the palm oil prices (the key raw material), we expect the margins of the company to substantially improve and result in a hefty growth of 35% yoy in its net profit in FY2010.
- With strong cash flows and healthy cash on books (Rs400 crore as on March 31, 2009), GCPL is well funded to make acquisitions in both domestic and international markets which we believe could act as additional triggers for the stock.
- We see impact of the recession on GCPL's business in the UK as a key concern, also on the domestic front deficient monsoons and its impact on rural incomes could slowdown the growth momentum for GCPL.
- With a 26.5% CAGR over FY2009-11 it will outperform the industry and remain one of the better performing companies in the FMCG space. At the current market price the stock trades at a valuation of 22x its FY2011E earnings (excluding Sara Lee acquisition). We maintain our Hold recommendation on the stock.

Name	CMP	PER			RoE (%)			Target	Upside
	(Rs)	FY09	FY10E	FY11E	FY09	FY10E	FY11E	price	(%)
IDBI Bank	**107**	9.0	7.2	5.7	12.1	13.2	14.5	**169**	58.7

Remarks:

- IDBI Bank, the eighth largest bank in India, is all set to improve its core performance with margin improvement already underway. The current environment is quite conducive for the bank's efforts to improve its net interest margin (NIM) further, as wholesale borrowing costs have come off significantly.
- Capital infusion by the government is on cards and would be a major catalyst in helping the bank improve its core banking operations. Already, the World Bank board has approved the loan to the government of India, which is aimed at recapitalisation of some of the banks. Final approval on the same is expected in mid September 2009.
- We expect the bank's return on equity (RoE; excluding revaluation reserves) to increase from 12.1% in FY2009 to 13.8% in FY2010 and to ~14% in FY2011 driven by improved core performance. Considering this along with the value of the bank's enviable investment portfolio, at the current valuation (of 1.0x FY2011E adjusted book value) the bank is trading at attractive valuations.

IPCA Labs	**700**	17.4	9.9	8.2	15.2	24.6	25.3	**770**	10.0

Remarks:

- With a strong presence in the branded segments in the semi-regulated markets, a significant scale-up expected in its US generic business and strong momentum in its retail domestic formulation business, Ipca is a strong play on the global pharmaceutical opportunity.
- Driven by steady new launches, a strong therapy-focused field force and good brand building abilities, Ipca's domestic formulation business has been growing at above industry growth rates. We expect Ipca's domestic formulation business to grow at 18% CAGR over FY2009-11.
- Africa and Russia would be the key growth drivers of exports on the back of the previous year's low base and a substantial increase in product offerings. The continued growth in exports at 13.5% CAGR over FY2005-09 and the expansion of margins are indicative of the underlying momentum in the overseas sales and reinforce our confidence in Ipca's export competitiveness.
- Over the past few years Ipca has steadily invested in building its sales network across the world and in developing APIs at the lowest cost. We believe Ipca is now set to reap the benefits of its investments and strong API capabilities to participate aggressively in the global generic opportunity.
- With the Indore SEZ ready be commissioned, we believe the company is through with its major expansion plans and would sweat its assets going forward, thereby improving the cash flow.
- With a strong growth in the branded portfolio and a low-cost operating structure, we expect Ipca's margins to remain on the up trend. At 9.9x FY2010E and 8.2x FY2011E earnings, the stock's valuations seem absolutely compelling when viewed in context of the strong growth potential that awaits the company.

ITC	**233**	27.1	22.9	19.8	25.3	25.8	25.1	**248**	6.3

Remarks:

- ITC's cigarette business that has dominance in the category continues to be a cash cow for the company. ITC has chalked out an aggressive roadmap for making a mark in the Indian FMCG market with successful brands such as *Bingo*, *Sunfeast* and *Aashirwaad* already in the reckoning among the best in the industry. The company has further ventured into the personal care category with the launch of *Superia* and *Fiama Di Wills* soaps and shampoos that would compete with the likes of products from HUL and Procter & Gamble.
- After a sharp increase in the excise duty on cigarettes in the last two union budgets, the government was less lethal in the FY2009-10 union budget and did not increase the excise duty. This augurs well for ITC's cigarette business. Further, the sharp correction in the raw material prices, rationalisation of the company's biscuit portfolio and an increase in the scale of its personal care business would lower the losses in the non-cigarette FMCG business in FY2010.
- An increase in taxation and the government's intentions to curb consumption of tobacco products remain the key risks to ITC's cigarette business over the longer term.
- We expect ITC's top line to grow at a CAGR of 13.6% and its bottom line to grow at a CAGR of 16.9% over FY2009-11. At the current market price, ITC trades at 19.8x its FY2011E earnings. We maintain our Hold recommendation on the stock.

Name	CMP	PER			RoE (%)			Target	Upside
	(Rs)	FY09	FY10E	FY11E	FY09	FY10E	FY11E	price	(%)
Reliance Industries	1,981	20.0	16.6	12.9	13.2	14.5	15.8	2,020	2.0

Remarks:

- With the start of commercial production of gas in April 2009 and that of crude oil in September 2008 (both from KG basin), Reliance Industries Ltd (RIL) holds a great promise in the E&P business. The E&P business is expected to add significantly to the company's earnings and cash flow from FY2010 onwards with majority of the earnings coming from the less volatile natural gas business. The gas production will begin in small tranches initially and is expected to 80mmscmd by the end of 2009. At present, the company's reserves are estimated at 9 billion barrels of oil equivalents.
- We expect the gross refining margin (GRM) of RIL to contract in the near to medium term, as new refineries with total capacity of 1.5-2.0 million barrel per day (including Reliance Petroleum Ltd [RPL]) are expected to come on-stream in 2009 in the environment of weak demand. However, we expect RIL to fetch a premium over Singapore Complex' GRM due to its superior refinery complexity. The refining volumes would also double as RPL's refinery became operational on December 25, 2008.
- We believe that RIL would be bale to maintain superior margin in the petrochemical business given its increased focus on the domestic market (strong demand and high price realisation environment).
- A delay in the ramp-up of KG D-6 gas production and an adverse verdict of the Supreme Court of India on its legal feud with RNRL and another legal case with NTPC are the key risks to our estimates. Furthermore, there is still ambiguity related to the likely change in the section 80IB, which could take away the benefit of the seven-year tax holiday from the gas production. Any further fall in the refining and petrochemical margins could result in deviation from our estimates.
- At the current market price, the stock is trading at 12.9x FY2011E consolidated earnings.

The author doesn't hold any investment in any of the companies mentioned in the article.