investor's eye

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Index

Take Five

Scrip	Reco Date	Reco Price	CMP	Target
Aban Loyd	03-Mar-05	330	**935**	1,760
Bajaj Auto	15-Nov-05	1,873	**2,487**	3,500
BHEL	11-Nov-05	1,203	**1,806**	2,650
Esab India	21-May-04	60	**296**	575
Infosys	30-Dec-03	689	**1,630**	1,865

Nelco

Vulture's Pick

Stock Update

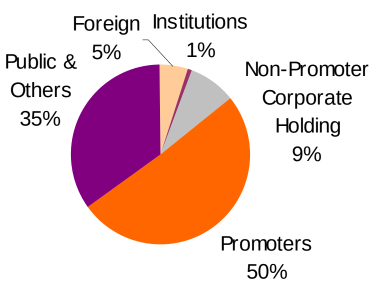
Deteriorating outlook

Hold; CMP: Rs81

Company details

Price target:	Rs216
Market cap:	Rs185 cr
52 week high/low:	Rs196/46
NSE volume: (No of shares)	36,435
BSE code:	504112
NSE code:	NELCO
Sharekhan code:	NELCO
Free float: (No of shares)	1.2 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	27.3	-36.0	-46.0	77.6
Relative to Sensex	21.6	-28.9	-51.6	23.3

During the first half ended March 2006, Nelco's revenues were flat and losses at the net level reduced to Rs7.3 crore from Rs14.1 crore in the corresponding period of the last fiscal. The loss at the operating level also reduced from Rs8.8 crore to Rs2.7 crore. However, the performance has been far below our expectations.

Defence orders delayed

The outlook for the second half is also not encouraging. In our recent interaction, the management indicated that the expected tenders for the procurement of surveillance equipment and solutions have been delayed. This essentially means that, unlike the last fiscal, the high-margin defence orders would not make any meaningful contribution to the company's overall turnover in this fiscal.

Second, there has been little progress in the proposed second phase of development at its Andheri property. The company has still not received the required statutory clearances to construct the proposed additional structure that was expected to get completed by December 2006 (as per its annual report FY2004-05 and the management's comment in the annual general meeting [AGM] held in December 2005).

Re-rating triggers uncertain

The two events that could result in the re-rating of the stock have also got postponed. First, one of the company's key foreign collaborators, Thales of France (in consortium with another large French company), has secured a $3-billion order for the supply of six conventionally propelled "Scorpene" submarines.

It is the first major defence order secured by India under the Defence Procurement Policy 2005. The policy has introduced offset clause in India, and the contract involves technology transfer and assisting Mumbai-based Mazagoan Dock to manufacture the six submarines. The portion of the deal for Thales is worth around $700 million, which involves the supply of sub-systems (for the combat system) like underwater sensors, communication systems, optronics and electronics warfare equipment. And given the French company's strong relationship with Nelco in India, some of the integration and implementation work is expected to be outsourced to Nelco. However, the contract has been entangled in controversies, with the opposition parties and certain factions of the ruling coalition government strongly opposing the deal.

Second, there has not been much progress on the possible induction of a strategic investor also. The management had indicated that it intended to induct a strategic investor in the company during its last AGM.

Valuation

Nelco's performance is likely to be lacklustre due to the delay in securing fresh orders from the defence sector. Moreover, the company's inability to get the required statutory approvals to develop an additional structure at its existing property is another concerning factor that is likely to affect its performance in the current fiscal. Over the long term as well, the re-rating triggers are also likely to get delayed. Consequently, we are downgrading the stock to Hold.

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

Deepak Fertilisers & Petrochemicals Corporation

Ugly Duckling

Stock Update

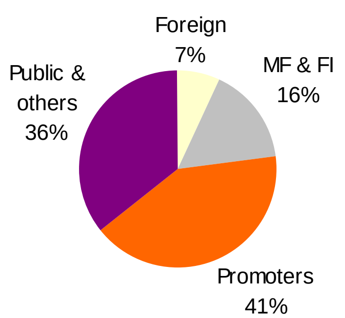
A turn-around in performance

Buy; CMP: Rs74

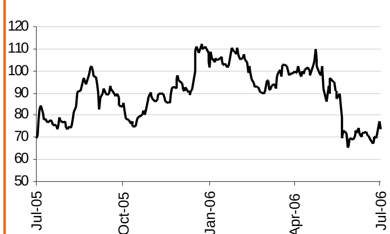
Company details

Price target:	Rs126
Market cap:	Rs650 cr
52 week high/low:	Rs117/63
NSE volume: (No of shares)	1.26 lakh
BSE code:	500645
NSE code:	DEEPAKFERT
Sharekhan code:	DPKFERT
Free float: (No of shares)	5.2 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	15.6	-18.6	-22.2	21.6
Relative to Sensex	10.5	-9.6	-30.3	-15.6

Result highlights

- Deepak Fertilisers and Petrochemicals Corporation Ltd (DFPCL) saw a turn-around in Q1FY2007 after a dull performance in the previous three quarters.
- The revenues for the quarter stood at Rs168.2 crore, up 20.6% year on year (yoy). The revenue growth was driven by the increase in the sale of the traded products.
- The operating profit margin (OPM) for the quarter under review was at 23%. Although it is lower than the Q1FY2006 OPM of 27.6%, the same is a major improvement over the margins in the previous three quarters. The operating profit declined by 1.9% yoy to Rs38.6 crore during the quarter.
- The lower tax outgo helped the company to report a growth of 9.6% yoy in the net profit to Rs24.8 crore.
- We have lowered our earnings per share (EPS) estimates for the company for FY2007 and FY2008 from Rs17 and Rs19 to Rs12.5 and Rs16 respectively to take into account the delayed start of the isopropyl alcohol (IPA) project and the Ishanya Mall as well as the lower margins in the bought ammonia-based production.
- We believe that DFPCL is entering into a new growth phase with its various investment plans which are likely to take place over next two to three years like
  - With no disruption in the gas supply the contribution from the existing business to earnings is likely to remain healthy.
  - The IPA plant as well as the Ishanya mall will be fully operational throughout FY2008.
  - The commencement of the Dahej-Uran-Pune pipeline in H1CY2007 will bring in liquefied natural gas (LNG) for six to nine months of FY2008.
  - The ammonium nitrate plant is likely to be fully operational through FY2009 and can contribute another Rs200 crore to the revenues in that year.
- At the current market price of Rs74, the stock is quoting at 4.8x its FY2008E EPS. We maintain a Buy recommendation on the stock with the price target of Rs126.

Result table Rs (cr)

Particulars	Q1FY2007	Q1FY2006	% yoy chg
Net sales	168.2	139.4	20.6
Other income	4.0	3.1	30.3
Total income	172.2	142.5	20.9
Total expenditure	129.6	100.1	29.5
Operating profit	38.6	39.4	-1.9
Interest	2.5	1.4	84.6
Depreciation	7.8	7.8	-0.4
Profit before tax	32.3	33.3	-2.8
Total tax	8.6	10.5	-18.4
Reported profit after tax	23.7	22.7	4.4
Extraordinary items	-1.1	0.1	
Adjusted profit after extraordinary item	24.8	22.6	9.6
OPM (%)	22.9	28.2	

Revenues grow by 20.6% yoy

DFPCL's revenues for Q1FY2007 grew by 20.6% yoy to Rs168.2 crore. The sales of the manufactured products remained flat at Rs83.2 crore, the same as in the last year. In Q1FY2006, the production of chemicals was higher as the company had access to additional gas. The plants of a few gas users around DFPCL's facilities were shut during the quarter and consequently the left-over gas was supplied to DFPCL.

Rs crore	Q1FY2007	Q1FY2006	% y-o-y chg
Manufactured products			
Chemicals	83.2	83.0	0.2
Fertilisers	17.7	9.6	83.8
Total	100.8	92.6	8.9
Traded products			
Chemicals	26.8	21.3	25.8
Fertilisers	43.5	27.6	57.4
Total	70.2	48.9	43.6

Operating profit declines by 1.9%

The operating profit for Q1FY2007 declined by 1.9% yoy to Rs38.6 crore as the OPM declined by 527 basis points to 23%. However, the OPM for Q1FY2006 was higher for two reasons:

- the higher availability of gas helped the company to report a better growth in volumes in Q1FY2006;
- the higher availability of gas also helped it to lower the use of the ammonia purchased in Q1FY2006.

Net profit grows by 9.6% yoy

The net profit for Q1FY2007 grew by 9.6% yoy as the effective tax rate for Q1FY2007 was lower at 26.6% compared with 31.7% in Q1FY2006. The tax rate was lower due to the accelerated depreciation on account of the IPA project.

Delay in execution of the projects

There has been a significant delay in the execution of the two major capital investment plans undertaken by DFPCL. The commencement of the IPA plant has been delayed by four months whereas the revenue flow on account of the shopping mall, Ishanya, has been delayed by at least six months. The IPA plant will be operational for a period of eight months in FY2007 whereas the Ishanya mall will contribute only six months of revenues. However FY2008 will see a full-fledged revenue flow from these two projects.

The project to expand the company's ammonium nitrate capacity by 300,000 tonne per annum at Paradip in Orissa is also likely to get delayed by three months and is expected to come on stream by March-April 2008.

DUP pipeline expected in H1CY2007

Gail India's DUP pipeline is likely to come up in H1CY2007. Currently DFPCL is operating at 70% of its capacity of which nearly 20% is based on the ammonia purchased. The availability of LNG through the DUP pipeline will help DFPCL to utilise the balance 30% capacity and also lower the use of ammonia. All this could improve the company's profitability significantly. However, we have not factored the impact of the same in our numbers.

Valuation and view

We have revised our EPS estimates for FY2007 and FY2008 from Rs17 and Rs19 to Rs12.4 and Rs16 respectively to take into account the delayed start of the IPA project and the Ishanya mall as well as the lower margins from the bought ammonia-based production.

However, we believe that DFPCL is entering a strong growth phase over next three years on account of the following.

- With no disruption in the gas supply the contribution from the existing business to earnings is likely to remain healthy.
- The IPA plant as well as the Ishanya mall will be fully operational throughout FY2008.
- The commencement of the Dahej-Uran-Pune pipeline in H1CY2007 will bring in liquefied natural gas (LNG) for nine months of FY2008 which might help it to stretch its capacity utilisation to 100% from the current 65-70%. This will help DFPCL to boost revenues by Rs130-150 crore and the net profit by Rs20-25 crore in FY2008.
- The ammonium nitrate plant is likely to be fully operational through FY2009 and can contribute another Rs200 crore to the revenues in that year.

Notably, despite the huge capex lined up we do not expect DFPCL's debt/equity ratio to go beyond 1:1. The expected dividend rate remaining the same at 30% gives a dividend yield of 4.1%.

At the current market price of Rs74, the stock is quoting at valuations of 4.8x its FY2008E EPS. We believe the valuations are attractive. We maintain a Buy recommendation on the stock with the price target of Rs126.

Valuation table

Particulars	FY2005	FY2006	FY2007E	FY2008E
Net profit (Rs crore)	78.1	74.6	109.2	139.1
Shares in issue (crore)	8.8	8.8	8.8	8.8
EPS (Rs)	8.9	8.5	12.4	15.8
% y-o-y chg	*7.0*	*-4.5*	*46.3*	*27.4*
PER (x)	8.4	7.9	6.2	4.8
Book value (Rs)	63.4	69.2	78.1	90.5
P/BV (x)	1.2	1.1	0.9	0.8
Dividend yield (%)	4.9	4.1	4.1	4.1
EV/EBIDTA (x)	4.3	6.0	3.9	3.4
EV/Sales (x)	1.1	1.1	0.9	0.8
RoCE (%)	11.5	11.3	13.6	16.1
RoNW (%)	14.1	14.2	16.2	18.2

Crompton Greaves

Apple Green

Stock Update

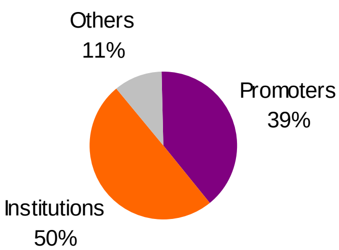
Q1FY2007 results first cut analysis

Buy; CMP: Rs910

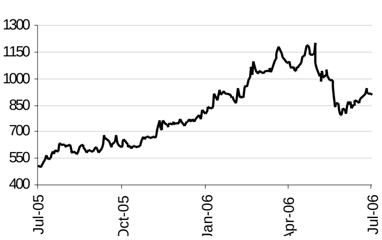
Company details

Price target:	Rs1,144
Market cap:	Rs4766 cr
52 week high/low:	Rs1,225/495
NSE volume: (No of shares)	44,605
BSE code:	500093
NSE code:	CROMPGREAVE
Sharekhan code:	CROMPTON
Free float: (No of shares)	3.2 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	9.4	-16.0	14.6	87.7
Relative to Sensex	4.5	-6.7	2.7	30.3

Result highlights

- Crompton Greaves' revenues grew by 42.5% year on year (yoy) in Q1FY2007 to Rs740.6 crore, way ahead of our expectations. Although all its three divisions reported strong performance, the power systems division was the pick of performance with a growth of 66.4% yoy to Rs346.9 crore. Consumer products division grew by 27.8% yoy to Rs265.8 crore and the industrial systems division grew by 26.8% yoy to Rs189.5 crore.
- The raw material cost to sales spiked to 73.3% in Q1FY2007 against 69.9% in Q1FY2006 largely due to changing revenue mix towards low margin power systems business. However, stable employee and other expenses negated the impact of the same. Consequently, the operating profit margin (OPM) improved by 100 basis points yoy to 9.7% and the operating profit for the quarter grew by 58.7% to Rs72.2 crore, which was ahead of our expectations.
- The growth in the net profit during the quarter was slower at 14.6% yoy (in comparison with the revenue and operating profit growth), but still was in line with our expectations. Slower growth was attributable to higher tax rate of 41% (including deferred tax) in the quarter as the company no longer falls under the minimum alternative tax regime as was the case last year.
- At the current market price of Rs910, Crompton Greaves is trading at 21.5x its FY2008E stand-alone earnings per share. We maintain a Buy on the stock with a price target of Rs1,144.

We also attended the annual general meeting of the company. A detailed analysis of the same and quarterly results will follow soon.

Result table (stand-alone) Rs (cr)

Particulars	Q1FY2007	Q1FY2006	% yoy chg
Net sales	740.6	519.8	42.5
Expenditure	668.5	474.3	40.9
Operating profit	72.2	45.5	58.7
Other income	4.9	7.7	-36.0
Interest	5.3	7.5	-29.5
Depreciation	10.0	10.5	-4.7
PBT	61.8	35.2	75.7
Tax	25.4	3.9	548.7
PAT	36.4	31.2	16.4
EPS (Rs/Share)	6.9	6.0	16.4
OPM (%)	9.7	8.7	100.0 bps

Earning table (stand-alone)

Particulars	FY2004	FY2005	FY2006	FY2007E	FY2008E
Net profit (Rs cr)	62.6	109.6	168.7	185.8	221.6
EPS (Rs)	11.9	20.9	32.2	35.5	42.3
% yoy growth	*232.3*	*75.1*	*53.9*	*10.1*	*19.3*
PER (x)	76.2	43.5	28.3	25.7	21.5
Book Value (Rs)	57.8	71.2	95.7	124.1	159.5
P/BV (x)	15.7	12.8	9.5	7.3	5.7
EV/Ebidta (x)	30.4	25.6	17.5	13.8	11.3
ROCE (%)	15.1	20.6	30.3	34.1	35.0
RONW (%)	18.4	26.8	31.4	27.1	25.5

Note: In the interest of timeliness, Crompton Greaves document was not edited.

Banking

Sector Update

Change in investment portfolio guidelines

MTM losses can be passed directly to balance sheet—a positive for banks

The Reserve Bank of India through its circular dated July 14, 2006 has issued draft guidelines on classification and valuation of investments by the Indian banks. Under the new guidelines the banks will not have to provide mark-to-market (MTM) losses on their investments in the "available for sale" (AFS) category in the Profit and Loss (P&L) account. The banks will have to provide for MTM losses only on the bonds in the "held for trading" portfolio in the P&L account. For the bonds in the AFS category, the MTM losses or gains can be debited or credited against an account called "Unrealised gain/loss on AFS portfolio (UGA)" account in the balance sheet.

We believe that the move is a positive for the banking sector for three reasons.

- *It will reduce earnings volatility to a great extent:* In today's rising interest rate scenario the provisioning on account of the MTM losses has gone up substantially, affecting the banks' profitability. As the MTM losses will not feature in the P&L account of the banks, it will reduce the volatility in the earnings of the banks on account of interest rate movements. This will help shift focus to the core earnings of the banks and consequently improve the valuation of their stocks.
- *Impact on Tier-I capital to be minimal:* Till now the banks had to ignore any appreciation in the AFS portfolio. The appreciation to the AFS bond portfolio will now be credited to the UGA account and can be counted as part of the Tier-I capital. But in a rising interest rate scenario we believe that it will have minimal or no impact. However, the debit balance in the UGA account will also have to be deducted for calculating the Tier-I capital.
- *Impact on book value to be minimal:* This will help the banks to improve their book value provided the MTM losses are not expected to be of long-term nature. However, if the MTM losses are likely to continue for a longer term, then their impact would be neutral, as for analytical purposes it would be prudent to deduct the debit balance in the UGA account from the net worth.

Change in HTM guidelines—appreciation in portfolio can be recognised

Under the existing guidelines the banks are required to write off the premium on the bond in the held till maturity (HTM) category over the life of the bond. However, if the bond is bought at a discount, the difference between the acquisition price and the face value cannot be recognised as income.

For instance, if a bank acquired a five-year bond with a face value of Rs100 at a price of Rs125, the premium of Rs25 over the cost price has to be amortised over the life of a bond. But if the same is acquired at Rs75, the discount of Rs25 cannot be recognised as income.

As per the new guidelines the appreciation in the HTM bond portfolio can be written back as income. We believe this will help the banks to reduce their amortisation expenses marginally.

During any year, if a bank sells or transfers more than 5% of its HTM bond portfolio held at the end of the previous year, it would need to re-classify the whole remaining HTM bond portfolio as AFS bond portfolio. The gains/losses on the same would then have to be adjusted against the UGA account.

Revised guidelines to be effective only in FY2008

The new guidelines are effective only from April 1, 2007, ie for FY2008 and onwards. The new guidelines would have benefited the banks in a great way had they been made applicable from FY2007 onwards. The yield on a ten-year government bond has gone up by approximately 78 basis points over March 31, 2006. Consequently, the banks are expected to report weak earnings over Q1FY2007 (see our report "Banking earnings preview' dated July 12, 2006). Over the high base of FY2007, the bond yields are not expected to depreciate much.

In case the ten-year bond yield crosses the current level of 8.36% in FY2008, the banks like Punjab National Bank and Canara Bank would gain the most from the change in the guidelines.

Bond portfolio position of banks

Bank	Investment portfolio	Rs crore HTM	Rs crore AFS	% of total HTM	% of total AFS
Allahabad Bank	17,984.7	5,449.4	9,352.0	52.0	48.0
Andhra Bank	11,444.2	3,204.4	6,980.9	61.0	39.0
Bank of Baroda	35,114.2	10,183.1	22,824.2	65.0	35.0
Canara Bank	36,974.0	9,983.0	15,529.1	42.0	58.0
Corporation Bank	10,652.0	2,929.3	7,136.8	67.0	33.0
HDFC Bank	28,394.0	7,382.4	22,715.2	80.0	20.0
ICICI Bank	71,547.0	17,886.8	53,660.3	75.0	25.0
IDBI	25,573.0	2,634.0	20,458.4	80.0	20.0
PNB	41,055.0	12,316.5	25,043.6	61.0	39.0
SBI	159,000.0	55,650.0	109,710.0	69.0	31.0
Syndicate Bank	17,269.1	5,008.0	12,433.8	72.0	28.0
Union Bank	25,917.6	6,738.6	18,919.8	73.0	27.0
UTI Bank	21,527.0	6,027.6	11,839.9	55.0	45.0

Valuations remain attractive

We believe that the Indian banking sector is likely to see a healthy growth in its core earnings (earnings excluding treasury income and losses on MTM and amortisation) over the next two years. Also the above mentioned norms will help to stabilise the banks' earnings and shift the focus to their core earnings (earnings excluding the treasury income and MTM losses). With a strong growth in the core earnings of the banks, the valuations of 0.6-0.8x FY2008E book value for the public sector banks and of 1.5-3.1x book value for the private sector banks remain attractive.

Valuation table

	Price (Rs)	PER (x) FY06	PER (x) FY07E	PER (x) FY08E	P/BV (x) FY06	P/BV (x) FY07E	P/BV (x) FY08E
Corp Bank	212.8	6.9	5.7	4.8	0.9	0.8	0.7
PNB	305.3	6.7	5.5	4.7	1.1	0.9	0.8
SBI	696.9	8.3	6.5	5.2	1.0	0.9	0.8
UBI	82.9	5.7	4.2	3.4	0.9	0.8	0.6
ICICI Bank	471.0	16.5	12.0	10.1	1.9	1.7	1.5
HDFC Bank	711.0	25.4	19.7	15.1	4.1	3.8	3.1
UTI Bank	252.0	14.6	11.7	9.7	2.4	2.1	1.8

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

Sharekhan Stock Ideas

Evergreen

- HDFC Bank
- Infosys Technologies
- Reliance Industries
- Tata Consultancy Services

Apple Green

- Aditya Birla Nuvo
- Associated Cement Companies
- Bajaj Auto
- Balrampur Chini Mills
- Bharat Bijlee
- Bharat Heavy Electricals
- Corporation Bank
- Crompton Greaves
- Godrej Consumer Products
- Elder Pharmaceuticals
- Grasim Industries
- Hindustan Lever
- Hyderabad Industries
- ICICI Bank
- Indian Hotel Company
- ITC
- Mahindra & Mahindra
- Marico Industries
- Maruti Udyog
- MRO-TEK
- Lupin
- Nicholas Piramal India
- Omax Auto
- Ranbaxy Laboratories
- Satyam Computer Services
- Sintex Industries
- SKF India
- State Bank of India
- Sundaram Clayton
- Tata Motors
- Tata Tea
- Unichem Laboratories
- Wipro

Cannonball

- Cipla
- Gateway Distriparks
- International Combustion (India)
- JK Cements
- Madras Cement
- Shree Cement
- Transport Corporation of India

Emerging Star

- 3i Infotech
- Aarvee Denims and Exports
- Aban Loyd Chiles Offshore
- Alok Industries
- Alphageo India
- Cadila Healthcare
- KSB Pumps
- Marksans Pharma
- Navneet Publications (India)
- New Delhi Television
- Orchid Chemicals & Pharmaceuticals
- ORG Informatics
- Solectron Centum Electronics
- Television Eighteen India
- Thermax
- Tube Investments of India
- TVS Motor Company
- UTI Bank
- Welspun Gujarat Stahl Rohren
- Welspun India

Ugly Duckling

- Ashok Leyland
- Deepak Fertilisers & Petrochemicals Corporation
- Genus Overseas Electronics
- HCL Technologies
- ICI India
- Jaiprakash Associates
- JM Financial
- KEI Industries
- NIIT Technologies
- Punjab National Bank
- Ratnamani Metals and Tubes
- Sanghvi Movers
- Saregama India
- Selan Exploration Technology
- Subros
- Sun Pharmaceutical Industries
- Surya Pharmaceuticals
- UltraTech Cement
- Union Bank of India
- Universal Cables
- Wockhardt

Vulture's Pick

- Esab India
- Nelco
- Orient Paper and Industries
- WS Industries India

Home