

### Contents

#### Update

**Reliance Industries:** We believe the tax holiday is unlikely to be restored

**Wipro:** On track—for 3QFY10 and beyond

**Hindustan Unilever:** P&G's low-price strategy: Non-event, for now

**Sun Pharmaceuticals:** Gaining more support in Taro deal

**BPCL, HPCL:** One is cheap (BPCL), the other cheaper (HPCL)

**Economy:** 2Q GDP growth: Surprise and more surprise?

**Banks/Financial Institutions:** RBI issues guidelines on minimal provision coverage for banks, fair value estimates remain unaffected

**Automobiles:** Auto sales remain in festive mood

#### News Round-up

- Fears of an imminent price rise, production spillovers owing to spare parts shortages plus a low base effect saw sales of the country's major **car makers grow a record 63% in November**. The eight car makers account for over 90% of the country's total domestic car sales. They sold 154,367 in November this year against 94,295 in the same month. (BS)
- **Bike sales vroom 32% in Nov**. Led by market leader Hero Honda, two-wheeler manufacturers posted an impressive growth in sales during the month of November. The aggregate two-wheeler sales of Hero Honda, TVS Motor, Yamaha and Suzuki rose 32% to 520,014 units last month, against the 393,604 units sold in the same month last year. (BS)
- **SAIL is set to reduce prices** of flat steel products sold in the spot market **by up to 3%** or Rs800/ tonne owing to mounting threat from low-priced imports. Other steel producers, including Ispat, Essar and JSW, are likely to follow suit this month. The new prices effective December will bring down raw material costs for car, television and fridge makers. (ET)
- **Taro investor reverses stance, backs Sun**. Sun Pharma's share price jumped 5.62% on the BSE after it gained a new ally in its legal battle to acquire Israel's Taro Pharmaceuticals with minority investor Templeton Asset Management switching sides to support Sun's bid. (Templeton holds 10% in Taro). (BS)
- **Areva T&D acquisition may trigger open offer**. A combine of Alstom and Schneider Electric have bought the entire stake in it of its majority holder, French nuclear major Areva. Areva today said the combine had won the bid for Areva T&D, beating the combine of GE, Toshiba and INCJ, in a deal valued at EUR2,290 million (about Rs16,000 crore). (BS)
- **L&T, HCC India and Simplex Infrastructure are in the race** to bag the airport construction mandate **for the Rs 10,000-crore upcoming aerotropolis project in West Bengal**. The project is being set up by Bengal Aerotropolis Project (BAPL), in which Singapore's Changi Airport holds 26% (ET)
- **Cement dispatches rise in Nov**. ACC and Ambuja Cements reported a 4-5 per cent growth in dispatches while the Aditya Birla Group and Shree Cement saw a 15 per cent growth, according to the numbers provided by the companies. (BL)

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

### EQUITY MARKETS

| India                          | Change % |       |       |       |
|--------------------------------|----------|-------|-------|-------|
|                                | 1-Dec    | 1-day | 1-mo  | 3-mo  |
| Sensex                         | 17,198   | 1.6   | 8.2   | 10.6  |
| Nifty                          | 5,122    | 1.8   | 8.7   | 10.7  |
| <b>Global/Regional indices</b> |          |       |       |       |
| Dow Jones                      | 10,472   | 1.2   | 7.8   | 12.5  |
| Nasdaq Composite               | 2,176    | 1.5   | 6.4   | 10.5  |
| FTSE                           | 5,312    | 2.3   | 5.3   | 10.2  |
| Nikkie                         | 9,579    | 0.1   | (2.3) | (6.8) |
| Hang Seng                      | 22,113   | 1.3   | 2.3   | 13.3  |
| KOSPI                          | 1,593    | 1.5   | 2.2   | (1.3) |
| <b>Value traded - India</b>    |          |       |       |       |
| Cash (NSE+BSE)                 | 206.9    |       | 220.2 | 233.8 |
| Derivatives (NSE)              | 606.6    |       | 783.4 | 745   |
| Deri. open interest            | 958.6    |       | 840   | 784   |

#### Forex/money market

|                               | Change, basis points |       |      |        |
|-------------------------------|----------------------|-------|------|--------|
|                               | 1-Dec                | 1-day | 1-mo | 3-mo   |
| Rs/US\$                       | 46.3                 | (21)  | (87) | (271)  |
| 10yr govt bond, %             | 7.6                  | 4     | 24   | 11     |
| <b>Net investment (US\$m)</b> |                      |       |      |        |
|                               | 30-Nov               |       | MTD  | CYTD   |
| FIs                           | 152                  |       | -    | 15,330 |
| MFs                           | 81                   |       | -    | (682)  |

#### Top movers -3mo basis

|                         | Change, % |       |        |        |
|-------------------------|-----------|-------|--------|--------|
|                         | 1-Dec     | 1-day | 1-mo   | 3-mo   |
| <b>Best performers</b>  |           |       |        |        |
| SESA IN Equity          | 368.1     | (0.0) | 21.7   | 75.2   |
| JSTL IN Equity          | 1015.9    | 2.3   | 34.5   | 53.1   |
| DRRD IN Equity          | 1145.0    | 1.4   | 13.2   | 47.0   |
| RBXY IN Equity          | 469.4     | 3.0   | 20.2   | 45.7   |
| TATA IN Equity          | 581.7     | 0.4   | 23.3   | 40.1   |
| <b>Worst performers</b> |           |       |        |        |
| IBULL IN Equity         | 125.8     | (1.3) | (26.0) | (36.2) |
| RCOM IN Equity          | 176.9     | 2.9   | 0.6    | (35.9) |
| IDEA IN Equity          | 52.0      | 2.1   | (0.1)  | (34.8) |
| BHARTI IN Equity        | 304.6     | 1.7   | 4.0    | (26.2) |
| SCS IN Equity           | 92.3      | 2.3   | (9.6)  | (23.6) |

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UPDATE

Coverage view: **Cautious**

Price (Rs): **1,098**

Target price (Rs): **900**

BSE-30: **17,198**

**We believe the tax holiday is unlikely to be restored.** We see the finance ministry's refusal to extend the 7-year tax holiday to gas production, as reported in media, to be negative for RIL's earnings and valuations. We compute EPS impact of 11-14% for FY2010-12E from non-availability of tax exemption. We maintain our SELL rating on RIL in view of (1) a weak business environment, (2) several potential negative developments and (3) lack of positive triggers. We compute an option value of US\$19 bn already being ascribed to future E&P discoveries.

#### Company data and valuation summary

Reliance Industries

| Stock data                      |             | Forecasts/Valuations |         |         |         |
|---------------------------------|-------------|----------------------|---------|---------|---------|
|                                 |             | 2009                 | 2010E   | 2011E   |         |
| 52-week range (Rs) (high,low)   | 1,268-513   | EPS (Rs)             | 50.6    | 48.3    | 68.8    |
| Market Cap. (Rs bn)             | 3,202.9     | EPS growth (%)       | (3.7)   | (4.5)   | 42.4    |
| <b>Shareholding pattern (%)</b> |             | P/E (X)              | 21.7    | 22.7    | 16.0    |
| Promoters                       | 40.9        | Sales (Rs bn)        | 1,418.5 | 1,737.3 | 1,900.6 |
| FIs                             | 19.8        | Net profits (Rs bn)  | 153.1   | 158.7   | 225.9   |
| MFs                             | 2.7         | EBITDA (Rs bn)       | 236.7   | 301.4   | 394.4   |
| <b>Price performance (%)</b>    |             | EV/EBITDA (X)        | 15.3    | 11.8    | 8.5     |
| Absolute                        | 1M 3M 12M   | ROE (%)              | 13.6    | 10.9    | 13.8    |
| Rel. to BSE-30                  | 5.1 0.7 5.1 | Div. Yield (%)       | 0.5     | 0.5     | 0.7     |

#### Denial of tax benefit on gas production would hurt

As per media reports, the ministry of finance has refused to grant tax exemption for gas production from blocks offered during NELP I-VII. We believe that this development, if confirmed, would be negative for RIL's earnings and valuations. Our earnings estimates and fair valuation assume availability of tax holiday for RIL's gas production. Our FY2010E, FY2011E and FY2012E EPS for RIL would drop to Rs44 (-11%), Rs60 (-14%) and Rs70 (-14%) without Section 80 IB tax benefits. Our fair valuation for RIL will also decline by Rs45/share due to removal of tax holiday. We maintain our earnings estimates given that RIL will likely continue to report earnings taking the benefit of availability of tax exemption pending clarity on the matter.

#### Valuations look expensive given the lack of positive triggers and potential negative developments

We maintain our SELL rating on RIL with a 12-month SOTP-based target price of Rs900 (see Exhibit 1). We see downside risks to our fair valuation arising from—(1) removal of tax holiday on gas production (-ve impact of Rs45), (2) potential negative development in RIL-RNRL legal dispute cases with RIL being asked to compensate the government at US\$4.2/mn BTU versus sale price of US\$2.34/mn BTU (-ve impact of Rs56/share) and (3) weaker-than-expected chemical and refining margins. In our view, RIL stock is a SELL at current levels as the stock price already factors in potential favorable developments regarding large E&P discoveries and value-accretive overseas acquisitions. Our reverse valuation analysis suggests that the stock is already implying an option value of US\$19 bn or 50 tcf of additional gas reserves (see Exhibits 2 and 3).

#### Core business value and earnings at risk

We see downside risks to our earnings estimates and fair valuation from weaker-than-expected refining and chemical margins. Exhibit 4 shows that refining margins have declined sharply from 2QFY10 and is at -US\$2.8/bbl in the recent week. We expect refining margins to remain subdued over FY2010-11E given large supply-demand imbalance. We note that a US\$1/bbl change in refining margin impacts RIL's FY2011E net income by 7%. We expect chemical margins to be very weak due to the large surplus; CY2010E will likely see the lowest rates for global capacity utilization for base polymers in the past 15 years (see Exhibit 5).

#### QUICK NUMBERS

- Potential downside of Rs45/share if tax holiday is not given
- Negative impact of Rs56/share in case of an unfavorable verdict in the RIL-RNRL case
- Current stock price implies 50 tcf in additional gas reserves

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SOTP valuation of Reliance is Rs900 per share on FY2011E estimates  
Sum-of-the-parts valuation of Reliance Industries, FY2011E basis (Rs)

|  | Valuation base (Rs bn) |        | Multiple (X) |           | EV<br>(Rs bn) | Valuation<br>(Rs/share) |
|--|------------------------|--------|--------------|-----------|---------------|-------------------------|
|  | Other                  | EBITDA | Multiple     | EV/EBITDA |               |                         |
| Chemicals  |                        | 83     |              | 7.5       | 625           | 214                     |
| Refining & Marketing                             |                        | 130    |              | 7.5       | 975           | 334                     |
| Oil and gas—producing                            |                        | 18     |              | 5.0       | 92            | 31                      |
| Gas—developing (DCF-based) (a)                   | 735                    |        |              |           | 735           | 252                     |
| KG D-6   | 359                    |        |              |           | 359           | 123                     |
| NEC-25   | 132                    |        |              |           | 132           | 45                      |
| CBM  | 70                     |        |              |           | 70            | 24                      |
| KG D-3   | 46                     |        |              |           | 46            | 16                      |
| KG D-9   | 72                     |        |              |           | 72            | 25                      |
| MN D-4   | 56                     |        |              |           | 56            | 19                      |
| Oil—KG-DWN-98/3 (b)                              | 83                     |        |              |           | 83            | 28                      |
| Investments other than valued separately         | 49                     |        |              |           | 49            | 17                      |
| Loans & advances to affiliates                   | 4                      |        |              |           | 4             | 1                       |
| Retailing  | 40                     |        | 80%          |           | 32            | 11                      |
| SEZ development                                  | 75                     |        | 80%          |           | 60            | 21                      |
| <b>Total enterprise value</b>                    |                        |        |              |           | <b>2,655</b>  | <b>910</b>              |
| Net debt adjusted for 50% of C-WIP of E&P assets |                        |        |              |           | 79            | 27                      |
| <b>Implied equity value</b>                      |                        |        |              |           | <b>2,576</b>  | <b>883</b>              |

Note:

- (a) We value KG D-6, NEC-25, CBM, KG D-3, KG D-9 and MN D-4 blocks on DCF.  
(b) 180 mn bbls of recoverable reserves based on gross OOIP of 0.5 bn bbls.  
(c) We use 2.917 bn shares (excluding treasury shares) for per share computations.

Source: Kotak Institutional Equities estimates

RIL stock price is implying US\$19 bn of new discoveries of hydrocarbons in the future  
Estimation of implied valuation of new businesses of Reliance Industries (US\$ bn)

|  |            | Comments  |
|--|------------|---|
| <b>1. Valuation of extant businesses</b>                     |            | <b>Chemicals, RIL refinery, extant oil and gas</b>  |
| FY2009 EPS of Reliance (standalone) (Rs)                     | 51         | FY2009 EPS  |
| FY2009 EPS adjusted for treasury shares (Rs)                 | 55         | Adjusted for 184 mn treasury shares and shares issued on merger of RPET   |
| Effective tax rate in FY2009 (%)                             | 16.9       |   |
| FY2009 EPS adjusted for tax rate                             | 43         | Normalized for 34% tax rate for extant earnings   |
| Appropriate P/E multiple (X)                                 | 7          | Reasonable given near peak-cycle margins, earnings in FY2009 and cost of equity of 12.5%                              |
| <b>Valuation of extant businesses excluding RPET (Rs)</b>    | <b>304</b> |   |
| <b>Valuation of extant businesses excluding RPET</b>         | <b>19</b>  | <b>Reasonable in the context of replacement value, returns</b>  |
| FY2011E earnings of RPET (US\$ bn)                           | 1          |   |
| FY2011E EPS of RPET (Rs)                                     | 14         |   |
| Appropriate P/E multiple (X)                                 | 9          |   |
| <b>Valuation of RPET refinery (Rs)</b>                       | <b>126</b> |   |
| <b>Valuation of extant businesses (including RPET) (Rs)</b>  | <b>430</b> |   |
| <b>Valuation of extant businesses</b>                        | <b>27</b>  |   |
| <b>2. Valuation of investments</b>                           |            | <b>Others (without Reliance Retail)</b>   |
| <b>Other investments (Rs)</b>                                | <b>11</b>  |   |
| <b>Valuation of RIL ex-new E&amp;P, retailing, SEZs (Rs)</b> | <b>441</b> |   |
| Current stock price  | 1,098      |   |
| <b>3. Valuation of new businesses</b>                        |            | <b>Emerging E&amp;P business, retailing, SEZs</b>   |
| <b>Market-ascribed value of new businesses</b>               | <b>657</b> |   |
| <b>Market-ascribed value of new businesses (US\$ bn)</b>     | <b>41</b>  |   |
| Estimated valuation of retailing (US\$ bn)                   | 0.7        | Valued at 0.8X of amount invested (Rs40 bn) at end-FY2009E  |
| Estimated valuation of SEZs (US\$ bn)                        | 1.3        | Value will take time to emerge  |
| <b>Market-ascribed value of emerging E&amp;P business</b>    | <b>39</b>  | <b>Seems high based on official reserves, announced discoveries</b>   |
| Estimated value of Reliance's stake in KG D-6 (gas)          | 10.5       | Based on gas production of 18.3 tcf, US\$8.8 bn capex and sale of 40 mcm/d of gas to RNRL and NTPC at US\$2.34/mn BTU |
| Estimated value of Reliance's stake in KG D-6 (oil)          | 1.8        | 0.5 bn bbls of OOIP assumed versus current announced reserves of 180 mn bbls  |
| Estimated value of Reliance's stakes in NEC-25               | 2.5        | Based on 5.3 tcf of production, US\$1.5 bn capex, US\$4.5/mn BTU  |
| Estimated value of Reliance's stakes in KG D-3               | 0.8        | Based on 9.6 tcf of production, US\$4.7 bn capex, US\$4.5/mn BTU  |
| Estimated value of Reliance's stakes in MN D-4               | 1.0        | Based on 10.2 tcf of production, US\$4.9 bn capex, US\$4.5/mn BTU   |
| Estimated value of Reliance's stakes in KG D-9               | 1.3        | Based on 10.9 tcf of production, US\$4.9 bn capex, US\$4.5/mn BTU   |
| Estimated value of Reliance's stakes in CBM                  | 1.5        | Based on 2.8 tcf of production  |
| <b>Implied value of new discoveries</b>                      | <b>19</b>  |   |

Source: Company, Kotak Institutional Equities estimates

Reliance's current stock price is implying additional recoverable reserves of ~50 tcf of gas today  
Valuation of Reliance's E&P segment and implied valuation for potential discoveries (US\$ bn)

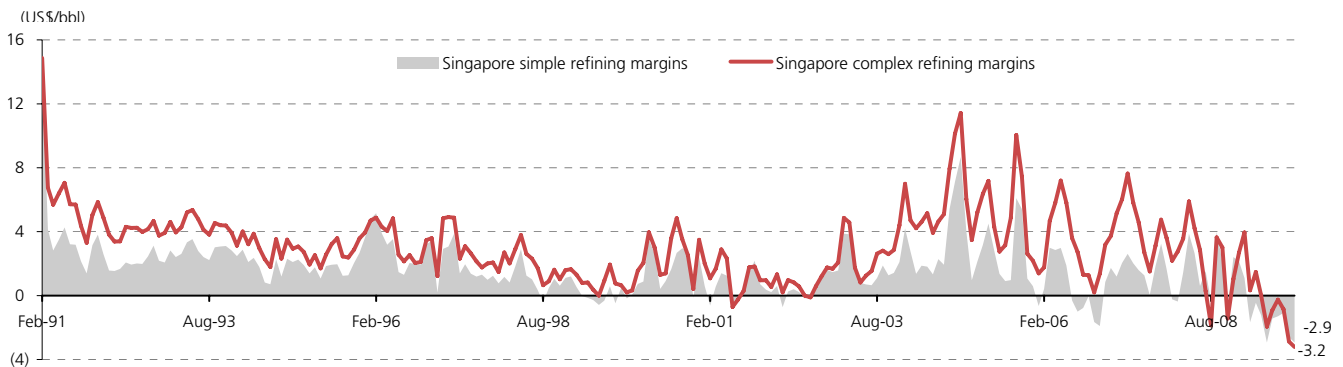
|  |           | Comments   |
|--|-----------|--|
| DCF valuation of KG D-6 block, gas for D1 & D3 fields                  | 10.4      | 15.4 tcf of net recoverable gas reserves                               |
| Valuation of KG D-6 block, oil for MA-1 field                          | 1.8       | 450 mn bbls of net proved oil reserves at EV/bbl of US\$10             |
| Valuation of Reliance's stakes in NEC-25                               | 2.5       | 4.6 tcf of net recoverable gas reserves                                |
| Valuation of Reliance's stakes in KG D-3, MN D-4 and KG D-9            | 3.2       | 27.1 tcf of net recoverable gas reserves                               |
| Valuation of Reliance's stakes in CBM blocks                           | 1.5       | 2.8 tcf of net recoverable gas reserves                                |
| <b>Total valuation of extant announced reserves</b>                    | <b>19</b> |  |
| <b>Total recoverable reserves (tcf)</b>                                | <b>51</b> |  |
| Implied valuation of new E&P discoveries                               | 19        |  |
| <b>Implied additional recoverable reserves in stock price (tcf)</b>    | <b>50</b> | <b>This is what Reliance needs to announce today</b>                   |
| # of years from discovery to production                                | 6         | KG D-6 first gas discovered in Oct-02, production in 2HFY09            |
| Cost of capital (%)  | 12        |  |
| <b>Additional gas reserves required to be added in six years (tcf)</b> | <b>98</b> | <b>This is what Reliance needs to bring in production in six years</b> |

Note:

(a) The above exercise assumes that all future gas and oil discovery would have similar PSC terms as the KG D-6 block.

Source: Kotak Institutional Equities estimates

Refining margins have collapsed in the recent months  
Singapore refining margins (US\$/bbl)



| Simple refining margins, March fiscal year-ends (US\$/bbl) |            |            |            |            |            |            |            |            |            |              |
|--|------------|------------|------------|------------|------------|------------|------------|------------|------------|--------------|
|  | 2001       | 2002       | 2003       | 2004       | 2005       | 2006       | 2007       | 2008       | 2009       | 2010 YTD     |
| 1Q   | 1.3        | 0.5        | 0.3        | 1.0        | 1.7        | 3.0        | 2.5        | 2.3        | 2.4        | (1.5)        |
| 2Q   | 2.5        | 0.4        | 0.1        | 1.2        | 3.1        | 2.8        | (0.7)      | 1.0        | 1.7        | (1.3)        |
| 3Q   | 1.7        | 1.1        | 1.4        | 1.6        | 6.5        | 2.2        | (1.2)      | 2.3        | 1.3        | (2.8)        |
| 4Q   | 0.2        | (0.0)      | 3.0        | 2.9        | 2.1        | 1.1        | 1.2        | 0.2        | 0.7        |              |
| <b>Average</b>   | <b>1.4</b> | <b>0.5</b> | <b>1.2</b> | <b>1.7</b> | <b>3.3</b> | <b>2.3</b> | <b>0.5</b> | <b>1.5</b> | <b>1.5</b> | <b>(1.7)</b> |

| Complex refining margins, March fiscal year-ends (US\$/bbl) |            |            |            |            |            |            |            |            |            |              |
|---|------------|------------|------------|------------|------------|------------|------------|------------|------------|--------------|
|   | 2001       | 2002       | 2003       | 2004       | 2005       | 2006       | 2007       | 2008       | 2009       | 2010 YTD     |
| 1Q  | 1.9        | 1.3        | 0.8        | 1.2        | 4.6        | 4.9        | 6.2        | 6.6        | 4.3        | (0.1)        |
| 2Q  | 4.0        | 0.6        | 0.1        | 2.3        | 5.8        | 6.1        | 2.5        | 2.9        | 0.7        | (0.7)        |
| 3Q  | 2.3        | 1.2        | 1.6        | 3.2        | 9.0        | 3.9        | 1.0        | 3.9        | 1.0        | (3.0)        |
| 4Q  | 1.6        | 0.6        | 3.7        | 5.4        | 5.0        | 2.8        | 4.1        | 2.8        | 2.4        |              |
| <b>Average</b>  | <b>2.4</b> | <b>0.9</b> | <b>1.5</b> | <b>3.1</b> | <b>6.1</b> | <b>4.4</b> | <b>3.4</b> | <b>4.0</b> | <b>2.1</b> | <b>(1.1)</b> |

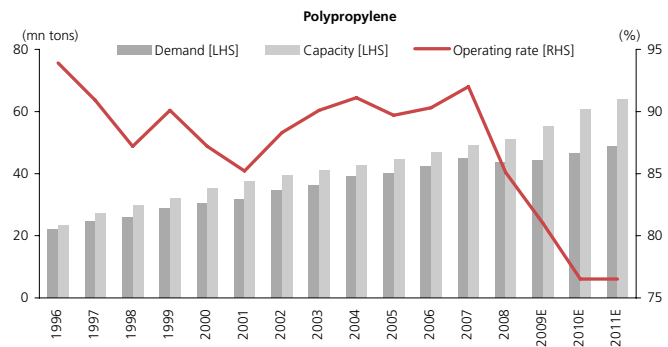
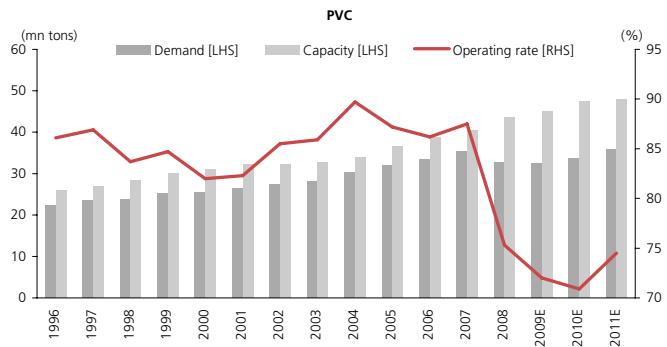
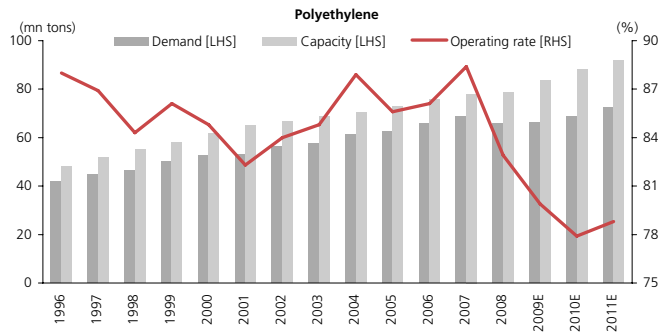
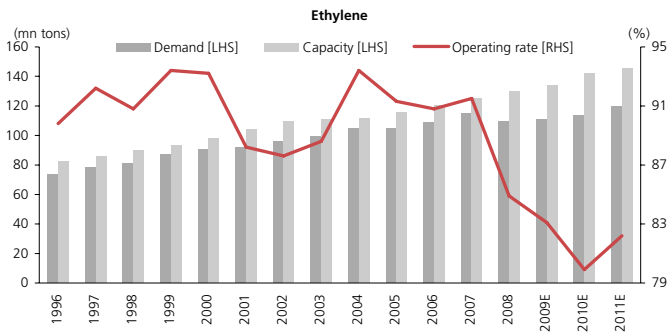
| Weekly margins |       |       |       |       |
|----------------|-------|-------|-------|-------|
| Current        | -1 Wk | -2 Wk | -3 Wk | -4 Wk |
| (2.6)          | (2.9) | (3.2) | (3.0) | (2.9) |

| Weekly margins |       |       |       |       |
|----------------|-------|-------|-------|-------|
| Current        | -1 Wk | -2 Wk | -3 Wk | -4 Wk |
| (2.8)          | (3.0) | (3.6) | (3.4) | (3.0) |

| Singapore refining margins, March fiscal year-ends (US\$/bbl) |      |      |      |      |      |      |      |      |      |          |
|---|------|------|------|------|------|------|------|------|------|----------|
|   | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 YTD |
| Simple  | 1.4  | 0.5  | 1.2  | 1.7  | 3.3  | 2.3  | 0.5  | 1.5  | 1.5  | (1.7)    |
| Complex   | 1.9  | 1.3  | 0.8  | 1.2  | 4.6  | 4.9  | 6.2  | 4.0  | 2.1  | (1.1)    |

Source: Bloomberg, Kotak Institutional Equities

**Global demand-supply balance for key chemical products**  
World demand and capacity (mn tons), operating rate (%), 1996-2011E



Source: CMAI, Kotak Institutional Equities estimates

RIL: Profit model, balance sheet, cash model, March fiscal year-ends, 2006-2012E (Rs mn)

|  | 2006            | 2007             | 2008             | 2009             | 2010E            | 2011E            | 2012E            |
|--|-----------------|------------------|------------------|------------------|------------------|------------------|------------------|
| <b>Profit model (Rs mn)</b>                |                 |                  |                  |                  |                  |                  |                  |
| Net sales                                  | 809,113         | 1,114,927        | 1,334,430        | 1,418,475        | 1,737,271        | 1,900,615        | 1,955,552        |
| <b>EBITDA</b>                              | <b>139,991</b>  | <b>198,462</b>   | <b>233,056</b>   | <b>233,139</b>   | <b>297,817</b>   | <b>390,796</b>   | <b>423,469</b>   |
| Other income                               | 6,829           | 4,783            | 8,953            | 20,599           | 28,093           | 23,414           | 20,906           |
| Interest                                   | (8,770)         | (11,889)         | (10,774)         | (17,452)         | (26,454)         | (25,299)         | (5,458)          |
| Depreciation & depletion                   | (34,009)        | (48,152)         | (48,471)         | (51,953)         | (96,541)         | (110,860)        | (115,616)        |
| Pretax profits                             | 104,041         | 143,205          | 182,764          | 184,332          | 202,913          | 278,051          | 323,301          |
| Extraordinary items                        | 3,000           | 2,000            | 47,335           | —                | —                | —                | —                |
| Tax  | (9,307)         | (16,574)         | (26,520)         | (12,634)         | (28,537)         | (63,152)         | (74,408)         |
| Deferred taxation                          | (7,040)         | (9,196)          | (8,999)          | (18,605)         | (15,700)         | 11,004           | 14,922           |
| Net profits                                | 90,693          | 119,434          | 194,580          | 153,093          | 158,676          | 225,902          | 263,815          |
| <b>Adjusted net profits</b>                | <b>88,152</b>   | <b>117,789</b>   | <b>152,605</b>   | <b>153,093</b>   | <b>158,676</b>   | <b>225,902</b>   | <b>263,815</b>   |
| <b>Earnings per share (Rs)</b>             | <b>32</b>       | <b>41</b>        | <b>52</b>        | <b>51</b>        | <b>48</b>        | <b>69</b>        | <b>80</b>        |
| <b>Balance sheet (Rs mn)</b>               |                 |                  |                  |                  |                  |                  |                  |
| Total equity                               | 430,543         | 673,037          | 847,853          | 1,263,730        | 1,432,093        | 1,627,275        | 1,853,543        |
| Deferred taxation liability                | 49,708          | 69,820           | 78,725           | 97,263           | 112,963          | 101,960          | 87,038           |
| Minority interest                          | —               | 33,622           | 33,622           | —                | —                | —                | —                |
| Total borrowings                           | 218,656         | 332,927          | 493,072          | 739,045          | 623,376          | 382,410          | 117,736          |
| Current liabilities                        | 164,545         | 192,305          | 251,427          | 357,019          | 319,539          | 332,151          | 340,235          |
| <b>Total liabilities and equity</b>        | <b>863,452</b>  | <b>1,301,712</b> | <b>1,704,700</b> | <b>2,457,057</b> | <b>2,487,971</b> | <b>2,443,796</b> | <b>2,398,551</b> |
| Cash                                       | 21,461          | 18,449           | 42,822           | 221,765          | 164,183          | 128,187          | 114,027          |
| Current assets                             | 224,283         | 286,566          | 402,721          | 325,358          | 386,953          | 400,667          | 404,188          |
| Total fixed assets                         | 626,745         | 899,403          | 1,081,638        | 1,693,869        | 1,720,769        | 1,698,876        | 1,664,271        |
| Investments                                | (9,038)         | 97,294           | 177,519          | 216,065          | 216,065          | 216,065          | 216,065          |
| Deferred expenditure                       | —               | —                | —                | —                | —                | —                | —                |
| <b>Total assets</b>                        | <b>863,452</b>  | <b>1,301,712</b> | <b>1,704,700</b> | <b>2,457,057</b> | <b>2,487,970</b> | <b>2,443,795</b> | <b>2,398,551</b> |
| <b>Free cash flow (Rs mn)</b>              |                 |                  |                  |                  |                  |                  |                  |
| Operating cash flow, excl. working capital | 119,520         | 164,285          | 180,718          | 174,508          | 222,282          | 292,099          | 330,757          |
| Working capital                            | (32,188)        | (13,075)         | (31,071)         | (37,983)         | (99,076)         | (1,101)          | 4,563            |
| Capital expenditure                        | (94,273)        | (247,274)        | (239,691)        | (247,128)        | (165,675)        | (73,025)         | (71,990)         |
| Investments                                | (32,364)        | (105,760)        | (78,953)         | (10,392)         | —                | —                | —                |
| Other income                               | 5,159           | 4,143            | 6,132            | 16,195           | 28,093           | 23,414           | 20,906           |
| <b>Free cash flow</b>                      | <b>(34,146)</b> | <b>(197,681)</b> | <b>(162,865)</b> | <b>(104,800)</b> | <b>(14,376)</b>  | <b>241,387</b>   | <b>284,235</b>   |
| <b>Ratios (%)</b>                          |                 |                  |                  |                  |                  |                  |                  |
| Debt/equity                                | 45.5            | 44.8             | 53.2             | 54.3             | 40.3             | 22.1             | 6.1              |
| Net debt/equity                            | 41.1            | 42.3             | 48.6             | 38.0             | 29.7             | 14.7             | 0.2              |
| RoAE                                       | 19.9            | 20.3             | 18.9             | 13.6             | 11.3             | 14.3             | 14.8             |
| <b>RoACE</b>                               | <b>13.8</b>     | <b>13.9</b>      | <b>12.7</b>      | <b>11.2</b>      | <b>9.5</b>       | <b>11.2</b>      | <b>12.5</b>      |

Source: Company, Kotak Institutional Equities estimates

**DECEMBER 02, 2009**
**UPDATE**

Coverage view: **Attractive**

Price (Rs): **638**

Target price (Rs): **675**

BSE-30: **17,198**

**On track—for 3QFY10 and beyond.** Our recent set of meetings with the Wipro management reinforced our positive investment thesis on the stock. We expect Wipro's strong positioning in some of the high-growth verticals and service lines, and changes made to the front-end organization, to drive better-than-peer revenue growth. Strong execution and improved acquisition performance should help margin protection. We reiterate our ADD rating on the stock.

**Company data and valuation summary**

Wipro

| Stock data                      |                | Forecasts/Valuations |       |       |       |
|---------------------------------|----------------|----------------------|-------|-------|-------|
|                                 |                | 2009                 | 2010E | 2011E |       |
| 52-week range (Rs) (high,low)   | 665-195        | EPS (Rs)             | 25.7  | 30.5  | 35.4  |
| Market Cap. (Rs bn)             | 933.0          | EPS growth (%)       | 15.8  | 18.6  | 15.8  |
| <b>Shareholding pattern (%)</b> |                | P/E (X)              | 24.8  | 20.9  | 18.0  |
| Promoters                       | 79.7           | Sales (Rs bn)        | 254.6 | 267.0 | 306.4 |
| FIs                             | 8.2            | Net profits (Rs bn)  | 37.6  | 44.6  | 51.7  |
| MFs                             | 0.9            | EBITDA (Rs bn)       | 50.6  | 57.8  | 66.2  |
| <b>Price performance (%)</b>    |                | EV/EBITDA (X)        | 18.3  | 15.4  | 13.0  |
| Absolute                        | 1M 3M 12M      | ROE (%)              | 26.9  | 26.4  | 25.0  |
|                                 | 5.3 15.1 173.9 | Div. Yield (%)       | 0.6   | 1.3   | 1.6   |
| Rel. to BSE-30                  | (2.7) 4.1 40.8 |                      |       |       |       |

**Portfolio advantage—we expect the company to deliver better-than-peer revenue growth**

We expect Wipro to outperform its Tier-I peers on revenue growth in FY2010E and FY2011E, as it had done in FY2009. Our confidence stems from—

- ▶ Wipro's diversified portfolio mix across verticals, service lines and geographies. Just as Wipro's weak positioning in BFSI and TSP verticals impacted the company's relative revenue performance through the previous high-growth phase, we expect the company's leadership position in the growth verticals/ geographies/ service lines (Energy & Utilities, Retail, Asia Pacific, BPO, IMS) for the next growth phase, to work in favor of the company.
- ▶ Strong senior management intervention to address the company's account management weaknesses—structured mega/gama account structure, reshuffling within the sales and marketing organization, partner-level consulting layer hires from the outside, and efforts to improve competitive intelligence function are all efforts in this direction. We highlight that the gap in top-10 client revenues account for the entire revenue gap between Wipro and Infosys.

**Margins likely to remain in a narrow range; levers under-appreciated by the street**

Wipro reiterated strong confidence in its ability to maintain its margins within a narrow band, barring a wild currency (Re/US\$) swing scenario. While the obvious margin levers like utilization and SG&A appear well-optimized, we highlight a few not-so-obvious margin levers at Wipro's disposal—(1) employee pyramid—Wipro's technical workforce is skewed towards lateral (more experienced) people as compared to an Infosys or a TCS; a robust volume growth phase is typically the best time to improve the rookie ratio and broaden the pyramid, (2) improvement in profitability of recent acquisitions, especially Infocrossing, and (3) stronger execution on FPP projects.

**December quarter could be better than guidance; reiterate ADD**

We expect Wipro to outperform the upper end (4.5% qoq) of its US\$ revenue growth guidance for 3QFY10. Reiterate our ADD rating on the stock with an end-March 2011 target price of Rs675.

**QUICK NUMBERS**

- Expect **outperformance of Dec 2009 revenue guidance**
- Expect **better-than-peer revenue growth in FY2010/11E**

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We find Wipro well-positioned across 'growth' verticals, geographies, and service lines

|                                  | 3QFY10 revenue (US\$ mn) | As % of revenue |
|----------------------------------|--------------------------|-----------------|
| <b>Energy and Utilities</b>      |                          |                 |
| Wipro                            | 96                       | 9.0             |
| Infosys                          | 68                       | 5.9             |
| TCS                              | 39                       | 2.8             |
| <b>Retail</b>                    |                          |                 |
| Wipro                            | 162                      | 15.2            |
| Infosys                          | 163                      | 14.1            |
| TCS                              | 169                      | 12.0            |
| <b>BPO</b>                       |                          |                 |
| Wipro                            | 112                      | 10.5            |
| Infosys                          | 72                       | 6.2             |
| TCS (1)                          | 166                      | 11.8            |
| <b>IMS</b>                       |                          |                 |
| Wipro                            | 219                      | 20.6            |
| Infosys                          | 90                       | 7.8             |
| TCS                              | 112                      | 8.0             |
| <b>Non North America/ Europe</b> |                          |                 |
| Wipro                            | 161                      | 15.1            |
| Infosys                          | 126                      | 10.9            |
| TCS                              | 300                      | 19.5            |

Note:

(1) ~45% of the BPO business comes from the recent e-Serve acquisition.

Source: Companies, Kotak Institutional Equities

Wipro - vertical-wise revenue split (Wipro Global IT), 1QFY09-2QFY10

|  | Jun-08       | Sep-08       | Dec-08       | Mar-09       | Jun-09       | Sep-09       |
|--|--------------|--------------|--------------|--------------|--------------|--------------|
| <b>Revenues (US\$ mn)</b>                    |              |              |              |              |              |              |
| Technology                                   | 127          | 124          | 120          | 104          | 97           | 93           |
| Telecom                                      | 110          | 105          | 106          | 92           | 87           | 86           |
| Communications, Media, and Service Providers | 94           | 94           | 91           | 86           | 92           | 102          |
| <b>Total TMT</b>                             | <b>331</b>   | <b>324</b>   | <b>317</b>   | <b>281</b>   | <b>276</b>   | <b>281</b>   |
| <b>Financial Services</b>                    |              |              |              |              |              |              |
| Manufacturing and Healthcare                 | 236          | 251          | 249          | 248          | 243          | 252          |
| Retail and Transportation                    | 137          | 151          | 160          | 163          | 157          | 162          |
| Energy and Utilities                         | 93           | 92           | 89           | 82           | 86           | 96           |
| <b>Total IT Services</b>                     | <b>1,068</b> | <b>1,110</b> | <b>1,100</b> | <b>1,046</b> | <b>1,033</b> | <b>1,065</b> |
| <b>Revenue contribution</b>                  |              |              |              |              |              |              |
| Technology                                   | 11.9         | 11.2         | 10.9         | 9.9          | 9.4          | 8.7          |
| Telecom                                      | 10.3         | 9.5          | 9.6          | 8.8          | 8.4          | 8.1          |
| Communications, Media, and Service Providers | 8.8          | 8.5          | 8.3          | 8.2          | 8.9          | 9.6          |
| <b>Total TMT</b>                             | <b>31.0</b>  | <b>29.2</b>  | <b>28.8</b>  | <b>26.9</b>  | <b>26.7</b>  | <b>26.4</b>  |
| <b>Financial Services</b>                    |              |              |              |              |              |              |
| Manufacturing and Healthcare                 | 22.1         | 22.6         | 22.6         | 23.7         | 23.5         | 23.7         |
| Retail and Transportation                    | 12.8         | 13.6         | 14.5         | 15.6         | 15.2         | 15.2         |
| Energy and Utilities                         | 8.7          | 8.3          | 8.1          | 7.8          | 8.3          | 9.0          |
| <b>Total IT Services</b>                     | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> |

Source: Company, Kotak Institutional Equities



## Wipro - service-wise revenue split (Wipro Global IT), 1QFY09-2QFY1

|                                 | Jun-08       | Sep-08       | Dec-08       | Mar-09       | Jun-09       | Sep-09       |
|---------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| <b>Revenues (US\$ mn)</b>       |              |              |              |              |              |              |
| Technology Infra services (IMS) | 199          | 216          | 213          | 219          | 216          | 219          |
| Testing                         | 115          | 123          | 127          | 124          | 125          | 128          |
| Package implementation          | 117          | 124          | 129          | 134          | 138          | 142          |
| BPO                             | 100          | 103          | 100          | 100          | 104          | 112          |
| Product Engineering             | 61           | 67           | 64           | 54           | 47           | 42           |
| ADM                             | 475          | 476          | 468          | 414          | 402          | 423          |
| <b>Total IT Services</b>        | <b>1,068</b> | <b>1,110</b> | <b>1,100</b> | <b>1,046</b> | <b>1,033</b> | <b>1,065</b> |
| <b>Revenue contribution</b>     |              |              |              |              |              |              |
| Technology Infra services (IMS) | 18.6         | 19.5         | 19.4         | 20.9         | 20.9         | 20.6         |
| Testing                         | 10.8         | 11.1         | 11.5         | 11.9         | 12.1         | 12.0         |
| Package implementation          | 11.0         | 11.2         | 11.7         | 12.8         | 13.4         | 13.3         |
| BPO                             | 9.4          | 9.3          | 9.1          | 9.6          | 10.1         | 10.5         |
| Product Engineering             | 5.7          | 6.0          | 5.8          | 5.2          | 4.6          | 3.9          |
| ADM                             | 44.5         | 42.9         | 42.5         | 39.6         | 38.9         | 39.7         |
| Total IT Services               | 100.0        | 100.0        | 100.0        | 100.0        | 100.0        | 100.0        |

Source: Company, Kotak Institutional Equities

## Size of top 10 clients account for a bulk of difference in revenues between Wipro and Infosys

| (US\$ mn)                          | Jun-08       | Sep-08       | Dec-08       | Mar-09       | Jun-09       | Sep-09       |
|------------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| <b>Wipro</b>                       |              |              |              |              |              |              |
| <b>Revenues</b>                    | <b>1,068</b> | <b>1,110</b> | <b>1,100</b> | <b>1,046</b> | <b>1,033</b> | <b>1,065</b> |
| Of which                           |              |              |              |              |              |              |
| Top client                         | 29           | 30           | 28           | 25           | 27           | 29           |
| Top 5 clients                      | 122          | 128          | 124          | 113          | 118          | 120          |
| <b>Top 10 clients</b>              | <b>223</b>   | <b>226</b>   | <b>222</b>   | <b>206</b>   | <b>213</b>   | <b>210</b>   |
| ex-top 10 clients                  | 844          | 883          | 878          | 840          | 820          | 855          |
| <b>Infosys</b>                     |              |              |              |              |              |              |
| <b>Revenues</b>                    | <b>1,156</b> | <b>1,218</b> | <b>1,171</b> | <b>1,122</b> | <b>1,122</b> | <b>1,154</b> |
| Of which                           |              |              |              |              |              |              |
| Top client                         | 91           | 93           | 73           | 64           | 50           | 53           |
| Top 5 clients                      | 230          | 226          | 203          | 193          | 183          | 190          |
| <b>Top 10 clients</b>              | <b>348</b>   | <b>341</b>   | <b>318</b>   | <b>301</b>   | <b>289</b>   | <b>302</b>   |
| ex-top 10 clients                  | 808          | 877          | 852          | 821          | 833          | 852          |
| <b>Difference: Wipro - Infosys</b> |              |              |              |              |              |              |
| <b>Revenues</b>                    | <b>(88)</b>  | <b>(108)</b> | <b>(71)</b>  | <b>(76)</b>  | <b>(89)</b>  | <b>(89)</b>  |
| Of which                           |              |              |              |              |              |              |
| Top client                         | (62)         | (63)         | (45)         | (39)         | (24)         | (24)         |
| Top 5 clients                      | (108)        | (99)         | (78)         | (80)         | (65)         | (70)         |
| <b>Top 10 clients</b>              | <b>(125)</b> | <b>(114)</b> | <b>(96)</b>  | <b>(95)</b>  | <b>(77)</b>  | <b>(93)</b>  |
| ex-top 10 clients                  | 37           | 7            | 26           | 19           | (13)         | 4            |

Source: Kotak Institutional Equities

Profit model, balance sheet, cash model of Wipro Limited, 2008-2012E, March fiscal year-ends (Rs mn)

|   | 2008            | 2009E          | 2010E          | 2011E          | 2012E          |
|---|-----------------|----------------|----------------|----------------|----------------|
| <b>Profit model</b>                             |                 |                |                |                |                |
| <b>Revenues</b>                                 | <b>197,428</b>  | <b>254,564</b> | <b>266,971</b> | <b>306,437</b> | <b>349,533</b> |
| Cost of revenues (incl. deprn)                  | (138,872)       | (178,368)      | (183,469)      | (209,646)      | (240,140)      |
| <b>Revenues</b>                                 | <b>58,556</b>   | <b>76,196</b>  | <b>83,502</b>  | <b>96,791</b>  | <b>109,393</b> |
| SG&A expenses (incl. deprn)                     | (24,229)        | (32,458)       | (33,392)       | (38,942)       | (44,060)       |
| <b>EBITA</b>                                    | <b>34,327</b>   | <b>43,738</b>  | <b>50,110</b>  | <b>57,849</b>  | <b>65,333</b>  |
| Amortization of intangibles                     | (617)           | (1,488)        | —              | —              | —              |
| <b>EBIT</b>                                     | <b>33,710</b>   | <b>42,250</b>  | <b>50,110</b>  | <b>57,849</b>  | <b>65,333</b>  |
| Other income                                    | 2,167           | 369            | 2,531          | 4,933          | 6,811          |
| <b>Pre-tax profits</b>                          | <b>35,877</b>   | <b>42,619</b>  | <b>52,641</b>  | <b>62,782</b>  | <b>72,144</b>  |
| Provision for tax                               | (3,873)         | (5,247)        | (8,231)        | (11,289)       | (15,518)       |
| <b>PAT</b>                                      | <b>32,004</b>   | <b>37,372</b>  | <b>44,410</b>  | <b>51,493</b>  | <b>56,626</b>  |
| Equity in earnings of affiliates                | 257             | 362            | 450            | 448            | 448            |
| <b>Reported PAT</b>                             | <b>32,261</b>   | <b>37,734</b>  | <b>44,860</b>  | <b>51,941</b>  | <b>57,074</b>  |
| <b>EPS (Rs)</b>                                 | <b>22.2</b>     | <b>25.7</b>    | <b>30.5</b>    | <b>35.4</b>    | <b>38.9</b>    |
| <b>Balance Sheet</b>                            |                 |                |                |                |                |
| Shareholders funds                              | 129,367         | 150,182        | 187,994        | 225,081        | 264,378        |
| Deferred tax liability/(assets)                 | —               | —              | —              | —              | —              |
| Borrowings                                      | 17,281          | 27,563         | 19,315         | 10,692         | 12,196         |
| Minority interest                               | 114             | 235            | 458            | 690            | 922            |
| <b>Total liabilities</b>                        | <b>146,762</b>  | <b>177,980</b> | <b>207,767</b> | <b>236,463</b> | <b>277,496</b> |
| Net fixed assets                                | 39,822          | 49,862         | 47,878         | 49,536         | 50,630         |
| Cash and bank balances                          | 54,078          | 65,297         | 51,112         | 72,238         | 105,660        |
| Net current assets excluding cash               | (2,274)         | (13,143)       | 32,038         | 36,465         | 41,404         |
| Other assets                                    | 55,136          | 75,964         | 76,740         | 78,223         | 79,802         |
| <b>Total assets</b>                             | <b>146,762</b>  | <b>177,980</b> | <b>207,767</b> | <b>236,463</b> | <b>277,496</b> |
| <b>Cashflow statement</b>                       |                 |                |                |                |                |
| Operating profit before working capital changes | 39,670          | 52,193         | 57,762         | 66,156         | 74,390         |
| Tax paid  | (4,089)         | (5,247)        | (8,231)        | (11,289)       | (15,518)       |
| Change in working capital/other adjustments     | (13,256)        | (11,753)       | (7,863)        | (4,086)        | (4,566)        |
| Capital expenditure                             | (14,194)        | (16,234)       | (5,668)        | (9,965)        | (10,151)       |
| Investments/ acquisitions                       | (38,068)        | (6,764)        | —              | —              | —              |
| <b>Free cash flow</b>                           | <b>(29,937)</b> | <b>12,194</b>  | <b>36,000</b>  | <b>40,816</b>  | <b>44,155</b>  |

Note:

(1) US GAAP financials till FY2009; IFRS starting FY2010E.

Source: Company, Kotak Institutional Equities estimates

DECEMBER 02, 2009

UPDATE

Coverage view: **Attractive**

Price (Rs): **279**

Target price (Rs): **320**

BSE-30: **17,198**

**P&G's low-price strategy: Non-event, for now**. We see merit in P&G's rational pricing for its lower-mid-segment detergents' launch as category margins are ~8%. The street appears to perceive a long-term threat to HUL from P&G. However, we highlight that P&G's global product portfolio is not fully conducive to India launches. We note that P&G could increase competitive activity in low-end shampoos and oral care or engage in development of skin care category. At ~4% dividend yield, and no material risk to earnings, BUY HUL.

#### Company data and valuation summary

Hindustan Unilever

| Stock data                      |           | Forecasts/Valuations |            |                |       |
|---------------------------------|-----------|----------------------|------------|----------------|-------|
|                                 |           | 2009                 | 2010E      | 2011E          |       |
| 52-week range (Rs) (high,low)   | 307-211   | EPS (Rs)             | 9.5        | 10.6           | 12.2  |
| Market Cap. (Rs bn)             | 607.3     | EPS growth (%)       | 19.0       | 11.1           | 15.0  |
| <b>Shareholding pattern (%)</b> |           | P/E (X)              | 29.3       | 26.3           | 22.9  |
| Promoters                       | 52.0      | Sales (Rs bn)        | 164.8      | 186.0          | 210.5 |
| FIs                             | 14.7      | Net profits (Rs bn)  | 20.7       | 23.1           | 26.5  |
| MFs                             | 3.8       | EBITDA (Rs bn)       | 25.7       | 29.4           | 33.8  |
| <b>Price performance (%)</b>    | <b>1M</b> | <b>3M</b>            | <b>12M</b> |                |       |
| Absolute                        | (1.7)     | 4.3                  | 19.5       | EV/EBITDA (X)  | 22.4  |
| Rel. to BSE-30                  | (9.2)     | (5.7)                | (38.6)     | ROE (%)        | 112.4 |
|                                 |           |                      |            | Div. Yield (%) | 3.1   |
|                                 |           |                      |            |                | 3.4   |
|                                 |           |                      |            |                | 3.9   |

#### BUY: Our reasons why

HUL volumes have likely turned around and we continue to see potential for double-digit volume growth in CY2010E. We maintain estimates; model EPS of Rs10.6 for FY2010E (+15.1%) and Rs12.2 (+15%) for FY2011E.

- ▶ Broad factors favoring HUL are intact (1) likely return of inflation, (2) likely stability in market shares as price cuts take effect, (3) benefits of major relaunches/brand activities will be seen in 2HFY10 and (4) renewed focus on regional jewel brands.
- ▶ P&G's new launch is likely to cannibalize Tide core sales and may take away market shares from 'Ghadi' (consumer offer in states where Ghadi is strong)
- ▶ Detergent powders account for 12% of HUL sales, the likely impacted brands are mid-end 'Rin' and low-end 'Wheel' detergent powders—accounting for about 9% of sales and 4% of profits
- ▶ While the risk of Rin powder consumers trading down to Tide Naturals is a reality, Rin powder accounts for ~3% of HUL's sales and ~2% of profits
- ▶ Wheel consumer uptrading to Tide Naturals is unlikely as Tide Naturals is at a 66% price premium
- ▶ Long-term threat from P&G perceived, however, we believe P&G's global product portfolio is not conducive to launches in India currently except low-end shampoos and oral care (unless P&G intends to do market development activities)
- ▶ At 22X FY2011E, HUL trades at 5% premium (one of the lowest ever) to consumer sector multiple, stock trades at ~4% dividend yield with no material risk to earnings

#### QUICK NUMBERS

- The street perceives a threat to HUL from P&G. We believe P&G's global product portfolio is not fully conducive to India launches
- HUL's likely impacted brands are 'Rin' and 'Wheel' powders—accounting for ~9% of sales and ~4% of profits
- P&G launched 'Tide Basic' in US few months back

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**P&G’s low-price strategy: Non-event, for now**

Channel sources indicate that P&G is launching a low-priced variant of mid-segment detergent ‘Tide’ and another top-end variant in ‘Olay’ skincare. Launches in mass market skincare, soaps and oral care are unlikely, for now. Key takeaways:

- ▶ ‘Tide Naturals’ is being launched at ~28% discount to normal Tide
- ▶ ‘Tide Naturals’ - 400 gms for Rs20 (effective price of Rs50 for 1 Kg versus current price of Rs70 for Tide, ‘100gms extra’ consumer offer is select states where ‘Ghadi’ is strong)
- ▶ ‘Olay Naturals’ launch at ~Rs100 is at 4X higher price compared to HUL’s Fair & Lovely (this launch to target the high-end ‘Garnier’ consumer, in our view)

**The impact on HUL’s detergents portfolio is likely to be very minimal**

- ▶ Detergent powders account for 12% of HUL sales, the likely impacted brands are mid-end ‘Rin’ and low-end ‘Wheel’ detergent powders—accounting for ~9% of sales and ~4% of profits (Exhibits 1 and 2)
- ▶ The new variant might cannibalize Tide core sales
- ▶ The new variant is still at a 66% price premium to HUL’s low-end brand ‘Wheel’
- ▶ P&G’s centralized distribution model currently is not conducive for selling high volume-low-value products like mass market detergents

Exhibit 1: The impact on HUL’s detergents portfolio is likely to be very minimal

|                         | Contribution<br>to sales<br>(%) | Contribution<br>to PBIT<br>(%) |                          |
|-------------------------|---------------------------------|--------------------------------|--------------------------|
| <b>Detergent powder</b> |                                 |                                |                          |
| Surf                    | 5                               | 5                              |                          |
| Rin                     | 3                               | 2                              | Likely impacted segments |
| Wheel                   | 6                               | 2                              |                          |
| <b>Detergent bar</b>    |                                 |                                |                          |
| Surf                    | 4                               | 4                              | No impact                |
| Rin                     | 2                               | 2                              |                          |
| Wheel                   | 4                               | 3                              |                          |
| <b>Total</b>            | <b>24</b>                       | <b>18</b>                      |                          |

Source: Kotak Institutional Equities estimates

Exhibit 2: P&G is likely trying to create a new segment in detergents category  
Retail prices of HUL and P&G detergents products (Rs/kg)

| HUL detergent brands | Indicative retail price (Rs/kg) | P&G detergent brands | Indicative retail price (Rs/kg) |
|----------------------|---------------------------------|----------------------|---------------------------------|
| Surf                 | 150                             | Ariel                | 150                             |
| Rin                  | 70                              | Tide                 | 70                              |
| <b>Wheel</b>         | <b>30</b>                       | <b>Tide Naturals</b> | <b>50 *</b>                     |

Note: Rs50/kg likely in most markets and promotional offer of Rs40/kg in select markets (dominated by Ghadi)

Source: Kotak Institutional Equities estimates

### P&G is taking Tide brand down the ladder in US as well

As per a report in WSJ; P&G has launched a low-end version of Tide in the US market branded as 'Tide Basic'. *"It is a traditional powder with fewer of the unique ingredients that set apart the specialized versions of Tide. The trick is to show that Tide Basic is more than "good enough" without making the more expensive Tide sub-brands seem superfluous"*.

We keenly await the likely launch of 'Tide Naturals' by P&G in Indian markets. Product packaging (for example Tide Basic's dominant color is yellow, an element of the Tide bulls-eye but not the orange color of the main Tide line) for Tide Naturals is important in our view—will likely decide the extent of consumer trading down for Tide core. (Exhibit 3)

Exhibit 3: P&G has launched a low-end version of Tide in the US market branded as 'Tide Basic



Source: www.mybrand.com, Kotak Institutional Equities

Exhibit 4: HUL: Profit model, balance sheet, cash model, calendar year-ends 2006-07, March fiscal year-ends 2009-11E (Rs mn)

|  | 2006          | 2007          | 15 months<br>2009 (a) | 2010E         | 2011E         |
|--|---------------|---------------|-----------------------|---------------|---------------|
| <b>Profit model (Rs mn)</b>                |               |               |                       |               |               |
| Net sales                                  | 121,034       | 136,754       | 202,393               | 185,987       | 210,525       |
| <b>EBITDA</b>                              | <b>16621</b>  | <b>18787</b>  | <b>26780</b>          | <b>25788</b>  | <b>29873</b>  |
| Other income                               | 3,545         | 4,315         | 5,678                 | 5,073         | 6,049         |
| Interest                                   | (107)         | (255)         | (253)                 | (391)         | (434)         |
| Depreciation                               | (1,302)       | (1,384)       | (1,953)               | (1,677)       | (1,998)       |
| Pretax profits                             | 18,757        | 21,463        | 30,251                | 28,794        | 33,489        |
| Tax  | (2,950)       | (3,660)       | (5,729)               | (5,548)       | (6,795)       |
| Deferred taxation                          | (268)         | (389)         | 0.2                   | (195)         | (191)         |
| <b>Net profit</b>                          | <b>15,539</b> | <b>17,415</b> | <b>24,522</b>         | <b>23,050</b> | <b>26,504</b> |
| <b>Earnings per share (Rs)</b>             | <b>7.0</b>    | <b>7.9</b>    | <b>11.3</b>           | <b>10.6</b>   | <b>12.2</b>   |
| <b>Balance sheet (Rs mn)</b>               |               |               |                       |               |               |
| Total equity                               | 27,235        | 14,392        | 20,615                | 23,008        | 25,760        |
| Total borrowings                           | 726           | 885           | 4,219                 | 4,219         | 4,219         |
| Current liabilities                        | 45,231        | 51,110        | 57,838                | 54,185        | 61,272        |
| <b>Total liabilities and equity</b>        | <b>73,191</b> | <b>66,387</b> | <b>82,673</b>         | <b>81,413</b> | <b>91,251</b> |
| Cash                                       | 4,169         | 2,009         | 17,773                | 15,731        | 17,580        |
| Current assets                             | 27,527        | 30,765        | 38,236                | 34,919        | 39,391        |
| Total fixed assets                         | 15,110        | 17,081        | 20,789                | 25,083        | 28,792        |
| Investments                                | 24,139        | 14,408        | 3,326                 | 3,326         | 3,326         |
| Deferred tax asset                         | 2,245         | 2,124         | 2,548                 | 2,353         | 2,163         |
| <b>Total assets</b>                        | <b>73,191</b> | <b>66,387</b> | <b>82,673</b>         | <b>81,413</b> | <b>91,251</b> |
| <b>Free cash flow (Rs mn)</b>              |               |               |                       |               |               |
| Operating cash flow, excl. working capital | 20,209        | 20,674        | 26,581                | 24,922        | 28,693        |
| Working capital                            | (471)         | 3,091         | (2,592)               | (1,035)       | 1,203         |
| Capital expenditure                        | (1,576)       | (3,355)       | (5,660)               | (5,972)       | (5,707)       |
| Investments                                | (4,309)       | 9,464         | 10,657                | 0             | 0             |
| <b>Free cash flow</b>                      | <b>13,852</b> | <b>29,873</b> | <b>28,986</b>         | <b>17,915</b> | <b>24,190</b> |
| <b>Key assumptions</b>                     |               |               |                       |               |               |
| Revenue Growth (%)                         | 9.4           | 13.0          | 48.0                  | (8.1)         | 13.2          |
| EBITDA Margin(%)                           | 13.9          | 13.7          | 13.2                  | 13.9          | 14.2          |
| EPS Growth (%)                             | 18.3          | 12.1          | 42.7                  | (6.0)         | 15.0          |

Note:

(a) 15 month period starting January 1, 2008 to March 31, 2009

Source: Company, Kotak Institutional Equities estimates

DECEMBER 02, 2009

UPDATE

Coverage view: **Attractive**

Price (Rs): **1,540**

Target price (Rs): **1,400**

BSE-30: **17,198**

**Gaining more support in Taro deal**, unconfirmed Israeli media reports say that Templeton Asset Management has decided to withdraw from Taro's appeal against Sun filed with the Supreme Court of Israel. We think the decision of Israel's Supreme Court alone can lead to a conclusion of the continuing battle between Taro's controlling shareholders and SUNP. Since Taro has not announced audited numbers for recent years, we are unable to estimate impact of the potential transaction. Our estimates, price target and rating are unchanged.

#### Company data and valuation summary

Sun Pharmaceuticals

##### Stock data

52-week range (Rs) (high,low) 1,600-953

Market Cap. (Rs bn) 300.7

##### Shareholding pattern (%)

Promoters 63.7

FIs 19.0

MFs 3.1

##### Price performance (%)

Absolute 1M 3M 12M

5.3 23.3 35.5

Rel. to BSE-30 (1.1) 14.1 (27.2)

##### Forecasts/Valuations

|                     | 2009 | 2010E  | 2011E |
|---------------------|------|--------|-------|
| EPS (Rs)            | 87.8 | 57.7   | 65.2  |
| EPS growth (%)      | 17.6 | (34.3) | 13.1  |
| P/E (X)             | 16.5 | 25.2   | 22.3  |
| Sales (Rs bn)       | 42.7 | 38.1   | 42.8  |
| Net profits (Rs bn) | 18.2 | 11.9   | 13.5  |
| EBITDA (Rs bn)      | 19.5 | 13.0   | 14.9  |
| EV/EBITDA (X)       | 13.7 | 19.7   | 16.5  |
| ROE (%)             | 30.2 | 15.9   | 15.9  |
| Div. Yield (%)      | 0.9  | 0.9    | 0.9   |

#### QUICK NUMBERS

- **SUNP battle with Taro controlling shareholders continues**
- **Estimates are unchanged**
- **Taro will host AGM on 31<sup>st</sup> December**

#### SUNP gets support from Templeton in its Taro bid

Israeli newspaper Globes reported that Templeton Asset Management has decided to withdraw from Taro's appeal against Sun filed with the Supreme Court. Globes reports that Templeton has stated in a statement to the Supreme Court of Israel that Taro's condition continues to deteriorate in terms of proper corporate governance. Under these circumstances, Templeton believes that it must act without delay to enable Taro to emerge from the situation in which it has found itself by removing the barriers for the transfer of control in Taro, for the good of all shareholders.

#### Does this mean we are any closer to the conclusion? We think not

Support from other shareholders for SUNP is welcome but that is not going to change the current impasse in any way. SUNP is legally not allowed to buy TARO shares from other shareholders at any price other than open offer which is currently on. This offer is at US\$7.75 a share while market price is well in excess of the offer price (~US\$9 a share). As a result, a shareholder may not participate in open offer.

#### Judgment of Israeli Supreme Court will resolve the issue

After the mediation efforts between SUNP and Taro failed, Supreme Court of Israel heard the matter in April 2009 and the decision is awaited. Taro has continued to file cases against SUNP. The latest was filed in September in US court alleging that SUNP failed to disclose to Taro shareholders material information about the action by US FDA against Caraco in which the FDA seized US\$20 mn in products.

#### Impact of potential Taro merger is not in estimates and price target

We maintain our PT of Rs1,400 and maintain ADD rating. At the current price, the stock is trading at 27X FY2010E and 24X FY2011E earnings. At our target price, it will trade at 21X FY2011E earnings. Since Taro has not announced audited results for recent years, we are not including any impact on sales/profits of the potential merger.

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## Profit and loss statement, March fiscal year-ends, 2006-2011E (Rs mn)

|   | 2006            | 2007            | 2008            | 2009            | 2010E           | 2011E           |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| <b>Net sales</b>                                  | <b>16,368</b>   | <b>21,321</b>   | <b>33,565</b>   | <b>42,723</b>   | <b>38,132</b>   | <b>42,763</b>   |
| Materials   | (4,872)         | (5,767)         | (7,222)         | (8,556)         | (9,300)         | (11,545)        |
| Selling and administration                        | (2,117)         | (2,616)         | (3,759)         | (5,543)         | (6,994)         | (5,862)         |
| Employee cost                                     | (1,416)         | (1,989)         | (2,331)         | (3,401)         | (5,149)         | (6,054)         |
| R&D   | (1,534)         | (2,440)         | (2,725)         | (3,099)         | (2,601)         | (3,421)         |
| Others  | (1,525)         | (1,785)         | (2,017)         | (3,484)         | (2,679)         | (2,138)         |
| <b>Total expenditure</b>                          | <b>(11,463)</b> | <b>(14,597)</b> | <b>(18,054)</b> | <b>(24,084)</b> | <b>(26,722)</b> | <b>(29,019)</b> |
| <b>EBITDA</b>                                     | <b>4,905</b>    | <b>6,724</b>    | <b>15,511</b>   | <b>18,640</b>   | <b>11,410</b>   | <b>13,744</b>   |
| Depreciation and amortisation                     | (610)           | (813)           | (969)           | (1,233)         | (1,580)         | (1,950)         |
| <b>EBIT</b>                                       | <b>4,295</b>    | <b>5,910</b>    | <b>14,543</b>   | <b>17,407</b>   | <b>9,830</b>    | <b>11,794</b>   |
| Net finance cost                                  | (156)           | (127)           | (88)            | —               | —               | —               |
| Other income                                      | 1,830           | 2,551           | 1,539           | 2,085           | 2,792           | 2,400           |
| <b>Pretax profits before extra-ordinaries</b>     | <b>5,969</b>    | <b>8,335</b>    | <b>15,994</b>   | <b>19,492</b>   | <b>12,621</b>   | <b>14,194</b>   |
| Current tax                                       | (83)            | (91)            | (1,288)         | (1,192)         | (345)           | (401)           |
| Deferred tax                                      | (157)           | 158             | 804             | 481             | (450)           | (450)           |
| <b>Reported net profit</b>                        | <b>5,730</b>    | <b>8,402</b>    | <b>15,509</b>   | <b>18,780</b>   | <b>11,826</b>   | <b>13,342</b>   |
| Minority Interests                                | (3)             | 559             | 640             | 603             | (120)           | (168)           |
| <b>Reported net profit after minority interes</b> | <b>5,733</b>    | <b>7,843</b>    | <b>14,869</b>   | <b>18,177</b>   | <b>11,946</b>   | <b>13,510</b>   |

Source: Kotak Institutional Equities estimates

## Balance sheet, cash model, March fiscal year-ends, 2006-2011E (Rs mn)

|  | 2006          | 2007          | 2008          | 2009          | 2010E         | 2011E          |
|--|---------------|---------------|---------------|---------------|---------------|----------------|
| <b>Balance sheet</b>                       |               |               |               |               |               |                |
| Total equity                               | 15,902        | 27,728        | 49,915        | 70,449        | 79,599        | 90,313         |
| Total debt                                 | 18,745        | 11,144        | 1,436         | 1,789         | 1,789         | 1,789          |
| Current liabilities                        | 3,515         | 3,046         | 6,373         | 7,198         | 7,021         | 7,421          |
| Minority Interests                         | 332           | 438           | 1,886         | 1,970         | 1,850         | 1,683          |
| Deferred tax liabilities                   | 1,053         | 895           | 92            | (679)         | (229)         | 221            |
| <b>Total equity and liabilities</b>        | <b>39,546</b> | <b>43,250</b> | <b>59,701</b> | <b>80,728</b> | <b>90,031</b> | <b>101,427</b> |
| Cash and cash equivalents                  | 15,323        | 13,802        | 12,389        | 16,690        | 27,499        | 37,255         |
| Current assets                             | 11,198        | 16,086        | 26,983        | 25,993        | 24,367        | 26,457         |
| <b>Net fixed assets</b>                    | <b>8,563</b>  | <b>9,514</b>  | <b>10,354</b> | <b>14,625</b> | <b>14,746</b> | <b>14,296</b>  |
| Intangible assets                          | 507           | 697           | 1,729         | 3,253         | 3,253         | 3,253          |
| Capital -WIP                               | 414           | 608           | 686           | 1,571         | 1,571         | 1,571          |
| Investments                                | 3,541         | 2,543         | 7,560         | 18,595        | 18,595        | 18,595         |
| <b>Total assets</b>                        | <b>39,546</b> | <b>43,250</b> | <b>59,701</b> | <b>80,728</b> | <b>90,031</b> | <b>101,427</b> |
| <b>Free cash flow</b>                      |               |               |               |               |               |                |
| Operating cash flow, excl. working capital | 5,506         | 8,134         | 15,198        | 18,841        | 12,281        | 14,164         |
| Working capital                            | (3,433)       | (5,568)       | (7,183)       | 1,113         | 1,389         | (1,857)        |
| Capital expenditure                        | (4,457)       | (2,103)       | (1,787)       | (6,401)       | (1,700)       | (1,500)        |
| Investments                                | 2,944         | 998           | (5,017)       | (11,035)      | —             | —              |
| <b>Free cash flow</b>                      | <b>560</b>    | <b>1,461</b>  | <b>1,210</b>  | <b>2,519</b>  | <b>11,971</b> | <b>10,807</b>  |

Source: Kotak Institutional Equities estimates

**DECEMBER 02, 2009**
**UPDATE**

Coverage view: **Cautious**

Price HPCL/BPCL(Rs): **361/606**

TP HPCL/BPCL (Rs): **525/675**

BSE-30: **17,198**

**One is cheap (BPCL), the other cheaper (HPCL).** We highlight that the recent strong outperformance of BPCL stock has opened a large valuation gap between BPCL and HPCL. We see similar upside/downside risks to the earnings of both the companies in the current macro-environment and find it hard to justify the valuation gap. Adjusted for value of investments, HPCL is trading at 4.8X FY2011E EPS and BPCL at 9X FY2011E EPS. We maintain our BUY rating on both stocks but prefer HPCL on higher potential upside (45% for HPCL and 11% for BPCL).

**Company data and valuation summary**

Hindustan Petroleum

**Stock data**

52-week range (Rs) (high,low) 426-216

Market Cap. (Rs bn) 122.4

**Shareholding pattern (%)**

Promoters 51.1

FIs 9.5

MFs 11.8

**Price performance (%)**

Absolute 1M 3M 12M 3.8 (6.3) 52.4

Rel. to BSE-30 (4.0) (15.2) (21.7)

**Forecasts/Valuations**

2009 2010E 2011E

EPS (Rs) 17.0 64.0 61.1

EPS growth (%) (49.3) 277.1 (4.5)

P/E (X) 21.3 5.6 5.9

Sales (Rs bn) 1,249.3 812.4 826.2

Net profits (Rs bn) 4.8 21.7 20.7

EBITDA (Rs bn) 28.7 46.9 47.0

EV/EBITDA (X) 7.6 4.8 4.4

ROE (%) 4.4 15.6 13.5

Div. Yield (%) 1.5 7.2 6.9

**Company data and valuation summary**

Bharat Petroleum

**Stock data**

52-week range (Rs) (high,low) 617-314

Market Cap. (Rs bn) 198.5

**Shareholding pattern (%)**

Promoters 54.9

FIs 9.3

MFs 7.4

**Price performance (%)**

Absolute 1M 3M 12M 18.4 12.0 67.1

Rel. to BSE-30 9.4 1.3 (14.1)

**Forecasts/Valuations**

2009 2010E 2011E

EPS (Rs) 20.6 75.0 64.3

EPS growth (%) (50.1) 264.1 (14.3)

P/E (X) 29.4 8.1 9.4

Sales (Rs bn) 1,340.7 878.5 905.1

Net profits (Rs bn) 7.5 27.1 23.3

EBITDA (Rs bn) 27.5 45.2 44.7

EV/EBITDA (X) 9.1 5.9 5.6

ROE (%) 5.3 17.7 13.7

Div. Yield (%) 1.2 5.0 4.2

**QUICK NUMBERS**

- **HPCL is trading at 4.8X FY2011E EPS and BPCL at 9X FY2011E EPS**
- **HPCL and BPCL are trading at 27% and 21% discount to replacement cost**
- **HPCL continues to be inexpensive at 0.9X FY2010E book value versus BPCL at 1.4X**

**BPCL's strong outperformance makes HPCL look cheaper**

BPCL stock (+16.3%) has outperformed the BSE-30 Index by 15% since November 20, 2009 versus a moderate 5.6% rise in HPCL stock price over the same period. We attribute the spurt in BPCL stock price partly to an announcement of a significant oil discovery in Brazil. However, it is difficult to justify the valuation gap of US\$1.8 bn between EVs of BPCL and HPCL. We note that HPCL stock offers a significant upside (+45%) to our 12-month target price of Rs525. The recent strong outperformance of BPCL leaves moderate upside for the stock (+11%) to our target price of Rs675. We maintain our BUY rating on both the stocks and find it difficult to justify the significant gap in valuations given similar operating environment.

**HPCL is trading at 4.8X P/E and BPCL is trading at 9X P/E**

We believe that the current relative valuations of BPCL and HPCL offer a good trading play. We do not see any justification for such a significant valuation gap as both companies have similar operating environment and regulatory exposure. HPCL stock is trading at 4.8X FY2011E EPS and BPCL at 9X FY2011E EPS (adjusted for the value of investments and dividends). Exhibit 1 gives our estimated replacement value for R&M companies broken down by various assets. At the current valuations, HPCL is trading at 27% discount to its replacement cost, as compared to BPCL which is trading at a 21% discount. Even on a P/B ratio, HPCL continues to be inexpensive at 0.9X in relation to BPCL which is trading at 1.44X (see Exhibit 2).

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### Potential triggers offer upside to earnings and valuations for HPCL and BPCL

We maintain our BUY rating on BPCL and HPCL stocks given (1) large upside to our 12-month target prices and (2) several potential catalysts. We see upside to earnings for FY2010E of BPCL and HPCL from a favorable subsidy-sharing scheme (see Exhibit 3). We currently assume that (1) the downstream companies will bear 25% of the subsidy burden from auto fuels and (2) the government will compensate the entire subsidy burden on cooking fuels through issue of oil bonds. We see potential positive catalysts in the medium term in the form of (1) potential deregulation of pricing of petroleum products and (2) removal of octroi.

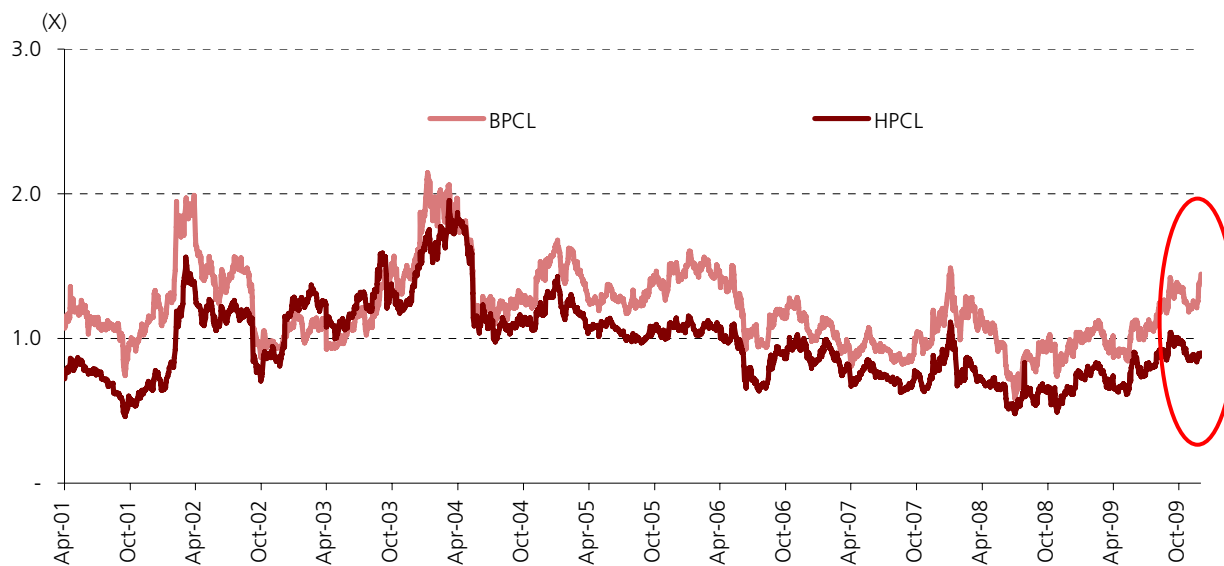
#### Enterprise value versus replacement cost of BPCL and HPCL (Rs mn)

|   | Rs/unit | BPCL    |                | HPCL    |                |
|---|---------|---------|----------------|---------|----------------|
|   |         | Details | Repl. cost     | Details | Repl. cost     |
| <b>Replacement cost calculation</b>       |         |         |                |         |                |
| Refining capacity (mtpa)                  | 7,000   | 20.0    | 140,000        | 16.2    | 113,610        |
| Product pipeline network (kms)            | 12.5    | 1,700   | 21,250         | 3,187   | 39,838         |
| LOBS capacity (000 tpa)                   | 12      | 180     | 2,160          | 335     | 4,020          |
| Retail outlets (#)-land                   |         | 8,402   | 7,021          | 8,539   | 7,370          |
| Retail outlets (#)-fixed assets           |         | 8,402   | 16,804         | 8,539   | 17,078         |
| Tanks, terminals etc. (mn kilo liters)    | 6,000   | 3.3     | 19,980         | 4.0     | 23,844         |
| LPG cylinders (100% of gross block)       |         |         | 32,626         |         | 12,650         |
| LPG bottling capacity (000 tpa)           | 10      | 2,126   | 21,260         | 2,440   | 24,400         |
| LPG import capacity (000 tpa)             | 3       | —       | —              | 1,600   | 4,800          |
| Petrochemicals (PX, PTA, LAB)             |         |         |                |         |                |
| Capital WIP                               |         |         | 20,375         |         | 22,634         |
| Fixed assets total                        |         |         | 281,475        |         | 270,243        |
| Investments (@ market value)              |         |         | 217,173        |         | 140,208        |
| Net working capital                       |         |         | 20,156         |         | 36,286         |
| Value of lubes business (@ 1X sales)      |         |         | 18,255         |         | 22,660         |
| <b>Replacement cost</b>                   |         |         | <b>537,060</b> |         | <b>469,397</b> |
| <b>Enterprise value calculation</b>       |         |         |                |         |                |
| Outstanding shares (mn)                   |         | 362     |                | 339     |                |
| Market price                              |         | 606     |                | 361     |                |
| Market capitalization (Rs mn)             |         |         | 218,924        |         | 122,307        |
| Net debt (Rs mn)                          |         |         | 207,299        |         | 221,469        |
| <b>Enterprise value (Rs mn)</b>           |         |         | <b>426,223</b> |         | <b>343,775</b> |
| <b>Current EV/RC (X)</b>                  |         |         | <b>0.79</b>    |         | <b>0.73</b>    |
| Implied market price at EV/RC=60%         |         |         | 318            |         | 178            |
| Implied market price at EV/RC=80%         |         |         | 615            |         | 455            |
| <b>Implied market price at EV/RC=100%</b> |         |         | <b>912</b>     |         | <b>732</b>     |

Source: Company, Kotak Institutional Equities estimates

## Downstream stocks are attractively valued

Price/book (price to current year-end book) ratio for BPCL and HPCL (X)



Source: Bloomberg, Kotak Institutional Equities estimates

## R&amp;M stocks' valuations are attractive even if crude continues at US\$75-80/bbl for the remaining part of FY2010E

Price/earnings (price to current year EPS) ratio for BPCL and HPCL (X)

| Crude price (US\$/bbl)                    | 25% share of subsidy burden on auto fuels |            |             | No subsidy burden |
|---|---|------------|-------------|-------------------|
|   | 70  | 75         | 80          |                   |
| <b>BPCL</b>                               |   |            |             |                   |
| Company's share of subsidy-burden (Rs mn) | 4,056                                     | 8,063      | 11,775      | —                 |
| FY2010E EPS (Rs)                          | 75.0                                      | 63.1       | 54.6        | 82.4              |
| <b>P/E (X)</b>                            | <b>8.1</b>                                | <b>9.6</b> | <b>11.1</b> | <b>7.3</b>        |
| <b>HPCL</b>                               |   |            |             |                   |
| Company's share of subsidy-burden (Rs mn) | 3,691                                     | 7,276      | 10,592      | —                 |
| FY2010E EPS (Rs)                          | 64.0                                      | 52.6       | 44.5        | 71.1              |
| <b>P/E (X)</b>                            | <b>5.6</b>                                | <b>6.9</b> | <b>8.1</b>  | <b>5.1</b>        |

Source: Bloomberg, Kotak Institutional Equities estimates

Profit model, balance sheet, cash model of HPCL, March fiscal year-ends, 2006-2012E (Rs mn)

|  | 2006            | 2007            | 2008            | 2009            | 2010E          | 2011E          | 2012E          |
|--|-----------------|-----------------|-----------------|-----------------|----------------|----------------|----------------|
| <b>Profit model (Rs mn)</b>                |                 |                 |                 |                 |                |                |                |
| Net sales                                  | 708,609         | 889,959         | 1,043,130       | 1,249,348       | 812,378        | 826,166        | 872,389        |
| <b>EBITDA</b>                              | <b>8,056</b>    | <b>24,036</b>   | <b>15,757</b>   | <b>28,707</b>   | <b>46,855</b>  | <b>46,994</b>  | <b>56,963</b>  |
| Other income                               | 3,285           | 6,845           | 11,980          | 9,057           | 10,689         | 9,073          | 6,974          |
| Interest                                   | (1,587)         | (4,230)         | (7,925)         | (20,828)        | (13,896)       | (13,432)       | (13,037)       |
| Depreciation                               | (6,902)         | (7,040)         | (8,508)         | (9,813)         | (10,804)       | (11,267)       | (11,791)       |
| Pretax profits                             | 2,851           | 19,611          | 11,303          | 7,122           | 32,844         | 31,368         | 39,110         |
| Extraordinary items                        | 2,201           | 3,030           | —               | —               | —              | —              | —              |
| Tax  | (898)           | (6,625)         | (1,799)         | (2,416)         | (9,942)        | (8,322)        | (11,168)       |
| Deferred taxation                          | (97)            | (365)           | (2,025)         | (343)           | (1,222)        | (2,340)        | (2,125)        |
| Prior period adjustment                    | —               | 61              | 3,870           | 1,387           | —              | —              | —              |
| <b>Net profits</b>                         | <b>4,056</b>    | <b>15,712</b>   | <b>11,349</b>   | <b>5,750</b>    | <b>21,681</b>  | <b>20,706</b>  | <b>25,816</b>  |
| <b>Earnings per share (Rs)</b>             | <b>6.6</b>      | <b>40.0</b>     | <b>33.5</b>     | <b>17.0</b>     | <b>64.0</b>    | <b>61.1</b>    | <b>76.2</b>    |
| <b>Balance sheet (Rs mn)</b>               |                 |                 |                 |                 |                |                |                |
| Total equity                               | 87,357          | 95,987          | 105,633         | 107,306         | 118,675        | 129,532        | 143,069        |
| Deferred tax liability                     | 13,844          | 14,209          | 15,960          | 16,034          | 17,256         | 19,596         | 21,721         |
| Total borrowings                           | 66,638          | 105,175         | 167,867         | 227,552         | 217,552        | 172,173        | 126,673        |
| Current liabilities                        | 79,549          | 101,195         | 124,337         | 117,558         | 91,282         | 96,320         | 99,791         |
| <b>Total liabilities and equity</b>        | <b>247,389</b>  | <b>316,566</b>  | <b>413,797</b>  | <b>468,450</b>  | <b>444,764</b> | <b>417,621</b> | <b>391,254</b> |
| Cash                                       | 426             | 868             | 2,940           | 6,083           | 1,230          | 1,208          | 1,266          |
| Current assets                             | 109,674         | 113,779         | 190,034         | 153,844         | 134,618        | 138,367        | 142,806        |
| Total fixed assets                         | 97,013          | 130,644         | 152,452         | 166,558         | 178,935        | 178,066        | 177,201        |
| Investments                                | 40,276          | 71,275          | 68,371          | 141,965         | 129,981        | 99,981         | 69,981         |
| <b>Total assets</b>                        | <b>247,389</b>  | <b>316,566</b>  | <b>413,796</b>  | <b>468,450</b>  | <b>444,764</b> | <b>417,621</b> | <b>391,255</b> |
| <b>Free cash flow (Rs mn)</b>              |                 |                 |                 |                 |                |                |                |
| Operating cash flow, excl. working capital | 10,126          | 23,966          | (18,679)        | (12,139)        | 20,551         | 24,336         | 32,758         |
| Working capital changes                    | (5,351)         | 8,936           | (6,504)         | 48,461          | (6,003)        | 2,119          | (968)          |
| Capital expenditure                        | (25,298)        | (38,510)        | (31,638)        | (19,275)        | (20,714)       | (9,493)        | (10,926)       |
| Investments                                | (22,884)        | (31,704)        | (1,851)         | (70,386)        | 11,984         | 30,000         | 30,000         |
| Other income                               | 941             | 2,067           | 4,692           | 3,187           | 9,642          | 8,243          | 6,974          |
| <b>Free cash flow</b>                      | <b>(42,466)</b> | <b>(35,246)</b> | <b>(53,980)</b> | <b>(50,151)</b> | <b>15,459</b>  | <b>55,205</b>  | <b>57,838</b>  |
| <b>Ratios (%)</b>                          |                 |                 |                 |                 |                |                |                |
| Debt/equity                                | 65.8            | 95.4            | 138.1           | 184.5           | 160.0          | 115.5          | 76.9           |
| Net debt/equity                            | 65.4            | 94.7            | 135.6           | 179.6           | 159.1          | 114.6          | 76.1           |
| RoAE                                       | 4.1             | 14.9            | 9.8             | 4.7             | 16.7           | 14.5           | 16.4           |
| <b>RoACE</b>                               | <b>2.5</b>      | <b>8.8</b>      | <b>6.4</b>      | <b>5.8</b>      | <b>9.3</b>     | <b>9.8</b>     | <b>12.2</b>    |
| <b>Key assumptions</b>                     |                 |                 |                 |                 |                |                |                |
| Crude throughput (mn tons)                 | 14.0            | 16.7            | 16.8            | 15.8            | 16.4           | 18.5           | 19.3           |
| Effective tariff protection (%)            | 3.1             | 1.4             | 1.3             | 2.4             | 2.4            | 2.4            | 2.4            |
| Net refining margin (US\$/bbl)             | 3.9             | 4.3             | 6.6             | 4.3             | 3.1            | 3.3            | 4.4            |
| Sales volume (mn tons)                     | 20.1            | 23.4            | 26.2            | 27.0            | 27.3           | 27.9           | 29.2           |
| Marketing margin (Rs/ton)                  | (463)           | (710)           | (2,345)         | (5,021)         | 946            | 1,426          | 1,435          |
| Subsidy under-recoveries (Rs mn)           | (29,671)        | (18,899)        | (28,549)        | (28,432)        | (3,691)        | —              | —              |

Source: Company, Kotak Institutional Equities estimates

Consolidated profit model, balance sheet, cash model of BPCL, March fiscal year-ends, 2006-2012E (Rs mn)

|  | 2006            | 2007            | 2008            | 2009            | 2010E          | 2011E          | 2012E          |
|--|-----------------|-----------------|-----------------|-----------------|----------------|----------------|----------------|
| <b>Profit model (Rs mn)</b>                      |                 |                 |                 |                 |                |                |                |
| Net sales  | 755,333         | 965,569         | 1,102,081       | 1,340,734       | 878,546        | 905,093        | 951,265        |
| <b>EBITDA</b>                                    | <b>9,407</b>    | <b>35,362</b>   | <b>28,472</b>   | <b>27,507</b>   | <b>45,179</b>  | <b>44,681</b>  | <b>50,465</b>  |
| Other income                                     | 4,653           | 7,332           | 13,954          | 15,087          | 18,236         | 12,459         | 10,694         |
| Interest   | (2,474)         | (4,774)         | (6,725)         | (21,664)        | (11,681)       | (10,002)       | (7,516)        |
| Depreciation                                     | (7,680)         | (9,041)         | (10,982)        | (10,755)        | (10,641)       | (11,904)       | (12,484)       |
| Pretax profits                                   | 3,906           | 28,879          | 24,719          | 10,176          | 41,093         | 35,233         | 41,160         |
| Extraordinary items                              | 176             | (68)            | —               | —               | —              | —              | —              |
| Tax  | (140)           | (9,286)         | (9,059)         | (5,103)         | (10,521)       | (10,370)       | (13,042)       |
| Deferred taxation                                | (1,025)         | (268)           | (1,108)         | 2,421           | (3,447)        | (1,606)        | (948)          |
| Net profits                                      | 2,916           | 18,055          | 15,806          | 7,359           | 27,125         | 23,258         | 27,170         |
| <b>Net profits after minority interests</b>      | <b>2,916</b>    | <b>18,055</b>   | <b>15,806</b>   | <b>7,359</b>    | <b>27,125</b>  | <b>23,258</b>  | <b>27,170</b>  |
| <b>Earnings per share (Rs)</b>                   | <b>7.6</b>      | <b>50.1</b>     | <b>43.7</b>     | <b>20.4</b>     | <b>75.0</b>    | <b>64.3</b>    | <b>75.1</b>    |
| <b>Balance sheet (Rs mn)</b>                     |                 |                 |                 |                 |                |                |                |
| Total equity                                     | 91,394          | 102,735         | 116,768         | 121,281         | 135,717        | 148,094        | 162,553        |
| Deferred taxation liability                      | 13,558          | 13,826          | 14,814          | 12,392          | 15,839         | 17,445         | 18,393         |
| Total borrowings                                 | 83,736          | 108,292         | 150,224         | 211,714         | 173,686        | 132,686        | 95,153         |
| Current liabilities                              | 94,070          | 112,767         | 145,803         | 128,313         | 109,090        | 117,443        | 120,056        |
| <b>Total liabilities and equity</b>              | <b>282,758</b>  | <b>337,620</b>  | <b>427,608</b>  | <b>473,701</b>  | <b>434,332</b> | <b>415,668</b> | <b>396,156</b> |
| Cash   | 4,921           | 8,640           | 9,616           | 4,416           | 4,795          | 4,734          | 4,388          |
| Current assets                                   | 128,208         | 127,698         | 187,457         | 148,469         | 138,365        | 142,458        | 145,061        |
| Goodwill   | —               | —               | —               | —               | —              | —              | —              |
| Total fixed assets                               | 110,855         | 118,334         | 127,354         | 140,033         | 165,050        | 167,356        | 170,586        |
| Investments                                      | 38,774          | 82,949          | 103,182         | 180,784         | 126,121        | 101,121        | 76,121         |
| <b>Total assets</b>                              | <b>282,758</b>  | <b>337,621</b>  | <b>427,608</b>  | <b>473,701</b>  | <b>434,332</b> | <b>415,668</b> | <b>396,157</b> |
| <b>Free cash flow (Rs mn)</b>                    |                 |                 |                 |                 |                |                |                |
| Operating cash flow, excl. working capital       | 9,275           | 29,920          | 22,988          | 19,717          | 22,977         | 24,309         | 29,908         |
| Working capital                                  | 1,577           | 11,451          | (25,161)        | 20,585          | (7,682)        | 5,470          | 9              |
| Capital expenditure                              | (19,945)        | (17,908)        | (20,665)        | (23,323)        | (35,659)       | (14,209)       | (15,715)       |
| Investments                                      | (28,146)        | (45,481)        | (21,684)        | (82,456)        | 54,663         | 25,000         | 25,000         |
| Other income                                     | 1,785           | 4,337           | 6,434           | 6,655           | 16,798         | 11,250         | 10,694         |
| <b>Free cash flow</b>                            | <b>(35,455)</b> | <b>(17,682)</b> | <b>(38,088)</b> | <b>(58,822)</b> | <b>51,098</b>  | <b>51,819</b>  | <b>49,897</b>  |
| <b>Ratios (%)</b>                                |                 |                 |                 |                 |                |                |                |
| Debt/equity                                      | 91.6            | 105.4           | 128.7           | 174.6           | 128.0          | 89.6           | 58.5           |
| Net debt/equity                                  | 86.2            | 97.0            | 120.4           | 170.9           | 124.4          | 86.4           | 55.8           |
| RoAE   | 3.3             | 16.3            | 12.7            | 5.5             | 19.0           | 14.7           | 15.7           |
| <b>RoACE</b>                                     | <b>4.1</b>      | <b>11.0</b>     | <b>7.9</b>      | <b>5.1</b>      | <b>11.7</b>    | <b>10.2</b>    | <b>11.6</b>    |
| <b>Key assumptions (standalone until FY2005)</b> |                 |                 |                 |                 |                |                |                |
| Crude throughput (mn tons)                       | 17.2            | 19.8            | 20.9            | 20.0            | 19.7           | 22.7           | 22.7           |
| Effective tariff protection (%)                  | 2.9             | 1.6             | 1.4             | 2.4             | 2.4            | 2.4            | 2.4            |
| Net refining margin (US\$/bbl)                   | 2.1             | 3.1             | 5.6             | 5.0             | 3.0            | 3.8            | 4.4            |
| Sales volume (mn tons)                           | 23.3            | 24.5            | 26.7            | 28.1            | 28.4           | 29.1           | 30.6           |
| Marketing margin (Rs/ton)                        | (671)           | (1,140)         | (3,010)         | (5,944)         | 923            | 1,474          | 1,480          |
| Subsidy under-recoveries (Rs mn)                 | (31,847)        | (20,159)        | (26,680)        | (27,706)        | (4,056)        | —              | —              |

Source: Company, Kotak Institutional Equities estimates

DECEMBER 02, 2009

UPDATE

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**2Q GDP growth: Surprise and more surprise?** The 2QFY10 GDP growth of 7.9% was a surprise — about 1.6 ppt above consensus. A closer look at the data suggests that it is bit of a conundrum that agriculture did not contract despite the severe drought. More importantly, in our view, the 2Q GDP surprise may mean that more surprise may follow soon as monetary policy may be tightened in January 2010, slightly ahead of the market expectations.

### Growth surprise a statistical conundrum

Despite the 18% drop in Kharif foodgrains production, the agriculture growth in 2QFY10 was +0.9%. This propelled GDP growth to way above market and our expectations. The positive agricultural growth may be a statistical conundrum. It is the outcome of the crop calendar methodology that gives insufficient weight to sowing of the main crops in India in this quarter. The methodology needs to be re-looked into by experts with a view to refine it.

### GDP growth may near 7.0% in FY2010E; but at 7.3% in FY2011E may still stay below potential

Factoring in the 2QFY10 GDP that is given, we are upgrading our FY2010E GDP growth to 6.9% from 6.0%. The large upgrade mainly reflects the upward revision in agriculture estimates, but in part is also the result of some buoyancy now seen in the manufacturing activity. However, with a higher-base, our FY2011E growth estimate now stands reduced to 7.3% from 7.5%.

### 2QFY10 GDP shows first signs of revival of private demand

High growth in 2QFY10 was still driven by government consumption that grew 27% yoy on back of the fiscal stimulus through wage hikes and other spending. However, in real terms, private consumption grew 5.6% in 2Q, the highest in six quarters. Gross capital formation grew less than 2% in contrast with anecdotal evidence that new investments are still strong, reflecting perhaps delays in actual investment spending.

### Surprise quicker exit from stimulus may follow the GDP surprise

It appears that the Indian economy is back to normal after three quarters of below potential growth as a fallout of the global slowdown. Non-agricultural GDP has grown at 9.0% in 2QFY10. With inflation becoming the primary macro-concern, we expect stimulus to be withdrawn over CY2010. In our view, the monetary policy may be tightened significantly in January 2010 and most of the tax cuts related to the three stimulus packages may be rolled back in FY2011 Union budget.

### QUICK NUMBERS

- Agriculture grows nearly 1% in 2Q despite drought
- Industry and services grow 9% in 2Q
- Our FY2010E GDP estimate increased to 6.5% from 6.0%
- We see 50 bps CRR hike, 25 bps policy rates hike in Jan

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### 2Q GDP surprise

2QFY10 GDP growth at 7.9% (see Exhibit 1) exceeded street consensus of 6.3% and our estimate of 6.0%. This surprise was the result of:

- ▶ 2QFY10 agriculture GDP growth of 0.9% (our estimate -7.0%)
- ▶ 2QFY10 community, social & personal services growing by 12.7% (our estimate 6.7%)

In our view, this surprise was the result of methodological peculiarities arising from a crop calendar that gives inadequate weight to main crops in 2Q.

#### Exhibit 1: India's 2QFY10 growth at 7.9% indicates sharp recovery

Sector-wise quarterly real GDP growth rates, March fiscal year-ends, 1QFY08-2QFY10

| Sector  | 1QFY08      | 2QFY08      | 3QFY08      | 4QFY08      | 1QFY09      | 2QFY09     | 3QFY09       | 4QFY09       | 1QFY10     | 2QFY10     |
|---|-------------|-------------|-------------|-------------|-------------|------------|--------------|--------------|------------|------------|
| <b>I Agriculture and allied activities</b>                | <b>4.3</b>  | <b>3.9</b>  | <b>8.1</b>  | <b>2.2</b>  | <b>3.0</b>  | <b>2.7</b> | <b>(0.8)</b> | <b>2.7</b>   | <b>2.4</b> | <b>0.9</b> |
| <b>II Industry (2+3+4)</b>                                | <b>8.5</b>  | <b>7.5</b>  | <b>7.6</b>  | <b>5.9</b>  | <b>5.1</b>  | <b>4.8</b> | <b>1.6</b>   | <b>(0.5)</b> | <b>4.2</b> | <b>9.0</b> |
| 2 Mining and quarrying                                    | 0.1         | 3.8         | 4.2         | 4.7         | 4.6         | 3.7        | 4.9          | 1.6          | 7.9        | 9.5        |
| 3 Manufacturing   | 10.0        | 8.2         | 8.6         | 6.3         | 5.5         | 5.1        | 0.9          | (1.4)        | 3.4        | 9.2        |
| 4 Electricity, gas and water supply                       | 6.9         | 5.9         | 3.8         | 4.6         | 2.7         | 3.8        | 3.5          | 3.6          | 6.2        | 7.4        |
| <b>III Services (5+6+7+8)</b>                             | <b>10.8</b> | <b>10.7</b> | <b>10.2</b> | <b>11.3</b> | <b>10.0</b> | <b>9.8</b> | <b>9.5</b>   | <b>8.4</b>   | <b>7.7</b> | <b>9.0</b> |
| 5 Construction  | 11.0        | 13.4        | 9.7         | 6.9         | 8.4         | 9.6        | 4.2          | 6.8          | 7.1        | 6.5        |
| 6 Trade, hotels, transport, storage and communication     | 13.1        | 10.9        | 11.7        | 13.8        | 13.0        | 12.1       | 5.9          | 6.3          | 8.1        | 8.5        |
| 7 Financing, insurance, real estate and business services | 12.6        | 12.4        | 11.9        | 10.3        | 6.9         | 6.4        | 8.3          | 9.5          | 8.1        | 7.7        |
| 8 Community, social and personal services                 | 4.5         | 7.5         | 5.5         | 9.5         | 8.2         | 9.0        | 22.5         | 12.5         | 6.8        | 12.7       |
| <b>IV Real GDP at factor cost (I+II+III)</b>              | <b>9.2</b>  | <b>9.0</b>  | <b>9.3</b>  | <b>8.6</b>  | <b>7.8</b>  | <b>7.7</b> | <b>5.8</b>   | <b>5.8</b>   | <b>6.1</b> | <b>7.9</b> |
| non-agricultural GDP                                      | 10.3        | 9.9         | 9.6         | 10.0        | 8.8         | 8.6        | 7.7          | 6.4          | 6.9        | 9.0        |

Source: Central Statistical Organisation and Kotak Institutional Equities

### 2Q GDP surprise a result of quixotic methodology

We find a positive agriculture growth a stark contrast with official crop data (First Advance Estimates of Kharif production) that show:

- ▶ 18% drop in Kharif foodgrains output (it is still 16% if the First Advance Estimate for FY2010 is compared with the First Advance Estimate last year)
- ▶ 15% drop in oilseeds production

In our view, the compilation methodology of the CSO needs to be debated to satisfy oneself on its scientific basis. On a thumb rule, 2Q accounts for a third of Kharif output, while 3Q takes two-thirds. In the 2QFY10 GDP weight to the foodgrains (rice, coarsegrains & pulses) and oilseeds — the crops that saw steep drop in output — was just 18%, while the weight to fruits and vegetables, other crops, livestock products, forestry and fishing was 82%. In terms of the official weights used by Ministry of Agriculture for compilation of agricultural growth, the weight of foodgrains and oilseeds was 75.6% in the principal crops in India for the triennium-ending 1981-82. Three decades down, the structure could have surely changed, but no formal exercise has been undertaken by the statistical agencies to capture that. CSO appears to be apportioning agriculture output considering the harvest stage, whereas the internationally recognized System of National Accounts (SNA), 1993 requires crop output to be distributed among quarters in proportion to the cost incurred in each quarter.

### Need to revamp estimation methodology

It is difficult to understand why so low a weight is given to the main Kharif crops in GDP compilation for 2Q, when the period till the end of the monsoon season is covered. In our view, there could be little case for doing so as all sowing is completed by August and the Kharif crop is ripe by September, leaving only harvesting and marketing to 3Q.

Similarly, the pay commission arrears merely reflect the deferred payments for a productive activity that has already been undertaken in the period for which arrears are given. So there is little justification of a spike in output under 'community, social and personal services' in a single quarter when arrears get paid. It would be better to revise data by spreading the arrear payments over 14 quarters, i.e., the entire period from the start of 2006 from which date the arrears are due.

In our view there is a case for expert group to look into the CSO's entire methodology for quarterly GDP estimation with a view to improve it. India has a rich tradition of firm statistical system compared with some of its emerging market counterparts and there is need to preserve integrity, transparency and faith in its statistical system by bringing about methodological improvements from time to time.

### FY2010E GDP may near 7.0%, but we see no significant upside for FY2011E

Considering the 2QFY10 GDP surprise and factoring in CSO's extant methodologies, we are upgrading our full year FY2010E GDP estimate to 6.9% (from 6.0% earlier), but slightly revising downwards our FY2011E estimate to 7.3% (from 7.5%) (see Exhibit 2).

Exhibit 2: India's FY2010E real GDP growth survives drought risks

Growth in real GDP at factor cost and components, March fiscal year-ends, 2007-2011E (%)

| Sector  | 2005       | 2006        | 2007        | 2008        | 2009       | 2010EAC      | 2010E        |              | 2011E      |            |
|---|------------|-------------|-------------|-------------|------------|--------------|--------------|--------------|------------|------------|
|   |            |             |             |             |            |              | Earlier      | Revised      | Earlier    | Revised    |
| <b>Agriculture and allied activities</b>                | <b>0.0</b> | <b>5.8</b>  | <b>4.0</b>  | <b>4.9</b>  | <b>1.6</b> | <b>(2.0)</b> | <b>(5.0)</b> | <b>(1.5)</b> | <b>6.8</b> | <b>3.5</b> |
| <b>Industry</b>   | <b>8.5</b> | <b>8.1</b>  | <b>10.7</b> | <b>7.4</b>  | <b>2.6</b> | <b>8.2</b>   | <b>8.3</b>   | <b>8.5</b>   | <b>6.3</b> | <b>6.3</b> |
| Mining and quarrying                                    | 8.2        | 4.9         | 8.8         | 3.3         | 3.6        | 10.0         | 11.1         | 8.9          | 7.6        | 10.1       |
| Manufacturing   | 8.7        | 9.1         | 11.8        | 8.2         | 2.4        | 7.7          | 7.9          | 8.6          | 6.2        | 5.8        |
| Electricity, gas and water supply                       | 7.9        | 5.1         | 5.3         | 5.3         | 3.4        | 7.4          | 8.0          | 7.2          | 5.1        | 6.0        |
| <b>Services</b>   | <b>9.9</b> | <b>11.2</b> | <b>11.3</b> | <b>10.8</b> | <b>9.4</b> | <b>8.2</b>   | <b>8.2</b>   | <b>8.0</b>   | <b>8.0</b> | <b>8.3</b> |
| Construction  | 16.1       | 16.2        | 11.8        | 10.1        | 7.2        | 8.8          | 7.6          | 8.2          | 9.6        | 9.0        |
| Trade, hotels, transport, storage and communication     | 10.7       | 12.1        | 12.8        | 12.4        | 9.0        | 8.4          | 8.3          | 9.4          | 8.6        | 9.7        |
| Financing, insurance, real estate and business services | 8.7        | 11.4        | 13.8        | 11.7        | 7.8        | 8.0          | 7.9          | 7.1          | 9.3        | 10.1       |
| Community, social and personal services                 | 6.8        | 7.1         | 5.7         | 6.8         | 13.1       | 8.0          | 8.8          | 6.2          | 4.7        | 3.3        |
| <b>Real GDP at factor cost</b>                          | <b>7.5</b> | <b>9.5</b>  | <b>9.7</b>  | <b>9.0</b>  | <b>6.7</b> | <b>6.5</b>   | <b>6.0</b>   | <b>6.5</b>   | <b>7.5</b> | <b>7.2</b> |
| non-agricultural GDP                                    | 9.5        | 10.4        | 11.2        | 9.9         | 7.8        | 8.2          | 8.2          | 8.1          | 7.6        | 7.9        |

Source: Central Statistical Organisation and Kotak Institutional Equities

- ▶ The upgrade of FY2010E GDP is largely accounted by the surprise on the agriculture
- ▶ The downward adjustment of FY2011E GDP largely reflects the impact of higher base with an upward revision in FY2010E GDP

In 2QFY10, GDP growth has exceeded potential, but we still see small slack in output prevailing till end-FY11E (see Exhibit 3). Output levels are likely to return to normal pre-crisis levels, but growth is unlikely to return to 9% growth path that we saw before the cyclical downturn began in FY2009.

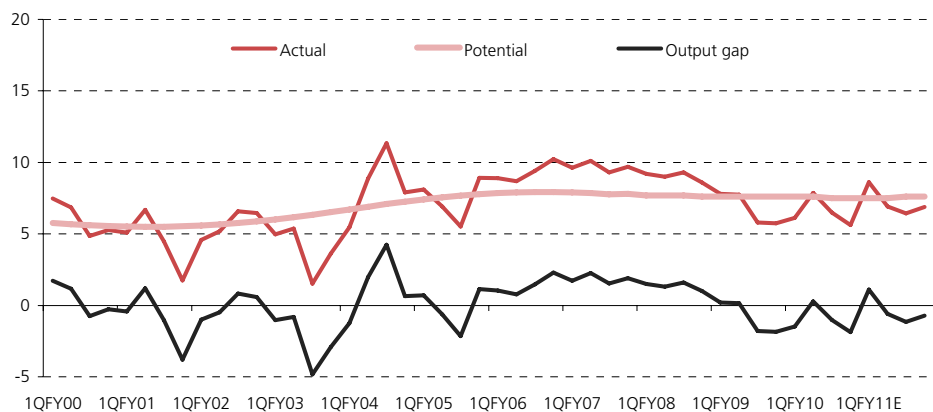
**FY2011E acceleration may be muted by withdrawal of fiscal stimulus**

We expect fiscal stimulus to be withdrawn in FY2011. This would keep further acceleration muted, with a sharp drop in government consumption that has been the key driver of growth in FY2009 and FY2010 so far (see Exhibit 4). In our view, the fiscal constraints have become binding and there is little choice but to cut fiscal gaps if crowding out of private investment through higher interest rates is to be avoided.

A notable feature of the 2QFY10 GDP is that it shows private consumption demand reviving. In real terms, private consumption demand was growing 1.6-2.7% in the four preceding quarters (2QFY09—1QFY10), but it expanded 5.6% in 2QFY10

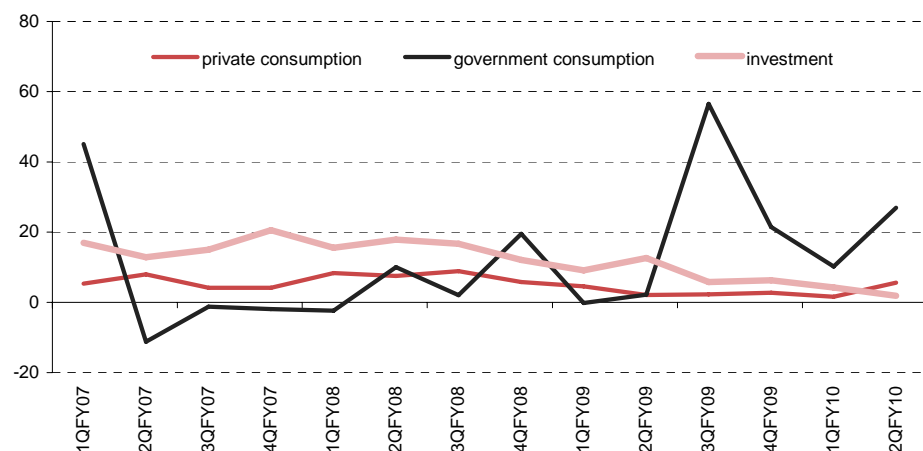
Real gross capital formation, however, decelerated further to 1.9%, suggesting that while investment intentions remain strong, actual execution is suffering.

**Exhibit 3: Growth may still remain slightly below potential in near term ahead**  
Growth in actual output, potential output and output gap, 1QFY98-4QFY11E (%)



Source: Central Statistical Organisation and Kotak Institutional Equities estimates

**Exhibit 4: Government spending still the key growth driver, but private demand improves**  
Growth in components of real aggregate demand, March fiscal year-ends, 1QFY07-4QFY09 (%)



Source: Central Statistical Organization and Kotak Institutional Equities

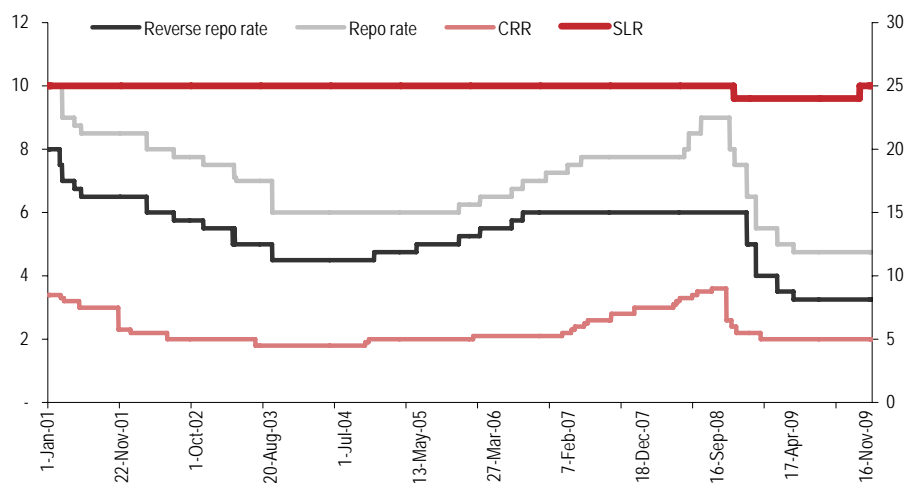
### Growth surprise paves way for monetary tightening in January 2010

In our assessment, the high 2QFY10 growth may result in:

- ▶ 50 bps CRR and a 25 bps repo & reverse repo rate hikes by RBI at its scheduled policy date of January 29, 2010.
- ▶ The CRR action may even precede the policy date and can occur post December 11, 2009 after the October IIP data release. We see October IIP growth in double digits.
- ▶ We continue to see headline inflation moving up sharply to 8.0% by end-FY10E, necessitating a monetary policy response.
- ▶ In our view, the seasonal decline in vegetable and fruit prices that typically occurs in November and December may not occur this time, prompting policy-makers to quickly tighten monetary policy in order to prevent more general price rise later on cost-push factors.

The high growth in 2QFY10E may settle the policy debate on exiting from the stimulus. IIP growth has averaged 8.9% in the last four months and now non-agricultural GDP has grown 9.0% in 2Q. On the other hand, relentless food price rise is fast becoming a major political issue that would shift the weight in policy-making to controlling inflation as a first priority as output levels may be seen back to normal. As such, tightening appears imminent to us after unprecedented monetary policy accommodation (see Exhibit 5).

**Exhibit 5 : Monetary measures on hold after aggressive easing; but tightening likely imminent**  
RBI's repo, reverse repo rates and cash reserve ratio on LHS, SLR on RHS (%)



Source: RBI and Kotak Institutional Equities

DECEMBER 02, 2009

UPDATE

BSE-30: 17,198

### RBI guidelines for minimum provisions: No impact on fair value estimates.

According to RBI's final guidelines on the minimum NPL provision requirement for Indian banks, Indian banks would be required to provide cover for at least 70% of their NPLs by September 2010. Banks would be allowed include technical / prudential write-offs in calculation of their provision coverage ratio. Earnings of companies like SBI, Canara Bank, IOB and OBC are likely to be impacted, but our fair value estimates of these companies remain unchanged.

### Impact on earnings to be around 10-15% for certain banks

This is likely to result in lower profits for banks that do not meet this criterion. Amongst the banks under our coverage, SBI, ICICI Bank, Canara Bank, IOB and OBC are likely to have lower provision coverage than 70% by FY2011E. Amongst these, ICICI Bank and Canara Bank do have relatively aggressive write off policies and the net impact on their P&L is likely to be lower. However, we believe earnings for SBI could get hit by 11% in FY2010E and FY2011E. The impact on networth is likely to be around 1-5%.

### Technical write-off higher in case of ICICI Bank and Canara Bank

We understand ICICI Bank and Canara Bank have a policy of aggressive write-offs. Given this, the additional provision requirement is likely to be low. For ICICI Bank, the impact on earnings is likely to be marginal given its conservative write-off policy and lower incremental delinquencies.

### Impact on profit could be lower in the event of lower delinquencies

We note that the impact on profits and net worth could be lower if delinquencies are lower than currently modeled by us—2.5-3X rise in gross NPLs over the next 18 months, which is likely conservative given the improved economic outlook and greater access to equity capital for most companies.

### Fair values however remain unaffected

We net off the net NPLs from the net worth of companies to arrive at our fair value estimates. Due to the change in provisioning norms, both the profits and reported net NPLs of companies will decrease compared to the erstwhile provisioning regime. The lower net NPLs would entirely neutralize the decline in net worth and have no impact on our fair value estimates. Hence, we believe that a sharp correction in prices solely as a reaction to change in provisioning policy is not warranted.

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Earnings of certain companies could be lower by 10-15% on account of the RBI policy  
Impact on earnings due to change in provisioning policy, March fiscal year-ends, 2010-11E

|                          | PBT (Rs bn) |       | Net worth (Rs bn) |       | Additional provision requirements (Rs bn) | Impact on PBT (%) |        | Impact on net worth (%) |
|--------------------------|-------------|-------|-------------------|-------|---|-------------------|--------|-------------------------|
|                          | 2010E       | 2011E | 2010E             | 2011E |   | 2010E             | 2011E  |                         |
| <b>Public banks</b>      |             |       |                   |       |   |                   |        |                         |
| Andhra Bank              | 11.0        | 9.6   | 42                | 47    | -   | -                 | -      | -                       |
| BoB                      | 37.4        | 40.1  | 134               | 155   | 0.5                                       | (0.6)             | (0.6)  | (0.1)                   |
| Bol                      | 32.4        | 34.9  | 138               | 159   | -   | -                 | -      | -                       |
| Canara Bank              | 31.3        | 32.9  | 120               | 140   | 13.0                                      | (20.7)            | (19.7) | (6.0)                   |
| Corporation Bank         | 13.1        | 13.2  | 56                | 62    | -   | -                 | -      | -                       |
| Indian Bank              | 19.1        | 20.9  | 66                | 78    | 4.7                                       | (12.2)            | (11.2) | (3.9)                   |
| IOB                      | 17.3        | 11.6  | 71                | 77    | 0.7                                       | (1.9)             | (2.8)  | (0.6)                   |
| OBC                      | 14.3        | 14.2  | 68                | 76    | 3.5                                       | (12.1)            | (12.2) | (3.0)                   |
| PNB                      | 52.4        | 56.4  | 158               | 187   | -   | -                 | -      | -                       |
| SBI                      | 149.7       | 168.7 | 656               | 744   | 34.3                                      | (11.5)            | (10.2) | (3.0)                   |
| Union Bank               | 24.2        | 26.5  | 85                | 101   | -   | -                 | -      | -                       |
| <b>Old private banks</b> |             |       |                   |       |   |                   |        |                         |
| Federal Bank             | 7.6         | 9.4   | 48                | 53    | -   | -                 | -      | -                       |
| J&K Bank                 | 7.1         | 7.8   | 30                | 34    | 1.0                                       | (7.1)             | (6.5)  | (2.0)                   |
| <b>New private banks</b> |             |       |                   |       |   |                   |        |                         |
| Axis Bank                | 36.0        | 44.1  | 159               | 181   | -   | -                 | -      | -                       |
| HDFC Bank                | 42.1        | 54.9  | 213               | 243   | -   | -                 | -      | -                       |
| ICICI Bank               | 57.9        | 71.1  | 521               | 552   | -   | -                 | -      | -                       |

Source: Source: Companies, Kotak Institutional Equities estimates

We assume a fairly sharp rise in NPLs for companies

Gross, net NPLs and credit provision estimates of companies, March fiscal year-ends, 2010-11E

|                          | Gross NPLs (Rs bn) |       |       | Net NPLs (Rs bn) |       |       | Provision coverage (%) |       |       | NPL provisions (Rs bn) |       |       |
|--------------------------|--------------------|-------|-------|------------------|-------|-------|------------------------|-------|-------|------------------------|-------|-------|
|                          | 2QFY10             | 2010E | 2011E | 2QFY10           | 2010E | 2011E | 2QFY10                 | 2010E | 2011E | 2009                   | 2010E | 2011E |
| <b>Public banks</b>      |                    |       |       |                  |       |       |                        |       |       |                        |       |       |
| Andhra Bank              | 4                  | 7     | 12    | 1                | 2     | 2     | 81                     | 71    | 81    | 2                      | 2     | 6     |
| BoB                      | 20                 | 32    | 55    | 4                | 6     | 17    | 79                     | 82    | 69    | 4                      | 9     | 13    |
| Bol                      | 39                 | 54    | 78    | 16               | 15    | 18    | 59                     | 72    | 76    | 8                      | 17    | 21    |
| Canara Bank              | 23                 | 46    | 66    | 17               | 28    | 33    | 28                     | 39    | 50    | 9                      | 11    | 16    |
| Corporation Bank         | 6                  | 7     | 14    | 2                | 0     | 3     | 75                     | 96    | 79    | 2                      | 3     | 4     |
| Indian Bank              | 5                  | 15    | 22    | 1                | 9     | 11    | 80                     | 39    | 48    | 1                      | 2     | 5     |
| IOB                      | 27                 | 45    | 54    | 12               | 28    | 17    | 54                     | 39    | 69    | 4                      | 7     | 19    |
| OBC                      | 12                 | 24    | 33    | 5                | 11    | 13    | 58                     | 54    | 59    | 2                      | 3     | 6     |
| PNB                      | 26                 | 57    | 86    | 2                | 19    | 25    | 91                     | 67    | 71    | 10                     | 14    | 22    |
| SBI                      | 174                | 264   | 332   | 99               | 135   | 134   | 43                     | 49    | 60    | 27                     | 47    | 70    |
| Union Bank               | 19                 | 29    | 40    | 2                | 3     | 4     | 88                     | 88    | 91    | 7                      | 10    | 11    |
| <b>Old private banks</b> |                    |       |       |                  |       |       |                        |       |       |                        |       |       |
| Federal Bank             | 8                  | 12    | 18    | 1                | 3     | 4     | 83                     | 75    | 76    | 4                      | 5     | 5     |
| J&K Bank                 | 5                  | 8     | 10    | 1                | 4     | 4     | 76                     | 53    | 60    | 1                      | 2     | 2     |
| <b>New private banks</b> |                    |       |       |                  |       |       |                        |       |       |                        |       |       |
| Axis Bank                | 11                 | 26    | 38    | 4                | 9     | 8     | 63                     | 66    | 78    | 9                      | 14    | 16    |
| HDFC Bank                | 20                 | 30    | 40    | 6                | 11    | 7     | 70                     | 64    | 81    | 17                     | 21    | 22    |
| ICICI Bank               | 95                 | 123   | 135   | 46               | 46    | 38    | 52                     | 62    | 72    | 38                     | 41    | 32    |

Source: Source: Companies estimates.

Fair value estimate remains unaffected by change in provisioning policy  
Illustration of impact on ABVPS before and after change in provisioning policy

| <b>Current scenario</b>        |   |           |
|--------------------------------|---|-----------|
| Net worth (Rs)                 | (1)   | 100       |
| Gross NPLs (Rs)                | (2)   | 45        |
| Net NPLs (Rs)                  | (3)   | 18        |
| Provision coverage (%)         | $(4) = (1 - (3)/(2)) \times 100$                | 60        |
| Provisions through P&L (Rs)    | (5)   | 9         |
| PAT (Rs)                       | (6)   | 15        |
| <b>Adjusted net worth (Rs)</b> | <b>(7) = (1) - (3) X 0.65</b>                   | <b>89</b> |
| <b>New provisioning regime</b> |   |           |
| Additional provisions (Rs)     | $(8) = ((70 - (4))/100 \times (2)) \times 50\%$ | 2         |
| Revised PAT (Rs)               | $(9) = (6) - (8) \times 0.65$                   | 13        |
| Revised net worth (Rs)         | $(10) = (1) - (6) + (9)$                        | 99        |
| Revised net NPLs (Rs)          | $(11) = (3) - (8) \times 2$                     | 16        |
| <b>Adjusted net worth (Rs)</b> | <b>(12) = (10) - (11) X 0.65</b>                | <b>89</b> |

Source: Source: Kotak Institutional Equities estimates



DECEMBER 02, 2009

UPDATE

BSE-30: 17,198

**Auto sales remain in festive mood.** Auto sales remained robust and, as expected, did not see the declines typical of the post-festival season. Overall, sales were largely in line with our estimates. Maruti improved sales 3% from October as the company replenished inventory at dealers. Hero Honda's volumes also grew 8% sequentially as volumes were no longer impacted by labor issues. Tata Motors reported strong M&HCV growth largely on account of the low base of the previous year.

#### Maruti: Domestic sales marginally better, exports slightly below estimates

Maruti reported total sales volumes of 87,807 units, up 67% yoy and 3% sequentially. Domestic sales were slightly stronger than expected as Maruti started getting the benefits of increased capacity through re-alignment in their Gurgaon facility. Retail sales were closer to 70,000 for the month and the company built inventory to more normalized levels. Exports of 11,448 were slightly below estimates on a missed shipment, which is expected to be made up in December. Fiscal year-to-date sales are up 29% yoy compared to our estimate of 23% growth for FY2010E.

#### M&M: Sequential decline in line with seasonal trends

M&M reported UV sales of 15,193 slightly below our expectation. Sales grew 102% yoy and declined 17.5% from October. Tractor sales were up 48% yoy at 12,592 and better than our estimate. Mahindra's new small commercial vehicle GIO sold 1,019 units in its second month of sale. Three-wheeler sales grew 79% yoy to 4,118 units and was flat sequentially. Fiscal year-to-date sales are up 33% yoy compared to our estimate of 27% for FY2010E.

#### Hero Honda: Sales improve 7.7% sequentially with labor issues behind it

Hero Honda reported volumes of 381,378, up 32% yoy and in-line with our 380,707 unit estimate. Volumes grew 7.7% from October as production was no longer impacted by labor issues. Fiscal year-to-date sales are up 21% yoy compared to our estimate of 23% for FY2010E.

#### Tata Motors: Strong volume growth led by easy financing, base effect

Tata Motors reported M&HCV growth of 116% yoy and 5% sequentially in Nov-2009 led largely by (1) easy financing and (2) low base effect of the previous year (due to economic slowdown in FY2009). Domestic M&HCV volume growth at 12,507 units was aided by increased economic activity and lower cost of financing. Meanwhile, LCV volumes grew 62% yoy but were down 9.3% sequentially. UVs grew 23% yoy, while on a sequential basis, volumes declined 8.6% as festival demand seems to have waned away. Passenger car segment volumes grew 49% yoy and 8% qoq—largely due to (1) launch of the new sedan Manza, (2) low base effect of FY2009 and (3) incremental volumes from Nano (approximately 3,400). We expect 2HFY10 volume growth numbers to be optically large as 2HFY09 volumes were severely impacted by slowdown in the economy and the credit crisis.

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## 4-wheelers Nov 2009 sales performance

|                                | Nov-09        | Nov-08        | yoy %        | Oct-09        | mom %         | YTD, FY2010    | YTD, FY2009    | yoy %        |
|--------------------------------|---------------|---------------|--------------|---------------|---------------|----------------|----------------|--------------|
| <b>Tata Motors</b>             |               |               |              |               |               |                |                |              |
| M&HCV                          | 12,507        | 5,792         | 115.9%       | 11,916        | 5.0%          | 85,845         | 81,909         | 4.8%         |
| LCV                            | 16,901        | 10,437        | 61.9%        | 18,625        | -9.3%         | 135,804        | 99,214         | 36.9%        |
| Domestic CV sales              | 29,408        | 16,229        | 81.2%        | 30,541        | -3.7%         | 221,649        | 181,123        | 22.4%        |
| CV Exports                     | 3,053         | 1,628         | 87.5%        | 2,443         | 25.0%         | 16,027         | 22,015         | -27.2%       |
| <b>Total CV</b>                | <b>32,461</b> | <b>17,857</b> | <b>81.8%</b> | <b>32,984</b> | <b>-1.6%</b>  | <b>237,676</b> | <b>203,138</b> | <b>17.0%</b> |
| UV                             | 2,263         | 1,840         | 23.0%        | 2,475         | -8.6%         | 20,711         | 26,961         | -23.2%       |
| Passenger Cars                 | 19,384        | 12,999        | 49.1%        | 17,945        | 8.0%          | 122,615        | 108,011        | 13.5%        |
| <b>Total</b>                   | <b>54,108</b> | <b>32,696</b> | <b>65.5%</b> | <b>53,404</b> | <b>1.3%</b>   | <b>381,002</b> | <b>338,110</b> | <b>12.7%</b> |
| <b>Mahindra &amp; Mahindra</b> |               |               |              |               |               |                |                |              |
| UVs                            | 15,193        | 7,523         | 102.0%       | 18,410        | -17.5%        | 137,603        | 97,839         | 40.6%        |
| LCVs                           | 778           | 302           | 157.6%       | 841           | -7.5%         | 6,487          | 6,559          | -1.1%        |
| SCV- GIO (standalone)          | 1,019         | -             | -            | -             | -             | 1,019          | -              | -            |
| Logan                          | 279           | 300           | -7.0%        | 401           | -30.4%        | 3,581          | 10,593         | -66.2%       |
| Tractors                       | 12,592        | 8,498         | 48.2%        | 18,772        | -32.9%        | 115,177        | 82,839         | 39.0%        |
| 3 Wheelers                     | 4,118         | 2,305         | 78.7%        | 4,886         | -15.7%        | 29,756         | 32,318         | -7.9%        |
| <b>Total</b>                   | <b>33,979</b> | <b>18,928</b> | <b>79.5%</b> | <b>43,310</b> | <b>-21.5%</b> | <b>293,623</b> | <b>230,148</b> | <b>27.6%</b> |
| <b>Maruti Udyog</b>            |               |               |              |               |               |                |                |              |
| Entry (A) segment              | 3,040         | 2,307         | 31.8%        | 3,124         | -2.7%         | 22,020         | 34,400         | -36.0%       |
| Van-segment                    | 8,320         | 3,845         | 116.4%       | 8,018         | 3.8%          | 60,771         | 51,177         | 18.7%        |
| Compact (B) segment            | 56,005        | 34,976        | 60.1%        | 51,437        | 8.9%          | 407,272        | 321,919        | 26.5%        |
| Mid-size (C) segment           | 8,741         | 5,975         | 46.3%        | 8,804         | -0.7%         | 61,770         | 46,176         | 33.8%        |
| MUV                            | 253           | 601           | -57.9%       | 168           | 50.6%         | 2,576          | 4,957          | -48.0%       |
| <b>Domestic</b>                | <b>76,359</b> | <b>47,704</b> | <b>60.1%</b> | <b>71,551</b> | <b>6.7%</b>   | <b>554,409</b> | <b>458,629</b> | <b>20.9%</b> |
| Exports                        | 11,448        | 5,007         | 128.6%       | 13,864        | -17.4%        | 91,731         | 40,606         | 125.9%       |
| <b>Total</b>                   | <b>87,807</b> | <b>52,711</b> | <b>66.6%</b> | <b>85,415</b> | <b>2.8%</b>   | <b>646,140</b> | <b>499,235</b> | <b>29.4%</b> |

Source: Company

## Reported monthly sales of two-wheeler companies - Nov 2009

|                         | Nov-09         | Nov-08         | yoy %        | Oct-09         | mom %        | YTD, FY2010      | YTD, FY2009      | yoy %        |
|-------------------------|----------------|----------------|--------------|----------------|--------------|------------------|------------------|--------------|
| <b>TVS Motor</b>        |                |                |              |                |              |                  |                  |              |
| Motorcycles             | 45,080         | 45,276         | -0.4%        | 56,465         | -20.2%       | 409,166          | 446,480          | -8.4%        |
| Scooty                  | 25,115         | 23,487         | 6.9%         | 28,301         | -11.3%       | 206,805          | 187,061          | 10.6%        |
| Moped                   | 50,649         | 34,397         | 47.2%        | 46,263         | 9.5%         | 373,432          | 288,656          | 29.4%        |
| <b>Total 2-Wheelers</b> | <b>120,844</b> | <b>98,402</b>  | <b>22.8%</b> | <b>131,029</b> | <b>-7.8%</b> | <b>989,403</b>   | <b>917,439</b>   | <b>7.8%</b>  |
| <b>Hero Honda</b>       |                |                |              |                |              |                  |                  |              |
| <b>Total 2-Wheelers</b> | <b>381,378</b> | <b>289,426</b> | <b>31.8%</b> | <b>354,156</b> | <b>7.7%</b>  | <b>3,037,756</b> | <b>2,508,214</b> | <b>21.1%</b> |

Source: Company



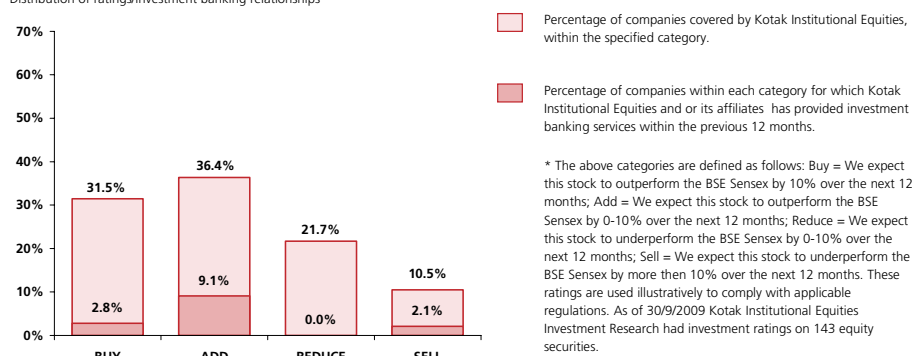




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#### Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of September 30, 2009

### Ratings and other definitions/identifiers

#### Rating system

Definitions of ratings

**BUY.** We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

**ADD.** We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

**REDUCE.** We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

**SELL.** We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

Other definitions

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