kotak® Institutional Equities

INDIA DAILY

October 18, 2007

EQUITY MARKETS

India	17-Oct	Change, % 1-day	1-mo	3-mo
Sensex	18,716	(1.8)	19.4	22.3
Nifty	5,559	(1.9)	22.3	23.6
Global/Regional indices				
Dow Jones	13,893	(0.1)	1.1	(0.2)
Nasdaq Composite	2,793	1.0	5.3	3.5
FTSE	6,678	1.0	6.3	1.7
Nikkie	17,097	0.8	8.2	(5.1)
Hang Seng	29,885	2.0	21.6	30.8
KOSPI	2,007	1.2	9.2	4.0

Value traded - India

	17-Oct		Moving avg, Rs bn 1-mo	3-mo
Cash (NSE+BSE)	340.6		257.4	192.6
Derivatives (NSE)	984.0		357.7	458.3
Deri. open interest	1,007.3		863.0	853.3

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News Roundup

Corporate

- Beer giants Carlsberg and Heineken informed the London Stock Exchange that they were in discussions for a consortium bid to buy out UK-headquartered Scottish & Newcastle (S&N) which owns a 37.5% stake in United Breweries (UB). (ET)
- In a sharp reaction to the Orissa government's "inaction" to provide "support and security" for the implementation of its Rs51,000-crore stell project at Paradip, South Korean steel major Posco withdrew most of its staff from the site office and relocated them to its Bhubaneshwar corporate office. (BS)
- Airbus is considering buying 10 Aorbus A380s, the world's largest civilian aircraft. (BS)
- Patni Computer Systems has signed a five-year deal worth US$200 mn with UK-based Carphone Warehouse, a leading independent mobile phone retailer. (BS)

Economic and political

- The Sensex closed Wednesday, October 17 down just 1.76% at 18,715.82, ending a day of twists and turns during which the benchmark Sensex plunged 10% within minutes of opening. The plunge forced a one-hour trading halt for the third time in the history of the markets, which recovered dramatically following clarifications from the finance minister and market regulator and buying interest from domestic institutions.
- TRAI (Telecom Regulatory Authority of India) has recommended a foreign equity cap of 74% for companies that want to operate Headend in the Sky (HITS).

Source: ET = Economic Times, BS = Business Standard, FE = Financial Express, BL = Business Line.

Forex/money market

	17-Oct	Change, basis points 1-day	1-mo	3-mo
Rs/US$	39.5	-	(100)	(83)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.0	(1)	8	5

Net investment (US$mn)

	16-Oct		MTD	CYTD
FIIs	286		4,890	17,909
MFs	(76)		(764)	(110)

Top movers -3mo basis

Best performers	17-Oct	Change, % 1-day	1-mo	3-mo
Reliance Energy	1,762	(7.5)	90.2	155.9
Neyveli Lignite	126	2.5	31.4	88.4
Tata Power	1,176	(14.2)	57.2	75.6
SAIL	247	(1.9)	43.6	60.5
Reliance Cap	1,845	(5.3)	27.6	57.6
Worst performers				
i-Flex	1,770	1.5	(6.6)	(26.9)
Punjab Tractors	218	(2.2)	(8.2)	(23.4)
Polaris	115	(0.6)	(0.7)	(18.2)
Britannia	1,389	(0.8)	(8.7)	(20.5)
Novartis India	294	(1.1)	0.7	(15.0)

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Utilities

RLEN.BO, Rs1762	
Rating	NR
Sector coverage view	Attractive
Target Price (Rs)	-
52W High -Low (Rs)	1959 - 448
Market Cap (Rs bn)	401.3

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	57.1	64.5	69.4
Net Profit (Rs bn)	7.5	8.0	8.3
EPS (Rs)	34.8	35.2	36.4
EPS gth	*(4.0)*	*1.0*	*3.4*
P/E (x)	50.6	50.1	48.5
EV/EBITDA (x)	56.3	49.2	47.1
Div yield (%)	0.2	0.5	0.5

Shareholding, June 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	34.6	-	-
FIIs	23.4	0.5	0.0
MFs	5.3	0.6	0.2
UTI	-	-	(0.4)
LIC	13.9	1.5	1.1

Reliance Energy: 2QFY08 income from power business in-line with expectations, EPC order book contracts

Aman Batra : aman.batra@kotak.com, +91-22-6634-1231

Murtuza Arsiwalla : murtuza.arsiwalla@kotak.com, 91-22-66341-125

- **Operating performance of power business on track**
- **Lower revenues but higher margins from EPC business**

Reliance Energy (REL) reported revenues of Rs15.4 bn (we estimated Rs15.6 bn) and EBITDA of Rs1.8 bn (we estimated Rs0.7 bn). While revenues from the power business increased on account of higher fuel charges and power purchase costs (and therefore higher tariffs), revenues from the EPC business declined by 43% yoy. The change in accounting policy (with effect from April 1, 2007) to reflect the fair value of foreign exchange derivative instruments resulted in a credit of Rs496 mn, in turn raising reported profits. REL reported a PAT of Rs2.46 bn, including forex gains, as against our estimate of Rs2 bn. We believe that a strong and liquid balance sheet, predictable cash flows of existing business puts the company in an excellent position to exploit emerging opportunities in the core power business.

Operating performance of power business on track. Income from the sale of electrical energy increased by about 40% to Rs12.8 bn. The increase in sales was on account of the higher sale of electrical energy (up 8.4% yoy to 2,371 MU in 2QFY08). Tariff realization also improved reflecting the higher cost of fuel and purchased power as well as a better tariff structure effected under the multi-year tariff formula. REL purchased 1,296 MU of power during the quarter from external sources at an average cost of Rs5.01/unit. Dahanu Thermal Power Station (DTPS) operated at a PLF of 93.7% during 2QFY08 against a PLF of 94.1% during 2QFY07. The Samalkot Power Plant operated at a PLF of 75.7%, against 46.5% achieved last year. According to the company, the improved performance is on account of mixed fuel operation and increased availability of gas.

Lower revenues but higher margins from EPC business. Income from EPC contracts declined by 43.8% yoy to Rs2.8 bn. Margin expansion (700 bps) in the EPC business resulted in EBIT growth 44% on lower revenues. We note that the order book of the company stood at Rs47.1 bn at the end of 2QFY08 as compared to Rs50 bn at the end of 1QFY06 and Rs55 bn at the end of FY2007. Revenue recognition of the EPC business tends to be erratic depending on actual execution schedule and achievement of milestones for projects under implementation. Key projects with the company include—2X300 MW thermal power station at Yamuna Nagar; 2X600 MW thermal power station at Hisar, rural electrification project in UP and 65-km long Allain Duhangan-Panarasa transmission project. We believe the EPC business of REL will likely benefit from the large capacity addition planned (about 24,200 MW) by its subsidiary Reliance Power as well as increased orders from IPPs/state gencos.

Reliance Energy - Quarterly results, March yearends (Rs mn)

	2Q FY2008	2Q FY2007	yoy % chg	Our est. 2Q FY2008	yoy % chg
Net sales from Electrical Energy	12,594	9,049	39.2	10,340	14.3
Income from EPC and Contracts	2,823	5,027	(43.8)	5,282	5.1
Net sales	**15,417**	**14,076**	**9.5**	**15,622**	**11.0**
Cost of electrical energy purchased	(6,492)	(3,344)			
Cost of fuel	(1,991)	(2,149)			
Tax on electricity	(337)	(315)			
Cost of matl. & other direct exp.(EPC & Contracts)	(2,222)	(4,397)			
Personnel costs	(1,044)	(749)			
Other expenses and provisions	(1,519)	(1,347)			
Total expense	(13,604)	(12,301)			
EBITDA	**1,813**	**1,775**	**2.1**	**715**	**(59.8)**
Depreciation	(556)	(635)		(600)	
EBIT	1,257	1,140		115	
Other income	2,582	1,761		3,000	
Net interest	(854)	(671)		(670)	
PBT	**2,984**	**2,230**	**33.8**	**2,445**	**9.6**
Tax	(352)	(353)		(439)	
Deferred tax	(170)	(14)		-	
Net profit	**2,462**	**1,864**	**32.1**	**2,005**	**7.6**
Extraordinary income	38	-		-	
EBITDA margin (%)	11.8	12.6		4.6	
Effective tax rate (%)	17.5	16.4		18.0	
Growth (%)					
Sales	9.5	35.0		11.0	
EBITDA	2.1	(12.7)		(59.8)	
PBT	33.8	24.2		9.6	
PAT	32.1	16.8		7.6	
Cost to sales ratio(%)					
Cost of Electrical Energy purchased (as % of net sales from Elec. Energy)	51.5	37.0			
Cost of Fuel (as % of net sales from Elec. Energy)	15.8	23.7			
Tax on electricity	2.2	2.2			
Cost of matl. & other direct exp.(EPC & Contracts)	78.7	87.5			
Personnel costs	6.8	5.3			
Other expenses	9.9	9.6			
Segment Revenues					
Electrical Energy	12,760	9,160			
EPC & Contracts	2,871	5,030			
Others	-	1			
Total	**15,631**	**14,191**			
Less: Inter segment revenues	-	-			
Net revenues	**15,631**	**14,191**			
Growth (%)					
Electrical Energy	39.3	11.7			
EPC & Contracts	(42.9)	108.9			
Others	(100.0)	(74.4)			
Total	**10.1**	**33.7**			
Profit/ loss before tax & int					
Electrical Energy	1,517	1,041			
EPC & Contracts	335	233			
Others	(0)	(0)			
Total	**1,852**	**1,273**			
EBIT Margin (%)					
Electrical Energy	11.9	11.4			
EPC & Contracts	11.7	4.6			
Others		(20.0)			
Total	**11.8**	**9.0**			

Source: Company data, Kotak Institutional Equities

Profit model, balance sheet, cash model 2005-2009E, March fiscal year-ends (Rs mn)

	2005	2006	2007	2008E	2009E
Profit model (Rs mn)					
Net sales	41,398	40,335	57,100	64,452	69,388
EBITDA	**6,687**	**7,476**	**4,975**	**7,386**	**7,584**
Other income	3,787	5,744	8,653	7,667	7,417
Interest	(1,348)	(1,919)	(2,503)	(2,890)	(2,500)
Depreciation	(3,464)	(3,486)	(2,401)	(2,463)	(2,653)
Extraordinary items	35	(806)	512	0	0
Pretax profits	5,696	7,010	9,235	9,700	9,848
Tax	(495)	(506)	(1,221)	(1,688)	(1,566)
Net profits	**5,201**	**6,504**	**8,015**	**8,012**	**8,281**
Earnings per share (Rs)	**26.1**	**36.3**	**34.8**	**35.2**	**36.4**
Balance sheet (Rs mn)					
Total equity	63,399	78,733	93,392	99,126	105,052
Deferred taxation liability	2,606	2,041	2,313	2,086	1,761
Total borrowings	37,387	42,669	58,583	52,468	43,117
Currrent liabilities	18,878	22,140	29,772	34,095	36,616
Service Line deposits form customers	221	235	246	246	246
Total liabilities and equity	**122,490**	**145,818**	**184,307**	**188,022**	**186,793**
Cash	60,454	56,529	21,759	20,166	17,511
Current assets	25,951	48,624	106,385	108,722	110,872
Total fixed assets	29,123	28,737	31,044	33,791	32,954
Investments	6,962	11,927	25,119	25,343	25,456
Total assets	**122,490**	**145,818**	**184,307**	**188,022**	**186,793**
Free cash flow (Rs mn)					
Operating cash flow, excl. working capital	8,792	11,889	10,922	10,720	10,926
Working capital	(1,281)	(21,693)	(51,372)	(542)	(63)
Capital expenditure	(1,677)	(3,100)	13,245	(5,210)	(1,816)
Investments	21,788	(4,965)	(13,191)	(224)	(113)
Free cash flow	**27,623**	**(17,870)**	**(40,396)**	**4,745**	**8,934**

Source: Company data, Kotak Institutional Equities estimates.

Energy

GAIL.BO, Rs417	
Rating	IL
Sector coverage view	Neutral
Target Price (Rs)	380
52W High -Low (Rs)	444 - 243
Market Cap (Rs bn)	353.0

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	160.5	228.5	241.3
Net Profit (Rs bn)	21.4	24.1	24.9
EPS (Rs)	25.3	28.6	29.4
EPS gth	*(9.5)*	*12.9*	*3.1*
P/E (x)	16.5	14.6	14.2
EV/EBITDA (x)	9.6	8.7	7.8
Div yield (%)	2.4	2.4	2.6

Shareholding, June 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	57.3	-	-
FIIs	22.0	0.8	0.0
MFs	1.4	0.3	(0.5)
UTI	-	-	(0.8)
LIC	6.4	1.3	0.5

GAIL (India): Weaker-than-expected 2QFY08 results due to significant E&P expenditure write-off

Sanjeev Prasad : sanjeev.prasad@kotak.com, +91-22-6634-1229

Gundeep Singh : gundeep.singh@kotak.com, +91-22-6634-1286

- **Weaker-than-expected results due to E&P expenditure write-off**
- **Lower-than-expected subsidy loss; full-year subsidy burden will likely be higher**
- **Key to stock is volume growth versus nature of regulations, government policy on subsidy**
- **Revised earnings and 12-month SOTP-based target price to Rs380 (Rs350 previously)**

GAIL (India) reported 2QFY08 net income at Rs5.7 bn versus our expected Rs6.4 bn and Rs4.5 bn in 2QFY07. GAIL's 2QFY08 EBITDA was Rs8.8 bn versus our expected Rs9.2 bn and Rs5.9 bn in 2QFY07. Subsidy loss was lower at Rs2.6 bn versus our expected Rs3.5 bn—a large write-off on E&P (dry well expense) of Rs2.6 bn partly explains the difference. The strong yoy performance reflects significantly higher subsidy loss in 1HFY07. We have revised our FY2008E, FY2009E and FY2010E EPS estimates to Rs28.6, Rs29.4 and Rs29, respectively, from Rs31.0, Rs32.3 and Rs34.1, respectively, to reflect (1) higher subsidy losses (-ve impact), (2) higher petrochemical and LPG prices (+ve) and (3) stronger rupee (-ve). We have revised our 12-month SOTP-based target price to Rs380 from Rs350 previously to reflect higher prices of investments (particularly 51 mn shares of ONGC) and modestly higher multiples for the petrochemical and LPG segments (see Exhibit 1). Key downside risks stem from higher-than-expected subsidy losses, weaker-than-expected commodity prices and imminent regulations.

2QFY08 results—E&P expenditure write-off dampens results but subsidy loss on provisional basis and looks to be on the lower side. Exhibit 2 gives details of GAIL's 2QFY08 and 1HFY08 results. (1) GAIL wrote off dry well expenditure of Rs2.57 bn in 1HFY08 versus Rs50 mn in the corresponding period. GAIL's accounting policy of "Successful Efforts Method" will likely make its results volatile if it does not make successful discoveries and such write-offs may be a recurring feature; it wrote off Rs2.8 bn of survey and dry well expenses in FY2007 compared to Rs0.96 bn in FY2006; (2) GAIL provided for subsidy loss of Rs2.6 bn versus Rs2.72 bn in 1QFY08. We find the subsidy loss figure on the lower side as we compute higher industry under-recoveries in 2QFY08 versus 1QFY08. GAIL's 1HFY08 subsidy loss is Rs5.32 bn versus Rs6.71 bn in 1HFY07; (3) Petrochemicals segment's EBIT declined 6.8% qoq (Rs235 mn) to Rs3.2 bn led by lower sales volumes (-8.6%) and lower sales (-17.7%); the decline in EBIT should have been higher based on the steep decline (Rs1.38 bn) in sales.

Key to stock price performance—volumes versus regulations, government policies

1. **Likely strong volume growth in gas transportation volumes beyond FY2010E.** We expect GAIL's gas transportation volumes to increase significantly beyond FY2010E propelled by a steep increase in domestic gas volumes. GAIL is in the process of augmenting its extant pipeline network. However, we believe GAIL's proposed pipeline network will take time to develop. We give details of its proposed expansion plans in Exhibit 3 and our expected schedules for the pipelines. GAIL has proposed to build 5,052 kms of pipelines (eight new ones) at a cost of Rs180 bn. However, we believe it may construct five pipelines by CY2010-2011 and the balance three will not start before CY2011-2012 and will depend on several currently unfathomable factors—(1) construction of LNG terminals, (2) availability of competitively-priced LNG and (3) development plans of Reliance and other operators for their offshore Orissa/West Bengal fields.

2. **Nature of regulations—may result in declining tariffs, profits from extant pipelines.** The methodology adopted for determination of transmission tariff by the newly-constituted Petroleum and Natural Gas Regulatory Board will influence GAIL's future profits from its mainstay gas transmission business. The key variables include (1) reasonable rate of return, (2) total capital employed (or return-earning asset) on which the reasonable rate of return will apply, (3) operating costs and (4) volumes. We see the first two as being more important.

   The draft regulations for natural gas pipelines prepared by the ministry of petroleum and natural gas defines capital employed as *gross fixed assets less depreciation plus normative working capital*; this is in line with the cost of services (COS) methodology followed globally. This would mean that GAIL's tariff for a pipeline (and earnings from the pipeline) would decline over a period of time due to a declining return-earning asset base. However, if the regulator allows a constant asset base for the economic life of the pipeline for as is the case in the power sector, then GAIL's tariff and earnings from a pipeline will largely remain constant over time and change modestly with changes in pass-through operating costs.

   Exhibit 4 gives our computation of GAIL's ROCE for its various segments based on FY2007 and 1HFY08 data. The pipeline segment shows a ROCE of 19% for 1HFY08 and 25.7% for FY2007. The decline in 1HFY08 reflects addition of new assets but limited revenues and profits on those assets. We clarify that the computed ROCE is on the current capital employed (end-2QFY08), which may or may not be the base for computation of regulated tariffs. The regulator may decide to use a different capital employed (total investment in pipeline and associated infrastructure since inception of a pipeline [GCI] or replacement value).

3. **Subsidy burden remains an issue especially at current very high crude prices.** We believe that high crude prices will continue to create uncertainty about GAIL's subsidy burden and earnings without a proper compensation and subsidy-sharing system. We believe significant upside risks exist given that the upstream companies can absorb higher subsidy losses compared to the downstream companies at higher crude oil prices. In particular, we believe that the GAIL would incur a higher subsidy burden in 2HFY08 versus 1HFY08 given that the government's estimate of FY2008 gross under-recoveries (Rs549 bn) will likely be exceeded by a significant amount due to significantly higher crude prices in 2HFY08 versus 1HFY08. Nonetheless, we model GAIL's subsidy burden at Rs13.5 bn for FY2008 versus Rs14.9 bn in FY2007. We assume that upstream companies will bear 33.33% of industry gross under-recovery in FY2008 versus 41.5% in FY2007. The government may yet revise the share of upstream companies upward to offset the impact of higher crude prices on downstream oil companies.

Earnings revisions. We have made several revisions to our earnings model—(1) higher subsidy losses, (2) stronger rupee and (3) higher crude and LPG prices. Exhibit 5 gives our key assumptions and Exhibit 6 gives key financials.

FY2008. We have reduced FY2008E EPS to Rs28.6 from Rs31.0. The downward revision primarily reflects (1) higher subsidy loss of Rs13.5 bn compared to Rs11.5 bn assumed previously and (2) stronger rupee at Rs40/US$ versus Rs41/US$ previously, which is a modest negative for the petrochemical and LPG segments. This is partly compensated by higher LPG prices due to revised crude prices (US$72/bbl versus US$70/bbl previously, Dated Brent basis); GAIL benefits from high crude prices due to fixed raw material costs.

FY2009. We have revised FY2009E EPS to Rs29.4 from Rs32.3. The downward revision reflects higher subsidy loss to Rs12 bn compared to Rs10 bn assumed previously to reflect higher crude prices and thus, higher industry gross under-recoveries. We had assumed that the government would raise prices of auto fuels in FY2009E, which would result in lower industry gross under-recoveries. We believe this looks unlikely in the current political environment and it would be best to assume flat auto fuels' prices. The higher subsidy loss is partly compensated by higher LPG (+2.6%) prices, which in turn reflects our higher crude price view (US$70/bbl versus US$68/bbl).

FY2010. We have revised FY2010E EPS to Rs29 from Rs34.1 to reflect (1) higher subsidy loss (Rs12 bn compared to Rs8.5 bn previously) and (2) stronger rupee at Rs38/US$ versus Rs41/US$ previously. However, we have assumed higher product (LPG, polyethylene) prices to factor in higher crude prices (US$70/bbl versus US$68/bbl).

We value GAIL stock at Rs380 per share

Sum-of-the-parts valuation of GAIL, FY2009 basis (Rs bn)

	Valuation base (Rs bn)		Multiples (X)		EV (Rs bn)		EV
	Replacement cost	EBITDA	EV/RC	EV/EBITDA	Replacement cost basis	EBITDA basis	(Rs/share)
Natural gas/LPG transportation		19		6.0		114	135
LPG production		22		4.0		88	104
Petrochemicals		6		4.0		25	29
Oil and gas upstream	17		1.00		17		21
Subsidy sharing scheme		(12)		1.0		(12)	(14)
Investments	84		0.80		67		79
ONGC shares	58		0.80		46		55
Others	26		0.80		20		24
Total		**35**				**214**	**353**
Net debt/(cash)					(22)	(22)	(26)
Implied value of share (Rs/share)							**379**

Note:

(1) Low multiples for LPG and petrochemicals segments reflects super-normal profitability of the businesses due to arbitrage between crude oil and gas prices.

Source: Kotak Institutional Equities estimates.

GAIL interim results, March fiscal year-ends (Rs mn)

		qoq			yoy			yoy		
	2008E	2Q 2008	1Q 2008	% chg	2Q 2008	2Q 2007	% chg	1H 2008	1H 2007	% chg
Sales (a)	228,498	45,289	42,457		45,289	43,583		87,746	90,886	
Total expenditure	192,659	36,506	32,070	13.8	36,506	37,692	(3.1)	68,576	75,579	(9.3)
(Inc)/dec in stock	—	(56)	32		(56)	272		(24)	(1,057)	
Purchase	152,236	25,398	23,529	7.9	25,398	28,088	(9.6)	48,926	58,640	(16.6)
Raw material	20,182	4,503	4,314	4.4	4,503	4,845	(7.1)	8,817	9,914	(11.1)
Staff cost	3,134	824	688	19.8	824	905	(8.9)	1,512	1,456	3.8
Other expenditure	17,107	5,838	3,508	66.4	5,838	3,582	63.0	9,345	6,626	41.0
EBITDA	**35,839**	**8,783**	**10,387**	**(15.4)**	**8,783**	**5,891**	**49.1**	**19,170**	**15,307**	**25.2**
Other income	4,796	1,806	913	97.9	1,806	1,674	7.9	2,719	2,474	9.9
Interest	726	201	204	(1.5)	201	291	(31.0)	405	579	(30.1)
Depreciation	6,084	1,492	1,407	6.0	1,492	1,436	3.9	2,899	2,844	1.9
Pretax profits	**33,825**	**8,897**	**9,689**	(8.2)	**8,897**	**5,838**	52.4	**18,585**	**14,359**	29.4
Tax	7,397	3,003	2,765	8.6	3,003	1,344	123.4	5,768	4,004	44.1
Deferred	2,279	168	72	135.5	168	10	1,584.0	240	(50)	(579.8)
Prior period adjust.	—	—	—		—	—		—	—	
Net income	**24,148**	**5,725**	**6,852**	(16.4)	**5,725**	**4,484**	27.7	**12,578**	**10,405**	20.9
Tax rate (%)	28.6	35.6	29.3		35.6	23.2		32.3	27.5	
Volume data										
Gas sales (mcm/d)		**70.4**	**68.1**	3.3	70.4	62.8	12.1	69.3	66.4	4.3
Gas transmission (mcm/d)		82.2	78.7	4.5	82.2	70.1	17.2	80.5	74.6	7.9
LPG transported ('000 tons)		640	621	3.1	640	582	10.0	1,261	1,104	14.2
LPG production ('000 tons)		279	274	1.8	279	230	21.3	553	499	10.8
LPG sales ('000 tons)		279	273	2.2	279	233	19.7	552	509	8.4
Other liquids prodn ('000 tons)		76	81	(6.2)	76	74	2.7	157	154	1.9
Other liquids sales ('000 tons)		78	81	(3.7)	78	74	5.4	159	153	3.9
Polymers ('000 tons)-prodn		97	103	(5.8)	97	73	32.9	200	161	24.2
Polymers ('000 tons)-sales		**96**	**105**	(8.6)	**96**	**70**	37.1	201	151	33.1
Subsidy payment		(2,600)	(2,720)	(4.4)	(2,600)	(4,210)	(38.2)	(5,320)	(6,710)	(20.7)
Segment revenue (Sales/Income)										
Transmission services										
(1) Natural gas		5,683	5,398	5.3	5,683	4,972	14.3	11,081	10,970	1.0
(2) LPG		896	922	(2.8)	896	816	9.8	1,818	1,531	18.8
Natural gas trading		32,093	29,563	8.6	32,093	29,237	9.8	61,656	59,014	4.5
Petrochemicals		6,402	7,783	(17.7)	6,402	5,456	17.4	14,185	10,958	29.4
LPG and liquid hydrocarbons		7,033	6,751	4.2	7,033	4,219	66.7	13,784	10,625	29.7
Telecom		76	67	14.0	76	63	21.9	143	114	26.3
Unallocated		1,636	806	103.0	1,636	1,607	1.8	2,442	2,349	4.0
Total		53,820	51,290	4.9	53,820	46,369	16.1	105,110	95,561	10.0
Less: Inter-segment revenue		6,725	6,452	4.2	6,725	6,513	3.2	13,177	13,032	1.1
Sales/Income from operations		**47,095**	**44,838**	**5.0**	**47,095**	**39,856**	**18.2**	**91,933**	**82,528**	**11.4**
Segment results (Profit before tax and interest)										
Transmission services										
(1) Natural gas		**3,955**	**3,683**	7.4	3,955	3,295	20.0	7,638	7,839	(2.6)
(2) LPG		521	545	(4.4)	521	449	16.1	1,066	817	30.5
Natural gas trading		704	246	0.0	704	614	14.7	950	887	7.1
Petrochemicals		3,195	3,430	(6.8)	**3,195**	**1,743**	83.4	6,625	3,763	76.1
LPG and liquid hydrocarbons		2,234	1,985	12.5	2,234	(545)	(509.6)	4,219	849	397.1
Telecom		14	5	176.0	14	4	236.6	19	4	394.7
Total		10,623	9,894	7.4	10,623	5,559	91.1	20,517	14,158	44.9
Less: Interest		201	204	(1.5)	201	291	(31.0)	405	579	(30.1)
Less: Other unallocable exp (net)		1,525	3	50,733.3	1,525	(571)	(367.3)	1,528	(780)	(295.9)
Total PBT		**8,897**	**9,687**	**(8.2)**	**8,897**	**5,838**	**52.4**	**18,584**	**14,359**	**29.4**
Capital employed										
Transmission services										
(1) Natural gas		52,028	45,779		52,028	34,815		52,028	34,815	
(2) LPG		10,109	10,277		10,109	10,737		10,109	10,737	
Petrochemicals		18,312	18,282		18,312	19,349		18,312	19,349	
LPG and liquid hydrocarbons		10,804	10,141		10,804	10,072		10,804	10,072	
Telecom		434	442		434	308		434	308	
Total		**91,687**	**84,921**		**91,687**	**75,280**		**91,687**	**75,280**	

Note:
(a) 1QFY08 and 4QFY07 sales and raw materials exclude internal consumption; corresponding figures of other quarters include internal consumption.

Source: Kotak Institutional Equities estimates, company reports.

Capital expenditure plan, March fiscal year-ends, 2006-2010E (Rs mn)

Natural gas pipelines	Project cost (Rs mn)	Length (Kms)	Comments
Dadri-Bawana-Nangal pipeline	25,000	610	
Chainsa-Gurgaon-Jhajar-Hissar	10,000	310	
Jagdishpur-Haldia	20,000	876	Unlikely before CY2011; contingent on Reliance group's Kakinada-Haldia pipeline
Dabhol-Bangalore	25,000	730	Contingent on development of Dabhol LNG terminal and availability of surplus LNG
Kochi-Kanjirrkod-Bangalore/Mangalore	25,000	840	Unlikely before CY2011; contingent on start of Petronet LNG's Kochi terminal
Dahej-Vijapur expansion	25,000	610	
Vijaipur-Dadri	25,000	505	
Vijaipur-Auraiya-Jagdishpur	25,000	571	
Total	**180,000**	**5,052**	

Source: Kotak Institutional Equities estimates.

GAIL's earnings may be at risk if impending regulations are less favorable versus street expectations
Return on capital employed for various segments of GAIL

	Transmission	Petrochemicals	LPG and liquid HCs
FY2007			
EBIT (Rs mn)	17,060	9,545	1,022
EBIT * (1-t)	12,215	6,834	731
Capital employed (Rs mn)	47,521	19,128	8,970
ROCE (%)	**25.7**	**35.7**	**8.2**
1HFY08			
Annualized EBIT (Rs mn)	17,408	13,251	8,438
EBIT * (1-t)	11,780	8,967	5,710
Capital employed (Rs mn)	62,137	18,312	10,804
ROCE (%)	**19.0**	**49.0**	**52.8**

Source: Company, Kotak Institutional Equities.

Key assumptions behind GAIL model, March fiscal year-ends, 2004-2010E

	2004	2005	2006	2007	2008E	2009E	2010E
Volumes							
Natural gas transportation, gross (mcm/day)							
HBJ pipeline	32	32	32	32	32	32	32
Other pipelines	31	36	36	39	40	40	40
Regassified LNG							
Dahej-Vijaipur pipeline (transmitted and sold)		2	7	6	9	9	9
Dahej-Vijaipur pipeline (transmitted)		1	4	4	6	6	6
Dahej-Uran pipeline					6	12	12
Panvel-Dabhol pipeline					4	6	8
Elimination of double-counted volumes (a)			(1)	(3)	(7)	(9)	(11)
Total gas transmission	**63**	**72**	**79**	**77**	**90**	**96**	**96**
LPG (000 tons)							
Sold	1,089	1,089	1,039	1,037	1,100	1,100	1,100
Transported	1,841	2,138	2,228	2,490	2,750	2,800	2,800
Petrochemicals (000 tons)							
Polyethylene							
Domestic sales	225	279	271	337	400	420	420
Exports	40	40	40	10	10	—	—
Total petrochemicals	**265**	**319**	**311**	**347**	**410**	**420**	**420**
Prices							
Natural gas (Rs/cubic meter)							
Natural gas ceiling price	2.85	2.85	3.52	4.21	5.24	5.83	6.42
Regassified LNG including transportation	6.61	6.50	6.47	6.93	6.40	5.18	6.53
Transmission plus marketing charges							
HBJ pipeline, Dahej-Vijaipur pipeline (from FY2007)	1.15	1.15	1.15	0.99	0.96	0.96	0.97
Dahej-Vijaipur, Dahej-Uran, Panvel-Dabhol pipeline	0.69	0.67	0.69	0.99	1.03	1.04	1.04
Other pipelines	0.40	0.41	0.42	0.40	0.42	0.44	0.46
LPG							
LPG (US$/ton)	319	399	510	531	625	609	609
Transmission charges (Rs/ton)							
Jamnagar-Loni	1,436	1,522	1,522	1,522	1,522	1,522	1,522
Vizag-Secunderabad	1,450	1,450	1,450	1,450	1,450	1,450	1,450
Other assumptions							
Polyethylene, HDPE (US$/ton)	680	990	1,055	1,315	1,380	1,305	1,255
Import tariff, Polyethylene	28%	17%	10%	5%	5%	4%	4%
Import tariff, LPG	10%	7%	0%	0%	0%	0%	0%
Exchange rate (Rs/US$)	46.0	45.0	44.3	45.3	40.0	39.0	38.0
Subsidy losses	4,280	11,380	10,640	14,880	13,500	12,000	12,000

Note:
(a) Gas transported through the HVJ or DV pipeline and then to smaller pipelines.

Source: Company, Kotak Institutional Equities estimates.

GAIL (India) Ltd: Profit model, balance sheet, cash model of GAIL 2004-2010E, March fiscal year-ends (Rs mn)

	2004	2005	2006	2007	2008E	2009E	2010E
Profit model (Rs mn)							
Net sales	116,395	135,914	163,513	160,472	228,498	241,293	264,090
EBITDA	**30,667**	**36,040**	**35,731**	**29,896**	**35,839**	**37,277**	**34,945**
Other income	2,440	3,491	4,555	5,450	4,796	4,956	6,916
Interest	(1,380)	(1,341)	(1,174)	(1,071)	(726)	(656)	(656)
Depreciation	(6,640)	(9,467)	(5,595)	(5,754)	(6,084)	(6,516)	(6,556)
Pretax profits	25,088	28,723	33,518	28,521	33,825	35,062	34,649
Tax	(8,373)	(8,898)	(9,221)	(7,941)	(7,397)	(9,252)	(9,669)
Deferred taxation	(1,078)	(277)	(445)	(190)	(2,279)	(921)	(446)
Net profits	**18,693**	**19,539**	**23,101**	**23,867**	**24,148**	**24,889**	**24,534**
Earnings per share (Rs)	**22.1**	**23.1**	**27.3**	**28.2**	**28.6**	**29.4**	**29.0**
Balance sheet (Rs mn)							
Total equity	74,452	86,261	99,733	113,929	128,183	142,189	154,851
Deferred taxation liability	12,276	12,552	12,997	13,187	15,466	16,387	16,833
Total borrowings	21,335	19,974	19,166	13,379	11,000	11,000	11,000
Current liabilities	30,302	34,742	37,522	45,512	43,726	45,630	49,401
Total liabilities and equity	**138,364**	**153,529**	**169,418**	**186,007**	**198,376**	**215,206**	**232,085**
Cash	15,680	34,468	44,959	26,604	10,722	33,302	55,208
Other current assets	25,391	29,671	28,309	50,851	62,867	61,823	61,541
Total fixed assets	89,574	81,550	81,716	93,913	110,149	105,443	100,697
Investments	7,720	7,840	14,434	14,638	14,638	14,638	14,638
Total assets	**138,364**	**153,529**	**169,418**	**186,007**	**198,376**	**215,206**	**232,085**
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	23,954	26,912	25,165	23,920	27,715	27,369	24,620
Working capital changes	580	49	5,950	(10,151)	(13,802)	2,948	4,053
Capital expenditure	(26,924)	(1,472)	(5,811)	(20,449)	(22,320)	(1,810)	(1,810)
Investments	(841)	(120)	(6,462)	(205)	—	—	—
Other income	1,826	2,416	3,995	3,884	4,796	4,956	6,916
Free cash flow	**(1,405)**	**27,787**	**22,837**	**(3,002)**	**(3,610)**	**33,463**	**33,779**
Ratios (%)							
Debt/equity	24.6	20.2	17.0	10.5	7.7	6.9	6.4
Net debt/equity	6.5	(14.7)	(22.9)	(10.4)	0.2	(14.1)	(25.7)
ROAE (%)	23.2	21.1	21.8	19.9	17.8	16.5	14.9
ROACE (%)	**16.2**	**18.0**	**19.7**	**15.5**	**16.7**	**15.6**	**14.2**

Source: Kotak Institutional Equities estimates.

Transportation

GATE.BO, Rs138	
Rating	OP
Sector coverage view	Neutral
Target Price (Rs)	180
52W High -Low (Rs)	172 - 110
Market Cap (Rs bn)	15.9

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	1.6	2.3	3.4
Net Profit (Rs bn)	0.8	0.8	1.0
EPS (Rs)	6.8	6.8	9.0
EPS gth	*8.9*	*(0.4)*	*34.2*
P/E (x)	20.3	20.4	15.3
EV/EBITDA (x)	16.5	14.8	10.9
Div yield (%)	1.2	1.2	1.6

Shareholding, June 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	39.1	-	-
FIIs	34.0	0.1	0.1
MFs	4.3	0.1	0.1
UTI	-	-	-
LIC	1.9	0.0	0.0

Gateway Distriparks: Volumes growth as well as margins decline probably contributed by consolidation of Punjab Conware; maintain target price and rating

Lokesh Garg : lokesh.garg@kotak.com, +91-22-6634-1496
Sandip Bansal : sandip.bansal@kotak.com, +91-22-6749-3327

- **Operating performance in line with expectations**
- **Volumes rise while margins decline due to consolidation of Punjab Conware**
- **Two owned rakes deployed in the domestic sector; plans to ramp-up significantly**
- **Snowman turns in a better performance, slow turnaround visible**
- **Maintain SOTP based target price of Rs180 and Outperform rating**

On a consolidated basis GDPL has reported revenues of Rs640 mn (up 68% yoy) and operating profit of Rs255 mn (up 17% yoy). Excluding the contribution of Snowman and Gateway Rail, revenues in 1QFY08 are Rs483 mn (up 25% yoy) and operating EBIT is Rs206 mn (up 5% yoy). The total number of TEUs handled by GDPL increased significantly in 2QFY08 to 90,277, up 49% yoy and 11% qoq. However, the EBIT margin of the CFS business has declined substantially by 590 bps, both on a yoy and qoq basis, to 42.6%. The steep decline is possibly due to commencement of operations of Punjab Conware and increased competition at JNPT as well as other CFSs. GDPL had two of its own rakes in operations in the domestic route during the quarter and expects to receive deliveries of a further 10 rakes by the end of FY2008. Snowman is showing signs of a turnaround as its revenues and performance improve sequentially quarter on quarter. We maintain our SOTP-based target price of Rs180 and Outperform rating, as we await details of the operating performance of various assets.

Operating performance in line with expectations

On a consolidated basis, GDPL has reported revenues of Rs640 mn (up 68% yoy) versus our expectation of Rs524 mn and operating profit of Rs255 mn (up 17% yoy) versus our expectation of Rs246 mn. However, comparison on a yoy basis is not appropriate as 2QFY08 numbers include Snowman and Gateway Rail operations, while those of 1QFY07 do not. Excluding the contribution of Snowman and Gateway Rail, revenues in 1QFY08 are Rs483 mn (up 25% yoy) and operating EBIT is Rs206 mn (up 5% yoy). PAT in 2QFY08 (on a consolidated basis) was Rs189 mn (down 10% yoy), versus our expectation of Rs205 mn. GDPL is making substantial investments in (1) rail freight business, (2) cold chain business and (3) Punjab Conware CFS, leading to lower other income on reduced cash position and higher depreciation charge. Other income has declined by Rs16 mn to Rs43 mn from Rs59 mn while depreciation has increased by Rs41 mn to Rs69 mn from Rs27 mn on a yoy basis. (Exhibits 1, 2 and 3)

Volumes growth as well as margins decline probably contributed by consolidation of Punjab Conware

The total number of TEUs handled by GDPL increased significantly in 2QFY08 to 90,277, up 49% yoy and 11% qoq. In 1HFY08, GDPL has handled 171,446 TEUs, up 45% yoy. However, the EBIT margin of the CFS business has declined substantially by 590 bps, both on a yoy and qoq basis, to 42.6% in 2QFY08. The operating profit margin of the standalone entity, declined to 51.8% - a fall of 760 bps yoy and 920 bps qoq. The margin decline in the standalone entity is possibly attributable to consolidation of operations of Punjab Conware and increased competition. Punjab conware may not have achieved full scale during the quarter and payment of operation and maintenance fees to Punjab government has affected margins in the CFS segment. In the CFS business revenues have increased by 43% in 1HFY08 (in comparison to 1HFY07), while EBIT margins have declined by 340 basis points.

Two owned rakes deployed in the domestic sector; plans to ramp-up significantly

GDPL had two of its own rakes in operations in the domestic route during the quarter. The train operations generated revenues of Rs91 mn and a negative EBIT of Rs10 mn. Possibly at an EBITDA level there were no losses from the rail operations in this quarter. GDPL expects to receive deliveries of a further 10 rakes by the end of FY2008 and hence a significant ramp-up of the rail operations is expected over the next few quarters.

Snowman turns in a better performance, slow turnaround visible

Snowman generated revenues of Rs71 mn in 2QFY08, up 10% yoy. The EBIT margins have also improved by 250 basis points (on a qoq basis) to a negative of 5.2%. Snowman is showing signs of a turnaround as its revenues and performance improve sequentially quarter on quarter (Exhibit 4). We believe that growth in organized retailing of fruits and vegetables would offer immense opportunity for a player in the organized sector offering pan-India cold chain logistics services. However, management has not shared any clear path for growth and turnaround of the business.

Maintain SOTP based target price of Rs180 and Outperform rating

We maintain our SOTP based target price of Rs180 and our Outperform rating. We will revisit our numbers after receiving details of the operating performance of various assets.

Exhibit 1. Consolidated financials of Gateway Distriparks, March fiscal year-ends FY2007-2008 (Rs mn)

	FY2007	FY2008E	2Q08	2Q07	% YoY	1Q08	% QoQ	1HFY08	1HFY07	% YoY
Income from Operations	1,610	2,278	640	382	*67.8*	483	*32.5*	1,124	727	*54.5*
Total Expenditure	(799)	(1,339)	(385)	(163)	*136.8*	(263)	*46.4*	(648)	(313)	*107.0*
Staff Cost	(89)	-	(43)	(16)	*164.0*	(23)	*86.9*	(65)	(31)	*108.4*
Transportation	(300)	-	(165)	(68)	*142.3*	(94)	*75.9*	(259)	(117)	*121.2*
Labour Charges	(64)	-	(35)	(10)	*240.0*	(21)	*69.5*	(56)	(23)	*149.1*
Sub Contract Charges	(71)	-	(21)	(19)	*12.4*	(19)	*9.0*	(40)	(36)	*10.4*
Auction Expenses	(14)	-	(3)	(1)	*138.8*	(2)	*110.9*	(5)	(4)	*24.8*
Fees on Operations & Management of Punjab Conware CFS	-	-	(26)	-		-		(26)	-	
Other Expenditure	(262)	-	(91)	(48)	*90.7*	(105)	*(12.8)*	(196)	(102)	*92.5*
Operating profit	**811**	**940**	**255**	**219**	***16.6***	**220**	***15.9***	**476**	**414**	***14.9***
Other Income	250	208	43	59	*(27.0)*	48	*(9.5)*	91	125	*(26.9)*
EBIDTA	1,060	1,148	299	279	*7.3*	268	*11.4*	567	539	*5.2*
Interest	(12)	(11)	(5)	(3)	*68.4*	(3)	*56.1*	(8)	(8)	*13.2*
Depreciation	(139)	(234)	(69)	(27)	*153.9*	(46)	*49.0*	(115)	(57)	*99.6*
Profit before Tax	909	903	225	248	*(9.4)*	219	*2.8*	444	474	*(6.3)*
Provision for taxation	(139)	(122)	(37)	(37)	*(2.0)*	(32)	*13.7*	(69)	(65)	*5.7*
Net Profit after Tax	771	782	188	211	*(10.7)*	187	*0.9*	375	409	*(8.3)*
Minority Interest	8	2	1	(0)	*(626.0)*	(1)	*(163.8)*	(0)	(0)	*11.2*
Net Profit	**778**	**783**	**189**	**211**	***(10.5)***	**186**	***1.6***	**375**	**408**	***(8.3)***
OPM	**50.3**	**41.2**	**39.9**	**57.4**		**45.6**		**42.3**	**56.9**	***(25.6)***
EBIDTA margin	**65.9**	**50.4**	**46.7**	**73.0**		**55.5**		**50.5**	**74.1**	***(31.9)***
Effective tax rate	**15.3**	**13.5**	**16.3**	**15.1**		**14.7**		**15.5**	**13.8**	***12.9***
Throughput (TEUs)	**-**	**-**								
GDPL Consolidated	**240,491**	**308,494**	**90,277**	**60,497**	***49.2***	**81,169**	***11.2***	**171,446**	**117,937**	***45.4***
	-	-								

Source: Company data, Kotak Institutional Equities estimates.

Exhibit 2. Stand-alone financials of Gateway Distriparks, March fiscal year-ends FY2007-2008 (Rs mn)

	2Q08	2Q07	% YoY	1Q08	% QoQ	1HFY08	1HFY07	% YoY
Income from Operations	419	342	*22.4*	313	*34.0*	732	658	*11.3*
Total Expenditure	(202)	(139)	*45.3*	(122)	*65.7*	(324)	(272)	*19.1*
Staff Cost	(15)	(13)	*17.6*	(11)	*40.3*	(26)	(25)	*3.7*
Transportation	(50)	(55)	*(9.3)*	(45)	*10.2*	(95)	(98)	*(2.5)*
Labour Charges	(28)	(11)	*152.2*	(10)	*165.0*	(38)	(22)	*73.3*
Sub Contract Charges	(19)	(17)	*9.4*	(17)	*11.5*	(36)	(36)	*1.3*
Auction Expenses	(2)	(1)	*35.5*	(2)	*19.0*	(3)	(4)	*(8.1)*
Fees on Operations & Management of Punjab Conware CFS	(26)	-		-		(26)	-	
Other Expenditure	(62)	(41)	*50.4*	(36)	*69.0*	(98)	(87)	*12.3*
Operating profit	**217**	**204**	***6.7***	**191**	***13.8***	**408**	**386**	***5.7***
Other Income	33	62	*(46.6)*	37	*(10.1)*	70	130	*(45.9)*
EBIDTA	250	266	*(5.8)*	228	*9.9*	478	516	*(7.3)*
Interest	(0)	(2)	*(98.2)*	(0)	*(66.7)*	(0)	(5)	*(97.2)*
Depreciation	(34)	(20)	*68.5*	(24)	*40.8*	(58)	(44)	*31.8*
Profit before Tax	217	244	*(11.1)*	204	*6.3*	420	466	*(9.9)*
Provision for taxation	(33)	(35)	*(7.0)*	(28)	*18.0*	(61)	(62)	*(2.6)*
Net Profit after Tax	**184**	**208**	***(11.8)***	**176**	***4.5***	**359**	**404**	***(11.0)***
OPM	**51.8**	**59.4**		**61.1**		**14.5**	**13.4**	
EBIDTA margin	**59.8**	**77.6**		**72.9**		**65.4**	**78.4**	
Effective tax rate	**15.2**	**14.5**		**13.7**		**14.5**	**13.4**	

Source: Company data.

Exhibit 3. Improvement in volumes, fall in margins in core CFS business
Segmental performance of Gateway Distriparks (Rs mn)

	FY2007	2Q08	2Q07	% YoY	1Q08	% QoQ	1HFY08	1HFY07	% YoY
Revenues	**1,859**	**684**	**441**	***55.0***	**531**	***28.7***	**1,215**	**852**	***42.6***
Container Freight Station	1,559	483	385	*25.6*	386	*25.2*	869	736	*18.2*
Container Rail Logistics	-	91	-		42	*116.2*	133	-	
Cold Chain Logistics	86	71	-		65	*10.1*	136	-	
Unallocated including income from interest and investments	215	38	56	*(32.8)*	38	*(0.8)*	76	116	*(34.7)*
EBIT	**923**	**230**	**251**	***(8.5)***	**222**	***3.6***	**452**	**481**	***(6.0)***
Container Freight Station	758	206	195	*5.3*	187	*9.8*	393	365	*7.6*
Container Rail Logistics	-	(10)	-		2	*(662.7)*	(8)	-	
Cold Chain Logistics	(17)	(4)	-		(5)	*(25.4)*	(9)	-	
Unallocated including income from interest and investments	182	38	56	*(32.8)*	38	*(0.8)*	76	116	*(34.7)*
EBIT margin									
Container Freight Station	-	42.6	48.4		48.5		45.2	48.6	
Container Rail Logistics		(10.5)			4.0		(5.9)		
Cold Chain Logistics		(5.2)			(7.7)		(6.4)	(19.3)	
Capital Employed	**6,896**	**7,270**	**6,485**		**7,201**		**7,270**	**6,485**	
Container Freight Station	2,699	2,514	2,465		2,837		2,514	2,465	
Container Rail Logistics	1,610	3,016	956		1,985		3,016	956	
Cold Chain Logistics	400	410	-		402		410	-	
Unallocated including income from interest and investments	2,187	1,330	3,064		1,978		1,330	3,064	

Source: Company data.

Exhibit 4. Improvement in performance of Snowman

Segmental performance of Cold Chain Logistics business of Gateway Distriparks (Rs mn)

	2Q08	1Q08	*% QoQ*	4Q07	3Q07	FY07
Revenues	71.4	64.9	*10.1*	57.4	24.8	85.5
EBIT	(3.7)	(5.0)	*(25.4)*	(11.9)	(4.6)	(16.5)
EBIT margin	(5.2)	(7.7)		(20.7)	(18.7)	(19.3)
Capital Employed	410	402		400	436	400

Source: Company data.

Technology

POLS.BO, Rs115	
Rating	U
Sector coverage view	Attractive
Target Price (Rs)	110
52W High -Low (Rs)	237 - 102
Market Cap (Rs bn)	11.3

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	10.3	11.4	13.3
Net Profit (Rs bn)	1.0	0.9	1.1
EPS (Rs)	10.3	9.1	11.6
EPS gth	*359.1*	*(12.0)*	*28.0*
P/E (x)	11.2	12.7	9.9
EV/EBITDA (x)	6.2	6.9	5
Div yield (%)	1.5	1.5	1.5

Shareholding, June 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	27.8	-	-
FIIs	6.0	0.0	(0.0)
MFs	3.6	0.0	(0.0)
UTI	-	-	(0.0)
LIC	-	-	(0.0)

Polaris Software Lab: Results below expectations. Better revenue growth trajectory critical to performance

Kawaljeet Saluja : kawaljeet.saluja@kotak.com, +91-22-6634-1243

Rohit Chordia : rohit.chordia@kotak.com, +91-22-6634-1397

- **Results below expectations**
- **Product business remains steady, sustainability the key**
- **Improved client mining required to push growth in FY2008**
- **Maintain Underperform with a Mar'09 DCF-based target price of Rs110/share**

Polaris' reported net income of Rs182 mn for the Sep '07 quarter was 16% below our expectations. The company disappointed on both revenue and margin performance. Revenues grew 6.3% to Rs2.74 bn (our expectation was Rs2.78 bn). Revenue growth in US$ terms was 7.6% qoq. More importantly, yoy revenue growth (US$ terms) stood at 22.6% (significantly below industry growth rate), despite a strong 57.4% yoy growth in the Intellect business. OPM improved 250 bps qoq (below our expectation of 380 bps), but was down 690 bps on a yoy basis. The performance, once again highlights that execution, though improving, is still a work in progress. The business model risks remain with a high dependence on a few clients, uncertainty around success of Intellect product suite and continuity of execution challenges (with a weak employee profile). We believe that improvement in revenue growth profile holds the key to stock performance. We have revised our FY2008 and FY2009 EPS estimates downwards by 13% and 10% to Rs9.1 and Rs11.6 respectively, primarily on the back of (1) revision in our Re/US$ assumption for FY2008 and FY2009 to 39.8 and 39 from 40.5 and 40 earlier (2) lower than earlier OPM assumptions. Maintain Underperform.

2QFY08 performance below expectations. Polaris reported 6.3% qoq revenue growth (7.6% qoq growth in US$ terms). Revenue growth was once again driven by a robust 10% qoq growth in the products business. OPM at 11% (up 250 bps qoq, down 690 bps yoy) was below our expectations of 12.3%. Net income at Rs182 mn (down 32.8% yoy) was 16% below our expectations. Company's BPO subsidiary Optimus had a strong quarter and grew 22% qoq in Re terms (off a small base).

OPM performance disappointing. Polaris' 2QFY08 OPM improved 250 bps qoq to 11% versus our expectation of a 380 bps improvement. More important, OPM decline yoy was 6.9% from 17.9% in 2QFY07. SG&A expenses as a percentage of revenues have increased 130 bps yoy to 21.5% as the company continues to invest in its sales and marketing activities. While the company highlights levers like pricing improvements and utilization rates for improving margins, we believe that an improved revenue growth profile holds the key to Polaris' OPM performance. We factor in a 310 bps decline in OPM in FY2008, driven primarily by rupee appreciation.

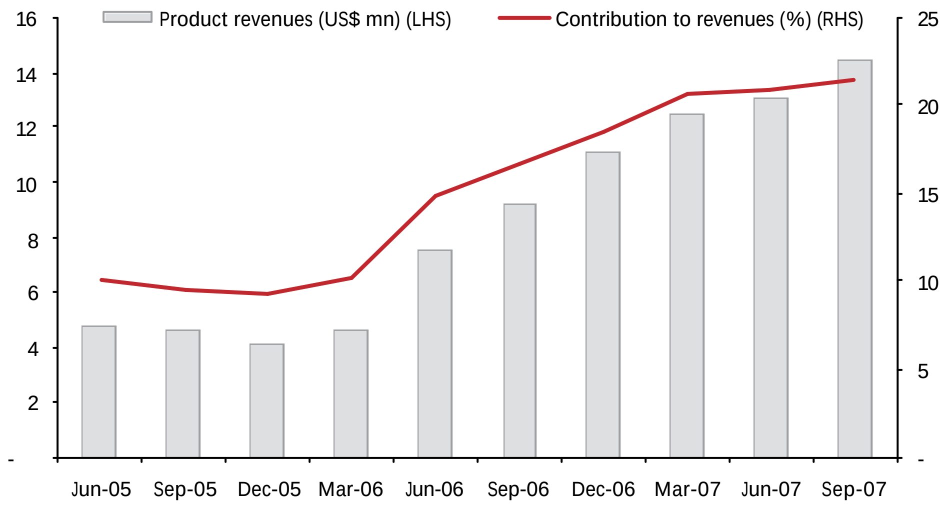
Product business remains steady, sustainability the key. Polaris' products business grew at a higher than company average rate of 10% (US$ terms). More important, the company signed up four new customers for its 'Intellect' suite. In addition, the company now has 25 live implementations of its different Intellect platforms. Polaris once again emphasized on its strategy to utilize its product 'Intellect' as an entry point into new customer relationships. Sustainable growth in products business is the key in our view to overall revenue growth in the coming quarters.

Better client mining and more efficient operations remain the key to a good FY2008. We believe that Polaris needs to improve its client mining to drive acceleration in its revenue growth. Polaris' impressive client base provides it ample scope to improve on its 22% yoy US$ terms revenue growth of FY2007. The management reiterated its target of 25% revenue growth in FY2008, which we believe is achievable with better sales execution (we factor in 26.4% US$ revenue growth in FY2008). Also, while the company has been taking steps to iron out inefficiencies, we believe that the company needs to increase its focus on driving revenue productivity and SG&A efficiencies to protect margins in the wake of the appreciating rupee scenario.

Business model risks remain higher than other players. While we like the product-led revenue growth strategy adopted by Polaris, we would like to highlight the potential risks of the approach in the event of a spending slowdown. Polaris' small size and weaker positioning with the clients (relative to some of its larger peers) makes it more vulnerable than peers to the risk of (1) a cut in new spending in the BFSI vertical and (2) vendor rationalization by some of the large clients.

Revising estimates. We have revised our FY2008 and FY2009 EPS estimates downwards by 13% and 10% to Rs9.1 and Rs11.6 respectively. We now factor in a Re/ US$ rate of 39.8 and 39 for FY2008 and FY2009 respectively versus 40.5 and 40 earlier. We maintain our Underperform rating with a revised Mar '09 DCF-based target price of Rs110/share.

Intellect has been growing strong and now contributes 21.4% to Polaris' overall revenues



Source: Company, Kotak Institutional Equities

Polaris Software Interim Results

Rs mn	2QFY07	1QFY08	2QFY08	QoQ % chg.	YoY % chg.	Kotak Estimates	% Deviation	Comments on QoQ performance
Revenues	**2,556**	**2,575**	**2,736**	**6.3**	**7.0**	**2,780**	**(1.6)**	Revenues grew 6.3% qoq versus our expectation of 8%. US$ terms revenue growth was 7.6% (driven by Intellect which grew 10% qoq)
Cost of revenues	(1,581)	(1,775)	(1,847)	4.1	16.8	(1,835)	0.6	
Gross profit	**975**	**800**	**889**	**11.1**	**(8.8)**	**945**	**(6.0)**	
Sales & marketing expenses	(265)	(310)	(315)	1.5	18.8	(320)	(1.5)	
General administration expenses	(252)	(270)	(272)	0.7	7.9	(284)	(4.1)	
SG&A expenses	(517)	(580)	(587)	1.1	13.5	(603)	(2.7)	
Operating Profits	**457**	**219**	**302**	**37.6**	**(34.1)**	**342**	**(11.8)**	Operating margins improved 250bps qoq against our expectation of 380bps improvement. Margin improvement was driven by (a) absorption of wage hikes and (b) SG&A efficiencies. Operating margin decline yoy stood at 690bps.
Non-operating Income	(7)	82	39	(52.6)	nmf	45	(12.6)	
EBIDTA	450	301	341	13.0	(24.3)	387	(11.9)	
Financial expenses	(2)	(2)	(2)	7.6	9.7	(2)		
EBDT	448	300	339	13.0	(24.5)	384	(11.9)	
Depreciation	(118)	(116)	(119)	2.7	0.5	(120)	(1.2)	Includes amortization of capitalized product development expenses
Pretax profits	**330**	**184**	**220**	19.5	(33.4)	264	(16.8)	
Tax	(59)	(40)	(37)	(5.5)	(36.5)	(48)	(21.2)	
Net profit	**271**	**144**	**182**	26.4	(32.8)	217	(15.9)	Net income 16% below expectations on account of lower than expected revenues as well as profitability
Extraordinaries	-	-	-			-		
PAT-Reported	**271**	**144**	**182**	26.4	(32.8)	**217**	(15.9)	
Period EPS								
EPS - recurring (Rs)	2.8	1.5	1.9	26.4	(32.8)	2.2		
EPS - reported (Rs)	2.8	1.5	1.9	26.4	(32.8)	2.2		
Margins								
Gross margin (%)	38.1	31.1	32.5			34.0		
SG&A expenses (%)	20.2	22.5	21.5			21.7		
Operating profit margin (%)	**17.9**	**8.5**	**11.0**			**12.3**		
Net profit margin (%)	10.6	5.6	6.7			7.8		
Revenue Mix (Rs mn)								
Services	2,130	2,036	2,151	5.6	1.0			
Products	426	538	585	8.6	37.4			Intellect revenues (up 10% qoq in US$ terms) continue to grow at higher than corporate average. Sustained momentum in Intellect revenues the key to company performance
Revenues from Citigroup (%)	48.8	39.6	38.7					
Revenues from Citigroup (Rs mn)	1,246.7	1,019.5	1,058.9	3.9	(15.1)			Slide in Citigroup revenues continues. Down 15% yoy.

Consumer Products

Sector coverage view			Neutral

		Price, Rs	
Company	**Rating**	**17-Oct**	**Target**
Hindustan Leve	L	209	230
ITC	OP	184	225
Nestle India	L	1,271	1,150
Colgate-Palmo	L	400	340
SmithKilne Cor	L	597	625
Asian Paints	L	947	890
Lakshmi	OP	200	338
Tata Tea	L	821	992
Godrej Consun	OP	122	185

ITC launches shampoo and soaps—HUL's bastions under attack?

Aman Batra : aman.batra@kotak.com, +91-22-6634-1231

Manoj Menon : manoj.menon@kotak.com, +91-22-6634-1110

- **Slew of launches in personal care products**
- **ITC is well-placed to make a dent into HUL's dominant shares in shampoos and soaps**
- **Higher A&P spends would be imperative in the short term, price war likely if ITC gains significant market share**

In line with its stated mission of becoming the leading FMCG Company in India, ITC has entered the personal care category with the recent launch of soaps and shampoos. We estimate about 27% of HUL's sales and about 35% of HUL's EBIT to be under threat from ITC's entry. The impact for Godrej Consumer (GCPL) could be much higher as its dependence on soaps is about 65% of sales (of which about 60% is Godrej No.1) and 35% of EBIT. Higher A&P spends in shampoo and soaps would be imperative in the short term, which could be followed by a price war in the medium term if ITC's market share gains in the next few quarters are significant. Over the last year, measured price hikes by HUL and GCPL have helped mitigate higher palm prices (up over 70%). ITC's entry could possibly cap this and the requirement for higher ad spends could adversely impact the margin profile of this category. We reiterate our Outperform rating on ITC with a target price of Rs225/share and In Line rating on HUL with a target price of Rs230/share. We will await market response to ITC's new launches before revising our estimates on these companies.

Slew of launches in personal care products. Expanding its range of personal care products and following the launch of Fiama Di Wills Shampoos in the premium segment, ITC has launched Superia shampoo at the lower end. The company has launched soaps under the Superia brand as well. Market sources indicate that the launch is in Andhra Pradesh and Orissa markets. The Fiama Di Wills range has been extended to shower gel as well.

- Fiama Di Wills' premium shampoo with four variants—Everyday Mild, Aqua Balance, Volume Boost and Silky Strong - priced at Rs 99 for 200 ml and Rs54 for 100 ml
- Fiama Di Wills' shower gel with three variants—Mild Dew, Clear Springs and Exotic Dream
- Superia shampoo at the lower end of the market with two variants—Shiny Black and Vibrant Green, priced at Rs 25 for 125 ml and Rs 10 for 55 ml
- Superia soaps at the lower end ('Popular' segment) of the category with four variants—Fragrant Flower, Soft Sandal, Natural Glow and Healthy Glow

Foaming up. We believe ITC is well-placed to make a dent into HUL's dominant shares, gain from CavinKare as well as garner a higher incremental share in this under-penetrated and fast growing shampoo category. HUL with about 47% market share is the leader and Proctor & Gamble with about 25% share is the nearest competitor. The estimated market size is Rs18 bn. We estimate HUL's Shampoo business at about Rs9 bn.

The pricing and the positioning of the ITC launches in shampoo indicate immediate threat to all HUL brands except Clinic All Clear, which is on the anti-dandruff platform. HUL has five brands in the shampoo category—Clinic Plus (50% of shampoo business), Sunsilk (20%), Clinic All Clear (20%), Lux (5%) and the recently launched Dove premium. We note that Superia is priced in line with the low-end brands like Chik, Nyle (CavinKare) and Lux. HUL is present in the low-end of the market through small pack sizes of Clinic Plus and Sunsilk. Our trade sources indicate that Lux shampoo is a non-focus brand currently sold in a few northern states.

We believe that higher A&P spends would be imperative in the short term, followed by a price war in the medium term if ITC's market share gains disturb HUL's equanimity in the segment. HUL's possible response to counter ITC could be:

1. **An aggressive push of Clinic Plus and Sunsilk with increased brand investments**
2. **Reviving Lux shampoo, taking it national**
3. **A possible price cut in select SKUs of Clinic Plus and Sunsilk**

Lots of lather. We expect ITC's task in penetrating further into the soap category to be much more challenging than in shampoos. Consumer loyalty in soaps is significantly lower compared to personal care products. The exceptions are highly differentiated products like Dove, Pears etc. Soaps is a highly penetrated (>90%), mature category and value market growth rates are in high single digits. However, the volume growth is flat or marginally negative (both HUL & Godrej had taken price hikes of about10% / grammage reductions during 1HCY07).

HUL is the leader in soaps with a dominant market share of about 54% and GCPL with 10% share is the nearest competitor. HUL dominates the Rs50-bn category with 10 brands covering the entire range (premium, mid-priced and popular). ITC's Superia is launched in the popular segment where it will compete with HUL's Lifebuoy (estimated Rs 9 bn sales), Breeze (estimated Rs 2 bn sales) and Godrej No.1 (about Rs 3 bn).

Over the past year, measured price hikes by HUL and Godrej have helped mitigate the higher palm prices (up over 70%). ITC's entry could possibly cap this and the requirement for higher ad spends could adversely impact the margin profile of this category.

Exhibit 1: ITC has entered the shampoo category at very competitive price points

Shampoo (bottles) - brands and price points

Brand	Company	Packsize 100 ml
Clinic All Clear	HUL	70
Dove	HUL	60
Fiama Di Wills	ITC	54
Sunsilk	HUL	45
Clinic Plus	HUL	39
Rejoice	P&G	32
Superia (a)	ITC	20
Chik	Cavinkare	18

(a) Rs 25 for 125 ml

Brand	Company	Packsize 200 ml
Clinic All Clear	HUL	135
Dove	HUL	115
Garnier	L'Oreal	110
Pantene	P&G	102
Fiama Di Wills	ITC	99
Sunsilk	HUL	82

Source: Company, Kotak Institutional Equities.

Exhibit 2: Attempt to ride on the distribution strength and a competitive product offering
Shampoo (Sachets) - Brands and price points

Price Point Rs	Packsize Ml	Brand	Company
0.5	3.5	Sunsilk	HUL
	3.5	Clinic Plus	HUL
	4	Superia	ITC
	4	Chik	Cavinkare
	4	Lux	HUL
1.0	8	Sunsilk	HUL
	8	Clinic Plus	HUL
2.0	9	Clinic Plus	HUL
	7	Clinic All Clear	HUL
	7	Head & Shoulders	P&G

Source : Company, Kotak Institutional Equities.

Exhibit 3: Competitive positioning in soaps
Soaps (Low-end / Popular segment) - Brands and price points

Brand	Company	MRP for 75 gm Rs	TFM (c) %
Breeze (a)	HUL	6.25	66
Godrej No.1	Godrej Consumer	6.75	76
Superia	ITC	6.50	70

(a) Banded pack of 4 soaps of 75 gm for Rs 25
(b) Banded pack of 4 soaps of 75 gm for Rs 27
(c) Total Fatty Matter (TFM) content indicates the oil content in soap.
Typical consumer perception is higher TFM = higher quality

Source : Company, Kotak Institutional Equities.

Exhibit 4: Existing brands of soaps (segmentwise) in the market

Segment	Brand	Company
Premium	Dove	HUL
	Pears	HUL
	Mysore Sandal	Karnataka Soaps
	Lux International	HUL
Mid-priced	Lux	HUL
	Hamam	HUL
	Rexona	HUL
	Cinthol	Godrej Consumer
	Lifebuoy Plus	HUL
	Santoor	Wipro
Low-end	Breeze	HUL
	Lifebuoy	HUL
	Nima	Nirma
	Nirma	Nirma
	Godrej No.1	Godrej Consumer

Source : Company, Kotak Institutional Equities.

Exhibit 5: Immense growth opportunities for ITC considering the high market shares of HUL and gap with the nearest competitor
Category snapshot for personal products

	Market share %		Market growth %		Category penetration %		
	HUL	Nearest competitor	2006	YTD 2007	All India	Urban	Rural
Personal wash	54.0	10.0	8.2	7.9	92.0	92.0	92.0
Shampoo	47.5	24.8	13.1	13.3	38.0	52.1	31.9
Skincare	55.1	7.5	15.0	16.3	22.0	31.5	17.8

Source : HUL presentation.

Exhibit 6: Business under threat from ITC's products
Segment contribution of categories

Company	Category	Contribution to	
		Sales (%)	PBIT (%)
HUL	Soap	20	22
HUL	Shampoo	7	12
Godrej	Soap	64	35

Source: Kotak Institutional Equities estimates.

Exhibit 7: Superia—targeting the popular segment

Source: Company.

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Kotak Institutional Equities Research coverage universe

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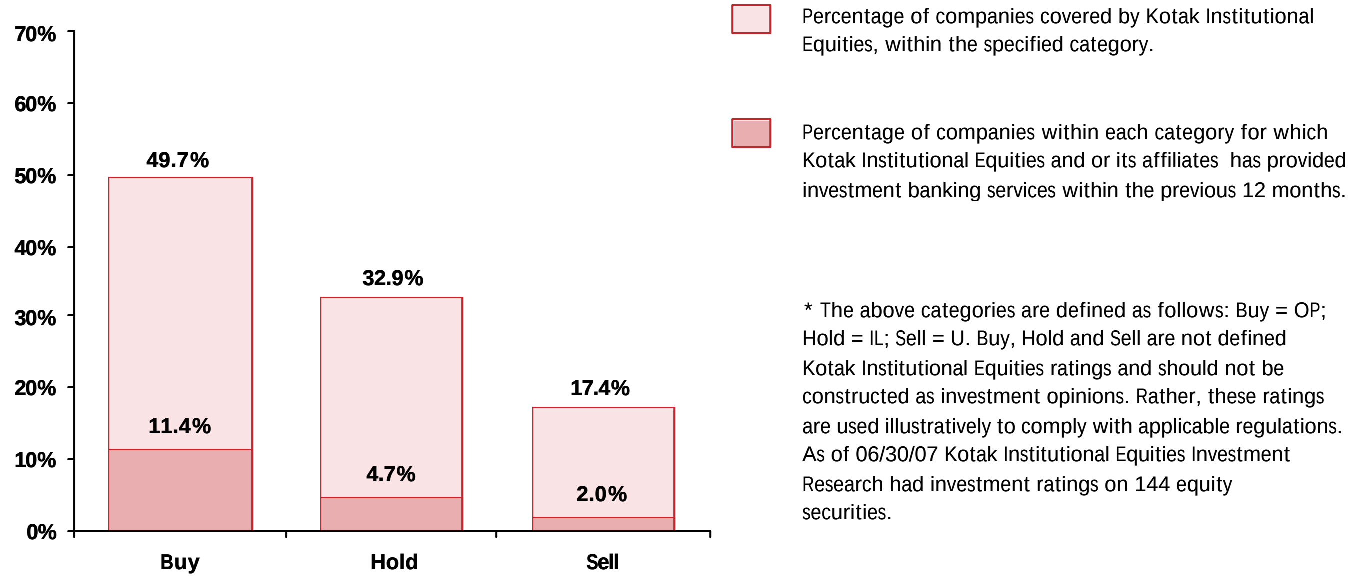

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Source: Kotak Institutional Equities. As of June 30, 2007

Ratings and other definitions/identifiers

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Corporate Office
Kotak Securities Ltd.
Bakhtawar, 1st Floor
229, Nariman Point
Mumbai 400 021, India
Tel: +91-22-6634-1100

Overseas Offices
Kotak Mahindra (UK) Ltd.
6th Floor, Portsoken House
155-157 The Minories
London EC 3N 1 LS
Tel: +44-20-7977-6900 / 6940

Kotak Mahindra Inc.
50 Main Street, Suite No.310
Westchester Financial Centre
White Plains, New York 10606
Tel: +1-914-997-6120

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