INDIA DAILY

November 28, 2007

EQUITY MARKETS

Contents

News Roundup

Corporate

- ICICI Venture Funds Management Co has concluded a US$800 mn deal to buy a minority stake in Delhi-based Jaypee Infratech, a subsidiary of the infrastructure-to-hotels Jaypee Group. (BS)
- Cement and construction major Jaiprakash Associates is believed to be in talks with the Aditya Birla group to acquire Bina Power Company in Madhya Pradesh. (ET)
- Citigroup is selling up to 4.9% of itself for US$7.5 bn to the investment arm of the Abu Dhabi government, giving the largest US bank fresh capital. (ET)
- Gujarat-based Nirma Ltd has entered into a definitive agreement for the acquisition of the US-based natural soda ash producer Searles Valley Minerals Operations Inc and Searles Valley Minerals Inc (collectively SVM) for an undisclosed amount, making the Indian company among the seven largest soda ash producers in the world with ne sales in excess of Rs3,500 crore p.a. (BL)

Economic and political

- Buckling under US pressure, the State Bank of India (SBI), has stopped honouring Iranian letters of credit (LCs), hurting trade between India and the West Asian nation. (ET)
- The Cabinet Committee on Economic Affairs has given in-principle approval to the Rs28,181-crore dedicated rail freight corridors between Ludhiana in Punbjab and Sonnagar in Bihar and between Mumbai and Delhi. (BS)

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

		Change, %		
India	**27-Nov**	**1-day**	**1-mo**	**3-mo**
Sensex	19,128	(0.6)	(0.6)	28.2
Nifty	5,698	(0.6)	(0.1)	31.9
Global/Regional indices				
Dow Jones	12,958	1.7	(6.1)	(2.7)
Nasdaq Composite	2,581	1.6	(8.0)	0.8
FTSE	6,141	(0.6)	(7.8)	(1.3)
Nikkie	15,163	(0.4)	(8.1)	(6.9)
Hang Seng	27,210	(1.5)	(10.5)	16.5
KOSPI	1,858	(0.1)	(8.4)	1.6
Value traded - India				
			Moving avg, Rs bn	
	27-Nov		1-mo	3-mo
Cash (NSE+BSE)	234.6		281.1	250.6
Derivatives (NSE)	56.4		738.4	527.5
Deri. open interest	270.8		751.9	851.6

Forex/money market

		Change, basis points		
	27-Nov	**1-day**	**1-mo**	**3-mo**
Rs/US$	39.8	-	39	(137)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.0	1	10	-

Net investment (US$mn)

	23-Nov		MTD	CYTD
FIIs	(43)		(1,204)	16,082
MFs	64		222	372

Top movers -3mo basis

		Change, %		
Best performers	**27-Nov**	**1-day**	**1-mo**	**3-mo**
Neyveli Lignite	222	(1.6)	67.3	197.0
Reliance Energy	1,755	(1.9)	5.1	129.0
Reliance Cap	2,314	(0.1)	27.1	101.9
Escorts	158	3.5	39.2	92.6
MRF	7,377	9.0	31.2	92.6
Worst performers				
i-Flex	1,518	4.7	(4.3)	(24.7)
Infosys	1,576	(0.0)	(14.8)	(16.3)
Container Corp	1,788	(0.5)	(14.4)	(13.8)
Punjab Tractors	200	(0.1)	(9.8)	(13.1)
Ingersoll Rand	302	(2.2)	2.9	(12.8)

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

Automobiles

MAHM.BO, Rs713	
Rating	BUY
Sector coverage view	Attractive
Target Price (Rs)	875
52W High -Low (Rs)	1002 - 608
Market Cap (Rs bn)	183.9

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	96.3	108.1	120.1
Net Profit (Rs bn)	9.7	11.4	11.5
EPS (Rs)	37.4	44.1	44.5
EPS gth	*42.4*	*17.7*	*1.0*
P/E (x)	19.0	16.2	16.0
EV/EBITDA (x)	12.8	11.8	11.0
Div yield (%)	1.5	1.3	1.3

Shareholding, September 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	22.6	-	-
FIIs	34.1	0.7	0.3
MFs	6.3	0.8	0.4
UTI	-	-	(0.5)
LIC	13.5	1.6	1.2

Mahindra & Mahindra: Reign to continue for UV king of the road

Amit Agarwal : agarwal.amit@kotak.com, +91-22-6749-3390

- **New launches to reinforce leadership**
- **Strong UV growth to drive earnings growth**
- **Our SOTP-based valuation of Rs875 implies a potential upside of 23%**
- **Key risks: Hike in interest rate, rising fuel costs and competition from peers**

Reign to continue for UV king of the road. We believe M&M's growth is likely to be driven by rising penetration of UVs led by (1) rising income levels, (2) softer interest rates and (3) new product launches. The various joint ventures entered into for sharing manufacturing facilities and technologies are likely to drive its volume growth. The tractor business is facing a slowdown but we believe M&M's acquisition of Punjab Tractors and Swaraj Engines would enable it to grow its presence in untapped regions. We reinitiate coverage on M&M with a BUY rating and a 12-month target price of Rs875/share.

New launches to reinforce leadership

We believe M&M's dominance in the UV segment will continue to drive its growth going forward. With rising income levels and growing penetration, demand for UVs is set to increase. M&M has planned new launches in the UV and LCV segments over the next 2-3 years—we believe the presence across all sub-segments would (a) boost M&M volumes considerably and (b) bolster its defenses against the competition.

Strong UV growth to drive earnings growth

We expect M&M's net income to grow 6% and 1% in FY2008E and FY2009E, respectively. We believe this would be driven mainly by a 10% and 12.5% growth in UV sales as growth in tractor business would be marginal.

Our SOTP-based valuation of Rs875 implies a potential upside of 23%

We value M&M's core auto business at 7X FY2009E EV/EBITDA implying a value of Rs490/ share. We value M&M's stake in its major subsidiaries at Rs351 per M&M share taking into consideration the holding company discount of 20%. We add Rs44/share of M&M for its cash and other investments.

Key risks: Hike in interest rate, rising fuel costs and competition from peers

Any increase in interest rates would negatively impact UV growth as well as tractor sales. Besides, competition from the successful launch of newer models by major foreign automobile manufacturers entering the Indian markets could impact volume growth. Key upside risks to our volume assumptions arise from higher-than-expected tractor sales growth. Divestment of stake in subsidiaries may provide upside to our target price.

M&M, SOTP-based valuation, March fiscal year-ends

	EBITDA (Rs mn)	Multiple (X)	Value (Rs mn)	Value per share (Rs)	Comment
M&M standalone business	16,575	7.0	116,027	450	Based on 7X EV/EBITDA FY2009E earnings
Less: Net debt			(10,366)	(40)	
Total				**490**	
Subsidiaries				**351**	
Tech Mahindra				217	Based on KIE target price of Rs1,300/per share
Mahindra Lifespace Developers Ltd				42	Based on KIE target price of Rs 890/share
Punjab Tractors				44	Valued at open-offer price of Rs360/share of Punjab Tractors
Mahindra & Mahindra Financial Services Ltd				48	Based on KIE target price of Rs 265/share
Cash and other investments				44	
SOTP-based value				**885**	
Target price				**875**	

Note
(1) The subsidiaries have been valued at a holding company discount of 20%.

Source: Company data, Kotak Institutional Equities estimates

Banking

IIFL.BO, Rs1285	
Rating	ADD
Sector coverage view	Attractive
Target Price (Rs)	1,300
52W High -Low (Rs)	1318 - 241
Market Cap (Rs bn)	69.0

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	4.3	8.4	14.1
Net Profit (Rs bn)	0.8	1.4	3.3
EPS (Rs)	15.1	26.8	50.1
EPS gth	*39.3*	*77.5*	*87.5*
P/E (x)	85.2	48.0	25.6
P/B (x)	21.2	12.8	5
Div yield (%)	0.2	-	-

Shareholding, September 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	35.8	-	-
FIIs	25.9	0.1	0.0
MFs	9.1	0.3	0.2
UTI	-	-	(0.1)
LIC	-	-	(0.1)

India Infoline: Raising target price to factor in value of finance business and growth in market volumes, retain ADD

Nischint Chawathe : nischint.chawathe@kotak.com, +91-22-6749-3588

Tabassum Inamdar : tabassum.inamdar@kotak.com, +91-22-6634-1252

- **IIL has placed a 22.5% stake in its consumer finance business at US$76.7 mn**
- **The deal values its finance business at US$340 mn (Rs13 bn)**
- **We raise our target price to Rs1,300 to factor in the value of the finance business and higher equity market volumes over the past two months, retain ADD**

India Infoline (IIL) has placed a 22.5% stake in India Infoline Investment Services (IISL) at US$76.7 mn with Orient Global—a Singapore-based private investment institution. IISL is engaged in the financing business and proposes to leverage IIL's network to scale up its presence in personal, auto and home loans. The deal values IISL at Rs13 bn (2.7X PBR – post money). We add Rs138 per share (after considering 10% holding company discount to the aforesaid valuation) to our sum-of-parts-based target price. We are also raising our estimates (of the brokerage and distribution business) by 15% for FY2008E and 11% for FY2009E to factor higher growth in market volumes, while we retain our ADD rating. We are awaiting further information from management to make projections for IISL. IIL's reported consolidated profit for FY2008 will likely be lower than our estimates since IISL, currently in the incubation stage, will likely report a net loss in FY2008.

Key risk: Given its high operating leverage, a decline or slower growth in volumes will likely impact both earnings and valuation multiples.

Higher market volumes in October 2007 and November 2007 (till date). Equity market volumes grew about 220% yoy in October 2007 on the back of high FII inflows. Based on market volume data till date, we expect volumes to grow by about 90% yoy in November 2007. Market volumes have come off from peak levels of October though growth remains high. We factor in 50% volume growth for 4QFY08 as we expect the traction to continue. For FY2009 and FY2010, we factor moderate cash market volume growth of 20% yoy and F&O market volume growth of 30% yoy.

We expect cash market volumes in the institutional segment to grow by about 65% in FY2008E on the back of over 200% growth in October 2007 and about 65% growth expected in November 2007. For FY2009 and FY2010, we factor moderate volume growth of 20% yoy on a higher base.

India Infoline (IIL) : Sum-of-parts based valuation

	Valuation of the company (Rs mn)	IIL's stake (%)	Value per share (Rs)	Comments
Brokarge & distribution busniess	77,135	100	1,151	PV of 18X FY2010 EPS in FY2009
India Infoline Investment Services	13,295	77.5	138	Based on placement of 22.5% stake at US$76.7 mn, 10% holding company discount
Total			**1,290**	

Source: Kotak Institutional Equities estimates.

India Infoline : Change in estimates

In Rs mn

	Old estimates (Rs mn)			New estimates (Rs mn)			Old vs. New (%)		
	FY08E	FY09E	FY10E	FY08E	FY09E	FY10E	FY08E	FY09E	FY10E
IIL - volume (Rs bn)	5,047	8,658	13,039	5,596	9,776	14,588	11	13	12
Total income	**7,904**	**13,248**	**19,046**	**8,442**	**14,050**	**19,932**	**7**	**6**	**5**
Broking commission and interest income	5,097	8,987	12,899	5,635	9,789	13,785	11	9	7
Insurance, MF and loan disbribution	1,373	1,997	2,724	1,373	1,997	2,724	(0)	0	0
Other income	1,433	2,264	3,423	1,433	2,264	3,423	(0)	0	0
Operating expenses	**5,571**	**8,707**	**12,291**	**5,824**	**8,990**	**12,530**	**5**	**3**	**2**
Direct brokerage expenses	1,226	1,907	2,732	1,303	2,067	2,957	6	8	8
Employee expenses	2,006	3,089	4,244	2,055	3,192	4,394	2	3	4
Others expenses	2,339	3,712	5,315	2,466	3,730	5,179	5	1	-3
PBT	**2,333**	**4,541**	**6,755**	**2,617**	**5,060**	**7,401**	**12**	**11**	**10**
Exceptional item	440			440					
Tax	644	1,544	2,296	740	1,720	2,516	15	11	10
PAT	**1,250**	**2,997**	**4,459**	**1,437**	**3,340**	**4,885**	**15**	**11**	**10**

Source: Kotak Institutional Equities estimates.

Market volume growth has been high since July 2007

Monthly market volumes, April 2007-March 2008E (Rs bn)

	Volumes in cash market							
Period	BSE (Rs bn)	NSE (Rs bn)	Total (Rs bn)	YoY (%)	F&O- NSE (Rs bn)	YoY (%)	Total vol. (Rs bn)	YoY (%)
Apr-07	759	1,686	2,445	(4)	6,163	(14)	8,608	(12)
May-07	952	2,076	3,028	4	7,235	(1)	10,263	0
Jun-07	915	1,934	2,849	30	8,065	46	10,914	41
Total	**2,627**	**5,695**	**8,322**	**9**	**21,463**	**7**	**29,785**	**8**
Jul-07	1,193	2,672	3,865	133	10,150	112	14,015	118
Aug-07	1,018	2,312	3,330	75	10,567	125	13,897	110
Sep-07	1,308	2,660	3,968	87	10,728	105	14,696	100
Total	**3,518**	**7,645**	**11,163**	**96**	**31,445**	**114**	**42,608**	**109**
Oct-07	1,802	4,556	6,358	220	18,336	267	24,694	253
Nov-07E	1,715	3,700	5,415	90	14,633	125	20,048	115
Dec-07E	1,179	2,552	3,730	50	10,038	50	13,768	50
Total	**4,695**	**10,808**	**15,503**	**112**	**43,007**	**136**	**58,510**	**129**
Jan-08E	1,220	2,627	3,847	50	9,411	50	13,258	50
Feb-08E	1,246	2,703	3,948	50	10,553	50	14,501	50
Mar-08E	1,127	2,519	3,646	50	10,407	50	14,053	50
Total	**3,593**	**7,849**	**11,442**		**30,371**		**41,812**	
Total (FY2008E)	**14,433**	**31,996**	**46,429**	**64**	**126,286**	**73**	**172,715**	**70**

Source: NSE, BSE and Kotak Institutional Equities estimates.

Consumer Products

GOCP.BO, Rs127	
Rating	ADD
Sector coverage view	Neutral
Target Price (Rs)	140
52W High -Low (Rs)	178 - 117
Market Cap (Rs bn)	28.6

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	9.5	11.1	12.3
Net Profit (Rs bn)	1.3	1.7	1.9
EPS (Rs)	5.9	7.5	8.3
EPS gth	*12.5*	*25.7*	*11.6*
P/E (x)	21.3	17.0	15.2
EV/EBITDA (x)	16.2	12.9	11
Div yield (%)	3.0	3.2	3.2

Godrej Consumer Products: Management meeting update—time to face the competition

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

Manoj Menon : manoj.menon@kotak.com, +91-22-6749-3391

- **Price hikes required in soaps going forward. Down-trading is a strong possibility**
- **Healthy growth potential in hair color remains, however time is running out**
- **Overseas forays are earnings accretive and have surpassed internal expectations**
- **Target price maintained at Rs140/share**
- **Rights issue upto a maximum of Rs4.0 bn for repayment of debt and strengthening the balance sheet**

We recently met the management of Godrej Consumer Products Limited (GCPL). The company continues to gain market shares in soaps while hair color continues to disappoint with declining market share. GCPL will need to take price hikes in soaps to mitigate higher palm prices (up over 100%). Healthy growth potential in hair color remains, however, time is running out to make an impact in the high-end fashion hair color segment. Both the acquisitions of Keyline Brands and Rapidol have been earnings accretive and surpassed the internal expectations/ benchmarks that GCPL had at the time of the transaction. We estimate EPS growth of 26% for FY2008E and 12% for FY2009E. The spectacular gains achieved by GCPL in soaps could potentially get capped with the entry of ITC. We retain our target price at Rs140/share (15% discount to our DCF value) implying a P/E of 18.7X on FY2008E and 16.7X on FY2009E. GCPL has announced a rights issue upto a maximum amount of Rs4.0 bn to pursue inorganic growth and to repay debt.

Price hikes required in soaps going forward. Over the past year, measured price hikes by industry leaders HUL and GCPL have helped mitigate higher palm prices (up over 100%). GCPL has secured the near-term performance in soap margins with forward covers for inputs (mainly palm oil and variants) till March 2008. Management indicated that it would look at measured price increases to protect margins. Management views that the impact of price hikes on eventual sales will be minimal in this highly penetrated category even though there could be a postponement of purchases. However, we estimate two possible scenarios in the event of unbridled price increases by the category leaders:

1. There is a substantial unorganized segment in personal wash category that stands to gain. There are strong regional players like Power Soaps in Tamil Nadu, Lyka in Madhya Pradesh, Aura in Punjab/Haryana etc. Down-trading by consumers from brands of organized players to local brands is a strong possibility.
2. Companies opting for TFM (Total Fatty Matter) reduction by increasing the filler content in soaps. A recent example is the 6% TFM reduction in 'Breeze' brand by HUL to 60%.

Godrej has positioned the flagship brand 'Godrej No.1' soap as Grade I soap under the value-for-money plank with minimum 76% TFM content. Typically, the actual TFM content in soap is 2-3% higher than the declared quantity. The product positioning reduces the flexibility for GCPL to review its formulations during periods of hyperinflation with regard to key inputs.

The recent entry of ITC into the soaps category could also possibly cap further price increases. The requirement for higher media spends could adversely impact the margin profile as well. We believe incremental growth will come at a significantly higher cost than before. ITC has recently launched the 'Superia' brand of soaps at the lower end ('popular' segment) of the category with four variants. The product and pricing is in direct competition with GCPL's 'Godrej No.1' (estimated sales about Rs3 bn) and HUL's Lifebuoy (estimated sales Rs9 bn) and Breeze (estimated sales Rs2 bn). Market sources indicate that ITC will enter all the segments in soaps in the near term.

The management does not expect the impact of 'Superia' on 'Godrej No.1' to be significant as Godrej No.1 is a Grade 1 soap and the direct competition brands have lower oil content. We believe that even though the TFM/oil content is important, attributes like product feel, perception, value proposition, wear rate (number of baths/soap tablet) and most important, the perfume quality, influences purchase decisions for soaps. We keenly await the market response to ITC's new launches.

Healthy growth potential in hair color remains, however, time is running out. GCPL is the leading player in hair color with a 35% market share. However, the company has been consistently losing market share in the category due to faster growth in the high-end fashion segment where GCPL is yet to establish a strong product range. There is an immediate requirement to secure the future of the business in the premium segment.

Though the management sounded very optimistic about the company's ability to have a presence and garner higher incremental share in the top-end fashion hair color market, we believe that substantial back-end and front-end investments would be required to mark an entry. We note the planned relaunch of powder hair dye and communication regarding newer consumer benefits can positively impact sales in the next two quarters.

Potential for geographic expansion led growth exists. Over the past three years, GCPL derived significant growth through geographic expansion in sales territories (sales growth by moving into newer markets / geographies). Currently, the company has a total reach of about 3 mn and direct reach of about six lakh retail outlets. The current coverage means that GCPL reaches all villages with populations of about 10,000. However, we believe that further geographical expansion will entail significantly higher incremental costs and would require higher concern sales (the total number of retail outlets in India as per AC Nielsen is 2.5 mn in urban areas and 5.0 mn in rural).

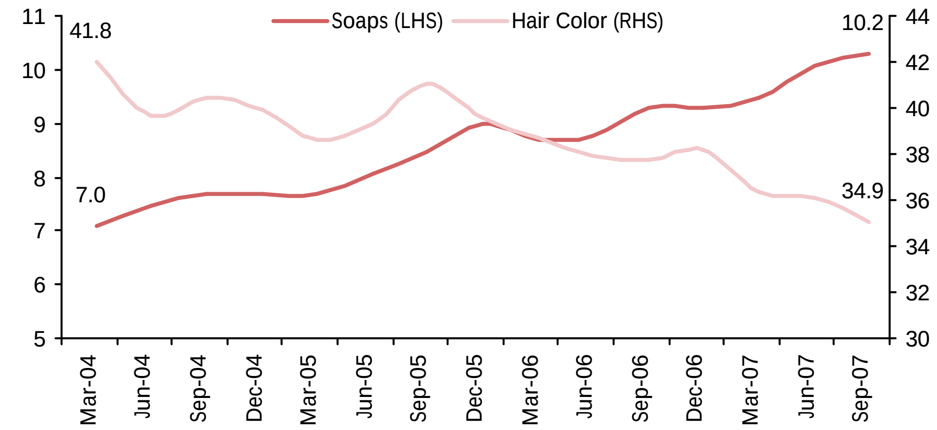
Overseas forays. As per the management, both the acquisitions (Keyline Brands and Rapidol) have been earnings accretive and have surpassed the internal expectations/ benchmarks, which GCPL had at the time of the transaction. The company plans to bring some of the brands from the global product portfolio into India in a phased manner. We believe that there are further synergies to be gained from these acquisitions (a) they provide GCPL's products with access to retail channels in the UK that cater to the Indian diaspora, (b) the acquisitions can leverage GCPL's R&D strengths to expand the portfolio and (c) they can utilize low-cost operations in India to manufacture products.

Retain ADD rating and target price at Rs140/share. We model soap and hair color to grow at 12% and 10%, respectively, in FY2009E and FY2010E. Modest growth of 2.7% in soaps and higher penetration and upgradation driven growth rates of 24.5% is considered for the hair color business during FY2011-15E. Our one-year forward DCF value works out to Rs161/share. We retain our target price at Rs140/share (15% discount to our DCF value) implying a P/E of 18.7X on FY2008E and 16.7X on FY2009E. Considering the expected heightened competitive activity in both the categories GCPL operates in—particularly soaps, we believe that the stock will trade at a discount to its DCF value.

Rights issue for supporting inorganic growth. GCPL has announced a rights issue for a maximum amount of Rs4.0 bn. The detailed structure and other terms of the rights issue is yet to be decided by the company. GCPL will likely utilize the money raised to pursue inorganic growth. We note that the current networth of the company restrains it from making large sized international acquisitions as per prevailing RBI guidelines. The purpose of raising additional capital is to pursue higher value international acquisitions and repayment of debt. As of September 30, 2007, GCPL had a networth of Rs1.6 bn and a debt of Rs1.1 bn (raised for funding the earlier acquisitions).

Exhibit 1: Share gains in soaps to moderate the worrying losses in hair color

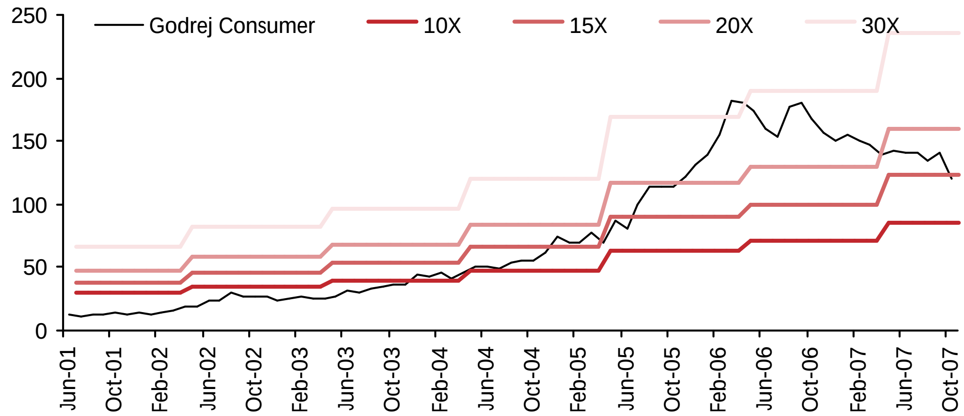
Value market shares (%) in soaps and hair color



Source: Company data.

Exhibit 2: Losses in hair color market shares, overhang of ITC's entry into soaps impacting the valuation

Price Earnings bands



Source: Company data.

Exhibit 3: GCPL: Profit model, balance sheet, 2006-2009E, March year-ends (Rs mn)

	2006	2007E	2008E	2009E
Profit model (Rs mn)				
Net sales	6,997	9,532	11,052	12,334
EBITDA	**1,412**	**1,797**	**2,163**	**2,363**
Other income	72	66	81	113
Interest	(65)	(135)	(94)	(95)
Depreciation	(115)	(142)	(185)	(195)
Extraordinary items	20	99	0	0
Pretax profits	1,325	1,684	1,965	2,187
Tax	(113)	(243)	(279)	(305)
Net profits (reported)	**1,212**	**1,440**	**1,686**	**1,882**
Earnings per share (Rs)	**5.3**	**5.9**	**7.5**	**8.3**
Balance sheet (Rs mn)				
Total equity	787	1,220	2,086	2,911
Total borrowings	687	1,736	1,147	1,147
Currrent liabilities	1,885	2,617	2,765	3,034
Deferred tax liability	66	80	86	87
Total liabilities and equity	**3,426**	**5,653**	**6,083**	**7,179**
Cash	263	475	1,130	1,957
Current assets	1,451	2,300	2,206	2,508
Total fixed assets	850	1,992	1,985	1,953
Investments	10	0	727	727
Goodwill	851	886	35	35
Total assets	**3,426**	**5,653**	**6,083**	**7,179**

Source: Kotak Institutional Equities estimates.

Economy

Sector coverage view N/A

RBI report: Net NPAs down to 1%, banks in profit despite negative treasury income

Mridul Saggar : mridul.saggar@kotak.com, +91-22-6634-1245

Ramnath Venkateswaran : ramnath.venkateswaran@kotak.com, +91-22-6634-1240

- **Net NPA ratio dips to 1% for the first time, validating confidence in financial stability**
- **Banks have maintained profits despite trading income falling with rising interest rates**
- **We believe that with interest rate having peaked, there is an upside to potential profits for the banking system ahead**

Non-Performing Assets (NPAs) at record low

Banking soundness has never been better in India. In 2006-07, gross and net NPAs declined to a record low of 2.5% and 1.0%, respectively, of advances despite some deterioration in asset quality of select new private sector banks. Capital adequacy ratio was maintained at 12.3% and continues to be way above the Basel I norm. We believe the excess capital maintained by the Indian banks would help in smoother transition to Basel II.

Key indicators suggest that banks in India (generally called Scheduled Commercial Banks) are in fine fettle, and are now converging towards global standards. The Report on Trends and Progress of Banking in India for the year 2006-07 released by the RBI on November 27, 2007 reaffirms that the capital base of the Indian banks is strong and bad loans are in check. This testifies to the soundness of India's financial sector vis-a-vis Asian peers. The following are the highlights of banking soundness:

1. Gross NPA ratio declined to 2.5% at end-FY2007 from 3.3% a year ago, while the net NPA ratio fell to 1.0% from 1.2% a year ago (Exhibit 1).
2. Indian banks have recovered Rs1 tn of NPAs (US$ 22.6 bn) over the past four years. At end-FY2007, they were left with US$11.6 bn of gross NPAs and net of provisions with only US$4.6 bn of net NPAs. This compares well with the total asset size of US$ 795 bn for the Indian banks.
3. All NPA ratios have trended downwards over past 10 years (Exhibit 2). The fall has been meteoric, aided by considerable policy efforts in the form of legal reforms (SARFESI Act), setting up of securitization and reconstruction companies, starting a corporate debt recovery tribunal, etc. However, in absolute terms, net NPAs have risen in FY2007 for the first time in five years, somewhat limiting the gains in asset quality.

4 Interestingly, NPA ratios for the new private sector banks increased slightly in FY2007. However, public sector banks and old private sector banks have succeeded in cutting NPAs aggressively, while the improvement in the case of foreign banks was marginal (Exhibit 3). However, NPA ratios for new private sector and foreign banks remain distinctly lower than other groups.

5. Gross NPA ratio has declined for all public sector banks with the exception of UCO bank for which the ratio has remained flat. Amongst private sector banks, there has been significant drop in NPA ratio for Development Credit Bank Limited (2.8% from 8.4% a year ago) and SBI Commercial and International Bank Limited (1.7% from 8.3% a year ago).
6. The capital adequacy ratio for all banks together remained unchanged at 12.3% at end-FY2007. This is below the peak of 12.9% at the end of FY2004, but considerably above the 8% Basel I norm or the 9% prescribed by Indian regulators. We believe the excess capital would help smoothen the transition to Basel II, which could add to capital requirements.

7. Capital adequacy ratio has been maintained in FY2007 with the decline in CRAR for new private sector (mainly ICICI Bank) and foreign banks being offset by increase in the case of State Bank, Canara Bank and some old private sector banks.
8. India's financial system appears robust and there are no major signs of vulnerability in the Indian financial system that one could discern from the RBI report, though it does cite high and volatile oil prices, sub-prime related developments in global markets and global imbalances as sources of risks. More significant, RBI has highlighted the equity market risk stating that the huge demand by FIIs has pushed up valuations of Indian equities beyond fundamentals and limited supply of domestic assets is putting pressure on these valuations. Also, RBI has stated that credit expansion over the past three years could lead to higher delinquencies. The report also hints at high SLR preemption even after the RBI Act amendment, empowering RBI to lower SLR on prudential considerations.

Banks maintain profitability despite negative trading income

Banks maintained profitability in FY2007. Net profits increased by Rs312 bn or 26.9%, up from 17.3% growth a year ago. Much of the income continued to be generated from interest income. The share of interest income in total income for all banks together increased to 85.9% in FY2007 from 81.9% two years ago. Within non-interest income, trading profits turned negative for the first time since the mid-1990s, but a significant increase in fee income helped banks maintain profitability, notwithstanding a significant increase of 24.9% in expenditure. The decline in trading income has been largely the outcome of firmer gilt yields which affected treasury profits. This, however, could change ahead.

Prospects ahead for Indian banks

We believe India's financial sector is financially sound and the banking sector provides an investment opportunity with reasonably good returns over the medium-term. Interest rates have peaked and could have a softer bias ahead. This could be a positive for both core lending business as well as for treasury income. The operational performance of banks has deteriorated in 1HFY2008 but we do expect an improvement ahead. Our banking analysts Tabassum Inamdar and Ramnath Venkateswaran estimate that in FY2009, profits of banks under coverage could increase by 5-12% if deposit rates fall by 25 bps and lending rates do not fall commensurately (please refer to the Kotak report titled "Aggressive rate cuts could improve profitability; drive stock price performance" dated November 16, 2007 for details).

Further, the bottom up analysis of 3005 companies (ex-IT, finance) by our banking analysts indicate that there has been considerable improvement in financials of companies since FY2002, which is corroborated by the improving asset quality of banks revealed from the RBI report. We expect an increase in debt to financially weaker companies to increase from current levels, which could arrest the asset quality improvement ahead (please refer to the Kotak report titled *"Asset quality likely to stay in fine fettle"* dated *November 16, 2007* for details).

Exhibit 1: Net NPAs/Net advances ratio falls to 1.0 percent for the first time

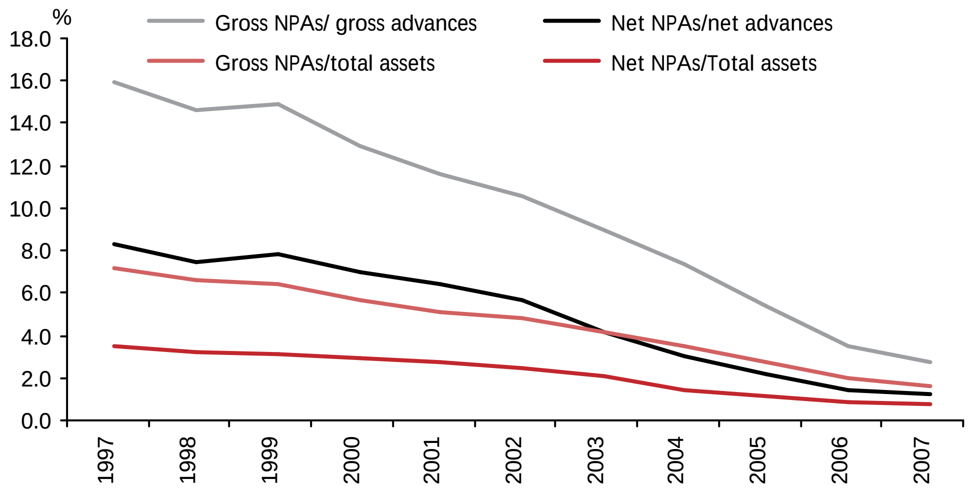
Non-performing assets (NPAs), March fiscal-year ends (in Rs. bn)

	2004	2005	2006	2007
Gross NPAs/Gross Advances (%)	7.2	5.2	3.3	2.5
Net NPAs/Net Advances (%)	2.9	2.0	1.2	1.0
Gross NPAs	631.0	591.2	518.2	504.9
Increase during the year	202.1	202.1	214.1	262.1
Recovered/written off	234.9	234.9	287.2	262.4
Net NPAs	244.0	217.5	185.4	201.0

Source: Reserve Bank of India

Exhibit 2: Meteoric Fall in NPAs achieve convergence with global standards

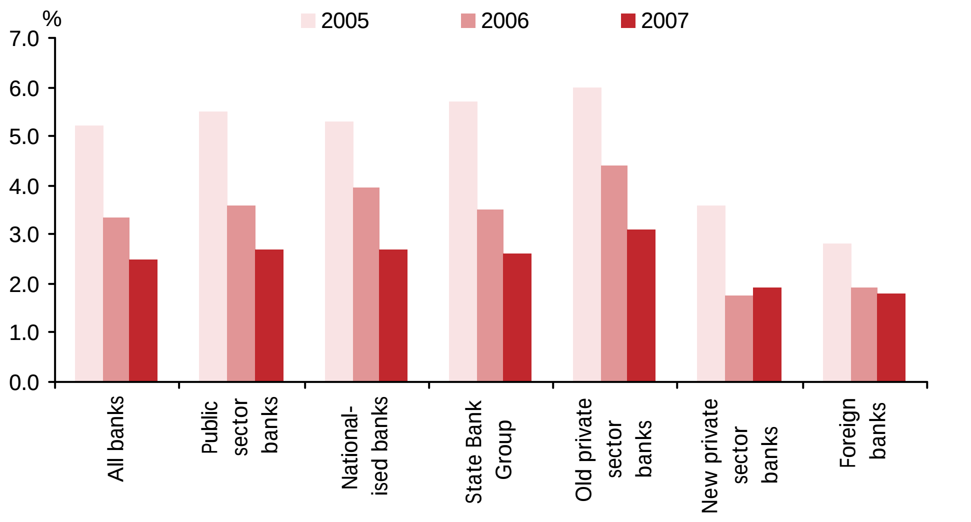
Gross and net NPA ratios



Source: Reserve Bank of India

Exhibit 3: Public sector and old private sector banks succeed in lowering NPAs

Gross NPAs/ gross advances

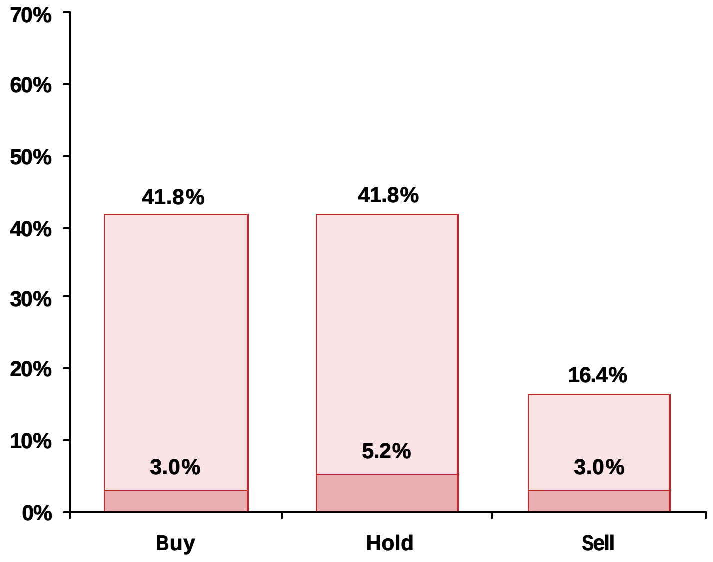


Source: Reserve Bank of India

"Each of the analysts named below hereby certifies that, with respect to each subject company and its securities for which the analyst is responsible in this report, (1) all of the views expressed in this report accurately reflect his or her personal views about the subject companies and securities, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report: Amit Agarwal, Nischint Chawathe, Aman Batra, Mridul Saggar."

Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Percentage of companies covered by Kotak Institutional Equities, within the specified category.

Percentage of companies within each category for which Kotak Institutional Equities and or its affiliates has provided investment banking services within the previous 12 months.

* The above categories are defined as follows: Buy = OP; Hold = IL; Sell = U. Buy, Hold and Sell are not defined Kotak Institutional Equities ratings and should not be constructed as investment opinions. Rather, these ratings are used illustratively to comply with applicable regulations. As of 09/30/07 Kotak Institutional Equities Investment Research had investment ratings on 144 equity securities.

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

Ratings and other definitions/identifiers

New 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 Sensexby more than 10% over the next 12 months.

Old rating system

Definitions of ratings

OP = Outperform. We expect this stock to outperform the BSE Sensex over the next 12 months.
IL = In-Line. We expect this stock to perform in line with the BSE Sensex over the next 12 months.
U = Underperform. We expect this stock to underperform the BSE Sensex over the next 12 months.

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

Other definitions

Coverage view. The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: Attractive (A), Neutral (N), Cautious (C).

Other ratings/identifiers

NR = Not Rated. The investment rating and target price, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.
CS = Coverage Suspended. Kotak Securities has suspended coverage of this company.
NC = Not Covered. Kotak Securities does not cover this company.
RS = Rating Suspended. Kotak Securities Research has suspended the investment rating and price target, if any, for this stock, because there is not a sufficient fundamental basis for determining an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.
NA = Not Available or Not Applicable. The information is not available for display or is not applicable.
NM = Not Meaningful. The information is not meaningful and is therefore excluded.

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

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

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

Kotak Securities Limited and its affiliates are a full-service, integrated investment banking, investment management, brokerage and financing group. We along with our affiliates are leading underwriter of securities and participants in virtually all securities trading markets in India. We and our affiliates have investment banking and other business relationships with a significant percentage of the companies covered by our Investment Research Department. Our research professionals provide important input into our investment banking and other business selection processes. Investors should assume that Kotak Securities Limited and/or its affiliates are seeking or will seek investment banking or other business from the company or companies that are the subject of this material and that the research professionals who were involved in preparing this material may participate in the solicitation of such business. Our research professionals are paid in part based on the profitability of Kotak Securities Limited, which include earnings from investment banking and other business. Kotak Securities Limited generally prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, Kotak Securities Limited generally prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover. Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of Kotak Securities Limited. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. Kotak Securities Limited does not provide tax advise to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment.

Certain transactions -including those involving futures, options, and other derivatives as well as non-investment-grade securities - give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have “long” or “short” positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein. For the purpose of calculating whether Kotak Securities Limited and its affiliates holds beneficially owns or controls, including the right to vote for directors, 1% of more of the equity shares of the subject issuer of a research report, the holdings does not include accounts managed by Kotak Mahindra Mutual Fund.Kotak Securities Limited and its non US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition , investors in securities such as ADRs, the value of which are influenced by foreign currencies affectively assume currency risk. In addition options involve risks and are not suitable for all investors. Please ensure that you have read and understood the current derivatives risk disclosure document before entering into any derivative transactions.

This report has not been prepared by Kotak Mahindra Inc. (KMInc). However KMInc has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed. Any reference to Kotak Securities Limited shall also be deemed to mean and include Kotak Mahindra Inc.